

IN THE MATTER OF AN INDEPENDENT REVIEW PROCESS  
BEFORE THE INTERNATIONAL CENTRE FOR DISPUTE RESOLUTION

AFILIAS DOMAINS NO. 3 LIMITED,

*Claimant*

v.

INTERNET CORPORATION FOR ASSIGNED NAMES AND NUMBERS,

*Respondent*

ICDR Case No. 01-18-0004-2702

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CLAIMANT'S EXHIBITS

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24 July 2020

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## LIST OF EXHIBITS

Exhibit No.	Description
<b>Exhibits submitted with Afiliias' Application for Leave to Add Exhibits C-125 through C-181 to the Record of this IRP (19 July 2020)</b>	
C-125	Letter from Deborah A. Garza (US Department of Justice, Antitrust Division) to Meredith A. Baker (US Department of Commerce) (3 Dec. 2008)
C-126	Dennis Carlton (Compass Lexecon), Comments on Michael Kende's Assessment of Preliminary Reports on Competition and Pricing (5 June 2009)
C-127	New gTLD Application submitted to ICANN by Ruby Glen, LLC, Application ID 1-1527-54849 (13 June 2012)
C-128	New gTLD Application submitted to ICANN by Schlund Technologies GmbH, Application ID 1-1013-77165 (13 June 2012)
C-129	ICANN, Assignment: Change of Control of Registry Operator (29 Jan. 2016), available at <a href="https://www.icann.org/resources/change-of-control">https://www.icann.org/resources/change-of-control</a> (last accessed 13 July 2020)
C-130	Derek Vaughn, "Inside the High Stakes Auction for .WEB," <i>InetServies</i> (25 July 2016), available at <a href="https://www.inetservices.com/blog/inside-the-high-stakes-auction-for-web/">https://www.inetservices.com/blog/inside-the-high-stakes-auction-for-web/</a> (last accessed 19 July 2020)
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C-133	ICANN, Board of Governance Committee, Agenda (2 Nov. 2016), available at <a href="https://www.icann.org/resources/board-material/agenda-bgc-2016-11-02-en">https://www.icann.org/resources/board-material/agenda-bgc-2016-11-02-en</a> (last accessed 17 July 2020)
C-134	ICANN, Board of Governance Committee, Meeting Minutes (2 Nov. 2016), available at <a href="https://www.icann.org/resources/board-material/minutes-bgc-2016-11-02-en">https://www.icann.org/resources/board-material/minutes-bgc-2016-11-02-en</a> (last accessed 17 July 2020)
C-135	ICANN, Board Audit Committee, Meeting Minutes (2 Nov. 2016), available at <a href="https://www.icann.org/resources/board-material/minutes-audit-2016-11-02-en">https://www.icann.org/resources/board-material/minutes-audit-2016-11-02-en</a> (last accessed 17 July 2020)
C-136	ICANN, Board Finance Committee, Meeting Minutes (2 Nov. 2016), available at <a href="https://www.icann.org/resources/board-material/minutes-bfc-2016-11-02-en">https://www.icann.org/resources/board-material/minutes-bfc-2016-11-02-en</a> (last accessed 17 July 2020)
C-137	ICANN, Organizational Effectiveness Committee, Meeting Minutes (3 Nov. 2016), available at <a href="https://www.icann.org/resources/board-material/minutes-oec-2016-11-03-en">https://www.icann.org/resources/board-material/minutes-oec-2016-11-03-en</a> (last accessed 17 July 2020)
C-138	ICANN, Board Risk Committee, Meeting Minutes (4 Nov. 2016), available at <a href="https://www.icann.org/resources/board-material/minutes-brc-2016-11-04-en">https://www.icann.org/resources/board-material/minutes-brc-2016-11-04-en</a> (last accessed 17 July 2020)



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C-139	Regular Meeting of the ICANN Board, Papers: Posting for Public Comment – Draft ICANN Community-Anti-Harassment Policy (Submission No. 2016.11.05.1a) (5 Nov. 2016)
C-140	Regular Meeting of the ICANN Board, Reference Materials: Posting for Public Comment – Draft ICANN Community-Anti-Harassment Policy (Draft: 31 October 2016) (Submission No. 2016.11.05.1a) (5 Nov. 2016)
C-141	ICANN, Regular Meeting of the ICANN Board, Agenda (5 Nov. 2016), available at <a href="https://www.icann.org/resources/board-material/agenda-2016-11-05-en">https://www.icann.org/resources/board-material/agenda-2016-11-05-en</a> (last accessed 17 July 2020)
C-142	ICANN, Regular Meeting of the ICANN Board, Minutes (5 Nov. 2016), available at <a href="https://www.icann.org/resources/board-material/agenda-2016-11-05-en">https://www.icann.org/resources/board-material/agenda-2016-11-05-en</a> (last accessed 17 July 2020)
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C-144	Organizational Meeting of the ICANN Board, Papers: AGENDA – 8 NOVEMBER 2016 ORGANIZATIONAL BOARD MEETING (8 Nov. 2016)
C-145	Organizational Meeting of the ICANN Board, Agenda (8 Nov. 2016), available at <a href="https://www.icann.org/resources/board-material/agenda-2-2016-11-08-en">https://www.icann.org/resources/board-material/agenda-2-2016-11-08-en</a> (last accessed 17 July 2020)
C-146	Organizational Meeting of the ICANN Board, Meeting Minutes (8 Nov. 2016), available at <a href="https://www.icann.org/resources/board-material/minutes-2-2016-11-08-en">https://www.icann.org/resources/board-material/minutes-2-2016-11-08-en</a> (last accessed 17 July 2020)
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C-154	ICANN, Board of Governance Committee, Agenda (5 Dec. 2016), available at <a href="https://www.icann.org/resources/board-material/agenda-bgc-2016-12-05-en">https://www.icann.org/resources/board-material/agenda-bgc-2016-12-05-en</a> (last accessed 17 July 2020)
C-155	ICANN, Board of Governance Committee, Meeting Minutes (5 Dec. 2016), available at <a href="https://www.icann.org/resources/board-material/minutes-bgc-2016-12-05-en">https://www.icann.org/resources/board-material/minutes-bgc-2016-12-05-en</a> (last accessed 17 July 2020)
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C-159	Special Meeting of the ICANN Board, Minutes (13 Dec. 2016), available at <a href="https://www.icann.org/resources/board-material/minutes-2016-12-13-en">https://www.icann.org/resources/board-material/minutes-2016-12-13-en</a> (last accessed 17 July 2020)
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C-162	ICANN, Board of Governance Committee, Meeting Minutes (16 Dec. 2016), available at <a href="https://www.icann.org/resources/board-material/minutes-bgc-2016-12-16-en">https://www.icann.org/resources/board-material/minutes-bgc-2016-12-16-en</a> (last accessed 17 July 2020)
C-163	Contact Information for Assignment - "Change of Control" (Oct. 2017)
C-164	ICANN, Change of Control Guide: How to Submit a Request for a Change of Control Assignment (13 Dec. 2017)
C-165	Letter from Steven Marenberg (Counsel for NDC) to John Jeffrey & Akram Atallah (ICANN) (28 Feb. 2018) [ICANN-WEB_000236 - ICANN-WEB_000237]
C-166	Email from Russ Weinstein (ICANN) to Lisa Carter et al. (6 June 2018) [ICANN-WEB_000458]
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C-171	Email from Christine Willett (ICANN) to Correspondence (10 July 2018) [ICANN-WEB_000485]
C-172	Kevin Murphy, "Donuts Loses to ICANN in \$135 million .web auction appeal," <i>DomainIncite</i> (16 Oct. 2018), available at <a href="http://domainincite.com/23581-donuts-loses-to-icann-in-135-million-web-auction-appeal">http://domainincite.com/23581-donuts-loses-to-icann-in-135-million-web-auction-appeal</a> (last accessed 7 Oct. 2019)
C-173	David Goldstein, "Donuts Loses Another Court Appeal Against ICANN Decision on .WEB," <i>DomainPulse</i> (17 Oct. 2018), available at <a href="https://www.domainpulse.com/2018/10/17/donuts-loses-another-court-appeal-against-icann-decision-on-web/">https://www.domainpulse.com/2018/10/17/donuts-loses-another-court-appeal-against-icann-decision-on-web/</a> (last accessed on 7 Oct. 2019)
C-174	David Goldstein, "Neustar's Nicolai Bezsonoff Discusses the 'Vote of Confidence' In Being Awarded 10 More Years of .US," <i>DomainPulse</i> (21 July 2019), available at <a href="https://www.domainpulse.com/2019/07/21/neustars-nicolai-bezsonoff-awarded-us/">https://www.domainpulse.com/2019/07/21/neustars-nicolai-bezsonoff-awarded-us/</a> (last accessed 13 July 2020)
C-175	Dilantha De Silva, "VeriSign: An Overvalued Company With A Strong Moat," <i>Seeking Alpha</i> (23 Sep. 2019), available at <a href="https://seekingalpha.com/article/4293005-verisign-overvalued-company-strong-moat">https://seekingalpha.com/article/4293005-verisign-overvalued-company-strong-moat</a> (last accessed 19 July 2020)
C-176	Ash Anderson, "VeriSign Is Immune From Coronavirus," <i>Seeking Alpha</i> (16 Mar. 2020), available at <a href="https://seekingalpha.com/article/4332180-verisign-is-immune-from-coronavirus">https://seekingalpha.com/article/4332180-verisign-is-immune-from-coronavirus</a> (last accessed 19 July 2020)
C-177	Written Testimony of John W. Elias before the U.S. House Committee on the Judiciary (24 June 2020), available at <a href="https://judiciary.house.gov/uploadedfiles/elias_written_testimony_hjc.pdf?utm_campaign=4024-519">https://judiciary.house.gov/uploadedfiles/elias_written_testimony_hjc.pdf?utm_campaign=4024-519</a> (last accessed 19 July 2020)
C-178	Delaware Department of State, Division of Corporations - Filings: Nu Dotco LLC (13 July 2020)
C-179	Comprehensive Business Report: Nu Dotco LLC (13 July 2020)
C-180	ICANN, Assignments: Change of Control of Registry Operator or Material Subcontracting Arrangement, available at <a href="https://www.icann.org/resources/assignments">https://www.icann.org/resources/assignments</a> (last accessed 13 July 2020)
C-181	ICANN, New Generic Top-Level Domains: Frequently Asked Questions, available at <a href="https://newgtlds.icann.org/en/applicants/global-support/faqs/faqs-en">https://newgtlds.icann.org/en/applicants/global-support/faqs/faqs-en</a> (last accessed 13 July 2020)

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<b>Exhibit submitted with Afiliias' Application for Leave to Add Exhibit C-182 to the Record of this IRP (21 July 2020)</b>	
C-182	Email from Jose Ignacio Rasco (NDC) to Peg Rettino (ICANN) (copy to John Jeffrey and Akram Atallah (ICANN)) (15 Dec. 2018) [ICANN-WEB_001061]
<b>Authorities submitted with Afiliias' Response to the <i>Amicus Curiae</i> Briefs (24 July 2020)</b>	
CA-44	<i>Pennell v. City of San Jose</i> , 485 U.S. 1 (1988)
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CA-47	<i>In re Aslan</i> , 65 B.R. 826 (Bankr. C.D. Cal. 1986), <i>rev'd in part on other grounds</i> , 909 F.2d 367 (9th Cir. 1990)
CA-48	<i>Vir2us, Inc. v. Sophos Inc.</i> , No. 2:19CV18, 2019 WL 8886440 (E.D. Va. Aug. 14, 2019)
CA-49	<i>In re Hat</i> , 310 B.R. 752 (Bankr. E.D. Cal. 2004)
CA-50	<i>U.S. v. Smithfield Foods, Inc.</i> , Case 1:10-cv-00120 (D.D.C.), Complaint (21 Jan. 2010)
CA-51	U.S. Department of Justice, <i>Smithfield Foods and Premium Standards Farms Charged with Illegal Premerger Coordination: Company Required to Pay \$900,000 Civil Penalty</i> (21 Jan. 2010), available at <a href="https://www.justice.gov/opa/pr/smithfield-foods-and-premium-standard-farms-charged-illegal-premerger-coordination">https://www.justice.gov/opa/pr/smithfield-foods-and-premium-standard-farms-charged-illegal-premerger-coordination</a> (last accessed 23 July 2020)
CA-52	<i>Principal Mut. Life Ins. Co. v. Vars, Pave, McCord &amp; Freedman</i> , 65 Cal. App. 4th 1469 (1998)
CA-53	<i>Mountain of Fire &amp; Miracles Ministries v. Oyeyemi</i> , No. B218591, 2012 WL 2373003 (Cal. Ct. App. June 25, 2012)
CA-54	<i>In re O'Neill Enterprises, Inc.</i> , 547 F.2d 812 (4th Cir. 1977)
CA-55	<i>Merriam-Webster Dictionary</i> (on-line version): inaccurate, available at <a href="https://www.merriam-webster.com/dictionary/inaccurate">https://www.merriam-webster.com/dictionary/inaccurate</a> (last accessed 21 July 2020)
CA-56	<i>Merriam-Webster Dictionary</i> (on-line version): untrue, available at <a href="https://www.merriam-webster.com/dictionary/untrue">https://www.merriam-webster.com/dictionary/untrue</a> (last accessed 21 July 2020)
CA-57	<i>Merriam-Webster Dictionary</i> (on-line version): subjugate, available at <a href="https://www.merriam-webster.com/dictionary/subjugation">https://www.merriam-webster.com/dictionary/subjugation</a> (last accessed 21 July 2020)
CA-58	<i>Boeing Co. v. March</i> , 656 F. Supp. 2d 837 (N.D. Ill. 2009)
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CA-60	<i>ICM Registry, LLC v. ICANN</i> , ICDR Case No. 50-117-T-00224-08, Expert Report of Jack Goldsmith (22 Jan. 2009)
CA-61	<i>ICM Registry, LLC v. ICANN</i> , ICDR Case No. 50-117-T-00224-08, ICANN's Response to ICM's Memorial on the Merits (8 May 2009)

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CA-63	<i>Nuclear Tests (Australia v. France)</i> , Judgment (20 Dec.), 1974 I.C.J. 253
CA-64	<i>Land and Maritime Boundary between Cameroon and Nigeria (Cameroon v. Nigeria)</i> , Judgment (11 June), 1998 I.C.J. 275
CA-65	Anthony D'Amato, "Good Faith" in <i>Encyclopedia of Public International Law</i> Vol. 2 (1995)
CA-66	<i>The Gibraltar Football Association (GFA) v. Union des Associations Européennes de Football (UEFA)</i> , CAS Case No. 2002/O/410, Award (7 Oct. 2003)
CA-67	<i>A. v. Fédération Internationale de Lutttes Associées (FILA)</i> , CAS Case No. 2001/A/317, Award (9 July 2001)
CA-68	<i>G. v. Fédération Equestre Internationale (FEI)</i> , CAS Case No. 1991/A/53, Award (15 Jan. 1992) in 1 <i>Digest of CAS Awards Series Set 79</i> (1998)
CA-69	<i>AEK Athens and SK Slavia Prague v. Union of European Football Associations (UEFA)</i> , CAS Case No. 98/200, Award (20 Aug. 1999)
CA-70	<i>Plama Consortium Ltd. v. Republic of Bulgaria</i> , ICSID Case No. ARB/03/24, Award (27 Aug. 2008)
CA-71	<i>AES Summit Generation Ltd. and AES-Tisza Erömu Kft. v. Republic of Hungary</i> , ICSID Case No. ARB/07/22, Award (23 Sep. 2010)
CA-72	<i>Ronald S. Lauder v. Czech Republic</i> , UNCITRAL Arbitration, Final Award (3 Sep. 2001)
CA-73	<i>Filippo Volandri v. International Tennis Federation (ITF)</i> , CAS Case No. 2009/A/1782, Award (12 May 2009)
CA-74	<i>Albert Ruckdeschel &amp; Co. and Hansa-Lagerhaus Ströh &amp; Co. v. Hauptzollamt Hamburg-St. Annen and Diamalt AG v. Hauptzollamt Itzenhoe</i> , Joined Cases 117/76 and 16/77, Judgment (19 Oct. 1977), 1977 E.C.R. 1753
CA-75	<i>Peter Überschär v. Bundesversicherungsanstalt für Angestellte</i> , Case 810/79, Judgment (8 Oct.), 1980 E.C.R. 2747
CA-76	<i>Bilka-Kaufhaus GmbH v. Karin Weber von Hartz</i> , Case 170/84, Judgment (13 May), 1986 E.C.R. 1620
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CA-78	<i>Saluka Inves. BV v. Czech Republic</i> , UNCITRAL Arbitration, Partial Award (17 Mar. 2006)
CA-79	<i>Kelly and Others v. United Kingdom</i> , ECHR, Case No. 30054/96, Final Judgment (4 Aug. 2001)
CA-80	Advisory Opinion OC-18/03 of September 17, 2003, Inter-Am. Ct. H.R., <i>Juridical Condition and Rights of the Undocumented Migrants</i>
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CA-83	<i>LG&amp;E Energy Corp. et al. v. Argentine Republic</i> , ICSID Case No. ARB/02/1, Decision on Liability (3 Oct. 2006)
CA-84	<i>Joseph Charles Lemire v. Ukraine</i> , ICSID Case No. ARB/06/18, Decision on Jurisdiction and Liability (14 Jan. 2010)
CA-85	United Nations Procurement Manual (30 June 2020)
CA-86	UNCITRAL Model Law on Public Procurement (2011)
CA-87	World Trade Organization, <i>Revised Agreement on Government Procurement and WTO related Legal Instruments</i> (in force 6 Apr. 2014)
CA-88	World Bank, <i>Bank Policy: Procurement in IPF and Other Operational Procurement Matters</i> (Nov. 2017)
CA-89	OECD, <i>Methodology for Assessing Procurement Systems (MAPS)</i> (2018)
CA-90	<i>Siemens A.G. v. Argentine Republic</i> , ICSID Case No. ARB/02/8, Award (17 Jan. 2007)
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CA-92	Akira Kotera, "Regulatory Transparency" in <i>The Oxford Handbook of International Investment Law</i> 617 (Peter Muchlinski et al. eds., 2008)
CA-93	Case C-532/06, <i>Emm G. Lianakis AE et al. v. Dimos Alexandroupolis et al.</i> , Judgment (24 Jan. 2008)
CA-94	Sacha Prechal and Madeleine de Leeuw, "Dimensions of Transparency: The Building Blocks for a New Legal Principle?," <i>Rev. Eur. Admin. L.</i> Vol. O, No. 1 (2007)
CA-95	<i>Bosh Int'l, Inc. and B &amp; P Ltd. Foreign Inves. Enter. v. Ukraine</i> , ICSID Case No. ARB/08/11, Award (25 Oct. 2012)
CA-96	<i>Spyridon Roussalis v. Romania</i> , ICSID Case No. ARB/06/1, Award (7 Dec. 2011)
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CA-100	<i>United States - Sections 301-310 of the Trade Act of 1974</i> , WTO Case No. WT/DS152/R, Report of the Panel (22 Dec. 1999)
CA-101	World Bank Administrative Tribunal, <i>Walter Prescott v. International Bank for Reconstruction and Development</i> , Decision No. 253 (4 Dec. 2001)



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CA-102	<i>Sullivan v. The Judo Federation of Australia Inc.</i> , CAS Case No. 2000/A/284, Award (14 Aug. 2000)
CA-103	<i>CME Czech Republic B.V. v. Czech Republic</i> , UNCITRAL Arbitration, Partial Award (13 Sep. 2001)
CA-104	<i>AlterG, Inc. v. Boost Treadmills LLC</i> , 388 F.Supp.3d 1133 (N.D. Cal. 2019)
CA-105	<i>Coley v. Eskaton</i> , 2020 WL 3833018 (Cal. Ct. App. 2020)
CA-106	<i>Palm Springs Villas II Homeowners Assn., Inc. v. Parth</i> , 248 Cal.App.4th 268 (Cal. Ct. App. 2016)
CA-107	<i>Ekstrom v. Marquesa at Monarch Beach Homeowners Assn.</i> , 168 Cal.App.4th 1111 (Cal. Ct. App. 2008)
CA-108	Stuart Chemtob, U.S. Department of Justice, The Role of Competition Agencies in Regulated Sectors (5th International Symposium on Competition Policy and Law, Institute of Law, Chinese Academy of Social Science, Beijing, China, 11 May 2007), available at <a href="https://www.justice.gov/atr/speech/role-competition-agencies-regulated-sectors">https://www.justice.gov/atr/speech/role-competition-agencies-regulated-sectors</a> (last accessed 23 July 2020)
CA-109	<i>In the Matter of Policies Regarding Mobile Spectrum Holdings</i> , FCC, WT Docket No. 12-269, Ex Parte Submission of the United States Department of Justice (11 Apr. 2013)
CA-110	U.S. Department of Justice and the Federal Trade Commission, <i>Horizontal Merger Guidelines</i> (19 Aug. 2010)
CA-111	Clayton Act, 15 U.S.C. § 18 (1996)
CA-112	<i>Steves and Sons, Inc. v. JELD-WEN, Inc.</i> , 345 F.Supp.3d 614 (E.D. Va. 2018)
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CA-115	<i>Merriam-Webster Dictionary</i> (on-line version): accountability, available at <a href="https://www.merriam-webster.com/dictionary/accountability">https://www.merriam-webster.com/dictionary/accountability</a> (last accessed 23 July 2020)
CA-116	<i>Oxford English Dictionary</i> (on-line version): accountability, available at <a href="https://www.oed-com.nyli.idm.oclc.org/view/Entry/1197?redirectedFrom=accountability&amp;&amp;print">https://www.oed-com.nyli.idm.oclc.org/view/Entry/1197?redirectedFrom=accountability&amp;&amp;print</a> (last accessed 24 July 2020)
CA-117	Dictionary.com: redress, available at <a href="http://dictionary.reference.com/browse/redress">http://dictionary.reference.com/browse/redress</a> (last accessed 23 July 2020)
CA-118	<i>Black's Law Dictionary</i> (11th ed. 2019): redress
CA-119	<i>Factory at Chorzów (Claim for Indemnity) (Merits)</i> , Judgment (Sep. 13), 1928 P.C.I.J. (Ser. A) No. 17
CA-120	Lexico.com: resolve, available at <a href="https://www.lexico.com/en/definition/resolve">https://www.lexico.com/en/definition/resolve</a> (last accessed 23 July 2020)

Exhibit No.	Description
CA-121	<i>Oxford English Dictionary</i> (on-line version): resolve, available at <a href="https://www-oed-com.nyli.idm.oclc.org/view/Entry/163733?rkey=u3QyP2&amp;result=2&amp;isAdvanced=false&amp;print">https://www-oed-com.nyli.idm.oclc.org/view/Entry/163733?rkey=u3QyP2&amp;result=2&amp;isAdvanced=false&amp;print</a> (last accessed 24 July 2020)
CA-122	<i>Interpretation of Judgments Nos. 7 and 8 (The Chorzów Factory)</i> , Judgment, 1927 P.C.I.J. (Ser. A) No. 13 (Dec. 16)
CA-123	Gary Born, <i>International Commercial Arbitration</i> (2d ed. 2014)
CA-124	Arbitration Act 1996 (Eng.)



## **LEGAL AUTHORITY CA-44**



KeyCite Yellow Flag - Negative Treatment

Declined to Extend by [Sullivan Properties, Inc. v. City of Winter Springs](#), M.D.Fla., September 25, 1995

108 S.Ct. 849

Supreme Court of the United States

Richard PENNELL and Tri-County Apartment  
House Owners Association, Appellants

v.

CITY OF SAN JOSE and City Council of San Jose.

No. 86-753.

|

Argued Nov. 10, 1987.

|

Decided Feb. 24, 1988.

**Synopsis**

Landlord and landlords' association brought action for declaratory and injunctive relief against city, attacking constitutionality of city rent control ordinance. The Superior Court, Santa Clara County, Bruce F. Allen, J., held that provision allowing hearing officer to consider "hardship to a tenant" when determining whether to approve rent increase proposed by landlord was unconstitutional, but upheld annual fee levied under ordinance on each rental unit, and both sides appealed. [The Court of Appeal, 201 Cal.Rptr. 728](#), affirmed, and both sides appealed. The California Supreme Court, [42 Cal.3d 365](#), [228 Cal.Rptr. 726](#), [721 P.2d 1111](#), reversed in part, determining that tenant hardship provision was not facially unconstitutional, and landlord and landlords' association appealed. The Supreme Court, Chief Justice Rehnquist, held that: (1) landlords had standing to challenge ordinance's constitutionality; (2) contention that application of ordinance's tenant hardship provisions violated takings clause was premature; and (3) ordinance did not on its face violate due process clause or equal protection clause.

Affirmed.

Justice Scalia filed opinion concurring in part and dissenting in part in which Justice O'Connor joined.

Justice Kennedy took no part in the consideration or decision of this case.

West Headnotes (19)

**[1] Associations** **Suits on Behalf of Members; Associational or Representational Standing**

"Associational or representational standing" requires actual injury redressable by court, that association's members would otherwise having standing to sue in their own right, that interests association seeks to protect are germane to association's purpose and that neither claim asserted nor relief requested requires participation of individual members in lawsuit. [U.S.C.A. Const. Art. 3, § 1 et seq.](#)

[44 Cases that cite this headnote](#)**[2] Federal Civil Procedure** **In general; injury or interest**

Application of constitutional standing requirement is not mechanical exercise. [U.S.C.A. Const. Art. 3, § 1 et seq.](#)

[11 Cases that cite this headnote](#)**[3] Federal Civil Procedure** **Pleading**

Upon challenge to standing on basis of pleadings, the Supreme Court of the United States accepts as true all material allegations of complaint and construes complaint in favor of complaining party. [U.S.C.A. Const. Art. 3, § 1 et seq.](#)

[99 Cases that cite this headnote](#)**[4] Municipal Corporations** **Proceedings concerning construction and validity of ordinances**

Landlord and landlords' association had standing to challenge constitutionality of city rent control ordinance allowing hearing officer to consider, among other factors "hardship to a tenant" when determining whether to approve rent increase proposed by landlord, even though complaint did not allege that landlords had "hardship tenants" who might trigger ordinance's hearing process or that they had been or would be aggrieved by hearing officer's determination that

certain proposed rent increase was unreasonable on ground of tenant hardship; allegation that landlords' properties were subject to ordinance and statement at oral argument that association represented most of residential unit owners in city and had many hardship tenants raised likelihood of enforcement of ordinance, with concomitant probability that rent would be reduced below what landlord would otherwise be able to obtain, so as to sustain landlords' burden of demonstrating realistic danger of sustaining direct injury as result of ordinance's operation or enforcement. [U.S.C.A. Const. Art. 3, § 1 et seq.](#)

[76 Cases that cite this headnote](#)

[5] **Federal Courts** 🔑 [Presentation of Questions Below or on Review; Record; Waiver](#)

Parties litigating in the Supreme Court of the United States should take pains to supplement record in any manner necessary to enable Court to address with as much precision as possible any question of standing that may be raised. [U.S.C.A. Const. Art. 3, § 1 et seq.](#)

[9 Cases that cite this headnote](#)

[6] **Eminent Domain** 🔑 [What Constitutes a Taking; Police and Other Powers Distinguished](#)

Fifth Amendment's just compensation provision is designed to bar Government from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by public as a whole. [U.S.C.A. Const.Amend. 5.](#)

[8 Cases that cite this headnote](#)

[7] **Constitutional Law** 🔑 [Necessity of Determination](#)

Constitutionality of statutes ought not be decided except in actual factual setting that makes such decision necessary, particularly in takings cases. [U.S.C.A. Const.Amends. 5, 14.](#)

[11 Cases that cite this headnote](#)

[8] **Municipal Corporations** 🔑 [Proceedings concerning construction and validity of ordinances](#)

Landlords' contention that city rent control ordinance's tenant hardship provision violated takings clause, alleging that reducing, because of tenant hardship, what would otherwise be "reasonable" rent under other, objective factors specified in ordinance, relating to landlord's cost or rental market's condition, accomplished taking and transfer of landlord's property to individual hardship tenants, was premature, absent evidence that tenant hardship provision had in fact ever been relied upon by hearing officer to reduce rent as alleged, particularly where ordinance did not require that hearing officer in fact reduce proposed rent increase on grounds of tenant hardship, but rather, only required that tenant hardship be considered. [U.S.C.A. Const.Amends. 5, 14.](#)

[24 Cases that cite this headnote](#)

[9] **Constitutional Law** 🔑 [Charges and prices in general](#)

State price-control regulation that is arbitrary, discriminatory, or demonstrably irrelevant to policy that legislature is free to adopt violates Due Process Clause. [U.S.C.A. Const.Amends. 5, 14.](#)

[30 Cases that cite this headnote](#)

[10] **Constitutional Law** 🔑 [Antitrust regulation in general](#)

Government's intervention in marketplace to regulate rates or prices that are artificially inflated as result of monopoly or near monopoly does not violate Due Process Clause. [U.S.C.A. Const.Amends. 5, 14.](#)

[1 Cases that cite this headnote](#)

[11] **Landlord and Tenant** 🔑 [Validity](#)

City rent control ordinance's purpose of preventing unreasonable rent increases caused by city's housing shortage was legitimate

exercise of city's police powers. [U.S.C.A. Const.Amend. 5, 14.](#)

[8 Cases that cite this headnote](#)

**[12] Eminent Domain** [↔ Rent control; housing](#)  
**Landlord and Tenant** [↔ Power to regulate](#)

States have broad power to regulate housing conditions in general and landlord-tenant relationship in particular without paying compensation for all economic injuries that such regulation entails. [U.S.C.A. Const.Amend. 5, 14.](#)

[15 Cases that cite this headnote](#)

**[13] Eminent Domain** [↔ Rent control; housing](#)  
Statutes regulating economic relations of landlords and tenants are not per se takings. [U.S.C.A. Const.Amend. 5, 14.](#)

[10 Cases that cite this headnote](#)

**[14] Constitutional Law** [↔ Charges and prices in general](#)

For purposes of due process analysis, protection of consumer welfare is legitimate and rational goal of price or rate regulation. [U.S.C.A. Const.Amend. 5, 14.](#)

[12 Cases that cite this headnote](#)

**[15] Landlord and Tenant** [↔ Purpose](#)

Protection of tenants is primary purpose of rent control.

[2 Cases that cite this headnote](#)

**[16] Constitutional Law** [↔ Rent control](#)  
**Landlord and Tenant** [↔ Validity](#)

Provision in city rent control ordinance that hearing officer may consider tenant's hardship, among other factors, in finally fixing reasonable rent, did not render ordinance facially invalid under Fourteenth Amendment's due process clause; ordinance's scheme represented rational attempt to accommodate conflicting interests

of protecting tenants from burdensome rent increases and from costs of dislocation while at same time ensuring that landlords were guaranteed fair return on their investment. [U.S.C.A. Const.Amend. 14.](#)

[38 Cases that cite this headnote](#)

**[17] Constitutional Law** [↔ Rent control](#)

In face of Equal Protection challenge to city rent control ordinance, city was only required to show that classification scheme embodied in ordinance was rationally related to legitimate state interest. [U.S.C.A. Const.Amend. 14.](#)

[54 Cases that cite this headnote](#)

**[18] Constitutional Law** [↔ Statutes and other written regulations and rules](#)

Statute that does not burden suspect class or fundamental interest will not be overturned on Equal Protection grounds unless varying treatment of different groups of persons is so unrelated to achievement of any combination of legitimate purposes as to compel conclusion that legislature's actions were irrational. [U.S.C.A. Const.Amend. 14.](#)

[86 Cases that cite this headnote](#)

**[19] Constitutional Law** [↔ Rent control](#)  
**Landlord and Tenant** [↔ Validity](#)

City rent control ordinance allowing hearing officer to consider, among other factors, "hardship to a tenant" when determining whether to approve rent increase proposed by landlord did not, on its face, violate Equal Protection Clause; treating landlords differently on basis of whether they had hardship tenants was rationally related to legitimate purpose of protecting tenants. [U.S.C.A. Const.Amend. 14.](#)

[21 Cases that cite this headnote](#)

**\*\*852 Syllabus \***

\* The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See *United States v. Detroit Lumber Co.*, 200 U.S. 321, 337, 26 S.Ct. 282, 287, 50 L.Ed. 499.

\*01 Under a San Jose, Cal., rent control ordinance (Ordinance), a landlord may automatically raise the annual rent of a tenant in possession by as much as eight percent, but if a tenant objects to a higher increase, a hearing is required to determine whether the landlord's proposed increase is "reasonable under the circumstances," and the hearing officer is directed to consider specified factors, including "the hardship to a tenant." Appellants, an individual landlord and Tri-County Apartment House Owners Association (Association), which represents owners and lessors of real property located in San Jose, filed a state-court action seeking a declaration that the Ordinance, particularly the "tenant hardship" provision, is facially invalid under the Federal Constitution. The court entered judgment on the pleadings in appellants' favor, and the California Court of Appeal affirmed. However, the California Supreme Court reversed, rejecting appellants' arguments under the Takings Clause of the Fifth Amendment and the Equal Protection and Due Process Clauses of the Fourteenth Amendment.

*Held:*

1. Appellants have standing to challenge the Ordinance's constitutionality, even though they did not allege that either the individual appellant or appellant Association's members have "hardship tenants" who might trigger the Ordinance's hearing process, or that they have been or will be aggrieved by a hearing officer's determination that a certain proposed rent increase is unreasonable on the ground of tenant hardship. When standing is challenged on the basis of the pleadings, all material allegations of the complaint must be taken as true, and the complaint must be \*2 construed in favor of the complaining party. Appellants alleged that their properties are subject to the Ordinance, and stated at oral argument that the Association represents "most of the residential unit owners in the city and [has] many hardship tenants." Thus, the likelihood of enforcement of the Ordinance, with the concomitant probability that a rent will be reduced below what the landlord would otherwise be able to obtain, is a sufficient threat of actual injury to satisfy Art. III's

requirement that a plaintiff who challenges a law must demonstrate a realistic danger of sustaining a direct injury as a result of the law's operation or enforcement. Pp. 854–855.

2. Appellants' contention that application of the Ordinance's tenant hardship provision violates the Takings Clause—since reducing, because of tenant hardship, what would otherwise be a "reasonable" rent under the other, objective factors specified in the Ordinance relating to the landlord's costs or the rental market's condition, accomplishes a taking and transfer of the landlord's property to individual hardship tenants—is premature. There is no evidence that the tenant hardship provision has in fact ever been relied upon by a hearing officer to reduce a rent below the figure it would have been set at on the basis of the other specified factors. In addition, the Ordinance does not require that a hearing officer in fact reduce a proposed rent increase on grounds of tenant hardship, but only makes it mandatory that tenant hardship be considered. In takings cases, the constitutionality of laws should not be decided except in an actual factual setting that makes such a decision necessary. Pp. 856–857.

3. The mere provision in the Ordinance that a hearing officer may consider the tenant's hardship in finally fixing a reasonable rent does not render the Ordinance facially invalid under the Due Process Clause. The Ordinance's purpose of preventing unreasonable rent increases \*\*853 caused by the city's housing shortage is a legitimate exercise of appellees' police powers. Moreover, there is no merit to appellants' argument that it is arbitrary, discriminatory, or demonstrably irrelevant for appellees to attempt to accomplish the additional goal of reducing the burden of housing costs on low-income tenants by requiring that "hardship to a tenant" be considered in determining the amount of excess rent increase that is "reasonable under the circumstances." The protection of consumer welfare is a legitimate and rational goal of price or rate regulation. The Ordinance's scheme represents a rational attempt to accommodate the conflicting interests of protecting tenants from burdensome rent increases while at the same time ensuring that landlords are guaranteed a fair return on their investment. Pp. 857–859.

4. The Ordinance, on its face, does not violate the Equal Protection Clause. Its classification scheme is rationally related to the legitimate \*3 purpose of protecting tenants. It is not irrational for the Ordinance to treat landlords differently on the basis of whether or not they have hardship tenants. Pp. 858–859.

42 Cal.3d 365, 228 Cal.Rptr. 726, 721 P.2d 1111 (1986), affirmed.

REHNQUIST, C.J., delivered the opinion of the Court, in which BRENNAN, WHITE, MARSHALL, BLACKMUN, and STEVENS, JJ., joined. SCALIA, J., filed an opinion concurring in part and dissenting in part, in which O'CONNOR, J., joined, *post*, p. ——. KENNEDY, J., took no part in the consideration or decision of the case.

### Attorneys and Law Firms

*Harry D. Miller* argued the cause for appellants. With him on the briefs were *Burch Fitzpatrick* and *Gary E. Rosenberg*.

*Joan R. Gallo* argued the cause for appellees. With her on the brief was *George Rios*.\*

\* Briefs of *amici curiae* urging reversal were filed for the California Association of Realtors by *William M. Pfeiffer*; for the National Apartment Association et al. by *Jon D. Smock*, *Wilbur H. Haines III*, and *Jeffrey J. Gale*; for the National Association of Realtors by *William D. North*; for the National Multi Housing Council by *Lawrence B. Simons* and *Michael E. Fine*; for the Rent Stabilization Association of New York City, Inc., et al. by *Erwin N. Griswold*; and for the Washington Legal Foundation by *Daniel J. Popeo*, *Paul D. Kamenar*, and *Todd Natkin*.

Briefs of *amici curiae* urging affirmance were filed for the American Civil Liberties Union et al. by *John A. Powell*, *Steven R. Shapiro*, *Helen Hershkoff*, *Paul L. Hoffman*, and *Mark Rosenbaum*; for the American Federation of Labor and Congress of Industrial Organizations by *Robert M. Weinberg* and *Laurence Gold*; for the Asian Law Alliance et al. by *Brenton Rogozen*; for the Center for Constitutional Rights by *Frank E. Deale*; for the National Housing Law Project by *David B. Bryson*; for the National Institute of Municipal Law Officers by *William I. Thornton, Jr.*, *Roger F. Cutler*, *Roy D. Bates*, and *William H. Taube*; and for the U.S. Conference of Mayors et al. by *Benna Ruth Solomon* and *H. Bartow Farr III*.

Briefs of *amici curiae* were filed for the city of Santa Monica et al. by *Joseph Lawrence*, *Karl M. Manheim*, *Joel M. Levy*, *Hadassa K. Gilbert*, *Manuela Albuquerque*, *Raymond E. Ott*, *Mary Jo Levinger*, *Marc G. Hynes*, *Jayne W. Williams*, *K. Duane Lyders*, *Louise H. Renne*, *Roger T. Picquet*, *Steven A. Amerikaner*, *Mark G. Sellers*, and *John M. Powers*; for the

Competitive Enterprise Institute by *Sam Kazman*; and for the National Association of Home Builders et al. by *Gus Bauman*.

### Opinion

\*4 Chief Justice REHNQUIST delivered the opinion of the Court.

This case involves a challenge to a rent control ordinance enacted by the city of San Jose, California, that allows a hearing officer to consider, among other factors, the “hardship to a tenant” when determining whether to approve a rent increase proposed by a landlord. Appellants Richard Pennell and the Tri-County Apartment House Owners Association sued in the Superior Court of Santa Clara County seeking a declaration that the ordinance, in particular the “tenant hardship” provisions, are “facially unconstitutional and therefore ... illegal and void.” The Superior Court entered judgment on the pleadings in favor of appellants, sustaining their claim that the tenant hardship provisions violated the Takings Clause of the Fifth Amendment, as made applicable to the States by the Fourteenth Amendment. The California Court of Appeal affirmed this judgment, 154 Cal.App.3d 1019, 201 Cal.Rptr. 728 (1984), but the Supreme Court of California reversed, 42 Cal.3d 365, 228 Cal.Rptr. 726, 721 P.2d 1111 (1986), each by a divided vote. The majority of the Supreme Court rejected appellants' arguments under the Takings Clause and the Equal Protection and Due Process Clauses of the Fourteenth Amendment; the dissenters in that court thought that the tenant hardship provisions were a “forced subsidy imposed on the landlord” in violation of the Takings Clause. *Id.*, at 377, 228 Cal.Rptr., at 734, 721 P.2d, at 1119. On appellants' appeal to this Court we postponed consideration of the question of jurisdiction, 480 U.S. 905, 107 S.Ct. 1346, 94 L.Ed.2d 517 (1987), and now having heard oral argument we affirm the judgment of the Supreme Court of California.

The city of San Jose enacted its rent control ordinance (Ordinance) in 1979 with the stated purpose of

“alleviat[ing] some of the more immediate needs created by San Jose's housing situation. These needs include but are not limited to the prevention of excessive and unreasonable rent increases, the alleviation of undue hardships \*5 upon individual tenants, and the assurance to landlords of a fair and reasonable return \*\*854 on the value of their property.” San Jose Municipal Ordinance 19696, § 5701.2.<sup>1</sup>



<sup>1</sup> In order to be consistent with the decisions below, we refer throughout this opinion to the sections of the Ordinance as originally designated. We note, however, that the San Jose Municipal Code has recently been recodified and the Ordinance now appears at Chapter 17.23 of the new Code.

At the heart of the Ordinance is a mechanism for determining the amount by which landlords subject to its provisions may increase the annual rent which they charge their tenants. A landlord is automatically entitled to raise the rent of a tenant in possession<sup>2</sup> by as much as eight percent; if a tenant objects to an increase greater than eight percent, a hearing is required before a “Mediation Hearing Officer” to determine whether the landlord’s proposed increase is “reasonable under the circumstances.” The Ordinance sets forth a number of factors to be considered by the hearing officer in making this determination, including “the hardship to a tenant.” § 5703.28(c)(7). Because appellants concentrate their attack on the consideration of this factor, we set forth the relevant provision of the Ordinance in full:

<sup>2</sup> Under § 5703.3, the Ordinance does not apply to rent or rent increases for new rental units first rented after the Ordinance takes effect, § 5703.3(a), to the rental of a unit that has been voluntarily vacated, § 5703.3(b)(1), or to the rental of a unit that is vacant as a result of eviction for certain specified acts, § 5703.3(b)(2).

“5703.29. Hardship to Tenants. In the case of a rent increase or any portion thereof which exceeds the standard set in Section 5703.28(a) or (b), then with respect to such excess and whether or not to allow same to be part of the increase allowed under this Chapter, the Hearing Officer shall consider the economic and financial hardship imposed on the present tenant or tenants of the unit or units to which such increases apply. If, on balance, the Hearing Officer determines that the proposed increase \*6 constitutes an unreasonably severe financial or economic hardship on a particular tenant, he may order that the excess of the increase which is subject to consideration under subparagraph (c) of Section 5703.28, or any portion thereof, be disallowed. Any tenant whose household income and monthly housing expense meets [certain income requirements] shall be deemed to be suffering under financial and economic hardship which must be weighed in the Hearing Officer’s determination.

The burden of proof in establishing any other economic hardship shall be on the tenant.”

If either a tenant or a landlord is dissatisfied with the decision of the hearing officer, the Ordinance provides for binding arbitration. A landlord who attempts to charge or who receives rent in excess of the maximum rent established as provided in the Ordinance is subject to criminal and civil penalties.

[1] Before we turn to the merits of appellants’ contentions we consider the claim of appellees that appellants lack standing to challenge the constitutionality of the Ordinance. The original complaint in this action states that appellant Richard Pennell “is an owner and lessor of 109 rental units in the City of San Jose.” Appellant Tri-County Apartment House Owners Association (Association) is said to be “an unincorporated association organized for the purpose of representing the interests of the owners and lessors of real property located in the City of San Jose.” App. 2–3. The complaint also states that the real property owned by appellants is “subject to the terms of” the Ordinance. But, appellees point out, at no time did appellants allege that either Pennell or any member of the Association has “hardship tenants” who might trigger the Ordinance’s hearing process, nor did they specifically allege that they have been or will be aggrieved by the determination of a hearing officer that a certain proposed rent increase is unreasonable on the ground of tenant hardship. As appellees put it, “[a]t \*\*855 this point in time, it is speculative” \*7 whether any of the Association’s members will be injured in fact by the Ordinance’s tenant hardship provisions. Thus, appellees contend, appellants lack standing under either the test for individual standing, see, e.g., *Valley Forge Christian College v. Americans United for Separation of Church & State, Inc.*, 454 U.S. 464, 472, 102 S.Ct. 752, 758, 70 L.Ed.2d 700 (1982) (individual standing requires an “ ‘actual injury redressable by the court’ ”), or the test for associational standing, see *Hunt v. Washington Apple Advertising Comm’n*, 432 U.S. 333, 343, 97 S.Ct. 2434, 2441, 53 L.Ed.2d 383 (1977) (an association has standing on behalf of its members only when “its members would otherwise have standing to sue in their own right”).<sup>3</sup>

<sup>3</sup> Our cases also impose two additional requirements for associational or representational standing: the interests the organization seeks to protect must be “germane to the organization’s purpose,” *Hunt*, 432 U.S., at 343, 97 S.Ct., at 2441, and “neither the claim asserted nor the relief requested requires the participation of individual members in the lawsuit,” *ibid.* See also *Automobile Workers v. Brock*, 477

U.S. 274, 281–282, 106 S.Ct. 2523, 2529, 91 L.Ed.2d 228 (1986). Both of these requirements are satisfied here. The Association was “organized for the purpose of representing the interests of the owners and lessors of real property” in San Jose in this lawsuit, App. 3, and the facial challenge that the Association makes to the Ordinance does not require the participation of individual landlords.

[2] [3] [4] We must keep in mind, however, that “application of the constitutional standing requirement [is not] a mechanical exercise,” *Allen v. Wright*, 468 U.S. 737, 751, 104 S.Ct. 3315, 3324, 82 L.Ed.2d 556 (1984), and that when standing is challenged on the basis of the pleadings, we “accept as true all material allegations of the complaint, and ... construe the complaint in favor of the complaining party,” *Warth v. Seldin*, 422 U.S. 490, 501, 95 S.Ct. 2197, 2206, 45 L.Ed.2d 343 (1975); see also *Gladstone, Realtors v. Village of Bellwood*, 441 U.S. 91, 109, 99 S.Ct. 1601, 1612, 60 L.Ed.2d 66 (1979). Here, appellants specifically alleged in their complaint that appellants' properties are “subject to the terms of” the Ordinance, and they stated at oral argument that the Association represents “most of the residential unit owners in the city and [has] many hardship tenants,” Tr. of Oral Arg. 42; see also *id.*, at 7; Reply Brief for Appellants 2. \*8 Accepting the truth of these statements, which appellees do not contest, it is not “unadorned speculation,” *Simon v. Eastern Kentucky Welfare Rights Organization*, 426 U.S. 26, 44, 96 S.Ct. 1917, 1927, 48 L.Ed.2d 450 (1976), to conclude that the Ordinance will be enforced against members of the Association. The likelihood of enforcement, with the concomitant probability that a landlord's rent will be reduced below what he or she would otherwise be able to obtain in the absence of the Ordinance, is a sufficient threat of actual injury to satisfy Art. III's requirement that “[a] plaintiff who challenges a statute must demonstrate a realistic danger of sustaining a direct injury as a result of the statute's operation or enforcement.” *Babbitt v. Farm Workers*, 442 U.S. 289, 298, 99 S.Ct. 2301, 2308, 60 L.Ed.2d 895 (1979).<sup>4</sup>

<sup>4</sup> Appellees also argue that Pennell lacks standing individually because in early 1987 he sold the properties he owned at the time the complaint in this action was filed. See Brief for Appellees 8. In a declaration submitted to the Court, Pennell admits that he sold these properties, but states that he recently repurchased and now owns one of the apartment buildings in San Jose that he formerly owned. Declaration of Richard Pennell ¶

7. That property was and still is “subject to the Ordinance.” *Id.*, ¶ 8. Because we conclude that the Association has standing and that therefore we have jurisdiction over this appeal, we find it unnecessary to decide whether Pennell's sale and repurchase of the property affects his standing here.

[5] This said, we recognize that the record in this case leaves much to be desired in terms of specificity for purposes of determining the standing of appellants to challenge this Ordinance. Undoubtedly this is at least in part a reflection of the fact that the case originated in a state court where Art. III's proscription against \*\*856 advisory opinions may not apply. We strongly suggest that in future cases parties litigating in this Court under circumstances similar to those here take pains to supplement the record in any manner necessary to enable us to address with as much precision as possible any question of standing that may be raised.

[6] Turning now to the merits, we first address appellants' contention that application of the Ordinance's tenant hardship provisions violates the Fifth and Fourteenth Amendments' \*9 prohibition against taking of private property for public use without just compensation. In essence, appellants' claim is as follows: § 5703.28 of the Ordinance establishes the seven factors that a hearing officer is to take into account in determining the reasonable rent increase. The first six of these factors are all objective, and are related either to the landlord's costs of providing an adequate rental unit, or to the condition of the rental market. Application of these six standards results in a rent that is “reasonable” by reference to what appellants contend is the only legitimate purpose of rent control: the elimination of “excessive” rents caused by San Jose's housing shortage. When the hearing officer then takes into account “hardship to a tenant” pursuant to § 5703.28(c)(7) and reduces the rent below the objectively “reasonable” amount established by the first six factors, this additional reduction in the rent increase constitutes a “taking.” This taking is impermissible because it does not serve the purpose of eliminating excessive rents—that objective has already been accomplished by considering the first six factors—instead, it serves only the purpose of providing assistance to “hardship tenants.” In short, appellants contend, the additional reduction of rent on grounds of hardship accomplishes a transfer of the landlord's property to individual hardship tenants; the Ordinance forces private individuals to shoulder the “public” burden of subsidizing their poor tenants' housing. As appellants point out, “[i]t is axiomatic that the Fifth Amendment's just compensation provision is ‘designed to bar Government from forcing some people alone to bear



public burdens which, in all fairness and justice, should be borne by the public as a whole.’ ” *First English Evangelical Lutheran Church of Glendale v. County of Los Angeles*, 482 U.S. 304, 318–319, 107 S.Ct. 2378, 2388, 96 L.Ed.2d 250 (1987) (quoting *Armstrong v. United States*, 364 U.S. 40, 49, 80 S.Ct. 1563, 1569, 4 L.Ed.2d 1554 (1960)).

[7] [8] We think it would be premature to consider this contention on the present record. As things stand, there simply is no evidence that the “tenant hardship clause” has in fact ever \*10 been relied upon by a hearing officer to reduce a rent below the figure it would have been set at on the basis of the other factors set forth in the Ordinance. In addition, there is nothing in the Ordinance requiring that a hearing officer in fact reduce a proposed rent increase on grounds of tenant hardship. Section 5703.29 does make it mandatory that hardship be considered—it states that “the Hearing Officer shall consider the economic hardship imposed on the present tenant”—but it then goes on to state that if “the proposed increase constitutes an unreasonably severe financial or economic hardship ... he may order that the excess of the increase” be disallowed. § 5703.29 (emphasis added). Given the “essentially ad hoc, factual inquir[y]” involved in the takings analysis, *Kaiser Aetna v. United States*, 444 U.S. 164, 175, 100 S.Ct. 383, 390, 62 L.Ed.2d 332 (1979), we have found it particularly important in takings cases to adhere to our admonition that “the constitutionality of statutes ought not be decided except in an actual factual setting that makes such a decision necessary.” *Hodel v. Virginia Surface Mining & Reclamation Assn., Inc.*, 452 U.S. 264, 294–295, 101 S.Ct. 2352, 2369–2370, 69 L.Ed.2d 1 (1981). In *Virginia Surface Mining*, for example, we found that a challenge to the Surface Mining Control and Reclamation Act of 1977, 91 Stat. 447, 30 U.S.C. § 1201 *et seq.*, was “premature,” \*\*857 452 U.S., at 296, n. 37, 101 S.Ct., at 2370, n. 37, and “not ripe for judicial resolution,” *id.*, at 297, 101 S.Ct., at 2371, because the property owners in that case had not identified any property that had allegedly been taken by the Act, nor had they sought administrative relief from the Act’s restrictions on surface mining. Similarly, in this case we find that the mere fact that a hearing officer is enjoined to consider hardship to the tenant in fixing a landlord’s rent, without any showing in a particular case as to the consequences of that injunction in the ultimate determination of the rent, does not present a sufficiently concrete factual setting for the adjudication of the takings claim appellants raise here. Cf. *CIO v. McAdory*, 325 U.S. 472, 475–476, 65 S.Ct. 1395, 1397, 89 L.Ed. 1741 (1945) (declining to consider the validity of a state statute

when the record did not \*11 show that the statute would ever be applied to any of the petitioner’s members).<sup>5</sup>

5 For this reason we also decline to address appellants’ contention that application of § 5703.28(c)(7) to reduce an otherwise reasonable rent increase on the basis of tenant hardship violates the Fourteenth Amendment’s due process and equal protection requirements. See *Hodel v. Indiana*, 452 U.S. 314, 335–336, 101 S.Ct. 2376, 2388–2389, 69 L.Ed.2d 40 (1981) (dismissing as “premature” a due process challenge to the civil penalty provision of the Surface Mining Act because “appellees have made no showing that they were ever assessed civil penalties under the Act, much less that the statutory prepayment requirement was ever applied to them or caused them any injury”). Appellants and several *amici* also argue that the Ordinance’s combination of lower rents for hardship tenants and restrictions on a landlord’s power to evict a tenant amounts to a physical taking of the landlord’s property. We decline to address this contention not only because it was raised for the first time in this Court, but also because it, too, is premised on a hearing officer’s actually granting a lower rent to a hardship tenant.

[9] [10] [11] [12] [13] [14] [15] [16] Appellants also urge that the mere provision in the Ordinance that a hearing officer may *consider* the hardship of the tenant in finally fixing a reasonable rent renders the Ordinance “facially invalid” under the Due Process and Equal Protection Clauses, even though no landlord ever has its rent diminished by as much as one dollar because of the application of this provision. The standard for determining whether a state price-control regulation is constitutional under the Due Process Clause is well established: “Price control is ‘unconstitutional ... if arbitrary, discriminatory, or demonstrably irrelevant to the policy the legislature is free to adopt....’ ” *Permian Basin Area Rate Cases*, 390 U.S. 747, 769–770, 88 S.Ct. 1344, 1361, 20 L.Ed.2d 312 (1968) (quoting *Nebbia v. New York*, 291 U.S. 502, 539, 54 S.Ct. 505, 517, 78 L.Ed. 940 (1934)). In other contexts we have recognized that the government may intervene in the marketplace to regulate rates or prices that are artificially inflated as a result of the existence of a monopoly or near monopoly, see, e.g., *FCC v. Florida Power Corp.*, 480 U.S. 245, 250–254, 107 S.Ct. 1107, 1111–1113, 94 L.Ed.2d 282 (1987) (approving limits on rates charged to cable companies

for access to telephone poles); *FPC v. Texaco Inc.*, 417 U.S. 380, 397–398, 94 S.Ct. 2315, 2326–2327, 41 L.Ed.2d 141 (1974) (recognizing that federal regulation of the natural gas market was in response to the threat of monopoly pricing), or a discrepancy between supply and demand in the market for a certain product, see, e.g., *Nebbia v. New York*, *supra*, 291 U.S., at 530, 538, 54 S.Ct., at 513, 516 (allowing a minimum price for milk to offset a “flood of surplus milk”). Accordingly, appellants do not dispute that the Ordinance’s asserted purpose of “prevent[ing] excessive and unreasonable rent increases” caused by the “growing shortage of and increasing demand for housing in the City of San Jose,” § 5701.2, is a legitimate exercise of appellees’ police powers.<sup>6</sup> Cf. *Block v. Hirsh*, 256 U.S. 135, 156, 41 S.Ct. 458, 459, 65 L.Ed. 865 (1921) (approving rent control in Washington, D.C., on the basis of Congress’ finding that housing in the city was “monopolized”). They do argue, however, that it is “arbitrary, discriminatory, or demonstrably irrelevant,” *Permian Basin Area Rate Cases*, *supra*, 390 U.S., at 769–770, 88 S.Ct. at 1361, for appellees to attempt to accomplish the additional goal of reducing the burden of housing costs on low-income tenants by requiring that “hardship to a tenant” be considered in determining the amount of excess rent increase that is “reasonable under the circumstances” pursuant to § 5703.28.<sup>7</sup> As appellants put it, “[t]he objective of alleviating individual tenant hardship is ... not a ‘policy the legislature is free to adopt’ in a rent control ordinance.” Reply Brief for Appellants 16.

<sup>6</sup> Appellants do not claim, as do some *amici*, that rent control is *per se* a taking. We stated in *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419, 102 S.Ct. 3164, 73 L.Ed.2d 868 (1982), that we have “consistently affirmed that States have broad power to regulate housing conditions in general and the landlord-tenant relationship in particular without paying compensation for all economic injuries that such regulation entails.” *Id.*, at 440, 102 S.Ct., at 3178 (citing, *inter alia*, *Bowles v. Willingham*, 321 U.S. 503, 517–518, 64 S.Ct. 641, 648–649, 88 L.Ed. 892 (1944)). And in *FCC v. Florida Power Corp.*, 480 U.S. 245, 107 S.Ct. 1107, 94 L.Ed.2d 282 (1987), we stated that “statutes regulating the economic relations of landlords and tenants are not *per se* takings.” *Id.*, at 252, 107 S.Ct., at 1112. Despite *amici*’s urgings, we see no need to reconsider the constitutionality of rent control *per se*.

<sup>7</sup> As we noted above, see n. 5, *supra*, to the extent that appellants’ due process argument is based on the claim that the Ordinance forces landlords to subsidize individual tenants, that claim is premature and not presented by the facts before us.

<sup>13</sup> We reject this contention, however, because we have long recognized that a legitimate and rational goal of price or rate regulation is the protection of consumer welfare. See, e.g., *Permian Basin Area Rate Cases*, *supra*, 390 U.S., at 770, 88 S.Ct., at 1361; *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 610–612, 64 S.Ct. 281, 291–292, 88 L.Ed. 333 (1944) (“The primary aim of [the Natural Gas Act] was to protect consumers against exploitation at the hands of natural gas companies”). Indeed, a primary purpose of rent control is the protection of tenants. See, e.g., *Bowles v. Willingham*, 321 U.S. 503, 513, n. 9, 64 S.Ct. 641, 646, n. 9, 88 L.Ed. 892 (1944) (one purpose of rent control is “to protect persons with relatively fixed and limited incomes, consumers, wage earners ... from undue impairment of their standard of living”). Here, the Ordinance establishes a scheme in which a hearing officer considers a number of factors in determining the reasonableness of a proposed rent increase which exceeds eight percent *and* which exceeds the amount deemed reasonable under either § 5703.28(a) or § 5703.28(b). The first six factors of § 5703.28(c) focus on the individual landlord—the hearing officer examines the history of the premises, the landlord’s costs, and the market for comparable housing. Section 5703.28(c)(5) also allows the landlord to bring forth any other financial evidence—including presumably evidence regarding his own financial status—to be taken into account by the hearing officer. It is in only this context that the Ordinance allows tenant hardship to be considered and, under § 5703.29, “balance[d]” with the other factors set out in § 5703.28(c). Within this scheme, § 5703.28(c) represents a rational attempt to accommodate the conflicting interests of protecting tenants from burdensome rent increases while at the same time ensuring that landlords are guaranteed a fair return on their investment. Cf. *Bowles v. Willingham*, *supra*, at 517, 64 S.Ct., at 648 (considering, but rejecting, the contention that rent control must be established “landlord by landlord, as in the fashion of utility rates”). We accordingly find that the Ordinance, which so carefully considers both the individual circumstances of the landlord and <sup>14</sup> the tenant before determining whether to allow an *additional* increase in rent over and above certain amounts that are deemed reasonable, does not on its face violate the Fourteenth Amendment’s Due Process Clause.<sup>8</sup>

8 The consideration of tenant hardship also serves the additional purpose, not stated on the face of the Ordinance, of reducing the costs of dislocation that might otherwise result if landlords were to charge rents to tenants that they could not afford. Particularly during a housing shortage, the social costs of the dislocation of low-income tenants can be severe. By allowing tenant hardship to be considered under § 5703.28(c), the Ordinance enables appellees to “fine tune” their rent control to take into account the risk that a particular tenant will be forced to relocate as a result of a proposed rent increase.

**\*\*859** [17] [18] [19] We also find that the Ordinance does not violate the Amendment's Equal Protection Clause. Here again, the standard is deferential; appellees need only show that the classification scheme embodied in the Ordinance is “rationally related to a legitimate state interest.” *New Orleans v. Dukes*, 427 U.S. 297, 303, 96 S.Ct. 2513, 2517, 49 L.Ed.2d 511 (1976). As we stated in *Vance v. Bradley*, 440 U.S. 93, 99 S.Ct. 939, 59 L.Ed.2d 171 (1979), “we will not overturn [a statute that does not burden a suspect class or a fundamental interest] unless the varying treatment of different groups or persons is so unrelated to the achievement of any combination of legitimate purposes that we can only conclude that the legislature's actions were irrational.” *Id.*, at 97, 99 S.Ct., at 943. In light of our conclusion above that the Ordinance's tenant hardship provisions are designed to serve the legitimate purpose of protecting tenants, we can hardly conclude that it is irrational for the Ordinance to treat certain landlords differently on the basis of whether or not they have hardship tenants. The Ordinance distinguishes between landlords because doing so furthers the purpose of ensuring that individual tenants do not suffer “unreasonable” hardship; it would be inconsistent to state that hardship is a legitimate factor to be considered but then hold that appellees could not tailor the Ordinance so that only legitimate hardship cases are redressed. Cf. *Woods v. Cloyd W. Miller Co.*, 333 U.S. 138, 145, 68 S.Ct. 421, 425, 92 L.Ed. 596 (1948) **\*15** Congress “need not control all rents or none. It can select those areas or those classes of property where the need seems the greatest”). We recognize, as appellants point out, that in general it is difficult to say that the landlord “causes” the tenant's hardship. But this is beside the point—if a landlord does have a hardship tenant, regardless of the reason why, it is rational for appellees to take that fact into consideration under § 5703.28 of the

Ordinance when establishing a rent that is “reasonable under the circumstances.”

For the foregoing reasons, we hold that it is premature to consider appellants' claim under the Takings Clause and we reject their facial challenge to the Ordinance under the Due Process and Equal Protection Clauses of the Fourteenth Amendment. The judgment of the Supreme Court of California is accordingly

*Affirmed.*

Justice KENNEDY took no part in the consideration or decision of this case.

Justice SCALIA, with whom Justice O'CONNOR joins, concurring in part and dissenting in part.

I agree that the tenant hardship provision of the Ordinance does not, on its face, violate either the Due Process Clause or the Equal Protection Clause of the Fourteenth Amendment. I disagree, however, with the Court's conclusion that appellants' takings claim is premature. I would decide that claim on the merits, and would hold that the tenant hardship provision of the Ordinance effects a taking of private property without just compensation in violation of the Fifth and Fourteenth Amendments.

I

Appellants contend that any application of the tenant hardship provision of the San Jose Ordinance would effect an uncompensated taking of private property because that provision does not substantially advance legitimate state interests and because it improperly imposes a public burden on individual **\*16** landlords. I can understand how such a claim—that a law applicable to the plaintiffs is, root and branch, invalid—can be readily rejected on the merits, **\*\*860** by merely noting that at least some of its applications may be lawful. But I do not understand how such a claim can possibly be avoided by considering it “premature.” Suppose, for example, that the feature of the rental ordinance under attack was a provision allowing a hearing officer to consider the race of the apartment owner in deciding whether to allow a rent increase. It is inconceivable that we would say judicial challenge must await demonstration that this provision has actually been applied to the detriment of one of the plaintiffs.

There is no difference, it seems to me, when the facial, root-and-branch challenge rests upon the Takings Clause rather than the Equal Protection Clause.

The Court confuses the issue by relying on cases, and portions of cases, in which the Takings Clause challenge was not (as here) that the law in all its applications took property without just compensation, but was rather that the law's application in regulating the use of particular property so severely reduced the value of that property as to constitute a taking. It is in *that* context, and not (as the Court suggests) generally, that takings analysis involves an “essentially ad hoc, factual inquir[y],” *Kaiser Aetna v. United States*, 444 U.S. 164, 175, 100 S.Ct. 383, 390, 62 L.Ed.2d 332 (1979). We said as much less than a year ago, and it is surprising that we have so soon forgotten:

“In addressing petitioners' claim we must not disregard the posture in which this case comes before us. The District Court granted summary judgment to respondents only on the facial challenge to the Subsidence Act. The court explained that ‘... *the only question before this court is whether the mere enactment of the statutes and regulations constitutes a taking.*’ ...

“The posture of the case is critical because we have recognized an important distinction between a claim that the mere enactment of a statute constitutes a taking and \*17 a claim that the particular impact of government action on a specific piece of property requires the payment of just compensation. This point is illustrated by our decision in *Hodel v. Virginia Surface Mining & Reclamation Assn., Inc.*, 452 U.S. 264 [101 S.Ct. 2352, 69 L.Ed.2d 1] (1981), in which we rejected a preenforcement challenge to the constitutionality of the Surface Mining Control and Reclamation Act of 1977.... The Court [there] explained:

“ ‘Because appellees’ taking claim arose in the context of a facial challenge, it presented no concrete controversy concerning either application of the Act to particular surface mining operations or its effect on specific parcels of land. Thus, the only issue properly before the District Court and, in turn, this Court, is whether the “mere enactment” of the Surface Mining Act constitutes a taking.... The test to be applied in considering this facial challenge is straightforward. A statute regulating the uses that can be made of property effects a taking if it “denies an owner economically viable use of his land.” ...’

“Petitioners thus face an uphill battle in making a facial attack on the Act as a taking.” *Keystone Bituminous Coal Assn. v. DeBenedictis*, 480 U.S. 470, 493–495, 107 S.Ct. 1232, 1246–1247, 94 L.Ed.2d 472 (1987).

While the battle was “uphill” in *Keystone*, we allowed it to be fought, and did not declare it “premature.”

The same was true of the facial takings challenge in *Hodel v. Virginia Surface Mining & Reclamation Assn., Inc.*, *supra*. It is remarkable that the Court should point to that case in support of its position, describing the holding as follows:

“In *Virginia Surface Mining*, for example, we found that a challenge to the Surface Mining Control and Reclamation Act ... was ‘premature,’ ... and ‘not ripe for judicial \*18 resolution,’ ... because the property owners in that case had not identified any property that had allegedly been taken by the Act, nor had they sought administrative relief from the \*\*861 Act's restrictions on surface mining.” *Ante*, at 856–857.

But this holding in *Virginia Surface Mining* applied only to “the taking issue decided by the District Court,” 452 U.S., at 297, 101 S.Ct., at 2371, which was the issue of the statute's validity *as applied*. Having rejected that challenge as premature, the Court then continued (in the language we quoted in *Keystone*):

“Thus, the only issue properly before the District Court and, in turn, this Court, is whether the ‘mere enactment’ of the Surface Mining Act constitutes a taking.” 452 U.S., at 295, 101 S.Ct., at 2370.

That issue was *not* rejected as premature, but was decided on its merits, *id.*, at 295–297, 101 S.Ct., at 2370–2371, just as it was in *Keystone*, and as it was before that in *Agins v. Tiburon*, 447 U.S. 255, 260–263, 100 S.Ct. 2138, 2141–2142, 65 L.Ed.2d 106 (1980).

In sum, it is entirely clear from our cases that a facial takings challenge is not premature even if it rests upon the ground that the ordinance deprives property owners of all economically viable use of their land—a ground that is, as we have said, easier to establish in an “as-applied” attack. It is, if possible, even more clear that the present facial challenge is not premature, because it does not rest upon a ground that would even profit from consideration in the context of particular application. As we said in *Agins*, a zoning law “effects a taking if the ordinance does not



substantially advance legitimate state interests, ... or denies an owner economically viable use of his land.” *Id.*, at 260, 100 S.Ct., at 2141. The present challenge is of the former sort. Appellants contend that providing financial assistance to impecunious renters is not a state interest that can legitimately be furthered by regulating the use of property. Knowing the nature and character of the \*19 particular property in question, or the degree of its economic impairment, will in no way assist this inquiry. Such factors are as irrelevant to the present claim as we have said they are to the claim that a law effects a taking by authorizing a permanent physical invasion of property. See *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419, 102 S.Ct. 3164, 73 L.Ed.2d 868 (1982). So even if we were explicitly to overrule cases such as *Agins*, *Virginia Surface Mining*, and *Keystone*, and to hold that a facial challenge will not lie where the issue can be more forcefully presented in an “as-applied” attack, there would still be no reason why the present challenge should not proceed.

Today's holding has no more basis in equity than it does in precedent. Since the San Jose Ordinance does not require any specification of how much reduction in rent is attributable to each of the various factors that the hearing officer is allowed to take into account, it is quite possible that none of the many landlords affected by the Ordinance will ever be able to meet the Court's requirement of a “showing in a particular case as to the consequences of [the hardship factor] in the ultimate determination of the rent.” *Ante*, at 857. There is no reason thus to shield alleged constitutional injustice from judicial scrutiny. I would therefore consider appellants' takings claim on the merits.

## II

The Fifth Amendment of the United States Constitution, made applicable to the States through the Fourteenth Amendment, *Chicago, B. & Q.R. Co. v. Chicago*, 166 U.S. 226, 239, 17 S.Ct. 581, 585, 41 L.Ed. 979 (1897), provides that “private property [shall not] be taken for public use, without just compensation.” We have repeatedly observed that the purpose of this provision is “to bar Government from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole.” *Armstrong v. United States*, 364 U.S. 40, 49, 80 S.Ct. 1563, 1569, 4 L.Ed.2d 1554 (1960); see also \*20 \*\*862 *First English Evangelical Lutheran Church of Glendale v. Los Angeles County*, 482 U.S. 304, 318–319, 107 S.Ct. 2378, 2388, 96

L.Ed.2d 250 (1987); *Webb's Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. 155, 163, 101 S.Ct. 446, 452, 66 L.Ed.2d 358 (1980); *Agins v. Tiburon*, *supra*, 447 U.S., at 260, 100 S.Ct. at 2141; *Penn Central Transportation Co. v. New York City*, 438 U.S. 104, 123, 98 S.Ct. 2646, 2658, 57 L.Ed.2d 631 (1978); *Monongahela Navigation Co. v. United States*, 148 U.S. 312, 325, 13 S.Ct. 622, 625, 37 L.Ed. 463 (1893).

Traditional land-use regulation (short of that which totally destroys the economic value of property) does not violate this principle because there is a cause-and-effect relationship between the property use restricted by the regulation and the social evil that the regulation seeks to remedy. Since the owner's use of the property is (or, but for the regulation, would be) the source of the social problem, it cannot be said that he has been singled out unfairly. Thus, the common zoning regulations requiring subdividers to observe lot-size and set-back restrictions, and to dedicate certain areas to public streets, are in accord with our constitutional traditions because the proposed property use would otherwise be the cause of excessive congestion. The same cause-and-effect relationship is popularly thought to justify emergency price regulation: When commodities have been priced at a level that produces exorbitant returns, the owners of those commodities can be viewed as responsible for the economic hardship that occurs. Whether or not that is an accurate perception of the way a free-market economy operates, it is at least true that the owners reap unique benefits from the situation that produces the economic hardship, and in that respect singling them out to relieve it may not be regarded as “unfair.” That justification might apply to the rent regulation in the present case, apart from the single feature under attack here.

Appellants do not contest the validity of rent regulation in general. They acknowledge that the city may constitutionally set a “reasonable rent” according to the statutory minimum and the six other factors that must be considered by the hearing officer (cost of debt servicing, rental history of the unit, physical condition of the unit, changes in housing services, other \*21 financial information provided by the landlord, and market value rents for similar units). San Jose Municipal Ordinance 19696, § 5703.28(c) (1979). Appellants' only claim is that a reduction of a rent increase below what would otherwise be a “reasonable rent” under this scheme may not, consistently with the Constitution, be based on consideration of the seventh factor—the hardship to the tenant as defined in § 5703.29. I think they are right.

Once the other six factors of the Ordinance have been applied to a landlord's property, so that he is receiving only a reasonable return, he can no longer be regarded as a "cause" of exorbitantly priced housing; nor is he any longer reaping distinctively high profits from the housing shortage. The seventh factor, the "hardship" provision, is invoked to meet a quite different social problem: the existence of some renters who are too poor to afford even reasonably priced housing. But *that* problem is no more caused or exploited by landlords than it is by the grocers who sell needy renters their food, or the department stores that sell them their clothes, or the employers who pay them their wages, or the citizens of San Jose holding the higher paying jobs from which they are excluded. And even if the neediness of renters could be regarded as a problem distinctively attributable to landlords in general, it is not remotely attributable to the *particular* landlords that the Ordinance singles out—namely, those who happen to have a "hardship" tenant at the present time, or who may happen to rent to a "hardship" tenant in the future, or whose current or future affluent tenants may happen to decline into the "hardship" category.

The traditional manner in which American government has met the problem of those who cannot pay reasonable prices for **\*\*863** privately sold necessities—a problem caused by the society at large—has been the distribution to such persons of funds raised from the public at large through taxes, either in cash (welfare payments) or in goods (public housing, publicly subsidized housing, and food stamps). Unless we are to **\*22** abandon the guiding principle of the Takings Clause that "public burdens ... should be borne by the public as a whole," *Armstrong*, 364 U.S., at 49, 80 S.Ct., at 1569, this is the only manner that our Constitution permits. The fact that government acts through the landlord-tenant relationship does not magically transform general public welfare, which must be supported by all the public, into mere "economic regulation," which can disproportionately burden particular individuals. Here the city is not "regulating" rents in the relevant sense of preventing rents that are excessive; rather, it is using the occasion of rent regulation (accomplished by the rest of the Ordinance) to establish a welfare program privately funded by those landlords who happen to have "hardship" tenants.

Of course all economic regulation effects wealth transfer. When excessive rents are forbidden, for example, landlords as a class become poorer and tenants as a class (or at least incumbent tenants as a class) become richer. Singling out landlords to be the transferors may be within our traditional

constitutional notions of fairness, because they can plausibly be regarded as the source or the beneficiary of the high-rent problem. Once such a connection is no longer required, however, there is no end to the social transformations that can be accomplished by so-called "regulation," at great expense to the democratic process.

The politically attractive feature of regulation is not that it permits wealth transfers to be achieved that could not be achieved otherwise; but rather that it permits them to be achieved "off budget," with relative invisibility and thus relative immunity from normal democratic processes. San Jose might, for example, have accomplished something like the result here by simply raising the real estate tax upon rental properties and using the additional revenues thus acquired to pay part of the rents of "hardship" tenants. It seems to me doubtful, however, whether the citizens of San Jose would allow funds in the municipal treasury, from wherever derived, to be distributed to a family of four with income as **\*23** high as \$32,400 a year—the generous maximum necessary to qualify automatically as a "hardship" tenant under the rental Ordinance.\* The voters might well see other, more pressing, social priorities. And of course what \$32,400-a-year renters can acquire through spurious "regulation," other groups can acquire as well. Once the door is opened it is not unreasonable to expect price regulations requiring private businesses to give special discounts to senior citizens (no matter how affluent), or to students, the handicapped, or war veterans. Subsidies for these groups may well be a good idea, but because of the operation of the Takings Clause our governmental system has required them to be applied, in general, through the process of taxing and spending, where both economic effects and competing priorities are more evident.

\* Under the San Jose Ordinance, "hardship" tenants include (though are not limited to) those whose "household income and monthly housing expense meets [*sic*] the criteria" for assistance under the existing housing provisions of § 8 of the Housing and Community Development Act of 1974, **42 U.S.C. § 1437f** (1982 ed. and Supp. III). The United States Department of Housing and Urban Development currently limits assistance under these provisions for families of four in the San Jose area to those who earn \$32,400 or less per year. Memorandum from U.S. Dept. of Housing and Urban Development, Assistant Secretary for Housing-Federal Housing Comm'r, Income Limits

for Lower Income and Very Low-Income Families  
Under the Housing Act of 1937 (Jan. 15, 1988).

That fostering of an intelligent democratic process is one of the happy effects of the constitutional prescription—perhaps accidental, perhaps not. Its essence, however, is simply the unfairness of making one **\*\*864** citizen pay, in some fashion other than taxes, to remedy a social problem that is none of his creation. As the Supreme Court of New Jersey said in finding unconstitutional a scheme displaying, among other defects, the same vice I find dispositive here:

“A legislative category of economically needy senior citizens is sound, proper and sustainable as a rational classification. But compelled subsidization by landlords

**\*24** or by tenants who happen to live in an apartment building with senior citizens is an improper and unconstitutional method of solving the problem.” *Property Owners Assn. v. North Bergen*, 74 N.J. 327, 339, 378 A.2d 25, 31 (1977).

I would hold that the seventh factor in § 5703.28(c) of the San Jose Ordinance effects a taking of property without just compensation.

**All Citations**

485 U.S. 1, 108 S.Ct. 849, 99 L.Ed.2d 1, 56 USLW 4168

**LEGAL AUTHORITY CA-45**



581 B.R. 452

United States Bankruptcy Court, D. Maryland,  
at Baltimore.

IN RE: Byung Mook CHO, Debtor.

In re The New Belvedere Cleaners, Inc., Debtor.

Case No. 17-22057-MMH,

Case No. 17-22058-MMH

|

Signed March 13, 2018

**Synopsis**

**Background:** Chapter 11 debtors that owned and operated dry cleaning business filed motion to reject executory contract, namely, a prepetition settlement agreement reached in state court suit brought by former owners of the business asserting claims against debtors for, inter alia, fraud and fraudulent conveyance, which debtors had refused to sign. Former owners objected.

**Holdings:** The Bankruptcy Court, [Michelle M. Harner, J.](#), held that:

[1] under Maryland law, state court's oral ruling requiring debtors to execute oral settlement agreement was not a final judgment for purposes of res judicata or issue preclusion;

[2] under Maryland law, parties' oral settlement agreement was a valid and enforceable contract; and

[3] agreement was an executory contract subject to rejection in the debtors' Chapter 11 cases.

Motion granted.

West Headnotes (14)

[1] **Bankruptcy** 🔑 Assumption, Rejection, or Assignment

Debtor may reject an executory contract if it is advantageous to the debtor to do so. 11 U.S.C.A. § 365(a).

[2] **Bankruptcy** 🔑 Grounds for and Objections to Assumption, Rejection, or Assignment

Debtor in possession or trustee must show that proposed rejection of executory contract or unexpired lease provides a benefit to, or eliminates burdensome obligations on, the estate. 11 U.S.C.A. § 365(a).

[3] **Bankruptcy** 🔑 "Business judgment" test in general

Courts generally refrain from second-guessing a debtor in possession's business judgment regarding a proposed assumption or rejection of an executory contract or unexpired lease. 11 U.S.C.A. § 365(a).

[4] **Judgment** 🔑 Nature and requisites of former recovery as bar in general

Under Maryland law, the elements of res judicata, or claim preclusion, are: (1) parties in the present litigation are the same or in privity with the parties to the earlier dispute; (2) claim presented in the current action is identical to the one determined in the prior adjudication; and (3) there has been a final judgment on the merits.

[5] **Judgment** 🔑 Finality of Determination

**Judgment** 🔑 Nature and elements of bar or estoppel by former adjudication

Under Maryland law, if a final judgment exists as to a controversy between parties, those parties and their privies are barred under doctrine of res judicata from relitigating any claim upon which the judgment is based.

[6] **Judgment** 🔑 Nature and requisites of former adjudication as ground of estoppel in general

Maryland law recognizes issue preclusion when an issue of fact or law is actually litigated and determined by a valid and final judgment, and the determination is essential to the judgment, the determination is conclusive in a subsequent

action between the parties, whether on the same or a different claim.

[7] **Judgment** 🔑 [Finality of determination](#)

Under Maryland law, state court's oral ruling requiring Chapter 11 debtors that owned and operated dry cleaning business to execute oral settlement agreement reached with former owners of the business in suit brought by former owners asserting claims against debtors for, inter alia, fraud and fraudulent conveyance was not a final judgment for purposes of res judicata or issue preclusion.

[8] **Compromise, Settlement, and Release** 🔑 [Finance, banking, and credit](#)

Under Maryland law, oral settlement agreement reached between Chapter 11 debtors that owned and operated dry cleaning business and former owners in state court suit brought by former owners of the business asserting claims against debtors for, inter alia, fraud and fraudulent conveyance was a valid and enforceable contract; debtor acknowledged the agreement under oath in state court.

[9] **Bankruptcy** 🔑 [Executory nature in general](#)

Contract is executory that debtor may reject if the obligations of both debtor and the other party to the contract are so far unperformed that the failure of either to complete the performance would constitute a material breach excusing the performance of the other. 11 U.S.C.A. § 365.

[10] **Contracts** 🔑 [Discharge of contract by breach](#)

Under Maryland law, although any breach of contract may give rise to a cause of action for damages, only a material breach discharges the non-breaching party of its duty to perform.

[11] **Contracts** 🔑 [Effect of breach in general](#)

Under Maryland law, a breach of contract is material if it affects the purpose of the contract in an important or vital way.

[12] **Bankruptcy** 🔑 [Executory nature in general](#)

Oral settlement agreement reached between Chapter 11 debtors that owned and operated dry cleaning business and former owners in state court suit brought by former owners of the business asserting claims against debtors for, inter alia, fraud and fraudulent conveyance, which debtors had refused to sign, was an executory contract subject to rejection in the debtors' Chapter 11 cases; core purpose of the agreement was to resolve the pending legal disputes between the parties, providing certainty and finality to each affected party, and in exchange for the transfer of a certain business and a cash payment, the parties agreed to dismiss the litigation between them. 11 U.S.C.A. § 365(a).

[13] **Bankruptcy** 🔑 [Protection Against Discrimination or Collection Efforts in General; "Fresh Start."](#)

The protections of the Bankruptcy Code are reserved for the honest but unfortunate debtor.

[14] **Bankruptcy** 🔑 [Protection Against Discrimination or Collection Efforts in General; "Fresh Start."](#)

In administering bankruptcy cases, courts should be concerned with ensuring that perpetrators of fraud are not allowed to hide behind the skirts of the Bankruptcy Code.

### Attorneys and Law Firms

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## MEMORANDUM OPINION

MICHELLE M. HARNER, U.S. BANKRUPTCY JUDGE

A debtor in possession may assume or reject an executory contract in a chapter 11 case.<sup>1</sup> The U.S. Bankruptcy Code<sup>2</sup> does not define the term “executory contract,” and courts often struggle to determine executoryness under applicable case law. The dispute before the Court is no exception—the primary issue concerns the characterization of a prepetition settlement agreement as an executory contract, and the parties vehemently disagree regarding its executoryness. Although the Debtors dispute in the first instance that they are bound by the settlement agreement, the record suggests otherwise, requiring the Court to determine whether the Debtors may reject the settlement agreement as an executory contract under section 365 of the Code.

<sup>1</sup> A debtor in possession, as the Plaintiff in this adversary proceeding, possesses powers similar to the bankruptcy trustee under [section 1107 of the Bankruptcy Code](#). 11 U.S.C. § 1107.

<sup>2</sup> 11 U.S.C. §§ 101, et seq. (the “Code”).

Whether a contract is executory depends on the facts of the particular matter, the language of the subject agreement, and the consequences under applicable nonbankruptcy law of either party ceasing to perform any ongoing or remaining obligations under the contract. Here, the core purpose of the settlement agreement was to resolve the pending legal disputes between the parties, providing certainty and finality to each affected party. In exchange for the transfer of a certain business and a cash payment, the parties agreed to dismiss the litigation between them; the non-debtor parties agreed to dismiss, and to take certain other action in, related litigation involving a third party; and the parties agreed to refrain from disparaging each other and their respective businesses. \*455 Considering the totality of the circumstances and the core purpose of the settlement agreement, the Court determines that the settlement agreement is an executory contract and subject to rejection in the Debtors' chapter 11 cases. Notably, because the Debtors are seeking rejection, which simply constitutes a prepetition breach of the settlement agreement under section 365(g) of the Code, the parties' respective rights may not differ significantly from those available if the Court had found the prepetition settlement agreement to be non-executory and the Debtors refused to perform. This question

is not, however, currently before the Court. Accordingly, for the reasons set forth below, the Court will grant the Motion and reserve judgment on the consequences of the Debtors' rejection of the settlement agreement.

### **I. Relevant Background**

Prior to the petition date in these chapter 11 cases, on or about December 28, 2015, Chong Ok Lim and Young Jun Jun (the “Plaintiffs”) filed a lawsuit against Byung Mook Cho and The New Belvedere Cleaners, Inc. (“New Belvedere” and collectively with Mr. Cho, the “Debtors”), the above-captioned debtors and debtors in possession, in the Circuit Court for Howard County, Maryland (the “State Court Action”). The State Court Action involved, among other things, allegations of fraud and fraudulent conveyance relating to the business of New Belvedere. November Hearing Transcript at 10, 14–16. On or about April 13, 2017, the Debtors and the Plaintiffs participated in a settlement conference before the Honorable Lynne Battaglia. That conference resulted in an oral settlement agreement that purported to resolve the pending disputes between the parties and that was subsequently memorialized in a written document (the “Settlement Agreement”). Pl. Ex. 8.

Mr. Cho would not sign the Settlement Agreement. Consequently, the Plaintiffs filed a Motion to Enforce Settlement Agreement (the “Motion to Enforce”) in the state court. Pl. Ex. 1. The Honorable Dennis Sweeney conducted a hearing on the Motion to Enforce on June 29, 2017 (the “State Court Hearing”). At the State Court Hearing, the Plaintiffs requested an order enforcing the Settlement Agreement, and the Defendants argued that they should not be bound by, or required to sign, the Settlement Agreement. The parties presented evidence to support their respective positions. Judge Sweeney ultimately determined to enforce the Settlement Agreement. Pl. Ex. 2 at 19.

Mr. Cho still did not sign the Settlement Agreement. Accordingly, on July 24, 2017, the Plaintiffs filed a Petition for Show Cause for Constructive Civil Contempt (“Show Cause Petition”). Pl. Ex. 3. A hearing on the Show Cause Petition was set for September 12, 2017. That hearing did not go forward; it was stayed as a result of the filing of the Debtors' chapter 11 petitions on September 8, 2017.

Shortly after filing these cases, on September 13, 2017, each of the Debtors filed a Motion Pursuant to [11 U.S.C. § 365](#) to Reject Executory Contract (collectively, the “Motion”) [ECF 15 in Case No. 17–22057; ECF 12 in Case No. 17–22058].

By the Motion, the Debtors seek to reject the Settlement Agreement. The Plaintiffs filed an Objection to the Motion in each of these cases (collectively, the “Objection”) [ECF 22 in Case No. 17–22057; ECF 14 in Case No. 17–22058].<sup>3</sup> The Court held a hearing on the Motion on November 21, 2017 (the \*456 “November Hearing”). The parties then submitted post-hearing briefs in December 2017 [ECF 45, 46], and offered closing arguments at a hearing before the Court on January 18, 2018 (the “January Hearing”).

<sup>3</sup> Subsequent to these separate filings, the Court entered an Order Providing for Joint Administration of Cases 17–22057 and 17–22058 [ECF 16; amended at ECF 17].

## II. Jurisdiction and Legal Standards

The Court has jurisdiction over this proceeding pursuant to 28 U.S.C. § 1334, 28 U.S.C. § 157(a), and Local Rule 402 of the United States District Court for the District of Maryland. This proceeding is a “core proceeding” under 28 U.S.C. § 157(b) (2).

[1] [2] Section 365(a) of the Code provides that a trustee or debtor in possession, “subject to the court’s approval, may assume or reject any executory contract or unexpired lease of the debtor.” 11 U.S.C. § 365(a). “A debtor may reject an executory contract if it is advantageous to the debtor to do so.” *In re Auto Showcase of Laurel, LLC*, 2011 WL 4054839, at \*5 (Bankr. D. Md. Sept. 12, 2011) (citing *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043, 1046 (4th Cir. 1985)). Thus, a debtor in possession or the trustee must show that the proposed rejection of the executory contract or unexpired lease provides a benefit to, or eliminates burdensome obligations on, the estate. *See, e.g., In re Alpha Natural Resources, Inc.*, 555 B.R. 520, 530 (Bankr. E.D. Va. 2016).

[3] A debtor in possession’s decision to assume or reject an executory contract or unexpired lease is subject to a business judgment standard, and “should be ‘accorded the deference mandated by the sound business judgment rule as generally applied by courts to discretionary actions or decisions of corporate directors.’” *Alpha Natural Resources*, 555 B.R. at 529–530 (quoting *Lubrizol*, 756 F.2d at 1046). Courts generally refrain from second-guessing a debtor in possession’s business judgment regarding a proposed assumption or rejection of an executory contract or unexpired lease. *See, e.g., Alpha Natural Resources*, 555 B.R. at 530 (noting deference by courts to a debtor in possession’s

business judgment “unless there is a showing of bad faith or gross abuse of discretion”). The rejection of an executory contract or unexpired lease that was not previously assumed in the case “constitutes a breach of such contract or lease ... immediately before the date of the filing of the petition.” 11 U.S.C. § 365(g)(1).

## III. Analysis

The Debtors argue that they never signed the Settlement Agreement and that, even if they are bound by it, the Settlement Agreement is “onerous and burdensome” on their estates. Motion at 2. They also allege that the terms of the agreement cannot be completed as drafted. *Id.* Accordingly, the Debtors seek a determination that the Settlement Agreement either is not a contract, or that it is an executory contract subject to rejection under section 365 of the Code. The Plaintiffs, on the other hand, assert that the Settlement Agreement is enforceable and is not an executory contract for purposes of the Code. The Court considers each of the parties’ respective arguments below.

### A. The Existence of the Settlement Agreement

The Debtors and the Plaintiffs have been involved in litigation for several years. The genesis of this litigation appears to be a dry-cleaning business once owned by the Plaintiffs and now owned and operated by the Debtors. The Plaintiffs allege fraud and fraudulent conveyance claims against the Debtors with respect to the events leading up to the \*457 Debtors’ ownership of the business. Specifically, the Plaintiffs allege that, after they obtained a judgment against Hee Sook Paik, Ms. Paik and Mr. Cho “conspired to fraudulently convey the business” to Mr. Cho. Pl. Post–Hearing Brief [ECF 45] at 16. Mr. Cho denies these allegations. The Settlement Agreement purports to resolve those claims and the related disputes among the parties concerning the dry-cleaning business. Settlement Agreement, Pl. Ex. 8 ¶ E.

At the State Court Hearing to enforce the Settlement Agreement, the issue before the state court was whether Mr. Cho should be compelled to execute the Settlement Agreement. Judge Sweeney accepted evidence on this issue. Mr. Cho did not deny the existence of the Settlement Agreement. Pl. Ex. 2 at 10. Rather, Mr. Cho testified that, at some point after the parties’ settlement conference, the Plaintiffs allegedly violated the non-disparagement provision of the Settlement Agreement, which upset Mr. Cho and

caused him to change his mind as to the prudence of the Settlement Agreement. *Id.* at 11–14. As such, Mr. Cho did not execute the agreement or take any action under it. *Id.* Judge Sweeney ultimately concluded, based on the evidence presented, that “the settlement agreement should be enforced and that the testimony supports that this was the agreement that was reached.” *Id.* at 19. Judge Sweeney then stated, “The Court finds that to be the case and the Court will require the parties execute the agreement within seven days of today’s date.” *Id.*

[4] [5] [6] The parties dispute the impact of Judge Sweeney’s oral ruling during the State Court Hearing on this Court’s evaluation of the Settlement Agreement. The United States Court of Appeals for the Fourth Circuit has instructed that “the full faith and credit statute requires a federal court to apply state res judicata law in determining the preclusive effect of a state court judgment.” *Meindl v. Genesys Pac. Tech., Inc. (In re Genesys Data Tech., Inc.)*, 204 F.3d 124, 129 (4th Cir. 2000) (citations omitted). *See also Shirazi v. Peninsula Internal Medicine, LLC*, 2010 WL 5173028, at \*2 (citing *Meindl* for same proposition). The res judicata doctrine typically encompasses two separate, but related concepts—that of claim preclusion and issue preclusion. “Under Maryland law, the elements of res judicata, or claim preclusion, are: (1) that the parties in the present litigation are the same or in privity with the parties to the earlier dispute; (2) that the claim presented in the current action is identical to the one determined in the prior adjudication; and, (3) that there has been a final judgment on the merits. ... If a final judgment exists as to a controversy between parties, those parties and their privies are barred from relitigating any claim upon which the judgment is based.” *Anne Arundel Cty. Bd. of Educ. v. Norville*, 390 Md. 93, 887 A.2d 1029, 1037 (2005) (citations omitted). In addition, Maryland law recognizes issue preclusion “when an issue of fact or law is actually litigated and determined by a valid and final judgment, and the determination is essential to the judgment, the determination is conclusive in a subsequent action between the parties, whether on the same or a different claim.” *Janes v. State*, 350 Md. 284, 711 A.2d 1319, 1324 (1998).

[7] Judge Sweeney’s oral ruling concerning the existence of the Settlement Agreement and the Debtors’ obligation to execute that agreement constitutes a decision on an issue of fact that was actually litigated by the parties. Judge Sweeney held an evidentiary issue on that precise issue, he made factual determinations based on the evidence, and both parties had an opportunity to litigate fully on that \*458 issue. The oral

ruling was not, however, incorporated into a final judgment or otherwise noted as a judgment, final or otherwise, on the docket. Pl. Ex. 9. *See also, e.g., Md. Rule 2–601; Scarborough v. Altstatt*, 228 Md.App. 560, 140 A.3d 497, 501 (2016) (explaining requirements for final judgment under Maryland law). Thus, Judge Sweeney’s oral ruling does not technically satisfy all of the required elements of claim or issue preclusion under Maryland law. *See, e.g., Snavely v. Miller (In re Miller)*, 397 F.3d 726, 729 (9th Cir. 2005) (holding that, under Washington law, a state court’s oral ruling that was not yet incorporated into final judgment was not a final judgment for purposes of res judicata and issue preclusion). The Court is unwilling, however, to ignore Judge Sweeney’s ruling on the precise issue before it. Accordingly, the Court considers Judge Sweeney’s ruling, which has been admitted into evidence in this matter, in the context of evaluating the Settlement Agreement under Maryland law.<sup>4</sup>

4 The transcript of the State Court Hearing was marked as Plaintiffs’ Exhibit 2 and admitted into evidence in its entirety during the November Hearing.

[8] The Court has reviewed the evidence submitted during the November Hearing and considered Mr. Cho’s testimony from the November Hearing and the State Court Hearing. Mr. Cho’s testimony during these two hearings was consistent on a few key points: (i) Mr. Shin represented Mr. Cho in the State Court Action and the settlement conference before Judge Battaglia;<sup>5</sup> (ii) Mr. Cho knew something about the agreement reached at that settlement conference, though his recollection of it was more precise during the State Court Hearing;<sup>6</sup> and (iii) Mr. Cho never notified Mr. Shin or any other party that Mr. Shin was not authorized to act on Mr. Cho’s behalf or to negotiate the Settlement Agreement.<sup>7</sup> The primary difference in Mr. Cho’s testimony surrounds his recollection of the content of the Settlement Agreement and his participation or role in the settlement conference and State Court Hearing. Although the Court understands Mr. Cho’s position concerning the Plaintiffs’ allegations, the Court is persuaded by Mr. Cho’s testimony before Judge Sweeney—a hearing in which Mr. Shin was present and represented (as well as questioned) Mr. Cho.<sup>8</sup>

5 State Court Hearing Transcript at 9–10; November Hearing Transcript at 33, 44–45.



6 For example, during the State Court Action, Mr. Cho testified that he recognized the Settlement Agreement, that it memorialized the agreement reached during the settlement conference, and that he refused to sign it. State Court Hearing Transcript at 9–10. At the November Hearing, Mr. Cho denied recognizing the Settlement Agreement, denied understanding its contents, and denied ever agreeing to its terms. November Hearing Transcript at 33–34, 39–40, 44–45. Mr. Cho's basic posture at the November Hearing was that he did nothing wrong and should not have to pay anything. Notably, the Settlement Agreement acknowledged no finding of wrongdoing or liability on any party's part; Mr. Cho's testimony in this respect at the November Hearing went more to the merits of the underlying allegations and less to the facts and circumstances surrounding the settlement itself.

7 November Hearing Transcript at 44–45.

8 As set forth herein in notes 6 and 9, there are distinct variances in Mr. Cho's testimony at the State Court Hearing and the November Hearing. The primary difference is Mr. Cho's insistence at the November Hearing that he did not want or agree to settle the State Court Action; his basic position was that he did nothing wrong. See *infra* note 9. Because Mr. Cho did acknowledge during the November Hearing that he was present with his attorney, Mr. Shin, at the settlement conference, and that he did not inform anyone that Mr. Shin was not authorized to settle the State Court Action, the Court does not need to rely on any of the controverted testimony to reach its conclusion. The Court also observes that Mr. Cho appeared to have trouble with translations during the November Hearing, as some of the testimony is confused and disjointed. Unfortunately, unlike during the State Court Action, the Court did not have another Korean speaking individual present at the November Hearing (at the State Court Hearing, both Mr. Shin and the translator spoke Korean). The Court notes, however, that Mr. Cho's testimony at both the State Court Hearing and the November Hearing are now part of the record in these chapter 11 cases.

\*459 For example, at the State Court Hearing, Plaintiffs' counsel asked, “Mr. Cho, the settlement agreement [marked

as an exhibit and shown to Mr. Cho] memorialized the terms of the settlement that you had agreed to on April 13<sup>th</sup>, correct?” State Court Hearing Transcript at 10. Mr. Cho responded, “Yes.” *Id.* Mr. Cho also testified that the non-disparagement provision was a material part of the agreement reached during the settlement conference. Mr. Shin specifically asked Mr. Cho, in reference to that provision, “[a]nd was this provision—or, was this agreement or understanding discussed in that settlement conference that we had with Judge Battaglia.” *Id.* at 13. Mr. Cho responded, “Yes.” *Id.*<sup>9</sup>

9 At the November Hearing, in response to a question from his attorney regarding whether the parties reached “a framework of a settlement” during the settlement conference, Mr. Cho testified, “[n]o, we didn't agree.” November Hearing Transcript at 33. When asked why he did not comply with Judge Sweeney's order, Mr. Cho responded, “[t]here—that is the side that is done—engaging in fraud, I didn't do anything that was fraudulent. That's the side that was calling for me to do things, and I did—I didn't do any fraud.” *Id.* at 34. In response to Plaintiffs' counsel then asking Mr. Cho if he remembered being present at the settlement conference, Mr. Cho responded, “[y]eah, but I don't want to remember that.” *Id.* at 43. Mr. Cho then testified that he did not remember the content of his testimony before Judge Sweeney. *Id.* at 44. Mr. Cho also did not directly answer the question concerning whether his counsel, Mr. Shin, lied when he told the Plaintiffs' counsel that Mr. Cho refused to attend the meeting with the landlord to facilitate aspects of the Settlement Agreement. *Id.* at 47.

In *Barranco v. Barranco*, the Maryland Court of Special Appeals determined that an oral settlement agreement was enforceable where the party acknowledged that his attorney was his agent and that a general agreement on settlement had been reached during telephone conversations that occurred over the course of a day. 91 Md.App. 415, 604 A.2d 931, 418–419 (Md. Ct. Spec. App. 1992). The party contesting the agreement argued that certain terms had not been discussed during those conversations and that the agreement was subject to being reduced to a formal writing. The Maryland Court of Special Appeals rejected those arguments, observing that “[t]he oral agreement here was not a tentative agreement. It was not contingent upon a written agreement. It did not

contemplate a written agreement to finalize terms not already finalized.” *Id.* at 421. As that court explained, “[i]n this case, the Husband and Wife struck a deal. The Husband cannot admit the agreement under oath but disavow it because he had a change of heart.” *Id.* The Maryland Court of Special Appeals affirmed the Circuit Court's order enforcing the settlement agreement. *Id.*

In this matter, Mr. Cho acknowledged the parties' agreement under oath in the State Court Hearing. Although his recollection concerning that testimony and the Settlement Agreement itself was foggy during the November Hearing, he did acknowledge that Mr. Shin was his counsel in the negotiation of the Settlement Agreement. *See, e.g., Hunt v. Schauerhamer*, 2016 WL 715797, at \*5–\*7 (D. Utah Feb. 22, 2016) (analyzing, among other things, the agency doctrines of actual and apparent authority in holding party was bound \*460 by attorney's agreement and enforcing settlement agreement) (applying Utah law). Based on the entirety of the record and the Court's observation of Mr. Cho's testimony during the November Hearing, the Court finds that the Plaintiffs and Mr. Cho did in fact reach an agreement, satisfying the required elements of mutual assent, for purposes on forming an enforceable contract under Maryland law. *See, e.g., Cochran v. Norkunas*, 398 Md. 1, 919 A.2d 700, 708 (2007) (“It is universally accepted that a manifestation of mutual assent is an essential prerequisite to the creation or formation of a contract.”) (citations omitted);<sup>10</sup> *Goss v. Bank of Am.*, 917 F.Supp.2d 445, 451 (D. Md. 2013) (“Under Maryland law, implied contracts, like all contracts, require ‘mutual assent (offer and acceptance), an agreement definite in its terms, and sufficient consideration.’”) (citations omitted). The decision of the Maryland Court of Special Appeals in *Barranco* and Judge Sweeney's oral ruling during the State Court Hearing further support this conclusion.<sup>11</sup> This result also accords with notions of comity<sup>12</sup> and judicial economy, particularly considering that parties relied on the state court process and the settlement conference in subsequent actions with respect to the litigation, the leasehold interest addressed in the Settlement Agreement, and other matters.<sup>13</sup>

<sup>10</sup> The Maryland Court of Appeals in *Cochran* did state that “[i]f the parties do not intend to be bound until a final agreement is executed, there is no contract.” 919 A.2d at 708. The Court recognizes that the agreement reached between the parties was not read into the record during the settlement

conference as there was no reporter present, and the Settlement Agreement as written does not address the status of the agreement pending execution by both parties. In light of this, the Court takes note that Mr. Shin—Mr. Cho's counsel in the State Court Action—did not argue that a formal written agreement was a contingency to the validity or enforceability of the Settlement Agreement. Rather, Mr. Shin's argument suggested that the agreement, specifically the non-disparagement provision, was in fact enforceable. Based on the record, the parties reached an agreement on the material terms of the Settlement Agreement during the settlement conference. *See, e.g., Campbell v. Adkisson, Sherbert & Assocs.*, 546 Fed. Appx. 146, 152 (4th Cir. 2013) (“To enforce a settlement agreement under its inherent equity power, the district court ‘(1) must find that the parties reached a complete agreement and (2) must be able to determine its terms and conditions.’”) (citations omitted). The record contains no evidence of any contingency to the enforcement of the agreement.

<sup>11</sup> Indeed, similar to the circumstances of *Barranco*, the Court finds that Mr. Cho has had a change of heart. That change may be based on how strenuously he now denies liability, but it does not change the fact that Mr. Cho, through his authorized agent Mr. Shin, agreed to the terms of the Settlement Agreement. Offer was made and accepted during the settlement conference. The record considered as a whole supports that conclusion.

<sup>12</sup> For a discussion of related principles of comity, see, e.g., *Levin v. Commerce Energy, Inc.*, 560 U.S. 413, 423, 130 S.Ct. 2323, 176 L.Ed.2d 1131 (2010) (discussing principles of comity); *Jaffe v. Accredited Surety and Casualty Co.*, 294 F.3d 584, 591 (4th Cir. 2002) (same); *Roberts v. Child*, 956 F.Supp. 923, 924 (D. Kan. 1997) (same).

<sup>13</sup> See Pl. Ex. 6 (stating actions taken by the Plaintiffs after the settlement conference with respect to the lease discussed in the Settlement Agreement).

The Court thus finds that, for the foregoing reasons, the Settlement Agreement represents the agreement reached by the parties and should be recognized as a valid and enforceable contract.

### B. The Executory Nature of the Settlement Agreement

Having determined that the Settlement Agreement is in fact a valid and enforceable contract, the Court must determine whether that agreement constitutes an executory contract for purposes of \*461 section 365 of the Code. 11 U.S.C. § 365(g)(1). The Code does not define the term “executory contract,” and the issue of executory nature often plagues litigants and bankruptcy courts alike. *See, e.g., In re Roomstore, Inc.*, 473 B.R. 107, 110 (Bankr. E.D. Va. 2012) (“Commentators and courts have noted that the law of executory contracts is ‘hopelessly convoluted’ and a ‘bramble filled thicket.’”) (citations omitted). The underlying purpose of section 365 of the Code is to allow a debtor in possession, in its business judgment, to assume or reject contracts in order to aid the debtor's reorganization.<sup>14</sup> Consequently, the potential benefits and burdens of the subject contract should be the primary focus of any motion under section 365. Yet, the gating question of whether a contract is executory for purposes of that section appears, in many cases, to steal the spotlight and distract from the critical question of whether assumption or rejection benefits the estate and the debtor's reorganization efforts.<sup>15</sup> This matter is no different.

<sup>14</sup> *See, e.g.,* Jay L. Westbrook and Kelsi Stayart White, *The Demystification of Contracts in Bankruptcy*, 91 AM. BANKR. L.J. 481, 491–495 (2017) (explaining history and purpose of section 365 of the Code).

<sup>15</sup> For thoughtful and comprehensive discussions on executory nature and the status of the related debate, see Westbrook and White, *supra* note 14, at 493–496 (discussing the tests articulated *infra* note 16); American Bankruptcy Institute Commission to Study the Reform of Chapter 11, *Final Report and Recommendations*, 23 AM. BANKR. INST. L. REV. 1, 121–125 (2015).

[9] Courts generally apply one of two tests to evaluate whether a contract is executory for purposes of section 365 of the Code—the Countryman test and the Functional test.<sup>16</sup> The Fourth Circuit has adopted the Countryman test. “By that test, a contract is executory if the ‘obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete the performance would constitute a material breach excusing the performance of the other.’” *Lubrizol*, 756 F.2d at

1045 (citations omitted). The Countryman test requires unperformed obligations on the part of both parties to the contract, and a breach of any those obligations must be material in the sense that it would allow the non-breaching party to rescind, or cease performing under, the contract under applicable nonbankruptcy law.

<sup>16</sup> The Countryman test focuses on the executory nature of the contract, whereas the Functional test foregoes that consideration. Under the Countryman test, courts evaluate whether both parties have unperformed obligations under the contract, which if not performed would result in a material breach of the contract. *See Vern Countryman, Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973). Under the Functional test, courts do not consider whether the contract is executory, but simply ask whether assumption or rejection of the contract provides a benefit to the estate. *See Jay L. Westbrook, A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227, 282–85 (1989). In addition, although not generally adopted by courts as an alternative to the Countryman test, several courts have relied on the “exclusionary approach” described by Professor Michael Andrew in his work on executory contracts. *See Michael T. Andrew, Executory Contracts in Bankruptcy: Understanding “Rejection,”* 59 U. COLO. L. REV. 845 (1988); Michael T. Andrew, *Executory Contracts Revisited: A Reply to Professor Westbrook*, 62 U. COLO. L. REV. 1 (1991). *See also In re Alongi*, 272 B.R. 148, 153–155 (Bankr. D. Md. 2001) (citing Professor Andrew's work).

What constitutes an unperformed obligation and whether a breach of that obligation is material or trivial are often contested by the parties and interposed as a barrier to the relief requested under section 365. For example, in this matter, the Plaintiffs assert that they have no remaining unperformed obligations under the \*462 Settlement Agreement and that, to the extent any obligations do remain on their part, they are trivial or ministerial in nature. The Debtors dispute this characterization of the parties' respective obligations under the Settlement Agreement. Before the Court can consider the Debtors' request to reject the Settlement Agreement, it must first resolve the parties' disagreement concerning the nature of their unperformed obligations under the agreement.



[10] [11] Maryland law governs the Settlement Agreement. Settlement Agreement, Pl. Ex. 8 § 10(f). Maryland courts have observed that “[s]ettlement agreements are enforceable as independent contracts, subject to the same general rules of construction that apply to other contracts.” *Maslow v. Vanguri*, 168 Md.App. 298, 896 A.2d 408, 419 (Md. Ct. Spec. App. 2005). Under Maryland law, “[a]lthough any breach of contract may give rise to a cause of action for damages, only a *material breach* discharges the non-breaching party of its duty to perform.” *CytImmune Scis., Inc. v. Paciotti*, 2016 WL 3218726, at \*3 (D. Md. June 10, 2016) (quoting *Jay Dee/Mole Joint Venture v. Mayor and City Council of Baltimore*, 725 F.Supp.2d 513, 526 (D.Md. 2010) (citing *Restatement (Second) of Contracts* § 236 cmt. a.; *23 Williston on Contracts* § 63:3 (4th ed. ) ) (emphasis in original). Maryland law provides that “[a] breach is material ‘if it affects the purpose of the contract in an important or vital way.’” *CytImmune Scis.*, 2016 WL 3218726, at \*3 (citations omitted). See also *Maslow*, 896 A.2d at 423 (explaining material breach as occurring “when ‘the act failed to be performed [goes] to the root of the contract or ... render[s] the performance of the rest of the contract a thing different in substance from that which was contracted for.’”) (citing *Traylor v. Grafton*, 273 Md. 649, 332 A.2d 651, 674 (1975)).

[12] Neither party disputes that the Debtors have unperformed, material obligations under the Settlement Agreement. Indeed, the Debtors must, among other things, transfer the dry-cleaning business, make a cash payment, and not interfere in the Plaintiffs' operation of the business. Settlement Agreement, Pl. Ex. 8 §§ 2.1, 4.3. The parties do not agree on the nature of the Plaintiffs' unperformed obligations. These obligations include: (i) authorizing their counsel “to file a Stipulation of Dismissal with the Circuit Court for Howard County, dismissing the Lawsuit”; and (ii) dismissing “their action pending against [Ms. Paik] in the United States Bankruptcy Court for the District of Maryland, Case No. 16–10260–DER, Adversary No. 16–00362, and note the judgment held against [Ms. Paik] in the Circuit Court for Baltimore City, Case No. 24–C–14–004134, as satisfied.” *Id.* at §§ 2.2, 3.2. Both of the foregoing obligations are triggered once the Debtors have, among other things, transferred the business and made the cash payment, neither of which has been done. *Id.* In addition, the Plaintiffs and the Debtors have an ongoing obligation “not to make any public statements, whether written or oral, or any other statements which the Parties reasonably believe are likely to become public, which could reasonably be interpreted, under the circumstances, as embarrassing, disparaging, prejudicial, or

in any way detrimental to the interests of the other” parties. Settlement Agreement § 4.1.

Both parties thus unquestionably have unperformed obligations under the Settlement Agreement. The question then becomes whether these obligations—particularly the Plaintiffs' unperformed obligations—are material under Maryland law. This question turns, in part, on the primary purpose of the contract. See, e.g., *CytImmune Scis.*, 2016 WL 3218726, at \*3; *Maslow*, 896 A.2d at 423. Here, the parties entered into the Settlement Agreement to resolve all of the outstanding disputes between them concerning the dry-cleaning business, including those involving Ms. Paik. Settlement Agreement, Pl. Ex. 8 ¶ E, § 3.2. Although the Plaintiffs are understandably focused on the Debtors' obligations under section 2.1 of the Settlement Agreement and the transfer of the business and cash, those actions were not the only or primary purpose of the agreement considering the interests of all affected parties. Rather, the Plaintiffs' obligations to dismiss the pending litigation against the Debtors, to dismiss the pending litigation against Ms. Paik, and to note satisfaction in full of the judgment they hold against Ms. Paik speak directly to the primary purpose of settling the litigation and providing finality and certainty for the parties. Likewise, the non-disparagement provision bolsters and serves this purpose.

At the January Hearing, the Plaintiffs emphasized the non-contingent nature of the releases granted by the parties under the Settlement Agreement and that the releases were performed simultaneously with the Settlement Agreement becoming effective. That argument does not, however, eliminate the parties' independent obligation to dismiss the State Court Action.<sup>17</sup> Perhaps more importantly, the releases in the Settlement Agreement speak only to the claims involving the Plaintiffs and the Debtors. The releases do not address the claims that the Plaintiffs assert against Ms. Paik. Those claims are addressed separately in section 3.2—a section that imposes on the Plaintiffs both an obligation to dismiss an action, and an obligation to acknowledge the satisfaction of certain claims, against Ms. Paik. If the Plaintiffs do not perform such obligations, the Plaintiffs' litigation and claims remain, they are not barred by any release provision, and the remedy is a claim for breach of the Settlement Agreement. As noted above, the purpose of the Settlement Agreement was to resolve these kinds of issues. The failure of the Plaintiffs to perform under section 3.2 of the Settlement Agreement is a material breach, and a breach that could be enforced by the Debtors as the direct

parties to the agreement. *See, e.g., Kaplan v. First Options of Chicago, Inc. (In re Kaplan)*, 143 F.3d 807, 813 (3d Cir. 1998) (explaining that “since [the debtor] is a direct party to the Agreement, he has standing to sue for the breach of First Options’ commitment to provide services to [the third-party beneficiary]”).

17 Although most courts characterize releases as material, courts differ in approaches to obligations relating to dismissal. Some suggest that such obligations might be ministerial, while other courts take a more holistic approach to analyzing the obligations at issue. *See, e.g., Schultz v. Verizon Wireless Services*, 833 F.3d 975, 979 (8th Cir. 2016) (“The form of the release and dismissal order is a material part of any settlement. Verizon considered the inclusion of a mutual non-disparagement clause to be an essential part of the release. Negotiations broke down when the Schultzes refused to agree to that term, conclusively establishing that it *was* a substantial matter.”) (emphasis in original).

Moreover, although some courts disagree, several courts have held that, in the settlement context, a non-disparagement provision is a material term of the settlement agreement.<sup>18</sup> *See, e.g., \*464 Higbee v. Sentry Insurance Co.*, 253 F.3d 994, 998 (7th Cir. 2001) (finding no enforceable settlement agreement because “material” terms were not agreed upon, and explaining that “the wording of the confidentiality and nondisparagement clause was a material term, at least as far as Higbee was concerned”); *Moreno v. Tringali*, 2017 WL 2779746, at \*4–\*9 (D. N.J. June 27, 2017) (finding a material breach of a litigation settlement agreement where evidence established that party violated non-disparagement provision). *See also Schultz*, 833 F.3d at 979. This approach is consistent with the core purpose of most litigation settlement agreements—i.e., the agreements are intended to provide finality and allow the parties to walk away from the litigation without findings of liability or other adverse consequences, such as negative comments and connotations from the adverse party or the fact that litigation was pending. *See, e.g., Moreno*, 2017 WL 2779746, at \*8 (“Under their Settlement Agreement, the parties exchanged material promises and received assurances not just to be free from what the law already protects them from—i.e., defamation—but for significantly broader relief from ‘any disparaging remarks’ and even ‘any’ remarks that ‘cast any such Party in a negative light.’ ”). Although the Court did not find any Maryland case law directly on point, and the parties did not cite any, the Court is persuaded

that under the circumstances of these cases and considering the purpose of a litigation settlement agreement, the non-disparagement provision is material and serves the core purpose of the Settlement Agreement. *See, e.g., Maslow*, 896 A.2d at 423 (“[W]e agree with appellee that the ‘no appeals’ provision was a central element of the Agreement, and appellant’s appeal of the jury’s verdict constituted a material, ‘substantial breach tending to defeat the object of the contract.’ ”) (quoting *Vincent v. Palmer*, 179 Md. 365, 19 A.2d 183, 188 (1941)); *Convenience Retailing, LLC v. Sunoco, Inc.*, 2006 WL 3797927, at \*2 (4th Cir. Dec. 21, 2006) (per curiam) (holding that facilities allowance fee included in reseller agreement was material and explaining that “[i]t is only when ‘a covenant goes only to part of a contract, is incidental and subordinate to its main purpose and its breach may be compensated in damages’ that a breach ‘does not warrant rescission of the contract but compensation in damages.’ ”) (quoting *Traylor*, 332 A.2d at 674).<sup>19</sup>

18 Although the Debtor testified concerning the materiality of the non-disparagement provision during the State Court Hearing, the Court did not consider that testimony in the context of evaluating the materiality of the provision for purposes of the Code. Maryland courts follow the objective approach to interpreting contract, unless the contract is ambiguous. *See, e.g., Maslow v. Vanguri*, 168 Md.App. 298, 896 A.2d 408, 420 (Md. Ct. Spec. App. 2006) (“To ascertain the parties’ intent, courts in Maryland ‘have long adhered to the objective theory of contract interpretation, giving effect to the clear terms of agreements, regardless of the intent of the parties at the time of contract formation.’ ”) (citations omitted); *Geoghegan v. Grant*, 2011 WL 673779, at \*6 (D. Md. Feb. 17, 2011). No party has argued that the Settlement Agreement is ambiguous. Accordingly, the Court considers only the plain language of the Settlement Agreement in making its determination. In addition, although the Debtors raised a violation of the nondisparagement provision during the State Court Hearing, Judge Sweeney was not asked to, and did not rule on, the materiality of, or a breach concerning, the non-disparagement provision.

19 *See also McClain & Co. v. Carucci*, 2011 WL 1706810, at \*8 (W.D. Va. May 4, 2011) (suggesting that a noncompete covenant that was only part of a

much larger agreement could constitute a material breach because “it ‘deprive[s] the injured party of the benefit that the party justifiably expected from the exchange’ ” (citations omitted).

In the bankruptcy context, several courts have held that negative obligations and obligations to refrain from taking certain actions are material and sufficient to render a contract executory when those obligations serve the underlying purpose of the contract at issue. Notably, some of these obligations to refrain are similar to \*465 not only the non-disparagement provision in the Settlement Agreement, but also to the Plaintiffs' affirmative obligation to act on certain pending litigation. For example, the court in *In re WorldCom, Inc.* found an obligation to refrain from challenging a state court consent judgment in the context of a settlement agreement material under section 365 of the Code. 343 B.R. 486, 496 (Bankr. S.D.N.Y. 2006). As that court explained, “[e]ach performance goes to the essence of what the other party sought and expected when he entered into the ... Agreement, and without it, the party will lose the benefit of the bargain that he thought he struck.” *Id.* at 496–497 (quoting *In re Teligent, Inc.*, 268 B.R. 723, 730–731 (Bankr. S.D.N.Y. 2001)). Likewise, in *Alpha Natural Resources*, the court determined that the agreement was executory because “the Debtors have a material obligation to tender the Payment Obligations” and “[b]oth parties also have a material obligation to refrain from bringing the underlying claims that the Agreement purported to resolve.” 555 B.R. at 525 n.8. See also, e.g., *Lubrizol*, 756 F.2d at 1045 (“The unperformed, continuing core obligations of notice and forbearance in licensing made the contract executory as to RMF.”); *RCI Tech. Corp. v. Sunterra Corp. (In re Sunterra Corp.)*, 361 F.3d 257, 264 (4th Cir. 2004) (finding contract executory where each party “possessed an ongoing obligation to maintain the confidentiality of the source code of the software developed by the other”); *Roomstore*, 473 B.R. at 114 (explaining that “continuing duties of the parties” to a contract can make the contract executory); *In re Spoverlook, LLC*, 551 B.R. 481, 486–487 (Bankr. D.N.M. 2016) (finding contingent obligation to release claims to be material).<sup>20</sup>

<sup>20</sup> The parties discussed the *Spoverlook* case in their post-hearing briefs, given the factual similarities between that case and the matter before the Court. The two settlement agreements have similar terms, but the release provision in *Spoverlook* was contingent on the debtor's performance of certain obligations. 551 B.R. at 486. Under the Settlement

Agreement, the release provision appears to have been operative upon execution of the agreement. Pl. Ex. 8. The court in *Spoverlook* found the release obligation (though self-executing) to be material under the facts of that case and, thus, did not address the other remaining obligation, which was an obligation to dismiss the underlying state court action. *Id.* at 487. The court did, however, suggest that “[i]f the HOA's only remaining obligation were to dismiss the state court action, then it might not be significant.” *Id.* The Court acknowledges this statement in *Spoverlook*, but reaches a different conclusion based on all of the provisions in the Settlement Agreement, the primary purpose of the parties entering into the Settlement Agreement, and the applicable nonbankruptcy law in this case.

The Court acknowledges that some courts have found negative covenants insufficient to render a contract executory for purposes of the Code. See, e.g., *Ready Productions, Inc. v. Jarvis (In re Jarvis)*, 2005 WL 758805, at \*4 (Bankr. D.N.H. Mar. 28, 2005) (discussing nondisparagement agreements); *In re Schneeweiss*, 233 B.R. 28, 31–32 (Bankr. N.D.N.Y. 1998) (discussing covenant not to compete). Although the Court appreciates the analysis included in these decisions, it respectfully declines to follow their guidance based on the facts and circumstances of this particular matter. In addition, as noted by the court in *WorldCom*, at least some of these decisions “base their ruling upon the argument that restrictive covenants create passive and not affirmative obligations on the part of the party being held to them, and that such passive obligations do not [ ] rise to the level of materiality necessary for an executory contract to exist.” 343 B.R. at 496. The court then observed that “applying these arguments to this case would inherently place form over substance.” *Id.* This Court agrees.

\*466 Every decision concerning whether a contract is executory must be made on the facts of the particular case and the standards set forth in the applicable nonbankruptcy law. Having analyzed the terms of the Settlement Agreement, considered the testimony of Mr. Cho at the November Hearing and the State Court Hearing, and reviewed applicable Maryland law, the Court finds that the Settlement Agreement is an executory contract under the Countryman test. Both parties to the Settlement Agreement have unperformed and, in some instances, ongoing obligations that, if not performed, would eviscerate the benefit of the bargain for the non-breaching party. Accordingly, the Debtors may seek to reject the Settlement Agreement under section 365 of the Code.

### C. The Rejection of the Settlement Agreement

As explained above, [section 365\(a\)](#) of the Code permits a debtor in possession, after notice and a hearing, to reject an executory contract, if such rejection is advantageous to the estate. “Courts addressing that question must start with the proposition that the bankrupt’s decision upon it is to be accorded the deference mandated by the sound business judgment rule as generally applied by courts to discretionary actions or decisions of corporate directors.” [Lubrizol](#), 756 F.2d at 1046. In these cases, the Debtors have asserted that the Settlement Agreement is onerous and, actually, counterproductive to the Debtors’ reorganization efforts. The terms of the Settlement Agreement require, among other things, the transfer of a business operated by the Debtors and a cash payment from the Debtors to two specific creditors in these cases on account of alleged prepetition claims. The Court appreciates the frustration articulated by the Plaintiffs in that they believe they hold valid claims against the Debtors and that they had, in good faith, reached a settlement of those claims prior to the filing of the Debtors’ chapter 11 petitions. The Plaintiffs are not, however, the only creditors in these cases,<sup>21</sup> and the Court must consider the interests of the estates in the context of the Debtors’ request to reject the Settlement Agreement.

<sup>21</sup> Notably, these chapter 11 cases do not only involve a two-party dispute. The Debtors have at least three secured creditors, including secured claims asserted by Columbia Bank and PNC Bank, at least two general unsecured creditors (not including the Plaintiffs), and a landlord. [ECF 1 Case No. 17–22057; ECF 1 in Case No. 17–22058].

On balance, the Court finds that the record supports the Debtors’ business judgment and their request to reject the Settlement Agreement. The Plaintiffs made various references to the Debtors’ alleged fraudulent conduct and bad faith in filing these chapter 11 cases. They did not, however, present any evidence beyond the facial allegations asserted in the State Court Action and the fact the Debtors filed these cases shortly before the hearing on the Show Cause Petition. The filing of a bankruptcy petition stops most prepetition litigation. That fact alone does not establish bad faith, particularly where the debtor has, as here, articulated a valid purpose to be served by the bankruptcy filing.<sup>22</sup> See, e.g., [Carolin Corp. v. Miller](#), 886 F.2d 693, 700 (4th Cir. 1989)

(setting forth test to evaluate alleged bad faith filings that places burden on party opposing bankruptcy and requires a showing of both objective futility and subjective bad faith); [In re Greenwood Supply Co.](#), 295 B.R. 787, 794 (Bankr. D. S.C. 2002) (explaining, among other things, that subjective bad faith is a \*467 totality of circumstances test, of which a bankruptcy filing to stop state court litigation is only one factor). Moreover, the Plaintiffs did not suggest or provide any evidence to suggest fraud or bad faith in the Debtors’ request to reject the Settlement Agreement, other than it is an effort to get out from under a deal the Debtors now do not like. Such motivation, however, often underlies a debtor’s request to reject an executory contract or unexpired lease in a bankruptcy case.

<sup>22</sup> The Court’s findings regarding fraud and bad faith are limited to evaluating the Motion and the Debtors’ business judgment in that context.

[13] [14] That said, the Court does not condone fraudulent conduct or bad faith filings. The protections of the Code are reserved for the “ ‘honest but unfortunate’ ” debtor. See, e.g., [Brown v. Felsen](#), 442 U.S. 127, 128, 99 S.Ct. 2205, 60 L.Ed.2d 767 (1979) (quoting [Local Loan Co. v. Hunt](#), 292 U.S. 234, 244, 54 S.Ct. 695, 78 L.Ed. 1230 (1934)). And the Court is mindful that, in administering bankruptcy cases, “courts should be ‘equally concerned with ensuring that perpetrators of fraud are not allowed to hide behind the skirts of the Bankruptcy Code.’ ” [Twin City Fire Ins. Co. v. Estrin](#) (*In re Estrin*), 2016 WL 691506, at \*7 (Bankr. D.S.C. Feb. 19, 2016) (quoting [Taylor v. Davis](#) (*In re Davis*), 494 B.R. 842, 867 (Bankr. D.S.C. 2013) and [Foley & Lardner v. Biondo](#) (*In re Biondo*), 180 F.3d 126, 130 (4th Cir. 1999)). Nevertheless, on the record before it, the Court finds no bad faith in connection with the Debtors’ request to reject the Settlement Agreement.

In addition, rejection of the Settlement Agreement simply means that Debtors are relieved of performing their obligations under that agreement. Rejection is a breach of the Settlement Agreement by the Debtors, deemed to occur immediately before the petition date. See, e.g., [11 U.S.C. § 365\(g\)](#); [Lubrizol](#), 756 F.2d at 1048. Rejection generally does not eviscerate the non-breaching party’s state law rights under the contract.

Although the non-breaching party may be limited to a damages claim against the estate under [sections 365\(g\)](#) and [502\(g\)](#) of the Code,<sup>23</sup> the Court is not by this Order addressing the parties’ respective rights upon breach, the



amount of any claim resulting from breach, or the treatment of the any claim in these chapter 11 cases.<sup>24</sup> Notably, any nonbankruptcy rights that the Plaintiffs may retain do not include the right to request specific performance of the Settlement Agreement.<sup>25</sup> See, e.g., \*468 *Newman Grill Sys., LLC v. Ducane Gas Grills, Inc.*, 320 B.R. 324, 337 (Bankr. D. S.C. 2004) (“Plaintiffs are not entitled to claim specific performance as a method of relief from Ducane’s rejection of executory contracts in light of 11 U.S.C. § 365(g) ...”). See also *Lubrizol*, 756 F.2d at 1048. Accordingly, the Court reserves judgment on these and related issues pending further action by the parties in these chapter 11 cases.

<sup>23</sup> See, e.g., *Lubrizol*, 756 F.2d 1043, 1048 (“Even though § 365(g) treats rejection as a breach, the legislative history of § 365(g) makes clear that the purpose of the provision is to provide only a damages remedy for the non-bankrupt party.”).

<sup>24</sup> For example, in the *Spoverlook* case cited above (551 B.R. 481), the bankruptcy case ultimately was dismissed and, in granting that dismissal, Judge Thuma explained, “Debtor’s rejection of the Agreement was a breach of contract, and will continue to be so after dismissal of the case. ... Dismissal of this case therefore leaves the HOA and Debtor much like they were before the bankruptcy case was filed. ... The HOA can seek to enforce the Agreement as before. The HOA’s specific performance and other remedies, which were potentially curtailed in bankruptcy, remain available in state court, the same as if the bankruptcy case had never been filed.” *In re Spoverlook*, 2017 WL 3084898, at \*2 (Bankr. D. New Mexico Jan. 4, 2017).

<sup>25</sup> The issue of specific performance could be viewed as one difference between rejection of the Settlement Agreement as an executory contract or characterization of that agreement as non-executory and subject to breach by the Debtors.

In the latter instance, the Plaintiffs’ monetary claims would still constitute prepetition claims because the Settlement Agreement was agreed upon prepetition. See, e.g., *Spoverlook*, 551 B.R. at 487 (citing *In re Hawker Beechcraft*, 486 B.R. 264, 276–277 (Bankr. S.D.N.Y. 2013) for the proposition that “rejection of an executory contract is the economic equivalent of the debtor’s refusal to perform a non-executory contract, giving rise to the same unsecured claim). The Plaintiffs may believe that, in the non-executory context, they could at least argue a claim for specific performance. The success of that claim is, however, speculative at best considering the broad definition of “claim” under section 101(5) of the Code, which includes equitable relief, and the fact that monetary damages could compensate the Plaintiffs for any losses. 11 U.S.C. § 101(5)(B). Indeed, under Maryland law, the remedy of specific performance is rare, often reserved for transfers of real property (which this is not), and only available where, among other things, the requesting party has performed all of its obligations under the agreement. See, e.g., *Cattail Assoc., Inc. v. Sass*, 170 Md.App. 474, 907 A.2d 828, 843 (Md. Ct. Spec. App. 2006); *Geoghegan v. Grant*, 2011 WL 673779, at \*9 (D. Md. Feb. 17, 2011).

#### IV. Conclusion

For the reasons set forth above, the Court concludes that the parties agreed to the terms of the Settlement Agreement prior to the petition date, the Settlement Agreement is an executory contract for purposes of section 365 of the Code, and the Debtors may reject the Settlement Agreement under section 365(a) of the Code. The Court will enter a separate order consistent with, and granting the relief set forth in, this Memorandum Opinion.

#### All Citations

581 B.R. 452, 65 Bankr.Ct.Dec. 106



## **LEGAL AUTHORITY CA-46**

560 B.R. 358

United States Bankruptcy Court, D. New Mexico.

IN RE: SPOVERLOOK, LLC, Debtor.

Case No. 15-13018 t11

Signed October 7, 2016

**Synopsis**

**Background:** Debtor moved to reject executory settlement agreement in bankruptcy, after state court had previously granted homeowners' association's request to enforce agreement against debtor.

**Holdings:** The Bankruptcy Court, [David T. Thuma, J.](#), held that:

[1] homeowners' association could be forced to accept claim for money damages in bankruptcy as alternative to whatever right of specific performance it otherwise would have upon debtor's breach of executory contract to convey real property to homeowners' association by rejecting it;

[2] state court's prepetition grant of motion by homeowners' association to enforce settlement agreement against debtor was not in nature of final judgment on association's right to specific performance of this agreement, of kind sufficient to reduce settlement agreement to final judgment for specific performance and to prevent debtor from rejecting agreement; and

[3] debtor's motion to reject could not be denied as having been filed in bad faith.

Motion granted.

West Headnotes (9)

[1] **Bankruptcy** 🔑 "Business judgment" test in general

"Business judgment" test determines whether court should approve debtor's proposed

assumption or rejection of executory contract. 11 U.S.C.A. § 365(a).

2 Cases that cite this headnote

[2] **Bankruptcy** 🔑 "Business judgment" test in general

"Business judgment" test is not particularly strict, and in applying this test to determine whether debtor should be allowed to reject an executory contract, bankruptcy court should defer to debtor's decision, as long as debtor demonstrates that rejection of contract is likely to benefit estate. 11 U.S.C.A. § 365(a).

2 Cases that cite this headnote

[3] **Bankruptcy** 🔑 Grounds for and Objections to Assumption, Rejection, or Assignment

Bankruptcy court will approve debtor's proposed assumption or rejection of executory contract unless it is manifestly unreasonable or derives from bad faith, whim, or caprice. 11 U.S.C.A. § 365(a).

1 Cases that cite this headnote

[4] **Specific Performance** 🔑 Contracts Relating to Real Property

Under New Mexico law, specific performance is an alternative to legal remedy of money damages for breach of contract involving real estate.

1 Cases that cite this headnote

[5] **Bankruptcy** 🔑 Effect of Acceptance or Rejection

Homeowners' association could be forced to accept claim for money damages in bankruptcy as alternative to whatever right of specific performance it otherwise would have upon debtor's breach of executory contract to convey real property to homeowners' association by rejecting it. 11 U.S.C.A. §§ 101(5)(B), 365(g)(1).

1 Cases that cite this headnote

**[6] Bankruptcy** 🔑 Executory nature in general

State court's prepetition grant of motion by homeowners' association to enforce settlement agreement against debtor was not in nature of final judgment on association's right to specific performance of this agreement, of kind sufficient to prevent debtor from rejecting agreement upon its bankruptcy filing; state court's order was not entered after trial and presentation of evidence or after any election of remedies by homeowners' association, but after short hearing consisting entirely or oral argument. 11 U.S.C.A. § 365(a).

**[7] Courts** 🔑 Debtor and creditor; bankruptcy; mortgages, liens, and security interests

State court's prepetition grant of motion by homeowners' association to enforce settlement agreement against debtor was not in nature of final judgment on merits and did not prevent debtor, based on principles of issue preclusion or pursuant to *Rooker-Feldman* doctrine, from seeking to reject settlement agreement in bankruptcy and to thereby avoid its obligation to convey real property to homeowners' association. 11 U.S.C.A. § 365(a).

**[8] Bankruptcy** 🔑 Grounds for and Objections to Assumption, Rejection, or Assignment**Bankruptcy** 🔑 "Bad faith."

It was not bad faith for debtor, after state court granted motion by homeowners' association to enforce executory settlement agreement against debtor, to file for bankruptcy for specific purpose of rejecting this settlement agreement, and motion to reject could not be denied as having been filed in bad faith. 11 U.S.C.A. § 365(a).

**[9] Bankruptcy** 🔑 "Bad faith."

In general, it is not bad faith for debtor to file a bankruptcy case for the purpose of rejecting a lease or executory contract. 11 U.S.C.A. § 365(a).

**Attorneys and Law Firms**

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**OPINION**

Hon. David T. Thuma, United States Bankruptcy Judge

Before the Court is Debtor's motion to reject a state court settlement agreement with a homeowner's association. The Court previously found the settlement agreement was an executory contract. The homeowner's association resists rejection, arguing that it can obtain specific performance of the agreement, rejection would improperly contravene a state court order, and the proposed rejection is in bad faith. The Court disagrees and will grant Debtor's motion.

**I. FACTS**

The Court finds:

Debtor is the developer of a 260-acre residential development called San Pedro \*360 Overlook (the "Subdivision") in the "East Mountains" area northeast of Albuquerque. Debtor has completed the first of three phases (Phase I), which consists of about 50 residential lots, a community center, and a gatehouse. The Subdivision was built on a large plot of open space in a manner that maintains the character of New Mexico's natural surroundings.

The Subdivision is near another high-end development called San Pedro Creeks ("SPC"). SPC currently is the only development that can be seen from the Subdivision. There is a large open space between the Subdivision and SPC, which includes a certain parcel of undeveloped property called "Tract D." A portion of Tract D abuts a highway.

Around 2003, buyers started purchasing and building on the residential lots in Phase I. The properties were primarily marketed by Campbell Ranch Realty, an affiliate of the Debtor. Debtor advertised that the Subdivision is adjacent to 625 acres of open space. It is unclear whether that open space includes Tract D.

By 2013, Debtor had sold all of its residential lots in Phase I. Pursuant to the restrictive covenants encumbering the Subdivision,<sup>1</sup> Debtor was obligated to cede control of the Subdivision to the San Pedro Overlook Community Association (the “HOA”) and to convey certain common areas to the HOA.

<sup>1</sup> Declaration of Covenants, Conditions, Restrictions, and Easement for San Pedro Overlook, admitted as Exhibit 21 (the “Declaration”).

Debtor did not timely perform these obligations, possibly because it could not afford the required inspections and repairs. Debtor's development plans were severely affected by the “great recession” of 2008. Throughout 2013, the HOA demanded that Debtor perform its transition obligations.

In 2014, the HOA sued Debtor in New Mexico's Thirteenth Judicial District Court, commencing an action styled *San Pedro Overlook Community Association v. SP Overlook, LLC*, cause no. D-1329-CV-2014-01119. The suit sought to compel Debtor to, inter alia, convey the common areas to the HOA.

On March 30, 2015, the HOA and the Debtor signed a settlement agreement, under which Debtor agreed to convey the common areas to the HOA by April 30, 2015, in exchange for a mutual release of claims. Each party also agreed to pay a certain portion of property taxes and to submit a stipulated order dismissing the lawsuit.

Debtor and the HOA thought they had settled their differences. It turned out, however, that a dispute remained concerning Tract D. Paragraph 2 of the agreement defines “common areas” as the areas identified in the Declaration. It is not clear Tract D comes within this definition. Paragraph 2 goes on to state, however, that “the parties agree that the real property described in Exhibit A to this Agreement constitutes the common areas to be conveyed by [Debtor] in accordance with this [paragraph] 2....” The description in Exhibit A includes Tract D.

Debtor maintains that Tract D is not and has never been part of the common areas, and that Debtor never intended to convey Tract D to the HOA. Accordingly, Debtor argues the settlement agreement is ambiguous, and/or that a mistake was made. The HOA, in contrast, argues that the agreement

unambiguously obligates Debtor to convey Tract D to the HOA.

The disposition of Tract D is important to the parties. Debtor wants to realize the value of Tract D so it can begin development \*361 on Phases II and III of the Subdivision. The HOA opposes any development of Tract D, and contends the Debtor represented that Tract D would remain undeveloped open space.

On July 22, 2015, the HOA filed a motion in state court to enforce the settlement agreement. The court held a short hearing on October 27, 2015. No witnesses testified, nor were any exhibits introduced into evidence. The hearing took about 33 minutes. The state court ruled for the HOA, stating:

I have reviewed this at some length, and I find that the settlement agreement is unambiguous, and should be ... enforced specifically by the Court. So the Court will decree that the defendant specifically perform and sign the deed. The issue concerning the tract—whichever one. ... I think the special warranty deed form is appropriate, in light of the fact that it calls out any and all easements of record. So the Court will order that defendant perform as indicated by the Court.

The parties agreed to submit an order memorializing the ruling within seven days. Counsel for the HOA prepared a form of order, but Debtor's counsel did not respond. On November 18, 2015, before the order was entered, Debtor filed this bankruptcy case. On the petition date, Debtor had not conveyed any property to the HOA, the HOA had not released any claims against the Debtor, and neither party had taken action to dismiss the lawsuit. At this Court's insistence, Debtor has since conveyed to the HOA all of the undisputed common areas, leaving only the disputed Tract D.

Debtor's interest in Tract D is its main asset. Debtor scheduled Tract D at \$300,000; a lawsuit against Sonida, LLC at \$250,000; and a potential malpractice suit against the lawyers who drafted the settlement agreement at \$250,000. The value of the lawsuits is highly speculative. Sonida, LLC dissolved,

and the malpractice suit may depend on, inter alia, the ultimate disposition of Tract D.

Debtor is not operating currently. Rejecting the settlement agreement and pursuing Tract D may be Debtor's main chance to reorganize.

By a memorandum opinion and order entered June 14, 2016, this Court determined the settlement agreement was an executory contract.

## II. DISCUSSION

### A. Rejecting Executory Contracts.

[1] A debtor-in-possession may assume or reject executory contracts, subject to bankruptcy court approval. 11 U.S.C. § 365(a).<sup>2</sup> The business judgment test determines whether the Court should approve a proposed assumption or rejection. *In re Tilco, Inc.*, 558 F.2d 1369, 1373 (10th Cir. 1977); *N.L.R.B. v. Bildisco and Bildisco*, 465 U.S. 513, 104 S.Ct. 1188, 79 L.Ed.2d 482 (1984) (business judgment test applies to authorize rejection of an ordinary executory contract); *In re Western Wood Products, Inc.*, 2013 WL 1386285, \*21 (Bankr. D.N.M.) (citing *Tilco* and applying the business judgment test).

<sup>2</sup> All statutory references are to 11 U.S.C.

[2] The test is not particularly strict. *In re Mile Hi Metal Systems, Inc.*, 899 F.2d 887, 896 n. 13 (10th Cir. 1990) (“We do not consider the ‘business judgment test’ to be a strict standard to meet.”) (quoting *In re W. & L. Assoc., Inc.*, 71 B.R. 962, 966 (Bankr. E.D. Pa. 1987)). Deference is given to the debtor's decision, provided it demonstrates “that rejection of the contract will be likely to benefit the \*362 estate.” *Id.* See also *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043, 1046 (4th Cir. 1985) (articulating a deferential “benefit to the estate” standard); *In re: Genco Shipping & Trading Limited*, 509 B.R. 455, 463 (Bankr. S.D.N.Y. 2014) (“A court should defer to a debtor's decision that rejection of a contract would be advantageous.”); *In re Malden Mills Industries, Inc.*, 303 B.R. 688, 701 (1st Cir. BAP 2004) (“A court will generally not second-guess a debtor's business judgment regarding whether the assumption or rejection of a contract will benefit the debtor's estate.”).

[3] An alternative articulation of the test is that the Court will approve a proposed assumption or rejection unless it is

manifestly unreasonable or derives from bad faith, whim, or caprice. *Western Wood*, 2013 WL 1386285, at \*21 (Court will not interfere unless the decision is “so manifestly unreasonable that it could not be based on sound business judgment”) (quoting *Lubrizol Enterprises, Inc.*, 756 F.2d at 1047); *In re Sabine Oil & Gas Corp.*, 550 B.R. 59, 75 (Bankr. S.D.N.Y. 2016) (court will defer to debtor's decision to reject unless it is “the product of bad faith, whim, or caprice”); *In re Cook*, 2012 WL 5408905, \*11 (Bankr. D.N.M. 2012) (same).

### B. Specific Performance.

The HOA argues that rejection of the Settlement Agreement would be futile because the HOA would be entitled to specific performance in the event of a breach. The Court disagrees.

Rejection of an executory contract constitutes a breach of the contract as of the date immediately before the petition date. § 365(g)(1); *In re Siggins*, 2014 WL 1796685, at \*5 (Bankr. D.N.M. 2014). The breach gives rise to a claim. § 502(g)(1). The non-debtor party's right to specific performance after rejection depends on whether the specific performance obligation qualifies as a “claim” that can be monetized and discharged.

A claim is defined to include a “right to an equitable remedy for breach of performance if such breach gives rise to a right to payment....” § 101(5)(B). As the Supreme Court noted:

Section [101(5)(B)] ... is intended to cause the liquidation or estimation of contingent rights of payment for which there may be an alternative equitable remedy with the result that the equitable remedy will be susceptible to being discharged in bankruptcy. For example, in some States, a judgment for specific performance may be satisfied by an alternative right to payment in the event performance is refused; in that event, the creditor entitled to specific performance would have a ‘claim’ for purposes of a proceeding under title 11.



*Ohio v. Kovacs*, 469 U.S. 274, 280, 105 S.Ct. 705, 83 L.Ed.2d 649 (1985) (quoting the sponsors of the 1978 Bankruptcy Reform Act, 124 Cong. Rec. 32393 (1978)).<sup>3</sup>

<sup>3</sup> Specific performance is an equitable remedy. *Kokoricha v. Estate of Keiner*, 148 N.M. 322, 236 P.3d 41, 48 (2010); *Westar Energy, Inc. v. Lake*, 552 F.3d 1215, 1222 (10th Cir. 2009).

[4] In New Mexico cases involving real estate, specific performance is an alternative to the legal remedy of money damages. See *Jones v. Lee*, 126 N.M. 467, 971 P.2d 858, 862 (1999) (“Where a party elects to sue for damages resulting from a breach of land sale contract, the burden is on that party to present competent evidence to support such claim for damages”); *Beaver v. Brumlow*, 148 N.M. 172, 231 P.3d 628, 630 (2010) (“The trial court allowed Buyers a choice of remedy: money damages for the prima facie tort or specific performance \*363 of the contract. Buyers chose specific performance.”); *Buckingham v. Ryan*, 124 N.M. 498, 953 P.2d 33, 38 (1997) (discussing the election of remedies on a land sale contract). Thus, a state law right to seek specific performance falls squarely within § 101(5)(B)'s definition of a claim.

[5] Consistent with the foregoing, the strong majority of courts addressing the issue have held that parties like the HOA can be forced to accept claims for money damages in bankruptcy. See *Route 21 Associates v. MHC, Inc.*, 486 B.R. 75, 85–87 (S.D.N.Y. 2012) (purchaser was not entitled to specific performance post-rejection because its claim could be monetized under § 101(5)(B)); *In re Young*, 214 B.R. 905, 912 (Bankr. D. Idaho 1997) (both specific performance and monetary damages were available under Idaho law for breach of a contract to sell real property, so the buyer had a claim under § 101(5)); *In re A.J. Lane & Co., Inc.*, 115 B.R. 738, 742 (Bankr. D. Mass. 1990) (debtor/seller's obligation under a real estate contract gives rise to a dischargeable claim if the buyer has the right to either damages or specific performance); *In re Kilpatrick*, 160 B.R. 560, 564–66 (Bankr. E.D. Mich. 1993); *In re Ground Round, Inc.*, 335 B.R. 253, 261 (1st Cir. BAP 2005), *aff'd*, 482 F.3d 15 (1st Cir. 2007) (an equitable remedy will be deemed a claim when the payment of monetary damages is an alternative); *In re Nickels Midway Pier, LLC*, 341 B.R. 486, 500 (Bankr. D.N.J. 2006); *In re Aslan*, 65 B.R. 826, 830–31 (Bankr. D. Cal. 1986), *rev'd in part on other grounds*, 909 F.2d 367 (9th Cir.1990) (specific

performance not available post-rejection based on legislative history of § 101(5)).<sup>4</sup>

<sup>4</sup> See also 3 Collier on Bankruptcy ¶ 365.10[1], p. 365–79 (16th ed. 2016) (“rejection deprives the nondebtor party of a specific performance remedy that it might otherwise have under applicable nonbankruptcy law”); *Lubrizol Enterprises*, 756 F.2d at 1048 (the purpose of § 365(g) is to limit remedies to money damages); *In re Scott Desert Shadows, LLC*, 2006 WL 1775828, \*4 (Bankr. D. Ariz. 2006) (specific performance is no longer available once a contract is rejected); *Moglia v. Pac. Employers Ins. Co. of North America*, 547 F.3d 835, 837 (7th Cir. 2008) (noting in dicta that rejection does not avoid the debtor's obligations but replaces specific performance with damages); *In re Ducane Gas Grills, Inc.*, 320 B.R. 341, 351 (Bankr. D.S.C. 2004) (“Plaintiffs are not entitled to the return of the Chuck Wagon as a specific performance remedy for Debtor's rejection of executory contracts ... and are limited to claiming a prepetition unsecured claim for damages from Debtor's bankruptcy estate pursuant to § 502(g)”); *In re Roman Crest Fruit, Inc.*, 35 B.R. 939, 946 (Bankr. S.D.N.Y. 1983) (“it would make no sense to order the debtor to specifically perform a contract that can be avoided or rejected”); *In re Sun Belt Elec. Constructors, Inc.*, 56 B.R. 686 (Bankr. N.D. Ga. 1986) (specific performance is not an appropriate remedy following rejection); *In re Fleishman*, 138 B.R. 641, 648 (Bankr. D. Mass. 1992) (same); *In re Rega Properties, Ltd.*, 894 F.2d 1136, 1140 (9th Cir. 1990) (allowing the non-debtor to enforce the contract as written following rejection would defeat the purpose of § 365, which is to relieve the debtor of burdensome obligations).

The majority rule is consistent with the statutory construction maxim *expression unius est exclusio alterius*. Section 365 identifies two instances in which the non-debtor may demand specific performance following contract rejection: § 365(i) (a non-debtor already in possession of real property is entitled to complete a pending sale), and § 365(n) (rejection cannot terminate the intellectual property rights of a technology licensee). These sections imply that Congress considered the issue of specific performance and limited the remedy as specified. See A. Scalia & B. Garner, *Reading Law: The*

*Interpretation of Legal Texts*, Canon 10, p. 107 (2014) (the expression of one thing implies the exclusion of others).

\*364 As the HOA points out, several courts have ruled the other way. *See, e.g., In re Walnut Associates*, 145 B.R. 489, 494 (Bankr. E.D. Penn. 1992) (“if state law ... authorize[s] specific performance under the rejected executory contract ... the non-debtor should be able to enforce the contract against the [d]ebtor”); *In re West Chestnut Realty of Haverford, Inc.*, 177 B.R. 501, 506 (E.D. Penn. 1995) (same). The Court is unconvinced by these cases, which do not acknowledge § 101(5)(B) or the impact of the bankruptcy discharge on a creditor's ordinary state law equitable remedies.

Thus, if the settlement agreement is rejected and Debtor confirms a plan of reorganization, the HOA would not be able to enforce its state law specific performance rights, but would have to settle for a claim for money damages. At this stage, the Court cannot say that rejection would be futile.

#### C. Effect of the State Court Order.

[6] [7] The HOA next argues that the state court has already ordered specific performance, which cannot be defeated by Debtor's rejection of the settlement agreement. The Court agrees that, had the settlement agreement been reduced to a final specific performance judgment, it would no longer be an executory contract subject to rejection. *See, e.g. In re Bassett*, 74 B.R. 361, 363 (Bankr. D. Colo. 1987) (land-sale contract buttressed by a prepetition order of specific performance is not an executory contract that can be rejected under § 365); *In re Pribonic*, 70 B.R. 596 (Bankr. W.D. Pa. 1987) (contract was no longer executory after entry of state law specific performance decree, and in any event by electing its remedy, non-debtor could not have a “claim” that could be monetized); *In re Sundial Asphalt Co., Inc.*, 147 B.R. 72, 80 (E.D.N.Y. 1992) (“[a] contract for the sale of land ceases to be executory, or rejectable in bankruptcy, at the instant a decree of specific performance is issued.”); *Roxse Homes, Inc. v. Roxse Homes Ltd. Partnership*, 83 B.R. 185, 187 (D. Mass. 1988) (same).

The Court has already ruled, however, that the settlement agreement is an executory contract, not a final judgment. While there is a state court order, it did not result from the full litigation of a land sale contract. There was no trial, virtually no evidence, and no election of remedies by the HOA. Instead, the state court conducted a short hearing consisting of oral argument and granted the HOA's motion to enforce the settlement agreement.<sup>5</sup> The issue of specific

performance was not litigated or finally determined, so the settlement agreement was not converted into a final, non-executory judgment. For the same reasons, the Court need not deny Debtor's motion based on comity, the Rooker–Feldman doctrine, or other preclusion theories.

5 For purposes of this opinion, the Court treats the state court's oral order the same as if it had been memorialized in writing.

#### D. Bad Faith.

[8] [9] Finally, the HOA asserts that Debtor is acting in bad faith by filing the bankruptcy case for the sole purpose of rejecting the settlement agreement. The Court disagrees. In general, filing a bankruptcy case to reject a lease or executory contract is not bad faith. *See, e.g., In re Balboa Street Beach Club, Inc.*, 319 B.R. 736, 740 (Bankr. S.D. Fla. 2005) (collecting cases and noting: “there is no such thing as ‘bad faith’ in bringing a bankruptcy case solely for the purposes of rejecting an overly burdensome executory contract”); \*365 *In re Chameleon Systems, Inc.*, 306 B.R. 666, 696 (Bankr. N.D. Cal. 2004) (“rejection and the capping of a landlord's claim is not per se bad faith”).<sup>6</sup> The power to reject burdensome leases or contracts under was granted to debtors by Congress. *Law v. Siegel*, — U.S. —, 134 S.Ct. 1188, 188 L.Ed.2d 146 (2014), teaches that bankruptcy courts should not alter the remedies specified in the Code to correct perceived unfairness. The Court therefore is unwilling to characterize Debtor's use of § 365 as bad faith.

6 *But see, e.g., In re Silberkraus*, 253 B.R. 890, 906 (Bankr. C.D. Cal. 2000) (“filing bankruptcy with the sole purpose of trying to reject an executory contract or lease is bad faith, and the rejection will be precluded”).

Furthermore, if filing a bankruptcy petition after entry of an adverse state court ruling automatically constitutes bad faith, many cases would have to be dismissed. Consumer debtors regularly file bankruptcy petitions after the entry of foreclosure judgments. Retailers and restaurateurs file petitions after litigation with vendors, landlords, franchisors, etc. By approving rejection, the Court is not disturbing or collaterally attacking a pre-petition state court judgment, nor is it modifying any of the HOA's rights that are independent of the rejected contract. For example, the HOA may still pursue Tract D if it has (as asserted) a right to the tract under the Declaration. The Court concludes Debtor is not acting in bad faith.

III. CONCLUSION

Debtor has exercised reasonable business judgment in electing to reject the settlement agreement, which is an executory contract. Upon rejection and subsequent plan confirmation, the HOA could be forced to settle for a money damages claim rather than specific performance. Debtor's

efforts in this case may or may not succeed, ultimately, but are not taken in bad faith. The Court will approve Debtor's rejection of the settlement agreement. A separate order will be entered consistent with this opinion.

**All Citations**

560 B.R. 358, 63 Bankr.Ct.Dec. 63

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Declined to Follow by *Crafts v. Pitts*, Wash., July 19, 2007

65 B.R. 826

United States Bankruptcy Court,  
C.D. California.

In re Moses N. ASLAN, Debtor.

Bankruptcy No. LA 86–03637–GM.

|  
Sept. 5, 1986.

### Synopsis

Chapter 11 debtor moved to reject executory contract for sale of real property. The Bankruptcy Court, Geraldine Mund, J., held that: (1) contract was still “executory contract,” such as could be assumed or rejected by trustee or debtor in possession; (2) purchaser's claim for specific performance was dischargeable in bankruptcy; and (3) debtor would be allowed to reject contract.


Motion granted.

West Headnotes (5)

[1] **Bankruptcy**  **Executory Nature in General**

Contract for sale of real property was “executory contract,” such as could be assumed or rejected by trustee or debtor-in-possession, where debtor had not yet conveyed title and escrow remained open. Bankr.Code, 11 U.S.C.A. § 365.

2 Cases that cite this headnote

[2] **Bankruptcy**  **Claims Allowable; What Constitutes “Claim.”**

**Bankruptcy**  **Particular Debts or Liabilities**

“Claim” included claim for specific performance of real estate sales agreement, for purpose of statutes providing that claim arising before plan is confirmed is dischargeable in bankruptcy, where purchaser had alternative state law remedy of suit for money damages. Bankr.Code, 11 U.S.C.A. §§ 101(4)(B), (11), 502(g), 1141(d).

17 Cases that cite this headnote

[3] **Bankruptcy**  **Grounds for and Objections to Assumption, Rejection, or Assignment**

Trustee may be allowed to reject executory contract only where bankruptcy court has first considered harm to debtor and other parties to contract and weighed this against benefit or harm to other creditors. Bankr.Code, 11 U.S.C.A. § 365.

[4] **Bankruptcy**  **Grounds for and Objections to Assumption, Rejection, or Assignment**

Debtor's good faith is factor in whether he will be allowed to reject executory contract. Bankr.Code, 11 U.S.C.A. § 365.

[5] **Bankruptcy**  **Grounds for and Objections to Assumption, Rejection, or Assignment**

Debtor in possession would be allowed to reject executory contract for sale of real property, where debtor's Chapter 11 petition was not filed for sole purpose of preventing consummation of purchaser's specific performance action, property had potential value in excess of contract price, and funds generated from sale of property could be used to pay all creditors in plan. Bankr.Code, 11 U.S.C.A. § 365.

7 Cases that cite this headnote

### Attorneys and Law Firms

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Edythe Bronston, Cox, Castle & Nicholson, Los Angeles, Cal., for creditor Siavoush Safaie-Kia.

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Barbara Dohrmann, Los Angeles, Cal., for creditors Jane C. Williams and Westwood Center Corp.

Patrick Smith, Los Angeles, Cal., for U.S. trustee.

MEMORANDUM OF OPINION RE MOTION  
TO REJECT EXECUTORY CONTRACT

GERALDINE MUND, Bankruptcy Judge.

On or about April 13, 1982, Moses Aslan and Sycamore Investment Company ("Sycamore") entered into a real estate purchase contract whereby Sycamore agreed to purchase the "Broadway Spring Arcade Buildings" (the "Arcade"). This agreement was amended a few days later to, among other things, increase the purchase price to \$4,500,000.00.

The agreement between the parties called for Aslan to deliver to Sycamore copies of leases, verbal tenancies, warranties, etc. within 10 days after the opening of the escrow. The escrow was to have opened on or before April 27, 1982 and was to have closed contingent upon Sycamore's review of the documents that it received. The escrow opened as scheduled, but Aslan only delivered part of the required documents and the escrow never closed.

On September 19, 1983, Sycamore filed a complaint for breach of contract and specific \*828 performance in the Superior Court of California, Case No. C 468496. In conjunction with that case, Sycamore filed a Notice of Action Pending, which is recorded with the County Recorder. This gave Sycamore a priority position on the building, should they prevail on their state court action for specific performance.

Aslan has vigorously defended this case in the state court, seeking to be relieved of any obligations under the purchase agreement. Prior to the filing of this bankruptcy, no resolution of the state court action had occurred.

The current case was filed on March 3, 1986, as a debtor-in-possession Chapter 11. Aslan sought to reject the purchase agreement. Thereafter, a trustee was appointed and the trustee has now joined the motion to reject the executory contract.

[1] There was dispute as to whether this contract is truly executory. The key case in issue is the Ninth Circuit decision of *In re Alexander*, 670 F.2d 885 (9th Cir.1982). The *Alexander* court held that the fact that the buyer had not yet paid the remainder of the purchase price for the real property and that title had not actually been conveyed by the seller left the contract sufficiently unperformed so that it remained executory.

Sycamore argues that no other courts (including later opinions of the Ninth Circuit) have followed *Alexander*. This does not appear to be the situation. While this Court also has trouble with the concepts expressed in *Alexander*, for it seems to say that unless the escrow has actually closed the contract is executory, it is the law of the Ninth Circuit and is binding upon the case before this Court. Therefore the Court finds that the contract in question is an executory contract and falls under the provisions of 11 U.S.C. § 365.

The Trustee argues that, since it appears that a higher price will be received for the building if it is now able to be sold, the "business judgment test" should allow him to reject the contract without further review by the Court. The Court believes that it first must determine the effect of rejection on the Specific Performance Action. If the rejection would transform the equitable remedy of specific performance into a monetary claim, it then must decide whether the business judgment test authorizes rejection.

Therefore the initial issue is whether rejection of an executory contract, where state law allows a remedy of specific performance, relieves the debtor/trustee from the requirement to specifically perform the contract. In other words, if the Court were to allow rejection of the contract, would the result be that Sycamore is left only with an unsecured pre-petition claim or would the result be that Sycamore (upon obtaining relief from the automatic stay) could go forward and obtain a state court judgment for specific performance and enforce that judgment against the estate?<sup>1</sup>

<sup>1</sup> The issue of rejection of executory contracts recently came before me in the case of *In re Carrere*, 64 B.R. 156 (Bankr.C.D.Cal.1986), in which I ruled that a personal services contract does

not become property of the estate in Chapters 7 and 11 and therefore cannot be rejected. At the end of that opinion I questioned whether rejection of contracts would transform an equitable remedy for specific performance into a claim for money, which could then be discharged. The opinion in the instant case modifies any comments that I made concerning the effect of rejection on a non-personal services contract in which equitable relief is sought.

The present case requires the Court to determine the congressional intent concerning the effect of rejection of a contract when state law allows a breach of contract to be remedied by specific performance. To that end the Court has delved deeply into the legislative history of the Bankruptcy Code and its various provisions and has taken the following analytical path:

11 U.S.C. § 365(g) states that rejection of an executory contract constitutes a breach of that contract immediately before the date of filing of the petition. This provision does not deal with the remedies involved, but establishes the time that the breach is deemed to have occurred.

11 U.S.C. § 1141(d) states that in Chapter 11, confirmation discharges the debtor \*829 from any “debt” that arose before the date of confirmation and from any “debt” of the kind specified in 11 U.S.C. §§ 502(g), 502(h), or 502(i). Therefore, if the breach described in § 365(g) creates a “debt” of the kind included in § 1141(d), that “debt” is discharged at time of confirmation.

11 U.S.C. § 502(g) specifies that a “claim” arising from rejection of an executory contract shall be determined and allowed under §§ 502(a), 502(b) or 502(c), or should be disallowed under §§ 502(d), or 502(e), as if such claim had arisen before the date of filing of the petition. So if the breach of an executory contract creates a “claim,” it is discharged under § 1141(d).

Up to this point there are two key words. Section 1141(d) talks about discharge of a “debt.” Section 502(g) talks about creation of a “claim.”

11 U.S.C. § 101(11) defines the term “debt” to mean a liability on a claim.

11 U.S.C. § 101(4)(B) defines a “claim” in the case of an equitable remedy to exist only if the breach of performance gives rise to a right of payment.<sup>2</sup> Nowhere in the definition

of claim does it include an equitable remedy which does not give rise to a right of payment.

2 11 U.S.C. § 101(4) states:

(4) “claim” means—

(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or

(B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.

Having followed this analytical path, the Court must interpret the phrase of § 101(4)(B) as being inclusive or exclusive. Does it mean to include or to exclude as a claim any cause of action which gives rise to a right to payment as an alternative remedy to equitable performance? The debtor and trustee take the position that § 101(4)(B) is inclusive of all causes of action which have an alternative right to payment, even if the choice of remedy would normally be in the control of the non-debtor. Sycamore argues the other position.

In support of its position that rejection of the contract relieves the debtor of any requirement to perform under state law, the debtor cites the case of *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir.1985). Although the facts in *Lubrizol* are very different, for they deal with using technology during the pendency of the lawsuit on breach, the issues are similar in that they require the Court to interpret the effect of an equitable remedy on the existence of a “claim.”

This Court agrees with the result in *Lubrizol*, for it holds that the equitable remedy is transformed into a monetary claim. However, the Court must respectfully disagree with the *Lubrizol* reasoning, for it is based upon H.R.Rep. 95–595, 95th Cong., 2nd Sess. 349 (1977), U.S.Code Cong. & Admin.News 1978, pp. 5787, 6305 and does not take into account the later legislative history of the definition of “claim,” which is specifically on point.

A summary of the legislative history of the creation of this bankruptcy code is set forth in *Collier on Bankruptcy* (15th Ed. Appendix 2). The bill which came through the House was designated H.R. 8200, 95th Cong., 1st Sess. (1977). It was considered, amended, and reported out of the Committee on

the Judiciary in September, 1977. That report was designated [H.R.Rep. No. 95-595](#), and is the one cited by the Fourth Circuit in *Lubrizol*. The text of [§ 101\(4\)](#), defining “claim,” in the House bill was as follows:

(4) “claim” means—

(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or

(B) right to an equitable remedy for breach of performance if such breach does not give rise to a right to payment, \*830 whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured;

The discussion cited in *Lubrizol* is that the House intended a claim to include “an equitable right to performance that does not give rise to a right to payment.” ([H.R.Rep. 95-595](#), p. 309, U.S.Code Cong. & Admin.News 1978, p. 6266).<sup>3</sup>

<sup>3</sup> The Fourth Circuit states that the legislative history “makes clear that the purpose of the provision is to provide only a damages remedy for the non-bankruptcy party.” The operative language that the Fourth Circuit is depending on in the House bill is “right to an equitable remedy for breach of performance *if such breach does not give rise to a right to payment ...*” The final version of the Code uses the phrase “right to an equitable remedy for breach of performance *if such breach gives rise to a right to payment....*” It is clear that the House intended that a claim would be all-inclusive and that if there was a right to payment, that would be included in [§ 101\(4\)\(A\)](#) and that other equitable remedies would be included in [§ 101\(4\)\(B\)](#). In this, the Fourth Circuit is correct that the House of Representatives intended there to be only a damages remedy for the non-debtor party. However, the operative language in the House bill was changed in the final version of the Code.

Some amendments were made to H.R. 8200 and it was passed by the House and sent to the Senate on February 8, 1978.

Meanwhile the Senate was working on its own bill, S. 2266, 95th Cong., 2d Sess. (1977) which was favorably reported on

July 14, 1978 and was accompanied by its own comments. The bill passed by the Senate defines a “claim” as follows:

(4) “claim”—

(A) means right to payment, other than of an expense allowable under section 503, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; and

(B) includes, except where specifically provided otherwise, interest thereon provided by law or contract.

The Senate version does not discuss equitable rights under the definition of claim and makes it clear that a claim must be a right to payment. The Senate passed its version on September 22, 1978.

Thereafter there were a series of conferences to work on the differences in the two bills that had been passed. A compromise was reached and the bill was passed by both Houses of Congress in October, 1978 and sent forward to the White House.

The compromises that were reached were reported in the Congressional Record. 124 Cong.Rec. H11090 (daily ed. Sept. 28, 1978) discusses the modification of [§ 101\(4\)\(B\)](#). It states as follows:

[Section 101\(4\)\(B\)](#) represents a modification of the House-passed bill to include [in] the definition of “claim” a right to an equitable remedy for breach of performance if such breach gives rise to a right to payment. This is intended to cause the liquidation or estimation of contingent rights of payment for which there may be an alternative equitable remedy with the result that the equitable remedy will be susceptible to being discharged in bankruptcy. For example, in some States, a judgment for specific performance may be satisfied by an alternative right to payment, in the event performance is refused; in that event, the creditor entitled to specific performance would have a “claim” for purposes of proceeding under [title 11](#).

On the other hand, rights to an equitable remedy for a breach of performance with respect to which such breach does not give rise to a right to payment are not “claims” and would therefore not be susceptible to discharge in bankruptcy.

The identical language was put forth in the Senate record, 124 Cong.Rec. S17406 (daily ed., Oct. 6, 1978).

[2] Therefore it is clear that the final version, as passed and signed into law, is intended to include as a claim a right to an equity remedy for breach of performance *if the breach gives rise to an alternative right to payment*. If the *only* remedy \*831 allowed by law is non-monetary, the equitable remedy is not transformed into a claim and it survives the rejection of the executory contract.

The question to be dealt with is whether, as a matter of state law, the non-breaching party to the contract has a right to obtain a money judgment, even though he also has a right to obtain an equitable judgment. If so, the remedy becomes a contingent claim and can be discharged in the bankruptcy.

There are certain cases in which no money damages can be awarded. For example, if the plaintiff is seeking to enforce his right to vote on a Board of Trustees, no amount of money can take the place of that right and that right cannot be estimated by the Court in terms of dollars so as to create a contingent claim. Because this is not the type of judgment which can be converted into money, it is not a "claim" under the Bankruptcy Code and cannot be discharged upon rejection of the contract. Therefore rejection of such a contract would not be possible and the statutory scheme of § 365 would not apply.<sup>4</sup>

<sup>4</sup> The Court is also aware of a possible situation where rejection of the contract and discharge of the claim would be in contravention of a state statute that is meant to protect public health. In such a situation it is probable that the reasoning of *Mid-Atlantic National Bank v. New Jersey Department of Environmental Protection*, 474 U.S. 494, 106 S.Ct. 755, 88 L.Ed.2d 859 (1986) would apply and would at least require the Court to condition the rejection on certain acts that would help to accomplish the state purpose.

In the case of transfer of real property, specific performance is allowed because courts have felt that real property is unique and that a money judgment cannot fully equate to the property itself. However, the law does allow the creditor to choose between receiving money and receiving specific performance.

Damages for rejection of an executory contract become a claim dischargeable in the bankruptcy only if under state law the creditor would have the choice of more than one possible remedy, with one of the choices being a money claim. The filing of the bankruptcy and the rejection of the contract under the bankruptcy shifts the choice of remedy from one which is solely in the hands of the creditor to a choice by the debtor, upon approval of the Court. Thus, in California, an executory contract for sale of real property can be rejected and the potential action for specific performance will be transformed into a pre-petition claim, which may be discharged in the bankruptcy.

[3] [4] However, before rejection actually can occur, the Court must determine whether it should be allowed. The Court must look at the harm to this creditor, weigh it against the benefit or harm to other creditors, and look at the potential harm to the debtor. *In re Huang*, 23 B.R. 798 (Bankr. 9th Cir.1982). Good faith plays a part in this weighing, as is shown by the recent opinion of *In re Chinichian*, 784 F.2d 1440 (9th Cir.1986). In *Chinichian* the Court found that the bankruptcy was filed for the sole purpose of preventing consummation of the state court's specific performance judgment and that no one except the debtors would benefit from the rejection of the contract. Therefore rejection was not allowed.

[5] This is not the situation concerning the Arcade Building. There are consensual and judgment liens junior to Sycamore's interest, there is potential value of \$8 Million for the property, and there are other properties. Some of the liens on the Arcade Building are cross-collateralized by other property. By selling the Arcade Building for \$8 Million, liens would be removed from other properties of the estate which could then be sold to generate sufficient monies to pay all creditors in full, including the "claim" of Sycamore.

Therefore the Court finds that the trustee's application to reject meets the requirements of the business judgment test and approves rejection upon receipt of a minimum cash bid of \$8 Million at a publicly noticed auction or some equivalent offer or refinance that values the property at \$8 Million or more.

#### All Citations

65 B.R. 826, 15 Bankr.Ct.Dec. 136, Bankr. L. Rep. P 71,536

## **LEGAL AUTHORITY CA-48**



2019 WL 8886440

Only the Westlaw citation is currently available.

United States District Court, E.D. Virginia,  
Norfolk Division.

VIR2US, INC., Plaintiff,

v.

SOPHOS INC., et al., Defendants.

Civil Action No. 2:19cv18

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Signed 08/12/2019

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Filed 08/14/2019

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**ORDER**HENRY COKE MORGAN, JR. SENIOR UNITED STATES  
DISTRICT JUDGE

\*1 This matter is before the Court on Defendants Sophos, Inc., Sophos Limited, Sophos Group PLC, and Invincea, Inc.'s (collectively, "Defendants' ") Motion to Dismiss Vir2us' Complaint, Doc. 34. For the reasons stated herein, the Court **GRANTS** Defendants' Motion to Dismiss, **IN PART, WITH LEAVE TO AMEND.**

**I. FACTUAL ALLEGATIONS**<sup>1</sup>

<sup>1</sup> "In considering a motion to dismiss, [the Court] accept[s] as true all well-pleaded allegations and view[s] the complaint in the light most favorable to the plaintiff." [Venkatraman v. REI Sys., Inc.](#), 417 F.3d 418, 420 (4th Cir. 2005) (citations omitted). The Court cautions, however, that the facts alleged by Plaintiff are recited here for the limited purpose of deciding the instant Motion to Dismiss. The recited facts are not factual findings upon which the parties may rely for any other issue in this proceeding.

This is an action brought by Plaintiff Vir2us, Inc. ("Plaintiff" or "Vir2us") to enforce the terms of a settlement agreement.

**A. Parties**

Plaintiff Vir2us is a California corporation that designs, markets, and sells computer security software and services. Compl. ¶ 17. It owns several patents that it has licensed to Defendants. Compl. ¶ 8. Defendant Invincea, Inc. ("Invincea") is a Delaware corporation that entered into a settlement agreement with Vir2us ("Patent License Agreement") in 2016. *Id.* ¶¶ 1, 12.

Defendant Sophos Inc. (hereinafter, "Sophos MA") is a Massachusetts corporation that owns one hundred percent (100%) of the shares of Invincea. *Id.* ¶¶ 9, 14. Sophos MA is a wholly-owned subsidiary of Defendant Sophos Ltd. ("Sophos UK"). *Id.* Sophos UK has its principal place of business in Oxford, U.K. *Id.* ¶ 10. Sophos UK, in turn, is a wholly-owned subsidiary of Sophos Group PLC ("Sophos Parent"), which is also located in Oxford, U.K. *Id.* ¶ 11.

**B. Patent License Agreement**

Vir2us filed a complaint for patent infringement against Invincea Inc. and Invincea Labs, LLC on April 15, 2015. Doc. 1 ("Compl.") ¶ 19. Vir2us alleged that Invincea infringed certain claims of [U.S. Patent Nos. 7,392,541](#) and [7,536,598](#) ("asserted patents") "by making, using, selling and offering to sell certain Invincea products, including Invincea FreeSpace which Invincea later sold as Invincea X Endpoint - Spearfish Protection." *Id.* On July 15, 2016, Vir2us and Invincea settled the matter before this Court. *Id.* ¶ 20.

As part of the settlement, Vir2us and Invincea entered into the Patent License Agreement. Doc. 1 at Ex. A (“Agreement”).<sup>2</sup> Pursuant to this Agreement, this District is “[t]he exclusive venue for disputes arising out of” the Agreement. Compl. ¶ 1; Agreement § 8.5. The Patent License Agreement grants “Invincea and its Affiliates a fully paid, non-exclusive, assignable (only as permitted in [the] license agreement), worldwide license under the Licensed Patents<sup>3</sup> for the life of the Licensed Patents ....” Agreement § 2.1. The Agreement defines “Affiliate” as follows:

[I]n relation to a Party [i.e. Vir2us or Invincea], another legal entity that, directly or indirectly, owns or controls, or is owned or controlled by, or is under common control with, such Party during the Term of this License Agreement. For the purposes of this definition a first legal entity shall be deemed to own or control a second legal entity if (i) the first legal entity holds, directly or indirectly, more than fifty per cent [sic] (50%) of the voting stock of the second legal entity, ordinarily entitled to vote in the meetings of shareholders of that entity, or (ii) if there is no such stock, the first legal entity holds, directly or indirectly, more than fifty per cent (50%) of the ownership or control in the second legal entity, or (iii) the first legal entity has the power, directly or indirectly, to control the decision of the second legal entity.

\*2 Agreement § 1.

<sup>2</sup> When evaluating a motion to dismiss, a court “may consider the facts alleged on the face of the complaint as well as matters of public record, orders, items appearing in the record of the case, and exhibits attached to the complaint... without converting a Rule 12(b)(6) motion into a Rule 56 motion for summary judgment.” [Spirito v. Peninsula Airport Comm'n](#), 350 F. Supp. 3d 471, 480 (E.D. Va. 2018) (citing [Pueschel v. United](#)

[States](#), 369 F.3d 345, 353 n.3 (4th Cir. 2004)). The unsealed Agreement is located at Doc. 6, Ex. 1.

<sup>3</sup> The Agreement defines “Licensed Patents” as all patents and patent applications owned by Vir2us, including the asserted patents, “any divisions, continuations, continuations-in-part, reissues, re-examinations, and foreign counterparts of any of the foregoing and all related patents.” Agreement § 1.

In exchange for use of the Licensed Patents, the Patent License Agreement imposes royalty and reporting obligations on Invincea. It provides: “Invincea shall pay to Vir2us a royalty of one dollar (\$1.00) for each Container Products and Services<sup>4</sup> Sold in the United States of America during the Term of this Agreement.” Agreement § 3.1. Invincea is responsible for the payment of “all Royalties due [under the Patent License Agreement] for each of Invincea and each Invincea Affiliate.” *Id.* ¶ 4.2 (hereinafter, “royalty obligations”). Invincea, “on behalf of itself and all Affiliates,” must also deliver to Vir2us, within forty-five (45) days following the end of each calendar quarter during the License Term, “a written report of the previous quarter’s transactions by Invincea and any Invincea Affiliate regarding all Licensed Products and Services” (hereinafter, “reporting obligations”). *Id.* ¶ 4.1.

<sup>4</sup> The Agreement defines “Container Products and Services” as “the accused container products currently called Invincea X Endpoint - Spearphish Protection and formerly known as Invincea FreeSpace, Invincea Enterprise, and Invincea Advanced Endpoint Protection, as well as natural evolutions and derivations of these products....” Agreement § 1.

The Patent License Agreement additionally provides a record-keeping requirement:

Each of Invincea and each Invincea Affiliate separately shall keep accurate and complete records and accounts pertaining to the identity and quantity of all Licensed Products and Services Sold.

*Id.* § 4.4.

### C. Post-Agreement Compliance and Acquisition

Through Q1 2017, Invincea fulfilled the royalty and reporting obligations. Compl. ¶ 32. On approximately February 8, 2017, Sophos<sup>5</sup> announced via press release that it had entered into an agreement to acquire Invincea from its current shareholders “for a cash consideration of \$100 million with a \$20 million earn-out.” Compl. ¶ 25. Sophos allegedly completed its acquisition on or around March 22, 2017, with Sophos MA acquiring one hundred percent (100%) of the shares of Invincea. *Id.* ¶ 28.

<sup>5</sup> The Complaint generically refers to all Sophos entities named in the Complaint as “Sophos.”

Beginning in Q2 2017, Sophos began delivering Quarterly Reports to Vir2us “on behalf of Invincea, which Sophos stated was ‘now a Sophos company.’” *Id.* ¶ 33. Sophos also made the royalty payments for the reported sales of the Licensed Products and Services after its acquisition of Invincea. *Id.*

### D. Alleged Breach

\*3 Vir2us alleges that, “[o]n information and belief Sophos integrated technology from the Invincea products covered by the Patent License Agreement into the Sophos Intercept X products, including technology from the X by Invincea, Invincea X Endpoint - Spearfish Protection, Invincea FreeSpace, Invincea Enterprise, and Invincea Advanced Endpoint Protection line of products.” Compl. ¶ 29. It further claims that “Sophos has advertised and represented to the public that it has, in fact, integrated technology from the Invincea products covered by the Patent License Agreement into Sophos’ Intercept X product.” *Id.* ¶ 30. However, on April 16, 2018, Sophos announced “the immediate end of sale for all Invincea-related products and support.” *Id.* ¶ 31.

Since then, Sophos has continued to deliver Quarterly Reports and make royalty payments for the sales of the Licensed Products and Services. *Id.* ¶ 34. However, “[n]oticeably absent from the Quarterly Reports ... were any Sophos products, including Sophos’ Intercept X product, which, on information and belief, contains technology from Invincea’s products covered by the Patent License Agreement.” *Id.* ¶ 35. Likewise, Vir2us alleges that “Sophos has failed to make any Royalty payment for any Sophos product, including Sophos’ Intercept X product, containing technology from the Invincea products covered by the Patent License Agreement.” *Id.*

As a result of Defendants’ alleged failure to fully satisfy the terms of the Patent License Agreement, Vir2us brings two (2) counts for Breach of Contract. Count I alleges that Defendants have breached their obligation to deliver, from Q1 2017 onward, Quarterly Reports that include the “quantity and description of all products sold and/or services offered by Invincea and/or its Affiliates.” *Id.* ¶ 42. Count II alleges that Sophos sold products including “at least, Sophos’ Intercept X product,” that integrated “Invincea technology from the listed Invincea products specified in the Patent License Agreement.” *Id.* ¶ 48. Vir2us alleges that Defendants breached the Patent License Agreement by failing to pay royalties for these products. *Id.* ¶¶ 50-51.

## II. PROCEDURAL HISTORY

Vir2us filed its Complaint on January 9, 2019. Doc. 1. Defendants filed the instant Motion to Dismiss on March 15, 2019. The matter was fully briefed on April 4, 2019. Doc. 48.

## III. MOTION TO DISMISS

### A. Legal Standard

“To survive a motion to dismiss, a complaint must contain sufficient factual matter, accepted as true, to ‘state a claim to relief that is plausible on its face.’” [Ashcroft v. Iqbal](#), 556 U.S. 662, 678 (2009) (citing [Bell Atl. Corp. v. Twombly](#), 550 U.S. 544, 570 (2007)); see also [Venkatraman v. REI Sys., Inc.](#), 417 F.3d 418, 420 (4th Cir. 2005) (“In considering a motion to dismiss, we accept as true all well-pleaded allegations and view the complaint in the light most favorable to the plaintiff.”). A complaint establishes facial plausibility “once the factual content of a complaint allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged.” [Nemet Chevrolet, Ltd. v. Consumeraffairs.com, Inc.](#), 591 F.3d 250, 256 (4th Cir. 2009) (quoting [Iqbal](#), 556 U.S. at 678). Therefore, the complaint need not include “detailed factual allegations,” as long as it pleads “sufficient facts to allow a court, drawing on judicial experience and common sense, to infer more than the mere possibility of misconduct.” *Id.* Although a court must accept as true all well-pleaded factual allegations, the same is not true for legal conclusions. “Threadbare recitals of the elements of a cause of action, supported by mere conclusory statements, do not suffice.” [Iqbal](#), 556 U.S. at 678.

## B. Analysis

Defendants move to dismiss Sophos MA, Sophos UK, and Sophos Parent (“Sophos Defendants”) from this action, arguing that they are not parties to the Patent License Agreement and therefore cannot be held liable under the Agreement. Doc. 38 at 12. They further argue that the products alleged to be missing from the Quarterly Reports and royalty payments are not covered by the plain terms of the Patent License Agreement. Doc. 38 at 14.

### *i. Legal Obligation of Sophos Defendants*

\*4 To state a claim for breach of contract in Virginia, a plaintiff must allege facts to support: (1) a legally enforceable obligation of the defendant to the plaintiff; (2) defendant's breach of that obligation; and (3) damage to the plaintiff as a result of the breach. [Navar, Inc. v. Fed. Bus. Council](#), 784 S.E.2d 296, 299 (Va. 2016). Defendants first argue that Vir2us fails to state a claim against Sophos Defendants because the Patent License Agreement imposes no legally enforceable obligation on them. Doc. 38 at 8. In response, Vir2us contends that Sophos Defendants are liable under a successor-in-interest theory, or as Affiliates under the terms of the Patent License Agreement. Doc. 47 at 6, 8.

#### **a. Piercing the Corporate Veil**

Defendants assert that as non-parties to the Patent License Agreement, they cannot be held liable under that agreement because Vir2us has failed to plead facts that would allow this Court to disregard corporate formalities between Invincea and Sophos Defendants. Doc. 38 at 14.

A corporation is a “legal entity separate and distinct from the stockholders or members who compose it.” [Federico v. Lincoln Military Housing, LLC](#), 127 F. Supp. 3d 623, 647 (E.D. Va. 2015) (quoting [Dana v. 313 Freeman](#), 587 S.E.2d 548, 553 (Va. 2003)). Therefore, “a parent corporation is not generally liable on the contracts of its subsidiary.” [Rhodes v. Geeks on Call Holdings, Inc.](#), No. 2:08CV575, 2009 WL 10688337, at \*2 (E.D. Va. Feb. 6, 2009). A court may only disregard the corporate entity and place liability on corporate shareholders, known as “piercing the corporate veil,” under extraordinary circumstances. See [Dana](#), 587 S.E.2d at 553. Although no single factor is determinative, Virginia courts generally require three (3) elements to be present to pierce the corporate veil: (1) undue dominion or control by the parent corporation over the subsidiary; (2) the use of such control

to perpetrate a fraud or to gain an unfair advantage; and (3) unjust loss or injury from such dominance unless the parent corporation is held liable. [Federico](#), 127 F. Supp. 3d at 647-48.

Defendants correctly argue, and Vir2us does not contest, that it has failed to plead the requisite elements to support veil piercing in the instant case. See Doc. 47 at 14. Namely, Vir2us makes no allegations that any of the Sophos Defendants have used the acquisition of Invincea to perpetrate a fraud or gain an unfair advantage, nor has it pleaded that it would suffer unjust loss if Sophos Defendants were dismissed from the case. Cf. [Dana](#), 127 F. Supp. 3d at 554 (affirming trial court's decision to pierce the corporate veil in part because the formation of the corporation was to avoid personal liability of shareholders). Without such allegations, the Court cannot pierce the corporate veil to hold Sophos Defendants liable.

#### **b. Affiliate Liability**

Vir2us instead argues that Sophos Defendants are liable under the Patent License Agreement as Affiliates of Invincea. Doc. 47 at 12.

The Patent License Agreement defines an Affiliate as, *inter alia*, a legal entity that “holds, directly or indirectly, more than fifty per cent (50%) of the ownership or control in” Invincea. Agreement § 1. The Agreement is explicitly binding on Vir2us, Invincea, and Invincea's Affiliates. Agreement at 1. All Sophos Defendants are alleged to satisfy this definition by holding, directly or indirectly, one hundred percent (100%) of Invincea stock. See Compl. ¶ 28. However, status as an Affiliate is not sufficient to confer liability for Vir2us' breach of contract claims.

Here, Sophos Defendants cannot be held liable as Affiliates under the Patent License Agreement because Vir2us' breach of contract claims do not correspond to legal obligations imposed on Affiliates under the Agreement. Vir2us brings claims for: (1) failure to deliver Quarterly Reports, Compl. at 10; and (2) failure to pay royalties, Compl. at 11. However, the Agreement explicitly imposes these obligations on Invincea, on behalf of itself and its Affiliates. See Agreement § 4.2 (“Invincea shall pay to Vir2us all Royalties due hereunder for each of Invincea and each Invincea Affiliate.”); *id.* § 4.1 (“Invincea (on behalf of itself and all Affiliates) shall deliver to Vir2us a written report of the previous quarter's transactions by Invincea and any Invincea Affiliate regarding all Licensed Products and Services.”); see also *id.* § 2.4 (“Invincea unconditionally and irrevocably guarantees performance under this Agreement by all its Affiliates.”). In



fact, it appears the Agreement requires few affirmative acts by Affiliates. *Cf. id.* § 4.4 (requiring Affiliates to maintain “accurate and complete records and accounts pertaining to the identity and quantity of all Licensed products and Services Sold”). Thus, although Sophos Defendants are clearly Affiliates within the meaning of the Patent License Agreement, this status cannot be the basis for their liability.

### c. Successor-in-interest Liability

\*5 Vir2us next insists that Sophos Defendants are bound by the Patent License Agreement as successors-in-interest to Invincea. Doc. 47 at 6.

“It is well settled that where one company sells or otherwise transfers all its assets to another company, the latter is not liable for the debts and liabilities of the transferor.” [City of Richmond v. Madison Mgmt. Grp., Inc.](#), 918 F.2d 438, 450 (4th Cir. 1990); *see also* [La Bella Dona Skin Care, Inc. v. Belle Femme Enters., LLC](#), 805 S.E.2d 399, 406-07 (Va. 2017) (“The general rule in Virginia is that a company may acquire the assets of another company without assuming responsibility for its debts and liabilities.”). In Virginia, there are four (4) exceptions to this rule:

- (1) [T]he purchasing corporation expressly or impliedly agreed to assume such liabilities,
- (2) the circumstances surrounding the transaction warrant a finding that there was a consolidation or de facto merger of the two corporations,
- (3) the purchasing corporation is merely a continuation of the selling corporation,
- or (4) the transaction is fraudulent in fact.

[Harris v. T.I., Inc.](#), 413 S.E.2d 605, 609 (Va. 1992). To state a claim against any of the Sophos Defendants, Vir2us must allege facts to support at least one of these factors.

Vir2us avers that “Sophos” is a successor-in-interest because it “has complete control over Invincea and is merely a continuation of Invincea.” Doc. 47 at 5. However, the Virginia Supreme Court has clearly stated that “[w]hen ... the purchase of all the assets of a corporation is a bona fide, arm's-length transaction, the ‘mere continuation’ exception does

not apply.” [Harris](#), 413 S.E.2d at 609 (citations omitted); *see also* [La Bella](#), 805 S.E.2d at 407 (noting that to establish the “mere continuation” exception of successor liability, a litigant “must ... establish that the asset transfer was not a bona fide, arm's-length transaction”); [In re SunSport, Inc.](#), 260 B.R. 88, 106 (Bankr. E.D. Va. 2000) (“[A] new corporation is not a mere continuation when the purchase of the seller's assets occurred in a bona fide, arm's length transaction.”) (emphasis in original).

Here, Vir2us has not alleged any facts to support a claim that Sophos MA's acquisition of Invincea was not a bona fide, arm's-length transaction.<sup>6</sup> There are no facts to suggest that Invincea and the Sophos Defendants had any relationship prior to the acquisition that would cause a conflict of interest. Moreover, Vir2us alleged that Sophos MA planned to acquire Invincea for valuable consideration. *See* Compl. ¶ 25 (“Sophos announced ... that it had entered into an agreement to acquire Invincea from its current shareholders for a cash consideration of \$100 million with a \$20 million earn-out.”). “[T]he acquisition of another company's assets for adequate consideration is evidence of an arm's-length transaction, and ... undermines any continuation claim.” [Waterford Inv. Servs., Inc. v. Bosco, No. 3:10CV548-REP](#), 2011 WL 3820723, at \*19 (E.D. Va. July 29, 2011), *aff'd* 682 F.3d 348 (4th Cir. 2012); *see also* [Taylor v. Atlas Safety Equip. Co.](#), 808 F. Supp. 1246, 1252 (E.D. Va. 1992) (finding no evidence that a transaction was not arm's-length when, *inter alia*, one party paid another valuable and adequate consideration). Accordingly, Vir2us has failed to plead that any of the Sophos Defendants were successors to Invincea pursuant to a continuation theory of liability.

<sup>6</sup> An “arm's-length transaction” is a “transaction between two parties, however closely related they may be, conducted as if the parties were strangers, so that no conflict of interest arises.” [Fuisz v. Lynch](#), 147 F. App'x 319, 323 (4th Cir. 2005) (quoting Black's Law Dictionary 1535 (8th ed.2004)).

\*6 Although not explicitly advanced by Vir2us, Sophos Defendants may be successors-in-interest to the Patent License Agreement under an alternative theory. “A successor corporation that expressly or impliedly agrees to assume the liabilities of its predecessor will be liable for such obligations.” [Vianix Delaware v. Nuance Commc'ns](#), 637 F. Supp. 2d 356, 359 (E.D. Va. 2009) (citing [Harris](#), 413 S.E.2d at 609); *see also* [City of Richmond](#), 918 F.2d at



451; [States Roofing Corp. v. Bush Const. Corp.](#), 426 S.E.2d 124, 127 (Va. Ct. App. 1993). For example, in [Vianix](#), this Court found that a plaintiff had sufficiently alleged successor liability to a software license of a defendant-parent company, even when the subsidiary continued to operate as an independent company. 637 F. Supp. 2d 356. In support, the Court observed that the parent company had: (1) added the subsidiary's software to its existing portfolio; (2) sold the software through its own website after the acquisition; and (3) provided customer support for the software after the acquisition. [Id.](#) at 360. Thus, by “adopting [the software] as its own product,” the parent company implicitly assumed responsibility for the software license. [Id.](#)

Vir2us has alleged sufficient facts to suggest that at least one Sophos entity implicitly assumed Invincea's royalty and reporting obligations under the Patent License Agreement. According to the Complaint, “Sophos” integrated “Invincea's products—including the Container Products and Services covered by the Patent License Agreement—into Sophos' flagship endpoint protection product (e.g., Sophos' Intercept X).” Compl. ¶ 5. Although Invincea survived the acquisition, on April 16, 2018, “Sophos announced the immediate end of sale for all Invincea related products.” Compl. at Ex. D. According to Sophos' website, “[s]upport and maintenance [for Invincea] will be available under existing contracts through December 31st, 2019.” [Invincea](#), Sophos (July 29, 2019, 4:07 p.m.), <https://www.sophos.com/en-us/lp/invincea.aspx>. After December 2019, a Sophos press release “strongly encourage[s] customers to consider migrating from Invincea to Sophos Intercept X,” which “features an enhanced Invincea deep learning malware detection engine, Sophos anti-exploit technology, specific anti-ransomware functionality, and more.” Compl. at Ex. D. Most importantly, following Sophos' acquisition of Invincea, it began making royalty payments to Vir2us under the Patent License Agreement and “delivering the Quarterly Reports to Vir2us on behalf of Invincea, which Sophos stated was ‘now a Sophos company.’ ” Compl. ¶ 33. These allegations, if proven, suggest that one or more of the Sophos Defendants implicitly assumed certain responsibilities of the Patent License Agreement by incorporating Invincea's technology as its own, discontinuing Invincea's products, and taking steps to comply with the royalty and reporting terms of the Patent License Agreement. Accordingly, Vir2us has alleged facts to support successor liability for the claims at issue through an implied assumption theory for at least one Sophos Defendant.

#### d. Failure to Distinguish Sophos Defendants

Defendants finally argue that the Court should dismiss Sophos UK and Sophos Parent because “if any entity allegedly ‘succeeded’ Invincea, it would be Sophos [MA], not the parent entities.” Doc.51 at 13. The Court agrees.

Vir2us' failure to distinguish among the Sophos Defendants compels this result. A complaint must generally “identify specific acts or conduct taken by each defendant to state a claim.” [Shinaberry v. Town of Murfreesboro, N.C.](#), No. 2:17-CV-7-D, 2018 WL 1801417, at \*5 (E.D.N.C. Apr. 16, 2018); [Evans v. Chalmers](#), 703 F.3d 636, 661 (4th Cir. 2012). Moreover, the Court has an interest in respecting the corporate formalities of the Sophos Defendants. See [Dana](#) 587 S.E.2d at 553 (“Stockholder immunity is a basic provision of statutory and common law and supports a vital economic policy underlying the whole corporate concept.”) (quotations omitted). Vir2us addresses this concern in a single footnote that describes case law on piercing the corporate veil. Doc. 47 at 13 n.6. However, as discussed in Section III.B.i.a., [supra](#), the Complaint includes no allegations that support a veil-piercing theory for any of the Sophos Defendants. Nevertheless, the allegation that Sophos MA directly acquired Invincea, in conjunction with the other allegations of the Complaint, sufficiently states a claim for successor liability against Sophos MA.

\*7 The Court is cognizant that “dismissals prior to giving the plaintiff ample opportunity for discovery should be granted very sparingly.” [Dickson v. Microsoft Corp.](#), 309 F.3d 193, 220 (4th Cir. 2002) (quoting [Hospital Bldg. Co. v. Trustees of Rex Hosp.](#), 425 U.S. 738, 747 (1976)). At this stage, “discovery of information concerning successor liability is likely within the sole knowledge and control of [Defendants].” [Azko Nobel Coatings Inc. v. Pearl Ave. USA, Ltd.](#), No. 2:09CV540, 2010 WL 11564918, at \*2 (E.D. Va. Feb. 23, 2010) (denying a motion to dismiss on this basis). Sophos' press releases and website represent Sophos Defendants as a single entity. See [Sophos](#) (July 29, 2019, 4:07 p.m.), <https://www.sophos.com/en-us.aspx>; Compl. at Exs. B-D. Prior to discovery, it is unlikely Vir2us would have the internal corporate information necessary to determine whether the remaining Sophos Defendants succeeded Invincea. Therefore, the Court **GRANTS** Defendant's Motion to Dismiss, **IN PART**, with respect to Sophos UK and Sophos Parent. However, the dismissal shall be **WITHOUT PREJUDICE**. Vir2us may, based on information obtained through discovery, request leave to amend the Complaint to include Sophos UK and/or Sophos Parent at any time through August 31, 2019.

*ii. Existence of Breach*

Defendants next move to dismiss Sophos Defendants from this matter because the alleged breach “is foreclosed by the express terms of the License Agreement.” Doc. 38 at 14.

**a. General Contract Terms**

Defendants argue that “Sophos products, such as Sophos's Intercept X,” are not covered by the Patent License Agreement. Doc. 38 at 14. This conclusion is contradicted by the plain terms of the Agreement.

As discussed in Section I.B., supra, the Agreement requires Invincea to pay Vir2us royalties for “each Container Products [sic] and Services Sold in the United States of America during the Term of this Agreement.” Agreement § 3.1. “Container Products and Services” are defined as “accused container products currently called Invincea X Endpoint – Spearfish Protection and formerly known as Invincea FreeSpace, Invincea Enterprise, and Invincea Advanced Endpoint Protection, as well as natural evolutions and derivations of these products ....” Id. § 1 (emphasis added). With respect the Agreement's reporting obligation, it provides that Invincea shall periodically “deliver to Vir2us a written report of the previous quarter's transactions by Invincea and any Invincea Affiliate regarding all Licensed Products and Services.” Id. § 4.2. “Licensed Products and Services,” in turn, are defined as “products Sold and/or services offered by Invincea or any of its Affiliates, with or without charge, during the Term of the License Agreement.” Id. § 1. In sum, the plain terms<sup>7</sup> of the Agreement require Invincea to periodically report the sales of all products by itself and its Affiliates during the term of the Agreement, and to pay royalties for the products, sold by itself and its Affiliates, that incorporate technology covered by the Agreement.

<sup>7</sup> “When the terms in a contract are clear and unambiguous, the contract is construed according to its plain meaning. Words that the parties used are normally given their usual, ordinary, and popular meaning.” RECP IV WG Land Inv'rs LLC v. Capital One Bank (USA) N.A., 811 S.E.2d 817, 825 (Va. 2018).

To state its claim for breach of contract, Vir2us alleges that Sophos MA acquired one hundred percent (100%)

of the shares of Invincea. Compl. ¶ 14. Therefore, all Sophos Defendants are Affiliates pursuant to the Agreement. See Section III.B.i.b., supra; Agreement § 1. Vir2us next alleges that “Sophos” integrated “technology from Invincea's products—including the Container Products and Services covered by the Patent License Agreement—into Sophos' flagship endpoint protection product (e.g., Sophos' Intercept X).” Id. ¶ 5. It further alleges that the Quarterly Reports required under the Agreement omitted mention of any Sophos products, including Sophos' Intercept X product. Id. ¶ 35. Finally, it states that “Sophos has failed to make any Royalty payment for any Sophos product, including Sophos' Intercept X product, containing technology from the Invincea products covered by the Patent License Agreement.” Id.

\*8 Based on the above facts, Vir2us clearly alleges: (1) the terms of the Patent License Agreement; (2) that Sophos Defendants are Affiliates covered by the Agreement; (3) that Sophos Defendants integrated technology covered by the Agreement into their own products, including Intercept X; and (4) that Invincea (or its successor-in-interest) did not fulfill the reporting or royalty obligations on behalf of Sophos Defendants for these products. If true, these allegations are sufficient to state a claim for breach of contract under the general terms of the Patent License Agreement. Whether Sophos products, including Intercept X, are “natural evolutions [or] derivations” of Vir2us technology presents a question of fact.

**b. Assignment provision**

Defendants insist that Section 5 of the Patent License Agreement creates a “carve-out” exception that applies to Sophos Defendants' products that existed prior to its acquisition of Invincea, including Intercept X. Doc. 38 at 14.

Section 5 is entitled “Assignment and Transferability.” Agreement § 5. The sections relevant to Defendants' argument are as follows:

§ 5.2. Except as set forth in Section 5.3 below, Invincea may not assign this Agreement or any or all of its rights and obligations under this License Agreement to a third party (“Acquiring Entity”) without prior notice to and express written consent of Vir2us.

§ 5.3. Notwithstanding Section 5.2, Vir2us' consent shall not be required and Invincea may assign this Agreement to a third party (“Acquiring Entity”), in connection with the assignment by Invincea of all its rights and duties

under this License Agreement to an Acquiring Entity in connection with the acquisition by such Acquiring Entity of Invincea, of all, or substantially all of the assets relating to the Container Products and Services, and/or an Affiliate (collectively, “Acquired Entities”), provided such Acquiring Entity expressly agrees in writing prior to such acquisition and assignment to assume and perform all of Invincea's obligations under this Agreement, and to the additional conditions and limitations in Section 5.3.1.

§ 5.3.1. The rights acquired by an Acquiring Entity as permitted by this Section shall apply only to Licensed Products and Services<sup>8</sup> and natural evolutions of Licensed Products and Services that were in existence as of the consummation of the acquisition and shall not apply to any other pre-existing or future products or services of the Acquiring Entity or of any subsequent Acquiring Entity.

Id. (emphasis added).

<sup>8</sup> Again, the Agreement defines “Licensed Products and Services” as products sold and/or services offered by Invincea or any of its Affiliates, with or without charge, during the Term of this License Agreement.

Defendants argue that Sophos MA is an “Acquiring Entity” pursuant to Section 5. Doc. 38 at 8. They therefore aver that some of their products, like Intercept X, are “pre-existing” products that fall under the exception enumerated in Section 5.3.1. Id. However, the Agreement does not support Defendants' definition of Acquiring Entity. According to the terms of the Agreement, Invincea may not assign “any or all” of its rights or duties under the License Agreement to a third-party, “Acquiring Entity” without Vir2us' written consent. Agreement § 5.2. Vir2us does not allege that it gave such consent. Accordingly, the Court must turn to Section 5.3. Cf. TC MidAtlantic Dev., Inc. v. Comm., Dep't of Gen. Servs., 695 S.E.2d 543, 547 (Va. 2010) (granting the defendant's motion to dismiss because the plaintiff failed to allege a condition precedent necessary to trigger the provision giving rise to a cause of action).

Section 5.3 defines an “Acquiring Entity” as a third party to whom Invincea assigns the Patent License Agreement: 1) with express written consent of the Acquiring Entity; and 2) in connection with the assumption of all Invincea's rights and obligations under the Agreement. Id. § 5.3. The Court must afford these specifications meaning. See Condo. Servs., Inc. v. First Owners' Ass'n of Forty Six Hundred Condo.,

709 S.E.2d 163, 170 (Va. 2011) (“Contract language will not be treated as meaningless where it can be given a reasonable meaning.”) (quotations omitted); Hale v. Hale, 590 S.E.2d 66, 68 (Va. App. 2003) (“Where possible, meaning must be given to every clause [of a contract].”). Neither party suggests that these conditions have been satisfied. There is no allegation that Sophos MA gave written consent to assume the Patent License Agreement, nor does Vir2us allege that the Sophos MA acquired all of Invincea's obligations under the Agreement. Accordingly, the Complaint does not support a finding that Sophos MA is an Acquiring Entity within the meaning of Section 5.3, and Section 5.3.1. does not apply.<sup>9</sup>

<sup>9</sup> Likewise, the Court rejects Defendants' argument that Section 5 addresses an entity's acquisition of Invincea, while Section 2.1.1 addresses Invincea's acquisition of another entity. See Doc. 38 at 12 n.7. The text of the Patent License Agreement makes no such distinction.

<sup>\*9</sup> Defendants contend that Section 5.3 provides specific conditions for Affiliates that acquire Invincea, and that it therefore governs over the more general terms of the Patent License Agreement concerning Affiliates. Doc. 38 at 15-16. However, Virginia law provides that a specific provision of a contract governs over one that is more general in nature only “where there are two clauses in any respect conflicting ....” Condo. Servs., 709 S.E.2d at 170 (citing Mutual Life Ins. Co. v. Hill, 193 U.S. 551, 558 (1904)). Here, Section 5 does not conflict with the remainder of the Patent License Agreement. First, “Acquiring Entity” and “Affiliate” are separately defined terms that contemplate distinct scenarios: an entity may purchase more than fifty percent (50%) ownership interest in Invincea, thereby becoming an Affiliate, without assuming all rights and obligations of the Patent License Agreement, as required to become an Acquiring Entity. See Agreement §§ 1, 5. Second, the title of Section 5, “Assignment and Transferability,” suggests the terms of that section are limited to circumstances in which Invincea is divested of its obligations under the Agreement. See Donnelly v. Donatelli & Klein, Inc., 519 S.E.2d 133, 138 (Va. 1999) (observing that contract labels, though not controlling, “may be helpful in determining contractual intent.”); see also Virginia Power Energy Mktg., Inc. v. EOT Energy, LLC, No. 3:11CV630, 2012 WL 2905110, at \*6 (E.D. Va. July 16, 2012) (observing that the parties' choice to write a separate, distinct paragraph... entitled “Non-Binding Effect” “must have some meaning”). Third, the plain language of the “carve-out” in Section 5.3.1. limits only the “rights” offered by the

Patent License Agreement to Licensed Products and Services obtained through acquisition. No obligations are imposed on an Acquiring Entity's pre-existing products, because no rights are afforded to those products. Construed with the Agreement as a whole, Section 5 logically imposes special limitations on a third-party's use of Vir2us technology when it replaces Invincea – the original party to the contract - under the Agreement.

The Court's holding that Sophos MA may be a successor-in-interest to Invincea's reporting and royalty obligations does not, at this stage in the litigation, trigger the complete assignment provision contemplated by Section 5. There is no allegation that any of the Defendants agreed in writing to a complete assignment of the Agreement. Moreover, Virginia law and the Agreement itself reveal that assignment of rights or obligations under the contract may be partial. See § 5.2 (“Invincea may not assign ... any or all of its rights and obligations under this License Agreement to a third party ... without prior notice to and express written consent of Vir2us.”);<sup>10</sup> [Newton v. White](#), 80 S.E. 561, 563 (Va. 1914) (discussing partial assignments of contracts). While neither party has offered case law on partial contract succession, the divisibility of contract rights and obligations through assignment suggests that partial succession is also permissible. Accordingly, this Court's finding that the Complaint supports successor-in-interest liability for Sophos Defendants with respect to the reporting and royalty obligations does not compel a finding that they are Acquiring Entities under the Agreement.

<sup>10</sup> If Sophos Defendants partially succeeded Invincea, and such succession is deemed equivalent to an assignment. Invincea may have breached Section 5.2 of the Patent License Agreement. However,

Vir2us does not state a claim for breach of contract based on this provision.

Because Vir2us has alleged a breach of contract under the general terms of the Patent License Agreement, and the assignment provision does not apply, the Court **DENIES** Defendants' Motion to Dismiss on this basis.

#### IV. PRETRIAL HEARING

The Court may hold a Markman-type hearing on the issue of whether there is sufficient evidence to determine if the accused products sold by Sophos MA utilize the patents that are the subject of the Patent License Agreement. If the Court determines such a hearing is necessary, it shall be scheduled for Wednesday, September 25, 2019, at 11:00 a.m.

#### V. CONCLUSION

For the reasons stated herein, the Court **GRANTS** Defendants' Motion to Dismiss, Doc. 34, **IN PART**, as to Sophos Limited and Sophos Group PLC. The dismissal is **WITHOUT PREJUDICE**, and Plaintiff may move to file an amended complaint prior to August 31, 2019.

The Clerk is **REQUESTED** to deliver electronically a copy of this Order to all counsel of record.

It is so **ORDERED**.

#### All Citations

Slip Copy, 2019 WL 8886440

## **LEGAL AUTHORITY CA-49**



 KeyCite Yellow Flag - Negative Treatment

Distinguished by [In re MSR Resort Golf Course LLC](#), S.D.N.Y., January 7, 2014

310 B.R. 752  
United States Bankruptcy Court,  
E.D. California,  
Modesto Division.

In re Michael HAT, dba Michael  
Hat Farming Company, Debtor.  
The Wine Group, Bank of the West and the Official  
Committee of Unsecured Creditors, Movants,  
v.  
Sharon Diamante and Phoenix  
Bio Industries, Inc., Respondents.

No. 01-92886-A-11.  
|  
Feb. 6, 2004.

#### Synopsis

**Background:** Unsuccessful bidder at auction sale of Chapter 11 debtor's winery moved for reconsideration of order approving sale of winery to non-debtor spouse in exercise of her statutory right of first refusal.

**Holdings:** The Bankruptcy Court, [Thomas C. Holman](#), J., held that:

[1] unsuccessful bidder had standing to challenge court order approving sale;

[2] sales order would be set aside, and new auction sale would be ordered, based on evidence of collusion between spouse and two potential bidders; and

[3] spouse would not be barred from participating in second sale.

Motion granted; sales order vacated.

West Headnotes (8)

[1] **Bankruptcy**  **Right of Review and Persons Entitled; Parties; Waiver or Estoppel**

Unsuccessful bidder, whose pecuniary loss is the speculative profit it might have made had it succeeded in purchasing property at auction, usually lacks standing to challenge bankruptcy court order approving sales transaction. Bankr.Code, 11 U.S.C.A. § 363.

[3 Cases that cite this headnote](#)

[2] **Bankruptcy**  **Right of Review and Persons Entitled; Parties; Waiver or Estoppel**

Unsuccessful bidder at auction sale of Chapter 11 debtor's winery had standing to challenge court order approving sale, where its challenge was based on equitable grounds related to intrinsic structure of sale, i.e., on alleged collusion among potential bidders and third party who held statutory right of first refusal, which allegedly tainted sale.

[4 Cases that cite this headnote](#)

[3] **Bankruptcy**  **Setting Aside**

Three factors that bankruptcy court had to consider in deciding whether to set aside order approving sale of Chapter 11 debtor's winery based on alleged collusion among potential bidders and third party holding a statutory right of first refusal were as follows: integrity of sale, third party's statutory right to purchase property at price at which sale was consummated, and preservation of best interests of estate. Bankr.Code, 11 U.S.C.A. § 363(n).

[4] **Bankruptcy**  **Setting Aside**

Bankruptcy court order approving sale of Chapter 11 debtor's winery to non-debtor spouse, in exercise of her statutory right of first refusal, would be set aside, and new auction sale would be ordered, based on evidence of collusion between spouse and two other potential bidders

to allow third bidder to set sales price without any competitive bidding on their part, on understanding that spouse would then exercise her right of first refusal and resell property to them. Bankr.Code, 11 U.S.C.A. § 363(n).

3 Cases that cite this headnote

[5] **Bankruptcy** 🔑 **Manner and Terms**

To come within terms of Bankruptcy Code provision prohibiting agreements among potential bidders that control price at which estate property is sold, it must be potential bidders' intention or objective in entering into agreement to influence sales price; parties' acts must cause more than an incidental or unintended impact on sales price. Bankr.Code, 11 U.S.C.A. § 363(n).

1 Cases that cite this headnote

[6] **Bankruptcy** 🔑 **Manner and Terms**

As general matter, bidding at sale of estate property is not improperly chilled merely because persons have associated for purposes of bidding; problem arises only when this association has purpose and effect of removing potential bidders from sales process. Bankr.Code, 11 U.S.C.A. § 363(n).

[7] **Bankruptcy** 🔑 **Encumbered Property; Limited or Joint Interests**

**Bankruptcy** 🔑 **Manner and Terms**

Purpose of Bankruptcy Code provision according non-debtor spouse or co-owner a statutory right of first refusal to purchase estate property at price at which sale would otherwise be consummated is to give non-debtor spouse the right to purchase property on same terms and conditions as winning bidder, after auction process has determined property's fair market value. Bankr.Code, 11 U.S.C.A. § 363(i).

[8] **Bankruptcy** 🔑 **Encumbered Property; Limited or Joint Interests**

**Bankruptcy** 🔑 **Manner and Terms**

While evidence of collusion among two potential bidders and spouse holding statutory right of first refusal, whereby these potential bidders would allow third bidder to set sales price without any competitive bidding on their part, on understanding that spouse would then exercise her right of first refusal and resell property to them, was such as to warrant setting sales order aside, such collusion did not warrant prohibition against spouse's participating in second sale, as long as spouse fully disclosed identities of all fellow investors and sources of financing, and as long as, upon spouse's exercise of first refusal right, high bidder be given opportunity to increase its bid. Bankr.Code, 11 U.S.C.A. § 363(n).

**Attorneys and Law Firms**

\*753 **William W. Nolan**, Sacramento, CA, for Michael Hat, dba Michael Hat Farming Company.

**Mary J. Martinelli**, Sacramento, CA, **Merle C. Meyers**, San Francisco, CA, for John Van Curen.

**MEMORANDUM DECISION**

**THOMAS C. HOLMAN**, Bankruptcy Judge.

Moving parties ask the court to reconsider an order (the "Sale Order") entered October 1, 2003 (Docket No. 2099) approving the sale of property of the estate in Kern County, California, consisting of a grape crush and winery facility on approximately 20 acres of land, approximately 130 additional acres planted to vineyard, approximately 170 additional acres of open land and related personal property (collectively, the "Capello Winery"). Sharon Diamante ("Diamante"), the purchaser designated in the Sale Order, opposes the motion to reconsider. For the reasons stated herein, the court grants the motion, vacates the Sale Order and orders a new sale of the Capello Winery.

\*754 The court held an evidentiary hearing in Modesto, California on January 22, 23, 29, and 30, and February 6, 2004. Appearances were noted on the record. At the

conclusion of the evidentiary hearing, the matter was taken under advisement.

This is a core proceeding and the court has jurisdiction over this matter. 28 U.S.C. §§ 1334 and 157. Venue is proper in this court under 28 U.S.C. § 1409. There is no dispute concerning jurisdiction or venue.

The following constitutes the court's findings of fact and conclusions of law pursuant to Fed. R. Bankr.P. 7052.

### PROCEDURAL HISTORY

On July 20, 2001, Michael Hat (“Hat”) commenced the above-captioned voluntary Chapter 11 case. Hat acted as debtor in possession until April 11, 2003, when John Van Curen, (the “Trustee”) was appointed Chapter 11 trustee.

On June 13, 2003, the Trustee filed Trustee's Motion For: Authority To Sell The Capello Winery Free And Clear Of Certain Interests In The Property With Contingent Lease, Approval Of Overbid Procedures, And Authorization To Pay A Breakup Fee In The Event Of Sale To Third Party, D.C. No. LRP-6, (the “Sale Motion”) to sell the Capello Winery to The Wine Group (“TWG”). A hearing on the Sale Motion was held on July 8, 2003. The court granted the Sale Motion in part, approving a requested one year lease of the Capello Winery to TWG. The court continued the balance of the Sale Motion to July 22, 2003 for further hearing. The court required the Trustee to file and serve an executed sale agreement by July 11, 2003. An order reflecting the July 8, 2003 rulings was entered July 14, 2003.

Another hearing on the Sale Motion was held on July 22, 2003. TWG increased its prior bid of \$4.75 million by the amount of \$142,500, for a proposed purchase price of \$4,892,500. The break up fee requested in the Sale Motion was approved by the court. There were no other bids.

The Court approved the sale to TWG. Diamante, the former spouse of Hat, asserted that the Capello Winery was community property and that she had the right under 11 U.S.C. § 363(i)<sup>1</sup> to purchase the Capello Winery by matching the TWG purchase price.<sup>2</sup>

<sup>1</sup> Unless otherwise noted, all statutory references are to the Bankruptcy Code, 11 U.S.C. § 101 *et seq.*,

and all “Rule” references are to the Federal Rules of Bankruptcy Procedure.

<sup>2</sup> Whether or not Diamante possesses rights under Section 363(i) is the subject of an adversary proceeding currently pending in this court: 03–9178–A. However, the Trustee conceded the existence of Diamante's Section 363(i) rights for purposes of the Sale Motion at the initial hearing held July 8, 2003.

The Court approved the sale of the Capello Winery to Diamante, as purchaser, at the purchase price of \$4,892,500.

On August 29, 2003, TWG filed the present motion to reconsider. The motion to reconsider included a request that the court delay the entry of the Sale Order pending a hearing on the motion to reconsider.

At a hearing on the motion to reconsider held September 30, 2003, the court denied the motion to reconsider in part, specifically the request for a delay in the entry of an order based on the ruling at the July 22, 2003 hearing. That request was denied without prejudice to a motion seeking a stay of the effect of the Sale Order. However, the effect of the Sale Order was temporarily stayed until October 28, 2003 to allow TWG to file and have its stay motion heard. The balance of the motion to \*755 reconsider was set for evidentiary hearing. An interim order to the foregoing effect was entered October 6, 2003.

As noted above, the Sale Order approving the sale to Diamante was entered October 1, 2003. On October 10, 2003, TWG timely filed its motion for a stay of the effect of the Sale Order (the “Stay Motion”).

On October 28, 2003, the court heard the Stay Motion and stayed the effect of the Sale Order pursuant to Federal Rule of Bankruptcy Procedure 7062 incorporating Federal Rule of Civil Procedure 62(b), until such time as the court decided the motion for reconsideration. The court entered an order on the Stay Motion on November 5, 2003.

The Trustee withdrew his opposition to the motion for reconsideration on October 24, 2003, after obtaining a written offer from TWG to purchase the Capello Winery for \$5,250,000 should the motion be granted and the prior sale vacated.

After a discovery period, a pre-trial conference was held December 18, 2004. Diamante's oral motion to exclude testimony on all issues other than whether Phoenix Bio Industries ("PBI") was a potential bidder at the sale was denied. The Trustee and Jerry Rava were dismissed as parties. The parties stipulated to a single list of exhibits and to their admission into evidence. There were also stipulations regarding allocation of time and to limiting the number of times that the same witness would be called to testify. The court set this matter for a four day trial on January 22, 23, 29, and 30, 2004.

The court heard from a total of twelve witnesses on the first three days of trial. When the matter recommenced on January 30, 2004, the parties notified the court that they had concluded presentation of their cases in chief. The trial was continued to February 6, 2004 for closing arguments after the conclusion of which, the matter was taken under submission.

### FACTS

The Capello Winery consists of approximately 320 acres of land on which a grape crush and winery facility occupies 20 acres; approximately 130 acres are planted to vineyard; and 170 acres is open land. The crush and winery facility also houses a distillery. The facility contains one hundred seven (107) stainless steel storage tanks of various capacities ranging from 350,000 gallons to 2,500 gallons. The total tank capacity is approximately 8.97 million gallons.

In 2002, PBI was in the business of producing non-food grade grain alcohol. It believed that the stainless steel tanks on the winery portion of the Capello Winery could be converted into fermentation tanks for grain and that those tanks could produce enough grain mash to keep the distillery busy around the clock, seven days a week.

In May, 2002, while Hat was debtor in possession in this bankruptcy case, PBI and Hat entered into a lease of the Capello Winery; however, no bankruptcy court approval of the lease was sought or obtained. PBI invested approximately \$514,574.00 in the Capello Winery in the belief that its lease was valid. In March 2003, prior to appointment of the Trustee, PBI submitted to Hat a written offer to purchase the Capello Winery for \$2.5 million. That offer was rejected.

After his appointment on April 11, 2003, the Trustee began actively marketing the Capello Winery. The Trustee thought

time was short because Yosemite Land Bank, the holder of the first deed of trust on the property, had not been paid for some time and was about to seek relief from the automatic stay to foreclose. The \*756 Trustee's analysis indicated that the estate needed at least \$4.5 million from the property to cover the Yosemite Land Bank lien, costs of sale, estate attorneys fees relating to a sale transaction, potential capital gains taxes and a return for other estate creditors.

PBI learned that its lease was potentially vulnerable because it had not been approved by the bankruptcy court.

On or around April 20, 2003, Richard Eastman ("Eastman") of PBI contacted the Trustee about acquiring the Capello Winery. PBI was motivated by the desire to protect its investment in the facility and by the desirability of the facility for its business. PBI made an oral offer to the Trustee to purchase the Capello Winery for \$4.1 million. The Trustee told Eastman that a purchase offer would have to be more than \$4.5 million.

PBI began the process of putting together a combination of financing and investors to acquire the Capello Winery. PBI got a commitment from Mark Wheeler, one of the principals of PBI, to invest up to \$2.5 million for the acquisition. Wheeler's limit for the investment was \$2.5 million. PBI also sought additional financing of between \$3.0 million and \$4.0 million from Wells Fargo Bank and other financial institutions. In a letter to Wells Fargo Bank, Eastman stated that he had offered the Trustee \$4.1 million for the Capello Winery. PBI also sought investors for additional funds. PBI's efforts to find funds to acquire the Capello Winery continued until mid-June, 2003.

TWG entered the picture at the beginning of May 2003. Kenneth Ford ("Ford"), president of winery operations for TWG, had contacted the Trustee on May 5, 2003. Ford and the Trustee met in person on May 6, 2003 and, after some negotiation, agreed that TWG would purchase the Capello Winery for \$4.75 million.

In the latter half of May 2003, PBI first learned that TWG was interested in the Capello Winery. On May 15, 2003, Ford and others from TWG toured the Capello Winery with the Trustee. During the tour, Eastman, who was on the property that day, introduced himself to Ford. Through general knowledge of the industry, PBI believed that TWG had far greater resources than PBI and that TWG could outbid PBI in a competitive sale.

On June 5, 2003, Eastman contacted Kenneth Ford of TWG for a meeting. PBI wanted to work out a deal with TWG to avoid competitive bidding. In preparation for the meeting, Eastman generated a proposed agenda. That document explicitly states in item A1: "Purchase price can be kept down by avoiding serious overbid situation." Ford initially agreed to meet with Eastman, but after consulting with counsel, he cancelled the meeting on June 9, 2003.

On or about June 10, 2003, Hat informed Eastman that Diamante had a right of first refusal under the Bankruptcy Code. Eastman followed up with Hat in a letter attaching the same agenda he had prepared for the cancelled TWG meeting. The meeting with Hat was successful. The parties agreed in principal to a deal whereby Diamante would exercise her rights under [Section 363\(i\)](#) in exchange for a three percent (3%) commission on the sale. Immediately after the sale closed, Diamante would assign her rights to the Capello Winery to PBI subject to a future right of her or her assignee to re-purchase a 50% interest in the property. However, the parties agreed that Diamante was serving as a middle person for a fee and would ultimately have no ownership of the property because any final agreement would require her to assign her rights to Hat.

**\*757** Upon reaching the foregoing agreement, PBI ceased its efforts to secure financing and investors to bid on the Capello Winery.

As ultimately drafted, the Memorandum of Understanding Concerning the Capello Winery ("MOU") provided that Diamante would be paid \$72,500 from PBI and \$72,500 from the Hat Group to exercise her [Section 363\(i\)](#) rights. PBI agreed to provide one-half of the funds for both the deposit and the final purchase price. The other half of the funding was to come through the so called Hat Group.

Diamante and Hat approached various relatives and business associates. They obtained an informal commitment from her and Hat's nephew, Lance Ioppini, to loan up to \$2 million.<sup>3</sup> The Ravas, who had no interest whatsoever in running a winery, agreed to lend Hat (but not Diamante) \$250,000 because Hat made it a condition of obtaining his help on another matter. They wished to purchase other estate property located in Monterey county, then involved in a pending foreclosure, and thought they needed Hat to sign off on the purchase. Hat first broached the idea of the loan the day before the July 22 hearing. The Ravas agreed to loan Hat the money

for 45 days in exchange for him signing off on the Monterey county properties. The money would be non-refundable if Hat signed off on the purchase.

<sup>3</sup> The testimony is inconsistent as to which of Diamante or Hat actually spoke with Mr. Ioppini. Mr. Ioppini stated in his testimony that he spoke only with Diamante. Diamante, in her deposition testimony, answered "No" when asked whether she "had any idea at all of who these investors might be."

The remainder of the Hat group's portion of the funding was to come through either an assumption or refinancing of the debt owed to the first deed of trust holder, Yosemite Land Bank, FLCA. The court notes that an assumption of existing debt was outside the scope of the sale agreement between the Trustee and TWG.

The MOU was executed by PBI, Diamante, and Hat on July 22, 2003, immediately prior to the hearing on the proposed sale of the Capello Winery. At the same time, an assignment of rights between Hat and the Ravas was signed by Hat, Diamante, and PBI. Neither of the Ravas signed the document despite the fact that it contained lines for their signatures. No evidence was presented of an assignment between Diamante and Hat.

The method by which Diamante proposes to fund her purchase of the Capello Winery has changed significantly since the entry of the Sale Order on October 1, 2003. Neither PBI nor the Ravas are willing to finance or otherwise participate in the purchase. PBI is no longer operating and has no assets with which to fund the purchase. The Ravas allege they were defrauded by Hat and have demanded return of their \$250,000.

Diamante testified that she proposed to form a limited liability company ("LLC") which would own the Capello Winery. Thirty percent (30%) of the LLC would be owned by a Dr. Paregian in exchange for a \$1.5 million investment. Thirty Percent (30%) would be owned by a Mr. Pistoresi who would also invest \$1.5 million. The final forty percent (40%) would be owned by Diamante. She proposes to fund her portion of the purchase through a \$1.1 million loan from Hat's sister and the estate of Hat's mother as well as investing an undisclosed amount of crop proceeds from other properties owned by Diamante. The last \$500,000 consists of the monies already placed in escrow by PBI and the Ravas.



### \*758 Analysis

The motion is granted to the extent set forth herein. The sale of the Capello Winery has been tainted by collusion between Diamante and potential bidders, and the order approving the sale of the Capello Winery to Diamante is vacated.

### Standing

As an initial matter, Diamante raises the issue of TWG's standing to bring this motion. Diamante argues that this motion is really a motion under [Section 363\(n\)](#) and actions under that section may only be brought by a trustee. Diamante's argument is unpersuasive.

[1] [2] “[A]n unsuccessful bidder—whose pecuniary loss is the speculative profit it might have made had it succeeded in purchasing property at an auction—usually lacks standing to challenge a bankruptcy court's approval of a sale transaction.” *Kabro Associates v. Colony Hill Associates (In re Colony Hill Associates)*, 111 F.3d 269, 273 (2nd Cir.1997) (citation omitted). However this rule is not absolute.

“Courts ... properly entertain suits challenging the equity of a bankruptcy sale transaction, on the assumption that sales tinged by fraud, mistake or unfairness would generally result in an accepted bid below that which might have been expected in a fair, free market situation. Thus, when an unsuccessful bidder attacks a bankruptcy sale on equitable grounds related to the intrinsic structure of the sale, he brings himself within the zone of interests which the Bankruptcy Act seeks to protect and to regulate.”

*Id.* at 274 citing *In re Harwald Co.*, 497 F.2d 443, 444–45 (7th Cir.1974) (internal citations omitted). See also *Ross v. Kirschenbaum (In re Beck Industries, Inc.)*, 605 F.2d 624, 634 n. 13 (2nd Cir.1979).

This is one such instance. TWG is attacking the sale not because it lost a bidding contest with another party but

because it alleges that two potential bidders colluded with a third party who held a statutory right of first refusal thus tainting the sale. The court finds that TWG has standing to bring this motion for reconsideration.

### Propriety of the Capello Winery Sale

Diamante correctly argues that she is not a bidder, holding (for purposes of the Sale Motion and this motion) a right of first refusal, but that does not exclude her from the scrutiny of the court. The very existence of her rights under [Section 363\(i\)](#) leads to certain chilling of the bid process. This fact was known and acknowledged by Congress at the time it enacted [Section 363\(i\)](#). By implication, it is therefore not grounds, in and of itself, for setting aside the sale. However, in this instance, the bidding has been further chilled by the agreement between Diamante and at least two potential bidders. The latter chilling is not inherent in the statute and is not permitted.

[3] [4] This court agrees with the bankruptcy court in *In re Fehl*, 19 B.R. 310, 311–12 (Bankr.N.D.Cal.1982) regarding the three factors to consider in circumstances such as this:

1. The integrity of the trustee's sale.
2. The 363(i) rights of the [spouse].
3. The preservation of the best interests of the estate.

The agreement between Diamante, PBI and Hat directly and negatively affects the first and third factors, and it goes beyond the legitimate interest acknowledged by the second factor.

### Sale Integrity

The evidence shows that the sale of the Capello Winery was tainted. Bidding was \*759 chilled through collusion between Diamante and two potential bidders: PBI and Hat. The conclusion that bidding has been impermissibly chilled dictates a new sale. *Beck Industries*, 605 F.2d at 637.

As conceded by all parties in pre-trial briefing, potential bidders are “all persons who are contemplating making an offer to purchase property of a bankrupt estate that the trustee seeks to sell, whether such sale be private or at public auction.” *Ramsay v. Vogel*, 970 F.2d 471, 473 (8th Cir.1992).

The court specifically notes that the definition is not limited to parties who believe they will necessarily be the successful bidder at the sale. PBI was not merely a potential bidder. The evidence shows that PBI actually made an offer of \$2.5 million in March 2003 and an offer of \$4.1 million in April 2003.<sup>4</sup> PBI continued to look for independent financing and investment totaling at least \$5.5 million to \$6.5 million through mid-June, 2003; ceasing its search only after it had entered into the agreement with Diamante and Hat. PBI was at least a potential bidder for the Capello Winery.

<sup>4</sup> Eastman's testimony at trial that PBI did not make the \$4.1 million offer is not credible in light of the contemporaneous documents executed by him and sent to Wells Fargo Bank.

Likewise, the evidence shows that Hat was also a potential bidder. Hat was the driving force behind the non-PBI half of the purchase. While at first blush it might seem that Hat was serving as Diamante's agent in the transaction, a review of actions taken by Hat directly contrary to Diamante's interests shows that Hat was acting for himself. Hat sought to arrange the transaction so that Diamante would serve as a middle person whose sole function was to exercise her [Section 363\(i\)](#) rights for a fee. While that may not have been Diamante's intent, that was the structure of the agreement.

Hat made all contacts with potential investors. It was Hat who first contacted PBI. Hat first contacted the Ravas. He structured the financing in place at the time of trial, and while he allegedly would not hold an ownership interest, he would run the Capello Winery for a "hefty salary." There can be no doubt of Hat's interest in retaining control of the property. Other than being a party to the contract, there is no reason for Hat to sign the July 22, 2003 Memorandum of Understanding.

[5] There is no disputing that Diamante, PBI and Hat colluded. The evidence also shows that their collusion controlled the price at which the Capello Winery sold. "[T]he term 'control' implies more than acts causing an incidental or unintended impact on the price; it implies an intention or objective to influence the price." *Lone Star Industries, Inc. v. Compania Naviera Perez Companc, et al.* (*In re New York Trap Rock Corp.*), 42 F.3d 747, 752 (2nd Cir.1994). The June 10, 2003 meeting agenda is particularly damning in that it expressly sets forth an intent to minimize the price. Ultimately, TWG was the only actual bidder at the sale. Both Hat and PBI sat on the sidelines behind Diamante's right of first refusal. Their control results from their ability to utilize

Diamante's rights to obtain the property without having to bid at all.

### Diamante's [Section 363\(i\)](#) Rights

The Trustee conceded the existence of these rights as to the Capello Winery at the initial hearing on the Sale Motion. The court takes no issue with Diamante's desire to utilize her right of first refusal to purchase the Capello Winery, provided that her rights are properly exercised.

\*760 [6] The holder of [Section 363\(i\)](#) rights may exercise those rights while obtaining financing from a lender that is not a potential bidder. Similarly, as a general matter, "bidding is not improperly chilled by the mere fact of an association of persons formed for the purpose of bidding at a sale since this may be not only unobjectionable but oftentimes meritorious, if not necessary to enable the persons associating themselves to participate in the bidding, rather than to shut out competition." *Beck Industries*, 605 F.2d at 635–36 (internal quotes and citation omitted).

A problem arises when, as here, the financing and/or association has the purpose and effect of removing potential bidders from the sale process.<sup>5</sup> In such circumstances, the [Section 363\(i\)](#) rights are not properly exercised.

<sup>5</sup> The court need not address either an improper purpose or an improper effect, standing alone, as both are clearly present here.

### Preservation of the Best Interests of the Estate

[7] The best interests of the estate were directly and negatively impacted by Diamante's collusion with PBI and Hat and the way in which Diamante exercised her [Section 363\(i\)](#) rights in this instance. The purpose of [Section 363\(i\)](#) is to give a non-debtor spouse the right to purchase property under the same terms and conditions as the winning bidder after the auction process has determined the fair market value. If the procedure works correctly, the estate is not harmed because it still receives the highest price the market will bear. The non-debtor spouse benefits by being able to retain the community property.

Here, there were only three potential bidders for the Capello Winery. Diamante entered into an agreement with two of the

three. As a direct result, there was no competitive bidding.<sup>6</sup> The auction was improperly restrained and therefore could not determine the fair market value for the Capello Winery. No one can state with certainty what the ultimate price would have been had competitive bidding taken place. However, the facts that PBI attempted to put together its own financial package in excess of \$5.0 million before it learned of Diamante's rights, and that TWG is now willing to bid at least \$5,250,000, \$357,500 more than the present sale price, create a strong indication that an auction with true competitive bidding would produce a higher price. Diamante's agreement has harmed the estate.

<sup>6</sup> The court acknowledges that TWG did overbid itself but it is clear that the only purpose was to become eligible to receive the negotiated break-up fee. In essence, TWG was to be repaid the bid increase.

#### **TWG's Request for Future Restrictions on Diamante's Exercise of Section 363(i) rights**

[8] TWG requests that Diamante be barred from any exercise her Section 363(i) rights in any future sale of the Capello Winery. In connection with that request and assuming that it is granted, TWG seeks an order that no potential bidders (Diamante included) may collude or cooperate in bidding on the sale. Those requests are denied.

TWG has provided no authority for this court to strip Diamante of her Section 363(i) rights. *Beck Industries* is factually distinguishable. That case involved a right of first refusal ("ROFR") in an employment contract made during a bankruptcy case with court approval. The decision suggests that the court's actions regarding the ROFR holder's participation in the new sale were based on the court's supervisory role over the court approved contract. *Beck Industries*, \*761 605 F.2d at 637. More importantly, the court in *Beck Industries* did not strip the holder of the ROFR of his rights. Rather, the court directed and suggested certain restrictions on the exercise of those rights. *Id.*

*Beck Industries* clearly stands for the proposition that the court may fashion equitable remedies for misconduct in connection with a sale that subjects the bankruptcy estate to expense and delay, the objective being to maximize bidding, not restrict it. Thus, the court in *Beck Industries* said:

We also direct that [the holder of the ROFR] shall not be allowed, after all that has here transpired, to interpose his [ROFR] on the [assets on which the ROFR was held] as a bar to the sale of the package [the assets on which the ROFR was held and other assets] and require a separation.

\* \* \*

Any legitimate interest of [the ROFR holder] can be protected by the bankruptcy judge's giving him a reasonable opportunity to meet any bid for the package, with the bidder then having an opportunity to make a still higher bid.

*Id.*

This court is indifferent to the identity of the purchaser of the Capello Winery, whether it is TWG, Diamante, or some other third party, so long as the sale process remains within the boundaries set by the Bankruptcy Code and the estate receives the highest price possible. To those ends, the court orders two things. First, Diamante shall make full disclosure in writing at the commencement of the subsequent sale of the identities of all investors, co-owners and sources of financing in connection with any bid or exercise of Section 363(i) rights that she may make at the subsequent sale of the Capello Winery. The court has previously ordered similar disclosure by Diamante on other sale motions, and the disclosure allows the Trustee, the Creditors Committee and other parties in interest to examine any arrangements before confirmation of the sale. Second, the high bidder prior to Diamante's first exercise of her Section 363(i) rights may thereafter raise its bid, the process to continue until either the bidder fails to raise its bid or Diamante fails to exercise her Section 363(i) rights. These provisions will ensure the highest price for the estate while preserving Diamante's right to meet, but not exceed, the highest bid.

The court will not place any additional restrictions on potential bidders. Collusion between or among bidders and potential bidders to control the price at a sale is already proscribed. 11 U.S.C. § 363(n). The court need not duplicate that proscription.

#### **Conclusion**

Based on the forgoing, the motion for reconsideration pursuant to Federal Rule of Bankruptcy Procedure 9023

incorporating [Federal Rule of Civil Procedure 59\(e\)](#) is granted. The Sale Order is vacated and the Trustee shall conduct another sale of the Capello Winery in a manner consistent with this ruling.

The court will issue a separate order.

**All Citations**

310 B.R. 752, 43 Bankr.Ct.Dec. 65

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End of Document

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## **LEGAL AUTHORITY CA-50**



UNITED STATES DISTRICT COURT  
FOR THE DISTRICT OF COLUMBIA

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**UNITED STATES OF AMERICA,** )  
 United States Department of Justice )  
 Antitrust Division )  
 450 Fifth Street, NW, Suite 8000 )  
 Washington, DC 20530 )  
 )  
 Plaintiff, )  
 )  
 v. )  
 )  
**SMITHFIELD FOODS, INC.,** )  
 200 Commerce Street )  
 Smithfield, Virginia 23430 )  
 )  
 and )  
 )  
**PREMIUM STANDARD FARMS, LLC,** )  
 Highway 65 N )  
 c/o P.O. Box 194 )  
 Princeton, Missouri 64673 )  
 )  
 Defendants. )  
 )  


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Civil Action No.

**Case: 1:10-cv-00120**  
**Assigned To : Huvelle, Ellen S.**  
**Assign. Date : 1/21/2010**  
**Description: Antitrust**

**COMPLAINT**

The United States of America, by its attorneys, acting under the direction of the Attorney General of the United States, brings this civil antitrust action to obtain civil penalties against Smithfield Foods, Inc. (“Smithfield”) and Premium Standard Farms, LLC, the successor in interest to Premium Standard Farms, Inc., (collectively “Premium Standard”) and alleges as follows:

## **I. NATURE OF THE ACTION**

1. The United States brings this action to recover civil penalties from the defendants for the violation of Section 7A of the Clayton Act, as amended, 15 U.S.C. § 18a, also commonly known as the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (“Section 7A” or the “HSR Act”). On May 7, 2007, Smithfield acquired Premium Standard, Inc. Prior to the expiration of the statutory waiting period applicable to Smithfield’s acquisition of Premium Standard, Smithfield exercised operational control over Premium Standard’s hog procurement and thereby acquired beneficial ownership of a significant segment of Premium Standard’s business. This conduct, called “gun jumping,” is prohibited by Section 7A.

## **II. JURISDICTION AND VENUE**

2. This Court has jurisdiction over this action and the defendants under 15 U.S.C. § 18a(g), and 28 U.S.C. §§ 1331, 1337(a), 1345, and 1355(a).

3. Defendants Smithfield and Premium Standard are engaged in interstate commerce and in activity substantially affecting interstate commerce.

4. Defendant Smithfield is incorporated under the laws of the Commonwealth of Virginia, with its principal place of business in Smithfield, Virginia.

5. At all times relevant to this Complaint, Premium Standard Farms, Inc. was incorporated under the laws of Delaware, with its principal place of business in Kansas City, Missouri. On May 7, 2007, Smithfield acquired Premium Standard Farms, Inc. and Premium Standard Farms, Inc. became a wholly-owned subsidiary of Smithfield. On August, 2, 2007, Premium Standard Farms, Inc. was merged with and into PSF LLC, with the surviving entity being named Premium Standard Farms, LLC. Defendant Premium Standard Farms, LLC is the

successor in interest to Premium Standard Farms, Inc. and is incorporated under the laws of Delaware, with its principal place of business in Princeton, Missouri.

6. Defendants waive any objection to venue and personal jurisdiction in this judicial district for the specific and limited purpose of this Complaint.

### **III. THE DEFENDANTS**

7. Smithfield is the largest pork packer and processor and the largest hog producer in the United States. Prior to the merger, it had seven pork packing plants in the United States.

8. Premium Standard was the sixth-largest pork packer and processor, with two pork packing plants, and the second-largest hog producer in the United States.

9. At all times relevant to this Complaint, Smithfield and Premium Standard purchased and raised hogs for slaughter and sold fresh and processed pork throughout the United States, in competition with each other.

10. Until May 7, 2007, Smithfield and Premium Standard were each engaged in commerce or activity affecting commerce within the meaning of Section 1 of the Clayton Act, 15 U.S.C. § 12, and Section 7A(a)(1) of the Clayton Act, 15 U.S.C. § 18a(a)(1).

### **IV. WAITING PERIOD REQUIREMENTS OF SECTION 7A OF THE CLAYTON ACT**

11. Section 7A establishes a waiting period that allows federal antitrust agencies to investigate certain mergers and to file suit to enjoin those acquisitions that violate the antitrust laws. When Section 7A applies, it requires parties to file premerger notifications with the Department of Justice and the Federal Trade Commission and to supply additional information and documents to the investigating agency upon request. Section 7A requires that the merging

parties observe a designated waiting period before the acquiring person may hold, directly or indirectly, the voting securities or assets of the acquired person. A purpose of this waiting period is to preserve the acquired firm as an independent company in case the proposed acquisition is blocked or otherwise not consummated so that the competition that the antitrust laws protect does not suffer.

12. The notification and waiting period requirements of Section 7A apply to direct or indirect acquisitions that meet the HSR Act's thresholds. At all times relevant to this Complaint, the HSR Act's reporting and waiting period requirements applied to certain transactions that would have resulted in the acquiring person holding more than \$56.7 million, and all transactions where the acquiring person would hold more than \$226.8 million of the acquired person's voting securities and/or assets except for certain exempted transactions.

13. Section 801(c)(1) of the Premerger Notification Rules, 16 C.F.R. § 800 *et seq.*, defines "hold" to mean to have "beneficial ownership." The Statement of Basis and Purpose that accompanied the issuance of Section 801(c)(1), 43 Fed. Reg. 33450, 33458 (July 31, 1978), states that "the existence of beneficial ownership is determined in the context of the particular case with reference to the person or persons that enjoy the indicia of beneficial ownership."

14. Section 7A(g)(1) of the Clayton Act, 15 U.S.C. § 18a(g)(1), provides that any person, or any officer, director, or partner thereof, who fails to comply with any provision of the HSR Act is liable to the United States for a civil penalty for each day during which such person is in violation. For the time period relevant to the Complaint, the maximum amount of civil penalty is \$11,000 per day, pursuant to the Debt Collection Improvement Act of 1996, Pub. L. 104-134, § 31001(s) (amending the Federal Civil Penalties Inflation Adjustment Act of 1990, 28

U.S.C. § 2461 note), and Federal Trade Commission Rule 1.98, 16 C.F.R. § 1.98, 61 Fed. Reg. 54548 (Oct. 21, 1996).

## **V. THE MERGER**

15. The notification and waiting period requirements of Section 7A applied to Smithfield's acquisition of Premium Standard. On September 17, 2006, Smithfield and Premium Standard entered into an Agreement and Plan of Merger (the "Merger Agreement"). Under the Merger Agreement, Smithfield agreed to acquire Premium Standard for approximately \$693 million in stock and cash and assume \$117 million of Premium Standard's debt for a total purchase price of about \$810 million. On October 6, 2006, Smithfield and Premium Standard filed premerger Notification and Report Forms required by Section 7A, marking the beginning of the Section 7A waiting period. The statutory 30-day waiting period was extended when the Antitrust Division issued requests for additional information on November 6, 2006. The waiting period expired on March 7, 2007, thirty days after both parties certified compliance with the requests. Smithfield completed its acquisition of Premium Standard on May 7, 2007.

16. The Merger Agreement contained certain customary interim "conduct of business" provisions limiting Premium Standard's operations during the Section 7A waiting period to protect Smithfield's legitimate interests in maintaining Premium Standard's value without impairing Premium Standard's independence. These included provisions regarding Premium Standard's rights to assume new debt or financing, issue new voting securities and sell assets, as well as requirements that Premium Standard "carry on its business in the ordinary course consistent with past practice." The Merger Agreement also conditioned the closing of the transaction on the absence of any material adverse effect, as such agreements customarily do.



## VI. DEFENDANTS' CONDUCT

17. Prior to its acquisition, Premium Standard purchased hogs from independent hog suppliers pursuant to contracts that ranged in length from one to five years. Procurement of hogs from independent hog suppliers was a focus of the Antitrust Division's investigation and Request for Additional Information. For 2008, Premium Standard projected purchasing hogs from about eleven independent hog producers.

18. After executing the Merger Agreement, Premium Standard needed to continue to purchase hogs from independent hog producers in order to carry on its business in the ordinary course consistent with its past practice.

19. After executing the Merger Agreement, Premium Standard stopped exercising independent business judgment in its hog purchases. Instead, beginning on or about September 20, 2006, Premium Standard submitted for Smithfield's consent each of the three contracts for hog purchases from an independent hog producer that arose during the Section 7A waiting period, including one contract accounting for less than one percent of Premium Standard's annual slaughter capacity. Together, the three multi-year contracts obligated Premium Standard to purchase, on an annual basis, between 400,000 to 475,000 hogs at a total cost ranging from approximately \$57 million to \$67 million. These hog procurement contracts were necessary to Premium Standard's ongoing business and entered into in the ordinary course. Each time Premium Standard sought consent, it provided Smithfield with the proposed contract terms, including the price to be paid, quantity to be purchased, and length of the contract.

## **VII. VIOLATION OF SECTION 7A OF THE CLAYTON ACT**

20. Through the conduct described in Paragraphs 17 through 19, Smithfield exercised operational control over a significant segment of Premium Standard's business prior to the expiration of the waiting period required by Section 7A. By controlling a significant segment of Premium Standard's business operations while having agreed to acquire Premium Standard, Smithfield acquired beneficial ownership of that significant segment of Premium Standard's business, and thus acquired and held those assets, valued in excess of the \$56.7 million threshold then in effect, within the meaning of Section 7A on or about September 20, 2006.

21. Smithfield and Premium Standard were continuously in violation of Section 7A from on or about September 20, 2006, through the expiration of the statutory waiting period on March 7, 2007.

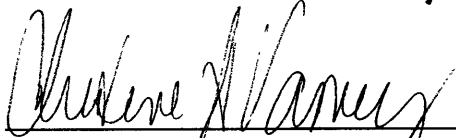
## **VIII. PRAYER FOR RELIEF**

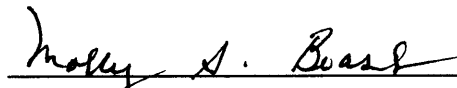
The United States requests:

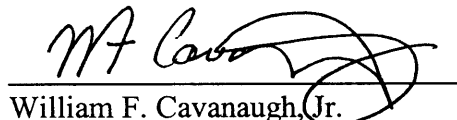
1. That the Court adjudge and decree that Smithfield and Premium Standard violated Section 7A of the HSR Act during the period beginning on September 20, 2006, and ending on March 7, 2007;
2. That each defendant pay to the United States an appropriate civil penalty as provided under Section 7A(g)(1) of the Clayton Act, 15 U.S.C. § 18a(g)(1), and 16 C.F.R. § 1.98(a);
3. That the United States have such other relief as the nature of the case may require and the Court may deem just and proper; and


4. That the United States recover its costs of this action.

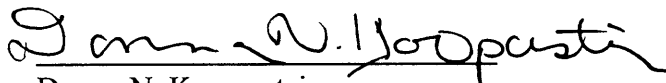
Dated this 21<sup>st</sup> day of January 2010.

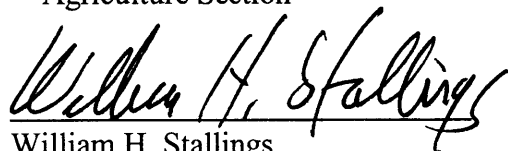
  
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Respectfully Submitted,

  
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## **LEGAL AUTHORITY CA-51**



**Department of Justice**

Office of Public Affairs

FOR IMMEDIATE RELEASE

Thursday, January 21, 2010

## **Smithfield Foods and Premium Standard Farms Charged with Illegal Premerger Coordination**

### **Companies Required to Pay \$900,000 Civil Penalty**

WASHINGTON – The Department of Justice today announced a settlement with Smithfield Foods Inc. and Premium Standard Farms LLC that requires the companies to pay a total of \$900,000 in civil penalties for violating premerger waiting period requirements.

The Department's Antitrust Division today filed a civil antitrust lawsuit in U.S. District Court for the District of Columbia, along with the proposed settlement that, if approved by the court, would resolve the lawsuit.

According to the complaint, after Smithfield and Premium Standard announced their proposed merger in September 2006, Smithfield exercised operational control over a significant segment of Premium Standard's business without observing the premerger waiting period requirement in violation of federal antitrust law. Such conduct, commonly known as "gun jumping" violates the Hart-Scott-Rodino (HSR) Act of 1976.

After entering into the merger agreement, Premium Standard stopped exercising its independent business judgment with respect to hog procurement. Instead, Premium Standard sought Smithfield's consent for all of the hog procurement contracts that arose during the waiting period, providing Smithfield with the contract terms, including price, quantity and duration. The hog procurement contracts were necessary to Premium Standard's ongoing business and were entered into in the ordinary course. Requiring a buyer's approval of the seller's ordinary course contracts can prematurely transfer operational control, violating premerger notification requirements, the Department said.

"Merging companies must remain independent in their ordinary business operations, including purchasing decisions, until the end of the premerger waiting period," said Christine Varney, Assistant Attorney General in charge of the Department's Antitrust Division. "Observing the waiting period ensures that the marketplace remains competitive which ultimately benefits consumers."

The HSR Act requires companies planning mergers or acquisitions that meet certain threshold requirements to file premerger notifications with the Department of Justice and Federal Trade Commission. The Act gives the federal antitrust agencies an opportunity before the parties merge to investigate the proposed transactions and determine whether they would violate the antitrust laws. When the HSR Act applies, it requires that companies observe a waiting period before the acquisition occurs. A purpose of the waiting period is to preserve the companies as independent companies in case the proposed merger or acquisition is blocked so that the competition that the antitrust laws protect does not suffer.

Federal courts can assess civil penalties for premerger notification or waiting period violations under the HSR Act in lawsuits brought by the Department of Justice. During the time period relevant to this case, the maximum civil penalty for a party in violation of the HSR Act is \$11,000 for each day it is in violation. The Department's complaint does not challenge the underlying merger, which the companies announced they had closed on May 7, 2007.

Smithfield is headquartered in Smithfield, Va. Premium Standard, now a subsidiary of Smithfield, maintains its principal offices in Princeton, Mo.

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**Component(s):**  
Antitrust Division

**Press Release Number:**  
10-062

*Updated September 15, 2014*



## **LEGAL AUTHORITY CA-52**

65 Cal.App.4th 1469  
 Court of Appeal, Second  
 District, Division 5, California.

PRINCIPAL MUTUAL LIFE INSURANCE  
 COMPANY, Plaintiff and Respondent,

v.

VARS, PAVE, McCORD & FREEDMAN  
 et al., Defendants and Appellants.

No. B108968.

|  
 Aug. 12, 1998.

|  
 Rehearing Denied Sept. 10, 1998.

|  
 Review Denied Nov. 18, 1998. \*

### Synopsis

After mortgagee foreclosed deed of trust on leased premises, mortgagee sued tenant, which was a partnership, and guarantors for breach of commercial lease. The Superior Court, Los Angeles County, No. LC026408, [Stephen D. Petersen](#), J., entered judgment for mortgagee. Guarantors appealed. The Court of Appeal, [Godoy Perez](#), J., held that: (1) foreclosure of deed of trust did not constitute rescission of junior lease, but instead extinguished the lease, and thus, mortgagee could enforce attornment provision in lease as third-party beneficiary of attornment provision; (2) attornment provision was not too vague or uncertain to be enforced; (3) mutuality of obligation doctrine did not preclude mortgagee from enforcing attornment provision; (4) guaranty was enforceable after lease was extinguished by foreclosure, as attornment renewed the lease and guaranty covered lease renewals; (5) breach of lease was chargeable to departing partner after partnership dissolution; and (6) partnership did not relieve departing partner of his lease obligations.

Affirmed.

**Procedural Posture(s):** On Appeal.

### Attorneys and Law Firms

\*\*481 \*1474 [Jerry L. Freedman](#) and Gail V. Phillips for Defendant and Appellant Jerry L. Freedman.

Robert J. Vars, in pro. per., and [James V. Jordan](#), Los Angeles, and [Michael R. Hambly](#) for Defendants and Appellants Robert J. Vars and Robert J. Vars, PC.

Peterson & Ross and [Karl W. Kime](#), Los Angeles, for Defendants and Appellants James W. McCord, Robert M. Pave, Robert M. Pave, PC, and J. Patrick Jacobs.

Allen, Matkins, Leck, Gamble & Mallory, [Patrick E. Breen](#) and [Rebecca Gilbert Gundzik](#), Los Angeles, for Plaintiff and Respondent.

### Opinion

[GODOY PEREZ](#), Associate Justice.

Defendants Jerry L. Freedman and Robert J. Vars appeal from the judgment entered on behalf of plaintiff Principal Mutual \*1475 Life Insurance Company in its action for breach of a commercial lease. For the reasons set forth below, we affirm the judgment.

### FACTS AND PROCEDURAL HISTORY <sup>1</sup>

In May 1985 the law firm of Vars, Pave, McCord & Freedman (VPMF) signed a lease \*\*482 for office space (the lease) in an Encino office building owned by 16030 Associates (the landlord). VPMF was a general partnership formed by lawyers Robert J. Vars, Robert Pave, James W. McCord and Jerry L. Freedman. The lease, which each partner personally guaranteed, ran for five years, starting August 1, 1985. The lease included an option to be renewed for another five years.

Relevant to this appeal are the following lease terms: Paragraph 31a, which stated that the lease would be deemed subordinate to all existing and future liens and mortgages on the landlord's property; and paragraph 31c, which stated that if the landlord sold the building or lost it in foreclosure, the tenant would attorn to the landlord's successor in interest upon request, and be bound by a new lease on the same terms as the old one. <sup>2</sup>

\*1476 On June 11, 1986, plaintiff and respondent Principal Mutual Life Insurance Company (Principal) recorded a trust deed to secure a loan which it made to the landlord. In May 1990, VPMF exercised its option to renew the lease for another five years through February 1996. In February 1992, at the instigation of Freedman, Vars was asked to leave

the firm. The VPMF partnership dissolved and carried on as Freedman, Pave, McCord & Jacobs. Vars moved his practice to a new location. In February 1993, Freedman voluntarily left the new partnership, which dissolved and carried on as Pave McCord & Jacobs.<sup>3</sup> Freedman also moved his practice to a different location. Neither Freedman nor Vars paid any rent after their respective departures from the firm.

On April 7, 1993, Principal recorded a document styled as a "Subordination Agreement" by which it purported to subordinate its trust deed to the leases of various tenants at the landlord's property, including VPMF. The stated purpose of the document was to prevent a foreclosure of the property from extinguishing those leases. The so-called subordination agreement was signed only by officers of Principal, not by any of the tenants. Principal acquired legal title to the building by way of foreclosure on August 13, 1993.

On September 15, 1993, Principal sent a letter to the firm stating that it had acquired the property, that pursuant to the terms of the lease Principal had assumed all of the landlord's lease obligations, and that it was "pleased to have you as a continuing tenant ... under the terms of the Lease." McCord \*\*483 wrote back on behalf of the firm in a letter dated September 29, 1993, taking the position that Principal's foreclosure of its senior encumbrance extinguished the lease, leaving the firm as a month-to-month tenant. Principal responded in an October 15, 1993, letter, pointing out that it had subordinated its trust deed to the lease before the foreclosure. Principal also contended that the firm was obligated by paragraph 31c of the lease to enter upon request a new lease under the same terms as the old one and asked that the firm do so.

The firm paid rent from August 1993 to December 1, 1993, then stopped. On March 22, 1994, the firm notified Principal it was vacating the office \*1477 space and moved out on April 16, 1994. Principal then sued the firm and the individual partners—Vars, Pave, McCord and Freedman—for breach of the lease and to enforce the partners' personal lease guarantees.

After a bench trial in July 1996, the trial court found that the lease and guarantees were enforceable for two reasons: First, because Principal had subordinated its trust deed to the lease before the foreclosure; and second, because the attornment clause in paragraph 31c of the lease obligated the firm to recognize Principal as its landlord under the terms of the original lease. The court also found that the landlord had not agreed to release Vars or Freedman from their lease

and guarantee obligations.<sup>4</sup> Principal was awarded more than \$460,000, plus attorney's fees and costs of approximately \$99,000.

The main issue on appeal is whether the firm was required to attorn to Principal and recognize it as the new landlord, or whether Principal's foreclosure of the landlord's property extinguished the lease, including the obligation to attorn. Vars and Freedman also contend that the attornment provision was unenforceable because it was vague, because it vested full control over whether the lease would continue with Principal and therefore lacked mutuality of obligation, and because Principal was a stranger to the lease with no right to enforce the guarantee. Freedman also contends that he was released from his lease and guarantee obligations by the conduct of the landlord and Principal.<sup>5</sup>

## STANDARD OF REVIEW

Interpretation of a lease presents a question of law which we independently review using principles of contract law. (*Miscione v. Barton* \*1478 *Development Co.* (1997) 52 Cal.App.4th 1320, 1325–1326, 61 Cal.Rptr.2d 280, hereafter *Miscione*.) In doing so, we apply certain well known rules of contract interpretation. A contract must be interpreted to give effect to the mutual intention of the parties at the time the contract was made. (Civ.Code, § 1636.) Courts will not adopt a strained or absurd interpretation to create an ambiguity where none exists. A contract extends only to those things concerning which it appears the parties intended to contract. Our function is to determine what, in terms and substance, is contained in the contract, not to insert what has been omitted. We do not have the power to create for the parties a contract which they did not make and cannot insert language which one party now wishes were there. Finally, words used in a certain sense in one part of a contract are deemed to have been used in the \*\*484 same sense elsewhere. (*Levi Strauss & Co. v. Aetna Casualty & Surety Co.* (1986) 184 Cal.App.3d 1479, 1485–1486, 237 Cal.Rptr. 473.)

## DISCUSSION

### 1. Attornment, Subordination And Nondisturbance Clauses

Title to real property which is conveyed after foreclosure by a trustee's deed relates back to the date the trust deed was executed. The title passed is that held by the trustor at the time

of execution. Liens which attached after the foreclosed trust deed was executed are extinguished and the purchaser takes title free of those junior or subordinate liens. (*Dover Mobile Estates v. Fiber Form Products, Inc.* (1990) 220 Cal.App.3d 1494, 1498, 270 Cal.Rptr. 183, hereafter *Dover*.)

This rule applies to tenants who have leased property which is later sold through foreclosure. A lease made before the foreclosed trust deed was executed survives the foreclosure and the purchaser takes the property subject to the lease. A subordinate lease, which was made after a trust deed was executed, is wiped out by the foreclosure of that deed, along with the tenant's rights and obligations under the lease. (*Dover, supra*, 220 Cal.App.3d at p. 1498, 270 Cal.Rptr. 183.) If the tenant remains, he does so only as a holdover tenant. If the purchaser of the foreclosed property accepts rent from the tenant, a month-to-month tenancy is created. (*Id.* at p. 1501, 270 Cal.Rptr. 183.)

Commercial landlords, their tenants and their lenders sometimes attempt to adjust their respective rights in the event of foreclosure by three types of lease clauses—subordination, nondisturbance and attornment (SNDA). All three are at issue here.

The parties to a real estate transaction may contractually agree to alter the priorities of encumbrances otherwise fixed by law. \*1479 (*Miscione, supra*, 52 Cal.App.4th at p. 1326, 61 Cal.Rptr.2d 280.) A lease may be deemed subordinate to an otherwise junior trust deed through a subordination agreement, which is “ ‘often used to adjust the priorities between commercial tenants and the mortgagee of the real estate ... Absent such an adjustment, priorities will be governed by the recording acts and related common law principles.’ [Citation.]” (*Dover, supra*, 220 Cal.App.3d at p. 1498, 270 Cal.Rptr. 183.) Some leases include so-called “automatic subordination” clauses, by which the tenant agrees that its lease will become subordinate to any liens or encumbrances on the landlord's property which attach after the lease is executed. (6 Matthew Bender, Cal. Real Estate Law & Practice (1998) Creation of Tenancies, § 153.50, pp. 153–92–153–93.) The firm's lease included such an automatic subordination clause.

In order to protect itself from the loss of its lease through foreclosure of the landlord's property, a tenant asked to subordinate its lease to any future encumbrances may negotiate with the landlord to obtain a nondisturbance agreement from any future lenders. Such an agreement

provides that a foreclosing lender with a superior lien will not disturb the tenant's possession so long as the tenant has not defaulted on the lease. (6 Matthew Bender, Cal. Real Estate Law & Practice (1998) Creation of Tenancies, § 153.50 [2], p. 153–94; *Miscione, supra*, 52 Cal.App.4th at p. 1327, 61 Cal.Rptr.2d 280.) McCord, who negotiated the lease on behalf of the firm in 1985, testified that: he wanted a nondisturbance clause; he was told it was not negotiable; and that such a provision was not so important that he was unwilling to sign the lease without it.

Attornment is a real property concept as old as the law itself. As originally practiced it was “ ‘the act of feudatory, vassal, or tenant by which he consents upon the alienation of the estate to receive a new lord or superior and transfers to him his homage and service.’ ” (Fisher & Goldman, *The Ritual Dance Between Lessee and Lender—Subordination, Nondisturbance, and Attornment* (Fall 1995) 30 Real Property, Prob. and Trust J. 355, 361–362, fn. omitted.) Attornment is not a fossilized concept, however, or one preserved in amber. Instead, it continues to have vitality in the commercial leasing \*\*485 area as “ ‘a corollary agreement addressing foreclosure.’ [Citation.]” (*Miscione, supra*, 52 Cal.App.4th at p. 1327, 61 Cal.Rptr.2d 280.) In its present form, it simply means that the tenant has agreed, or will agree, to recognize its landlord's successor in interest as its new landlord. (*Id.* at pp. 1327–1328, 61 Cal.Rptr.2d 280.)

While few reported decisions have considered the operation and effect of SNDA's, they have attracted more attention in recent years. Critical to our decision are two of these—*Dover* and *Miscione*.

#### \*1480 2. *The Dover And Miscione Decisions*

In *Dover, supra*, 220 Cal.App.3d 1494, 270 Cal.Rptr. 183, tenant Fiber Form entered a five-year lease which contained an automatic subordination clause. That clause stated the lease would be subordinate to any trust deeds or mortgages encumbering the property unless the lender elected to have the lease be superior. After Fiber Form entered the lease, a second trust deed was placed on the property. That lender later foreclosed and the property was bought by Dover at the foreclosure sale. The lender never elected to have the lease be superior to its second trust deed. When Fiber Form moved out, Dover sued for breach of the lease.

Citing the general rule that foreclosure by a senior encumbrancer extinguishes the lease, the appellate court held that Fiber Form's lease had been extinguished, leaving it free

to vacate the property. (*Dover, supra*, 220 Cal.App.3d at pp. 1499–1500, 270 Cal.Rptr. 183.) This holding comports with basic notions of priorities and notice, the court said. If a trust deed is recorded before the lease, the tenant enters the lease with notice that the lease will be subordinate. If the tenant and landlord agree that the lease should be subordinate, then the tenant is aware that its lease could be extinguished by foreclosure. Since Fiber Form expressly agreed to take that risk, it made no difference that Fiber Form, not Dover, wanted the lease extinguished after the foreclosure. (*Id.* at p. 1500, 270 Cal.Rptr. 183.)

The court rejected Dover's argument that instead of terminating the lease, foreclosure gave the buyer the option of doing so. Such a rule would let the buyer do whatever was most profitable, depending on whether rental values had gone up or down since the lease was executed. Even though the lease had been extinguished, however, "the tenant and purchaser are not precluded from entering into a new lease agreement." (*Dover, supra*, 220 Cal.App.3d at p. 1500, 270 Cal.Rptr. 183.) Finally, the court noted that the tenant under a subordinate lease could gain some protection by requiring a nondisturbance clause. In addition, the tenant could bargain with its landlord for the right to cure the landlord's default. (*Ibid.*)

In *Miscione*, tenant Barton Development (Barton) entered a lease of commercial property which contained both attornment and subordination clauses. The attornment clause stated that in the event of foreclosure, the tenant shall attorn to the new owner and recognize it as landlord under the lease, provided that the new owner acquires and accepts the property subject to the lease. The subordination clause provided that any first trust deed holder had the right to request that the tenant subordinate its lease, so long as \*1481 the tenant could first require the lender to sign a nondisturbance agreement and also provided that the holder of any security interest in the property could, upon written notice to the tenant, elect that the lease be superior to its security interest.

The property was eventually foreclosed upon by the holder of a first trust deed which predated the lease. While the foreclosing lender and its successor-in-interest each sought to enforce the lease against Barton, Barton took the position that the lease had been extinguished by the foreclosure pursuant to the rule in *Dover*. The trial court granted Barton summary judgment, in part on the basis that the foreclosing first trust

deed holder failed to elect under the lease to have the lease become senior to the trust deed.

The *Miscione* court reversed, distinguishing *Dover* in several respects. It first noted that the subordination clause had no effect because the foreclosing lender's first trust deed predated and was therefore senior to the lease by operation of law. Since the \*\*486 lender had no reason to insist on subordination of the lease, and since the tenant could only demand a nondisturbance clause if it were asked to subordinate under the lease terms, then the nondisturbance clause was also of no effect, the court reasoned. (*Miscione, supra*, 52 Cal.App.4th at p. 1328, 61 Cal.Rptr.2d 280.) The only potentially operative portion of the subordination provisions was the one which permitted the lender to elect that its lien become junior to the lease. That did not happen and the seniority of the lender's trust deed was therefore fixed by law. (*Ibid.*) This left the attornment clause, an issue not discussed or considered in *Dover*; and the determinative issue for the *Miscione* court. (*Id.* at p. 1329, 61 Cal.Rptr.2d 280.)

Barton contended that the foreclosing lender failed to satisfy a condition precedent to invoking the attornment provision—the lease provision which required it to acquire and accept the property subject to the lease. Barton interpreted this provision to include the exercise of the lender's option to subordinate its deed to Barton's lease, an option which was part of the lease's subordination clause.

The court rejected this contention, in part because the subordination and attornment clauses were separate from and independent of each other. The subordination clause could have applied to several different parties, the court noted, and could have been used to alter the priorities of the parties with respect to insurance awards and condemnation proceeds as well as competing encumbrances. (*Miscione, supra*, 52 Cal.App.4th at p. 1330, 61 Cal.Rptr.2d 280.) "However, the creation of an obligation for the tenant to attorn to a new landlord is quite different. The tenant presumably negotiated the lease with the landlord, and, \*1482 for consideration, contracted to attorn to a new landlord under the described conditions. A landlord could want such a provision in the lease for a number of reasons, not the least of which is that the landlord could show the lease to others with whom it deals to demonstrate that its tenants are bound to new landlords. Such a provision could be a persuasive argument to a lender who was considering the financial condition of the landlord or the landlord's position vis-à-vis other parties involved with the real property. Thus, an attornment clause



is not just gratuitously given in a vacuum, but has a meaning that can impact upon the rights and obligations of parties other than the immediate parties to the lease.” (*Id.* at p. 1330, 61 Cal.Rptr.2d 280, italics added.)

The court gave an additional reason for rejecting Barton's contention that the foreclosing first trust deed holder had to exercise its option to subordinate its deed to Barton's lease as a condition precedent to invocation of the attornment clause: Requiring the foreclosing lender to subordinate its senior encumbrance to the lease before the foreclosure occurs would simply make no sense. “As noted above, prior to the trustee's sale, [the lender] could not know whether it would be the successful bidder. It is illogical to expect [a lender], as a prospective purchaser at the foreclosure sale, to exercise some option provided in a separate clause of the lease. It is common to have all three parts of SNDA clauses included in leases. If we were to support the rule proposed by defendant, all lenders similarly situated ... would have to ‘exercise their option’ to subordinate their position to that of the tenant before they bid in at a foreclosure sale. There is neither logic nor fairness in such a rule, and we will not promulgate it here.” (*Miscione, supra*, 52 Cal.App.4th at p. 1331, 61 Cal.Rptr.2d 280.)

Instead, all the foreclosing lender had to do was acquire and accept the premises subject to the lease, which it did on the day of acquisition by notifying Barton that it was the new owner and directed that all future rent payments be made to it. (*Miscione, supra*, 52 Cal.App.4th at pp. 1331–1332, 61 Cal.Rptr.2d 280.) The court concluded that the attornment clause was an agreement by the tenant to alter the priorities between its lease and the first trust deed, making the lease a senior encumbrance which was not extinguished by the foreclosure. (*Id.* at pp. 1328, 1330–1332, 61 Cal.Rptr.2d 280.)<sup>6</sup>

**\*\*487** Appellants contend that *Dover* governs and that their duty to attorn was extinguished along with the lease upon foreclosure. Principal asks that we follow *Miscione* and hold that the attornment clause was enforceable after it obtained the landlord's building through foreclosure.

### **\*1483** 3. *The Attornment Clause Was Enforceable*

#### *A. The Attornment Clause Survived Extinguishment Of The Lease*

We begin by noting the utility of attornment clauses. They “assist[ ] the mortgagee and tenant in clarifying their rights and responsibilities in the event of foreclosure. By preserving

the economic terms of the lease, attornment boosts and fosters certainty. And certainty is vitally important, not only to tenant entrepreneurs, but to portfolio-balancing mortgagees as well.” (Feinstein & Keyles, *Foreclosure: Subordination, Non-Disturbance and Attornment Agreements* (Aug.1989) 3 Prob. & Property 38, 39, hereafter, *Foreclosure*; accord, *Miscione, supra*, 52 Cal.App.4th at p. 1330, 61 Cal.Rptr.2d 280.) As the *Miscione* court observed, such clauses are “not just gratuitously given in a vacuum, but [have] a meaning that can impact upon the rights and obligations of parties other than the immediate parties to the lease.” (*Miscione, supra*, 52 Cal.App.4th at p. 1330, 61 Cal.Rptr.2d 280.)

The attornment provision at issue here was part of the bargain struck between the firm and the landlord which, by its terms, was specifically intended to come into play after (and in the event) the property was obtained by another through foreclosure. To hold that Principal's foreclosure extinguished the firm's duty to attorn would render that clause meaningless, a violation of long-established rules of contract interpretation. (Civ.Code, § 1641; *Miscione, supra*, 52 Cal.App.4th at pp. 1329–1330, 61 Cal.Rptr.2d 280.)

Appellants contend that under *Dover* it would be unfair to give Principal or any other foreclosing lender the unfettered option of either holding a tenant to its lease or forcing it to move out. While the *Dover* court held that strict application of the rule of automatic extinguishment would avoid such an inequitable result, we agree with the *Miscione* court that *Dover's* failure to discuss and consider the effect of an attornment clause on the status of a subordinate lease after foreclosure by a senior encumbrancer renders *Dover* inapplicable here.

*Dover* focused on the terms of the lease and the tenant's reasonable expectations in the event of foreclosure. Since the automatic subordination clause meant the tenant in *Dover* agreed that its lease would be extinguished upon foreclosure, the court held the purchaser after foreclosure to the bargain struck between landlord and tenant. (*Dover, supra*, 220 Cal.App.3d at p. 1500, 270 Cal.Rptr. 183.) Nor did *Dover* hold, as appellants suggest, that a nondisturbance clause is essential to the validity of an attornment provision. The court merely noted that the tenant could “obtain some protection by requiring the landlord to obtain from its lender a nondisturbance agreement.” (*Ibid.*) The **\*1484** authority cited for this proposition (Johnson & Moskovitz, Cal. Real Estate Law & Practice, § 153.50, p. 153–94) makes clear that a nondisturbance provision should be negotiated at the



inception of the lease. (*Ibid.*) As noted earlier, while the firm wanted such a provision, it did not believe the clause so important that it would not agree to enter the lease without one.

We part company, however, with *Miscione's* blanket pronouncement that an attornment clause alters the priorities between lease and trust deed and therefore prevents the lease from being extinguished.

The apparent authority for this holding is a passage from *Foreclosure* cited in *Miscione*: “Under an attornment clause, a ‘tenant covenants with the mortgagee that, in the event of foreclosure, the lease will not be extinguished but will continue as a lease between the mortgagee (or any successor to it) and the tenant. The tenant, in other words, agrees to recognize that another party who **\*\*488** would not otherwise have privity may enforce the lease agreement as though the third party were originally a beneficiary of the agreement.’ ” (*Miscione, supra*, 52 Cal.App.4th at p. 1328, 61 Cal.Rptr.2d 280, quoting *Foreclosure, supra*, at p. 39.)

*Foreclosure* was not a comprehensive law review article which was supported by underlying case authority. Instead, it was an overview of SNDA practice which set forth general principles applicable to all 50 states regardless of whether they followed the automatic extinguishment rule of California or the so-called “pick-and-choose” rule followed in some states, where the mortgagee must take certain actions during foreclosure in order to wipe out a subordinate lease.<sup>7</sup> (*Foreclosure, supra*, at p. 39.) When viewed in this context, the statement that a lease containing an attornment clause will not be extinguished cannot be considered a rule of general application, particularly in California where the law has long since been that foreclosure by a senior encumbrancer extinguishes a subordinate lease. (See, e.g., *McDermott v. Burke* (1860) 16 Cal. 580, 589–590.)

We think the better definition of attornment is one cited by both the majority and the dissent in *Miscione*: That attornment is the act of a tenant by which he agrees to become the tenant of the property's new owner. (*Miscione, supra*, 52 Cal.App.4th at pp. 1327–1328, and at p. 1335, 61 Cal.Rptr.2d 280 (dis. opn. of Hollenhorst, Acting P.J.), both quoting Black's Law Dict. (6th ed.1990) p. 130, col. 1.) When a lease obligates a tenant to attorn to a new **\*1485** landlord in the event of a foreclosure by a senior encumbrancer, the terms of the attornment provision will govern how that is to occur and its effect on the existing lease.

In *Miscione*, the tenant agreed to attorn to the new owner and recognize that party “under this Lease” so long as the new owner acquired and accepted the property “subject to this Lease.” The bargain struck between landlord and tenant therefore contemplated the continued existence of their lease even after foreclosure. Based on this, the *Miscione* court correctly reasoned that the original lease was intended to survive the foreclosure sale.<sup>8</sup>

The attornment clause at issue here is far different. Instead of providing for the continued existence of the current lease even after foreclosure by a senior encumbrancer, the firm agreed with the landlord that the tenant would, upon request, “enter into a *new lease*, containing all of the terms and provisions of this Lease ... or at the election of such successor in interest, this Lease shall automatically become a *new lease* ... upon all of the terms and conditions hereof...” (Italics added.) This language is significant. Reading paragraph 31 of the lease as a whole, even though the firm agreed to enter a new lease with the landlord's successor in interest, the firm and the landlord also agreed that the firm's lease would be automatically subordinated to any future encumbrances, including Principal's trust deed. Unlike the lease in *Miscione*, there was no intent that the current lease survive. By operation of law, therefore, the lease would be extinguished in the event of foreclosure. How then could the firm be required to attorn to Principal? We hold that the answer lies in the contract law doctrine of third-party beneficiaries.

#### B. Principal Was A Third Party Beneficiary Of The Lease's Attornment Provision

California law permits third-party beneficiaries to enforce the terms of a contract made for their benefit. [Civil Code section 1559](#) states: “A contract, made expressly for the benefit of a third person, may be enforced by him at any time before the parties thereto rescind it.” The third party need not be identified by name. It is sufficient **\*\*489** if the claimant belongs to a class of persons for whose benefit it was made. **\*1486** (*Marina Tenants Assn. v. Deauville Marina Development Co.* (1986) 181 Cal.App.3d 122, 128, 226 Cal.Rptr. 321.) A third party may qualify as a contract beneficiary where the contracting parties must have intended to benefit that individual, an intent which must appear in the terms of the agreement. (*Harper v. Wausau Ins. Co.* (1997) 56 Cal.App.4th 1079, 1087, 66 Cal.Rptr.2d 64.)

Appellants raise only one challenge to the applicability of third-party beneficiary law. In order for a third-party beneficiary to enforce an agreement made by others, there must be a “valid and subsisting obligation between the promisor and the promisee.” (1 Witkin, Summary of Cal. Law (9th ed. 1987) § 662, p. 601.) Since the lease was extinguished by the foreclosure, appellants contend that Principal's rights under the attornment clause vanished along with it. This argument misapprehends the circumstances under which a third-party beneficiary may lose its right to enforce an agreement.

Civil Code section 1559 provides that a third-party beneficiary may enforce a contract at any time before it is rescinded. The principles governing rescission of third-party beneficiary contracts are those applicable to the rescission of contracts generally. (*R.J. Cardinal Co. v. Ritchie* (1963) 218 Cal.App.2d 124, 149, 32 Cal.Rptr. 545.) Civil Code section 1689 governs the rescission of contracts. Under subdivision (a), both parties may consent to a rescission. (Civ.Code, § 1689, subd. (a).) Under subdivision (b), one party may unilaterally rescind based on a variety of grounds, including fraud, mistake or duress, if there has been a failure of consideration, if the contract is unlawful, or if the public interest will be prejudiced by leaving the contract intact. (See Civ.Code, § 1689, subd. (b)(1)-(7).)

If rescission has not occurred according to the statutory procedures, but the contract is instead terminated for some other reason, a third-party beneficiary may still enforce the agreement. In *Pearsall v. Townsend* (1935) 7 Cal.App.2d 162, 45 P.2d 824 (hereafter *Pearsall*), a real estate broker entered into a real estate development agreement with Parkford and the broker hired Pearsall to do the surveying work. When a dispute arose between the broker and Parkford, the broker assigned all his interest in the subdivision to Parkford, by which Parkford agreed to pay the broker's outstanding expenses incurred for work done on the project. The broker later sued Parkford for fraud and Parkford raised the broker's fraud as an affirmative defense. The trial court found that Parkford properly terminated its contracts with the broker due to fraud and ordered the broker to pay damages. Pearsall then sued Parkford to recover for the cost of his surveying services, contending he was a third-party beneficiary of the broker's assignment agreement.

\*1487 The appellate court affirmed the judgment for the surveyor, rejecting Parkford's contention that the assignment had been rescinded and was therefore unenforceable. Instead

of being rescinded, the contract was “merely terminated.” (*Pearsall, supra*, 7 Cal.App.2d at p. 166, 45 P.2d 824.)

In *Mannon v. Pesula* (1943) 59 Cal.App.2d 597, 139 P.2d 336, hereafter *Mannon*, the conditional buyers of certain sawmill equipment promised to pay the sellers' creditor instead of the sellers. The contract impliedly provided that in the event the buyers defaulted, the sellers and their creditor would have a security interest in the items sold. When the buyers defaulted, the creditor claimed it was entitled to the proceeds from the later sale of the equipment. The appellate court confirmed that the creditor was a third-party beneficiary of the sales agreement. The court rejected the buyers' contention that their default effected a rescission which terminated the contract, along with the creditor's third-party rights. First, the court held, termination by way of the buyer's default was not a rescission. Second, the contract provided that in the event of default, the creditor would have a security interest in the repossessed property. “*The default by [the buyers] was the very event which brought this implied term of the contract into operation. Even a formal rescission would not affect that provision.*” (*Mannon*, \*\*490 *supra*, 59 Cal.App.2d at pp. 608–609, 139 P.2d 336, italics added.)

We find *Mannon* and *Pearsall* highly analogous. The firm's lease was not rescinded. There was no attempt by either party to restore the consideration obtained under the lease. (Civ.Code, § 1691, subd. (b).) Instead, the lease was extinguished by operation of law when Principal foreclosed. Much as in *Mannon*, however, the lease contained a provision which was specifically designed to take effect upon its extinguishment by foreclosure: the attornment provision which obligated the firm to enter a new lease with Principal on the same terms as the preexisting lease with the landlord. As discussed *ante*, a contrary holding would violate well-established rules of contract interpretation by rendering the attornment clause meaningless. (Civ.Code, § 1641; *Miscione, supra*, 52 Cal.App.4th at pp. 1329–1330, 61 Cal.Rptr.2d 280.)<sup>9</sup>

After Principal acquired the property at foreclosure, it was therefore entitled to enforce its rights as a third-party beneficiary of the attornment clause and require that the firm enter a new lease on the same terms as the \*1488 original lease. The firm's failure to do so and concomitant departure from the premises were a breach of this obligation.

*C. Other Contract Defenses Are Not Applicable*

Appellants also challenge the attornment provision on the following grounds: (1) because it does not specify who is to enforce the provision or the manner in which it shall be invoked, the clause is fatally vague and uncertain; (2) because Principal was free to pick and choose when or whether it invoked the attornment clause, the provision lacked mutuality of obligation and therefore failed for a lack of consideration; and (3) even if the attornment clause were enforceable by Principal, the partners' personal guarantees were not.

Paragraph 31c of the lease states if the property is sold or acquired by foreclosure, the tenant "shall, upon request, attorn to such successor in interest and, upon request, enter into a new lease, containing all of the terms and provisions of this Lease, with such successor in interest ... or at the election of such successor in interest, this Lease shall automatically become a new lease between Tenant and such successor in interest..." This provision is designed to give the new owner the choice whether to have the tenant attorn. While it could have been made more explicit, when viewed in this context it seems clear to us that the landlord's successor in interest would be the party to make that request. Though the provision is silent as to how that request must be made, appellants do not contend that a written request in the form of a letter, as occurred here, is insufficient.

As to the failure to specify a deadline for such a request, a reasonable time will be implied. (Civ.Code, § 1657.) What constitutes a reasonable time presents a question of fact which depends on the circumstances of the particular case. (*Eidsmore v. RBB, Inc.* (1994) 25 Cal.App.4th 189, 198, 30 Cal.Rptr.2d 357.) Appellants have not addressed this issue at all and we therefore deem it waived. (*Unilogic, Inc. v. Burroughs Corp.* (1992) 10 Cal.App.4th 612, 624, 12 Cal.Rptr.2d 741.)<sup>10</sup>

Next, mutuality of obligation is necessary only in bilateral contracts where there are mutual promises. The doctrine states that the promises on both sides must be binding obligations in order to be consideration for each other. Problems arise in two instances: illusory agreements where no obligation at all is assumed; and where the promise states a definite obligation, but the \*1489 promisor has an election to perform or withdraw at his pleasure. (1 Witkin, Summary of Cal. Law (9th ed. 1987) § 228, pp. \*\*491 236–237.) Appellants contend the doctrine applies because Principal was free to choose for itself whether to require that the firm attorn. This contention fails to recognize that Principal was a third-party beneficiary of the lease between the firm and the landlord,

not a party to the lease. A third-party beneficiary need not supply any consideration to enforce an agreement made for its benefit. (*Macaulay v. Norlander* (1992) 12 Cal.App.4th 1, 8, fn. 3, 15 Cal.Rptr.2d 204.) There is no dispute that the lease was supported by ample consideration, consisting of, among others, the landlord's promise to place the firm in possession of the premises and the firm's promise to pay rent. Where sufficient consideration is present, mutuality is not essential. (*Brawley v. Crosby etc. Foundation, Inc.* (1946) 73 Cal.App.2d 103, 113, 166 P.2d 392.)

Finally, the partners' personal guarantee was made an exhibit to the lease and specifically provided that it would apply to the landlord's successors in interest and continue during the term of the lease or any renewals of the lease. It also provided that: the guarantee would not be affected by any modifications, alterations or extensions of the lease; and that the lease provisions could be changed by agreement or course of conduct between the landlord or its successors and the tenants and that the guarantee "shall guarantee the performance of the Lease as changed." We believe this encompassed a new lease on the same terms as the previous one which would result from an attornment. On these facts, we conclude that the partners' personal guarantee of the lease obligations was enforceable by Principal.

#### 4. Freedman Was Not Relieved Of Liability

Freedman contends that he was not liable for the firm's breach of the lease because it was not an act necessary to wind up the affairs of the dissolved partnership or to complete unfinished partnership transactions. (Corp.Code, §§ 15029, 15030, 15033.) Instead, he contends, the firm could only bind him to its breach of the lease under Corporations Code section 15035, which states, in relevant part: "(1) After dissolution a partner can bind the partnership except as provided in paragraph three, [¶] (a) By any act appropriate for winding up partnership affairs or completing transactions unfinished at dissolution; [¶] (b) By any transaction which would bind the partnership if dissolution had not taken place, provided, the other party to the transaction: [¶] I. Had extended credit to the partnership prior to dissolution and had no knowledge or notice of the dissolution; or [¶] II. Though he had not so extended credit, had nevertheless known of the partnership \*1490 prior to dissolution, and, having no knowledge or notice of dissolution, the fact of dissolution had not been advertised in a newspaper of general circulation...." Freedman then points to evidence that the landlord knew the original partnership had dissolved after he and Vars left and accepted

rent from the successor firms, thus relieving him of further liability under the lease.

This argument must fail because the firm's conduct in breaching the lease is chargeable to Freedman as an act within the scope of winding up the firm's affairs. "In general a dissolution operates only with respect to future transactions; as to everything past the partnership continues until all pre-existing matters are terminated. [Citations.] *The dissolution does not destroy the authority of a partner to act for his former associates in matters in which they still have a common interest and are under a common liability.* [Citations.]" (*Cotten v. Perishable Air Conditioners* (1941) 18 Cal.2d 575, 577, 116 P.2d 603, italics added.) The lease was a partnership obligation which came into being before dissolution and was a matter in which all the partners had a common interest and were under a common liability. Accordingly, Freedman is bound by the firm's breach of the lease.<sup>11</sup>

Finally, Freedman contends that his partners, the landlord and Principal released him from his lease obligations by operation \*\*492 of [Corporations Code section 15036](#), which states, in relevant part: "(1) **Effect of dissolution alone.** The dissolution of the partnership does not of itself discharge the existing liability of any partner. [¶] (2) **Agreement to discharge.** A partner is discharged from any existing liability upon dissolution of the partnership by an agreement to that effect between himself, the partnership creditor and the person or partnership continuing the business; and such agreement may be inferred from the course of dealing between the creditor having knowledge of the dissolution and the person or partnership continuing the business."

While Freedman again points to evidence which he contends shows an agreement to release him from his lease obligations, the evidence on this point was highly conflicting. Freedman testified that at some point after he left the firm, McCord offered to assume his lease obligations in exchange for a

\$50,000 reduction of the firm's debt to Freedman, an offer which Freedman rejected. This alone is substantial evidence that the firm never agreed to release Freedman from his lease obligations under [Corporations Code section 15036, subdivision \(2\)](#).

**\*1491** 5. *The Lender Could Not Unilaterally Subordinate Its Trust Deed*

One alternative ground for the trial court's judgment was Principal's unilateral recordation of a "subordination agreement" purporting to alter the priority of its trust deed and thereby make it junior to the firm's lease. The priority rights fixed by a subordination agreement are strictly limited by the terms of that agreement. (*Miller v. Citizens Sav. & Loan Assn.* (1967) 248 Cal.App.2d 655, 663, 56 Cal.Rptr. 844; *Bank of America v. Hirsch Merc. Co.* (1944) 64 Cal.App.2d 175, 182-183, 148 P.2d 110.) While the lease at issue in *Miscione* contained a provision by which a lender could elect to undo the automatic subordination of a tenant's lease to the lender's trust deed, the lease at issue here did not. Instead, it is silent on that topic. Because the firm's lease provides only that it was automatically subordinated to Principal's trust deed, Principal could not unilaterally reverse those priorities.

## DISPOSITION

For the reasons set forth above, the judgment for Principal is affirmed. Respondent to recover its costs on appeal.

TURNER, P.J., and ARMSTRONG, J., concur.

### All Citations

65 Cal.App.4th 1469, 77 Cal.Rptr.2d 479, 98 Cal. Daily Op. Serv. 6334, 98 Daily Journal D.A.R. 8723

## Footnotes

\* Kennard, J., dissented.

1 The parties stipulated at trial to most of the essential facts. As to the remaining facts, to the extent resolution of this matter turns on the existence of substantial evidence to support the judgment, we state them in the manner most favorable to the judgment, resolving all conflicts and drawing all inferences in favor of respondent. (*Aceves v. Regal Pale Brewing Co.* (1979) 24 Cal.3d 502, 507, 156 Cal.Rptr. 41, 595 P.2d 619.)



- 2 Paragraph 31a states: "This Lease is, and at all times hereafter shall be, subject and subordinate (i) to any and all ground and underlying leases which now exist or may hereafter be executed affecting the Building or the land upon which the Building is situated or both, and (ii) to the lien of any mortgages or deeds of trust in any amount or amounts whatsoever now or hereafter placed on or against said land and Building or either of them or on Landlord's interest or estate therein, or on or against any ground or underlying lease, and to all renewals, consolidations, replacements and extensions thereof, and to all loans or advances heretofore or hereafter made upon the security thereof, all without the necessity of the execution and delivery of any further instruments on the part of Tenant to effectuate said subordination. Notwithstanding the foregoing, Tenant shall execute and deliver to Landlord such further instrument or instruments evidencing such subordination of this Lease as Landlord or its successors in interest may from time to time request."
- Paragraph 31c states: "In the event that Landlord at any time sells or conveys its estate in the Building and/or the related land and real property, or any part thereof, to any other party, or in the event Landlord's estate therein is at any time acquired by any other party upon the foreclosure of any mortgage or deed of trust, or upon any termination of any ground or underlying lease to which this Lease is subordinated as provided in Section 31a hereof, or by reason of any merger or consolidation or otherwise by operation of law, (i) Tenant shall, upon request, attorn to such successor in interest and, upon request, enter into a new lease, containing all of the terms and provisions of this Lease, with such successor in interest for the remainder of the term hereof, or at the election of such successor in interest, this Lease shall automatically become a new Lease between Tenant and such successor in interest, upon all of the terms and conditions hereof, for the remainder of the term hereof, and (ii) Landlord shall be relieved of any further obligations hereunder, provided that such successor in interest assumes all of such obligations of Landlord, but such successor in interest shall not become liable for any default hereunder theretofore committed by Landlord."
- 3 Because the distinctions between these reconstituted versions of the original VPMF are irrelevant to our decision, for ease of reference we will hereafter refer to all of them as "the firm."
- 4 At the close of the trial on the lease obligations, the court suggested that the individual partners file cross-complaints for indemnity and contribution in order to sort out their respective liabilities. The parties did so, and the cross-complaints of the firm and Freedman included causes of action for an accounting of all the partnership assets and liabilities. The trial court then separated the trial of the lease indemnification issue from the trial of the other causes of action in those cross-complaints with the intent of rendering an appealable judgment on only that portion of the cross-complaints. The court found that Vars was entitled to total indemnity from his former partners and determined the liability percentages of the remaining partners. Freedman also appealed from that portion of the judgment, contending that he was entitled to total indemnity as well and that the partners' indemnification obligations needed to be otherwise adjusted. By order dated August 12, 1998, we dismissed that portion of the appeal because there was not yet one final and appealable judgment on the various cross-complaints. ([Morehart v. County of Santa Barbara \(1994\) 7 Cal.4th 725, 736-744, 29 Cal.Rptr.2d 804, 872 P.2d 143.](#))
- 5 Only Vars and Freedman appealed from the judgment. We will sometimes refer to them collectively as "appellants."
- 6 Justice Hollenhorst filed a strong dissent from the majority decision, believing that under *Dover* the lease and its concomitant obligation to attorn were extinguished by the foreclosure. ([Miscione, supra, 52 Cal.App.4th at pp. 1332-1340, 61 Cal.Rptr.2d 280](#) (dis. opn. of Hollenhorst, Acting P.J.).)
- 7 We found *Foreclosure* a helpful guide to understanding the interplay between the various components of SNDAs and intend no slight to the article or its authors. Instead, we merely believe that the passage relied on by the *Miscione* court was not reliable precedential authority for the blanket proposition stated.
- 8 We therefore disagree with the *Miscione* court's conclusion that the attornment clause altered the priorities between Barton's lease and the first trust deed. Instead, it appears to us the parties simply contracted that the lease would not be extinguished by the foreclosure.
- 9 Also, rescission may not be allowed if a third party beneficiary has acted in reliance on the promises made for his benefit. ([Dick v. Woolson \(1951\) 106 Cal.App.2d 415, 419, 235 P.2d 119.](#)) While there is no evidence that

Principal's trust deed was made in reliance on the attornment provision, if that were the case, then rescission could not have occurred.

- 10 The better practice, however, would be to set forth a more detailed mechanism and timetable for attornment.
- 11 Our holding does not consider whether the firm's breach was wrongful as to Freedman or Vars, an issue which bears only on the previously dismissed portion of the appeal from the partners' various cross-complaints for indemnity and an accounting.

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Court of Appeal,  
Second District, Division 4, California.

MOUNTAIN OF FIRE AND  
MIRACLES MINISTRIES, Hayward  
Branch, Plaintiff and Respondent,

v.

Ade OYEYEMI, Defendant and Appellant.

B218591

Filed June 25, 2012

APPEAL from a judgment of the Superior Court of Los Angeles, [Rex Heeseman](#), Judge. Reversed and remanded, with directions. (Los Angeles County Super. Ct. No. BC 352398).

#### Attorneys and Law Firms

Law Office of Jeanne Collachia and [Jeanne Collachia](#) for Defendant and Appellant.

The Garcia Law Firm and [Gilbert A. Garcia](#) for Plaintiff and Respondent.

#### Opinion

[MANELLA, J.](#)

\*1 Appellant Ade Oyeyemi (Pastor Oyeyemi) challenges a judgment for conversion and negligent interference with prospective economic relations in favor of respondent Mountain of Fire and Miracles Ministries, Hayward Branch. He contends that respondent lacked standing to assert claims against him, and that it had no property interest in the assets underlying the claims; in addition, he maintains that respondent did not establish certain elements of the claims. We conclude that the interference claim fails as a matter of law on the evidence presented at trial, and that the conversion

claim is similarly defective insofar as it targeted assets in which respondent had no property interests. We thus reverse the judgment, and remand for a new trial on the conversion claim.

#### FACTS

##### A. Background

Mountain of Fire and Miracles Ministries (MFMM) is an international ministry founded by Dr. Daniel K. Olukoya. Its headquarters is in Lagos, Nigeria, where Dr. Olukoya holds the position of General Overseer. Pastor Oyeyemi participated in MFMM and had a personal relationship with Dr. Olukoya.

In the early 2000's, using the business name, "Mountain of Fire and Miracles Ministries," Pastor Oyeyemi founded a church in Los Angeles and acted as its pastor. Following the creation of Pastor Oyeyemi's church in Los Angeles, respondent was established in Hayward. Respondent's pastor was Grace Ugeh.

On November 28, 2002, Pastor Oyeyemi executed a form agreement with MFMM that provided in part: "I hold this church in trust for and on behalf of Mountain of Fire and Miracles Ministries." On September 19, 2003, Pastor Oyeyemi filed articles of incorporation for a California nonprofit corporation named, "Mountain of Fire and Miracles Ministries, Inc." (Mountain). Pastor Oyeyemi was initially identified as Mountain's agent for service of process; in addition, he served as its first chief executive officer.

In late 2004 and early 2005, MFMM begin implementing an organizational plan that divided the United States into regions. Region 4, which contained both Mountain and respondent, was placed under the oversight of Pastor Paul Campbell, whose headquarters was in Houston, Texas. A dispute soon arose between Pastor Oyeyemi and Pastor Campbell regarding Mountain's compliance with MFMM's financial reporting requirements.

In November 1, 2005, Pastor Campbell sent Pastor Oyeyemi a notice requiring him to meet with Dr. Olukoya in Lagos within 72 hours. The notice further stated that Pastor Oyeyemi's failure to attend the meeting would be deemed his termination from MFMM. On November 6, 2005, Pastor Oyeyemi agreed to return MFMM's property to a designated agent. He became pastor of a new church named "Blood of Jesus Prayer and Deliverance" (Blood of Jesus).

## B. Underlying Action

### 1. Initial Proceedings

The underlying action against Pastor Oyeyemi commenced in May 2006. The original and first amended complaints identified Mountain as the plaintiff, and alleged that Pastor Oyeyemi had engaged in misconduct while acting as a fiduciary of Mountain, including diverting its members and assets to a new church. Pastor Oyeyemi demurred to the first amended complaint, contending that Mountain lacked standing to act as plaintiff in the action. The trial court overruled the demurrer.<sup>1</sup>

<sup>1</sup> In October 2006, Pastor Oyeyemi filed a cross-complaint for libel against MFMM, Pastor Campbell, and Dr. Olukoya. Pastor Oyeyemi abandoned his cross-claims during the trial on respondent's second amended complaint.

\*2 In August 2008, a trial began on the first amended complaint. Following an initial bifurcated bench trial on the issue of Mountain's standing, the court concluded that Mountain lacked standing to pursue the action. The court continued the trial to permit respondent to substitute in as plaintiff and file an amended complaint.

Prior to the filing of respondent's amended complaint, Pastor Oyeyemi challenged respondent's standing to assert claims against him. Respondent replied that MFMM's November 2002 agreement with Pastor Oyeyemi impressed a trust on the assets of his church in favor of MFMM, and that respondent was the assignee of MFMM's right to collect its property from Pastor Oyeyemi. Following a hearing, the trial court rejected Pastor Oyeyemi's objection to respondent's standing.

On February 17, 2009, respondent filed a second amended complaint for conversion and interference with economic relations.<sup>2</sup> The complaint alleged that beginning May 25, 2005, Pastor Oyeyemi converted respondent's property for use in his new church, Blood of Jesus, and that in establishing the new church, he had improperly diverted respondent's members and their donations to the new church.

<sup>2</sup> The complaint also contained a claim for defamation and requested injunctive relief. Respondent abandoned its defamation claim during the trial on its second amended complaint.

### 2. Trial

The three-day jury trial on respondent's claims began on April 20, 2009. Pastor Oyeyemi testified that the church he established in Los Angeles in the early 2000's, although independent of MFMM, was "loosely affiliated" with MFMM in view of his personal relationship with Dr. Olukoya and longstanding participation in MFMM. After starting the Los Angeles church, he used some of MFMM's religious materials and paid ten percent of the offerings he received from churchgoers to the division of MFMM located in the United States.

In April 2002, Pastor Oyeyemi filed a fictitious business name statement that listed himself and Dr. Olukoya as doing business as "Mountain of Fire and Miracles Ministries." Later, in November 28, 2002, Pastor Oyeyemi executed an agreement with MFMM that provided: "I ... [ ] hereby affirm my loyalty to the Mountain of Fire & Miracles Ministries worldwide. [¶] 1. I will not do anything that would jeopardize the unity of the church, Mountain of Fire & Miracles Ministries in Los Angeles, California. [¶] 2. I hold this church in trust for and on behalf of Mountain of Fire & Miracles Ministries and it is not a personal property. [¶] 3. I will not take any action that would split the church, seize its assets or change the name of the Church. [¶] 4. Any action taken in that direction shall make it haste [*sic*] to prosecutions."

In connection with Mountain's incorporation in September 2003, Pastor Oyeyemi filed articles identifying the corporation's "specific purpose" as "organiz [ing] a Christian fellowship and a church congregation[ ] to develop mental health programs for the public and to provide social services to the poor and the needy." The bylaws also provided that "[t]he Senior Pastor of the Church shall operate under the guidance of the General Overseer of [MFMM] and the Board of Directors." After Mountain's incorporation, Pastor Oyeyemi reported frequently to Dr. Olukoya. When Mountain purchased a building for use as a church, Pastor Oyeyemi invited Dr. Olukoya to the dedication ceremony.

\*3 In January 2005, Pastor Oyeyemi attended the first MFMM Region 4 conference in Houston. At the conference, he signed the following declaration: "I undertake to be bound by the rules and regulations governing [MFMM] and subsequent rules and regulations which may, thereafter, from time to time, be made by the council of the church." MFMM's new organizational plan was announced during the conference. According to Pastor Oyeyemi, when Mountain's board of directors learned that Mountain and other California

churches were to be supervised by a regional supervisor in Houston, the board decided to complain to Dr. Olukoya. Pastor Oyeyemi also believed that Mountain should not be placed under Pastor Campbell's supervision.<sup>3</sup>

<sup>3</sup> In addition, Pastor Oyeyemi testified that he was offered a supervisory position regarding the California churches, but he refused the offer.

When Pastor Campbell introduced a new financial reporting system, Pastor Oyeyemi—who had worked as an accountant—concluded that the required forms were defective under United States tax law. Although Dr. Olukoya urged Pastor Oyeyemi to use the forms, Pastor Oyeyemi refused to do so, but offered to draft adequate forms. Despite the dispute, Pastor Oyeyemi attended the second Region 4 conference in April 2005.

In May 2005, Pastor Campbell asked Pastor Oyeyemi to provide copies of Mountain's financial records. After Pastor Oyeyemi forwarded some financial documents, Pastor Campbell informed him that the showing was inadequate. In October 2005, at Pastor Campbell's request, Pastor Oyeyemi substituted Dr. Olukoya for himself as Mountain's agent for purposes of service of process.

On October 30, 2005, a group of pastors, including Pastors Campbell and Ugeh, appeared at Mountain's church to discuss Pastor Oyeyemi's financial showing with him. According to Pastor Oyeyemi, all but one member of the group left when churchgoers became angry at them; the remaining member engaged in a prayer service with Pastor Oyeyemi. On November 2, 2005, Pastor Oyeyemi received the notice from Pastor Campbell, dated November 1, 2005, requiring him to appear in Lagos, Nigeria, within 72 hours of the date of the notice.

According to Pastor Oyeyemi, on November 5, 2005, he and Mountain's board of directors decided to establish a new church. The board devised a plan to pay off Mountain's existing debts and transfer its assets—including the proceeds from a sale of the church building—to the new church.<sup>4</sup> On November 6, 2005, Pastor Oyeyemi responded to the notice by a letter to Dr. Olukoya, which stated: "In reference to [the notice], which instructed me with [an] ultimatum to be in Lagos ... within 72 hours (November 3, 2005), or consider myself terminated effective immediately as pastor of Mountain of Fire and Miracles [,] Los Angeles chapter[,] [¶] ... [¶] and arrange for the handover of all church properties

to a designated coordinator[,] [¶] ... [¶] I hereby inform you that the church's properties under my care are ready to be handed over to the designated coordinator." Pastor Oyeyemi testified that the only MFMM property in his or Mountain's possession were approximately 100 books that had been sent from Houston.

<sup>4</sup> The church building had been purchased shortly before Mountain's board decided to establish a new church. Although Pastor Oyeyemi acknowledged that he held title to Mountain's church building in his own name, he testified that he did so because Mountain lacked the credit to obtain a loan. According to Pastor Oyeyemi, Mountain's board approved his holding title to the building, Mountain's members provided the funds for the building's purchase, and the proceeds from the sale of the building were used to buy a new building for Blood of Jesus.

\*<sup>4</sup> Pastor Oyeyemi denied that he misappropriated any assets belonging to Mountain. According to Pastor Oyeyemi, Mountain's board of directors transferred its assets to a nonprofit corporation established for Blood of Jesus. On March 26, 2007, a certificate of dissolution was filed for Mountain.

Pastor Ugeh testified that Pastor Oyeyemi was her senior pastor within California.<sup>5</sup> According to Pastor Ugeh, Pastor Oyeyemi viewed Pastor Campbell as unfit to act as regional overseer; in addition, he viewed Pastor Ugeh as incompetent to act as a pastor because she was a woman. Pastor Oyeyemi also refused to comply with Pastor Campbell's financial reporting requirements.

<sup>5</sup> Pastor Ugeh further testified that Pastor Oyeyemi opened a bank account for her church using Mountain's tax identification number, and that donations from her churchgoers were deposited in it. In view of Pastor Oyeyemi's conduct, she believed that respondent was included within Mountain until Mountain was dissolved as a corporation in 2007.

On October 30, 2005, at Dr. Olukoya's request, Pastors Ugeh and Campbell, along with three other ministers, appeared at Mountain's church to resolve Pastor Oyeyemi's noncompliance with the requirements. When the group of pastors spoke with Pastor Oyeyemi and Mountain's board of directors, angry churchgoers entered the meeting room

and “chased” them off the church property. Later, at Dr. Olukoya's request, Pastor Campbell asked Pastor Ugeh to recover MFMM's assets from Pastor Oyeyemi's church. As all but three of Mountain's churchgoers had become members of Pastor Oyeyemi's new church, Pastor Ugeh also established a new MFMM church in Los Angeles.

Pastor Campbell testified that his conflict with Pastor Oyeyemi arose when Pastor Campbell found what he regarded as serious deficiencies in Pastor Oyeyemi's financial records. After the events in early November 2005, he designated Pastor Ugeh to recover MFMM property because she was the most senior pastor in California after Pastor Oyeyemi.

Michael Rosen, an accounting expert, testified that he had examined the records for two bank accounts used in connection with Pastor Oyeyemi's church beginning in 2002. He estimated that from 2002 through November 2005, there had been withdrawals from the accounts totaling \$546,610 for which there was no adequate documentation. He also calculated that absent the disruptive events in November 2005, Mountain would have collected a total of \$283,786 in offerings from November 2005 to the end of 2007. As the new MFMM church in Los Angeles had collected only \$72,872 during that period, he estimated that its shortfall in collections amounted to \$210,913.<sup>6</sup>

<sup>6</sup> At our request, respondent has provided us with copies of exhibits A and B, which summarized Rosen's testimony and were admitted at trial. We hereby augment the record to include the exhibits. (Cal. Rules of Court, rules 8.122(a)(3), 8.155(a)(1) (A).)

### 3. Judgment

The jury found that Pastor Oyeyemi had engaged in conversion and negligent interference with prospective economic relations, and awarded respondent \$99,786.78 in damages.<sup>7</sup> On May 20, 2009, judgment was entered in favor of respondent and against Pastor Oyeyemi in accordance with the jury's special verdicts. Later, the trial court denied Pastor Oyeyemi's post-trial motions for a new trial and judgment notwithstanding the verdict.

<sup>7</sup> Although the parties refer to the latter tort as “negligent interference with an economic relationship,” the jury was instructed with former

CACI No. 2204, which defines the elements of a tort called “negligent interference with prospective economic relations” or “negligent interference with prospective economic advantage.” (*Venhaus v. Shultz* (2007) 155 Cal.App.4th 1072, 1077.) For clarity, we use the name found in the CACI instruction.

## DISCUSSION

\*5 Pastor Oyeyemi contends that respondent's claims against him fail because respondent had no standing to assert the claims and no property interest in Mountain's assets, which respondent sought to recover at trial. In addition, he contends that respondent never sufficiently specified the funds he allegedly converted or the independently wrongful conduct required for negligent interference with prospective economic relations.

As explained below, we reject Pastor Oyeyemi's contention that respondent lacked standing to assert claims against him. We nonetheless agree that respondent's claims, as elaborated at trial, were defective insofar as they were predicated on Mountain's assets and income. Although the crux of respondent's claims was that Pastor Oyeyemi, in establishing Blood of Jesus, wrongfully converted Mountain's assets and diverted Mountain's prospective income to Blood of Jesus, respondent failed to show that MFMM had any property interest in Mountain's assets and prospective income.

### A. Standing

We begin by examining whether respondent established its standing to assert claims for conversion and negligent interference with prospective economic relations against Pastor Oyeyemi. Generally, standing presents a “threshold question of law” when the material facts are undisputed. (*People v. Superior Court (Plascencia)* (2002) 103 Cal.App.4th 409, 424.) Lack of standing is a jurisdictional defect to an action that mandates dismissal (*Cummings v. Stanley* (2009) 177 Cal.App.4th 493, 501), unless the complaint can be amended to substitute the proper plaintiff (*Cloud v. Northrop Grumman Corp.* (1998) 67 Cal.App.4th 995, 1004–1011 (*Cloud*)). Because the defect is not forfeited by a failure to object, it may be raised at any time in an action, including on appeal. (*Common Cause v. Board of Supervisors* (1989) 49 Cal.3d 432, 438–439.)



The demand for standing is founded on [Code of Civil Procedure section 367](#), which requires that “[e]very action must be prosecuted in the name of the real party in interest, except as provided by statute.” Under this statute, “[a] real party in interest is one who has ‘an actual and substantial interest in the subject matter of the action and who would be benefited or injured by the judgment in the action.’” (*Martin v. Bridgeport Community Assn., Inc.* (2009) 173 Cal.App.4th 1024, 1031–1032, quoting *Friendly Village Community Assn., Inc. v. Silva & Hill Constr. Co.* (1973) 31 Cal.App.3d 220, 225.) For this reason, “a complaint by a party lacking standing fails to state a cause of action by the particular named plaintiff, inasmuch as the claim belongs to somebody else. [Citation.] A more accurately stated rationale would be that there is a defect in the parties, since the party named as plaintiff is not the real party in interest.” (*Cloud, supra*, 67 Cal.App.4th at p. 1004.)

In rejecting Pastor Oyeyemi's objections to respondent's standing, the trial court accepted respondent's theory of standing, which relied on two premises. The first premise is that Pastor Oyeyemi held at least some of his church's assets in trust for MFMM. Before the trial court and on appeal, respondent has placed special emphasis on Pastor Oyeyemi's November 2002 agreement, in which he stated, “I hold this church in trust for and on behalf of [MFMM].” The second premise is that Pastor Campbell designated respondent “under the pastorate of Grace Ugeh” to recover MFMM's assets from Pastor Oyeyemi. Before the trial court and on appeal, respondent has maintained that Pastor Campbell's designation assigned to respondent MFMM's right to recover its assets from Pastor Oyeyemi.

\*6 We conclude that respondent demonstrated its standing to assert claims for conversion and interference with prospective economic relations. Regarding the first premise, the parties do not dispute that as early as April 2002, Pastor Oyeyemi operated his church under a registered fictitious business name or “d.b.a.,” and that in November 2002, while he used the d.b.a., he entered into an agreement with MFMM to hold the assets of his church in trust for MFMM. These facts were sufficient to show that after November 2002, Pastor Oyeyemi personally held the assets of his church in trust for MMFA, to the extent the assets fell within the scope of the November 2002 agreement.<sup>8</sup> Furthermore, as the beneficiary of the trust, MFMM was entitled to assert claims that Pastor Oyeyemi had misappropriated or diverted the assets that he held in trust for MFMM. (*McElroy v. McElroy* (1948) 32 Cal.2d 828, 831.)

8 Generally, courts have concluded that the designation “d.b.a.” in connection with an individual indicates that the individual operates a business and is liable for its obligations. (See *Providence Washington Ins. Co. v. Valley Forge Ins. Co.* (1996) 42 Cal.App.4th 1194, 1200; *Pinkerton's, Inc. v. Superior Court* (1996) 49 Cal.App.4th 1342, 1348–1349 and the cases cited therein.)

Regarding the second premise, respondent established that it had been assigned MFMM's claims for conversion and interference with prospective economic relations. To begin, we observe that claims of this type are assignable. Generally, the assignment of a cause of action passes title to it from one person to another. (*McDermott, Will & Emery v. Superior Court* (2000) 83 Cal.App.4th 378, 382.) Claims arising out of “an obligation, breach of contract, violation of a right of property, or damage to personal or real property” are ordinarily assignable, unlike claims arising “from a wrong done to the person, the reputation, or the feelings of the injured party, and from breaches of contracts of a purely personal nature ( [such as] promises of marriage).” (*Curtis v. Kellogg & Andelson* (1999) 73 Cal.App.4th 492, 504.) Under these principles, a claim for conversion is assignable. (*Staley v. McClurken* (1939) 35 Cal.App.2d 622, 625.) We reach the same conclusion regarding a claim for negligent interference with prospective economic relations, as determinable interests in future earnings and profits are subject to assignment (*Bank of California v. Connolly* (1973) 36 Cal.App.3d 350, 367–368; *H.S. Mann Corp. v. Moody* (1956) 144 Cal.App.2d 310, 318; see *Superior Gunitite v. Ralph Mitzel, Inc.* (2004) 117 Cal.App.4th 301, 305–306, 316 [affirming damages awarded in connection with assigned claims for negligence and negligent interference with an economic relationship] ).

Furthermore, respondent established that MFMM had assigned its claims to respondent. “[A]n assignment, to be effective, must include manifestation to another person by the owner of his intention to transfer the right, without further action, to such other person or to a third person. [Citation.] It is the substance and not the form of a transaction which determines whether an assignment was intended. [Citations.] If[,] from the entire transaction and the conduct of the parties it clearly appears that the intent of the parties was to pass title to the [cause of action], then an assignment will be held to have taken place. [Citations.]” (*McCown v. Spencer* (1970) 8 Cal.App.3d 216, 225.) Here, Pastors Ugeh and Campbell each



testified that MFMM had authorized Pastor Ugeh to recover its assets from Pastor Oyeyemi.

Pastor Oyeyemi suggests that this testimony showed no assignment of MFMM's claims to respondent. We disagree. As noted above, the existence of an assignment must be discerned on the basis of all the circumstances, including the parties' conduct; moreover, the assignee of a cause of action may assign it to another party (see *Miller v. Bank of America* (1942) 52 Cal.App.2d 512, 515–516). As both Pastors Campbell and Ugeh voiced no objection to respondent's status as plaintiff during the trial, their conduct unequivocally showed that respondent had been assigned MFMM's claim through a direct assignment by MFMM or a subsequent reassignment by Pastor Ugeh. In sum, respondent had standing to assert its claims for conversion and negligent interference with prospective economic relations.

#### B. No Property Interest in Mountain's Assets

\*7 We turn to Pastor Oyeyemi's contention that respondent's claims, as elaborated at trial, were defective as a matter of law because respondent established no property interest in Mountain's assets. We agree. Although respondent had standing as MFMM's assignee to assert claims for conversion and negligent interference with prospective economic advantage against Pastor Oyeyemi (see pt. A., *ante*), the primary damages respondent sought at trial were related to Mountain's assets, which respondent maintained Pastor Oyeyemi held in trust for MFMM. However, absent a showing that MFMM had a property interest in Mountain's assets, MFMM's assignment of its claims against Pastor Oyeyemi to respondent did not authorize respondent's claims regarding Mountain's assets. (See *Judelson v. American Metal Bearing Co.* (1948) 89 Cal.App.2d 256, 261–266, [assignment of claims against incorporator does not, by itself, entitle assignee to assert claims against pertinent corporation].) As explained below, respondent failed to show that MFMM had any such interest in Mountain's assets.

##### 1. Governing Principles

There is no dispute that Mountain was a nonprofit religious corporation (*Corp.Code*, § 9111 *et seq.*).<sup>9</sup> As such, it was a charitable trust required to use its assets for the purpose stated in its articles of incorporation. (*In re Metropolitan Baptist Church of Richmond, Inc.* (1975) 48 Cal.App.3d 850, 856–857; 9 Witkin, *Summary of Cal. Law* (10th ed. 2005) *Corporations*, §§ 252, 383, pp. 1016–1017, 1120–1121.) As is typical for such corporations, the evidence at trial

established that its assets “consisted of gifts, or the proceeds and increment of gifts.” (*In re Metropolitan Baptist Church of Richmond, Inc.*, *supra*, 48 Cal.App.3d at p. 857.) Mountain obtained funds from churchgoers, which were placed in bank accounts and withdrawn for various reasons, including the purchase of a church building. Mountain's articles of incorporation specified its purpose as “organiz[ing] a Christian fellowship and a church congregation [ ] to develop mental health programs for the public and to provide social services to the poor and the needy.” In addition, Mountain's bylaws identified its purpose as “organiz[ing] a Teaching and a Praying Church and ... provid[ing] Social and Charitable Services to the public.”

<sup>9</sup> All further statutory citations are to the Corporations Code.

In asserting that Pastor Oyeyemi misappropriated or wrongfully diverted assets belonging to MFMM after Mountain's incorporation, respondent necessarily maintained that Mountain held its assets for MFMM. In *Episcopal Church Cases* (2009) 45 Cal.4th 467, 478–485, our Supreme Court elaborated how California courts should resolve “internal church disputes” of this type regarding the ownership of church property. There, a local church that operated as a religious corporation disaffiliated itself from the national church, resulting in a property dispute regarding the ownership of the local church's building. (*Id.* at pp. 474–476.)

As explained in *Episcopal Church Cases*, the United States Supreme Court has held that state courts may resolve church property disputes in accordance with state law, provided the method of resolution does not contravene the First Amendment to the United States Constitution. (*Episcopal Church Cases*, *supra*, 45 Cal.4th at p. 478.) The United States Supreme Court has approved two such methods. (*Id.* at p. 480.) Under the first method, which is often called the “‘principle of government’” approach, a court examines whether the general church manifested a hierarchical organization in which the local church subordinated itself to higher church authorities on questions of faith, discipline, or other matters; if so, the court, in resolving the property dispute, places special emphasis on the decisions of the higher church authorities. (*Id.* at p. 480.) In contrast, if the general church does not display a hierarchical organization, the court resolves the dispute in accordance with ordinary principles applicable to voluntary associations. (*Ibid.*) Under the second method, which our Supreme Court called the “neutral principles of law” approach, a court resolves the dispute by examining the constitutions, articles of incorporation, and

other governing rules of the local and general churches, viewed in light of relevant state statutes, including suitably “neutral” laws concerning religious property. (*Id.* at pp. 480–485.)

\*8 California courts have long applied the neutral principles approach. (*Episcopal Church Cases, supra*, 45 Cal.4th 467.) In *Episcopal Church Cases*, our Supreme Court dispelled residual doubts regarding this matter, holding that to the extent property disputes involve no point of religious doctrine, California courts must apply neutral principles of law. (*Id.* at p. 485.) Under this approach, “[t]he court should consider sources such as the deeds to the property in dispute, the local church’s articles of incorporation, the general church’s constitution, canons, and rules, and relevant statutes, including statutes specifically concerning religious property, such as ... section 9142.” (*Ibid.*)

Regarding religious property, subdivision (c) of section 9142 provides: “No assets of a religious corporation are or shall be deemed to be impressed with any trust, express or implied, statutory or at common law unless one of the following applies:

“(1) Unless, and only to the extent that, the assets were received by the corporation with an express commitment by resolution of its board of directors to so hold those assets in trust.

“(2) Unless, and only to the extent that, the articles or bylaws of the corporation, or the governing instruments of a superior religious body or general church of which the corporation is a member, so expressly provide.

“(3) Unless, and only to the extent that, the donor expressly imposed a trust, in writing, at the time of the gift or donation.”

The neutral principles approach, insofar as it relies on section 9142, overlaps in some measure with the principle of government approach. (*Episcopal Church Cases, supra*, 45 Cal.4th at pp. 484, 492.) Thus, in *Episcopal Church Cases*, the court concluded that under subdivision (c)(2) of section 9142, a hierarchically organized general church can unilaterally impress a trust upon the assets of a subordinated local religious corporation when the general church’s governing instruments expressly provide for a trust. (*Episcopal Church Cases, supra*, at pp. 491–492.) Nonetheless, under the neutral principles approach, the mere existence of a hierarchical organization is insufficient to create such a trust, absent

provisions regarding the disposition of local church property in the governing documents of the general or local church. (*Iglesia Evangelica Latina, Inc. v. Southern Pacific Latin American Dist. of the Assemblies of God* (2009) 173 Cal.App.4th 420, 443.)

In resolving issues arising under the neutral principles approach, we apply two standards of review. To the extent our inquiry hinges on the interpretation of the articles of incorporation, bylaws, and other governing documents of MFMM and Mountain, we apply neutral principles of law de novo. (*Concord Christian Center v. Open Bible Standard Churches* (2005) 132 Cal.App.4th 1396, 1408–1409.) However, to the extent the application of the governing documents hinges on factual questions regarding the underlying circumstances, we examine the record for substantial evidence favorable to the judgment. (*Ibid.*) Under this standard, “we must consider all the evidence in the light most favorable to the prevailing part[y], giving [it] the benefit of every reasonable inference, and resolving conflicts in support of the judgment.” (*Ibid.*)

## 2. Analysis

We conclude that respondent failed to show that a trust had been impressed in MFMM’s favor on Mountain’s assets. As explained above (see pt. B.1, *ante*), Mountain’s assets were not subject to any trust—whether “express or implied, statutory or at common law”—unless respondent demonstrated that at least one of the provisions of section 9142, subdivision (c), had been satisfied. This respondent did not do.<sup>10</sup>

<sup>10</sup> We note that Pastor Oyeyemi never expressly directed the trial court’s attention to the neutral principles approach during the underlying proceedings. Nonetheless, we conclude that he has not forfeited his contention, as he challenged respondent’s standing on the ground that respondent had not shown that a trust had been impressed on Mountain’s assets under section 9142, subdivision (c).

\*9 At trial, respondent presented evidence that MFMM is a hierarchical church. Pastor Campbell testified that MFMM imposed requirements on its pastors regarding conduct and salaries, and financial reporting requirements on its local branches to ensure that MFMM was “seen ... by the public to be accountable.” In addition, Pastor Ugeh testified that Dr. Olukoya had ordered local churches that incorporated

to provide in its articles and bylaws that pastors and their relations could not be members of the board of directors.

There was also evidence that Mountain and Pastor Oyeyemi had subordinated themselves to MFMM's authority in various respects. Mountain's bylaws provided that “[t]he Senior Pastor of the Church shall operate under the guidance of the General Overseer of [MFMM] [¶] ... [¶] and the Board of Directors.” In addition, Mountain paid ten percent of its churchgoers' offerings to the division of MFMM located in the United States. There was also evidence that Pastor Oyeyemi had personally subordinated himself on certain matters, as his November 2002 agreement required him to remain loyal to MFMM and hold the assets of his church in trust for MFMM, and his January 2005 agreement subjected him to MFMM's directives.

Although this evidence shows that Mountain was a local religious corporation within a hierarchical church, it fails to establish the existence of a trust on Mountain's assets under any of the three provisions of section 9142, subdivision (c). The record discloses no resolution by Mountain's board of directors expressly placing its assets in trust for MFMM, for purposes of section 9142, subdivision (c)(1). Nor is there evidence that Mountain's articles and bylaws or MFMM's “governing documents” expressly provided for a trust on Mountain's assets, for purposes of section 9142, subdivision (c)(2). Finally, nothing in the record suggests that MFMM was the “donor” of the assets it sought to recover or that it imposed a trust on any such assets “at the time of the gift or donation,” for purposes of section 9142, subdivision (c)(3).

Respondent contends that Pastor Oyeyemi's November 2002 agreement operated to impose a trust in MFMM's favor on Mountain's assets. Pointing to *Episcopal Church Cases*, respondent argues that the November 2002 agreement, coupled with MFMM's hierarchical organization, was sufficient to create a trust. We disagree. As explained in *Episcopal Church Cases*, under section 9142, subdivision (c)(2), a general church with a hierarchical organization can unilaterally impress a trust only when its governing instruments “‘so provide.’” (*Episcopal Church Cases, supra*, 45 Cal.4th at p. 492.)

The November 2002 agreement cannot be regarded as an MFMM “governing instrument” that impressed a trust on Mountain's assets, as it was executed nearly a year before Mountain was created, and was signed by Pastor Oyeyemi as an individual while he operated his church under a “d.b.a.”

Generally, a corporation is not bound by contracts executed by its incorporator prior to the corporation's creation absent ratification or adoption by the corporation itself. (*Chapman v. Sky L'Onda etc. Water Co.* (1945) 69 Cal.App.2d 667, 675.) As noted above, once incorporated, Mountain never ratified or adopted Pastor Oyeyemi's personal trust obligations. For this reason, the November 2002 agreement encompassed only those assets held by Pastor Oyeyemi while he operated his church under a “d.b.a.,” but not the assets that accrued to Mountain after its creation. To hold otherwise would be to disregard the neutral principles of law central to the method for resolving property disputes mandated in *Episcopal Church Cases*.<sup>11</sup>

11 In a related contention, respondent maintains that the November 2002 agreement between MFMM and Pastor Oyeyemi rendered Mountain an agent of MFMM. This contention also fails, as Mountain never ratified or adopted the November 2002 agreement.

\*10 Furthermore, MFMM had considerable opportunity to impose a trust unilaterally on Mountain's assets before the critical events in November 2005, but failed to do so. Under the doctrine of estoppel, when a corporation takes over its incorporator's business, a third party's claims against the incorporator may attach to the corporation when the third party was denied notice of the incorporation. (*Judelson v. American Metal Bearing Co., supra*, 89 Cal.App.2d at pp. 263–264.) However, no evidence at trial suggested that Pastor Oyeyemi hid Mountain's incorporation from MFMM or that MFMM was unaware of it. On the contrary, the evidence showed that Pastor Oyeyemi communicated frequently with Dr. Olukoya, that Pastors Campbell and Ugeh knew that Mountain had been incorporated, that several churches in Region 4 had been incorporated, and that MFMM propounded some general requirements for incorporated churches. Nonetheless, after Mountain's incorporation in September 2003, MFMM took no action to ensure that Mountain held its assets in trust for MFMM.<sup>12</sup>

12 For similar reasons, we reject any contention that the November 2002 agreement imposed a trust on Mountain's assets under section 9142, subdivision (c)(3). Respondent never showed that any assets held in trust by Pastor Oyeyemi under the November 2002 agreement were given or donated to Mountain. However, assuming—without deciding—that this occurred, the

November 2002 agreement was executed over a year before Mountain was incorporated, and thus the agreement was not executed “at the time of the gift or donation” (§ 9142, subd. (c)(3)); furthermore, MFMM never executed any other written document expressly impressing a trust on any such assets, despite ample opportunity to do so.

Respondent also contends that the provision in Mountain's bylaws that “[t]he Senior Pastor of the Church shall operate under the guidance of the General Overseer of [MFMM] [¶] ... [¶] and the Board of Directors,” coupled with the other facts regarding Mountain's subordination to MFMM, operated to create a trust in MFMM's favor on Mountain's assets. We find guidance on this contention from *Protestant Episcopal Church v. Barker* (1981) 115 Cal.App.3d 599 (*Protestant Episcopal Church*), a leading case in the application of the neutral principle approach to church property disputes. There, four local religious corporations affiliated with a national church fell into property disputes with the national church when they severed their relationship with it. (*Id.* at pp. 604–605.) The articles of incorporation for each local corporation stated that it was a “constituent part” of the national church or an organizational subunit (diocese) of the national church, but only one corporation operated under articles expressly providing that its assets would be surrendered to the national church upon disaffiliation. (*Id.* at pp. 606–611, 625.) The appellate court concluded that only the latter held its assets in trust for the national church, even though the other three corporations had declared themselves to be “constituent parts” of the national church or its subunits and had voluntarily submitted to the national church's financial reporting requirements. (*Id.* at pp. 625–626.) In view of *Protestant Episcopal Church*, we conclude that Mountain's articles of incorporation did not impose an express trust on Mountain's assets, as they merely obliged its pastor to find guidance from Dr. Olukoya. In sum, respondent established no ownership interest in Mountain's assets as MFMM's assignee.

### 3. Prejudice

The remaining issues concern whether respondent's failure to establish MFMM's interest in Mountain's assets was prejudicial to Pastor Oyeyemi, and, if so, what remedy is appropriate. As explained below, the effect of the failure was to permit respondent to litigate its claims on the incorrect theory that Mountain's corporate existence was irrelevant to Pastor Oyeyemi's liability for conversion and negligent

interference with prospective economic relations. As a result, the failure cannot be regarded as harmless.<sup>13</sup>

<sup>13</sup> Generally, an error or defect at trial “is usually deemed harmless ... unless there is a ‘reasonabl[e] probab[ility]’ that it affected the verdict.” (*College Hospital, Inc. v. Superior Court* (1994) 8 Cal.4th 704, 715, quoting *People v. Watson* (1956) 46 Cal.2d 818, 836.) In this context, “a ‘probability’ ... does not mean more likely than not, but merely a reasonable chance, more than an abstract possibility. [Citations.]” (*College Hospital, Inc. v. Superior Court, supra*, at p. 715, italics omitted.)

\*<sup>11</sup> Here, the special verdict form asked the jury to make specific findings with respect to the elements of each tort, with the exception of damages. Regarding damages, the special verdict form requested the jury to render only a consolidated finding regarding the total amount of damages arising from the torts. After determining that the elements of each tort had been established, the jury found the total amount of damages to be \$99,786.78.

Respondent's interference claim is incapable of supporting the award of damages: because the claim relied *entirely* on Mountain's assets, the claim is fatally defective. To establish this tort, respondent was obliged to show that “an economic relationship existed between [MFMM] and [Mountain] which contained a reasonably probable future economic benefit or advantage to [MFMM],” and that Pastor Oyeyemi had wrongfully disrupted the relationship. (*Venhaus v. Shultz, supra*, 155 Cal.App.4th at p. 1077.) In an effort to carry this burden, respondent maintained that the creation of Blood of Jesus improperly diverted churchgoers' contributions from Mountain to Blood of Jesus. Because MFMM had no ownership interest in these contributions to Mountain, respondent did not establish the requisite economic relationship between MFMM and Mountain.

We also conclude that the award of damages cannot be affirmed on the basis of respondent's conversion claim. Generally, conversion is “ ‘any act of dominion wrongfully exerted over another's personal property in denial of or inconsistent with his rights therein.’ ” (*Messerall v. Fulwider* (1988) 199 Cal.App.3d 1324, 1329.)<sup>14</sup> To establish conversion, respondent maintained that Pastor Oyeyemi had withdrawn funds in his church's bank accounts without adequate documentation. Respondent relied on its accounting expert, Michael Rosen, who testified that he had examined



the records for two bank accounts used in connection with Pastor Oyeyemi's church beginning in 2002. The first account was opened in early 2002, and the second was opened in January 2005. Some of the suspect withdrawals from the first account may have occurred before Mountain came into existence; however, Rosen was not asked to differentiate between withdrawals occurring before and after Mountain's incorporation.<sup>15</sup>

<sup>14</sup> The remedies for conversion include specific recovery of the property, damages, and a quieting of title. (5 Witkin, *Summary of Cal. Law* (10th ed. 2005) Torts, § 700, pp. 1024–1205.) Respondents' claim sought damages and “other and further relief as the [c]ourt ... deem[ed] proper.”

<sup>15</sup> Although respondent has suggested that its conversion claim against Pastor Oyeyemi involved items of property other than the bank accounts, the record establishes that the conversion claim hinged on Rosen's testimony. During the closing arguments at trial, respondent's counsel maintained that Pastor Oyeyemi engaged in conversion with respect to his church's building, which was purchased shortly before the disruptive events in October 2005. However, respondent's counsel identified no specific damages from this misconduct other than a \$139,786 withdrawal in October 2005 from the church's accounts to pay for the building's purchase, which Rosen had included among the suspect withdrawals from the accounts. On appeal, respondent argues that its conversion claim was also predicated on chairs, books, and other tangible items that were transferred to Blood of Jesus. This contention finds no support in the record. Aside from the monetary damages respondent asserted at trial, the only evidence that Pastor Oyeyemi or Mountain held items of property belonging to MFMM came from Pastor Oyeyemi, who testified that he and Mountain possessed approximately 100 books from MFMM that he had offered to return. Although respondent's counsel briefly referred to these books during his closing argument, respondent never included the restoration of these items or their monetary value within the remedies it sought. Respondent did not request the recovery of *any* specific items of property, and the special verdict form asked the jury solely to assess monetary damages

for conversion. During a conference on jury instructions, respondent's counsel acknowledged that no evidence had been admitted regarding the fair market value of items of property, for purposes of a conversion claim.

\*12 The remaining issue concerns the appropriate remedy. Because the conversion claim was tried on an incorrect legal theory that impaired full development of the evidence relevant to conversion, we remand the matter for a new trial on respondent's conversion claim, limited to whether Pastor Oyeyemi converted bank account funds entrusted to him by MFMM under the November 2002 agreement prior to Mountain's incorporation. (See *Toscano v. Greene Music* (2004) 124 Cal.App.4th 685, 695–697.)

#### *C. Pastor Oyeyemi's Contention of Instructional Error*

For the guidance of trial court upon remand, we address Pastor Oyeyemi's remaining contention regarding respondent's conversion claim. He maintains that during the underlying trial, the court improperly rejected a special instruction that he requested. As explained below, we see no error in the ruling.

Generally, “[a] party is entitled upon request to correct, nonargumentative instructions on every theory of the case advanced by him which is supported by substantial evidence.” (*Soule v. General Motors Corp.* (1994) 8 Cal.4th 548, 572.) However, “[i]n order to complain of failure to instruct on a particular issue the aggrieved party must request the specific proper instructions. [Citations.] ... [T]he court has no duty to modify erroneous instructions submitted to it, and there is no error if it simply rejects such instructions. [Citation.] ... [¶] Furthermore, the duty of the court is fully discharged if the instructions given by the court embrace all the points of the law arising in the case. [Citations.]” (*Hyatt v. Sierra Boat Co.* (1978) 79 Cal.App.3d 325, 335.)

Pastor Oyeyemi contends that although the jury was instructed with a modified version of CACI No. 2100, which sets forth the general elements of conversion, an additional instruction was needed to guide the jury regarding respondent's conversion claim, which focused on the funds in the two bank accounts. Generally, “[a] cause of action for conversion of money can be stated only where a defendant interferes with plaintiff's possessory interest in a specific, identifiable sum, such as when a trustee or agent misappropriates the money entrusted to him.” (*Kim v. Westmoore Partners, Inc.* (2011) 201 Cal.App.4th 267, 284, italics omitted.) Nonetheless, although “a specific sum

capable of identification” must be involved, “it is not necessary that each coin or bill be earmarked.” (*Haigler v. Donnelly* (1941) 18 Cal.2d 674, 681.) Thus, in *Fischer v. Machado* (1996) 50 Cal.App.4th 1069, 1072–1074, the appellate court affirmed the plaintiffs' judgment for conversion against the plaintiff's agents, reasoning that the plaintiffs had sufficiently identified the amount of money due them, even though the agents had commingled the funds they received on the plaintiffs' behalf with other money in a bank account.

Here, Pastor Oyeyemi's proposed instruction stated: “Where the relationship of debtor and creditor only exists[,] conversion of the funds representing the indebtedness is not actionable against the debtor unless the debtor is required to return to the owner the identical money. In other words, dollars which are deposited in a general bank account with other dollars are not the subject of an action for conversion.” This instruction was derived from *Watson v. Stockton Morris Plan Co.* (1939) 34 Cal.App.2d 393, 403, in which the appellate court explained that a creditor cannot assert a conversion claim based on an amount of money against a debtor unless the debtor holds the funds in a fiduciary capacity.

\*13 Under the principles regarding instructions described above, the trial court properly rejected the proposed instruction, as the record was devoid of evidence that Pastor Oyeyemi's relationship with MFMM was merely that of a debtor to a creditor. On the contrary, the undisputed evidence

at trial established that he became a trustee for MFMM under the November 2002 agreement. Nor did the CACI instruction, viewed in context, fail to “embrace all the points of the law arising in the case” (*Hyatt v. Sierra Boat Co.*, *supra*, 79 Cal.App.3d at p. 335), as respondent apprised the jury that it sought specific sums in bank accounts that Pastor Oyeyemi purportedly held for MFMM under the November 2002 agreement. In sum, there was no instructional error.

## DISPOSITION

The judgment is reversed, and the matter is remanded to the trial court for a new trial on respondent's claim for conversion in accordance with this opinion, limited to whether Pastor Oyeyemi converted bank account funds entrusted to him by MFMM under the November 2002 agreement prior to Mountain's incorporation. Pastor Oyeyemi is awarded his costs on appeal.

We concur:

EPSTEIN, P.J.

SUZUKAWA, J.

## All Citations

Not Reported in Cal.Rptr.3d, 2012 WL 2373003



## **LEGAL AUTHORITY CA-54**

547 F.2d 812  
 United States Court of Appeals,  
 Fourth Circuit.

In re O'NEILL ENTERPRISES, INC., Bankrupt.  
 JACKSON PARK REALTY  
 COMPANY, INC., et al., Appellants,  
 v.  
 Gray WILLIAMS, Trustee of  
 O'Neill Enterprises, Inc., Appellee.

No. 76-1301.

|  
 Argued Nov. 8, 1976.

|  
 Decided Jan. 18, 1977.

### Synopsis

The United States District Court for the Western District of Virginia, James C. Turk, Chief Judge, affirmed bankruptcy judge's order that trustee in bankruptcy was entitled to cash surrender value of policy on life of president and sole stockholder of bankrupt, and appeal was taken. The Court of Appeals, K. K. Hall, Circuit Judge, held that lenders' security interest in policy, which was intended to serve merely as secondary security to be drawn upon only in event of deficiency after applying proceeds from real estate, was discharged when real estate was sold at foreclosure at price in excess of first lien debt, that policy, although validly assigned to lenders, was nevertheless asset of bankrupt, and that trustee, who was not aware of insurance fund or its amount at time of abandonment, did not intend to abandon anything other than bankrupt's equity in land and building.

Affirmed.

West Headnotes (3)

#### [1] **Insurance** 🔑 **Rights of Creditors**

Where policy on life of bankrupt's president and sole stockholder was intended to serve merely as secondary security for construction loan and was to be drawn upon only in event of deficiency after applying proceeds from real estate, and lenders elected not to foreclose under deed of trust but instead allowed holder

of subordinated deed of trust to foreclose and assume first lien indebtedness, there was no deficiency and consequently no right in lenders to policy proceeds in view of discharge of their security interest as result of sale of real estate at foreclosure at price in excess of their lien debt.

[3 Cases that cite this headnote](#)

#### [2] **Bankruptcy** 🔑 **Insurance Policies and Liabilities Thereon**

While insurance policy on life of president and sole stockholder of bankrupt was validly assigned to lenders as security for construction loan to bankrupt, policy was nevertheless an asset of bankrupt and, following filing of involuntary petition and adjudication of bankruptcy, title to such asset vested in trustee of bankrupt subject to interest of lenders. Bankr.Act, § 70, 11 U.S.C.A. § 110.

[3 Cases that cite this headnote](#)

#### [3] **Bankruptcy** 🔑 **Concealed or Undiscovered Assets**

Trustee, who was not aware at time of abandonment of value and amount of policy on life of bankrupt's president and sole stockholder that had been assigned to lenders as additional security for construction loan, did not surrender his title to policy, which constituted separate asset of bankrupt estate, as part of his abandonment of bankrupt's real estate and thus, since lenders' security interest was discharged when real estate was sold at foreclosure to realty company for price in excess of their lien debt and since realty company's subordinate deed of trust, which was foreclosed, was not secured by policy, neither lenders nor realty company had present interest in policy proceeds.

[5 Cases that cite this headnote](#)

## Attorneys and Law Firms

\*813 John K. Taggart, III, Charlottesville, Va. (Lloyd T. Smith, Jr., Tremblay & Smith, Charlottesville, Va., on brief), for appellants.

T. Munford Boyd, Charlottesville, Va. (Paxson, Smith, Boyd, Gilliam & Gouldman, Charlottesville, Va., on brief), for appellee.

Before BRYAN, Senior Circuit Judge, and WIDENER and HALL, Circuit Judges.

## Opinion

K. K. HALL, Circuit Judge:

This is an appeal by Jackson Park Realty Company, Inc. (hereinafter Jackson Park), Fidelity Bankers Life Insurance Company (hereinafter Fidelity) and Philadelphia Life Insurance Company (hereinafter Philadelphia) from an adverse ruling in a bankruptcy case. The district judge affirmed an order entered by the bankruptcy judge in the bankruptcy of O'Neill Enterprises, Inc. The case involves conflicting claims to the cash surrender value of a life insurance policy on the life of Mr. Frank A. O'Neill. It was held below that the trustee in bankruptcy for O'Neill Enterprises, Inc., was entitled to the fund. This appeal was filed pursuant to the Bankruptcy Act. Title 11 U.S.C. s 47 specifically gives jurisdiction to this court.

For purposes of securing financing for an office building it planned to construct at 2007 Earhart Street in the City of Charlottesville, Virginia, O'Neill Enterprises entered into a loan agreement in January 1967 with Philadelphia and Fidelity whereby the two insurance companies agreed to make a \$750,000 loan to O'Neill Enterprises. Pursuant to that loan, two notes of \$375,000 each were executed by O'Neill Enterprises on June 15, 1967. Security for these notes included a first deed of trust on the property at 2007 Earhart Street. As additional collateral security for the loan, the bankrupt O'Neill Enterprises was required to furnish an assignment of rents effective upon any default and six life insurance policies with a total face value of \$1,000,000. The policy which is subject of this appeal is a \$250,000 policy on the life of Frank A. O'Neill, the president and sole stockholder of O'Neill Enterprises.<sup>1</sup> This policy has a cash surrender value of \$25,715.70.

<sup>1</sup> The other five insurance policies insured the lives of Mr. O'Neill's wife and children. The

bankruptcy judge denied Jackson Park's claim to these policies on grounds that they had been issued to a party not having an insurable interest in the lives of the insured for the mere purpose of assignment which was in violation of Virginia law. Cash surrender value of these five policies is approximately \$3,000; however, their appeal was abandoned during appeal to the district court.

In January of 1968, O'Neill Enterprises executed a subordinate deed of trust on the same property to secure a \$100,000 loan by Jackson Park. The insurance policies which served the first lien debt were not involved in any way as security for this loan.

O'Neill Enterprises was adjudicated bankrupt on January 5, 1972, following a filing of an involuntary petition in bankruptcy. A receiver, and subsequently a trustee, took over the estate of the bankrupt. In the schedules filed by the trustee in behalf of the bankrupt, the six insurance policies were listed in Schedule B-3, Choses in Action, with the notation that the policies were believed to have no cash value.<sup>2</sup> This information was garnered from Mr. O'Neill. After institution of the bankruptcy \*814 proceeding the two insurance companies surrendered the six life insurance policies for their cash value. The policies had lapsed for nonpayment of premiums, but while their worth was unbeknown to the trustee or bankrupt, they were surrendered for their cash value of \$28,789.66.<sup>3</sup> The trustee was not informed of this figure until October 4, 1972.

<sup>2</sup> Title 11 U.S.C. s 25(a)(8) requires the bankrupt to file such a schedule of property and its money value.

<sup>3</sup> Of this amount, \$25,715.70 was the cash surrender value of the only policy in question in this appeal, i. e. the policy on the life of Mr. O'Neill.

The trustee continued to hold and operate the Earhart Street building until June 9, 1972, when the property was ordered abandoned by the bankruptcy judge. An attempted sale failed to produce a bid which appeared sufficient to produce any equity for the estate and general creditors. Thus abandonment seemed proper. The order of abandonment referred only to the real estate at 2007 Earhart Street; it did not refer to the additional security (insurance policies). The trustee was not then aware of the intention to abandon anything but the real estate. Had the trustee known of the \$28,789.66 credit to the first lien indebtedness, all indications are that there would not

have been an abandonment and a bid for the property would have been accepted.<sup>4</sup>

<sup>4</sup> By letter of July 13, 1972, sent to O'Neill Enterprises, it was disclosed that the insurance policies were worth something and Philadelphia and Fidelity intended to surrender the policies for their cash value and hold the proceeds as security for the debt. The trustee sent a reply letter within a week, indicating that the bankrupt had no interest in "maintaining" the insurance policies, and the trustee inquired as to the "amount of the cash value of each such policy which has been paid on the indebtedness for which the policies constituted security."

By letter dated October 4, 1972, four months after abandonment of the Earhart property, Philadelphia responded to the trustee's inquiry and disclosed the cash surrender value of the six policies.

Following abandonment, Philadelphia and Fidelity entered into an agreement with Jackson Park whereby Jackson Park would be allowed to foreclose under its second deed of trust, and if it were the successful bidder at the foreclosure sale, it would purchase the property subject to assumption of the first lien debt and certain other incidental expenses. In exchange for Jackson Park's promise to bring the first lien debt current and to assume the debt, Philadelphia and Fidelity agreed to transfer to Jackson Park, along with their interest in the rentals collected during the bankruptcy administration, their rights in the six insurance policies once they were satisfied that the first lien debt was otherwise adequately secured. Therefore, the two insurance companies, Philadelphia and Fidelity, refused to devote the insurance proceeds to reduction of the debt, but instead continued to hold the fund as further security for Jackson Park's performance of its obligation to them.

These negotiations and the final arrangement between the insurance companies and Jackson Park were carried out entirely without the knowledge or notice to the trustee or the bankruptcy court.

At a foreclosure sale on July 10, 1972, Jackson Park purchased the property, subject to the first deed of trust for \$84,000.<sup>5</sup> Thereafter, on June 4, 1973, the trustee filed a petition in the bankruptcy court to recover the cash value of the insurance policies which were still held by Philadelphia and Fidelity. Following a hearing, the bankruptcy judge entered a decision in favor of the trustee, which was affirmed by the district court. We are in agreement.

<sup>5</sup> This was the approximate amount of indebtedness then due Jackson Park from the secondary loan to O'Neill Enterprises.

[1] The life insurance policies securing the first lien debt were initially intended by O'Neill Enterprises and the first lien noteholders to serve merely as secondary security "to be drawn upon only in the event of a deficiency after applying proceeds from the real estate." Philadelphia and Fidelity elected not to foreclose under their deed of trust, but instead allowed Jackson Park to foreclose under the second deed of trust and assume the first lien indebtedness. There was no deficiency and consequently no right in Philadelphia or Fidelity to proceed \*815 against the insurance policies. Their security interest in the insurance policies was discharged when the real estate was sold, by virtue of their agreement, at foreclosure for a price in excess of the first lien debt.

[2] [3] While the insurance policy on the life of Mr. O'Neill was validly assigned to Philadelphia and Fidelity, it was nevertheless an asset of the bankrupt. By operation of law under s 70 of the Bankruptcy Act, title to this asset vested in the trustee of the bankrupt, subject to the interest of Philadelphia and Fidelity. The trustee was not a party to the agreement between the two insurance companies and Jackson Park regarding this insurance fund, nor did the trustee acquiesce in that agreement. Although he abandoned the real estate, there was no abandonment of the insurance fund, which remains an asset of the bankrupt estate. The agreement between Philadelphia and Fidelity and Jackson Park regarding the insurance fund cannot be given effect. Jackson Park, by its agreement aforementioned, assumed the position of the bankrupt with regard to the primary indebtedness on the property by virtue of the property having been abandoned by the trustee. However, there can be no claim by Jackson Park to the insurance fund as additional security because it remains a separate asset of the bankrupt estate.

Appellants' primary contention in this appeal is that when the trustee abandoned the real property, the insurance fund as additional security was abandoned also, leaving it to be freely assigned by Philadelphia and Fidelity. We find this claim to be totally without merit.

In petitions for abandonment of the real estate filed by the insurance companies, they made no mention of the insurance. Nor did the abandonment order of the bankruptcy court

contain any provision relating to the policies of any other collateral security. When the real property was ultimately sold on foreclosure of Jackson Park's second lien deed of trust, its bid was exclusively for real estate, and only real estate was sold.

It is clear that the trustee did not intend to abandon anything other than the equity in the land and building at 2007 Earhart Street when he moved to abandon the property. He was not aware of the insurance fund or its amount at that time. Although the trustee had inquired of the policies' worth, it was four months after abandonment that the cash surrender value was disclosed.<sup>6</sup> Without possessing full knowledge of all the facts regarding the value and amount of the insurance proceeds and without ever intending to abandon that property, the trustee may not properly be deemed to have surrendered his title to the insurance as a part of his abandonment of the real estate. *In re Humeston*, 83 F.2d 187 (2nd Cir. 1936).<sup>7</sup>

<sup>6</sup> See n. 3, *supra*.

<sup>7</sup> In the *Humeston* case, a mortgagee had appealed a bankruptcy referee's order forbidding abandonment of real estate. The mortgagee asserted that if the property had been abandoned, the abandonment would have carried with it the rents which the trustee had collected from the property. In affirming the action of the referee, and denying the mortgagee's contention, Judge Learned Hand said, "In the first place the trustee never meant to abandon the rents and as abandonment is always a

matter of intent, he should not have been forced to abandon them in invitum when he was mistaken in the consequences of his act. Moreover, even if the trustee did abandon the equity, he did not include the rents; the two were not inseparably linked."

In furtherance of the lack of abandonment, this court enunciated in *Textile Banking Company v. Widener*, 265 F.2d 446 (4th Cir. 1959), that a decision of abandonment by the trustee in bankruptcy "is to be made in the exercise of a sound judgment under the approval of the Court." The bankruptcy judge in the instant case neither approved of abandonment of the insurance fund, nor did he have any knowledge of its existence.<sup>8</sup>

<sup>8</sup> Rule 608 of the Rules of Bankruptcy Procedure requires that, generally, abandonment of property by the trustee of the bankrupt must be with approval of the bankruptcy court, preferably by express order.

\*816 Therefore, we agree that neither of the insurance companies nor Jackson Park have any present claim to this insurance fund. The fund no longer exists for the purpose of additional security for the first lien indebtedness.

The decision of the district court is accordingly affirmed.

AFFIRMED.

**All Citations**

547 F.2d 812

**LEGAL AUTHORITY CA-55**






SINCE 1828

# **inaccurate**

[adjective](#)

in·ac·cu·rate | \ (,)i-'na-kyə-rət , -k(ə-)rət \

## Definition of *inaccurate*

: not accurate : [faulty](#) inaccurate information

 [Other Words from \*inaccurate\*](#)  [Synonyms & Antonyms](#)  [More Example Sentences](#)  [Learn More about \*inaccurate\*](#)

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## Other Words from *inaccurate*

inaccurately \ (,)i-'na-kyə-rət-lē , -k(ə-)rət- , -kyərt- \ adverb

## Synonyms & Antonyms for *inaccurate*

### Synonyms

- [erroneous](#),
- [false](#),
- [incorrect](#),
- [inexact](#),
- [invalid](#),
- [off](#),
- [unsound](#),
- [untrue](#),
- [untruthful](#),
- [wrong](#)

### Antonyms

- [accurate](#),
- [correct](#),
- [errorless](#),
- [exact](#),
- [factual](#),
- [precise](#),
- [proper](#),
- [right](#),
- [sound](#),
- [true](#),
- [valid](#),
- [veracious](#)

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## Examples of *inaccurate* in a Sentence

he claimed that the TV ratings were *inaccurate* because they didn't take into account all those viewers in health clubs  
the estimate is *inaccurate*, but will do for our purposes

Recent Examples on the Web The handful of point-of-care devices now on the market are frequently *inaccurate*.—  
[BostonGlobe.com](#), "Confirmed coronavirus cases in US hit 3 million and climbing." 9 July 2020 Regardless of the  
future trajectory of the COVID-19 pandemic, the post's primary claim is historically *inaccurate*.— [Matthew Brown](#),

## **LEGAL AUTHORITY CA-56**



SINCE 1828

**untrue**

**Definition of *untrue***

1 : not faithful : [disloyal](#)


2 : not according with a standard of correctness : not level or exact

3 : not according with the facts : [false](#)

[↓ Other Words from untrue](#) [↓ Synonyms & Antonyms](#) [↓ Example Sentences](#) [↓ Learn More about untrue](#)

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## Other Words from *untrue*

untruly \ ,ən-ˈtrü-lē  \ adverb

## Synonyms & Antonyms for *untrue*

### Synonyms

- [erroneous](#),
- [false](#),
- [inaccurate](#),
- [incorrect](#),
- [inexact](#),
- [invalid](#),
- [off](#),
- [unsound](#),
- [untruthful](#),
- [wrong](#)

### Antonyms

- [accurate](#),
- [correct](#),
- [errorless](#),
- [exact](#),
- [factual](#),
- [precise](#),
- [proper](#),
- [right](#),
- [sound](#),
- [true](#),
- [valid](#),
- [veracious](#)

[Visit the Thesaurus for More](#) 

## Examples of *untrue* in a Sentence

He made *untrue* statements to the press. Her lover had been *untrue*.

Recent Examples on the Web The most glaring difference between the two posts is that Phariss does not disclose that the legend is *untrue*.— [Devon Link, USA TODAY, "Fact check: No, Freddy Krueger was not a real 19th century serial killer," 12 July 2020](#) Defense Minister Ismail Sabri Yaakob has demanded that Al Jazeera apologize to Malaysians for *untrue* claims of discrimination and mistreatment of migrants.— [Washington Post, "Malaysian police grill Al Jazeera over report on immigrants," 10 July 2020](#) Now a source tells People that Markle was frustrated by her inability to deny the *untrue* stories being written about her.— [Abby Gardner, Glamour, "Meghan Markle Was Reportedly 'Actively Prevented' From Responding to Rumors," 8 July 2020](#) One, that's very likely *untrue* and two, ignorance is not an excuse.— [Paul Daugherty, The Enquirer, "Doc's Morning Line: This MLB season will purely be about entertainment," 29 June 2020](#) Trump allies claimed protesters outside the event were preventing more

supporters from coming inside, but reporters at the scene said that was *untrue*.— [Caitlin Yilek, \*Washington Examiner\*, "Biggest mistake you can make in politics': Corey Lewandowski takes shot at Trump campaign over Tulsa turnout," 22 June 2020](#) This legal argument would be impossible to make if the Administration was claiming that Bolton's allegations are simply *untrue*.— [Susan B. Glasser, \*The New Yorker\*, "John Bolton's Epic Score-Settling," 18 June 2020](#) We are supposed to feel bad for conservatives who complain that white people can't even get a job anymore because of affirmative action—clearly *untrue*—or that political correctness is stifling their freedom of thought and expression.— [Libby Watson, \*The New Republic\*, "The Police Can't Shake Their Persecution Complex," 17 June 2020](#) The claim, which experts say is also often politically motivated, is *untrue*.— [Matthew Brown, \*USA TODAY\*, "Fact check: The Irish were indentured servants, not slaves," 17 Mar. 2015](#)

These example sentences are selected automatically from various online news sources to reflect current usage of the word 'untrue.' Views expressed in the examples do not represent the opinion of Merriam-Webster or its editors. [Send us feedback](#).



**LEGAL AUTHORITY CA-57**



SINCE 1828

## subjugate

[verb](#)

## Definition of *subjugate*

[transitive verb](#)


1 : to bring under control and governance as a [subject](#) : [conquer](#)


2 : to make submissive : [subdue](#)

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[↓ Synonyms](#)
[↓ Did You Know?](#)
[↓ Example Sentences](#)
[↓ Learn More about \*subjugate\*](#)

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## Other Words from *subjugate*

subjugation \ ,səb-ji-'gā-shən  \ noun

subjugator \ 'səb-ji-,gā-tər  \ noun

## Synonyms for *subjugate*

Synonyms

- [conquer](#),
- [dominate](#),
- [overpower](#),
- [pacify](#),
- [subdue](#),
- [subject](#),
- [subordinate](#),
- [vanquish](#)

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## Did You Know?

Since *jugus* means "yoke" in Latin, *subjugate* means literally "bring under the yoke". Farmers control oxen by means of a heavy wooden yoke over their shoulders. In ancient Rome, conquered soldiers, stripped of their uniforms, might actually be forced to pass under an ox yoke as a sign of submission to the Roman victors. Even without an actual yoke, what happens to a population that has come under the control of another can be every bit as humiliating. In dozens of countries throughout the world, ethnic minorities are denied basic rights and view themselves as subjugated by their country's government, army, and police.

## Examples of *subjugate* in a Sentence

The emperor's armies *subjugated* the surrounding lands. a people *subjugated* by invaders  
 Recent Examples on the Web It's time to stop local tyrants from massive government reach and *subjugating* us.—[Lauren Mcgaughy, Dallas News, "The politics of protest: Organizers of anti-shutdown rallies in North Texas say efforts are homegrown," 24 Apr. 2020](#) But only one group of people is essentially *subjugated* by this kind of gratuitous violence.—[Frank B. Wilderson Iii, Harper's Magazine, "Color Theory," 30 Mar. 2020](#) Harriot saw that they could not be effortlessly *subjugated*.—[Stephen Greenblatt, The New Yorker, "Invisible Bullets: What Lucretius Taught Us About Pandemics," 16 Mar. 2020](#) Though Franz remains far from the frontlines, conscientious objection is its own sort of battle, one between the human spirit and outside forces that seek to *subjugate* it.—[Barbara Vandenburgh, azcentral, "'A Hidden Life' a sublime moral meditation from Terrence Malick," 19 Dec. 2019](#) Had the unprecedented news media coverage of the events that transpired so influenced and *subjugated* the minds of prospective jurors that a fair trial could not have been accorded Nixon for a year, for two years—three years?—[Matt](#)

[Ford, \*The New Republic\*, "Ex-President Trump on Trial," 18 June 2019](#) The United States has split into two tribes, and one of them must always feel itself to be *subjugated* and humiliated while the other's chief occupies the highest office in the land.— [Kevin D. Williamson, \*National Review\*, "A Host of Squalid Oligarchs," 3 Oct. 2019](#) With the farming left to the second class or the *subjugated*, full citizens were free to participate in a unique military culture that made Sparta the most formidable polis in Hellas.— [Steele Brand, \*Time\*, "What Ancient Rome and Greece Can Teach Us About the Modern American Military," 20 Sep. 2019](#) The West resolved to become a model liberal democracy, atoning for Nazi crimes and *subjugating* national interests to those of a post-nationalist Europe.— [Katrin Bennhold, \*New York Times\*, "Germany Has Been Unified for 30 Years. Its Identity Still Is Not.," 9 Nov. 2019](#)

These example sentences are selected automatically from various online news sources to reflect current usage of the word 'subjugate.' Views expressed in the examples do not represent the opinion of Merriam-Webster or its editors. [Send us feedback.](#)

## **LEGAL AUTHORITY CA-58**

656 F.Supp.2d 837  
 United States District Court,  
 N.D. Illinois,  
 Eastern Division.

The BOEING COMPANY and the Boeing Company  
 Retiree Health and Welfare Plan, Plaintiffs,

v.

Lori M. MARCH, William G. Takacs, and [the  
 International Union](#), United Automobile,  
 Aerospace and Agricultural Implement  
 Workers of America, UAW, Defendants.  
 John R. Mayfield, Robert Mecleary, and  
 Thomas J. Sheridan, on behalf of themselves  
 and a similarly situated class, Plaintiffs,

v.

The Boeing Company and the Boeing Company  
 Retiree Health and Welfare Plan, Defendants.

The Boeing Company and the  
 Boeing Company Retiree Health and  
 Welfare Plan, Counter-Claimants,

v.

John R. Mayfield, Robert Mecleary, and Thomas  
 J. Sheridan, on behalf of themselves and a  
 similarly situated class, Counter-Defendants.

Nos. 06 CV 4997 (lead), 07  
 CV 3555 (closed member).

|  
 Sept. 9, 2009.

### Synopsis

**Background:** Participants in retiree health plan filed class action complaint against employer seeking, under the Labor Management Relations Act (LMRA) and the Employee Retirement Income Security Act (ERISA), a declaratory judgment that employer was obligated to provide health benefits to the class for the lives of the retirees and their surviving spouses, preliminary and permanent injunctive relief requiring employer to maintain the level of benefits established in applicable collective bargaining agreements (CBAs), and damages for any losses incurred as a result of benefit changes. Employer filed complaint against participants and union seeking a declaration that CBAs negotiated by employer and union did not vest lifetime health benefits for the class and that it had the right to modify, amend,

or terminate class members' health benefits. Actions were consolidated, and the parties moved for summary judgment.

**Holdings:** The District Court, David H. Coar, J., held that:

Court had federal-question jurisdiction over employer's ERISA claims against participants;

employer lacked standing to bring ERISA claims against union;

Court had subject-matter jurisdiction over employer's LMRA claims against union as an entity;

employer lacked standing to bring claims for declaratory relief under LMRA against union as a representative of or in behalf of class of participants;

current CBA did not prohibit employer from making unilateral changes to benefits for participants that simply brought their benefits in line with those of active employees; and

CBAs and plan documents did not provide for vesting of retiree health benefits.

Ordered accordingly.

**Procedural Posture(s):** Motion for Summary Judgment.

### Attorneys and Law Firms

\*840 [Gregory Lee Curtner](#), [Robert J. Wierenga](#), Miller, Canfield, Paddock and Stone, PLC, Ann Arbor, MI, [Carrie Alice Herschman](#), Penny Nathan Kahan & Associates, Ltd., Chicago, IL, [Richard W. Warren](#), Miller, Canfield, Paddock & Stone, PLC, Detroit, MI, for Plaintiffs.

[Laurie Marie Burgess](#), Burgess Law Offices, P.C., Chicago, IL, for Defendants.

[Robert A. Seltzer](#), Cornfield & Feldman, [George Jackson, III](#), [Mary Margaret Moore](#), Bryan Cave LLP, Chicago, IL, for Plaintiffs/Counter-Defendants.

### MEMORANDUM OPINION AND ORDER



DAVID H. COAR, District Judge.

These two cases, which involve claims under the Employee Retirement Income Security Act of 1974 and the Labor–Management Relations Act, were consolidated for all purposes. In both matters, the Boeing Company seeks a declaration that a series of collective bargaining agreements negotiated by Boeing with the UAW and Local 1069 (collectively, “the Union”) did not vest lifetime health benefits for the following class:

All former employees of Boeing who retired from Boeing Rotorcraft before March 18, 2006; who, as employees, were represented by the Union in collective bargaining; and who are participants in the Retiree Health Plan (i.e., those currently participating in The Boeing Company Retiree Health and Welfare Benefit Plan (Plan 502) and receiving pension benefits under the Local 1069 Non–Contributory Retirement Plan (Plan 005)); and their spouses, same-gender domestic partners, and eligible dependents, and surviving spouses and eligible dependents, who are participants \*841 in the Retiree Health Plan, as described above.

Boeing also seeks a declaration that it has the right to modify, amend, or terminate class members' health benefits. On September 30, 2008, 2008 WL 4450309, this court certified the class for all pending claims in the consolidated litigation.

Represented by lead plaintiffs John R. Mayfield, Robert Meclary, and Thomas J. Sheridan, the class argues that Boeing does not have a unilateral right to modify class members' health benefits under the current collective bargaining agreement (CBA). Specifically, they protest the changes Boeing made to those benefits in September 2006 and July 2009. The UAW, for its part, also considers these changes to be a breach of the CBA and a violation of Boeing's obligation to provide lifetime benefits to retirees. It contends, however, that the court lacks subject-matter jurisdiction over Boeing's claims against the Union.

The UAW, the class, and Boeing each have filed motions for summary judgment. This opinion resolves the three motions.

## I. JURISDICTION

Before delving into the substantive dispute, the court considers its jurisdiction over each claim in the consolidated litigation. The court begins this analysis by briefly identifying the parties and recounting the litigation's history.

### A. Background

On one side of the dispute is the Boeing Company (“Boeing”) and the Boeing Company Retiree Health and Welfare Plan (“Retiree Health Plan”). Boeing is a Delaware corporation with its corporate headquarters and principal place of business in Chicago, Illinois. One of its divisions, Boeing Rotorcraft (which went by other names in the past) has manufacturing facilities in Ridley Township, Pennsylvania (“the Ridley plant”), and at the Wilmington Airport in New Castle County, Delaware (“the Wilmington Airport facility”). At all relevant times, Boeing has been an “employer” within the meaning of Section 3(5) of ERISA, 29 U.S.C. § 1002(5), and the “plan sponsor” of the Retiree Health Plan within the meaning of Section 3(16)(B) of ERISA, 29 U.S.C. § 1002(16)(B). The Retiree Health Plan, meanwhile, is an “employee welfare benefit plan” within the meaning of ERISA § 3(1), 29 U.S.C. § 1002(1), and it is administered primarily in Chicago, Illinois.

On the other side are the named plaintiffs in the *Mayfield* complaint, John Mayfield, Robert Meclary, and Thomas Sheridan (“*Mayfield* plaintiffs”); the named defendants in the *March* complaint, Lori March and William Takacs (“*March* defendants”); and the International Union, United Automobile, Aerospace & Agricultural Implement Workers (“UAW”) and UAW Local 1069 (collectively, the “Union”). The *Mayfield* plaintiffs all retired from Boeing Rotorcraft before March 6, 2006, and the court has ruled that they adequately represent the class certified for this consolidated litigation. The *March* defendants were served on September 23 and September 21, 2006, respectively; they have not participated further in the litigation.

The class representatives and members are “participants” in the Retiree Health Plan, within the meaning of Section 3(7) of ERISA, 29 U.S.C. § 1002(7). Mayfield retired in 1988;

Mecleary retired in 1999; and Sheridan retired in 2003. While employed at Boeing, Mayfield, Sheridan, and Mecleary were represented in collective bargaining by the UAW and UAW Local 1069, which are labor organizations as defined in Section 2(5) of the National Labor Relations Act, 29 U.S.C. § 152(5).

\*842 On August 21, 2006, the UAW and four retirees filed a class action-complaint in the Eastern District of Michigan (the “Wood complaint”). They voluntarily dismissed that complaint on September 13, 2006—the day the *Mayfield* plaintiffs filed suit in the Middle District of Tennessee. Two days later, Boeing and the Retiree Health Plan filed its declaratory complaint against the retirees and the Union in the Northern District of Illinois. The *Mayfield* complaint was subsequently transferred to this court, and the two actions were consolidated.

Both the *Wood* and *Mayfield* complaints contained an allegation that Boeing's changes to the retirees' health benefits breach its contractual obligation to provide vested, lifetime health benefits to the class. And both complaints included an allegation that the changes breach Boeing's obligations under the Retiree Health Plan. Finally, both complaints sought, under the LMRA and ERISA, a declaratory judgment that Boeing is obligated to provide health benefits to the class for the lives of the retirees and their surviving spouses; preliminary and permanent injunctive relief requiring Boeing to maintain the level of benefits established in the applicable collective bargaining agreements; and damages plus interest for any losses incurred as a result of the benefit changes.

## B. Analysis

There is no dispute that the court's jurisdiction over the class's amended complaint (formerly known as the *Mayfield* plaintiffs' amended complaint) is secure under section 301 of the LMRA, 29 U.S.C. § 185 and 28 U.S.C. § 1331, which empowers the court to resolve the class's claim for injunctive relief and damages for breach of a collective bargaining agreement. And the court has jurisdiction under sections 502(a)(1)(B), 502(a)(3), 502(e), and 502(f) of ERISA, 29 U.S.C. § 1132(a)(1)(B), 1132(a)(3), 1132(e) & 1132(f), and 28 U.S.C. § 1331, to resolve the class's claims for benefits due, to clarify the class's rights to future benefits under an employee welfare benefit plan, and to enjoin illegal changes to an employee welfare benefit plan. Jurisdiction over Boeing's declaratory complaint, however, is more complicated.

Boeing does not dispute that it lacks independent standing to sue under section 502(a)(3) of ERISA, 29 U.S.C. § 1132(a)(3), because it is not a participant, beneficiary, or fiduciary, as those terms are defined in the Act. Boeing argues, though, that the court has subject-matter jurisdiction over the ERISA claims in its declaratory complaint because the retirees and the Union could bring (and indeed have brought) a coercive action against Boeing. The Union and the retirees disagree: they both argue that Boeing may not use the Declaratory Judgment Act, 28 U.S.C. § 2201, to “piggyback” on their standing under ERISA. The Union argues, moreover, that Boeing has not shown that the Union would have standing to bring ERISA and LMRA claims on behalf of the retirees—in other words, that there is any standing to “piggyback” on. Finally, the Union contests whether Boeing may bring an LMRA claim without alleging a contract violation. The court addresses each of these contentions below.

### 1. “Coercive Action” Jurisdiction Over Boeing's ERISA Claims Against the Class

Relying primarily on the fact that Congress expressly limited private ERISA claimants to participants, fiduciaries, and beneficiaries, the Union argues that Boeing, an employer, may not subvert congressional intent by using the Declaratory Judgment Act to bring a claim it otherwise \*843 would not have standing to pursue. In a separate brief, the class joins, without elaborating, the Union's argument. Boeing responds that its declaratory complaint raises a substantial federal question because the class and the Union could (and in fact did) file a lawsuit alleging a violation of section 502 of ERISA, and federal-question jurisdiction would exist over such claims. And Boeing contends that, if a plaintiff invokes the Declaratory Judgment Act, there is no requirement that it have “independent standing” to sue under ERISA. Because the court has separate reservations about its jurisdiction over Boeing's claims against the Union, the court focuses here on Boeing's ability to “piggyback” on the class's standing.

This court has jurisdiction over “all civil actions arising under the Constitution, laws, or treaties of the United States.” 28 U.S.C. § 1331. And, under the well-pleaded complaint rule, a federal question must be evident on the face of the plaintiff's complaint. *City of Beloit v. Local 643*, 248 F.3d 650, 652 (7th Cir.2001). The court may exercise jurisdiction only “where it is specifically authorized by federal statute,” and the Declaratory Judgment Act itself does not provide independent jurisdictional footing. *Newell Operating Co. v. UAW*, 532 F.3d 583, 587 (7th Cir.2008). (citation and quotation marks omitted). Thus, in a declaratory-judgment action, the well-

pleaded complaint rule requires the court to assess whether a federal question would be present had the declaratory defendant filed suit against the declaratory plaintiff over the subject matter in the complaint. *City of Beloit*, 248 F.3d at 652; *Primax Recoveries, Inc. v. Sevilla*, 324 F.3d 544, 548 (7th Cir.2003).

Because ERISA occupies the field of law related to employee-welfare plans, disputes regarding these plans generally arise under federal law. See *Spitz v. Tepfer*, 171 F.3d 443, 447 (7th Cir.1999); *Ceres Terminals, Inc. v. Industrial Commission of Illinois*, 53 F.3d 183, 185 (7th Cir.1995). There are, however, exceptions—disputes that concern an employee-welfare plan but do not “arise under” ERISA. *Franchise Tax Board v. Construction Laborers Vacation Trust*, 463 U.S. 1, 103 S.Ct. 2841, 77 L.Ed.2d 420 (1983), the main case upon which the Union relies, is an example.

In *Franchise Tax Board*, a state tax authority was trying to levy funds from an ERISA vacation-benefit plan, to apply the money to unpaid state income taxes. *Id.* at 3, 103 S.Ct. 2841. When the trustees refused to turn over the funds, the tax authority filed suit in state court, seeking (1) enforcement of the levy under state law, and (2) a declaration that the trustees of the plan had a duty under state law to relinquish levied funds from the trust, notwithstanding their obligations under ERISA. *Id.* at 14, 103 S.Ct. 2841. The trustees sought and obtained removal of the suit to federal court, but the Supreme Court concluded that there was no federal jurisdiction. The Court found applicable the *Skelly Oil* doctrine, which demands that “if, but for the availability of the declaratory judgment procedure, the federal claim would arise only as a defense to a state created action, jurisdiction is lacking.” *Id.* at 16, 103 S.Ct. 2841; see *Skelly Oil Co. v. Phillips Petroleum Co.*, 339 U.S. 667, 70 S.Ct. 876, 94 L.Ed. 1194 (1950). Applying the *Skelly Oil* doctrine, the Court ruled that the state's claims did not arise under federal law because its suit for a declaration of the validity of its own tax-levying law, despite possibly conflicting federal law, “is sufficiently removed from the spirit of necessity and careful limitation” that defines the scope of federal jurisdiction. *Franchise Tax Board*, 463 U.S. at 21–22, 103 S.Ct. 2841. Thus, it did not \*844 matter that the trustees could have brought in federal court a declaratory-suit (under ERISA, alone) to determine whether they could comply with the levy. *Id.* at 20, 26–27, 103 S.Ct. 2841. The state's complaint, even if it was certain to require interpretation of ERISA, did not arise under federal law.

The Union (and the class) contend that *Franchise Tax Board* thus requires that a declaratory plaintiff advancing claims under ERISA itself have standing to sue under the statute. One court in this circuit has so held, see *Pabst Brewing Co. v. Corrao*, 176 F.R.D. 552, 560–61 (E.D.Wis.1997), *aff'd on other grounds*, 161 F.3d 434 (7th Cir.1998), but other courts, in this circuit and elsewhere, have rejected this interpretation. See *BorgWarner Diversified Transmission Prods v. UAW*, No. 1:06-cv-058-LJM-WTL, 2006 WL 1328723, 2006 U.S. Dist. LEXIS 30101 (S.D.Ind. May 12, 2006); *Bowe Bell + Howell Co. v. IMMCO Employees' Ass'n*, No. 03 C 8010, 2004 WL 1244143, 2004 U.S. Dist. LEXIS 10264 (N.D. Ill. June 2, 2004); *Prudential Ins. Co. of Am. v. Doe*, 76 F.3d 206, 210 (8th Cir.1996). The interpretation relies in part on the following passage in *Franchise Tax Board*:

The express grant of federal jurisdiction in ERISA is limited to suits brought by certain parties as to whom Congress presumably determined that a right to enter federal court was necessary to further the statute's purposes. It did not go so far as to provide that any suit *against* such parties must also be brought in federal court when they themselves did not choose to sue.

463 U.S. at 21, 103 S.Ct. 2841 (citation and footnote omitted) (emphasis in original).

This court does not read this passage, or *Franchise Tax Board* generally, to set forth an independent standing requirement for declaratory suits under ERISA. Rather, in this passage the Supreme Court was making a point in service of its broader holding: In enacting ERISA, Congress did not intend for federal courts to have exclusive jurisdiction over any case involving an employee-welfare plan where a participant, beneficiary, or fiduciary was sued, irrespective of whether the claims presented in the complaint have a federal character. The jurisdictional deficiency that the Court addressed in this passage was not that the declaratory plaintiff did not have independent standing to sue under ERISA (although that foreclosed a different jurisdictional theory), but that the controversy presented in the complaint—a dispute about the validity of a state tax-levying regulation—was not within the carefully circumscribed ambit of federal jurisdiction.

The Seventh Circuit, for its part, has not directly commented on the Union's "independent standing" argument. In its most recent examination of jurisdiction under ERISA and the Declaratory Judgment Act, the court did not have occasion to consider it. See *Newell Operating Co. v. UAW*, 532 F.3d 583 (7th Cir.2008). The Seventh Circuit has explained, however, that in the context of a declaratory complaint a federal court's jurisdiction "comes from the underlying controversy, not the particular party initiating suit." *Ameritech Benefit Plan Comm. v. CWA*, 220 F.3d 814, 819 (7th Cir.2000). Thus, it has found jurisdiction lacking for declaratory-judgment complaints where the presumed suit by the declaratory defendant would arise under state law. See *Primax Recoveries, Inc. v. Sevilla*, 324 F.3d 544, 548–49 (7th Cir.2003) (declaratory complaint did not present federal question where, had it been filed by declaratory defendant, it would be to force endorsement of a check for reimbursement of funds recovered from a third party under state law); \*845 *Commercial Nat'l Bank of Chicago v. Demos*, 18 F.3d 485, 490 (7th Cir.1994) (declaratory complaint did not present federal question because potential suit by declaratory defendant would raise only state-law question of ownership of accounts). And the court recently held that jurisdiction was secure over a declaratory complaint arising under a federal statutory provision that authorized suit by the declaratory defendant, but not the declaratory plaintiff. See *Wisconsin v. Ho-Chunk Nation*, 512 F.3d 921, 935 (7th Cir.2008) (finding jurisdiction secure because declaratory-defendant, an American-Indian tribe, could bring suit against declaratory-plaintiff, a state, under 25 U.S.C. § 2710(d)(7)(A)(i)).

Applying these broad principles here, the court concludes that Boeing may use the Declaratory Judgment Act to "piggyback" on the class's standing to sue under ERISA because the underlying dispute arises under federal law: whether an employer may make unilateral changes to retirees' benefits under an ERISA welfare plan is entirely a federal question, requiring interpretation only of federal statutes and federal common law, and not state law. And there is no dispute that the court would have jurisdiction under ERISA to resolve the class's presumed complaint against Boeing. Accordingly, the court's jurisdiction over the live controversies in Boeing's declaratory complaint against the class is secure.

## 2. Jurisdiction Over Boeing's ERISA Claims Against the Union

Boeing's ERISA claims against the Union present a different complication. In Boeing's amended complaint, the company

and the plan administrator seek a declaration, enforceable against the Union on behalf of the class, that Boeing and the plan administrator may modify, amend or terminate the class's health insurance benefits, and that the September 2006 and July 2009 changes did not violate ERISA. The Union contends that the court lacks jurisdiction over these claims because Boeing has not shown that the Union has standing to represent retirees (or other members of the class). Boeing responds that the Union could bring ERISA claims on behalf of retirees based on its associational standing, and it notes that the Union in fact did so in the *Wood* complaint.

Under some circumstances, a union may sue on behalf of its members in its "associational capacity." *UAW v. Brock*, 477 U.S. 274, 281–82, 106 S.Ct. 2523, 91 L.Ed.2d 228 (1986). Thus, while generally only participants, beneficiaries, and fiduciaries may bring claims under ERISA, 29 U.S.C. § 1132(a), the Seventh Circuit has held that a union may sue under ERISA on behalf of plan participants—its members—in an associational capacity. See *Southern Illinois Carpenters Welfare Fund v. Carpenters Welfare Fund*, 326 F.3d 919, 922 (7th Cir.2003). A due-process problem arises, though, when associations do not "represent adequately the interests of their injured members." *Brock*, 477 U.S. at 290, 106 S.Ct. 2523.

The Union contends that Boeing has not shown that the Union would represent adequately the interests of the retirees. First, it notes that, as "members in retired status," retirees enjoy the same privileges of membership as active employees, but they lack critical voting rights: under Article 6, Section 19 of the UAW Constitution, retirees are not allowed to vote on the ratification of contracts, the election of stewards and committeepersons, and in decisions related to strikes. The Union contends that, particularly because the retirees are not empowered to choose the individuals who would be responsible for representing their interests in this lawsuit, it cannot be an adequate representative. Second, the Union notes that, because it is \*846 primarily responsible for its active employees, their interests will trump the retirees' interests in the case of conflict.

The Union has a point. See generally *Allied Chem. & Alkali Workers of Am. v. Pittsburgh Plate Glass Co.*, 404 U.S. 157, 92 S.Ct. 383, 30 L.Ed.2d 341 (1971). After all, the Union is not the retirees' exclusive bargaining representative. See *id.* For this reason, the Seventh Circuit has held, in the context of a union's motion to compel arbitration of retirees' grievances, that a union cannot represent retirees without a showing that the retirees assent to such representation. *Rossetto v. Pabst*



*Brewing Co.*, 128 F.3d 538, 540 (7th Cir.1997); see also *United Steelworkers of Am. v. Cooper Tire & Rubber Co.*, 474 F.3d 271, 282–83 (6th Cir.2007) (same). The *Rossetto* court reasoned that, because retirees are not employees included in a “bargaining unit” under the National Labor Relations Act, the union is not their exclusive bargaining representative, and they may deal with their former employer on their own. 128 F.3d at 539–40. Because the union in that case had not shown that the retirees assented to its representation, the Seventh Circuit concluded that it lacked standing to seek arbitration of their grievances. *Id.* at 541.

Boeing insists that proof of the retirees' assent is unnecessary here because the Union already brought suit on behalf of the retirees (the *Wood* complaint), and, Boeing contends, there is no obligation to make such a showing in the context of a declaratory complaint. The court disagrees with both contentions. First, the fact that the Union has purported to represent the retirees says nothing about the retirees' assent. It's true that Retiree Chapter President Jerry Patrone, a Local 1069 official who served on the 1986 bargaining committee, testified that he would be comfortable with the Union representing the retirees' interests in this lawsuit, and Joseph Sinni, a Union representative, testified that the Union is “fully supportive” of the retirees' claims that they have lifetime benefits and would “stand behind” them. But even if the Union's stance in this case would be sympathetic to the retirees' own perspectives, the retirees cannot be bound to it without their consent. *Cf. Rossetto*, 128 F.3d at 540. Second, this court would have jurisdiction over the presumed suit by the Union on behalf of the retirees only if the retirees consent to its representation. Thus, the Union's standing is critical to establish the jurisdictional basis for Boeing's declaratory claims under ERISA. And Boeing, as the proponent of federal jurisdiction, bears the burden of proving this jurisdictional fact by a preponderance of the evidence. *Meridian Sec. Ins. Co. v. Sadowski*, 441 F.3d 536, 543 (7th Cir.2006).

The court concludes that Boeing has not shown, by a preponderance of the evidence, that the retirees would assent to the Union's representation in this matter. Indeed, Boeing has not presented *any* evidence of such assent. Accordingly, this court lacks jurisdiction over Boeing's declaratory action under ERISA against the Union. But the court notes that, even if its jurisdiction were secure over the claims, it would as a matter of discretion decline to entertain them. *See* 28 U.S.C. § 2201(a); *Newell*, 532 F.3d at 590 (“A district court has ‘wide discretion’ to decline to hear actions that pursue only declaratory relief.”). The retirees are represented here,

a class has been certified, and the Union's participation is largely unnecessary. Accordingly, the court dismisses Boeing's declaratory claims under ERISA against the Union.

### 3. Jurisdiction Under the LMRA

Boeing also asks the court to interpret the CBAs under the LMRA; it filed \*847 claims for declaratory relief against the class and the Union (both as an entity in itself and as a representative of the retirees in an associational capacity). The Union contests the court's jurisdiction over these claims on the ground that Boeing has not alleged a violation of any contract.

In the *Wood* complaint, the Union alleged that Boeing had violated the CBAs. Boeing now seeks a declaration that its actions have *not* been violations, and that if it were to make further changes it would *not* violate the CBAs. The Union argues that, because Boeing does not contend that there has been a violation, its complaint does not fall within the strict jurisdictional contours of the LMRA. Boeing responds that it does not need to allege that it violated the CBA to invoke the court's jurisdiction; it is enough that the Union has asserted as much, and has publicly declared that position by filing the *Wood* complaint.

The court concludes that its jurisdiction is secure. Section 301 of the LMRA states:

Suits for violation of contracts between an employer and a labor organization representing employees in an industry affecting commerce as defined in this chapter ... may be brought in any district court of the United States having jurisdiction of the parties, without respect to the amount in controversy or without regard to the citizenship of the parties.

29 U.S.C. § 185(a). Although the statute authorizes federal courts only to decide suits “for violation of contracts,” it would be absurd to require that Boeing plead that it is violating the CBA in order to proceed with its declaratory complaint. It is enough that the underlying controversy concerns whether there has been, or will be, a violation of the CBAs.

The nature of the controversy here distinguishes it from *Textron Lycoming Reciprocating Engine Div. v. UAW*, 523 U.S. 653, 657, 118 S.Ct. 1626, 140 L.Ed.2d 863 (1998), the case upon which the Union relies. There the union sought a declaration that its collective bargaining agreement with an employer was invalid. Specifically, the union alleged that the employer had fraudulently induced it to sign the agreement by concealing its plans to subcontract work to non-union workers. *Textron*, 523 U.S. at 655, 118 S.Ct. 1626. The union did not allege, however, that either it or the employer had ever violated the terms of their agreement. *Id.* For this reason, the Supreme Court concluded that the LMRA did not confer subject-matter jurisdiction over the union's claim. *Id.* at 661–62, 118 S.Ct. 1626. The Court explicitly stated, however, that “a declaratory judgment plaintiff accused of violating a collective-bargaining agreement may ask a court to declare the agreement invalid” under the LMRA. *Id.* at 658, 118 S.Ct. 1626. The problem in that case was that *no one* contended that there had been a violation.

The Seventh Circuit has ruled that *Textron* did not foreclose jurisdiction in a similar case, *J.W. Peters, Inc. v. Bridge, Structural & Reinforcing Iron Workers*, 398 F.3d 967 (7th Cir.2005). There the employer was accused of violating the terms of a collective bargaining agreement by attempting to terminate the collective bargaining relationship without providing proper notice, and it sought declaratory relief from this alleged violation. Although the employer did not allege that it had violated the agreement, the Seventh Circuit described the suit as “for violation of contracts” within the meaning of § 301. *Id.* at 973. And more recently in *Newell*, the Seventh Circuit concluded that an employer's suit for a declaration that amendments to retirees' health benefits did not \*848 violate the CBA fell within the “jurisdictional contours” of LMRA § 301. *Newell*, 532 F.3d at 590. The court explained that the suit “involves the alleged violation of the collective-bargaining agreement and therefore falls within the plain terms of LMRA § 301.” *Id.* The Union has not explained why these cases do not control the outcome here, and the court sees no reason why they would not.

There is, however, a lingering standing issue for Boeing's claim against the Union under the LMRA and the Declaratory Judgment Act. Boeing has sued the Union both as a representative of—or “in behalf of”—the retirees, and the Union again challenges whether it may be sued in this capacity. It notes that LMRA § 301(b) provides that a “labor organization may sue or be sued ... in behalf of *the employees whom it represents* in the courts of the United States,” 29

U.S.C. § 185(b) (emphasis added), but retirees, the Union contends, are not “employees whom it represents.” The Union also notes, again, that the retirees have not assented to its representation.

For the same reasons the court concluded that it lacked jurisdiction over Boeing's ERISA claims against the Union as a representative of the retirees, the court agrees. And, in the alternative, the court declines to exercise jurisdiction because the class can adequately represent the retirees' interests with respect to the LMRA claims in this suit. This does not, however, dispose of all of Boeing's LMRA claims against the Union. Unlike ERISA, the LMRA explicitly provides that a union may sue or be sued “as an entity.” 29 U.S.C. § 185(b). And it is “axiomatic” that a party who negotiated a contract on behalf of a third party has standing to sue to enforce that contract. *See Rossetto*, 128 F.3d at 539; *Frontier Communications of New York, Inc. v. Int'l Brotherhood of Electrical Workers*, No. 07 Civ. 10327, 2008 WL 1991096, at \*2–\*4 & n. 3, 2008 U.S. Dist. LEXIS 37213, at \*8–\*12 & n. 3 (S.D.N.Y. May 6, 2008) (collecting cases). Accordingly, the court concludes that its jurisdiction is secure for Boeing's declaratory-judgment claim under the LMRA against the Union as an entity itself.

With these jurisdictional knots untied, the court moves on to examine the merits of the class's complaint, Boeing's declaratory complaint against the class, and Boeing's claim for declaratory relief under the LMRA against the Union.

## II. FACTS<sup>1</sup>

### A. Retiree Health Coverage under the Current CBA

Between 1956 and 2005, the Union participated in collective bargaining on behalf of hourly employees at the Ridley plant and the Wilmington Airport facility, negotiating a series of successive collective bargaining agreements (“CBAs”) on their behalf. Since the 1971–74 CBA, every CBA through the current CBA has provided health insurance benefits to retirees in Article XVI.

#### 1. The Current CBA

The Union and Boeing entered into the most recent CBA (“current CBA”) on March 18, 2006. Article XVI, Section 5 of the current CBA says, “the Company will provide medical coverage for the duration \*849 of this agreement for retirees,



their spouses, same-gender domestic partner, and eligible dependents ....”

For active employees and employees who retire during the term of the agreement (“future retirees”), the current CBA makes changes from the previous CBA to medical plan options, deductibles, copayments and benefit payment levels. The current CBA does not apply these changes to current retirees.

The current CBA also includes a change in Article XVI, Section 1, entitled “Eligibility and Effective Date of Coverage,” which says:

The provisions of Article XVI of this Agreement shall be amended as described below for employees in active service ... on the dates of the amendments .... The provisions of the Group Medical Plans *as they apply to current employees or to employees who retiree [sic] during the term of this Agreement* not specifically modified below will remain in full force and effect.

(emphasis added). In the previous CBA, the last sentence of Section 1 did not limit its application to active employees and future retirees; it said, simply, “[t]he provisions of the Group Benefit Plans not specifically modified below will remain in full force and effect.” The parties dispute whether they changed the language because there was no need to say that current retirees’ benefits would remain in full force and effect because no modifications were made to those benefits (the class’s view), or to reflect that current retirees’ benefits could in fact be changed during the course of the agreement (Boeing’s view).

## 2. Negotiation History for the Current CBA

During the negotiations for the current CBA, neither Boeing nor the Union proposed any changes to health benefits for current retirees, including changes to the medical plans, prescription-drug programs, deductibles, or prescription-drug copayments. Boeing did, however, propose language limiting the provision of medical coverage (a paragraph in Article XVI, Section 6) only to future retirees. The corresponding

paragraph in the 2002–05 CBA applied such medical coverage to then-current retirees. Boeing also proposed language that would limit this provision of coverage to “employees on the active payroll, on layoff, or on a leave of absence on December 31, 1992,” rather than “eligible retirees who commenced receiving retirement benefits prior to January 1, 1993, as well as employees on the active payroll, on layoff, or on leave of absence on December 31, 1992,” as it stated in the previous CBA.

Bruce Hanson, a Boeing senior manager of union pay and benefits, who participated in the negotiations for the current CBA, testified that the reason for Boeing’s proposal was “to be specific that our negotiations were for employees who retired during the term of the collective bargaining agreement and the medical benefits available to them upon retirement during the term of the agreement.”

By letter dated November 22, 2005, Boeing responded, as relevant here, to the Union’s inquiry about these proposed changes as follows: “As we explained on October 17, 2005, we are negotiating benefits for only those employees who will retire under the terms of this agreement. The language deleted refers to employees [retired] prior to the effective date of this agreement. Any changes to benefits for current retirees are not a subject of these negotiations.” Boeing reiterated this response in a letter to the Union dated February 17, 2006.

By letter dated February 13, 2006, the Union stated the following regarding medical **\*850** benefits for current retirees: “Please not[e] that the Union continues to propose no changes to current retirees as proposed on 7/15/05, however, we do have open proposals on future retirees and we continue to wait for answers and information concerning the Company’s proposals on future retirees.”

By letters dated February 27, 2006, and March 10, 2006, Boeing again proposed different language that would limit the promise of medical coverage in Article XVI, Section 6 to “eligible employees who retire after the ratification date and prior to the termination date of this Agreement during the term of this agreement,” and only “employees on the active payroll, on layoff, or on a leave of absence on December 31, 2006.”

The Union opposed Boeing’s proposals. In response, close to the end of the negotiation process, Boeing agreed to leave the language in the current CBA the same as it was written in the 2002–05 CBA, with the exception of the inclusion of the phrase “same-gender domestic partner.” Both

Thomas A. Easley, Boeing's Director of Labor Relations, who participated in the negotiations for the current CBA, and Joseph Sinni, who led the Union's negotiations, confirmed these facts.

On or about March 10, 2006, Boeing presented its best and final offer to the Union, which consisted of over one hundred pages. Easley's cover letter stated:

All Articles, Appendices, and Attachments of the 2002–2005 Agreement have been reviewed in detail by the Company and Union negotiators. *Except as agreed to by the negotiators or set forth in this offer letter, all Articles, Appendices, and Attachments of the 2002–2005 Agreement will remain unchanged.* This constitutes The Boeing Company's entire proposal and is contingent upon the explicit understanding that *only those provisions which have been agreed to by the parties during these negotiations will be considered as part of this Agreement. All others will be considered as “of the table.”*

(emphasis added).

During a “side bar” discussion, Easley told Sinni and Local 1069 President John DeFrancisco that Boeing “would be implementing and making changes to the existing, the current retirees,” meaning “those retirees that had retired prior to the expiration of the agreement.”

### 3. Details of Coverage

Historically, Boeing has issued insurance booklets, summary plan descriptions and benefit updates (also called “summaries of material modifications”) that describe the benefits provided under the retiree medical plan. The insurance booklets and SPDs, as amended by the summaries of material modifications, include separate provisions for deductibles, co-payments and coinsurance, and contributions. Until 1989, descriptions of the medical benefits provided to retirees were

included in the same booklet describing active employee benefits.

Two current SPDs, as later amended by the July 2006 Benefit Information Update for Retired Employees, describe the terms of the retiree medical plans effective July 1, 2000 for (a) individuals who retired before February 1, 1996, and (b) those who retired on or after February 1, 1996. The first is titled “Boeing Retiree Medical Plans Summary Plan Description, Retired Production and Maintenance Employees—UAW Local 1069/2000 Edition (Retired before February 1, 1996),” and the second is titled “Boeing Retiree Medical Plans Summary Plan Description, Retired Production and Maintenance Employees—UAW Local No. 1069/2000 Edition (Retired on or after \*851 February 1, 1996);” both SPDs will be referred to as “Retiree SPDs.” Both Retiree SPDs state that the Plan “is provided according to Article XVI of the collective bargaining agreement that became effective September 2, 1999” between Boeing and the Union.

Article XVI, Section 11 of the current CBA states, in relevant part: “The details of the ... Medical, Dental and Vision Care coverages are set out in the Health Care Plans and Disability, Life, and Accident Plans Summary Plan Descriptions ....” (The parties dispute whether this refers only to the SPDs for active employees; the court will assume for present purposes that it refers to all of the 2000 SPDs, including the Retiree SPDs.)

The Retiree SPDs contain a “General Plan Provisions” section that states, “Although [Boeing] fully intends to continue the plans, it reserves the right (subject to the provisions of any applicable collective bargaining agreement) to change, modify, amend, or terminate them at any time.” They also contain a “Termination of Coverage” section that states, “Coverage for an eligible retired employee, spouse, or surviving spouse is subject to the terms of the collective bargaining agreement between the Company and the collective bargaining representative ... and any Company rights to amend or terminate the plan.”

The 2000 SPD for pre-February 1, 1996 retirees (and their eligible dependents) provides medical benefits for both non-Medicare eligible and Medicare-eligible participants under the “Traditional Medical Plan.” This includes the following deductibles, copayments and benefit payment levels:

- Annual Deductible: per person—\$75; families of three or more—\$225.

- Emergency Room Copayment: \$25.
- Prescription Drug Copayments: pharmacy—\$2 generic and \$5 brand-name; mail service program—\$0 generic and \$5 brand-name.
- Covered services of network providers generally paid in full; covered services of nonnetwork providers paid at 70 percent of usual and customary charges in location where there are network providers, and at 100 percent of usual and customary charges where there are no network providers of any type.
- Mental Health Treatment: Covered inpatient, partial hospital or intensive outpatient services obtained from provider referred by Boeing Helpline paid in full.
- Substance Abuse Treatment: Covered inpatient, partial hospital, residential, intensive outpatient, or outpatient services obtained from provider referred by Boeing Helpline paid in full.

The 2000 SPD for post-February 1, 1996 (and their eligible dependents) provides for non-Medicare eligible participants the option of either the Traditional Medical Plan or a coordinated care plan. The latter option, which is like an HMO, covers services provided by network and nonnetwork providers. For Medicare-eligible participants, the SPD provides the option of the Traditional Medical Plan or a Medicare+Choice HMO. The Traditional Medical Plan for these retirees includes the same prescription-drug copayments, mental-health treatment coverage, and substance-abuse treatment coverage as for pre-February 1, 1993 retirees, with the following deductibles, copayments and benefit payment levels:

- Annual Deductible: per person—\$125; families of three or more—\$375.
- Emergency Room Copayment: \$50.
- Covered services of network providers generally paid in full; covered services of nonnetwork providers paid at 60 percent of usual and customary charges in location where there are network providers, \*852 and at 100 percent of usual and customary charges where there are no network providers of any type.

#### **B. Boeing's Unilateral Changes to Retiree Health Benefits, 2006–2009**

In July 2006, Boeing notified the retirees that it was modifying their health insurance benefits on September 1, 2006. The changes were described in a summary of material modifications titled “Benefit Information Update, Summary of Benefit Plan Changes and Clarifications, Retired Employees Formerly Represented by UAW 1069.” Annual deductibles for all retirees enrolled in the Traditional Medical Plan or the Medicare Traditional Indemnity Plan increased to \$300 per individual and \$600 or \$900 per family. Other changes included: different provider options, including Aetna HMO, Aetna Medicare Advantage HMO, Keystone 10 HMO, Keystone Medicare Advantage HMO, and Regence Medicare Traditional Indemnity Plan; the office-visit copayment increased to \$15; out-of-pocket maximums increased to \$2000 per individual and \$4000 per family; the emergency-room deductible increased to \$50; and the co-insurance provisions changed, requiring retirees to pay at least 5% of their medical costs. Additionally, under all four HMOs, nonnetwork services and supplies are not covered except for emergency care, which is a change from the coordinated care plans they replaced. The Aetna HMO and the Keystone 10 HMO have higher office visit copayments than the coordinated care plans, which covered, with some limitations, office visits and most covered services from nonnetwork providers. Finally, the 2006 Benefits Update provides medical benefits for same-gender domestic partners of current retirees, and specifies that “effective September 1, 2006, Company contributions for the Medicare Part B premium reimbursement will be frozen at \$88.50 per month for eligible retirees and dependents.”

The changes to medical plan options, deductibles, copayments and benefit-payment levels set forth in the July 2006 Benefits Update generally track those set forth in the current CBA for active employees and future retirees. And, in a notice to participants, the Retiree Health Plan stated in relevant part:

As a result of a new collective bargaining agreement, you can enroll in a new retiree medical plan or make certain dependent changes ...

**Traditional Medical Plan benefits and monthly contributions will change on September 1, 2006.** These changes are the result of a new collective bargaining agreement .... Also, note that for Medicare-eligible retirees, the Traditional Medical Plan will change its name to the Medicare Traditional Indemnity Plan.

**Aetna and Keystone plan changes-if you're not eligible for Medicare.** For retirees not eligible for Medicare, the Aetna and Keystone coordinated care plans will become HMO plans beginning September 1, 2006....

**Aetna and Keystone plan changes-if you are eligible for Medicare.** The Aetna and Keystone Medicare Supplement HMO plans won't be available after August 31, 2006. This change applies to a small number of retirees who were previously notified by mail. After August 31, the only plan available in the area in which you live will be the Medicare Traditional Indemnity Plan.

**Same-gender domestic partners are eligible for coverage.**

(emphasis in original).

### **C. Boeing's Unilateral Changes to Retiree Benefits, 1987–2002**

The recent changes are not the only unilateral changes that Boeing has made \*853 to retirees' health benefits. In the past, the changes generally tracked whatever amendments the parties negotiated for active employees' medical benefits.

#### *1. 1987 Changes*

From 1971 through 1986, the CBAs provided that retiree health insurance would be provided at Boeing's expense. During this period, the Plan generally did not require retirees to pay annual deductibles or a percentage of their incurred covered expenses (“coinsurance”), and there were no changes to the retirees' benefits.

During negotiations for the 1986 CBA, Boeing and the UAW agreed on a revised medical plan for active employees that introduced a preferred provider organization (“PPO”) that required, for the first time, annual deductibles (\$75 per individual and \$225 per family) and coinsurance provisions. The parties also amended the language in Article XVI to provide that active employees would be provided benefits at no cost only until December 31, 1986.

Effective January 1, 1987, Boeing applied those same changes to retirees. Additionally, the retirees were required to make a \$25 copayment for each visit to a hospital emergency room that did not result in an immediate inpatient admission, and the Plan only paid a percentage of the charges for certain covered services and expenses (the coinsurance provisions).

And in 1989, after soliciting the Union's comments, Boeing issued a new benefit booklet for retired production and maintenance employees, which described the new deductible, co-payment and coinsurance provisions. Prior to the issuance of this booklet for retirees, descriptions of their medical benefits were included in the same booklet describing active employee benefits.

Retiree Chapter President Jerry Patrone, a Local 1069 official who served on the 1986 bargaining committee, testified that retirees had expressed that they were unhappy about the changes. He testified that retirees complained to him about the imposition of deductibles, which they believed broke a promise by Boeing. Meanwhile, Local 1069 President DeFrancisco, who testified in his [Federal Rule of Civil Procedure 30\(b\)\(6\)](#) capacity on behalf of Local 1069, stated that the imposition of a \$75 deductible per individual and \$225 deductible per family in 1987 to then-existing retirees was a breach of the Company's commitment to those retirees. And in a letter dated March 10, 1987, the UAW informed Boeing that there might be litigation over a proposed CBA because of a dispute over the terms and conditions of the medical plan. But neither the UAW nor the retirees filed a lawsuit contesting the 1987 changes to retiree health benefits.

#### *2. 1993–1994 Changes*

On January 1, 1993, pursuant to a new CBA, Boeing began requiring retirees and surviving spouses “to contribute \$100 a month for spouse medical coverage, if the spouse is eligible for coverage under another employer-sponsored plan as an active employee and waives such coverage.” (The UAW and Mayfield plaintiffs dispute whether spouses previously were required to pay this cost.) That same year, the out-of-pocket maximum for coinsurance provisions increased from \$500 per individual and \$1000 per family in 1989 to \$1000 per individual and \$2000 per family. Boeing also reduced the portion of the charges it would pay for health-care services from providers who were in the preferred network service area but who were not members of the network, from 80% to 70%. Finally, Boeing required retirees to pay copayments of \$2 for generic drugs and \$5 for brand-name drugs, with no copayments for mail-order generic drugs and \$5 copayments \*854 for mail-order, brand-name drugs. Neither the Union nor the retirees sued over these changes.

In August 1994, Boeing issued a revised Retiree Medical Plan booklet describing the Plan's features as of January 1, 1993. The foreword to the 1993 Retiree Medical Plan booklet states that “Although the Company fully intends to continue



the Plan, it reserves the right to change, modify, amend or terminate it at any time.” And the “Plan Continuation” section of the 1993 Retiree Medical Plan booklet states, “The Company intends to continue this Retiree Medical Plan indefinitely, but reserves the right to change, amend, modify or terminate the Plan at any time.”

### 3. 1996 Changes

According to minutes from a meeting during the 1996 negotiations, Boeing's Director of Labor Relations, Al Mansi, expressed the position that, even if he put in writing a statement that current retirees' benefits would not change, his “hands will not be tied. We will treat [current retirees] just as we are doing now. We believe we can make unilateral rights [sic]. We can do that in the future. We will not give you something that says we won't make changes.” Subsequently, Boeing required individuals retiring on or after February 1, 1996 who were participating in the Traditional Medical Plan to pay annual deductibles of \$125 for individuals and \$375 for families.

### 4. 2002–2005 CBA

Boeing did not make unilateral changes during the term of the 2002–05 CBA. During negotiations for that CBA, Boeing told the Union that “there [would be] no change to existing medical benefits for current or future retirees for the life of this Agreement. Benefits, co-pays, etc. will remain the same as those in place during the term of the 1999 Collective Bargaining Agreement.” The letter with that assurance was penned by Virginia J. Sauve, Director of Labor Relations for Boeing, and it was not included in the Articles, Appendices or Attachments of the 2002–05 CBA. Boeing did not make this assurance during negotiations for the current CBA.

### D. Vesting of Benefits

Article XVI, Section 3 of the 1971–74 CBA was the first CBA to provide benefits to retirees. In contrast to the same section's language providing coverage for active employees “for the duration of this Agreement,” the promise of coverage for retirees contains no durational limit:

Effective December 1, 1968 a semi-private plan will be furnished by the Company at no cost to the employee for coverage of himself and his dependents for the duration of this

Agreement. *The Company will provide Hospital–Medical–Surgical benefits for retirees, their spouses and eligible dependents, surviving spouses and eligible dependents .... This will be a full service plan under Blue Cross and Blue Shield on a prevailing fee basis. Where coverage can be integrated with Medicare–Part B, it will be so integrated and the Company will continue the payment of the Medicare Part B premium.*

(emphasis added). Similarly, Article XVI of the CBAs effective February 13, 1975, December 19, 1977, October 17, 1980, and October 31, 1983, explicitly states that medical benefits for active employees and their dependents will be furnished “for the duration of this Agreement,” but there is no similar limitation for retirees and their dependents. Article XVI of the CBA effective Sept. 2, 1999 was the first to state that the Company will provide medical coverage “for the duration of this agreement” for retirees and their dependents, \*855 and each CBA since then has included this language.

Each CBA also contains an article stating that the entire agreement remains in effect only up to a specific point in time. The cover page of the current CBA and Article XXIII state that it lasts from September 2, 2005 “until midnight at the close of October 1, 2009, and thereafter for yearly periods unless notice is given in writing ... of [the Company or the Union's] desire to modify, amend or terminate the Agreement.” The UAW has admitted that this clause applies to each provision in the CBA. And it has in the past provided notice of its intent to terminate the then-current CBAs—in 1971, 1995, 2002, and 2005. The Union also has provided notice of its intent to modify the Retirement Plan Agreement in 1971, 1995, and 2002; to modify the Supplemental Unemployment Plan in 1971; and to modify the Layoff Benefit and Security Program Agreement in 1995.

James Donahue was a UAW International Representative for Local 1069 between 1984 and 2002. He testified that, in sending notice to Boeing of the Union's intent to terminate a then-current CBA, he would do so “with the intentions of renegotiating a total collective bargaining agreement”—a completely new agreement. He further explained that his intention was to terminate the CBA “as it related to the active employees in those areas which were noted.” According to

Donahue, the Union would not terminate the Retirement Plan Agreement and the Layoff Benefit and Security Program Agreement because the Union “[is] not in the business of terminating pensions” and it did “not want to terminate [the layoff security benefit] program.”

Former Local 1069 President Forte and Local 1069 President and Local 1069 [Rule 30\(b\)\(6\)](#) designee DeFrancisco testified that the Union distributes “highlight memoranda” to tout significant achievements that were made during negotiations, and to explain the nature and extent of members' benefits. The Union has never signaled to its members by way of “highlight memoranda” that it has secured vested, lifetime health benefits for retirees.

Both Donahue and DeFrancisco admitted that there is no language clearly stating Boeing's commitment to provide vested lifetime health insurance benefits in the CBAs. Patrone and DeFrancisco testified, moreover, that they were not aware of any Union benefit proposal seeking, in writing, Boeing's promise to provide vested, lifetime retiree insurance benefits. The UAW notes, however, that Donahue, the UAW International Representative who negotiated the 1986, 1989, 1992, 1996, 1999 and 2002 CBAs, testified that, although he never submitted a written proposal for vested benefits, the UAW negotiated for lifetime health benefits in discussions throughout the bargaining history. Donahue admitted, however, that if he could draft the agreements without anyone disagreeing with his choice of words, he would use language stating that eligible retirees have vested benefits for the duration of their lives that cannot be changed. He said he did not negotiate for such language with employers because “[if] there was an understanding and it had always been adhered to and the obligation met, there was no need; or, because a company would not want to include something along those lines within the framework of the collective bargaining agreement because it would precipitate problems with the other labor unions they dealt with.”

Sinni, the UAW [30\(b\)\(6\)](#) designee, negotiated the 2005 CBA. He could not point to any language in the CBAs establishing that medical benefits for retirees are vested \*856 for life. And he testified that, “when the circumstances are right,” it would be ideal to spell out in writing whether health insurance benefits were vested and could not be changed. But he stated that, throughout the years, Boeing and the Union “infer[red] or impl[ied]” that the benefits were for life, during negotiations. Sinni testified that this implicit understanding was passed down by “word of mouth”

within the Union, and from company representatives. And, according to Sinni, any negative changes to retiree benefits—including instituting annual deductibles and increasing prescription-drug copayments—“[w]ould be a violation of the promise made to that retiree, which we say is a lifetime vested benefit.” According to Sinni, Easley and Hanson (of Boeing) had agreed with him that the benefits were vested, although they disagreed about whether they could make changes.

### III. LEGAL STANDARD ON SUMMARY JUDGMENT

A party seeking summary judgment has the burden of showing, through “pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any,” that there are no genuine issues of material fact that would prevent judgment as a matter of law. [Fed.R.Civ.P. 56\(c\)](#). On a motion for summary judgment, courts “must construe all facts in the light most favorable to the non-moving party and draw all reasonable and justifiable inferences in favor of that party.” [Allen v. Cedar Real Estate Group, LLP](#), 236 F.3d 374, 380 (7th Cir.2001).

The nonmoving party, in turn, may not rest on the allegations in its pleadings or conclusory statements in affidavits; it must support its contentions with evidence that would be admissible at trial. [Celotex Corp. v. Catrett](#), 477 U.S. 317, 322–23, 106 S.Ct. 2548, 91 L.Ed.2d 265 (1986); see [Albiero v. City of Kankakee](#), 246 F.3d 927, 932 (7th Cir.2001); [Fed.R.Civ.P. 56\(c\)](#). To avoid summary judgment, the nonmovant must do more than raise a “metaphysical doubt” as to the material facts. See [Wolf v. Northwest Ind. Symphony Soc'y](#), 250 F.3d 1136, 1141 (7th Cir.2001) (citation and quotation omitted). And “a complete failure of proof concerning an essential element of the nonmoving party's case necessarily renders all other facts immaterial.” [Celotex](#), 477 U.S. at 323, 106 S.Ct. 2548.

### IV. ANALYSIS

The heart of the parties' dispute is whether Boeing may make unilateral changes to the class's health benefits. The court first will consider whether such changes are prohibited under the current CBA. Because the court concludes that the current CBA does not restrict Boeing's right to make changes, like those here, that simply bring the retirees' benefits in line with those of active employees, the court also will consider



whether the changes are prohibited because the retirees' benefits are vested at a particular level.

#### **A. Legitimacy of Boeing's Unilateral Changes to Retirees' Health Benefits Under the Current CBA**

The Seventh Circuit has held that retiree health benefits, unlike pensions, do not vest as a matter of law. See *Bland v. Fiatallis N. Am.*, 401 F.3d 779, 783 (7th Cir.2005). Thus, absent agreement to the contrary, employers generally are free to modify or terminate retiree welfare plans. See *Curtiss-Wright Corp. v. Schoonejongen*, 514 U.S. 73, 78, 115 S.Ct. 1223, 131 L.Ed.2d 94 (1995); *Cherry v. Auburn Gear*, 441 F.3d 476, 481 (7th Cir.2006); *Bland*, 401 F.3d at 783. To determine whether a contrary agreement was reached in the current CBA, the \*857 court reads the document as a whole, "so that all its parts will be given effect." *Murphy v. Keystone Steel & Wire Co.*, 61 F.3d 560, 565 (7th Cir.1995). And it interprets the current CBA "in light of the concrete circumstances in which it was written." *Id.* A contract is ambiguous only if it is susceptible to more than one reasonable interpretation. *Id.* "The reasonableness of a proposed interpretation of contractual language requires consideration of the contract as a whole, including terms incorporated by reference." *Chicago Dist. Council of Carpenters Pension Fund v. K & I Construction, Inc.*, 270 F.3d 1060, 1069 (7th Cir.2001).

According to the class, two sections of the current CBA operate together to bar Boeing's unilateral changes. First, Article XVI, Section 5 ("Medical Benefits"), which provides in relevant part:

Medical benefit costs for eligible retirees and dependents will be paid as follows:

1. For eligible retirees who commenced receiving retirement benefits prior to January 1, 1993, as well as employees on the active payroll, on layoff, or on leave of absence on December 31, 1992, the Company will provide medical coverage for the duration of this agreement for retirees, their spouses, same-gender domestic partner, and eligible dependents, surviving spouses and eligible dependents of the following categories, except as described in Paragraph 5 below:

- a. Of a pensioner who receives Company pension.
- b. Of an active employee who died while eligible to retire.

Where coverage can be integrated with Medicare—Part B for retirees, it will be so integrated. The Company will freeze the payment of Medicare—Part B premium of \$88.50.

...

4. Company contributions will be made only if such retiree authorizes deduction of the required contributions balance of such costs, if any, from the monthly retirement benefit payment or makes timely monthly payments of the required contributions.

5. The retired employee is required to contribute \$100 a month to enroll a dependent spouse or same-gender domestic partner for Retiree Medical coverage if the spouse or same-gender domestic partner is eligible for coverage under another employer sponsored plan as an active employee and waives such coverage. In no case will the retired employee be required to contribute more than the greater of the amount required in Paragraph b. above, or this paragraph, to enroll such spouse or same-gender domestic partner.

Second, Article XVI, Section 11 ("Miscellaneous") of the CBA, which provides in relevant part:

- a. The details of the Group Life, Accidental Death and Dismemberment, Short-Term Disability, Survivor Income Benefit, Medical, Dental and Vision Care coverages are set out in the Health Care Plans and Disability, Life, and Accident Plans Summary Plan Descriptions which will be available to all participants.

The class contends that, through the latter section, the current CBA incorporates by reference the Retiree SPDs. And, by incorporating the SPDs, argues the class, the parties intended to fix the benefit levels in those SPDs for the duration of the agreement.

Boeing, for its part, does not dispute that under the current CBA it must provide medical coverage to retirees for the duration of the agreement. But Boeing contends that the CBA

does not evidence \*858 any agreement about the retirees' cost-sharing obligations, let alone an agreement that benefits must remain fixed at the levels provided in the 2000 SPDs.

### *1. Boeing's Ability to Make Changes, Absent Incorporation of the Retiree SPDs*

Before addressing the class's incorporation argument, the court considers whether there is any other language in the current CBA restricting Boeing's right to change the retirees' benefits. Section 5 provides that the retirees will receive "medical coverage" for the duration of the agreement. And in that section the parties also agreed about enrollment costs for current retirees' spouses and domestic partners, as well as Boeing's share of the Medicare Part B premium—features of coverage that would persist until the CBA expires. But there is otherwise no agreement about the *type* of coverage to which the retirees are entitled for the duration of the CBA—nothing about, for example, plan options, deductibles, coinsurance, and copayments. And there is no language providing that retirees would receive coverage under the terms of a particular plan.

Meanwhile, whereas in the 2002 CBA the parties had agreed in Article XVI, Section 1 that "the Group Medical Plans not specifically modified below will remain in full force and effect," in the current CBA the same clause says, "The provisions of the Group Medical Plans *as they apply to current employees or to employees who retiree* [sic] *during the term of this Agreement* not specifically modified below will remain in full force and effect." Applying the principle of *expressio unius est exclusio alterius*, this strongly implies that in the current CBA the parties did *not* intend to limit Boeing's ability to modify current retirees' benefits. But it need not prove that much: it is enough that the current CBA does not include an agreement that the retirees' plans would "remain in full force and effect," given the presumption that retiree benefits do not vest. Accordingly, absent incorporation of the Retiree SPDs, there is no language in the current CBA restricting Boeing's right to change current retiree benefits.

### *2. Incorporation of the Retiree SPDs*

The class argues that the parties incorporated by reference the Retiree SPDs in Article XVI, section 11 by providing that the "details of the Group ... Medical ... coverages are set out in the Health Care Plans ... Summary Plan Descriptions." Boeing responds that section 11 does not even *refer* to the Retiree SPDs, let alone incorporate them.

The court concludes that both parties' interpretation of section 11 are reasonable. As both parties acknowledge, section 11 clearly refers to one or more of the health and welfare SPDs from 2000. But the words it uses—"the Health Care Plans ... Summary Plan Descriptions"—does not identify by name any of the possible SPDs to which it could refer. The active employees' health-care SPD is titled "Health and Welfare Plans SPD," and the retirees' health-care SPDs each are titled "Retiree Medical Plan SPD," with different subtitles. Thus, because "Health Care Plans" could be read as an umbrella term for all of the available healthcare plans, including those for the retirees, one could reasonably interpret section 11 to refer, at least in part, to the Retiree SPDs. At the same time, because section 11 does not explicitly reference the Retiree SPDs by name, Boeing's interpretation also is reasonable.

Assuming, for present purposes, that the parties intended the clause to refer to the Retiree SPDs, it is also both reasonable to infer an intent to incorporate the terms of the Retiree SPDs and reasonable not to \*859 infer such intent. The CBA says that the "details" of "coverages" are "set out" in the SPDs. Given the earlier promise of "coverage"—with its scope undefined—one could reasonably infer from this language an intent that the "details" in the SPDs provide such definition. At the same time, the parties did not use explicit language of incorporation—they did not say, for example, that those SPDs are "hereby made part of this agreement." This is in contrast to other, explicit language of incorporation in the current CBA: Article VI, Section 3, for example, states that "[a] list of all job classifications, job family groupings, and proper labor grades as existing on the effective date of this Agreement are outlined in the appendices and are made a part of this Agreement." In short, section 11 is ambiguous.

The problem for the class is that, even assuming that the current CBA incorporates the Retiree SPDs, it does not reflect an agreement that the benefits remain fixed at the levels provided in those documents. First, even if the benefits outlined in the Retiree SPDs could define the scope of the retirees' "coverage," it doesn't naturally follow that those benefits must be provided for the duration of the CBA. Section 5 assures the *fact* of coverage for the duration of the agreement; it does not provide that the *details* of coverage are fixed for that term. Meanwhile, section 11 says that the details of coverage are in the SPDs, but it is silent about whether those details are fixed for the duration of the agreement. This is in contrast to the contract in *Pabst Brewing Co. v. Corrao*, 161 F.3d 434 (7th Cir.1998), where the duration clause applied both to the fact of coverage and to the "details"

of the plan: “For the term of this Agreement, the Employer, at its sole cost and expense, shall provide major medical, health, dental, sickness and accident, and life insurance benefits in accordance with and as summarized in Appendix A attached.” *Id.* at 435–36. The Seventh Circuit ruled that the effect of this was to read along with each detail in “Appendix A” the phrase “for the duration of the CBA.” Here, it would stretch the bounds of the parties’ expressed intent to apply Section 5’s durational term to each provision of a document incorporated in Section 11.

More importantly, the Retiree SPDs both contain reservation of rights clauses, which provide that, “[a]lthough The Boeing Company (“the Company”) fully intends to continue this plan, it reserves the right (subject to the provisions of any applicable collective bargaining agreement) to change, modify, amend, or terminate it at any time.” They also contain a clause that says, “coverage for an eligible retired employee, spouse, or surviving spouse is subject to the terms of the [CBA] between the Company and collective bargaining representative ... and any Company rights to amend or terminate the plan.” Thus, if the Retiree SPDs are incorporated into the current CBA, then Boeing’s reservation of its right to modify the plan is incorporated, too. *See UAW v. Rockford Powertrain, Inc.*, 350 F.3d 698, 704–05 (7th Cir.2003) (“The CBA’s incorporation of the Insurance Agreement necessarily incorporated the reservation of rights clause found in the plan description.”) Because this fully incorporated agreement would then have to be read to effectuate each of its terms, *see Murphy*, 61 F.3d at 565, it would say this: “Boeing shall provide medical coverage to current retirees, their spouses, same-gender domestic partners, and dependents for the duration of the agreement, but it reserves the right to change, modify, amend, or terminate the Retiree plans at any time.” Thus, Boeing may make changes without violating the current CBA, even if the Retiree SPDs are incorporated. Indeed, Boeing could terminate \*860 the current Retiree plans, as long as it continued to provide medical coverage for the retirees—access to the active employees’ plan, for example, could suffice.

### 3. Nullification of the Promise of Coverage

Having concluded that Boeing may make changes to the retirees’ benefits under the terms of the current CBA, a question remains: To what extent could Boeing make changes before breaching its obligation to provide coverage for the duration of the agreement? The class’s concern is that, through unilateral reductions *ad infinitum* of the retirees’ benefits,

Boeing could effectively “cover” nothing—an understanding of Boeing’s power that the parties clearly did not reach. So what is the baseline?

The class contends that the absence of negotiations about changes to retiree benefits, combined with the promise of coverage (despite Boeing’s initial efforts to exclude retirees entirely from the current CBA) show that the parties intended the scope of coverage to remain the same—i.e., at the level provided in the Retiree SPDs—and that this would least upset the parties’ expectations. But the absence of negotiated changes is not the same as a relinquishment of Boeing’s right to change the retirees’ benefits. As explained *supra*, the default rule is that Boeing may make changes to retiree benefits at any time. *See Curtiss–Wright*, 514 U.S. at 78, 115 S.Ct. 1223; *Cherry*, 441 F.3d at 481; *Bland*, 401 F.3d at 783. In the current CBA, the parties restricted this right only to the extent that Boeing must provide “coverage”; but there is no evidence that they understood “coverage” to mean, exclusively, “the benefit levels in the Retiree SPDs.”

Meanwhile, the court does not agree with Boeing’s contention that a promise of coverage reflects *no* agreement about cost-sharing. Boeing relies on Judge Easterbrook’s dissent in *Bidlack v. Wheelabrator Corp.*, 993 F.2d 603 (7th Cir.1993) (en banc), but his point—that there is a difference between a promise of coverage and a promise of free medical care—is non-responsive here. *See id.* at 615 (Easterbrook, J., dissenting). The retirees do not contend that Boeing must provide *free* medical care; they recognize their own cost-sharing obligations. The extent, not the existence, of those obligations is at issue.

*Senn v. United Dom. Indus.*, 951 F.2d 806 (7th Cir.1992), the other case upon which Boeing relies, is more instructive. There the retirees were promised “coverage” under an applicable CBA. *Id.* at 810. They argued, however, that their former employer could not require them to pay the cost difference between an HMO plan and a conventional health insurance plan (a new cost-sharing arrangement introduced in the applicable CBA) because they had vested rights to benefits. The Seventh Circuit disagreed, explaining that because the retirees’ rights were not vested, they were not entitled to a specific type of coverage at a particular cost. *Id.* at 816. Therefore, the cost-sharing arrangement that the employer and union had negotiated could apply to the retirees without violating the promise of coverage.

Similarly although here the term “coverage” is not explicitly defined, the benefits provided to active employees would certainly qualify. First, in the current CBA the parties used the word to describe the medical benefits for active employees (“The current medical benefits coverage for eligible employees and dependents is continued subject to the following coverage revisions ...”). Since the parties understood *that* arrangement to be “coverage,” it follows that changes to retiree benefits \*861 that put them in line with those of active employees would not nullify the promise of “coverage.” Second, this understanding is consistent with the history of Boeing's unilateral changes, which reflects a trend: in 1987, 1993, and 1996, the company applied changes negotiated for active employees to current retirees. Although the retirees and the Union initially protested these changes, they never sued, and their later silence implies an acquiescence to Boeing's assertion of this right. Meanwhile, although Boeing did not make changes during the term of the 2002 CBA, that year Boeing had explicitly agreed that it would not change the retirees' benefits, and there was no similar agreement during negotiations for the current CBA—indeed, Boeing explicitly asserted its right to change retiree benefits. Accordingly, the September 2006 and July 2009 changes, because they simply extend features of the active employees' benefits to the retirees, are well within Boeing's rights, and they do not nullify the promise of coverage.

### B. Vesting of Benefits

The final issue is whether the retirees' health benefits were vested under the terms of another agreement, in which case they are “forever unalterable.” *Bland*, 401 F.3d at 784. If so, Boeing's unilateral changes in September 2006 and July 2009 would violate that agreement.

“ERISA does not require the vesting of welfare benefits,” so if the retirees' health benefits “vest at all, they do so under the terms of a particular contract.” *Pabst Brewing Co. v. Corrao*, 161 F.3d 434, 439 (7th Cir.1998); *Barnett v. Ameren Corp.*, 436 F.3d 830, 832 (7th Cir.2006); *UAW v. Rockford Powertrain*, 350 F.3d 698, 702 (7th Cir.2003). “[B]ecause employers are not legally required to vest benefits, the intention to vest must be found in clear and express language.” *Bland*, 401 F.3d at 784 (quotation marks omitted). The parties need not use the word “vest,” nor must they “state unequivocally” that the employer is creating rights that will not expire. *Id.* But without language suggesting that benefits are vested, “the presumption is that benefits terminate when a collective bargaining agreement ends.” *Cherry*, 441 F.3d at 481. “This presumption can be rebutted by extrinsic evidence

only if an ambiguity exists in the contractual language or if there is a yawning void that cries out for an implied term.” *Id.* (internal quotation marks, ellipses and citation omitted).

In *Rossetto*, the Seventh Circuit summarized the vesting rules as follows:

1. If a collective bargaining agreement is completely silent on the duration of health benefits, the entitlement to them expires with the agreement, as a matter of law ... unless the [retirees] can show by objective evidence that the agreement is latently ambiguous ....
2. If the agreement makes clear that the entitlement expires with the agreement, as by including such a phrase as ‘during the term of this agreement,’ then, once again, the [retirees lose] as a matter of law unless [they] can show a latent ambiguity by means of objective evidence ....
3. If there is language in the agreement to suggest a grant of lifetime benefits, and the suggestion is not negated by the agreement read as a whole, the [retirees] [are] entitled to a trial. Of course, if the agreement expressly grants such benefits, the [retirees] [are] entitled, not to a trial, but to judgment in his favor ....
4. If the [retirees are] entitled to a trial by reason of either a patent or a latent ambiguity, the normal rules of evidence will govern the trial, and \*862 so the parties will not be limited at trial to presenting objective evidence of meaning.

*Rossetto v. Pabst Brewing Co.*, 217 F.3d 539, 547 (7th Cir.2000).

Here, the class points to no language within the CBAs or plan documents providing for the vesting of retiree health benefits. Representatives of the union confirmed in their testimony, moreover, that they were aware of no such language. There also is no language that benefits would continue beyond the term of each CBA, let alone for the rest of the retirees' (or their survivors') lives. Meanwhile, in the Retiree SPDs, Boeing explicitly reserved its right to change, modify, or terminate the retirees' medical plan. And as far back as 1993, in the “Plan Continuation” section of the 1993 Retiree Medical Plan booklet, it states, “The Company intends to continue this Retiree Medical Plan indefinitely, but reserves the right to change, amend, modify or terminate the Plan at any time.”

Without any clear expression of an intent to vest the retirees' benefits, the class relies on what it argues is a



patent ambiguity in the 1971–1983 CBAs: these agreements include a durational limitation for active employees' medical coverage, but not for the retirees. Specifically, these CBAs say only that “the Company will provide [health] benefits to [current retirees] ....” And they argue that, as a result, there is a latent ambiguity in the CBAs beginning in 1999, which provide that medical coverage for both active employees and retirees would last for the duration of the agreement.

“When an ambiguity is apparent just from reading the contract without having to know anything about how it interacts with the world—then the contract has what is called a patent, or intrinsic, ambiguity, and evidence is admissible to cure it.” *Cherry*, 441 F.3d at 482 (quotation marks and internal citations omitted). A latent ambiguity, on the other hand, can arise in a contract that is “clear on its face” (to the uninformed reader), but is in fact susceptible to more than one interpretation when applied to a particular dispute. *Rossetto*, 217 F.3d at 542.

Here, the 1971–1983 CBAs are ambiguous regarding the duration of retiree benefits, but they cannot reasonably be interpreted to vest those benefits for life. Normally their silence would trigger a presumption that the benefits expire at the end of each agreement. But because these CBAs explicitly limit the duration of active employees' benefits to that term—but do not do so for the retirees' benefits—one could reasonably infer, under the principle of *expressio unius est exclusio alterius*, that the parties did not intend to limit the duration of the retirees' benefits to that term. This ambiguity, though, does not help the retirees. At most, the retirees could show from the ambiguous language that the parties intended the benefits to continue beyond each agreement; that is not the same as an intent to vest the benefits for life. The language is far weaker than any Seventh Circuit case that has found a promise of vested benefits: it does not state that the benefits are “vested,” “shall continue,” are provided “for life” or “until death,” and it does not suggest that they last beyond the retirees' death. See generally *Bland*, 401 F.3d at 785–86 (collecting examples of strong, ambiguous, and weak vesting language).

Because the parties never expressed a clear intent to vest retirees' benefits, the parties' later introduction of durational limits does not create a latent ambiguity. Rather, any ambiguity about the duration of benefits in the earlier CBAs was resolved in the 1999 CBA, which explicitly limited retiree medical coverage to the term of the CBA, regardless

of when the \*863 retirees had retired. See *Pabst Brewing Co. v. Corrao*, 161 F.3d 434, 441–42 (7th Cir.1998) (affirming dismissal of retiree's lifetime benefit claims and finding no ambiguity where the clause “for the term of the agreement” was added to the 1984 and subsequent CBAs, but was absent from prior agreements.) The parties' intent, moreover, has been reaffirmed in each successive CBA, which include this durational limitation.

The class's evidence of a contrary intent is extremely limited. There is only the testimony of union representatives that the parties had “an implicit understanding” that the benefits were vested. But their own subjective view is not enough to establish a latent ambiguity. See *Corrao*, 161 F.3d at 442. Proof that their interpretation is reasonable must come from objective facts, and “[e]vidence is not objective when it is the self-serving testimony of one party to the contract as to what the contract, clear on its face, ‘really’ means, contrary to what it seems to mean.” *Rossetto*, 217 F.3d at 546. In any event, the representatives' testimony as to their subjective belief is contradicted both by their agreement to apply durational limitations to the retirees' medical coverage and by their failure to challenge Boeing's unilateral changes in 1987, 1993, and 1996.

Accordingly, the court concludes that Boeing's September 2006 and July 2009 changes do not violate any agreement to provide vested benefits to retirees, as no such agreement was reached.<sup>2</sup>

## V. CONCLUSION

For these reasons, the UAW's motion for summary judgment is GRANTED in part: the court DISMISSES for lack of jurisdiction Boeing's ERISA and LMRA claims against the UAW on behalf of the retirees, and the court DENIES the motion as to Boeing's LMRA claims against the UAW as an entity; Boeing's motion for summary judgment against the class and the UAW is GRANTED with respect to those claims over which the court has exercised jurisdiction; and the class's motion for summary judgment is DENIED as moot. It is so ordered.

### All Citations


656 F.Supp.2d 837, 187 L.R.R.M. (BNA) 2028, 47 Employee Benefits Cas. 2258, 74 A.L.R.6th 697

## Footnotes

- 1 The facts presented here are undisputed, unless otherwise noted. Although each side has labeled some facts “disputed,” if the basis for the dispute is not supported by competent evidence, the court treats the fact as admitted. See N.D. III. L.R. 56.1(a), (b)(3)(C). Similarly, if a fact is unsupported by competent evidence, the court omits it. On its own motion, the court also omits facts that are not relevant to this decision.
- 2 Because the court concludes that the retirees are not entitled to vested, lifetime health benefits, it declines to consider Boeing's argument that pre-1993 retirees' claims for vested benefits are time-barred.



## **LEGAL AUTHORITY CA-59**

 KeyCite Yellow Flag - Negative Treatment  
Distinguished by [Gentle Wind Project v. Garvey](#), D.Me., January 3, 2006

378 F.3d 71

United States Court of Appeals,  
First Circuit.

UNITED STATES of America, Appellee,

v.

Vincent A. CIANCI, Jr., Frank E. Corrente, and  
Richard E. Autiello, Defendants, Appellants.

Nos. 02–2158, 02–2159, 02–  
2165, 02–2166, 02–2288.

|  
Heard Oct. 9, 2003.

|  
Decided Aug. 10, 2004.

#### Synopsis

**Background:** Defendants were convicted in the United States District Court for the District of Rhode Island, Ernest C. Torres, Chief Judge, of various offenses, including Racketeer Influenced and Corrupt Organizations Act (RICO) conspiracy, and government's forfeiture motion was granted, [218 F.Supp.2d 232](#). Defendants appealed.

**Holdings:** The Court of Appeals, [Stahl](#), Senior Circuit Judge, held that:

[1] indictment was sufficient to apprise defendants of nature and extent of the charges;

[2] municipal entities could be part of associated-in-fact enterprise charged under RICO;

[3] evidence was sufficient to support RICO conspiracy convictions;

[4] evidence of a connection between defendants' conduct and federal funds received by city police department was not required to support conviction under federal bribery statute;

[5] evidence was sufficient to support Hobbs Act attempted extortion and Hobbs Act extortion conspiracy convictions;

[6] taped statements of alleged coconspirator were admissible under coconspirator exception to the hearsay rule; and

[7] defendant's taped statements to undercover FBI agent was inadmissible under state of mind exception to hearsay rule.

Affirmed in part.

[Howard](#), Circuit Judge, filed opinion concurring in part and dissenting in part.

West Headnotes (43)

#### [1] [Racketeer Influenced and Corrupt Organizations](#) [Indictment and information](#)

Indictment charging defendants with conspiracy to operate Racketeer Influenced and Corrupt Organizations Act (RICO) enterprise whose purpose included enrichment of one of the defendants, as city's mayor, and to protect the power and assets of its members was sufficient to apprise defendants of nature and extent of the charges; indictment delineated members of the enterprise, roles of defendants in the enterprise, purposes and goals of the racket, and ways in which defendants used other members of the enterprise, specifically, municipal entities that they controlled as part of conspiracy, to further those purposes and goals. [18 U.S.C.A. § 1961\(4\)](#).

[2 Cases that cite this headnote](#)

#### [2] [Indictments and Charging Instruments](#) [Purpose of Accusation](#)

[Indictments and Charging Instruments](#)  [Informing defendant of nature of charge; notice](#)


[Indictments and Charging Instruments](#)  [Protection against subsequent prosecution](#)

[Indictments and Charging Instruments](#)  [Nature, Elements, and Incidents of Offenses in General](#)

Indictment is sufficient if it, first, contains the elements of the offense charged and fairly informs a defendant of the charge against which he must defend, and, second, enables him to

plead an acquittal or conviction in bar of future prosecutions for the same offense.

[7 Cases that cite this headnote](#)

- [3] **Indictments and Charging Instruments**  Necessity and sufficiency of using statutory language

It is generally sufficient that an indictment set forth the offense in the words of the statute itself, as long as those words of themselves fully, directly, and expressly, without any uncertainty or ambiguity, set forth all the elements necessary to constitute the offense intended to be punished.

[8 Cases that cite this headnote](#)

- [4] **Racketeer Influenced and Corrupt Organizations**  Informal entities; associations-in-fact

In cases involving an alleged associated-in-fact Racketeer Influenced and Corrupt Organizations Act (RICO) enterprise, the existence of the charged enterprise does not follow, ipso facto, from evidence that those named as the enterprise's associates engaged in crimes that collectively may be characterized as a pattern of racketeering activity. 18 U.S.C.A. § 1961 et seq.

[5 Cases that cite this headnote](#)

- [5] **Racketeer Influenced and Corrupt Organizations**  Informal entities; associations-in-fact

Criminal actors who jointly engage in criminal conduct that amounts to a pattern of “racketeering activity” do not automatically thereby constitute an association-in-fact Racketeer Influenced and Corrupt Organizations Act (RICO) enterprise simply by virtue of having engaged in the joint conduct; something more must be found, something that distinguishes RICO enterprises from ad hoc one-time criminal ventures. 18 U.S.C.A. § 1961 et seq.

[6 Cases that cite this headnote](#)

- [6] **Racketeer Influenced and Corrupt Organizations**  Governmental entities

Municipal entities could be part of associated-in-fact enterprise charged under Racketeer Influenced and Corrupt Organizations Act (RICO); city itself was not alleged to have formed an unlawful intent, and instead common purpose was imputed to the city by way of the individual defendants' control, influence, and manipulation of city for their illicit ends. 18 U.S.C.A. § 1961 et seq.

[3 Cases that cite this headnote](#)

- [7] **Racketeer Influenced and Corrupt Organizations**  Governmental entities

Municipal entities can be part of an unlawful purpose association-in-fact enterprise charged under Racketeer Influenced and Corrupt Organizations Act (RICO) so long as those who control the entities share the purposes of the enterprise. 18 U.S.C.A. § 1961 et seq.

[2 Cases that cite this headnote](#)

- [8] **Racketeer Influenced and Corrupt Organizations**  Informal entities; associations-in-fact

Racketeer Influenced and Corrupt Organizations Act (RICO) does not require intentional or purposeful behavior by corporations charged as members of an association-in-fact. 18 U.S.C.A. § 1961 et seq.

[1 Cases that cite this headnote](#)

- [9] **Racketeer Influenced and Corrupt Organizations**  Governmental entities

Racketeer Influenced and Corrupt Organizations Act (RICO) enterprise animated by an illicit common purpose can be comprised of an association-in-fact of municipal entities and human members when the latter exploits the former to carry out that purpose. 18 U.S.C.A. § 1961 et seq.

[6 Cases that cite this headnote](#)

**[10] Racketeer Influenced and Corrupt Organizations** 🔑 Governmental entities

Evidence in Racketeer Influenced and Corrupt Organizations Act (RICO) conspiracy trial was sufficient to establish that alleged schemes were carried out by alleged racketeering enterprise that included municipal entities as associates; evidence indicated that individual defendants, as city's mayor and chief of administration, exercised substantial control over the municipal entities named as members of the enterprise, and used their positions and influence to sell municipal favors on a continuing basis. 18 U.S.C.A. § 1961 et seq.

[1 Cases that cite this headnote](#)

**[11] Racketeer Influenced and Corrupt Organizations** 🔑 Continuity or relatedness; ongoing activity

Evidence was sufficient to establish pattern of racketeering activity in Racketeer Influenced and Corrupt Organizations Act (RICO) conspiracy prosecution in which municipal entities were named as associates in alleged racketeering enterprise; evidence indicated that there were nine schemes that lasted over nine years, and defendants, including city's mayor, were the beneficiaries of most if not all of the nine alleged schemes, which were designed to line mayor's pockets as well as to maintain his political power in city. 18 U.S.C.A. § 1961 et seq.

**[12] Racketeer Influenced and Corrupt Organizations** 🔑 Continuity or relatedness; ongoing activity

Two or more Racketeer Influenced and Corrupt Organizations Act (RICO) predicate acts form a "pattern" if they are (1) related and (2) amount to or pose a threat of continued criminal activity. 18 U.S.C.A. § 1961 et seq.

[2 Cases that cite this headnote](#)

**[13] Racketeer Influenced and Corrupt Organizations** 🔑 Continuity or relatedness; ongoing activity

Predicate acts are "related" for Racketeer Influenced and Corrupt Organizations Act (RICO) purposes if they have the same or similar purposes, results, participants, victims, or methods of commission, or otherwise are interrelated by distinguishing characteristics and are not isolated events. 18 U.S.C.A. § 1961 et seq.

[2 Cases that cite this headnote](#)

**[14] Racketeer Influenced and Corrupt Organizations** 🔑 Time and duration

Continuity of the pattern of racketeering may be shown in Racketeer Influenced and Corrupt Organizations Act (RICO) prosecution by either a series of related predicates extending over a substantial period of time, or a pattern of more limited duration where the racketeering acts themselves include a specific threat of repetition extending indefinitely into the future or the predicate acts or offenses are part of an ongoing entity's regular way of doing business. 18 U.S.C.A. § 1961 et seq.

[1 Cases that cite this headnote](#)

**[15] Conspiracy** 🔑 Elections and political activity, offenses concerning

Evidence was sufficient to establish existence of conspiracy between three individual defendants in Racketeer Influenced and Corrupt Organizations Act (RICO) conspiracy prosecution in which municipal entities were named as associates in alleged racketeering enterprise; evidence indicated that defendants, including city's mayor and its chief of administration, participated in schemes designed to obtain contributions to mayor's political fund. 18 U.S.C.A. § 1961 et seq.

**[16] Conspiracy** 🔑 Racketeering conspiracies in general

Racketeer Influenced and Corrupt Organizations Act (RICO) conspiracy does not require proof that a defendant himself committed or agreed to commit the two predicate acts requisite for a substantive RICO offense; rather, he must intend to further an endeavor which, if completed, would satisfy all of the elements of a substantive criminal offense, but it suffices that he adopt the goal of furthering or facilitating the criminal endeavor. 18 U.S.C.A. § 1961 et seq.

[14 Cases that cite this headnote](#)

[17] **Conspiracy** 🔑 Racketeering conspiracies in general

Jury's conclusion in special verdict form that government failed to prove certain predicate acts underlying substantive Racketeer Influenced and Corrupt Organizations Act (RICO) counts against three defendants did not preclude defendants' conviction for RICO conspiracy; evidence relating to those acts that were found unproven by the jury was still available to the jury in its evaluation of the overall RICO charge. 18 U.S.C.A. § 1961 et seq.

[3 Cases that cite this headnote](#)

[18] **Criminal Law** 🔑 General Verdict  
**Criminal Law** 🔑 Verdict or findings

Ordinarily, when a jury returns a general verdict of guilty on a substantive Racketeer Influenced and Corrupt Organizations Act (RICO) count and one of the predicate acts is later found to be legally insufficient by a reviewing court, the conviction must be overturned where it is impossible to determine whether two legally sufficient predicate acts support a RICO conviction. 18 U.S.C.A. § 1961 et seq.

[1 Cases that cite this headnote](#)

[19] **Criminal Law** 🔑 Special verdict or findings

Special verdict form in Racketeer Influenced and Corrupt Organizations Act (RICO) prosecution allows juries to specifically identify the predicates for the general verdict. 18 U.S.C.A. § 1961 et seq.

[2 Cases that cite this headnote](#)

[20] **Criminal Law** 🔑 Province of jury or trial court

In reviewing a criminal conviction for sufficiency, Court of Appeals does not assess the credibility of the witnesses, which is the sole function of the trier of fact.

[1 Cases that cite this headnote](#)

[21] **Indictments and Charging Instruments** 🔑 Conspiracy, racketeering, and money laundering

District Court did not constructively amend indictment in Racketeer Influenced and Corrupt Organizations Act (RICO) conspiracy prosecution in which municipal entities were named as associates in alleged racketeering enterprise when it stated, in denying defendants' motion to dismiss, that defendants were accused of conducting affairs of city through pattern of racketeering activity, where court instructed jury on association-in-fact enterprise theory alleged in indictment.

[2 Cases that cite this headnote](#)

[22] **Indictments and Charging Instruments** 🔑 Amendment of Indictment in General

Amendment of indictment occurs when the charging terms of the indictment are altered, either literally or in effect, by the prosecutor or the court after the grand jury has returned the indictment.

[1 Cases that cite this headnote](#)

[23] **Criminal Law** 🔑 Amendment  
**Indictments and Charging Instruments** 🔑 Prejudice to defendant

Amending the indictment is considered prejudicial per se and thus demands reversal.

**[24] Indictments and Charging****Instruments** ➔ [Material variance](#)

“Variance” arises when the proof at trial depicts a scenario that differs materially from the scenario limned in the indictment.

[2 Cases that cite this headnote](#)

**[25] Criminal Law** ➔ [Indictment or information in general](#)

Variance requires reversal only when it is both material and prejudicial, for example, if the variance works a substantial interference with the defendant's right to be informed of the charges laid at his doorstep.

[1 Cases that cite this headnote](#)

**[26] Racketeer Influenced and Corrupt Organizations** ➔ [Instructions](#)

Jury instructions in Racketeer Influenced and Corrupt Organizations Act (RICO) conspiracy prosecution did not permit conviction for performing acts without control over some part of the “direction” of the enterprise; jury was instructed that defendant must have “played some part in the operation or management of the enterprise.” 18 U.S.C.A. § 1961 et seq.

[3 Cases that cite this headnote](#)

**[27] Conspiracy** ➔ [Obstructing justice, bribery, and perjury](#)

Evidence of a connection between defendants' conduct and federal funds received by city police department was not required in prosecution for conspiracy to violate federal bribery statute based on defendants' alleged participation in scheme to require “campaign contributions” from those who wished to remain on the police department's tow list. 18 U.S.C.A. § 666(a)(1)(B).

[1 Cases that cite this headnote](#)

**[28] Conspiracy** ➔ [Obstructing justice, bribery, and perjury](#)

Evidence that defendant who held no authority to make police academy admission decisions told victims that they had not made any “contributions” and that they needed to come up with \$5,000 in cash if they wanted their son to be accepted into police academy was sufficient to establish that defendant passed bribe along to public official, or conspired to do so, as required to support federal bribery conspiracy conviction; evidence permitted inference that the \$5,000 was to be political “contribution” that would serve as ticket of admission when passed along to someone with authority over admission decisions. 18 U.S.C.A. § 666(a)(1)(B).

[1 Cases that cite this headnote](#)

**[29] Commerce** ➔ [Federal Offenses and Prosecutions](#)**Extortion** ➔ [Federal offenses](#)

Evidence that, but for victim's agreement to pay defendant, a city official, for favorable intervention on his behalf with school department, there was a realistic probability that city contractor, an entity engaged in interstate commerce and whose lease agreement would be a transaction affecting interstate commerce, would have leased space in another city was sufficient to establish that defendant's conduct had de minimis effect on interstate commerce, as required to support Hobbs Act attempted extortion and Hobbs Act extortion conspiracy convictions. 18 U.S.C.A. § 1951(a).

[1 Cases that cite this headnote](#)

**[30] Commerce** ➔ [Federal Offenses and Prosecutions](#)**Conspiracy** ➔ [Extortion, threats, stalking, and harassment](#)**Extortion** ➔ [Federal offenses](#)

Evidence that, as result of defendant's scheme, a city contractor that was engaged in interstate commerce was deprived of \$1,100 in order to facilitate payments to which it was entitled was sufficient to establish that defendant's conduct had de minimis effect on interstate commerce, as required to support Hobbs Act attempted



extortion and Hobbs Act extortion conspiracy convictions. [18 U.S.C.A. § 1951\(a\)](#).

[2 Cases that cite this headnote](#)

- [31] **Criminal Law** 🔑 [Furtherance or Execution of Common Purpose](#)

**Criminal Law** 🔑 [Weight and sufficiency](#)

In determining whether the Government has met prerequisites of coconspirator exception to the hearsay rule, the district court must determine that it is more likely than not that the declarant and the defendant were members of a conspiracy when the hearsay statement was made, and that the statement was in furtherance of the conspiracy. [Fed.Rules Evid.Rule 801\(d\)\(2\)\(E\)](#), [28 U.S.C.A.](#)

[1 Cases that cite this headnote](#)

- [32] **Criminal Law** 🔑 [Character of acts or declarations](#)

Taped statements of alleged coconspirator were admissible in Racketeer Influenced and Corrupt Organizations Act (RICO) conspiracy prosecution under coconspirator exception to the hearsay rule; statements described the roles that declarant and others played in the conspiracy and what needed to be done to carry out two schemes to extort money, and were uttered as part of and in furtherance of the conspiracy. [18 U.S.C.A. § 1961 et seq.](#); [Fed.Rules Evid.Rule 801\(d\)\(2\)\(E\)](#), [28 U.S.C.A.](#)

[2 Cases that cite this headnote](#)

- [33] **Criminal Law** 🔑 [Review De Novo](#)

Court of Appeals reviews Confrontation Clause challenges de novo. [U.S.C.A. Const.Amend. 6](#).

[2 Cases that cite this headnote](#)

- [34] **Criminal Law** 🔑 [Coconspirators' statements](#)

Confrontation Clause does not require a showing of unavailability as a condition to admission of the out-of-court statements of a nontestifying co-conspirator, when those statements otherwise

satisfy the requirements of the co-conspirator exception to the hearsay rule; it also does not require a court to embark on an independent inquiry into the reliability of statements that satisfy the requirements of that rule. [U.S.C.A. Const.Amend. 6](#); [Fed.Rules Evid.Rule 801\(d\)\(2\)\(E\)](#), [28 U.S.C.A.](#)

- [35] **Criminal Law** 🔑 [Coconspirators' statements](#)

Admission of coconspirator's taped statements in Racketeer Influenced and Corrupt Organizations Act (RICO) conspiracy prosecution did not violate confrontation clause because they were made to person who was eliciting incriminating statements as part of FBI "sting" operation, where co-conspirator was unaware he was being "stung," and there was no indication that his behavior would have been different had the conversation not been made at the FBI's direction. [U.S.C.A. Const.Amend. 6](#); [18 U.S.C.A. § 1961 et seq.](#)

- [36] **Constitutional Law** 🔑 [Interference with witnesses](#)

**Criminal Law** 🔑 [Nonproduction of Witness or Rendering Witness Unavailable](#)

Government's plea agreement with alleged co-conspirator, under which he plead guilty to some counts in return for dismissal of remaining counts at sentencing, did not make alleged conspirator unavailable as a witness, in violation of due process; although defendants claimed that co-conspirator would have asserted his Fifth Amendment rights against self-incrimination if called to testify because he potentially faced additional charges, he was sentenced when government was still presenting its case-in-chief, and defendants did not attempt to call him as witness after that point. [U.S.C.A. Const.Amend. 5](#).

- [37] **Criminal Law** 🔑 [Mode of making objection](#)

**Criminal Law** 🔑 [General or specific](#)

District Court did not abuse its discretion in Racketeer Influenced and Corrupt Organizations

Act (RICO) conspiracy prosecution when it refused to entertain piecemeal objections at trial to taped statement of alleged co-conspirator; pretrial scheduling order required memoranda in support of objections to be accompanied by copies of the transcripts objected to on which proposed deletions and corrections were noted, and defendants failed to provide the court with specific objections.

**[38] Criminal Law** 🔑 Then-existing state of mind or body

To be admissible under state of mind exception to the hearsay rule, a declaration, among other things, must mirror a state of mind, which, in light of all the circumstances, including proximity in time, is reasonably likely to have been the same condition existing at the material time. [Fed.Rules Evid.Rule 803\(3\)](#), [28 U.S.C.A.](#)

3 Cases that cite this headnote

**[39] Criminal Law** 🔑 Particular determinations, hearsay inadmissible

Defendant's taped statement to undercover FBI agent was hearsay in Racketeer Influenced and Corrupt Organizations Act (RICO) conspiracy prosecution; statement was offered to prove the truth of the assertion that defendant did not tolerate corruption. [18 U.S.C.A. § 1961 et seq.](#)

**[40] Criminal Law** 🔑 Particular cases  
**Criminal Law** 🔑 Then-existing state of mind or body

Defendant's taped statements to undercover FBI agent, offered to show that defendant, as city's mayor, did not tolerate corruption, was inadmissible under state of mind exception to hearsay rule in Racketeer Influenced and Corrupt Organizations Act (RICO) conspiracy prosecution; statement, at least in part, applied to past acts of defendant's administration and were to a large extent "self-serving" attempts to cover tracks already made. [18 U.S.C.A. § 1961 et seq.](#); [Fed.Rules Evid.Rule 803\(3\)](#), [28 U.S.C.A.](#)

2 Cases that cite this headnote

**[41] Criminal Law** 🔑 Necessity of Objections in General

Under plain error review, the defendant must show (1) that an error occurred (2) which was "obvious" in the sense that governing law was clearly settled to the contrary, (3) affected the defendant's substantial rights, and (4) seriously impaired the fairness, integrity, or public reputation of judicial proceedings.

1 Cases that cite this headnote

**[42] Criminal Law** 🔑 Necessity and scope of proof

Application of evidentiary rules do not abridge an accused's right to present a defense so long as they are not arbitrary or disproportionate to the purposes they are designed to serve. [U.S.C.A. Const.Amend. 5.](#)

**[43] Constitutional Law** 🔑 Right to present witnesses; compulsory process

**Criminal Law** 🔑 Necessity and scope of proof

Exclusion of defendant's taped statements to undercover FBI agent, offered to show that defendant, as city's mayor, did not tolerate corruption, did not violate defendant's due process right to present a complete defense in Racketeer Influenced and Corrupt Organizations Act (RICO) conspiracy prosecution; even if statements had some exculpatory value, given the amount of evidence of defendant's criminal knowledge and intent presented at trial, its absence from the evidence does not rise to egregious violation of defendant's interest in defeating government's case. [U.S.C.A. Const.Amend. 5](#); [18 U.S.C.A. § 1961 et seq.](#)

## Attorneys and Law Firms

\*77 [John A. MacFadyen](#), for appellant Vincent A. Cianci, Jr.

[Anthony M. Traini](#), for appellant Frank E. Corrente.

[Richard C. Bicki](#) with whom [Cerilli & Bicki](#) and [Edward Gerstein](#) were on brief for appellant Richard E. Autiello.

[Donald C. Lockhart](#), Assistant United States Attorney with whom [Margaret E. Curran](#), United States Attorney, [Richard W. Rose](#) and [Terrence P. Donnelly](#), Assistant United States Attorneys were on brief, for appellee.

Before [HOWARD](#), Circuit Judge, [CAMPBELL](#) and [STAHL](#), Senior Circuit Judges.

## Opinion

[STAHL](#), Senior Circuit Judge.

Vincent A. Cianci was the Mayor of Providence, Rhode Island; Frank E. Corrente was the City's Director of Administration; Richard E. Autiello was a member of the Providence City Towing Association, a private organization. Between April 23 and June 24, 2002, the three were jointly tried on a superseding indictment that charged them and others with forty-six violations of federal statutes prohibiting public corruption. The district court entered judgments of acquittal on eight of the charges but submitted the rest to the jury.

On June 24, 2002, the jury returned a total of eight guilty verdicts but acquitted on the remaining thirty counts. All three defendants were convicted on a single count charging a conspiracy to violate the RICO (Racketeer Influenced and Corrupt Organizations) statute. *See* 18 U.S.C. § 1962(d). Corrente and Autiello were convicted on a count charging a federal bribery conspiracy. *See* 18 U.S.C. §§ 371 & 666(a)(1)(B). Corrente was convicted on a count charging a substantive RICO violation, *see* 18 U.S.C. § 1962(c), two counts charging Hobbs Act extortion conspiracies, *see* 18 U.S.C. § 1951(a), and two counts charging Hobbs Act attempted extortions, *see id.* Autiello was convicted on an additional count charging a second federal bribery conspiracy. *See* 18 U.S.C. §§ 371 & 666(a)(1)(B). The jury also answered “YES” to four of thirty-seven special interrogatories, which asked whether the government had “proven” the alleged predicate acts underlying the racketeering counts; all other special interrogatories were answered “NO” or not answered at all.

The district court subsequently granted a judgment of acquittal on one of the \*78 extortion conspiracy charges of which Corrente had been convicted; ordered the forfeiture of \$250,000 in a campaign contribution fund controlled by Cianci and Corrente pursuant to RICO's forfeiture provisions, *see* 18 U.S.C. § 1963(a)(1); and sentenced the defendants to prison terms of sixty-four months (Cianci), sixty-three months (Corrente), and forty-six months (Autiello).

Cianci, Corrente, and Autiello appeal their convictions and sentences, and Cianci and the government cross appeals the district court's forfeiture ruling. We begin with challenges to defendants' RICO convictions.

## I. The RICO Convictions (All Defendants)

### A. Indictment

[1] Count One of the indictment charged Cianci, Autiello, and Corrente with conspiracy to operate the affairs of an enterprise consisting of the defendants themselves, the City of Providence, “various officers, agencies and entities of Providence” including thirteen specified agencies, Jere Realty, and Friends of Cianci, and others “known or unknown to the Grand Jury.” The purpose of the enterprise “included the following: a. Enriching Defendant Vincent A. Cianci ... Friends of Cianci through extortion, mail fraud, bribery, money laundering, and witness tampering, and b. Through the same means enriching, promoting and protecting the power and assets of the leaders and associates of the enterprise.” In a pre-trial motion, defendants moved to dismiss the RICO allegations, asserting that the enterprise as charged was improper in that it was overly broad, vague, and legally impossible.<sup>1</sup> The district court denied the motion. The issues raised by this motion were revisited on motions for judgment of acquittal and for a new trial. The court denied these motions as well.

<sup>1</sup> We address this legal impossibility argument later in the context of whether sufficient evidence supported the charged RICO enterprise.

Defendants argue that the enterprise charged in the indictment was purposefully obscure and did not provide adequate notice to defendants of the crimes for which they were charged and ultimately convicted. The argument is couched in two ways: that 18 U.S.C. § 1961(4) is unconstitutional as applied for failure to provide “fair warning” of the alleged criminal conduct and that the charged enterprise failed to provide

adequate notice against which the defendants could defend themselves. The government counters that, under the RICO statute, enterprise is defined broadly and that defendants were sufficiently apprised of the nature and extent of the charges.

RICO makes it unlawful “for any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity[.]” 18 U.S.C. § 1962(c). The statute also outlaws conspiracies to violate § 1962(c). See *id.* § 1962(d). As stated above, Corrente was convicted of a substantive violation of § 1962(c), and all three defendants were convicted of RICO conspiracy under § 1962(d).

A RICO “enterprise” “includes any individual, partnership, corporation, association, or other legal entity, and any union or group of individuals associated in fact although not a legal entity.” 18 U.S.C. § 1961(4). See *United States v. DeCologero*, 364 F.3d 12, 18 (1st Cir.2004). It is important to stress that the Supreme \*79 Court has admonished that RICO and the term “enterprise” be construed expansively. See *United States v. Turkette*, 452 U.S. 576, 586–87, 101 S.Ct. 2524, 69 L.Ed.2d 246 (1981); *Sedima, S.P.R.L. v. Imrex Co., Inc.*, 473 U.S. 479, 497–98, 105 S.Ct. 3275, 87 L.Ed.2d 346 (1985); see also *United States v. London*, 66 F.3d 1227, 1243–44 (1st Cir.1995); *United States v. Lee Stoller Enterprises, Inc.*, 652 F.2d 1313, 1318 (7th Cir.1981). The term's flexibility is denoted by the use of the word “includes” rather than “means” or “is limited to”; it does not purport to be exhaustive. See *United States v. Masters*, 924 F.2d 1362, 1366 (7th Cir.1991) (Posner, J.); *United States v. Perholtz*, 842 F.2d 343, 353 (D.C.Cir.1988). Accordingly, “enterprise” has been interpreted *inter alia* to include (1) legal entities such as legitimate business partnerships and corporations, and (2) illegitimate associations-in-fact marked by an ongoing formal or informal organization of individual or legal-entity associates, see *London*, 66 F.3d at 1243–44 (associations-in-fact may include legal entities such as corporations), who or which function as a continuing organized crime unit “for a common purpose of engaging in a course of conduct.” *Turkette*, 452 U.S. at 580–83, 101 S.Ct. 2524; see also *United States v. Patrick*, 248 F.3d 11, 19 (1st Cir.2001), *cert. denied*, 535 U.S. 910, 122 S.Ct. 1215, 152 L.Ed.2d 152 (2002). The enterprise charged in this case is of the latter, associated-in-fact variety.

Here, the superseding indictment delineated the members of the enterprise, the roles of the defendants in the enterprise, the purposes and goals of the racket, and the ways in which the defendants used other members of the enterprise—specifically, municipal entities that they controlled as part of the conspiracy—to further those purposes and goals. It alleged that defendants conspired to violate and did in fact violate RICO through their involvement in an associated-in-fact enterprise devoted to enriching and empowering defendants and others through unlawful means. The enterprise was alleged to have been comprised of the individual defendants; the City of Providence “including, but not limited to” many of its departments, offices, and agencies; the campaign contribution fund controlled by Cianci and Corrente; and others known and unknown to the grand jury. The enterprise allegations, which we reproduce as redacted following the district court's entry of the eight judgments of acquittal prior to the jury charge, read as follows:

#### THE RACKETEERING ENTERPRISE

Defendants VINCENT A. CIANCI, JR., a/k/a “Buddy”; FRANK E. CORRENTE; RICHARD E. AUTIELLO; the City of Providence (“Providence”), including, but not limited to, the Office of Mayor, the Office of the Director of Administration, the Providence City Solicitor's Office, the Department of Planning and Development, the Providence Redevelopment Agency, the Tax Collector's Office, the Tax Assessor's Office, the Board of Tax Assessment Review, the Finance Department, the Department of Public Safety, the Providence School Department, the Department of Inspection and Standards, and the Building Board of Review; Friends of Cianci, the political organization of Defendant VINCENT A. CIANCI, JR., a/k/a “Buddy”; and others known and unknown to the Grand Jury, constituted an “enterprise” as defined by 18 U.S.C. § 1961(4), that is, a group of individuals and entities associated in fact. This enterprise, which operated in the District of Rhode Island and elsewhere, was engaged in, and its activities affected interstate commerce.

#### \*80 PURPOSES OF THE ENTERPRISE

The purposes of the enterprise included the following:

- a. Enriching Defendant VINCENT A. CIANCI, JR., a/k/a “Buddy” and Friends of Cianci through extortion,

mail fraud, bribery, money laundering, and witness tampering; and

b. Through the same means enriching, promoting, and protecting the power and assets of the leaders and associates of the enterprise.

#### *DEFENDANTS AND THEIR ROLES IN THE ENTERPRISE*

Defendants VINCENT A. CIANCI, JR., a/k/a “Buddy;” and FRANK E. CORRENTE were the leaders of the enterprise....

Defendant RICHARD E. AUTIELLO, and others known and unknown to the Grand Jury, were associated with, and conducted and participated, directly and indirectly, in the conduct of the enterprise's affairs, including but not limited to extortion, mail fraud, and bribery.

Superseding Redacted Indictment, ¶¶ 38–41. This enterprise was alleged to have existed “from in or about January 1991 through in or about December 1999.”

The balance of the indictment (again, in the redacted form in which it went to the jury) also detailed the “pattern of racketeering activity” underlying the grand jury's RICO and RICO conspiracy allegations. The unlawful conduct comprising the alleged pattern was set forth in a section detailing the predicate RICO “Racketeering Acts” and in separate offense counts. The pattern was itself subdivided into nine alleged schemes:

1. A scheme, carried out between 1991 and late 1999, in which Corrente (with Autiello serving as his intermediary) pressured companies with whom the Providence Police Department contracted for towing services to make campaign contributions totaling some \$250,000 to Friends of Cianci in order to remain on the tow list (“the Tow List scheme”);

2. A scheme, carried out between 1991 and 1998, in which the owner of Jere Realty, a local real estate company, was alleged to have paid bribes and kickbacks which made their way to Corrente in order to secure a Providence School Department lease for one of the company's Providence buildings (“the Jere Lease scheme”);

3. A 1998 scheme in which Cianci was alleged to have been involved in extorting a \$10,000 contribution from the estate of Fernando Ronci (which owed the City some \$500,000 in back taxes) in exchange for his support in the estate's efforts

to secure a tax abatement from the corrupt Board of Tax Assessment Review, which was chaired by co-conspirator Joseph Pannone and vice-chaired by co-conspirator David Ead (“the Ronci Estate scheme”);

4. A 1996–97 scheme in which Cianci was alleged to have arranged for Christopher Ise to obtain a job in the City's Department of Planning and Development in return for a \$5,000 contribution (“the Ise Job scheme”);

5. A 1999 scheme in which Cianci was alleged to have supported the contemplated sale of two City lots to a City vendor, Anthony Freitas, in return for a \$10,000 contribution (“the Freitas Lots scheme”);

6. A 1998–99 scheme in which Corrente was alleged to have attempted to influence the Providence School Department to encourage a city contractor entitled to reimbursement from the City for its lease expenses to lease a building owned by Anthony Freitas in return for contributions \*81 totaling \$2,000 (“the Freitas Lease scheme”);

7. A 1998 scheme in which Corrente, acting through Joseph Pannone, was alleged to have facilitated prompt payments of invoices submitted to the City by a business owned by Anthony Freitas in return for contributions totaling \$1,100 (“the Freitas Invoices scheme”);

8. A 1998 scheme in which Cianci was alleged (a) to have attempted to influence the City's Building Board of Review to deny a request for construction variances made by the private University Club in retaliation for the Club's having refused to admit him as a member back in the 1970s and its continuing refusal to admit him, and (b) to have extorted a free honorary membership from the Club as the construction variance dispute was unfolding (“the University Club scheme”); and

9. A 1996 scheme in which Autiello conspired with an unnamed public official to facilitate the hiring of Joseph Maggiacomo as a Providence police officer in return for a \$5,000 cash contribution by Joseph's mother, Mary Maggiacomo (“the Maggiacomo Job scheme”).

[2] [3] “[A]n indictment is sufficient if it, first, contains the elements of the offense charged and fairly informs a defendant of the charge against which he must defend, and, second, enables him to plead an acquittal or conviction in bar of future prosecutions for the same offense.” *Hamling v. United States*, 418 U.S. 87, 117, 94 S.Ct. 2887, 41 L.Ed.2d 590 (1974).



“It is generally sufficient that an indictment set forth the offense in the words of the statute itself, as long as ‘those words of themselves fully, directly, and expressly, without any uncertainty or ambiguity, set forth all the elements necessary to constitute the offense intended to be punished.’ ” *Id.* (citations omitted); *see also United States v. McDonough*, 959 F.2d 1137, 1140 (1st Cir.1992).

The indictment not only tracks the language of the RICO statute, but also goes into considerable detail with respect to the underlying factual allegations. Hence, we conclude that defendants were more than sufficiently apprised of the charges.

#### B. Enterprise

The defendants also argue that their RICO convictions cannot stand because there was insufficient evidence to ground the jury's foundational finding that the government had proved the existence of the RICO “enterprise” that the government charged.<sup>2</sup> We begin our analysis by summarizing the relevant legal principles and the government's RICO theory and proof.

<sup>2</sup> The indictment and the jury instructions required that the government prove the same enterprise, described below, in order to secure convictions on both the substantive RICO count and the RICO conspiracy count. The analysis that follows therefore applies with equal force to the substantive RICO conviction returned against Corrente and to the RICO conspiracy convictions returned against Cianci, Corrente, and Autiello.

[4] [5] In cases involving an alleged associated-in-fact RICO enterprise, the existence of the charged enterprise does not follow, ipso facto, from evidence that those named as the enterprise's associates engaged in crimes that collectively may be characterized as a “pattern of racketeering activity”:

While the proof used to establish these separate elements [i.e., the “enterprise” and the “pattern of racketeering activity”] may in particular cases coalesce, proof of one does not necessarily establish the other. The “enterprise” is not the “pattern of racketeering activity”; it \*82 is an entity separate and

apart from the pattern of activity in which it engages. The existence of an enterprise at all times remains a separate element which must be proved by the Government.

*Turkette*, 452 U.S. at 583, 101 S.Ct. 2524. In other words, criminal actors who jointly engage in criminal conduct that amounts to a pattern of “racketeering activity” do not automatically thereby constitute an association-in-fact RICO enterprise simply by virtue of having engaged in the joint conduct. Something more must be found—something that distinguishes RICO enterprises from ad hoc one-time criminal ventures. *See Bachman v. Bear Stearns & Co., Inc.*, 178 F.3d 930, 932 (7th Cir.1999) (Posner, C.J.) (noting that a contrary rule would erroneously make “every conspiracy to commit fraud ... a RICO [enterprise] and consequently every fraud that requires more than one person to commit ... a RICO violation”).

Courts have divided over the legal standards that guide the drawing of this distinction. Some require proof that an alleged associated-in-fact enterprise have an “ascertainable structure distinct from that inherent in the conduct of a pattern of racketeering activity ... , which might be demonstrated by proof that a group engaged in a diverse pattern of crimes or that it has an organizational pattern or system of authority beyond what was necessary to perpetrate the predicate crimes.” *Patrick*, 248 F.3d at 18 (quoting *United States v. Bledsoe*, 674 F.2d 647, 664 (8th Cir.1982), and discussing cases from other circuits that have adopted *Bledsoe's* “ascertainable structure” standard) (internal quotation marks omitted). Courts following the “ascertainable structure” approach do so out of concern that the factfinder not be misled into “collaps[ing] ... the enterprise element with the separate pattern of racketeering activity element of a RICO offense.” *Id.* (quoting *Bledsoe*, 674 F.2d at 664) (internal quotation marks omitted).

This circuit has cast its lot with courts that have declined to make *Bledsoe's* “ascertainable structure” criterion a mandatory component of a district court's jury instructions explaining RICO associated-in-fact enterprises. *See id.* at 18–19. Instead, we have approved instructions based strictly on *Turkette's* explanation of how a criminal association might qualify as a RICO enterprise. *See, e.g., Patrick*, 248 F.3d at 17–19. In doing so, we have read *Turkette* to impose a requirement that those associated in fact “function as an



ongoing unit” and constitute an “ongoing organization.” *Id.* at 19. Also important to such an enterprise is that its members share a “common purpose.” *See, e.g., id.; Ryan v. Clemente*, 901 F.2d 177, 180 (1st Cir.1990) (“[A]lthough much about the RICO statute is not clear, it is very clear that those who are ‘associates’ ... of a criminal enterprise must share a ‘common purpose’ ....”) (citations omitted).

[6] We turn now to the particulars of the defendants’ argument. First, they contend that the indictment charged a legal impossibility in alleging that municipal entities were themselves part of the unlawful purpose associated-in-fact enterprise. They base this argument on the requirement that members of such an enterprise share a common unlawful purpose and cases holding that municipalities cannot be found to have acted with unlawful intent. *See, e.g., Lancaster Comm. Hosp. v. Antelope Valley Hosp. Dist.*, 940 F.2d 397, 404 (9th Cir.1991) (“[G]overnment entities are incapable of forming a malicious intent.”); *United States v. Thompson*, 685 F.2d 993, 1001 (6th Cir.1982) (“Criminal activity is private activity even when it is carried out in a public forum and even though the activity can only be undertaken by an official’s use of a state given power[.]”).

\*83 [7] [8] [9] Defendants’ argument misses the mark because neither the indictment nor the jury instructions compel the conclusion that the City itself had to have formed an unlawful intent. It is uncontroversial that corporate entities, including municipal and county ones, can be included within association-in-fact RICO enterprises. *See, e.g., London*, 66 F.3d at 1244; *Masters*, 924 F.2d at 1366. It is also beyond dispute, as the Supreme Court held in *Turkette*, that “the term ‘enterprise’ as used in RICO encompasses both legitimate and illegitimate enterprises.” 452 U.S. at 578, 101 S.Ct. 2524. As the D.C. Circuit elucidated:

[A restrictive] reading of 1961(4) would lead to the bizarre result that only criminals who failed to form corporate shells to aid their illicit schemes could be reached by RICO. [Such an] interpretation hardly accords with Congress’ remedial purposes: to design RICO as a weapon against the sophisticated racketeer as well as (and perhaps more than) the artless.

*Perholtz*, 842 F.2d at 353. Municipal entities can be part of an unlawful purpose association-in-fact enterprise so long as those who control the entities share the purposes of the enterprise. “RICO does not require intentional or ‘purposeful’ behavior by corporations charged as members of an association-in-fact.” *United States v. Feldman*, 853 F.2d 648, 657 (9th Cir.1988). A RICO enterprise animated by an illicit common purpose can be comprised of an association-in-fact of municipal entities and human members when the latter exploits the former to carry out that purpose. Cianci, Corrente, and Autiello—those who wielded influence, exerted pressure, and effectively controlled the City’s various components—are the criminals here. Defendants’ legal impossibility argument holds water only had the government sought prosecution of the City itself. The City and its component agencies are not the defendants in this case; they were deemed members of the enterprise because without them, Cianci, Corrente, and Autiello would not have been able to even attempt to perpetrate the charged racketeering schemes. Indeed, this is not the first time an association-in-fact enterprise composed in this manner has been found to exist. *See, e.g., Masters*, 924 F.2d at 1362; *United States v. McDade*, 28 F.3d 283 (3d Cir.1994) (upholding association-in-fact enterprise consisting of congressman, his two offices, and congressional subcommittees that he chaired); *United States v. Dischner*, 974 F.2d 1502 (9th Cir.1992) (upholding association-in-fact enterprise consisting of municipal officials, office of mayor, and department of public works); *United States v. Angelilli*, 660 F.2d 23, 31–33 (2d Cir.1981) (“We view the language of § 1961(4), ... as unambiguously encompassing governmental units, ... and the substance of RICO’s provisions demonstrate a clear congressional intent that RICO be interpreted to apply to activities that corrupt public or governmental entities.”). In each of these cases, the groupings of individuals and corporate or municipal entities were sufficiently organized and devoted to the alleged illicit purposes that the resulting whole functioned as a continuing unit. The common purpose was dictated by individuals who controlled the corporate or municipal entities’ activities and manipulated them to the desired illicit ends.

The indictment and jury instructions are consistent with this framing of the enterprise. The district court instructed the jury, without objection from either party, that “the Government must prove that the alleged enterprise had an ongoing organization, whether it be formal or informal, and that its various associates functioned together as a continuing unit to achieve common goals.” The court continued, “It \*84 is not necessary in proving the existence of an enterprise to show

that each member of the enterprise participated in or even knew of all of its activities, but it is necessary to show that all members of the alleged enterprise shared a common purpose.” Requiring the government to prove that all members named in the enterprise shared a common purpose of illegality did not compel the government to show that the City itself had the mens rea to seek bribes and to extort. The Ninth and Sixth Circuits articulated what in some sense is the obvious: that a corporate or municipal entity does not have a mind of its own for purposes of RICO. *Lancaster Comm. Hosp.*, 940 F.2d at 404; *Thompson*, 685 F.2d at 1001. Unlawful common purpose is imputed to the City by way of the individual defendants’ control, influence, and manipulation of the City for their illicit ends. Whether the defendants did exercise sufficient control over the City for purposes of the enterprise is one of fact for the jury and evidentiary sufficiency.

[10] It follows that the defendants also have an evidence-based argument. They contend that their RICO convictions must be reversed because the evidence introduced at trial in support of the alleged schemes set forth above—the only proof from which the jury might have inferred that the schemes were carried out, or were intended to be carried out, by means of a RICO enterprise, see *Turkette*, 452 U.S. at 583, 101 S.Ct. 2524 (observing that proof of the pattern of racketeering activity may in particular cases also constitute the proof of the enterprise itself)—was insufficient to ground a finding that the schemes were conducted through the specific entity alleged in the indictment to have constituted a RICO enterprise. Defendants base this argument on an assertion that there was no evidence from which the jury might have inferred a shared purpose between defendants and the municipal entities named as associates of the enterprise and through which many of the schemes were conducted. In support of this argument, the defendants point to specific statements by the district court that “there is no evidence that the [City] departments and/or agencies, themselves, shared [the enterprise’s] purposes,” *United States v. Cianci*, 210 F.Supp.2d 71, 73 (D.R.I.2002) (denying defendants’ motions for judgments of acquittal), and that “none of [defendants’] acts ... resulted in any significant disruption of a Governmental function.” *Id.* The defendants also emphasize that, even if we were to evaluate the sufficiency of the evidence underlying the RICO convictions by construing the *entire* record in the light most favorable to the government, the evidence is insufficient.

As set forth above, we have identified *Turkette*’s “ongoing organization,” “continuing unit,” and “common purpose”

requirements as the principal tools a factfinder should use to distinguish a RICO enterprise from an ad hoc criminal confederation. We have applied these requirements to unlawful purpose associations-in-fact involving corporate legal entities. See *London*, 66 F.3d at 1243–45. The district court adequately set out these requirements to the jury; hence, we see no basis for disregarding the court’s instructions in the course of our sufficiency review. See, e.g., *United States v. Zanghi*, 189 F.3d 71, 79–80 (1st Cir.1999) (an unchallenged jury instruction that is faithful to the indictment and “not patently incorrect or internally inconsistent” becomes the standard by which evidentiary sufficiency is to be measured) (citing *United States v. Gomes*, 969 F.2d 1290, 1294 (1st Cir.1992)).

\*85 After careful scrutiny of the record and setting the evidence against the jury instructions, we conclude that the jury could have found the above requirements, specifically that the defendants and others named as enterprise members comprised an ongoing organization that functioned as a continuing unit and was animated by common purposes or goals.

We agree with the government’s assertion that the jury’s enterprise finding is sustainable because there was sufficient evidence that Cianci and Corrente exercised substantial control over the municipal entities named as members of the enterprise. Cianci was the City’s mayor and Corrente its chief of administration. They were alleged and were shown to have used their positions and influence to sell municipal favors on a continuing basis. The evidence indicates a close relationship “in fact” among them, the City they managed, and Cianci’s political organization. Cianci, as mayor, and Corrente and Autiello, as city officials, were strongly connected to and had considerable influence over the various City employees and departments. Their illegal schemes could function only with the cooperation, witting or unwitting, of certain City agencies and officials. Insofar as Cianci’s and the other defendants’ criminal schemes were or would be carried out by themselves and others acting in their municipal roles, the City—if only to that extent—did share in the same common criminal purpose.<sup>3</sup> The defendants were not only human members of the enterprise, but were the City’s official leaders with considerable express and implicit authority over its departments and employees. Moreover, the enterprise’s corrupt purposes were aimed at exploiting the City’s resources. It is because of this control and these close connections that the jury could have imputed the enterprise’s common purpose to the City. See *Masters*, 924 F.2d at

1366 (“Surely if three individuals can constitute a RICO enterprise, ..., then the larger association that consists of them plus entities that they control can be a RICO enterprise too.”).

3 The evidence depicted a behavioral spectrum ranging from innocent cooperation to willful complicity in unlawful conduct. For example, with respect to the Freitas Invoices scheme, the evidence was merely that an employee within the City's Finance Department (Lorraine Lisi), acting at Corrente's request, paid valid invoices more promptly than usual. Similarly, with respect to the Ise Job scheme, the evidence was merely that the Deputy Director of the Department of Planning and Development (Thomas Deller) created a temporary position for Ise within the department at Cianci's request. At the more culpable end of the spectrum, however, there was evidence that, in connection with the Jere Lease scheme, the head of the Department of Public Property (Alan Sepe) and the Director of Business Relations for the School Department (Mark Dunham) were influenced by Corrente to tailor the specifications in a School Department lease bid to fit the dimensions of Jere Realty's building, and then to support the Jere Realty lease before the Board of Contract and Supply (which was the entity formally empowered to accept or reject bids of City contracts). Similarly, in connection with the Freitas Lease scheme, there was evidence that Corrente again contacted Dunham prior to finalization of the lease and influenced him to drop consideration of an alternative lease.

Evidence of defendants' control, both titular and actual, was sufficient to deem the enterprise a “continuing unit” and “ongoing organization.” The jury could easily glean from taped conversations and the trial testimony of David Ead—a co-conspirator and vice-chair of the Board of Tax Assessment Review—that there existed an organized structure with Cianci at the top, Corrente as a middle man facilitating and often initiating transactions, and others, including Autiello, Ead, and Pannone, that fed deals into the organization (or in Ead's case, sometimes tried to \*86 replace Corrente as the middle man). The defendants attempted to use, to varying degrees of success, various municipal agencies in committing a series of related bribes and extortions. These agencies were used in this manner on an ongoing basis from 1991 through 1999. The fact that other persons and entities were used in

some transactions but not in others does not matter; the jury instructions reflected this flexibility.<sup>4</sup>

4 The court instructed, in relevant part:

“An enterprise may exist even though individual members come and go as long as it continues in an essentially unchanged form during substantially the entire period alleged in the indictment,....”

“It is not necessary in proving the existence of an enterprise to show that each member of the enterprise participated in or even knew of all of its activities,....”

“... a Defendant need not have been associated with an enterprise for the entire time that the enterprise existed in order to have been associated with the enterprise, but a Defendant must share some common goal or objective of the enterprise in order to be a member.”

There was detailed evidence, moreover, placing Cianci, the City's mayor, in the middle of at least four of the enumerated racketeering acts. With regard to the Ronci Estate scheme, David Ead testified at trial that he suggested to Ronci's attorney that the estate settle its tax claim with the City for \$100,000 in exchange for a \$10,000 contribution to the Friends of Cianci. Ead met with Cianci and discussed the proposed deal. The settlement was approved by the City's Board of Tax Assessment Review. Ead testified that shortly thereafter, he was contacted by Corrente, who told him that Cianci wanted Corrente to collect the money. Ead responded that he was waiting for the Ronci attorney, to which Corrente replied, “Well you know that the Mayor he's on my back—do

your best.” After receiving the money from Ronci's attorney, Ead brought the money to Corrente who put his finger on his lips and took the envelope. A tape-recorded conversation between Joseph Pannone and Anthony Freitas provided additional evidence.<sup>5</sup> Our dissenting brother recognizes that there was enough evidence for the jury to conclude that defendants functionally controlled the Board of Tax Assessment Review, often for criminal purposes.

<sup>5</sup> Pannone said to Freitas, “Ead took care of the Mayor, don't know what he gave the Mayor ... He took care of me, too. He pushed the Ronci settlement through.”

With regard to the Ise Job, Ead again testified that he served as a middleman for Mayor Cianci, this time arranging a \$5,000 bribe in exchange for a municipal job. According to Ead, Cianci asked during their conversation about Ise, cautious about whether “he's alright” and looking for assurances that “he's not going to say nothing.” Upon learning that the City's Department of Planning and Development had no positions available, Cianci ordered the Department to “make one.” Upon receiving the \$5,000 “contribution,” Cianci told Ead, “Don't get nervous.”

In their trial testimony, which closely tracked taped conversations among Freitas, Pannone, and other City officials, both Freitas and Ead implicated Cianci in the Freitas Lots scheme, in which Cianci pressured the Providence Redevelopment Authority, the entity empowered to sell the lots, to expedite the sale of two City-owned lots to Freitas in exchange for a \$10,000 “contribution” by Freitas to the Cianci political fund. Finally, with regard to the Tow List scheme, Dorothy Deveraux—Corrente's assistant and the Friends' bookkeeper—wrote a note to Corrente which implicated all three defendants in \*87 that scheme.<sup>6</sup> Moreover, as Judge Howard concedes, the jury could have found, based primarily on taped statements and the trial testimony of towing association chairman Kenneth Rocha, that Corrente effectively controlled who made it onto the police department's tow list.

<sup>6</sup> Deveraux's note supported the prosecution theory that when towers occasionally “contributed” too much money under the same name, the defendants arranged for “replacement” checks to be made by third-party straw contributors. The note read, “FRANK—attached are two over checks—Please sign and Dick Autiello will be by today to replace

with new checks—I need your help with the other people—these overages total \$3,420.00. I know the Mayor does not want to part with that—without money being replaced. Please assign someone to talk to these people.”

We recognize that the defendants did not always get their way with municipal departments and employees.<sup>7</sup> But the fact that some racketeering schemes did not go as planned, and that certain elements within the City may not have completely complied with the defendants' wishes, does not defeat the integrity of the charged enterprise. The jury could have concluded that these glitches in the schemes only meant that certain substantive crimes went uncompleted and that otherwise, defendants possessed and exercised considerable control over crucial elements of the City. The evidence amply establishes a close relationship between defendants and the City in which they exercised their leadership roles. The enterprise and the conspiracy still thrived and the defendants were able to complete other schemes through their abuse of the municipal apparatus.

<sup>7</sup> For example, in connection with the Freitas Lots scheme, Cianci was displeased that elements within the Providence Redevelopment Agency did not sufficiently accede to his wishes, specifically when the PRA sold one of the “Freitas lots” before Cianci had a chance to finalize a deal with Freitas. In connection with the University Club scheme, Cianci was displeased when members of the Providence Building Board of Review ignored his wishes and granted the club some of the variances that it sought. Finally, in connection with the Maggiacomo Job scheme, the Chief of Police declined to admit Maggiacomo to the police academy because he had a criminal history and had been untruthful during a screening interview.

Defendants attempt to expose what they deem an error by the government in charging an overly broad enterprise that places a criminal onus on a largely innocent City. They warn that an enterprise such as that charged here implicates non-culpable municipal parties in associations which they had little or no idea were engaged in illicit activities. But this fear is misplaced. Here, as long as elements within the City, such as the police chief and members of the Building Review Board and Redevelopment Agencies, in fact did not *actively* share in the defendants' illegal purposes, we see no reason why we run into now-Justice Breyer's admonition in *Ryan*: that of failing to differentiate between associations that fall within the sweep



of RICO and associations involving only the exploitation of others by criminals. See 901 F.2d at 180–81 (emphasizing the need to limit “the potentially boundless scope of the word ‘enterprise’ so as to distinguish culpable from non-culpable associations,” and recognizing “the serious consequences for any man or woman, state official or private person, who is publicly accused of racketeering”); see also *Fitzgerald v. Chrysler Corp.*, 116 F.3d 225, 226–28 (7th Cir.1997).<sup>8</sup> Justice Breyer’s \*88 limiting principle of a shared common purpose among members of an association-in-fact enterprise still functions here to prevent a “boundless enterprise.” Those employees of a city that do not exhibit the requisite mens rea with regard to the enterprise’s illicit purposes will not be criminally or civilly implicated. In the present litigation, the City was named a member of the charged enterprise, not a defendant. The City “shared” in the enterprise’s purpose only to the extent of the defendants’ considerable influence and control over the relevant municipal agencies, and to the extent of those officials and departments who were wittingly or unwittingly involved in the various schemes. Being named in the enterprise does not make the City itself criminally or civilly liable under RICO.<sup>9</sup> It bears repeating that the RICO statute defines “enterprise” broadly and that the Supreme Court has consistently instructed that we read the overall statute expansively. See *Turkette*, 452 U.S. at 586–87, 101 S.Ct. 2524; *Sedima, S.P.R.L.*, 473 U.S. at 497–98, 105 S.Ct. 3275. A liberal construal of the RICO statute and in particular, the term “enterprise,” leads us to the conclusion that the enterprise, as charged, is supported by the evidence.

<sup>8</sup> We distinguish Judge Howard’s law firm hypothetical on the same basis by which defendants’ criminal purpose is imputed to the City: that defendants, as City officials and leaders, had effective titular and actual control over these municipal agencies. The same presumably cannot be said for the hypothetical Providence law firm.

<sup>9</sup> The definitions of an enterprise in the RICO statute and the jury instructions in no way require an enterprise to include nothing but criminal actors. To the contrary, a legitimate business, exploited by racketeers, may be an enterprise. It is true that members of an association-in-fact enterprise, such as is now charged, must be connected by a common thread of purpose; and one might often expect such a purpose to be of a criminal nature. See *Turkette*, 452 U.S. at 578, 101 S.Ct. 2524. But the ultimate question is whether an association-in-fact exists.

For this, it is not required that each participant have a separate mens rea so long as each can reasonably be said to share in the common purpose. The City’s role here in the overall plans of the defendants suffices for it be part of the association-in-fact enterprise.

#### C. Pattern of racketeering activity

[11] Defendants also argue that there was insufficient evidence of a pattern of racketeering activity. For purposes of a RICO conspiracy, the sufficiency questions boils down to whether a jury could have found that the defendants intended to further an endeavor which, if completed, would have satisfied the “pattern” requirement of RICO. See *Salinas v. United States*, 522 U.S. 52, 61–66, 118 S.Ct. 469, 139 L.Ed.2d 352 (1997); *United States v. Edwards*, 303 F.3d 606, 642 (5th Cir.2002). Here, the evidence shows that the endeavor resulted in a series of completed crimes. Evidence of all nine schemes enumerated in the indictment, including the two that underlie Corrente’s substantive RICO conviction, shows a pattern of racketeering activity.

[12] Two or more RICO predicate acts form a “pattern” if they are (1) “related” and (2) “amount to or pose a threat of continued criminal activity.” *H.J., Inc. v. Northwestern Bell Tel. Co.*, 492 U.S. 229, 239, 109 S.Ct. 2893, 106 L.Ed.2d 195 (1989); *Systems Mgmt., Inc. v. Loiselle*, 303 F.3d 100, 105 (1st Cir.2002).

[13] Predicate acts are “related” for RICO purposes if they “have the same or similar purposes, results, participants, victims, or methods of commission, or otherwise are interrelated by distinguishing characteristics and are not isolated events.” *H.J., Inc.*, 492 U.S. at 240, 109 S.Ct. 2893 (quotation marks omitted). We must bear in mind that “a criminal enterprise is more, not less, dangerous if it is versatile, flexible, diverse in its objectives and capabilities. Versatility, flexibility, and diversity are not inconsistent with pattern.” *Masters*, 924 F.2d at 1367.

\*89 The evidence shows that the defendants, and ultimately Cianci, were the beneficiaries of most if not all of the nine schemes. The jury could have concluded that the schemes were designed to line Cianci’s pockets as well as to maintain his political power in the City. As for methods, most of the schemes involved either Cianci or Corrente calling or personally meeting with city officials and influencing municipal decision-making either through explicit or implicit orders. As the government points out, important “sub-trends”

underlay the schemes. The Jere Realty Lease and the Freitas Lease dealt with the School Department. The Tow List and Maggiamo Job involved the Police Department. The Ise and Maggiamo Jobs both involved pawning of municipal jobs. Both the Ronci Estate and Freitas Lots schemes involved extortions for tax abatements. All of the offenses involve trading jobs, contracts, and official acts for money, contributions to Cianci's political fund, or other items of value. In most of the schemes, the money was solicited by, paid to, or collected by Corrente.

In addition, the schemes often shared the same players. Corrente, Ead, Pannone, and Autiello were all fundraisers for the Friends of Cianci. Ead participated in the Ronci Estate, the Ise Job, and the Freitas Lots schemes, while Pannone played important roles in the Ronci Estate, the Freitas Lease, and Pay-to-Get-Paid schemes. Autiello was the chief associate in the Tow List extortion and Maggiamo Job sale. Overall, the evidence shows that the individual racketeering acts were not isolated events but rather parts of a pattern of racketeering activity contemplated and committed by an overarching RICO conspiracy to which all three defendants, along with other co-conspirators, belonged.

[14] “Continuity” of the pattern of racketeering may be shown by either “a series of related predicates extending over a substantial period of time,” or a pattern of more limited duration where “the racketeering acts themselves include a specific threat of repetition extending indefinitely into the future” or “the predicate acts or offenses are part of an ongoing entity's regular way of doing business.” *H.J., Inc.*, 492 U.S. at 242, 109 S.Ct. 2893.

Defendants were accused of conducting a RICO conspiracy that lasted nine years. The Tow List scheme spanned approximately the entire period. During this time, Autiello regularly channeled contributions to Corrente. When towers contributed too much money under the same name, the conspirators scrambled to find other straw contributors, or “replacement” contributors.

The Jere Realty and Freitas Lots schemes both involved kickbacks to the defendants in exchange for pressure on the City to grant leases. As the district court concluded, “[I]t was reasonable for the jury to infer that additional payments would be made in order to renew the lease[s].” The Pay-to-Get-Paid scheme presented the same danger: “[T]he City's habitual tardiness in paying its vendors, and the period of time over which Freitas made payments to expedite payment of his

invoices, provided ample justification for the jury to conclude that such payments would continue to be made in the future.”

Evidence concerning the Ise and Maggiamo Jobs, both transpiring in 1996, was enough for the jury to conclude that these bribes were part of the same, continuous pattern that these jobs in the City could be had for a price. The Freitas Lots, Freitas Lease, and Freitas Invoices schemes revolved around deals with Anthony Freitas, whose testimony revealed an especially active \*90 stage of the conspiracy in 1998 and 1999.

There is no need to go into more detail. The evidence speaks more than enough to the conclusion that the jury could have found the requisite “pattern of racketeering activity” here.

#### D. Conspiracy

[15] [16] Based on the same evidence, the jury could have found a conspiracy involving all three defendants. We reiterate that RICO conspiracy does not require proof that a defendant “himself committed or agreed to commit the two predicate acts requisite for a substantive RICO offense under § 1962(c).” *Salinas*, 522 U.S. at 61–66, 118 S.Ct. 469. Rather, he “must intend to further an endeavor which, if completed, would satisfy all of the elements of a substantive criminal offense, but it suffices that he adopt the goal of furthering or facilitating the criminal endeavor.” *Id.* at 65, 118 S.Ct. 469. We have noted that “[t]he conspiratorial agreement need not be express so long as its existence can plausibly be inferred from the defendants' words and actions and the interdependence of activities and persons involved.” *United States v. Boylan*, 898 F.2d 230, 241–42 (1st Cir.1990). The evidence, detailed above and throughout this opinion, amply fills this requirement.

As for Cianci, Ead's testimony placed Cianci at the head of the Ronci Estate, Ise Job, and Freitas Lots schemes. Taped remarks by Corrente implicated Cianci in the Freitas Lease. Corrente's position as Cianci's Director of Administration is itself circumstantial evidence of Cianci's conspiratorial involvement.

Corrente was implicated in at least five of the nine racketeering schemes. He initiated the Tow List scheme and played a major part in maintaining it throughout the duration of the conspiracy. Corrente received cash payments as part of the Jere Realty, Ronci Estate, Freitas Lease, and Pay-to-Get-Paid schemes.



Testimony by Kenneth Rocha, the chairman of the towers' association, revealed that Autiello was the point person for towers when it came time to make contributions to Cianci's political fund. Autiello took in the payments and reminded towers when their payments were due. As for Autiello's part in the Maggiocomo Job scheme, Mary Maggiacommo testified that she asked Autiello, who was in charge of maintenance of police cruisers, to help her son obtain a job on the City force. She delivered the \$5,000 payment to him. When her son was ultimately denied admission into the police, Autiello refused to return the payment to Mrs. Maggiacommo.

#### E. Special verdict

[17] At the government's request, the district court submitted to the jury a special verdict form. Under the substantive RICO count (Count Two), the verdict form contained special interrogatories for each of the RICO predicates, listing them separately for each defendant. For each of the RICO predicates, the form asked the jury to check off "yes" or "no" to indicate whether the government had proven the predicate with respect to each defendant. As to Cianci, the jury returned the verdict form with "no" checked for every box (except one) indicating the government had not proven those racketeering acts. The one unchecked box was for Act Ten (University Club); we offer no opinion on why the jury decided to leave it blank. For Corrente, the jury checked off "no" for all racketeering acts except Act Eight (Freitas Lease) and Act 9(a) ("Pay-to-Get-Paid"), for which the jury checked off "yes." For Autiello, the jury checked off "no" for all racketeering acts except Act Twelve (Maggiacommo job), which the jury \*91 concluded the government had proven. Ultimately, only Corrente was convicted on Count Two, substantive RICO, and all three defendants were found guilty on Count One, RICO conspiracy.

[18] Defendants argue that the jury's responses to the interrogatories in the special verdict form under Count Two (the substantive RICO count) should bear on the verdict as to Count One (the RICO conspiracy). They claim that the jury's negative responses to these interrogatories indicate their rejection of the evidence proffered by the government for each of those offenses to which the jury responded "no." Defendants further contend that given the jury's specific findings, the evidence is insufficient to support the conspiracy verdict as a matter of law. They postulate that the specific purpose of the special verdict form is to limit the facts found at trial for the purpose of assessing on appeal the sufficiency of the prevailing party's case. Ordinarily, when a jury returns a general verdict of guilty on a *substantive* RICO count and one

of the predicate acts is later found to be legally insufficient by a reviewing court, the conviction must be overturned where it is impossible to determine whether two legally sufficient predicate acts support a RICO conviction. See *United States v. Holzer*, 840 F.2d 1343, 1352 (7th Cir.1988); *United States v. Kragness*, 830 F.2d 842, 861 (8th Cir.1987).

[19] The special verdict form allows juries to specifically identify the predicates for the general verdict. In *United States v. Torres Lopez*, 851 F.2d 520 (1st Cir.1988), we reversed a *substantive* RICO conviction where the jury's responses to interrogatories on a special verdict form properly related to the substantive conviction revealed that the government proved only time-barred predicates. The defendants in that case argued that as indicated by the special verdict, the jury found them guilty of only two predicates. When both of those predicates were shown to be outside the statute of limitations, we overturned the substantive RICO conviction. Other circuits have employed the special verdict form similarly. See *United States v. Edwards*, 303 F.3d 606 (5th Cir.2002) (court used special verdict to uphold RICO conviction as being based on two valid predicates); *United States v. Kramer*, 73 F.3d 1067 (11th Cir.1996) (money laundering conviction cannot stand where special verdict established defendant involvement in only foreign transactions).

The government counters that defendants' argument fails under the doctrine articulated by the Supreme Court in *Dunn v. United States*, 284 U.S. 390, 52 S.Ct. 189, 76 L.Ed. 356 (1932) and *United States v. Powell*, 469 U.S. 57, 105 S.Ct. 471, 83 L.Ed.2d 461 (1984). In both cases, the Court held that acquittals on certain counts of an indictment play no role in the analysis of whether there is sufficient evidence supporting the surviving counts. *Powell*, 469 U.S. at 64–69, 105 S.Ct. 471; *Dunn*, 284 U.S. at 392–94, 52 S.Ct. 189; see also *United States v. Alicea*, 205 F.3d 480 (1st Cir.2000). The reasoning is that a jury's decision to acquit on a particular count or counts may well be the product of "mistake, compromise, and lenity" and "a criminal defendant already is afforded protection against jury irrationality or error by the independent review of the sufficiency of the evidence undertaken by the trial and appellate courts."<sup>10</sup> *Powell*, 469 U.S. at 65–67, 105 S.Ct. 471. The Court was \*92 concerned with the impracticality of a rule that would allow defendants to challenge inconsistent verdicts where such a challenge was speculative or would require inquiries into the jury's deliberations. See *id.* at 68, 105 S.Ct. 471.

10 This rationale applies more directly to defendants' other argument that the jury's acquittals on the substantive, non-RICO counts should influence our review of the sufficiency of the evidence on the RICO conspiracy count.

[20] The defendants claim that neither *Powell* nor *Dunn* undermines the purpose and viability of special verdict forms in defining the universe of resolved facts. They assert that in this case, we should exempt from our sufficiency review those pieces of evidence that have “been conclusively contradicted[.]” *Chongris v. Bd. of Appeals*, 811 F.2d 36, 37 (1st Cir.1987). In reviewing a criminal conviction for sufficiency, we do not assess the credibility of the witnesses, “which is the sole function of the trier of fact.” *Burks v. United States*, 437 U.S. 1, 16, 98 S.Ct. 2141, 57 L.Ed.2d 1 (1978); *Torres Lopez*, 851 F.2d at 527.

We have been steadfast with *Powell* and have repeatedly refused to carve out exceptions to the rule. *United States v. Bucuvalas*, 909 F.2d 593, 595–97 (1st Cir.1990) (adhering to *Powell* rule in affirming bribery conspiracy conviction of defendant, where jury acquitted all of the charged conspirators except defendant); *Alicea*, 205 F.3d at 484 (“[I]n a single, multi-count trial, acquittal on one or more counts does not preclude conviction on other counts based upon the same evidence, as long as that evidence is legally sufficient to support a finding of guilt on the count(s) of conviction.”); see also *United States v. Richard*, 234 F.3d 763, 768 (1st Cir.2000); *United States v. Hernandez*, 146 F.3d 30, 33 (1st Cir.1998); *United States v. Crochiere*, 129 F.3d 233, 239 (1st Cir.1997).

We are similarly hard pressed to make an exception here. The RICO conspiracy count and substantive RICO count are *separate*. The list of racketeering acts to which the jury answered interrogatories is part of the substantive RICO count only. The government requested the form so that if the jury did convict on substantive RICO, the conviction would be buttressed by express jury findings as to the two-predicate requirement. The jury appears to have understood the two-predicate requirement, in that it checked off two predicates (extortion conspiracies for the Freitas Lease and “Pay-to-Get-Paid” schemes) for Corrente, who was the only defendant convicted on the substantive RICO count. No predicates were checked off for Cianci, and only one (bribery conspiracy in connection with the Maggiacomo Job) was found proven for Autiello; hence, neither was convicted of substantive RICO.

The “separate-ness” of the counts in the indictment, however, is not the central point of contention in this issue. *Powell*, 469 U.S. at 64, 105 S.Ct. 471. Defendants concede that “a person may be convicted of *RICO* conspiracy and acquitted of all substantive acts.” (emphasis added). If proof of the requisite criminal agreement exists, “whether or not the substantive crime ensues” is irrelevant. *Salinas*, 522 U.S. at 65, 118 S.Ct. 469. Hence, the jury did not go out-of-bounds by convicting on the RICO conspiracy count while concluding the government failed to prove certain predicate racketeering acts underlying the substantive RICO count. See *United States v. Weiner*, 3 F.3d 17, 22 (1st Cir.1993) (“[D]espite the dismissal of the separate [substantive] counts, the jury was entitled to consider the evidence [underlying those substantive counts] in support of the RICO counts”).

Most instructive is *United States v. Connolly*, 341 F.3d 16 (1st Cir.2003), where we upheld a substantive RICO and RICO conspiracy conviction. The defendant contended that the government's failure to prove an “enterprise” was evidenced by \*93 the jury's finding that nine of fourteen racketeering acts listed in the indictment had not been proven beyond a reasonable doubt. Specifically, the defendant argued that the evidence did not establish that the charged enterprise was “continuous” or “ongoing.” We stated that

simply because the jury found a specified racketeering act as “unproven beyond a reasonable doubt” does not mean that the jury found the evidence relating to that act unpersuasive, in combination with other evidence in the case, on the existence of an association-in-fact enterprise. Rather, it may only mean that the government did not prove a requisite element of the underlying crime alleged as a racketeering act.... In returning a finding of “unproven,” the jury could have concluded that the evidence underlying a [particular racketeering act], while failing to [prove all the elements of the crime committed by the act], nevertheless demonstrated a corrupt gratuity evidencing the existence of an illegal enterprise.

*Id.* at 26–27. The evidence relating to those acts that were found “unproven” by the jury was still available to the jury in its evaluation of the overall RICO charge. “That being so, the inquiry on appeal is whether the jury, in light of the totality of the evidence, was presented with sufficient evidence of “continuity” to support a conviction.” *Id.* at 27. The jury verdict may be a compromise reflecting evil preparations by all three defendants but some doubt about implementation by Cianci and Autiello. In other words, though the evidence might not have shown completed commission of the racketeering acts, it could have led the jury to find the requisites of a RICO *conspiracy* among the defendants to commit the racketeering acts.

#### F. Amendment and variance

[21] Defendants claim that the district court was only able to deny their dismissal motions by constructively amending the indictment. They point to the court's statement, in denying these motions, that “it seems to the Court that the indictment alleges that what the Defendants are accused of doing is having conducted the affairs of the City through a pattern of racketeering activity.” Defendants also claim that post-trial, the district court erroneously concluded that the indictment could have alleged that the City was an innocent, unwitting participant in the criminal enterprise. This, defendants contend, conflicts with how they understood the indictment—that the City was a culpable participant in the RICO enterprise—and hence constituted a constructive amendment of the indictment.

[22] [23] An amendment of the indictment occurs when the charging terms of the indictment are altered, either literally or in effect, by the prosecutor or the court after the grand jury has returned the indictment. *United States v. Dubon-Otero*, 292 F.3d 1 (1st Cir.2002). Amending the indictment is considered prejudicial *per se* and thus demands reversal. *Id.* at 4. The government argues that regardless of the alleged disparity between the indictment and the trial judge's characterization thereof, there was no constructive amendment where the court instructed the jury “on the theory as charged.” Indeed, the court specifically instructed, without objection from either party, that “the Government must prove that the Defendant[s] knowingly and willfully joined the conspiracy with knowledge of its unlawful purpose and with the intent that the purpose would be accomplished.”

We find defendants' claimed understanding of the illicit-purpose RICO enterprise charged in the indictment to be

both inaccurate \*94 and disingenuous. The indictment does not compel a reading that the City itself (or its constituent agencies) had to be found criminally culpable, as we explain in more detail *supra*. Defendants allude to *United States v. Weissman*, 899 F.2d 1111, 1115 (11th Cir.1990), where the Eleventh Circuit held that the district court's jury charge “in effect altered an essential element of the crime charged” in the indictment. Here, the charge was taken largely from the indictment. No intimations by the court recast the “essential” elements of RICO outlined in the indictment. At no point, pre-trial or post-trial, did the district court transform the charged association-in-fact enterprise into a legal-purpose or legal-entity enterprise. The court's descriptions of the enterprise were in accord with the breadth of the enterprise charged in the indictment and the breadth the Supreme Court has assigned to RICO overall.

[24] [25] Alternatively, defendants contend that disparities between the indictment and the evidence resulted in a prejudicial variance. “A variance arises when the proof at trial depicts a scenario that differs materially from the scenario limned in the indictment.” *United States v. Villarman-Oviedo*, 325 F.3d 1, 12 (1st Cir.2003) (internal quotation marks omitted). A variance requires reversal only when it is “both material and prejudicial, for example, if the variance works a substantial interference with the defendant's right to be informed of the charges laid at his doorstep.” *Id.* (internal quotations marks omitted).

First, we reiterate that the jury's acquittals on the substantive counts and negative decisions on the racketeering acts listed under Count Two do not make the evidence underlying those counts and acts irrelevant to the RICO conspiracy count. Second, we repeat that the evidence as a whole, viewed in the light most favorable to the verdict, is sufficient as to the RICO conspiracy convictions for all three defendants. Accordingly, defendants' reliance on *United States v. Morales*, 185 F.3d 74 (2d Cir.1999) (reversing RICO convictions where evidence established that defendants had all been incarcerated early in the period of racketeering activity alleged in the indictment), is misplaced. The evidence at trial, covering acts that occurred from 1991 to 1999 as charged in the indictment, tracked and satisfied the RICO elements and factual allegations contained in the indictment.

#### G. “Associate” Liability

[26] Autiello, and Corrente by adoption, argues that the court's instructions on “associate” liability under RICO failed to comply with the standard set out by the Supreme

Court in *Reves v. Ernst & Young*, 507 U.S. 170, 113 S.Ct. 1163, 122 L.Ed.2d 525 (1993). The Court in *Reves* created the “operation management” test for determining RICO “associate” liability. In order to have taken part in, or associated with the conduct of an enterprise, an “associate” must have had some part in directing those affairs of the enterprise. *Id.* at 177–78, 113 S.Ct. 1163. The Court also stated that “an enterprise is operated not just by upper management but also by lower-rung participants in the enterprise who are under the direction of upper management.” *Id.* at 184, 113 S.Ct. 1163. The Court further elucidated:

Of course, the word “participate” makes clear that RICO liability is not limited to those with primary responsibility for the enterprise's affairs, just as the phrase “directly or indirectly” makes clear that RICO liability is not limited to those with a formal position in the enterprise, but some part in directing the enterprise's affairs is required. The “operation \*95 or management” test expresses this requirement in a formulation that is easy to apply.

*Id.* at 179, 113 S.Ct. 1163.

Autiello and Corrente argue that the district court “watered down” the government's burden of proof in its jury instruction on “associate” RICO liability.<sup>11</sup> Specifically, they claim that the instructions permitted conviction for performing acts without control over some part of the “direction” of the enterprise.

<sup>11</sup> The court instructed, in relevant part: “I told you that the Government has to prove that a Defendant is employed by or associated with an enterprise. A person is considered to be associated with an enterprise if he or she knowingly participates directly or indirectly in the conduct of the enterprise's affairs or business. A person doesn't have to have a formal relationship with or an official position in an enterprise in order to be associated with that enterprise.

Association may include an informal relationship or agreement between a person and an enterprise. A person also may be associated with an enterprise even though his or her role is a relatively minor role, just as the case with respect to conspiracy. ... In order to establish that Defendant conducted or participated directly or indirectly in the conduct of an enterprise's affairs, the Government must prove that the Defendant played some part in the operation or management of the enterprise. Conducting or participating in the conduct of an enterprise's affairs includes things like performing acts, function or duties which are related to the operation of the enterprise. The Government doesn't have to prove that a Defendant exercised significant control over or within the enterprise, and the Government doesn't have to prove that the Defendant was an upper echelon member of the enterprise.

An enterprise is operated not only upper management but also by lower rung participants who work under the direction of the managers of the enterprise.”

We find no merit in defendants' objection. The instructions did not misstate the law; in fact, they reflected *Reves* nearly verbatim. Defendants argue that the buzz word on “associate” liability is that an associate “direct” or be “integral” to the affairs of the enterprise. The crucial words, however, are “operation and management,” which effectively communicate to a jury that in order for a defendant to have been an associate of the RICO enterprise, his participation needs to have had “an element of direction” of the enterprise's affairs. *Id.* at 178, 113 S.Ct. 1163; *United States v. Marino*, 277 F.3d 11, 33 (1st Cir.), cert. denied, 536 U.S. 948, 122 S.Ct. 2639, 153 L.Ed.2d 819 (2002); *United States v. Oreto*, 37 F.3d 739, 750 (1st Cir.1994). The court more than sufficiently accounted for this requirement by instructing that the defendant must have “played some part in the operation or management of the enterprise.”

In general, we have fashioned the *Reves* “operation or management” test in accordance with the breadth with which we must construe RICO:

The requirement of association with the enterprise is not strict. The RICO net is woven tightly to trap even the smallest fish, those peripherally



involved with the enterprise. The RICO statute seeks to encompass people who are merely associated with the enterprise. The defendant need only be aware of at least the general existence of the enterprise named in the indictment, and know about its related activities.

*Marino*, 277 F.3d at 33 (citations and internal quotations omitted). Hence, as an evidentiary matter, the government presented more than enough to establish that, if there was an enterprise, the two, at various times, played important roles in the direction and supervision of the enterprise's operations. Neither was merely "peripherally involved with the enterprise." \*96 The direct testimony of Kenneth Rocha demonstrated that not only was Autiello aware of the general existence of the enterprise, but that he was central to furthering the goals of the enterprise, specifically as the collection agent for Corrente in obtaining payments from the Tow List members. His participation in the Maggiacomo Job scheme again evinced his awareness of the general enterprise as well as his direct involvement in the direction and management of the enterprise. As for Corrente, we need not rehash the evidence that amply establishes his role in the enterprise. The fact that he was Cianci's right-hand man, in addition to evidence specifically showing his directorial or supervisory involvement in individual racketeering acts, puts him in the heartland of "associate" RICO liability as set out in *Reves*.

## II. The Joint Federal Bribery Conspiracy Convictions (Corrente and Autiello)

In relevant part, the federal bribery statute provides:

(a) Whoever, if the circumstance described in subsection (b) of this section exists—

(1) being an agent of an organization, or of a State, local, or Indian tribal government, or any agency thereof-

\* \* \*

(B) corruptly solicits or demands for the benefit of any person, or accepts or agrees to accept, anything of value from any person, intending to be influenced or rewarded in connection with any business, transaction, or series of

transactions of such organization, government or agency involving any thing of value of \$5000 or more ...

\* \* \*

shall be fined under this title, imprisoned not more than 10 years, or both.

(b) The circumstance referred to in subsection (a) of this section is that the organization, government, or agency receives, in any one year period, benefits in excess of \$10,000 under a Federal program involving a grant, contract, subsidy, loan, guarantee, insurance, or other form of Federal assistance.

18 U.S.C. § 666(a)(1)(B). Corrente and Autiello were convicted of conspiring to violate this statute, *see* 18 U.S.C. § 371, for their roles in the Tow List scheme. The government's theory was that, in requiring "campaign contributions" from those who wished to remain on the police department's tow list, Corrente (in cahoots with Autiello, who acted as the towers' agent) acted as an "agent" of the police department within the meaning of subsection (a)(1). The department qualified as an "agency" under subsection (b) because it received an average of about \$1 million in federal aid annually (and never less than \$10,000) between 1991 and 1999. A portion of that aid (conferred in connection with a federal anti-domestic violence program) was used in and around 1996(1) to train dispatchers for the police unit that, among their other duties, called companies on the City's tow list when towing was needed, and (2) to purchase the communications and computer equipment used by the dispatchers who made these calls.

[27] Corrente and Autiello argue that their convictions cannot stand because there is insufficient evidence of a connection between their conduct and the federal funds received by the police department. The district court instructed the jury, without objection, that such a connection is required. The court described the connection (in relevant part) as follows: "[T]he Government must ... prove that there is some connection between the alleged bribe \*97 and the federal funds received by the local government or agency...." Corrente and Autiello contend that the "federal funds" evidence described in the preceding paragraph is patently inadequate to ground a finding that such a connection existed in this case.

The two concede that the statute itself does not require that the offense conduct have an effect on the federal

funds. See *Salinas*, 522 U.S. at 61, 118 S.Ct. 469 (“[A]s a matter of statutory construction, § 666(a)(1)(B) does not require the Government to prove the bribe in question had any particular influence on federal funds ....”) (emphasis supplied). They also acknowledge that, at the time of oral argument, a post-*Salinas* circuit split had emerged over whether, as a statutory and/or constitutional matter, *some* connection between the offense conduct and a federal interest (if not federal funds themselves) was required. Compare, e.g., *United States v. Zwick*, 199 F.3d 672, 682–88 (3d Cir.1999) (treating the statute as having been enacted under the Spending Clause and holding, in part because the Constitution requires that “legislation regulating behavior of entities receiving federal funds must ... be based upon a federal interest in the particular conduct,” (citing *South Dakota v. Dole*, 483 U.S. 203, 207, 107 S.Ct. 2793, 97 L.Ed.2d 171 (1987))), that the statute requires the government to prove that a federal interest is implicated by the offense conduct), and *United States v. Santopietro*, 166 F.3d 88, 92–93 (2d Cir.1999) (similar, endorsing the post-*Salinas* vitality of prior Second Circuit law interpreting the statute to require that the offense conduct threaten the integrity and proper operation of a federal program), with, e.g., *United States v. Sabri*, 326 F.3d 937, 940–53 (8th Cir.2003) (no connection between the offense conduct and a case-specific federal interest is required by either the Constitution or the statute, which was lawfully enacted under the Necessary and Proper Clause and not the Spending Clause).

Unsurprisingly, Corrente and Autiello prefer the approach exemplified by *Zwick* and *Santopietro*. They emphasize that *Salinas* explicitly left open whether *some* connection between the offense conduct and a federal interest is required for the statute to be constitutionally applied. See 522 U.S. at 60–61, 118 S.Ct. 469 (declining to decide the broader constitutional issue because the statute was constitutionally applied on the case facts). They argue that requiring a connection such as the one identified in *Zwick* and *Santopietro* is necessary to maintain an appropriate state–federal balance in a criminal law area that has been the traditional province of the states.

While these appeals were under advisement, the Supreme Court granted a writ of certiorari in *Sabri* and resolved the circuit split in favor of the position adopted by the Eighth Circuit. See *Sabri v. United States*, 541 U.S. 600, 124 S.Ct. 1941, 1945–49, 158 L.Ed.2d 891 (2004). If error can be “plain” within the meaning of Fed.R.Crim.P. 52(b) even if it only becomes so while the case in which it is raised is on appeal, see *Johnson v. United States*, 520 U.S. 461,

467–68, 117 S.Ct. 1544, 137 L.Ed.2d 718 (1997), we see no reason why it should not also be “patent” for purposes of applying the *Zanghi* principle, see 189 F.3d at 79–80, discussed and applied *supra* at 84–85. Because application of *Zanghi* requires that we disregard the nexus instruction upon which Corrente and Autiello base their sufficiency challenges to their joint federal bribery conspiracy convictions, we must reject those challenges.

### III. The Remaining Convictions

#### A. Federal Bribery Conspiracy (Autiello)

[28] Autiello argues that there was insufficient evidence to support his conviction \*98 for federal bribery conspiracy in connection with the Maggiacomo Job scheme. Autiello contends that, because there was no direct evidence about either the identity of his co-conspirator or the fate of the \$5,000 Mary Maggiacomo paid him, the evidence gave nearly equal circumstantial support to an inference that he pocketed the money as a payment for *his* efforts with the police department (with which he had influence) on behalf of Joseph Maggiacomo as it did to an inference that he passed the bribe along to some public official, or at least conspired to do so. See *United States v. Andujar*, 49 F.3d 16, 20 (1st Cir.1995) (“If the evidence viewed in the light most favorable to the prosecution gives equal or nearly equal circumstantial support to a theory of guilty and a theory of innocence of the crime charged, this court must reverse the conviction.”) (citation and internal quotation marks omitted). The argument is unconvincing.

There was evidence that, during a face-to-face meeting in which his favorable intercessions were sought, Autiello told Mary Maggiacomo and her husband that Providence police officer positions were prized and that Joseph Maggiacomo's chances were not good because the Maggiacomos were not Providence taxpayers and had not made any “contributions.” In nearly the same breath, Autiello told them that, if they wanted Joseph to be accepted into the police academy, they would have to come up with \$5,000 in cash. The juxtaposition of these two comments, combined with the evidence that Autiello himself held no authority to make police academy admission decisions, permitted a reasonable inference that the \$5,000 was to be a political “contribution” that would serve as Joseph's ticket of admission when passed along to someone with authority over academy admission decisions.

#### B. Hobbs Act Attempted Extortion and Extortion Conspiracy (Corrente)



Corrente makes three arguments in favor of reversing or vacating his convictions for Hobbs Act attempted extortion and Hobbs Act extortion conspiracy in connection with the Freitas Lease and Freitas Invoices schemes: (1) there was insufficient evidence that these schemes had the constitutionally required impact on interstate commerce; (2) there was insufficient evidence that he affirmatively acted in such a way as to be fairly accused of having attempted or conspired to engage in extortion; and (3) the district court's jury instructions erroneously described what was required to establish an attempt or conspiracy to engage in extortion. There is some question whether each of these arguments was made below as to each of the three convictions, but we bypass issues of forfeiture because none of the arguments is persuasive on its merits.

Corrente's first argument is largely based on an assertion that his convictions are unconstitutional because his offense conduct had to, but did not, have more than a de minimis effect on interstate commerce in order to jibe with the Supreme Court's decisions in *United States v. Lopez*, 514 U.S. 549, 115 S.Ct. 1624, 131 L.Ed.2d 626 (1995), and *United States v. Morrison*, 529 U.S. 598, 120 S.Ct. 1740, 146 L.Ed.2d 658 (2000). After briefs were filed in this case, another panel of the court rejected this argument, *United States v. Capozzi*, 347 F.3d 327, 334–336 (1st Cir.2003), so we must reject it too, see, e.g., *United States v. Downs–Moses*, 329 F.3d 253, 263 (1st Cir.2003).

Corrente alternatively argues that no reasonable factfinder could have found that his offense conduct had such a de minimis effect. He is wrong.

\*99 [29] With respect to Corrente's attempted extortion in connection with the Freitas Lease scheme, the jury could have found that, but for Freitas' agreement to pay Corrente for favorable intervention on his behalf with the school department, there was a realistic probability that the City contractor (an entity engaged in interstate commerce and whose lease agreement would be a transaction affecting interstate commerce<sup>12</sup>) would have leased space in Cranston, Rhode Island. This evidence alone satisfies constitutional concerns, even if the space for which Corrente advocated actually proved to be a better fit for the contractor. See *Capozzi*, 347 F.3d at 335 (extortionate conduct need only create a realistic probability of an effect on interstate commerce) (citations omitted); *id.* at 337 (conviction for attempted extortion requires only a showing that the identified effect would have occurred had the defendant succeeded in

the extortion); *United States v. Tormos–Vega*, 959 F.2d 1103, 1113 (1st Cir.1992) (extortionate conduct meets constitutional requirements even where it “has a beneficial effect on interstate commerce”) (citation and internal quotation marks omitted); *id.* (where the victim's acquiescence in an extortion results in a transaction with effects on interstate commerce, constitutional concerns are satisfied).

12 The contractor, the Marriott Corporation, supplied lunches and custodial services to all Providence schools. There was evidence that the company was incorporated in New York and had offices in Washington, D.C., and Newark, Delaware.

[30] With respect to the Freitas Invoices scheme, the jury could have found that a city contractor that was indisputably engaged in interstate commerce was deprived of \$1,100 in order to facilitate payments to which it was entitled. This was enough. See *Capozzi*, 347 F.3d at 337 (“One common method for the government to establish the required ‘de minimis effect’ on interstate commerce is to show that the defendant's activity “minimally depletes the assets of an entity doing business in interstate commerce.””) (quoting *United States v. Nguyen*, 246 F.3d 52, 54 (1st Cir.2001)).

Corrente's other two arguments are very difficult to follow. In the main, they appear to be interrelated attacks on the correctness of *Evans v. United States*, 504 U.S. 255, 112 S.Ct. 1881, 119 L.Ed.2d 57 (1992). *Evans* interpreted the provision of the Hobbs Act under which Corrente was convicted—one which prohibits extortion by means of “the obtaining of property from another, with his consent, ... [2] under color of official right,” 18 U.S.C. § 1951(b)(2)—not to require that the government prove that the defendant initiated the extortionate transaction or otherwise induced the payments. Rather, “the Government need only show that a public official has obtained a payment to which he was not entitled, knowing that the payment was made in return for official acts.” *Id.* at 268, 112 S.Ct. 1881. Corrente appears to believe that the *Evans* Court erred in concluding that the defendant need not induce the payment or otherwise initiate the event. See Corrente Br. at 49. To the extent that he is so arguing, Corrente acknowledges that we are powerless to grant him relief and that he must go to the Supreme Court. *Id.*

There are hints of other arguments in Corrente's brief, but none is sufficiently developed to warrant consideration on the merits. See *United States v. Zannino*, 895 F.2d 1, 17 (1st Cir.1990). In any event, our review of the record convinces

us that there is no basis for reversing or vacating Corrente's attempted extortion and extortion conspiracy convictions.

\***100** Any sufficiency challenge is doomed because there was sufficient evidence to support the convictions even under the more demanding interpretation of the Hobbs Act for which Corrente advocates. With respect to the Freitas Lease scheme, the jury could have found that Corrente “induced” payments from Freitas when, at one point prior to receiving any money related to this scheme, he suggested to Freitas that City Hall could either hurt or help his chances of securing the lease (depending, presumably, on whether Freitas anted up). With respect to the Freitas Invoices scheme, the jury could have found that Pannone, Corrente's co-conspirator, induced payments on Corrente's behalf by encouraging Freitas to “throw something” at Corrente—i.e., to “pay to get paid.”

So too with the jury instructions. As clarified in a supplemental charge just prior to the return of the verdicts, the instructions on the attempted extortion and extortion conspiracy charges were, if anything, overly generous to Corrente. And because the evidence was sufficient to support the convictions even under the arguably too lenient instructions, any error was harmless. *See Fed.R.Crim.P. 52(a); United States v. Royal*, 100 F.3d 1019, 1027 (1st Cir.1996).

#### IV. Admission of the Pannone Tapes

Defendants contend that the district court violated various Rules of Evidence and their confrontation and due process rights in admitting into evidence certain tape-recorded conversations among Freitas (who was acting as a government agent), Pannone, the Chairman of the Board of Tax Assessment Review and an alleged co-conspirator, and various other individuals, some identified and others not. They also argue that the court erred in precluding them from interposing objections to the admission of these tape recordings for their failure to abide by a procedural order requiring that Rule 403 and 404(b) objections be identified with specificity in advance of trial.

##### A. *Petrozziello* determination

[31] Defendants argue that the district court erred when it concluded that Pannone's statements fell outside of the hearsay rule under *Fed.R.Evid. 801(d)(2)(E)*.<sup>13</sup> We review this determination for clear error. *United States v. Geronimo*, 330 F.3d 67, 74 (1st Cir.2003); *Marino*, 277 F.3d at 25. In determining whether the Government has met *Rule 801(d)(2)(E)* prerequisites, the district court must determine that it

is “more likely than not that the declarant and the defendant were members of a conspiracy when the hearsay statement was made, and that the statement was in furtherance of the conspiracy.” *United States v. Petrozziello*, 548 F.2d 20, 23 (1st Cir.1977). We refer to this determination as a “*Petrozziello* ruling.” *Geronimo*, 330 F.3d at 75.

13 “A statement is not hearsay if ... [t]he statement is offered against the party[-opponent] and is ... a statement by a coconspirator of a party during the course and in furtherance of the conspiracy.” *Fed.R.Evid. 801(d)(2)(E)*.

[32] Defendants contend that there was “scanty” evidence of a conspiracy among defendants and Pannone. They argue that Pannone's taped statements were unreliable and there was insufficient extrinsic evidence of the conspiracies because some of the conversations on the tape were “rambling and unfocused” and not all of the defendants were ultimately convicted as part of the three racketeering acts—the Ronci Estate, Freitas Lease, and Freitas Invoices schemes—of which Pannone had first-hand knowledge.

\***101** We disagree. As we have detailed *supra*, the government presented sufficient evidence of a RICO conspiracy—conspiracy, enterprise, and pattern of racketeering activity—to satisfy the evidentiary standard set forth in *Petrozziello*. In particular, on tape, Corrente intimated to Freitas with respect to the Freitas Lease scheme, “Don't get involved with Joe unless something happens.” Corrente also admits on tape to receiving cash from Pannone in connection with the Pay-to-Get-Paid scheme. Pannone chaired the Board of Tax Assessment Review, a municipal office which we have already detailed to be crucial to the conspiracy. Both Freitas and Ead testified at trial to Pannone's involvement in the Ronci Estate, Freitas Lease, and Pay-to-Get Paid schemes. With regard to the Ronci Estate scheme, the evidence showed a sub-conspiracy among Cianci, Corrente, and Pannone to extort money from the Ronci estate in exchange for a reduction of back taxes owed to the City and the assessment of property owned by the estate. At the times the taped statements were made, the evidence also shows a conspiracy between at least Corrente and Pannone to extort money from Tony Freitas and JKL Engineering in exchange for assistance in leasing property owned by Freitas to the City or to the Marriott Corporation. Third, the evidence was sufficient to establish a conspiracy between at least Corrente and Pannone to extort money from Freitas and JKL in exchange for facilitating payments due from the City to JKL.

Pannone's taped statements were not made "after the fact," but were uttered as part of and in furtherance of the conspiracy. In these statements, Pannone described the roles that he, Cianci, Corrente, and Ead played in the conspiracy and in particular, what he and Freitas should do to carry out the Freitas Lease and Pay-to-Get-Paid schemes. Such statements are well within the core of Rule 801(d)(2)(E). See *United States v. Martinez-Medina*, 279 F.3d 105, 117 (1st Cir.), cert. denied, 537 U.S. 921, 123 S.Ct. 311, 154 L.Ed.2d 210 (2002); *United States v. Eke*, 117 F.3d 19, 21 (1st Cir.1997). The district court did not commit clear error in admitting the Pannone tapes and we decline to reverse defendants' convictions on *Petrozziello* grounds.

#### B. Confrontation Clause and Due Process claims

[33] [34] Defendants contend that Pannone's taped statements are inherently unreliable and hence should not have been admitted in evidence. As a constitutional matter, they claim that the statements' unreliability implicates Sixth Amendment witness confrontation concerns. This Court reviews Confrontation Clause challenges *de novo*. *United States v. Ventura-Melendez*, 275 F.3d 9, 15 (1st Cir.2001). The Confrontation Clause does not require "a showing of unavailability as a condition to admission of the out-of-court statements of a nontestifying co-conspirator, when those statements otherwise satisfy the requirements of Federal Rule of Evidence 801(d)(2)(E)." *United States v. Inadi*, 475 U.S. 387, 391, 106 S.Ct. 1121, 89 L.Ed.2d 390 (1986). It also "does not require a court to embark on an independent inquiry into the reliability of statements that satisfy the requirements of Rule 801(d)(2)(E)." *Bourjaily v. United States*, 483 U.S. 171, 183-84, 107 S.Ct. 2775, 97 L.Ed.2d 144 (1987).

[35] Defendants argue that notwithstanding *Inadi* and *Bourjaily*, Pannone's statements should not have been admitted because he was unavailable and unreliable. They assert that the present case is anomalous and that "corruption stings" such as this one should not fall within *Inadi* and *Bourjaily*. We find no case law excepting the case from the *Inadi* and *Bourjaily* rules. Defendants further suggest that Pannone was outside of his "natural habitat" because Freitas was eliciting incriminating statements from him as part of his cooperation with the FBI. Pannone, however, was unaware that he was being stung. We see no reason how his behavior would have been different had Freitas been making the same conversation without the FBI's direction.

To further address defendants' contention that Pannone's statements are inherently unreliable, we agree with the district court that Pannone "did have or was in a position to have firsthand knowledge of some of the things that he testified about." He was an insider to the conspiracy. Again, he was directly involved and even played a supervisory role in the Ronci Estate, Freitas Lease, and Freitas Invoices schemes. Trial testimony by Ead, Rocha, Freitas, and others corroborated Pannone's taped statements setting out how Corrente was often the middleman in the racket, that Cianci used Corrente as a buffer, and that money given to Corrente found its way into the campaign and eventually benefitted Cianci or the administration in some way. Taped conversations between Freitas and Corrente confirmed the same.

[36] The government questions Cianci and Corrente's motive for failing to call Pannone as a witness for cross-examination as Fed.R.Evid. 806 permits. Cianci and Corrente repeatedly contend that Pannone was unavailable to them because he would assert his Fifth Amendment rights against self-incrimination if called to testify. They claim that Pannone's behavior was "orchestrated" by the Government in their plea arrangements with him.

This alleged "attempt to thwart cross-examination" forms the basis of defendants' Fifth Amendment due process claim. The procedural travel of the case, however, reveals little to support this accusation. The indictment in this case originally named Pannone as a defendant on Counts 1, 2, 8, 9, 16-19, and 21-24. On February 14, 2002, he signed a plea agreement in which he agreed to plead guilty to Counts 1, 2, 8, 16, 19, and 22. The government agreed to dismiss the remaining counts at sentencing. Hence, dismissal of the remaining charges against Pannone was contingent upon sentencing.

On April 16, 2002, during a hearing to resolve defendants' motion to exclude the Pannone tapes, Corrente complained that Pannone's plea agreement had "left open" the remaining counts, suggesting that Pannone's fear of the government's handling of the remaining counts would cause him to assert his Fifth Amendment rights if he were called by the defense to testify. The court, though ultimately rejecting defendants' legal arguments, assured them that it would try to accelerate Pannone's sentencing, which at that time had been scheduled for July.

Thereafter, the district court moved up Pannone's sentencing in order to accommodate defendants in this case. Pannone

was sentenced on May 24, 2002, while the government was still presenting its case-in-chief and almost two weeks before the defense presented their own case. Immediately after sentencing, the government moved to dismiss the remaining counts against Pannone; the court granted the motion. During a bench conference four days after Pannone's sentencing, Corrente's counsel briefly remarked that he had been informed by Pannone's counsel that Pannone would persist in his Fifth Amendment claim "because of a variety of reasons which I won't go into right now." Nothing more was made of these "reasons."

**\*103** After this point, defendants did not attempt to call Pannone as a witness. We find no evidence that Pannone would have invoked his Fifth Amendment right against self-incrimination if called to testify, and whether the court would have permitted him to do so. There simply is no evidence of an "orchestration" by the government to keep Pannone away from defendants. Thus, there were no constitutional infringements here.<sup>14</sup>

<sup>14</sup> To the extent that defendants' due process claim incorporates their argument that Pannone's statements are unreliable, our affirmance of the district court's *Petrozziello* ruling sufficiently responds to that claim.

#### C. Rules 403 and 404(b)

[37] Finally, with respect to the Pannone tapes, defendants argue that the district court erred by failing to consider their objections to admission of the tapes under [Fed.R.Evid. 403](#)<sup>15</sup> and [404\(b\)](#).<sup>16</sup> They claim that they made timely objections pre-trial. They further recount that the court decided not to address the objections prior to trial, but then mistakenly at trial ruled that defendants waived their right to object to admission of the tapes.

<sup>15</sup> "Although relevant, evidence may be excluded if its probative value is substantially outweighed by the danger of unfair prejudice, confusion of the issues, or misleading the jury, or by considerations of undue delay, waste of time, or needless presentation of cumulative evidence." [Fed.R.Evid. 403](#).

<sup>16</sup> "Other Crimes, Wrongs, or Acts—Evidence of other crimes, wrongs, or acts is not admissible to prove the character of a person in order to

show action in conformity therewith. It may, however, be admissible for other purposes, such as proof of motive, opportunity, intent, preparation, plan, knowledge, identity, or absence of mistake or accident, provided that upon request by the accused, the prosecution in a criminal case shall provide reasonable notice in advance of trial, or during trial if the court excuses pre-trial notice on good cause shown, of the general nature of any such evidence it intends to introduce at trial." [Fed.R.Evid. 404\(b\)](#).

We first recount the procedural history giving rise to this issue. On April 24, 2001, the government provided defendants with copies of the two hundred tapes relating to their investigation of defendants, along with an index showing the dates of the recordings and the conversation participants. Three days later, the court issued an Arraignment and Pre-trial Discovery Order, whereby the government was ordered to provide the defendants with transcripts of the tapes. The court also ordered that all pre-trial motions be filed by December 31, 2001.

The government eliminated all but twenty-two tapes as possible trial exhibits. By October 31, 2001—two months before the deadline for pre-trial motions and six months before the commencement of trial—the government had provided transcripts of these twenty-two tapes to defendants.

On March 28, 2002, the district court issued a Pre-trial Scheduling Order, which read:

On or before April 12, 2002, counsel for any party disputing the audibility or admissibility of any such recording or the accuracy of any such transcript shall file an objection identifying the recording to which objection is being made. Memoranda in support of objections to the accuracy or completeness of transcripts shall be accompanied by copies of the transcripts objected to on which proposed deletions and corrections are noted.

In offering recorded conversations, counsel shall make every effort to edit out footage that contains no audible discussion or contains irrelevant material so that the jury will not be required to **\*104** listen for protracted periods of time to portions of recordings that provide little or no assistance in determining the pertinent facts. In order to achieve that objective, counsel shall meet and confer, *in advance*, in an effort to resolve any disputes with respect to editing.



... Failure to comply with the provisions of this paragraph may be considered as a waiver, by the proponent, of the right to offer the recorded conversation(s) at issue; or, alternatively, as a waiver of the right to object to omission of the recorded conversation(s) and/or dispute the accuracy or completeness of the transcript, as the case may be.

On April 8, 2002, defendants filed a motion objecting to the admission of the Pannone tapes. They based their motion primarily on *Petrozziello* and constitutional grounds, and mentioned [Rules 403](#) and [404](#) in a general observation that “any given statement may also be inadmissible” under those rules. They did not identify which statements were inadmissible, but instead suggested that the court itself should “go through” the tapes “line-by-line, making individual assessments as to each declarative statement.” Defendants stated that they would provide the court with a schedule identifying offending statements and detailing the bases for their exclusion. They never provided this schedule.

At the April 16 hearing on the motion, defendants again focused on *Petrozziello* and the constitutional theories. Corrente's counsel acknowledged that the government had edited the tapes to deal with [Rule 403](#) concerns. Nothing more was said with regard to either 403 or 404. The court denied the motion to suppress the Pannone statements and refused to undertake the line-by-line analysis, explaining that it “would take easily, ... weeks ... and it would delay the trial by that period of time.” The court expressed its plan to “minimize the risk of a mistrial in the event that statements are presented that later are found not satisfy the requirements” by requiring the government to present “additional evidence above and beyond the statements themselves to support a finding that they qualify as admissible co-conspirator statements.”

On April 24, the second day of trial, the government in-chambers mentioned that defendants had failed to propose cuts to the Pannone tapes. In response to Corrente's counsel's suggestion that the defense would later in the trial move to excise other taped statements pursuant to [Rules 403](#) and [404](#), the court stated that such motions “should have been done long ago.”

Throughout trial, the court repeated that proposals for cuts to the tapes had been due by April 12, 2002, pursuant to its Pre-trial Scheduling Order. Upon challenges at trial by defendants to the admissibility of individual tapes, the court stated that they could not make these objections because they had failed to tender such an objection pre-trial.

Defendants argue that they complied with the pre-trial scheduling order because they timely filed “an objection identifying the recording to which objection is being made” as required by the Pre-trial Scheduling Order. However, they fail to mention that the order also mandates that “[m]emoranda in support of objections ... shall be accompanied by copies of the transcripts objected to *on which proposed deletions and corrections are noted.*” Defendants failed to provide the district court with these specific objections. The supplemental schedule promised by defendants never materialized; the schedule, moreover, was not an “extra” offer, but explicitly required by the order as part of any objection to the tapes. The district court declined to perform a line-by-line assessment \*105 of the transcripts because it had specifically provided in the order that the parties do it. After repeated general objections non-compliant with the procedural order, the court decided that the defendants waived their right to object pursuant to the order. It did not abuse its discretion in refusing to entertain piecemeal objections to evidence in the Pannone tapes.

Regardless, admission of the taped statements—which defendants still have failed to itemize—did not prejudice defendants. As we have explained *supra*, the government has produced sufficient evidence of the tapes' reliability and probative value. Moreover, the court followed through on its assurance that it would “minimize the risk” of improper admission by requiring the government to produce evidence corroborative of statements made in the tapes.

We stress that the court wisely recognized that stop-and-go evidentiary evaluations of these tapes during trial would unduly delay the case and perhaps even cause the very prejudice and confusion that defendants contemplated in their general objection. Accordingly, the court fashioned a system well before trial through which it expected both parties to whittle down the tapes to their relevant portions. See *United States v. Nelson–Rodriguez*, 319 F.3d 12, 34 (1st Cir.2003) (“The trial court has wide discretion in determining admissibility under [Rule 403](#) since the trial judge ‘is more directly familiar than a court of appeals with the need for the evidence and its likely effect.’”) (citations omitted). An important part of this system was for defendants to produce transcripts of the tapes denoting which portions they wished to redact out of [Rule 403](#), [Rule 404](#), constitutional, or *Petrozziello* concerns. Even in their appeal, defendants persist in the ambiguity of their objection to the tapes. Other circuits have not tolerated this type of objection. See, e.g., *United*

*States v. Holland*, 880 F.2d 1091, 1094–95 (9th Cir.1989) (where some parts of audiotape were admissible but “much of the tape was irrelevant,” the defendant’s “blanket objection to the admission of the tape does not preserve an objection to failure to redact the tape”). We find no abuse in the district court’s exercise of its broad discretion over Rule 403 and 404 considerations.

## V. Cianci’s Taped Statement

### A. Hearsay

In 1995, a government agent posing as an air conditioning businessman taped his conversation with Cianci when he requested a city contract. Cianci assured the agent that he would refer him to Alan Sepe, who Cianci believed knew more about air conditioning matters than he did. Cianci then told the agent, “[Sepe] is honest as the day is long. He deals in governments and ..... No one will ask you for a thing. If anybody does, you pick up the phone and call me. I’ll cut his .... off and have him arrested, okay?” The agent had said or done nothing to prompt discussion of corruption. Then, Cianci, in introducing the agent to an unidentified man, remarked, “He’s probably an FBI agent.”

The district court refused to admit this tape on relevancy grounds, holding that the conversation in it “does not relate to any predicate act or to any specific matter with respect to which the Government has presented any evidence.” In response to Cianci’s argument that the statements were admissible under the “state of mind” exception to the hearsay rule, see Fed.R.Evid. 803(3), the court concluded, “This statement or the import of the statement is to show what Mr. Cianci did or didn’t do on other occasions with respect to unrelated matters, so therefore it does not fall under the exception to the hearsay rule \*106 created by Rule 803(3) for state of mind existing at the time of the event in question.” Cianci argues that the district court’s refusal to admit this taped statement in evidence was an abuse of discretion and violated his right to due process. *Colasanto v. Life Ins. Co. of North America*, 100 F.3d 203, 213 (1st Cir.1996).

The district court deemed Cianci’s taped statement irrelevant because it did “not relate to any predicate act or to any specific matter with respect to which the Government has presented any evidence.” Cianci argues that the court failed to recognize the statement’s relevance to the RICO charges in general. He asserts that the statement tends to make the existence of the enterprise less likely than without the statement, Fed.R.Evid.

401, and that the court “conflat[ed] the provisions of Rule 803(3) ... with the relevancy requirements of Rule 401.”

[38] Cianci recapitulates that if the statement in the tape is hearsay, it falls within the state of mind exception to the hearsay rule. Fed.R.Evid. 803(3). “To be admissible under this exception, a declaration, among other things, must ‘mirror a state of mind, which, in light of all the circumstances, including proximity in time, is reasonably likely to have been the same condition existing at the material time.’ ” *Colasanto*, 100 F.3d at 212 (quoting 2 John W. Strong, *McCormick on Evidence* § 274 (4th ed.1992)). Cianci contends that the statement evinces a contemporaneous intent not to endorse bribery in his administration, rather than a statement denying past instances of corrupt acts. In addition to adopting the district court’s conclusion that the statement evinced a “state of mind” as to events or behavior on other occasions, the government argues that Cianci’s statements were self-serving, and hence outside the ambit of Rule 803(3), because he knew that he was talking to a federal agent.

[39] [40] As an initial matter, the taped statement is hearsay. Cianci offered it to prove the truth of the assertion that Cianci did not tolerate corruption. Another thing is certain: the statement was not admissible in order to show what Cianci might have done or not done on other occasions not proximate to the time the statement was uttered. The only purpose for which the statement could have been admitted would have been to establish Cianci’s state of mind at the time the statement was made. Because “disputes over whether particular statements come within the state-of-mind exception are fact-sensitive, the trial court is in the best position to resolve them.” *Colasanto*, 100 F.3d at 212. That the statement was made at one point during the time of charged conspiracy cannot be sufficient to mandate its admission, especially where the latter part of the statement—“He’s probably an FBI agent”—places doubt on what Cianci claims is the probative value and relevance of the statement as a whole. Whether Cianci’s statement is “forward-looking” or refers to past acts and events is unclear from the statement itself. This issue is further complicated by the fact that Cianci’s mention of pay-offs was “gratuitous” and not provoked by anything the agent said or did. Hence, it was within the district court’s discretion to conclude that the statement, at least in part, applied to past acts of the Cianci administration and were to a large extent “self-serving” attempts to cover tracks already made. Such observations are well-established grounds for non-admission. See, e.g., *United States v. Bishop*, 264 F.3d 535, 549 (5th Cir.2001), cert. denied, 535 U.S. 1016, 122 S.Ct. 1605, 152



L.Ed.2d 620 (2002); *United States v. Miller*, 874 F.2d 1255, 1265–66 (9th Cir.1989); *United States v. \*107 Jackson*, 780 F.2d 1305, 1313–15 (7th Cir.1986). Thus, as the district court determined that Cianci sought to admit the statement “to show that he did not and does not take bribes or engage in corrupt activity,” we are loath to disturb the court’s exercise of discretion to deny admission of the statement.

#### B. Due Process claim

[41] Cianci claims that by denying admission of his taped statement, the district court violated his Fifth Amendment due process right to “a meaningful opportunity to present a complete defense.” *Crane v. Kentucky*, 476 U.S. 683, 687, 106 S.Ct. 2142, 90 L.Ed.2d 636 (1986). We review this claim for plain error because it was not raised at trial. Under plain error review, the defendant must show (1) that an error occurred (2) which was “obvious” in the sense that governing law was clearly settled to the contrary, (3) affected the defendant’s substantial rights, and (4) seriously impaired the fairness, integrity, or public reputation of judicial proceedings. *United States v. Gomez*, 255 F.3d 31, 37 (1st Cir.2001).

[42] [43] Application of evidentiary rules “do not abridge an accused’s right to present a defense so long as they are not ‘arbitrary’ or ‘disproportionate to the purposes they are designed to serve.’ ... [W]e have found the exclusion of evidence to be unconstitutionally arbitrary or disproportionate only where it has infringed upon a weighty interest of the accused.” *United States v. Scheffer*, 523 U.S. 303, 308, 118 S.Ct. 1261, 140 L.Ed.2d 413 (1998) (citing *Rock v. Arkansas*, 483 U.S. 44, 56, 107 S.Ct. 2704, 97 L.Ed.2d 37 (1987)). We have described the Supreme Court’s rule as overturning convictions only in “egregious cases.” *Fortini v. Murphy*, 257 F.3d 39, 47 (1st Cir.2001). Cianci outlines his “weighty interest” as his effort to disprove the government’s theory of criminal intent. Even if we were to give some exculpatory value to the statement, given the amount of evidence of Cianci’s criminal knowledge and intent presented at trial, its absence from the evidence does not rise to an “egregious” violation of Cianci’s interest in defeating this part of the government’s case. Arguably, the statement itself indicates that Cianci knew he was talking to an FBI agent. Regardless, the court acted well within its discretion in determining that Cianci’s taped statement did not pass muster under Rule 401 and that its value, if any, fell outside of Rule 803(3)’s exception to the hearsay rule. Accordingly, we conclude that the court’s refusal to admit his taped statement did not constitute error, let alone plain error, and thus, Cianci’s due process claim fails.

## VI. Conclusion

Accordingly, defendants’ convictions are affirmed.

## VII. Sentencing and Forfeiture Appeals

In light of the Supreme Court’s recent decision in *Blakely v. Washington*, 542 U.S. 296, 124 S.Ct. 2531, 159 L.Ed.2d 403 (June 24, 2004), we do not decide the sentencing appeals raised by all defendants as well as challenges by defendants and the government to the district court’s forfeiture order. By separate order, we have requested additional briefing and oral argument on these issues.

HOWARD, Circuit Judge, concurring in part and dissenting in part.

The majority has skillfully analyzed a number of very difficult issues, and I concur in parts II and III of its opinion, which affirm Corrente’s and Autiello’s non-RICO-related convictions. As to the RICO-related convictions, I am not persuaded \*108 that the majority correctly disregards the jury’s interrogatory answers in conducting its sufficiency review, *see ante* part I–E, or that it has convincingly fended off defendants’ argument that a municipal entity, which is incapable of being found to have acted with an unlawful purpose, cannot coherently be regarded as a member of an associated-in-fact RICO enterprise that is defined by the shared unlawful purposes of its associates, *see ante* part I–B. But even if I assume that the jury’s interrogatory answers are irrelevant and that municipal entities can be named as associates of the type of RICO enterprise that was alleged in this case, I still must dissent from the majority’s conclusion that there is sufficient record evidence to sustain defendants’ RICO-related convictions. In my view, the RICO-related judgments (including the forfeiture judgment) should be reversed and this matter should be remanded for resentencing.

The majority has done an excellent job of summarizing the relevant legal principles, the nature of the associated-in-fact RICO enterprise alleged in this case, and the pattern of racketeering activity underlying the RICO and RICO conspiracy allegations. *See ante* at 78–81 & 81–82. I adopt this discussion by reference and turn to the particulars of the argument I find persuasive.

Defendants contest their RICO-related convictions, in part, on the ground that the evidence introduced at trial in support

of the nine alleged schemes was inadequate to establish that the schemes were conducted through the amalgam of persons and entities alleged in the indictment to have constituted the RICO enterprise. Defendants premise this argument on an underlying assertion that there was no proof to ground an inference of a shared purpose among defendants and all of the municipal entities named as associates of the enterprise—a required finding (at least usually, *see ante* at 82) if an unlawful criminal association is to be regarded as a RICO enterprise. Defendants say that their position is bolstered by two “findings” made by the district court and not contradicted by the government (or at least not clearly so): (1) “there is no evidence that the [City] departments and/or agencies, themselves, shared [the enterprise's] purposes,” *United States v. Cianci*, 210 F.Supp.2d 71, 73 (D.R.I.2002), and (2) “none of [defendants'] acts ... resulted in any significant disruption of a Governmental function.” Thus, the argument goes, even if we were to assess the adequacy of the evidence supporting the RICO convictions by looking at the whole record and construing it in favor of the government (despite the nine judgments of acquittal entered by the district court and the special interrogatory answers collectively indicating that much of the government's RICO case was not “proven”), we would find only a few, relatively inconsequential interactions between the defendants and these municipal entities during the nearly eight years the enterprise was alleged to have existed.

The government's response tracks the grounds on which the district court rejected the defendants' motions for judgments of acquittal: (1) we should follow the Ninth Circuit and hold that “RICO does not require intentional or ‘purposeful’ behavior by corporations charged as members of an association-in-fact,” *United States v. Feldman*, 853 F.2d 648, 657 (9th Cir.1988); and (2) the jury's enterprise finding was sufficiently supported by evidence that Cianci and Corrente (Autiello, who was not a municipal employee, is not mentioned) “using the Office of the Mayor and the Office of Director of Administration as base camps, ... controlled” the municipal entities named as enterprise associates. The government's first suggestion, \*109 that we reject defendants' argument on the basis of the *Feldman* principle, faces insurmountable obstacles. This court has identified the “common purpose” requirement discussed in *United States v. Turkette*, 452 U.S. 576, 580–83, 101 S.Ct. 2524, 69 L.Ed.2d 246 (1981), as one of the principal tools a factfinder should use to distinguish a RICO enterprise from an ad hoc criminal confederation. *See ante* at 82; *see also Ryan v. Clemente*, 901 F.2d 177, 180 (1st Cir.1990) (emphasizing that the common

purpose requirement is necessary to “limit the potentially boundless scope of the word ‘enterprise’ ” and thereby “distinguish culpable, from non-culpable, associations”).<sup>1</sup> Indeed, we have applied the requirement (albeit without acknowledging *Feldman*) in a case involving an unlawful purpose RICO association-in-fact involving corporate legal entities. *See United States v. London*, 66 F.3d 1227, 1243–45 (1st Cir.1995). Moreover, and decisively, the district court instructed the jury *without objection from the government*: “[I]t is not necessary in proving the existence of an enterprise to show that each member of the enterprise participated in or even knew of all of its activities, but it is necessary to show that all members of the alleged enterprise shared a common purpose.” The government has not attempted to reconcile *Feldman* with *Turkette*, *Ryan*, *London*, or our other cases applying *Turkette*. *See ante* at 82. Thus, as the majority concedes, we cannot disregard the common-purpose instruction in analyzing defendants' sufficiency challenges. *See ante* at 84–85 (citing *United States v. Zanghi*, 189 F.3d 71, 79–80 (1st Cir.1999)). The question whether *Feldman* correctly states the law must be left to another day.<sup>2</sup>

<sup>1</sup> *Ryan*, which was authored by then-Judge Breyer, involved a civil RICO claim, but precedent generated in civil RICO cases applies to criminal RICO cases. *See United States v. Shifman*, 124 F.3d 31, 35 n. 1 (1st Cir.1997).

<sup>2</sup> Even under the *Feldman* approach, the court still would face the question whether entities not controlled by those accused of operating the alleged association-in-fact enterprise are properly considered part of such an enterprise. For the reasons that follow, I do not think that they are. Thus, my conclusion that the *Feldman* rule does not apply under the facts of this case is not outcome determinative.

This leaves the government's undeveloped assertion—an assertion that the majority finds convincing—that the jury's enterprise finding is sustainable because there was evidence that Cianci and Corrente exercised “control” over the municipal entities named as members of the enterprise. Because the common-purpose instruction binds for purposes of our analysis, I shall assume that the government intends by this assertion to argue that such “control” is sufficient to impute to the entities the unlawful purposes of those alleged to control them—i.e., Cianci and Corrente. *Compare London*, 66 F.3d at 1243–45 (involving closely held corporations operated

by the defendant and alleged to be members of his unlawful associated-in-fact RICO enterprise); *United States v. Masters*, 924 F.2d 1362, 1366–67 (7th Cir.1991) (involving a law firm and two police departments associated in fact with those who controlled or manipulated them). I also shall assume that it would be fair to sustain the defendants' convictions on evidence of such control, notwithstanding the absence of jury instructions explaining that a municipal entity's "purposes" may be so ascertained. Even so, I do not see how the convictions can stand.

In my view, there is no proof that Cianci and Corrente so controlled the activities of all the municipal entities alleged to be associates of the charged enterprise that the two's shared criminal purposes are \*110 reasonably imputed to each such entity. There is no evidence that, for example, Cianci and Corrente themselves could provide those willing to pay bribes with jobs in City departments over which they lacked hiring authority; or that they could contractually bind City departments under separate leadership; or that they could sell City property; or that they could grant or deny construction variances. Nor did the government show that the persons, committees, and boards within the municipal departments, offices, and agencies whose assistance the schemes required abdicated their decision-making responsibilities to Cianci or Corrente.<sup>3</sup> In short, neither Cianci nor Corrente was shown to have so dominated the affairs of the departments, offices, and agencies claimed to be associated with the unlawful purpose enterprise that each of these municipal entities might fairly be found to have been an alter ego of Cianci or Corrente with respect to the transactions in question.<sup>4</sup> Rather, the evidence showed only that Cianci and Corrente periodically used the power inherent in their positions to influence (or attempt to influence)<sup>5</sup> the decisions \*111 of other municipal actors—actors who, with the exceptions noted in the preceding footnote, were not shown to be privy to, let alone supportive of, the alleged enterprise's purposes.

<sup>3</sup> This statement is subject to the following two qualifications. First, the jury could have found that Corrente himself had the ability to dictate which towers were placed on the police department's tow list. Second, the jury could have found that the Board of Tax Assessment Review was effectively controlled by Cianci and Corrente through the corrupt machinations of RICO co-conspirators Joseph Pannone (BTAR's Chairman) and David Ead (BTAR's Vice-Chairman).

<sup>4</sup> By this statement, I do not mean to imply that those municipal actors to whom Cianci and Corrente directed their successful requests and demands (*compare infra* note 5) always acted within standard operating procedures or even lawfully. To the contrary, as the majority explains it:

[T]he evidence depicted a behavioral spectrum ranging from innocent cooperation to willful complicity in unlawful conduct. For example, with respect to the Freitas Invoices scheme, the evidence was merely that an employee within the City's Finance Department (Lorraine Lisi), acting at Corrente's request, paid valid invoices more promptly than usual. Similarly, with respect to the Ise Job scheme, the evidence was merely that the Deputy Director of the Department of Planning and Development (Thomas Deller) created a temporary position for Ise within the department at Cianci's request. At the more culpable end of the spectrum, however, there was evidence that, in connection with the Jere Lease scheme, the head of the Department of Public Property (Alan Sepe) and the Director of Business Relations for the School Department (Mark Dunham) were influenced by Corrente to tailor the specifications in a School Department lease bid to fit the dimensions of Jere Realty's building, and then to support the Jere Realty lease before the Board of Contract and Supply (which was the entity formally empowered to accept or reject bids of City contracts). Similarly, in connection with the Freitas Lease scheme, there was evidence that Corrente again contacted Dunham prior to finalization of the lease and influenced him to drop consideration of an alternative lease.

*Ante* at 85 n. 3. But importantly, even in connection with these latter two schemes, Sepe and Dunham were not shown to have known of and willingly joined the alleged RICO enterprise conspiracy. Nor was there a basis for finding that a majority of the Board of Contract and Supply, the entity which ultimately voted to accept the Jere Realty lease, did so for purposes of furthering the alleged RICO enterprise conspiracy, or even with knowledge that it was ratifying a contract that had been formed in disregard of standard operating procedures.

<sup>5</sup> The majority acknowledges that Cianci and Corrente "did not always get their way...." *Ante* at

87. As the majority notes, there was uncontradicted evidence that, in connection with the Freitas Lots scheme, Cianci was displeased that elements within the Providence Redevelopment Agency, the entity empowered to sell the lots, did not sufficiently accede to his wishes. *See id.* n. 7. There also was uncontradicted evidence that, in connection with the University Club scheme, Cianci was angered when members of the Providence Building Board of Review ignored his wishes and granted the club some of the variances that it sought. *See id.* Finally, there was uncontradicted evidence that, in connection with the Maggiacomo Job scheme, the Chief of Police declined to admit Maggiacomo to the police academy because he had a criminal history and had been untruthful during a screening interview. *See id.*

The majority suggests that this evidence “does not defeat the integrity of the charged enterprise” because the jury could have concluded that “these glitches in the schemes only meant that certain substantive crimes went uncompleted....” *Id.* With respect, I think that the evidence is more telling on the point in question—whether there was sufficient evidence that Cianci and Corrente so controlled the Providence Redevelopment Agency, the Providence Building Board of Review, and the Department of Public Safety that their unlawful purposes should be imputed to these entities—than the majority acknowledges. There was, after all (and as the majority concedes, *see ante* at 84), no other evidence from which the jury might have found that defendants controlled these agencies (or at least relevantly so).

The question arises why this evidence of influence is not sufficient to make the persons and entities influenced part of the alleged enterprise. The answer, I believe, lies in the fact that we are here deciding what is required for membership in an associated-in-fact RICO enterprise *defined only by the common unlawful purposes of its members*. This is a highly ramified decision with implications, criminal and civil, that extend far beyond this case. Were we to permit a person or entity to be named part of an unlawful purpose enterprise on mere evidence that the person or entity acceded to a mobster's request (but without knowledge of the purposes underlying the request), we would be heading down the slippery slope against which then-Judge Breyer warned in *Ryan*: that of failing to differentiate between associations that fall within the sweep of RICO and associations involving

only the exploitation of others by criminals. *See* 901 F.2d at 180–81 (emphasizing the need to limit “the potentially boundless scope of the word ‘enterprise’ so as to distinguish culpable from non-culpable associations,” and recognizing “the serious consequences for any man or woman, state official or private person, who is publicly accused of racketeering”); *see also* *Fitzgerald v. Chrysler Corp.*, 116 F.3d 225, 226–28 (7th Cir.1997).<sup>6</sup> As *Ryan* suggests, membership in an unlawful purpose RICO enterprise implies potential culpability under the RICO statute. *See* 901 F.2d at 181; *see also* 18 U.S.C. § 1962(d) (allowing for the imposition of RICO liability under conspiracy principles). Thus, as a matter of logic (not to mention due process), one who lacks the mental state necessary for the imposition of RICO liability because he is unaware of the enterprise or its purposes also lacks the mental state necessary to be part of a RICO enterprise that is defined solely by the shared, culpable mental state of its members. This is ultimately what, in my view, dooms the government's enterprise allegations in this case.

<sup>6</sup> To illustrate, suppose there was evidence that a young law school graduate made a \$5,000 “campaign contribution” to Cianci and asked for a recommendation to the hiring partner of a Providence law firm that does a substantial amount of city business. Suppose further that there was evidence that Cianci called the firm's hiring partner and asked that the firm give serious consideration to hiring the young lawyer. If the firm did so, would it become a member of the common purpose enterprise alleged in this case? If the answer is “no” (as I think it clearly should be), on what principled basis can we find that the Department of Planning and Development—the agency that created a temporary position for Christopher Ise at the request of Cianci—was proved to be part of the enterprise?

There was in this case significant evidence of public corruption. Perhaps the \*112 government could have proved that Cianci and Corrente ran the Office of the Mayor or the Office of the Director of Administration as a RICO enterprise. Or perhaps the defendants (or, more likely, a subset thereof) might have been shown to be members of one or more smaller, associated-in-fact RICO enterprises. But the government successfully persuaded the grand jury to cast a wider net and to allege that the persons named as enterprise associates, along with the campaign contribution fund, the City of Providence, and many of its departments,



offices and agencies, functioned as a de facto organized crime syndicate. Framing the case in this way permitted the government to allege that defendants were responsible under RICO's conspiracy provision for *all* of the illegal and unethical conduct put on display in this trial—even that in which they were not shown to have personally participated.<sup>7</sup> But this broad case theory obligated the government to prove that *each* municipal entity alleged to have engaged in conduct that constituted part of the “pattern of racketeering activity” identified in the indictment was itself a member of the enterprise. As another court has put it:

<sup>7</sup> For example, Autiello was responsible under RICO for the unlawful conduct underlying the Freitas Lease and Freitas Invoice schemes—schemes on which the jury returned substantive convictions but in which he was not involved—on the theory that he was a member of a conspiracy to conduct the enterprise that carried out these schemes.

[I]t must be stressed that the government, through its ability to craft indictments, is the master of the scope of the charged RICO conspiracy.... [RICO's conspiracy provision] is capable of providing for the linkage in one proceeding of a number of otherwise distinct crimes and/or conspiracies through the concept of enterprise conspiracy. The government, through the vehicle of the indictment, provides the linking conspiratorial objective of a *specific* RICO violation. The “specific” violation can be broad or narrow. It is the prosecution which sets the parameters to which a RICO conspiracy trial must be confined; having set the stage, the government must be satisfied with the limits of its own creation.

*United States v. Weissman*, 899 F.2d 1111, 1115 (11th Cir.1990) (quoting *United States v. Neapolitan*, 791 F.2d 489, 501 (7th Cir.1986)) (internal quotation marks omitted; emphasis in original).

RICO is a powerful weapon that can cause mischief if abused by an overzealous prosecutor.<sup>8</sup> While I do not doubt that RICO will sometimes apply in cases of political corruption, I fear the consequences of making the statute too easy to invoke—or too easy to apply broadly—in the political context, where persons who have made a contribution to a politician

routinely receive favorable treatment from offices or agencies over which the politician has influence. I therefore agree with Justice Breyer that we must place comprehensible limits on RICO's reach and that an important way of cabining the statute is to require true culpability before one may be named part of an associated-in-fact RICO enterprise defined by the common unlawful purposes of its constituents. See *Ryan*, 901 F.2d at 180–81. Such a limitation helps to ensure that cases involving claims of political corruption will not also inevitably give rise to a RICO charge, and that cases involving multiple acts of common law fraud will not also inevitably give rise to civil liability under the statute.

<sup>8</sup> I am speaking generally here and in no way intend to impugn those who brought this case. Indeed, there is no reason to doubt that the government's enterprise allegations were made in a good faith attempt to comply with circuit precedent in this tricky area of the law.

\*113 In this case, the government proved only that many of the municipal entities named in the indictment were used as tools by defendants. For reasons I have explained, this is not enough to prove that these entities were part of a RICO enterprise defined only by the shared unlawful goals of its members. Thus, the government failed to prove the existence of the enterprise alleged in connection with the RICO counts, and the RICO convictions cannot stand. See *United States v. Morales*, 185 F.3d 74, 80–82 (2d Cir.1999) (reversing on sufficiency grounds where the proof failed as to the specific enterprise charged in the indictment); *Weissman*, 899 F.2d at 1113–15 (vacating a conviction obtained after the trial court constructively amended the indictment in a supplemental jury instruction by permitting the jury to find a different enterprise than that charged in the indictment).

I respectfully dissent from part I of the majority opinion and would not reach the issues addressed in parts IV–VI (which are rendered immaterial by my conclusion that the defendants' RICO-related convictions must be reversed).

#### All Citations

378 F.3d 71, 64 Fed. R. Evid. Serv. 1208

## **LEGAL AUTHORITY CA-60**





## I. Introduction

1. My name is Jack Goldsmith. I have been asked by Claimant ICM Registry, LLC, to give an opinion on certain questions of conflicts of law, international law, and Internet law as they relate to the captioned Request for Independent Review.

2. I am the Henry L. Shattuck Professor of Law at Harvard Law School. I have also been on the faculties of the University of Chicago Law School (1997-2003) and the University of Virginia Law School (1994-1997; 2003-2004). My fields of academic research, scholarship, and teaching include public international law, conflicts of law, and the law of the Internet. I have published numerous law review articles in these fields in, among other places, the *Harvard Law Review*, the *Yale Law Journal*, the *University of Chicago Law Review*, and the *European Journal of International Law*. I am also the co-author of, among other publications, *Who Controls The Internet?: Illusions of a Borderless World* (2006), and *The Limits of International Law* (2005). In addition, I am a member of the State Department Advisory Committee on International Law, the American Society of International Law, and the National Academy of Science Study of the Policy Consequences and Legal Ethical Implications of Offensive Information Warfare.

3. Before teaching at Harvard Law School, I was Assistant Attorney General, Office of Legal Counsel from 2003 to 2004, and Special Counsel to the General Counsel of the Department of Defense from 2002 to 2003. In addition, from 1991 to 1992, I was a legal assistant at the Iran-U.S. Claims Tribunal in The Hague, where I assisted George Aldrich, one of the American arbitrators.

4. I received a B.A., *summa cum laude*, from Washington and Lee University (1984), a B.A., first class honours, from Oxford University (1986), a J.D. from Yale Law

School (1989), and a Diploma in Private International Law from the Hague Academy (1992). I am admitted to practice law in Washington, D.C. (1993). My CV, including a complete list of my scholarship, is attached as Exhibit A.

## II. Background and Scope of Analysis

5. The Internet is the global network of computers that communicate with one another through a decentralized data routing mechanism. The Internet is, however, centralized in one crucial respect: its naming and numbering system. This system matches the unique Internet Protocol address of each computer in the world (for example, 123.456.78.912) with a recognizable “domain name” like <mcdonalds.com> or <whitehouse.gov> or <metmuseum.org.> Computers around the world are able to find and communicate with one another on the Internet because these Internet Protocol addresses uniquely and reliably correlate with domain names.

6. Some organization must ensure that this crucial naming and numbering system operates properly. Some organization must also decide which top-level domains (such as .COM, .GOV, and .ORG) shall exist. And some organization must administer the distribution and use of these top-level domains. From the 1970s until the late 1990s, these and related functions were performed by the Internet Assigned Numbers Authority (“IANA”), an informal organization run by Professor Jon Postel at the University of Southern California, pursuant to various contracts and understandings with the U.S. government.<sup>1</sup> Since the late 1990s, these functions have been performed by the Internet Corporation for Assigned Names and Numbers (“ICANN”).

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<sup>1</sup> See MILTON L. MUELLER, RULING THE ROOT: INTERNET GOVERNANCE AND THE TAMING OF CYBERSPACE 73-104 (2002); A. Michael Froomkin, *Wrong Turn in Cyberspace: Using ICANN to Route Around the APA and the Constitution*, 50 DUKE LAW J. 17, 51-69 (2000).

7. ICANN is a California non-profit corporation headquartered in Marina Del Rey, California. But it is perhaps the most unusual and powerful non-profit corporation in the world, for it creates and distributes billions of dollars of global property rights on the Internet. The mismatch between ICANN's ostensible private status and its plenary governance authority over one of the globe's most important resources generated significant controversy at ICANN's inception. The nub of the controversy was that ICANN's extraordinary authority over the Internet was untempered by any form of administrative law or other checks and balances that usually accompany such large exercises of effective governmental power.<sup>2</sup>

8. In Article 4 of its Articles of Incorporation, ICANN assumed obligations, including obligations under international law. These obligations were designed to add legitimacy to ICANN's decisions and to address the concerns of those in the United States and the international community who believed that ICANN is, and should function as, an international organization. The original draft of ICANN's Articles of Incorporation did not contain any reference to international law. The first version of what became Article 4 of the Articles was introduced in the "fifth iteration" of the draft Articles of Incorporation in September 1998. It provided:

The Corporation shall operate for the benefit of the Internet community as a whole, carrying out its activities with due regard for applicable local and international law and, to the extent appropriate and consistent with these Articles and its Bylaws, through open and transparent processes that enable competition and open entry in Internet-related markets.<sup>3</sup>

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<sup>2</sup> See, e.g., MUELLER, *supra* note 1, at 1-11, 141-184; Jonathan Weinberg, *ICANN and the Problem of Legitimacy*, 50 DUKE L.J. 187, 212-217 (2000).

<sup>3</sup> See Internet Assigned Numbers Authority, Draft Articles of Incorporation – Fifth Iteration, available at <http://web.archive.org/web/19990220074640/www.iana.org/articles5.html>.

This “fifth iteration” draft explained that Article 4 “was added in response to various suggestions to recognize the special nature of this organization and the general principles under which it will operate.”<sup>4</sup>

9. This initial effort to acknowledge ICANN’s “special nature” and “the general principles under which it will operate” was viewed as inadequate. On November 21, 1998, following discussions with U.S. government officials, the ICANN Board of Directors held a special meeting “to approve revisions of the Corporation’s articles of incorporation and bylaws.”<sup>5</sup> The Board voted to revise Article 4 to what became its final version:

The Corporation shall operate for the benefit of the Internet community as a whole, carrying out its activities in conformity with relevant principles of international law and applicable international conventions and local law and, to the extent appropriate and consistent with these Articles and its Bylaws, through open and transparent processes that enable competition and open entry in Internet-related markets. To this effect, the Corporation shall cooperate as appropriate with relevant international organizations.

This final version of Article 4 amplified ICANN’s international law obligations. While the original version obliged ICANN to carry out its activities “with due regard for applicable . . . international law,” the final version obliged ICANN to carry out its activities “in conformity with relevant principles of international law and applicable international conventions.” As ICANN’s Interim Chairman of the Board explained to the Department of Commerce, these and other changes made to its Articles “reflect emerging

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<sup>4</sup> *Id.*

<sup>5</sup> See Internet Corporation for Assigned Names and Numbers, Minutes of Special Meeting (Nov. 21, 1998), available at <http://www.icann.org/en/minutes/minutes-21nov98.html>.



consensus about our governance and structure.”<sup>6</sup> She added that Article 4 in particular “mak[es] it clear that ICANN will comply with relevant and applicable international and local law.”<sup>7</sup>

10. ICANN in its Bylaws took complementary steps to bring basic due process mechanisms, including checks and balances, to its decision-making.<sup>8</sup> Article 3(1) of the Bylaws provides that the corporation “shall operate to the maximum extent feasible in an open and transparent manner and consistent with procedures designed to ensure fairness.” The Bylaws further state that “[i]n carrying out its mission as set out in these Bylaws, ICANN should be accountable to the community for operating in a manner that is consistent with these Bylaws, and with due regard for the core values set forth in Article I of these Bylaws.”<sup>9</sup> These core values include “open and transparent policy development mechanisms that . . . promote well-informed decisions based on expert advice,” and a requirement to make decisions “by applying documented policies neutrally and objectively, with integrity and fairness.”<sup>10</sup>

11. The Bylaws additionally require ICANN to “have in place a separate process for independent third-party review of Board actions alleged by an affected party

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<sup>6</sup> *Joint Hearings before the Committee on Science Subcommittee on Basic Research and Subcommittee on Technology To Consider Department of Commerce Discussion Draft Proposal To Restructure and Privatize the Internet Domain Name System (DNS)*, 105th Cong. 336 (1998) (Letter of Nov. 23, 1998 from Ester Dyson, ICANN Interim Chairman of the Board, to J. Beckwith Burr, Acting Associate Administrator, National Telecommunications and Information Administration, United States Department of Commerce)

<sup>7</sup> *Id.*

<sup>8</sup> Bylaws for Internet Corporation for Assigned Names and Numbers, art. IV, § 3(b) (May 29, 2008), available at <http://www.icann.org/general/bylaws.htm>.

<sup>9</sup> *Id.* at art. IV, § 1.

<sup>10</sup> *Id.* at art. I, § 2.

to be inconsistent with the Articles of Incorporation or Bylaws.”<sup>11</sup> When a party affected by an adverse ICANN Board decision submits a request for “independent review” of the decision, the Independent Review Panel (“IRP”) “shall be charged with comparing contested actions of the Board to the Articles of Incorporation and Bylaws, and with declaring whether the Board has acted consistently with the provisions of those Articles of Incorporation and Bylaws.”<sup>12</sup>

12. This review process emerged from what ICANN’s first Chairman of the Board described as the “need for a way to obtain recourse in the event that someone may believe ICANN or its staff has broken our own bylaws or otherwise not followed the rules that we have set up for ourselves and our successors.”<sup>13</sup> The process was included in ICANN’s Bylaws at “the insistence of the U.S. government” as a condition for delegating its control over the Internet’s naming and numbering system to ICANN.<sup>14</sup> As Paul Twomey, ICANN’s President and CEO, recently told Congress, the “independent review panel and independent arbitration” are the ultimate guarantors of ICANN’s “accountability in its decision making.”<sup>15</sup>

13. This is the first ICANN IRP ever formed. The issue before the IRP grows out of ICANN’s rejection of an application by Claimant ICM Registry, LLC (“ICM”), a

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<sup>11</sup> *Id.* at art. IV, § 3(1).

<sup>12</sup> *Id.* at art. IV, § 3(3).

<sup>13</sup> Letter from Ester Dyson, *supra* note 6.

<sup>14</sup> *See* Weinberg, *supra* note 2, at 228-229 & nn. 211-213.

<sup>15</sup> *ICANN Internet Governance: Is It Working?, Hearing Before the H. Subcommittee on Commerce, Trade, and Consumer Protection and Subcommittee on Telecommunications and the Internet of the Committee on Energy and Commerce*, 109<sup>th</sup> Cong. 19 (2006).

Delaware corporation with its principal place of business in Jupiter, Florida, for a sponsored top-level domain (“sTLD”). ICM alleges that ICANN had determined that it qualified for a sTLD under a detailed “request for proposal” but then, under belated pressure from national governments and the Government Advisory Committee (“GAC”), changed its mind and rejected ICM’s application. ICM further alleges that ICANN’s decision to deny ICM the .XXX sTLD, and the process leading up to that decision, were arbitrary, lacking in transparency, discriminatory, contrary to ICANN’s evaluation criteria, and outside ICANN’s mission, all in violation of ICANN’s Articles and Bylaws as well as international law and local law.

14. This Report will address some of the international law, conflicts of law, and Internet law issues raised by these allegations. Part III will explain why international law matters in this proceeding. Part IV will explain why the phrase “relevant principles of international law and applicable international conventions” in Article 4 of ICANN’s Articles of Incorporation includes general principles of law. Part V will describe the content of some of the general principles of law that apply in this Review.

### III. Why International Law Matters in This Proceeding

15. ICANN Bylaws require the IRP to determine whether an ICANN Board decision is consistent with ICANN's Bylaws and Articles of Incorporation. Article 4 of the ICANN Articles states that ICANN "shall . . . carry[] out its activities in conformity with relevant principles of international law and applicable international conventions and local law. . . ."<sup>16</sup> It follows straightforwardly from these provisions that this IRP must determine whether ICANN's decision to deny ICM a .XXX sTLD, as well as the process leading to that decision, were consistent with "relevant principles of international law and applicable international conventions and local law."

16. The IRP can reach this conclusion about governing law, and in particular about international law's relevance, without a choice-of-law analysis. But if the IRP performs a choice-of-law analysis, it will reach the same conclusion. This Independent Review is governed by the International Arbitration Rules of the American Arbitration Association's International Centre for Dispute Resolution Procedures (hereinafter "ICDR Rules"), as modified by the Supplementary Procedures for Internet Corporation for Assigned Names and Numbers (ICANN) Independent Review Process.<sup>17</sup> Article 28 of the ICDR Rules provides that "[t]he tribunal shall apply the substantive law(s) or rules of

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<sup>16</sup> Articles of Incorporation of Internet Corporation for Assigned Names and Numbers, art. 4 (Nov. 21, 1998), *available at* <http://www.icann.org/general/articles.htm>.

<sup>17</sup> *See* American Arbitration Association, International Dispute Resolution Procedures [*hereinafter* IDRPs], *available at* <http://www.adr.org/sp.asp?id=33994>; Supplementary Procedures for Internet Corporation for Assigned Names and Numbers (ICANN) Independent Review Process, *available at* <http://www.adr.org/sp.asp?id=32197>.

law designated by the parties as applicable to the dispute.”<sup>18</sup> The parties to this dispute have designated the laws contained in Article 4 as applicable to this dispute.

17. An offer to arbitrate can be contained in a corporate charter or corporate bylaws.<sup>19</sup> Such charters and bylaws typically concern arbitration with shareholders or partners, but there is no reason that a corporation’s charter or bylaws could not include an offer to arbitrate with affected third parties.<sup>20</sup> It is also well established that a party’s participation in arbitral proceedings without protest can be the basis for a valid arbitration agreement.<sup>21</sup> Indeed, the ICDR Rules provide that any objections to arbitral jurisdiction must be raised in the statement of defense or are waived.<sup>22</sup>

18. Just as a corporate charter or corporate bylaws can contain an arbitration agreement, so too they can contain a governing law clause. In addition, parties can consent to governing law through other methods that reveal unambiguous intent. As Born’s treatise notes, “[c]hoice-of-law agreements may be implied or tacit, as well as express. This is recognized in all developed legal systems and has particular importance

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<sup>18</sup> *See id.* at art. 28(1).

<sup>19</sup> *See, e.g.*, UNIF. ARBITRATION ACT § 6, cmt. 1, 7 U.L.A. 14-15 (2005) (citing authorities); GARY B. BORN, INTERNATIONAL COMMERCIAL ARBITRATION 1223-26 (2009) (same).

<sup>20</sup> *Cf.* Jan Paulsson, *Arbitration Without Privity*, 10 ICSID REVIEW 232 (1995).

<sup>21</sup> *See, e.g.*, BORN, *supra* note 19, at 672 (citing arbitration legislation, national court decisions, and arbitral institution rules for proposition that “a party’s tacit acceptance of its counterparty’s initiation of arbitration, through participation in the arbitral proceedings without raising a jurisdictional objection, can provide the basis for a valid agreement to arbitrate.”).

<sup>22</sup> *See* IDRPs Procedures, *supra* note 17, arts. 3, 15(3).

in the context of international commercial arbitration.”<sup>23</sup> Moreover, parties, including private parties, can choose to have their dispute governed by international law, including general principles of law.<sup>24</sup> In fact, Article 28’s reference to “rules of law” is a standard way to establish that parties can choose non-national laws, including international law, to govern their disputes.<sup>25</sup>

19. Putting these principles together and applying them to this case, ICM and ICANN have agreed to arbitrate whether ICANN’s denial of ICM’s application for a .XXX sTLD (as well as the process leading to that denial) complied with “relevant principles of international law and applicable international conventions and local law.” The Bylaws establish an offer to arbitrate board decisions under a standard of review of consistency with, among other things, “principles of international law.” ICM accepted this offer when it brought this proceeding, effectively establishing an agreement to arbitrate and an agreement on governing law. Any uncertainty in the nature or scope of the agreement on arbitration and governing law was resolved by ICANN’s Response, which acknowledged that the IRP must assess the consistency of its actions against the Articles of Incorporation, including Article 4’s international law standard.

20. The same conclusion follows even if the parties have not effectively designated the governing laws or rules of law. In such a case, Article 28(1) of the ICDR

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<sup>23</sup> BORN, *s upra* note 19, at 2207; *see also* ALAN REDFERN & MARTIN HUNTER (WITH NIGEL BLACKABY & CONSTANTINE PARTASIDES), *LAW AND PRACTICE OF INTERNATIONAL COMMERCIAL ARBITRATION* 2-76 (4th ed. 2004).

<sup>24</sup> *See* REDFERN & HUNTER, *s upra* note 23, at 2-46 (noting that there is “no reason in principle” why private parties and corporations “should not select public international law, or alternatively the general principles of law, as the law which is to govern their contractual relationship”).

<sup>25</sup> *See, e.g.*, BORN, *s upra* note 19, at 2144.



Rules requires the IRP to apply the “appropriate” law. The “appropriate” starting place for determining whether ICANN has acted consistent with its Articles and Bylaws (including the international law obligations it assumed in the Articles) is almost certainly California law.<sup>26</sup> California law permits a non-profit corporation like ICANN to limit its powers in its Articles of Incorporation without qualification.<sup>27</sup> And ICANN has in fact limited its power by agreeing to act in conformity with “relevant principles of international law and applicable international conventions and local law.” As a result, and once again, the IRP must assess whether ICANN’s actions are consistent with these laws in Article 4.

21. In sum, in an attempt to bring accountability and thus legitimacy to its decisions, ICANN (a) assumed in its Articles of Incorporation an obligation to act in conformity with “relevant principles of international law,” and (b) in its Bylaws extended to adversely affected third parties a novel right of independent review in this arbitration proceeding for consistency with ICANN’s Articles and Bylaws. The parties have agreed to international arbitration in this forum to determine consistency with the international law standards set forth in Article 4 of the Articles of Incorporation. California law allows a California non-profit corporation to bind itself in this way.

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<sup>26</sup> This is so because, among other reasons, California law is “local law” within the meaning of Article 4 of the Articles of Incorporation and the law that would be chosen by all relevant state or national choice-of-law rules.

<sup>27</sup> See Cal. Corp. Code §§ 5131, 5140 (2007) (recognizing that a California nonprofit corporation’s “articles of incorporation may set forth a further statement *limiting the purposes or powers* of the corporation,” and that such a corporation has the powers of a natural person “[s]ubject to *any* limitations contained in the articles or bylaws.”) (emphases added).

#### IV. The Meaning of Article IV

22. The phrase “principles of international law and applicable international conventions and local law” refers to three types of law. “Local law” means California law. “Applicable international conventions” refers to treaties. The term “principles of international law” includes general principles of law.<sup>28</sup>

23. The place to begin for understanding the meaning of “principles of international law” is Article 38 of the Statute of the International Court of Justice (“ICJ”), which has become the canonical reference for the sources of international law. It lists three primary sources of international law that the ICJ shall apply:

- a. international conventions, whether general or particular, establishing rules expressly recognized by the contesting states;
- b. international custom, as evidence of a general practice accepted as law;
- c. the general principles of law recognized by civilized nations; . . .<sup>29</sup>

The phrase “principles of international law” would normally be interpreted to include all three of these sources. Since the first one, “international conventions,” is specified in the ICANN Articles, the reference to “principles of international law” in the Articles refers to the last two, customary international law and general principles of law.<sup>30</sup>

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<sup>28</sup> I also believe the phrase includes customary international law, but ICM has not asked me to address issues of customary international law in this Report.

<sup>29</sup> Statute of the International Court of Justice art. 38, June 26, 1945, 59 Stat. 1055, 33 U.N.T.S 993.

<sup>30</sup> It is conceivable that the reference to “*principles* of international law” (as opposed to “rules” of international law or merely “international law”) was meant to pick out “general principles” but exclude customary international law. I doubt this is the correct interpretation. I know of no precedent for an entity to hold itself accountable to treaties and general principles and not custom, and I know of no reason why ICANN would wish to organize itself in this way. But in any event the important point is that Article 4 is best read to include a requirement to act in conformity with general principles of law.

24. This conclusion is confirmed by the drafting history of the ICANN Articles of Incorporation. As noted above, a draft of the Articles assumed an obligation to give “due regard” to “applicable . . . international law,” a reference that would naturally have meant all three of the sources in Article 38 of the ICJ Statute. The final draft changed the standard of compliance from “due regard” to “conformity,” and changed “applicable . . . international law” to “relevant principles of international law and applicable international conventions.” This change ratcheted up ICANN’s standard of compliance, for “conformity” is more demanding than “due regard.” And it clarified that its commitment to international law extended to international law in all its forms.

25. This interpretation of “principles of international law” is further confirmed by the interpretation given to similar provisions in many other international law instruments. Most analogous is the Iran-U.S. Claims Tribunal, which is charged with applying “*principles of commercial and international law* as the Tribunal determines to be applicable.”<sup>31</sup> The Tribunal has interpreted this phrase to include “general principles of law” and “general principles of international law.”<sup>32</sup> Similarly, Article 31(3)(c) of the Vienna Convention on Treaties provides that, in interpreting treaties, account must be taken of “any *relevant rules of international law* applicable in the relations between the

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<sup>31</sup> Declaration of the Government of the Democratic and Popular Republic of Algeria Concerning the Settlement of Claims by the Government of the United States of America and the Government of the Islamic Republic of Iran, Jan. 19, 1981, art. V, *reprinted in* 1 Iran-U.S. Cl. Trib. Rep. 9 (1983) (emphases added).

<sup>32</sup> See Grant Hanessian, *General Principles of Law in the Iran-U.S. Claims Tribunal*, 27 COLUM. TRANSNAT’L L. 309 (1989) (citing many examples); John R. Crook, *Applicable Law in International Arbitration: The Iran-U.S. Claims Tribunal Experience*, 83 A.J.I.L. 278 (1989) (same).

parties,” a term that has been interpreted to include general principles of law.<sup>33</sup>

Arbitrators in the International Centre for Settlement of Investment Disputes (“ICSID”) are charged, in the absence of party choice, with applying “such rules of international law as may be applicable.”<sup>34</sup> Both the Report of the ICSID Executive Directors and ICSID Tribunals have interpreted “rules of international law” to include general principles of law.<sup>35</sup> NAFTA Chapter 11 similarly charges a Tribunal with applying “applicable rules of international law,” and that term too has been interpreted to include general principles.<sup>36</sup> In short, references to “principles of international law” and the related phrase “rules of international law” are commonly interpreted to include “general principles.”

26. It is perfectly appropriate to apply “general principles” in this IRP even though ICANN is technically a non-profit corporation and ICM is a private corporation. ICANN voluntarily subjected itself to these general principles in its Articles of Incorporation, something that both California law permits and that is typical in international arbitrations, especially when public goods are at stake. The “international” nature of this arbitration – which is evidenced by the global impact of ICANN’s

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<sup>33</sup> See, e.g., Appellate Body Report, *United States - Import Prohibition of Certain Shrimp and Shrimp Products*, ¶158, WT/DS58/AB/R (Oct. 12, 1998).

<sup>34</sup> Convention on the Settlement of Investment Disputes between States and Nationals of Other States art. 42(1), opened for signature Mar. 18, 1965, 17 U.S.T. 1270, 575 U.N.T.S. 159.

<sup>35</sup> See Executive Directors of the International Bank for Reconstruction and Development, Report of the Executive Directors on the Convention on the Settlement of Investment Disputes Between States and Nationals of Other States, para. 40 (Mar. 18, 1965), available at <http://icsid.worldbank.org/ICSID/StaticFiles/basicdoc/partB.htm>; CHRISTOPH H. SCHREUER, THE ICSID CONVENTION: A COMMENTARY art. 42, para. 113 (2001).

<sup>36</sup> See *Methanex Corporation v. United States (NAFTA)*, Final Award on Jurisdiction and Merits (Ad hoc) (UNCITRAL) (Aug. 3, 2005), at para. II(B)3.

decisions, by ICANN's self-description as a "special . . . organization" that should be governed by international law,<sup>37</sup> and by the fact that ICANN itself chose an international arbitral institution for this Independent Review – confirms the appropriateness of applying general principles. Moreover, ICANN is only nominally a private corporation. It exercises extraordinary authority, delegated from the U.S. Government, over one of the globe's most important resources. Though for reasons just explained its status as a de facto public entity is not necessary for the application of general principles here, its control over the Internet naming and numbering system does make sense of its embrace of the "general principles" standard. As explained above, the Article 4 limitations were a response to ICANN's legitimacy deficit and were designed to bring accountability and international legal order to ICANN's decisions.

27. While there is no doubt that ICANN can and has bound itself to general principles of law as that phrase is understood in international law, there is an issue about how general principles should be applied in conjunction with the other legal limitations ICANN assumed in Article 4, and, in particular, with its duty to act in conformity with "local law." When international law is included in a treaty or governing law clause as a source of law alongside national or local law, arbitrators sometimes conclude that international law, including general principles, should trump when in conflict with national law. Here, however, there are no conflicts between the various forms of law in Article 4. In fact, as explained below, the general principles relevant here complement, amplify, and give detail to the requirements of independence, transparency, and due process that ICANN has otherwise assumed in its Articles and Bylaws and under

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<sup>37</sup> See *infra* text accompanying note 4.

California law. General principles thus play their classic supplementary role in this proceeding.

**V. The Content of “General Principles of Law” in this Proceeding: Good Faith**

28. The analysis thus far has shown that the IRP must assess whether ICANN’s decision to deny ICM a sTLD, and the process leading to that decision, were consistent with ICANN’s Articles of Incorporation and Bylaws, and that among the obligations assumed in the Articles was a substantive standard of conformity with general principles of law. I now turn to describe some of the “general principles” that apply in this proceeding.

29. The notion of “general principles” as originally articulated in the Permanent Court of International Justice referred to widely accepted principles recognized in national law, and was designed primarily as a gap-filler to avoid *non liquet* when treaties and custom did not address an issue. However, as international law has grown during the last sixty years, the concept of “general principles” has expanded to include general principles that emerge across different types of international legal relations and those that inhere in all forms of legal reasoning, domestic and international.<sup>38</sup> Brownlie correctly notes that “general principles” cannot be reduced to a

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<sup>38</sup> See, e.g., Hermann Mosler, *General Principles of Law*, in THE ENCYCLOPEDIA OF PUBLIC INTERNATIONAL LAW [hereinafter “ENCYCLOPEDIA”], vol. 2, at 511-512 (1992) (“general principles of law” can mean “principles applied as law generally in national law,” “principles having their origin directly in international legal relations,” and “principles recognized in all kinds of legal relations, regardless of the legal order to which they may belong”).



“rigid categorization of sources,” and that while many such principles can be “traced to state practice,” they are “primarily abstractions from a mass of rules and have been so long and generally accepted as to be no longer directly connected with state practice.”<sup>39</sup>

30. There are many ostensible general principles of law, but perhaps none as settled or important – across domestic legal systems and in international law – as the principle of good faith.<sup>40</sup> The general principle of good faith is “the foundation of all law and all conventions.”<sup>41</sup> As the International Court of Justice has noted, “the principle of good faith is a well-established principle of international law.”<sup>42</sup> It is a fundamental principle of treaty law,<sup>43</sup> of the U.N. Charter,<sup>44</sup> of the law of the World Trade Organization,<sup>45</sup> of international commercial law,<sup>46</sup> and of international investment

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<sup>39</sup> IAN BROWNLIE, *PRINCIPLES OF PUBLIC INTERNATIONAL LAW* 19 (7th ed. 2008).

<sup>40</sup> J.F. O’CONNOR, *GOOD FAITH IN INTERNATIONAL LAW* 35 (1991) (noting that “[t]he principle of good faith probably receives more unqualified acceptance than any other in international law”).

<sup>41</sup> BIN CHENG, *GENERAL PRINCIPLES OF LAW AS APPLIED BY INTERNATIONAL COURTS AND TRIBUNALS* 105 (*quoting* Megalidis Case, 8 T.A.M. 386, 395 (1928)); *see also* MALCOLM SHAW, *INTERNATIONAL LAW* 97 (2002) (“[p]erhaps the most important general principle, underpinning many international legal rules, is that of good faith”).

<sup>42</sup> *Land and Maritime Boundary (Cameroon v. Nig.)*, 1998 I.C.J. 275, 296 (June 11).

<sup>43</sup> *See* Vienna Convention on the Law of Treaties, preamble (“*Noting* that the principles of free consent and of *good faith* and the *pacta sunt servanda* rule are universally recognized”) (emphasis added); art. 26 (“Every treaty in force is binding upon the parties to it and must be performed by them in good faith.”); art. 31(1) (“A treaty shall be interpreted in good faith . . .”).

<sup>44</sup> U.N. Charter, art. 2, para. 2 (“All Members, in order to ensure to all of them the rights and benefits resulting from membership, shall fulfill in good faith the obligations assumed by them in accordance with the present Charter.”).

<sup>45</sup> *See* Helge Elisabeth Zeitler, ‘*Good faith*’ in the *WTO Jurisprudence: Necessary Balancing Element or an Open Door to Judicial Activism*, 8(3) J. INT’L ECON. L. 721 (2005).

<sup>46</sup> *See* UNIDROIT Principles of International Commercial Contracts 2004 [hereinafter “UNIDROIT Principles 2004”], art 1.7, *available at* <http://www.unidroit.org/english/principles/contracts/main.htm> (“[e]ach party must act in accordance with good faith and fair dealing in international trade”). Note that the UNIDROIT

law.<sup>47</sup> Good faith is also a prevalent general principle in domestic commercial laws.<sup>48</sup>

31. ICANN voluntarily held itself to the good faith standard when, in Article 4 of its Articles of Incorporation, it obliged itself to act “in conformity with principles of international law.” The good faith principle has at least three related applications in this proceeding: (a) the requirement of good faith in complying with legal restrictions; (b) the requirement of good faith in the exercise of discretion, also known as the doctrine of non-abuse of rights; and (c) the requirement of good faith in contractual negotiations.

A. Good Faith in Complying With Legal Restrictions

32. As Shaw has noted, summarizing many arbitral decisions, good faith operates as “a background principle informing and shaping the observance of existing rules of international law and in addition constraining the manner in which those rules may legitimately be exercised.”<sup>49</sup> Shaw was writing about the good faith principle as it applied to relations among states governed by international law. But the good faith

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Principles provide that “[t]hey may be applied when the parties have agreed that their contract be governed by general principles of law,” and as an interpretive guide and supplement to domestic law. UNIDROIT Principles 2004, Preamble.

<sup>47</sup> See, e.g., *Tecnicas Medioambientales Tecmed S.A. v. Mexico*, Award, May 29, 2004, 43 ILM 133, para. 154; *Waste Management v. Mexico*, Final Award, Apr. 30, 2004, 43 ILM 967, para. 138; *Eureko B.V. v. Poland*, Partial Award, Aug. 19, 2005, para. 235; *Saluka B.V. v. Czech Republic*, Partial Award, Mar. 17, 2006, paras. 361-432.

<sup>48</sup> See, e.g., E. Allan Farnsworth, *Duties of Good Faith and Fair Dealing under the UNIDROIT Principles, Relevant International Conventions, and National Laws*, 3 TUL. J.INT’L & COMP. L. 47 (1995).

<sup>49</sup> SHAW, *supra* note 41, at 98 (citing many sources). Shaw’s dictum about good faith applying to extant legal rules explains what the International Court of Justice meant when it said that good faith, while “one of the basic principles governing the creation and performance of legal obligations,” is “not in itself a source of obligation where none would otherwise exist.” *Border and Transborder Armed Actions (Nicar. v. Hond.)*, 1988 I.C.J. 69, 105 (Dec. 20).

principle is “equally applicable to relations between individuals and to relations between nations.”<sup>50</sup>

33. The good faith principle attaches to the obligations and legal limitations that ICANN assumed in its Articles and Bylaws and demands that ICANN comply with them “honestly and fairly.”<sup>51</sup> It “requires that one party should be able to place confidence in the words of the other,” and insists that “promises should be scrupulously kept so that . . . confidence . . . may be reasonably placed upon them.”<sup>52</sup> Similarly, in the investment dispute context, arbitral tribunals have applied the good faith principle, often through the lens of the fair and equitable treatment standard, to require the state to uphold the investor’s legitimate law-based expectations.<sup>53</sup> The principle of good faith also encompasses the related principles of fairness, estoppel, and transparency.

34. Taking ICM’s allegations as true, ICANN acted inconsistently with the good faith standard when it denied ICM’s application for a .XXX sTLD, for ICANN did not apply its rules and procedures honestly and fairly and thus did not fulfill ICM’s legitimate expectations based on these rules and procedures. According to the allegations, ICANN departed from its stated sponsorship criteria and instead used

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<sup>50</sup> CHENG, *supra* note 41, at 105.

<sup>51</sup> Anthony D’Amato, *Good Faith*, in *ENCYCLOPEDIA* vol. 2, *supra* note 38, at 599; *see also* CHENG, *supra* note 41, at 119. It is important to note that the good faith principle imposes duties on top of ICANN’s many obligations under its Articles of Incorporation and Bylaws, and provides a legal framework for the analysis of ICM’s claims that numerous provisions of the Articles and Bylaws, including many that I do not mention here, were violated. My focus in this Report is only on the independent duties arising from ICANN’s decision to conform its behavior to principles of international law.

<sup>52</sup> CHENG, *supra* note 41, at 107, 119.

<sup>53</sup> *See supra* note 47.

sponsorship criteria related to vague and undefined public policy and law enforcement concerns that are beyond, and inconsistent with, ICANN's technical mandate. Moreover, ICANN allegedly violated its Bylaws by, among other things, singling out a particular party for disparate treatment and not operating in an open and transparent fashion. These allegations, if true, violate ICANN's good faith obligations.

B. Good Faith In Exercising Discretion: Abuse of Rights

35. Closely related to the general principle of good faith, and indeed a specific application of it, is the general principle of non-abuse of right. The prohibition on abuse of right has many dimensions, but its core meaning is that the exercise of legal discretion or legal rights must be made in good faith.<sup>54</sup>

36. In the *United States Nationals in Morocco Case*, for example, the ICJ held that French officials in Morocco had the legally circumscribed power to value U.S. goods at the Moroccan border, but concluded that the power "must be exercised reasonably and in good faith."<sup>55</sup> Similarly, in the *Anglo-Norwegian Fisheries Case*, the ICJ determined that Norway had committed no "manifest abuse" in part because its maritime delineation decisions were "moderate and reasonable."<sup>56</sup> And in the *Admissions of a State to the United Nations Case*, the ICJ held that Article 4 of the U.N. Charter prescribed the exclusive conditions that states could invoke in determining whether to admit a new

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<sup>54</sup> See Complaint by United States, *United States – Import Prohibition of Certain Shrimp and Shrimp Products*, ¶158, WT/DS58/AB/R (1998) (noting that "[o]ne application of this general principle [of good faith], the application widely known as the doctrine of *abus de droit*, prohibits the abusive exercise of a state's rights"); CHENG, *supra* note 41, at 121 (noting that the abuse of rights principle "is merely an application of this [good faith] principle to the exercise of rights").

<sup>55</sup> *Rights of Nationals of United States of America in Morocco (Fr. v. U.S.)*, 1952 I.C.J. 176, 212 (Aug. 27).

<sup>56</sup> *Anglo-Norwegian Fisheries Case (U.K. v. Nor.)*, 1951 I.C.J. 116, 141-142 (Dec. 18).

nation to the United Nations, and added that “Article 4 does not forbid the taking of account of any factor which it is possible *reasonably and in good faith* to connect to the conditions laid down in that Article.”<sup>57</sup>

37. In all of these cases, nations had legally circumscribed discretion to act, but this discretion was tempered by the good faith principle. Cheng deduces from these and many other arbitral decisions the following principle:

Where the right confers upon its owner a discretionary power, this must be exercised honestly, sincerely, reasonably, in conformity with the spirit of the law and with due regard to the interests of others. . . . They must not be exercised fictitiously so as to evade such obligations or rules of law, or maliciously so as to injure others. Violations of these requirements of the principle of good faith constitute abuses of right . . . .<sup>58</sup>

Or as O’Connor states the rule, drawing on subsequent decisions not analyzed by Cheng, “the expression ‘abuse of rights’ may be taken to include cases where a legal right – whether arising from a treaty or by virtue of customary rules – is exercised arbitrarily, maliciously or unreasonably, or fictitiously to evade a legal obligation.”<sup>59</sup>

38. Taking ICM’s allegations as true, ICANN violated the prohibition against abuse of right. There are many possible abuses of right alleged by ICM, but the one that strikes me as most obvious is the clearly fictitious basis ICANN gave for denying ICM’s application. ICANN’s reasons for denial included the following:

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<sup>57</sup> Conditions of Admission of a State to Membership in the United Nations, 1948 I.C.J. 57, 63 (May 28) (emphasis added).

<sup>58</sup> CHENG, *supra* note 41, at 136; *see also id.* at 132-34 (“discretion must be exercised in good faith, and the law will intervene in all cases where this discretion is abused. . . . Whenever, therefore, the owner of a right enjoys a certain discretionary power, this must be exercised in good faith, which means that it must be exercised reasonably, honestly, in conformity with the spirit of the law and with due regard to the interest of others.”).

<sup>59</sup> O’Connor, *supra* note 40, at 38; *see also* Alexandre Kiss, *Abuse of Rights*, in *ENCYCLOPEDIA* vol 1, at 4 (“In international law, abuse of rights refers to a State exercising a right . . . for an end different from that for which the right was created, to the injury of another state.”).

The ICM Application raises significant law enforcement compliance issues because of countries' varying laws relating to content and practices that define the nature of the application, therefore obligating ICANN to acquire a responsibility related to content and conduct.

The Board agrees with the reference in the GAC communiqué from Lisbon, that under the Revised Agreement, there are credible scenarios that lead to circumstances in which ICANN would be forced to assume an ongoing management and oversight role regarding Internet content, which is inconsistent with its technical mandate.<sup>60</sup>

This explanation appears fictitious, and thus an abuse of right, for at least two reasons.

39. First, the concern about "law enforcement compliance issues because of countries' varying laws relating to content and practices that define the nature of the application" applies to many top-level domains besides .XXX. The website <pornography.com.> would be no less subject to various differing laws around the world than the website <pornography.xxx.> If anything, pornography on a website on the .XXX domain is *easier* for nations to regulate and exclude from computers in their countries because they can block all sites on the .XXX domain with relative ease but have to look at the content, or make guesses based on domain names, to block unwanted pornography on .COM and other top level domains.<sup>61</sup> In short, this reason for ICANN's denial, if genuine, would extend to many top-level domains and would certainly apply to all generic top-level domains (like .COM,

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<sup>60</sup> Adopted Resolutions from ICANN Board Meeting (Mar. 30, 2007), *available at* <http://www.icann.org/en/minutes/resolutions-30mar07.htm>.

<sup>61</sup> On the techniques of Internet content blocking and their effectiveness, see *ACCESS DENIED: THE PRACTICE AND POLICY OF GLOBAL INTERNET FILTERING* (Ronald Deibert, John Palfrey, Rafal Rohozinski, Jonathan Zittrain, eds., 2008).



.INFO, .NET, and .ORG) where pornographic websites can be found.<sup>62</sup> But ICANN has only applied this reason for denial to the .XXX domain. This strongly suggests that the reasons for the denial are pretextual and thus that the denial is an abuse of right. Under the guise of content-neutrality, ICANN seems to be exercising power in a content-sensitive way; and it appears to be doing so without candor.

40. Second, and similarly pretextual, is ICANN's claim that "there are credible scenarios that lead to circumstances in which ICANN would be forced to assume an ongoing management and oversight role regarding Internet content." In fact it is hard to imagine such circumstances. In the unlikely scenario that (a) a national court ordered ICM to shut down a .XXX site that violated a law in that country, and (b) ICM ignored the court order, and (c) the court had jurisdiction over ICANN, it is possible that ICANN could become involved in a national law Internet content dispute. It is implausible to assume that this scenario would be "ongoing." But more importantly, *the same logic applies to generic top level domains like .COM*. The identical scenario could arise if a national court ordered VeriSign (as the registry operator for .COM) to shut down one of the hundreds of thousands of pornography sites on .COM. But ICANN has only expressed concern about an "ongoing management and oversight role regarding Internet

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<sup>62</sup> The worry about multiple law enforcement is not limited to pornography, and .XXX is not the only sTLD that implicates the worry. National laws related to the Internet differ on scores of issues ranging from free speech to gambling to intellectual property to spam. And many sTLDs besides .XXX can potentially run afoul of these laws. For example, a website called <teens.jobs> that solicits the labor of teenagers would likely be illegal in some places and not in others. If national law enforcement compliance issues were a genuine reason not to grant a top-level domain, there would be many fewer top-level domains, and the Internet would be much less robust.

content” in connection with ICM’s application. This strongly suggests, once again, that its reasons are pretextual, and thus that the denial was an abuse of right.

C. Good Faith in Contract Negotiations

41. An additional way that the good faith principle applies here is in requiring ICANN to negotiate its contracts in good faith. It is settled that “[a]s a general principle of law, contracts must be *negotiated* and performed in good faith.”<sup>63</sup> In particular, a lack of candor in negotiations can violate the good faith principle.<sup>64</sup> The requirement of candor also flows from the UNIDROIT commercial principles. These principles apply in cases, like this one, that are governed by general principles.<sup>65</sup> They require that “each party must act in accordance with good faith and fair dealing in international trade,” and state that it is “bad faith, in particular, for a party to enter into or continue negotiations when intending not to reach an agreement with the other party.”<sup>66</sup>

42. ICM has alleged an absence of good faith and a lack of candor on ICANN’s part in its contractual negotiations. ICM essentially contends that the ICANN Board authorized ICM to enter into contract negotiations over technical and commercial

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<sup>63</sup> R. DOAK BISHOP, JAMES CRAWFORD, W. MICHAEL REISMAN, FOREIGN INVESTMENT DISPUTES: CASES AND CONTROVERSIES 15 (2005) (emphasis added); *see also* Nuclear Tests (Australia v. Fr.), 1974 I.C.J. 253, 268 (Dec. 20) (noting that principle of good faith is “one of the basic principles governing the *creation* and performance of legal obligations”) (emphasis added).

<sup>64</sup> *See* SHABTAI ROSENNE, DEVELOPMENTS IN THE LAW OF TREATIES: 1945-1986, at 173-74 (1989) (summarizing treaty and arbitral developments and concluding that “uncandidness . . . could well be taken as an indication that the negotiations were not being conducted in good faith”).

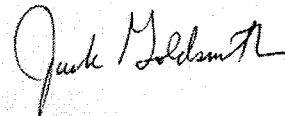
<sup>65</sup> *See* UNIDROIT Principles 2004, Preamble (noting that UNIDROIT principles “may be applied when the parties have agreed that their contract be governed by general principles of law”); Iran v. Cubic Defense Systems, 29 F. Supp. 2d 1168, 1173 (S.D. Cal. 1998) (confirming International Chamber of Commerce Tribunals Award that appeared to apply UNIDROIT Principles to the dispute as an instance of “general principles of international law”).

<sup>66</sup> UNIDROIT Principles 2004, arts. 1.7, 2.1.15.

matters without caveats or special instructions; that ICANN gave ICM every indication that ICM had satisfied the RFP evaluation criteria and that the contract negotiations would be straightforward and uncomplicated; that ICM negotiated agreement after agreement with the ICANN staff to meet the increasingly stringent demands imposed by the ICANN Board, acting under pressure from the GAC; and that the ICANN Board ultimately rejected the ICM proposed registry agreement on the basis of criteria that were unrelated to the original published evaluation criteria and beyond ICANN's mandate. These allegations, if true, suggest that the ICANN Board, after the GAC intervention, had no intention of reaching a registry agreement contract, and thus did not negotiate the contract in good faith.

\* \* \*

43. I hereby declare that I have prepared this Expert Report to the best of my knowledge and belief.



Jack Goldsmith

January 22, 2009

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**INTERNATIONAL CENTRE FOR DISPUTE RESOLUTION**

In the Matter of the Independent Review Process:

ICM Registry, LLC,

Claimant,

v.

Internet Corporation For Assigned Names and  
Numbers ("ICANN"),

Respondent.

CASE MANAGER: Carolina Cárdenas

ICDR Case No. 50 117 T 00224 08

**ICANN'S RESPONSE TO  
CLAIMANT'S MEMORIAL ON THE MERITS**

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## TABLE OF ABBREVIATIONS

ALAC	ICANN's At-Large Advisory Committee
DNS	domain name system
DNSO	Domain Name Supporting Organization
ERC	ICANN Evolution and Reform Committee
Evaluation Panel	independent panel of experts convened in April 2004 to review and make recommendations with respect to the sTLD applications
GAC	ICANN's Governmental Advisory Committee
GNSO	ICANN's Generic Names Supporting Organization
gTLD	generic Top Level Domain
ICANN	Internet Corporation for Assigned Names and Numbers
ICDR	International Centre for Dispute Resolution
ICDR Rules	ICDR International Arbitration Rules
ICM	ICM Registry, LLC
IFFOR	International Foundation for Online Responsibility
IP	Internet Protocol
IRP	ICANN's independent review process
Memorial	ICM's Memorial on the Merits
NTIA	National Telecommunications and Information Administration (an agency of the United States Department of Commerce)
Panel	IRP Panel
RFP	request for proposal
sTLD	sponsored Top Level Domain
TLD	Top Level Domain
uTLD	unsponsored Top Level Domain

Pursuant to Article IV, section 3 of the Bylaws for the Internet Corporation for Assigned Names and Numbers (“ICANN”), and the Rules of the International Centre for Dispute Resolution (“ICDR”) as amended and supplemented in this proceeding, ICANN hereby submits this Response (the “Response”) to Claimant’s Memorial on the Merits submitted by ICM Registry, LLC (“ICM”).

## **I. INTRODUCTION**

1. This dispute relates to ICM’s proposal to operate a new sponsored Top Level Domain (an “sTLD”) on the Internet known as “.XXX.” The .XXX sTLD was intended to serve the online adult-entertainment (*i.e.*, pornography) community. ICM asserts that ICANN’s denial of ICM’s proposal violated ICANN’s Bylaws and Articles of Incorporation, in particular that the Board did not act in an open, transparent, and procedurally fair manner.

2. The ICANN Board did deny ICM’s application, but only after a multi-year and extensive debate, during which the Board: (i) repeatedly allowed ICM to provide information in support of its application and to amend its proposed registry agreement to address ICANN’s concerns; (ii) received a significant amount of input from members of the “community” that ICM proposed to represent, as well as from several governments that were concerned about the proposed .XXX sTLD; (iii) debated the issues publicly and at great length; and (iv) ultimately determined that ICM had failed to meet the criteria established for the delegation of a sponsored TLD. Throughout ICANN’s review, evaluation and ultimate rejection of ICM’s proposal, ICANN adhered rigorously to its Bylaws and Articles of Incorporation. Indeed, it is hard to imagine a process that could have been *more* open, transparent, and procedurally fair.

3. These independent review proceedings are truly unique. ICANN, which has existed since 1998, established the process of independent review in Bylaws revisions that were adopted in 2002. The Bylaws provide that the limited purpose of independent review is to provide a forum to address whether ICANN acted inconsistently with its Bylaws and Articles of Incorporation. ICM’s challenge is the first time that the process has been invoked.

4. The independent review process must, of course, adhere strictly to the Bylaws that established the process. The process was not intended to provide for a “Supreme Court” of ICANN that would address all aspects of ICANN’s conduct, nor was the process intended to

provide for a panel of three jurists who would substitute their views on the operation of the Internet's domain name system for the views of the ICANN Board following a *de novo* review of all the facts. This, however, is ICM's position in these proceedings, a position that is utterly inconsistent not only with the Bylaws but with the extensive process that resulted in ICANN's adoption of the Bylaws.

5. In this Response, ICANN will address these subjects in detail. After providing some general background on ICANN and the dispute at issue, this Response will proceed as follows:

- First, ICANN will address the nature of these proceedings and the fact that the Panel's declaration will not be legally binding on ICANN. *See infra* Section III.A.1.
- Second, ICANN will address the appropriate standard of review that applies to these proceedings, and show that decisions of the Board are entitled to significant deference. *See infra* Section III.A.2.
- Third, ICANN will address the law that applies to these proceedings. ICM attempts to import "international law" and assorted claims arising under international law, but the Articles and Bylaws are clear that international law does not apply here. *See infra* Section III.A.3.
- Fourth, and with respect to the factual merits of ICM's claims, ICANN will address the four major factual disputes that ICM has identified. ICANN will demonstrate that ICM's interpretation of the facts is demonstrably wrong in each respect. As a result, and whatever deference that the Panel elects to afford to the decisions of the Board, ICM has no basis for claiming any inconsistency with ICANN's Articles and Bylaws. *See infra* Sections III.B and III.C.

6. ICANN regrets the need to address so many issues. ICM knows better than to be arguing that these proceedings are binding or that the Panel should be conducting a *de novo* review. Indeed, ICM's own counsel, who participated in drafting the Bylaws governing these proceedings, has written that these proceedings are merely advisory and not binding. Under the standards unambiguously set out in the Bylaws, these proceedings are not nearly as complicated as ICM attempts to make them, and a hearing with live witnesses is unnecessary for the Panel to carry out its mandate, particularly in view of the enormous amount of materials that the parties have submitted to the Panel. In any event, there is little doubt that the ICANN Board's

extremely comprehensive review of ICM's application for the .XXX sTLD was fully compliant with the Bylaws and Articles. The fact that ICM did not like the final outcome hardly means that ICANN violated its Bylaws or Articles; to the contrary, as will be discussed in this Response, ICANN devoted a tremendous amount of time to the .XXX sTLD application because: (i) the application was controversial; (ii) it involved complex issues in a world-wide setting that were not easily resolved; (iii) from the outset, the application generated significant concerns that it did not meet the "sponsorship" requirements for ICANN to approve .XXX as a *sponsored* TLD (as the application criteria clearly required); and (iv) it was the only sTLD application that ICANN received that did not appear to have support from the "community" it proposed to represent and, even more complicating, generated significant opposition over time.

7. Nearly all of ICM's arguments rest on the assertion that, in June 2005, the ICANN Board finally and unconditionally deemed ICM's application to satisfy ICANN's requirements for approval of a sponsored TLD. But the facts (including the resolutions that the Board adopted), and the parties' course of conduct following the June 2005 Board resolutions, make clear that the Board did not unconditionally approve ICM's application; to the contrary, the Board remained extremely concerned that ICM's application was lacking with respect to a critical component – sponsorship. Many Top Level Domains do not have (or require) sponsorship, but sponsorship was the key ingredient in this particular process that the ICANN Board had adopted and under which ICM submitted its application.

8. ICM assumes incorrectly that the two steps involved in reviewing sTLD applications (namely, review of the application's compliance with the requirements for issuance and the negotiation of an acceptable contract) could never overlap in time, so that *any* authorization to proceed with contract negotiations would always constitute an implicit approval of the application. This assumption is baseless. The language of the rules governing the process, the understanding of the participants, the operation of the process in practice, ICANN's historical practice, and common sense all uniformly show that ICANN was free to consider both steps simultaneously, because contract negotiations could sometimes facilitate resolution of issues regarding the requirements for any sTLD. The evidence shows beyond any doubt that this is precisely what ICANN did with respect to ICM's application. Because the ICANN Board did not approve ICM's application in June 2005, but merely voted to allow negotiations to proceed



with ICM for the purpose of determining whether such negotiations might bear on the outstanding issues surrounding the application, ICM's arguments collapse.

9. ICM's insinuation that ICANN denied ICM's application based on vague public policy considerations is false. ICANN denied the application for the same reasons, among others, that had caused a completely independent Evaluation Panel to recommend that ICANN not proceed with ICM's .XXX sTLD – because ICM failed to satisfy essential “sponsorship” requirements. ICM's suggestion that these determinations were somehow pretextual is amply refuted by the fact that the Evaluation Panel reached precisely the same conclusion as ICANN, as well as by copious evidence demonstrating that those requirements were not, as a matter of fact, satisfied. Further, as ICANN explains herein, the Board properly considered the substantial public policy objections that numerous governments asserted during the course of the Board's deliberations.

10. ICANN could have denied ICM's application immediately upon the adverse recommendation of the Evaluation Panel, which determined that ICM failed to satisfy essential requirements for an sTLD and recommended that ICM's application receive no further consideration. Nonetheless, ICANN's Board chose to extend far greater review and latitude to ICM than was required by the process, permitting additional submissions, written and oral presentations to ICANN, and efforts to address ICM's shortcomings through negotiation. None of these additional activities were required by the sTLD process that ICANN had adopted for evaluating sTLD applications, but ICANN extended them to ICM (and others) nevertheless. Perhaps the Board should have denied ICM's application in 2004, but it extended the process in order to determine whether ICM could ultimately satisfy the necessary criteria for the TLD it proposed to operate. Over time, the answer turned to be “no,” but the notion that ICANN somehow violated its Bylaws or Articles of Incorporation in the process is unsupportable as a legal or factual matter.

## **II. BRIEF SUMMARY OF RELEVANT FACTS AND ICM'S MEMORIAL.**

### **A. ICANN'S FUNCTION AND DECISION-MAKING.**

11. ICANN is a not-for-profit public benefit corporation that was organized under California law in 1998.<sup>1</sup> ICANN's mission is to protect the stability, integrity, and utility of the Internet domain name system (the "DNS") on behalf of the global Internet community,<sup>2</sup> pursuant to a series of agreements with the United States Department of Commerce.<sup>3</sup> In carrying out its functions, ICANN solicits and receives input from a wide variety of Internet stakeholders.

12. ICANN has a Board of Directors, a Staff, an Ombudsman, a Nominating Committee for Directors, three Supporting Organizations,<sup>4</sup> four Advisory Committees, and numerous other stakeholders that participate in the ICANN process.<sup>5</sup> ICANN's Board of Directors (the "Board") consists of one compensated voting director (the President and CEO)

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<sup>1</sup> Articles of Incorporation of Internet Corporation for Assigned Names and Numbers (last modified November 21, 1998), attached to Claimant's Memorial on the Merits, Exhibit 4 (Hereinafter referred to as "Cl. Ex. \_\_").

<sup>2</sup> ICANN Bylaws, Article 1, § 1 (Mission), Cl. Ex. 5.

<sup>3</sup> See, e.g., Memorandum of Understanding between the U.S. Department of Commerce and ICANN, November 25, 1998, Cl. Ex. 32.

<sup>4</sup> The Supporting Organizations are responsible for the development and recommendation of policies concerning the Internet's technical management within their areas of expertise. For example, the Generic Names Supporting Organization (the "GNSO") is responsible for advising the ICANN Board on substantive policy issues relating to generic top-level domains. See Generic Names Supporting Organization, GNSO Reference Documents, available at <http://gnso.icann.org/reference-documents.htm> (last visited May 4, 2009), attached hereto as ICANN Exhibit A.

<sup>5</sup> ICANN Bylaws, *supra* note 2, Articles V-XI. ICANN's Bylaws provide for four Advisory Committees – the Governmental Advisory Committee (discussed in the next paragraph), the Security and Stability Advisory Committee, the Root Server System Advisory Committee, and the At-Large Advisory Committee. See *id.* at Article XI, §§ 1-2 (Advisory Committees). The Bylaws also provide that the ICANN Board may liaise with additional Committees, which it has done with the Technical Liaison Group and the Internet Engineering Task Force. The Bylaws established the Technical Liaison Group as a group of four preexisting, non-ICANN organizations intended to "connect the Board with appropriate sources of technical advice on specific matters pertinent to ICANN's activities." See *id.* at Article XI-A, §§ 1-2 (Technical Liaison Group). The Internet Engineering Task Force, which is also a non-ICANN organization, is an "open international community of network designers, operators, vendors, and researchers concerned with the evolution of the Internet architecture and the smooth operation of the Internet." Overview of the IETF, available at <http://www.ietf.org/overview.html> (last visited May 4, 2009), attached hereto as ICANN Exhibit B.

and fourteen volunteer voting directors,<sup>6</sup> two-thirds of whom presently reside outside of the United States. In addition, each of the Advisory Committees, along with the Technical Liaison Group (the “TLG”) and the Internet Engineering Task Force (the “IETF”), appoint a volunteer, non-voting liaison to the Board, who takes part in Board discussions and deliberations.<sup>7</sup>

13. The Governmental Advisory Committee (the “GAC”) is one of ICANN’s Advisory Committees, made up of representatives of national governments and intergovernmental organizations.<sup>8</sup> The GAC provides advice to ICANN on issues of public policy, acting as a conduit for different national governments to express their views to ICANN. In particular, the GAC considers ICANN’s activities and policies as they relate to the concerns of governments, particularly in matters where there may be an interaction between ICANN’s policies and national laws or international agreements.<sup>9</sup>

14. ICANN’s Bylaws provide that the ICANN Board shall notify the Chair of the GAC in a timely manner of any proposal raising public policy issues.<sup>10</sup> The GAC may also “put issues to the Board directly, either by way of comment or prior advice, or by way of specifically recommending action or new policy development or revision to existing policies.”<sup>11</sup>

15. The Bylaws *require* the ICANN Board to consider the GAC’s advice.<sup>12</sup> Where the Board elects to take actions that are inconsistent with the GAC’s advice, it must inform the

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<sup>6</sup> ICANN Bylaws, *supra* note 2, Article VI, § 1 (Board of Directors). Eight directors are selected by ICANN’s Nominating Committee and the other six directors are selected by ICANN’s three Supporting Organizations (each selecting two). The ICANN President also serves as a voting director. *Id.* at Article VI, § 2.

<sup>7</sup> *Id.* at Article VI, § 9 (Non-Voting Liaisons).

<sup>8</sup> *Id.* at Article XI, § 2.

<sup>9</sup> *Id.* at Article XI, § 2.1(a); *see also* The Internet Domain Name System and the Governmental Advisory Committee (GAC) of the Internet Corporation for Assigned Names and Numbers (ICANN), Cl. Ex. 40; ICANN Governmental Advisory Committee, Operating Principles, Cl. Ex. 41 (“GAC’s Operating Principles”).

<sup>10</sup> ICANN Bylaws, *supra* note 2, Article XI, § 2.1(h) (Advisory Committees).

<sup>11</sup> *Id.* at Article XI, § 2.1(i).

<sup>12</sup> *Id.* at Article XI, § 2.1(j); *see also* GAC’s Operating Principles, *supra* note 9 (“The Governmental Advisory Committee should consider and provide advice on the activities of ICANN as they relate to concerns of governments and where they may affect public policy issues. The Advice of the

GAC and state its reasons for doing so. The GAC and the ICANN Board must then attempt to find a mutually acceptable solution.<sup>13</sup>

**B. THE INITIAL ROUND FOR INTRODUCING NEW TLDs AND ICM'S APPLICATION FOR AN UNSPONSORED .xxx TLD.**

16. When ICANN was formed, there were only three “generic” TLDs – .com, .net, and .org.<sup>14</sup> Since its inception, ICANN has worked to introduce new TLDs. Indeed, ICANN began to explore the possibility of adding new TLDs to the DNS shortly after ICANN's formation in 1998.

17. There are several types of TLDs. Currently, the TLDs with three or more characters are called “generic” TLDs or “gTLDs.” Other types of TLDs include two-letter country-code TLDs, such as .fr and .cz. TLDs are run by “registries” (or “registry operators”).

18. gTLDs can be subdivided into two types: “unsponsored” TLDs (“uTLDs”) and “sponsored” TLDs (previously defined as “sTLDs”). In general, a uTLD operates for the benefit of the global Internet community and has no restrictions on which “second level” domain names – *i.e.*, “google.com” – can be registered in that TLD. An sTLD, by contrast, is a specialized TLD that has a “Sponsor” representing a specified community for whose benefit it wishes to operate the TLD, and the Sponsor places limitations on those who wish to register second level domain names.

19. An sTLD “Sponsor” (or “sponsoring organization”) is delegated the authority to control the operation of the sTLD. Each sTLD has a “Charter,” which defines the purpose of the

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(continued...)

Governmental Advisory Committee on public policy matters shall be duly taken into account by ICANN, both in the formulation and adoption of policies.”)

<sup>13</sup> ICANN Bylaws, *supra* note 2, Article XI, § 2.1(j).

<sup>14</sup> There were also four other limited-use TLDs that are sometimes referred to as “gTLDs”: .gov (for United States government use); .edu (for educational institutions, mainly in the United States); .int (for international treaty organizations); and .arpa (for infrastructural identifier spaces).

sTLD. The Sponsor must develop policies to implement the Charter for the benefit of a defined group of stakeholders, known as the “Sponsored TLD Community.”<sup>15</sup>

20. On July 16, 2000, after lengthy deliberation and public comment, the ICANN Board adopted a “measured and responsible” application process for the introduction of new gTLDs.<sup>16</sup> This initial round was a preliminary effort to constitute a “proof of concept” to improve ICANN’s understanding and experience in practical and policy issues involved in adding new TLDs.<sup>17</sup>

21. ICANN received forty-seven applications for over 200 new gTLDs (both unsponsored and sponsored). Among the forty-seven proposals was an application by ICM for an *unsponsored* .XXX TLD. ICANN staff recommended that the Board not select .XXX during this “proof of concept” round for three reasons: (1) a .XXX TLD “did not appear to meet unmet needs”; (2) there was significant “controversy surrounding” the application; and (3) the application adopted a “poor definition of the hoped-for benefits” of .XXX.<sup>18</sup> “The evaluation concluded that at this early ‘proof of concept’ stage with a limited number of new TLDs

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<sup>15</sup> The purpose and function of uTLDs and sTLDs may evolve as ICANN continues to add new TLDs to the DNS. With respect to sTLDs, ICM’s expert, Dr. Milton Mueller, criticizes ICANN for being “in the position of approving who [is] the appropriate representative of a ‘community,’” and argues that “[s]uch a determination bears little direct connection to ICANN’s technical mandate.” ICM Memorial, Expert Report of Dr. Milton Mueller at p. 23. Dr. Mueller’s criticism is misplaced. Sponsorship permits sTLD policies to be developed by an independent sponsor, with more limited supervision by ICANN than is present in uTLDs. Far from accreting power to ICANN, sponsorship shifts policymaking *away* from ICANN in favor of independent actors.

<sup>16</sup> ICANN TLD Application Process: Information for Applicants, *available at* <http://www.icann.org/en/tlds/tld-application-process.htm> (last visited May 4, 2009), attached hereto as ICANN Exhibit C; *see also* Resolutions of the ICANN Board on New TLDs, July 16, 2000, *available at* <http://www.icann.org/en/tlds/new-tld-resolutions-16jul00.htm> (last visited May 4, 2009), attached hereto as ICANN Exhibit D.

<sup>17</sup> ICANN Criteria for Assessing TLD Proposals, August 15, 2000, Cl. Ex. 52 (“The current program of establishing new TLDs is intended to allow the Internet community to evaluate possible additions and enhancements to the DNS and possible methods of implementing them. Stated differently, the current program is intended to serve as a ‘proof of concept’ for ways in which the DNS might evolve in the longer term.”).

<sup>18</sup> ICANN Report on TLD applications: Application of the August 15 Criteria to Each Category or Group, November 9, 2000, *available at* <http://www.icann.org/en/tlds/report/report-iiib1c-09nov00.htm> (last visited May 4, 2009), attached hereto as ICANN Exhibit E.

contemplated, other proposed TLDs without the controversy of an adult TLD would better serve the goals of this initial introduction of new TLDs.”<sup>19</sup>

22. On November 16, 2000, the ICANN Board passed a resolution authorizing ICANN’s President and General Counsel to commence contract negotiations with seven of the applicants, each for one TLD, including four uTLDs (.biz, .info, .name, and .pro) and three sTLDs (.museum, .aero, and .coop).<sup>20</sup> These seven were selected for negotiations following extensive input from ICANN staff, outside advisors, and the Internet community as a whole. ICM’s .XXX TLD application was not among those selected.<sup>21</sup>

23. The Board’s resolution that authorized ICANN staff to conduct contract negotiations with the proposed registry operators and sponsoring organizations did not constitute “final approval” of any proposed TLD:

Resolved [00.89], the Board selects the following proposals for negotiations toward appropriate agreements between ICANN and the registry operator or sponsoring organization, or both: JVTeam (.biz), Afiliias (.info), Global Name Registry (.name), RegistryPro (.pro), Museum Domain Management Association (.museum), Société Internationale de Télécommunications Aéronautiques (.aero), Cooperative League of the USA dba National Cooperative Business Association (.coop); [and]

Resolved [00.90], the President and General Counsel are authorized to conduct those negotiations on behalf of ICANN and, ***subject to further Board approval or ratification, to enter into appropriate agreements . . . .***<sup>22</sup>

24. After the November 16, 2000 resolution, ICANN commenced lengthy negotiations with the seven applicants, after which negotiated contracts were submitted to the

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<sup>19</sup> *Id.*

<sup>20</sup> Preliminary Report, Second Annual Meeting and Organizational Meeting of the ICANN Board, available at <http://www.icann.org/en/minutes/prelim-report-16nov00.htm> (last visited May 4, 2009), attached hereto as ICANN Exhibit F.

<sup>21</sup> *Id.*

<sup>22</sup> Minutes of Second Annual Meeting of the Board, November 16, 2000, available at <http://www.icann.org/en/minutes/minutes-annual-meeting-16nov00.htm> (last visited May 4, 2009) (emphasis added), attached hereto as ICANN Exhibit G.



Board for approval. For example, authorization to enter into the agreement for “.museum” was granted on September 10, 2001, concurrently with a resolution in favor of further negotiation of the registry agreements for the “.aero” and “.coop” sTLDs. The “.pro” TLD was not approved until March 14, 2002, after negotiations finally demonstrated a solution to serious issues that had stood in the way of its approval.<sup>23</sup>

25. Even with the approval of the ICANN Board, these TLDs could be added to the DNS only upon United States Department of Commerce approval because the Department of Commerce retains ultimate authority to approve or reject recommendations by ICANN for inclusion of new TLDs into the root zone.

26. ICANN considered the launch of the seven new TLDs to be successful because, among other things, the launch did not impair the security or stability of the Internet, and the new TLDs facilitated additional competition. As a result, following the completion of the “proof of concept” round and the addition of the new TLDs to the DNS, ICANN considered adopting procedures for the introduction of more TLDs, as described in the next section.

**C. THE SECOND ROUND FOR INTRODUCING NEW TLDs AND ICM’S APPLICATION FOR A SPONSORED .XXX TLD.**

27. On October 18, 2002, then-ICANN President Stuart Lynn issued “A Plan for Action Regarding New gTLDs.”<sup>24</sup> Mr. Lynn recommended that the ICANN Board consider initiating a new round of proposals for “sponsored” TLDs.

28. In 2003, ICANN solicited public comments about developing proposed criteria and procedures for evaluating sTLD proposals.<sup>25</sup> Consistent with its mandate for open and

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<sup>23</sup> ICANN Montevideo Meeting Topic: New TLD Agreements, September 5, 2001, *available at* <http://www.icann.org/en/meetings/montevideo/new-tld-topic.htm> (last visited May 4, 2009), attached hereto as ICANN Exhibit H.

<sup>24</sup> A Plan for Action Regarding New gTLDs, Stuart Lynn, ICANN President, October 18, 2002, Cl. Ex. 60.

<sup>25</sup> Although Mr. Lynn’s Action Plan suggested limiting the number of sTLDs in this round of proposals to three, community comment encouraged ICANN not to adopt that limit. *See* Establishment of new sTLDs: Request for Proposals (Draft for public comment), June 24, 2003, Cl. Ex. 72.

transparent processes, ICANN posted a draft Request for Proposals (“RFP”) for new sTLDs on June 24, 2003, and invited further public comment through August 25, 2003.<sup>26</sup>

29. The draft RFP received significant input through ICANN’s online public comment forum. The ICANN Board reviewed the public comments provided on the draft RFP and noted “an appreciation of the importance to the community of this topic, and the intent to seek further input and open communication with the community on this topic” before arriving at any decision.<sup>27</sup>

30. On October 9, 2003, ICANN’s At-Large Advisory Committee (the “ALAC”), which is “responsible for considering and providing advice on the activities of ICANN as they relate to the interests of individual Internet users (*i.e.*, the ‘At-Large’ community),” drafted a “Response to the Proposed sTLD RFP and Suggested Principles for New TLD Processes.”<sup>28</sup> ICANN’s Generic Names Supporting Organization (the “GNSO”)<sup>29</sup> provided its comments shortly thereafter and called upon the ICANN Board to move forward with the process for sTLDs.<sup>30</sup>

31. On October 31, 2003, the ICANN Board met in Carthage, Tunisia, and passed resolutions for the introduction of new sponsored TLDs.<sup>31</sup> The Board also determined that a

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<sup>26</sup> *Id.*

<sup>27</sup> ICANN Minutes, Special Meeting of the Board, October 13, 2003, *available at* <http://www.icann.org/en/minutes/minutes-13oct03.htm> (last visited May 5, 2009), attached hereto as ICANN Exhibit I.

<sup>28</sup> At-Large Advisory Committee (ALAC), At-Large Community Website, *available at* <http://www.icann.org/en/committees/alac/> (last visited May 5, 2009), attached hereto as ICANN Exhibit J; Response to the Proposed sTLD RFP and Suggested Principles for New TLD Processes, October 9, 2003, *available at* <http://www.atlarge.icann.org/correspondence/response-stld-process-09oct03.htm> (last visited May 5, 2009), attached hereto as ICANN Exhibit K.

<sup>29</sup> The GNSO succeeded ICANN’s Domain Name Supporting Organization (the “DNSO”) with respect to gTLD responsibilities. ICANN, Registrars, *available at* <http://gns0.icann.org/registrars/> (last visited *date*) (“On December 14, 2002 the DNSO has been replaced by the GNSO.”), attached hereto as ICANN Exhibit L.

<sup>30</sup> GNSO Council Carthage Meetings Minutes, October 29, 2003, *available at* <http://gns0.icann.org/meetings/minutes-gns0-29oct03.shtml> (last visited May 5, 2009), attached hereto as ICANN Exhibit M.

<sup>31</sup> ICANN Board Resolutions in Carthage, Tunisia, October 31, 2003, Cl. Ex. 78.

policy process should commence through ICANN’s newly-formed GNSO to establish how the new uTLDs or “generic” TLDs would be added into the Root Zone in the future. (This policy process culminated with the ICANN Board vote in June 2008 for the policy to introduce new gTLDs. Presently, ICANN is working on a proposal to allow the launch of numerous additional unsponsored TLDs.<sup>32</sup>)

32. On December 15, 2003, ICANN launched the sTLD selection process by posting the final RFP and permitting interested parties to apply for the creation of new sTLDs.<sup>33</sup> Unlike the “proof of concept” round, this new round was limited to “sponsored” TLDs; as a result, all applications needed to satisfy additional requirements related to the sponsorship of TLDs.

33. The RFP began with an introduction “provid[ing] applicants with explanatory notes on the process as well as an indication of the type of information requested by ICANN.”<sup>34</sup> The RFP then included an application form setting out the selection criteria that would be used to evaluate proposals. These “objective criteria” were designed to enable the independent evaluators to determine which applicants “best” met ICANN’s requirements.<sup>35</sup> The selection criteria consisted of four categories: (1) Sponsorship Information; (2) Business Plan Information; (3) Technical Standards; and (4) Community Value.<sup>36</sup>

34. The RFP’s explanatory notes provided that the sponsorship criteria required “the proposed sTLD [to] address the needs and interest of a ‘*clearly defined community*’ (the Sponsored TLD Community), which can benefit from the establishment of a TLD operating in a policy formulation environment in which the community would participate.” Accordingly, applicants had to demonstrate that the Sponsored TLD Community was:

- (a) Precisely defined, so it can readily be determined which persons or entities make up that community; and

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<sup>32</sup> ICANN, New gTLD Program, *available at* <http://www.icann.org/en/topics/new-gtld-program.htm> (last visited May 5, 2009), attached hereto as ICANN Exhibit N; P. Twomey Witness Statement, ¶ 14.

<sup>33</sup> New sTLD Application, December 15, 2003, Cl. Ex. 45.

<sup>34</sup> *Id.* (Part A. Explanatory Notes – Selection Criteria).

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

- (b) Comprised of persons that have needs and interests in common but which are differentiated from those of the general global Internet community.<sup>37</sup>

35. The sponsorship criteria further required applicants to provide an explanation of the Sponsoring Organization’s policy-formulation procedures, demonstrating that the organization:

- (a) Would operate primarily in the interests of the Sponsored TLD Community;
- (b) Has a clearly defined delegated policy-formulation role and is appropriate to the needs of the Sponsored TLD Community;
- (c) Has defined mechanisms to ensure that approved policies are primarily in the interests of the Sponsored TLD Community and the public interest; and
- (d) Is *tailored to meet the particular needs of the defined Sponsored TLD Community* and the characteristics of the policy formulation environment.<sup>38</sup>

36. Finally, the sponsorship criteria required the applicant to demonstrate support for the TLD from the Sponsored TLD Community: “A key requirement of a sTLD proposal is that it demonstrates *broad-based support* from the community it is intended to represent.”<sup>39</sup>

Accordingly, applicants were required to “demonstrate that there is”:

- (a) Evidence of *broad-based support* from the Sponsored TLD Community for the sTLD, for the Sponsoring Organization, and for the proposed policy-formulation process; and

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<sup>37</sup> *Id.* (Part A. Explanatory Notes – Sponsorship Information – Definition of Sponsored TLD Community) (emphasis added).

<sup>38</sup> *Id.* (Part A. Explanatory Notes – Sponsorship Information – Appropriateness of the Sponsoring Organization and the Policy Formulation Environment) (emphasis added).

<sup>39</sup> *Id.* (Part A. Explanatory Notes – Sponsorship Information – Level of Support from the Community) (emphasis added).

- (b) An outreach program that illustrates the Sponsoring Organization's capacity to represent a wide range of interests within the community.<sup>40</sup>

37. ICM contends that “the final criteria were completely silent on the subject of adult content, or morality or offensive content generally, and the related public relations controversy.”<sup>41</sup> But in fact, such considerations were squarely embraced by the community value component, which required the applicants to demonstrate that their proposal “represents an endeavor or activity that has importance across multiple geographic regions.”<sup>42</sup> This necessarily requires an understanding of how sTLDs such as ICM's proposed adult content sTLD would be received globally.

38. Given the debate surrounding ICM's application for an unsponsored .XXX TLD in the 2000 “proof of concept” round, combined with the fact that ICANN had specifically noted in the 2000 uTLD round that “controversy surrounding” .XXX was great,<sup>43</sup> ICM had to know that its proposed sTLD inevitably would generate public policy concerns.

#### **D. CONSIDERATION AND ULTIMATE DENIAL OF ICM'S SPONSORED .XXX TLD APPLICATION.**

39. ICANN received a total of ten sTLD applications, including ICM's March 16, 2004 application for a .XXX sTLD.<sup>44</sup> The International Foundation for Online Responsibility (“IFFOR”) was proposed as .XXX's sponsoring organization. In light of ICM's previous application for the .XXX TLD as an unsponsored TLD, ICM knew that establishing the

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<sup>40</sup> *Id.* (emphasis added).

<sup>41</sup> ICM Memorial ¶ 121.

<sup>42</sup> New sTLD Application, December 15, 2003, Part A. Explanatory Notes – Community Value – Addition of new value to the Internet name space, Cl. Ex. 45.

<sup>43</sup> ICANN Report on TLD Applications: Application of the August 15 Criteria to Each Category or Group, November 9, 2000, *available at* <http://www.icann.org/en/tlds/report/report-iiib1c-09nov00.htm> (last visited May 5, 2009), attached hereto as ICANN Exhibit E. *See also* ICM Memorial, Dr. Elizabeth Williams Witness Statement, ¶ 7 (“It was also obvious from the 2000 ‘proof of concept’ round that an application for an adult content string would be controversial from a public relations standpoint.”).

<sup>44</sup> New sTLD RFP Application, .XXX, Part B. Application Form, *available at* <http://www.icann.org/en/tlds/stld-apps-19mar04/xxx.htm> (last visited May 5, 2009), attached hereto as ICANN Exhibit O.

requisite “community” of a sponsored TLD and other sponsorship-specific requirements presented complex issues that would need to be addressed.<sup>45</sup>

40. In April 2004, ICANN convened an independent panel of experts (the “Evaluation Panel”) to review and recommend those sTLD applications that satisfied the selection criteria.<sup>46</sup> After an initial review period, the Evaluation Panel submitted a list of questions to each applicant. The Evaluation Panel asked ICM to elaborate on how the proposed .XXX sTLD would “create a new and clearly differentiated space, and satisfy needs that cannot be readily met through the existing TLDs,” and how ICM planned to reconcile “various culturally-based definitions.”<sup>47</sup> Later that same month, ICM submitted a response to the Evaluation Panel.<sup>48</sup> The Evaluation Panel prepared a report regarding each application and made a determination as to whether the application met the baseline criteria set out in the RFP.<sup>49</sup>

41. The Evaluation Panel submitted to ICANN its evaluations for all ten sTLD applications by the end of August 2004. The Evaluation Panel found that two applicants – the applicants for .cat and .post – met all of the selection criteria of the RFP. It determined that three more applicants – applicants for .asia, .jobs, and .travel – did not meet all of the selection criteria but merited further consideration. The Evaluation Panel found that the remaining four

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<sup>45</sup> See P. Twomey Witness Statement, ¶ 16.

<sup>46</sup> For example, the sponsorship/community value team was chaired by Dr. Williams and included Pierre Ouédraogo and Daniel Weitzner. See Status Report on the sTLD Evaluation Process, at 5, Cl. Ex. 83. Dr. Williams had been active in ICANN’s Registrars’ Constituency and the ccTLD constituency as a member of the .auDA (the ccTLD for Australia) Board, among other activities. New sTLD Applications, Appendix D - Evaluation Reports, August 27, 2004, at 116, Cl. Ex. 110. Mr. Ouédraogo had been an Information Society Project Manager at the Francophone Institute for Information and Learning New Technologies (INTIF), as well as a founding member of AFRINIC (the African Internet Registry for IP addresses), the AfTLD (African Internet Top-Level Domain Names Association), AFNOG (African Network Operators Group), and AfrICANN (the African network of participants in the ICANN process), and also a member of the ccNSO launching group at ICANN and a technical contact for .bf ccTLD (Burkina Faso). *Id.* at 115. Mr. Weitzner had been a Director of the World Wide Web Consortium’s Technology and Society activities. *Id.* at 115-16.

<sup>47</sup> Confidential Exhibit – Evaluation Team Questions for ICM and IFFOR, attached to ICANN’s First Brief as Confidential Ex. A.

<sup>48</sup> Confidential Exhibit – ICM and IFFOR’s Joint Response to Evaluation Team Questions, attached to ICANN’s First Brief as Confidential Ex. B.

<sup>49</sup> sTLD Status Report, Appendix B, Status Report on the sTLD Evaluation Process, November 28, 2005, Cl. Ex. 108.



applicants – applicants for .mail, .mobi, .tel, and .XXX – did not meet all of the selection criteria and had “deficiencies [that] cannot be remedied within the applicant’s proposed framework.” The Panel recommended that ICANN not consider those four applications further.<sup>50</sup>

42. With respect to .XXX, the Evaluation Panel found that ICM’s application met both the technical and business selection criteria but concluded that the .XXX application did not meet four of the nine subparts of the sponsorship selection criteria.<sup>51</sup> Specifically, the Evaluation Panel: (1) “did not believe that the .XXX application represented a clearly defined community”; (2) found that the lack of cohesion in the community, and the planned involvement of child advocates and free expression interest groups, would preclude the effective formulation of policy for the community; (3) was not convinced that there was sufficient evidence of community support outside of North America or from child safety, law enforcement, or freedom of expression organizations; and (4) “did not agree that the application added new value to the Internet name space.”<sup>52</sup> Each of these issues ultimately plagued ICM’s application.

43. Because the Evaluation Panel had recommended approval of only two sTLD applicants, in August 2004, the ICANN Board decided to give all of the other sTLD applicants another opportunity to provide clarifying information and to answer further questions “relating to any potential deficiencies in the application that were highlighted in the independent evaluation.”<sup>53</sup> All applicants were encouraged to review the contents of the reports and to respond in writing to ICANN.<sup>54</sup> One of ICM’s witnesses praises the action of the ICANN Board in permitting a new chance, not required by the process outlined in the RFP, for applicants, including ICM, to pursue the creation of new sTLDs.<sup>55</sup>

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<sup>50</sup> ICANN, New sTLD Applications, Appendix D, Evaluation Reports, August 27, 2004, at 82, Cl. Ex. 110.

<sup>51</sup> *Id.* at 110.

<sup>52</sup> *Id.*

<sup>53</sup> Confidential Exhibit – Correspondence from Kurt Pritz, ICANN, to Stuart Lawley, ICM, erroneously dated July 31, 2004, enclosing Independent Evaluation Report for .XXX, Prepared for ICANN, Compiled on August 27, 2004, attached to ICANN’s First Brief as Confidential Exhibit D.

<sup>54</sup> *Id.*

<sup>55</sup> ICM Memorial, Ms. J. Beckwith Burr Witness Statement, ¶ 25.

44. ICM responded to the Board's request for more information and provided ICANN staff with a formal response to the Evaluation Panel's report, arguing that the Evaluation Panel's sponsorship concerns were unfounded.<sup>56</sup> The ICANN Board discussed ICM's application and its ability to satisfy the sponsorship criteria, and suggested that it might be helpful for ICM to make a formal presentation to the Board on this issue.<sup>57</sup> On April 3, 2005, ICM gave its presentation to the ICANN Board.<sup>58</sup>

45. On June 1, 2005, the ICANN Board held a special meeting via teleconference. The Board engaged in extensive discussion regarding ICM's .XXX sTLD application and ultimately passed two resolutions (with a 6-3 vote in favor, 2 abstentions, and 4 Board members absent):

Resolved [05.32] the Board authorizes the President and General Counsel to enter into negotiations relating to proposed commercial and technical terms for the .XXX sponsored top-level domain (sTLD) with the applicant.

Resolved [05.33] if after entering into negotiations with the .XXX sTLD applicant the President and General Counsel are able to negotiate a set of proposed commercial and technical terms for a contractual arrangement, the President shall present such proposed terms to this board, for approval and authorization to enter into an agreement relating to the delegation of the sTLD.<sup>59</sup>

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<sup>56</sup> Confidential Exhibit – Formal Response to ICANN's Independent Evaluation Report on .XXX sTLD, from Stuart Lawley, ICM, to Kurt Pritz, ICANN, October 9, 2004, attached to ICANN's Opening Brief as Confidential Exhibit F. ICM and IFFOR later provided the ICANN Board with a memorandum similar to its formal response to ICANN staff, outlining the reasons why they believed the ICANN Board should allow the .XXX sTLD to proceed despite the recommendation of the Evaluation Panel. *See* Confidential Exhibit – Memorandum to the ICANN Board of Directors, November 2, 2004, Revised December 7, 2004, attached to ICANN's Opening Brief as Confidential Exhibit G.

<sup>57</sup> ICANN Minutes, Special Meeting of the Board, January 24, 2005, Cl. Ex. 132.

<sup>58</sup> *See* Confidential Exhibit - ICM Slide Presentation, attached to ICANN's Opening Brief as Confidential Exhibit H.

<sup>59</sup> ICANN Minutes, Special Meeting of the Board, June 1, 2005, Cl. Ex. 120; *see also* ICANN Bylaws, *supra* note 2, Article II, § 1 (“With respect to any matters that would fall within the provisions of Article III, Section 6, the Board may act only by a majority vote of all members of the Board. In all other matters, except as otherwise provided in these Bylaws or by law, the Board may act by majority vote of those present at any annual, regular, or special meeting of the Board.”).

46. While still uncertain whether ICM satisfied the requisite sponsorship criteria, the Board took this step of permitting contract negotiations to explore whether terms of a proposed contract could resolve some of the ongoing concerns regarding sponsorship.<sup>60</sup> Although the supplemental materials that ICM presented to the Board provided additional clarification, “the Board still expressed concerns about whether the applicant had met all of the criteria, and took the view that such concerns could possibly be addressed by contractual obligations to be stated in a registry agreement.”<sup>61</sup> “Other applicants have not yet been determined to meet the baseline criteria. We are working with them still actively to determine if the application can be configured in a way so that baseline criteria can be met.”<sup>62</sup> As the then-Chair of the ICANN Board explained, proceeding to contract negotiations would allow Board members “to understand more deeply exactly how [ICM’s] proposal would be implemented, and seeing the contractual terms, it seemed to [him], would put much more meat on the bones of the initial proposal.”<sup>63</sup>

47. Contrary to ICM’s position in these proceedings, the Board’s resolutions did *not* constitute an “unconditional” approval of ICM’s .XXX application, just as the Board’s original vote in November 2000 did not constitute final approval of the seven new TLDs at that time.<sup>64</sup> The resolutions themselves expressly disclaim any final decision by the Board that the .XXX application satisfied the sponsorship criteria (or any baseline selection criteria) set forth in the RFP. Instead, the resolutions expressly say that, notwithstanding the approval to negotiate, any ultimate “approval and authorization to enter into an agreement relating to the delegation of the sTLD” could only be sought in the future, and further Board action would be required to grant such approval.

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<sup>60</sup> Letter from Paul Twomey, ICANN, to Mohamed Sharil Tarmizi, GAC Chairman, May 4, 2006, Cl. Ex. 188.

<sup>61</sup> *Id.*

<sup>62</sup> ICANN Meetings in Mar Del Plata, April 7, 2005, *available at* <http://www.icann.org/en/meetings/mardelplata/captioning-public-forum-2-07apr05.htm> (last visited May 5, 2009), attached hereto as ICANN Exhibit P.

<sup>63</sup> *See, e.g.*, ICANN Meetings in Lisbon Portugal, Transcript – ICANN Board of Directors Meeting, March 30, 2007, Real-Time Captioning, Cl. Ex. 201.

<sup>64</sup> *Compare* ICM Memorial ¶ 186, *with* P. Twomey Witness Statement, ¶ 28; V. Cerf Witness Statement, ¶ 25; A. Pisanty Witness Statement, ¶ 16.

48. The plain language of the resolutions is reinforced by the subsequent conduct by members of the Board regarding its effect. Following the resolutions, which were promptly publicly posted (along with the Board minutes) on ICANN's website, the Board continued to debate ICM's ability to satisfy the sponsorship selection criteria at several Board meetings up to and including the March 30, 2007 meeting when the Board ultimately rejected the .XXX application and ICM's proposed registry contract.<sup>65</sup>

49. The Board's conduct with regard to other applicants also shows that permitting contract negotiations to proceed did not constitute an approval of the ICM application. The Board allowed applicants for other sTLDs – namely, .jobs and .mobi – to commence with contract negotiations despite open questions relating to the RFP selection criteria.<sup>66</sup> The Board permitted .jobs to proceed to contract negotiations while specifically requesting that during the negotiations, “special consideration be taken as to how broad-based policymaking would be created for the sponsored community, and how this sTLD would be differentiated in the name space.”<sup>67</sup> With respect to .mobi, the Board specifically requested that during contract negotiations “special consideration be taken as to confirm the sTLD applicant's proposed community of content providers for mobile phone users, and confirmation that the sTLD applicant's approach will not conflict with the current telephone numbering systems.”<sup>68</sup>

50. The Board's conduct after the June 2005 resolutions further demonstrates that those resolutions did not constitute a finding that ICM met the RFP criteria. In accordance with the June 2005 resolutions, ICANN staff entered into contract negotiations with ICM for a proposed registry agreement. By August 9, 2005, ICM's first draft .XXX sTLD registry agreement was posted on ICANN's website for public comment and submitted to the Board.

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<sup>65</sup> The meetings at which the Board discussed ICM's XXX sTLD application included Board meetings on September 15, 2005; April 18, 2006; May 10, 2006; February 12, 2007; and March 30, 2007.

<sup>66</sup> See, e.g., ICANN Minutes, Special Meeting of the Board, December 13, 2004, *available at* <http://www.icann.org/en/minutes/minutes-13dec04.htm> (last visited May 5, 2009), attached hereto as ICANN Exhibit Q.

<sup>67</sup> *Id.*

<sup>68</sup> *Id.*

ICANN's next Board meeting was scheduled for August 16, 2005, at which time ICANN had planned on discussing ICM's first draft of the .XXX registry agreement.<sup>69</sup>

51. However, following the publication of ICM's first draft, the GAC's Chairman and several member countries expressed concerns with the proposed .XXX sTLD, and requested that the Board provide additional time for governments to express their concerns before the Board reached a final decision on the proposed registry agreement.<sup>70</sup> As shown above, *see supra* ¶ 15, ICANN was required by its Bylaws to consider these concerns, and the Board postponed discussion of ICM's first draft registry agreement to allow for input from the GAC.

52. In August and September 2005, members of the ICANN Board corresponded with various governments and members of the Internet community, and reflected on such communications at its September 15, 2005 Board meeting, where the ICANN Board engaged in a "lengthy discussion" regarding the sponsorship criteria, ICM's application and supporting materials, and the specific terms of ICM's draft .XXX sTLD registry agreement.<sup>71</sup> The Board did not approve the draft agreement, but instead voted 11-0 (with 3 abstentions) in favor of a resolution authorizing further negotiation.<sup>72</sup> Not a single Board member voted to approve the proposed agreement on the basis that the Board "already had approved" the .XXX sTLD.

53. The September 15, 2005 resolution of the ICANN Board specifically addressed the negotiation of sponsorship-related terms within the .XXX sTLD registry agreement:

Resolved (05.75), that the ICANN President and General Counsel are directed to discuss possible additional contractual provisions or modifications for inclusion in the .XXX Registry Agreement, to ensure that there are effective provisions requiring development and implementation of policies consistent with the principles in the ICM application. Following such additional discussions, the

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<sup>69</sup> See ICM Draft, August 1, 2005, Sponsored TLD Registry Agreement, *available at* <http://www.icann.org/en/tlds/agreements/xxx/proposed-xxx-agmt-09aug05.pdf> (last visited May 5, 2009), attached hereto as ICANN Exhibit R.

<sup>70</sup> See Letter from Mohamed Sharil Tarmizi, GAC Chairman, to ICANN Board Regarding .XXX TLD, August 12, 2005, Cl. Ex. 163; Letter from Michael D. Gallagher, U.S. DOC, to Vinton Cerf, received August 15, 2005, Cl. Ex. 162.

<sup>71</sup> ICANN Minutes, Special Meeting of the Board, September 15, 2005, Cl. Ex. 119.

<sup>72</sup> *Id.*

President and General Counsel are requested to return to the board for additional approval, disapproval or advice.

54. At that point, in view of the controversy surrounding .XXX (with continuing correspondence from GAC members),<sup>73</sup> and at the specific request of ICM,<sup>74</sup> the Board decided to postpone formal consideration of ICM's proposed registry agreement until the GAC was able to review and comment on ICM's proposal. ICANN staff continued to work with ICM on its proposed registry agreement in order to address concerns posed by various members of the Internet community. In March 2006, a second draft of the registry agreement was posted.

55. As the time approached for the ICANN Board's March 31, 2006 meeting in Wellington, New Zealand, several of the GAC member countries expressed the view that they and other member countries should address the public policy issues raised by the .XXX sTLD application. Thus, after extensive meetings and discussions among 33 GAC members over the course of several days, the GAC issued a document (the "Wellington Communiqué") on March 28, 2006. The Wellington Communiqué stated that the public interest benefits promised by ICM had not yet been included as ICM's obligations in the draft .XXX sTLD registry agreement,<sup>75</sup> and asked that ICANN confirm that any final registry agreement contain enforceable provisions covering all of ICM's commitments. The Wellington Communiqué also stated that "without prejudice to the above, several members of the GAC are emphatically opposed from a public policy perspective to the introduction of a .xxx sTLD."<sup>76</sup>

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<sup>73</sup> ICANN continued to receive correspondence from GAC members specifically requesting ICANN to defer any decisions on the .XXX sTLD to allow for further comment. *See, e.g.*, Letter from Peter Zangl, European Commission, to Vint Cerf, ICANN, September 16, 2005, Cl. Ex. 172 (urging ICANN to reconsider any decision to proceed with the .XXX sTLD application until the GAC has an opportunity to comment); Letter from Dr. Kai-Sheng Kao, GAC Representative to Taiwan, to ICANN Board, September 30, 2005, Cl. Ex. 169 (requesting the Board defer final decision on the .XXX sTLD to allow for further public comment; noting that ICANN should "consider all social and cultural aspects" of the TLD "to reduce the possible negative impacts and ill effects").

<sup>74</sup> Letter from Stuart Lawley, ICM, to Paul Twomey, August 15, 2005, *available at* <http://www.icann.org/correspondence/lawley-to-twomey-15aug05.pdf> (last visited May 5, 2009) ("[T]o preserve the integrity of the ICANN process, we request that the Board defer final approval of the ICM Registry Agreement."), attached hereto as ICANN Exhibit S.

<sup>75</sup> GAC Communiqué – Wellington, New Zealand, March 28, 2006, Cl. Ex. 181.

<sup>76</sup> *Id.*

56. Following the issuance of the Wellington Communiqué, the ICANN Board conducted its March 31, 2006 meeting in Wellington and adopted by a 12-0 vote (with 3 abstentions) a resolution directing ICANN's President and General Counsel to "analyze all publicly received inputs, to continue negotiations with ICM Registry, and to return to the Board with any recommendations regarding amendments to the proposed sTLD registry agreement, particularly to ensure that the TLD sponsor will have in place adequate mechanisms to address any potential registrant violations of the sponsor's policies."<sup>77</sup>

57. ICANN staff and ICM continued to negotiate a revised registry agreement to address the GAC's concerns. Although the staff believed serious issues remained, ICM insisted that the Board vote at the May 10, 2006 Board meeting on the existing registry agreement.<sup>78</sup> At that May 10, 2006 meeting, the ICANN Board, after considerable discussion, voted 9-5 against ICM's draft of the proposed .XXX sTLD registry agreement.<sup>79</sup> Because a number of Board members did not view the contract negotiations as having adequately resolved the underlying sponsorship issues, some ICANN Board members were beginning to think that further contract negotiations would be pointless.<sup>80</sup>

58. The Board's May 10, 2006 vote did not deny ICM's application outright. Instead, ICANN permitted ICM another opportunity to negotiate with ICANN staff and attempt to revise the registry agreement to conform to the RFP specifications. ICANN staff and ICM thereafter worked to negotiate additional revisions to the draft .XXX sTLD registry agreement that addressed the concerns regarding the sponsorship requirements, among others.

59. After another revised .XXX sTLD registry agreement was posted on the ICANN website, various members of the purported .XXX community provided comments on ICANN's online public comment forum in opposition to the proposed .XXX sTLD. At the Board's

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<sup>77</sup> ICANN Minutes, Regular Meeting of the Board, March 31, 2006, Cl. Ex. 184.

<sup>78</sup> ICANN Minutes, Special Meeting of the Board, April 18, 2006, Cl. Ex. 186 (Dr. Cerf noting "the desire of ICM to have an up or down vote at the May 10[, 2006] meeting").

<sup>79</sup> ICANN Minutes, Special Meeting of the Board, May 10, 2006, *available at* <http://www.icann.org/en/minutes/minutes-10may06.htm> (last visited May 5, 2009), attached hereto as ICANN Exhibit T.

<sup>80</sup> P. Twomey Witness Statement, ¶¶ 30, 55; V. Cerf Witness Statement, ¶¶ 35-37.



meeting held on February 12, 2007, several Board members expressed concern about the apparent splintering of community support for the .XXX sTLD, a key RFP sponsorship requirement. As a result, the Board unanimously approved a resolution directing ICANN staff to further consult with ICM in an effort to inform the Board's upcoming decision on whether the sponsorship criteria could be met.<sup>81</sup>

60. Nevertheless, it had become increasingly clear to several members of the ICANN Board that ICM's proposal was not going to satisfy the RFP sponsorship criteria. On March 30, 2007, the Board adopted (by a 9-5 vote) a resolution rejecting ICM's revised agreement and denying ICM's application for the .XXX sTLD.<sup>82</sup>

#### **E. ICM'S INITIATION OF THE INDEPENDENT REVIEW PROCESS AND ICANN'S RESPONSE**

61. On June 6, 2008 (over a year after the final rejection of its application), ICM initiated this independent review proceeding pursuant to Article IV, Section 3 of ICANN's Bylaws. That provision allows "[a]ny person materially affected by a decision or action of the Board that he or she asserts is inconsistent with the Articles of Incorporation or Bylaws [to] submit a request for independent review of that decision or action."<sup>83</sup> After ICM submitted its initial brief requesting independent review, and ICANN submitted its response, ICM submitted its Memorial on January 22, 2009.

62. Invoking provisions in ICANN's Articles and Bylaws on openness, transparency, procedural fairness, and non-discrimination, along with ICANN's mission and "international law," ICM's Memorial challenges the Board's consideration and review of ICM's .XXX sTLD application. ICM's fundamental claim is that the Board acted contrary to the RFP, and that many Board members simply acted irrationally in voting to reject the .XXX application.

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<sup>81</sup> ICANN Minutes, Special Meeting of the Board, February 12, 2007, Cl. Ex. 199 (The Board passed a Resolution directing "ICANN staff [to] consult with ICM and provide further information to the Board prior to its next meeting, so as to inform a decision by the Board about whether sponsorship criteria is met for the creation of a new .XXX sTLD.").

<sup>82</sup> ICANN, Meeting of the Board, Transcript, March 30, 2007, *available at* <http://www.icann.org/en/meetings/lisbon/transcript-board-30mar07.htm> (last visited May 5, 2009), attached hereto as ICANN Exhibit U.

<sup>83</sup> ICANN Bylaws, *supra* note 2, at Article IV, § 3.

63. Along with its Memorial, ICM submitted statements from Dr. Elizabeth Williams, Ms. J. Beckwith Burr, and Mr. Stuart Lawley, as well as expert reports from Dr. Milton Mueller and Professor Jack Goldsmith. Dr. Williams, who chaired the Evaluation Panel that twice rejected ICM's Application on the grounds that it failed to satisfy the sponsorship criteria, states that it was her "personal belief" that (even after the extensive discussion of the sponsorship criteria and the negative recommendation prepared by her own panel) the ICANN Board's June 1, 2005 vote "was a definitive statement that the Board . . . had approved the application based on its determination that the application met the selection criteria."<sup>84</sup> Similarly, Ms. Burr, ICM's counsel during the contract negotiations, now claims that the Board's June 1, 2005 vote irreversibly established that ICM had met the RFP criteria and was thereby entitled to delegation of the new sTLD regardless of the outcome of the contract negotiations.<sup>85</sup> (Notably, Ms. Burr does not address whether these proceedings are binding under ICANN's Bylaws, even though, during her work drafting the Bylaws, she acknowledged that independent review proceedings would be advisory and not binding on the ICANN Board.<sup>86</sup>) Mr. Lawley, ICM's President and CEO, articulates his "suspicion" that his company's application was rejected solely based on opposition by the United States government.<sup>87</sup> Dr. Mueller, ICM's "expert" on ICANN, shares this view.<sup>88</sup> Professor Goldsmith addresses the law governing this proceeding, opining that Article 4 of ICANN's Articles of Incorporation is a "choice-of-law provision" importing international law principles into this dispute.

64. In response, ICANN will show that the Board's consideration and rejection of ICM's application was fully consistent with ICANN's Articles and Bylaws. As described more fully in Section III.B below, the Board ultimately rejected ICM's application because, after thorough consideration of the application, the Board determined that ICM had failed to satisfy the RFP requirements in the following ways:

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<sup>84</sup> ICM Memorial, Dr. Elizabeth Williams Witness Statement, ¶ 24.

<sup>85</sup> ICM Memorial, Ms. J. Beckwith Burr Witness Statement, ¶ 32.

<sup>86</sup> See, e.g., Becky Burr, Recommendations Regarding Accountability at II (August 23, 2002), available at <http://www.icann.org/en/committees/evol-reform/afap-report-23aug02.htm> (last visited May 5, 2009, attached hereto as ICANN Exhibit V).

<sup>87</sup> ICM Memorial, Mr. Stuart Lawley Witness Statement, ¶ 65.

<sup>88</sup> ICM Memorial, Expert Report of Dr. Milton Mueller at p. 44-45.

- ICM's definition of its sponsored TLD community was not capable of precise or clear definition;
- ICM's policies were not primarily in the interests of the sponsored TLD community;
- ICM's proposed community did not have needs and interests which are differentiated from those of the general global Internet community;
- ICM could not demonstrate that it had the requisite community support; and
- ICM was not adding new and valuable space to the Internet name space.

65. The RFP required ICM to address each of these items to the Board's satisfaction, but the Board ultimately concluded (just as the Evaluation Panel previously had) that ICM had failed in each of these respects. In all respects, ICANN operated in a fair, transparent, and reasoned manner in accordance with its Bylaws and Articles of Incorporation. Indeed, it is difficult to imagine a process more open and transparent, fair, and non-discriminatory – ICANN is quite unique in how it conducts its business, and its review of ICM's application was entirely consistent with its corporate requirements.

66. In support of its brief, and in response to ICM's filings, ICANN submits statements from the following individuals, each of whom was associated with ICANN at the time of the issue in dispute: Alejandro Pisanty (then-Vice Chair of the Board), Dr. Vinton Cerf (then-Chair of the Board), and Dr. Paul Twomey (ICANN's then- and current-President).

67. ICANN also submits an expert opinion by Professor David D. Caron to address ICM's international law arguments based on Professor Goldsmith's report. Professor Caron is a member of the Faculty of Law at the University of California at Berkeley, where he has taught since 1987 and since 1996 has held the C. William Maxeiner Distinguished Professor of Law Chair. Professor Caron's scholarship covers various aspects of international law and organization, with the corpus of this work focusing on public and private international dispute resolution, international courts and tribunals, the United Nations, the law of the sea, international environmental law, climate change, and general theory of international law. Professor Caron's other positions and awards are noted in his opinion and attached curriculum vitae.

**III. THE PANEL SHOULD DECLARE THAT THE ICANN BOARD DID NOT ACT INCONSISTENTLY WITH ICANN'S ARTICLES AND BYLAWS IN CONSIDERING AND ULTIMATELY DENYING ICM'S APPLICATION.**

68. ICM's claims are premised on several mischaracterizations of the nature of the independent review process and the law that applies to the facts and circumstances at issue here. In Section III.A, ICANN addresses these preliminary issues. Specifically, ICANN demonstrates that: (i) the decision that the Panel has been asked to render will not be legally binding on ICANN; (ii) decisions of the Board are entitled to great deference; and (iii) claims arising based on principles of international law do not apply in the circumstances of this proceeding.

69. With these legal matters clarified, ICANN will turn to the merits of ICM's claims, which revolve around four central factual assertions. As explained in Section III.B, the record makes clear that ICM's central assertions are wrong. As a result, and as shown in Section III.C, ICM's claims have no merit. At every stage in the process of considering and ultimately denying ICM's application, the ICANN Board acted in a manner consistent with ICANN's Articles and Bylaws.

**A. ICM MISCHARACTERIZES THE NATURE OF THESE PROCEEDINGS AND THE LAW THAT APPLIES TO THEM.**

70. This independent review process (the "IRP") is designed to provide a forum to address whether ICANN acted inconsistently with its Articles and Bylaws. The unique process was established to ensure that parties had the ability to seek consideration of actions of the ICANN Board by an entity outside of ICANN.

71. Despite the manner in which ICM has approached these proceedings, the process is not open-ended or all-encompassing. To the contrary, the provisions of the ICANN Bylaws that created the process are quite clear as to the purpose of these types of proceedings and the scope of the review they afford. Without meaningfully addressing the actual language of the Bylaws, ICM grossly mischaracterizes the nature of the IRP and the law that governs these proceedings. These mischaracterizations would radically transform this proceeding in a manner directly contrary to the plain and unambiguous language of the documents governing this proceeding, and would essentially place the Panel in the position of the "Supreme Court" of

ICANN. This concept was explored and completely rejected at the time that ICANN adopted the current version of the IRP.

72. ICANN wishes to make clear that its rejection of ICM's positions does not diminish in any way the seriousness with which ICANN approaches this proceeding. The thoroughness of this response should put to rest any issue in this regard. Frankly, the lengths to which ICM appears willing to mischaracterize the Panel's role and the applicable authority suggest an appreciation by ICM of the weakness of its claims and the need to create new legal theories and standards of review that were never intended to apply in an IRP proceeding.

73. ICM's mischaracterizations of the IRP concern three aspects of the Panel's role.<sup>89</sup> *First*, ICM claims that the Panel should declare that its results are "binding" on ICANN.<sup>90</sup> As an initial matter, the Panel need not address that question: the ultimate binding or non-binding character of IRP declarations is an issue to be resolved later, if necessary, in any subsequent forum where the effect of a ruling may be involved. In any event, ICM's position is plainly wrong. The language and drafting history of the provisions governing the IRP make clear that any IRP results are not binding, but rather are addressed to the discretion of the ICANN Board to consider.

74. *Second*, ICM claims that the Panel should conduct a "full review" of ICANN's actions and decisions, by which ICM means *de novo* review without any deference to reasonable judgments of the ICANN Board.<sup>91</sup> This argument again ignores the plain language of the provisions governing the IRP, as well as other provisions in ICANN's Bylaws consistently demonstrating that substantial deference is owed to judgments of the ICANN Board. ICM's argument is also contrary to well-settled principles of the law governing review of corporate board actions.

75. *Third*, ICM claims that the Panel should apply international law to this proceeding (and thus that the Panel should consider claims under international law that are not referenced in

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<sup>89</sup> See ICM Memorial ¶ 279.

<sup>90</sup> *Id.* ¶¶ 279, 284-309.

<sup>91</sup> *Id.* ¶¶ 279, 310-23.

the Bylaws that created the IRP process). ICM makes this claim despite the fact that the IRP procedure provides for review only of ICANN's "conformity" with its Bylaws and Articles of Incorporation.<sup>92</sup> In claiming that ICANN's actions and decisions should be evaluated under international law, ICM misinterprets Article 4 of ICANN's Articles of Incorporation (which states that ICANN will operate for the benefit of the Internet community by carrying out its activities "in conformity with relevant principles of international law") as a "choice-of-law provision" governing the IRP, thereby allowing a party to bring into an IRP freestanding claims based on any and all general principles of international law (or to interpret ICANN's Articles and Bylaws under any and all general principles of international law).<sup>93</sup> ICM's reading – which is in no way "straightforward[]" as ICM contends<sup>94</sup> – contravenes the plain language of the governing provisions as well as their drafting history. Because ICM's misreading is the basis for many of ICM's claims, many of those claims may and should be disregarded.<sup>95</sup>

### **1. The Results of The Independent Review Process Are Not Binding.**

76. Ordinarily, the binding or non-binding character of a declaration issued by a panel such as this one would not be addressed by the panel itself; any such questions would be addressed in future proceedings, if needed. Nonetheless, ICM asks the Panel to state affirmatively that its declaration is "final and binding" on ICM and ICANN.<sup>96</sup> ICM's request is improper, but, in any event, the Bylaws and other provisions governing IRPs make clear that this proceeding leads to a declaration that the ICANN Board must review and consider, but which it is not bound to act upon.

77. ICM suggests that, if the Panel's declaration is not "binding," ICANN will somehow take the process less seriously. ICANN hopes that its approach to this proceeding has made clear that ICANN takes this process seriously. Indeed, as shown below, ICANN

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<sup>92</sup> See *id.* ¶ 279.

<sup>93</sup> See *id.* ¶¶ 279, 324-42.

<sup>94</sup> *Id.* ¶ 332.

<sup>95</sup> See Caron Opinion ¶¶ 23-24 (stating that ICM's interpretation of Article 4 "misapprehends the question" before the Panel, and this "confusion infuses ICM's argument").

<sup>96</sup> ICM Memorial ¶ 279.

established the IRP to serve the important function of increasing accountability by leading to public decisions that “shall be posted on the [ICANN] Website when they become available.”<sup>97</sup> The underlying petitions and claims must also be posted on the ICANN website, as ICANN has in fact done.<sup>98</sup> Because ICANN’s continuing existence is premised on its long tradition of transparency and involvement from the broader Internet community, the ICANN Board will be under enormous public pressure to take seriously its duty to “consider” and “review[]” IRP declarations as directed in the Bylaws.<sup>99</sup> But the seriousness with which ICANN addresses this proceeding is beside the point for the Panel and not a basis for the Panel to find that the proceedings are, or should be, “binding” in some fashion not contemplated by the Bylaws.

**a. The Bylaws And Their Drafting History Make Clear That IRP Declarations Are Not Binding.**

78. The plain language of the IRP provisions, which are set forth in Article IV, section 3 of ICANN’s Bylaws, provides that the Panel’s declaration is advisory to the ICANN Board and not binding. The drafting history of the development of the IRP provisions – history that ICM ignores even though its own counsel participated in it – similarly makes clear that IRP declarations are not binding on ICANN.

**i. The Bylaws Make Clear That IRP Declarations Are Not Binding.**

79. The starting point is the plain text of the Bylaws governing the IRP process. A reader of ICM’s Memorial would be unaware that any text of the Bylaws addresses the effect of a panel’s declarations. Yet the Bylaws speak directly to the manner in which ICANN should treat a panel’s declarations, and makes clear that such declarations are advisory and not binding.

80. The Bylaws that govern the IRP process, entitled “Independent Review of Board Actions,” provide in full:

1. In addition to the reconsideration process described in Section 2 of this Article [on reconsideration by the Board], ICANN shall

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<sup>97</sup> ICANN Bylaws, *supra* note 2, Article IV, § 3.13. ICANN’s Bylaws require ICANN to “maintain a publicly-accessible Internet World Wide Web site.” *Id.* at Article III, § 2.

<sup>98</sup> *Id.*; see generally [www.icann.org](http://www.icann.org) (last visited May 5, 2009).

<sup>99</sup> ICANN Bylaws, *supra* note 2, Article IV, §§ 3.8.c, 3.15.



have in place a separate process for independent third-party review of Board actions alleged by an affected party to be inconsistent with the Articles of Incorporation or Bylaws.

2. Any person materially affected by a decision or action by the Board that he or she asserts is inconsistent with the Articles of Incorporation or Bylaws may submit a request for independent review of that decision or action.
3. Requests for such independent review shall be referred to an Independent Review Panel (“IRP”), which shall be charged with comparing contested actions of the Board to the Articles of Incorporation and Bylaws, and with declaring whether the Board has acted consistently with the provisions of those Articles of Incorporation and Bylaws.
4. The IRP shall be operated by an international arbitration provider appointed from time to time by ICANN (“the IRP Provider”) using arbitrators under contract with or nominated by that provider.
5. Subject to the approval of the Board, the IRP Provider shall establish operating rules and procedures, which shall implement and be consistent with this Section 3.
6. Either party may elect that the request for independent review be considered by a three-member panel; in the absence of any such election, the issue shall be considered by a one-member panel.
7. The IRP Provider shall determine a procedure for assigning members to individual panels; provided that if ICANN so directs, the IRP Provider shall establish a standing panel to hear such claims.
8. The IRP shall have the authority to:
  - a. request additional written submissions from the party seeking review, the Board, the Supporting Organizations, or from other parties;
  - b. declare whether an action or inaction of the Board was inconsistent with the Articles of Incorporation or Bylaws; and
  - c. recommend that the Board stay any action or decision, or that the Board take any interim action, until such time as the Board reviews and acts upon the opinion of the IRP.

9. Individuals holding an official position or office within the ICANN structure are not eligible to serve on the IRP.

10. In order to keep the costs and burdens of independent review as low as possible, the IRP should conduct its proceedings by e-mail and otherwise via the Internet to the maximum extent feasible. Where necessary, the IRP may hold meetings by telephone.

11. The IRP shall adhere to conflicts-of-interest policy stated in the IRP Provider's operating rules and procedures, as approved by the Board.

12. Declarations of the IRP shall be in writing. The IRP shall make its declaration based solely on the documentation, supporting materials, and arguments submitted by the parties, and in its declaration shall specifically designate the prevailing party. The party not prevailing shall ordinarily be responsible for bearing all costs of the IRP Provider, but in an extraordinary case the IRP may in its declaration allocate up to half of the costs of the IRP Provider to the prevailing party based upon the circumstances, including a consideration of the reasonableness of the parties' positions and their contribution to the public interest. Each party to the IRP proceedings shall bear its own expenses.

13. The IRP operating procedures, and all petitions, claims, and declarations, shall be posted on the Website when they become available.

14. The IRP may, in its discretion, grant a party's request to keep certain information confidential, such as trade secrets.

15. Where feasible, the Board shall consider the IRP declaration at the Board's next meeting.

81. In several places, the Bylaws make clear that panel declarations are advisory and not binding. The Bylaws charge the Panel with "comparing contested actions of the Board to the Articles of Incorporation and Bylaws, and with declaring whether the Board has acted consistently with the provisions of those Articles of Incorporation and Bylaws."<sup>100</sup> The Panel's "declarations" on this question are not binding on the Board. To the contrary, the IRP provisions repeatedly explain that panel declarations are committed to the ICANN Board for review and

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<sup>100</sup> *Id.* at Article IV, § 3.3.

consideration. In particular, the Bylaws direct the Board to “consider” the declaration.<sup>101</sup> The direction to “consider” the Panel’s declaration necessarily means that the Board has discretion whether and how to implement it; if the declaration were binding, such as with a court judgment or binding arbitration ruling, there would be nothing to consider, only an order to implement.

82. Another provision similarly states that the Board is to “review[]” IRP determinations, again making clear that ultimate authority is reserved to the Board.<sup>102</sup> ICM argues that the word “review” entails a supervisory (and hence controlling) function.<sup>103</sup> Yet, this argument actually defeats ICM’s position because the ICANN Board is specifically directed to “review” the Panel’s declarations, not to “implement” them.<sup>104</sup>

83. ICM offers no explanation for how the Panel’s declarations could be binding where the Board is expressly directed to “consider” and “review” the declarations, and is nowhere required to implement them uncritically (or otherwise).<sup>105</sup> ICM also offers no explanation for how declarations could be binding where the Panel is not given authority to issue injunctions or award damages.

84. Notably, the Board is not even required to review or consider the declaration immediately, or at any particular time. Instead, the Bylaws simply encourage the Board to consider the declaration at the next Board meeting, but specifically provide that the Board need only do so “[w]here feasible.”<sup>106</sup> The use of non-mandatory language in this timing provision reinforces the fact that the Board’s action (review and consideration) is not itself contemplated to require acceptance of the Panel’s declaration.

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<sup>101</sup> *Id.* at Article IV, § 3.15.

<sup>102</sup> *Id.* at Article IV, § 3.8.c.

<sup>103</sup> *See* ICM Memorial ¶¶ 281, 312.

<sup>104</sup> *See also* V. Cerf Witness Statement, ¶¶ 10-12 (explaining that the IRP provisions “demonstrate that the ICANN Board retains ultimate authority over ICANN’s affairs, and that any declaration by the Independent Review Panel is not binding on the ICANN Board”).

<sup>105</sup> Likewise, the Bylaws do not provide – as they would have had the dispute resolution process been intended to result in a binding decision – for a process by which the parties could enforce the panel’s decision. Nor do the Bylaws provide how any decision of the panel might be self-enforcing. The absence of all such provisions merely confirms again that the panel’s decision is not binding.

<sup>106</sup> ICANN Bylaws, *supra* note 2, Article IV, § 3.15.

85. Providing still further proof of the Board’s ultimate authority, for the period during which the Board is reviewing and considering the Panel’s declaration, the Panel may merely “*recommend* that the Board stay any action or decision, or that the Board take any interim action.”<sup>107</sup> The Panel’s limited authority to recommend, rather than to require, temporary action reinforces the conclusion that the Board retains ultimate authority to decide what actions to take – both temporary and permanent – in response to the Panel’s conclusions in an IRP. If *final* declarations were binding, it would make no sense for *interim* remedies merely to be *recommended* to the Board. ICM offers no explanation as to how this provision can be reconciled with its position urging a binding effect for the Panel’s results.

**ii. The Drafting History of the Bylaws Makes Clear That IRP Declarations Are Not Binding.**

86. The lengthy drafting history of ICANN’s independent review process confirms that ICM’s position is wrong. ICM ignores *all* of this history, despite the fact that one of its witnesses in this proceeding was directly involved in the drafting, and her recognition during the drafting that a Panel’s findings would *not* be binding could not have been more clear.

87. The original version of the Bylaws, adopted in November 1998 when ICANN was first formed, did not contain a provision establishing an independent review process. The Bylaws simply stated that “[t]he Board may, in its sole discretion, provide for an independent review process by a neutral third party.”<sup>108</sup> When the Bylaws were revised later that month, this provision was amended to direct the adoption of a review process, but it did not provide additional specificity as to the process itself.<sup>109</sup>

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<sup>107</sup> *Id.* at Article IV, § 3.8.c (emphasis added).

<sup>108</sup> ICANN Bylaws, Article III, § 4 (November 6, 1998), *available at* <http://www.icann.org/en/general/archive-bylaws/bylaws-06nov98.htm> (last visited May 5, 2009), attached hereto as ICANN Exhibit W.

<sup>109</sup> The revised provision states that the Board shall, “following solicitation of input from the Advisory Committee on Independent Review and other interested parties and consideration of all such suggestions, adopt policies and procedures for independent third-party review of Board actions alleged by an affected party to have violated the Corporation’s articles of incorporation or bylaws.” ICANN Bylaws, Article III, § 4(b) (November 21, 1998), *available at* <http://www.icann.org/en/general/archive-bylaws/bylaws-23nov98.htm> (last visited May 5, 2009), attached hereto as ICANN Exhibit X.

88. In nine subsequent revisions to the Bylaws during ICANN’s early formative period, from March 31, 1999, through February 12, 2002, the IRP Bylaws remained the same.<sup>110</sup> But during that period, ICANN proceeded with various activities to establish the independent review process as directed by the Bylaws. As part of that process, an advisory committee began working on the development of an independent review process and ultimately issued draft principles on matters ranging from the number of panelists to their length of service and required qualifications.<sup>111</sup>

89. Throughout its work, the committee consistently emphasized the non-binding nature of the review process. For instance, in comments issued in 1999, the committee stated that the IRP would be persuasive in its authority, “rest[ing] on its independence, on the prestige and professional standing of its members, and on the persuasiveness of its reasoned opinions.”<sup>112</sup> But the committee explained that “the ICANN Board *should retain ultimate authority* over ICANN’s affairs – after all, it is the Board, not the [independent review panel], that will be chosen by (and is directly accountable to) the membership and the supporting organizations,” and that the “reasoned and persuasive decision[s]” of the panel, which would be “made public,” would “have to be taken seriously by the Board.”<sup>113</sup>

90. When the committee’s ideas were discussed at the Board’s open meeting in May 1999, the non-binding nature of the contemplated process was again confirmed. A question was asked whether the Board’s action would have “[p]recedence” over the conclusion of the

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<sup>110</sup> See generally ICANN Bylaws Archive, Cl. Ex. 38.

<sup>111</sup> See Draft Principles for Independent Review, Interim Report of the Advisory Committee on Independent Review With Addendum, *available at* <http://cyber.law.harvard.edu/icann/berlin/archive/IRdraft.html> (last visited May 5, 2009), attached hereto as ICANN Exhibit Y; *see also* Independent Review Policy, March 10, 2000, *available at* <http://www.icann.org/en/committees/indreview/policy.htm> (last visited May 5, 2009), attached hereto as ICANN Exhibit Z.

<sup>112</sup> Draft Principles for Independent Review, Interim Report of the Advisory Committee on Independent Review With Addendum, *available at* <http://cyber.law.harvard.edu/icann/berlin/archive/IRdraft.html> (last visited May 5, 2009), attached hereto as ICANN Exhibit Y.

<sup>113</sup> *Id.* (emphasis added).

reviewing panel.<sup>114</sup> The response was clear as to the non-binding effect of a panel's results: "If the board disagreed with the independent review committee, the board would do what it thought was appropriate. But it would all be public."<sup>115</sup>

91. The committee's work did not lead to the creation of an independent review process in 1999, but ICANN renewed its efforts in 2001 as part of a broader evaluation of its structure and processes.<sup>116</sup> In November 2001, ICANN established a committee that became known as the Committee on ICANN Evolution and Reform (the "ERC"), with responsibility for recommending changes to ICANN's structure and processes.<sup>117</sup> The ERC was tasked with, among other things, identifying workable "checks and balances that will ensure both the effectiveness and the openness of the organization."<sup>118</sup> To that end, in June 2002, the ERC issued a report entitled "ICANN: A Blueprint for Reform," which outlined the Committee's recommendations.<sup>119</sup> The Board subsequently adopted the Blueprint.

92. The Blueprint stated unequivocally that any new independent review process would be non-binding. In a section entitled "Accountability," the Blueprint recommended (and the Board agreed) that the Board would "create a process to require *non-binding* arbitration by an

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<sup>114</sup> ICANN Open Meeting – Afternoon Session, May 25 & 26, 1999, *available at* <http://cyber.law.harvard.edu/icann/berlin/archive/open2.html> (last visited May 5, 2009), attached hereto as ICANN Exhibit AA.

<sup>115</sup> *Id.* Indeed, the committee initially described the review process as resulting in "advisory opinions." *Id.* While the committee later substituted that phrase with the term "declar[at]ions," it made clear that this change merely reflected the committee's interest in "more firmly root[ing]" the independent review process in the overall structure of ICANN (*id.* at Addendum to Interim Report) and did not alter the non-binding nature of the review process.

<sup>116</sup> The delay in implementing the committee's suggestions resulted from the need for procedures and requirements for appointing the panelists, which proved more time-consuming to accomplish than anticipated. *See* Draft Principles for Independent Review, Interim Report of the Advisory Committee on Independent Review, *available at* <http://cyber.law.harvard.edu/icann/berlin/archive/IRdraft.html> (last visited May 5, 2009), attached hereto as ICANN Exhibit Y.

<sup>117</sup> *See* Committee on ICANN Evolution and Reform, *available at* <http://www.icann.org/en/committees/evol-reform> (last visited May 5, 2009), attached hereto as ICANN Exhibit AB.

<sup>118</sup> *See id.*

<sup>119</sup> *See* ICANN: A Blueprint for Reform (June 20, 2002) (the "Blueprint"), *available at* <http://www.icann.org/en/committees/evol-reform/blueprint-20jun02.htm> (last visited May 5, 2009), attached hereto as ICANN Exhibit AC.

international arbitration body to review any allegation that the Board has acted in conflict with ICANN's Bylaws."<sup>120</sup> The Blueprint included three other recommendations for accountability: establishing an office of ombudsman; establishing a public-outreach staff position; and modifying the pre-existing reconsideration process in certain respects.<sup>121</sup> Each of these recommendations, along with the IRP process, served the common purpose of "advanc[ing] ICANN's core values of openness and transparency."<sup>122</sup>

93. ICM's counsel in conjunction with its sTLD application, Ms. J. Beckwith Burr, actively participated in the process and expressly agreed that the review process would *not* be binding. Ms. Burr, who had previously worked for the United States Department of Commerce, where she was responsible for issues related to ICANN, was in private law practice in 2002 (at the firm where she later represented ICM with respect to its .XXX sTLD application<sup>123</sup>) when the ERC asked her to suggest ways to implement the Blueprint's recommendations on accountability. In a report dated August 23, 2002, Ms. Burr provided her suggestions, within the framework of the ERC's concern that "ICANN's decision making process must be perceived as unbiased."<sup>124</sup>

94. In addressing the independent review process, Ms. Burr explained that IRP "*decisions will be nonbinding, because the Board will retain final decision-making authority.*"<sup>125</sup> Ms. Burr further noted that, especially when compared to the reconsideration process administered by the Board rather than a "neutral" entity, the significance of the IRP process was not any binding effect but rather the IRP's status as a "formal process to review allegations that the Board has acted in conflict with ICANN's Bylaws."<sup>126</sup> Accountability would

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<sup>120</sup> *Id.* at § 5 (emphasis added).

<sup>121</sup> *Id.*

<sup>122</sup> *Id.*

<sup>123</sup> See ICM Memorial, Ms. J. Beckwith Burr Witness Statement, ¶ 7.

<sup>124</sup> Becky Burr, Recommendations Regarding Accountability at II (August 23, 2002), available at <http://www.icann.org/en/committees/evol-reform/afap-report-23aug02.htm> (last visited May 5, 2009), attached hereto as ICANN Exhibit V.

<sup>125</sup> *Id.* (emphasis added).

<sup>126</sup> *Id.*



be achieved by a panel’s “persuasive public power,” which would be possible by making panel announcements “easily available” to the public.<sup>127</sup>

95. In this proceeding, ICM has submitted a lengthy witness statement by Ms. Burr, but her statement does not address any of her work on the IRP drafting issue.<sup>128</sup>

96. The ERC ultimately proposed a set of substantially revised Bylaws to the Board, addressing a new independent review process as well as a host of other issues evaluated during the evolution-and-reform process.<sup>129</sup> In doing so, the ERC explained that the proposed IRP Bylaws (which became Article IV, section 3 of the Bylaws) “largely track[ed] the recommendations” of Ms. Burr.<sup>130</sup>

97. In preparing and proposing the new Bylaws, the ERC again emphasized the non-binding nature of the new IRP. In an August 2002 interim report, the ERC stated: “We do not believe that ICANN should have either a Supreme Court or a ‘Super Board’ with the ability to nullify decisions reached by the ICANN Board, which will be the most broadly representative body within the ICANN structure.”<sup>131</sup> In its final report issued in October 2002 along with the new set of Bylaws, the ERC similarly stated that “a ‘Supreme Court,’ with the power to revisit and potentially reverse or vacate decisions of the ICANN Board, would itself raise many difficult questions” and thus had not been adopted.<sup>132</sup> As these comments demonstrate, although focused on providing accountability for the Board’s actions through the IRP, the ERC did not replace the

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<sup>127</sup> Id.

<sup>128</sup> See ICM Memorial ¶ 10.

<sup>129</sup> See Proposed New Bylaws Recommended by the Committee on ICANN Evolution and Reform, Art. 4, § 3, ¶¶ 12-13 (October 23, 2002), available at <http://www.icann.org/en/committees/evol-reform/proposed-bylaws-23oct02.htm> (last visited May 5, 2009), attached hereto as ICANN Exhibit AD.

<sup>130</sup> ERC, Final Implementation Report and Recommendations, at § 5 (October 2, 2002) [“Final Implementation Report”], available at <http://www.icann.org/en/committees/evol-reform/final-implementation-report-02oct02.htm> (last visited May 5, 2009), attached hereto as ICANN Exhibit AE.

<sup>131</sup> ERC, First Interim Implementation Report, at § 2 (August 1, 2002), available at <http://www.icann.org/en/committees/evol-reform/first-implementation-report-01aug02.htm> (last visited May 5, 2009), attached hereto as ICANN Exhibit AF.

<sup>132</sup> Final Implementation Report, *supra* note 130.

ultimate authority of that broadly representative Board with that of an independent third party otherwise unconnected to ICANN and its constituencies.

98. In reviewing and ultimately adopting the ERC's proposed Bylaws in December 2002, the Board again confirmed the non-binding nature of the IRP. The Board agreed with the ERC that the Board would retain ultimate authority, and amended the language proposed by the ERC to clarify even further the non-binding nature of the IRP. Specifically, it replaced the ERC's reference to IRP "decisions" with the term "declarations."<sup>133</sup> As explained in the Board's minutes, this replacement was precisely to avoid any erroneous inference that the IRP determinations are binding decisions akin to those of a judicial or arbitral tribunal.<sup>134</sup>

99. In his witness statement, Dr. Cerf, who was Chair of the ICANN Board when it adopted the IRP Bylaws, confirmed the Board's intent that the IRP would be non-binding. As he explained, "[w]hen the IRP was created, it was intended that an Independent Review Panel would consider claims that the ICANN Board violated ICANN's Articles of Incorporation or Bylaws, would conduct a reasoned and persuasive analysis of those claims, and would make public its conclusion and rationale so that members of the Internet community would understand the results of the process."<sup>135</sup> An independent review panel "was never meant to have the authority to overrule, nullify, or stay decisions of the ICANN Board."<sup>136</sup>

### **iii. ICM's Contrary Arguments Are Baseless.**

100. ICM does not acknowledge the Bylaws provisions and the substantial drafting history. Instead, in support of its argument that the IRP Bylaws provide for "final and binding" declarations, ICM takes a few fragmentary phrases in the IRP Bylaws out of context.

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<sup>133</sup> Compare Proposed New Bylaws Recommended by the Committee on ICANN Evolution and Reform, Art. 4, § 3, ¶¶ 12-13 (October 23, 2002), available at <http://www.icann.org/en/committees/evol-reform/proposed-bylaws-23oct02.htm> (last visited May 5, 2009), attached hereto as ICANN Exhibit AD, with ICANN Bylaws, Art. 4, § 3, ¶¶ 12-13 (December 15, 2002) (referring to panel "declarations"), available at <http://www.icann.org/en/general/archive-bylaws/bylaws-15dec02.htm> (last visited May 5, 2009), attached hereto as ICANN Exhibit AG.

<sup>134</sup> See ICANN Minutes, October 31, 2002, available at <http://www.icann.org/en/minutes/minutes-31oct02.htm> (last visited May 5, 2009), attached hereto as ICANN Exhibit AH.

<sup>135</sup> V. Cerf Witness Statement, ¶ 9.

<sup>136</sup> *Id.*

101. ICM's primary argument is that the IRP Bylaws' use of the word "arbitration" necessitates the conclusion that the IRP is binding.<sup>137</sup> This is wrong. The Bylaws never characterize the IRP as "arbitration." To the contrary, they consistently refer to the proceeding as an "independent review" and never as "arbitration."<sup>138</sup> The Bylaws' one use of the word "arbitration" refers not to the nature of the IRP proceeding, but rather to the *entity* that will implement the IRP.<sup>139</sup> Because arbitral bodies are suitable entities to implement the process that ICANN established, it is unremarkable that they would be used to implement the IRP, and an occurrence of the word "arbitration" in that context does not support ICM's contention. In limiting the word's occurrence to a reference to the entity conducting the review, and consistently refraining from using the term to characterize the nature of the proceedings or the effects of the Panel's conclusions, the Bylaws actually reinforce that the IRP is not binding. Plainly, the Bylaws used the word "arbitration" where appropriate, so the failure to use the word "arbitration" in explaining the nature of the proceeding was deliberate.

102. Moreover, as shown above, the drafters of the Bylaws obviously did not understand the term "arbitration" to refer to a proceeding with necessarily binding results; in the course of the drafting history, they occasionally used the phrase "non-binding arbitration" to refer to the process.<sup>140</sup> Thus, the word "arbitration" would not be dispositive even if it had been used in reference to the proceeding as ICM wrongly claims.

103. ICM's only other textual argument is to quote phrases in the Bylaws out of context that, according to ICM, also suggest a "binding" effect. Thus, ICM points to the phrases "independent review," "declaration," "decisions/opinions," "writing[s]," "act[ing] upon the opinion of the IRP," and "prevailing party."<sup>141</sup> None of these terms, standing on their own and especially in their context, can possibly be read to require a binding decision, particularly in the

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<sup>137</sup> ICM Memorial ¶¶ 291-92, 298-302.

<sup>138</sup> See ICANN Bylaws, *supra* note 2, Article IV, §§ 3.1-6, 3.9.

<sup>139</sup> See *id.* at Article IV, § 3.4 (stating that the review process should be administered by an "international arbitration provider . . . using arbitrators under contract with or nominated by that provider").

<sup>140</sup> See Blueprint, *supra* note 119, at § 5.

<sup>141</sup> See ICM Memorial ¶¶ 282, 304, 306-07.

face of the voluminous evidence ignored by ICM showing that the contrary was presupposed.<sup>142</sup> ICM offers no contextual analysis that could in any way support its bare assertions.

104. ICM also quotes statements by then-ICANN president Stuart Lynn and current-president Dr. Paul Twomey discussing the need for transparency and accountability in ICANN's structure and processes.<sup>143</sup> ICM's quotations are badly inapposite. Interest in greater transparency and accountability, however, obviously does not require, or even suggest, a binding result. To the contrary, these statements make clear that the driving purpose of the IRP was *not* to create a new tribunal to impose binding decisions, but rather to provide another means to foster openness and accountability, which the IRP accomplishes through the persuasive public power of the panel's declarations.<sup>144</sup>

105. ICM's heavy emphasis<sup>145</sup> on Dr. Twomey's use of the word "final" is particularly mystifying. During hearings before Congress in 2006 in which he addressed three "processes for accountability in [ICANN's] decision-making and in its bylaws," Dr. Twomey characterized the IRP as the Bylaws' "final method of accountability."<sup>146</sup> The IRP process was certainly "the final" (*i.e.*, the last in time) of the three methods to which Dr. Twomey referred (the first two

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<sup>142</sup> With respect to the phrase "prevailing party," ICM relies on case law addressing that term for purposes of attorneys' fee awards in civil rights litigation. *See* ICM Memorial ¶ 306. ICM provides no basis for applying that authority to the different situation here of an alternative dispute resolution where neither judicial litigation, civil rights, nor attorneys' fees are at issue. Obviously, a party "prevails" here if the panel issues a declaration in that party's favor, whether or not that declaration is binding.

<sup>143</sup> *See* ICM Memorial ¶¶ 284-89. Indeed, ICM claims that "it is instructive to consider" these statements "[b]efore considering the plain language of the provisions governing the Independent Review Process." ICM Memorial ¶ 284 (emphasis added). ICM's backward approach to interpreting the Bylaws underscores the absence of any textual basis for ICM's argument.

<sup>144</sup> *See* ICANN Governance, Hearing before the S. Subcommittee on Science, Technology, and Space of the Committee on Commerce, Science, and Transportation, 107 Cong. 2 (2002) (statement of Mr. Lynn that any reform efforts should "retain the fair, open, and transparent character of ICANN processes"); Hearings Before the H. Subcommittee on Commerce, Trade, and Consumer Protection and Subcommittee on Telecommunications & the Internet of the Committee on Energy and Commerce, 109th Cong. 19 (2006) (statement of Dr. Twomey emphasizing that the IRP is part of ICANN's "well-established principles and processes for accountability").

<sup>145</sup> ICM Memorial ¶¶ 288-89.

<sup>146</sup> Hearings Before the H. Subcommittee on Commerce, Trade, and Consumer Protection and Subcommittee on Telecommunications & the Internet of the Committee on Energy and Commerce, 109th Cong. 19 (2006).

being the Board’s initial decision-making process and the reconsideration process administered by the Board). Dr. Twomey obviously was not addressing whether an IRP declaration was legally binding on ICANN.

106. Likewise, ICM’s reliance on Mr. Lynn’s and Dr. Twomey’s references to “arbitrators” or “arbitration” is similarly misplaced.<sup>147</sup> The context of the statements ICM references makes clear that neither Mr. Lynn nor Dr. Twomey was referring to the question of whether a panel’s declarations were binding.<sup>148</sup> The word “arbitration” in this context does not have any relevance to the effect of IRP declarations, because, as shown above, ICANN has expressly used the term “arbitration” to refer to a “non-binding” process.<sup>149</sup>

107. In short, nothing in the IRP provisions in any way suggests that the Panel’s declaration is “binding.” To the contrary, the provisions’ plain language and drafting history make clear that the Panel’s declarations, have persuasive and advisory force, but do not bind the ICANN Board.

**b. The Supplementary Procedures Governing The IRP Confirm That IRP Declarations Are Not Binding.**

108. The operating rules and procedures for the IRP confirm that IRP declarations are not binding. Pursuant to Article IV, section 3.5 of the ICANN Bylaws, ICANN established rules to govern the IRP, selecting the ICDR International Arbitration Rules (“ICDR Rules”)<sup>150</sup> as amended by ICANN’s Supplementary Procedures.<sup>151</sup> ICANN’s individualization of the ICDR

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<sup>147</sup> See ICM Memorial ¶¶ 287-88.

<sup>148</sup> See ICANN Governance, Hearing before the S. Subcommittee on Science, Technology, and Space of the Committee on Commerce, Science, and Transportation, 107 Cong. 2 (2002) (statement of Mr. Lynn that ICANN was creating a mechanism for “independent review of ICANN Board actions by experienced arbitrators”); Hearings Before the H. Subcommittee on Commerce, Trade, and Consumer Protection and Subcommittee on Telecommunications & the Internet of the Committee on Energy and Commerce, 109th Cong. 19 (2006) (statement of Dr. Twomey describing the IRP as “an independent review panel or arbitration process”).

<sup>149</sup> See Blueprint, *supra* note 119, § 5.

<sup>150</sup> See International Centre for Dispute Resolution, International Dispute Resolution Procedures [“ICDR Rules”], Cl. Ex. 11.

<sup>151</sup> See Supplementary Procedures for Internet Corporation for Assigned Names and Numbers [“Supplementary Procedures”], Cl. Ex. 12.

Rules, through those Supplementary Procedures, makes clear that IRP declarations are not binding.

109. Supplementary Procedures 6 and 8 are determinative. Supplementary Procedure 6, entitled “Interim Measures of Protection,” tracks the similar provision in the IRP Bylaws by stating that the Panel may merely “*recommend* that the Board stay any action or decision, or that the Board take any interim action, until such time as the Board reviews and acts upon the opinion of the IRP.”<sup>152</sup> As noted above, the authority merely to “recommend” temporary action, until the Board “reviews” the panel’s conclusions, demonstrates that the panel’s declarations do not have binding force. Moreover, this Supplementary Procedure replaces Article 21 of the ICDR Rules, also entitled “Interim Measures of Protection.” Article 21 authorizes an arbitral panel to “take whatever measures it deems necessary, including injunctive relief and measures for the protection or conservation of property” or “an interim award” that may require “security for the costs of such measures.”<sup>153</sup> By replacing the ICDR rule that authorizes the panel itself to award interim relief, and providing its own rule that retains the ICANN Board’s judgment and decision-making authority, ICANN ensured that even interim declarations by a panel would not be binding on the Board.

110. Supplementary Procedure 8 similarly confirms the non-binding nature of IRP declarations. In the ICDR Rules, Article 27 is entitled “Form and Effect of the Award” and specifies that arbitration awards are “final and binding.”<sup>154</sup> ICANN, however, adopted Supplementary Procedure 8, which replaces this provision. The title of Supplementary Procedure 8 – “Form and Effect of an IRP Declaration” – corresponds to Article 27 but, again, is tailored to ICANN’s particular review process. Like the IRP Bylaws that it tracks,<sup>155</sup> the supplementary rule refers to “declarations” and specifically *omits* the Article 27 reference to a

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<sup>152</sup> *Id.* at Supplementary Procedure 6 (emphasis added). The IRP Bylaws state that the panel may “recommend that the Board stay any action or decision, or that the Board take any interim action, until such time as the Board reviews and acts upon the opinion of the IRP.” ICANN Bylaws, *supra* note 2, Article IV, § 3.8.c.

<sup>153</sup> ICDR Rules, *supra* note 150, Article 21; *see also id.*, Article 27(7) (“In addition to making a final award, the tribunal may make interim, interlocutory or partial orders and awards.”).

<sup>154</sup> *Id.* at Article 27.

<sup>155</sup> *See* ICANN Bylaws, *supra* note 2, Article IV, § 3.12.

binding effect. The supplementary rule states that declarations shall: (i) “be made in writing, promptly by the [panel], based on the documentation, supporting materials and arguments submitted by the party,” (ii) “designate the prevailing party,” (iii) “be made public” if the parties consent, and (iv) be provided to the parties.<sup>156</sup> Supplementary Procedure 8 thus squarely rejects the “final and binding” language contained in Article 27.<sup>157</sup>

111. ICM claims that Supplementary Rule 8 has no effect on Article 27 or its reference to “final and binding” awards.<sup>158</sup> ICM would have the Panel reach the absurd conclusion that there are *two* different rules, both labeled “Form and Effect” of a result, with largely overlapping but different content, despite the fact that one was specially adopted for this proceeding and differs from the other, which is a standardized rule governing proceedings in the absence of modification. ICM’s only rationale for this nonsensical position is that, whereas ICANN expressly provided that another ICDR Rule (Article 37 addressing procedures for emergency proceedings) “will not apply,” ICANN did not make a similar statement with respect to Article 27. But it would have made no sense for ICANN to have made such a statement regarding Article 27. Unlike with Article 37, which ICANN eliminated wholesale without any corresponding replacement, ICANN *modified* Article 27 by expressly adopting a supplemental provision with a corresponding title that altered the content of Article 27. In light of Article 27’s modification, rather than entire elimination, it would have made no sense for ICANN to state, as it did with respect to Article 37, that Article 27 “did not apply.”

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<sup>156</sup> See Supplementary Procedures, *supra* note 151, Supplementary Procedure 8.

<sup>157</sup> Setting aside prefatory Supplementary Procedures 1 and 2 (identifying definitions and scope of the Supplementary Procedures), ICANN’s other Supplementary Procedures, like Procedures 6 and 8, correspond to particular provisions in the ICDR Rules. Specifically, Procedure 3, entitled “Number of Independent Review Panelists,” corresponds to Article 5 on “Number of Arbitrators”; Procedure 4, entitled “Conduct of the Independent Review,” corresponds to Article 16 on “Conduct of the Arbitration”; Procedure 5, entitled “Written Statements,” corresponds to Article 17 of the same name; Procedure 7, entitled “Declarations,” corresponds to Article 26 on “Awards, Decisions and Rulings”; and Procedure 9, entitled “Costs,” corresponds to Article 31 of the same name. In modifying the ICDR Rules in each instance, ICANN replaced references to “arbitration” or “tribunal” with “independent review” or “IRP”; references to “arbitrators” with “independent review panelists”; and references to “award, decision, or ruling” with “declaration.” ICANN’s consistent and repeated tailoring of the ICDR Rules confirms that ICANN rejected any binding effect of results otherwise provided for in those Rules.

<sup>158</sup> See ICM Memorial ¶¶ 282, 308. ICM does not address the significance of Supplementary Rule 6’s replacement of Article 21.



112. ICM also argues that the act of using the ICDR Rules on arbitration somehow transforms this proceeding into a binding arbitration.<sup>159</sup> But the use of the ICDR Rules – as amended by ICANN’s Supplementary Procedures – actually proves just the opposite. While the ICDR Rules on arbitration apply well-established rules to the conduct of an IRP – to govern such procedural matters as the appointment of panelists, scheduling, and the manner in which the parties may discuss and provide evidence – the Supplementary Procedures expressly replace those provisions in the ICDR Rules that concern the effect of a panel’s determinations, tailoring the rules to ICANN’s process in which a panel’s declarations are not binding. In relying superficially on the word “arbitration” in the title of the ICDR Rules, ICM ignores the content of ICANN’s amendments to those rules. Some of those amendments would not have been required if ICANN had intended the IRP to be binding. As a result, to the extent any aspects of “arbitration” are part of the IRP, they relate to the operation of the proceeding, not to its results, which are governed by ICANN’s Supplementary Procedures that render the results non-binding.<sup>160</sup>

113. Finally, as with ICM’s misplaced reliance on various terms in the Bylaws, ICM cannot rely on the Supplementary Procedures’ various references to “independent review,” “declaration,” “decisions/opinions,” “writing[s],” “act[ing] upon the opinion of the IRP,” or “prevailing party” to infer a binding nature of the IRP.<sup>161</sup> Whether in isolation or in context, none of those terms implies a binding result.

## **2. The Actions Of The ICANN Board Are Entitled To Substantial Deference From This Tribunal.**

114. As explained above, ICANN created the IRP process as part of its effort to allow aggrieved parties to challenge whether the conduct of the ICANN Board was inconsistent with

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<sup>159</sup> See ICM Memorial ¶ 293.

<sup>160</sup> ICM argues that the fact that ICANN selected the ICDR Rules on arbitration over its mediation rules supports ICM’s argument. See ICM Memorial ¶ 293. Mediation, however, is an entirely different and inapposite process designed to facilitate agreement of the parties, not an independent review. See Black’s Law Dictionary 996 (7th ed. 1999) (defining mediation as “help[ing] the disputing parties reach a mutually agreeable solution”). Mediation could not possibly have supplied the form of review called for in ICANN’s Bylaws.

<sup>161</sup> See ICM Memorial ¶¶ 282, 304-07.

ICANN’s Bylaws and Articles of Incorporation. ICANN and its community deliberated with great care in crafting the rules governing this proceeding, and the rules and proceeding are unique to ICANN.

115. ICM suggests that the ICANN-created process, including the plain language of the governing Bylaws, be ignored and that the Panel should engage in a “full, non-deferential review of the ICANN’s actions.”<sup>162</sup> ICM’s argument is also contrary to well-settled principles of law on deferential review of corporate board decisions. ICM rests its argument instead on a misinterpretation of a single word (“independent”) that has absolutely nothing to do with the appropriate degree of deference in this proceeding.

**a. ICANN’s Bylaws Expressly Confer Discretionary Authority Upon The Board In Applying The Provisions At Issue Here.**

116. The Bylaws provisions to which ICM asks the Panel to compare ICANN’s actions are collected and summarized in section 2 of Article I. This section identifies eleven “core values” of ICANN governance, several of which (*e.g.*, the adoption of “open and transparent” decision-making procedures (Article I, section 2) form the basis of ICM’s request for review.<sup>163</sup> This section directly speaks to the degree of latitude afforded to the Board and other ICANN decision-makers in implementing the provisions in question.

117. Article I, section 2 explains that the core values are “very general,” and that therefore “situations will inevitably arise in which perfect fidelity to all eleven core values simultaneously is not possible.” The Bylaws thus make clear that the requirements must not be construed in a “narrowly prescriptive” manner. To the contrary, Article 1, section 2 emphatically provides that the ICANN Board is vested with broad discretion in implementing these provisions. The section begins by noting that the core values “should guide” ICANN’s decisions and actions, and the section concludes by elaborating on this broad guidance:

*Any ICANN body making a recommendation or decision shall exercise its judgment to determine which core values are most relevant and how they apply*

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<sup>162</sup> ICM Memorial ¶ 323.

<sup>163</sup> ICM expressly relies on core values 1, 2, 7, and 8.

to the specific circumstances of the case at hand, and to determine, if necessary, *an appropriate and defensible balance among competing values*.<sup>164</sup>

118. The discretion given to the Board with respect to the core values contrasts with the unconditional requirement of adhering to ICANN’s mission – the other provision in Article I. Whereas the mission statement in Article 1, section 1 provides ultimate (albeit expansive) boundaries on ICANN’s scope, the core values in Article 1, section 2 provide judgment-driven guidance for “performing its mission” within that scope.<sup>165</sup>

119. While several provisions governing ICANN’s obligations on which ICM relies are provisions other than Article I, section 2, the Board’s actions pursuant to those obligations are due the same deference that applies to Board actions pursuant to Article I, section 2.<sup>166</sup> Each of these other obligations in ICANN’s governing documents either repeats core values as to which Board deference is expressly afforded in Article I, or implements Article I core values in specific contexts. For instance, the Bylaws addressing openness and transparency in Article III, section 1 simply repeat the core value on the same topic.<sup>167</sup> And the Bylaws prohibiting ICANN from providing “disparate treatment unless justified by substantial and reasonable cause” address more specifically what the core values of neutral, objective, and fair decision-making state in

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<sup>164</sup> *Id.* (emphasis added).

<sup>165</sup> ICANN Bylaws, *supra* note 2, Article I, § 2.

<sup>166</sup> ICM relies on the following provisions in ICANN’s Bylaws and Articles that occur elsewhere than in the list of core values in Article I, section 2 (but nonetheless implement those core values, as discussed in the accompanying text): Article I, section 1 of the Bylaws and Article III of the Articles (both on the stable and secure operation of the Internet), which implement core value 1 on the same topic; Article II, section 3 of the Bylaws (on non-discriminatory treatment), which implements core value 8 on neutral, objective, and fair decision-making; Article III, section 1 of the Bylaws and Article IV of the Articles (both on openness and transparency), which implement core value 7 on the same topic; and Article XI, section 2.1 of the Bylaws (on the role of the GAC) and Article IV of the Articles (on operating for the benefit of the Internet community, carrying out activities in conformity with relevant principles of international law), which implement core values 4 and 11 on seeking and supporting diverse input, including from governments, in policy development and decision-making.

<sup>167</sup> Compare ICANN Bylaws, *supra* note 2, Article III, § 1 (requiring ICANN and its constituent bodies to “operate to the maximum extent feasible in an open and transparent manner and consistent with procedures designed to ensure fairness”), with Article I, § 2.7 (identifying the core value of “[e]mploying open and transparent policy development mechanisms that (i) promote well-informed decisions based on expert advice, and (ii) ensure that those entities most affected can assist in the policy development process”).

general terms.<sup>168</sup> Because the Bylaws expressly confer on ICANN bodies the discretion to make reasonable judgments as to how to balance the various core values, it would make no sense to interpret other similar Bylaws' provisions as silently taking that discretion away because there is no superfluous reiteration that discretion should be exercised.

120. By its terms, then, the deference expressly accorded to the Board in implementing the core values applies to all of these provisions. ICM itself appears to recognize this point, as it nowhere urges a different degree of deference to the Board's judgment.

121. In sum, the Bylaws expressly confer upon the ICANN Board the authority – in “its judgment” – to select and “balance” the principles that ICM claims were contravened in this case (both those listed in the core-values provision and those identified elsewhere). Thus, by its terms, the Bylaws' conferral of discretionary authority makes clear that any reasonable decision of the ICANN Board is, *ipso facto*, not inconsistent with the Bylaws and consequently must be upheld. Indeed, the Bylaws even go so far as to provide that outright departure from a core value is permissible in the judgment of the Board, so long as the Board reasonably “exercise[s] its judgment” in determining that other relevant principles outweighed that value in the particular circumstances at hand.

122. Here, as will be shown in the factual discussion in Parts III.B and III.C, there was not even any *arguable* departure from any of the Bylaws or Articles provisions that ICM cites. Thus, even without the substantial deference due to ICANN's reasonable actions pursuant to those provisions, ICANN's handling of the ICM application should not be found to violate the Bylaws or Articles. But because such substantial deference is in fact due, there is no basis whatsoever for a declaration in ICM's favor because the Board's decisions in this matter were, at a minimum, clearly justified and within the range of reasonable conduct.

123. The deference due to the ICANN Board is further reinforced by the Bylaws provision governing the independent review process itself. Article IV, section 3 strictly limits

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<sup>168</sup> Compare ICANN Bylaws, *supra* note 2, Article II, § 3 (prohibiting ICANN from providing “disparate treatment unless justified by substantial and reasonable cause”), with Article I, § 2.8 (identifying core value of “[m]aking decisions by applying documented policies neutrally and objectively, with integrity and fairness”).

the scope of independent review proceedings to the narrow question of whether ICANN acted in a manner “inconsistent with” the Articles of Incorporation and Bylaws. In confining the inquiry into whether ICANN’s conduct was *inconsistent with* its governing documents, the presumption is one of consistency so that inconsistency must be established, rather than the reverse. Other language in section 3 confirms this deference. The provision charges the Panel with the duty of “comparing contested actions of the Board to the Articles of Incorporation and Bylaws, and with declaring whether the Board has acted consistently with” those two documents. By making clear that the Panel’s role is limited to finding actual and specific violations of express provisions of the Bylaws or Articles (as opposed to a broader inquiry into the propriety of Board actions more generally), the provision governing this tribunal’s review makes clear that independent review is not to be used as a mechanism to upset arguable or reasonable actions of the Board.

124. The drafters of the IRP provision (including Ms. Burr) confirmed this plain meaning in explaining the IRP’s purpose and effect. In the Report that recommended the language of the IRP provision, the drafters stated that the IRP “is not the ‘Supreme Court of ICANN’ that some in the community have urged.”<sup>169</sup> The Report made clear that the limited scope of review proceedings had been decided precisely in light of the appropriate latitude of the Board to make decisions on behalf of ICANN. “We believe that the ICANN Board envisioned in the New Bylaws . . . is broadly representative of the entire range of ICANN stakeholders, and is thus the most appropriate body to make final decisions on ICANN policies, within the scope of the mission also set forth in those New Bylaws.”<sup>170</sup> For instance, the Board is composed of fifteen members – who, except for ICANN’s President, are volunteers – drawn from a variety of different constituencies in the Internet community. Two-thirds of the Board members presently reside in countries other than the United States, reflecting ICANN’s commitment to represent the

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<sup>169</sup> Final Implementation Report, *supra* note 130, at § 5.

<sup>170</sup> *Id.* See also, e.g., Committee on ICANN Evolution and Reform, First Interim Implementation Report § 2 (August 1, 2002), available at <http://www.icann.org/en/committees/evol-reform/first-implementation-report-01aug02.htm> (last visited May 5, 2009) (“We do not believe that ICANN should have either a Supreme Court or a ‘Super Board’ with the ability to nullify decisions reached by the ICANN Board, which will be the most broadly representative body within the ICANN structure.”), attached hereto as ICANN Exhibit AB; Becky Burr, *Recommendations Regarding Accountability* at II (August 23, 2002), available at <http://www.icann.org/en/committees/evol-reform/afap-report-23aug02.htm> (last visited May 5, 2009), attached hereto as ICANN Exhibit V.

views and interests of the Internet community globally. Thus, as the drafters explained and in keeping with the plain language of the Bylaws, the narrow scope of the independent review process was designed precisely to protect the prerogatives of the Board in making decisions for which there is a range of reasonable conduct. Deference to such discretionary Board determinations is therefore inherent in the structure, as well as the text, of the Bylaws.

125. ICM offers no response to any of the foregoing Bylaws provisions or their drafting history. ICM's silence is puzzling in light of the fact that ICANN addressed these issues in its previous brief to the Panel.<sup>171</sup> Because the Bylaws directly speak to the question and make clear that a violation of the Bylaws and Articles can be found only in the event of a plain and unequivocal contravention of those documents, the Panel should give substantial deference to the actions of the ICANN Board in this proceeding.

**b. Well-Established Principles Of Corporate Law Independently Compel Strong Deference To Decisions Of The ICANN Board.**

126. Basic principles of corporate law supply an independent basis for the deference due to the reasonable judgments of the ICANN Board in this matter. It is black-letter law that “there is a presumption that directors of a corporation have acted in good faith and in the best interest of the corporation.”<sup>172</sup> This presumption ordinarily operates to “preclude[] judicial inquiry into actions of corporate directors taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes,” and, if unrebutted, forecloses a reviewing court from substituting its judgment for that of the board.<sup>173</sup>

127. In California, where ICANN is located and incorporated, these principles require deference to actions of a corporate board of directors so long as the board acted “upon reasonable investigation, in good faith and with regard for the best interests of” the corporation, and

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<sup>171</sup> See ICANN's Response to Request for Independent Review ¶ 87.

<sup>172</sup> 19 C.J.S. Corporations § 568 (2008); *accord, e.g.*, 18B Am. Jur. 2d Corporations § 1476 (2008). For the Panel's convenience, ICANN has submitted all legal authorities cited herein as ICANN Exhibits BF-BZ.

<sup>173</sup> *Id.*

“exercised discretion clearly within the scope of its authority.”<sup>174</sup> This includes the boards of not-for-profit corporations.<sup>175</sup> As California courts have explained, this doctrine rests on the well-accepted premise that those to whom decision-making has been entrusted are better equipped to make policy and management decisions than courts.<sup>176</sup> Thus, the amount of deference typically afforded to a board is extensive. Courts will only scrutinize the decisions of a corporate board where there are allegations of facts that tend to show that the board’s conclusions were made: (1) with inadequate information, or (2) in bad faith.<sup>177</sup> The presumption of sound business judgment is only rebutted by “allegations of facts which, if proven, would establish fraud, bad faith, overreaching or an unreasonable failure to investigate material facts.”<sup>178</sup>

128. For instance, in *Lamden*, a case cited by ICM, the court found that the board of directors of a community association should be afforded similar deference as under the business judgment rule, holding that actions taken “upon reasonable investigation, in good faith, and in a manner the Board believed was in the best interests of the Association and its members” would withstand court scrutiny.<sup>179</sup> “The theory behind the business judgment rule is that directors are not required to guarantee that their decisions will succeed, rather they are only expected to use ordinary and reasonable care in making corporate policy.”<sup>180</sup>

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<sup>174</sup> *Lamden v. La Jolla Shores Clubdominium Homeowners Ass’n*, 21 Cal. 4th 249, 265 (1999); accord, e.g., *Lee v. Interinsurance Exchange of Auto. Club of S. Cal.*, 50 Cal. App. 4th 694, 714 (1996) (noting that these principles “insulate[] from court intervention those management decisions which are made by directors in good faith in what the directors believe is the organization’s best interest”); *Frances T. v. Village Green Owners Ass’n*, 42 Cal. 3d 490, 508 n.14 (1986) (noting that such judicial deference to corporate boards “exists in one form or another in every American jurisdiction”).

<sup>175</sup> See, e.g., *Harvey v. Landing Homeowners Ass’n*, 162 Cal. App. 4th 809, 821-22 (2008).

<sup>176</sup> *Lee*, 50 Cal. App. 4th at 711 (extending business judgment rule to members of the Board of Governors of the Insurance Exchange); *Frances T.*, 42 Cal. 3d at 508 n.14.

<sup>177</sup> *Lee*, 50 Cal. App. 4th at 716.

<sup>178</sup> *Id.* at 715.

<sup>179</sup> *Lamden*, 21 Cal. 4th at 265; see also *Hannula v. Hacienda Homes, Inc.*, 34 Cal. 2d 442, 447 (1949) (realty corporation’s building restriction must only meet the test of “a reasonable determination made in good faith”).

<sup>180</sup> *Hill v. State Farm Mut. Auto. Ins. Co.*, 166 Cal. App. 4th 1438, 1492 (2008).



129. Likewise, in *Katz v. Chevron Corp.*, the court emphasized that a board’s decisions or actions will be given deference if they are reasonable. In *Katz*, the court applied principles of reasonableness to reject challenges to the Chevron board’s response to a potential threat from Penzoil’s accumulation of stock and the amount of information that the board considered in developing its response.<sup>181</sup> The court explained that the business judgment rule “is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”<sup>182</sup> Under the rule, “a court will not substitute its judgment for that of the board if the latter’s decision can be attributed to any rational business purpose.”<sup>183</sup> Because the board had both reasonably perceived what it believed to be a threat and acted reasonably in response, there was no triable issue of fact upon which to claim it had violated its duties.<sup>184</sup>

130. The California Corporations Code further supports the common law deference to corporate directors under the business judgment rule. The statutory rules for directors and management of for-profit and not-for-profit corporations provide, through the use of nearly identical language, that directors must act in good faith, in a manner the director believes to be in the best interests of the corporation, and with reasonable and prudent care under the circumstances.<sup>185</sup>

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<sup>181</sup> *Katz v. Chevron Corp.*, 22 Cal. App. 4th 1352, 1370-75 (1994).

<sup>182</sup> *Id.* at 1366 (citing *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985)) (internal quotations omitted).

<sup>183</sup> *Id.*

<sup>184</sup> *Id.* at 1375; *see also Lewin v. St. Joseph Hosp.*, 82 Cal. App. 3d 368, 384-85 (1978) (applying principles of reasonableness under the business judgment rule to a private not-for-profit hospital corporation, explaining that “[a] managerial decision . . . made rationally and in good faith by the board . . . should not be countermanded by the courts unless it clearly appears it is unlawful or will seriously injure a significant public interest”); *Harvey*, 162 Cal. App. 4th at 821-22 (evidence of the board’s efforts to conduct an investigation, consult with professionals, communicate with owners, and pass a resolution on the issue at hand indicated that the board performed a reasonable investigation in good faith); *Beehan v. Lido Isle Comm. Cmty. Ass’n*, 70 Cal. App. 3d 858, 865 (1977) (court would not substitute its judgment for that of nonprofit corporation where its board of directors, in deciding not to enforce amendment it believed had not been properly enacted, “acted in good faith and with a view to the best interests of the corporation and all its shareholders”).

<sup>185</sup> Cal. Corp. Code §§ 309, 7231 (2009). Furthermore, under California’s common law fair procedure doctrine, a Board’s action must be (1) substantively rational; and (2) procedurally fair. *Pinsker v. Pac.*

131. ICM’s challenge stems from the ICANN Board’s denial of an application. Therefore, long-established principles of corporate law require that Board decisions receive substantial deference, even apart from the fact that, in this case, such deference is required by the language of the Bylaws (as shown above).

132. This deference is particularly appropriate with respect to ICANN in light of the unusual and carefully crafted structure of its Board. As noted, the Board’s fifteen members are drawn from a variety of different constituencies in the Internet community.<sup>186</sup> The Board is frequently called upon to make difficult decisions concerning complex issues that affect multiple constituencies, often issues for which there is no precedent of any kind. Certainly, the question of whether to add a “sponsored” Top Level Domain to the Internet that would be dedicated exclusively to pornography was not an issue that any corporation, entity, or government had ever addressed, which explains why ICANN, ICM, the GAC, and others struggled over an extended period to address the issues. It is unreasonable to suppose in this context that there would be no deference whatsoever to the decisions of the ICANN Board, yet that is exactly what ICM proposes.

133. ICM’s primary argument against the extension of the ordinary deference to Board actions in this case is its suggestion that such deference “applies only to protect individual directors from liability.”<sup>187</sup> Yet, ICM’s only authority for this claim is *Lamden*, where the California Supreme Court *gave* such deference to board determinations despite the fact that the case (like this one) did not involve any attempt to impose liability on any individual directors.<sup>188</sup>

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(continued...)

*Coast Soc’y of Orthodontists*, 12 Cal. 3d 541, 550-51 (1974). Fair procedure is violated where the decision is arbitrary, capricious, discriminatory, irrational or “contrary to public policy.” *Id.* at 553.

<sup>186</sup> See, e.g., Final Implementation Report § 5, *supra* note 130 (noting “that the ICANN Board . . . is broadly representative of the entire range of ICANN stakeholders and is thus the most appropriate body to make final decisions on ICANN policies”).

<sup>187</sup> ICM Memorial ¶ 470.

<sup>188</sup> See *Lamden*, 21 Cal. 4th at 265; see also *id.* at 258 (noting that “no individual directors are defendants here”).

In short, California’s highest court rejected ICM’s argument in the very case ICM cites to support it.

134. ICM also cites the decision of a lower California court in *Ritter & Ritter, Inc. v. Churchill Condominium Association*, 166 Cal. App. 4th 103 (2008), which distinguished *Lamden*.<sup>189</sup> But the *Ritter* court merely observed that deference to a corporate board may not extend “to a board action involving an extraordinary situation.”<sup>190</sup> While the court found *Lamden* distinguishable on the facts,<sup>191</sup> it expressly recognized that, under *Lamden*, deference applies even in suits where individual board members are not defendants.<sup>192</sup> ICM makes no argument (and could not have) that the ICANN Board’s action in reviewing ICM’s application was an “extraordinary action” outside its ordinary competence. To the contrary, making decisions about adding TLDs, including decisions about registry operators and sponsoring organizations, is a Board activity that is explicitly within ICANN’s mission.<sup>193</sup>

135. ICM also observes that there is an exception to the requirement of deference where the Board’s own governing documents disclaim the need for such deference.<sup>194</sup> Yet, in this case, as shown above in Section III.A.2, far from eliminating deference, the governing Bylaws emphasize the strong need for, and propriety of, substantial deference to Board actions, particularly in the context of the present independent review proceeding. Because, as shown above, ICM offers no response whatsoever to this showing, the exception ICM cites is wholly inapplicable. Indeed, to the contrary, it reaffirms the need for deference, because the governing documents affirmatively demand it.

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<sup>189</sup> ICM Memorial ¶ 474.

<sup>190</sup> *Ritter*, 166 Cal. App. 4th at 122.

<sup>191</sup> *Id.* at 125.

<sup>192</sup> *Id.* at 122.

<sup>193</sup> See *supra* at Section II; ICANN Bylaws, *supra* note 2, Article I, §1 (stating that ICANN’s mission “is to coordinate, at the overall level, the global Internet’s systems of unique identifiers, and in particular to ensure the stable and secure operation of the Internet’s unique identifier systems,” and this mission includes coordinating domain names).

<sup>194</sup> See ICM Memorial ¶ 475.

**c. ICM’s Other Argument Based On The Meaning Of  
“Independent Review” Is Baseless.**

136. ICM argues that no deference is necessary because the term “independent” modifies “review” in the Bylaws.<sup>195</sup> ICM concedes that “independent review” is “not a term of common usage or general meaning within the context of international law or dispute resolution,”<sup>196</sup> but it nonetheless contends that the word “independent” connotes a full, non-deferential standard of review.

137. While the word “independent” can have a variety of meanings depending upon the context, there can be no doubt what meaning it has in the context of Article IV, section 3 of the ICANN Bylaws because the Bylaws themselves make that clear. The word “independent” in section 3 merely refers to the fact that it is a review conducted by an entity separate from (*i.e.*, “independent” of) ICANN itself. The text eliminates any imaginable ambiguity on this point because the very sentence that introduces the term “independent” makes clear that it refers to the “third-party” nature of the entity, not to standards governing deference.<sup>197</sup> To carry out that independence, the Bylaws provide that a non-ICANN entity will operate the review process and appoint members to each panel, and further provides that no panel member may hold an official position or office within ICANN.<sup>198</sup> In addition, the Bylaws distinguish the independent review process as “separate” from the reconsideration process, which is not independent because it is administered by the ICANN Board.<sup>199</sup> In short, section 3 make clear that the word

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<sup>195</sup> ICM Memorial ¶¶ 311-17.

<sup>196</sup> ICM Memorial ¶ 313.

<sup>197</sup> *See id.* (noting that “ICANN shall have in place a separate process for independent *third-party* review of Board actions alleged by an affected party to be inconsistent with the Articles of Incorporation or Bylaws” (emphasis added)).

Further reinforcing this conclusion is the language from the original Bylaws on the IRP, which called for “an independent review process by a neutral third party.” ICANN Bylaws, Article III, § 4 (November 6, 1998), available at <http://www.icann.org/en/general/archive-bylaws/bylaws-06nov98.htm> (last visited May 5, 2009), attached hereto as ICANN Exhibit W. Especially where no reference is made to standards of review, the natural reading is that the independence of the review process refers to, and was effectuated by, the “neutral third party.”

<sup>198</sup> ICANN Bylaws, *supra* note 2, Article IV, §§ 3.4, 3.7, 3.9.

<sup>199</sup> *Id.* at Article IV, § 3.1.

“independent” simply refers to the fact that the panel conducting the review in question is not part of ICANN itself.<sup>200</sup>

138. The structure of ICANN’s Bylaws further reinforces this plain language; section 3 follows the “separate” accountability mechanism set out in section 2 – *i.e.*, the neutral reconsideration process conducted by the ICANN Board itself. Thus, the reference to “independent” review in section 3 plainly establishes a contrast from the internal reconsideration procedures set out in the preceding section, and does not connote a standard of review, as ICM acontextually argues. Ms. Burr’s comments during the drafting of the IRP provisions confirm this reading. She contrasted the IRP process with the reconsideration process “run by a subcommittee of the ICANN Board rather than a neutral.”<sup>201</sup> In short, the word “independent” refers to the fact that the panel conducting the review in question is a “neutral” entity not part of ICANN itself.

139. ICM’s citation of a handful of judicial decisions using the word “independent” or cognates thereof in discussing a *de novo* standard of review merely reinforces the error in ICM’s argument.<sup>202</sup> None of these cases uses the phrase “independent review” as synonymous with *de novo* inquiry; rather, they merely use the word “independent” to refer to the fact that, under *de novo* review, the decision of an appellate tribunal is reached, in some sense, “independent” of the decision of a trial court. Here, the IRP provisions do *not* provide for *de novo* review but, as explained above, require substantial deference. Thus, cases that use the word “independent” in the context of *de novo* review are beside the point. ICM is trying to bootstrap its inapposite

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<sup>200</sup> In addition, in comments issued by the advisory committee that was tasked with establishing principles for an earlier version of the IRP, the committee explained that “independent review should be conducted by a body that is independent of the ICANN Board of Directors, both in its appointment and in its proceedings.” Draft Principles for Independent Review: Interim Report of the Advisory Committee on Independent Review With Addendum, available at <http://cyber.law.harvard.edu/icann/berlin/archive/IRdraft.html> (last visited May 5, 2009), attached hereto as ICANN Exhibit Y. Here again, “independent” plainly refers to the independence of the reviewing body from ICANN, not to any standards of review.

<sup>201</sup> Becky Burr, Recommendations Regarding Accountability at II (August 23, 2002), available at <http://www.icann.org/en/committees/evol-reform/afap-report-23aug02.htm> (last visited May 5, 2009), attached hereto as ICANN Exhibit V.

<sup>202</sup> ICM Memorial ¶¶ 311-17.

interpretation of “independent” in the present context with cases using an inapposite interpretation of that word; ICM’s argument is easily rejected.

140. Moreover, case law on any standard of review (whether *de novo* or otherwise) can have no possible application here, even under ICM’s own incorrect theory that this proceeding is a form of arbitration. Because the issue in those cases involved the standards governing review of the decision of a lower tribunal, they have no application to the present context. Here, the Panel is not reviewing the intermediate decision of a lower tribunal that reviewed the Board’s actions. Instead, the issue is deference to the ICANN Board. The fact that the word “independent” can occasionally occur in discussions of appellate review standards cannot possibly bear on the meaning of the term in the context of section 3 of ICANN’s Bylaws.

### **3. ICM’s Cited Principles Of International Law Do Not Apply To The Circumstances At Issue In This Proceeding.**

141. ICM claims that the Panel should declare whether ICANN acted in conformity with certain “principles of international law” in considering and rejecting ICM’s .XXX application. Specifically, ICM refers to general commercial principles of good faith, estoppel, legitimate expectations, and abuse of rights. ICM’s invocation of international law depends on a two-step argument: first, ICM interprets Article 4 of the Articles of Incorporation (which provides that ICANN will operate for the benefit of the Internet community “in conformity with relevant principles of international law”) as a “choice-of-law provision” requiring ICANN to conform to an unlimited set of principles of international law; second, ICM infers that any violation of any principles of international law constitutes a violation of Article 4 (thus allegedly falling within the Panel’s jurisdiction to evaluate ICANN’s consistency with its Articles and Bylaws). Thus, ICM’s reading obliterates the express and straightforward limitation of the IRP Bylaws to ensure simple consistency with the Bylaws and Articles.

142. ICM’s interpretation of Article 4 contravenes the plain language of the governing provisions as well as their drafting history. Article 4 does not operate as a “choice-of-law provision” importing international law into the IRP without limitation. Instead, the substantive provisions of the Bylaws and Articles, as construed in light of the law of California (where ICANN is incorporated), govern the claims before the Panel. In any event, even if Article 4 did

operate as ICM contends, the particular principles of international law that ICM invokes are not relevant to the circumstances at issue in this proceeding.

**a. Article 4 Is Not A “Choice-Of-Law Provision.”**

143. ICM argues that Article 4 operates as a “choice-of-law provision” permitting ICM to shoehorn into the IRP process any claim that ICANN acted in a manner inconsistent with any and all general principles of international law.<sup>203</sup> This is wrong.

144. To determine the meaning of Article 4, California law (where ICANN is incorporated) applies the common rules of statutory interpretation.<sup>204</sup> The use of California law to interpret Article 4 is not controversial. Not only does California law follow generally accepted rules for interpreting articles of incorporation, but ICM agrees that California law governs this issue.<sup>205</sup> Under the rules of interpretation, the plain language of the article controls, supplemented by canons of interpretation and the article’s drafting history.<sup>206</sup>

145. The plain language shows that Article 4 is not a “choice-of-law provision.”<sup>207</sup> Article 4 provides in full:

The Corporation shall operate for the benefit of the Internet community as a whole, carrying out its activities in conformity with relevant principles of international law and applicable international conventions and local law and, to the extent appropriate and consistent with these Articles and its Bylaws, through open and transparent processes that enable competition and open entry in Internet-related markets. To this effect, the Corporation shall cooperate as appropriate with relevant international organizations.

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<sup>203</sup> See, e.g., Goldsmith Report ¶ 24 (claiming that Article 4 committed ICANN to follow “international law in all its forms”).

<sup>204</sup> See, e.g., *Sanchez v. Grain Growers Ass’n*, 126 Cal. App. 3d 665, 672 (1981); see also Caron Opinion ¶ 27 (“California law would be applicable particularly to the question of interpretation of the Articles of Incorporation and the Bylaws,” and California law uses “the common rules of statutory interpretation” to interpret articles of incorporation.).

<sup>205</sup> See ICM Memorial ¶ 336 (stating that California law applies to the interpretation of ICANN’s Articles and Bylaws and, in any event, interpretation “would almost certainly be the same in any jurisdiction”); Goldsmith Report ¶¶ 20-21.

<sup>206</sup> See *Sanchez*, 126 Cal. App. 3d at 672.

<sup>207</sup> See also Caron Opinion ¶ 22 (observing that “Article 4 is not by its language a choice of law clause”).



146. The article thus begins by reiterating ICANN’s mission and purpose to “operate for the benefit of the Internet community as a whole.”<sup>208</sup> The same sentence states that ICANN will, in so operating, “carry[] out its activities in conformity with relevant principles of international law and applicable international conventions and local law” and, as appropriate and consistent with ICANN’s two governing documents, “through open and transparent processes that enable competition and open entry in Internet-related markets.”<sup>209</sup> The second sentence adds that, to meet the objective of the first sentence, ICANN “shall cooperate as appropriate with relevant international organizations.”<sup>210</sup> ICM does not allege that ICANN acted in a manner inconsistent with this latter sentence, so it is not at issue here.

147. The specific “activities” that ICANN must “carry[] out in conformity with relevant principles of international law and applicable international conventions and local law” are, in turn, set out in the preceding Article 3.<sup>211</sup> As the list of activities in Article 3 makes clear, the activities in question are those relating to ICANN’s mission and purpose of operating for the benefit of the Internet community as a whole, which Article 3 describes in more detail as ICANN’s “charitable and public purposes of lessening the burdens of government and promoting the global public interest in the operational stability of the Internet.”<sup>212</sup>

148. Article 3 refers to ICANN’s activities in the following areas, which relate to the global nature of the Internet:

- (i) coordinating the assignment of Internet technical parameters as needed to maintain universal connectivity on the Internet;

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<sup>208</sup> Articles of Incorporation, Article 4, Cl. Ex. 4.

<sup>209</sup> *Id.*

<sup>210</sup> *Id.*

<sup>211</sup> *See also* Caron Opinion ¶ 38.

<sup>212</sup> Articles of Incorporation, Article 3, Cl. Ex. 4; *accord* ICANN Bylaws, *supra* note 2, Article I, § 1 (stating that ICANN’s overall mission “is to coordinate, at the overall level, the global Internet’s systems of unique identifiers, and in particular to ensure the stable and secure operation of the Internets unique identifier systems”).

- (ii) performing and overseeing functions related to the coordination of the Internet Protocol (“IP”) address space;
- (iii) performing and overseeing functions related to the coordination of the Internet domain name system (“DNS”), including the development of policies for determining the circumstances under which new top-level domains are added to the DNS root system;
- (iv) overseeing operation of the authoritative Internet DNS root server system; and
- (v) engaging in any other related lawful activity in furtherance of items (i) through (iv).<sup>213</sup>

149. Taking these two provisions together, the word “relevant” in Article 4 means only that principles of international law that are relevant *to the activities specifically referred to in the same sentence* and addressed with greater specificity in the adjoining Article 3, namely, principles concerned with ICANN’s substantive Internet activities are included.<sup>214</sup> Because the word “relevant” is a relational concept, which requires that the modified phrase be relevant to something else, the first clause of the same sentence, discussing ICANN’s mission, sets out what the referenced international law principles must be relevant to.<sup>215</sup> Therefore, only principles of international law that are specially relevant or related to ICANN’s Internet-related activities, and not merely principles of general applicability that apply to the Internet only in the same way that they apply to other kinds of conduct, are included as “relevant” principles in Article 4. This limitation of the referenced principles of international law in Article 4 to those specially relevant to the Internet makes perfect sense. ICANN did not adopt principles of international law indiscriminately, but rather to ensure consistency between its policies developed for the world-wide Internet community and well-established substantive international law on matters relevant

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<sup>213</sup> *Id.*

<sup>214</sup> See Articles of Incorporation, Articles 3 & 4, Cl. Ex. 4.

<sup>215</sup> See Caron Opinion ¶ 24 (chart) (explaining that, in Article 4, “ICANN has offered an IRP process to decide whether an act of the Board was inconsistent with it operating for the benefit of the Internet community as a whole, carrying out its activities in conformity with relevant principles of international law”); *id.* ¶ 56 (“[I]n my opinion the word ‘relevant’ implies those principles of international law that are . . . addressed to the subject matter of the first sentence of Article 4, that is, relevant to the ‘activities’ which are carried out so as to ‘operate for the benefit of the Internet community as a whole’ as contemplated by Article 3.”).

to various stakeholders in the global Internet community, such as general principles on trademark law and freedom of expression relevant to intellectual property constituencies and governments.<sup>216</sup>

150. For instance, a concern leading to the adoption of this language was that in its absence, ICANN might exclusively apply “U.S. trademark law as the law of the Internet.”<sup>217</sup> In other words, the provision was directed to ICANN’s special operation of the Internet, and incorporates only those international law principles specially “relevant” to those activities. Even ICM’s expert has acknowledged (in a separate publication not written for this proceeding) that the substantive issues specific to the operation of the Internet – “a revolutionary medium of communication” – include “a debate about speech governance.”<sup>218</sup> The principles of international law relied upon by ICM in this proceeding – the requirement of “good faith” and related doctrines – are principles of general applicability, and are not specially directed to concerns relating to the Internet, such as freedom of expression or trademark law. Therefore, those principles are not among the class of “relevant” principles directed to ICANN’s particular function and activities.

151. This conclusion is reinforced by the circumstances surrounding ICANN’s formation, and ICANN’s commitment to consider and act in conformity with certain law from sources beyond the United States. When authority for the DNS was being transferred from the U.S. Department of Commerce to ICANN, some members of the Internet community, particularly those outside the United States, expressed concern that a U.S. corporation deriving its authority from the U.S. government would lead the corporation to institute Internet policies closely patterned solely on United States law, thereby diminishing the Internet’s promise as a

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<sup>216</sup> The parties agree that Article 4’s reference to “international law” means public international law. See Caron Opinion ¶ 47; ICM Memorial ¶ 345. For that reason, the principle of *lex mercatoria* (the law of merchants) does not come into play here, because it is not a part of public international law. See *id.* ¶ 51. Thus, the international sports cases cited by ICM (although not by its expert), which refer to a sports-based body of law akin to *lex mercatoria*, are off point. See ICM Memorial ¶¶ 381-84.

<sup>217</sup> See United States Department of Commerce, Statement of Policy, Cl. Ex. 31.

<sup>218</sup> Jack Goldsmith & Tim Wu, *Who Controls the Internet?* 150 (2008) (emphasis omitted).

truly global resource.<sup>219</sup> For instance, when the Department of Commerce solicited comments for its general policy statement that the DNS should be managed by a private corporation headquartered in the United States, some commentators were concerned “that the proposal to headquarter the new corporation in the United States represented an inappropriate attempt to impose U.S. law on the Internet as a whole” and that requiring domain name registrants to agree to the jurisdiction of U.S. courts in the event of a domain-name trademark dispute would be “an inappropriate attempt to establish U.S. trademark law as the law of the Internet.”<sup>220</sup> In its responses, the Department of Commerce focused on the new corporation’s mission of serving “the Internet community as a whole” – the same beneficiary identified in Article 4.<sup>221</sup>

152. In light of such concerns about the historic role of the U.S. government in overseeing the global resource of the Internet, and recognizing ICANN’s important responsibility for serving the global Internet community, ICANN (the new corporation headquartered in the United States) made clear in Article 4 that it will act in conformity with sources of law beyond U.S. law with respect to policies developed for the world-wide Internet community (*i.e.*, the “Internet community as a whole”). In other words, Article 4’s reference to “international law” ensures that ICANN policy governing the Internet is suitably international to promote the Internet as a broadly accessible, truly global resource.<sup>222</sup>

153. ICM interprets the reference to “relevant principles of international law” in Article 4 far too broadly and entirely out of context. Article 4 does not operate as a choice-of-law provision requiring ICANN to adapt its conduct to any and all principles of international law, such as the general principles relating to commercial contracting that ICM invokes in this

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<sup>219</sup> *Accord* ICM Memorial ¶¶ 45-49, 326-28. As noted above, ICANN has authority over the naming and numbering system pursuant to a series of agreements with the U.S. Department of Commerce.

<sup>220</sup> *See* United States Department of Commerce, Statement of Policy, Cl. Ex. 31.

<sup>221</sup> *Id.*; *see also id.* (reiterating that “[t]he new corporation should operate as a private entity for the benefit of the Internet community as a whole”).

<sup>222</sup> *See* Draft Articles of Incorporation, Fifth Iteration, Cl. Ex. 209 (noting that the Articles of Incorporation included a reference to international law “in response to various suggestions to recognize the special nature of this organization and the general principles under which it will operate”).

proceeding.<sup>223</sup> ICM’s misreading stems from a myopic focus on the excerpted phrase “conformity with relevant principles of international law.” Article 4 requires more specifically that ICANN “*operate for the benefit of the Internet community as a whole, carrying out its activities in conformity with relevant principles of international law...*” When read in context, Article 4 does not operate as a choice-of-law provision for IRP proceedings, nor is it concerned with commercial principles of international law of the sort that ICM invokes as “a prism through which” the Articles and Bylaws must be read or, even more drastically, as freestanding claims that take the IRP process well beyond that envisioned in the Bylaws.<sup>224</sup> Instead, Article 4 and its “relevant principles of international law” are intended to promote achievement of “the benefit of the Internet community as a whole” (the clause that the international-law phrase modifies), and are therefore concerned with ensuring that ICANN does not establish policies for coordination of the Internet that are contrary to international legal principles relevant to the global community’s use of the Internet.<sup>225</sup>

154. Thus, as Professor Caron explains, ICM’s arguments are contrary to the plain language of Article 4. “Article 4 is not by its language a choice of law clause,” so any conclusion that it is a choice-of-law provision “must be implied.”<sup>226</sup> And any such implication would be unwarranted. While there is no dispute as to the theoretical possibility of a choice-of-law provision in a corporate charter, such a theoretical possibility does not establish that the possibility is actuality here.<sup>227</sup> ICM and its expert simply “jump” from the theoretical possibility of having such a provision to their conclusion that Article 4 is such a provision, without offering “an analysis of *why* Article 4 in particular is such a choice of law clause.”<sup>228</sup> Especially where

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<sup>223</sup> See Caron Opinion ¶ 54 (noting that international law “is not by its own terms applicable to the manner in which a California non-profit corporation is ‘carrying out its activities’”).

<sup>224</sup> ICM Memorial ¶ 344.

<sup>225</sup> In light of the foregoing discussion, which makes clear ICANN’s position that Article 4 incorporates international legal principles (but not those relied upon by ICM), ICM’s claim that ICANN reads Article 4 to “create[] no obligations or responsibilities” under international law is entirely wrong. ICM Memorial ¶ 329.

<sup>226</sup> Caron Opinion ¶ 22.

<sup>227</sup> See *id.* ¶ 21.

<sup>228</sup> *Id.* (emphasis in original).

the plain language points in the opposite direction, ICM’s lack of analysis is remarkable. For instance, as Professor Caron notes, “it is unlikely, and at a minimum unusual, that a choice of law clause would designate three sources of law joined by the conjunction ‘and,’ that is, three laws at the same level of hierarchy,” without further choosing among those three.<sup>229</sup>

155. As to how ICANN runs its business and interacts in a commercial manner with another entity, California law governs those matters, just like the law of the state of incorporation governs the operational matters of any other corporation.<sup>230</sup> Moreover, this application of California law arises out of ICANN’s incorporation – not Article 4’s reference to “local law.”<sup>231</sup> Article 4’s reference to “local law,” like its reference to international law, has a scope directed at the nature of ICANN’s global-coordination policies that do not reach ICM’s dispute here. As Professor Caron observes, there is no “doubt that California courts and the California Attorney General would apply the law of the State of California” to questions concerning ICANN’s Articles of Incorporation and Bylaws.<sup>232</sup> He thus concludes that, without a choice-of-law provision governing this dispute, the Panel “should ascertain the meaning of the various articles of the Bylaws and Articles in accordance with the law of the State of California.”<sup>233</sup>

156. The extensive drafting history of the IRP provisions similarly confirms that Article 4 is not a “choice-of-law provision” for IRP proceedings. As noted above, the IRP Bylaws were drafted with an eye to improving ICANN’s accountability and transparency. Nowhere in this drafting history did ICANN associate the IRP with Article 4 to treat the latter provision as a choice-of-law clause governing the IRP. Indeed, nowhere in this extensive drafting history did ICANN even *mention* Article 4, which was written years before the current IRP provisions were added to the Bylaws, as discussed below. ICANN implemented

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<sup>229</sup> *Id.* ¶ 22.

<sup>230</sup> ICM concedes that California law governs ICANN’s affairs. *See, e.g.*, ICM Memorial ¶ 336 & n.680.

<sup>231</sup> *See* Draft Articles of Incorporation, Fifth Iteration, Cl. Ex. 209 (noting that ICANN’s incorporation under California law means that California’s “reasonably well-defined nonprofit corporation jurisprudence” governs ICANN).

<sup>232</sup> Caron Opinion ¶ 26; *see also* ICDR Rules, *supra* note 150, Article 28 (directing the panel to apply the law it determines to be “appropriate” if the parties have not designated the applicable law).

<sup>233</sup> Caron Opinion ¶ 28.

transparency and accountability in other, explicit ways, such as establishing the IRP itself and providing that IRP declarations be made public. Further, the language governing the scope of IRP proceedings, which confines the issues before the Panel to the narrow question of whether ICANN violated the specific provisions of the Bylaws or Articles, was crafted precisely to constrain the analysis and to foreclose the consideration of vague and open-ended standards drawn from sources external to those documents of exactly the sort ICM relies upon here.

157. The fact that Article 4 and the IRP provisions were enacted at different times – indeed, four years apart – and in different documents reinforces the conclusion that Article 4 does not operate as a choice-of-law provision for an IRP. Article 4, along with all of ICANN’s Articles of Incorporation, was adopted in 1998 when ICANN first incorporated. The point of that document was to incorporate ICANN under California law, not to establish rules governing dispute resolution (and certainly not a dispute resolution process that had not yet been created). During its formation, ICANN never alluded to any expectation that in its Articles it would incorporate by reference all international law principles without any limitation.

158. The IRP provisions, by contrast, are found in ICANN’s Bylaws. When ICANN incorporated and adopted Article 4 in 1998, there was no IRP provision, only a direction to consider adopting one.<sup>234</sup> No particulars about the process itself were provided, and certainly no indication that ICANN intended Article 4 of the Articles of Incorporation to act as an “implicitly and retroactively incorporated” choice-of-law provision governing the type and scope of claims that could be raised in an IRP. Thus, when the current IRP provisions were drafted and adopted in 2002, neither Article 4 nor the idea of applying international law in IRP proceedings was mentioned. Given ICANN’s silence on Article 4 when later enacting the IRP provisions, it

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<sup>234</sup> See ICANN Bylaws, Article III, § 4(b) (November 21, 1998), *available at* <http://www.icann.org/en/general/archive-bylaws/bylaws-23nov98.htm> (last visited May 5, 2009), attached hereto as ICANN Exhibit X.

After an initial provision merely permitting ICANN to establish an IRP, the Articles were amended directing the Board, “following solicitation of input from the Advisory Committee on Independent Review and other interested parties and consideration of all such suggestions, [to] adopt policies and procedures for independent third-party review of Board actions alleged by an affected party to have violated the Corporation’s articles of incorporation or bylaws.” *Id.*



would require a tortured reading of Article 4 to find an intent to adopt “principles of international law” retrospectively as governing a review process created four years later.<sup>235</sup>

159. Professor Caron makes the same observation about the different enactment dates of Article 4 and the IRP Bylaws. As he notes, “Article 4 was adopted at an earlier point in time [than the IRP provisions], yet it is not referenced in the Bylaws.”<sup>236</sup> He succinctly points out that the IRP provisions “could have made an explicit choice of the law for the IRP, but did not.”<sup>237</sup>

160. For all of these reasons, the general commercial principles of international law on which ICM relies – good faith, estoppel, legitimate expectations, and abuse of rights – do not fall within the scope of Article 4. Thus, in its review of ICANN’s consideration and rejection of ICM’s .XXX sTLD application, the Panel has no basis for considering whether, pursuant to Article 4, ICANN acted in conformity with those principles of international law. As a precaution, ICANN addresses these factual issues below, but if the Panel agrees with ICANN’s view of the applicable law, this portion of ICM’s “claims” should be disregarded.

161. ICM’s other arguments for importing any and all international law into this proceeding are equally without merit. The fact that the issuance of a particular TLD would have international effects does not make general commercial principles of international law “relevant” pursuant to Article 4.<sup>238</sup> As made clear by the context and language of Article 4, the principles that are relevant under Article 4 concern ICANN’s obligation to operate for the benefit of the Internet community as a whole, not ICANN’s commercial activities with respect to a particular TLD applicant. ICANN’s governing corporate law – California law – fills that latter role.

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<sup>235</sup> Also undercutting ICM’s reading of Article 4 is the later establishment of the procedures and criteria for the sTLD application process that ICM has put at issue here. ICANN did not post the criteria for the sTLD applications until December 2003; in those, ICANN never mentioned principles of international law governing ICANN’s (or any other party’s) negotiating conduct. In light of this omission, and especially given that international legal principles are general and evolving, it would be remarkable to interpret Article 4 as an “implicitly and retroactively incorporated” choice-of-law provision applying general principles of international law to the application process.

<sup>236</sup> Caron Opinion ¶ 22.

<sup>237</sup> *Id.*

<sup>238</sup> See ICM Memorial ¶ 339; see also Goldsmith Report ¶ 26.

162. Likewise, the Bylaws' direction that the IRP shall be conducted by an "international arbitration provider" does not provide support for ICM's position that any and all international law applies here.<sup>239</sup> Arbitration or other adjudication described as "international" recognizes that the parties likely come from different nation-states, and that principles of international law that are "relevant" in the sense contemplated by Article 4 (unlike those relied upon by ICM here) may be raised in the proceedings; the description does not import international law into the proceeding indiscriminately.

163. As a final matter, ICANN notes that, by their terms, the IRP provisions are limited to determining whether the Board acted in a manner that is *inconsistent* with the Bylaws or Articles. As the above discussion on deference noted, the IRP is not to be used to upset arguable or reasonable actions of the Board; this includes the Board's reasonable interpretations of what the Bylaws and Articles mean. Thus, to the extent there is any ambiguity (and there is none) about the scope and meaning of Article 4, the Panel should defer to ICANN's understanding – *i.e.*, that Article 4's reference to relevant principles of international law means well-established substantive principles tailored to ICANN's Internet-based purpose and mission – so that ICM's cited principles do not apply here.

**b. Even If Article 4 Were Read As Broadly As ICM Urges, ICM's Cited Principles Of International Law Still Would Not Apply To This Dispute Between Two Private Entities From The Same Nation.**

164. Even if Article 4 were interpreted as a choice-of-law provision requiring ICANN to comply with principles of international law even if unrelated to ICANN's Internet-based activities (and thus unmoored to the limiting first clause in Article 4), the particular principles that ICM cites, including the underlying authorities, still would not apply because they are not "relevant." If the term "relevant" in Article 4 means anything, it must mean principles of international law that apply to a private entity such as ICANN. As Professor Caron explains, in this sense of the word "relevant," "the 'principles of international law' to be considered [] are not those principles applicable to States, but rather those rare principles of international law intended

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<sup>239</sup> See ICM Memorial ¶¶ 7, 340 (quoting Goldsmith Report ¶ 26 that "ICANN itself chose an international arbitral institution for this Independent Review").

to be applicable to private entities such as ICANN.”<sup>240</sup> ICM’s principles and cited authorities are not of that rare sort, and, to the extent they are, they are merely duplicative of California law.<sup>241</sup>

165. In urging the application of its cited principles, ICM and its expert repeatedly cite international law governing sovereigns.<sup>242</sup> For instance, ICM relies on *Rights of Nationals of the United States of America in Morocco (France v. United States of America)*, 1952 I.C.J. 176 (August 27, 1952).<sup>243</sup> Yet, that case involved Morocco’s and the United States’ competing claims, as sovereigns, to establish the import value for the purpose of assessing customs to United States imports into Morocco.<sup>244</sup> By its terms, the decision has no application to a dispute between ICM and ICANN, two private entities.

166. In relying on these cases involving sovereigns, ICM and its expert claim that they can treat ICANN as if it were a sovereign for purposes of ICM’s international law claims because, they assert, ICANN agreed to be treated as such in Article 4.<sup>245</sup> But Article 4 says nothing of the kind, and neither ICM nor its expert offers any textual exegesis to support this bare assertion. Even if Article 4 incorporated international law as some sort of “choice-of-law” provision, at most it would incorporate “relevant” international law. Here, “relevant” law could only mean law governing private actors because ICANN is a private entity. ICM does not dispute ICANN’s private-party status,<sup>246</sup> and ICANN’s governing documents confirm that ICANN is not a sovereign – to the contrary, ICANN’s Articles of Incorporation note that ICANN is designed to “lessen[] the burdens of government.”<sup>247</sup>

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<sup>240</sup> Caron Opinion ¶ 58.

<sup>241</sup> See Section III.C.5, *infra* (addressing duplicative international law analysis).

<sup>242</sup> See ICM Memorial ¶¶ 418, 428-31, 434-38, 441-43; see also Goldsmith Report at 14-15, 17-18, 20-21.

<sup>243</sup> See ICM Memorial ¶ 428.

<sup>244</sup> See *Rights of Nationals of the United States of America in Morocco (France v. United States of America)*, 1952 I.C.J. 176 at 181, 212 (August 27, 1952).

<sup>245</sup> See ICM Memorial ¶ 351.

<sup>246</sup> See ICM Memorial ¶ 350; see also Goldsmith Report ¶ 26. Although ICM and its expert claim that ICANN “voluntarily subjected itself to” international law governing sovereigns (Goldsmith Report ¶ 26; accord ICM Memorial ¶ 350), that “is a very substantial assumption” (Caron Opinion ¶ 59), and, as addressed above, one for which ICM and its expert provide no support.

<sup>247</sup> Articles of Incorporation, Article 3, Cl. Ex. 4.

167. As a private party, ICANN is not subject to law governing sovereigns. International law governing sovereigns generally does not carry over automatically to private entities, and ICM provides no reason for proceeding otherwise here, other than its wholly baseless assertion that ICANN volunteered to be treated as such. ICM's expert has acknowledged (outside of the context of this proceeding) that "international law addresses itself to states"; "for the most part," it does not address itself "to individuals."<sup>248</sup> Accordingly, whether read as a "choice-of-law provision" or in any other broad manner, Article 4's reference to "relevant principles of international law" does not incorporate international law governing the conduct of nations. To put it another way, a private party's choice-of-law clause incorporating "French law" would not, of course, be interpreted as assuming the obligations of the French sovereign.<sup>249</sup> Similarly, any incorporation by Article 4 of "international law" cannot properly be interpreted as assuming the obligations governing nations, because ICM has chosen not to dispute (nor could it reasonably dispute) that ICANN is a wholly private actor. Accordingly, ICM cannot support its claims with inapposite international legal principles and authorities directed to states instead of private entities. At most, ICANN would be governed by "those admittedly rare principles of international law intended to be applicable to private entities such as ICANN."<sup>250</sup>

168. Nor is ICANN an international organization<sup>251</sup>; indeed, ICM ignores this intermediate category between sovereigns and private entities.<sup>252</sup> But even assuming *arguendo* that ICANN were an international organization, it would not be bound by the same law applicable to states. International organizations that govern themselves according to international law are subject to different rules and principles than states. The distinction between

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<sup>248</sup> Jack L. Goldsmith & Eric A. Posner, *The Limits of International Law* 5 (2005).

<sup>249</sup> See Caron Opinion ¶ 59.

<sup>250</sup> Caron Opinion ¶¶ 56, 66 (stating that "relevant" means at least "applicable to the actions of a private non-profit corporation").

<sup>251</sup> See Caron Opinion ¶ 61 n.44 (noting that "it is clear" that ICANN "is not an international organization, such as the World Bank or the United Nations" because, among other things, ICANN was not established pursuant to a treaty or other instrument of international law and its membership is not primarily or exclusively states).

<sup>252</sup> See ICM Memorial ¶ 350 (distinguishing between state actors and private corporations, and failing to mention international organizations).

states and international organizations – of which ICANN is neither – reinforces the meaningfully different status that ICANN has as a private entity, the least among the three to be subject to international law.<sup>253</sup>

169. Moreover, status as an “international” organization does not automatically make any and all international law “relevant” to that organization. An international organization may choose to be governed by the national law of one or more nation-states, and to the extent international law does apply, it is limited to certain categories of law, such as “international administrative law” and law governing “the interpretation” and “responsibility” of the organization.<sup>254</sup>

170. Again assuming, *arguendo*, that ICANN were treated as an international organization, the law that would be “of particular relevance” would be the principle “that international tribunals in reviewing discretionary acts of international organizations (or national agencies) do not substitute their own judgment for that of the agency under review but rather look for ‘an egregious error that calls into question the good faith’ of the body reviewed.”<sup>255</sup> As Professor Caron explains, this principle is “an analog to the business judgment rule” in California law that ICM seeks to avoid.<sup>256</sup> Under this principle, tribunals “afford[] a degree of deference when reviewing a decision made under the discretionary authority of an international organization.”<sup>257</sup> Thus, if ICM’s cited principles were “relevant,” this deferential-review principle would be “relevant” as well, and “the demands” of ICM’s cited principles would “require accommodation with” this principle.<sup>258</sup> ICM overlooks that its cited principles would

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<sup>253</sup> See Caron Opinion ¶¶ 62-65. As Professor Caron observes, “it must be emphasized it is difficult to transform the law of international organizations and distill principles applicable to a private non-profit corporation.” *Id.* ¶ 62.

<sup>254</sup> See Caron Opinion ¶ 65.

<sup>255</sup> *Id.* ¶ 99; see also *id.* ¶¶ 99-104.

<sup>256</sup> *Id.* ¶¶ 99-100.

<sup>257</sup> *Id.* ¶ 104.

<sup>258</sup> *Id.*

“not exist in a vacuum”<sup>259</sup> in which ICM could pick and choose only those principles that allegedly favor it.

171. Because ICANN is not a state nor an international organization, ICM errs in invoking the doctrine of non-abuse of rights. Because that doctrine applies to states, it does not apply in this proceeding.<sup>260</sup>

172. ICM similarly errs in relying on state-investor cases and government-procurement treaties.<sup>261</sup> For instance, ICM relies heavily on *Lauder v. The Czech Republic*, Final Award dated September 3, 2001 (UNCITRAL).<sup>262</sup> Yet, the dispute in that case was governed by the terms of a bilateral investment treaty; the tribunal expressly rejected the claimant’s attempt to rely on “general principles of international law” exclusive of express obligations under the treaty.<sup>263</sup> By its terms, therefore, *Lauder* has no application to a dispute between ICM and ICANN, two private entities.

173. Moreover, these cases depend upon the existence of a relevant treaty conferring the rights in question. They do not provide international legal principles relevant in the absence of such treaties. Of course, neither ICANN nor ICM is a party to any treaty conferring rights on the other, and ICM does not make any contrary contention.<sup>264</sup>

174. To the extent any of ICM’s cited principles have some application to private parties beyond treaties, the principles still are not relevant here because of the domestic nature of the dispute.<sup>265</sup> International legal principles of the sort cited by ICM do not govern commercial

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<sup>259</sup> *Id.* ¶ 99.

<sup>260</sup> See Caron Opinion ¶ 81 (stating, with respect to non-abuse of rights, that he “fail[s] to readily see the application in these proceedings of a doctrine applied to States”).

<sup>261</sup> See ICM Memorial ¶¶ 359-67, 384-85, 397, 446-53; see also Goldsmith Report ¶ 30.

<sup>262</sup> See ICM Memorial ¶¶ 384-85.

<sup>263</sup> *Lauder* at ¶ 209.

<sup>264</sup> See also Caron Opinion ¶¶ 78, 90-92 (explaining that ICM “inappropriately relies” on cases in which obligations of good faith, legitimate expectations, and transparency arise from treaties).

<sup>265</sup> See Caron Opinion ¶ 57 (stating that “relevant” “bear[s] on the particular subject matter addressed or implicated in the action of the Board”).

disputes between two private U.S. corporations regarding a contract to be performed by one of those U.S. parties within the United States.<sup>266</sup>

175. Indeed, ICM recognizes that only one country is involved by conceding<sup>267</sup> that California law is the only applicable local law; ICM nowhere identifies the law of any other country that could conceivably be relevant. With only one country involved, international legal principles are not needed to avoid favoritism, to provide an “even playing field,” or to protect another sovereign – the typical purposes of applying international legal principles to a dispute that contains an international element.<sup>268</sup> Accordingly, the cases that ICM (although not its expert) cites, in which the conduct of certain private parties (international sports federations) were subject to principles of international law, are irrelevant; in each of those cases, the disputing parties were from different countries.<sup>269</sup> Moreover, the principles applied in those international sports cases had “developed and consolidated along the years” to address the specific conduct of international sports leagues.<sup>270</sup> ICM does not contend that any such body of law has developed and consolidated with respect to the consideration of TLD name applications.

176. ICM suggests that, even for this transaction involving two U.S. corporations, international law is “relevant” because awarding a TLD can have global effects.<sup>271</sup> But international legal principles do not apply to a dispute between private entities located in the

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<sup>266</sup> See, e.g., *de Sanchez v. Banco Central De Nicaragua*, 770 F.2d 1385, 1395 (5th Cir. 1985) (“With a few exceptions [not applicable here], international law delineates minimum standards for the protection only of aliens; it does not purport to interfere with the relations between a nation and its own citizens.”); *id.* at 1396 (recognizing that “an injury by a state to its own nationals might implicate international law if the injury occurred within another state’s territory” but the injury must be “of such a nature as to” have a transnational element).

<sup>267</sup> See ICM Memorial ¶¶ 246-65; see also Goldsmith Report ¶ 22.

<sup>268</sup> See *Skiriotes v. Florida*, 313 U.S. 69, 73 (1941) (explaining that international law is not concerned with domestic rights and duties); CHESHIRE & NORTH’S PRIVATE INTERNATIONAL LAW 3 (11th ed. 1987) (noting that international law “functions only when” a “foreign element” is present in the dispute).

<sup>269</sup> See ICM Memorial ¶¶ 381-84 (citing cases involving disputes between parties from: the United Kingdom on the one side and Switzerland on the other; the United States on the one side and Monaco on the other; Greece and the Czech Republic on the one side and Switzerland on the other; and Switzerland on the one side and Spain on the other).

<sup>270</sup> *AEK Athens and SK Slavia Prague v. Union of European Football Associations (UEFA)*, Arbitration CAS 98/200, award of 20 August 1999, at ¶ 156.

<sup>271</sup> See ICM Memorial ¶ 349.



same nation simply because the dispute may have global effects. Such a rule, apart from being unprecedented, would have the absurd effect of transforming all large disputes (*e.g.*, disputes between two U.S. companies that both operate in more than a single country) into cases governed by international law. A stronger international connection, such as “affront[ing] the territorial sovereignty” of a nation<sup>272</sup> or involving an international transaction, must exist for principles of international law to apply to private parties. ICM itself appears to recognize that U.S., not international, law would govern any contract ultimately formed between ICM and ICANN for the .XXX name.<sup>273</sup> Under those circumstances, any international effects of a TLD are simply beside the point.

177. Finally, two of ICM’s cited principles (so-called “principles” of estoppel and legitimate expectations), and its reliance on a good-faith application of transparency, are not even well established, and thus would not apply in any event.<sup>274</sup> Therefore, ICM’s invocation of them in this proceeding is especially off point.

**c. ICM’s Cited Principles Are Ineffective Because California Law More Specifically Governs The Dispute.**

178. Even if ICM’s cited principles were “relevant,” they nonetheless would not govern the Panel’s review because other law (namely, the ICANN Bylaws and Articles, as well as California law) deals specifically with the circumstances of this dispute. This more specific law renders unnecessary any resort to ICM’s general principles of international law.

179. By its terms, Article 4 acknowledges that types of law other than “relevant principles of international law” may be at issue. Specifically, in addition to referring to such principles, Article 4 refers to “applicable international conventions and local law.”<sup>275</sup> Those types of law are more specific than “principles of international law” and, as a general matter, will provide sufficient guidance without resort to principles. As Professor Caron puts it, while “[i]t is theoretically possible that satisfaction of all of the rules of applicable ‘international conventions’

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<sup>272</sup> *de Sanchez*, 770 F.2d at 1396

<sup>273</sup> See ICM Memorial ¶ 254 (referring to U.S. law as governing a contract for the .XXX sTLD).

<sup>274</sup> See Caron Opinion ¶¶ 84, 86-98.

<sup>275</sup> Articles of Incorporation, Article 4, Cl. Ex. 4.

and ‘local law’ might not also satisfy all ‘relevant principles of international law,’” that “would be a rare case.”<sup>276</sup>

180. To elaborate, treaties and local law are generally rule-based, making them “inherently more specific than principles.”<sup>277</sup> By contrast, principles are, as their name suggests, more general; they are “abstract statements of legal truth” that are used “to fill in the interstices between rules.”<sup>278</sup> Where gaps do not exist, principles are not needed. Professor Caron emphasizes that “the distinction between principles and rules is of critical and fundamental importance to the interpretation and application of Article 4.”<sup>279</sup>

181. In light of the distinction between rules and principles, the phrase “principles of international law” in Article 4 has “a limited general effect compared to ‘applicable international conventions’ or ‘local law.’”<sup>280</sup> This effect of Article 4 – “that the more exacting requirements of Article 4 are provided by the specific rules present in applicable international conventions and local law rather than by principles of international law” – is “not at all surprising” to Professor Caron.<sup>281</sup>

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<sup>276</sup> Caron Opinion ¶ 74. ICM’s expert himself recognizes that there is only a limited exception to the sufficiency of local law when that law covers the dispute. *See* Goldsmith Report ¶ 27 (noting that “arbitrators sometimes conclude that international law, including general principles, should trump *when in conflict* with national law” (emphasis added)). ICM never alleges such a conflict here. Indeed, ICM urges that the result would be the same under California law and ICM’s cited principles of international law. *See* ICM Memorial ¶¶ 336, 341; *see also* Goldsmith Report ¶ 22, 27.

<sup>277</sup> Caron Opinion ¶ 74.

<sup>278</sup> Caron Opinion ¶¶ 12, 85; *see also id.* ¶¶ 39-40; Riccardo Monaco, *Sources of International Law*, in 7 ENCYCLOPEDIA OF PUBLIC INTERNATIONAL LAW 429 (1984) (“Max Planck”) (“[R]ecourse may be had to [general principles of international law] in order to fill certain gaps in general international law.”); *id.* at 429 (even stating that general principles of international law are “not part of the formal category of sources” of international law). ICM’s expert acknowledges the vagueness of principles of international law, admitting that they are “primarily abstractions from a mass of rules.” Goldsmith Report ¶ 29 (citation omitted).

<sup>279</sup> Caron Opinion ¶ 105.

<sup>280</sup> *Id.* ¶ 74. Even without Article 4, principles of international law would likely have a limited effect because, as explained in the text above, principles of international law are generally secondary to other law.

<sup>281</sup> *Id.* ¶ 105.

182. The relatively diminished efficacy of principles is reinforced by the place of principles of international law among other sources of international law.<sup>282</sup> A “hierarchy” of laws “establish[es] which source [of international law] should prevail over the others” when more than one source of international law is potentially applicable.<sup>283</sup> There are three major categories of sources of international law: (1) treaties, (2) custom, and (3) “general principles” (which include “the general principles of civilized nations,” the sort of principles on which ICM and its expert rely).<sup>284</sup> Under the hierarchy, the more specific sources (treaties and custom) have priority because they are generally rule-based and addressed to particular circumstances; they can confidently be applied to those circumstances (and not to others). Giving precedence to this more specific law promotes certainty and predictability. Principles, as noted, are general and thus have a “subsidiary status.”<sup>285</sup> Generally speaking, then, general principles of international law take second place to other types of international law where the latter govern the conduct in question.<sup>286</sup> For instance, “if there is a custom, then one looks to it and not to general principles generally held by civilized nations.”<sup>287</sup>

183. ICM acknowledges<sup>288</sup> that its cited principles are of the least forceful type of international law – general principles.<sup>289</sup> Yet ICM treats its cited principles “with the

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<sup>282</sup> As noted, the parties agree that “international law” in Article 4 means public international law. See Caron Opinion ¶ 47; ICM Memorial ¶ 345.

<sup>283</sup> MAX PLANCK, *supra*, at 432-33; see also Caron Opinion ¶¶ 40, 55-56 (discussing the hierarchy of law).

<sup>284</sup> See Caron Opinion ¶ 47; accord Goldsmith Report ¶ 23.

<sup>285</sup> Caron Opinion ¶¶ 12, 38-40, 50, 68-71; *id.* at ¶ 68 (describing principles as “abstract considerations that might be applied in the way that the common law would term equity, and that can serve as the abstract limits within which more specific rules are articulated”); see also MAX PLANCK, *supra*, at 429-30.

<sup>286</sup> See MAX PLANCK, *supra*, at 429, 432 (noting that general principles of international law follow “constitutional principles, custom and agreement” in terms of priority); *id.* at 433 (“[B]elow customary rules, come the general principles of international law.”); *id.* (stating that “rules laid down by agreement” prevail over customary rules, which prevail over general principles of international law); *id.* at 427 (custom “is a primary source of law since it is itself capable of giving force to the rules which result from it”); see also Caron Opinion ¶ 40.

<sup>287</sup> Caron Opinion ¶ 49.

<sup>288</sup> See, e.g., ICM Memorial ¶¶ 346-47.

<sup>289</sup> Caron Opinion ¶ 12.

definiteness of rules rather than the generality of principles.”<sup>290</sup> In this way, ICM “inappropriately characterize[s]” its principles as more specific and exacting than they are.<sup>291</sup> As a result, as Professor Caron observes, ICM renders its analysis “unnecessarily confusing.”<sup>292</sup>

184. The opinion of ICM’s expert similarly confuses the analysis by discussing principles of international law as “amplify[ing]” and “giv[ing] detail” to more specific rules.<sup>293</sup> That is exactly the opposite of the way the different laws interact. As Professor Caron explains, “‘principles by their nature do not ‘amplify and give detail’ to requirements.”<sup>294</sup> Instead, principles “provide the outer boundaries of a norm.”<sup>295</sup> Thus, ICM’s expert misses the point in opining that ICM’s cited principles of international law “complement, amplify, and give detail to the requirements of independence, transparency, and due process that ICANN has otherwise assumed in its Articles and Bylaws and under California law.”<sup>296</sup> There is no “supplementary role”<sup>297</sup> for international law to play when more specific local law already addresses the matter.

185. The proper analysis, then, is to consider whether ICM’s cited principles would perform any clarifying role in this proceeding. They do not. In the circumstances at issue in this proceeding, the generally limited effect of Article 4’s “principles of international law” and the applicable rules set forth in the ICANN Bylaws and Articles as well as California law render resort to ICM’s cited principles unnecessary. As noted, local law is a specific type of law, almost always composed of rules rather than principles. That is the case here, where the Bylaws

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<sup>290</sup> *Id.* ¶ 48.

<sup>291</sup> *Id.*

<sup>292</sup> *Id.* As Professor Caron explains, ICM’s expert appears to have misinterpreted a list carefully distinguishing among different meanings ascribed to “general principles of international law” as a list showing “that all of these various meanings have come together.” *Id.* ¶ 51. As a result, “ICM and its expert move too easily among possible sources of general principles and in seeking to articulate the contours of a particular principle of international law on occasion refer to sources that are not necessarily on point and thus must be approached with care.” *Id.*

<sup>293</sup> Goldsmith Report ¶ 27.

<sup>294</sup> Caron Opinion ¶¶ 72, 76.

<sup>295</sup> *Id.*

<sup>296</sup> Goldsmith Report ¶ 27.

<sup>297</sup> *Id.*

and Articles provide clear rules of decision, and where California law, in its many particulars, extensively addresses a non-profit corporation's conduct of its general business activities such as deciding whether to enter into contracts with other U.S. corporations and how contracts are formed and interpreted. For instance, with respect to the principle of good faith (the primary principle on which ICM relies), Professor Caron explains that, to the extent that the principle is found to apply in this proceeding, "its place as a practical matter comes *after* more specific rules and laws" addressing the same concerns motivating the good-faith principle.<sup>298</sup> He elaborates: "[T]he principle of good faith, perhaps the most broad and general of general principles of law, must indeed play second fiddle to those rules and obligations that specifically apply in this review."<sup>299</sup> And while status as "second fiddle" does not itself render the principle wholly ineffective, the principle's role in "the background" is relevant only "to the extent that the rules and laws applicable in this review do not completely provide the basis for this Panel's consideration."<sup>300</sup> ICM agrees that the "applicable local law" under Article 4 is California law and that California law reaches the same result as its cited principles.<sup>301</sup> Moreover, as explained in Parts III.B and III.C below, ICANN's conduct was consistent with ICANN's Bylaws and Articles in every respect, under any exacting requirements of ICANN's Articles and Bylaws interpreted under the particulars of California law. Thus, even if ICM's cited principles were "relevant principles of international law" within the meaning of Article 4, they still would not play a role in this proceeding because local law and the Bylaws and Articles themselves provide sufficient guidance for the Panel's analysis. With ICM's principles providing no clarifying role, they are essentially irrelevant.

186. ICM also confuses the analysis by interpreting "principles of international law" to mean only "general principles of law recognized by civilized nations" and omitting any attention

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<sup>298</sup> Caron Opinion ¶ 85 (emphasis added).

<sup>299</sup> *Id.*

<sup>300</sup> *Id.*; see also *id.* ¶ 77 ("Indeed, many of the cases in which the term 'good faith' appears do not involve a finding that a party did not act in good faith but rather is a term added seemingly as a reminder to the parties of the conduct required by the principle.").

<sup>301</sup> See ICM Memorial ¶¶ 336, 341; see also Goldsmith Report ¶¶ 22, 27 (stating that California law is the applicable local law and that here "there are no conflicts between the various forms of law in Article 4").

to principles found elsewhere in international law, particularly in customary international law.<sup>302</sup> At ICM's request, ICM's expert does likewise, expressly refusing to discuss customary international law because he had been instructed not to do so.<sup>303</sup> But principles of international law are "found in customary international law" and "on occasion in universal multilateral treaties as well as general principles of law recognized by civilized nations."<sup>304</sup> Both ICM and its expert focus on only one source of principles – and indeed, the least forceful source of international law: "general principles of law recognized by civil nations".<sup>305</sup> As Professor Caron observes, "it is astounding" and "incomprehensible" that, in asking for an opinion on the meaning of Article 4, ICM directed its expert to not address issues of customary international law.<sup>306</sup> That omission is "disabling of any opinion" on Article 4's meaning.<sup>307</sup>

187. None of ICM's other arguments salvage its approach to Article 4. ICM claims that the order in which ICANN listed the types of law in Article 4 should establish that principles of international law are primary.<sup>308</sup> But ICM provides no support for this interpretation of Article 4, which is contrary to the well-established distinction between specific and general law. The less persuasive force of principles is inherent in their nature; they are characteristically stated broadly and govern only when no local law applies. Thus, regardless of the order in which sources of law happen to be listed in Article 4, principles (such as principles of international law)

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<sup>302</sup> See ICM Memorial ¶ 347.

<sup>303</sup> See Goldsmith Report ¶ 22 n.28.

<sup>304</sup> Caron Opinion ¶ 52. ICM's expert similarly observes that it would be unlikely that "principles of international law" would "pick out 'general principles' but exclude customary international law." Goldsmith Report ¶ 23 n.30.

<sup>305</sup> *Id.* ¶ 49 (identifying the "limited role given to 'general principles of law recognized by civilized nations'").

<sup>306</sup> *Id.* ¶ 48.

<sup>307</sup> *Id.* Indeed, as Professor Caron observes, if, as ICM contends, ICANN had intended to adopt international law governing sovereigns, such intent must also encompass custom, yet ICM and its expert remarkably and curiously elide any discussion of custom. See *id.* at ¶ 59; see also *id.* ¶ 47 n.26 (addressing the "clear interstate character" of customary international law).

<sup>308</sup> ICM Memorial ¶ 339 (contending that Article 4's placement of "relevant principles of international law before international conventions or local law" prioritizes the law with which ICANN agreed to act in conformity).

are less forceful than more specific law in treaties (which are listed second) and applicable local law (which is listed third).

188. ICM further suggests that, at least in this instance, local law is not more specific than ICM's cited principles, and therefore the cited principles provide an independent source of law to apply.<sup>309</sup> To urge this point, ICM falls back on its misplaced reliance on ICANN's oversight of the Internet as "a global resource."<sup>310</sup> As noted above, the international applicability of a TLD does not render this dispute – between two U.S. corporations concerning an application process governed by U.S. law – international in character for purposes of Article 4.

189. ICM also relies on its muddled application of the hierarchy of law to contend that international law has an independent role here. Quoting, once again, individual phrases out of context, ICM attempts to rely on the "general duty to bring internal [*i.e.*, local] law into conformity with obligations under international law."<sup>311</sup> As an initial matter, that duty applies only where international legal obligations already exist; here, no international legal obligations exist as relevant to these proceedings. Moreover, as the fuller context surrounding ICM's quotation confirms, this duty to conform local law to international law "aris[es] from the nature of treaty obligations and from customary law"<sup>312</sup> – two sources of international law that ICM does not rely on here. Nothing in the quoted excerpt suggests that specific local law must incorporate general principles of international law, which play only a gap-filling, not a primary, role.

190. In sum, even if Article 4 operates as a choice-of-law clause bringing general commercial principles of international law into an IRP proceeding, those principles nonetheless

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<sup>309</sup> See ICM Memorial ¶ 461 (contending that California law is "less analogous" to this dispute than ICM's cited principles of international law).

<sup>310</sup> ICM Memorial ¶ 461; *see also* Goldsmith Report ¶ 26.

<sup>311</sup> ICM Memorial ¶ 339 (quoting IAN BROWNLIE, *PRINCIPLES OF PUBLIC INTERNATIONAL LAW* 35 (7th ed. 2008)).

<sup>312</sup> BROWNLIE, *supra*, at 35.



do not provide guidance in this particular proceeding because rules under local law provide more specific guidance for the circumstances at issue here.<sup>313</sup>

**B. EACH OF ICM’S KEY FACTUAL ASSERTIONS IS WRONG.**

191. ICANN now turns to the factual issues on which ICM focuses. Because of the limited nature of these proceedings and the fundamental infirmities of ICM’s claims, ICANN focuses its response on the four central factual issues that ICM has identified; each of ICM’s claims rests upon one of more of these four central issues.

192. With respect to each of these four issues, ICANN is absolutely confident that, even if (as ICM contends) these proceedings involved *de novo* review and the evaluation by this Panel sitting as a “Supreme Court of ICANN,” the Panel still would determine that ICANN’s conduct was not inconsistent with ICANN’s Bylaws and Articles in any respect. For this reason, ICANN addresses each of these four issues in some detail in order to demonstrate that ICM’s characterizations of the facts are wrong.

193. In so doing, however, ICANN does not wish to leave the impression that the Panel should (or somehow needs to) address these matters at this level of detail. To the contrary, in light of the deference that should be accorded to the Board’s decisions in this matter, the Panel should declare that ICANN’s conduct was not inconsistent with its Bylaws and Articles even if ICM’s version of the facts is largely correct (which it is not). The issues presented to the ICANN Board by the ICM .XXX sTLD application were difficult, and the Panel can determine that ICANN’s Board addressed ICM’s application with great care, devoted an enormous amount of time trying to determine the right course of action, allowed ICM to be heard frequently, and

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<sup>313</sup> Even setting aside that ICM’s cited principles of international law do not apply here because they are not relevant, those cited principles do not permit any relief to ICM. As demonstrated in Parts III.B and III.C below, ICANN’s conduct was appropriate and consistent with the international legal principles that ICM invokes. In asserting otherwise, ICM’s expert inappropriately exceeds his role as an expert by applying the law to the facts of this case. *See, e.g.*, Goldsmith Report ¶¶ 34, 37-40, 42. By doing so, ICM’s expert usurps not only the role of counsel in this proceeding but the role of the Panel as well, which has the sole province in this proceeding to declare whether, under the law as applied to the facts of this case, the ICANN Board has acted inconsistently with ICANN’s Articles and Bylaws. Moreover, ICM’s expert applies the law to *assumed* facts, which inappropriately overlooks the adversarial process because the facts here are disputed. *Id.* Thus, those portions of his report that apply the law to ICM’s facts should have no substantive bearing whatsoever on this proceeding.

deliberated openly and transparently. Indeed, ICANN is unaware of a corporate deliberative process that is *more* open and transparent than ICANN’s process, and that openness and transparency was fully apparent with respect to ICM’s application for .XXX. After this intensive process, the majority of the ICANN Board twice concluded that ICM’s proposal should be rejected, with no hint whatsoever of the “bad faith” ICM alleges.

194. In short, there is no basis to find that ICANN’s conduct was inconsistent with its Bylaws or Articles – to the contrary, ICANN tackled extremely difficult and controversial issues with great care, and each of the members of ICANN’s Board worked hard to try to identify the best answers. By the time of the last vote, five of the members of the Board supported the .XXX sTLD application, while nine of the members did not. ICM disagrees with the majority, but there is no basis to find that the Board – with each of the nine Board members in the majority expressing (often at some length) his or her own reasons for his/her vote – actually violated ICANN’s Bylaws or Articles in the course of this process.<sup>314</sup> The evidence before the Panel is in black and white, and no amount of “spin” can alter the foundational facts and reasons for the Board’s decisions.

195. *First*, ICM claims that ICANN adopted a rigidly non-overlapping two-step procedure for approving new sTLDs, under which applications would first be tested for baseline selection criteria, and only after the applications were finally and irrevocably approved by the ICANN Board could the applications proceed to technical and commercial contract negotiations with ICANN staff.

196. *Second*, ICM alleges that despite the Evaluation Panel’s conclusion that ICM did not satisfy the sponsorship criteria, ICANN’s Board “unconditionally approved” the .XXX TLD on June 1, 2005, when the Board allowed ICANN staff to begin registry agreement negotiations with ICM.

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<sup>314</sup> According to the Bylaws, the limited purpose of independent review is to provide a forum to address whether the ICANN Board as a whole, and not individual members, acted consistently with ICANN’s Bylaws and Articles of Incorporation. ICANN Bylaws, *supra* note 2, Article IV, § 3.1 (“ICANN shall have in place a separate process for independent third-party review of Board actions alleged by an affected party to be inconsistent with the Articles of Incorporation or Bylaws.”). Thus, while nothing suggests that any individual Board member violated the Bylaws or Articles, the relevant inquiry is the Board’s actions as a whole.

197. *Third*, ICM asserts that, during technical and commercial negotiations with ICANN staff, ICM satisfied all relevant concerns about the .XXX sTLD and presented a registry contract that the ICANN Board should have approved.

198. *And fourth*, ICM claims that, in a March 30, 2007 vote, the ICANN Board reversed its “unconditional approval” of the .XXX sTLD based on “vague and unannounced” notions of public policy, which were outside of the stated evaluation criteria for sTLDs.

199. In the sections below, ICANN demonstrates that ICM’s version of the facts is wrong in each respect. Much more importantly, none of these events supports a finding that the Board violated its Bylaws or Articles.

**1. ICANN Was Not Bound By A Non-Overlapping, “Two-Step” Procedure For Evaluating sTLD Applications.**

200. ICM’s claims begin with the notion that ICANN adopted, and was bound by, an inflexible, two-step procedure for evaluating sTLD applications. First, according to ICM, applications would be reviewed by the Evaluation Panel for the baseline selection criteria. Second, only after applications were finally and irrevocably approved by the ICANN Board would the applications proceed to contract negotiations with ICANN staff with no ability by the Board to address any of the issues that the Board previously had raised in conjunction with the sTLD application.

201. The RFP, however, decisively refutes this contention. Neither the RFP nor any other official statement regarding the RFP process suggests that ICANN had implemented a consecutive two-step process for evaluating sTLD applications in a manner that never permitted the evaluation process and contractual negotiations to overlap in time. The evaluation process in the RFP was described as follows:

- (a) The selection procedure is based on principles of objectivity, non-discrimination and transparency.
- (b) An independent team of evaluators will perform the evaluation process. The evaluation team will make recommendations about the preferred applications, if any applications are successful in meeting the selection criteria.

(c) Based on the evaluator’s recommendations, ICANN staff will proceed with contract negotiations and develop an agreement reflecting the commercial and technical terms to be agreed, although such terms may be subject to further amendment, as appropriate. ICANN will negotiate specific terms and conditions with each Registry Operator.<sup>315</sup>

202. The RFP makes clear that an sTLD registry agreement could not be presented to the Board for final approval without having proceeded through the evaluation process and contract negotiations. The RFP does not, however, suggest the Board’s allowance for an application to proceed to contract negotiation confirms the close of the evaluation process.

203. Consistent with the language of the RFP, ICANN announced nearly a year before authorizing any contract negotiations with ICM that contract negotiations *precede* any approval or disapproval of the underlying application: “Upon completion of the technical and commercial negotiations, successful applicants will be presented to the ICANN Board with *all* the associated information, so the Board can independently review the findings along with the information and make their own adjustments. *And then* final decisions will be made by the Board, and they’ll authorize staff to complete or execute the agreements with the sponsoring organizations, thereby designated in the registries.”<sup>316</sup>

204. This approach to contract negotiations was the only logical approach. The Board could not always know whether applications are able to satisfy the sponsorship (or other evaluation) criteria until it was shown how the criteria would be implemented in the contract. As former Chairman of the Board Vinton Cerf notes, in keeping with the plain language of the RFP, “ICANN never intended that this would be a formal ‘two-step’ process, where proceeding to contract negotiations automatically constituted a *de facto* final and irrevocable approval with respect to the baseline selection criteria, including sponsorship.”<sup>317</sup>

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<sup>315</sup> See New sTLD application, December 15, 2003, Part A. Explanatory Notes – Selection Criteria, Cl. Ex. 45.

<sup>316</sup> ICANN Meetings in Kuala Lumpur ICANN Public Forum, Thursday, July 22, 2004, Real-Time Captioning, Cl. Ex. 111 (comments of Kurt Pritz, ICANN) (emphasis added).

<sup>317</sup> V. Cerf Witness Statement, ¶ 15.

205. Instead, before the ICANN Board could approve an sTLD application, applicants had to satisfy the baseline selection criteria set forth in the RFP, including the technical, business/financial, and sponsorship criteria, and also negotiate an acceptable registry contract with ICANN staff.<sup>318</sup> These were two overlapping phases in the evaluation of the sTLDs. And the established process for evaluating the sTLD applications always gave the ICANN Board the right to vote against a proposed sTLD should the Board find deficiencies in the proposed registry agreement or in the sTLD proposal as a whole.

206. ICANN did employ a two-stage process – insofar as the evaluation of the RFP criteria and technical negotiations involved different functions – but a review of the relevant documents and contemporaneous statements by the Board makes clear that the two phases could (and often did) overlap in time.

207. Dr. Twomey (ICANN’s then and current-President), Alejandro Pisanty (then-Vice Chairman of the Board), and Dr. Cerf (then-Chairman of the Board) unanimously confirm this understanding. Each explains that the ICANN Board retained the authority to review and assess the baseline RFP selection criteria even after some of the applicants were allowed to proceed to contract negotiations.<sup>319</sup> ICM and other applicants were thus permitted to begin contract negotiations despite unresolved RFP issues, in the hope that those concerns might be addressed to the Board’s satisfaction via the contract negotiations.

208. These views are also confirmed by the conduct of the ICANN Board members who were *in favor of* ICM’s .XXX sTLD application in June 2005. During the many discussions of ICM’s sponsorship shortcomings after ICM was allowed to proceed to contract negotiations

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<sup>318</sup> *Id*; see also P. Twomey Witness Statement, ¶ 18.

<sup>319</sup> P. Twomey Witness Statement, ¶¶ 18-22 ; V. Cerf Witness Statement, ¶¶ 15-20; see also Cerf Comments on March 30, 2007 vote, ICANN Meetings in Lisbon, Portugal, Transcript, March 30, 2007, Cl. Ex. 201 (“The record will show that at one point I voted in favor of proceeding to negotiate a contract. Part of the reason for that was to try to understand more deeply exactly how this proposal would be implemented, and seeing the contractual terms, it seemed to me, would put much more meat on the bones of the *initial proposal*.”) (emphasis added); A. Pisanty Witness Statement, ¶ 16 (“As the adopted resolutions made clear, the Board’s vote was intended only to permit ICM to proceed with contract negotiations. Under no circumstances was ICANN bound by this vote to award the .XXX sTLD to ICM because the resolution that the Board adopted was not a finding that ICM had satisfied the sponsorship criteria set forth in the Request for Proposal.”).

on June 1, 2005, none of these Board members ever objected that the Board had already approved the .XXX sTLD. Plainly, if the June 1, 2005 resolutions had constituted a final approval of ICM's application, the Board members supporting that application could have argued as much. Notably, two Board members who had originally voted to allow ICM to proceed to contract negotiations ultimately voted against the proposed registry contract.<sup>320</sup>

209. ICM's "evidence" is not to the contrary. Despite the fact that ICM makes this issue the lynchpin of its arguments, ICM cites nothing more than a few comments by ICANN staff and Board Members stating that there were "two major steps" in the evaluation process.<sup>321</sup> These statements were accurate because there *were* two major steps in the evaluation process. The relevant question, however, is whether ICANN's Bylaws required these two steps to be non-overlapping in time, such that contract negotiations could not commence until the satisfaction of the RFP criteria was finally and irrevocably determined, and that consequently any resolution permitting contract negotiations with an applicant would constitute an implicit determination that all of the RFP criteria were, *sub silentio*, deemed satisfied. Nothing in ICM's citations even hints at such an atextual view of the RFP process, and ICM offers no response at all to the foregoing evidence proving that the fundamental underlying premise of its entire claim is wrong.<sup>322</sup>

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<sup>320</sup> The two Board members were Dr. Cerf and Vanda Scartezini.

<sup>321</sup> See, e.g., ICANN Meetings in Rome, ICANN Public Forum, Part 1, Thursday, March 4, 2004, Real-Time Captioning, *available at* <http://www.icann.org/en/meetings/rome/captioning-forum1-04mar04.htm> (last visited May 5, 2009) (Kurt Pritz provided a summary of the anticipated sTLD evaluation process: "There's two major steps to the process. The first is the application process as you see it now ... the process is to demonstrate involvement in the community, technical competence, financial viability, and a robust business model. After that, as I stated before, we'll enter into this commercial and technical negotiation phase."), attached hereto as ICANN Exhibit AI.

<sup>322</sup> Throughout the evaluation process, ICANN altered the evaluation schedule in order to provide applicants, especially ICM, an opportunity to address problems that had been identified in their applications. For instance, after the Evaluation Panel's initial findings, the ICANN Board instructed the Panel to reconsider their findings as to all applicants. After the Evaluation Panel confirmed its initial findings, the ICANN Board gave each of the applicants an opportunity to respond to the findings in writing to the Board. After ICM responded to the findings of the Evaluation Panel, the ICANN Board offered ICM an opportunity to make an in-person presentation to the Board.

## 2. ICANN's Board Did Not Approve The .XXX sTLD On June 1, 2005.

210. ICM's claims are also premised on the argument that, on June 1, 2005, the ICANN Board voted to give ICM an "unconditional" approval of the .XXX sTLD application.

211. As discussed above, on June 1, 2005, the ICANN Board held a special meeting in which it passed two resolutions authorizing ICANN staff to negotiate contract terms with ICM:

Resolved [05.32] the Board authorizes the President and General Counsel to enter into negotiations relating to proposed commercial and technical terms for the .XXX sponsored top-level domain (sTLD) with the applicant.

Resolved [05.33] if after entering into negotiations with the .XXX sTLD applicant the President and General Counsel are able to negotiate a set of proposed commercial and technical terms for a contractual arrangement, the President shall present such proposed terms to this board, for approval and authorization to enter into an agreement relating to the delegation of the sTLD.<sup>323</sup>

212. ICM's claims are predicated on the assumption that these resolutions "by [their] terms" reflect the Board's "unconditional decision that ICM's application satisfied the RFP selection criteria, including the sponsorship criteria," and thus constituted approval of ICM's .XXX sTLD application.<sup>324</sup> But because nothing in the resolutions actually says that, ICM's argument rests on ICM's assumption that the two steps of ICANN's evaluation process were rigidly non-overlapping, so that any authorization to negotiate (irrespective of the language of the agreement that was negotiated) must always be an unconditional approval. Because, as shown above, this premise is demonstrably incorrect, ICM's characterization of the resolutions also fails.

213. In fact, nothing in the resolutions expresses any approval at all, let alone an unconditional approval, of the .XXX sTLD application. To the contrary, the text of the resolutions makes clear that they did *not* constitute "approval and authorization," which could occur only in the future. The resolutions provided that "*if* after entering into negotiations with the .XXX sTLD applicant the President and General Counsel are able to negotiate a set of

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<sup>323</sup> See ICANN Minutes, Special Meeting of the Board, June 1, 2005, Cl. Ex. 120.

<sup>324</sup> ICM Memorial ¶ 186.

proposed commercial and technical terms for a contractual arrangement, the President shall present such proposed terms to this Board, *for approval* and authorization to enter into an agreement relating to the delegation of the sTLD.”<sup>325</sup> The plain language of the resolutions makes clear that they did not themselves constitute approval of the .XXX sTLD application.<sup>326</sup> The resolutions thus track the RFP, which makes clear that a “final decision will be made by the Board” only *after* “completion of the technical and commercial negotiations.”<sup>327</sup>

214. As of June 2005, there remained numerous unanswered questions and concerns regarding ICM’s ability to satisfy the *baseline* sponsorship criteria set forth in the RFP.<sup>328</sup> Despite these open questions, some Board members believed that the best way to test whether ICM could satisfy the sponsorship criteria was to determine whether the deficiencies could be addressed in a registry agreement with ICM.<sup>329</sup> Thus, contrary to the views of ICM’s witness Ms. Burr, the Board had good reason “to authorize ICM to proceed to negotiations for the registry agreement [even though] it did not feel that the application met the criteria.”<sup>330</sup> Had the Board not taken this action in order to further test ICM’s proposal, some Board members likely would have voted “no” and ICM’s proposal would have been rejected at that time.<sup>331</sup> One important purpose of the resolutions was to permit ICM to proceed to contract negotiations in an effort to determine whether ICM’s sponsorship shortcomings could be resolved in the contract.<sup>332</sup>

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<sup>325</sup> *Id.* (emphasis added).

<sup>326</sup> ICM’s argument also supposes that the Board intended to confer approval of the controversial .XXX sTLD without even postponing the June 1 vote to allow the four absent Board members to voice their opinions regarding this important matter.

<sup>327</sup> See ICANN Meeting in Kuala Lumpur ICANN Public Forum, Thursday, July 22, 2004, Real-Time Captioning, Cl. Ex. 111 (comments of Kurt Pritz, ICANN) (emphasis added).

<sup>328</sup> See ICANN Minutes, Special Meeting of the Board, June 1, 2005, Cl. Ex. 120 (The Board’s discussion “surrounded the adequacy of the application with particular focus on the ‘sponsored community’ issues.”).

<sup>329</sup> A. Pisanty Witness Statement, ¶ 15; V. Cerf Witness Statement, ¶¶ 17-18.

<sup>330</sup> ICM Memorial, Ms. J. Beckwith Burr Witness Statement, ¶ 32.

<sup>331</sup> P. Twomey Witness Statement, ¶ 27; V. Cerf Witness Statement, ¶ 24.

<sup>332</sup> V. Cerf Witness Statement, ¶ 24 (“Allowing ICM to proceed to contract negotiations allowed us to truly test ICM’s ability to satisfy the sponsorship selection criteria, among other things. Had this not been



215. The Board also permitted other applicants for sTLDs – .jobs and .mobi – to proceed to contract negotiations despite open questions relating to the initial RFP selection criteria. However, ICM was unique among the field of sTLD applicants due to the extremely controversial nature of the proposed TLD, and concerns as to whether ICM had identified a “community” that existed and actually supported the proposed sTLD. Thus, while there was essentially no opposition to .jobs and .mobi from the sTLD communities defined by those applications, there was a significant negative response to ICM’s proposed .XXX sTLD by many adult entertainment providers, the very individuals and entities who logically would be in ICM’s proposed community.<sup>333</sup> There was no doubt that these issues warranted further evaluation and that ICM would have to continue to “prove” the validity of its application at subsequent Board meetings. ICM’s conduct, as discussed below, makes clear that it understood its challenge.

216. ICM’s position is further refuted by the actions taken by the Board after the June 2005 resolutions. At five subsequent Board meetings in which the Board discussed ICM’s application, the Board continued to discuss whether ICM was going to be able to satisfy the baseline sponsorship criteria required under the RFP. Many of these discussions were open to the public, and minutes from every meeting were posted on ICANN’s website.

217. For example, the Board extensively discussed its concerns regarding ICM’s ability to meet the sponsorship criteria at the September 15, 2005 special meeting (“after a lengthy discussion involving nearly all of the directors regarding the sponsorship criteria....”);<sup>334</sup> at the May 10, 2006 special meeting (ICANN Board and staff “entered into a detailed discussion on the following points: agreement terms against the application statements and promises made by ICM in support of their proposal; concerns regarding ICANN’s ability to enforce the promises made by ICM through a contractual framework and the potential harm if such enforcement could not be maintained; the sponsorship criteria in the RFP and materials submitted in support by

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(continued...)

a viable option for testing ICM’s proposal, I likely would have voted ‘no’ and I believe ICM’s proposal would have been turned down at that time.”).

<sup>333</sup> P. Twomey Witness Statement, ¶ 31.

<sup>334</sup> ICANN Minutes, Special Meeting of the Board, September 15, 2005, Cl. Ex. 119.

ICM and others . . . and ICM’s submission and supporting letters and documentation.”);<sup>335</sup> and again at the February 12, 2007 special meeting (where the Board discussed the “splintering” of support for the .XXX sTLD in the online adult entertainment community, a topic that “had been the subject of debate by the Board in earlier discussion in 2006”).<sup>336</sup>

218. Notably, at the February 12, 2007 special meeting, the Board conducted a “straw poll” for Board members to express their individual views with respect to the “serious concerns” expressed by “a majority of Board members” about ICM’s ability to satisfy the baseline sponsorship criteria set out in the RFP. Eight members and three non-voting liaisons expressed “serious concern.”<sup>337</sup> One of those non-voting liaisons also noted that “ALAC did not yet have a final and unanimous view on whether the domain should be created or not, and in any case, as it had said previously, did not support the requirement of the sponsorship for new TLDs in itself.”<sup>338</sup> Only three members stated that they did not have serious concerns.<sup>339</sup>

219. The fact that most Board members expressed significant concerns about ICM’s sponsorship shortcomings *after* the June 1, 2005 resolutions negates any notion that the June 2005 resolutions (which do not say that the Board is approving anything and, to the contrary, state clearly that the Board is *not* doing so) conclusively determined the sponsorship issue.

220. The sponsorship shortcomings in ICM’s application were also raised by Board members who joined the Board after the June 1, 2005 resolutions.<sup>340</sup> ICANN’s Board members are seated in a staggered fashion approximately every six months and the regular term of office for persons other than the President is three years. Thus, over the Board’s nearly two-year consideration of ICM’s application for the .XXX sTLD, the Board’s composition changed, and new members were seated. Several of these new members believed (quite appropriately) that it

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<sup>335</sup> ICANN Minutes, Special Meeting of the Board, May 10, 2006, Cl. Ex. 122.

<sup>336</sup> ICANN Minutes, Special Meeting of the Board, February 12, 2007, Cl. Ex. 199.

<sup>337</sup> *Id.*

<sup>338</sup> *Id.*

<sup>339</sup> *Id.*

<sup>340</sup> V. Cerf Witness Statement, ¶ 39.

was incumbent on them to make their own evaluations of ICM's application because the issue continued to be addressed.

221. Contrary to ICM's odd assertion, it was not "impossible for the new Board members to absorb the relevant information before [each] vote."<sup>341</sup> Members of corporate boards routinely change over time, and those board members "get up-to-speed" on issues facing the board. In this circumstance, new Board members endeavored in good faith to review the pertinent materials and bring themselves up to speed.<sup>342</sup>

222. ICM's speculative assertion that a particular Board member (whether new or not) did not "fully grasp" the issues is hardly a basis to conclude that the Board violated ICANN's Bylaws, as ICM contends.<sup>343</sup> The statement of Ms. Burr that "it is a fact that most Board members lacked the legal training necessary to question the legitimacy of, or to identify legal inadequacies in, the tactics employed by ICANN's management" in rejecting ICM's registry agreement and application, not only improperly denigrates the credentials of the ICANN Board, but more importantly, confuses the issue. No member of the ICANN Board is required to have legal training, and whether any member does or does not have legal training is utterly irrelevant in determining whether ICANN violated its Bylaws by voting to reject ICM's sTLD application. (ICM's argument is also self-defeating because, if correct, it would show that a vote *in favor* of ICM's application would have been equally unsupportable.)

223. The addition of new Board members provided further opportunities for the Board to confirm that ICM's application satisfied the RFP specifications (if, as ICM contends, that is what the Board had decided in June 2005). Between the June 2005 and February 2007 Board meetings, there were a total of six new voting Board members (out of a total of fifteen) considering ICM's application. One such Board member was Rita Rodin Johnston (formerly Rita Rodin, who is a partner in the Intellectual Property and Technology practice at the Skadden Arps law firm and in fact does have substantial legal training). Ms. Rodin Johnston was

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<sup>341</sup> ICM Memorial ¶ 262.

<sup>342</sup> V. Cerf Witness Statement, ¶ 39.

<sup>343</sup> ICM Memorial ¶ 263.

appointed to the Board by the GNSO in May 2006, and thus did not participate in the June 2005 and May 2006 votes. Ms. Rodin Johnston stated at the February 12, 2007 special meeting that “in preparation for the meeting [she] had reviewed the materials prepared by staff and other information available about the proposed domain.”<sup>344</sup> Based on her review, she expressed “some concerns about whether the proposal met the criteria set forth in the RFP. For example, [Ms. Rodin Johnston] noted that it was not clear to her whether the sponsoring community seeking to run the domain genuinely could be said to represent the adult on-line community.”<sup>345</sup>

224. The minutes further note that, in expressing these concerns, Ms. Rodin Johnston requested that John Jeffrey (ICANN’s General Counsel and Secretary) and Dr. Twomey “confirm that this sort of discussion should take place during this meeting. She said that she did not want to reopen issues if they had already had been decided by the Board.”<sup>346</sup> In response to Ms. Rodin Johnston’s query, *no one stated that the sponsorship issue had already been decided by the Board.* To the contrary, Dr. Cerf “noted that [it] had been the subject of debate by the Board in earlier discussions in 2006” and opined that “in recent times (over the last six months) there seemed to have been a more negative reaction from members of the adult online community to the proposal.”<sup>347</sup> Ms. Rodin Johnston agreed, saying that “a review of the materials indicates that there seems to be a ‘splintering’ of support in the adult on-line community” and that “this splintering suggested there may not be widespread support within the adult online community.”<sup>348</sup>

225. Contemporaneous correspondence from the ICANN Board to interested third-parties further confirms that the June 1, 2005 vote did not constitute unconditional approval of the .XXX sTLD. After the June 1, 2005 vote, the ICANN Board received correspondence from numerous governments and entities around the world expressing concerns about the proposed .XXX sTLD. On January 17, 2006, Dr. Cerf responded to concerns expressed by Peter Zangl

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<sup>344</sup> ICANN Minutes, Special Meeting of the Board, February 12, 2007, Cl. Ex. 199.

<sup>345</sup> *Id.*

<sup>346</sup> *Id.*

<sup>347</sup> *Id.*

<sup>348</sup> *Id.*

(Deputy Director General of the Information Society and Media DG for the European Commission) regarding ICM's application. In describing the June 1, 2005 resolutions, Dr. Cerf stated that the Board had merely "voted to begin discussion of proposed commercial and technical terms with ICM" and "also requested the President to present any such negotiated agreement to the Board *for approval and authorization.*"<sup>349</sup>

226. Dr. Twomey also confirmed ICANN's position that the June 1, 2005 resolutions did not constitute approval of ICM's application. In a May 4, 2006 letter from Dr. Twomey to Mohamed Sharil Tarmizi, then-Chairman of the GAC, Dr. Twomey noted that:

it is important to note that the Board decision as to *the .XXX application is still pending*. The decision by the ICANN Board at its June 1, 2005 Special Board Meeting reviewed the criteria against the materials supplied and the results of the independent evaluations. *After consultation with ICM, the board voted to authorize staff to enter into contractual negotiations without prejudicing the Board's right to evaluate the resulting contract and to decide whether it meets all of the criteria before the Board including public policy advice such as might be offered by the GAC.* The final conclusion on the Board's decision to accept or reject the .XXX application has not been made and will not be made until such time as the Board either approves or rejected the registry agreement relating to the .XXX application.<sup>350</sup>

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<sup>349</sup> Letter from Vinton Cerf to Peter Zangl, January 17, 2006, *available at* <http://www.icann.org/correspondence/cerf-to-zangl-30jan06.pdf> (emphasis added) (last visited May 5, 2009), attached hereto as ICANN Exhibit AJ.

<sup>350</sup> Letter from Paul Twomey, ICANN, to Mohamed Sharil Tarmizi, GAC Chairman, May 4, 2006, Cl. Ex. 188 (emphasis added).

Contrary to Ms. Burr's assertion, Dr. Twomey's May 4, 2006 letter was not the "first indication of a new strategy to re-open the selection criteria question." *See* ICM Memorial, Ms. J. Beckwith Burr Witness Statement, ¶ 63. As previously noted, it was known since the "proof of concept" round in 2000 that Board approval was required before delegation of a new TLD, and that the authorization to enter contract negotiations with a proposed registry operator or sponsoring organization would not, on its own, signify final approval of any proposed TLD. In the context of the sTLD round, Dr. Twomey confirmed the same position in an earlier letter to the GAC. *See* Letter from Paul Twomey, ICANN, to Mohamed Sharil Tarmizi, GAC Chairman, February 11, 2006, *available at* <http://www.icann.org/correspondence/twomey-to-tarmizi-16feb06.pdf> (last visited May 5, 2009) ("It should be noted that, consistent with Article II, section 1 of the Bylaws, it is the ICANN Board that has the authority to decide, upon the conclusion of technical and commercial negotiations, whether or not to approve the creation of a new sTLD. Such decisions are not made by outside evaluators or by ICANN Staff. Indeed, the sTLD RFP made it clear that the evaluators would make 'recommendations' to ICANN. Responsibility for resolving issues

227. Dr. Cerf reconfirmed this view in another letter to Mr. Tarmizi in March 2007. Dr. Cerf wrote that “the ICANN Board *has not made a final decision* on the .XXX application.”<sup>351</sup>

228. Contrary to ICM’s position that “ICANN never gave ICM any reason to doubt that the application had been approved,”<sup>352</sup> ICM was aware of all of the Board’s discussions and correspondence subsequent to June 1, 2005. Likewise, ICM was aware that members of the Board continued to express significant concerns about sponsorship issues associated with the proposed sTLD, and were noting objections of governments and the GAC to the sTLD. The Board minutes and correspondence discussed above were all publicly posted on ICANN’s website throughout the process.

229. Finally, the witness statements of ICANN Board members Dr. Cerf, Dr. Twomey, and Mr. Pisanty also confirm that the June 1, 2005 resolutions were not an “unconditional” or final approval of ICM’s .XXX sTLD application.<sup>353</sup>

230. Mr. Pisanty explains: “As the adopted resolutions made clear, the Board’s vote was intended only to permit ICM to proceed with contract negotiations. Under no circumstances was ICANN bound by this vote to award the .XXX sTLD to ICM because the resolution that the Board adopted was not a finding that ICM had satisfied the sponsorship criteria set forth in the

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(continued...)

relating to an applicant’s readiness to proceed to technical and commercial negotiations and, subsequently, whether or not to approve delegation of a new sTLD, rests with the Board.”), attached hereto as ICANN Exhibit AK.

<sup>351</sup> Letter from Vint Cerf, ICANN, to Mohamed Sharil Tarmizi, GAC Chairman, March 14, 2007, available at <http://www.icann.org/correspondence/cerf-to-tarmizi-karklins-14Mar07.pdf> (last visited May 5, 2009) (emphasis added), attached hereto as ICANN Exhibit AL.

<sup>352</sup> ICM Memorial ¶ 194.

<sup>353</sup> P. Twomey Witness Statement, ¶ 28; V. Cerf Witness Statement, ¶ 25; A. Pisanty Witness Statement, ¶ 16. The sworn testimony of ICANN Board members who actually participated in the decision and voted at the June 1, 2005 Board meeting is more persuasive than ICM’s reliance on the “understanding” of Dr. Williams and various unidentified third parties who had simply “monitor[ed] the process.” See ICM Memorial ¶ 193.

Request for Proposal. There were simply too many open questions concerning sponsorship in June 2005 for the Board to find that ICM had fulfilled the sponsorship selection criteria.”<sup>354</sup>

231. Dr. Cerf similarly notes: “The Resolutions did not constitute approval of ICM’s .XXX application. First, the Resolutions make no mention of any decision (final or otherwise) by the Board that the .XXX sTLD application satisfied the selection criteria (including the sponsorship criteria) set forth in the RFP. As is clear on the face of the Resolutions, the Board’s action was intended only to permit ICM to proceed with contract negotiations, nothing more. The alternative was simply to reject the .XXX sTLD application at that time, without giving ICM the opportunity to demonstrate that the concerns that had been raised could be addressed adequately by negotiated contractual provisions. Second, as of June 1, 2005, there were a number of unanswered questions and concerns regarding ICM’s ability to satisfy the requisite sponsorship criteria, including concerns relating to ICM’s definition of Sponsored Community and the level of support from the community.”<sup>355</sup>

232. And Dr. Twomey confirms: “There can be no doubt that these Resolutions did not constitute approval of ICM’s .XXX application, despite ICM’s argument in this proceeding to the contrary.”<sup>356</sup>

233. Thus, ICM’s baffling contention that “nothing in any Board minutes, transcripts or other ICANN pronouncements suggest that the Board’s approval to proceed to the registry agreement negotiation stage was subject to any residual concerns as to whether ICM’s application satisfied all of the RFP selection criteria”<sup>357</sup> is refuted by mountains of evidence that ICM simply ignores.

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<sup>354</sup> A. Pisanty Witness Statement, ¶ 16.

<sup>355</sup> V. Cerf Witness Statement, ¶¶ 25-26.

<sup>356</sup> P. Twomey Witness Statement, ¶ 28.

<sup>357</sup> ICM Memorial ¶ 230.

### **3. ICM Could Not Cure Its Sponsorship Shortcomings, Along With Other Deficiencies, During Contract Negotiations.**

234. ICM claims that it addressed all relevant concerns regarding the .XXX sTLD through the registry contract negotiations and discussions with ICANN staff. ICM is wrong. Further, throughout 2005 and up to the Board's denial of the .XXX sTLD on March 30, 2007, a number of additional concerns and issues appeared beyond those originally voiced by the Evaluation Panel at the beginning of the review process. Despite the best efforts of many, ICM could not satisfy these additional concerns, and most importantly, could not cure the continuing sponsorship defects.

#### **a. Concerns Raised By The GAC.**

235. Following the Board's June 1, 2005 resolution, ICANN staff, as directed by the ICANN Board, entered into contract discussions with ICM for a proposed registry agreement. By August 9, 2005, ICM's first draft .XXX sTLD registry agreement was posted on ICANN's website and submitted to the Board for approval. ICANN's next Board meeting was scheduled for August 16, 2005, at which time the Board had planned on discussing the proposed agreement.<sup>358</sup>

236. Within days of ICANN posting the proposed registry agreement, GAC Chairman Mr. Tarmizi wrote Dr. Cerf a letter expressing the GAC's "diverse and wide ranging" concerns with the .XXX sTLD (concerns that echoed those of the Board) and requesting that the Board provide additional time for governments to express their public policy concerns before the Board reached a final decision on the proposed registry agreement.<sup>359</sup> Because contract negotiations were still pending, an immediate written response to the GAC was premature.<sup>360</sup>

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<sup>358</sup> See ICM Draft, August 1, 2005, Sponsored TLD Registry Agreement, *available at* <http://www.icann.org/en/tlds/agreements/xxx/proposed-xxx-agmt-09aug05.pdf> (last visited May 5, 2009), attached hereto as ICANN Exhibit R.

<sup>359</sup> The GAC's statements in August 2005 disprove ICM's contention that the GAC had made in April 2005 "an affirmative statement that the GAC was declining to take a position on the .XXX, or any other, application." ICM Memorial ¶ 204. The GAC clearly took a position, and it was one of concern over ICM's .XXX application. And even if the GAC had declined to take a position in April 2005 – which it did not – ICANN was required under its Bylaws to consider the GAC's views, whether they were expressed in August 2005 or at any other time.

<sup>360</sup> V. Cerf Witness Statement, ¶ 32.



237. The GAC's input was significant because the ICANN Bylaws *require* the Board to take into account advice from the GAC on public policy matters, both in formulation and adoption of policies.<sup>361</sup> Where the Board seeks to take actions that are inconsistent with the GAC's advice, the Board must tell the GAC why.<sup>362</sup> Thus, it was perfectly appropriate, and fully consistent with the Bylaws and Articles, for the Board to consider and try to address the GAC's (and others') concerns.<sup>363</sup>

238. ICM's expert, Dr. Mueller, had already concluded (long before these proceedings began) that ICANN's treatment of the .XXX sTLD application had "proved conclusively" that the U.S. Government would influence the outcome "when domestic political pressures make it politically profitable to do so."<sup>364</sup> Dr. Mueller's opinions appear to be based largely on a suspicion of government involvement on issues of public policy, particularly by the United States, and by his personal view that such involvement, even as authorized through the GAC under the Bylaws, should be avoided. Thus, Dr. Mueller disagrees with ICANN's Bylaws, a disagreement that, of course, has nothing to do with whether ICANN's Board violated those Bylaws.

239. Dr. Mueller claims that, in raising its policy concerns through the GAC, the U.S. Government acted beyond the "oversight role contemplated" by the documents establishing the U.S. Government's relationship with ICANN.<sup>365</sup> But without regard to the merits of

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<sup>361</sup> ICANN Bylaws, *supra* note 2, Article XI, § 2.1(j) ("The advice of the Governmental Advisory Committee on public policy matters shall be duly taken into account, both in the formulation and adoption of policies.").

<sup>362</sup> *Id.*

<sup>363</sup> V. Cerf Witness Statement, ¶ 30. In any event, the GAC's concerns were consistent with the ICANN Board's concerns regarding ICM's ability to satisfy the sponsorship criteria.

<sup>364</sup> See, e.g., Milton Mueller, *Triple X, Internet Content Regulation and the ICANN Regime*, available at [www.internetgovernance.org/pdf/new-xxx-contract.pdf](http://www.internetgovernance.org/pdf/new-xxx-contract.pdf) (January 16, 2007) (last visited May 5, 2009), attached hereto as ICANN Exhibit AM. On April 5, 2005, Dr. Mueller co-authored a concept paper proposing structural reforms to address a perception of "unilateralism by the US Government in its control of the DNS root and its supervision of ICANN." Milton Mueller & Hans Klein, *What to Do About ICANN: A Proposal for Structural Reform*, Concept Paper by the Internet Governance Project, at p. 1, available at <http://internetgovernance.org/pdf/igp-icannreform.pdf> (Apr. 5, 2005) (last visited May 5, 2009), attached hereto as ICANN Exhibit AN.

<sup>365</sup> ICM Memorial, Expert Report of Dr. Milton Mueller at p. 39.

Dr. Mueller's views about U.S. Government involvement with ICANN, the GAC does not exercise any "oversight" over ICANN but rather acts in an advisory role. When the U.S. Government requested additional time to allow opinions to be voiced about the .XXX application – the event Dr. Mueller describes as having reversed "the fate" of .XXX – the Board undoubtedly was justified in taking those opinions into consideration, just as the GAC had requested in a prior communication.<sup>366</sup>

240. The notion that the ICANN Board actually violated its Bylaws or Articles by taking those views into consideration is illogical. The fact that the Board did not follow the process that Dr. Mueller (and ICM) wish were required under the Bylaws is not relevant in this proceeding. Further, ICM has presented no facts (or legal argument) that would support its view that the Board violated its Bylaws or Articles by listening to and considering the GAC's position on the .XXX sTLD application.

241. Dr. Mueller has acknowledged that the GAC has only an advisory role under the Bylaws.<sup>367</sup> Nevertheless, in his report, he reaches the contradictory conclusion that the ICANN Board's rejection of ICM's application "impl[ies] that the Board must defer indiscriminately to any claim of public policy concerns raised by any member of the GAC at any time."<sup>368</sup> He now takes issue even with the GAC's limited advisory role as it relates to matters of public policy

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<sup>366</sup> See *id.* at p. 42. Contrary to ICM's assertion, Suzanne Sene, the representative from the U.S. Department of Commerce on the GAC, did not "tr[y] to prevent GAC from expressing negative views about .xxx" as Dr. Mueller now claims. See ICM Memorial, Expert Report of Dr. Milton Mueller at p. 41. While it is true that Ms. Sene believed "the matter could have been raised before at Plenary or Working group level," she did not try to stop other GAC representatives from expressing their views. More importantly, the minutes of the same meeting make clear that "[t]he Chair [of the GAC] confirmed that, having consulted the ICANN Legal Counsel, GAC could still advise ICANN about the .xxx proposal, should it decide to do so." Minutes of GAC Meeting XXII, held in Luxembourg from July 11-12, 2005, dated November 23, 2005, Cl. Ex. 139.

<sup>367</sup> ICM Memorial, Expert Report of Dr. Milton Mueller at p. 26 ("[T]he GAC is institutionalized as simply a committee that advises the Board of Directors."); Milton Mueller & Hans Klein, *What to Do About ICANN: A Proposal for Structural Reform*, Concept Paper by the Internet Governance Project, at p. 1, available at <http://internetgovernance.org/pdf/igp-icannreform.pdf> (Apr. 5, 2005) (last visited May 5, 2009) (expressing "[d]issatisfaction" that the GAC "ha[s] only advisory powers"), attached hereto as ICANN Exhibit AN.

<sup>368</sup> ICM Memorial, Expert Report of Dr. Milton Mueller at p. 50.

because “governments do not speak with one voice on public policy.”<sup>369</sup> When many governments actually did agree on policy concerns raised by the .XXX proposal, Dr. Mueller could only surmise that “something is terribly wrong with governments – with governments as governments – when Brazil, France and the Bush administration agree on something this silly and arbitrary.”<sup>370</sup> At odds with his fear of “unilateralism by the US Government,”<sup>371</sup> he seems not willing to consider that other governments should be heard, believing that all policy matters should instead be handled by the GNSO.<sup>372</sup>

242. The bottom line, however, is that Dr. Mueller’s preferred processes for ICANN, including his preference that ICANN completely ignore the views expressed by governments, are not at issue in this proceeding because they are inconsistent with the processes actually required by ICANN’s Bylaws.

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<sup>369</sup> ICM Memorial, Expert Report of Dr. Milton Mueller at p. 26.

<sup>370</sup> Milton Mueller, *Milton Mueller on governmental flap over .xxx domains*, POLITECH: Politics & Tech. Blog, available at <http://www.politechbot.com/2005/08/16/milton-mueller-on/> (August 16, 2005) (last visited May 5, 2009), attached hereto as ICANN Exhibit AO.

<sup>371</sup> Milton Mueller & Hans Klein, *What to Do About ICANN: A Proposal for Structural Reform*, Concept Paper by the Internet Governance Project, at p. 1, available at <http://internetgovernance.org/pdf/igp-icannreform.pdf> (Apr. 5, 2005) (last visited *date*), attached hereto as ICANN Exhibit AN.

<sup>372</sup> ICM Memorial, Expert Report of Dr. Milton Mueller at p. 25. In an article drafted for the Internet Governance Project (“IGP”) (an academic consortium composed of many members from the Syracuse University of Information Studies where Dr. Mueller is employed, see IGP, *Scientific Committee/Organizational Information*, available at <http://www.internetgovernance.org/people.html> (last visited May 5, 2009), attached hereto as ICANN Exhibit AP), Dr. Mueller did not appear to support .XXX based on ICM’s ability to satisfy the sponsorship criteria actually under consideration, but instead on his opinion that, “[i]f there are problems here, they are not problems with the .xxx gTLD application. *They are problems inherent in ICANN’s institutional structure.*” Milton Mueller, *Triple X, Internet Content Regulation and the ICANN Regime*, available at [www.internetgovernance.org/pdf/new-xxx-contract.pdf](http://www.internetgovernance.org/pdf/new-xxx-contract.pdf) (January 16, 2007) (emphasis added) (last visited May 5, 2009), attached hereto as ICANN Exhibit AM. Thus, his views with respect to ICM’s .XXX sTLD application, as expressed *prior* to these proceedings, had nothing to do with the claims ICM has asserted. Instead, Dr. Mueller believes the entire ICANN structure needs to be changed, changes that the ICANN community has thus far rejected. For example, Dr. Mueller has argued that the GAC should be abolished. See ICM Memorial, Expert Report of Dr. Milton Mueller at p. 22-23; Milton Mueller & Hans Klein, *What to Do About ICANN: A Proposal for Structural Reform*, Concept Paper by the Internet Governance Project, at p. 1, available at <http://internetgovernance.org/pdf/igp-icannreform.pdf> (Apr. 5, 2005) (last visited May 5, 2009), attached hereto as ICANN Exhibit AN.

243. Notwithstanding Dr. Mueller's views, ICM understood that it was necessary for ICANN to include the GAC and other interested parties in the process.<sup>373</sup> ICM – recognizing, in its own words, the “need for all stakeholders to feel that they have had an adequate and meaningful opportunity to express their views,” and in order to “preserve the integrity of the ICANN process” – even requested, on August 15, 2005, that the ICANN Board defer a vote on the pending draft registry agreement in order to allow ICM to respond to the GAC's concerns (and the ICANN Board agreed to do so).<sup>374</sup> ICM knew that it was critical to try to address the GAC's concerns because ICM's application was very much at risk.

244. ICM blames the Bush Administration for expressing opinions about the .XXX application and for prompting the GAC to come forward with concerns.<sup>375</sup> ICM complains that the U.S. Government requested that the ICANN Board “provide a proper process and adequate additional time for concerns to be voiced and addressed before any additional action takes place.”<sup>376</sup> But ICM does not explain why ICANN should have ignored the fact that governments (including the U.S. government) wanted more of a “process” in the evaluation of sTLDs. Moreover, even if the U.S. Government did change its mind, as ICM alleges, it could not possibly be improper for ICANN to consider the government's new views (and certainly could not constitute a violation of ICANN's Bylaws or Articles of Incorporation).<sup>377</sup> Even ICM recognizes that ICANN could not and should not have simply “ignore[d] the demands of the U.S.

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<sup>373</sup> Letter from Stuart Lawley, ICM, to Paul Twomey, ICANN, August 15, 2005, *available at* <http://www.icann.org/correspondence/lawley-to-twomey-15aug05.pdf> (last visited May 5, 2009), attached hereto as ICANN Exhibit S.

<sup>374</sup> *Id.* Notably, if ICM truly believed that the Board already had approved the sTLD in June 2005, this would have been a good opportunity for ICM to say so. Instead, ICM asked for extra time to address the concerns that surfaced immediately *after* the Board's June 2005 vote. Special Meeting of the Board, Preliminary Report, August 16, 2005, *available at* <http://www.icann.org/minutes/resolutions-16aug05.htm> (last visited *date*) (“XXX was deferred in response to requests from the applicant ICM, as well as the ICANN Government Advisory Committee Chairman's and the US Department of Commerce's request to allow for additional time for comments by interested parties.”), attached hereto as ICANN Exhibit AQ.

<sup>375</sup> ICM Memorial, ¶¶ 206-12.

<sup>376</sup> *Id.* at ¶ 207.

<sup>377</sup> *See* ICM Memorial ¶ 208.

government.”<sup>378</sup> And ICM never explains how listening to the views of the U.S. Government possibly could amount to a violation of ICANN’s Bylaws or Articles.

**b. Concerns Raised During ICANN’s September 15, 2005 Board Meeting.**

245. By the time of the Board’s September 2005 meeting, although there remained unresolved concerns dealing with, among other things, sponsorship and content issues relating to child pornography, ICM’s counsel Ms. Burr requested that the Board put the existing draft of the proposed .XXX sTLD registry agreement to a vote of the Board.<sup>379</sup> At the September 15, 2005 meeting, the Board agreed to vote on ICM’s application, doing so after a “lengthy discussion” regarding the sponsorship criteria, the application and additional supplemental materials, and the specific terms of ICM’s proposed registry agreement.<sup>380</sup> The primary concern of many Board members was that the proposed registry agreement did not match up to the promises made in ICM’s application. The Board therefore did not approve the contract, but instead voted, 11-0, to authorize further negotiations:

Resolved (05.75), that the ICANN President and General Counsel are directed to discuss possible additional contractual provisions or modifications for inclusion in the .XXX Registry Agreement, to ensure that there are effective provisions requiring development and implementation of policies consistent with the principles in the ICM application. Following such additional discussions, the President and General Counsel are requested to return to the board for additional approval, disapproval or advice.<sup>381</sup>

246. Although ICM now claims that ICANN “made no mention of any concern that the application had not met the sponsorship or other RFP criteria” in its September 15, 2005 resolution,<sup>382</sup> the evidence is to the contrary. The resolution reflected the concerns expressed

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<sup>378</sup> ICM Memorial ¶ 211.

<sup>379</sup> See Letter from Stuart Lawley, ICM, to Vinton Cerf, ICANN, September 15, 2005, attached as Confidential Exhibit I to ICANN’s First Brief: Hours before the September 15, 2005 Board Meeting, ICM “request[ed] that the ICANN Board take the next step and approve the registry agreement without further delay.” See also P. Twomey Witness Statement, ¶ 43.

<sup>380</sup> See ICANN Minutes, Special Meeting of the Board, September 15, 2005, Cl. Ex. 119 (“after a lengthy discussion involving nearly all of the directors regarding the sponsorship criteria....”).

<sup>381</sup> *Id.*

<sup>382</sup> ICM Memorial ¶ 217.

during the September 15 Board meeting, namely “the lengthy discussion involving nearly all of the directors regarding the sponsorship issue.”<sup>383</sup> Moreover, as the resolution makes clear, contract language had to be negotiated that satisfied the Board’s concerns regarding sponsorship for “development and implementation of policies [for .XXX]” (and other principles in the ICM application”) before ICM’s sTLD .XXX application could be approved.

**c. At The Vancouver Meeting, ICM Made A Presentation To The GAC Promising Public Interest Benefits Of The Proposed .XXX sTLD.**

247. The GAC and ICANN met in Vancouver, Canada, on November 29, 2005, to discuss Mr. Tarmizi’s July 2005 statement that the “GAC could still advise ICANN about the .XXX proposal, should it decide to do so. However, no member [of the GAC] ha[d] yet raised this as an issue for formal comments to be given to ICANN in the Communiqué.”<sup>384</sup> The day before the Vancouver meeting, ICANN posted on its website a status report on the sTLD evaluation process.<sup>385</sup> With respect to ICM’s proposal for the .XXX sTLD, the status report noted that “[t]he sponsorship/community value team found that the relevant selection criteria had not been met,” and the report cited: (1) “[t]he extreme variability in definitions of what constitutes the [adult] content which defines this community,” (2) uncertainty as to the interests of the proposed community, and (3) a lack of support among users and members of the community, including those outside North America.<sup>386</sup>

248. At the conclusion of the November 29, 2005 meeting between the GAC and ICANN, ICM made a presentation to the GAC in which ICM promised “a range of public interest benefits” in support of its .XXX sTLD application.<sup>387</sup>

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<sup>383</sup> See ICANN Minutes, Special Meeting of the Board, September 15, 2005, Cl. Ex. 119 (“after a lengthy discussion involving nearly all of the directors regarding the sponsorship criteria....”).

<sup>384</sup> Minutes of GAC Meeting 22, held in Luxembourg from July 11-12, 2005, dated November 23, 2005, Cl. Ex. 139).

<sup>385</sup> See Status Report on the sTLD Evaluation Process, November 28, 2005, *available at* <http://icann.org/tlds/stld-apps-19mar04/stld-status-report.pdf> (last visited May 5, 2009), attached hereto as ICANN Exhibit AR.

<sup>386</sup> *Id.*

<sup>387</sup> GAC Communiqué – Wellington, New Zealand, March 28, 2006, Cl. Ex. 181 (“In its application, supporting materials and presentation to the GAC in November 2005, ICM Registry promised a range of

249. After the meeting, the GAC requested from the ICANN Board an explanation of the process used in the sTLD round of applications and in particular the .XXX application. On February 11, 2006, Dr. Twomey wrote to Mr. Tarmizi in response to this request. Dr. Twomey explained the difference between the “proof of concept” round of applications in 2000 and the sTLD round of applications and emphasized that the passing over of ICM and other applicants in favor of the seven gTLDs chosen in the “proof of concept” round did not constitute a permanent rejection of those TLDs by the ICANN Board.<sup>388</sup> The letter also underscored that, notwithstanding the decision to proceed to contract negotiations with any applicant, “it is the ICANN Board that has the authority to decide, upon the conclusion of technical and commercial negotiations, whether or not to approve the creation of a new sTLD.”<sup>389</sup>

**d. Concerns Raised In The Wellington Communiqué.**

250. As the time approached for the ICANN Board’s March 31, 2006 meeting in Wellington, New Zealand, several GAC member countries had raised concerns regarding the public policy issues implicated by the .XXX sTLD application. Sweden, Brazil, the European Commission, and the United States were among those member countries raising concerns.<sup>390</sup>

251. After extensive meetings and discussions among 33 members over the course of several days, the GAC issued its “Wellington Communiqué” on March 28, 2006, stating the “emphatic[] oppos[ition]” of several of its members to the .XXX sTLD from a public policy

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(continued...)

public interest benefits as part of its bid to operate the .xxx domain.”); *See also* GAC Meeting Agenda, Vancouver, Canada, November 27 to December 1, 2005, *available at* [http://old.gac.icann.org/web/meetings/mtg23/VANCOUVER\\_AGENDA.doc](http://old.gac.icann.org/web/meetings/mtg23/VANCOUVER_AGENDA.doc) (Presentation of ICM (.xxx) Registry on November 29, 2005) (last visited May 5, 2009), attached hereto as ICANN Exhibit AS.

<sup>388</sup> Letter from Paul Twomey, ICANN, to Mohamed Sharil Tarmizi, GAC Chairman, May 4, 2006, Cl. Ex. 188.

<sup>389</sup> *Id.*

<sup>390</sup> *See, e.g.*, Letter from Marcelo de Carvalho Lopes to Mohamed Sharil Tarmizi, September 6, 2005, Cl. Ex. 167; *see also* Letter from Peter Zangl to Vinton Cerf, September 16, 2005, Cl. Ex. 172; Letter from Jonas Bjelfvenstam to Paul Twomey, November 23, 2005, Cl. Ex. 168; Letter from Michael D. Gallagher to Vinton Cerf, August 11, 2005, Cl. Ex. 162.

perspective.<sup>391</sup> Those concerns included: (1) “appropriate measures to restrict access to illegal and offensive content,” (2) “the development of tools and programs to protect vulnerable members of the community,” (3) the means to “[m]aintain accurate details of registrants and assist law enforcement agencies to identify and contact the owners of particular websites,” and (4) “[a]ct[ions] to ensure the protection of intellectual property and trademark rights, personal names, country names, names of historical, cultural and religious significance and names of geographic identifiers . . . .”<sup>392</sup>

252. In addition, some countries were concerned that, because the .XXX application would not require all pornography to be located within the .XXX domain, a new .XXX sTLD would simply result in the expansion of the number of domain names that involved pornography.<sup>393</sup> Indeed, ICM had confirmed that it could not require migration of pornography sites from .com and other TLDs to .XXX, which created a concern that a new TLD devoted exclusively to pornographic sites would do little more than expand the number of pornography websites available on the Internet without imposing any restrictions on the sites that were maintained at .com and other TLDs.

253. The GAC also requested a written explanation from the Board on how the .XXX sTLD application could satisfy the sponsored community and public interest criteria, noting that ICM’s proposed draft registry agreement had not, to date, addressed the “range of public interest benefits” that had been promised in its application and November 29, 2005 presentation to the GAC.<sup>394</sup>

254. On May 4, 2006, Dr. Twomey wrote again to Mr. Tarmizi in response to the GAC’s request in the Wellington Communiqué for information about the Board’s decision to proceed with several sTLD applications, notwithstanding negative reports from the independent

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<sup>391</sup> GAC Communiqué – Wellington, New Zealand, March 28, 2006, Cl. Ex. 181.

<sup>392</sup> *Id.*

<sup>393</sup> P. Twomey Witness Statement, ¶ 50.

<sup>394</sup> GAC Communiqué – Wellington, New Zealand, March 28, 2006, Cl. Ex. 181.



evaluation teams. As the letter explained, “the Board decision as to the .XXX application [wa]s still pending.”

The decision by the ICANN Board during its June 1, 2005 Special Board Meeting reviewed the criteria against the materials supplied and the results of the independent evaluations. After additional consultation with ICM, the board voted to authorize staff to enter into contractual negotiations without prejudicing the Board’s right to evaluate the resulting contract and to decide whether it meets all of the criteria before the Board including public policy advice such as might be offered by the GAC. ***The final conclusion on the Board’s decision to accept or reject the .XXX application has not been made and will not be made until such time as the Board either approves or rejects the registry agreement relating to the .XXX application.*** In fact, it is important to note that the Board has reviewed previous proposed agreements with ICM for the .XXX registry and has expressed concerns regarding the compliance structures established in those drafts.<sup>395</sup>

255. Dr. Twomey also explained that the Board allowed those applicants (such as ICM) that the Evaluation Panel had not viewed as having satisfied the sponsorship criteria to present additional supporting documentation directly to the Board for review and consideration. Although in the case of .XXX, as well as others, “the additional materials provided sufficient clarification to proceed with contractual discussions, the Board still expressed concerns about whether the applicant met all of the criteria, but took the view that such concerns could possibly be addressed by contractual obligations to be stated in a registry agreement.”<sup>396</sup>

256. In revising its proposed registry agreement to address the GAC’s concerns regarding the “range of public interest benefits” that had been promised in its application and presentation, as ICM knew it must, ICM took the position that it would install “appropriate measures to restrict access to illegal and offensive content,” including monitoring such content globally.<sup>397</sup> This was immediately controversial among many ICANN Board members because complaints about ICM’s “monitoring” would inevitably be sent to ICANN, which is neither

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<sup>395</sup> Letter from Paul Twomey, ICANN, to Mohamed Sharil Tarmizi, GAC Chairman, May 4, 2006, Cl. Ex. 188 (emphasis added).

<sup>396</sup> *Id.*

<sup>397</sup> GAC Communiqué – Wellington, New Zealand, March 28, 2006, Cl. Ex. 181; *see also* V. Cerf Witness Statement, ¶ 37.

equipped nor authorized to monitor (much less resolve) “content-based” objections to Internet sites.<sup>398</sup>

257. ICM did not do anything to address the sponsorship concerns raised in the Wellington Communiqué or the monitoring issues created by ICM in the draft registry agreement. Instead, ICM insisted that the Board vote on the draft agreement as it existed at that time without making further changes to accommodate the concerns that had been expressed.<sup>399</sup>

**e. Concerns Raised During The May 10, 2006 And February 12, 2007 Board Meetings.**

258. During the ICANN May 10, 2006 Board meeting, the Board conducted a lengthy discussion concerning the sponsorship issue for the .XXX sTLD and then voted 9-5 against ICM’s then-current draft of the proposed .XXX sTLD registry agreement.<sup>400</sup>

259. By this time, some Board members had concluded that ICM’s registry agreement would not be able to yield the results that ICM had predicted and that the Board had requested. For instance, Board member Hagen Hultzsch voted against the proposed agreement because “the negotiations didn’t produce the required and expected results.”<sup>401</sup> Board member Alejandro Pisanty asserted that he did not believe “the agreement as stated [had] built-in structural guarantees that the conditions and representations made by ICM can be fulfilled. Many of them are not so because of any fault of ICM itself, but because of the complexities of developing them further in an international, multilingual, and multicultural environment.”<sup>402</sup> Dr. Cerf commented

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<sup>398</sup> V. Cerf Witness Statement, ¶ 37; *see also* ICANN Meeting Minutes for Special Meeting of the Board, April 18, 2006, Cl. Ex. 186 (The ICANN Board discussed their concerns about the manner in which ICM guaranteed compliance by the registry operator and whether the right level of policy enforcement processes were in place within the proposed agreement to respond to a community as complex as the adult entertainment community. Concerns were also expressed about how to implement the proposed compliance process and whether ICANN was structured to respond to the proposed process.).

<sup>399</sup> ICANN Minutes, Special Meeting of the Board, April 18, 2006, Cl. Ex. 186 (Dr. Cerf noting “the desire of ICM to have an up or down vote” at the May 10, 2006 meeting).

<sup>400</sup> ICANN Minutes, Special Meeting of the Board, May 10, 2006, *available at* <http://www.icann.org/en/minutes/minutes-10may06.htm> (last visited May 5, 2009), attached hereto as ICANN Exhibit T.

<sup>401</sup> *Id.*

<sup>402</sup> *Id.*

that he was voting against the agreement because he “no longer believe[d] it’s possible for ICM to achieve the conditions and recommendations that the GAC has placed before [the Board] as a matter of public policy and that the terms of the contract do not assure any of those – the ability of ICM to provide the protections that are requested.”<sup>403</sup> And Board member Vanda Scartezini, who had voted in favor of authorizing staff to enter contract negotiations with ICM in June 2005, now voted against the proposed agreement because “the contract language did not come with the guarantee that [she had] expected.”<sup>404</sup>

260. ICM criticizes these views of individual members of the Board, but there is no doubt that the members took their responsibilities seriously and analyzed the issues with care. And more importantly, whether or not the Board members “got it right” is irrelevant for purposes of determining whether the Board violated its Bylaws or Articles in rejecting ICM’s application.

261. Moreover, prominent members of the online adult entertainment industry, including Larry Flynt Publications and Wicked Pictures, had begun to voice opposition to ICM’s application, and tension between these firms and IFFOR, ICM’s proposed Sponsoring Organization, was growing.<sup>405</sup> This growing opposition led many Board members to conclude that ICM could not satisfy the sponsorship criteria and in fact did not even have a “community” that supported the application, which was one of the original concerns of the Evaluation Panel two years earlier.<sup>406</sup>

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<sup>403</sup> *Id.*

<sup>404</sup> *Id.*

<sup>405</sup> See Letter from Larry Flynt to ICANN Board, April 30, 2006, *available at* <http://www.icann.org/correspondence/flynt-to-board-30apr06.jpg> (last visited May 5, 2009), attached hereto as ICANN Exhibit AT; *see also* Letter from Steve Orenstein, Wicked Pictures, to ICANN, April 10, 2006, *available at* <http://www.icann.org/correspondence/orenstein-to-board-10apr06.jpg> (last visited May 5, 2009) (expressing Wicked Pictures’ “profound opposition to the establishment of a .XXX” sTLD), attached hereto as ICANN Exhibit AU; *see also* Letter from Johan Gillborg, Private Media Group, to ICANN, March 22, 2006, *available at* <http://www.icann.org/correspondence/gillborg-to-board-22mar06.pdf> (last visited May 5, 2009) (expressing Private Media Group’s opposition to the creation of the .XXX sTLD and its belief that there is no compelling reason to establish such TLD), attached hereto as ICANN Exhibit AV.

<sup>406</sup> P. Twomey Witness Statement, ¶ 56.

262. Indeed, ICM's application unnaturally described the Sponsored TLD Community only using the future tense. Unlike with the other sTLD applicants, it was clear that a community did not yet exist separate and apart from the proposed .XXX sTLD itself. Instead, ICM asserted that the sponsoring community would emerge once the .XXX sTLD was approved, but this circular approach to the sponsorship requirement was fundamentally at odds with the RFP.<sup>407</sup>

263. The Board's May 10, 2006 vote rejected ICM's then-current draft of the proposed .XXX sTLD registry agreement. Nonetheless, the Board did not deny ICM's application in its entirety at that time, but instead provided ICM yet another opportunity to attempt to revise the agreement to conform to the RFP specifications. Notably, the Board's decision to allow ICM to continue to work the problem is directly at odds with ICM's position that the Board had decided "for political reasons" to reject ICM's application; if so, it would have been much easier for the Board to reject ICM's application in its entirety in 2006. And giving ICM another opportunity obviously does not constitute a violation of ICANN's Bylaws.

264. Throughout the rest of 2006, ICANN staff and ICM worked on additional revisions to the draft registry agreement in an attempt to address the concerns regarding the sponsorship requirements, among others. On January 5, 2007, a revised agreement was posted for public comment.

265. After the agreement was posted, ICANN staff and ICM negotiated additional clarifying language to Appendix S of the revised agreement, which was critical to the sponsorship analysis.<sup>408</sup> Appendix S, *inter alia*, identified the purpose for which .XXX would be

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<sup>407</sup> Compare New sTLD application, Part A. Explanatory Notes – Sponsorship Information – Definition of Sponsored TLD Community, December 15, 2003, Cl. Ex. 45 ("Applicants must demonstrate that the Sponsored TLD Community is precisely defined, so it can readily be determined which persons or entities make up that community.") with New sTLD RFP application, .XXX, Part B. Application Form, available at <http://www.icann.org/en/tlds/stld-apps-19mar04/xxx.htm> (last visited May 5, 2009) (defining the .XXX Sponsored TLD Community as self-selecting and "intended primarily to serve the needs of the global online adult-entertainment community"), attached hereto as ICANN Exhibit O.

<sup>408</sup> ICM argues incorrectly that Appendix S provided only "slight revisions." See ICM Memorial ¶ 257. In fact, Appendix S provided key clarifying language to the registry agreement, particularly with respect to sponsorship issues.

delegated and the community to be served by its delegation, a description of the sTLD community, and relevant information regarding how the .XXX Registry would be operated. Appendix S was thereafter posted for public comment.

266. After the public comment period closed, the Board's next meeting was held on February 12, 2007. During this meeting, the Board reviewed the recently posted public comments on the revised agreement, including Appendix S. The vast majority of comments were opposed to the introduction of the .XXX sTLD, prompting many Board members to reiterate the concern that ICM's proposed .XXX sTLD lacked the broad-based support of the community ICM intended to represent. Indeed, *77% of the comments posted to the public forum were opposed to ICM's .XXX sTLD.*<sup>409</sup> Only 16% expressed support.<sup>410</sup>

267. Despite such evidence of splintering community support, the Board did not deny ICM's application in February 2007. Instead, the Board unanimously approved a resolution directing ICANN staff to further consult with ICM in an effort to facilitate the Board's upcoming decision of whether the sponsorship criteria could be met for the creation of a new .XXX sTLD.<sup>411</sup>

**f. ICM Failed To Address The Board's Concerns, As Made Clear In The Board's March 30, 2007 Denial Of The Proposed .XXX sTLD.**

268. On March 30, 2007, the Board voted 9-5 (with one abstention and one absent Board member) to reject ICM's revised agreement and deny ICM's application for the .XXX sTLD. This vote came after extensive review, analysis, and debate among ICANN Board members, and followed a public presentation and debate during the March 29, 2007 ICANN

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<sup>409</sup> ICANN Minutes, Special Meeting of the Board, February 12, 2007, Cl. Ex. 199.

<sup>410</sup> *Id.*

<sup>411</sup> *Id.* (The Board passed a Resolution directing "ICANN staff [to] consult with ICM and provide further information to the Board prior to its next meeting, so as to inform a decision by the Board about whether sponsorship criteria is met for the creation of a new .XXX sTLD.").

Public Forum among representatives of the adult entertainment industry who opposed the application and those who were in favor.<sup>412</sup>

269. The primary factors that influenced the nine members who voted against ICM’s application can be summarized in five respects.

270. *First*, the RFP required applicants to “demonstrate that the Sponsored TLD Community is: Precisely defined, so it can readily be determined which persons or entities make up that community....”<sup>413</sup> Several Board members determined that ICM could not satisfy this criterion, despite having had ample opportunity to do so throughout the contract negotiations. Ultimately, ICM’s proposed sponsored community definitions were circularly defined to include only those members of the online adult entertainment industry who *supported* the creation of the .XXX sTLD, and thus by definition excluded all online adult entertainment industry members who opposed ICM’s application. Such self-selection and extreme subjectivity regarding what constituted the content that defined the .XXX community made it nearly impossible to determine which persons or services would be in or out of the community.<sup>414</sup> Moreover, the definition of “adult entertainment” varies considerably from region to region and culture to culture, depending on one’s moral, religious, national, or cultural perspective, such that there was not a global definition that could be applied to the .XXX sTLD community.

271. ICM was first apprised of this concern by the Evaluation Panel in its rejection of ICM’s .XXX application on August 27, 2004.<sup>415</sup> Despite its efforts, ICM was unable to cure this critical defect. Several Board members, in adhering to the RFP criteria – obviously not a

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<sup>412</sup> ICANN Meetings in Lisbon, Portugal, Transcript of ICANN Public Forum, March 29, 2007, *available at* <http://www.icann.org/en/meetings/lisbon/transcript-public-forum-29mar07.htm> (last visited May 5, 2009), attached hereto as ICANN Exhibit AW; *See also* Meeting of the Board, Transcript, March 30, 2007, Cl. Ex. 201.

<sup>413</sup> New sTLD application, December 15, 2003, Part A. Explanatory Notes – Sponsorship Information – Definition of Sponsored TLD Community, Cl. Ex. 45.

<sup>414</sup> ICM admits as much in its Memorial: “Since membership in the [.XXX] community would be voluntary, registrants would only become members after affirmatively identifying themselves as responsible providers of adult content....” ICM Memorial ¶ 148.

<sup>415</sup> ICANN, New sTLD applications, Appendix D: Evaluation Reports, August 27, 2004, p. 95, Cl. Ex. 110.

violation of ICANN’s Bylaws or Articles – ultimately voted against ICM’s application because ICM failed to satisfy this fundamental sponsorship requirement.<sup>416</sup> In short, without a precisely defined Sponsored TLD Community, the Board could not approve ICM’s sTLD application.

272. *Second*, the RFP required that the Sponsored TLD Community be “[c]omprised of persons that have needs and interests in common but which are differentiated from those of the general global Internet community.”<sup>417</sup> While on its face ICM’s sponsored community appeared to have common needs and interests, some Board members deemed that the revised agreement posted in 2007 failed to meet this portion of the RFP specification because of its selective membership. The sponsored community as defined by ICM was simply a subset of all online adult entertainment providers, and ICM never provided any documentation or information that the excluded providers had separate needs or interests from the sponsored community it sought to represent. Online adult entertainment providers, whether they seek the type of self-regulation proffered by ICM or not, all face issues of privacy, free expression and child protection, among others. Thus, as contract negotiations progressed, it became increasingly evident that ICM was simply proposing an *unsponsored* TLD for adult entertainment – a uTLD, disguised as an sTLD, just as ICM had proposed in 2000.

273. *Third*, the RFP required ICM to “demonstrate broad-based support from the community it is intended to represent.”<sup>418</sup> The RFP was phrased in the present tense, such that to satisfy the RFP criteria, ICM had to show “evidence of broad-based support from the Sponsored TLD Community for the sTLD, for the Sponsoring Organization, and for the proposed policy-formulation process,” *at all times*.<sup>419</sup>

274. Whatever community support ICM may have had at one time, however, had fallen apart by early 2007. As noted above, during the final public comment period from January 5,

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<sup>416</sup> P. Twomey Witness Statement, ¶¶ 57, 63; V. Cerf Witness Statement, ¶ 38; A. Pisanty Witness Statement, ¶ 23.

<sup>417</sup> New sTLD application, December 15, 2003, Part A. Explanatory Notes – Sponsorship Information – Definition of Sponsored TLD Community, Cl. Ex. 45.

<sup>418</sup> *Id.* at Part A. Explanatory Notes – Sponsorship Information – Level of Support from the Community, Cl. Ex. 45.

<sup>419</sup> *Id.*

2007 to February 5, 2007, a vast majority of the comments posted to the public forum and sent to ICANN staff opposed ICM's .XXX sTLD. ICM was not able to provide evidence that the larger online adult entertainment provider community supported the .XXX sTLD, ICM, or the policy-formation process. Even those who had initially supported the sTLD began to change their minds.

275. For example, support from major child advocacy organizations and major law enforcement organizations was absent. There was also insufficient support from the freedom of expression community, which ICM had initially hoped to include as a supporting organization. Indeed, the free expression advocates came out *against* the .XXX sTLD out of fear that it would provide a mechanism either to over-define the realm of adult entertainment and/or to force all adult-related content to the .XXX sTLD.<sup>420</sup> For example, at the March 29, 2007 ICANN public forum, Ms. Diane Duke, the executive director for the Free Speech Coalition, a U.S. based trade association for the adult entertainment industry with membership worldwide, stated:

First of all, I would like to thank the ICANN board for allowing us this time to speak, and to speak of our concerns of the dot xxx sponsored top-level domain.

Let me be clear. As the only trade association for the adult entertainment industry, we represent the sponsorship community. It is our organization that sued the United States government on behalf of the industry and won in the U.S. Supreme Court.

It was our organization that ICM itself came to five years ago offering a portion of the proceeds from the sTLD in return for our support of their proposed domain.

ICM recognized us as the representative for the sponsorship community even then.

Today, we are here because the adult entertainment community believes that the views of the industry are being misrepresented on the issue of the dot xxx sponsored top-level domain.

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<sup>420</sup> See, e.g., Comments at <http://forum.icann.org/lists/xxx-icm-agreement/msg00526.html> (last visited May 5, 2009) (.XXX sTLD poses serious free speech challenges), attached hereto as ICANN Exhibit AX; <http://forum.icann.org/lists/xxx-icm-agreement/msg00453.html> (last visited May 5, 2009) (same), attached hereto as ICANN Exhibit AY; <http://forum.icann.org/lists/xxx-icm-agreement/msg00609.html> (last visited May 5, 2009) (Free Speech Coalition opposes creation of .XXX sTLD), attached hereto as ICANN Exhibit AZ.



Let me be clear. The adult entertainment industry, the sponsorship community, not only does not support ICM's proposal but it actively opposes the creation of a dot xxx top-level domain.

Five years ago when ICM approached the free speech coalition with a proposal that could increase our income by tenfold, we turned down that, recognizing the negative ramification that dot xxx [TLD] would have for the industry.

Today industry leaders as well as small webmasters have joined together not only to publicly oppose the creation of a dot xxx TLD but also to fund our trip to this conference, ensuring that their opposition is clearly communicated to the people who will be making this critical decision.

ICM will tell you that it already has met the obligation of sponsorship. Through interest received early in the process before some of the details and dangers had been made apparent and when financial wind falls were promised to many, ICM claimed to have industry support.

Support no longer exists.<sup>421</sup>

276. While there was some (mixed) support for a .XXX sTLD from North American representatives of the adult industry, there did not appear to be much, if any, support from the Internet community (adult entertainment or otherwise) outside of the United States. ICM admits that community support outside of North America was limited to “members from the United Kingdom, Australia, Netherland Antilles, Spain and the Caribbean.”<sup>422</sup> This hardly constitutes “broad-based support” as required by the RFP.<sup>423</sup>

277. With inadequate evidence that the relevant community (even assuming it was clearly defined, which it was not) actually sought, much less supported, the services that ICM

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<sup>421</sup> ICANN Meetings in Lisbon, Portugal, Transcript of ICANN Public Forum, March 29, 2007, *available at* <http://www.icann.org/en/meetings/lisbon/transcript-public-forum-29mar07.htm> (last visited May 5, 2009), attached hereto as ICANN Exhibit AW.

<sup>422</sup> Confidential Exhibit – Formal Response to ICANN’s Independent Evaluation Report on .XXX sTLD, from Stuart Lawley, ICM, to Kurt Pritz, ICANN, October 9, 2004, attached to ICANN’s Opening Brief as Confidential Exhibit F; *See also* ICANN, New sTLD applications, Appendix D: Evaluation Reports, August 27, 2004, p. 95, Cl. Ex. 110 (“There was considerable support from North American representatives of the adult industry. However, virtual[ly] no support was available from the rest of the world, or from users or other members of this community.”).

<sup>423</sup> New sTLD application, December 15, 2003, Part A. Explanatory Notes – Sponsorship Information – Level of Support from the Community, Cl. Ex. 45.

proposed to offer, the Board plainly was justified in denying ICM's application for failure to satisfy the RFP sponsorship selection criteria. And, with due apologies to the Panel for the repetition of the point, there truly is no basis for a finding that the Board violated its Bylaws or Articles in rejecting the .XXX application after finding that there was no "community" that supported the sponsored TLD.

278. *Fourth*, ICM could not demonstrate that it was adding new and valuable space to the Internet name space, as required by the RFP. To the extent that online adult service providers chose not to register within the .XXX sTLD (and the opposition to the sTLD made clear that there would be many), the .XXX sTLD would represent merely a duplicate space on the Internet. In fact, the existence of industry opposition to the .XXX sTLD demonstrated that the needs of online adult entertainment industry members were met via existing TLDs without any need for a new sTLD. Further, the increasing governmental opposition suggested that there might be massive blocking of the .XXX sTLD by individual nations, which further demonstrated a lack of broad geographic scope as the RFP required.<sup>424</sup>

279. *Fifth and finally*, in the February 2007 revised draft agreement, ICM undertook certain commitments regarding policy development and stakeholder protection, including the delegation of issues of "Best Business Practices." Specifically, ICM provided that it will establish "policy development procedures and mechanisms" that include "sufficient opportunity for public comment and input from concerned and affected groups," including procedures that "support informed participation reflecting the functional, geographic, and cultural diversity of the responsible online adult entertainment community and the broader Internet stakeholders at all levels of policy development and decision making."<sup>425</sup> As part of its commitment to resolve global concerns, ICM and its supporting organization, IFFOR, proposed to "proactively reach

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<sup>424</sup> New sTLD application, December 15, 2003, Part A. Explanatory Notes – Community Value – Enrichment of Broad Global Communities, Cl. Ex. 45.

<sup>425</sup> ICM Registry LLC, Appendix S, February 8, 2007, *available at* <http://www.icann.org/en/tlds/agreements/xxx/appendix-S-rev-16feb07.pdf> (last visited May 5, 2009), attached hereto as ICANN Exhibit BA.

out to governments and international organizations to provide information about IFFOR’s activities and solicit input and participation.”<sup>426</sup>

280. Such measures diluted the possibility that the policies would be “primarily in the interests of the Sponsored TLD Community,” as required by the sponsorship selection criteria, because the measures specifically obligated ICM to seek input from multiple governments and organizations on local concerns, which added yet another non-community voice to the policy formulation aspect. And with the inclusion of multiple governments in the policy-making process, ICM ran the specific risk of needing to tailor its policies to conform to the varying legal requirements of the countries, some of which may run counter to the interests of the sponsored community. Moreover, the process by which ICM proposed to address “geography and cultural diversity” and seek foreign input was not clearly defined in the revised registry agreement, which abrogated the RFP requirement for clear definition of the policy-setting mechanisms.<sup>427</sup>

281. In short, despite the good-faith efforts of both ICANN and ICM over a lengthy period of time, the majority of the Board determined that ICM could not satisfy, among other things, the sponsorship requirements of the RFP. The sTLD was controversial worldwide, and no consensus had emerged as to how ICM could address the concerns of the many who had questioned the value of the sTLD. ICANN gave ICM numerous opportunities to demonstrate that the .XXX sTLD could satisfy the criteria set forth in the RFP, but in the end, the majority of the Board was not satisfied that the problems had been adequately addressed. Reasonable people might disagree – including the five members of ICANN’s Board who voted in favor of ICM’s application at the March 2007 Board meeting – but that disagreement does not even approach a violation of a Bylaw or Article of Incorporation. Instead, ICM simply challenges the ultimate outcome, but disagreement with a Board vote does not translate into a “lack of transparency” or “unequal treatment.” It simply means ICM and a majority of the ICANN Board disagreed – nothing more complicated or nefarious than that.

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<sup>426</sup> *Id.*

<sup>427</sup> New sTLD application, December 15, 2003, Part A. Explanatory Notes – Sponsorship Information – Appropriateness of the Sponsoring Organization and the Policy Formulation Environment, Cl. Ex. 45.

**4. ICANN Ultimately Rejected ICM’s Application Due To Its Failure To Satisfy The Sponsorship Criteria, Not Because Of “Vague And Previously Unannounced” Notions Of Public Policy.**

282. ICM claims that ICANN ultimately rejected ICM’s application because of “vague and previously unannounced” public policy concerns and based on a “different definition of the sponsorship criteria.”<sup>428</sup> There is no question that a number of Internet stakeholders raised public policy issues with respect to the overall implications of a .XXX sTLD. There also is no question that ICANN considered the concerns of the GAC, the U.S. Department of Commerce, and the European Commission, among others. Public policy concerns may have played a role in the overall context of the debate, but those concerns were appropriately considered by the Board because it was required under the Bylaws to consider the GAC’s advice. Although the Board’s decision is entitled to substantial deference in view of ICANN’s good faith and robust debate on the issue, ICANN nevertheless has demonstrated in this Response that the Board’s decision was prudent and consistent with its obligations, including its Bylaws and Articles of Incorporation.

**a. The Sponsorship Criteria Were Consistently Applied.**

283. ICM claims that ICANN changed the definition of a sponsored community to require that ICM have the full support of everyone who might possibly be a community member,<sup>429</sup> and that this amounted to a “new and different definition of the sponsorship criteria.”<sup>430</sup> ICM is wrong, as detailed above in Section III.B.3: the ICANN Board carefully applied the RFP’s sponsorship criteria and ultimately determined that ICM failed to satisfy the fundamental sponsorship requirements.

284. The original RFP called for a “[e]vidence of *broad-based support* from the Sponsored TLD Community for the sTLD.”<sup>431</sup> ICM did not come close to satisfying this requirement. Although support for the .XXX sTLD seemed to ebb and flow, by February 2007,

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<sup>428</sup> ICM Memorial ¶¶ 369-77.

<sup>429</sup> *Id.* at ¶ 375.

<sup>430</sup> *Id.*

<sup>431</sup> New sTLD application, December 15, 2003, Part A. Explanatory Notes – Sponsorship Information – Definition of Sponsored TLD Community, Cl. Ex. 45 (emphasis added).

77% of the comments posted on ICANN's public forum were opposed to ICM's .XXX sTLD.<sup>432</sup> Of the various commentators, 88 identified themselves as "webmasters of adult content, of whom 74% were opposed to the creation of ICM's .XXX sTLD."<sup>433</sup> Further, prominent members of the adult entertainment industry, including Larry Flynt Publications and AVN Media Network, were adamantly opposed to the creation of the .XXX sTLD.<sup>434</sup>

285. ICM argues that it had support from the proposed community because ICM received 75,000 pre-registrations for .XXX.<sup>435</sup> Out of the over 4.2 million adult content websites in operation,<sup>436</sup> this tiny number (less than 2%) hardly represents the "broad based support" required under the sponsorship criteria.

286. Further, the view of ICM's expert, Dr. Mueller, that the sponsorship criteria were somehow inconsistently applied is impossible to reconcile with the facts.<sup>437</sup> There is no doubt that the majority of the Board determined, among other things, that ICM failed to meet the baseline sponsorship criteria laid out in the original RFP. Notwithstanding Dr. Mueller's unhappiness with the "institutional structure" of ICANN, the Board consistently applied the sponsorship criteria and did not violate its Bylaws in so doing. ICM simply second-guesses the

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<sup>432</sup> ICANN Minutes, Special Meeting of the Board, February 12, 2007, Cl. Ex. 199.

<sup>433</sup> *Id.*

<sup>434</sup> See, e.g., Letter from L. Flynt, Flynt Management Group, LLC, to ICANN, April 30, 2006, available at <http://www.icann.org/correspondence/flynt-to-board-30apr06.jpg> (last visited May 5, 2009), attached hereto as ICANN Exhibit AT; see also Letter from Steve Orenstein, Wicked Pictures, to ICANN, April 10, 2006, available at <http://www.icann.org/correspondence/orenstein-to-board-10apr06.jpg> (last visited May 5, 2009) (expressing Wicked Pictures' "profound opposition to the establishment of a .XXX" sTLD), attached hereto as ICANN Exhibit AU; see also Letter from Johan Gillborg, Private Media Group, to ICANN, March 22, 2006, available at <http://www.icann.org/correspondence/gillborg-to-board-22mar06.pdf> (last visited May 5, 2009) (expressing Private Media Group's opposition to the creation of the .XXX sTLD and its belief that there is no compelling reason to establish such TLD), attached hereto as ICANN Exhibit AV.

<sup>435</sup> ICM Memorial ¶ 247.

<sup>436</sup> ICM's President "Mr. Lawley estimates there are four million adult websites, owned by 100,000 webmasters." Tom Pullar-Strecker, The Age, *Once again, US blocks porno domain*, available at <http://www.theage.com.au/articles/2006/03/28/1143441122717.html?from=rss> (last visited May 5, 2009), attached hereto as ICANN Exhibit BB; see also BYU Women's Services and Resources, *National Pornography Statistics*, available at <http://wsr.byu.edu/content/view/2591/> (last visited May 5, 2009), attached hereto as ICANN Exhibit BC.

<sup>437</sup> ICM Memorial, Expert Report of Dr. Milton Mueller § 6.3.

Board's judgment as to whether ICM's .XXX application conformed with the RFP. But even if that judgment were flawed (which it was not), there is no evidence that the Board's decision amounted to a violation of ICANN's Bylaws.

**b. ICANN Ultimately Denied ICM's Application Because It Failed To Satisfy The Sponsorship Criteria.**

287. The Board's rejection of ICM's proposed sTLD application on March 30, 2007 was based largely on ICM's inability to meet the sponsored community requirement, which was the key problem identified in ICM's application from the outset.<sup>438</sup> As then-ICANN Board member Ms. Rodin Johnston (who was not a member of the Board during the earlier discussions concerning ICM's application) noted:

[M]y obligation as a board member is to take a look at this application, this applicant, to look at the sponsorship criteria and the content that has been proposed, when I do that myself, I believe that I am compelled to vote no for this application.

As others have said, I don't believe that this is an appropriate sponsored community. I think it's inappropriate to allow an applicant in any sTLD to simply define out what could potentially be any people that are not in favor of a TLD, and particularly in this case where you define those that aren't in favor of this TLD that are part of the adult webmaster community as irresponsible.

288. The reasoning for additional Board members' votes to deny the .XXX sTLD are presented in Section III.B.3.f, above. As the transcripts made clear, these Board members voted to reject the .XXX sTLD because of ICM's sponsorship shortcomings.

289. Even if "public policy" issues had influenced the Board, ICM could hardly have been surprised by that. The original proposal in 2000 for .XXX had been rejected, in part, because the "controversy surrounding .XXX was great."<sup>439</sup> As events unfolded, the Board's ultimate decision was in accord with the views of ICANN's Evaluation Panel, which noted

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<sup>438</sup> P. Twomey Witness Statement, ¶¶ 57, 63; V. Cerf Witness Statement, ¶ 38; A. Pisanty Witness Statement, ¶ 23.

<sup>439</sup> ICANN Report on TLD Applications: Application of the August 15 Criteria to Each Category or Group, November 9, 2000, *available at* <http://www.icann.org/en/tlds/report/report-iiib1c-09nov00.htm> (last visited May 5, 2009), attached hereto as ICANN Exhibit E; *see also* ICM Memorial, Dr. Elizabeth Williams Witness Statement, ¶ 7 ("It was also obvious from the 2000 'proof of concept' round that an application for an adult content string would be controversial from a public relations standpoint.").

potential public policy issues in its early communications with ICM. For example, the Evaluation Panel asked ICM to explain how it would deal with “various culturally-based definitions” of the relevant content (*i.e.*, pornography).<sup>440</sup> To that end, the Panel ultimately found that “[t]here can be no disagreement about the fact that the definition of such content and the scope of this content category varies considerably depending on one’s moral, religious, national or cultural perspective.”<sup>441</sup>

290. ICM itself recognized the “need for all stakeholders to feel that they have had an adequate and meaningful opportunity to express their views” and in order to “preserve the integrity of the ICANN process.”<sup>442</sup> Thus, in November 2005, ICM made presentations to the GAC in an effort to satisfy the GAC’s public policy concerns by promising, among other things, “public interest benefits” that would flow from the .XXX sTLD.<sup>443</sup> But, as noted in the GAC’s Wellington Communiqué, the public interest benefits promised by ICM during its November 2005 presentation had not yet been included as ICM’s obligations in the proposed .XXX registry agreement. ICM knew, early on, that it had to satisfy the public policy concerns raised in the GAC’s Wellington Communiqué and live up to its own promises of public interest benefits.<sup>444</sup>

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<sup>440</sup> Confidential Exhibit – Evaluation Team Questions for ICM and IFFOR, attached to ICANN’s First Brief as Confidential Ex. A.

<sup>441</sup> ICANN, New sTLD applications, Appendix D: Evaluation Reports, August 27, 2004, p. 95, Cl. Ex. 110.

<sup>442</sup> Letter from Stuart Lawley, ICM, to Paul Twomey, ICANN, August 15, 2005, *available at* <http://www.icann.org/correspondence/lawley-to-twomey-15aug05.pdf> (last visited May 5, 2009), attached hereto as ICANN Exhibit S.

<sup>443</sup> *See* Confidential Exhibit - ICM Slide Presentation, attached to ICANN’s First Brief as Confidential Ex. H.

<sup>444</sup> GAC Communiqué – Wellington, New Zealand, March 28, 2006, Cl. Ex. 181 (“ICM Registry promised a range of public interest benefits as part of its bid to operate the .xxx domain. To the GAC’s knowledge, these undertakings have not yet been included as ICM obligations in the proposed .xxx Registry Agreement negotiated with ICANN.”).

**c. The Fact That the GAC’s Comments Regarding The .XXX sTLD Came After ICM Had Submitted Its Proposal To ICANN Was Not A Basis To Ignore Those Comments.**

291. ICANN rejected ICM’s application due to its failure to satisfy the sponsorship criteria,<sup>445</sup> which were clearly defined and previously announced in the RFP and were known by ICM to be of concern at the outset of and throughout the negotiation of the registry agreement.<sup>446</sup> The fact that those negotiations continued as the GAC expressed its concerns does not alter the fact that the sponsorship concerns were a principal issue.

292. That the GAC did not express views prior to June 2005 certainly was not a basis to ignore the GAC’s views once they were expressed. There appear to have been at least two reasons the GAC did not comment on the .XXX sTLD prior to the June 1, 2005 ICANN Board vote. First, some countries believed (erroneously) that, because ICM’s .XXX *unsponsored* TLD had been rejected in the 2000 “proof of concept” round, it would not be considered in the new sTLD round. Second, because the Evaluation Panel had rejected the .XXX sTLD application for failure to satisfy the sponsorship selection criteria, many countries likely believed that the application would not be allowed to proceed.

293. Whatever the reason for the timing of the GAC’s statements, ICM’s position that ICANN should have disregarded the GAC’s concerns because they were articulated during the so-called “second step” of the process cannot possibly amount to a violation of ICANN’s Bylaws because the Bylaws expressly require the Board to consider the GAC’s opinions, whenever expressed. ICM’s position also depends on a finding that the ICANN Board “finally” approved the .XXX sTLD in June 2005, which did not occur.

294. In addition to expressing public policy concerns, the GAC also noted the sponsorship deficiencies in ICM’s application and proposed registry agreements in each of its communications to ICANN.<sup>447</sup> Amid the GAC’s concerns regarding the sponsorship

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<sup>445</sup> Meeting of the Board, Transcript, March 30, 2007, Cl. Ex. 201.

<sup>446</sup> See New sTLD application, December 15, 2003, Part A. Explanatory Notes – Sponsorship Information, Cl. Ex. 45.

<sup>447</sup> See GAC Communiqué – Vancouver, Canada, December 1, 2005, available at <http://old.gac.icann.org/web/communiques/gac23com.pdf> (last visited May 5, 2009) (“[T]he GAC



deficiencies of ICM's application, and the atmosphere of disintegrating support and opposition among prominent members of the community ICM purported to represent, ICM's speculation that its application was rejected solely due to "vague and previously unannounced" notions of public policy is unfounded. ICM's application was rejected for its failure to satisfy the sponsorship criteria.<sup>448</sup> In addition to its failure to satisfy those baseline criteria, the Board's consideration of public policy concerns raised by the GAC was not only appropriate but required under the Bylaws.

**C. AT EVERY STAGE OF THE EVALUATION PROCESS, ICANN COMPLIED WITH ITS BYLAWS AND ARTICLES IN CONSIDERING AND DENYING ICM'S STLD APPLICATION.**

295. The facts simply do not support ICM's claims that ICANN violated its Bylaws and Articles of Incorporation. The Board's discussions concerning ICM's .XXX sTLD application were open and transparent; its decisions, which are entitled to substantial deference, were made in good faith; the Board did not apply its procedures in a discriminatory manner; and ICM was at all times given substantial opportunities to be heard.

**1. At All Times, ICANN Operated In An Open, Transparent, And Procedurally Fair Manner.**

296. ICM claims that ICANN failed to act openly and transparently and in a procedurally fair manner. ICM's misguided perceptions notwithstanding, all of ICANN's actions were open, transparent, and procedurally fair.

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(continued...)

welcome[s] the decision to postpone the Board's consideration of the .XXX application . . . until such time as the GAC has been able to review the Evaluation Report . . ."), attached hereto as ICANN Exhibit BD; GAC Communiqué – Wellington, New Zealand, March 28, 2006, Cl. Ex. 181 ("The GAC would request a written explanation of the Board decision, particularly with regard to the sponsored community and public interest criteria outlined in the sponsored top level domain selection criteria."); GAC Communiqué – Lisbon, Portugal, March 28, 2007, Cl. Ex. 200 ("The GAC does not consider the information provided by the Board to have answered the GAC concerns as to whether the ICM application meets the sponsorship criteria.").

<sup>448</sup> Meeting of the Board, Transcript, March 30, 2007, Cl. Ex. 201.

**a. ICANN Operated With Openness And Transparency.**

297. ICM alleges that ICANN failed to act openly and transparently by failing to adhere to the selection criteria established in the RFP.<sup>449</sup> Specifically, ICM asserts that (i) “despite the erroneous conclusions of the” Review Panel, ICM’s application clearly satisfied the sponsorship criteria”; (ii) the ICANN Board “specifically determined that ICM’s application met the criteria when it approved the resolutions allowing ICM to proceed to registry agreement negotiations” on June 1, 2005; (iii) the ICANN Board “reversed” this decision because of “sponsorship issues” and “vague and previously unannounced criteria such as ‘public policy issues’”; and (iv) that the ultimate rejection of the .XXX sTLD was based on a “different definition of the sponsorship criteria, one that apparently required the applicant to have the full support of everyone who might possible be a community member.”<sup>450</sup> All of this, according to ICM, “are clear violations of the obligation to be open and transparent.”<sup>451</sup> ICM’s disagreement with the Board’s honest judgments and carefully crafted decision does not support a conclusion that the ICANN Board violated its Bylaws. In any event, ICM is wrong in each instance.

298. *First*, ICM did not satisfy the sponsorship criteria, as ICM contends. As explained above, a majority of the Board determined that ICM failed to set forth a precisely defined community, proposed language that would require ICANN to monitor (outside of its technical mandate) illegal and offensive content according to all law globally, could not identify a community that was comprised of persons with needs and interests in common but which are differentiated from those of the general global Internet community, and ultimately failed to garner support from the larger online adult entertainment provider community. Each of these facts placed ICM directly at odds with the requirements set forth in the RFP at the outset of the sTLD process.

299. *Second*, the ICANN Board did not approve the .XXX sTLD application on June 1, 2005. All of the evidence identified throughout this Response proves that the Board’s

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<sup>449</sup> ICM Memorial ¶¶ 369-377.

<sup>450</sup> *Id.* at ¶¶ 372-375.

<sup>451</sup> *Id.* at ¶ 377.

June 1, 2005 vote did *not* determine that ICM had satisfied the RFP selection criteria, including sponsorship.

300. *Third*, ICANN never “reversed” its decision because ICANN never found that ICM satisfied the RFP requirements in the first place. ICANN’s final decision to deny ICM’s application was based on ICM’s inability to satisfy the sponsorship selection criteria as set forth clearly in the RFP.

301. *Fourth and finally*, the ultimate rejection of the .XXX sTLD was not based on a “different definition of the sponsorship criteria, one that apparently required the applicant to have the full support of everyone who might possibly be a community member.”<sup>452</sup> The RFP explicitly required the proposed sTLD to address the needs and interests of a “clearly defined community” that can benefit from the establishment of the sTLD. The RFP further required that applicants demonstrate that the sTLD community was “precisely defined, so it can be determined which persons or entities make up that community.” ICM defined the sponsoring community as the “responsible online adult-entertainment community.” The Board’s vote made clear that ICM’s defined community was based on self-selection and was not capable of objective definition. Moreover, unlike other sTLD applicants, ICM’s proposed community did not yet exist. As a result, ICM was asking ICANN to evaluate a proposed hypothetical community that ICM believed would coalesce around the .XXX TLD. In short, ICM did not propose a “clearly defined community” as required by the RFP.

302. ICM was never in the dark on any of these issues. Instead, ICM was apprised of all relevant procedures, standards, and decisions throughout the process. ICM was provided with copies of all materials used in the evaluation process, and minutes of the Board’s meetings were posted on ICANN’s website. Indeed, nearly all of documents ICM relies upon to establish the factual record in its brief are publicly available documents.

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<sup>452</sup> ICM Memorial ¶ 375.

**b. ICANN's Review Was Procedurally Fair.**

303. ICM argues that ICANN failed to provide procedural fairness because, ICM believes: (1) the RFP process called for a rigid two-step evaluation wherein, if an applicant cleared the “first step” by entering contract negotiations, it necessarily satisfied all RFP criteria and ICANN could not subsequently revisit the RFP criteria – even if it appeared that the applicant’s intractable problems with respect to those criteria could not be addressed through any number of proposed registry agreements; (2) ICANN allegedly added new, substantive criteria by considering the GAC’s public policy comments with respect to ICM’s application; and (3) ironically, given ICM’s claims that ICANN did not act openly and transparently, ICM believes that ICANN should *not* have published the Evaluation Panel’s reports because they contained negative comments with respect to ICM’s application.<sup>453</sup>

304. As discussed above, the ICANN Board’s process for evaluating ICM’s sTLD application was both consistent with ICANN’s Bylaws and procedurally fair under California law. First, there was never an inflexible two-step sequential process. The Board could not know if an sTLD application would be able to satisfy the RFP criteria, including sponsorship, until it was shown how the applicant’s ideas would be implemented in the registry agreement. Thus, an evaluation process divided into two concrete and inflexible “steps” would be unworkable in practice, at least with respect to proposed sTLDs that had “sponsorship issues,” because it would have been impractical for the Board to commit to a new sTLD without knowing the details of the registry that would operate it. While there is no doubt that ICANN employed a two-staged process – insofar as the evaluation of the RFP criteria and contractual negotiations involved different functions – both of these phases needed to be completed before a sTLD application could be submitted to the Board for approval, and the evaluation process and contract negotiations could overlap in time. This was absolutely consistent with how ICANN managed the earlier TLD expansion in 2000 as well.

305. ICM was not the only sTLD applicant that ICANN permitted to move on to contract negotiations before satisfying the selection criteria. Applications for .jobs and .mobi were also allowed to proceed to contract negotiations despite open questions relating to the RFP

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<sup>453</sup> *Id.* ¶¶ 386-93.

selection criteria.<sup>454</sup> This negates any notion put forth by ICM that ICANN somehow applied “new substantive criteria in evaluating ICM’s application.”<sup>455</sup> ICM was treated in a non-discriminatory manner.

306. It is ironic that ICM complains of being treated “unfairly” in this process given that ICM was permitted numerous additional opportunities – opportunities that were not called for in the RFP – to prove to ICANN that it could satisfy the sponsorship criteria. For instance, after the Evaluation Panel’s initial findings, the ICANN Board instructed the Evaluation Panel to reconsider its findings as to all applicants; this was not called for in the ICANN evaluation schedule. After the Evaluation Panel confirmed its initial findings, ICANN gave each of the applicants an opportunity to respond in writing to the findings; this also was not called for in the ICANN evaluation schedule. After ICM responded to the findings of the Evaluation Panel, ICANN offered ICM an opportunity to make an oral presentation to the Board; this also was not called for in the ICANN evaluation schedule. Then, the Board voted to proceed to contract negotiations, despite significant concerns on the critical sponsorship issues. There is no conceivable basis that any of this could be viewed as “unfair,” much less in derogation of ICANN’s Bylaws.

307. The Board’s authorization to ICANN staff to commence negotiations on a registry agreement did not reflect an unconditional approval of ICM’s .XXX sTLD.<sup>456</sup> Therefore, ICANN did not “approve” the .XXX sTLD on June 1, 2005, and subsequently “reverse” that decision, as ICM contends.

308. ICANN made its ultimate decision to reject ICM’s application and proposed registry agreement by applying documented policies neutrally and objectively, with integrity and fairness. ICM was provided with every opportunity to address the concerns of the Board and the GAC, and ICM provided numerous memoranda to the Board and the GAC. Multiple drafts of

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<sup>454</sup> See, e.g., ICANN Minutes, Special Meeting of the Board, December 13, 2004, Cl. Ex. 116.

<sup>455</sup> ICM Memorial ¶ 390.

<sup>456</sup> See P. Twomey Witness Statement ¶ 28.

the proposed registry agreement were presented to the Board for its consideration, and the Board devoted countless hours evaluating and debating the merits of ICM's application.

309. Finally, ICM takes the position that ICANN should not have published the Evaluation Panel's reports because they reflected negatively on ICM's application.<sup>457</sup> ICM, which also alleges that ICANN did not act in an open and transparent manner, asks the Panel to find that ICANN violated its Bylaws because it publicly disclosed information about the status of ICM's sTLD application during the selection process. ICM appears not to recognize the irony of its position. While ICM may have preferred that the negative conclusions of the Evaluation Panel not be published, there can be no credible argument that ICANN's Articles and Bylaws required their suppression.

## **2. ICANN Did Not Apply Its Procedures In A Discriminatory Fashion.**

310. ICM maintains that ICANN applied its procedures in a discriminatory fashion by considering public policy issues that were unique to ICM's application, defining the sTLD community and requirement of "broad-based support" differently with respect to ICM's application, and allowing different contract terms to be used during negotiations of the proposed registry agreement.<sup>458</sup> Here, again, ICM is wrong.

311. As discussed above, ICANN did not reject ICM's application based only on issues of public policy (although these were important and well-reasoned concerns). ICM's sTLD application was rejected because of ICM's inability to show how the sTLD would satisfy the sponsorship criteria. The definitions relevant to those criteria never changed during the contract negotiations, nor were they applied any differently with respect to ICM's application. This much is clear from the consistency of the Board's ultimate decision to reject ICM's application for many of the same sponsorship concerns noted in the initial recommendation of the Evaluation Panel.

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<sup>457</sup> ICM Memorial ¶ 393.

<sup>458</sup> *Id.* ¶¶ 399-404.

312. ICM has no basis to argue that it was treated differently than other sTLD applicants. ICANN applied its standards, policies, procedures, and practices equitably, without singling out any particular party for disparate treatment. The fact that ICM's application ultimately was rejected obviously does not, by itself, lead to the conclusion that ICM was treated differently. Any applicant presenting an application having the infirmities of ICM's .XXX application would have been rejected. And the length of time that ICANN devoted to the ICM application hardly reflects a breach of ICANN's Bylaws or Articles (much less "bad faith" on ICANN's part).

313. Similarly, the fact that certain contract terms for ICM may have been different from those proposed for the registry agreements for other sTLDs is not a manifestation of a discriminatory intent, but simply reflects the inherent differences among the needs of the proposed Sponsored TLD communities.

314. ICM's application was (by far) the most controversial and complicated application. The fact that some Board members disagreed with the Board's final vote in March 2007 shows that ICM's application was the subject of legitimate debate among the members of the Board, and that ICM was able to persuade some, but ultimately not a majority, of Board members that its .XXX sTLD application met the criteria set forth in the RFP. Such disagreement is not evidence of discriminatory treatment of ICM's application.<sup>459</sup>

315. In sum, the fact that ICANN's Board ultimately turned down this sTLD application obviously does not mean that the Board must have "mistreated" the applicant. The facts demonstrate that ICM was treated fairly.

### **3. ICANN Did Not Act In Excess Of Its Mission.**

316. ICM argues that ICANN acted in excess of its purpose and mission, which is to protect the stability, integrity, and utility of the Internet domain name system. ICM contends that the Board's rejection of ICM's application was premised on a "substantive judgment of Internet

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<sup>459</sup> ICM Memorial, ¶¶ 239- 242.

content,” which was beyond ICANN’s technical mandate.<sup>460</sup> But no such rationale was ever articulated by the Board or could be inferred from the process.

317. To the contrary, ICANN did not reject ICM’s application based on a “substantive judgment of Internet content,” but because ICM could not satisfy the sponsorship criteria, and also because ICM’s proposed registry agreement would have required ICANN to manage the content of the .XXX sTLD – exactly the type of content-based function that ICM now complains is improper. Under these circumstances, the fact that Board decided that ICANN’s mission was best served by denial of ICM’s application does not demonstrate any objective error in judgment or lack of good faith on the part of the Board. Certainly, it cannot be said that the Board acted in excess of its mission.

**4. The Board Reached Its Decision Independently, Giving Due Consideration, As It Was Required Under the Bylaws, To The GAC’s Comments.**

318. ICM alleges that ICANN violated the Bylaws provisions with respect to the GAC. Recognizing that the Board is required under the Bylaws to consider the GAC’s advice on issues of public policy, ICM claims that the Board was “overly deferential” to the GAC’s concerns.<sup>461</sup>

319. The Bylaws do not limit the extent to which the Board can consider the GAC’s views. Although ICANN did take into account the opinion of the GAC as well as other Internet stakeholders, as it was required to do under the Bylaws, the Board reached its decision independently and rejected ICM’s proposal based on the RFP selection criteria. Had the ICANN Board taken the view that the GAC’s views must in every case be followed without independent judgment, the Board presumably would have rejected ICM’s application in late 2005 or early 2006, rather than waiting another full year for the parties to try to identify a resolution that would have allowed the sTLD to proceed.

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<sup>460</sup> *Id.* ¶¶ 405-11.

<sup>461</sup> *Id.* ¶¶ 412-14.



## 5. ICANN Did Not Violate International Law.

320. The same facts foreclose ICM's international law claims. As shown above, *see supra* section III.A.3, the principles of international law that ICM cites are inapplicable to this proceeding for a variety of reasons. The Panel should therefore disregard such claims.

321. Further, each of ICM's international law principles – the duty of good faith (and related applications), abuse of rights, legitimate expectations, and estoppel – depends upon the same assumptions of wrongdoing on the part of ICANN that never actually occurred. Thus, ICM's international law claims, unsupportable as they are as a matter of law, fail even to provide an alternative basis to support claims against ICANN, but rather merely repackage the same erroneous factual arguments in a different guise.<sup>462</sup>

## IV. CONCLUSION AND PROPOSED FORMAT FOR THE HEARING

322. For all of the reasons set forth above, the Panel should declare, pursuant to Article IV, Section 12 of the Bylaws, that the ICANN Board did not act inconsistently with ICANN's Articles and Bylaws. At every stage of ICANN's comprehensive review and ultimate denial of ICM's .XXX sTLD application, the ICANN Board fully complied with the provisions in the Articles and Bylaws raised by ICM – providing an open, transparent, and procedurally fair process; applying its procedures in a non-discriminatory fashion; adhering to ICANN's purpose and mission; and reaching its decision independently based on the RFP selection criteria. ICM is simply trying to second-guess the well-reasoned and careful judgment of the ICANN Board, which is not the proper subject of an independent review proceeding.

323. The Panel should further declare, again pursuant to Article IV, Section 12 of the Bylaws, that ICANN is the prevailing party; that ICM is the party not prevailing; and that ICM is responsible for bearing all costs of the independent review process provider (*i.e.*, the ICDR).

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<sup>462</sup> *See, e.g.*, Caron Opinion ¶ 99 (noting that the principle of good faith is “an analog to the business judgment rule”). ICANN further notes that Article 4 does not require “perfect compliance” with any international legal principles that may apply. Caron Opinion ¶¶ 41-44; *id.* ¶ 41 (noting that “in conformity with” is “not a precise standard”). Because Article 4 requires only that ICANN act “in conformity with” such principles, ICANN's consistency with its other Bylaws and Articles *a fortiori* satisfies Article 4.

The Panel should also declare that, as the party not prevailing, ICM is not entitled to any of the relief it seeks.

324. ICANN looks forward to the hearing that is scheduled to begin on September 21, 2009. ICANN respectfully submits that this hearing should be limited to the equivalent of a closing argument. The parties have provided the Panel with a substantial amount of briefing, and counsel should be prepared to address these issues, perhaps in a sequenced manner, during the course of the hearing.

325. ICANN does not believe, however, that the hearing should involve live testimony from the witnesses who have submitted statements in conjunction with these proceedings. The parties already have submitted considerable evidence by way of witness statements as well as documentation. While live testimony might (or might not) supplement the factual record in some way, the Panel has ample facts on which to determine whether the Board violated its Bylaws or Articles of Incorporation. It is hard to imagine that further development of the factual record would be useful in facilitating the Panel's work. ICM's counsel even told the Panel that ICM would be satisfied to present a response in a reply brief instead of holding any live hearing.<sup>463</sup>

326. Although a hearing with live witnesses is not forbidden by the Bylaws that created this independent review process, the procedures that apply to this unique process of independent review certainly support a hearing limited to attorney presentation, without live witnesses. The Bylaws provide that this independent review proceeding be conducted in a manner "to keep the costs and burdens of independent review as low as possible,"<sup>464</sup> and encourage resolution of disputes "on the papers" using email and conference calls as necessary.<sup>465</sup> Nowhere do the procedures contemplate the presentation of live witnesses.

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<sup>463</sup> See Email Correspondence from Arif Hyder Ali to the Panel (Apr. 16, 2009) (stating that ICM would be satisfied responding to ICANN's submission "*either* at a hearing on the merits *or* through a written response") (emphasis added), attached hereto as ICANN Exhibit BE.

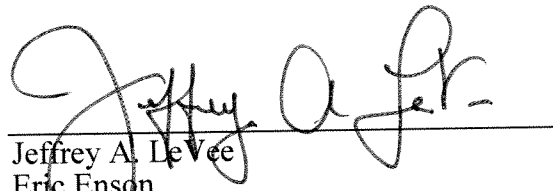
<sup>464</sup> ICANN Bylaws, *supra* note 2, Article IV, § 3.10.

<sup>465</sup> See *id.* at Article IV, § 3.10 ("In order to keep the costs and burdens of independent review as low as possible, the [Panel] should conduct its proceedings by e-mail and otherwise via the Internet to the maximum extent feasible. Where necessary, the IRP may hold meetings by telephone."); see also

Indeed, the procedures specify that the Panel “shall make its declaration based solely on the documentation, supporting materials, and arguments *submitted* by the parties.”<sup>466</sup>

327. For all of these reasons, ICANN proposes that the hearing that the Panel has scheduled to begin September 21, 2009 consist of detailed closing arguments by counsel, but not provide for live witness testimony. The closing argument could, for example, be structured according to the various legal and factual issues that the parties have addressed in ICM’s Memorial and ICANN’s Response.

Respectfully submitted,



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(continued...)

Supplementary Procedures, *supra* note 151, Supplementary Procedure 4 (“The IRP should conduct its proceedings by electronic means to the extent feasible. Where necessary, the IRP may conduct telephone conferences.”).

<sup>466</sup> ICANN Bylaws, *supra* note 2, Article IV, § 3.12 (emphasis added).

## APPENDIX A

## Appendix A: Chronology of Key Events

DATE	EVENT
<b>1998</b>	
<b>September 30, 1998</b>	<ul style="list-style-type: none"> <li>Articles of Incorporation filed and ICANN formed</li> </ul>
<b>November 6, 1998</b>	<ul style="list-style-type: none"> <li>Bylaws (original version) adopted</li> </ul>
<b>November 21, 1998</b>	<ul style="list-style-type: none"> <li>Bylaws modified to provide for independent third-party review of Board actions alleged by an affected party to have “violated the Corporation’s articles of incorporation or bylaws.”</li> </ul>
<b>2000</b>	
<b>July 16, 2000</b>	<ul style="list-style-type: none"> <li>ICANN Board adopts policy for the introduction of new TLDs</li> </ul>
<b>August 15, 2000</b>	<ul style="list-style-type: none"> <li>ICANN posts criteria to be used in the “proof of concept” round for assessing gTLD applications.</li> <li>ICM Registry’s unsponsored .XXX TLD application is one of 47 proposals submitted to ICANN</li> </ul>
<b>November 9, 2000</b>	<ul style="list-style-type: none"> <li>Report issued by ICANN staff evaluating each TLD proposal.</li> <li>ICM’s .XXX unsponsored TLD proposal is not selected for 3 reasons: (1) “it did not appear to meet unmet needs;” (2) “the controversy surrounding .XXX was great;” and (3) the application included a “poor definition of the hoped-for benefits of [] .XXX.”</li> </ul>
<b>2002</b>	
<b>June 20, 2002</b>	<ul style="list-style-type: none"> <li>ICANN Board adopts recommendation from the Committee on ICANN Evolution and Reform (“ERC”) that would “create a process to require <i>non-binding</i> arbitration by an international arbitration body to review any allegation that the Board has acted in conflict with ICANN’s Bylaws.”</li> </ul>
<b>August 1, 2002</b>	<ul style="list-style-type: none"> <li>ERC states: “We do not believe that ICANN should have either a Supreme Court or a ‘Super Board’ with the ability to nullify decisions reached by the ICANN Board, which will be the most broadly representative body within the ICANN structure.”</li> </ul>
<b>October 2, 2002</b>	<ul style="list-style-type: none"> <li>ERC states that “a ‘Supreme Court,’ with the power to revisit and potentially reverse or vacate decisions of the ICANN Board, would itself raise many difficult questions” and thus is not the process recommended by the ERC.</li> </ul>
<b>October 18, 2002</b>	<ul style="list-style-type: none"> <li>ICANN President Stuart Lynn issues “A Plan for Action Regarding New gTLDs”</li> </ul>
<b>December 15, 2002</b>	<ul style="list-style-type: none"> <li>ICANN contemplates draft Request for Proposal (RFP) for purpose of soliciting proposals for a limited number of additional new sponsored TLDs.</li> </ul>
<b>December 15, 2002</b>	<ul style="list-style-type: none"> <li>ICANN Board adopts ERC’s proposed Bylaws, but replaces the ERC’s reference to IRP “decisions” with the term “declarations.”</li> </ul>
<b>2003</b>	
<b>December 15, 2003</b>	<ul style="list-style-type: none"> <li>ICANN launches round for sTLDs and posts final RFP.</li> <li>The final RFP requests information on: (1) Sponsorship; (2) Business Plan; (3) Technical Standards; and (4) Community Value.</li> </ul>

## Appendix A: Chronology of Key Events

DATE	EVENT
<b>2004</b>	
<b>March 19, 2004</b>	<ul style="list-style-type: none"> <li>ICANN receives 10 applications for sTLDs, including one from ICM Registry for the introduction of .XXX.</li> </ul>
<b>April 7, 2004</b>	<ul style="list-style-type: none"> <li>Independent Evaluation Panel is appointed to review sTLD applications.</li> </ul>
<b>August 27, 2004</b>	<ul style="list-style-type: none"> <li>Independent Evaluation Panel submits its reports on each sTLD application. ICM's application is found to meet both the technical and business selection criteria but not the sponsorship selection criteria.</li> <li>Evaluation Panel recommends that ICANN not consider ICM's application further.</li> </ul>
<b>August 31, 2004</b>	<ul style="list-style-type: none"> <li>ICANN Board encourages ICM to review the Evaluation Panel's report and suggest how the Evaluation Panel's concerns could be addressed.</li> </ul>
<b>October 9, 2004</b>	<ul style="list-style-type: none"> <li>ICM provides list of reasons why Evaluation Panel was mistaken as to sponsorship.</li> </ul>
<b>2005</b>	
<b>May 3, 2005</b>	<ul style="list-style-type: none"> <li>Special Meeting of the ICANN Board. Detailed discussion regarding .XXX and whether or not the application meets the "sponsored community" criteria of the RFP</li> </ul>
<b>June 1, 2005</b>	<ul style="list-style-type: none"> <li>Special Meeting of the ICANN Board. Board adopts two resolutions: (1) authorizing the President and General Counsel to enter negotiations with ICM relating to the proposed commercial and technical terms; and (2) requesting the President to present a negotiated agreement to the Board for approval and authorization.</li> </ul>
<b>July 11-12, 2005</b>	<ul style="list-style-type: none"> <li>GAC Meeting in Luxembourg. Concerns expressed about .XXX sTLD</li> <li>GAC Communiqué asks ICANN to hold consultations on new TLDs and looks forward to providing advice on the process.</li> </ul>
<b>August 9, 2005</b>	<ul style="list-style-type: none"> <li>First draft .XXX sTLD registry agreement posted and submitted to the ICANN Board.</li> </ul>
<b>August 15, 2005</b>	<ul style="list-style-type: none"> <li>ICM requests that ICANN Board "defer final approval of the ICM Registry Agreement until its September call."</li> </ul>
<b>August 16, 2005</b>	<ul style="list-style-type: none"> <li>Special Meeting of the ICANN Board. Review of the .XXX sTLD Registry Agreement deferred until Board's September 15, 2005 Meeting.</li> </ul>
<b>August – Sept. 2005</b>	<ul style="list-style-type: none"> <li>"Strong opposition to the creation of a .XXX TLD" expressed by numerous governments and entities.</li> </ul>
<b>September 15, 2005</b>	<ul style="list-style-type: none"> <li>Special Meeting of the ICANN Board. Board expresses concerns about proceeding with the .XXX sTLD domain name</li> <li>ICANN President and General Counsel directed to discuss possible contract modifications to ensure compliance with RFP specifications</li> </ul>
<b>November 29, 2005</b>	<ul style="list-style-type: none"> <li>GAC meeting in Vancouver.</li> <li>Presentation by ICANN Board to the GAC on .XXX; consideration of the .XXX Application will be postponed as requested.</li> <li>Presentation by ICM to the GAC; ICM promises a range of public interest</li> </ul>

## Appendix A: Chronology of Key Events

DATE	EVENT
	benefits.
<b>2006</b>	
<b>March 30, 2006</b>	<ul style="list-style-type: none"> <li>• GAC’s “Wellington Communiqué ” published.</li> <li>• Several GAC members are “emphatically opposed from a public policy perspective to the introduction of a .XXX sTLD.”</li> </ul>
<b>March 31, 2006</b>	<ul style="list-style-type: none"> <li>• ICANN Board Meeting. Board directs President and General Counsel to “analyze all publicly received inputs, to continue negotiations with ICM Registry, and to return to the Board with any recommendations regarding amendments to the proposed sTLD Registry Agreement.”</li> </ul>
<b>April 18, 2006</b>	<ul style="list-style-type: none"> <li>• ICM submits – and ICANN posts – revised draft .XXX Registry Agreement.</li> <li>• ICM requests a vote on the Agreement at the Board’s May 10, 2006 meeting.</li> </ul>
<b>May, 10 2006</b>	<ul style="list-style-type: none"> <li>• ICANN’s Board Meeting. Board votes 9-5 against ICM’s then-current draft of the proposed .XXX Registry Agreement, but does not reject ICM’s application outright.</li> </ul>
<b>2007</b>	
<b>January 5, 2007</b>	<ul style="list-style-type: none"> <li>• Revised Proposed Registry Agreement for the .XXX sTLD is posted.</li> </ul>
<b>February 12, 2007</b>	<ul style="list-style-type: none"> <li>• Special meeting of the Board.</li> <li>• Majority expresses concerns about whether .XXX has the support of a clearly-defined sponsored community.</li> <li>• ICANN Staff directed to consult with ICM to provide further information at the Board’s next meeting.</li> </ul>
<b>March 28, 2007</b>	<ul style="list-style-type: none"> <li>• ICM gives presentation to ICANN Board on support in the Sponsored Community.</li> </ul>
<b>March 30, 2007</b>	<ul style="list-style-type: none"> <li>• The GAC Lisbon Communiqué published.</li> </ul>
<b>March 30, 2007</b>	<ul style="list-style-type: none"> <li>• ICANN Board approves a resolution rejecting the Revised Agreement with ICM and denying ICM’s application for the .XXX sTLD.</li> </ul>
<b>2008</b>	
<b>June 6, 2008</b>	<ul style="list-style-type: none"> <li>• ICM files a Request for Independent Review with the International Centre for Dispute Resolution.</li> </ul>

## APPENDIX B



**Appendix B: Comparison of the RFP and How ICM Failed to Meet the RFP Criteria**

RFP Criteria	How ICM Failed to Meet RFP Criteria
<ul style="list-style-type: none"> <li>• <b><u>Sponsorship Information</u></b> <ol style="list-style-type: none"> <li>1. <b>Definition of a sponsored community</b> (The RFP required that the proposed sTLD address the needs and interests of a “<b>clearly defined community</b>” that can benefit from the establishment of the sTLD, and required that the community be “<b>comprised of persons that have needs and interests in common but which are differentiated from those of the general global Internet community.</b>”);</li> <li>2. Support by a Sponsoring Organization</li> <li>3. <b>The appropriateness of the Sponsoring Organization (including that it operate primarily in the interests of the sTLD Community); and</b></li> <li>4. <b>“Broad-Based Support from the Community” is a “Key Requirement”</b></li> </ol> </li> </ul>	<ul style="list-style-type: none"> <li>• <b>ICM failed to set forth a precisely defined community.</b> <ul style="list-style-type: none"> <li>○ ICM defined the sponsoring community as the “responsible online adult-entertainment community.” ICM’s defined community was based on self-selection and was not capable of objective definition. ICM’s proposed community did not yet exist. As a result, ICM was asking ICANN to evaluate a hypothetical community that ICM believed would coalesce around the .XXX TLD. In short, the community was not “clearly defined.”</li> </ul> </li> <li>• <b>ICM failed to identify a community that was “comprised of persons with needs and interests in common but which are differentiated from those of the general global Internal community.”</b> <ul style="list-style-type: none"> <li>○ ICM failed to meet this portion of the RFP specification because of its selective membership. The sponsored community as defined by ICM was but a subset of all online adult entertainment providers (i.e., those that supported the sTLD), and ICM never provided any documentation or information that the excluded providers had separate needs or interests from the sponsored community it sought to represent.</li> </ul> </li> <li>• <b>ICM failed to propose policies “primarily in the interests of the Sponsored TLD Community.”</b> <ul style="list-style-type: none"> <li>○ ICM undertook to delegate issues of “Best Business Practices” in the proposed registry agreement. Such measures diluted the possibility that the policies would be “primarily in the interests of the Sponsored TLD Community” because the measures specifically obligated ICM to seek input from foreign governments and organizations on local concerns, which added yet another non-community voice to the policy formulation aspect.</li> </ul> </li> <li>• <b>ICM ultimately failed to garner support from the larger online adult entertainment provider community.</b> <ul style="list-style-type: none"> <li>○ During the final public comment period, the majority of the comments posted to the public forum and sent to ICANN staff opposed ICM’s .XXX sTLD. ICM was not able to provide evidence to the contrary.</li> </ul> </li> </ul>

<ul style="list-style-type: none"> <li>• <b><u>Community Value</u></b> <ol style="list-style-type: none"> <li>1. <b>Addition of new value to the Internet name space;</b></li> <li>2. Protecting the rights of others;</li> <li>3. Assurance of charter-compliant registrations and avoidance of abusive registration tactics;</li> <li>4. Assurance of adequate dispute-resolution mechanisms; and</li> <li>5. Provision of ICANN-policy compliant WHOIS service</li> </ol> </li> </ul>	<ul style="list-style-type: none"> <li>• <b>ICM failed to demonstrate that it was adding new and valuable space to the Internet Name Space.</b> <ul style="list-style-type: none"> <li>○ To the extent that online adult service providers chose not to register within the .XXX sTLD (and the opposition to the sTLD made clear that there would be many), the .XXX sTLD would represent merely duplicate space on the Internet.</li> </ul> </li> </ul>
<ul style="list-style-type: none"> <li>• <b><u>Technical Standards</u></b> <ol style="list-style-type: none"> <li>1. Ability to ensure stable registry operation;</li> <li>2. Ability to ensure best practices;</li> <li>3. A full range of registry services; and</li> <li>4. Assurance of continuity of registry operation in the event of business failure of the proposed registry</li> </ol> </li> </ul>	<ul style="list-style-type: none"> <li>• <b>ICM proposed language that would require ICANN to monitor illegal and offensive content according to all law globally. This requirement fell outside of ICANN’s mandate.</b></li> </ul>
<ul style="list-style-type: none"> <li>• <b><u>Business Plan Information</u></b> <ol style="list-style-type: none"> <li>1. Business Plan; and</li> <li>2. Financial Plan</li> </ol> </li> </ul>	

## **LEGAL AUTHORITY CA-62**

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CA-62

A MANUAL  
OF  
INTERNATIONAL LAW

by  
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countries with different civilisations in the Near, Middle and Far East. Capitulation treaties provided means of harmonising discrepancies in standards of conduct, especially in the administration of civil and criminal law. In this way, foreigners resident in Asian and African countries were largely exempted from local territorial jurisdiction and made amenable to that of their home States which exercised jurisdiction on the spot through their consular courts or in their own colonial possessions nearby.<sup>18</sup>

Finally, matters might be left in the hands of colonial companies such as the Dutch and British East India Companies. They were not considered as themselves endowed with international personality, but were regarded as organs of the States which had granted them their charters. They had, however, wide discretionary powers and used them in concluding treaties with, or making war on, local rulers. Some of these treaties make sense only on the assumption that the colonial company acknowledged the sovereignty and international personality of the local princes concerned. Others are more akin to public contracts under the municipal law of the colonial Power concerned. Today, these aspects of international law are primarily of historical significance. They are by-products of the transition of the European State system from periods of early colonialism and imperialism to the era of a slowly maturing world society.

### *B. International Law in Sociological Perspective*

#### *1. The Structure of International Law*

Three features characterise the structure of international law on the level of *unorganised* international society: (a) its universality, (b) its exclusiveness and (c) its individualistic character.

(a) *The Universality of International Law.* On the level of unorganised international society, the geographical scope of international law is universal, in the sense that it extends to the whole world. International law on this level comprises the sum total of the rules from which the seven fundamental and inter-related principles of sovereignty, recognition, consent, good faith, freedom of the seas, responsibility and self-defence can be abstracted.<sup>19</sup>

The subjects of international law are, however, free to organise themselves on higher levels of integration. They may, for instance, become parties to a general agreement for the renunciation of resort to war, such as the Kellogg Pact of 1928,<sup>20</sup> or join regional or universalist international institutions, such as the Organisation of American States or the United Nations.<sup>21</sup> They may even coalesce into territorial or functional federations on the model of Switzerland or the European Economic Community.<sup>22</sup> Inside such institutional superstructures, international law may

<sup>18</sup> See below, p. 74 *et seq.*

<sup>19</sup> See below, p. 33 *et seq.*

<sup>20</sup> See below, p. 151.

<sup>21</sup> See below, pp. 222 *et seq.* and 273 *et seq.*

<sup>22</sup> See below, pp. 45 and 288.

## **LEGAL AUTHORITY CA-63**

INTERNATIONAL COURT OF JUSTICE

REPORTS OF JUDGMENTS,  
ADVISORY OPINIONS AND ORDERS

**NUCLEAR TESTS CASE**  
(AUSTRALIA *v.* FRANCE)

**JUDGMENT OF 20 DECEMBER 1974**

**1974**

COUR INTERNATIONALE DE JUSTICE

RECUEIL DES ARRÊTS,  
AVIS CONSULTATIFS ET ORDONNANCES

**AFFAIRE DES ESSAIS NUCLÉAIRES**  
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**ARRÊT DU 20 DÉCEMBRE 1974**

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20 DECEMBER 1974

JUDGMENT

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AFFAIRE DES ESSAIS NUCLÉAIRES  
(AUSTRALIE *c.* FRANCE)

20 DÉCEMBRE 1974

ARRÊT

## INTERNATIONAL COURT OF JUSTICE

YEAR 1974

1974  
20 December  
General List  
No. 58

20 December 1974

## NUCLEAR TESTS CASE

(AUSTRALIA v. FRANCE)

*Questions of jurisdiction and admissibility—Prior examination required of question of existence of dispute as essentially preliminary matter—Exercise of inherent jurisdiction of the Court.*

*Analysis of claim on the basis of the Application and determination of object of claim—Significance of submissions and of statements of the Applicant for definition of the claim—Power of Court to interpret submissions—Public statements made on behalf of Respondent before and after oral proceedings.*

*Unilateral acts creative of legal obligations—Principle of good faith.*

*Resolution of dispute by unilateral declaration giving rise to legal obligation—Applicant's non-exercise of right of discontinuance of proceedings no bar to independent finding by Court—Disappearance of dispute resulting in claim no longer having any object—Jurisdiction only to be exercised when dispute genuinely exists between the Parties.*

## JUDGMENT

*Present: President LACHS; Judges FORSTER, GROS, BENGZON, PETRÉN, ONYEAMA, DILLARD, IGNACIO-PINTO, DE CASTRO, MOROZOV, JIMÉNEZ DE ARÉCHAGA, Sir Humphrey WALDOCK, NAGENDRA SINGH, RUDA; Judge ad hoc Sir Garfield BARWICK; Registrar AQUARONE.*

In the Nuclear Tests case,

*between*

Australia,

represented by

Mr. P. Brazil, of the Australian Bar, Officer of the Australian Attorney-General's Department,

as Agent,

assisted by

H.E. Mr. F. J. Blakeney, C.B.E., Ambassador of Australia,  
as Co-Agent,

Senator the Honourable Lionel Murphy, Q.C., Attorney-General of  
Australia,

Mr. M. H. Byers, Q.C., Solicitor-General of Australia,

Mr. E. Lauterpacht, Q.C., of the English Bar, Lecturer in the University of  
Cambridge,

Professor D. P. O'Connell, of the English, Australian and New Zealand  
Bars, Chichele Professor of Public International Law in the University of  
Oxford,

as Counsel,

and by

Professor H. Messel, Head of School of Physics, University of Sydney,

Mr. D. J. Stevens, Director, Australian Radiation Laboratory,

Mr. H. Burmester, of the Australian Bar, Officer of the Attorney-General's  
Department,

Mr. F. M. Douglas, of the Australian Bar, Officer of the Attorney-General's  
Department,

Mr. J. F. Browne, of the Australian Bar, Officer of the Department of  
Foreign Affairs,

Mr. C. D. Mackenzie, of the Australian Bar, Third Secretary, Australian  
Embassy, The Hague,

as Advisers,

*and*

the French Republic,

THE COURT,

composed as above,

*delivers the following Judgment:*

1. By a letter of 9 May 1973, received in the Registry of the Court the same day, the Ambassador of Australia to the Netherlands transmitted to the Registrar an Application instituting proceedings against France in respect of a dispute concerning the holding of atmospheric tests of nuclear weapons by the French Government in the Pacific Ocean. In order to found to the jurisdiction of the Court, the Application relied on Article 17 of the General Act for the Pacific Settlement of International Disputes done at Geneva on 26 September 1928, read together with Articles 36, paragraph 1, and 37 of the Statute of the Court, and alternatively on Article 36, paragraph 2, of the Statute of the Court.

2. Pursuant to Article 40, paragraph 2, of the Statute, the Application was at once communicated to the French Government. In accordance with paragraph 3 of that Article, all other States entitled to appear before the Court were notified of the Application.

3. Pursuant to Article 31, paragraph 2, of the Statute of the Court, the Government of Australia chose the Right Honourable Sir Garfield Barwick, Chief Justice of Australia, to sit as judge *ad hoc* in the case.

4. By a letter dated 16 May 1973 from the Ambassador of France to the Netherlands, handed by him to the Registrar the same day, the French Government stated that, for reasons set out in the letter and an Annex thereto, it considered that the Court was manifestly not competent in the case, and that it could not accept the Court's jurisdiction; and that accordingly the French Government did not intend to appoint an agent, and requested the Court to remove the case from its list. Nor has an agent been appointed by the French Government.

5. On 9 May 1973, the date of filing of the Application instituting proceedings, the Agent of Australia also filed in the Registry of the Court a request for the indication of interim measures of protection under Article 33 of the 1928 General Act for the Pacific Settlement of International Disputes and Article 41 of the Statute and Article 66 of the Rules of Court. By an Order dated 22 June 1973 the Court indicated, on the basis of Article 41 of the Statute, certain interim measures of protection in the case.

6. By the same Order of 22 June 1973, the Court, considering that it was necessary to resolve as soon as possible the questions of the Court's jurisdiction and of the admissibility of the Application, decided that the written proceedings should first be addressed to the questions of the jurisdiction of the Court to entertain the dispute and of the admissibility of the Application, and fixed 21 September 1973 as the time-limit for the filing of a Memorial by the Government of Australia and 21 December 1973 as the time-limit for a Counter-Memorial by the French Government. The Co-Agent of Australia having requested an extension to 23 November 1973 of the time-limit fixed for the filing of the Memorial, the time-limits fixed by the Order of 22 June 1973 were extended, by an Order dated 28 August 1973, to 23 November 1973 for the Memorial and 19 April 1974 for the Counter-Memorial. The Memorial of the Government of Australia was filed within the extended time-limit fixed therefor, and was communicated to the French Government. No Counter-Memorial was filed by the French Government and, the written proceedings being thus closed, the case was ready for hearing on 20 April 1974, the day following the expiration of the time-limit fixed for the Counter-Memorial of the French Government.

7. On 16 May 1973 the Government of Fiji filed in the Registry of the Court a request under Article 62 of the Statute to be permitted to intervene in these proceedings. By an Order of 12 July 1973 the Court, having regard to its Order of 22 June 1973 by which the written proceedings were first to be addressed to the questions of the jurisdiction of the Court and of the admissibility of the Application, decided to defer its consideration of the application of the Government of Fiji for permission to intervene until the Court should have pronounced upon these questions.

8. On 24 July 1973, the Registrar addressed the notification provided for in Article 63 of the Statute to the States, other than the Parties to the case, which were still in existence and were listed in the relevant documents of the League of Nations as parties to the General Act for the Pacific Settlement of International Disputes, done at Geneva on 26 September 1928, which was invoked in the Application as a basis of jurisdiction.

9. The Governments of Argentina, Fiji, New Zealand and Peru requested that the pleadings and annexed documents should be made available to them

in accordance with Article 48, paragraph 2, of the Rules of Court. The Parties were consulted on each occasion, and the French Government having maintained the position stated in the letter of 16 May 1973, and thus declined to express an opinion, the Court or the President decided to accede to these requests.

10. On 4-6, 8-9 and 11 July 1974, after due notice to the Parties, public hearings were held, in the course of which the Court heard the oral argument, on the questions of the Court's jurisdiction and of the admissibility of the Application, advanced by Mr. P. Brazil, Agent of Australia and Senator the Honourable Lionel Murphy, Q.C., Mr. M. H. Byers, Q.C., Mr. E. Lauterpacht, Q.C., and Professor D. P. O'Connell, counsel, on behalf of the Government of Australia. The French Government was not represented at the hearings.

11. In the course of the written proceedings, the following submissions were presented on behalf of the Government of Australia:

in the Application:

*"The Government of Australia asks the Court to adjudge and declare that, for the above-mentioned reasons or any of them or for any other reason that the Court deems to be relevant, the carrying out of further atmospheric nuclear weapon tests in the South Pacific Ocean is not consistent with applicable rules of international law.*

*And to Order*

*that the French Republic shall not carry out any further such tests."*

in the Memorial:

*"The Government of Australia submits to the Court that it is entitled to a declaration and judgment that:*

- (a) the Court has jurisdiction to entertain the dispute, the subject of the Application filed by the Government of Australia on 9 May 1973; and*
- (b) the Application is admissible."*

12. During the oral proceedings, the following written submissions were filed in the Registry of the Court on behalf of the Government of Australia:

*"The final submissions of the Government of Australia are that:*

- (a) the Court has jurisdiction to entertain the dispute the subject of the Application filed by the Government of Australia on 9 May 1973; and*
- (b) the Application is admissible*

*and that accordingly the Government of Australia is entitled to a declaration and judgment that the Court has full competence to proceed to entertain the Application by Australia on the Merits of the dispute."*

13. No pleadings were filed by the French Government, and it was not represented at the oral proceedings; no formal submissions were therefor made by that Government. The attitude of the French Government with regard to the question of the Court's jurisdiction was however defined in the above-mentioned letter of 16 May 1973 from the French Ambassador to the

Netherlands, and the document annexed thereto. The said letter stated in particular that:

“... the Government of the [French] Republic, as it has notified the Australian Government, considers that the Court is manifestly not competent in this case and that it cannot accept its jurisdiction”.

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14. As indicated above (paragraph 4), the letter from the French Ambassador of 16 May 1973 also stated that the French Government “respectfully requests the Court to be so good as to order that the case be removed from the list”. At the opening of the public hearing concerning the request for interim measures of protection, held on 21 May 1973, the President announced that “this request . . . has been duly noted, and the Court will deal with it in due course, in application of Article 36, paragraph 6, of the Statute of the Court”. In its Order of 22 June 1973, the Court stated that the considerations therein set out did not “permit the Court to accede at the present stage of the proceedings” to that request. Having now had the opportunity of examining the request in the light of the subsequent proceedings, the Court finds that the present case is not one in which the procedure of summary removal from the list would be appropriate.

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15. It is to be regretted that the French Government has failed to appear in order to put forward its arguments on the issues arising in the present phase of the proceedings, and the Court has thus not had the assistance it might have derived from such arguments or from any evidence adduced in support of them. The Court nevertheless has to proceed and reach a conclusion, and in doing so must have regard not only to the evidence brought before it and the arguments addressed to it by the Applicant, but also to any documentary or other evidence which may be relevant. It must on this basis satisfy itself, first that there exists no bar to the exercise of its judicial function, and secondly, if no such bar exists, that the Application is well founded in fact and in law.

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\*

16. The present case relates to a dispute between the Government of Australia and the French Government concerning the holding of atmospheric tests of nuclear weapons by the latter Government in the South Pacific Ocean. Since in the present phase of the proceedings the Court has to deal only with preliminary matters, it is appropriate to recall that its approach to a phase of this kind must be, as it was expressed in the *Fisheries Jurisdiction* cases, as follows:

“The issue being thus limited, the Court will avoid not only all expressions of opinion on matters of substance, but also any pronouncement which might prejudice or appear to prejudice any eventual decision on the merits.” (*I.C.J. Reports 1973*, pp. 7 and 54.)

It will however be necessary to give a summary of the principal facts underlying the case.

17. Prior to the filing of the Application instituting proceedings in this case, the French Government had carried out atmospheric tests of nuclear devices at its Centre d'expérimentations du Pacifique, in the territory of French Polynesia, in the years 1966, 1967, 1968, 1970, 1971 and 1972. The main firing site used has been Mururoa atoll some 6,000 kilometres to the east of the Australian mainland. The French Government has created “Prohibited Zones” for aircraft and “Dangerous Zones” for aircraft and shipping, in order to exclude aircraft and shipping from the area of the tests centre; these “zones” have been put into effect during the period of testing in each year in which tests have been carried out.

18. As the United Nations Scientific Committee on the Effects of Atomic Radiation has recorded in its successive reports to the General Assembly, the testing of nuclear devices in the atmosphere has entailed the release into the atmosphere, and the consequent dissipation in varying degrees throughout the world, of measurable quantities of radioactive matter. It is asserted by Australia that the French atmospheric tests have caused some fall-out of this kind to be deposited on Australian territory; France has maintained in particular that the radio-active matter produced by its tests has been so infinitesimal that it may be regarded as negligible, and that such fall-out on Australian territory does not constitute a danger to the health of the Australian population. These disputed points are clearly matters going to the merits of the case, and the Court must therefore refrain, for the reasons given above, from expressing any view on them.

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\*       \*  
\*

19. By letters of 19 September 1973, 29 August and 11 November 1974, the Government of Australia informed the Court that subsequent to the Court's Order of 22 June 1973 indicating, as interim measures under Article 41 of the Statute (*inter alia*) that the French Government should avoid nuclear tests causing the deposit of radio-active fall-out in Australian territory, two further series of atmospheric tests, in the months of July and August 1973 and June to September 1974, had been carried out at the Centre d'expérimentations du Pacifique. The letters also stated that fall-out had been recorded on Australian territory which, according to the Australian Government, was clearly attributable to these tests,

and that “in the opinion of the Government of Australia the conduct of the French Government constitutes a clear and deliberate breach of the Order of the Court of 22 June 1973”.

20. Recently a number of authoritative statements have been made on behalf of the French Government concerning its intentions as to future nuclear testing in the South Pacific Ocean. The significance of these statements, and their effect for the purposes of the present proceedings, will be examined in detail later in the present Judgment.

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21. The Application finds the jurisdiction of the Court on the following basis:

“(i) Article 17 of the General Act for the Pacific Settlement of International Disputes, 1928, read together with Articles 36 (1) and 37 of the Statute of the Court. Australia and the French Republic both acceded to the General Act on 21 May 1931 . . .

(ii) Alternatively, Article 36 (2) of the Statute of the Court. Australia and the French Republic have both made declarations thereunder.”

22. The scope of the present phase of the proceedings was defined by the Court’s Order of 22 June 1973, by which the Parties were called upon to argue, in the first instance, questions of the jurisdiction of the Court and the admissibility of the Application. For this reason, as already indicated, not only the Parties but also the Court itself must refrain from entering into the merits of the claim. However, while examining these questions of a preliminary character, the Court is entitled, and in some circumstances may be required, to go into other questions which may not be strictly capable of classification as matters of jurisdiction or admissibility but are of such a nature as to require examination in priority to those matters.

23. In this connection, it should be emphasized that the Court possesses an inherent jurisdiction enabling it to take such action as may be required, on the one hand to ensure that the exercise of its jurisdiction over the merits, if and when established, shall not be frustrated, and on the other, to provide for the orderly settlement of all matters in dispute, to ensure the observance of the “inherent limitations on the exercise of the judicial function” of the Court, and to “maintain its judicial character” (*Northern Cameroons, Judgment, I.C.J. Reports 1963*, at p. 29). Such inherent jurisdiction, on the basis of which the Court is fully empowered to make whatever findings may be necessary for the purposes just indicated, derives from the mere existence of the Court as a judicial



organ established by the consent of States, and is conferred upon it in order that its basic judicial functions may be safeguarded.

24. With these considerations in mind, the Court has first to examine a question which it finds to be essentially preliminary, namely the existence of a dispute, for, whether or not the Court has jurisdiction in the present case, the resolution of that question could exert a decisive influence on the continuation of the proceedings. It will therefore be necessary to make a detailed analysis of the claim submitted to the Court by the Application of Australia. The present phase of the proceedings having been devoted solely to preliminary questions, the Applicant has not had the opportunity of fully expounding its contentions on the merits. However the Application, which is required by Article 40 of the Statute of the Court to indicate "the subject of the dispute", must be the point of reference for the consideration by the Court of the nature and existence of the dispute brought before it.

25. The Court would recall that the submission made in the Application (paragraph 11 above) is that the Court should adjudge and declare that "the carrying out of further atmospheric nuclear weapon tests in the South Pacific Ocean is not consistent with applicable rules of international law"—the Application having specified in what respect further tests were alleged to be in violation of international law—and should order "that the French Republic shall not carry out any further such tests".

26. The diplomatic correspondence of recent years between Australia and France reveals Australia's preoccupation with French nuclear atmospheric tests in the South Pacific region, and indicates that its objective has been to bring about their termination. Thus in a Note dated 3 January 1973 the Australian Government made it clear that it was inviting the French Government "to refrain from any further atmospheric nuclear tests in the Pacific area and formally to assure the Australian Government that no more such tests will be held in the Pacific area". In the Application, the Government of Australia observed in connection with this Note (and the French reply of 7 February 1973) that:

"It is at these Notes, of 3 January and 7 February 1973, that the Court is respectfully invited to look most closely; for it is in them that the shape and dimensions of the dispute which now so sadly divides the parties appear so clearly. The Government of Australia claimed that the continuance of testing by France is illegal and called for the cessation of tests. The Government of France asserted the legality of its conduct and gave no indication that the tests would stop." (Para. 15 of the Application.)

That this was the object of the claim also clearly emerges from the request for the indication of interim measures of protection, submitted to the Court by the Applicant on 9 May 1973, in which it was observed:

"As is stated in the Application, Australia has sought to obtain from the French Republic a permanent undertaking to refrain from

further atmospheric nuclear tests in the Pacific. However, the French Republic has expressly refused to give any such undertaking. It was made clear in a statement in the French Parliament on 2 May 1973 by the French Secretary of State for the Armies that the French Government, regardless of the protests made by Australia and other countries, does not envisage any cancellation or modification of the programme of nuclear testing as originally planned.” (Para. 69.)

27. Further light is thrown on the nature of the Australian claim by the reaction of Australia, through its Attorney-General, to statements, referred to in paragraph 20 above, made on behalf of France and relating to nuclear tests in the South Pacific Ocean. In the course of the oral proceedings, the Attorney-General of Australia outlined the history of the dispute subsequent to the Order of 22 June 1973, and included in this review mention of a communiqué issued by the Office of the President of the French Republic on 8 June 1974. The Attorney-General’s comments on this document indicated that it merited analysis as possible evidence of a certain development in the controversy between the Parties, though at the same time he made it clear that this development was not, in his Government’s view, of such a nature as to resolve the dispute to its satisfaction. More particularly he reminded the Court that “Australia has consistently stated that it would welcome a French statement to the effect that no further atmospheric nuclear tests would be conducted ... but no such assurance was given”. The Attorney-General continued, with reference to the communiqué of 8 June:

“The concern of the Australian Government is to exclude completely atmospheric testing. It has repeatedly sought assurances that atmospheric tests will end. It has not received those assurances. The recent French Presidential statement cannot be read as a firm, explicit and binding undertaking to refrain from further atmospheric tests. It follows that the Government of France is still reserving to itself the right to carry out atmospheric nuclear tests.” (Hearing of 4 July 1974.)

It is clear from these statements that if the French Government had given what could have been construed by Australia as “a firm, explicit and binding undertaking to refrain from further atmospheric tests”, the applicant Government would have regarded its objective as having been achieved.

28. Subsequently, on 26 September 1974, the Attorney-General of Australia, replying to a question put in the Australian Senate with regard to reports that France had announced that it had finished atmospheric nuclear testing, said:

“From the reports I have received it appears that what the French Foreign Minister actually said was ‘We have now reached a stage in

our nuclear technology that makes it possible for us to continue our program by underground testing, and we have taken steps to do so as early as next year' . . . this statement falls far short of a commitment or undertaking that there will be no more atmospheric tests conducted by the French Government at its Pacific Tests Centre . . . There is a basic distinction between an assertion that steps are being taken to continue the testing program by underground testing as early as next year and an assurance that no further atmospheric tests will take place. It seems that the Government of France, while apparently taking a step in the right direction, is still reserving to itself the right to carry out atmospheric nuclear tests. In legal terms, Australia has nothing from the French Government which protects it against any further atmospheric tests should the French Government subsequently decide to hold them."

Without commenting for the moment on the Attorney-General's interpretation of the French statements brought to his notice, the Court would observe that it is clear that the Australian Government contemplated the possibility of "an assurance that no further atmospheric tests will take place" being sufficient to protect Australia.

29. In the light of these statements, it is essential to consider whether the Government of Australia requests a judgment by the Court which would only state the legal relationship between the Applicant and the Respondent with regard to the matters in issue, or a judgment of a type which in terms requires one or both of the Parties to take, or refrain from taking, some action. Thus it is the Court's duty to isolate the real issue in the case and to identify the object of the claim. It has never been contended that the Court is entitled to interpret the submissions of the parties, and in fact is bound to do so; this is one of the attributes of its judicial functions. It is true that, when the claim is not properly formulated because the submissions of the parties are inadequate, the Court has no power to "substitute itself for them and formulate new submissions simply on the basis of arguments and facts advanced" (*P.C.I.J., Series A, No. 7, p. 35*), but that is not the case here, nor is it a case of the reformulation of submissions by the Court. The Court has on the other hand repeatedly exercised the power to exclude, when necessary, certain contentions or arguments which were advanced by a party as part of the submissions, but which were regarded by the Court, not as indications of what the party was asking the Court to decide, but as reasons advanced why the Court should decide in the sense contended for by that party. Thus in the *Fisheries* case, the Court said of nine of the thirteen points in the Applicant's submissions: "These are elements which might furnish reasons in support of the Judgment, but cannot constitute the decision"

(*I.C.J. Reports 1951*, p. 126). Similarly in the *Minquiers and Ecrehos* case, the Court observed that:

“The Submissions reproduced above and presented by the United Kingdom Government consist of three paragraphs, the last two being reasons underlying the first, which must be regarded as the final Submission of that Government. The Submissions of the French Government consist of ten paragraphs, the first nine being reasons leading up to the last, which must be regarded as the final Submission of that Government.” (*I.C.J. Reports 1953*, p. 52; see also *Nottebohm, Second Phase, Judgment, I.C.J. Reports 1955*, p. 16.)

30. In the circumstances of the present case, although the Applicant has in its Application used the traditional formula of asking the Court “to adjudge and declare” (a formula similar to those used in the cases quoted in the previous paragraph), the Court must ascertain the true object and purpose of the claim and in doing so it cannot confine itself to the ordinary meaning of the words used; it must take into account the Application as a whole, the arguments of the Applicant before the Court, the diplomatic exchanges brought to the Court’s attention, and public statements made on behalf of the applicant Government. If these clearly circumscribe the object of the claim, the interpretation of the submissions must necessarily be affected. In the present case, it is evident that the *fons et origo* of the case was the atmospheric nuclear tests conducted by France in the South Pacific region, and that the original and ultimate objective of the Applicant was and has remained to obtain a termination of those tests; thus its claim cannot be regarded as being a claim for a declaratory judgment. While the judgment of the Court which Australia seeks to obtain would in its view have been based on a finding by the Court on questions of law, such finding would be only a means to an end, and not an end in itself. The Court is of course aware of the role of declaratory judgments, but the present case is not one in which such a judgment is requested.

31. In view of the object of the Applicant’s claim, namely to prevent further tests, the Court has to take account of any developments, since the filing of the Application, bearing upon the conduct of the Respondent. Moreover, as already mentioned, the Applicant itself impliedly recognized the possible relevance of events subsequent to the Application, by drawing the Court’s attention to the communiqué of 8 June 1974, and making observations thereon. In these circumstances the Court is bound to take note of further developments, both prior to and subsequent to the close of the oral proceedings. In view of the non-appearance of the Respondent, it is especially incumbent upon the Court to satisfy itself that it is in possession of all the available facts.

32. At the hearing of 4 July 1974, in the course of a review of developments in relation to the proceedings since counsel for Australia had

previously addressed the Court in May 1973, the Attorney-General of Australia made the following statement:

“You will recall that Australia has consistently stated it would welcome a French statement to the effect that no further atmospheric nuclear tests would be conducted. Indeed as the Court will remember such an assurance was sought of the French Government by the Australian Government by note dated 3 January 1973, but no such assurance was given.

I should remind the Court that in paragraph 427 of its Memorial the Australian Government made a statement, then completely accurate, to the effect that the French Government had given no indication of any intention of departing from the programme of testing planned for 1974 and 1975. That statement will need now to be read in light of the matters to which I now turn and which deal with the official communications by the French Government of its present plans.”

He devoted considerable attention to a communiqué dated 8 June 1974 from the Office of the President of the French Republic, and submitted to the Court the Australian Government's interpretation of that document. Since that time, certain French authorities have made a number of consistent public statements concerning future tests, which provide material facilitating the Court's task of assessing the Applicant's interpretation of the earlier documents, and which indeed require to be examined in order to discern whether they embody any modification of intention as to France's future conduct. It is true that these statements have not been made before the Court, but they are in the public domain, and are known to the Australian Government, and one of them was commented on by the Attorney-General in the Australian Senate on 26 September 1974. It will clearly be necessary to consider all these statements, both that drawn to the Court's attention in July 1974 and those subsequently made.

33. It would no doubt have been possible for the Court, had it considered that the interests of justice so required, to have afforded the Parties the opportunity, e.g., by reopening the oral proceedings, of addressing to the Court comments on the statements made since the close of those proceedings. Such a course however would have been fully justified only if the matter dealt with in those statements had been completely new, had not been raised during the proceedings, or was unknown to the Parties. This is manifestly not the case. The essential material which the Court must examine was introduced into the proceedings by the Applicant itself, by no means incidentally, during the course of the hearings, when it drew the Court's attention to a statement by the French authorities made prior to that date, submitted the documents containing it and presented an interpretation of its character, touching particularly upon the question whether it contained a firm assurance. Thus both the statement and the Australian interpretation of it are before

the Court pursuant to action by the Applicant. Moreover, the Applicant subsequently publicly expressed its comments (see paragraph 28 above) on statements made by the French authorities since the closure of the oral proceedings. The Court is therefore in possession not only of the statements made by French authorities concerning the cessation of atmospheric nuclear testing, but also of the views of the Applicant on them. Although as a judicial body the Court is conscious of the importance of the principle expressed in the maxim *audi alteram partem*, it does not consider that this principle precludes the Court from taking account of statements made subsequently to the oral proceedings, and which merely supplement and reinforce matters already discussed in the course of the proceedings, statements with which the Applicant must be familiar. Thus the Applicant, having commented on the statements of the French authorities, both that made prior to the oral proceedings and those made subsequently, could reasonably expect that the Court would deal with the matter and come to its own conclusion on the meaning and effect of those statements. The Court, having taken note of the Applicant's comments, and feeling no obligation to consult the Parties on the basis for its decision finds that the reopening of the oral proceedings would serve no useful purpose.

34. It will be convenient to take the statements referred to above in chronological order. The first statement is contained in the communiqué issued by the Office of the President of the French Republic on 8 June 1974, shortly before the commencement of the 1974 series of French nuclear tests:

“The Decree reintroducing the security measures in the South Pacific nuclear test zone has been published in the Official Journal of 8 June 1974.

The Office of the President of the Republic takes this opportunity of stating that in view of the stage reached in carrying out the French nuclear defence programme France will be in a position to pass on to the stage of underground explosions as soon as the series of tests planned for this summer is completed.”

A copy of the communiqué was transmitted with a Note dated 11 June 1974 from the French Embassy in Canberra to the Australian Department of Foreign Affairs, and as already mentioned, the text of the communiqué was brought to the attention of the Court in the course of the oral proceedings.

35. In addition to this, the Court cannot fail to take note of a reference to a document made by counsel at a public hearing in the proceedings, parallel to this case, instituted by New Zealand against France on 9 May 1973. At the hearing of 10 July 1974 in that case, the Attorney-General of New Zealand, after referring to the communiqué of 8 June 1974, mentioned above, stated that on 10 June 1974 the French Embassy in Wellington sent a Note to the New Zealand Ministry of Foreign Affairs, containing a passage which the Attorney General read out, and which, in the translation used by New Zealand, runs as follows:

“France, at the point which has been reached in the execution of its programme of defence by nuclear means, will be in a position to move to the stage of underground tests, as soon as the test series planned for this summer is completed.

Thus the atmospheric tests which are soon to be carried out will, in the normal course of events, be the last of this type.”

36. The Court will also have to consider the relevant statements made by the French authorities subsequently to the oral proceedings: on 25 July 1974 by the President of the Republic; on 16 August 1974 by the Minister of Defence; on 25 September 1974 by the Minister for Foreign Affairs in the United Nations General Assembly; and on 11 October 1974 by the Minister of Defence.

37. The next statement to be considered, therefore, will be that made on 25 July at a press conference given by the President of the Republic, when he said:

“... on this question of nuclear tests, you know that the Prime Minister had publicly expressed himself in the National Assembly in his speech introducing the Government’s programme. He had indicated that French nuclear testing would continue. I had myself made it clear that this round of atmospheric tests would be the last, and so the members of the Government were completely informed of our intentions in this respect . . .”

38. On 16 August 1974, in the course of an interview on French television, the Minister of Defence said that the French Government had done its best to ensure that the 1974 nuclear tests would be the last atmospheric tests.

39. On 25 September 1974, the French Minister for Foreign Affairs, addressing the United Nations General Assembly, said:

“We have now reached a stage in our nuclear technology that makes it possible for us to continue our programme by underground testing, and we have taken steps to do so as early as next year.”

40. On 11 October 1974, the Minister of Defence held a press conference during which he stated twice, in almost identical terms, that there would not be any atmospheric tests in 1975 and that France was ready to proceed to underground tests. When the comment was made that he had not added “in the normal course of events”, he agreed that he had not. This latter point is relevant in view of the passage from the Note of 10 June 1974 from the French Embassy in Wellington to the Ministry of Foreign Affairs of New Zealand, quoted in paragraph 35 above, to the effect that the atmospheric tests contemplated “will, in the normal course of events, be the last of this type”. The Minister also mentioned that, whether or not other governments had been officially advised of the

decision, they could become aware of it through the press and by reading the communiqués issued by the Office of the President of the Republic.

41. In view of the foregoing, the Court finds that France made public its intention to cease the conduct of atmospheric nuclear tests following the conclusion of the 1974 series of tests. The Court must in particular take into consideration the President's statement of 25 July 1974 (paragraph 37 above) followed by the Defence Minister's statement on 11 October 1974 (paragraph 40). These reveal that the official statements made on behalf of France concerning future nuclear testing are not subject to whatever proviso, if any, was implied by the expression "in the normal course of events [*normalement*]".

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42. Before considering whether the declarations made by the French authorities meet the object of the claim by the Applicant that no further atmospheric nuclear tests should be carried out in the South Pacific, it is first necessary to determine the status and scope on the international plane of these declarations.

43. It is well recognized that declarations made by way of unilateral acts, concerning legal or factual situations, may have the effect of creating legal obligations. Declarations of this kind may be, and often are, very specific. When it is the intention of the State making the declaration that it should become bound according to its terms, that intention confers on the declaration the character of a legal undertaking, the State being thenceforth legally required to follow a course of conduct consistent with the declaration. An undertaking of this kind, if given publicly, and with an intent to be bound, even though not made within the context of international negotiations, is binding. In these circumstances, nothing in the nature of a *quid pro quo* nor any subsequent acceptance of the declaration, nor even any reply or reaction from other States, is required for the declaration to take effect, since such a requirement would be inconsistent with the strictly unilateral nature of the juridical act by which the pronouncement by the State was made.

44. Of course, not all unilateral acts imply obligation; but a State may choose to take up a certain position in relation to a particular matter with the intention of being bound—the intention is to be ascertained by interpretation of the act. When States make statements by which their freedom of action is to be limited, a restrictive interpretation is called for.

45. With regard to the question of form, it should be observed that this is not a domain in which international law imposes any special or strict requirements. Whether a statement is made orally or in writing makes no essential difference, for such statements made in particular circumstances may create commitments in international law, which does not require that they should be couched in written form. Thus the ques-



tion of form is not decisive. As the Court said in its Judgment on the preliminary objections in the case concerning the *Temple of Preah Vihear*:

“Where . . . as is generally the case in international law, which places the principal emphasis on the intentions of the parties, the law prescribes no particular form, parties are free to choose what form they please provided their intention clearly results from it.”  
(*I.C.J. Reports 1961*, p. 31.)

The Court further stated in the same case: “. . . the sole relevant question is whether the language employed in any given declaration does reveal a clear intention . . .” (*ibid.*, p. 32).

46. One of the basic principles governing the creation and performance of legal obligations, whatever their source, is the principle of good faith. Trust and confidence are inherent in international co-operation, in particular in an age when this co-operation in many fields is becoming increasingly essential. Just as the very rule of *pacta sunt servanda* in the law of treaties is based on good faith, so also is the binding character of an international obligation assumed by unilateral declaration. Thus interested States may take cognizance of unilateral declarations and place confidence in them, and are entitled to require that the obligation thus created be respected.

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47. Having examined the legal principles involved, the Court will now turn to the particular statements made by the French Government. The Government of Australia has made known to the Court at the oral proceedings its own interpretation of the first such statement (paragraph 27 above). As to subsequent statements, reference may be made to what was said in the Australian Senate by the Attorney-General on 26 September 1974 (paragraph 28 above). In reply to a question concerning reports that France had announced that it had finished atmospheric nuclear testing, he said that the statement of the French Foreign Minister on 25 September (paragraph 39 above) “falls far short of an undertaking that there will be no more atmospheric tests conducted by the French Government at its Pacific Tests Centre” and that France was “still reserving to itself the right to carry out atmospheric nuclear tests” so that “In legal terms, Australia has nothing from the French Government which protects it against any further atmospheric tests”.

48. It will be observed that Australia has recognized the possibility of the dispute being resolved by a unilateral declaration, of the kind specified above, on the part of France, and its conclusion that in fact no “commitment” or “firm, explicit and binding undertaking” had been given is based on the view that the assurance is not absolute in its terms,

that there is a “distinction between an assertion that tests will go underground and an assurance that no further atmospheric tests will take place”, that “the possibility of further atmospheric testing taking place after the commencement of underground tests cannot be excluded” and that thus “the Government of France is still reserving to itself the right to carry out atmospheric nuclear tests”. The Court must however form its own view of the meaning and scope intended by the author of a unilateral declaration which may create a legal obligation, and cannot in this respect be bound by the view expressed by another State which is in no way a party to the text.

49. Of the statements by the French Government now before the Court, the most essential are clearly those made by the President of the Republic. There can be no doubt, in view of his functions, that his public communications or statements, oral or written, as Head of State, are in international relations acts of the French State. His statements, and those of members of the French Government acting under his authority, up to the last statement made by the Minister of Defence (of 11 October 1974), constitute a whole. Thus, in whatever form these statements were expressed, they must be held to constitute an engagement of the State, having regard to their intention and to the circumstances in which they were made.

50. The unilateral statements of the French authorities were made outside the Court, publicly and *erga omnes*, even though the first of them was communicated to the Government of Australia. As was observed above, to have legal effect, there was no need for these statements to be addressed to a particular State, nor was acceptance by any other State required. The general nature and characteristics of these statements are decisive for the evaluation of the legal implications, and it is to the interpretation of the statements that the Court must now proceed. The Court is entitled to presume, at the outset, that these statements were not made *in vacuo*, but in relation to the tests which constitute the very object of the present proceedings, although France has not appeared in the case.

51. In announcing that the 1974 series of atmospheric tests would be the last, the French Government conveyed to the world at large, including the Applicant, its intention effectively to terminate these tests. It was bound to assume that other States might take note of these statements and rely on their being effective. The validity of these statements and their legal consequences must be considered within the general framework of the security of international intercourse, and the confidence and trust which are so essential in the relations among States. It is from the actual substance of these statements, and from the circumstances attending their making, that the legal implications of the unilateral act must be deduced. The objects of these statements are clear and they were addressed to the international community as a whole, and the Court holds that they constitute an undertaking possessing legal effect. The Court considers

that the President of the Republic, in deciding upon the effective cessation of atmospheric tests, gave an undertaking to the international community to which his words were addressed. It is true that the French Government has consistently maintained, for example in a Note dated 7 February 1973 from the French Ambassador in Canberra to the Prime Minister and Minister for Foreign Affairs of Australia, that it "has the conviction that its nuclear experiments have not violated any rule of international law", nor did France recognize that it was bound by any rule of international law to terminate its tests, but this does not affect the legal consequences of the statements examined above. The Court finds that the unilateral undertaking resulting from these statements cannot be interpreted as having been made in implicit reliance on an arbitrary power of reconsideration. The Court finds further that the French Government has undertaken an obligation the precise nature and limits of which must be understood in accordance with the actual terms in which they have been publicly expressed.

52. Thus the Court faces a situation in which the objective of the Applicant has in effect been accomplished, inasmuch as the Court finds that France has undertaken the obligation to hold no further nuclear tests in the atmosphere in the South Pacific.

53. The Court finds that no question of damages arises in the present case, since no such claim has been raised by the Applicant either prior to or during the proceedings, and the original and ultimate objective of Applicant has been to seek protection "against any further atmospheric test" (see paragraph 28 above).

54. It would of course have been open to Australia, if it had considered that the case had in effect been concluded, to discontinue the proceedings in accordance with the Rules of Court. If it has not done so, this does not prevent the Court from making its own independent finding on the subject. It is true that "the Court cannot take into account declarations, admissions or proposals which the Parties may have made during direct negotiations between themselves, when such negotiations have not led to a complete agreement" (*Factory at Chorzów (Merits)*, P.C.I.J., Series A, No. 17, p. 51). However, in the present case, that is not the situation before the Court. The Applicant has clearly indicated what would satisfy its claim, and the Respondent has independently taken action; the question for the Court is thus one of interpretation of the conduct of each of the Parties. The conclusion at which the Court has arrived as a result of such interpretation does not mean that it is itself effecting a compromise of the claim; the Court is merely ascertaining the object of the claim and the effect of the Respondent's action, and this it is obliged to do. Any suggestion that the dispute would not be capable of being terminated by statements made on behalf of France would run counter to the unequivocally expressed views of the Applicant both before the Court and elsewhere.

55. The Court, as a court of law, is called upon to resolve existing disputes between States. Thus the existence of a dispute is the primary

condition for the Court to exercise its judicial function; it is not sufficient for one party to assert that there is a dispute, since "whether there exists an international dispute is a matter for objective determination" by the Court (*Interpretation of Peace Treaties with Bulgaria, Hungary and Romania (First Phase)*, *Advisory Opinion*, *I.C.J. Reports 1950*, p. 74). The dispute brought before it must therefore continue to exist at the time when the Court makes its decision. It must not fail to take cognizance of a situation in which the dispute has disappeared because the object of the claim has been achieved by other means. If the declarations of France concerning the effective cessation of the nuclear tests have the significance described by the Court, that is to say if they have caused the dispute to disappear, all the necessary consequences must be drawn from this finding.

56. It may be argued that although France may have undertaken such an obligation, by a unilateral declaration, not to carry out atmospheric nuclear tests in the South Pacific Ocean, a judgment of the Court on this subject might still be of value because, if the judgment upheld the Applicant's contentions, it would reinforce the position of the Applicant by affirming the obligation of the Respondent. However, the Court having found that the Respondent has assumed an obligation as to conduct, concerning the effective cessation of nuclear tests, no further judicial action is required. The Applicant has repeatedly sought from the Respondent an assurance that the tests would cease, and the Respondent has, on its own initiative, made a series of statements to the effect that they will cease. Thus the Court concludes that, the dispute having disappeared, the claim advanced by Australia no longer has any object. It follows that any further finding would have no *raison d'être*.

57. This is not to say that the Court may select from the cases submitted to it those it feels suitable for judgment while refusing to give judgment in others. Article 38 of the Court's Statute provides that its function is "to decide in accordance with international law such disputes as are submitted to it"; but not only Article 38 itself but other provisions of the Statute and Rules also make it clear that the Court can exercise its jurisdiction in contentious proceedings only when a dispute genuinely exists between the parties. In refraining from further action in this case the Court is therefore merely acting in accordance with the proper interpretation of its judicial function.

58. The Court has in the past indicated considerations which would lead it to decline to give judgment. The present case is one in which "circumstances that have . . . arisen render any adjudication devoid of purpose" (*Northern Cameroons, Judgment*, *I.C.J. Reports 1963*, p. 38). The Court therefore sees no reason to allow the continuance of proceedings which it knows are bound to be fruitless. While judicial settlement may provide a path to international harmony in circumstances of conflict, it is none the less true that the needless continuance of litigation is an obstacle to such harmony.

59. Thus the Court finds that no further pronouncement is required

in the present case. It does not enter into the adjudicatory functions of the Court to deal with issues *in abstracto*, once it has reached the conclusion that the merits of the case no longer fall to be determined. The object of the claim having clearly disappeared, there is nothing on which to give judgment.

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60. Once the Court has found that a State has entered into a commitment concerning its future conduct it is not the Court's function to contemplate that it will not comply with it. However, the Court observes that if the basis of this Judgment were to be affected, the Applicant could request an examination of the situation in accordance with the provisions of the Statute; the denunciation by France, by letter dated 2 January 1974, of the General Act for the Pacific Settlement of International Disputes, which is relied on as a basis of jurisdiction in the present case, cannot by itself constitute an obstacle to the presentation of such a request.

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61. In its above-mentioned Order of 22 June 1973, the Court stated that the provisional measures therein set out were indicated "pending its final decision in the proceedings instituted on 9 May 1973 by Australia against France". It follows that such Order ceases to be operative upon the delivery of the present Judgment, and that the provisional measures lapse at the same time.

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62. For these reasons,

THE COURT,

by nine votes to six,

finds that the claim of Australia no longer has any object and that the Court is therefore not called upon to give a decision thereon.

Done in English and in French, the English text being authoritative, at the Peace Palace, The Hague, this twentieth day of December, one thousand nine hundred and seventy-four, in three copies, one of which will be placed in the archives of the Court and the others transmitted to the Government of Australia and the Government of the French Republic, respectively.

(Signed) Manfred LACHS,  
President.

(Signed) S. AQUARONE,  
Registrar.

President LACHS makes the following declaration:

Good administration of justice and respect for the Court require that the outcome of its deliberations be kept in strict secrecy and nothing of its decision be published until it is officially rendered. It was therefore regrettable that in the present case, prior to the public reading of the Court's Order of 22 June 1973, a statement was made and press reports appeared which exceeded what is legally admissible in relation to a case *sub judice*.

The Court was seriously concerned with the matter and an enquiry was ordered in the course of which all possible avenues accessible to the Court were explored.

The Court concluded, by a resolution of 21 March 1974, that its investigations had not enabled it to identify any specific source of the statements and reports published.

I remain satisfied that the Court had done everything possible in this respect and that it dealt with the matter with all the seriousness for which it called.

Judges BENGZON, ONYEAMA, DILLARD, JIMÉNEZ DE ARÉCHAGA and Sir Humphrey WALDOCK make the following joint declaration:

Certain criticisms have been made of the Court's handling of the matter to which the President alludes in the preceding declaration. We wish by our declaration to make it clear that we do not consider those criticisms to be in any way justified.

The Court undertook a lengthy examination of the matter by the several means at its disposal: through its services, by convoking the Agent for Australia and having him questioned, and by its own investigations and enquiries. Any suggestion that the Court failed to treat the matter with all the seriousness and care which it required is, in our opinion, without foundation. The seriousness with which the Court regarded the matter is indeed reflected and emphasized in the communiqués which it issued, first on 8 August 1973 and subsequently on 26 March 1974.

The examination of the matter carried out by the Court did not enable it to identify any specific source of the information on which were based the statements and press reports to which the President has referred. When the Court, by eleven votes to three, decided to conclude its examination it did so for the solid reason that to pursue its investigations and inquiries would in its view, be very unlikely to produce further useful information.

Judges FORSTER, GROS, PETRÉN and IGNACIO-PINTO append separate opinions to the Judgment of the Court.

Judges ONYEAMA, DILLARD, JIMÉNEZ DE ARÉCHAGA and Sir Humphrey WALDOCK append a joint dissenting opinion, and Judge DE CASTRO and Judge *ad hoc* Sir Garfield BARWICK append dissenting opinions to the Judgment of the Court.

*(Initialed)* M.L.

*(Initialed)* S.A.

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## **LEGAL AUTHORITY CA-64**



COUR INTERNATIONALE DE JUSTICE

RECUEIL DES ARRÊTS,  
AVIS CONSULTATIFS ET ORDONNANCES

**AFFAIRE DE LA FRONTIÈRE TERRESTRE  
ET MARITIME ENTRE LE CAMEROUN  
ET LE NIGÉRIA**

(CAMEROUN *c.* NIGÉRIA)

EXCEPTIONS PRÉLIMINAIRES

**ARRÊT DU 11 JUIN 1998**

**1998**

INTERNATIONAL COURT OF JUSTICE

REPORTS OF JUDGMENTS,  
ADVISORY OPINIONS AND ORDERS

**CASE CONCERNING  
THE LAND AND MARITIME BOUNDARY  
BETWEEN CAMEROON AND NIGERIA**

(CAMEROON *v.* NIGERIA)

PRELIMINARY OBJECTIONS

**JUDGMENT OF 11 JUNE 1998**

Mode officiel de citation :

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## INTERNATIONAL COURT OF JUSTICE

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General List  
No. 94CASE CONCERNING  
THE LAND AND MARITIME BOUNDARY  
BETWEEN CAMEROON AND NIGERIA

(CAMEROON v. NIGERIA)

## PRELIMINARY OBJECTIONS

*(1) Optional Clause (Article 36, paragraph 2, of Statute) — Deposit of Declaration with United Nations Secretary-General (Article 36, paragraph 4, of Statute) — Transmission of copy by Secretary-General to States parties to Statute — Interval between deposit of Declaration and filing of Application — Alleged abuse of Optional Clause system — Date of establishment of consensual bond under Article 36, paragraph 2, of Statute — Res judicata — Article 59 of Statute.*

*Articles 16, 24 and 78 of Vienna Convention on the Law of Treaties.*

*Withdrawal of declarations of acceptance of compulsory jurisdiction — Reasonable period of notice — Question whether such period should be required for deposit of declarations.*

*Whether a State subscribing to Optional Clause and filing an application shortly thereafter has obligation to inform prospective respondent State — Principle of good faith.*

*Condition of reciprocity — Reservation ratiōne temporis.*

*(2) Asserted duty to resort exclusively to bilateral machinery — Estoppel — Principle of good faith — Rule pacta sunt servanda — Whether exhaustion of diplomatic negotiations is precondition for referral to the Court.*

*(3) Whether Lake Chad Basin Commission has exclusive jurisdiction for settlement of boundary disputes — Arrangements or agencies within meaning of Article 52 of United Nations Charter — Estoppel — Claim that the Court should decline to decide merits of submissions for reasons of judicial propriety.*

*(4) Boundary terminating in a tripoint in Lake Chad — Possible effect on legal interests of third States.*

(5) *Question relating to the existence of a boundary dispute — Determination of the existence of a dispute.*

(6) *Presentation of facts in an application — Requirements of Article 38, paragraph 2, of Rules of Court — Meaning of “succinct”.*

(7) *Determination of title to a peninsula prior to maritime delimitation — Discretionary power of the Court concerning sequence in which it settles issues before it — Alleged absence of sufficient action by Parties to effect delimitation by agreement on basis of international law — Seisin based on declarations made under Article 36, paragraph 2, of Statute — Sufficiently precise character of a dispute.*

(8) *Maritime delimitation which may involve rights and interests of third States — Whether objection raised has exclusively preliminary character (Article 79, paragraph 7, of Rules of Court).*

## JUDGMENT

*Present: President SCHWEBEL; Vice-President WEERAMANTRY; Judges ODA, BEDJAOUI, GUILLAUME, RANJEVA, HERCZEGH, SHI, FLEISCHHAUER, KOROMA, VERESHCHETIN, HIGGINS, PARRA-ARANGUREN, KOOLMANS, REZEK; Judges ad hoc MBAYE, AJIBOLA; Registrar VALENCIA-OSPINA.*

In the case concerning the land and maritime boundary between Cameroon and Nigeria,

*between*

the Republic of Cameroon,

represented by

H.E. Mr. Laurent Eso, Minister of Justice, Keeper of the Seals,  
as Agent;

Mr. Douala Moutomé, Member of the Cameroon Bar, former Minister,  
Mr. Maurice Kamto, Professor, University of Yaoundé II, Member of the  
Paris Bar,

Mr. Peter Ntamark, Dean, Professor of Law, Faculty of Law and Political  
Science, University of Yaoundé II, Barrister-at-Law, member of the Inner  
Temple,

as Co-Agents;

H.E. Mr. Joseph Owona, Minister of Youth and Sport,

Mr. Joseph-Marie Bipoun Woum, Professor, University of Yaoundé II,  
former Minister,

as Special Advisers;

Mr. Alain Pellet, Professor, University of Paris X-Nanterre and Institute of  
Political Studies, Paris,

as Deputy-Agent, Counsel and Advocate;

Mr. Michel Aurillac, avocat à la cour, Honorary Member of the Council of  
State, former Minister,

Mr. Jean-Pierre Cot, Professor, University of Paris I (Panthéon-Sorbonne),  
Vice-President of the European Parliament, Member of the Paris and  
Brussels Bars, former Minister,

Mr. Keith Highet, Counsellor in International Law, Vice-Chairman, Inter-  
American Juridical Committee, Organization of American States,

Mr. Malcolm N. Shaw, Barrister-at-Law, Sir Robert Jennings Professor of  
International Law, Faculty of Law, University of Leicester,

Mr. Bruno Simma, Professor, University of Munich,

Sir Ian Sinclair, K.C.M.G., Q.C., Barrister-at-Law,

Mr. Christian Tomuschat, Professor, University of Berlin,

as Counsel and Advocates;

H.E. Mr. Pascal Biloa Tang, Ambassador of Cameroon to France,

H.E. Mrs. Isabelle Bassong, Ambassador of Cameroon to the Benelux Coun-  
tries,

H.E. Mr. Martin Belinga Eboutou, Ambassador, Permanent Representative  
of Cameroon to the United Nations,

Lieutenant General Pierre Semengue, Chief of Staff of the Armed Forces,

Mr. Robert Akamba, Principal Civil Administrator, chargé de mission, Sec-  
retariat of the Presidency of the Republic,

Mr. Etienne Ateba, Minister-Counsellor, Chargé d'affaires a.i. at the  
Embassy of Cameroon, The Hague,

Mr. Ernest Bodo Abanda, Director of the Cadastral Survey, Member of the  
National Boundary Commission of Cameroon,

Mr. Ngolle Philip Ngwesse, Director at the Ministry of Territorial Adminis-  
tration,

Mr. Thomas Fozein Kwanke, Counsellor in Foreign Affairs, Deputy Direc-  
tor at the Ministry of Foreign Relations,

Mr. Jean Gateaud, ingénieur général géographe,

Mr. Bienvenu Obelabout, Director, Central Administration, General Secre-  
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Mr. Daniel Khan, Assistant, University of Munich,

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tute of Political Studies, Paris,

as Research Assistants;

Mr. Guy Roger Eba'a,  
 Mr. Daniel Nfan Bile,  
 as Communications Specialists;  
 Mrs. René Bakker,  
 Mrs. Florence Jovis,  
 Mrs. Mireille Jung,  
 as Secretaries,

*and*

the Federal Republic of Nigeria,  
 represented by

H.E. the Honourable Alhaji Abdullahi Ibrahim, OFR, SAN, Attorney-  
 General of the Federation and Minister of Justice,

as Agent;

Chief Richard Akinjide, SAN, FCIArb, former Minister, Member of the  
 English and Gambian Bars,

as Co-Agent;

Mr. Ian Brownlie, C.B.E., Q.C., F.B.A., Chichele Professor of Public Inter-  
 national Law, University of Oxford, Member of the International Law  
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Sir Arthur Watts, K.C.M.G., Q.C., Member of the English Bar,

Mr. James Crawford, S.C., Whewell Professor of International Law, Univer-  
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 ber of the Australian Bar,

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Mr. David Lerer, Solicitor, D. J. Freeman of the City of London,

Mr. Christopher Hackford, Solicitor, D. J. Freeman of the City of London,

Ms Louise Cox, trainee Solicitor, D. J. Freeman of the City of London,

as Solicitors;

Mr. A. H. Yadudu, Professor, Special Adviser to the Head of State on Legal  
 Matters,

Mr. A. Oye Cukwurah, Professor, National Boundary Commission, Abuja,

Mr. I. A. Ayua, Professor, Director-General, NIALS,

Brigadier General L. S. Ajiborisha, Director of Operations, DHQ,

Mrs. Stella Omiyi, Director, International and Comparative Law Depart-  
 ment, Federal Ministry of Justice,

Mr. K. Mohammed, Director of Research and Analysis, the Presidency,

Mr. Jalal A. Arabi, Legal Adviser to the Secretary to the Government of the  
 Federation,

Mr. M. M. Kida, Assistant Director, Ministry of Foreign Affairs,

Mr. Alhaji A. A. Adisa, Deputy Surveyor-General of the Federation, Abuja,

Mr. P. M. Mann, Chargé d'affaires, Embassy of Nigeria, The Hague,

Mrs. V. Okwecheme, Counsellor, Embassy of Nigeria, The Hague,  
Mr. Amuzuei, Counsellor, Embassy of Nigeria, The Hague,  
Mr. Clive Schofield, Cartographer, International Boundaries Research Unit,  
Durham University,  
Mr. Arthur Corner, Cartographer, Durham University,  
Ms Michelle Burgoine, Information Technology Assistant,  
as Advisers;  
Mrs. Coralie Ayad, D. J. Freeman of the City of London  
as Secretary.

THE COURT,

composed as above,  
after deliberation,

*delivers the following Judgment:*

1. On 29 March 1994, the Government of the Republic of Cameroon (hereinafter called "Cameroon") filed in the Registry of the Court an Application instituting proceedings against the Government of the Federal Republic of Nigeria (hereinafter called "Nigeria") in respect of a dispute described as "relat[ing] essentially to the question of sovereignty over the Bakassi Peninsula". Cameroon further stated in its Application that the "delimitation [of the maritime boundary between the two States] has remained a partial one and [that], despite many attempts to complete it, the two parties have been unable to do so". It accordingly requested the Court, "in order to avoid further incidents between the two countries, . . . to determine the course of the maritime boundary between the two States beyond the line fixed in 1975". In order to found the jurisdiction of the Court, the Application relied on the declarations made by the two Parties accepting the jurisdiction of the Court under Article 36, paragraph 2, of the Statute of the Court.

2. Pursuant to Article 40, paragraph 2, of the Statute, the Application was immediately communicated to the Government of Nigeria by the Registrar.

3. On 6 June 1994, Cameroon filed in the Registry an Additional Application "for the purpose of extending the subject of the dispute" to a further dispute described in that Additional Application as "relat[ing] essentially to the question of sovereignty over a part of the territory of Cameroon in the area of Lake Chad". Cameroon also requested the Court, in its Additional Application, "to specify definitively" the frontier between the two States from Lake Chad to the sea, and asked it to join the two Applications and "to examine the whole in a single case". In order to found the jurisdiction of the Court, the Additional Application referred to the "basis of . . . jurisdiction . . . already . . . indicated" in the Application instituting proceedings of 29 March 1994.

4. On 7 June 1994, the Registrar communicated the Additional Application to the Government of Nigeria.

5. At a meeting which the President of the Court held with the representatives of the Parties on 14 June 1994, the Agent of Nigeria stated that he had no objection to the Additional Application being treated, in accordance with the wish expressed by Cameroon, as an amendment to the initial Application, so that the Court could deal with the whole in a single case. By an Order dated 16 June 1994, the Court indicated that it had no objection itself to such a procedure, and fixed 16 March 1995 and 18 December 1995, respectively, as the

time-limits for the filing of the Memorial of Cameroon and the Counter-Memorial of Nigeria.

6. Pursuant to Article 40, paragraph 3, of the Statute, all States entitled to appear before the Court were notified of the Application.

7. Cameroon duly filed its Memorial within the time-limit prescribed in the Court's Order dated 16 June 1994.

8. Within the time-limit fixed for the filing of its Counter-Memorial, Nigeria filed preliminary objections to the jurisdiction of the Court and the admissibility of the Application. Accordingly, by an Order dated 10 January 1996, the President of the Court, noting that, under Article 79, paragraph 3, of the Rules of Court, the proceedings on the merits were suspended, fixed 15 May 1996 as the time-limit within which Cameroon might present a written statement of its observations and submissions on the preliminary objections.

Cameroon filed such a statement within the time-limit so prescribed, and the case became ready for hearing in respect of the preliminary objections.

9. Since the Court included upon the Bench no judge of the nationality of the Parties, each Party exercised its right under Article 31, paragraph 3, of the Statute of the Court to choose a judge *ad hoc* to sit in the case: Cameroon chose Mr. Kéba Mbaye and Nigeria chose Mr. Bola Ajibola.

10. By a letter dated 10 February 1996 and received in the Registry on 12 February 1996, Cameroon submitted a request for the indication of provisional measures under Article 41 of the Statute. By an Order dated 15 March 1996, the Court, after hearing the Parties, indicated certain provisional measures.

11. By various communications, Cameroon stressed the importance of a speedy disposal of the case; it also filed, under cover of a letter dated 9 April 1997, a document with annexes entitled "Memorandum of the Republic of Cameroon on Procedure". Nigeria made known its views on the latter communication in a letter dated 13 May 1997.

12. By a letter dated 2 February 1998, Nigeria sought to introduce a volume of documents entitled "Supplemental Documents (Lake Chad Basin Commission Proceedings)". By a letter dated 16 February 1998, the Agent of Cameroon indicated that Cameroon did not oppose their introduction. The Court admitted the said documents pursuant to Article 56, paragraph 1, of the Rules of Court.

13. By a letter dated 11 February 1998, the Agent of Cameroon sought to introduce certain "new documents relating to events occurring since the filing of the Memorial" of Cameroon, and "moreover requested the Court to consider the annexes to the [Memorandum of April 1997] as an integral part of the proceedings". Having considered the views expressed by Nigeria in its above-mentioned letter of 13 May 1997 (see paragraph 11 above) and in its letter of 24 February 1998, the Court admitted the documents pursuant to the provisions of Article 56 of its Rules.

14. In accordance with Article 53, paragraph 2, of its Rules, the Court decided to make accessible to the public, on the opening of the oral proceedings, the preliminary objections of Nigeria and the written statement containing the observations and submissions of Cameroon on the objections, as well as the documents annexed to those pleadings.



15. Public sittings were held between 2 March and 11 March 1998, at which the Court heard the oral arguments and replies of:

*For Nigeria:* H.E. the Honourable Alhaji Abdullahi Ibrahim,  
Mr. Richard Akinjide,  
Mr. Ian Brownlie,  
Sir Arthur Watts,  
Mr. James Crawford.

*For Cameroon:* H.E. Mr. Laurent Easo,  
Mr. Douala Moutomé,  
Mr. Maurice Kamto,  
Mr. Peter Ntamark,  
Mr. Joseph-Marie Bipoun Woum,  
Mr. Alain Pellet,  
Mr. Michel Aurillac,  
Mr. Jean-Pierre Cot,  
Mr. Keith Highet,  
Mr. Malcolm N. Shaw,  
Mr. Bruno Simma,  
Sir Ian Sinclair,  
Mr. Christian Tomuschat.

At the hearings, a Member of the Court put a question to the Parties, who answered in writing after the close of the oral proceedings.

\*

16. In its Application, Cameroon made the following requests:

“On the basis of the foregoing statement of facts and legal grounds, the Republic of Cameroon, while reserving for itself the right to complement, amend or modify the present Application in the course of the proceedings and to submit to the Court a request for the indication of provisional measures should they prove to be necessary, asks the Court to adjudge and declare:

- (a) that sovereignty over the Peninsula of Bakassi is Cameroonian, by virtue of international law, and that that Peninsula is an integral part of the territory of Cameroon;
- (b) that the Federal Republic of Nigeria has violated and is violating the fundamental principle of respect for frontiers inherited from colonization (*uti possidetis juris*);
- (c) that by using force against the Republic of Cameroon, the Federal Republic of Nigeria has violated and is violating its obligations under international treaty law and customary law;
- (d) that the Federal Republic of Nigeria, by militarily occupying the Cameroonian Peninsula of Bakassi, has violated and is violating the obligations incumbent upon it by virtue of treaty law and customary law;
- (e) that in view of these breaches of legal obligation, mentioned above, the Federal Republic of Nigeria has the express duty of putting an end to its military presence in Cameroonian territory, and effecting an immediate and unconditional withdrawal of its troops from the Cameroonian Peninsula of Bakassi;

- (e') that the internationally unlawful acts referred to under (a), (b), (c), (d) and (e) above involve the responsibility of the Federal Republic of Nigeria;
- (e'') that, consequently, and on account of the material and non-material damage inflicted upon the Republic of Cameroon, reparation in an amount to be determined by the Court is due from the Federal Republic of Nigeria to the Republic of Cameroon, which reserves the introduction before the Court of [proceedings for] a precise assessment of the damage caused by the Federal Republic of Nigeria.
- (f) In order to prevent any dispute arising between the two States concerning their maritime boundary, the Republic of Cameroon requests the Court to proceed to prolong the course of its maritime boundary with the Federal Republic of Nigeria up to the limit of the maritime zones which international law places under their respective jurisdictions."

17. In its Additional Application, Cameroon made the following requests:

"On the basis of the foregoing statement of facts and legal grounds, and subject to the reservations expressed in paragraph 20 of its Application of 29 March 1994, the Republic of Cameroon asks the Court to adjudge and declare:

- (a) that sovereignty over the disputed parcel in the area of Lake Chad is Cameroonian, by virtue of international law, and that that parcel is an integral part of the territory of Cameroon;
- (b) that the Federal Republic of Nigeria has violated and is violating the fundamental principle of respect for frontiers inherited from colonization (*uti possidetis juris*), and its recent legal commitments concerning the demarcation of frontiers in Lake Chad;
- (c) that the Federal Republic of Nigeria, by occupying, with the support of its security forces, parcels of Cameroonian territory in the area of Lake Chad, has violated and is violating its obligations under treaty law and customary law;
- (d) that in view of these legal obligations, mentioned above, the Federal Republic of Nigeria has the express duty of effecting an immediate and unconditional withdrawal of its troops from Cameroonian territory in the area of Lake Chad;
- (e) that the internationally unlawful acts referred to under (a), (b), (c) and (d) above involve the responsibility of the Federal Republic of Nigeria;
- (e') that consequently, and on account of the material and non-material damage inflicted upon the Republic of Cameroon, reparation in an amount to be determined by the Court is due from the Federal Republic of Nigeria to the Republic of Cameroon, which reserves the introduction before the Court of [proceedings for] a precise assessment of the damage caused by the Federal Republic of Nigeria.
- (f) That in view of the repeated incursions of Nigerian groups and armed forces into Cameroonian territory, all along the frontier between the two countries, the consequent grave and repeated incidents, and the vacillating and contradictory attitude of the Federal Republic of Nigeria in regard to the legal instruments defining the

frontier between the two countries and the exact course of that frontier, the Republic of Cameroon respectfully asks the Court to specify definitively the frontier between Cameroon and the Federal Republic of Nigeria from Lake Chad to the sea.”

18. In the written proceedings, the Parties presented the following submissions:

*On behalf of the Government of Cameroon,*  
in the Memorial:

“The Republic of Cameroon has the honour to request that the Court be pleased to adjudge and declare:

(a) That the lake and land boundary between Cameroon and Nigeria takes the following course:

- from the point at longitude 14° 04' 59" 9999 E of Greenwich and latitude 13° 05' 00" 0001 N, it then runs through the point located at longitude 14° 12' 11" 7 E and latitude 12° 32' 17" 4 N;
- thence it follows the course fixed by the Franco-British Declaration of 10 July 1919, as specified in paragraphs 3 to 60 of the Thomson-Marchand Declaration, confirmed by the Exchange of Letters of 9 January 1931, as far as the ‘very prominent peak’ described in the latter provision and called by the usual name of ‘Mount Kombon’;
- from Mount Kombon the boundary then runs to ‘Pillar 64’ mentioned in paragraph 12 of the Anglo-German Agreement of Obokum of 12 April 1913 and follows, in that sector, the course described in Section 6 (1) of the British Nigeria (Protectorate and Cameroons) Order in Council of 2 August 1946;
- from Pillar 64 it follows the course described in paragraphs 13 to 21 of the Obokum Agreement of 12 April 1913 as far as Pillar 114 on the Cross River;
- thence, as far as the intersection of the straight line joining Bakassi Point to King Point and the centre of the navigable channel of the Akwayafe, the boundary is determined by paragraphs 16 to 21 of the Anglo-German Agreement of 11 March 1913.

(b) That notably, therefore, sovereignty over the Peninsula of Bakassi and over the disputed parcel occupied by Nigeria in the area of Lake Chad, in particular over Darak and its region, is Cameroonian.

(c) That the boundary of the maritime zones appertaining respectively to the Republic of Cameroon and to the Federal Republic of Nigeria follows the following course:

- from the intersection of the straight line joining Bakassi Point to King Point and the centre of the navigable channel of the Akwayafe to ‘point 12’, that boundary is determined by the ‘compromise line’ entered on British Admiralty Chart No. 3343 by the Heads of State of the two countries on 4 April 1971 (Yaoundé Declaration) and, from that ‘point 12’ to ‘point G’, by the Declaration signed at Maroua on 1 June 1975;

- from point G that boundary then swings south-westward in the direction which is indicated by points G, H, I, J and K represented on the sketch-map on page 556 of this Memorial and meets the requirement for an equitable solution, up to the outer limit of the maritime zones which international law places under the respective jurisdictions of the two Parties.
- (d) That by contesting the courses of the boundary defined above under (a) and (c), the Federal Republic of Nigeria has violated and is violating the fundamental principle of respect for frontiers inherited from colonization (*uti possidetis juris*) and its legal commitments concerning the demarcation of frontiers in Lake Chad and land and maritime delimitation.
  - (e) That by using force against the Republic of Cameroon and, in particular, by militarily occupying parcels of Cameroonian territory in the area of Lake Chad and the Cameroonian Peninsula of Bakassi, and by making repeated incursions, both civilian and military, all along the boundary between the two countries, the Federal Republic of Nigeria has violated and is violating its obligations under international treaty law and customary law.
  - (f) That the Federal Republic of Nigeria has the express duty of putting an end to its civilian and military presence in Cameroonian territory and, in particular, of effecting an immediate and unconditional withdrawal of its troops from the occupied area of Lake Chad and from the Cameroonian Peninsula of Bakassi and of refraining from such acts in the future.
  - (g) That the internationally wrongful acts referred to above and described in detail in the body of this Memorial involve the responsibility of the Federal Republic of Nigeria.
  - (h) That, consequently, and on account of the material and non-material damage inflicted upon the Republic of Cameroon, reparation in a form to be determined by the Court is due from the Federal Republic of Nigeria to the Republic of Cameroon.

The Republic of Cameroon further has the honour to request the Court to permit it to present an assessment of the amount of compensation due to it as reparation for the damage it has suffered as a result of the internationally wrongful acts attributable to the Federal Republic of Nigeria, at a subsequent stage of the proceedings.

These submissions are lodged subject to any points of fact and law and any evidence that may subsequently be lodged; the Republic of Cameroon reserves the right to complete or amend them, as necessary, in accordance with the Statute and the Rules of Court.”

*On behalf of the Government of Nigeria,*

in the preliminary objections:

*First preliminary objection:*

- “(1) that Cameroon, by lodging the Application on 29 March 1994, violated its obligations to act in good faith, acted in abuse of the system established by Article 36, paragraph 2, of the Statute, and disregarded the requirement of reciprocity established by Article 36,

- paragraph 2, of the Statute and the terms of Nigeria's Declaration of 3 September 1965;
- (2) that consequently the conditions necessary to entitle Cameroon to invoke its Declaration under Article 36, paragraph 2, as a basis for the Court's jurisdiction did not exist when the Application was lodged; and
  - (3) that accordingly, the Court is without jurisdiction to entertain the Application."

*Second preliminary objection:*

"For a period of at least 24 years prior to the filing of the Application the Parties have in their regular dealings accepted a duty to settle all boundary questions through the existing bilateral machinery.

- (1) This course of joint conduct constitutes an implied agreement to resort exclusively to the existing bilateral machinery and not to invoke the jurisdiction of the Court.
- (2) *In the alternative*, in the circumstances the Republic of Cameroon is estopped from invoking the jurisdiction of the Court."

*Third preliminary objection:*

"Without prejudice to the second preliminary objection, the settlement of boundary disputes within the Lake Chad region is subject to the exclusive competence of the Lake Chad Basin Commission, and in this context the procedures of settlement within the Lake Chad Basin Commission are obligatory for the Parties.

The operation of the dispute settlement procedures of the Lake Chad Basin Commission involved the necessary implication, for the relations of Nigeria and Cameroon *inter se*, that the jurisdiction of the Court by virtue of Article 36, paragraph 2, would not be invoked in relation to matters within the exclusive competence of the Commission."

*Fourth preliminary objection:*

"The Court should not in these proceedings determine the boundary in Lake Chad to the extent that that boundary constitutes or is constituted by the tripoint in the Lake."

*Fifth preliminary objection:*

"(1) In the submission of Nigeria there is no dispute concerning boundary delimitation as such throughout the whole length of the boundary from the tripoint in Lake Chad to the sea, and in particular:

- (a) there is no dispute in respect of the boundary delimitation as such within Lake Chad, subject to the question of title to Darak and adjacent islands inhabited by Nigerians;
- (b) there is no dispute relating to the boundary delimitation as such from the tripoint in Lake Chad to Mount Kombon;
- (c) there is no dispute relating to the boundary delimitation as such between Boundary Pillar 64 on the Gamana River and Mount Kombon; and
- (d) there is no dispute relating to the boundary delimitation as such between Pillar 64 on the Gamana River and the sea.

(2) This preliminary objection is without prejudice to the title of Nigeria over the Bakassi Peninsula.”

*Sixth preliminary objection:*

- “(1) that the Application (and so far as relevant, Amendment and Memorial) filed by Cameroon does not meet the required standard of adequacy as to the facts on which it is based, including the dates, circumstances and precise locations of the alleged incursions and incidents by Nigerian State organs;
- (2) that those deficiencies make it impossible
- (a) for Nigeria to have the knowledge to which it is entitled of the circumstances which are said by Cameroon to result in Nigeria’s international responsibility and consequential obligation to make reparation; and
- (b) for the Court to carry out a fair and effective judicial examination of, or make a judicial determination on, the issues of State responsibility and reparation raised by Cameroon; and
- (3) that accordingly all the issues of State responsibility and reparation raised by Cameroon in this context should be declared inadmissible.”

*Seventh preliminary objection:*

“There is no legal dispute concerning delimitation of the maritime boundary between the two Parties which is at the present time appropriate for resolution by the Court, for the following reasons:

- (1) no determination of a maritime boundary is possible prior to the determination of title in respect of the Bakassi Peninsula;
- (2) at the juncture where there is a determination of the question of title over the Bakassi Peninsula, the issues of maritime delimitation will not be admissible in the absence of sufficient action by the Parties, on a footing of equality, to effect a delimitation ‘by agreement on the basis of international law’.”

*Eighth preliminary objection:*

“The question of maritime delimitation necessarily involves the rights and interests of third States and is inadmissible.”

*Concluding submissions:*

“For the reasons advanced, the Federal Republic of Nigeria requests the Court to adjudge and declare that:

it lacks jurisdiction over the claims brought against the Federal Republic of Nigeria by the Republic of Cameroon;

and/or

the claims brought against the Federal Republic of Nigeria by the Republic of Cameroon are inadmissible to the extent specified in these preliminary objections.”

*On behalf of the Government of Cameroon,*

in the written statement containing its observations on the preliminary objections:

“For the reasons given . . . , the Republic of Cameroon requests the International Court of Justice:

- (1) to dismiss the preliminary objections raised by the Federal Republic of Nigeria;
- (2) to find that, by its formal declarations, Nigeria has accepted the jurisdiction of the Court;
- (3) to adjudge and declare:
  - that it has jurisdiction to decide on the Application filed by Cameroon on 29 March 1994 as supplemented by the additional Application of 6 June 1994; and
  - that the Application, thus consolidated, is admissible;
- (4) having due regard to the particular nature of the case, which relates to a dispute concerning the territorial sovereignty of Cameroon and is creating serious tensions between the two countries, to fix time-limits for the further proceedings which will enable the Court to proceed to the merits at the earliest possible time.”

19. In the oral proceedings, the Parties presented the following submissions:

*On behalf of the Government of Nigeria,*

at the hearing on 9 March 1998:

“[F]or the reasons that have been stated either in writing or orally, Nigeria submits:

*First preliminary objection*

1.1. That Cameroon, by lodging the Application on 29 March 1994, violated its obligations to act in good faith, acted in abuse of the system established by Article 36, paragraph 2, of the Statute, and disregarded the requirement of reciprocity established by Article 36, paragraph 2, of the Statute and the terms of Nigeria’s Declaration of 3 September 1965;

1.2. that consequently the conditions necessary to entitle Cameroon to invoke its Declaration under Article 36, paragraph 2, as a basis for the Court’s jurisdiction did not exist when the Application was lodged;

1.3. that accordingly, the Court is without jurisdiction to entertain the Application.

*Second preliminary objection*

2.1. That for a period of at least 24 years prior to the filing of the Application, the Parties have in their regular dealings accepted a duty to settle all boundary questions through the existing bilateral machinery;

2.1.1. that this course of joint conduct constitutes an implied agreement to resort exclusively to the existing bilateral machinery and not to invoke the jurisdiction of the Court;

2.1.2. that *in the alternative*, in the circumstances the Republic of Cameroon is estopped from invoking the jurisdiction of the Court.

*Third preliminary objection*

3.1. That without prejudice to the second preliminary objection, the

settlement of boundary disputes within the Lake Chad region is subject to the exclusive competence of the Lake Chad Basin Commission, and in this context the procedures of settlement within the Lake Chad Basin Commission are obligatory for the Parties;

3.2. that the operation of the dispute settlement procedures of the Lake Chad Basin Commission involved the necessary implication, for the relations of Nigeria and Cameroon *inter se*, that the jurisdiction of the Court by virtue of Article 36, paragraph 2, would not be invoked in relation to matters within the exclusive competence of the Commission.

#### *Fourth preliminary objection*

4.1. That the Court should not in these proceedings determine the boundary in Lake Chad to the extent that that boundary constitutes or is constituted by the tripoint in the Lake.

#### *Fifth preliminary objection*

5.1. That, without prejudice to the title of Nigeria over the Bakassi Peninsula, there is no dispute concerning boundary delimitation as such throughout the whole length of the boundary from the tripoint in Lake Chad to the sea, and in particular:

- (a) there is no dispute in respect of the boundary delimitation as such within Lake Chad, subject to the question of title to Darak and adjacent islands inhabited by Nigerians;
- (b) there is no dispute relating to the boundary delimitation as such from the tripoint in Lake Chad to Mount Kombon;
- (c) there is no dispute relating to the boundary delimitation as such between boundary pillar 64 on the Gamana River and Mount Kombon; and
- (d) there is no dispute relating to the boundary delimitation as such between pillar 64 on the Gamana River and the sea.

#### *Sixth preliminary objection*

6.1. That the Application (and so far as permissible, subsequent pleadings) filed by Cameroon does not meet the required standard of adequacy as to the facts on which it is based, including the dates, circumstances and precise locations of the alleged incursions and incidents by Nigerian State organs;

6.2. that those deficiencies make it impossible

- (a) for Nigeria to have the knowledge to which it is entitled of the circumstances which are said by Cameroon to result in Nigeria's international responsibility and consequential obligation to make reparation; and
- (b) for the Court to carry out a fair and effective judicial examination of, or make a judicial determination on, the issues of State responsibility and reparation raised by Cameroon;

6.3. that accordingly all the issues of State responsibility and reparation raised by Cameroon in this context should be declared inadmissible;

6.4. that, without prejudice to the foregoing, any allegations by Cameroon as to State responsibility or reparation on the part of Nigeria in



respect of matters referred to in paragraph 17 (*f*) of Cameroon's amending Application of 6 June 1994 are inadmissible.

*Seventh preliminary objection*

7.1. That there is no legal dispute concerning delimitation of the maritime boundary between the two Parties which is at the present time appropriate for resolution by the Court, for the following reasons:

- (1) no determination of a maritime boundary is possible prior to the determination of title in respect of the Bakassi Peninsula;
- (2) in any event, the issues of maritime delimitation are inadmissible in the absence of sufficient action by the Parties, on a footing of equality, to effect a delimitation 'by agreement on the basis of international law'.

*Eighth preliminary objection*

8.1. That the question of maritime delimitation necessarily involves the rights and interests of third States and is inadmissible beyond point G.

Accordingly, Nigeria formally requests the Court to adjudge and declare that:

- (1) it lacks jurisdiction over the claims brought against the Federal Republic of Nigeria by the Republic of Cameroon; and/or
- (2) the claims brought against the Federal Republic of Nigeria by the Republic of Cameroon are inadmissible to the extent specified in the preliminary objections."

*On behalf of the Government of Cameroon,*

at the hearing on 11 March 1998:

"For the reasons developed in the written pleadings and in the oral proceedings, the Republic of Cameroon requests the International Court of Justice:

- (a) to dismiss the preliminary objections raised by the Federal Republic of Nigeria;
- (b) completely in the alternative, to join to the merits, as appropriate, such of those objections as it may deem not to be of an exclusively preliminary character;
- (c) to adjudge and declare: that it has jurisdiction to decide on the Application filed by Cameroon on 29 March 1994 as supplemented by the Additional Application of 6 June 1994; and that the Application, thus consolidated, is admissible;
- (d) having due regard to the particular nature of the case, to fix time-limits for the further proceedings which will permit examination of the merits of the dispute at the earliest possible time."

\* \* \*

20. The Court will successively examine the eight preliminary objections raised by Nigeria.

## FIRST PRELIMINARY OBJECTION

21. The first objection contends that the Court has no jurisdiction to entertain Cameroon's Application.

22. In this regard, Nigeria notes that it had accepted the Court's compulsory jurisdiction by a declaration dated 14 August 1965, deposited with the Secretary-General of the United Nations on 3 September 1965. Cameroon had also accepted the Court's compulsory jurisdiction by a declaration deposited with the Secretary-General on 3 March 1994. The Secretary-General transmitted copies of the Cameroon Declaration to the parties to the Statute eleven-and-a-half months later. Nigeria maintains, accordingly, that it had no way of knowing, and did not actually know, on the date of the filing of the Application, i.e., 29 March 1994, that Cameroon had deposited a declaration. Cameroon consequently is alleged to have "acted prematurely". By proceeding in this way, the Applicant "is alleged to have violated its obligation to act in good faith", "abused the system instituted by Article 36, paragraph 2, of the Statute" and disregarded "the condition of reciprocity" provided for by that Article and by Nigeria's Declaration. The Court consequently does not have jurisdiction to hear the Application.

23. In contrast, Cameroon contends that its Application fulfils all the conditions required by the Statute. It notes that in the case concerning *Right of Passage over Indian Territory*, the Court held that

"the Statute does not prescribe any interval between the deposit by a State of its Declaration of Acceptance and the filing of an Application by that State, and that the principle of reciprocity is not affected by any delay in the receipt of copies of the Declaration by the Parties to the Statute" (*Right of Passage over Indian Territory, Preliminary Objections, Judgment, I.C.J. Reports 1957*, p. 147).

Cameroon indicates that there is no reason not to follow this precedent, at the risk of undermining the system of compulsory jurisdiction provided by the Optional Clause. It adds that the Cameroonian Declaration was in force as early as 3 March 1994, as at that date it was registered in accordance with Article 102 of the United Nations Charter. Cameroon states that in any event Nigeria has acted, since the beginning of these proceedings, in such a way that it should be regarded as having accepted the jurisdiction of the Court.

24. Nigeria argues in reply that the "case concerning the *Right of Passage over Indian Territory*, was a first impression", that the Judgment given is outdated, and that it is an isolated one; that international law, especially as it relates to good faith, has evolved since and that in accordance with Article 59 of the Statute, that Judgment only has the force of *res judicata* as between the parties and in respect of that case. For these reasons, the solution adopted in 1957 should not be adopted here. Nigeria does not accept the reasoning of Cameroon based on Article 102 of the Charter. Nigeria also contends that there is no question of its

having consented to the jurisdiction of the Court in the case and hence there is no *forum prorogatum*.

Cameroon contests each of these arguments.

25. The Court observes initially that, in accordance with Article 36, paragraph 2, of the Statute:

“The States parties to the present Statute may at any time declare that they recognize as compulsory *ipso facto* and without special agreement, in relation to any other State accepting the same obligation, the jurisdiction of the Court in all legal disputes”

as specified in that clause.

Article 36, paragraph 4, provides:

“Such declarations shall be deposited with the Secretary-General of the United Nations, who shall transmit copies thereof to the parties to the Statute and to the Registrar of the Court.”

In the case concerning *Right of Passage over Indian Territory*, the Court concluded, in the light of these provisions, that:

“by the deposit of its Declaration of Acceptance with the Secretary-General, the accepting State becomes a Party to the system of the Optional Clause in relation to the other declarant States, with all the rights and obligations deriving from Article 36. The contractual relation between the Parties and the compulsory jurisdiction of the Court resulting therefrom are established, ‘*ipso facto* and without special agreement’, by the fact of the making of the Declaration . . . For it is on that very day that the consensual bond, which is the basis of the Optional Clause, comes into being between the States concerned.” (*Right of Passage over Indian Territory, Preliminary Objections, Judgment, I.C.J. Reports 1957*, p. 146.)

The conclusions thus reached by the Court in 1957 reflect the very essence of the Optional Clause providing for acceptance of the Court’s compulsory jurisdiction. Any State party to the Statute, in adhering to the jurisdiction of the Court in accordance with Article 36, paragraph 2, accepts jurisdiction in its relations with States previously having adhered to that clause. At the same time, it makes a standing offer to the other States party to the Statute which have not yet deposited a declaration of acceptance. The day one of those States accepts that offer by depositing in its turn its declaration of acceptance, the consensual bond is established and no further condition needs to be fulfilled. Thus, as the Court stated in 1957:

“every State which makes a Declaration of Acceptance must be deemed to take into account the possibility that, under the Statute, it may at any time find itself subjected to the obligations of the Optional Clause in relation to a new Signatory as the result of the deposit by that Signatory of a Declaration of Acceptance” (*ibid.*, p. 146).

26. Furthermore, and as the Court also declared in the case concerning *Right of Passage over Indian Territory*, the State making the declaration

“is not concerned with the duty of the Secretary-General or the manner of its fulfilment. The legal effect of a Declaration does not depend upon subsequent action of the Secretary-General. Moreover, unlike some other instruments, Article 36 provides for no additional requirement, for instance, that the information transmitted by the Secretary-General must reach the Parties to the Statute, or that some period must elapse subsequent to the deposit of the Declaration before it can become effective. Any such requirement would introduce an element of uncertainty into the operation of the Optional Clause system. The Court cannot read into the Optional Clause any requirement of that nature.” (*I.C.J. Reports 1957*, pp. 146-147.)

27. The Court furthermore recalls that, contrary to what is maintained by Nigeria, this Judgment is not an isolated one. It has been reaffirmed in the case concerning the *Temple of Preah Vihear (Preliminary Objections, I.C.J. Reports 1961*, p. 31), and in the case concerning *Military and Paramilitary Activities in and against Nicaragua (Nicaragua v. United States of America) (Jurisdiction and Admissibility, Judgment, I.C.J. Reports 1984*, p. 392). In that latter case, the Court pointed out that:

“as regards the requirement of consent as a basis of its jurisdiction, and more particularly as regards the formalities required for that consent to be expressed in accordance with the provisions of Article 36, paragraph 2, of the Statute, the Court has already made known its view in, *inter alia*, the case concerning the *Temple of Preah Vihear*. On that occasion it stated: ‘The only formality required is the deposit of the acceptance with the Secretary-General of the United Nations under paragraph 4 of Article 36 of the Statute.’ (*I.C.J. Reports 1961*, p. 31.)” (*I.C.J. Reports 1984*, p. 412, para. 45.)

28. Nigeria nonetheless contests that conclusion pointing out that, in accordance with Article 59 of the Statute, “[t]he decision of the Court has no binding force except between the parties and in respect of that particular case”. Thus, judgments given earlier, in particular in the case concerning *Right of Passage over Indian Territory*, “clearly [have] no direct compelling effect in the present case”.

It is true that, in accordance with Article 59, the Court’s judgments bind only the parties to and in respect of a particular case. There can be no question of holding Nigeria to decisions reached by the Court in previous cases. The real question is whether, in this case, there is cause not to follow the reasoning and conclusions of earlier cases.

29. In this regard, Nigeria maintains first of all that the interpretation given in 1957 to Article 36, paragraph 4, of the Statute should be reconsidered in the light of the evolution of the law of treaties which has occurred since. In that connection, Nigeria relies on Article 78 (c) of the Vienna Convention on the Law of Treaties of 23 May 1969. That Article relates to the notifications and communications made under that Convention. It provides that:

“Except as the treaty or the present Convention otherwise provide, any notification or communication to be made by any State under the present Convention shall:

- .....
- (c) if transmitted to a depositary, be considered as received by the State for which it was intended only when the latter State has been informed by the depositary.”

According to Nigeria, that rule “must apply to Cameroon’s Declaration”. In the light of the provisions of the Vienna Convention, Nigeria contends that the Court should overturn the solution it adopted earlier in the case concerning *Right of Passage over Indian Territory*. Cameroon states, for its part, that the declarations of acceptance of the Court’s compulsory jurisdiction “are not treaties within the meaning of the Vienna Convention” and “it was clearly no part of the intentions of the drafters of the . . . Convention . . . to interfere with the settled jurisprudence of the Court in this matter”. This jurisprudence, Cameroon argues, should be followed.

30. The Court notes that the régime for depositing and transmitting declarations of acceptance of compulsory jurisdiction laid down in Article 36, paragraph 4, of the Statute of the Court is distinct from the régime envisaged for treaties by the Vienna Convention. Thus the provisions of that Convention may only be applied to declarations by analogy (*Military and Paramilitary Activities in and against Nicaragua (Nicaragua v. United States of America)*, *Jurisdiction and Admissibility, Judgment, I.C.J. Reports 1984*, p. 420, para. 63).

31. The Court furthermore observes that in any event the provisions of the Vienna Convention do not have the scope which Nigeria imputes to them. Article 78 of the Convention is only designed to lay down the modalities according to which notifications and communications should be carried out. It does not govern the conditions in which a State expresses its consent to be bound by a treaty and those under which a treaty comes into force, those questions being governed by Articles 16 and 24 of the Convention. Indeed, the International Law Commission, in its Report to the General Assembly on the draft which was subsequently to become the Vienna Convention, specified that if the future Article 78 included *in limine* an explicit reservation, that was “primarily in order to prevent any misconception as to the relation” between that Article and the future Articles 16 and 24 (*Yearbook of the International Law Com-*

mission, 1966, Vol. II, p. 271). It added that consequently "specific provisions [of those latter Articles] will prevail".

According to Article 16:

"Unless the treaty otherwise provides, instruments of ratification, acceptance, approval or accession establish the consent of a State to be bound by a treaty upon:

.....  
 (b) their deposit with the depositary."

Article 24 further provides in its paragraph 3 that:

"When the consent of a State to be bound by a treaty is established on a date after the treaty has come into force, the treaty enters into force for that State on that date, unless the treaty otherwise provides."

In its report to the General Assembly, the International Law Commission had pointed out that:

"In the case of the deposit of an instrument with a depositary, the problem arises whether the deposit by itself establishes the legal nexus between the depositing State and other contracting States or whether the legal nexus arises only upon their being informed by the depositary." (*Yearbook of the International Law Commission*, 1966, Vol. II, p. 201.)

After describing the advantages and disadvantages of both solutions, it concluded that:

"The Commission considered that the existing general rule clearly is that the act of deposit by itself establishes the legal nexus . . . This was the view taken by the International Court of Justice in the *Right of Passage over Indian Territory* (preliminary objections) case in the analogous situation of the deposit of instruments of acceptance of the optional clause under Article 36, paragraph 2, of the Statute of the Court . . . [Therefore] the existing rule appears to be well-settled." (*Ibid.*)

This general rule is reflected in Articles 16 and 24 of the Vienna Convention: the deposit of instruments of ratification, acceptance, approval or accession to a treaty establishes the consent of a State to be bound by a treaty; the treaty enters into force as regards that State on the day of the deposit.

Thus the rules adopted in this sphere by the Vienna Convention correspond to the solution adopted by the Court in the case concerning *Right of Passage over Indian Territory*. That solution should be maintained.

32. Nigeria maintains however that, in any event, Cameroon could not file an application before the Court without allowing a reasonable period to elapse "as would . . . have enabled the Secretary-General to take the

action required of him in relation to Cameroon's Declaration of 3 March 1994". Compliance with that time period is essential, the more so because, according to Nigeria, the Court, in its Judgment of 26 November 1984 in the case concerning *Military and Paramilitary Activities in and against Nicaragua*, required a reasonable time for the withdrawal of declarations under the Optional Clause.

33. The Court, in the above Judgment, noted that the United States had, in 1984, deposited with the Secretary-General, three days before the filing of Nicaragua's Application, a notification limiting the scope of its Declaration of acceptance of the Court's jurisdiction. The Court noted that that Declaration contained a clause requiring six months' notice of termination. It considered that that condition should be complied with in cases of either termination or modification of the Declaration, and concluded that the 1984 notification of modification could not, with immediate effect, override the obligation entered into by the United States beforehand (*Military and Paramilitary Activities in and against Nicaragua (Nicaragua v. United States of America)*, *Jurisdiction and Admissibility*, *I.C.J. Reports 1984*, p. 421, para. 65).

The Court noted, moreover, in relation to Nicaragua's Declaration upon which the United States was relying on the grounds of reciprocity, that, in any event,

"the right of immediate termination of declarations with indefinite duration is far from established. It appears from the requirements of good faith that they should be treated, by analogy, according to the law of treaties, which requires a reasonable time for withdrawal from or termination of treaties that contain no provision regarding the duration of their validity" (*ibid.*, p. 420, para. 63).

The Court added: "the question of what reasonable period of notice would legally be required does not need to be further examined: it need only be observed that [three days] would not amount to a 'reasonable time'" (*ibid.*).

34. The Court considers that the foregoing conclusion in respect of the withdrawal of declarations under the Optional Clause is not applicable to the deposit of those declarations. Withdrawal ends existing consensual bonds, while deposit establishes such bonds. The effect of withdrawal is therefore purely and simply to deprive other States which have already accepted the jurisdiction of the Court of the right they had to bring proceedings before it against the withdrawing State. In contrast, the deposit of a declaration does not deprive those States of any accrued right. Accordingly no time period is required for the establishment of a consensual bond following such a deposit.

35. The Court notes moreover that to require a reasonable time to elapse before a declaration can take effect would be to introduce an element of uncertainty into the operation of the Optional Clause system. As set out in paragraph 26 above, in the case concerning *Right of Passage*

over *Indian Territory*, the Court had considered that it could not create such uncertainty. The conclusions it had reached then remain valid and apply all the more since the growth in the number of States party to the Statute and the intensification of inter-State relations since 1957 have increased the possibilities of legal disputes capable of being submitted to the Court. The Court cannot introduce into the Optional Clause an additional time requirement which is not there.

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36. Nigeria's second argument is that Cameroon omitted to inform it that it intended to accept the jurisdiction of the Court, then that it had accepted that jurisdiction and, lastly, that it intended to file an application. Nigeria further argued that Cameroon even continued, during the first three months of 1994, to maintain bilateral contacts with it on boundary questions while preparing itself to address the Court. Such conduct, Nigeria contends, infringes upon the principle of good faith which today plays a larger role in the case-law of the Court than before, and should not be accepted.

37. Cameroon, for its part, argues that it had no obligation to inform Nigeria in advance of its intentions, or of its decisions. It adds that in any event "Nigeria was not at all surprised by the filing of Cameroon's Application and . . . knew perfectly well what Cameroon's intentions were in that regard several weeks before the filing". The principle of good faith was not at all disregarded.

38. The Court observes that the principle of good faith is a well-established principle of international law. It is set forth in Article 2, paragraph 2, of the Charter of the United Nations; it is also embodied in Article 26 of the Vienna Convention on the Law of Treaties of 23 May 1969. It was mentioned as early as the beginning of this century in the Arbitral Award of 7 September 1910 in the *North Atlantic Fisheries* case (United Nations, *Reports of International Arbitral Awards*, Vol. XI, p. 188). It was moreover upheld in several judgments of the Permanent Court of International Justice (*Factory at Chorzów, Merits, Judgment No. 13, 1928, P.C.I.J., Series A, No. 17, p. 30; Free Zones of Upper Savoy and the District of Gex, Order of 6 December 1930, P.C.I.J., Series A, No. 24, p. 12, and 1932, P.C.I.J., Series A/B, No. 46, p. 167*). Finally, it was applied by this Court as early as 1952 in the case concerning *Rights of Nationals of the United States of America in Morocco* (*Judgment, I.C.J. Reports 1952, p. 212*), then in the case concerning *Fisheries Jurisdiction (Federal Republic of Germany v. Iceland)* (*Jurisdiction of the Court, Judgment, I.C.J. Reports 1973, p. 18*), the *Nuclear Tests* cases (*I.C.J. Reports 1974, pp. 268 and 473*), and the case concerning *Border and Transborder Armed Actions (Nicaragua v. Honduras)* (*Jurisdiction and Admissibility, Judgment, I.C.J. Reports 1988, p. 105*).



39. The Court furthermore notes that although the principle of good faith is “one of the basic principles governing the creation and performance of legal obligations . . . it is not in itself a source of obligation where none would otherwise exist” (*Border and Transborder Armed Actions (Nicaragua v. Honduras)*, *Jurisdiction and Admissibility, Judgment, I.C.J. Reports 1988*, p. 105, para. 94). There is no specific obligation in international law for States to inform other States parties to the Statute that they intend to subscribe or have subscribed to the Optional Clause. Consequently, Cameroon was not bound to inform Nigeria that it intended to subscribe or had subscribed to the Optional Clause.

Moreover:

“A State accepting the jurisdiction of the Court must expect that an Application may be filed against it before the Court by a new declarant State on the same day on which that State deposits with the Secretary-General its Declaration of Acceptance.” (*Right of Passage over Indian Territory, Preliminary Objections, Judgment, I.C.J. Reports 1957*, p. 146.)

Thus, Cameroon was not bound to inform Nigeria of its intention to bring proceedings before the Court. In the absence of any such obligations and of any infringement of Nigeria’s corresponding rights, Nigeria may not justifiably rely upon the principle of good faith in support of its submissions.

40. On the facts of the matter, to which the Parties devoted considerable attention, and quite apart from legal considerations, the Court would add that Nigeria was not unaware of Cameroon’s intentions. On 28 February 1994, Cameroon had informed the Security Council of incidents which had occurred shortly beforehand in the Bakassi Peninsula. In response, on 4 March 1994, Nigeria apprised the Security Council of its surprise in noting that “the Cameroon Government had decided to raise the matter to an international level by . . . (c) bringing proceedings before the International Court of Justice”. Indeed on 4 March, Cameroon had deposited its declaration of acceptance of the compulsory jurisdiction of the Court, but had not yet seised the Court. Nigeria’s communication to the Security Council nevertheless showed that it was not uninformed of Cameroon’s intentions.

Further the Court points out that, on 4 March 1994, the *Journal of the United Nations*, issued at Headquarters in New York to United Nations organs and to the permanent missions, reported that Cameroon had deposited with the Secretary-General a “declaration recognizing as compulsory the jurisdiction of the International Court of Justice under Article 36, paragraph 2, of the Statute of the Court” (*Journal of the United Nations*, Friday 4 March 1994, No. 1994/43 (Part II)).

Lastly, on 11 March 1994, the bringing of the matter to the Security Council and the International Court of Justice by Cameroon was men-

tioned at the extraordinary general meeting of the Central Organ of the Mechanism for Conflict Prevention, Management and Resolution of the Organization of African Unity, devoted to the border conflict between Cameroon and Nigeria.

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41. Nigeria recalls in the third place that, by its Declaration deposited on 3 September 1965, it had recognized

“as compulsory *ipso facto* and without special agreement, in relation to any other State accepting the same obligation, that is to say, on the sole condition of reciprocity, the jurisdiction of the International Court of Justice in conformity with Article 36, paragraph 2, of the Statute of the Court”.

Nigeria maintains that on the date on which Cameroon’s Application was filed, it did not know that Cameroon had accepted the Court’s compulsory jurisdiction. Accordingly it could not have brought an application against Cameroon. There was an absence of reciprocity on that date. The condition contained in the Nigerian Declaration was operative; consequently, the Court does not have jurisdiction to hear the Application.

42. Cameroon disputes this argument in fact as well as in law. It states that, in the minds of the States party to the Optional Clause, the condition of reciprocity never possessed the meaning which Nigeria now ascribes to it; the Court had ascribed a completely different meaning to it in a number of its judgments. The interpretation now provided by Nigeria of its own declaration was a new interpretation for which no authority was cited in support. In sum, the purpose of the Nigerian Declaration, according to Cameroon, was only to emphasize that there is “a sole and unique condition to the compulsory character of the Court’s jurisdiction in this case, i.e., that Cameroon should accept the same obligation as Nigeria, or in other words that it should accept the jurisdiction of the Court. This Cameroon does.”

43. The Court has on numerous occasions had to consider what meaning it is appropriate to give to the condition of reciprocity in the implementation of Article 36, paragraph 2, of the Statute. As early as 1952, it held in the case concerning *Anglo-Iranian Oil Co.* that, when declarations are made on condition of reciprocity, “jurisdiction is conferred on the Court only to the extent to which the two Declarations coincide in conferring it” (*I.C.J. Reports 1952*, p. 103). The Court applied that rule again in the case of *Certain Norwegian Loans (I.C.J. Reports 1957*, pp. 23 and 24) and clarified it in the *Interhandel* case where it held that:

“Reciprocity in the case of Declarations accepting the compulsory jurisdiction of the Court enables a Party to invoke a reservation to that acceptance which it has not expressed in its own Declaration but which the other Party has expressed in its Declaration. . . Reciprocity enables the State which has made the wider acceptance of the

jurisdiction of the Court to rely upon the reservations to the acceptance laid down by the other Party. There the effect of reciprocity ends." (*I.C.J. Reports 1959*, p. 23.)

In the final analysis, "[t]he notion of reciprocity is concerned with the scope and substance of the commitments entered into, including reservations, and not with the formal conditions of their creation, duration or extinction" (*Military and Paramilitary Activities in and against Nicaragua (Nicaragua v. United States of America)*, *Jurisdiction and Admissibility, Judgment*, *I.C.J. Reports 1984*, p. 419, para. 62). It simply requires that the Court ascertain whether, at the time of filing the Application instituting proceedings "the two States accepted 'the same obligation' in relation to the subject-matter of the proceedings" (*ibid.*, pp. 420-421, para. 64).

Therefore, in legal proceedings, the notion of reciprocity, and that of equality, "are not abstract conceptions. They must be related to some provision of the Statute or of the Declarations" (*Right of Passage over Indian Territory, Preliminary Objections, Judgment*, *I.C.J. Reports 1957*, p. 145). Consequently, "the principle of reciprocity is not affected by any delay in the receipt of copies of the Declaration by the Parties to the Statute" (*ibid.*, p. 147).

Nigeria considers, however, that that precedent does not apply here. It points out that, although in its 1965 Declaration, it recognized the jurisdiction of the Court as compulsory in relation to any other State accepting the same obligation, it was more explicit in adding the words "and that is to say, on the sole condition of reciprocity". "Those additional words clearly have some meaning and effect . . . it is the supplementing of the 'coincidence' required by Article 36, paragraph 2, by the element of mutuality inherent in the concept of 'reciprocity'." The Nigerian condition, in other words, sought "to mitigate the effects" of the Court's earlier decision in the case concerning *Right of Passage over Indian Territory* by creating an equality of risk and precluding that proceedings be brought before the Court by surprise.

44. In support of its position, Nigeria invokes the decision given in the case concerning *Anglo-Iranian Oil Co.*, in which the Court stated that it could not base its interpretation of the Iranian Declaration recognizing the jurisdiction of the Court

"on a purely grammatical interpretation of the text. It must seek the interpretation which is in harmony with a natural and reasonable way of reading the text, having due regard to the intention of the Government of Iran at the time when it accepted the compulsory jurisdiction of the Court." (*Anglo-Iranian Oil Co., Preliminary Objection*, *I.C.J. Reports 1952*, p. 104.)

The Court had concluded that "[i]t is unlikely that the Government of Iran . . . should have been willing, on its own initiative, to agree that disputes relating" (*ibid.*, p. 105) to the capitulations which it had just denounced be submitted to an international court of justice.

45. The Court considers that the situation in this case is very different. Nigeria does not offer evidence in support of its argument that it intended to insert into its Declaration of 14 August 1965 a condition of reciprocity with a different meaning from the one which the Court had drawn from such clauses in 1957. In order to protect itself against the filing of surprise applications, in 1965, Nigeria could have inserted in its Declaration an analogous reservation to that which the United Kingdom added to its own Declaration in 1958. Ten or so other States proceeded in this way. Nigeria did not do so at that time. Like the majority of States which subscribe to the Optional Clause, it merely specified that the commitments it was entering into, in accordance with Article 36, paragraph 2, of the Statute, were reciprocal in relation to any other State accepting the same obligation. In the light of this practice, the additional phrase of the sentence, "that is to say, on the sole condition of reciprocity" must be understood as explanatory and not adding any further condition. This interpretation is "in harmony with a natural and reasonable way of reading the text" (*Anglo-Iranian Oil Co., Preliminary Objection, I.C.J. Reports 1952*, p. 104) and Nigeria's condition of reciprocity cannot be treated as a reservation *ratione temporis*.

46. The Court therefore concludes that the manner in which Cameroon's Application was filed was not contrary to Article 36 of the Statute. Nor was it made in violation of a right which Nigeria may claim under the Statute, or by virtue of its Declaration, as it was in force on the date of the filing of Cameroon's Application.

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47. Nigeria's first preliminary objection is accordingly rejected. The Court is therefore not called upon to examine the reasoning put forward by Cameroon under Article 102 of the Charter, nor Cameroon's alternative submissions based on *forum prorogatum*. In any event, the Court has jurisdiction to pass upon Cameroon's Application.

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#### SECOND PRELIMINARY OBJECTION

48. Nigeria raises a second preliminary objection stating that

"for a period of at least 24 years prior to the filing of the Application the Parties have in their regular dealings accepted a duty to settle all boundary questions through the existing bilateral machinery".

According to Nigeria, an implicit agreement is thus said to have been reached with a view to resorting exclusively to such machinery and to

refraining from relying on the jurisdiction of the International Court of Justice. In the alternative, Nigeria claims that by its conduct Cameroon is estopped from turning to the Court. Finally, Nigeria invokes the principle of good faith and the rule *pacta sunt servanda* in support of this argument.

49. Cameroon maintains that the bilateral bodies which dealt with various boundary difficulties that had emerged between the two countries had only been temporary and that no permanent institutional machinery had been set up. It contends that no explicit or implicit agreement had been established between the Parties with a view to vesting exclusive jurisdiction in such bodies. Finally, according to Cameroon, the conditions laid down in the Court's case-law for the application of estoppel to arise were not fulfilled here. Therefore, there was no occasion to apply the principle of good faith and the rule *pacta sunt servanda*.

50. Nigeria's objection thus consists of two branches. But before making a legal determination considering them in turn, the Court will review the relevant facts.

51. The first bilateral contact referred to in the pleadings concerns a local dispute in the districts of Danare (Nigeria) and Budam (Cameroon). This dispute gave rise in 1965 to "exploratory talks" concerning the demarcation of the boundary in this sector. That course having been determined by the German and British authorities at the beginning of the century, it was agreed to locate existing boundary pillars with a view to identifying the boundary and proceeding with its demarcation not only between Danare and Budam, but also on a stretch of some 20 miles from Obokum Falls to Bashu (boundary pillars Nos. 114 to 105). The existing pillars were identified but none of the work planned was subsequently carried out.

52. Five years later, in response to incidents that occurred in the Cross River region and the Bakassi Peninsula, the two Governments decided to set up a Joint Boundary Commission. At the first meeting of that Commission, the delegates from Cameroon and Nigeria approved, on 14 August 1970, a declaration recommending that the delimitation of the boundary be carried out in three stages:

- (a) the delimitation of the maritime boundary;
- (b) the delimitation of the land boundary as defined in the Anglo-German Protocol signed at Obokum on 12 April 1913 and confirmed by the London Anglo-German agreement 'respecting (1) the settlement of Frontier between Nigeria and Cameroon from Yola to the sea; and (2) the Regulation of navigation on the Cross River', and the exchange of letters between the British and German Governments on 6 July 1914;
- (c) the delimitation of the rest of the land boundary".

The declaration further specified the bases on which the delimitation of the maritime boundary was to be carried out. It recommended that the demarcation work commenced in 1965 be resumed. Finally, it recommended that, on completion of each of these stages, a separate treaty be

signed by the two countries to give effect to the boundary so demarcated and surveyed.

A Joint Technical Committee was then set up for the purpose of implementing the joint declaration. As agreed, it began its work with the delimitation of the maritime boundary. Negotiations went on at various levels on this matter for almost five years. They concluded on 4 April 1971 as regards the maritime boundary at the mouth of the Cross River, then led on 1 June 1975 to a declaration in Maroua by the two Heads of State concerning the course of the maritime boundary from the mouth of the Cross River to a point denominated "G" situated, according to the Parties, some 17 nautical miles from the coast.

53. Over the following years, contacts between the two countries on these boundary issues became less frequent. At most, it may be noted that two Joint Committee meetings were held. The first, in 1978, was attended by the two Foreign Ministers. They set forth their points of view on a number of boundary problems without undertaking negotiations and the meeting did not result in any joint minutes. The second meeting, held in 1987, brought together the Ministers responsible for planning in the two countries and did not broach boundary matters.

54. The negotiations on these issues, which were interrupted after 1975, were only resumed between the two States 16 years later when, on 29 August 1991, the two Foreign Ministers adopted a joint communiqué stating:

"On border issues, the two sides agreed to examine in detail all aspects of the matter by the experts of the National Boundary Commission of Nigeria and the experts of the Republic of Cameroon at a meeting to be convened at Abuja in October 1991 with a view to making appropriate recommendations for a peaceful resolution of outstanding border issues."

Indeed, a first meeting of these experts took place at the same time as that of the Foreign Ministers in August 1991. It was followed by a second meeting at Abuja in December 1991, then by a third at Yaoundé in August 1993. No agreement could be reached at these meetings, in particular as regards the Maroua Declaration, which was considered binding by Cameroon but not by Nigeria.

55. In sum, the Court notes that the negotiations between the two States concerning the delimitation or the demarcation of the boundary were carried out in various frameworks and at various levels: Heads of State, Foreign Ministers, experts. The negotiations were active during the period 1970 to 1975 and then were interrupted until 1991.

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56. Turning to legal considerations, the Court will now consider the first branch of the Nigerian objection. It recalls first that, "Negotiation

and judicial settlement are enumerated together in Article 33 of the Charter of the United Nations as means for the peaceful settlement of disputes" (*Aegean Sea Continental Shelf, Judgment, I.C.J. Reports 1978*, p. 12, para. 29). Neither in the Charter nor otherwise in international law is any general rule to be found to the effect that the exhaustion of diplomatic negotiations constitutes a precondition for a matter to be referred to the Court. No such precondition was embodied in the Statute of the Permanent Court of International Justice, contrary to a proposal by the Advisory Committee of Jurists in 1920 (*Advisory Committee of Jurists, Procès-verbaux of the Proceedings of the Committee (16 June-24 July 1920) with Annexes*, pp. 679, 725-726). Nor is it to be found in Article 36 of the Statute of this Court.

A precondition of this type may be embodied and is often included in compromissory clauses of treaties. It may also be included in a special agreement whose signatories then reserve the right to seise the Court only after a certain lapse of time (cf. *Territorial Dispute (Libyan Arab Jamahiriya/Chad), Judgment, I.C.J. Reports 1994*, p. 9). Finally, States remain free to insert into their optional declaration accepting the compulsory jurisdiction of the Court a reservation excluding from the latter those disputes for which the parties involved have agreed or subsequently agree to resort to an alternative method of peaceful settlement. In this case, however, no reservation of this type was included in the Declarations of Nigeria or Cameroon on the date of the filing of the Application.

Moreover, the fact that the two States have attempted, in the circumstances set out in paragraphs 54 and 55 above, to solve some of the boundary issues dividing them during bilateral contacts, did not imply that either one had excluded the possibility of bringing any boundary dispute concerning it before other fora, and in particular the International Court of Justice. The first branch of Nigeria's objection accordingly is not accepted.

57. Turning to the second branch of the objection, the Court will examine whether the conditions laid down in its jurisprudence for an estoppel to exist are present in the instant case.

An estoppel would only arise if by its acts or declarations Cameroon had consistently made it fully clear that it had agreed to settle the boundary dispute submitted to the Court by bilateral avenues alone. It would further be necessary that, by relying on such an attitude, Nigeria had changed position to its own detriment or had suffered some prejudice (*North Sea Continental Shelf, Judgment, I.C.J. Reports 1969*, p. 26, para. 30; *Land, Island and Maritime Frontier Dispute (El Salvador/Honduras), Application to Intervene, Judgment, I.C.J. Reports 1990*, p. 118, para. 63).

These conditions are not fulfilled in this case. Indeed, as pointed out in paragraph 56 above, Cameroon did not attribute an exclusive character to the negotiations conducted with Nigeria, nor, as far as it appears, did

Nigeria. Furthermore, Nigeria does not show that it has changed its position to its detriment or that it has sustained prejudice in that it could otherwise have sought a solution to the border problems existing between the two States by having recourse to other procedures, but was precluded from doing so by reliance on the positions allegedly taken by Cameroon.

58. Finally, the Court has not been persuaded that Nigeria has been prejudiced as a result of Cameroon's having instituted proceedings before the Court instead of pursuing negotiations which, moreover, were deadlocked when the Application was filed.

59. This being so, in bringing proceedings before the Court, Cameroon did not disregard the legal rules relied on by Nigeria in support of its second objection. Consequently, Nigeria is not justified in relying on the principle of good faith and the rule *pacta sunt servanda*, both of which relate only to the fulfilment of existing obligations. The second branch of Nigeria's objection is not accepted.

60. The second preliminary objection as a whole is thus rejected.

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### THIRD PRELIMINARY OBJECTION

61. In its third preliminary objection, Nigeria contends that "the settlement of boundary disputes within the Lake Chad region is subject to the exclusive competence of the Lake Chad Basin Commission".

62. In support of this argument, Nigeria invokes the treaty texts governing the Statute of the Commission as well as the practice of member States. It argues that "the procedures for settlement by the Commission are binding upon the Parties" and that Cameroon was thus barred from raising the matter before the Court on the basis of Article 36, paragraph 2, of the Statute.

63. For its part, Cameroon submits to the Court that

"no provision of the Statute of the Lake Chad Basin Commission establishes in favour of that international organization any exclusive competence in relation to boundary delimitation".

It adds that no such exclusive jurisdiction can be inferred from the conduct of member States. It therefore calls upon the Court to reject the third preliminary objection.

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64. The Court observes that the Statute of the Lake Chad Basin Commission was annexed to an Agreement of 22 May 1964 signed on that



date by Cameroon, Chad, Niger and Nigeria. According to its preamble, this convention concerning the development of the Lake Chad Basin is designed “to formulate principles of the utilization of the resources of the Basin for economic purposes, including the harnessing of the water”. Article IV of the Statute develops those principles by providing that

“[t]he development of the said Basin and in particular the utilisation of surface and ground waters shall be given its widest connotation and refers in particular to domestic, industrial and agricultural development, the collection of the products of its fauna and flora”.

In addition, under Article VII of the Statute, member States undertake to “establish common rules for the purpose of facilitating navigation on the Lake and on the navigable waters in the Basin and to ensure the safety and control of navigation”.

Article I of the Convention establishes the Lake Chad Basin Commission. The Commission comprises two commissioners per member State. In accordance with Article X, paragraph 3, of the Statute, the decisions of the Commission shall be by unanimous vote.

The functions of the Commission are laid down in Article IX of the same Statute. They are *inter alia* to prepare “general regulations which will permit the full application of the principles set forth in the present Convention and its annexed Statute, and to ensure their effective application”. The Commission exercises various powers with a view to co-ordinating action by member States regarding the use of the waters of the Basin. Finally, one of its responsibilities under Article IX, paragraph (g), is “to examine complaints and to promote the settlement of disputes and the resolution of differences”.

65. Member States have also entrusted to the Commission certain tasks that had not originally been provided for in the treaty texts. Further to incidents between Cameroon and Nigeria in 1983 in the Lake Chad area, an extraordinary meeting of the Commission was convened from 21 to 23 July 1983 in Lagos on the initiative of the Heads of State concerned, in order to entrust to the Commission certain boundary and security matters. Two sub-commissions of experts were then set up. They met from 12 to 16 November 1984. An agreement was immediately reached between the experts to adopt “as working documents” various bilateral conventions and agreements concluded between Germany, France and the United Kingdom between 1906 and 1931 “on the delimitation of Borders in the Lake Chad area”. The experts proposed at the same time that the boundary so delimited be demarcated as early as possible.

This demarcation was carried out from 1988 to 1990 in the course of three boundary-marking operations involving the setting up of seven main and 68 intermediary boundary pillars. The Final Report on Beaconing was signed by the delegates of the four States concerned. Then,

on 23 March 1994, at the Eighth Summit of the Lake Chad Basin Commission in Abuja, the Heads of State and Government were informed that “the physical work in the field on the border demarcation exercise was fully completed”. They then decided “to approve the technical document on the demarcation of the international boundaries of member States in Lake Chad”, on the understanding “that each country should adopt the document in accordance with its national laws”. The question of the ratification of that document came up at the Ninth Summit of Heads of State of the Commission held on 30 and 31 October 1996 in N’Djamena when Heads of State of Cameroon and Nigeria were absent and where no progress was recorded. Since then, however, on 22 December 1997, Cameroon deposited its instrument of ratification, whereas Nigeria has not done so.

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66. In the light of the treaty texts and the practice thus recalled, the Court will consider the positions of the Parties on this matter. For its part, Nigeria first of all contends that “the role and Statute of the Commission” must be understood “in the framework of regional agencies” referred to in Article 52 of the United Nations Charter. It accordingly concludes that “the Commission has an exclusive power in relation to issues of security and public order in the region of Lake Chad and that these issues appropriately encompass the business of boundary demarcation”.

Cameroon argues, for its part, that the Commission does not constitute a regional arrangement or agency within the meaning of Article 52 of the Charter, pointing in particular to the fact that

“there has never been any question of extending this category to international regional organizations of a technical nature which, like the [Commission], can include a mechanism for the peaceful settlement of disputes or for the promotion of that kind of settlement”.

67. The Court notes that Article 52, paragraph 1, of the Charter refers to “regional arrangements or agencies for dealing with such matters relating to the maintenance of international peace and security as are appropriate for regional action”. According to paragraph 2 of that Article,

“[t]he Members of the United Nations entering into such arrangements or constituting such agencies shall make every effort to achieve pacific settlement of local disputes through such regional arrangements or by such regional agencies before referring them to the Security Council”.

Under Article 53, the Security Council may use these arrangements or agencies for “enforcement action under its authority”.

From the treaty texts and the practice analysed at paragraphs 64 and

65 above, it emerges that the Lake Chad Basin Commission is an international organization exercising its powers within a specific geographical area; that it does not however have as its purpose the settlement at a regional level of matters relating to the maintenance of international peace and security and thus does not fall under Chapter VIII of the Charter.

68. However, even were it otherwise, Nigeria's argument should nonetheless be set aside. In this connection, the Court notes that, in the case concerning *Military and Paramilitary Activities in and against Nicaragua*, it did not consider that the Contadora process could "properly be regarded as a 'regional arrangement' for the purposes of Chapter VIII of the United Nations Charter". But it added that, in any event,

"the Court is unable to accept either that there is any requirement of prior exhaustion of regional negotiating processes as a precondition to seising the Court; or that the existence of the Contadora process constitutes in this case an obstacle to the examination by the Court of the Nicaraguan Application" (*Military and Paramilitary Activities in and against Nicaragua (Nicaragua v. United States of America)*, *Jurisdiction and Admissibility, Judgment, I.C.J. Reports 1984*, p. 440).

Whatever their nature, the existence of procedures for regional negotiation cannot prevent the Court from exercising the functions conferred upon it by the Charter and the Statute.

69. Nigeria further invokes Article 95 of the United Nations Charter according to which:

"Nothing in the present Charter shall prevent Members of the United Nations from entrusting the solution of their differences to other tribunals by virtue of agreements already in existence or which may be concluded in the future."

According to Nigeria, the Lake Chad Basin Commission should be seen as a tribunal falling under the provisions of this text. This would mean that, if the Court were to pronounce on this submission of Cameroon it "would be in breach of the principle of the autonomy of jurisdictional competence" and "would be exercising an appellate jurisdiction".

The Court considers that the Lake Chad Basin Commission cannot be seen as a tribunal. It renders neither arbitral awards nor judgments and is therefore neither an arbitral nor a judicial body. Accordingly, this contention of Nigeria must also be set aside.

70. Nigeria further maintains that the Convention of 22 May 1964, confirmed by the practice of the member States of the Commission, attributes to that Commission an exclusive competence for the settlement of boundary disputes. It concludes from this that the Court cannot entertain Cameroon's submissions requesting it to determine the boundary between the two countries in this sector.

The Court cannot subscribe to that reasoning. It notes first of all that no provision in the Convention ascribes jurisdiction and *a fortiori* exclusive jurisdiction to the Commission as regards the settlement of boundary disputes. In particular, such a jurisdiction cannot be deduced from Article IX, paragraph (g), of the Convention (see paragraph 64 above).

The Court further notes that the member States of the Commission subsequently charged it with carrying out the demarcation of boundaries in the region on the basis of the agreements and treaties referred to in the experts' report of November 1984 (see paragraph 65 above). Thus, as pointed out by Nigeria, "the question of boundary demarcation was clearly within the competence of the [Commission]". This demarcation was designed by the States concerned as a physical operation to be carried out in the field under the authority of the Commission with a view to avoiding the reoccurrence of the incidents that had arisen in 1983.

But the Commission has never been given jurisdiction, and *a fortiori* exclusive jurisdiction, to rule on the territorial dispute now involving Cameroon and Nigeria before the Court, a dispute which moreover did not as yet exist in 1983. Consequently, Nigeria's argument must be dismissed.

71. Nigeria also argues that, from 1983 to 1994, "Cameroon had clearly and consistently evinced acceptance of the régime of exclusive recourse to the Lake Chad Basin Commission"; Cameroon then appealed to the Court contrary to the commitments it had entered into. This course of conduct, it was argued, had been prejudicial to Nigeria, deprived as it was of the "consultation" and "negotiation" procedures afforded by the Commission. Nigeria claims that Cameroon is estopped from making its Application.

The Court points out that the conditions laid down in its case-law for an estoppel to arise, as set out in paragraph 57 above, are not fulfilled in this case. Indeed, Cameroon has not accepted that the Commission has jurisdiction to settle the boundary dispute now submitted to the Court. This argument must also be set aside.

72. In the alternative, Nigeria finally argues that, on account of the demarcation under way in the Lake Chad Basin Commission, the Court "cannot rule out the consideration of the need for judicial restraint on grounds of judicial propriety" and should decline to rule on the merits of Cameroon's Application, as it did in 1963 in the case concerning *Northern Cameroons*.

In that case, the Court had noted that the United Nations General Assembly had terminated the trusteeship agreement in respect of the Northern Cameroon by resolution 1608 (XV); it observed that the dispute between the parties "about the interpretation and application [of that agreement therefore concerned a treaty] no longer in force"; it went on to say that "there can be no opportunity for a future act of interpretation or application of that treaty in accordance with any judgment the

Court might render". It had concluded that any adjudication would thus be "devoid of purpose" and that no purpose "would be served by undertaking an examination of the merits in the case". Observing that the limits of its judicial function "do not permit it to entertain the claims submitted to it [by Cameroon, it had considered itself unable to] adjudicate upon the merits of [those] claim[s]" (*Northern Cameroons, Judgment, I.C.J. Reports 1963*, pp. 37-38).

The Court considers that the situation in the present case is entirely different. Indeed, whereas in 1963 Cameroon did not challenge the validity of the General Assembly resolution terminating the trusteeship, Nigeria, in the present case, does not regard the technical document on the demarcation of the boundaries, approved at the Abuja Summit of the Lake Chad Basin Commission, as a document definitively settling boundary problems in that region. Nigeria reserved its position before the Court as regards the binding character of that document. It contends that the document requires ratification and recalls that it has not ratified it. Lastly, it specified at the Ninth Summit of the Commission at N'Djamena in 1996 that "Nigeria could not even start processing ratification unless the issue was out of Court".

Cameroon for its part considers that Nigeria is obliged to complete the process of approval of the document concerned and, that, even in the absence of so doing, the boundary between the two countries in this sector is "legally defined", "marked out on the ground" and "internationally recognized".

It is not for the Court at this stage to rule upon these opposing arguments. It need only note that Nigeria cannot assert both that the demarcation procedure initiated within the Lake Chad Commission was not completed and that, at the same time, that procedure rendered Cameroon's submissions moot. There is thus no reason of judicial propriety which should make the Court decline to rule on the merits of those submissions.

73. In the light of the above considerations, Nigeria's third preliminary objection must be rejected.

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#### FOURTH PRELIMINARY OBJECTION

74. The Court will now turn to the fourth preliminary objection raised by Nigeria. This objection contends that:

"The Court should not in these proceedings determine the boundary in Lake Chad to the extent that that boundary constitutes or is constituted by the tripoint in the Lake."

75. Nigeria holds that the location of the tripoint within Lake Chad directly affects a third State, the Republic of Chad, and that the Court

therefore cannot determine this tripoint. Nigeria maintains that the finding of the Chamber in the case concerning the *Frontier Dispute (Burkina Faso/Republic of Mali)*

“that its jurisdiction is not restricted simply because the end-point of the frontier lies on the frontier of a third State not party to the proceedings. The rights of the neighbouring State, Niger, are in any event safeguarded by the operation of Article 59 of the Statute . . .”  
(*I.C.J. Reports 1986*, p. 577, para. 46)

is not applicable in the present case. It says there is a difference because the 1986 *Frontier Dispute* case was instituted by Special Agreement, which reflected the agreement of the Parties to have the entire boundary delimited. In addition, in the *Frontier Dispute* case Niger was treated as a wholly third party, while in the present case there is the Lake Chad Basin Commission in which the States bordering Lake Chad co-operate. Because of that co-operation, boundary or other agreements relating to Lake Chad between Nigeria and Cameroon are not *res inter alios acta* for the other member States of the Commission. Therefore, neither Niger nor Chad are simple third parties in this case. According to Nigeria, “the régime of Lake Chad is subject to multilateral co-operation, and is not susceptible to the thorough-going bilateralization” which the Chamber adopted in the *Frontier Dispute* case.

Nigeria also alleges that it is not the case that Chad as a third party is merely theoretically or contingently involved in the question of boundaries; there had been clashes between Nigeria and Chad in and in relation to Lake Chad. Finally, Nigeria questions the distinction which the Chamber in the *Frontier Dispute* case drew between maritime and land delimitation. “Criteria of equidistance, proportionality and equity have been applied to the delimitation of lacustrine boundaries, especially in large lakes.” Nigeria’s position is such that it would warrant the conclusion that its fourth preliminary objection goes not only to the jurisdiction of the Court (by analogy with the principle in the case of the *Monetary Gold Removed from Rome in 1943, Preliminary Question, Judgment, I.C.J. Reports 1954*, p. 19), but also to the admissibility of the Application, as the objection is in its view well founded on either basis.

76. Cameroon claims that the Court must exercise its jurisdiction over the totality of the disputed boundary, as far as the northern end-point within Lake Chad; Nigeria’s fourth preliminary objection directly conflicts with consistent case-law relating to tripoints. Cameroon particularly rejects the Nigerian argument which distinguishes the *Frontier Dispute* decision from the present case: the absence of a special agreement, and therefore the consent of Nigeria to the institution of the proceedings, is irrelevant; Nigeria does not cite any precedent in which a differentiation was made between “wholly third States” and States which would not be

real third States. *Inter se* boundary agreements from which third States are absent are frequent. Article 59 suffices as protection of the third States' rights. The concept of theoretical involvement of a third State in a boundary question is, in the view of Cameroon, not pertinent. There is no support for this concept, the implications of which are not clearly explained. Lastly Cameroon contests the efforts made by Nigeria to exclude the applicability of the *Frontier Dispute* Judgment to delimitation in lakes.

77. The Court notes that, to the extent that Nigeria's reference to the Lake Chad Basin Commission is to be understood as referring to an exclusive competence of the Commission for boundary delimitation in Lake Chad, this argument has been dealt with under the third preliminary objection. As the third preliminary objection has not been upheld, the Court need not deal with this argument again.

78. The Court moreover notes that the submissions of Cameroon addressed to it in the Additional Application (para. 17) and as formulated in the Memorial of Cameroon (Memorial of Cameroon, pp. 669-671, para. 9) do not contain a specific request to determine the localization of the tripoint Nigeria-Cameroon-Chad in the Lake. The Additional Application requests the Court "to specify definitively the frontier between Cameroon and the Federal Republic of Nigeria from Lake Chad to the sea" (para. 17 (*f*) of the Additional Application), while the Memorial requests the Court to adjudge and declare:

"that the lake and land boundary between Cameroon and Nigeria takes the following course:

— from the point at longitude 14° 04' 59" 9999 E of Greenwich and latitude 13° 05' 00" 0001 N, it then runs through the point located at longitude 14° 12' 11" 7 E and latitude 12° 32' 17" 4 N" (p. 669, para. 9.1 (*a*)).

These submissions nevertheless bear upon the localization of the tripoint. They could lead either to a confirmation of the localization of the tripoint as accepted in practice up to now on the basis of acts and agreements of the former colonial powers and the demarcation carried out by the Commission (see paragraph 65 above), or they could lead to a redetermination of the situation of the tripoint, possibly as a consequence of Nigeria's claims to Darak and adjacent islands. Thus these claims cannot be considered on the merits by the Court at this stage of the proceedings. However, the Court notes, at the present stage, that they are directed against Cameroon and that in due course the Court will be in a position to take its decision in this regard without pronouncing on interests that Chad may have, as the Court will demonstrate hereafter.

79. The Court therefore now turns to the crux of Nigeria's fourth preliminary objection, namely the assertion that the legal interests of Chad

would be affected by the determination of the tripoint, and that the Court can therefore not proceed to that determination.

The Court recalls that it has always acknowledged as one of the fundamental principles of its Statute that no dispute between States can be decided without their consent to its jurisdiction (*Monetary Gold Removed from Rome in 1943, Judgment, I.C.J. Reports 1954*, p. 32.) Nevertheless, the Court has also emphasized that it is not necessarily prevented from adjudicating when the judgment it is asked to give might affect the legal interests of a State which is not a party to the case; and the Court has only declined to exercise jurisdiction when the interests of the third State “constitute the very subject-matter of the judgment to be rendered on the merits” (*Certain Phosphate Lands in Nauru (Nauru v. Australia), Preliminary Objections, Judgment, I.C.J. Reports 1992*, p. 261, para. 55; *East Timor (Portugal v. Australia), Judgment, I.C.J. Reports 1995*, pp. 104-105, para. 34).

The Court observes that the submissions presented to it by Cameroon refer to the frontier between Cameroon and Nigeria and to that frontier alone. These submissions do not refer to the frontier between Cameroon and the Republic of Chad either as contained in the Additional Application of Cameroon or as formulated in the Memorial. Certainly, the request to “specify definitively the frontier between Cameroon and the Federal Republic of Nigeria from Lake Chad to the sea” (para. 17 (f) of the Additional Application) may affect the tripoint, i.e., the point where the frontiers of Cameroon, Chad and Nigeria meet. However, the request to specify the frontier between Cameroon and Nigeria from Lake Chad to the sea does not imply that the tripoint could be moved away from the line constituting the Cameroon-Chad boundary. Neither Cameroon nor Nigeria contests the current course of that boundary in the centre of Lake Chad as it is described in the “technical document on the demarcation of the . . . boundaries” mentioned in paragraph 65 above. Incidents between Nigeria and Chad in the Lake, as referred to by Nigeria, concern Nigeria and Chad but not Cameroon or its boundary with Chad. Any redefinition of the point where the frontier between Cameroon and Nigeria meets the Chad-Cameroon frontier could in the circumstances only lead to a moving of the tripoint along the line of the frontier in the Lake between Chad and Cameroon. Thus, the legal interests of Chad as a third State not party to the case do not constitute the very subject-matter of the judgment to be rendered on the merits of Cameroon’s Application; and therefore, the absence of Chad does not prevent the Court from proceeding to a specification of the border between Cameroon and Nigeria in the Lake.

80. The Court notes also that, in the case concerning the *Territorial Dispute (Libyan Arab Jamahiriya/Chad)*, the tripoint where the boundary between Libya and Chad meets the western boundary of the Sudan, on the 24th meridian east of Greenwich, was determined without involve-



ment of the Sudan. The eastern end-points of the principal lines taken into consideration by the Court in that case for the delimitation of the boundary between Libya and Chad were situated at various locations on the western boundary of the Sudan.

Furthermore, in that case, the Court, in the absence of Niger, fixed the western boundary between Libya and Chad as far as the point of intersection of the 15th meridian east and the parallel 23° of latitude north, a point at which, according to Chad, the frontiers of Chad, Libya and Niger meet.

81. The factual situation underlying the case concerning the *Frontier Dispute (Burkina Faso/Republic of Mali)* was quite different from the present case in the sense that the relevant part of the boundary of Niger at the time was not delimited; in that case the fixing of the tripoint therefore immediately involved Niger as a third State, which, however, did not prevent the Chamber from tracing the boundary between Burkina Faso and the Republic of Mali to its furthest point. Whether the location of the tripoint in Lake Chad has actually to be changed from its present position will follow from the judgment on the merits of Cameroon's Application. Such a change would have no consequence for Chad.

82. Finally the Court observes that, since neither Cameroon nor Nigeria challenge the current course of the boundary, in the centre of Lake Chad, between Cameroon and the Republic of Chad (see paragraph 79 above), it does not have to address — even if that was possible at the present preliminary stage — the argument presented by Nigeria concerning the legal principles applicable to the determination of boundaries in lakes and especially in large lakes like Lake Chad.

83. The fourth preliminary objection is accordingly rejected.

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#### FIFTH PRELIMINARY OBJECTION

84. In its fifth preliminary objection Nigeria alleges that there is no dispute concerning "boundary delimitation as such" throughout the whole length of the boundary from the tripoint in Lake Chad to the sea, subject, within Lake Chad, to the question of the title over Darak and adjacent islands, and without prejudice to the title over the Bakassi Peninsula.

85. In the course of the oral proceedings, it became clear that in addition to Darak and Bakassi, there are competing claims of Nigeria and Cameroon in respect of the village of Tipsan, which each Party claims to be on its side of the boundary. Also, in the course of the oral proceedings, a question was asked of the Parties by a Member of the Court as to whether Nigeria's assertion that there is no dispute as regards the land

boundary between the two States (subject to the existing problems in the Bakassi Peninsula and the Darak region) signifies,

“that, these two sectors apart, there is agreement between Nigeria and Cameroon on the geographical co-ordinates of this boundary as they result from the texts relied on by Cameroon in its Application and its Memorial”.

The reply given to this question by Nigeria will be examined below (paragraph 91).

86. For Cameroon its existing boundary with Nigeria was precisely delimited by the former colonial powers and by decisions of the League of Nations and acts of the United Nations.

These delimitations were confirmed or completed by agreements made directly between Cameroon and Nigeria after their independence. Cameroon requests that the Court “specify definitively the frontier between Cameroon and Nigeria from Lake Chad to the sea” (Additional Application, para. 17 (*f*)) along a line the co-ordinates of which are given in Cameroon’s Memorial.

The fact that Nigeria claims title to the Bakassi Peninsula and Darak, and adjacent islands, means, in the view of Cameroon, that Nigeria contests the validity of these legal instruments and thus calls into question the entire boundary which is based on them. That, in the view of Cameroon, is confirmed by the occurrence, along the boundary, of numerous incidents and incursions. Nigeria’s claims to Bakassi as well as its position regarding the Maroua Declaration also throw into doubt the basis of the maritime boundary between the two countries. In Cameroon’s view, and contrary to what Nigeria asserts, a dispute has arisen between the two States concerning the whole of the boundary.

87. The Court recalls that,

“in the sense accepted in its jurisprudence and that of its predecessor, a dispute is a disagreement on a point of law or fact, a conflict of legal views or interests between parties (see *Mavrommatis Palestine Concessions, Judgment No. 2, 1924, P.C.I.J., Series A, No. 2*, p. 11; *Northern Cameroons, Judgment, I.C.J. Reports 1963*, p. 27; and *Applicability of the Obligation to Arbitrate under Section 21 of the United Nations Headquarters Agreement of 26 June 1947, Advisory Opinion, I.C.J. Reports 1988*, p. 27, para. 35)” (*East Timor (Portugal v. Australia), Judgment, I.C.J. Reports 1995*, pp. 99-100, para. 22);

and that,

“[i]n order to establish the existence of a dispute, ‘It must be shown that the claim of one party is positively opposed by the other’ (*South West Africa, Preliminary Objections, Judgment, I.C.J. Reports 1962*,

p. 328); and further, 'Whether there exists an international dispute is a matter for objective determination' (*Interpretation of Peace Treaties with Bulgaria, Hungary and Romania, First Phase, Advisory Opinion, I.C.J. Reports 1950, p. 74*)" (*I.C.J. Reports 1995, p. 100*).

On the basis of these criteria, there can be no doubt about the existence of disputes with respect to Darak and adjacent islands, Tipsan, as well as the Peninsula of Bakassi. This latter dispute, as indicated by Cameroon, might have a bearing on the maritime boundary between the two Parties.

88. All of these disputes concern the boundary between Cameroon and Nigeria. However, given the great length of that boundary, which runs over more than 1,600 km from Lake Chad to the sea, it cannot be said that these disputes in themselves concern so large a portion of the boundary that they would necessarily constitute a dispute concerning the whole of the boundary.

89. Further, the Court notes that, with regard to the whole of the boundary, there is no explicit challenge from Nigeria. However, a disagreement on a point of law or fact, a conflict of legal views or interests, or the positive opposition of the claim of one party by the other need not necessarily be stated *expressis verbis*. In the determination of the existence of a dispute, as in other matters, the position or the attitude of a party can be established by inference, whatever the professed view of that party. In this respect the Court does not find persuasive the argument of Cameroon that the challenge by Nigeria to the validity of the existing titles to Bakassi, Darak and Tipsan, necessarily calls into question the validity as such of the instruments on which the course of the entire boundary from the tripoint in Lake Chad to the sea is based, and therefore proves the existence of a dispute concerning the whole of the boundary.

90. The occurrence of boundary incidents certainly has to be taken into account in this context. However, not every boundary incident implies a challenge to the boundary. Also, certain of the incidents referred to by Cameroon took place in areas which are difficult to reach and where the boundary demarcation may have been absent or imprecise. And not every incursion or incident alleged by Cameroon is necessarily attributable to persons for whose behaviour Nigeria's responsibility might be engaged. Even taken together with the existing boundary disputes, the incidents and incursions reported by Cameroon do not establish by themselves the existence of a dispute concerning all of the boundary between Cameroon and Nigeria.

91. However, the Court notes that Nigeria has constantly been reserved in the manner in which it has presented its own position on the matter. Although Nigeria knew about Cameroon's preoccupation and concerns, it has repeated, and has not gone beyond, the statement that there is no

dispute concerning “boundary delimitation as such”. Nigeria has shown the same caution in replying to the question asked by a Member of the Court in the oral proceedings (see paragraph 85 above). This question was whether there is agreement between the Parties on the geographical co-ordinates of the boundary as claimed by Cameroon on the basis of the texts it relies upon. The reply given by Nigeria reads as follows:

“The land boundary between Nigeria and Cameroon is not described by reference to geographical co-ordinates. Rather, the relevant instruments (all of which pre-date the independence of Nigeria and Cameroon) and well-established practice, both before and after independence, fix the boundary by reference to physical features such as streams, rivers, mountains and roads, as was common in those days. Since independence, the two States have not concluded any bilateral agreement expressly confirming or otherwise describing the pre-independence boundary by reference to geographical co-ordinates. Nevertheless, the course of the boundary, which was well established before independence and related United Nations procedures, has continued to be accepted in practice since then by Nigeria and Cameroon.”

92. The Court notes that, in this reply, Nigeria does not indicate whether or not it agrees with Cameroon on the course of the boundary or on its legal basis, though clearly it does differ with Cameroon about Darak and adjacent islands, Tipsan and Bakassi. Nigeria states that the existing land boundary is not described by reference to geographical co-ordinates but by reference to physical features. As to the legal basis on which the boundary rests, Nigeria refers to “relevant instruments” without specifying which these instruments are apart from saying that they pre-date independence and that, since independence, no bilateral agreements “expressly confirming or otherwise describing the pre-independence boundary by reference to geographical co-ordinates” have been concluded between the Parties. That wording seems to suggest that the existing instruments may require confirmation. Moreover, Nigeria refers to “well-established practice both before and after independence” as one of the legal bases of the boundary whose course, it states, “has continued to be accepted in practice”; however, it does not indicate what that practice is.

93. The Court is seised with the submission of Cameroon which aims at a definitive determination of its boundary with Nigeria from Lake Chad to the sea (see paragraph 86 above). Nigeria maintains that there is no dispute concerning the delimitation of that boundary as such throughout its whole length from the tripoint in Lake Chad to the sea (see paragraph 84 above) and that Cameroon’s request definitively to determine

that boundary is not admissible in the absence of such a dispute. However, Nigeria has not indicated its agreement with Cameroon on the course of that boundary or on its legal basis (see paragraph 92 above) and it has not informed the Court of the position which it will take in the future on Cameroon's claims. Nigeria is entitled not to advance arguments that it considers are for the merits at the present stage of the proceedings; in the circumstances however, the Court finds itself in a situation in which it cannot decline to examine the submission of Cameroon on the ground that there is no dispute between the two States. Because of Nigeria's position, the exact scope of this dispute cannot be determined at present; a dispute nevertheless exists between the two Parties, at least as regards the legal bases of the boundary. It is for the Court to pass upon this dispute.

94. The fifth preliminary objection raised by Nigeria is thus rejected.

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#### SIXTH PRELIMINARY OBJECTION

95. The Court will now turn to Nigeria's sixth preliminary objection which is to the effect that there is no basis for a judicial determination that Nigeria bears international responsibility for alleged frontier incursions.

96. Nigeria contends that the submissions of Cameroon do not meet the standard required by Article 38 of the Rules of Court and general principles of law regarding the adequate presentation of facts on which Cameroon's request is based, including dates, the circumstances and precise locations of the alleged incursions and incidents into and on Cameroonian territory. Nigeria maintains that what Cameroon has presented to the Court does not give Nigeria the knowledge which it needs and to which it is entitled in order to prepare its reply. Similarly, in Nigeria's view, the material submitted is so sparse that it does not enable the Court to carry out fair and effective judicial determination of, or make determination on, the issues of State responsibility and reparation raised by Cameroon. While Nigeria acknowledges that a State has some latitude in expanding later on what it has said in its Application and in its Memorial, Cameroon is said to be essentially restricted in its elaboration to the case as presented in its Application.

97. Cameroon insists that it stated clearly in its pleadings that the facts referred to in order to establish Nigeria's responsibility were only of an indicative nature and that it could, where necessary, amplify those facts when it comes to the merits. Cameroon refers to the requirements established in Article 38, paragraph 2, of the Rules and which call for a "succinct" presentation of the facts. It holds that parties are free to develop

the facts of the case presented in the application or to render them more precise in the course of the proceedings.

98. The decision on Nigeria's sixth preliminary objection hinges upon the question of whether the requirements which an application must meet and which are set out in Article 38, paragraph 2, of the Rules of Court are met in the present instance. The requirements set out in Article 38, paragraph 2, are that the Application shall "specify the precise nature of the claim, together with a succinct statement of the facts and grounds on which the claim is based". The Court notes that "succinct", in the ordinary meaning to be given to this term, does not mean "complete" and neither the context in which the term is used in Article 38, paragraph 2, of the Rules of Court nor the object and purpose of that provision indicate that it should be interpreted in that way. Article 38, paragraph 2, does therefore not preclude later additions to the statement of the facts and grounds on which a claim is based.

99. Nor does Article 38, paragraph 2, provide that the latitude of an applicant State, in developing what it has said in its application is strictly limited, as suggested by Nigeria. That conclusion cannot be inferred from the term "succinct"; nor can it be drawn from the Court's pronouncements on the importance of the point of time of the submission of the application as the critical date for the determination of its admissibility; these pronouncements do not refer to the content of applications (*Questions of Interpretation and Application of the 1971 Montreal Convention arising from the Aerial Incident at Lockerbie (Libyan Arab Jamahiriya v. United Kingdom)*, *Preliminary Objections, Judgment, I.C.J. Reports 1998*, p. 26, para. 44; and *Questions of Interpretation and Application of the 1971 Montreal Convention arising from the Aerial Incident at Lockerbie (Libyan Arab Jamahiriya v. United States of America)*, *Preliminary Objections, Judgment, I.C.J. Reports 1998*, p. 130, para. 43). Nor would so narrow an interpretation correspond to the finding of the Court that,

"whilst under Article 40 of its Statute the subject of a dispute brought before the Court *shall be* indicated, Article 32 (2) of the Rules of Court [today Article 38, paragraph 2] requires the Applicant 'as far as possible' to do certain things. These words apply not only to specifying the provision on which the Applicant founds the jurisdiction of the Court, but also to stating the precise nature of the claim and giving a succinct statement of the facts and grounds on which the claim is based." (*Northern Cameroons (Cameroon v. United Kingdom)*, *Preliminary Objections, Judgment, I.C.J. Reports 1963*, p. 28.)

The Court also recalls that it has become an established practice for States submitting an application to the Court to reserve the right to present additional facts and legal considerations. The limit of the freedom to present such facts and considerations is "that the result is not to transform the dispute brought before the Court by the application into

another dispute which is different in character” (*Military and Paramilitary Activities in and against Nicaragua (Nicaragua v. United States of America)*, *Jurisdiction and Admissibility, Judgment, I.C.J. Reports 1984*, p. 427, para. 80). In this case, Cameroon has not so transformed the dispute.

100. As regards the meaning to be given to the term “succinct”, the Court would simply note that Cameroon’s Application contains a sufficiently precise statement of the facts and grounds on which the Applicant bases its claim. That statement fulfils the conditions laid down in Article 38, paragraph 2, and the Application is accordingly admissible.

This observation does not, however, prejudice the question whether, taking account of the information submitted to the Court, the facts alleged by the Applicant are established or not, and whether the grounds it relies upon are founded or not. Those questions belong to the merits and may not be prejudged in this phase of the proceedings.

101. Lastly, the Court cannot agree that the lack of sufficient clarity and completeness in Cameroon’s Application and its inadequate character, as perceived by Nigeria, make it impossible for Nigeria to respond effectively to the allegations which have been presented or makes it impossible for the Court ultimately to make a fair and effective determination in the light of the arguments and the evidence then before it. It is the applicant which must bear the consequences of an application that gives an inadequate rendering of the facts and grounds on which the claim is based. As the Court has stated in the case concerning *Military and Paramilitary Activities in and against Nicaragua (Nicaragua v. United States of America)*:

“[u]ltimately . . . however, it is the litigant seeking to establish a fact who bears the burden of proving it; and in cases where evidence may not be forthcoming, a submission may in the judgment be rejected as unproved, but is not to be ruled out as inadmissible *in limine* on the basis of an anticipated lack of proof.” (*Ibid.*, p. 437, para. 101.)

102. The Court consequently rejects the sixth preliminary objection raised by Nigeria.

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#### SEVENTH PRELIMINARY OBJECTION

103. In its seventh preliminary objection Nigeria contends that there is no legal dispute concerning delimitation of the maritime boundary between the two Parties which is at the present time appropriate for resolution by the Court.

104. Nigeria says that this is so for two reasons: in the first place, no determination of a maritime boundary is possible prior to the determination of title in respect of the Bakassi Peninsula. Secondly, at the juncture when there is a determination of the question of title over the Bakassi

Peninsula, the issues of maritime delimitation will not be admissible in the absence of prior sufficient action by the Parties, on a footing of equality, to effect a delimitation “by agreement on the basis of international law”. In Nigeria’s view, the Court cannot properly be seised by the unilateral application of one State in relation to the delimitation of an exclusive economic zone or continental shelf boundary if that State has made no attempt to reach agreement with the respondent State over that boundary, contrary to the provisions of Articles 74 and 83 of the United Nations Convention on the Law of the Sea. Any such unilateral application, in the view of Nigeria, is inadmissible.

105. Cameroon is of the view that the first argument invoked by Nigeria concerns neither jurisdiction nor the admissibility of its Application, but simply the method whereby the merits of the case are best addressed, a decision which falls within the discretion of the Court. As to the second argument put forward by Nigeria, Cameroon denies that the conduct of negotiations is a precondition for instituting proceedings before the Court in cases of delimitation. Cameroon views the identical paragraphs 2 of Articles 74 and 83 of the United Nations Convention on the Law of the Sea not as barring recourse to third party settlement, but as an obligation for such recourse in order to avoid unilateral delimitations.

Cameroon says that, in any event, it had sufficiently negotiated with Nigeria before it seised the Court, and it seised the Court only when it became clear that any new negotiation would be doomed to failure. In this respect, it contends that since the actual occupation of the Bakassi Peninsula by Nigeria, any negotiation on the delimitation of the maritime boundary has become impossible.

106. The Court will initially address the first argument presented by Nigeria. The Court accepts that it will be difficult if not impossible to determine the delimitation of the maritime boundary between the Parties as long as the title over the Peninsula of Bakassi has not been determined. The Court notes, however, that Cameroon’s Application not only requests the Court

“to proceed to prolong the course of its maritime boundary with the Federal Republic of Nigeria up to the limit of the maritime zones which international law places under their respective jurisdictions” (Application of Cameroon of 29 March 1994, p. 15; para. 20 (*f*)),

but also,

“to adjudge and declare:

- (a) that sovereignty over the Peninsula of Bakassi is Cameroonian, by virtue of international law, and that that Peninsula is an integral part of the territory of Cameroon” (*ibid.*, para. 20).



Since, therefore, both questions are before the Court, it becomes a matter for the Court to arrange the order in which it addresses the issues in such a way that it can deal substantively with each of them. That is a matter which lies within the Court's discretion and which cannot be the basis of a preliminary objection. This argument therefore has to be dismissed.

107. As to the second argument of Nigeria, the Court notes that, while its first argument concerned the whole maritime boundary, the second one seems only to concern the delimitation from point G seawards. That was accepted by counsel for Nigeria and seems to correspond to the fact that there were extensive negotiations between the two Parties in the period between 1970 and 1975 on the maritime boundary from the land-fall on Bakassi to point G, which resulted in the disputed Maroua Declaration.

Moreover, the Court recalls that, in dealing with the cases brought before it, it must adhere to the precise request submitted to it. Nigeria here requests the Court to hold that,

“at the juncture where there is a determination of the question of title over the Bakassi Peninsula, the issues of maritime delimitation will not be admissible in the absence of sufficient action by the Parties, on a footing of equality, to effect a delimitation ‘by agreement on the basis of international law’”.

What is therefore in dispute between the Parties and what the Court has to decide now is whether the alleged absence of sufficient effort at negotiation constitutes an impediment for the Court to accept Cameroon's claim as admissible or not.

This matter is of a genuinely preliminary character and has to be decided under Article 79 of the Rules of Court.

108. In this connection, Cameroon and Nigeria refer to the United Nations Convention on the Law of the Sea, to which they are parties. Article 74 of the Convention, relating to the exclusive economic zone, and Article 83, concerning the continental shelf, provide, in their first identical paragraphs, that the delimitation

“between States with opposite or adjacent coasts shall be effected by agreement on the basis of international law, as referred to in Article 38 of the Statute of the International Court of Justice, in order to achieve an equitable solution”.

These are followed by identical paragraphs 2 which provide that “If no agreement can be reached within a reasonable period of time, the States concerned shall resort to the procedures provided for in Part XV.” One of these procedures is the submission of the case to the Court for settlement by contentious proceedings.

109. However, the Court notes that, in this case, it has not been seised on the basis of Article 36, paragraph 1, of the Statute, and, in pursuance

of it, in accordance with Part XV of the United Nations Convention on the Law of the Sea relating to the settlement of disputes arising between the parties to the Convention with respect to its interpretation or application. It has been seised on the basis of declarations made under Article 36, paragraph 2, of the Statute, which declarations do not contain any condition relating to prior negotiations to be conducted within a reasonable time period.

The second argument of Nigeria cannot therefore be upheld.

\*

110. In addition to what has been put forward by the Parties, the question could arise whether, beyond point G, the dispute between the Parties has been defined with sufficient precision for the Court to be validly seised of it. The Court observes not only that the Parties have not raised this point, but Cameroon and Nigeria entered into negotiations with a view to determining the whole of the maritime boundary. It was during these negotiations that the Maroua Declaration relating to the course of the maritime boundary up to point G was drawn up. This declaration was subsequently held to be binding by Cameroon, but not by Nigeria. The Parties have not been able to agree on the continuation of the negotiations beyond point G, as Cameroon wishes. The result is that there is a dispute on this subject between the Parties which, ultimately and bearing in mind the circumstances of the case, is precise enough for it to be brought before the Court.

\*

111. The Court therefore rejects the seventh preliminary objection.

\* \*

#### EIGHTH PRELIMINARY OBJECTION

112. The Court will now deal with the eighth and last of the preliminary objections presented by Nigeria. With that objection Nigeria contends, in the context of and supplementary to the seventh preliminary objection, that the question of maritime delimitation necessarily involves the rights and interests of third States and is to that extent inadmissible.

113. Nigeria refers to the particular concave configuration of the Gulf of Guinea, to the fact that five States border the Gulf and that there are no agreed delimitations between any two of those States in the disputed

area. In these circumstances, the delimitation of the maritime zones appertaining to two of the States bordering the Gulf will necessarily and closely affect the others. Nigeria also holds that the situation between Cameroon and Nigeria is distinct from that underlying the case concerning the *Frontier Dispute (Burkina Faso/Republic of Mali)* (*Judgment, I.C.J. Reports 1986*, p. 554) as that case concerned a land boundary to the delimitation of which apply principles that are different from those applying to the delimitation of maritime boundaries. The case concerning the *Continental Shelf (Libyan Arab Jamahiriya/Malta)* (*Application for Permission to Intervene, Judgment, I.C.J. Reports 1984*, p. 3) was different from the present case in the sense that the areas to which the claims of the third State (Italy) related, were known; and in the case concerning the *Continental Shelf (Tunisia/Libyan Arab Jamahiriya)* (*Application for Permission to Intervene, Judgment, I.C.J. Reports 1981*, p. 3) the Court was merely laying down principles applicable to the delimitation of the continental shelf in a given context without actually drawing any particular line. Nigeria acknowledges that by virtue of Article 59 of the Statute, third States are not formally bound by decisions of the Court; it maintains nevertheless that Article 59 of the Statute gives insufficient protection, since in specific situations, in spite of that Article, decisions of the Court may have clear and direct legal and practical effects on third States, as well as on the development of international law.

114. Cameroon holds that the maritime delimitation which it is requesting the Court in part to confirm and in part to determine, concerns only the Parties to the present dispute. In Cameroon's view, the interests of all other States are preserved by Article 59 of the Statute and by the principle according to which any delimitation as between two States is *res inter alios acta*. Referring to the jurisprudence of the Court, Cameroon claims that the Court has not hesitated to proceed to maritime delimitations in cases where the rights of third States were more clearly in issue than they are in the present case. Cameroon also finds that practice of State treaties confirms that a delimitation is in no way made impossible by the existence of the interests of neighbouring States.

115. The Court notes, as do the Parties, that the problem of rights and interests of third States arises only for the prolongation, as requested by Cameroon, of the maritime boundary seawards beyond point G. As to the stretch of the maritime boundary from point G inwards to the point of landfall on the Bakassi Peninsula, certainly a dispute has arisen because of the rival claims of the Parties to Bakassi and the fact that the Maroua Declaration is considered binding by Cameroon but not by Nigeria.

That dispute however does not concern the rights and interests of third States. That is so because the geographical location of point G is clearly

closer to the Nigerian/Cameroonian mainland than is the location of the tripoint Cameroon-Nigeria-Equatorial Guinea to the mainland.

116. What the Court has to examine under the eighth preliminary objection is therefore whether prolongation of the maritime boundary beyond point G would involve rights and interests of third States and whether that would prevent it from proceeding to such prolongation. The Court notes that the geographical location of the territories of the other States bordering the Gulf of Guinea, and in particular Equatorial Guinea and Sao Tome and Principe, demonstrates that it is evident that the prolongation of the maritime boundary between the Parties seawards beyond point G will eventually run into maritime zones where the rights and interests of Cameroon and Nigeria will overlap those of third States. It thus appears that rights and interests of third States will become involved if the Court accedes to Cameroon's request. The Court recalls that it has affirmed, "that one of the fundamental principles of its Statute is that it cannot decide a dispute between States without the consent of those States to its jurisdiction" (*East Timor (Portugal v. Australia)*, *Judgment*, *I.C.J. Reports 1995*, p. 101, para. 26). However, it stated in the same case that, "it is not necessarily prevented from adjudicating when the judgment it is asked to give might affect the legal interests of a State which is not a party to the case" (*ibid.*, p. 104, para. 34).

Similarly, in the case concerning *Certain Phosphate Lands in Nauru (Nauru v. Australia)*, it adopted the same approach:

"a finding by the Court regarding the existence or the content of the responsibility attributed to Australia by Nauru might well have implications for the legal situation of the two other States concerned, but no finding in respect of that legal situation will be needed as a basis for the Court's decision on Nauru's claims against Australia. Accordingly, the Court cannot decline to exercise its jurisdiction." (*I.C.J. Reports 1992*, pp. 261-262, para. 55.)

The Court cannot therefore, in the present case, give a decision on the eighth preliminary objection as a preliminary matter. In order to determine where a prolonged maritime boundary beyond point G would run, where and to what extent it would meet possible claims of other States, and how its judgment would affect the rights and interests of these States, the Court would of necessity have to deal with the merits of Cameroon's request. At the same time, the Court cannot rule out the possibility that the impact of the judgment required by Cameroon on the rights and interests of the third States could be such that the Court would be prevented from rendering it in the absence of these States, and that consequently Nigeria's eighth preliminary objection would have to be upheld at least in part. Whether such third States would choose to exercise their rights to intervene in these proceedings pursuant to the Statute remains to be seen.

117. The Court concludes that therefore the eighth preliminary objec-

tion of Nigeria does not possess, in the circumstances of the case, an exclusively preliminary character.

\* \* \*

118. For these reasons,

THE COURT,

(1) (a) By fourteen votes to three,

*Rejects* the first preliminary objection;

IN FAVOUR: *President* Schwebel; *Judges* Oda, Bedjaoui, Guillaume, Ranjeva, Herczegh, Shi, Fleischhauer, Vereshchetin, Higgins, Parra-Aranguren, Kooijmans, Rezek; *Judge ad hoc* Mbaye;

AGAINST: *Vice-President* Weeramantry; *Judge* Koroma; *Judge ad hoc* Ajibola;

(b) By sixteen votes to one,

*Rejects* the second preliminary objection;

IN FAVOUR: *President* Schwebel; *Vice-President* Weeramantry; *Judges* Oda, Bedjaoui, Guillaume, Ranjeva, Herczegh, Shi, Fleischhauer, Vereshchetin, Higgins, Parra-Aranguren, Kooijmans, Rezek; *Judges ad hoc* Mbaye, Ajibola;

AGAINST: *Judge* Koroma;

(c) By fifteen votes to two,

*Rejects* the third preliminary objection;

IN FAVOUR: *President* Schwebel; *Vice-President* Weeramantry; *Judges* Oda, Bedjaoui, Guillaume, Ranjeva, Herczegh, Shi, Fleischhauer, Vereshchetin, Higgins, Parra-Aranguren, Kooijmans, Rezek; *Judge ad hoc* Mbaye;

AGAINST: *Judge* Koroma; *Judge ad hoc* Ajibola;

(d) By thirteen votes to four,

*Rejects* the fourth preliminary objection;

IN FAVOUR: *President* Schwebel; *Vice-President* Weeramantry; *Judges* Bedjaoui, Guillaume, Ranjeva, Herczegh, Shi, Fleischhauer, Vereshchetin, Higgins, Kooijmans, Rezek; *Judge ad hoc* Mbaye;

AGAINST: *Judges* Oda, Koroma, Parra-Aranguren; *Judge ad hoc* Ajibola;

(e) By thirteen votes to four,

*Rejects* the fifth preliminary objection;

IN FAVOUR: *President* Schwebel; *Vice-President* Weeramantry; *Judges* Bedjaoui, Guillaume, Ranjeva, Herczegh, Shi, Fleischhauer, Higgins, Parra-Aranguren, Kooijmans, Rezek; *Judge ad hoc* Mbaye;

AGAINST: *Judges* Oda, Koroma, Vereshchetin; *Judge ad hoc* Ajibola;

(f) By fifteen votes to two,

*Rejects* the sixth preliminary objection;

IN FAVOUR: *President* Schwebel; *Vice-President* Weeramantry; *Judges* Oda, Bedjaoui, Guillaume, Ranjeva, Herczegh, Shi, Fleischhauer, Vereshchetin, Higgins, Parra-Aranguren, Kooijmans, Rezek; *Judge ad hoc* Mbaye;

AGAINST: *Judge* Koroma; *Judge ad hoc* Ajibola;

(g) By twelve votes to five,

*Rejects* the seventh preliminary objection;

IN FAVOUR: *President* Schwebel; *Vice-President* Weeramantry; *Judges* Bedjaoui, Guillaume, Ranjeva, Herczegh, Shi, Fleischhauer, Vereshchetin, Parra-Aranguren, Rezek; *Judge ad hoc* Mbaye;

AGAINST: *Judges* Oda, Koroma, Higgins, Kooijmans; *Judge ad hoc* Ajibola;

(2) By twelve votes to five,

*Declares* that the eighth preliminary objection does not have, in the circumstances of the case, an exclusively preliminary character;

IN FAVOUR: *President* Schwebel; *Vice-President* Weeramantry; *Judges* Bedjaoui, Guillaume, Ranjeva, Herczegh, Shi, Fleischhauer, Vereshchetin, Parra-Aranguren, Rezek; *Judge ad hoc* Mbaye;

AGAINST: *Judges* Oda, Koroma, Higgins, Kooijmans; *Judge ad hoc* Ajibola;

(3) By fourteen votes to three,

*Finds* that, on the basis of Article 36, paragraph 2, of the Statute, it has jurisdiction to adjudicate upon the dispute;

IN FAVOUR: *President* Schwebel; *Judges* Oda, Bedjaoui, Guillaume, Ranjeva, Herczegh, Shi, Fleischhauer, Vereshchetin, Higgins, Parra-Aranguren, Kooijmans, Rezek; *Judge ad hoc* Mbaye;

AGAINST: *Vice-President* Weeramantry; *Judge* Koroma; *Judge ad hoc* Ajibola;

(4) By fourteen votes to three,

*Finds* that the Application filed by the Republic of Cameroon on 29 March 1994, as amended by the Additional Application of 6 June 1994, is admissible.

IN FAVOUR: *President* Schwebel; *Judges* Oda, Bedjaoui, Guillaume, Ranjeva, Herczegh, Shi, Fleischhauer, Vereshchetin, Higgins, Parra-Aranguren, Kooijmans, Rezek; *Judge ad hoc* Mbaye;

AGAINST: *Vice-President* Weeramantry; *Judge* Koroma; *Judge ad hoc* Ajibola.

Done in French and in English, the French text being authoritative, at the Peace Palace, The Hague, this eleventh day of June, one thousand

nine hundred and ninety-eight, in three copies, one of which will be placed in the archives of the Court and the others transmitted to the Government of the Republic of Cameroon and the Government of the Federal Republic of Nigeria, respectively.

*(Signed)* Stephen M. SCHWEBEL,  
President.

*(Signed)* Eduardo VALENCIA-OSPINA,  
Registrar.

Judges ODA, VERESHCHETIN, HIGGINS, PARRA-ARANGUREN and KOOIJMANS append separate opinions to the Judgment of the Court.

Vice-President WEERAMANTRY, Judge KOROMA and Judge *ad hoc* AJIBOLA append dissenting opinions to the Judgment of the Court.

*(Initialed)* S.M.S.

*(Initialed)* E.V.O.

## **LEGAL AUTHORITY CA-65**



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VOLUME TWO

EAST AFRICAN COMMUNITY TO  
ITALY-UNITED STATES AIR TRANSPORT  
ARBITRATION (1965)



1995

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favoured passing under Spanish sovereignty. Then Great Britain again enlarged the powers of the local Gibraltarian authorities by issuing an Order in Council entitled *The Gibraltar Constitution Order* (1969). Spain promptly terminated all communications between Gibraltar and the mainland, which remained closed until they were partially reopened in December 1982.

### 5. Conclusion

When Spain became a member of the → North Atlantic Treaty Organization, the former made sovereignty over Gibraltar a major issue. However, a subsequent Spanish Government removed the barriers to access from Spain to Gibraltar and negotiations have been initiated for the joint operation of the Gibraltar airport. With the advent in 1992 of further changes in the European Economic Community, of which Spain is now a member, Gibraltar once again is looking forward to becoming the "Hong Kong of the Mediterranean", particularly in financial matters.

There are many problems to be resolved before there can be a final settlement between Spain and Great Britain with respect to the problem of Gibraltar. The only really viable solution appears to be the transfer of sovereignty to Spain, with appropriate agreed provisions to protect both the Gibraltarians and Great Britain.

- LOPEZ DE AYALA, *História de Gibraltar* (1782).  
 J.M. DE AREILZA and F.M. CASTIELLA, *Reivindicaciones de España* (1941).  
 J. PLA CARCELES, *Gibraltar* (1955).  
 G. HILLS, *Rock of Contention: A History of Gibraltar* (1974).  
 T. FRANCK and P. HOFFMAN, *The Right of Self-Determination in Very Small Places*, *New York University Journal of International Law and Politics*, Vol. 8 (1975-1976) 331-386.  
 E. BRADFORD, *Gibraltar: The History of a Fortress* (1977).  
 H. LEVIE, *The Status of Gibraltar* (1983).

[1990]

HOWARD S. LEVIE

## GOOD FAITH

### 1. Notion

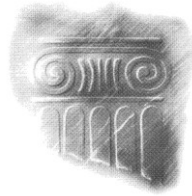
The principle of good faith requires parties to a transaction to deal honestly and fairly with each other, to represent their motives and purposes

truthfully, and to refrain from taking unfair advantage that might result from a literal and unintended interpretation of the agreement between them (→ Interpretation in International Law). The concept figures prominently in the → Vienna Convention on the Law of Treaties, which by virtue of its careful draftsmanship and wide ratification has assumed an authoritative place in international law on questions relating to the interpretation and enforcement of → treaties. Art. 31(1) of that Convention provides: "A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose." These references to context and purpose demonstrate that the substance of the principle of good faith is the negation of unintended and literal interpretations of words that might result in one of the parties gaining an unfair or unjust advantage over another party.

A secondary notion of good faith in the context of explicit agreements pertains to the duties of signatories to a treaty prior to ratification. The early rule of international law to the effect that States had an obligation to ratify treaties that their diplomatic agents had signed has been replaced since the 18th century by the concept of discretionary ratification (→ Treaties, Conclusion and Entry into Force). This change came about as a result of the growth of parliamentary institutions within States that adopted constitutional checks and balances against the acts of the executive branch or its diplomatic agents abroad (→ Diplomatic Agents and Missions). Yet the new concept of discretionary ratification carried over the old notion to the extent that the executive branch, having signed the treaty through its agents, now had an obligation to make every effort in good faith to obtain the consent of the sovereign, and not to act in the interim period in such a way as to prejudice the unperfected rights of the signatories to the treaty. Art. 18 of the Vienna Convention on the Law of Treaties, while not explicitly referring to the principle of good faith, summarizes its substance by providing that a signatory, prior to ratification, "is obliged to refrain from acts which would defeat the object and purpose" of the treaty.

Finally, the principle of good faith may be said to apply, apart from treaties or other agreements, to the general performance of a State's obligations under international law. According to a significant

## **LEGAL AUTHORITY CA-66**



**Arbitration CAS 2002/O/410 The Gibraltar Football Association (GFA)/Union des Associations Européennes de Football (UEFA), award of 7 October 2003**

Panel : Mr. Bruno Simma (Germany), President; Professor Pierre Lalive (Switzerland); Mr. Dirk-Reiner Martens (Germany)

*Football*

*Application for UEFA membership*

*Rules on membership applicable at the time when the application was made*

*Legality of a change of rule with a retrospective effect*

*Principles of fairness and good faith*

*Freedom of association*

- 1. According to the new version of Article 5 of the UEFA Statutes, UEFA membership is restricted to associations in countries which are recognised as independent States by the United Nations. This new rule should not be regarded as a rule dealing only with procedural aspects justifying immediate application regardless of when the facts at issue occurred. The immediate application in this matter would entail a violation of general principles of law which are widely recognised, particularly the principles of fairness and of good faith.**
- 2. According to the old version of Article 5 of the UEFA Statutes “Membership of UEFA is open to national football associations situated in the continent of Europe which are responsible for the organisation and implementation of football-related matters in their particular territory”. GFA indisputably exercises sole responsibility for the organisation and structure of football in its territory. The concept of “nation” or “country” in the sports environment must not necessarily be “understood within its common political meaning. More importantly, UEFA already has – and had at the time when the application was made – a number of member associations from countries which do not enjoy independent statehood, such as Scotland, Wales or the Faroe Islands.**
- 3. Generally, freedom of association includes the freedom of an association to accept or to refuse any applicant for membership, even if the applicant fulfils all statutory conditions. However, the exclusion of athletes, or of a sports association to which athletes are affiliated, from an international sports organisation which occupies a dominant or monopolistic position in the organisation of sports competitions may have the effect of a boycott. Such an exclusion should therefore be held invalid, at least to the extent that it is not grounded on objective and justified reasons.**

The Claimant, the Gibraltar Football Association (“GFA”), is an unincorporated body that is responsible for the organisation of all football in the territory of Gibraltar. The GFA was established in 1895, and today it has between 2000 and 2500 members.

The GFA has a Men’s senior league composed of three divisions, a Junior league, and Ladies and “Futsal” competitions. All football currently organised by the GFA is non-professional.

Despite proposals made in the past that the Claimant may become affiliated to the Spanish Football Association, the GFA has always been independent from any other football association, whether within Gibraltar or elsewhere.

The territory of Gibraltar is a dependent territory of the United Kingdom. It forms part of Her Majesty the Queen’s Dominions, but it is not part of the United Kingdom, and it is not an independent State either although it enjoys a certain level of autonomy.

The Respondent, the Union des Associations Européennes De Football (“UEFA”), is an association incorporated under the laws of Switzerland with its headquarters in Nyon, Switzerland. UEFA is the governing body of European football, dealing with all questions relating to European football and exercising regulatory, supervisory and disciplinary functions over national associations, clubs, officials and players of the European continent.

The Respondent is one of the continental football confederations. All national associations located in Europe and which wish to be affiliated to the Fédération Internationale de Football Association (“FIFA”) must previously become a member of UEFA.

In January 1997, the GFA applied to FIFA for membership.

On 27 November 1997, the English Football Association (“FA”) confirmed to FIFA its thorough support of the GFA's application for membership.

On 3 March 1999, FIFA wrote to the GFA confirming that the “*preliminary procedure*” was completed, and that “consequently, FIFA may submit the file to the confederation concerned for the second phase of the procedure (evaluation of the organisation for a period of at least two years)”.

In that same letter, FIFA further stated that “according to article 4.7 of the FIFA Statutes the confederation concerned shall decide whether to grant provisional membership or associate membership to the applicant association”.

In parallel to this letter, FIFA forwarded to UEFA the GFA's file for membership, as confirmed by UEFA to the Claimant on 23 March 1999. The GFA was consequently invited to make an oral presentation of its application to UEFA representatives in April 1999 in Nyon, Switzerland.

On 20 April 1999, following the presentation made by the GFA's representatives in Nyon, UEFA informed the Claimant that they would examine the file with FIFA, possibly proceed with a visit on site in Gibraltar, and then make a recommendation to the UEFA Executive Committee, outlining that “no final decision will be taken until the year 2000”.

On 7 January 2000, UEFA informed the GFA that FIFA was in the process of reviewing its affiliation procedure rules, that a meeting was scheduled to take place within FIFA's organisation in March 2000 and, therefore, that UEFA would not be able to give the GFA more information on the process of its own affiliation request until that time.

By letter dated 19 January 2000, the GFA responded to UEFA that it failed to understand why a “present ongoing review of affiliation procedure rules” within FIFA should affect the application by the GFA which had been made before such review was commenced. The Claimant further expressed its concern because the UEFA inspection of the GFA's facilities should have occurred already by the end of the year 1999, and it insisted that it be given “the necessary assurances that our application is being processed as per the present applicable procedures”.

By e-mail dated 25 March 2000, UEFA informed the GFA that “FIFA and UEFA administrations have discussed the application procedure for your association. After having received also the green light by the FIFA Committee for national associations we inform you that a joint FIFA/UEFA delegation will visit your association”.

On 25 April 2000, UEFA provided the GFA with details of the visit to the GFA's facilities and infrastructures by representatives of FIFA and of UEFA. Such visit was scheduled to take place between 8 and 10 May 2000.

A joint delegation from the FIFA and UEFA administrations eventually conducted the inspection visit in Gibraltar between 8 and 10 May 2000.

On 11 July 2000, the UEFA delegation issued a report of the visit conducted in Gibraltar two months earlier. In this report, the UEFA delegation proposed *inter alia* that “the FA of Gibraltar be admitted to UEFA on a provisional basis” under three cumulative conditions, namely that (i) Gibraltar teams could not enter club competitions or senior and Under-21 national-team competitions immediately, but only UEFA's youth, women's and amateur competitions; (ii) the football infrastructure in Gibraltar must correspond to the UEFA requirements at the time of entering the relevant competitions; and (iii) the GFA's statutes had to be adapted to UEFA's requirements.

The UEFA administration justified this position, which in principle favoured the affiliation of the GFA, by stating that “the FA of Gibraltar fulfils all requisite statutory conditions for admission to UEFA (Article 2 of the Regulations governing the implementation of the UEFA Statutes)”.

The report on the FIFA/UEFA joint visit to Gibraltar and the proposals contained therein were supposed to be submitted to the UEFA Executive Committee at its next meeting which was scheduled to be held on 25-26 August 2000.

On 3 August 2000, the FIFA Executive Committee apparently decided to freeze all applications from associations to FIFA, pending the approval of new FIFA Statutes in the year 2004. FIFA informed UEFA of this decision in September 2001.

On 26 August 2000, the UEFA Executive Committee decided to postpone its decision concerning the GFA's provisional membership until its next meeting which was scheduled to take place in October 2000, and to call a meeting between UEFA, the English FA and the Spanish FA on 22 September 2000 in order to discuss this matter.

The meeting between UEFA, the English FA and the Spanish FA did not take place until 30 November 2000. During its meeting on 4-5 October 2000, the UEFA Executive Committee had decided to postpone its decision on the matter again as it was waiting for the results of the aforementioned meeting with the English FA and the Spanish FA.

On 14-15 December 2000, the UEFA Executive Committee met again. In respect of the GFA's application for membership, it considered that independent legal advice was necessary for it to be able to evaluate the application. Therefore, the UEFA Executive Committee decided to set up a legal panel with three members from UEFA's External Legal Experts Panel which was entrusted with the preparation of a substantiated report to the UEFA Executive Committee based on the FIFA and UEFA Statutes (the "Expert Panel").

The Claimant was informed of these decisions by UEFA on 15 December 2000. At that time, UEFA also provided the GFA with a copy of a written report that had been filed by the Spanish FA (in which the latter opposed the GFA's application), asking the GFA to comment thereon in writing by the end of January 2001. The same request was made by UEFA to the English FA.

By the end of the year 2000, the Expert Panel set up by UEFA had received all of the written submissions by the Spanish FA, the English FA and the GFA. The Claimant also filed a supplementary report in March 2001.

The aforementioned three parties made oral submissions before the Expert Panel on 19 April 2001. According to the order of procedure decided by its members, the Expert Panel was then to submit a written legal report to the UEFA Executive Committee, for it to take a final decision on the GFA's application.

As from June 2001, the Claimant repeatedly asked the UEFA what the conclusions of the Expert Panel were. The UEFA Executive Committee was to meet in July 2001 and the GFA assumed that the report of the Expert Panel would be available before such meeting, where the GFA's application for membership would be on the agenda.

The UEFA Executive Committee met on 11-12 July 2001. It did not take any decision on the GFA's application. However, what the UEFA Executive Committee did decide was to put an amendment of the UEFA Statutes before the UEFA Congress to be held in October 2001.

According to this proposed amendment, UEFA membership would be restricted to associations in countries which are recognised as independent States by the United Nations.

On 30 July 2001 and 20 August 2001, the GFA again asked the UEFA what the conclusions of the Expert Panel were.

On 27 August 2001, the Expert Panel appointed by the UEFA rendered its written legal opinion to the UEFA Executive Committee.

The members of the Expert Panel unanimously considered that according to Art. 5 paragraph 1 of the UEFA Statutes (NB: the version that came into force on 24 December 1997 and was amended on 30 June and 1 July 2000) and to Art. 1 and 2, sentence 1 of the Regulations governing the implementation of the UEFA Statutes, “the GFA was entitled to provisional admission as a member of UEFA”.

In the same Expert Report of 27 August 2001, the members of the Expert Panel suggested to the UEFA Executive Committee “to amend the UEFA Statutes (...) to avoid similar problems in the future”. The Expert Panel thus proposed “an amendment to the effect that only UN-recognised States may apply for admission to and membership of UEFA”.

On 30 August 2001, the UEFA confirmed to the GFA that the Expert Panel had rendered its decision. However, as per the order of procedure decided from the outset, the UEFA refused to communicate a copy of the Expert Report to the GFA. The UEFA indicated to the Claimant that the report would be discussed by the members of the UEFA Executive Committee on 6-8 September 2001 and that a decision on the GFA's application would then be taken.

In addition, the UEFA also communicated to the GFA on 30 August 2001 that “as regards the extraordinary Congress in October in Prague, we confirm that there is a request for a change of the UEFA Statutes, and especially the provision of UEFA membership. However we cannot provide you with a copy of these amendments until you are part of the UEFA family”.

On 5 September 2001, FIFA's Secretary General wrote to UEFA stating that in FIFA's view it would be premature to proceed with the affiliation of the GFA in the forthcoming months, and that FIFA was planning to change its rules on membership.

On 7 September 2001, UEFA wrote to the GFA and informed it that, at its most recent meeting on the same day, “the Executive Committee did not enter into the request of the Football Association of Gibraltar to be provisionally affiliated to UEFA. The UEFA Executive Committee has already discussed and decided at its July 2001 meeting to change the membership conditions in the UEFA Statutes. These proposals will be dealt with by the UEFA member associations at the next extraordinary Congress in Prague in October 2001. (...) The decision concerning the affiliation request of the Football Association of Gibraltar is therefore postponed until further notice.”



During the same meeting of the UEFA Executive Committee, a request for admission to UEFA filed by the Football Association of Kazakhstan was considered, and the Executive Committee agreed that such request should proceed.

The Football Association of Kazakhstan, which requested admission to UEFA after leaving the Asian confederation in 2001, was eventually admitted as a UEFA member by the UEFA Congress upon the recommendation of the UEFA Executive Committee in April 2002. Kazakhstan is an independent State and accepted as a member by the United Nations.

As from September 2001, the GFA repeatedly requested UEFA to render a decision on its request for provisional membership without delay, and to do so on the basis of the UEFA rules that existed at the time when the application was made.

On 5 October 2001, a meeting took place between senior officers of UEFA and of the GFA during which no solution could be found.

On 11 October 2001, the UEFA Congress approved the change of the UEFA Statutes, whereby UEFA membership would from then on be open only to associations in a country “recognised by the United Nations as an independent State”.

On 13 November 2001, UEFA wrote to the Claimant rejecting the latter’s repeated demands for immediate consideration of its affiliation request and stating that “the Executive Committee has so far not taken a *negative* decision on your application request but has only postponed its decision upon FIFA's request”.

The GFA replied to UEFA on 20 November 2001 that it considered that UEFA had acted illegally in this matter.

It must be noted that in November 2001, a number of national Football bodies of UK Dependencies which are not independent States and not members of the United Nations were already FIFA members, such as the FA of Anguilla or the FA of the Turks and Caicos Islands. Similarly, the FA of the Faroe Islands, which is not an independent State but a dependency of Denmark, is a FIFA member since 1988 and was admitted as a UEFA member in the mid-nineties.

On 26 April 2002, the GFA, acting through one of its counsel, wrote to UEFA stating that “the GFA (...) understands UEFA’s position to be that the GFA is not eligible for membership of UEFA under (new) Article 5.1 and that therefore the GFA's application cannot succeed”. The GFA further stated that “(a) UEFA’s failure to assess the GFA's application to become a member of UEFA by reference to the rules applicable when the application was made in 1999, under which the application would have been successful, and (b) UEFA’s decision instead to change the rules with purportedly retrospective effect in such a way as to make the GFA's application incapable of success, are illegal.”

In that same letter, the GFA requested UEFA to accept CAS arbitration in this matter. The same request was submitted again by the Claimant to UEFA on 6 June 2002.

On 12 July 2002, UEFA confirmed to the GFA that its Executive Committee had accepted CAS jurisdiction in respect of the GFA's claims against UEFA in this matter.

On 16 August 2002, the GFA filed a Request for Arbitration accompanied by 38 Exhibits with the CAS, asking principally (i) that the UEFA Executive Committee be ordered to consider the GFA's application for membership by reference to the rules applicable when the application was made in 1999, (ii) to declare that under those rules the GFA is entitled to provisional membership of UEFA with immediate effect, and (iii) to order payment by the Respondent UEFA of all costs of the arbitration as well as legal costs suffered by the Claimant.

The Respondent filed its Answer, accompanied by 8 Exhibits, on 27 September 2002, requesting the CAS to “dismiss all Principal Orders of the Request for Arbitration”, with all costs and compensations to be charged to the Claimant.

The hearing was held on 27 May 2003 in Lausanne.

The Claimant presented in its Request for Arbitration and specified in its Statement of Claim the following principal requests for relief:

- That UEFA be ordered to decide the GFA's application for membership by reference to the rules applicable when the application was made or was or ought to have been considered prior to 11 October 2001.
- That it be declared that under those rules the GFA is entitled to provisional membership of UEFA with immediate effect;
- That the Respondent UEFA be ordered to pay of all the costs of the arbitration as well as the legal costs incurred by the Claimant.

The Claimant principally submits that:

- a) Under the rules on membership contained in the UEFA Statutes before the modification approved by the UEFA Congress on 11 October 2001, the GFA's application for provisional membership fulfilled all requisite conditions.
- b) Under those rules, the GFA was therefore entitled to membership, as evidenced by the behaviour of the UEFA competent bodies in their processing of the Claimant's application.
- c) The change of the UEFA rules on membership was inspired by the simple wish to prevent the GFA's application from succeeding, and the reason for that wish was to be seen in the political pressure exercised by the powerful Spanish FA.
- d) In July 2001, when the UEFA Executive Committee proposed that the UEFA Statutes be amended to the effect that only associations in countries which are recognised by the United Nations as independent States are eligible for membership, the UEFA Executive Committee must have been aware of the Expert Panel's conclusions.
- e) It would be unfair under the circumstances to permit the dismissal of the GFA's application for affiliation by reference to the amended version of the UEFA rules on membership.

The Respondent submitted in both its Answer and its Response the following principal requests for relief:

- That all of the principal orders requested in the Request for arbitration be dismissed.
- That the Claimant be ordered to pay all of the costs of the arbitration as well as the legal costs incurred by UEFA.

The Respondent is principally of the opinion that:

- a) Under Swiss law, any association, such as UEFA, has a discretionary right to refuse a person or entity as a member, even if such person or entity fulfils all of the conditions stipulated in the association's statutes.
- b) While there are limits to this discretionary right of the association under Swiss law, namely the protection of the personality (art. 28 Swiss Civil Code) and the rules of Swiss Cartel law, those limits were not violated in the present case since UEFA's attitude was neither arbitrary nor based on unjustified reasons.
- c) UEFA's attitude in this matter was not dictated by political pressure exercised by the Spanish FA, which however openly opposed the application made by the GFA.

## LAW

1. The CAS has jurisdiction over this dispute on the basis of the correspondence exchanged by the parties on 6 June and 12 July 2002.  
Furthermore, during the hearing in Lausanne on 27 May 2003, it was explicitly acknowledged between the parties that the competence of the CAS is not in dispute.
2. Pursuant to Article R45 of the Code, the dispute must be decided "according to the rules of law chosen by the parties or, in the absence of such a choice, according to Swiss law".
3. The issue of the Claimant's right to membership of UEFA is to be examined in the light of the applicable UEFA Statutes. The Panel considers that Swiss civil law is applicable to all aspects of the dispute relating to the construction of the FIFA and UEFA Statutes and Regulations, in accordance with Article R45 of the Code, Article 4, par. 3 a) of the FIFA Statutes and Article 59, par. 1 of the UEFA Statutes.
4. In addition, to the extent that it deems it appropriate, the Panel may apply general principles of law, which are applicable as a type of *lex mercatoria* for sports regardless of their explicit presence in the applicable UEFA or FIFA Statutes. Such general principles of law include for example the principle of fairness, which implies *inter alia* the obligation to respect fair procedures (see, in particular, AEK Athens and SK Slavia Prague vs. UEFA, CAS 98/200,

sections 60/61 and 155 and seq., in Digest of CAS Awards II, 1998-2000, edited by Matthieu Reeb, pp. 65-66 and 102-103).

5. At the time when the GFA applied for membership to FIFA, and when FIFA subsequently forwarded the GFA's application file to UEFA, the criteria for eligibility as a member of UEFA provided for under Article 5 paragraph 1 of the UEFA Statutes were set out as follows:

“Membership of UEFA is open to national football associations situated in the continent of Europe which are responsible for the organisation and implementation of football-related matters in their particular territory” (the prevailing German text read “Mitglieder der UEFA können europäische Verbände werden, die in ihrem Gebiet für die Organisation und Durchführung des Fussballsports verantwortlich sind”; hereinafter the “Old Rule”).

6. Article 5 paragraph 1 of the UEFA Statutes was amended by the UEFA Congress on 11 October 2001. According to the new version of this provision, UEFA membership is restricted to associations in countries which are recognised as independent States by the United Nations (hereinafter the “New Rule”). The Panel interprets this text to mean that the respective country must have been admitted as a member of the United Nations. The United Nations do not “*recognise*” countries in the strict sense of the word. However, what is clear is that under the New Rule, the GFA would not be eligible as a member of UEFA, since Gibraltar is not an independent State admitted to membership in the United Nations.

7. The first question which the Panel must address is therefore to establish whether today, taking into account the circumstances of this particular case, UEFA may validly rely on the New Rule to appraise (and hypothetically dismiss) the GFA's application, although such application was filed and dealt with for a period of several years on the basis of the Old Rule.

8. The CAS has already considered in the past that in the absence of an express provision to the contrary, laws and rules relating to procedural matters apply immediately upon entering into force and regardless of when the facts occurred. On the other hand, it is a general principle that laws, regulations and rules of a substantive nature that were in force at the time when the facts occurred must be applied. Such principles were set out in particular in the CAS award S. vs. FINA, CAS 2000/A/274, sections 72-73 (see, in Digest of CAS Awards II, op. cit., p. 405):

“Under Swiss law, the prohibition against the retroactive application of law is well-established. In general, it is necessary to apply those laws, regulations or rules that were in force at the time that the facts at issue occurred (...).

This general principle is, however, subject to several exceptions, including an exception for laws or rules that are procedural in nature. In the absence of an express provision to the contrary, laws and rules relating to procedural matters apply immediately upon entering into force and regardless of when the facts at issue occurred (...).”

9. In the present instance, while the third sentence of Article 2 of the Regulations governing the implementation of the UEFA Statutes sets out the formal conditions which an application for

UEFA membership has to meet, it is quite another question whether Article 5 paragraph 1 of the UEFA Statutes is to be seen as merely procedural.

10. This provision sets out the substantive conditions that any applicant will need to fulfil in order to become a member. For this first reason, in accordance with the general principle of non-retroactivity of laws and rules, the Panel may have to consider that the New Rule may not apply to the GFA's application.
11. Even if the New Rule was to be regarded as a rule dealing only with procedural aspects, the Panel is of the opinion that its application in this matter would entail a violation of general principles of law which are widely recognised, particularly the principles of fairness and of good faith. In particular, the Panel refers to the principle of *venire contra factum proprium*. This principle provides that when the conduct of one party has led to raise legitimate expectations on the part of the second party, the first party is barred from changing its course of action to the detriment of the second party (see, AEK Athens and SK Slavia Prague vs. UEFA, CAS 98/200, in Digest of CAS Awards II, op. cit., pp. 38 and seq.; S. vs. FINA, CAS 2000/A/274, section 37, in Digest of CAS Awards II, op. cit., p. 400; Art. 2 of the Swiss Civil Code).
12. *In casu*, upon receipt of the GFA's application in 1997, the UEFA administration processed it at first without any reservations. The visit on site in Gibraltar by a delegation of UEFA and FIFA representatives in May 2000 was carried out in knowledge of the fact that FIFA was already considering changing its rules on membership in the future (see above).
13. In July 2000, a favourable report was rendered by the UEFA representatives who had inspected Gibraltar's facilities, outlining that all requisite conditions set out in the applicable UEFA Statutes and Regulations were fulfilled (see above). Subsequently, the UEFA Executive Committee decided to ask for advice of an Expert Panel before rendering a decision on the GFA's application. It was therefore legitimate for the GFA to understand that UEFA would decide on its application on the basis of the conclusions of the Expert Panel, bearing in mind that the GFA, the English FA and the Spanish FA had all been requested to make written and oral submissions in this context.
14. The Expert Panel came to the main conclusion that the GFA was entitled to UEFA provisional membership. In the Expert Report which was submitted in writing to the UEFA Executive Committee on 27 August 2001, the members of the Expert Panel suggested to the UEFA Executive Committee "to amend the UEFA Statutes (...) to avoid similar problems *in the future*" (emphasized added). The Expert Panel thus proposed "an amendment to the effect that only UN-recognised States may apply for admission to and membership of UEFA".
15. However, before any decision on the merits was taken by UEFA on the GFA's application on the basis of the Expert Panel's main conclusion, as one would have reasonably expected, the relevant Old Rule on membership was changed in October 2001 upon a recommendation made in July of that same year by the UEFA Executive Committee. The New Rule actually implemented the recommendation that the Expert Panel had made, but only for *future* cases.

16. The present Panel is of the opinion that such a recommendation to replace the Old Rule by the New Rule was made in the light of the conclusions of the Expert Panel. The fact that the UEFA Executive Committee had already made such an amendment proposal at its meeting of 11-12 July 2001 (i.e. prior to receiving the Expert Panel's written report in August) tends to suggest that the UEFA Executive Committee was aware of the Expert Panel's conclusions at that time. The panel is thus satisfied that one of the main purposes for the amendment proposal made by the UEFA Executive Committee was to prevent the GFA's application from succeeding.
17. To apply the New Rule to the Claimant's case under these circumstances would be unfair and contrary to the above mentioned general principles of law. It were the actions of UEFA itself which created legitimate expectations that the GFA's application would be processed under the Old Rule, with adequate speed or at least upon receipt of and in compliance with the advice of the Expert Panel that UEFA had appointed specifically for that purpose.
18. The GFA's application to be admitted as a provisional UEFA member shall therefore be examined on the basis of the Old Rule, namely the rule applicable when the application was made and on the basis of which the Expert Panel appointed by the UEFA rendered its opinion.
19. As mentioned above, according to the Old Rule "Membership of UEFA is open to national football associations situated in the continent of Europe which are responsible for the organisation and implementation of football-related matters in their particular territory".
20. When reviewing whether the GFA's application fulfilled the conditions set out in this provision, the Expert Panel considered that "given that Gibraltar is a European association which is no longer dependent on the [British] FA and which has become autonomous in a sporting respect, and given that the GFA indisputably exercises sole responsibility for the organisation and structure of football in its territory, Article 5 paragraph 1 can only be interpreted as to mean that the GFA from a legal perspective fulfils the criteria of the UEFA statutes for becoming a UEFA member".
21. The same opinion was given by the UEFA administration itself in its inspection report and recommendations issued on 11 July 2000 (see, sections 18 and 19 above).
22. The Panel considers that these opinions are accurate and that there is no reason for considering, as submitted by the Respondent on the basis of the words used in Article 5 paragraph 2 of the UEFA Statutes, that the Old Rule on UEFA membership should in fact – as the New Rule eventually expressed in an explicit way - be construed as restricting eligibility to associations of countries which are recognized politically as independent States.
23. Such a point of view is in fact not supported by the letter of the Old Rule. Neither is it consistent with the opinion of CAS, as expressed in previous cases, that the concept of "nation" or "country" in the sports environment must not necessarily be "understood within its common political meaning" (see, Celtic Plc vs. UEFA, CAS 98/2001, paragraphs 25 seq.,

in Digest of CAS Awards II, op. cit., pp. 118-120). More importantly, the Respondent's argument is contradicted by the fact that UEFA already has – and had at the time when the application was made – a number of member associations from countries which do not enjoy independent statehood, such as Scotland, Wales or the Faroe Islands.

24. As a consequence of the above considerations the Panel is of the opinion that the GFA's application for UEFA membership meets the requirements set out in Article 5 paragraph 1 of the Old Rule.
25. Upon receipt of an application file from FIFA, as in the present case, UEFA must "decide whether to grant provisional membership or associate membership to the applicant association" (Article 4 paragraph 7 of the FIFA Statutes).
26. Article 6 paragraph 3 of the UEFA Statutes provides that the UEFA Executive Committee is competent to admit an applicant association as a provisional UEFA member, while the decision on full admission must be taken by the UEFA Congress.
27. The Respondent submits that even though the GFA's application might meet all requisite conditions for UEFA membership, an association like UEFA remains free to admit or to refuse the applicant as a new member by virtue of the principle of autonomy of the association under Swiss law.
28. The Panel must therefore examine whether the fact that the GFA's application meets the requirements of Article 5 paragraph 1 of the Old Rule entitles the GFA to provisional membership or whether UEFA has discretion to invoke the principle of freedom of association and has the right to deny membership on that basis.
29. Generally, freedom of association includes the freedom of an association to accept or to refuse any applicant for membership, even if the applicant fulfils all statutory conditions (see, *inter alia* HEINI A., *Das Schweizerische Vereinsrecht*, Bâle 1988, p. 48).
30. However, this principle is now generally considered to be limited, such limits being derived in particular from:
  - (i) the contractual nature of the membership to an association and the related obligation to act in good faith in the context of contractual or pre-contractual discussions (Article 2 Swiss Civil Code; see, *inter alia* ZEN-RUFFINEN P., *Droit du sport*, Zurich 2002, n° 279 and references; BADDELEY M., *L'association sportive face au droit*, Genève 1994, p. 75; HEINI A., op.cit., p.48);
  - (ii) the general prohibition of arbitrary decisions and the need of a control of the association's decision to refuse a new member (Article 2 paragraph 2 Swiss Civil Code);
  - (iii) in professional matters, the provisions of competition law and the related need to protect personality rights (see, JdT 1957 I 202-212; Article 7 of the Swiss Federal Law on Cartels).

31. Furthermore, in the context of sports associations, it is now often considered that associations in a monopolistic position – which is undoubtedly the case for the Respondent in Europe – have in fact a duty to accept new members if they fulfil all statutory conditions to that effect. This opinion is derived both from the legislation on cartels and from the provisions on the protection of the personality (see, HEINI A., *op.cit.*, p. 49; BADDELEY M., *op. cit.*, p. 82).
32. The Panel holds, in that respect, that the exclusion of athletes, or of a sports association to which athletes are affiliated, from an international sports organisation which occupies a dominant or monopolistic position in the organisation of the sports competitions at issue may have the effect of a boycott. It is the Panel's opinion that such an exclusion should therefore be held invalid, at least to the extent that it is not grounded on objective and justified reasons.
33. The Respondent itself admitted that a refusal by UEFA to grant the GFA provisional membership could be considered as illegal if it were arbitrary or based on "unjustified reasons".
34. The above legal considerations lead to the general conclusion that, under Swiss law, an association does not remain entitled, under any circumstances, to accept or refuse a new member at its sole discretion. However, in order to rule on the present case, there is no need for the Panel to develop a position of principle on this question. The Panel thus leaves open the question of the right of UEFA to accept or refuse new members at its sole discretion. The Panel is of the opinion that it may rely on the particular circumstances surrounding the GFA's application and the way it was processed by UEFA to decide upon the present case.
35. As pointed out above, UEFA acted from the outset as if the applicant would be granted provisional membership if all applicable conditions were met. The GFA invested a considerable amount of time and resources in obtaining its admission as a UEFA member, relying on the legitimate expectation that UEFA would not refuse its application without any justified reason.
36. The Panel holds that it is therefore the behaviour of the UEFA itself which created such legitimate expectations on the part of the Claimant (visits on site, favourable visit report and recommendation, appointment of an Expert Panel to assist the Executive Committee to decide on the case, favourable conclusions of the Expert Panel following a comprehensive and adversary procedure, etc.).
37. UEFA chose to process thoroughly the GFA's application and by doing so, it led the Claimant to believe that it would be admitted as a provisional member if the Statutes' conditions were met. By doing so, UEFA waived the right that it may have had under Swiss law to reject the Claimant's request for membership without justified reasons.
38. In that respect, it is the Panel's opinion that neither the change of membership rules by UEFA, the purpose of which may have been to enable UEFA to dismiss the GFA's application, nor the clearly negative position allegedly taken by the Spanish FA, which may



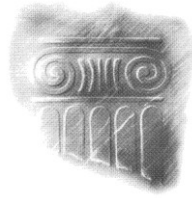
have influenced the UEFA's change of attitude and progressive reluctance to decide in a timely manner upon the GFA's application, constitute any such justified reasons.

39. The 11 July 2000 report by the UEFA delegation (see, section 18 above) lists certain conditions which have to be met in order for the GFA application for UEFA membership to succeed. It is for UEFA to decide whether these conditions are in fact met. Given the length of time which has elapsed since the application was first made, such a decision will have to be taken forthwith and will have to conform with the views expressed in this award.
40. The Panel further stresses that the possible change of FIFA rules on membership, which has been put forward by the Respondent as a reason for postponing any decision on the GFA's application, should not be an impediment to the UEFA granting provisional UEFA membership to the GFA.
41. Under Art. 4 paragraph 7 of the FIFA Statutes, the confederation "shall notify FIFA as soon as it considers a provisional member national association to be qualified to become a member of FIFA". This wording suggests that in two years' time, the UEFA shall remain entitled to assess whether the GFA fulfils the criteria for FIFA membership on the basis of the FIFA Statutes then in force.

**The Court of Arbitration for Sport rules that:**

1. UEFA is ordered to decide on the GFA's application for membership on the basis of the UEFA rules applicable at the time when the application was made. The decision has to be made by the UEFA no later than 31 March 2004.
2. GFA's other motions are rejected.
3. (...)

**LEGAL AUTHORITY CA-67**



**Arbitration CAS 2001/A/317 A. / Fédération Internationale de Lutttes Associées (FILA), award of 9 July 2001**

Panel: Mr. Dirk-Reiner Martens (Germany), President; Mr. Odd Seim Haugen (Norway); Mr. Jean-Philippe Rochat (Switzerland)

*Wrestling*

*Doping (nandrolone)*

*Use of nutritional supplements*

*Strict Liability Rule*

*Mitigating circumstances*

1. The legal relations between an athlete and a federation are of a civil nature and do not leave room for the application of principles of criminal law. This is particularly true for the principles of *in dubio pro reo* and *nulla poena sine culpa* and the presumption of innocence as enshrined in Art. 6 ECHR.
2. It is perfectly proper for the rules of a sporting federation to establish that the results achieved by an athlete at a competition during which he was under the influence of a prohibited substance must be cancelled irrespective of any guilt on the part of the athlete. This conclusion is the natural consequence of sporting fairness against the other competitors. The interests of the athlete concerned in not being punished without being guilty must give way to the fundamental principle of sport that all competitors must have equal chances.
3. If the federation is able to establish the objective elements of a doping offence, there is a presumption of guilt against the athlete. The principle of presumed fault on the part of the athlete does not, however, leave him without protection because he/she has the right to rebut the presumption, i.e. to establish that the presence of the prohibited substance in his/her body was not due to any intent or negligence on his/her part.
4. An athlete cannot exculpate himself/herself by simply stating that the container of the particular product taken by him/her did not specify that it contained a prohibited substance. It is obvious that the sale of nutritional supplements, many of which are available over the internet and thus sold without an effective governmental control, would go down dramatically if they properly declared that they contain (or could contain) substances prohibited under the rules governing certain sports. Therefore, to allow athletes the excuse that a nutritional supplement was mislabelled would provide an additional incentive for the producers to continue that practice. In summary, therefore, it is no excuse for an athlete found with a prohibited substance in his/her body that he/she checked the label on the product he took and that the label did not specify that the product contained a prohibited substance.

A. participated in the XXVII Olympic Games in Sydney as a wrestler in the 85 kg weight category, Greco Roman Style. He finished fourth in his competition which took place on September 27, 2000.

After the end of his competition he underwent a doping control. The A sample (No. A403123) showed the presence of "metabolites of nandrolone, norandrostenedione or norandrostenediol (19-norandrosterone and 19-noretiocholanolone). The concentration of norandrosterone in the sample was more than twice the IOC threshold" (4 ng/ml). In his subsequent request for arbitration A. specified the concentration as having been 8 ng/ml.

By decision of the IOC Executive Board of October 1, 2000, A. was disqualified and excluded from the Games of the XXVII Olympiad for the use of prohibited substances (Chapter II, Article 2.2 of the Olympic Movement Anti-Doping Code). He did not challenge this disqualification.

Upon the request of the athlete's national delegation, the test of the B-sample (No. B403123) was carried on October 3, 2000 in the presence of Mr. J. Segura and Mr. S. Nolan. No member of the national delegation was present at the opening of the B-sample since the Chef de Mission and all physicians had already left. The test result of the B-sample confirmed the result of the A-sample.

The FILA Sport Judge suspended A. from all national and international wrestling competitions for a period of two years. On November 3, 2000 this decision was notified to the national Wrestling Federation and subsequently communicated by it to A. The athlete and his national Wrestling Federation unsuccessfully challenged this decision before internal FILA instances.

Over a period of several months prior to the Olympic Games in Sydney A. had taken 8 to 10 different vitamins/nutritional supplements in accordance with a schedule developed by his sponsor, the witness L. who is a wholesaler of health products in Sweden. During this period A. underwent several doping control tests which were always negative. Approximately 5 to 6 weeks before the Sydney Olympic Games A. began taking six tablets a day of Pyrovate 500, a nutritional supplement produced by the US-company Pinnacle and recommended and supplied to A. by L.. A. did not undergo a doping test after he began taking Pyrovate 500 until the positive test at the Olympic Games. When already in Australia in a training camp, the athlete's trainers heard that a weight-lifter had tested positive for nandrolone and that food supplements were suspected to be responsible for this result. As a consequence, the labels of every product taken by A., in particular the Pyrovate 500 label, were checked as to whether the products contained any prohibited substances. The label did not show any such substance and A. continued to take – inter alia – Pyrovate 500. Following the athlete's positive doping test in Sydney Pyrovate 500 was tested by the IOC accredited laboratory in Cologne. The test revealed the presence of anabolic androgenic steroids (nandrolone precursors) which were not declared on the label.

On January 4, 2001 Appellant filed a request for arbitration with the Court of Arbitration for Sport against the decision of FILA's Sport Judge of October 24, 2000.

By letter dated February 19, 2001 the Respondent filed its response to the request for arbitration.

The Appellant claims that his rights were infringed during the internal FILA-proceedings since he was not given the benefit of a fair hearing before the decision of the FILA Sport Judge. With respect to the merits of the case, the Appellant contends that the Respondent cannot rely on "strict liability". Athletes who have broken the rules without intent or negligence should not be punished. Moreover, since the FILA doping regulations required "use" of a forbidden substance, they themselves showed that an intentional element was required for a doping offence. Since Appellant took the forbidden substance neither intentionally nor negligently, the FILA decision should be annulled. Even if the FILA doping rules were considered to contain a strict liability regime the Panel should take into account that there was a case of exceptional circumstances which did not warrant a suspension in addition to disqualification from the Olympic Games. Regarding the product Pyrovate 500 the Appellant observes that neither he nor his trainer were aware of the fact that this supplement could contain a forbidden substance. Finally, A. adds that all his previous doping tests had been negative and that his clean record should also be considered. In conclusion, the Appellant requests that the FILA decision be declared invalid.

The Respondent requests the CAS to reject the appeal and to confirm the decision to suspend the Appellant for a duration of two years. Since in the case in hand it was not contested that a forbidden substance was found in the Appellant's body, in the Respondent's view the suspension was correct since the Appellant was unable to show that he had fulfilled all his duties of care. The Respondent submits that high level athletes have known for several years that nutritional supplements available from US-American producers may sometimes contain forbidden substances. In this respect Respondent cites press releases by the IOC issued in 1999 and at the beginning of 2000 as evidence of the level of awareness in the sports world. The fact that the Appellant tested positive after ingestion of a product which contained a prohibited substance not marked on the label could not in itself provide a valid excuse because this would open a wide door to any kind of abuse. However, the Respondent conceded that the special circumstances of the case might allow the sanction to be reduced.

A first hearing was held on April 3, 2001 and a second one on May 15, 2001, both in Lausanne.

## **LAW**

1. The Appellant alleges a violation of his right to be heard since he was not given the opportunity to present his case before the FILA Sport Judge rendered his decision on the suspension.
2. The CAS jurisdiction is based on the arbitration agreement reached by the parties at the hearing of 3 April 2001 but also results from FILA's rules and regulations (Article 37(c) of the FILA Constitution and Article 6 of the FILA Disciplinary Regulations).

3. Pursuant to Article R58 of the Code, the Panel is required to decide the dispute according to the applicable regulations of FILA and Swiss law since Respondent has its seat in Switzerland and the parties did not choose a different governing law.
4. Since the doping control and the analysis of the samples took place after the FILA Congress held on September 22, 2000 in Sydney the Panel will apply the FILA Constitution as amended at that Congress (FILA Official Bulletin No. 166-167/2001) and the FILA Doping Regulations as well as the Disciplinary Regulation in force at that time. For the interpretation of the FILA rules the Panel will have special regard to Swiss law in accordance with Article R58 of the Code.
5. Indeed, there is no evidence that the FILA Sport Judge heard the Appellant either personally or by written submissions. It seems that he rendered his decision without further inquiries, only on the basis of the documentation on the disqualification by the IOC, provided to him by FILA.
6. However, the Panel will not deal with this argument in detail. It observes that the CAS has always considered the right to be heard as a general legal principle which has to be respected also during internal proceedings of the federations (CAS 91/53 G. v/ FEI, award of January 15, 1992, Digest, p. 79, 86 f). Federations have the obligation to respect the right to be heard as one of the fundamental principles of due process.
7. However, according to Article R57 of the Code, the Panel will hear the case *de novo*. This means that, even if a violation of the principle of due process occurred in the first instance, any such violation may be cured by a full hearing following appeal to the CAS (CAS 94/129 USA Shooting & Q. v/ UIT, Digest, p. 187, 203).
8. The Panel is satisfied that the Appellant committed a doping offence under the relevant FILA Rules as interpreted pursuant to Swiss law.
9. Provisions on doping can be found in several places in FILA's regulations (the following quotes are based on the version of the regulations as applicable after the 22 September 2000 FILA Congress).
10. FILA Constitution  
*"Article 9. – Doping  
The absorption of any substance intended to artificially improve the performance of the athlete is strictly prohibited. The IOC's official list is authoritative."*  
[The French text reads: "L'absorption de toutes substances destinées à accroître artificiellement la performance..."].
11. The FILA Doping Regulations state the following:  
*"Art. 1 – Definition of doping in sport*

*Doping is defined as the use, intake or administration of any substance that may affect the mental state or the physical performance of the competitor in a positive or negative way.*

...

*Doping consists of*

- a) *the administration, intake and use of substances belonging to the classes of forbidden pharmacological agents and the use of forbidden methods by athletes...,*
- b) *resorting to substances or methods which are potentially dangerous for the athlete's health, or are capable of increasing his performance artificially,*
- c) *the presence in the athlete's organisation of forbidden substances or the certification of the use of methods which are not allowed, by referring to the list provided by the IOC and to its successive updates".*

12. Art. 27 of the FILA Doping Regulations then makes reference to the IOC Anti-Doping Code by stating:

*"Art. 27 Particular and Final Provisions*

...

2. *Concerning anything which is not indicated in these Regulations, the standards and provisions laid down by the IOC's anti-doping code are applicable.*

...

6. *Bearing in mind that the anti-doping code of the Olympic Movement has been drawn up in close cooperation with the International Federations, it must apply to ... the various Championships ..., to all other competitions organised by the FILA...  
Therefore, any problems of interpretation of any article in these Regulations or for any question not dealt with here, must be referred to the IOC's Anti-Doping Code Lausanne 2000."*

13. Finally, the IOC Anti-Doping Code to which the FILA Doping Regulations refer states that (Chapter II Art. 2 and Art. 3):

*"Article 2*

*Doping is:*

...

2. *the presence in the athlete's body of a Prohibited Substance or evidence of the use thereof or evidence of the use of a Prohibited Method.*

*Article 3*

1. *In a case of doping, the penalties for a first offence are as follows:*

...

- b) *If the prohibited substance is one other than those referred to in a) above:*

...

- III) *Suspension from any competition for a minimum period of two years. However, based on specific, exceptional circumstances to be evaluated in the first instance by the competent IF bodies, there may be a provision for a possible modification of the two-year sanction.*

2. *In case of*

- a) *intentional doping:*

...

*The sanctions are as follows: [sanctions of up to a life ban]"*

The notion of "intentional doping" is further defined in the IOC's Explanatory Memorandum (p. 9):

*"With regard to intentional doping, this is a new notion which is added to that of doping as a breach of these rules. The latter exists as soon as the presence of a banned substance has been detected in an athlete's body, independent of any element of intention. Therefore, the athlete has to be punished. Nothing has changed as far as this is concerned. However, in the rare cases where it can be proved that doping was intentional, the Code allows for the imposition of much stricter sanctions..."*

14. As to sanctions, Annex D of the FILA Anti-Doping Regulations provides:

*"Sanctions*

1. *In the event of proving responsibility, the sanctions laid down by the IOC and quoted in annexe 1 which is an integral part of the FILA anti doping regulations. Any updates by the Olympic Movements will be introduced following deliberation by the Executive Committee and defined as follows:*

*Constitutes a violation of the anti doping standards:*

A. *Administering or use of substances which are part of the following classes of forbidden medication:  
... anabolising agents ...*

B. *The use of doping practices ...*

C. *The absorption of substances belonging to the following classes of pharmaceutical classes whose use is subject to restriction: alcohol ...*

D. *The administration or absorption of the following substances: ephedrine ...*

2. *For violations mentioned in point 1, letters A, B, C, the following sanctions are applicable:*

- *two years for the first offence;*

- *life ban for the second offence."*

15. Finally, with regard to sanctions, Art. 26 of the FILA Doping Regulations provides the following:

*"Art. 26 Violations of the anti-doping standards and the relative sanctions*

*...*

4. *The FILA, depending on the case, for positive doping results, can apply heavier sanctions than those laid down in the Regulations.*

5. *The FILA, through its own justice bodies, can find specific and exceptional attenuating circumstances which will enable the sanctions to be reduced."*

16. The Panel finds the provisions on doping in the various FILA regulations rather confusing.

According to the Constitution, doping is the "absorption" of a "substance intended to artificially improve the performance". In turn Art. 1 of the FILA Anti Doping Regulations states that it is sufficient for the substance to "affect" the performance and the same Article declares that "the presence in the athlete's organism of forbidden substances" constitutes a doping offence.

The FILA Doping Regulations then confirm that the IOC Anti Doping Code "must apply" to all FILA competitions and this very IOC Anti-Doping Code states that "Doping is ... the



presence in the athlete's body of a Prohibited Substance" and the IOC's Explanatory Memorandum further explains that doping "exists as soon as the presence of a banned substance has been detected in an athlete's body, independent of any element of intention".

17. Finally, according to Annex D of the FILA Anti Doping Regulations there seems to be a requirement of "proving responsibility" in order for sanctions to be imposed. The same can be concluded from Art. 17.21 of the same regulations which provides for sanctions of a "wrestler at fault".

18. The Panel observes that this "cocktail" of definitions and legal principles in connection with the fight against doping certainly falls short of the clarity and certainty desirable in an area as sensitive as doping and as demanded by CAS (CAS 94/129, USA Shooting & Q. v/ UIT, Digest, p. 187, 203). However, in the opinion of the Panel, the lack of clarity in the FILA Regulations does not go quite far enough to justify rejecting them as a whole as being so unclear that they cannot be applied at all. The Panel will therefore apply these rules as they are but will, if necessary, interpret any uncertainties *contra stipulatorem*, i.e. against FILA.

19. The facts of the case in hand are more straight forward than in most other doping cases:

It is uncontested that a substance prohibited under Art. 6 of the FILA Doping Regulations (metabolites of nandrolone, norandrostenedione or norandrostenediol (19-norandrosterone and 19-noretiocholanolone)) in quantities in excess of that allowed under the FILA rules (2ng/ml according to Article 27.2 of the FILA Doping Regulations; indeed, the Appellant himself states "a level of 8ng/ml of nandrolone") were found in the Appellant's urine sample taken on 27 September 2000. The Appellant admits that he took Pyrovate 500 during the time preceding his doping test and that – according to the findings of the IOC accredited laboratory in Cologne – this product contained anabolic-androgenic-steroids although this was not declared on the label. No challenge has been brought forward with respect to the conduct of the doping test, the chain of custody of the sample or the laboratory analysis.

20. The parties differ in their interpretation of the FILA rules and the consequences to be drawn from them.

According to the Appellant

"(I)t is clear that athletes, who have not broke the rules of doping with intent or negligently, cannot be punished" (Statement of Appeal dated 5 December 2000),

while the Respondent is of the opinion that:

"(I)he doping definition resulting from the applicable FILA Regulations is a strict liability definition. If the presence of a doping agent is established, then the sanction applies. No intention has to be shown" (Answer dated 19 February 2000).

21. If, indeed, under the FILA rules no subjective element, i.e. no intent or negligence on the part of the athlete were required for a doping offence to have been committed the Panel would in principle have to apply the two-year sanction provided for in Annex D, Section 2 of the FILA Doping Regulations and would be limited to evaluating whether there are "specific and

exceptional attenuating circumstances which will enable the sanctions to be reduced" (Art. 26, Section 5 of the FILA Doping Regulations).

22. However, the Panel is of the opinion that as a matter of principle and irrespective of "specific and exceptional circumstances" an athlete cannot be banned from competition for having committed a doping offence unless he is guilty, i.e. he has acted with intent or negligence. Even if the rules and regulations of a sports federation do not expressly provide that the guilt of the athlete has to be taken into account the foregoing principle will have to be read into these rules to make them legally acceptable.
23. CAS panels have to interpret the rules in question in a way "which seeks to discern the intention of the rule maker, and not to frustrate it" (CAS 96/149 A.C. v/ FINA, award of March 13, 1997, Digest, p. 251, 259). In interpreting the FILA rules the Panel does not find any indication that they intended to ignore the subjective elements as such. Since the Panel is of the opinion that under Swiss law an athlete cannot validly be banned in the absence of any fault (see *infra*), an interpretation to the contrary would lead to the rules being void which would frustrate the objective of the fight against doping pursued by the entire sporting world.
24. Before explaining the reasons for the principle of guilt the Panel wishes to clarify that this principle does not apply to the disqualification of a "doped athlete" from the event at which the doping test was conducted. It is therefore perfectly proper for the rules of a sporting federation to establish that the results achieved by a "doped athlete" at a competition during which he was under the influence of a prohibited substance must be cancelled irrespective of any guilt on the part of the athlete. This conclusion is the natural consequence of sporting fairness against the other competitors. The interests of the athlete concerned in not being punished without being guilty must give way to the fundamental principle of sport that all competitors must have equal chances (CAS 94/129 USA Shooting & Q. v/ UIT, Digest, p. 187, 193 et seq.; CAS 95/141 C. v/ FINA, Digest, p. 215, 220; CAS 98/214 B. v/ FIJ, p. 17; CAS 94/126 N. v/ FEI, p. 8).
25. The Panel comes to a different conclusion with regard to the suspension of an athlete from future competition. The so-called "strict liability" rule, i.e. a rule as advocated by the Respondent according to which the mere presence of a prohibited substance in an athlete's body justifies his suspension, does not, in the Panel's opinion, sufficiently respect the athlete's right of personality ("*Persönlichkeitsrecht*") as established in Articles 20 and 27 et seq. of the Swiss Civil Code which CAS panels are required to apply (Art. 58 of the Code of Sports-related Arbitration). In fact, under Swiss law also sporting federations are under a duty to respect the framework established by Articles 20 and 27 et seq. Swiss Civil Code (BADDELEY M., *L'association sportive face au droit*, Basel et al. 1994, p. 227).
26. As a preliminary remark the Panel wishes to clarify that the legal relations between an athlete and a federation are of a civil nature and do not leave room for the application of principles of criminal law. This is particularly true for the principles of *in dubio pro reo* and *nulla poena sine culpa* and the presumption of innocence as enshrined in Art. 6 ECHR (Swiss Federal Tribunal, ASA Bull. 1993, p. 398, 409 et seq. [G. v/ FEI] and Swiss Federal Tribunal judgment of March

- 31, 1999 [5P. 83/1999], unreported, p. 12; see also BADDELEY M., op. cit., p. 220; SCHERRER U., in: FRITZWEILER J. (ed), *Doping-Sanktionen, Beweise, Ansprüche*, Bern et al. 2000, p. 119, 127).
27. When deciding whether a "strict liability" rule is proper under Swiss law, the Panel has to weigh the interests of the federation against those of the athlete, in particular his right of personality (see BADDELEY M., op. cit., p. 239).
  28. In recent times the fight against doping has become sport's most burning problem. At times, public attention and, in particular, that of the media is focused more on whether the athletes are under the influence of doping substances than on the sporting event itself and its results. This development is a very serious threat to the entire sporting movement and, indirectly, to an industry which accounts for an important percentage of the world economy.
  29. It is obvious that it would be an important weapon in the fight against doping if the federations were able to impose sanctions on athletes who have tested positive, without having to establish any element of guilt on the part of the athlete. However, this argument, which is one of prevention and deterrence, loses sight of the general objective of doping sanctions, namely the punishment of the athlete for having violated the rules (BADDELEY M., op. cit., p. 219).
  30. On the other hand, it has to be recognised that in professional sport doping sanctions have the effect of restraining the athlete from carrying out his chosen trade and thus from earning a living for a certain period of time. In addition, doping sanctions clearly affect the honour and social standing of the athlete concerned and are a stigma on his future.
  31. When weighing up the interests of both sides the Panel is of the view that the interests of the athlete take precedence over those of the federation to enforce a rule of "strict liability". The contrary view would only be acceptable if a strict liability rule were the only meaningful weapon in the fight against doping. (see BADDELEY M., in: FRITZWEILER J. (ed), op. cit., p. 9, 22; SCHERRER U., op. cit., p. 119, 127; see also CAS 95/142 L. v/ FINA, Digest, p. 225, 231). As will be shown below, there are other means, in particular when allocating the burden of proof, to ensure an effective fight against doping without accepting the risk of sanctioning an athlete who is not guilty of an offence or whose level of guilt does not justify the full extent of the sanction.
  32. The Panel further notes that in a recent decision the Court of Appeals of Frankfurt/Main, Germany also held that liability without fault was incompatible with the rights of the athlete and German law (OLG Frankfurt/Main, judgment of May 18, 2000, 13W29/00 [B. v/ DLV] p. 15).
  33. Having established the principle that the suspension of an athlete for a doping offence requires fault on his/her part, this does not, in the Panel's view, mean that it is for the federation to provide full proof of every element of the offence, as is necessary in respect of a criminal act for which a presumption of innocence operates in favour of the accused. There is

- no doubt that the federation has to establish and – if contested – to prove the objective elements of the offence, in particular, for example, that the sample was taken properly, that there was a complete chain of custody of the sample on its way to the laboratory and that the analysis of the sample was state-of-the-art. This follows from the general rule that a person who alleges a fact has the burden of proof (CAS 98/208 N., J., Y., W. v/ FINA, Digest II, p. 247; CAS 99/A/234 & CAS 99/A/235 M.M. & M. v/ FINA, award of February 29, 2000, p. 14).
34. However, it would put a definite end to any meaningful fight against doping if the federations were required to prove the necessary subjective elements of the offence, i.e. intent or negligence on the part of the athlete (CAS 95/141 C. v/ FINA, Digest, p. 215, 220; CAS 98/214 B. v/ FIJ, Digest II, p. 318 et seq.). In fact, since neither the federation nor the CAS has the means of conducting its own investigation or of compelling witnesses to give evidence, means which are available to the public prosecutor in criminal proceedings, it would be all too simple for an athlete to deny any intent or negligence and to simply state that he/she has no idea how the prohibited substance arrived in his/her system (see CAS 96/156 F. v/ FINA).
  35. For this reason the Panel believes that, with regard to the subjective elements of a doping offence, when weighing the interests of the federation to combat doping and those of the athlete not to be punished without fault, the scales tip in favour of the fight against doping. In fact, doping only happens in the sphere of the athlete: he/she is in control of his/her body, of what he/she eats and drinks, of who has access to his/her nutrition, of what medication he/she takes, etc. In these circumstances it is appropriate to presume that the athlete has knowingly or at least negligently consumed the substance which has led to the positive doping test (see also: BADDELEY M., *op. cit.*, p. 243; BELOFF M., *Drugs, Laws and Versapaks*, in O'LEARY J. (ed.), *Drugs and Doping in Sport*, London 2000, p. 39, 49; STEINER U., *Doping aus verfassungsrechtlicher Sicht*, in RÖHRICHT/VIEWEG (eds.), *Doping Forum*, Stuttgart et al. 2000, p. 125, 134; BADDELEY M., in: FRITZWEILER (ed.), *op. cit.*, p. 9, 22).
  36. Therefore, if the federation is able to establish the objective elements of a doping offence, there is a presumption of guilt against the athlete.
  37. The principle of presumed fault on the part of the athlete does not, however, leave him without protection because he/she has the right to rebut the presumption, i.e. to establish that the presence of the prohibited substance in his/her body was not due to any intent or negligence on his/her part (CAS 95/141 C. v/ FINA, Digest, p. 215, 220 et seq.; CAS 98/214 B. v/ FIJ, Digest II, p. 319). The athlete may for example provide evidence that the presence of the forbidden substance is the result of an act of malicious intent by a third party (CAS 91/56 S. v/ FEI, Digest, p. 93, 97; CAS 92/63 G. v/ FEI, Digest, p. 115, 121; CAS 92/73 N. v/ FEI, Digest, p. 153, 157).
  38. It is noteworthy that the Swiss Federal Tribunal has accepted an interpretation of doping rules to the effect that it is admissible to presume an athlete's guilt if he/she has been tested positive for a prohibited substance. The athlete is then accorded the opportunity to rebut the

presumption (Swiss Federal Tribunal, Digest, p. 561, 575 [G. v/ FEI]; Swiss Federal Tribunal, 5P.83/1999 [W., C., Z., W. v/ FINA], p. 12).

39. The principle of presumption of guilt and rebuttal thereof by the athlete has also been applied by several CAS decisions, not only with respect of the rules of the FEI which expressly provide for a presumption of guilt, but also in connection with regulations which appear to follow a system of liability without fault (see CAS 91/56 S. v/ FEI, Digest, p. 93, 95; CAS 92/63 G. v/ FEI, p. 115, 120; CAS 92/73 N. v/ FEI, Digest, p. 153, 157; CAS 92/86 W. v/ FEI, Digest, p. 161, 163; CAS 98/204 R. v/ FEI, p. 8; CAS 91/53 G. v/ FEI, Digest, p. 79, 87; see especially: CAS 95/141 C. v/ FINA, Digest, p. 215, 220; CAS 96/156 F. v/ FINA, p. 40 et seq.; CAS 98/214 B. v/ FIJ, Digest II, p. 319; CAS 99/A/252 FCLP v/ IWF, p. 22 et seq.; CAS 2000/A/309 R. v/ RLVB, p. 5). On the other hand, the Panel is conscious of the fact that there have been CAS decisions where the Panel was prepared to apply a strict liability standard with respect to suspensions and was not willing to take into account the subjective elements of the case in questions (see: CAS 98/208 N., J., Y., W.. v/ FINA, Digest II, p. 25; CAS 98/222 B. v/ ITU, Digest II, p. 336-337; see also: CAS 95/150 V. v/ FINA, Digest, p. 265, 272). However, it should be noted that all these decisions took account of the level of "guilt" on the part of the athlete when establishing the duration of the suspension. It can also be taken from these awards that their reasoning was often based on arguments invoked to justify a simple disqualification. They did not consider the very purpose of suspensions as opposed to a mere disqualification and the differences between them. For these reasons the Panel is not prepared to follow these decisions.
40. The Panel recognises that the opinions of the courts and legal authorities differ as to whether the reversal of the burden of proof puts too much burden on the athlete. As an example the OLG Frankfurt in its decision of 18 May 2000 (see above) is in favour of a rule pursuant to which the presence of a prohibited substance in an athlete's body provides prima facie evidence of guilt on the part of the athlete; this leaves the athlete with the burden of proving that, in his/her particular case, the facts were different from the normal sequence of events. In many cases the practical results of both scenarios – a reversal of the burden of proof or the rebuttal of prima facie evidence – will be the same, but the Panel does recognise that the burden on the athlete is slightly less in the latter case. The Panel does, however, believe that, as a matter of principle, the reversal of the burden of proof and thus the burden being on the athlete to provide full proof of the absence of intent or negligence, is adequate and appropriate when weighing the interests of both sides.

In the case in hand, in which none of the objective elements of the offence is in dispute, the Appellant is thus presumed to have intentionally or negligently committed the offence.

41. As has been shown above, the burden is on the Appellant to prove that he is not guilty of a doping offence. To this end, the Panel took the testimony of several witnesses proffered by the Appellant.
42. It is the opinion of the Panel that the Appellant has not succeeded in proving that he was without fault.

43. The Appellant contends that he was not aware that Pyrovate 500 contained a substance which was the source of his positive doping test in Sydney.
44. In fact, the Panel accepts, in the Appellant's favour, that he did not intentionally take a prohibited substance, in other words, that he did not know that Pyrovate 500 contained precursors of nandrolone. The Panel further assumes, in the Appellant's favour, that his use of Pyrovate 500 was in fact the cause for his positive doping test in Sydney.
45. However, the Panel is of the opinion that under the circumstances the Appellant acted negligently when he took Pyrovate 500 without making certain that it did not contain a prohibited substance.
46. As a general remark, the Panel observes that the sporting world has, for quite some time even before the 2000 Sydney Games, been well aware of the risks in connection with using so called nutritional supplements, i.e. the risk that they may be contaminated or, in fact, "spiked" with anabolic steroids without this being declared on the labels of the containers. There have been several cases of positive tests for nandrolone which have been attributed to nutritional supplements and which have been widely publicised in the sports press. This fact was the likely motive for the IOC press releases in October 1999 and February 2000 which give an unequivocal warning about the use of imported and unlicensed nutritional supplements and their possible mislabelling.
47. Under these circumstances it is certainly not a valid excuse for an athlete to contend that he/she – personally – was not aware of these warnings. In fact, athletes are presumed to have knowledge of information which is in the public domain. In this context, the Panel notes that there is CAS case law to the effect that athletes are themselves solely responsible for, inter alia, the medication they take and that even a medical prescription from a doctor is no excuse for the athlete (CAS 92/73, N. v/ FEI, Digest, p. 153, 158). Furthermore an athlete cannot exculpate himself/herself by simply stating that the container of the particular product taken by him/her did not specify that it contained a prohibited substance. It is obvious that the sale of nutritional supplements, many of which are available over the internet and thus sold without an effective governmental control, would go down dramatically if they properly declared that they contain (or could contain) substances prohibited under the rules governing certain sports. Therefore, to allow athletes the excuse that a nutritional supplement was mislabelled would provide an additional incentive for the producers to continue that practice. In summary, therefore, it is no excuse for an athlete found with a prohibited substance in his/her body that he/she checked the label on the product he took and that the label did not specify that the product contained a prohibited substance.
48. The Panel can leave open the question whether a "doped athlete" can be sanctioned on the basis alone that he/she knew (or is presumed to have known) the risk involved in taking nutritional supplements which may contain a prohibited substance not declared on the label. In the case in hand there are additional elements which establish negligence on the Appellant's part:

49. In his statement before this Panel the Appellant admitted that during his training camp before the Olympic Games he had been informed that a weightlifter had tested positive for nandrolone and that nutritional supplements were suspected to be the cause of his positive test. At that point in time at the very latest the Appellant should have ceased taking a nutritional supplement which, it should be noted, was not prescribed to him by a medical doctor but was supplied by his "sponsor", a wholesaler of health products with a direct economic interest in marketing (and testing) these products in the sports world.
50. The rules and regulations of the Respondent (and of the IOC) provide for a two-year sanction in the case of a positive doping test for nandrolone. Even though it is well established that a two-year suspension for a first time doping offence is legally acceptable, there are several CAS decisions according to which a sanction may not be disproportionate and must always reflect the extent of the athlete's guilt (CAS 95/141 C. v/ FINA, Digest, p 215, 222; CAS 92/73 N. v/ FEI, Digest, p. 153, 159; CAS 96/156 F. v/ FINA, p. 48). Therefore, this Panel in its capacity as an appeals body enjoys the same discretion in fixing the extent of the sanction as the Respondent's internal instances (Art. 26.5 of the FILA Doping Regulations, see above). In fact, the Panel would enjoy this discretion even if there were no "exceptional attenuating circumstances".
51. When taking into consideration all the elements of this case, in particular the fact that the Appellant acted negligently but without intent to indulge in doping, the Panel is of the view that, based on the evidence produced, there are mitigating circumstances which warrant a reduction of the maximum penalty allowed under the rules and regulations of the Respondent. As a result, the Panel is of the opinion that it is adequate and appropriate to suspend the Appellant for 15 months. As regards the date upon which the suspension should begin, the Panel takes note of the fact that the sanction imposed by the Respondent started to run on the date the test was carried out (27 September 2000). The Panel sees no reason why it should change this date. Therefore, the Appellant's suspension will last until 26 December 2001.

#### **The Court of Arbitration for Sport rules:**

1. The appeal filed by A. on 3 January 2001 is partially upheld.
2. The decision of the FILA Sport Judge of 24 October 2000 shall be modified as follows:  
A. is suspended for a period of 15 months from 27 September 2000 to 26 December 2001.
3. (...).

## **LEGAL AUTHORITY CA-68**



# G. v Fédération Equestre Internationale (FEI), Award, CAS Case No. 1991/A/53, 15 January 1992

G. is a member of the Italian national equestrian team. At the end of September, G. and her mother left their residence, in Lecce, in order to participate with two horses, including the mare F., in a national show jumping event in Grosseto. The horses covered the journey of approximately 700 km by road, in a horse-box.

During the week preceding the national showjumping event, Grosseto hosted the national foal breeders' show. There had been 400 or 500 foals in this competition up to Wednesday 26th September 1990, housed in the stables created for the occasion and for the national showjumping event which was to follow.

G. and her mother arrived in Grosseto late on Thursday evening, and went in search of loose-boxes for their two horses. It should be noted that, while these boxes were numbered, the organization, described as lacking by the appellant and her mother, had not arranged for any allocation of boxes by name, leaving each competitor to sort things out for themselves. Normally, it was the job of the organizer to disinfect and clean out the boxes. However, when G. arrived, the few boxes that were [page "79"](#) free had not been cleaned out nor, more importantly, disinfected. She had to take the boxes which she could find, since the large majority of the foals had not yet left Grosseto.

The litter of the box in which G. put her mare F. was dirty, and still contained remains of fodder and feedstuffs. Not having any means of disinfection with her, she did what she could, that is to say gave the box a brief clean out. She was not able to change all the litter owing to the lack of straw, since this was delivered for the needs of the competitors only once a day, in the morning. When she arrived, there was almost none left. She did not, however, take the precaution of emptying her horse's manger.

During her stay in Grosseto, G. competed with two horses, F. being left alone when she was looking after the other horse. During the day, there was no guard provided for the stables; during the night, there was one guard who went from stable to stable.

The event in Grosseto, which was won by G. with the mare F., ended at around 13.00 hours on Sunday 30th September 1990. There was no veterinary control after the competition. G. and her mother stayed in Grosseto until around 09.00 hours on Monday 1st October 1990.

Upon leaving Grosseto, the two horses were once again placed in a horse-box for the journey to Catane (Sicily) where G. and the mare F. were entered to take part in the CSI cat. A competitions taking place during the weekend of 6/7th October 1990. This involved a distance of some 700 km, covered in around 15 hours. Such a journey is relatively long for a horse and creates a degree of stress, particularly as it involves a thirty-minute crossing of the Straits of Messina by ferry, a means of transport which horses do not enjoy.

When asked about the length of the journey and the risk of stress and anxiety, increased by a ferry crossing, the appellant and her mother provided the following information which the Court of Arbitration for Sport regards as constant:

- The mare F. has been used to making long journeys for several years. Indeed, living in Lecce, G. is often obliged to make journeys of 500 or 600 km, or even longer, in order to take part in events with her mare.
- F. is an eight-year old mare. She is described as being very sensitive, but not highly strung.
- For approximately the last five-and-a-half years, she has been treated by a single veterinarian, Dr. C., who has attested in writing that he has never had to prescribe any tranquilizing therapy, and that no substance has ever been given to the horse by G. without his opinion having been sought beforehand.

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## Organization

- › Court of Arbitration for Sport

## Arbitrators/Judges

- › Denis Oswald, President
- › Hans Ulrich Sutter
- › Benigno Alvarez

## Case date

- › 15 January 1992

## Case number

- › CAS Case No. 1991/A/53

## Parties

- › Claimant, G.
- › Respondent, Fédération Equestre Internationale (FEI)

## Key words

- › Horse doping (promazine)
- › Right to be heard
- › Negligence by the rider

## Source

- › **G. v Fédération Equestre Internationale (FEI), Award, CAS Case No. 1991/A/53, 15 January 1992** in Matthieu Reeb (ed), Digest of CAS Awards I 1986-1998, Digest of CAS Awards Series Set, Volume 1 (© Kluwer Law International; Kluwer Law International 1998) pp. 79 - 91

– G. travels with a first aid kit for her horses which was given to her by Dr. C. and which contains a few medicaments including “combelen”, which is in all likelihood a sedative, but which G. declares she has never used on her horse. At best, she knows that, if she uses it, she has to inform the veterinarian at the following event, in accordance with the Veterinary Regulations.

Both G. and her mother rule out the possibility that, during the journey from Grosseto to Catane someone could have had access to the horse-box, which remained locked at all times when they were not present. The horses did not leave the horse-box, even during the stopover made on the evening of the first day, that is to say from 19.00 hours until around 08.00 hours the following morning. The horses were fed by nobody other than G. with fodder brought with them from Lecce at the start of the trip.


G. arrived in Catane two days before the start of the CSI. In this town the stables are permanent, and when she arrived the loose-boxes were clean. G. and her mother were accommodated some 500 metres away from the stables. Only the horse F. took part in the event.

On Sunday 7th October 1990, G. and her mare F. took part in the “Premio no. 7” of the Catane CSI, where they placed thirty-fourth. After the event, the horse was chosen by the drawing of lots for a medication control which was performed immediately after the event. The analysis by the Horseracing Forensic Laboratory Ltd, Newmarket (England), dated 31st October 1990, established the presence of Hydroxypromazine in the urine (sample A) of the mare F. “as a result of the administration of promazine”.

By fax of 1st November 1990, the FEI informed the Italian Equestrian Sports Federation of the positive result of the analysis, stating the following:

*Please refer to Veterinary Regulations arts. 1023, 1024 and 1025 and indicate:*

- 1. If you accept the result or if you require a confirmatory analysis (art. 1023.3). Please advise prior to 12th November 1990.*
- 2. If you require a witnessing analyst and, if so, whom (art. 1023.4).*

*May we have the written explanation of the Person Responsible prior to 23rd November 1990? All written evidence and any request for a personal hearing must be sent to the FEI before this deadline, in accordance with art. 050.6 of the Statutes. The cost of such a hearing, including the travel and accommodation expenses for the Judicial Committee, will  page "81" be to the account of the Person Responsible if the Judicial Committee so decides (art. 177.10 of the General Regulations).*

*Please note that you are responsible for communicating the content of this letter/fax to the Person Responsible. The Judicial Committee will consider this case based on the written evidence filed unless you request a hearing as indicated above.*

Before the deadline of 12th November 1990, the appellant requested a confirmatory analysis and designated Dr. Z. from the Brughiera Veterinary Clinic near Varese as her expert witness.

The confirmatory analysis was performed in England by the same laboratory on 20th November 1990, in the presence of Dr. Z. who knew on the same day that the result of the first analysis was confirmed, in that the urine of F. contained in the B sample showed exactly the same presence of Hydroxypromazine.

The result of the confirmatory analysis was communicated to the FEI by letter on 23rd November 1990, and received on 26th November 1990.

At almost exactly the same time, that is to say by fax of 23rd November 1990, the Italian Equestrian Sports Federation wrote the following to the FEI:

*With regard to the defence of G., please could you give us the following information:*

- 1) What is the deadline laid down for presenting the account of the defence?*

2) *In the event of a positive response from the confirmatory analysis, may the owner of the horse take part in the meeting of the Judicial Committee?*

In a fax dated 29th November 1990, the FEI gave, *inter alia*, the following answer:

*In response to your fax of 23rd November 1990, may we inform you of the following:*

- 1) *In accordance with the legal procedure of the FEI, positive cases are submitted to the Judicial Committee for examination of all the information as soon as this is received (explanation by the Person Responsible, by the national federation, laboratory report, report on the confirmatory analysis, etc.).*
- 2) *In accordance with article 052.3 of the Statutes, G. has the option to appear, alone or accompanied by witnesses, before the Judicial Committee in order to defend her case. She may also ask to be represented by a lawyer.*


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*The confirmatory analysis of the samples taken from the horse F. took place on 20th November 1990 in the presence of Dr. Z. The result from the HFL laboratory confirmed the presence of the prohibited substance Hydroxy-Promazine. We should be grateful if you could send us the report by Dr. Z. so that we can submit the file to the Judicial Committee.*

The FEI did not include the letter from the laboratory with its fax, nor did it ask the Italian Equestrian Sports Federation to inform G., nor did it inform the latter directly. It considered that the presence of the analyst, a witness at the confirmatory analysis, constituted sufficient communication.

Complying with the request of the FEI, confirmed by telephone on 21st January 1991, the Brughiera veterinary clinic, under the signature of Dr. Z., sent an expert appraisal on 3-Hydroxypromazine on 21st January 1991.

The aforementioned report contained, *inter alia*, the following information (summarized translation):

- Promazine HC1 is a depressive drug which affects the central nervous system and which is widely used as a tranquilizer for horses.
- Researchers who have studied the influence of promazine on the metabolism of horses have found at least five urinary metabolites, the most important of which is 3-Hydroxypromazine (1, 2, 3, 4). All the research performed has shown that, apart from the metabolites, the urine from horses always contains a small but determining quantity of non-metabolized promazine.
- The elimination of 3-Hydroxypromazine, the most important of the metabolites, takes longer than for the minor metabolites and the non-metabolized promazine. In practice, when the other metabolites can no longer be detected with the usual methods, 3-Hydroxypromazine can still be detected. As a result, if, in a horse's urine, one finds only small residues of the minor metabolites and non-metabolized promazine, it is possible to deduce that the period of time elapsed between ingestion and the analysis is relatively long.
- A comparative analysis has shown, upon analysis, that the laboratory horse which had been injected with 0.3 to 0.4 mg/kg of promazine (the normal therapeutic dose is between 0.4 and 1.1 mg/kg), displayed a concentration of 3-Hydroxypromazine twenty times higher than that found in the urine of F.
- Referring to the works devoted to the dynamics of metabolites, Dr. Z. and the cosignatory of the report reached the conclusion that the concentration of 3-Hydroxypromazine found in the urine of the  [page "83"](#) horse F. necessarily implied that the ingestion took place at least 72 to 96 hours before the urine samples were taken.
- Finally, they explain that the duration of activity of promazine (4 to 6 hours after ingestion) was already long past by the time of the competition, and therefore no longer had any tranquilizing effect, with there being only the residual presence of the metabolite 3-Hydroxypromazine, which in itself has no pharmacological effect.

On 7th May 1991, the FEI Judicial Committee, basing its action on the analysis and confirmatory analysis and mentioning the written declaration by G. according to which she had not administered any prohibited substance to her horse F., made the following decision:

1. *Disqualification of the horse F. from all CSI, cat. A events in Catane.*
2. *Suspension of G. from all national and international competitions for three months.*
3. *Publication of the sanction inter alia in the FEI bulletin after expiry of the appeal deadline.*


G. appealed against the decision by the FEI Judicial Committee in a document which was not dated, but which reached the FEI by 24th June at the latest.

Through the intermediary of her counsel, the appellant admitted that Hydroxypromazine, a metabolite of promazine, was a prohibited substance in the sense of art. 1013 of the Veterinary Regulations and that such a metabolite had been found in the urine of the horse F. by two uncontested analyses.

### ***In Law***

1. The competence of the Court of Arbitration for Sport to review an appeal against the decisions of the Judicial Committee derives from articles 051.6.2 and 053.1 of the Statutes of the FEI under the new terms thereof in accordance with the modifications decided by the General Assembly of March 1991.

Where the limit of competence with regard to sanctions is concerned, this derives from art. 169 of the FEI General Regulations which refers to art. 168.

2. For the rest, in terms of its form, the appeal was in accordance with the regulations. It therefore fulfilled all the conditions of admissibility.  [page "84"](#)
3. The appellant having expressly drawn attention to the violation of the right to be heard by the Judicial Committee, a right provided for under art. 052.5 of the Statutes of the FEI, the Court of Arbitration for Sport must examine this question prejudicially.
4. The competition took place on 7th October 1990, and the "A" sample of urine from the mare F. reached the laboratory in Newmarket (England) on 11th October 1990. The analysis was performed on 31st October 1990, that is to say within the time limit of 21 days stipulated in art. 1023.1 of the Veterinary Regulations. The result of such analysis was notified to the FEI by fax on 1st November 1990, and two deadlines were fixed:
  - a) a deadline of 12th November 1990 by which to request a confirmatory analysis;
  - b) a deadline of 23rd November 1990 by which to provide written explanations, evidence and request a personal hearing by the Judicial Committee.
5. With regard to the first deadline, this derives from art. 1023 of the Veterinary Regulations of the FEI which states, under paragraph 3, that the person responsible may request a confirmatory analysis *"within the ten days following the written notification by the FEI of the result of the analysis of the 'A' sample to the national federation concerned"*.
6. With regard to the second deadline of 23rd November 1990, the Court of Arbitration for Sport notes first of all that no provision of any kind expressly provides for this. The reference to art. 050.6 of the Statutes is, moreover, erroneous, as the section which deals with this matter is actually to be found under art. 052.5, which stipulates the following: *"The Commission must take into consideration all the appropriate evidence, provided orally or in writing. The parties must receive all the details of the case, together with copies of written evidence, and be informed of the dates, places and manner in which the inquiry will be conducted, and have the possibility of appearing in person in order to submit oral and/or written evidence, and to call witnesses with a view to examination thereof"*.

7. The text of the fax of 1st November 1990 from the FEI is unclear, and leads one to wonder whether the two deadlines are of an alternative or cumulative nature. In accordance with the general principle of law whereby a declaration must be interpreted *contra stipulatorem*, the Court of Arbitration for Sport deems that the indication of a double [page "85"](#) deadline was of an alternative nature, in the sense that, from the moment that the appellant had asked for a confirmatory analysis before the deadline of 12th November 1990 – which was the case –, she had respected the requirement of the rules as formulated by the FEI. In the logic of the double analysis system, the simultaneous fixing of two deadlines seems totally inadequate, as it was manifestly inappropriate to demand written explanations and evidence together with a personal hearing before knowing the definitive objective result of the analyses, that is to say the result of the confirmatory analysis as well.
8. Moreover, it is implicit in the fax of 23rd November that the Italian Equestrian Sports Federation interpreted the double deadline in the alternative sense, since it asked the general secretariat of the FEI by what deadline the person responsible could present her defence and how such person could take part in the meeting of the Judicial Committee in the event that the second analysis were to confirm the results of the first.
9. The FEI did not give a clear answer to this double request in its fax of 29th November 1990 and, what is more, did not draw attention to the fact that the deadline of 23rd November 1990 had already passed six days previously.
10. In art. 1024 of the Veterinary Regulations of the FEI, the Court of Arbitration for Sport sees an implicit confirmation of the alternative nature of the deadlines fixed in the fax of 1st November 1990. Indeed, it stipulates in this article that *"if the analysis of the 'B' sample cannot legally be performed, the case must be abandoned and no subsequent action may be undertaken"*. In the light of this perfectly clear provision, it would be pointless, even specious, to require written explanations or evidence before knowing the result of the confirmatory analysis which might prove negative and therefore result in the whole procedure's being abandoned. It would be equally premature to seek a personal hearing in such conditions.
11. In the case in point, upon reception of the positive result of the confirmatory analysis, the FEI should have notified this formally to the Italian Equestrian Sports Federation, fixing a new deadline by which to provide written explanations and evidence and to request a personal hearing by the FEI Judicial Committee. By not fixing a new deadline – on the erroneous assumption that the deadline had not been respected – and by making a decision without further investigation [page "86"](#), the FEI violated the general legal principle, expressly provided for by the statutes, of the right to be heard.
12. On the basis of the foregoing, the Court of Arbitration for Sport considers that the decision by the Judicial Committee of 7th May 1991 must be annulled, and a new decision made by the Panel.
13. Taking up the case again, the Court of Arbitration for Sport considers as follows:
 

The appellant, rightly, did not call into question the two analyses which she does not contest and which revealed the presence of Hydroxypromazine, the metabolite of promazine, in the two urine samples from the horse F. taken after the CSI "Premio no. 7" in Catane on 7th October 1990. Again with just cause, she admitted that Hydroxypromazine is a Prohibited Substance in the sense of art. 1013 of the Veterinary Regulations, since this stipulates that *"a prohibited substance includes the metabolites of such substance"*.
14. In accordance with art. 149.2 of the FEI General Regulations, the presence of the prohibited substance results in a pure strict liability which is expressed in the automatic disqualification of the horse and the rider *"from all competitions at that event"* which implies loss of all rankings obtained. This consequence is confirmed by art. 177.5.1 of the FEI General Regulations.
15. Still to be examined is the problem of the additional penalty which may or must be imposed on the person responsible in application of art. 177.5.2 or 177.5.3 of the FEI General Regulations.



16. The Court of Arbitration for Sport wishes first of all to recall that, where doping or the taking of prohibited substances is concerned, there is normally and generally in the sporting regulations of Federations an inversion of the burden of proof in the sense that, as soon as the presence of prohibited substances is detected, there is the presumption of a voluntary act. It is then up to the athlete to produce evidence to the contrary.
17. The system provided for by the General Regulations of the FEI is different, since the result of the analyses – it rests with the FEI to produce such evidence – must tend to “*be construed as a deliberate attempt to affect the performance of the horse ...*” (art. 177.5.2) or “*may not be construed as a deliberate attempt to affect the performance of the horse*” (art. 177.5.3). In other words, it rests with the FEI to establish [page "87"](#) the burden of proof of a presumption of intent or a presumption of negligence, principally by means of the analyses performed.
18. It is not for the Court of Arbitration for Sport to judge the system instituted by the General Regulations, but it does wish to note that it is almost impossible to offer proof of the presumption of intent or the presumption of negligence on the basis of simple objective analyses like those performed on the A and B samples by the Horseracing Forensic Laboratory Ltd, such analyses being satisfied with establishing the presence or absence of a prohibited substance, to the exclusion of any other consideration or any other more exhaustive analysis. Already at this stage, the Court of Arbitration for Sport finds that the FEI has not offered proof of a presumption of intent.
19. Consequently, for this first reason, art. 177.5.2 is inapplicable. On the other hand, the presence of a prohibited substance in the urine of a horse presumes negligence on the part of the person responsible and automatically results in the application of art. 177.5.3, unless the person responsible clears himself from such presumption by proving that he had taken all the necessary precautions.
20. The Court of Arbitration for Sport does not know how the FEI learned that Dr. Z. of the Brughiera Veterinary Clinic had produced a report interpreting the results of the analysis. This question may remain undecided. The Panel notes, however, that the FEI asked for such report to be produced in its fax of 29th November 1990 through the intermediary of the Italian Equestrian Sports Federation. Not having received anything, the FEI secretariat asked Dr. Z. directly for it by telephone on 21st January 1991, before taking a decision. One must therefore infer from the above, and especially from the postponement of the decision until such time as the contents of the report from the Brughiera Veterinary Clinic were known, that the Judicial Committee would regard this report as an important piece of evidence. It is therefore surprising to see that the Judicial Committee, which *inter alia* waited for this report before taking the decision which is the subject of this appeal on 7th May 1991, makes no mention of it, in particular under paragraph 2.1, not even to distance itself from it.
21. As this report was not contested either by the decision which is the subject of this appeal or by the FEI during the proceedings of the present case, the Court of Arbitration for Sport regards it as a piece of evidence in the same way as the other documents produced. [page "88"](#)
22. The report concludes that the ingestion of promazine took place at least 72 to 96 hours before the urine samples were taken, based on the concentration of the metabolite 3-Hydroxypromazine revealed by the analysis. It explains that the duration of activity of promazine is limited to 4 to 6 hours after ingestion, and that the metabolite 3-Hydroxypromazine as found in the samples – which is just a “residue” of promazine – has no pharmacological effect.
23. Admittedly, this report does not explain in what circumstances this substance found its way into the body of the horse F., but its pharmacological inefficacy at the time of the event constitutes an element which should be taken into account in order to determine whether there is an indication of negligence or intent.
24. This report does not in any case prove that G. deliberately and intentionally sought to improve the performance of her horse. It therefore remains to determine whether she could clear herself of the presumption of negligence indicated by the presence of a prohibited substance in the urine of the mare F.

25. The appellant displayed culpable negligence when she took possession of the loose-boxes for her horses on the occasion of the event held in Grosseto a few days before, by not sufficiently cleaning out the litter and by not removing the fodder and feedstuffs left in the manger. Investigation of the case on this point did not enable her to overturn the presumption of negligence and, on the contrary, established the existence of such negligence.
26. For this second reason, art. 177.5.3 must apply, whereas the application of art 177.5.2 must be ruled out, the proof of intent not having been offered.
27. In short, not only has the FEI not produced proof of a deliberate attempt in the sense of art. 177.5.2, but also, thanks to the report from the Brughiera Veterinary Clinic, and thanks to testimony and her personal hearing, G. has provided evidence which tends to prove that there was no deliberate attempt to alter the performance of the mare F. in the sense of this same provision which, as a result, cannot apply. On the other hand, G. has not shown herself to have taken all the precautions which would have enabled her to clear herself of the presumption of negligence which results from the presence, in the urine of her horse, of a Prohibited Substance. In accordance with the system chosen by the FEI, the Court of Arbitration for Sport must therefore apply art. 177.5.3 of the General Regulations. [page "89"](#)
28. The Court of Arbitration for Sport notes finally that, in addition, apart from referring to the automatic disqualification, the decision of 7th May 1991 makes no mention of the legal basis of the additional penalty, that is to say whether it is in application of art. 177.5.2 or art. 177.5.3.
29. Consequently, only art. 177.5.3 is applicable, which provides for an obligatory fine of CHF 1,000.– to CHF 15,000.– and a possible suspension of one to three months. Taking into account the personal details of the rider and the unintentional nature of the infraction, but also of the need to fight against doping in general, the Court of Arbitration for Sport, basing its decision *inter alia* on the guidelines contained in the International Olympic Charter against Doping in Sport, considers that a fine of CHF 1,000.– and a suspension from international equestrian competitions for the period of one month are sufficient penalty for the present case.
30. With regard to publication of the award, the Court of Arbitration for Sport considers that this must be authorized, not only for technical reasons relating to the organization of the FEI, but also in the interest of G. whose case has become known among equestrian circles. To take this double interest into account, the Court of Arbitration for Sport orders the publication of the award by the FEI, but only in a summarized form established by the Court of Arbitration for Sport which indicates expressly the unintentional nature of the infraction in the sense of art. 177.5.3.

**The Court of Arbitration for Sport pronounces:**

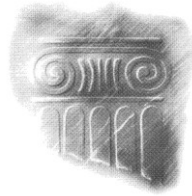
1. The appeal is partially upheld.
2. The decision of 7th May 1991 by the FEI is annulled.  
In a new ruling, the Court of Arbitration for Sport pronounces:
  3. The mare F. and the rider G. are disqualified from all the CSI cat. A competitions in Catane on 7th October 1990.
  4. In application of art. 177.5.3 GR, the rider G. is punished:
    - with a suspension from international equestrian competitions for the period of one month;
    - with a fine of 1,000.– Swiss francs to be paid to the FEI.
  5. (...)
  6. (...) [page "90"](#)
  7. The award shall be published in the next bulletin of the FEI. The award shall appear in a summarized form to be established by the Court of Arbitration for Sport. [page "91"](#)

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## **LEGAL AUTHORITY CA-69**



**Arbitration CAS 98/200 AEK Athens and SK Slavia Prague / Union of European Football Associations (UEFA), award of 20 August 1999**

Panel: Mr. Massimo Coccia (Italy), President; Dr. Christoph Vedder (Germany); Dr. Dirk-Reiner Martens (Germany)

*Football*

*Conflicts of interest related to multi-club ownership within the same competition*

*Application of EC law to sport*

*Status of UEFA according to EC law*

*Right to be heard*

*Principle of procedural fairness*

1. If clubs with the same owner can take part in the same competitions, whether national or international, doubts may arise as to whether the outcome is really undecided in advance. The challenged UEFA Rule is therefore an essential feature for the organization of a professional football competition and is not more extensive than necessary to serve the fundamental goal of preventing conflicts of interest which would be publicly perceived as affecting the authenticity, and then the uncertainty, of results in UEFA competitions.
2. Membership of UEFA is open only to national football associations situated on the continent of Europe who are responsible for the organization and implementation of football-related matters in their particular territory. The UEFA Statutes attribute voting rights only to national federations, and article 75 of the Swiss Civil Code (CC) refers to members which have voting rights within the association whose resolution is challenged. Clubs do not meet these requirements.
3. Under Article 75 CC, members of an association have the right to be heard when resolutions are passed which affect them to a significant extent. However, requiring an international sports federation to provide for hearing to any party potentially affected by its rule-making authority could quite conceivably subject the international federation to a quagmire of administrative red tape which would effectively preclude it from acting at all to promote the game.
4. The doctrine of *venire contra factum proprium* provides that where the conduct of one party has led to the legitimate expectations on the part of a second party, the first party is estopped from changing its course of action to the detriment of the second party. *In casu*, UEFA may not change its Cup Regulations without allowing the clubs sufficient time to adapt their operations to the new rules accordingly. However, such procedural defect by itself does not warrant the permanent annulment of the contested UEFA Rule.

- 5. Sport is subject to Community law only insofar as it constitutes an economic activity within the meaning of Article 2 of the EC Treaty. EC law does not prevent the adoption of rules or of a practice excluding foreign players from participation in certain matches for reasons which are not of an economic nature, which relate to the particular nature and context of such matches and are thus of sporting interest only.**

The Claimant AEK PAE (hereinafter «AEK») is a Greek football club incorporated under the laws of the Hellenic Republic and having its seat in Athens. AEK currently plays in the Greek first division championship and over the years has often qualified for the European competitions organized by UEFA. At the end of the 1997/98 football season AEK ranked third in the Greek championship, thus becoming eligible to participate in the 1998/99 UEFA club competition called «UEFA Cup». AEK is owned as to 78.4% by ENIC Hellas S.A., a company wholly controlled, through subsidiaries, by the English company ENIC plc.

The Claimant SK Slavia Praha (hereinafter «Slavia») is a Czech football club incorporated under the laws of the Czech Republic and having its seat in Prague. Slavia currently plays in the Czech-Moravian first division championship and along the years has often qualified for the UEFA competitions. At the end of the 1997/98 football season, Slavia ranked second in the Czech-Moravian championship, thus becoming eligible to participate in the 1998/99 UEFA Cup. Slavia is owned as to 53.7% by ENIC Football Management Sarl, a company wholly controlled, through subsidiaries, by ENIC plc.

Both AEK and Slavia are under the control of ENIC plc (hereinafter «ENIC»), a company incorporated under the laws of England and listed on the London Stock Exchange. In the last couple of years ENIC, through subsidiaries, has invested in several European football clubs, acquiring controlling interests in AEK, Slavia, the Italian club Vicenza Calcio SpA, the Swiss club FC Basel, and a minority interest in the Scottish club Glasgow Rangers FC.

The Respondent Union of European Football Associations (hereinafter «UEFA»), association which has its seat in Nyon, Switzerland, is a sports federation which has as its members all the fifty-one national football associations (*i.e.* federations) of Europe. UEFA is the governing body for European football, dealing with all questions relating to European football and exercising regulatory, supervisory and disciplinary functions over national associations, clubs, officials and players. Pursuant to the UEFA Statutes, member associations must comply with such Statutes and with other regulations and decisions, and must apply them to their own member clubs. Until the 1998/99 European football season UEFA has organized three main club competitions: the Champions' League, the Cup Winners' Cup and the UEFA Cup. UEFA has recently resolved to cancel the Cup Winners' Cup and, as of the 1999/2000 season, has reduced the main club competitions to the Champions' League and the UEFA Cup.

During 1997 ENIC acquired the above-mentioned controlling interests in AEK, Slavia and Vicenza. In the 1997/98 European football season, these three clubs took part in the UEFA Cup Winners'

Cup and all qualified for the quarter final. At this stage, the three ENIC-owned clubs were not drawn to play against each other and only one of them reached the semi-finals (AEK lost to the Russian club Lokomotiv Moscow, Slavia lost to the German club VfB Stuttgart, whereas Vicenza defeated the Dutch club Roda JC). Being confronted with a situation where three out of eight clubs left in the same competition belonged to a single owner, UEFA started to consider the problems at stake.

On 24 February 1998, at ENIC's request, representatives of UEFA and ENIC met in order to discuss the issue of «multi-club ownership», that is the ethical and non-ethical questions raised by the circumstance that two or more clubs controlled by the same owner take part in the same competition. In that meeting ENIC proposed to UEFA a «code of ethics» to be adopted by football clubs, with a view to convincing UEFA not to adopt a rule banning teams with common ownership from participating in the same UEFA competition.

After the meeting, ENIC exchanged correspondence with UEFA and submitted a draft code of ethics for consideration. Thereafter, UEFA referred the issue of multiple ownership to some of its internal bodies, namely the Committee for Non-Amateur Football, the Juridical Committee and the Committee for Club Competitions. These came to the conclusion that there was no guarantee that a code of ethics would be effectively implemented and that a code of ethics was not a viable solution. They therefore recommended to the Executive Committee of UEFA that the rule at issue in this arbitration be adopted.

On 7 May 1998, UEFA sent to its member associations several documents to be communicated to the clubs entitled to compete in the 1998/99 UEFA Cup. In particular, UEFA sent the regulations and the entry forms for the 1998/99 UEFA Cup and the booklet entitled «Safety and security in the stadium – For all matches in the UEFA competitions». The UEFA Cup regulations set forth the conditions of participation without any mention of a limitation related to multi-club ownership. Moreover, the regulations did not make reservation for future amendments, except in the event of «force majeure». At that time, pursuant to the regulations, both AEK and Slavia were entitled to compete in the 1998/99 UEFA Cup because of their results in the 1997/98 national championships.

On 19 May 1998, the UEFA Executive Committee finally addressed the issue of multi-club ownership and adopted the rule at issue in these proceedings (hereinafter the «Contested Rule»). The Contested Rule is entitled «*Integrity of the UEFA Club Competitions: Independence of the Clubs*» and reads as follows:

*«A. General Principle*

*It is of fundamental importance that the sporting integrity of the UEFA club competitions be protected. To achieve this aim, UEFA reserves the right to intervene and to take appropriate action in any situation in which it transpires that the same individual or legal entity is in a position to influence the management, administration and/or sporting performance of more than one team participating in the same UEFA club competition.*

*B. Criteria*

*With regard to admission to the UEFA club competitions, the following criteria are applicable in addition to the respective competition regulations:*

1. *No club participating in a UEFA club competition may, either directly or indirectly:*
  - (a) *hold or deal in the securities or shares of any other club, or*
  - (b) *be a member of any other club, or*
  - (c) *be involved in any capacity whatsoever in the management, administration and/or sporting performance of any other club, or*
  - (d) *have any power whatsoever in the management, administration and/or sporting performance of any other club participating in the same UEFA club competition.*
2. *No person may at the same time, either directly or indirectly, be involved in any capacity whatsoever in the management, administration and/or sporting performance of more than one club participating in the same UEFA club competition.*
3. *In the case of two or more clubs which are under common control, only one may participate in the same UEFA club competition. In this connection, an individual or legal entity has control of a club where he/she/it:*
  - (a) *holds a majority of the shareholders' voting rights, or*
  - (b) *has the right to appoint or remove a majority of the members of the administrative, management or supervisory body, or*
  - (c) *is a shareholder and alone controls a majority of the shareholders' voting rights pursuant to an agreement entered into with other shareholders of the club in question.*
4. *The Committee for the UEFA Club Competitions will take a final decision with regard to the admission of clubs to these competitions. It furthermore reserves the right to act vis-à-vis clubs which cease to meet the above criteria in the course of an ongoing competition».*

On 20 May 1998, UEFA released a press statement announcing the adoption of the Contested Rule. On 26 May 1998, UEFA communicated the Contested Rule to all its member associations through Circular Letter no. 37, a copy of which was sent to ENIC, informing that the new provision would be effective as of the start of the new season.

Subsequently, pursuant to Paragraph B.4 of the Contested Rule, the UEFA Committee for Club Competitions decided that the following criteria would determine which of two or more commonly owned clubs should be admitted to a UEFA club competition: first, the club with the highest «club coefficient» (based on the club's results of the previous five years) would be admitted; then, if the club coefficients were the same, the club with the highest «national association coefficient» (based on the previous results of all the teams of a national association) would be admitted; lastly, in case of equal national association coefficients, lots would be drawn.

On 25 June 1998, UEFA informed AEK of the criteria adopted by the UEFA Committee for Club Competitions and of the resulting non-admission of AEK to the UEFA Cup, while Slavia was authorized to compete. The Hellenic Football Association was called upon to enter a substitute for AEK, by designating the club which finished the domestic championship immediately below AEK. In the same letter, UEFA granted AEK a last opportunity to take part in the competition, if it were

to submit a statement confirming a change of control in compliance with the Contested Rule by 1 July 1998 (this was later extended to 20 July 1998).

On 12 June 1998, the parties executed an arbitration agreement, by which they agreed to submit the present dispute to the Court of Arbitration for Sport («CAS») in accordance with the Code of Sports-related Arbitration (the «Code»).

On 15 June 1998, AEK and Slavia filed with the CAS a request for arbitration together with several exhibits, primarily petitioning that the Contested Rule be declared void or annulled (*see infra*, para. 32). On the same day, AEK and Slavia also filed a request for interim relief, petitioning that during the proceedings UEFA be restrained from giving effect to the Contested Rule and, in particular, from excluding either Claimant from the 1998/99 UEFA Cup competition.

UEFA filed its reply to the Claimants' request for interim relief on 26 June 1998 and filed its answer to the request for arbitration, with some exhibits, on 22 July 1998.

On 15 July 1998, the President of the Ordinary Division of CAS held a hearing at the CAS offices in Lausanne, where the parties and their counsel answered questions of fact and law raised by the President and counsel presented oral arguments.

On 16 July 1998, the CAS issued a «Procedural Order on Application for Preliminary Relief», granting the following interim relief:

- «1. For the duration of this arbitration or for the duration of the 1998/99 season of the UEFA Cup, whichever is shorter, the Respondent shall not give effect to the decision taken by its Executive Committee on May 19, 1998 regarding the "Integrity of the UEFA Club Competitions: Independence of the Clubs";
2. As a result, the Respondent shall admit AEK Athens to the 1998/99 UEFA Cup Competition, in addition to Slavia Prague;
3. The costs of the present stage of the proceedings shall be settled in the final award or in any other final disposition of this arbitration».

As a result, AEK and Slavia were allowed to participate in the 1998/99 UEFA Cup (where they were eliminated after winning a few rounds of the competition and did not end up playing each other).

According to the grounds of the interim order, released the following day, the CAS based its decision primarily on the circumstance that UEFA violated its duties of good faith and procedural fairness insofar as it enacted the Contested Rule too late, when the Cup Regulations for the 1998/99 season – containing no restriction for multiple ownership – had already been adopted, and shortly before the start of the 1998/99 season, at a time when ENIC and its clubs could legitimately expect that no restriction was going to be adopted for the said season.

In the interim order the CAS left open for the final award the question whether the Contested Rule could be deemed lawful under competition law and civil law, stating that all findings of fact and legal

assessments were made on a *prima facie* basis, without prejudice to the CAS final award to be rendered after additional factual and legal investigation.

On 23 July 1998, the CAS issued a notice that the CAS Arbitration Panel for the present dispute (hereinafter the «Panel») was constituted in the following composition: Mr. Massimo Coccia as President, Dr. Christoph Vedder as arbitrator appointed by the Claimants and Mr. George Abela as arbitrator appointed by the Respondent.

On 4 September 1998, upon request of the Claimants, pursuant to Article R44.3 of the Code the Panel ordered the Respondent to produce the reports and minutes of the meetings of the UEFA Juridical Committee and of the UEFA Committee for Club Competitions related to the present case. UEFA produced such documents, later providing a few more internal documents upon request of the Claimants.

On 14 September 1998, the CAS issued an order of procedure, detailing the procedural guidelines for the conduct of the arbitration. The order of procedure was accepted and countersigned by both sides. Subsequently, in the course of the proceedings, the Panel supplemented the initial order of procedure with several other orders concerning procedural and evidentiary questions.

On 15 October 1998, the Claimants filed their statement of claim, together with eleven bundles of exhibits. UEFA's response, together with forty exhibits, was submitted to the CAS on 27 November 1998.

On 18 November 1998, the Claimants filed with the CAS a petition pursuant to Article R34 of the Code, challenging the appointment of Mr. George Abela as arbitrator, on the grounds that some circumstances gave rise to legitimate doubts over his independence *vis-à-vis* UEFA, and requesting his removal. On 25 November 1998, Mr. Abela communicated to the CAS that he deemed the Claimants' allegations to be totally unfounded and unjustified; however, because of the very fact that doubts had been expressed regarding his independence and impartiality, for the sake of the CAS he felt that he had to resign from his function as arbitrator in the present case.

On 3 December 1998, the Respondent communicated to the CAS that, in substitution of Mr. Abela, it appointed as arbitrator Dr. Dirk-Reiner Martens. Therefore, the Panel was reconstituted in the new formation comprising Mr. Coccia as President and Messrs. Vedder and Martens as arbitrators. No objection has been raised by either party with respect to the new formation of the Panel.

On 24 December 1998, the Claimants filed with the CAS their reply to UEFA's response. On 1 February 1999, the Respondent filed its rejoinder. Subsequently, on 26 and 28 February 1999, both sides submitted their lists of witnesses and expert witnesses to be summoned to the hearing.

On 12 March 1999, the Panel issued a procedural order detailing directions with respect to the hearing and to the witnesses and experts to be heard.

The hearing was held on 25 and 26 March 1999 at the World Trade Center in Lausanne. The Panel was present, assisted by the *ad hoc* clerk Mr. Stefano Bastianon, attorney-at-law in Busto Arsizio/IT,

and by Mr. Matthieu Reeb, attorney-at-law and counsel to the CAS. The Claimants were represented by Mr. Petros Stathis, General Manager of AEK, and Mr. Vladimir Leska, General Manager of Slavia Prague, assisted by his personal interpreter, and represented and assisted by the following attorneys: Mr. Michael Beloff QC and Mr. Tim Kerr, attorneys-at-law in London/UK (Gray's Inn), Mr. Stephen Kon, Ms. Lesley Farrel and Mr. Tom Usher, attorneys-at-law in London/UK (SJ Berwin), Mr. Jean-Louis Dupont, attorney-at-law in Brussels/BEL, Mr. Marco Niedermann and Mr. Roberto Dallafior, attorneys-at-law in Zurich/CH. The Respondent was represented by Mr. Marcus Studer, Deputy Secretary General of UEFA, and represented and assisted by Mr. Ivan Cherpillod, attorney-at-law in Lausanne/CH, and by Mr. Alasdair Bell, attorney-at-law in Brussels/BEL. With the agreement of all parties two directors of ENIC, Mr. Rasesh Thakkar and (after his testimony had been given) Mr. Daniel Levy, also attended the hearing.

During the two days of hearing the following witnesses and expert witnesses were heard: Mr. Gerald Boon (economist of Deloitte & Touche), Mr. Ivo Trijbits (legal counsel to the Dutch club AFC Ajax NV), Mr. Daniel Levy (managing director of ENIC), Sir John Smith (advisor on security issues to the English Football Association), Lord Kingsland QC (former Member of the European Parliament) and Prof. Paul Weiler (professor of law at Harvard Law School), all called by the Claimants; Mr. Gordon Taylor (chief executive of the Professional Footballers Association) and Prof. Gary Roberts (professor of law at Tulane Law School), called by the Respondent. Each witness and expert witness was invited by the Panel to introduce himself and to tell the truth subject, as to statements related to facts, to the sanctions of perjury in accordance with Article R44.2 of the Code and Articles 307 and 309 of the Swiss Penal Code; each witness and expert witness rendered his testimony and was then examined and cross-examined by the parties and questioned by the Panel.

The parties presented their opening and intermediate statements on 25 March 1999 and their final arguments on 26 March 1999, the Respondent having the floor last in accordance with Article R44.2 of the Code. At the end of the final arguments both sides confirmed their written legal petitions (*infra*, paras. 1 and 4), with counsel for the Claimants also petitioning that the interim stay of the Contested Rule be extended indefinitely and that the award be communicated to the parties on a Friday after the closing of the London stock exchange and rendered public on the following Monday. The parties did not raise with the Panel any objection in respect of their right to be heard and to be treated equally in the present arbitration proceedings.

On 26 March 1999, after the parties' final arguments, the Panel closed the hearing and reserved its final award.



## LAW

### Parties' legal petitions and basic positions

1. The Claimants presented in their request for arbitration of 15 June 1998 and confirmed in their statement of claim of 15 October 1998 the following legal petitions:

*«That it be declared that the resolution of the Executive Committee of the UEFA of 19 May 1998, as notified to the UEFA member associations on 26 May 1998, regarding the Integrity of the UEFA Club Competitions: Independence of the Clubs is void;*

***eventualiter:***

*that the resolution of the Executive Committee of the UEFA of 19 May 1998, as notified to the UEFA member associations on 26 May 1998, regarding the Integrity of the UEFA Club Competitions: Independence of the Clubs be annulled;*

***subeventualiter:***

*that the Defendant be ordered not to deny now and in the future the admission of the Clubs to the UEFA Club Competitions on the ground that they are under common control; with all costs and compensations to be charged to the Defendant».*

At the hearing the Claimants also petitioned that the stay of the Contested Rule ordered by the CAS on 16 July 1998 be extended indefinitely and that the award be notified to the parties on a Friday afternoon and rendered public on the following Monday. The latter petition was subsequently reiterated in writing, with no objection raised by the Respondent.

2. The Claimants argue that the Contested Rule is unlawful because it violates Swiss civil law, European Community (hereinafter «EC») competition law and Swiss competition law, general principles of law, and EC provisions on freedom of establishment and free movement of capital. The Claimants focus their grievances particularly on Paragraph B.3 of the Contested Rule, providing that «in the case of two or more clubs which are under common control, only one may participate in the same UEFA club competition». In summary, they assert the unlawfulness of the Contested Rule on the following ten grounds:
  - (a) *infringement of Swiss civil law* (grounds 1, 2, 3 and 4 of the statement of claim): violation of the UEFA Statutes because of the argued creation of different categories of members; breach of the principle of equal treatment because of discrimination between clubs which are under common control and clubs which are not; disregard of the Claimants' right to be heard; unjustified violation of the Claimants' personality;
  - (b) *infringement of EC competition law* (grounds 5 and 7 of the statement of claim): contravention of Article 85 (now 81) of the EC Treaty, because of an agreement between undertakings which has the object and effect of restricting, distorting and preventing competition and limiting investment within the common market; contravention of Article 86 (now 82) of the EC Treaty, because of an abuse by

- UEFA of its dominant position within the market for the provision of European football and related markets;
- (c) *infringement of Swiss competition law* (grounds 6 and 8 of the statement of claim): contravention of Article 5 of the Swiss Federal Act on cartels, because of an agreement between undertakings significantly affecting competition; contravention of Article 7 of the Swiss Federal Act on cartels, because of an abuse of UEFA's dominant position;
  - (d) *infringement of EC law on freedom of movement* (ground 10 of the statement of claim): contravention of Articles 52 (now 43) and 73 B (now 56) of the EC Treaty, because of restrictions on freedom of establishment and on free movement of capitals;
  - (e) *infringement of general principles of law* (ground 9 of the statement of claim): abuse by UEFA of its regulatory power with the purpose of preserving its position as the dominant organizer of European football competitions.
3. Underlying all such grounds are the Claimants' basic allegations that UEFA's predominant purpose in adopting the Contested Rule has been to preserve its monopolistic control over European football competitions and that a code of ethics would be adequate enough to address the issue of conflict of interests in the event that two commonly owned clubs are to participate in the same UEFA competition.
4. The Respondent submitted both in its answer of 22 July 1998 and in its response of 27 November 1998 the following legal petition:
- «UEFA respectfully requests the Court of Arbitration for Sport to dismiss all the legal petitions submitted by the Claimants, with all costs and compensations to be charged to the Claimants».*
5. The Respondent asserts that each and every legal ground put forward by the Claimants is entirely without merit. In particular, the Respondent asserts that it enacted the Contested Rule with the sole purpose of protecting the integrity of European football competitions and avoiding conflicts of interests. The Respondent argues that a code of ethics would be inadequate to that purpose, whereas the Contested Rule is a balanced and proportionate way of addressing the question, as it deals only with the issue of common control – basing the definition of «control» on EC Directive no. 88/627 (the so-called «Transparency Directive») – rather than with investment in football clubs.

## **Procedural issues**

### *Jurisdiction of the CAS*

6. The CAS has jurisdiction over this dispute on the basis of the arbitration agreement executed by and between the parties on 12 June 1998. Neither side has contested the validity of such arbitration agreement nor raised any objection to the jurisdiction of the CAS over the present dispute.

7. In addition, the Panel notes that the CAS could also be deemed to have jurisdiction under Article 56 of the UEFA Statutes, according to which «CAS shall have exclusive jurisdiction to deal with all civil law disputes (of a pecuniary nature) relating to UEFA matters which arise *between UEFA and Member Associations, clubs, players or officials, and between themselves*» (emphasis added).

#### *Applicable law*

8. Pursuant to Article R45 of the Code, the dispute must be decided «*according to the rules of law chosen by the parties or, in the absence of such a choice, according to Swiss law*». The parties agreed at the hearing of 15 July 1998 and confirmed in their briefs that Swiss law governs all issues of association law arising in this arbitration, and that the Panel should apply EC competition law and Swiss competition law if the dispute falls within the scope of these laws.
9. The choice of Swiss law does not raise any questions. Even if the parties had not validly agreed on its application, Swiss civil law would be applicable anyway pursuant to Article R45 of the Code and to Article 59 of the UEFA Statutes, according to which UEFA Statutes are governed in all respects by Swiss law. As to Swiss competition law, an arbitration panel sitting in Switzerland is certainly bound to take into account any relevant Swiss mandatory rules in accordance with Article 18 of the Swiss private international law statute (*Loi fédérale sur le droit international privé* of 18 December 1987, or «LDIP»).
10. With regard to EC competition law, the Panel holds that, even if the parties had not validly agreed on its applicability to this case, it should be taken into account anyway. Indeed, in accordance with Article 19 of the LDIP, an arbitration tribunal sitting in Switzerland must take into consideration also foreign mandatory rules, even of a law different from the one determined through the choice-of-law process, provided that three conditions are met:
  - (a) such rules must belong to that special category of norms which need to be applied irrespective of the law applicable to the merits of the case (so-called *lois d'application immédiate*);
  - (b) there must be a close connection between the subject matter of the dispute and the territory where the mandatory rules are in force;
  - (c) from the point of view of Swiss legal theory and practice, the mandatory rules must aim to protect legitimate interests and crucial values and their application must allow an appropriate decision.
11. The Panel is of the opinion that all such conditions are met and that, pursuant to Article 19 of LDIP, EC competition law has to be taken into account. Firstly, antitrust provisions are often quoted by scholars and judges as fundamental rules typically pertaining to the said category of mandatory rules. Then, the close connection with the case derives from the fact that EC competition law has direct effect in eighteen European countries – fifteen from the European Union and three from the European Economic Area – in whose jurisdiction one can find most of the strongest football clubs taking part in UEFA competitions and, in

particular, one of the Claimants (AEK). Lastly, the Swiss Cartel Law, as is the case with various national competition laws around Europe (well beyond the borders of the said eighteen countries), has been inspired by and modelled on EC competition law; accordingly, the interests and values protected by such EC provisions are shared and supported by the Swiss legal system (as well as by most European legal systems).

12. The Panel notes that the Claimants have argued *inter alia* that UEFA violated the provisions of the EC Treaty on the right of establishment and on free movement of capital, but the parties have not explicitly agreed on the applicability of such provisions to this case. However, for the same reasons outlined with respect to EC competition law (*supra*, paras. 10-11), the Panel holds that it must also take into account EC provisions on freedom of establishment and of movement of capital.

## Merits

### *Relevant circumstances concerning European football*

13. Prior to discussing the specific legal issues raised by the parties, the Panel wishes to describe and discuss certain circumstances and situations concerning European football which have to be taken into account with reference to all such legal issues. In particular, the Panel considers it useful to briefly describe the current structure and regulation of football in Europe and to address the issue of the so-called «integrity of the game».
  - a) Regulation and organization of football in Europe
14. In European football there are several private bodies performing regulatory and administrative functions, each of which has different institutional roles, constituencies and goals. Leaving aside the international football federation («FIFA»), which is certainly the body exercising the highest regulatory and supervisory authority worldwide, UEFA is the only regulator of football throughout Europe. UEFA performs its regulatory function with respect to both professional and amateur football, including youth football. For the time being, UEFA is also the only entity organizing pan-European competitions both for club teams and national representative teams. With particular regard to UEFA club competitions, each season the participating clubs are the few top-ranked clubs of each national league, which at the end of a season earn the right to play in the UEFA competitions of the subsequent season. As already mentioned, UEFA organizes the Champions' League, the Cup Winners' Cup (cancelled as of the 1999/2000 season) and the UEFA Cup, with the minor competition Intertoto Cup used also as a qualifier for the UEFA Cup. The competition format has traditionally been the knock-out system based on the aggregate result of one home-match and one away-match (played two weeks later), with away goals and penalty kicks as tie-breakers. Clubs (particularly those investing more) tend to dislike this system because a single unlucky match can be enough to terminate the whole international season, and because there are fewer high-level matches to play. Mainly for this

reason, UEFA has in recent years organized rounds of competition (particularly in the Champions' League) based on small groups of teams playing each other home and away in round-robin fashion, with the top clubs of each group qualifying for the next round. The trend seems to be towards increasing this competition format, reserving the knock-out system only for a few rounds of the competition.

15. Since UEFA is a confederation of fifty-one national football federations, it has below it many football associations and organizations which set rules for their constituent members, in particular clubs and individuals associated with them, and organize and/or oversee all national, regional and local competitions. The structure of European football is often described as a hierarchical pyramid (*see* the EC Commission's «consultation document» drafted by the Directorate General X and entitled *The European model of sport*, Brussels 1999, chapter one).
16. At national level, the primary regulators are the national federations. Each national federation has a wide constituency of regional and local federations, associations, clubs, leagues, and individuals such as players, coaches and referees. National federations are private bodies which pursue the mission – which in some countries is entrusted upon them by national legislation as a form of delegation of governmental powers (as is the case, *e.g.*, in France with Law no. 84-610 of 16 July 1984) – to promote and organize football at all levels and to care for the interests of the whole of the sport and all its members, whether they are involved in the amateur or in the professional game. National federations also organize and manage the national representative teams, selections of the best national players which compete against the other national representative teams in competitions such as the World Cup, the Olympic Games and the European Championship.
17. In the European countries where football is most developed, a very important role is also performed by professional «leagues» (*e.g.*, the «Premier League» in England, the «Liga Nacional de Fútbol Profesional» in Spain or the «Lega Nazionale Professionisti» in Italy). National professional leagues are bodies concerned only with professional football, as their members are only the clubs which participate in the most important national professional championships. They organize and manage yearly, under the jurisdiction of the respective national federation, the highest national professional championship. Such annual championship is traditionally organized in round-robin format, with each club playing against all the other clubs twice, once at home and once away; clubs are awarded points depending upon whether they win (three points), draw (one point) or lose matches (no points), and the club with the highest number of points each season is the champion (usually with no final playoff, differently from other sports). National professional leagues are indeed similar in many respects to trade associations. They exist primarily to protect the interests of their member clubs and to provide them with some services, for instance settling disputes between them and trying to maximize their commercial benefits (*e.g.*, selling collectively some of the television rights) and to minimize their costs (*e.g.*, negotiating with players' associations).

18. Throughout Europe a general trend can be detected towards an increasing independence and autonomy of leagues *vis-à-vis* the national federations; accordingly, tense confrontation between leagues and federations is nowadays not rare. However, thus far leagues are still associated within, and supervised by, the respective national federations – in several countries, this is even mandated by the law – with degrees of autonomy varying from country to country. Due to this system, national football leagues around Europe do not enjoy the absolute independence and autonomy which United States sports leagues enjoy. In addition to other major differences, European professional leagues are not «closed» leagues, and their membership varies slightly each season because at the end of the season some of the bottom-ranked clubs are relegated to the inferior national division and the highest ranked clubs from such division are promoted to the higher national division. This system of relegation and promotion applies more or less in the same way to all the other national and regional divisions and championships below the high-level ones. Consequently, it can happen in European football – as indeed it has done more than just a few times – that amateur or semi-amateur clubs, even from small towns, over the years earn their way up to professional championships and eventually transform into successful professional clubs. This system of promotion and relegation is generally regarded as «one of the key features of the European model of sport» (EC Commission, DG X, *The European model of sport*, Brussels 1999, para. 1.1.2).
  
19. At pan-European level, no transnational football leagues exist yet. Currently, there is only an association of the main national leagues in Europe, which does not organize any competitions and is basically only a forum for discussion and an instrument of coordination. Recently, a private commercial group («Media Partners») has attempted to create *ex novo* a European football league outside of the UEFA realm and has even notified the EC Commission of a number of draft agreements between Media Partners and eighteen founder clubs – comprising some of the most famous European clubs – concerning the establishment and the administration of two main pan-European football competitions, the «Super League» and the «Pro Cup», involving a total of 132 clubs from all territories covered by UEFA-affiliated national associations (*see Official Journal EC*, 13 March 1999, C 70/5). For the time being this attempt seems to have been aborted, *inter alia* probably because UEFA has modified the organization of its competitions in a way which is certainly pleasing to most important European clubs.
  
20. As to European football clubs, they are not all shaped in the same legal manner around Europe. Most professional clubs are incorporated as stock companies – and sometimes their shares are even listed on some stock exchanges (*e.g.* Manchester United and several other clubs in England, S.S. Lazio in Italy) –, but there are countries where some or all the clubs are still unincorporated associations with sometimes thousands of members who elect the association's board (*e.g.* F.C. Barcelona and Real Madrid C.F. in Spain or the German clubs).
  
21. The above outlined traditional structure of European football might change in the future. In particular, especially after the cited attempt of Media Partners, it might be envisaged that sooner or later there will be in some countries or at a pan-European level some closed (or semi-closed) leagues independent from national federations and from UEFA and modelled

on United States professional leagues. However, for the time being, the above outlined structure still prevails and it is very difficult to compare it to the sports structure in the United States. Not only are there in Europe no closed professional leagues such as the NBA or the NFL, but there are no collegiate competitions such as the NCAA either. As a result, the Panel maintains that although any analysis of United States sports law is very instructive – in this respect the Panel appreciates the parties’ efforts in presenting the views and testimony of renowned experts on this subject – it has limited precedential value for the present dispute and its significance must be weighed very carefully. For example, the Panel considers that to characterize UEFA as a «league» comparable to United States professional leagues, as has been done in some testimony, is factually and legally misplaced and, therefore, potentially misleading for an examination of the present dispute.

b) The «integrity of the game» question

22. Much of the written and oral debate in this case has centred around the question of the «integrity of the game». Both Claimants and Respondent have shown that they are seriously concerned with this question. On the one hand, the Respondent has repeated over and over that it has a specific duty to protect the integrity of the game and that this has been the only motive behind the Contested Rule. On the other hand, the Claimants have expressly stated that they and ENIC accept and espouse the need to preserve sporting integrity, and that they also accept that UEFA has a current responsibility to safeguard the integrity of football in its role as organizer and regulator of European football competition.
23. Several witnesses have stated that the highest standards are needed for the integrity of the game (Mr. Taylor), that the integrity of sports is crucial to the sports consumer (Professor Weiler), and that *«football can only continue to be successful if it is run according to the highest standards of conduct and integrity, both on and off the field»* (Sir John Smith).
24. As concern for the integrity of the game is indeed common ground between the parties, the question is then how «integrity» needs to be defined and characterized in the context of sports in general and football in particular. Part of the debate between the parties has focused on integrity in its typical meaning of honesty and uprightness, and the Claimants have argued, supported by some witnesses (in particular Sir John Smith) for the necessity of a «fit and proper» test in order to vet owners, directors and executives of football clubs before allowing them to hold such positions. The debate has also evidenced the connection between the notion of integrity in football and the need for authenticity and uncertainty of results from both a sporting and an economic angle. Some witnesses have stated that uncertainty of results is the most important objective of football regulators (Mr. Taylor) and the critical element for the business value of football (Mr. Boon).
25. The Panel notes, quite obviously, that honesty and uprightness are fundamental moral qualities that are required in every field of life and of business, and football is no exception. More specifically, however, the Panel is of the opinion that the notion of integrity as applied to football requires something more than mere honesty and uprightness, both from a

sporting and from a business point of view. The Panel considers that integrity, in football, is crucially related to the *authenticity of results*, and has a critical core which is that, in *the public's perception*, both single matches and entire championships must be a true test of the best possible athletic, technical, coaching and management skills of the opposing sides. Due to the high social significance of football in Europe, it is not enough that competing athletes, coaches or managers are in fact honest; the public must perceive that they try their best to win and, in particular, that clubs make management or coaching decisions based on the single objective of their club winning against any other club. This particular requirement is inherent in the nature of sports and, with specific regard to football, is enhanced by the notorious circumstance that European football clubs represent considerably more in emotional terms to fans – the ultimate consumers – than any other form of leisure or of business.

26. The Panel finds *inter alia* confirmation and support for the view that the crucial element of integrity in football is the *public's perception of the authenticity of results* in two documents exhibited by the Claimants, *viz.* the well researched and very insightful reports presented by Sir John Smith to the English Football Association on «Betting on professional football within the professional game» (1997) and on «Football, its values, finances and reputation» (1998). The Smith reports are particularly valuable evidence because they were not prepared specifically for this case. Both reports make quite clear that the most important requirement for football is not honesty in itself or authenticity of results in itself, but rather the public's perception of such honesty and such authenticity.

27. Here are a few excerpts from the Smith reports (with emphasis added):

*«public perception* dictates that players and others involved in the game should not benefit from their “insider” position»;

*«the public has a right to expect* that a participant in football will play for his team to win, or make management decisions based on the team winning, as their sole objective. Anything whatsoever that detracts from that prime purpose has to be positively discouraged»;

*«even if a result of such a bet is not that a player or official actually intends not to try to win the game, the public's perception* of the integrity of the game would be prejudiced in such a situation»;

*«the interest of fans in the game would quite rightly not continue at present levels if they had reason to believe* that the outcome of any matches was or may be controlled by factors other than personal efforts of those participating in the game, aimed at their team winning»;

*«football must preserve its great strength in business terms: the enormous hold which individual clubs have over the loyalty of their supporters. This makes the game attractive to advertisers, sponsors, television and so on. Maintaining that loyalty is not being sentimental; being responsive to spectator concerns is simply good business. That means, amongst other things, being able to reassure supporters* that the game is straight».

28. Having clarified what is meant by integrity of the game, the question is then whether multiple ownership of clubs in the context of the same competition has anything to do with



such integrity and, therefore, represents a legitimate concern for a sports regulator and organizer. In other words, can multiple ownership within the same football competition be publicly perceived as affecting the authenticity of sporting results? Can the public perceive a conflict of interest which might contaminate the competitive process when two commonly owned clubs play in the same sporting event?

29. The Claimants have addressed this question mostly from the angle of match-fixing, arguing that it is highly unlikely that a match could be fixed without being detected sooner or later and that, insofar as match-fixing is possible at all, it is also feasible – as has happened on some occasions in the past – with respect to matches between unrelated clubs. In particular, the Claimants have argued that match-fixing necessarily involves complicity by a significant number of people whom, if the truth were discovered, would be ruined and each of whom would, after the event, have a hold over the accomplices. The Claimants have also argued that it is in the interest of a common owner, especially if the common owner is a corporation listed on the stock exchange, that each club does as well as possible on both the economic and sporting level, and that the existing criminal and sporting penalties are sufficient to deal with the risk of match-fixing as well as the perceived risk thereof. The Claimants have supported such arguments with several written statements by players, referees and managers, all essentially asserting in a similar vein that it is almost impossible to fix a football match, that multi-club ownership does not entail any greater threat to sporting integrity than single ownership and that a pledge to respect a «code of ethics» would suffice. Mr. Boon has also testified that multi-club owners would place their entire business at risk if they sought to fix matches and, therefore, this cannot be part of their financial strategy or activity. The Respondent has, in turn, presented some written statements supporting its argument that common ownership is a threat to the integrity of competition and that self-control by multi-club owners through a code of ethics would not be an adequate response to such threat.
30. The Panel is not persuaded that the main problem lies in direct match-fixing (meaning by this the instructions and bribes given to some players so that they lose a match). Indeed, the Panel finds some merit in the Claimants' arguments that direct match-fixing in football is quite difficult (albeit far from impossible, as notorious past cases in France, Italy or other countries demonstrate), that an attempt at direct match-fixing has a fair chance of being detected sooner or later, that any such discovery would eventually harm the multi-club controlling company and that in principle the honesty rate of multi-club owners, directors and executives cannot be any worse than that of single club owners, directors and executives.
31. However, even assuming that no multi-club owner, director or executive will ever try to directly fix the result of a match between their clubs or will ever break the law, the Panel is of the opinion that the question of integrity, as defined, must still be examined, also in the broader context of a whole football season and of a whole football competition. In short, the Panel finds that the main problem lies in the aggregate of three issues that need further analysis: the allocation of resources by the common owner among its clubs, the

administration of the commonly owned clubs in view of a match between them, and the interest of third clubs.

32. The analysis of such issues relies on two assumptions. The first assumption, as already mentioned, is that multi-club owners, directors or executives do not try to directly fix a match and always act in compliance with any laws and with sporting regulations. The second underlying assumption is that the multi-club controlling company's executives are in constant contact with the controlled clubs' own executives and structures, as is normal within a group of companies; in fact, according to EC case law and practice all the companies within a group – parent companies, holding companies, subsidiaries, *etc.* – are considered as a single economic entity (*see e.g.* the EC Commission Notice «on the concept of undertakings concerned», in *Official Journal EC*, 2 March 1998, C 66/14, para. 19). The Panel has indeed been impressed by ENIC's description of its *bona fide* efforts at isolating the management of each of its controlled clubs from the controlling company's and from other clubs' structures. However, the analysis is not to be made with reference to ENIC but with reference to a hypothetical individual, company or group owning two or more football clubs and whose organization might be less careful than ENIC about isolating each controlled club's structure. After all, even ENIC's isolation policy does not seem so strict, as Mr. Boon reports that:

*«during the time for completion of this report, I have also noted that employees from ENIC's head office in London have travelled to Greece, Italy, the Czech Republic and Switzerland to impart their industry and cross-club experience to individual clubs controlled by ENIC».*

This has been confirmed by Mr. Patrick Comminos, General Manager of AEK, who has stated in his written testimony:

*«As general Manager, my contact with the owners of the club is on a daily basis, especially with whichever member of ENIC is in Athens at the time».*

Accordingly, the Panel is of the opinion that also the second underlying assumption is appropriate.

33. The first issue is the *allocation of resources by the common owner among its clubs*. Given that in UEFA competitions there is only one sporting winner and there are only a few business winners (the clubs which advance to the last rounds of the competition), and given that a huge amount of money is required in order to keep a football club at the top European level, it would appear to be a waste of resources for a common owner to invest in exactly the same way in two or more clubs participating in the same competition. This is particularly true if the commonly owned clubs are located in different countries (as is generally the case, since at national level there are often rules hindering multiple ownership). After the *Bosman* ruling (EC Court of Justice, Judgement of 15 December 1995, case C-415/93, in *E.C.R.* 1995, I-4921), competition for hiring the top European players is wholly transnational, whereas most of a club's revenues – television rights, game and season tickets, merchandising, advertising and sponsorship – still depend on the national and local markets because of consumer preferences and natural barriers. Therefore, although the costs of creating a team which will potentially be successful in a UEFA competition tend nowadays

to be comparable all over Europe – players’ remuneration being by far the single most important cost for professional clubs – a club’s revenues and rates of return on investments are quite different even with comparable successful sporting results. Revenues and rates of return for football clubs are much higher in a few countries, such as England, France, Germany, Italy and Spain. This explains why the best, and most costly, players always end up in those few countries and why clubs from those countries currently dominate UEFA competitions.

34. The data contained in the economic report presented by Mr. Boon provide ample support for such propositions. As to transnational competition for players and as to their remuneration, Mr. Boon’s research shows that: *«internationally renowned clubs in Europe are willing to compete for the services of leading football players to maintain their successful international position. They are also typically the clubs with the financial resources to do so. ... it costs a significant amount to buy a leading player out of his existing club contract and, typically, to offer the player a premium on his remuneration to entice him to move elsewhere. ... the rate of increase in players’ wages has been nothing short of spectacular in the last five years. In Italy, from 1995/96 to 1996/97 the increase was 24.1% and 35% in the English Premier League».*

Mr. Boon’s report shows also that *«there is an active cross-border European transfer market in which clubs compete for the top players. ... 31% of transfers between major European associations in 1996/97 were cross border».*

With regard to the enormous disparity of revenues between different countries, Mr. Boon reports that *«in 1996/97 the second largest English club (Newcastle) had a turnover of ... \$69.9 million and Juventus’ turnover in Serie A was \$74.1 million; whereas SK Slavia Prague (the number 2 Czech club) had an income of ... \$2.2 million and AEK (one of the top 3 Greek clubs) an income of ... \$4.9 million»* (figures in national currencies have been omitted).

With regard to sporting results deriving from this situation, Mr. Boon confirms the well-known fact that *«there is some polarisation of market power developing within the European market. That polarisation is manifest in that clubs from the larger (and relatively more prosperous) countries with bigger “budgets” for transfers and players’ wages have increasingly come to dominate European competition».*

35. Given the above situation, assuming the viewpoint of the shareholders of a corporation controlling two clubs of different nationality participating in the same UEFA competition, it would certainly be a more efficient and more productive allocation of the available resources (and thus an economically sounder conduct by directors and executives) to allocate them, and thus to allocate the best players, in such a way as to have a «first team», capable of competing at top European level and situated in the richer market, and a «second team» located in the less developed market and which would be useful for, *inter alia*, allowing younger players to gain experience and to be tested with a view to a possible transfer to the first team. The testimony of Mr. Trijbits has given some empirical evidence of this kind of attitude by top rated clubs which acquire interests in clubs of lower rank.

36. The Panel is of the opinion that such differentiated allocation of resources among the commonly owned clubs is in itself perfectly legitimate from an economic point of view, and given its economic soundness it might even be regarded as a duty of the directors *vis-à-vis* the shareholders of the controlling corporation. However, the fans/consumers of the «second club» – which, in order to be eligible for UEFA competitions, is necessarily one of the top clubs of its country, supported in its international matches by most of the football fans of that country – would inevitably perceive that management decisions are not based on the only objective of their club winning against anybody else.
37. Furthermore, even if the different clubs are located in equally profitable (or unprofitable) markets and there is no diverse treatment as a first team and a second team, the common parent company might nevertheless decide, as is usual in a group of companies, to divert resources from one controlled club to another in order to follow wholly legitimate business strategies, for example if the sale of one of the clubs is contemplated. Some examples of such diversion of resources have been provided by Mr. Taylor, who stated in his written testimony:

*«When we had common ownership in this country of Oxford United and Derby County by Robert Maxwell there was a transfer of Oxford United's leading players to Derby County at a sum that was less the normal market value and this was very much against the wishes of the then manager of Oxford, Mark Lawrenson. We also had problems regarding Peter Johnson, owner of Tranmere Rovers, moving to Everton and consequent problems with the transfer of monies and questions about the transfer of the goalkeeper from Tranmere to Everton. Similar problems occurred with common ownership by Anton Johnson of Rotherham United and Southern United and there were allegations of asset stripping».*

In any event, the Panel is of the opinion that in situations of common ownership, even if a diversion of resources does not really happen, the fans of either club would always be inclined to doubt whether any transfer of players or other management move is decided only in the interest of the club they support rather than in the interest of the other club controlled by the same owner.

38. The second issue is the *administration of commonly owned clubs before a match between them*. It has already been described how shareholders, and thus executives, of the common parent company might have a legitimate economic interest in seeing a given controlled club prevail over another because of the better financial rewards which can be reaped from the success of the first one. In line with the initial assumption, the Panel considers that multi-club owners or executives might favour one club over another without any need to violate the law or to resort to risky attempts of direct match-fixing. In this respect, if a coach (or maybe a club physician) is encouraged or forced to ensure that the best team available is not fielded, it is unclear whether this could meet the definition of match-fixing. However, since there are sporting rules prescribing that clubs always field the best team available – albeit such rules are usually deemed impossible to apply and enforce – and risks (due to the involvement of coaches or physicians) perhaps close to those of direct match-fixing, the Panel does not wish to take into account this hypothetical circumstance in the present analysis.

39. Executives might have various ways of affecting or conditioning the performance of their teams in a given match, or set of matches, without even getting close to violating laws or sporting regulations and without even speaking to players or coaches. A first way might be connected with performance-related bonuses, which are wholly legitimate under any law. As has been evidenced at the hearing, bonuses linked to results in single matches or in entire championships are always a fair portion of players' (and coaches') remuneration, and ENIC clubs are no exception to this practice (Mr. Levy's testimony). In Mr. Boon's written report it is stated that one of the relevant costs associated with a club playing in Europe is «player bonuses for playing and winning UEFA matches». Mr. Boon also testified that all club owners and executives would, understandably, like a larger percentage of the total player remuneration to relate to performance than the percentage which usually applies (10% to 20%). The Panel observes that the widespread practice of bonuses demonstrates that professional players – no differently from other professionals (one can think of contingent fees) – are quite sensitive to incentives. Accordingly, it would be easily possible and perfectly legal for multi-club executives, by adjusting bonuses, to highly motivate the players of one team with suitable incentives and not at all (or much less) the players of the other team.
40. A second way might be connected with players' transfers. Up to a certain point in the football season (nowadays, very late in the season) it is always possible to obtain new players or to let players leave. It is quite easy to induce players to move from a club to another through a wage hike or the opportunity to play in a winning team. Therefore, at any moment before a match between the commonly owned clubs, team rosters could easily change because of management and business needs rather than coaching decisions. One can find in the sporting press plenty of examples of players given away or hired by club owners and executives without the prior consent, and sometimes even without the prior knowledge, of the coaching staff.
41. A third relevant way of influencing the outcome of a match between commonly owned clubs might be connected with «insider information». One team could have, through common executives, access to special knowledge or information about the other team which could give the first team an unfair advantage. There is a relevant difference between widely available information (such as tapes of the other team's official matches or any news which has appeared in the press) and confidential information obtained from a person within the opponent club's structure (*e.g.* with regard to unpublicized injuries, training sessions, planned line-up, match tactics and any other peculiar situation concerning the other team).
42. Another, more trivial, way of conditioning team performances could even be connected with the day-to-day administration of a team in view of a match, particularly of an away match. There are plenty of choices usually made by club executives – *e.g.* with regard to travel, lodging, training, medical care and the like – which may condition either positively or negatively the attitude and performance of professional football players.
43. The third issue concerns *the interest of third clubs*. Whenever competitions have qualification rounds based on groups of teams playing each other home and away in round-robin format, the interest of unrelated third clubs ending up in a qualification group together with two

commonly owned clubs is quite evident. Football history provides unfortunately various instances of matches – even in the World Cup under the eyes of hundreds of millions of television viewers – where both teams needed a draw to the detriment of a third team and in fact obtained such a draw without much effort and without anybody explicitly admitting any agreement afterwards (in fact, probably true agreements were never made, common interest being enough for an unspoken understanding, an «*entente cordiale*»). It is true, this can happen with single owned clubs as well as with commonly owned clubs, but the multi-club owner or executive has additional ways of facilitating an (already easy) unspoken understanding between the teams, for example setting bonuses for drawing higher than, or even equal to, bonuses for winning the match. A third club's interest might also be affected when, before playing the last match or matches of a round-robin group, one of the two commonly owned clubs has already virtually qualified or been eliminated and the other is still struggling; in this case the multi-club owner or executive might be tempted to induce (by the described lawful means) the first club to favour the other club in the last match or matches.

44. As mentioned (*supra*, para. 14), due also to the preferences of the most influential clubs, the current trend in the organization of UEFA competitions (particularly the Champions' League) is more and more towards qualification rounds in round-robin format and, conversely, away from competition rounds played in knock-out format. Such an organizational trend renders this issue particularly delicate, because it increases the need to protect third competitors. Needless to say, even if in fact the outcome of a game between two commonly owned clubs is absolutely genuine, a disadvantaged third club and its fans will inevitably tend to perceive the outcome as unfair.
45. The analysis of the three above issues shows that, even assuming that multi-club owners, directors or executives always act in compliance with the law and do not try to directly fix any match, there are situations when the economic interests of the multi-club owner or parent company are at odds with sporting needs in terms of public perception of the authenticity of results. It may be desirable that multi-club directors and executives safeguard sporting values and act counter to the parent company's wishes and economic interests. However, what about the legitimate economic interests of the shareholders? What about the investors in the stock exchange? Would the shareholders and investors be prepared to accept from a director or an executive the «sporting uncertainty» justification for not having done his/her best, without violating any laws, to promote their economic interests? The Panel is of the opinion that in such a situation there is an inescapable pressure for legitimate (or sometimes «grey-area») behaviour which is in the interest of the controlling company and in the interest of some of the controlled clubs, but not in the interest of *all* the controlled clubs and their fans, or not in the interest of third clubs or football fans in general. As a result, the Panel holds that a problem of *conflict of interest* does exist in multi-club ownership situations.
46. Several sporting bodies and some State legislators have indeed issued rules in order to deal with this question. For example, among European sports bodies there are rules dealing with multi-club ownership in the English Premier League, the English Football League, the Scottish Football Association, and the Spanish football and basketball professional leagues.

In Spain a limit to multi-club ownership in the same competition is prescribed by law: Article 23 of the 1990 Sports Act (*«Ley 10/1990, de 15 de octubre, del Deporte»* as subsequently amended) currently forbids any kind of cross-ownership between Spanish professional clubs and limits the possible direct or indirect shareholding or voting rights in more than one club participating in the same competition to 5%. In Spain, the issue appears to be of particular public awareness because of the case of a well-known entrepreneur who has been suspected and found to hold indirectly, through various companies or figure-heads, shares in various professional football clubs, some of them participating in the same league division. In particular, the Spanish press raised some serious suspicions with regard to the outcome of certain matches between clubs allegedly under common control. Rules prohibiting investment in more than one professional club can also be found in renowned United States sports leagues, such as the National Basketball Association («NBA»), the National Football League («NFL»), the National Hockey League («NHL»), and in baseball the American League and the National League (forming together the Major League Baseball or «MLB») and the minor leagues associated with the National Association of Professional Baseball Leagues («NAPBL»). This attitude by the most important American sports leagues seems to be shared by the United States Court of Appeals for the Second Circuit, which has stated that *«no single owner could engage in professional football for profit without at least one other competing team. **Separate owners for each team are desirable in order to convince the public of the honesty of the competition**»* (Judgement of 27 January 1982, *NASL v. NFL*, 670 F.2d 1249, at 1251, emphasis added).

47. The Panel notes that there is evidence enough showing that a certain number of sports regulators, and some national legislators or judges, perceive that multi-club ownership within the same sporting competition implies a conflict of interest. Even Mr. Karel Van Miert, EC Commissioner for competition policy, has stated before the European Parliament, in reply to written and oral questions posed by some Parliament Members, that *«clearly, if clubs with the same owner can take part in the same competitions, whether national or international, **doubts may arise as to whether the outcome is really undecided in advance**»* (answers given by Mr. Van Miert on behalf of the Commission to parliamentary questions nos. E-3980/97, 0538/98, P-2361/98, emphasis added).

In his testimony, Professor Weiler characterized this conflict of interest issue as an «illusion» and counsel for the Claimants picked up and utilized such locution in the course of the final oral argument. The Panel is of the opinion that, even assuming (but not conceding) that there is no true conflict of interest, it must be acknowledged that «clearly ... doubts may arise» (as put by Mr. Van Miert). The mere fact that some knowledgeable authorities like sports regulators, national legislators or judges, and European commissioners are under such «illusion» proves that the general public – the consumers – might also easily fall under an analogous «illusion». After all, even Professor Weiler himself, a couple of years before studying in depth the issue of multi-club ownership in order to be an expert witness before this Panel, wrote that *«from the point of view of the League as a whole, there are also significant potential advantages from assigning control and responsibility for individual teams to an identifiable owner. On the playing field or court, **this reinforces the impression among fans that their favored team is fully committed to winning all its games.** ... With respect to business decisions made off the field, separate*

*ownership and control of individual teams may be more likely to enhance the team's appeal and extract the revenues available in its local market» (WEILER, Establishment of a European League, in FIBA International Legal Symposium (June 1997), Bilbao 1999, 77, at 87-88).*

Therefore, the perception of an inherent conflict of interest in multi-club ownership within the same championship or competition seems wholly reasonable.

48. As a result, the Panel finds that, when commonly controlled clubs participate in the same competition, the *«public's perception will be that there is a conflict of interest potentially affecting the authenticity of results»*. This reasonable public perception, in the light of the above characterization of the integrity question within football (*see supra*, paras. 25-27), is enough to justify some concern, also in view of the fact that many football results are subject to betting and are inserted into football pools all over Europe. This finding in itself, obviously, does not render the Contested Rule admissible under the different principles and rules of law which still have to be analyzed. At this stage of its findings, the Panel merely concludes that ownership of multiple clubs competing in the same competition represents a justified concern for a sports regulator and organizer.

#### *Swiss civil law*

49. The Claimants argue that the Contested Rule is unlawful under Swiss civil law because of the procedure by which it was adopted and for reasons of substance. With respect to procedural grounds, the Claimants assert that in adopting and enforcing the Contested Rule the Respondent (1) violated the UEFA Statutes by creating different categories of members, and (2) failed to observe fair procedures, disregarding in particular the clubs' right to a legal hearing. As to substantive grounds, the Claimants assert that the Respondent (3) infringed the principle of equal treatment by discriminating between clubs which are under common control and clubs which are not, and (4) violated without justification the personality of the clubs. The Respondent rejects all such claims.
- a) Compliance with UEFA Statutes
50. Article 75 CC provides that a resolution taken by an organ of an association which contravenes the law or the association statutes can be judicially challenged by any member of the association who has not approved it.
51. The Claimants argue that they should be considered as «indirect members» of UEFA because they are members of the respective national associations (*i.e.* federations) which, in turn, are members of UEFA. Therefore, they claim that UEFA violated its own Statutes insofar as the Executive Committee created different categories of clubs – clubs under common control *vis-à-vis* clubs which are not – and thus different categories of indirect members, without the power to do so (as the creation of different categories of members would require an amendment to the Statutes, which can be done only by the UEFA



Congress). In response, UEFA points out that the national federations rather than the clubs are its members and that, in any event, it did not create different membership categories but it merely amended the conditions of admission to UEFA club competitions in order to eliminate conflict of interest situations.

52. The Panel is not persuaded that clubs could be considered «indirect members» of UEFA. Art. 65.1 CC provides that the general assembly of a Swiss association is competent to decide on the admission of its members. If clubs had a right to be considered (indirect) members of UEFA because they are affiliated to their national federation, they evidently would acquire such status through a decision of such national federation, that is a body which surely is not the competent general assembly – the UEFA Congress – and this would be hardly compatible with Article 65.1 CC. Moreover, Article 5.1 of the UEFA Statutes, entitled «Membership», establishes that «membership of UEFA is open only to national football associations situated in the continent of Europe who are responsible for the organization and implementation of football-related matters in their particular territory»; clearly clubs do not meet these requirements. Clubs are not ignored by the Statutes, as they are mentioned in several provisions (Articles 1, 7, 23, 45, 46, 49, 54, 55 and 56) but without any hint of them being considered indirect members. The UEFA Statutes attribute voting rights only to national federations, and Article 75 CC refers to members which have voting rights within the association whose resolution is challenged. Clubs are affiliated to and may have membership and voting rights within their national federations, where they can elect the federation’s board and president, who represents the national federation and thus all the national clubs within UEFA. Within the national federations there are indeed different categories of clubs – *e.g.* female and male clubs, amateur and professional clubs – but this depends only on provisions included in the statutes of the national federations.
53. In any event, even assuming that the clubs could be regarded as indirect members of UEFA, the Panel does not see in the Contested Rule any creation of different categories of member clubs but rather the establishment of conditions of participation in UEFA competitions. Among such conditions are also, for example, stadium safety requirements (Articles 3 and 8 of the 1998/99 Regulation of the UEFA Cup and the related booklet; *see supra*, para. 8). Applying the Claimants’ rationale, this would imply the creation of different categories of clubs, those with an adequate stadium and those without. In other words, any condition of admission to a competition could be interpreted as a creation of categories of clubs. The Panel considers that there is a substantial difference between «club categories» and «conditions of participation». On the one hand, the notion of category implies a club’s formal and steady status, which is prerequisite for any kind of competition (national or international) in which that club takes part, and which is modifiable only through given formal procedures (*e.g.*, the transformation of an amateur club into a professional one, or *vice versa*). On the other hand, the notion of «conditions of participation» implies more volatile requirements which are checked when, and only when, a club enters a given competition, and which are often specific to that competition (*e.g.*, in order to compete in some national championships, clubs must provide financial guarantees which are different in type and amount from country to country; at the same time, in order to compete in, say, the Greek

championship it is absolutely irrelevant that the owner of a participating club controls other clubs abroad).

54. Article 46.1 of the UEFA Statutes provides that the «*Executive Committee shall draw up regulations governing the conditions of participation in and the staging of UEFA competitions*». As the UEFA Statutes confer to the Executive Committee the power to enact rules concerning conditions of participation in a UEFA competition, the Panel holds that in adopting the Contested Rule the UEFA Executive Committee did not act *ultra vires*, and thus UEFA did not violate its own Statutes.
- b) Right to a legal hearing and to fair procedures
55. The Claimants argue that, under Article 75 CC, members of an association have the right to be heard when resolutions are passed which affect them to a significant extent. Therefore, the Claimants assert that, being indirect members of UEFA, they were entitled to a legal hearing before the adoption of the Contested Rule, and that UEFA therefore infringed the principle *audiatur et altera pars*. More generally, the Claimants assert that association members have a right to fair procedures, and that *inter alia* the Respondent adopted the Contested Rule too shortly before the start of the new season. The Respondent replies by insisting that the clubs are not indirect members of UEFA and by asserting that it acted strictly in accordance with its statutory regulations and that AEK had enough time to adjust to the Contested Rule.
56. The Panel notes that the Claimants base this ground, like the previous one, on the assumption that clubs are «indirect» members of UEFA, because they are affiliated to their respective national federations which in turn are members of UEFA. For the reasons already stated, the Panel is not persuaded by this construction. The Panel finds the argument even less persuasive if such characterization of the clubs as indirect members implies, as the Claimants argue, the necessary consequence that *every indirect member* should be heard by UEFA before passing a resolution which could affect such indirect member. This would mean that, if a resolution affects amateur clubs, UEFA should consult with tens (perhaps even hundreds) of thousands of clubs. As all players, coaches and referees are also affiliated to their national federations – millions of individuals throughout Europe –, they could also claim to be indirect members and every one of them could request that he/she be heard by UEFA. Even if one was to limit the right to be heard only to clubs potentially interested in UEFA competitions – *i.e.* all clubs competing in the highest championship of every UEFA member federation – there would still be hundreds of clubs to be consulted. For an international federation, this would amount to a procedural nightmare and would paralyze any possibility of enacting regulations. The Panel maintains that the consequence is so absurd that the reasoning is fallacious.
57. In any event, even assuming that for some purposes clubs could be considered as indirect members of UEFA, the Panel is of the opinion that «indirect» members could not be wholly equated with «direct» members. Therefore, clubs could not claim anyway the right to be

heard when general resolutions are adopted by UEFA. It is certainly opportune that UEFA consults with at least some of the clubs, or possibly with some of the national leagues, before adopting rules concerning conditions of admission to its competitions, but in the Panel's view this cannot be construed as a legal obligation under Swiss association law.

58. With regard to the right to be heard, the Panel wishes to stress that the CAS has always protected the principle *audiatur et altera pars* in connection with any proceedings, measures or disciplinary actions taken by an international federation *vis-à-vis* a national federation, a club or an athlete (*see* CAS 91/53 *G. v. FEI*, award of 15 January 1992, in M. REEB [ed.], *Digest of CAS Awards 1986-1998*, Berne 1998, 87, paras. 11-12; CAS 94/129 *USA Shooting & Q. v. UIT*, award of 23 May 1995, *ibidem*, 203, paras. 58-59; CAS OG 96/005, award of 1 August 1996, *ibidem*, 400, paras. 7-9). However, there is a very important difference between the adoption by a federation of an *ad hoc* administrative or disciplinary decision directly and individually addressed to designated associations, teams or athletes and the adoption of a general regulation directed at laying down rules of conduct generally applicable to all current or future situations of the kind described in the regulation. It is the same difference that one can find in every legal system between an administrative measure or a penalty decided by an executive or judicial body concerned with a limited and identified number of designees and a general act of a normative character adopted by the parliament or the government for general application to categories of persons envisaged both in the abstract and as a whole. The Panel remarks that there is an evident analogy between sports-governing bodies and governmental bodies with respect to their role and functions as regulatory, administrative and sanctioning entities, and that similar principles should govern their actions. Therefore, the Panel finds that, unless there are specific rules to the contrary, only in the event of administrative measures or penalties adopted by a sports-governing body with regard to a limited and identified number of designees could there be a right to a legal hearing. For a regulator or legislator, it appears to be advisable and good practice to acquire as much information as possible and to hear the views of potentially affected people before issuing general regulations – one can think of, *e.g.*, parliamentary hearings with experts or interest groups – but it is not a legal requirement. As a United States court has stated, requiring an international sports federation «*to provide for hearings to any party potentially affected adversely by its rule-making authority could quite conceivably subject the [international federation] to a quagmire of administrative red tape which would effectively preclude it from acting at all to promote the game*» (*Gunter Harz Sports v. USTA*, 1981, 511 F. Supp. 1103, at 1122).
59. Furthermore, in any event, the Panel observes that ENIC – clearly being the most interested party and evidently representing also the Claimants – was in fact heard by UEFA at a meeting held on 24 February 1998 (*supra*, para 6). In a letter from Mr. Hersov of ENIC (enclosing the proposed *Code of Ethics*) sent on the following day to Mr. Studer of UEFA, it is possible to read *inter alia*:

*«...We appreciated your and Marcel's open and frank discussion with us, and the mutual recognition of UEFA and ENIC's interests, objectives and concerns. From UEFA's perspective, the sanctity of the game and the various European competitions are paramount. You are also under some pressure to be seen to be responding responsibly to members concerns, and we appreciate and recognize this pressure. ... We feel that the proposed rule change banning teams with common ownership from competing*

*in the same competition would be extremely damaging to ENIC. Its implementation would be very harmful to ENIC and it would materially impact the clubs which we currently own ...»* (emphasis added).

Hence, at the meeting of 24 February 1998 UEFA did raise the issue of a rule such as the Contested Rule being contemplated and the Claimants in fact had a possibility, through their common parent company ENIC, of expressing their opinion to UEFA and of making very clear their dissatisfaction with the envisaged new rule on multi-club ownership and the potential damage deriving therefrom. For all the above reasons, the Panel holds that the Respondent did not infringe the principle *audiatur et altera pars* and did not violate any right to be heard in adopting the Contested Rule.

60. With regard to the more general requirement of respecting fair procedures, however, the Panel considers that this is a principle which must always be followed by a Swiss association even *vis-à-vis* non-members of the association if such non-members may be affected by the decision adopted. In this respect, the Panel notes that the President of the Ordinary Division of the CAS based its interim order of 16-17 July 1998 on the circumstance that UEFA violated the principle of procedural fairness. The Panel agrees with the President's view that UEFA adopted the Contested Rule too late, when the Cup Regulations for the 1998/99 season, containing no restriction for multiple ownership, had already been issued. In the CAS interim order it was observed *inter alia*:

*«By adopting the Regulation to be effective at the start of the new season, UEFA added an extra requirement for admission to the UEFA Cup after the conditions for participation had been finally settled and communicated to all members. It did so at a time when AEK already knew that it had met the requirements for selection of its national association. Furthermore, it chose a timing that made it materially impossible for the clubs and their owner to adjust to the new admission requirement. ...*

*The doctrine of venire contra factum proprium ... provides that, where the conduct of one party has led to the legitimate expectations on the part of a second party, the first party is estopped from changing its course of action to the detriment of the second party ...*

*By referring to this doctrine, CAS is not implying that UEFA is barred from changing its Cup Regulations for the future (provided, of course, the change is lawful on its merits). However, it may not do so without allowing the clubs sufficient time to adapt their operations to the new rules, here specifically to change their control structure accordingly».*

61. The Panel essentially agrees with the foregoing remarks by the President of the Ordinary Division of the CAS and with the ensuing conclusion that UEFA violated its duties of procedural fairness with respect to the 1998/99 season. Indeed, a sports-governing organization such as an international federation must comply with certain basic principles of procedural fairness *vis-à-vis* the clubs or the athletes, even if clubs and athletes are not members of the international federation (*see* the Swiss Supreme Court decision in the *Grossen* case, in ATF 121 III 350; *see also infra*). The Panel does not find a hurried change in participation requirements shortly before the beginning of the new season, after such requirements have been publicly announced and the clubs entitled to compete have already been designated, admissible. Therefore, the Panel approves and ratifies the CAS Procedural

Order of 16 July 1998, which has granted interim relief consisting in the suspension of the application of the Contested Rule «*for the duration of this arbitration or for the duration of the 1998/99 season of the UEFA Cup, whichever is shorter*».

62. The Panel observes that the above conclusion does not require that the Contested Rule be annulled on procedural grounds, given that the lawfulness of the Contested Rule must be evaluated on its merits with respect to all future football seasons. In the Panel's view, if the Contested Rule would be found to violate any of the substantive rules and principles of Swiss and/or EC law invoked by the Claimants, no amount of procedural fairness could save it; conversely, if the Contested Rule would not be found to infringe such rules and principles, a minor lack of procedural protection could not render it unlawful *per se*. Therefore, while approving the interim stay of the Contested Rule, the Panel holds that UEFA's procedural unfairness concerning the timing of the new rule's entry into force is of a transitory nature and, as a result, it is not such as to render the Contested Rule unlawful on its merits with respect to all future football seasons. The Claimants' request to annul the Contested Rule on this procedural ground is thus rejected. However, as will be seen *infra*, the said procedural defect will have some consequences with respect to the temporal effects of this award.
- c) Principle of equal treatment
63. The Claimants remind that Article 75 CC also protects members of a Swiss association against resolutions which infringe the principle of equal treatment of the association's members and, therefore, argue that the Contested Rule violates the corresponding rights of the Claimants. In particular, the Claimants assert that UEFA formed different categories of members and violated the principle of relative equality because it established membership distinctions – clubs commonly controlled *vis-à-vis* the other clubs – in an arbitrary manner. The Claimants argue that there are no substantial objective grounds which UEFA could invoke to justify the unequal treatment provided by the Contested Rule because the Contested Rule is neither necessary, nor appropriate and, in addition, fails the test of proportionality insofar as it is a disproportionate means of achieving the objective of protecting the integrity of UEFA competitions. In reply, the Respondent argues that the principle of equal treatment does not prevent differentiation between objectively different situations, that the common control of clubs is an objectively relevant factor, and that in any event the Contested Rule is a proportionate response to the need to protect the integrity of the game.
64. The Panel notes that this argument is also based on the assumption that clubs are indirect members of UEFA, as under Article 75 CC only association members can judicially challenge a resolution infringing their right to equal treatment. The Panel has already disavowed such construction of the clubs' status within UEFA and here refers to the views previously stated in this respect (*see supra*, paras. 52 and 56).

65. The Panel has also already expressed the opinion that, even assuming that the clubs could be regarded as indirect members of UEFA, the Contested Rule did not create different categories of clubs but rather established an additional condition of participation in UEFA competitions (*see supra*, para. 53). The Panel does not find any discrimination or unequal treatment in establishing conditions of participation which are applicable to all clubs. It seems to the Panel that there is no discrimination in denying admission to a club whose owner is objectively in a conflict of interest situation; likewise, *e.g.*, there is no discrimination in denying admission to a club whose stadium is objectively below the required safety standards. In both cases, if the shareholding structure or the safety conditions are modified, the club is admitted to the UEFA competition. Therefore, the Contested Rule does not target or single out specific clubs as such but simply sets forth objective requirements for all clubs willing to participate in UEFA competitions.

66. As a result, the Panel holds that the Contested Rule does not violate the principle of equal treatment. Since the proportionality test is supposed to be applied only in order to verify whether an unequal treatment is justified, it is not necessary to rule on the proportionality issue in connection with this ground. In any event, the Panel observes that the discussion on proportionality developed under Article 81 (*ex* 85) of the EC Treaty (*infra*, paras. 131-136) could be applied in its entirety to this ground as well.

d) Personality of the clubs

67. The Claimants argue that the Contested Rule is not compatible with Article 28 CC, which reads as follows:

*«1. Celui qui subit une atteinte illicite à sa personnalité peut agir en justice pour sa protection contre toute personne qui y participe. 2. Une atteinte est illicite, à moins qu'elle ne soit justifiée par le consentement de la victime, par un intérêt prépondérant privé ou public, ou par la loi»* («1. A person who is unlawfully injured in his personality may bring proceedings for protection against any party to such injury. 2. Such injury is unlawful unless it is justified by consent of the injured person, by an overriding private or public interest, or by the law»).

The Claimants assert that Article 28 CC applies both to individuals and to corporate legal entities, and that the development of both the sporting and economic personality of commonly owned clubs would be impaired as a consequence of the non-admission to a UEFA competition. The Respondent argues that Article 28 CC has no relevance at all because it is applicable to different types of situations, and that in any event UEFA pursued overriding interests in enacting the Contested Rule.

68. The Panel is not persuaded that Article 28 CC could be applied to the case at stake. The notion of «personality» (or of «personhood») is to be characterized by reference to the fundamental attributes which every person, and in some measure every legal entity such as an association or a corporation, has a right to see protected against external intrusion and interference. It is difficult to find definitions in the abstract as there is an indefinite number of liberties, varying from time to time and from country to country, which can be

encompassed within the concept of personality rights. Examples are core rights related to privacy, name and personal identity, physical integrity, image, reputation, marriage, family life, sexual life and the like.

69. Swiss case law has sometimes stretched the notion of personality rights in order to protect a wider number of rights, such as the right to be economically active and even the freedom of performing sporting activities. The Claimants argue that the present dispute can be compared to the *Gasser* case, concerning the two-year exclusion of an athlete from any kind of competition due to a doping offence. In the *Gasser* case, the judge considered as a personality right the athlete's freedom of action and freedom of physical movement and, therefore, «*the freedom of performing sporting activities and of participating in a competition between athletes of the same level*» (Office of Judge III, Berne, Decision of 22 December 1987, in *SJZ*, 1988, 84 at 87). However, the Panel finds the *Gasser* case quite different from, and thus of no precedential value for, the present dispute. Indeed, the Contested Rule is a general regulation establishing a condition of participation applicable to all clubs (*see supra*, paras. 53 and 58) and not, as in the *Gasser* case, a disciplinary measure individually addressed to a designated athlete. Accordingly, the Contested Rule as such cannot be considered an exclusionary sanction within the meaning of the *Gasser* ruling. Moreover, the Contested Rule sets forth a condition for access to a single competition rather than an absolute exclusion from all sporting activities. The Panel considers that, while an unfairly adopted long doping ban might harm the whole sporting career of an athlete, and thus his/her personality, a club's non-participation in a UEFA competition would involve some loss of income but, since the club would still take part in other important football competitions such as the national championship and the national cup (which are competitions appreciated by fans and economically rewarding, as will be seen *infra* at para. 131), its «personality» would not be affected. In any event, even a restriction of a personality right could be justified by an «overriding private or public interest» (Article 28.2 CC), and the Panel is of the opinion that the public's perception of a conflict of interest potentially affecting the authenticity of results (*see supra*, para. 48) would constitute such an «overriding interest».
70. The Claimants have also made reference to Swiss judgements limiting an association's right to exclude a member, pursuant to Article 72.2 CC, in situations where the exclusion would injure the personality of the member concerned. Swiss courts have applied this doctrine to associations which hold monopolistic positions, such as professional associations or sports federations. However, apart from the illustrated difficulty of considering the Claimants as (indirect) members of UEFA (*see supra*, paras. 52 and 56), the Panel observes that non-admission to a competition cannot be equated to the loss of membership due to expulsion from an association and, therefore, cannot be considered as an injury to personality. In any event, even if one were to admit that the effects of the Contested Rule could be compared to an actual exclusion from membership, according to Swiss case law this could always be justified if there is «good cause» (Swiss Federal Court, Decision of 14 March 1997, in *SCP* 123 III, 193). The Panel is of the opinion that the public's perception of a conflict of interest potentially affecting the authenticity of results (*see supra*, para. 48) would constitute «good cause». In conclusion, the Panel holds that the Contested Rule does not violate Article 28 CC.

*European Community competition law*

a) Introductory remarks

71. Article 81.1 (*ex* 85.1) of the EC Treaty prohibits *«as incompatible with the common market: all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the common market»*.

Under Article 81.2 (*ex* 85.2) *«any agreements or decisions prohibited pursuant to this Article shall be automatically void»*.

Under Article 82 (*ex* 86) of the EC Treaty *«any abuse by one or more undertakings of a dominant position within the common market or in a substantial part of it shall be prohibited as incompatible with the common market in so far as it may affect trade between Member States»*.

72. According to the EC Commission's «Notice on cooperation between national courts and the Commission in applying Articles 85 and 86 of the EC Treaty» (in *Official Journal EC*, 13 February 1993, C 39/6), before ascertaining whether there is an infringement of the prohibitions laid down in Article 85.1 (now 81.1) or 86 (now 82), national courts (and thus arbitrators) *«should ascertain whether the agreement, decision or concerted practice has already been the subject of a decision, opinion or other official statement issued by an administrative authority and in particular by the Commission. Such statements provide national courts with significant information for reaching a judgement, even if they are not formally bound by them»* (*ibidem*, para. 20).

73. The Panel is not aware of any decision, opinion or other official statement issued by the Commission or other administrative authority with regard to the Contested Rule. However, as already mentioned (*supra*, para. 47), there have been a few replies by the Commission under Article 197 (*ex* 140) of the EC Treaty to questions specifically devoted to the Contested Rule put to it by some Members of the European Parliament (questions nos. E-3980/97, 0538/98, P-2361/98). The wording of all such replies is similar or identical. In the answer given on 3 September 1998 (*Official Journal EC*, 1999, C 50/143), the EC Commissioner responsible for competition policy Mr. Van Miert, answering on behalf of the Commission, has stated as follows:

*«The Commission is aware that the Union of European football associations (UEFA) has recently adopted rules that regulate the participation in European competitions of clubs belonging to the same owner. It seems at first sight that these rules have a sporting nature and that they aim to preserve uncertainty of results, an objective which the Court of Justice has recognised as legitimate in its judgement of 15 December 1995 in the Bosman case. Clearly, if clubs with the same owner can take part in the same competitions, whether national or international, doubts may arise as to whether the outcome is really undecided in advance. Nevertheless, it is necessary to determine whether these UEFA rules are limited to what is strictly necessary to attain the objective of ensuring the uncertainty as to results or whether there exist less restrictive means to achieve it. Provided that such rules remain in proportion to the sporting objective pursued, they would not be covered by the competition rules laid down in the EC Treaty. At this stage, the Commission does not possess all the*



*necessary information to assess the compatibility of the rules with Articles 85 and 86 of the EC Treaty. Whether UEFA has or not consulted other bodies is not relevant for this assessment».*

74. The Respondent has attributed great weight to this statement, while the Claimants have underlined that it has no legal force whatsoever and that anyway it provides no answer to the question of whether the Contested Rule is compatible with the EC Treaty. The Panel is not sure whether an answer given by the Commission in the European Parliament can be regarded as a «decision, opinion or other official statement» within the meaning of the above-mentioned Commission Notice. Probably, the Commission did not have in mind answers to parliamentary questions when it drafted the Notice, and its reference to *official* statements would imply a less informal statement than a parliamentary one. In any event, since Mr. Van Miert's answer is quite concise and given without the Commission *«possess[ing] all the necessary information to assess the compatibility of the rules with Articles 85 and 86 of the EC Treaty»*, and since any statement issued in the Parliament inevitably has a political rather than a legal nuance, the Panel is of the opinion that it should not base this award on Mr. Van Miert's answer.
75. The Panel also notes that the EC Commission has recently issued a more general statement with regard to the application of competition rules to sport. The Commission has publicly noted as follows: *«Sport comprises two levels of activity: on the one hand the sporting activity strictly speaking, which fulfils a social, integrating and cultural role that must be preserved and to which in theory the competition rules of the EC Treaty do not apply. On the other hand a series of economic activities generated by the sporting activity, to which the competition rules of the EC Treaty apply, albeit taking into account the specific requirements of this sector. The interdependence and indeed the overlap between these two levels render the application of competition rules more complex. Sport also has features, in particular the interdependence of competitors and the need to guarantee the uncertainty of results of competitions, which could justify that sporting organizations implement a specific framework, in particular on the markets for the production and the sale of sports events. However, these specific features do not warrant an automatic exemption from the EU competition rules of any economic activities generated by sport, due in particular to the increasing economic weight of such activities»* (EC Commission, Press Release no. IP/99/133, 24 February 1999).
76. The Panel shares the EC Commission's position that the application of competition rules to sports regulations is a particularly complex task because of the peculiarities of sport and because of the inescapable link between sporting and economic aspects. Therefore, all the relevant elements of competition law have to be carefully weighed in this award together with the peculiar sporting elements, in order to ascertain whether the Contested Rule violates Articles 81 (*ex* 85) and 82 (*ex* 86) of the EC Treaty or not.
- b) Position of the parties
77. With respect to Article 81 (*ex* 85) of the EC Treaty, the Claimants assert, firstly, that the Contested Rule is a decision by an association of undertakings, and/or an agreement between undertakings, falling within the scope of such provision. Then, they argue that the

Contested Rule has the effect of both actually and potentially affecting competition to an appreciable extent in the football market, and in various ancillary football services markets, by preventing or restricting investments by multi-club owners in European clubs, by changing the nature, intensity and patterns of competition between commonly controlled clubs and the others, and by enhancing the economic imbalance between football clubs. They also assert that the Contested Rule affects the pattern of trade between Member States. They also argue that no «sporting exception» could be applied to this issue, that the Contested Rule is unnecessary and disproportionate to the professed objective, and that less restrictive alternatives exist. For these reasons, the Claimants contend that the Contested Rule is incompatible with Article 81.1 and, as no exemption has been given by the EC Commission under Article 81.3, it is automatically void pursuant to Article 81.2. The Respondent counter-argues that the Contested Rule is not caught by Article 81, or by any other provision of the EC Treaty, because it is a rule of sporting interest only, which is proportionate to the legitimate objective of preventing situations of conflict of interest and, thus, of promoting and ensuring genuine competition between the clubs playing in pan-European competitions.

78. With respect to Article 82 (*ex* 86), the Claimants argue that UEFA is the only body empowered to organize European competitions and, consequently, holds a dominant position in the European professional football market and the ancillary football services markets. Then, they assert that the Contested Rule constitutes an abuse by UEFA of its dominant position contrary to Article 82 because, without any objective justification, it restricts competition, it is unnecessary and disproportionate, and it unfairly discriminates between clubs with different ownership structures. The Respondent replies by denying that it is in a dominant position, and by asserting that the adoption of a rule in order to preserve the integrity of club competitions could not amount to an abuse.

c) The «sporting exception»

79. The Respondent argues that the Contested Rule is not caught at all by EC law, because it is a rule of a merely sporting character purporting to protect the integrity of the game by preventing any conflict of interest within UEFA club competitions. The Respondent refers to what has come to be termed as the «sporting exception», after the EC Court of Justice stated in the *Walrave* and *Donà* cases that «*the practice of sport is subject to Community law only in so far as it constitutes an economic activity within the meaning of Article 2 of the Treaty*» (Judgements of 12 December 1974, case 36/74, *Walrave*, in *E.C.R.* 1974, 1405, para. 4; 14 July 1976, case 13/76, *Donà*, in *E.C.R.* 1976, 1333, para. 12), that EC law «*does not affect the composition of sport teams, in particular national teams, the formation of which is a question of purely sporting interest and as such has nothing to do with economic activity*» (*Walrave*, para. 8), and that EC law does not «*prevent the adoption of rules or of a practice excluding foreign players from participation in certain matches for reasons which are not of an economic nature, which relate to the particular nature and context of such matches and are thus of sporting interest only, such as, for example, matches between national teams from different countries*» (*Donà*, para. 14).

In both cases, the Court also added that the «restriction on the scope of the provisions in question must however remain limited to its proper objective» (*Walrave*, para. 9; *Donà*, para. 15).

80. In the more recent *Bosman* case, the Court of Justice referred to the *Walrave* and *Donà* precedents in order to reiterate that «sport is subject to Community law only in so far as it constitutes an economic activity within the meaning of Article 2 of the Treaty» (Judgement of 15 December 1995, case C-415/93, *Bosman*, in E.C.R. 1995, I-4921, para. 73), and that «the provisions of Community law concerning freedom of movement of persons and of provision of services do not preclude rules or practices justified on non-economic grounds which relate to the particular nature and context of certain matches. It stressed, however, that such a restriction on the scope of the provisions in question must remain limited to its proper objective. It cannot, therefore, be relied upon to exclude the whole of the sporting activity from the scope of the Treaty» (*ibidem*, para. 76).
81. The Claimants acknowledge that some matters concerned with the rules of the game would fall within the so-called sporting exception, mentioning as examples «a ban on drugs, the size of the pitch or the ball, or the methods of selection of national teams». However, the Claimants deny that the Contested Rule might fall within such an exception because it is economic in its language, its subject matter and its effects. In the final oral argument, counsel for the Claimants vividly described the Contested Rule as «impregnated» with economic elements.
82. The Panel observes that it is quite difficult to deduce the extent of the «sporting exception» from the mentioned case law of the Court of Justice. It is clear that a sporting exception of some kind does exist, in the sense that some sporting rules or practices are somewhat capable of, as the Court puts it, «restricting the scope» of EC provisions. In the light of the Court's jurisprudence, it seems that a sporting rule should pass the following tests in order not to be caught by EC law: (a) it must concern a question of sporting interest having nothing to do with economic activity, (b) it must be justified on non-economic grounds, (c) it must be related to the particular nature or context of certain competitions, and (d) it must remain limited to its proper objective.
83. With regard to test (a), the Contested Rule certainly concerns a question of great sporting interest, such as the integrity of the game within the already illustrated meaning of the public perception of the authenticity of sporting results (*see supra*, para. 24 *et seq.*). However, the Contested Rule also has a lot to do with economic activity. Indeed, the Contested Rule addresses the question of ownership of clubs taking part in UEFA competitions, that is the economic status of clubs which certainly perform economic activities (*see infra*, para. 88). Therefore, the requirement of test (a) is not met, and the Panel holds that the Contested Rule is not covered by the «sporting exception». As a consequence, tests (b), (c) and (d) are not relevant in this context, and the Panel need not discuss them.
84. In the light also of the recent opinions of Advocate General Cosmas in the pending *Delière* case (opinion delivered on 18 May 1999, joint cases C-51/96 and C-191/97) and of Advocate General Alber in the pending *Lehtonen* case (opinion delivered on 22 June 1999, case C-176/96), the Panel wonders whether, applying the Court of Justice tests, it is really

possible to distinguish between sporting questions and economic ones and to find sporting rules clearly falling within the «sporting exception» (besides those expressly indicated by the Court, concerning national teams). For instance, among the examples indicated by the Claimants, the reference to anti-doping rules might be misplaced, because to prevent a professional athlete – *i.e.* an individual who is a worker or a provider of services – from performing his/her professional activity undoubtedly has a lot to do with the economic aspects of sports. The same applies to the size of sporting balls, which is certainly of great concern to the various firms producing them. In conclusion, the Panel is not convinced that existing EC case law provides a workable «sporting exception» and it must, therefore, proceed with a full analysis of the present dispute under Articles 81 (*ex* 85) and 82 (*ex* 86) of the EC Treaty.

d) Undertakings and association of undertakings

85. Article 81.1 (*ex* 85.1) of the EC Treaty prohibits any cooperation or coordination between independent undertakings which may affect trade between Member States and which has the object or the effect of preventing, restricting or distorting competition. Such forbidden cooperation or coordination between undertakings may be accomplished through agreements, decisions by associations of undertakings or concerted practices. Article 82 (*ex* 86) of the EC Treaty prohibits any abuse of a dominant position by one or more undertakings which may affect trade between Member States. Both provisions, in order to be applied, require that the Panel ascertain whether the Respondent can be regarded as an undertaking and/or an association of undertakings.
86. The notion of undertaking is not defined in the EC Treaty. The EC Court of Justice has stated that such notion includes «*every entity engaged in an economic activity, regardless of the legal status of the entity and the way in which it is financed*» (Judgement of 23 April 1991, case C-41/90, *Höfnér*, in *E.C.R.* 1991, I-1979, para. 21). The fact that a given entity is a «non-profit» entity is irrelevant, provided that it does perform some economic activity.
87. As illustrated above, UEFA is a private association exerting regulatory authority in European football and organizing pan-European competitions. A good part of UEFA's activities is of a purely sporting nature, particularly when it adopts measures as a mere regulator of sporting matters. However, UEFA also carries out activities of an economic nature, *e.g.* with regard to advertising contracts and to contracts relating to television broadcasting rights (*see* EC Commission decision of 27 October 1992, *1990 World Cup*, in *Official Journal EC*, 12 November 1992, L 326/31, para. 47). Therefore, with respect to the economic activities in which it is involved, UEFA can be characterized as an undertaking within the meaning of EC competition law, as construed by the Court of Justice. The fifty-one national federations affiliated to UEFA also carry out economic activities at national level, notably by exploiting their logos, managing their national teams and selling television rights; with respect to those activities, they are also undertakings within the meaning of EC competition law. Therefore, the Panel holds that UEFA, with respect to the economic

activities in which it is engaged and in which national federations are engaged, is at the same time an undertaking and an association of undertakings.

88. The Panel wonders whether UEFA should also be regarded, as argued by the Claimants, as an «association of associations of undertakings» – within the meaning of the EC Commission decisions of 15 December 1982, *BNIC*, and of 7 December 1984, *Milchförderungsfonds*, in which Article 81.1 (*ex* 85.1) was applied to resolutions issued by trade associations having as their members other trade associations –, that is whether UEFA should be regarded not only as an association of (so to say) «federation undertakings» but also, through the federations, as an association of «club undertakings». In fact, if UEFA was found not to be an association of «club undertakings», its resolutions concerning the way club competitions are organized could not be considered as instruments of horizontal coordination of the clubs' competitive behaviour and would not be caught by Article 81.1 (*ex* 85.1) of the EC Treaty. In other words, with respect to UEFA rules which govern club competitions – *e.g.* establishing conditions of participation, disqualifying clubs or players from the competition, setting forth players' transfer rules, designating referees, fixing schedules, and the like – UEFA could be considered merely as a regulator above the clubs rather than a sort of clubs' trade association; accordingly, the Contested Rule would not be considered as the product of a horizontal collusion between the clubs and would not be caught by Article 81.1 (*ex* 85.1).
89. In order to ascertain whether UEFA should be regarded as an association of associations of undertakings or not, it is necessary to assess whether national football federations affiliated to UEFA are to be considered as associations of undertakings or not. There is no doubt that professional football clubs engage in economic activities and, consequently, are undertakings. In particular, they engage in economic activities such as the sale of entrance tickets for home matches, the sale of broadcasting rights, the exploitation of logos and the conclusion of sponsorship and advertising contracts. Numerous minor clubs, which are formally non-profit making, also engage in some of those economic activities – although on a much lower scale – and are also to be regarded as undertakings (for example, clubs taking part in championships pertaining to the third or fourth national divisions). In all national federations, there is also a very large number of truly amateur clubs (including youth clubs), which are run by unpaid volunteers, perform purely sporting activities and do not engage in any economic activity (the EC Commission has recently defined such clubs as «grassroots clubs» in the already quoted document *The European model of sport*, Brussels, 1999). Accordingly, these grassroots clubs should not be regarded as undertakings (*see* Judgement of 17 December 1993, joined cases C-159/91 and C-160/91, para. 18, where the Court of Justice held that an entity fulfilling a social function and entirely non-profit making does not perform an economic activity and thus is not an undertaking within the meaning of *ex* Article 85). The line between non-amateur clubs (which are undertakings) and amateur or grassroots clubs (which are not) should obviously be drawn at different levels from country to country, depending on the national economic development of football. What is common within all fifty-one European federations is the circumstance that the number of amateur or grassroots clubs is largely preponderant over that of non-amateur clubs.

90. Advocate General Lenz stated in his *Bosman* opinion that national football federations «are to be regarded as associations of undertakings within the meaning of Article 85. The fact that in addition to the professional clubs, a large number of amateur clubs also belong to those associations makes no difference» (Opinion delivered on 20 September 1995, case C-415/93, *Bosman*, in *E.C.R.* 1995, I-4921, para. 256).

Therefore, according to the argument of Advocate General Lenz, UEFA is an association of associations of undertakings, acting as a instrument of professional clubs' cooperation. Advocate General Lenz did not provide any further discussion on this issue. As is well known, in the *Bosman* case the Court of Justice declined to rule on competition law issues (Judgement of 15 December 1995, *ibidem*, para. 138), and the previous sports cases decided by the Court did not involve competition rules either (Judgement of 12 December 1974, case 36/74, *Walrave*, in *E.C.R.* 1974, 1405; Judgement of 14 July 1976, case 13/76, *Donà*, in *E.C.R.* 1976, 1333; Judgement of 15 October 1987, 222/86, *Heylens*, in *E.C.R.* 1987, 4097). Therefore, no specific guidance can be found on this question in the European Court jurisprudence related to sport.

91. The Panel is not entirely persuaded by the assertion of Advocate General Lenz that it «makes no difference» that national federations encompass a large number of amateur or grassroots clubs. In fact, the amateur or grassroots clubs, truly not engaged in economic activities, may condition the will and the acts of national federations more than professional and semi-professional clubs. Due to the democratic voting and electoral systems prevailing within national federations, the majority of votes tend to be controlled by amateur or grassroots clubs, and federations' executive organs – the President and the Board – often tend to be the expression of such majority. In some national federations even athletes and coaches have some electoral standing. This deficit of representativeness *vis-à-vis* professional clubs is the main reason why such clubs have created national «leagues» as their own truly representative bodies and why there are often conflicts between leagues and federations (*see supra*, paras. 17-18). Through the leagues, which are their true trade associations, professional clubs tend to manage their championships by themselves, retaining all the related revenues (television rights, advertising, *etc.*), and in several countries have progressively acquired a noticeable degree of autonomy from federations (*e.g.* the Premier League in England or the «Lega Nazionale Professionisti» in Italy).
92. In other words, the executives of national federations formally represent *all* the clubs of their respective countries but their constituency is mostly composed of amateur or grassroots clubs. Also within UEFA, representatives of national federations should be regarded less as delegates of the clubs engaged in economic activities than as delegates of amateur or grassroots clubs. It should also be mentioned that federation posts are honorary, and individuals elected to such posts are not bound by instructions or orders coming from the electors. Obviously, professional clubs have their ways of influencing federations and federation executives much more than their mere electoral weight would suggest, but it would still seem inaccurate *sic et simpliciter* to regard national federations as associations of undertakings and, automatically, national federations' regulations as decisions by associations of undertakings within the meaning of Article 81.1. It should not be overlooked

that decisions by associations of undertakings are caught by Article 81.1 in order to prevent circumvention of the prohibition of restrictive agreements and concerted practices. Decisions by associations of undertakings are typically a medium for the coordination and cooperation of undertakings of a given sector. The Panel observes that national leagues (where they exist) rather than federations currently seem to be the actual medium for the coordination of professional clubs. Therefore, national leagues seem to be the true associations of «club undertakings», league executives seem to be the true delegates of such undertakings, and the acts and conduct of leagues seem to truly reflect the will of such undertakings. National leagues are not direct members of UEFA and, as mentioned (*supra*, para. 19), the most important of them have recently constituted their own independent association in order to have their interests truly represented at pan-European level.

93. The Panel notes that in the *BNIC/Clair* case, the Court of Justice held that BNIC – the French cognac industry board – was in fact an association of undertakings because its measures were negotiated and adopted by individuals who were (formally appointed by the competent Minister but in fact) designated by the undertakings or associations of undertakings concerned and had to be considered as their representatives (Judgment of 30 January 1985, case 123/83, *BNIC/Clair*, in *E.C.R.* 1985, 391, para. 19). In *Reiff*, the Court of Justice held that the individuals composing a German tariff commission for road freight, appointed by the Minister upon the proposal of the undertakings or associations of undertakings of the interested sector, could not be deemed as representatives of the industry because they were not bound by instructions or orders coming from those undertakings or associations; therefore, the Court concluded that the tariff commission was not an association of undertakings and that its decisions were not caught by Article 85 (now 81) of the EC Treaty (Judgment of 17 November 1993, case C-185/91, *Reiff*, in *E.C.R.* 1993, I-5801, para. 19).
  
94. In the light of this case law and in the light of the circumstances described above (*supra*, paras. 91-92), the Panel is quite doubtful as to whether UEFA can be truly characterized as an association of associations of undertakings and as to whether members of the UEFA Executive Committee or of the UEFA Congress can be seen as actually representing the «club undertakings». At the very least, before reaching any such conclusions, it would be necessary to examine in detail the process leading to the appointment or election of individuals to national federation posts and to the various UEFA bodies, to look into the links of those individuals with professional clubs, and to investigate case by case whether a UEFA measure is in fact the expression of an agreement by or with the professional clubs or whether it strengthens already existing agreements between these clubs. Neither the Claimants nor the Respondent have supplied any evidence which could help the Panel in any such analysis. Therefore, the Panel must content itself with the stated conclusion (*supra*, para. 87) that UEFA, with respect to the economic activities in which it is involved and in which national federations are involved, is surely an undertaking and an association of «federation undertakings», leaving the question open as to whether UEFA is also an association of «club undertakings» through which clubs coordinate their economic behaviour. In any event, despite underlying doubts on this issue, given that UEFA essentially advanced no arguments to counter the Claimants' assertion that UEFA is an

association of associations of undertakings, the Panel will assume for the purposes of the ensuing discussion of competition law that UEFA is in fact an association of «club undertakings» whose decisions and rules concerning club competitions constitute a medium of horizontal cooperation between the competing clubs (as asserted by Advocate General Lenz in his *Bosman* opinion; see *supra*, para. 90). As a result, in order to proceed with its analysis, the Panel assumes that the Contested Rule is a decision by an association of associations of undertakings and, as such, falls within the scope of Article 81.1 (*ex* 85.1).

e) Market definition

95. The Panel notes that, in order to examine whether the Contested Rule has the object or the effect of appreciably restricting competition (Article 81) or constitutes an abuse of dominant position (Article 82), it is necessary to identify and define the relevant market in both its product and geographic dimensions.
96. As to *product market* definition, the Panel observes that, according to EC law and practice, essentially «*a relevant product market comprises all those products and/or services which are regarded as interchangeable or substitutable by the consumer, by reason of the products' characteristics, their prices and their intended use*» (EC Commission Notice «on the definition of relevant market for the purposes of Community competition law», in *Official Journal EC*, 9 December 1997, C 372/5, para. 7).
97. The Claimants, referring to the economic report prepared by Mr. Boon upon their request, allege that the relevant product market is a «European football market». According to the Claimants, such market would comprise the supply of all football matches played in Europe and a variety of related «ancillary football services markets», such as the market for capital investment in football clubs, the players market, the media rights market, the sponsorship and advertising market and the merchandising market. In his written report, Mr. Boon includes within the boundaries of this general «European football market» all UEFA «matches played out before a paying public across Europe and in the wider world». At the hearing, the Panel asked Mr. Boon to better identify the product, the demand side (the consumers) and the supply side (the suppliers) in the alleged «European football market». Mr. Boon answered that the product is constituted by all matches played in UEFA club competitions, the consumers are all the football fans and supporters, and the suppliers are the clubs and the players together. The notion that clubs and players supply matches together on the market is clearly unfounded in terms of competition law (and inconsistent with Mr. Boon's several references in his report to a players' market where clubs are on the demand side and players on the supply side), and the Panel can thus discard it immediately without further discussion.
98. The Panel finds that the Claimants' definition of the product market is not a viable one in terms of competition law. The notion of a general European football market is too ample, and the other related markets are too heterogeneous to be included therein. Given that the definition of a market should be determined primarily by interchangeability (or



substitutability) from the consumers' viewpoint, it is implausible to regard all European football matches as interchangeable. Certainly, in terms of stadium attendance most of the matches are not interchangeable because of geographic constraints and of consumer preferences, notably constituted by the supporters' allegiance to a given team. Indeed, virtually every club playing in a UEFA competition can be deemed to hold a sort of «captive market» with regard to live attendance of its home matches. Even in terms of television audience, a UEFA Cup or Champions' League match between a Swiss and a German team would hardly be considered by British viewers as a substitute – possibly with the only exception of the final match of the competition or some other unusual circumstances (*e.g.* the presence of several renowned British players in the match), and even in such cases it would be a poor substitute – for a match involving a British team (*see* Monopolies and Mergers Commission, *British Sky Broadcasting Group plc and Manchester United plc. A report on the proposed merger*, London, 12 March 1999, hereinafter «MMC Report», paras. 2.16-2.24). Furthermore, if the products of the European football market are the European matches, most of the various other markets mentioned by the Claimants are certainly related in some way or another to the supply of such football matches, but they cannot be «comprised» within that market. A few examples suffice: the sale of merchandise can and does take place regardless of European matches; contracts for advertising on panels within a given stadium can be concluded regardless of any connection with football matches (*e.g.* in view of a series of rock concerts or of non-football sporting events) or regardless of any connection with *European* football matches; some of the mentioned products or services are not offered to the final consumers (in particular sponsorship contracts, free-to-air broadcasting rights and capital investment in clubs not listed on the stock exchange).

99. The Panel observes that in fact there appears to be no single «European football market» comprising various ancillary markets. Rather, there are several «football markets» in which professional football clubs operate, such as those referred to by the Claimants, but they are all separate markets for the purposes of competition law. Support for such proposition can be found in the already quoted recent report by the British Monopolies and Mergers Commission (now transformed into the Competition Commission) concerning the proposed acquisition of the football club Manchester United by the broadcasting company BskyB, where it is evidenced how Manchester United operates in several separate markets such as the supply of football matches, television rights to football matches, advertising and sponsorship, retailing of merchandise, and various services such as catering and hospitality associated with its stadium (MMC Report, para. 2.16).
  
100. Most of such football markets are clearly segmented in both their product and geographic dimensions. With regard to the television broadcasting market, there appears to be a growing consensus among competition authorities that pay (including pay-per-view) television and free-to-air television are separate product markets (*see* MMC Report, paras. 2.36 and 2.39; Office of Fair Trading, *The Director General's review of BskyB's position in the wholesale pay TV market*, London, December 1996, paras. 2.3 and 2.6; «Autorità garante della concorrenza e del mercato», that is the Italian competition authority, Decision no. 6999 of 26 March 1999, *Stream/Telepiù*, in *Bollettino* 12/1999, para. 9). Also from the geographic point of view, although sports broadcasting is becoming more and more international and cross-

border, competition authorities and courts throughout Europe tend to maintain that broadcasting markets are mostly national, even if some of the broadcasting companies are multi-national and some of the events are covered worldwide (*see e.g.* the Decision of 11 December 1997 by the «*Bundesgerichtshof*», that is the highest German court in civil matters, upholding the previous decisions of the German competition authority «*Bundeskartellamt*» and of the appellate court «*Kammergericht*» in a case concerning television rights to European matches). As mentioned (*supra*, para. 98), another example of extreme geographic segmentation is to be found in the market for gate revenues (including both season tickets and match tickets). The sale of a club's merchandise tends also to be geographically very defined, with the only possible exception of a few top European clubs.

101. Having found that separate football markets exist, rather than a single and comprehensive European football market, the Panel must establish the relevant product market within which to assess whether the Contested Rule restricts competition or not. It is undisputed that the Claimants' basic grievance in this case concerns UEFA's interference with their wish to keep owning (and even further acquiring) various football clubs capable of competing in UEFA competitions. Indeed, the Claimants repeatedly stressed in their written and oral submissions that the Contested Rule would restrict investments in European football clubs' stocks. Accordingly, the Panel finds that the market more directly related to, and potentially affected by, the Contested Rule appears to be a market which can be defined as the «*market for ownership interests in football clubs capable of taking part in UEFA competitions*». A market for ownership interests in professional clubs has been identified as the relevant market in some United States antitrust cases, particularly in cases related to league rules banning cross-ownership of clubs of other professional sports leagues or subjecting to authorization the sale of a club. *See e.g. NASL v. NFL*, 505 F.Supp. 659 (S.D.N.Y. 1980), *reversed* 670 F.2d 1249 (2d Cir. 1982); *Sullivan v. NFL*, 34 F.3d 91 (1st Cir. 1994); *Piazza v. MLB*, 831 F.Supp. 420 (1993). The Panel finds also, in the light of the content of the Contested Rule and on the basis of the available evidence, that the Contested Rule appears to be only indirectly related, if at all, to the various other markets suggested by the Claimants, such as the market for players, the sponsorship market, the merchandising market, the media rights market and the market for gate revenues. Therefore, the effects on these markets will be considered only on a subsidiary basis to the said principal relevant market, concerning ownership interests in European professional football clubs.
  
102. The Panel considers that the relevant market, as defined, would include on the supply side – that is, the potential sellers of ownership interests – all the owners of European football clubs which can potentially qualify for a UEFA competition. Mr. Boon has illustrated how an investment in clubs which can qualify for UEFA competitions (referring to the main UEFA competitions, the Champions' League and the UEFA Cup) is much more attractive than an investment in other football clubs because «*from a financial perspective, access to European club competition is disproportionately important to club success*». Therefore, according to this economic analysis, clubs which cannot hope to qualify for one of the main UEFA competitions should not be viewed as substitutes by investors interested in football clubs. In principle, only clubs competing in the top division of one of the fifty-one European national federations can hope to qualify (the only exception being the rare occurrence of a club from

a lower division winning the national cup). According to the Boon report, there are currently 737 clubs playing in the top divisions of the fifty-one UEFA countries. While the number of such clubs is basically the same every year, their identity varies slightly every football season because of the promotion/relegation system which has already been described (*see supra*, para. 18). Of those 737 clubs, however, probably less than a half – perhaps 350 clubs – have a realistic chance of qualifying for one of the two main UEFA competitions, given that less than 200 slots are available. It should also be considered that the number of clubs having a realistic chance of passing the first rounds is even smaller: as reported by Mr. Boon, over the five year period 1993/94-1997/98 only 66 clubs have achieved a place in the quarter final of one of the three main UEFA competitions.

103. The Panel observes that, because of the peculiarities of the football sector, investment in football clubs does not appear to be interchangeable with investments in other businesses, or even in other leisure businesses. The publicity and notoriety given by the ownership of a football club, besides the inherent excitement and gratification of running such a popular and emotional business, have always rendered such activity particularly attractive in terms of so-called VIP status and of high profile relationships with politicians and local communities. Indeed, ownership of a football club has often proved to be quite helpful, and sometimes expedient, to other business or political activities. Nowadays, because of the enormous increase in the amounts paid to clubs for television broadcasting rights, the profitability of professional clubs is also becoming interesting (*see MMC Report*, para. 3.79 *et seq.*). In particular, ownership of European professional football clubs appears to be an attractive strategic fit for media groups, given that football is a key media asset with further growth potential (*see MMC Report*, paras. 2.136-2.139 and 3.103). In economic terms, the circumstance that club ownership involves significant additional aspects to the mere profitability of a club means that the individual or corporate owner places on its club a significant instrumental and consumption value in addition to its possible investment value. This is not to be found in other business activities, which, therefore, are not interchangeable with the ownership of a football club. Moreover, given the largely leading position of football in European sports, clubs of other sports (*e.g.* a professional basketball club) can be deemed as potential substitutes only in few and very defined locations where such other sports enjoy popular success. Looking at Europe as a whole, other sports do not appear to offer a suitable alternative to the acquisition and ownership of football clubs.
  
104. In the light of the above, on the demand side (that is, the potential buyers of ownership interests) the market would include any individual or corporation potentially interested in an investment opportunity in a football club which could qualify for a UEFA competition. In this respect, the Claimants assert that availability of capital for investment in clubs is limited, that multi-club ownership is a rational economic investment strategy and, thus, multi-club owners are a key source of capital for football clubs within UEFA's jurisdiction. The Panel finds this argument unconvincing. As has already been said, ownership of football clubs has always been particularly attractive for reasons that go beyond mere economic considerations. Changes in clubs' ownership are notoriously quite common, and the Claimants have provided no substantial evidence proving that owners willing to sell a club of UEFA level encounter particular problems in finding suitable buyers. In fact, there is

even some empirical evidence that in some markets football clubs have been able to attract substantial capital investment from new sources, not from the historic owners of the clubs, despite the presence of a rule somewhat analogous to, or even stricter than, the Contested Rule (*see infra*, para. 120).

105. The Panel remarks that the possible profitability of a football club and its attractiveness to investors depends much more on its specific characteristics, particularly its location and its «brand», than on the identity of the potential buyers. The Boon report mentions that multi-club owners enjoy economies of scale and synergies such as sharing of information and expertise, single sourcing of supplies and centralized services. However, the extent to which football clubs located in different countries could share resources appears to be quite limited, particularly if clubs must be kept isolated from each other for sporting reasons as ENIC affirms it is doing (*see supra*, para. 32). Moreover, most of such economies of scale – such as headquarters costs, in-house expertise and common purchase of services of various kinds (*e.g.* computer consultancy) – would also be available to clubs belonging (as most often is the case) to entrepreneurs or groups involved in other non-football businesses. As to media rights, given the current negative attitude of most competition authorities and judges throughout Europe concerning the collective sale of television broadcasting rights (*see e.g.* the notorious Decision of 11 December 1997 by the *Bundesgerichtshof*, *supra* at para. 100), multi-club owners would conceivably be barred from collectively selling the rights to their clubs' matches and, therefore, no economies of scale could be enjoyed in this area. In any event, given the said separation of national television markets (*supra*, para. 100), the joint sale of broadcasting rights to matches of clubs located in different countries would appear not to afford a particular negotiating advantage.
106. The Panel observes that several of the benefits mentioned by the Claimants, which clubs allegedly attain when they are controlled by multi-club owners are, in fact, benefits that any clubs would derive from qualified and efficient management, regardless of the ownership structure. In this respect, the Panel is impressed by the improvements allegedly brought by ENIC to the management of its clubs, but it is not prepared to accept the proposition that multi-club owners are better owners than single club owners. In the Panel's view, it is changes in management rather than in ownership that affect the way football clubs are run. Moreover, the Panel remarks that, given the cost structure of football clubs, the savings due to the supposed economies of scale would be negligible compared to the current costs for players' (or even coaches') remuneration (*see supra*, paras. 32-33). In other terms, economies of scale do not yield what mostly matters in order to keep clubs successful on and off the field: good players and coaches. An instance of this can be given by the sporting results of the Italian club Vicenza; notwithstanding the supposed economies of scale and efficient management related to its being controlled by ENIC, at the end of the 1998/99 season Vicenza has been relegated to the Italian second division. Furthermore, the Panel finds the Claimants' argument (that there is a scarcity of potential buyers of clubs) particularly unconvincing in the light of the circumstance that the price for obtaining control of a club able to qualify for UEFA competitions – although not one of the top European clubs – appears to be affordable by a large number of corporate or individual entrepreneurs. For instance, in order to obtain control of the Claimants – clubs at the top of their countries and

able to achieve the quarter final of a UEFA competition – ENIC paid approximately £ 2.5 million for AEK and £ 2.2 million for Slavia, which are prices comparable to those of rather small enterprises in various European business sectors. As a result, the Panel concludes that there are countless potential buyers of ownership interests in football clubs which could qualify for a UEFA competition.

107. As to *geographic market* definition, the Panel observes that, according to EC law and practice, essentially «*a relevant geographic market comprises the area in which the undertakings concerned are involved in the supply and demand of products or services, in which the conditions of competition are sufficiently homogeneous and which can be distinguished from neighbouring areas because the conditions of competition are appreciably different in those areas*» (EC Commission Notice «on the definition of relevant market for the purposes of Community competition law», in *Official Journal EC*, 9 December 1997, C 372/5, para. 8).
108. The evidence provided by the Claimants shows how the geographic dimension of the market for ownership interests in football clubs potentially taking part in UEFA competition is pan-European. There are no impediments for clubs in attracting potential investors from all over Europe and, conversely, almost no obstacles for a potential investor in buying an ownership interest in any given club around Europe. The actual investments by ENIC confirm this pan-European dimension. Therefore, the Panel concludes that the relevant geographic market extends to Europe as a whole, or more precisely to the territories of the fifty-one European federations affiliated to UEFA (which in reality, for historical reasons, encompasses federations that do not correspond to States, such as Scotland or Wales, and goes beyond geographical Europe, insofar as it includes Israel). As mentioned, other football markets tend to be geographically more segmented (*see supra*, para. 99).
- f) Compatibility with Article 81 (*ex 85*) of the EC Treaty
109. For an agreement between undertakings or a decision by an association of undertakings to be caught by Article 81.1, it must have the «object or effect» of restricting competition (as is customary in EC case law and practice, reference is here made only to «restriction» of competition as the general term encompassing also prevention and distortion). Since the «object» and the «effect» are not cumulative but alternative requirements, as suggested by the conjunction «or» (*see* Court of Justice, Judgement of 30 June 1966, case 56/65, *Société Technique Minière*, in *E.C.R.* 1966, 235, at 249), the Panel needs first to consider the *object* of the Contested Rule, *i.e.* its purpose in the context in which it is to be applied. Then, if the purpose of the Contested Rule does not appear to be anti-competitive, the Panel needs to take into consideration its actual *effect* on the relevant market. Should the Contested Rule have either the object or the effect of hindering competition, the Panel would then be required by EC case law to assess the Contested Rule in its economic context in order to decide whether it affects competition and trade between Member States to an *appreciable* extent (*see e.g.* Court of Justice, Judgement of 9 July 1969, case 5/69, *Völk*, in *E.C.R.* 1969,

295, para. 3; Judgement of 8 February 1971, case 22/71, *Béguelin*, in *E.C.R.* 1971, 949, para. 16).

110. As to the *object* of the Contested Rule, the Claimants assert that UEFA's predominant purpose has been to preserve its monopoly control over European football competitions rather than to preserve the integrity of the game. The Claimants' argue that support for this assertion can be found in the UEFA internal memorandum of 25 February 1998, drafted by Mr. Marcel Benz after the meeting with ENIC representatives of the previous day, and in the rules of the UEFA Statutes providing for the monopoly power of UEFA over European competitions. In the UEFA internal memorandum, under the heading «possible problems, questions and risks», it is possible to read *inter alia*:

*«Does the ENIC group form the basis for a European league ... Couldn't a media mogul take advantage of ENIC's groundwork and create a European league with the ENIC clubs? Couldn't other investors (e.g. IMG) pursue the same strategy and buy up clubs on a large scale? ... Isn't it a risk for UEFA in the media sector if TV stations own the rights of clubs in the domestic competition? Won't central marketing by UEFA be infringed upon sooner or later? The search for UEFA Champions League sponsors could also become harder, as sponsors would also get a similar market presence throughout Europe with ENIC».*

111. The Respondent replies by asserting that, besides the endeavour to prevent a clear conflict of interest situation and thus to ensure that competition is genuine, there was no ulterior motive for the adoption of the Contested Rule. The Respondent finds support in the same UEFA internal memorandum of 25 February 1999, where questions are raised on *«how UEFA could guarantee sporting competition if two clubs of the ENIC group met in the same UEFA competition. Who would win? Would ENIC or its management decide, or would the winners be decided on the pitch, in a purely sporting encounter, as desired by UEFA and its public? ... UEFA must take all legal measures possible to guarantee clean competition. ... The interests of clean competition in sport are at stake».*

112. The Panel notes that both the title and the text of the Contested Rule appear *prima facie* to support the Respondent's assertion that the Contested Rule is only designed to ensure that competition is genuine. The title reads «Integrity of the UEFA Club Competitions: Independence of the Clubs», while Paragraph A declares the object of the Contested Rule as follows:

*«It is of fundamental importance that the sporting integrity of the UEFA club competitions be protected. To achieve this aim, UEFA reserves the right to intervene and to take appropriate action in any situation in which it transpires that the same individual or legal entity is in a position to influence the management, administration and/or sporting performance of more than one team participating in the same UEFA club competition».*

Moreover, the Panel points out that the Contested Rule is not limited to banning multi-club ownership within the same competition but also forbids any other type of structure or behaviour which could potentially enable a club (or a related person) to influence a competitor in the same competition (*see* Paragraphs B.1 and B.2 of the Contested Rule).

113. The Panel considers that the Claimants had the burden of rebutting such *prima facie* evidence by proving that the true object of the Contested Rule was an anti-competitive one. The

Panel finds that the Claimants have not satisfied this burden of proof, given that the only plausible evidence relied upon is the UEFA internal memorandum of 25 February 1998, which is at best ambiguous. Apart from the fact that it was drafted by an individual who is not a member of the body which adopted the rule, the memorandum appears to contain meeting notes rather than statements of policy and questions rather than answers. As a matter of fact, the memorandum lends support to contradictory arguments; therefore, it is of little avail for the rebuttal of the said *prima facie* evidence. As to the provisions of the UEFA Statutes mentioned by the Claimants, they simply confirm the notorious circumstance that UEFA is the institutional and regulatory authority over European football, as normally happens with all international sports federations: in no way do such provisions prove or disprove a particular object of the Contested Rule. The Panel finds, therefore, that in enacting the Contested Rule UEFA did purport to prevent the conflict of interest inherent in commonly owned clubs taking part in the same competition and to ensure a genuine athletic event with truly uncertain results. As a result, the Panel holds that the object of the Contested Rule is not to restrict competition within the meaning of Article 81.1 of the EC Treaty.

114. As to the *effect* of the Contested Rule, the Claimants assert that it appreciably restricts competition by preventing or restricting investment by multiple owners in European clubs, by changing the nature, intensity and pattern of competition between commonly controlled clubs and those having other ownership structures, and by enhancing the economic imbalance between football clubs leading to an increase in the market dominance of a few clubs over the majority of smaller and medium-sized clubs. On the other hand, the Respondent asserts that the Contested Rule has an overwhelmingly pro-competitive purpose and effect, namely to preserve the integrity of sporting competition between football clubs.
115. According to EC case law, in order to ascertain whether competition is in fact restricted to an appreciable extent, the Panel must essentially look at the competition which would occur on the relevant market *in the absence* of the Contested Rule (*see* Court of Justice, Judgement of 30 June 1966, case 56/65, *Société Technique Minière*, in E.C.R. 1966, 235, at 250; Judgement of 11 July 1985, case 42/84, *Remia*, in E.C.R. 1985, 2545, para. 18).
116. The Panel observes that the Contested Rule undoubtedly discourages to some extent any current owner of a club potentially capable of qualifying for UEFA competitions from buying ownership interests in another club having the same capability. In the absence of the Contested Rule, not only would there not be such discouragement but, according to the Boon report, multi-club control could be expected to expand. Assuming that Mr. Boon's conjecture is correct, single club owners would probably perceive that multi-club owners retain market advantages from their expanded dimension and might decide that the best way to improve their own position would be also to acquire additional clubs. With an expansion of multi-club ownership throughout Europe the total number of club owners, and thus the total number of undertakings on the market, would evidently decrease, even though the number of clubs realistically aspiring to a slot in a UEFA competition would probably remain the same because the number of talented players cannot be increased at will. As

mentioned (*supra*, para. 102), probably no more than 350 clubs can each year realistically aspire to a UEFA slot, of which substantially less than one hundred could realistically hope to pass the first rounds and achieve a satisfactory number of matches and sufficient television exposure. In economic terms, within the relevant market there would be a reduction of the number of actors on the supply side *vis-à-vis* an unvarying large number of actors on the demand side (*see supra*, para 104). In other words, there could be a process of concentration of club ownership into fewer hands, given that there is a sporting barrier to any sudden entry into the market. As is well known, an entry into the market is hindered by the circumstance that in the European sporting system a new club must go through the pyramidal structure of national championships for several years before attaining a top professional level (*see supra*, paras. 15 and 18). As nobody can suddenly create a new football club and apply to directly enter into a top national championship or a UEFA competition (as happens for instance when United States professional leagues expand and add new franchises), a viable entry into the market is possible only through the purchase of an already existing club playing at good level in one of the fifty-one European top divisions.

117. The Panel observes that, from an economic point of view, the said decrease in the number of club owners could be expected either not to have any effect on prices of ownership interests in clubs – because club owners willing to sell their club would still be quite numerous, and because price is determined not only by supply and demand but also by the mentioned instrumental and consumption value placed by owners on clubs (*see supra*, para. 103) – or to bring about an increase in prices once the decrease in owners becomes noticeable. If, stretching the argument to extremes, the said concentration trend led to there being only a few owners of clubs capable of qualifying for UEFA competitions, the market for ownership interests in such clubs would be characterized by an oligopoly – presenting inherent incentives for cartel behaviour – with which any interested buyer would have to deal. Even on other football markets mentioned by the Claimants, where clubs are on the supply side – gate revenues, media rights, merchandising –, the reduction of club owners and the potentially resulting oligopoly could eventually bring about increases in prices to the detriment of consumers (*e.g.* increase in prices of match tickets or of pay television subscriptions). The Panel finds such an oligopoly scenario to be probably too extreme. The fact that when the Contested Rule was enacted the total number of European clubs controlled by multi-club owners was very low – only 12 clubs, according to the Boon report – seems to demonstrate, first, that a rush towards multi-club ownership would be unlikely (at least in the short term) and, second, that the postulated concentration process would in any event need several years to develop. However, even without admitting all the way the oligopoly scenario, it must be acknowledged that in the absence of the Contested Rule the number of undertakings on the market would sooner or later decline while the effects on prices, although scarcely noticeable in the short term, would in due course tend to show an increase.
118. As a result of the foregoing analysis, the Panel finds that, in the absence of the Contested Rule, competition on the relevant market and on other football markets would initially probably remain unaffected and, when affected, it would be restricted. In the light of this *a contrario* test, the Panel finds that the actual effect of the Contested Rule is to place some



limitation on mergers between European high level football clubs, and thus to increase the number of undertakings on the relevant market and on other football markets; accordingly, the Contested Rule preserves or even enhances economic competition between club owners and economic and sporting competition between clubs. The Panel notes that, according to the Court of Justice, clauses restraining competitors' freedom which are indirectly conducive to increasing the number of undertakings on the relevant market must be deemed as pro-competitive (Judgement of 11 July 1985, case 42/84, *Remia*, in *E.C.R.* 1985, 2545, last sentence of para. 19).

119. The Panel observes, consequently, that either the Contested Rule does not affect the relevant market at all or, if it does, it exerts a beneficial influence upon competition, insofar as it tends to prevent a potential increase in prices for ownership interests in professional football clubs (and to prevent potential price increases in other football markets as well), and thus it tends to encourage investment in football clubs. As a result, the Panel finds that the Contested Rule, by discouraging merger and acquisition transactions between existing owners of clubs aspiring to participate in UEFA competitions, and conversely by encouraging investments in such football clubs by the many potential newcomers, appears to have the effect of preserving competition between club owners and between football clubs rather than appreciably restricting competition on the relevant market or on other football markets.
120. Empirical support for the proposition that the Contested Rule not only does not prevent or restrict investment in football clubs, but even favors it, can be found in the British market. There the Premier League has a rule not allowing any person or corporate entity, except with the prior written consent of the Board (which thus far has never been granted), to «*directly or indirectly hold or acquire any interest in more than 10 per cent of the issued share capital of a Club while he or any associate is a director of, or directly or indirectly holds any interest in the share capital of, any other Club*».

Despite a rule substantially stricter than the Contested Rule – 10% rather than a controlling interest – British clubs, as reported by Mr. Boon, have successfully attracted capital investment in recent years and a substantial proportion of such capital investment has been from new corporate investors, not from the historic owners of the clubs.

121. The Claimants also allege that the Contested Rule has the effects of altering the nature, intensity and pattern of competition between commonly controlled clubs and other clubs, and of enhancing the economic imbalance between football clubs, leading to an increase in the market dominance of a few big clubs over the majority of smaller and medium sized clubs. In other words, the Claimants argue that the Contested Rule favours the rich and strong clubs over the weak and poor ones. The Claimants base this argument on the assumption that multi-club owners would tend to own only small and medium clubs and to invest more in countries where football is economically less developed, and thus would mitigate the process of polarization of market power between the bigger clubs in the larger football countries and other clubs. The Claimants' evidence in support of this argument is basically the pattern of ENIC's own investments.

122. The Panel finds that the said assumption is unsupported by meaningful evidence and fails to discern the logic of the argument. Certainly, ENIC has thus far followed the strategy of acquiring medium-sized clubs; however, if such an investment strategy is convenient, nothing will prevent owners of big clubs from acquiring medium-sized clubs as well. As mentioned, it appears to be a reasonable strategy to control clubs of different sporting levels, and some big clubs are indeed doing it: Mr. Boon has mentioned the well known media magnate group controlling AC Milan which also owns Monza (a smaller Italian club not playing in the top Italian division) and Mr. Trijbits has testified with regard to the attitude of top Dutch clubs (*see supra*, para. 35). Therefore, in the absence of the Contested Rule, not only would the polarization of market power between bigger and smaller clubs continue but, in the light of the previous findings, it would probably even be enhanced. After all, polarization of market power is what usually happens in any business sector when mergers and acquisitions are completely left to market dynamics and dominant companies are free to acquire smaller competitors (which is why regulators enact rules such as the EC Merger Regulation no. 4064/89). Moreover, the problem with this scenario is that, while in other types of business it is economically desirable for consumers that marginal and less efficient undertakings disappear from the market, in the sports business consumer welfare requires that numerous clubs remain on the market and achieve the highest possible economic and sporting balance between them. The Panel is of the view that to provide incentives for actual or potential club owners to invest their resources in only one high level club, as the Contested Rule tends to do, is conducive to an economic and sporting balance, rather than an imbalance, between football clubs. Therefore, from this point of view as well, the Panel finds the Contested Rule to be beneficial to competition in football markets.
123. Furthermore, in terms of consumer welfare, the quality of the entertainment provided to European football fans – with reference to both live attendance and television audience – does not appear to be appreciably affected by the Contested Rule. The only conceivable effect of the Contested Rule is that a club which has qualified for a UEFA competition would be replaced by the club from the same country which, in the previous season's national championship, ranked immediately below the excluded club. Obviously, the replaced club would suffer a harm and its committed supporters would resent the replacement, but at the same time the substitute club and its committed supporters would enjoy a benefit exactly corresponding to the injury of the replaced club. The Panel observes in this respect that in principle competition law protects competition and the market as a whole, not individual competitors. Accordingly, in order to establish an injury to consumer welfare – *i.e.* that fans with a general interest in football are harmed – evidence should be provided that the substitute team would be less skilled and entertaining than the excluded one. This has not been proven by the Claimants and, in any event, it appears quite hard to prove, given that the quality and talent of the players and coach of two closely ranked teams are essentially analogous, and given that participation in UEFA competitions occurs one season later, when the coach or several players might have moved elsewhere and, in fact, the substitute team might well be more talented and entertaining than the replaced one. Therefore, the Panel finds that the Contested Rule does not appear to appreciably affect the quality of the sporting product offered to consumers.

g) Objective necessity of regulating multi-club ownership and proportionality of the Contested Rule

124. The foregoing findings appear to suffice for rejecting the contention that the Contested Rule appreciably restricts competition, and thus appear to suffice for excluding it from the scope of the prohibition set forth by Article 81 (*ex* 85) of the EC Treaty. However, in order to further support those findings, the Panel deems it opportune to verify whether the limitation on multi-club ownership can also be regarded as an essential feature in order to ensure the proper functioning of a professional football competition. In this regard, the Panel notes that the EC Court of Justice has held in several judgements that restraints on competitors' conduct do not amount to restrictions on competition within the meaning of Article 81.1 (*ex* 85.1), provided that such restraints do not exceed what is necessary for the attainment of legitimate aims and remain proportionate to such aims (*see e.g.* Judgement of 11 July 1985, case 161/84, *Remia*, in *E.C.R.* 1985, 2545; Judgement of 28 January 1986, case 161/84, *Pronuptia*, in *E.C.R.* 1986, 353; Judgement of 19 April 1988, case 27/87, *Erauw*, in *E.C.R.* 1988, 1919; Judgement of 15 December 1994, case C-250/92, *DLG*, in *E.C.R.* 1994, I-5641; Judgement of 12 December 1995, case C-399/93, *Oude Luttikhuis*, in *E.C.R.* 1995, I-4515).
125. The Claimants assert that the means employed by UEFA are disproportionate to the objective of protecting the integrity of European football competitions and have submitted for consideration a variety of «less restrictive alternatives». In particular, the Claimants argue that criminal penalties provided by the various State laws, in addition to UEFA disciplinary powers, are sufficient to deal severely with match-fixing in any case where such wrongdoing is proved. In addition, according to the Claimants, a more proportionate approach could include the adoption by UEFA and by all clubs participating in UEFA competitions of a code of ethics, and more particularly of a draft document prepared by ENIC and by the Claimants entitled «Proposed measures to guarantee sporting integrity in European football competition organised by UEFA». The Claimants have also suggested that the Contested Rule could include a clause for a case by case examination of multi-club ownership in order to appraise particular circumstances, and have proposed a «fit and proper» test for every club owner as a condition for participation in UEFA competitions or even as a requirement for the purchase of a club. They have also proposed that UEFA enact rules limiting the number of clubs which the same owner can control, or that an independent trust be established to which control of commonly owned clubs could be transferred for the duration of UEFA competitions. Moreover, in order to avoid problems with bonuses and transfers, inevitably connected with multi-club ownership (*see supra*, paras. 39-40), suggestions were also advanced that UEFA enact schemes, either general or special to commonly owned clubs, limiting bonuses and transfers of players.
126. The Respondent replies by asserting that the Contested Rule corresponds to the minimum degree of regulation necessary to protect the integrity of football competition and is, therefore, fully compatible with the law. The Respondent argues that the Contested Rule does not prohibit multi-club ownership, but simply prevents commonly controlled clubs

from participating in the same UEFA club competition, and that any investor may acquire a shareholding of up to 50% in any two or more European football clubs participating in UEFA competitions without ever being affected by the Contested Rule. In this respect, the Respondent mentions the stricter regulations which may be found in the United Kingdom, such as the rules of the Premier League, the Football League and the Scottish Football Association, or in the United States, such as the rules of the NBA, the NFL, the NHL and the MLB. The Respondent also argues that preventive measures are necessary in order to avoid conflicts of interest, and cites in this respect the principles applicable to lawyers and arbitrators. The Respondent also criticizes the draft regulation submitted by the Claimants for proposing rules which already exist (such as the obligations to play always to win and to field the best available team, and the disciplinary proceedings for anyone suspected of match-fixing), or rules which are impractical and unrealistic to enforce (such as the obligation for any multi-club owner to ensure the autonomy of each club's coaching and playing staff and the limitation of contacts between the clubs in the event that they play against each other, or the obligation to include in any club at least one minority shareholder capable of exercising minority shareholder's rights), or measures hard to assess and which would probably be challenged in court (such as the exclusion from competition of clubs whose owner is not a fit and proper person).

127. The Panel has already analyzed the «integrity question» and has found that, when commonly controlled clubs participate in the same competition, the consumers would reasonably perceive this situation as a conflict of interest potentially affecting the authenticity of results (*supra*, paras. 22-48). Accordingly, the Panel has concluded that multiple ownership of clubs in the context of the same competition is a justified cause for concern by a sports regulator and organizer such as UEFA (*supra*, para. 48). The Panel has also already found that the intention of the Contested Rule is to prevent the conflict of interest inherent in commonly controlled clubs participating in the same UEFA competition and to preserve the genuineness of results (*supra*, para. 113). In this respect, the Panel is persuaded that this is a legitimate goal to pursue, and finds evident support for this proposition in the *Bosman* ruling, where the EC Court stated that the aim «*of maintaining a balance between clubs by preserving a certain degree of equality and uncertainty as to results ... must be accepted as legitimate*» (Judgement of 15 December 1995, case C-415/93, *Bosman*, in *E.C.R.* 1995, I-4921, para. 106).
128. The Panel observes that organizing sports leagues and competitions needs a certain amount of coordination and horizontal restraints between clubs in order to supply the «product» to the consumers. As was remarked by a leading United States antitrust scholar (and later federal judge) «some activities can only be carried out jointly. Perhaps the leading example is league sports» (R.H. BORK, *The antitrust paradox. A policy at war with itself*, 2<sup>nd</sup> edition, New York 1993, 278). Indeed, each professional club competing in a league or in a competition has an evident interest in combining sporting and economic rivalry with sporting and economic cooperation. In the words of the Supreme Court of the United States, sport is «*an industry in which horizontal restraints on competition are essential if the product is to be available at all. ... What the NCAA and its member institutions market in this case is competition itself – contests between competing institutions. Of course, this would be completely ineffective if there were no rules on which the competitors agreed to create and define the competition to be marketed. A myriad of rules affecting such*

*matters as the side of the field, the number of players on a team, and the extent to which physical violence is to be encouraged or proscribed, all must be agreed upon, and all restrain the manner in which institutions compete. ... And the integrity of the "product" cannot be preserved except by mutual agreement»* (Judgement of 27 June 1984, *NCAA v. Board of Regents of the University of Oklahoma*, in 468 U.S. 85, 101-102).

Advocate General Lenz basically espoused such line of reasoning when he stated that *«the field of professional football is substantially different from other markets in that the clubs are mutually dependent on each other»* and that *«certain restrictions may be necessary to ensure the proper functioning of the sector»* (Opinion delivered on 20 September 1995, case C-415/93, *Bosman*, in *E.C.R.* 1995, I-4921, para. 270).

129. The Panel is of the opinion that among the «myriad of rules» needed in order to organize a football competition, rules bound to protect public confidence in the authenticity of results appear to be of the utmost importance. The need to preserve the reputation and quality of the football product may bring about restraints on individual club owners' freedom. In this respect, the Panel sees an analogy with restraints which the Court of Justice has regarded as inherent in, and thus necessary for, franchising systems (Judgement of 28 January 1986, case 161/84, *Pronuptia*, in *E.C.R.* 1986, 353, para. 15 *et seq.*).
  
130. Given that the Panel has found that in multi-club ownership situations a problem of conflict of interest objectively exists (*supra*, para. 45), and that this has been found to affect the public perception of the authenticity of results (*supra*, para. 48), the Panel is persuaded that a rule concerning multi-club ownership is objectively necessary in order to provide the consumers with a credible sporting contest. The question is whether the Contested Rule is proportionate to the legitimate objective pursued or whether UEFA should have adopted a less restrictive means to achieve it. With regard to the principle of the «less restrictive alternative», however, the Panel is of the opinion that this does not necessarily mean that it is necessary to test the Contested Rule against any conceivable alternative. Judges should not substitute for legislators, and the former should always allow the latter to retain a certain margin of appreciation. In other words, «the principle of proportionality cannot be applied mechanically» and «the less restrictive alternative test is not an end in itself but simply facilitates the judicial enquiry» (T. TRIDIMAS, *The principle of proportionality in Community law: from the rule of law to market integration*, in *The Irish Jurist* 1996, 83, at 93-94). Such position is supported by some significant Court of Justice case law (*see e.g.* Judgement of 10 May 1995, case C-384/93, *Alpine Investment*, in *E.C.R.* 1995, I-1141, paras. 51-54).
  
131. With regard to proportionality, the Panel observes that the Contested Rule has been narrowly drawn to proscribe only the participation in the same UEFA competition of commonly controlled clubs and does not prohibit multi-club ownership as such. The Contested Rule does not proscribe the participation of commonly controlled clubs in two different UEFA competitions and does not prevent the acquisition of shares – up to 49% of the voting rights – in a large number of clubs participating in the same competition. As the scope of the Contested Rule is strictly limited to participation in the same UEFA competition, a multi-club owner can control clubs in several countries and obtain a good

return on the investments even if only one of its clubs is allowed to take part in a given UEFA competition. In this respect, the already quoted MMC Report contains some evidence – referred to the British market, but arguably representative of other national markets – suggesting that the top national championship (in England the Premier League) and the national cup (in England the FA Cup) are the football competitions most preferred by consumers and most economically rewarding, because of their unique combination of volume and popularity of matches (MMC Report, para. 2.22). Indeed, in response to a 1996 British survey, 71% of pay-television subscribers who watched football said that the Premier League was very important to them and 68% said the same of the FA Cup; only 50% said the same of UEFA matches involving British clubs (*ibidem*). Moreover, the number of UEFA matches played by a club (even achieving the final) is substantially fewer than the number of national championship and national cup matches. Accordingly, European football clubs still derive most of their revenues from national championship and cup matches; for example, about 75% of Manchester United’s profits come from Premier League matches (*ibidem*, para. 2.125). In the light of the foregoing data and remarks, and of the circumstance that participation in national competitions is not affected at all, the Panel finds that the Contested Rule appears *prima facie* to be limited to its proper objective and not to be disproportionate or unreasonable. This *prima facie* conclusion needs now to be examined in the light of the less restrictive alternative test.

132. Before proceeding with the less restrictive alternative test, the Panel remarks that, as a normative technique, rules which are applied *a priori* differ from rules which are applied *a posteriori*. Rules that are applied *a priori* tend to prevent undesirable *situations* which might prove difficult or useless to deal with afterwards, rather than imposing a penalty on someone guilty of something. On the other hand, rules that are applied *a posteriori* are bound to react to specific *behaviours*. For example, under EC law and several national laws, rules on mergers are applied *a priori*, whereas rules on abuses of dominant position are applied *a posteriori*. Merger operations are checked before they actually take place, and are blocked if the outcome of the merger would be the establishment of a dominant position because of the possible negative consequences on the market and not because the individuals owning or managing the merging undertakings are particularly untrustworthy and the company after the merger is expected to abuse of its dominant position. Among the myriad of possible examples, another obvious example of rules applied *a priori* can be found in provisions of company law restraining cross-ownership of shares (*see* Article 24a of the Second Council Directive of 13 December 1976, no. 77/91/EEC, in *Official Journal EC*, 31 January 1977, L 26/1, as subsequently amended by Council Directive of 23 November 1992, no. 92/101/EEC, in *Official Journal EC*, 28 November 1992, L 347/64). One can think also of all the rules providing for incompatibility between a given position and another (say, between membership of a company’s board of directors and membership of the same company’s board of auditors). All such *a priori* rules are applied on a preventive basis, with no appraisal of any specific wrongdoing and no moral judgement on the individuals or companies concerned. On the other hand, rules setting forth obligations and corresponding penalties or sanctions, such as criminal or disciplinary rules, can be applied only after someone has been found guilty of having violated an obligation. In summary, *a priori* and *a posteriori* rules respond to different legal purposes and are legally complementary rather than

alternative. Therefore, the Panel finds that the Contested Rule, which is clearly to be applied *a priori*, can be supplemented but cannot be substituted by any sporting rules establishing disciplinary sanctions or any State laws forbidding match-fixing. Therefore, such disciplinary and criminal rules cannot be «less restrictive alternatives» insofar as they are not truly «alternative» to the Contested Rule.

133. As to the other alternative means proposed by the Claimants, the Panel is not persuaded that they are viable or that they really can be considered as less restrictive. The Claimants have particularly relied on a draft document headed «*Proposed measures to guarantee sporting integrity in European football competition organised by UEFA*» (hereinafter «the Claimants' Proposal»). According to the Claimants' Proposal, *inter alia*, UEFA would be required in consultation with the relevant national association to control the ownership structure of every club wishing to participate in a UEFA competition and would be «*entitled to take appropriate steps in cases where it considers that a particular individual or legal entity is not a fit and proper person to be or become an owner of a club*», and could «*after giving that person or legal entity a reasonable opportunity to make representations, decide that the club or clubs owned or to be owned by him or it may, subject to giving one season's notice, become ineligible to participate in European competitions*».

At the hearing, the Claimants also proposed to extend this fit and proper test to clubs' directors and executives. Since one season's notice should be granted, the Claimants' Proposal would imply that every summer the UEFA offices should check the ownership structures of all the clubs (established in about fifty different legal systems) which can potentially qualify for the UEFA competitions of the following season – as said, in all the European top national divisions there are 737 clubs, of which perhaps 350 have a realistic chance of qualifying for UEFA competitions (*see supra*, para. 102) – and, after a legal hearing, pass moral judgements on the owners', directors' and executives' adequacy to run a football club. The Panel finds that, from a substantive point of view, it would be very difficult to come up with some objective requirements in order to fairly carry out a fit and proper test and, from a procedural point of view, the administrative costs involved and the legal risks of being sued for economic and moral damages after publicly declaring in front of the whole of Europe that someone is not a fit and proper person are practically incalculable (in this respect, as UEFA is a private body, no comparison can be made with fit and proper tests carried out by public authorities prior to granting bookmaking licences, because such public authorities are essentially immune from being sued for declaring that someone is not «fit and proper»). The Panel notes that the Court of Justice has stated, with reference to the fashion sector, that if it is too difficult to establish objective quality requirements and it is too expensive to control compliance with such requirements, some preventive restraints are acceptable and do not violate Article 81.1 (*ex 85.1*) of the EC Treaty (Judgement of 28 January 1986, case 161/84, *Pronuptia*, in *E.C.R.* 1986, 353, para. 21). Analogously, the Panel finds that the Claimants' Proposal would be very difficult and way too expensive to administer and cannot be regarded as a viable alternative to the Contested Rule. Moreover, hardly could a UEFA rule requiring an inherently intrusive ethical examination of clubs' owners, directors and executives be characterized as a «less restrictive» alternative.

134. The Claimants have also mentioned approvingly some of the rules adopted by national leagues with reference to multi-club ownership – in the United Kingdom: Section J.4.2 of the FA Premier League Rules, Paragraph 84.1 of the Football League Regulations, and Paragraph 13 of the Articles of Association of the Scottish Football Association; in the United States: Article 3 of the NBA Articles of Association, and Article 3, Section 3.11 of the MLB National League Constitution – because they have provision for derogation and for individual cases to be considered on their own merits. The Panel, however, upon reading such rules finds that they are in principle *more* restrictive than the Contested Rule, insofar as they forbid a holding of more than 10% of the shares of another club (the Premier League), or a holding of or dealing in *any* shares or securities of more than one club (Football League, Scottish Football Association), or a holding of *any* financial interest in more than one club (NBA, MLB National League). Admittedly, most of these rules provide for the possibility of trying to obtain the prior approval of the respective sports governing body. However, apart from the fact that in practice no such approval has ever been granted, it seems to the Panel that such possibility for derogation in individual cases is strictly linked to the extremely rigorous rules in force within those leagues. Support for this interpretation can be found in the NBA rules, which clearly distinguish between the mere holding of financial interests, where application for derogation is possible, and *control* of more than one club, which is absolutely forbidden with no provision for derogation. The Panel finds that control of more than one club taking part in the same football competition is so inherently conducive to a conflict of interest, and to the related public suspicions, that there is no scope for the examination of individual cases. In addition, any legal regime based on *ad hoc* authorizations would cause unpredictability and uncertainty, and every denial of authorization would in all likelihood bring about expensive litigation, such as the present one. In this respect, the Panel is of the opinion that, for the good of sports and of consumers, it is advisable that sports leagues and federations try to shape their regulations in such a way that organization and administration of sports are not permanently conditioned by the risk of being sued.
135. The Claimants have then proposed other miscellaneous measures as alternatives to the Contested Rule, but the Panel finds that they are not suitable options. One proposed measure is the enactment of rules limiting the number of clubs that the same owner can control but, as has been seen, even two commonly controlled clubs suffice to give rise to conflict of interest problems. Other proposals try to address the issue by requiring that multi-club owners divest their ownership interests in all but one of the owned clubs solely for the period of the UEFA competition. This would be done through the establishment of an independent trust to which control of commonly owned clubs could be transferred for the duration of UEFA competitions or through the appointment of an independent nominee who would exercise the owner's voting rights in its sole discretion. The Panel finds that this solution would be not only complex to administer but also quite intrusive upon the clubs' structure and management; in any event, the true problem would be that the interim suspension of control or voting rights does not modify the substantial ownership of a club, and thus does not exclude the underlying continuance of a conflict of interest. Lastly, the proposed regulations restricting bonuses and transfers of players in view of a game between two commonly owned clubs would only take care of some aspects of the conflict of interest but, in particular, would not avoid the objective problems related to the allocation of



resources by the multi-club owner among its clubs (*supra*, para. 33 *et seq.*) and to the interest of third clubs (*supra*, para. 43).

136. In conclusion, the Panel finds that the Contested Rule is an essential feature for the organization of a professional football competition and is not more extensive than necessary to serve the fundamental goal of preventing conflicts of interest which would be publicly perceived as affecting the authenticity, and thus the uncertainty, of results in UEFA competitions. The Panel finds the Contested Rule to be proportionate to such legitimate objective and finds that no viable and realistic less restrictive alternatives exist. As a result, also in the light of the previous findings that the Contested Rule does not appear to have the object or effect of restricting competition, the Panel holds that the Contested Rule does not violate Article 81 (*ex 85*) of the EC Treaty.

h) Compatibility with Article 82 (*ex 86*) of the EC Treaty

137. The Claimants assert that UEFA is the only body empowered to organize European competitions and, consequently, holds a dominant position in the various European football markets. According to the Claimants, UEFA enjoys a position of economic strength which enables it to behave to an appreciable extent independently of the other undertakings which operate in the relevant markets, including the football clubs which participate in European competitions, and ultimately independently of supporters and spectators. The Claimants also assert that UEFA and its member associations, which normally enjoy monopoly power in their respective countries, enjoy joint dominance by virtue of their economic and legal links. The Claimants argue that the adoption of the Contested Rule constitutes an abuse of UEFA's dominant position contrary to Article 82 (*ex 86*) of the EC Treaty because the Contested Rule restricts competition, is unnecessary and disproportionate, unfairly discriminates between commonly controlled clubs and other clubs, and is not objectively justified. In order to support their contention that UEFA's conduct amounts to an abuse, the Claimants expressly rely on essentially the same arguments already advanced in connection with Article 81 (*ex 85*) of the EC Treaty.

138. The Respondent replies by denying that UEFA is in a dominant position within the meaning of Article 82 (*ex 86*), and in particular by denying that UEFA is able to behave independently of the clubs. The Respondent remarks that adopting a rule to preserve the integrity of the UEFA club competitions cannot amount to an abuse of a dominant position. The Respondent also asserts that the allegations concerning proportionality, discrimination and anti-competitive behaviour contain nothing new, and thus relies on the arguments advanced with reference to previous grounds.

139. The Panel notes that currently UEFA is the only pan-European regulator and administrator of football in general. However, it is not enough to state that a federation enjoys a monopolistic role in regulating and administering its sport, because this is inherent in the current European sports structure and «is recognized to be the most efficient way of organising sport» (EC Commission, *The European model of sport*, Brussels 1999, para. 3.2; *see*

also CAS 96/166 *K. v. FEI*, preliminary award of 18 November 1997, in *Digest of CAS Awards 1986-1998*, *op. cit.*, p. 371, para. 38). The Panel observes that in order to establish whether an undertaking has a dominant position, it is necessary to evaluate such dominance not in the abstract but in relation to one or more specific relevant markets. In this respect, UEFA's activities as an undertaking are developed as the sole – thus far – organizer of pan-European football competitions, retaining the related revenues from the sale of television rights for Champions' League matches and for the final match of the UEFA Cup and from the Champions' League group of sponsors. UEFA also cooperates with local undertakings (national federations or other entities) in organizing the final matches of its competitions. Revenues derived from UEFA's organization of pan-European competitions are apportioned among UEFA, including therein member national associations, and the participating clubs. In substance, UEFA can exert a dominant market power in the market for the organization of pan-European football matches and competitions.

140. In order to find an abuse of dominant position, the Panel needs to find that UEFA is seeking to overcome rival competitors through its dominant market power. In this respect, the Panel observes that if UEFA were found to exploit its market power in order, for example, to obstruct the establishment of another entity organizing pan-European football matches, this should certainly be analyzed with particular attention being paid to Article 82 (*ex 86*) of the EC Treaty. A case of this kind was faced by the Italian competition authority, which held that the Italian sailing federation violated Article 3 of the Italian competition statute – essentially identical to Article 82 of the EC Treaty – insofar as it used its dominant position to obstruct and boycott in various ways an independent organizer of sailing regattas with the purpose of profiting more from the organization of its own regattas (*see Autorità garante della concorrenza e del mercato*, Decision no. 788 of 18 November 1992, *AICI/FIV*, in *Bollettino* 22/1992). However, these theoretical and actual examples appear to bear no analogy to the enactment of the Contested Rule. The Claimants are not trying to organize pan-European competitions, nor are they selling television rights to existing pan-European competitions organized in competition with UEFA (as Media Partners would have done if the planned new pan-European football competitions, the Super League and the Pro Cup, had in fact been created outside of UEFA; *see supra*, para. 19).
141. The Panel has already identified the relevant product market as the market for ownership interests in football clubs capable of taking part in UEFA competitions (*see supra*, para. 100). The Panel observes that UEFA does not own any football club, nor can it buy or run one. Accordingly, UEFA is not present at all on this market and cannot be held to enjoy a dominant position. With respect to the relevant market it appears that UEFA may act, and has acted, only as a mere regulator. The Panel also observes that the national federations are not on the relevant market either; therefore, UEFA and its member associations do not enjoy a joint dominant position on such market. The Panel finds that, as a United States court has recognized, «if a regulation is adopted by an independent sanctioning organization with no financial stake in the outcome, a court will have maximum assurance that the regulation is to protect fair competition within the sport», (*M&H Tire v. Hoosiers*, 733 F.2d 973, 1st Cir. 1984, at 982-983).

142. The Claimants have pointed out that, according to EC case law, in certain circumstances an undertaking dominant on one market can commit an abuse on a neighbouring market (*see* Court of Justice, Judgement of 6 March 1974, cases 6-7/73, *Commercial Solvents*, in *E.C.R.* 1974, 223; *AKZO*, Judgement of 3 July 1991, case C-62/86, in *E.C.R.* 1994, I-3439; Court of First Instance, Judgement of 1 April 1993, case T-65/89, *British Gypsum*, in *E.C.R.* 1993, II-392; Judgement of 6 October 1994, case T-83/91, *Tetra Pak II*, in *E.C.R.* 1994, II-762).
143. The Panel remarks, however, that in all such EC precedents the dominant undertakings were active on both the market of dominance and the neighbouring non-dominated market. Accordingly, in order to find an abuse of dominant position on a market other than the market of dominance it must be proven that, through the abusive conduct, the dominant undertaking – or the group of dominant undertakings in the event of joint dominance – tends to extend its presence also on the other market or tends to strengthen its dominant position on the market of dominance (or at least tends to undermine the competitors’ competitiveness). In the present case, UEFA (or any national federation) is obviously not going to enter, let alone extend its presence, in the market for ownership interests in football clubs. Furthermore, the Claimants have not provided adequate evidence that UEFA, in adopting the Contested Rule, has tried to strengthen its monopolistic position on the market for the organization of pan-European football matches and competitions (nor have Claimants provided any evidence that there is conduct of this kind attributable to the national federations collectively). Besides such lack of evidence, the Panel fails to see any logical link between the rule on multi-club ownership and the alleged attempt or intent to hinder the entry into the market of a new competitor (which could be the group that has planned to establish a «Super League» or some other entity or individual who might try to create a football league in Europe modelled on United States leagues). The opposite would seem more logical, insofar as the Contested Rule tends to alienate multi-club owners and thus might eventually tend to facilitate their secession from UEFA in order to join alternative pan-European competitions or leagues (*see also supra*, paras. 110-113).
144. In any event, with regard to the various abuses alleged by the Claimants, the Panel observes that it has already dealt with them in connection with other grounds. The Panel has found above that the Contested Rule does not restrict competition (*see supra*, paras. 114-123), that it is necessary and proportionate to the objective pursued (*see supra*, paras. 125-136), that it does not unfairly discriminate between commonly controlled clubs and other clubs (*see supra*, para. 65), and that it is objectively justified (*see supra*, para. 130).
145. In conclusion, the Panel holds that the adoption by UEFA of the Contested Rule has not constituted an abuse of an individual or a collective dominant position within the meaning of Article 82 (*ex* 86) of the EC Treaty.

*Swiss competition law: articles 5 and 7 of the Federal Act on Cartels*

146. Article 5.1 of the «*Loi fédérale sur les cartels et autres restrictions à la concurrence*» of 6 October 1995 (*i.e.* the Swiss Federal Act on Cartels and Other Restraints of Competition, hereinafter «Swiss Cartel Act») reads as follows:

*«Les accords qui affectent de manière notable la concurrence sur le marché de certains biens ou services et qui ne sont pas justifiés par des motifs d'efficacité économique, ainsi que tous ceux qui conduisent à la suppression d'une concurrence efficace, sont illicites»* («All agreements which significantly affect competition in the market for certain goods or services and are not justified on grounds of economic efficiency and all agreements that lead to the suppression of effective competition are unlawful»).

It is a provision which essentially corresponds to Article 81 (*ex* 85) of the EC Treaty (*supra*, para. 71).

147. Article 7.1 of the Swiss Cartel Act reads as follows:

*«Les pratiques d'entreprises ayant une position dominante sont réputées illicites lorsque celles-ci abusent de leur position et entravent ainsi l'accès d'autres entreprises à la concurrence ou son exercice, ou désavantagent les partenaires commerciaux»* («Practices of undertakings having a dominant position are deemed unlawful when such undertakings, through the abuse of their position, prevent other undertakings from entering or competing in the market or when they injure trading partners»).

This provision essentially corresponds to Article 82 (*ex* 86) of the EC Treaty (*supra*, para. 71).

148. With respect to the relevance of the Swiss Cartel Act, the Claimants have remarked that the Contested Rule affects trade within Switzerland in that Swiss football clubs are eligible to compete in, and do compete in, UEFA competitions; moreover, the Swiss club FC Basel is currently controlled by ENIC. The Respondent has not objected to the possible relevance of the Swiss Cartel Act in the present dispute. Both the Claimants and the Respondent have essentially relied on the analysis developed with reference to Article 81 (*ex* 85) and 82 (*ex* 86) of the EC Treaty. The only alleged difference with EC law is that, according to the Claimants, there is no «sporting exception» in Switzerland but only a very narrow exemption (to be interpreted quite rigorously) for the «rules of the game» *vis-à-vis* the «rules of law», which cannot be applied in the present case. The Respondent agrees with the Claimants that the Contested Rule cannot be considered as a «rule of the game» under Swiss law, but contends that Swiss competition law is not more restrictive than EC competition law and, therefore, limitations which are introduced with the sole aim of guaranteeing or enhancing sporting quality of competitions can be justified by a sort of sporting exception.
149. With regard to the «sporting exception», the Panel notes that it has already excluded that it can serve the purpose of exempting the Contested Rule from the application of competition rules (*supra*, para. 83). Consequently, the Panel need not rule on whether such an exception exists under Swiss competition law or not. Furthermore, the Panel observes that, in the light

of the textual similarities and the conceptual correspondence of Swiss competition law to EC competition law, the above findings concerning Articles 81 (*supra*, paras. 109-136) and 82 of the EC Treaty (*supra*, paras. 137-145) are applicable *mutatis mutandis* to Articles 5 and 7 of the Swiss Cartel Act. With particular regard to Article 5, the Panel remarks that the envisaged oligopoly scenario (*supra*, para. 117) is much more likely within a small market such as Switzerland, where there are not many teams aspiring to participate in UEFA competitions; indeed, there are only twelve clubs in the Swiss first division. Therefore, the described pro-competitive effect of the Contested Rule is even amplified within the Swiss market. As a result, the Panel holds that, within the Swiss market, the Contested Rule does not significantly restrict competition within the meaning of Article 5 of the Swiss Cartel Act, nor does it constitute an abuse of dominant position within the meaning of Article 7 of the Swiss Cartel Act.

*European community law on the right of establishment and on free movement of capital*

150. Article 43 (*ex* 52) of the EC Treaty prohibits «restrictions on the freedom of establishment of nationals of a member State in the territory of another Member State». Under Article 56 (*ex* 73 B) all restrictions on movement of capital and on payments within the Community and between the Member States and third countries are prohibited. Both provisions are directly effective and can therefore be applied by national tribunals or arbitration courts.
  
151. The Claimants assert that the essence of the Contested Rule is to restrict the possibility of multi-club owners setting up subsidiaries in more than one EC Member State, in violation of Article 43 (*ex* 52) of the EC Treaty. The Claimants also assert that the Contested Rule restricts capital movements within the meaning of Article 56 (*ex* 73 B) of the EC Treaty. The Respondent replies that the Contested Rule, even if caught by such EC provisions, would not infringe them because it is a proportionate means to achieve a legitimate objective.
  
152. The Panel observes that the Contested Rule does not entail any discrimination based on a person's (or corporation's) nationality; therefore, under EC law jargon, it can be characterized as an «equally applicable measure». As a result, even assuming that the Contested Rule somewhat restricts the right of establishment or the free movement of capital, EC case law envisages the existence of justifications on grounds of reasonableness and public interest, provided that the requirements of necessity and proportionality are met (*see supra*, para. 130).
  
153. As the Panel has already noted, the Court of Justice has stated that «*in view of the considerable social importance of sporting activities and in particular football in the Community, the aims of maintaining a balance between clubs by preserving a certain degree of equality and uncertainty as to results ... must be accepted as legitimate*» (Judgement of 15 December 1995, case C-415/93, *Bosman*, in *E.C.R.* 1995, I-4921, para. 106).

Therefore, the aim of the Contested Rule of preserving the authenticity and uncertainty of results – by preventing the conflict of interest inherent in commonly owned clubs participating in the same football competition – is certainly to be considered in principle as a legitimate justification, as long as the aim is pursued through necessary and proportionate means.

154. The Panel has already found that the Contested Rule meets the requirements of objective necessity and of proportionality (*see supra*, paras. 125-136). Consequently, the Panel holds that the Contested Rule does not infringe Article 43 (*ex 52*) and Article 56 (*ex 73 B*) of the EC Treaty.

*General principle of law*

155. The Claimants assert that it is a general principle of law that a quasi-public body exercising regulatory powers, such as an international federation, must not abuse its powers. The Claimants argue that in adopting the Contested Rule UEFA has abused its powers because it has tried to protect its monopoly power over the organization of pan-European football competitions. The Respondent rejects this allegation.

156. The Panel is of the opinion that all sporting institutions, and in particular all international federations, must abide by general principles of law. Due to the transnational nature of sporting competitions, the effects of the conduct and deeds of international federations are felt in a sporting community throughout various countries. Therefore, the substantive and procedural rules to be respected by international federations cannot be reduced only to its own statutes and regulations and to the laws of the country where the federation is incorporated or of the country where its headquarters are. Sports law has developed and consolidated along the years, particularly through the arbitral settlement of disputes, a set of unwritten legal principles – a sort of *lex mercatoria* for sports or, so to speak, a *lex ludica* – to which national and international sports federations must conform, regardless of the presence of such principles within their own statutes and regulations or within any applicable national law, provided that they do not conflict with any national «public policy» (*«ordre public»*) provision applicable to a given case. Certainly, general principles of law drawn from a comparative or common denominator reading of various domestic legal systems and, in particular, the prohibition of arbitrary or unreasonable rules and measures can be deemed to be part of such *lex ludica*. For example, in the CAS award *FIN/FINA* the Panel held that it could intervene in the sanction imposed by the international swimming federation (FINA)

*«if the rules adopted by the FINA Bureau are contrary to the general principles of law, if their application is arbitrary, or if the sanctions provided by the rules can be deemed excessive or unfair on their face»* (CAS 96/157 *FIN v. FINA*, award of 23 April 1997, in *Digest of CAS Awards 1986-1998, op. cit.*, p. 358, para. 22; *see also* CAS OG 96/006 *M. v. AIBA*, award of 1 August 1996, *ibidem*, p. 415, para. 13).

157. The Panel, on the basis of previous remarks, finds that UEFA did not adopt the Contested Rule with the purpose of protecting its monopoly power over the organization of pan-

European football competitions (*see supra*, paras. 110-113 and 143), and finds that the Contested Rule is not arbitrary nor unreasonable (*see supra*, paras. 48 and 125-136). Therefore, with regard to the substantive content of the Contested Rule, the Panel holds that UEFA did not abuse its regulatory power and did not violate any general principle of law.

158. The Panel observes, however, that under CAS jurisprudence the principle of procedural fairness is surely among the unwritten principles of sports law to be complied with by international federations (*see CAS OG 96/001 US Swimming v. FINA*, award of 22 July 1996, in *Digest of CAS Awards 1986-1998, op. cit.*, p. 381, para. 15; *CAS 96/153 Watt v. ACF*, award of 22 July 1996, *ibidem*, p. 341, para. 10). The Panel has already found that UEFA violated its duty of procedural fairness because it adopted the Contested Rule too late, when the Cup Regulations for the 1998/99 season, containing no restriction for multiple ownership, had already been issued and communicated to the interested football clubs (*see supra*, para. 61). The Panel has also already remarked that such procedural defect by itself does not warrant the permanent annulment of the Contested Rule (*see supra*, para. 62). Therefore, as is going to be seen (*infra*, paras. 159-163), the said lack of procedural fairness will have some consequences only in connection with the temporal effects of this award.

### Temporal effects of this award

159. The Panel, approving the CAS interim order of 16 July 1998, has held that UEFA violated its duties of procedural fairness with respect to the 1998/99 season, insofar as it modified the participation requirements for the UEFA Cup at an exceedingly late stage, after such requirements had been publicly announced and the clubs entitled to compete had already been designated (*see supra*, paras. 60-62 and 158). This procedural defect caused the above-mentioned interim suspension of the Contested Rule, freezing the situation as it was before the enactment of the Contested Rule.
160. These proceedings then required more than one whole year to fully develop and come to an end with this award. The interim order appropriately remarked: «*At this preliminary stage, CAS is further of the opinion that the outcome of the Claimants' action is uncertain*» (CAS Procedural Order of 16-17 July 1998, para. 69). The number and complexity of the issues involved and the wide-ranging nature of the dispute have all along given the proceedings a state of uncertainty as to the outcome of the present case. With the release of the present award the CAS ends such state of uncertainty. However, the 1999/2000 football season has already begun and an immediate application of the Contested Rule for this season might involve for some clubs a sudden loss of their eligibility to participate in UEFA competitions (eligibility obtained on the basis of their results in 1998/99 national championships, at a time when the Contested Rule was not in force because of the interim order and there was uncertainty as to the outcome of this case).
161. Moreover, in their written briefs and oral arguments, the Claimants have drawn the Panel's attention to the harmful consequences which might ensue for them and for ENIC from an

award rejecting their petitions. The interim order already stated (*see* CAS Procedural Order of 16-17 July 1998, para. 54) that an adjustment to the Contested Rule should not be arranged hurriedly, and commonly controlled clubs and their owners should have some time to determine their course of action, also taking into account possible legal questions (*e.g.* if shares are to be sold, minority shareholders may be entitled to exercise preemptive rights within given deadlines). There is an obvious need for a reasonable period of time before entry into force, or else the implementation of the Contested Rule may turn out to be excessively detrimental to commonly controlled clubs and their owners.

162. The Panel considers that an immediate application of the effects of the award could be unreasonably harmful to commonly owned clubs which during the recently terminated 1998/99 season have qualified for one of the 1999/2000 UEFA competitions. Such clubs, if any, would find themselves in the same situation as they were in when the CAS rightly stayed the implementation of the Contested Rule. If UEFA had announced in the Summer of 1998 that the Contested Rule was going to be implemented at the beginning of the 1999/2000 football season, no club could have later claimed to have legitimate expectations with respect to the treatment of multi-club ownership. In other words, without a ruling on the temporal effects of this award, the Panel would not give sufficient weight to the procedural defect which occurred in the adoption of the Contested Rule.
  
163. In conclusion, paramount considerations of fairness and legal certainty, needed in any legal system, militate against allowing UEFA to implement immediately the Contested Rule in the 1999/2000 football season which has already begun. Accordingly, the Panel partially upholds the Claimants' petition to extend the stay of the Contested Rule, and deems it appropriate to extend such stay until the end of the current 1999/2000 football season; for the remaining part, the petition for an indefinite extension of the stay is rejected. As a result, the Panel holds that the Contested Rule can be implemented by UEFA starting from the 2000/2001 football season.

### **The Court of Arbitration for Sport:**

1. Rejects the petitions by AEK Athens and Slavia Prague to declare void or to annul the resolution adopted by UEFA on 19 May 1998 on the «Integrity of the UEFA Club Competitions: Independence of the Clubs».
  
2. Partially upholding the petition by AEK Athens and Slavia Prague to extend indefinitely the interim stay ordered by the CAS on 16 July 1998, orders the extension of the stay until the end of the 1999/2000 football season and, accordingly, orders UEFA not to deny admission to or exclude clubs from the 1999/2000 UEFA club competitions on the ground that they are under common control; consequently, UEFA is permitted to implement its resolution of 19 May 1998 starting from the 2000/2001 football season.
  
3. Rejects all other petitions lodged by AEK Athens and Slavia Prague.



## **LEGAL AUTHORITY CA-70**

**International Centre for Settlement of Investment Disputes**

1818 H Street, N.W., Washington, D.C. 20433, U.S.A.  
Telephone: (202) 458-1534 Faxes: (202) 522-2615/2027  
Website: [www.worldbank.org/icsid](http://www.worldbank.org/icsid)

**CERTIFICATE**

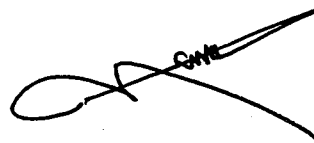
Plama Consortium Limited

v.

Republic of Bulgaria

(ICSID Case No. ARB/03/24)

I hereby certify that the attached is a true copy of the Award of the Arbitral Tribunal,  
dated August 27, 2008.

A handwritten signature in black ink, appearing to read 'Nassib G. Ziadé', with a stylized flourish at the end.

Nassib G. Ziadé  
Acting Secretary-General

Washington, D.C., August 27, 2008

INTERNATIONAL CENTRE FOR SETTLEMENT  
OF INVESTMENT DISPUTES  
WASHINGTON, D.C.

IN THE PROCEEDINGS BETWEEN

**PLAMA CONSORTIUM LIMITED**  
(CLAIMANT)

and

**REPUBLIC of BULGARIA**  
(RESPONDENT)

(ICSID Case No. ARB/03/24)

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**AWARD**

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*Members of the Tribunal*  
Carl F. Salans, President  
Professor Albert Jan van den Berg, Arbitrator  
V.V. Veeder, Arbitrator

*Administrative Assistant to the Tribunal*  
Ms. Anne Secomb

*Representing Claimant*

Mr. Frank H. Penski  
Ms. Abigail Reardon  
*Nixon Peabody LLP*  
Mr. Ciril Pelovski  
*Denev & Oysolov Law Office*

*Representing Respondent*

Mr. Ivan Kondov  
*Head of the Judicial Protection of the Ministry  
of Finance of the Republic of Bulgaria*  
Mr. Paul D. Friedland  
Ms. Carolyn B. Lamm  
Ms. Abby Cohen Smutny  
Mr. Jonathan C. Hamilton  
Mr. Francis A. Vasquez, Jr.  
*White & Case LLP*  
Mr. Lazar Tomov  
*Tomov & Tomov*

Date of dispatch to the Parties: [August 27, 2008]

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ANNEX

## I. INTRODUCTION

1. The present arbitration arises under the Energy Charter Treaty (“ECT” or the “Treaty”), a multilateral convention whose purpose, according to Article 2 thereof, is to establish a legal framework in order to promote long-term cooperation in the energy sector. In Article 10 of Part III of the ECT, Contracting States undertake the obligation to encourage and create stable, equitable, favorable and transparent conditions for Investments of Investors (as those terms are defined in the ECT -- see Annex) of other Contracting States.
2. The conditions include a commitment to accord at all times to Investments of Investors of other Contracting States “fair and equitable treatment,” “the most constant protection and security” and treatment no less favorable than that required by international law. The Contracting Parties further undertake not to impair in any way by unreasonable or discriminatory measures the management, maintenance, use, enjoyment or disposal of Investments and to observe any obligations they have entered into with an Investor or an Investment of an Investor of another Contracting State. Article 13 prohibits expropriation “or measures having effect equivalent to [...] expropriation,” except in certain circumstances and subject to certain conditions. By Article 17 of the ECT, which is also found in Part III, Contracting States reserve the right to deny the advantages of Part III to a legal entity if citizens or nationals of a third State own or control that entity and if that entity has no substantial business activities in the area of the Contracting Party in which it is organized.<sup>1</sup> Part V of the ECT provides for dispute resolution, and its Article 26 permits, *inter alia*, Investors to resort to arbitration pursuant to the ICSID Convention concerning alleged breaches by a Contracting State of an obligation under Part III.

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<sup>1</sup> Bulgaria denied the protections of the ECT to Claimant, prospectively, from 18 February 2003. See paragraph 21 below and the discussion in the Decision on Jurisdiction, pp. 50 *et seq.*

3. Because they are referred to in the Parties' submissions and in this Award, the texts of the relevant provisions of the ECT are set forth in the Annex to this Award.

## **II. PROCEDURE**

### **A. Registration of the Request for Arbitration**

4. On 6 January 2003, the International Centre for Settlement of Investment Disputes ("ICSID" or "the Centre") received a request for arbitration dated 24 December 2002 ("Request for Arbitration") from Plama Consortium Limited ("PCL" or "Claimant"), a Cypriot company, with its address at 4 Tenarou Street, Ayios Dometios, Nicosia, Cyprus, against the Republic of Bulgaria ("Bulgaria" or "Respondent"). The two parties together are referred to as "the Parties." The Request for Arbitration invoked the ICSID arbitration provisions of the ECT and the most favored nation ("MFN") provision of a bilateral investment treaty ("BIT") concluded in 1987 between the Government of the Republic of Cyprus and the Government of the People's Republic of Bulgaria ("the BIT"), which allegedly imported into the BIT the ICSID arbitration provisions of other BITs concluded by Bulgaria, in particular the Bulgaria – Finland BIT.
5. The Centre, on 14 January 2003, in accordance with Rule 5 of the ICSID Rules of Procedure for the Institution of Conciliation and Arbitration Proceedings ("ICSID Institution Rules"), acknowledged receipt of the Request for Arbitration and, on the same day, transmitted a copy to Bulgaria and to the Bulgarian Embassy in Washington, D.C., USA.
6. There ensued exchanges of correspondence between the Parties and the Acting Secretary-General of ICSID concerning the jurisdiction of ICSID over the Request for Arbitration and its registerability under Article 36(3) of the Convention on the Settlement of Investment Disputes Between States and Nationals of Other States ("the ICSID Convention") and ICSID Institution Rules 6 and 7.
7. On 17 April 2003, Claimant filed a Supplement to Request for Arbitration dated 6 April 2003. The Centre acknowledged receipt of the Supplement to

Request for Arbitration on 17 April 2003 and, on the same day, transmitted a copy to Bulgaria and to the Bulgarian Embassy in Washington, D.C.

8. Upon requests from both Parties, the Centre deferred registration. A further postponement of registration was sought by Respondent on 12 August 2003 but was opposed by Claimant.
9. The Request for Arbitration, as supplemented, was registered by the Centre on 19 August 2003, pursuant to Article 36(3) of the ICSID Convention and, on the same day, the Acting Secretary-General, in accordance with ICSID Institution Rule 7, notified the Parties of the registration and invited them to proceed to constitute an Arbitral Tribunal as soon as possible.
10. By letter of 12 June 2003, Emmanuel Gaillard and John Savage of the law firm Shearman & Sterling LLP<sup>2</sup> informed the Centre that they had been retained to represent Claimant, replacing Christian Nordtømme in these proceedings. Claimant further advised that it was also represented by Ciril Pelovski of the law firm Denev & Oysolov. On 20 August 2003, Respondent informed the Centre that it had retained as Counsel in the proceedings Paul D. Friedland, Carolyn B. Lamm and Abby Cohen Smutny of the law firm White & Case LLP. By a letter of 25 March 2004, Respondent further indicated having retained Lazar Tomov of the law firm Tomov & Tomov.

**B. Constitution of the Arbitral Tribunal and Commencement of the Proceedings**

11. Following the registration of the Request for Arbitration by the Centre, the Parties agreed on a three-member arbitral tribunal (the “Arbitral Tribunal” or the “Tribunal”). The Parties agreed that each of them would appoint an arbitrator and that the third arbitrator, who would be the President of the Tribunal, would be appointed by agreement of the Parties. The Parties agreed that the Centre would appoint the President of the Arbitral Tribunal should they fail to agree on the presiding arbitrator.

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<sup>2</sup> Subsequently, Shearman & Sterling was succeeded as Counsel to Claimant by Virginie Colaiuta and, thereafter, by the law firm Nixon Peabody LLP, *see infra*, paragraphs 38 and 45.



16. At that first session of the Arbitral Tribunal held in Paris on 25 March 2004, the Parties reiterated their agreement on the points communicated to the Tribunal in their joint letter of 19 March 2004, and the remainder of the procedural issues on the agenda for the session were discussed and agreed. All the conclusions were reflected in the written minutes of the session, signed by the President and the Secretary of the Arbitral Tribunal and provided to the Parties, as well as all members of the Tribunal. It was agreed that Respondent's objections to jurisdiction would be treated as a preliminary question. A schedule for the filing of memorials and for the holding of a hearing on jurisdiction in Paris on 20 and 21 September 2004 was agreed.
17. Pursuant to the agreed schedule, Respondent filed a Memorial on Jurisdiction on 26 May 2004. In support of its Memorial, Respondent submitted written statements of MM. Rudolph Dolzer, Charles Kerins, Sean McWeeney, Elias A. Neocleous, Timothy O'Neill, Christo Tepavitcharov and Thomas W. Wälde, accompanied by a further copy of Mr. Jean Christophe Vautrin's first declaration.<sup>4</sup> Claimant submitted a Counter-Memorial on Jurisdiction dated 25 June 2004, supported by Mr. Jean Christophe Vautrin's second declaration and a declaration from Mr. Jacques Python. This was followed, on 26 July 2004, by a Reply on Jurisdiction from Respondent, accompanied by statements from MM. Stanislav Ananiev, Alexander D. Boshkov, Elias A. Neocleous, Plamen Oresharski, Todor Marinov Palazov, Tencho Ivanov Tenev, Nikolay Vassilev and Milen Veltchev. Claimant's Rejoinder on Jurisdiction, dated 26 August 2004, supported by Mr. Jean Christophe Vautrin's third declaration, was received by the Centre on 30 August 2004.
18. On 26 July 2004, Respondent submitted to the Arbitral Tribunal a request for the production of documents by Claimant. By letter dated 6 August 2004, Claimant opposed that request. After considering the views of the Parties, the Arbitral Tribunal, on 11 August 2004, issued Procedural Order No. 1 directing Claimant to produce all documents falling within the categories listed in the

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<sup>4</sup> Mr. Vautrin's first declaration had been submitted earlier by Claimant's Counsel at the Tribunal's first session of 25 March 2004.

Order, no later than with the filing of its Rejoinder on Jurisdiction. Claimant filed certain documents with its Rejoinder of 26 August 2004. Further to a request for extension made on 17 August 2004, which was accepted by Respondent, Claimant submitted to Respondent, under cover of a letter dated 6 September 2004, other documents pursuant to the Tribunal's Order. Claimant produced an additional set of documents by letter dated 13 September 2004.

19. An oral hearing on the preliminary question of jurisdiction was held in Paris on 20 and 21 September 2004. Counsel for both Parties addressed the Tribunal. One witness, Mr. Jean-Christophe Vautrin, testified orally for Claimant.
20. On 22 October 2004, Respondent filed a Post-Hearing Submission on Jurisdiction, to which Claimant responded by its Post-Hearing Response on Jurisdiction of 19 November 2004. On 3 December 2004, Respondent filed a Post-Hearing Reply on Jurisdiction.
21. On 8 February 2005, the Arbitral Tribunal rendered its Decision on Jurisdiction. In the operative part, it ruled as follows:
  - A. *As to the jurisdictional issues with respect to the ECT:*
    - (1) *Under Article 26 ECT and the ICSID Convention, the Tribunal has jurisdiction to decide on the merits the Claimant's claims against the Respondent for alleged breaches of Part III of the ECT.*
    - (2) *Article 17(1) ECT has no relevance to the Tribunal's jurisdiction to determine the Claimant's claims against the Respondent under Part III of the ECT.*
  - B. *As to the merits of the Respondent's case under Article 17(1) ECT:*
    - (1) *Article 17(1) requires the Contracting State to exercise its right of denial and such exercise operates with prospective effect only, as it did in this case from the Respondent's exercise by letter of 18 February 2003.*

- (2) *The second limb of Article 17(1) regarding “no substantial business activities” is met to the Tribunal’s satisfaction in favor of the Respondent; and*
- (3) *The Tribunal declines for the time being to decide the first limb of Article 17(1) regarding the Claimant’s “ownership” and “control.”*
- C. *The most favored nation provision of the Bulgaria-Cyprus BIT, read with other BITs to which Bulgaria is a Contracting Party (in particular the Bulgaria-Finland BIT), cannot be interpreted as providing the Respondent’s consent to submit the dispute with the Claimant under the Bulgaria-Cyprus BIT to ICSID arbitration or entitling the Claimant to rely in the present case on dispute settlement provisions contained in these other BITs.*
- D. *The Tribunal rejects the Respondent’s application to suspend the proceedings pending the final outcome of the litigation concerning Dolsamex and Mr. O’Neill.*
- E. *The arbitration will now move to the second phase, that is, an examination of the parties’ claims on the merits.*
- F. *A decision on costs is deferred to the second phase of the arbitration on the merits.*

This decision is incorporated by reference into the present award (collectively the “Award”).

- 22. The Parties then agreed on a procedural timetable for the merits phase, which was reflected in Procedural Order No. 2 dated 31 March 2005. On the same date, the Centre sent to the Parties new certified copies of the Decision on Jurisdiction correcting a clerical error at paragraph 55 of the Decision.
- 23. On 29 July 2005, Claimant filed a Request for Urgent Provisional Measures in accordance with ICSID Arbitration Rule 39, seeking urgent recommendations of provisional measures pursuant to Article 47 of the ICSID Convention. Claimant sought an order recommending that, *inter alia*, (1) Respondent

immediately discontinue and/or cause to be discontinued all pending proceedings and refrain from bringing or participating in any future proceedings before the Bulgarian courts and Bulgarian authorities relating in any way to this ICSID arbitration; and (2) Respondent take no action that might aggravate or further extend the dispute.

24. On 19 August 2005, Respondent filed its Opposition to Claimant's Request for Urgent Provisional Measures, contending that the relief sought by Claimant was unnecessary because Claimant had failed to demonstrate that its rights in this ICSID arbitration would be irreparably harmed without the measures it sought.
25. This was followed by Claimant's Response to Respondent's Opposition to Claimant's Request for Urgent Provisional Measures dated 25 August 2005, and Respondent's Rejoinder to Claimant's Request for Urgent Provisional Measures dated 31 August 2005. A procedural meeting by telephone conference with the Parties' Counsel followed on 1 September 2005, during which the Arbitral Tribunal put various questions to Counsel and discussed the procedure and timetable for rendering the order on provisional measures.
26. On 6 September 2005, the Arbitral Tribunal issued an Order rejecting Claimant's Request for Urgent Provisional Measures in its entirety and reserving its decision on the costs resulting from the foregoing procedure to a later stage of the arbitration.
27. Following Claimant's request of 30 September 2005, the Arbitral Tribunal granted to Claimant a four-week extension of time to submit its Memorial on the Merits and issued, on 6 October 2005, Procedural Order No. 3, which modified the procedural calendar set forth in Procedural Order No. 2 for the filing of submissions on the merits.
28. Accordingly, Claimant filed its Memorial on the Merits on 28 October 2005, supported by the fourth written declaration of Mr. Jean Christophe Vautrin as well as written declarations by Mr. Vladimir Lazarov and Mr. Dimitar Stefanov and expert reports by MM. Robert Duchesne, Nikolay Todorov Dikov and Lyubomir Denev. On 22 December 2005, Claimant sent English translations of some of the exhibits to its Memorial on the Merits and asked

the members of the Arbitral Tribunal to incorporate into their respective copies of the Memorial corrections of some clerical errors therein.

29. On 7 February 2006, Respondent asked Claimant to produce certain documents by 28 February 2006. Although not within the time frame requested by Respondent, Claimant did submit numerous responsive documents but objected to some of Respondent's requests.
30. By e-mail and facsimile of 21 April 2006, Respondent requested an order from the Arbitral Tribunal calling upon Claimant to produce, by 5 May 2006, various documents set forth in its request of 7 February 2006 which Claimant had failed to produce.
31. After further correspondence on this subject between the Parties and considering their respective positions, the Tribunal issued Procedural Order No. 4 on 27 April 2006, directing Claimant to produce to Respondent additional documents.
32. By letter dated 22 May 2006, Respondent requested a modification of the procedural timetable, to which Claimant agreed. On 26 May 2006, the Arbitral Tribunal issued Procedural Order No. 5 to modify, as per the Parties' agreement, certain dates for the filing of submissions in the merits phase set forth in Procedural Order No. 3.
33. Following the execution by the Parties of a confidentiality agreement, Claimant further produced, on 16 June 2006, two confidential documents.
34. On 28 July 2006, Respondent filed its Counter-Memorial on the Merits supported by statements from MM. Kaloyan Vassilev Bonev, Milcho Dimitrov Boyadzhiev, Doncho Brainov, Hristo Dimitrov, Chavdar Georgiev Georgiev, Georgi Ivanov Georgiev, Roumen Georgiev Hristov, Bojko Iliev, Krassimir Vutev Katev, Nikolay Kavardzhikliev, Lyubka Kostova, Nikola Djipov Nikolov, Nikolai Marinov Nikolov, Lyudmil Zhivkov Parvanov, Ognyan Viktorov Petkov, Aksinia Stoyanova Slavcheva, Lilia Nikolova Smokova, Tencho Ivanov Tenev, Tsvetan Tsekov, Maria Lyubenova Tsekova, Nikolay Vassilev and Svetoslav Yordanov and accompanied by legal opinions of Mr. Teodor Antonov Chipev and Professor Metody Markov as well as reports

by Gaffney, Cline & Associates, Navigant Consulting, Inc. and Transacta OOD.

35. By letter dated 10 September 2006, Claimant notified the Tribunal and Respondent that Shearman & Sterling was no longer acting as Claimant's legal Counsel in this arbitration and requested an extension of three months for filing its Reply and such further adjustments to the procedural calendar as would consequently be required.
36. In a letter of 14 September 2006, Respondent objected to this request but urged the Arbitral Tribunal, if it should, nevertheless, grant Claimant's request, to do so only on the condition that Claimant post security in the form of a bond in the amount of no less than USD 2,000,000 against an award of costs in Respondent's favor.
37. On 20 September 2006, the Arbitral Tribunal issued Procedural Order No. 6 in which it (1) agreed in principle to grant a maximum three-month extension of time to Claimant for the filing of its Reply from the date of Claimant's request, (2) urged Claimant to act with the utmost diligence in appointing new Counsel, (3) stated that it would decide the consequent modification of the procedural calendar after discussion with the Parties' Counsel, including Claimant's new Counsel, in a conference call during which the Tribunal would also hear the Parties' arguments regarding Respondent's request that Claimant be ordered to post security for costs, and (4) invited Claimant to submit, by 6 October 2006, any comments it wished to make concerning Respondent's request for security for costs.
38. On 18 December 2006, Claimant informed ICSID that it had appointed new Counsel to represent it in the person of Virginie A. Colaiuta, 25 Boulevard de l'Amiral Bruix, 75782 Paris Cedex 16, France.<sup>5</sup>
39. There ensued correspondence between the Parties and the Arbitral Tribunal in which, among other matters, Respondent requested an increase in the amount of the security for costs that Claimant be ordered to post to USD 9,000,000

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<sup>5</sup> Ms. Colaiuta's address was subsequently changed to 9 rue de Picardie, 75003 Paris, France.

and, in addition, requested that any further proceedings in this arbitration be limited to the oral hearing, contending that Claimant had foregone its right to file any additional written submissions by failing to file its Reply by the deadline fixed in Procedural Order No. 6.

40. It proved difficult to find an early common date for the procedural meeting by conference call envisaged in Procedural Order No. 6. Consequently, the Tribunal organized a meeting in person with the Parties in Paris on 16 February 2007 to discuss Respondent's requests to limit the written phase of these proceedings and to order Claimant to post a bond as security for costs, as well as to fix a time schedule for the future conduct of the arbitration.
41. After hearing presentations by the Parties' Counsel on Respondent's request to limit the proceedings, the Tribunal decided not to grant that request. It communicated that decision to the Parties in writing by Procedural Order No. 8, dated 21 February 2007. The Tribunal next heard the Parties' arguments regarding security for costs. The Parties and the Tribunal then discussed the further steps in these proceedings, the result of which was agreement on a procedural calendar, communicated to the Parties in Procedural Order No. 7 on 21 February 2007. Following the meeting, the Arbitral Tribunal issued Procedural Order No. 9 on 28 February 2007, denying Respondent's request for security for costs. ICSID issued summary minutes of the meeting.
42. Pursuant to Procedural Order No. 7, Claimant made requests to Respondent for the production of documents. With respect to those requests regarding which the Parties could not agree, the Arbitral Tribunal issued Procedural Order No. 10 deciding upon the various document production requests at issue. In an accompanying letter, the Tribunal denied Claimant's request for additional time to file its Reply.
43. By Procedural Order No. 11, the Arbitral Tribunal extended Claimant's time to file its Reply by a few days.
44. Claimant filed its Reply to Respondent's Counter-Memorial on 11 April 2007, together with a second expert report by Mr. Duchesne.
45. In a letter of 25 May 2007, Ms. Colaiuta informed the Arbitral Tribunal that she was withdrawing as Counsel to Claimant. The Tribunal was subsequently

advised that the law firm Nixon Peabody LLP, of 437 Madison Avenue, NY, NY, USA had been appointed by Claimant as its new Counsel.

46. Respondent submitted a Rejoinder on the Merits, dated 27 July 2007, accompanied by written statements of MM. Ivan Iskrov, Alexander Rakov, Nikloay Vassilev and Svetoslav Yordanov, as well as a legal opinion of Mr. Teodor Antonov Chipev, an expert report of Ms. Villy Dashinova-Stefanova, a supplemental expert report of Gaffney, Cline & Associates, a supplemental legal opinion of Professor Metody Markov and a second expert report of Navigant Consulting, Inc.
47. A procedural meeting by telephone conference with the Parties and the Arbitral Tribunal took place on 22 October 2007 for the purpose of preparing the hearing scheduled for January – February 2008 and to address certain other procedural matters. Prior to that conference, the Tribunal circulated to the Parties an agenda and requested the Parties to consult each other with a view to agreeing on a common approach to the agenda's items. The Parties submitted a joint letter dated 18 October 2007 responding to the Arbitral Tribunal's request. Following the telephone conference, ICSID issued summary minutes of the discussion, and the Arbitral Tribunal issued Procedural Order N° 12, dated 30 October 2007, containing its decisions and instructions regarding the matters discussed.
48. On 12 November 2007, Respondent addressed a letter to the Arbitral Tribunal objecting to certain decisions in Procedural Order N° 12. Claimant submitted its comments regarding Respondent's objections in a letter dated 13 November 2007. The Tribunal rendered its decision regarding Respondent's objections on 14 November 2007, which was communicated by ICSID to the Parties.
49. On 8 January 2008, Respondent addressed a letter to the Arbitral Tribunal objecting to the use of a specific exhibit by Claimant in the impending oral hearing. Claimant offered its comments to Respondent's objection by letter of 10 January 2008. The Tribunal rendered its decision regarding Respondent's objections on 11 January 2008, which was communicated by ICSID to the Parties.



50. A hearing on the merits was held at the seat of the Centre in Washington D.C. from 28 January 2008 to 1 February 2008. Counsel for both Parties addressed the Arbitral Tribunal. One witness, Mr. Jean-Christophe Vautrin, and one expert, Mr. Robert Duchesne, appeared for Claimant. Five witnesses, Ms. Aksinia Stoyanova Slavcheva, Minister Nikolay Vassilev, Mr. Svetoslav Yordanov, Mr. Ognyan Viktorov Petkov and Mr. Nikola Djipov Nikolov appeared for Respondent, as well as two experts, Ms. Zoë Reeve of Gaffney, Cline & Associates and Mr. Brent Kaczmarek of Navigant Consulting, Inc. All witnesses and experts were cross-examined by opposing Counsel and re-examined by Counsel for the Party presenting them. ICSID issued summary minutes of the hearing on 13 February 2008.
51. On 20 March 2008, both Parties made written Post-Hearing Submissions.
52. Final oral argument was made by Counsel for the two Parties at a hearing in Washington, D.C. at the seat of the Centre on 14 April 2008.
53. Following the hearing for oral argument, both Parties filed their claims for costs in written submissions dated 21 May 2008. Each Party filed written comments regarding the cost submission of the other on 4 June 2008.
54. The Arbitral Tribunal pronounced the proceedings closed on 9 June 2008 according to ICSID Arbitration Rule 38(1).

### III. SUMMARY OF THE DISPUTE

55. The following is a summary of the dispute in the present case. Additional facts appear in Chapters IV and V, “Discussion of the Issues,” *infra*. The facts set forth in this Award are those which the Tribunal determines to be most relevant to its decisions on the Parties’ respective cases.

#### A. The Refinery’s Acquisition

56. Prior to its privatisation in 1996, Plama AD, which later changed its name to Nova Plama AD (“Nova Plama”), was a Bulgarian 100% State-owned joint stock company which owned an oil refinery (“the Refinery”) in Bulgaria. On 5 September 1996, Bulgaria privatized Nova Plama and sold 75% of its shares to EuroEnergy Holding OOD (“EEH”) (the “1996’ or ‘First’ Privatization

Agreement”, Claimant’s Exhibit (“C’s Exh.”) 177). In October 1997, EEH increased Nova Plama’s capital, after which EEH held 96.78% of the company’s outstanding and issued share capital.

57. A year later, Claimant – then known as Trammel Investment Limited – purchased from EEH all of EEH’s 49,837,849 shares of Nova Plama, which represented that 96.78% shareholding. The share purchase agreement, which was subject to the consent of the Bulgarian Privatization Agency, was concluded on 18 September 1998 (C’s Exh. 128). The agreement was amended on 18 December 1998 (C’s Exh. 182).
58. Negotiation for the purchase of Nova Plama shares started at the end of 1997 when Mr. Jean-Christophe Vautrin, who was then working at André & Cie (“André”), a Swiss multinational company involved in trading, project and trade financing, energy and transportation, was contacted by Mr. Boni Bonev of Banque Internationale pour le Commerce et le Developpement (“BICD”). Mr. Bonev mentioned that PriceWaterhouseCoopers (“PWC”) had approached the BICD on behalf of EEH, which was seeking to obtain trade financing facilities for the Refinery (see Claimant’s Counter-Memorial on Jurisdiction, para. 49; Respondent’s Counter-Memorial on the Merits, para. 15).
59. At around the same time, Mr. Vautrin was also approached by the Central Wechsel und Creditbank, which expressed its willingness to facilitate financing for the Refinery, provided, *inter alia*, that it received a counter-guarantee from various partners, including a lubricant oil specialist. Consequently, Mr. Vautrin contacted Mr. Harald Svindseth from Norwegian Oil Trading AS (“NOT”), a company that specialised in the distribution and fabrication of lubricants in emerging markets (see Claimant’s Counter-Memorial on Jurisdiction, para. 49).
60. While André and NOT were not willing to provide financing to EEH because they doubted its trustworthiness, they expressed an interest in acquiring EEH’s shares in Nova Plama. Although negotiations broke down in February 1998, they resumed later that year (see Claimant’s Counter-Memorial on Jurisdiction, para. 52; Respondent’s Counter-Memorial on the Merits, para. 17). As a result, on 18 August 1998, NOT and André entered into a

Memorandum of Agreement with the Privatization Agency (also referred to as the “Memorandum of Understanding”), which was subsequently amended on 21 September 1998 (Respondent’s Exhibits (“R’s Exhs.”) 664, 671), by which the Privatization Agency, in accordance with Article 22 of the First Privatization Agreement, gave consent for the sale and transfer of all shares of Nova Plama to a company presented by NOT and André, provided the satisfaction of a number of conditions stated therein was assured.

61. These conditions, as amended on 21 September 1998, included *inter alia*, (i) evidence of financial resources to resume the operation of the Refinery; (ii) an agreement with the trade unions of Nova Plama; (iii) an agreement with the main creditors of Nova Plama; and (iv) an agreement with the Privatization Agency to “*take over any and all purchaser rights*” in accordance with the First Privatization Agreement (R’s Exhs. 664, 671).
62. On 5 October 1998, Claimant submitted a letter from the Central Wechsel und Creditbank stating that a USD 8 million facility “*for start up and operation of Plama refinery is being organised with the guarantee of André & Cie S.A and Norwegian Oil Trading a.s.*” (R’s Exh. 672). On 11 October 1998, PCL signed an agreement with Nova Plama’s employees (R’s Exh. 673); and, on 26 October 1998, PCL and various creditors of Nova Plama entered into a Debt Settlement Agreement (R’s Exh. 675).
63. Finally, on 17 November 1998, Claimant and the Bulgarian Privatization Agency entered into an agreement (“the Second Privatization Agreement,” R’s Exh. 676) specifying, *inter alia*, the obligations taken over by Claimant under the First Privatization Agreement and indicating that the date of entry into force would be the date of transfer of Nova Plama shares from EEH to PCL .
64. By letter dated 23 November 1998, the Privatization Agency informed EEH and PCL that the conditions stipulated by the Memorandum of Agreement had been met and that, consequently, the Privatization Agency gave its final consent to the transfer of shares (R’s Exh. 677). Following approval by the Privatization Agency, the transfer of shares took place on 18 December 1998.
65. Following a Bulgarian court decision in 2004 invalidating the 1997 capital increase, Nova Plama’s registered share capital reverted to the original number

of shares, so that Claimant then owned 75% of Nova Plama's shares (C's Exh. 183, note 14).

**B. The Refinery's Operation and the Bankruptcy**

66. The Refinery's key industrial asset was a lubricants manufacturing unit which had processed base-oils produced by the Refinery into a wide range of industrial and consumer lubricants which were used as raw materials for lubricants at the Refinery or by third party blenders. Nova Plama also had its own power plant, with a capacity for sales of excess electric power to the local grid.
67. Nova Plama ceased operations in 1996, while it was still State-owned, due to poor economic conditions and, during EEH's ownership, production was never resumed (Hearing Transcript ("H. Tr."), Day 1, 28 January 2008, p. 28 at lines 20 *et seq.*, p. 85 at lines 14 *et seq.*). On 10 June 1998, Bulgaria's State Fund for Reconstruction and Development initiated insolvency proceedings against Nova Plama (C's Exh. 167). It was while the insolvency proceedings were underway that EEH agreed, with the consent of the relevant Bulgarian authorities, to sell its shares in Nova Plama to Claimant and that the Second Privatization Agreement was concluded.
68. The Refinery re-commenced operations in January 1999, shortly after its acquisition by Claimant, but shut down again in early April 1999 (Claimant's Memorial on the Merits, paras. 37 and 156; H. Tr., Day 1, 28 January 2008, pp. 50 *et seq.* and 202 *et seq.*; R's Exh. 376; Respondent's Counter-Memorial on the Merits, paras. 46 *et seq.*). Claimant and Nova Plama submitted to the Pleven District Court a Recovery Plan dated 5 May 1999, which had been negotiated with Nova Plama's creditors and other interested parties (including the Bulgarian Government). The Court approved this Recovery Plan and terminated Nova Plama's bankruptcy proceedings by decision of 8 July 1999 (R's Exh. 409). In August 1999, Nova Plama's operations resumed, but only until December 1999, when the Refinery was shut down for good (Claimant's Memorial on the Merits, para. 156; Respondent's Counter-Memorial on the Merits, para. 53; H. Tr., Day 1, 28 January 2008, p. 59, lines 11 *et seq.*, p. 69 lines 3 *et seq.*). Discussions ensued among the various interested parties to get

the Refinery back into operation, all of which failed for reasons which are at the heart of the present dispute between the Parties.

69. It should be noted that, as a provisional measure, during the 1998 insolvency proceedings, the bankruptcy court had appointed two provisional syndics or trustees in bankruptcy on 25 June 1998, Syndic Penev and Syndic Todorova (R's Exh. 898); their appointment was extended by the court's decision to open bankruptcy proceedings on 29 July 1998.
70. By decision of 18 May 1999, the Pleven District Court appointed Mr. Penev as a permanent syndic (R's Exh. 900).
71. In July 2005, creditors of Nova Plama re-opened the bankruptcy proceedings, a decision reversed by order of the Bulgarian Supreme Cassation Court of 27 December 2005 (R's Exh. 572). Upon re-filing by the creditors of their applications, the Pleven District Court re-opened the bankruptcy proceedings on 28 April 2006 (R's Exh. 966). Nova Plama underwent liquidation and, on 18 June 2007, its assets were sold to Highway Logistics Center ECOD for approximately USD 30.6 million (R's Exh. 1036; Second Navigant Report, p. 31; H. Tr., Day 1, 28 January 2008, p. 20, lines 3 *et seq.* and p. 73, lines 17 *et seq.*; Respondent's Rejoinder on the Merits, para. 8d).
72. Claimant alleges that the Bulgarian Government, the national legislative and judicial authorities and other public authorities and agencies deliberately created numerous, grave problems for Nova Plama and/or refused or unreasonably delayed the adoption of adequate corrective measures. These actions and omissions, according to Claimant, caused material damage to the operations of the Refinery and have had a direct negative impact on the reputations and market values of the respective Plama Group companies. Bulgaria's actions and/or omissions violate the ECT, to which both Bulgaria and Cyprus are parties.<sup>6</sup>

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<sup>6</sup> Bulgaria ratified the ECT on 15 November 1996 and Cyprus on 16 January 1998.

### C. The Dispute

73. It is Claimant's case that, in violation of its obligations under the ECT, Bulgaria has failed to create stable, equitable, favorable and transparent conditions for Claimant's investment in Nova Plama; failed to provide Claimant's investment fair and equitable treatment; and failed to provide Claimant's investment the most constant protection and security. Bulgaria has subjected Claimant's investment to unreasonable and discriminatory measures, breached its contractual obligations *vis-à-vis* Claimant, and has subjected Claimant's investment to measures having an effect equivalent to expropriation. Bulgaria's actions have, Claimant contends, deprived PCL of its chance to make its investment in Nova Plama successful and profitable (Claimant's Reply on the Merits, para. 44). In its Request for Arbitration, Claimant also submits that Respondent had breached its obligations under Article 10(12) of the ECT. It claims compensation for all of these breaches.

74. Respondent denies Claimant's allegations.

75. A statement of the Parties' respective positions on the issues is set forth in Chapters IV and V of this Award, in which the Tribunal examines Bulgaria's alleged breach of its obligations under the ECT and the Parties' respective positions. Before that analysis, the Tribunal will address, as a preliminary matter, the issues that were left unresolved in the Decision on Jurisdiction: Claimant's 'ownership' and 'control' and the allegations on misrepresentation by Claimant.

76. While the Tribunal will not elaborate each and every one of the Parties' arguments with respect to each issue, it has submitted all arguments to exhaustive examination. It will confine itself in the following discussion to those issues which it considers most relevant to the decisions it must make.

### IV. **PRELIMINARY DISCUSSION: CLAIMANT'S 'OWNERSHIP' AND 'CONTROL' AND THE ALLEGATIONS OF MISREPRESENTATION**

77. In the operative part of the Decision on Jurisdiction, quoted at paragraph 21 above, two matters were reserved for decision at a later stage: First, the question whether Claimant is a legal entity owned or controlled by citizens or nationals of a State Party to the ECT – this is a question regarding the first

limb of Article 17(1) of the ECT (see Decision on Jurisdiction, paras. 170-178 and 240(B)(3)); and second, the question whether Claimant has misrepresented or willfully failed to disclose to Respondent Claimant's true ownership (see Decision on Jurisdiction, paras. 126-131 and 228-230). These two questions will be examined in the present Section.

78. It is important to note that, in its Decision, the Tribunal made clear that none of these issues affected its jurisdiction and that, consequently, it joined them to the consideration of the merits of the case (see Decision on Jurisdiction, paras. 151 and 229-230 and paras. 130-144 *infra*). A third question deferred in the Decision on Jurisdiction to this second phase of the arbitration, that of costs, is dealt with in Chapter V. F. below.

**A. Is Respondent Entitled to Deny the Advantages of Part III of the ECT to Claimant under Article 17(1)?**

79. Article 17 of the ECT provides:

*Each Contracting Party reserves the right to deny the advantages of this Part [Part III] to:*

*(1) a legal entity if citizens or nationals of a third state own or control such entity and if that entity has no substantial business activities in the Area of the Contracting Party in which it is organized; . . .*

80. Under Article 17(1) of the ECT, Respondent can refuse to afford the protections of Part III of the ECT to Claimant if the latter has no substantial business activities in the State Party to the ECT where it is incorporated and if it is not owned or controlled by nationals of a Contracting Party. Both conditions must be met before a Contracting State may invoke Article 17(1). Both Parties accepted that ownership or control may be direct or indirect.
81. Claimant is incorporated in Cyprus. Cyprus is a party to the ECT. Claimant has acknowledged that it does not have significant business activities in Cyprus (Claimant's Rejoinder on Jurisdiction, footnote 49).

82. The question then arises whether Claimant is owned or controlled by a national or another Contracting Party. The burden of proof on this issue lies with Claimant (C's Exh. 3, p. 18, para. IV section 3).
83. Mr. Vautrin is a French national and, therefore, a national of a Contracting Party (France being a party to the ECT). Mr. Vautrin claims that he indirectly owns and controls 100% of the shares of PCL.
84. As previously stated (para. 57 *supra*), as a result of the Second Privatization Agreement, PCL became the owner of 96.78% of the shares of Nova Plama. At the time, Plama Holding Limited ("PHL"), another Cyprus company, was the beneficial owner of 100% of the shares of PCL (C's Exhs. 41, 42, 43, 93 and 94). Subsequently, PCL issued additional shares to EMU Investments Limited ("EMU"; C's Exhs. 51, 52 and 95), a company incorporated in the British Virgin Islands (C's Exh. 53). As a consequence, PHL owns 20% of the shares of PCL and EMU, 80%. On 13 September 1998, PHL issued 500 shares to Mediterranean Link (Nominees) Limited and 100 shares to Mediterranean Link (Trustees) Limited, both acting as nominees of EMU. PHL also issued 400 shares to Mediterranean Link (Trustees) as nominee of NOT (C's Exhs. 47, 48 and 49). On 26 October 1998, these 400 shares were transferred from Mediterranean Link (Trustees) Limited, as nominee of NOT, to Mediterranean Link (Trustees) Limited, as nominee of EMU (C's Exh. 50). Thus, since 26 October 1998, EMU owned 100% of the shares of PHL. The capital of EMU is represented by 60 bearer shares (C's Exhs. 54 and 74), 30 of which are said by Claimant to be held in trust for Mr. Vautrin by Mr. Per Christian Nordtømme and 30 of which are said to be held in trust for Mr. Vautrin by Mr. Tom Eivind Haug (see affidavits of MM. Nordtømme and Haug, C's Exhs. 57 and 58, and statements of Mr. Vautrin).
85. Respondent contends that the evidence produced by Claimant is not sufficient to establish Mr. Vautrin's indirect ownership or control of PCL. Among other matters, Respondent has produced documents which indicate that two companies incorporated in the Seychelles, Allspice Trading Inc. ("Allspice") and Panorama Industrial Limited ("Panorama") owned and may still own EMU, and that Panorama agreed to pledge 30 bearer shares in EMU to an undisclosed financial arranger (Respondent's Post-Hearing Submission on



Jurisdiction paras. 41 *et seq.*; Exhs. 57 and 58 to Respondent's Post-Hearing Submission on Jurisdiction). However, Mr. Vautrin claims that the transaction underlying the pledge agreement whereby Panorama and Allspice each expected to obtain ownership of 30 bearer shares was never completed and that the pledge agreement was useless, incorrect and not valid. In any event, Mr. Vautrin testified that Allspice and Panorama were owned indirectly by him (Claimant's Post-Hearing Response on Jurisdiction, para. 20; Exhs. 80 and 81 to Respondent's Post-Hearing Submission on Jurisdiction).

86. The contentions of the Parties regarding the application of Article 17(1) of the ECT were fully developed during the jurisdictional phase of this arbitration and will not all be repeated here. Only those arguments most relevant to the Tribunal's decision are here considered.
87. Respondent's contention, essentially, is that Claimant has failed to prove that it is a legal entity owned or controlled by citizens or nationals of a Contracting Party to the ECT within the meaning of Article 17(1) of the ECT and, therefore, is not entitled to the benefits of Part III of the ECT. The evidence, Respondent says, shows that PCL was and is owned by EMU, which is not a national of an ECT Contracting Party. According to Respondent, Claimant has failed to prove with credible evidence that Mr. Vautrin ultimately owns or controls EMU. Therefore, pursuant to Article 17(1), its claims are inadmissible.
88. Claimant rejects Respondent's argument that it is not entitled to the benefits of Part III because of Article 17(1), stating that Mr. Vautrin is a national of France, a Contracting Party to the ECT, and owns and controls the company, EMU, which in turn controls PHL, which controls Claimant.
89. In its Decision on Jurisdiction, the Arbitral Tribunal decided that Article 17(1) of the ECT has no relevance to the Tribunal's jurisdiction to determine Claimant's claims against Respondent under Part III of the Treaty (para. 21 *supra*). It confirms this decision. The Tribunal will, therefore, examine Respondent's arguments concerning the ownership and control of PCL in order to determine whether they justify a denial of the benefits of Part III to

Claimant. As already indicated, the burden of proof to establish ownership and control is on Claimant.

90. As the Tribunal stated in its Decision on Jurisdiction, “*Mr. Vautrin’s evidence as to his ultimate ownership and control of the Claimant is not only largely unsupported by contemporary documentation but . . . is materially inconsistent with parts of that documentation and also contradicted by other statements apparently attributable to Mr. Vautrin...*” (para. 177). On the other hand, the Tribunal noted that it did not wish to reject his evidence adduced at the jurisdictional hearing at that stage of the proceedings (para. 178). During the merits phase and at the Final Hearing, the Parties made further submissions on all the evidence submitted, including Mr. Vautrin’s numerous statements and oral testimony. The Tribunal has reached the following conclusions on these disputed matters.
91. As seen above, 20% of PCL’s shares are owned by PHL, another Cyprus-incorporated company (para. 84 *supra*) and 80% of PCL’s shares are held by EMU. EMU owns 100% of PHL’s shares. Mr. Vautrin’s testimony and the affidavits of MM. Nordtømme and Haug indicate that the latter each hold half of EMU’s shares in trust for Mr. Vautrin. The record also contains documents or affidavits from other persons acting for the companies concerned to the effect that they were always acting pursuant to instructions received from Mr. Vautrin. André and NOT have written that they were not shareholders at the time of the Second Privatization Agreement (Exhs. 20 and 23 to Mr. Vautrin’s Third Declaration). Moreover, when testifying before the Tribunal and in his witness statements, Mr. Vautrin demonstrated an intimate knowledge of the structure and affairs of the companies concerned, which lend credence to Claimant’s contention that he does own or control them.
92. As for the evidence introduced by Respondent that the shares of EMU were transferred to two Seychelles companies, Panorama and Allspice, the Arbitral Tribunal accepts Mr. Vautrin’s testimony that the transactions, which were contemplated, were never in fact consummated and that, in any event, he was and remains the ultimate owner of the shares of those two companies.

93. The Arbitral Tribunal has also considered the fact that there is litigation pending in Switzerland, discussed in the Decision on Jurisdiction, in which a company, Dolsamex S.A., and Mr. Timothy O'Neill claim ownership of PCL. However, until that litigation is completed, those claims remain just that: mere claims with allegations that cannot and do not affect the ownership or control of PCL.
94. The Arbitral Tribunal accepts Mr. Vautrin's testimony. Moreover, without losing sight of the fact that Claimant bears the burden of proof on this issue, the Arbitral Tribunal has not found Respondent's attempt to cast doubt on Mr. Vautrin's ownership and control of PCL convincing. Respondent has not been able to show to the Arbitral Tribunal's satisfaction that the evidence produced by Claimant as to its ownership is wholly unreliable nor has it introduced cogent evidence as to who is (or are) the persons or entities who own or control the company, other than Mr. Vautrin.
95. In these circumstances, the Arbitral Tribunal decides that Mr. Vautrin owns and controls PCL. Since Mr. Vautrin is a French national (Exh. 1 to Mr. Vautrin's First Declaration, 25 March 2004), and France is a Contracting Party to the ECT, Respondent cannot rely on Article 17(1) of the ECT to deny to PCL the benefits of Part III of the Treaty.

## **B. Misrepresentation**

### **1. Parties' Positions**

96. Respondent, at the jurisdictional hearing, in its Counter-Memorial on the Merits, Rejoinder on the Merits and Post-Hearing Submission on the Merits, raises objections to jurisdiction over and admissibility of Claimant's claims. It says that Claimant obtained its investment in Nova Plama via misrepresentations in violation of Bulgarian law, which is, therefore, void *ab initio* under the Privatisation Act and voidable under the Bulgarian Obligations and Contracts Act. Accordingly, Claimant does not own the investment and did not acquire control of it in accordance with Bulgarian law. As a consequence, there is no "Investment" within the meaning of Article 1(6) of the ECT, and hence the Arbitral Tribunal lacks jurisdiction over Claimant's claims. Even if the Tribunal were to conclude that it did have jurisdiction,

however, Claimant having obtained its investment by unlawful means would render its claim inadmissible.

97. In the Decision on Jurisdiction, the Tribunal concluded that Respondent's allegations on misrepresentation did not deprive it of jurisdiction in this case and, in light of the serious charges raised, the Tribunal decided to examine these allegations during the merits phase.
98. In its Counter-Memorial on the Merits, Rejoinder on the Merits and Post-Hearing Submission on the Merits, Respondent insisted that obtaining the investment via misrepresentation in violation of Bulgarian law made Claimant's claims inadmissible and, in any event, such misrepresentations defeated its claims on the merits. Since the protections provided in Articles 10 and 13 of the ECT can only apply to an Investment made in accordance with law, Claimant cannot seek the protections of the ECT for that investment, having obtained it in violation of international and Bulgarian law.
99. In addition, Respondent pointed out that Bulgaria denied Claimant the advantages of the ECT's substantive protections prospectively from 18 February 2003. Consequently, to the extent that Claimant seeks to present claims in these proceedings as to alleged violations by Respondent of ECT obligations after that date (*e.g.*, claims relating to the re-opened bankruptcy proceedings against Nova Plama in 2005 and claims regarding Varna Port based on facts arising after 18 February 2003), those claims are inadmissible.<sup>7</sup>
100. In support of its allegation of misrepresentation, Respondent contends that Mr. Vautrin and others representing Claimant during the negotiations for the acquisition of Nova Plama consistently represented to the Bulgarian Privatization Agency and others that Claimant was a consortium owned by two large commercial entities, André and NOT. According to Respondent, after these entities withdrew their interest in the investment, Mr. Vautrin intentionally concealed that fact and the fact that he was the sole owner of

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<sup>7</sup> This argument is no longer relevant, since in this Award the Arbitral Tribunal has decided that Bulgaria cannot deny the benefits of Part III to Claimant on the basis of Article 17(1) of the ECT, see paragraph 95 *supra*.

Claimant. Although Mr. Vautrin contends that he informed someone at some point within the Bulgarian Government of André's and NOT's withdrawal, Respondent asserts that this remains unproven.

101. Respondent says that Claimant was obliged to obtain the consent of the Privatization Agency to its purchase of EEH's shares in Nova Plama. This was a requirement of EEH's 1996 Privatization Agreement and the Bulgarian Privatization Act. Respondent says that Claimant procured the Privatization Agency's consent by means of misrepresentations as to Claimant's actual ownership, in violation of Bulgarian law. The consent thus obtained was null and void under Bulgarian law. According to Respondent, because the consent of the Privatization Agency was a legal prerequisite to Claimant's purchase and also a legal prerequisite to the lawfulness and effectiveness of the Share Purchase Agreement between Claimant and EEH (pursuant to which Claimant acquired the shares in Nova Plama that it claims as its investment), Claimant neither owns nor acquired control of its investment in accordance with Bulgarian law and the ECT.
102. Respondent cites Article 5(1) of the Bulgarian Privatization Act "*...[t]ransactions for acquisition under the Act conducted through a fictitious party or by an unidentified proxy shall be deemed null and void*" and states that Claimant misrepresented its ownership and misled the Privatization Agency within the meaning of Article 5(1) in order to obtain the latter's consent to PCL's acquisition of Nova Plama, thus rendering that consent null and void *ab initio*.
103. Respondent contends that the existence of an "Investment" within the meaning of the ECT is a fundamental element necessary for the observance of Article 26 of the ECT. In view of the lack of an Investment within the meaning of Article 1(6) of the ECT, Respondent asserts, this case should be dismissed.
104. Respondent adds that, under international and Bulgarian law, Claimant had an obligation to act honestly and in good faith in its dealings and contract negotiations and that it violated this obligation.
105. Alternatively, Respondent contends that, should the Arbitral Tribunal not find the Second Privatization Agreement null and void under Article 5.1 of the

Privatization Law, that agreement would be voidable under Bulgarian law due to Claimant's misrepresentations.

106. Respondent's argument under the ECT is that Claimant's misrepresentation defeats its claim on the merits. The obligations undertaken by Bulgaria under Articles 10 and 13 of the ECT can only apply to an Investment made in accordance with law. Respondent asserts that, having obtained its investment in violation of international and Bulgarian law, Claimant cannot seek the protections of the ECT for that investment.
107. Claimant denies that it made any misrepresentation to the Bulgarian Government concerning its investment in Nova Plama. It says it had no duty to inform Respondent of the identity of the shareholder(s) of PCL. Claimant acknowledges, in its Memorial on the Merits, that André and NOT were originally interested in buying the Refinery and accepts that the Bulgarian Government, through its Privatization Agency, wanted to screen foreign investors in privatized enterprises (see para. 27). Claimant contends that during the period July-September 1998, André decided that it was not interested in purchasing Nova Plama and only wanted to play an advisory role; so Mr. Vautrin personally took up the opportunity, together with NOT, to make the investment (*ibid.*, para. 30, p. 9).<sup>8</sup> Subsequently, NOT, too, withdrew from the project as an investor.
108. Claimant says that it informed the Privatization Agency that the purchase of Nova Plama's shares was to be made by a company "*presented by*" André and NOT – not that the purchase was to be made by André and NOT themselves – and that this description of the purchaser was included in the Memorandum of Agreement of 18 August 1998 (Article 1.1), agreeing to the share transfer by EEH to PCL, signed on behalf of the Privatization Agency and PCL. According to Claimant, this wording of the Memorandum of Agreement followed an earlier draft of the agreement, which is not in the record, which stipulated that the company purchasing Nova Plama's shares was a company

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<sup>8</sup> Mr. Vautrin testified at the January-February 2008 hearing (H. Tr., Day 2, 29 January 2008, p. 280) that NOT held 40 percent of the shares of PCL until the end of October 1998.

“formed by” André and NOT (See Mr. Vautrin’s testimony at the January – February 2008 hearing, H. Tr., Day 2, 29 January 2008, pp. 305 *et seq.*). Therefore, Claimant says, the Privatization Agency knew or should have known that a company different from André or NOT was the purchaser. If the Privatization Agency wanted to receive specific information about the change in the language of the agreement and ownership of the investor to be introduced by André and NOT, it could, contends Claimant, have asked for that information. In fact, Claimant says, the Privatization Agency was not interested in the identity of the investor’s shareholders and never asked; they simply wanted the investor to undertake the obligations in the Second Privatization Agreement, which Claimant did. Mr. Vautrin also testified that he had told relevant members of the Bulgarian Government that André and NOT were not to be the ultimate purchasers of Nova Plama’s shares (H. Tr. in French, Mr. Vautrin, 20 September 2004, p. 19).

109. Claimant further contends that nowhere is it accused of having made a positive misrepresentation, that is, Claimant is not accused of having falsely informed the Privatization Agency about its ownership. Therefore, there is no proof of a “wrong by Claimant” and Respondent’s allegations are only limited to the subjective impressions of various Bulgarian authorities.
110. Moreover, Claimant contends that Article 5(1) of the Privatization Act invoked by Respondent is not applicable to this case since the purchase of Nova Plama shares by PCL from EEH did not correspond to a privatization. According to Claimant, the Refinery had already been privatized after its sale to EEH in 1996. If Respondent retained the right to consent to any further sale, such consent was foreseen only for the sale of a minority of Nova Plama shares.
111. Claimant adds that, even if there were a “passive misrepresentation”, as alleged by Respondent, the consent of the Privatization Agency was necessary, if at all, only for the purchase of a minor portion of the shares of Nova Plama – 4.5 million shares out of 51 million. This is so, Claimant contends, because, after the initial privatization of Nova Plama, EEH had increased the company’s capital. Consequently, it was possible for Claimant to purchase from EEH 90% of the shares, which represented the increased capital not

covered by the First Privatization Agreement, without the need for any consent from the Privatization Agency. Moreover, even without the consent of the Privatization Agency, Claimant says, it would have owned and made an Investment within the meaning of Article 1(6) of the ECT, which entitles it to the protection in Part III of the ECT.

## **2. The Requirement of Approval by the Privatization Agency**

112. Contrary to Respondent's argument, the matter of the alleged misrepresentation by Claimant does not pertain to the Tribunal's jurisdiction: that was already decided in the Decision on Jurisdiction (paras. 126-130 and 228-230). Rather, the matter concerns the question as to whether Claimant is entitled to the substantive protections offered by the ECT.
113. The Arbitral Tribunal does not accept Claimant's argument that no approval by the Privatization Agency was necessary for PCL's acquisition of Nova Plama's shares because those shares had already been privatized under the First Privatization Agreement. Claimant itself did not at the time act in a manner consistent with the case it is now advancing; it actively sought and obtained the Privatization Agency's approval to purchase Nova Plama's shares from EEH. The First Privatization Agreement was clear, in its Article 22, that EEH did not have the right to sell or transfer Nova Plama's shares for a period of five years without the prior approval of the Privatization Agency. When EEH did, within that period, sell its shares to PCL, the Privatization Agency's approval was, therefore, required. Claimant's submission that, even without the Privatization Agency's agreement, it would have made an Investment within the meaning of ECT is irrelevant because, in fact, it sought and obtained the Privatization Agency's consent to its purchase of the Refinery.
114. Nor does the Arbitral Tribunal accept Claimant's contention that, if any authorization or approval of the Privatization Agency were required, it only pertained to 10% of Nova Plama's shares. Claimant's case is based on the fact that, after the First Privatization Agreement, Nova Plama's share capital was increased and that Article 22 of the First Privatization Agreement only applied to the shares existing at the time of the first privatization. While the language of Article 22, "[t]he Buyer shall not have the right to sell or transfer the



*shares acquired under this Contract . . .*” (emphasis added), if literally read, could be interpreted in the manner contended by Claimant, the Arbitral Tribunal does not consider that that was what the Parties intended. Again, Claimant did not in 1998, when it sought and obtained the approval of the Privatization Agency for its purchase of Nova Plama’s shares, act in conformity with the case it is now advancing. It sought approval for the purchase of *all* of Nova Plama’s then-outstanding shares.

115. The Arbitral Tribunal has now to determine whether the alleged misrepresentation did in fact occur as alleged by Respondent, and, if so, what the consequences are for the application of the protections provided under the ECT claimed by Claimant.

### **3. The Occurrence of Misrepresentation**

116. The Tribunal accepts Respondent’s factual allegation as to the occurrence of misrepresentation by Claimant. It is important here to review the most pertinent elements which lead the Tribunal to this conclusion.
117. By Order No. 456 of 7 August 1998, the Executive Director of the Privatization Agency established an inter-institutional working group of experts to prepare the transfer of Nova Plama shares from EEH to the Consortium André and NOT. On the same date, the Privatization Agency wrote a letter to EEH and to the “*Coordinator of the Consortium,*” Mr. Boni Bonev, announcing that it would give its consent for EEH to transfer its shares in Nova Plama to “*the Consortium ‘André & Cie and Norwegian Oil Trading’*” in case an agreement were signed with the Consortium for “*updating and unconditional fulfilment of the obligations already undertaken with the signed contract*” (R’s Exhs. 658, 659).
118. Ernst & Young sent a letter on 11 August 1998 to the Privatization Agency, indicating that the foreign investor André & Cie had assigned to it the conduct of due diligence of Nova Plama in view of signing a contract for the purchase of shares in the company (R’s. Exh. 660).
119. On 14 August 1998, the Privatization Agency sent a letter to Mr. Bonev enclosing a draft agreement between the consortium “*André & Cie and Norwegian Oil Trading*” and the Privatization Agency (R’s. Exh. 197).

120. Thereafter – and in accordance with the draft agreement – a Memorandum of Agreement was made on 18 August 1998 by NOT and André, represented by Mr. Bonev, and the Privatization Agency for the sale of all shares of Nova Plama to a company presented by NOT and André. The agreement was signed by Mr. Bonev “*For company*” (R’s Exh. 198). Mr. Bonev provided to the Privatization Agency two powers of attorney to act on behalf of André & Cie and NOT. The first document was dated 17 August 1998 and signed by W. Brocard and J.C. Vautrin in the name of André & Cie, to represent it “*in the negotiations to be held with relevant Bulgarian authorities regarding Plama project.*” The second document was also dated 17 August 1998 and was signed by Born Kanppskog and Torgeir Lien to “*negotiate and sign the Memorandum of Understanding concerning Plama AD on our behalf*” (R’s Exhs. 662, 663).
121. On 20 August 1998, the Privatization Agency sent two letters to record that a Memorandum of Agreement had been signed between the Agency, on the one hand, and André and NOT, on the other, authorizing the transfer of Nova Plama shares to a company presented by NOT and André. The first letter was sent to EEH and Mr. Bonev as the “*Consortium Coordinator*” and the second one, to Mr. Radev, Minister of Finance.
122. While Claimant made much of the argument that the language “*a company presented by NOT and André*” did not mean a company *owned* by NOT and André, at the January-February 2008 hearing, Mr. Vautrin testified that, at the time when André and NOT were still contemplating purchasing the Refinery, a July 1998 version of the Memorandum of Understanding (R’s Exh. 657) used similar terminology: “*a corporation to be introduced by André and Norwegian Oil Trading.*” How Bulgaria was reasonably to understand without an explicit explanation that virtually the same language was to mean different things at different times has not been explained by Claimant (H. Tr., Day 2, 29 January 2008, pp. 265 *et seq.*). In addition, the evidence, as set out in this section, indicates that the Privatization Agency had strong reasons to believe that NOT and André were part of the consortium.
123. The Business Plan presented by MM. Bonev and Vautrin to the creditors of Nova Plama in September 1998 described the “*Consortium*” which would

“revive” the Refinery as consisting of NOT, André, Ingérop and Ernst & Young. This is one of the puzzling elements of the misrepresentation issue, because it is difficult to believe that anyone could reasonably consider Ernst & Young and Ingérop as investors. The same is not true for NOT and André. Throughout the Business Plan, reference was made to the measures to be undertaken by the Consortium to resume operation of the Refinery. Information detailing the organization and experience of NOT and André was provided as Annexes 1 and 2 to the Business Plan (R’s Exh. 669).

124. On 8 September 1998, the Ministry of Finance sent a letter to Mr. Bonev, as “representative of Norwegian Oil Trading A.S and André & Cie”, inviting him to a meeting on the following day, in view of the intentions expressed by both companies to acquire the shares of Nova Plama (R’s Exh. 667). This and similar statements made in the correspondence exchanged at that time, were never corrected by Mr. Bonev, Mr. Vautrin or anyone else on Claimant’s side.
125. The meeting was held on 9 September 1998 with representatives of the Bulgarian Government, including the Minister of Finance and the Minister of Labour, Mr. Bonev, Mr. Vautrin and Mr. Nordtømme as representatives of the Consortium, as well as the Ambassador of Switzerland, who vouched for the good standing of André (R’s. Exh. 668 and witness statement of Mrs. Slavcheva, 28 July 2006). According to Mr. Vautrin, this meeting occurred after André had decided to withdraw as an investor (H. Tr., Day 2, 29 January 2008, p. 279). There was no apparent Swiss interest other than André.
126. The “Additional Agreement to the Memorandum of Understanding” dated 21 September 1998 named André and NOT as parties and was signed by Mr. Bonev, this time, on behalf of André and NOT (R’s. Exh. 671).
127. Mr. Vautrin has testified on several occasions that he had informed relevant Bulgarian authorities that André and NOT had decided not to be investors (see, e.g., H. Trans., in French, Mr. Vautrin, 20 September 2004, p. 19 and H. Tr., Day 2, 29 January 2008, p. 295). However, these statements contradict declarations made by the authorities concerned, in particular, Mr. Oresharski (who was the Minister of Finance at the time of the Hearing and the former Deputy Minister of Finance at the time of the transaction) and Mr. Palazov

(the Secretary-General of the Agency of State Receivables). They declared that it was their clear understanding, at all relevant times, that André and NOT were to be the ultimate purchasers of Nova Plama (H. Tr. Day 2, 29 January 2008, p. 329, lines 1 *et seq.*; witness statement of Mr. Oresharki, at paras. 7, 9; and witness statement of Mr. Palazov, at para. 10).<sup>9</sup> Moreover, Mr. Rakov, deputy of the Ministry of Finance, submitted a statement expressly denying Mr. Vautrin's assertions that Mr. Vautrin had informed him that NOT had withdrawn from PCL (witness statement of Mr. Rakov, paras. 5,6; H. Tr., Day 2, 29 January 2008, p. 333, lines 2 *et seq.*).

128. The conclusion which the Arbitral Tribunal draws from all of these elements is that the Bulgarian Government clearly understood NOT and André to be the investors (see, *e.g.*, R's Exh. 39) and that PCL – the “*company presented by*” them – was a special purpose vehicle created by them as a consortium for the purpose of the Nova Plama acquisition (see Mr. Vautrin's testimony, H. Tr., Day 2, 29 January 2008, p. 310).
129. It also appears to the Arbitral Tribunal that Mr. Vautrin did nothing to remove this misunderstanding, of which he was undoubtedly aware. In particular, Mr. Vautrin deliberately did not inform the Bulgarian Government that he was the sole, ultimate owner of PCL (Claimant's Rejoinder on Jurisdiction, paras. 124 and 129). Mr. Vautrin testified during the jurisdictional phase of the arbitration that, for reasons of personal security, he did not want the Bulgarian Government to know that he was the investor who owned and controlled PCL (see Mr. Vautrin's Third Witness Declaration, 26 August 2004, at para. 8 *et seq.* and H. Tr. Jurisdictional Phase, pp. 65-7). However, Mr. Vautrin has insisted throughout the arbitration that he never represented to the Bulgarian Government that André and NOT were the investors. As noted earlier (para.108 *supra*), Mr. Vautrin testified that he did inform certain Bulgarian officials that André and NOT were not investors. His testimony, also referred to earlier, that a comparison of the language “*formed by*” in an early draft of

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<sup>9</sup> This understanding was confirmed by other Bulgarian authorities including Ms. Slavcheva (in her witness statement and during her cross-examination at the Final Hearing, H. Tr., Day 2, 29 January 2008, p. 450) and Mr. Tenev.

the Memorandum of Understanding (which is not in the record) with the final text “*presented by*” showed clearly that André and NOT were not shareholders cannot be verified (H. Tr., Day 2, 29 January 2008, pp. 295 *et seq.*) and is contested by Respondent (Respondent’s Post-Hearing Submission on the Merits, para. 15). What is clear is that Mr. Vautrin was determined not to disclose his true role in the privatization and, by doing so, he deliberately misrepresented to the Bulgarian authorities the true identity of the investors in Nova Plama.

#### 4. The Consequences of the Misrepresentation

130. It is Respondent’s contention that Claimant’s investment is null and void under Article 5.1 of the Privatization Act (para. 102 *supra*), when examined in light of the terms of this so-called “straw man” provision. Counsel for Respondent explained in the January-February 2008 hearing that the straw man in the present case was Mr. Vautrin, acting *as if* he were the representative of André when in fact he was acting for his own account (H. Tr., Day 2, 29 January 2008, pp. 463-4).<sup>10</sup> In the opinion of Respondent’s legal expert, Professor Markov, dated 16 July 2006, an “unidentified proxy” within the meaning of Article 5.1. “*acts in his own name but on the ultimate account of and in the ultimate benefit of somebody else*” (para. 54). This is not what happened here. The party to the Second Privatization Agreement, *i.e.*, the party making the investment, was PCL, not Mr. Vautrin. PCL was not a “straw man” acting for someone else; it was acting for its own account.
131. Professor Markov cites a Bulgarian Supreme Court decision, in paragraph 55 of his 16 July 2006 opinion, as follows:

*What is an interpositioned person? The concept of interpositioned person, known also in legal theory as “straw man” or “wooden head,” requires the existence of an agreement between the real right-holder (real party) under the*

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<sup>10</sup> In its Post-Hearing Submission on the Merits, Respondent changed its identification of the straw man as being André and NOT whom Mr. Vautrin used as straw men to conclude the transactions (para. 30).

*contract, i.e. the person economically interested in the transaction who actually enters into it, and the interpositioned person. Under this agreement the interpositioned person gives his consent that his name will appear in the real estate contract as though he is the party to the contract, whereas the contract is actually between the economically interested person and a third person, the other party to the contract.*

132. In paragraph 56 of his 16 July 2006 opinion, Professor Markov cites the treatise, “Civil Law – General Part” by Professor Pavlova:

*§ 5 of the Additional Provisions of TPSOMEA (the Privatization Act) deserves to be noted among the cases of invalidity for prohibition provided for in special legal provisions. Pursuant to this provision the acquisition transactions under this Act shall be invalid where they are executed through an interpositioned person or an undisclosed representative. The law refers to the cases where the transferee under the privatization transaction conceals his name using another person’s name (interpositioned person) or where a person in his own name acquires privatized property acting as a mandatary (a party to a mandate contract) on somebody else’s account and with an obligation to transfer the property acquired to the principal. The severe sanction, envisaged in the provision in question, is designed by the legislator to provide maximum transparency in the acquisitions through privatization transactions. The requirement to reveal the identity of the transferee under the transaction constitutes a guarantee against abuse of official and social position and allows the public to watch closely whether the law is circumvented through follow up actions.*

Here, again, we are not dealing with a person who used the name of another person while entering into the Privatization Agreement, nor is the contract signatory acting as a *mandatary* for somebody else’s account and with an

obligation to transfer the investment to the principal. In the present case, PCL was the contracting party, acting for its own account and in its own name.

133. Rather, what happened here was that Mr. Vautrin and his representatives presented PCL as a consortium of major companies having substantial assets, whereas in truth, Mr. Vautrin, who personally did not have significant financial resources, was acting alone as the sole investor in the guise of that “consortium.” The Arbitral Tribunal is persuaded that Bulgaria would not have given its consent to the transfer of Nova Plama’s shares to PCL had it known it was simply a corporate cover for a private individual with limited financial resources. Given the strategic importance of the Refinery and the significant number of employees and creditors, the managerial and financial capacities of the acquirer were a natural concern to the Bulgarian authorities. André, as a world-wide trader and financial institution and NOT as an experienced oil company, appeared to have the required capacities. Mr. Vautrin alone did not.
134. Claimant contends that it acted in good faith, that Respondent never asked who the shareholders of PCL were and that Claimant had no obligation to volunteer this information. The Arbitral Tribunal does not consider that, in the circumstances of the present case, this contention can be accepted. Claimant represented to the Bulgarian Government that the investor was a consortium – which was true during the early stages of negotiations. It then failed, deliberately, to inform Respondent of the change in circumstances, which the Tribunal considers would have been material to Respondent’s decision to accept the investment. On the basis of the evidence in the record, Bulgaria had no reason to suspect that the original composition of the consortium, consisting of two major experienced companies, had changed to an individual investor acting in the guise of that “consortium”, and no duty to ask. It was Claimant, knowing the facts, which had an obligation to inform Respondent.
135. The investment in Nova Plama was, therefore, the result of a deliberate concealment amounting to fraud, calculated to induce the Bulgarian authorities to authorize the transfer of shares to an entity that did not have the financial and managerial capacities required to resume operation of the Refinery. While the Arbitral Tribunal considers that this situation does not involve the “straw-

man” provision set out in the Bulgarian Privatization Law, the Tribunal is of the view that this behavior is contrary to other provisions of Bulgarian law and to international law and that it, therefore, precludes the application of the protections of the ECT.

136. As noted by Professor Markov in his expert report, Articles 27 and 29 of the Obligations and Contracts Acts (OCA) state:<sup>11</sup>

*Art. 27. Contracts concluded by persons of legal incapacity, or by their agents without observing the requirements established for such agents, as well as contracts concluded under mistake, fraud, duress or extreme necessity shall be subject to invalidation.*

*Art. 29. Fraud shall constitute grounds for invalidating a contract provided that one of the parties has been misled by the other party into concluding the contract through intentional misrepresentation.*

In addition, Article 12 OCA introduces the principle of good faith by stating that “*parties must negotiate and enter contracts in good faith.*” According to Bulgaria’s expert, this principle covers various obligations of the parties, including the obligation to inform the other party of all facts relevant to making a decision concerning the conclusion of the contract.<sup>12</sup>

137. The negotiation and conclusion of the Second Privatization Agreement were carried out by PCL and its owner, Mr. Vautrin, in flagrant violation of these provisions of Bulgarian law. The misrepresentation made by Claimant renders the Agreement unlawful.
138. Unlike a number of Bilateral Investment Treaties,<sup>13</sup> the ECT does not contain a provision requiring the conformity of the Investment with a particular law.

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<sup>11</sup> Legal Opinion of Professor Markov, dated 16 July 2006, para. 64.

<sup>12</sup> *Ibid*, para 71.

<sup>13</sup> For example the Germany-Philippines BIT, Lithuania-Ukraine BIT, and Italy-Morocco BIT.



This does not mean, however, that the protections provided for by the ECT cover all kinds of investments, including those contrary to domestic or international law. As noted by the Chairman's statement at the adoption session of the ECT on 17 December 1994:

*[...] the Treaty shall be applied and interpreted in accordance with generally recognized rules and principles of observance, application and interpretation of treaties as reflected in Part III of the Vienna Convention on the Law of Treaties of 25 May 1969. [...] The Treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of treaty in their context and in the light of its object and purpose.*<sup>14</sup>

139. In accordance with the introductory note to the ECT “[t]he fundamental aim of the Energy Charter Treaty is to strengthen the rule of law on energy issues [...]”.<sup>15</sup> Consequently, the ECT should be interpreted in a manner consistent with the aim of encouraging respect for the rule of law. The Arbitral Tribunal concludes that the substantive protections of the ECT cannot apply to investments that are made contrary to law.
140. The Tribunal finds that the investment in this case violates not only Bulgarian law, as noted above, but also “*applicable rules and principles of international law*”, in conformity with Article 26(6) of the ECT which states that “[a] tribunal established under paragraph (4) shall decide the issues in dispute in accordance with this Treaty and applicable rules and principles of international law”. In order to identify these applicable rules and principles, the Arbitral Tribunal finds helpful guidance in the decisions made in other investment arbitrations cited by Respondent.

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<sup>14</sup> Energy Charter Secretariat, *The Energy Charter Treaty and Related Documents. A Legal Framework for International Energy Cooperation*, Chairman's Statement at Adoption Session on 17 December 1994, p. 158.

<sup>15</sup> Energy Charter Secretariat, *The Energy Charter Treaty and Related Documents. A Legal Framework for International Energy Cooperation*, An Introduction to the Energy Charter Treaty, p. 14.

141. In *Inceysa v. El Salvador*,<sup>16</sup> a case in which the investor procured a concession contract for vehicle inspection services in El Salvador through fraud in the public bidding process, the tribunal found that the investment violated the following general principles of law: (i) the principle of good faith defined as the “*absence of deceit and artifice during the negotiation and execution of instruments that gave rise to the investment*”<sup>17</sup> and (ii) the principle of *nemo auditur propriam turpitudinem allegans* – that nobody can benefit from his own wrong – understood as the prohibition for an investor to “*benefit from an investment effectuated by means of one or several illegal acts*”.<sup>18</sup> In addition, the tribunal found that recognizing the existence of rights arising from illegal acts would violate the “respect for the law” which is a principle of international public policy.<sup>19</sup>
142. The notion of international public policy was also invoked by an award in the case of *World Duty Free v. Kenya*.<sup>20</sup> In this case, the investor had obtained a contract by paying a bribe to the Kenyan President. According to the tribunal, the term “international public policy” was interpreted to signify “*an international consensus as to universal standards and accepted norms of conduct that must be applied in all fora*.”<sup>21</sup> Accordingly, the tribunal found that “*claims based on contracts of corruption or contracts obtained by corruption cannot be upheld by this Arbitral Tribunal*.”<sup>22</sup> The tribunal further concluded that “*as regards public policy both under English and Kenyan law [...] the Claimant is not legally entitled to maintain any of its pleaded claims in these proceedings on the ground of ex turpi causa non oritur actio*.”<sup>23</sup> As

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<sup>16</sup> *Inceysa Vallisoletana S.L. v. Republic of El Salvador*, Award of 2 August 2006, ICSID Case No. ARB/03/26 (“Inceysa”).

<sup>17</sup> *Ibid.*, para. 231.

<sup>18</sup> *Ibid.*, paras. 240-242.

<sup>19</sup> *Ibid.*, para. 249.

<sup>20</sup> *World Duty Free Company Limited v. The Republic of Kenya*, Award of 4 October 2006, ICSID Case No. Arb/00/7.

<sup>21</sup> *Ibid.*, para. 139.

<sup>22</sup> *Ibid.*, para. 157.

<sup>23</sup> *Ibid.*, para. 179.

explained in the award, the *ex turpi causa* defence “rests on a principle of public policy that the courts will not assist a plaintiff who has been guilty of illegal (or immoral) conduct [...]”<sup>24</sup>

143. Claimant, in the present case, is requesting the Tribunal to grant its investment in Bulgaria the protections provided by the ECT. However, the Tribunal has decided that the investment was obtained by deceitful conduct that is in violation of Bulgarian law. The Tribunal is of the view that granting the ECT’s protections to Claimant’s investment would be contrary to the principle *nemo auditur propriam turpitudinem allegans* invoked above. It would also be contrary to the basic notion of international public policy – that a contract obtained by wrongful means (fraudulent misrepresentation) should not be enforced by a tribunal.
144. The Tribunal finds that Claimant’s conduct is contrary to the principle of good faith which is part not only of Bulgarian law - as indicated above at paragraphs 135-136 - but also of international law - as noted by the tribunal in the *Inceysa* case. The principle of good faith encompasses, *inter alia*, the obligation for the investor to provide the host State with relevant and material information concerning the investor and the investment. This obligation is particularly important when the information is necessary for obtaining the State’s approval of the investment.
145. Claimant contended that it had no obligation to disclose to Respondent who its real shareholders were. This may be acceptable in some cases but not under the present circumstances in which the State’s approval of the investment was required as a matter of law and dependant on the financial and technical qualifications of the investor. If a material change occurred in the investor’s shareholding that could have an effect on the host State’s approval, the investor was, by virtue of the principle of good faith, obliged to inform the host State of such change. Intentional withholding of this information is therefore contrary to the principle of good faith.

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<sup>24</sup> *Ibid.*, para. 161.

146. In consideration of the above and in light of the *ex turpi causa* defence, this Tribunal cannot lend its support to Claimant's request and cannot, therefore, grant the substantive protections of the ECT.

## V. DISCUSSION OF THE ISSUES – CLAIMANT'S CLAIMS ON THE MERITS

147. The Parties have extensively documented their allegations; numerous exhibits, witness statements and expert reports have been submitted by both Parties. The factual and legal arguments have been discussed in detail during the Final Hearing, in which a number of witnesses and experts were also examined by the Parties and the arbitrators. The Tribunal has therefore decided that, in acknowledgement of the Parties' efforts, it will consider their further allegations on the merits. This consideration will lead to the conclusion that, even if Claimant would have had the benefit of the substantive protections of the ECT, Claimant's claims on the merits would have failed.
148. In its analysis, the Tribunal will follow Claimant's presentation of the allegedly unlawful acts and omissions by Respondent (Section C). Accordingly, the Tribunal will first address the allegations regarding environmental damages (Section C.1 *infra*), followed by the allegations regarding the action of the syndics (Section C.2 *infra*), the so-called paper profits (Section C.3 *infra*), the privatization of the Varna Port (Section C.4 *infra*) and Biochim Bank's unlawful breaches of its debt settlement agreement with PCL (Section C.5 *infra*). Before addressing these allegations, the Arbitral Tribunal will consider the ECT protections invoked by Claimant (Section B *infra*). It will rely on those considerations in its subsequent analysis. The Tribunal will commence by presenting a summary of the Parties' contentions on the merits and the relief sought (Section A *infra*).

### A. Summary of the Contentions of the Parties and Relief Sought

#### 1. Claimant's Position

149. According to Claimant, despite the promises made at the pre-acquisition stage, the Bulgarian Government, its legislative and judicial bodies and other State organs and agencies "*dashed*" Nova Plama's prospects of success. PCL found itself "*a victim of a series of unlawful acts and omissions which individually*

*and cumulatively defeated its efforts to operate the Refinery beyond 1999 and make good its investment.*" (Claimant's Memorial on the Merits, para. 9).

These unlawful acts and omissions included:

- (i) *Environmental damages*: Bulgaria's sudden and unfair amendment of its environmental law to exclude the State's liability for past environmental damages at the Refinery site, effectively making Nova Plama and PCL liable instead;
- (ii) *Paper Profits*: Bulgaria's failure to amend its corporate income tax laws in a timely manner to enable PCL to file Nova Plama's annual accounts;
- (iii) *Varna Port*: the unlawful *de facto* privatization of the Varna Port, which Nova Plama relied upon for its crude oil supply;
- (iv) *Actions of the Syndics*: the unlawful actions of Nova Plama's syndics who, *inter alia*, instigated a riot at the Refinery which resulted in the first shutdown of the Refinery in April 1999; and
- (v) *Biochim Bank*: the State-owned Biochim Bank's deliberate breaches of its debt settlement agreement with PCL.

150. Claimant alleges that, as a result of these actions, it was unable to secure any working capital financing for Nova Plama since the financial institutions that were initially involved withdrew from the project, and other financial institutions simply refused to participate. Nova Plama was obliged to close the Refinery indefinitely on 15 December 1999 and was consequently unable to settle its debts under the Recovery Plan. Its creditors re-opened the insolvency proceedings against it; and a Bulgarian court ordered the liquidation of Nova Plama in July 2005. Claimant asserts that it has therefore been deprived of all economic benefit and use of its investment since 15 December 1999.

151. It is Claimant's view that these acts are wholly the responsibility of Bulgaria and constitute a violation of several of the protections owed by Bulgaria under Articles 10(1) and 13 of the ECT. In particular, Claimant alleges that Bulgaria has:

- (a) failed to create a stable, equitable, favorable and transparent conditions for making the investment;
  - (b) failed to provide fair and equitable treatment to Claimant's investment;
  - (c) failed to provide to Claimant's investment the most constant protection and security;
  - (d) subjected Claimant's investment to unreasonable measures;
  - (e) breached contracts with PCL; and
  - (f) subjected Claimant's investment to measures having an effect equivalent to expropriation.
152. Claimant submits that, as a result of the expropriation of its investment, and in accordance with Article 13(1) of the ECT, it is entitled to full compensation in the form of fair market value of the shares of Nova Plama at the time immediately before the expropriation calculated using the Discounted Cash Flow ("DCF") method (Claimant's Memorial on the Merits, para. 341). The same compensation should be granted for the other breaches committed by Bulgaria because the nature of the breaches has caused long-term losses to the Claimant as investor.
153. On the basis of the DCF method, Claimant's expert values PCL's losses in the amount of USD 122,258,000. Accordingly, Claimant's request for relief in its Memorial on the Merits (para. 347) reads:
- (a) *an order that Bulgaria pay PCL compensation for losses suffered as a result of the expropriation of its investment in the amount of USD122,258,000;*
  - (b) *an order that Bulgaria pay PCL compound interest on such compensation at a commercial rate from December 15, 1999 until the date of payment;*
  - (c) *in the alternative, an order that Bulgaria pay PCL (i) compensation for losses suffered as a result of the Other ECT Breaches, in the amount of USD122,258,000 and compound*

*interest on the compensation awarded at a commercial rate established from December 15, 1999 until the date of payment;*

- (d) an order that Bulgaria pay PCL's costs occasioned by this arbitration, including the arbitrators' fees and administrative costs fixed by ICSID, the expenses of the arbitrators, the fees and expenses of its experts, and the legal costs incurred by the parties (including fees of counsel); and*
- (e) any other relief that the Tribunal deems appropriate.*

154. In its Reply, Claimant supplements its initial request and indicates that, if the Tribunal were to find that the principles of compensation provided in Article 13(1) – full market value of the Investment immediately before the measures – are not applicable to Claimant's claims on expropriation and the violation of the other ECT standards, Claimant should be compensated according to established principles of customary international law as restated in the International Law Commission's Articles on State Responsibility (Claimant's Reply on the Merits, paras. 214, 217).

155. Accordingly, Claimant alleges its right to recover *damnum emergens* and *lucrum cessans* and reformulates its request for relief from the Arbitral Tribunal in the following terms:

- (a) to confirm that it has jurisdiction to entertain the claim as submitted by PCL and that such claims are admissible;*
- (b) to order the Republic of Bulgaria to indemnify Claimant in the amount of US\$ 122,258,000 representing the fair market value of its investment in the Plama Refinery;*
- (c) subsidiarily, to order the Republic of Bulgaria to pay Claimant an amount of US\$13,862,152 for its losses, outlays, unpaid loans, financings and expenses relating to its investment in the Plama Refinery, all of which have been lost due to Bulgaria's actions, together with compensation in the amount of US\$ 10,000,000*

*representing its loss of a chance or opportunity of making a commercial success of the project.*

- (d) to award compound interest at a commercial rate on all sums awarded pursuant to b) and/or c) above from 15 December 1999 through the date of award and until such award is effectively paid in full;*
- (e) to declare that all costs of this arbitral proceeding, including legal fees, are to be borne by the Republic of Bulgaria; and*
- (f) to grant Claimant such other relief as the Arbitral Tribunal may deem appropriate.*

## **2. Respondent's Position**

156. Respondent denies all of Claimant's claims. It contends that the Refinery's difficulties derived from factors not attributable to the Republic of Bulgaria, in particular, from the combination of Nova Plama's high costs structure and the very difficult market conditions (Respondent's Counter-Memorial on the Merits, paras. 70, 530).
157. It is Respondent's view that it did not engage in unlawful acts and omissions. In particular, Respondent contends:
- (a) *Environmental Damages*: Claimant mischaracterizes not only the state of Bulgarian environmental law that was applicable when it acquired Nova Plama but also the terms of the First Privatization Agreement and of the 1999 amendment to the environmental law (Respondent's Counter-Memorial on the Merits, para. 72);
  - (b) *Actions of the Syndics*: the syndic's actions are not legally attributable to the State and, in any event, Claimant has failed to demonstrate in what manner the syndics acted contrary to law or otherwise improperly and in a manner that caused any harm to Claimant (Respondent's Counter-Memorial on the Merits, para. 72);



- (c) *Paper Profits*: the ECT Contracting States do not accept obligations under Article 10 of the ECT with regard to taxation and, in any event, the Bulgarian tax code and accounting rules were transparent and accessible to Claimant; and it had no basis to expect that it would receive some sort of exemption or special treatment (Respondent's Counter-Memorial on the Merits, paras. 285, 308-309);
- (d) *Varna Port*: the Varna Port is not "exclusive state property" and Claimant never had any legitimate or reasonable expectation that it would remain in the possession of the State; and its privatization was lawful (Respondent's Counter-Memorial on the Merits, para. 311); and
- (e) *Biochim Bank*: Biochim Bank acted in a commercially predictable and reasonable manner in all its dealings with Nova Plama and did not breach any contractual obligations (Respondent's Counter-Memorial on the Merits, para. 360).

158. Consequently, Respondent alleges that it has not breached its obligations under the ECT, nor did the alleged breaches of Articles 10(1) and 13 of the ECT cause Claimant to lose the value of its investment in Nova Plama's shares. It is Respondent's contention that Claimant is not entitled to any compensation because (Respondent's Rejoinder on the Merits, para. 320):

(a) *Claimant failed to establish a causal connection between Bulgaria's conduct and the failure of its investment; [footnote omitted]*

(b) *Claimant failed to particularize and quantify its alleged losses; [footnote omitted]*

(c) *Claimant's use of the DCF method of valuation is inappropriate because Plama has no relevant history of profitability as its cash flows for years were all negative; [footnote omitted]*

(d) *Even if one were to accept a valuation of Claimant's investment on the basis of the DCF method, Claimant's*

*valuation of Plama is flawed in numerous material respects;  
[footnote omitted]*

*(e) Plama was not a money-making enterprise [footnote  
omitted].*

159. Finally, Claimant failed to support its alternative claim for compensation on the basis of Claimant's alleged expenses and expenditures or its claim for compensation in the amount of USD 10,000,000 for its alleged loss of chance to make Nova Plama a profitable enterprise (Respondent's Rejoinder on the Merits, paras. 320-321).
160. Consequently, Respondent requests that the Tribunal dismiss Claimant's claims in their entirety and order Claimant to bear all costs incurred by Bulgaria in connection with this arbitration (Respondent's Counter-Memorial on the Merits, para. 575).

**B. The ECT Protections Invoked by Claimant**

161. Claimant's allegations refer to violations of the protections provided in Articles 10(1) and 13 of the ECT. Whilst Article 13 contains a standard provision on expropriation – including the condition that the expropriation be lawful and that compensation be prompt, adequate and effective, amounting to the fair market value of the Investment expropriated – Article 10(1) contains a complex provision that refers equally to the obligation to create stable, equitable, favorable and transparent conditions for making the Investment and to the standards of fair and equitable treatment, constant protection and security, the prohibition of unreasonable or discriminatory measures and the observance of obligations entered into with an Investor or an Investment.
162. Professor Schreuer has pointed out the interaction of the standards of protection, in particular under Article 10 of the ECT, and notes that the tribunal in *Petrobart v. The Kyrgyz Republic*, a case decided under the ECT,

opted for subsuming all standards under the purview of fair and equitable treatment.<sup>25</sup>

163. This Tribunal is also of the view that the standards of protection of Article 10(1) are closely interrelated. This interrelation will surface when analyzing the Parties' factual allegations. It does not mean, however, that each standard could not be defined autonomously. As noted by Professor Schreuer:

*[...] FET is connected to other standards of protection in a variety of ways. It has points of contact to the standards of 'constant protection and security' and protection against unreasonable or discriminatory measures'. Some tribunals have even found it unnecessary to distinguish these two standards from FET. The better view is that these standards, though related, are separate and autonomous. In fact, some tribunals have given them their own specific meaning.*<sup>26</sup>

164. The Arbitral Tribunal will therefore attempt to provide a relevant definition of the standards, taking into account practice under the ECT and the practice of tribunals under other investment treaties. It will also apply the rules of interpretation delineated by the Chairman's statement at the adoption session of the ECT on 17 December 1994, quoted at paragraph 139. The Tribunal will also apply the rules provided in the Vienna Convention on the Law of Treaties and, in particular, the ECT will be "[...] *interpreted in good faith in accordance with the ordinary meaning to be given to the terms of treaty in their context and in the light of its object and purpose.*"<sup>27</sup>

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<sup>25</sup> The tribunal noted: "*The Arbitral Tribunal does not find it necessary to analyse the Kyrgyz Republic's action in relation to the various specific elements in Article 10(1) of the Treaty but notes that this paragraph in its entirety is intended to ensure a fair and equitable treatment of investments,*" *Petrobart v. The Kyrgyz Republic*, Award of 29 March 2005. See also C.H. Schreuer, *Fair and Equitable Treatment (FET): Interaction with other Standards*, *Transnational Dispute Management*, Vol. 4, issue 5, September 2007, p. 1.

<sup>26</sup> C.H. Schreuer, *op.cit.*, pp. 25-26.

<sup>27</sup> See Article 31(1) of the Vienna Convention on the Law of Treaties and Energy Charter Secretariat, *The Energy Charter Treaty and Related Document. A Legal Framework for International Energy Cooperation*, Chairman's Statement at Adoption Session on 17 December 1994, p. 158.

165. As noted by both Parties, Article 2 of the ECT states that the purpose of the Treaty is to establish “*a legal framework in order to promote long-term cooperation in the energy field, based on complementarities and mutual benefits, in accordance with the objectives and principles of the Charter.*” Claimant alleges that these objectives and principles of the Treaty include the creation of “*a climate favourable to the operation of enterprises and to the flow of investments and technologies by implementing market principles in the fields of energy.*”<sup>28</sup> Consequently, Claimant concludes that the overall aim of the ECT should be considered as one of favoring the protection of foreign investments.
166. Respondent, for its part, cites the guide to the Energy Charter and the Concluding Document of the Hague Conference on the European Energy Charter to explain that the aim of the ECT is not just the promotion of Investments but also the promotion of the economic development of the Contracting States (Respondent’s Counter-Memorial on the Merits, paras. 430-431).
167. The Arbitral Tribunal is of the view that a balanced interpretation which takes into account the totality of the Treaty’s purpose is appropriate. In the words of the tribunal in *El Paso Energy International Co. v. Argentina*:

*This Tribunal considers that a balanced interpretation is needed, taking into account both State sovereignty and the State’s responsibility to create an adapted and evolutionary framework for the development of economic activities, and the necessity to protect foreign investment and its continuing flow.*

**1. Protections provided in Article 10(1)**

168. The starting point of the Tribunal is therefore the text of Article 10(1) of the ECT:

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<sup>28</sup> European Energy Charter, Title I – Objectives. Cited by Claimant in its Memorial on the Merits, para. 245.

*Each Contracting Party shall, in accordance with the provisions of this Treaty, encourage and create stable, equitable, favourable and transparent conditions for Investors of other Contracting Parties to make Investments in its Area. Such conditions shall include a commitment to accord at all times to Investments of Investors of other Contracting Parties fair and equitable treatment. Such Investments shall also enjoy the most constant protection and security and no Contracting Party shall in any way impair by unreasonable or discriminatory measures their management, maintenance, use, enjoyment or disposal. In no case shall such Investments be accorded treatment less favourable than that required by international law, including treaty obligations. Each Contracting Party shall observe any obligations it has entered into with an Investor or an Investment of an Investor of any other Contracting Party. [Footnotes omitted]*

### **1.1 Stable, Equitable, Favorable and Transparent Conditions**

169. Only in its Reply does Claimant introduce the claim that Respondent failed to create stable, equitable, favorable and transparent conditions. Claimant limited its arguments to claiming that it was constantly subjected to “*haphazard and opaque*” decisions by Respondent and that repeated “*interventions*” created “*unstable, inequitable, unfavorable and non-transparent conditions*” for PCL’s investment. Claimant was a victim of “*chronic features of unpredictability and inconsistency.*”
170. Claimant did not, however, set out the content of this standard or to explain precisely how it has been violated. The only specific reference in this regard is that the amendment of the Environmental Law allegedly created unstable and inequitable conditions (Claimant’s Reply on the Merits, para. 178). As noted by Respondent in its Rejoinder on the Merits, Claimant later used the language of the first part of Article 10(1) with respect to the Paper Profit and Varna Port claims.

171. In addition, Respondent alleges that, since the obligation of the Contracting Parties in the first sentence of Article 10(1) is to create conditions “*to make Investments in its Area*”, it applies only to pre-Investment matters or, at most, to the circumstances prevailing when the Investor makes its Investment. In any event, contends Respondent, it did not fail to comply with this standard.
172. The Tribunal observes that the second sentence of Article 10(1) indicates that the conditions listed in the first sentence “*shall include a commitment to accord at all times to Investments of Investors of other Contracting Parties fair and equitable treatment*” and the next sentence links these Investments to the remainder of the protections of this Article. The application of the conditions of the first sentence of Article 10(1) extends in this way to all stages of the Investment and not only to the pre-Investment matters.
173. In addition, the conditions are dependent on their accordance with the other standards. For instance, stable and equitable conditions are clearly part of the fair and equitable treatment standard under the ECT.
174. Consequently, the Tribunal will assess the compliance with these conditions in connection with the other standards analyzed below.

## **1.2 Fair and Equitable Treatment**

175. The Parties appear to agree that, despite the succinct wording of the standard of fair and equitable treatment, arbitral awards published in the past few years have contributed to providing some guidance to ascertain the content of this standard. The Parties agree that the standard includes to a certain extent the protection of the investor’s legitimate expectations and the provision of a stable legal framework (Claimant’s Memorial on the Merits, paras. 251-252; Respondent’s Counter-Memorial on the Merits, para. 436). The Arbitral Tribunal is nonetheless conscious that this may now be a controversial area, particularly with different interpretations being given to the decision of the *ad hoc* Committee in *MTD v Chile*.<sup>29</sup> However, in the Tribunal’s view, the

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<sup>29</sup> *MTD Equity Sdn. Bhd. and MTD Chile S. A. v. Republic of Chile*, Award of 25 May 2004, ICSID Case No. ARB/01/7 (“MTD”); *ad hoc* Committee Decision on Annulment of 21 March 2007.

present case can be decided on the facts, whatever interpretation is made of the FET standard in the ECT. Accordingly, for the purpose of this Award, the Tribunal has assumed the interpretation most favorable to the Claimant, as follows.

176. With regard to the protection of legitimate expectations, the Tribunal observes that these include the “*reasonable and justifiable*”<sup>30</sup> expectations that were taken into account by the foreign Investor to make the Investment.<sup>31</sup> These should, therefore, include the conditions that were specifically offered by the State to the Investor when making the Investment and that were relied upon by the Investor to make its Investment.<sup>32</sup> These expectations would equally include “*the observation by the host State of such well-established fundamental standards as good faith, due process, and non-discrimination.*”<sup>33</sup>
177. The stability of the legal framework has been identified as “*an emerging standard of fair and equitable treatment in international law.*”<sup>34</sup> However, the State maintains its legitimate right to regulate, and this right should also be considered when assessing the compliance with the standard of fair and equitable treatment. The tribunal in the *CMS v. Argentina* case explained the situation in the following terms:

*It is not a question of whether the legal framework might need to be frozen as it can always evolve and be adapted to changing circumstances, but neither is it a question of whether the*

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<sup>30</sup> *Thunderbird v. The United Mexican States*, Award of 26 January 2006, UNCITRAL-NAFTA, para. 147 (“Thunderbird”).

<sup>31</sup> *Técnicas Medioambientales Tecmed S.A. v. The United Mexican States*, Award of 29 May 2003, ICSID Case No. ARB(AF)/00/2, para. 154 (“Tecmed”); *MTD*, para. 114; *Occidental Exploration and Production Company (OPEC) v. The Republic of Ecuador*, Final Award of 1 July 2004, LCIA Case No. UN3467, UNCITRAL, para. 185; *Eureko B.V. v. Republic of Poland*, Partial Award of 19 August 2005, para. 235; *LG&E v. Argentine Republic*, Decision on Liability of 25 July 2007, ICSID Case No. ARB/02/1, para. 127 (“LG&E”).

<sup>32</sup> *CME Czech Republic B. V v. The Czech Republic*, Partial Award of 13 September 2001, UNCITRAL, para. 611 (“CME”); *Tecmed*, para. 154; *Thunderbird*, para. 147; *LG&E*, para. 127.

<sup>33</sup> *Saluka*, para. 303.

<sup>34</sup> *LG&E*, para. 125.

*framework can be dispensed with altogether when specific commitments to the contrary have been made. The law of foreign investment and its protection has been developed with the specific objective of avoiding such adverse legal effects.*<sup>35</sup>

178. Finally the Tribunal observes that the condition of transparency, stated in the first sentence of Article 10(1) of the ECT, can be related to the standard of fair and equitable treatment. Transparency appears to be a significant element for the protection of both the legitimate expectations of the Investor and the stability of the legal framework.

### **1.3 Constant Protection and Security**

179. Article 10(1) of the ECT also requires the host State to provide to the Investor's Investment "*the most constant protection and security.*" The Parties are in agreement that this standard imposes an obligation of "due diligence" (Claimant's Memorial on the Merits, paras. 277, 286; Respondent's Counter-Memorial on the Merits, para. 466). As noted by the tribunal in *AMT v. Zaire*, later quoted by the tribunals in *Wena v. Egypt* and *Saluka v. Czech Republic*:

*The obligation incumbent on the [host State] is an obligation of vigilance, in the sense that the [host State] shall take all measures necessary to ensure the full enjoyment of protection and security of its investments and should not be permitted to invoke its own legislation to detract from any such obligation.*<sup>36</sup>

180. The standard includes, in this manner, an obligation actively to create a framework that grants security. Although the standard has been developed in the context of physical security, some tribunals have also included protection

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<sup>35</sup> *CMS Gas Transmission Company v. The Argentine Republic*, Award of 12 May 2005, ICSID Case No. AR/O1/8, para. 277 ("CMS").

<sup>36</sup> *American Manufacturing & Trading v. Republic of Zaire*, Award of 21 February 1997, ICSID Case No. AR/93/1, para. 28; *Wena Hotel Limited v. Arab Republic of Egypt*, Award on the Merits of 8 December 2000, ICSID Case No. ARB/98/4, para. 84; *Saluka*, para. 484.



concerning legal security. In this last respect, the standard becomes closely connected with the notion of fair and equitable treatment.<sup>37</sup>

181. Finally, this Tribunal observes that the standard is not absolute and does not imply strict liability of the host State. As noted by the tribunal in *Tecmed* and later quoted by the tribunal in *Saluka* “. . . the guarantee of full protection and security is not absolute and does not impose strict liability upon the State that grants it.”<sup>38</sup>

#### 1.4 Unreasonable and Discriminatory Measures

182. The host State must also, under Article 10(1) of the ECT, refrain from subjecting the Investor’s Investment to “*unreasonable or discriminatory measures*.” In its Memorial on the Merits, Claimant contends that Respondent’s conduct was “*unreasonable*” and makes no reference to the existence of discriminatory treatment. However, in its Reply, Claimant introduces the allegation that Respondent has engaged in discriminatory practices in favor of Neftochim, a direct competitor of PCL.
183. The Tribunal observes that, on a number of occasions, tribunals in investment arbitrations have found a strong correlation between this standard and the fair and equitable treatment standard. For instance, the tribunal in *Saluka* noted that:

*The standard of “reasonableness” has no different meaning in this context than in the context of the “fair and equitable treatment” standard with which it is associated; and the same is true with regard to the standard of “non-discrimination”. The standard of “reasonableness” therefore requires, in this context as well, a showing that the State’s conduct bears a reasonable relationship to some rational policy, whereas the*

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<sup>37</sup> Schreuer, *op. cit.*, p. 4.

<sup>38</sup> *Tecmed*, para. 177; *Saluka*, para. 484.

*standard of “non-discrimination” requires a rational justification of any differential treatment of a foreign investor.*<sup>39</sup>

184. However, this Tribunal believes that, while the standards can overlap on certain issues, they can also be defined separately. Unreasonable or arbitrary measures – as they are sometimes referred to in other investment instruments – are those which are not founded in reason or fact but on caprice, prejudice or personal preference.<sup>40</sup> With regard to discrimination, it corresponds to the negative formulation of the principle of equality of treatment. It entails like persons being treated in a different manner in similar circumstances without reasonable or justifiable grounds.<sup>41</sup>

### 1.5 Obligations Undertaken Towards Investors

185. The last sentence of Article 10(1) mandates the host State to observe any obligations it has entered into with the Investor or an Investment of an Investor and is described by Claimant as an “*umbrella clause*”.
186. The Arbitral Tribunal can limit itself to noting that the wording of this clause in Article 10(1) of the ECT is wide in scope since it refers to “*any obligation*.” An analysis of the ordinary meaning of the term suggests that it refers to any obligation regardless of its nature, *i.e.*, whether it be contractual or statutory.<sup>42</sup> However, the *ad hoc* Committee that decided the annulment in the case, *CMS v. Argentina*, commented that the use of the expression “*entered into*” should

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<sup>39</sup> *Saluka*, para. 460. Other arbitration tribunals have taken a similar position merging this standard and the notion of fair and equitable treatment. As noted by Professor Schreuer, in the context of NAFTA this position could be explained by the fact that there is not a separate provision on the prohibition of arbitrary or discriminatory treatment. Schreuer, *op.cit.*, p. 5. See, *e.g.*, *S.D. Myers v. Canada*, Award on Liability of 13 Nov. 2000, 8 ICSID Reports 18, para. 263; *Waste Management, Inc. v. United Mexican States*, Award, 30 April 2004, ICSID Case No. ARB(AF)/00/3, para. 98. Tribunals deciding cases under other investment treaties that have taken a similar position include *CMS*, para. 290; *Impregilo v. Pakistan*, Decision on Jurisdiction of 22 April 2005, ICSID Case No. ARB /02/2, paras. 264-270; *MTD*, para. 196.

<sup>40</sup> See *Ronald Lauder v. The Czech Republic*, Final Award of 3 September 2001, UNCITRAL, paras. 221, 222, 232; Schreuer, *op.cit.* pp. 8-9.

<sup>41</sup> See A.F.M. Maniruzzaman, *Expropriation of Alien Property and the Principle of Non-Discrimination in International Law of Foreign Investment: An Overview*, 8 J. Transnational Law & Policy, Vol. 8:1 (1998).

<sup>42</sup> *Enron Corporation Ponderosa Assets L.P. v. Argentine Republic*, Award of 22 May 2007, ICSID Case No. ARB/01/3, para. 274.

be interpreted as concerning only consensual obligations.<sup>43</sup> In any case, these obligations must be assumed by the host State with an Investor.<sup>44</sup>

187. Following either the wide interpretation of the clause or the more restricted one proposed by the *ad hoc* Committee, contractual obligations are covered by the last sentence of Article 10(1) ECT. Since the Parties are exclusively concerned with the application of the last sentence of Article 10(1) ECT to this type of obligation, the Tribunal need not extend its analysis any further.

## 2. Protections Provided in Article 13

188. The relevant part of Article 13 of the ECT reads as follows:

*Investments of Investors of a Contracting Party in the Area of any other Contracting Party shall not be nationalized, expropriated or subjected to a measure or measures having effect equivalent to nationalization or expropriation (hereinafter referred to as "Expropriation") except where such Expropriation is:*

- (a) for a purpose which is in the public interest;*
- (b) not discriminatory;*
- (c) carried out under due process of law; and*
- (d) accompanied by the payment of prompt, adequate and effective compensation.*

*Such compensation shall amount to the fair market value of the Investment expropriated at the time immediately before the Expropriation or impending Expropriation became known in such a way as to affect the value of the Investment (hereinafter referred to as the "Valuation Date").*

189. The Parties are in agreement in identifying the main elements of this provision. In fact, Respondent acknowledged in its Counter-Memorial on the

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<sup>43</sup> *CMS v. Argentina*, Annulment Decision of 25 September 2007, para. 95.

<sup>44</sup> *Impregilo v. Pakistan*, Decision on Jurisdiction of 22 April 2005, paras 214-216.

Merits that it did not dispute that “*Article 13(1) of the ECT states an obligation as to expropriation, or the general propositions that expropriation may be indirect; accomplished by omissions as well as by actions; and measured by means of the effect upon the investment [...] that any determination as to whether an expropriation has occurred must be made by reference to the specific facts of an individual case, and [...] the claimed loss of the value of the investment must be due to the actions of the State.*” (footnotes omitted) (Respondent’s Counter-Memorial on the Merits, para. 505)

190. Claimant’s claims refer to the existence of indirect expropriation, *i.e.*, its claims do not relate to the physical taking of the property but to the impact that the State’s conduct had on the enjoyment and value of its investment.
191. The Tribunal observes that it is widely acknowledged that expropriation can result from State conduct that does not amount to physical control or loss of title but that adversely affects the economic use, enjoyment and value of the investment. This approach was adopted by the Iran–U.S. Claims Tribunal in the *Starret Housing Corp v. Iran* case in the following terms:

*[I]t is recognized by international law that measures taken by a State can interfere with property rights to such an extent that these rights are rendered so useless that they must be deemed to have been expropriated even though the state does not purport to have expropriated them and the legal title to the property formally remains with the original owner.<sup>45</sup>*

192. This position has been reiterated by a number of subsequent arbitral tribunals. In the *Tecmed v. Mexico* arbitration, the tribunal stated:

*. . . it is understood that the measures adopted by a State, whether regulatory or not, are an indirect de facto expropriation if they are irreversible and permanent and if the assets or rights subject to such measure have been affected in such a way that “... any form of exploitation thereof ...” has*

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<sup>45</sup> *Starrett Housing Corporation v. Islamic Republic of Iran*, Case No. 24, Interlocutory Award No. ITL 32-24-1, 19 December 1983, 4 Iran-US CTR 122, p.154.

*disappeared; i.e. the economic value of the use, enjoyment or disposition of the assets or rights affected by the administrative action or decision have been neutralized or destroyed . . . Under international law, the owner is also deprived of property where the use or enjoyment of benefits related thereto is exacted or interfered with to a similar extent, even where legal ownership over the assets in question is not affected, and so long as the deprivation is not temporary. The government's intention is less important than the effects of the measures on the owner of the assets or on the benefits arising from such assets affected by the measures; and the form of the deprivation measure is less important than its actual effects. (Footnotes omitted)<sup>46</sup>*

193. The Arbitral Tribunal considers that the decisive elements in the evaluation of Respondent's conduct in this case are therefore the assessment of (i) substantially complete deprivation of the economic use and enjoyment of the rights to the investment, or of identifiable, distinct parts thereof (*i.e.*, approaching total impairment); (ii) the irreversibility and permanence of the contested measures (*i.e.*, not ephemeral or temporary); and (iii) the extent of the loss of economic value experienced by the investor.<sup>47</sup>

## **C. Analysis of the Alleged Violations**

### **1. Environmental Damages**

#### **1.1 The Parties' Positions**

194. Claimant contends that, by holding Nova Plama liable for environmental damage caused at the plant site prior to its acquisition by Claimant, Bulgaria breached its obligations under Article 10 of the ECT. It did so by failing to

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<sup>46</sup> *Tecmed*, para. 116.

<sup>47</sup> See for a summary of the elements of expropriation under Article 1110 of the NAFTA (which resembles Article 13 of the ECT), *Fireman's Fund Insurance Company (FFIC) v. United Mexican States*, Award of 17 July 2006, ICSID Case No. ARB(AF)/02/01, para. 176.

accord to PCL's investment fair and equitable treatment, failing to provide it the most constant protection and security, impairing by unreasonable or discriminatory measures the management, maintenance, use, enjoyment or disposal of PCL's investment and by failing to observe obligations Bulgaria had entered into with PCL. Claimant bases this claim essentially on the alleged breaches by Bulgaria of the provisions of the Second Privatisation Agreement and on the provisions of the Bulgarian environmental law which were amended in 1999, after PCL's acquisition of Nova Plama.

195. Claimant also alleges that Bulgaria violated Article 13 of the ECT because the unlawful amendment of the environmental law resulted in its inability to secure financing for the Refinery. As a consequence, it was forced to shut the Refinery down in December 1999 and was prevented from enjoying any economic benefit from its investment (Claimant's Memorial on the Merits, paras. 332-334).

196. At the time of the Second Privatization agreement, the Bulgarian law on the environment read, in pertinent part, as follows:

*In case of restitution, privatization or investment in new construction facilities by foreign and Bulgarian natural and legal persons, such persons shall not be liable for environmental damages resulting from past actions or omissions.*<sup>48</sup>

197. The Second Privatisation Agreement (Article 4) provided that:

*Plama Consortium Limited shall ensure the maintenance of the required level of the environmental conditions related to the activities of the company in accordance with the provisions of the Bulgarian law. Plama Consortium shall bear no*

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<sup>48</sup> In its Post-Hearing Submission, Claimant called this provision "poorly drafted" (para. 49) and as not expressly providing that the Bulgarian State would be liable for environmental damage incurred during the period that the Bulgarian State had owned the polluting enterprise (para. 50).

*responsibility for any environmental pollution arising prior to the date of signing of this Agreement.” (R’s Exh. 676)*

198. Claimant contends that this language – and the existing environmental law – protected it from liability both directly and indirectly (*i.e.*, through Nova Plama’s being held liable for costs which PCL as shareholder would ultimately have to bear) for the estimated 37.4 million BGN pre-acquisition pollution clean-up costs with respect to Nova Plama.

199. In February 1999, shortly after PCL’s acquisition of the Nova Plama shares in November 1998, the Environmental Protection Act was amended<sup>49</sup> so as to provide, in Section 9(1), that:

*In the event of privatisation, with the exception of privatisation agreements concluded prior to 1 February 1999, or in case of restitution, or in the event of investment in new construction facilities by foreign and Bulgarian natural and legal persons, the liability for any environmental damages resulting from past actions or omissions shall be borne by the State under such terms and procedures as set forth by the Council of Ministers.*

200. PCL claims that it understood the language of Article 5.1 of the Second Privatization Agreement and the Bulgarian environmental law in force at the time to mean that it – and the company whose shares it was acquiring, Nova Plama – would not be responsible to pay for the clean-up of past environmental damage. It believed that the State would assume such liability, especially since the pollution had occurred during the period when Nova Plama was a State-owned enterprise.

201. Claimant refers, in this respect, to the Neftochim Information Memorandum, dated 11 February 1999 (R’s Exh. 811, p. 90), in other words before the above amendment entered into effect, which states that “*according to applicable law, the Bulgarian Government is responsible for funding the environmental remediation programme*”. It cites this as evidence that the Bulgarian

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<sup>49</sup> The amendment entered into force on 16 February 1999 (Declaration of Denev, para. 58; Claimant’s Post-Hearing Submission, para. 51).

environmental law in force even *prior to* the 16 February 1999 amendment and, therefore, at the time of Nova Plama's second privatization, placed responsibility for past environmental damage on the State. However, as Respondent explains in its Post-Hearing Submission on the Merits, at paragraph 51, the amendment to the environmental law explicitly placing such responsibility on the State was adopted by the Parliament on 29 January 1999 and, although it only entered into force on 16 February 1999, provided for an effective date of 1 February 1999; thus, the Neftochim Information Memorandum referred to the law as amended, not as it stood in 1998. The Arbitral Tribunal accepts this explanation.

202. PCL's understanding of past environmental damage finds expression in the Recovery Plan which was adopted pursuant to the Privatization Agreement. At the end of the Recovery Plan, in Section 7, after referring to the issue of cleaning up past environmental damage, it is stated that "[t]he Bulgarian Government has taken into consideration this fact and has released the new owners (including Plama AD) of any responsibility for environmental pollution having arisen prior to the date of signing the Privatization Contract, i.e. 17 November 1998." (Underlining added. See R's Exh. 609.)
203. Claimant contends that, by adopting amendments to its environmental law that would hold the State of Bulgaria responsible only for past ecological damage with respect to privatizations occurring *after* 1 February 1999 – and, therefore, not to the privatization of Nova Plama which occurred in 1998 – Bulgaria changed its law to the detriment of Claimant and Nova Plama and breached the contractual obligations to PCL as set out in the Second Privatisation Agreement. This was, in turn, a clear violation of the final sentence of Article 10(1) of the ECT.
204. Claimant also cites a letter of 14 June 2002 (C's Exh. 383) from the Bulgarian Minister of Finance to Nova Plama, threatening to reopen the insolvency proceedings against Nova Plama unless it, among other things, undertook its obligation to clean up the pollution at the Refinery, thereby illegally attempting to force Nova Plama to assume liabilities of which it had been contractually absolved.



205. It is Claimant's case that, as a consequence of this change in the law, Nova Plama became liable for past environmental damage at the Refinery – evaluated by it at 31.4 million BGN – and that the burden of such a financial liability rendered it incapable of raising the necessary financing to resume production at the Plama Refinery.
206. Claimant further asserts that, by adopting the February 1999 amendment to apply prospectively only, Respondent acted in a discriminatory way *vis-à-vis* Claimant and Nova Plama by comparison with the treatment accorded to Nova Plama's competitor, Neftochim, another Bulgarian oil Refinery which was privatized in October 1999 and which, by virtue of the 1999 amendment to the environmental law, was exonerated from responsibility for past environmental damage. This discriminatory treatment violated Respondent's obligations under Article 10(1) of the ECT.
207. Respondent contends that, while the language of Article 5.1 of the Privatization Agreement provides to the investor, PCL, immunity from liability for past environmental damage, it does not remove responsibility from the acquired company, Nova Plama. The law in force at the time of the Second Privatization Agreement was no different concerning this issue, as seen from the text quoted above (para. 196 *supra*). Nothing in the law or in the agreement made the State liable for past pollution.
208. Respondent denies that it committed any breach of its obligations under the ECT to PCL. It contends that Bulgaria's actions *vis-à-vis* Nova Plama concerning the environment at the Refinery site were not aimed at imposing onerous liability for remediation of past environmental damage but rather at ensuring that Nova Plama would take the necessary measures to operate the Refinery in a manner compliant with existing regulations. It cites a 1998 information letter (R's Exh. 528; C's Exh. 189) addressed by the Bulgarian Regional Inspectorate to the effect that Nova Plama had no outstanding unpaid sanctions or fines and summarizing pending steps to bring the Refinery's operations into compliance with environmental regulations. In fact, Respondent asserts that there is no evidence that Nova Plama was ever subject to any sanction by Bulgaria in connection with alleged past environmental damages (Respondent's Counter-Memorial on the Merits, para. 119).

209. Respondent contests the reliability of an expert report prepared for Nova Plama in 1999 (the so-called “Control P. Report” – R’s Exh. 521) as an assessment of the measure of past environmental damage. It is upon this report that Claimant relies to determine its estimate of the cost of remediation of past environmental damage. Respondent contends that the Control P. Report is not consistent with the established methodology for assessing the existence of damages actually requiring remediation and that it does not properly assess the costs of any such remediation. It contends that the report fails to distinguish between remediation of past environmental damages and measures regarding compliance with current regulations for re-establishing refinery operations and does not set out reliable costs estimates for the measures it advises should be taken (Respondent’s Counter-Memorial on the Merits, paras. 130 *et seq.*).
210. Respondent also says that Claimant has not proven any detrimental consequences to itself or to Nova Plama due to liability for past environmental damage. It has not been fined, sanctioned or banned. Nor, asserts Respondent, does the evidence submitted by Claimant prove that it was unable to obtain financing or insurance due to outstanding environmental liabilities. Respondent adds that Nova Plama benefitted from the sale of liquid waste, which reduced its environmental remediation costs.
211. As regards the Second Privatization Agreement, Respondent says that it is clear from the language of the Agreement that, while the investor – PCL – would not be held liable for past environmental damage, nothing is said regarding the liability of the target of the investment, Nova Plama. Under the Bulgarian environmental legislation in force at the time of Nova Plama’s privatization (both in 1996 and 1998), Nova Plama remained liable for past environmental damage and, according to Respondent, that fact must have been taken into account in negotiating the terms of Claimant’s purchase of Nova Plama’s shares. Respondent contends that the fact that, prior to Nova Plama’s privatization, the State owned and controlled the Refinery did not, under the law in force during that time, mean that the State was responsible for environmental damage; rather, the liability, under the law, remained with Nova Plama. Respondent denies that the 1999 amendment of the

environmental law discriminated against Claimant and asserts that Claimant and the investor in Neftochim were not in similar circumstances.

## 1.2 The Tribunal's Analysis

212. The Arbitral Tribunal does not find the evidence and arguments very clear-cut. It seems not unreasonable for PCL to have understood from the text of Article 4 of the Second Privatization Agreement that neither it nor the company it was acquiring would be held liable for cleaning up past environmental damage. After all, where would a bankrupt company, which Nova Plama was at the time of its acquisition by PCL, obtain the money to clean up past pollution if not from its shareholders(s)? In that case, the exemption of PCL alone from liability for past pollution was a hollow provision. This view finds support in a letter from the Ministry of Economy to Nova Plama dated 8 July 2002 (R's Exh. 465) in which the Ministry states, ". . . *the Ministry of Economy deems valid the text of the agreement signed by Plama Consortium Ltd and the Privatization Agency on 17.11.1998 (the Second Privatization Agreement), i.e., we think that Nova Plama AD should not have to bear material responsibility for cleaning out the past ecological damages.*"
213. At the same time, Mr. Vautrin, in his Fourth Witness Statement, said that obtaining a specific provision in the privatization agreement by which the State accepted liability for past environmental damage was a fundamental condition for him to purchase Nova Plama's shares (see para. 37). Yet, one searches in vain for such an explicit exemption in the Second Privatization Agreement. Such an exemption might have been obtained in negotiation; but no evidence was given as to whether an effort was actually made to procure it. Respondent has submitted evidence of other privatizations in which investor and privatized company were exempted from liability for past environmental damage and in which State responsibility for pre-privatization environmental damage was explicitly provided for (R's Exhs. 701 and 702). If it is correct, as Claimant's Counsel implied during the hearing in January-February 2008 (H. Tr. Day 1, 28 January 2008, p. 49), that Bulgaria changed its environmental law in 1999 in order to protect Neftochim from liability for past environmental damage as part of that company's privatization, how do we know that the

Government would not have done the same for Nova Plama had Claimant bargained for it? Respondent asserts that the price paid for Nova Plama's shares reflected (or should have reflected) all known liabilities, past, present and future and that the state of environmental pollution at Nova Plama was known to all parties. No evidence was given on these aspects of the negotiations.

214. Respondent has contended that, if the assumption of State liability for past environmental damage adopted in February 1999 had been made retroactive beyond 1 February 1999, it would have had to extend such liability to a prohibitive number of other Bulgarian companies (see, e.g., R's Exh. 452). However, when one looks at other evidence in the record, for example the World Bank's Implementation Report (C's Exh. 187), it appears that many of the very companies cited by Respondent as being those to which State aid for past environmental damage would have had to be extended if the February 1999 legislation had been retroactive, were in fact beneficiaries of such aid.
215. Another element which renders the issue of past environmental damage unclear is Section 7 of the Recovery Plan (R's Exh. 609), drafted essentially by Claimant, which states that the Government of Bulgaria excused PCL "*(including Plama AD)*" from paying for past environmental damage. If PCL really believed what it wrote in the Recovery Plan, why did it have to enter a reserve in Nova Plama's books for such damage? Moreover, there is other evidence indicating that Nova Plama did not have any significant past environmental damage to clean up (R's Exhs. 526 and 727, Appendix 3, page 8).<sup>50</sup>
216. Yet, there are elements in the record which seem to indicate the contrary of what is said in Section 7 of the Recovery Plan. Thus, for example, a note to PCL's 1999 Financial Statements stating that, by virtue of the 1999 amendment of the environmental law, Nova Plama is liable for past ecological damages caused in the period when the State was Nova Plama's sole owner

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<sup>50</sup> The Arbitral Tribunal is, of course, mindful of the Control P Report which assesses the Refinery's environmental status.

(C's Exh. 203, p. 13, Section 6), as well as a note from Nova Plama's Chief Ecologist to Syndic Todorova also addressing the Refinery's liability for past pollution (C's Exh. 186, p. 2). There exists also a letter from Minister Vassilev to Mr. Vautrin, dated 14 June 2002 (R's Exh. 463), demanding that Nova Plama "*shoulder the expenses for cleaning out all environmental pollutions resulting from the Refinery's work.*"

217. In light of the foregoing, the Arbitral Tribunal comes to the question of whether there is any element in this confusing situation which establishes a violation by Bulgaria of its obligations under the ECT.
218. The Arbitral Tribunal finds no evidence that the modification of Bulgaria's environmental law in 1999 was aimed directly against Claimant and its investment in Nova Plama or in favor of Neftochim. That modification, implemented pursuant to recommendations made by the World Bank, is seen by the Arbitral Tribunal rather as an effort by Bulgaria to meet its obligations under Article 10(1) of the ECT to create favorable conditions for Investors.
219. In his legal opinion of 28 October 2005, Mr. Denev says that the 1999 amendment of the environmental law was discriminatory against prior investors and, therefore, unconstitutional. The Arbitral Tribunal cannot opine on the constitutionality of the 1999 amendment. However, the Tribunal believes that the ECT does not protect investors against any and all changes in the host country's laws. Under the fair and equitable treatment standard the investor is only protected if (at least) reasonable and justifiable expectations were created in that regard. It does not appear that Bulgaria made any promises or other representations to freeze its legislation on environmental law to the Claimant or at all.
220. Moreover, Bulgaria's environmental law, as it existed prior to PCL's acquisition of Nova Plama (quoted earlier), could give no assurance to Claimant that Nova Plama would be exempt from liability for cleaning up past environmental damage. Claimant admits that the Bulgarian law, as it existed at the time of Nova Plama's second privatization, was, at best, unclear as to liability for past environmental damages (H. Tr. Day 1, 28 January 2008, p. 67). Indeed, Mr. Vautrin must have recognized the uncertainty in the law

because, as he testified (Fourth Witness Declaration, 28 October 2005, para. 37), State assumption of liability for past environment damage was so essential to him that he insisted on an explicit provision in the privatization agreement, exempting Nova Plama from such liability. This indicates to the Arbitral Tribunal that he was aware that Bulgarian law at the time did *not* protect Nova Plama against liability for past pollution but failed to negotiate the contractual guarantees he believed were necessary to avoid such risk. While Claimant criticizes Bulgaria for the inadequacy of its environmental law in this regard, Claimant was, of course, aware of, or should have been aware of, the state of Bulgarian law when it invested in Nova Plama.

221. Claimant also complains that, at the same time as the Privatization Agency was negotiating with PCL over the environmental issue in 1998, the proposal to make the State liable for past environmental damages of privatized companies (which became the February 1999 amendment) was being debated in the Bulgarian Parliament without informing PCL of this impending change in the law. But those parliamentary debates were in the public record and should have been known by PCL's Bulgarian advisors.
222. In light of these circumstances, the Arbitral Tribunal cannot uphold Claimant's allegations that Respondent violated the standard of fair and equitable treatment by amending its environmental law. It is also unclear how Respondent's conduct in this context could amount to a violation of the obligation to provide constant protection and security. Even accepting the approach that this standard includes an obligation to provide legal security, the Tribunal has established that Claimant failed fully to appreciate the scope and specificities of Bulgarian legislation. In addition, Claimant failed to identify and the Tribunal was unable to establish a lack of due diligence in Respondent's treatment of Claimant and its investment with regard to the environmental amendments.
223. As to the claim concerning discriminatory treatment, Bulgaria contended that all companies privatized before 1999 were in the same situation as Nova Plama and did not receive aid to clean up past pollution. There is, nevertheless, evidence that, in the implementation of the 1999 amendment, there may have been some companies not covered by the new law which,

nevertheless, received State assistance, whereas Nova Plama did not (see para. 206 *supra*). However, insufficient evidence has been given to permit the Arbitral Tribunal to determine that Bulgaria's treatment of Nova Plama in this respect was discriminatory. Therefore, the Arbitral Tribunal dismisses Claimant's allegations in this regard.

224. With respect to Claimant's allegation as to the violation of the last sentence of Article 10(1) of the ECT, the Tribunal finds no violation by Bulgaria of its contractual undertakings to PCL. The amendment of the Environmental Law did not breach Article 4 of the Second Privatization Agreement since this provision did not shift Nova Plama's liability to the State.
225. In addition, the Arbitral Tribunal has examined the evidence to see what harm or loss to Claimant or its investment resulted from Nova Plama's liability to clean up past pollution, assuming it existed. Claimant's contention that it could not obtain financing for the project given the large liability for past pollution on its books is not supported by sufficient documentary evidence of a contemporary nature. The only document in the record is a letter from a Swiss insurance company, Intersure, (C's Exh. 204) saying that it needed "*confirmation that the outstanding ecological issue has been solved.*" But such a letter from one insurance company hardly proves that financing was impossible to obtain because of any liability for environmental clean-up. As Counsel for Claimant stated at the January-February 2008 hearing (H. Tr. Day 1, 28 January 2008, p. 42), "*no company or bank would advance money to [Nova Plama] because Plama itself had bad credit.*"
226. Bulgaria has insisted in submissions that its governmental authorities never sought to enforce the obligation to clean up past pollution on Nova Plama.<sup>51</sup> While Claimant, in its Post-Hearing Submission on the Merits (para. 91), asserted that the damage to its investment from liability for past environmental damage is readily quantifiable at USD 23 million, nowhere does it show that it

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<sup>51</sup> Indeed, two governmental documents, evaluating Nova Plama's environmental status (R's Exhs. 526 and 528) do not refer to significant past pollution at the Refinery but more to measures which the Refinery would have to take to bring itself into compliance with current standards.

had to pay such amount. There is no evidence of what amounts, if any, Nova Plama actually spent to clean up past environmental damage. In fact, Claimant's Post-Hearing Submission on the Merits does not refer to PCL's or Nova Plama's having had to pay for past environmental damage but rather to the prospect of a demand that they pay (see para. 76). Thus the very basis of Claimant's claim, summarized in paragraph 194 above, that Bulgaria is guilty of "*holding Nova Plama liable for environmental damage*," is not factually established.

227. Absent any proof of harm or loss to the investment or limitation to Claimant's right to use or enjoy its investment as a result of Respondent's conduct with regard to the environmental amendments, it is impossible to see how a claim concerning the expropriation of Claimant's investment could be successful.
228. Therefore, the Arbitral Tribunal is unable to conclude that Respondent violated its obligations under Articles 10(1) and 13 of the ECT.

## **2. Actions of the Syndics**

229. Claimant essentially complains that the syndics appointed to manage Nova Plama while it was in bankruptcy in 1998-1999 failed to fulfil their obligations and took unlawful actions which harmed Nova Plama. It contends that the Bulgarian Government and Courts failed properly to control them, in violation of Respondent's obligations under Article 10(1) of the ECT to afford fair and equitable treatment, the most constant protection and security and to avoid unreasonable measures. Together with other violations, the syndics' actions amount to an indirect expropriation contrary to Article 13 of the ECT.

### **2.1 Irregularities in the Appointment of the Syndics**

230. Claimant contends that there were irregularities in the appointment of the syndics and in the retention of Syndic Penev as a supervisory syndic after approval of the Recovery Plan.

### **2.2 Unlawful Increases in the Salaries of Nova Plama's Workers**

231. Claimant alleges that, prior to its acquisition of Nova Plama, while Claimant was negotiating an agreement with the workers of Nova Plama regarding



payment of back salaries, one of the syndics of Nova Plama, then in insolvency, Syndic Todorova, *ex officio*, and without consulting PCL or Nova Plama, undertook to index workers' salaries in such a way as to increase the amounts owing to the employees as well as to include in the company's receivables payments for taxes, insurance, etc., which were not foreseen. Claimant considers these acts by the syndics, which increased Nova Plama's financial burden, unlawful, citing a Pleven Regional Prosecution Office's conclusion that the syndics had caused Nova Plama to suffer damages in the amounts of BGN 1,583,738.553 by unlawful salary indexation and BGN 2,025,313.581 by unlawful acceptance of amounts corresponding to workers' income tax, social insurance, etc.

### **2.3 Overloading of Debt by the Syndics**

232. Claimant alleges that the syndics unlawfully accepted as debts of Nova Plama pre-insolvency claims which were either fabricated or inflated, thereby burdening the company's debts by BGN 40 million. The creditors of these debts were Mineralbank, First Private Bank and the Bank for Agricultural Credit (BAC). According to Claimant, the Pleven District Court approved all the syndics' actions on 31 May 1999 (C's Exh. 224).
233. Claimant also complains that the syndics unlawfully accepted claims against Nova Plama by First Private Bank which were not owing by Nova Plama to the bank but which were, nevertheless, approved by the competent court. Claimant alleges that the two syndics were criminally indicted in 2004 for accepting non-existent debts in the amount of BGN 40,886,453.645.
234. Claimant says that because, at the time, management of Nova Plama was in the hands of the syndics, and Nova Plama's management board was not given access to the company's financial accounts, PCL and Nova Plama had no way of ascertaining whether the claimed receivables were legitimate or not.

### **2.4 Misappropriation of Nova Plama's Funds**

235. Claimant further alleges that Syndic Penev misappropriated Nova Plama's funds and carried out other unlawful actions during the period from May 1999 to October 2000. According to Claimant, Syndic Penev was found guilty by

the Pleven Regional Court of criminal action in the course of his duties as syndic of Nova Plama.

## **2.5 Worker Riots**

236. Claimant accuses Syndic Todorova of inciting the workers of Nova Plama to strike and riot unlawfully at the Refinery, of herself participating in these actions, and of using violence to evict the Refinery's director from his office (which led to the shutdown of the Refinery on 8 April 1999). In this connection, the police, according to Claimant, failed adequately to protect the Refinery and its management. These unlawful actions allegedly paralyzed the production of the Refinery and blocked all movements of products in and out of the Refinery for two and a half months, escalating into anarchy which lasted for many weeks. Despite reporting these events to the Bulgarian Government, Nova Plama received no police assistance to restore order. Claimant contends that these actions and omissions violate Bulgaria's obligation under Article 10(1) to afford the most constant protection and security to its investment and fall within the scope of Article 12 of the ECT<sup>52</sup>, entitling it to compensation for losses caused by civil disturbances.

## **2.6 Parallel Recovery Plan**

237. In its Reply, Claimant alleges that Syndic Todorova unlawfully submitted a parallel recovery plan to that of Claimant's which delayed the lifting of Nova Plama's insolvency (Claimant's Reply on the Merits, paras. 122-3).
238. Claimant further complains that Syndic Todorova refused to account for products shipped to and from the Refinery and refused PCL's request that its own designated financial and accounting representative be on site (Claimant's Post-Hearing Submission on the Merits, para. 17).
239. Respondent denies that it bears any responsibility for the actions of the syndics complained of by Claimant and contends that, in any event, the syndics' actions were in accordance with Bulgarian law in effect at the time.

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See text of Article 12 in the Annex to this Award.

Respondent goes on to rebut Claimant's arguments as to the appointment of the syndics, as to unlawful salary increases having been given to the workers, as to debt overloading by the syndics, as to misappropriation by Syndic Penev, as to the alleged riot and unlawful strike and Syndic Todorova's role therein, as to the failure of the police to provide protection to the Refinery and its management and as to the syndics' submission of a parallel recovery plan. Moreover, the so-called "riot", which occurred on 8 April 1999 could not have caused the Refinery shutdown, which began on 5 April 1999 and, therefore, predated this "riot".

240. Respondent's principal contention is that, under Bulgarian law, a syndic is not an organ of the State and does not perform governmental functions; therefore, his/her actions cannot be imputed to the State. Although a syndic is appointed by a court upon nomination by the creditors, the syndic does not, according to Respondent, perform governmental functions or operate under the direction or control of the State and does not act as an agent of the State or of the court. Therefore, contends Respondent, if Claimant complains about the actions of the syndics, those actions cannot form the basis of claims against Respondent under the ECT.
241. In any event, Respondent says, Claimant has failed to demonstrate that the syndics acted contrary to law or otherwise improperly in a manner which caused any harm to Claimant. Nor has Claimant established that the Bulgarian courts took any action or failed to take any action which was improper.
242. With respect to Claimant's contention that the syndics unlawfully accepted pre-insolvency claims against Nova Plama made by BAC, Mineralbank and First Private Bank, Respondent contends that Claimant ratified, at a creditors' meeting on 22 June 1999, a list of accepted claims containing all claims now challenged by it as well as the Recovery Plan which included such claims. In this connection, Respondent challenges Claimant's assertion that it had no legal standing to contest any measures in the insolvency proceeding.
243. Respondent says that, prior to its acquisition of Nova Plama's shares, Claimant had full knowledge of and unimpeded access to information about the Nova Plama bankruptcy proceedings and all claims admitted therein; that Claimant

specifically agreed to the claims it now contests in the Recovery Plan and elsewhere<sup>53</sup>; that Claimant failed to utilize at the time the remedies available to it under Bulgarian law for contesting the claims in question; and that the syndics' acceptance of the claims of Mineralbank, BAC and First Private Bank was not unlawful because the claims were supported by sufficient evidence.

244. Respondent contends that the syndics' acceptance of the claims in question did not increase Nova Plama's debts and had no adverse effect on the Refinery's net economic condition.
245. As to the workers' "riot", Respondent denies that the workers' protests over not being paid their salaries amounted to a "riot" or that Syndic Todorova in any way instigated a "riot" by the workers. Respondent adds that the Bulgarian police were constantly present at the Refinery at the time the alleged "riot" occurred and provided any necessary protection. In no event, says Respondent, did the events or "riot" of 8 April 1999 cause the shutdown of the Refinery. According to Respondent, the shutdown began – on Claimant's own initiative – on 4 or 5 April 1999.<sup>54</sup> Nor, contends Respondent, were the workers' actions responsible for blocking product from coming into or going out of the Refinery.
246. Respondent contests Claimant's argument regarding the parallel recovery plan submitted by Syndic Todorova, saying she had the right under Bulgarian law to submit such a plan.
247. Finally, Respondent states that the Bulgarian courts, on 13 November 2006, properly acquitted the syndics of criminal charges with the exception of one minor one which had been filed against them (C's Exh. 241).

## 2.7 The Tribunal's Analysis

248. The factual evidence with respect to the actions of the syndics and the alleged riot of the Refinery's workers is in virtually all respects contradictory.

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<sup>53</sup> See, e.g., R's Exhs. 142 and 598.

<sup>54</sup> Claimant's Counsel appeared to verify Respondent's argument at the January-February 2008 hearing (H. Tr., Day 5, 1 February 2008, p. 983, lines 20-22 and p. 984, line 1).

Eyewitnesses to the same events gave conflicting testimony as to what they saw. Thus witnesses presented by Claimant testified that the workers at the Refinery rioted, used violence to evict the Refinery's director, Mr. Beauduin, from his office, were encouraged and even led in their actions by Syndic Todorova and that the police did nothing to intervene and afford protection to the premises and its management. Respondent's witnesses testified that the workers gathered to demand payment of their overdue wages, that their demonstration was peaceful, that Syndic Todorova was not seen encouraging or leading the demonstration, that there was no violence and that Mr. Beauduin left his office of his own volition, safely escorted by the police.<sup>55</sup>

249. Given this conflicting evidence, the Arbitral Tribunal is unable to form any firm view as to what really transpired. The burden of proof being on Claimant, the Tribunal cannot, therefore, rule in its favor concerning these allegations, including with respect to its claim under Article 12 of the ECT.
250. As to Claimant's arguments that there were irregularities in the appointment of the syndics, that the syndics unlawfully increased the salaries of the workers, that they accepted debts unlawfully and that they improperly submitted a "*parallel*" recovery plan, the Arbitral Tribunal considers that the evidence shows the contrary (See, e.g., R's Exh. 1030, a decision from the Pleven Municipal Court acquitting the syndics of criminal charges related to the acceptance of claims in the course of the bankruptcy proceedings). The Tribunal is persuaded by Respondent's rebuttal of Claimant's arguments in its Post-Hearing Submission on the Merits (pp. 23 *et seq.*).
251. However, in order to determine the responsibility of Respondent under the ECT, the crucial questions for the Arbitral Tribunal are whether the State is legally responsible for the actions of syndics, whether syndics are instruments of the State and perform State functions and whether the Bulgarian courts failed to control or supervise the syndics in a way which gives rise to State responsibility. Here again, the Arbitral Tribunal has before it conflicting

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<sup>55</sup> This version of the facts is supported by Mr. Beauduin's memorandum dated 8 April 1999, recounting the events of that day (R's Exh. 840).

experts' opinions on the role and authority of syndics and the courts in a bankruptcy situation in Bulgaria such as that of Nova Plama.

252. Article 8 of the Articles on State Responsibility of the International Law Commission provides:

*The conduct of a person or a group of persons shall be considered an act of State under international law if the person or group of persons is in fact acting on the instructions of, or under the direction or control of, that State in carrying out the conduct.*

253. Having reviewed the experts' opinions, the evidence presented and the submissions of the Parties on these points, the Arbitral Tribunal has come to the conclusion that syndics in bankruptcy proceedings, such as that involving Nova Plama, are not instruments or organs of the State for whose acts the State is responsible. Although Claimant's legal expert, Mr. Denev, in his opinion of 28 October 2005 annexed to Claimant's Memorial on the Merits, cites a Bulgarian Supreme Court decision to the effect that a syndic is "a court's authority" (see para. 37), the Arbitral Tribunal does not interpret this to mean that a syndic carries out judicial or State functions. Mr. Denev quotes the Commercial Law as defining the syndic as an "organ of the estate of insolvency" (see para. 36). The opinions of Professor Chipev, dated 16 July 2006 and 19 July 2007, presented by Respondent, seem more persuasive to the Tribunal in concluding that a syndic is not a State organ and accord with the experience of the members of the Tribunal in other civil law countries. Thus the Arbitral Tribunal concludes that the acts of the syndics, if they were wrongful – and the Tribunal makes no finding in this respect – are not attributable to Respondent, which cannot, therefore, be said to have violated its obligations towards PCL under the ECT.
254. As for Claimant's allegation that the Bulgarian courts failed adequately to control and supervise the acts of the syndics, the Arbitral Tribunal accepts Mr. Denev's opinion that the Bulgarian courts had a role in supervising the work of the syndics. Obviously the courts of a State are organs of that State, and the State may bear responsibility for the acts or omissions of its courts.

According to the expert opinions of Professor Chipev, presented by Respondent, the powers of supervision and control of the courts over syndics are relatively limited, an opinion which the Arbitral Tribunal accepts. It appears that Claimant and/or Nova Plama had access to the Bulgarian courts to complain of actions of the syndics with which they disagreed. In fact, they did bring certain actions in this respect.<sup>56</sup> The Tribunal can find no evidence that such access to the courts was in any way obstructed or that the courts decided the issues presented to them in anything other than a fair way. The Tribunal finds no evidence which would engage the responsibility of Respondent under the ECT.

255. Consequently, the Arbitral Tribunal rejects Claimant's complaints regarding the syndics.

### **3. Paper Profits**

#### **3.1 The Parties' Positions**

256. Claimant contends that, because Bulgaria lacked appropriate accounting rules and tax legislation, the discount or rescheduling of Nova Plama's debts in its Recovery Plan resulted in artificial profit which became taxable and thus created a new debt for the company, requiring an accounting reserve in its books. As a consequence, Nova Plama was not in a position to finalize its 1999, 2000 and 2001 financial statements and missed the deadline for filing its tax return for the 1999 fiscal year and in subsequent years. This, in turn, created a new tax liability. The result was that, being unable to show that taxes due had been paid and therefore to present audited financial statements, it was impossible for Nova Plama to obtain the necessary financing to start up the Refinery.
257. Claimant contends that Bulgaria did not have a proper legal framework for companies which had terminated insolvency proceedings, thereby violating its undertaking in Article 10(1) of the ECT to create stable, equitable and

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<sup>56</sup> Claimant made the general allegation that Respondent violated Article 10(12) of the ECT. The Arbitral Tribunal is not persuaded that this is the case.

favorable conditions for Investors. From 1999 to 2001, Claimant says that Nova Plama sought the Government's approval for various accounting measures which would avoid its having to declare a "paper profit" but never received a satisfactory response.

258. Eventually, says Claimant, Bulgaria acknowledged the gap in its legislation and, at the end of 2001, adopted legislation absolving companies of profit tax on such "paper profits".
259. Claimant concludes that, by refusing to assist Nova Plama in finding a solution to the problem of "paper profits" and by failing to amend its laws in a timely way regarding the taxation of the paper profit which resulted from the discounted liabilities under the Recovery Plan, Bulgaria violated its obligation under Article 10(1) of the ECT to accord fair and equitable treatment and the most constant protection and security to Claimant's investment and to avoid unreasonable measures. It also violated Article 13 of the ECT, because Bulgaria's conduct in this regard contributed to PCL's inability to secure financing for the Refinery and resulted in the deprivation of Claimant's right to the use and enjoyment of the economic benefits of its investment.
260. Respondent replies that ECT Contracting States do not accept an obligation under Article 10(1) of the ECT regarding fair and equitable treatment with respect to tax. It refers to Article 21(1) of the ECT which provides:

*Except as otherwise provided in this Article, nothing in this Treaty shall create rights or impose obligations with respect to Taxation Measures of the Contracting Parties. In the event of any inconsistency between this Article and any other provision of the Treaty, this Article shall prevail to the extent of the inconsistency [...]*

261. In any event, Respondent contends, Claimant could not have had any legitimate or reasonable expectation that Nova Plama would not be subject to existing tax law, of which it was perfectly well aware when it purchased the company. It was not excused from filing obligatory tax returns or prevented from preparing financial statements; rather than doing so, it chose to lobby for tax relief and for a change in the law. Respondent submits that the various



Bulgarian authorities concerned acted reasonably and in good faith to respond to Claimant's inquiries and that Bulgaria's tax laws were reasonable and consistent with international standards.

262. In fact, according to Respondent, Nova Plama had available to it alternative accounting methods for treating the discounted debts to that which it adopted which would have avoided the problems it encountered (see Transacta Report, paras. 38-39).
263. Respondent also points out that, in 2001, it did adopt the change to its tax law which Nova Plama sought.
264. Finally, Respondent says that Claimant has failed to produce evidence that it or Nova Plama made any serious attempts to obtain financing that were rejected because of Nova Plama's alleged inability to prepare its financial statements and file tax returns. Nor has it proven otherwise that the "paper profit" issue caused it any injury.

### **3.2 The Tribunal's Analysis**

265. The problem of which Claimant here complains is that the discounted debt (which it was able to negotiate with Nova Plama's creditors) unfairly gave rise under Bulgarian tax law to a "paper profit" on which it was liable to pay company income tax. It demanded a modification of Bulgaria's tax law to eliminate the tax consequences, which it finally obtained in 2001, but until then it was unable, in light of the enormous potential tax liability, to file certified audited financial statements without paying the tax; and this meant it could not obtain financing for the operation of the Refinery.
266. The Arbitral Tribunal cannot see how this claim gives rise to a violation of Bulgaria's obligations under the ECT. In the first place, Article 21 of the ECT specifically excludes from the scope of the ECT's protections taxation measures of a Contracting State, with certain exceptions, one of which is that, if a tax constitutes or is alleged to constitute an expropriation or is discriminatory, the Investor must refer the issue to the competent tax authority, which Claimant did not do.

267. Even putting aside Article 21 of the ECT, the Tribunal finds no action by Respondent which comes anywhere near to being unfair or inequitable treatment or amounting to expropriation. When Claimant purchased the shares of Nova Plama and negotiated its Debt Settlement Agreement, it was or should have been aware of the taxation treatment that would be accorded to debt reduction by Bulgarian law. It could not have had any legitimate expectation that it would be treated otherwise. It had Ernst & Young, one of the world's leading tax advisory firms, advising it on its acquisition.
268. It has been suggested by Respondent and its experts (see Report of Transacta, 28 July 2006, Respondent's Counter-Memorial on the Merits) that Nova Plama could have adopted a method of accounting for its debt reduction under Bulgarian law which would have avoided the tax consequences it complains of. Claimant says that it was not informed at the time. While the members of the Arbitral Tribunal are not experts in Bulgarian accounting or tax law, it is clear to the Tribunal that Claimant, as the investor, was responsible for doing its due diligence regarding the tax consequences of debt reduction and for taking the necessary measures to deal with them.
269. Respondent produced evidence which shows that the tax laws of many countries around the world treat debt reductions, as were negotiated in this case, as income taxable to the beneficiary (see Report of International Fiscal Association, R's Exh. 1027). It cannot be said that Bulgaria's law in this respect was unfair, inadequate, inequitable or discriminatory. It was part of the generally applicable law of the country like that of many other countries.
270. Here again, as in the case of liability for past environmental damage, discussed earlier in this Award, if Claimant was concerned about the tax consequences of the debt reduction it sought and obtained, it could have attempted to negotiate provisions in the Privatization Agreement protecting Nova Plama against them. There is no evidence that it did so.

271. The evidence also shows that Bulgaria did not in fact seek to collect the taxes which were due from Nova Plama.<sup>57</sup> On the contrary, there is much evidence in the record which demonstrates the Government of Bulgaria's efforts to try to assist Claimant and Nova Plama in this respect (C's Exhs. 273, 275, 282). While in its Post-Hearing Submission, Claimant asserts that its damage from the "hollow" tax is readily quantifiable at USD 23 million (see para. 91), nowhere does it say that it ever had to pay any such tax. And in the end, in 2001, Bulgaria changed its tax laws to exempt Nova Plama from any taxation on these "paper profits". (See Report of Transacta, 28 July 2006, paras. 59 *et seq.*; Respondent's Counter-Memorial on the Merits, paras. 289-301; Respondent's Rejoinder on the Merits, paras. 123-4). In terms of diligence, Bulgaria's behavior with regard to the above is beyond reproach and the claim concerning the violation of the standard of constant protection and security under the ECT is without merit.
272. Finally, the Arbitral Tribunal is not persuaded by the evidence that it was the "paper profits" issue that made it impossible for Claimant or Nova Plama to obtain financing for the operation of the Refinery. As Counsel for Claimant stated at the January-February 2008 hearing (H. Tr. Day 1, January 28, 2008, p. 42), Nova Plama in 1998 "*had bad credit, and no company or bank would advance money to it.*" It is therefore not apparent how Bulgaria's conduct could have deprived Claimant of the economic benefits of its investment. Claimant's claim concerning expropriation on this account must be dismissed.
273. In conclusion, the Arbitral Tribunal finds no evidence that Bulgaria violated its obligations under the ECT (assuming it applies to this issue) towards Claimant with respect to the paper profits issue and, therefore, rejects Claimant's claims.

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<sup>57</sup> Claimant's allegation to the contrary at the January-February 2008 hearing (H. Tr., Day 1, 28 January 2008, p. 21 lines 17 *et seq.*) is unsupported by evidence.

#### 4. Varna Port

##### 4.1 The Parties' Positions

274. Claimant submits that Varna Port is the only Bulgarian port through which crude oil and oil products can be supplied to it by tankers. It contends that, under Bulgarian law, Varna Port is “exclusive state property”, by virtue of the constitution of the Republic of Bulgaria,<sup>58</sup> the Bulgarian Law on Maritime Spaces, Internal Water Roads and Ports, the Law on Concessions and court decisions. It explains that Varna Port was under the control of a State-owned entity, Petrol A.D., which was privatized in 1999. Claimant says that, contrary to Bulgarian law and its constitution, the Bulgarian Government purported to include Varna Port in the assets owned by Petrol A.D. at the time it was privatized. Even if Varna Port could be transferred to private ownership, it was not transferred to the privatized Petrol A.D. in accordance with the methods available for such transfers under Bulgarian law.
275. As a consequence of Varna Port’s unlawful possession by Petrol A.D., Nova Plama (according to Claimant) could not deal with Petrol A.D. since it was not a lawful owner of the port. It could not know with legal certainty with whom it should contract to obtain port services at Varna. Nor did Nova Plama have any guarantee that it would have access to Varna Port as a public service provided by the State in the future. Respondent refused to provide it any assurances that, if it negotiated a contract with Petrol A.D., its contractual rights would be respected. Petrol A.D. was in a position to abuse its dominant position by terminating unreasonably Nova Plama’s access to the port or by imposing on it unreasonable conditions. In fact, Claimant alleges, the newly privatized Petrol A.D., controlled by the Naftex Group, a competitor of Nova Plama (Claimant’s Reply on the Merits, para. 37), threatened Nova Plama and attempted to impose outrageous prices and conditions for the transit of its crude oil through Varna Port.

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<sup>58</sup> Claimant’s legal expert, Mr. Denev, opined in his statement of 28 October 2005 that under the Bulgarian Constitution ports were “republican roads” which could not be privatized.

276. Claimant also complains that Bulgaria amended its Maritime Law in 2004 to make fundamental changes in the regime governing its ports of public transport. By virtue of this amendment, Varna Port can now be divided into two parts, one remaining public property (wharfs, piers, beach and aquatorium) and the other (a load storage area) as the property of Petrol A.D. Claimant characterizes this amendment as arbitrary and unlawful, causing Nova Plama significant loss, in violation of the ECT.
277. Bulgaria's actions, says Claimant, are a violation of its obligation in Article 10(1) of the ECT to accord PCL fair and equitable treatment, and the most constant protection and security to its investment and have subjected its investment to unreasonable measures. Taken together with the other actions of Bulgaria *vis-à-vis* Nova Plama, its unlawful privatization of Varna Port amounts to an expropriation in violation of Article 13 of the ECT.
278. Respondent replies, first, that Varna Port is not exclusive State property under the Bulgarian constitution or Maritime Act or under decisions of the competent courts and that, therefore, Claimant had no legitimate expectation that the port would remain owned by the State. Respondent points out that there is a pending dispute between Petrol A.D. and the State as to the legal status of certain parts of Varna Port. Respondent contends that Claimant has failed to show that this ownership dispute has had any adverse impact on Nova Plama. According to Respondent, Nova Plama was not denied access to Varna Port or use of its facilities, and, in any event, Nova Plama had other alternatives to Varna Port available to it. Nor has Claimant substantiated its allegation that Petrol A.D. abused a dominant position in its dealings with Nova Plama; and in any case Claimant's claims of anti-competitive conduct by Petrol A.D. are inadmissible (see Respondent's Counter-Memorial on the Merits, paras. 348-351).

#### 4.2 The Tribunal's Analysis

279. Claimant's contentions that Respondent violated its obligations *vis-à-vis* PCL under the ECT can be dismissed in a relatively brief manner. This is so because the Arbitral Tribunal finds no evidence that Nova Plama was in any way denied access to Varna Port and to the use of its facilities on

commercially reasonable terms. In its submissions to the Tribunal, Claimant complains about the effects of the privatisation of Varna Port on its ability to use the port and its facilities. It alleges that the new owner of the port threatened Nova Plama's representatives and intended to drive the company back into bankruptcy; but the Tribunal has been unable to verify these allegations through any cogent evidence in the record. Otherwise, the concerns expressed by Claimant seem largely theoretical; and there is persuasive evidence that in practice – if Nova Plama had really wanted access to the port and its facilities – it could have obtained it on terms equivalent to other users. The evidence shows that Rexoil, an affiliated company of Nova Plama, imported oil through Varna Port throughout the year 1999. Why Nova Plama could not do the same was never explained to the satisfaction of the Arbitral Tribunal.

280. Claimant's allegations that Varna Port was unconstitutionally privatized do not fall within the competence of the Arbitral Tribunal to determine but rather that of the Bulgarian courts. However, the ordinary meaning of the words "republican roads" in the Bulgarian constitution, relied upon by Claimant to show that Varna Port was exclusive State property, does not seem to include ports.<sup>59</sup> Claimant's concern that the ownership of Varna Port by Petrol A.D., an alleged competitor of Nova Plama, gave it power to strangle Nova Plama by charging it exorbitant rates or denying it access to and use of the port and its facilities could and should have been tested by Nova Plama's entering into negotiations with Petrol A.D. to see whether commercially acceptable terms could be obtained. Even if Claimant believed that Petrol A.D. was not the legal owner of the port facilities, with the backing of the Government, it could, nevertheless, have negotiated with those who were incontestably in control of the port. The Government offered its assistance in this regard (see, for example, R's Exhs. 458, 463, 465 and 481). There was no evidence that any other person or enterprise had any like difficulty in negotiating terms for use

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<sup>59</sup> See also Article 3(2) of the Bulgarian Roads Act, cited in Professor Chipev's legal opinion of 16 July 2006, para. 163: "[T]he republican roads shall be motorways and first, second and third grade roads ensuring transportation connections of national significance and forming the state road network."

of the port or actually using it, including Rexoil, Claimant's affiliate.<sup>60</sup> While the evidence shows that there were some exchanges and meetings between representatives of Nova Plama and Petrol A.D., there was no evidence that Nova Plama or PCL made any serious effort to work out the terms of an agreement with Petrol A.D. for the use of Varna Port, despite Claimant's contention in its Post-Hearing Submission on the Merits (at paragraph 82 and elsewhere) that it "*attempted to negotiate a renewal of its contract with Petrol.*" The Arbitral Tribunal does not consider that Respondent had an obligation to assure Nova Plama that its rights under any contract it negotiated with Petrol A.D. would be respected, as Claimant demanded.

281. Moreover, the acts of Petrol A.D. complained of by Claimant cannot be attributed to Respondent under Bulgarian or international law. There is no evidence that the Government intervened with Petrol A.D. in any way to encourage it to deny Nova Plama's use of Varna Port on reasonable commercial terms. To the contrary, the evidence shows that the Government tried to assist Claimant and the Refinery to make an arrangement that would allow fuel to flow to the Refinery.
282. The fact that the Government privatized Varna Port is not, in and of itself, violative of any obligation it owed to Claimant under the ECT. There is nothing in the ECT which would prevent Bulgaria from privatizing its ports so long as it was done in a way which did not discriminate against Claimant and did not deprive it of a right necessary to the economic operation of the Refinery - a right which it obtained under its agreements with the Government to purchase the shares of Nova Plama. Nothing in the evidential record persuades the Tribunal that the privatization of Varna Port was done otherwise.<sup>61</sup> As for Bulgaria's amendment of its Maritime Law in 2004, the Arbitral Tribunal finds nothing arbitrary or unlawful in this enactment.

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<sup>60</sup> See R's Exhs. 881, 882, 883, 884, 885, 886, 984, 985, 986, 987 and 988.

<sup>61</sup> During oral argument at the January-February 2008 Hearing concerning Varna Port, Counsel for Claimant alleged that Respondent allowed a Government-owned oil refinery company, Neftochim, to operate in 1999 on discriminatory terms which made competition by Nova Plama nearly impossible (H. Tr., Day 1, January 28, 2008, pp. 23-24). The Arbitral Tribunal is not persuaded by the evidence of these allegations. In any event, allegations of

283. Respondent's final argument that, in any event, this amendment occurred after 18 February 2003, when Bulgaria exercised its right to deny the privileges of the ECT to Claimant, falls away, given that the Tribunal in this Award decides that Mr. Vautrin owned or controlled Claimant (para. 95 *supra*).
284. Given these elements, the Arbitral Tribunal finds no breach by Respondent of its obligations to Claimant under the ECT with respect to the use of Varna Port.

## **5. Biochim Bank**

### **5.1 The Parties' Positions**

285. Claimant states that through a State-owned bank, the Commercial Bank Biochim ("Biochim Bank"), Nova Plama received credit facilities which resulted in the accrual of significant debts owed by Nova Plama to Biochim Bank. Claimant claims that during the negotiation of Nova Plama's Recovery Plan, Biochim Bank coerced the company to accept burdensome amendments and refused to fulfil its obligations under the Debt Settlement Agreement and the Recovery Plan unless its amendments were accepted. Thus, according to Claimant, Biochim Bank refused to accept that PCL buy Nova Plama's debts to Biochim Bank at a discounted value and imposed the requirement that Nova Plama repay 100% of its debts. Biochim Bank had, in Article 4.4 of the Debt Settlement Agreement, agreed, on condition that PCL invest USD 6 million in Nova Plama within two months of the date of start-up of the Refinery, to release Nova Plama's property pledged and mortgaged to it so that PCL could use the property to attract new investment financing. Nonetheless, Biochim Bank reneged on its undertaking even though PCL fulfilled its investment commitment.
286. In addition, Biochim Bank refused to extend the time limit for repayment by Nova Plama of its debts to Biochim Bank even though such extension was



foreseen in the Recovery Plan, threatening to reopen Nova Plama's bankruptcy proceedings.

287. In 2002, Nova Plama contends it tried unsuccessfully to negotiate another debt settlement agreement with Biochim Bank. It then filed a claim against Biochim Bank in the Sofia City Court, which prompted the Bulgarian Ministry of Transport to convoke the company's management to a meeting where, according to Claimant, they were threatened that the State, as a creditor of Nova Plama, would reopen the insolvency proceedings if it did not withdraw the court action. Claimant also alleges that the chairman of Biochim Bank was convoked to a meeting in the Bulgarian Parliament and instructed not to sign a settlement agreement with Nova Plama. In effect, Claimant says, the Government, which was in the process of privatizing Biochim Bank, favored Biochim Bank to the detriment of PCL and Nova Plama, in order to increase the value of Biochim Bank for purposes of its privatization.
288. Biochim Bank was eventually privatized in June 2002 and sold to Bank Austria. According to Claimant, as soon as Biochim Bank was no longer controlled by the Bulgarian State, Nova Plama reached a debt settlement agreement with Bank Austria.
289. Because of the Government's ownership interest in Biochim Bank, Claimant submits that Biochim Bank's actions *vis-à-vis* Nova Plama violate the last sentence of Article 10(1) of the ECT by breaching contractual obligations entered into with PCL. Bulgaria is also in violation of its obligations under Article 22 of the ECT.<sup>62</sup>
290. Bulgaria's intervention in the relationship of Biochim Bank with Nova Plama is also, contends Claimant, a violation of the fair and equitable treatment standard of Article 10(1) of the ECT, a violation of Bulgaria's obligation to provide PCL's investment the most constant protection and security, a subjection of PCL's investment to unreasonable measures and that it amounts,

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62 See Annex for text of Article 22.

together with the other acts of Bulgaria complained of by Claimant, to an expropriation in violation of Article 13 of the ECT.

291. Respondent's reply is, essentially, that there is no persuasive evidence of State intervention in Biochim Bank's decision-making, that Biochim Bank acted in a commercially predictable and reasonable manner in its dealings with Nova Plama and that Biochim Bank did not breach any contractual obligation. On the contrary, Respondent contends, Claimant and Nova Plama made unrealistic and commercially unreasonable demands of the bank, and even when Biochim Bank agreed to terms with Nova Plama, the latter failed to fulfil its obligations.
292. Respondent says that the Debt Settlement Agreement, which provided for Biochim Bank's release of its mortgage over the Nova Plama plant, never entered into force because it was not signed by all parties, including Biochim Bank, as required by its Article 5.1, and, therefore, Biochim Bank cannot be said to have breached any contractual obligations under it. Moreover, Respondent contends that Claimant has never provided any evidence that it fulfilled its commitment to invest at least USD 6 million within two months of the date of start-up of the Refinery. Finally, Respondent contends, Biochim Bank's General Meeting of Shareholders never approved the release of its mortgage, a requirement of the Debt Settlement Agreement.
293. Respondent denies that Biochim Bank coerced Claimant to accept burdensome amendments to the Recovery Plan. It claims that PCL and Nova Plama themselves submitted an amendment to the Recovery Plan which provided that all creditors of Nova Plama, including Biochim Bank, would retain their pre-existing secured interests (R's Exh. 407). The amended Recovery Plan did not obligate Biochim Bank to release its mortgage over the Refinery. Even if Biochim Bank had released its mortgage, says Respondent, Claimant has failed to prove that it would have been able to secure additional financing for Nova Plama's operations.
294. Respondent also contradicts Claimant's assertion that as soon as Biochim Bank was privatized and no longer under Government control, Nova Plama reached a debt settlement with the bank. Respondent says it took two years of

negotiation to reach that settlement which settlement was due essentially to the unlikelihood by that time that Biochim Bank could ever recover any significant amounts from Nova Plama. Respondent says Nova Plama has never paid anything to Biochim Bank.

295. In any event, Respondent contends that the acts of Biochim Bank are not attributable to the State of Bulgaria, which cannot be responsible for them under Article 10(1) of the ECT. Nor is Article 22 of the ECT applicable, since that provision is found in Part IV of the ECT and, therefore, does not fall within the scope of an arbitration under Article 26. Moreover, Biochim Bank is and was even prior to its privatization a commercial bank governed by private law and not a “State enterprise” within the meaning of Article 22 of the ECT.

## 5.2 The Tribunal’s Analysis

296. As noted above, Claimant contends that Biochim Bank, a State-owned bank, “coerced” Nova Plama into accepting “burdensome amendments” and deliberately refused to fulfill its obligations under the Debt Settlement Agreement and the Recovery Plan, causing Nova Plama great difficulties in obtaining new financing. Moreover, Claimant alleges that the State interfered with Biochim Bank and prevented it from reaching a settlement agreement with Nova Plama prior to Biochim Bank’s privatization. Claimant attributes this unlawful conduct to the State on one of two alternative grounds: (i) because Biochim Bank was a State-owned bank and the State used its ownership interest to direct the bank’s acts; and (ii) because of the application of Article 22 of the ECT to Biochim Bank’s conduct.
297. Article 8 of the ILC Articles on State Responsibility contemplates the possibility that the conduct of companies or enterprises owned or controlled by the State be attributable to that state. In the Commentary to the Articles, the ILC notes that:

*Since corporate entities, although owned by and in that sense subject to the control of the State, are considered to be separate, prima facie their conduct in carrying out their*

*activities is not attributable to the State, unless they are exercising elements of governmental authority . . .*<sup>63</sup>

298. However, before the question of attribution arises, it is first necessary to determine whether the corporation has in fact engaged in an unlawful act. The ILC notes in this respect that “[i]f *such corporations* [State-owned and controlled] *act inconsistently with the international obligations of the State concerned the question arises whether such conduct is attributable to the State.*”<sup>64</sup> The Arbitral Tribunal will therefore proceed to determine whether Biochim Bank acted inconsistently with Respondent’s obligations under the ECT.
299. On the evidence before it, the Arbitral Tribunal is not persuaded that Biochim Bank acted *vis-à-vis* Claimant and Nova Plama other than reasonably for its own commercial interests. Nor does it accept Claimant’s argument that Biochim Bank’s refusal to give up its mortgage over Nova Plama’s assets amounted to a breach by Respondent of its obligations *vis-à-vis* Claimant in violation of Article 10(1) of the ECT.
300. Furthermore, while Respondent’s argument that the Debt Settlement Agreement by which Biochim Bank gave up its mortgage over Nova Plama’s assets never entered into force is correct; Biochim Bank’s refusal to give up its mortgage on Nova Plama’s assets was also accepted by Claimant and Nova Plama and confirmed in the Recovery Plan, as amended pursuant to a proposal made by Claimant itself (R. Exh. 407). Undoubtedly, Claimant was under pressure to accept Biochim Bank’s position; but it was free not to accept it and refuse to make further investments on those conditions. It still had considerable negotiating leverage at that time, given Respondent’s strong desire to see Nova Plama continue operations.
301. Nor does the Tribunal find convincing the evidence presented by Claimant that Biochim Bank breached the Recovery Plan or that Respondent exercised undue pressure on Nova Plama to force it into accepting burdensome

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<sup>63</sup> Commentary to Article 8 of the ILC Articles, p. 107, para. 6.

<sup>64</sup> *Ibid.*

conditions. In particular, the evidence is not sufficient to substantiate the claim that Bulgaria interfered in any way with Biochim Bank's reasonable commercial decision to decline Nova Plama's settlement offer.

302. Under these circumstances, the Tribunal considers that Biochim Bank has not engaged in any unlawful act. There is, therefore, no need to address the question of attribution, nor the issue under Article 22 of the ECT.
303. In conclusion, the Arbitral Tribunal finds that Respondent has not committed any violation of its obligations under the ECT with respect to Biochim Bank.

#### **6. Re-opened Bankruptcy Proceedings**

304. Claimant contended that the re-opened bankruptcy proceedings in 2005 were violative of its rights (Claimant's Memorial on the Merits, paras. 229 *et seq.*). The claim was subject to supplementation, depending on the outcome of local proceedings initiated to contest the decision to re-open the bankruptcy proceedings. Claimant did not submit evidence which persuaded the Tribunal of the merits of this claim.

#### **D. Concluding Observations**

305. Based on all that the Arbitral Tribunal has seen and heard in this arbitration, it concludes that what happened with respect to Claimant's investment in Nova Plama is that Mr. Vautrin and PCL undertook a high risk project, without having the financial assets of their own to carry it out. It was based on an ambitious plan to borrow enough money to get the Refinery into operation, hoping thereby to generate sufficient revenues through sales of product to finance the continuing operation of the Refinery, to pay off Nova Plama's creditors over time, to pay wages to the Refinery's workers and to make a profit. Unfortunately, for reasons which, in the Tribunal's opinion, were not attributable to any unlawful actions of Bulgaria, Mr. Vautrin's plan did not work, and Nova Plama fell back into bankruptcy.

#### **E. Damages**

306. Since the Arbitral Tribunal has found that Claimant is not entitled to the protections of the ECT and that, in any event, Respondent did not breach its

obligations to Claimant under the ECT, the Tribunal need not address Claimant's claims for damages.

**F. Costs**

307. Claimant requests an award to it of the costs of the arbitration, including legal fees and other costs, as well as such other relief as the Tribunal may deem appropriate.
308. Likewise, Respondent claims all costs of the arbitration, including its legal fees and other costs, and adds that this is so regardless of whether any aspect of Claimant's case is sustained, because of the obstructionist tactics used by Claimant in this arbitration. Respondent did not claim interest on these costs.
309. Each Party has, pursuant to the Arbitral Tribunal's request, subdivided its costs into different categories: costs for the jurisdictional phase of the arbitration, costs for the procedure relating to Claimant's request for provisional measures, costs for the procedure relating Respondent's request for security for costs, and costs for the merits phase of the arbitration.
310. Accordingly, the Parties have submitted the following claims for legal and other costs (excluding advances made to ICSID):

Claimant:	USD
Jurisdictional phase:	1,662,789.49
Provisional remedies	150,211.00
Merits phase:	2,864,521.30
Total:	4,677,521.79
Respondent:	
Jurisdictional phase:	3,023,288.00
Request for urgent provisional measures:	584,024.00
Request for security for costs:	381,992.00
Merits phase:	9,254,053.00
Total:	13,243,357.00

311. Claimant has advanced USD 459,985 and Respondent USD 460,000 (totaling USD 919,985) on account of the fees and expenses of the members of the Arbitral Tribunal as well as ICSID's administrative charges. As of 31 July

2008, interest accrued on the advances made amounted to USD 28,076.82. Therefore, the advances plus interest amounted to USD 948,061.82.

312. The fees and expenses of the Tribunal as well as ICSID's administrative charges and expenses are the following (in USD):

Arbitrators' fees and expenses	803,866.04
ICSID's administrative charges and expenses	144,195.78
Total	948,061.82

313. The Arbitrators' fees and expenses as well as ICSID's administrative charges and expenses are paid out of the advances made by the Parties.

314. Article 61 of the ICSID Convention provides, with respect to costs, that :

*[...] The Tribunal shall, except as the parties otherwise agree, assess the expenses incurred by the parties in connection with the proceedings and shall decide how and by whom these expenses, the fees and expenses of the members of the Tribunal and the charges for the use of the facilities of the Centre shall be paid. Such decision shall form part of the award.*

315. Rule 47(1) of the ICSID Arbitration Rules provides that the Arbitral Tribunal's Award "*shall contain [...] (j) any decision [...] regarding the cost of the proceeding.*"

316. Article 61 of the ICSID Convention gives the Arbitral Tribunal the discretion to allocate all costs of the arbitration, including attorney's fees and other costs, between the Parties as it deems appropriate. In the exercise of this discretion, the Arbitral Tribunal will apply the principle that "costs follow the event," by a weighing of relative success or failure, that is to say, the loser pays costs including reasonable legal and other costs of the prevailing party; or costs are allocated proportionally to the outcome of the case, save for the circumstances described below.

317. In this arbitration, in the jurisdictional phase, in which Respondent sought a decision that the Arbitral Tribunal had no jurisdiction, it was in part the losing party. Respondent contended, however, that whether it won or lost on its jurisdictional pleas, it should be awarded costs for that phase of the arbitration because of the behavior of Claimant (Respondent's Rejoinder on the Merits, paras. 370 *et seq.*).
318. In its Decision on Jurisdiction (para. 238), the Arbitral Tribunal criticized Claimant for not having earlier disclosed to Respondent the details of the ownership and structure of the PCL-PHL-EMU group. That failure of disclosure certainly added to the costs of Respondent during the jurisdictional phase, which have been taken into account by the Tribunal.
319. Following the Decision on Jurisdiction, Claimant made a request for urgent provisional measures, which the Arbitral Tribunal rejected entirely. The Tribunal reserved a decision on the costs resulting from the proceedings on this request to a later stage.
320. The Arbitral Tribunal convened a meeting in Paris on 16 February 2007 to consider with the Parties Respondent's request to limit the scope of further proceedings and to order Claimant to post security for costs. The Tribunal denied both of Respondent's requests (see paras. 36-42 *supra*). Mr. Vautrin testified at this meeting that "*if the costs are reasonable, Plama Consortium will pay through disposal of other assets*" (H. Tr. p. 55).
321. In the merits phase, Respondent is not only the prevailing party, but the Arbitral Tribunal has found that Claimant was guilty of fraudulent misrepresentation in obtaining its investment in Bulgaria and has denied to Claimant the protections of the ECT for that reason.
322. In light of these factors and in particular the circumstance mentioned in the preceding paragraph, the Arbitral Tribunal decides that Claimant shall bear all of the fees and expenses of the Tribunal and ICSID's administrative charges plus the reasonable legal fees and other costs incurred by Respondent.
323. As to the reasonable amount of those legal fees and other costs, taking into account all the circumstances of the present case, the Tribunal determines those fees and other costs of Respondent at USD 7,000,000.



324. Accordingly, the Tribunal determines that Claimant will bear all fees and expenses of the Arbitral Tribunal as well as ICSID's administrative charges and will order Claimant to pay to Respondent USD 460,000 on account of its advance on costs as well as USD 7,000,000 as a reasonable proportion of Respondent's legal fees and other costs.

**VI. DISPOSITIVE**

325. On the basis of the foregoing, the Arbitral Tribunal makes the following decisions:

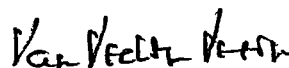
1. Incorporates by reference its Decision on Jurisdiction of 8 February 2005;
2. Respondent cannot rely on Article 17(1) of the Energy Charter Treaty to deny Claimant the benefits of Part III of the Treaty until 17 February 2003;
3. Claimant is not entitled to any of the substantive protections afforded by the ECT;
4. Assuming that Claimant would have been entitled to substantive protections afforded by the ECT:
  - (a) Respondent did not violate its obligations to Claimant under the ECT with respect to issues of past environmental damages;
  - (b) Respondent did not violate its obligations to Claimant under the ECT by virtue of the actions of the syndics;
  - (c) Respondent did not violate its obligations to Claimant under the ECT with respect to the matter of taxation of "*paper profits*", even assuming that the ECT applies to this issue;
  - (d) Respondent did not breach its obligations to Claimant under the ECT with respect to the use of Varna Port;
  - (e) Respondent did not breach its obligations to Claimant under the ECT with respect to the actions of Biochim Bank;
  - (f) The Arbitral Tribunal finds no other violations by Respondent of its obligations to Claimant under the ECT;
  - (g) The Arbitral Tribunal rejects all Claimant's claims for damages;

5. Claimant bears all fees and expenses of the Arbitral Tribunal as well as ICSID's administrative charges, being USD 919,985, which are paid out of the advances made by the Parties.
6. Claimant is ordered to pay Respondent USD 460,000 on account of Respondent's advance on costs as well as USD 7,000,000 on account of Respondent's legal fees and other costs.
7. All other claims and requests by the Parties are rejected.



Professor Albert Jan van den Berg  
Arbitrator

[August 18, 2008]



V.V. Veeder  
Arbitrator

[August 13, 2008]



Carl F. Salans  
President

[August 8, 2008]

## ANNEX

### ECT

#### Article 1 - Definitions

*As used in this Treaty:*

...

*(6) "Investment" means every kind of asset, owned or controlled directly or indirectly by an Investor and includes:*

*(a) tangible and intangible, and movable and immovable, property, and any property rights such as leases, mortgages, liens, and pledges;*

*(b) a company or business enterprise, or shares, stock, or other forms of equity participation in a company or business enterprise, and bonds and other debt of a company or business enterprise;*

*(c) claims to money and claims to performance pursuant to contract having an economic value and associated with an Investment;*

*(d) Intellectual Property;*

*(e) Returns;*

*(f) any right conferred by law or contract or by virtue of any licences and permits granted pursuant to law to undertake any Economic Activity in the Energy Sector.*

*A change in the form in which assets are invested does not affect their character as investments and the term "Investment" includes all investments, whether existing at or made after the later of the date of entry into force of this Treaty for the Contracting Party of the Investor making the investment and that for the Contracting Party in the Area of*

*which the investment is made (hereinafter referred to as the "Effective Date") provided that the Treaty shall only apply to matters affecting such investments after the Effective Date.*

*"Investment" refers to any investment associated with an Economic Activity in the Energy Sector and to investments or classes of investments designated by a Contracting Party in its Area as "Charter efficiency projects" and so notified to the Secretariat.*

*(7) "Investor" means:*

*(a) with respect to a Contracting Party:*

*(i) a natural person having the citizenship or nationality of or who is permanently residing in that Contracting Party in accordance with its applicable law;*

*(ii) a company or other organization organized in accordance with the law applicable in that Contracting Party;*

*(b) with respect to a "third state", a natural person, company or other organization which fulfils, mutatis mutandis, the conditions specified in subparagraph (a) for a Contracting Party.*

...

*Article 10 – Promotion, Protection and Treatment of Investments.*

*(1) Each Contracting Party shall, in accordance with the provisions of this Treaty, encourage and create stable, equitable, favourable and transparent conditions for Investors of other Contracting Parties to make Investments in its Area. Such conditions shall include a commitment to accord at all times to Investments of Investors of other Contracting Parties fair and equitable treatment. Such Investment shall also enjoy the most constant protection and security and no Contracting Party shall in any way impair by unreasonable or discriminatory measures their management, maintenance, use,*

*enjoyment or disposal. In no case shall such Investments be accorded treatment less favourable than that required by international law, including treaty obligations. Each Contracting Party shall observe any obligations it has entered into with an Investor or an Investment of an Investor of any other Contracting Party.*

*(2) Each Contracting Party shall endeavour to accord to Investors of other Contracting Parties, as regards the Making of Investments in its Area, the Treatment described in paragraph (3).*

*(3) For the purposes of this Article, "Treatment" means treatment accorded by a Contracting Party which is no less favourable than that which it accords to its own Investors or to Investors of any other Contracting Party or any third state, whichever is the most favourable.*

*(4) A supplementary treaty shall, subject to conditions to be laid down therein, oblige each party thereto to accord to Investors of other parties, as regards the Making of Investments in its Area, the Treatment described in paragraph (3). That treaty shall be open for signature by the states and Regional Economic Integration Organizations which have signed or acceded to this Treaty. Negotiations towards the supplementary treaty shall commence not later than 1 January 1995, with a view to concluding it by 1 January 1998.*

*(5) Each Contracting Party shall, as regards the Making of Investments in its Area, endeavour to:*

*(a) limit to the minimum the exceptions to the Treatment described in paragraph (3);*

*(b) progressively remove existing restrictions affecting Investors of other Contracting Parties.*

*(6)(a) A Contracting Party may, as regards the Making of Investments in its Area, at any time declare voluntarily to the*

*Charter Conference, through the Secretariat, its intention not to introduce new exceptions to the Treatment described in paragraph (3).*

*(b) A Contracting Party may, furthermore, at any time make a voluntary commitment to accord to Investors of other Contracting Parties, as regards the Making of Investments in some or all Economic Activities in the Energy Sector in its Area, the Treatment described in paragraph (3). Such commitments shall be notified to the Secretariat and listed in Annex VC and shall be binding under this Treaty.*

*(7) Each Contracting Party shall accord to Investments in its Area of Investors of other Contracting Parties, and their related activities including management, maintenance, use, enjoyment or disposal, treatment no less favourable than that which it accords to Investments of its own Investors or of the Investors of any other Contracting Party or any third state and their related activities including management, maintenance, use, enjoyment or disposal, whichever is the most favourable.*

*(8) The modalities of application of paragraph (7) in relation to programmes under which a Contracting Party provides grants or other financial assistance, or enters into contracts, for energy technology research and development, shall be reserved for the supplementary treaty described in paragraph (4). Each Contracting Party shall through the Secretariat keep the Charter Conference informed of the modalities it applies to the programmes described in this paragraph.*

*(9) Each state or Regional Economic Integration Organization which signs or accedes to this Treaty shall, on the date it signs the Treaty or deposits its instrument of accession, submit to the Secretariat a report summarizing all laws, regulations or other measures relevant to:*



*(a) exceptions to paragraph (2); or*

*(b) the programmes referred to in paragraph (8).*

*A Contracting Party shall keep its report up to date by promptly submitting amendments to the Secretariat. The Charter Conference shall review these reports periodically.*

*In respect of subparagraph (a) the report may designate parts of the energy sector in which a Contracting Party accords to Investors of other Contracting Parties the Treatment described in paragraph (3).*

*In respect of subparagraph (b) the review by the Charter Conference may consider the effects of such programmes on competition and Investments.*

*(10) Notwithstanding any other provision of this Article, the treatment described in (3) and (7) shall not apply to the protection of Intellectual Property; instead the treatment shall be as specified in the corresponding provisions of the applicable international agreements for the protection of Intellectual Property rights to which the respective Contracting Parties are parties.*

*(11) For the purposes of Article 26, the application by a Contracting Party of a trade-related investment measure as described in Article 5(1) and (2) to an Investment of an Investor of another Contracting Party existing at the time of such application shall, subject to Article 5(3) and (4), be considered a breach of an obligation of the former Contracting Party under this Part.*

*(12) Each Contracting Party shall ensure that its domestic law provides effective means for the assertion of claims and the enforcement of rights with respect to Investments, investment agreements, and investment authorizations.*

Article 12 – Compensation for Losses

*(1) Except where Article 13 applies, an Investor of any Contracting Party which suffers a loss with respect to any Investment in the Area of another Contracting Party owing to war or other armed conflict, state of national emergency, civil disturbance, or other similar event in that Area, shall be accorded by the latter Contracting Party, as regards restitution, indemnification, compensation or other settlement, treatment which is most favourable of that which that Contracting Party accords to any other Investor, whether its own Investor, the Investor of any other Contracting Party, or the Investor of any third state.*

...

Article 13 - Expropriation

*(1) Investments of Investors of a Contracting Party in the Area of any other Contracting Party shall not be nationalized, expropriated or subjected to a measure or measures having effect equivalent to nationalization or expropriation (hereinafter referred to as "Expropriation") except where such Expropriation is:*

- (a) for a purpose which is in the public interest;*
- (b) not discriminatory;*
- (c) carried out under due process of law; and*
- (d) accompanied by the payment of prompt, adequate and effective compensation.*

*Such compensation shall amount to the fair market value of the Investment expropriated at the time immediately before the Expropriation or impending Expropriation became known in such a way as to affect the value of the Investment (hereinafter referred to as the "Valuation Date").*

*Such fair market value shall at the request of the Investor be expressed in a Freely Convertible Currency on the basis, of the market rate of exchange existing for that currency on the Valuation Date. Compensation shall also include interest at a commercial rate established on a market basis from the date of Expropriation until the date of payment.*

*(2) The Investor affected shall have a right to prompt review, under the law of the Contracting Party making the Expropriation, by a judicial or other competent and independent authority of that Contracting Party, of its case, of the valuation of its Investment, and of the payment of compensation, in accordance with the principles set out in paragraph (1).*

*(3) For the avoidance of doubt, Expropriation shall include situations where a Contracting Party expropriates the assets of a company or enterprise in its Area in which an Investor of any other Contracting Party has an Investment, including through the ownership of shares.*

*Article 17 – Non-Application of Part III<sup>65</sup> in Certain Circumstances.*

*Each Contracting Party reserves the right to deny the advantages of this Part to:*

*(1) a legal entity if citizens or nationals of a third state own or control such entity and if that entity has no substantial business activities in the Area of the Contracting Party in which it is organized;...*

---

<sup>65</sup> Part III of the ECT provides for the treatment to be accorded by the Contracting Parties to investments covered by the Treaty in their territory and includes Articles 10, 13 and 17 quoted in the Annex to this Award.

*(2) an Investment, if the denying Contracting Party establishes that such Investment is an Investment of an Investor of a third state with or as to which the denying Contracting Party:*

*(a) does not maintain a diplomatic relationship; or*

*(b) adopts or maintains measures that:*

*(i) prohibit transactions with Investors of that state; or*

*(ii) would be violated or circumvented if the benefits of this Part were accorded to Investors of that state or to their Investments.*

#### *Article 22 - State and Privileged Enterprises*

*(1) Each Contracting Party shall ensure that any state enterprise which it maintains or establishes shall conduct its activities in relation to the sale or provision of goods and services in its Area in a manner consistent with the Contracting Party's obligations under Part III of this Treaty.*

*(2) No Contracting Party shall encourage or require such a state enterprise to conduct its activities in its Area in a manner inconsistent with the Contracting Party's obligations under other provisions of this Treaty.*

*(3) Each Contracting Party shall ensure that if it establishes or maintains an entity and entrusts the entity with regulatory, administrative or other governmental authority, such entity shall exercise that authority in a manner consistent with the Contracting Party's obligations under this Treaty.*

*(4) No Contracting Party shall encourage or require any entity to which it grants exclusive or special privileges to conduct its activities in its Area in a manner inconsistent with the Contracting Party's obligations under this Treaty.*

*(5) For the purposes of this Article, "entity" includes any enterprise, agency or other organization or individual.*

Article 26 – Settlement of Disputes Between An Investor and a Contracting Party.

(1) *Disputes between a Contracting Party and an Investor of another Contracting Party relating to an Investment of the latter in the Area of the former, which concern an alleged breach of an obligation of the former under Part III shall, if possible, be settled amicably.*

(2) *If such disputes can not be settled according to the provisions of paragraph (1) within a period of three months from the date on which either party to the dispute requested amicable settlement, the Investor party to the dispute may choose to submit it for resolution:*

(a) *to the courts or administrative tribunals of the Contracting Party to the dispute;*

(b) *in accordance with any applicable, previously agreed dispute settlement procedure; or*

(c) *in accordance with the following paragraphs of this Article.*

(3) (a) *Subject only to subparagraphs (b) and (c), each Contracting Party hereby gives its unconditional consent to the submission of a dispute to international arbitration or conciliation in accordance with the provisions of this Article.*

...

(4) *In the event that an Investor chooses to submit the dispute for resolution under subparagraph (2)(c), the Investor shall further provide its consent in writing for the dispute to be submitted to:*

(a)(i) *The International Centre for Settlement of Investment Disputes, established pursuant to the Convention on the Settlement of Investment Disputes between States and Nationals of other States opened for signature at Washington, 18 March 1965 (hereinafter referred to as the “ICSID Convention”), if the Contracting Party of the Investor and the Contracting Party to the dispute are both parties to the ICSID Convention;*

...

*(6) A tribunal established under paragraph (4) shall decide the issues in dispute in accordance with this Treaty and applicable rules and principles of international law.*

...

*(8) The awards of arbitration, which may include an award of interest, shall be final and binding upon the parties to the dispute.*

...

## **LEGAL AUTHORITY CA-71**

**CERTIFICATE**


**AES Summit Generation Limited and AES-Tisza Erömu Kft.**

**v.**

**Republic of Hungary**

(ICSID Case No. ARB/07/22)

I hereby certify that the attached is a true copy of the Award of the Arbitral Tribunal dated September 23, 2010.



Meg Kinnear  
Secretary-General

Washington, D.C.  
September 23, 2010



**INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES**

In the matter of the arbitration between

**AES SUMMIT GENERATION LIMITED  
AES-TISZA ERŐMŰ KFT**

(Claimants)

- and -

**THE REPUBLIC OF HUNGARY**

(Respondent)

(ICSID Case No. ARB/07/22)

**AWARD**

**Members of the Tribunal**

Mr. Claus Werner von Wobeser, President  
Prof. Brigitte Stern, Arbitrator  
J. William Rowley QC, Arbitrator

**Secretary of the Tribunal**

Ms. Frauke Nitschke

**Date of Dispatch to the Parties**

September 23, 2010

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## **1. ABBREVIATIONS AND DEFINED TERMS**

- 1.1 **1994 Electricity Act** - Act XLVIII of 1994 on the Generation, Supply and Provision of Electricity.
- 1.2 **1995 Framework Decree** - GKM Decree 63/1995 (XI.24.) on the regulation of prices of electricity and hot water and steam sold by public utility electricity units and their heat generating installations.
- 1.3 **2000 Framework Decree** - GM Decree 45/2000 (XII. 24.) on the regulation of prices of electricity and hot water and steam sold by public utility electricity units and their heat generating installations.
- 1.4 **2000 PSA Claim** - The arbitration commenced by the AES Corporation (the ultimate parent company of the Claimants) and AES Summit against APV and MVM in October 2000 for breach of the PSA.
- 1.5 **2000 Treaty Claim** - The arbitration commenced by AES Summit against Hungary in November 2000 under the ECT and also under the Agreement Between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People's Republic of Hungary for the Promotion and Reciprocal Protection of Investments.
- 1.6 **2001 Amendment Agreement** - The agreement dated 19 December 2001 made between AES Tisza and MVM which amended and extended the original PPA as required by the 2001 Settlement Agreement.
- 1.7 **2001 Electricity Act** - Act CX of 2001 on Electricity.
- 1.8 **2001 PPA** - The Original PPA as amended by the 2001 Amendment Agreement.
- 1.9 **2001 Settlement Agreement** - The agreement settling, amongst other things, the 2000 PSA Claim and the 2000 Treaty Claim, dated 19 December 2001.

- 1.10 **2006 Electricity Act Amendment** - The amendment to the 2001 Electricity made by the Hungarian parliament on 6 February 2006, coming into force on 3 March 2006.
- 1.11 **2006 Price Decree** - Decree GKM No. 80/2006 (XI.24.) issued by GKM on 24 November 2006.
- 1.12 **2007 Price Decree** - Decree GKM No. 14/2007 (I.26.) issued by GKM on 26 January 2007.
- 1.13 **2007 Electricity Act** - Act LXXXVI of 2007 on Electricity.
- 1.14 **AES Corp** - AES Corporation, the ultimate parent company of the company of the Claimants.
- 1.15 **AES Summit** - AES Summit Generation Limited, the First Claimant.
- 1.16 **AES Tisza** - AES – Tisza Erömu Kft, the Second Claimant.
- 1.17 **Amendment Agreement** - The agreement between MVM and all generators and electricity suppliers, amending the terms of the Original PPA, dated 18 December 1995, during the privatization process.
- 1.18 **ÁPV** - Állami Privatizációs és Vagyonkezelő Részvénytársaság (since 8 February 2006 Állami Privatizációs es Vagyonkezelő Zártkörűen Működő Részvénytársaság).
- 1.19 **Availability Fee (Sometimes, Capacity Fee)** - As defined in the 2001 PPA.
- 1.20 **Borsod Project** - The construction of a new power plant at Borsod.
- 1.21 **Centre** - The International Centre for Settlement of Investment Disputes.
- 1.22 **Claimants** - AES Summit and AES Tisza.
- 1.23 **Commission** - The Commission of the European Communities.

- 1.24 **Community competition law** - The body of laws of the European Community regarding competition.
- 1.25 **Community law** - The law of the European Community.
- 1.26 **Community State Aid Rules** - The body of rules of the European Community regarding state aid.
- 1.27 **Convention** - The Convention on the Settlement of Investment Disputes between States and Nationals of Other States.
- 1.28 **Development Projects** - The Borsod Project and the Tisza II Retrofit.
- 1.29 **DG Comp.** - The Competition Directorate General of the European Commission.
- 1.30 **ECT** - The Energy Charter Treaty.
- 1.31 **EC** - The European Community.
- 1.32 **Eeckhout Report** - The Expert Report dated 30 October 2008 of Professor Piet Eeckhout.
- 1.33 **Energy Fee** - As defined in the 2001 PPA.
- 1.34 **Facilities Agreement** - The €98 million project finance loan facilities agreement dated 20 December 2002.
- 1.35 **Fazekas Report** - The Expert Report dated 7 July 2008 of Dr. Mariana Fazekas.
- 1.36 **FIDESZ** - The Conservative Party in Hungary.
- 1.37 **First Horrocks Statement** - The First Witness Statement dated 6 March 2008 of Andrew Joseph Horrocks.
- 1.38 **GKM** - The Hungarian Ministry of Economy and Transport.
- 1.39 **HEO** - The Hungarian Energy Office.

- 1.40 **Hungary** - The Republic of Hungary.
- 1.41 **ICSID** - The International Centre for Settlement of Investment Disputes.
- 1.42 **Lithgow Statement** - The Witness Statement dated 7 March 2008 of Peter Lithgow.
- 1.43 **MVM** - Magyar Villamos Művek Részvénytársaság (since 21 October 2005 Magyar Villamos Művek Zártkörűen Működő Részvénytársaság) and its wholly owned subsidiaries, including MVM Trader.
- 1.44 **Navigant Report** - The Expert Report dated 11 July 2008 of Mr. Brent C. Kaczmarek, CFA of Navigant Consulting, Inc.
- 1.45 **Original Tisza II PPA** - The Tisza II power purchase agreement dated 10 October 1995.
- 1.46 **Petersen Report** - The Expert Report dated 30 October 2008 of Mr. Asger Petersen.
- 1.47 **Price Act** - LXXXVII of 1990 on the determination of prices.
- 1.48 **Price Decrees** - The 2006 Price Decree and the 2007 Price Decree.
- 1.49 **PSA** - Purchase and Sale Agreement between MVM, ÁPV, AES Summit and the AES Corporation as guarantor, dated 4 July 1996.
- 1.50 **Request** - The Request for Arbitration dated 6 July 2007.
- 1.51 **Respondent** - The Republic of Hungary.
- 1.52 **Salzburg Report** - Expert Opinions of Professor Thomas Eilmansberger, Thomas Jaeger Mag., LL.M, and Peter Thyri Mag., LL.M on the Compatibility of Hungarian System of Long-term Capacity and Power Purchase Agreement with EU Energy and Competition Law dated 23 November 2004.
- 1.53 **SAMO** - State Aid Monitoring Office of the Ministry of Finance.

- 1.54 **Second Horrocks' Statement** - The Second Witness Statement dated 31 October 2008 of Andrew Joseph Horrocks.
- 1.55 **Second LECG Report** - The Second Expert Report dated 31 October 2008 of Dr. Manuel A. Abdala and Professor Pablo T. Spiller of LECG LLC.
- 1.56 **Slot Report** - The Expert Report dated 4 July 2008 of Professor Piet Jan Slot.
- 1.57 **State Aid Decision** - The Commission's decision on the state aid awarded by Hungary through Power Purchase Agreements adopted 4 June 2008.
- 1.58 **Stranded Costs Decree** - GKM Decree 183/2002 implementing the two solutions mandated by the 2001 Electricity Act, allowing consumers above a certain consumption threshold to choose their suppliers freely and go out to the liberalized part of the market.
- 1.59 **Tisza II Retrofit** - Part of the "Development Project," a defined term in the PSA: Describes a major retrofit of all four units at the Tisza II power station.
- 1.60 **Varga Report** - The Expert Report of Dr. István Varga dated 30 October 2008.
- 1.61 **Vienna Convention** - The Vienna Convention on the Law of Treaties of 1969.
- 1.62 **WACC** - The Weighted Average Cost of Capital.

## **2. THE PARTIES AND THEIR REPRESENTATIVES**

### **2.1 Claimants**

2.1.1 The Claimants in this arbitration are AES Summit Generation Limited ("AES Summit") and AES-Tisza Erömu Kft. ("AES Tisza").

2.1.2 AES Summit, the first Claimant, is a company incorporated under the laws of the United Kingdom ("UK"). AES Tisza, the second Claimant, is a company incorporated under the



laws of the Republic of Hungary. AES Summit owns 99% of, and exercises ownership and control over, AES Tisza.

2.1.3 AES Summit and AES Tisza (the “Claimants”) are represented in this proceeding by Stephen Jagusch, Richard Farnhill, Jeffrey Sullivan, Sophie Minoprio, Orsolya Toth and Alex Hiendl of Allen & Overy, London, and Dr. Csaba Polgár of Polgár & Bebók Law Office, Budapest.

## **2.2 Respondent**

2.2.1 The Respondent in this arbitration is the Republic of Hungary (“Hungary” or “the Respondent”). Hungary is an Eastern European country, which entered into the European Union in the year 2004.

2.2.2 Hungary is represented in this arbitration by Jean Kalicki, Luc Gyselen, Dmitri Evseev, Alessando Maggi, Suzana Medeiros Blades, and Clara Vondrich of Arnold & Porter, Washington and Brussels offices, and Dr. János Katona of the Law Office of Dr. János Katona, Budapest.

## **3. THE TRIBUNAL AND THE PROCEDURE**

3.1 On 9 July 2007, the International Centre for Settlement of Investment Disputes (“ICSID” or the “Centre”) received a Request for Arbitration (“Request for Arbitration” or the “Request”) of the same date from AES Summit Generation Limited, a company incorporated under the laws of the United Kingdom, and AES-Tisza Erömö Kft., a company incorporated under the laws of the Republic of Hungary, against the Republic of Hungary.

3.2 In the Request, the Claimants invoke the ICSID arbitration provision contained in Article 26 of the 1994 Energy Charter Treaty (the “ECT” or the “Treaty”).

3.3 In accordance with Rule 5 of the ICSID Rules of Procedure for the Institution of Conciliation and Arbitration Proceedings (the “ICSID Institution Rules”), the Centre acknowledged receipt of the Request on 9 July 2007, and on the same day transmitted a copy of the Request to the Respondent and counsel for the Respondent.

3.4 The Request for Arbitration was registered by the ICSID Secretary-General on 13 August 2007, pursuant to Article 36(3) of the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (the “ICSID Convention” or “Washington Convention”) and, on the same day, the Secretary-General, in accordance with ICSID Institution Rule 7, notified the parties of the registration and invited them to proceed to the constitution of an Arbitral Tribunal as soon as possible.

3.5 On 12 September 2007, the parties agreed in accordance with Rule 2 of the ICSID Rules of Procedure for Arbitration Proceedings (the “ICSID Arbitration Rules”) on the method of constitution of the Arbitral Tribunal, providing for an Arbitral Tribunal consisting of three arbitrators, one arbitrator appointed by each party (by 12 September 2007, and 12 October 2007, respectively), and the third, presiding, arbitrator to be appointed by the party-appointed arbitrators by 12 November 2007. In the event that the two party-appointed arbitrators were unable to reach agreement within the agreed time period, the presiding arbitrator was to be appointed by the ICSID Secretary-General.

3.6 By letter of the same date, *i.e.*, 12 September 2007, the Claimants appointed J. William Rowley QC, a national of Canada, as arbitrator. Mr. Rowley accepted his appointment on 14 September 2007.

3.7 By letter of 12 October 2007, the Respondent appointed Professor Brigitte Stern, a French national, as arbitrator. Professor Stern accepted her appointment on 16 October 2007.

3.8 In accordance with the parties' agreement, the two party-appointed arbitrators appointed, on 5 November 2007, Claus von Wobeser, a national of Mexico, as the President of the Tribunal. By letter of 14 November 2007, Mr. Wobeser accepted his appointment.

3.9 By letter of 21 November 2007, the ICSID Acting Secretary-General informed the parties that all arbitrators had accepted their appointments and that the Tribunal was deemed to have been constituted and the proceeding to have begun on that date, pursuant to Rule 6(1) of the ICSID Arbitration Rules. On the same day, Mr. Ucheora Onwuamaegbu was appointed Secretary of the Tribunal. Later, on 26 January 2010, Mr. Ucheora Onwuamaegbu was replaced as Secretary of the Tribunal by Ms. Frauke Nitschke.

3.10 By letters of 29 November 2007 and 3 December 2007, the Centre requested each party to make an initial advance payment to defray the cost of the proceeding in its first three to six months. The Claimants' share was received on 12 December 2007, and the Respondent's payment was received on 28 December 2007. An additional advance payment was requested from the parties by letter of 14 January 2009. Payment from the Respondent was received on 11 February 2009 and the Claimants' share was received on 13 February 2009. A further advance payment was requested from the parties by letter of 12 February 2010. The Claimants' share was

received on 23 February 2010. Payment from the Respondent was received on 5 April 2010. A final advance payment was requested from the parties on 3 June 2010. Payment from the Claimants was received on 28 June 2010, and the Respondent's share was received on 31 August 2010.

3.11 Following an agreement between the parties and the Tribunal to hold the first session in this proceeding on 9 January 2008, the parties submitted, under cover of a letter of 19 December 2007, a joint statement concerning the items of the draft agenda for the first session, which was earlier circulated by the Secretary of the Tribunal.

3.12 By agreement of the parties, the first session was held on 9 January 2008, in London. Present at the session were: Mr. Claus von Wobeser, President of the Tribunal, Mr. J. William Rowley QC, Arbitrator, and Professor Brigitte Stern, Arbitrator. Attending on behalf of the Claimants: Mr. Stephen Jagusch, Mr. Jeffrey Sullivan, and Ms. Caroline Bordas of Allen & Overy, and Mr. Benedek Sipocz of AES-Tisza Erőmű Kft. Attending on behalf of the Respondent: Ms. Jean E. Kalicki and Mr. Dmitri Evseev of Arnold & Porter, Dr. János Katona of the Law Offices of János Katona, Budapest, and Mr. Peter Gordos, Head of the Energy Department at the Ministry of Economy, Republic of Hungary. The Secretary of the Tribunal, Mr. Ucheora Onwuamaegbu, attended by video-conference from Washington, D.C.

3.13 At the first session, the parties' agreement regarding the procedural calendar was noted. Pursuant to this agreement, the following calendar was established for the further written and oral procedure:

- (a) Claimants' Memorial (together with supporting documents, witness statements and expert reports) by 7 March 2008;

- (b) Respondent's Counter-Memorial (together with supporting documents, witness statements and expert reports) by 11 July 2008;
- (c) Claimants' Reply to Respondent's Counter-Memorial, (together with reply witness statements and supplementary expert reports) by 10 October 2008;
- (d) Respondent's Rejoinder to Claimants' Reply, (together with reply witness statements and supplementary expert reports) by 9 January 2009; and
- (e) Hearing on the merits to be held from 9 to 13 March 2009.

3.14 In accordance with the procedural calendar agreed at the first session, the Claimants' Memorial on the merits was filed on 7 March 2008.

3.15 By letter of 17 April 2008, the Respondent filed a request for production of documents before the Tribunal, to which the Claimants objected by letter of 18 April 2008. By letter of 21 April 2008, the Respondent filed observations on the Claimants' objection of 18 April 2008. On 6 May 2008, the Tribunal issued Procedural Order No. 1, on the Respondent's request for production of documents.

3.16 By letter of 19 May 2008, the Respondent filed a further request for production of documents. The Claimants filed observations on this request by letter of 21 May 2008. By letter of 22 May 2008, the Respondent filed a response to the Claimants' observations. On 9 June 2008, the Tribunal issued Procedural Order No. 2, on the Respondent's further request for production of documents.

3.17 On 11 July 2008, the Respondent filed its Counter-Memorial on the merits, which was supplemented by a letter of 23 July 2008.

3.18 Under cover of a letter of 3 September 2008, the office of the Acting Director-General, Legal Service, of the European Commission, filed an application under ICSID Arbitration Rule 37 as a non-disputing party. By letter of 18 September 2008, the Tribunal requested the European Commission to clarify certain aspects of its application. On 3 October 2008, the European Commission filed a response to the Tribunal's request, which was transmitted to the parties the same day, with an invitation from the Tribunal to comment on the European Commission's application by 24 October 2008.

3.19 By letter of 18 September 2008, the parties agreed to amend the procedural calendar for the written procedure, providing for the Claimants to file their Reply on the merits by 31 October 2008, and the Respondent its Rejoinder by 13 February 2009.

3.20 By respective letters of 22 October 2009, each side filed observations on the European Commission's application of 3 September 2008, as supplemented by its letter of 3 October 2008.

3.21 In accordance with the amended procedural calendar, the Claimants filed the Reply on the merits on 31 October 2008. This was followed on 25 November 2008, by a correction to the Reply.

3.22 On 26 November 2008, the Tribunal issued Procedural Order No. 3 concerning the European Commission's application to file a written submission pursuant to ICSID Arbitration Rule 37(2). In its Order, the Tribunal allowed the European Commission to file a submission pursuant to ICSID Arbitration Rule 37, within certain prescribed limits, by 15 January 2009. The Tribunal further denied the European Commission's request for copies of the parties' written submissions in light of the fact that the parties had not reached an agreement on this issue.

3.23 By letter of 1 August 2008, the Claimants filed a request for production of documents, and also filed a renewed request for production of documents on 6 October 2008. Following several rounds of observations by both parties on the Claimants' requests, the Tribunal issued, on 22 December 2008, and 5 January 2009, Procedural Order Nos. 4 and 5 concerning production of documents.

3.24 By letter of 7 January 2009, the Claimants filed a further request for production of documents. Having considered several written observations on this request from both parties, the Tribunal issued, on 13 January 2009, Procedural Order No. 6 concerning the Claimants' requests for production of documents.

3.25 Under cover of a letter of 15 January 2009, the European Commission filed a written submission pursuant to ICSID Arbitration Rule 37, in accordance with the Tribunal's Procedural Order No. 3.

3.26 By letter of 26 January 2009, the Claimants filed a further request for production of documents. Following several rounds of communication by the parties on this request, the Tribunal issued, on 4 February 2009, Procedural Order No. 7 concerning the Claimants' request for production of documents.

3.27 On 13 February 2009, each party filed observations on the written submission by the European Commission of 15 January 2009. On the same day, the Respondent filed its Rejoinder on the merits.

3.28 In accordance with the procedural calendar agreed at the first session, the hearing on the merits was held from 9 to 13 March 2009 in Washington, D.C. At the hearing, both sides

presented oral arguments on the merits of the dispute, and provided witness and expert testimony.

3.29 Following an application by the Claimants, the Tribunal ordered the Respondent during the hearing, on 11 March 2009, to produce certain documents. The Tribunal further specified that certain portions of these documents could be redacted by the Respondent. However, it was agreed by the parties and the Tribunal that any disagreement between the parties on any redactions proposed by the Respondent would be submitted to the Secretary of the Tribunal for decision, without recourse to the Tribunal. Following a number of written exchanges between the parties regarding proposed redactions by the Respondent, the parties invited the Secretary's decision.

3.30 On 27 March 2009, pursuant to the Tribunal's document request during the hearing, the parties jointly filed post-hearing bundles. The parties also exchanged correspondence on the suspense file produced at the hearing. Consequently, further documents were introduced into the suspense file following the hearing.

3.31 On 3 April 2009, the Secretary of the Tribunal issued his decision on the Respondent's proposed redactions to certain documents.

3.32 On 20 April 2009, the Respondent filed a request for the admissibility of new evidence. Following several communications by the parties, the Tribunal issued, on 13 May 2009, Procedural Order No. 8 concerning the admissibility of new evidence and the further procedural calendar.



3.33 On 29 May 2009, the parties filed post-hearing briefs, in accordance with the procedural calendar set forth by the Tribunal in its Procedural Order No. 8.

3.34 Under cover of a letter of 4 June 2009, the Claimants requested to file a further post-hearing submission. The Respondent filed observations on this request by letter of 5 June 2009, which Claimants replied to by letter of 9 June 2009. The Tribunal, having considered the parties' submissions, denied the Claimants' request on 3 September 2009.

3.35 On 24 December 2009, the Claimants filed a request for the admissibility of new evidence. Following several rounds of communications by the parties on this request, the Tribunal issued, on 4 February 2010, Procedural Order No. 9 concerning the admissibility of new evidence.

3.36 On 4 June 2010, the Tribunal declared the proceeding closed pursuant to ICSID Arbitration Rule 38(1).

3.37 By letter of 25 June 2010, the Respondent filed its final Statement of Costs incurred in the proceeding, which amounted to a total cost of US\$ 5,522,883.

3.38 On 8 July 2010, the Claimants filed their final Statement of Costs, which amounted to a total cost of US\$ 8,787,993.70

3.39 The Members of the Tribunal deliberated by various means of communication, including meetings in Washington, D.C. on 13 March 2009 and in New York on 1 September 2009.

#### 4. FACTUAL BACKGROUND

4.1 This arbitration arises from an alleged violation by Respondent of Articles 10(1), 10(7) and 13 of the 1994 Energy Charter Treaty (the “ECT” or the “Treaty”).<sup>1</sup> Claimants argue that an act of the Republic of Hungary, which was the reintroduction in 2006 and 2007 of administrative

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<sup>1</sup> Article 10(1) and 10(7), and Article 13 of the ECT read as follows:

Article 10(1) Each Contracting Party shall, in accordance with the provisions of this Treaty, encourage and create stable, equitable, favourable and transparent conditions for Investors of other Contracting Parties to make Investments in its Area. Such conditions shall include a commitment to accord at all times to Investments of Investors of other Contracting Parties fair and equitable treatment. Such Investments shall also enjoy the most constant protection and security and no Contracting Party shall in any way impair by unreasonable or discriminatory measures their management, maintenance, use, enjoyment or disposal. In no case shall such Investments be accorded treatment less favourable than that required by international law, including treaty obligations. Each Contracting Party shall observe any obligations it has entered into with an Investor or an Investment of an Investor of any other Contracting Party.

Article 10(7) Each Contracting Party shall accord to Investments in its Area of Investors of other Contracting Parties, and their related activities including management, maintenance, use, enjoyment or disposal, treatment no less favourable than that which it accords to Investments of its own Investors or of the Investors of any other Contracting Party or any third state and their related activities including management, maintenance, use, enjoyment or disposal, whichever is the most favourable.

Article 13(1) Investments of Investors of a Contracting Party in the Area of any other Contracting Party shall not be nationalized, expropriated or subjected to a measure or measures having effect equivalent to nationalization or expropriation (hereinafter referred to as “Expropriation”) except where such Expropriation is:

- (a) for a purpose which is in the public interest;
- (b) not discriminatory;
- (c) carried out under due process of law; and
- (d) accompanied by the payment of prompt, adequate and effective compensation.

Such compensation shall amount to the fair market value of the Investment expropriated at the time immediately before the Expropriation or impending Expropriation became known in such a way as to affect the value of the Investment (hereinafter referred to as the “Valuation Date”).

Such fair market value shall at the request of the Investor be expressed in a Freely Convertible Currency on the basis of the market rate of exchange existing for that currency on the Valuation Date. Compensation shall also include interest at a commercial rate established on a market basis from the date of Expropriation until the date of payment.

Article 13(2) The Investor affected shall have a right to prompt review, under the law of the Contracting Party making the Expropriation, by a judicial or other competent and independent authority of that Contracting Party, of its case, of the valuation of its Investment, and of the payment of compensation, in accordance with the principles set out in paragraph (1).

Article 13(3) For the avoidance of doubt, Expropriation shall include situations where a Contracting Party expropriates the assets of a company or enterprise in its Area in which an Investor of any other Contracting Party has an Investment, including through the ownership of shares.

pricing pursuant to two Price Decrees, after administrative prices had been abolished as of 1 January 2004, violated their rights under the ECT.

4.2 In 1995, Hungary announced an energy sector privatization as part of a modernization strategy, which included the privatization of certain state-owned power stations.

4.3 On 4 July 1996, a Purchase and Sale Agreement (“PSA”)<sup>2</sup> was signed between, on the one hand, two Hungarian state-owned entities, ÁPV and MVM, and on the other hand, AES Summit, pursuant to which AES Summit purchased a majority shareholding in the company Tiszai Erőmű Részvénytársaság (now called AES Tisza – the second Claimant in this arbitration). The assets of AES Tisza included a power station known as Tisza II as well as two older coal-fired power stations, known as the Borsod power station and the Tiszapalkonya power station. The investment made by AES Summit was approximately US\$ 130 million.

4.4 As a result of the PSA, Hungary was obliged to amend and extend the term of the existing power purchase agreement with Tisza II – which had been signed on 10 October 1995 (“Original Tisza II PPA”)<sup>3</sup> – and to enter into a new long-term power purchase agreement for the Borsod power station (“Borsod PPA”). For its part, AES Summit agreed to pursue and complete a retrofit of all four units at the Tisza II power station and the construction of a new power plant at Borsod.

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<sup>2</sup> Exhibit C-4.

<sup>3</sup> The Original PPA required MVM to pay several different types of fees to AES Tisza, of which there were two major components: (a) the Availability Fee (payment for capacity to be in place in case it is needed); and (b) the Energy Fee (payment for the cost of the power it actually requires to have generated).

4.5 In October 2000, AES Corporation (the ultimate parent company of the Claimants) and AES Summit commenced an arbitration against ÁPV and MVM regarding an alleged failure of Hungary, ÁPV and MVM to grant the promised amendment and extension of the Original Tisza II PPA and the Borsod PPA (the “2000 PSA Claim”).<sup>4</sup>

4.6 A month later, in November 2000, AES Summit commenced another arbitration against Hungary under the ECT and the Agreement Between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People’s Republic of Hungary for the Promotion and Reciprocal Protection of Investments (the “2000 Treaty Claim”).<sup>5</sup>

4.7 Both arbitrations were settled by a Settlement Agreement dated 19 December 2001<sup>6</sup> (the “2001 Settlement Agreement”), by which the Claimants granted a release by way of a full and final settlement of all claims made in the arbitration proceeding. Hungary was a party to the 2001 Settlement Agreement. The 2001 Settlement Agreement superseded all prior agreements, understandings, negotiations and discussions of the parties. Some other terms of the 2001 Settlement Agreement that concern this arbitration are the following:

- (a) the 2001 Settlement Agreement contained “amendments to the 1995 Tisza PPA [Original Tisza II PPA] to be entered into pursuant to this Agreement, in the form contained in schedule 1 [of the Settlement Agreement];”<sup>7</sup>

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<sup>4</sup> Memorial, ¶ 79.

<sup>5</sup> Memorial, ¶ 79.

<sup>6</sup> Exhibit C-7.

<sup>7</sup> Exhibit C-7, p. 4.

- (b) AES Summit and AES Corporation were released “from any and all obligations and/or liabilities arising under the PSA to pursue the implementation of the Development Projects.”

4.8 The 2001 Settlement Agreement also contained a waiver of sovereign immunity clause, which reads as follows:

“WAIVER OF SOVEREIGN IMMUNITY

Each of APV and MVM (as to (a) through (d)) and the Republic (as to (a) only) unconditionally and irrevocably:

- (a) agrees that the execution and performance by it of this Agreement constitute private and commercial acts rather than public, administrative or governmental acts;
- (b) agrees that should any proceedings arising out of this Agreement be brought against it or its assets, no immunity from such proceedings shall be claimed by or on behalf of itself or with respect to its assets;
- (c) waives any right of immunity which it or any of its assets now has or may acquire in the future in any jurisdiction in connection with proceedings arising out of this Agreement; and
- (d) consents to the enforcement of any arbitration award against it in proceedings brought in accordance with Clause 11 in any jurisdiction (including without limitation the making, enforcement or execution against or in respect of any property whatsoever, irrespective of its use or intended use).”

4.9 The inclusion of the sovereign immunity clause indicates that the parties agreed that the execution and performance of the 2001 Settlement Agreement and its Annexes constituted private and commercial acts, which means that Hungary was acting in its private character rather than in a public or governmental character.

4.10 Also on 19 December 2001, as required by clause 4.1 of the 2001 Settlement Agreement, the Original Tisza II PPA was amended by agreement between MVM and AES Tisza (the “2001 Amendment Agreement”). The Original Tisza II PPA, as amended by the Amendment Agreement, will be referred hereinafter as the “2001 PPA.” The Amendment Agreement was to be governed by Hungarian Law and read and construed as one document with the Original Tisza II PPA.<sup>8</sup> In pertinent part, the Amendment Agreement provided that:

- (a) the term of the Original Tisza II PPA was to be extended to 31 December 2016;
- (b) AES Tisza would make a four-phased series of improvements (“Retrofit”) to the power stations and, in order to finance the proposed retrofit, it could assign, and/or create security interests in the Amendment Agreement; and
- (c) a new clause was to be inserted into the Original Tisza II PPA, Clause 3.7, regarding a possible change in the law. That clause provides:

“3.7 Change in Law

(a) Illegality

If, during the term of this Agreement, a Change in Law occurs as a result of which either party’s obligations under this Agreement become illegal, unenforceable or impossible to perform, the Parties must give each other notice of the relevant Change in Law and its effect on this Agreement and the Parties shall be obliged for the Negotiating Period following such notice to conduct good faith negotiations and use all reasonable efforts to agree to changes (if any) that can be made to this Agreement in order to reflect the intent of the Parties at the date of the Amendment Agreement

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<sup>8</sup> Exhibit C-9, p. 2.

and the nature of the circumstances in question. If, despite their reasonable efforts, the Parties are unable to agree upon such changes by the expiration of such Negotiating Period, either Party shall have the right to terminate this Agreement by written notice to the other Party. Upon such termination:

- (i) if the Law affected by the relevant Change in Law is of the type specified in point (i) of the definition of “Laws”, the following shall apply:
  - (A) if the relevant Change in Law occurs on or prior to January 1, 2007 or the date of the accession of the Republic of Hungary to the European Union, if later then Section 3.3 (c) shall apply and on the first day of effectiveness of the Utilization Agreement of New PPA, the Transmission Company shall pay to Generator an amount equal to the Recognized Debt, outstanding at the date of the termination notice (and, without prejudice to the terms of the Settlement Agreement, no other termination charge or other compensation, liquidated damages or any indemnification shall be payable by either Party to the other Party relating to a condition or circumstance occurring because of such Change in Law or such termination); and
  - (B) if the relevant Change of Law occurs after January 1, 2007 or the date of the accession of the Republic of Hungary to the European Union, if later, then, without prejudice to the terms of the Settlement Agreement, neither Party shall be obliged to pay a termination charge or other compensation, liquidated damages or any indemnification to the other Party Relating to a condition or circumstance occurring because of such Change in Law or such termination.
- (ii) if the Law affected by the relevant Change in Law is not of the type specified in point (i) of the definition of “Laws”, then Section 3.3 (c) shall apply and on the first day of effectiveness of the Utilization Agreement or New PPA, Transmission Company shall pay compensation to Generator in the amount of the Recognized Debt outstanding at the time of the termination notice.”

4.11 Pursuant to the Amendment Agreement, the existing pricing schedule in the Original Tisza II PPA (Schedule 6) was replaced by a new pricing schedule which provided, *inter alia*, that “... as long as the public utility generator prices are subject to administrative pricing, the prices published by Decree No. 55/1996 (20 December) of the Ministry of Economy (GM) (and any amendments thereof, including currently published GM Decree No. 46/2000 (21 December)) and determined on the basis of the cost review and price review of [the Hungarian Energy Office (“HEO”)] pursuant to the rules and prescriptions set forth in GM Decree No. 45/2000 (21 December) shall be acknowledged and applied.”<sup>9</sup> The new pricing schedule also went on to set out detailed pricing formula which were to be applied “following the termination of price administration of public utility generator prices.”<sup>10</sup>

4.12 In 2004, Hungary acceded to the European Union.

4.13 As of 1 January 2004, the administrative pricing regime for generators was terminated as had been foreshadowed by the 2001 Electricity Act. Thereafter, at least for a time, the specific formula established in the new pricing schedule in the 2001 PPA was used to calculate the prices paid to AES Tisza II.

4.14 By December 2004, AES Tisza had completed three of the four phases of the Tisza II Retrofit at a cost of €98 million.<sup>11</sup>

4.15 In 2005, a political debate arose in Hungary regarding what were thought by some to be the high profits of the energy generators.

4.16 The debate included argumentations in parliamentary sessions and publication of articles in the media, which discussed the existence of alleged excessive profits being earned by the

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<sup>9</sup> Exhibit C-9, p. 24 of the 2001 Amendment Agreement.

<sup>10</sup> This latter provision is to be understood against Act CX of 2001 on Electricity (“2001 Electricity Act”) which provided for termination of Hungary’s existing administrative pricing regime for generators from 1 January 2004.

<sup>11</sup> Claimants’ Request for Arbitration, p. 8. This is not contested by the Respondent.



generators.<sup>12</sup> Amongst other things, MVM was said to be charging less to the consumers than the price it was paying to the generators for such electricity.<sup>13</sup>

4.17 On 23 March 2005, during a debate before the Economic Committee of Parliament, Ferenc Horváth, president of the Hungarian Energy Office, argued that if the HEO was to meet the deadline for market pricing in 2007, a financially feasible solution for the problems of MVM's stranded costs<sup>14</sup> had to be found. He stated that a "reasonable" profit rate for the generators of below 10% could be acceptable.

4.18 On 10 November 2005, HEO sent a letter to AES Tisza in which it claimed that the profits of the company were "unjustifiable high" and suggested that the profits should be capped at a maximum of 7.1%.

4.19 On 28 November 2005, a first meeting took place between representatives of HEO, MVM and the Claimants. At least four more meetings took place without reaching an agreement between the parties.

4.20 On 3 March 2006, the Hungarian parliament amended the 2001 Electricity Act (the "2006 Electricity Act") by reintroducing a regime of administrative prices for electricity sold by generators to MVM.

4.21 On 6 November 2006, the GKM Decree No. 80/2006 was issued, which became effective on 9 December 2006 ("2006 Price Decree").

4.22 On 26 January 2007, the GMK issued Decree No. 14/2007, which was to remain effective until December 2007 ("2007 Price Decree").

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<sup>12</sup> As the debate developed, references in the press and elsewhere were made to generators profits as "extra," "too high," "huge" and "luxury." The Hungarian public was described as "defenceless" against rising prices and it was said that such "luxury profits" must be "knocked down."

<sup>13</sup> Memorial, ¶ 110.

<sup>14</sup> The difference between what MVM paid for electricity and what it could recover.

4.23 Both Decrees provided a fixed price for each generator. Consequently, the formula established in Schedule 6 of the 2001 PPA was no longer applicable.

4.24 The Claimants allege that due to the issue of both Price Decrees, they have suffered a price cut of approximately 43% (under the 2006 Price Decree) and 35% (under the 2007 Price Decree) of the Availability Fee that MVM was obligated to pay pursuant to the 2001 Tisza II PPA.

4.25 The Claimants contend that the Price Decrees were reintroduced for political reasons and that, in addition to the direct loss of revenue for AES Tisza, their lenders have declared it in default under the loan documentation in respect to the €98 million project finance loan facilities made to the company to finance the Tisza II Retrofit.

4.26 The Claimants filed a Request for Arbitration on 6 July 2007.

## **5. THE CLAIMS**

5.1 The Claimants submit that Hungary violated its obligations under the ECT by reintroducing administrative pricing through the issuance of the Price Decrees. Specifically the alleged violations are the following:

- (a) breach of its obligation to provide fair and equitable treatment;
- (b) impairment of AES' investment by unreasonable and discriminatory measures;
- (c) breach of its obligation to provide national treatment;
- (d) breach of its obligation to provide most favoured nation treatment;
- (e) breach of its obligation to provide constant protection and security; and
- (f) expropriation.

5.2 The Respondent did not question the Claimants' right to bring its claims to ICSID arbitration. Nevertheless, there are some conditions which define the jurisdiction of an ICSID tribunal. In order for the Centre to have jurisdiction over a dispute, three – well-known –

conditions must be met, according to Article 25 of the ICSID Convention, to which one must add a condition resulting from the general principle of non-retroactivity:

- (a) a condition *ratione personae*: the dispute must oppose a contracting state and a national of another contracting state;
- (b) a condition *ratione materiae*: the dispute must be a legal dispute arising directly out of an investment;
- (c) a condition *ratione voluntatis*, *i.e.*, the contracting state and the investor must consent in writing that the dispute be settled through ICSID arbitration;
- (d) a condition *ratione temporis*: the ICSID Convention must have been applicable at the relevant time.

5.3 Pursuant to Article 41 of the ICSID Convention, the Tribunal is the judge of its own competence and therefore compliance with certain preconditions must be analyzed.

## **6. JURISDICTION AND ADMISSIBILITY**

### **6.1 The Parties (*ratione personae*)**

6.1.1 The conditions for the existence of ICSID jurisdiction are stated in the Washington Convention and the Energy Charter Treaty.

#### ***Claimants***

6.1.2 The UK signed the ICSID Convention on 26 May 1965 and deposited instruments of ratification on 19 December 1966. The ICSID Convention entered into force for the UK on 18 January 1967.

6.1.3 The UK ratified the ECT on 16 December 1997 and the Treaty entered into force on 16 April 1998.

6.1.4 AES Summit Generation Limited (“AES Summit”) is a company incorporated under the laws of the United Kingdom on 7 December 1995 and has its principal place of business at 37-39 Kew Foot Road, Richmond, Surrey, TW9 2SS. As a national of the United Kingdom, AES Summit is a national of a “contracting state” for purposes of Article 25(1) of the Convention.

6.1.5 AES-Tisza Eromu Kft (“AES Tisza”) is a company incorporated under the laws of the Republic of Hungary and has its principal place of business at H-3581 Tiszaújváros, Pf: 53, Hungary.

6.1.6 AES Summit owns 99% of, and exercises ownership and control over, AES Tisza. Therefore, pursuant to Article 26(7)<sup>15</sup> of the ECT, AES Tisza shall be treated as a national of “another contracting state” for purposes of Article 25(2)(b) of the Convention.

### ***Respondent***

6.1.7 Hungary signed the ICSID Convention on 1 October 1986 and deposited instruments of ratification on 4 February 1987. The ICSID Convention entered into force for Hungary on 6 March 1987.

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<sup>15</sup> Article 26(7) ECT reads:

(7) An Investor other than a natural person which has the nationality of a Contracting Party party to the dispute on the date of the consent in writing referred to in paragraph (4) and which, before a dispute between it and that Contracting Party arises, is controlled by Investors of another Contracting Party, shall for the purpose of article 25(2)(b) of the ICSID Convention be treated as a “national of another Contracting State” and shall for the purpose of article 1(6) of the Additional Facility Rules be treated as a “national of another State.”

6.1.8 Respondent signed the ECT on 27 February 1995, ratified the Treaty on 8 April 1998, and the Treaty entered into force on 16 April 1998.

## **6.2 Legal Dispute Arising Directly out of an Investment (*ratione materiae*)**

6.2.1 Claimants allege violations of their rights under the ECT. There are disagreements on different points of law and fact, which creates a conflict of legal views and interests between the parties, and the present dispute hence qualifies as a legal dispute under Article 25(1) of the ICSID Convention.

6.2.2 Claimants claim to have invested approximately US\$ 130 million and €98 million into the Hungarian electricity sector.

6.2.3 First, in 1996, AES Summit entered into a Purchase and Sale Agreement of approximately US\$ 130 million with the Hungarian state privatization and electricity transmission companies, ÁPV and MVM respectively, for a majority shareholding in a Hungarian electricity generation company which, after its purchase, became known as AES Tisza.

6.2.4 Later in 2001, AES Tisza invested approximately €98 million to retrofit the power station.

6.2.5 Both actions (purchasing the company and carrying out the Retrofit of the power station) qualify as investments in accordance with Article 1(6) of the ECT and Article 25 of the ICSID Convention.<sup>16</sup>

### **6.3 Written Consent (*ratione voluntatis*)**

6.3.1 In the Request for Arbitration, Claimants provide their written consent to submit the dispute to the jurisdiction of the Centre.

6.3.2 In addition, in their Request for Arbitration and in their Memorial, Claimants maintain that Hungary gave its consent to the submission of the dispute to the jurisdiction of the Centre pursuant to Articles 26(3) and 26(5)(a) of the ECT.

6.3.3 This statement was not disputed by Hungary in its Counter-Memorial, nor was it contested in the Respondent's Rejoinder. Hence, the parties have consented in writing to ICSID jurisdiction in accordance with Article 25 of the ICSID Convention.

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<sup>16</sup> Article 1(6) of the ECT reads:

(6) "Investment" means every kind of asset, owned or controlled directly or indirectly by an Investor and includes: tangible and intangible, and movable and immovable, property, and any property rights such as leases, mortgages, liens, and pledges; (b) a company or business enterprise, or shares, stock, or other forms of equity participation in a company or business enterprise, and bonds and other debt of a company or business enterprise; (c) claims to money and claims to performance pursuant to contract having an economic value and associated with an Investment; (d) Intellectual Property; (e) Returns; (f) any right conferred by law or contract or by virtue of any licences and permits granted pursuant to law to undertake any Economic Activity in the Energy Sector. A change in the form in which assets are invested does not affect their character as investments and the term "Investment" includes all investments, whether existing at or made after the later of the date of entry into force of this Treaty for the Contracting Party of the Investor making the investment and that for the Contracting Party in the Area of which the investment is made (hereinafter referred to as the "Effective Date") provided that the Treaty shall only apply to matters affecting such investments after the Effective Date. "Investment" refers to any investment associated with an Economic Activity in the Energy Sector and to investments or classes of investments designated by a Contracting Party in its Area as "Charter efficiency projects" and so notified to the Secretariat.

#### **6.4 Condition *ratione temporis***

6.4.1 Hungary signed the Treaty on 27 February 1995 and expressly declared that it did not accept the provisional application of the ECT (*see* Article 45(2)(a) of the ECT). Nevertheless, in accordance with Article 1(6), the investments protected by the ECT include those made before the entry into force of this Treaty, provided that it shall only apply to matters affecting such investments after the Effective Date.

6.4.2 Consequently this Tribunal can analyze the alleged breaches of the ECT given that they are said to have occurred after the entry into force of the Treaty, and after the entry into force of the ICSID Convention.

#### **6.5 Procedural requirements pursuant to Article 26 of the ECT.**

6.5.1 Regarding Article 26(1) and (2) of the ECT,<sup>17</sup> the Tribunal observes that communications between the Claimants and the Respondent regarding negotiations of the dispute began in January 2007. Furthermore, in April 2007, the parties conducted in person negotiations without reaching a resolution of the dispute.

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<sup>17</sup> Article 26(1) and (2) of the ECT read:

(1) Disputes between a Contracting Party and an Investor of another Contracting Party relating to an Investment of the latter in the Area of the former, which concern an alleged breach of an obligation of the former under Part III shall, if possible, be settled amicably.

(2) If such disputes can not be settled according to the provisions of paragraph (1) within a period of three months from the date on which either party to the dispute requested amicable settlement, the Investor party to the dispute may choose to submit it for resolution...

6.5.2 Therefore, the Tribunal considers that the three month “cooling-off period” was respected and that the Claimants had the right to submit the dispute to resolution according to Article 26(2) of the Convention.

6.5.3 Based on the evidence provided in the proceeding, there is no record that Claimants chose to submit their dispute before Hungary’s courts or administrative tribunals. Therefore, it is clear to this Tribunal that the dispute does not fall within the scope of Article 26(2)(a) of the ECT.

6.5.4 Similarly, there is no evidence that either party used any applicable or previously agreed dispute settlement procedure in order to settle the dispute.<sup>18</sup>

6.5.5 Consequently, the Tribunal concludes that Article 26(3)<sup>19</sup> of the ECT applies to this case.

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<sup>18</sup> Even though there was a procedure started by the European Commission to investigate the alleged state aid awarded by Hungary through Power Purchase Agreements, it is to be noted that such procedure was not between the parties to this dispute but between the European Commission and Hungary. In addition, the subject matter in such investigation was to determine whether the Power Purchase Agreements contained state Aid, under European Law (Final Decision C(2008)2223 of June 04, 2008), which is a different dispute than the one subject to this arbitration. The subject matter of that proceeding being different from the subject matter of this dispute, allows the Tribunal to sustain that the claim should not be barred by *res judicata*.

<sup>19</sup> Article 26(3) of the ECT reads:

(3)(a) Subject only to subparagraphs (b) and (c), each Contracting Party hereby gives its unconditional consent to the submission of a dispute to international arbitration or conciliation in accordance with the provisions of this Article.

(b)(i) The Contracting Parties listed in Annex ID do not give such unconditional consent where the Investor has previously submitted the dispute under subparagraph (2)(a) or (b)

(ii) For the sake of transparency, each Contracting Party that is listed in Annex ID shall provide a written statement of its policies, practices and conditions in this regard to the Secretariat no later than the date of the deposit of its instrument of ratification, acceptance or approval in accordance with Article 39 or the deposit of its instrument of accession in accordance with Article 41.



## **7. APPLICABLE LAW**

### **7.1 Claimants' Applicable Law Arguments as Presented in the Memorial**

7.1.1 On 7 March 2008, Claimants filed their Memorial, asserting that the law applicable to the dispute was found in Article 26(6) of the ECT, which provides that “[a] tribunal established under paragraph (4) [referring to ICSID arbitration] shall decide the issues in dispute in accordance with this Treaty and applicable rules and principles of international law.” This was not further developed.

### **7.2 Respondent's Applicable Law Arguments as presented in the Counter-Memorial**

7.2.1 In its Counter-Memorial, Respondent highlighted the inconveniences and the negative consequences of a ruling under the ECT, which, in its opinion, requires Hungary to act inconsistently with mandatory laws of the EU.

7.2.2 It is Hungary's contention that the ECT must be read in light of one of its own objectives, which is to promote the European Union's key energy objectives, market liberalization and free competition, and not as if it was entirely independent of critical EU laws and developments.

7.2.3 Consequently, Hungary states that “it defies logic to suggest, as Claimants do, that the ECT can be read as entirely divorced from EC competition law.” It argues that when a state has obligations under two different treaties involving overlapping subject matter, those obligations should – to the extent possible – be read in harmony and be interpreted to minimize conflict.

7.2.4 In addition, Respondent says that the fact that Claimants' 2001 PPA was governed by the law of Hungary, now an EU member state, further underscores the need to take European

Community (“EC”) competition law into account in determining whether any modification of the 2001 PPA transgressed the limits set forth in the ECT. Hungary relies on part of a text that Bernard Hanotiau wrote in 1995 which states that: “if the applicable law ... is the law of a state of the European Union, such law includes the rules of Community law, and these rules should therefore be applied ...”

7.2.5 Finally, Hungary alleges that there is no true conflict between the provisions of the ECT and the mandatory public policy reflected in the EC competition law (incorporated in Hungarian law governing the 2001 PPA), because:

“Accepting the notion that “legitimate expectations” is the bedrock on which many of the ECT’s investor-protection provisions rest, this notion fully supports a finding that Hungary honored its commitments. As set forth below, Claimants could have had no “legitimate” expectation that Hungary would blithely ignore EC demands to minimize or eliminate prohibited State aid. Nor could they legitimately expect that Hungary would never consider, as a rational vehicle for addressing these concerns, the temporary reintroduction of administrative price controls, predicated on the very notions of “reasonable return” upon which Claimants originally invested.”

### **7.3 Claimants’ Applicable Law Arguments as Presented in the Reply**

7.3.1 On 31 October 2008, the Claimants filed their Reply. There, they stated that the parties to this arbitration made a clear choice as to the applicable law and that choice does not include Community competition law or Hungarian law. They argue that the applicable law will only be the ECT and applicable rules and principles of international law under article 26(6) of the ECT. The law applicable to the merits of this ICSID proceeding is governed by Article 42(1) of the ICSID Convention and, thus, by Article 26(6) of the ECT.

7.3.2 The Claimants say that Community law is irrelevant to the interpretation of the ECT, and that assertions to the contrary ignore the basic principles of treaty interpretation.

7.3.3 According to the Claimants, this is so because the ECT is to be interpreted in accordance with customary international law as codified in the Vienna Convention, Articles 31 and 32. They maintain that the principles set out in the Vienna Convention require that the ECT “be interpreted in accordance with the Law of Nations, and not any municipal code.”

7.3.4 This is also said to be so given that Community law, including Community competition law, is considered the equivalent of internal or municipal law for the purposes of this proceeding. Community law is thus merely a fact to be considered by the Tribunal when determining the applicable law.

7.3.5 Claimants state that Respondent argues that, under Article 32 of the Vienna Convention, there is some unidentified provision of the ECT which is either ambiguous or absurd, and therefore recourse should be had to supplementary means of interpretation, including the preparatory work or the circumstances surrounding the conclusion of the ECT. Nevertheless, in their opinion, Hungary fails to point to any specific provision of the ECT which it believes to be ambiguous or absurd.

7.3.6 In addition, Claimants argue that the ECT was not solely a European initiative, because Russia, Canada, USA, Japan, and other countries were each heavily involved in its inception.

7.3.7 Claimants also mention that their “legitimate expectations” are irrelevant to the interpretation of the ECT and they underscore that Hungary did not identify any provision of

either the Vienna Convention or customary international law which suggests that this Tribunal should interpret the ECT by reference to the expectations of an investor.

7.3.8 Claimants further claim that Community law is not a defence to Hungary's breaches of the ECT, because Article 27 of the Vienna Convention provides that a "Party may not invoke the provisions of its internal law as justifications for its failure to perform a treaty."

7.3.9 Regarding Respondent's alleged "conflict" between Community Law and the ECT, Claimants posit that the EC is a signatory to the ECT and is thus bound by its provisions, including those as to the choice of law. Claimants conclude that it is clear that the "EC institutions are bound by the provisions of an international treaty concluded by the EC, and that all acts of those institutions should comply with such treaties."

7.3.10 Claimants point out that despite not articulating any legal basis for its Community competition law defence, and despite the established legal principle that a state cannot invoke its own internal law as a defence to its violations of international law, Hungary suggests that any finding by this Tribunal that Hungary should be held accountable for its violations of international law would "seriously undermine the integrity of EC State aid law."

7.3.11 In answer to this point, Claimants assert that Respondent's argument ignores the parties' express choice of law in Article 26(6) and the provisions of the ECT on investor protection that flow, automatically, from that choice.

7.3.12 Furthermore, Claimants say that the ECT has addressed this issue and determined that, while the notion of state aid covers all aid granted by a member state to undertakings which

might have the effect of distorting trade, it is fundamentally different in its legal nature from the damages which Hungary may have to pay as a result of this arbitration.

7.3.13 In their view, all Community institutions, including the Commission, must, as a matter of Community law, respect any award issued by this Tribunal.

7.3.14 Claimants' conclusion is that Hungary's alleged "circularity" problem does not exist as a matter of fact or as a matter of Community law, and that the alleged "circularity" problem has been invented by Hungary in an effort to avoid responsibility for its internationally wrongful acts. The Eeckhout Report confirms that this is the case.

#### **7.4 Respondent's Applicable Law Arguments as Presented in the Rejoinder**

7.4.1 On 13 February 2009, Hungary filed its Rejoinder and clarified that it never contended, as Claimants asserted, that EC law rather than the ECT governs this arbitration. Hungary insists that it has always acknowledged that the ECT supplies the decisional standards that this Tribunal must apply. But it argues that in applying these standards, the EC law framework as well as the illegality of the 2001 PPA under Hungarian law have to be considered as facts.

7.4.2 The Respondent notes that Claimants themselves admitted that issues of national law are frequently factual predicates for the application of ECT decisional standards.

7.4.3 Consequently, the Respondent concludes that there is thus no real dispute between the parties on this issue.

## **7.5 Arguments Expressed During the Hearing**

7.5.1 During the hearing, Claimants argued (on 9 March 2009) that Hungary had retreated from its previous position as set out in the Counter-Memorial, and thus that this Tribunal no longer had to determine the conflict regarding the applicable law (Transcript, p. 170:5-8). Claimants further asserted that there is “no dispute between the parties that the ECT is the applicable law” (Transcript, page 346:8).

7.5.2 During the hearing (on 13 March 2009), both parties and experts agreed that:

- (a) the ECT was the applicable law;
- (b) the EC law is relevant as a fact (Transcript, Slot: p. 1469: 8-11), (Transcript, Eeckhout: p. 1415: 6-9).

7.5.3 Even though there was a consensus between the parties that the ECT is the applicable law to this dispute, and that the EC law is to be taken into account as a relevant fact, the parties maintained different interpretations regarding the following issues:

- (a) should the ECT be interpreted due to ambiguous provisions? And, in such case, should the interpretation method be a historical interpretation of the formation of the ECT, or the Vienna Convention?
- (b) does Article 16 of the ECT apply to this dispute?
- (c) should Article 307 of the EC Treaty be applied to this dispute?

### ***Interpretation of the ECT***

7.5.4 The Respondent alleged that the ECT should be interpreted using a historical method that takes into account the formation of the ECT, and therefore the EC law principles. Claimants disagreed, stating that any interpretation of the ECT had to be made in accordance with the Vienna Convention.

### *Application of Article 16 of the ECT*

7.5.5 Claimants also noted that the Respondent failed to make reference to Article 16 of the ECT, which states that if there is a conflict between the ECT and any other treaty which deals with the subject matter of ECT Part III or Part V, then according to the law expressly chosen by the parties, the provisions which are more favourable to the investor or the investment prevail. The Respondent denied that Article 16 of the ECT was applicable to the dispute.<sup>20</sup>

### *Application of Article 307 of the EC Treaty*

7.5.6 During the hearing, Claimants' expert Professor Eeckhout stated that, in his opinion, Article 307 of the EC Treaty is a "crucial provision which enables member states to honor international obligations under an agreement they signed and concluded before joining the European community, and that insofar as there are those obligations, Article 307 of the EC Treaty authorized Hungary to ignore the Commission's order for the benefit of a EU member state company."<sup>21</sup>

7.5.7 For its part, Respondent argued that as the admitted purpose of Article 307 was to protect non-member states, Article 307 of the EC Treaty should be read as authorizing Hungary to ignore the Commission's binding order for the benefit of an EU member state company "even though AES's home state (from which its ECT rights derive) by no means could be deemed a beneficiary of Article 307."<sup>22</sup>

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<sup>20</sup> Respondent's post-hearing submission, ¶ 95.

<sup>21</sup> Transcript, p. 1422: 1-6

<sup>22</sup> Respondent's post-hearing submission, ¶ 96.

## **7.6 Findings of the Tribunal**

7.6.1 Article 41(2) of the ICSID Convention provides that this Tribunal shall decide the dispute “in accordance with such rules of law as may be agreed by the parties.”

7.6.2 Article 26(6) of the ECT provides that “a tribunal established under paragraph (4) shall decide the issue in dispute in accordance with this Treaty [ECT] and applicable rules and principles of international law.”

7.6.3 Given that this Tribunal is established under paragraph (4) of Article 26 of the ECT, it is Article 26(6) of the ECT which contains the rules of law agreed by the parties and the ones that this Tribunal will use to decide the dispute.

7.6.4 We therefore conclude that the applicable law to this proceeding is the ECT, together with the applicable rules and principles of international law.

### ***Interpretation of the ECT***

7.6.5 If interpretation of the ECT is required, the general rules of interpretation of the Vienna Convention, established in its Articles 31 and 32 should be applied. Although Article 32 provides for the use of historical interpretation, the Tribunal notes that such use is only as a complementary method of interpretation.

7.6.6 Regarding the Community competition law regime, it has a dual nature: on the one hand, it is an international law regime, on the other hand, once introduced in the national legal orders, it is part of these legal orders. It is common ground that in an international arbitration, national laws are to be considered as facts. Both parties having pleading that the Community



competition law regime should be considered as a fact, it will be considered by this Tribunal as a fact, always taking into account that a state may not invoke its domestic law as an excuse for alleged breaches of its international obligations.

### ***Application of Article 16 of the ECT***

7.6.7 The Tribunal observes that the application of Article 16 of the ECT only requires to be analyzed in the event the ECT contains a provision that conflicts with EC law. In the case of any conflict that is said to exist between the ECT and Community law, the relevant provision is Article 16 of the ECT:

“Where two or more Contracting Parties have entered into a prior international agreement, or enter into a subsequent international agreement, whose terms in either case concern the subject matter of Part III or V of this Treaty,

(1) nothing in Part III or V of this Treaty shall be construed to derogate from any provision of such terms of the other agreement or from any right to dispute resolution with respect thereto under that agreement; and

(2) nothing in such terms of the other agreement shall be construed to derogate from any provision of Part III or V of this Treaty or from any right to dispute resolution with respect thereto under this Treaty, where any such provision is more favourable to the Investor or Investment.”

7.6.8 However, the Tribunal concludes that, properly understood, the dispute under analysis in the present arbitration is not about a conflict between the EC Treaty or Community competition law and the ECT.

7.6.9 Rather, the dispute is about the conformity or non-conformity of Hungary’s acts and measures with the ECT. Therefore, it is the behaviour of the state (the introduction by Hungary of the Price Decrees) which must be analyzed in light of the ECT, to determine whether the

measures, or the manner in which they were introduced, violated the Treaty. The question of whether Hungary was, may have been, or may have felt obliged under EC law to act as it did, is only an element to be considered by this Tribunal when determining the “rationality,” “reasonableness,” “arbitrariness” and “transparency” of the reintroduction of administrative pricing and the Price Decrees.

### ***Application of Article 307 of the EC Treaty***

7.6.10 Finally, the Tribunal concludes that Article 307 of the ECT is not applicable, as such, in this arbitration. Article 307 (ex Article 234) states:

“The rights and obligations arising from agreements concluded before 1 January 1958 or, for acceding States, before the date of their accession, between one or more Member States on the one hand, and one or more third countries on the other, shall not be affected by the provisions of this Treaty.

To the extent that such agreements are not compatible with this Treaty, the Member State or States concerned shall take all appropriate steps to eliminate the incompatibilities established. Member States shall, where necessary, assist each other to this end and shall, where appropriate, adopt a common attitude.

In applying the agreements referred to in the first paragraph, Member States shall take into account the fact that the advantages accorded under this Treaty by each Member State form an integral part of the establishment of the Community and are thereby inseparably linked with the creation of common institutions, the conferring of powers upon them and the granting of the same advantages by all the other Member States.”

7.6.11 Article 307 only applies to agreements between member states and non-member states, and Hungary and the United Kingdom are both member states. Moreover, the Claimants are not states, and even if sometimes individuals are granted rights under international law, Article 307 of the EC Treaty specifies that it only applies to states.

7.6.12 In summary, the Tribunal determines that the Respondent's acts/measures are to be assessed under the ECT as the applicable law but that the EC law is to be considered and taken into account as a relevant fact.

## **8. THE TRIBUNAL'S APPROACH TO THE SUBSTANTIVE CLAIMS**

8.1 The Tribunal starts its analysis of the substantive issues before it by dealing first, in Section 9 below, with Hungary's obligation to provide fair and equitable treatment to Claimants and their investment(s). This is followed, successively, by the Tribunal's analysis of Claimants' claim regarding unreasonable and discriminatory measures (Section 10), national treatment (Section 11), most favoured nation treatment (Section 12), constant protection and security (Section 13), and, finally expropriation (Section 14).

8.2 In addressing each claim, the Tribunal summarizes briefly the scope of Claimants' and Respondent's positions as advanced in their initial pleadings, written memorials, during the course of oral argument and in their written post-hearing submissions. The Tribunal also acknowledges the efforts made by the European Commission to explain its own position to the Tribunal and has duly considered the points developed in its *amicus curiae* brief in its deliberations. After having thus thoroughly examined the whole file, the Tribunal presents its analyses and conclusions.

## 9. OBLIGATION TO PROVIDE FAIR AND EQUITABLE TREATMENT

### 9.1 Claimants' Position

9.1.1 Regarding the obligation of Hungary to provide fair and equitable treatment, the Claimants advance four main arguments which are summarized under the relevant descriptive headings below.

#### *Contractual Obligations*

9.1.2 The Claimants state that the obligation of Hungary to provide fair and equitable treatment includes the obligation of honouring contractual obligations, upon which the investor reasonably relied.<sup>23</sup> These are said to include promises by Hungary “not to interfere with Claimants’ PPA,” “not to frustrate ...[the 2001 Settlement Agreement’s] purposes and intent” and to require another overall price and cost review prior to the introduction of any new pricing mechanism.<sup>24</sup>

9.1.3 Specifically, Claimants allege that with the March 2006 amendment of the 2001 Electricity Act and the introduction of the 2006 and 2007 Price Decrees, Hungary caused and encouraged MVM to refuse to fulfill its contractual commitments to AES Tisza under the 2001

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<sup>23</sup> In order to support this claim, Claimants mention that: a) in *CME v. Czech Republic*, the Tribunal found that the breach of legal security of contract rights underpinned the Claimants’ investment; b) Schreuer has maintained that “a willful refusal by a government authority to abide by its contractual obligations, abuse of government authority to evade agreements with foreign investors and action in bad faith in the course of contractual performance may well lead to a finding that the Standard of fair and equitable treatment has been breached”; and c) in the *CMS v. Argentina* case, the Tribunal considered that the fair and equitable treatment standard was violated when the state put a freeze on contractually agreed tariff adjustments intended to increase gas prices. Claimants’ Memorial, ¶¶ 200-204.

<sup>24</sup> Claimants’ post-hearing submission, ¶¶ 101-103.

PPA, and refused to fulfill its own contractual obligations to the Claimants as set out in the 2001 Settlement Agreement.<sup>25</sup>

### ***Breach of the Obligation to Act in Good Faith and to Respect Legitimate Expectations***

9.1.4 Claimants argue that, by amending the 2001 Electricity Act in 2006 and by introducing the Price Decrees, Hungary failed to act in good faith and in accordance with the basic and legitimate expectations (described above) upon which the Claimants relied when making their investments in Hungary in 1996 and following the 2001 Settlement Agreement and the execution of the 2001 PPA.

### ***Stability and Predictability of Business***

9.1.5 Claimants say that Hungary agreed to provide a certain level of financial and legal stability to the Claimants' investment by way of the 2001 PPA. The ECT also expressly requires Hungary to provide "stable, equitable, favourable and transparent conditions" for Claimants' investment.<sup>26</sup> But Claimants argue that the promised stability was short-lived, as the organs of the state began accusing AES of earning luxury profits and tried to force a re-negotiation of the PPA, and the Hungarian parliament finally amended the 2001 Electricity Act which would re-introduce administrative pricing. This action eviscerated the legal framework upon which the Claimants had legitimately relied.<sup>27</sup>

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<sup>25</sup> Memorial, ¶ 215.

<sup>26</sup> Exhibit C-1, Article 10(1).

<sup>27</sup> Claimants note that in *Metalcald* and in *Tecmed*, the Tribunals found that stability and predictability of business framework was an accepted element of the fair and equitable standard. Memorial, ¶ 202.

***The Reintroduction of the Price Decrees was Arbitrary, Non-Transparent and Lacking in Due Process***

9.1.6 Claimants also contend that Hungary’s conduct was non-transparent, arbitrary, lacking in due process, and discriminatory.<sup>28</sup>

9.1.7 In support of this claim, they argue that the 2006 Electricity Act Amendment was adopted for purely political reasons (arising out of the political debate about the generators’ “excessive” and “intolerable” profits), and was aimed specifically at reducing the profits being earned by generators such as AES Tisza. Claimants note that even minister Kokka acknowledged that it was a measure that would “effect centralization or take over by the state.”

9.1.8 In addition, Claimants allege that the manner in which the Price Decrees were issued demonstrates a lack of transparency, lack of due process and inherent arbitrariness in Hungary’s actions.

9.1.9 Claimants point out that the maximum profit figure of 7.1% set forth by the HEO was based on the profit figure used for distribution companies, which bears no rational relationship to generation companies.

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<sup>28</sup> In order to support this claim, Claimants mention that: a) the *Tecmed* Tribunal resolved that “the foreign investor expects the host state to act in a consistent manner, free from ambiguity and totally transparently in its relations with the foreign investor”; b) in *Maffezini v. Spain*, the Tribunal said that “the lack of transparency with which this loan transaction was conducted is incompatible with Spain’s commitment to ensure the investor a fair and equitable treatment in accordance with Article 4(1) of the same treaty. Accordingly, the Tribunal finds that, with regard to this contention, the claimant has substantiated his claim and is entitled to compensation...”; and c) the Tribunal in *Waste Management* determined that the lack of due process may be a “manifest failure of natural justice in judicial proceedings or a complete lack of transparency and candor in an administrative process.” Memorial, ¶¶ 205-208.

9.1.10 Moreover, the HEO gave no explanation as to how it actually arrived at the prices set out in the Price Decrees. Unlike previous administrative prices, AES Tisza was given no opportunity to comment on the prices before the Price Decrees were issued. Hungary is also said to have demanded that Claimants comment on the draft language of the draft Price Decrees within four business days, and on the language of the Price Decrees themselves within one business day.<sup>29</sup> And Hungary failed to perform a costs and assets' review prior to issuing the Price Decrees.

## **9.2 Respondent's Position**

9.2.1 Hungary's defence may be summarized as follows:

- (a) Claimants can have had no legitimate expectations that administered prices would not be reintroduced;
- (b) Hungary's decision to do so was neither arbitrary, nor an abuse of state power;
- (c) Hungary's dealing with Claimants prior to the decision to reintroduce administered pricing were both reasonable and in good faith having regard to the concerns being expressed in various quarters about the generators' PPAs;
- (d) there were no due process failings (*i.e.*, there was nothing arbitrary or unfair in HEO's methodology or its procedures) which led to the adoption of the Price Decrees themselves.

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<sup>29</sup> Claimants' post-hearing submission, ¶¶ 84-86.

### *Legitimate Expectations*

9.2.2 Hungary says that Claimants invested originally in the full expectation of administrative price regulation. Even though Claimants rely on the 2001 expectations, the expectations that should count are the ones that Claimants had at the moment of deciding to make the investment, which was in 1996.

9.2.3 Hungary accepts that there were limitations on the future regulation, *i.e.*, (a) prices would be set at levels sufficient to provide a “reasonable return” on investment; and (b) returns of 8% on equity had been targeted, but it was understood that this figure might change.

9.2.4 For these reasons, Hungary contends that no legitimate expectations were created that administrative prices would never be reintroduced. Hungary points out that, in their submission to the EC, Claimants themselves stated that the price controls were simply “suspended for a brief interlude” commencing 1 January 2004.

9.2.5 In order for legitimate expectations to exist, Hungary says that two elements are necessary:

- (a) the existence of government representations and assurances. In this regard, Hungary maintains that the 2001 Settlement Agreement mentioned nothing in connection with prices and that although the 2001 PPA contained a pricing schedule for when the regulatory prices regime ended, it contained no representations by MVM or anyone else that the pricing regime would never change again in the future; and
- (b) the reliance of the investor on such assurances to make its investment. Hungary claims that the fact that clause 3.7 of the 2001 PPA referred to a change in the law



shows that the investor knew that there could be changes as regards regulatory pricing, amongst other changes in the law.

9.2.6 Hungary accepts that “[a]s of 2001, based on the new 2001 Electricity Act, it did appear that administrative price caps would be phased out beginning 2004.”<sup>30</sup> However, it says that this did not create legitimate expectations because those were created in 1996 and not in 2001.

9.2.7 But even if expectations could have been created by the 2001 PPA, in the absence of stability agreement or the like (*e.g.*, an undertaking that the government would never again regulate prices), Claimants could have had no such legitimate expectation in 2001.

9.2.8 Hungary argues that even if new “expectations” were created, this did not create objective rights because the expectations were not “legitimate.” In order for the expectations to be legitimate, they have to be based on affirmative government representations or assurances and these were not made. Some tribunals say that the investor’s expectations are legitimate if the investor received an explicit promise or guaranty from the host state.<sup>31</sup>

### ***No Abusive or Arbitrary Behaviour***

9.2.9 Hungary says that, in the absence of legitimate expectations, only “manifestly arbitrary conduct” or the “abuse of state power” can provoke a violation of the fair and equitable treatment obligation.

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<sup>30</sup> Counter-Memorial, ¶ 125.

<sup>31</sup> Hungary refers to the *Saluka* case and says “that the tribunal found that regulatory changes, if not discriminatorily applied, would not amount to a fair and equitable treatment violation.” Counter-Memorial, ¶ 326.

9.2.10 Hungary contends that its decision temporarily to restore administrative pricing was neither arbitrary nor an abuse of state power. It places special emphasis on the fact that countries which are in the process of becoming members of the European Community are likely to have legislative changes.

9.2.11 Hungary further says that Claimants did not show that the temporary reintroduction of administrative price caps was either an abuse of state power or manifestly arbitrary.

9.2.12 Hungary points out that Claimants submitted no expert opinion on Hungarian law regarding the power of the state to regulate maximum prices.

9.2.13 Regarding Claimants assertion that the Price Decrees were enacted for “purely political reasons” and without any “rational public policy” objective of the state, Hungary notes that the generators’ PPAs had been a concern to Hungary since 2002 and that “it was under serious pressure from the EC to take action at least to minimize the effects of what the EC considered to be unlawful state aid, if not to terminate the PPAs outright. In these circumstances, it tried to increase the pressure on the generators (including AES Tisza) to renegotiate the PPAs. Hungary insists on the fact that AES Tisza refused any renegotiation of the PPA which created great difficulties for Hungary in its endeavour to develop a free market, in line with the European Community standards. When the authorities were unable to renegotiate the PPAs, they took the next step, which was the least drastic of the alternatives available. They temporarily restored the system of administrative price caps, based on notions of reasonable return that had long been used in Hungary.

9.2.14 Hungary responds to Claimants' argument, that the expiration of the 2007 Price Decrees demonstrates that it "could not have been related to any rational policy goal," by stating that, to the contrary, there were rational and legal reasons why administrative price regulation could not be continued in 2008, because it was contrary to the notion of full liberalization which had been introduced by the 2001 Electricity Act and which entered into effect on 1 January 2008. Hungary had also become legitimately concerned about the profit levels generators enjoyed under non-competitive PPAs, at the expense of consumers, as well as by the failure of generators to agree to any reductions in contracted PPA capacity, to free up electricity for direct sale to the parallel free market. These were thus transitional measures, put in place while Hungary sought to negotiate with the generators to find alternative commercial arrangements that would meet the EC's competition law concerns and address its own political issues.

***Dealings were Reasonable and in Good Faith***

9.2.15 As regards Claimants allegation that Hungary threatened AES Tisza to terminate the PPA, Hungary contends that Hungarian officials were simply acknowledging what the EC had indicated, that there was a possibility that the PPAs would have to be terminated.

9.2.16 Hungary did not violate fair and equitable treatment in its consultations with Claimants. Hungary says that Claimants equate a notion of a failure to act in good faith with Hungary's unwillingness to capitulate to Claimants' unilateral demands that they receive the full value of PPA pricing, notwithstanding the EC's condemnation of that pricing as illegal state aid. In fact, Hungary argues, it was Claimants who acted unreasonably in the negotiations which preceded the reintroduction of administered pricing, by refusing even to acknowledge the new realities imposed by the EC's position and by market liberalization.

### ***Due Process Observed in Implementing Price Regulation***

9.2.17 Hungary asserts that neither HEO's methodology and procedures for implementing maximum prices, nor the resulting prices were arbitrary or irrational.

9.2.18 According to Hungary, no "due process" or transparency rights were violated because, even though Claimants allege that there was no explanation as to how the HEO actually arrived at the prices set out in the Price Decrees, AES Tisza was well aware that the HEO was planning to use the 7.1% profit level as the target for determining appropriate prices, and knew that the HEO had drawn that figure from the level used to set maximum prices for distribution companies.

9.2.19 Hungary argues that the 7.1% rate of return on assets is comparable to the 8% return on equity target in place at the time of privatization, particularly given the fact that return on assets is a more favorable measure than return on equity. It also contends that there was nothing wrong in applying the same Weighted Average Cost of Capital ("WACC") calculation to different players in the regulated electricity market. Hungary says that, according to Navigant's report, AES Tisza could have paid all its debt prior to 2007.

9.2.20 As to Claimants' allegation that, unlike in previous administrative price cycles, AES Tisza was given no opportunity to comment on the prices set out in the Price Decrees before they were issued, Hungary responds that Claimants were invited to comment on the appropriateness of this approach, and did so, in November 2005 and in May 2006.

9.2.21 In addition, Hungary says that, as Dr. Fazekas discusses in her expert report, the obligation of the state to address petitions for review of individual price levels arises only after

their publication and not prior to it and that AES Tisza did not submit any request for price review during 2006 and 2007. In addition, Hungary recalls that Dr. Fazekas also said that the AAP (administrative proceeding) rules do not apply because it is a lawmaking function and not an administrative case or proceeding.

9.2.22 Hungary argues that even if the Tribunal finds that there were imperfections in the execution of the state's obligation of transparency, this is not enough to determine that a violation of fair and equitable treatment occurred.<sup>32</sup>

9.2.23 In connection with a state's obligation to act in a transparent manner, Claimants maintain that the ECT imposes its own transparency obligations, separate and apart from the requirements of national law. In this regard, Hungary says that Article 10(1) does not impose a particularly high threshold for transparency.<sup>33</sup>

9.2.24 Hungary also says that the general investment treaty jurisprudence does not require states to comply with ideal notions of transparency, in which every single consideration in policy making is first publicly announced.

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<sup>32</sup> Hungary notes that in the *Eastern Sugar* case, the Tribunal stated that an investment treaty may not be invoked "each time the law is flawed or not fully and properly implemented by a State," otherwise "every aspect of any legislation or its implementations could be brought before an international arbitral tribunal under the guise of a violation of a BIT." Counter-Memorial, ¶ 359.

<sup>33</sup> Hungary indicates that "As Thomas Wälde has explained, "[t]he general investment standards under Article 10(1) ... need to be specified and applied in light of Article 20(2)," which is the ECT's specific provision on transparency. This imposes a "relatively toothless obligation," requiring only that States promptly publish laws and regulations affecting investments." Counter-Memorial, ¶ 360.

### **9.3 Findings of the Tribunal**

#### *Findings Concerning Contractual Obligations*

9.3.1 The Tribunal makes it clear at the outset that it only has jurisdiction over Treaty claims. In connection with the alleged breach of contractual rights and consequently the violation of fair and equitable treatment obligation, the Tribunal considers that it cannot hear this claim as such.

9.3.2 It is true that Article 26 of the ECT contains an umbrella clause which allows the submission to international arbitration of disputes concerning an alleged breach of an obligation under Part III of the Treaty. Specifically the last sentence of Article 10(1) – which is contained in Part III of the ECT – establishes that “[e]ach Contracting Party shall observe any obligations it has entered into with an Investor or an Investment of an Investor of any other Contracting Party.”

9.3.3 However, Annex IA of the ECT contains a List of Contracting Parties, which includes Hungary, which do not allow an Investor or Contracting Party to submit a dispute concerning the last sentence of Article 10(1) to international arbitration.<sup>34</sup>

9.3.4 Therefore, this Tribunal cannot rule on the scope of contract obligations and consequently cannot determine if the Claimants’ contract rights under the 2001 Settlement Agreement – and the 2001 PPA – were eviscerated because it has no jurisdiction to do so.

9.3.5 Nonetheless, the Tribunal considers that it has the right and duty to determine whether Hungary’s conduct – which include acts that could have breached contractual obligations –

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<sup>34</sup> Counter-Memorial, footnote 561; Memorial, footnote 222.

violated a specific Treaty obligation. In making this assessment, the Tribunal should not be considered to be analyzing the performance of contractual obligations as such.

### ***Findings Concerning Legitimate Expectations***

9.3.6 In connection with the reintroduction of administrative prices in 2006 and 2007, and the context in which such reintroduction took place, Claimants allege a breach of the basic and legitimate expectations upon which they relied when making their investment and consequently a violation of the fair and equitable treatment standard.

9.3.7 As stated above, the Respondent argues that no new expectations could be created in 2001 due to the fact that the original investment was made in 1996, and that legitimate expectations can only be created at the moment of the investment, which, in its eyes, was 1996.

9.3.8 This rule that legitimate expectations can only be created at the moment of the investment, has been supported by several ICSID tribunals (for example: *Duke Energy Electroquil Partners and Electroquil S.A. v. Republic of Ecuador* (ICSID Case No. ARB/04/19), Award, Aug. 18, 2008, ¶ 340; *Técnicas Medioambientales Tecmed, S.A. v. United Mexican States* (ICSID Case No. ARB(AF)/00/2), Award, May 29, 2003, ¶ 154 and *LG&E Energy Corp., LG&E Capital Corp. and LG&E International Inc. v. Argentine Republic* (ICSID Case No. ARB/02/1), Decision on Liability, Oct. 6, 2006).

9.3.9 In *Duke Energy*, the Tribunal stated that “[t]o be protected, the investor’s expectations must be legitimate and reasonable at the time when the investor makes the investment.”

9.3.10 The above interpretation was confirmed by the *Tecmed* Tribunal, which concluded that “this provision of the Agreement, in light of the good faith principle established by international

law, requires the Contracting Parties to provide to international investments treatment that does not affect the basic expectations that were taken into account by the foreign investor to make the investment.”

9.3.11 The *LG&E* Tribunal determined that “[i]n addition to the state’s obligation to provide a stable legal and business environment, the fair and equitable treatment analysis involves consideration of the investor’s expectations when making its investment in reliance on the protections to be granted by the host state.”

9.3.12 Indeed, several other tribunals have established, as quoted above, that the expectations can only be created at the time of the investment. Nevertheless, the interpretation of “time of the investment” has been quite broad. For example, in *CMS Gas Transmission Company v. Argentine Republic* (ICSID Case No. ARB/01/8), the Tribunal held that it is the time when “the investment was decided and made.” (Award, May 12, 2005, ¶ 275).

9.3.13 As an initial question, this Tribunal therefore has to determine whether Claimants’ investment(s) was/were decided and made in 1996, at the time AES Summit purchased the outstanding shares of Tiszai Erömu Részvénytársaság (now AES Tisza), and/or in 2001, at the time AES Tisza actually began to invest in (spend money on) the Retrofit of the Tisza II plant.

9.3.14 Dealing first with the 1996 PPA, there is no question that AES Summit made an investment in Hungary at that time. Accordingly, it is proper to consider whether it had legitimate expectations at that time, with which Hungary has wrongfully interfered.

9.3.15 As to that question, the Tribunal concludes that AES Summit can have had no legitimate expectation at that time regarding the conduct of Hungary about which it now



complains (*i.e.*, the fact of, motivation for and methodology relating to the reintroduction of administrative pricing in 2006/2007). Both the privatization materials and the relevant investment agreements (the Original Tisza II PPA and the 1996 PSA) were explicit that Hungary would continue to set maximum administrative prices for electricity sales indefinitely into the future. This was subject only to the principle that such pricing would provide a “reasonable return” on investment, which would “target” returns in the general range of 8% on equity for the first regulatory period beginning in 1997.

9.3.16 Turning to the year 2001, there can also be no question that AES Tisza then and thereafter made an investment in Hungary as the term “investment” is defined in the Treaty. It is not contested that, between 2001 and 2005, AES Tisza spent approximately € 98 million to complete three of the four phases of the Tisza II Retrofit. It is also clear that the decision to make the investment was re-confirmed at the time of the 2001 Settlement Agreement. This fact is self-evident from the terms of the relevant agreements that were then executed.

9.3.17 The enquiry therefore turns to whether: (a) there were government representations and assurances made or given to Claimants at that time, and upon which they relied, of the sort alleged; and (b) Hungary acted in a manner contrary to such representations and assurances.

9.3.18 And as to this, the Tribunal concludes that Hungary made no representations/gave no assurances of a nature that go to the heart of Claimants’ complaint – *i.e.*, that following the termination of price administration on 31 December 2003, regulated pricing would not again be introduced.

9.3.19 As regards Claimants' reliance on statements found in the 1996 Industry Information Memorandum relating to "an 8% return on shareholder funds"<sup>35</sup> and the requirement for "another overall price and cost review" prior to the introduction of "any new pricing mechanism,"<sup>36</sup> the first was simply a target rate for a "reasonable return" for the first regulatory period and the second was made in the context of the HEO not expecting radical changes in Hungary's administrative pricing system. It is of course true that Hungary moved away from administrative pricing at the end of 2003 (and that this future course was known in 2001 at the time of the 2001 Settlement), but the 1996 statement simply does not relate in a sufficiently material way to Claimants' central complaint (the reintroduction of administrative pricing in 2006/2007) for the Tribunal to find that Hungary's conduct in 2006/2007 was contrary to representations and assurances said to have been made to AES Summit in 1996.

9.3.20 As regards Hungary's letter of 21 October 1999 from Mr. Pal Ligati (Head of Department, Ministry of Economic Affaires), which Claimants classify as an "express promise not to interfere with Claimants' PPA," as well as a promise that "the contractual pricing formula set out in the PPA would not be altered by political considerations,"<sup>37</sup> all that sensibly can be said is that, whatever the context of the letter (it was produced only during the hearing and never explained), it does not say what Claimants' say it does. Moreover, it predated the 2001 Tisza II PPA by approximately two years and no evidence was led to suggest that such a new PPA was then contemplated. Indeed, the letter was written immediately before Claimants commenced the

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<sup>35</sup> Exhibit C-111, pp. 102 *et seq.* and F(i).

<sup>36</sup> Claimants' post-hearing submission, ¶ 101.

<sup>37</sup> Claimants' post-hearing submission, ¶ 102.

PSA and Treaty arbitrations in 2000. Accordingly, the Tribunal does not consider it plausible that Claimants can be said to have relied on this assurance when, two years later, they entered into the 2001 Settlement Agreement and the 2001 Amendment Agreement.

9.3.21 This then leaves for consideration Claimants' contention that, as a party to the 2001 Settlement Agreement, Hungary, by reason of clause 21, "expressly promised ... not to frustrate the purposes and intent" of the agreement, which promise it breached through the reintroduction of regulated pricing which was said to be directly contrary to the object and intent of that agreement.

9.3.22 Again, the Tribunal concludes that Claimants' reliance on frustrated legitimate expectations based on clause 21 is unavailing.

9.3.23 Clause 21 of the 2001 Settlement Agreement provides as follows:

"Each of the Parties agrees to execute and deliver all such further instruments and documents and to do and perform all such acts and things as may be necessary and any Party may reasonably request to enable it to carry out the provisions of this Agreement and/or to effect the purposes and intent of this agreement" (Emphasis added).

9.3.24 Such "further acts" clauses are commonplace in commercial agreements, including settlements. Properly construed, the plainly worded provisions of clause 21 do no more than obligate a party to the 2001 Settlement Agreement, if requested reasonably by another party, to execute and deliver specific instruments/documents or to take specific steps as may be necessary, to enable the requesting party to carry out or effect the purposes and intent of the 2001 Settlement Agreement. This does not, as alleged, constitute a specific promise by Hungary not to

frustrate the purposes and intent of the 2001 Settlement Agreement by the reintroduction of administrative pricing.

9.3.25 It is also common ground that the 2001 Settlement Agreement does not contain a so-called “stabilization clause” – *i.e.*, a covenant not to change the relevant law, usually for a certain period. To the contrary, the 2001 Settlement Agreement introduced a “Change in Law” provision (clause 3.7) into the Original Tisza II PPA (or the 2001 PPA), which dealt carefully with the PPA parties’ rights (including financial) should a change of law occur during the now extended term of the PPA. And “Law,” as defined, included all acts of the Hungarian parliament, as well as other governmental or ministerial decrees as might be issued from time to time. In the case under consideration, in 2001, there was a great probability that there would be no administrative pricing after 2004, but this does not equate to absolute certainty, giving rise to internationally protected legitimate expectations.

9.3.26 In these circumstances, the Tribunal concludes that Claimants cannot legitimately have been led by Hungary to expect that a regime of administrative pricing would not be reintroduced under any circumstances during the term of the 2001 Tisza II PPA.

***Findings Concerning Stable Legal and Business Framework***

9.3.27 The analysis of the duty to provide a stable legal and business framework has to be made in light of the ECT and the applicable rules and principles of international law.<sup>38</sup>

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<sup>38</sup> Article 26(6) ECT.

9.3.28 Specifically, article 10(1) of the ECT provides that “each contracting Party shall, in accordance with the provisions of this Treaty, encourage and create stable ... conditions for investors of other Contracting Parties ....”

9.3.29 The stable conditions that the ECT mentions relate to the framework within which the investment takes place. Nevertheless, it is not a stability clause. A legal framework is by definition subject to change as it adapts to new circumstances day by day and a state has the sovereign right to exercise its powers which include legislative acts.

9.3.30 Therefore, to determine the scope of the stable conditions that a state has to encourage and create is a complex task given that it will always depend on the specific circumstances that surrounds the investor’s decision to invest and the measures taken by the state in the public interest.

9.3.31 In this case, however, the Tribunal observes that no specific commitments were made by Hungary that could limit its sovereign right to change its law (such as a stability clause) or that could legitimately have made the investor believe that no change in the law would occur.<sup>39</sup>

9.3.32 Moreover, it is clear from clause 3.7 of the 2001 PPA that the parties to the agreement were aware that a change in the law could occur that could make the obligations under the agreement become illegal, unenforceable or impossible to perform.

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<sup>39</sup> Specifically, the 2001 Settlement Agreement and the 2001 PPA did not contemplated that after 2004 no reintroduction of regulated pricing could take place.

9.3.33 Mechanisms were established in clause 3.7 of the 2001 PPA, which dealt with the possible actions that could be taken by the parties in the event that a change of law, as defined, occurred. Consequently, the Tribunal concludes that the investment(s) by the Claimants in 2001 and thereafter were made in the knowledge that a change in law could occur that could make the obligations of the 2001 PPA illegal, unenforceable or impossible to perform.

9.3.34 In these circumstances, absent a specific commitment from Hungary that it would not reintroduce administrative pricing during the term of the 2001 PPA, Claimants cannot properly rely on an alleged breach of Hungary's Treaty obligation to provide a stable legal environment based on the passage of Act XXXV and the Price Decrees. This is because any reasonably informed business person or investor knows that laws can evolve in accordance with the perceived political or policy dictates of the times.

9.3.35 The Tribunal therefore concludes that no breach of the fair and equitable treatment standard took place based on Hungary's alleged failure to provide a stable legal and business framework.

***Findings Concerning Due Process / Arbitrariness / Transparency***

9.3.36 In their unfair and inequitable treatment case, Claimants rely both on the irrational and unreasonable character of Hungary's decision to reintroduce administrative pricing, as well as the arbitrary and unfair manner (failures in due process) in which the Price Decrees were issued.

9.3.37 For reasons which are set out in Section 10 below (dealing with Unreasonable and Discriminatory Measures), the Tribunal has concluded that there was nothing so irrational or otherwise unreasonable in Hungary's policy decision to reintroduce administrative prices in 2006

as would constitute a breach of its Treaty obligation to ensure that Claimants were treated fairly and equitably and that their investments were not impaired by unreasonable or discriminatory measures.

9.3.38 For this reason, the Tribunal limits its analysis here to the manner or methodology in or by which the Price Decrees were brought into force, with a view to assessing whether “process” failures existed which were such as would constitute a failure to provide Claimants with fair and equitable treatment.

9.3.39 To the Tribunal, this ultimately became the heart of the case, and this is why it asked the parties to address this question in detail in their post-hearing submissions.

9.3.40 The Tribunal has approached this question on the basis that it is not every process failing or imperfection that will amount to a failure to provide fair and equitable treatment. The standard is not one of perfection. It is only when a state’s acts or procedural omissions are, on the facts and in the context before the adjudicator, manifestly unfair or unreasonable (such as would shock, or at least surprise a sense of juridical propriety) – to use the words of the *Tecmed* Tribunal<sup>40</sup> – that the standard can be said to have been infringed.

9.3.41 And for the reasons noted below, the Tribunal does not believe the process of implementing the Price Decrees was so flawed as to amount to a breach of the fair and equitable standard of the ECT.

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<sup>40</sup> Award, May 29, 2003, ¶ 154, quoting the International Court of Justice, Case: *Elletronica Sicula S.p.A. (ELSI)* (*United States of America v. Italy*), 128, p. 65, July 20, 1989, ICJ, General List No. 76.

9.3.42 In reaching this conclusion, the Tribunal was greatly assisted by the testimony offered by György Békés, the head of the Electricity Office Preparation Department of the HEO at the time. To our minds, his evidence describes a not culpably unreasonable implementation process in relation to the Price Decrees.

9.3.43 It is also to be noted that Mr. Békés was not cross-examined. This was, of course, Claimants' right. Mr. Jagusch made the point during the hearing that, in international arbitration, it is not necessary for a party to cross-examine a witness with whose testimony that party may disagree. While this may be so, Mr. Békés was not confronted by Claimants on his evidence and his relevant testimony on process also stands un-contradicted by other testimony or contrary documentation.

9.3.44 Turning to the implementation process itself, Respondent's post-hearing brief provides a useful comparison of Hungary's three administrative pricing cycles for the public utility sector that bears on the issue before the Tribunal.<sup>41</sup> Because Claimants do not fault the first two cycles, it is relevant to their allegation of procedural failings that each and every of the three cycles were somewhat similar.

9.3.45 Mr. Békés recalled that, following the Hungarian parliament's authorization of a return to administrative pricing for generators in early March 2006, the Ministry expected a proposal for an implementing decree from HEO by the end of May, which it intended would go into effect by July 2006.

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<sup>41</sup> First Cycle, 1992-2000; Second Cycle, 2001-2004 (generators exempted for 2004); Third Cycle, 2005-2008 (applied to generators from December 2006-2007).



9.3.46 Mr. Békés explained that for HEO to have done a bottom up cost study in the spring of 2006, in the time frame the Ministry had in mind to issue a decree, was impractical.

9.3.47 However, at this time, the HEO had in hand a study for 2005-2009, that indicated a 7.1% WACC for the electricity sector as a whole.<sup>42</sup> The generators had also previously been informed, on 10 November 2005, in Mr. Horvath's (the HEO president) letter, that a 7.1% return on assets was the target.

9.3.48 Capping profits was the objective at this time. Thus, on 14 March 2006, HEO asked AES and other generators for their financial figures for the 2003-2005 calendar years, *i.e.*, their books. AES supplied its figures by letter, dated 30 March 2006. HEO had previously identified four generators whose returns exceeded 7.1%. It thus determined (based on the generators' own figures) by how much each generator exceeded the 7.1% return concept, and proceeded on the basis that each generator's fees would be reduced accordingly. The same methodology was then applied to all generators. Mr. Békés also made the point that the value of AES's post-retrofit assets were taken into account in determining the price that AES would be able to charge.

9.3.49 On 11 May 2006, the HEO sent each generator the text of the draft 2006 Price Decree, and solicited comments by 18 May 2006 on its proposed approach. (Although no specific prices were provided – this was the same approach HEO had applied in the previous two cycles).

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<sup>42</sup> This study had been done earlier by HEO economists to determine the appropriate figure for return on assets for the initial price calculation for the 2005-2009 pricing cycle for electricity supply and distribution companies which had remained under an administrative pricing regime for that period.

9.3.50 AES commented on 18 May 2006 in accordance with HEO's, admittedly short, deadline. It then amended its comments, four days later, on 22 May 2006. These amended comments were substantive, detailed and led to changes to the draft 2006 Price Decree.

9.3.51 HEO next met AES, on 31 May 2006, to discuss possible changes to the draft 2006 Price Decree.

9.3.52 On 2 June 2006, HEO presented the draft 2006 Price Decree to the Ministry. All of the principal comments that had been received from the generators, along with HEO's preliminary views regarding these comments, were summarized in a table that HEO presented to the Ministry.

9.3.53 Subsequent to HEO's initial proposal to the Ministry, several changes were made to the draft 2006 Price Decree, although the capacity fee proposed for AES Tisza II remained unchanged.

9.3.54 Nevertheless, one important change that was made was the elimination of the original post-hoc profit sharing provision that would have required generators to make payments to MVM, if their profits exceeded the 7.1% target.

9.3.55 This change, which was made by the Ministry in response to the objections in May 2006 from a number of the generators, including AES Tisza, provides at least a partial answer to Claimants' allegations of arbitrary behaviour by Hungary at this time. It also moved the proposed Price Decree to a price capping, not a profit capping model.

9.3.56 Thus, each of Hungary's three relevant pricing cycles used price caps (not a profit cap in the third cycle, as alleged by Claimants). Moreover, the prices established in the last two cycles were both based on returns on assets.

9.3.57 The so-called "reasonable" rate of return (of 7.1% return on assets) was also based on a WACC calculated for the electricity sector as a whole. It can therefore not be said that it bore no rational relationship to the generation companies. Generators also had the ability to exceed the target 7.1% rate of return and AES subsequently did so.

9.3.58 On 17 November 2006, AES wrote to Mr. Horvath complaining about there having been no comprehensive cost review and asserting a right to participate in a price determination process.

9.3.59 The final text of the draft Decree was adopted by the Ministry on 24 November 2006 for the 2006 year.

9.3.60 HEO replied to AES's cost review complaint on 30 November 2006, expressing its position that such a cost review was not required.

9.3.61 With the 2006 Price Decree about to take effect, on 5 December 2006, HEO wrote to AES and the other generators to propose that the prices fixed for each generator for 2006 would be adjusted upward (to the same extent the relevant generator's 2007 PPA price was predicted to exceed the relevant generator's 2006 PPA price) for use in 2007. A two-day comment period was given. AES did not comment.

9.3.62 The 2006 Price Decree went into effect on 9 December 2006.

9.3.63 The 2007 Price Decree was adopted on 26 January 2007, and came into force on 1 February 2007.

9.3.64 The March 2006 amendments to the 2001 Electricity Act (that provided for the reintroduction of administrative prices) did not affect its existing provisions which allow generators to petition for individual price review. Mr. Békés testified that AES Tisza did not submit a request for price review during the relevant review period applicable to the Price Decrees.

9.3.65 AES also had the opportunity to seek to review the process under which the Price Decrees were introduced by proceedings in the Hungarian courts, but did not do so.

9.3.66 Having regard to this uncontested procedural history, the Tribunal does not feel that the several procedural shortcomings in Hungary's implementation of the price decrees (the most obvious being the short-fused periods given by HEO on 11 May and 5 December 2006 to AES to comment on the text of the draft Price Decrees) are sufficient to constitute unfair and inequitable treatment.

9.3.67 The Tribunal was comforted in this view because HEO made it clear to the generators, not later than November 2005, that it considered a 7.1% return on assets to be an appropriate rate of return.

9.3.68 Thus, pre-warned as it had been, AES found it possible to respond to HEO's 11 May 2006 letter requesting comment on the draft 2006 Price Decree within the very short (in the Tribunal's view, over-short) time specified. AES did not apparently consider it necessary to seek

an extension of the deadline. Moreover, it supplemented and amended its comments four days later.

9.3.69 AES's 'late' amendments were not only accepted by HEO as being timely; HEO also acted on some of them. This is not conduct that can substantiate in this case allegations of such a degree of arbitrariness, a lack of transparency, or a lack of due process that amounts to unfair or inequitable treatment.

9.3.70 And, as already indicated, the fact that HEO, following criticism from the generators, eliminated its proposed post-hoc profit sharing provision, shows that it was not behaving in an arbitrary manner. In short, while HEO's consultations with Claimants on the Prices Decrees may not have been optimal, they do not amount to a culpable "failure to consult properly" as alleged.

9.3.71 As regards HEO's failure to perform a costs and assets review, it is true that this was done in the case of the two previous prices cycles. Nevertheless, the Tribunal has concluded that HEO's decision not to follow this practise at this time was not unfair to AES.

9.3.72 This is because HEO accepted AES's costs as reflected in AES's 2004 and 2005 own financial statements as supplied to HEO and its return-on-assets calculations were based on the book value of assets, also as reported in AES's financial statements, precisely as it had done for the second price cycle with which Claimants have no complaint.

9.3.73 In summary, Respondent's process of introducing the Price Decrees, while sub-optimal, did not fall outside the acceptable range of legislative and regulatory behaviour. That being the case, it cannot be defined as unfair and inequitable.

## **10. UNREASONABLE AND DISCRIMINATORY MEASURES**

### **10.1 Claimants' Position**

10.1.1 As regards the Treaty's prohibition of the impairment of investments by unreasonable or discriminatory measures, Claimants say that Hungary's actions must be judged against a standard that its conduct bears a reasonable relationship to some rational policy – rationality to be assessed objectively by the Tribunal.

10.1.2 To support these claims, Claimants say that a return to regulated pricing was irrational, if it was aimed at state aid concerns, because:

- (a) Hungary did not believe, at the time, that there was a state aid problem;
- (b) there is no obligation under Community law to introduce profit caps – profitability having no direct relationship to state aid;
- (c) Hungary had promised to respect civil law contracts; and
- (d) Hungary never consulted the State Aid Monitoring Office of the Ministry of Finance (“SAMO”), which was the state agency responsible for dealing with state aid issues.

10.1.3 On discrimination, Claimants point to the fact that HEO's letter of 10 November 2005 was sent to just four generators, indicating that they should voluntarily give up their contractual rights and reduce their PPA prices. And when the 2006 Price Decree was issued on 24 November 2006, it affected only these four generators. Discrimination is thus evident having regard to the fact that the Commission was concerned that all generator PPAs contained state aid.

## **10.2 Respondent's Position**

10.2.1 Hungary contends it is well settled that states may implement regulatory change as long as they do so for rational, non-arbitrary reasons, and that such regulatory changes do not discriminate unlawfully against a foreign investor that is protected by an applicable investment treaty.

10.2.2 The standard for examining a state's reasons for acting is not a testing one. States have a broad discretion in deciding whether and how to regulate and the burden is on the challenger to demonstrate irrationality, arbitrariness, or a lack of a reasonable relationship to some rational policy.

10.2.3 As regards Claimants' allegations that Hungary's decision to re-regulate prices was a "money grab" to help MVM, based on nothing more than domestic policy grandstanding about "luxury profits," Hungary says that there were legitimate and inter-related reasons for temporarily reintroducing price regulation in 2006:

- (a) Hungary was legitimately concerned about the failure of generators to agree to negotiate any reductions in contracted PPA capacity, to free up electricity for sale to the free market;
- (b) Hungarian policymakers were well aware of the Commission's state aid investigations and of the Commission's concern that generator PPAs contained state aid and prevented new market entrants; and
- (c) the Hungarian authorities were legitimately concerned about the profit levels that some generators were enjoying under non-competitive PPAs.

10.2.4 Thus, Hungary says that there were rational reasons that led it to reintroduce the price regulation for a transitional period, pending full market liberalization and while awaiting the EC's Final Decision on the legality of the PPAs'.

10.2.5 Hungary also argues that there was nothing irrational about the government's use of its right to exercise supervisory authority over generator prices by setting certain maximum levels, for generators that were not under market conditions. Moreover, the fact that the methodologies for implementing the policy evolved over the intervening decade does not suggest that the underlying policy itself was no longer rational.

10.2.6 As to Claimants' discrimination case, Hungary says that Claimants must show there was: (a) differential treatment between parties similarly situated; and (b) no justification for such differentiation.

10.2.7 In this regard, Hungary argues that Claimants cannot succeed because there was no differential treatment at all. This is because prices (and especially capacity fees) were never uniform across generators in Hungary – they were always set in relation to each power plant's underlying costs, and the generators' cost structures varied substantially. Also, Tisza II's capacity fee had always been lower than that of other generators, whether under administrative or PPA pricing, because of its lower fixed costs.

10.2.8 In addition, Hungary maintains that price caps were set by a uniform methodology which was applied to all generators and was based on a uniform measure of reasonable return



(i.e., a 7.1% return on assets). It was simply the fact that each plant had a different starting point of prior returns that made the resulting price outcomes different.<sup>43</sup>

10.2.9 In response to Claimants' allegation that only four generators were targeted and affected by the Price Decrees, Hungary relies on Mr. Békés's uncontradicted explanation that the HEO reviewed financial performance data for all generators and determined that only four had exceeded the identified target return of 7.1%. The fact that only those generators whose returns exceed a maximum permitted level would be affected by a price cap does not constitute unlawful discriminatory targeting.

### **10.3 Findings of the Tribunal**

10.3.1 Article 10(1) of the ECT provides that "no Contracting Party shall in any way impair by unreasonable or discriminatory measure their [investment's] management, maintenance, use, enjoyment or disposal."

10.3.2 Hungary was thus obliged to avoid any impairment of Claimants' investment as a consequence of either: (a) unreasonable or (b) discriminatory measures.

10.3.3 An analysis of the nature of a state's measures, in order to determine if they are unreasonable or discriminatory, is only necessary when an impairment of the investment took place.

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<sup>43</sup> Counter-Memorial, ¶ 376.

10.3.4 It is undisputed that, as a result of the reintroduction of the Price Decrees, Claimants received lower prices than they had been receiving pursuant to the formula set out in the 2001 PPA.

10.3.5 It follows that AES's receipt of a lower payment from MVM, whilst burdened by unchanged costs, had a detrimental impact on Claimants' investment, as it altered – in a negative way – AES Tisza's regular income.

10.3.6 However, for such impairment to amount to a breach of the ECT, it must be the result of an unreasonable or discriminatory measure.

10.3.7 There are two elements that require to be analyzed to determine whether a state's act was unreasonable: the existence of a rational policy; and the reasonableness of the act of the state in relation to the policy.

10.3.8 A rational policy is taken by a state following a logical (good sense) explanation and with the aim of addressing a public interest matter.

10.3.9 Nevertheless, a rational policy is not enough to justify all the measures taken by a state in its name. A challenged measure must also be reasonable. That is, there needs to be an appropriate correlation between the state's public policy objective and the measure adopted to achieve it. This has to do with the nature of the measure and the way it is implemented.

10.3.10 Hungary has argued that it had three main reasons for introducing the Price Decrees.<sup>44</sup>

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<sup>44</sup> Respondent's post-hearing submission, ¶ 65.

10.3.11 First, Hungary was concerned about the failure of generators to agree over several years to any reductions in contracted PPA capacity, to free up electricity for direct sale to the parallel free market, that had to be developed during the period of transition from the centralized economy to a liberal market.<sup>45</sup>

10.3.12 As to this point, the Tribunal finds that it cannot be considered a reasonable measure for a state to use its governmental powers to force a private party to change or give up its contractual rights. If the state has the conviction that its contractual obligations to its investors should no longer be observed (even if it is a commercial contract, which is the case), the state would have to end such contracts and assume the contractual consequences of such early termination.

10.3.13 This does not mean that the state cannot exercise its governmental powers, including its legislative function, with the consequence that private interests – such as the investor’s contractual rights – are affected. But that effect would have to be a consequence of a measure based on public policy that was not aimed only at those contractual rights. Were it to be otherwise, a state could justify the breach of commercial commitments by relying on arguments that such breach was occasioned by an act of the state performed in its public character.

10.3.14 Therefore, the Tribunal cannot consider it to have been reasonable for Hungary to have issued the Price Decrees because of Claimants’ failure to agree to, or even to negotiate for, a reduction in the capacity to which it was contractually entitled under the 2001 PPA.

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<sup>45</sup> Respondent’s post-hearing submission, ¶ 67.

10.3.15 Hungary's second stated reason for the introduction of the Price Decrees was the pressure of the EC Commission's investigations and the foreseeable obligation to correct (recover) state aid that the Commission's decision would impose.

10.3.16 Had Hungary been motivated to reintroduce price regulation with a view to addressing the EC's state aid concerns, there is no doubt that this would have constituted a rational public policy measure. However, the Tribunal notes that as long as the Commission's state aid decision was not issued, Hungary had no legal obligation to act in accordance with what it believed could be the result of the decision and to start a limitation of potential state aid.

10.3.17 During the hearing, it became clear to the Tribunal that SAMO, the Hungarian agency in charge of dealing with state aid issues, had not even been consulted when the government reintroduced regulated pricing in March 2006. Another important fact is that the use of the 7.1% cap on profits had no direct relation with state aid, because state aid occurs when the entity is receiving above-market prices. The elimination of above-market prices is not achieved by a cap on profits. To address such price concerns requires a general market price analysis.

10.3.18 Consequently, the majority concludes that Hungary's decision to reintroduce administrative pricing was not motivated by pressure from the EC Commission.

10.3.19 Arbitrator Stern considers that it was not exclusively so motivated, but that the enquiry and subsequent pressures from the Commission certainly was in the Hungarian authorities' mind when they decided to reintroduce price regulation. In her view, it appears from the record that the high prices were also a serious problem for the Commission and it is quite evident that even before Hungary was under a legal obligation to follow the Commission's decision, it had been

made abundantly clear to Hungary that the PPAs raised considerable concerns at the European level, as being in contradiction with the European free market policies. For example, in a meeting with the Commission in Brussels on 15 July 2004, concerns were expressed by the Commission that the stranded costs mechanism of Decree 183/ 2002 constitutes state aid to the generators, stating that “it must be ensured that none of the power plants reaches *extra profits* under the PPAs.” In other words, the EC position on the PPAs cannot be separated from the motivation that was behind the Price Decrees. It is noticeable that it is on 10 November 2005, one day after a European Commission’s decision strongly critical of the PPAs, that HEO sent the letter to AES Tisza in which it claimed that the profits of the company were “unjustifiable high” and suggested that the profits should be capped at a maximum of 7.1%. Several factors – the state aid investigation, the obstacles to liberalization and the generators’ excessive returns – were clearly interrelated, in the minds of the Hungarian government and regulators, when faced with the high profits of the generators. To arbitrator Stern, the evidence is overwhelming that the decision to reintroduce maximum administrative prices was a rational, non-arbitrary response to a complex set of legitimate policy concerns.

10.3.20 Hungary’s third reason for acting had to do with the allegations that the profits enjoyed under the PPAs, in the absence of either competition or regulation, exceeded reasonable rates of return for public utility sales. Hungary does not deny that one of its reasons for acting had to do with these concerns.

10.3.21 In 2005, HEO made calculations that showed that several generators were earning returns in excess of the WACC level for the regulated electricity sector as a whole. After a series

of unsuccessful attempts at PPA renegotiations, HEO presented the data regarding the generator's returns to the parliament's Energy Subcommittee.<sup>46</sup>

10.3.22 In the meantime, the level of the generators' returns became a public issue and something of a political lightning rod in the face of upcoming elections.

10.3.23 However, the fact that an issue becomes a political matter, such as the excessive profits of the generators and the reintroduction of the Price Decrees, does not mean that the existence of a rational policy is erased.

10.3.24 In fact, it is normal and common that a public policy matter becomes a political issue; that is the arena where such matters are discussed and made public.

10.3.25 Eventually, an amendment to the 2001 Electricity Act and the Price Act, to enable the reintroduction of regulatory pricing, was proposed to parliament by Mr. Podolák on 5 December 2005. The objective of the amendment was that "the transmission and distribution of electricity, the controlling of the system, the selling of electricity contracted for public utility purposes by generators, trading between the public utility wholesaler and the public utility service provider and the electricity sold to consumers in the public utility sector are subject to the regulatory pricing stipulated under the act on the determination of prices."<sup>47</sup>

10.3.26 This amendment proposal contained a general explanation in the following terms:

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<sup>46</sup> Exhibit R-196.

<sup>47</sup> Exhibit C-82.

“This act shall be enacted by the Parliament to include the generators’ price of electricity contracted for public utility purposes in the scope of regulatory pricing.

During the privatization of power stations in 1995-96, long-term power purchase agreements were concluded between power stations and MVM Rt. State revenue resulting from the conclusion of long-term power purchase agreements represented revenue from privatization. By way of the agreements stable and foreseeable returns are ensured to those investors who secure the availability of electricity generation capacities necessary to meet domestic demand through the modernization of existing power stations (or the construction of new ones).

Price formulas had been identified in the agreements but the application of these formulas was abrogated by regulatory pricing.

In the Government Decree 1074/1995 (4th August) on the regulation of electricity prices and price correction to be in effect until 1st January 1997 the Horn Cabinet guaranteed an 8% return on capital by way of regulatory pricing during the conclusion of privatization agreements. Pursuant to the above decree an administrative price regulation scheme came into effect for a period of 4 years (JKM Decree No. 63/1995 (24th November) Annex 1).

In 1997 the generators’ average profit was 8.23%, a percentage that steadily increased until 2000 as a result of the efficiency improvement of power stations. By 2000 the average profit of generators was 15.71%.

In 2000 PriceWaterhouseCoopers International consulting company, upon engagement by the Orbán Cabinet, indicated in its report titled “Energy Market Opening Program” that the long-term agreements are impeding the liberalization of the energy market as the agreements contract nearly all domestic power station capacities until 2010-2015 and as such there is no free marketable electricity remaining in the market. Due to the above the international consultant proposed to the Orbán Cabinet to reduce regulatory prices during the new price regulatory period using this as an additional measure to encourage generators to renegotiate the agreements.

Had the Orbán Cabinet given consideration to the proposal presented by the international consultant engaged by it, then the Hungarian Energy Office (lead by Director General Péter Kaderják, appointed by György Matolcsi Minister of Economy) would have been required to propose an administrative price determination that would have repeatedly reduced the generators’

profit to 8% in relation to the on-coming 4-year price regulation period to be determined in 2000. On the contrary the administrative price decree (No. 45/2000 (21st December) issued by the Ministry of Economy) abrogated the regulation concerning the 8% profit margin and introduced new price formulas.

As a result of the decision made by the Minister of Economy on the Orbán Cabinet, the 2001 profit of power stations was 22.83% as opposed to the expected 8%. This price regulation was in effect until the end of 2003 ensuring a steadily high profit level to power station investors. Act 110 (in its final clauses, Section 117 paragraph (2)) on electricity presented by the Orbán Cabinet and approved by the Fidesz-FKGP MPs on 18th December 2001 terminated administrative price regulation for generators as of 1st January 2004. Therefore the previously unapplied price formulas that are based on administrative pricing and are stipulated in the agreements came into effect.

The margins generated by power stations between 1997 and 2004 were as follows:

1997	1998	1999	2000	2001	2002	2003	2004
8.23%	12.73%	12.70%	15.71%	22.83%	21.62%	14.49%	22.36%

This draft legislation includes a proposal for correcting the regulatory error by the Orbán Cabinet and allows for the Government to exercise the measure of administrative pricing in the absence of agreement between the parties, which measure also affects the sale prices stipulated in long-term power purchase agreements providing high profit levels.”

10.3.27 For its part, the FIDESZ presented an independent representative proposal,<sup>48</sup> which did not propose the reintroduction of the Price Decrees but requested the government, among other

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<sup>48</sup> Exhibit C-83.



things, to review the PPAs, to create the conditions of fair competition in the national electric energy market and to ensure affordable prices.

10.3.28 The reasoning behind the FIDESZ proposal was similar to Mr. Podolák’s proposal, as it indicated that:

“the prices of electric power are unfairly high compared to the price level of countries around us. For the security of the people and in order to lighten the financial burden of families and to increase the competitiveness of enterprises and with the intention to perceivably reduce the price of electric energy and to create honest competition in the market, the National Assembly passes the following resolution ...

#### REASONING

Of all new EU members states, it is we, Hungarians, that pay the most for electric energy. A Hungarian household and family pays twice as much for electricity as the Baltic States, 40% more than the Polish and the Czech and 20% more than Slovaks. The price of electric energy turned out like this despite of the fact that there is official price setting giving the State the opportunity to set a more favorable price ...”<sup>49</sup>

10.3.29 On 3 March 2006, the Electricity Act was amended by the Hungarian parliament, reflecting the amendment proposed by Mr. Podolák on 5 December, 2005.<sup>50</sup> The FIDESZ abstained from voting on the proposal.

10.3.30 Based on the debates in parliament and outside parliament, the majority of the Tribunal has concluded that Hungary’s decision to reintroduce administrative pricing was not based on the

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<sup>49</sup> Exhibit C-83.

<sup>50</sup> Exhibit C-82.

EC Commission's investigation. Nor, however, was it made with the intention of affecting Claimants' contractual rights

10.3.31 Rather, against this factual background, the majority has concluded that Hungary's reintroduction of administrative pricing in 2006 was motivated principally by widespread concerns relating to (and it was aimed directly at reducing) excessive profits earned by generators and the burden on consumers.<sup>51</sup>

10.3.32 This is because virtually all of the debate in parliament at the relevant time was about "profits." Indeed, government minister Mr. Tibor Kovács specifically asked the opposition parties if they were prepared to support the proposal, which he said "gives tools for the government to limit the alleged and so-called luxury profits."<sup>52</sup>

10.3.33 There is also no reference to be found to EC state aid or negotiations with EC in the official reasons for Act XXXV.

10.3.34 Having concluded that Hungary was principally motivated by the politics surrounding so-called luxury profits, the Tribunal nevertheless is of the view that it is a perfectly valid and rational policy objective for a government to address luxury profits. And while such price regimes may not be seen as desirable in certain quarters, this does not mean that such a policy is irrational. One need only recall recent wide-spread concerns about the profitability level of banks to understand that so-called excessive profits may well give rise to legitimate reasons for governments to regulate or re-regulate.

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<sup>51</sup> Transcript, pp. 844:2-845:2; Exhibit R-172, ¶ 229.

<sup>52</sup> Exhibit SF 19, p. 9.

10.3.35 As to the need for a reasonable correlation between the state's policy objective and the measures adopted to achieve it, the Tribunal notes that before the amendment of the 2001 Electricity Act, Hungary had approached the generators to renegotiate the PPAs. Given that no agreement was reached, and in the absence of a specific commitment to the Claimants that administrative pricing was never going to be reintroduced, the Hungarian parliament voted for the reintroduction of administrative pricing, which parliament considered to be the best option at the moment.

10.3.36 The Tribunal finds that both the 2006 Electricity Act and the implementing Price Decrees were reasonable, proportionate and consistent with the public policy expressed by the parliament.

10.3.37 Having determined that the decision to introduce the Price Decrees was not an arbitrary or unreasonable measure, it is also necessary to determine if, as stated by Hungary, the generators were still going to receive a reasonable return.

10.3.38 The regulatory regime in place at the time of the privatization was provided by the 1994 Electricity Act. Under the 1994 Act, the HEO would issue detailed rules on pricing, based on which the minister would determine prices to be announced in the form of a decree.<sup>53</sup> The 1994 Electricity Act also provided, in Article 55(3), that the HEO should review the price levels and actual prices on the basis of the initiative of any interested party, and shall make the results of the process public. This provision is understood by the Tribunal as providing the right to any

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<sup>53</sup> Exhibit C-58, Article 55 of the 1994 Electricity Act.

interested party (obviously including generators) to request a costs review of the prices, but only after they have been issued by the minister.

10.3.39 In addition, the Original PPA provided that payment was to be made by reference mainly to both the Availability Fee which is “paying the need for capacity to be in place in case it is needed” and the Electricity Fee which is “the cost of the power it actually requires to have generated.”<sup>54</sup> Both fees’ values to be specified in the Annual Commercial Agreement should be considered based upon the order of the Ministry of Industry and Trade.

10.3.40 The HEO issued a detailed framework pertaining to the pricing every four years, beginning in 1997. Under the 1994 Electricity Act, there were two pricing frameworks:

- (a) the 1995 Framework Decree. Both parties agree that with this decree, the profit was supposed to be an 8% return on equity, approximately;<sup>55</sup>
- (b) the 2000 Framework Decree. The starting point of the price regulation mechanism was provided by the base prices on 1 January 2001 and the preceding assets and cost reviews carried out by HEO. A mechanism of yearly price correction was established, and inflation was also taken into account.

10.3.41 The 2000 Framework Decree was valid until 1 January 2004, which was the date established in the 2001 Electricity Act for the abolishment of regulated prices.

10.3.42 Therefore, starting on 1 January 2004, the formula established in Schedule 6 of the 2001 PPA was applied to AES Tisza’s payments.

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<sup>54</sup> Memorial, ¶ 65.

<sup>55</sup> On the one hand, Claimants stated that the 8% return on equity was a starting price, on the other hand, Respondent stated that the 8% return on equity was a maximum cap.

10.3.43 The Price Decrees provided a 7.1% pre-tax return on assets.

10.3.44 Against the factual background which preceded the March 2006 price re-regulation, the Tribunal considers that the 7.1% rate of return on assets, which it prescribed, to be comparable to the 8% return on equity target that was in place at the time of the privatization.<sup>56</sup> Consequently, in the Tribunal's view, the prices fixed for AES Tisza pursuant to the Price Decrees were reasonable, taking into account their consistency with the original returns it earned at the time of the Claimants' original investment.

10.3.45 Turning finally to Claimants' case based on discrimination, the Tribunal observes that the Price Decrees, which were applicable to all the generators, established a specific price per KHUF/MW/YR to be paid for the Availability Fee (Capacity Fee) depending on the generator.

10.3.46 Claimants contend that this constitutes discrimination, given that the price fixed for AES Tisza was the lowest of all the generators (including foreign and local).

10.3.47 However, the Tribunal finds that the price established for each of the generators was reached using the same methodology. The fact that the price for each generator was different was simply the result of the use of a different starting point of prior returns which was fed into the methodology.<sup>57</sup>

10.3.48 Moreover, to suggest that AES's low capacity fee ranking (in comparison to other generators) is indicative of discrimination is misleading. AES's capacity fees were always at the

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<sup>56</sup> Kovacs Statement, ¶ 39.

<sup>57</sup> Békés First Statement, p. 36 and p. 38.

bottom of the scale (*see* Appendix C, Respondent’s post-hearing brief) in each of the three relevant price cycles. But, as Mr. Békés explained, that was because capacity fees were based on cost structure, and the Tisza II plant had relatively low fixed costs per unit of capacity.

10.3.49 By contrast, energy fees (Electricity Fees) were based on variable operating costs, which were relatively high at Tisza II. This resulted in AES Tisza always receiving amongst the highest energy fee of any of the generators.

10.3.50 The Tribunal thus concludes that neither its low capacity fees, nor its high energy fees suggest discrimination. Both were the logical result of a uniform methodology that was applied equally to all generators, based on their differing assets and operating cost structures.

10.3.51 The same can be said for Claimants’ assertions of discrimination based on the fact that only four generators were affected (“targeted”) by the reintroduction of price regulation. This is because the notion of a cap on prices based on a starting target of “reasonable returns” means that generators that are already earning below that return will not be affected by the regulation.

10.3.52 And having regard to the objective of 2006/2007 price cap regulation, of protecting consumers from having to fund so-called “excessive profits” of generators, it is perfectly logical that generators whose returns were not “excessive” at the time of re-regulation would not be affected by the cap.

10.3.53 Discrimination necessarily implies that the state benefited or harmed someone more in comparison with the generality. In this case, on the uncontradicted facts, the Tribunal finds that there has been no different treatment of AES Tisza in comparison with the other generators and, thus, that it was not the subject of discriminatory treatment.

## **11. NATIONAL TREATMENT**

### **11.1 Claimants' Position**

11.1.1 Claimants argue in support of their national treatment case that the treatment received by the Paks power station, a domestically owned electricity generator, and wholly-owned subsidiary of MVM, was more favorable than the treatment received by all the other generators, because Paks actually received a price increase under the Price Decreases in comparison with the one agreed in its PPA.<sup>58</sup>

### **11.2 Respondent's Position**

11.2.1 The Respondent denies a breach of the ECT's national treatment obligation and asserts that the Price Decreases "only overrode contractual pricing when it exceeded the "maximum" level set by the uniform 7.1% return-on-assets methodology" and that such situation did not happen in the case of Paks because, based on contractual formula in its PPA, its actual return was significantly lower than the target level.<sup>59</sup>

### **11.3 Findings of the Tribunal**

11.3.1 Article 10(7) of the ECT obliges each signatory party to accord "treatment no less favorable than that which it accords to Investments of its own Investors or for the Investors of any other Contracting Party or any third state and their related activities."

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<sup>58</sup> Memorial, ¶ 239.

<sup>59</sup> Counter-Memorial, ¶ 383.

11.3.2 The alleged breach of the obligation to provide national treatment is based on the same facts that Claimants alleged amounted to a discriminatory measure,<sup>60</sup> where the Tribunal found that no discriminatory measure was taken by the government. Indeed, Claimants’ admitted that the generator with the highest capacity fee was, like itself, foreign.

11.3.3 Therefore, as was concluded in Section 10 above, the Tribunal finds that Hungary did not breach its ECT obligation to provide national treatment to AES Tisza.

## **12. MOST FAVOURED NATION TREATMENT**

### **12.1 Claimants’ Position**

12.1.1 The Claimants allege that the facts relied on in relation to discriminatory measures also establish a violation of the most favoured nation treatment obligation.

### **12.2 Respondent’s Position**

12.2.1 The Respondent claims that “the application of a uniform methodology to all power plants with PPAs, based on the objective of capping returns at prescribed rates of reasonableness, is not rendered discriminatory simply because some plants had previously exceeded the “reasonable” level by more than others.”

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<sup>60</sup> With the difference that Claimants specify that the national generator that received a better treatment is Paks. Memorial, ¶ 239.



### **12.3 Findings of the Tribunal**

12.3.1 Article 10(7) of the ECT obliges each signatory party to accord “treatment no less favorable than that which it accords to Investments of its own Investors or for the Investors of any other Contracting Party or any third state and their related activities.”

12.3.2 The alleged breach of the most favoured nation treatment obligation is based on the same facts that Claimants alleged amounted to a discriminatory measure,<sup>61</sup> where the Tribunal found that no discriminatory measure was taken by the government – *i.e.*, that each generator’s price was determined based on the application of a uniform methodology. This being the case, there can be no suggestion that AES was treated “less favourably” than any other similarly positioned investor.

12.3.3 Therefore, as was concluded in Section 10, the Tribunal finds that Hungary did not breach its ECT obligation to provide most favoured nation treatment to AES Tisza.

## **13. CONSTANT PROTECTION AND SECURITY**

### **13.1 Claimants’ Position**

13.1.1 Claimants maintain that the state’s obligation to provide constant protection and security covers not only the physical security of the investment but also the legal security and protection.

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<sup>61</sup> With the difference that Claimants specify that the other generators that received a better treatment are Budapesti, Pannon, Mátra and Csepeli. Memorial, ¶ 245.

13.1.2 In their opinion, Hungary breached the standard when it failed to ensure the legal security of the investments through the 2006 Electricity Act Amendment and the ensuing implementation of the Price Decrees, given that such acts have substantially devalued their investment.

13.1.3 Relying on the duty identified by the Tribunal in *CME*, Claimants say that the 2006 Electricity Amendment Act and the Price Decrees eviscerated their rights under the 2001 Settlement Agreement and the 2001 PPA. Hungary thus made it “impossible to preserve and continue contractual arrangements underpinning the investment” and has therefore breached the most constant protection and security provisions of Article 10(1).<sup>62</sup>

13.1.4 The requirement to provide constant protection and security is a duty:

“to use the powers of government to ensure the foreign investment can function properly on a level playing field, unhindered and not harassed by the political and economic domestic powers that be.”<sup>63</sup>

13.1.5 And the level playing field here, which Hungary itself destroyed, was the pre-existing, freely negotiated contractual relationship that the generators enjoyed with MVM.

## **13.2 Respondent’s Position**

13.2.1 To the contrary, Hungary argues that the obligation to provide constant protection and security cannot be understood as a treaty-based stabilization clause, tantamount to a guarantee of a “legal security” under which a state will take no action that interferes with the “contractual

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<sup>62</sup> Memorial, ¶ 254.

<sup>63</sup> Exhibit CA-80, T.M. Wälde, *Energy Charter Treaty-based Arbitration*, Transactional Dispute Management, Vol. 1, Issue 3, p.30.

arrangements underpinning [an] investment.” Respondent says that the standard imposes a duty of “due diligence” that requires the state to afford reasonable protection to investors against foreseeable harm from third parties. It adds that there can be no credible suggestion that the Price Decrees were designed to destroy a “level playing field on which Claimants could properly function unhindered and not harassed by the political and economic powers that be” when their very purpose was to ensure a reasonable return for all generators with PPAs.

13.2.2 Respondent admits that some tribunals have recently expanded the scope of protection beyond the two traditional areas (*i.e.*, physical protection and the provision of reasonable legal avenues to enforce investors’ rights) to include general references to legal security. But even under such an expansive reading, the protection is not absolute, and applies only in exceptional circumstances.

### **13.3 Findings of the Tribunal**

13.3.1 In addition to the fair and equitable standard, Article 10(1) of the ECT establishes that the “investments shall also enjoy the most constant protection and security and no Contracting Party shall in any way impair by unreasonable or discriminatory measures their management, maintenance, use, enjoyment or disposal.”

13.3.2 In the Tribunal’s view, the duty to provide most constant protection and security to investments is a state’s obligation to take reasonable steps to protect its investors (or to enable its investors to protect themselves) against harassment by third parties and/or state actors. But the standard is certainly not one of strict liability. And while it can, in appropriate circumstances,

extend beyond a protection of physical security,<sup>64</sup> it certainly does not protect against a state's right (as was the case here) to legislate or regulate in a manner which may negatively affect a claimant's investment, provided that the state acts reasonably in the circumstances and with a view to achieving objectively rational public policy goals.

13.3.3 In the words of Brownlie, the duty is no more than to provide "a reasonable measure of prevention which a well-administered government could be expected to exercise under similar circumstances."<sup>65</sup>

13.3.4 Claimants' argument, that the "level playing field," defined as "the pre-existing, freely negotiated contractual relationship that the generators enjoyed with MVM" had somehow to be protected by Hungary is seriously overreaching, given that neither the 2001 Settlement Agreement, nor the 2001 PPA, contemplated that pricing regulation could not be reintroduced. The PPA only stipulated that if the administrative pricing disappeared specific formulas would be applied.

13.3.5 To conclude that the right to constant protection and security implies that no change in law that affects the investor's rights could take place, would be practically the same as to recognizing the existence of a non-existent stability agreement as a consequence of the full protection and security standard.

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<sup>64</sup> *Compañía de Aguas del Aconquija, S.A. and Vivendi Universal S.A. v. Argentine Republic*, Award, 20 August 2007, ¶ 7.4.16

<sup>65</sup> Brownlie, Ian, *System of the Law of Nations: State Responsibility* (1986), p. 162.

13.3.6 The Tribunal finds that there can have been no breach of the obligation to provide constant protection and security as a result of Hungary’s reintroduction of regulated pricing in 2006-2007, such reintroduction being based on rational public policy grounds.

## **14. EXPROPRIATION**

### **14.1 Claimants’ Position**

14.1.1 Claimants’ argue that Hungary “summarily and arbitrarily expropriated substantial revenues which AES Tisza had been contractually entitled to receive under the 2001 PPA”<sup>66</sup> by amending the 2001 Electricity Act and issuing of the Price Decrees. This act is considered by Claimants as a conduct “equivalent to nationalization or expropriation.”<sup>67</sup>

14.1.2 In this regard, Claimants state that, as it has been decided by numerous arbitral tribunals, an act tantamount to expropriation occurs when the state deprives an investor of its contractual rights even when the act does not involve a taking of physical property.<sup>68</sup>

14.1.3 In addition, Claimants maintain that the expropriation may be indirect when there is an interference with the use of property, even if is incidental and even if the state does not benefit from such interference.<sup>69</sup>

14.1.4 Moreover, Claimants contend that a state’s measures can amount to expropriation even when they are in force for only a limited period. Reliance is placed on *Wena Hotels v. Arab*

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<sup>66</sup> Memorial, ¶ 255.

<sup>67</sup> Memorial, ¶ 255.

<sup>68</sup> Memorial, ¶¶ 256 *et seq.*

<sup>69</sup> Memorial, ¶ 258.

*Republic of Egypt* (ICSID Case No. ARB/98/4), in which the Tribunal determined that an expropriation can take place even when the interference was executed only during a limited period of time.<sup>70</sup>

## **14.2 Respondent's Position**

14.2.1 Respondent contends, in brief, that Claimants have no legal basis to claim an expropriation (direct or indirect) given that Hungary's acts did not deprive the Claimants from the use and control of their investment and the investment was not deprived of all meaningful value.<sup>71</sup> Respondent says that such requirements are preconditions to a finding of an expropriation by the Tribunal. Furthermore, the Respondent argues that Claimants do not contend that AES suffered harm remotely equivalent to a traditional expropriation and that they cannot expand the doctrine of indirect expropriation to cover acts which may lead to the temporary diminution of their profits. According to the Respondent, Claimants themselves acknowledged to the EC that regulating prices was more the rule than the exception in Hungary: in a letter dated 13 February 2006, Claimants described price controls as having been simply “*suspended for a brief interlude commencing 1st January 2004.*”<sup>72</sup>

## **14.3 Findings of the Tribunal**

14.3.1 It is evident that many state's acts or measures can affect investments and a modification to an existing law or regulation is probably one of the most common of such acts or

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<sup>70</sup> Memorial, ¶ 263.

<sup>71</sup> Counter-Memorial, ¶ 406.

<sup>72</sup> AES's memorandum to the EC, R-93, 13 February 2006.

measures. Nevertheless, a state's act that has a negative effect on an investment cannot automatically be considered an expropriation. For an expropriation to occur, it is necessary for the investor to be deprived, in whole or significant part, of the property in or effective control of its investment: or for its investment to be deprived, in whole or significant part, of its value.

14.3.2 But, in this case, the amendment of the 2001 Electricity Act and the issuance of the Price Decrees did not interfere with the ownership or use of Claimants' property. Claimants retained at all times the control of the AES Tisza II plant, thus there was no deprivation of Claimants' ownership or control of their investment.

14.3.3 Moreover, Claimants continued to receive substantial revenues from their investments during 2006 and 2007, which proves that the value of their investment was not substantially diminished and that they were not deprived of the whole or a significant part of the value of their investments.

14.3.4 In these circumstances, the Tribunal concludes that the effects of the reintroduction of the Price Decrees do not amount to an expropriation of Claimants' investment(s).

## **15. COSTS**

### **15.1 Claimants' Position**

15.1.1 On 8 July 2010, the Claimants filed their final Statement of Costs which amounted to a total cost of US\$ 8,787,993.70 and included legal fees and expenses. To date, Claimants have paid an advance on costs to ICSID and the Tribunal in the amount of US\$ 459,945.00.

## **15.2 Respondent's Position**

15.2.1 For its part, on 25 June 2010, Respondent filed its final Statement of Costs which amounted to a total cost of US\$ 5,522,883.00 which included legal fees and expenses. To date, Respondent has paid an advance on costs to ICSID and the Tribunal in the amount of US\$ 460,000.00.

## **15.3 Findings of the Tribunal**

15.3.1 The cost of the arbitration, which includes, *inter alia*, the arbitrators' fees, the expenses of the Tribunal, the Secretariat's administrative fee and the charges for the use of the facilities of the Centre, at the time of the award, amounts to US\$ 887,839.04.<sup>73</sup>

15.3.2 Pursuant to Article 61(2) of the ICSID Convention, as well as Rule 28 of the ICSID Arbitration Rules, the Tribunal has the discretion in the absence of a prior agreement between the parties to decide the allocation of the costs and the legal fees and expenses between the parties.

15.3.3 It is the view of the Tribunal that no frivolous claim was filed in the proceeding and that no bad faith was observed from the parties. In fact, the Tribunal notes that the submissions and the argumentations of both parties were presented in a professional manner. Consequently, the Tribunal concludes that each party shall bear its own costs and expenses and share equally in the costs and charges of the Tribunal and the ICSID Secretariat.

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<sup>73</sup> The total cost of the arbitration proceeding (US\$ 887,839.04) includes an estimate of the courier expenses for the dispatch of the award and may thus be subject to slight change. A final financial statement will be issued by the Centre upon the closure of the trust fund account established for this case.



## 16. OPERATIVE PART

16.1 On the basis of the foregoing reasons, this Tribunal **ORDERS AND AWARDS** as follows:

- (a) The Tribunal has jurisdiction over all the ECT claims presented in this arbitration;
- (b) The Respondent did not breach Articles 10(1), 10(7) and 13 of the ECT;
- (c) The parties shall bear the costs of the arbitration in equal shares;
- (d) The parties shall bear their own costs and legal fees;
- (e) All other claims are dismissed.



Claus Werner von Wobeser  
(President)

Date: September 17, 2010



J. William Rowley QC  
(Arbitrator)

Date: 26 August 2010



Prof. Brigitte Stern  
(Arbitrator)

Date: 30 August 2010

## **LEGAL AUTHORITY CA-72**

**F I N A L**

**A W A R D**

**FINAL**

**AWARD**

**IN THE MATTER OF AN UNCITRAL ARBITRATION**

between

**Ronald S. Lauder**

757 Fifth Avenue

Suite 4200

New York, New York 10153

United States of America

The Claimant

and

**The Czech Republic**

Letenská 15

118 10 Prague 1

The Czech Republic

The Respondent

*represented by:*

John S. Kierman, W. Friedman

and M. Ostrove

Debevoise & Plimpton

875 Third Avenue

New York, New York 10022

United States of America

*represented by :*

Vladimir Petrus and

Miroslav Dubovsky

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110 00 Prague 1

Czech Republic

and

Mr. Jeremy Carver CBE

Mr. Audley Sheppard

Clifford Chance

200 Aldersgate Street

GB-London EC1A 4JJ

## 1. Introduction

1. In 1989, the Czech and Slovak people overthrew the communist regime and adopted a democratic governance system embracing market economy. New laws had to be adopted, foreign investment was encouraged.
2. Various Bilateral Investment Treaties were concluded to create the necessary legal protection for new investments, among them the Treaty between the United States of America and the Czech and Slovak Federal Republic Concerning the Reciprocal Encouragement and Protection of Investment, entered into on 22 October 1991 (the Treaty).
3. On 30 October 1991, a new Act on Operating Radio and Television Broadcasting (the Media Law) was adopted. It provided for the creation of the Council of the Czech Republic for Radio and Television Broadcasting (the Media Council) to ensure the observance of the Media Law, the development of plurality in broadcasting, and the development of domestic and European audio-visual work. The Media Council was also competent to grant operating licences.
4. In 1992, the Media Council commenced the necessary licensing procedures for nationwide private television broadcasting, and, on 9 February 1993, it granted License No 001/1993 to Central European Television 21, CET 21 spol. s r.o. (hereafter „CET 21“), a company founded by a small number of Czech citizens.
5. During the license application proceedings, CET 21 had worked closely with a foreign group, Central European Development Corporation GmbH (hereafter “CEDC”), in which Mr. Ronald S. Lauder (hereafter the “Claimant” or “Mr. Lauder”), an American citizen, had an important interest. At that time and since then, Mr. Lauder has among other activities been an important player in the audio-visual media in the former communist States of Central and Eastern Europe.
6. The formula which was finally adopted envisaged the formation of a new joint company, Česká nezávislá televizní společnost, spol. s r.o. (hereafter “CNTS”), with

the participation of CET 21, a Czech bank and, as a majority shareholder, a company representing the foreign investors.

7. The key person was Dr. Vladimír Železný, a Czech citizen with a long experience in the media field, also a scriptwriter, etc. Mr. Železný became at the same time what amounted to the Chief Operating Officer of both CET 21 and CNTS. The new television station, TV Nova, immediately became very popular and very profitable.
8. The successful venture came to an end in 1999 when CNTS, on April 19, fired Mr. Železný from his functions with CNTS and when CET 21, on 5 August 1999, terminated its contractual relations with CNTS, after CNTS, on 4 August 4 1999, had not submitted the so-called Daily Log regarding the broadcasting for the following day.
9. During all this period the Media Council of the Czech Republic played an important role, especially during three periods. First, at the end of 1992 and the beginning of 1993, when it granted the License. Then, at the end of 1995 and in 1996, when a new Media Law became effective and the Media Council commenced administrative proceedings against CNTS, whereupon the agreements between CNTS and CET 21 were modified. Finally, during the Spring and Summer of 1999, when the final breach between CET 21 and CNTS occurred.
10. On 19 August 1999, Mr. Lauder commenced arbitration proceedings against the Czech Republic (hereafter the “Defendant”) under the Treaty, claiming that the Czech Republic, through its Media Council, had violated the Treaty. This Award examines the claims brought forward by Mr. Lauder.

## 2. Procedural History

11. On 19 August 1999, Ronald S. Lauder initiated these arbitration proceedings by giving Notice of Arbitration to the Czech Republic. The Notice submitted that the dispute is subject to arbitration pursuant to Articles VI(2) and (3) of the Treaty and should be

heard by a panel of three arbitrators pursuant to Article 5 of the UNCITRAL Rules. The Notice of Arbitration also stated that the Czech Republic had consented to submit the dispute to arbitration pursuant to Article VI(3)(b) of the Treaty. The Claimant sought the following relief:

*“[An] order [to] the Czech Republic to take such actions as are necessary to restore the contractual and legal rights associated with the claimant’s investments. Among other things, the Czech Republic should:*

- a) be ordered to impose conditions on the License that adequately reflect and secure CNTS’s exclusive right to provide broadcast services and its right to obtain all corresponding income in connection with the operation of TV Nova;*
- b) be required to enforce such conditions, including by revoking the License and reissuing it to CNTS or to such other entity and under such other circumstances as would restore the initial economic underpinnings of Mr. Lauder’s investment; and*
- c) be held liable for the damages Mr. Lauder has incurred to date, in an amount to be determined by the Tribunal, taking into account, among other factors, the fair market value of Mr. Lauder’s investment prior to the breaches of the Treaty”.*

12. The Claimant appointed Mr. Lloyd N. Cutler as co-arbitrator. The Respondent appointed Mr. Bohuslav Klein as co-arbitrator. Both co-arbitrators chose Mr. Robert Briner as Chairman of the Arbitral Tribunal.
13. On 5 November 1999, the Arbitral Tribunal issued Procedural Order No 1 provisionally fixing Geneva, Switzerland, as the place of arbitration, and determining English as the language of arbitration.
14. On 13 December 1999, the Arbitral Tribunal issued Procedural Order No 2 taking note of the agreement of the Parties proposing London as the place of arbitration.
15. On 31 January 2000, the Czech Republic submitted a Statement of Defence in which it requested that reference to arbitration by Mr. Lauder be dismissed on the grounds that the Arbitral Tribunal has no jurisdiction over the claim; and/or no investment dispute contemplated by the Treaty exists; and/or Mr. Lauder’s Notice of Arbitration was premature or otherwise formally defective.



16. On 17 March 2000, a Procedural Hearing was held in London. The Arbitral Tribunal (i) decided that the issue of jurisdiction would be joined to the merits and that no separate decision on jurisdiction would be taken unless the Arbitral Tribunal would hold that a separate determination would shorten the proceedings; (ii) took note of the agreement of the Parties that they would make good faith efforts to agree by 30 April 2000 on a solution to the issue of the scope and timing of the production of documents required from the Respondent; (iii) took note of the agreement of the Parties that in general the IBA Rules on the Taking of Evidence in International Commercial Arbitration would be used; (iv) took note of the agreement of the Parties on the schedule for the submission of further briefs; (v) considered that a bifurcation of liability and remedy would not be helpful; (vi) took note of the agreement of the Parties with respect to the issues of confidentiality of the proceedings; (vii) took note of the absence of an agreement between the Parties to consolidate or coordinate the parallel UNCITRAL arbitration between CME and the Czech Republic; and (viii) addressed some other minor issues.
17. On 10 May 2000, the Claimant sent a letter to the Arbitral Tribunal regarding the production of further documents. The 14 March 2000 Declaration of Mr. Richard Baček was attached to this letter.
18. On 17 May 2000, the Arbitral Tribunal issued Procedural Order No 3 pursuant to which the Respondent was given a time limit until 23 May 2000 to answer the Claimant's request for production of further documents.
19. On 31 May 2000, after receipt of the Claimant's letter of 10 May 2000 requesting the production of further files, documents, minutes and other records in the possession of the Media Council, and of the Respondent's letter of 23 May 2000 requesting that the application be rejected, the Arbitral Tribunal issued Procedural Order No 4 rejecting the Claimant's request for production of further documents on the ground that it first needed to receive the Claimant's Memorial and the Respondent's Response.
20. On 30 June 2000, the Claimant filed his Memorial of Claimant. The following Witness Declarations were made in support of the Memorial:

- 29 June 2000 Declaration of Michel Delloye
  - 29 June 2000 Declaration of Fred T. Klinkhammer
  - 30 June 2000 Supplemental Declaration of Richard Baček
  - 30 June 2000 Declaration of Laura DeBruce
  - 30 June 2000 Declaration of Martin Radvan
  - 30 June 2000 Declaration of Jan Vávra
21. On 16 October 2000, the Respondent filed its Response. The following Witness Declarations were made in support of the Response:
- 13 October 2000 Statement of Doc. Ing. Pavel Mertlík CSc
  - 16 October 2000 Statement of Josef Josefík
  - 16 October 2000 Statement of RNDR. Josef Musil
  - 16 October 2000 Statement of PhDr. Helena Havíková
22. On 6 November 2000, the Arbitral Tribunal issued Procedural Order No 5 inviting the Respondent to respond by 10 November 2000 to the renewed request of the Claimant that the Respondent be ordered to produce documents and material identified in the Supplemental Statement in Support of the Claimant's Request for Documents of 30 June 2000.
23. On 13 November 2000, the Arbitral Tribunal issued Procedural Order No 6 inviting the Claimant to respond by 16 November 2000 to the letter of the Respondent of 10 November 2000.
24. On 17 November 2000, the Arbitral Tribunal issued Procedural Order No 7 pursuant to which it decided that the Claimant's request for production of general categories of documents was inappropriate, but that the Respondent was ordered to submit to the Claimant and to the Arbitral Tribunal copies of those documents which the Claimant had previously been able to inspect but had not been allowed to copy.
25. On 8 December 2000, the Claimant filed his Reply Memorial. The following Witness Declarations were made in support of this Reply Memorial:
- 14 November 2000 Declaration of Jacob Z. Schuster

- 5 December 2000 Supplemental Declaration of Jan Vávra
  - 5 December 2000 Statement of Ing. Jiří Brož
  - 5 December 2000 Declaration of OhDr Marína Landová
  - 7 December 2000 Declaration of Leonard M. Fertig
  - 7 December 2000 Declaration of Nicholas G. Trollope
  - 8 December 2000 Supplemental Declaration of Laura DeBruce
  - 8 December 2000 Supplemental Declaration of Fred T. Klinkhammer
  - 8 December Supplemental Declaration of Martin Radvan
  - 21 December 2000 Declaration of Ing. Miroslav Pýcha
26. On 31 January 2001, the Respondent filed its Sur-Reply. The following Witness Declarations were made in support of this Reply Memorial:
- 19 February 2001 Second Statement of Josef Josefík
  - 20 February 2001 Statement of Mgr. Milan Jakobec
27. On 19 February 2001, the Arbitral Tribunal issued Procedural Order No 8 in which the Respondent's Requests No 1 for an order for the Claimant to provide certain documents was denied; the Respondent's Request No 2, repeating the Request No 1 and asking in addition that Mr. Morgan-Jones be subpoenaed was denied; the Claimant's request that the Respondent be directed to cease its review of certain stolen and confidential documentation was denied; and the Respondent's Request No3 to submit pleadings, submission and evidence which had been submitted in other proceedings between other parties was denied.
28. On 20 February 2001, the Claimant filed the following additional Witness Declarations:
- 20 February 2001 Second Supplemental Declaration by Laura DeBruce
  - 20 February 2001 Supplemental Declaration of Jacob Z. Schuster
  - 20 February 2001 Declaration of Ira T. Wender
29. From 5 March to 13 March 2001, the Arbitral Tribunal held hearings in London. The Claimant presented the following witnesses:
- Mrs. Marina Landová

- Mr. Jan Vávra
- Mr. Martin Radvan
- Mrs. Laura DeBruce
- Mr. Leonard M. Fertig
- Mr. Fred T. Klinkhammer
- Mr. Michael Delloye

The Respondent presented the following witnesses:

- Mr. Josef Josefík
- Mr. Milan Jakobec
- Mrs. Helena Havlíková
- Mr. Josef Musil

Two witnesses, Mr. Jiří Brož and Mr. Josef Musil, did not attend the hearings. It was agreed by the Parties on 13 March 2001 that the Arbitral Tribunal would give these witnesses' recorded statements the weight the Tribunal believes to be appropriate (Transcript of 13 March 2001, p. 225-226).

On 13 March 2001, the Chairman declared that the proceedings were closed subject to the Parties' filing of their Written Closing Submissions by 30 March 2001 and their Replies by 6 April 2001, as well as the Parties' filing of their Statement of Costs and Expenses as agreed between the Parties (Transcript of 13 March 2001, p, 230-232).

30. On 30 March 2001, the Claimant filed a Summary of Summation, and the Respondent filed a Written Closing Submissions.
31. On 6 April 2001, the Claimant filed a Rebuttal to the Respondent's Written Closing Submission and the Respondent a Reply Written Closing Submissions.
32. On 17 April 2001, the Claimant filed a Statement of Costs, and the Respondent a Summary of the Costs.

33. On 19 April 2001 the Respondent filed an Amended Summary of Costs to include costs incurred between 1 April and 6 April 2001 and the advance on costs paid to the Tribunal. In this exchange, the Respondent also provided Comments on Costs of the Claimant.
34. On 18 June 2001, the Respondent, referring to an agreement of the Parties, asked for permission to submit pages from the transcript of the hearing held in Stockholm in the arbitration between CME and the Czech Republic (the Stockholm Hearing).
35. On 21 June 2001, the Claimant confirmed his agreement with respect to the submission of excerpts from the transcript of the Stockholm Hearing.
36. On 25 June 2001, the Arbitral Tribunal agreed that each Party may submit (i) by 3 July 2001 a maximum of 25 pages of excerpts from the Stockholm Hearing, together with a short brief not exceeding 10 pages, and (ii) by 10 July 2001 rebuttals not exceeding 5 pages.
37. On 3 July 2001, the Claimant filed Comments on Selected Excerpts from Testimony in Stockholm Proceedings and the Respondent a letter concerning submission of parts of the record from the Stockholm Hearing.
38. On 10 July 2001, both Parties filed their Replies to Submission of the other Party of 3 July 2001.
39. On 12 July 2001, the Respondent filed a larger excerpt of Mr. Klinkhammer's statements at the Stockholm hearing.
40. On 19 July 2001 the Claimant submitted, as proposed by the Respondent, a further excerpt from Mr. Klinkhammer's testimony.
41. The sole remaining dispute regarding discovery was with respect to specific communications (e-mails) from the Media Council, which the Respondent wanted the Claimant to provide along with the name of the person who had provided said communications to the Claimant (see Respondent's Request No 1 of 30 January 2001),

which request the Arbitral Tribunal had denied in Procedural Order No 8. On 1 March 2001, the Respondent declared that it accepted to participate in the arbitration under protest and reserved all its rights with respect to the denial of its request. At the 13 March 2001 hearing, the Chairman stated that the Respondent had not pointed out during the hearing that there was anything which would have impeded presentation of its defence but that due note was taken of the Respondent's reservation thereon (Transcript of hearing of 13 March 2001, p 232-233).

42. In the course of the proceedings, the Claimant withdrew his two first reliefs (see 1.1(a) and 1.1 (b) above), and maintained the relief for damages (see 1.1 (c)) above; Transcript of 5 March 2001, p. 57-58). The final relief sought by the Claimant is an award:

*(1) Declaring that Respondent has violated the following provisions of the Treaty:*

- a. The obligation of fair and equitable treatment of investments (Article II(2)(a));*
- b. The obligation to provide full protection and security to investments (Article II(2)(a));*
- c. The obligation to treat investments at least in conformity with principles of international law (Article II(2)(a));*
- d. The obligation not to impair investments by arbitrary and discriminatory measures (Article II(2)(b)); and*
- e. The obligation not to expropriate investments directly or indirectly through measures tantamount to expropriation (Article III);*

*(2) Declaring that Claimant is entitled to damages for the injury that he has suffered as a result of Respondent's violations of the Treaty, in an amount to be determined at a second phase of this arbitration; and*

*(3) Directing Respondent to pay the costs Claimant has incurred in these proceedings to date, including the costs for legal representation and assistance (Relief Sought By Claimant of 10 March 2001).*

43. The final relief sought by the Respondent is an award that:

- (1) *Mr. Lauder's claim be dismissed on grounds of lack of jurisdiction, namely (i) no "investment dispute" as contemplated by the Treaty exists; and/or (ii) Mr. Lauder's Notice was premature or otherwise formally defective.*
- (2) *And/or Mr. Lauder's claim be dismissed on grounds of lack of admissibility, namely it is an abuse of process*
- (3) *And/or Mr. Lauder's claim be dismissed on grounds that the Czech Republic did not violate the following provisions of the Treaty as alleged (or at all):-*
  - (a) *The obligation of fair and equitable treatment of investments (Article II(2)(a)).*
  - (b) *The obligation to provide full protection and security to investments (Article II(2)(a)).*
  - (c) *The obligation to treat investments at least in conformity with principles of international law (Article II(2) (a)).*
  - (d) *The obligation not to impair investments by arbitrary and discriminatory measures (Article II(2)(b)).*
  - (e) *The obligation not to impair investments directly or indirectly through measures tantamount to expropriation (Article III).*
- (4) *And/or Mr. Lauder's claim be dismissed and/or Mr. Lauder is not entitled to damages, on ground that the alleged injury to Mr. Lauder's investment was not the direct and foreseeable result of any violation of the Treaty.*
- (5) *And Mr. Lauder pay the costs of the proceedings and reimburse the reasonable legal and other cost of the Czech Republic (Relief Sought by the Czech Republic of 13 March 2001).*

### 3. Facts

#### 3.1 The 1992-1993 events

43. On 30 October 1991, the Czech and Slovak Federal Republic adopted the Act on Operating Radio and Television Broadcasting (hereinafter: the “Media Law”). The Media Law empowered the Federal Council for Radio and Television Broadcasting (hereinafter: “the Media Council”) to grant a license to broadcast radio and television programs (Exhibit R2).
44. Pursuant to the Act on the Czech Republic Council for Radio and Television Broadcasting of 21 February 1992, one of the duties of the Media Council is to supervise the observance of legal regulations governing radio and television broadcasting (Exhibit R6).
45. In 1992, the Media Council invited interested candidates to apply for a license for a new radio and television broadcasting on the third channel (hereinafter: “the License”) (Exhibit R53).
46. On 27 August 1992, CET 21, a Czech company originally owned by some individuals (hereinafter: “the Founders”), and whose General Director was Mr. Železný, a Czech citizen, filed an application for the License (Exhibit C63).
47. Prior to the filing of the application, CET 21 had held discussions with the CEDC, a German company over which Mr. Ronald S. Lauder (hereinafter: “Mr. Lauder” or “the Claimant”), an American citizen, had indirect voting control.
48. The original idea was that CEDC would participate in the broadcasting operation by acquiring stock of CET 21 (Exhibit C134). Such a participation would comply with the requirements of the Media Law, which expressly envisaged in Article 10.6 the applications for license *“from companies with foreign equity participation”* (Exhibit R2).



49. On 31 August 1992, CEDC and the Founders of CET 21 agreed on a draft document named "Terms of Agreement". This document provided that CEDC would invest a sum of at least USD 10,000,000 in the establishment of a commercial television station in Prague *"through an equity investment in CET21"* in the form of redeemable *"preferred stock or equivalent equal to 49% ownership of CET 21"* and of *"an equal amount of common stock"*. The Founders would be entitled to 2% of CET 21 each, i.e. 14% in total. The remaining 37% of CET 21 would be held by the Founders in reserve for additional investors (Exhibit C139).
50. On 28 September 1992, CET 21 prepared a document named "Project of an Independent Television Station". This document stated that CEDC *"is a direct participant in CET21's application for the license"* (Exhibit C9).
51. On 21 December 1992, the Media Council held preliminary hearings for the granting of the License. Messrs. Mark Palmer, President of CEDC, and Len Fertig, then consultant with CEDC, were present at the portion of the hearings on CET 21's application. The record of this portion of the hearings, drafted by the Media Council, speaks of *"extensive share reserved for foreign capital"* and *"direct capital share, not credit"*. It also states that *"they [CEDC] see themselves as a predominantly passive investor, we want a station independent of foreign influence and political influence"* (Exhibit R58).
52. On 5 January 1993, CEDC and the Founders of CET 21 signed a document named "Terms of Agreement". This document provided for the same participation of CEDC in CET 21 as the above mentioned draft agreement dated 31 August 1992, i.e. 49% of redeemable preferred stock and of common stock (Exhibit C61).
53. The same day, the Media Council held a hearing which was attended by Messrs. Palmer, Fertig and Železný. The participants addressed the issues of other possible partners besides CEDC in the CET 21 investments, mainly Česká spořitelna, a.s., the Czech Savings Bank (hereinafter: "CSB"), the scope of CEDC's investments in the project, and the programming (Exhibit C141).

54. On 22 January 1993, the Media Council held further preliminary hearings. The record of the portion of the hearings on CET 21 expressly referred to CEDC. It stated that *“the participation of foreign capital is expected”* and *“the combination of domestic and foreign capital is important, necessity of safeguard - diversification of the investments sources”* (Exhibit C64).
55. On 30 January 1993, the Media Council held a session on the issuance of the License. It was decided that CET 21 was awarded the License. The following statements were made by some members of the Media Council at this session: *“(…) it is very significant that this is a business which can not be financed only by credit”* (Mr. Brož); *“considers the Czech and foreign capital in CET 21 positive”* (Mr. Brož); *“positive in that there is a stabilisation factor, as far as foreign capital and its involvement is concerned”* (Mr. Pýcha) (Exhibit R54).
56. The same day, the Media Council issued a press release announcing that CET 21 had been awarded the License. The press release stated that *“A direct participant in the application is the international corporation CEDC (…)”* (Exhibit C11).
57. The same day, the Media Council sent a letter to CET 21 informing them of its decision on the award of the License. This document also referred to *“(…) a direct party to the application being the international corporation CEDC (…)”* (Exhibit R9).
58. The Media Council’s decision to award the License to CET 21 raised strong opposition, mainly from the political party ODS. The ODS blamed the Media Council for having hastily chosen a company, CET 21, whose representatives were bankrupt politicians and in which foreign capital prevailed (Exhibits R83, C144, and C145).
59. On 3 February 1993, CET 21 and CEDC submitted to the Media Council a document named *“Overall Structure of a New Czech Commercial Television Entity”*. This document stated that CET 21 and CEDC would jointly create a new Czech company, which would have the exclusive use of the License *“(…) as long as CET 21 and CEDC have such a license”*. The shareholders of the new company would be CET 21, CEDC and CSB, the last two of them providing the necessary funds (Exhibits C14 and C149).

60. At the oral request of Mr. Jakobec, director of the Programming and Monitoring Section of the Media Council, the above mentioned document of 3 February 1993, was significantly modified, mainly to reflect the fact that the License would be granted to CET 21 only, and not to CET 21 and CEDC jointly. The modified document was issued on 5 February 1993 (Exhibit C150; declaration of Mrs. Landová of 5 December 2000, p. 8).
61. The same day, the Media Council held a meeting to which representatives of CET 21 were invited. The latter submitted to the Media Council the modified version of the above mentioned document named "Overall Structure of a New Czech Commercial Television Entity" (Exhibit R55).
62. On 9 February 1993, CET 21 issued a document stating that its general assembly, which had met the previous day, approved the conditions of the Media Council for the legal confirmation of the License (Exhibit R78).
63. The same day, the Media Council rendered the decision to award the License to CET 21. This decision referred to CEDC as CET 21's "*contractual partner*" (Exhibits R10 and C16).
64. The same day, the Media Council issued the License for a period of 12 years, expiring on 30 January 2005. The Appendix to the License set forth 31 conditions (hereinafter: "the Conditions") that CET 21 had to observe. Condition 17 required among other matters that CET 21, CEDC and CSB submit a business agreement to the Media Council for approval within 90 days (Exhibit R5).
65. The same day, CET 21 accepted without reservation the License, including the Conditions (Exhibits R11 and R77).
66. The same day, CSB confirmed its intention to participate in the broadcasting company to be set up together with CET 21 and CEDC (Exhibit R81).
67. On 8 April 1993, Mr. Železný acquired a 16.66% participation in CET 21.

68. On 21 April 1993, after having held several sessions to discuss the draft business agreements between CET 21, CEDC and CSB, and after having had several contacts in this matter with the representatives of these companies, the Media Council issued a letter approving the last version of the business agreement (Exhibit C19).
69. On 4 May 1993, CET 21, CEDC and CSB signed the final version of the business agreement, named “Memorandum of Association and Investment Agreement” (hereinafter: “the MOA”). The MOA provided for the formation of the CNTS, a Czech company which would manage the television station. CEDC would contribute 75% of CNTS’s capital and obtain a 66% ownership interest (Article 1.4.3), CSB would contribute 25% of the capital and obtain a 22% ownership interest (Article 1.4.2). and CET 21 would contribute “*the right to use, benefit from, and maintain the License (...) on an unconditional, irrevocable and exclusive basis*” and obtain a 12% ownership interest (Article 1.4.1) (Exhibit R12).
70. On 12 May 1993, the Media Council rendered a decision amending and clarifying the License issued on 9 February 1993. The main amendment regarded Condition 17, which stated that the MOA was “*an integral part of the license terms*” (Exhibit C20).
71. On 8 July 1993, CNTS was incorporated in the Commercial Register administered by the District Court for Prague (Exhibit C89).
72. Mr. Železný was appointed General Director of the company.
73. CNTS then launched a television station named TV Nova, which soon became very successful.

### **3.2 The 1994-1997 events**

74. On 12 May 1994, the Czech Parliament’s Committee for Science, Education, Culture, Youth, and Physical Training PSP issued a statement that the Media Council had allowed television broadcasting by an unauthorized entity, i.e. CNTS.

75. In an undated opinion, the Media Council answered that CET 21 was the holder of the License, and CNTS was authorized by the former to perform all acts related to the development and operation of TV Nova. However, the License “*as such has not been contributed to CNTS and is separate from all other activities of CNTS*”. The Media Council added that, after having consulted “*with a number of leading legal experts, both Czech and foreign*”, this “*standard business procedure*” was discussed and approved, and did not violate any effective legal regulations (Exhibit C21).
76. On 4 July 1994, CNTS and CSB acquired 1.25% each of CET 21’s stock (Exhibit R107). As a result, the participation in CET 21 was as follows:
- Mr. Železný: 16,66%
  - The remaining Founders: 80.84%
  - CEDC: 1.25%
  - CSB: 1.25%.
77. On 28 July 1994, CEDC assigned all its capital interest in CNTS to CME Media Entreprises B.V. (hereinafter: “CME”), a Dutch company over which the Claimant also exercised control (Exhibit C128).
78. In the summer of 1994, the Czech Parliament replaced some members of the Media Council.
79. On 8 December 1995, the Czech Parliament amended the Media Law, effective 1 January 1996. Among the most relevant modification was the deletion of Article 12(3) of the original Media Law, which stated that “*In addition to conditions stated in paragraph 2, the decision to grant a license also includes conditions which the license-granting body will set for the broadcasting operator*”. The Media Law in Article 3 also contained a much narrower definition of the term “broadcaster” as the person to whom a license had been granted (see also the memorandum of Mrs. DeBruce of CME of 15 May 1996; Exhibit C111) (Exhibit R3).

80. On 2 January 1996, CET 21 applied to the Media Council for the cancellation of most of the Conditions set in the License (Exhibit R31).
81. On 18 January 1996, the Media Council asked the District Court for Prague 1, acting as authority for the Commercial Register, to re-examine CET 21's and CNTS's registrations and to submit a report thereon, being noted that such request had already been made on 2 February 1995, and was later repeated on 11 April 1996 (Exhibits R30, R32 and R33).
82. On 12 February 1996, the Media Council requested Mr. Bárta, at the State and Law Institute of the Academy of Science of the Czech Republic, to provide an expert opinion on CNTS's authority to operate television broadcasting (Exhibit C27).
83. On 19 February 1996, Mr. Bárta issued the requested expert opinion on the letterhead of the State and Law Institute of the Academy of Science of the Czech Republic. Based on the assumption that television broadcasting of TV Nova was operated by CNTS, the author came to the conclusion that administrative proceedings could be initiated to impose a fine for unauthorized broadcasting against CNTS. In addition, the Media Council could decide to cancel the License of CET 21 (Exhibit R14).
84. On 13 March 1996, a meeting was held between the Media Council and CET 21. Several issues were discussed, among them the relationship between CET 21 and CNTS regarding the operation of television broadcasting. The Media Council was concerned with the fact that CNTS was operating television broadcasting without being the holder - or the co-holder - of the License. Mr. Železný, acting on behalf of CET 21, argued that the current situation had been approved by the Media Council. At the Media Council's request, it was eventually agreed that a contract on the provision of performances and services between CET 21 and CNTS would be drafted and further discussed. It was also agreed that CET 21 would not require, in its application for cancellation of license conditions dated 2 January 1996, the cancellation of Condition 17. The application for cancellation of this specific condition would be the subject of further administrative proceedings (Exhibit C84).
85. On 21 March 1996, CET 21 applied for cancellation of Condition 17 (Exhibit R62).

86. At some time in April 1996 and as requested at the meeting of 13 March CET 21 and CNTS submitted to the Media Council two draft agreements setting forth their legal relationships (Exhibit R15).
87. On 2 May 1996, the State and Law Institute of the Academy of Science of the Czech Republic provided the Media Council with a legal opinion on the two above mentioned draft agreements between CET 21 and CNTS. It concluded that the situation of CET 21 was correctly resolved, the key point being that CET 21, and not CNTS, actually operated broadcasting on its own account (Exhibit R16).
88. On 15 May 1996, CME expressed its concern to Messrs. Železný and Fertig with respect to the contemplated changes to the MOA resulting from the above mentioned draft agreements. CME specifically referred to CET 21's envisaged power to withdraw CNTS's use of the License if CNTS allegedly breached the agreement (Exhibit C111).
89. On 23 May 1996, after two additional meetings between the Media Council and CET 21 (Exhibits R105 and C85), CNTS and CET 21 entered into a new agreement (hereinafter: "the May 1996 Agreement") setting forth their legal relationships. The Agreement stated in preamble that the MOA was not changed. In substance, it set forth that CET 21 was the holder of the License and the operator of television broadcasting, that the License was non-transferable, and was not the subject of a contribution from CET 21 to CNTS. CNTS's role was to arrange the television broadcasting (Exhibit R17).
90. On 4 June 1996, the Media Council informed CET 21 that the latter had breached the License by failing to timely announce changes in the registered capital, in the signing process, and in the company's registered office. It directed CET 21 and CNTS to change their registrations with the Commercial Registry, in particular to modify CNTS's business activity with respect to "*television broadcasting*" (Exhibit R95).
91. In June 1996, the Supreme State Attorney Office requested the Media Council to enable it to consult the files relating to the issue of the License to CET 21 and to CNTS's rights as the administrator of TV Nova. On this occasion, the Media Council

was informed that criminal investigations were pending with respect to CET 21's and CNTS's rights to administer TV Nova (Exhibit R89).

92. On 28 and 29 June 1996, the Media Council held a meeting during which it decided to cancel most of the Conditions to the License. The cancellation of Condition 17 was postponed in light of the court proceedings with respect to the registration in the Commercial Registry and the criminal investigation (Exhibit R56).
93. On 17 July 1996, CME purchased the 22% interest in CNTS held by CSB for a consideration in excess of USD 36,000,000 (declaration of Mrs. DeBruce of 30 June 2000, p. 5; declaration of Mr. Radvan of 30 June 2000, p. 5). As a result, CME held 88% of CNTS's stock, and CET 21 maintained its participation of 12% in CNTS.
94. On 22 July 1996, as its previous requests of 2 February 1995, 18 January and 11 April 1996, had been ignored, the Media Council asked the Regional Commercial Court in Prague to start proceedings on compliance of CET 21's and CNTS's registrations in the Commercial Register (Exhibit R36).
95. On 26 July 1996, the Media Council issued a decision regarding the cancellation of most of the Conditions to the License, as per its above mentioned meeting of 28 and 29 June (Exhibit R35).
96. The same day, the Media Council issued a decision to interrupt the administrative proceedings with respect to the envisaged cancellation of Condition 17 to the License because of the pending criminal investigation (Exhibit R34).
97. On 23 July 1996, the Media Council decided to commence administrative proceedings against CNTS for operating television broadcasting without authorization. CNTS was informed of said decision the same day (Exhibits R37 and R18).
98. On 1 August 1996, CME and Mr. Železný entered into a loan agreement pursuant to which the former would provide the latter with a loan of USD 4'700'000 for acquiring from the other individual shareholders 47% of CET 21's stock. The agreement provided for Mr. Železný to exercise all his voting rights as directed by CME until full



repayment of the loan (Exhibit R38). As a result, the participation in CET 21 was as follows:

- Mr. Železný: 60%
- The four remaining Founders: 37.5%
- CME: 1.25%
- CSB: 1.25%.

99. The Media Council was not informed of the change in CET 21's ownership.
100. On 13 August 1996, the Institute of the State and Law of the Academy of Sciences of the Czech Republic issued a legal opinion to CNTS pursuant to which the Media Council was obliged to meet CET 21's application to cancel the Conditions to the Licence (Exhibit C28).
101. On 21 August 1996, CET 21 requested the Media Council to cancel Condition 17 to the Licence (Exhibit R63).
102. On 4 October 1996, CET 21 and CNTS made proposals to the Media Council aimed at resolving the differences with respect to the legal relationships between the two companies. CET 21 and CNTS would enter into a new agreement providing that CET 21 is the operator of television broadcasting and is entirely responsible before the Media Council. Both companies would request that their registrations with the Commercial Register be modified. The Media Council, in turn, would continue the administrative proceedings on the cancellation of Condition 17 to the License, and would confirm that the arrangements between the two companies are in compliance with legal regulations. However, there was no mention of the administrative proceedings initiated by the Media Council against CNTS for unauthorized conducting of television broadcasting (Exhibit R19).
103. The same day, CNTS provided the Media Council with its position with respect to the initiation of the administrative proceedings against it. It denied the allegation of unauthorized television broadcasting (Exhibit C26).

104. The same day, CET 21 and CNTS signed an agreement (hereinafter: “the October 1996 Agreement”) specifying their legal relationships as set forth in the amended MOA. The October 1996 Agreement was similar to the May 1996 Agreement. The main difference was in the October 1996 Agreement’s statement that such agreement did not affect CET 21’s exclusive liability for the programming (Exhibit R21).
105. On 6 November 1996, the Media Council’s legal department issued an internal memorandum on the legal aspects of the October 1996 Agreement. It stated that said agreement “undoubtedly reacts to the commencement of administrative proceedings against CNTS for illegal broadcasting with the aim of making it seem that CNTS has not been committing such illegal acts”. The memorandum nevertheless expressed some doubts if the October 1996 Agreement fully achieved this purpose (Exhibit R96).
106. On 14 November 1996, CME issued a memorandum expressing its concern about the contemplated amendment of Article 1.4.1 of the MOA. CME’s main fear was that the draft amendment would allow CET 21 to chose another party to benefit from the License (Exhibit C112).
107. The same day, a meeting was held between CNTS’s shareholders, i.e. CME, CSB and CET 21. Article 1.4.1(a) of the MOA was amended and replaced as follows: “*the Company is granted the unconditional, irrevocable, and exclusive right to use and maintain the know-how and make it the subject of profit to the Company, in connection with the License, its maintenance, and protection*”. In addition CNTS was granted the right to acquire the License from CET 21 “*[i]n the case of change in the legal regulation and in the prevailing interpretation of the legal community*” (Exhibit C59).
108. On 20 November 1996, the Media Council expressed to the Police of the Czech Republic its opinion that none of the Media Council’s members could be criminally liable with respect to CNTS’s alleged illegal television broadcasting (Exhibit R66).
109. On 13 December 1996, the October 1996 Agreement was slightly amended (Exhibit R21).

110. On 17 December 1996, the Media Council decided to cancel Condition 17 to the Licence (Exhibits R57 and C30).
111. In December 1996, CME acquired from CET 21 a 5,2% participation in CNTS for a consideration of about USD 5,300,000. During the same period, the Founders of CET 21 transferred an additional 5,8% interest to Nova Consulting a.s. (hereinafter: “Nova Consulting”), a Czech company owned by Mr. Železný (declaration of Mrs. DeBruce of 30 June 2000, p. 5; declaration of Mr. Radvan of 30 June 2000, p. 5). As a result, the participation in CNTS was as follows:
- CME: 93,2%
  - Nova Consulting: 5,8%
  - The Founders: 1%.
112. On 29 January 1997, the Media Council, which had become aware of the loan agreement between CME and Mr. Železný, held a meeting with CET 21 for the purpose of obtaining information thereon from Mr. Železný (Exhibit R123).
113. On 5 February 1997, the October 1996 Agreement was amended to replace all previous agreements between CET 21 and CNTS with respect to their legal relationships (see Exhibit R21).
114. On 12 February 1997, CNTS’s registration in the Commercial Registry was modified as to delete, under the company’s business, the sentence “*operating television broadcasting under license no. 001/93*” (Exhibit R25).
115. On 21 April 1997, Mr. Radvan, counsel for CME, issued an affidavit stating that the loan agreement between CME and Mr. Železný had been terminated pursuant to an agreement entered into by the parties on 24 February 1997 (Exhibit C91).
116. On 15 May 1997, the criminal investigation against CNTS for alleged illegal operation of television broadcasting was suspended (Exhibit R25).
117. On 21 May 1997, CNTS and CET 21 entered into an agreement named “Contract on cooperation in ensuring service for television broadcasting,” together with a

supplement to this agreement (hereinafter: “the 1997 Agreement”), replacing all previous agreements between the parties. The 1997 Agreement confirmed that CET 21 was the holder of the License and the operator of television broadcasting and had the exclusive responsibility for programming. CNTS had the exclusive rights and obligations to arrange services for television broadcasting (Exhibits C29 and R22).

118. The same day, CME transferred all its interests in CNTS to CME Czech Republic B.V. (hereinafter: also “CME”), a Dutch company, for a consideration of USD 52,723,613 (Exhibit C130).

119. On 1 July 1997, the Czech Parliament passed the Act on the Czech Republic Council for Radio and Television Broadcasting, which represented a consolidated version of the statute (Exhibit R7).

120. In August 1997, CME purchased Nova Consulting, which owned a 5.8% participation in CNTS, from Mr. Železný for a consideration of USD 28,500,000. As a result, CME held 99% of CNTS’s stock and the founders of CET 21 were left with a 1% participation in CNTS (declaration of Mrs. DeBruce of 30 June 2000, p. 5; declaration of Mr. Radvan of 30 June 2000, p. 5).

121. On 16 September 1997, the Media Council decided to stop the administrative proceedings against CNTS for illegal operation of television broadcasting. The Media Council’s main reasoning was that CNTS had “*removed the inadequacies*” by modifying its registration with the Commercial Registry and by proceeding to “*amendments to the contractual relationship*” with CET 21 (Exhibit R25).

### **3.3 The 1998-2000 events**

122. On 31 January 1998, the Media Council issued its 1997 Report to the Czech Parliament. The report contained a long statement of the Media Council’s relationship with CNTS and CET 21. The Media Council explained that the legal relationship set up at the time the License was granted complied with the law as it then was in force

and the Conditions to the License, mainly Conditions 17 and 18 had been issued in accordance with the Law. When the Media Law was amended and provided for the cancellation of all the Conditions, the Media Council protested on the ground that it *"practically lost every possibility of checking on CNTS and its relationship to CET21. (...) The situation changed fundamentally when the amendment of the broadcasting law became effective. The licensing conditions that in principle guaranteed the legal character of the existing links between the license holder and the servicing firms were annulled and the Council had to solve the issue about how to attend, in the newly formed situation, to the sharp loosening up of the regulatory possibilities. The Council had an expertise made concerning the related issues and on the basis of it, initiated gradually negotiations with the affected Companies and opened up administrative proceedings in the subject of unauthorized broadcasting (...)"*. CET 21 and CNTS took the necessary steps to carry out the necessary adjustments, by changing their registrations in the Commercial Registry and the agreements setting forth their legal relationships. These actions led to the termination of the administrative proceedings for unauthorized television broadcasting. However, the Media Council's decision was not unanimous (5 in favor, 3 against and 1 abstention), and even reflected *"the big difference of opinions over this case"* (Exhibit C12).

123. On 21 June 1998, Mr. Radvan, counsel for CME, had lunch with Mrs. Hulová, Vice Chairman of the Media Council. According to Mr. Radvan, Mrs. Hulová said during lunch that CNTS had become *"the target for a group of disgruntled persons"* (Exhibit R102).
124. On 1 July 1998, the Media Council informed CET 21 that it was opening administrative proceedings against the latter to revoke the License on the ground that the television station was not providing information *"in an objective and balanced manner"* (Exhibit R124).
125. On 17 November 1998, the Media Council decided to stop the above mentioned administrative proceedings against CET 21, due to the fact that appropriate actions had been taken (Exhibit R125).

126. On 15 December 1998, CME and CET 21 amended the MOA so that all prior changes were incorporated (Exhibit C60).
127. On 24 February 1999, a Meeting of the Board of Representatives of CNTS took place during which the relationships between CET 21 and CME were discussed. The Minutes of the meeting indicate that Mr. Železný reported that at least one member of the Media Council had claimed that the actual situation contravened the law, and that *"the Council wants to change its original decision and to write a letter with the statement that the present relationship between CET 21 and CNTS is not correct"*. Mr. Železný asserted that in his view, which he claimed was confirmed by his lawyers, the 1997 Agreement was not exclusive and CET 21 could request any services then provided by CNTS from any other company. He informed CNTS that, based on this assertion, CET 21 would hire another advertising agency. He added that, *"in case he would be asked"*, he would resign from his function of executive as well as General Director of CNTS. He stated that *"his proposal was an ultimatum, which meant that CME could either accept or not"* (Exhibit C31).
128. On 2 March 1999, the Media Council held a meeting to which Mr. Železný was invited. According to the Minutes, CME's alleged financial difficulties were discussed. Mr. Železný, acting on behalf of CET 21, asked the Media Council to repeat some of its previous statements about exclusivity and the withdrawal of the License *"in relation to all steps within the logic of the development of the relationships between CET and the Council"*. It was then stated that *"[I]f Zelezny wants to affect the interests of CNTS, he will need to be supported by a formal or informal letter"* (Exhibit R97).
129. On 3 March 1999, Mr. Železný, on the letterhead of CET 21, sent a letter to the Media Council requesting that the latter issue an opinion defining the relationship between CET 21 and CNTS, to be used by CET 21 *"for discussions with our contractual partners"*. The opinion was to assert that *"[r]elations between the operator of broadcasting [CET 21] and its service organisations must be established on a nonexclusive basis"*. CET 21 *"should order services from service organizations at regular prices so as to respect rules of equal competition. (...) the licensed subject must have the ability to select relevant services anytime and anywhere at will"* (Exhibit C33).

130. On 15 March 1999, the Media Council issued a letter to CET 21 laying out, *inter alia*, the non-exclusive basis of the relations between the operator of broadcasting and the service organizations, the operator's responsibility for structuring and composing the program, and the allocation to the operator of the revenues from advertising (Exhibit C34).
131. In March 1999, CME set up an action plan to deal with the tense situation with CET 21 (Exhibit R132).
132. On 19 April 1999, Mr. Železný was dismissed from his position as General Director and Chief Executive of CNTS (Exhibit C68).
133. On 24 June 1999, CNTS requested the Media Council to give its position or to take measures aimed at resolving the current dispute between CNTS, CME and CET 21, resulting, among other reasons, from CET 21 entering into contracts with third parties, which "were *granted rights to trade benefits from the License*" (Exhibit C39).
134. On 28 June 1999, after CNTS had positioned two commercial spots into television broadcasting despite CET 21's disapproval, the Regional Commercial Court in Prague rendered a preliminary measure ordering CNTS to refrain from any interference with television broadcasting operated by CET 21 (Exhibit C13).
135. On 13 July 1999, in the context of the Media Council's opinion to the Permanent Media Commission of the Parliament of the Czech Republic, CNTS provided the Media Council with an analysis of its legal relationship with CET 21 (Exhibit C40).
136. On 26 July 1999, the Media Council sent a letter to CNTS calling it to stop its media campaign in connection with its dispute with CET 21. CNTS was also to inform the Media Council on the steps taken to minimize the risks described in its opinion to the above-mentioned Commission, mainly the risks of breaches of the Media Law, and on the actions taken to come to a final settlement of the dispute. Enclosed with this letter were Sections 7 and 8 of the Media Council's opinion to the Permanent Media Committee with respect to the dispute between CET 21 and CNTS (Exhibit C44).

137. On 2 August 1999, CNTS and CME sent a letter to the Permanent Media Committee of the House of Representatives of the Parliament of the Czech Republic in response to Sections 7 and 8 of the Media Council's opinion to the Permanent Media Committee, a copy of which had been provided to CNTS with the Media Council's letter of 26 July 1999 (Exhibit C41), raising the question that the acts of the Media Council might constitute violations of the Treaty.
138. On 5 August 1999, Mr. Rozehnal, counsel for CET 21, informed CNTS that CET 21 *"hereby withdraws from the Agreement on Cooperation in Provision of Services for Television Broadcasting, as amended, concluded on May 21, 1997"*. This decision was based on CNTS's failure on 4 August 1999 to submit to CET 21 within the usual deadline the Daily Log, which contains the daily programming, regarding the broadcasting for the following day (Exhibit C35).
139. On 6 August 1999, CNTS filed a request with the Media Council for the withdrawal of the License to CET 21 (Exhibit C42).
140. On 13 August 1999, CNTS informed the Media Council of its willingness to conduct negotiations with CET 21 to resolve their dispute, and requested that CNTS and CME be invited to the Media Council's ordinary session to be held on 17 August 1999 (Exhibit C43).
141. On 16 August 1999, CET 21 sent a letter to CME Ltd. detailing the business relationship between CET 21 and CNTS (Exhibit C13).
142. On 19 August 1999, Mr. Lauder initiated the present arbitration proceedings.
143. Numerous other court and arbitration proceedings opposing CNTS, CME, CET 21, Mr. Lauder and/or Mr. Železný were commenced in the context of the disputes between CNTS, CME and Mr. Lauder, on the one side, and CET 21 and Mr. Železný, on the other side. In particular:
- CME initiated parallel UNCITRAL arbitration proceedings against the Czech Republic on the basis of the bilateral investment treaty between the Netherlands and the Czech Republic;



- CME brought ICC arbitration proceedings against Mr. Železný (Exhibit R46);
- Numerous civil actions were commenced before the Czech courts, most of them opposing CNTS and CET 21 (Exhibit R49).

144. On 19 September 1999, the Media Council issued a written opinion for the Permanent Media Commission of the House of Deputies of the Parliament with respect to the dispute between CET 21 and CNTS. It was qualified as a “*typical commercial dispute*” related to the assessment of the real value of CME in the context of its merger with Scandinavian Broadcasting Services. Generally, this dispute could be identified as an issue of relations between the broadcaster, investors and service organizations, resulting from insufficiently transparent arrangements and leading to a dual broadcasting system. Similar problems were encountered with almost all nationwide broadcasters (Exhibit C68).
145. On 30 September 1999, the Standing Committee for Mass Media of the House of Representatives of the Czech Republic issued a resolution stating its serious dissatisfaction with the work of the Media Council in the context of the dispute between CNTS and CET 21 (Exhibit C108).
146. On 15 November 1999, the Media Council provided the Permanent Commission for the Media of the House of Representatives of the Czech Republic with a supplement to its position on the situation of TV Nova (Exhibit R126).
147. On 21 December 1999, the Media Council rendered a decision pursuant to which CME could be a party to the administrative proceedings regarding changes in the License at CET 21’s request (increase in the registered capital, changes in the participants and values of their capital contributions) (Exhibit C50).
148. As a result of the end of the relationships between CET 21 and CNTS, the latter had to take drastic measures to cut its spending, e.g. to lay off many employees (Exhibit C38).
149. On 4 May 2000, the Regional Commercial Court in Prague decided that CET 21 was obligated to procure all services for television broadcasting exclusively through

CNTS. However, the Court refused to decide that CET 21's withdrawal from the 1997 Agreement was invalid, nor to confirm the existence of CNTS's exclusive right on the basis of the 1997 Agreement (Exhibit C54).

150. On 1 June 2000, CET 21 filed an appeal against the above mentioned judgment with the High Court in Prague (Exhibit C55).
151. On 14 December 2000, the High Court in Prague granted CET 21's appeal and decided that CET 21 was not obligated to procure all services for television broadcasting exclusively through CNTS (Exhibit R134).
152. The case is now pending before the Czech Supreme Court.

#### **4. Jurisdiction and Admissibility**

##### **4.1 Introduction**

153. At various stages of the proceedings, the Respondent challenged the Arbitral Tribunal's jurisdiction on several grounds:
  - a) The Claimant has failed to prove that he owns or controls an investment within the Czech Republic;
  - b) The Claimants claim is not an investment dispute under the Treaty;
  - c) The Claimant already submitted the same dispute to the courts of the Czech Republic and to other arbitral tribunals (Article VI(3)(a) of the Treaty);
  - d) The Claimant may not concurrently pursue the same remedies in different fora;
  - e) The Claimant's claim constitutes an abuse of process;
  - f) The Claimant did not comply with the six-month waiting period (Article VI(2)(a) of the Treaty) (see Statement of Defence, p. 12-13; Response, p. 40-49; Sur-Reply, p. 14-17).
154. In the Written Closing Submissions of 30 March 2001, the Respondent stated that it did not dispute that:

- The Treaty is *prima facie* applicable to events occurring after 19 December 1992;
- Mr. Lauder is a national of the United States;
- CEDC's (and later CME's) shareholding in CNTS is an investment;
- The Claimant's allegations constitute an investment dispute for the purpose of the Treaty;
- For jurisdictional purpose only, the Claimant controlled the investment (see Written Closing Submissions, p. 4-5).

155. The Arbitral Tribunal therefore takes note that the Respondent has withdrawn the two grounds under a) and b) above. The Arbitral Tribunal will therefore only address the four remaining grounds under c), d), e) and f) above.

#### **4.2 The same dispute is submitted to state courts and to other arbitral tribunals**

156. The Respondent argues that Article VI(3)(a) of the Treaty precludes the Arbitral Tribunal from exercising jurisdiction on the ground that the same dispute was submitted to Czech courts and to another arbitral tribunal before the present proceedings were initiated. Those proceedings arise from the same circumstances and seek the same substantive remedy, so that the issue in dispute is the same in all cases. As a result, Mr. Lauder has removed the dispute from any arbitral tribunal under the Treaty (Response, p. 47-48).

157. The Claimant argues that the present proceeding is the only one in which he claims that the Czech Republic violated obligations under the Treaty. Article VI(3)(a) actually sets forth a limited form of the principle of *lis alibi pendens*, whose elements are not met (Reply Memorial, p. 50-62).

158. Article VI(3)(a) of the Treaty reads as follows:

*"(...) Once the national or company concerned has so consented, either party to the dispute may institute such proceeding provided:*

- (i) *the dispute has not been submitted by the national or the company for resolution in accordance with any applicable previously agreed dispute-settlement procedures; and*
- (ii) *the national of company concerned has not brought the dispute before the courts of justice or administrative tribunals or agencies of competent jurisdiction of the Party that is a party to the dispute. (...)"*

159. The Arbitral Tribunal considers that the word “dispute” in Article VI(3)(a) of the Treaty has the same meaning as the words “investment dispute” in Article VI(1), which reads as follows:

*“For the purposes of this Article, an investment dispute is defined as a dispute involving (a) the interpretation or application of an investment agreement between a Party and a national or company of the other Party; (b) the interpretation or application of any investment authorization granted by a Party’s foreign investment authority to such national or company; or (c) an alleged breach of any right conferred or created by this Treaty with respect to an investment”.*

160. It is undisputed that the Claimant’s allegations concern an investment dispute under Article VI(1)(c) of the Treaty, i.e. *“an alleged breach of any right conferred or created by this Treaty with respect to an investment”.*

161. The purpose of Article VI(3)(a) of the Treaty is to avoid a situation where the same investment dispute (“the dispute”) is brought by the same the claimant (“the national or the company”) against the same respondent (a Party to the Treaty) for resolution before different arbitral tribunals and/or different state courts of the Party to the Treaty that is also a party to the dispute.

162. The resolution of the investment dispute under the Treaty between Mr. Lauder and the Czech Republic was not brought before any other arbitral tribunal or Czech court before – or after - the present proceedings was initiated. All other arbitration or court proceedings referred to by the Respondent involve different parties, and deal with different disputes.

163. In particular, neither Mr. Lauder nor the Czech Republic is a party to any of the numerous proceedings before the Czech courts, which opposed or are opposing CNTS or the various CME entities, on the one side, and CET 2.1 or Mr. Železný, on the other side. The Respondent has not alleged - let alone shown - that any of these courts would decide the dispute on the basis of the Treaty.
164. The ICC arbitration proceeding was between CME and Mr. Železný, and dealt with the latter's alleged breach of the 11 August 1997 Share Purchase Agreement pursuant to which CME acquired a 5.8% participation in CNTS held by Nova Consulting, a.s., an entity owned by Mr. Železný.
165. The parallel UNCITRAL arbitration proceeding (hereinafter: "the Stockholm Proceedings") is between CME and the Czech Republic, and is based on the bilateral investment treaty between the Netherlands and the Czech Republic.
166. Therefore, the Arbitral Tribunal holds that Article VI(3)(a) of the Treaty does not preclude it from having jurisdiction in the present proceedings.

#### **4.3 The same remedies are sought in different fora**

167. The Respondent argues that, independently of Article VI(3)(a) of the Treaty, the Claimant cannot seek the same remedies in multiple parallel actions.
168. At first the Respondent asserted that if the Claimant chooses to pursue a contractual remedy in the local courts or in an arbitral tribunal, he should not be allowed to concurrently pursue a remedy under the Treaty. The Claimant could indeed not complain of any mistreatment of his investment by the State until that State's courts had finally disposed of the case. In addition, by initiating proceedings under the Treaty, the Claimant deprives the other party to the court proceedings of the opportunity to argue its case before the Treaty tribunal. Here, the existence of multiple proceedings creates a risk of incompatible decisions, a prospect of disorder "*that the principle of lis alibi pendens is designed to avert*" (Response, p. 46-47).

169. Later the Respondent indicated that it was not seeking “to rely upon technical doctrines of *lis alibi pendens* or *res judicata*”, but on a new “important issue of principle, not yet tested (...) in previous court or arbitral proceedings”. The multiplicity of proceedings involving, directly or indirectly, the State “amounts to an abuse of process”, in that no court or arbitral tribunal would be in a position to ensure that justice is done and that its authority is effectively upheld. The Respondent added that there is “an obvious risk of conflicting findings between the two Treaty tribunals” (Sur-Reply, p. 14-15).
170. The Claimant argues that no principles of *lis alibi pendens* are applicable here. Should such principles apply, it would not deprive the Arbitral Tribunal of jurisdiction, since the other court and arbitration proceedings involve different parties, different claims, and different causes of action. However, if CNTS could obtain any recovery from the Czech courts, this may reduce the amount of damage claimed in the present proceedings (Reply Memorial, p. 50-62).
171. The Arbitral Tribunal considers that the Respondent’s recourse to the principle of *lis alibi pendens* to be of no use, since all the other court and arbitration proceedings involve different parties and different causes of action (see 4.2 above). Therefore, no possibility exists that any other court or arbitral tribunal can render a decision similar to or inconsistent with the award which will be issued by this Arbitral Tribunal, i.e. that the Czech Republic breached or did not breach the Treaty, and is or is not liable for damages towards Mr. Lauder.
172. It is to be noted that the risk of conflicting findings is even less possible since the Claimant withdrew his two reliefs on the imposition of conditions to the License and the enforcement of such conditions, and only maintained its relief for damages. Assuming that the Arbitral Tribunal would decide that the Respondent breached the Treaty and that the Claimant is entitled to damages, such findings could not be contradicted by any other court or arbitral decision. The damages which could be granted in the parallel proceedings could only be based on the breach by CET 21 and/or Mr. Železný of their contractual obligations towards CNTS or any CME entity (decision by Czech courts or the ICC arbitral tribunal) or on the breach by the Czech Republic of its obligations towards CME pursuant to the Dutch/Czech bilateral

investment treaty (decision by the parallel UNICTRAL arbitral tribunal). The only risk, as argued by the Claimant, is that damages be concurrently granted by more than one court or arbitral tribunal, in which case the amount of damages granted by the second deciding court or arbitral tribunal could take this fact into consideration when assessing the final damage.

173. There might exist the possibility of contradictory findings of this Arbitral Tribunal and the one set up to examine the claims of CME against the Czech Republic under the Dutch-Czech Bilateral Investment treaty. Obviously, the claimants in the two proceedings are not identical. However, this Arbitral Tribunal understands that the claim of Mr. Lauder giving rise to the present proceeding was commenced before the claims of CME was raised and, especially, the Respondent itself did not agree to a *de facto* consolidation of the two proceedings by insisting on a different arbitral tribunal to hear CME's case.

174. Finally, there is no abuse of process in the multiplicity of proceedings initiated by Mr. Lauder and the entities he controls. Even assuming that the doctrine of abuse of process could find application here, the Arbitral Tribunal is the only forum with jurisdiction to hear Mr. Lauder's claims based on the Treaty. The existence of numerous parallel proceedings does in no way affect the Arbitral Tribunal's authority and effectiveness, and does not undermine the Parties' rights. On the contrary, the present proceedings are the only place where the Parties' rights under the Treaty can be protected.

175. Therefore, the Arbitral Tribunal holds that the seeking of the same remedies in a different fora does not preclude it from having jurisdiction in the present proceedings.

#### **4.4 The abuse of process**

176. Besides the already addressed issue of alleged abuse of process in connection with the fact that the same remedies are sought in different fora (see 4.3 above), the Respondent argues that the Claimant commits an abuse of process (i) in pursuing his

claim in the present proceedings under the Treaty whereas it is alleged in the parallel arbitration proceedings that CME has a better claim, and (ii) in not disclosing a *prima facie* case that the Respondent has breached the Treaty (Response, p. 48-49).

177. The Arbitral Tribunal does not see any abuse of process by the Claimant's pursuit of his claim in the present proceedings and by CME's pursuit of its claim in the parallel arbitration proceedings. As already stated (see 4.3 above), the claimants and the causes of action are not the same in the two cases. Only this Arbitral Tribunal can decide whether the Czech Republic breached the Treaty towards Mr. Lauder, and only the arbitral tribunal in the parallel Stockholm Proceedings can decide whether the Czech Republic breached the Dutch/Czech bilateral investment treaty in relation to CME. As a result, CME has neither a better - nor a worse - claim in the parallel arbitration proceedings than Mr. Lauder's claim in the present arbitration proceedings. It only has a different claim.
178. It should furthermore be noted that the Respondent refused to allow the constitution of identical arbitral tribunals to hear both treaty cases. If the same tribunal would have been appointed in both cases the procedure could have been co-ordinated with the corresponding reduction in work and time and of cost to the Parties. The possibility of conflicting decisions would also have been greatly reduced.
179. There is also no abuse of process by the Claimant's alleged non-disclosure of a *prima facie* case that the Respondent has breached the Treaty. No such obligation derives from the Treaty or from the UNCITRAL Arbitration Rules. Even less would the absence of such disclosure result in the Arbitral Tribunal lacking jurisdiction. Furthermore, as stated hereunder, the Claimant actually disclosed more than just a *prima facie* case against the Respondent.
180. Therefore, the Arbitral Tribunal holds that there is no abuse of process on the part of the Claimant which would preclude it from having jurisdiction in the present proceedings.



#### 4.5 The six-month waiting period

181. The Respondent argues that the Claimant did not comply with the waiting period set forth in Article VI(3)(a) of the Treaty pursuant to which arbitration can be initiated only six months after the dispute arose. For the purpose of this provision, the dispute arises when the State is advised that a dispute exists. Here, the Czech Republic was first advised of Mr. Lauder's complaints under the Treaty by CNTS's and CME's letter to the Media Committee of the Czech Parliament of 2 August 1999. Therefore, the Notice of Arbitration served only 17 days later is defective, and the Arbitral Tribunal lacks jurisdiction (Statement of Defence, p. 13; Written Closing Submissions, p. 5).
182. The Claimant argues that the Respondent has waived or abandoned this objection by not having advanced it between its Statement of Defence of 31 January 2000 and its Written Closing Submissions of 30 March 2001 (Rebuttal to The Respondent's Written Closing Submission, p. 4-5).
183. Article VI(3)(a) of the Treaty reads as follows:
- "At any time after six months from the date on which the dispute arose, the national or company concerned may choose to consent in writing to the submission of the dispute for settlement by conciliation or binding arbitration (...)"*
184. The Arbitral Tribunal considers that, as stated above with respect to the Respondent's other objection based on Article VI(3)(a) of the Treaty (see 4.2 above), the word "dispute" in the context of the six-month waiting period shall have the same meaning as the words "investment dispute" in Article VI(1), i.e. in this case "*an alleged breach of any right conferred or created by this Treaty with respect to an investment*".
185. However, the waiting period does not run from the date at which the alleged breach occurred, but from the date at which the State is advised that said breach has occurred. This results from the purpose of the waiting period, which is to allow the parties to enter into good-faith negotiations before initiating arbitration.

186. Here, the Respondent's alleged violations of the Claimant's rights under the Treaty occurred during the period from February 1993, when the License was granted, until 15 March 1999, when the Media Council sent a letter to CET 21 expressing its opinion on the requirements of television broadcasting (see Summary of Summation, p. 1-9). No evidence was, however, put forward that the Czech Republic was advised of said alleged Treaty violations before CNTS's and CME's 2 August 1999 letter to the Media Committee of the Czech Parliament. Only 17 days lie between said letter and the filing of the Notice of Arbitration on 19 August 1999.
187. However, the Arbitral Tribunal considers that this requirement of a six-month waiting period of Article VI(3)(a) of the Treaty is not a jurisdictional provision, i.e. a limit set to the authority of the Arbitral Tribunal to decide on the merits of the dispute, but a procedural rule that must be satisfied by the Claimant (Ethyl Corp. v. Canada, UNCITRAL June 24, 1998, 38 I.L.M. 708 (1999), paragraphs 74-88). As stated above, the purpose of this rule is to allow the parties to engage in good-faith negotiations before initiating arbitration.
188. Here, although there were only 17 days between CNTS's and CME's letter to the Media Committee of the Czech Parliament of 2 August 1999 and the filing of the Notice of Arbitration on 19 August 1999, there is no evidence that the Respondent would have accepted to enter into negotiation with Mr. Lauder or with any of the entities he controlled and which were involved in the dispute during the waiting period. On the contrary, the Media Council did not react at all to CNTS's letter of 13 August 1999 requesting that CNTS and CET 21 be invited to the Media Council's ordinary session to be held on 17 August 1999 in order to try to find a solution to their dispute (Exhibit C43).
189. Furthermore, the Respondent did not propose to engage in negotiations with the Claimant following the latter's statement in his Notice of Consent of 19 August 1999, filed together with the Notice of Arbitration, that he remained "*open to any good faith efforts by the Czech Republic to remedy this situation*". Had the Respondent been willing to engage in negotiations with the Claimant, in the spirit of Article VI(3)(a) of the Treaty, it would have had plenty of opportunities to do so during the six months after the 19 August 1999 Notice of Arbitration.

190. To insist that the arbitration proceedings cannot be commenced until 6 months after the 19 August 1999 Notice of Arbitration would, in the circumstances of this case, amount to an unnecessary, overly formalistic approach which would not serve to protect any legitimate interests of the Parties.
191. Therefore, the Arbitral Tribunal holds that the requirement of the six-month waiting period in Article VI(3)(a) of the Treaty does not preclude it from having jurisdiction in the present proceedings.

## **5. Findings**

### **5.1 Introduction**

192. The Claimant alleges that the Respondent, through the Media Council actions, has breached five independent obligations under the Treaty within three separate time periods.
193. The five obligations are the followings:
- a) the prohibition against arbitrary and discriminatory measures;
  - b) the obligation to provide fair and equitable treatment;
  - c) the obligation to provide full protection and security;
  - d) the obligation of treatment in accordance with general principles of international law;
  - e) the obligation not to expropriate unlawfully (Reply Memorial, p. 62; Summary of Summation, p. 13-14).
194. The three time periods are the followings:
- a) the 1993-1994 period;
  - b) the 1996-1997 period;
  - c) the 1998-1999 period (see Mr. Kiernan's oral opening submission, 5 March 2001, p. 18).

195. The Arbitral Tribunal feels it appropriate to address the issues in the following order:
- a) the obligation not to expropriate unlawfully with respect to all time periods;
  - b) the obligation of treatment in accordance with the general principles of international law with respect to all time periods;
  - c) all remaining alleged violations of the Treaty within the 1992-1993 time period;
  - d) all remaining alleged violations of the Treaty within the 1994-1997 and 1998-1999 time periods.

## 5.2 The obligation not to expropriate unlawfully (all time periods)

196. The Claimant alleges that the Media Council committed unlawful expropriation by instituting administrative proceedings against CNTS in 1996 and by other actions that forced CNTS to amend the MOA, as well as by the accumulation of actions and inactions over the period from 1996 through 1999 to which the Claimant never consented voluntarily or otherwise. The Claimant precisely referred to (i) the 1996 administrative and criminal proceedings, (ii) the indication by the Media Council in 1998 and thereafter that it did not accept an exclusive business relationship between CET 21 and CNTS, coupled with the Media Council's continued pressures to restructure said relationship, (iii) the Media Council's 15 March 1999 letter to CET 21, and (iv) the Media Council's refusal to take action against CET 21 when the latter severed all dealings with CNTS (Reply Memorial, p. 73-77).
197. The Claimant argues that the Treaty protects foreign investors from direct and indirect expropriation, i.e. not only from the taking of tangible property, but also from measures tantamount to expropriation. Expropriation includes interference by the State in the use of property or with the enjoyment of its benefits, even if legal title to the property is not affected. There is even heightened protection against deprivations resulting from regulatory actions when the acquired rights have obtained legal approval on which investors justifiably rely. The intent of the State to deprive the investor of property is not a necessary element of expropriation. There is no regulatory exception (Memorial, p. 50-52; Reply Memorial, p. 63-73).

198. The Respondent argues that, although the Treaty includes both direct and indirect forms of expropriation, interference with property rights has to be so complete as to amount to a taking of those rights. Detrimental effect on the economic value of property is not sufficient. Parties to the Treaty are not liable for economic injury that is the consequence of bona fide regulation within the accepted police powers of the State. The Respondent asserts that the lawful commencement of administrative proceedings against CNTS in 1996 in respect of a suspected violation of the law did not constitute expropriation. Furthermore, there is no evidence that the Media Council threatened to revoke the License. In addition, CNTS and/or Mr. Lauder made no mention of expropriation before the Notice of Arbitration was filed on 19 August 1999. Finally, Mr. Lauder failed to prove that the Czech Republic caused CET 21 to withdraw from its contractual relationship with CNTS, the acts of the latter's contractual counter-party not constituting expropriation by the State (Response, p. 50-55; Written Closing Submissions, p. 9-10).

199. Article III(1) of the Treaty provides:

*"Investments shall not be expropriated or nationalized either directly or indirectly through measures tantamount to expropriation or nationalization ("expropriation") except for a public purpose; in accordance with due process of law; in a nondiscriminatory manner; upon payment of prompt, adequate and effective compensation; and in accordance with the general principles or treatment provided for in Article II(2) ".*

200. The Bilateral Investment Treaties (hereinafter: "BITs") generally do not define the term of expropriation and nationalization, or any of the other terms denoting similar measures of forced dispossession ("dispossession", "taking", "deprivation", or "privation"). Furthermore, the practice shows that although the various terms may be used either alone or in combination, most often no distinctions have been attempted between the general concept of dispossession and the specific forms thereof. In general, expropriation means the coercive appropriation by the State of private property, usually by means of individual administrative measures. Nationalization involves large-scale takings on the basis of an executive or legislative act for the

purpose of transferring property or interests into the public domain. The concept of indirect (or “*de facto*”, or “*creeping*”) expropriation is not clearly defined. Indirect expropriation or nationalization is a measure that does not involve an overt taking, but that effectively neutralizes the enjoyment of the property. It is generally accepted that a wide variety of measures are susceptible to lead to indirect expropriation, and each case is therefore to be decided on the basis of its attending circumstances (Rudolf Dolzer & Margrete Stevens, Bilateral Investment Treaties, p. 98-100 (1995); Georgio Sacerdoti, Bilateral Treaties and Multilateral Instruments on Investment Protection, 379-382 (1997)). The European Court of Human Rights in *Mellacher and Others v. Austria* (1989 Eur.Ct.H.R. (ser. A, No. 169)), held that a “*formal*” expropriation is a measure aimed at a “*transfer of property*”, while a “*de facto*” expropriation occurs when a State deprives the owner of his “*right to use, let or sell (his) property*”.

201. The Arbitral Tribunal holds that the Respondent did not take any measure of, or tantamount to, expropriation of the Claimant’s property rights within any of the time periods, since there was no direct or indirect interference by the Czech Republic in the use of Mr. Lauder’s property or with the enjoyment of its benefits.
  
202. The Claimant has indeed not brought sufficient evidence that any measure or action taken by the Czech Republic would have had the effect of transferring his property or of depriving him of his rights to use his property or even of interfering with his property rights. All property rights of the Claimant were actually fully maintained until the contractual relationship between CET 21 and CNTS was terminated by the former. It is at that time, and at that time only, that Mr. Lauder’s property rights, i.e. the use of the benefits of the License by CNTS, were affected. Up to that time, CNTS had been in a position to fully enjoy the economic benefits of the License granted to CET 21, even if the nature of the legal relationships between the two companies had changed over the time. Because the Claimant has not alleged – and even less proved – that the action which seriously interfered with the Claimants property rights, i.e. CET 21’s decision to withdraw from the 1997 Agreement on 5 August 1999, was one of the State, and not one of a private entity completely independent of the State, there can be no expropriation under the Treaty.

203. In addition, even assuming that the actions taken by the Media Council in the period from 1996 through 1999 had the effect of depriving the Claimant of his property rights, such actions would not amount to an appropriation - or the equivalent - by the State, since it did not benefit the Czech Republic or any person or entity related thereto, and was not taken for any public purpose. It only benefited CET 21, an independent private entity owned by private individuals.
204. Finally, the Claimant, directly or through CNTS or any other entity controlled by himself, did not complain of *any* action taken by the Media Council and which allegedly constituted an expropriation, or a measure tantamount to expropriation, before CME's and CNTS's letter to the Czech Parliament of 2 August 1999, after Mr. Železný had been dismissed of his functions with CNTS and at a time of great tensions between CNTS and CET 21. This failure by the Claimant to invoke the Treaty or to advance any violation of the obligations of the Czech Republic when the now disputed actions were taken, tends to show that no violations of his property rights were committed at that time.

### **5.3 The obligation of treatment in accordance with general principles of international law (all time periods)**

205. The Claimant alleges that the Media Council violated its obligations arising under international law when it withdrew its prior approval of CNTS's activities, and by committing "*the same wrongs that establish its breach of other individual protections under the Treaty*" (Reply Memorial, p. 89; Mr. Kiernan's oral closing submissions, p. 177-178).
206. The Claimant argues that the general principles of international law include, among others, a variant of *pacta sunt servanda*, the protection of acquired rights, the treatment of foreign investment in good faith, the principle of estoppel, and recognized standards relating to the protection of property. These general standards refer exclusively to international law, to the exclusion of domestic law (Reply Memorial, p. 88-89; Mr. Kiernan's oral closing submissions, p. 177-178).

207. The Respondent argues that the Claimant has not identified any obligation of treatment in accordance with general principles of international law which is distinct to the other obligations (Written Closing Submissions, p. 14).
208. Article II(2)(a) of the Treaty provides that "*[i]nvestment (...) shall in no case be accorded treatment less than that which conforms to principles of international law*".
209. The Arbitral Tribunal considers that the Claimant has not identified any specific obligation of international law which would provide the foreign investor with a broader protection than the other four Treaty obligations on which he otherwise relies. In particular, the Claimant does not allege that either the variant of the principle *pacta sunt servanda*, which would create under certain circumstances a *sui generis* investor-state relationship, or the general obligation of good faith goes further in the protection of the foreign investor than the Respondent's obligation to provide fair and equitable treatment (see below 5.5.3) or the Respondent's obligation to provide full protection and security (see below 5.5.4). On the contrary, by stating that the Respondent's alleged "*breach of the obligation to adhere to general international law arises from the same wrongs that establish its breach of other individual protections under the Treaty*", the Claimant himself recognizes that there is no action or inaction by the Czech Republic which could amount exclusively to a violation of the obligation of treatment in accordance with general principles of international law, without also constituting a violation of other obligations under the Treaty.
210. Therefore, the Arbitral Tribunal will refer to the developments made in the other sections of the present award.

## **5.4 The 1992-1993 time period**

### **5.4.1 Introduction**

211. Because the Claimant, in his more general statement about the "*totality of other actions and inactions by the Media Council*", expressly refers to the rights provided to



CNTS, the Arbitral Tribunal considers that his allegation of unfair and inequitable treatment does not cover the events leading to the creation of CNTS and the replacement of the Media Council, i.e. the first time period in 1993-1994, but includes only the second and third time periods in 1996-1997 and 1998-1999.

212. With respect to the separate obligation to provide fair and equitable treatment, the Claimant alleged that the Respondent breached said obligation through the Media Council's reversal of critical prior approvals, i.e. when the Media Council directed in 1996 the removal in the MOA of the provision giving CNTS the exclusive right to use, benefit from and maintain the License, and through its hostile conduct towards CNTS, i.e. the totality of other actions and inactions by the Media Council that undermined the rights which had been provided to CNTS (Reply Memorial, p. 77-83; Summary of Summation, p. 13).
213. The only identified alleged violation of specific Treaty obligations within the 1992-1994 time period concerns the prohibition against arbitrary and discriminatory measures. Such measures occurred when the Media Council insisted on CEDC not becoming a direct shareholder of CET 21 in 1993 (Reply Memorial, p. 87; Mr. Kiernan's oral closing submissions, 12 March 2001, p. 175).

#### **5.4.2 The prohibition against arbitrary and discriminatory measures**

214. The Claimant alleges that the Respondent took arbitrary and discriminatory measures when the Media Council insisted in 1993 on CEDC not becoming a direct shareholder of CET 21. The Claimant argues that the prohibition against arbitrary and discriminatory measures must be inferred from the circumstances. It is not necessary that a measure be founded on a violation of domestic law for such a measure to be arbitrary and/or discriminatory. Arbitrary action may actually include regulatory actions without good-faith governmental purpose (Memorial, p. 54; Reply Memorial, p. 85-88; Mr. Kiernan's closing submissions, Transcript of 12 March 2001, p. 175-176; Summary of Summation, p. 14).

215. The Respondent argues that Article II(2)(b) of the Treaty, in comparison with Article II(1), requires the Claimant to prove that the Respondent's conduct was both arbitrary and discriminatory. Only an illegal act under domestic law can be - but is not necessarily - arbitrary, and the Claimant did not even prove that the Czech Republic behaved unlawfully. For an act to constitute discrimination, it must first result in actual injury and, second, it must be done with the intention to harm the aggrieved party. In particular, there is no discrimination in the requirement that foreign investors invest in the State through the medium of a locally-incorporated company, since it is only a regulation on how foreign investment is to be organized. Here, the Media Council awarded the License on the precise terms of CET 21's application, pursuant to which CEDC would become a minor shareholder in CET 21. The CNTS structure was proposed by CEDC (Response, p. 56-57; Written Closing Submissions, p. 12-13).

216. Article II(2)(b) of the Treaty provides:

*“Neither Party shall in any way impair by arbitrary and discriminatory measures the management, operation, maintenance, use, enjoyment, acquisition, expansion, or disposal of investment. For the purpose of dispute resolution under Articles VI and VII, a measure may be arbitrary and discriminatory notwithstanding the fact that a party has had or has exercised the opportunity to review such measure in the courts or administrative tribunals of a Party”.*

217. Article II(1) of the Treaty reads as follows:

*“Each Party shall permit and treat investment, and activities associated therewith, on a nondiscriminatory basis, subject to the right of each Party to make or maintain exceptions falling within one of the sectors or matters listed in the Annex to this Treaty. (...).”*

218. Clause 3 of the Annex to the Treaty provides:

*“Consistent with Article II, paragraph 1, the Czech and Slovak Federal Republic reserves the right to make or maintain limited exceptions to national treatment in the sectors or matters it has indicated below:*

*ownership of real property; and insurance”.*

219. The Arbitral Tribunal considers that a violation of Article II(2)(b) of the Treaty requires both an arbitrary and a discriminatory measure by the State. It first results from the plain wording of the provision, which uses the word “and” instead of the word “or”. It then results from the existence of Article II(1) of the Treaty, which sets forth the prohibition of any discriminatory treatment of investment, except in the sectors or matters expressly listed in the Annex to the Treaty. If Article II(2)(b) prohibited only arbitrary *or* discriminatory measures, it would be partially redundant to the prohibition of discriminatory measure set forth in Article II(1).
220. A discriminatory measure is defined in Article II(1) and the Clause 3 of the Annex to the Treaty. It is one that fails to provide the foreign investment with treatment at least as favorable as the treatment of domestic investment (“*national treatment*”: see Annex 3 to the Treaty). For a measure to be discriminatory, it does not need to violate domestic law, since domestic law can contain a provision that is discriminatory towards foreign investment, or can lack a provision prohibiting the discrimination of foreign investment. It is only in the sectors or matters for which it has reserved the right to make or maintain an exception in the Annex to the Treaty that the State may treat foreign investment less favorably than domestic investment. Due to the fact that the Czech Republic has not made any reserve in the matter of broadcasting television, contrary to the reserve made by the United States of America in the matter of “*ownership and operation of broadcast or common carrier radio and television stations*” (Clause 1 of the Annex to the Treaty; Exhibits R1 and C1), the Czech Republic is bound to provide U.S. investment in the field of broadcasting with a treatment at least as favorable as Czech investment.
221. The Treaty does not define an arbitrary measure. According to Black’s Law Dictionary, arbitrary means “*depending on individual discretion; (...) founded on prejudice or preference rather than on reason or fact*” (Black’s Law Dictionary 100 (7th ed. 1999)).

#### **5.4.2.1 CEDC not becoming a shareholder in CET 21**

222. The Arbitral Tribunal holds that the Czech Republic took a discriminatory and arbitrary measure against Mr. Lauder in violation of Article II(2)(b) of the Treaty when the Media Council, after having accepted the idea of a direct investment in CET 21 by CEDC , a company which Mr. Lauder controlled, eventually did not allow such investment, and required that a third company, CNTS, be created.
223. There is clear evidence that CEDC intended to acquire a direct participation in CET 21, should the latter be awarded the License. The draft “Terms of Agreement” prepared by CEDC and CET 21 in August 1992 (Exhibit C139) as well as the final version of this document signed by both companies in January 1993 (Exhibit C61) expressly referred to *“an equity investment in CET 21”* from CEDC. The document named “Project of an Independent Television Station” drafted by CET 21 in September 1992 stated that CEDC is *“a direct participant in CET 21's application for the license”* (Exhibit C9).
224. There is also clear evidence that the Media Council was aware of such intention. The Minutes of the preliminary hearings held on 21 December 1992 by the Media Council with the various bidders for TV Nova stated, as regards CET 21, that *“extensive share [is] reserved for foreign capital; (...) direct capital share, not credit”*(Exhibit R58). The Minutes of the further preliminary hearings held on 22 January 1993 provided that *“[t]he participation of foreign capital is expected”* and that *“the combination of domestic and foreign capital is important, necessity of safeguard - diversification of the investments sources”* (Exhibit C64). The Minutes of the session of the Media Council of 30 January 1993, where the decision to award the License to CET 21 was made, stated some member’s of the Media Council’s words that *“(...) it is very significant that this is a business which can not be financed only by credit”, “the Czech and foreign capital in CET 21 [is] positive”, and it is “positive in that there is a stabilisation factor, as far as foreign capital and its involvement is concerned”* (statements of Messrs. Brož and Pýcha; Exhibit R54).

225. The above mentioned statements also clearly indicate that the Media Council had accepted, and even was satisfied with, the fact that CEDC would be a shareholder of CET 21. As a result, this Tribunal Arbitral considers that there can be no doubt that when the Media Council informed CET 21 in its letter of 30 January 1993 (Exhibit R9) and the public in its press release of the same day (Exhibit C11) that the License had been granted to CET 21 and that "[a] direct participant in the application is the international corporation CEDC", the Media Council agreed and approved meant that CEDC would be a shareholder of CET 21.
226. Even assuming that the Media Council thought of another form of participation of CEDC at the time it made the decision to award the License to CET 21, CEDC could reasonably believe that its project of becoming a shareholder in CET 21 had been properly understood and accepted by the Media Council. At no time until the decision was made did the Media Council express any misunderstanding or dissatisfaction with such project.
227. The various statements of the members and staff of the Media Council in the beginning of 1993 submitted in the present proceedings, the immediate rising of strong political opposition to the Media Council's choice in favor of CET 21, and the overall circumstances of the case show that the Media Council realized immediately after the decision on the award of the License had been made that it had to bring some modifications to the project of CET 21 and CEDC. In particular, the Media Council could no longer accept CEDC as a shareholder of CET 21, as it became clear from the political reactions to the recent decision to award the License to CET 21 that even stronger political opposition would arise, opening the way for an attack on the entire selection process. The Media Council therefore gave CET 21 and CEDC the task of proposing an acceptable structure (declaration of Mrs. Landová of 5 December 2000, p. 6-7; declaration of Mr. Brož of 5 December 2000, p. 2-3; declaration of Mr. Pýcha of 21 December 2000, p. 1-3; Exhibits R83, C144 and C145).
228. As a result, CET 21 and CEDC prepared a document named "Overall Structure of a New Czech Commercial Television Entity" pursuant to which CET 21 and CEDC would jointly create a new Czech company which would have the exclusive use of the License. The shareholders of the new company would be CET 21, CEDC and CSB,

the last two of them providing the necessary funds. There was no mention anymore of any direct participation of CEDC in CET 21 (Exhibits C14 and C149). After some modifications were made at the request of the director of the Programming and Monitoring Section of the Media Council, the final version of the document was submitted to the Media Council on February 5, 1993 (Exhibits C150 and R55). On the basis of this document, the Media Council rendered its decision to award the License to CET 21, which stated that CEDC was a "*contractual partner*" of CET 21 (Exhibits R10 and C16).

229. The 1997 Report of the Media Council to the Czech Parliament actually provides a good summary of the actions and their motivations which took place between 30 January and 9 February 1993: "*When granting the license to the Company CET 21, for fear that a majority share of foreign capital in the license holder's Company might impact the independence of full-format broadcasts, the Council assumed a configuration that separates the investor from the license holder himself. That is how an agreement came into existence (upon a series of remarks from the Council) by which the Company CNTS was established the majority owner of which is CEDC/CME*".
230. The Arbitral Tribunal holds that the Media Council decision to move from a direct participation by CEDC, a German company controlled by Mr. Lauder, an American citizen, to a contractual relationship providing for the creation of a third company amounted to an arbitrary and discriminatory measure.
231. The measure was discriminatory because it provided the foreign investment with a treatment less favorable than domestic investment. It indeed results from the above mentioned circumstances that the Media Council changed its mind because of its fear that the strong and rising political opposition to the granting of the License to an entity with significant foreign capital could lead to an attack on the entire selection process. It is probable that if CEDC had been a Czech investor, there would have been no political outcry, and the original plan of becoming a shareholder in CET 21 could have been carried out.

232. The measure was arbitrary because it was not founded on reason or fact, nor on the law which expressly accepted "*applications from companies with foreign equity participation*" (Exhibit R2), but on mere fear reflecting national preference.
233. However, there is no single piece of evidence that CEDC opposed, or protested against, or even less fought against, this measure. On the contrary, it results from the circumstances that CEDC immediately proposed a new structure in which it would become a contractual partner of, rather than a shareholder in, CET 21. CEDC and its successor CME actually accepted the measure without reservation for the next six years, as long as it was able to conduct the joint venture profitably. It is only in the context of the present proceedings, after CET 21 had terminated the contractual relationship with CNTS, which was by that time fully controlled by CME, that CME complained about the measure. Even the Notice of Arbitration did not refer to the measure, which was first mentioned in the Memorial (p. 1-2).
234. The question therefore arises if the breach by the Respondent of its Treaty obligations gives rise to any damages to be paid to the Claimant. It is most probable that if in 1993 Mr. Lauder's investment in the Czech television could have been made directly in CET 21, the Licence holder, the possible breach of any exclusive agreements in 1999 could not have occurred in the way it did. Even if the breach therefore constitutes one of several "*sine qua non*" acts, this alone is not sufficient. In order to come to a finding of a compensable damage it is also necessary that there existed no intervening cause for the damage. In our case the Claimant therefore has to show that the last, direct act, the immediate cause, namely the termination by CET 21 on 5 August 1999 (and the preceding conclusions by CET 21 of service agreements with other service providers) did not become a superseding cause and thereby the proximate cause. In other words, the Claimant has to show that the acts of CET 21 were not so unexpected and so substantial as to have to be held to have superseded the initial cause and therefore become the main cause of the ultimate harm. This the Claimant has not shown. First of all, the Claimant itself in 1993 did not protest against the change imposed by the Media Council. Furthermore, it was completely impossible at that time to envisage that the Claimant itself would actively participate in all those later steps which allowed Mr. Železný to disengage himself from CNTS and to acquire control of CET 21 in order to be able to pursue his own interests without having to rely on CME. These acts

of CET 21, and through it by Mr. Železný, are the real cause for the damage which apparently has been inflicted to the Claimant.

235. The arbitrary and discriminatory breach by the Respondent of its Treaty obligations constituted a violation of the Treaty. The alleged harm was, however, caused in 1999 by the acts of CET 21, controlled by Mr. Železný. The 1993 breach of the Treaty was too remote to qualify as a relevant cause for the harm caused. A finding on damages due to the Claimant by the Respondent would therefore not be appropriate.

## **5.5 The 1994-1997 and 1998-1999 time periods**

### **5.5.1 Introduction**

236. Within the 1994-1997 and 1998-1999 time periods, the Claimant alleges that the Respondent violated all five obligations under the Treaty (see above 5.1). As the Arbitral Tribunal has already addressed the alleged violations of the obligation not to expropriate unlawfully (see above 5.2) and of the obligation of treatment in accordance with general principles of international law (see above 5.3) with respect to all time periods, it will address the three other alleged violations in the context of the events which occurred in the period from 1994 through 1999, i.e.:

- a) the prohibition against arbitrary and discriminatory measures;
- b) the obligation to provide fair and equitable treatment;
- c) the obligation to provide full protection and security (Reply Memorial, p. 62-89; Summary of Summation, p. 13-14).

### **5.5.2 The prohibition against arbitrary and discriminatory measures**

237. The Claimant alleges that the Respondent took arbitrary and discriminatory measures (i) when the Czech Parliament replaced the Media Council in 1994, (ii) when the Media Council initiated in 1996 the administrative proceedings against CNTS for



unauthorized television broadcasting, (iii) when the Media Council stated in its 1996 and 1998 reports that the target of its investigations was CNTS, and that the others did not receive any attention: (iv) through ongoing efforts to eliminate the original structure between CET 21 and CNTS in favor of non-exclusive contractual arrangements; (v) by statements of a Media Council's member, Mr. Štěpánek, that CNTS was promoting flight of Czech capital abroad; and (vi) when Mr. Josefík admitted that it did not even occur to him to consider the interest of foreign investor after Mr. Železný's request of March 2, 1999 (Reply Memorial, p. 87-88; Mr. Kiernan's closing submissions, Transcript of 12 March 2001, p. 175-176).

238. The Respondent mainly alleges that the Media Council did not discriminate in the treatment of the Claimant's investment. The administrative proceedings were initiated because there were objective grounds for suspecting a breach of the law, especially when similar proceedings were commenced against others in a similar situation. Furthermore that the existence of anti-American feelings within the Czech Republic was the result of a democratic freedom of expression (Response, p. 56-57; Written Closing Submissions, p. 12-14).
239. As regards the content of the prohibition against discriminatory and arbitrary measures, the Arbitral Tribunal refers to the developments made in the context of the 1992-1993 time period (see above 5.4.2).

#### **5.5.2.1 The replacement of the Media Council**

240. The Arbitral Tribunal holds that the replacement of the Media Council in 1994 did not amount to an arbitrary and discriminatory measure of the Czech Republic.
241. There is indeed no evidence that this replacement was in any direct relation to the involvement of Mr. Lauder in TV Nova, nor that it constituted in any manner a discriminatory and arbitrary measure vis-a-vis the Claimant and his investment in CNTS.

242. Furthermore, any country is entitled to organize its own organs as it pleases as long as this does not result in a discriminatory and arbitrary measure against a foreign investor, protected by the investment Treaty.
243. The replacement of the Media Council in 1994 as such did not cause any harm to Mr. Lauder's investment in the Czech Republic.

#### **5.5.2.2 The Media Council's 1996 and 1998 reports, and Messrs. Štěpánek 's and Josefík's statements**

244. The Arbitral Tribunal holds that the Claimant's allegations of discriminatory and arbitrary measures with respect to the Media Council statements in its 1996 and 1998 reports that the target of its efforts was CNTS; to Mr. Štěpánek's statements that CNTS was promoting flight of Czech capital abroad; and to Mr. Josefík admission that it did not even occur to him to consider the interest of foreign investor after Mr. Železný's request of 2 March 1999, are clearly unfounded for similar reasons. Therefore, the Arbitral Tribunal will examine these three allegations together.
245. First, the Media Council alleged statement in its 1996 and 1998 reports that its target effort was CNTS does not constitute a "measure" under the Treaty. Such a statement did indeed not have any direct effect on the Claimant's investment, and it is not alleged that it had such an effect. In the light most favorable to the Claimant, it may only have been evidence of the Media Council's intent to treat CNTS as a target in the context of a measure contemporaneously taken by the Media Council. Therefore, such a statement in itself cannot amount to an arbitrary and discriminatory measure.
246. Then, the alleged statements of Mr. Štěpánek that CNTS was promoting flight of Czech capital abroad does not constitute a "measure" under the Treaty either. Furthermore, a statement by a member of the Media Council is not attributable as such to the Media Council, and to the Czech Republic. On the contrary, it must be considered as a personal opinion of said member, which may or may not reflect the Media Council's opinion on the subject. Therefore, it cannot amount to an arbitrary

and discriminatory measure. It apparently also did not occur to the Claimant that this alleged measure would constitute a violation of the Treaty at the time the statement was made, as this allegation of a violation of the Treaty was raised for the first time in the course of the present arbitration proceedings.

247. Finally, the alleged admission by Mr. Josefík that it did not even occur to him to consider the interest of foreign investor after Mr. Železný's request of 2 March 1999 is also a personal statement, and, as such, does not constitute a "measure" under the Treaty. In addition, it is not attributable to the Czech Republic. Therefore, it cannot amount to an arbitrary and discriminatory measure. Apparently it did also not occur to the Claimant until the August 2, 1999 letter of CNTS and CME (Exhibit C41)!

### **5.5.2.3 The initiation of the administrative proceedings**

248. The Arbitral Tribunal holds that the initiation in 1996 of the administrative proceedings against CNTS for unauthorized television broadcasting did not constitute an arbitrary and discriminatory measure of the Czech Republic.

249. There is indeed sufficient evidence that the Media Council thought – or could think – that CNTS was violating the Media Law. The Media Council had indeed received complaints from the public on the content of the programs of TV Nova. As regulatory body for radio and television broadcasting, it was responsible, among other duties, for ensuring the observance of the Media Law (Article 16(2)).

250. Article 3(l) of the Media Law, as amended with effect on 1 January 1996, set forth that a broadcasting operator was one who had "*acquired authorization to broadcasting on the basis of law (a "broadcaster by law") or being granted a license under this Act (a "licensed broadcaster") or by registration under this Act (a "registered broadcaster")*". According to Article 2(1)(a), broadcasting "*means dissemination of program services or pictures and sound information by transmitters, cable systems, satellites and other means intended to be received by the public*" (Exhibit R3).

251. Here, the License had been granted to CET 21, and not to CNTS (Exhibits R10 and C16). CNTS actually did not enter into any of the three categories of broadcaster under Article 3(1) of the Media Law (broadcaster by law, licensed broadcaster and registered broadcaster).
252. Several objective facts existed which could cast the doubt on whether CET 21 or CNTS was actually operating the broadcasting of TV Nova. For instance, CNTS's entry into the Commercial Registry stated that its business activity was "*operating television broadcasting on the basis of the license no. 001/1003*" (Exhibits R10 and C16). CNTS had also directly entered into agreements with other companies for the dissemination of broadcasting. In addition, Mr. Železný held at that time the position equivalent to that of a Chief Operating Officer of both companies. Finally, most activities in connection with TV Nova were performed from CNTS's large premises in Prague with an important staff, whereas CET 21 had a much smaller organization.
253. All these facts lead to a confusion of the roles actually played by CNTS and CET 21, and the Media Council could legitimately fear that a situation had arisen where there had been a *de facto* transfer of the License from CET 21 to CNTS.
254. Furthermore, the Media Council, upon its request, had been provided with an expert opinion from Mr. Jan Bárta from the State and Law Institute of the Academy of Science of the Czech Republic stating that the License was issued to CET 21, and therefore this company had to itself operate the broadcasting activities. Assuming that broadcasting was actually operated by CNTS, administrative proceedings to impose a fine could be initiated against the latter (Exhibits C27 and R14). In this respect, the Arbitral Tribunal considers that this opinion was issued by the State and Law Institute of the Academy of Science of the Czech Republic and not only by Mr. Bárta personally, since the Media Council's letter requesting the opinion had been sent to Mr. Bárta at the Institute, and the opinion was issued on the Institute's letterhead.
255. The commencement of the administrative proceedings against CNTS for alleged unauthorized broadcasting constituted the normal exercise of the regulatory duties of the Media Council. Therefore, this measure was not arbitrary.

256. In addition, administrative proceedings for unauthorized broadcasting were not only initiated against CNTS, a company controlled by a foreign investor, but also against two other companies, Premiera TV a.s. and Radio Alfa a.s. (Exhibits R37 and C22). Although Radio Alfa was also controlled by CME in 1996 and thus can equally be qualified as a foreign investor, Premiera TV was controlled by a domestic investor.
257. The Arbitral Tribunal considers that the Media Council decision to initiate administrative proceedings against CNTS was objectively not discriminatory, since the same measure was taken against Premiera TV, which was controlled by a domestic investor. The foreign investment of Mr. Lauder was therefore not provided a treatment less favourable than the domestic investment controlling Premiera TV. In this respect, the Arbitral Tribunal is of the opinion that the Claimant's allegation that the consequences of the administrative proceedings were less serious for Premiera TV than for CNTS is not relevant, because the measure itself is the same in both cases, i.e. the existence of administrative proceedings for unauthorized broadcasting. Discrimination can only occur when the measure against foreign investment and the measure against domestic investment are of a different nature, and the former is less favourable than the latter.
258. Therefore, the initiation of the administrative proceedings against CNTS was also not discriminatory.
259. This being said, the Arbitral Tribunal notes that neither CNTS nor CME raised any objection at the time the administrative proceedings were initiated that this action was in violation of any Czech law let alone that they violated the Treaty or any obligation of the Czech Republic.

#### **5.5.2.4 The Media Council's ongoing efforts to eliminate the original structure between CET 21 and CNTS**

260. The Arbitral Tribunal also considers that the alleged ongoing efforts by the Media Council to eliminate the original structure between CET 21 and CNTS in favor of non-

exclusive contractual arrangements did not constitute an arbitrary and discriminatory measure of the Czech Republic.

261. It is first to be noted that this allegation is rather vague. The Arbitral Tribunal understands that the alleged ongoing efforts to eliminate the original structure between CET 21 and CNTS refer both to the changes in their contractual relationships, i.e. the amendment to the MOA and the conclusion of the various agreements, and to the issuance by the Media Council of its 15 March 1999 letter, in response to CET 21's request of 3 March 1999 (Exhibit C34).
262. For the sake of clarity, the Arbitral Tribunal will examine these two sets of facts separately.

#### **5.5.2.4.1 The changes to the contractual relationships between CET 21 and CNTS**

263. The Arbitral Tribunal considers that the Media Council's actions leading to the changes to the MOA and the conclusion of the various agreements between CET 21 and CNTS did not constitute arbitrary and discriminatory measures.
264. The Arbitral Tribunal is of the opinion that the main reason for the Media Council to direct CME, CET 21 and CNTS to bring some modifications to their legal relationships was the same as the ground for initiating the administrative proceedings against CNTS for unauthorized broadcasting, i.e. the fear that the unclear legal and factual situation could actually amount to a *de facto* transfer of the License from CET 21 to CNTS, in violation of the Media Law.
265. Article 1.4.1(a) of the original MOA stated that "*CET shall contribute to the Company unconditionally, unequivocally, and on an exclusive basis the right to use, exploit and maintain the License held by CET*". The MOA did not contain any definition of the words "*use, exploit and maintain*", which remained open for interpretation.

266. This legal uncertainty, reinforced by the doubts about the factual allocation of responsibilities between CET 21 and CNTS, led the Media Council to ask the two companies to enter into a service contract setting forth their respective roles in the operation of TV Nova. This process was initiated at the meeting between the Media Council and CET 21 of 13 March 1996. The first conclusion of this meeting was that *"[l]awyers of the Council and CET 21 will prepare the first version of a contract on provision of performances and services between CET 21 and CNTS (...)"* (Exhibit C84).
267. As a result, CET 21 and CNTS concluded the May 1996 Agreement. This agreement expressly set forth in the preamble that its *"purpose (...) is to specify the mutual rights and mutual obligations which arise to CET 21 as the party making and CNTS as the party accepting a contribution made under the memorandum of association of May 4, 1993, by which CNTS was established. The memorandum of association is not changed by this agreement"*. The agreement stated that CNTS had the authorization to *"arrange"* the television broadcasting operated on the basis of the License (Article 2(1); Exhibit R17).
268. The amendment to the MOA in November 1996 (Exhibit C59), as well as the conclusions of the October 1996 Agreement (Exhibit R21) and of the 1997 Agreement (Exhibits C29 and R22), were further steps of the same process consisting in specifying the legal relationship between CET 21, CME and CNTS in order to ensure the creation of a clear situation in observance of the Media Law.
269. In this respect, the October 1996 Agreement was mainly similar to the May 1996 Agreement, except for the new Article 1(3) providing that said agreement *"does not affect the exclusive liability of CET 21 for the programming"* under the Media Law. The amended Article 1.4.1(a) of the MOA stated that *"the Company is granted the unconditional, irrevocable, and exclusive right to use and maintain the know-how and make it the subject of profit to the Company, in connection with the License, its maintenance, and protection"*. Finally, the 1997 Agreement further specified CNTS's activities by listing the scope of its business (Article 1(3)), and expressly stated that the contracts on the provision of services would be concluded by CNTS on behalf of CET 21 (Article 5(1) and (2)).

270. As they were based on an objective ground, i.e. the efforts to create a clear legal situation in compliance with the Media Law, and as there is no sufficient evidence that they were specifically targeted against foreign investment, the Media Council's actions leading to the changes to the MOA and the conclusion of the various agreements between CET 21 and CNTS did not constitute arbitrary and discriminatory measures.
271. This being said, neither CNTS nor CME raised any objections to this process to the Media Council. On the contrary, both CET 21 and CNTS fully collaborated. The letter sent by both companies to the Media Council on 4 October 1996 indeed constituted a proposal to take several steps "*(...) for how to best and most quickly meet the parliamentary commission's demands and thus how to amicably resolve the prolonged differences which arose in addressing the legal situation concerning the arrangement of legal relationships between [CNTS] and CET 21 s.r.o., as well as around the cancellation of license conditions (...)*" (Exhibit R19). These steps were, among others, the above mentioned amendment to the MOA and conclusion of the agreements between CET 21 and CNTS.
272. This collaboration took place despite the CME's awareness that their legal situation vis-à-vis CET 21 might be affected. In an memorandum dated 15 May 1996, Mrs. DeBruce of CME indeed expressed her concern with respect to the contemplated amendment to the MOA. All proposed amendments to the MOA and contracts between CET 21 and CNTS should be reviewed by legal counsel prior to be entered into (Exhibit C111).
273. Therefore, the Arbitral Tribunal holds that the Claimant acquiesced to the Media Council's above mentioned actions, and is in any event barred from making a claim deriving therefrom.
274. Finally, the Arbitral Tribunal notes that no sufficient evidence was offered that the damage claimed by Mr. Lauder in the present arbitration proceedings, i.e. the termination of the contractual relationship between CET 21 and CNTS on 5 August 1999 on the initiative of the former, was caused by the insistence of the Media Council on the respect of the Media Law in 1996 and 1997. On the contrary, such damage was



the direct result of Mr. Železný's own behavior, which was not backed in 1996 or 1997 by the Media Council or any other organ of the Respondent. Regarding further the question of causality between the alleged acts of the Media Council and the damage claimed see above § 234 and 235.

#### **5.5.2.4.2 The 15 March 1999 opinion of the Media Council**

275. The Claimant especially draws the attention of the Arbitral Tribunal to the visit by Mr. Železný to the Media Council on 2 March 1999 (R97), the following letter of CET 21, signed by Mr. Železný to the Media Council on 3 March 1999 (C33) and the answer to the Media Council by its Chairman Josef Josefík of 15 March 1999, addressed to Mr. Železný “CEO of TV NOVA and Executive Director of CET 21” (C34). According to these documents, and especially the description of the oral discussion which took place between Mr. Železný and the Media Council, it is clear that the Media Council was informed of the differences between Mr. Železný as master of CET 21 and CNTS. It was clear that Mr. Železný wanted the support of the Media Council in his struggle to free CET 21, and therefore himself, from the restrictions of the arrangements with CNTS. Although not in all points but at least in one of the key issues, namely the exclusive nature of the agreements between CET 21 and CNTS, the Media Council clearly expressed its opinion that in the context of television broadcasting the *“business relations between the operator of broadcasting and service organizations are built on a non-exclusive basis.”*
276. This view would seem to be contrary to what the 1996 Agreements, which were discussed and agreed with the Media Council in 1996, with the very active participation of Mr. Železný, then wearing the two hats of CEO of both CNTS and CET 21 have stipulated. The question which this Arbitral Tribunal, however, has to decide is not whether the Media Council was allowed to send such a letter, but whether the sending of the letter constituted a breach of the Treaty obligations of the Respondent.

277. The Arbitral Tribunal considers that the issuance of the Media Council's 15 March 1999 letter does not constitute an arbitrary measure and therefore cannot be considered as a breach of the Treaty.
278. As stated above (see 5.5.2.3 and 5.5.2.4.1), the Media Council was concerned with the fact that the unclear legal and factual situation may lead to a *de facto* transfer of the License to CNTS, in violation of the Media Law. The exclusive relationship between CET 21, the licensed broadcaster, and CNTS, its partner in the operation of TV Nova, was regarded with suspicion, because the Media Council was of the opinion that it presented the inherent danger of a *de facto* transfer of the License.
279. The Media Council's view on this issue was expressed, for instance, in its opinion to the Permanent Media Commission of the House of Deputies of the Parliament of 19 September 1999 with respect to the dispute between CET 21 and CNTS. Chapter 4 reads as follows: "*Each party has its own version of the heart of the issue based on a different interpretation of concluded agreements. CME insists on exclusivity and claims that CET 21 is obliged to broadcast exclusively through CNTS whereas CET 21 denies exclusivity and claims its right to conclude service agreements with any companies it pleases. As in the past, the Council's position in this matter is closer to the opinion that an exclusive relationship between the license holder and a service company is not desirable as it gives an opportunity to manipulate with the license*" (Exhibit C68). The Media Council also expressed its view on this issue in the supplementary report of 15 November 1999 to the same Commission: "*Administrative proceedings to revoke a license can be started only in the event of serious violation of the Broadcasting Act, and there must be provable reasons for them. Interrupting the cooperation of two private companies is not such a reason, and in addition, the council considers the exclusive relationship between the broadcaster and the only service organization as undesirable, due to the danger of a hidden transfer of the license*" (Exhibit R126).
280. The disputed 15 March 1999 letter to CET 21 contained the following statement: "*Business relations between the operator of broadcasting and service organizations are built on a nonexclusive basis. Exclusive relations between the operator and the service organization may result in de facto transfer of some functions and rights*

*pertaining to the operator of broadcasting and, in effect, a transfer of the license”* (Exhibit C34).

281. This statement is to be replaced in the context of the letter, which expressed the Media Council’s opinion on the requirements of the Media Law with respect to television broadcasting: *“Because the Council was also asked by the Parliamentary Media Committee to issue an opinion on whether commercial television broadcasting complies with the Act on Broadcasting and valid licenses, we would like to summarize requirements that, in our opinion, express the contents of television broadcasting: (...).”* Beside the list of said requirements, among them the above mentioned statement on regarding the exclusive relationship, the letter also explained the reason for terminating the administrative proceedings against CNTS for unauthorized broadcasting, and requested CET 21 to inform the Media Council about the implementation of the various changes with respect to the legal relationships between CET and CNTS, and to submit the current program composition and broadcasting schedule.
282. Although the statement about the non exclusive basis of the relationship between the holder of the license and the service organization might be viewed as a change of the previous position of the Media Council with respect to this issue, because the Media Council had been satisfied with the amendment of the MOA and the various 1996 and 1997 agreements between CET 21 and CNTS, which all stated the exclusive basis of the relationship between the two companies, the Arbitral Tribunal considers that it does not constitute a “measure” within the meaning of the Treaty, but merely expresses the general opinion of a regulatory body regarding the proper interpretation which should be given to the Media Law.
283. This letter was not aimed at having, and could not have, any legal effect. Condition 17 to the License, which required CET 21 to submit to the Media Council for approval any change in the MOA, had been cancelled end of 1996 (Exhibits R57 and C30). Since then, the Media Council had no authority to approve or disapprove any modification to the relationship between CET 21 and CNTS.

284. Since the Media Council's 15 March 1999 letter to CET 21 did not amount to a "measure", the Respondent did not violate the prohibition against arbitrary and discriminatory measures.
285. The Arbitral Tribunal also considers that said letter was neither arbitrary nor discriminatory. There indeed existed reasonable grounds, even if not necessarily conclusive, for the Media Council to view the existence of an exclusive relationship between CET 21 and CNTS as a danger of a de facto transfer of the License.
286. In addition, the Media Council remained independent from the dispute between CET 21 and CNTS. The 15 March 1999 letter was indeed significantly different from the request for said letter filed by CET 21 on 3 March 1999. In particular, the Media Council's letter did not reproduce CET 21's statement that the operator, i.e. CET 21, *"should order services from service organizations at regular prices so as to respect rules of equal competition"*, nor the statement that *"[f]or the level of provided services to agree with the terms of the license and Czech regulatory requirements, the licensed subject must have the ability to select relevant services anytime and anywhere at will"* (Exhibit C33). Those differences between CET 21's request and the Media Council's letter show that the latter did not just follow the wishes Mr. Železný, who controlled CET 21 at that time.
287. In this respect, the Arbitral Tribunal notes that the Claimant or the entities he controls did not commence any administrative or other proceedings before the appropriate courts of the Czech Republic in the course of which the issue of the overall attitude of the Media Council in this affair, mainly its alleged contradictory interpretation of the Media Law, could be addressed and decided. The Arbitral Tribunal considers that these proceedings do not constitute the appropriate forum to decide on hypothetical questions of the interpretation of the Media Law.
288. The Arbitral Tribunal also considers that the issuance of the Media Council's 15 March 1999 letter was not the cause of the damage incurred by the Claimant. Although this letter might have strengthened the resolve of Mr. Železný to break up the relationship between CET 21 and CNTS, it was not used to achieve this purpose. CET 21 did not terminate the 1997 Agreement on the basis that it provided for an

exclusive relationship with CNTS whereas the Media Council expressed the view such a relationship was undesirable. The legal reason for the termination was that CNTS had failed to submit a television program (Daily Log) on time, a requirement under the 1997 Agreement. Furthermore, there is no evidence that even if the Media Council had not written the 15 March 1999 letter, CET 21 would not have tried to terminate the 1997 Agreement on the ground of breach of contract.

### **5.53. The obligation to provide fair and equitable treatment**

289. The Claimant alleges that the Respondent breached the obligation to provide fair and equitable treatment to the Claimant's investments through the Media Council's reversal of critical prior approvals. This concerns the Media Council's proceedings in 1996 aimed at removing in the MOA the provision giving CNTS the exclusive right to use, benefit from and maintain the License. Furthermore the Claimant asserts that the Media Council demonstrated hostile conduct towards CNTS, by the totality of its other actions and inactions that undermined the rights which had been provided to CNTS (Reply Memorial, p. 81; Summary of Summation, p. 13).
290. The Claimant argues that the obligation to provide fair and equitable treatment has its basis in the general principle of good faith. The State bound by the Treaty must indeed pursue the stated goal of achieving a stable framework for investment. The minimum requirement is that the State not engage in inconsistent conduct, e.g. by reversing to the detriment of the investor prior approvals on which he justifiably relied. Such a requirement is independent of the State's domestic law, i.e. the obligation to provide fair and equitable investment can be violated even if the State complied with the requirements under its domestic law. In addition, it is not relevant whether domestic investors in the same field received the same treatment as the foreign investor, since the level of protection may be different under domestic law and under the Treaty (Reply Memorial, p. 77-83; Mr. Kiernan's oral closing submissions, p. 161-168).

291. The Respondent argues that there exists no precise definition of the obligation to provide fair and equitable treatment. What is fair and equitable is to be determined on the basis of the facts in each individual case. Anyway, this obligation is concerned with the conduct of the State, not with the results of the investments. Therefore, the fact that the investor loses money does not indicate that the State has breached the obligation to provide fair and equitable treatment. There is no evidence of a violation of this obligation by the Czech Republic. Up to 1997, the Media Council was indeed seeking to monitor and enforce the Media Law in the face of growing concern that CNTS was breaching it. The Media Council did not discriminate against the Claimant in favor of nationals, did not reverse prior express permissions, and did not maliciously misapply the law. Between 1997 and 1999, the Media Council did not want to take sides with respect to the dispute between CET 21 and CNTS, which was considered a commercial dispute. In particular, the Media Council's letter of March 15, 1999, whose wording is different from the one requested by Mr. Železný, expressed the Media Council's policy in a lawful and non-discriminatory manner (Response, p. 55; Written Closing Submissions, p. 10-11).
292. Article II(2)(a) of the Treaty sets forth that "*[i]nvestments shall at all times be accorded fair and equitable treatments, (...)*". As with any treaty, the Treaty shall be interpreted by reference to its object and purpose, as well as by the circumstances of its conclusion (Vienna Convention on the Law of Treaties, Articles 31 and 32). The preamble of the Treaty states that the Parties agree "*that fair and equitable treatment of investment is desirable in order to maintain a stable framework for investment and maximum effective utilization of economic resources*". The Arbitral Tribunal notes that there is no further definition of the notion of fair and equitable treatment in the Treaty. The United Nations Conference On Trade And Development has examined the meaning of this doctrine. Fair and equitable treatment is related to the traditional standard of due diligence and provides a "*minimum international standard which forms part of customary international law*" (U.N. Conference On Trade & Development: Bilateral Investment Treaties In The Mid-1990s at 53, U.N. Doc. UNCTAD/ITE/IIT/7, U.N. Sales No. E.98.II.D.8 (1998) (English version). In the context of bilateral investment treaties, the "fair and equitable" standard is subjective and depends heavily on a factual context. It "*will also prevent discrimination against the beneficiary of the standard, where discrimination would amount to unfairness or*

*inequity in the circumstances*” (U.N. Conference On Trade & Development: Fair And Equitable Treatment, Vol. III at 10,15, U.N. Doc. UNCTAD/ITE/IIT/II, U.N. Sales No. E.99.11.D.15 (1999) (English version)).

293. The Arbitral Tribunal holds that none of the actions and inactions of the Media Council, which have already been examined with respect to the prohibition against arbitrary and discriminatory measures (see above 5.5.2), constitutes a violation of the duty to provide fair and equitable treatment.
294. In order to avoid redundancy, the Arbitral Tribunal mainly refers to the developments made under the chapter addressing the issue of the prohibition against arbitrary and discriminatory measures, for most of the arguments denying the existence of any arbitrary and discriminatory measure from the Czech Republic as from 1996 also apply to the Respondent’s compliance with the obligation to provide fair and equitable treatment.
295. This being said, the Arbitral Tribunal does not see any inconsistent conduct on the part of the Media Council which would amount to an unfair and inequitable treatment.
296. In particular, the initiation of the administrative proceedings for unauthorized broadcasting in 1996 was not inconsistent with any prior conduct of the Media Council. At that time, the Media Council had objective reasons to think that CNTS was violating the Media Law, i.e. that it was the broadcaster of TV Nova in lieu of CET 21, the holder of the License. The Media Council’s duties were, among others, to ensure the observance of the Media Law.
297. There can not be any inconsistent conduct in a regulatory body taking the necessary actions to enforce the law, absent any specific undertaking that it will refrain from doing so. No such undertaking was given by the Media Council or any other organ of the Czech Republic.
298. The prior approval by the Media Council of the MOA, in the context of the License being granted to CET 21, contained no commitment to allow CET 21 and CNTS to violate the Media Law. On the contrary, the License expressly stated that “[t]he

*license holder (...) also agrees to observe the conditions stated in the appendix to this license*". Condition 1 to the License set forth that "[t]he license holder agrees (...) that its broadcasting will be in accordance with the laws of the Czech Republic and the international obligations of the Czech Republic. Broadcasting will, in particular, observe (...) the provisions of Act no. 468/1991 Coll., on operating radio and television (...)" (Exhibit R5). The amendment to the Media Law did not change anything with respect to CET 21's obligation to comply with the Media Law.

299. The administrative proceedings against CNTS for unauthorized broadcasting was not initiated on the ground that CNTS would have abided by the previously approved MOA, which would itself then be considered as violating the Media Law. As already stated, the reason for commencing such proceedings was the Media Council's concern that CNTS was operating the broadcasting of TV Nova in violation of the License and of the Media Law.
300. Regarding the changes to the legal relationships between CET 21 and CNTS, i.e. the amendment to the MOA and the conclusion of the various agreements between the two companies, there was also no inconsistent conduct on the part of the Media Council.
301. At no time did the Media Council decide that the approval of the original MOA was deemed null and void, and that any guarantee given to CET 21 and CNTS at that time had to be withdrawn. As stated above (see 5.5.2.4.1), all changes to the legal relationships between CET 21 and CNTS made in 1996 and 1997 were aimed at *specifying*, not altering, the content of said relationships in order to ensure a clear situation in observance of the Media Law.
302. Furthermore, CET 21, CNTS and CME fully cooperated to this process, after being given proper legal advice on the various issues addressed.
303. Finally, the issuance of the 15 March 1999 letter by the Media Council, although in some way in contradiction with the previously approved MOA on the question of the exclusive nature of the contractual relationship between CET 21 and CNTS, was nothing more than an opinion without any legal effect. It did not alter - and was not



aimed at altering – the contractual relationships between the two companies, which remained governed by the 1997 Agreement then in force.

304. In addition, the Arbitral Tribunal is of the opinion that the 15 March 1999 letter was not the direct cause of the damage allegedly suffered by the Claimant. Any damage resulted from the decision of CET 21, controlled by Mr. Železný, to terminate the 1997 Agreement with CNTS. CET 21 made no use of the 15 March 1999 letter. There is no evidence that CET 21 would not have terminated the contractual relationships with CNTS if the Media Council had not issued the 15 March letter, or, for argument's sake, had stated that it was of the opinion that an exclusive relationship between the two companies fully complied with the Media Law. With respect to causality in general see above § 234 and 235.

#### **5.5.4 The obligation to provide full protection and security**

305. The Claimant alleges that the Respondent failed to provide full protection and security to his investment (i) by forcing a change in the Media Law, (ii) by initiating the administrative proceedings against CNTS in 1996, (iii) by subsequent pressures to bring about the restructuring of CNTS, (iv) by issuing the 15 March 1999 letter, (v) by refusing all CNTS's requests to halt CET 21's dismantling of all dealings with the former, and (vi) by authorizing a share capital increase in CET 21 with knowledge that it would frustrate the ICC arbitral panel's interim order and would defy an express contrary request from Parliament (Reply Memorial, p. 85).

306. The Claimant argues that the obligation of full protection and security requires that the State take all steps necessary to protect foreign investments whatever the requirements of domestic law are and regardless of whether the threat to the investment arises from the State's own actions. The State has an obligation of vigilance under which it must take all measures necessary to ensure the full enjoyment of protection and security of the foreign investment (Memorial, p. 55; Reply Memorial, p. 83-85).

307. The Respondent argues the obligation of full protection and security is not an absolute obligation. A State is only obliged to provide protection which is reasonable under the circumstances. Furthermore, the obligation is limited to the activities of the State itself, and does not extend to the activities of a private person or entity. There can also be no legitimate expectation that there will not be any regulatory change (Response, p. 57-59).
308. Article II(2)(a) of the Treaty provides that "*[i]nvestment (...) shall enjoy full protection and security*". There is no further definition of this obligation in the Treaty. The Arbitral Tribunal is of the opinion that the Treaty obliges the Parties to exercise such due diligence in the protection of foreign investment as reasonable under the circumstances. However, the Treaty does not oblige the Parties to protect foreign investment against any possible loss of value caused by persons whose acts could not be attributed to the State. Such protection would indeed amount to strict liability, which can not be imposed to a State absent any specific provision in the Treaty (Dolzer and Stevens, *Bilateral Investment Treaties*, p. 61).
309. The Arbitral Tribunal holds that none of the facts alleged by the Claimant constituted a violation by the Respondent of the obligation to provide full protection and security under the Treaty.
310. Here again, in order to avoid redundancy, the Arbitral Tribunal refers to the findings made under the chapter addressing the issue of the prohibition against arbitrary and discriminatory measures (see above 5.5.2), for most of the arguments denying the existence of any arbitrary and discriminatory measure from the Czech Republic as from 1996 also apply to the Respondent's compliance with the obligation to provide full protection and security.
311. In particular, as regards the amendment to the Media Law in late 1995, effective on 1 January 1996, there is no evidence that such amendment, enacted by the Czech Parliament, was forced by the Media Council. Furthermore, the change in the Media Law did not constitute a danger for the Claimant's investment in the Czech Republic. In particular, the deletion of Article 12(3) authorizing the Media Council to include conditions to the grant of a license was not aimed at, nor suited to, destroying

Mr. Lauder's investment. On the contrary, such a change was favorably viewed by the entities operating TV Nova, since CET 21, represented by Mr. Železný, who was at that time on the side of the Claimant, immediately applied to the Media Council for the cancellation of most of the Conditions set in the License, among others Condition 17 (Exhibit R31).

312. Furthermore, the Arbitral Tribunal considers that it is not the Media Council's role to halt the alleged dismantling by CET 21 of all its dealings with CNTS, nor to enforce an ICC arbitral tribunal interim order. In any event, if the Media Council had acted in violation of its own obligations in respect of these two issues, the present arbitration proceedings are not the proper forum to seek relief. The Claimant should have and in fact did initiate action before the competent administrative or civil courts of the Czech Republic.
313. In addition, the Arbitral Tribunal considers that none of the actions or inactions of the Media Council caused a direct or indirect damage to Mr. Lauder's investment. The action which actually caused the Claimant to lose part of his investment was the termination by CET 21 of its contractual relationship with CNTS in 1999. In other words, the business relationship between CET 21 and CNTS survived all the alleged actions and inactions of the Media Council. It so did until Mr. Železný changed sides and decided to act in favor of CET 21, which by 1999 he controlled, against CNTS in which he no longer had any direct or indirect control. Regarding the issue of causality for the alleged loss suffered by the Claimant see especially § 234 and 235 above.
314. The investment treaty created no duty of due diligence on the part of the Czech Republic to intervene in the dispute between the two companies over the nature of their legal relationships. The Respondent's only duty under the Treaty was to keep its judicial system available for the Claimant and any entities he controls to bring their claims, and for such claims to be properly examined and decided in accordance with domestic and international law. There is no evidence – not even an allegation – that the Respondent has violated this obligation. On the contrary, the numerous Czech court proceedings initiated by CNTS, CME and Mr. Lauder against CET 21 and Mr. Železný show that the Czech judicial system has remained fully available to the Claimant. In particular, the 4 May 2000 decision by the Regional Commercial Court in

Prague that CET 21 was obligated to procure all services for television broadcasting exclusively through CNTS (Exhibit C54) is conclusive evidence of this availability. While this decision was later annulled by the High Court in Prague (Exhibit R134) an appeal is now pending before the Czech Supreme Court, which may still rule in favor of CNTS.

## **6. Costs**

315. Article 38 of the UNCITRAL Rules states that the Arbitral Tribunal shall fix the costs of arbitration in its Award and defines the term "costs".
316. At the Hearing of 17 March 2000 the Parties and the Arbitrators agreed on the formula for the fees of the Arbitral Tribunal. The fees and travel and other expenses incurred by the Arbitrators are herewith fixed at United States Dollars 501'370.20
317. According to Article 40 of the UNCITRAL Rules, the costs of arbitration shall in principle be borne by the unsuccessful party. However, the Arbitral Tribunal may apportion such costs between the Parties if it determines that apportionment is reasonable, taking into account the circumstances of the case. The same applies according to Article 40(2) with respect to the costs of legal representation and assistance. The Arbitral Tribunal can take into account the circumstances of the case and is free to determine which Party shall bear such costs or may apportioned such costs between the Parties if it determines that apportionment is reasonable.
318. Among the circumstances the Tribunal has taken into account is its finding that the Respondent, at the very beginning of the investment by the Claimant in the Czech Republic, breached its obligations not to subject the investment to discriminatory and arbitrary measures when it reneged on its original approval of a capital investment in the licence holder and insisted on the creation of a joint venture. Furthermore, various steps were taken by the Media Council, especially, but not only, the 15 March 1999 letter to CET 21. Although the Arbitral Tribunal came to the conclusion that such acts did not constitute a violation of the Treaty obligations of the Respondent, the Claimant

*bona fide* could nevertheless feel that he had to commence these arbitration proceedings. Furthermore, the behaviour of the Respondent regarding the discovery of documents, which the Claimant could rightly feel might shed more light on the acts of the Respondent, needs to be mentioned in this context.

319. Taking all these circumstances of the case into account, the Arbitral Tribunal comes to the decision that each Party shall pay one half of the fees and expenses of the Arbitral Tribunal and the hearing cost and bear its own costs for legal representation and assistance and the costs of its witnesses.

## **NOW THEREFORE THE ARBITRAL TRIBUNAL**

### **DECIDES**

1. It has jurisdiction to hear and decide this case.
2. The Respondent committed a breach of its obligation to refrain from arbitrary and discriminatory measures when in the Winter of 1993 it changed its original position, which had been made known to the Claimant and to the public at large, allowing an equity investment of the Claimant in CET 21, the holder of the licence to broadcast, and insisted that the participation of the Claimant could not be made in the form of an equity participation but only through a joint venture company.
3. The claim for a declaration that the Respondent committed further breaches of the Treaty are denied and all claims for damages are denied.

4. Each Party shall pay one half of the fees and expenses of the Arbitral Tribunal which are fixed at US\$ 501'370.20
5. Each Party shall pay one half of the direct costs involved in the London Hearings, including room hire, cost of court reporters, etc.
6. Each Party shall carry its own costs for legal representation and assistance, including the travel and other expenses of witnesses presented by the respective Party.
7. All other claims are herewith dismissed.


Place of arbitration: London

Date of this Arbitral Award: 3 September 2001

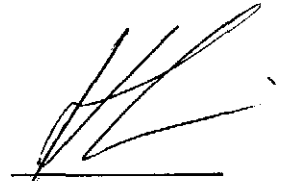
The Arbitral Tribunal



Lloyd Cutler  
Lloyd Cutler  
Arbitrator



Robert Briner  
Robert Briner  
Chairman



Bohuslav Klein  
Bohuslav Klein  
Arbitrator

## **LEGAL AUTHORITY CA-73**



**Arbitration CAS 2009/A/1782 Filippo Volandri v. International Tennis Federation (ITF), award of 12 May 2009**

Panel: Mr Efraim Barak (Israel), President; Prof. Luigi Fumagalli (Italy); Prof. Ulrich Haas (Germany)

*Tennis*

*Doping (Salbutamol)*

*CAS scope of review*

*Burden of proof*

*Degree of fault of the player*

1. By adopting and implementing the principle of consistency with the WADAC and by adopting the commitment to “*incorporate without any substantive changes*” the provision of the WADAC which recognize inter alia the unrestricted scope of review of the CAS Panel as provided under R57 of the CAS Code, the 2008 ITF Programme actually solves by itself the question of the co-existence of its two apparently conflicting provisions regarding the CAS scope of review. In order to exercise its power of review (as apparently allowed by the 2008 ITF Programme), the CAS must be able to examine the formal aspects of the appealed decisions but also, above all, to evaluate – sometimes even *de novo* – all facts and legal issues involved in the dispute.
2. According to the ITF Programme, the fact that a player has established, on the balance of probabilities, how the specified substance entered his body and has also established, to the comfortable satisfaction of the hearing body, that his ingestion of the specified substance was not intended to enhance his sporting performance or to mask the use of another prohibited substance only allows the player to benefit from the possible elimination or reduction of the period of suspension but is irrelevant with regard to the occurrence or non occurrence of the adverse analytical finding. As the player has not offered any persuasive evidence of how the concentration found in his urine could be the result of the therapeutic use, he has not succeeded in discharging the onus on him and, hence, must be considered as having committed a doping offence.
3. The degree of a player's fault is minor if the threshold of 1,000 ng/mL is just exceeded. Furthermore, the fact that the player has never previously been found guilty of an anti-doping rule violation, and more importantly, the fact that the procedures before the IF were slow and suffered from inconsistencies, with the result that the player was left in a state of uncertainty of over 8 months before formally being charged with a doping offence, must be taken into account to assess the player's degree of fault. Such a long period is unacceptable and incompatible with the intention of the anti-doping regime that matters should be dealt with speedily.



Mr Filippo Volandri, born on 5 September 1981, is a professional tennis player of Italian nationality (the “Player”). He entered the top 50 in the world ranking in 2003 and obtained the best result of his career in 2007, when he reached the 25<sup>th</sup> place in the ATP world rankings.

The International Tennis Federation (ITF) is the international governing body for sports related to tennis worldwide. It has its registered seat in London, England.

The circumstances stated below are a summary of the main relevant facts, as established on the basis of the written submissions of the parties and the evidence examined in the course of the proceedings. Additional facts may be set out, where relevant, in connection with the legal discussion.

Since his early childhood, Mr Filippo Volandri has suffered from asthma induced by dust-mite, dog epithelium as well as by physical exercise. His treating physician was then Dr Fabrizio Gadducci, presently director of the Bronchopneumology and Respiratory Allergology Section of the Livorno Hospital, Italy.

When he first started his professional career as a tennis player, Mr Filippo Volandri did not take any medication for asthma nor did he seek any specific medical care.

Over the years, the Player’s condition worsened and required notably a treatment in the form of inhalation of Ventolin, a salbutamol-based asthma medicine, achieved through a metered-dose inhaler.

Salbutamol is included in the list of prohibited substances under the World Anti-Doping Code (WADC), which is incorporated in the ITF Tennis Anti-Doping Programme (the “ITF Programme”). The authorisation to take this substance for a legitimate medical need is treated differently depending on whether the 2008 or the 2009 ITF Programme is applicable. In the first case, the administration of salbutamol by inhalation requires an application for an abbreviated Therapeutic Use Exemption whereas in the second case, the submission for a standard Therapeutic Use Exemption is needed. Also, in the first case, salbutamol in a concentration greater than 1,000 ng/mL is a prohibited substance and not a specified substance, whereas in the second case, salbutamol, even in a concentration greater than 1,000 ng/mL, is qualified as a specified substance. However, both the 2008 and 2009 ITF Programmes provide that despite the granting of a Therapeutic Use Exemption (TUE), the presence of salbutamol in urine in excess of 1,000 ng/mL will be considered an adverse analytical finding unless the Athlete proves that the abnormal result was the consequence “*of the therapeutic use of inhaled salbutamol*” or “*of the use of a therapeutic dose of inhaled salbutamol*”.

In respect of his use of salbutamol, Mr Filippo Volandri was granted his first TUE in 2003. Since then he applied for TUEs every year.

Regarding the year 2006, Mr Filippo Volandri filed a submission for a TUE for the use of salbutamol by inhalation. This document is dated 8 December 2005 and the indicated dosage strength was 100 mcg to be administered by a metered-dose inhaler *“if necessary”*. On the application form, the box marked *“once only”* and the box marked *“emergency”* were ticked. The space provided to *“indicate all relevant information to explain the emergency or the insufficient time to submit the TUE application”* was filled in with the words *“weezing e/o dispnea”*.

On 8 December 2005, the International Doping Tests and Management of Lindigö, Sweden (IDTM) confirmed the receipt of Mr Filippo Volandri’s application, accepted it without reservation and drew the Player’s attention on the fact that *“the dose, method and frequency of administration as it has been notified have to be followed meticulously!”*.

On 1 December 2006, Mr Filippo Volandri applied for a TUE covering the year 2007 and permitting the use of salbutamol by inhalation. The indicated dosage strength was 200 mcg to be administered three times a day. On the application form, the box marked *“once only”* and the box marked *“emergency”* were also ticked. It is not disputed that this document was eventually accepted by the IDTM.

On 21 November 2007, Mr Filippo Volandri and Dr Fabrizio Gadducci signed a TUE application form for the year 2008. The prohibited substances concerned were formoterol and albuterol, which is another name for salbutamol. Regarding this last drug, the treatment foreseen consisted in two puffs of 100 mcg to be administered by inhalation twice daily. On the application form, the box marked *“once only”* and the box marked *“emergency”* were also ticked and the space provided to *“indicate all relevant information to explain the emergency or the insufficient time to submit the TUE application”* was filled in with the words *“2 puffs if necessary”*.

It is accepted by the parties as well as by the lower instance that the present case must be examined in the light of the content of the TUE application form signed by the Player on 21 November 2007 (the *“TUE of November 2007”*). It is undisputed that the subsequent management of this document by the IDTM is irrelevant.

On 19 November 2008, Mr Filippo Volandri signed a TUE, seeking permission to take montelukast, budesonide and salbutamol. With regard to the last substance, the indicated dosage strength was 2 puffs of 100 mcg to be administered by inhalation. The box related to the *“frequency”* of administration was filled with the words *“Rescue”* and *“al bisogno”*.

On 24 November 2008 and following his application, Mr Filippo Volandri received from the IDTM an approval for the therapeutic use of budesonide and salbutamol. This document is a fix-term authorisation for two years, effective from 21 November 2008 to 22 November 2010 and allows the Player to use salbutamol in a dosage of 200 mcg by inhalation, *“as needed”*. It is also stipulated that the dose, method and frequency of administration as notified have to be followed meticulously.

At the end of the year 2008, Mr Filippo Volandri was referred to an asthma specialist, Mr Pierluigi Paggiaro, Professor in Respiratory Medicine, at the University of Pisa, Italy, and member of the

executive committee of the Global Initiative for Asthma. In a written statement made on 8 December 2008, Professor Pierluigi Paggiaro confirmed among other things that *“In the last months, symptoms are present every day (2-3 times daily use of rescue medication) particularly during physical activity. (...) Therefore, we conclude for **“Bronchial asthma with severe bronchial hyperresponsiveness”** and we recommended the following therapeutic regimen: Budesonide. Viatrix 400 mcg, one inhalation in the morning and in the evening. Montelukast 10 mg, one tablet in the evening. Rescue salbutamol, 2 puffs when needed. Periodic evaluations of pulmonary function are recommended”*.

In March 2008, Mr Filippo Volandri was participating in an ATP Tour tournament, which took place in Indian Wells, California, United-States.

In the morning of 13 March 2008, at about 2:30, Mr Filippo Volandri was awakened by what he says to be the most serious asthma attack of his life. This happened just a few hours before his first match in the tournament, which was scheduled for the early afternoon of the same day.

Some details of this incident can be found in the transcript of the hearing held before the ITF Independent Anti-Doping Tribunal on 7 January 2009:

***Filippo Volandri***

*I used Ventolin every 20 minutes up to the situation getting back to normal.*

***Jonathan Taylor***

*Do you remember how many puffs you had to take to get the situation back to normal?*

***Filippo Volandri***

*No, I don't recall the number exactly.*

*(...)*

***Jonathan Taylor***

*I'm not asking you exactly for how many puffs you think it took to get you back to normal, but one can try and narrow the range, so would it have been more than four?*

***Filippo Volandri***

*I don't feel I can answer that question because I don't remember when exactly it happened when I wake up, so I'm not really entirely awake yet and I can't actually count them sometimes. It was a situation which started during the night.*

***Jonathan Taylor***

*...any range, it would have been something between zero and ten, it would have been something between 20 and 30, or you just simply can't say?*

***Filippo Volandri***

*I cannot say, but it's between zero and ten, I would say (...)*”.

Transcript: pages 48 and 49

**“Filippo Volandri**

*What I remember was that this attack began in the middle of the night as usually happens. It was perhaps half past two/three o'clock in the morning I woke up due to this attack. The attack woke me up and I wasn't breathing well. I didn't wake up to say go to the toilet and then realise that I wasn't breathing well. I woke up because I was not breathing well. I began using Ventolin as had been explained to me by my physician, one or two puffs every 15 to 20 minutes. I was a little concerned about the situation, I called my trainer because it was the first time that such a serious attack had taken place, and apart from the fact that my trainer could not help me, he came to me for support. I continued using Ventolin, he came to my room approximately an hour later because we were sleeping in different hotels. I continued with the Ventolin, also following his own advice, he noticed that my medical situation was not normal, and around four/half past four in the morning the situation normalised and my trainer left my room. One of his pieces of advice was, 'Let's call a doctor,' then luckily there was no need for this.*

(...)

**Jonathan Taylor**

*First of all you say you were taking – would it be two puffs every 15 to 20 minutes?*

**Filippo Volandri**

*Yes.*

**Jonathan Taylor**

*In this period did you do that throughout? So in every 15/20 minutes you took two puffs, or were there sometimes longer gaps?*

**Filippo Volandri**

*There were some longer gaps when the situation went back to normal, and then perhaps I had another small attack, but I'd say 15/20 minutes, or maybe when my coach arrived it was a longer gap, one hour, for instance. What I want you to understand is that in a situation like this, looking at the watch to see how long the gap is, is a bit unrealistic.*

**Jonathan Taylor**

*I'm trying to see if there's any way for us to getting the parameters of how many puffs. Let me see if I've got this right. The period lasted from about 2.30 to three, to four to 4.30, so that would be a maximum of two hours about?*

**Filippo Volandri**

*More or less, yes.*

**Jonathan Taylor**

*And during that time the trainer came and there was a gap then of about an hour when you didn't need to take any puffs? Did I understand that correct?*

### ***Filippo Volandri***

*More or less, yes. I repeat that it's hard to remember exactly because this happened last March, not last week, so it's difficult to remember the times. I can give you a general timeframe, but I cannot be more precise than this".*

In the briefs filed on behalf of Mr Filippo Volandri with the ITF Independent Anti-Doping Tribunal and with the Court of Arbitration for Sport, it is stated that when his coach joined the Player in his hotel room, he found the latter "gasping for breath".

On 13 March 2008, just after the loss of his first game in two straight sets, Mr Filippo Volandri was subject to in-competition doping testing. On the doping control form, the Player indicated the correct number of his TUE as well as the use of Ventolin.

It is undisputed that the WADA-accredited laboratory in Montreal, Canada, was instructed to conduct the analysis of Mr Filippo Volandri's urine sample and that, on 9 April 2008, it identified in the Player's A sample the presence of salbutamol in a concentration of 1,167 ng/mL (without taking into account the measurement uncertainty of 87 ng/mL).

It is only on 25 July 2008 (three and a half months after the finding on the A sample and four and a half months after the doping test), that Mr Stuart Miller, the ITF technical manager, notified in writing the Player of the result of the A sample analysis and asked him documented explanations with regard to the said concentration of 1,167 ng/mL.

The same day, the Player sent to Mr Stuart Miller an e-mail with the following justification: *"the reason why the level of salbutamol on my urine collected during the last Indian Wells was a bit higher, is that due to a strong attack of allergy caused by the dust of the carpet I had to use more Ventolin, the inhalation spray with salbutamol. I use as therapeutic treatment. I had to do that because I couldn't breath well, especially with that hot temperature"*.

It then took the ITF another almost two months to refer to the Player's letter. By courier dated 18 September 2008, Mr Stuart Miller acknowledged receipt of the Player's e-mail and explained that his clarifications were insufficient. On this letter, that was sent six months after the event, Mr Miller requested Mr Filippo Volandri to provide details on a) the time at which he last urinated prior to providing sample on 13 March 2008, b) the time(s) at which he used his inhaler on 13 March 2008 and c) the number of puffs he took on each of those occasions. In particular, Mr Stuart Miller stated that *"if the Review Board finds that you have no case to answer, you will be informed and no further action will be taken. If the Review Board finds that you have a case to answer, then you will be charged with commission of a Doping Offence under Article C.1 of the Programme"*.

On 22 September 2008, the Player answered to Mr Stuart Miller by e-mail, referring to his TUE and confirming notably the following:

*"I wouldn't be honest, Dr Stuart, if I try to answer to the 3 questions you sent me in the letter, as I have no chance to remember when I urinated before the one connected to the fact, or the times I used the inhaler on 13 March 2008.*

*The only thing I can perfectly remember is that the temperature at the tennis centre was terrible, and I had to use the inhaler several times in those days, also during the night because of the dust of the carpet in my room. I had so many problems to breath and sleep.*

*I had to do that otherwise I would have called the hospital”.*

In a letter dated 8 October 2008 and addressed to Mr Filippo Volandri, Mr Staffan Sahlström of IDTM, presented himself as the Anti-Doping Programme Administrator of the ITF Programme appointed by the ITF “to administer various aspects of the Programme”. Mr Staffan Sahlström informed the Player that a confirmatory analysis was going to be carried out on his B sample. He also reported to the Player that he or his representative could attend the opening of the B sample. The letter also reads as follow:

*“No Provisional Suspension*

*For the avoidance of any doubt, (1) you have not yet been formally charged with the commission of a Doping Offence; and (2) unless and until you are charged and you have formally admitted committing a Doping Offence, or you have been found by Anti-Doping Tribunal to have committed a Doping Offence, you will not be deemed to have committed such an offence. Nor will any provisional period of ineligibility be imposed upon you and you will remain free to compete. (See Article J.4.1 of the Programme).*

*However, in the event that you are subsequently found to have committed a Doping Offence, and a period of Ineligibility is imposed, any period after the date of receipt of this letter during which you have voluntarily foregone any form of involvement in Competitions will be credited against the total period of any Ineligibility that you have to serve. (See Article M.8.3 of the Programme)”.*

On 16 October 2008, the WADA accredited laboratory in Montreal, Canada, conducted the confirmatory analysis on the Player’s B sample and corroborated the presence of salbutamol in a concentration of 1,192 ng/mL.

By letter dated 13 November 2008, Mr Stuart Miller notified Mr Filippo Volandri that he was charged with commission of a doping offence within the meaning of article C.1 of the ITF Programme. The letter also indicates the potential consequences of a doping offence: Disqualification of the results obtained at the Indian Wells tournament; disqualification of the results obtained in Covered Events since 13 March 2008; imposition of ineligibility for a period of two years.

Between the period following the 2008 edition of the Indian Wells tournament and the notice of charge dated 13 November 2008, Mr Filippo Volandri took part in several tennis tournaments and was selected for three doping controls:

Event	Date	Event Points	Prize Money	Concentration of salbutamol found after deduction of the measurement uncertainty
ATP Master Series Miami	27.03.08	5	[...]	
ATP Masters Series Monte Carlo	20.04.08	35	[...]	
Barcelona	28.04.08	15	[...]	
ATP Masters Series Rome	05.05.08	5	[...]	634
ATP Masters Series Hamburg	11.05.08	5	[...]	978
Roland Garros	25.05.08	5	[...]	
Warsaw	09.06.08	0	[...]	
Wimbledon	23.06.08	5	[...]	937
Turin	30.06.08	0	[...]	
Bastad	07.07.08	0	[...]	
Umag	14.07.08	15	[...]	
San Marino	21.07.08	80	[...]	
Cordenons	28.07.08	80	[...]	
Manerbio	18.08.08	31	[...]	
Como	25.08.08	0	[...]	
Bucharest	08.09.08	0	[...]	
Naples	22.09.08	14	[...]	
Vienna	06.10.08	0	[...]	
St. Petersburg	20.10.08	0	[...]	

On 7 January 2009, a hearing was held before the ITF Independent Anti-Doping Tribunal (the “ITF Tribunal”).

On 15 January 2009, the ITF Tribunal passed a decision (the “Appealed Decision”), in which it concluded that the ITF had sufficiently established the objective elements of a violation of the applicable ITF Programme, *i.e.* the presence of salbutamol in the Player’s A sample in a concentration of 1,167 ng/mL, which amounts to an adverse analytical finding.

In its decision, the ITF Tribunal held that *“Our best estimate on the basis of the evidence we have is that [Mr Filippo Volandri] probably took between 10 and 20 puffs overall. It was common ground that one puff corresponds to 100 mcg of salbutamol. Therefore the amount taken corresponds, in our estimation, to between 1,000 and 2,000 mcg”*. Based on these findings, it concluded that the Player took too much salbutamol. It was fortified in its conclusion *“by the fact that the player did not adduce any scientific evidence to show that the amount of salbutamol which he took, according to his best estimate, could have produced a concentration of 1,167 ng/ mL in his urine 8-18 hours later”*.

The ITF Tribunal accepted that Mr Filippo Volandri inhaled salbutamol and did not ingest it in any other way. However, it held that the Player did not meet his burden of proof that his use of salbutamol on 13 March 2008 was therapeutic or in compliance with the TUE of November 2007,

according to which salbutamol was to be administered daily with 2 times two puffs of 100 mcg, plus “2 puffs if necessary”. The ITF Tribunal found that the reference to inhalation of salbutamol “if necessary” must be interpreted in line with an objective approach, which requires treating as therapeutic only doses of salbutamol which do not exceed what is regarded as necessary and appropriate treatment, according to accepted medical opinion. The ITF Tribunal held that the appropriate treatment is to be found in the guidelines issued by the Global Initiative for Asthma, as revised in 2007, known as the “GINA guidelines”. In the view of the circumstances and in the presence of a severe asthma attack qualified by the Player himself as life threatening, the ITF Tribunal was of the opinion that the GINA guidelines commended the Player to seek care in a clinic or a hospital. *“He decided not to do so. Instead, he called his coach and opted to deal with the situation by inhaling salbutamol, apparently without imposing any limit on himself. (...) If this were acceptable, the player himself would become the judge of what is therapeutic, even though he is not medically qualified. We do not think that can be right. The issue must be judged by reference to accepted medical opinion, not the player’s subjective and medically uninformed view of what dose is therapeutic”.*

With regard to the sanction imposed upon Mr Filippo Volandri, according to the 2009 ITF Programme, the ITF Tribunal, applying the *lex mitior* principle, accepted that salbutamol is a specified substance and that it had not been used to enhance sport performance or to mask the use of a performance enhancing substance. It held that the Player was at fault for inhaling too much salbutamol. It found fair not to disqualify the Player’s results (including ranking points and prize money) obtained before the Manerbio tournament, as he was not aware of any problem arising from the test done at the 2008 edition of the Indian Wells tournament. *“However, by 18 August 2008 when the player next competed at Manerbio, he had had sufficient time to obtain some advice about the adverse A sample result, including on the question of whether to cease competing. [The ITF Tribunal] consider[s] that fairness does not require his results in competitions from then onwards to remain undisturbed”.*

On 15 January 2009, the ITF Tribunal decided the following:

*“Accordingly, for the reasons given above, the Tribunal:*

- (1) confirms the commission of the doping offence specified in the notice of charge set out in the ITF’s letter to the player dated 13 November 2008; namely that a prohibited substance, salbutamol, has been found to be present in the urine sample that the player provided at Indian Wells on 13 March 2008;*
- (2) finds that the player has failed to establish on the balance of probabilities that the abnormal test result was the consequence of the player’s therapeutic use of inhaled salbutamol;*
- (3) orders that the player’s individual result must be disqualified in respect of the Indian Wells tournament, and in consequence rules that the prize money and ranking points obtained by the player through his participation in that event must be forfeited;*
- (4) orders, further, that the player’s individual results (including ranking points and prize money) in competitions including and subsequent to the Manerbio competition on 18 August 2008 shall be disqualified and all prize money and ranking points in respect of those competitions shall be forfeited;*
- (5) orders, however, that the player’s results (including ranking points and prize money) in all competitions subsequent to the Indian Wells tournament up to and including the Cordenons competition on 28 July 2008 shall remain undisturbed;*



*(6) finds that the player has succeeded in establishing to the comfortable satisfaction of the Tribunal that his use of the prohibited substance leading to the positive test result in respect of the sample taken on 13 March 2008 was not intended to enhance his sport performance;*

*(7) declares that the player shall be ineligible for a period of three months (i.e. calendar months) starting on 15 January 2009 and expiring at midnight London time on 14 April 2009 from participating in any capacity in any event or activity (other than authorised anti-doping education or rehabilitation programmes) authorised by the ITF or any national or regional entity which is a member of or is recognised by the ITF as the entity governing the sport of tennis in that nation or region”.*

On 4 February 2009, Mr Filippo Volandri filed a statement of appeal and, on 13 February 2009, an appeal brief with the Court of Arbitration for Sport (CAS). It challenged the Appealed Decision of the ITF Tribunal, submitting the following request for relief:

*“Appellant prays the Court:*

***principally:** to acquit Filippo Volandri of the charge of having committed a doping offence as specified in the charge dated 13 November 2008, and as a consequence revoke the period of disqualification imposed, and declare that the player’s results (including ranking points and prize money), which have been revoked, be declared to be valid;*

***alternatively:** in the unlikely event that the player were still to be considered guilty of having committed a doping offence, to backdate the period of disqualification imposed, counting the period of voluntary suspension observed by the athlete, and as a result, declare that all of the player’s results (including ranking points and prize money) which have been revoked, be considered valid, and in any case, to reduce the period of disqualification, because it is excessive”.*

On 9 March 2009, the ITF submitted an answer containing the following prayers for relief:

*“For the reasons set out above, the ITF respectfully submits that the Player has failed to make out any grounds for disturbing the Decision and that therefore the appeal should be dismissed in its entirety”.*

A hearing was held on 26 March 2009 at the CAS premises in Lausanne.

## LAW

### CAS Jurisdiction

1. The jurisdiction of the CAS, which is not disputed, derives (a) from article 33 of the Articles of Association of ITF Limited, (b) from section O of the 2008 ITF Programme and (c) from article R47 of the Code of Sports-related Arbitration (the “CAS Code”). It is further confirmed by the order of procedure duly signed by the parties.
2. It follows that the CAS has jurisdiction to decide the present dispute.

## Applicable law

3. Article R58 of the CAS Code provides the following:

*“The Panel shall decide the dispute according to the applicable regulations and the rules of law chosen by the parties or, in the absence of such a choice, according to the law of the country in which the federation, association or sports-related body which has issued the challenged decision is domiciled or according to the rules of law, the application of which the Panel deems appropriate. In the latter case, the Panel shall give reasons for its decision”.*

4. In the present case, it results from their respective submissions that the parties agree that the matter under appeal is governed by the rules and regulations of the ITF. In this respect and on 28 December 2007, Mr Filippo Volandri signed an agreement confirming that he would comply with and be bound *“by all provisions of the 2008 ATP OFFICIAL RULEBOOK and the ATP Tour, Inc’s (“ATP”) By-Laws (the “ATP Rules”), including, but not limited to, all amendments to the ATP Rules”.*

5. The 2009 ITF Programme reads as follows where relevant:

*“A.5 The effective date of this Programme is 1 January 2009 (the “Effective Date”)*

*A.6 Transitional provisions:*

*A.6.1 The Programme shall apply in full to all cases where the alleged Doping Offence occurs after the Effective Date.*

*A.6.2 Any case pending prior to the Effective Date, or brought after the Effective Date but based on a Doping Offence that occurred before the Effective Date, shall be governed by the predecessor version of the Programme in force at the time of the Doping Offence, subject to any application of the principle of *lex mitior* by the Anti-Doping Tribunal hearing the case”.*

6. It appears that the 2009 ITF Programme contains an express transitional provision, which clearly indicates that the 2008 ITF Programme remains applicable in the present proceedings because Mr Filippo Volandri’s case was pending before the 2009 ITF Programme came into force on 1 January 2009. However, article A.6 of the 2009 ITF Programme allows the ITF Independent Anti-Doping Tribunal as well as the CAS Panel to apply the *lex mitior* principle, *i.e.* the principle whereby a disciplinary regulation applies as soon as it comes into force if it is more favourable to the accused. This is a fundamental principle of law applicable and accepted by most legal regimes and which applies by analogy to anti-doping regulations in view of the quasi penal or at the very least disciplinary nature of the penalties that they allow to be imposed (CAS 2005/C/841, page 14; CAS 94/128, in Digest of CAS Awards (1986-1998), p. 477 at 491).
7. It follows that the ITF regulations, in particular the 2008 ITF Programme (subject to more favourable provisions to Mr Filippo Volandri under the 2009 ITF Programme) are applicable.

8. Article A.10 of the 2008 ITF Programme provides that it is governed by and shall be construed in accordance with English law, subject to article A.8, which requires the ITF Programme to be interpreted in a manner that is consistent with the WADC. The WADC prevails in the event of a conflict between its provisions and those of the ITF Programme.
9. The application of the (rules of) law chosen by the parties has its confines in the *ordre public* (Zürcher Kommentar zum IPRG/HEINI, 2nd edition 2004, Art. 187 marg. no. 18; see also KAUFMANN-KOHLER/RIGOZZI, Arbitrage International, 2006, marg. no. 657). Usually, the term *ordre public* is thereby divested of its purely Swiss character and is understood in the sense of a universal, international or transnational sense (KAUFMANN-KOHLER/RIGOZZI, Arbitrage International, 2006, margin no. 666; Zürcher Kommentar zum IPRG/HEINI, 2nd edition 2004, Art. 187 margin no. 18; cf. also PORTMANN, *causa sport 2/2006* pp. 200, 203 and 205). The *ordre public* proviso is meant to prevent a decision conflicting with basic legal or moral principles that apply supranationally. This, in turn, is to be assumed if the application of the rules of law agreed by the parties were to breach fundamental legal doctrines or were simply incompatible with the system of law and values (TF 8.3.2006, 4P.278/2005 marg. no. 2.2.2; Zürcher Kommentar zum IPRG/HEINI, 2nd edition 2004, Art. 190 margin no. 44; CAS 2006/A/1180, no. 7.4; CAS 2005/A/983 & 984, no. 70).

### Admissibility

10. The appeal was filed within the deadline provided by article O.4.1 of the 2008 ITF Programme. Furthermore, it complied with all other requirements of article R48 of the CAS Code.
11. It follows that the appeal is admissible.

### Procedural motions – scope of review of the CAS

12. Article R57 of the CAS Code provides that “*the Panel shall have full power to review the facts and the law*”. Under this provision, the Panel’s scope of review is basically unrestricted. It has the full power to review the facts and the law and may even request the production of further evidence. In other words, the Panel not only has the power to establish whether the decision of a disciplinary body being challenged was lawful or not, but also to issue an independent decision (CAS 2004/A/607; CAS 2004/A/633; CAS 2005/A/1001; CAS 2006/A/1153).
13. The CAS Code contemplates a full hearing *de novo* of the original matter.
14. However, in the present case, the ITF submits a) that the power of review of the CAS Panel is limited by the applicable ITF regulations and b) that article R57 of the CAS Code applies only to the extent agreed by the parties, which did not accept the rules of arbitration fixed by the CAS Code in whole. The ITF alleges that the scope of review of the CAS is restricted to

determining whether the Player has established that the ITF Tribunal's findings were erroneous based on all of the evidence before it at first instance.

15. To support its opinion, the ITF refers to article O.5.1 of the 2008 ITF Programme, which reads as follows:

*“Where required in order to do justice (for example to cure procedural errors at the first instance hearing), appeals before CAS pursuant to this Article O shall take the form of a re-hearing de novo of the issues raised by the case. In all other cases such appeals shall not take the form of a de novo hearing but instead shall be limited to a consideration of whether the decision being appealed was erroneous. The CAS Panel shall be able to substitute its decision for the decision being appealed where it considers that decision to be erroneous or procedurally unsound”.*

16. The CAS Panel observes that the situation is not clear because of the confusion generated (a) by the apparent conflict between article O.2 and O.5.1 of the 2008 ITF Programme and (b) by the unclear wording of article O.5.1 of the 2008 ITF Programme. However, the Panel is of the opinion that this unclear situation is actually and practically solved by the ITF Programme itself, as will be explained hereunder, by reference to other articles of the ITF Programme which leads to the conclusion that the unrestricted scope of review of the CAS Panel as provided under R57 of the CAS Code does not seem to be limited by article O.5.1 of the 2008 ITF Programme.

*A. The apparent conflict between the 2008 ITF Programme articles*

17. Pursuant to article O.2.1 of the 2008 ITF Programme *“A decision that a Doping Offence has been committed, a decision imposing Consequences for a Doping Offence, a decision that no Doping Offence has been committed, a decision by the Review Board that there is no case to answer in a particular matter, a decision that the ITF lacks jurisdiction to rule on an alleged Doping Offence or its Consequences, may be appealed by any of the following parties exclusively to CAS, in accordance with CAS's Procedural Rules for Appeal Arbitration Procedures (...)”.*
18. Article O.2.1 of the 2008 ITF Programme refers to the CAS Code without any restrictions or limitations, whereas article O.5.1 of the same Programme seems to limit, in certain circumstances, the CAS Panel's scope of review. At a first glance, the 2008 ITF Programme seems to offer no indication as to which of those two provisions should prevail or as to how they should co-exist. However, as will be further explained, this question is indeed solved within the framework of the 2008 ITF Programme itself.
19. This possible confusion was obviously noticed by the ITF which amended its 2009 ITF Programme by suppressing the reference to the *“CAS's Procedural Rules for Appeal Arbitration Procedures”* in its new article O.2.1.
20. Moreover, the ITF is a signatory to the WADC. Its 2008 Programme was adopted and implemented pursuant to the mandatory provisions of the WADC (Article A.2 of the 2008 ITF Programme). According to article A.8 of the 2008 ITF Programme, *“The Programme shall*

*be interpreted in a manner that is consistent with the [WADC] (...). In the case of a conflict between the Programme on the one hand and the mandatory provisions of the [WADC] (as referenced in the Introduction to the [WADC]) on the other hand, the mandatory provisions of the [WADC] shall prevail”.*

21. In its Part One, the applicable WADC (the version approved in 2003 and effective 1 January 2004 to 31 December 2008) reads as follows where relevant: *“While some provisions of Part One of the [WADC] must be incorporated essentially verbatim by each Anti-Doping Organization in its own anti-doping rules, other provisions of Part One establish mandatory guiding principles that allow flexibility in the formulation of rules by each Anti-Doping Organization or establish requirements that must be followed by each Anti-Doping Organization but need not be repeated in its own anti-doping rules. The following Articles, as applicable to the scope of anti-doping activity which the Anti-Doping Organization performs, must be incorporated into the rules of each Anti-Doping Organization without any substantive changes (allowing for necessary non-substantive editing changes to the language in order to refer to the organization’s name, sport, section numbers, etc.); Articles 1 (Definition of Doping), 2 (Anti-Doping Rule Violations), 3 (Proof of Doping), 9 (Automatic Disqualification of individual Results), 10 (Sanctions on Individuals), 11 (Consequences to Teams), 13 (Appeals) with the exception of 13.2.2, 17 (Statute of Limitations) and Definitions”.*
  22. Article 13 of the WADC sets forth the appeal process applicable in case of decisions made under the WADC or rules adopted pursuant to the WADC. It specifies in great detail which decisions may be subject to appeal, and who is entitled to file an appeal. Pursuant to article 13.2.1 of the WADC, *“In cases arising from competitions in an international Event or in cases involving International-Level Athletes, the decision may be appealed exclusively to the Court of Arbitration for Sport (“CAS”) in accordance with the provisions applicable before such court”* (emphasis added).
  23. It is therefore the view of the CAS Panel that Art. A.8 of the 2008 ITF Programme, by adopting and implementing the principle of consistency with the WADAC and the ITF’s commitment hereunder to *“incorporate (...) without any substantive changes”*, *inter alia*, article 13 (Appeals) of that Code, actually solves by itself the question of the co-existence of these two articles and establishes the supremacy of Art. O.2.1. over Art. O.5.1.
- B. *The ambiguous wording of article O.5.1 of the 2008 ITF Programme*
24. The wording of article O.5.1 of the 2008 ITF Programme is ambiguous and leaves the Panel in a state of perplexity:
    - on the one hand, the said provision allows the CAS to review the appeal in the form of a *de novo* hearing only *“where required in order to do justice”*.
    - on the other hand, in all the other cases (*i.e.* where *not* required in order to do justice), the CAS must limit its scope of review to a *“consideration of whether the decision being appealed was erroneous”*.
  25. The concept of *“in order to do justice”* is illustrated in the Programme with just one example (*i.e.* *“for example to cure procedural errors at first instance hearing”*), which does not help to understand

why the CAS Panel does not “*justice*” when/if it considers that the “*decision being appealed was erroneous*”.

26. However, the Panel is a fortiori allowed to review the Appealed Decision if it is arbitrary, *i.e.* if it severely fails to consider fixed rules, a clear and undisputed legal principle or breaches a fundamental principle. A decision may be considered arbitrary also if it harms in a deplorable way a feeling of justice or of fairness or if it is based on improper considerations or lacks a plausible explanation of the connection between the facts found and the decision issued. Likewise, the Panel is of the opinion that it must be able to review the Appealed Decision with regard to the fundamental rights of the Player. Any other interpretation would lead to possible abuse of process and of authority, which would be absolutely unacceptable and would represent a substantial and specific danger to sporting spirit. Furthermore, any agreement between the parties to restrict the powers of this Panel would have to be viewed critically in the light of the limitations imposed by the Swiss *ordre public*. Agreements between athletes and international federations are – in general terms – not concluded voluntarily on the part of the athletes but rather imposed upon them unilaterally by the federation (ATF 133 III 235, 242 *et seq.*). There is, therefore, a danger that a federation acts in excess of its powers unless the contents of the agreement does take sufficiently into account also the interests of the athlete. The Panel has some doubts whether a provision that restricts the Panel’s power to amend a wrong decision of a federation to the benefit of the athlete balances the interests of both parties in a proportionate manner.
27. In order to exercise such a review (as apparently allowed by the 2008 ITF Programme), the CAS must be able to examine the formal aspects of the appealed decisions but also, above all, to evaluate – sometimes even *de novo* – all facts and legal issues involved in the dispute.
28. The Panel wonders if the purpose of article O.5.1 of the 2008 ITF Programme is to prohibit the parties to bring before the CAS Panel new evidence which has not been presented to the ITF Tribunal. In this respect, the Panel observes that all the parties – including ITF – have filed various submissions and evidence after the hearing before the ITF Tribunal. Moreover, in the case at hand, there was no “evidential ambush” which might have given unfair advantages to one or the other party.
29. In the view of all the above and under the circumstances of the case and the findings of the Panel as explained hereunder, the unrestricted scope of review of the CAS Panel as provided under R57 of the CAS Code does not seem to be limited by article O.5.1 of the 2008 ITF Programme. Furthermore, at the present case, it is the view of the Panel that there are sufficient grounds to resolve the issue at stake (*i.e.* its scope of review) even within the framework of article O.5.1 as is.

## Merits

30. In the view of the above, the main issues to be resolved by the Panel are:
  - a) Has a doping offence been committed?

- b) If the first question is answered in the affirmative, are the sanctions imposed by the ITF Tribunal upon the Player appropriate?

A. *Has a doping offence been committed?*

31. The following is undisputed:
- Mr Filippo Volandri suffers from asthma.
  - The presence of salbutamol in a concentration of 1,167 ng/mL was found in Mr Filippo Volandri's A sample collected on 13 March 2008. The analysis on the Player's B sample confirmed the presence of salbutamol in a concentration of 1,192 ng/mL.
  - The accuracy of the testing methods or the test results and positive findings are not contested. Mr Filippo Volandri did not try to allege the possible occurrence of a breach in the chain of custody.
  - The presence of salbutamol in urine in excess of 1,000 ng/mL is considered an adverse analytical finding unless the player proves that the abnormal result was the consequence "*of the therapeutic use of inhaled salbutamol*" or "*of the use of a therapeutic dose of inhaled salbutamol*".
  - The present case must notably be examined in the light of the content of the TUE of November 2007 irrespective of the subsequent management of this document by the IDTM. In this respect, it is not disputed that the indication "*2 puffs if necessary*" on the TUE of November 2007 must be interpreted in accordance with the GINA guidelines.
  - The GINA guidelines determine the appropriate treatment objectively admissible in terms of "*therapeutic*" (or "*therapeutic dose*" under the 2009 Programme) use of salbutamol.
32. In sum, the only question that arises is whether the concentration of salbutamol found in Mr Filippo Volandri's samples is consistent with the inhalation of the substance in accordance with the GINA guidelines.
33. Salbutamol is a rapid-acting inhaled beta2-agonist indicated for relief of bronchospasm during acute exacerbations of asthma and for pre-treatment of exercise-induced bronchoconstriction.
34. It is here interesting to note that according to the GINA guidelines, medications to treat asthma can be classified as controllers or relievers. Controllers are medication taken daily on a long-term basis to keep asthma under clinical control. Relievers are medications used "*on a as-needed basis*" that act quickly to reverse bronchoconstriction and relieve its symptoms.
35. It appears that the terms "*as needed*", "*if necessary*", "*al bisogno*" seen on the ATUE/TUE application forms filled on behalf of Mr Filippo Volandri are not just an easy to understand way of expression, but are actually used in medical terms and are consistent with the GINA guidelines.

36. The ITF has successfully established that the presence of salbutamol in Mr Filippo Volandri's samples was in a higher concentration than 1,000 ng/mL. Under the 2008 and 2009 ITF Programmes, the burden of adducing exculpatory circumstances is on Mr Filippo Volandri, who must prove that the abnormal result was the consequence "*of the therapeutic use of inhaled salbutamol*" (Par. S3, appendix 2 to the 2008 ITF Programme) or "*of the use of a therapeutic dose of inhaled salbutamol*".
37. The ITF Tribunal held that the asthma attack on 13 March 2008 was severe as it was potentially life threatening. It held that Mr Filippo Volandri a) took too much salbutamol and b) should have sought medical help as the Player's condition did not improve one hour after the beginning of the asthma attack. In particular, he relied on Dr Fabrizio Gadducci's statements according to which, if after the first hour, normal breathing was not restored, the patient should go to the hospital. The ITF Tribunal concluded that by not complying with those requirements, the Player did not respect the GINA guidelines and the use of salbutamol was therefore not "*therapeutic*". The ITF Tribunal was "*fortified in that conclusion by the fact that the player did not adduce any scientific evidence to show that the amount of salbutamol which he took, according to his best estimate, could have produced a concentration of 1,167 ng/mL in his urine 8-18 hours later*".
38. In the present case, Mr Filippo Volandri has established, on the balance of probabilities, how the specified substance entered his body. It is not contested that the positive findings are the result of the inhalation of salbutamol between 12 and 13 March 2008. It is also not challenged that the Player established, to the comfortable satisfaction of the hearing body, that his ingestion of the specified substance was not intended to enhance his sporting performance or to mask the use of another prohibited substance. However, those accepted facts only allow the Player to benefit from the possible elimination or reduction of the period of suspension (See article M.4 of the 2009 ITF Programme) but are irrelevant with regard to the occurrence or non occurrence of the adverse analytical finding.
39. It is Mr Filippo Volandri's burden to explain that the presence of salbutamol in a concentration of 1,167 ng/mL is consistent with the "*therapeutic*" use of the concerned specified substance. With this respect, Mr Filippo Volandri simply affirmed that, between 12 and 13 March 2008, he only took the amount of salbutamol recommended by the GINA guidelines. Based on the Pocket Guide for Asthma Management and Prevention revised in 2007 by the GINA, the Player submitted that there was an authorized intake of approximately 32 puffs of salbutamol in the 8-18 hours before the providing of his sample on 13 March 2008. The Player alleged that the concentration of salbutamol greater than the 1,000 ng/mL is the inevitable consequence of those puffs. However, he did not offer any scientific evidence whatsoever to support this position. In order to corroborate his allegations, he exclusively produced an "*expert opinion*" issued on 9 February 2009 by F., professor of forensic toxicology, at the institute of forensic medicine in Milan, Italy. This document contains no reference to any scientific literature, no technical data, no indication with regard to F.'s field of expertise or qualifications. The CAS Panel may take into consideration the declarations of F. as mere personal statements, with no additional evidentiary value. This is particularly true as F. was not present at the hearing. The Player chose, although he had the right to bring any witness before the Panel, not to invite him to the hearing, and, therefore, F. was not exposed



to any cross-examination on his opinion by Counsel for the ITF, which should have been a minimum requirement in order to add some weight to his opinion which, as already mentioned, was not supported by any scientific literature, nor any technical data.

40. The CAS Panel considers that Mr Filippo Volandri did not offer any persuasive evidence of how the concentration of 1,167 ng/mL found in his urine could be the result of the therapeutic use of salbutamol. Based upon the evaluation of the foregoing facts, the Player has not succeeded in discharging the onus on him and, hence, must be considered as having committed a doping offence.

B. *Are the sanctions imposed by the ITF Tribunal upon the Player appropriate?*

a) The undisputed facts

- Under the 2008 ITF Programme, salbutamol in a concentration greater than 1,000 ng/mL was qualified as a prohibited substance. The presence of salbutamol in a player's specimen was sanctioned with a two-year period of ineligibility, unless the player could a) establish that the presence is consistent with a therapeutic use exemption (article C.1) and/or b) show "*No Fault or Negligence*" (article M.5.1) or "*No Significant Fault or Negligence*" (article M.5.2) or c) provide assistance in discovering or establishing a doping offence by another person (article M.5.3). There was no other provision in the 2008 Programme that could have given the ITF Tribunal discretion to depart from a two-year ban.
- Under the 2009 ITF Programme, salbutamol, even in a concentration greater than 1,000 ng/mL, is reclassified as "*Specified Substances*", meaning that the hearing body has discretion (assuming it accepted that the Player did not take the medication with intent to enhance his performance or mask the use of a performance-enhancing substance) to impose a sanction of anything from a reprimand up to a two-year period of ineligibility.
- It is accepted that, on the basis of article A.6 of the 2009 ITF Programme, salbutamol must be treated as a specified substance and that the regime of sanction implemented by the 2009 ITF Programme is applicable in the present case. Therefore, Mr Filippo Volandri is entitled to rely on article M.4 of the 2009 ITF Programme ("*Elimination or Reduction of the Period of Ineligibility for Specified Substances under Specified Circumstances*").
- The player has been able to establish how salbutamol entered his body and it is accepted that he inhaled the substance and did not ingest it in any other way. It is also not challenged that the player took salbutamol to treat his asthma and not to enhance his sporting performance. There is no question of masking the use of a performance-enhancing substance in the present case.
- In the event Mr Filippo Volandri is found guilty of a doping offence, his individual results in respect of the 2008 Indian Wells tournament must be disqualified, and in consequence, the prize money and ranking points obtained by him through his participation in that event must be forfeited.

b) In the case at hand:

41. The ITF Tribunal found that the *“player was unwilling to speculate about how many puffs he took, even when pressed by Mr Taylor at the hearing. Our best estimate on the basis of the evidence we have is that he probably took between 10 and 20 puffs overall. It was common ground that one puff corresponds to 100 mcg of salbutamol. Therefore the amount taken corresponds, in our estimation, to between 1,000 and 2,000 mcg”*.

42. Based on the foregoing, the ITF Tribunal concluded *“In the present case, the player was at fault for inhaling too much salbutamol. He ought to have sought medical advice on what dose was therapeutic, just as he ought to have sought medical assistance if he felt his life was at risk”*.

43. The CAS Panel considers the Appealed Decision of the ITF Tribunal as arbitrary, because it harms a feeling of justice and of fairness and because it lacks a plausible explanation of the connection between the facts found and the decision issued.

44. As a matter of fact, the first instance held that because Mr Filippo Volandri took between 10 to 20 puffs of salbutamol, he is *“at fault for inhaling too much salbutamol”*. This is inconsistent with the ITF Tribunal own findings according to which the GINA guidelines determine the appropriate treatment objectively admissible in terms of “therapeutic” use of salbutamol. Based on the said guidelines, Mr Filippo Volandri was allowed to take, during the relevant period of time, much more puffs than “between 10 to 20 overall” as accepted by the ITF Tribunal:

*On 12 March 2008: 2 puffs evening as allowed by the TUE of November 2007*

*During asthma attack: 16 puffs 4 puffs every 20 minutes for the 1st hour as recommended by the GINA guidelines*

*10 puffs 2nd hour as recommended by the GINA guidelines*

*On 13 March 2008: 2 puffs morning as allowed by the TUE of November 2007*

*Before the match: 2 puffs as recommended by the GINA guidelines*

***Total 32 puffs***

45. The Player could have taken up to 32 puffs during the 8-18 hours before the providing of his samples. There is a considerable difference between the figures in accordance with the GINA guidelines and the figures taken into consideration by the ITF Tribunal. Thus, the lower instance has not ascertained objectively how the Player’s degree of fault has been calculated or on what basis it was founded.

46. The ITF Tribunal held that Mr Filippo Volandri should have sought medical help as the asthma attack was life threatening. It was of the opinion that by not going to the hospital, the Player did not follow the GINA guidelines. Further, it found that *“that the player felt able to regain control of his breathing by using the inhaler, without calling for medical help, and that he used his inhaler to the extent needed to regain control of his breathing”*.

47. Again, if “*the extent needed to regain control of his breathing*” amounts to 10-20 puffs, then the Player was within the limits set in the GINA guidelines.
48. Moreover, the life-threatening emergency justifying clinical assistance seems very difficult to assess as Mr Filippo Vollandri was by himself when the asthma attack occurred. Under those circumstances, the CAS Panel does not see how the ITF Tribunal is in a better position than the Player to decide what is right for him. It is accepted by the Player that he called his coach and asked the latter to come to his room. This validates the fact that the situation was somehow out of ordinary. It is also agreed that it was the worse asthma attack the Player has ever dealt with and that the coach suggested to go to the hospital. In contrast, Mr Filippo Vollandri obviously decided that he was able to take care of the problem. This is also in accordance with the GINA guidelines which seek to encourage self-management, that is, to give people with asthma the ability to control their own condition. It appears that after a couple hours, the situation went back to normal.
49. ITF submitted that after an hour following the beginning of the attack, the breathing of Mr Filippo Vollandri did not improve. In order to corroborate this allegation, it refers to the Player’s own brief according to which the coach found the latter “*gasping for breath*”. Here too, the only witnesses are the Player himself and his coach. At what precise time did the coach arrive? What does “*gasping for breath*” actually mean? Does it mean that the respiratory distress was greater than the one usually observed by asthmatic people under asthma attack? Was the coach impressed by a situation he is not familiar with? How much longer was the Player “*gasping for breath*” after the arrival of his coach? How many puffs did the Player take on the arrival of his coach? How is the life-threatening situation compatible with the fact that the only testimony on the event is the one of the Player who described it during his cross-examination in front of the ITF Tribunal in the words: “***I was a little concerned about the situation?***”, and how is the life-threatening situation compatible with the fact that the Player was able to play his match 8 hours later, and, most of all, with the fact that the coach left just an hour after he joined the Player in his room, *i.e.* less than two hours following the beginning of the asthma attack? Under such circumstances, how can the ITF Tribunal qualify the asthma attack as “*severe*” and not just “*mild*”? With this regard, and according to the GINA guidelines, milder exacerbations are defined by a reduction in peak flow of less than 20% and nocturnal awakening. Why does this definition not fit the events of the 13 March 2008?
50. The fact that the above questions, that could lead to a better understanding of the circumstances and the facts and to a more accurate assessment of the severance of the event, did not find an answer cannot be blamed on Mr Filippo Vollandri as he was informed of the positive findings only on 25 July 2008, that is more than 4 month after the sample collection. Despite of the facts that those questions remain unanswered, the ITF Tribunal felt comfortable to come to the conclusion that Mr Filippo Vollandri violated the Gina guidelines by not going to a hospital. It is obvious to the CAS Panel that the lower instance has assumed that the Player was at high risk of asthma-related death, which is arbitrary and purely speculative.

51. Furthermore, the ITF Tribunal has not explained how or why Mr Filippo Vollandri did not respect the GINA guidelines when *“he probably took between 10 and 20 puffs overall”* nor has it established that the Player had to get medical help. Under such circumstances, the CAS Panel does not see on what basis the ITF Tribunal imposed such harsh sanctions upon the Player.
52. As a result, the CAS Panel considers that it has no duty of deference towards the holdings of the ITF Tribunal.
53. The CAS Panel observes that Mr Filippo Vollandri was indeed at fault, as he has not been able to prove that the presence of salbutamol in his sample in excess of 1,000 ng/mL was the consequence *“of the therapeutic use of inhaled salbutamol”*. However, the degree of his fault is minor as the threshold of 1,000 ng/mL was just exceeded. If, as ascertained by the ITF Tribunal itself, one puff corresponds to 100 mcg of salbutamol, the litigious excess represents less than a couple of puffs. Furthermore, the CAS Panel cannot ignore the fact that the Player traveled all the way to California to take part in a tournament, that he was far from home, a few hours away from a match, in the very early morning. After having put all that effort into coming to play, it is understandable that Mr Filippo Vollandri decided not to go to the hospital as it would probably have kept him from playing.
54. However, in assessing the appropriate sanction, the CAS Panel also took the following factors into account. First, Mr Filippo Vollandri has never previously been found guilty of an anti-doping rule violation. This, of itself, is of comparatively little weight: the same point can be made for any first-time offender. Secondly, however, and more importantly, the CAS Panel has been concerned that the procedures before the ITF were slow and suffered from inconsistencies, with the result that the Player was left in a state of uncertainty of over 8 months, which is very long in sporting matters. As a matter of fact, it is only on 13 November 2008 that the Player was formally charged with a doping offence. Before then, Mr Filippo Vollandri received information from the ITF which is to some extent contradictory and may also be confusing:
  - The litigious samples collection occurred on 13 March 2008; the positive findings were known on 9 April 2008 but communicated to the Player on 25 July 2008. Between the sampling and the communication of its results, the Player was able to take part in 12 tournaments and to undergo 3 anti-doping tests (which were all negative).
  - On 25 July 2005, the Player was requested by the ITF to explain the presence of the important concentration of salbutamol found in his urine in March 2008. The same day, Mr Filippo Vollandri wrote to the ITF to give his version of the facts. It is only on 18 September 2008 that the ITF reacted to the Player’s mail. Between those two dates, the Player took part in at least four more tournaments.
  - On 8 October 2008, the Anti-Doping Programme Administrator of the ITF Programme wrote to the Player a letter with very ambiguous terms, which could easily be misleading: *“For the avoidance of any doubt, (1) you have not yet been formally charged with the commission of a Doping Offence; and (2) unless and until you are charged and you have formally admitted committing a Doping Offence, or you have been found by Anti-Doping Tribunal to have committed a Doping Offence, you will not be deemed to have committed such an offence. Nor will any*

*provisional period of ineligibility be imposed upon you and you will remain free to compete. (See Article J.4.1 of the Programme)” (emphasis added).*

- Finally a notice of charge was addressed to Mr Filippo Volandri on 13 November 2008. Between 18 September and 13 November 2008, the latter played in three more tournaments.
55. Although the ITF knew of the adverse analytical findings, it chose not to inform Mr Filippo Volandri and to let the latter take part in 19 tournaments before formally charging him with a doping offence. Such a long period is unacceptable and incompatible with the intention of the anti-doping regime that matters should be dealt with speedily. The Panel was taken aback when it saw that on 18 September 2008 (more than 6 months after the sampling collection) the ITF requested Mr Filippo Volandri to provide details on a) the time at which he last urinated prior to providing sample on 13 March 2008, b) the time(s) at which he used his inhaler on 13 March 2008 and c) the number of puffs he took on each of those occasions. It is obvious that the Player was not in the position to answer to such questions precisely, because of ITF’s fault and was therefore deprived of the right to fair evidence proceedings, which emerges from the right to be heard, the right to a fair trial and the principle of equal treatment, which are fundamental and which were disregarded in the present case.
56. Based on the above considerations, the Panel is of the opinion that fairness requires that a) a reprimand is imposed upon Mr Filippo Volandri, b) that no period of ineligibility is imposed on the Player and c) that his individual result in respect of the 2008 Indian Wells tournament only is disqualified, and in consequence, the prize money and ranking points obtained by him through his participation in that event are forfeited.

**The Court of Arbitration for Sport rules that:**

1. The appeal of Mr Filippo Volandri against the decision of the ITF Independent Anti-Doping Tribunal dated 15 January 2009 is partially upheld.
2. The decision issued by the ITF Independent Anti-Doping Tribunal on 15 January 2009 is set aside.
3. On these grounds:
  - a. Mr Filippo Volandri is found guilty of the anti-doping offence specified in the notice of charge set out in the ITF’s letter to the player dated 13 November 2008.
  - b. A reprimand is imposed upon Mr Volandri.
  - c. No period of ineligibility is imposed on Mr Volandri.

- d. Mr Volandri's individual result in respect of the 2008 Indian Wells tournament only is disqualified, and in consequence, the prize money and ranking points obtained by him through his participation in that event are forfeited.
  - e. All of Mr Volandri's results (including ranking points and prize money) in all competitions subsequent to the 2008 Indian Wells tournament shall remain undisturbed.
4. (...)
  5. All other motions or prayers for relief are dismissed.

## **LEGAL AUTHORITY CA-74**

3. In the particular circumstances of the case, this finding of illegality does not inevitably involve a declaration that a provision of Regulation (EEC) No 1125/74 is invalid. The illegality of Article 5 of Regulation (EEC) No 1125/74 cannot be removed merely by the fact that the Court, in proceedings under Article 177, rules that the contested provision was in part or in whole invalid. As the situation created, in law, by Article 5 of Regulation (EEC) No 1125/74 is incompatible with the principle of equality, it is for the competent institutions of the Community to adopt the measures necessary to correct this incompatibility.

In Joined Cases 117/76 and 16/77,

Reference to the Court under Article 177 of the EEC Treaty by the Finanzgericht Hamburg for a preliminary ruling in the actions pending before that court, in Case 117/76 between

The consortium of:

1. ALBERT RUCKDESCHEL & Co., Kulmbach (Germany),
2. HANSA-LAGERHAUS STRÖH & Co., Hamburg,

and

HAUPTZOLLAMT HAMBURG-ST. ANNEN

and, in Case 16/77, between

DIAMALT AG, Munich,

and

HAUPTZOLLAMT ITZENHOE,

on the validity of Article 11 of Regulation No 120/67/EEC of the Council of 13 June 1967 on the common organization of the market in cereals (OJ English Special Edition 1967, p. 33) as last amended by Regulation (EEC) No 665/75 of 4 March 1975 (OJ L 72, p. 14) and of Article 1 of Regulation (EEC) No 1955/75 of the Council of 22 July 1975 on production refunds in the cereals and rice sectors (OJ L 200, p. 1) and, if need be, of Article 11 of Regulation (EEC) No 2727/75 of 29 October 1975 on the common organization of the market in cereals (OJ L 281, p. 1) in so far as these measures make no provision for a production refund for maize used in the manufacture of quellmehl of an amount equivalent to that of the refund granted for the processing of this product into starch,



## THE COURT

composed of: H. Kutscher (President), M. Sørensen and G. Bosco, Presidents of Chambers, A. M. Donner, P. Pescatore, J. Mertens de Wilmars, Lord Mackenzie Stuart, A. O'Keefe and A. Touffait, Judges,

Advocate-General: F. Capotorti  
 Registrar: A. Van Houtte

gives the following

## JUDGMENT

### Facts and issues

The facts of the case, the course of the procedure and the written observations submitted under Article 20 of the Protocol on the Statute of the Court of Justice of the EEC may be summarized as follows:

#### I — Facts and written procedure

1. Quellmehl, a product processed from maize, common wheat or broken rice, and pre-gelatinized starch, which is processed from the same basic products, are to some extent in competition with each other, their common feature being that they are both used as an aid to baking, more specifically as leavening in the making of rye bread.

2. Regulation No 19 of the Council of 4 April 1962 on the progressive establishment of the common organization of the market in cereals (JO of 20. 4. 1962, p. 933), introduced a system of levies for certain cereal products. Article 24 of the regulation provided however that the Council might adopt measures derogating from those provisions.

Such measures had been adopted by Regulation No 55 of the Council of 30 June 1962 relating to the system in respect of processed products based on cereals (JO of 2. 7. 1962, p. 1583). Article 17 of that regulation had established the system of discretionary refunds for certain starches. The thirteenth recital in the preamble to the regulation reads as follows:

'Whereas because of the special situation on the market in starches and in particular the need for that industry to keep prices competitive with those for substitute products, it is necessary by way of derogation from the provisions ... of Regulation No 19 of the Council, to ensure by means of a production refund that the basic products used by the industry are made available to it, at a lower price than that which would result from applying the system of levies...'

Regulation No 141/64/EEC of the Council of 21 October 1964 concerning the rules applying to processed products derived from rice and other cereals (JO of 27. 10. 1964, p. 2666) had continued the system of discretionary production

refunds. It had however established for the first time a production refund for maize and common wheat used in the quellmehl industry.

Regulation No 142/64/EEC of the Council of 21 October 1964 providing for the extension and adjustment to 31 March 1965 of the limitations on the production refunds for cereal and potato starch (JO of 27. 10. 1964, p. 2673) and fixing the refunds provided for under Regulation No 141/64/EEC accordingly provided in Article 1 (1) (e) thereof that:

'In the case of quellmehl the refund for maize, common wheat and broken rice used in the manufacture of that product shall be the same as that granted for the same cereals used for starch manufacture.'

The system established by the definitive basic Regulation No 120/67/EEC of the Council of 13 June 1967 on the common organization of the market in cereals (OJ English Special Edition 1967, p. 33) made the grant of the production refund compulsory. In the tenth recital in the preamble to that regulation it is *inter alia* stated

'Whereas ... because of the interchangeability of starches with quellmehl and maize groats and meal, production refunds should also be granted in respect of the latter products;'

Article 11 (1) of the regulation reads:

- '1. A production refund shall be granted:
- (a) for maize and common wheat used by the starch industry for the manufacture of starch and quellmehl;
  - (b) for potato starch;
  - (c) for maize used in the maize industry for the manufacture of maize groats and meal (gritz) used by the brewing industry.

Regulations Nos 178/67/EEC of 27 June 1967, 371/67/EEC of 25 July 1967 of the

Council, fixing the production refunds for starch, potato starch and quellmehl (JO of 28. 6. 1967, p. 2617 and of 31. 7. 1967, p. 40) maintained this parity between starch and quellmehl.

The production refund for quellmehl was maintained until 1 August 1974 with effect from which date it was abolished by Regulation (EEC) No 1125/74 of the Council of 29 April 1974 amending Regulation No 120/67/EEC (OJ L 128 of 10. 5. 1974, p. 12). However the refunds for maize, common wheat and broken rice used for the manufacture of starch and consequently pre-gelatinized starch continued to be granted.

The third and fourth recitals in the preamble to the latter regulation stated that:

'the production refund for quellmehl was initially granted with a view to promoting certain specific uses of quellmehl as a food for human consumption, account being taken of the possibility of its competing with a number of other products;'

and that

'experience has shown that the opportunity for such substitution is economically slight, if not non-existent; ... the production refund for quellmehl should therefore be abolished;'

Regulation (EEC) No 1132/74 of the Council of 29 April 1974 on production refunds in the cereal and rice sectors (OJ L 128 of 10. 5. 1974, p. 24), which fixed the refunds provided for by Regulation (EEC) No 1125/74, resulted in the reduction of the production refund for maize and common wheat used for the manufacture of starch to 24.60 units of account per metric ton [hereinafter called 'tonne']. In order to give a reason for the maintenance of the refund for starch manufacture, the second recital in the preamble to the regulation states *inter alia* that

'a precise assessment of the situation resulting from the level of common prices and from the competition between, on the one hand, maize starch, rice starch, potato starch and, on the other, the substitute chemical products, indicates that the refund should be fixed at such a figure that the price of maize used in starch manufacture is brought down to 8.20 u. a. per 100 kg...'

Regulation (EEC) No 3113/74 of the Council of 9 December 1974 amending Regulation (EEC) No 1132/74 on production refunds in the cereals and rice sectors (OJ L 332, p. 1) resulted in a subsequent reduction (to 15.55 u. a. per tonne) of the refund granted for maize for the manufacture of starch.

Regulation (EEC) No 665/75 of the Council of 4 March 1975 amending Regulation (EEC) No 120/67/EEC (OJ L 72 of 20. 3. 1975, p. 14) which entered into force on 1 August 1975 made, *inter alia*, the production refund for cereals used in the manufacture of starch no longer compulsory. Moreover the regulation abolished the production refund for maize groats and meal (gritz) used by the brewing industry.

In Regulation (EEC) No 1955/75 of the Council of 22 July 1975 on production refunds in the cereals and rice sectors (OJ L 200 of 31. 8. 1975, p. 1) which also entered into force on 1 August 1975, the production refund on, *inter alia*, maize for the manufacture of starch was once more reduced and fixed at 10 u. a. per tonne.

3. The respective plaintiffs in the main actions, who are producers of quellmehl, applied to the respective defendants in the main actions on 22 July (Case 117/76) and 15 August (Case 16/77) 1975 for a permit relating to the grant of a production refund for maize used for the manufacture of quellmehl. These applications were rejected on the ground that Community regulations no longer

provided for the grant of production refunds for quellmehl.

The plaintiffs in the main actions brought the present proceedings before the Finanzgericht Hamburg against these decisions rejecting the applications.

Before that court, the plaintiffs in the main actions urged in particular that the prohibition of discrimination laid down in the second subparagraph of Article 40 (3) of the Treaty has been infringed in so far as a production refund was granted only for pre-gelatinized starch and not for quellmehl, a product which is in competition with starch.

The defendants in the main actions contended that the applications should be dismissed.

4. Holding that the cases raised questions of interpretation of Community law the Finanzgericht Hamburg, by orders of 8 November 1976 and 18 January 1977, stayed the proceedings and requested the Court of Justice under Article 177 of the EEC Treaty to give a preliminary ruling on the following questions:

- '1. Do Article 11 of Regulation No 120/67/EEC as last amended by Regulation (EEC) No 665/75 of 4 March 1975 (OJ L 72 of 20. 3. 1975, p. 14) and Article 1 of Regulation (EEC) No 1955/75 of 22 July 1975 (OJ L 200 of 31. 8. 1975, p. 1) or does Article 11 of Regulation (EEC) No 2727/75 of 29 October 1975 (OJ L 281 of 1. 11. 1975, p. 1) infringe the prohibition of discrimination contained in Article 40 (3) of the EEC Treaty and are they invalid in so far as they do not grant a production refund of the same amount on maize for the manufacture of quellmehl as they do for the processing of this product into starch?
2. If the answer to Question 1 is in the affirmative, have manufacturers of quellmehl a direct claim to the same

production refund as the manufacturers of pre-gelatinized starch or is a legal measure adopted by the Council required for this?

5. In the grounds for the orders making the reference the Finanzgericht Hamburg made, *inter alia*, the following comments:

‘The determination of this dispute turns on the question whether the abolition of the production refund on maize for the manufacture of quellmehl is invalid because it infringes the prohibition of discrimination in Article 40 (3) of the EEC Treaty.

‘There might under Community law be prohibited discrimination if — as the plaintiff maintains — quellmehl and pre-gelatinized starch are interchangeable as aids to baking in the baking industry and if as a result of the abolition of the production refund for quellmehl on the one hand and the retention of the production refund for pre-gelatinized starch on the other hand quellmehl is no longer competitive and has been ousted from its former market. The recitals in the preamble to Regulation No 120/67/EEC state that a production refund should be granted because of the inter-changeability of starches with quellmehl. Accordingly if the purpose of the production refund is the interchangeability of the products, there might be discrimination against the plaintiff in connexion with the manufacture of quellmehl if and in so far as a production refund is granted on the raw materials used in the manufacture of pre-gelatinized starch, because from the point of view of technology, economics and price quellmehl and pre-gelatinized starch are interchangeable. The plaintiff submits that the recital in the preamble to Regulation (EEC) No 1125/74, which states that the production refund for the manufacture of quellmehl should be abolished, because experience has shown that the opportunity for such substitution is economically slight, if not

non-existent, does not correspond to the facts.

‘The adjudicating Senate finds that it is unable to ascertain and review the actual prerequisites for the abolition of the production refund in connexion with the manufacture of quellmehl, in order to be able to decide accordingly whether there is any prohibited discrimination against the plaintiff and other similar undertakings. The recitals in the preamble to Regulation (EEC) No 1125/74 disclose that those responsible for the regulation were in possession of information, which is not available to the court, to the effect that quellmehl as a substitute product in fact was not or was only to an economically insignificant extent in competition in the territory of the EEC with products containing starch. Since the plaintiff contests this, with supporting evidence, the question arises whether Regulation (EEC) No 1125/74 is valid in so far as it relates to the abolition of the production refund on quellmehl, since it may infringe Article 40 (3) of the EEC Treaty. The adjudicating Senate therefore considers that a ruling by the European Court of Justice is necessary in the interest of a uniform application of Community law.

If the Court of Justice should come to the conclusion that the abolition of the production refund on quellmehl is invalid, then there remain doubts as to the legal basis upon which the plaintiff can satisfy its claim and as to the formal conditions which have to be fulfilled. For this reason it has been necessary to refer Question 2.’

6. The orders making the references were registered at the Court Registry on 10 December 1976 and 31 January 1977 respectively.

In accordance with Article 20 of the Protocol on the Statute of the Court of Justice of the EEC, written observations were submitted by the plaintiffs in the main actions, the plaintiff in Case 117/76

being represented by the Chambers of Fritz Modest, Hamburg, the plaintiff in Case 16/77 being represented by E. Eckelt, A. Kallenbach and K.-D. Rathke, Advocates, of Augsburg, and by the Council, represented by Daniel Bignes, Director of its Legal Service, assisted, in Case 16/77, by Felix Van Craeynest, Principal Administrator of the said service and by the Commission, represented by its Legal Advisers Peter Kalbe and Götz zur Hausen, acting as Agents.

By order of 25 May 1977 the Court decided to join the cases for the purposes of the procedure.

After hearing the report of the Judge-Rapporteur and the views of the Advocate-General the Court decided to open the oral procedure without any preparatory inquiry.

Nevertheless the Court requested the parties, the Council and the Commission to give certain explanations in writing either before or during the hearing.

## II — Written observations submitted to the Court

### *The first question*

1. (a) The *plaintiffs in the main actions* point out first of all that quellmehl does not have the same importance in the other Member States as in Germany. On the other hand it is not correct to claim, as the defendants in the main actions have done, that quellmehl is of importance only in Germany.

(b) From the technical point of view quellmehl and pre-gelatinized starch are interchangeable and equal from the point of view of their use as aids to the baking of products made from rye flour.

(c) Where there is free competition as regards prices, quellmehl has a slight

advantage over pre-gelatinized starch. This advantage amounts to less than the production refund paid in respect of maize starch. On the other hand the advantage is so marked that in the first place, the baking industry and bakers prefer quellmehl-based aids to baking and, secondly, the starch industry no longer disputes that advantage because it has other ways of selling its starch. The grant of a production refund of the same amount as for maize and rice processed into quellmehl or starch has enabled quellmehl to retain intact its competitive advantage over pre-gelatinized starch.

(d) The reasons advanced to justify the abolition of the production refund granted for the manufacture of quellmehl and the retention of the refund for starch are untrue.

(e) It is only because the allocation of a production refund of an equivalent amount enables the natural competitive situation between pre-gelatinized starch and quellmehl to be maintained that pre-gelatinized starch has not ousted quellmehl from the market in baking aids for rye-flour-based products.

(f) The abolition of the production refund for quellmehl created a fundamental change in the competitive situation which naturally exists between quellmehl and pre-gelatinized starch; after it was abolished pre-gelatinized starch could be offered on the market at a lower price than quellmehl.

According to the plaintiff in the main action in Case 117/76 it is because the manufacturers of quellmehl and of ingredients of quellmehl-based baking products paid the production refund out of their own pockets that they have been able, in the main, to maintain their position on the market.

The plaintiff in the main action in Case 16/77 considers that the level of prices subsequent to the abolition of the

production refund led to a reduction of more than 70 % in the turnover in quellmehl-based products. It adds that the selling price of quellmehl cannot, on the most conservative estimate, be less than DM 100 per 100 kg. On the other hand pre-gelatinized starch made from maize or wheat is at present already being offered at from DM 85 per 100 kg free at destination. The two biggest manufacturers of quellmehl-based ingredients of baking products have suffered a reduction in their turnover in one case of 7.5 % in 1975, compared with 1974, in the other case of 40 % in 1976, compared with 1974. In the case of the two undertakings referred to this reduction in sales has, apart from the abolition of the production refund, resulted in a substantial reduction in the cover for overheads (Deckungsbeiträgen). The plaintiff in the main action in Case 16/77 points out that, until the spring of 1975, the two manufacturers still held their stocks of maize for which production refunds had been granted before entry into force of the contested regulation. The result is that the reduction in the cover for overheads (Deckungsbeiträgen) has become more marked. The manufacturers of quellmehl are suffering losses or, according to circumstances, a considerable reduction in their income and the sole reason for this is to be found in the fact that a production refund is paid for the manufacture of pre-gelatinized starch, whereas, in contrast to this, none is paid for the manufacture of quellmehl.

(g) According to the official statement of the grounds, a production refund for maize, rye and potato starch appears to be required only to enable the starch industry to compete with chemical substitute products. This is an admission that it is not necessary in so far as starch is sold for use in connexion with food for human consumption. Despite this, the production refund is granted for products used in the manufacture of starch without regard to the sector in which the starch is sold.

According to the plaintiffs in the main actions it is possible to restrict the allocation of a production refund for the processing of maize, rice and potatoes used in the manufacture of starch inasmuch as this starch is intended for the industrial sector and is in competition with chemical substitute products.

(h) There is also an unofficial reason for the abolition of the production refund for quellmehl: that a great deal of quellmehl based on maize and rice is sold for animal feed and its use for this purpose is an abuse which must be redressed by abolishing the production refund.

The plaintiffs in the main actions dispute this statement. The association of manufacturers of ingredients for baking products has declared that its members have never sold quellmehl for animal feed. There still exist in the Federal Republic of Germany one or two small undertakings which do not belong to the association of manufacturers of ingredients for baking products but their output is not very great. Outside Germany, there is an undertaking manufacturing quellmehl in Denmark and there are one or two in the Netherlands, but their output is insignificant. But even if these undertakings were to have sold quellmehl for use as animal feed such sales would still have been of comparatively little importance.

They go on to say that the Community regulations on production refunds for the two products in question did not prohibit sale of those products for animal feed. Nor is the production refund restricted to quellmehl or starch used for human consumption or for chemical products.

Unlike quellmehl, large quantities of maize starch are in fact sold for animal feed. But a production refund continues to be granted even for starch used in the animal feed industry.

(i) In the same way as the production refund can be restricted to starch used in industry for chemical purposes, it can, in the case of quellmehl or starch, be restricted exclusively to cases where these products are used for human consumption.

It is not difficult for control to be effectively exercised. The unofficial reason for the abolition of the production refund does not therefore stand up to scrutiny on any count.

(j) The plaintiff in the main action in Case 16/77 refers furthermore to the fact that the need to reduce the budget of the Community was also used as an excuse to justify the abolition of the production refund for quellmehl. It finds this argument unconvincing: in the first place the production refund granted hitherto for the manufacture of quellmehl is of little importance compared with the total volume of production refunds and also with the production refund for the manufacture of starch. Secondly, there is no doubt that it is perfectly possible to abolish the production refunds. Nevertheless, when account is taken of the principle of non-discrimination, this could only lead to the abolition of the production refund both for the manufacture of quellmehl and for the manufacture of pre-gelatinized starch. Finally, it would not be possible to effect any saving in the budget of the Community for the simple reason that, as is shown by the state of the market, after the abolition of the refund for quellmehl, pre-gelatinized starch, for the manufacture of which a production refund is granted, would be used in its place.

(k) Finally the plaintiffs in the main actions contend that there is no substantial ground for abolishing the natural disparity between the competitiveness of the two products in question. Contrary to the contention of the defendant in the main action, it is not true that there is discrimination only

if quellmehl is of economic importance in the food industry throughout the Common Market. There are in the Community production refunds which benefit only the undertakings in certain Member States such as the aid to durum wheat, colza and olive oil.

(l) Moreover, in the case of the quellmehl manufacturers concerned, discrimination is appreciable and substantial and even if discrimination were minimal the *de facto* situation would not justify it.

The plaintiffs in the main actions accordingly request the Court to answer the first question of the Finanzgericht to the effect that the provisions mentioned therein are contrary to the prohibition of discrimination laid down in Article 40 (3) of the Treaty and are null and void in so far as they make no provision for a production refund for maize used in the manufacture of quellmehl up to the same amount as that of the refund granted for the processing of this product into starch.

2. (a) The *Council and the Commission* point out in the first place that, in Case 117/76, the plaintiff in the main action lodged its application on 22 July 1975, that is to say, during the 1974/75 marketing year, while in Case 16/77 the application was lodged on 15 August 1975 and therefore during the 1975/76 marketing year.

In consequence, any entitlement to the refunds and the amounts of the refunds depend, in Case 117/76, on Regulations (EEC) Nos 1125/74, 1132/74 and 3113/74 of the Council and on Regulation (EEC) No 2518/74 of the Commission of 4 October 1974 (OJ L 270, p. 1) and, in Case 16/77, on Regulations (EEC) Nos 1125/74, 665/75 and 1955/75 of the Council.

(b) According to the *Council*, quellmehl and pre-gelatinized starch are to some extent interchangeable in particular when used as baking materials in the manufacture of rye bread. However

because of its different properties quellmehl is more useful than pre-gelatinized starch. It has a greater capacity to absorb water; apart from starch it contains other raw material constituents which are of nutritional value; the process enabling it to be extracted from the raw material is a relatively simple physical operation whereas the manufacture of starch employs a technique which involves relatively more work; and the raw material extraction level is higher. The effect of these advantages is to make quellmehl from 15 to 20 % cheaper than pre-gelatinized starch, which is far more than the amount of the refund which pre-gelatinized starch continued to receive until the 1975/76 marketing year.

Thus the abolition of the subsidy would not have abolished the advantages as regards price and quality which quellmehl enjoys in terms of the manufacture of cooking agents.

(c) As the result of the oil crisis, prices of products competing with starch went up and in consequence did not compete so strongly against starch which, in turn, became a weaker competitor against quellmehl. The competitive pressure of imported processed products was also weaker. Moreover the maize market itself felt the repercussions of the world increase in the prices of cereals and there was less need to protect the processing industries of the Community. Again, the fact that the manufacture of starch is much more costly and complex than that of quellmehl also resulted in making the production costs of starch markedly more sensitive to the increase in investment costs and in labour costs. Finally, the Community realized that quellmehl was no longer put solely to its traditional use, baking, but that, owing to the refund, it was used as a constituent of animal feed. But these developments, which arose from the refund, do not fall within the objectives of the common agricultural policy for the purposes of which the refund was introduced.

It was because it was aware of this state of affairs that the Council reduced the refund for starch (in Regulations (EEC) Nos 1132/74, 3113/74 and 1955/75), made it discretionary (in Regulation (EEC) No 665/75) and abolished it for quellmehl (in Regulations (EEC) Nos 1125/74 and 1132/74).

(d) To grant a refund for starch is consistent with the provisions of Article 39 (1) (c) and (d) of the Treaty. Conversely, because of the use of quellmehl as animal feed, the abolition of the refund for this product furthers the objective designed to limiting the common agricultural policy 'to pursuit of the objectives set out in Article 39' (second subparagraph of Article 40 (3) of the Treaty).

(e) With regard to the alleged infringement of the rule against discrimination, the Council contends that to treat dissimilar situations differently does not amount to discrimination. The grant of a production refund for starch is justified by the state of the market in this product and by its key position between the common agricultural market and the common industrial market. Quellmehl, however, is in a different position. The grant of a refund for quellmehl is in the first place unnecessary as protection for its traditional outlets since the refund granted for pre-gelatinized starch has on several occasions been considerably reduced and, secondly, unjustified inasmuch as it helps to create an unintended outlet by way of animal feed. This different position justifies different treatment despite the fact that the two products concerned are to some extent in competition.

(f) The Council also states that even if, in the past, quellmehl and starch have in general received the same treatment this does not constitute a right to the same treatment, as claimed by the plaintiffs in the main actions. In this connexion the Council refers to the various grounds



which it has already given and which, it declares, have now ceased to exist, however much they may have justified this identity of treatment in the past.

This is clear from the fourth recital in the preamble to Regulation (EEC) No 1125/74 which gives grounds for the abolition of the payment of a refund for quellmehl and begins to reduce it for starch. The reduction to 10 u.a. per tonne of the refund for starch restored the natural superiority of quellmehl as a cooking agent.

(g) In terms of law, the Council refers to the decisions of the Court since its judgment of 17 July 1963 in Case 13/63 *Italy v Commission* [1963] ECR 165 which laid down that it is not discriminatory to treat dissimilar situations differently. The Council also refers to paragraph 22 of the judgment of the Court of 11 July 1974 in Case 11/74, *Union des Minotiers de la Champagne v France* [1974] ECR 877, according to which difference in treatment cannot be regarded as constituting discrimination which is prohibited unless it appears arbitrary.

In the Council's view it appears to be clear from the facts which it has set out, especially from those relating to the natural superiority of quellmehl from the competitive point of view and its use in the manufacture of animal feed, which is contrary to the original object of the subsidy, that it was not guilty of arbitrary discrimination in Regulation (EEC) No 1125/74 (1974/75 marketing year, Case 117/76) or in Regulations (EEC) Nos 665/75 and 1955/75 (1975/76 marketing year, Case 16/77). The same applies to Regulation (EEC) No 2727/75, which was effective only from 1 November 1975.

3. (a) The *Commission* states that the abolition of the production refund for quellmehl is only one aspect of the comprehensive change in the Community's subsidies policy in the case of products processed from cereals, one

of the consequences of which is the reduction of refunds for starch. A charge of discrimination cannot therefore be based on the abolition *per se* of refunds in the case of quellmehl but at most on the fact that the refund granted for pre-gelatinized starch was not abolished in its entirety.

(b) From the legal standpoint the Commission contends that an economic decision of the same kind as the contested measure cannot be discriminatory unless it was based on considerations which are manifestly erroneous; judgment of the Court of 24 October 1973 in Case 43/72, *Merkur v Commission* [1973] ECR 1055.

(c) The Commission accordingly sets forth the considerations on which the contested measures were based: the financial burdens of the common agricultural policy had to be reduced; price arrangements under the system of production refunds had to be adjusted to economic realities: the supply price (the basis of calculation of the production refund, which represents the difference between this price and the Community threshold price) had not followed the trend of market and threshold prices, which was steadily rising and the refunds were, in consequence, practically doubled; and, because of the increase in the price of synthetic products which are in competition with cereal-based starch as the result of the rise in price of oil products, consideration was being given to the need for a fundamental reappraisal of the policy of granting refunds.

(d) Because starch was in competition with synthetic substitute products, the Council did not abolish production refunds for starch but merely reduced the relevant amounts.

(e) In consequence the question arose whether the timing of the reduction in the production refund for quellmehl should be the same as in the case of starch.

An analysis of the competitive position of these two products disclosed vital differences which made it unnecessary to keep the regulations governing the refund so completely in parallel as they had been hitherto. The explanation why quellmehl and starch are treated alike in Article 11 of Regulation No 120/67/EEC lies in the political argument of the 'preservation of the acquired rights' of quellmehl manufacturers rather than in economic necessity and the similarity of economic conditions. In this connexion it must be borne in mind that the manufacture of quellmehl has benefited from a German internal subsidy since 1930.

(f) The amount of the refunds is based on the overall assumption that 161 kg of maize are required for the manufacture of 100 kg of starch. On the other hand the extraction rate for quellmehl is, at most, between 102 and 110 kg and the manufacture of quellmehl involves much less work and requires much less technical knowhow than the manufacture of starch.

Furthermore, cereals themselves need not necessarily serve as raw material for quellmehl. All the other cheaper starch-producing products of the milling industry can be used.

(g) The interchangeability of the two products in question has, in practice, been hitherto of little importance.

On this point the Commission quotes the plaintiff in the main action in Case 16/77 as follows:

'... quellmehl has better technical qualities. The capacity to absorb water in particular ... is higher in the case of quellmehl; ... quellmehl has better qualities from the nutritional point of view ... ;'

'... In the end, however, the choice between the two products is only a matter of price since the use of a greater

quantity of pre-gelatinized starch makes it possible to obtain absolutely the same capacity to absorb water ...'

Given that the cost price of the raw material is the same, the refund, adapted to the needs of starch manufacture, has over-subsidized the already cheaper production of quellmehl. This difference in price, together with the ability to use cheaper low grade flour, makes it possible for the quellmehl industry to invade the market in animal feed.

It is for this reason that the Community institutions reached the conclusion that there was no compelling reason to adhere to the principle of strict equality of treatment between the manufacturers of quellmehl and manufacturers of starch.

In view of the substantial reductions which took place in the production refunds for starch simultaneously with the abolition of the refund for quellmehl, there is no reason to suppose that great and irreparable harm would be done to the competition with pre-gelatinized starch.

In the animal feed industry, the higher prices of maize as a raw material could have been easily offset by the use of lower-grade flours which are cheaper.

Similarly, there is little reason to suppose that pre-gelatinized starch is forcing rye-flour cooking agents out of the traditional market. Pre-gelatinized starch is certainly coming to supersede quellmehl but not specific cooking agents because it does not possess their qualities.

(h) Nor is there any reason to fear that the natural advantage possessed by quellmehl-based products in terms of competition will be reversed as a result of the undue advantage granted to pre-gelatinized starch in terms of price.

The increase in the price of raw material caused by the abolition of the refund is

not reflected fully but only in part in the price of quellmehl, which is also considerably influenced by other factors. The effect of this increase on the price of cooking agents ready to be marketed, like those manufactured by the plaintiffs in the main actions, is even less significant.

Similarly the reduction, owing to the maintenance of refunds, in the price of maize as a raw material compared with the cost price of quellmehl has only a partly favourable effect on the price of pre-gelatinized starch as the finished product.

Price fluctuations due to changes in the amount of the refunds amount to discrimination only if they cause the price of quellmehl to rise appreciably above that of starch.

Like quellmehl producers, the starch manufacturing industry had to bear substantial price increases for maize as its raw material. The advantage which that industry enjoyed in terms of price compared with quellmehl manufacturers lay only in the maintenance of a lower production refund. The amount of the refund which, in the beginning, was as much as 20.40 units of account per tonne fell to 18.45 units of account per tonne in July 1975 and, after August 1975, to 10 units of account per tonne. This was not enough even to come within reach of the advantage of at least DM 100 which quellmehl previously enjoyed as a finished product.

Nor has experience gained in the meantime supplied any evidence of competition which makes it possible for pre-gelatinized starch to replace quellmehl because of the refunds it receives.

### *Second question*

1. The *plaintiff in the main action* in Case 117/76 states that, in the present case, discrimination can be eliminated retroactively by granting, with retroactive

effect, the production refund for the manufacture of quellmehl from maize and rice up to an amount equal to that granted for the manufacture of starch from maize and rice during the same period.

The plaintiff in the main action in Case 16/77 adds that if Regulation (EEC) No 1125/74 is annulled it will mean that Article 11 of Regulation No 120/67/EEC, as it was worded before the entry into force of Regulation (EEC) No 1125/74, is again valid in so far as it governs the production refund for maize used in the manufacture of quellmehl.

The second paragraph of Article 215 of the Treaty has the same legal effect. The principle that the person responsible for the damage should, in the first place, restore the situation to what it would have been if the event causing the damage had not taken place is one of the general principles relating to the liability of the Community for damage caused by its institutions. The same principle is illustrated by the right to have the consequences made good, which is recognized in administrative law and is also common to the legal systems of the Member States.

The plaintiffs in the main actions accordingly request the Court to give an affirmative answer to the second question.

2. The *Council* contends that, even if the Court finds that a set of regulations is legally invalid, it may not put itself in the place of the Community legislature in the exercise of the powers of discretion conferred upon the latter and promulgate a positive rule since a whole range of alternative courses is open to the legislature.

Moreover, the aim of the second question is to have an issue concerning the application of the law settled by the Court, and this is not possible.

3. The *Commission* points out that, even if quellmehl were reentered on the list in Article 11 of Regulation No 120/67/EEC of the products entitled to a refund, the Council is not bound to grant a refund for quellmehl. Regulation (EEC) No 665/75 abolished the compulsory refund which existed previously and left the decision whether a refund should be granted for one of the listed products to the discretion of the Council.

A finding that there had been a misuse of powers would mean that the measures taken were invalid and would oblige the Council to replace them with a non-discriminatory measure coming within the scope of its discretionary power.

There could be an exception only if the Council's margin of discretion was confined to one decision only: that of restoring unchanged and with retroactive effect the right to the refund. In this case, there is, in any event, a choice of several possible solutions.

### III — The written reply to a question put by the Court

In response to the Court's request for evidence to prove that quellmehl has been used for animal feed, the Commission produced a telex from the Federal Ministry of Food.

According to this telex the trade association for the animal feed production industry ('Fachverband der Futtermittelindustrie') is one of the groups which has got into touch with the Ministry concerning the abolition of the production refund for quellmehl because its abolition placed quellmehl at a disadvantage compared with pre-gelatinized starch in the production of milk substitute foods for calves and pigs. It also appears from the telex that the Ministry of Food is in possession of a report which shows that, at that time, quellmehl was being offered on the

market in animal feed components at a price of from DM 65 to DM 70 per 100 kg compared with starch products fetching from DM 80 to DM 85 per 100 kg and was thus selling at from about 80 % to 82 % of the price of starch-based and glucose-based products.

The Commission has not been able to see the original documents or to place them at the disposal of the Court because they contained certain confidential matter.

### IV — Oral procedure

At the hearing on 21 June 1977, oral observations were made by the plaintiff in the main action in Case 117/76, represented by Fritz Modest, the plaintiff in the main action in Case 16/77, represented by K.-D. Rathke, the Council, represented by the Director of its Legal Service, Daniel Vignes, acting as Agent, and the Commission, represented by its Legal Adviser, Götz zur Hausen, acting as Agent.

The *plaintiff in the main action in Case 117/76* states that, according to information which it is unable to prove beyond doubt, only one undertaking in the Federal Republic of Germany, Interquell, has processed some 5 000 tonnes of maize into quellmehl, half of its output, or 2 500 tonnes, being sent to the animal feed industry, while the quellmehl industry as a whole processes from about 40 000 to 50 000 tonnes of maize into quellmehl.

It does not understand how pre-gelatinized starch can replace quellmehl but not the particular baking aids which have different properties; like quellmehl, pre-gelatinized starch can be used as the basic ingredient of an aid for bakery products.

The cost price of quellmehl is DM 98.79 per 100 kg while starch was, owing to the refund, on offer at DM 98 per 100 kg.

The *plaintiff in the main action in Case 16/77* states that, while quellmehl, like starch, is largely used as a component of food products other than cooking agents, the ways in which the two products can be used are much the same. The production costs of pre-gelatinized starch and of quellmehl are the same.

It is not true that quellmehl is from 15 to 20 % cheaper to produce than starch. In the foodstuffs industry the price relationship is the opposite: prices are from 20 % higher in the case of quellmehl than in the case of pre-gelatinized starch. Prices mentioned in the telex of the German Federal Ministry of Food referred only to animal feed.

Referring to the statement of the plaintiff in the main action that pre-gelatinized starch was on sale at DM 98 per 100 kg, the *Commission* states that this figure relates to the present position whereas the comparison of prices made by the Commission refers to the time when the abolition of the refund was being discussed.

The fact that quellmehl was used in the animal feed industry was not merely an unofficial ground: there was a reference, though rather vague, to this effect in the third recital in the preamble to the regulation.

The Court invited the Commission to develop its arguments at the hearing on the following point:

The difference between Cases 117/76 and 16/77 arising from the fact that the application for grant of a refund in the first case was submitted on the date when Article 11, as amended, of Regulation No 120/67/EEC made the grant of a refund for the products covered by the article compulsory (refund shall be granted), whereas the application in the second case was submitted on a date when the wording in force of Article 11 provided for the refund in respect of the products

covered to be discretionary (refund may be granted).'

The Commission's reply was that, in neither case, was quellmehl any longer mentioned by the aforesaid provision. This is therefore a question which would arise only if the abolition of the refund for quellmehl were to be declared invalid by the Court. If that occurred, quellmehl would, as a finished product, once more come under the regulation concerning the basic product in respect of which a production refund is granted in the first case and may be granted in the second case.

Even if a basic regulation lays down that a refund shall be granted this does not confer any right to it on the party concerned. A right would be conferred on the party concerned only by the fixing of the amount of the refund. Nor, against this, could it be objected that the amount of the refund had already been fixed for pre-gelatinized starch and that a now legislative measure was not therefore necessary to introduce the refund; this would amount to saying that the Council had exercised its discretion irrevocably, once and for all, because it had fixed the refund at a specific sum for starch. In the Commission's view such a contention would be difficult to justify: the act of simply transferring to quellmehl the refund which had originally been fixed for starch is not the only way to achieve this equality of treatment. It is equally possible to confine the refunds to food for human consumption or to restrict the level of the refund for the two products. That, too, can ensure equality of treatment. In the case of the 1975/76 marketing year, equality is a matter for decision by the legislature and could even consist of the total abolition of the refund for pre-gelatinized starch because at the material time the refund was not compulsory.

The Advocate-General delivered his opinion at the hearing on 22 September 1977.

## Decision

- 1 By two orders dated respectively 8 November 1976 and 18 January 1977, which reached the Court on 10 December 1976 and 31 January 1977, the Finanzgericht Hamburg has referred to the Court under Article 177 of the EEC Treaty two questions concerning the validity of certain provisions of Community regulations on the subject of refunds for the manufacture of products derived from maize.
- 2 Since the questions referred in both cases are identical and have essentially the same object, it is proper to join the cases for the purposes of judgment.
- 3 The substance of the first question is whether the provisions of Article 11 of Regulation No 120/67/EEC of the Council on the common organization of the market in cereals, as subsequently amended, are invalid in so far as they do not grant a production refund of the same amount on maize for the manufacture of quellmehl as they do for the processing of this product into starch.

The second question is whether, in the event of the reply being in the affirmative, manufacturers of quellmehl can lay direct claim to the same production refund as that granted to manufacturers of pre-gelatinized starch or whether a legal measure adopted by the Council is required for this.

- 4 These questions were referred in connexion with proceedings for the payment of a production refund for quellmehl brought against the competent national authorities by the manufacturers of this product, who claim that the provisions which abolished this refund while maintaining it for starch constitute discrimination contrary to the second subparagraph of Article 40 (3) of the Treaty.
- 5 The production refund for quellmehl extracted from maize, which has been granted in Germany since 1930, was introduced into the common organization of the market in cereals, first as discretionary by Regulation No 142/64/EEC of the Council of 21 October 1964 (JO of 27. 10. 1964, p. 2673) and subsequently as compulsory by Article 11 of Regulation No 120/67/EEC of the Council of 13 June 1967 (JO English Special Edition 1967, p. 33).

These arrangements were identical with those established by the same regulations for the grant of production refunds for starch and the amount of the refunds was also the same for the two products.

Although the reason for the grant of production refunds for starch was the need to keep prices competitive compared with the prices of substitute products derived principally from oil, the reason for the grant of production refunds for quellmehl was, as is made clear in particular by the tenth recital in the preamble to Regulation No 120/67/EEC, the interchangeability of starch and quellmehl.

- 6 The situation remained the same until 1 August 1974, the date of the entry into force of Regulation (EEC) No 1125/74 of the Council of 29 April 1974 (OJ L 128 of 10. 5. 1974, p. 12), whereby Article 11 of Regulation No 120/67/EEC was superseded by a new text providing for the grant of production refunds for starch but not for quellmehl.

The recitals in the preamble to Regulation (EEC) No 1125/74 stated that the reason for abolishing the production refund for quellmehl was that experience had shown that the opportunity for substituting quellmehl for starch for certain specific uses as food for human consumption was 'economically slight, if not non-existent'.

- 7 The second subparagraph of Article 40 (3) of the Treaty provides that the common organization of agricultural markets 'shall exclude any discrimination between producers or consumers within the Community'.

Whilst this wording undoubtedly prohibits any discrimination between producers of the same product it does not refer in such clear terms to the relationship between different industrial or trade sectors in the sphere of processed agricultural products.

This does not alter the fact that the prohibition of discrimination laid down in the aforesaid provision is merely a specific enunciation of the general principle of equality which is one of the fundamental principles of Community law.

This principle requires that similar situations shall not be treated differently unless differentiation is objectively justified.

- 8 It must therefore be ascertained whether quellmehl and starch are in a comparable situation, in particular in the sense that starch can be substituted for quellmehl in the specific use to which the latter product is traditionally put.

In this connexion it must first be noted that the Community regulations were, until 1974, based on the assertion that such substitution was possible.

However, the plaintiffs in the main actions on the one hand, and the Council and the Commission on the other are not in agreement concerning the continued existence of that situation.

The plaintiffs in the main actions contend that the opportunities for substitution are the same as previously, with the result that, since the abolition of the refund for quellmehl, trade in the latter has fallen off in favour of starch.

While the Council and the Commission have given detailed information on the manufacture and sale of the products in question, they have produced no new technical or economic data which appreciably change the previous assessment of the position.

It has not therefore been established that, so far as the Community system of production refunds is concerned, quellmehl and starch are no longer in comparable situations.

Consequently, these products must be treated in the same manner unless differentiation is objectively justified.

- 9 With regard to this latter aspect, the Council and the Commission contend that the abolition of the refund for quellmehl is justified by the fact that quellmehl has been to a great extent diverted from its specific use in food for human consumption in order to be sold as animal feed.

Although this ground, the correctness of which is moreover disputed by the plaintiffs in the main actions, is referred to in the statement which accompanied the proposal submitted by the Commission to the Council and later adopted as Regulation (EEC) No 1125/74, it does not appear in the recitals to that regulation.



During the proceedings, the Commission was requested by the Court to produce evidence to show that quellmehl had been used for animal feed but it was unable to comply with this request.

Even if adequate proof had been forthcoming that it was put to such use and that subsidized starch had not been put to similar use this could have justified the abolition of the refund only in respect of the quantities put to such use and not in respect of the quantities of the products used in food for human consumption.

- 10 In view in particular of the length of time during which the two products were given equality of treatment with regard to production refunds, it has not been established that there are objective circumstances which could have justified altering the previous system as was done by Regulation (EEC) No 1125/74, which put an end to this equality of treatment.

It is clear from the foregoing that the abolition, as a result of Regulation (EEC) No 1125/74, of the refund for quellmehl, while the refund was maintained for maize-based starch, amounts to a disregard of the principle of equality.

- 11 In the particular circumstances of the case, however, this finding of illegality does not inevitably involve a declaration that a provision of Regulation (EEC) No 1125/74 is invalid.
- 12 It must first of all be borne in mind that the amendment of Article 11 of Regulation No 120/67/EEC effected by Article 5 of Regulation (EEC) No 1125/74 took the form not of the deletion of that part of the text which relates to quellmehl but of the replacement of the previous wording by a new wording in which there is no mention of that product.

Thus the provision is unlawful because of something for which it makes no provision rather than on account of any part of its wording.

- 13 However, this unlawfulness cannot be removed merely by the fact that the Court, in proceedings under Article 177, rules that the contested provision is in part or in whole invalid.

On the other hand the conclusion must be drawn that, in law, the situation created by Article 5 of Regulation (EEC) No 1125/74, whereby the previous text was replaced by a new wording of Article 11 of Regulation No 120/67/EEC, is incompatible with the principle of equality and that it is for the competent institutions of the Community to adopt the measures necessary to correct this incompatibility.

The need for a reply to this effect to the questions asked is borne out by the existence of several courses of action which would enable the two products in question once again to be treated equally and to make good any damage sustained by those concerned and by the fact that it is for the institutions responsible for the common agricultural policy to assess the economic and political considerations on which this choice of action depends.

#### Costs

- 14 The costs incurred by the Council and the Commission of the European Communities, which have submitted observations to the Court, are not recoverable.

As these proceedings are, in so far as the parties to the main action are concerned, in the nature of a step in the action pending before the national court, the decision on costs is a matter for that court.

On those grounds,

#### THE COURT

in answer to the questions referred to it by the Finanzgericht Hamburg by orders of 8 November 1976 and 18 January 1977, hereby rules:

1. The provisions of Article 11 of Regulation No 120/67/EEC of the Council of 13 June 1967, as worded with effect from 1 August 1974 following the amendment made by Article 5 of Regulation (EEC) No 1125/74 of the Council of 29 April 1974, and repeated in subsequent regulations, are incompatible with the principle of equality in so far as they provide for quellmehl and pre-gelatinized starch to receive different treatment in respect of production refunds for maize used in the manufacture of these two products.

2. It is for the institutions competent in matters of common agricultural policy to adopt the measures necessary to correct this incompatibility.

Kutscher                      Sørensen                      Bosco                      Donner                      Pescatore  
Mertens de Wilmars              Mackenzie Stuart              O'Keeffe              Touffait

Delivered in open court in Luxembourg on 19 October 1977.

A. Van Houtte  
Registrar

H. Kutscher  
President

OPINION OF MR ADVOCATE-GENERAL CAPOTORTI  
DELIVERED ON 22 SEPTEMBER 1977<sup>1</sup>

*Mr President,  
Members of the Court,*

1. The opinion which I have to deliver today is concerned with six cases (Joined Cases 64 and 113/76, Joined Cases 117/76 and 16/77 and Joined Cases 124/76 and 20/77) relating to agriculture and they have one important feature in common: they all raise the issue of observance of the principle of non-discrimination by the Community legislature. More specifically, the central issue is whether and under what conditions the principle of non-discrimination must be considered to have been breached when, by means of regulations, the Community authorities decide to abolish aids granted for a time to particular products while maintaining aids already granted to a product in competition with them.

I should state at once that the products which in the present case no longer

benefit from aids (in the form of 'production refunds') are 'quellmehl' and 'gritz'; the product which continues to benefit from them is starch. Quellmehl, which is produced by the processing of maize, wheat or broken rice by means of a heat treatment helps to keep dough damp in the breadmaking process and is traditionally used in Germany and Denmark as an additive in the manufacture of rye bread. Gritz is meal which is made from maize by means of a purely mechanical operation and is mainly used in the brewing of beer. For the main purpose for which they are used, each of the two products can, technically speaking, be replaced by starch.

During the stage at which the common organization of the market in cereals was being progressively established, the similar treatment of starch and quellmehl in the matter of production refunds was the outcome, in particular, of

<sup>1</sup> - Translated from the Italian.

## **LEGAL AUTHORITY CA-75**

**Judgment of the Court of 8 October 1980. - Peter Überschär v Bundesversicherungsanstalt für Angestellte. - Reference for a preliminary ruling: Bundessozialgericht - Germany. - German voluntary insurance. - Case 810/79.**

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## Keywords

*1 . SOCIAL SECURITY FOR MIGRANT WORKERS - VOLUNTARY INSURANCE - SPECIAL WAYS OF GIVING EFFECT TO CERTAIN LAWS - FEDERAL REPUBLIC OF GERMANY - PARAGRAPHS 8 AND 9 OF PART C OF ANNEX V TO REGULATION NO 1408/71 - CONDITION OF RETROGRESSIVE BUYING-IN LAID DOWN BY NATIONAL LEGISLATION - SCOPE - GERMAN NATIONAL WHO HAS PAID CONTRIBUTIONS TO OLD-AGE PENSION INSURANCE IN ANOTHER MEMBER STATE*

*( PARAGRAPHS 8 AND 9 OF PART C OF ANNEX V TO REGULATION NO 1408/71 OF THE COUNCIL , AS AMENDED BY REGULATION NO 1392/74 )*

*2 . SOCIAL SECURITY FOR MIGRANT WORKERS - VOLUNTARY INSURANCE - SPECIAL WAYS OF GIVING EFFECT TO CERTAIN LAWS - FEDERAL REPUBLIC OF GERMANY - PARAGRAPHS 8 AND 9 OF PART C OF ANNEX V TO REGULATION NO 1408/71 - CONDITION OF RETROGRESSIVE BUYING-IN LAID DOWN BY NATIONAL LEGISLATION - DISCRIMINATION AGAINST GERMAN WORKERS AND FOREIGNERS RESIDING IN THE FEDERAL REPUBLIC OF GERMANY - NONE*

*( PARAGRAPHS 8 AND 9 OF PART C OF ANNEX V TO REGULATION NO 1408/71 OF THE COUNCIL , AS AMENDED BY REGULATION NO 1392/74 )*

*3 . COMMUNITY LAW - PRINCIPLES - EQUAL TREATMENT - CONCEPT*

## Summary

*1 . IT FOLLOWS FROM THE OBJECTS AND THE WORDING OF PARAGRAPHS 8 AND 9 OF PART C OF ANNEX V TO REGULATION NO 1408/71 ( AS AMENDED BY REGULATION NO 1392/74 ) THAT THOSE PROVISIONS AND IN PARTICULAR THE FIRST SENTENCE OF PARAGRAPH 9 ARE INTENDED TO ENABLE THE REQUIREMENT OF RETROGRESSIVE BUYING-IN SET FORTH IN ARTICLE 49A ( 2 ) OF THE ANGESTELLTENVERSICHERUNGS-NEUREGELUNGSGESETZ ( CLERICAL STAFF PENSION REFORM LAW ), AS AMENDED BY THE RENTENREFORMGESETZ ( PENSION REFORM LAW ) OF 16 OCTOBER 1972 , TO CONTINUE TO EXIST IN THE LEGISLATION OF THE FEDERAL REPUBLIC OF GERMANY EVEN THOUGH THE MOST RECENT PERIODS CORRESPOND TO PERIODS IN WHICH CONTRIBUTIONS WERE COMPULSORY IN ANOTHER MEMBER STATE . WHENEVER A GERMAN NATIONAL OR A NATIONAL OF ANOTHER MEMBER STATE RESIDING IN THE FEDERAL REPUBLIC OF GERMANY CLAIMS THE BENEFIT OF ARTICLE 49A ( 2 ) THE CONTRIBUTION PERIODS IN OTHER MEMBER STATES ARE NOT THEREFORE REGARDED AS ' ' COVERED ' ' BUT MUST BE BOUGHT IN FIRST IF THEY ARE MORE RECENT THAN NATIONAL PERIODS WHICH ARE IN FACT NOT COVERED . ON THE OTHER HAND , THAT REQUIREMENT MAY NOT BE APPLIED AGAINST THE PERSONS REFERRED TO IN PARAGRAPH 8 ( B ) AND ( C ) WHO , MOREOVER , ARE NOT IN ANY EVENT ALLOWED TO BUY-IN PERIODS COMPLETED IN OTHER MEMBER STATES .*

*CONSEQUENTLY A GERMAN NATIONAL WHO HAS PAID CONTRIBUTIONS TO OLD-AGE PENSION INSURANCE IN ANOTHER MEMBER STATE AND WHO SUBSEQUENTLY WISHES TO PAY A POSTERIORI , BUT WITH RETROACTIVE EFFECT WITHIN THE MEANING OF ARTICLE 49A ( 2 ) OF THE CLERICAL STAFF PENSION REFORM LAW GERMAN*

*PENSION CONTRIBUTIONS IN RESPECT OF PREVIOUS PERIODS , MAY BE REQUIRED TO PAY GERMAN CONTRIBUTIONS IN RESPECT OF PERIODS COVERED BY CONTRIBUTIONS IN ANOTHER MEMBER STATE .*

*2 . THE DIFFERENCE IN TREATMENT WHICH IS INDISPUTABLY APPLIED BY PARAGRAPHS 8 AND 9 OF PART C OF ANNEX V TO REGULATION NO 1408/71 ( AS AMENDED BY REGULATION NO 1392/74 ) BETWEEN , ON THE ONE HAND , GERMAN WORKERS AND FOREIGNERS RESIDING IN THE FEDERAL REPUBLIC OF GERMANY - REFERRED TO IN THE FIRST SENTENCE OF PARAGRAPH 9 - AND , ON THE OTHER HAND , WORKERS FROM OTHER MEMBER STATES - REFERRED TO IN THE SECOND SENTENCE OF PARAGRAPH 9 - DOES NOT CONSTITUTE DISCRIMINATION AGAINST THE FORMER .*

*AN EXAMINATION OF THE ADVANTAGES AND DRAWBACKS OF THE TWO LEGAL SITUATIONS WHICH HAVE TO BE COMPARED SHOWS IN FACT THAT THEY CANNOT BE REGARDED AS BEING MORE FAVOURABLE TO ONE THAN TO THE OTHER CATEGORY OF WORKERS CONCERNED .*

*3 . THE GENERAL PRINCIPLE OF EQUALITY , OF WHICH THE PROHIBITION OF DISCRIMINATION ON GROUNDS OF NATIONALITY IS MERELY A SPECIFIC ENUNCIATION , IS ONE OF THE FUNDAMENTAL PRINCIPLES OF COMMUNITY LAW . THIS PRINCIPLE REQUIRES THAT SIMILAR SITUATIONS SHALL NOT BE TREATED DIFFERENTLY UNLESS DIFFERENTIATION IS OBJECTIVELY JUSTIFIED .*

## **Parties**

*IN CASE 810/79*

*REFERENCE TO THE COURT UNDER ARTICLE 177 OF THE EEC TREATY BY THE BUNDESSOZIALGERICHT ( FEDERAL SOCIAL COURT ) FOR A PRELIMINARY RULING IN THE CASE PENDING BEFORE THAT COURT BETWEEN*

*PETER UBERSCHAR , HASSELT , BELGIUM ,*

*PLAINTIFF AND RESPONDENT IN THE APPEAL ON A POINT OF LAW ,*

*AND*

*BUNDESVERSICHERUNGSANSTALT FUR ANGESTELLTE ( FEDERAL INSURANCE INSTITUTION FOR CLERICAL STAFF ) , BERLIN ,*

*DEFENDANT AND APPELLANT IN THE SAID APPEAL ,*

## **Subject of the case**

*UPON THE INTERPRETATION OF ANNEX V TO REGULATION NO 1408/71 OF THE COUNCIL OF 14 JUNE 1971 ON THE APPLICATION OF SOCIAL SECURITY SCHEMES TO EMPLOYED PERSONS AND THEIR FAMILIES MOVING WITHIN THE COMMUNITY ( OFFICIAL JOURNAL , ENGLISH SPECIAL EDITION 1971 ( II ) , P . 416 ) AS AMENDED BY REGULATION NO 1392/74 OF THE COUNCIL OF 4 JUNE 1974 ( OFFICIAL JOURNAL L 152 , P . 1 )*

## **Grounds**

*1 BY AN ORDER DATED 12 OCTOBER 1979 WHICH WAS RECEIVED AT THE COURT ON 7 DECEMBER 1979 THE BUNDESSOZIALGERICHT ( FEDERAL SOCIAL COURT ) REFERRED TO THE COURT FOR A PRELIMINARY RULING UNDER ARTICLE 177 OF THE EEC TREATY A QUESTION FRAMED AS FOLLOWS :*

*' ' MUST THE FIRST SENTENCE OF PARAGRAPH 9 OF PART C OF ANNEX V TO REGULATION ( EEC ) NO 1408/71 , AS AMENDED BY REGULATION ( EEC ) NO 1392/74 , BE INTERPRETED TO MEAN THAT A GERMAN NATIONAL WHO HAS PAID CONTRIBUTIONS TO THE PENSION INSURANCE OF ANOTHER MEMBER STATE AND WHO SUBSEQUENTLY WISHES TO BUY-IN GERMAN CONTRIBUTIONS FOR EARLIER PERIODS IN RESPECT OF WHICH CONTRIBUTIONS HAVE NOT YET BEEN PAID , ( ART . 49A ( 2 ) OF PART 2 OF THE CLERICAL STAFF PENSION REFORM LAW ( ANGESTELLTENVERSICHERUNGS-NEUREGELUNGSGESETZ ) , AS AMENDED BY THE PENSION REFORM LAW ( RENTENREFORMGESETZ ) OF 16 OCTOBER 1972 , MUST FIRST PAY GERMANY CONTRIBUTIONS FOR THE PERIODS COVERED BY CONTRIBUTIONS IN ANOTHER MEMBER STATE OR IS THIS UNNECESSARY UNDER COMMUNITY LAW?*

*' '*

*2 THAT QUESTION HAS BEEN SUBMITTED IN THE CONTEXT OF A DISPUTE BETWEEN A GERMAN NATIONAL , THE PLAINTIFF IN THE MAIN ACTION , AND THE BUNDESVERSICHERUNGSANSTALT FUR ANGESTELLTE ( FEDERAL*

INSURANCE INSTITUTION FOR CLERICAL STAFF ). THE PLAINTIFF PAID CONTRIBUTIONS TO GERMAN INSURANCE FOR CLERICAL STAFF FROM APRIL 1948 TO JUNE 1969 , AND THEN FROM 1973 TO 1974 . IN THE INTERVENING PERIOD ( 1969 TO 1973 ) HE WAS EMPLOYED IN BELGIUM AND COMPULSORILY INSURED UNDER THE BELGIAN INSURANCE SCHEME FOR CLERICAL STAFF . IN HIS FIRST GERMAN INSURANCE PERIOD THERE WERE SOME INTERRUPTIONS , NAMELY FOUR MONTHS IN 1956 AND 41 MONTHS BETWEEN 1964 AND 1967 , DURING WHICH HE WAS NOT INSURED EITHER IN ANOTHER MEMBER STATE OR UNDER ANY OTHER OLD-AGE PENSION INSURANCE SCHEME IN THE FEDERAL REPUBLIC OF GERMANY .

3 THE APPLICANT EXPRESSED THE DESIRE TO MAKE USE OF THE FACILITIES AVAILABLE TO PERSONS IN HIS SITUATION UNDER ARTICLE 49A ( 2 ) OF THE ANGESTELLTENVERSICHERUNGS-NEUREGELUNGSGESETZ ( CLERICAL STAFF PENSION REFORM LAW , HEREINAFTER REFERRED TO AS ' ' THE 1957 LAW ' ' ) , AS AMENDED BY ARTICLE 2 ( 2 ) 14 OF THE RENTENREFORMGESETZ ( PENSION REFORM LAW , HEREINAFTER REFERRED TO AS ' ' THE 1972 LAW ' ' ) OF 16 OCTOBER 1972 . ACCORDING TO THAT PROVISION : ' ' PERSONS WHO ARE ENTITLED TO BECOME VOLUNTARILY INSURED PURSUANT TO ARTICLE 10 OF THE CLERICAL STAFF INSURANCE LAW MAY , AT THEIR REQUEST , IN DEROGATION FROM THE PROVISIONS OF ARTICLE 140 OF THAT LAW , VOLUNTARILY BUY-IN CONTRIBUTIONS IN RESPECT OF PERIODS FROM 1 JANUARY 1956 TO 31 DECEMBER 1973 WHICH ARE NOT YET COVERED BY CONTRIBUTIONS TO STATUTORY PENSION INSURANCE , PROVIDED THAT A CONTRIBUTION RELATING TO ANY MONTH MAY NOT BE PAID UNLESS THE CONTRIBUTIONS COVERING ALL SUBSEQUENT MONTHS HAVE FIRST BEEN PAID . A CONTRIBUTION RELATING TO ANY MONTH MAY NOT EXCEED THE SMALLEST CONTRIBUTION PAID IN RESPECT OF A LATER MONTH ' ' .

4 RELYING ON THAT TEXT THE APPLICANT APPLIED TO PAY IN THAT WAY THE CONTRIBUTIONS WHICH HE WOULD HAVE PAID HAD HE BEEN INSURED IN THE FEDERAL REPUBLIC OF GERMANY BETWEEN 1948 AND 1969 ( 45 MONTH IN ALL ) . WHILST NOT CONTESTING THAT THE PLAINTIFF SATISFIES THE CONDITIONS FOR THE EXERCISE OF THE OPTION OF MAKING BACK-PAYMENTS , THE DEFENDANT INSTITUTION REFERS TO THE SENTENCE IN ARTICLE 49A ( 2 ) WHICH SAYS THAT SUCH ENTITLEMENT SHALL EXIST ' ' PROVIDED THAT A CONTRIBUTION RELATING TO ANY MONTH MAY NOT BE PAID UNLESS THE CONTRIBUTIONS COVERING ALL SUBSEQUENT MONTHS HAVE FIRST BEEN PAID ' ' , ARGUING THAT THE APPLICANT MUST START BY PAYING THE GERMAN CONTRIBUTIONS IN RESPECT OF THE PERIOD CORRESPONDING TO THAT IN WHICH HE WAS COMPULSORILY INSURED AND PAID CONTRIBUTIONS IN BELGIUM . IT IS THAT REQUIREMENT WHICH IS THE SUBJECT-MATTER OF THE MAIN ACTION . THE APPLICANT HAS AN INTEREST IN CHALLENGING IT OWING TO THE FACT THAT THE ' ' BUYING-IN ' ' OF RECENT MISSING PERIODS , IN THIS CASE FROM 1969 TO 1973 , IS MORE EXPENSIVE THAN THAT FOR PERIODS FURTHER BACK , NAMELY 45 MONTHS BETWEEN 1956 AND 1967 .

5 THE PARTIES TO THE MAIN ACTION ARE AGREED THAT THE APPLICANT DOES COME UNDER ARTICLE 49A ( 2 ) AND THAT THE REQUIREMENT LAID DOWN BY THE INSURANCE INSTITUTION OF PAYING FIRST THE CONTRIBUTIONS FOR THE PERIODS BETWEEN 1969 AND 1973 , NOTWITHSTANDING THE FACT THAT THEY CORRESPOND TO COMPULSORY INSURANCE PERIODS IN BELGIUM , DERIVES FROM A PROPER CONSTRUCTION OF THE RELEVANT PROVISIONS OF THE GERMAN LEGISLATION IN THE MATTER . THEY ARE AGREED THAT THE OBLIGATION UNDER GERMAN VOLUNTARY INSURANCE TO BUY-IN THE PERIODS CORRESPONDING TO INSURANCE PERIODS IN ANOTHER MEMBER STATE MAY BE IMPOSED ONLY ON GERMAN NATIONALS AND ON WORKERS FROM OTHER MEMBER STATES WHO LIVE IN THE FEDERAL REPUBLIC OF GERMANY AND THAT IT CANNOT BE IMPOSED ON WORKERS FROM OTHER MEMBER STATES LIVING OUTSIDE GERMANY .

6 ACCORDING TO THE DEFENDANT INSTITUTION THE CONFORMITY OF THAT REQUIREMENT WITH COMMUNITY LAW IS APPARENT FROM THE TEXT OF PARAGRAPHS 8 AND 9 OF PART C OF ANNEX V TO REGULATION NO 1408/71 OF THE COUNCIL . ON THE OTHER HAND THE PLAINTIFF IN THE MAIN ACTION CONTESTS THAT INTERPRETATION OF THOSE PROVISIONS . HE FURTHER MAINTAINS , AS HIS PRIMARY CONTENTION , THAT IF THE INTERPRETATION PUT FORWARD BY THE DEFENDANT WERE CORRECT , THE DISPUTED PROVISIONS WOULD CONSEQUENTLY BE TAINTED WITH DISCRIMINATION AND WOULD THEREFORE BE ILLEGAL OWING TO THE DIFFERENT TREATMENT IMPOSED ON GERMAN NATIONALS AND ON NATIONALS OF OTHER MEMBER STATES LIVING IN GERMANY BY COMPARISON WITH WORKERS FROM OTHER MEMBER STATES HAVING ACCESS TO THE GERMAN VOLUNTARY INSURANCE SCHEME AND TO THE ' ' BUYING-IN ' ' SCHEME , UPON WHOM SUCH AN OBLIGATION TO BUY-IN PERIODS CORRESPONDING TO A PERIOD OF INSURANCE IN ANOTHER MEMBER STATE CANNOT BE IMPOSED .

7 CONSEQUENTLY THE QUESTION REFERRED TO THE COURT PRIMARILY SEEKS TO DETERMINE WHETHER PARAGRAPHS 8 AND 9 OF PART C OF ANNEX V MUST INDEED BE CONSTRUED IN THE MANNER SUGGESTED BY THE DEFENDANT INSTITUTION AND , SECONDLY , SHOULD THE PROVISIONS IN QUESTION HAVE THAT EFFECT , WHETHER THEY ARE NOT THEREFORE INVALID BY REASON OF THE DIFFERENT TREATMENT OF TWO CATEGORIES OF WORKERS BOTH OF WHOM ARE ALLOWED ACCESS TO VOLUNTARY INSURANCE WITH THE OPTION OF MAKING BACK-PAYMENTS IN RESPECT OF EARLIER PERIODS .

8 THE PROVISIONS WHICH REQUIRE CONSIDERATION ARE ARTICLE 89 OF REGULATION NO 1408/71 AND PARAGRAPHS 8 AND 9 OF PART C OF ANNEX V TO THE SAME REGULATION . THOSE PROVISIONS READ AS FOLLOWS :

ARTICLE 89

' ' SPECIAL PROCEDURES FOR IMPLEMENTING THE LEGISLATIONS OF CERTAIN MEMBER STATES ARE SET OUT IN ANNEX V . ' '



PARAGRAPH 8 OF PART C OF ANNEX V

' ' ARTICLE 1233 OF THE INSURANCE CODE ( RVO ) AND ARTICLE 10 OF THE CLERICAL STAFF INSURANCE LAW ( AVG ), AS AMENDED BY THE PENSION REFORM LAW OF 16 OCTOBER 1972 , WHICH GOVERN VOLUNTARY INSURANCE UNDER GERMAN PENSION INSURANCE SCHEMES , SHALL APPLY TO NATIONALS OF THE OTHER MEMBER STATES AND TO STATELESS PERSONS AND REFUGEES RESIDING IN THE TERRITORY OF THE OTHER MEMBER STATES , ACCORDING TO THE FOLLOWING RULES :

WHERE THE GENERAL CONDITIONS ARE FULFILLED VOLUNTARY CONTRIBUTIONS TO THE GERMAN PENSION SCHEME MAY BE PAID :

( A ) IF THE PERSON CONCERNED HAS HIS DOMICILE OR RESIDENCE IN THE TERRITORY OF THE FEDERAL REPUBLIC OF GERMANY ;

( B ) IF THE PERSON CONCERNED HAS HIS DOMICILE OR RESIDENCE IN THE TERRITORY OF ANOTHER MEMBER STATE AND AT ANY TIME PREVIOUSLY BELONGED COMPULSORILY OR VOLUNTARILY TO A GERMAN PENSION INSURANCE SCHEME ;

( C ) IF THE PERSON CONCERNED IS A NATIONAL OF ANOTHER MEMBER STATE , HAS HIS DOMICILE OR RESIDENCE IN THE TERRITORY OF A THIRD STATE AND HAS PAID CONTRIBUTIONS FOR GERMAN PENSION INSURANCE FOR AT LEAST 60 MONTHS , OR WAS ELIGIBLE FOR VOLUNTARY INSURANCE UNDER THE TRANSITIONAL PROVISIONS PREVIOUSLY IN FORCE AND IS NOT COMPULSORILY OR VOLUNTARILY INSURED UNDER THE LEGISLATION OF ANOTHER MEMBER STATE . ' '

PARAGRAPH 9 OF PART C OF ANNEX V

' ' THE REGULATION SHALL NOT AFFECT ARTICLE 51A ( 2 ) OF THE MANUAL WORKERS PENSION REFORM LAW ( ARVNG ) OR ARTICLE 49A ( 2 ) OF THE CLERICAL STAFF PENSION REFORM LAW ( ANVNG ), AS AMENDED BY THE PENSION REFORM LAW OF 16 OCTOBER 1972 . THE PERSONS WHO , UNDER PARAGRAPH 8 ( B ) AND ( C ), MAY JOIN VOLUNTARY INSURANCE , MAY PAY CONTRIBUTIONS ONLY IN RESPECT OF PERIODS FOR WHICH THEY HAVE NOT YET PAID CONTRIBUTIONS UNDER THE LEGISLATION OF ANOTHER MEMBER STATE . ' '

THE CONSTRUCTION OF PARAGRAPHS 8 AND 9 OF PART C OF ANNEX V TO REGULATION NO 1408/71

9 WHEN ARTICLE 49A INCLUDING PARAGRAPH ( 2 ) THEREOF WAS ADDED TO THE 1957 LAW IN 1972 THE BENEFIT OF ' ' BUYING-IN ' ' WHICH IT INTRODUCED WAS RESTRICTED TO GERMAN NATIONALS AND TO FOREIGNERS LIVING IN THE FEDERAL REPUBLIC OF GERMANY . IN THE CASE OF THOSE PERSONS THREE CONDITIONS ARE IMPOSED ON THE RIGHT TO ' ' BUY-IN ' ' :

( A ) BUYING-IN IS RESTRICTED TO A PERIOD BETWEEN 1 JANUARY 1956 AND 31 DECEMBER 1973 ;

( B ) IT MAY BE EFFECTED ONLY IN RESPECT OF PERIODS FOR WHICH THE PERSON CONCERNED PAID CONTRIBUTIONS TO STATUTORY INVALIDITY AND OLD-AGE PENSION INSURANCE ( PRINCIPLE OF THE PROHIBITION ON OVERLAPPING INSURANCE ) - THAT PROVISION , AS HAS JUST BEEN INDICATED , BEING UNDERSTOOD AND IMPLEMENTED BY THE COMPETENT INSTITUTIONS AS REFERRING ONLY TO PERIODS OF CONTRIBUTION TO INSURANCE IN THE FEDERAL REPUBLIC OF GERMANY - AND ,

( C ) BUYING-IN MUST START WITH THE MOST RECENT MISSING PERIODS AND GO PROGRESSIVELY FURTHER BACK IN THE PAST ( PRINCIPLE OF RETROGRESSIVE BUYING-IN ).

10 FOLLOWING THE INTERVENTION OF THE COMMISSION THE FEDERAL REPUBLIC OF GERMANY ACCEPTED THAT THE BENEFIT OF THAT PROVISION SHOULD BE EXTENDED TO THE NATIONALS OF OTHER MEMBER STATES WHO DID NOT RESIDE IN THE FEDERAL REPUBLIC OF GERMANY PROVIDED THAT THEY HAD PREVIOUSLY BEEN COMPULSORILY OR VOLUNTARILY INSURED UNDER THE GERMAN OLD-AGE PENSION INSURANCE SCHEME . THAT IS THE OBJECT OF PARAGRAPHS 8 AND 9 OF PART C OF ANNEX V , AMENDED TO THAT END IN 1974 .

11 THOSE TWO PROVISIONS ARE CLOSELY LINKED AND MUST BE CONSTRUED IN CONJUNCTION WITH ONE ANOTHER . THEY DISTINGUISH BETWEEN , ON THE ONE HAND , WORKERS WHO DERIVE THEIR RIGHT TO AVAIL THEMSELVES OF ARTICLE 49A ( 2 ) DIRECTLY FROM THE GERMAN LEGISLATION , NAMELY GERMAN NATIONALS WHATEVER THEIR PLACE OF RESIDENCE AND NATIONALS OF OTHER MEMBER STATES RESIDING IN THE FEDERAL REPUBLIC OF GERMANY WHO ARE REFERRED TO IN PARAGRAPH 8 ( A ) AND IN THE FIRST SENTENCE OF PARAGRAPH 9 , AND , ON THE OTHER HAND , WORKERS ENTITLED TO APPLY TO ' ' BUY-IN ' ' ONLY BY VIRTUE OF COMMUNITY LAW , WHO ARE REFERRED TO IN PARAGRAPH 8 ( A ) AND ( B ) AND IN THE SECOND SENTENCE OF PARAGRAPH 9 .

12 ACCORDING TO THE SECOND SENTENCE OF PARAGRAPH 9 PERSONS IN THE SECOND CATEGORY , THAT IS TO SAY THOSE REFERRED TO IN PARAGRAPH 8 ( B ) AND ( C ), MAY ' ' PAY CONTRIBUTIONS ONLY IN RESPECT OF PERIODS FOR WHICH THEY HAVE NOT YET PAID CONTRIBUTIONS UNDER THE LEGISLATION OF ANOTHER MEMBER STATE ' ' . IN OTHER WORDS , THEY ARE BARRED FROM ' ' BUYING-IN ' ' PERIODS WHICH , FROM THE POINT OF VIEW OF THE GERMAN LEGISLATION , ARE ACTUALLY MISSING , WHILST THEY CORRESPOND TO CONTRIBUTION PERIODS IN ANOTHER MEMBER STATE , EVEN THOUGH IT MAY BE IN THEIR INTERESTS TO DO SO BECAUSE , FOR INSTANCE , THEY DO NOT HAVE ANY OTHER PERIODS TO BE BOUGHT IN . IT IS THEREFORE



*SELF-EVIDENT THAT THE COMPETENT GERMAN INSTITUTIONS CANNOT REQUIRE THEM TO ' ' BUY-IN ' ' THOSE PERIODS EVEN THOUGH THEY ARE MORE RECENT THAN THE PERIODS TO BE ' ' BOUGHT-IN ' ' .*

*13 ON THE OTHER HAND , IN THE CASE OF WORKERS IN THE FIRST CATEGORY WHO DERIVE THE RIGHT TO ' ' BUY-IN ' ' DIRECTLY FROM THE GERMAN LEGISLATION , THE SITUATION PRIOR TO THE AMENDMENT OF PART C OF ANNEX V MAINTAINED . THEY MAY BUY-IN EVEN PERIODS COVERED BY CONTRIBUTIONS IN OTHER MEMBER STATES - WHICH MAY IN FACT BE TO THEIR ADVANTAGE - BUT THE COUNTERPART OF THAT OPTION IS THAT THEY MAY BE REQUIRED TO BUY-IN THOSE PERIODS BEFORE THE GERMAN PERIODS LYING FURTHER BACK IN TIME . THAT IS CLEARLY EXPRESSED AT THE BEGINNING OF PARA- GRAPH 9 WHICH STATES : ' ' REGULATION ( NO 1408/71 ) SHALL NOT AFFECT . . . ARTICLE 49A ( 2 ) OF THE CLERICAL STAFF PENSION REFORM LAW . ' ' THE COMMISSION HAS STATED THAT IT HAS ACCEPTED THE SPECIAL SITUATION OF THOSE WORKERS , NOW IN DISPUTE , OWING TO THE CLOSE AND LEGITIMATE LINK , PARTICULARLY FROM THE FINANCIAL VIEWPOINT , WHICH THE GERMAN LEGISLATURE HAS PLACED BETWEEN A RIGHT TO BUY-IN , WHICH WAS GENEROUSLY EXTENDED TO COVER A WIDE CATEGORY OF PERSONS , AND AN OBLIGATION INTENDED TO PREVENT INSURED PERSONS FROM BEING ABLE TO BUY-IN SYSTEMATICALLY THE LEAST EXPENSIVE PERIODS , IN THIS CASE THOSE FURTHER BACK IN TIME .*

*14 IT THUS FOLLOWS FROM THE OBJECTS AND THE WORDING OF PARAGRAPHS 8 AND 9 OF PART C OF ANNEX V THAT THOSE PROVISIONS , AND IN PARTICULAR THE FIRST SENTENCE OF PARAGRAPH 9 , ARE INTENDED TO ENABLE THE REQUIREMENT OF RETROGRESSIVE BUYING-IN SET FORTH IN ARTICLE 49A ( 2 ) OF THE 1957 LAW TO CONTINUE TO EXIST IN THE LEGISLATION OF THE FEDERAL REPUBLIC OF GERMANY EVEN THOUGH THE MOST RECENT PERIODS CORRESPOND TO PERIODS IN WHICH CONTRIBUTIONS WERE COMPULSORY IN ANOTHER MEMBER STATE . WHENEVER A GERMAN NATIONAL OR A NATIONAL OF ANOTHER MEMBER STATE RESIDING IN THE FEDERAL REPUBLIC OF GERMANY CLAIMS THE BENEFIT OF ARTICLE 49A ( 2 ) THE CONTRIBUTION PERIODS IN OTHER MEMBER STATES ARE NOT THEREFORE REGARDED AS ' ' COVERED ' ' BUT MUST BE BOUGHT-IN FIRST IF THEY ARE MORE RECENT THAN NATIONAL PERIODS WHICH ARE IN FACT NOT COVERED . ON THE OTHER HAND , THAT REQUIREMENT MAY NOT BE APPLIED AGAINST THE PERSONS REFERRED TO IN PARAGRAPH 8 ( B ) AND ( C ) WHO , MOREOVER , ARE NOT IN ANY EVENT ALLOWED TO ' ' BUY-IN ' ' PERIODS COMPLETED IN OTHER MEMBER STATES .*

#### *BREACH OF THE PRINCIPLE OF NON-DISCRIMINATION*

*15 IT IS NOW APPROPRIATE TO EXAMINE THE QUESTION WHETHER THE DIFFERENCE IN TREATMENT WHICH IS INDISPUTABLY APPLIED BY PARAGRAPHS 8 AND 9 OF PART C OF ANNEX V BETWEEN , ON THE ONE HAND , GERMAN WORKERS AND FOREIGNERS RESIDING IN THE FEDERAL REPUBLIC OF GERMANY - REFERRED TO IN THE FIRST SENTENCE OF PARAGRAPH 9 - AND , ON THE OTHER HAND , WORKERS FROM OTHER MEMBER STATES - REFERRED TO IN THE SECOND SENTENCE OF PARAGRAPH 9 - DOES NOT CONSTITUTE DISCRIMINATION AGAINST THE FORMER .*

*16 ACCORDING TO THE ESTABLISHED CASE-LAW OF THE COURT THE GENERAL PRINCIPLE OF EQUALITY , OF WHICH THE PROHIBITION ON DISCRIMINATION ON GROUNDS OF NATIONALITY IS MERELY A SPECIFIC ENUNCIATION , IS ONE OF THE FUNDAMENTAL PRINCIPLES OF COMMUNITY LAW . THIS PRINCIPLE REQUIRES THAT SIMILAR SITUATIONS SHALL NOT BE TREATED DIFFERENTLY UNLESS DIFFERENTIATION IS OBJECTIVELY JUSTIFIED .*

*17 AN EXAMINATION OF THE ADVANTAGES AND DRAWBACKS OF THE TWO LEGAL SITUATIONS WHICH HAVE TO BE COMPARED LEADS TO THE CONCLUSION THAT THE OBJECTION AS TO DISCRIMINATION CANNOT BE SUSTAINED IN REGARD TO EITHER OF THOSE SITUATIONS SINCE THEY CANNOT BE REGARDED AS BEING MORE FAVOURABLE TO ONE THAN TO THE OTHER CATEGORY OF WORKERS CONCERNED . THE FINANCIAL BURDEN OF THE BUYING-IN TRANSACTION WILL IN FACT BE HEAVIER OR LIGHTER FOR EITHER CATEGORY DEPENDING ON WHETHER THE PERIODS TO BE BOUGHT-IN ARE MORE RECENT OR FURTHER BACK IN TIME SO THAT THE FINANCIAL EFFECT OF THE RULES IN QUESTION IS NOT IN GENERAL MORE UNFAVOURABLE TO ONE THAN TO THE OTHER OF THE TWO CATEGORIES . THE VARIATIONS IN THAT FINANCIAL BURDEN FROM ONE INDIVIDUAL CASE TO ANOTHER ARE IN FACT EXCLUSIVELY THE RESULT OF THE OBJECTIVELY DIFFERENT FACTUAL SITUATIONS IN WHICH THE INSURED PERSONS CONCERNED MAY FIND THEMSELVES DEPENDING ON THE CHANGES AND CHANCES OF THEIR WORKING LIFE .*

*18 THE REPLY TO THE QUESTION SUBMITTED SHOULD THEREFORE BE THAT PARAGRAPHS 8 AND 9 OF PART C OF ANNEX V TO REGULATION NO 1408/71 , AS AMENDED BY REGULATION NO 1392/74 , MUST BE INTERPRETED TO MEAN THAT A GERMAN NATIONAL WHO HAS PAID CONTRIBUTIONS TO OLD-AGE PENSION INSURANCE IN ANOTHER MEMBER STATE AND WHO SUBSEQUENTLY WISHES TO PAY A POSTERIORI , BUT WITH RETROACTIVE EFFECT WITHIN THE MEANING OF ARTICLE 49A ( 2 ) ADDED TO THE ANGESTELLTENVERSICHERUNGS-NEUREGELUNGSGESETZ BY THE RENTENREFORMGESETZ OF 16 OCTOBER 1972 , GERMAN PENSION CONTRIBUTIONS IN RESPECT OF PREVIOUS PERIODS MAY BE REQUIRED TO PAY GERMAN CONTRIBUTIONS IN RESPECT OF PERIODS COVERED BY CONTRIBUTIONS IN ANOTHER MEMBER STATE AND THAT CONSIDERATION OF THE SAID PARAGRAPHS 8 AND 9 , AS THUS CONSTRUED , HAS DISCLOSED NO FACTOR OF SUCH A KIND AS TO AFFECT THEIR VALIDITY .*

## **Decision on costs**

*19 THE COSTS INCURRED BY THE COMMISSION OF THE EUROPEAN COMMUNITIES , WHICH HAS SUBMITTED OBSERVATIONS TO THE COURT , ARE NOT RECOVERABLE . SINCE THE PROCEEDINGS ARE , IN SO FAR AS THE PARTIES TO THE MAIN ACTION ARE CONCERNED , IN THE NATURE OF A STEP IN THE ACTION PENDING BEFORE THE NATIONAL COURT , THE DECISION ON COSTS IS A MATTER FOR THAT COURT .*

## **Operative part**

*ON THOSE GROUNDS ,*

*THE COURT ,*

*IN ANSWER TO THE QUESTIONS REFERRED TO IT BY THE BUNDESSOZIALGERICHT BY AN ORDER OF 12 OCTOBER 1979 RECEIVED AT THE COURT ON 7 DECEMBER 1979 , HEREBY RULES :*

*PARAGRAPHS 8 AND 9 OF PART C OF ANNEX V TO REGULATION NO 1408/71 OF THE COUNCIL OF 14 JUNE 1971 ON THE APPLICATION OF SOCIAL SECURITY SCHEMES TO EMPLOYED PERSONS AND THEIR FAMILIES MOVING WITHIN THE COMMUNITY , AS AMENDED BY REGULATION NO 1392/74 OF THE COUNCIL OF 4 JUNE 1974 , MUST BE INTERPRETED TO MEAN THAT A GERMAN NATIONAL WHO HAS PAID CONTRIBUTIONS TO OLD-AGE PENSION INSURANCE IN ANOTHER MEMBER STATE AND WHO SUBSEQUENTLY WISHES TO PAY A POSTERIORI , BUT WITH RETROACTIVE EFFECT WITHIN THE MEANING OF ARTICLE 49A ( 2 ) ADDED TO THE ANGESTELLTENVERSICHERUNGS-NEUREGELUNGSGESETZ BY THE RENTENREFORMGESETZ OF 16 OCTOBER 1972 , GERMAN PENSION CONTRIBUTIONS IN RESPECT OF PREVIOUS PERIODS , MAY BE REQUIRED TO PAY GERMAN CONTRIBUTIONS IN RESPECT OF PERIODS COVERED BY CONTRIBUTIONS IN ANOTHER MEMBER STATE . CONSIDERATION OF THE SAID PARAGRAPHS 8 AND 9 , AS THUS CONSTRUED , HAS DISCLOSED NO FACTOR OF SUCH A KIND AS TO AFFECT THEIR VALIDITY .*

## **LEGAL AUTHORITY CA-76**

JUDGMENT OF THE COURT  
13 May 1986\*

In Case 170/84

REFERENCE to the Court pursuant to Article 177 of the EEC Treaty by the Bundesarbeitsgericht [Federal Labour Court] for a preliminary ruling in the proceedings pending before that court between

**Bilka-Kaufhaus GmbH**

and

**Karin Weber von Hartz**

on the interpretation of Article 119 of the EEC Treaty,

THE COURT

composed of: Lord Mackenzie Stuart, President, T. Koopmans, U. Everling, K. Bahlmann and R. Joliet (Presidents of Chambers), G. Bosco, O. Due, Y. Galmot and C. Kakouris, Judges,

Advocate General: M. Darmon

Registrar: D. Louterman, Administrator

after considering the observations submitted on behalf of

Bilka-Kaufhaus GmbH, the appellant in the main proceedings, by K. H. Koch, J. Burkardt and G. Haberer, Rechtsanwälte, Frankfurt am Main,

Mrs Weber von Hartz, the respondent in the main proceedings, by H. Thon, Rechtsanwalt, Frankfurt am Main,

the United Kingdom, by S. H. Hay, of the Treasury Solicitor's Department, acting as Agent,

\* Language of the Case: German.

the Commission of the European Communities, by J. Pipkorn and M. Beschel, members of its Legal Department, acting as Agents,

after hearing the Opinion of the Advocate General delivered at the sitting on 15 October 1985,

gives the following

## JUDGMENT

(The account of the facts and issues which is contained in the complete text of the judgment is not reproduced)

### Decision

1 By an order of 5 June 1984, which was received at the Court on 2 July 1984, the Bundesarbeitsgericht referred to the Court for a preliminary ruling under Article 177 of the EEC Treaty three questions on the interpretation of Article 119 of that Treaty.

2 Those questions arose in the course of proceedings between Bilka-Kaufhaus GmbH and its former employee Karin Weber von Hartz concerning the payment to Mrs Weber von Hartz of a retirement pension from a supplementary pension scheme established by Bilka for its employees.

3 It appears from the documents before the Court that for several years Bilka, which belongs to a group of department stores in the Federal Republic of Germany employing several thousand persons, has had a supplementary (occupational) pension scheme for its employees. This scheme, which has been modified on several occasions, is regarded as an integral part of the contracts of employment between Bilka and its employees.

4 According to the version in force since 26 October 1973, part-time employees may obtain pensions under the scheme only if they have worked full time for at least 15 years over a total period of 20 years.

- 5 Mrs Weber was employed by Bilka as a sales assistant from 1961 to 1976. After initially working full time, she chose to work part time from 1 October 1972 until her employment came to an end. Since she had not worked full time for the minimum period of 15 years, Bilka refused to pay her an occupational pension under its scheme.
  
- 6 Mrs Weber brought proceedings before the German labour courts challenging the legality of Bilka's refusal to pay her a pension. She argued *inter alia* that the occupational pension scheme was contrary to the principle of equal pay for men and women laid down in Article 119 of the EEC Treaty. She asserted that the requirement of a minimum period of full-time employment for the payment of an occupational pension placed women workers at a disadvantage, since they were more likely than their male colleagues to take part-time work so as to be able to care for their family and children.
  
- 7 Bilka, on the other hand, argued that it was not guilty of any breach of the principle of equal pay since there were objectively justified economic grounds for its decision to exclude part-time employees from the occupational pension scheme. It emphasized in that regard that in comparison with the employment of part-time workers the employment of full-time workers entails lower ancillary costs and permits the use of staff throughout opening hours. Relying on statistics concerning the group to which it belongs, Bilka stated that up to 1980 81.3% of all occupational pensions were paid to women, although only 72% of employees were women. Those figures, it said, showed that the scheme in question does not entail discrimination on the basis of sex.
  
- 8 On appeal the proceedings between Mrs Weber and Bilka came before the Bundesarbeitsgericht; that court decided to stay the proceedings and refer the following questions to the Court:
  - (1) May there be an infringement of Article 119 of the EEC Treaty in the form of 'indirect discrimination' where a department store which employs predominantly women excludes part-time employees from benefits under its occupational pension scheme although such exclusion affects disproportionately more women than men?

(2) If so:

- (a) Can the undertaking justify that disadvantage on the ground that its objective is to employ as few part-time workers as possible even though in the department store sector there are no reasons of commercial expediency which necessitate such a staff policy?
- (b) Is the undertaking under a duty to structure its pension scheme in such a way that appropriate account is taken of the special difficulties experienced by employees with family commitments in fulfilling the requirements for an occupational pension?

9 In accordance with Article 20 of the Protocol on the Statute of the Court of Justice of the EEC written observations were submitted by Bilka, Mrs Weber von Hartz, the United Kingdom and the Commission of the European Communities.

#### The applicability of Article 119

10 The United Kingdom puts forward the preliminary argument that the conditions placed by an employer on the admission of its employees to an occupational pension scheme such as that described by the national court do not fall within the scope of Article 119 of the Treaty.

11 In support of that argument it refers to the judgment of 15 June 1978 (Case 149/77 *Defrenne v Sabena* [1978] ECR 1365), in which the Court held that Article 119 concerns only pay discrimination between men and women workers and its scope cannot be extended to other elements of the employment relationship, even where such elements may have financial consequences for the persons concerned.

12 The United Kingdom cites further the judgment of 16 February 1982 (Case 19/81 *Burton v British Railways Board* [1982] ECR 555) where the Court held that alleged discrimination resulting from a difference in the ages of eligibility set for men and women for payment under a voluntary redundancy scheme was covered not by Article 119 but by Council Directive 76/207 of 9 February 1976 on the

implementation of the principle of equal treatment for men and women as regards access to employment, vocational training and promotion, and working conditions (Official Journal 1976, L 39, p. 40).

- 13 At the hearing the United Kingdom also referred to the proposal for a Council directive on the implementation of the principle of equal treatment for men and women in occupational social security schemes submitted by the Commission on 5 May 1983 (Official Journal 1983, C 134, p. 7). According to the United Kingdom, the fact that the Commission considered it necessary to submit such a proposal shows that occupational pension schemes such as that described by the national court are covered not by Article 119 but by Articles 117 and 118, so that the application of the principle of equal treatment for men and women in that area requires the adoption of special provisions by the Community institutions.
  
- 14 The Commission, on the other hand, has argued that the occupational pension scheme described by the national court falls within the concept of pay for the purposes of the second paragraph of Article 119. In support of its view it refers to the judgment of 11 March 1981 (Case 69/80 *Worringham and Humphreys v Lloyds Bank* [1981] ECR 767).
  
- 15 In order to resolve the problem of interpretation raised by the United Kingdom it must be recalled that under the first paragraph of Article 119 the Member States must ensure the application of the principle that men and women should receive equal pay for equal work. The second paragraph of Article 119 defines 'pay' as 'the ordinary basic or minimum wage or salary and any other consideration, whether in cash or in kind, which the worker receives, directly or indirectly, in respect of his employment from his employer'.
  
- 16 In its judgment of 25 May 1971 (Case 80/70 *Defrenne v Belgium* [1971] ECR 445), the Court examined the question whether a retirement pension paid under a statutory social security scheme constitutes consideration received by the worker indirectly from the employer in respect of his employment, within the meaning of the second paragraph of Article 119.



- 17 The Court replied in the negative, taking the view that, although pay within the meaning of Article 119 could in principle include social security benefits, it did not include social security schemes or benefits, in particular retirement pensions, directly governed by legislation which do not involve any element of agreement within the undertaking or trade concerned and are compulsory for general categories of workers.
- 18 In that regard the Court pointed out that social security schemes guarantee workers the benefit of a statutory scheme to which workers, employers and in some cases the authorities contribute financially to an extent determined less by the employment relationship between the employer and the worker than by considerations of social policy, so that the employer's contribution cannot be regarded as a direct or indirect payment to the worker for the purposes of the second paragraph of Article 119.
- 19 The question therefore arises whether the conclusion reached by the Court in that judgment is also applicable to the case before the national court.
- 20 It should be noted that according to the documents before the Court the occupational pension scheme at issue in the main proceedings, although adopted in accordance with the provisions laid down by German legislation for such schemes, is based on an agreement between Bilka and the staff committee representing its employees and has the effect of supplementing the social benefits paid under national legislation of general application with benefits financed entirely by the employer.
- 21 The contractual rather than statutory nature of the scheme in question is confirmed by the fact that, as has been pointed out above, the scheme and the rules governing it are regarded as an integral part of the contracts of employment between Bilka and its employees.

- 22 It must therefore be concluded that the scheme does not constitute a social security scheme governed directly by statute and thus outside the scope of Article 119. Benefits paid to employees under the scheme therefore constitute consideration received by the worker from the employer in respect of his employment, as referred to in the second paragraph of Article 119.
- 23 The case before the national court therefore falls within the scope of Article 119.

### **The first question**

- 24 In the first of its questions the national court asks whether a staff policy pursued by a department store company excluding part-time employees from an occupational pension scheme constitutes discrimination contrary to Article 119 where that exclusion affects a far greater number of women than men.
- 25 In order to reply to that question reference must be made to the judgment of 31 March 1981 (Case 96/80 *Jenkins v Kingsgate* [1981] ECR 911).
- 26 In that judgment the Court considered the question whether the payment of a lower hourly rate for part-time work than for full-time work was compatible with Article 119.
- 27 Such a practice is comparable to that at issue before the national court in this case: Bilka does not pay different hourly rates to part-time and full-time workers, but it grants only full-time workers an occupational pension. Since, as was stated above, such a pension falls within the concept of pay for the purposes of the second paragraph of Article 119 it follows that, hour for hour, the total remuneration paid by Bilka to full-time workers is higher than that paid to part-time workers.

- 28 The conclusion reached by the Court in its judgment of 31 March 1981 is therefore equally valid in the context of this case.
- 29 If, therefore, it should be found that a much lower proportion of women than of men work full time, the exclusion of part-time workers from the occupational pension scheme would be contrary to Article 119 of the Treaty where, taking into account the difficulties encountered by women workers in working full-time, that measure could not be explained by factors which exclude any discrimination on grounds of sex.
- 30 However, if the undertaking is able to show that its pay practice may be explained by objectively justified factors unrelated to any discrimination on grounds of sex there is no breach of Article 119.
- 31 The answer to the first question referred by the national court must therefore be that Article 119 of the EEC Treaty is infringed by a department store company which excludes part-time employees from its occupational pension scheme, where that exclusion affects a far greater number of women than men, unless the undertaking shows that the exclusion is based on objectively justified factors unrelated to any discrimination on grounds of sex.

### Question 2 (a)

- 32 In its second question the national court seeks in essence to know whether the reasons put forward by Bilka to explain its pay policy may be regarded as 'objectively justified economic grounds', as referred to in the judgment of 31 March 1981, where the interests of undertakings in the department store sector do not require such a policy.
- 33 In its observations Bilka argues that the exclusion of part-time workers from the occupational pension scheme is intended solely to discourage part-time work, since in general part-time workers refuse to work in the late afternoon and on Saturdays. In order to ensure the presence of an adequate workforce during those

periods it was therefore necessary to make full-time work more attractive than part-time work, by making the occupational pension scheme open only to full-time workers. Bilka concludes that on the basis of the judgment of 31 March 1981 it cannot be accused of having infringed Article 119.

34 In reply to the reasons put forward to justify the exclusion of part-time workers Mrs Weber von Hartz points out that Bilka is in no way obliged to employ part-time workers and that if it decides to do so it may not subsequently restrict the pension rights of such workers, which are already reduced by reason of the fact that they work fewer hours.

35 According to the Commission, in order to establish that there has been no breach of Article 119 it is not sufficient to show that in adopting a pay practice which in fact discriminates against women workers the employer sought to achieve objectives other than discrimination against women. The Commission considers that in order to justify such a pay practice from the point of view of Article 119 the employer must, as the Court held in its judgment of 31 March 1981, put forward objective economic grounds relating to the management of the undertaking. It is also necessary to ascertain whether the pay practice in question is necessary and in proportion to the objectives pursued by the employer.

36 It is for the national court, which has sole jurisdiction to make findings of fact, to determine whether and to what extent the grounds put forward by an employer to explain the adoption of a pay practice which applies independently of a worker's sex but in fact affects more women than men may be regarded as objectively justified economic grounds. If the national court finds that the measures chosen by Bilka correspond to a real need on the part of the undertaking, are appropriate with a view to achieving the objectives pursued and are necessary to that end, the fact that the measures affect a far greater number of women than men is not sufficient to show that they constitute an infringement of Article 119.

37 The answer to question 2 (a) must therefore be that under Article 119 a department store company may justify the adoption of a pay policy excluding part-time workers, irrespective of their sex, from its occupational pension scheme on the ground that it seeks to employ as few part-time workers as possible, where it is

found that the means chosen for achieving that objective correspond to a real need on the part of the undertaking, are appropriate with a view to achieving the objective in question and are necessary to that end.

**Question 2 (b)**

- 38 Finally, in Question 2 (b), the national court asks whether an employer is obliged under Article 119 of the Treaty to organize its occupational pension scheme in such a manner as to take into account the fact that family responsibilities prevent women workers from fulfilling the requirements for such a pension.
- 39 In her observations Mrs Weber von Hartz argues that the answer to that question should be in the affirmative. She argues that the disadvantages suffered by women because of the exclusion of part-time workers from the occupational pension scheme must at least be mitigated by requiring the employer to regard periods during which women workers have had to meet family responsibilities as periods of full-time work.
- 40 According to the Commission, on the other hand, the principle laid down in Article 119 does not require employers, in establishing occupational pension schemes, to take into account their employees' family responsibilities. In the Commission's view, that objective must be pursued by means of measures adopted under Article 117. It refers in that regard to its proposal for a Council directive on voluntary part-time work submitted on 4 January 1982 (Official Journal 1982, C 62, p. 7) and amended on 5 January 1983 (Official Journal 1983, C 18, p. 5), which has not yet been adopted.
- 41 It must be pointed out that, as was stated in the judgment of 15 June 1978, the scope of Article 119 is restricted to the question of pay discrimination between men and women workers. Problems related to other conditions of work and employment, on the other hand, are covered generally by other provisions of Community law, in particular Articles 117 and 118 of the Treaty, with a view to the harmonization of the social systems of Member States and the approximation of their legislation in that area.

42 The imposition of an obligation such as that envisaged by the national court in its question goes beyond the scope of Article 119 and has no other basis in Community law as it now stands.

43 The answer to Question 2 (b) must therefore be that Article 119 does not have the effect of requiring an employer to organize its occupational pension scheme in such a manner as to take into account the particular difficulties faced by persons with family responsibilities in meeting the conditions for entitlement to such a pension.

### Costs

44 The costs incurred by the United Kingdom and the Commission of the European Communities, which have submitted observations to the Court, are not recoverable. As these proceedings are, in so far as the parties to the main proceedings are concerned, in the nature of a step in the proceedings pending before the national court, the decision on costs is a matter for that court.

On those grounds,

### THE COURT,

in answer to the questions submitted to it by the Bundesarbeitsgericht by order of 5 June 1984, hereby rules:

- (1) Article 119 of the EEC Treaty is infringed by a department store company which excludes part-time employees from its occupational pension scheme, where that exclusion affects a far greater number of women than men, unless the undertaking shows that the exclusion is based on objectively justified factors unrelated to any discrimination on grounds of sex.

- (2) Under Article 119 a department store company may justify the adoption of a pay policy excluding part-time workers, irrespective of their sex, from its occupational pension scheme on the ground that it seeks to employ as few part-time workers as possible, where it is found that the means chosen for achieving that objective correspond to a real need on the part of the undertaking, are appropriate with a view to achieving the objective in question and are necessary to that end.
- (3) Article 119 does not have the effect of requiring an employer to organize its occupational pension scheme in such a manner as to take into account the particular difficulties faced by persons with family responsibilities in meeting the conditions for entitlement to such a pension.

Mackenzie Stuart	Koopmans	Everling	Bahlmann	
Joliet	Bosco	Due	Galmot	Kakouris

Delivered in open court in Luxembourg on 13 May 1986.

P. Heim  
Registrar

A. J. Mackenzie Stuart  
President

**LEGAL AUTHORITY CA-77**



**Arbitral Award**

Rendered in Stockholm, Sweden  
on 16 December 2003

Claimant: Nykomb Synergetics Technology Holding AB, Stockholm

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Respondent: The Republic of Latvia, Riga

Counsel:  
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The Arbitral Tribunal: Bjørn Haug, chairman  
Rolf A. Schütze  
Johan Gernandt

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# 1 Introduction

## 1.1 Overview

Nykomb Synergetics Technology Holding AB (“Nykomb”) is a joint stock company organized in 1995 under the laws of Sweden.

SIA Windau (“Windau”) is a joint stock company organized in 1991 under the laws of Latvia. Windau was originally 100 per cent owned and controlled by Latvian citizens, but Nykomb acquired 51 per cent of the share capital in March 1999 and 49 per cent in September 2000, making Windau a 100 per cent owned subsidiary of Nykomb.

The State Joint-Stock Company Latvenergo (“Latvenergo”) was organized as a state enterprise under Latvian law in 1991, and was in 1993 transformed into a joint stock company under Latvian law. The Republic of Latvia (the “Republic”) owns 100 per cent of the shares in Latvenergo. By an amendment of 3 August 2000 to the Latvian Energy Law the company is defined as “a national economy object of the State economy” that shall not be privatized. The company is actively involved in the production, purchase and distribution of electric power in Latvia.

On 24 March 1997 Latvenergo and Windau entered into an agreement called Contract No. 16/97 (the “Contract” or “Contract No. 16/97”) whereby Windau undertook to build a so called cogeneration plant in the town of Bauska, which was to produce electric power and heat on the basis of natural gas, the electric power to be purchased by Latvenergo and distributed over the national grid, and the heat to be purchased and distributed by the Bauska municipality. The plant was built and was ready to start production on 17 September 1999, but did not start until 28 February 2000 due to a dispute over the purchase price to be paid by Latvenergo. Since 28 February 2000 the Bauska plant has been delivering electric power to Latvenergo according to an interim or settlement agreement of 10 March 2000, at a price which in the Claimant’s view is less than Windau is entitled to under the Contract. The price dispute will be further explored below, but in short the delivery price stipulated in the purchase contracts entered into by Latvenergo is composed of two elements, the general tariff for average sales prices per kWh set by regulatory authorities and a multiplier set by Latvian laws or regulations. The Claimant contends that Windau was ensured for the first eight years of operation a multiplier of two (the “double tariff”), while Latvenergo considers the correct multiplier to be 0.75 of the tariff.

After unsuccessful attempts to reach an amicable settlement Nykomb on 11 December 2001 requested arbitration at the Stockholm Chamber of Commerce in accordance with Article 26.4.c of the Energy Charter Treaty of 17 December 1994 (the “Treaty” or the “ECT”). After exchanges of written briefs a preparatory meeting on 28 February 2003 and a hearing on 15 – 19 September 2003 was held in Stockholm.

## 1.2 *The Claimant's prayers for relief and legal grounds*

### 1.2.1 *The Claimant's prayers for relief*

In its Statement of Claim the Claimant made the following prayers for relief:

“Nykomb respectfully requests that the Arbitral Tribunal order the Republic:

- (i) to pay to Nykomb an amount of 667 158 Lats together with interest thereon from 17 September 1999 until actual payment at an annual rate of 6 per cent.
- (ii) to pay to Nykomb an amount of 2 311 020 Lats together with interest thereon from 28 February 2000 until actual payment at an annual rate of 6 per cent.
- (iii) to pay to Nykomb an amount of 4 119 502 Lats together with interest thereon from 16 September 2002 until actual payment at an annual rate of 6 per cent.

Nykomb respectfully requests the Arbitral Tribunal to order the Republic to compensate Nykomb for its cost of arbitration in an amount to be specified later and, as between the parties, alone to bear the responsibility for the compensation to the Arbitral Tribunal and to the Arbitration Institute of the Stockholm Chamber of Commerce.”

In its Brief No. I of 21 March 2003 the Claimant presented as secondary prayers for relief the following:

“Should the Tribunal find that compensation for future losses, i.e. compensation for the period from 30 April 2003 until 16 September 2007 as described above, may not be awarded as claimed by Nykomb in the Statement of Claim – with the exception of the applied discount rate of 6 per cent in Nykomb's present value computation or a finding of an expected yearly production of less than 24 813 MWh - Nykomb respectfully, as a secondary prayer for relief, requests the Tribunal to

- (i) order the Republic, to pay to Nykomb, an amount of 667 158 Lats together with interest thereon from 17 September 1999 until actual payment is made at an annual rate of 6 per cent;
- (ii) order the Republic, to pay to Nykomb, an amount of 2 817 591,7 Lats - or such higher amount that may follow from electricity produced and supplied during March and April 2003 - together with interest thereon from 28 February 2000 until actual payment is made at an annual rate of 6 per cent;
- (iii) confirm that the surplus electric power produced by and purchased from the Bauska Plant is to be purchased at a tariff to be calculated as twice the average electric sales tariff approved by the relevant regulatory body in the Republic of Latvia, currently  $30,28 \times 2 = 60,56$  Lats/MWh, and
- (iv) confirm that the surplus electric power so purchased shall be paid on a monthly basis.”

In its Brief No. I of 21 March 2003 the Claimant also stated:

“1.8 As a general point for the primary as well as secondary prayers for relief forwarded by Nykomb, the Tribunal may in the alternative and at its discretion decide whether any award shall be performed by the Republic on its own behalf or as principal for (on behalf of) Latvenergo, and likewise whether such performance shall be made to Nykomb on its own behalf or as principal for (on behalf of) its investment enterprise Windau.

1.9 Despite that Windau is not a party to this arbitration; it would in Nykomb's opinion not be incompatible with international law and the concept of arbitration under the Treaty to extend the res judicata effect of an award also to Windau, being wholly-owned and under direct control of Nykomb.

1.10 The Tribunal may also, as far as Nykomb is concerned, in the alternative and at its discretion, consider to ordering that any damages be paid directly to the investment enterprise Windau rather than to Nykomb as claimant investor. Such a solution is supported by arbitral jurisprudence within international investment law (see the “Mondev Award”, at para 86). “

In its Brief No. III of 9 September 2003 the Claimant amended its prayers for relief as follows:

“A. The Tribunal shall:

- (i) order the Republic, to pay to Nykomb, an amount of 667 158 Lats together with interest thereon from 17 September 1999 until the day of judgement at an annual rate of 6 per cent, and for the period thereafter until actual payment at an annual rate of 18 %.
- (ii) order the Republic, to pay to Nykomb, an amount of 2 311 020 Lats together with interest thereon from 28 February 2000 until the day of judgement at an annual rate of 6 per cent, and for the period thereafter until actual payment at an annual rate of 18 %.
- (iii) order the Republic, to pay to Nykomb, an amount of 4 119 502 Lats together with interest thereon from 16 September 2002 until the day of judgement at an annual rate of 6 per cent, and for the period thereafter until actual payment at an annual rate of 18 %.

B. Nykomb’s secondary prayer for relief, as submitted in Brief I dated 21 March 2003, shall be adjusted accordingly. The Tribunal shall:

- (i) order the Republic, to pay to Nykomb, an amount of 667 158 Lats together with interest thereon from 17 September 1999 until the day of judgement at an annual rate of 6 per cent, and for the period thereafter until actual payment at an annual rate of 18 %.
- (ii) order the Republic, to pay to Nykomb, an amount of 3 019 030 Lats together with interest thereon from 28 February 2000 until the day of judgement at an annual rate of 6 per cent, and for the period thereafter until actual payment at an annual rate of 18 %.
- (iii) confirm that the surplus electric power produced by and purchased from the Bauska Plant is to be purchased at a tariff to be calculated as twice the average electric sales tariff approved by the relevant regulatory body in the Republic of Latvia, currently 30,28 (double tariff = 60,56) Lats/MWh.
- (iv) confirm that the surplus electric power so purchased shall be paid on a monthly basis.”

### 1.2.2 Calculation of the amounts in the Claimant's prayers for relief

The specifications given in the Statement of Claim and in subsequent briefs show that the amounts in the Prayers for Relief have been arrived at as follows:

a) <u>Calculations used in the Statement of Claim Prayers for Relief</u>	
(i) <i>Deadlock period 17 September 1999-28 February 2000</i>	
Expected production (like September 2000-February 2001)	14.661.35 MWh
At double tariff 60.56 amounts to (for 163 days)	779.593 Lats
Lost income on heat	82.700 Lats
Less calculated cost of gas	<u>- 215.135 Lats</u>
Calculated net loss on electricity and heat	<u>667.158 Lats</u>
(ii) <i>Loss of income 28 February 2000-16 September 2002</i>	
Actual production in period (according to invoices)	61.057.33 MWh
Difference double-0.75 tariff (60.56-22.71) = 37.85 Lats	<u>2.311.020 Lats</u>

(iii) <i>Loss of income in rest of the 8 years' period, 16 September 2002-16 September 2007</i>	
Estimated 5 years' production (like 2001 = 25.249,62 MWh)	126.248.1 MWh
Difference double-0.75 tariff (60.56-22.71) = 37.85 Lats	4.778.491.20 Lats
Discounted at 6 percent per annum	<u>4.119.502.00 Lats</u>

b) Calculations used in the Brief No. III Prayers for Relief

***Primary Request for Relief:***

Calculations not presented, but the capital sums are identical to the calculations in the Statement of Claims (see details above).  
Claims for interest differ from the claims in the Statement of Claim.

(i) <i>Deadlock period 17 September 1999-28 February 2000</i>	
Net calculated loss on electricity and heat	<u>667.158 Lats</u>
(ii) <i>Loss of income 28 February 2000-16 September 2002</i>	<u>2.311.020 Lats</u>
(iii) <i>Loss of income 16 September 2002 – 16 September 2007</i>	<u>4.119.502.00 Lats</u>

***Secondary Request for Relief:***

(i) <i>Deadlock period 17 September 1999-28 February 2000</i>	
Net calculated loss (presumably calculated as above)	<u>667.158 Lats</u>
(ii) <i>Loss of income 28 February 2000-30 April 2003</i>	
Actual production in period (see Brief No. II page 40)	79.763 MWh
Difference double-0.75 tariff (60.56-22.71) = 37.85 Lats	<u>3.019.030 Lats</u>
(iii) <i>Order for double tariff to be paid in the future.</i>	
(This claim is not specified as to time period, but presumably relates to the period 30 April 2003 – 16 September 2007.)	

The Arbitral Tribunal notes that the primary request for relief in its final version continues to be based on a period of actual deliveries from 28 February 2000 to 16 September 2002, while the secondary request for relief has been updated to cover a period of actual deliveries from 28 February 2000 to 30 April 2003. Consequently, in both cases the third period concerning future deliveries up to 16 September 2007 includes a period up to the time of this award where deliveries have actually taken place and have been paid at 0.75 of the tariff.

The Arbitral Tribunal further notes that, apart from the claim for lost net income on heat production in the “deadlock” period, all the claimed amounts are based on the estimated or actual production of electricity at Bauska in the various periods, with calculation of the price at the double tariff, less the price at 0.75 of the tariff actually paid by Latvenergo to Windau for deliveries after 28 February 2000. In other words, the amounts claimed in the prayers for relief are equal to Windau’s alleged loss of net income for non-delivered heat and electricity in the deadlock period plus Windau’s alleged loss of income for the period

after 28 February 2000 due to the fact that Latvenergo has only paid 0.75 of the tariff for delivered electricity.

### *1.2.3 Legal grounds asserted by the Claimant*

Notwithstanding the way the Claimant calculates its losses, and notwithstanding the remarks in section 1.8-1.10 of the Claimant's brief of 21 March 2003 cited above, the Claimant does not appear to assert that it is entitled to claim payment directly to itself of the damages allegedly due to Windau for loss of net income on undelivered fuel and electricity during the deadlock period or the difference in purchase prices between the double tariff and the price actually paid to Windau for delivered electricity, nor does the Claimant appear to claim that it is entitled to pursue such a claim on behalf of its subsidiary Windau in this arbitration.

The Claimant must be understood to claim for the losses or damages it has incurred *itself* as a result of the undelivered heat and electricity during the deadlock period and as a result of the refusal of Latvenergo to pay the double tariff in the first eight years of production at Bauska. The Republic is asserted to be liable for breaches of its obligations under the Treaty, a) either directly liable on account of its own actions or lack of action, or liable because Latvenergo is a state organ or enterprise, or because Latvenergo's actions are attributable to the Republic, and b) because the non-payment of the double tariff amount to breaches of the Republic's obligations under Part III of the Treaty.

The Claimant asserts that Latvenergo's refusal to pay the double tariff:

- violates the obligation of fair and equitable treatment of investors, Article 10 (1);
- constitutes a treatment less favorable than required by international law, including treaty obligations, Article 10 (1);
- constitutes an impairment by unreasonable or discriminatory measures, Article 10 (1);
- constitutes measures having effect equivalent to expropriation, Article 13 (1).

With regard to Article 22 in Part IV of the Treaty the Claimant remarked in its closing statement:

“There was no negotiation, and there was obviously no economic motivation for Latvenergo to enter into one or several double tariff agreements, but Latvenergo had to deal with Nykomb, and others, and under conditions established by law only. There was no normal “haggling” about price as stated by Professor Wälde. Latvenergo held and still holds that position itself. It is in a monopolistic, public-service market that this transaction took place and which dominates its character from beginning to the end. This attribution – i.e. the operation by which the conduct of Latvenergo is treated as if it were an integral part of the state and by which the veil of its corporate personality is pierced (or lifted) – is based on customary international law (applicable under Art. 26 (6) of the Treaty), the State Responsibility draft of the International Law Commission as interpreted in the most recent and relevant awards, namely Maffezini I and II and in particular *Salini v. Morocco*. In addition it is also operated by operation of Art. 22 (1, 3 and 4) of the Treaty. We believe Art. 22 to be a special attribution norm for the primary obligations contained in part III of the Treaty, but whatever the legal argument about this, customary international law rules are fully sufficient for attribution and Art. 22 (1, 3 and 4) merely reinforce, by direct effect or by an indirect interpretative support, the attribution. Using a very old and in civil law established concept, Art 22 is clearly “accessory” (“akzessorisch”, “accessorisk”), to the “primary” obligations in Part III of the Treaty.”

The Claimant denies that its claims, or any part thereof, should be dismissed for lack of jurisdiction.

### *1.3 The Respondent's prayers for relief and asserted legal grounds*

In its statement of Defence of 27 November 2002 the Respondent made the following “Prayers for dismissal”:

“3.1 The Republic respectfully requests the Arbitral Tribunal:

(i) to dismiss the claim on its merits;

(ii) to order Nykomb to compensate the Republic for its costs of arbitration in an amount to be specified later; and

(iii) to order Nykomb, as between the parties, alone to be liable for the compensation to the Arbitral Tribunal and to the Arbitration Institute of the Stockholm Chamber of Commerce.

3.2 The Republic does not admit to the amount of Nykomb’s claim.

3.3 Should the Arbitral Tribunal find that Nykomb has a valid claim for damages the Republic respectfully requests the Arbitral Tribunal to limit any adjudged damages to an amount that does not exceed the loss incurred by Nykomb on its investment”.

In its Response of 4 September 2003 to Claimant’s Brief II the Respondent summed up its position as follows:

“8.2 Accordingly, Latvia respectfully requests that the Arbitral Tribunal adjudge and declare:

(i) that it lacks the jurisdiction to entertain the claim in the nature submitted by Nykomb; or

(ii) that Latvenergo’s conducts are not attributable to Latvia; and/or

(iii) that Latvia has not contravened any of its obligations under Part III of the Treaty; or

(iv) that Nykomb has not suffered any loss to warrant compensation; and

(v) that all costs of this arbitral proceedings, including legal costs, are to be borne by Nykomb”.

The Arbitral Tribunal understands these statements to the effect that the Respondent principally claims that all the Claimant’s claims should be dismissed for lack of jurisdiction, and in any event be dismissed on their merits. With respect to the Claimant’s new claims for interest at 18 per cent rather than 6 percent per annum from the time of the award, the Respondent requests that the new interest claim be dismissed for being submitted too late.

## **2 Jurisdiction**

### *2.1 The general basis for the Arbitral Tribunal’s jurisdiction*

The Claimant claims jurisdiction for this arbitration on the basis of Article 26.4.c of the Energy Charter Treaty of 17 December 1994 (the “Treaty” or the “ECT”). The article reads in part:

“ARTICLE 26 SETTLEMENT OF DISPUTES BETWEEN AN INVESTOR AND A CONTRACTING PARTY

(1) Disputes between a Contracting Party and an Investor of another Contracting Party relating to an Investment of the latter in the Area of the former, which concern an alleged breach of an obligation of the former under Part III shall, if possible, be settled amicably.



(2) If such disputes can not be settled according to the provisions of paragraph (1) within a period of three months from the date on which either party to the dispute requested amicable settlement, the Investor party to the dispute may choose to submit it for resolution:

- (a) to the courts or administrative tribunals of the Contracting Party party to the dispute;
- (b) in accordance with any applicable, previously agreed dispute settlement procedure; or
- (c) in accordance with the following paragraphs of this Article.

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(3) ---

(4) In the event that an Investor chooses to submit the dispute for resolution under subparagraph (2) (c), the Investor shall further provide its consent in writing for the dispute to be submitted to:

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(c) an arbitral proceeding under the Arbitration Institute of the Stockholm Chamber of Commerce.”

“Investment” and “investor” as used in Article 26 are defined in Article 1 of the Treaty:

#### ARTICLE 1 DEFINITIONS

As used in this Treaty:

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(6) “Investment” means every kind of asset, owned or controlled directly or indirectly by an Investor and includes:

- (a) tangible and intangible, and movable and immovable, property, and any property rights such as leases, mortgages, liens, and pledges;
- (b) a company or business enterprise, or shares, stock, or other forms of equity participation in a company or business enterprise, and bonds and other debt of a company or business enterprise;
- (c) claims to money and claims to performance pursuant to contract having an economic value and associated with an Investment;
- (d) Intellectual Property;
- (e) Returns;
- (f) any right conferred by law or contract or by virtue of any licences and permits granted pursuant to law to undertake any Economic Activity in the Energy Sector.

A change in the form in which assets are invested does not affect their character as investments and the term “Investment” includes all investments, whether existing at or made after the later of the date of entry into force of this Treaty for the Contracting Party of the Investor making the investment and that for the Contracting Party in the Area of which the investment is made (hereinafter referred to as the “Effective Date”) provided that the Treaty shall only apply to matters affecting such investments after the Effective Date.

“Investment” refers to any investment associated with an Economic Activity in the Energy Sector and to investments or classes of investments designated by a Contracting Party in its Area as “Charter efficiency projects” and so notified to the Secretariat

(7) “Investor” means:

(a) with respect to a Contracting Party:

- (i) a natural person having the citizenship or nationality of or who is permanently residing in that Contracting Party in accordance with its applicable law;
- (ii) a company or other organization organized in accordance with the law applicable in that Contracting Party;

(b) with respect to a “third state”, a natural person, company or other organization which fulfils, mutatis mutandis, the conditions specified in subparagraph (a) for a Contracting Party.

(8) “Make Investments” or “Making of Investments” means establishing new Investments, acquiring all or part of existing Investments or moving into different fields of Investment activity.

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Both Sweden and Latvia are Parties to the Treaty. It is not in dispute that Nykomb, being a company organized under the laws of Sweden and having its seat in Sweden is an investor, and that its acquisition of shares in and its giving of credits to Windau constitute investments within the meaning of the Treaty.

Nor is it contested that Nykomb made attempts at an amicable settlement and made a timely request for arbitration sufficient to meet the requirements set out in Article 26 (1) and (2).

## *2.2 The claims must be relating to an investment*

Article 26 requires that claims raised in an arbitration are relating to an investment under the Treaty. The Claimant’s losses or damages are allegedly caused by the reduced income flow into Windau which affects the Claimant’s investment. The Claimant’s allegations create a clear relationship between the claims and the Claimant’s investments in Windau as required by Article 26. However, it remains to be considered in connection with the merits whether there is a causal link between the refusal of Latvenergo to pay the double tariff and the alleged losses or damages.

## *2.3 The claims must be based on obligations under Part III of the Treaty*

Article 26 further requires that the claims must be based on alleged breaches of the Republic’s obligations under Part III of the Treaty.

As summarized in section 1.2.3 above, the Claimant alleges that all its claims against the Republic are based on breaches of provisions in Articles 10 and 13, which are contained in Part III of the Treaty.

The Claimant has also referred to parts of Article 22. The Respondent has objected to the Tribunal’s jurisdiction on the ground that Article 22 is placed in Part IV of the Treaty. The Arbitral Tribunal notes, however, that the Claimant has stated that the provisions Article 22 referred to do not give rise to any separate claim, but are rather invoked as provisions which clarify the scope and contents of other treaty provisions, among them the provisions in Part III that the Claimant relies on as bases for its claims. The Tribunal finds that the interpretation and application of the relevant Articles of the Treaty, Articles 10 and 13, are best considered under the merits part of this award, and that the references to Article 22 cannot as such be dismissed as inadmissible in the form the references are relied on.

## 2.4 *Lack of jurisdiction due to jurisdiction of Latvian courts*

a) The *Respondent* requests, for several reasons all denied by the Claimant, that the Claimant's claims shall be dismissed in their entirety for lack of jurisdiction.

The Respondent notes that the Claimant's claims are based on the alleged breach of the agreements between Latvenergo and Windau, viz. Contract No. 16/97 and the agreement of 10 March 2000, and argues on that basis as follows:

- The Claimant is not party to these agreements, Windau's contract rights are not transferred to, nor can they be pursued by Nykomb even if it is a 100 per cent parent company. The claims are not owned by the Claimant;
- Both agreements contain a jurisdiction clause giving exclusive jurisdiction to Latvian courts;
- There is nothing to prevent Windau from suing for the same alleged breaches in a Latvian court, with a risk of double payment of the same claim; and
- When the Republic signed and ratified the Treaty, it did not contemplate that such claims as raised by the Claimant in this arbitration would be capable of being brought under Article 26 of the Treaty, and consequently has not agreed to this arbitration.

As for the first of these arguments, the Tribunal must agree that if the Claimant were to be understood as pursuing a contractual claim directly and exclusively based on the agreements between Latvenergo and Windau, such claims would not be admissible since Article 26 only allows arbitration of claims based on alleged breaches of the Treaty. However, as stated in section 1.2.3 above, the Claimant must be understood to claim for the losses or damages it has incurred *itself* as a result of the undelivered heat and electricity in the deadlock period and the refusal of Latvenergo to pay the double tariff during the eight year period, and such claims are alleged to constitute breaches of the Treaty.

As for the second argument, Nykomb is undeniably a legal entity separate from its subsidiary Windau. Nykomb is not a party to either of the two contracts in question and already therefore not bound by their jurisdiction clauses. Nor would Windau have any authority or power, by means of the contract clauses submitting its contracts disputes to the jurisdiction of Latvian courts, to exclude Nykomb from pursuing its own claims in an arbitration under ECT Article 26, even in a situation where Nykomb's claims are based on alleged breaches of Windau's contracts.

The risk of double payment is admittedly an effect of the establishment of an arbitration facility also for alleged losses or damages suffered indirectly by an investor, for instance through violations against its subsidiary in a country that has adhered to the Treaty. No definite remedies have been developed at this stage, but clearly the Treaty based right to arbitration is not excluded or limited in cases where there is a possible risk of double payment. This risk of double payment is only likely to be resolved through the further development of the law in this area, such as by the means of new judgements, decisions, guidance or other relevant developments.

Finally, the Tribunal notes that the Republic did not file any reservations concerning the scope or interpretation of Article 26 when adhering to the Treaty. Clearly, the Republic must then be obliged to accept Treaty arbitration with such scope as follows from a proper interpretation of that Treaty provision.

b) The *Respondent* further argues that the dispute concerning the alleged breaches of the agreements between Latvenergo and Windau must first be settled by Latvian courts. In its brief of 4 September 2003 the Respondent states:

“Furthermore, Latvia’s argument should not be understood (as do Nykomb and its expert) to advocate the principle of exhaustion of local remedies as a procedural requirement in the traditional sense of international law. Rather, Latvia’s argument regarding Nykomb’s claim for an alleged and contested breach of contract cannot be ascertained until the proper forum has first pronounced on the issue. There is no evidence to suggest that Windau has been prevented from pursuing such a course of action. It is in this sense that Latvia has presented its argument concerning the exhaustion of local remedies, which Nykomb and its legal expert persist in misunderstanding.

For the above reasons, Latvia is of the view that the Arbitral Tribunal lacks the jurisdiction to entertain Nykomb’s claim for the double tariff. Whether such a tariff is due or not is a matter of dispute, and if contested (as seems to be the case here) can only be determined by the proper forum, and in accordance with the proper law of the contracts in question.”

The *Arbitral Tribunal* understands the quoted statement to the effect that the Respondent does not claim the existence of a general obligation under the Treaty or under international law that local remedies must be exhausted before arbitration can be requested under Article 26 of the Treaty. Nonetheless the Tribunal finds it appropriate to state that in the Tribunal’s view, no such general obligation to exhaust local remedies can be derived from the Treaty or international law in general. On the contrary, according to ECT Article 26 (4) the investor has the option of requesting Treaty arbitration even if it has agreed to the jurisdiction of a local forum – which, however, it has not done in the present case. As a preliminary issue, the Tribunal has come to the conclusion that it has jurisdiction to determine, as a preliminary matter, whether there has been a breach of the contract, insofar as it is necessary for its decision in relation to the claims raised on the basis of the Treaty.

## 2.5 *Lack of jurisdiction due to limited scope of Treaty provisions*

The *Respondent* has asserted several limitations to the scope of the Treaty provisions relied on by the Claimant, which under the circumstances of this case bring the Claimant’s claims outside the jurisdiction of the Tribunal, primarily interpreted as follows:

- a) Contract No. 16/97 was entered into on 24 March 1997, before the Treaty entered into force on 17 March 1998 and at a time when Windau had only Latvian shareholders. The Treaty does not apply retroactively to situations established prior to the entry into force of the Treaty;
- b) The withdrawal of the right to the double tariff occurred before the Claimant’s investments in Windau. The Treaty does not apply retroactively to situations established prior to the Claimant’s investment;
- c) Nykomb was aware of the price dispute, or ought to have been aware of it, before it bought the shares in Windau. Nykomb took a purely business or commercial risk when

investing in Windau. The Treaty only protects against political risks and not against commercial or business risks;

- d) Also, the Contract between Latvenergo and Windau for the purchase of electric power, upon which all the Claimant's claims are based, is a commercial contract and as such not protected by the Treaty. The Treaty protection only applies to investment contracts within the meaning of the Treaty.

The *Arbitral Tribunal* finds that the scope and application of the Treaty provisions relied on by the Claimant is best considered after a general description of the background for the dispute, including the successive laws and regulations and of the purchase contracts entered into by Latvenergo. After such general description the Tribunal will decide whether a claim or a part thereof is found to fall outside the scope of a treaty provision and shall be dismissed for lack of jurisdiction, and, if found to be within the scope of the Tribunal's jurisdiction, whether it shall be dismissed on its merits. See section 4.3.3 below.

### **3 General background**

#### *3.1 Latvian public policy concerning electric power*

The Claimant has given the following account of the situation since the early 90'ies<sup>1</sup> which appears largely to be undisputed between the parties.

“When the Soviet Union's occupation of the Republic came to an end in 1991, the Republic needed to reduce its dependency on electricity imported from Russia, Lithuania and Estonia. In the long term, the Republic was faced with a possible shutdown of the nuclear reactors in Russia and Lithuania and a significant uncertainty regarding power generation based on oil shale in Estonia. This dependency on electricity imports was deemed to be a national security risk. If the nuclear reactors in Russia and Lithuania had been closed, or had otherwise become unavailable because of breakdowns or defects, the Republic would have been unable to satisfy its needs for electricity. Electricity from Russia and Belarus is transmitted to the Republic through a connection of the main power system of Russia with the high-voltage networks in the Republic. Russia had, however, and still has, the technical ability to disconnect the high-voltage networks from the main power system of Russia. Such a disconnection would, *inter alia*, raise the electricity costs in the Republic. At the same time, it became apparent that the domestic generating capacity was insufficient to meet the increasing demands on electricity as the Republic was rebuilding its economy. The Republic had also been left with enormous ecological problems, e.g. air pollution from usage of dirty fossil fuels in local heating plants, and needed to encourage the use of cleaner fuels to stimulate a better environment.

To increase domestic generating capacity and the use of cleaner fuels, the Republic needed to attract private investments in the electricity industry, particularly from foreign investors. However, electricity prices were very low in the Republic. This was due mainly to the low import prices charged by the Russian state electricity monopoly and by the Ignalina power plant in Lithuania. Another contributing factor to the low prices in the Republic was the prohibition on several major Latvian hydropower producers to charge the full price for their electricity. Foreign investors could, however, hardly compete on a market so strongly influenced and dependent on import dumping; i.e. the large import of cheap electricity from Russia and Lithuania. Generally, Western investors were quite reluctant at the beginning of the 1990's to risk their capital in Eastern Europe. As a result, Western investors needed a strong incentive, an economic “premium”, to invest in new power generation and co-generation capacity in the Republic.

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<sup>1</sup> See the Statement of Claim page 16.

A co-generation plant is able to produce both electricity and heat, hence co-generation. Through the combined production of electricity and heat co-generation plants are able to use more than 80 per cent of the energy contents in the fuels used. The traditional condensing power plants, which were unable to produce both electricity and heat, could only use between 30 to 40 per cent of the energy contents in the fuels used. When introducing co-generation based on natural gas in Latvia, the Republic could, *inter alia*, streamline the use of the energy contents in the fuels used and improve the ecological situation by phasing out highly pollutant fossil fuels.”

In pursuance of its policies concerning electric power production and the attraction of foreign investment in general, the Republic took the following measures: On 5 November 1994 the Republic enacted a Law on International Agreements, on 17 December 1994 signed and subsequently ratified the Energy Charter Treaty, on 13 January 1995 signed the US - Latvia Bilateral Investment Treaty (the “US-Latvia BIT”) and on 6 September 1995 enacted a law “On the Regulation of Entrepreneurial Activity in Energetics” (the “Entrepreneurial Law”). The purpose of enacting the Entrepreneurial Law was to “encourage entrepreneurial activity in this field” (cf. Article 2 of the Law). The law established, in Articles 27(9) and (10), that electricity from, *inter alia*, cogeneration plants with installed capacity from 1 to 12 megawatts was to be purchased into the national power transmission grid at a price twice as high as the average consumer price, i.e. the double tariff. In September 1997 the Parliament adopted the Latvian National Energy Programme. The main purpose of the Energy Programme was to integrate the Latvian electricity market with the European Union and to harmonize Latvian legislation with EU directives and regulations. The Energy Programme aimed to increase competition in the energy sector especially with regard to pricing and tariffs. The Energy Law of 3 September 1998 was enacted as a result of the adoption of the Energy Programme.

### 3.2 *The organization of the Latvian electricity market*

According to the Claimant<sup>2</sup>, and not contested by the Respondent, in 2000 slightly more than 25 per cent of the electricity consumed in Latvia was imported, mainly from Russia and Lithuania. Of the electricity generated in Latvia, Latvenergo produced approximately 97 per cent while independent producers such as Windau produced the remaining 3 per cent. Latvenergo is also the sole distributor of electric power through the national grid. In its capacity as the main domestic producer and the sole distributor of electricity in Latvia, Latvenergo was, and still is, holding a dominant position in the Latvian electricity market.

There are also a number of smaller domestic producers, with various capacities and various production techniques. Among the domestic producers are about 28 cogeneration plants of different sizes.

Latvenergo is by law the sole distributor of imported and domestically produced electricity through the national grid, and is for this reason in effect the sole purchaser of electricity produced by private entrepreneurs. The purchase price is derived from the electricity tariff consecutively set by public authorities in accordance with methodologies set out in laws and regulations, and from the so called multipliers which are laid down in laws and regulations. Latvenergo states that it has no authority to deviate from the officially determined tariffs and multipliers. But the purchase prices are set out, with reference to relevant tariffs and multipliers, in Latvenergo’s purchase contracts for electricity.

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<sup>2</sup> See the Statement of Claim page 15.

It follows that the part of the Latvian domestic electricity market in which Windau operates is highly regulated. There is no competition between purchasers when an entrepreneur is ready to sell energy produced in Latvia, nor is there any price competition among the domestic producers of electricity.

### 3.3 *The building and financing of the Bauska cogeneration plant*

No information has been given with respect to the activities of Windau from its incorporation in 1991 up to 1996, nor concerning its activities, if any, beside the Bauska and the other 15 cogeneration projects mentioned below.

On 1 July 1996 Windau entered into a contract with Latvenergo for the building of a cogeneration plant at Bauska. The 1996 contract was replaced by the above-mentioned Contract No. 16/97 of 24 March 1997 concerning the building of the same cogeneration plant. On the same day the parties also entered into a Contract No. 17/97 in which Windau undertook to install three cogeneration plants in the cities of Jelgava, Dobeles and Iecava. A third agreement, Contract No. 18/97 entered into on 26 March 1997, is a general agreement pursuant to which Windau undertook to install a further 12 cogeneration plants in various, not specified, cities of Latvia. In all the contracts Windau undertook to sell and Latvenergo undertook to buy any surplus electric power from the plants, that is all the electric power in excess of the power required by the plants for the purposes of their own production.

The three contracts in 1997 were all made effective as of the date of signing. It has been explained by the Claimant that Contract No. 16/97 concerning Bauska, and then presumably also the other two contracts, were signed in anticipation of a limitation of a Latvian law provision which prescribed the double tariff to be paid for a period for eight years for electric power from cogeneration plants. The law amendment was enacted in June 1997 and excluded the double tariff for plants with contracts effective after 31 May 1997. Apparently, the board of Latvenergo reacted negatively to the Windau contracts, and decided on 25 September 1997 that no further contracts were to be entered into with Windau. In a letter of 2 October 1997 to Windau, Latvenergo declared Contracts Nos. 16/97 and 17/97 invalid, *inter alia* asserting that they were signed on behalf of Latvenergo by an unauthorized person. The same claim was made against another cogeneration operator, Latelektro-Gulbene. Latelektro-Gulbene brought a court action against Latvenergo and defeated Latvenergo's contentions. Latvenergo later brought a court action in a Latvian court against Windau, and withdrew the case in January 2003. But it still refuses to pay to Windau the double tariff referred to in Contract No. 16/97.

Noell-KRC Energie- und Umwelttechnik GmbH ("Noell") was a joint stock company established under the laws of the Federal Republic of Germany and was a subsidiary of the German company Preussag AG. Noell had been engaged in supplying cogeneration plants in Germany and other locations, and the group took an interest in participating in the project of building up to 16 cogeneration plants in Latvia as contracted for by Windau. A PriceWaterhouseCoopers report of 30 October 1998 suggested an investment value of DEM 5,6 million per plant, or all in all a contract value of DEM 90 million for the 16 plants. On 19 February 1998 Noell concluded an agreement with Windau providing for mutual co-operation and the supply of turnkey facilities to the cogeneration plants to be built. The first plant was to be built in Bauska, and was to serve as the model project for

the other plants to be built. Noell was to be Windau's turnkey supplier, technical service partner and technical adviser with respect to cogeneration technology.

In mid-1998 major changes took place within the Preussag group. Preussag decided to go out of the engineering business and stop their long term engagement in engineering projects. Noell transferred its power plant business to the German company BBP Power Plants GmbH, a subsidiary of the German company Babcock Borsig AG. Babcock Borsig AG filed for insolvency on 4 July 2002.

According to the oral witness statement by Mr. Bernt Kulbe, the managing director of Noell, Noell in 1998 went looking for another equity holder in the Latvian project. Noell had been working together with Nykomb on different projects since 1996. In the spring of 1998 Noell/Borsig invited Nykomb to take over the developer role for the cogeneration project. Nykomb performed an in-house analysis of the economic and technical parameters of the project and decided in July 1998 to engage and mobilize staff resources to complete the project development process. After further investigations and analyses, including a PriceWaterhouseCoopers report and analysis of 30 October 1999, negotiations concerning financing of the Bauska project were conducted with the Vereinsbank, both with its Riga branch and with its German head office, resulting in a loan agreement dated 12 February 1999 from the Riga branch in the amount of approximately € 1.533.000. It was foreseen at the time that an investment in Bauska would amount to 1.9 million Lats, of which 1.4 million Lats was planned to be covered by loans and 0.4 million Lats by equity.

One part of the financing package was that Nykomb undertook to acquire 51 per cent of the share capital in Windau. In consequence hereof, Nykomb, by a purchase agreement of 11 March 1999 registered on 25 March 1999' bought 51 per cent of the existing shares in Windau and participated with 51 per cent in an increase of the share capital. On 7 September 2000 Nykomb acquired the remaining 49 per cent of the shares to become a 100 per cent shareholder in Windau. It is still the sole shareholder in the company.

Noell and the PreussAG/Borsig group are said to have granted considerable credits to Windau, although further details have not been given. According to a letter of 12 April 2000 from Windau to Latvenergo:

“Currently there is over Lts 2,250,000 invested in this project represented by Lts 750,000 of equity (provided as to Lts 650,000 by Nykomb), Lts 200,000 in supplier credits from Germany and Lts 1,300,000 of local bank loans backed by a strong guarantee from the parent company of Noell KRC in Germany. In addition Nykomb has invested some Lts 200,000 in upgrading the heating grid in the municipality of Ogre.”

By way of illustration, this corresponds to, in Swedish kronor (at 15/-):

	Lats	SEK
Equity	750 000	11 250 000
Supplier credits	200 000	3 000 000
Local bank loans	<u>1 300 000</u>	<u>19 500 000</u>
Investment in Bauska	<u>2 250 000</u>	<u>33 750 000</u>

Plus, as stated in the letter, “Backed by a strong guarantee from the parent company of Noell KRC”.



The Tribunal also notes that according to Windau's annual report for 2001, the managing director of Noell, Mr. Kulbe, was the chairman of the board of Windau. The German group's interest is also indicated by the fact that the German ambassador to Latvia as well as representatives of Noell participated in the meeting with the Prime Minister of Latvia on 26 October 1999, see sections 3.4 and 3.5.7 below. The legal relationship between Nykomb and the German group might have been of interest to the Tribunal when considering the alleged losses or damages incurred by Nykomb because of the reduced income flow into Windau, but this has not been further documented by the Claimant.

The Bauska cogeneration plant was completed and ready for operation on 17 September 1999, but did not start its production until 28 February 2000 due to the dispute over the purchase price for electric power as will be further dealt with below.

### *3.4 Windau's other cogeneration projects*

Preparatory work was also carried out with respect to the other 15 cogeneration plants covered by Contracts Nos. 17/97 and 18/98. Thus, licenses were obtained for two plants in the city of Ogre and for plants in two other cities. An investment was also made in upgrading the grid for distributing heat in Ogre. After the Bauska plant was ready for operation and after the price dispute at Bauska had emerged, a meeting was held on 26 October 1999 with the Prime minister, with the participation of the Swedish and German ambassadors to Latvia as well as representatives of Windau and Noell. The need for a solution of the price dispute was underscored, as was the fact that such a solution was necessary in order for the project work on the other 15 contracted plants to proceed. As will be further explored in section 3.5.7 below, the meeting resulted in a Resolution No. 67 of the Cabinet of Ministers of 30 November 1999 ordering the double tariff to be adhered to. The resolution was however later annulled by the Constitutional Court for constitutional reasons. Thereafter, work on Windau's other cogeneration projects were halted, awaiting a clarification of the purchase prices for electric power at Bauska.

### *3.5 Latvian laws and regulations concerning purchase prices for electric energy*

The Tribunal finds it practical to give a general description of the Latvian laws and regulations pertaining to purchase prices for electric power produced in domestic cogeneration plants, and a description of the parties' differing views on the contents and applicability of some of these legislative instruments.

#### *3.5.1 Regulation No. 54 of 14 March 1995*

The system of varying multipliers was first introduced by this regulation, which reads as follows:

“1. In order to promote the production of electric power in the Republic of Latvia, these Regulations provide that the state joint stock company Latvenergo shall purchase electric power from the electric station not under the authority of Latvenergo (hereafter, the “decentralized electric stations”).

2. The purchasing price for electric power produced by decentralized electric stations, except those specified in section 3 hereof, shall correspond to the average calculated tariff for electric power sale of the state joint stock company Latvenergo.

3. The purchasing price for electric power produced by such small-size electric hydroelectric power stations (*not in excess of 2 MW*), which operate or which shall be restored by 2000, shall correspond to the double average tariff for the sale of electric power for a period of eight years from the start of operation of the respective electric station.” (Emphasis added.)

### 3.5.2 *The Entrepreneurial Law of 6 September 1995*

The Law of 6 September 1995 On the Regulation of Entrepreneurial Activity in Energetics (the “Entrepreneurial Law”) replaced Resolution No. 54 and extended the group of power producers to include, *inter alia*, co-generation plants. Article 27 reads in part as follows:

“Article 27. Procedure for setting tariffs.

(1) The tariffs charged for energy supply shall be calculated by an energy supply enterprise in accordance with the methodology for tariff calculation determined by the Council.

(2) The tariffs shall provide for that enterprises gain economically justified revenues from payments received from the consumers for the coverage of justified costs of energy resources production, salaries, operational and administrative costs, as well as maintenance of existing assets and new approved investments.

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(9) Spare power which corresponds to the state power standard from renewable energy resources (minihydropower plants with installed capacity up to 2 MW and wind power plants), as well as from *little capacity cogeneration plants with installed capacity from 1 MW up to 12 MW* shall be purchased into the state power transmission grid at a higher tariff.

(10) The power purchase price from power plants mentioned in part 9 of this article shall correspond to *the double average sales tariff* of power and shall be valid for eight years from the starting day of operation of the power plant. After that the purchase price shall correspond to the average tariff of power.”(Emphasis added.)

The parties agree that the Entrepreneurial Law unequivocally provided for the double tariff to be paid for electric power from cogeneration plants with installed capacity from 1 MW up to 12 MW. There was no limitation with respect to the time when a purchase contract with Latvenergo must have been entered into or when the production must have started. Windau’s Contract No. 16/97 with Latvenergo expressly states that the price for electric power from Bauska shall be based on the Entrepreneurial Law.

### 3.5.3 *Regulation No. 23 of 10 January 1997*

On 21 December 1995, the Cabinet of Ministers submitted a draft law to the Latvian Parliament proposing to repeal, *inter alia*, Articles 27 (9) and (10) of the Entrepreneurial Law, in other words a proposal to withdraw the offer to pay the double tariff to cogeneration plants pronounced by the Entrepreneurial Law. However, the draft law was rejected by the Parliament on 25 November 1996. This notwithstanding, the Cabinet of Ministers on 10 January 1997 issued Regulation 23 with a view to amending Article 27 (9) and repealing Article 27 (10), *inter alia* to the effect that the offer to pay the double tariff contained in the Law was removed, and the authority to determine the price setting procedures was passed to the Cabinet. Upon appeal from Parliament members the Constitutional Court, by decision of 7 May 1997, found the Cabinet’s regulation to be in conflict with Article 81 of the Constitution and declared Regulation No. 23 null and void, however only as from the time of the Court’s decision. In a later decision, the Constitutional Court remarked that Regulation No. 23 was in effect when Contract No. 16/97 was signed on 25 March 1997.

### 3.5.4 Amendments of 11 June 1997 to Art. 27 (9) and (10) of the Entrepreneurial Law

Subsequent to the judgement of the Constitutional Court of 7 May 1997 the Parliament amended Articles 27 (9) and (10) of the Entrepreneurial Law to read as follows:

“(9) Produced spare power which corresponds to the state power standard from renewable energy resources (minihydropower plants with installed capacity up to 2 MW and wind power plants), as well as from *little capacity cogeneration plants with installed capacity up to 12 MW*= shall be purchased into the state power transmission grid at a higher tariff. These provisions on purchase of power from the cogeneration plants shall be applied to all physical persons and legal entities whose/which contract with the State Joint-Stock Company “Latvenergo” to be privatised on purchase of the power into the state power transmission grid from cogeneration plants has taken effect by May 31, 1997;

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(10) The power purchase price from power plants mentioned in part 9 of this article shall correspond to *double average sales tariff* of power and shall be valid for eight years from the transferring for operation of the power plant. After that the spare power, which corresponds to the power standard established by the state, shall be purchased into the state power transmission grid at the tariffs established by the Cabinet of Ministers.”

(emphasis added)

This amendment limited the general application of the double tariff to cogeneration plants where its power purchase contract with Latvenergo “has taken effect by May 31, 1997”. As will be further explored below, Latvenergo and Windau had entered into a contract on 1 July 1996 concerning the installation of a cogeneration plant at Bauska. The contract stipulated that “(t)his Contract shall come into force from the moment when the cogeneration equipment is installed and the Deed of Conveyance signed”. That contract was however replaced by the above-mentioned new Contract No. 16/97 of 24 March 1997, which stipulated that “(t)his Agreement shall take effect as of the date of its signing”. The Claimant has explained that the new contract was negotiated and signed in anticipation of the limitation enacted on 11 June 1997. The Respondent has not denied that the new contract ensured Windau’s continued right to the double tariff also under the Entrepreneurial Law as amended.

### 3.5.5 The Energy Law of 3 September 1998

The Power Industry Law (the “Energy Law”) was adopted on 3 September 1998 and came into force on 6 October 1998. It repealed the Entrepreneurial Law from the date when the Energy Law was taking effect.

The Energy Law contained no specific provision concerning the use of the double tariff. The right to the double tariff was not repeated for any category of electric power plants in the new law, nor were there any transitory provisions upholding this right for those who were ensured the double tariff under the Entrepreneurial Law as amended in 1997, hereunder the cogeneration plants which had obtained a contract with Latvenergo effective before 31 May 1997 (see section 3.5.4 above).

However, Article 41 provides as follows:

“The Cabinet of Ministers shall determine a common procedure by which licensed electric power supply enterprises must buy up surplus electric power produced which remain after usage for self-needs and in compliance with the electric power parameters determined within the state, from co-

generation stations located within the zone of activity of their license and *the exploitation of which has been started.*” (Emphasis added.)

It is undisputed that this article, authorizing the Cabinet of Ministers to determine common procedures, including price setting for electric power from cogeneration plants, draws a distinction between two categories of plants, depending on the starting point for exploitation. Thus, it is undisputed that the law authorizes the Cabinet to determine procedures for one but not for the other category of cogeneration plants.

However, the parties disagree as to the interpretation and application of Article 41. The *Claimant* contends that the provision applies only to cogeneration plants that had started production at the time of the enactment of the Energy Law, and consequently does not apply to the Bauska plant, which was only ready for production in September 1999. And since the Energy Law does not otherwise open for the determination of tariffs and multipliers this means, in the Claimant’s view, that for cogeneration plants starting after the Energy Law came into force the Entrepreneurial Law (as stipulated in Contract No. 16/97) must still regulate the purchase price-to be paid, even though the Entrepreneurial Law itself was declared to be null and void and no longer in force as from 6 October 1998.

The *Respondent* contends that the correct translation of the expression emphasized above is “the exploitation of which *has not yet started*”. It has submitted a letter dated 17 September 2003 from the legal bureau of the Latvian Parliament, citing and commenting upon the Latvian words used in the law text and in the parliamentary debate, and expressing as its opinion that according to the Latvian wording of Article 41 of the Law means to apply to cogeneration plants the operation of which will be started, *i.e.*, to new cogeneration plants.

The *Arbitral Tribunal* is satisfied, upon the presented evidence of the meaning of Article 41 in its Latvian original, that the authority of the Cabinet to determine the procedures concerning cogeneration plants according to Article 41 was limited to plants which were starting its production after the enactment (or the coming into force) of the Energy Law.

The Tribunal may add that this understanding is also supported by the logic of the choice. It appears less logical to the Tribunal that the new law should only allow for the determination of new procedures for cogeneration plants already in operation, presumably with established prices and conditions, while not authorizing the Cabinet to determine prices and procedures for new cogeneration plants coming into production after the new law. It appears more logical, taking into account that the legislators wished to limit the authority to determine procedures, that the setting of new procedures was authorized for cogeneration plants not yet in operation while the legislative authority was not extended to plants already established and operating. This limitation of the Cabinet’s power might even be seen as the legislator’s will that plants already in operation shall not be subjected to new price setting procedures.

In consequence of the Claimant’s view that Article 41 only applies to cogeneration plants having started production before the Energy Law was enacted (or came into force), the Claimant draws the conclusion that Regulation No. 425 of 31 October 1998 and Resolution No. 9 of 8 January 2002 issued pursuant to Article 41 (see sections 3.5.6 and 3.5.9 below) do not apply to the Bauska production. The Respondent draws the conclusion that Article 41 authorizes the Cabinet to determine new procedures for cogeneration plants not yet in

production, including the Bauska plant, without any limitation with regard to upholding the right to the double tariff ensured under the Entrepreneurial Law.

### 3.5.6 Regulation No. 425 of 31 October 1998

On 31 October 1998 the Cabinet of Ministers issued Regulation No. 425 pursuant to Article 41 of the Energy Law, effective as from 4 November 1998.

The Regulation reads in part:

“These Regulations stipulate:

1.1. that licenced electric power supply enterprises shall have the obligation to purchase generated surplus electric power ... from the cogeneration stations starting their operation ..., with the installed electric capacity ... *not in excess of four MW*;

1.2 the procedure in which licenced electric power supply enterprises shall purchase electric power surplus from cogeneration stations with electric capacity not in excess of four MW.

2. If electric power surplus is purchased from *cogeneration stations with capacity not in excess of four MW*, the purchase tariffs shall be determined based on the value of the average electric power sale tariff (Tv). The Purchase tariff shall change depending on the value of the average electric power sale tariff (Tv), approved by the Energy Supply Regulation Council and which has been published in the newspaper of Latvijas Vestnesis.

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4. If surplus electric power is purchased from co-generation stations with *capacity from 0,5 MW to four MW*, the purchase tariff (Tie) shall be determined depending on the type of fuel used in the technological process of the production:

4.1. Tie = 0,95 TV, if local fuel is used

4.2 Tie= 0,75 Tv, if imported fuel is used”

(Emphasis added.)

The Regulation makes no exception for cogeneration plants which had obtained agreements with Latvenergo before 31 May 1997 and therefore had been ensured the double tariff under the Entrepreneurial Law as amended. The parties agree that this Regulation by its wording expressly prescribes the use of a 0.75 multiplier for this category of cogeneration plants, and thereby expressly abolishes the mandatory use of the double tariff prescribed by the Entrepreneurial Law as amended. But the Claimant contends, as already mentioned, that this new multiplier does not apply to the Bauska plant since Article 41 of the Energy Law did not apply to cogeneration plants not yet in operation, while the Respondent contends – and for that matter procedurally admits – that the applicable multiplier in the case of Bauska was reduced from 2 to 0.75 by this legislative act by the Cabinet.

### 3.5.7 Resolution No. 67 of 30 November 1999

After a meeting on 29 October 1999 between the Prime Minister of Latvia and the ambassadors of Germany and Sweden, and representatives of Noell and Windau, the Cabinet of Ministers on 30 November 1999 issued the following Resolution:

“1. According to Clause 8, part four, of the Law “On Foreign Investment in the Republic of Latvia”, the Privatization Agency shall ensure conclusion of an agreement between the State Joint-Stock Company under Privatization “Latvenergo” and the Limited Liability Company “Windau” on purchase of surplus electric power, produced by Bauska cogeneration station and meeting electric

power parameters established in the State, transmitted to the electric power distribution grid, for a *price equal to the double average tariff* of electric power sale for eight years after the corresponding power station is commissioned.

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2. The Minister of Economy V. Makarovs shall inform the Ambassador of the Kingdom of Sweden about the decision passed.

3 The Ministers, whose Ministries organize tenders for issue of licenses, shall pay special attention to the provisions of the Law “On Foreign Investments in the Republic of Latvia.”

(Emphasis added.)

The Latvian Law on Foreign Investments is dated 5 November 1991. Clause 8.4 reads as follows:

“8.4. In the event, that future laws of the Republic worsen the investment conditions, a foreign investment shall be subject to the laws which were in effect on the date the investment was made.”

Again, the decision of the Cabinet was appealed to the Constitutional Court, which on 24 March 2000 ruled that Section 1 of the decision was null and void from the moment of its adoption. One reason given was that the first foreign investments in Windau were registered only on 24 October 1997 and that Clause 8.4 therefore could not be applied to the case. It also found that “the validity of [the agreement of 26 March 1997] is a dispute of civil legal character, which must be settled in a court of general jurisdiction”. The Tribunal notes that this attempt by the Cabinet to safeguard Windau’s rights was unsuccessful, a main reason being that the Latvian Law on Foreign Investment was inapplicable. No position appears to have been taken by the Constitutional Court as to Windau’s right to the double tariff, which obviously was the basis for the Cabinet’s action.

### 3.5.8 Amendment of 1 June 2001 to Article 41 of the Energy Law

On 1 June 2001 Article 41 of the Energy Law was amended to read as follows:

“1. The Cabinet of Ministers stipulates common requirements to co-generation plants with respect to their operation mode, reliability and efficiency, as well as the common procedure in which, depending on the type of fuel and efficiency, *the price for the surplus electricity* that is left after consumption for own needs and is purchased from co-generation plants that correspond to the requirements stipulated in this Article shall be determined.

2. The procedure stipulated in Paragraph One of the current Article shall not apply to producers who, *by 1 June 2001, have received a license for electricity generation and have commenced the operation* of these plants and equipment within the term stipulated in the license.”

(Emphasis added)

By this amendment the Cabinet’s authority under Article 41 apparently was excluded for cogeneration plants that had received a license and had commenced their operations before 1 June 2001. This wording of the law apparently excluded the Bauska plant, which had received its license on 4 April 1999 and started operation on 28 February 2000. But there is no indication in the amendment law, or other documented material, whether this new limitation of the Cabinet’s authority under Article 41 should have the effect of a corresponding limitation of Regulation No. 425 of 31 October 1998 issued under Article 41 in its original wording (see section 3.5.6 above), nor have the parties commented on this particular question. As will be seen in section 3.5.9 below, resolution No. 425 was

formally repealed on 8 January 2002, and then replaced by a provision again determining 0.75 to be the multiplier applicable to plants like the Bauska plant.

### *3.5.9 Regulation No. 9 of 8 January 2002*

Regulation No. 9 of 8 January 2002 repealed Regulation No. 425 of 31 October 1998, and stated in its section V. Price determination, *inter alia* the following:

“20. If the electrical capacity installed is more than 0.5 megawatts, but does not exceed four megawatts and fossil fuel has been utilized in its production process, the price for the purchase of surplus electricity shall be determined by applying the coefficient 0.75 to the average sales tariff in the operating area of the relevant system operator’s licence.”

This Regulation was also issued pursuant to Article 41 of the Energy Law, evidently then in its amended version. As mentioned above, the Claimant contends that this regulation is not applicable to the Bauska plant since Article 41 is not applicable.

### *3.5.10 Conclusions as to the legislative acts*

The development with regard to regulation of purchase prices for electric power from cogeneration plants bears witness of a development from an initial broad-sweeping offer in the 1995 Entrepreneurial Law of the double tariff as an investment incentive, towards a gradual limitation and eventually the abolishment of the double tariff as a mandatory incentive prescribed by statute.

There is agreement between the parties that the double tariff was unequivocally set down by the Entrepreneurial Law in 1995, with a legal obligation for Latvenergo to apply it in its purchase contracts for power plants covered by the law. With the exception of an interim period from 10 January to 7 May 1997, see section 3.5.3 above, the double tariff for certain power plants was in force at least until the Energy Law came into force on 6 October 1998. The Claimant contends that Windau continues to have the right to the double tariff, since the transitory provisions of the Energy Law and subsequent regulations emanated in pursuance of that law do not apply to cogeneration plants coming into production after the enactment of the Energy Law. The Respondent contends, and the Arbitral Tribunal accepts upon the evidence presented, that the categorical application of the double tariff was repealed by the Energy Law and replaced by the subsequent Regulation No. 425 of 31 October 1998, the latter replaced by Regulation No. 9 of 8 January 2002 again determining the multiplier to be 0.75 for plants like the Bauska plant.

### *3.6 Agreements concerning purchase prices for electric energy*

The Tribunal also finds it practical to give a description of contracts entered into by Latvenergo with Windau and others. The agreements presented in this arbitration suggest a system of specific contracts between Latvenergo and prospective producers and sellers of electric power within Latvia; first, a relatively short master agreement setting out the sellers obligation to build the plant and to sell the electric power not needed for its own production, and Latvenergo’s obligation to buy the produced electricity, always stipulating the purchase price with reference to relevant Latvian laws and regulations, and, secondly, a more detailed off-take contract, stipulating mostly technical details. According to the Respondent such off-take contracts were consistently entered into by Latvenergo only at

the point in time when the producer had completed its installations and was ready to start production.

As a general background for the dispute concerning the price and *force majeure* clauses in the Windau agreements a description is given below of such clauses in the purchase agreements documented in this arbitration.

### 3.6.1 *The Liepājas Siltums agreement of 4 April 1995*

The first purchase contract documented in this arbitration is an Agreement of 4 April 1995 between Latvenergo (referred to in the agreement as the “Energy System”) and the joint stock company Liepājas Siltums concerning a cogeneration plant with electric power of 4.9 million kWh. The Agreement contains the following clause:

“5. The Energy System shall pay to the Cogeneration Station for the balance of electric power delivered by the Cogeneration Station to the Energy System’s grid according to Regulations No. 54, issued by the Republic of Latvia Cabinet of Ministers on 14.03.95.”

On 1 January 1996, after Regulations No. 54 had been replaced by the Entrepreneurial Law (see sections 3.5.1 and 3.5.2 above), the parties entered into a supplemental agreement replacing *inter alia* the above-mentioned Clause 5:

“1. From the day of signing this Agreement, [the Parties have agreed] to change and express in the following wording the following Clauses:

Clause 5:

As from 10 January 1996 and until the end of the term of this agreement, the Energy System shall pay to the Cogeneration Station for the balance of electric power delivered by the Cogeneration Station to the Energy System’s grid according to the double calculated average sales tariff for electric power of VAS “Latvenergo” (or its legal successors).

As for 1996, the double average sales tariff for electric power of VAS “Latvenergo” has been mutually agreed in Supplement No. 1 to this Agreement of 01.01.1996, it is 0.048 Ls per 1 kWh.

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### 3.6.2 *The Windau contract of 1 July 1996 Bauska*

In the contract of 1 July 1996 between Latvenergo and Windau, the first contract concerning the Bauska plant, the price clauses read as follows:

“II. Price

Price for the electric power is defined in lats according to double average electric power sales tariffs on the basis of the Republic of Latvia Law “On Regulation of Entrepreneurial Activities in Energy Industry”.

Prices are fixed in Supplement No. 1, which is an integral part of this Contract.

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V. Liability

The Parties shall be released from liability for violation against their contractual obligations, if it has been caused by force majeure conditions – changes in the legislation and decisions of the Government, earthquake, war, floods, etc.

VI. Additional provisions

If the average electric power sales price changes, changes shall also be made in prices defined in this Contract.



--"

The Supplement No. 1 referred to reads:

"The Seller shall sell the excess electric power to the Buyer for the price 0.052 Ls/kWh."

### *3.6.3 The Windau contract No. 16/97 of 24 March 1997 Bauska*

In Contract No. 16/97 of 24 March 1997 that replaced the contract of 1 July 1996 the price clause reads as follows:

#### "II. PRICE

Price for electric power shall be stated in lats, based on of the Republic of Latvia law "On Regulation of Entrepreneurial Activity in Power Industry".

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#### V. RESPONSIBILITY

The parties shall be released from responsibility for breach of obligations under this Agreement, if the reason for such breach is the so-called FORCE MAJEURE circumstances – changes in laws and resolutions of the Government, earthquakes, war, floods, etc.

#### VI. ADDITIONAL PROVISIONS

Upon change of average sale price of electric power, also the prices under this agreement shall be changed."

### *3.6.4 The Windau contract No. 17/97 of 24 March 1997 Jelgava, Dobele and Iecava*

In the Contract No. 17/97 of the same date as Contract No. 16/97, concerning cogeneration plants in Jelgava, Dobele and Iecava, the price clauses reads as follows:

#### "2. Contract price

The price for electric power shall be established in lats on the basis of the law "On the Regulation of Entrepreneurial Activities in the Energy Sector" of the Republic of Latvia.

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#### 5. Liability of the Parties

The Parties shall not be liable for the infringement of any provision of this Contract if such infringement is caused by force majeure, i.e. amendments to legislative regulations, government resolutions, earthquake, war, flood, etc.

#### 6. Additional conditions

If the average sales price of electric power changes, the Contract price shall be modified accordingly.

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### *3.6.5 The Windau contract No. 18/97 of 26 March 1997 12 cogeneration plants*

In the Contract No. 18/97 signed two days later, on 26 March 1997, concerning the set up of 12 cogeneration plants in (unspecified) towns in Latvia, the purchase price was determined as follows:

#### "2. Purchase Price

Surplus electric power shall be purchased for the price, which is effective in Latvia on the specific date of purchase."

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## 5. Force majeure

The parties shall be fully or partially released from responsibility, if Force Majeure circumstances have occurred, moreover, if such circumstances have occurred after the execution of relevant agreements and the parties could neither foresee nor influence them.

The parties acknowledge that Force Majeure circumstances include resolutions of the Parliament and the Cabinet of Ministers which eliminate or materially affect the performance of the agreements, natural catastrophes – floods, fire and rebellions. - - -“

### 3.6.6 *The Latelektro-Gulbene letter of intent of 19 May 1997*

Concerning another cogeneration plant, “Latelektro-Gulbene”, an agreement called a “letter of intent” was entered into on 19 May 1997, in which the parties *inter alia* agreed as follows:

2. ... “Latvenergo” agrees:

2.1 - - -

2.2 To pay the invoices for the electric power produced once every month according to the tariff defined in the law. ...”

The Arbitral Tribunal notes that this plant was granted its production license on 3 April 1997, the same date as the Bauska plant was granted its production license, and the letter of intent, similar to the new Contract No. 16/97 for Bauska, was entered into shortly before the adoption on 11 June 1997 of the amendment to the Entrepreneurial Law providing that only agreements being effective before 31 May 1997 would continue to benefit from the double tariff.

See also section 3.6.8 below.

### 3.6.7 *The Latvenergo – Windau agreement of 10 March 2000*

As already mentioned, the Bauska plant was ready for production on 17 September 1999, but Latvenergo refused to enter into an off-take agreement, and production was not commenced, apparently due to the dispute over the multiplier to be used in determining the purchase price. On 30 November 1999 the Cabinet had issued Resolution No. 67 in support of the double tariff. The Resolution was however appealed to the Constitutional Court, see section 3.5.7 above.

With this as a background, operation was started 28 February 2000 and on 10 March 2000, the parties entered into a detailed off-take agreement. With respect to the purchase price for electric energy this agreement provided as follows:

“2. Purchase Price and Sale Price of Electric Energy.

2.1 Latvenergo shall buy from Windau the surplus electric energy generated in cogeneration regime pursuant to requirement of the issued license, after satisfaction of Windau’s own needs (power surplus transmitted to the power system network) and which energy corresponds to parameters specified in the country, at the following price:

(a) until the judgment of the Constitutional Court in respect of the case relating to the acknowledgement as being invalid of Section of the November 30, 1999 protocol decision the Cabinet of Ministers, Latvenergo shall buy from Windau and pay for the electric energy generated at the power plant pursuant to the formula  $Tie = 0.75 Tv$  ...the difference ... shall be paid by

Latvenergo ... to the escrow account at A/S Vereinsbank Riga, which shall be used pursuant to the following conditions:

i in the event that the Constitutional Court acknowledges Section 1 of the November 30, 1999 protocol decision of the Cabinet of Ministers to be valid, this money shall be immediately transferred into the bank account of Windau at the S/S Vereinsbank Riga;

ii ...

(b) after the judgment of the Constitutional Court, Latvenergo shall buy from Windau and pay for the surplus electric energy generated at the power plant for the period of eight years after the commissioning of the Windau cogeneration plant in Bauska, in the following amount

i if by virtue of the judgment of the Constitutional Court, the November 30, 1999 decision of the Cabinet of Ministers or Section 1 thereof will remain effective, the purchase price from the cogeneration plant in Bauska shall be calculated pursuant to the formula  $Tie = 2.0 Tv$ ;

ii if by virtue of the judgement of the Constitutional Court, the November 30, 1999 protocol decision of the Cabinet of Ministers or Section 1 thereof will lose effect, the purchase price from the cogeneration plant in Bauska shall be calculated pursuant to the formula  $Tie = 0.75 Tv$ .

2.2 The parties mutually agree that irrespective of adoption of any judgment of the Constitutional Court, either party shall be entitled to submit its objections or claims in respect of the purchase price of electric energy stated in Section 2.1 (b) of this Agreement in the manner prescribed by law, and the parties agree that in the event that following the review of such objection or claim, the decision adopted by court differs from the provisions of Section 2.1.(b), the purchase price, determined pursuant to this court decision shall further be applied.

...”

#### 7. Force Majeure

7.1 The Party referring to Force Majeure circumstances as a hindrance for the performance of its obligations ... shall give notice thereof ... within three calendar days ... .

7.2 If either Party fails to perform its obligations in accordance with this Agreement due to Force Majeure, it shall be released from responsibility ... .”

The Arbitral Tribunal notes that the *force majeure* clause in this contract does not define or exemplify what is to be considered as force majeure.

#### 3.6.8 *The Latelektro-Gulbene agreement of 30 October 2001*

The Latelektro-Gulbene plant went into operation on 6 March 1998 but was disconnected from the grid in July 1998 because Latvenergo refused to pay the double tariff prescribed in the Entrepreneurial Law. In October 1998 Latelektro-Gulbene Ltd. filed a claim for the double tariff against Latvenergo in the Riga Regional Court, and won by the court's judgement of 16 December 1998. The decision was appealed, but was confirmed by an appellate court on 30 March 1999 and by the Latvian Supreme Court by a decision of 30 June 1999. All the courts found that the letter of intent of 19 May 1997 constituted a legally binding contract and that it unequivocally stipulated that the double tariff was to be paid in the eight years' period from the commissioning of the plant, by referring to the law in force at the moment of signing the contract. The Tribunal notes that all three court decisions were rendered after the Energy Law had been enacted and had come into force on 6 October 1998.

Following the Supreme Court decision Latvenergo accepted the double tariff and entered into a new agreement with Latelektro-Gulbene dated 30 October 2001. The purchase price is not specifically defined, but the double tariff in the first eight years is clearly assumed in clause 10.3:

“7. Force Majeure

7.1 None of the Parties shall be held liable if the performance of any provision hereof is delayed or made impossible by any natural or man-made calamities, by mass disorders, war, riots, as well as action of state authorities or any other condition beyond the control of the Party whose obligations are affected by it, which the Parties could not anticipate, while making this Agreement, and which the Parties are unable to prevent by using reasonable methods available to them.

7.2 The Party, which refers to force majeure conditions ... shall report about it ... not later than within three calendar days ...

- - -

10. Term of Agreement

10.1 The Parties agree that this Agreement shall be in force for an undetermined period of time, subject to Clause 10.3 hereof.

10.3 If the Parties do not agree on a new purchase price for electric power by 6 March 2006, when the duty of Latvenergo to buy electric power for the double tariff expires, then this agreement shall lose its legal force at the moment when the said term expires.”

*3.7 The legal significance of the price and force majeure clauses*

Although the wording of the agreements varies, the purchase agreements documented in this arbitration all have the same general structure: The seller undertakes to install the power plant(s) and to sell to Latvenergo its surplus power (that is, produced power beyond what is needed by the seller for its own production), and Latvenergo undertakes to purchase the surplus power on the basis of tariffs stipulated by law.

Apart from specifying in a couple of the contracts the precise tariff to be paid in the current year, all contracts consistently refer to actual laws and regulations as determining the price to be paid and do not stipulate prices other than those deriving from legislation and administrative decrees. None of the contracts suggests that Latvenergo has had the authority or even the intention to deviate from what follows from laws and regulations, and Latvenergo has expressly denied having any such authority. Thus, in a letter to Windau of 20 March 1998 Latvenergo stated that

“...the law regulates purchase of power from cogeneration stations and it is a state regulated business. At the moment determining a different purchase price would be a violation of the given law”.

However, as may be derived from the court decisions in the Latelektro-Gulbene case, the price clauses in the purchase contracts are not merely references to Latvian laws and regulations at any time, but these clauses are deemed by the highest legal authority, the Latvian Supreme Court, to be legally binding contractual obligations under Latvian law. And specifically, the contracts are to be interpreted as fixing the multiplier in effect at the moment of signing the contract. The situation thus documented are facts interpreted by the Latvian courts concerning the Latvian legal situation that can be taken into regard by this Tribunal, without any need for the Tribunal to embark on any interpretation or application of Latvian national law on its own.

The Tribunal will add that there are several other circumstances that support the understanding of the purchase agreements set down by the Latvian Supreme Court. One is that several of the agreements make express reservations for changes of the tariff for average sale prices but not for changes of the multiplier. Such reservations would be

superfluous if the contract was to be understood merely to refer to laws and regulations at any time, and do support the impression that the multiplier was unreservedly granted for the eight years as stipulated in the Entrepreneurial Law. Another is that the offering of an investment incentive to prospective investors for a period of eight years would naturally be perceived by investors as a firm commitment for the full eight year period unless clear reservations were made to the contrary.

### 3.8 *The purchase price agreed between Latvenergo and Windau*

a) Following the legal findings of the Latvian Supreme Court in the quite similar Latelektro-Gulbene case there can be no doubt that Contract No. 16/97 of 24 March 1997 stipulated the purchase price for electric power from the Bauska plant to be the double tariff for a period of eight years from the time when Windau was ready to start production and had been commissioned.

b) However, the *Respondent* has contended that the *force majeure* clause in Contract No. 16/97 expressly makes reservations for new laws or regulations, which may alter the parties' rights or obligations under the contract. The *Claimant* denies that the clause can be read to this effect.

The *Arbitral Tribunal* considers that it would not be an evident conclusion of the unspecific reference to new legislation in the *force majeure* clause in Contract No. 16/97 that the legislator should be free to revoke the double tariff commitment, leaving the investor with no protection against a reduction or abolishment of this investment incentive. In particular, the structure of Contract No. 16/97, setting out in Article V a general reservation for changes in the legislation, immediately followed by a specific reservation in Article VI for changes of the "average sale price of electric power" (but thus not in the multiplier), strongly supports that changes affecting the price setting were not meant to be included in the *force majeure* clause. The Latvian Supreme Court decision in the Latelektro-Gulbene case, pronouncing that the purchase price (except for changes in the average tariff) is to be the one following from laws and regulations in force at the time of signing the contract, also gives strong support to the conclusion that the contractually stipulated multiplier may not be changed by means of the general reservation in the *force majeure* clause in Contract No. 16/97, even if the Gulbene letter of intent did not contain a similar general reservation against changes in the legislation. – As will be seen from the quotations above, the Latvenergo – Windau contract of 10 March 2000 does not contain any definition of *force majeure* which includes later changes in the legislation.

c) Further, the *Respondent* contends that Contract No. 16/97, including its agreement on the purchase price, was replaced by the agreement of 10 March 2000 (see section 3.6.7 above), fixing the multiplier at 0.75 after the Constitutional Court's decision. The *Claimant* contends that the 10 March 2000 agreement was a purely interim agreement, entered into under a certain degree of duress and in order to get out of the loss-producing standstill situation while waiting for the Constitutional Court's decision.

The *Arbitral Tribunal* notes that, after Windau was ready to start production on 17 September 1999 and the price dispute had emerged in full, Latvenergo sent Windau the following letter dated 27 September 1999:

"Subject: On signing the interim agreement

During the negotiations in the Privatization Agency Latvenergo orally expressed you an offer to sign an interim agreement until our disagreement in the matters related to the purchase of the produced surplus power is solved.

Taking into account the tense course of the negotiations, the oral offer as if did not receive the necessary attention.

Therefore we repeatedly offer you to sign an **interim agreement** on purchasing surplus power from the station and on supplying power to the station from Latvenergo, determining the precise term for such an agreement. ...

We understand that a station, which has been launched, has to start operating as soon as possible and this is exactly the reason for our proposal. Understanding your concern, we can include in the agreement the provision that the agreement shall not be in any way related to the previous or future relationship between Latvenergo and 'Windau Ltd'."

The Tribunal further notes that the agreement of 10 March 2000 itself does not state whether it is an interim agreement, or whether it constitutes a replacement of or a supplement to Contract No. 16/97. But the agreement states in clause 10.1 that its term of validity shall not be limited, and in clause 10.2 that the validity of the agreement shall depend on the validity of the licenses issued to the parties.

With regard to the clauses regarding the purchase price to be paid, the agreement stands out as an interim agreement concerning what payments shall be made in the period until the price dispute has been settled. The parties agree (see section 2.1 of the agreement) that up to the time of the Constitutional Court's decision payment shall be made at 0.75 of the tariff, with an immediate correction of the payment up to the double tariff if the Constitutional Court decides the issue before it in favour of the Claimant. And for the time after the Constitutional Court's decision, payments shall be at the double tariff if confirmed by the Constitutional Court but otherwise be based on the 0.75 multiplier, in both cases until such time as the price dispute is settled "in the manner prescribed by law". See section 2.2.

Section 2.2 of the agreement expressly stipulates that either party shall be entitled to submit its objections or claims in respect of the prices payable under the payment arrangement in section 2.1, irrespective of the adoption of any judgement of the Constitutional Court. This must reasonably be interpreted to mean that the price and payment clauses in the agreement constitute no change in the parties' claims and material basis with regard to the long-term price to be paid. In the Tribunal's opinion this confirms that Contract No. 16/97 was not revoked or replaced by the new agreement.

As mentioned above, for the period up to the decision of the Constitutional Court, the agreement makes it clear that the payment at 0.75 is an interim payment arrangement, with the payments to be corrected up to the double tariff if that would follow from the Court's decision. For the period from the Constitutional Court's decision up to the time when the dispute is settled "in the manner prescribed by the law", the interim payment is also to be at 0.75 of the tariff (unless otherwise determined by the Constitutional Court), but the agreement does not state expressly whether the interim payments are to be corrected, provided that the subsequent legal decision concludes that the correct payment according to Contract No. 16/97 is the double tariff. The Tribunal has considered whether the agreement must be interpreted as establishing that the interim payments shall be final. In other words, whether a legal decision establishing that Contract No. 16/97 determines the price to be the double tariff is only to take effect from the time of the legal decision, in the present case only from the time of this arbitration award. However, the agreement's clear

stipulation that the parties maintain their rights to pursue their claims under Contract No. 16/97 and obtain a legal decision without any limitation created by the agreement of 10 March 2000, leads the Arbitral Tribunal to the conclusion that also the agreement for the period after the Constitutional Court's decision is only an interim payment arrangement, with the payments to be corrected in accordance with the subsequent legal decision.

The Arbitral Tribunal therefore concludes that the agreement of 10 March 2000 is an interim agreement for the payments to be made during an unspecified period until the price dispute can be finally settled, making no changes with regard to the purchase price ultimately payable under Contract No. 16/97.

d) The *conclusion* must consequently be that the contractually agreed purchase price between Latvenergo and Windau for electric power from the Bauska plant shall be the double tariff for a period of eight years from the time when Windau was ready to start production and the plant had been commissioned.

## **4 The legal basis for the claims against the Republic**

### *4.1 Introduction*

The Claimant's claims are based on the undisputed fact that the start-up of production at the Bauska plant was delayed from 17 September 1999 until 28 February 2000, apparently due to Latvenergo's refusal to pay the double tariff for electric power from the Bauska plant, and due to the undisputed fact that all electric power delivered after the start-up on 28 February 2000 has only been paid at 0.75 of the average tariff.

The Arbitral Tribunal holds, and the parties seem to agree, that for the Republic to be held responsible in this arbitration the following conditions must be satisfied:

- a) The non-payment must be caused directly by the Republic or a state organ, or Latvenergo's actions in the contractual relationship with Windau must be attributable to the Republic;
- b) The non-payment and the circumstances around such non-payment must constitute a violation of an obligation under Part III of the Treaty; and
- c) The non-payment of the double tariff must have caused loss or damage to the Claimant's investment.

The condition under lit. c) will be dealt with under section 5 below.

### *4.2 The Republic's responsibility for the non-payment*

As concluded in sections 3.5.10 and 3.8.d above, the Arbitral Tribunal considers that Windau originally had both a statutory and a contractually established right to the double tariff for an eight year period.

It is conceded by the Respondent that the Entrepreneurial Law in force at the time of Latvenergo and Windau entering into Contract No. 16/97 on 24 March 1997 gave Windau a *statutory right* to the double tariff during the first eight years of production. The Respondent has also conceded that Windau's acquired statutory right to the double tariff was taken away by successive legislative acts, first, possibly, with the amendment to the Entrepreneurial Law of 11 June 1997 (see section 3.5.4), then definitely by the repeal of the Entrepreneurial Law by the Energy Law with effect from 6 October 1998 and the Cabinet of Ministers' Regulation No. 425 of 31 October 1998 (see sections 3.5.5 and 3.5.6 above). These are acts for which the Republic is directly responsible.

With regard to a *contractually established* right to the double tariff the Arbitral Tribunal concludes that by entering into Contract No. 16/97 Latvenergo also gave Windau a contractual right to the double tariff for eight years, see section 3.8.d above. It is not contested that Latvenergo has never paid the double tariff for electricity delivered by Windau.

No explicit explanation or documentation has been given as to the reasons for Latvenergo's refusal to pay the double tariff, but apparently the immediate reason for Latvenergo's refusal to pay was the repeal of the statutory right to the double tariff. It is in evidence that Latvenergo had no authority of its own to decide or negotiate purchase prices for electric power produced in Latvia. The average price tariff at any time was determined by regulatory authorities, and the so called multipliers were determined by law, or according to law, with an obligation for Latvenergo to apply the relevant tariff and the multipliers determined by the public authorities. Failing any indication to the contrary, it may be assumed that Latvenergo felt it to be its duty to deny Windau the double tariff after the legislators' decision to repeal Windau's established statutory right to the double tariff.

However, Latvenergo must have been aware that Windau in all likelihood had a contractual right to the double tariff. As mentioned above, the Latvian Supreme Court in a judgement of 30 June 1999 decided, in the quite parallel case of Latelektro-Gulbene, that Latvenergo had a contractual obligation to pay according to the multiplier in force at the time of entering into the agreement, regardless of later changes in the legislation. Latvenergo also signed a new contract with Latelektro-Gulbene confirming payment of the double tariff during the eight year period.

The central government of Latvia was also fully aware of Latvenergo's refusal to pay the double tariff. After a meeting with the Prime Minister on 29 October 1999 the Cabinet of Ministers on 30 November 1999 issued a Resolution ordering the double tariff to be paid to Windau (see section 3.5.7 above). As explained, the Resolution was later invalidated by the Constitutional Court for constitutional reasons, but the incident is evidence of the central government's full knowledge of Latvenergo's failure to pay the double tariff. There is no evidence of the government taking any further steps to protect Windau's rights under the contract, or to reinstate Windau's statutory right to the double tariff, for instance in accordance with the Republic's obligations to protect foreign investments under the Energy Charter Treaty, see section 4.3.2 below.

It must therefore be concluded that the breach of Windau's contractual rights was allowed to continue, and in that sense was caused, by the government's failure to act in order to correct the situation.



The Arbitral Tribunal is also of the view that in the circumstances of this case, the Republic must be considered responsible for Latvenergo's actions under the rules of attribution in international law.

Latvenergo was established in 1991 as a state enterprise, and was in 1993 transformed into a joint stock company with the Republic as a 100 per cent owner. For a while the plans were to privatize the company, and the company was administered by the Latvian Agency for Privatization. But by a change in the Energy Law on 3 August 2000 it was decreed that:

“As a national economy object of the State importance, the Joint Stock Company “Latvenergo” shall not be privatized. All shares in the Joint Stock Company “Latvenergo” are owned by the State.”

By order of the Cabinet of Ministers of 9 August 2000 the supervision of the company was transferred to the Ministry of Economy.

Both before and after these organizational changes Latvenergo held a dominant position as a major domestic producer of electric power and as sole distributor of electricity over the national grid. It was clearly an instrument of the State in a highly regulated electricity market. In the market segment where Windau operated, Latvenergo had no commercial freedom. It had no freedom to negotiate electricity prices but was bound, and considered itself to be bound, by the legislation and the regulatory bodies' determination of the purchase prices to be paid for electric power produced by cogeneration plants. Latvenergo cannot be considered to be, or to have been, an independent commercial enterprise, but clearly a constituent part of the Republic's organization of the electricity market and a vehicle to implement the Republic's decisions concerning the price setting for electric power.

For this reason, whether Latvenergo's refusal to pay the double tariff was based on a misunderstanding of the legal situation, or whether it for other reasons ignored the legal framework under which it was operating, its actions concerning the purchase price are attributable to the Republic. Consequently, the Republic must be found responsible for Latvenergo's failure to pay the double tariff. – The Tribunal will add that for this finding it is not necessary to rely on the supplemental rule in Article 22 (1) of the Treaty contended by the Claimant (see section 4.3.1 below).

### *4.3 Violations of Treaty obligations*

The *Claimant* alleges that the non-payment of the double tariff constitutes violation of several of the provisions of Article 10 of the Treaty, and also amounts to expropriation, or having an effect equivalent to an expropriation, as defined in Article 13 of the Treaty. It also relies on Article 22 (1) of the Treaty.

These Articles read in part:

“ARTICLE 10 PROMOTION, PROTECTION AND TREATMENT OF INVESTMENTS

(1) Each Contracting Party shall, in accordance with the provisions of this Treaty, encourage and create stable, equitable, favorable and transparent conditions for Investors of other Contracting Parties to make Investments in its Area. Such conditions shall include a commitment to accord at all times to Investments of Investors of other Contracting Parties fair and equitable treatment. Such

Investments shall also enjoy the most constant protection and security and no Contracting Party shall in any way impair by unreasonable or discriminatory measures their management, maintenance, use, enjoyment or disposal. In no case shall such Investments be accorded treatment less favorable than that required by international law, including treaty obligations. Each Contracting Party shall observe any obligations it has entered into with an Investor or an Investment of an Investor of any other Contracting Party.

- - -

(3) For the purposes of this Article, "Treatment" means treatment accorded by a Contracting Party which is no less favourable than that which it accords to its own Investors or to Investors of any other Contracting Party or any third state, whichever is the most favourable.

- - -

(7) Each Contracting Party shall accord to Investments in its Area of Investors of other Contracting Parties, and their related activities including management, maintenance, use, enjoyment or disposal, treatment no less favourable than that which it accords to Investments of its own Investors or of the Investors of any other Contracting Party or any third state and their related activities including management, maintenance, use, enjoyment or disposal, whichever is the most favourable.

- - -“

#### “ARTICLE 13 EXPROPRIATION

(1) Investments of Investors of a Contracting Party in the Area of any other Contracting Party shall not be nationalized, expropriated or subjected to a measure or measures having effect equivalent to nationalization or expropriation (hereinafter referred to as "Expropriation") except where such Expropriation is:

- (a) for a purpose which is in the public interest;
- (b) not discriminatory;
- (c) carried out under due process of law; and
- (d) accompanied by the payment of prompt, adequate and effective compensation.

Such compensation shall amount to the fair market value of the Investment expropriated at the time immediately before the Expropriation or impending Expropriation became known in such a way as to affect the value of the Investment (hereinafter referred to as the "Valuation Date"). - - -“

#### “ARTICLE 22 STATE AND PRIVILEGED ENTERPRISES

(1) Each Contracting Party shall ensure that any state enterprise which it maintains or establishes shall conduct its activities in relation to the sale or provision of goods and services in its Area in a manner consistent with the Contracting Party's obligations under Part III of this Treaty..

- - -”

With reference to these Treaty provisions the Claimant mainly contends that:

- Windau is subject to a treatment having an effect equivalent to expropriation;
- The Republic fails to accord fair and equitable treatment of investments and constant protection and security of such investments;
- The failure to pay the double tariff represents discrimination, and a violation of the obligation to most-favoured nation's treatment; and
- Latvenergo is under both statutory and contractual obligation to purchase electric power from the Bauska plant at the double tariff, and the Republic is, pursuant to

Article 10 (1), under a duty to observe obligations that it has entered into, including obligations entered into by Latvenergo.

The *Respondent* denies for a number of reasons that the Respondent is in breach of any obligations under the Treaty, mainly contending that Latvenergo is a separate legal entity for which the Republic is not responsible, and that the scope of the asserted Treaty provisions are limited as set out in section 2.5 above.

#### 4.3.1 Expropriation

The *Claimant* does not contend that the non-payment of the double tariff amounts to a direct and formal expropriation meeting the requirements of Article 13 (1) (a)-(c), but rather that it constitutes an “indirect” or “creeping” expropriation. By taking away a substantial part of Windau's income from sales it makes the enterprise not economically viable and the Claimant's investment worthless.

The *Respondent* denies that Latvenergo’s non-payment amounts to the equivalent of an expropriation even in the wider sense developed under recent international treaty law and practice. First, no public authority is involved in Latvenergo’s action under the contract, second, there is no taking of possession or control over the enterprise, and third, the payment of 0.75 rather than 2.00 of the tariff does not result in the investment becoming worthless. The Claimant itself admits that the pay-back time is only lengthened, but that does not amount to expropriation.

The *Arbitral Tribunal* has considered the expert legal opinions and arbitral awards rendered under similar treaties presented in this case by the parties. The Tribunal finds that “regulatory takings” may under the circumstances amount to expropriation or the equivalent of an expropriation. The decisive factor for drawing the border line towards expropriation must primarily be the degree of possession taking or control over the enterprise the disputed measures entail. In the present case, there is no possession taking of Windau or its assets, no interference with the shareholder’s rights or with the management’s control over and running of the enterprise – apart from ordinary regulatory provisions laid down in the production licence, the off-take agreement, etc.

The Tribunal therefore *concludes* that the withholding of payment at the double tariff does not qualify as an expropriation or the equivalent of an expropriation under the Treaty.

#### 4.3.2 Fair and equitable treatment, discrimination etc.

The *Claimant* contends that Latvenergo’s actions, and the Republic's responsibility for such actions, constitutes violations of several of the Republic's obligations contained in or made operative by Article 10 of the Treaty, and has submitted evidence of circumstances upon which it bases its contentions.

The *Respondent* denies any violation of any international obligations contained in or referred to in Article 10, and has submitted evidence and explanations to counter the Claimant's contentions.

The *Arbitral Tribunal* notes in general that the actions for which the Republic is asserted to be responsible may qualify as a violation of various Treaty provisions. The Tribunal

further notes that the damage or loss caused by the non-payment of the double tariff is the same. Thus, in order to establish liability for the Republic it is strictly speaking sufficient to find that one of the relevant provisions has been violated.

a) *Unreasonable or discriminatory measures*

Article 10 (1) provides *inter alia* that

“...no Contracting Party shall in any way impair by ...unreasonable or discriminatory measures their [the Investor’s Investments] ...use, enjoyment or disposal”.

The *Claimant* contends that Windau has been subject to discriminatory measures by Latvenergo’s refusal to pay the double tariff. Latvenergo has been, and still is, paying SIA “Latelektro-Gulbene” and Joint Stock Company “Liepājas Siltums” the double tariff for its surplus electric power. There is no legitimate reason to treat Windau differently from the two aforementioned enterprises.

The *Respondent* does not deny the fact of the double tariff being paid to the two companies mentioned, but contends that the situations are not comparable. The Respondent has provided lists and some details concerning the 28 cogeneration power plants existing in Latvia, and asserted that they are in many respects different and therefore have been awarded different multipliers. An evaluation must take place in each case. No discrimination is demonstrated by the fact that the two above-mentioned plants have been granted the double tariff, whereas Bauska has not.

The *Arbitral Tribunal* accepts that in evaluating whether there is discrimination in the sense of the Treaty one should only “compare like with like”. However, little if anything has been documented by the Respondent to show the criteria or methodology used in fixing the multiplier, or to what extent Latvenergo is authorized to apply multipliers other than those documented in this arbitration. On the other hand, all of the information available to the Tribunal suggests that the three companies are comparable, and subject to the same laws and regulations. In particular, this appears to be the situation with respect to Latelektro-Gulbene and Windau. In such a situation, and in accordance with established international law, the burden of proof lies with the Respondent to prove that no discrimination has taken or is taking place. The Arbitral Tribunal finds that such burden of proof has not been satisfied, and therefore *concludes* that Windau has been subject to a discriminatory measure in violation of Article 10 (1).

b) *Other asserted Treaty violations*

For the reason stated above, the Arbitral Tribunal does not find it necessary to adjudge the other Treaty violations asserted in this arbitration.

#### 4.3.3 *Limited scope of the Treaty provisions allegedly breached*

As mentioned in section 2.5 above, the Respondent has asserted several limitations to the scope of the Treaty provisions relied on by the Claimant:

a) *The Treaty does not apply retroactively to contracts entered into before the Treaty entered into force:*

It is undisputed that Contract No. 16/97 was entered into on 24 March 1997 and that the Energy Charter Treaty only came into force on 17 March 1998. However, none of the Claimant's claims are based on the date of the signing of the Contract. The claims are built on the repeal of Windau's statutory right to the double tariff, which took place in September/October 1998, and on the breach of the contractual obligation to pay the double tariff, which materialized in September 1999 when the Bauska plant was ready to go into operation, and which has been maintained since then, albeit in accordance with the interim agreement of 10 March 2000. Both the changes in the law and the breach of contract occurred after the entry into force of the Treaty. There is therefore no question of retroactive effects of the Treaty in this situation.

*b) The Treaty does not apply retroactively to a withdrawal of the right to the double tariff which was effected before Nykomb's investment took place:*

It is undisputed that the Claimant's first investment in Windau occurred by the contract of 11 March 1999, registered on 25 March 1999, for the purchase of 51 per cent of the shares in Windau. The withdrawal of Windau's statutory right to the double tariff took place in September/October 1998, which was before Nykomb's investment. But as pointed out in lit. a) above, the claims for losses or damages are also based on the breach of the Contract which occurred from September 1999, which is after Nykomb's first investment was made. At least in the latter situation there is no question of the retroactive effects of the Treaty.

*c) Nykomb was aware of the price dispute, or ought to have been aware of it, and took a commercial risk not protected by the Treaty:*

The Respondent also contends that Nykomb was aware of the price dispute, or ought to have been aware of it, before it bought the shares in Windau. Nykomb took a purely business or commercial risk when investing in Windau. The Treaty only protects against political risks and not against commercial or business risks.

This contention raises the question of what Nykomb knew, or ought to have known, about Latvenergo's refusal to pay the double tariff at the time of its investment. It also invites the question of whether a Contracting State to the Treaty can free itself from its Treaty obligations simply by informing a prospective foreign investor that it has established and intends to continue a discrimination of the foreign investment which would otherwise be a violation of the Treaty.

The Tribunal will first deal with the dispute between Latvenergo and Windau concerning the validity of Contract No. 16/97. The relevant sequence of events in connection with this can be summarized as follows:

24 Mar 1997	Contract Nos. 16/97 and 17/97 entered into
26 Mar 1997	Contract No. 18/97 entered into
11 June 1997	The Entrepreneurial Law was amended, excluding contracts after 31 May 1999
25 Sep 1997	Latvenergo board decision: No further contracts with Windau
2 Oct. 1997	Latvenergo declared Contract Nos. 16/97 and 17/97 invalid
24 Oct. 1997	Dupont Aldrich Inc. and Jonathan Moseley became shareholders

19 Feb 1998	Noell turnkey and supply contract with Windau
6 Mar 1998	Windau compromise proposal to Latvenergo on invalidity dispute
20 Mar 1998	Latvenergo rejected any compromise, referring to being "bound by law"
Spring 1998	Noell invited Nykomb to take over as equity investor
8 May 1998	Windau asks for an off-take contract for Bauska
21 May 1998	Latvenergo refused, referring to board decision of 25 September 1997
29 Jun 1997	Windau letter to Council concerning the double tariff
30 Jun 1998	Council's letter to Windau confirming the double tariff
July 1998	Nykomb involved itself in project investigations
30 Oct. 1998	PriceWaterhouseCooper's financial proposal
16 Dec 1998	First instance Court decision in the Latelektro-Gulbene case
12 Feb 1999	Loan agreement between Vereinsbank and Windau
11 Mar 1999	Nykomb's purchase agreement for 51 per cent of the shares in Windau
30 Jun 1999	The Latvian Supreme Court ruling in the Latelektro-Gulbene case
11 Sep 1999	Bauska ready to start operation. Latvenergo refuses to pay double tariff
28 Feb 2000	Bauska started operation
10 Mar 2000	Windau –Latvenergo interim agreement
About Jan 2002	Latvenergo's court action against Windau on validity of Contract 16/97
11 Feb 2002	Nykomb Request for Arbitration
January 2003	Latvenergo's court action withdrawn, according to Claimant.

As will be seen, there was an ongoing dispute between Latvenergo and Windau almost from the beginning concerning the validity of Contract No. 16/97. As early as 2 October 1997 Latvenergo proclaimed that it considered the Contract invalid. As late as at the turn of the year 2001/2002, according to the Claimant, Latvenergo brought an action in the Latvian courts against Windau, claiming the invalidity of the Contract.

A similar court action had earlier been brought by the company Latelektro-Gulbene against Latvenergo. In both cases Latvenergo appears to have argued that the purchase agreements were invalid, because they were signed on behalf of Latvenergo by a person unauthorized to do so, because the price clauses (see section 3.6.3 and 3.6.6 above) were unclear and therefore not legally binding, and because the purchase price agreement had been superseded by subsequent legislation.

Latelektro-Gulbene won its case in three Latvian court instances, which culminated in the decision of the Latvian Supreme Court in June 1999 (see section 3.6.8 above). Latvenergo's court action against Windau was initiated after the Latelektro-Gulbene case had been decided and Latvenergo had entered into a new contract with Latelektro-Gulbene accepting the double tariff, see section 3.6.8 above. The case against Windau was only withdrawn in January 2003. It has not been explained why Latvenergo gave up the court case.

In the present arbitration the Respondent does not challenge the general validity of Contract No. 16/97, but contends that it does not establish a right to the double tariff for

eight years. As further developed above, the Arbitral Tribunal finds and concludes to the contrary.

But it remains to be considered whether it is of any legal significance whether Nykomb was aware of, or ought to have been aware of, Latvenergo's contentions that Contract No. 16/97 was invalid and that therefore the right to the double tariff was contended to be ineffective.

The representatives of Nykomb must clearly have been aware of the dispute between Latvenergo and Windau over the validity of Contract No. 16/97, and therefore aware of an uncertainty as to whether the whole contract would fall away, and with it Windau's right to the double tariff. This uncertainty is reflected in the PriceWaterhouseCoopers financial analysis of 30 October 1998, where calculations were made alternatively on the basis of a 1.00 multiplier (that is, ordinary tariff price for electric power) and the 2.00 multiplier according to the Contract.

The double tariff was also treated as a condition for the repurchase of shares in the agreement of 11 March 1999 whereby Nykomb bought 51 per cent of the shares in Windau. According to Clause 5.1 of the agreement the sellers were secured the right to repurchase 21 per cent of the shares, subject to several conditions, mainly,

- that Windau shall have sold all generated electricity to Latvenergo at the double tariff provided for by the Latvenergo agreements (defined in clause 2.2.9 as Contract Nos. 16/97, 17/97 and 18/97);
- that three years had expired after the commissioning of the Bauska plant; and
- that Windau had fulfilled all its liabilities and repaid all loans and covered all expenses connected with the purchase, construction and commissioning of (the 16) co-generation plants.

By clause 2.2.9 of the agreement the sellers represented and warranted that “[T]he Latvenergo Agreements are in full force and effect and enforceable in accordance with its terms”, compare in relation to this the Council's letter of 30 June 1998 confirming the double tariff.

It must therefore be concluded that Nykomb was fully aware of the uncertainty and risk deriving from Latvenergo's position, but took its precautions in the share purchase agreement and took the risk that the Contract was valid and invested in the Windau shares.

Whether or not one would characterize the risk Nykomb was taking as a commercial risk, is in the Tribunal's view immaterial. It is the Tribunal's conclusion that Windau had entered into a purchase contract for the delivery of electric power that was, and is, legally valid and binding and gave Windau the right to the double tariff for eight years. Nykomb made its share investment relying on this contract. Latvenergo's contentions that Contract No. 16/97 was invalid and did not establish the right to the double tariff were legally unfounded. Nykomb's awareness of Latvenergo's contentions does not relieve the Republic of its obligations under the Treaty resulting from Latvenergo's refusal to pay the double tariff. Generally, a Contracting Party to the Treaty cannot be relieved of its obligations

under the Treaty simply by letting it be announced that legally binding commitments, upon which the foreign investor is relying, will not be honored.

d) *The Claimant's claims are based on a commercial contract not protected by the Treaty*

Finally, the Respondent contends that the Contract between Latvenergo and Windau for the purchase of electric power, upon which all the Claimant's claims are based, is a commercial contract and as such not protected by the Treaty. The Treaty protection only applies to investment contracts within the meaning of the Treaty.

It follows from the remarks above that the Arbitral Tribunal cannot regard the purchase contract as purely commercial, nor can the action to refuse payment of the double tariff under the contract be considered as purely commercial.

As for the objection that the purchase contract is not an investment contract within the meaning of the Treaty, it suffices to note that such a contract clearly falls within the definition of investments in Article 1 of the Treaty.

#### 4.3.4 Conclusion

In consequence of the above findings the *Arbitral Tribunal concludes* that the Respondent is found to be liable under the Treaty for the losses or damages incurred by the Claimant.

## 5 Assessment of losses or damages

### 5.1 Legal principles of assessment

Article 13 (1) of the Treaty spells out the principles of compensation in the special case of investments being nationalized, expropriated or subjected to measures having effect equivalent to nationalization or expropriation. As concluded in section 4.3.1 above, the Tribunal does not find that the refusal to pay the double tariff amounts to expropriation or the equivalent of an expropriation within the meaning of Article 13 (1). The Tribunal considers that the principles of compensation provided for in Article 13 (1) are not applicable to the assessment of damages or losses found to be caused by violations of Article 10, as in the present case.

Another assessment rule is contained in Article 26 (8), which provides that the awards of arbitration according to Article 26 may include an award of interest. The question of interest will be dealt with below.

The Arbitral Tribunal holds, and it seems to be agreed between the parties, that the question of remedies to compensate for losses or damages caused by the Respondent's violation of its obligations under Article 10 of the Treaty must primarily find its solution in accordance with established principles of customary international law. Such principles have authoritatively been restated in The International Law Commission's Draft Articles on State Responsibility adopted in November 2001 (hereinafter referred to as the "Articles ILC").



According to Articles 34 and 35 ILC restitution is considered to be the primary remedy for reparation. Article 35 states:

“A State responsible for an internationally wrongful act is under an obligation to make restitution, that is, to re-establish the situation which existed before the wrongful act was committed, provided and to the extent that restitution:

- (a) is not materially impossible;
- (b) does not involve a burden out of all proportion to the benefit deriving from restitution instead of compensation.”

Restitution in the present case is conceivable, either through a juridical restitution of provisions of Latvian law ensuring Windau’s right to the double tariff as it was ensured under the Entrepreneurial Law, or through a monetary restitution to Windau of the missing payments of the difference between the contractually established double tariff and 0.75 of the tariff actually paid. But even if damage or losses to an investment may be inflicted indirectly through loss-creating actions towards a subsidiary in the country of a Contracting State, restitution must primarily be seen as an appropriate remedy in a situation where the Contracting State has instituted actions directly against the investor. An award obliging the Republic to make payments to Windau in accordance with the Contract would also in effect be equivalent to ordering payment under Contract No. 16/07 in the present Treaty arbitration. The Arbitral Tribunal therefore finds the appropriate approach, for the time up to the time of this award, to be an assessment of compensation for the losses or damages inflicted on the Claimant's investments. For the time after this award see section 5.2, last paragraph, below.

## 5.2 *Assessment of losses or damages suffered by the Claimant*

a) As already pointed out (see section 1.2.2 above) the Claimant requests a relief equal to Windau's alleged loss of net income on heat and electric power in the “dead-lock” period 16 September 1999 – 28 February 2000 and Windau’s alleged loss of sales income on electric power for the rest of the eight years’ period to 16 September 2007, namely the difference between the double tariff and the 0.75 of the tariff actually paid, or expected to be paid.

The *Respondent* has argued, and the *Arbitral Tribunal* must agree, that the reduced flow of income into Windau obviously does not cause an identical loss for Nykomb as an investor. If one compares this with a situation where Latvenergo would have paid the double tariff to Windau, it is clear that the higher payments for electric power would not have flowed fully and directly through to Nykomb. The money would have been subject to Latvian taxes etc., would have been used to cover Windau's costs and down payments on Windau's loans etc., and disbursements to the shareholder would be subject to restrictions in Latvian company law on payment of dividends. An assessment of the Claimant's loss on or damage to its investment based directly on the reduced income flow into Windau is unfounded and must be rejected.

b) However, there can be no doubt that the non-payment of the double tariff to Windau has caused a substantial reduction of the economic value and security of the Claimant's investments in the Windau enterprise.

A primary measurement of an investment is the capitalized earnings value. A substantial reduction of Windau's earnings as demonstrated in this case must be considered as

convincing evidence that a substantial damage to or loss on the Claimant's investment has been suffered. A reduction of the tariff multiplier from 2.00 to 0.75 represents a 62.5 per cent reduction of the sales income from electric power. Furthermore, if one takes as illustrative the relationship between Windau's gross income on electricity and heat sales suggested by the Claimant's calculation for the "dead-lock" period, the reduction of the tariff multiplier results in a reduction of the total income from sales by about 57 per cent, more than half of Windau's total income as compared with a situation where the double tariff would be paid.

It is also clear that the higher income flow would have served to consolidate Windau's financial position, provided means for paying back bank loans and other credits, and ensured a quicker pay-back on the investments in the cogeneration plant. For Nykomb as an investor the effect would be increased security for its investments in credits, shares and subordinated loans. From another perspective, the Claimant has pointed out that the reduced liquidity caused by the refusal to pay the double tariff may lead to the consequence that Windau shall not be able to pay back the loan to Vereinsbank that is due for payment in January 2004.

But the loss or damage suffered by Nykomb as an investor is difficult to quantify. The difficulty is also increased by the fact that the Claimant has submitted rather limited documentation concerning the financial and economic situation of Windau and the circumstances concerning its own investment, for instance the relationship between Nykomb and Noell and the Noell group.

At the hearing the Claimant submitted a list of "capital requirements" for the Bauska plant 1999-2003, including the situation at the end of 2000 (for illustration, SEK at 15/- is added here):

		End 2000	
		Lats	SEK
NYKOMB			
	Shares	250 000	3 750 000
	Loans	380 000	5 700 000
	Owner costs	439 000	6 585 000
		<u>1 069 000</u>	<u>16 035 000</u>
NOELL/BBP	1 495 000	22 425 000	
VEREINSBANK	622 000	9 330 000	
SUM TOTAL		<u>3 186 000</u>	<u>47 790 000</u>

This statement concerning the Claimant's total investment would appear to suggest a maximum of what the Claimant stands to lose on account of Latvenergo's non-payment of the double tariff. But the loss of Windau's future earning potential, and the conceivable consequential loss for Nykomb as a 100 per cent owner of the enterprise, must also be considered. As for this last element the Tribunal has little material upon which to base an assessment, apart from various submitted financial analyses and Windau's accounts for the last few years.

Faced with the lack of further specifics, together with the undeniable finding that Nykomb as an investor has suffered economic loss or damage on its investment, the Arbitral Tribunal is compelled to make an assessment, taking into regard the requirements under applicable customary international law of causation, foreseeability and the reasonableness of the result.

The Tribunal finds that the best available basis for such an assessment is the calculated loss of electricity production in the “dead-lock” period and the actual production of electric energy up to the time of this award. The Tribunal does not consider the asserted loss of heat production in the “dead-lock” period to be helpful in connection with this, nor is it substantiated in any sufficient degree what net loss has been suffered on the non-production of heat. The only cost deducted in the Claimant's calculation of the net loss is the cost of natural gas required for the production.

The Tribunal considers that in the circumstances a discretionary award of one third of the estimated loss in purchase prices of electricity up to the time of this award may serve as a reasonable basis for quantification of the Claimant's assumed losses up to the time of this award, due to the Respondent's violations of its Treaty obligations.

To develop the chosen basis for the Arbitral Tribunal's assessment the Tribunal has added, to the Claimant's figures for electricity production up to 30 April 2003, an estimated figure for power production from 1 May 2003 up to the time of the award, based on the figures for power production up to 30 April 2003. It has also been found reasonable to include in the estimate a 6 per cent simple interest, reckoned for practical reasons for each of the periods in question from the mid point of the respective periods up to the time of the award.

On this basis the Arbitral Tribunal assesses a reasonable compensation in the sum of Lats 1.600.000. In view of the Claimant's use of the Latvian currency in its requests for relief the same currency is used in this assessment.

As specifically regards the asserted losses on delivery of electric power to Latvenergo for the remainder of the eight year period, the Tribunal considers this potential loss to be too uncertain and speculative to form the basis for an award of monetary compensation. But the Tribunal considers it to be a continuing obligation upon the Republic to ensure the payment at the double tariff for electric power delivered under the Contract for the rest of the eight year period, and therefore gives an order for the Republic to fulfill its obligation under the Treaty to protect the Claimant's investment.

### *5.3 Payment of interest*

The *Claimant* has claimed interest on the claimed amounts in the various periods, from the beginning of each of the designated periods until payment. In its first requests for relief, and in its calculations of net present values of future losses on the sale of electric power, the Claimant claimed for an annual interest rate of six per cent, stating that this is the prevailing interest rate in Latvia. In its Brief No. III of 9 September 2003 (see section 1.2.1 above) the Claimant claimed for an annual interest rate of six per cent up to the date of the award, and 18 per cent from that date until payment. The Claimant contends that it has the

right to claim 18 per cent which is the stipulated interest rate in the Contract between Windau and Latvenergo in the event of late payment.

The *Respondent* has not objected to the statement regarding the prevailing interest rate in Latvia of six per cent per annum, but has objected to the Claimant's asserting a right to the interest rate in the Windau – Latvenergo contract.

According to Article 26 (8) of the Treaty an arbitration award may include the award of interest. The *Arbitral Tribunal* finds it appropriate in the present case to award interest.

As mentioned above, the Tribunal has, for the periods up to the time of the award, included an interest element at six per cent per annum as a basis for the assessment of the Claimant's accumulated losses by the time of the award.

As for the time after the award the Tribunal finds it appropriate to award six per cent per annum on the awarded amounts, from the time of the award until payment is effected. This interest rate must be seen as accepted by the parties to be the prevailing rate in Latvia.

The Claimant has no right to claim in this arbitration the interest rate agreed between Windau and Latvenergo. The interest to be considered under the Treaty is a compensation related to the compensation to the Claimant for its own damages or losses. The interest clause in the Windau – Latvenergo contract is related to late payments under the contract and clearly includes a penalty element not applicable in the present case.

## **6 Allocation and allowability of costs**

### *6.1 The Parties' arguments*

The *Claimant* claims compensation for its own costs, which amount to SEK 8.354.000. The Claimant also requests the Arbitral Tribunal to order the Respondent to pay all the costs and expenses of this arbitration.

The *Respondent* claims compensation for its own costs, which amounts to SEK 6.435.270 and LAT 229.174. The Respondent also requests the Arbitral Tribunal to order the Claimant to pay all the costs and expenses of this arbitration.

The only comment from the parties in relation to costs is from the Respondent saying that it is not reasonable that the Republic should bear the increase in the Claimant's costs which must have been the result of a new counsel for the Claimant coming in at a late stage in the proceedings.

### *6.2 In general*

According to Article 41 of the Rules of the Arbitration Institute of the Stockholm Chamber of Commerce, the Arbitral Tribunal may, unless the parties have agreed otherwise, at the request of a party in the Award, order the losing party to compensate the other party for legal representation and other expenses for presenting its case. An arbitral tribunal may

apportion such costs between the parties if it determines that apportionment is reasonable, taking into account the circumstances of the case.

The Claimant has to a certain extent been successful in its claim and is therefore, in principle, entitled to an award ordering the Respondent to bear part of the costs for this arbitration.

### *6.3 The fees and costs of the Arbitral Tribunal and the Arbitration Institute*

The fees and costs of the arbitrators amount to the following.

The fee of the chairman of the Arbitral Tribunal, Mr. Bjørn Haug, amounts to € 90.000. His costs amount to € 7.677.

The fee of Mr. Rolf A. Schütze amounts to € 49.500. His costs amount to € 10.475.

The fee of Mr. Johan Gernandt amounts to € 49.500. His costs amount to € 2.763.

Value Added Tax (“VAT”) at a rate of 25 per cent for Mr. Johan Gernandt (Swedish VAT) and 16 per cent for Mr. Rolf A. Schütze (German VAT) is to be imposed on charges for legal services.

The fee of The Stockholm Chamber of Commerce Arbitration Institute amounts to € 20.946. Value Added Tax (“VAT”) at a rate of 25 per cent is to be imposed on the part of the administrative fee payable by the Swedish party.

As follows from section 6.1 and 6.2 above, and considering the other circumstances of the case, the Arbitral Tribunal concludes that it is reasonable to apportion the costs of the arbitration (except for the parties’ own costs) equally between the parties.

Consequently, the costs of the arbitration, notably the fees, charges and disbursements of the Arbitral Tribunal and the Arbitration Institute shall be paid by the Claimant with 50 per cent and by the Respondent with 50 per cent. The Arbitral Tribunal will so award.

### *6.4 The costs for legal representations and expenses*

The Claimant has, as also stated above, to a certain extent been successful in its claim and is therefore, in principle, entitled to an award ordering the Respondent to bear some part of the Claimant’s costs for this arbitration.

The Arbitral Tribunal notes that the major part of the work involved in presenting the Claimant’s claim has, in the opinion of the Arbitral Tribunal, been devoted to the difficult legal issue of whether or not the Respondent is liable for the claim, in which the Claimant has been successful. However, the Arbitral Tribunal finds reason to make some adjustment of the Claimant’s monetary claim. The Arbitral Tribunal concludes that the amount requested by the Claimant, i.e. SEK 8.354.000, is high, that the Claimant has changed its counsel, which normally leads to additional costs, and that a reasonable sum to be awarded in favour of the Claimant to be paid by the Respondent, considering the circumstances and the outcome of the case, is SEK 2,000,000. The Arbitral Tribunal will so award.

## 7 Arbitral Award

For the reasons stated above, the Arbitral Tribunal unanimously renders the following

### Arbitral Award

1. a) The Republic of Latvia is ordered to pay to Nykomb Synergetics Technology Holding AB, Stockholm, Lats 1,600,000 –onemillionsixhundredthousand Lats – plus interest at the rate of 6 (six) per cent per annum from the date of the award until full payment is effective.  
b) The Republic of Latvia is ordered to ensure the payment of the double tariff to Windau SIA, Riga, for electric power delivered from Windau's cogeneration plant at Bauska in accordance with Contract No. 16/97 for the period from the date of this award until 16 September 2007.
2. The Republic of Latvia is ordered to pay to Nykomb Synergetics Technology Holding AB, Stockholm, as compensation for its costs incurred in connection with this arbitration SEK 2,000,000 –twomillion SEK.
3. In accordance with the decision of the Arbitration Institute of the Stockholm Chamber of Commerce, the arbitrators and the said Arbitration Institute shall be entitled to fees and compensation for expenses in the following amounts:

a) Bjørn Haug, chairman,	
fees	€ 90.000
costs	€ 7.677
	€ 97.677
b) Rolf A. Schütze, arbitrator,	
fees	€ 49.500
costs	€ 10.475
16 per cent VAT on fees and costs	€ 9.596
	€ 69.571
c) Johan Gernandt, arbitrator,	
fees	€ 49.500
costs	€ 2.763
25 per cent VAT on fees and costs	€ 13.066
	€ 65.329
d) The Arbitration Institute,	
administrative fee	€ 20.946
Sum total	€ 253.523

As between the parties, Nykomb Synergetics Technology Holding AB shall be responsible for 50 per cent and the Republic of Latvia for 50 per cent of the amounts due in this arbitration to the arbitrators and the Arbitration Institute.

In relation to the arbitrators and the Arbitration Institute the parties shall be jointly and severally liable for the payment of the amounts due to the arbitrators and the Arbitration Institute.

- Nykomb Synergetics Technology Holding AB shall also pay 25 per cent VAT on its part of the administrative fee to the Arbitration Institute, i.e. (25 per cent of €20.946/2) = € 2.618.

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Stockholm, 16 December 2003.

Rolf A. Schütze (s)

Bjørn Haug (s)

Johan Gernandt (s)

**LEGAL AUTHORITY CA-78**



THE MATTER OF AN ARBITRATION  
UNDER THE UNCITRAL ARBITRATION RULES 1976

**SALUKA INVESTMENTS BV (THE NETHERLANDS)**

Claimant

v

**THE CZECH REPUBLIC**

Respondent

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**PARTIAL AWARD**

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*Arbitral Tribunal*

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*Registry*

Permanent Court of Arbitration

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## DEFINED TERMS

Allianz	Allianz AG
Bankovní	Bankovní Holding a.s. (see also Bivalence and České pivo)
Big Four banks	Česká spořitelna, a.s. (“CS”); Komerční banka, a.s. (“KB”); Ceskoslovenská obchodní banka a.s. (“CSOB”); and Investiční a Poštovní banka a.s. (later known as IP banka a.s., or “IPB”)
CI	Česká inkasní, s.r.o.
CNB	Czech National Bank
CS	Česká spořitelna, a.s., one of the Big Four banks
CSC	Czech Securities Commission
CSOB	Ceskoslovenská obchodní banka a.s., one of the Big Four banks
CZK	Czech Republic Koruny
GDP	Gross Domestic Product
Hypo- Vereinsbank	Hypo-und Vereinsbank AG
IPB	Investiční a Poštovní banka a.s./IP banka a.s., one of the Big Four banks
KB	Komerční banka, a.s., one of the Big Four banks
KBC	KBC Bank of Belgium NV
KoB	Konsolidační banka, s.p. ú v likvidaci, State-owned debt consolidation agency
NPF	National Property Fund
OJ	Official Journal of the European Communities
OPC	Office for the Protection of Economic Competition
PCA	Permanent Court of Arbitration
Saluka	Saluka Investments BV
SI	Slovenská Inkasní, spol, s.r.o.
Treaty	Agreement on Encouragement and Reciprocal Protection of Investments Between the Kingdom of The Netherlands and the Czech and Slovak Federal Republic, signed on 29 April 1991
UniCredito	UniCredito Italiano Group

## I. INTRODUCTION

### A. Commencement of the Arbitration

1. This arbitration arises out of events consequent upon the reorganisation and privatisation of the Czech banking sector as it had formerly existed under the centralised banking system of the Communist period, which ended in 1990. The Czech Government privatised one of the major Czech banks, known as IPB (see below, paragraph 33), by selling the State's shareholding to a company within the Nomura group of companies. The Nomura Group (see below, paragraph 42) is a major Japanese merchant banking and financial services group of companies, which typically operates also through subsidiaries set up in various countries. The Nomura company which bought the shares in IPB transferred them to another Nomura subsidiary, Saluka Investments BV ("Saluka"), a legal person constituted under the laws of The Netherlands.

2. By a Notice of Arbitration dated 18 July 2001 Saluka initiated arbitration proceedings against the Czech Republic as the Respondent, under Article 8 of the Agreement on Encouragement and Reciprocal Protection of Investments Between the Kingdom of The Netherlands and the Czech and Slovak Federal Republic, signed on 29 April 1991 ("the Treaty"). The Czech and Slovak Federal Republic was dissolved on 31 December 1992, and its two constituent parts became independent States as the Czech Republic and the Slovak Republic. The Czech Republic confirmed to the Kingdom of The Netherlands that, upon the separation of the Czech and Slovak Federal Republic into two separate Republics, the Treaty remained in force between the Czech Republic and the Kingdom of The Netherlands.

3. In accordance with Article 8(5) of the Treaty, the arbitration tribunal ("the Tribunal"), in determining its own procedure, has to apply the arbitration rules of the United Nations Commission for International Trade Law ("the UNCITRAL Rules"). Although, inevitably, at the time when the Notice of Arbitration was served the Tribunal had not been constituted, the Claimant's Notice of Arbitration was, as is usual in these circumstances, given to the Respondent pursuant to Article 3.1 of those Rules.

### B. Constitution of the Tribunal

4. Article 8 of the Treaty provides that the Tribunal will consist of three persons, each party appointing one member and those two members appointing a third person as Chairman of the Tribunal. Within the time-limits set out in that Article the three appointments were made, Mr Daniel Price being appointed by the Claimant, Professor Dr Peter Behrens being appointed by the Respondent, and Professor Sir Elihu Lauterpacht CBE QC being appointed as Chairman by agreement between the two previously-appointed members.

5. On 5 June 2002 Mr Price tendered his resignation. On 20 June 2002 the Claimant appointed in his place Maître L. Yves Fortier CC QC as a member of the Tribunal.

6. On 24 February 2003 Professor Sir Elihu Lauterpacht tendered his resignation. The two party-appointed members of the Tribunal agreed upon the appointment of Sir Arthur Watts KCMG QC in his place as Chairman of the Tribunal, and the parties were notified of this on 25 March 2003.

C. Procedural Timetable

7. At a Procedural Meeting held in London on 2 November 2001:

a. it was agreed that the UNCITRAL Rules were the applicable rules of procedure in this arbitration;

b. the parties accepted the Tribunal's proposal that registry services for the arbitration should be provided by the Permanent Court of Arbitration ("PCA"), and the PCA agreed to provide such services;

c. Geneva, Switzerland, was selected as the place of arbitration, although this did not preclude the Tribunal from holding meetings at any other place, including The Hague, for the sake of convenience;

d. English was agreed as the language of the arbitration;

e. arrangements were made for the discovery of certain documents;

f. the following timetable for the submission of written pleadings by the parties was laid down (it being agreed that it would be more appropriate to use the international nomenclature for the parties' written submissions rather than the terms used in the UNCITRAL Rules):

Claimant's Memorial – 5 March 2002, and  
Respondent's Counter-Memorial – 17 May 2002;

g. the possibility of there being a second round of written submissions was reserved for future decision by the Tribunal, but tentative deadlines were set as follows:

Claimant's Reply – 19 July 2002, and  
Respondent's Rejoinder – 13 September 2002; and

h. arrangements were made regarding questions of confidentiality.

8. The timetable laid down for the first round of written pleadings was subsequently amended from time to time, by agreement of the parties.

D. The Written Pleadings

9. Two days before the amended date fixed for the submission of the Claimant's Memorial, the Respondent on 13 August 2002 filed a Notice to Dismiss, by which it requested that the Tribunal dismiss the Claimant's claims.

10. At a Procedural Meeting in London on 10 September 2002 to consider this request, the Tribunal ruled that because the facts alleged in the Respondent's Notice to Dismiss were so closely related to the facts involved in the principal claim, the dismissal issue should be joined to the merits and ruled upon in the Tribunal's final award.

11. Meanwhile, in accordance with the amended timetable, the Claimant filed its Memorial on 15 August 2002.

#### E. The Respondent's Counterclaim

12. Before the amended deadline set for the filing of its Counter-Memorial, the Respondent submitted on 4 December 2002 a Notice of Counterclaim, setting forth a counterclaim against the Claimant in which it stated that it would elaborate in its Counter-Memorial.

13. By a letter dated 16 December 2002 the Claimant informed the Respondent of its view that the Tribunal lacked jurisdiction under the Treaty to hear a Counterclaim by the Czech Republic. In a subsequent exchange of correspondence, the Claimant proposed that the Tribunal hear its objections to jurisdiction prior to the filing of the Respondent's Counter-Memorial, while the Respondent suggested that any objections to the jurisdiction of the Tribunal to consider the Counterclaim be raised, and resolved by the Tribunal, after the filing of the Counter-Memorial.

14. In a "Direction by the Tribunal" ("Direction") issued on 15 January 2003 the Tribunal permitted the Respondent to proceed in the manner set out in its Notice of Counterclaim, by elaborating such claims within its Counter-Memorial (then due to be filed by 21 February 2003), and ordered the Claimant to respond by 31 March 2003 to the parts of the Counter-Memorial dealing with the Counterclaim by Objections limited to the question of the Tribunal's jurisdiction in that respect.

15. The Tribunal added that it expected the Respondent's elaboration to cover comprehensively the questions of the Tribunal's jurisdiction over the Counterclaim, and whether any connection is required between the Counterclaim and the Claimant's claim as submitted in its Memorial of 15 August 2002 and, if so, the nature and extent of such connection. The Direction reserved the question whether oral proceedings would be necessary on this issue, and suspended the proceedings in respect of the rest of the case until the question of the Tribunal's jurisdiction over the Counterclaim had been decided.

16. The Tribunal set, and at the request of the parties varied from time to time, a timetable for the submission by the parties of their pleadings on the issue of jurisdiction, and the parties duly complied with that timetable as amended.

17. In its Counter-Memorial, submitted on 7 March 2003, the Respondent both set out its response to the Claimant's claims and dealt with the question of counterclaims.

18. As regards its Counterclaim, the Respondent set out the various heads of its Counterclaim in the Counter-Memorial, and addressed separately the question of the

Tribunal's jurisdiction over the Counterclaim. On 15 May 2003 the Claimant filed its "Objections to Jurisdiction over the Czech Republic's Counterclaims" ("the Objections"). This was followed, on 29 September 2003, by the Respondent's "Response to the Claimant's Objections to Jurisdiction over the Czech Republic's Counterclaims" ("the Response"), and on 10 November 2003 by the Claimant's "Reply to the Czech Republic's Response to the Claimant's Objections to Jurisdiction over the Czech Republic's Counterclaims" ("the Reply").

19. On 11 November 2003 the Respondent requested a hearing on the issue of the Tribunal's jurisdiction over its Counterclaim. The Tribunal fixed 6 March 2004 for the hearing, and the Tribunal and the parties met in London on that date for the purpose of hearing oral argument on this issue.

20. On 7 May 2004 the Tribunal handed down its *Decision on Jurisdiction over the Czech Republic's Counterclaim* ("Decision on Jurisdiction over Counterclaims"). For the reasons set out in that Decision, the Tribunal decided

- a. that it was without jurisdiction to hear and determine the Counterclaim put forward by the Respondent in its Counter-Memorial;
- b. that that Decision was without prejudice to the issue raised by the Respondent's Notice to Dismiss of 15 August 2002, which had been joined to the merits by the Tribunal's ruling of 10 September 2002;
- c. that questions of costs arising as a result of the presentation by the Respondent of the Counterclaim set out in its Counter-Memorial were reserved until final consideration could be given to questions of costs in this arbitration as a whole; and
- d. that the Tribunal would separately set out a revised timetable for the remaining written pleadings of the parties.

21. In a letter dated 9 June 2004 the Claimant subsequently raised a question as to the effect of the Tribunal's Decision on Jurisdiction over Counterclaims, contending that Part IV of the Respondent's Counter-Memorial (in which the Respondent had set out its arguments on its counterclaims) was to be treated as struck out and that in consequence the Claimant need not in its Reply deal with the matters contained in that Part IV. After obtaining the views of the parties the Tribunal on 26 July 2004 conveyed to the parties its view that its Decision on Jurisdiction over Counterclaims had the consequence that Part IV of the Respondent's Counter-Memorial was no longer relevant to the arbitration in so far as it concerned the question of counterclaims, but that it did not necessarily follow that Part IV was also irrelevant to other questions which might still arise in the arbitration. Since the possible relevance of Part IV to such other questions was a matter to be argued by the parties as part of the further proceedings on the merits, the Tribunal was unable to agree to the Claimant's request that the Tribunal should now order that Part IV be struck out of the pleadings altogether.



F. Subsequent Procedural Timetable

22. Having already received the Claimant's Memorial and the Respondent's Counter-Memorial, the Tribunal on 9 June 2004 endorsed the parties' agreement to the following timetable for the submission of further written pleadings:

Claimant's Reply – 24 September 2004; and  
Respondent's Rejoinder – 4 February 2005.

Those further written pleadings were submitted by the parties within the time allowed for them.

G. Oral Hearings

23. In subsequent discussion with the parties, it was agreed that oral hearings would be held in London, at the International Dispute Resolution Centre, from Friday, 8 April 2005 to Wednesday, 20 April 2005. The hearings duly took place between those dates.

24. At those hearings, the Tribunal was addressed by:

On behalf of the Claimant: Mr Jan Paulsson  
Mr Peter Turner  
Professor James Crawford SC

On behalf of the Respondent: Mr George von Mehren

In addition, the Tribunal heard the following witnesses:

Called by the Claimant: Mr Randall Dillard  
Professor Hyun Song Shin

Called by the Respondent: Mr Michael Descheneaux  
Mr Pavel Racoča  
Mr Luděk Niedermayer  
Mr Jan Mládek  
Mr Pavel Mertlík  
Mr Kamil Rudolecký  
Mr Ivan Pilip  
Mr Pavel Kavánek  
Professor Joseph J. Norton  
Mr Brent Kaczmarek

25. After the conclusion of the oral hearings, the Tribunal allowed the parties, if they so wished, to file post-hearing briefs by 30 June 2005. Both parties filed post-hearing briefs within that deadline.

## II. THE FACTS

26. Saluka claims in this arbitration that the Czech Republic acted in relation to Saluka and its investment in a manner inconsistent with the Czech Republic's obligations under the bilateral investment treaty ("BIT") between The Netherlands and the Czech Republic. In particular, Saluka claims that it was deprived of its investment contrary to Article 5 of that treaty, and that, contrary to Article 3, its investment was not treated fairly and equitably.

27. While the parties differed as to some of the facts and as to the interpretation to be made of the facts (those differences will emerge later in this Award), it appears to the Tribunal that the essential facts underlying this dispute were as follows.

### A. The Banking System in Czechoslovakia during the Period of Communist Rule

28. As was the case in many sectors of the economy, the banking sector in Communist Czechoslovakia – more formally, the Czech and Slovak Federal Republic – was highly centralised: it was an integral part of central State economic planning. That Communist era came to an end in 1990.

### B. The Agreement on Encouragement and Reciprocal Protection of Investments Between the Kingdom of the Netherlands and the Czech and Slovak Federal Republic 1991

29. As a step towards encouraging the development of a market economy in this former Communist State, a number of Western States concluded BITs with the Czech and Slovak Federal Republic. One such treaty was the Agreement on Encouragement and Reciprocal Protection of Investments Between the Kingdom of the Netherlands and the Czech and Slovak Federal Republic 1991 concluded with The Netherlands on 29 April 1991. The Treaty entered into force on 1 October 1992.

### C. The Separation of the Czech Republic and Slovakia

30. Following the end of the Communist era, the Czech and Slovak Federal Republic separated into its two constituent parts on 31 December 1992, and in its place the two independent States of the Czech Republic and Slovakia were created.

31. The Treaty had been concluded with the former State, the Czech and Slovak Federal Republic. By letter of 8 December 1994, the Minister of Foreign Affairs of the Czech Republic confirmed to the Minister of Foreign Affairs of the Kingdom of The Netherlands that the Treaty remained in force between the two States. No question of State succession in relation to the Treaty has been raised by the parties in this arbitration. The Tribunal, and the parties, have therefore proceeded on the basis that the Treaty applies to the situation which has given rise to the present dispute.

#### D. The Reorganisation and Privatisation of the Banking System in the Czech Republic

32. With the end of the period of Communist rule in 1990 and the subsequent establishment of the Czech Republic, the Czech authorities also took various steps to transform the economy into a more market-based system. This involved amongst other things attracting investment from abroad in order to provide the expertise to assist with this transformation. In particular it was necessary to reorganise the previously centralised banking sector.

33. By about 1994, the distinct segments of the former centralised banking system which revolved around the State Bank of Czechoslovakia had separated into four large State-owned commercial banks which dominated the banking sector in the Czech Republic. These “Big Four” banks were Česká spořitelna, a.s. (“CS”), Komerční banka, a.s. (“KB”), Československá obchodní banka a.s. (“CSOB”), and Investiční a Poštovní banka a.s. (later known as IP banka a.s., or “IPB”). The Czech banking sector was administered and regulated by the Czech National Bank (“CNB”).

34. IPB was the result of a merger in December 1993 between a bank known as “IB” (which had been formed in 1990 from part of the State Bank of Czechoslovakia) and the Post Office Bank: this merger gave IPB a right to provide banking services at 3,500 branches of Czech Post Offices until 2008 – the country’s largest retail banking network. IPB, however, did not just conduct a banking operation. By early 1996 it also managed a varied industrial portfolio, which included a substantial (83%) holding of shares in Plzeňský Prazdroj, the company that produces Pilsner Urquell beer. IPB’s corporate structure involved a Management Board of Directors (responsible for the day-to-day management of the bank) and a Supervisory Board (appointed and/or elected by IPB’s shareholders and employees, and responsible for general supervision and control), together with a General Assembly of shareholders. There was also a Chief Executive Officer.

35. With the end of the Communist period of control, the Czech Republic sought to transfer large parts of its hitherto State-owned economy into private ownership. It wanted to do this as rapidly as possible, and embarked upon a system of “mass voucher” privatisation – a system whereby State-owned firms were converted into joint stock companies, the shares in which were sold to Czech citizens for vouchers which they purchased for a nominal price. This process was substantially completed in two waves, and was concluded by 1995. In the case of larger and more strategic enterprises, however, only part of the share ownership was distributed through this mass privatisation procedure. A State agency known as the National Property Fund (“NPF”) retained a significant stake in these strategic enterprises, which included the Big Four banks – IPB, CSOB, CS and KB. The Czech State retained (directly or indirectly) a significant minority stake in and control over these banks: while the precise degree of the State’s shareholdings varied over time, at the times relevant to these proceedings, the State’s stake in CS amounted approximately to 45%, in KB to 48.75%, in IPB to 36%, and in CSOB to 46%. The final sale of the State’s remaining stakes in the banks and their privatisation was to follow in the period 1998-2001.

## E. The Czech Banking Sector's "Bad Debt" Problem

36. One of the legacies from the Communist era was a large level of outstanding debt, much of which included non-performing loans granted to large State enterprises which were insolvent. A large proportion of this bad debt problem found its way to the balance sheets of the Big Four banks. From them it was passed to the State-owned debt consolidation agency, Konsolidační banka, s.p. ú v likvidaci ("KoB"), which bought specific loans from the banks, whereby the purchase price exceeded the value of the loans. By 1995 most Communist-era bad debts had fed through the system.

37. However, economic practices in the post-Communist period created a substantial further bad debt problem in relation to new loans. It was government policy to continue the supply of credit to newly privatised firms, not necessarily on commercial terms, in order to keep the firms operating while they undertook the necessary restructuring; this liberal credit policy was applied even when, in truth, the firms being assisted were floundering and had ceased to service their loans. The Big Four banks (in which the State retained a significant stake) assisted in the carrying out of this policy. The balance sheets of the Big Four banks were once again seriously affected. By the end of 1999 the stock of non-performing loans in the portfolios of commercial and special institutions associated with the transformation of the economy amounted to one third of total loans or the equivalent of 26% of the Czech Republic's gross domestic product ("GDP"): a World Bank study in 2000 noted that this was one of the highest ratios in the new market economies of Central and Eastern Europe.

38. The problem was exacerbated by the absence at the time in the Czech legal system of an effective procedure to enable creditors to enforce payment of debts owing to them: moreover, collateral security for loans could not be sold without the debtor's consent. The CNB reported in 1997 that "[t]he balance between the rights and obligations of debtors and creditors is, on the long-term basis, tilted in favour of the debtors."<sup>1</sup> Some improvements in the legal regime regarding creditors' rights were made by new legislation, but this only entered into force on 1 May 2000.

39. This combination of relatively liberal credit policies and inadequate creditors' rights created a new "bad debts" or "bad loans" problem for the Czech banking system. By 1998 the Big Four banks again had a large non-performing loan problem, estimated at 34% for KB, 23.3% for CS, 16.6% for CSOB, and 21.75% for IPB.

40. A new Social Democratic Government which came to power in June 1998 sought to address these problems by action directed at business enterprises, through what was referred to as a "Revitalisation Programme"; both the Prime Minister and Minister of Finance expressly rejected the provision of further State aid directly to the banks. The new Government also claimed that it would improve creditors' rights, thereby helping creditor banks to recover their loans, but these promises either were not fulfilled, or were only fulfilled belatedly.

41. Given the continuing inadequacies in the legal regime of creditors' rights, the CNB felt obliged to take tough regulatory action in mid-1998 to protect the stability of the banking system. This action seriously affected the performance of the major banks, which had to

allocate a substantial part of their operating profits to additional provisions and reserves, causing some to return substantial losses for 1998.

F. Nomura's Acquisition of Control over IPB on 8 March 1998

42. Meanwhile, from mid-1996, Nomura began negotiations for the purchase of the State's shares in IPB. At this point the Tribunal must observe that "Nomura" is, in these proceedings, something of a *portmanteau* term. The Nomura Group, as a major international provider of banking and financial services, operates through a complex of associated and subsidiary companies, and it is not always easy to distinguish the separate capacities in which they act. For present purposes, it is convenient to distinguish between (1) the overall Nomura enterprise (which will be referred to as "the Nomura Group", "Nomura International" or sometimes simply "Nomura"), (2) an English-incorporated Nomura subsidiary known as Nomura Europe plc ("Nomura Europe" or sometimes simply "Nomura"), and (3) the Dutch-incorporated Nomura subsidiary known as Saluka Investments BV ("Saluka") and the Claimant in these arbitration proceedings. It is not, however, always possible to distinguish between these various emanations of Nomura, particularly since neither party has consistently made the necessary distinctions, much of the correspondence tendered in evidence is on writing paper headed "Nomura International PLC" even when dealing with the consequences of the Nomura/Saluka shareholding in IPB, and the Respondent indeed avowedly uses the term "Nomura" and "Saluka" interchangeably, in keeping with its view that as a practical matter Saluka is a mere shell used by Nomura for its own purposes.

43. The Nomura Group had had considerable direct experience of the Czech economy since about 1990, including advising the Czech Government on the privatisation of Czech breweries, and experience of the Czech banking sector, having previously advised both the Government and the Big Four banks in general as well as IPB in particular (with whom it had a long-standing relationship); it had also invested in Czech enterprises, and had an office in Prague since 1992.

44. In April 1996 IPB appointed Nomura to manage an equity offering, but ultimately this offering was abandoned. On 26 September 1996 Nomura offered to purchase the Government's shareholding in IPB at the price of CZK 300 per share, and to provide CZK 9 billion of new capital to the bank. The Government's shareholding consisted of 31.5% of IPB's shares held through the NPF, and a further 4.8% through other sources, in particular Czech Post – a total Government holding of some 36.3%.

45. A Nomura delegation led by Mr Yoshihisa Tabuchi (a Director and Counsellor at Nomura) met Mr Václav Klaus (Prime Minister), Mr Ivan Kočárník (Minister of Finance), Mr Josef Tošovský (Governor of the CNB) and others, including the management of IPB, at the end of October 1996 to discuss Nomura's offer. By about that time, Nomura reached an understanding with IPB's management that control over IPB would be exercised through shareholders agreements between Nomura and the management of IPB.

46. On 27 November 1996 the Government announced its intention to sell its shareholding in IPB through a public tender process, and therefore rejected Nomura's offer to buy the shares.

47. An internal Nomura analysis of December 1996 concluded that the viability of IPB as an investment depended on State support. Even so, on 23 December 1996, Nomura, through various subsidiaries, purchased approximately 5% of IPB shares (and by April 1997 had acquired almost 10% of IPB's shares). In or about December 1996 Nomura retained the firm later known as Price Waterhouse Coopers (after the merger of Price Waterhouse and Coopers & Lybrand in July 1998) to conduct due diligence of IPB: previously Nomura, as an "insider" working for IPB's management, had conducted extensive due diligence in connection with the abandoned equity offering of April 1996.

48. On 24 March 1997 the tender for the sale of up to 36% of the shares in IPB was announced by the NPF. The next day, Nomura International wrote to the Vice-Chairman of the NPF to declare its interest (the only other bidder to respond was ING Financial Services International). On 17 April 1997 Nomura presented a proposal to the Government for the purchase of the NPF's minority stake at CZK 300 per share (subject to due diligence and documentation).

49. As it was already a (minority) shareholder in IPB, Nomura then on 16 April 1997 entered into a shareholders agreement with other IPB shareholders whereby Nomura affiliates would offer to purchase the State's interest in IPB, and Nomura and the IPB management would jointly exercise control of IPB. On the same day, a second shareholders agreement which gave certain employment benefits to some of IPB's senior officials was also concluded.

50. On the next day, 17 April 1997, Nomura presented the NPF with a proposal to purchase its IPB shares and strengthen IPB's capital, and it informed the NPF that it had entered into shareholders agreements which gave it a strong position in IPB.

51. On 29 April 1997 Mr Jiří Tesař and Mr Libor Procházka, two senior members of IPB's Managing Board, were detained on charges of embezzlement. They were subsequently released, but nevertheless (and against a background of generally low public confidence in the banking sector) IPB's share price fell and clients began withdrawing funds. The NPF suggested to Nomura that, as a mark of confidence in IPB, a Nomura employee should join IPB's Management Board. Accordingly, in May 1997, Mr Eduard Onderka, a Director within Nomura's Merchant Banking Group, was appointed to IPB's Management Board; Nomura also provided a CZK 5 billion liquidity line to IPB following the drain on its liquidity caused by the outflow of deposits.

52. After receiving a provisional report on IPB from Price Waterhouse Coopers in June 1997, and a further Nomura internal analysis, both of which drew attention to IPB's poor financial position, Nomura International submitted a further proposal to the Government on 16-17 June 1997 whereby Nomura and the NPF would together have a controlling majority of IPB's shares. The Government rejected this proposal as not being consistent with Government policy, and requested Nomura to submit a further proposal on the lines of an outright purchase of the NPF's shareholding.

53. On 7 July 1997 Nomura submitted a new proposal for the purchase of up to 36.29% of IPB's share capital at CZK 285 per share (subject to due diligence and documentation); Nomura also proposed to subscribe a new issue of not more than 60,000,000 shares in IPB

(totalling CZK 6 billion), and an issue of 10-year subordinated bonds with a total face value not exceeding CZK 6 billion, with another similar issue if needed; and Nomura required a 10-year extension of IPB's franchise agreement with the Czech Post Office.

54. On 23 July 1997 this proposal was accepted by the Government. The purchase price was subject to adjustment based on IPB's net asset value (with the transaction capable of being unwound if the adjusted share price was below CZK 100 per share).

55. Matters appear to have rested there for several months. During that time (and particularly in July and August 1997) Nomura conducted further studies of IPB's financial position. These forecast that Nomura's anticipated profit from its IPB transaction would be US\$50-88 million, but also made it clear that IPB was in a serious financial state and without a large and immediate injection of capital, IPB could face forced administration, and that there were serious risks to investing in IPB.

56. In September-October 1997 Nomura sought an assurance from Mr Ivan Pilip (then Minister of Finance) that others of the Big Four banks would not be privatised under conditions more favourable to their investors than the conditions being offered to Nomura. Mr Pilip said that if he remained Finance Minister he would privatise other large banks in the same way as IPB, *i.e.* sell them in the condition they were in and without helping them to solve their debt problems prior to their sale, but added that he could not give Nomura any assurance that the privatisation of the other banks would proceed in the same way as the privatisation of IPB, since he could not bind a different future government which might adopt a different policy. Nor was any such assurance included in the eventual Share Purchase Agreement.

57. On 18-19 January 1998 Nomura and the NPF agreed to submit two alternative versions of their prospective share purchase agreement to the Government for approval, each based on different valuations of IPB's shares. The first provided for a share price of CZK 117 plus a commitment by Nomura to subscribe to CZK 6 billion of new share capital in IPB and an underwriting commitment for CZK 6 billion of subordinated debt; the second provided for a share price of CZK 147 and the same commitment to subscribe to CZK 6 billion of new share capital but only a "reasonable efforts" commitment for the issue of the CZK 6 billion of subordinated capital for the bank. On 2 February 1998 IPB's auditors Ernst & Young (on the basis of whose audit the Government insisted on working) confirmed that the net asset value of IPB shares was (as at 31 July 1997) CZK 147 per share. Price Waterhouse Coopers were unable to finalise a parallel audit of IPB on behalf of Nomura. The Government, in choosing between the two alternative versions of the prospective share purchase agreement, selected the alternative with the higher purchase price, namely CZK 147 per share.

58. From 3-4 February 1998, a Nomura International representative, Mr David Thirsk, met with a representative of IPB's senior managers to discuss Nomura's plans for IPB, which linked Nomura's purchase of IPB shares with Nomura's purchase of a shell company to hold IPB's Pilsner Urquell shares (as to which, see below, paragraphs 68-69). On 6 February 1998 Nomura wrote to the NPF emphasizing that Nomura was not entering into IPB as a strategic partner (*i.e.* an investor who acquires a company with a view to integrating the acquisition into its operations), but rather that it intended its role to be that of a limited recourse equity investor in IPB, or portfolio investor (*i.e.* an investor who acquires shares in a company as an investment, with a view to their eventual sale at, it would be hoped, a profit). Consistent with

this view of its position, Nomura Europe limited its shareholding in IPB to less than 50%, holding most (and eventually all) of its shares through Saluka, and allowing Nomura personnel to act only as shareholder representatives on IPB's Supervisory Board, and not as executive directors on IPB's Management Board.

59. At about this time, Nomura had agreed with certain significant counterparties an option – the so-called “Put Option” – whereby Nomura Europe could put its shares in IPB (at an initial price of CZK 115 per share) towards the purchase of other assets (notably IPB's holding of Pilsner Urquell shares), clearing the way for Nomura Europe's eventual acquisition in March 1998 of the NPF's shares in IPB. During this period the complex series of transactions regarding the acquisition and sale of Pilsner Urquell shares taking place (see below, paragraphs 68-69).

60. On 16 February 1998 and 2 March 1998 Nomura Europe submitted to the Czech authorities a paper on a “Strategy of Nomura Europe plc for IPB” in support of its application for CNB approval for its purchase of IPB shares: that approval was required by section 16 of the Czech Banking Act 1998. Nomura Europe did not disclose in this paper the Put Option which it had negotiated, nor its objectives in relation to the Pilsner Urquell shares. On 20 February 1998 Nomura filed for approval by the Office for the Protection of Economic Competition (“OPC”) of its acquisition of IPB shares; it did not inform the OPC that Nomura indirectly controlled the Radegast brewery and that IPB indirectly controlled the Pilsner Urquell brewery (the OPC's approval was given on 13 May 1998).

61. On 4 March 1998 the Government approved the sale of the IPB shares held by the NPF to Nomura Europe. On 7 March 1998 Nomura entered into a new shareholders agreement with the other parties to the shareholders agreement of 16 April 1997.

62. On 8 March 1998 Nomura Europe signed a Share Purchase Agreement with the NPF for the purchase of its approximately 36% holding of 20,620,083 IPB shares for about CZK 3 billion. The Agreement contemplated that Nomura Europe could transfer its shares to any special purpose company, trust, foundation, *Anstalt* or other entity, and provided also for a capital increase in IPB by a subscription of 60,000,000 further shares at CZK 100 per share, and for Nomura to reasonably endeavour to procure the underwriting of CZK 6,000,000 of subordinated debt. The total strengthening of IPB's balance sheet was thus some CZK 12 billion (about US\$348 million). The Agreement also gave the NPF pre-emption rights for a period of 5 years over the shares sold to Nomura Europe. The issue of the 60,000,000 shares was approved the next day at an extraordinary general meeting of IPB. Nomura Europe subscribed to all of those shares, at CZK 100 per share.

63. Certain important personnel changes were also made at the same time: Mr Randall Dillard and Mr Eduard Onderka were appointed to the Supervisory Board of IPB, Mr Jiří Tesař resigned as Chairman of the Board of Directors and moved to the advisory level of the Supervisory Board, Mr Libor Procházka resigned as Chief Executive Officer and became Deputy Chief Executive responsible for investment banking, and Mr Jan Klacek was appointed Chairman and Chief Executive Officer. Later, on 12 June 1998, Mr Daniel Jackson was appointed to the Supervisory Board of IPB.



64. On 10 July 1998 Nomura provided IPB with access to a US\$70 million revolving credit facility.

65. With its existing holding of about 10%, Nomura Europe now held, as a result of these transactions and the acquisition of the further 36%, some 46% of IPB's shares, thus giving Nomura Europe effective (although still minority) control over IPB.

66. The sale to Nomura Europe of the NPF's shareholding in IPB was the first situation in which the Czech Republic had fully disposed of its holding in a major bank. To some extent, therefore, it was a precedent for the projected privatisation of the whole banking sector.

#### G. Acquisition and Sale of Pilsner Urquell Brewery

67. In September 1997 IPB filed a merger notification with the OPC regarding Radegast and Pilsner Urquell breweries, but the merger was disapproved by the OPC on 10 December 1997 – a decision against which IPB appealed on 17 December 1997, and in which Nomura itself intervened on 19 January 1998 in support of IPB's appeal. That 10 December decision was cancelled on 5 June 1998. Further enquiries were ordered, but the merger was again disapproved on 12 August 1998, and again Nomura appealed but the merger notification was withdrawn on 22 November 1998, and the OPC closed the proceeding on 23 December 1998.

68. An internal "Transaction Structure" paper was prepared on 3 February 1998 by Nomura for its proposed purchase of IPB shares. In that paper IPB's shareholding in the company producing Pilsner Urquell beer was identified as IPB's most valuable strategic holding, and the paper indicated an intention, first, to buy 62.8 million shares in IPB for an amount which would be equal to the purchase price of the Pilsner Urquell shares, and, second, to sell those shares later to an international brewery company for a much greater price. On 3-4 February 1998, a Nomura International representative, Mr David Thirsk, met with a representative of IPB's senior managers to discuss Nomura's plans for IPB, which linked Nomura's purchase of IPB shares with Nomura's purchases of a shell company to hold IPB's Pilsner Urquell shares. On 5 February 1998 Nomura concluded a Cooperation Agreement with IPB's management. Under this agreement IPB would contribute its Pilsner Urquell shares, and Nomura would contribute its substantial (59.22%) interest in Radegast Brewery (which a Nomura affiliate had purchased from IPB on 19 September 1997) to a new entity. As already noted (above, paragraph 60), in its paper on a "Strategy of Nomura Europe plc for IPB" which Nomura Europe submitted to the Czech authorities in support of its application for CNB approval for its purchase of IPB shares, Nomura Europe did not disclose the Put Option which it had negotiated, nor its objectives in relation to the Pilsner Urquell shares. Similarly, in filing on 20 February 1998 for the OPC's approval of its acquisition of IPB shares, Nomura did not inform the OPC that Nomura indirectly controlled Radegast and that IPB indirectly controlled Pilsner Urquell. The OPC's approval was given on 13 May 1998. On 25 February 1998 Bankovní Holding a.s. ("Bankovní" – an affiliate of and controlled by IPB) purchased Bivalence, renamed the next day České pivo, a special purpose company whose only shareholder was Bankovní and whose only assets proved to be the Pilsner Urquell shares it purchased (with deferred payment) from IPB on 26 February 1998 and which it was to administer (Nomura appears never to have transferred its Radegast brewery shares to České pivo as originally planned). On 26 February 1998 České pivo signed an agreement with IPB to buy the bank's majority shareholding in Pilsner Urquell brewery.

69. On about 4 March 1998 Nomura set in motion a complex series of transactions which by June 1998 resulted in Pembridge Investments BV (“Pembridge”), a Nomura controlled entity, having the right to pay for the České pivo shares (*i.e.* holding Pilsner Urquell) with IPB shares. A further series of complex transactions between 31 May 1999 and 3 June 1999 involving three Cayman Islands companies – referred to as Torkmain, Levitan and Tritton – led to Nomura acquiring 84% of the shares of the Pilsner Urquell brewery with the right to pay for them by the delivery of IPB shares. These various transactions successfully operated the Put Option which Nomura had negotiated earlier (above, paragraph 59). In December 1999 Nomura International entered into an agreement which combined the Pilsner Urquell shares and Radegast shares, and then transferred all of those shares to a Dutch company, Pilsner Urquell Investments BV, and then sold that company to South African Breweries for a sum greatly in excess of the amount originally paid by Nomura for the Pilsner Urquell shares.

#### H. The Transfer of Nomura Europe’s IPB Shares to Saluka

70. Meanwhile, Saluka Investments BV (“Saluka”) had been established on 3 February 1998 as a special-purpose vehicle for the express purpose of holding the shares in IPB the purchase of which Nomura Europe was contemplating at the time. Saluka was incorporated in The Netherlands on 3 February 1988, and was owned by a Dutch charitable trust, Stichting Saluka Investments, and was managed by Nationwide Management Services BV

71. With its purchase of IPB shares completed, Nomura Europe, pursuant to the Share Purchase Agreement and with the approval of the CNB, transferred its IPB shares to Saluka in two tranches. In this way Saluka acquired ownership of 51,315,283 shares of Nomura Europe’s IPB shareholding on 2 October 1998, and Nomura Europe’s remaining 10,465,421 shares on 24 February 2000. Saluka bought these shares by issuing promissory notes to Nomura Europe, those notes being secured by a pledge over the shares; that pledge provided that Nomura Europe had the right to vote on the IPB shares. At the same time, Saluka entered into an agreement with Nomura International plc whereby the latter became Saluka’s sole sales agent for the IPB shares.

72. Saluka thus became the registered holder of the 61,780,704 shares in IPB which are the subject matter of this arbitration. Saluka subsequently agreed with Nomura Europe in June 2000 to sell the shares in return for the cancellation of the promissory notes which had been issued to pay for them. However, by the time of the hearings in this arbitration and still, so far as the Tribunal is aware, at the date of this Award, Saluka continues to hold the shares pending an instruction from Nomura Europe as to whom to transfer them: no such instruction has been given because of certain unresolved disputes. Consequently, at the time this arbitration was initiated, Saluka continued to be the registered holder of the IPB shares.

73. It is thus apparent that ownership of the controlling shares in IPB – and with it control over IPB’s other assets – vested in Saluka. In reality and in substance, however, it is equally apparent that Saluka’s rights of ownership seem to have been exercised in accordance with directions given by Nomura Europe or other elements of the Nomura Group. This duality of ownership and control is reflected in the parties’ pleadings, which in general do not distinguish carefully or consistently between Saluka and Nomura (whether Nomura Europe or other elements of the Nomura Group).

74. Upon acquiring effective control of IPB, Nomura set about various reorganizations of IPB's senior personnel, its banking strategy, its portfolio activities, its customer relations, its loan and loan recovery strategies, and its operational arrangements – all in the interests of strengthening IPB's market position in the Czech banking sector. These measures had considerable success, and IPB's position improved markedly.

#### I. The Government's Assistance to the Banking Sector (1998-2000)

75. While IPB is the Czech bank of principal importance for this arbitration, it was, as already noted, just one of the Big Four Czech banks, together with CSOB, CS and KB. In addition was the State-owned bad debt agency, KoB.

76. By mid-1998 the Czech banking sector was in serious difficulties, mainly as a combined result of the existence of a large bad debt problem, inadequate provision for creditors to enforce the rights to recover their loans, and the tough new regulatory steps taken by the CNB. One of the banks' particular problems was their ability or otherwise to maintain a capital adequacy ratio above the 8% minimum limit fixed by the CNB; if the ratio fell below that level, the CNB would have to take remedial measures, possibly involving revocation of a bank's banking licence.

77. The Czech Government embarked on a process of finally privatizing the Big Four banks which had previously only been partially privatised (above, paragraph 35). From early 1998 onwards the Government took a number of steps to assist one or other of the Big Four banks to overcome the difficulties with which they were faced. These varied forms of assistance mainly included, but were not necessarily limited to, those types mentioned hereunder.

78. As regards KB, the CNB at first saw no need for State participation in efforts to resolve KB's bad debt problem. However, in October 1998, the CNB itself proposed State participation in the light of recent developments in the financial markets. State participation in strengthening KB's capital participation was seen as necessary, especially given KB's dominant position in the Czech banking sector and the wider economic destabilisation to which serious weakening in its position could lead. The Czech Government decided by Resolution No. 820 of 28 July 1999 to arrange the purchase of major stocks of non-performing loans which were on KB's balance sheet. Accordingly, in August 1999, KoB purchased CZK 23.1 billion of KB's non-performing loans (at 60% of their face value) amounting to a capital injection into KB of CZK 9.5 billion. From December 1999-January 2000 the NPF subscribed to an increase of CZK 6.77 billion in the share capital of KB, thereby increasing the NPF's shareholding in KB from 48.74% to 60%. Despite these injections of State funds, KB reported a loss of CZK 9.2 billion for 1999. On 16 February 2000 the Government resolved to transfer a further CZK 60 billion of KB's non-performing loans, this time to a subsidiary of KoB but again at 60% of face value, amounting to a capital injection into KB of CZK 36 billion. By 2000 its share price had nearly trebled compared with its low point in 1999. The Government renewed its attempt fully to privatise KB by selling its now-majority stake in the bank. To facilitate a sale, KoB guaranteed a portfolio of KB's classified loans up to CZK 20 billion: this guarantee was signed on 29 December 2000, thereby avoiding the need for approval by the Czech Parliament under a new law which came into force on 1 January 2001. The net value of State assistance to KB in the period 1998-2000 thus amounted to some CZK 75 billion (with a further tax break to KB of CZK 4 billion

which only recently came to light). On 28 June 2001 the Czech Republic sold its 60% share in KB to Société Générale S.A. for CZK 40 billion (or EUR 1.19 billion).

79. CS, too, had a major bad debt problem. Its significance as a major element in the Czech banking sector made its continued viability important to the Czech Government. Its ability on its own to maintain the required 8% capital ratio was in doubt, but its private investors were unwilling to participate in any capital injections. The Government stepped into the breach. On 27 May 1998 the Government resolved to transfer CZK 4.1 billion to CS to cover losses of CS related to its deposits in the failed “AB banka.” On 9 December 1998 the Government resolved that CZK 10.5 billion of CS’ classified loans should be transferred to KoB at a price of CZK 4 billion (although their security value was much less). In December 1998 CS and KoB concluded an agreement for a ten-year loan for subordinated debt amounting to CZK 5.5 billion, which was fully funded by KoB on 23 December 1998. On 10 March 1999 the Government resolved to double CS’ share capital from CZK 7.6 billion to CZK 15.2 billion. On 8 November 1999 the Government approved the purchase of CZK 33 billion of CS’ non-performing loans by KoB at 60% of their face value, up to a maximum of CZK 20 billion. Meanwhile, in October 1999, the Government had embarked on the privatisation of CS by way of a sale of the NPF’s substantial stake in CS to Erste Bank of Austria, to whom the Government gave an exclusive negotiating position. To facilitate the conclusion of this sale the Government gave on 2 February 2000 a State guarantee until 2005 against losses from non-performing loans which were on the balance sheet of CS at the end of 1999 (the guarantee covered a portfolio of loans with a book value of CZK 88 million) and sold its (the NPF’s) shares in CS to Erste Bank for CZK 19 billion.

80. In relation to CSOB, the situation was for various largely historical reasons somewhat different from that at the other Big Four banks; in particular it did not suffer in quite the same way from the bad debt problem which afflicted the other banks. CSOB’s ability to ride out the economic crisis which affected the other banks was in considerable part due to various Government guarantees which had earlier been given to CSOB in relation to Česká inkasní, s.r.o. (“CI”), and then, on 14 April 1998, in relation to Slovenská Inkasna, spol. s.r.o. (“SI”), for which the Government indemnified CSOB from any liability resulting from Slovakia’s refusal to continue to fund that company. On 24 February 1999 the Government resolved to compensate CSOB for loans to industrial borrowers worth CZK 2.3 billion. On 31 May 1999 the Government resolved to assume CSOB’s liability on a loan made to failed Banka Bohemia in 1994. CSOB was privatised by virtue of the Government’s approval on 31 May 1999 of the sale, for CZK 40 billion, of the State’s 65.69% shareholding in CSOB (held through the NPF, the CNB, and the Ministry of Finance) to KBC Bank of Belgium NV (“KBC”) (which would eventually come to acquire 80% of CSOB).

81. In addition to these various forms of State assistance to CSOB, the relationship between CSOB and IPB gave rise to a special series of events involving further assistance to CSOB. In circumstances which will become apparent below (paragraph 143 and following), and which lie at the heart of the Claimant’s claims in this arbitration, IPB was sold to CSOB in June 2000. That transaction was complex, but a major element of it was the need for CSOB to be “held harmless” for any negative value associated with its purchase of IPB. The Tribunal sees no need for present purposes to set out the relevant provisions in all their complexity, since the main elements are clear and uncontested. These are that (1) CSOB had to pay a symbolic CZK 1 for its purchase of IPB; (2) CSOB benefited from arrangements which enabled it to avoid any downside risks arising from its purchase of any particular

assets of IPB; and (3) a substantial element of State aid was involved in the transaction, estimated at CZK 160-200 billion by the Ministry of Finance in June 2000 and audited by KPMG on 1 June 2001 at 159.9 billion. The acquisition of IPB made CSOB the leading bank in the Czech Republic.

82. Various measures of State assistance to KB, CS and CSOB have been described in the preceding paragraphs. With respect to IPB, assistance given to it by the State appears to have involved certain loss-producing loans worth CZK 16.1 billion being transferred to KoB in early 1998 (before Nomura Europe's purchase of IPB shares in March 1998), and the extension of IPB's past post office franchise when Nomura Europe bought the IPB shares, thereby giving it exclusive access to over 1,000 sales counters across the country. However, when the Government's Revitalization Programme (above, paragraph 40) for industrial enterprises finally received formal approval by the Government on 14 April 1999, its terms excluded IPB from the Programme, and IPB was excluded as a beneficiary.

83. The Big Four banks were of comparable strategic importance for the Czech economy as a whole; they also shared exposure to the bad debt problem, and to the inadequacies of the legal regime relating to creditors' rights. Collectively, these problems threatened the collapse of the Big Four banks, but they were too big to be allowed to fail: State assistance to avert collapse was necessary. The State assistance provided to KB, CS and CSOB amounted to 19% of the Czech Republic's GDP for 1999. It appears from various statements made by the banks and by the Government and the NPF in April-May 1998 that State assistance was given to KB, CS and CSOB on the basis that they were banks in which the State had a major shareholding interest, while IPB was not given such assistance as (after Nomura's investment in March 1998) it was regarded as a private institution whose fate was a matter for its private shareholders.

#### J. Developments in Respect of IPB (August 1999-end May 2000)

84. Following growing concerns at the CNB during 1998 with regard to IPB's banking practices, and CNB information-finding visits to IPB from mid-April 1999 to end-June 1999, the CNB began a regulatory inspection of IPB on 30 August 1999 which lasted until 5 November 1999. Serious financial deficiencies and irregularities were apparent.

85. In October 1999 Nomura began the search for a strategic partner for IPB. The involvement of the Czech Government was needed in this connection, in order to ensure the necessary level of State support for IPB's financial position (without which private sector investors would not find IPB an attractive proposition). In any event, the Czech Government would need to be involved since the approval of the Czech regulatory authorities would be required for any strategic partnership, and in the event of a merger with any other of the Big Four banks, the Government, as (directly or indirectly) a shareholder in those banks, would also have to give its consent.

86. During the autumn of 1999 it was clear that IPB needed an increase of capital to provide for its bad loans. In October, the CNB requested a significant increase in IPB's equity capital.

87. On 16 November 1999 IPB's General Assembly resolved to increase IPB's share capital, but this resolution was subsequently blocked by a minority shareholder on technical grounds. Another General Meeting was called for 19 February 2000 to seek approval for a capital increase of CZK 2.6 billion, to CZK 13.3 billion.

88. As a result of the CNB's August-November 1999 inspection of IPB, the CNB concluded both that IPB was not performing prudently, and that IPB needed to create at least CZK 40 billion of provisions – an amount the size of which made it clear that a major crisis was possible.

89. Discussions subsequently took place between representatives of the CNB and Ministry of Finance and representatives of IPB and Nomura to seek to identify possible solutions.

90. Meanwhile, IPB's management focussed on securing State aid, while Nomura concentrated on seeking a foreign strategic partner for IPB. A number of institutions showed interest, including in particular Allianz AG ("Allianz") and Hypo-und Vereinsbank AG ("Hypo-Vereinsbank"), with which Nomura signed a confidentiality agreement on 24 November 1999. However, on 26 January 2000 Hypo-Vereinsbank pulled out of the consortium with Allianz, and was later replaced by the UniCredito Italiano Group ("UniCredito").

91. In December 1999 Nomura (with reservations on the part of IPB's management) proposed a merger with CS. Nomura was able to make progress with an offer from Allianz for both IPB and CS, and the parties agreed on a framework for the transaction by 21 January 2000. These arrangements, however, came to nothing: the State had already issued a public tender for its interest in CS, the deadline for bids had passed, the proposal to merge IPB with CS was not specific enough in any event to comply with the rules of the tender, and the State was in the final stages of negotiations with Erste Bank of Austria (to which CS was eventually sold) (above, paragraph 79).

92. IPB's bid for CS attracted some media publicity and in January 2000 this led in turn to media criticism of the CNB, its Governor (Mr Josef Tošovský), and the Minister of Finance (Mr Pavel Mertlík). Mr Tošovský and Mr Mertlík blamed IPB's management for instigating these criticisms, which IPB's management strongly denied. On 4 January 2000 Mr Tošovský informed Mr Mertlík of the gravity of the situation at IPB.

93. On 10 January 2000 Mr Pavel Kavánek of CSOB met Mr Mertlík and expressed CSOB's interest in an acquisition to expand its share of the retail banking market, with IPB amongst possible targets.

94. On 20 January 2000 media reports of a statement by a CNB official, Mr Pavel Racoča, relating to the CNB's investigation of IPB, raised speculation as to the possibility of IPB being subjected to forced administration. Ten days later, on 30 January 2000, the CNB issued a press release stating that the inspection was a routine regulatory matter and had not yet been completed, and that suggestions that IPB's forced administration was under discussion were unfounded.

95. During February and March 2000 IPB and Nomura developed a proposal for a merger between IPB and KB, and later made presentations regarding it to the Government and the CNB, but this proposal came to nothing and was rejected.

96. In mid-February 2000 representatives of Nomura had several meetings with officials from the CNB. During these meetings, the CNB is said to have requested the resignation of two people from their senior positions on IPB's Supervisory and Management Boards – respectively, Mr Jiří Tesař (Chairman of the Supervisory Board) and Mr Libor Procházka (Deputy CEO of the Management Board) (they both resigned on 25 April 2000) – and also asked Nomura to provide the additional capital which IPB needed (*i.e.* for Nomura to take on the role of a strategic investor at IPB), failing which the CNB would seek to denigrate Nomura internationally. For his part, Mr Randall Dillard (Nomura's representative on IPB's Supervisory Board, and Vice-Chairman of that Board) and his colleagues claimed that, in the Share Purchase Agreement, the Czech Republic had agreed not to sell the State's interest in the other major banks on more favourable terms than its sale of IPB shares (a claim denied by the Respondent) (above, paragraph 56), and consequently that Nomura would not act to rescue IPB (*i.e.* provide the necessary additional capital) without State assistance (a position repeated in April 2000) – assistance which the Czech Republic was in the circumstances unwilling to provide.

97. Also during February 2000 Mr Daniel Jackson (Deputy Managing Director, Nomura, and member of the IPB Supervisory Board) began negotiations with Mr Luděk Niedermayer (Vicegovernor of the CNB) for a Memorandum of Understanding intended to establish a framework for their future. Although by the first week in March agreement had seemed close, ultimately the initiative came to nothing.

98. On 19 February 2000 IPB's General Assembly approved a capital increase of CZK 2.6 billion to CZK 13.3 billion.

99. On 25 February 2000 the CNB delivered its formal report regarding its previous year's inspection of IPB and, in March and April 2000, IPB, in accordance with the law, submitted written objections to specific parts of the report. Subsequent legal procedures could not be concluded because IPB's financial condition deteriorated too quickly.

100. In late February 2000 there was renewed and sustained media speculation about the CNB's review of IPB. The earlier rumours of IPB's possible forced administration (above, paragraph 94) persisted. In the week of 28 February 2000 IPB suffered a run on the bank (which was to prove to be the first of two major runs on IPB), and customers withdrew CZK 30 billion in deposits. Banks cut their credit lines to IPB, and froze or restricted their dealings with it. Meetings with high-level official Czech personnel during the week of the bank run led to a statement by IPB denying rumours of forced administration and emphasizing the strength of the bank, and the Minister of Finance, Mr Pavel Mertlík, and a senior official of the CNB, Mr Pavel Racoča, also made public statements seeking to calm depositors. The bank run stopped.

101. It seems that, at about this time, the course of the discussions between Czech officials and Nomura led to the Ministry of Finance and the CNB asserting their loss of trust in Nomura. The Minister of Finance refused to meet Nomura representatives. In mid-March

2000 the Minister of Finance and the Governor of the CNB appointed deputies (respectively, Mr Jan Mládek and Mr Luděk Niedermayer) to deal with Saluka/IPB. Thereafter, it appears that Czech officials had only a “soft mandate” in dealing with Saluka/IPB, and Mr Randall Dillard (then Head of the Merchant Banking Group at Nomura International, and who would later become Chairman of IPB’s Supervisory Board upon the resignation of Mr Jiří Tesař) could only have unofficial meetings off Ministry premises with the Deputy Finance Minister, Mr Mládek.

102. On 6 March 2000 the CNB obtained an expert study which showed that the macroeconomic costs which would be associated with IPB’s collapse (if it were to occur) would directly lead to a fall of about 4% in nominal GDP, and would probably cause a systemic crisis in the Czech financial sector.

103. On 14 March 2000 Mr Miloš Zeman, the Prime Minister of the Czech Republic, told Mr Dillard that discussions on the provision of State aid to IPB and on a merger between IPB and KB were conditional on Nomura injecting new capital into IPB.

104. Also in March 2000 CSOB approached Nomura for discussions with respect to IPB.

105. On 22 March 2000 Ernst & Young (IPB’s auditors) informed the CNB of the possibility that IPB might not comply with the required capital adequacy requirements, as a result of which the CNB formally asked IPB to prepare alternative methods for strengthening its capital should the minority shareholders block an increase in equity capital.

106. On 25 April 2000 the personnel changes at IPB requested by the CNB in February 2000 were made (above, paragraph 96). Mr Jiří Tesař resigned as Chairman of the IPB Supervisory Board and became instead Vice-Chairman, and Mr Libor Procházka resigned from his position as Deputy CEO of the IPB Board of Directors. Mr Randall Dillard took over as Chairman of the Supervisory Board.

107. In mid-April 2000 IPB submitted to the CNB some draft proposals to stabilise IPB, and submitted a further draft to the Government in May 2000, but the proposals were not acceptable as they did not give the State sufficient control over the restructuring process.

108. Nomura continued its attempts to find a strategic partner for IPB. Progress was made with the Allianz/UniCredito consortium. On 4 April 2000 a term sheet was signed providing for a capital increase for IPB and UniCredito’s entry as a strategic partner for the bank. By the middle of May active steps were being taken to follow through with this arrangement and on 22 May 2000 UniCredito began its due diligence enquiries on IPB. On 26 May 2000 UniCredito was in a position to propose the purchase of IPB at an opening bid of CZK 25-30 billion (twice its book value, subject to agreement on that book value) with a possibility of paying more.

109. At the same time as these discussions were taking place, Nomura’s representatives had since March 2000 also been meeting with representatives of CSOB to discuss CSOB’s potential entry into IPB as a Czech domestic partner. These discussions did not proceed smoothly, with CSOB, for example, refusing to sign a confidentiality agreement as a condition for access to IPB’s commercially-sensitive information, and insisting on taking



over IPB first and only thereafter negotiating the acquisition. CSOB's attitude by 5 May 2000 was that if IPB wanted Government support, then IPB needed CSOB.

110. The Government had also in April 2000 begun discussions with the potential investors in IPB which had been identified by Nomura, namely Allianz/UniCredito and CSOB. Both wanted to purchase IPB's assets rather than its shares, and both were unwilling to take over IPB without a guarantee and promise of indemnity from the State. Allianz/UniCredito moreover wanted several months to conduct due diligence, so only CSOB was able to take over IPB and continue its banking operations immediately.

111. Discussions between the Government and CSOB led to the preparation of a written presentation of CSOB's plans for IPB, dated 26 April 2000.

112. In May 2000 IPB, at the CNB's request, submitted a revised draft document to the CNB entitled "Measures for the stabilisation of IPB, a.s." This document became available to the press, leading ultimately to a second bank run in June 2000 (below, paragraph 126 and following).

113. On 2 May 2000 the Governor of the CNB, Mr Josef Tošovský, wrote to the Minister of Finance, Mr Pavel Mertlík, indicating the seriousness of IPB's capital position, its need for new capital, the impossibility of finding a strategic investor without State support, IPB's inability (as set out in the "Measures for the stabilisation of IPB, a.s.") to address the problem of capital adequacy without State assistance, and the imminence of the bank's collapse. The Governor saw the options as either stabilising the bank with a private investor and with State support, or nationalising the bank, or imposing forced administration, or revoking the bank's licence.

114. On 5 May 2000 (with follow-up letters on 8 and 9 May), and at the request of the CNB, Nomura wrote to the Ministry of Finance requesting discussions on the entry of a strategic partner into IPB, and stated its willingness to arrange for up to CZK 13.2 billion of new capital on reasonable commercial terms. No reply to these letters was received.

115. On 18 May 2000 Mr Jan Mládek, the Deputy Finance Minister, informed Mr Randall Dillard that the Ministry of Finance wanted to nationalise IPB, and proposed to buy Nomura's shares (*i.e.* by this time, Saluka's shares) at a symbolic price of 1 euro: to this end Mr Mládek wanted Nomura to obtain an additional 5% in IPB.

116. On 24 May 2000 Nomura informed the CNB that, because of the timing of IPB's auditor's statement and the IPB's General Assembly in late June 2000, the deadline for finding a solution was mid-June. Mr Pavel Racoča, for the CNB, explained that if neither IPB nor IPB's shareholders resolved IPB's problems, the CNB would have to impose forced administration on IPB. On 26 May 2000 Ernst & Young, IPB's auditors, informed the CNB that IPB needed provisions of CZK 21 billion.

117. Also on 24 May 2000 Mr Dillard submitted to the Prime Minister a further proposal entitled "Securing future for IPB", involving Nomura assuring a CZK 20 billion capital increase, a sale of 51% of IPB shares to Allianz/UniCredito and CSOB/KBC, and a KoB guarantee of IPB's balance sheet; on 25 May 2000 he gave the same presentation to the

Deputy Finance Minister, Mr Mládek. On 29 May 2000 Mr Mládek replied, rejecting that proposal (because it involved direct aid to IPB without the State having any control over the use of the funds), and reiterating the Government's offer to buy Nomura/Saluka's shares in IPB for a symbolic price of 1 euro. Nomura responded by asking how its proposal might be made acceptable. By 31 May the Ministry of Finance had refused to meet officially with Nomura or to consider any solution relating to IPB.

118. While those various developments were taking place, and despite the Government's appearance of co-operation with Nomura and IPB, the discussions between the Government and CSOB which began earlier in the year (above, paragraphs 109-111) to explore the possibility of CSOB gaining control of IPB should IPB run into serious difficulties, continued. These discussions were to lead to important developments at a meeting at which Mr Mertlík (Minister of Finance) and Mr Tošovský (Governor of the CNB) agreed to meet Mr Pavel Kavánek (CEO and Chairman of the Board of CSOB, aided by Mr Zdeněk Bakala, a well-known political lobbyist) and Mr Remi Vermeiren (President/CEO of KBC, a Belgian bank which was CSOB's largest shareholder): this meeting was to be held on 30 May 2000 in Paris where those concerned would be attending a banking conference.

#### K. Developments in Respect of IPB (end May 2000-7 June 2000)

119. In anticipation of that Paris meeting on 26 May 2000 Mr Kavánek wrote to Mr Tošovský and Mr Mertlík with certain proposals regarding the future of IPB, describing CSOB's proposed takeover of IPB and CSOB's readiness to act immediately. He enclosed two documents which emphasised the potential advantages of a merger between IPB and CSOB, and setting out CSOB's plan for the integration of IPB and CSOB. Further documents were to be delivered personally on the evening of 29 May 2000. These various documents have been together referred to by the Claimant as "the Paris Plan". It envisaged two possible alternatives for CSOB's takeover of IPB – a negotiated solution, or forced administration. The forced administration solution was presented as having fewer risks (although it appears that later the CNB would have preferred the more co-operative, negotiated solution, while also preparing for forced administration in case of an emergency). A detailed proposal for the carrying out of the forced administration solution was set out in the documents provided by Mr Kavánek, involving only a limited role for the Forced Administrator over the business activities of IPB and a transfer of IPB's day-to-day business to CSOB as quickly as possible.

120. On 30 May 2000 that meeting took place in Paris, to discuss CSOB's entry into IPB, or at least to allow the Government representatives the opportunity to listen to CSOB's proposals as part of their efforts to explore possible solutions to the IPB crisis. Mr Mertlík denied at the time that he participated in the meeting, and denied it also to the Czech Parliamentary Commission which subsequently investigated these matters. He also denied that KBC's entry into IPB was on the agenda of the Paris talks, and stated that, at the meeting, issues related to CSOB were primarily discussed.

121. On 1 June 2000 Ernst & Young, IPB's auditor, informed Mr Dillard that IPB was not a going concern because it was not meeting the CNB's capital adequacy requirements, and this triggered the CNB's obligation to revoke IPB's banking licence. On the same day the Government informed Nomura that State assistance would only be forthcoming if Nomura acquired a 51% stake in IPB (*i.e.* if it acquired a further 5%, since, as already explained, Nomura, through Saluka, already owned 46% of IPB's shares).

122. On 2 June 2000 the Government again repeated its 1 euro proposal. Nomura investigated ways of accommodating that proposal and, on 4 or 5 June 2000, presented three alternative proposals for the sale of IPB to the Government. None of these proposals was acceptable to the Government.

123. By about 6 June 2000 Nomura was focussing on asset sale as a solution.

124. On 7 June IPB's auditor informed the CNB that IPB needed to create provisions of at least CZK 20 or 21 billion, and possibly as much as CZK 40 billion. This meant that IPB could not meet capital adequacy requirements without external support. On 7 June 2000 Mr Mládek told Mr Dillard that IPB would be "toast" if it did not accept the 1 euro offer.

125. At about this time, Mr Mertlík met representatives of Allianz and UniCredito, who made proposals which, in their basic principles, were similar to that made by CSOB. Both banks wished to purchase IPB's assets, and both required a guarantee.

#### L. The Second Bank Run on IPB and its Aftermath

126. Statements apparently made by CNB officials and reported in the media on 8 June 2000, and a statement on 9 June 2000 by Mr Ladislav Zelinka, Deputy Finance Minister, raised speculation that IPB might be put into forced administration, and media speculation increased the following day (10 June 2000 – a Saturday). On Monday, Tuesday and Wednesday, 12-14 June 2000, there were mass withdrawals from IPB, amounting to CZK 17 billion. Reassuring statements by Government officials that were reported on 15 June had little or no effect.

127. The Parliamentary Commission which later enquired into these matters (below, paragraphs 144-147) found that by Monday, 12 June, documents before the CNB already set out a detailed time schedule of the steps to be taken to sell the enterprise, and that the Friday to Sunday period was essential to avoid the risk of legal actions being filed against the Forced Administrator. The Commission also noted that the CNB had already indicated the need to identify an individual to accept the appointment as Forced Administrator, and to ensure that he was familiar with the proposed measures and the proposed timetable as well as his contemplated role.

128. On 14 June 2000 Mr Kavánek (CSOB) wrote to Mr Niedermayer (CNB) with a detailed proposal for accepting the operations of IPB, which he had been asked to submit at a meeting held the previous day. A written proposal was also received on the same day from Allianz/UniCredito.

129. During the run on IPB, Nomura (on behalf of Saluka) had been involved in intensive negotiations regarding the stabilisation of IPB with strategic investors, officials at the CNB and Ministry of Finance, and the Prime Minister. On 14 June 2000 IPB submitted a proposal to the Ministry of Finance, the CNB and the Prime Minister. The proposal involved a transfer of IPB's banking business to KoB for CZK 1 for on-sale to a long-term commercial banking partner acceptable to the Government (with arrangements for the distribution of such sale proceeds), accompanied by an expressed readiness on IPB's part to execute the proposal on or before Friday, 16 June 2000.

130. Representatives of the CNB and Ministry of Finance met on 15 June 2000 to discuss the 14 June proposal. Discussions lasted into the evening and, after the meeting closed, there was an e-mail exchange. The final e-mail (to IPB's lawyer, Mr Tomáš Brzobohatý) concluded by saying that the Ministry of Finance team was "now leaving for home and will continue tomorrow in the morning". With that e-mail, Nomura's representatives were under the impression (which proved to be mistaken) that the detailed heads of terms to implement their proposal had been substantially agreed and that negotiations would continue the following day. IPB notified both the Ministry of Finance and the CNB that its Supervisory Board had approved, and had recommended the Management Board to approve, this transaction. However, the proposal was seen by the Czech authorities to involve serious economic, legal and organizational risks for the Czech Republic.

131. After the bank run had started the Government and CNB held meetings with Allianz/UniCredito and CSOB on proposals for the takeover of IPB. Allianz/UniCredito's proposal was such that it was not in a position to take over IPB's enterprise quickly.

132. On Wednesday, 14 June 2000, the CNB prepared a report for the Government on IPB's situation and possible solutions, which included forced administration and, in that eventuality, the need for any subsequent sale to a strategic investor to be accompanied by a State guarantee, since otherwise no investor would be interested.

133. Also on that day, IPB wrote to the CNB (the letter being received on 15 June) stating that IPB's liquidity had seriously deteriorated and that its solvency was threatened. On Thursday, 15 June, withdrawals from IPB continued. Representatives of the Government and CNB met those from IPB and Nomura, who were told that, if IPB did not immediately get CZK 10 billion from the State, it would revoke IPB's banking licence. That afternoon Mr Petr Staněk – the prospective Forced Administrator (*i.e.* a sort of trustee in bankruptcy) – was approached by the CNB.

134. On the night of Thursday, 15 June 2000, the Government met to consider the IPB situation. The Governor of the CNB and the Minister of Finance explained the gravity of the situation, with Nomura unwilling to invest the necessary capital and unable to identify a strategic partner and with IPB's failure to comply with capital adequacy requirements leading to the withdrawal of its banking licence with consequential threat to the stability of the banking sector. They presented as solutions either a cooperative solution involving IPB's shareholders, or forced administration coupled with a quick sale accompanied by State guarantees. The Government decided not to adopt the IPB proposal but instead to impose forced administration coupled with a quick sale to a strategic investor, with CSOB as the only bank which could quickly take over IPB. Resolution No. 622 of 15 June 2000 approved the forced administration of IPB with the objective of a subsequent sale to CSOB as the strategic investor, the provision of a government guarantee for the assets of IPB in favour of CSOB, and the issue of guarantees by the CNB to CSOB.

135. Also on 15 June, the Czech Securities Commission ("CSC") applied a preliminary injunction which imposed an immediate suspension of trading in IPB shares.

## M. The Forced Administration of IPB and its Aftermath

136. On Friday, 16 June 2000, the CNB put IPB into forced administration. Although IPB considered that it had sufficient liquidity to survive a bank run, the CNB's stated reasons for imposing forced administration were that there was a considerable risk of the bank not being able to make payments (*i.e.* to survive a bank run) and that the CNB had to avoid a situation where panic among the bank's depositors permanently destabilised its operations. Moreover, the CNB explained that IPB's financial situation threatened the stability of the Czech banking system, and that the CNB was entitled to impose forced administration to remedy the bank's shortcomings which the bank's shareholders had failed to take the necessary measures to correct.

137. Late on the morning of Friday, 16 June 2000, the CNB informed IPB of its decision to introduce forced administration upon IPB and appointed Mr Petr Staněk as the Forced Administrator of IPB. The Forced Administrator thereupon assumed the powers of IPB's Board of Directors (*i.e.* took over the management of IPB), and all the powers of all corporate governing bodies of IPB were immediately suspended. The Forced Administrator was to do what was necessary to secure its unproblematic operations and to achieve an accelerated sale of IPB to CSOB, being its strategic partner. His monthly remuneration was also specified, with mention of a special bonus ("extraordinary reward") for the implementation of the sale to CSOB (the figures for the remuneration and the bonus were, however, removed by the Respondent from the copy of the document submitted in evidence). The CNB issued an irrevocable guarantee for all IPB creditors on that day, to prevent any panic.

138. Also on Friday, 16 June, IPB requested a short-term loan of CZK 10 billion from the CNB to maintain its liquidity – a request which was received after the appointment of the Forced Administrator. On that same day, CSOB also informed the Forced Administrator of its interest in purchasing IPB's enterprise.

139. Armed police entered IPB's headquarters and effected the physical removal from the premises of all bank managers.

140. On Saturday, 17 June 2000, and Sunday, 18 June 2000, the Forced Administrator discussed IPB's financial situation with Ernst & Young, IPB's auditor, who, on 18 June, told the CNB that IPB's capital adequacy ratio was in fact negative. The Forced Administrator informed the CNB of this (as required by the Czech Banking Act), whereupon the CNB (also as required by that Act) began the process of revoking IPB's banking licence.

141. In response to an expression of interest by CSOB in purchasing IPB's enterprise, the Forced Administrator engaged in extensive discussions with CSOB and its majority shareholder, KBC (a Belgian bank), on 17-18 June 2000; CSOB and KBC also had discussions with the CNB and the Ministry of Finance. The Forced Administrator, who had only limited options, decided to pursue the sale of IPB's enterprise to CSOB, for which on 18 June 2000 he sought the CNB's approval, which was granted. CSOB, however, had insisted on receiving a State guarantee from the Ministry of Finance, and a promise of indemnity from the CNB.

142. As the State guarantee and the CNB's promise of indemnity to CSOB involved State aid, the approval of the OPC was required. The OPC was accordingly involved in the final stages of the transaction, and reached a preliminary conclusion that State aid under the Sale Agreement and State Guarantee should be exempted from the general prohibition against State aid, characterised as restructuring aid and aid to remedy a serious disturbance in the Czech economy. On around 14 June Mr Kamil Rudolecký (Director of State Aid Department of the OPC) was first officially informed by his superior, Dr Jiří Buchta, of the plans to offer financial assistance to IPB, and, on Sunday, 18 June, he and Dr Buchta met with representatives of CSOB, including Mr Kavánek, to discuss the aid package about to be given to IPB. Subsequently, on the evening of Sunday, 18 June 2000, the OPC informed the Ministry of Finance of its approval of the aid packages under certain conditions, and delivered its formal decision to that effect on Monday, 19 June 2000. This decision (which was in some respects in terms identical with elements in the Paris Plan) had the appearance of retrospectively granting an exemption for the aid given to CSOB in the sale agreed over the weekend.

143. IPB was transferred to CSOB on Monday, 19 June 2000, and the Ministry of Finance signed the State guarantee to CSOB while the CNB signed its promise of indemnity to CSOB.

144. On 3 July 2000 the Ministry of Finance and the CNB prepared a report which was submitted to the Czech Parliament (Chamber of Deputies) to inform the public about the circumstances leading to the forced administration of IPB and its sale to CSOB. The next day the Chamber, at the instigation of the opposition parties, set up an Investigation Commission to clarify the State's decisions. The opposition parties had eight of the ten seats on the Commission. Its findings were summarised in a report submitted to the Chamber of Deputies on 11 August 2001.

145. The circumstances in which the sale of IPB to CSOB was effected were such as to raise questions as to its lawfulness under Czech law. The Parliamentary Investigation Commission appointed a legal expert to consider the matter who, in his report of 10 May 2001, concluded that the CNB was not entitled to put IPB into forced administration, that the Forced Administrator had not (particularly at the speed with which he disposed of IPB) fulfilled his responsibilities correctly, that the CNB's irrevocable guarantee for all IPB creditors of 16 June 2000 was null and void, and that CSOB had provided no consideration for IPB's banking business and accompanying State aid. The Commission itself found that by instructing the Forced Administrator to sell IPB's business to CSOB as quickly as possible the CNB had exceeded its legal powers, and that the way in which the strategic partner had been selected between 16 and 19 June was "unprecedented and non-transparent". The Commission also found that the CSOB Transaction Document signed on 19 June 2000 gave IPB to CSOB "effectively as a gift", that CSOB "obtained an undeserved benefit of many tens of billions of Czech crowns to the detriment of the state budget", and that the Minister of Finance, had he acted as he should have done, would have ensured that CSOB paid an appropriate price.

146. The Commission further found that the CNB had issued instructions to the Forced Administrator and in so doing had acted unlawfully, and that his testimony, in denying that he was acting under the instructions of the CNB, was false. In mid-September 2000 the Chairman of the Parliamentary Commission filed a criminal complaint against Mr Mertlík

and the Forced Administrator in respect of false testimony. The Commission concluded that the Forced Administrator “did not administer the bank. He only fulfilled his task to take over and sell the bank without having an idea of what he was actually selling”. In several respects it appears that the Forced Administrator, in selling IPB to CSOB as quickly as possible, may have acted inconsistently with his statutory and fiduciary duties under Czech law. The Commission did not, however, conclude that the Ministry of Finance or the CNB had done anything illegal. Its findings, in the view of the Respondent, were largely speculative and a politically motivated attempt to discredit the Government.

147. Apart from raising questions as to the lawfulness of the transaction under Czech law relating to aspects of the forced administration, the circumstances also raised similar questions as regards the granting of State aid in connection with the transaction. Under Czech law the Public Assistance Act generally prohibited the grant of State aid unless the aid had been notified to the OPC and granted a formal exemption by it: that Act came into force on 1 January 2000, and brought Czech domestic law on State aid into line with the Czech Republic’s international obligations under the Agreement of 4 October 1993 establishing an Association between the European Communities and their Member States, of the one part, and the Czech Republic, of the other (“the Europe Agreement”).<sup>2</sup> The various guarantees and indemnities which formed part of the transaction whereby CSOB acquired IPB could be regarded as State aid, under both the relevant Articles of the Treaty Establishing the European Community (“EC”) (“EC Treaty”)<sup>3</sup> and the parallel provisions of the Public Assistance Act.

148. In various respects, it was questionable whether the legal requirements for the granting of State aid were complied with in respect of, in particular, the guarantee announced on 19 June 2000, the Ministry of Finance’s non-compliance by the stipulated deadline with certain conditions imposed by the OPC in relation to the exemption granted for that guarantee, the indemnity given by the CNB to CSOB, the agreement of 19 June 2000 between the Ministry of Finance and CSOB whereby the Ministry undertook to compensate CSOB for all of the purchase price which CSOB would become obligated to pay to IPB for the IPB enterprise, and the conclusion, without the OPC’s approval, of a restructuring agreement of 31 August 2001 granting to CSOB an asset management contract over IPB’s former assets.

149. Nevertheless, the sale of IPB to CSOB went ahead on the basis of the Forced Administrator’s actions.

150. On 21 June 2000 the Government approved the provision of a State guarantee to CSOB for the assets of IPB provided that that guarantee would be replaced by a restructuring agreement whereby KoB would assume the security for IPB’s assets, and also approved the Ministry of Finance’s guarantee to the CNB to cover losses ensuing from the CNB’s promise to indemnify CSOB.

151. On 23 June 2000 Ernst & Young, IPB’s auditor, reported to the CNB that it had been unable to complete IPB’s audit for 1999 because IPB had failed to provide the auditor with necessary information.

152. On 30 June 2000 Saluka transferred 61,780,694 IPB shares back to Nomura. On 7 July 2000 Saluka submitted a Transfer Notice to the NPF, but on 21 July 2000 the NPF informed Saluka that it did not consider the document served to have been a proper Transfer Notice.

153. On 24 August 2000 the OPC approved the exemption of the State aid arising from the indemnity given to CSOB by the CNB.

154. On 6 September 2000 the CSC made a decision on the merits of the suspension of trading in IPB shares which hitherto had been based only on a preliminary injunction (above, paragraph 135). This decision became binding on 25 September 2000 and extended the suspension in trading which had previously been based on the preliminary injunction. The reasons given by the CSC for the actions it took were in the Claimant's view of questionable accuracy but, in the Respondent's view, were in no way improper. So far as the Tribunal is aware, the suspension of trading in IPB's shares still continues, as a result of further successive "temporary" injunctions issued by the CSC. Saluka's appeal to the Presidium of the CSC against the CSC's decision of 6 September 2000 and its imposition of a "new" temporary suspension on 11 October 2000 were rejected by two decisions of 18 January 2001.

155. On 16 January 2001 the CSC, acting under a new amendment to the Czech Securities Act, issued a Notice of Loss of Position as a Participant against Saluka, having the effect that Saluka was no longer considered a party to the "new" suspension proceedings commenced on 11 October 2000, or any other suspension proceedings commenced after 1 January 2001. Shareholders were thereby excluded from challenging suspensions of trading in shares owned by them.

156. On 26 October 2000 a Police Order was issued, at the request of CSOB, which required the CSC permanently to suspend Saluka's right to dispose of its shares in IPB. Saluka appealed against this Police Order to the State Prosecutor and this challenge was upheld on 5 February 2001. However, the Czech police issued a new suspension Order over IPB's shares, which the Securities Centre registered on 31 January 2001. Following a request from Saluka on 1 November 2001 (*i.e.* after the present arbitration had been initiated) for the removal of the suspension Order, and the police's refusal to do so, the Public Prosecutor's Office in Prague ruled on 23 April 2002 that there was no legal basis for the suspension Order against the shares, but ordered that Saluka's IPB shares be held in the custody of the District Court of Prague. On appeal to the Supreme Public Prosecutor's Office on 16 May 2002 the Public Prosecutor's custodial order over Saluka's shares was quashed. The Supreme Public Prosecutor's Office, however, also held – on a point which was not part of Saluka's appeal, and on which Saluka had not been heard – that it was still justifiable to secure Saluka's shares in IPB by suspending trading in them. Since the Supreme Public Prosecutor's Office was the final appellate instance, Saluka lodged a petition with the Czech Constitutional Court on 18 July 2002 seeking an appropriate remedy.

157. On 30 January 2001, the Czech police carried out a search of Nomura's Prague Representative Office and seized documents belonging to Nomura. This police search was subsequently held by the Constitutional Court on 10 October 2001 (*i.e.* after the present arbitration had been initiated) to have violated Nomura's fundamental rights, and the Court ordered the return of the documents seized during the search.



158. On 19 March 2001, the OPC reopened the proceedings which led to its decision of 19 June 2000 (above, paragraph 142) approving the Agreement for the sale of IPB to CSOB and the associated State Guarantee Agreement. On 23 August 2001, *i.e.* after the present arbitration had been initiated, the OPC disapproved the payment to CSOB for the costs of the forced administration, but, in a further decision of 15 December 2003, the OPC approved that item and approved the Sale Agreement and State Guarantee.

159. On 18 July 2001 Saluka filed its Notice of Arbitration initiating the present arbitration against the Czech Republic. All subsequent events (to some of which attention has already been drawn) therefore post-date the commencement of this arbitration.

160. On 16 June 2002 the forced administration of IPB ended and Nomura resumed control over IPB. IPB subsequently filed several claims against the Czech Republic, CSOB and JP Morgan. On 4 December 2002 the Czech Republic and the NPF initiated the NPF arbitration against Saluka and Nomura, and later that month an arbitration tribunal ordered Nomura to transfer the IPB shares to CSOB.

161. On 16 December 2003 and in January 2004 the European Commission (“EC”) made decisions which had the effect of establishing that it would not review the compatibility of all State measures towards KB and CS with EC State aid rules.

162. At the end of January 2004 the Board of Directors of IPB (controlled by Nomura) and Mr Petr Beneš (former director of IPB) separately filed for IPB’s bankruptcy. On 5 February 2004 IPB was declared bankrupt.

163. On 16 February 2004 the CSC registered CSOB as the new owner of Saluka’s IPB shares.

### III. THE PARTIES’ ARGUMENTS AND SUBMISSIONS

164. On the basis of the facts and the law as it saw them, the Claimant considered that the Czech Republic had acted in a way which was discriminatory, unfair, inequitable and expropriatory, and was thus in breach of its obligations under the Treaty, in particular those arising under Articles 3 and 5.

165. In its Memorial, the Claimant requested the following relief:

- (a) a declaration that the Czech Republic has breached Article 3 of the Treaty by failing to accord Saluka’s investment fair and equitable treatment;
- (b) a declaration that the Czech Republic has breached Article 5 of the Treaty by depriving Saluka of its investment unlawfully and without just compensation equal to the genuine value of the investment;
- (c) an order that the Czech Republic pay Saluka compensation for the damages that it has suffered as a result of the breaches of the Treaty, such damages to be determined by the Tribunal based on further submissions;

- (d) interest on the compensation to be awarded to Saluka, in an amount to be determined by the Tribunal; and
- (e) an order that the Czech Republic pay the costs of these arbitration proceedings, including the costs of the Tribunal and the legal and other costs incurred by Saluka, on a full indemnity basis.

166. The Claimant's subsequent pleadings, both written and oral, did not vary those requests.

167. For its part, the Respondent, on the basis of the facts and the law as it saw them, denied that there had been any breach of its obligations under the Treaty and, in any event, challenged the entitlement of Saluka to invoke the arbitration provisions of the Treaty.

168. In its pleadings, the Respondent requested the following relief:

- (a) In its Notice to Dismiss, "that the Tribunal dismiss with prejudice the arbitration filed by Saluka and award the Czech Republic its attorneys' fees and costs";
- (b) In its Counter-Memorial,
  - (i) a declaration that Saluka breached the Agreement and engaged in other unlawful acts;
  - (ii) an order that Saluka pay the Czech Republic compensation for the damages suffered as a result of Saluka's unlawful acts presently estimated to be approximately CZK 100 billion to CZK 260 billion (approximately US\$3.22 billion to US\$8.38 billion);
  - (iii) interest on the compensation awarded to the Czech Republic, in an amount to be determined by the Tribunal; and
  - (iv) an order that Saluka pay the costs of these arbitration proceedings, including the costs of the Tribunal and the legal and other costs incurred by the Czech Republic, on a full indemnity basis;
- (c) In its Rejoinder (*i.e.* after the Tribunal's Decision on Jurisdiction over the Respondent's Counterclaims), "that the Tribunal render a final Award determining that the Czech Republic has not violated Articles 3 and 5 of the Treaty"; and
- (d) At the conclusion of its oral submissions, the Respondent asked that the Tribunal "render an award determining that there was no violation of either Article 3 or Article 5 of the Treaty" and, in its Post-Hearing Brief, "that the Tribunal issue a Final Award determining that the Treaty was not violated".

169. The Claimant in its Memorial stated that it was “appropriate and efficient to postpone precise issues of the quantification of Saluka’s loss to a separate phase of the proceedings when the Tribunal’s decision on liability is known”. In its Counter-Memorial, the Respondent stated that “[l]ike Saluka, the Czech Republic concludes that it is appropriate and efficient to postpone precise issues of the quantification of the Czech Republic’s loss to a separate phase of the proceedings”.

170. The parties developed their respective arguments fully in their written pleadings, which were submitted in the manner set out in Part I of this Award, the Introduction. They also refined their positions and put forward further arguments in support of their respective cases in the course of the oral hearings which were held in April 2005, as also set out in Part I of this Award.

171. The Tribunal considers that it will be more convenient if, rather than attempting to summarise the parties’ arguments as a whole, it instead summarises their contentions separately in the course of its consideration of each of the various particular issues which it is called upon to determine, and so far as they may be relevant to those issues.

#### IV. THE TRIBUNAL’S JURISDICTION

172. The Tribunal must first address the issue of its jurisdiction to hear and decide the dispute which Saluka has submitted to it.

##### A. The Parties’ Arguments

173. The Claimant’s Memorial was due to be filed on 15 August 2002. Two days earlier, on 13 August 2003, the Respondent filed a Notice to Dismiss, by which it requested that the Tribunal dismiss the Claimant’s claims.

174. By its Notice to Dismiss, the Respondent argued that (a) Nomura did not buy IPB shares in order to invest in IPB’s banking operations, but instead its true purpose was to facilitate its acquisition of Czech breweries in which IPB held a controlling shareholding; (b) Nomura did not disclose that true purpose to the Czech authorities at the time of its purchase of IPB shares; (c) Nomura had thus not acted in good faith and had violated the principle of non-abuse of rights, and was therefore not a *bona fide* investor; and (d) therefore Saluka, to whom Nomura had transferred its IPB shareholding, was precluded from having recourse to arbitration under the Treaty.

175. The filing of such a Notice had not been envisaged in the timetable fixed by the Tribunal, nor is it envisaged in the UNCITRAL Rules.

176. Article 21.3 of those Rules provides:

A plea that the arbitral tribunal does not have jurisdiction shall be raised not later than in the statement of defence or, with respect to a counter-claim, in the reply to the counter-claim.

177. Article 21.4 of the UNCITRAL Rules provides:

In general, the arbitral tribunal should rule on a plea concerning its jurisdiction as a preliminary question. However, the arbitral tribunal may proceed with the arbitration and rule on such a plea in their final award.

178. At a Procedural Meeting in London on 10 September 2002 to consider the Respondent's request, the Tribunal ruled that, because the facts alleged in the Respondent's Notice to Dismiss were so closely related to the facts involved in the principal claim, the dismissal issue should be joined to the merits and ruled upon in the Tribunal's final award (above, paragraph 20, Part I.E. of the Decision on Jurisdiction over Counterclaims).

179. Nevertheless, the issue surfaced again in the context of the Respondent's Counterclaims. In the Notice of Counterclaim which the Respondent volunteered on 4 December 2002 the Respondent set out its proposed "counterclaim against Saluka" and stated that it would elaborate on such claims when it filed its Counter-Memorial. The Respondent stated in paragraph 380 of its Counter-Memorial that by its Counterclaim the Czech Republic sought relief on account of the manner in which Saluka (*sic*) handled its "purported investment". Although it thus appeared that the Counterclaim was intended to be directed against the Claimant, under each of the more specific heads of its Counterclaim, the Respondent's Counter-Memorial identified Nomura as the defendant (essentially Nomura Europe, which is a legal person constituted under the laws of England), whereas the Claimant in this arbitration is Saluka (which is a legal person constituted under the laws of The Netherlands).

180. The Claimant attached overriding weight to the fact that Nomura Europe on the one hand and Saluka on the other were separate legal persons constituted under the laws of different States, that only Saluka was the Claimant in this arbitration and within the jurisdiction of the Tribunal, that Nomura Europe could not be brought within the scope of the Czech-Netherlands Treaty, and that a counterclaim against Nomura Europe could not therefore be brought in these arbitration proceedings instituted by Saluka. The Respondent, however, maintained that, in the context of the circumstances which gave rise to this arbitration, the relationship between Nomura and Saluka was so close that they were in effect interchangeable as parties in these proceedings; indeed, in the Respondent's submission, such was the closeness of the relationship that the real party in interest was Nomura, and that Saluka was not a *bona fide* "investor" under the Treaty, for which reason the Respondent requested that the proceedings initiated by Saluka be dismissed.

181. The Tribunal did not, however, find it necessary to touch on those issues for the immediate purpose of reaching a decision on its jurisdiction to hear and determine the counterclaim advanced in this case by the Respondent. For that purpose, the Tribunal found it appropriate to proceed in the first place on the basis that the question of the relationship between Saluka and Nomura was assumed to be determined on the basis most favourable to the Respondent (see Decision on Jurisdiction over the Czech Republic's Counterclaim, paragraphs 41-44 and 81-82). Accordingly, the Tribunal initially proceeded on the assumption, but without deciding, that the relationship between Saluka and Nomura Europe was sufficiently close to enable the Tribunal's jurisdiction in proceedings instituted by Saluka to extend to claims against Nomura. The Tribunal then on that hypothetical basis addressed the several heads of the Counterclaim put forward by the Respondent, and concluded that the

disputes which had given rise to the Respondent's Counterclaim were not sufficiently closely connected with the subject-matter of the original claim put forward by Saluka to fall within the Tribunal's jurisdiction under Article 8 of the Treaty.

182. It followed from that conclusion that the Tribunal did not find it necessary in the context of its decision on its jurisdiction over counterclaims to reach any decision as to the nature of the relationship between Saluka and Nomura Europe and the consequences of that relationship, whatever it may be. Accordingly, the Tribunal's decision that it was without jurisdiction to hear and determine any of the heads of counterclaim put forward by the Respondent was without prejudice to the eventual consideration of that issue, involving in particular Saluka's standing as an "investor" under the Treaty. That issue remained to be considered at the merits phase of these proceedings, as originally decided by the Tribunal in its ruling of 10 September 2002.

183. In its Counter-Memorial and in subsequent pleadings, the Respondent elaborated its "dismissal" arguments, and added further arguments contesting the Tribunal's jurisdiction. In particular:

(a) The Respondent repeated its contention that Nomura had not made its investment in IPB in order to keep IPB viable but to facilitate the acquisition of two valuable Czech breweries through control of IPB's stake in them: Nomura's real objective was not to invest in IPB's banking operations but, by way of a Put Option scheme which in effect eliminated all downside risk from Nomura's purchase of the IPB shares, to acquire and then sell on IPB's shareholding in the brewery companies, which made Nomura's real objective something other than a *bona fide* investment in IPB. The investment had not been lawfully made (as was generally required for investment protection), but was part of a "dishonest scheme to secure enormous benefits". Czech law required Nomura to file a business plan for its investment in IPB, and a false filing was a breach of that legal requirement. Nomura's failure, in its filed business plan, to disclose its true objectives to the Czech authorities had led them to approve the purchase of IPB's shares, which they would not otherwise have done. Nomura had not acted in good faith and had violated the principle of non-abuse of rights, for which reason Saluka was precluded from relying on the international arbitral process provided by the Treaty.

(b) In any event, the Respondent contended that Saluka did not have any real and continuous *bona fide* social or economic factual links to The Netherlands, and should therefore be disqualified from being considered as an "investor".

(c) Moreover, the Respondent maintained that, in the context of the circumstances which gave rise to this arbitration, the relationship between Nomura and Saluka was so close that they were in effect interchangeable as parties in these proceedings and that the terms "Nomura" and "Saluka" could be used interchangeably, Saluka being nothing more than a shell used by Nomura for its own purposes. Indeed, in the Respondent's submission, such was the closeness of the relationship that the real party in interest was Nomura, and Nomura was not an eligible claimant under the Treaty.

(d) Saluka was not, so the Respondent contended, a *bona fide* “investor” as defined in the Treaty and was thus unable to have recourse to arbitration under it. The Respondent accordingly requested that the proceedings initiated by Saluka be dismissed.

184. In its subsequent pleadings (Rejoinder, oral argument, and Post-Hearing Brief), the Respondent contended principally that:

(a) Saluka had not made an investment in the Czech Republic since it had invested nothing, acting merely as a conduit for Nomura’s investment: Nomura retained the voting rights associated with the IPB shares, participated in the management of IPB, and conducted all the dealings with the Czech authorities. Saluka was a mere surrogate for Nomura, and a claim under an investment treaty could not be brought by an entity which was a surrogate for another entity which, like Nomura, was not covered by the Treaty. Saluka was an agent for Nomura, not a true investor.

(b) While a simplistic or literal view of Article 1 of the Treaty might suggest that Saluka was a qualified investor, the Treaty had to be interpreted in light of the realities of the situation, and they showed that Nomura and Saluka had not conducted themselves as true investors.

(c) “Piercing the corporate veil” was permissible as an equitable remedy where corporate structures had been utilised to perpetrate fraud or other malfeasance. Nomura had used corporate structures to realise profit and put the banking sector at risk, and to perpetrate fraud against the Czech Republic. The corporate veil should therefore be pierced, the real interest at stake should be recognised to be Nomura’s, and, as Nomura was not within the Treaty definition of an “investor”, the Tribunal was without jurisdiction.

(d) The Nomura Group had acted fraudulently and dishonestly throughout the events to which the case related. Nomura’s circular financing arrangements, the Czech beer deal, the Put Option and the establishment of the “Tritton Fund” (in the Cayman Islands) had all been conducted contrary to international *bonos mores*. This continuing failure to act in good faith and the abuse of process required that Saluka – which had never even been a *bona fide* holder of an investment which might have been injured – should be denied protection under the Treaty. Allegations of harm suffered by Nomura (rather than Saluka), and allegations based on the period before October 1998 when Saluka acquired its IPB shares, were outside the Tribunal’s jurisdiction.

(e) Moreover, the Claimant was acting in abuse of rights in instituting the arbitration since its purpose in doing so was to take advantage of the delay which would thereby be occasioned so that Nomura might gain advantage from the running of statutes of limitation in relation to civil or criminal proceedings which might be instituted by the Czech Republic in other fora.

185. In the Claimant’s Memorial, the Claimant simply relied on the fact that the Claimant was established under Dutch law for the express purpose of holding the IPB shares which Nomura had purchased, and that consequently it was an “investor” as defined in the Treaty and its shareholding was an “investment” as also so defined. The facts surrounding the purchase of the IPB shares showed that Saluka had fulfilled the requirement of Article 2 of

the Treaty that investments be lawfully made, and this was borne out by the approval given to the share purchase agreement by the Czech authorities. In its more specific written responses to the Respondent's more detailed exposition of its arguments on the question of the Tribunal's jurisdiction over counterclaims (*i.e.* in its Objections to Jurisdiction over the Czech Republic's Counterclaims and its Reply to the Czech Republic's Response to the Claimant's Objections to Jurisdiction over the Czech Republic's Counterclaims), the Claimant attached overriding weight to the fact that Nomura Europe on the one hand and Saluka on the other were separate legal persons constituted under the laws of different States, that only Saluka was the Claimant in this arbitration and within the jurisdiction of the Tribunal, and that Nomura Europe, as an English company, could not be brought within the scope of the Czech-Netherlands Treaty.

186. In its subsequent pleadings (Reply, oral argument, and Post-Hearing Brief), the Claimant repeated its view that Saluka was a Dutch legal entity and thus an "investor" and that its ownership of IPB shares was an "investment". The Claimant added further argument, in particular:

(a) Saluka's shareholding was not negated by allegedly not being "lawfully made" and therefore not *bona fide*; the only illegality which had been alleged concerned the Put Option, for which there was no basis and which in any event had already been held to be valid in an associated arbitration. In connection with obtaining the CNB's approval for the Share Purchase Agreement, Nomura had duly filed its business plan, which had only to relate to its intentions regarding the future conduct of IPB's banking operations.

(b) There was no need to consider whether or not Saluka had any factual links with The Netherlands, since the Treaty adopted the place-of-incorporation test and there was no basis for adding a "factual link" test.

(c) Saluka's investment in IPB was a real investment.

(d) Nomura did not mislead the Czech authorities as to the nature of its investment in IPB, having made clear its role as a portfolio investor all along.

(e) Nomura's acquisition of the brewery shares was a commercial and financial transaction which was not tainted by any impropriety.

(f) Nomura was a *bona fide* investor.

187. At the close of the oral hearings, the Tribunal asked the parties to address, in their post-hearing briefs, the following question:

[T]o what extent, if at all, (1) can the Tribunal consider and make findings about the conduct of Nomura? (2) is Nomura a necessary party to these proceedings in relation to that conduct?

188. The Claimant's response was that the Tribunal had jurisdiction to consider and make factual findings about the conduct of Nomura in so far as such findings might be relevant to

Saluka's positive case or the Czech Republic's defence, and that the possibility that the Tribunal had to make findings of fact with respect to Nomura's conduct did not require Nomura to be joined as a party to the proceedings.

189. The Respondent's answer to the Tribunal's question was that (1) the Tribunal might make findings of fact regarding Nomura's conduct without considering Nomura to be a "necessary party" to the proceedings, such an approach being typical in BIT arbitrations, and (2) although the Tribunal might make findings of fact regarding Nomura's conduct, Saluka could not recover any damages on the basis of Nomura's alleged loss – and since Saluka's alleged claims for damages were in fact Nomura's claims, Saluka's claims could be dismissed because Saluka is not seeking to recover for any losses that it had itself sustained.

190. In considering the various issues of jurisdiction and admissibility which have been raised, the Tribunal first notes that the Respondent's Notice to Dismiss in substance argues that the Tribunal should decline to entertain the proceedings initiated by the Claimant on the ground that the Claimant is not qualified to bring arbitration proceedings under the Treaty.

191. Accordingly, although the Notice to Dismiss is not worded as an objection to the Tribunal's jurisdiction, it may be assimilated to an objection that the Tribunal is without jurisdiction. As such, it was permissible (although perhaps procedurally unorthodox) for the Respondent to file its Notice making that objection. Doing so by way of the Notice to Dismiss filed on 13 August 2003 was within the time limit prescribed by Article 21.3 of the UNCITRAL Rules. So too was the further elaboration of the Respondent's arguments in its Counter-Memorial.

192. The Tribunal will now address the substantive arguments advanced by the Respondent by which it sought to show that the Tribunal was without jurisdiction to entertain the present proceedings.

#### B. Relevant Terms of the Treaty

193. The Tribunal's jurisdiction is governed by the terms of the Treaty. The immediately relevant terms of the Treaty are Article 8.1 and Article 1.

194. In relevant part, Article 8.1, to which Article 8.2 refers back, relates to "[a]ll disputes between one Contracting Party and an investor of the other Contracting Party concerning an investment of the latter . . .".

195. In these proceedings, the Czech Republic is the relevant "Contracting Party" with which the Claimant claims a dispute exists.

196. In accordance with Article 8, the competence to make use of the arbitral process provided for in Article 8 of the Treaty is possessed by "investors" in respect of their "investments". Those terms are defined in Article 1 of the Treaty.

197. An investor of the "other" Contracting Party (in these proceedings, The Netherlands) must in the first place satisfy the definition of "investors" in Article 1(b)(ii) of the Treaty.



Under that definition, for the purposes of the present proceedings, that term comprises “legal persons constituted under the laws of [The Netherlands]”.

198. In the second place, the dispute between the Czech Republic and such an investor must be one “concerning an investment of [the investor]”. The term “investments” is defined in Article 1(a) as follows:

The term “investments” shall comprise every kind of asset invested either directly or through an investor of a third State and more particularly, though not exclusively:

- (i) movable and immovable property and all related property rights;
- (ii) shares, bonds and other kinds of interests in companies and joint ventures, as well as rights derived therefrom;
- (iii) title to money and other assets and to any performance having an economic value;
- (iv) rights in the field of intellectual property, also including technical processes, goodwill and know-how;
- (v) concessions conferred by law or under contract, including concessions to prospect, explore, extract and win natural resources.

### C. The Respondent’s Challenges to the Tribunal’s Jurisdiction

199. Although the Respondent did not always articulate the various grounds on which it challenged the Tribunal’s jurisdiction with the utmost clarity or consistency, and given its contention that Nomura and Saluka were interchangeable, the principal jurisdictional contentions put forward by the Respondent may be considered under the following headings:

- (a) the purchase of IPB shares was not an investment since Nomura/Saluka had invested nothing in IPB;
- (b) in so far as the purchase of IPB shares was an investment, it had not been lawfully made;
- (c) the real party in interest in the arbitration was not the Claimant, Saluka, but Nomura, which was not an eligible claimant under the Treaty;
- (d) the relationship between Nomura and Saluka was so close as to make them interchangeable;
- (e) Nomura/Saluka was not a *bona fide* investor in IPB;
- (f) Nomura/Saluka did not act in good faith in purchasing the IPB shares;

- (g) Nomura/Saluka acted in abuse of rights in the purchase of IPB shares;
- (h) Saluka had no real and continuous social and economic links with The Netherlands.

200. The Tribunal has concluded that the Claimant's shareholding of IPB shares is an "investment" within the meaning of the Treaty, that the Claimant is in respect of that investment an "investor" within the meaning of the Treaty, and that the Tribunal has jurisdiction to hear claims brought before it by the Claimant.

201. The Tribunal will now address each of the Respondent's contentions.

D. The Purchase of IPB Shares as an Investment and Compliance with Legal Requirements

202. Under a Share Purchase Agreement of 8 March 1998, Nomura Europe bought a controlling (but not majority) holding of shares in the Czech bank IPB. Most of Nomura Europe's shareholding in IPB was transferred to Saluka on 2 October 1998, with the balance being transferred on 24 February 2000. Saluka instituted these present proceedings by a Notice of Arbitration dated 18 July 2001, at a time when it was still the registered owner of the shares, alleging various Treaty breaches in respect of its holding of IPB shares.

203. The first question to be addressed is whether Saluka's holding of IPB shares is an "investment" for purposes of the Treaty. "Investments" are defined in the Treaty very widely. They comprise "every kind of asset invested directly or through an investor of a third State", certain of the more usual kinds of investments then being identified by way of illustration. These illustratively identified assets include in particular "shares, bonds and other kinds of interests in companies and joint ventures, as well as rights derived therefrom".

204. The Tribunal notes in passing that, although not in terms part of the definition of an "investment", it is necessarily implicit in Article 2 of the Treaty that an investment must have been made in accordance with the provisions of the host State's laws. In relevant part, Article 2 stipulates that "[e]ach Contracting Party . . . shall admit such investments in accordance with its provisions of law". Accordingly, and as both parties acknowledge, the obligation upon the host State to admit an investment by a foreign investor (*i.e.* in the present context, to allow the purchase of shares in a local company) only arises if the purchase is made in compliance with its laws.

205. There seems no room for doubt that a qualified investor's holding of shares in a Czech company such as IPB constitutes an investment within the scope of the definition.

206. The Respondent challenges that conclusion on a variety of grounds, notably on the basis that it was not an investment since Saluka had in reality invested nothing in IPB, and that, in so far as the purchase of IPB shares was an investment, it had not been lawfully made.

207. The argument that Saluka had invested nothing in IPB and for that reason the purchase of IPB shares could not be considered an "investment" seems to be based on two

considerations. The first is that Nomura, in making the original purchase of IPB's shares, and Saluka, in subsequently acquiring them, had no intention to make any true investment in the Czech Republic or in IPB's banking operations. The acquisition of IPB shares was never intended, so it is said, to be anything more than a short-term holding of shares with a view to the making of a large profit from the sale of major assets controlled by IPB, to be followed by the sale of the shares at an appropriate moment; Nomura and Saluka, so it is said, showed by their conduct throughout the events to which this case relates that they were not true investors.

208. The Tribunal first notes that the original purchase of IPB shares in March 1998 was not the act of Saluka but of Nomura Europe. Until 2 October 1998 only Nomura Europe held those IPB shares. It is consequently only the subsequent acquisition and holding of those shares by Saluka, from 2 October onwards, in respect of which the Respondent's arguments are relevant.

209. The Tribunal does not believe that it would be correct to interpret Article 1 as excluding from the definition of "investor" those who purchase shares as part of what might be termed bare profit-making or profit-taking transactions. Most purchases of shares are made with the hope that, in one way or another, the result will in due course be a degree of profit on the transaction. It is relevant in this context that, throughout the many discussions which took place between Nomura and the Czech authorities, Nomura insisted that it was only a portfolio investor in IPB and not a strategic investor. Even if it were possible to know an investor's true motivation in making its investment, nothing in Article 1 makes the investor's motivation part of the definition of an "investment".

210. The second consideration which is said by the Respondent to undermine any determination that the purchase of IPB's shares was an "investment" appears to be that Saluka itself invested nothing in IPB but was merely a conduit for the investment made by Nomura, which retained the voting rights associated with the IPB shares, participated in the management of IPB, and conducted all the dealings with the Czech authorities. Saluka was a mere surrogate for Nomura, being no more than an agent for Nomura and not itself a true investor.

211. To a considerable extent, this argument seeks to replace the definition of an "investment" in Article 2 of the Treaty with a definition which looks more to the economic processes involved in the making of investments. However, the Tribunal's jurisdiction is governed by Article 1 of the Treaty, and nothing in that Article has the effect of importing into the definition of "investment" the meaning which that term might bear as an economic process, in the sense of making a substantial contribution to the local economy or to the well-being of a company operating within it. Although the *chapeau* of Article 2 refers to "every kind of asset *invested*", the use of that term in that place does not require, in addition to the very broad terms in which "investments" are defined in the Article, the satisfaction of a requirement based on the meaning of "investing" as an economic process: the *chapeau* needs to contain a verb which is apt for the various specific kinds of investments which are listed, and since all of them are being defined as various kinds of investment it is in the context appropriate to use the verb "invested" without thereby adding further substantive conditions.

212. So far as concerns the lawfulness of the original purchase of IPB shares by Nomura Europe, the Respondent has argued that that shareholding cannot be regarded as a capital

investment through the purchase of IPB shares. These were that Nomura was not investing in IPB in order to support IPB's banking operations and keep IPB viable but to facilitate the acquisition of two valuable Czech breweries through control of IPB's stake in them: this was to be achieved by way of a Put Option scheme which in effect eliminated all downside risk from Nomura's purchase of the IPB shares, so enabling Nomura to acquire and then sell on IPB's shareholding in the brewery companies. This, so it was contended, made Nomura's real objective something other than a *bona fide* investment in IPB: the purchase of IPB's shares was part of a "dishonest scheme to secure enormous benefits". Czech law required a prospective purchaser of controlling shares in a bank to obtain the consent of the Czech authorities for that purchase, which meant that Nomura was required to file a business plan for its investment in IPB, and a false filing was a breach of that legal requirement. Nomura's failure, in its filed business plan, to disclose its true objectives to the Czech authorities had led them to approve the purchase of IPB's shares, which they would not otherwise have done.

213. In this context, the Respondent has invoked the requirements of Section 16(1)(a) and (e) of the Czech Banking Act. This provides (in the translation submitted by the Respondent):

Prior approval of the Czech National Bank shall be required

(a) for the establishment of an ownership interest by foreign a person in an existing bank,<sup>4</sup>

...

(e) acquisitions or transfers of registered capital amounting to more than 15% of a bank's registered capital, in the course of one or more transactions, by/to an individual or several persons acting in concert, unless due to inheritance.

While that provision of the Czech Banking Act establishes the need to obtain the CNB's approval, it says nothing about the investor's obligation to disclose its long-term plans and ultimate objectives.

214. The Respondent has in that respect invoked the provisions of the CNB's Official Communication 23/1995, Article III(2)(c) of which provides:

The investor shall submit the application to the CNB together with the following documents:

2. if the investor is a legal entity

...

(c) a business plan (in the event that the required volume of shares represents 10% and more of the registered capital of the bank).

While that provision requires the submission of a business plan, the Tribunal has seen nothing to suggest that it imposes a legal obligation upon an investor to disclose its future

long-term plans and objectives going far beyond the immediate purposes of its investment in the bank whose shares are being purchased. A “business plan” is inherently a label of considerable generality, and a Tribunal such as this must hesitate before reading into that label such a particular and far-reaching content.

215. The Respondent has not identified any other specific legal requirements relating to the filing obligation which have allegedly been violated. And although Mr Pavel Racoča (Executive Director of the Banking Supervision Department at the CNB) has testified that, had he been aware of the full story, he would not have approved Nomura’s share purchase, the Tribunal does not see in that statement anything to transform full disclosure of future long-term plans and objectives into a legal obligation for the investor.

216. So far as concerns any alleged illegality involved in the creation or operation of the Put Option, the Tribunal notes, and sees no reason to dissent from, the decision of the tribunal in the first arbitration under the Put Option agreement in *Torkmain Investments Ltd et al. v. Pembridge Investments BV et al.*,<sup>5</sup> in its second interim award, that the Put Option agreement was valid, as was the Put Option itself. Moreover, the Tribunal notes that, in the second such arbitration, it was accepted by CSOB (apparently acting on behalf of the Czech Republic) that those two matters were *res judicata* as a matter of Czech law.

217. The Tribunal is accordingly unable to conclude that the circumstances surrounding the original purchase of the shares by Nomura Europe have been shown to involve any breach of the law by Nomura Europe such as to warrant its purchase of IPB shares being considered an unlawful investment and so not entitled to protection under the Treaty. In this connection, the Tribunal notes that, throughout the events giving rise to this arbitration, the Czech authorities have never questioned either the legality of the original transaction by which Nomura acquired the IPB shares, or the legality of Saluka’s subsequent ownership of them: on the contrary, the Czech authorities took many steps explicitly acknowledging Saluka’s status as properly the owner of those shares after October 1998.

218. In any event, the Tribunal again observes that any illegality allegedly involved in Nomura Europe’s conduct at the time of its purchase of the IPB shares would be a failing by Nomura, not by the Claimant in these proceedings, Saluka. To be relevant to the present proceedings, Nomura’s failings (if any) at the time of purchasing the IPB shares in March 1998 need also to be in some way attributable to Saluka in relation to its acquisition and subsequent holding of the shares after October 1998.

219. So far as concerns the subsequent transactions by which those shares were transferred to Saluka, the Respondent appears to address this aspect of the matter by arguing that since, as it submitted, Nomura had not lawfully acquired any investment in IPB shares, therefore Saluka, which subsequently acquired the IPB shares from Nomura, was precluded from having recourse to arbitration under the Treaty, possibly (although this is not specified by the Respondent) either on the ground that the original purchase being unlawful, that illegality taints the subsequent holder’s title to the shares, or on the ground that since Nomura and Saluka are in effect interchangeable (as to which, see below), Nomura’s unlawful conduct is at the same time Saluka’s unlawful conduct.

220. Given the Tribunal's finding in paragraph 42 above, the Tribunal has no need to consider these arguments further.

221. The Tribunal accordingly concludes that there are no good reasons for declining to consider the Claimant's holding of IPB shares in issue in this case to be an "investment" within the meaning of the definition of that term in Article 1 of the Treaty.

E. Saluka's Qualification as an "Investor" Entitled to Initiate the Arbitration Procedures under the Treaty

222. The question which must next be considered is whether Saluka is a qualified "investor" for purposes of the Treaty.

223. There is no doubt that Saluka meets the only requirements expressly stipulated in Article 1 of the Treaty for qualification as an investor, namely that it be a "legal person", and be "constituted under the law of [The Netherlands]".

224. The Respondent, however, advances several arguments why Saluka should nevertheless not be considered an "investor" entitled to invoke the arbitration provisions of the Treaty in respect of Saluka's holding of IPB shares. These have been summarised in paragraph 199(c-h) above:

225. The six separate grounds there summarised amount, in substance, to three main arguments involving, first, the closeness of the relationship between Nomura and Saluka, second, the lack of good faith involved in the acquisition of IPB shares, and third, Saluka's lack of real links with The Netherlands.

1. The Corporate Relationship between Saluka and Nomura

226. As regards the first of these main lines of argument, the essential facts regarding the relationship between Saluka and Nomura have already been set out. In brief, "Nomura" or "the Nomura Group" is the convenient group name of a major Japanese merchant banking and financial services group of companies. It typically operates through subsidiaries set up in various countries. One element of the Nomura Group was Nomura Europe plc, a company constituted under the laws of England. (For convenience, where this company needs to be separately identified, it is referred to as "Nomura Europe".) Another part of the Nomura Group was Saluka, the Claimant in this arbitration. Saluka was constituted under the laws of The Netherlands for the sole and express purpose of holding the shares in IPB which Nomura Europe was at the time in the process of purchasing. Saluka was wholly controlled by Nomura Europe.

227. In those circumstances, the Respondent contended that, in the context of the circumstances which gave rise to this arbitration, the relationship between Nomura and Saluka was so close that they were in effect interchangeable as parties in these proceedings, Saluka being nothing more than a shell used by Nomura for its own purposes. Indeed, in the Respondent's submission, such was the closeness of the relationship that the real party in interest was Nomura (which was not eligible to present claims under the Treaty), and that

therefore Saluka was not a *bona fide* “investor” under the Treaty (a use of “*bona fide*” which, in this context, the Tribunal takes to mean something like “genuine” or “real”) and was therefore not entitled to have recourse to arbitration under it: Saluka was, in effect, a mere surrogate for Nomura, and a claim under an investment treaty could not be brought by an entity which was a surrogate for another entity which, like Nomura, was not covered by the Treaty. Although this involved looking behind the formal corporate structures of Nomura and Saluka, such “piercing the corporate veil” was permissible as an equitable remedy where corporate structures had been utilised to perpetrate fraud or other malfeasance. Nomura had used corporate structures to realise profit and put the banking sector at risk, and to perpetrate fraud against the Czech Republic. The corporate veil should therefore be pierced, the real interest at stake should be recognised to be Nomura’s, and as Nomura was not within the Treaty definition of an “investor”, the Tribunal was without jurisdiction.

228. The Tribunal accepts – and the parties have made no attempt to conceal, either from the Tribunal or, in the Claimant’s case, from the Czech authorities – the closeness of the relationship between Nomura and Saluka. In that respect, the companies concerned have simply acted in a manner which is commonplace in the world of commerce.

229. In dealing with the consequences of that way of acting, the Tribunal must always bear in mind the terms of the Treaty under which it operates. Those terms expressly give a legal person constituted under the laws of The Netherlands – such as, in this case, Saluka – the right to invoke the protection of the Treaty. To depart from that conclusion requires clear language in the Treaty, but there is none. The parties to the Treaty could have included in their agreed definition of “investor” some words which would have served, for example, to exclude wholly-owned subsidiaries of companies constituted under the laws of third States, but they did not do so. The parties having agreed that any legal person constituted under their laws is entitled to invoke the protection of the Treaty, and having so agreed without reference to any question of their relationship to some other third State corporation, it is beyond the powers of this Tribunal to import into the definition of “investor” some requirement relating to such a relationship having the effect of excluding from the Treaty’s protection a company which the language agreed by the parties included within it.

230. While it might in some circumstances be permissible for a tribunal to look behind the corporate structures of companies involved in proceedings before it, the Tribunal is of the view that the circumstances of the present case are not such as to allow it to act in that way. The Respondent acknowledges that this possibility presents itself as an equitable remedy where corporate structures had been utilised to perpetrate fraud or other malfeasance, but, in the present case, the Tribunal finds that the alleged fraud and malfeasance have been insufficiently made out to justify recourse to a remedy which, being equitable, is discretionary.

## 2. The Alleged Lack of Good Faith and Abuse of Rights

231. As regards the bundle of arguments which are said to involve in one way or another considerations of the alleged lack of good faith shown by Nomura/Saluka in the acquisition of the IPB shares, it seems that the Respondent relies on a variety of circumstances in support of its contention. Principal among these is that Nomura Europe did not, at the time of purchasing the IPB shares, disclose to the Czech authorities that its true purpose in doing so was not to invest in IPB’s banking operations, but rather, by way of the Put Option, to

facilitate its acquisition of Czech breweries in which IPB had a controlling interest, and that, by such non-disclosure, Nomura had not acted in good faith and had violated the principle of abuse of rights and was therefore not a *bona fide* investor. Expressed more generally (as set out above in paragraph 184), the Respondent maintained that the Nomura Group had acted fraudulently and dishonestly throughout the events to which the case related. Nomura's circular financing arrangements, the Czech beer deal, the Put Option and the establishment of the Tritton Fund had all been conduct contrary to international *bonos mores*. This continuing failure to act in good faith and the abuse of process required that Saluka – which had never even been a *bona fide* holder of an investment which might have been injured – should be denied protection under the Treaty.

232. The Tribunal does not consider that an investor – and particularly a portfolio investor – shows a lack of good faith in failing to disclose to the seller of shares, or to the host State's regulatory authorities, its ultimate objectives in entering into a share purchase transaction. The seller of shares, and the regulatory authorities, must be taken to be aware that a portfolio investor, particularly one forming part of a very large international financial group, will be making investments as part of a much wider corporate strategy than is involved in the purchase of shares in one particular company. In the Tribunal's view, it is both unreasonable and unrealistic to posit an obligation upon an investor to disclose its ultimate objectives in making a particular investment, whether through the purchase of shares or otherwise. Ultimate objectives will, in any event, often be highly speculative and not susceptible to precise articulation, and will be subject to change over time. An investor may choose to make its long-term plans known to a greater or (in the absence of a clearly legal requirement to the contrary) lesser degree, but that is quite different from establishing an obligation to that effect such as to make non-disclosure a head of "bad faith".

233. The Tribunal has already addressed the Respondent's further argument that Nomura's non-disclosure of its long-term intentions regarding its plans for the acquisition of Czech breweries and the construction of the Put Option involved a breach of the Czech law.

234. So far as specifically concerns the alleged abuse of rights by the Claimant, the right allegedly being abused could be either the right to acquire the shares in IPB, or the right to be regarded as an investor entitled to invoke the Treaty's arbitration provisions: the Respondent appears to assert that the circumstances are in either case sufficient to deprive the Claimant of its standing as an investor entitled to avail itself of those provisions. Those circumstances on which the Respondent relies appear to be Nomura's non-disclosure of its true long-term intentions with regard to its investment in IPB, and its alleged wish to use the delays which would be occasioned by recourse to arbitration so that Nomura might gain advantage from the running of statutes of limitation in relation to civil or criminal proceedings which might be instituted by the Czech Republic in other fora.

235. The Tribunal has already addressed the argument based on non-disclosure, and concluded that an investor – and particularly a portfolio investor – shows no lack of good faith in failing to disclose to the seller of shares, or to the host State's regulatory authorities, its ultimate objectives in entering into a share purchase transaction. Similarly, the Tribunal cannot see in such non-disclosure any circumstance which it could regard as an abuse of the right to acquire the shares or of the right to initiate the Treaty's arbitration procedures.



236. As regards the Respondent's allegation that the Claimant had in mind ulterior litigation motives in instituting the arbitration procedures provided by the Treaty, the Tribunal has to observe that, even if such an ulterior motive could be such as to involve an abuse of the right to invoke the arbitration procedures, that allegation is unsubstantiated and cannot be the basis for a decision by the Tribunal which would deprive it of jurisdiction to proceed with the arbitration which the Claimant has initiated.

237. In any event, the Tribunal again observes that the illegality, lack of good faith, or abuse of rights allegedly involved in Nomura Europe's conduct at the time of its purchase of the IPB shares would be a failing by Nomura, not by the Claimant in these proceedings, Saluka. To be relevant to the present proceedings, Nomura's failings (if any) at the time of purchasing the IPB shares in March 1998 need also to be in some way attributable to Saluka in relation to its acquisition and subsequent holding of the shares after October 1998.

238. The Respondent addresses this aspect of the matter by arguing that since, as it submitted, Nomura was not a *bona fide* or lawful investor, therefore Saluka, which subsequently acquired the IPB shares from Nomura, was precluded from having recourse to arbitration under the Treaty. Since the Tribunal is not persuaded that the original conduct of Nomura involved any illegality, lack of good faith, or abuse of rights, the Tribunal does not find it necessary to examine further the extent to which, had it made any findings of that kind, they might have affected Saluka's right to initiate arbitration proceedings under the Treaty.

### 3. Saluka's Lack of Factual Links with The Netherlands

239. The Respondent also argues that Saluka did not have *bona fide* (which term again seems to connote genuineness rather than any issue of bad faith), real and continuous links to The Netherlands, and for that reason did not satisfy the requirements which are necessary to qualify as an "investor" able to benefit from the provisions of the Treaty.

240. The Tribunal has some sympathy for the argument that a company which has no real connection with a State party to a BIT, and which is in reality a mere shell company controlled by another company which is not constituted under the laws of that State, should not be entitled to invoke the provisions of that treaty. Such a possibility lends itself to abuses of the arbitral procedure, and to practices of "treaty shopping" which can share many of the disadvantages of the widely criticised practice of "forum shopping."

241. However that may be, the predominant factor which must guide the Tribunal's exercise of its functions is the terms in which the parties to the Treaty now in question have agreed to establish the Tribunal's jurisdiction. In the present context, that means the terms in which they have agreed upon who is an investor who may become a claimant entitled to invoke the Treaty's arbitration procedures. The parties had complete freedom of choice in this matter, and they chose to limit entitled "investors" to those satisfying the definition set out in Article 1 of the Treaty. The Tribunal cannot in effect impose upon the parties a definition of "investor" other than that which they themselves agreed. That agreed definition required only that the claimant-investor should be constituted under the laws of (in the present case) The Netherlands, and it is not open to the Tribunal to add other requirements which the parties could themselves have added but which they omitted to add.

242. The Tribunal is confirmed in the appropriateness of the view which it has taken by the consideration, in the particular circumstances of the present case, that it was always apparent to the Czech authorities that it was Nomura's intention to transfer the IPB shares it was purchasing to another company within the Nomura Group, and that that other company would be a special-purpose vehicle set up for the specific and sole purpose of holding those shares. The Share Purchase Agreement contained express provision to that effect. By applying the provisions of the Treaty in conformity with their express terms, no violence is done to the positions knowingly adopted by the parties at all relevant times.

#### F. The Tribunal's Conclusions as to Jurisdiction

243. Having thus considered the various challenges to its jurisdiction which the Respondent has advanced, the Tribunal concludes that the Claimant's shareholding of IPB shares is an "investment" within the meaning of the Treaty, and that the Claimant is in respect of that investment an "investor" within the meaning of the Treaty. Accordingly, the Tribunal is satisfied that it has jurisdiction to hear the claims brought before it by the Claimant under the arbitration procedure provided for in Article 8 of the Treaty.

244. In reaching that conclusion, however, the Tribunal wishes to emphasise that, in accordance with the Treaty, its jurisdiction is limited to claims brought by the Claimant, Saluka, in respect of damage suffered by itself in respect of the investment represented by its holding of IPB shares. It follows, therefore, that the Tribunal does not have jurisdiction in respect of any claims of Nomura, or any claims in respect of damage suffered by Nomura and not by Saluka, or any claims in respect of damage suffered in respect of the IPB shares before October 1998 when the bulk of those shares became vested in the Claimant. Although Nomura is not a party to these proceedings, the Tribunal nevertheless has jurisdiction to consider and make factual findings about the conduct of Nomura in so far as such findings might be relevant to the Tribunal's consideration of arguments advanced by the Claimant or the Respondent.

### V. SALUKA'S CLAIMS UNDER ARTICLE 5 OF THE TREATY

#### A. The Treaty

245. Article 5 of the Treaty reads as follows:

Neither Contracting Party shall take any measures depriving, directly or indirectly, investors of the other Contracting Party of their investments unless the following conditions are complied with:

- a. the measures are taken in the public interest and under due process of law;
- b. the measures are not discriminatory;
- c. the measures are accompanied by provision for the payment of just compensation. Such compensation shall represent the genuine value of the investments affected and shall, in order to be effective for the claimants, be paid and made transferable, without undue delay, to the country designated

by the claimants concerned and in any freely convertible currency accepted by the claimants.

B. The Parties' Principal Submissions

246. The Claimant asserts that Saluka has been deprived of the value of its shares in IPB by the Czech Republic's intervention which culminated in the forced administration of IPB.

247. The Claimant further maintains that, in this context, the only issue before the Tribunal is whether this deprivation was unlawful in accordance with the criteria of Article 5.

248. The Claimant concludes that the Czech Republic is liable under Article 5 if it can establish that one or more of the conditions set out in Article 5 has not been complied with, *i.e.* that:

- (a) the measures depriving Saluka of its investment were not taken in the public interest and under due process of law; or that
- (b) the measures were discriminatory; or that
- (c) the measures were not accompanied by payment of just compensation.

249. In support of its main contention, Saluka, in brief, maintains that the evidence before the Tribunal demonstrates the following:

- (a) The IPB proposal, rejected by the Czech Government, would have cost Czech taxpayers far less than the forced administration option. That option, says Saluka, was thus not in the public interest;
- (b) The Respondent's fact and expert witnesses were unable to point to a precise regulation with respect to a bank's liquidity requirements which had been breached by IPB. There was thus, argues Saluka, no due process;
- (c) The Forced Administrator never exercised truly independent judgment. Again, says Saluka, the forced administration measure was not taken under due process and was discriminatory;
- (d) The Czech Government granted State aid to IPB's competitors, thus infringing, says Saluka, the non-discrimination provision of Article 5;
- (e) The Czech Government resorted to its regulatory power unlawfully for the sole purpose of transferring IPB's business to CSOB. The measure, argues Saluka, was thus clearly discriminatory;
- (f) The Czech Government never paid any compensation to Saluka after having deprived Saluka of its investment.

250. The Czech Republic denies that it has violated Article 5 of the Treaty. In essence, it submits that the measures which it resorted to in order to address the IPB situation in the spring of 2000 and which culminated in the decision by the CNB to put IPB into forced administration were “permissible regulatory actions” which cannot be considered as expropriatory.

251. In support of its principal defense, the Czech Republic also avers that each of the measures cited by Saluka in its attempt to demonstrate that the Czech Republic’s actions were not genuine regulatory measures were indeed authorised by Czech law.

252. Subsidiarily, the Czech Republic argues that, since Saluka sold its IPB shares back to Nomura after June 2000 for the same amount as it purchased them, Saluka “has failed to establish a deprivation of sufficient magnitude to form the basis of an expropriation claim”.

### C. The Law

253. The Tribunal agrees with Saluka that the principal, if not the sole, issue which it must determine in the present chapter of its Award is whether the actions by the Czech Republic complained of by the Claimant are lawful or unlawful measures.

254. The Tribunal acknowledges that Article 5 of the Treaty in the present case is drafted very broadly and does not contain any exception for the exercise of regulatory power. However, in using the concept of deprivation, Article 5 imports into the Treaty the customary international law notion that a deprivation can be justified if it results from the exercise of regulatory actions aimed at the maintenance of public order. In interpreting a treaty, account has to be taken of “any relevant rules of international law applicable in the relations between the parties”<sup>6</sup> – a requirement which the International Court of Justice (“ICJ”) has held includes relevant rules of general customary international law.<sup>7</sup>

255. It is now established in international law that States are not liable to pay compensation to a foreign investor when, in the normal exercise of their regulatory powers, they adopt in a non-discriminatory manner *bona fide* regulations that are aimed at the general welfare.

256. Nearly forty-five years ago, the Harvard Draft Convention on the International Responsibility of States for Injuries to Aliens (“Harvard Draft Convention”),<sup>8</sup> which instrument is relied upon by the Czech Republic, recognised the following categories of non-compensable takings:

An uncompensated taking of an alien property or a deprivation of the use or enjoyment of property of an alien which results from the execution of tax laws; from a general change in the value of currency; from the action of the competent authorities of the State in the maintenance of public order, health or morality; or from the valid exercise of belligerent rights or otherwise incidental to the normal operation of the laws of the State shall not be considered wrongful.

257. As Saluka correctly reminded the Tribunal, the above-quoted passage in the Harvard Draft Convention is subject to four important exceptions. An uncompensated taking of the sort referred to shall not be considered unlawful provided that:

- (a) it is not a clear and discriminatory violation of the law of the State concerned;
- (b) it is not the result of a violation of any provision of Articles 6 to 8 [of the draft Convention];
- (c) it is not an unreasonable departure from the principles of justice recognised by the principal legal systems of the world;
- (d) it is not an abuse of the powers specified in this paragraph for the purpose of depriving an alien of his property.

258. These exceptions do not, in any way, weaken the principle that certain takings or deprivations are non-compensable. They merely remind the legislator or, indeed, the adjudicator, that the so-called “police power exception” is not absolute.

259. The Tribunal further recalls that, in an accompanying note to the 1967 OECD Draft Convention on the Protection of Foreign Property,<sup>9</sup> it is provided that measures taken in the pursuit of a State’s “political, social or economic ends” do not constitute compensable expropriation.

260. Similarly, the United States Third Restatement of the Law of Foreign Relations in 1987<sup>10</sup> includes *bona fide* regulations and “other action of the kind that is commonly accepted as within the police power of State” in the list of permissible – that is, non-compensable – regulatory actions.

261. It is clear that the notion of deprivation, as that word is used in the context of Article 5 of the Treaty, is to be understood in the meaning it has acquired in customary international law.<sup>11</sup>

262. In the opinion of the Tribunal, the principle that a State does not commit an expropriation and is thus not liable to pay compensation to a dispossessed alien investor when it adopts general regulations that are “commonly accepted as within the police power of States” forms part of customary international law today. There is ample case law in support of this proposition. As the tribunal in *Methanex Corp. v. USA* said recently in its final award, “[i]t is a principle of customary international law that, where economic injury results from a *bona fide* regulation within the police powers of a State, compensation is not required”.<sup>12</sup>

263. That being said, international law has yet to identify in a comprehensive and definitive fashion precisely what regulations are considered “permissible” and “commonly accepted” as falling within the police or regulatory power of States and, thus, non-compensable. In other words, it has yet to draw a bright and easily distinguishable line between non-compensable regulations on the one hand and, on the other, measures that have the effect of depriving foreign investors of their investment and are thus unlawful and compensable in international law.

264. It thus inevitably falls to the *adjudicator* to determine whether particular conduct by a state “crosses the line” that separates valid regulatory activity from expropriation. Faced with the question of *when, how and at what point an otherwise valid regulation becomes, in fact*

and effect, an unlawful expropriation, international tribunals must consider the circumstances in which the question arises. The context within which an impugned measure is adopted and applied is critical to the determination of its validity.<sup>13</sup>

265. In the present case, the Tribunal finds that the Czech Republic has not “crossed that line” and did not breach Article 5 of the Treaty, since the measures at issue can be justified as permissible regulatory actions.

#### D. Analysis and Findings

266. Saluka’s shares in IPB were assets entitled to protection under the Treaty. Pursuant to Article 5 of the Treaty, the Czech Republic was prohibited from taking any measures depriving, directly or indirectly, Saluka of its investment in IPB unless one or more of the cumulative conditions set out in that Article were complied with. If the Tribunal finds that the Czech Republic has adopted such measures without having complied with one or more of these conditions, the conclusion will inevitably follow that the Respondent has breached Article 5 of the Treaty.

267. There can be no doubt, and the Tribunal so finds, that Saluka has been deprived of its investment in IPB as a result of the imposition of the forced administration of the bank by the CNB on 16 June 2000.

268. In Part III of the present Award, the Tribunal has reviewed in considerable detail the facts which led the CNB, on 16 June 2000, to “introduce forced administration” of IPB pursuant to Section 26(1)(d) of the Czech Banking Act.<sup>14</sup>

269. A translation of the CNB decision of 16 June 2000 has been produced as an exhibit before the Tribunal. It sets forth the many reasons which convinced the CNB, as the Czech banking regulator, to decide that the time had come to impose forced administration of IPB and appoint an administrator to exercise the forced administration. The decision also refers to the Czech legislation on which the CNB relied.

270. Rather than attempting to summarise the CNB’s decision, the Tribunal reproduces it here *in extenso*, in translation supplied by the Respondent:

#### Decision

On the basis of the establishment that INVESTIČNÍ A POŠTOVNÍ BANKA, akciová společnost, with its registered office in Praha 1, Senovážné nam. 32, IČO (Identification No.): 45 31 66 19 (the “Bank”) continually fails to maintain payment ability both in Czech currency and in foreign currencies and, accordingly, fails to comply with its obligation under Section 14 of Act No. 21/1992 Coll., the Banking Act, as amended (the “Banking Act”), the Czech National Bank has decided, pursuant to the provision of Section 26(1)(d), in accordance with the provisions of Section 30, Section 26(2), Section 26(6) and Section 26(3)(b) and with regard to the provisions of Section 27(1)(a) and (b) of the Banking Act, as follows:

- I. Forced administration shall be introduced in the Bank as of June 16, 2000.

- II. The administrator exercising the forced administration shall be Mr. Petr Staněk, birth number 670725/0847.

#### Reasoning

Under the provisions of Section 14, of the Banking Act, banks are obligated to continually maintain payment ability both in Czech currency and in foreign currencies. The Czech National Bank has evaluated, on the basis of the findings set forth below, the state of matters as of the date of issue of this Decision with the result that the Bank is in breach of said provision.

In its letter Ref. No. 277/520, dated March 2, 2000, the Czech National Bank requested data on liquidity condition and payment ability of the Bank to be provided by the Bank on a daily basis. In accordance with the Czech National Bank's requirement, the Bank provided, on a daily basis, tables showing the development of primary deposits (deposits from clients) in the preceding two weeks, the development of monitored items of financial market (the so-called liquidity cushion securing the Bank's payment ability) in the preceding two weeks and a summary of the development of primary deposits (deposits from clients) since February 20, 2000. On the basis of the documents provided, the Czech National Bank regularly monitored the development of the Bank's payment ability whose deterioration is shown by the data for the period from February 20, 2000, to June 11, 2000, and further from June 12, 2000 to June 14, 2000.

From the table "Development of primary deposits in the past two weeks in millions of CZK" provided by the Bank in its letter dated June 12, 2000, Ref. No. 1107/00/3-1, the Czech National Bank ascertained that in the period from February 20, 2000, to June 11, 2000, the amount of primary deposits (deposits from clients) decreased in the aggregate from CZK 237,966 million to CZK 204,155 million, i.e., by CZK 33,811 million. At the same time, the Czech National Bank ascertained from the table "Development of monitored items of the financial market in the past two weeks in millions of CZK" provided by the Bank in its letter dated March 6, 2000, Ref. No. 451/2000/3-1 and its letter dated June 12, 2000, Ref. No. 1107/00/3-1 that due to the decrease in the primary deposits (deposits from clients), the financial market balance (the so-called liquidity cushion) decreased from CZK 64,452 million to CZK 38,658 million in that same period.

From the table "Development of primary deposits in the past two weeks in millions of CZK" provided by the Bank in its letter dated June 15, 2000, Ref. No. 1143/00/3-1, the Czech National Bank ascertained that on June 12, 2000, the amount of primary deposits (deposits from clients) decreased in the aggregate from CZK 204,153 million to CZK 199,628 million, i.e., by CZK 4,525 million, on June 13, 2000, it decreased from CZK 199,628 million to CZK 193,664 million, i.e., by CZK 5,964 million, and on June 14, 2000, from CZK 193,664 million to CZK 187,173 million, i.e., by CZK 6,491 million. At the same time, the Czech National Bank ascertained from the table "Development of monitored items of the financial market in the past two weeks in millions of CZK" provided by the Bank in its letter dated June 15, 2000, Ref. No. 1143/00/3-1 that due to the decrease in the primary deposits (deposits from clients) in that period, the financial market balance (the so-called liquidity cushion) decreased on June 12, 2000, from CZK 39,385 million to CZK 34,926 million, i.e., by CZK 4,459 million, on June 13, 2000, it decreased from CZK 34,926 million to CZK 25,446 million, i.e., by CZK 9,480 million, and on June 14, 2000, from CZK 25,446 million to CZK 16,625 million, i.e., by CZK 8,821 million.

The Bank's Board of Directors addressed, in accordance with Section 26b of the Banking Act, a letter dated June 14, 2000, Ref. No. GR 202/2000 to the Czech National Bank stating that as a result of intensified cash and cash-free withdrawals in the last days, the Bank's liquidity condition had significantly deteriorated and a risk existed that if the current trend continued, the Bank could get into a situation where it would no longer be able to maintain the amount of the mandatory minimum reserves and consequently to comply with its obligations under debit clearing transactions, i.e., it would not be able to perform its clients' payment instructions.

The development in the deposits and liquidity cushion at the Bank constitutes a considerable risk from the point of view of a threat to its payment ability since, as established by the Czech National Bank, the current amount of the liquidity cushion that is constantly decreasing is not adequate for the current and constantly increasing requirements of the clients for deposit withdrawals. All factual findings made as of the date of issue of this Decision evidence that the current trend is continuing.

The Czech National Bank is entitled to introduce forced administration pursuant to Section 26(1)(d) of the Banking Act only after it has established deficiencies in a bank's operation. Under the provisions of Section 26(3)(b) of the Banking Act, "deficiencies in a bank's operation" means, among other things, a breach of the Banking Act. It has been unambiguously established on the basis of the aforementioned findings that the Bank has failed to comply with its obligation under Section 14 of the Banking Act. Accordingly it is in breach of that law, and a fundamental deficiency has been ascertained in its operation which deficiency continues.

Pursuant to the provisions of Section 30 of the Banking Act, the Czech National Bank is entitled to introduce forced administration in a bank if the deficiencies in such bank's operation endanger the stability of the banking system. According to the findings made by the Czech National Bank, this legal condition is fulfilled on the following grounds.

In 1999, the Bank ranked second within the interbank payment system of the Czech Republic in terms of the amount of payments processed – the Bank received and dispatched 2.3 million transactions totaling CZK 2,000 billion.

Second, according to the data stated in the statement "Bil 1-12. Monthly statement of assets and liabilities" as at April 30, 2000, the Bank's share in the amount of deposits from the public within the banking sector of the Czech Republic is 22% while its shares in the aggregate amount of assets within the banking sector of the Czech Republic amounts to 13.2% and the number of its clients is over 2.9 million.

In addition, the Bank is a major shareholder of two other banks operating in the Czech Republic, namely Českomoravská stavební spořitelna, akciová společnost, the leading building and loan association in the building loan market in the Czech Republic, and Českomoravská hypoteční banka, a.s., the leading bank in the mortgage-backed loan market in the Czech Republic. The severe financial condition of the Bank contests its position as the major shareholder or shareholder with the decisive controlling influence of these banks and is a threat to these banks' position.

On the basis of the above, the Czech National Bank holds as evidenced that the Bank directly endangers the stability of the banking system of the Czech Republic.

The Bank is a significant debtor of other banks, consequently its lower payment ability is liable to adversely affect the payment ability of the banks that are its



creditors. In addition, the Bank administers funds of many entities whose inability to pay caused by the Bank (the Bank's low liquidity) would result in serious consequences, whether direct or indirect, for the creditors of such entities including, without limitation, other banks constituting the banking system. Given the above, the Bank participates to a significant extent in the functioning of the entire banking system. The fact that, according to the notice given by its own statutory bodies, it may not be able to maintain its payment ability endangers the stability of the banking system in its entirety.

All the above facts with respect to the Bank's share in the interbank payment system, in the amount of deposits from the public within the banking sector, in the aggregate amount of assets within the banking sector, the number of its clients and its significant position as a shareholder evidence that the serious difficulties in the Bank's payment ability endanger the stability of the banking system in the Czech Republic to a considerable extent.

Pursuant to the provisions of Section 30 of the Banking Act, the Czech National Bank is entitled to introduce forced administration in a bank if such bank's shareholders have failed to take necessary measures to correct deficiencies. The effect of such measures may be measured only by the result, i.e., improvement in such bank's payment ability. According to the data ascertained with respect to the Bank's payment ability, it is evident that the situation of the Bank necessitates an immediate solution. The constant deterioration of the Bank's payment ability demonstrates that either the Bank's shareholders have failed to take appropriate measures securing the permanent payment ability of the Bank or such measures have been insufficient and ineffective as the Bank's payment ability is markedly deteriorating. The foregoing is implied both by the Czech National Bank's own findings and by the information contained in the letter from the Bank's Board of Directors, dated June 14, 2000, delivered to the Czech National Bank on June 15, 2000.

Based on the above, the Czech National Bank holds as evidenced that the conditions for the introduction of forced administration in the Bank, as set forth in the provisions of Section 26(1)(d) and Section 30 of the Banking Act with respect to the introduction of forced administration in a bank, are fulfilled.

Pursuant to the provisions of Section 2 of Act No. 6/1993 Coll., the Czech National Bank Act, as amended (the "Czech National Bank Act"), the responsibilities of the Czech National Bank include the management of monetary circulation and payments including banking clearance, maintaining the continuity and efficiency thereof, exercise of supervision over banking activities and maintaining the safe functioning and purposeful development of the banking system in the Czech Republic.

In addition, the Czech National Bank is responsible, under the provisions of Section 44(1)(a) of the Czech National Bank Act, for the exercise of supervision over banking activities and the safe functioning of the banking system. Given the critical financial condition of the Bank and with regard to the threat to the stability of the banking system constituted by the aforementioned deficiency in the Bank's operations as well as the failure of the Bank's shareholders to take necessary measures to correct such deficiencies, the Czech National Bank must avoid a situation where a panic among the Bank's depositors would result in a permanent destabilization of its operations and consequently in undermined confidence in the banking system in its entirety. By the introduction of forced administration, the Czech National Bank prevents further gradation of the Bank's critical situation.

Pursuant to the provisions of Section 26(2) of the Banking Act, the Czech National Bank is obligated to decide on the introduction of forced administration upon a bank's failure to correct deficiencies on the Czech National Bank's demand made pursuant to Section 26(1)(a) of the Banking Act. However, pursuant to Section 26(2) of the Banking Act, the Czech National Bank may introduce forced administration without a demand for correcting measures under Section 26(1)(a) of the Banking Act if the matter cannot withstand delay.

On the basis of the information ascertained by the Czech National Bank, it is incontestable that the Bank's payment ability is rapidly and significantly deteriorating and, consequently, the Czech National Bank considers the introduction of forced administration to be a matter that cannot withstand delay.

The Czech National Bank has requested, in accordance with the provisions of Section 30 of the Banking Act, the standpoint of the Ministry of Finance with respect to the introduction of forced administration. In its standpoint dated June 16, 2000, the Ministry of Finance consented to the introduction of forced administration.

Pursuant to the provisions of Section 28(1) of the Banking Act, the Banking Board has the obligation to appoint the administrator charged with the exercise of forced administration and determine the amount of his remuneration. However, pursuant to the provision of Section 27(1)(b) of the Banking Act, the decision on the introduction of forced administration must include, in addition to the grounds for the introduction of forced administration, also the name, surname and birth code of the administrator.

#### Advice on Appeal

An appeal may be lodged against this Decision pursuant to Section 61(1) of Act No. 71/1967 Coll., the Administrative Procedural Code (the Administrative Code), as amended, with the Czech National Bank, Na Příkopě 28, Praha 1, PSČ 115 03, within 15 days of the delivery hereof. In accordance with the provisions of Section 41(1) of the Banking Act, the Banking Board of the Czech National Bank decides on the appeal. An appeal lodged has no suspensive effect.

(Circular Seal)

(signature)

Ing. Pavel Racoča, MIA  
Senior Director

(signature)

Ing. Vladimír Krejča  
Director of the Banking Supervision Section

This Decision is addressed to:  
INVESTIČNÍ A POŠTOVNÍ BANKA, akciová společnost  
Senovazné nam. 32  
Praha 1

271. As will be seen, the CNB's decision is fully motivated. Having reviewed the totality of the evidence which the CNB invoked in support of its decision, the Tribunal is of the view that the CNB was justified, under Czech law, in imposing the forced administration of IPB and appointing an administrator to exercise the forced administration.

272. The Czech State, in the person of its banking regulator, the CNB, had the responsibility to take a decision on 16 June 2000. It enjoyed a margin of discretion in the

exercise of that responsibility. In reaching its decision, it took into consideration facts which, in the opinion of the Tribunal, it was very reasonable for it to consider. It then applied the pertinent Czech legislation to those facts – again, in a manner that the Tribunal considers reasonable.

273. In the absence of clear and compelling evidence that the CNB erred or acted otherwise improperly in reaching its decision, which evidence has not been presented to the Tribunal, the Tribunal must in the circumstances accept the justification given by the Czech banking regulator for its decision.

274. The Tribunal notes, additionally, that the decision of the CNB was confirmed by the CNB Appellant Board and subsequently upheld by the City Court in Prague on two occasions, firstly on an appeal lodged by three members of IPB's Board of Directors and later on an appeal lodged by Saluka itself.

275. The CNB's decision is, in the opinion of the Tribunal, a lawful and permissible regulatory action by the Czech Republic aimed at the general welfare of the State, and does not fall within the ambit of any of the exceptions to the permissibility of regulatory action which are recognised by customary international law. Accordingly, the CNB's decision did not, fall within the notion of a "deprivation" referred to in Article 5 of the Treaty, and thus did not involve a breach of the Respondent's obligations under that Article.

#### E. Conclusion

276. In summary, the Tribunal finds, based on the totality of the evidence which has been presented to it, that in imposing the forced administration of IPB on 16 June 2000 the Czech Republic adopted a measure which was valid and permissible as within its regulatory powers, notwithstanding that the measure had the effect of eviscerating Saluka's investment in IPB.

277. Having so determined, it is not necessary for the Tribunal to address the Respondent's subsidiary argument that, because Saluka sold its IPB shares back to Nomura after June 2000 for the same amount as it purchased those shares, the Claimant has failed to establish a deprivation of sufficient magnitude to form the basis of an expropriation claim.<sup>15</sup>

278. The Tribunal, in this Chapter of the present Award dealing with Saluka's claim that the Czech Republic breached Article 5 of the Treaty, does not consider the Claimant's allegations that the Czech Republic was an accessory to CSOB's alleged plan to take over IPB, that the Forced Administrator did not exercise truly independent judgment or that the Czech Government discriminated against IPB by granting State aid to Saluka's competitors. In the view of the Tribunal, these allegations, even if proven, would not rise to the level of a breach of Article 5. They will in any event be considered in the next Chapter of this Award that addresses the alleged breach by the Respondent of Article 3 of the Treaty.

## VI. SALUKA'S CLAIMS UNDER ARTICLE 3 OF THE TREATY

279. The way in which events unfolded with respect to Saluka's shareholding in IPB amounted, in the Claimant's view, to a breach by the Czech Republic of its obligation under Article 3 of the Treaty. The Respondent has denied that it breached Article 3 of the Treaty.

280. Article 3, paragraphs 1 and 2 of the Treaty provided that:

1. Each Contracting Party shall ensure fair and equitable treatment to the investments of investors of the other Contracting Party and shall not impair, by unreasonable or discriminatory measures, the operation, management, maintenance, use, enjoyment or disposal thereof by those investors.
2. More particularly, each Contracting Party shall accord to such investments full security and protection which in any case shall not be less than that accorded either to investments of its own investors or to investments of investors of any third States, whichever is more favourable to the investor concerned.

281. For reasons set out below, the Tribunal finds that the treatment accorded to Saluka's investment by the Czech Republic

- (a) was in some respects unfair and inequitable, and
- (b) impaired, by certain unreasonable and discriminatory measures, the enjoyment of such investment by Saluka,

and that the Czech Republic has therefore violated Article 3 of the Treaty.

### A. The Content of the Czech Republic's Obligations under Article 3 of the Treaty

282. Article 3.1 of the Treaty requires the signatory governments to treat investments of investors of the other Contracting Party according to the standards of "fairness" and "equity" and to avoid impairment of such investments by measures which are not in compliance with the standards of "reasonableness" and "non-discrimination". It is common ground that such general standards represent principles that cannot be reduced to precise statements of rules.

283. Even though Article 3.2 sets out, "more particularly", obligations to accord "full security and protection" as well as national and most-favoured-nation treatment, these formulations are merely indicative and are not exhaustive of the scope of the general standards laid down in Article 3.1. Furthermore, a violation of the national and most-favoured-nation treatment obligations is not at issue here, and "full security and protection" is not less general a formulation than the standards set out in Article 3.1.

284. This does not imply, however, that such standards as laid down in Article 3 of the Treaty would invite the Tribunal to decide the dispute in a way that resembles a decision *ex aequo et bono*. This Tribunal is bound by Article 6 of the Treaty to decide the dispute on the

basis of the law, including the provisions of the Treaty. Even though Article 3 obviously leaves room for judgment and appreciation by the Tribunal, it does not set out totally subjective standards which would allow the Tribunal to substitute, with regard to the Czech Republic's conduct to be assessed in the present case, its judgment on the choice of solutions for the Czech Republic's.<sup>16</sup> As the tribunal in *S.D. Myers* has said, the "fair and equitable treatment" standard does not create an "open-ended mandate to second-guess government decision-making".<sup>17</sup> The standards formulated in Article 3 of the Treaty, vague as they may be, are susceptible of specification through judicial practice and do in fact have sufficient legal content to allow the case to be decided on the basis of law. Over the last few years, a number of awards have dealt with such standards yielding a fair amount of practice that sheds light on their legal meaning.<sup>18</sup>

## B. Fair and Equitable Treatment

### 1. Meaning of the Standard

#### a) The Parties' Arguments

285. There is agreement between the parties that the determination of the legal meaning of the "fair and equitable treatment" standard is a matter of appreciation by the Tribunal in light of all relevant circumstances. As the tribunal in *Mondev* has stated, "[a] judgment of what is fair and equitable cannot be reached in the abstract; it must depend on the facts of the particular case".<sup>19</sup> There is disagreement between the parties, however, about the limits of such appreciation. These limits are reflected in the threshold that is relevant for the determination of the unlawfulness of the Czech Republic's conduct in the present case.

286. The Claimant argues that the standard is a specific and autonomous Treaty standard. Since it is not in any way qualified, it should be interpreted broadly. The Claimant relies, *inter alia*, on *Pope & Talbot, Inc. v. The Government of Canada*, where the arbitral tribunal stated that guarantees similar to those contained in Article 3 of the Treaty do not limit an investor's recourse to protection only against conduct that is "egregiously unfair", but rather are meant to ensure "the kind of hospitable climate that would insulate them from political risks or incidents of unfair treatment".<sup>20</sup>

287. According to the Claimant, Article 3.1 does not refer to any high threshold of unreasonableness or flagrancy of the conduct constituting a breach and it must be interpreted broadly enough to translate into real and effective protection of the type that would encourage investors to participate in the economy of the host State.

288. The Claimant endorses, however, and commends as a useful guide, even in the present context, the threshold defined by the Tribunal in *Waste Management, Inc. v. United Mexican States*, which held that the fair and equitable treatment standard in Article 1105(1) of the North American Free Trade Agreement ("NAFTA")<sup>21</sup> is infringed if the conduct of the State

is arbitrary, grossly unfair, unjust or idiosyncratic, is discriminatory and exposes the claimant to sectional or racial prejudice, or involves a lack of due process leading to an outcome which offends judicial propriety – as might be the case with a manifest

failure of natural justice in judicial proceedings or a complete lack of transparency and candour in an administrative process.<sup>22</sup>

289. The Respondent argues that the standard laid down in Article 3.1 conforms in effect to the “minimum standard” which forms part of customary international law. The Respondent relies, *inter alia*, on the *Genin* award where the tribunal interpreted the “fair and equitable treatment” standard indeed as “a minimum standard”. The *Genin* tribunal held that:

acts that would violate this minimum standard would include acts showing a wilful neglect of duty, an insufficiency of action falling far below international standards, or even subjective bad faith.<sup>23</sup>

290. For the determination of the relevant threshold, the Respondent also refers the Tribunal to the historical development of the customary minimum standard and, in particular, to the *Neer* case where it was held that the treatment of aliens, in order to constitute an international delinquency,

should amount to an outrage, to bad faith, to willful neglect of duty, or to an insufficiency of governmental action so far short of international standards that every reasonable and impartial man would recognize its insufficiency.<sup>24</sup>

The Respondent therefore argues that it is for the Tribunal to determine whether, under the circumstances,

the governmental action in question was willfully wrong, actually malicious, or so far beyond the pale that it cannot be defended among reasonable members of the international community.

291. Whatever the merits of this controversy between the parties may be, it appears that the difference between the Treaty standard laid down in Article 3.1 and the customary minimum standard, when applied to the specific facts of a case, may well be more apparent than real. To the extent that the case law reveals different formulations of the relevant thresholds, an in-depth analysis may well demonstrate that they could be explained by the contextual and factual differences of the cases to which the standards have been applied.

292. Also, it should be kept in mind that the customary minimum standard is in any case binding upon a State and provides a minimum guarantee to foreign investors, even where the State follows a policy that is in principle opposed to foreign investment; in that context, the minimum standard of “fair and equitable treatment” may in fact provide no more than “minimal” protection. Consequently, in order to violate that standard, States’ conduct may have to display a relatively higher degree of inappropriateness.

293. Bilateral investment treaties, however, are designed to promote foreign direct investment as between the Contracting Parties; in this context, investors’ protection by the “fair and equitable treatment” standard is meant to be a guarantee providing a positive incentive for foreign investors. Consequently, in order to violate the standard, it may be sufficient that States’ conduct displays a relatively lower degree of inappropriateness.

294. Whichever the difference between the customary and the treaty standards may be, this Tribunal has to limit itself to the interpretation of the “fair and equitable treatment” standard as embodied in Article 3.1 of the Treaty. That Article omits any express reference to the customary minimum standard. The interpretation of Article 3.1 does not therefore share the difficulties that may arise under treaties (such as the NAFTA) which expressly tie the “fair and equitable treatment” standard to the customary minimum standard.<sup>25</sup> Avoidance of these difficulties may even be regarded as the very purpose of the lack of a reference to an international standard in the Treaty.<sup>26</sup> This clearly points to the autonomous character of a “fair and equitable treatment” standard such as the one laid down in Article 3.1 of the Treaty.

295. Moreover, the Tribunal is not convinced that, as the Respondent suggests, Article 3.1 at least implicitly incorporates the customary minimum standard. The *Genin* case on which the Respondent relies does not support this suggestion. The *Genin* tribunal merely held that a BIT standard of “fair and equitable” treatment provides “a basic and general standard which is detached from the host States’ domestic law”.<sup>27</sup> This standard is characterised by the *Genin* tribunal as “an” international minimum standard, not as “the” international minimum standard. Far from equating the BIT’s standard with the customary minimum standard, the *Genin* tribunal merely emphasised that the “fair and equitable treatment” standard requires the Contracting States to accord to foreign investors treatment which does not fall below a certain minimum, this minimum being in any case detached from any lower minimum standard of treatment that may prevail in the domestic laws of the Contracting States. Also, the way the *Genin* tribunal defined the threshold for the finding of a violation of the “fair and equitable treatment” standard<sup>28</sup> does not incorporate the traditional *Neer* formula<sup>29</sup> which reflects the traditional, and not necessarily the contemporary, definition of the customary minimum standard, at least in certain non-investment fields.

b) The Tribunal’s Interpretation

296. In order to give specific content of the Czech Republic’s general obligation to accord “fair and equitable treatment” to Saluka’s investment in IPB shares, this Tribunal, being established under the Treaty, has to interpret Article 3 in accordance with the rules of interpretation laid down in the 1969 Vienna Convention on the Law of Treaties (the “Vienna Convention”).<sup>30</sup> These rules are binding upon the Contracting Parties to the Treaty,<sup>31</sup> and also represent customary international law. Article 31.1 of the Vienna Convention requires that a treaty is interpreted

in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.

i) The Ordinary Meaning

297. The “ordinary meaning” of the “fair and equitable treatment” standard can only be defined by terms of almost equal vagueness. In *MTD*, the tribunal stated that:

In their ordinary meaning, the terms “fair” and “equitable” [...] mean “just”, “even-handed”, “unbiased”, “legitimate”.<sup>32</sup>

On the basis of such and similar definitions, one cannot say much more than the tribunal did in *S.D. Myers* by stating that an infringement of the standard requires

treatment in such an unjust or arbitrary manner that the treatment rises to the level that is unacceptable from the international perspective.<sup>33</sup>

This is probably as far as one can get by looking at the “ordinary meaning” of the terms of Article 3.1 of the Treaty.

ii) The Context

298. The immediate “context” in which the “fair and equitable” language of Article 3.1 is used relates to the level of treatment to be accorded by each of the Contracting Parties to the investments of investors of the other Contracting Party. The broader “context” in which the terms of Article 3.1 must be seen includes the other provisions of the Treaty. In the preamble of the Treaty, the Contracting Parties

recognize[d] that agreement upon the treatment to be accorded to such investments will stimulate the flow of capital and technology and the economic development of the Contracting Parties and that fair and equitable treatment is desirable.

The preamble thus links the “fair and equitable treatment” standard directly to the stimulation of foreign investments and to the economic development of both Contracting Parties.

iii) The Object and Purpose of the Treaty

299. The “object and purpose” of the Treaty may be discerned from its title and preamble. These read:

Agreement on encouragement and reciprocal protection of investments between the Kingdom of the Netherlands and the Czech and Slovak Federal Republic

The Government of the Kingdom of the Netherlands

And

The Government of the Czech and Slovak Federal Republic,

hereinafter referred to as the Contracting Parties,

Desiring to extend and intensify the economic relations between them particularly with respect to investments by the investor of one Contracting Party in the territory of the other Contracting Party,

Recognizing that agreement upon the treatment to be accorded to such investments will stimulate the flow of capital and technology and the economic development of the Contracting Parties and that fair and equitable treatment is desirable.



Taking note of the Final Act of the Conference on Security and Cooperation in Europe, signed on August, 1st 1975 in Helsinki.

300. This is a more subtle and balanced statement of the Treaty's aims than is sometimes appreciated. The protection of foreign investments is not the sole aim of the Treaty, but rather a necessary element alongside the overall aim of encouraging foreign investment and extending and intensifying the parties' economic relations. That in turn calls for a balanced approach to the interpretation of the Treaty's substantive provisions for the protection of investments, since an interpretation which exaggerates the protection to be accorded to foreign investments may serve to dissuade host States from admitting foreign investments and so undermine the overall aim of extending and intensifying the parties' mutual economic relations.

301. Seen in this light, the "fair and equitable treatment" standard prescribed in the Treaty should therefore be understood to be treatment which, if not proactively stimulating the inflow of foreign investment capital, does at least not deter foreign capital by providing disincentives to foreign investors. An investor's decision to make an investment is based on an assessment of the state of the law and the totality of the business environment at the time of the investment as well as on the investor's expectation that the conduct of the host State subsequent to the investment will be fair and equitable.

302. The standard of "fair and equitable treatment" is therefore closely tied to the notion of legitimate expectations<sup>34</sup> which is the dominant element of that standard. By virtue of the "fair and equitable treatment" standard included in Article 3.1 the Czech Republic must therefore be regarded as having assumed an obligation to treat foreign investors so as to avoid the frustration of investors' legitimate and reasonable expectations. As the tribunal in *Tecmed* stated, the obligation to provide "fair and equitable treatment" means:

to provide to international investments treatment that does not affect the *basic expectations* that were taken into account by the foreign investor to make the investment.<sup>35</sup>

Also, in *CME*, the tribunal concluded that the Czech authority

breached its obligation of fair and equitable treatment by evisceration of the arrangements in reliance upon which the foreign investor was induced to invest.<sup>36</sup>

The tribunal in *Waste Management* equally stated that:

In applying [the "fair and equitable treatment"] standard it is relevant that the treatment is in breach of representations made by the host State which were reasonably relied on by the claimant.<sup>37</sup>

303. The expectations of foreign investors certainly include the observation by the host State of such well-established fundamental standards as good faith, due process, and non-discrimination.<sup>38</sup> And the tribunal in *OEPC* went even as far as stating that

[t]he *stability* of the legal and business framework is thus an essential element of fair and equitable treatment.<sup>39</sup>

304. This Tribunal would observe, however, that while it subscribes to the general thrust of these and similar statements, it may be that, if their terms were to be taken too literally, they would impose upon host States' obligations which would be inappropriate and unrealistic. Moreover, the scope of the Treaty's protection of foreign investment against unfair and inequitable treatment cannot exclusively be determined by foreign investors' subjective motivations and considerations. Their expectations, in order for them to be protected, must rise to the level of legitimacy and reasonableness *in light of the circumstances*.

305. No investor may reasonably expect that the circumstances prevailing at the time the investment is made remain totally unchanged. In order to determine whether frustration of the foreign investor's expectations was justified and reasonable, the host State's legitimate right subsequently to regulate domestic matters in the public interest must be taken into consideration as well. As the *S.D. Myers* tribunal has stated, the determination of a breach of the obligation of "fair and equitable treatment" by the host State

must be made in the light of the high measure of deference that international law generally extends to the right of domestic authorities to regulate matters within their own borders.<sup>40</sup>

306. The determination of a breach of Article 3.1 by the Czech Republic therefore requires a weighing of the Claimant's legitimate and reasonable expectations on the one hand and the Respondent's legitimate regulatory interests on the other.

307. A foreign investor protected by the Treaty may in any case properly expect that the Czech Republic implements its policies *bona fide* by conduct that is, as far as it affects the investors' investment, reasonably justifiable by public policies and that such conduct does not manifestly violate the requirements of consistency, transparency, even-handedness and non-discrimination. In particular, any differential treatment of a foreign investor must not be based on unreasonable distinctions and demands, and must be justified by showing that it bears a reasonable relationship to rational policies not motivated by a preference for other investments over the foreign-owned investment.

308. Finally, it transpires from arbitral practice that, according to the "fair and equitable treatment" standard, the host State must never disregard the principles of procedural propriety and due process<sup>41</sup> and must grant the investor freedom from coercion or harassment by its own regulatory authorities.

#### iv) Conclusion

309. The "fair and equitable treatment" standard in Article 3.1 of the Treaty is an autonomous Treaty standard and must be interpreted, in light of the object and purpose of the Treaty, so as to avoid conduct of the Czech Republic that clearly provides disincentives to foreign investors. The Czech Republic, without undermining its legitimate right to take measures for the protection of the public interest, has therefore assumed an obligation to treat a foreign investor's investment in a way that does not frustrate the investor's underlying

legitimate and reasonable expectations. A foreign investor whose interests are protected under the Treaty is entitled to expect that the Czech Republic will not act in a way that is manifestly inconsistent, non-transparent, unreasonable (*i.e.* unrelated to some rational policy), or discriminatory (*i.e.* based on unjustifiable distinctions). In applying this standard, the Tribunal will have due regard to all relevant circumstances.

## 2. Application of the Standard

310. In applying Article 3 of the Treaty to the present case, the Claimant contends that the Czech Republic has violated the “fair and equitable treatment” standard in Article 3.1 of the Treaty in a number of ways. The Claimant principally contends that

(a) the Czech Republic gave a discriminatory response to the systemic bad debt problem in the Czech banking sector, especially by providing State financial assistance to the other Big Four banks to the exclusion of IPB, and thereby created an environment impossible for the survival of IPB;

(b) the Czech Republic failed to ensure a predictable and transparent framework for Saluka’s investment;

(c) the Czech Republic’s refusal to negotiate with IPB and its shareholders in good faith prior to the forced administration was unreasonable and discriminatory;

(d) the provision by the Czech Republic of massive financial assistance to IPB’s business, once the beneficiary of such assistance had become CSOB following the forced administration, was unfair and inequitable; and

(e) the Czech Republic’s failure to prevent the unjust enrichment of CSOB at the expense of the IPB shareholders, including Saluka, upon the transfer of IPB’s business to CSOB and the aforementioned State aid following the forced administration was equally unfair and inequitable.

311. The Tribunal will examine each of these claims separately.

### a) The Czech Republic’s Discriminatory Response to the Bad Debt Problem

312. The Claimant contends that, whereas the “systemic” bad debt problem which contributed to the serious difficulties of the Czech banking sector from 1998 to 2000 equally affected the Big Four banks (*i.e.* IPB, KB, CS and CSOB), the Czech Republic, in assisting these banks to overcome the problem, treated IPB differently in an unreasonable way which made it impossible for IPB to survive, especially by excluding IPB from the state assistance that was granted to its competitors, and which resulted in Saluka’s loss of its investment.

313. State conduct is discriminatory, if (i) similar cases are (ii) treated differently (iii) and without reasonable justification.

i) Comparable Position of the Big Four Banks regarding the Bad Debt Problem

314. According to the Claimant, the Big Four banks were in a comparable position in terms of their macroeconomic significance in the transitional period of the Czech Republic and their resulting share of the systemic bad debt problem.

315. By 1998 all of them had large non-performing loan portfolios and they were equally suffering from inadequacies of the legal regime for the enforcement of collateral rights. The impact of these bad debts was felt by all of the Big Four banks, although to different degrees. IPB, KB and CS suffered heavily, and only CSOB was relatively better off.

316. Another factor that the Big Four banks had in common was that they were all equally exposed to the increasingly rigorous banking supervision by the CNB and to the prudential standards that were drastically tightened by the CNB in order to bring them into line with the norms of the European Union. These measures resulted in major increases in loan loss provisions which caused losses that, in the longer term, none of these banks was able to absorb by drawing upon shareholder equity. Beyond a certain point the survival of all the banks was dependent upon some form of assistance from the Czech State.

317. The Claimant has put much emphasis on the “systemic” nature of the bad loan problem that affected the Big Four banks from 1998 to 2000. The Claimant has referred in this context to an International Monetary Fund (“IMF”) Report, defining a problem as “systemic” where the affected banks hold, in the aggregate, at least 20% of the total deposits of the banking system.<sup>42</sup>

318. The Respondent has denied that IPB’s position was comparable with the position of the other three of the Big Four banks. Much emphasis is put by the Respondent on the fact that IPB had already been privatised, whereas the State still held large blocks of shares in KB, CS and CSOB. Furthermore, the financial difficulties with which IPB was faced are said to have been caused by mismanagement and irresponsible lending practices. The Respondent has, *inter alia*, referred to a CNB inspection report of 25 February 2000 which had identified serious deficiencies regarding IPB’s internal organisation and operation.

319. The Tribunal is not convinced that the increasing financial difficulties with which IPB was faced and that finally resulted in its forced administration were predominantly due to bad banking management and organisational deficiencies. Even though the irregularities identified in the CNB inspection report of 25 February 2000 were serious and must have to some extent contributed to IPB’s problems, it can hardly be disputed that the bad debt problem still lay at the heart of IPB’s difficulties. In the autumn of 1999 it became abundantly clear that IPB needed more than a correction of the irregularities identified by the CNB. The CNB itself requested a significant increase in IPB’s equity capital. It is therefore not plausible that, had IPB solved the organisational problems identified by the CNB, it would no longer have suffered from its large non-performing loan portfolio and from the insufficiency of its regulatory capital.

320. The expert witnesses introduced by the Respondent have reported a number of differences between IPB and its competitors as far as liquidity, credit rating and business

strategies are concerned. The expert witnesses introduced by the Claimant have, however, questioned the validity of these findings and have arrived at the opposite conclusions. The Tribunal does not find that the evidence placed before it enables it to conclude that IPB differed sufficiently drastically from the other Big Four banks with regard to the risks involved in its lending policies so as to warrant a finding that the financial problems with which IPB was faced could not be attributed predominantly to the bad debt problem that plagued all the Big Four banks equally.

321. The Respondent also disagrees with the Claimant's characterisation of the bad debt problem as being "systemic". According to the Respondent, a "systemic" crisis is one affecting the entire commercial banking industry. The Claimant had not shown, however, that this had been the case. More than fifty of the other Czech commercial banks holding more than 30% of the country's banking assets had not at all been taken into consideration by the Claimant.

322. The Tribunal finds that, irrespective of whether the bad debt problem with which the Big Four banks were faced from 1998 to 2000 may properly be characterised as "systemic" or not, these banks were in a sufficiently comparable situation: All of them had large non-performing loan portfolios resulting in increased provisions and consequently in insufficient regulatory capital. None of them was able to absorb the losses by calling on shareholder equity. The survival of all of them was sooner or later seriously threatened unless the Czech State was willing to provide financial assistance. On the other hand, due to the macroeconomic significance of the Big Four banks, the Czech State apparently could not afford to let any one of these banks fail. And, as set out below, the Czech State did in fact sooner or later provide such assistance to all of them, including IPB after it had been acquired by CSOB. The Czech Government therefore has implicitly recognised that all the Big Four banks were in a comparable situation.

323. Consequently, as far as the Claimant is concerned, Nomura (and subsequently Saluka) was justified in expecting that the Czech Republic, should it consider and provide financial assistance to the Big Four banks, would do so in an even-handed and consistent manner so as to include rather than exclude IPB.

ii) Differential Treatment of IPB Regarding State Assistance

324. In 1997 and 1998 the Czech Government began to develop a strategy of dealing with the bad debt problem at the enterprise level. According to this strategy, the Government would directly finance the forgiveness of the indebted companies and provide guarantees for new loans (the so-called "Revitalisation Programme"). Consequently, the Government took a negative position towards financial assistance for the banking sector. This approach was clearly stated by the Czech Government at the time IPB was privatised (by way of the sale of the State's 36% shareholding to Nomura on 8 March 1998). The Czech Government was, however, careful not to give Nomura any assurance that this policy would never be changed by future Governments with regard to the privatisation of one or other of IPB's competitors.

325. Since the bad debt problem became worse, however, the Czech Government changed its policy and did in fact take a number of steps to assist the other of the Big Four banks to

overcome the financial difficulties with which they were faced. These measures were also deliberately taken in order to prepare IPB's competitors for privatisation. CSOB was privatised in 1999 (by way of a sale of the State's 65.69% shareholding to KBC of Belgium), CS was privatised in 2000 (by way of a sale of the State's 53.07% shareholding to Erste Bank of Austria), and KB was privatised in 2001 (by way of a sale of the State's 60% shareholding to Société Générale S.A.). All three banks had received considerable financial assistance from the Czech Republic before privatisation took place. Without such assistance, privatisation would clearly not have been possible.

326. IPB had also received some financial assistance before its privatisation. After Nomura had acquired its IPB shareholding, however, IPB was excluded as a beneficiary from the Revitalisation Programme as well as from the Czech Government's strategy to solve the bad debt problem of IPB's competitors by the provision of direct financial assistance to the banks. Only in the course of CSOB's acquisition of IPB's business during IPB's forced administration was considerable financial assistance from the Czech Government forthcoming. It follows that IPB has clearly been treated differently.

iii) Lack of a Reasonable Justification

327. The Respondent has argued that this differential treatment of IPB was justified for a number reasons.

328. Firstly, the Respondent argues that Nomura was not given any assurance that its competitors would be privatised in the same way as IPB, *i.e.* without previous support allowing them to get rid of the problems involved in the non-performing loan portfolios.

329. The Tribunal finds that the Claimant's reasonable expectations to be entitled to protection under the Treaty need not be based on an explicit assurance from the Czech Government. It is sufficient that Nomura (and subsequently Saluka), when making its investment, could reasonably expect that, should serious financial problems arise in the future for all of the Big Four banks equally and in case the Czech Government should consider and provide financial support to overcome these problems, it would do so in a consistent and even-handed way.

330. Secondly, the Respondent argues that Nomura (and subsequently Saluka) had no reason to expect that the Czech Government would be willing to alleviate IPB's future problems by providing State financial assistance, since Nomura, having gone through an extensive due diligence, had been aware of the risks involved in acquiring the shareholding in IPB. Nomura is even said to have known before it made its investment that the Czech Government planned to give aid to the other three of the Big Four banks during their privatisation. Nomura had therefore voluntarily assumed these risks and they were reflected in the share price paid by Nomura. Once these risks had materialised, Nomura (and subsequently Saluka) should not be allowed to ask for assistance.

331. On the basis of the available evidence, the Tribunal finds that the Czech Government changed its policy of non-assistance only after Nomura had acquired the shareholding in IPB on March 8, 1998. The earliest hint of such policy change was contained in a letter from the

head of the NPF, Mr Ceska, to the chairmen of the boards of directors of KB, CS and CSOB dated 21 April 1998 which contained the following statement:

We further confirm that, during the period prior to the full privatisation of the banks as aforesaid, we are ready to take such steps within our authority and power as shareholder of each of the banks [to ensure that the banks] comply with all regulatory requirements applicable to them, including capital adequacy and liquidity.

On 27 May 1998 the Government passed the following resolution:

The Government states that it is aware of its responsibility for the financial stability of the joint stock companies CSOB, KB and CS and that it is ready to secure such financial stability until the completion of the privatisation of those joint-stock companies.<sup>43</sup>

332. Furthermore, whatever the scope of Nomura's due diligence may have been, it could not possibly lead to a reliable forecast as to which policies future governments would adopt should an aggravation of the bad debt problem occur as it did after Nomura had made its investment. Therefore, the Claimant cannot be said to have assumed the risk of being treated differently when the Czech Government in fact decided to step in with financial assistance.

333. Thirdly, the Respondent argues that the Claimant was the dominant shareholder of IPB and should therefore itself have rescued IPB by providing the necessary additional capital. The Czech Republic therefore considers itself justified in expecting that the Claimant would have acted as a responsible strategic investor. Also, by providing the necessary financial support to IPB's competitors, the Czech Republic considers itself to have in fact done no more than act as a responsible shareholder. In doing so, the Czech Republic considers itself to have been justified in limiting its assistance to its own banks.

334. The Tribunal finds that Nomura cannot be said to have entered IPB as a strategic investor. Nomura has made it sufficiently clear from the beginning that it came as a portfolio investor acquiring a considerable block of shares with a view to selling it once IPB had improved and the value of its shares had appreciated. The Claimant as a private investor could not reasonably be expected to provide new capital unless this could be done on commercial terms. In this respect the Claimant was in a position similar to an investor acquiring a shareholding in IPB's still-to-be-privatised competitors: unless the bad debt problem was taken care of by financial assistance from the State, no new (or additional) private investment could reasonably be expected in any of the Big Four banks. The Czech Government implicitly recognised this when it provided considerable support to IPB's business upon the acquisition of IPB's business by CSOB.

335. Furthermore, it is less than plausible that, by granting State aid to one or other of the Big Four banks, the Czech Republic acted exclusively as a shareholder. Even though the Government may have expected to secure a better price for the shares when the other banks were privatised, this would not have been a commercially rational conduct. If that had been the motivation, the Czech Republic could just as well have saved the financial resources used for the provision of State aid and sold the shares at a lower price. Recovering the State aid by selling the shares at a higher price would have merely caused additional transaction costs. Anyway, even when acting in its role as a shareholder of IPB's competitors, the Czech

Republic could not at the same time disregard its role as the regulator of the banking sector who was responsible for somehow resolving the bad debt problem with which all the Big Four banks were faced. Consequently, by insisting on its role as shareholder in the other three banks the Czech Republic cannot reasonably justify the differential treatment of IPB. Also, once IPB's business was acquired by CSOB in the course of IPB's forced administration, the Czech Government abandoned its position and did in fact provide considerable financial assistance for IPB's business.

336. Fourthly, the Respondent argues that the financial assistance granted to IPB's competitors was closely linked to the Czech Government's privatisation strategy. The Czech State still held large blocks of shares in KB, CS and CSOB which could have been privatised either on an "as is" basis or after clearing of the non-performing loan portfolios. It is said to have been in the discretion of the Czech State to make this policy choice.

337. It is clearly not for this Tribunal to second-guess the Czech Government's privatisation policies. It was perfectly legitimate for the Government to sell its stakes in the remaining banks only after they had been relieved from the bad debt problem. This, however, did not at the same time relieve the Czech Government from complying with its obligation of non-discriminatory treatment of IPB. The Czech Republic, once it had decided to bind itself by the Treaty to accord "fair and equitable treatment" to investors of the other Contracting Party, was bound to implement its policies, including its privatisation strategies, in a way that did not lead to unjustified differential treatment unlawful under the Treaty.

338. Fifthly, the Respondent argues that, had IPB also received financial assistance, the benefits from clearing the non-performing loan portfolio would have accrued to IPB's private shareholders, whereas in case of the other three of the Big Four banks the benefits accrued to the Czech State itself which at the time was their dominant shareholder. This position is belied by the fact that at the time the Czech Republic granted financial assistance to CSOB after its acquisition of IPB's business, CSOB had already been privatised (by way of a sale of the State's 65.69% shareholding to KBC of Belgium). The policy on which the Respondent relies was therefore at least not consistently implemented and cannot therefore justify IPB's differential treatment.

339. Sixthly, the Respondent has asserted that IPB did not disclose its desire to receive State financial assistance until April 2000. Consequently, Saluka, and indeed IPB, could not now claim that it has been negatively affected by the Czech Republic's failure to provide such assistance.

340. It is undisputed, however, that at least during the autumn of 1999 it was clear that IPB needed an increase of capital to provide for its bad loans and that the CNB expressly requested a significant increase in IPB's equity capital. Also, in the context of the negotiations that took place during the spring of 2000 in order find a solution for IPB, the Czech Government made it known to Nomura on 14 March 2000 that the provision of State aid to IPB was conditional on Nomura injecting new capital into IPB. Nomura, on the other hand, made it known in the course of these negotiations that it was unwilling to provide such capital unless at the same time the Czech State provided adequate financial assistance to IPB. The parties were, however, unable to bridge this gap in their approaches.



341. The Tribunal therefore finds that the Czech Government was fully aware of IPB's need for State assistance at a time when it was still feasible to prevent IPB from failing.

342. Finally, the Respondent argues that IPB's financial problems that ultimately led to its failure and forced administration were due to IPB's own irresponsible business strategy, especially its lending policy. The Respondent therefore denies that the Claimant could legitimately expect a government bailout.

343. The Claimant denies that IPB differed in any significant way from the other Big Four banks, especially CS and KB: neither in terms of the size and the impact of its non-performing loan portfolio or in terms of its credit rating, nor in terms of its liquidity or in terms of the management of its loan portfolio could IPB be said to have been uniquely bad.

344. The Tribunal finds that the size of the non-performing loan portfolios and their impact on the balance sheet was in fact comparable for all the Big Four banks, with the exception, to some degree, of CSOB. Accordingly, the credit ratings of all these banks were equally downgraded in 1998 and the relative improvement of IPB's competitors in 2000 was due to the State aid they had received in the meantime.

345. As far as the Big Four banks' liquidity position until 1999 is concerned, the parties disagree on the criteria that are relevant for a comparison between IPB and its competitors. In principle, liquidity is defined as the sum of assets that can be easily turned into assets that may be used for the payment of debts in relation to total assets. In order to prove that IPB's liquidity position was worse than its competitors', the Respondent relies on the "liquid asset ratio" and the "cash asset ratio". The Claimant, in order to prove that IPB's liquidity position was even relatively better than its competitors', relies on the "quick asset ratio". The Tribunal finds, however, that "quick assets" are not much different from "liquid assets". Consequently, the parties' diverging calculations are less due to the criteria, but rather to their statistical foundations. Whatever the correct liquidity ratios of the Big Four banks from 1998 to early 2000 may have been, the Tribunal is not convinced that different liquidity ratios warranted different treatment with regard to the provision of State financial assistance in order to overcome the bad debt problem.

346. As far as the Respondent's contention relating to IPB's allegedly flawed business strategy and imprudent loan portfolio management is concerned, the Tribunal notes that IPB's competitors (especially CS and KB) proved not to be able to overcome the bad loan problem without financial assistance from the Czech State, even though they allegedly followed a less flawed business strategy and had a more prudent loan management.

347. The Tribunal therefore finds that the Respondent has not offered a reasonable justification for IPB's differential treatment. Consequently, the Czech Republic is found to have given a discriminatory response to the bad debt problem in the Czech banking sector, especially by providing state financial assistance to three of the Big Four banks to the exclusion of IPB, and thereby created an environment impossible for the survival of IPB.

b) Failure to Ensure a Predictable and Transparent Framework

348. The Czech Republic has failed to ensure a predictable and transparent framework for Saluka's investment, if it has frustrated Saluka's legitimate expectations regarding the treatment of IPB without reasonable justifications.

349. The Claimant argues that the Czech Republic has frustrated Saluka's expectations

(a) by contradictory and misleading declarations about its policy towards the banking sector in crisis and by justifying IPB's exclusion from the State aid granted to save the other banks on the grounds that it had already been fully privatised;

(b) by the unpredictable increase of the provisioning burden for non-performing loans; and

(c) by leaving the banks with no effective mechanisms to enforce loan security.

350. The Tribunal will assess the legitimacy and reasonableness of these expectations and, if they were legitimate and reasonable, whether they have been frustrated by the Czech Republic without reasonable justification.

i) Nomura's Expectation that IPB would not be Treated Differently

351. Firstly, Nomura's expectation that the Government would not address the bad loan problem by support to the banks was initially said to have been based on an express assurance to that effect given by the then Minister of Finance. The Claimant has also argued that this was consistent with the obligations undertaken by the Czech Government in their pre-accession agreement with the European Commission (the Europe Agreement) to adhere to European Union norms on State aid. The Claimant has admitted, however, that whatever assurance the Minister of Finance may have given, he could not bind future Governments. Especially, he could not give any assurance that the privatisation of the other banks would proceed in the same way as the privatisation of IPB, *i.e.* without any State financial assistance. Nomura therefore had no basis for expecting that there would be no future change in the Government's policy towards the banking sector's bad loan problem or in the Government's willingness to adhere during the pre-accession period to the rules on State aid in the Europe Agreement.

352. The Claimant insists, however, that Nomura was justified in expecting that, should the Czech Government change its policy and provide State financial assistance to the banks in order for them to overcome the "systemic" problem of bad loans, that solution would itself be "systemic" and thus non-discriminatory. The Claimant contends that the Czech Government has frustrated this expectation by excluding IPB from the financial assistance provided to IPB's competitors. This discriminatory treatment is said to have been unpredictable.

353. The Tribunal notes that this claim is in substance identical with the Claimant's previous claim according to which the Czech Republic has violated the "fair and equitable

treatment” standard by the discriminatory response of the Czech Republic to the bad debt problem in the Czech banking sector. It has therefore already been dealt with in the context of the Claimant’s first claim.

ii) The Unpredictable Increase of the Provisioning Burden for Non-Performing Loans

354. Secondly, the Claimant argues that Nomura’s legitimate expectations have been frustrated by the CNB’s introduction of more stringent prudential rules for the banks. The CNB should rather have taken a “gradualist” approach so that the banks had time to adjust.

355. The Respondent argues that Nomura was aware of some of the CNB’s regulatory amendments at the time the shareholding in IPB was acquired, and others were clearly foreseeable.

356. The Tribunal notes that the increased stringency of the CNB’s prudential rules contributed to the distress suffered by the Czech banking system by forcing the banks to increase provisioning. Consequently, it became even more difficult for the banks to meet the regulatory capital requirements than it had been before due to the bad loan problem.

357. However, the CNB’s policy of tightening the regulatory regime must be seen in the context of the Czech Republic’s preparation for accession to the European Union. It was the CNB’s declared intention to bring its regulatory regime into line with the norms in the European Union. In 1999 a “Twinning Programme” for banking supervision had been launched which was deliberately designed to adjust the Czech regulatory methodology and the practical implementation of banking supervision to European Union standards.<sup>44</sup>

358. It can hardly be disputed that these developments could have been anticipated in 1998. Nomura was, therefore, not justified to expect that the CNB would not introduce a more rigid system of prudential regulation and thereby change the framework for Nomura’s investment in IPB shares. However, Nomura was unable to anticipate the discriminatory way in which the Czech Government responded to the distress suffered by the Czech banking sector, *i.e.* the exclusion of IPB from any State assistance that was granted to the other three of the Big Four banks in order for them to overcome their inability to meet the regulatory capital requirements. This aspect of the Czech Government’s attitude towards the banking sector has, however, already been dealt with in the context of the Claimant’s first claim.

iii) Nomura’s Expectation regarding the Legal Framework for the Enforcement of Loan Security

359. It is undisputed between the parties that Czech Law failed to provide effective mechanisms to enforce loan security. The CNB expressly acknowledged that its tightening of the prudential regulations and the increase of the provisioning requirements were in fact a response to the shortcomings in the legislation to protect creditors in recovering receivables and exercising liens as well as to other institutional shortcomings that were preventing banks in practice from realising real estate pledged as collateral.

360. The Tribunal finds that the aforementioned legal shortcomings must have been known to Nomura when it made its investment. An expectation that such shortcomings would quickly be fixed by the Czech legislature would have been unfounded. Consequently, even though the lack of adequate protection of creditors' rights will most certainly have contributed to the aggravation of the bad debt problem, the Tribunal is unable to find that the Czech Republic has frustrated Nomura's legitimate and reasonable expectations and violated the "fair and equitable treatment" standard by its failure to improve the legal framework within a timescale of help to Nomura.

c) Refusal to Negotiate in Good Faith

361. The Claimant contends that, whereas Saluka and Nomura as well as IPB were actively engaged in seeking a solution to IPB's financial problems, the Czech Government refused to negotiate in good faith on the proposals made by IPB and its shareholders. The Czech Ministry of Finance and the CNB are said to have instead conspired and taken sides with CSOB, which was interested in acquiring IPB's business. While purporting to negotiate with IPB and its shareholders, the Czech Government is said to have acted as an accessory to CSOB's plan to take over IPB's business. According to this plan (the Paris Plan), IPB's business would be transferred to CSOB upon the pretence of forced administration. The Claimant argues that this conduct of the Czech Government was unreasonable and discriminatory.

362. The Respondent argues that the Claimant's proposition is unfounded. The Czech Government had neither engaged in a conspiracy nor taken sides with CSOB to the detriment of IPB and its shareholders. The Respondent denies that there was a premeditated plan (the Paris Plan) to oust IPB from control over its enterprise by transferring it to CSOB by way of IPB's forced administration. The CNB is rather said to have been compelled to impose forced administration because IPB was no longer meeting the regulatory requirements for its banking business. Also, IPB's banking business had to be transferred to CSOB since there was no other strategic investor capable of saving IPB's business and prepared to step in immediately. The Respondent therefore argues that the Czech Government's conduct was reasonable under the circumstances and that it did not in any way imply an unjustifiable discrimination against IPB and its shareholders.

363. The Tribunal's assessment starts from the proposition that the Czech Republic's conduct was unfair and inequitable if it unreasonably frustrated IPB's and its shareholders' good faith efforts to resolve the bank's crisis. A host State's government is not under an obligation to accept whatever proposal an investor makes in order to overcome a critical financial situation like that faced by IPB. Neither is a host State under an obligation to give preference to an investor's proposal over similar proposals from other parties. An investor is, however, entitled to expect that the host State takes seriously a proposal that has sufficient potential to solve the problem and deal with it in an objective, transparent, unbiased and even-handed way.

364. The Claimant has identified a number of elements of the factual record which are said to support the Claimant's proposition that the Czech Government used its power to unilaterally support CSOB in implementing its strategy to acquire the business of IPB to the detriment of IPB and Saluka. The factual details and especially the inferences and conclusions that may be derived therefrom are, however, highly disputed between the parties.

365. In light of the evidence before it, the Tribunal considers it helpful to contrast two intertwined but distinguishable developments during the first half of 2000: the unfolding of CSOB's acquisition of IPB, on the one hand, and the unfolding of the negotiations between IPB and Saluka/Nomura and the Czech Government, on the other.

i) The Developments during the First Half of 2000

(a) The Government's Role in CSOB's Acquisition of IPB

366. By January 2000 it became clear to CSOB that it could implement its strategic objective of expanding into the retail banking sector only by acquiring IPB. CSOB's interest in this acquisition was, if not "discussed" as the Claimant contends, then at least expressed at a meeting of the CEO and Chairman of the Board of CSOB, Mr Kavánek, with the Minister of Finance, Mr Mertlík, as early as 10 January 2000. It is not clear whether further meetings took place in January and February 2000.

367. In March 2000 CSOB retained Consilium Rothchilds and Boston Consulting Group to start preparing a deal structure for acquiring IPB.

368. On 26 April 2000 CSOB prepared a presentation to the Czech Government about its acquisition plans for IPB. This presentation entitled "Discussion Materials" provided an analysis of IPB's situation, CNB's objectives and the "main options" available to the Czech Government, including "do nothing", "self-help" of IPB, "broker a deal with a third party" and "full intervention". The two last options clearly referred to the entry of a strategic partner into IPB, on the one hand, and to forced administration (which was, however, characterised as being generally seen as the last resort) on the other. Since "self-help" was no longer considered a viable option in IPB's circumstances, "broker a deal" was seen as the next best option in persuading the CNB, whereas "full intervention" should remain a "credible potential stick" for IPB/Nomura to facilitate the process.

369. On 30 May 2000 the CEO and Chairman of the Board of CSOB, Mr Kavánek, presented several documents at a meeting held in Paris by the Czech Minister of Finance, Mr Mertlík, the Governor of the CNB, Mr Tošovský, and the President of CSOB's parent company KBC, Mr Remi Vermeiren, who on that day were attending a banking conference. The documents presented by Mr Kavánek, together referred to by the Claimant as "the Paris Plan", set out a "Preliminary approach to the Carthago-India business case"<sup>45</sup> (in which CSOB explained the potential synergies to be expected from a combination of CSOB and IPB), CSOB's "Readiness to act" (in terms of CSOB's readiness and capability to manage the integration of IPB into CSOB) and a "Summary Transaction Structure" (explaining the procedural steps to be taken for the integration of IPB into CSOB).

370. In the two appendices to the latter document, CSOB explained in more detail two alternative strategies for a takeover of IPB: firstly, the "transaction structure to be used in negotiated transaction with India"; secondly, the "transaction structure to be used in forced administration of India". The first "transaction structure" was characterised as not being without legal, political and implementation risk; but it was emphasised that it would "present a potential (and perhaps only [*sic*]) structure which, in light of the options available under

current Czech law, addresses the goal of a rapid transfer of the India business to Carthago”. The second “transaction structure” was characterised as being novel and as not being without legal, political and implementation risk either; it was also emphasised, however, that it would “present a potential (and perhaps only [*sic*]) structure which, in light of the options available under current Czech law, addresses the goals of minimal involvement of the Forced Administrator and of a rapid transfer of the India business to Carthago”.

371. In anticipation of the Paris meeting, the Chairman of the Board of CSOB, Mr Kavánek, had written a letter dated 26 May 2000 to the Minister of Finance expressing his expectation that the Paris meeting would “contribute to additional positive progress in the subject matter”. Nevertheless, the precise nature and content of the talks at the Paris meeting are a matter of dispute between the parties and remain unclear.

372. On 13 June 2000, after the second run on IPB had already set in, the Vicegovernor of the CNB, Mr Niedermayer, acting on behalf of an *ad hoc* working group whose mission was to determine a solution for IPB including a transfer of IPB’s business to a strategic investor, requested CSOB to submit by 9:00 a.m. the next day a “co-operative” proposal for a takeover of IPB.

373. On 14 June 2000 the CEO and Chairman of the Board of CSOB, Mr Kavánek, wrote a letter to the Vicegovernor of the CNB, Mr Niedermayer, setting out a detailed proposal for a takeover of IPB to be negotiated with Nomura. It was clearly stated that State participation in the risks and losses linked with the operation had to be anticipated. The letter stated at the same time, however, that Nomura had declared its lack of interest in the proposal. The Claimant has denied that Nomura had in fact been contacted to discuss the proposal.

374. Also on 14 June 2000 the Director of the State Aid Department of the OPC, Mr Rudolecký, was informed by his superior, Dr Buchta, of the State aid envisaged for IPB/CSOB in case of CSOB’s takeover of IPB’s business. It was anticipated that an exemption from the prohibition of State aid would be necessary.

375. On 15 June 2000 the Czech Government met to assess the situation of IPB. The Cabinet’s deliberations were based on “Materials for the Talks of the Czech Republic’s Government” prepared and submitted by the Minister of Finance, Mr Mertlík, and the Governor of the CNB, Mr Tošovský. The “Materials” took two alternative solutions into consideration: a cooperative solution involving IPB’s shareholders and a non-cooperative solution involving forced administration coupled with a quick sale to a strategic investor. In Appendix No. 3 to the “Materials” the strategic investor was clearly identified as being CSOB. Also, the “Materials” expressly stated that any solution “necessitates a support on the side of the state”.

376. The Claimant contends that only the non-cooperative solution was seriously presented to the Cabinet with CSOB being the only candidate taken into consideration as a strategic investor of IPB. The Respondent insists that the Cabinet was fully briefed on both alternative solutions, including the cooperative solution. In any event the Government, by Resolution No. 622 of 15 June 2000, consented to and recommended the imposition of forced administration upon IPB with the objective of a subsequent sale to CSOB as the strategic investor, the provision of a government guarantee for the assets of IPB in favour of CSOB

and the issuing of government guarantees in favour of the CNB in order to cover the losses resulting from the indemnity to be issued by the CNB in favour of CSOB for the debts assumed from IPB and the losses suffered from the takeover of IPB's business.

377. On 16 June 2000 the CNB decided to introduce forced administration of IPB and appointed Mr Staněk as administrator (*i.e.* a sort of trustee in bankruptcy). Mr Staněk was expressly instructed to “perform all required steps that would result in accelerated sale of the company to [CSOB], being its strategic partner”. He was also promised a “special bonus” for the implementation of this instruction.

378. On 19 June 2000 IPB's business was transferred to CSOB. The Ministry of Finance granted the guarantee envisaged in such Resolution No. 622 of the Government and the CNB signed its promise of compensation for any risk and loss that CSOB had requested. Also, on the same day, the OPC (to which the Government's guarantee and indemnity in favour of IPB/CSOB had been formally notified the day before) issued a decision exempting the State's financial assistance from the legal prohibition of State aid provided by the Public Assistance Act.

(b) The Government's Role in IPB's and Saluka's/Nomura's Attempts to Negotiate a Cooperative Solution

379. Nomura began searching for a strategic partner for IPB in October 1999. It was clear from the beginning that the involvement of the Czech Government would be needed, not only in terms of the various approvals required from the Czech regulatory authorities, but especially in terms of State financial assistance without which private investors would find an investment in IPB unattractive given the finding of the CNB that IPB was massively under-provisioned and had insufficient regulatory capital.

380. Discussions began between representatives of the CNB and the Ministry of Finance, on the one hand, and representatives of IPB and Saluka/Nomura on the other.

381. It appears that the CNB and the Ministry of Finance initially expected a Nomura-led solution, because they assumed that Nomura as IPB's largest shareholder (through Saluka) would try to preserve its investment in IPB and lead the effort to solve IPB's problems either by injecting additional capital into IPB or by identifying a strategic investor for IPB. It transpires from the evidence before the Tribunal that some representatives of the Government and the CNB regarded Saluka/Nomura itself as a *de facto* strategic investor whose responsibility it was to assist IPB in overcoming its difficulties.<sup>46</sup> Nomura has, however, always insisted on its role as a portfolio investor and has made its willingness to rescue IPB dependent upon State financial assistance which the Czech Republic was unwilling to provide in the circumstances.

382. It soon turned out that some foreign financial institutions began to show an interest in becoming a strategic partner of IPB, especially a consortium formed by Allianz and Hypo-Vereinsbank which was later replaced by the UniCredito.

383. In December 1999 Nomura proposed a merger of IPB and CS, since Allianz considered an offer for both IPB and CS. This proposal was rejected by the State, because a public tender for the State's shareholding in CS was already underway and negotiations with Erste Bank of Austria (to which CS was eventually sold) were in their final stages.

384. In February and March 2000 IPB and Nomura developed a proposal for a merger of IPB and KB. This proposal was also rejected by the Government, because it would have led to a combination of two banks both of which required consolidation and substantial assistance.

385. Also in February and March 2000 the Deputy Managing Director of Nomura, Mr Jackson, entered into negotiations with the Vicegovernor of the CNB, Mr Niedermayer, on the draft of a "Memorandum of Understanding on the restructuring of IPB by Nomura in cooperation with shareholders of IPB and with the Czech Republic" ("MOU"). The purpose of the cooperation was said "to combine private sector and public sector resources". Nomura expressly declared its willingness to invest in IPB "on commercial terms applicable to comparable investments by private sector investors", including Nomura's participation in an increase of IPB's capital. It was made equally clear, however, that the CNB and the Ministry of Finance were required to assure State measures of support for IPB, including the purchase of subordinated debt and potentially participating in the capital increase. The Memorandum was finally rejected by the Czech side on the ground that it did not specify any concrete steps that Nomura would take to address IPB's problem and that there was no assurance for the State that its financial input would be spent effectively or would not wind up in the hands of IPB's shareholders or management.

386. On 14 March the Prime Minister of the Czech Republic expressed the view that the provision of State aid to IPB was conditional on Nomura injecting new capital into IPB. Nomura for its part reiterated on 3 April 2000 its unwillingness to address IPB's capital adequacy problems without State support.

387. Sometime in mid-March 2000 the Minister of Finance and the CNB are said to have lost trust in Nomura, *i.e.* confidence that Nomura would be able to come up with a viable solution for IPB. The Minister of Finance refused to meet personally with representatives of Nomura any longer. Instead, he and the Governor of the CNB appointed deputies (Deputy Finance Minister, Mr Mládek, and Vicegovernor of the CNB, Mr Niedermayer) to deal with Saluka/IPB. They were merely provided with a "soft mandate" and could only have unofficial meetings off Ministry premises.

388. On 14 April 2000 IPB submitted to the CNB a draft proposal of "Measures for the Stabilisation of IPB". A revised draft of this proposal was submitted to the CNB in May 2000. It explored various possibilities of rescuing IPB from its untenable situation by "bridging measures" as well as by "stabilisation measures" which included again the idea of merging IPB and KB as well as the search for a strategic partner. In any case, all the solutions explored in the proposal required the State's financial assistance. The proposal envisaged, however, that "as for the principal solution related to the entry of a strategic partner, the requested government assistance should focus on that part of [the] loan and asset portfolio which was created before the IPB privatisation and is comparable with portfolios of KB and CS where the government assistance is being provided". The proposal was rejected as



unacceptable, because it did not give the State sufficient control over the restructuring process.

389. In April and May 2000 Nomura's attempt to find a strategic partner for IPB made some progress. The Allianz/UniCredito consortium's interest became more and more concrete. Finance Minister Mertlík met with representatives of the Allianz/UniCredito consortium who made proposals similar to those made by CSOB, *i.e.* they wished to purchase IPB's assets. On 22 May 2000 UniCredito began due diligence enquiries on IPB and on 26 May 2000 UniCredito in fact proposed to purchase IPB's assets at an opening bid for IPB of CZK 25-30 billion (twice its book value, subject to agreement on the book value) with a possibility of paying more. Allianz/UniCredito made it clear, however, that their willingness to acquire IPB's assets was dependent upon a guarantee and promise of indemnity from the Czech State. Also, Allianz/UniCredito wanted several months to conduct due diligence.

390. At the same time representatives of CSOB also had meetings with Nomura's representatives to discuss CSOB's potential entry into IPB as a strategic partner. CSOB made it clear to Nomura that if IPB wanted Government support, it needed CSOB. However, these discussions led nowhere, because CSOB wanted to take over IPB first and negotiate the terms of the acquisition later. This was (perhaps not surprisingly) unacceptable to Nomura.

391. On 2 May 2000 the Governor of the CNB, Mr Tošovský, expressed in a letter to the Minister of Finance, Mr Mertlík, some dissatisfaction with the negotiations between the Czech Government and Saluka/Nomura. He wrote:

As is well-known to you from a number of working meetings, the CNB, apart from the performance of its legal obligation of banking supervision, has also acted on the grounds of care in regard of the stability of the financial system and together with representatives of the Ministry of Finance and the National Property Fund it entered the talks with the main shareholder of the bank [*i.e.* Saluka/Nomura] and is contributing to the work of a working group whose establishment it initiated some time ago.

The aforesaid work brought about a widening of the awareness of the situation, clarified some opinions and priorities, but has not led as yet to a sufficiently expedite and clear course of action. The problem is not only the slow communication with the main shareholder [*i.e.* Saluka/Nomura], his unclear position at the bank and a certain unwillingness to discuss a specific course of action, but also certain "half-officiality" of communication between the state, the shareholder and the bank at a level other than supervisory.

However, Governor Tošovský also stated in the following terms the basic conditions for a satisfactory solution:

I believe the most necessary is to expedite and refine the works and prevent thereby the creation of still greater costs. For this reason allow me to acquaint you with the foundation and conclusions which I made together with my colleagues in regard to the situation:

- a) regardless of the specific results of the audit or supervision of the CNB at IPB it is possible to believe that without the substantial strengthening of the capital of the bank or a clean-up of assets, the bank will not be able to further exist,
- b) from this point of view it appears to be unlikely that the planned sale of the bank to a new strategic investor is realizable as a commercial transaction without the support of the state.

The letter concluded by setting out three options for action: the stabilisation of IPB by a private entity with the support of the State (the option favoured by the Governor, provided the State would retain a certain control over the whole process), the nationalisation of the bank (an option that was said to involve considerable risk), liquidation or bankruptcy (an option that was characterised as totally undesirable).

392. Shortly thereafter the CNB requested Nomura to approach the Minister of Finance and engage in formal dialogue about the future of IPB. However, letters addressed by Nomura to the Minister of Finance on 5, 8 and 9 May 2000, setting out its willingness to meet the CNB's request for an injection of fresh capital in IPB and to arrange for up to CZK 13.2 billion of new capital for a capital increase, remained without any response from the Minister.

393. Nomura continued its efforts to meet government officials in order to find a solution for IPB. Further letters dated 9, 18 and 24 May 2000 were sent to representatives of the Ministry of Finance and the CNB.

394. On 18 May 2000 Nomura was informed by the Deputy Finance Minister, Mr Mládek, that the Ministry of Finance intended to nationalise IPB and proposed that Nomura should sell Saluka's IPB shares at a symbolic price of 1 euro. Moreover, Mr Racoča for the CNB explained that, if neither IPB nor its shareholders resolved IPB's problems, the CNB would impose forced administration on IPB. Both propositions were not the ones that had been favoured by Governor Tošovský in his aforementioned letter of 2 May 2000 to the Minister of Finance.

395. On 24 May 2000 Nomura submitted to the Prime Minister a further proposal ("Securing future for IPB"). It involved a capital injection by Nomura of CZK 20 billion for a capital increase, a sale of 51% of IPB shares to the Allianz/UniCredito consortium and to CSOB/KBC, and a KoB guarantee of IPB's balance sheet. The same presentation was given to the Deputy Finance Minister, Mr Mládek, on 25 May 2000. On 29 May 2000 Mr Mládek rejected the proposal, the major concern being again that it involved direct aid to IPB without the State having any control over the use of the funds. More precisely, Mr Mládek declared the proposal regarding the guarantee of IPB's balance sheet by KoB to a new commercial bank unacceptable. Instead, Mr Mládek reiterated his proposal that Nomura should sell Saluka's IPB shares at a symbolic price of 1 euro.

396. Nomura subsequently wrote to Mr Mládek suggesting that the Ministry of Finance propose an amendment to Nomura's proposal that would make it acceptable to the Ministry. However, by 31 May 2000, the Ministry had refused to communicate officially with Nomura in order to consider any solution relating to IPB.

397. On 1 June 2000 the Government informed Nomura that State assistance would only be forthcoming if Nomura acquired a 51% stake in IPB (*i.e.* an additional 5%, since Saluka already held 46%).

398. On 2 June 2000 the Government repeated its 1 euro proposal. On 4 and 5 June, Nomura attempted to accommodate that proposal by presenting to the Deputy Finance Minister, Mr Mládek, and the Vicegovernor of the CNB, Mr Niedermayer, three alternative solutions to enable the entry of a strategic investor:

(1) Nomura would procure the transfer of 51% of the shares of IPB to the Government in return for acceptable financial assistance. The purchasing price should be 1 euro for 46.16% (*i.e.* the stake that Saluka already held in IPB) and market price for the remaining shares (which Saluka would have to acquire first). The IPB shares would then be sold for their purchase price to a commercial banking investor that was agreed in advance among the Government, CNB and Nomura. The commercial banking shareholder would recapitalise IPB and take management control on terms agreed in advance.

(2) Nomura would procure the recapitalisation of IPB with CZK 20 billion of new capital in return for acceptable financial assistance. The current and new shares of IPB would then be sold to a commercial banking shareholder who would become a controlling shareholder in IPB. The commercial shareholder would then recapitalise IPB and take management control.

(3) Nomura would procure the sale of 51% shareholder ownership of IPB to the CNB or the Government at fair market value defined as CZK 116 per share, representing the average purchase price of the seller.

None of these proposals was considered acceptable to the Government, mainly because they were seen to involve direct financial assistance by the State in favour of Nomura, or the State's assumption of all of IPB's losses and of the costs of IPB's restructuring.

399. Subsequently, by about 6 June 2000, Nomura was focussing on an asset sale as a solution.

400. On 7 June 2000 the Deputy Finance Minister, Mr Mládek, urged Nomura again to accept the 1 euro proposal, otherwise IPB would be "toast".

401. On Friday, 9 June 2000, the Czech news agency CTK reported the Deputy Finance Minister, Mr Zelinka, to have said that

[c]ompulsory administration makes sense, because talks with a potential investor are at an advanced stage and there is a danger that the bank will go bankrupt in the meantime.

Even though by law compulsory administration does not mean freezing the deposits, Zelinka does not see any other way of protecting the bank from being invaded by its customers.

402. During the run on IPB, which started the following Monday, 12 June 2000, Nomura, on behalf of Saluka, continued to search for a solution. On 14 June 2000 Nomura submitted a new proposal to the Ministry of Finance, the CNB and the Prime Minister (the “IPB Proposal”) that also received the approval of IPB’s Board of Directors and of IPB’s Supervisory Board. According to this proposal, IPB would transfer its banking business to KoB for CZK 1 for on-sale to a long-term commercial banking partner acceptable to the Government (*i.e.* Allianz/UniCredito or CSOB/KBC). The proposal also stated IPB’s readiness to execute the transaction before 16 June 2000.

403. Under this proposal KoB would have provided limited State assistance to accomplish the sale to a strategic partner. The sale proceeds would have been distributed to the Government as reimbursement for the costs of any financial assistance, and any excess would have been shared by IPB and the Government.

404. On 15 June 2000 Nomura’s representatives met with representatives of the CNB and of the Ministry of Finance, including the Deputy Finance Minister, Mr Mládek, to discuss the IPB Proposal. From the Czech side the IPB Proposal was seen to involve serious economic, legal and organisational risks. The Czech Republic’s main concern was the uncertain scope of the IPB assets that would not be covered by the proposed transfer to KoB but rather retained by IPB, especially the assets belonging to IPB’s Tritton Fund. Negotiations continued into the evening and, after their closure, continued by e-mail. The final e-mail concluded by saying that the Ministry of Finance team was “now leaving for home and will continue tomorrow morning”. This left Nomura’s representatives with the impression that the IPB Proposal had been substantially agreed and that the negotiations would continue the next day. That impression proved to be mistaken.

405. On the evening of 15 June 2000 the Government (*i.e.* the Cabinet Presidium) convened and considered IPB’s situation. The materials on which the Cabinet Presidium based its deliberations referred to both cooperative solutions and forced administration. However, the two cooperative solutions (the one relating to Saluka’s sale of its shareholding in IPB to the State and the other relating to IPB’s partial sale of its assets to KoB) were only briefly mentioned. The focus was on the CSOB proposal for forced administration followed by a quick sale to itself as a strategic investor. The Government preferred anyway the imposition of forced administration upon IPB with the objective of a subsequent sale of IPB’s business to CSOB on the terms mentioned before.

406. The Claimant argues that the IPB proposal would have been by far the better deal and the Government has therefore failed to choose the solution with the least cost for the State’s budget. The Respondent insists that after the run on IPB had started and IPB’s liquidity had deteriorated dramatically, forced administration was unavoidable and CSOB was the only bank that was prepared and able in terms of management capacity to step in immediately to rescue IPB’s banking business.

ii) The Tribunal’s Finding

407. In light of all the factual elements relating to the Czech Government’s role in CSOB’s successful acquisition of IPB’s business, and IPB’s as well as Saluka’s/Nomura’s unsuccessful attempts to find a cooperative solution, the Tribunal finds, for the reasons set

out below, that the Czech Republic's conduct towards IPB and Saluka/Nomura in respect of Saluka's investment in IPB shares was unfair and inequitable. In particular, the Ministry of Finance and the CNB unreasonably frustrated IPB's and its shareholders' good faith efforts to resolve the bank's crisis. The Czech Government failed to deal with IPB's as well as Saluka's/Nomura's proposals in an unbiased, even-handed, transparent and consistent way and it unreasonably refused to communicate with IPB and Saluka/Nomura in an adequate manner.

(a) The Lack of Even-Handedness

408. The Czech Government failed to deal with IPB and its shareholder Saluka/Nomura, on the one hand, and CSOB, on the other hand, in an unbiased and even-handed way.

409. It transpires from the evidence before the Tribunal that both CSOB as well as IPB and its shareholder Saluka/Nomura clearly needed the cooperation of the Czech Government in order to implement their plans to acquire IPB's business or find a strategic investor for IPB. The involvement of the Czech Government was indispensable in terms of the various approvals needed from the Czech regulatory authorities as well as in terms of State financial assistance without which neither CSOB nor any other private investor, including Saluka/Nomura, would find an injection of new capital, a strategic investment or a takeover of IPB's business attractive given IPB's financial distress. Moreover, the Allianz/UniCredito consortium had made this point sufficiently clear.

410. It is, however, equally clear that only CSOB met with the degree of responsiveness on the part of the Czech Government which was a prerequisite for a successful search for a strategic investment or a takeover of IPB's business. In particular, the Ministry of Finance and the CNB were always open to receive information about CSOB's plan to acquire IPB, to discuss CSOB's strategy and finally to contribute to its implementation both in terms of granting the necessary regulatory approvals and in terms of massive State financial assistance.

411. In principle, there is nothing wrong with a Government deciding in favour of an investor which is determined, ready and capable of maintaining the business of an important bank suffering serious financial problems such as IPB. It is also very doubtful whether a Government can be said to be under an international legal obligation always to choose the least cost alternative and not to waste taxpayers' money. A Government that is bound by the standard of fair and equitable treatment of foreign investors, however, cannot avoid paying due regard to the good faith efforts of a foreign investor holding a considerable block of shares in the bank to solve the bank's problems.

412. In the case before the Tribunal, the Czech Government was determined at a rather early stage to give preference to CSOB. Since mid-March 2000 – three months before IPB had to be put into forced administration – the Minister of Finance refused further meetings with representatives of Saluka/Nomura thereby indicating that he no longer considered proposals from Saluka/Nomura helpful in solving IPB's problems. The seriousness of any negotiations with IPB or Saluka/Nomura on alternative solutions was thereby undermined relatively early on when there was still time for alternative cooperative solutions. The failure to develop a workable cooperative solution in good time led to a situation where the forced

administration of IPB could be regarded as unavoidable and CSOB could appear as the only choice available for an immediate rescue of IPB's banking business whose failure was imminent.

413. An even-handed dealing with the situation would have required that the Government (*i.e.* the Cabinet Presidium) in its meeting on the evening of 15 June 2000 had paid the same attention to the two cooperative solutions proposed by Nomura (the one relating to Saluka's sale of its shareholding in IPB to the State and the other relating to IPB's partial sale of its assets to KoB) as was paid to the non-cooperative solution favoured in the meantime by CSOB. The Tribunal is sufficiently satisfied that in fact the contrary had happened: the cooperative solutions involving Nomura and IPB were not seriously considered because at this point they appeared to the Cabinet Presidium not satisfactory for whatever reasons, whereas it had already been decided that the forced administration and the subsequent transfer of IPB's business to CSOB was the Government's first choice. The Tribunal notes that, the day before the Cabinet meeting (*i.e.* on 14 June 2000), the Director of the State Aid Department of the OPC, Mr Rudolecký, had already been informed by his superior, Dr Buchta, of the financial assistance envisaged for IPB/CSOB in the event of CSOB's takeover of IPB's business, because the Government anticipated that an exemption from the prohibition of State aid would be necessary.

414. Furthermore, the Forced Administrator was not left with his usual discretion to find the most appropriate solution for IPB's future based on an objective and unbiased assessment of all relevant factors. Instead he was instructed by the Government to implement immediately the transfer of IPB's business to CSOB and he was even provided a financial incentive to follow exclusively the Government's instruction.

415. A crucial element in the Czech Republic's preferential treatment of CSOB was once again the Government's willingness to support CSOB's acquisition of IPB's business by granting massive State aid while at the same time refusing to provide similar support for the implementation of the proposals originating from IPB or its shareholder Saluka/Nomura.

416. The justifications offered by the Government for its uneven treatment of IPB and Saluka/Nomura, on the one hand, and CSOB, on the other hand, are unconvincing. The Government's position was largely based on the misconception that Saluka/Nomura was a *de facto* strategic investor in IPB and was therefore itself responsible for solving IPB's problem by injecting new capital. Nomura, however, had always made it clear that this was not so, that Nomura had entered IPB rather as a portfolio investor and that the Government was not justified in imposing upon Nomura a shareholder's responsibility that was unfounded. Furthermore, when CSOB planned its takeover of IPB's business, it did not consider entering IPB as a strategic investor either, but nevertheless successfully relied on the Government's willingness to provide financial assistance to overcome IPB's financial problem.

(b) The Lack of Consistency

417. The Czech Government's conduct was also characterised by inconsistencies which made it difficult or even impossible for IPB and Saluka/Nomura to accommodate their proposals to the Government's position.

418. IPB's and Saluka's/Nomura's requests for State assistance were always part of their various proposals. Yet, the Czech Government took varying, sometimes even contradictory positions. Basically, the Government's position was that it was Saluka's/Nomura's own responsibility to rescue IPB without any State aid. The MOU on which Nomura had negotiated with the Vicegovernor of the CNB, Mr Niedermayer, in February and March 2000 was, however, aborted on the grounds that there was no assurance for the State that its financial input would be spent effectively or would not wind up in the hands of IPB's shareholders or management. This reasoning implicitly acknowledged at least in principle that State aid was needed for the rescue of IPB, an acknowledgement that was later even expressly stated in the letter from the Governor of the CNB, Mr Tošovský, addressed to the Minister of Finance, Mr Mertlík, on 2 May 2000. On 14 March 2000 the Prime Minister expressed the view that the provision of State aid to IPB was conditional on Nomura injecting new capital: not only was this a suggestion that had in principle always been part of Saluka's/Nomura's own proposals, but it demonstrated that the provision of State aid for IPB was by no means excluded in principle. IPB's draft proposal of "Measures for the Stabilisation of IPB" submitted to the CNB on 14 April 2000 made an attempt to accommodate the request for State financial assistance to the Government's concern that the State would bail out IPB for losses caused after its privatisation by its own imprudent loan policy: the proposal limited the request for State aid to that part of the bad loan portfolio which was created before the privatisation. The proposal was nevertheless rejected. On 1 June 2000 the Government took another turn and informed Nomura that State assistance would be forthcoming, if Nomura acquired a 51% stake in IPB (*i.e.* an additional 5%, since Saluka already held 46%).

419. Moreover, the Czech Republic acted rather inconsistently in its overall communications with IPB and Saluka/Nomura. The MOU on which Nomura had negotiated with the Vicegovernor of the CNB in February and March 2000 was designed to lead to a mutually satisfactory solution still to be determined in detail. Before that could be achieved, however, the "Memorandum" was already aborted on the grounds that it did not specify any concrete steps that Nomura would take to address IPB's problem. Furthermore, since mid-March 2000, the Minister of Finance had refused to meet Saluka's/Nomura's representatives because he had lost confidence in Nomura's ability to develop a solution for IPB, but at the same time he kept the channel for communication formally open by appointing deputies to deal with Saluka/Nomura and IPB on the basis of a "soft mandate" off the Ministry's premises.

(c) The Lack of Transparency

420. The Czech Government's exchange of views with Saluka/Nomura and IPB on possible solutions for IPB also lacked sufficient transparency to allow Saluka/Nomura and IPB to understand exactly what the Government's preconditions for an acceptable solution were.

421. Saluka/Nomura and/or IPB made various proposals all of which the Czech Government simply rejected with varying reasons.

422. Some of the reasons, however, were not totally unfounded. Thus, Nomura's December 1999 proposal of a merger of IPB and CS as well as IPB's and Nomura's proposal for a merger of IPB and KB were rejected on acceptable grounds.

423. The MOU, however, which Nomura had negotiated with the Vicegovernor of the CNB in February and March 2000, was said to lack specific steps that Nomura would take to address IPB's problem, even though the specification of such steps was the very objective of the ongoing negotiations. The Government failed to respond in any constructive way. IPB's proposal of 14 April 2000 submitted to the CNB was refused because it allegedly did not give the State sufficient control over the restructuring process. The proposal submitted on 24 May 2000 to the Prime Minister was rejected on the grounds that it involved direct aid to IPB without the State having any control over the use of the funds.

424. Nomura's proposals of 4 and 5 June 2000, which were designed to lead to the entry of a strategic investor, attempted to accommodate the Government's proposal of 1 June 2000 as well as its 1 euro proposal. They were nevertheless rejected on the grounds that they involved direct financial assistance from the State in favour of Nomura or the State's assumption of all of IPB's losses and of the costs of IPB's restructuring, even though the Governor of the CNB, Mr Tošovský, had already stated in his letter of 2 June 2000 to the Minister of Finance, Mr Mertlík, that a sale of IPB to a new strategic investor was not realizable without the support of the State.

425. Nomura's last proposal of 14 June 2000 also sought to accommodate the 1 euro proposal by offering a partial sale of IPB's assets to KoB for 1 CZK (for on-sale to a strategic investor such as Allianz/UniCredito or CSOB/KBC). The next day representatives of the CNB and of the Ministry of Finance began even to negotiate this proposal with Nomura's representatives and led them to believe that negotiations would be continued the next day, the main point for further clarification being the specification of IPB's assets that would not be covered by the transfer to KoB. This proposal was aborted by the supervening imposition of forced administration upon IPB.

(d) The Refusal of Adequate Communication

426. In light of the serious difficulties IPB was in and the urgency of finding a solution that would rescue IPB, the Czech Government's refusal to actively engage in constructive and direct negotiations with IPB and its major shareholder Saluka/Nomura was unreasonable. There could not have been any doubt that any cooperative solution necessarily made Saluka's/Nomura's involvement indispensable.

427. From mid-March onwards – three months before forced administration was imposed upon IPB – the Minister of Finance, Mr Mertlík, simply gave up communicating directly with IPB's major shareholder Saluka/Nomura. He downgraded the Ministry's communication with Saluka/Nomura to the Deputy level while at the same time he continued communicating personally with the CEO and Chairman of the Board of Directors of CSOB, Mr Kavánek.

428. Even on the Deputy level, communication with Saluka's/Nomura's representatives was not allowed on the premises of the Ministry of Finance.

429. Letters addressed by Nomura to the Minister of Finance on 5, 8 and 9 May 2000, setting out Nomura's willingness to meet the CNB's request for an injection of fresh capital and to arrange for up to CZK 13.2 billion of new capital for a capital increase in IPB simply remained without any response from the Minister.



430. Nomura nevertheless continued its efforts to meet Government officials, although with only limited success. Instead of engaging in meaningful negotiations, Nomura was confronted with the possibility of IPB's nationalisation or forced administration and with the 1 euro proposal.

431. On 31 May 2000, one day after the Minister of Finance, Mr Mertlík, had met with the CEO and Chairman of the Board of Directors of CSOB, Mr Kavánek, in Paris, official communication with Saluka/Nomura was discontinued even on the Deputy level. Saluka's representative, Mr Dillard, had to meet informally with Deputy Minister of Finance, Mr Mládek, in a wine bar.

432. Official communication was resumed on 15 June 2000 in order to discuss Nomura's last proposal. The Tribunal is very doubtful whether these discussions between Nomura's representatives and representatives of the CNB and of the Ministry of Finance were seriously meant as a last-minute effort of the Czech Government to find a cooperative solution. The OPC had already been informed the day before of the imminent takeover of IPB's business by CSOB. Already on 9 June 2000 the Deputy Minister of Finance, Mr Zelinka, had indicated to the Czech news agency CTK that forced administration of IPB was unavoidable.

d) Provision of Financial Assistance to IPB after Acquisition by CSOB

433. The Claimant argues that the Czech Republic acted in violation of the "fair and equitable treatment" standard by illegally granting massive financial assistance to IPB's business, once the beneficiary of such assistance had become CSOB following the forced administration.

434. On 19 June 2000 the Ministry of Finance, following the Government's Resolution No. 622 of 15 June 2000, issued an unlimited and unconditional guarantee of all on- and off-balance sheet assets transferred to CSOB, and the CNB entered into an agreement with CSOB under which the CNB promised to indemnify CSOB for certain other potential risks in connection with the acquisition of IPB's business. The transaction implemented by the Forced Administrator therefore conveyed to CSOB a fully guaranteed bank without requiring any substantial payment for its franchise value.

435. The Claimant, relying on the expert evidence of Professor Piet Jan Slot, contends that the Government Guarantee and the CNB indemnity were State aids provided in contravention of the Czech Public Assistance Act and in breach of the Czech Republic's obligations under the Europe Agreement, concluded between the European Communities and the Czech Republic on 4 October 1993.<sup>47</sup> Article 64 of that Agreement provided:

- (1) The following are incompatible with the proper functioning of the Agreement, in so far as they may affect trade between the Community and the Czech Republic:

...

- (iii) any public aid which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods.

436. The OPC's decision of 19 June 2000 exempted the Government's financial assistance for CSOB/IPB from the legal prohibition of State aid, on the grounds that it was "restructuring aid" and especially aid to remedy a "serious disturbance" in the Czech economy consistent with the Europe Agreement as interpreted by the EC Commission in its Guidelines on Rescue and Restructuring Aid. The validity of that decision is questioned by the Claimant, in particular, on the grounds that the assistance did not properly qualify as "restructuring aid" or aid to remedy a "serious disturbance", and that the OPC lacked independence and had also violated the procedural rules of the Public Assistance Act. Furthermore, the Government is said to have illegally implemented its aid for CSOB/IPB before the OPC's exemption decision came into effect.

437. The Claimant has also emphasised that the exemption decision was in any case conditional upon the Ministry of Finance subsequently submitting to the OPC (i) by 19 September 2000 a restructuring plan for IPB; (ii) by 19 September 2000 preliminary information concerning the amount of assistance provided under the Government Guarantee; and (iii) by 19 December 2000 final information concerning the assistance. The Ministry of Finance is said to have failed to comply with the last of these Conditions and to have thereby committed another breach of the Public Assistance Act which was not adequately penalised by the OPC.

438. The Claimant argues that the Czech Republic, by providing illegal State aid and by failing to implement procedural rules giving effect to violations of the prohibition of State aid, violated its international Treaty obligation under the Europe Agreement thereby establishing a *prima facie* violation of the "fair and equitable treatment" standard in Article 3.1 of the Treaty.

439. The Respondent, relying on the expert testimony of Professor Dr Jürgen Basedow, contested the subject matter jurisdiction of the Tribunal as far as the application of the substantive rules on State aid of the Europe Agreement are concerned. Since the Europe Agreement's substantive provisions are not "directly applicable" (self-executing), it is said to be not for this Tribunal to assess the legality of the Czech Government's financial assistance for CSOB/IPB under the Europe Agreement. The Tribunal is said to be only competent to assess the procedural legality of that assistance.

440. In any case, the OPC is said to have been justified in exempting the Government's financial assistance as "restructuring aid" and as a remedy for a "serious disturbance". Also, the State aid could have been exempted as indirect investment aid or operating aid in accordance with the EC Commission's Guidelines on national regional aid. The Claimant's criticism is therefore said to be unfounded.

441. The Tribunal finds, for the reasons set out below, that the Claimant's claim is without merit. The Czech Government's provision of State financial assistance to CSOB/IPB, *i.e.* upon the acquisition of IPB's business by CSOB subsequent to the imposition of forced administration upon IPB, did not amount to a breach of Article 3.1 of the Treaty.

442. The unlawfulness of a host State's measures under its own legislation or under another international agreement by which the host State may be bound, is neither necessary nor sufficient for a breach of Article 3.1 of the Treaty. The Treaty cannot be interpreted so as to penalise each and every breach by the Government of the rules or regulations to which it is subject and for which the investor may normally seek redress before the courts of the host State.

443. As the tribunal in *ADF Group Inc.* has stated with regard to the "fair and equitable treatment" standard contained in Article 1105(1) NAFTA:

something more than simple illegality or lack of authority under the domestic law of a State is necessary to render an act or measure inconsistent with the customary international law requirements....<sup>48</sup>

Quite similarly, the *Loewen* tribunal stated in the same legal context that

whether the conduct [of the host State] amounted to a breach of municipal law as well as international law is not for us to determine. A NAFTA claim cannot be converted into an appeal against decisions of [the host State].<sup>49</sup>

444. The Czech Government's conduct of which the Claimant is complaining must therefore be assessed in light of the Treaty's own "fair and equitable treatment" standard. Consequently, the Tribunal does not find it necessary to determine the legality of the financial assistance given to CSOB/IPB under Czech national law or under the Europe Agreement. The only relevant question is whether the Czech Government's provision of financial assistance to CSOB/IPB constituted unfair and inequitable treatment of Saluka irrespective of whether it was in compliance with the Czech Public Assistance Act or the Europe Agreement.

445. The "fair and equitable treatment" standard cannot easily be assumed to include a general prohibition of State aid. Financial assistance is a tool used by States to implement their commercial policies. Even though it tends to distort competition and to undermine the level playing field for competitors, States cannot be said to be generally bound by international law to refrain from using this tool. According to States' treaty practice, prohibitions of State aid are explicitly stated and defined in international agreements such as the Europe Agreement. A similar prohibition cannot be read into general principles such as the "fair and equitable treatment" standard. Consequently, an investor cannot claim to be generally protected against the host State providing State aid to its competitors.

446. Having said this, the Tribunal also emphasises that the host State, in providing State aid, is clearly bound not to frustrate an investor's legitimate and reasonable expectation to be treated fairly and equitably. The host State is therefore obliged to provide financial assistance to firms or industries in a way that does not amount to an unfair or inequitable treatment of a foreign investor. In particular, the provision of State aid to specific firms or industries must not be discriminatory or unreasonably harmful for the foreign investor.

447. In the case before the Tribunal, the Czech Government's guarantees and indemnities in favour of CSOB/IPB were part of the overall transaction whereby IPB's banking business

was transferred to CSOB subsequent to the imposition of forced administration upon IPB. At the time the financial assistance was implemented, IPB had already lost its banking business to CSOB. It is therefore not conceivable that, due to the State aid provided for CSOB/IPB, IPB and its shareholders could have suffered harm in addition to the harm that had already been caused by the forced administration and the subsequent loss of the banking business. After the takeover of IPB's banking business by CSOB, IPB was no longer a competitor of CSOB whose competitive position could be undermined by the State aid provided by the Czech Government.

e) Unjust Enrichment of CSOB at the Expense of Saluka

448. The Claimant contends that the Czech Republic failed to prevent the unjust enrichment of CSOB at the expense of the IPB shareholders including Saluka upon the transfer of IPB's business to CSOB and the provision of the aforementioned State aid following the forced administration.

449. The concept of unjust enrichment is recognised as a general principle of international law.<sup>50</sup> It gives one party a right of restitution of anything of value that has been taken or received by the other party without a legal justification. As the Iran-United States Claims Tribunal has stated more specifically:

There must have been an enrichment of one party to the detriment of the other, and both must arise as a consequence of the same act or event. There must be no justification for the enrichment, and no contractual or other remedy available to the injured party whereby he might seek compensation from the party enriched.<sup>51</sup>

450. If it is assumed that the "fair and equitable treatment" standard also includes the general principle of unjust enrichment, an investor would therefore also be protected by this standard against unjust enrichment by the host State.

451. In the case before the Tribunal, the question would be whether the Czech State has, by means of the transfer of IPB's business to CSOB and the provision of the aforementioned State aid following the forced administration, taken or received anything of value at the expense of Saluka. For the reasons set out below, the Tribunal would answer this question in the negative.

452. Firstly, it was not the Respondent which received the banking business from IPB, but CSOB. Even though the Czech State was still a (minority) shareholder of CSOB, CSOB cannot be equated with the Czech State. It is a general principle of company law that a company is a legal entity separate from its shareholders. The corporate assets are owned by the company itself, not by the shareholders. The concept of piercing the company's veil would be totally inapposite in this context. Anything acquired by CSOB from IPB was therefore not acquired by the Respondent.

453. Secondly, it was IPB's and not the Claimant's banking business that was transferred to CSOB. IPB's assets were owned by IPB itself, not by its shareholders. Again, the concept of the separateness of the company from its shareholders prevents the Tribunal from equating IPB and Saluka. Consequently, CSOB did not receive anything at the expense of Saluka.

454. The Claimant has in fact acknowledged that the transfer of IPB's business to CSOB resulted in the enrichment, if any, of one private entity at the expense of another. The Claimant has also argued, however, that in order for the Czech Republic to become liable towards Saluka it is sufficient to establish that the Czech Republic actively participated in a conspiracy to enrich one private party at the expense of another by using regulatory powers to effect an illegal transfer of ownership in IPB's business.

455. The Tribunal finds that the Claimant's argument is legally not well founded. It stretches the principle of unjust enrichment beyond its proper scope. The notion of one party being an accessory to an unjustified transfer between two other parties is not part of the concept of unjust enrichment. Even though, according to the Claimant, it is well established in the general international law of State responsibility for wrongful acts, especially in case of unlawful expropriation, that the ultimate beneficiary of the wrongful act of the State need not be the State itself, the Tribunal has not been convinced that this holds true for the principle of unjust enrichment.

456. Since there was no enrichment of the Respondent to the detriment of the Claimant, the Tribunal does not consider it necessary to assess the legal justification of the transfer of IPB's business to CSOB at any length. Suffice it to say that the transfer was based on the Sale Agreement between the Forced Administrator of IPB, and CSOB. It cannot be for this Tribunal to question the validity of this agreement as long as it has not been invalidated by a competent court or tribunal. Questionable as the circumstances surrounding the Sale Agreement may be, it provides, within the context of the principle of unjust enrichment, a sufficient legal justification for the transfer of IPB's banking business to CSOB.

### C. Non-Impairment

457. The legal basis of the Claimant's claims is not limited to the "fair and equitable treatment" standard contained in Article 3.1 of the Treaty but includes the non-impairment obligation contained in the same provision. Article 3.1 of the Treaty provides that:

[W]ith reference to the investments of investors of the other Contracting Party, each Contracting Party . . . shall not impair, by unreasonable or discriminatory measures, the operation, management, maintenance, use, enjoyment or disposal thereof by those investors.

It is for the Tribunal therefore, to determine whether the Czech Republic has, by certain measures, violated this obligation.

#### 1. Meaning of the Standard

458. "Impairment" means, according to its ordinary meaning (Article 31 of the Vienna Convention on the Law of Treaties), any negative impact or effect caused by "measures" taken by the Czech Republic.

459. The term "measures" covers any action or omission of the Czech Republic. As the ICJ has stated in the *Fisheries Jurisdiction Case (Spain v. Canada)*

[I]n its ordinary sense the word is wide enough to cover any act, step or proceeding, and imposes no particular limit on their material content or on the aim pursued thereby.<sup>52</sup>

460. The standard of “reasonableness” has no different meaning in this context than in the context of the “fair and equitable treatment” standard with which it is associated; and the same is true with regard to the standard of “non-discrimination”. The standard of “reasonableness” therefore requires, in this context as well, a showing that the State’s conduct bears a reasonable relationship to some rational policy, whereas the standard of “non-discrimination” requires a rational justification of any differential treatment of a foreign investor.

461. Insofar as the standard of conduct is concerned, a violation of the non-impairment requirement does not therefore differ substantially from a violation of the “fair and equitable treatment” standard. The non-impairment requirement merely identifies more specific effects of any such violation, namely with regard to the operation, management, maintenance, use, enjoyment or disposal of the investment by the investor.

462. The term “investment” is defined in Article 1 of the Treaty so as to include, *inter alia*, shares, bonds and other kinds of interests in companies [...], as well as rights derived therefrom.

As the Tribunal has already stated earlier, Saluka’s shareholding in IPB clearly is an “investment” in this sense.

463. It will transpire from the application of the non-impairment standard to the facts of this case that among the various objects of a potential impairment listed in Article 3.1 of the Treaty only Saluka’s “enjoyment” of its investment appears to be relevant in the present context. “Enjoyment” means, *inter alia*,

[t]he exercise of a right [...] [which] includes the beneficial use, interest and purpose to which property may be put, and implies right to profits and income therefrom.<sup>53</sup>

## 2. Application of the Standard

464. Three different sets of facts need to be assessed in light of the non-impairment obligation:

(a) first, the facts that have given rise to the Tribunal’s findings of violations of the “fair and equitable treatment” standard contained in Article 3.1 of the Treaty;

(b) second, the facts on which the Claimant has based its deprivation claim under Article 5 of the Treaty;

(c) third, the facts relating to the second run on IPB which subsequently led to the forced administration of IPB.

The Tribunal will assess these three sets of facts separately.

a) The Facts Underlying the Violations of the “Fair and Equitable Treatment” Standard (Article 3.1 of the Treaty)

465. The Tribunal finds that the Czech Republic, by violating the “fair and equitable treatment” standard of Article 3.1 of the Treaty, at the same time violated its non-impairment obligation under the same provision.

466. The Czech Republic, by

(i) giving a discriminatory response to the bad debt problem in the Czech banking sector, especially by providing State financial assistance to three of the Big Four banks to the exclusion of IPB and thereby creating an environment impossible for the survival of IPB, and

(ii) by refusing to negotiate in good faith on the proposals made by IPB and its shareholders,

impaired the “enjoyment” of Saluka’s investment, *i.e.* the shareholding in IPB.

467. There can be no doubt that the Czech Republic’s discriminatory response to the bad debt problem in the Czech banking sector and its unfair and inequitable treatment of IPB regarding the provision of State aid as well as its refusal to negotiate in good faith on the proposals made by IPB and its shareholders for the rescue of IPB had a detrimental impact upon IPB and Saluka’s shareholding in IPB. The unlawful conduct of the Czech Government contributed to the aggravation of IPB’s financial distress and to its subsequent failure and thereby impaired Saluka’s beneficial use of and interest in its shareholding in IPB.

b) The Facts Underlying the Deprivation Claim (Article 5 of the Treaty)

468. The Claimant’s allegation that the Czech Republic has, by certain measures, unlawfully deprived Saluka of its investment in IPB also includes the allegation that the Czech Republic has, by the same measures, impaired the operation, management, maintenance, use, enjoyment or disposal of Saluka’s investment in IPB. A “deprivation” is most certainly at the same time an “impairment”.

469. In order for the Tribunal to find in favour of the Claimant, the “measures” assessed in light of Article 5 of the Treaty must be shown, in the context of Article 3.1 of the Treaty, to have been “unreasonable or discriminatory”.

470. As far as the Claimant’s allegation of an unlawful impairment of Saluka’s investment by the Czech Government’s imposition of forced administration upon IPB is concerned, the reasons which led the Tribunal, in the preceding Chapter of this Award, to find that the “deprivation” of Saluka’s investment caused by the forced administration was lawful and that the Czech Republic did not violate Article 5 of the Treaty also lead the Tribunal to find that the “impairment” of Saluka’s investment by the same measure was lawful as well and that the

Czech Republic did not violate Article 3.1 of the Treaty in this respect either. Since in the context of Article 5, the “deprivation” of Saluka’s investment by the imposition of forced administration upon IPB was justified on reasonable regulatory grounds, the same applies *a majore ad minus* to the “impairment” of Saluka’s investment in the context of Article 3.1. In other words: to the extent that the concepts of “deprivation” and “impairment” overlap, because a “deprivation” is just one variety of possible “impairments”, the regulatory power exception (or “police power exception”) explained in the previous Chapter of this Award applies to both.

c) The Czech Government’s Alleged Triggering of the Second Run on IPB

471. The Claimant contends that the second run on IPB, which began on 12 June 2000 and which led directly to the imposition of forced administration upon IPB, was triggered by the Czech Government’s leaks of information. The Respondent has denied any such leaks. The details are highly controversial.

472. The Tribunal finds, for the reasons set out below, that the Government did in fact unreasonably spread negative information on IPB to the public and that this contributed to the aggravation of IPB’s financial distress and to its subsequent failure.

473. According to the evidence before the Tribunal, the following appears to be undisputed: In May 2000 IPB submitted to the CNB its revised draft proposal of “Measures for the Stabilisation of IPB”. Shortly thereafter, the Czech newspaper *Mladá Fronta DNES* reported that:

According to a highly reliable source, the central bank received a document titled “Measures for stabilisation of IPB” where the managers of the bank, among others things, propose the transfer of bad debts to the State-owned Konsolidacni banka.

The source quoted in the newspaper was the CNB.

474. On 8 June 2000 Dow Jones Newswires reported that

a source in the central bank [has told] [there was] a “fifty-fifty” chance forced administration will occur [at IPB].

475. According to the Claimant, on 9 June 2000 the Czech news agency CTK reported the Deputy Finance Minister, Mr Zelinka, as having said that

[c]ompulsory administration makes sense, because talks with a potential investor are at an advanced stage and there is a danger that the bank will go bankrupt in the meantime.

Even though by law compulsory administration does not mean freezing the deposits, Zelinka does not see any other way of protecting the bank from being invaded by its customers.



476. On 10 June 2000 *Mladá Fronta DNES* wrote:

According to reliable sources at the central bank, IPB does not have adequate reserves to cover losses from bad loans ... in such a case, the current status of IPB may lead to the withdrawal of its banking licence.

An undisclosed source from the ministry [of Finance] ... said that the intent is to cut off the existing shareholders from any influence on the operations of the bank.

...

The State has two possibilities for nationalisation of the bank and continuation of operations. It either acquires the majority share from Nomura, or takes over control of the bank via imposing forced administration.

...

“Both variants are possible”, said a source from the ministry that is a party to the negotiations. After the taking over control of the bank and an expensive cleaning up of its portfolio, it is to be sold to a strategic partner. Among the interested parties are, for example, CSOB or Italian Unicredito.

However, Nomura for the present does not want to accept the proposal to assign the shares to the State at a symbolic price of 1.- CZK, since it doesn't want to participate in the stabilisation of the bank.

477. As will be recalled, on 12 June 2000 the second run on IPB began.

478. None of the aforementioned press reports was in any way misstating the situation. Almost all of them contained a clear indication that forced administration of IPB was imminent. All of the reported information was said to have been received from Government sources.

479. The Respondent, by contending that there had been numerous press articles about the bank, some reporting publicly available information in ways that could easily create public panic or cause depositors to begin to make withdrawals, implicitly admits that there have also been press articles reporting confidential information that was not publicly available. There is even reason to believe that certain information was deliberately leaked to the press by “sources” in the CNB and the Ministry of Finance.

480. The crucial question for the Tribunal to determine relates to causation: was the publication of the information referred to a *conditio sine qua non* for IPB's forced administration? The nature of the information was such that IPB's customers could become seriously concerned about the safety of their savings deposited with IPB and start to withdraw their deposits. On the other hand, it is inconceivable that the public was not already to some degree aware that IPB had problems with its bad loan portfolio. It was one thing, however, for the public to have known of IPB's distress in general terms; it was quite another for the public to have been informed that the failure of IPB was imminent and forced administration

unavoidable, as stated by the Deputy Finance Minister, Mr Zelinka, on 9 June 2000 (*i.e.* on the Friday before the Monday when the second bank run set in).

481. Furthermore, there is some indication that the Government “sources” deliberately engineered the circulation of negative information about IPB in order to precipitate IPB’s failure. Mr Zelinka’s statement of 9 June 2000 may well be interpreted in this sense. Once forced administration was publicly stated to be unavoidable, that statement became a self-fulfilling prophecy, because the bank run was certain to set in the following Monday. This conduct of the Government was unjustifiable and unreasonable and contributed in all probability to the unsustainability of IPB’s situation. The Respondent has provided no convincing evidence to the contrary.

#### D. Full Security and Protection

482. The Claimant has argued that the Czech Republic has also violated its obligation under Article 3.2 of the Treaty which “more particularly” provides that each Contracting Party shall accord to the investments of investors covered by the Treaty “full security and protection”.

##### 1. Meaning of the Standard

483. The “full protection and security” standard applies essentially when the foreign investment has been affected by civil strife and physical violence.<sup>54</sup> In the *AMT* arbitration, it was held that the host State “must show that it has taken all measures of precaution to protect the investments of [the investor] in its territory”.<sup>55</sup>

484. The standard does not imply strict liability of the host State however. The *Tecmed* tribunal held that “the guarantee of full protection and security is not absolute and does not impose strict liability upon the State that grants it”.<sup>56</sup> The host State is, however, obliged to exercise due diligence.<sup>57</sup> As the tribunal in *Wena*, quoting from *American Manufacturing and Trading*,<sup>58</sup> stated,

The obligation incumbent on the [host State] is an obligation of vigilance, in the sense that the [host State] shall take all measures necessary to ensure the full enjoyment of protection and security of its investments and should not be permitted to invoke its own legislation to detract from any such obligation.<sup>59</sup>

Accordingly, the standard obliges the host State to adopt all reasonable measures to protect assets and property from threats or attacks which may target particularly foreigners or certain groups of foreigners.<sup>60</sup> The practice of arbitral tribunals seems to indicate, however, that the “full security and protection” clause is not meant to cover just any kind of impairment of an investor’s investment, but to protect more specifically the physical integrity of an investment against interference by use of force. In light of the following findings, it appears not to be necessary for the Tribunal to precisely define the scope of the “full security and protection” clause in this case.

## 2. Application of the Standard

485. The Claimant contends that the Czech Republic has failed to accord Saluka's investment full protection and security by its oppressive use of public powers, post-forced administration, with a view to depriving Saluka of any residual economic benefit or use of its investment and by harassing its officers and employees. The measures complained of by the Claimant relate more specifically to

- (a) the suspension of trading of IPB shares;
- (b) the prohibition of transfers of Saluka's shares; and
- (c) the police searches of premises occupied by Nomura and its employees.

The Tribunal will assess these three groups of measures separately.

### a) The Suspension of Trading in IPB Shares

486. According to the Claimant, the CSC's preliminary injunction of 15 June 2000 imposing an immediate suspension of trading in IPB shares as well as the subsequent successive extensions thereof were unjustified. The Respondent argues that there was nothing improper with the suspension decisions.

487. Saluka has lodged appeals against the CSC's suspension decisions. The appeals were rejected, however, by the competent Presidium of the CSC.

488. On 1 January 2001, the Czech Securities Act was amended to the effect that shareholders no longer had standing to appeal a CSC's suspension of trading in the shares held by the shareholders. Consequently, after 1 January 2001 Saluka was excluded from challenging suspensions of trading in its IPB shares.

489. The Respondent argues that the amendment to the Czech Securities Act was of general application and was not specifically targeted against Saluka.

490. Even assuming that the suspension of trading of shares may be State conduct within the scope of the "full security and protection" clause, the Tribunal, without deciding that question, finds that this claim of the Claimant is without merit. On this account, the Czech Republic cannot be said to have failed to provide "full protection and security" to Saluka's investment. The reasoning behind the CSC's suspension decisions cannot be said to have been totally devoid of legitimate concerns relating to the securities market. The suspensions of trading in IPB shares were at least justifiable on regulatory grounds. Also, the elimination of shareholders' right of appeal does not *per se* transcend the limits of a legislator's discretion. Shareholder's rights vary greatly in different jurisdictions. The amendment of the Czech Securities Act cannot be said to be totally unreasonable and unjustifiable by some rational legal policy.

b) The Prohibition of Transfers of Saluka's Shares

491. The Claimant also argues that the Police Order issued at the request of CSOB by the Public Investigator's Office on 26 October 2000 as well as subsequent decisions of the police authorities, freezing specifically Saluka's shareholding in IPB, were unjustified.

492. Saluka, however, appealed, with some success, against the freezing orders. Even the Public Prosecutor's Office's order of 23 April 2002 which upheld the freezing order on different grounds was quashed, upon Saluka's appeal, by the Supreme Public Prosecutor's Office. The Claimant still feels aggrieved by a procedural denial of justice due to the fact that the latter office, which was the last instance for appeals, upheld the freezing of Saluka's shares in IPB on still different grounds on which Saluka had not been heard. No further appeal being possible, on 18 July 2002 Saluka lodged a petition with the Constitutional Court seeking an appropriate remedy.

493. Even assuming that the freezing of the IPB shares held by Saluka may be State conduct within the scope of the "full security and protection" clause, the Tribunal, without deciding that question, fails to see a procedural denial of justice that would violate the Czech Republic's Treaty obligations. The absence of further appeals against decisions of the last instance for appeals is not *per se* a denial of justice. The alleged denial of Saluka's right to be heard is the basis for the petition lodged with the Constitutional Court. Nothing therefore emerges from the facts before the Tribunal that would amount to a manifest lack of due process leading to a breach of international justice and to a failure of the Czech Republic to provide "full protection and security" to Saluka's investment.

c) The Police Searches

494. The Claimant furthermore complains of the search of Nomura's (not Saluka's) Prague Representative Office and the seizure of Nomura's documents. According to the Claimant, these police actions were illegal and violated Nomura's fundamental rights to the inviolability of privacy and home, to the protection against unauthorised interference with its privacy and unauthorised gathering of data, and to the protection of ownership rights.

495. Saluka (not Nomura), however, successfully lodged a petition with the Czech Constitutional Court which in a decision of 10 October 2001 held in favour of Saluka.

496. Consequently, having been granted the relief petitioned for, the Claimant can no longer be aggrieved. The Tribunal, without going into the relevance of the distinction between Nomura and Saluka in this context, therefore finds that, on this account also, the Czech Republic cannot be found to have violated its Treaty obligation to accord "full protection and security" to Saluka's investment.

E. Conclusion

497. In summary, the Tribunal finds, based on the totality of the evidence which has been presented to it, that the Respondent's treatment of Saluka's investment was in some respects

unfair and inequitable and violated the “fair and equitable treatment” obligation as well as the “non-impairment” obligation under Article 3.1 of the Treaty.

498. The Respondent has violated the “fair and equitable treatment” obligation by responding to the bad debt problem in the Czech banking sector in a way which accorded IPB differential treatment without a reasonable justification. The Big Four banks were in a comparable position regarding the bad debt problem. Nevertheless, the Czech Republic excluded IPB from the provisioning of financial assistance. Only in the course of CSOB’s acquisition of IPB’s business during IPB’s forced administration was considerable financial assistance from the Czech Government forthcoming. Nomura (and subsequently Saluka) was justified, however, in expecting that the Czech Republic would provide financial assistance in an even-handed and consistent manner so as to include rather than exclude IPB. That expectation was frustrated by the Respondent. The Tribunal finds that the Respondent has not offered a reasonable justification for IPB’s differential treatment.

499. The Czech Republic has furthermore violated its “fair and equitable treatment” obligation by unreasonably frustrating IPB’s and its shareholders’ good faith efforts to resolve the bank’s crisis. Saluka was entitled to expect that the Czech Republic took seriously the various proposals that may have had the potential of solving the bank’s problem and that these proposals were dealt with in an objective, transparent, unbiased and even-handed way. The fundamentally different approach of the Czech Government towards CSOB’s acquisition of IPB, on the one hand, and towards IPB’s and Saluka’s/Nomura’s attempts to negotiate a cooperative solution, on the other, frustrated Saluka’s legitimate expectations. The Czech Government’s conduct lacked even-handedness, consistency and transparency and the Czech Government has refused adequate communication with IPB and its major shareholder, Saluka/Nomura. This made it difficult and even impossible for IPB and Saluka/Nomura to identify the Czech Government’s position and to accommodate it. The Respondent has not offered a reasonable justification for its treatment of Saluka.

500. The Tribunal does not find, however, that the Respondent has violated its “fair and equitable treatment” obligation by a failure to ensure a predictable and transparent framework for Saluka’s investment. Neither was the increase of the provisioning burden for non-performing loans unpredictable for Saluka/Nomura, nor could Saluka/Nomura legitimately expect that the Czech Republic would fix the legal shortcomings regarding the protection of creditor’s rights and the enforcement of loan security within a timescale of help to Nomura.

501. Nor does the Tribunal find that the Respondent has violated its “fair and equitable treatment” obligation by providing financial assistance to CSOB after its acquisition of IPB. At the time the financial assistance was implemented, IPB had already lost its banking business to CSOB. Therefore, IPB and its shareholders could no longer have suffered harm in addition to the harm that had already been caused by the forced administration and the subsequent loss of the banking business. After the takeover of IPB’s banking business by CSOB, IPB was no longer a competitor of CSOB whose competitive position could be undermined by the State aid provided by the Czech Government.

502. The Tribunal also cannot find that the Respondent has violated its “fair and equitable treatment” obligation by a failure to prevent the unjust enrichment of CSOB at the expense of the IPB shareholders, including Saluka, upon the transfer of IPB’s business to CSOB and the provision of State aid following forced administration. For there to be an actionable, unjust

enrichment as between the parties, the Respondent must have received something at the expense of the Claimant. It was not the Respondent which received the banking business from IPB, but rather CSOB, nor was it the Claimant's banking business that was transferred to CSOB, but rather IPB's.

503. The Tribunal does find a violation by the Respondent of its "non-impairment" obligation under Article 3.1 of the Treaty. This violation is based firstly on the same grounds which have led the Tribunal to find a violation of the "fair and equitable treatment" standard. The unjustified differential treatment of IPB regarding the Czech Republic's response to the bad debt problem in the banking sector as well as the Czech Government's refusal to negotiate in good faith on the proposals made by IPB and its shareholders were measures that impaired the enjoyment of Saluka's investment, *i.e.* the shareholding in IPB.

504. The violation of the "non-impairment" obligation is based secondly on the Czech Government's unjustifiable and unreasonable conduct regarding the circulation of negative information about IPB during the week before the second run on IPB that led to its failure. This conduct contributed in all probability to the unsustainability of IPB's situation.

505. The Tribunal fails to find a breach by the Respondent of its "full security and protection" obligation under Article 3.2 of the Treaty. Neither the suspension of trading of IPB shares, which was justifiable by legitimate concerns relating to the securities market, nor the prohibition of transfers of Saluka's IPB shares or the police searches of Nomura's Prague Representative Office and the seizure of Nomura's documents, against which Saluka has lodged appeals or petitions to the competent authorities or courts, amount to a breach of that obligation.

## VII. OTHER MATTERS

506. The Claimant, in its Memorial, considered it appropriate and efficient to postpone precise issues of the loss it had suffered to a separate phase of the proceedings when the Tribunal's decision on liability would be known. The Respondent, in its Counter-Memorial, was of the same view in relation to losses which were the subject to its counterclaims. Accordingly, neither party pursued questions of *quantum* in any detail in their various pleadings on the merits of the dispute submitted to arbitration.

507. Now that the Tribunal's conclusions of the question of liability are known, and include its finding that there has been a breach by the Respondent of its obligations under Article 3 of the Treaty, it is necessary to address the question of the appropriate redress for that breach, including questions of *quantum* which arise in that context.

508. The Tribunal, pursuant to Article 32.1 of the UNCITRAL Rules, accordingly renders its present Award as only a partial Award. The Tribunal retains its jurisdiction in order to decide the outstanding question of redress, including questions of *quantum*, in a second phase of this arbitration.

509. The Tribunal, bearing in mind Article 23 of the UNCITRAL Rules, will communicate with the parties about appropriate periods of time for the filing by the parties of written statements on the question of redress, including questions of *quantum*.

510. The Tribunal, bearing in mind Article 38 of the UNCITRAL Rules, will address questions of costs within the framework of its eventual decision at the conclusion of the second phase of this arbitration.

### VIII. DECISIONS

511. For the foregoing reasons, the Tribunal unanimously renders the following decisions as its Partial Award in the present arbitration:

- a. The Tribunal has jurisdiction to hear and decide the dispute which the Claimant, Saluka Investments BV, has submitted to it;
- b. the Respondent, the Czech Republic, has not acted in breach of Article 5 of the Treaty;
- c. the Respondent has acted in breach of Article 3 of the Treaty;
- d. the question of the appropriate redress for that breach, including questions of *quantum*, will be addressed in a second phase of this arbitration, for which the Tribunal retains jurisdiction;
- e. the Tribunal will separately determine the timetable for the second phase of this arbitration; and
- f. the Tribunal reserves questions of costs until final consideration can be given to the costs of this arbitration as a whole.

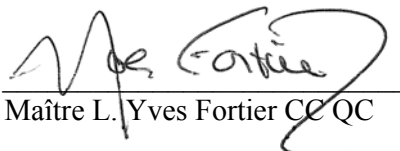
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Place of arbitration: Geneva, Switzerland

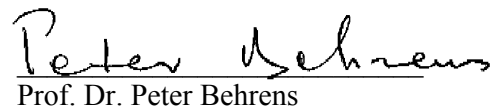
Dated: 17 March 2006



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Sir Arthur Watts KCMG QC  
Chairman



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Maître L. Yves Fortier CCQC



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Prof. Dr. Peter Behrens

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- <sup>1</sup> CNB Report, *The Banking Sector During the Economic Transformation* 7 (1997).
- <sup>2</sup> Decision of the Council and Commission of 19 December concerning the conclusion of a Europe Agreement establishing an association between the European Communities and their Member States, of the one part, and the Czech Republic, of the other, OJ (L 360/1), 31 December 1994 [hereinafter Europe Agreement].
- <sup>3</sup> Treaty Establishing the European Community, OJ (C 325), 24 December 2002.
- <sup>4</sup> *Sic.* Presumably, “by a foreign person” was intended.
- <sup>5</sup> Claimant’s Reply, para. 30.
- <sup>6</sup> Article 31(3)(c) of the 1969 Vienna Convention on the Law of Treaties, 1155 UNTS 331.
- <sup>7</sup> See Case Concerning Oil Platforms (Islamic Republic of Iran v. USA), Judgment, 6 November 2003, ICJ Reports (2003), paras 23 and 41. See also *AAPL v. Sri Lanka*, 106 ILR 440, para. 41 (1990).
- <sup>8</sup> L.B. Sohn & R.R. Baxter, *Responsibility of States for Injuries to the Economic Interests of Aliens*, 55 AJIL 515 (1961).
- <sup>9</sup> OECD Draft Convention on the Protection of Foreign Property (12 October 1967), 71 ILM 117.
- <sup>10</sup> Restatement (Third) of Foreign Relations Law § 712 cmt. g (1987).
- <sup>11</sup> The tribunal in *ADF Group Inc. v. United States of America* agreed with the position taken by a tribunal in another case (*Mondev International Ltd. v. United States of America*, ICSID Case No. ARB(AF)/99/2) “that any general requirement to accord ‘fair and equitable treatment’ ... must be disciplined by being based upon State practice and judicial or arbitral caselaw or other sources of customary or general international law”. Although the foregoing case deals with “fair and equitable” treatment, the principle quoted applies in the same way to “deprivation”. See *ADF Group Inc. v. USA*, ICSID Case No. ARB(AF)/00/1, Award, 9 January 2003, para. 184.
- <sup>12</sup> *MethanexCorp. v. USA*, Final Award, 3 August 2005, 44 ILM 1343, para. 410 (2005). See also *Too v. Greater Modesto Insurance Associates*, 23 Iran U.S. Cl. Trib. Rep. 378, para. 26 (1989); *S.D. Myers, Inc. v. Canada*, 40 ILM 1408, para. 281 (2001); *Lauder (USA) v. Czech Republic*, Final Award, 3 September 2002, para. 198 (available at [www.investmentclaims.com](http://www.investmentclaims.com)); *Technicas Medioambientales Tecmed S.A. v. United Mexican States*, ICSID Case No. ARB(AF)/00/2, 29 May 2003, para. 119.
- <sup>13</sup> See *Too v. Greater Modesto*, 23 Iran U.S. Cl. Trib. Rep. 378; *Robert Azinian and others v. United Mexican States*, ICSID Case No. ARB(AF)97/2, Award, 1 November 1999; and *S.D. Myers Inc.*, 40 ILM 1408.
- <sup>14</sup> The Presidium of the Cabinet of the Czech Republic had consented to the imposition of forced administration by Resolution on 15 June 2000.
- <sup>15</sup> In any event, the Respondent will have the opportunity to raise this argument, if it wishes, in the quantum phase of this arbitration.
- <sup>16</sup> See *NAFTA Arbitration Pope & Talbot Inc. v. The Government of Canada*, Award on the Merits of Phase 2, 10 April 2001, para. 155 (available at [www.naftaclaims.com](http://www.naftaclaims.com)).
- <sup>17</sup> *S.D. Myers, Inc.*, 40 ILM 1408, para. 261.
- <sup>18</sup> Guidance may also be derived from some comprehensive surveys that have recently taken stock of States’ treaty practice, arbitral jurisprudence, relevant literature and documents prepared by international organisations. See, e.g., OECD, *Fair and Equitable Treatment Standard in International Investment Law*, Working Papers on International Investment, No. 2004/3 (2004) [hereinafter OECD Working Papers]; R. Dolzer, *Fair and Equitable Treatment: A Key Standard in Investment Treaties*, *The International Lawyer* 87-106 (Spring 2005); C. Schreuer, *Fair and Equitable Treatment in Arbitral Practice*, *Journal of World Investment & Trade* 357-386 (June 2005).
- <sup>19</sup> *Mondev International Ltd. v. United States of America*, ICSID Case No. ARB(AF)/99/2, 11 October 2002, para. 118; see also *Waste Management, Inc. v. United Mexican States*, 30 April 2004 (available at [www.naftaclaims.com](http://www.naftaclaims.com)) and *MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Republic of Chile*, ICSID Case No. ARB/01/7, 25 May 2004.
- <sup>20</sup> *Pope & Talbot*, 10 April 2001; other arbitral awards referred to by the Claimant in support of its submission include *Lauder v. Czech Republic*, 3 September 2002, para. 292, and *CME Czech Republic BV (The Netherlands) v. Czech Republic*, Partial Award, 13 September 2001, para. 611 (available at [www.investmentclaims.com](http://www.investmentclaims.com)), both of which were also based on Article 3 of the Treaty.



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<sup>21</sup> North American Free Trade Agreement, 8-17 December 1992, 32 ILM 605 (entered into force 1 January 1994).

<sup>22</sup> *Waste Management*, 30 April 2004, para. 98.

<sup>23</sup> See Alex Genin, Eastern Credit Limited, Inc. and A.S. Baltoil v. The Republic of Estonia, ICSID Case No. ARB/99/2, 25 June 2001, para. 367.

<sup>24</sup> USA (L.F. Neer) v. United Mexican States, 21 AJIL 555, at 556 (1927).

<sup>25</sup> Article 1105(1) of NAFTA, *supra* note 21, provides that:

Each Party shall accord to investments of investors of another Party treatment in accordance with international law, including fair and equitable treatment and full protection and security.

<sup>26</sup> See G. Sacerdoti, *Bilateral Treaties and Multilateral Instruments on Investment Protection, Recueil des Cours*, Tome 269, at 341 (1997); R. Dolzer & M. Stevens, *Bilateral Investment Treaties* 60 (ICSID 1995); see also United Nations Conference on Trade and Development (UNCTAD), *Fair and Equitable Treatment*, Series on Issues in International Investment Agreements 40 (1999).

<sup>27</sup> *Genin*, ICSID Case No. ARB/99/2.

<sup>28</sup> *Genin*, ICSID Case No. ARB/99/2, para. 289.

<sup>29</sup> *Genin*, ICSID Case No. ARB/99/2, para. 290; see also *Mondev*, ICSID Case No. ARB(AF)/99/2, para. 116.

<sup>30</sup> Vienna Convention on the Law of Treaties, May 23, 1969, 1155 UNTS 331.

<sup>31</sup> The Treaty entered into force on 1 October 1992 for both The Netherlands and the Czech and Slovak Federal Republic.

<sup>32</sup> See *MTD Equity*, ICSID Case No. ARB/01/7, para. 113, where the Tribunal referred to The Concise Oxford Dictionary of Current English (5<sup>th</sup> ed.).

<sup>33</sup> *S.D. Myers, Inc.*, 40 ILM 1408, para. 263.

<sup>34</sup> For a comprehensive account of recent arbitral practice see Schreuer, *supra* note 18, at 374-380; see also Dolzer, *supra* note 18, at p. 103.

<sup>35</sup> *Tecmed*, ICSID Case No. ARB(AF)/00/2, para. 154 (emphasis added).

<sup>36</sup> *CME v. Czech Republic*, 13 September 2001, para. 155 (emphasis added).

<sup>37</sup> *Waste Management*, 30 April 2004, para. 98 (emphasis added).

<sup>38</sup> See the comprehensive account of arbitral practice in OECD Working Papers, *supra* note 18, at 25-39; see also Schreuer, *supra* note 18, at 373-385.

<sup>39</sup> Occidental Exploration and Production Company (OEPC) v. Ecuador, 1 July 2004, para. 183 (emphasis added).

<sup>40</sup> *S.D. Myers, Inc.*, 40 ILM 1408, para. 263.

<sup>41</sup> For a comprehensive account of arbitral practice see Schreuer, *supra* note 18, at 380-383.

<sup>42</sup> IMF, *Lessons from Systemic Bank Restructuring: A Survey of 24 Countries* (Washington 1997).

<sup>43</sup> Resolution of the Czech Government No. 369, 27 May 1998.

<sup>44</sup> See Czech National Bank, *Report on Banking Supervision in the Czech Republic* 24-28 (December 1999).

<sup>45</sup> In the documents, the following code names were used for CSOB and IPB: “Carthago” for CSOB; “India” for IPB.

<sup>46</sup> Witness Statement of Mr Daniel Jackson, at para. 72: “Mr Niedermayer [Vicegovernor of the CNB] warned that there was little appreciation within the Government or the CNB about the limitations of shareholder liability, and this misapprehension underlay the expectation that Nomura must cover any losses at IPB”.

<sup>47</sup> Europe Agreement, *supra* note 2.

<sup>48</sup> *ADF Group*, ICSID Case No. ARB(AF)/00/1, para. 42.

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<sup>49</sup> The Loewen Group, Inc. and Raymond L. Loewen v. United States of America, ICSID Case No. ARB(AF)/98/3, 19 June 2003, para. 134.

<sup>50</sup> See the Award in the Lena Goldfields, Ltd., Arbitration, 3 September 1930, 36 Cornell Law Quarterly 42, paras. 23-24 (1950); A. Nussbaum, *The Arbitration Between the Lena Goldfields, Ltd., and the Soviet Government*, 36 Cornell Law Quarterly 31, at 41 (1950); C. Schreuer, *Unjustified Enrichment in International Law*, 22 American Journal of Comparative Law 281 (1974).

<sup>51</sup> *Benjamin Isaiah v. Bank Mellat*, 2 Iran U.S. Cl. Trib. Rep., 30 March 1983, 232, at 236-237.

<sup>52</sup> Fisheries Jurisdiction Case (Spain v. Canada), Judgment on Jurisdiction of the Court, 4 December 1998, ICJ Reports (1998), at para. 66.

<sup>53</sup> Black's Law Dictionary (6<sup>th</sup> ed. 1990).

<sup>54</sup> See American Manufacturing & Trading, Inc. (AMT) (USA) v. Republic of Zaire, ICSID Case No. ARB/93/1, 21 February 1997 (lack of protection against loss of investment caused by widespread looting); *Tecmed*, ICSID Case No. ARB(AF)/00/2, paras. 175-177 (alleged lack of the host State's protection against interference with the investor's investment by adverse social demonstrations).

<sup>55</sup> *AMT*, ICSID Case No. ARB/93/1, para. 6.05; see also *Wena Hotels Ltd. (UK) v. Arab Republic of Egypt*, ICSID Case No. ARB/98/4, 8 December 2000 (lack of protection against loss of investment by forced and illegal seizure of investor's hotels).

<sup>56</sup> *Tecmed*, ICSID Case No. ARB(AF)/00/2, para. 177.

<sup>57</sup> Dolzer & Stevens, *supra* note 26, at 61.

<sup>58</sup> *AMT*, ICSID Case No. ARB/93/1, para. 28.

<sup>59</sup> *Wena*, ICSID Case No. ARB/98/4, para. 84.

<sup>60</sup> See OECD Working Papers, *supra* note 18, at 26-28 ("obligation of vigilance and protection").

## **LEGAL AUTHORITY CA-79**



COUR EUROPÉENNE DES DROITS DE L'HOMME  
EUROPEAN COURT OF HUMAN RIGHTS

THIRD SECTION

**CASE OF KELLY AND OTHERS v. THE UNITED KINGDOM**

*(Application no. 30054/96)*

JUDGMENT

STRASBOURG

4 May 2001

**FINAL**

*04/08/2001*

This judgment will become final in the circumstances set out in Article 44 § 2 of the Convention. It may be subject to editorial revision.

**In the case of Kelly and Others v. the United Kingdom,**

The European Court of Human Rights (Third Section), sitting as a Chamber composed of:

Mr J.-P. COSTA, *President*,

Mr W. FUHRMANN,

Mr L. LOUCAIDES,

Mrs F. TULKENS,

Mr K. JUNGWIERT,

Sir Nicolas BRATZA,

Mr K. TRAJA, *judges*,

and Mrs S. DOLLÉ, *Section Registrar*,

Having deliberated in private on 4 April 2000 and on 11 April 2001,

Delivers the following judgment, which was adopted on the last-mentioned date:

## PROCEDURE

1. The case originated in an application (no. 30054/96) against the United Kingdom lodged with the European Commission of Human Rights (“the Commission”) under former Article 25 of the Convention for the Protection of Human Rights and Fundamental Freedoms (“the Convention”) by Irish nationals, Vincent Kelly, Kevin McKearney, Amelia Arthurs, Letitia Donnelly, Mary Kelly, Annie Gormley, Patrick O’Callaghan, Carmel Lynagh and Brigid Hughes (“the applicants”), on 5 October 1995.

2. The applicants, who had been granted legal aid, were represented by Mr P. Mageean and Mr D. Korff, lawyers practising in Belfast and London, respectively. The United Kingdom Government (“the Government”) were represented by their Agent, Mr C. Whomersley of the Foreign and Commonwealth Office, London.

3. The applicants, next-of-kin of nine men killed during a security force operation at Loughgall on 8 May 1987 – Patrick Kelly, Patrick McKearney, Declan Arthurs, Seamus Donnelly, Eugene Kelly, Michael Gormley, Gerard O’Callaghan, James Lynagh and Antony Hughes – alleged that their relatives had been kill unjustifiably, without any attempt being made to bring them before a court, that this disclosed discrimination and that there was no effective remedy available to them in respect of their complaints. They invoked Articles 2, 6, 14 and 13 of the Convention.

4. The application was transmitted to the Court on 1 November 1998, when Protocol No. 11 to the Convention came into force (Article 5 § 2 of Protocol No. 11).

5. The application was allocated to the Third Section of the Court (Rule 52 § 1 of the Rules of Court). Within that Section, the Chamber that

would consider the case (Article 27 § 1 of the Convention) was constituted as provided in Rule 26 § 1 of the Rules of Court.

6. Having consulted the parties, the President of the Chamber decided that in the interests of the proper administration of justice, the proceedings in the present case should be conducted simultaneously with those in the cases of *Jordan v. the United Kingdom* (no. 24746/94), *McKerr v. the United Kingdom* (no. 28883/95) and *Shanaghan v. the United Kingdom* (no. 37715/97).

7. Third-party comments were received from the Northern Ireland Human Rights Commission on 23 March 2000, which had been given leave by the President to intervene in the written procedure (Article 36 § 2 of the Convention and Rule 61 § 3).

8. A hearing took place in public in the Human Rights Building on 4 April 2000.

There appeared before the Court:

(a) *for the Government*

Mr C. WHOMERSLEY,	<i>Agent,</i>
Mr R. WEATHERUP, QC,	
Mr P. SALES,	
Mr J. EADIE,	
Mr N. LAVENDER,	<i>Counsel,</i>
Mr O. PAULIN,	
Ms S. McCLELLAND,	
Ms K. PEARSON,	
Mr D. McILROY,	
Ms S. BRODERICK,	
Ms L. McALPINE,	
Ms J. DONNELLY,	
Mr T. TAYLOR,	<i>Advisers;</i>

(b) *for the applicants*

Mr D. KORFF,	
Ms F. DOHERTY,	<i>Counsel,</i>
Mr P. MAGEEAN,	<i>Solicitor.</i>

The Court heard addresses by Mr Weatherup and Mr Korff.

9. By a decision of 4 April 2000, the Chamber declared the application admissible.

10. The applicant and the Government each filed observations on the merits (Rule 59 § 1).

## THE FACTS

### I. THE CIRCUMSTANCES OF THE CASE

11. The facts of the case, as submitted by the parties and which may be deduced from the documents, may be summarised as follows. The applicants accepted that the summaries below are an accurate reflection of the written statements made by the official personnel involved, without making any admission as to the credibility, consistency and veracity of these statements.

#### **A. Background to the operation at Loughgall**

12. Following a briefing that there was likely to be a terrorist attack on Loughgall station of the Royal Ulster Constabulary (the RUC) in County Armagh on 8 May 1987, twenty four soldiers and three RUC officers arrived at the station in the early hours of that day. Under the command of Soldier A, the soldiers positioned themselves in six locations surrounding the RUC station. Soldiers A, B, C, D, E and F were dressed in plain clothes and remained inside the RUC station (Position 1). All the other soldiers wore military uniform. Soldiers G, H, I and J were positioned in a wooded area to the south of the Loughgall Road, near the junction with a road which is the first on the right from the police station going towards Armagh (Position 2). Soldiers K, L, M and N were positioned in a wooded area to the south of the Loughgall road, generally opposite No. 202 Loughgall Road (Position 3). Soldiers O, P, Q and R were instructed to position themselves in a wooded area to the south of the Loughgall Road, near what is known as Ballygasey Cottage (Position 4). Soldiers S, T and U were positioned in a wooded area to the rear of St Luke's Church, on the south side of the Loughgall Road and to the east of the RUC station (Position 5). Soldiers V, W and X occupied a position in a wooded area to the north of the Loughgall Road, about 300 to 400 yards to the rear of the RUC station (Position 6).

13. Three members of the RUC, Constables A, B and C, were positioned inside the RUC station. The RUC station, which operated on a part-time basis only, was opened as normal at 9 a.m. on 8 May 1987. Police Constable A was in charge of the station, with B and C assisting him in the running of the station. The station was closed at 11 a.m., re-opened at 5 p.m. and closed again at 7 p.m.

14. At about 2.30 p.m. two hooded men hijacked a blue Toyota Hiace van from a Mr Corr, who was carrying out some work at the Snooker Club, Mountjoy Road, Dungannon, Co Tyrone. He was warned not to report the incident to the police for four hours. When the men left, Mr Corr phoned his employer, the van's owner, and told him about the incident. The owner,

Mr McGrath, waited four hours and reported the incident to Coalisland RUC at approximately 6.50 p.m.

15. At about 6 p.m., three armed men who said they were from the IRA entered the house of the Mackle family in Aghinlig Upper, Dungannon. The men said they wanted to borrow the digger and one of the sons was brought outside to fill it with diesel. At about 6.30 p.m., a vehicle pulled up outside and a fourth man arrived. It appears that a bomb containing 300 to 400 pounds of explosives was prepared in the yard of the house and placed in the bucket of the digger. At about 6.50 p.m. the digger was driven out of the yard and the other vehicle left shortly afterwards. At about 7.10 p.m. the remaining two gunmen left the house. Attempts by the family to phone the police failed as their phone and that of their neighbour were out of order. However, two of the sons eventually alerted a police patrol.

### **B. The incident at Loughgall**

16. The soldiers reported a number of sightings of the blue Hiace van passing in front of the RUC station in both directions. Reports that the van had been hijacked, and that a digger was acting suspiciously in the area, were also received. Given this information and the knowledge that diggers had been used in previous terrorist attacks, the soldiers were on full alert when, between 7.15 and 7.30 p.m., the blue van came from the Loughgall direction and parked outside the station on the far side of the road facing Armagh.

17. A man, dressed in blue overalls and wearing a balaclava, emerged from the rear of the van and began to walk into the roadway. He raised his rifle and began to shoot at the RUC station. Soldiers A to E, who had positioned themselves at windows on the first floor of the station began to return fire without warning. Soldier F had set up the radio equipment in the rear ground floor room, and he remained there during the shooting. The driver then got out of the van and began to fire at the station. At least four more men emerged from the rear of the van and commenced firing at the station. Following continuous fire from the direction of the RUC station and from other soldiers, some of the IRA men began to take cover behind the van and others went to get into the back of the van. Soldiers A to E fired into the side of the van. Soldier B received a facial injury from flying glass after a window by which he was standing was broken by gunfire.

18. During this time, one of the IRA men drove the digger through the front gate of the station and Soldier B, having spotted this, fired a short burst at the driver. The digger stopped and shortly afterwards there was an explosion which caused masonry and dust to fly everywhere. Soldiers A to F and Constable A were unhurt by the blast, which damaged a large part of the station. Constable C was later treated for a fractured skull, damage to his left sinus, broken facial bone, a broken finger, a broken toe and bruising.



Constable B also received some injuries. Constables B and C were led outside by Constable A and Soldier C, who administered first aid to them. Soldier F also left the station by the rear and did not take any part in the shooting.

19. Soldiers A, B, D and E moved towards the front of the RUC station and continued to fire at the men near the van, firing through the sides of the van when the men took cover inside, until there was no further movement from the gunmen. In his statement to the police, Soldier B stated that he approached the van to clear it of further danger to his life and those of his colleagues. As he looked into the back of the van, he saw two men and a number of weapons. One of the men made a sudden movement and Soldier B fired one round into him as it was his belief that it was the man's intention to get one of the weapons. Soldier V stated that he approached the van with Soldier B, carrying out a visual check of the bodies. As he moved alongside the van, there was a movement in the area of a body that caught his eye. He took this as an immediate threat and fired one burst into the body.

20. Soldiers positioned in other areas also fired at the various gunmen once they had begun to shoot at the RUC station. Some of the soldiers stated that they came under fire. Shortly after the bomb exploded, Soldiers K and R observed what they thought was a gunman lying in the grass behind the police station. He failed to stand up when challenged to do so, and both soldiers fired several rounds at what turned out to be a large lump of wood. Moving down along the back of the houses towards the police station, Soldier K saw a man whom he apprehended, tied his hands and feet and handed him over to the RUC who arrested him. This man was a Mr Tennyson who was not involved in the attack. He happened on the shooting, and had left his car to seek cover when he was detained.

21. Soldier V fired at a man in a blue boiler suit crossing the road in a crouched manner. The man fell. He saw another man behind a wall and shouted to him to stand up. The man moved away quickly, then turned fully towards Soldier V who saw something in his hand which he regarded as an immediate threat and fired two bursts from his rifle until the man fell. Soldier S passing the body saw no weapon near it.

22. When the blue van and the digger arrived at the RUC station, there had been a white Citroen car right behind them. After shooting started but before the bomb went off, this car began to reverse towards the soldiers in position 5. Soldiers S, T and U opened automatic fire on the car and when they stopped firing the vehicle was about 20 metres away. The front seat passenger got out of the car despite a warning from Soldier U not to move. He was wearing blue coveralls. Almost immediately, he was hit by gunfire from Soldier U and he fell to the ground. Later realising that he was still alive, Soldiers S and U moved him onto the pavement and put two field

dressings on his wounds. The driver of the car was dead at the wheel of the car.

23. Soldier W approaching the police station noticed ten feet away in the driveway a person lying on his back still moving. He saw that the man's right hand was clenched and that something metallic was protruding. Believing the man to be a threat to himself and Soldier V, he fired two shots at him. Soldier X checking the body found that the man was holding a cigarette lighter.

24. Other vehicles near the scene of the attack included a red Sierra 15 metres from position 6, occupied by a woman and her daughter, a blue Escort about 70 metres from the scene which was empty and a white Sierra, with three female occupants. These cars, or their occupants, were directed to positions of safety by soldiers as soon as the opportunity arose.

25. When the shooting ceased the soldiers and members of the RUC were airlifted back to their barracks.

### **C. Police investigation of the incident**

26. From 7.35 p.m., officers from the RUC Criminal Investigation Department, the Scenes of Crime Department and the Northern Ireland Forensic Laboratory began arriving to survey the crime scene and identify items of forensic interest. Photographs were taken of the scene and of the bodies. The scene can be described as follows:

27. There were two significantly bullet damaged vehicles, a blue Toyota Hiace van (with approximately 125 bullet holes in the bodywork) and a white Citroen car (with approximately 34 bullet holes in the front, rear and side of the car). In the vicinity of the junction of Clovenden Road/Ballygasey Road there were bullet damaged Vauxhall Cavalier and Ford estate cars.

28. The bodies were wearing blue boiler suits except where specified otherwise.

The first body (Patrick Kelly) was found lying at the front of the van with a radio lying on the ground beside the body and a rifle lying on the body. There was debris on the rifle suggesting that this person was lying on the ground before the explosion. The pathologist noted that his right upper canine tooth had recently been torn out.

The second body (Michael Gormley) was lying on the pavement at the north side of the van near the open side door with a rifle nearby. The body was lying on top of the right leg of body 3, strongly suggesting that body 3 was lying on the ground before body 2 fell.

The third body (Seamus Donnelly) was lying on the pavement towards the north side of the Toyota van. There was ammunition and a cigarette lighter near the body. The pathologist observed at least twenty separate missile wounds (i.e. bullet and fragment) and found that discharge abrasion

on an entry wound on the front of the neck indicated that when the gun was discharged the muzzle was within several feet of the body, probably while it was lying on the ground.

The fourth body (Patrick McKearney) was lying face down along the outside panel inside the rear of the van with the head towards the rear door. There was ammunition in the pocket of the boiler suit (he was also wearing a flak jacket) and in the jeans pocket. The *post mortem* examination revealed at least a dozen wounds to the torso and head.

The fifth body (James Lynagh) was lying diagonally across the interior of the van with the feet towards the rear door. There was ammunition in the pocket of the boiler suit and in the anorak and jeans pockets. Material on the body suggested that it was on the floor before the explosion occurred. He had received multiple bullet and fragment injuries.

There were four loaded rifles and one shotgun found in the van. Three of the stocks were folded.

The sixth body (Eugene Kelly), which had massive head damage and multiple injuries elsewhere, was seated in the driver seat of the van. There was a revolver lying between the driver's seat and his door.

The seventh body (Declan Arthurs) was lying in a lane-way opposite the premises of the Loughgall Football Club. This body was not wearing a boiler suit and there was a cigarette lighter close to the right hand.

The eighth body (Gerald O'Callaghan) was lying on its right side on the pavement at the Loughgall side of the lane-way. Twelve wounds were noted by the pathologist.

The ninth body (Antony Hughes) was seated with the seat belt on in the driver's seat of the white Citroen car. The body was not wearing a boiler suit. The *post mortem* examination showed twenty-nine wounds (bullet and shrapnel).

29. At 10.35 p.m. on 8 May 1987, the police took possession of the firearms used by Soldiers A to X which were delivered the following day to the Northern Ireland Forensic Science Laboratory for examination.

30. On the morning of 9 May 1987, a scene of crimes officer and forensic experts from the Northern Ireland Forensic Science Laboratory conducted an examination of the scene and took possession of a large number of exhibits. The cars were removed for expert examination.

31. Spent cartridge cases were recovered from all over the crime scene which stretched from the junction of Cloveneden Road/Ballygasey Road to the Church/Church Hall in the vicinity of the start of Main Street, Loughgall. In total, 678 spent cartridge cases were recovered, 78 of which were from IRA weapons.

32. On 9 and 10 May 1987, two forensic doctors carried out *post mortem* examinations of the bodies.

33. Between 9 and 12 May 1987, police officers conducted lengthy interviews with soldiers A to X, each of whom made a written statement.

On 16 March 1988, soldier L was asked by the police to clarify his statement.

34. On 21 July 1988, the RUC forwarded a report to the Director of Public Prosecutions for Northern Ireland (the DPP) on the outcome of their RUC investigation. On 22 September 1988, he concluded that the evidence did not warrant the prosecution of any person involved in the shootings. The Government stated that this decision was notified to the next-of-kin of the deceased. The applicants stated that only the family of Antony Hughes was informed.

#### **D. The inquests**

35. On 9 May 1990, the statements taken during the RUC investigation were forwarded to the Coroner.

36. On 6 September 1990, the Coroner held a preliminary meeting attended by the lawyers representing the relatives of the deceased. At their request, he adjourned the inquest which he had intended to hold on 24 September 1990, pending the determination of the *Devine* case, before the Court of Appeal (and subsequently the House of Lords), which concerned the powers of Coroners and the procedure at inquests. Judgments were given by the Court of Appeal on 6 December 1990 and by the House of Lords on 6 February 1992, pursuant to which it was established that rule 17 of the Coroners' Rules did not prevent coroners admitting written statements in evidence.

37. The inquests were further adjourned pending the outcome of proceedings relating to the inquests into the deaths of Gervaise McKerr, Eugene Toman and Sean Burns (see application no. 28883/95 brought by Jonathan McKerr). These proceedings involved decisions by the High Court on 2 June 1992 and 21 December 1992 and by the Court of Appeal on 28 May 1993, by which it was held that relatives' counsel was entitled to see a document used by a witness to refresh his memory. There were further proceedings before the High Court on 20 April 1994, when the writs of subpoena, by which the Coroner had attempted to obtain, *inter alia*, copies of the Stalker and Sampson Reports, were set aside. The McKerr, Toman and Burns inquests terminated on 8 September 1994.

38. An inquest into the deaths of the men in the present case was opened on 30 May 1995 in public before a Coroner and a jury of 10 members. It lasted four days. The RUC and Ministry of Defence were represented. On the first day of the inquest, counsel representing the families of six out of the nine deceased (Patrick Kelly, Declan Arthurs, Eugene Kelly, Michael Gormley, Seamus Donnell and Gerard O'Callaghan) sought for the statements of prospective witnesses to be made available to them at the commencement of the proceedings together with the maps and photographs. The Coroner made available the maps and photographs but did not permit

counsel (other than those instructed on the Coroner's behalf) to see witness statements until the witness was giving evidence.

39. On the same day of the inquest, counsel for the six families asked for the proceedings to be adjourned to allow them to seek judicial review of the decision to refuse access to the witness statements. This adjournment was refused and, following the rejection of a second application, counsel was instructed by the six families to withdraw from the hearing to seek a remedy by way of judicial review. This step was taken on 31 May 1995 following consultation with the families and because it was felt "utterly impossible for the applicants' interests to be fairly or adequately represented given the rulings of the Coroner".

40. The hearing of the inquest proceeded without representation for any of the nine families. The Coroner heard 45 witnesses, including the brother of Antony Hughes who had been shot and injured, civilian and police eye-witnesses, including Constables A and B and the police officers involved in the investigation. None of the soldiers appeared but their statements were lodged. It was concluded on 2 June 1995 that all nine men had died from serious and multiple gun shot wounds.

41. The family of Declan Arthurs sought judicial review of the Coroner's decisions not to allow the legal representatives to see witness statements before they gave evidence, not to allow additional time to their advisers to consider expert and controversial evidence, and the refusal of the application for an adjournment. Leave was granted on 1 June 1995. In his judgment of 24 May 1996, Mr Justice McCollum in the High Court refused to quash the Coroner's decisions or the jury verdict. In doing so, the judge placed considerable emphasis on the character of an inquest as a fact finding exercise and not a method of apportioning guilt.

### **E. Civil proceedings**

42. Seven of the families (the relatives of Antony Hughes, Kevin Antony McKearney, Michael Gormley, Seamus Donnelly, Declan Arthurs, Gerard O'Callaghan and Eugene Kelly) issued civil proceedings against the Ministry of Defence on 2 December 1988, 20 March 1990 and 4 May 1990 respectively.

43. On 25 April 1991, the Hughes family settled proceedings for 100,000 pounds sterling (GBP) in respect of Antony Hughes, who was a civilian unconnected with the IRA gunmen.

44. No further steps were taken to pursue the proceedings by the family of Kevin Antony McKearney. Regarding the remaining five families, who are represented by the same lawyer, statements of claim were issued in October 1993, alleging that the shooting of the deceased represented excessive force and was unnecessary and unlawful or, alternatively, that

there was negligence, *inter alia*, in failing to give warnings or an opportunity to submit to lawful arrest and using excessive force.

45. On 13 January 1994, the five families issued notice of their intention to proceed with their claims.

46. On 3 March 1994, the Ministry of Defence served their defence, stating *inter alia* that the force used was necessary to prevent the deceased committing unlawful acts and to protect lives and personal safety. They also served a notice requesting further and better particulars of the statement of claim.

## II. RELEVANT DOMESTIC LAW AND PRACTICE

### A. Use of lethal force

47. Section 3 of the Criminal Law Act (Northern Ireland) 1967 provides *inter alia*:

“1. A person may use such force as is reasonable in the circumstances in the prevention of crime, or in effecting the arrest or assisting in the lawful arrest of offenders or suspected offenders or persons unlawfully at large.”

Self-defence or the defence of others is contained within the concept of the prevention of crime (see e.g. Smith and Hogan on Criminal Law).

### B. Inquests

#### 1. Statutory provisions and rules

48. The conduct of inquests in Northern Ireland is governed by the Coroners Act (Northern Ireland) 1959 and the Coroners (Practice and Procedure) Rules (Northern Ireland) 1963. These provide the framework for a procedure within which deaths by violence or in suspicious circumstances are notified to the Coroner, who then has the power to hold an inquest, with or without a jury, for the purpose of ascertaining, with the assistance as appropriate of the evidence of witnesses and reports, *inter alia*, of *post mortem* and forensic examinations, who the deceased was and how, when and where he died.

49. Pursuant to the Coroners Act, every medical practitioner, registrar of deaths or funeral undertaker who has reason to believe a person died directly or indirectly by violence is under an obligation to inform the Coroner (section 7). Every medical practitioner who performs a *post mortem* examination has to notify the Coroner of the result in writing (section 29). Whenever a dead body is found, or an unexplained death or

death in suspicious circumstances occurs, the police of that district are required to give notice to the Coroner (section 8).

50. Rules 12 and 13 of the Coroners Rules give power to the Coroner to adjourn an inquest where a person may be or has been charged with murder or other specified criminal offences in relation to the deceased.

51. Where the Coroner decides to hold an inquest with a jury, persons are called from the Jury List, compiled by random computer selection from the electoral register for the district on the same basis as in criminal trials.

52. The matters in issue at an inquest are governed by Rules 15 and 16 of the Coroners Rules:

“15. The proceedings and evidence at an inquest shall be directed solely to ascertaining the following matters, namely: -

(a) who the deceased was;

(b) how, when and where the deceased came by his death;

(c) the particulars for the time being required by the Births and Deaths Registration (Northern Ireland) Order 1976 to be registered concerning his death.

16. Neither the coroner nor the jury shall express any opinion on questions of criminal or civil liability or on any matters other than those referred to in the last foregoing Rule.”

53. The forms of verdict used in Northern Ireland accord with this recommendation, recording the name and other particulars of the deceased, a statement of the cause of death (e.g. bullet wounds) and findings as to when and where the deceased met his death. In England and Wales, the form of verdict appended to the English Coroners Rules contains a section marked “conclusions of the jury/coroner as to the death” in which conclusions such as “lawfully killed” or “killed unlawfully” are inserted. These findings involve expressing an opinion on criminal liability in that they involve a finding as to whether the death resulted from a criminal act, but no finding is made that any identified person was criminally liable. The jury in England and Wales may also append recommendations to their verdict.

54. However, in Northern Ireland, the Coroner is under a duty (section 6(2) of the Prosecution of Offences Order (Northern Ireland) 1972) to furnish a written report to the DPP where the circumstances of any death appear to disclose that a criminal offence may have been committed.

55. Until recently, legal aid was not available for inquests as they did not involve the determination of civil liabilities or criminal charges. Legislation which would have provided for legal aid at the hearing of inquests (the Legal Aid, Advice and Assistance (Northern Ireland) Order 1981, Schedule 1 paragraph 5) has not been brought into force. However, on 25 July 2000, the Lord Chancellor announced the establishment of an Extra-Statutory Ex

Gratia Scheme to make public funding available for representation for proceedings before Coroners in exceptional inquests in Northern Ireland. In March 2001, he published for consultation the criteria to be used in deciding whether applications for representation at inquests should receive public funding. This included *inter alia* consideration of financial eligibility, whether an effective investigation by the State was needed and whether the inquest was the only way to conduct it, whether the applicant required representation to be able to participate effectively in the inquest and whether the applicant had a sufficiently close relationship to the deceased.

56. The Coroner enjoys the power to summon witnesses who he thinks it necessary to attend the inquest (section 17 of the Coroners Act) and he may allow any interested person to examine a witness (Rule 7). In both England and Wales and Northern Ireland, a witness is entitled to rely on the privilege against self-incrimination. In Northern Ireland, this privilege is reinforced by Rule 9(2) which provides that a person suspected of causing the death may not be compelled to give evidence at the inquest.

57. In relation to both documentary evidence and the oral evidence of witnesses, inquests, like criminal trials, are subject to the law of public interest immunity, which recognises and gives effect to the public interest, such as national security, in the non-disclosure of certain information or certain documents or classes of document. A claim of public interest immunity must be supported by a certificate.

## 2. *The scope of inquests*

58. Rules 15 and 16 (see above) follow from the recommendation of the Brodrick Committee on Death Certification and Coroners:

“... the function of an inquest should be simply to seek out and record as many of the facts concerning the death as the public interest requires, without deducing from those facts any determination of blame... In many cases, perhaps the majority, the facts themselves will demonstrate quite clearly whether anyone bears any responsibility for the death; there is a difference between a form of proceeding which affords to others the opportunity to judge an issue and one which appears to judge the issue itself.”

59. Domestic courts have made, *inter alia*, the following comments:

“... It is noteworthy that the task is not to ascertain how the deceased died, which might raise general and far-reaching issues, but ‘how...the deceased came by his death’, a far more limited question directed to the means by which the deceased came by his death.

... [previous judgments] make it clear that when the Brodrick Committee stated that one of the purposes of an inquest is ‘To allay rumours or suspicions’ this purpose should be confined to allaying rumours and suspicions of how the deceased came by his death and not to allaying rumours or suspicions about the broad circumstances in which the deceased came by his death.” (Sir Thomas Bingham, MR, Court of Appeal, *R. v the Coroner for North Humberside and Scunthorpe ex parte Roy Jamieson*, April 1994, unreported)



“The cases establish that although the word ‘how’ is to be widely interpreted, it means ‘by what means’ rather than in what broad circumstances ... In short, the inquiry must focus on matters directly causative of death and must, indeed, be confined to those matters alone ...” (Simon Brown LJ, Court of Appeal, *R. v. Coroner for Western District of East Sussex, ex parte Homberg and others*, (1994) 158 JP 357)

“... it should not be forgotten that an inquest is a fact finding exercise and not a method of apportioning guilt. The procedure and rules of evidence which are suitable for one are unsuitable for the other. In an inquest it should never be forgotten that there are no parties, no indictment, there is no prosecution, there is no defence, there is no trial, simply an attempt to establish the facts. It is an inquisitorial process, a process of investigation quite unlike a trial...

It is well recognised that a purpose of an inquest is that rumour may be allayed. But that does not mean it is the duty of the Coroner to investigate at an inquest every rumour or allegation that may be brought to his attention. It is ... his duty to discharge his statutory role - the scope of his enquiry must not be allowed to drift into the uncharted seas of rumour and allegation. He will proceed safely and properly if he investigates the facts which it appears are relevant to the statutory issues before him.” (Lord Lane, Court of Appeal, *R v. South London Coroner ex parte Thompson* (1982) 126 SJ 625)

### 3. Disclosure of documents

60. There was no requirement prior to 1999 for the families at inquests to receive copies of the written statements or documents submitted to the Coroner during the inquest. Coroners generally adopted the practice of disclosing the statements or documents during the inquest proceedings, as the relevant witness came forward to give evidence.

61. Following the recommendation of the Stephen Lawrence Inquiry, Home Office Circular No. 20/99 (concerning deaths in custody or deaths resulting from the actions of a police officer in purported execution of his duty) advised Chief Constables of police forces in England and Wales to make arrangements in such cases for the pre-inquest disclosure of documentary evidence to interested parties. This was to “help provide reassurance to the family of the deceased and other interested persons that a full and open police investigation has been conducted, and that they and their legal representatives will not be disadvantaged at the inquest”. Such disclosure was recommended to take place 28 days before the inquest.

62. Paragraph 7 of the Circular stated:

“The courts have established that statements taken by the police and other documentary material produced by the police during the investigation of a death in police custody are the property of the force commissioning the investigation. The Coroner has no power to order the pre-inquest disclosure of such material... Disclosure will therefore be on a voluntary basis..”

Paragraph 9 listed some kinds of material which require particular consideration before being disclosed, for example:

- where disclosure of documents might have a prejudicial effect on possible subsequent proceedings (criminal, civil or disciplinary);
- where the material concerns sensitive or personal information about the deceased or unsubstantiated allegations which might cause distress to the family; and
- personal information about third parties not material to the inquest.

Paragraph 11 envisaged that there would be non-disclosure of the investigating officer's report although it might be possible to disclose it in those cases which the Chief Constable considered appropriate.

### **C. Police Complaints Procedures**

63. The police complaints procedure was governed at the relevant time by the Police (Northern Ireland) Order 1987 (the 1987 Order). This replaced the Police Complaints Board, which had been set up in 1977, by the Independent Commission for Police Complaints (the ICPC). The ICPC has been replaced from 1 October 2000 with the Police Ombudsman for Northern Ireland appointed under the Police (Northern Ireland) Act 1998.

64. The ICPC was an independent body, consisting of a chairman, two deputy chairmen and at least four other members. Where a complaint against the police was being investigated by a police officer or where the Chief Constable or Secretary of State considered that a criminal offence might have been committed by a police officer, the case was referred to the ICPC.

65. The ICPC was required under Article 9(1)(a) of the 1987 Order to supervise the investigation of any complaint alleging that the conduct of a RUC officer had resulted in death or serious injury. Its approval was required of the appointment of the police officer to conduct the investigation and it could require the investigating officer to be replaced (Article 9(5)(b)). A report by the investigating officer was submitted to the ICPC concerning supervised investigations at the same time as to the Chief Constable. Pursuant to Article 9(8) of the 1987 Order, the ICPC issued a statement whether the investigation had been conducted to its satisfaction and, if not, specifying any respect in which it had not been so conducted.

66. The Chief Constable was required under Article 10 of the 1987 Order to determine whether the report indicated that a criminal offence had been committed by a member of the police force. If he so decided and considered that the officer ought to be charged, he was required to send a copy of the report to the DPP. If the DPP decided not to prefer criminal charges, the Chief Constable was required to send a memorandum to the ICPC indicating whether he intended to bring disciplinary proceedings against the officer (Article 10(5)) save where disciplinary proceedings had been brought and the police officer had admitted the charges (Article 11(1)). Where the Chief Constable considered that a criminal offence had been

committed but that the offence was not such that the police officer should be charged or where he considered that no criminal offence had been committed, he was required to send a memorandum indicating whether he intended to bring disciplinary charges and, if not, his reasons for not proposing to do so (Article 11(6) and (7)).

67. If the ICPC considered that a police officer subject to investigation ought to be charged with a criminal offence, it could direct the Chief Constable to send the DPP a copy of the report on that investigation (Article 12(2)). It could also recommend or direct the Chief Constable to prefer such disciplinary charges as the ICPC specified (Article 13(1) and (3)).

#### **D. The Director of Public Prosecutions**

68. The Director of Public Prosecutions (the DPP), appointed pursuant to the Prosecution of Offences (Northern Ireland) 1972 (the 1972 Order) is an independent officer with at least 10 years' experience of the practice of law in Northern Ireland who is appointed by the Attorney General and who holds office until retirement, subject only to dismissal for misconduct. His duties under Article 5 of the 1972 Order are *inter alia*:

“(a) to consider, or cause to be considered, with a view to his initiating or continuing in Northern Ireland any criminal proceedings or the bringing of any appeal or other proceedings in or in connection with any criminal cause or matter in Northern Ireland, any facts or information brought to his notice, whether by the Chief Constable acting in pursuance of Article 6(3) of this Order or by the Attorney General or by any other authority or person;

(b) to examine or cause to be examined all documents that are required under Article 6 of this Order to be transmitted or furnished to him and where it appears to him to be necessary or appropriate to do so to cause any matter arising thereon to be further investigated;

(c) where he thinks proper to initiate, undertake and carry on, on behalf of the Crown, proceedings for indictable offences and for such summary offences or classes of summary offences as he considers should be dealt with by him.”

69. Article 6 of the 1972 Order requires *inter alia* Coroners and the Chief Constable of the RUC to provide information to the DPP as follows:

“(2) Where the circumstances of any death investigated or being investigated by a coroner appear to him to disclose that a criminal offence may have been committed he shall as soon as practicable furnish to the [DPP] a written report of those circumstances.

(3) It shall be the duty of the Chief Constable, from time to time, to furnish to the [DPP] facts and information with respect to –

(a) indictable offences [such as murder] alleged to have been committed against the law of Northern Ireland; ...

and at the request of the [DPP], to ascertain and furnish to the [DPP] information regarding any matter which may appear to the [DPP] to require investigation on the ground that it may involve an offence against the law of Northern Ireland or information which may appear to the [DPP] to be necessary for the discharge of his functions under this Order.”

70. According to the Government’s observations submitted on 18 June 1998, it had been the practice of successive DPPs to refrain from giving reasons for decisions not to institute or proceed with criminal prosecutions other than in the most general terms. This practice was based upon the consideration that

- (1) if reason were given in one or more cases, they would be required to be given in all. Otherwise, erroneous conclusions might be drawn in relation to those cases where reasons were refused, involving either unjust implications regarding the guilt of some individuals or suspicions of malpractice;
- (2) the reason not to prosecute might often be the unavailability of a particular item of evidence essential to establish the case (e.g. sudden death or flight of a witness or intimidation). To indicate such a factor as the sole reason for not prosecuting might lead to assumptions of guilt in the public estimation;
- (3) the publication of the reasons might cause pain or damage to persons other than the suspect (e.g. the assessment of the credibility or mental condition of the victim or other witnesses);
- (4) in a substantial category of cases decisions not to prosecute were based on the DPP’s assessment of the public interest. Where the sole reason not to prosecute was the age, mental or physical health of the suspect, publication would not be appropriate and could lead to unjust implications;
- (5) there might be considerations of national security which affected the safety of individuals (e.g. where no prosecution could safely or fairly be brought without disclosing information which would be of assistance to terrorist organisations, would impair the effectiveness of the counter-terrorist operations of the security forces or endanger the lives of such personnel and their families or informants).

71. Decisions of the DPP not to prosecute have been subject to applications for judicial review in the High Court.

In *R. v. DPP ex parte C* (1995) 1 CAR, p. 141, Lord Justice Kennedy held, concerning a decision of the DPP not to prosecute in an alleged case of buggery:

“From all of those decisions it seems to me that in the context of the present case this court can be persuaded to act if and only if it is demonstrated to us that the Director of Public Prosecutions acting through the Crown Prosecution Service arrived at the decision not to prosecute:

(1) because of some unlawful policy (such as the hypothetical decision in Blackburn not to prosecute where the value of goods stolen was below £100);

(2) because the Director of Public Prosecutions failed to act in accordance with his own settled policy as set out in the code; or

(3) because the decision was perverse. It was a decision at which no reasonable prosecutor could have arrived.”

72. In the case of *R. v. the DPP and Others ex parte Timothy Jones* the Divisional Court on 22 March 2000 quashed a decision not to prosecute for alleged gross negligence causing a death in dock unloading on the basis that the reasons given by the DPP – that the evidence was not sufficient to provide a realistic prospect of satisfying a jury - required further explanation.

73. *R. v. DPP ex parte Patricia Manning and Elizabeth Manning* (decision of the Divisional Court of 17 May 2000) concerned the DPP’s decision not to prosecute any prison officer for manslaughter in respect of the death of a prisoner, although the inquest jury had reached a verdict of unlawful death - there was evidence that prison officers had used a neck lock which was forbidden and dangerous. The DPP reviewing the case still concluded that the Crown would be unable to establish manslaughter from gross negligence. The Lord Chief Justice noted:

“Authority makes clear that a decision by the Director not to prosecute is susceptible to judicial review: see, for example, R. v. Director of Public Prosecutions, ex parte C [1995] 1 Cr. App. R. 136. But, as the decided cases also make clear, the power of review is one to be sparingly exercised. The reasons for this are clear. The primary decision to prosecute or not to prosecute is entrusted by Parliament to the Director as head of an independent, professional prosecuting service, answerable to the Attorney General in his role as guardian of the public interest, and to no-one else. It makes no difference that in practice the decision will ordinarily be taken by a senior member of the CPS, as it was here, and not by the Director personally. In any borderline case the decision may be one of acute difficulty, since while a defendant whom a jury would be likely to convict should properly be brought to justice and tried, a defendant whom a jury would be likely to acquit should not be subjected to the trauma inherent in a criminal trial. If, in a case such as the present, the Director’s provisional decision is not to prosecute, that decision will be subject to review by Senior Treasury Counsel who will exercise an independent professional judgment. The Director and his officials (and Senior Treasury Counsel when consulted) will bring to their task of deciding whether to prosecute an experience and expertise which most courts called upon to review their decisions could not match. In most cases the decision will turn not on an analysis of the relevant legal principles but on the exercise of an informed judgment of how a case against a particular defendant, if brought, would be likely to fare in the context of a criminal trial before (in a serious case such as this) a jury. This exercise of judgment involves an assessment of the strength, by the end of the trial, of the evidence against the defendant and of the likely defences. It will often be impossible to stigmatise a judgment on such matters as wrong even if one disagrees with it. So the courts will not easily find that a decision not to prosecute is bad in law, on which basis alone the court is entitled to interfere. At the same time, the standard of review should not be set too high, since judicial review is the only

means by which the citizen can seek redress against a decision not to prosecute and if the test were too exacting an effective remedy would be denied.”

As regards whether the DPP had a duty to give reasons, the Lord Chief Justice said:

“It is not contended that the Director is subject to an obligation to give reasons in every case in which he decides not to prosecute. Even in the small and very narrowly defined cases which meet Mr Blake’s conditions set out above, we do not understand domestic law or the jurisprudence of the European Court of Human Rights to impose an absolute and unqualified obligation to give reasons for a decision not to prosecute. But the right to life is the most fundamental of all human rights. It is put at the forefront of the Convention. The power to derogate from it is very limited. The death of a person in the custody of the State must always arouse concern, as recognised by section 8(1)(c), (3)(b) and (6) of the Coroner’s Act 1988, and if the death resulted from violence inflicted by agents of the State that concern must be profound. The holding of an inquest in public by an independent judicial official, the coroner, in which interested parties are able to participate must in our view be regarded as a full and effective inquiry (see *McCann v. United Kingdom* [1996] 21 EHRR 97, paragraphs 159 to 164). Where such an inquest following a proper direction to the jury culminates in a lawful verdict of unlawful killing implicating a person who, although not named in the verdict, is clearly identified, who is living and whose whereabouts are known, the ordinary expectation would naturally be that a prosecution would follow. In the absence of compelling grounds for not giving reasons, we would expect the Director to give reasons in such a case: to meet the reasonable expectation of interested parties that either a prosecution would follow or a reasonable explanation for not prosecuting be given, to vindicate the Director’s decision by showing that solid grounds exist for what might otherwise appear to be a surprising or even inexplicable decision and to meet the European Court’s expectation that if a prosecution is not to follow a plausible explanation will be given. We would be very surprised if such a general practice were not welcome to Members of Parliament whose constituents have died in such circumstances. We readily accept that such reasons would have to be drawn with care and skill so as to respect third party and public interests and avoid undue prejudice to those who would have no opportunity to defend themselves. We also accept that time and skill would be needed to prepare a summary which was reasonably brief but did not distort the true basis of the decision. But the number of cases which meet Mr Blake’s conditions is very small (we were told that since 1981, including deaths in police custody, there have been seven such cases), and the time and expense involved could scarcely be greater than that involved in resisting an application for judicial review. In any event it would seem to be wrong in principle to require the citizen to make a complaint of unlawfulness against the Director in order to obtain a response which good administrative practice would in the ordinary course require.”

On this basis, the court reviewed whether the reasons given by the DPP in that case were in accordance with the Code for Crown Prosecutors and capable of supporting a decision not to prosecute. It found that the decision had failed to take relevant matters into account and that this vitiated the decision not to prosecute. The decision was quashed and the DPP was required to reconsider his decision whether or not to prosecute.

74. *In the Matter of an Application by David Adams for Judicial Review*, the High Court in Northern Ireland on 7 June 2000 considered the

applicant's claim that the DPP had failed to give adequate and intelligible reasons for his decision not to prosecute any police officer concerned in the arrest during which he had suffered serious injuries and for which in civil proceedings he had obtained an award of damages against the police. It noted that there was no statutory obligation on the DPP under the 1972 Order to give reasons and considered that not duty to give reasons could be implied. The fact that the DPP in England and Wales had in a number of cases furnished detailed reasons, whether from increasing concern for transparency or in the interests of the victim's families, was a matter for his discretion. It concluded on the basis of authorities that only in exceptional cases such as the Manning case (paragraph 73 above) would the DPP be required to furnish reasons to a victim for failing to prosecute and that review should be limited to where the principles identified by Lord Justice Kennedy (paragraph 71 above) were infringed. Notwithstanding the findings in the civil case, they were not persuaded that the DPP had acted in such an aberrant, inexplicable or irrational manner that the case cried out for reasons to be furnished as to why he had so acted.

### III. RELEVANT INTERNATIONAL LAW AND PRACTICE

#### A. The United Nations

75. The United Nations Basic Principles on the Use of Force and Firearms by Law Enforcement Officials (UN Force and Firearms Principles) were adopted on 7 September 1990 by the Eighth United Nations Congress on the Prevention of Crime and the Treatment of Offenders.

76. Paragraph 9 of the UN Force and Firearms Principles provides, *inter alia*, that the "intentional lethal use of firearms may only be made when strictly unavoidable in order to protect life".

77. Other relevant provisions read as follows:

#### Paragraph 10

"... law enforcement officials shall identify themselves as such and shall give a clear warning of their intent to use firearms, with sufficient time for the warnings to be observed, unless to do so would unduly place the law enforcement officials at risk or would create a risk of death or serious harm to other persons, or would be clearly inappropriate or pointless in the circumstances of the incident."

#### Paragraph 22

"... Governments and law enforcement agencies shall ensure that an effective review process is available and that independent administrative or prosecutorial authorities are in a position to exercise jurisdiction in appropriate circumstances. In cases of death and serious injury or other grave consequences, a detailed report shall be sent promptly to the competent authorities responsible for administrative review and judicial control."

### Paragraph 23

“Persons affected by the use of force and firearms or their legal representatives shall have access to an independent process, including a judicial process. In the event of the death of such persons, this provision shall apply to their dependants accordingly.”

78. Paragraph 9 of the United Nations Principles on the Effective Prevention and Investigation of Extra-Legal, Arbitrary and Summary Executions, adopted on 24 May 1989 by the Economic and Social Council Resolution 1989/65, (UN Principles on Extra-Legal Executions) provides, *inter alia*, that:

“There shall be a thorough, prompt and impartial investigation of all suspected cases of extra legal, arbitrary and summary executions, including cases where complaints by relatives or other reliable reports suggest unnatural death in the above circumstances ...”

79. Paragraphs 10 to 17 of the UN Principles on Extra-Legal Executions contain a series of detailed requirements that should be observed by investigative procedures into such deaths.

Paragraph 10 states, *inter alia*:

“The investigative authority shall have the power to obtain all the information necessary to the inquiry. Those persons conducting the inquiry ... shall also have the authority to oblige officials allegedly involved in any such executions to appear and testify ...”

Paragraph 11 specifies:

“In cases in which the established investigative procedures are inadequate because of a lack of expertise or impartiality, because of the importance of the matter or because of the apparent existence of a pattern of abuse, and in cases where there are complaints from the family of the victim about these inadequacies or other substantial reasons, Governments shall pursue investigations through an independent commission of inquiry or similar procedure. Members of such a commission shall be chosen for their recognised impartiality, competence and independence as individuals. In particular, they shall be independent of any institution, agency or person that may be the subject of the inquiry. The commission shall have the authority to obtain all information necessary to the inquiry and shall conduct the inquiry as provided in these principles.”

Paragraph 16 provides, *inter alia*:

“Families of the deceased and their legal representatives shall be informed of, and have access to, any hearing as well as all information relevant to the investigation and shall be entitled to present other evidence ...”

Paragraph 17 provides, *inter alia*:

“A written report shall be made within a reasonable time on the methods and findings of such investigations. The report shall be made public immediately and shall include the scope of the inquiry, procedures, methods used to evaluate evidence as well as conclusions and recommendations based on findings of fact and on applicable law ...”



80. The “Minnesota Protocol” (Model Protocol for a legal investigation of extra-legal, arbitrary and summary executions, contained in the UN Manual on the Effective Prevention and Investigation of Extra-legal, Arbitrary and Summary Executions) provides, *inter alia*, in section B on the “Purposes of an inquiry”:

“As set out in paragraph 9 of the Principles, the broad purpose of an inquiry is to discover the truth about the events leading to the suspicious death of a victim. To fulfil that purpose, those conducting the inquiry shall, at a minimum, seek:

- (a) to identify the victim;
- (b) to recover and preserve evidentiary material related to the death to aid in any potential prosecution of those responsible;
- (c) to identify possible witnesses and obtain statements from them concerning the death;
- (d) to determine the cause, manner, location and time of death, as well as any pattern or practice that may have brought about the death;
- (e) to distinguish between natural death, accidental death, suicide and homicide;
- (f) to identify and apprehend the person(s) involved in the death;
- (g) to bring the suspected perpetrator(s) before a competent court established by law.”

In section D, it is stated that “In cases where government involvement is suspected, an objective and impartial investigation may not be possible unless a special commission of inquiry is established ...”

## **B. The European Committee for the Prevention of Torture**

81. In the report on its visit to the United Kingdom and the Isle of Man from 8 to 17 September 1999, published on 13 January 2000, the European Committee for the Prevention of Torture (the CPT) reviewed the system of preferring criminal and disciplinary charges against police officers accused of ill-treating persons. It commented, *inter alia*, on the statistically few criminal prosecutions and disciplinary proceedings which were brought, and identified certain aspects of the procedures which cast doubt on their effectiveness:

The chief officers appointed officers from the same force to conduct the investigations, save in exceptional cases where they appointed an officer from another force, and the majority of investigations were unsupervised by the Police Complaints Authority.

It stated at paragraph 55:

“As already indicated, the CPT itself entertains reservations about whether the PCA [the Police Complaints Authority], even equipped with the enhanced powers which have been proposed, will be capable of persuading public opinion that complaints against the police are vigorously investigated. **In the view of the CPT, the creation of a fully-fledged independent investigating agency would be a most welcome development. Such a body should certainly, like the PCA, have the power to direct that disciplinary proceedings be instigated against police officers. Further, in the interests of bolstering public confidence, it might also be thought appropriate that such a body be invested with the power to remit a case directly to the CPS for consideration of whether or not criminal proceedings should be brought.**

In any event, **the CPT recommends that the role of the ‘chief officer’ within the existing system be reviewed.** To take the example of one Metropolitan Police officer to whom certain of the chief officer’s functions have been delegated (the Director of the CIB [Criminal Investigations Bureau]), he is currently expected to: seek dispensations from the PCA; appoint investigating police officers and assume managerial responsibility for their work; determine whether an investigating officer’s report indicates that a criminal offence may have been committed; decide whether to bring disciplinary proceedings against a police officer on the basis of an investigating officer’s report, and liaise with the PCA on this question; determine which disciplinary charges should be brought against an officer who is to face charges; in civil cases, negotiate settlement strategies and authorise payments into court. It is doubtful whether it is realistic to expect any single official to be able to perform all of these functions in an entirely independent and impartial way.

57. ...Reference should also be made to the high degree of public interest in CPS [Crown Prosecution Service] decisions regarding the prosecution of police officers (especially in cases involving allegations of serious misconduct). Confidence about the manner in which such decisions are reached would certainly be strengthened were the CPS to be obliged to give detailed reasons in cases where it was decided that no criminal proceedings should be brought. The CPT recommends that such a requirement be introduced.”

## THE LAW

### I. ALLEGED VIOLATIONS OF ARTICLE 2 OF THE CONVENTION

82. The applicants submitted that their relatives had been unjustifiably killed and that there had been no effective investigation into the circumstances of their death. They invoked Article 2 of the Convention which provides:

“1. Everyone’s right to life shall be protected by law. No one shall be deprived of his life intentionally save in the execution of a sentence of a court following his conviction of a crime for which this penalty is provided by law.

2. Deprivation of life shall not be regarded as inflicted in contravention of this Article when it results from the use of force which is no more than absolutely necessary:

- (a) in defence of any person from unlawful violence;
- (b) in order to effect a lawful arrest or to prevent the escape of a person lawfully detained;
- (c) in action lawfully taken for the purpose of quelling a riot or insurrection.”

## **A. The submissions made to the Court**

### *1. The applicant*

83. The applicants submitted that the death of their relatives was the result of the unnecessary and disproportionate use of force by SAS soldiers and that their relatives were the victims of a shoot-to-kill policy operated by the United Kingdom Government in Northern Ireland. They argued that in this case the planning and conduct of the operation were such as to suggest that its object was to kill all those involved or that it was negligent as to whether deaths would occur. They referred to the context in which the authorities were applying a more aggressive security response, to the prior knowledge which the security forces had of the operation, including the members of the IRA involved, the fact that no steps were taken to arrest or intercept the IRA members before the incident and that the operation was run as an ambush intended to kill those walking into it. There was no attempt to warn or arrest the IRA members when they arrived on the scene. Instead, there was a heavy concentration of fire which also placed civilians at risk of death and injury. No attempt was made to stop civilian cars from entering the location of the ambush. Having regard to the number and type of bullets fired (600 bullets were recovered out of a possible 2585 used and a mixture of ball tracer and armour piercing ammunition employed), the fact that at least three of the dead men were unarmed, the way in which the soldiers acted to neutralise any perceived threat and the evidence that at least one man (Seamus Donnelly) had been shot at close range while on the ground, the operation could not be regarded as employing minimum or proportionate force.

84. The inadequate investigations into this and other cases were also evidence of official tolerance on the part of the State of the use of unlawful lethal force. Here, none of the soldiers were arrested although there were grounds for doing so. They were allowed to leave the scene and not questioned for up to three days later. They had not been isolated from each other and their statements bore remarkable similarity in language, structure and content.

85. The applicants submitted that, while they had been denied any effective resolution to their claims, there was sufficient evidence to justify the Court in ruling that there had been a substantive violation of Article 2. They pointed out that the Government had not presented any arguments that the authorities had done their best to minimise the risk to life during the operation. To the extent that the Court felt unable to reach any conclusions on the facts, they argued that the Court should hear evidence from the soldiers and police officers involved in the incident and the investigation.

86. The applicants further submitted that there had been no effective official investigation carried out into the killings, relying on the international standards set out in the Minnesota Protocol. They argued that the RUC investigation was inadequate and flawed by its lack of independence from the security forces involved in the operation, as well as a lack of publicity or input from the family. The DPP's own role was limited by the RUC investigation and he did not make public his reasons for not prosecuting. The inquest procedure was flawed by the delays, the limited scope of the enquiry which could not deal with issues of training or planning or control of the operation, a lack of legal aid for relatives, a lack of access to documents and witness statements, the non-compellability of security force or police witnesses and the use of public interest immunity certificates. The Government could not rely on civil proceedings either, as this depended on the initiative of the deceased's family.

## *2. The Government*

87. While the Government did not accept the applicants' claims under Article 2 that their relatives were killed by any excessive or unjustified use of force, they considered that it would be wholly inappropriate for the Court to seek itself to determine the issues of fact arising on the substantive issues of Article 2. This might involve the Court seeking to resolve issues, and perhaps examining witnesses and conducting hearings, at the same time as the High Court in Northern Ireland, with a real risk of inconsistent findings. It would also allow the applicants to forum-shop and would thus undermine the principle of exhaustion of domestic remedies. They submitted that there were in any event considerable practical difficulties for the Court to pursue an examination of the substantive aspects of Article 2 as the factual issues would be numerous and complex, involving live evidence with a substantial number of witnesses. This primary fact finding exercise should not be performed twice, in parallel, such an undertaking wasting court time and costs and giving rise to a real risk of prejudice in having to defend two sets of proceedings simultaneously.

88. Insofar as the applicants invited the Court to find a practice of killing rather than arresting terrorist suspects, this allegation was emphatically denied. The Government submitted that such a wide ranging allegation calling into question every anti-terrorist operation over the last thirty years

went far beyond the scope of this application and referred to matters not before this Court. They denied that there had been any inadequacy in the investigation in this case. The police officers who investigated had no prior knowledge of, or involvement in the operation, and their independence and integrity were not compromised by the fact that they were stationed in Armagh. The soldiers were interviewed as soon as the interviewing officers were ready to do so and the number of soldiers involved resulted in the process taking several days. They were entitled to have their legal advisers present and were instructed not to discuss the incident beforehand or to bring statements ready prepared. There was no evidence of collusion in the statements given.

89. The Government further denied that domestic law in any way failed to comply with the requirements of this provision. They argued that the procedural aspect of Article 2 was satisfied by the combination of procedures available in Northern Ireland, namely, the police investigation, which was supervised by the ICPC and by the DPP, the inquest proceedings and civil proceedings. These secured the fundamental purpose of the procedural obligation, in that they provided for effective accountability for the use of lethal force by State agents. This did not require that a criminal prosecution be brought but that the investigation was capable of leading to a prosecution, which was the case in this application. They also pointed out that each case had to be judged on its facts since the effectiveness of any procedural ingredient may vary with the circumstances. In the present case, they submitted that the available procedures together provided the necessary effectiveness, independence and transparency by way of safeguards against abuse.

### 3. *The Northern Ireland Human Rights Commission*

90. Referring to relevant international standards concerning the right to life (e.g. the Inter-American Court's case-law and the findings of the UN Human Rights Committee), the Commission submitted that the State had to carry out an effective official investigation when an agent of the State was involved or implicated in the use of lethal force. Internal accountability procedures had to satisfy the standards of effectiveness, independence, transparency and promptness, and facilitate punitive sanctions. It was however, in their view, not sufficient for a State to declare that while certain mechanisms were inadequate, a number of such mechanisms regarded cumulatively could provide the necessary protection. They submitted that the investigative mechanisms relied on in this case, singly or combined, failed to do so. They referred, *inter alia*, to the problematic role of the RUC in Northern Ireland, the allegedly serious deficiencies in the mechanisms of police accountability, the limited scope of and delays in inquests, and the lack of compellability of the members of the security forces who have used lethal force to appear at inquests. They drew the Court's attention to the

form of enquiry carried out in Scotland under the Sheriff, a judge of criminal and civil jurisdiction, where the next of kin have a right to appear. They urged the Court to take the opportunity to give precise guidance as to the form which investigations into the use of lethal force by State agents should take.

## **B. The Court's assessment**

### *1. General principles*

91. Article 2, which safeguards the right to life and sets out the circumstances when deprivation of life may be justified, ranks as one of the most fundamental provisions in the Convention, to which in peacetime no derogation is permitted under Article 15. Together with Article 3, it also enshrines one of the basic values of the democratic societies making up the Council of Europe. The circumstances in which deprivation of life may be justified must therefore be strictly construed. The object and purpose of the Convention as an instrument for the protection of individual human beings also requires that Article 2 be interpreted and applied so as to make its safeguards practical and effective (see the *McCann and Others v. the United Kingdom* judgment of 27 September 1995, Series A no. 324, pp. 45-46, §§ 146-147).

92. In the light of the importance of the protection afforded by Article 2, the Court must subject deprivations of life to the most careful scrutiny, taking into consideration not only the actions of State agents but also all the surrounding circumstances. Where the events in issue lie wholly, or in large part, within the exclusive knowledge of the authorities, as for example in the case of persons within their control in custody, strong presumptions of fact will arise in respect of injuries and death which occur. Indeed, the burden of proof may be regarded as resting on the authorities to provide a satisfactory and convincing explanation (see *Salman v. Turkey* [GC] no. 21986/93, ECHR 2000-VII, § 100, and also *Çakıcı v. Turkey*, [GC] ECHR 1999- IV, § 85, *Ertak v. Turkey* no. 20764/92 [Section 1] ECHR 2000-V, § 32 and *Timurtaş v. Turkey*, no; 23531/94 [Section 1] ECHR 2000-VI, § 82).

93. The text of Article 2, read as a whole, demonstrates that it covers not only intentional killing but also the situations where it is permitted to “use force” which may result, as an unintended outcome, in the deprivation of life. The deliberate or intended use of lethal force is only one factor however to be taken into account in assessing its necessity. Any use of force must be no more than “absolutely necessary” for the achievement of one or more of the purposes set out in sub-paragraphs (a) to (c). This term indicates that a stricter and more compelling test of necessity must be employed from that normally applicable when determining whether State action is “necessary in a democratic society” under paragraphs 2 of Articles 8 to 11

of the Convention. Consequently, the force used must be strictly proportionate to the achievement of the permitted aims (the McCann judgment, cited above, §§ 148-149).

94. The obligation to protect the right to life under Article 2 of the Convention, read in conjunction with the State's general duty under Article 1 of the Convention to "secure to everyone within [its] jurisdiction the rights and freedoms defined in [the] Convention", also requires by implication that there should be some form of effective official investigation when individuals have been killed as a result of the use of force (see, *mutatis mutandis*, the McCann judgment, cited above, p. 49, § 161, and the *Kaya v. Turkey* judgment of 19 February 1998, *Reports of Judgments and Decisions* 1998-I, p. 329, § 105). The essential purpose of such investigation is to secure the effective implementation of the domestic laws which protect the right to life and, in those cases involving State agents or bodies, to ensure their accountability for deaths occurring under their responsibility. What form of investigation will achieve those purposes may vary in different circumstances. However, whatever mode is employed, the authorities must act of their own motion, once the matter has come to their attention. They cannot leave it to the initiative of the next of kin either to lodge a formal complaint or to take responsibility for the conduct of any investigative procedures (see, for example, *mutatis mutandis*, *İlhan v. Turkey* [GC] no. 22277/93, ECHR 2000-VII, § 63).

95. For an investigation into alleged unlawful killing by State agents to be effective, it may generally be regarded as necessary for the persons responsible for and carrying out the investigation to be independent from those implicated in the events (see e.g. *Güleç v. Turkey* judgment of 27 July 1998, *Reports* 1998-IV, §§ 81-82; *Öğür v. Turkey*, [GC] no. 21954/93, ECHR 1999-III, §§ 91-92). This means not only a lack of hierarchical or institutional connection but also a practical independence (see for example the case of *Ergi v. Turkey* judgment of 28 July 1998, *Reports* 1998-IV, §§ 83-84 where the public prosecutor investigating the death of a girl during an alleged clash showed a lack of independence through his heavy reliance on the information provided by the gendarmes implicated in the incident).

96. The investigation must also be effective in the sense that it is capable of leading to a determination of whether the force used in such cases was or was not justified in the circumstances (e.g. *Kaya v. Turkey* judgment, cited above, p. 324, § 87) and to the identification and punishment of those responsible. This is not an obligation of result, but of means. The authorities must have taken the reasonable steps available to them to secure the evidence concerning the incident, including *inter alia* eye witness testimony, forensic evidence and, where appropriate, an autopsy which provides a complete and accurate record of injury and an objective analysis of clinical findings, including the cause of death (see concerning autopsies, e.g. *Salman v. Turkey* cited above, § 106; concerning witnesses e.g.

*Tanrikulu v. Turkey* [GC], no. 23763/94, ECHR 199-IV, § 109; concerning forensic evidence e.g. *Gül v. Turkey*, 22676/93, [Section 4], § 89). Any deficiency in the investigation which undermines its ability to establish the cause of death or the person responsible will risk falling foul of this standard.

97. A requirement of promptness and reasonable expedition is implicit in this context (see *Yaşa v. Turkey* judgment of 2 September 1998, *Reports* 1998-IV, pp. 2439-2440, §§ 102-104; *Cakıcı v. Turkey* cited above, §§ 80, 87 and 106; *Tanrikulu v. Turkey*, cited above, § 109; *Mahmut Kaya v. Turkey*, no. 22535/93, [Section I] ECHR 2000-III, §§ 106-107). It must be accepted that there may be obstacles or difficulties which prevent progress in an investigation in a particular situation. However, a prompt response by the authorities in investigating a use of lethal force may generally be regarded as essential in maintaining public confidence in their adherence to the rule of law and in preventing any appearance of collusion in or tolerance of unlawful acts.

98. For the same reasons, there must be a sufficient element of public scrutiny of the investigation or its results to secure accountability in practice as well as in theory. The degree of public scrutiny required may well vary from case to case. In all cases, however, the next of kin of the victim must be involved in the procedure to the extent necessary to safeguard his or her legitimate interests (see *Güleç v. Turkey*, cited above, p. 1733, § 82, where the father of the victim was not informed of the decisions not to prosecute; *Öğür v. Turkey*, cited above, § 92, where the family of the victim had no access to the investigation and court documents; *Gül v. Turkey* judgment, cited above, § 93).

## 2. Application in the present case

### a. Concerning alleged responsibility of the State for the death of the nine men at Loughgall

99. It is undisputed that the nine men at Loughgall were shot and killed by SAS soldiers. Three of the men at least were unarmed: Antony Hughes who was a civilian unconnected with the IRA, as well as the IRA members Declan Arthurs and Gerard O'Callaghan. This use of lethal force falls squarely within the ambit of Article 2, which requires any such action to pursue one of the purposes set out in second paragraph and to be no more than absolutely necessary for that purpose. A number of key factual issues arise in this case, in particular whether any warnings could have been given; whether the soldiers acted on an honest belief perceived for good reasons to be valid at the time but which turned out subsequently to be mistaken, namely, that they were at risk from the men who were shot, and whether any of the deceased were shot when they were already injured and on the ground in circumstances where it would have been possible to carry out an arrest.



Determining these issues would involve *inter alia* careful scrutiny of the accounts of the soldiers as to the circumstances in which they fired their weapons during the operation. Assessment of the credibility and reliability of the various witnesses would play a crucial role.

100. These are matters which were raised in the civil proceedings lodged by seven of the families. The action in negligence brought by the family of Antony Hughes was settled, the family of Kevin McKearney have dropped their proceedings, whilst the claims of five other families are still pending (see paragraphs 42-46 above).

(i) *Concerning the five families involved in pending civil proceedings*

101. The Court considers that in the circumstances of this case it would be inappropriate and contrary to its subsidiary role under the Convention to attempt to establish the facts of this case by embarking on a fact finding exercise of its own by summoning witnesses. Such an exercise would duplicate the proceedings before the civil courts which are better placed and equipped as fact finding tribunals. While the European Commission of Human Rights has previously embarked on fact finding missions in cases from Turkey where there were pending proceedings against the alleged security force perpetrators of unlawful killings, it may be noted that these proceedings were criminal and had terminated, at first instance at least, by the time the Court was examining the applications. In those cases, it was an essential part of the applicants' allegations that the defects in the investigation were such as to render those criminal proceedings ineffective (see e.g. *Salman v. Turkey*, cited above, § 107, where the police officers were acquitted of torture due to the lack of evidence resulting principally from a defective autopsy procedure; *Gül v. Turkey*, cited above, § 89, where *inter alia* the forensic investigation at the scene and autopsy procedures hampered any effective reconstruction of events).

102. In the present case, the Court does not consider that there are any elements established which would deprive the civil courts of their ability to establish the facts and determine the lawfulness or otherwise of the deaths (see further below concerning the applicants' allegations about the defects in the police investigation, §§ 112-113).

103. Nor is the Court persuaded that it is appropriate to rely on the documentary material provided by the parties to reach any conclusions as to responsibility for the death of the applicants' relatives. The written accounts provided have not been tested in examination or cross-examination and would provide an incomplete and potentially misleading basis for any such attempt. The situation cannot be equated to a death in custody where the burden may be regarded as resting on the State to provide a satisfactory and plausible explanation.

104. The Court is also not prepared to conduct, on the basis largely of statistical information and selective evidence, an analysis of incidents over

the past thirty years with a view to establishing whether they disclose a practice by security forces of using disproportionate force. This would go far beyond the scope of the present application.

105. Conversely, as regards the Government's argument that the availability of civil proceedings provided the applicants with a remedy which they have not exhausted as regards Article 35 § 1 of the Convention and, therefore, that no further examination of the case is required under the Article 2, the Court recalls that the obligations of the State under Article 2 cannot be satisfied merely by awarding damages (see e.g. *Kaya v. Turkey*, p. 329, § 105; *Yaşa v. Turkey*, p. 2431, § 74). The investigations required under Articles 2 and 13 of the Convention must be able to lead to the identification and punishment of those responsible. The Court therefore examines below whether there has been compliance with this procedural aspect of Article 2 of the Convention.

*(ii) Concerning the family of Antony Hughes*

106. The Court considers that in bringing civil proceedings for aggravated damages in respect of her husband Antony Hughes the applicant, Bridget Hughes, has used the local remedies available. It has not been shown that the state of domestic law *per se* fails to comply with the Convention standards or that there has been an administrative practice which would render civil procedures ineffective as a remedy for her complaints. Nor has it been shown that the applicant had no alternative to accepting the settlement offered by the authorities in those proceedings and therefore that the civil courts offered no prospect to the applicant of obtaining a finding of liability in her favour.

107. The Court therefore finds that in settling her claims in civil proceedings concerning the death of her husband, and in accepting and receiving compensation, the applicant has effectively renounced further use of these remedies. She may no longer, in these circumstances, claim to be a victim of a violation of the Convention as regards the alleged excessive or disproportionate force used in killing her husband. Her complaints concerning the procedural obligations under Article 2 will be considered below, with those of the other applicants.

*(iii) Concerning the families who did not pursue or lodge any civil proceedings*

108. The Court has noted above that civil proceedings offered the possibility of obtaining a determination of the issues of lawfulness of the use of force, including its proportionality, as well as providing the possibility of compensation. The applicants have stated that it was not worthwhile to embark on such proceedings as the practice of the State in offering settlements prevented any admissions of liability being issued by the courts, which was what they wanted rather than money as such.

109. The Court observes that in only one of the seven cases introduced by the applicants was a settlement offered by the authorities. In the previous case of *Caraheer v. the United Kingdom*, (no. 24520/94, decision [Section 3] 11.01.00), where the applicant accepted a settlement of her action in respect of the killing of her husband by two soldiers, the Court did not find that the civil proceedings had been shown to be ineffective as a means of redress for the applicant's complaints. It finds nothing in the submissions of the applicants in this case to persuade it to reach another conclusion.

110. Consequently, as regards those applicants who did not take or pursue civil proceedings regarding the alleged unlawfulness of the deaths of their relatives, the Court finds that they have failed to make use of the available domestic remedies. It is therefore precluded from examining the applicants' complaints of a substantive violation of Article 2 due to the alleged excessive use of force or negligence in the planning or control of the operation. Their complaints concerning the procedural obligations under Article 2 will be considered below, with those of the other applicants.

**b. Concerning the procedural obligation under Article 2 of the Convention**

111. Following the deaths of the nine men at Loughgall, an investigation was commenced by the RUC. On the basis of that investigation, there was a decision by the DPP not to prosecute any soldier. An inquest was opened on 30 May 1995 and terminated on 2 June 1995 with verdicts that the nine men had died from serious and multiple gun shot wounds.

112. The applicants have made numerous complaints about these procedures, while the Government have contended that even if one part of the procedure failed to provide a particular safeguard, taken as a whole, the system ensured the requisite accountability of the police for any unlawful act.

*(i) The police investigation*

113. Firstly, concerning the police investigation, the Court finds little substance in the applicants' criticisms. It appears that the investigation started immediately after the operation ended. The necessary scene of the incident procedures were carried out and evidence secured. The appropriate forensic examinations were conducted. While the soldiers were not interviewed immediately, the interviews were concluded within three days, a not unreasonable period of time considering the numbers involved. While the applicants alleged that the soldiers were not kept apart from their colleagues and their statements showed similarities, the Court does not find any striking signs of stereotyping which would support a finding that the investigators had colluded in, or facilitated, the production of co-ordinated statements.

114. The applicants also complained that the RUC officers involved in the investigation could not be regarded as independent or impartial. While

the investigating officers did not appear to be connected structurally or factually with the soldiers under investigation, the operation at Loughgall was nonetheless conducted jointly with local police officers, some of whom were injured, and with the co-operation and knowledge of the RUC in that area. Even though it also appears that, as required by law, this investigation was supervised by the ICPC, an independent police monitoring authority, this cannot provide a sufficient safeguard where the investigation itself has been for all practical purposes conducted by police officers connected, albeit indirectly, with the operation under investigation. The Court notes the recommendation of the CPT that a fully independent investigating agency would help to overcome the lack of confidence in the system which exists in England and Wales and is in some respects similar (see paragraph 81 above).

115. It is furthermore the case that the investigation was not open to the public and did not involve the applicants or the families. Investigation files are not accessible in this way in the United Kingdom, the Government submitting that the efficiency of procedures requires that the contents be kept confidential until the later stages of a prosecution. The Court considers that disclosure or publication of police reports and investigative materials may involve sensitive issues with possible prejudicial effects to private individuals or other investigations and, therefore, cannot be regarded as an automatic requirement under Article 2. The requisite access of the public, or the victim's relatives may be provided for in other stages of the available procedures.

*(ii) The role of the DPP*

116. The Court recalls that the DPP is an independent legal officer charged with the responsibility to decide whether to bring prosecutions in respect of any possible criminal offences carried out by a police officer. He is not required to give reasons for any decision not to prosecute and in this case he did not do so. No challenge by way of judicial review exists to require him to give reasons in Northern Ireland, though it may be noted that in England and Wales, where the inquest jury may still reach verdicts of unlawful death, the courts have required the DPP to reconsider a decision not to prosecute in the light of such a verdict, and will review whether those reasons are sufficient. This possibility does not exist in Northern Ireland where the inquest jury is no longer permitted to issue verdicts concerning the lawfulness or otherwise of a death.

117. The Court does not doubt the independence of the DPP. However, where the police investigation procedure is itself open to doubts of a lack of independence and is not amenable to public scrutiny, it is of increased importance that the officer who decides whether or not to prosecute also gives an appearance of independence in his decision-making. Where no reasons are given in a controversial incident involving the use of lethal

force, this may in itself not be conducive to public confidence. It also denies the family of the victim access to information about a matter of crucial importance to them and prevents any legal challenge of the decision.

118. In this case, nine men were shot and killed, of whom one was unconnected with the IRA and two others at least were unarmed. It is a situation which, to borrow the words of the domestic courts, cries out for an explanation. The applicants however were not informed of why the shootings were regarded as not disclosing a criminal offence or as not meriting a prosecution of the soldiers concerned. There was no reasoned decision available to reassure a concerned public that the rule of law had been respected. This cannot be regarded as compatible with the requirements of Article 2, unless that information was forthcoming in some other way. This however is not the case.

*(iii) The inquest*

119. In Northern Ireland, as in England and Wales, investigations into deaths may also be conducted by inquests. Inquests are public hearings conducted by coroners, independent judicial officers, normally sitting with a jury, to determine the facts surrounding a suspicious death. Judicial review lies from procedural decisions by coroners and in respect of any mistaken directions given to the jury. There are thus strong safeguards as to the lawfulness and propriety of the proceedings. In the case of *McCann and Others v. the United Kingdom* (cited above, p. 49, § 162), the Court found that the inquest held into the deaths of the three IRA suspects shot by the SAS on Gibraltar satisfied the procedural obligation contained in Article 2, as it provided a detailed review of the events surrounding the killings and provided the relatives of the deceased with the opportunity to examine and cross-examine witnesses involved in the operation.

120. There are however a number of differences between the inquest as held in the *McCann* case and those in Northern Ireland.

121. In inquests in Northern Ireland, any person suspected of causing the death may not be compelled to give evidence (Rule 9(2) of the 1963 Coroners Rules, see paragraph 56 above). In practice, in inquests involving the use of lethal force by members of the security forces in Northern Ireland, the police officers or soldiers concerned do not attend. Instead, written statements or transcripts of interviews are admitted in evidence. At the inquest in this case, none of the soldiers A to X appeared. They have therefore not been subject to examination concerning their account of events. The records of their statements taken in interviews with investigating police officers were made available to the Coroner instead (see paragraphs 16 to 23 above). This does not enable any satisfactory assessment to be made of either their reliability or credibility on crucial factual issues. It detracts from the inquest's capacity to establish the facts immediately relevant to the death, in particular the lawfulness of the use of

force and thereby to achieve one of the purposes required by Article 2 of the Convention (see also paragraph 10 of the United Nations Principles on Extra-Legal Executions cited at paragraph 79 above).

122. It is also alleged that the inquest in this case is restricted in the scope of its examination. According to the case-law of the national courts, the Coroner is required to confine his investigation to the matters directly causative of the death and not extend his inquiry into the broader circumstances. This was the standard applicable in the McCann inquest also and did not prevent examination of those aspects of the planning and conduct of the operation relevant to the killings of the three IRA suspects. The Court is not persuaded therefore that the approach to inquests taken by the domestic courts necessarily contradicts the requirements of Article 2. The domestic courts accept that an essential purpose of the inquest is to allay rumours and suspicions of how a death came about. The Court agrees that a detailed investigation into policy issues or alleged conspiracies may not be justifiable or necessary. Whether an inquest fails to address necessary factual issues will depend on the particular circumstances of the case. It has not been shown in the present application that the scope of the inquest as conducted prevented any particular matters relevant to the death being examined. The inability to address issues of the planning, control and execution of the operation resulted primarily from the absence of the soldiers concerned.

123. Nonetheless, unlike the McCann inquest, the jury's verdict in this case could only give the identity of the deceased and the date, place and cause of death (see paragraph 53 above). In England and Wales, as in Gibraltar, the jury is able to reach a number of verdicts, including "unlawful death". As already noted, where an inquest jury gives such a verdict in England and Wales, the DPP is required to reconsider any decision not to prosecute and to give reasons which are amenable to challenge in the courts. In this case, the only relevance the inquest may have to a possible prosecution is that the Coroner may send a written report to the DPP if he considers that a criminal offence may have been committed. It is not apparent however that the DPP is required to take any decision in response to this notification or to provide detailed reasons for not directing a prosecution as recommended.

124. Notwithstanding the useful fact finding function that an inquest may provide in some cases, the Court considers that in this case it could play no effective role in the identification or prosecution of any criminal offences which may have occurred and, in that respect, falls short of the requirements of Article 2.

125. The public nature of the inquest proceedings is not in dispute. Indeed the inquest appears perhaps for that reason to have become the most popular legal forum in Northern Ireland for attempts to challenge the conduct of the police and security forces in the use of lethal force. The

applicants complained however that their ability to participate in the proceedings as the next of kin to the deceased was significantly prejudiced as legal aid was not available in inquests and documents were not disclosed in advance of the proceedings.

126. The Court notes that six of the families were represented by counsel at the inquest. Legal aid was also available for a judicial review application concerning the Coroner's procedural decisions. It has not been explained why the others were not represented by the same, or by another, counsel or indeed whether they wished to be represented at the inquest. It has not been established therefore that the applicants have been prevented, by the lack of legal aid, from obtaining any necessary legal assistance at the inquest.

127. As regards access to documents, the applicants were not able to obtain copies of any witness statements until the witness concerned was giving evidence. This was also the position in the McCann case, where the Court considered that this had not substantially hampered the ability of the families' lawyers to question the witnesses (cited above, p. 49, § 62). However it must be noted that the inquest in that case was to some extent exceptional when compared with the proceedings in a number of cases in Northern Ireland (see also the cases of *Jordan v. the United Kingdom*, no. 24746/94, *McKerr v. the United Kingdom*, no. 28883/95, and *Shanaghan v. the United Kingdom*, no. 37715/97). The promptness and thoroughness of the inquest in the McCann case left the Court in no doubt that the important facts relating to the events had been examined with the active participation of the applicants' experienced legal representative. The non-access by the next-of-kin to the documents did not, in that context, disclose any significant handicap. However, since that case, the Court has laid more emphasis on the importance of involving the next of kin of a deceased in the procedure and providing them with information (see *Öğür v. Turkey*, cited above, § 92).

Further, the Court notes that the practice of non-disclosure has changed in the United Kingdom in the light of the Stephen Lawrence Inquiry and that it is now recommended that the police disclose witness statements 28 days in advance (see paragraph 61 above).

128. In this case, it may be observed that problems of lack of access to the witness statements was the reason for several long adjournments before the inquest opened. This contributed significantly to prolonging the proceedings. The Court considers this further below in the context of the delay (see paragraphs 130-134). Once the inquest opened, the applicants who were represented requested an adjournment to apply for judicial review of the Coroner's decision not to give them prior access to witness statements. When this was refused, they instructed their lawyer to withdraw from the inquest. The inability of the families to have access to witness statements before the appearance of the witness must be regarded as having

placed them at a disadvantage in terms of preparation and ability to participate in questioning. This contrasts strikingly with the position of the RUC and army (Ministry of Defence) who had the resources to provide for legal representation and had access to information about the incident from their own records and personnel. The Court considers that the right of the family of the deceased whose death is under investigation to participate in the proceedings requires that the procedures adopted ensure the requisite protection of their interests, which may be in direct conflict with those of the police or security forces implicated in the events. The Court is not persuaded that the interests of the applicants as next-of-kin were fairly or adequately protected in this respect.

129. Reference has also been made to the allegedly frequent use of public interest immunity certificates in inquests to prevent certain questions or the disclosure of certain documents. However, no certificate in fact issued in the inquest in this case. There is therefore no basis for finding that the use of these certificates prevented examination of any circumstances relevant to the deaths of the applicants' relatives.

130. Finally, the Court has had regard to the delay in the proceedings. The inquest opened on 30 May 1995, more than eight years after the deaths occurred. Although the DPP's decision not to prosecute issued on 22 September 1988, the RUC did not forward the papers to the Coroner until 9 May 1990. No explanation has been forthcoming for this delay. There were then a series of adjournments before the inquest opened. Once it opened, it concluded within a matter of days, on 2 June 1995. The adjournments were as follows:

- The inquest was due to open on 24 September 1990. The Coroner agreed to an adjournment on 6 September 1990 at the request of the applicants pending the determination of the *Devine* case concerning access of relatives to witness statements. The *Devine* case concluded on 6 February 1992, some sixteen months later.
- The Coroner agreed to an adjournment pending the judicial review proceedings in the McKerr, Toman and Burns inquests concerning access to documents used by witnesses to refresh their memories. These concluded on 28 May 1993, fifteen months later.
- The adjournment continued pending the court proceedings in the McKerr, Toman and Burns inquests concerning access to the Stalker and Sampson Reports which allegedly concerned issues of a shoot-to-kill policy. These concluded on 20 April 1994, eleven months further on. The inquest however only resumed on 30 May 1995 more than a year later.

131. The Court observes that these adjournments were requested by, or consented to, by the applicants. They related principally to legal challenges to procedural aspects of the inquest which they considered essential to their ability to participate - in particular as regards their access to the documents. It may be noted that the judicial review proceedings which resulted in an



adjournment from 6 September 1990 to 6 February 1992 (over one year and four months) concerned access to witness statements which are now being disclosed voluntarily due to developments in what is perceived as a desirable practice *vis-à-vis* a victim's relatives. The second set of judicial proceedings also concluded in favour of the families, since the courts held that Coroners should make available statements used by witnesses to refresh their memories. Nor can it be regarded as unreasonable that the applicants agreed to an adjournment to await the possible disclosure of an independent police enquiry which was alleged to concern issues of a deliberate policy of the security forces in using lethal force.

132. While it is therefore the case that the applicants contributed significantly to the delay in the inquest being opened, this has to some extent resulted from the difficulties facing relatives in participating in inquest procedures (see paragraphs 127-128 above concerning the non-disclosure of witness statements). It cannot be regarded as unreasonable that the applicants had regard to the legal remedies being used to challenge these aspects of inquest procedure. The Court observes that the Coroner, who was responsible for the conduct of the proceedings, acceded to these adjournments. The fact that they were requested by the applicants do not dispense the authorities from ensuring compliance with the requirement for reasonable expedition (see *mutatis mutandis* concerning speed requirements under Article 6 § 1 of the Convention, *Scopelliti v. Italy* judgment of 23 November 1993, Series A no. 278, p. 9, § 25). If long adjournments are regarded as justified in the interests of procedural fairness to the deceaseds' families, it calls into question whether the inquest system was at the relevant time structurally capable of providing for both speed and effective access for the families concerned.

133. Nor did the inquest progress with diligence in the periods unrelated to the adjournments. The Court refers to the delay in commencing the inquest and the lapse of time in scheduling the resumption of the inquest after the adjournments.

134. Having regard to these considerations, the time taken in this inquest cannot be regarded as compatible with the State's obligation under Article 2 of the Convention to ensure that investigations into suspicious deaths are carried out promptly and with reasonable expedition.

(iv) *Civil proceedings*

135. As found above (see paragraph 102), civil proceedings would provide a judicial fact finding forum, with the attendant safeguards and the ability to reach findings of unlawfulness, with the possibility of damages. It is however a procedure undertaken on the initiative of the applicant, not the authorities, and it does not involve the identification or punishment of any alleged perpetrator. As such, it cannot be taken into account in the

assessment of the State's compliance with its procedural obligations under Article 2 of the Convention.

(v) *Conclusion*

136. The Court finds that the proceedings for investigating the use of lethal force by the security forces have been shown in this case to disclose the following shortcomings:

- a lack of independence of the investigating police officers from the security forces involved in the incident;
- a lack of public scrutiny, and information to the victims' families of the reasons for the decision of the DPP not to prosecute any soldier;
- the inquest procedure did not allow for any verdict or findings which could play an effective role in securing a prosecution in respect of any criminal offence which might have been disclosed;
- the soldiers who shot the deceased could not be required to attend the inquest as witnesses;
- the non-disclosure of witness statements prior to the witnesses' appearance at the inquest prejudiced the ability of the applicants to participate in the inquest and contributed to long adjournments in the proceedings;
- the inquest proceedings did not commence promptly and were not pursued with reasonable expedition.

137. It is not for this Court to specify in any detail which procedures the authorities should adopt in providing for the proper examination of the circumstances of a killing by State agents. While reference has been made for example to the Scottish model of enquiry conducted by a judge of criminal jurisdiction, there is no reason to assume that this may be the only method available. Nor can it be said that there should be one unified procedure providing all requirements. If the aims of fact finding, criminal investigation and prosecution are carried out or shared between several authorities, as in Northern Ireland, the Court considers that the requirements of Article 2 may nonetheless be satisfied if, while seeking to take into account other legitimate interests such as national security or the protection of the material relevant to other investigations, they provide for the necessary safeguards in an accessible and effective manner. In the present case, the available procedures have not struck the right balance.

138. The Court would observe that the shortcomings in transparency and effectiveness identified above run counter to the purpose identified by the domestic courts of allaying suspicions and rumours. Proper procedures for ensuring the accountability of agents of the State are indispensable in maintaining public confidence and meeting the legitimate concerns that might arise from the use of lethal force. Lack of such procedures will only add fuel to fears of sinister motivations, as is illustrated *inter alia* by the

submissions made by the applicants concerning the alleged shoot-to-kill policy.

139. The Court finds that there has been a failure to comply with the procedural obligation imposed by Article 2 of the Convention and that there has been, in this respect, a violation of that provision.

### III. ALLEGED VIOLATION OF ARTICLE 6 § 1 OF THE CONVENTION

140. The applicants invoked Article 6 § 1 which provides as relevant:

“1. In the determination of his civil rights and obligations or of any criminal charge against him, everyone is entitled to a fair and public hearing within a reasonable time by an independent and impartial tribunal established by law. ...”

141. The applicants claimed that their relatives were arbitrarily killed in circumstances where an arrest could have been effected by the soldiers and that the soldiers deliberately killed their relatives as an alternative to arresting them. They referred to concerns expressed, for example, by Amnesty International that killings by the security forces in Northern Ireland reflected a deliberate policy to eliminate individuals rather than arrest them and bring them before a court for any determination of a criminal charge.

142. The Government submitted that the shooting of the applicants' relatives could not be regarded as a summary punishment for a crime. Nor could the alleged failure to prosecute raise any issues under Article 6 § 1 of the Convention.

143. The Court recalls that the lawfulness of the shooting of the nine men at Loughgall is pending consideration in the civil proceedings instituted by five of the applicants' families. The Hughes family have settled their civil claims, while three families have not considered it worthwhile to lodge or pursue proceedings (see paragraphs 42-46 above). In these circumstances and in the light of the scope of the present application, the Court finds no basis for reaching any findings as to the alleged improper motivation behind the incident. Any issues concerning the effectiveness of criminal investigation procedures fall to be considered under Articles 2 and 13 of the Convention.

144. There has, accordingly, been no violation of Article 6 § 1 of the Convention.

### IV. ALLEGED VIOLATION OF ARTICLE 14 OF THE CONVENTION

145. The applicants invoked Article 14 of the Convention, which provides:

“The enjoyment of the rights and freedoms set forth in this Convention shall be secured without discrimination on any ground such as sex, race, colour, language, religion, political or other opinion, national or social origin, association with a national minority, property, birth or other status.”

146. The applicants submitted that the circumstances of the killing of their relatives disclosed discrimination. They alleged that, between 1969 and March 1994, 357 people had been killed by members of the security forces, the overwhelming majority of whom were young men from the Catholic or nationalist community. When compared with the numbers of those killed from the Protestant community and having regard to the fact that there have been relatively few prosecutions (31) and only a few convictions (four, at the date of this application), this showed that there was a discriminatory use of lethal force and a lack of legal protection vis-à-vis a section of the community on grounds of national origin or association with a national minority.

147. The Government replied that there was no evidence that any of the deaths which occurred in Northern Ireland were analogous or that they disclosed any difference in treatment. Bald statistics (the accuracy of which was not accepted) were not enough to establish broad allegations of discrimination against Catholics or nationalists.

148. Where a general policy or measure has disproportionately prejudicial effects on a particular group, it is not excluded that this may be considered as discriminatory notwithstanding that it is not specifically aimed or directed at that group. However, even though statistically it appears that the majority of people shot by the security forces were from the Catholic or nationalist community, the Court does not consider that statistics can in themselves disclose a practice which could be classified as discriminatory within the meaning of Article 14. There is no evidence before the Court which would entitle it to conclude that any of those killings, save the four which resulted in convictions, involved the unlawful or excessive use of force by members of the security forces.

149. The Court finds that there has been no violation of Article 14 of the Convention.

## V. ALLEGED VIOLATION OF ARTICLE 13 OF THE CONVENTION

150. The applicants complained that they had no effective remedy in respect of their complaints, invoking Article 13 which provides:

“Everyone whose rights and freedoms as set forth in this Convention are violated shall have an effective remedy before a national authority notwithstanding that the violation has been committed by persons acting in an official capacity.”

151. The applicants referred to their submissions concerning the procedural aspects of Article 2 of the Convention, claiming that in addition to the payment of compensation where appropriate Article 13 required a

thorough and effective investigation capable of leading to the identification and punishment of those responsible and including effective access for the complainant to the investigatory procedure.

152. The Government submitted that the complaints raised under Article 13 were either premature or ill-founded. They claimed that the combination of available procedures, which included the pending civil proceedings and the inquest, provided effective remedies.

153. The Court's case-law indicates that Article 13 of the Convention guarantees the availability at the national level of a remedy to enforce the substance of the Convention rights and freedoms in whatever form they might happen to be secured in the domestic legal order. The effect of Article 13 is thus to require the provision of a domestic remedy to deal with the substance of an "arguable complaint" under the Convention and to grant appropriate relief, although Contracting States are afforded some discretion as to the manner in which they conform to their Convention obligations under this provision. The scope of the obligation under Article 13 varies depending on the nature of the applicant's complaint under the Convention. Nevertheless, the remedy required by Article 13 must be "effective" in practice as well as in law (see the *Aksoy v. Turkey* judgment of 18 December 1996, *Reports* 1996-IV, p. 2286, § 95; the *Aydın v. Turkey* judgment of 25 September 1997, *Reports* 1997-VI, pp. 1895-96, § 103; the *Kaya v. Turkey* judgment cited above, pp. 329-30, § 106).

154. In cases of the use of lethal force or suspicious deaths, the Court has also stated that, given the fundamental importance of the right to the protection of life, Article 13 requires, in addition to the payment of compensation where appropriate, a thorough and effective investigation capable of leading to the identification and punishment of those responsible for the deprivation of life, including effective access for the complainant to the investigation procedure (see the *Kaya v. Turkey* judgment cited above, pp. 330-31, § 107). In a number of cases it has found that there has been a violation of Article 13 where no effective criminal investigation had been carried out, noting that the requirements of Article 13 were broader than the obligation to investigate imposed by Article 2 of the Convention (see also *Ergi v. Turkey*, cited above, p.1782, § 98; *Salman v. Turkey* cited above, § 123).

155. It must be observed that these cases derived from the situation pertaining in south-east Turkey, where applicants were in a vulnerable position due to the ongoing conflict between the security forces and the PKK and where the most accessible means of redress open to applicants was to complain to the public prosecutor, who was under a duty to investigate alleged crimes. In the Turkish system, the complainant was able to join any criminal proceedings as an intervenor and apply for damages at the conclusion of any successful prosecution. The public prosecutor's fact-finding function was also essential to any attempt to take civil proceedings.

In those cases, therefore, it was sufficient for the purposes of former Article 26 (now Article 35 § 1) of the Convention, that an applicant complaining of unlawful killing raised the matter with the public prosecutor. There was accordingly a close procedural and practical relationship between the criminal investigation and the remedies available to the applicant in the legal system as a whole.

156. The legal system pertaining in Northern Ireland is different and any application of Article 13 to the factual circumstances of any case from that jurisdiction must take this into account. An applicant who claims the unlawful use of force by soldiers or police officers in the United Kingdom must as a general rule exhaust the domestic remedies open to him or her by taking civil proceedings by which the courts will examine the facts, determine liability and if appropriate award compensation. These civil proceedings are wholly independent of any criminal investigation and their efficacy has not been shown to rely on the proper conduct of criminal investigations or prosecutions (see e.g. *Caraheer v. the United Kingdom*, no. 24520/94, decision of inadmissibility [Section 3] 11.01.00).

157. In the present case, seven of the applicants lodged civil proceedings, of which five are still pending, the Hughes family having settled their claims and another family having ceased to pursue their claims. Two families did not consider that it was worthwhile bringing such proceedings. The Court has found no elements which would prevent civil proceedings providing the redress identified above in respect of the alleged excessive use of force (see paragraph 102 above).

158. As regards the applicants' complaints concerning the investigation into the death carried out by the authorities, these have been examined above under the procedural aspect of Article 2 (see paragraphs 111-139 above). The Court finds that no separate issue arises in the present case.

159. The Court concludes that there has been no violation of Article 13 of the Convention.

## VI. APPLICATION OF ARTICLE 41 OF THE CONVENTION

160. Article 41 of the Convention provides:

“If the Court finds that there has been a violation of the Convention or the Protocols thereto, and if the internal law of the High Contracting Party concerned allows only partial reparation to be made, the Court shall, if necessary, afford just satisfaction to the injured party.”

### A. Damage

161. The applicants submitted that though their primary goal was to obtain a judgment from the Court to the effect that the respondent

Government had violated the Convention, they considered that an award of damages should be made. They argued that, where there was a finding of a violation of a fundamental right, the Court should impose the only penalty it can on the offending State. Not to do so sent the wrong signal and appeared to penalise the victims rather than those responsible for the violation. This was particularly the case concerning Antony Hughes who was unconnected with the IRA though it was accepted that an amount of compensation had been given domestically in that case.

162. The Government disputed that any award of damages would be appropriate in the present case. They considered that the applicant, Mrs Bridget Hughes, had been fully compensated for the loss suffered as a result of the death of Antony Hughes as she had accepted the settlement in the civil proceedings. In their view, no loss flowed from any violation of the procedural elements of Article 2 of the Convention and a finding of violation in that context would in itself constitute just satisfaction.

163. The Court recalls that in the case of McCann and others (cited above, p. 63, § 219) it found a substantive breach of Article 2 of the Convention, concluding that it had not been shown that the killing of the three IRA suspects constituted the use of force which was no more than absolutely necessary in defence of persons from unlawful violence. However, the Court considered it inappropriate to make any award to the applicants, as personal representatives of the deceased, in respect of pecuniary or non-pecuniary damage, “having regard to the fact that the three terrorist suspects who were killed had been intending to plant a bomb in Gibraltar”.

164. In contrast to the McCann case, the Court in the present case has made no finding as to the lawfulness or proportionality of the use of lethal force which killed the nine men at Loughgall, or as to the factual circumstances, including the activities of the deceased which led up to the killing, which issues are pending in the civil proceedings. Accordingly, no award of compensation falls to be made in this respect. On the other hand, the Court has found that the national authorities failed in their obligation to carry out a prompt and effective investigation into the circumstances of the death. The applicants must thereby have suffered feelings of frustration, distress and anxiety. The Court considers that the applicants sustained some non-pecuniary damage which is not sufficiently compensated by the finding of a violation as a result of the Convention. It has not taken into account the settlement in the Hughes case, which related to the substantive claims of that applicant and not to the lack of procedural efficacy in the investigation.

165. Making an assessment on an equitable basis, the Court awards each applicant the sum of 10,000 pounds sterling (GBP).

## **B. Costs and expenses**

166. The applicant claimed a total of GBP 54,594.20. This included GBP 5,218.20 and GBP 20,000 respectively for two counsel and GBP 29,276 for solicitors' fees, exclusive of VAT.

167. The Government submitted that these claims were excessive, noting that the issues in this case overlapped significantly with the other cases examined at the same time.

168. The Court recalls that this case has involved several rounds of written submissions and an oral hearing, and may be regarded as factually and legally complex. Nonetheless, it finds the fees claimed to be on the high side when compared with other cases from the United Kingdom and is not persuaded that they are reasonable as to quantum. Having regard to equitable considerations, it awards the global sum of GBP 30,000, plus any value added tax which may be payable. It has taken into account the sums paid to the applicants by way of legal aid from the Council of Europe.

## **C. Default interest**

169. According to the information available to the Court, the statutory rate of interest applicable in the United Kingdom at the date of adoption of the present judgment is 7,5% per annum.

## **FOR THESE REASONS, THE COURT UNANIMOUSLY**

1. *Holds* that there has been a violation of Article 2 of the Convention in respect of failings in the investigative procedures concerning the deaths of the applicants' relatives;
2. *Holds* that there has been no violation of Article 6 § 1 of the Convention;
3. *Holds* that there has been no violation of Article 14 of the Convention;
4. *Holds* that there has been no violation of Article 13 of the Convention;
5. *Holds*
  - (a) that the respondent State is to pay the applicants, within three months from the date on which the judgment becomes final according to Article 44 § 2 of the Convention, the following amounts, plus any value-added tax that may be chargeable;
    - (i) 10,000 (ten thousand) pounds sterling to each applicant in respect of non-pecuniary damage;



- (ii) a global sum of 30,000 (thirty thousand) pounds sterling in respect of all their costs and expenses;
- (b) that simple interest at an annual rate of 7,5% shall be payable from the expiry of the above-mentioned three months until settlement;

6. *Dismisses* the remainder of the applicants' claims for just satisfaction.

Done in English, and notified in writing on 4 May 2001, pursuant to Rule 77 §§ 2 and 3 of the Rules of Court.

S. DOLLÉ  
Registrar

J.-P. COSTA  
President

## **LEGAL AUTHORITY CA-80**

**INTER-AMERICAN COURT OF HUMAN RIGHTS****ADVISORY OPINION OC-18/03  
OF SEPTEMBER 17, 2003,  
REQUESTED BY THE UNITED MEXICAN STATES*****Juridical Condition and Rights of the Undocumented Migrants.***

Those present\*:

Antônio A. Cançado Trindade, President;  
Sergio García Ramírez, Vice President;  
Hernán Salgado Pesantes, Judge;  
Oliver Jackman, Judge;  
Alirio Abreu Burelli, Judge, and  
Carlos Vicente de Roux Rengifo, Judge,

also present,

Manuel E. Ventura Robles, Secretary, and  
Pablo Saavedra Alessandri, Deputy Secretary.

**THE COURT**

composed as above,

renders the following Advisory Opinion:

**I****PRESENTATION OF THE REQUEST**

1. On May 10, 2002, the State of the United Mexican States (hereinafter "Mexico" or "the requesting State"), based on Article 64(1) of the American Convention on Human Rights (hereinafter "the American Convention", "the Convention" or "the Pact of San José"), submitted to the Inter-American Court of Human Rights (hereinafter "the Inter-American Court" or "the Court") a request for an advisory opinion (hereinafter also "the request") on the "[...] deprivation of the enjoyment and exercise of certain labor rights [of migrant workers,] and its compatibility with the obligation of the American States to ensure the principles of legal equality, non-discrimination and the equal and effective protection of the law embodied in international instruments for the protection of human rights; and also with the subordination or conditioning of the observance of the obligations imposed by international human rights law, including those of an *erga omnes* nature, with a

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\* Judge Máximo Pacheco Gómez advised the Court that, owing to circumstances beyond his control, he would be unable to attend the sixtieth regular session of the Court; therefore, he did not take part in the deliberation and signature of this Advisory Opinion.

view to attaining certain domestic policy objectives of an American State.” In addition, the request dealt with “the meaning that the principles of legal equality, non-discrimination and the equal and effective protection of the law have come to signify in the context of the progressive development of international human rights law and its codification.”

2. Likewise, Mexico stated the considerations that gave rise to the request and, among these, it indicated that:

Migrant workers, as all other persons, must be ensured the enjoyment and exercise of human rights in the States where they reside. However, their vulnerability makes them an easy target for violations of their human rights, based, above all, on criteria of discrimination and, consequently, places them in a situation of inequality before the law as regards the effective enjoyment and exercise of these rights

[...]

In this context, the Government of Mexico is profoundly concerned by the incompatibility with the OAS human rights system of the interpretations, practices and enactment of laws by some States in the region. The Government of Mexico considers that such interpretations, practices and laws imply the negation of labor rights based on discriminatory criteria derived from the migratory status of the undocumented workers, among other matters. This could encourage employers to use those laws or interpretations to justify a progressive loss of other labor rights; for example: payment of overtime, seniority, outstanding wages and maternity leave, thus abusing the vulnerable status of undocumented migrant workers. In this context, the violations of the international instruments that protect the human rights of migrant workers in the region are a real threat to the exercise of the rights protected by such instruments.

3. Mexico requested the Court to interpret the following norms: Articles 3(1) and 17 of the Charter of the Organization of American States (hereinafter “the OAS”); Article II (Right to Equality before the Law) of the American Declaration on the Rights and Duties of Man (hereinafter “the American Declaration”); Articles 1(1) (Obligation to Respect Rights), 2 (Domestic Legal Effects), and 24 (Equality before the Law) of the American Convention; Articles 1, 2(1) and 7 of the Universal Declaration of Human Rights (hereinafter “the Universal Declaration”), and Articles 2(1), 2(2), 5(2) and 26 of the International Covenant on Civil and Political Rights.

4. Based on the preceding provisions, Mexico requested the Court’s opinion on the following issues:

In the context of the principle of equality before the law embodied in Article II of the American Declaration, Article 24 of the American Convention, Article 7 of the Universal Declaration and Article 26 of the [International] Covenant [of Civil and Political Rights ...]:

1) Can an American State establish in its labor legislation a distinct treatment from that accorded legal residents or citizens that prejudices undocumented migrant workers in the enjoyment of their labor rights, so that the migratory status of the workers impedes *per se* the enjoyment of such rights?

2.1) Should Article 2, paragraph 1, of the Universal Declaration, Article II of the American Declaration, Articles 2 and 26 of the [International] Covenant [of Civil and Political Rights], and Articles 1 and 24 of the American Convention be interpreted in the sense that an individual’s legal residence in the territory of an American State is a necessary condition for that State to respect and ensure the rights and freedoms recognized in these provisions to those persons subject to its jurisdiction?

2.2) In the light of the provisions cited in the preceding question, can it be considered that the denial of one or more labor right, based on the undocumented status of a migrant worker, is compatible with the obligations of an American State to ensure

non-discrimination and the equal, effective protection of the law imposed by the above-mentioned provisions?

Based on Article 2, paragraphs 1 and 2, and Article 5, paragraph 2, of the International Covenant on Civil and Political Rights,

3) What would be the validity of an interpretation by any American State which, in any way, subordinates or conditions the observance of fundamental human rights, including the right to equality before the law and to the equal and effective protection of the law without discrimination, to achieving migration policy goals contained in its laws, notwithstanding the ranking that domestic law attributes to such laws in relation to the international obligations arising from the International Covenant on Civil and Political Rights and other obligations of international human rights law that have an *erga omnes* character?

In view of the progressive development of international human rights law and its codification, particularly through the provisions invoked in the instruments mentioned in this request,

4) What is the nature today of the principle of non-discrimination and the right to equal and effective protection of the law in the hierarchy of norms established by general international law and, in this context, can they be considered to be the expression of norms of *ius cogens*? If the answer to the second question is affirmative, what are the legal effects for the OAS Member States, individually and collectively, in the context of the general obligation to respect and ensure, pursuant to Article 2, paragraph 1, of the [International] Covenant [on Civil and Political Rights], compliance with the human rights referred to in Articles 3 (l) and 17 of the OAS Charter?

5. Juan Manuel Gómez-Robledo Verduzco was appointed as the Agent and the Ambassador of Mexico to Costa Rica, Carlos Pujalte Piñeiro, as the Deputy Agent.

## II PROCEEDING BEFORE THE COURT

6. In notes of July 10, 2002, the Secretariat of the Court (hereinafter "the Secretariat"), in compliance with the provisions of Article 62(1) of the Rules of Procedure of the Court (hereinafter "the Rules of Procedure"), transmitted the request for an advisory opinion to all the member States, to the Secretary General of the OAS, to the President of the OAS Permanent Council and to the Inter-American Commission on Human Rights. It also advised them of the period established by the President of the Court (hereinafter "the President"), in consultation with the other judges of the Court, for submission of written comments or other relevant documents with regard to this request.

7. On November 12, 2002, Mexico presented a communication, with which it forwarded a copy of a communication from its Ministry of Foreign Affairs providing information about an opinion of the International Labour Organization (ILO) related to labor rights for migrant workers.

8. On November 14, 2002, the State of Honduras presented its written comments. Some pages were illegible. On November 1, 2002, the complete version of the brief with comments was received.

9. On November 15, 2002, Mexico presented a communication in which it forwarded information that was complementary to the request, and included the English version of a formal opinion that it had requested from the International Labor Office of the International Labor Organization (ILO) and which, according to Mexico, "was of particular relevance for the [...] request procedure."

10. On November 26, 2002, the State of Nicaragua presented its written comments.
11. On November 27, 2002, the Legal Aid Clinic of the College of Jurisprudence of the Universidad San Francisco de Quito presented an *amicus curiae* brief.
12. On December 3, 2002, Mexico presented a communication, with which it forwarded the Spanish version of the formal opinion that it had requested from the International Labor Office of the International Labor Organization (ILO) (*supra* para. 9).
13. On December 12, 2002, the Delgado Law Firm presented an *amicus curiae* brief.
14. On January 8, 2003, Liliana Ivonne González Morales, Gail Aguilar Castañón, Karla Micheel Salas Ramírez and Itzel Magali Pérez Zagal, students of the Faculty of Law of the Universidad Nacional Autónoma de México (UNAM), presented an *amici curiae* brief by e-mail. The original of this communication was submitted on January 10, 2003.
15. On January 13, 2003, the States of El Salvador and Canada presented their written comments.
16. On January 13, 2003, the Inter-American Commission on Human Rights presented its written comments.
17. On January 13, 2003, the United States of America presented a note in which it informed the Court that it would not present comments on the request for an advisory opinion.
18. On January 13, 2003, the Harvard Immigration and Refugee Clinic of the Greater Boston Legal Services and the Harvard Law School, the Working Group on Human Rights in the Americas of the Harvard and Boston College Law Schools, and the Global Justice Center presented an *amici curiae* brief.
19. On January 16, 2003, the President issued an Order in which he convened "a public hearing on the request for Advisory Opinion OC-18, on February 24, 2002, at 9 a.m." so that "the member States and the Inter-American Commission on Human Rights [could] present their oral arguments."
20. On January 17, 2003, the State of Costa Rica presented its written comments.
21. On January 29, 2003, the Secretariat, on the instructions of the President, and in communication CDH-S/067, invited Gabriela Rodríguez, United Nations Special Rapporteur on the Human Rights of Migrants to attend the public hearing convened for February 24, 2003 (*supra* para. 19), as an observer.
22. On February 3, 2003, the Secretariat transmitted a copy of the complementary information to its request for an advisory opinion forwarded by Mexico (*supra* paras. 9 and 12), the written comments submitted by the States of Honduras, Nicaragua, El Salvador, Canada and Costa Rica (*supra* paras. 8, 10, 15

and 20), and by the Inter-American Commission (*supra* para. 16), to all the foregoing.

23. On February 6, 2003, Mario G. Obledo, President of the National Coalition of Hispanic Organizations, presented a brief supporting the request for an advisory opinion.

24. On February 6, 2003, Thomas A. Brill of the Law Office of Sayre & Chavez, presented an *amicus curiae* brief.

25. On February 6, 2003, Javier Juárez of the Law Office of Sayre & Chavez, presented an *amicus curiae* brief.

26. On February 7, 2003, Mexico presented a brief in which it substituted the Deputy Agent, Ambassador Carlos Pujalte Piñero, by Ricardo García Cervantes, actual Ambassador of Mexico to Costa Rica (*supra* para. 5).

27. On February 10, 2003, Beth Lyon forwarded, via e-mail, an *amici curiae* brief presented by the Labor, Civil Rights and Immigrants' Rights Organizations in the United States.

28. On February 13, 2003, the Harvard Immigration and Refugee Clinic of the Greater Boston Legal Services and the Harvard Law School, the Working Group on Human Rights in the Americas of the Harvard and Boston College Law Schools and the Global Justice Center forwarded the final, corrected version of the *amici curiae* brief that they had presented previously (*supra* para. 18).

29. On February 13, 2003, Rebecca Smith forwarded another copy of the *amici curiae* brief presented by the Labor, Civil Rights and Immigrants' Rights Organizations in the United States (*supra* para. 27).

30. On February 21, 2003, the Academy of Human Rights and International Humanitarian Law of the American University, Washington College of Law, and the Human Rights Program of the Universidad Iberoamericana of Mexico submitted an *amici curiae* brief.

31. On February 21, 2003, the Center for International Human Rights of the School of Law of Northwestern University submitted an *amicus curiae* brief. The original of this brief was presented on February 24, 2003.

32. On February 24, 2003, a public hearing was held at the seat of the Court, in which the oral arguments of the participating States and the Inter-American Commission on Human Rights were heard.

There appeared before the Court:

*for the United Mexican States:*

-Juan Manuel Gómez Robledo, Agent;  
 -Ricardo García Cervantes, Deputy Agent and  
 Ambassador of Mexico to Costa Rica;  
 -Víctor Manuel Uribe Aviña, Adviser;

-*Salvador Tinajero Esquivel*, Adviser, Director of Inter-institutional Coordination and NGOs of the Human Rights Directorate of the Ministry of Foreign Affairs, and  
 -*María Isabel Garza Hurtado*, Adviser;

*for Honduras:* -*Álvaro Agüero Lacayo*, Ambassador of Honduras to Costa Rica, and  
 -*Argentina Wellermann Ugarte*, First Secretary of the Embassy of Honduras in Costa Rica;

*for Nicaragua:* -*Mauricio Díaz Dávila*, Ambassador of Nicaragua to Costa Rica;

*for El Salvador:* -*Hugo Roberto Carrillo*, Ambassador of El Salvador to Costa Rica, and  
 -*José Roberto Mejía Trabanino*, Coordinator of Global Issues of the Ministry of Foreign Affairs of El Salvador;

*for Costa Rica:* -*Arnoldo Brenes Castro*, Adviser to the Minister of Foreign Affairs;  
 -*Adriana Murillo Ruin*, Coordinator of the Human Rights Division of the Foreign Policy Directorate;  
 -*Norman Lizano Ortiz*, Official of the Human Rights Division of the Foreign Policy Directorate;  
 -*Jhonny Marín*, Head of the Legal Department of the Directorate of Migration and Aliens, and  
 -*Marcela Gurdíán*, Official of the Legal Department of the Directorate of Migration and Aliens; and

*for the Inter-American Commission on Human Rights:*

-*Juan Méndez*, Commissioner, and  
 -*Helena Olea*, Assistant.

Also present as Observers:

*for the Oriental Republic of Uruguay:* -*Jorge María Carvalho*, Ambassador of Uruguay to Costa Rica;

*for Paraguay:* -*Mario Sandoval*, Minister, Chargé d'Affaires of the Embassy of Paraguay in Costa Rica;

*for the Dominican Republic:* -*Ramón Quiñones*, Ambassador, Permanent Representative of the Dominican Republic to the OAS;  
 -*Anabella De Castro*, Minister Counselor, Head of the Human Rights Section of the Ministry of Foreign Affairs, and  
 -*José Marcos Iglesias Iñigo*, Representative of the State of the Dominican Republic to the Inter-American Court of Human Rights;



- for Brazil:* -Minister *Nilmário Miranda*, Secretary for Human Rights of Brazil;  
-*María De Luján Caputo Winkler*, Chargé d’Affaires of the Embassy of Brazil in Costa Rica, and  
-*Gisele Rodríguez Guzmán*, Official of the Embassy of Brazil in Costa Rica;
- for Panama:* -*Virginia I. Burgoa*, Ambassador of Panama to Costa Rica;  
-*Luis E. Martínez-Cruz*, Chargé d’Affaires of the Embassy of Panama in Costa Rica, and  
-*Rafael Carvajal Arcia*, Director of the Legal Adviser’s Office of the Ministry of Labor and Employment;
- for Argentina:* -*Juan José Arcuri*, Ambassador of Argentina to Costa Rica;
- for Peru:* -*Fernando Rojas S.*, Ambassador of Peru to Costa Rica, and  
-*Walter Linares Arenaza*, First Secretary of the Embassy of Peru in Costa Rica; and
- for the United Nations:* -*Gabriela Rodríguez*, Special Rapporteur on the Human Rights of Migrants.

33. On March 5, 2003, Mexico presented a brief with which it forwarded a copy of the “revised text of the oral argument made by the Agent” in the public hearing held on February 24, 2003 (*supra* para. 32).

34. On March 20, 2003, Mexico forwarded a copy of the press communiqué issued by its Ministry of Foreign Affairs on March 11, 2003.

35. On March 28, 2003, Mexico presented a brief in which it remitted the answers to the questions formulated by Judge Cañado Trindade and Judge García Ramírez during the public hearing (*supra* para. 32).

36. On April 7, 2003, the President issued an Order in which he convened “a public hearing on the request for Advisory Opinion OC-18, at 10 a.m. on June 4, 2003”, so that the persons and organizations that had forwarded *amici curiae* briefs could present their respective oral arguments. The Order also indicated that if any person or organization that had not presented an *amicus curiae* brief wished to take part in the public hearing, they could do so, after they had been accredited to the Court.

37. On May 15, 2003, the Center for Justice and International Law (CEJIL) presented an *amicus curiae* brief.

38. On May 16, 2003, the Center for Legal and Social Studies (CELS), the Ecumenical Service for the Support and Orientation of Refugees and Immigrants (CAREF) and the Legal Clinic for the Rights of Immigrants and Refugees of the School of Law of the Universidad de Buenos Aires, submitted an *amici curiae* brief by e-mail. The original of this brief was presented on May 28, 2003.

39. On June 4, 2003, a public hearing was held in the Conference Hall of the former Chamber of Deputies, Ministry of Foreign Affairs, in Santiago, Chile, during which the oral arguments presented as *amici curiae* by various individuals, universities, institutions and non-governmental organizations were presented.

There appeared before the Court:

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| <i>for the Faculty of Law of the Universidad Nacional Autónoma de México (UNAM):</i>   | <ul style="list-style-type: none"> <li>- Itzel Magali Pérez Zagal, Student</li> <li>- Karla Micheel Salas Ramírez, Student</li> <li>- Gail Aguilar Castañón, Student and</li> <li>- Liliana Ivonne González Morales, Student</li> </ul>  |
| <i>for the Harvard Immigration and Refugee Clinic of Greater Boston Legal Services and the Harvard Law School, the Working Group on Human Rights in the Americas of Harvard and Boston College Law Schools and the Global Justice Center:</i>  | <ul style="list-style-type: none"> <li>- James Louis Cavallaro, Associate Director, Human Rights Program, Harvard Law School</li> <li>- Andressa Caldas, Attorney and Legal Director, Global Justice Center, Rio de Janeiro, Brazil and</li> <li>- David Flechner, Representative, Harvard Law Student Advocates for Human Rights</li> </ul> |
| <i>for the Law Office of Sayre &amp; Chavez:</i>   | <ul style="list-style-type: none"> <li>- Thomas A. Brill, Attorney at Law</li> </ul>   |
| <i>for the Labor, Civil Rights and Immigrants' Rights Organizations in the United States of America:</i>   | <ul style="list-style-type: none"> <li>- Beth Lyon, Assistant Professor of Law, Villanova University School of Law, and Rebecca Smith, Attorney, National Employment Law Project</li> </ul>  |
| <i>for the Center for International Human Rights of Northwestern University School of Law:</i>   | <ul style="list-style-type: none"> <li>- Douglas S. Cassel, Director, and</li> <li>- Eric Johnson</li> </ul>   |
| <i>for the Juridical Research Institute of the Researcher; Universidad Nacional Autónoma de México:</i>  | <ul style="list-style-type: none"> <li>- Jorge A. Bustamante,</li> </ul>   |
| <i>for the Center for Justice and International Law (CEJIL):</i>   | <ul style="list-style-type: none"> <li>- Francisco Cox, Lawyer;</li> </ul>   |
| <i>for the Center for Legal and Social Studies CELS, and (CELS), the Ecumenical Service for the Support and Orientation of Immigrants and Refugees (CAREF) and the Legal Clinic for the Rights of Immigrants and Refugees of the School of Law of the Universidad de Buenos Aires:</i> | <ul style="list-style-type: none"> <li>- Pablo Ceriani Cernadas, Lawyer, Coordinator of the Legal Clinic;</li> </ul>   |

for the Office of the United Nations High Commissioner for Refugees (UNHCR): -Juan Carlos Murillo, Training Officer, Regional Legal Unit; and

for the Central American Council of Ombudsmen: -Juan Antonio Tejada Espino, President, Central American Council and Ombudsman of the Republic of Panama.

Also present as *Observers*:

for the United Mexican States: and - Ricardo Valero, Ambassador of Mexico in Chile

- Alejandro Souza, Official, General Coordination of Legal Affairs of the Ministry of Foreign Affairs Of Mexico; and

for the Inter-American Commission on Human Rights: - Helena Olea, Lawyer.

40. On June 4, 2003, during the public hearing held in Santiago, Chile, the Central American Council of Ombudsmen presented and *amicus curiae* brief.

41. On June 24, 2003, Jorge A. Bustamante remitted, by e-mail, an *amicus curiae* brief presented by the Juridical Research Institute of the Universidad Nacional Autónoma de México (UNAM). The original of this brief was presented on July 3, 2003.

42. On July 3, 2003, Thomas A. Brill, of the Law Office of Sayre & Chavez, presented his final written arguments.

43. On July 8, 2003, Beth Lyon forwarded, by e-mail, the final written arguments of the Labor, Civil Rights and Immigrants' Rights Organizations in the United States. The original of this brief was received on August 7, 2003.

44. On July 11, 2003, Liliana Ivonne González Morales, Gail Aguilar Castañón, Karla Micheel Salas Ramírez and Itzel Magali Pérez Zagal, Students of the Faculty of Law of the Universidad Nacional Autónoma de México (UNAM), presented their brief with final arguments by e-mail. The original of this brief was presented on July 18, 2003.

45. On July 11, 2003, the Center for International Human Rights of the School of Law of Northwestern University, presented its final written arguments, by e-mail. The original of this brief was presented on July 18, 2003.

46. On July 30, 2003, the Center for Legal and Social Studies (CELS), the Ecumenical Service for the Support and Orientation of Immigrants and Refugees (CAREF) and the Legal Clinic for the Rights of Immigrants and Refugees of the School of Law of the Universidad de Buenos Aires presented their final written arguments.

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47. The Court will now summarize the written and oral comments of the requesting State, the participating States and the Inter-American Commission, and also the briefs and oral arguments presented by different individuals, universities, institutions and non-governmental organizations as *amici curiae*:

*The requesting State:*            *Regarding the admissibility of the request, Mexico stated in its brief that:*

By clarifying the scope of the State's international obligations with regard to the protection of the labor rights of undocumented migrant workers, irrespective of their nationality, the opinion of the Court would be of considerable relevance for effective compliance with such obligations by the authorities of States that receive those migrants.

The request submitted by Mexico does not expect the Court to rule in the abstract, "but to consider concrete situations in which it is called on to examine the acts of the organs of any American State, inasmuch as the implementation of such acts may lead to the violation of some of the rights protected in the treaties and instruments mentioned in the [...] request." Nor does it expect the Court to interpret the domestic law of any State.

*In addition to the considerations that gave rise to the request and that have been described above (supra para. 2), the requesting State indicated that:*

The protection of the human rights of migrant workers is also an issue of particular interest to Mexico, because approximately 5,998,500 (five million nine hundred and ninety-eight thousand five hundred) Mexican workers reside outside national territory. Of these, it is estimated that 2,490,000 (two million four hundred and ninety thousand) are undocumented migrant workers who, lacking regular migratory status, "become a natural target for exploitation, as individuals and as workers, owing to their particularly vulnerable situation."

In less than five months (from January 1 to May 7, 2002), the Mexican Government had to intervene, through its consular representatives, in approximately 383 cases to defend the human rights of Mexican migrant workers, owing to issues such as discrimination in employment-related matters, unpaid wages, and compensation for occupational illnesses and accidents.

The efforts made by Mexico and other States in the region to protect the human rights of migrant workers have been unable to avoid a resurgence of discriminatory legislation and practices against aliens seeking employment in a foreign country, or the regulation of the labor market based on discriminatory criteria, accompanied by xenophobia in the name of national security, nationalism or national preference.

*With regard to the merits of the request, Mexico indicated in its brief:*

*Regarding the first question of the request (supra para. 4):*

In the context of the principle of equality before the law embodied in Article II of the American Declaration, Article 24 of the American Convention, Article 7 of the Universal Declaration and Article 26 of the Covenant, any measures that promotes a harmfully different treatment for persons or groups of persons who are in the territory of an American State and subject to its jurisdiction, are contrary to the acknowledgment of equality before the law that prohibits any discriminatory treatment established by law.

Workers whose situation is irregular are subjected to harsh treatment owing to their migratory status and, consequently, are considered an inferior group in relation to the legal or national workers of the State in question.

An organ of a State party to the international instruments mentioned above which, when interpreting domestic legislation, establishes a different treatment in the enjoyment of a labor right, based solely on the migratory status of a worker, would be making an interpretation contrary to the principle of legal equality.

This interpretation could provide justification for employers to dismiss undocumented workers, under the protection of a prior decision entailing the suppression of certain labor rights because of an irregular migratory status.

The circumstance described above is particularly critical when we consider that this irregular situation of the undocumented worker leads to the latter being afraid to have recourse to the government bodies responsible for monitoring compliance with labor standards; consequently, employers who utilize such practices are not punished. It is more advantageous from a financial point of view to dismiss an undocumented worked

because, contrary to what happens when national or legal resident workers are dismissed, the employer is not obliged to compensate such dismissals in any way; and this is in "evident contradiction with the principle of equality before the law."

The right to equality before the law is not applicable only with regard to the enjoyment and exercise of labor rights, it also extends to all rights recognized in domestic legislation; thus it covers "a much broader universe of rights that the fundamental rights and freedoms embodied in international law." The scope of the right to equality "has important applications in the jurisdiction of human rights bodies." For example, the United Nations Human Rights Committee has examined complaints concerning discrimination of rights that are not expressly included in the International Covenant on Civil and Political Rights, and rejected the argument that it lacks the competence to hear complaints about discrimination in the enjoyment of rights protected by the International Covenant on Economic, Social and Cultural Rights.

Mexico referred to the contents of General Comment 18 of the Human Rights Committee on Article 26 of the International Covenant on Civil and Political Rights.

*Regarding the second question of the request (supra para. 4):*

The provisions of Articles 2(1) of the Universal Declaration, II of the American Declaration, 2 and 26 of the International Covenant on Civil and Political Rights, and 1 and 24 of the American Convention, underscore the obligation of States to ensure the effective exercise and enjoyment of the rights encompassed by those provisions, and also the prohibition to discriminate for any reason whatever.

The obligation of the American States to comply with their international human rights commitments "goes beyond the mere fact of having laws that ensures compliance with such rights." The acts of all the organs of an American State must strictly respect such rights, so that "the conduct of the State organs leads to real compliance with and exercise of the human rights guaranteed in international instruments."

Any acts of an organ of an American State resulting in situations contrary to the effective enjoyment of the fundamental human rights, would be contrary to that State's obligation to adapt its conduct to the standards established in international human rights instruments.

*Regarding the third question of the request (supra para. 4):*

It is “unacceptable” for an American State to subordinate or condition in any way respect for fundamental human rights to the attainment of migratory policy objectives contained in its laws, evading international obligations arising from the International Covenant on Civil and Political Rights and other obligations of international human rights law of an *erga omnes* nature. This is so, even when domestic policy objectives are cited, which are provided for in domestic legislation and considered legitimate for attaining certain ends from the Government’s point of view, “including, for example, the implementation of a migratory control policy based on discouraging the employment of undocumented aliens.”

Even in the interests of public order – which is the ultimate goal of the rule of law – it is unacceptable to restrict the enjoyment and exercise of a right. And, it would be much less acceptable to seek to do so by citing domestic policy objectives contrary to the public welfare.

“Although [...] in some cases and in very specific circumstances, an American State may restrict or condition the enjoyment of a particular right, in the situation brought to the attention of the Court [...] the requirements for these circumstances are not met.”

Article 5(2) of the International Covenant on Civil and Political Rights enshrines the pre-eminence of the norm most favorable to the victim; “this establishes the obligation to seek, in the *corpus iuris gentium*, the norm intended to benefit the human being as the ultimate owner of the rights protected in international human rights law.”

This is similar to transferring to international human rights law the *Martens* clause, which is part of international humanitarian law, and which confirms the principle of the applicability of international humanitarian law to all circumstances, even when existing treaties do not regulate certain situations.

The legal effects of obligations *erga omnes lato sensu* are not established only between the contracting parties to the respective instrument. These effects “are produced as rights in favor of third parties (*stipulation pour autrui*), thus recognizing the right, and even the obligation, for other States – whether or not they are parties to the instrument in question – to guarantee

their fulfillment.” In this respect, Mexico invoked the decisions of the International Court of Justice in the *Barcelona Traction* (1970), *East Timor* (1995) and *Implementation of the Convention for the Prevention and Punishment of the Crime of Genocide* (1996) cases.

International case law, with the exception of that related to war crimes, “has not interpreted [...] fully the legal regime applicable to obligations *erga omnes*, or, at best, it has done so cautiously and perhaps with a certain trepidation. The Inter-American Court of Human Rights is hereby called on to play an essential role in establishing the applicable law and affirming the collective guarantee that is evident in Article 1 of its Statute.”

*Regarding the fourth question of the request (supra para. 4):*

Abundant “teachings of the most highly qualified publicists of the various nations (Article 38, paragraph (d), of the Statute of the International Court of Justice)[,] have stated that the fundamental human rights belong *ab initio* to the domain of norms of *ius cogens*.” Judges have also rendered individual opinions about the legal effect of recognition that a provision enjoys the attributes of a norm of *jus cogens*, in accordance with Article 53 of the Vienna Convention on the Law of Treaties.

Mexico referred to the commentary of the International Law Commission on Articles 40 and 41 of the then draft articles on State responsibility.

As in the case of obligations *erga omnes*, “case law has acted cautiously and even lagged behind the *opinio iuris communis* (the latter as a manifestation of the principle of universal morality) to establish the norms of *jus cogens* concerning the protection of the fundamental human rights definitively and to clarify the applicable legal norms.”

*Furthermore, in the brief submitted on November 15, 2002 (supra paras. 9 and 12), Mexico added that:*

*Regarding the first question of the request (supra para. 4):*

This question “is intended to clarify the existence of fundamental labor rights which all workers should enjoy[,], and which are internationally recognized in different instrument [,] and to determine whether denying those rights to workers because of their



migratory status would signify according a harmful treatment, contrary to the principles of legal equality and non-discrimination.”

States may accord a distinct treatment to documented migrant workers and to undocumented migrant workers, or to aliens with regard to nationals. For example, political rights are only recognized to nationals. However, in the case of internationally recognized human rights, all persons are equal before the law and have the right to equal protection in accordance with Article 26 of the International Covenant on Civil and Political Rights.

A harmfully distinct treatment may not be accorded in the implementation of the fundamental labor rights, “even though, except as provided for in this basic body of laws, States are empowered to accord a distinct treatment.” Harmfully distinct treatment of undocumented migrant workers would violate fundamental labor rights.

Several international instruments permit us to identify the fundamental labor rights of migrant workers. For example, Articles 25 and 26 of the International Convention on the Protection of the Rights of all Migrant Workers and Members of their Families recognize fundamental labor rights to all migrant workers, irrespective of their migratory status.

In addition, on November 1, 2002, the International Labor Office of the International Labor Organization issued a formal opinion on the scope and content of ILO Convention No. 143 concerning Migrations in Abusive Conditions and the Promotion of Equality of Opportunity and Treatment of Migrant Workers and Recommendation No. 151 on Migrant Workers. This opinion elaborates on other fundamental labor rights of all migrant workers. Mexico agrees with the International Labor Office that there is a basic level of protection that is applicable to documented and undocumented workers.

*Regarding the second question of the request (supra para. 4):*

States may accord a different treatment to migrant workers, whose situation is irregular; however, under no circumstance are they authorized to take discriminatory measures as regards the enjoyment and protection of internationally recognized human rights.

Even though it is possible to identify fundamental labor rights based on the international instruments, “this

concept is evolving. As new norms arise and are incorporated into the body of fundamental labor rights, they should benefit all workers, irrespective of their migratory status.”

*In response to the questions of some of the judges of the Court, Mexico added that:*

The fundamental labor rights that may not be restricted are those that are established in international human rights instruments with regard to all workers, including migrants, irrespective of their regular or irregular situation. In this respect, there appears to be consensus, deriving from these international instruments, that there are “a series of rights that, by their very nature, are so essential to safeguard the principle of equality before the law and the principle of non-discrimination, that their restriction or suspension, for any reason, entails the violation of these two cardinal principles of international human rights law.” Some examples of these fundamental rights are: the right to equal remuneration for work of equal value; the right to fair and satisfactory remuneration, including social security and other benefits derived from past employment; the right to form and join trade unions to defend one’s interests; the right to judicial and administrative guarantees to determine one’s rights; the prohibition of obligatory or forced labor, and the prohibition of child labor.

Any restriction of the enjoyment of the fundamental rights derived from the principles of equality before the law and non-discrimination violates the obligation *erga omnes* to respect the attributes inherent in the dignity of the human being, and the principal attribute is equality of rights. Specific forms of discrimination can range from denying access to justice to defend violated rights to denying rights derived from a labor relationship. When such discrimination is made by means of administrative or judicial decisions, it is based on the thesis that the enjoyment of fundamental rights may be conditioned to the attainment of migratory policy objectives.

The individual has acquired the status of a real active and passive subject of international law. The individual may be an active subject of obligations as regards human rights, and also individually responsible for non-compliance with them. This aspect has been developed in international criminal law and in international humanitarian law. On other issues, such as the one covered by this request for an advisory opinion, it can be established that “in the case of fundamental norms, revealed by objective manifestations and provided there

is no doubt concerning their validity, the individual, such as an employer, may be obliged to respect them, irrespective of the domestic measures taken by the State to ensure or even violate, compliance with them."

The "transfer" of the *Martens* clause to the protection of the rights of migrant workers would imply that such persons had been granted an additional threshold of protection, according to which, in situations in which substantive law does not recognize certain fundamental rights or considers them less important, such rights would be justiciable. The safeguard of such fundamental human rights as those evident from the principles of equality before the law and non-discrimination, is protected by "the principles of universal morality," referred to in Article 17 of the OAS Charter, even in the absence of provisions of substantive law that are immediately binding for those responsible for ensuring that such rights are respected.

*Honduras:*

*In its written and oral comments, Honduras stated that:*

*Regarding the first question of the request (supra para. 4):*

Not every legal treatment establishing differences violates *per se* the enjoyment and exercise of the right to equality and to non-discrimination. The State is empowered to include objective and reasonable restrictions in its legislation in order to harmonize labor relations, provided it does not establish illegal or arbitrary differences or distinctions. "Legality is intended to guarantee the right to fair, equitable and satisfactory conditions."

The State may regulate the exercise of rights and establish State policies by legislation, without this being incompatible with the purpose and goal of the Convention.

*Regarding the second question of the request (supra para. 4):*

The legal residence of a person who is in an American State cannot be considered *conditio sine qua non* to ensure the right to equality and non-discrimination, as regards the obligation established in Article 1(1) of the American Convention and in relation to the rights and freedoms recognized to all persons in this treaty.

Article 22 of the American Convention guarantees freedom of movement and residence, so that every person lawfully in the territory of another State has the

right to move about in it and to reside in it subject to the provisions of the law. The American Convention and the International Covenant on Civil and Political Rights grant "States the right that those subject to their jurisdiction must observe the provisions of the law."

The regulation concerning legal residence established in the laws of the State does not violate the international obligations of the State if it has been established by a law – *strictu sensu* and including the requirements that are established – which does not violate the intent and purpose of the American Convention.

"[I]t cannot be understood that legislation establishes a harmfully distinct treatment for undocumented migrant workers, when the Convention determines that the movement and residence of an alien in the territory of a State party should be legal and is not incompatible with the intent and purpose of the Convention."

*Regarding the third question of the request (supra para. 4):*

Determining migratory policies is a decision for the State. The central element of such policies should be respect for the fundamental rights arising from the obligations assumed before the international community. An interpretation that violates or restricts human rights "subordinating them to the attainment of any objective[,] violates the obligation to protect such rights." The interpretation must not deviate from the provisions of the American Convention, or its intent and purpose.

The purpose of compliance with the provisions of the law is to protect national security, public order, public health or morality, and the rights and freedoms of others.

The General Study on Migrant Workers conducted by the International Labour Organization concluded that "it is permissible" to restrict an alien's access to employment, when two conditions are met: a) in the case of "limited categories of employment or functions"; and b) when the restriction is necessary in "the interests of the State." These conditions may refer to situations in which the protection of the State's interest justifies certain employments or functions being reserved to its citizens, owing to their nature.

*Regarding the fourth question of the request (supra para. 4):*

In certain cases, inequality in treatment by the law may

be a way of promoting equality or protecting those who appear to be weak from a legal standpoint.

The fact that there are no discriminatory laws or that the legislation of Honduras prohibits discrimination is not sufficient to ensure equality of treatment or equality before the law in practice.

The American States must guarantee a decorous treatment to the migrant population in general, in order to avoid violations and abuse of this extremely vulnerable sector.

*Nicaragua:*

*In its written and oral comments, Nicaragua indicated that:*

The request for an advisory opinion submitted by Mexico "is one more measure that can assist States, and national and international organizations, define the scope of their peremptory obligations[,] established in human rights treaties, and apply and comply with them, in particular, with regard to strengthening and protecting the human rights of migratory workers."

Article 27 of the Constitution of Nicaragua establishes that, in national territory, all persons enjoy State protection and recognition of the rights inherent in the human being, the respect, promotion and protection of human rights, and the full exercise of the rights embodied in the international human rights instruments acceded to and ratified by Nicaragua.

*El Salvador:*

*In its written and oral comments, El Salvador indicated that:*

It considers that the request should take into account provisions of the International Covenant on Economic, Social and Cultural Rights, the Additional Protocol to the American Convention on Human Rights in the Area of Economic, Social and Cultural Rights ("Protocol of San Salvador") and the International Convention on the Protection of the Rights of all Migrant Workers and Members of their Families, "because these treaties are relevant to the opinion requested on the protection of human rights in the American States."

"[T]he implementation and interpretation of secondary legislation cannot subordinate the international obligations of the American States embodied in international human rights treaties and instruments."

When an employment relationship is established between a migrant worker and an employer in an

American State, the latter is obliged to recognize and guarantee to the worker the human rights embodied in international human rights instruments, including those relating to the right to employment and to social security, without any discrimination.

*Canada:*

*In its written comments, Canada stated that:*

Three elements of Canadian legislation and policy relate to the subject of the request for an advisory opinion: first, the international support that Canada provides to matters concerning migrants; second, the categories of migrants and temporary residents (visitors) that are established in the Canadian Immigration and Refugee Protection Act; and, third, the protection of fundamental rights and freedoms in Canada.

Canada is concerned about the violations of the rights of migrants throughout the world. Canada supported the United Nations resolution establishing the Office of the Special Rapporteur on the Human Rights of Migrants and collaborated in drafting the mandate of this Office in order to make it strong and balanced.

Immigration is a key component of Canadian society. Attracting and selecting migrants can contribute to the social and economic interests of Canada, reuniting families and protecting the health, security and stability of Canadians.

The term "migrant" is not generally used in Canada. However, the term "migrants," as understood in the international context, covers three categories of person.

The first category corresponds to permanent residents. It includes migrants, refugees who come to live in Canada and asylum seekers who obtained this status through the corresponding procedure. All these persons have the right to reside permanently in Canada and to request citizenship after three years' residence.

The second category refers to persons who have requested refugee status, as defined in the 1951 United Nations Convention relating to the Status of Refugees and its 1967 Protocol, and who have not obtained the corresponding response. If it is established that the person fulfills the conditions to request refugee status, he has the right to represent himself or to be represented by a lawyer in the proceeding to determine his refugee status. Any person who represents a serious danger to Canada or to Canadian society may not proceed with a request for refugee status. In most cases, those who request refugee status have access to

provincial social services, medical care and the labor market. They and their minor children have access to public education (from pre-school to secondary). Once they are granted refugee status, they may request permanent residence and include their immediate family in their request, even if the latter are outside Canada.

The third category corresponds to temporary residents who arrive in Canada for a temporary stay. There are several categories of temporary residents according to the Immigration and Refugee Protection Act: visitors (tourists), foreign students and temporary workers.

Although temporary workers do not enjoy the same degree of freedom as Canadian citizens and permanent residents on the labor market, their fundamental human rights are protected by the Canadian Charter of Rights and Freedoms, enacted in 1982 as part of the 1982 Constitution Act. This Charter applies to all government legislation, programs and initiatives (federal, provincial, territorial and municipal). Most of the fundamental rights and freedoms protected by the Canadian Charter of Rights and Freedoms are guaranteed to all individuals who are in Canadian territory, irrespective of their migratory status or citizenship. Some of these rights are: freedom of association, the right to due process, the right to equality before the law, and the right to equal protection without discrimination of any kind owing to race, national or ethnic origin, color, religion, sex, age, or mental or physical disability. There are some exceptions, because the Canadian Charter of Rights and Freedoms guarantees some rights only to Canadian citizens, such as: the right to vote, and the right to enter, remain in and depart from Canada. The right to travel between the provinces, and the right to work in any province is guaranteed to citizens and permanent residents. Many of these guarantees reflect the right of sovereign States to control the movement of persons across international borders.

The right to equality guaranteed by section 15 of the Canadian Charter of Rights and Freedoms is of particular importance in the context of this request for an advisory opinion. In 1989, in *Andrews v. Law Society of British Columbia*, the Supreme Court of Canada established that the right to equality includes substantive rather than merely formal equality. Substantive equality usually refers to equal treatment of all individuals and, on some occasions, requires that the differences that exist be acknowledged in a non-discriminatory manner. For example, giving equal treatment to the disabled involves taking the necessary measures to adapt to such

differences and to promote the access and inclusion of such individuals in government programs.

In order to demonstrate that section 15 of the Canadian Charter of Rights and Freedoms has been violated, a person alleging discrimination must prove: 1) that the law has imposed on him a different treatment from that imposed on others, based on one or more personal characteristics; 2) that the differential treatment is due to discrimination based on race, national or ethnic origin, color, religion, sex, age, mental or physical disability, or nationality; and 3) that discrimination in the substantive sense exists, because the person is treated with less concern, respect and consideration, so that his human dignity is offended.

For example, in *Lavoie v. Canada*, most members of the Supreme Court of Canada decided that the preference given to Canadian citizens in competitions for employment in the federal public service discriminates on the grounds of citizenship, and therefore violates section 15(1) of the Canadian Charter of Rights and Freedoms.

In addition to constitutional protection, the federal provincial and territorial governments have enacted human rights legislation to promote equality and prohibit discrimination in employment and services. This legislation applies to the private sector acting as an employer and provider of services, and to the governments.

The Supreme Court of Canada has established that the courts must interpret human rights legislation so as to advance towards the goal of ensuring equal opportunities to all. Following this interpretation, the Supreme Court has reached a series of conclusions on the scope of human rights codes, including the principle of their precedence over regular legislation, unless the latter establishes a clear exception. Discriminatory practices can be contested, even when they are legal. Although the Canadian jurisdictions have different human rights legislation, they are subject to these general principles and must provide the same fundamental protections.

*Inter-American Commission on Human Rights: In its written and oral comments, the Commission stated that:*

*Human Rights:*

In international human rights law, the principle of non-discrimination enshrines equality between persons and imposes certain prohibitions on States. Distinctions based on gender, race, religion or national origin are



specifically prohibited in relation to the enjoyment and exercise of the substantive rights embodied in international instruments. Regarding these categories, any distinction that States make in the application of benefits or privileges must be carefully justified on the grounds of a legitimate interest of the State and of society, "which cannot be satisfied by non-discriminatory means."

International human rights law prohibits not only deliberately discriminatory policies and practices, but also policies and practices with a discriminatory impact on certain categories of persons, even though a discriminatory intention cannot be proved.

The principle of equality does not exclude consideration of migratory status. States are empowered to determine which aliens may enter their territory and under what conditions. However, the possibility of identifying forms of discrimination that are not specifically intended, but which constitute violations of the principle of equality must be preserved.

States may establish distinctions in the enjoyment of certain benefits between its citizens, aliens (with regular status) and aliens whose situation is irregular. Nevertheless, pursuant to the progressive development of norms of international human rights law, this requires detailed examination of the following factors: 1) the content and scope of the norm that discriminates between categories of persons; 2) the consequences that this discriminatory treatment will have on the persons prejudiced by the State's policy or practice; 3) the possible justifications for this differentiated treatment, particularly its relationship to the legitimate interest of the State; 4) the logical relationship between the legitimate interest and the discriminatory practice or policies; and 5) whether or not there are means or methods that are less prejudicial for the individual and allow the same legitimate ends to be attained.

The international community is unanimous in considering that the prohibition of racial discrimination and of practices directly associated with it is an obligation *erga omnes*. The *jus cogens* nature of the principle of non-discrimination implies that, owing to their peremptory nature, all States must observe these fundamental rules, whether or not they have ratified the conventions establishing them, because it is an obligatory principle of international common law. "Even though the international community has not yet reached consensus on prohibiting discrimination based on motives other than racial discrimination, this does not

lessen its fundamental importance in all international laws.”

To underscore the importance of the principle of equality and non-discrimination, human rights treaties expressly establish this principle in articles related to determined categories of human rights. In this respect, we should mention Article 8.1 of the American Convention, owing to its particular relevance for this request for an advisory opinion. Equality is an essential element of due process.

Any distinction based on one of the elements indicated in Article 1 of the American Convention entails “a strong presumption of incompatibility with the treaty.”

Basic human rights must be respected without any distinction. Any differences established with regard to the respect and guarantee of the fundamental rights must have limited application and comply with the conditions indicated in the American Convention. Some international instruments explicitly establish certain distinctions.

At times the principle of equality requires States to adopt positive measures to reduce or eliminate the conditions that cause or facilitate the perpetuation of the discrimination prohibited by the treaties.

The American States are obliged to guarantee the basic protection of the human rights established in the human rights treaties to all persons subject to their authority, “and [this] does not depend[...] for its application on factors such as citizenship, nationality or any other aspect of the person, including his migratory status.”

The rights embodied in the human rights treaties may be regulated reasonably and the exercise of some of them may be subject to legitimate restrictions. The establishment of such restrictions must respect the relevant formal and substantive limits; in other words, it must be accomplished by law and satisfy an urgent public interest. Restrictions may not be imposed for discriminatory purposes, nor may they be applied in a discriminatory manner. Furthermore, “any permissible restriction of rights may never imply the total negation of the right.”

The elaboration and execution of migratory policies and the regulation of the labor market are legitimate objectives of the State. To achieve such objectives, States may adopt measures that restrict or limit some rights, provided they respect the following criteria: 1)

some rights are non-derogable; 2) some rights are reserved exclusively for citizens; 3) some rights are conditioned to the status of documented migrant, such as those relating to freedom of movement and residence; and 4) some rights may be restricted, provided the following requirements are met: a) the restriction must be established by law; b) the restriction must respond to a legitimate interest of the State, which has been explicitly stated; c) the restriction must have a "reasonable relationship to the legitimate objective", and d) there must not be "other means to achieve these objectives that are less onerous for those affected."

It is the State's responsibility to prove that it is "permissible" to restrict or exclude a specific category of persons, such as aliens, from the application of some provision of the international instrument. "Migratory status can never be grounds for excluding a person from the basic protections granted to him by international human rights law."

In addition, the Inter-American Commission on Human Rights indicated that labor rights are protected in international human rights instruments and, in this respect, referred to the Declaration on Fundamental Principles and Rights at Work of the International Labor Organization (ILO) and the International Convention on the Protection of the Rights of all Migrant Workers and Members of their Families.

Bearing in mind the development of international human rights law and international labor law, it can be said that "there are a series of fundamental labor laws that derive from the right to work and are at the very center of it."

Lastly, the Inter-American Commission on Human Rights requested the Court to systematize the rights related to employment "ranking them in order to show that some of these labor rights are considered fundamental" and that, consequently, such rights would "comprise the category of rights regarding which no discrimination is allowed, not even owing to migratory status."

*Costa Rica:*

*In its written and oral comments, Costa Rica stated that it would not refer to the last question formulated by the requesting State. Before making its comments on the other three questions, it set out the following considerations on the "protection of the human rights of migrants in Costa Rica" and on the "principle of reasonableness in the differential treatment of nationals and aliens."*

The Costa Rican Constitution establishes a situation of

equality in the exercise of rights and obligations between nationals and aliens, with certain exceptions, such as the prohibition to intervene in the country's political affairs, and others established in legal norms. Those exceptions may not violate the other rights enshrined in the Constitution.

"Despite legal measures and executive actions, some situations of a less favorable treatment for illegal immigrant workers unfortunately occur in the area of employment." The General Law on Migration and Aliens prohibits the employment of aliens residing in the country illegally; however, it also establishes that those who do employ such persons are not exempt from the obligation to provide workers with the wages and social security benefits stipulated by law. In this respect, the Legal Department of the Directorate of Migration and Aliens has established that all workers, irrespective of their migratory status, have the right to social security.

The principles of equality and non-discrimination do not imply that all aspects of the rights of aliens must be equated with the rights of nationals. Each State exercises its sovereignty by defining the legal status of aliens within its territory. To this end, "the principle of reasonableness should be used to define the scope of the activities of aliens in a country."

The Constitutional Chamber of the Supreme Court of Justice of Costa Rica has established that reasonableness is a fundamental requirement for an exclusion or restriction to the rights of aliens compared to nationals to be constitutional. Exclusion is when a right is not recognized to aliens, denying them the possibility of performing some activity. Examples of constitutional exclusions relating to aliens are the prohibition to intervene in political affairs and to occupy certain public offices. To the contrary, restrictions recognize a right to the alien, but restrict or limit it reasonably, taking into account the protection of a group of nationals or a specific activity, or the fulfillment of a social function. Restrictions based exclusively on nationality should not be imposed because xenophobic factors, unrelated to parameters of reasonableness, could exist.

The Constitutional Chamber also indicated that "[e]vidently, the equality of aliens and nationals declared in Article 19 of the Constitution is related to that core of human rights regarding which no distinctions are admissible for any reason whatsoever, particularly owing to nationality. However, the Constitution reserves the exercise of political rights to

nationals, because such rights are an intrinsic consequence of the exercise of the sovereignty of the people[...].”

The Constitutional Court has emphasized that any exception or restriction to the exercise of a fundamental rights affecting an alien must have constitutional or legal rank, and that the measures should be reasonable and proportional and should not be contrary to human dignity.

The Constitutional Court has declared some norms unconstitutional because it considered them irrational or illogical. They include: legal restrictions for aliens to take part as merchants in a “bonded warehouse”; the prohibition for aliens to be notaries, for advertisements recorded by aliens to be broadcast, and for aliens to act as private security agents; and the exclusion of foreign children as possible beneficiaries of the basic education allowance.

*Regarding the first question of the request (supra para. 4):*

No human right is absolute and, therefore, the enjoyment of human rights is subject to certain restrictions. The legislator may establish logical exceptions arising from the natural difference between nationals and aliens, but may not establish distinctions that imply a void in the principle of equality. “It should be recalled that, in all countries, there are differences of treatment – which do not conflict with international standards of protection – for reasons such as age and gender.”

There can be no differences as regards salary, and working conditions or benefits.

As in most countries, Costa Rican law establishes that aliens who reside illegally in the country may not work or carry out paid or lucrative tasks, either for their own or someone else’s account with or without a relation of dependency. Accordingly, the irregular situation of a person in a State of which he is not a national results *per se* in a considerable limitation in his conditions of access to many workers’ rights. Many social benefits for health and employment security and those that are strictly related to employment “entail a series of bureaucratic procedures which cannot be carried out when a person is undocumented.”

When the domestic legislation of a State establishes essential requirements that a persons must fulfill to be

eligible for a specific service, this cannot be considered to signify a harmfully distinct treatment for undocumented migrant workers. "Moreover, if an employer includes the names of his undocumented workers in certain records, it would imply that he is violating migratory legislation, which would make him liable to punishment."

Owing to the way in which States organize their administrative structure, in practice, there are a series of provisions that indirectly prevent undocumented migrant workers from enjoying their labor rights.

Notwithstanding the above, an employer who has engaged undocumented workers is obliged to pay them wages and other remunerations. Furthermore, "the irregular status of a person does not prevent him from having recourse to the courts of justice to claim his rights"; in other words, "as regards access to judicial bodies, irregular immigrant workers and members of their families have the right to judicial guarantees and judicial protection in the same conditions as nationals."

*Regarding question 2(1) of the request (supra para. 4):* Respect for the principles of equality and non-discrimination does not mean that some restrictions or requirements for the enjoyment of a specific right cannot be established, using a criterion of reasonableness. The classic example is the exercise of political rights, which is reserved for nationals of a country.

There are other rights that may not be restricted or limited in any way and must be respected to all persons without distinction. In Costa Rica, the right to life is one of these rights. This implies, for example, that a directive ordering border guards to fire on those who try and enter national territory through a non-authorized border post would be a flagrant violation of human rights.

*Regarding question 2(2) of the request (supra para. 4):* The legal residence of an alien in a recipient State is not a necessary condition for his human and labor rights to be respected. All persons, regardless of whether or not they are authorized to enter or remain in Costa Rica, may have recourse to the Constitutional Chamber of the Supreme Court of Justice to uphold or re-establish their constitutional and other fundamental rights.

*Regarding the third question of the request (supra para. 4):*

To answer this question, we must refer to the rank of human rights in domestic law. The human rights instruments in force in Costa Rica "are not only of similar weight to the Constitution, but, to the extent that they grant greater rights or guarantees to individuals, they have prevalence over the Constitution." The Constitutional Chamber of the Supreme Court of Justice has taken international human rights legislation as the benchmark for interpreting the Constitution or as a parameter of the constitutionality of other lesser legal norms.

Any migratory norm or policy contrary to the provisions of the International Covenant on Civil and Political Rights would be totally null and void, even if adopted as law by the Legislature.

*The Legal Clinics of the College of In their brief of November 27, 2002, indicated that:*

*Jurisprudence of the Universidad  
San Francisco de Quito:*

*Regarding the first question of the request (supra para. 4):*

Undocumented migrant workers should not lack protection before the State; migratory status does not deprive them of their human condition. The violation of domestic legislation cannot be considered grounds to deprive a person of the protection of his human rights; in other words, it does not exempt States from complying with the obligations imposed by international law. "To affirm the contrary would be to create an indirect means of discriminating against undocumented migrant workers by, to a certain extent, denying them legal personality and creating legal inequality between persons."

There is no provision of the International Covenant on Civil and Political Rights or the International Covenant on Economic, Social and Cultural Rights that allows the right to work to be restricted owing to migratory status. Article 26 of the International Covenant on Civil and Political Rights is explicit when referring to national origin as grounds that may not be used to discriminate against a person; moreover, it adds that neither can "other status" be cited to deny a person equal treatment by the law. "The norm is clear: the documented or undocumented status may not be used as grounds to deny the exercise of any human right and, consequently, to be treated unequally by the law." Moreover, no interpretation of Article 24 of the American Convention allows equality to be subordinated to a

person's legal residence or citizenship.

Nowadays, migrants are faced with discriminatory State legislation and labor practices and, what is worse, they are constantly denied access to governmental bodies and guarantees of due process; "this is a serious situation for migrants who are documented, but even more so for those who have been unable to legitimize their legal status in the country in which they reside."

The United Nations and the International Labour Organization (ILO) have drawn up norms to guard against the lack of legal protection for migrants. For example, when referring to migrant workers, the International Convention on the Protection of the Rights of all Migrant Workers and Members of their Families does not establish any difference on the basis of their legal status, "in other words, it recognizes to migrant workers all the human, civil, political, social, cultural or labor rights, whether or not they are documented." Furthermore, in a previous effort to improve the human rights situation of migrants, ILO Convention No. 143 concerning Migrant Workers (Supplementary Provisions) of 1975, contains important provisions in this respect.

The General Conference of the International Labor Organization has issued two relevant recommendations. However, Recommendation No. 86 on Migrant Workers (revised in 1949) "is discriminatory, inasmuch as it only applies to workers who are accepted as migrant workers. It appears that it does not apply to undocumented migrant workers. In 1975, the International Labor Organization issued Recommendation No. 151 on Migrant Workers, which also only refers to documented migrants. "In other words, although there is concern for migrant workers, they are recognized rights only because of their legal status, and not because of their status as human beings."

In this respect, the route followed by the United Nations in the field of international law has been more coherent. For example, resolution 1999/44 of the Commission on Human Rights recognizes that the principles and standards embodied in the Universal Declaration of Human Rights apply to everyone, including migrants, without making any reference to their legal status.

The International Convention on the Protection of the Rights of All Migrant Workers and Members of their Families refers to the migrant worker without differentiating between the documented and the undocumented migrant worker.



States may not provide different treatment to migrants who are in their territory, whatever their migratory status. “[T]he Court must respond to the first question by affirming that[,] in accordance with the international norms in force, a harmfully different treatment may not be established for undocumented migratory workers.”

*Regarding the second question of the request (supra para. 4):*

States may not establish discrimination because a person’s residence has not been regularized, and it may not disregard the guarantees necessary for the protection of universal fundamental rights. “It is unacceptable for a State not to guarantee and protect the human rights of all persons in its territory.”

The articles mentioned in the questions at issue establish categorically that all persons are equal before the law. An individual does not acquire the status of person when he is admitted legally into a certain territory; it is an intrinsic quality of the human being. Furthermore, the provisions referred to contain a list of grounds on which a person may not be discriminated against and conclude with phrases such as “nor any other” or “any other condition.” The rights and freedoms proclaimed in international instruments “belong to all individuals, because they are persons, and not because of the recognition a State grants them, owing to their migratory status.” “[I]nternational law does not permit any grounds for distinction that would allow human rights to be impaired or restricted.”

The State may not deny any person the labor rights embodied in many international norms. The denial of one or more labor rights, based on the undocumented status of a migrant workers is entirely incompatible with the obligations of the American States to ensure non-discrimination and the equal and effective protection of the law, to which the said provisions commit them.

According to Article 5 of the International Covenant on Civil and Political Rights and Article 29 of the American Convention, “it cannot be alleged that a State has the right to accept or not a certain individual into its territory and to limit the right to equality before the law, or any of the rights established in the said instrument.”

*Regarding the third question of the request (supra para. 4):*

“[I]t is unacceptable to restrict the enjoyment and

exercise of a human right citing domestic policy objectives, even when public order (*ordre public*), the ultimate goal of any State, is involved.”

Human rights cannot be subordinated to domestic laws, whether these relate to migratory or any other policy. The right to non-discrimination cannot be conditioned to compliance with migratory policy objectives, even when such objectives are established in domestic legislation. “In accordance with international obligations, laws that restrict the equal enjoyment of human rights of any person are inadmissible and the State is obliged to abolish them.” Moreover, since they are of an *erga omnes* nature, these obligations may be applied to third parties that are not a party to the Convention recognizing them.

In addition to convention-related obligations concerning the prohibition to discriminate, all States have the obligation *erga omnes*, namely, to the international community, to prevent any form of discrimination, including discrimination derived from their migratory policy. The prohibition to discriminate is of fundamental importance to the international community; “consequently, no domestic policy may be aimed at tolerating or permitting discrimination in any form that affects the enjoyment and exercise of human rights.”

“[T]he Court must answer this question by indicating that any subordination of the enjoyment and exercise of human rights to the existence of migratory policies and the achievement of the objectives established in those policies is unacceptable.”

*Regarding the fourth question of the request (supra para. 4):*

International human rights law establishes limits to the exercise of power by States. These limits are determined in conventions and in customary law provisions and peremptory or *jus cogens* norms.

“Like obligations *erga omnes*, *jus cogens* contains elements of fundamental importance for the international community, elements that are so essential that they are more important than State consent, which, in international law, determines the validity of norms.”

There is little disagreement about the existence of these peremptory norms in international law. In this respect, the Vienna Convention on the Law of Treaties does not set limits to the content of *jus cogens*; that is, it does not determine what these peremptory norms are, but

merely cites some examples. Article 53 of the Convention establishes four requisites for determining whether a norm is of a *jus cogens* character. They are: it must be a norm of general international law, it must be accepted and recognized by the international community, it must be non-derogable, and it may only be modified by a subsequent norm having the same character.

"Therefore, we must ask ourselves whether it would offend the human conscience and public morality if a State [should reject] the principle of non-discrimination and the right to equal and effective protection of the law. The answer is evidently in the affirmative."

"The Court must evaluate whether the principle of non-discrimination and the right to equal and effective protection of the law fulfill the four requirements of a *jus cogens* norm."

If the Court accepts that both the principle of non-discrimination and the right to equal and effective protection of the law are *jus cogens* norms, this would have several legal effects. In this regard, the European Court of Human Rights has indicated that such effects include: recognition that the norm ranks higher than any norm of international law, except other *jus cogens* norms; should there be a dispute, the *jus cogens* norm would prevail over any other norm of international law and any provision contrary to the peremptory norm would be null or lack legal effect.

The legal effects derived, individually and collectively, from the norms contained in Article 3(1) and 17 of the OAS Charter must be determined. According to these norms, the States parties assume a commitment, both individually and collectively, to "prevent, protect and punish" any violation of human rights. The spirit of Article 17 of the OAS Charter is to create binding principles for the States, even if they have not accepted the competence of the Court, so that they respect the fundamental rights of the individual. The Charter proclaims that human rights should be enjoyed without any distinction. Both the States parties and the OAS organs have the obligation to prevent any violation of human rights and to allow them to be enjoyed fully and absolutely.

"If the Court decides that the principle of non-discrimination is a rule of *jus cogens*[,] then we may infer that these norms are binding for States, whether or not the international conventions have been ratified; since [...] the principles [of] *jus cogens* create

obligations *erga omnes*." If this principle were to be considered a norm of *jus cogens* it would form part of the fundamental rights of the human being and of universal morality.

The Court must answer this question by stating that the principle of non-discrimination is a peremptory international norm, "therefore, the provisions of Articles 3(1) and 17 of the OAS Charter must be interpreted similarly."

*The Delgado Law Firm:*

*In its brief of December 12, 2002, stated that:*

The decision of the United States Supreme Court in *Hoffman Plastic Compounds Inc. v. National Labor Relations Board* has given rise to uncertainty with regard to the rights of migrants in that country – a situation which could have serious implications for migrants.

In the area of labor law, the United States does not treat irregular migrants with equality before the law. The United States Supreme Court decided that a United States employer could violate the labor rights of an irregular migrant worker without having to give him back pay. In the *Hoffman Plastic Compounds* case, the United States Supreme Court did not impose a fine on the employer who violated the labor rights of an irregular migrant worker and did not order any compensation for the worker.

According to the decision in the *Hoffman Plastic Compounds* case, a migrant worker incurs in "serious misconduct" when he obtains employment in breach of the Immigration Reform and Control Act (IRCA). However, in this case, the United States Supreme Court did not deny that the employer had dismissed the worker for trying to organize a union, which entailed the responsibility of the employer for having committed an evident violation of the labor laws. Even though the employer committed this violation, he was not treated equally by the Supreme Court.

Although the United States affirms that its domestic policy discourages illegal immigration, in practice, it continues to take measures that make it less expensive and therefore more attractive for United States employers to engage irregular migrant workers. For example, even in the United States, it is agreed that the decision in the *Hoffman Plastic Compounds* case will result in an increase in discrimination against undocumented workers, because employers can allege that they did not know that the worker was

undocumented so as to avoid any responsibility for violating the rights of their workers.

This discriminatory treatment of irregular migrants is contrary to international law. Using cheap labor without ensuring workers their basic human rights is not a legitimate immigration policy.

The effects of the Immigration Reform and Control Act and the *Hoffman Plastic Compounds* case indicate that there is an increase in discrimination against undocumented migrant workers. Indeed, the reasoning of the United States Supreme Court suggests that allowing irregular workers to file actions or complaints would only "encourage illegal immigration."

In the United States, irregular workers are exposed to "dangerous" working conditions. Domestic immigration policy should not be distorted in order to use it to exonerate employers who expose irregular migrant workers to unreasonable risk of death.

The United States continue to benefit daily from the presence in its workforce of a significant number of irregular migrant workers. Conservative estimates suggest that there are at least 5.3 million irregular migrants working in the United States and that three million of them are Mexicans. No State should be allowed to benefit knowingly and continuously from the labor of millions of migrant workers, while pretending it does not want such workers and, hence, does not have to guarantee them even the most basic rights. Migrant workers have the right to equal protection of the law, including the protection of their human rights.

Undocumented workers who have filed complaints about remuneration and working conditions in the United States have been intimidated by their employers, who usually threaten to call the Immigration and Naturalization Service.

Moreover, in the *Hoffman Plastic Compounds* case, the United States Supreme Court stated that, owing to his migratory status, no individual whose situation in the country was irregular could require his former employer to pay back wages.

The principle of equality before the law embodied in Article 26 of the International Covenant on Civil and Political Rights obliges States not to enact legislation that creates differences between workers based on their ethnic or national origin.

The principle of equality before the law applies to the enjoyment of civil, political, economic and social rights, without any distinction.

All workers have the right to recognition of their basic human rights, including the right to earn their living and to be represented by a lawyer, despite their migratory status.

The International Labor Organization has drafted important treaties, such as Convention No. 143 concerning Migrations in Abusive Conditions and the Promotion of Equal Opportunity and Treatment of Migrant Workers. This Convention establishes equal treatment between migrants and nationals as regards security of employment, rehabilitation, social security, employment-related rights and other benefits.

Many of the rights included in the International Labor Organization conventions are considered international customary law. These rights are also included in the most important human rights conventions, such as the International Covenant on Economic, Social and Cultural Rights, the International Covenant on Civil and Political Rights, and the International Convention on the Elimination of All Forms of Racial Discrimination.

Lastly, it should be stressed that human rights extend to all migrant workers, whether their situation in a State is regular or irregular.

*Students of the Law  
Faculty of the  
Universidad Nacional  
Autónoma de México  
(UNAM):*

*In their written and oral statements, indicated that:*

*Regarding the admissibility of the consultation:*

The advisory opinion requested is clearly important, "not only for Mexico, but also for all Latin America, owing to the number of migrants in an irregular situation in other countries and because they are considered a vulnerable group, prone to systematic violation of their human rights."

*Regarding the first question of the consultation (supra para. 4):*

Even though labor rights have been included among the economic, social and cultural rights, in reality, they form part of an indissoluble whole of all human rights, with no hierarchy, because they are inherent to human dignity.

"The problem of discrimination occurs particularly in

labor-related matters." Undocumented migrants endure several disadvantages; for example, they are paid low wages, receive few or no social benefits or health expenses, are not allowed to join unions and are under constant threat of dismissal or being reported to the migration authorities. "This is confirmed institutionally." Some United States laws and decisions establish a distinction between undocumented migrants, nationals and residents "that is neither objective nor reasonable and, consequently, results in evident discrimination."

The principle of non-discrimination applies to all rights and freedoms, pursuant to domestic law and international law, in accordance with the provisions of Article II of the American Declaration and Articles 1(1) and 24 of the American Convention.

Obviously, States have the sovereign authority to enact labor laws and regulations and establish the requirements they consider appropriate for aliens who become part of their workforce. However, this authority may not be exercised disregarding the international human rights *corpus juris*.

"Human rights do not depend on the nationality of an individual, on the territory where he is, or on his legal status, because they are inherent in him. Upholding the contrary would be akin to denying human dignity. If the exercise of authority is limited by human rights, State sovereignty cannot be cited to violate them or prevent their international protection."

*Regarding the second question of the consultation (supra para. 4):*

Human rights treaties are based on a notion of collective guarantee; consequently, they do not establish mutual obligations between States; rather, they determine the State obligation to respect and guarantee the rights contained in such instruments to all persons.

Any interpretation of the international human rights instruments must take into account the *pro homine* principle; in other words, they must be interpreted so as to give preference to the individual, "it is therefore unacceptable that Article 2, paragraph 1, of the Universal Declaration, Article II of the American Declaration, and Articles 2 and 26 of the Covenant, as well as Articles 1 and 24 of the American Convention should be interpreted as limiting the human rights of a group of persons, merely because of their undocumented status."

An interpretation of any international instrument that leads to the restriction of a right or freedom of an individual, who is not legally resident in the country where he resides, is contrary to the object and purpose of all international human rights instruments.

*Regarding the third question of the consultation (supra para. 4):*

States have the sovereign authority to issue migratory laws and regulations and to establish differences between nationals and aliens, provided that such domestic norms are compatible with their international human rights obligations. These differences must have an objective, reasonable justification; consequently, they should have a legitimate objective and there must be a reasonable relationship of proportionality between the means used and the aim sought.

A State party to the International Covenant on Civil and Political Rights which enacts a law that clearly violates this instrument or takes measures that limit the rights and freedoms embodied in this treaty to the detriment of a group of persons incurs international responsibility,

Equality before the law and non-discrimination are essential principles that apply to all matters. Therefore, any act of the State, including an act in keeping with its domestic laws, which subordinates or conditions the fundamental human rights of a group of persons, entails the State's non-compliance with its obligations *erga omnes* to respect and guarantee those rights. Consequently, it results in the increased international responsibility of the State and any subject of international law may legitimately cite this.

*Regarding the fourth question of the consultation (supra para. 4):*

The 1969 Vienna Convention on the Law of Treaties has recognized the existence of norms of *jus cogens*, by establishing them as peremptory norms of international law. However, it did not define them clearly.

Norms of *jus cogens* respond to the need to establish an international public order (*ordre public*), because a community ruled by law requires norms that are superior to the will of those who form part of it.

The international community has repudiated violations of the principle of non-discrimination and the right to the equal and effective protection of the law.



The principle of non-discrimination and the right to equality before the law are of transcendental importance in relation to the situation of undocumented migrant workers, because their violation involves the systematic violation of other rights.

The principle of non-discrimination and the right to equal protection of the law, "which are the essence of human rights, are norms of *ius cogens*." Norms of *ius cogens* are enforceable *erga omnes*, because they contain elemental values and concerns of mankind based on universal consensus, owing to the special nature of the prerogative they protect.

*Javier Juárez, of the Law Office of Sayre & Chavez:* *In his brief of February 6, 2003, stated that:*

On March 27, 2002, the United States Supreme Court decided that undocumented migrant workers, who had been unduly dismissed because they had organized unions, did not have the right to back pay under the National Labor Relations Act.

For undocumented workers, this decision creates a clear legal exception to the guarantees granted to other workers; therefore, it contravenes the provisions of the international agreements that seek to ensure equal protection for migrant workers and it increases the vulnerability that distinguishes them from other groups in the general population.

The case cited involves Mr. Castro, a worker employed in the plant of the *Hoffman Plastic Compounds* company in Los Angeles, California. In 1989, when Mr. Castro helped organize a union to improve working conditions in the plant, he was dismissed. In January 1992, the National Labor Relations Board decided that Mr. Castro's dismissal was illegal and ordered payment of back pay and his reinstatement.

In June 1993, during the hearing held before an administrative judge of the National Labor Relations Board to determine the amount of back pay, Mr. Castro indicated that he had never been legally admitted or authorized to work in the United States. As a result of this statement, the administrative judge decided that he could not grant payment of back pay, because this would conflict with the 1986 Immigration Control and Reform Act, which prohibits employers from knowingly employing undocumented workers, and employees from using false documents in order to seek employment.

In September 1998, the National Labor Relations Board revoked the decision of the administrative judge and indicated that the most effective way to promote immigration policies was to provide undocumented workers with the same guarantees and remedies as those granted to other employees under the National Labor Relations Act.

The National Labor Relations Board decided that, even though the undocumented worker did not have the right to be reinstated, he should receive back pay and the interest accrued for the three years' lost work.

The United States Court of Appeal denied the request for review filed by *Hoffman Plastic Compounds* and reaffirmed the decision of the National Labor Relations Board.

On March 27, 2002, the United States Supreme Court considered the case and annulled the payment that was to be made to the worker.

The decision of the United States Supreme Court rejecting the payment to the worker stated that allowing the National Labor Relations Board to allow payment of back pay to illegal aliens would prejudice statutory prohibitions that were essential to the federal immigration policy. This would help individuals avoid the migratory authorities, pardon violations of immigration laws and encourage future violations.

The minority opinion of the United States Supreme Court indicated that the decision adopted in the *Hoffman Plastic Compounds* case would undermine labor legislation and encourage employers to hire undocumented workers. The dissenting opinion in the case established that payment of back pay is not contrary to the national immigration policy.

This dissenting opinion also indicated that, by failing to apply the labor legislation, those persons who most needed protection were left open to exploitation by employers. It added that the immigration law did not weaken or reduce legal protection, or limit the power to remedy unfair practices carried out against undocumented workers.

In its broadest sense, the decision of the United States Supreme Court implies that undocumented workers do not have the right to file proceedings to obtain payment of overtime, or to claim violations of the minimum wage or discrimination.

However, in two different cases related to violations of the minimum wage, a district court and a superior court decided that the migratory status of workers was not relevant in order to request payment of the minimum wage for the period of employment.

Several state authorities were mentioned which consider that the decision of the United States Supreme Court in the *Hoffman Plastic Compounds* case has a negative impact on the labor rights of migrant workers.

Most migrant workers are unwilling to exercise their rights and, on many occasions, do not report the abuses to which they are subjected.

Corporate associations also confirm the legal, social and economic vulnerability of undocumented workers. Recently, the Center for Labor Market Studies of Northwestern University conducted a study on the impact of migrants in the United States. The study director indicated that, over the last 100 years, the economy of the United States has become more dependent on migrant labor. He added that many of these new migrant workers, possibly half of them, are in the United States without legal documents, which means that the economy depends on individuals who are in a "legal no-man's land."

In summary, the decision of the United States Supreme Court in the *Hoffman Plastic Compounds* case may be seen as one of the latest additions to the legal structure that, directly or indirectly, has denied migrants the basic guarantees required to alleviate their social and economic vulnerability.

Many differences in treatment are derived directly from the undocumented status of workers and, at times, these differences also extend to documented migrants.

*Harvard Immigration and Refugee Clinic of Greater Boston Legal Services and the Harvard Law School, the Working Group on Human Rights in the Americas of Harvard and Boston College Law Schools, and the Global Justice Center:*

*In their written and oral statements, indicated that:*

They are interested in this case and, in particular, in the labor rights of migrant workers in the Americas.

They endorse Mexico's argument that the facts show that migrant workers do not enjoy universal human rights in fair and equitable conditions. The disparity between existing international norms that protect migrant workers and national discriminatory practices and legislation is the greatest challenge faced by migrant workers.

They proceeded to review the laws and practice of

some American States in order to understand the disparity that exists between the rights of migrant workers and the relevant public policy.

*Regarding laws and practices in Argentina:*

According to the Argentine General Migration Act only migrants admitted as permanent residents enjoy all the civil rights guaranteed in the Constitution, including the right to work. The right to work granted to temporary or transitory migrants is more limited, while migrants who are in breach of the General Migrations Act do not have the right to work and may be detained and expelled.

It is almost impossible for many undocumented migrants to comply with the requirements for obtaining legal residence in Argentina established in Decree No. 1434/87, which stipulates that the Migrations Department may deny legal residence to migrants who: 1) entered the country avoiding migratory control; 2) remained in the country for more than 30 days, in violation of the law; or 3) work without the legal authorization of the Migrations Department. Likewise, the Ministry of the Interior has extensive discretionary powers to deny legal residence to migrants.

In the practice, because most migrants in Argentina have few resources, are not professionals and do not have Argentine relatives, the best way to regularize their migratory status is to present an employment contract entered into with an Argentine employer. However, as the regulations are very complex, many migrants are obliged to maintain their illegal status. Consequently, they have to accept precarious working conditions and very low salaries, and endure other abuse from their employers.

*Regarding laws and practice in Brazil:*

The 1988 Federal Constitution of Brazil guarantees the legitimacy of the rights embodied in the international treaties to which Brazil is a party. The Federal Constitution also establishes equal treatment for nationals and aliens.

Brazilian labor laws make no distinction between nationals and aliens. Undocumented workers have the right to receive wages and social benefits for work performed. Moreover, there are no provisions that limit access to justice because of the complainant's nationality.

In practice, irregular workers in Brazil endure many

difficulties, including long working hours and lower than minimum wages. Many irregular migrants never report abuses for fear of being deported. This fear also means that irregular migrants do not send their children to school, request driving licenses, buy goods, or visit their countries of origin.

Likewise, these workers have little information about their rights and can only claim them when they receive help from non-governmental organizations working with migrants.

*Regarding laws and practice in Chile:*

According to Chilean laws and regulations, national and foreign workers have equal labor rights.

Under Chilean labor legislation, an employment contract does not have to be in writing; however, the migratory law requires migrant workers to have a written contract drawn up before a public notary, in which the employer commits himself to paying the migrant's transport back to his country of origin on termination of the contract.

Migrant workers working in Chile without a written contract often receive very low wages, do not have access to social security benefits and can be dismissed at any time without monetary compensation. This situation is especially difficult for irregular migrant workers, because they fear being identified by the immigration authorities.

Likewise, given that irregular workers often do not possess national identity documents, they do not have access to many public services, including medical care and public housing.

The labor legislation does not expressly regulate the rights of workers without a contract, so the Labor Department and the Inspections Unit regulate their situation. Information on how these labor authorities interpret the law is not readily available to migrant workers. Chilean legislation on foreign workers has not been updated and provides them with very little protection, particularly in labor disputes.

*Regarding laws and practice in the Dominican Republic:*  
The greatest obstacle to the protection of the rights of migrant workers in the Dominican Republic is the difficulty that Haitians face in establishing legal residence there. Once they have obtained their legal status, the law guarantees migrants the same civil

rights as Dominicans. The law does not distinguish between citizens and documented aliens as regards their economic, social and cultural rights. Basic labor rights are guaranteed to all workers, regardless of whether or not they are legally resident in the country.

There are diverse problems in the workplace. For example, the minimum wage is insufficient to enjoy a decent life; the requirements for collective negotiation are unattainable; the fines imposed on employers are insufficient to prevent the violation of workers' rights, and many health and security inspectors are corrupt.

Most Haitian migrant workers in the Dominican Republic face long working hours, low wages and lack of employment security. Their living conditions are inadequate. Most workers do not have drinking water, latrines, medical care or social services.

Haitian migrant workers have a very limited possibility of combating these unfair working conditions. They have to face political and social attitudes that are generally hostile. At the same time, most of these workers do not have access to legal aid and, consequently, to the labor courts.

The way that the migratory and citizenship laws are applied in the Dominican Republic contributes to perpetuating the permanent illegality of Haitians and Dominicans of Haitian descent. Moreover, given their poverty and illiteracy, it is very difficult for migrant workers to comply with the requirements to obtain temporary employment permits. The status of Haitian workers as irregular migrants affects their children, even those born in the Dominican Republic. The children of Haitians, who are born in the Dominican Republic, are not considered citizens, because Haitians are classified as aliens in transit. This situation has meant that Haitians are subject to deportation at any time and mass expulsions have been carried out in violation of due process.

For decades, the Dominican Republic has benefited from the cheap labor of Haitians and the State has developed a system that maintains this flow of migrant workers without taking the minimum measures to ensure their fundamental rights.

*Regarding laws and practice in the United Mexican States:*

Pursuant to Articles 1 and 33 of the Constitution, which refer to equal protection, constitutional labor rights

must be guaranteed to all migrants.

According to its Constitution, Mexico is obliged to implement the bilateral and multilateral treaties on the labor rights of migrant workers to which it has acceded. These treaties ensure equal protection and non-discrimination, as well as other more specific guarantees.

The Federal Labor Act allows migrants to work legally in Mexico as visitors. However, there are professional restrictions on certain categories of visitors; these categories include most migrant workers from Central America, who are usually less qualified. Therefore, workers from Central America can only enter Mexico legally under the "Migratory Form for Agricultural Visitors" or under the "Migratory Form for Local Border Visitors." Some provisions of the Federal Labor Act allow preferential treatment in contracting Mexican workers in relation to migrant workers.

The most common violations of the rights of migrant workers are: long working hours; inadequate living, health and transport conditions; below minimum wages; deductions from wages for food and housing; retention of wages and employment documents and racial discrimination. Owing to the bleak social and economic conditions in their countries of origin, many migratory agricultural workers are obliged to accept these abuses.

Although the "Migratory Form for Agricultural Visitors" and the "Migratory Form for Local Border Visitors" programs exist, and measures have been taken to protect the rights of migrant workers, these programs have been managed inadequately and have not prevented the abuse of workers. For example, the Local Arbitration and Conciliation Committees settle disputes between workers and employers, but the process is often slow. Also, many workers resort to the Committees without any legal representation and are summarily deported, even when their cases are pending.

*Regarding laws and practice in the United States of America:*

As a State party to the OAS Charter, the United States are subject to the obligations established by the American Declaration, which guarantee the right to work and to fair wages, as well as the right to organize unions and to receive equal treatment before the law. The Universal Declaration also guarantees the right to

form trade unions and to equal remuneration for work of equal value. The International Covenant on Civil and Political Rights, to which the United States is a party, guarantees the right to equality before the law, without discrimination, and establishes the right to form trade unions. Lastly, the International Labor Organization conventions protect the labor rights of irregular workers.

Under existing labor legislation in the United States, irregular workers are recognized as "employees," which gives them the right to the protection indicated in the principal federal labor laws. However, in practice they are not treated equally.

The National Labor Relations Act (NLRA) authorizes the National Labor Relations Board (NLRB) to establish remedies for employees who are victims of unfair labor practices. For example, in cases of unjustified dismissal, the remedy might consist of reinstatement and payment of back pay. In *Hoffman Plastic Compounds v. National Labor Relations Board* (2002), the United States Supreme Court decided that an irregular worker did not have the right to back pay, even when he had been dismissed for taking part in the organization of a union to obtain fair pay. In this case, the Supreme Court determined that "migratory policy had precedence over labor policy." According to the Supreme Court's decision in *Sure-Tan v. National Labor Relations Board* (1984), workers can be handed over to the Immigration and Naturalization Service even when the employer's reason for doing so is unlawful retaliation against a worker who is carrying out an activity protected by the National Labor Relations Act. With these decisions, the Supreme Court has created inequality in the labor laws of the United States, based on migratory status.

Many irregular workers in the United States face serious problems owing to poor health and security conditions in the workplace, because they are paid less than the legal minimum. Migrant workers are also the target of discrimination and violence by third parties. Several States deny irregular workers access to education and medical care. Also, irregular workers who defend their rights run the risk of being reported to the Immigration and Naturalization Service. Undocumented migrants do not have access to legal aid, which makes it more difficult for workers to insist on their rights.

The difficult situation faced by irregular workers also affects migrant workers who are covered by the "H2A"



and "H2B" visa programs. The rights of such workers are extremely restricted; for example, they are not covered by the law that establishes payment for overtime. In addition, the permit to be in the country legally is conditioned to remaining in a job with one employer, which restricts the worker's possibility of insisting on his rights.

Lastly, approximately 32 million workers, including many migrants who provide domestic services or work on farms, are not protected by the provision of the National Labor Relations Act establishing the right to organize unions or by any state legislation.

*Thomas Brill, of the Law Office of Sayre & Chavez:* *In his written and oral statements, indicated that:*

In March 2002, the United States Supreme Court decided, in *Hoffman Plastic Compounds v. National Labor Relations Board*, that an undocumented worker did not have the right to the payment of lost wages, after being illegally dismissed for trying to exercise rights granted by the National Labor Relations Act.

*Hoffman Plastic Compounds* engaged José Castro in May 1988. In December 1988, Mr. Castro and other workers began a campaign to organize a union. In January 1989, the company dismissed Mr. Castro and three other workers for trying to create and join a union. In January 1992, the National Labor Relations Board ordered *Hoffman Plastic Compounds* to reinstate Mr. Castro and to give him the back pay he would have received, had it not been for the company's decision to dismiss him because he was involved in union activities. The company refused to give Mr. Castro the back pay, because he admitted that he did not have an employment permit.

In September 1998, the National Labor Relations Board decided that *Hoffman Plastic Compounds* must pay Mr. Castro back pay corresponding to the period from his dismissal up until the date on which he admitted that he did not have the documentation corresponding to the employment permit. In its decision, the National Labor Relations Board said that "[t]he most effective way to adapt and promote the United States immigration policies [...] is to provide the guarantees and remedies of the National Labor Relations Act to undocumented workers in the same way as to other workers." The National Labor Relations Board ordered *Hoffman Plastic Compounds* to pay Mr. Castro the amount of US\$66,951 (sixty-six thousand nine hundred and fifty-one United States dollars) for the concept of back pay. *Hoffman Plastic Compounds* refused to pay

Mr. Castro and filed an appeal. In 2001, the Federal Appeals Court confirmed the decision of the National Labor Relations Board and *Hoffman Plastic Compounds* filed an appeal before the United States Supreme Court.

In its decision of March 2002, the Supreme Court revoked the decisions of the Appeals Court and the National Labor Relations Board. It denied Mr. Castro's request for back pay and stated that, in the case of irregular workers who are dismissed for carrying out union-related activities, the prohibition to work without an authorization contained in the immigration legislation prevailed over the right to establish and join a union.

The National Employment Law Project, an American non-profit agency that examined the effect of the decision in the *Hoffman Plastic Compounds* case, determined that, as of that decision, employers have tried to deteriorate further the rights of irregular workers in the United States.

Many employers have infringed the rights of their employees since the decision in the *Hoffman Plastic Compounds* case was published. Indeed, employers can argue that irregular workers cannot file a complaint with the justice system when they are discriminated against or when their right to the minimum salary is violated. Clearly, the decision in the *Hoffman Plastic Compounds* case has led employers to discriminate against their irregular workers, arguing that the latter have no right to take legal action when their labor rights are violated. Thus, engaging irregular workers has been encouraged, because they are cheaper for the employer, and so as not to employ citizens or residents who can demand the protection of their rights before the courts.

However, it is important to note that the decision in the *Hoffman Plastic Compounds* case was not adopted unanimously by the United States Supreme Court, but by a majority of 5 votes to 4; the author of the dissenting opinion was Judge Breyer. He indicated that allowing irregular migrants access to the same legal remedies as citizens was the only way to ensure that migrants' rights were protected. Judge Breyer carefully examined the possible impact of the decision on irregular workers and stated that if undocumented workers could not receive back pay when they were illegally dismissed, employers would dismiss such workers when they tried to establish trade unions, because there would be no consequences for the

employer, at least the first time he used this method.

Likewise, as Judge Breyer stated, there is no provision in the United States immigration legislation that prohibits the National Labor Relations Board from allowing irregular workers to file remedies or actions when their rights are violated. However, the majority opinion of the United States Supreme Court eliminated the possibility that an irregular worker could file a claim for back pay before the courts, based on the alleged conflict between the National Labor Relations Act and the 1986 Immigration Reform and Control Act.

Both the National Labor Relations Board and the Supreme Court approached the *Hoffman Plastic Compounds* case as one that required a balance between labor legislation and immigration legislation. The National Labor Relations Board and the four judges of the Supreme Court in the minority gave priority to labor laws, while the five judges who comprised the majority granted priority to immigration laws.

In their decisions, the National Labor Relations Board and the Supreme Court did not take international human rights law and the norms of international labor law into consideration. Nor did they consider the obligations of the United States, pursuant to international law, to "ensure, in cooperation with the United Nations, the universal and effective respect for the fundamental rights and freedoms of man."

In summary, the decision in the *Hoffman Plastic Compounds* case denies a group of workers their inherent labor rights that have been recognized by the international community.

One of the principal entities that has referred to the topic of human rights is the Organization of American States (OAS). The United States and Mexico are two of the 35 States parties actively involved in the OAS administration and, in theory, they adhere to the general principles and standards established by this international organization.

In this respect, it is important to cite Articles 3(I) and 17 of the OAS Charter, which refer to equality and non-discrimination. These principles are also mentioned in the American Declaration.

However, Mexico has not requested the Court to examine the United States immigration legislation. The right of each State to establish immigration rules is not questioned. Nevertheless, when the legislators of any

specific State establish policies that discriminate against certain categories of workers in the labor market, it can have a devastating result on the protection of human rights. Fundamental human rights must prevail over the objective of preventing certain workers from enjoying the benefits granted by law.

For the above reasons, it is considered that the recent decision of the United States Supreme Court in *Hoffman Plastic Compounds v. National Labor Relations Board* creates a system that violates international law.

*Labor, Civil Rights and  
Immigrants' Rights  
Organizations in the United  
States of America:*

*In their written and oral statements, they stated that:*

The brief was prepared in representation of 50 civil rights, labor and immigrant organizations in the United States.

Migrant workers in the United States are among those workers who receive the lowest wages and most unfair treatment. Attempts by organizations to protect the rights of migrants, including "unauthorized" workers, have been obstructed by United States laws that discriminate based on the status of alien and migrant and, above all, owing to the decision of the United States Supreme Court in *Hoffman Plastic Compounds v. National Labor Relations Board*. Moreover, federal and state labor legislation violate international human rights law, which is obligatory for the United States. There is an urgent need for strong regional standards for the protection of migrant workers.

The expression "unauthorized worker" is used to describe migrant workers who are not authorized to be employed legally in the United States. This group includes workers who, for different reasons, are legally in the United States but are not authorized to work. The expression "undocumented" migrant is used to describe migrants whose presence in the United States is illegal. These workers form a subgroup of the migrant population that is not authorized to work. Most decisions taken by the courts are based on the authorization to work.

The United States has the largest migrant population in the world. For the purposes of this brief, the figure of 5.3 million persons (an approximate calculation of the total number of undocumented workers in the United States), will be sufficient to establish that this population represents a sizeable economic factor and an issue of political and human concern. Undocumented workers perform most of their work in sectors characterized by low salaries and high risk.

The practice of threatening migrant workers with reporting them to the Immigration and Naturalization Service (INS), in order to limit the exercise of their labor rights, has been common for many years and has not decreased since the decision in *Hoffman Plastic Compounds v. National Labor Relations Board*.

Penalties for employers who hire "unauthorized" workers are ineffective in the United States. The 1986 Immigration Reform and Control Act (IRCA) establishes that an employer must verify the identity and eligibility of the personnel he engages. However, the law allows employers to review the documents superficially. Employers have very little reason to fear that the Immigration and Naturalization Service will penalize them for engaging undocumented migrants; rather, they see this as a legitimate decision that saves them money. Even when employers break the law, the penalties and fines they receive are low and infrequent. Therefore, under current legislation, employers can engage "unauthorized" workers, benefit from them and threaten to report them to the Immigration and Naturalization Service, without fear of possible Government action.

Some migrant workers, particularly those who are "unauthorized", are expressly excluded from the possibility of receiving certain reparations that are available to United States citizens. For examples in the *Hoffman Plastic Compounds* case, the United States Supreme Court decided that "unauthorized" workers could not receive back pay following a dismissal in reprisal for union activities, which is illegal under by the National Labor Relations Act that protects the right to organize unions and negotiate collectively. The Equal Employment Opportunity Commission (EEOC), the governmental agency that applies most of the federal labor laws on discrimination, has indicated that it is reviewing the practice of ordering payment of back pay to undocumented workers in light of the decision in the *Hoffman Plastic Compounds* case.

Lastly, the decision in the *Hoffman Plastic Compounds* case leaves intact the right to a minimum wage and the payment of overtime, under the Fair Labor Standards Act, because it referred only to the payment of back pay for work that had not been performed. However, the US Department of Labor, the federal agency responsible for applying the Fair Labor Standards Act, has not defined its opinion on the right of "unauthorized" migrants to payment of back pay arising from dismissals for reprisals, and has said that

"it is still considering the effect of the *Hoffman [Plastic Compounds]* case on this reparation."

Even before the *Hoffman Plastic Compounds* case, some United States laws discriminated explicitly against workers in certain migratory categories, including "unauthorized" workers and those who held specific types of visas. In most states, "unauthorized" workers have the right to receive compensation for occupational accidents or incapacity. In general, such compensation is regulated by state legislation and this varies in each state. Workers usually receive medical expenses, a partial reimbursement of their salaries, pensions, benefits in case of death and, at times, training for new employment. While the legislation on compensations in almost all the states applies to "unauthorized" workers, the laws of the state of Wyoming explicitly exclude them from the benefits of compensation, while other judicial decisions and provisions restrict payment of compensation for factors such as rehabilitation, death and back pay.

Workers included in the H-2A visa program (for agricultural employment), who are mostly from Mexico, are denied many basic federal labor measures protection. They are excluded from the protection of the Migrant and Seasonal Agricultural Worker Protection Act (MSAWPA), the principal labor act regulating agricultural workers. Therefore, their employer is not controlled by the United States Labor Department. In addition, the permit for H-2A workers to remain legally in the United States is linked to a single employer. Consequently, these workers are not at liberty to change employment.

The right of migrant workers to legal representation is also seriously restricted. The 1974 Legal Services Corporation Act created the Legal Services Corporation, and its programs are prohibited from providing legal aid for, or in representation of, most migrants who are not legal permanent residents.

Once an alien is physically in the territory of a country and has found employment, the refusal to provide him with labor protection measures violates the human right to non-discrimination. Numerous international instruments that are obligatory for the United States establish a universal norm of non-discrimination that protects all persons within the jurisdiction of a State. Differences in treatment based on nationality or migratory status, such as those established in the above-mentioned United States labor laws, violate Articles 2 and 26 of the International Covenant on Civil

and Political Rights, and Article II of the American Declaration. The wording of these provisions and that of the conventions of the International Labor Organization indicate that the guarantee of equality and non-discrimination, as well as others related to work, are universal and apply "to all persons."

States may not discriminate on the basis of nationality or any other condition, according to the International Covenant on Civil and Political Rights, but only to establish distinctions based on reasonable and objective criteria. The argument that some United States labor laws establish discriminations that violate Articles 2 and 26 of the International Covenant on Civil and Political Rights is supported by the interpretation of the United Nations Committee on Human Rights. In *Gueye et al. v. France*, the Committee reasserted its position that the provisions of the International Covenant on Civil and Political Rights are applicable to non-nationals, provided that the contrary is not expressly established. It was also shown that distinctions based on being an alien violate Article 26 of the International Covenant on Civil and Political Rights, even though this treaty does not expressly guarantee the substantive benefit in dispute (in this case, the right to a pension or, for example, the right to fair wages, adequate working conditions and an effective remedy with legal assistance). The decision in this case states that a distinction based on a person's status as an alien is inadmissible, when it lacks reasonable and objective grounds, even though the substantive rights, in themselves, are not fundamental and are not recognized by the International Covenant on Civil and Political Rights. Finally, the decision establishes that if the distinction in the employment benefit is reasonable and objective and, therefore, permissible, a court must examine the implicit purpose of the labor law in order to determine whether the distinction is relevant for attaining the proposed objective. United States labor rights laws that discriminate on the basis of alien or migratory status do not resist this examination. Once an alien has been engaged, his nationality and his legal status are irrelevant for the purpose of protecting an individual in his place of employment and preventing his exploitation. Migratory control cannot be considered the principal aim of labor protection legislation, and restrictions imposed by the United States on the labor protection of aliens does not contribute objectively or reasonably to this end.

The language and the arguments *expresio unius* established in the International Covenant on Civil and

Political Rights also apply to the American Declaration and Convention. The language of the inter-American instruments is universal and does not establish express distinctions based on alien or migratory status. The case law of the inter-American system on non-discrimination agrees substantially with case law relating to the International Covenant on Civil and Political Rights and helps us conclude that the United States labor laws discriminate unduly against migrant workers.

Other international treaties and declarations applicable to the United States, including the International Covenant on Economic, Social and Cultural Rights and Convention No. 111 of the International Labour Organization, confirm that the basic principles of non-discrimination apply to labor protection without distinction owing to nationality or migratory status.

In addition to violating the principle of international law of non-discrimination, United States labor legislation does not protect the freedom of association of "unauthorized" workers and other migrant workers and violates the fundamental international principle of freedom of association. The International Labor Organization has expressly recognized freedom of association as one of the four fundamental human rights that protect all workers, including "unauthorized" and undocumented workers. Other international instruments (such as the American Declaration, the American Convention, the OAS Charter and the International Covenant on Civil and Political Rights), applicable to the United States, allow exceptions to the right to freedom of association only in limited circumstances, which do not justify the failure to guarantee this right to aliens and "unauthorized" migrants.

The decision of the United States Supreme Court in the *Hoffman Plastic Compounds* case that back pay cannot be paid to "unauthorized" workers when they are improperly dismissed for taking part in union activities, affects the right to freedom of association of such workers. Since these workers do not have the right to reinstatement when they are improperly dismissed, payment of back pay is the only available effective reparation for violations of the National Labor Relations Act.

*The Academy of Human Rights and International Humanitarian Law of the American University,*

*In their brief of February 21, 2003, indicated that:*

This request for an advisory opinion should take into consideration the "autonomous clauses" of the



*Washington College of Law, and the Human Rights Program of the Universidad Iberoamericana de México:*

international treaties and instruments cited by the requesting State; that is, Articles II of the American Declaration, 24 of the American Convention, 7 of the Universal Declaration and 26 of the International Covenant on Civil and Political Rights. Regarding the norms that embody the principle of non-discrimination subordinated to the existence of a violation of one of the rights protected in these instruments, "there is no doubt that Articles 1(1) of the American Convention and 2(1) of the International Covenant on Civil and Political Rights should be excluded from the analysis, because these instruments do not guarantee labor rights. The situation concerning Article 2 of the Universal Declaration is different, because this instrument effectively guarantees such rights, including, in particular, what could be considered minimum standards of protection in this area."

The human rights norms cited by the requesting State do not expressly forbid making distinctions based on the nationality or migratory status of an alien. However, the provisions being examined do not establish a specific or exhaustive list of reasons for which distinctions may not be established; to the contrary, "they appear to admit that, in principle, a distinction on some specific grounds may result in discriminatory treatment."

The provisions applicable to this request have all been interpreted under international human rights law, in the sense that a measure is discriminatory only when the distinction in treatment is not based on objective and reasonable grounds; in other words, when it does not pursue a legitimate goal or when the relationship between the means used and the goal that the measure is intended to achieve is not proportionate. However, States enjoy a certain margin of maneuver to evaluate whether a difference in treatment between persons who are in a similar situation is justified.

This analysis makes no specific reference to Mexico's two final questions, because the answer to those questions is subsumed in the analysis of the other questions.

Although the requesting State referred to "labor rights" in their broadest sense in its questions, this analysis focuses specifically on the "right of all persons to wages and benefits for work performed"; therefore, there is no doubt that, in international human rights law applicable to the American States, this minimum labor protection must be guaranteed to every individual, including undocumented workers. In this respect, it is important to clarify that, for the purposes of this *amici curiae*, the

definition of "remuneration and benefits for work performed" includes not only the so-called back pay, but also other accessory labor rights such as the right to join a union or the right to strike.

*Regarding the first question of the consultation (supra para. 4):*

In different international instruments, international human rights law enshrines a wide variety of norms on workers' rights. The labor rights provisions contained in instruments adopted or ratified by OAS Member States are: Article 23 of the Universal Declaration; Articles 34(g), 45(b) and 45(c) of the OAS Charter, and Article XIV of the American Declaration. Other relevant international instruments also determine the scope of regional human rights obligations with regard to workers' rights, they include: Articles 6, 7 and 8 of the International Covenant on Economic, Social and Cultural Rights; the American Convention; the Additional Protocol to the American Convention on Human Rights in the Area of Economic, Social and Cultural Rights; Convention No. 97 of the International Labour Organization concerning Migrant Workers; the Constitution of the International Labour Organization; and the International Convention on the Protection of the Rights of all Migrant Workers and their Families.

The right of all persons to receive remuneration for work performed is one of a group of rights that "are closer to civil and political rights, either because they have a direct impact on rights such as the right to property or the right to legal personality [...] or because of their immediate and urgent nature, which is implicitly or explicitly reiterated in many [...] instruments".

Articles 34(g) and 45(b) of the OAS Charter presume the existence of the worker's right to receive remuneration for work performed, a right that is so obvious that it was not necessary to enshrine it explicitly. The right is explicitly protected in Article XIV of the American Declaration. The OAS Charter and the American Declaration do not differentiate between a citizen and an alien whose status is irregular, but refer in general to "person" or "worker."

Article 23 of the Universal Declaration reflects implicitly and explicitly the general principle that if a person has worked, he should receive the corresponding remuneration.

Mexico did not cite the International Covenant on Economic, Social and Cultural Rights in its request for an advisory opinion; however, this treaty also contains

relevant references to the right to receive remuneration for work performed. In the same way, Article 7 of the Additional Protocol of the American Convention on Human Rights in the Area of Economic, Social and Cultural Rights "Protocol of San Salvador" guarantees the right to a "fair and equal wages for equal work, without distinction." The International Convention on the Protection of the Rights of all Migrant Workers and Members of their Families explicitly embodies minimum guarantees, including the right of undocumented migrant workers to the remuneration for which they have already worked.

As irregular migrant workers and the members of their families are a particularly vulnerable sector of society, the State has the special obligation "to grant particular protection or, in this case, to abstain from taking excessively oppressive measures that restrict the labor rights of such persons and that, evidently, are not only unnecessary to achieve the legitimate goal sought, but also have the contrary effect."

In addition to any legal construct relating to international instruments, "the most elemental sense of justice requires that a person who has worked should be guaranteed that he will receive his remuneration"; the contrary would mean the acceptance of a modern form of slave labor.

The general practice of States, reflected in international instruments, and the perception of those States that it is a legal norm sustaining the notion of *opinio juris*, suggest the existence of an international norm of customary law concerning the right of the worker to receive remuneration for work performed. Moreover, it appears that States do not oppose recognizing this right, which excludes the possibility of arguing that there has been a persistent objection to this norm.

Human rights, such as the right to equality or the right to remuneration may be restricted, but limitations must respond to criteria of necessity and proportionality in order to attain a legitimate objective. Implementing measures to control irregular immigration into a State's territory is a legitimate objective. However, if such measures are intended to strip irregular migrant workers of the right to receive remuneration for work performed, it is urgent to examine the proportionality and the need and, to do this, we must consider whether there are other measures that are less restrictive of the said right.

There are other mechanisms that can be adopted to

control irregular immigration into a State's territory. They include the possibility of penalizing those who employ undocumented workers administratively or criminally, reinforcing border immigration controls, establishing mechanisms to verify legal status in order to avoid the falsification of documents, deporting undocumented persons, and investigating and punishing those who commit offences. It does not appear proportionate or necessary to adopt measures aimed at stripping migrant workers of the remuneration for which they have already worked. Such measures "appear to be a 'punishment' that excessively affects not only the worker but also the members of his family." The International Convention on the Protection of the Rights of all Migrant Workers and Members of their Families can serve as a guide to confirm that some restrictions to the right to receive remuneration for work performed are neither necessary nor proportionate.

Likewise, the right to receive remuneration for work performed cannot be limited by indirect measures, such as the adoption of measures restricting the right of the worker whose situation is irregular to take legal action to claim his wages; for example, by demanding that he should be physically present in the jurisdiction of the recipient State in order to be able to make this claim, after he has been deported and will not be granted authorization to enter the said State again.

*Regarding question 2(1) of the request (supra para. 4):* Regarding the provisions of the Universal Declaration – except for Articles 21 and 13 – there is agreement that, under norms of customary law, States have the obligation to respect and guarantee fundamental human rights to aliens under their jurisdiction, including those whose resident status is irregular.

International customary law obliges States to guarantee the principle of equality before the law and non-discrimination to all aliens resident in their jurisdiction and to prohibit differences in treatment between citizens and aliens that could be considered unreasonable. However, the rights and freedoms are not absolute and certain restrictions regulated in Article 29(2) of the Universal Declaration may be established.

In conclusion, the international instruments cited by Mexico in the request guarantee the right to equality before the law to all persons subject to the jurisdiction of a State, irrespective of their nationality or migratory status. However, this right is not absolute; consequently, it may be subject to reasonable restrictions. Moreover, under the International Covenant

on Civil and Political Rights and the American Convention, the right to equality before the law is not considered a non-derogable norm; in other words, it may be suspended under certain circumstances.

*Regarding question 2(2) of the request (supra para. 4):* We must bear in mind that the existence of discrimination is not determined in the abstract, but because of the concrete circumstances of each case. In the specific context of the request made by Mexico, the grounds for distinguishing between irregular migrant workers and other workers, for the recognition of minimum labor rights, is the migratory status of the former and not their nationality.

The different treatment that certain States afford irregular workers, owing to their migratory status, does not imply discrimination *per se*. Pursuant to constant international case law, a difference in treatment will be discriminatory when it is not based on objective and reasonable grounds; that is, when it does not have a legitimate objective or when there is no proportionality between the means used and the end sought with the questioned measure or practice. Likewise, the right to equality is not absolute; consequently, it may be subject to permissible restrictions and its exercise may be suspended in states of emergency. When examining the proportionality of the difference in treatment, the fact that labor rights are in question and that they would be denied to a vulnerable population should be taken into consideration.

Also, even though States enjoy a margin of discretion to establish differences in treatment between nationals and aliens in the application of immigration laws, this margin is considerably reduced when the rights at stake are so fundamental that their restriction or deprivation affects the minimum principles of respect for human dignity.

In circumstances when denying rights could place a person in a situation similar to forced labor, “[the] Honorable Court should restrict to a minimum the State’s freedom to decide and exercise strict control on the justifications put forward by the latter as the basis for its policies.”

Only in exceptional situations, with characteristics such as those of a state of emergency, and in the case of measures strictly limited to the requirements of the situation, can a different treatment be justified as regards the enjoyment of the minimum labor rights previously indicated, between aliens in an irregular migratory situation and nationals or legal residents.

The practice of some American States to subordinate recognition of the right to remuneration, understood in its broadest sense, to compliance with norms of immigration law, is unreasonable and incompatible with the obligation to respect and guarantee the right to equality before the law.

Denying minimum labor standards to undocumented workers does not help restrict the entry of irregular migrants into States. To the contrary, it encourages unscrupulous employers to hire more workers whose situation is irregular, owing to the possibility of subjecting them to extreme working conditions without any penalty from the State. If undocumented workers unite to claim their rights, employers can report their irregular situation and thus avoid complying with minimum labor standards.

A more appropriate policy to control immigration would be to apply severe penalties to those who employ irregular migrants, despite knowing or having the obligation to know their migratory status, so as to benefit from being able to offer inferior labor guarantees. Several American States do not have legislation penalizing this type of conduct and, in the States that have established fines, it is recognized that these are not sufficiently severe to discourage the employment of workers whose situation is irregular.

The standard of interpretation proposed does not restrict the right of States to apply the corresponding penalties, such as the deportation of those who fail to comply with the provisions of immigration legislation or who violate in any way the criminal provisions of domestic law. Nevertheless, even when an individual is subject to deportation for having been found to be in the territory of a State illegally, the latter must fulfill its obligations to respect the fundamental rights embodied in international human rights instruments.

In conclusion, denying undocumented workers minimum labor standards, understood as the right to remuneration in the broadest sense, based on their migratory status, is contrary to the right to equality before the law, because it is a disproportionate measure to achieve the immigration policy objectives of the States who adopt this practice.

*The Center for Justice  
and International Law  
(CEJIL):*

*In its written and oral statements, indicated that:*

Mexico's request is directly related to a very serious concrete situation; it will therefore be very useful for the region.

This *amicus curiae* focuses on questions 1(1), 2(1) and 2(2) of the request for an advisory opinion.

In law, the principle of equality is considered a fundamental right and the obligation not to discriminate is one of the essential prohibitions of international human rights law. This principle "is a basic rule, applicable to all rights."

In practice, the right to equality may be violated in different ways; for example, by the issue or implementation of discriminatory norms, the establishment or implementation of rules that are *prima facie* neutral, but have a negative differentiated effect on an individual or a group of individuals, and the establishment of measures or practices that are directly harmful to an individual or a group.

Although no instrument of the inter-American system is exclusively devoted to protecting migrant workers from discrimination, the American Convention and the American Declaration contain provisions that establish a commitment for States to ensure equality before the law and the exercise of the rights enshrined in the different conventions, without any discrimination. The inter-American system extends protection from non-discrimination to rights protected at the national level by means of the article on equality before the law. Therefore, Member States must ensure that their legislation does not contain discriminatory provisions and that there are no measures, practices, acts or omissions that cause harm to a group or to an individual.

Article 26 of the International Covenant on Civil and Political Rights does not simply reiterate the provisions of Article 2(1) of this instrument, but "extends autonomous protection because it prohibits any discrimination on any grounds as well as protection before the public authorities." This principle is directly applicable to economic, social and cultural rights because it is included in the International Covenant on Economic, Social and Cultural Rights.

The rights embodied in the International Convention on the Protection of the Rights of all Migrant Workers and Members of their Families must be guaranteed to all migrant workers, regardless of their migratory status.

The principle of equality and non-discrimination is recognized in the American Declaration, the American Convention and other international treaties, which coincide in ensuring to all persons the rights embodied

in these instruments, without any discrimination based on sex, language, religion, national or social origin, or other status.

The potential grounds for discrimination are not limited to those expressly included in the inter-American instruments. The texts of the American Convention, the American Declaration and other international instruments presume the existence of other possible grounds for discrimination. The United Nations Committee on Human Rights has indicated that the non-discrimination clause applies to cases that are not specifically set out in the international covenants. In this respect, the European Court has examined discriminatory treatment on the grounds of sexual orientation and age.

Likewise, the grounds that can create a "suspect category" are not exhausted in the list that appears in the inter-American instruments. The establishment of these categories "relates to the characteristics of discrimination at a specific time in a country or region." The relevance of the identification of a "suspect category" will depend largely on examination of the specific situation that is being regulated. Hence, in the case of migrant workers, it is essential to examine the concrete issues regulated by labor law.

To establish whether an act arising from the differentiation of two actual situations is discriminatory under the inter-American system, we must first evaluate whether we are faced with a situation that is truly and objectively unequal; then, we must assess whether the norm or measure that has made the distinction seeks a legitimate goal; and, finally, we must establish whether there is a relationship of proportionality between the differences established by the norm or measure and its aims.

Many States have become originators or recipients of persons who emigrate in search of work. A study of 152 States by the International Labor Organization found that, from 1979 to 1990, the number of States classified as major recipients of migrants in search of employment increased from 39 to 67, and the number of States considered major originators of migrants for economic reasons/employment increased from 29 to 55. In recent decades, the principal reason for which individuals have abandoned their country of origin has been to find better employment opportunities or to have access to better wages.

Irregular immigration has been growing as a result of



extreme poverty and lack of opportunities in the States of origin. This has encouraged the appearance of the "migration industry." Employers opt to employ undocumented migrants, so as not to pay adequate salaries or make an effort to provide suitable working conditions. "The recipient States are not unaware of the exploitation, since they also benefit from that 'industry', since their economy grows by dint of this irregular situation."

On the American continent, migrant workers, whose status is irregular, are subject to many discriminatory and abusive practices, which may be observed in their traumatic entry into the recipient State, in the discrimination and the xenophobic attacks they endure in their daily life, in the ill-treatment they receive at work, and in the way in which they are expelled from the recipient State.

The inequality of conditions between the employer and the undocumented migrant worker is more critical than in other labor relations, because of the latter's irregular situation. Owing to their precarious economic situation, undocumented migrant workers are ready to accept inferior working conditions to those of other persons who are legally resident in the country. The occupations to which migrant workers have access vary according to each country; however, "as regards wages, the employment they obtain is always the least attractive and, as regards hygiene and health, it is always the most dangerous."

Migrant workers whose situation is irregular have limited possibilities (*de facto* and *de jure*) of obtaining the protection of their rights when confronted by precarious situations or exploitation. In general, there is a system of immunity for those who abuse the vulnerability of these workers and a system of punishment for the latter.

All these conditions which undocumented migrant workers are subjected to convert them into a disadvantaged group that is the victim of systematic discriminatory practices throughout the region. Furthermore, the situation of migrant women merits special mention because they are victims of double discrimination: first as women and then as migrants.

Frequently, the departure of migrants from recipient States takes place in the context of arbitrary procedures. Deportation procedures are not always conducted in accordance with the required minimum guarantees.

"In conclusion, studies by supranational and non-governmental organizations describe the precarious situation of irregular migrants workers, both men and women, as regards the enjoyment and exercise of their human rights in the countries which receive them. In particular, they stress the systematic discrimination to which such migrant workers are subject in the workplace."

Owing to the vulnerability of irregular migrant workers, it is essential to pay special attention to any distinction in treatment based on their migratory status, because such a situation creates a "suspect category." Identification of a "suspect category" requires a presumption that the distinction is illegal.

The definition of situations that create a "suspect category" should include those that depict the realities of actual systematic discrimination and abuse in the region.

The first justification for recognizing that irregular migrant workers comprise a "suspect category" is that discrimination against this group is closely linked to its nationality, ethnic origin or race, which is always different from the majority in the State of employment. In this respect, nationality, race or ethnic origin are explicitly prohibited as grounds for distinction. In its decision in *Trimble v. Gordon*, the United States Supreme Court considered that classifications based on national origin were "first cousin" to those based on race; accordingly, they related to areas where it was necessary to apply the principle of equality and equal protection.

The second justification for recognizing that irregular migrant workers comprise a "suspect category" is the special vulnerability of this group, particularly because of the systematic discrimination they suffer in the workplace in recipient States. Undocumented migrant workers are discriminated against in several areas of their lives. However, discrimination is most clearly visible in the workplace.

Human rights treaties refer to the rights of "all persons" and treaties that establish workers' rights speak of the rights of "all workers," without making distinctions as to their migratory status. Similarly, the International Convention on the Protection of the Rights of All Migrant Workers and their Families recognizes the rights of migrant workers irrespective of whether they are documented or undocumented.

Distinctions in treatment owing to national or ethnic origin or race are explicitly prohibited in the American Convention, the American Declaration and other international instruments. The European Court of Human Rights has considered that cases of discrimination based on nationality should be closely examined and that, in the case of rights to social security, national origin should be considered a "suspect category." In *Gaygusuz v. Austria*, the European Court indicated that very powerful reasons must be alleged for difference in treatment, based solely on nationality, to be considered compatible with the European Convention and decided that Article 14 of the Convention had been violated by denying unemployment insurance to a Turkish worker based on his nationality.

The prohibition to afford a different treatment based on nationality, added to the systematic discrimination to which irregular migrant workers are subjected in the workplace, requires that any distinction between undocumented migrant workers and legal migrant workers or citizens in the workplace "must bear a relationship to the aim sought."

The elaboration and implementation of migratory policies and the regulation of the labor market can justify restrictions to the labor rights of migrants, provided such restrictions are necessary. "[A] legal or practical distinction between undocumented migrants on the one hand and documented residents and citizens on the other hand, which denies the former the right to enjoy dignified and equitable working conditions, limited working days, paid vacations, fair wages and promotion, or any other labor right recognized in the recipient country's legislation, or which disregards their right to join unions to defend their interests or denies their right to social security, can never be necessary for the regulation of migratory or labor market policies."

In principle, there is no "relationship of necessity" between, on the one hand, the elaboration and implementation of migratory policies and the regulation of the labor market and, on the other hand, possible restrictions of labor rights while a contract is in force, which would allow those restrictions to be defined as proportionate to the aims sought. "Such restrictions are not the kind that clearly seek an essential social interest, or the kind that restrict the protected right to a lesser degree."

The labor rights contained in international covenants correspond to workers because they are workers, irrespective of their nationality or migratory status. The

unprotected situation in which undocumented migrant workers find themselves cannot be aggravated or perpetuated, citing as an aim, "the formulation and implementation of migratory policies or the regulation of the labor market."

Restricting the enjoyment of labor rights by irregular migrant workers is unreasonable and unnecessary. Such restrictions encourage the employment of undocumented migrants and increase the vulnerability of a sector of the population that faces a situation of systematic discrimination and serious defenselessness.

The aims of migratory policies and labor market regulation can be achieved through measures that are less onerous for the protection of the rights of irregular migrant workers. For example, increased control, through migrant entry policies or monetary penalties for employers.

The International Convention on the Protection of the Rights of All Migrant Workers and their Families shows that the aim of regulating the labor market can be achieved by measures that are less onerous for migrant workers, when it establishes that "[t]he recourse of the employment of migrant workers who are in an irregular situation will be discouraged if the fundamental human rights of all migrant workers are more widely recognized."

The costs of a policy that does not protect the labor rights of irregular migrant workers, but provides economic benefits by exploiting their work should be identified. "If international law is intended to strengthen democratic societies, States should be encouraged to provide generous protection to undocumented migrant workers, both men and women, based on labor law, international law and human rights law, instead of permitting the continuation of situations of exclusion, which are merely another means of penalizing migrants."

In conclusion, no difference should be established in the scope of labor law protection with regard to undocumented migrants. The actual conditions of irregular migrant workers engender a "suspect category," so that any potential restriction of their labor rights should be strictly monitored. Irregular migrant workers who are employed to perform a task should enjoy all labor rights.

The State can respond to the special vulnerability of irregular migrant workers in different ways, but their

special situation of systematic discrimination and defenselessness cannot be ignored. “[I]n the face of this reality, special or differentiated measures should be taken in order to ensure equality.”

During the World Conference against Racism, Racial Discrimination, Xenophobia and Related Forms of Intolerance, held in Durban in 2001, the need to eliminate discrimination against migrant workers was reaffirmed. Likewise, it was recommended that all possible measures should be adopted to ensure that migrants can enjoy human rights, in particular the rights related to: fair wages and equal remuneration for work of equal value, without any distinction; the right to insurance in case of unemployment, illness, disability, death of a spouse, old age, or any other lack of means of subsistence owing to circumstances beyond their control; and to social benefits, including social security.

Among the measures tending to eliminate such discriminations, States must modify discriminatory conduct and examine their legislation and practices in order to repeal all provisions that restrict the rights of migrant workers. Nevertheless, States may “promote public policies to foment respect for diversity, discourage discrimination and encourage public institutions to adopt concrete measures to promote equality.” The State may also organize educational and awareness-raising campaigns aimed at its officials and the general public.

The existence of conditions of genuine inequality makes it necessary to adopt compensatory measures that help reduce or eliminate the obstacles and restrictions that impede or reduce the effective defense of the interests of migrant workers.

In addition, a fundamental measure to ensure the effective protection of the labor rights of irregular migrant workers is “to establish procedures for the justice system to listen to their complaints,” because the mere existence of substantive rights is not enough to guarantee their exercise. Likewise, when migrants have returned to their State of origin, the recipient State must also guarantee access to justice. If employers treat migrants in a manner contrary to the norms of international human rights law, the latter can demand the corresponding reparation, irrespective of their migratory status. “Therefore, the State should provide irregular migrant workers with free or low-cost legal assistance so that they may file complaints using a simple and prompt remedy.” This principle is included in Article 18 of the International Convention on the

### Rights of All Migrant Workers and Members of Their Families.

Reforms established by the State to improve the situation of irregular migrants should have effect in both the public and the private sector, because violations of rights "that occur in the private sector, insofar as they have been perpetrated with the consent or complicity of the State[,] may be attributed to the State." In this respect, the United Nations Committee on Human Rights, in its General Comment 28, has stated that States must eliminate discriminatory activities in both the public and the private sector.

The migratory status of migrant workers cannot be a variable that is taken into consideration to recognize them their labor rights while they are employed. They must be guaranteed not only the fundamental labor rights, but also all the labor rights recognized in the international covenants applicable in the Americas.

Human rights are interrelated, not only as regards different categories of rights, but also "all the rights that are included in a single category of rights, such as labor rights, in this case." In particular, the International Convention on the Rights of All Migrant Workers and the Members of Their Families establishes that the labor rights of migrant workers, whether they are documented or undocumented, cannot be restricted in any way.

For the purposes of this *amicus curiae*, the rights included in the international covenants include: 1) labor rights in the context of the employment contract; 2) rights of association, and 3) rights to social security.

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*In its written and oral statements, indicated that:*

This *amici curiae* merely answers questions 2(1) and 3.

Migratory status has been and continues to be an obstacle for the access of all migrants to their fundamental human rights. There are a series of legal and non-legal norms, which are contrary to the provisions of the American Convention and the American Declaration and other international instruments, and which deprive individuals of their human rights because of their migratory status.

*Regarding the second question (supra para. 4):*

The preamble to the American Convention recognizes the universal and essential nature of human rights, which are based upon attributes of the human

personality and not on nationality. Consequently, the protection of the individual encompasses all persons; in other words, it is universal in nature.

When acceding to and ratifying international human rights treaties, States assume a series of mandatory obligations towards all persons subject to their jurisdiction. These obligations have been extensively clarified by the different treaty-monitoring bodies, "either generically, with regard to a particular social group, or with reference to each specific right."

When interpreting the International Covenant on Civil and Political Rights recently, the Human Rights Committee, in its General Comment 15, emphasized that the enjoyment of the rights recognized by the Covenant *is not limited to the citizens* of States parties *but* should *also* be accessible to all individuals irrespective of their nationality or statelessness, including those requesting asylum, refugees, *migrant workers and other persons who are within the territory or subject to the jurisdiction* of the State party.

According to international human rights instruments, and their interpretation by monitoring bodies and legal writings, all persons who are within the territory of a State may require the State to protect their rights. The principle of non-discrimination is an essential element of international human rights law and is embodied in all international human rights instruments.

The millions of migrants throughout the world, who do not have regular residence in the country they live in, constitute a group in a particular "social condition." The principle of non-discrimination should be considered intimately and inseparably linked to the concept of a group in an extremely vulnerable situation that requires special protection. Therefore, the situation of vulnerability and the "social condition" of migrants, particularly those whose status is irregular, could determine the existence of grounds on which discrimination is prohibited, according to the principle of non-discrimination.

The United Nations has organized three world conferences against racism and discrimination and, at all of them, extensive reference has been made to discrimination against migrants, with express mention of their residence status. Moreover, special rapporteurs have been appointed at the regional and global level to verify the human rights situation of migrants and the discrimination they suffer owing to their status as aliens or their residence status.

Likewise, national legislation has included the concept of "migratory status" as a social condition that should be considered grounds that are prohibited, according to the principle of non-discrimination.

State obligations arising from international instruments cannot be bypassed because of the nationality, migratory status or residence status of a person. On this question, the bodies created by virtue of the Charter of the United Nations or the human rights treaties have conclusively stated that migrants, irrespective of their migratory status, are protected by all the international human rights instruments ratified by the State where they live.

The United Nations Inter-governmental Working Group of Experts on the Human Rights of Migrants has stated that "[a]ll persons, regardless of their place of residence, have a right to the full enjoyment of all the rights established in the Universal Declaration of Human Rights. States must respect the fundamental human rights of migrants, irrespective of their legal status." It has also emphasized that "[a] basic principle of human rights is the fact of entering a foreign country, violating the immigration laws of that country, does not lead to losing the human rights of an 'immigrant with an irregular status.' Nor does it eliminate the obligation of a Member State to protect them."

In conclusion, the response to question 2(1) may be summarized as "[t]he obligations and responsibility of States within the framework of international human rights law are not altered in any way by the residence status of an individual in the State in which he resides. The rights arising from international human rights law apply to all persons because they are human beings and should be respected, protected and guaranteed, without any discrimination on prohibited grounds (including, the migratory status of the person). In addition [...], all persons are subject to the jurisdiction of the State on whose territory they reside, irrespective of their migratory status. Consequently, the monitoring bodies of the human rights treaties – and also those deriving from the Charter of the United Nations – have repeatedly stressed that human rights must be respected and guaranteed to all persons, irrespective of their migratory status."

*Regarding the third question (supra para. 4):*

Each State has the authority – based on the principle of sovereignty – to formulate its own migratory policy and, consequently, to establish criteria for the admission and



residence of migrants. However, this does not mean that the said policy is exempt from the obligations of each State under international human rights law.

Migratory policy and legislation should respect all the provisions of the international human rights instruments recognized by each State. According to the provisions of international human rights law and their interpretation by the competent bodies, the sovereign authority to establish migratory policy – and also other policies emanating from State sovereignty – *“does not in any way exempt or restrict the obligations of respect, protection and guarantee to all persons subject to the jurisdiction of each State.”*

With regard to migratory legislation, as in any other area of State policy, each law or policy defined by the State or its absence could constitute the violation of rights embodied in the international instruments to which that State is a party. To avoid this situation, international human rights law establishes a series of principles, standards and limits that each State must respect when it institutes any policy, including migratory policy and legislation.

At the Durban Conference, the States committed themselves to “revising, when necessary, their immigration laws, policies and practices, to ensure that they are free of all racial discrimination and that they are compatible with the obligations of the States under international human rights instruments.” Similarly, at the regional conference for the Americas, the Governments committed themselves to “reviewing their immigration policies and practices in order to eliminate those that discriminate against migrants in a way that is not coherent with the obligations assumed under international human rights instruments.”

Each international human rights instrument has been careful to establish expressly the criteria and requirements that each State party must respect when regulating and restricting the rights recognized in such instruments.

Any restrictions to the exercise of human rights must be established in accordance with certain formal requirements and substantive conditions.

Article 30 of the American Convention indicates the formal requirements for such restrictions. The need for a formal law implies that States have the obligation to adopt all necessary measures to ensure that any norm that does not originate from “democratically elected and constitutionally empowered bodies” should not establish

any illegal restriction or violation or affect a right recognized in the Convention.

In order to comply with this obligation in the case of the rights of migrants, States must first examine the norms issued by agencies specializing in migratory matters. Then they must analyze the different decisions (resolutions, decrees, etc.) issued in all sectors and policies of the State that have or may have a serious and indisputable influence on the violation of the rights of migrants, as a result of their migratory status.

The fact that the restriction must be promulgated by law "supposes a norm of general application that should be compatible with respect for the principle of equality and not be arbitrary, meaningless or discriminatory."

To be legitimate, in addition to complying with the formal requirement, the restriction of a human right must be addressed at attaining a specific valid objective.

According to the provisions of the international instruments, the objectives that justify or legitimize a restriction of human rights – in other words the basic requirements – are concepts such as "democratic necessity", "public order (*ordre public*)", "national security", "the common good", "public health" and "morality." Each of these concepts was then examined.

The questions posed by Mexico can only have one answer: "international human rights law is intended for the universal protection of all persons, without any discrimination on prohibited grounds (including a person's migratory status)."

In conclusion, any migratory policy or legislation must conform to the international and regional standards in force with regard to legitimate restrictions to human rights. First, rights may only be limited to the extent that the restriction is aimed at achieving a legitimate end provided for in international human rights instruments. Second, the restriction must be established by a formal law, which must respect the principle of equality and be neither arbitrary nor discriminatory. Third, there should be no alternative that would be less restrictive of the rights in question. Lastly, in each specific case, the State must justify not only the reasonableness of the measure, but also examine rigorously whether it damages the principle of illegitimacy that affects all measures that restrict a right based on grounds that are prohibited by the principle of non-discrimination.

"[P]eople who migrate for reasons related to poverty have previously been deprived of their rights (including the right to employment, education, housing, health, etc.). Confronted by this lack of protection by their own State (or rather the human rights violations committed by the State), the person decides to migrate to another country, in which he hopes to be able to enjoy the rights guaranteed in international instruments [...]. Consequently, it is particularly inadmissible that millions of persons can be excluded from the international system for the protection of human rights, this time owing to their migratory status in the country to which they have migrated."

*United Nations High  
Commissioner for  
Refugees (UNHCR):*

*In its oral statement UNHCR indicated that:*

Nowadays it is meaningless to trace a strict line between voluntary and enforced displacement of persons, because the motives for migration are complex and imply a combination of political, economic and social factors. The nature and complexity of current displacements make it difficult to draw a clear line between migrants and refugees. As of the 1990s, UNHCR has been studying the link between asylum and migration and, in particular, the need to protect refugees within the migratory flows. However, there is still no international mechanism that deals exclusively with migration.

Although migratory policies fall within the sphere of State sovereignty, human rights instruments establish limits to the adoption and implementation of such policies. These limits include those stipulated in the American Convention, the 1951 Convention Relating to the Status of Refugees and its 1966 Protocol, and the International Convention for the Protection of the Rights of all Migrant Workers and Members of their Families. These instruments should also guide the decision of the Court in this request for an advisory opinion, pursuant to Article 29 of the American Convention and the *pro homine* principle.

Regarding the connection between asylum and migration, it is worth mentioning that, in the current circumstances, migrants and other persons who seek protection, such as asylum seekers and refugees, are all part of the same migratory flows and all require protection. Although not all these persons qualify as refugees under the international instruments, safeguards should be established that allow different migratory categories to be identified and granted protection. Since there are limited legal options for the entry into and residence in determined territories,

"asylum systems are increasingly being used to give certain migratory categories the possibility of remaining in a country.

Nowadays, it is presumed not only that aliens who enter a territory are migrants, but also that, when they are categorized as such, "what is meant is that they do not have rights and, therefore, that the State, in exercise of its sovereignty, may expel or deport them, or violate their basic rights." Likewise, the lack of legal options for migration and the restrictive policies on asylum and migration mean that refugees and migrants "face inhuman conditions, with an uncertain legal status and, in many cases, with their rights openly restricted," are more vulnerable to the problem of trafficking in persons, and are subject to greater discrimination and xenophobia in most recipient States.

The irregular status of a migrant should not deprive him of the enjoyment and exercise of the fundamental rights established in the American Convention and other human rights instruments. The State must protect all persons subject to its jurisdiction, whether or not they are nationals.

The vulnerability of migrants should be underscored and this is exacerbated not only by the limited number of countries that have ratified the international instruments protecting them, but also by the absence of an international organization with the specific mandate of protecting the fundamental rights of such persons. In this respect, it is important to point out that the Statute of the International Organization for Migration (IOM) refers to the management and administration of migration, which does not necessarily correspond to the protection of the fundamental rights of migrants.

In a context where most American States are parties to the international conventions on refugees, it should be stressed that most of them do not have appropriate instruments to identify those persons who require protection. This does not refer only to asylum seekers and refugees, but also to migrants who do not have the necessary safeguards to guarantee the minimum respect for their fundamental rights, embodied in the American Convention.

Also, the implementation of increased migratory controls and interception policies means that, in most cases, anonymity and irregular residence are chosen; thus, contrary to what occurred in the past, today we can speak of "*de facto* refugees", because most do not wish to be recognized by the States or are being returned.

Moreover, although a refugee's right to work is embodied in the 1951 Convention relating to the Status of Refugees, unfortunately this international instrument, which establishes minimum rights for that migratory category, does not refer to asylum seekers. In this respect, a simplistic interpretation could even say that asylum seekers and migrants have no labor rights. This interpretation is not only contrary to the spirit of the international instruments; it is also an evident step backward as regards the progressive nature of human rights.

Consequently, the protection parameters established by this request for an advisory opinion may be applicable, by analogy, to the protection of the labor rights of asylum seekers.

Migratory status "is and must be prohibited grounds for discrimination in our hemisphere, based on the American Declaration and the American Convention on Human Rights". The principle of non-discrimination is embodied in all human rights instruments.

The United Nations Committee on Human Rights has expanded the grounds for non-discrimination, based on Article 2(1) of the International Covenant on Civil and Political Rights. It has established that any differentiation must be reasonable, objective and aimed at achieving a legitimate goal. In the case of the International Covenant on Economic, Social and Cultural Rights, the United Nations Committee on Economic, Social and Cultural Rights has established the grounds of discrimination for "other status," which would be equivalent to "other condition"; in other words, there could be cases of discrimination for grounds that are not explicitly set out in that Covenant.

That line of reasoning is relevant for the present advisory opinion, because the American Declaration establishes that there may be discrimination for "other" distinctions, in addition to race, sex, language and religion. In the case of the American Convention on Human Rights, this treaty prohibits any kind of discrimination of rights and freedoms, establishing twelve grounds, including nationality and "any other social status."

Since the principle of non-discrimination is a basic rule of international human rights law and in light of statements made by the monitoring bodies of the United Nations international treaties, we must conclude that "the grounds for non-discrimination established in the inter-American instruments are equally indicative and

illustrative and never exhaustive or restrictive, as that would distort the object and purpose of the American Convention on Human Rights, which is the protection of the fundamental rights and freedoms in our hemisphere."

In particular, based on the exceptionally vulnerable situation of asylum seekers, refugees and migrants, it may validly be inferred that, according to the American Declaration and the American Convention, any other social condition or "*any other factor*" would provide sufficient grounds to indicate that, in our hemisphere, there is a specific prohibition to discriminate.

We should point out that, in the Americas, the vulnerability of migrants, asylum seekers and refugees has been explicitly recognized in the Inter-American Convention on the Prevention, Punishment, and Eradication of Violence against Women, the Convention of Belém do Pará, which stipulated that, "with respect to the adoption of the measures in this chapter, the States Parties shall take special account of the vulnerability of women to violence by reason of, among others, their race or ethnic background or their status as migrants, refugees or displaced persons."

In view of the above, we must conclude that the prohibited discriminations include "any distinction, exclusion, restriction or preference based on any grounds such as nationality" aimed at invalidating the recognition, enjoyment or exercise of the rights established in the international instruments, in equal conditions.

Likewise, the judicial and legal guarantees established in Articles 8 and 25 of the American Convention are equally applicable when determining a situation that affects the rights of asylum seekers or refugees, but they should also guide the protection of migrants in the hemisphere.

*The Central American Council of Ombudsmen with the support of its Technical Secretariat (the Inter-American Institute of Human Rights):*

*In its written and oral statements, indicated that:*

*Regarding the first question (supra para. 4):*

It is necessary to recognize the distinction between the human right not to be subjected to discriminatory treatments (in either the formulation of the law or its implementation) and the obligation of States not to make any discrimination in the enjoyment and exercise of human rights with regard to persons subject to their jurisdiction.

In international human rights law, the principle of equality has two dimensions: a) equality in the

enjoyment and exercise of human rights; and b) the right of all persons to be treated equally before the law. The importance of these two dimensions is not merely their recognition in a constitutional text, but also that the State should implement all pertinent measures to ensure that the obstacles to equality among persons are removed in practice, in accordance with Article 1 of the American Convention and Article 2(1) of the International Covenant on Civil and Political Rights. The State must not only abstain from generating *de jure* discriminations, but must also eliminate the factors that give rise to *de facto* discrimination in relation to civil and political rights and also to economic, social and cultural rights.

The answer to the first question alludes to labor-related human rights that are regulated in an extensive series of norms in the inter-American system, which has two levels of recognition: one applicable to OAS member States which are not parties to the Additional Protocol to the American Convention on Human Rights in the Area of Economic, Social and Cultural Rights; and a second applicable to OAS member States who are also parties to the Additional Protocol to the American Convention on Human Rights in the Area of Economic, Social and Cultural Rights, "Protocol of San Salvador." These two levels entail two distinct legal situations regarding the protection of labor rights: the States who belong to the first group are obliged by Articles 30, 34 and 45 of the OAS Charter and Articles XIV, XV and XVI of the American Declaration; while the States parties to the Protocol, in addition to being obliged by the preceding provisions, have obligations arising from Articles 3, 4, 5, 6, 7, 8 and 9 of the Protocol.

To understand the expression "labor legislation" in Mexico's request, we should mention that, in the legal systems of all OAS member States, the international obligations they have assumed arising from conventions, "may be classified as legislation; in other words, as an integral part of their domestic law." Thus, the expression "labor legislation" included in the requesting State's first question refers to the domestic law of the States. The norms of international law indicated above do not admit a restrictive or discriminatory interpretation or implementation, in particular because they are based on a specific migratory status. "From the legal perspective of migration, the regular or irregular situation does not alter or affect the scope of the State obligation" to respect and ensure human rights. Domestic labor legislation includes more rights than those protected in the international norms cited above. States have the right to exercise control on migratory matters and to

adopt measures to protect their national security and public order; but States must exercise this control, respecting human rights.

A detailed answer to Mexico's first question would require a specific examination of each State. Nevertheless, we can say that, like human rights, labor rights correspond to all persons and are required in the context of labor relations. Consequently, the ability to perform a productive activity depends exclusively on professional training and skill, and is never related to the migratory status of a person.

The causes of migration, particularly irregular migration, are different from the conditions of persecution that give rise to the existence of refugees, who are protected by refugee law. Irregular migration is associated with socio-economic conditions and the search for better opportunities and means of subsistence than those the person has in his State of origin. In practice, high levels of irregular migrants increase the offer of manpower and affect how it is valued. Since the irregular migrant does not want to be discovered by the State authorities, he refuses to have recourse to the courts, and this encourages the violation of his human rights in the workplace.

A person who migrates to another State and enters into an employment relationship "activates his human rights" in that context, irrespective of his migratory status. He also "activates" the obligations of the recipient State contained in the OAS Charter, the American Declaration (in the case of an OAS member State) and the Additional Protocol to the American Convention on Human Rights in the Area of Economic, Social and Cultural Rights (where the State is also a party to the latter). This "activation" of rights implies that a measure taken by the State with the aim of producing a denial of the enjoyment and exercise of labor human rights based on the migratory status of a person "would lead to a differentiated treatment that would give rise to arbitrariness, and consequently discrimination."

Accordingly, we consider that the answer to Mexico's first question is: OAS member States and States parties to the Additional Protocol to the American Convention on Human Rights in the Area of Economic, Social and Cultural Rights, "may not apply a distinct treatment that is harmful to undocumented migrant workers as regards the enjoyment of their labor rights," understanding such rights to be those contained in Articles 30, 34(g) and 45 of the OAS Charter; Articles XIV, XV and XVI of the American Declaration; and Articles 6, 7, 8 and 9 of the



said Protocol, as well as those recognized in the domestic legislation of the States, using the migratory status of the said workers as a basis for this distinct treatment. Those human rights are enjoyed as soon as an employment relationship is established and do not depend on migratory status.

*Regarding the second question (supra para. 4):*

The obligations to respect and guarantee human rights do not arise from Article 1(1) of the American Convention or from Article 2 of the International Covenant on Civil and Political Rights, but from the nature of human rights and human dignity, which does not depend on a classification based on some positive act of the State. Thus, the enforceability of these obligations does not depend on a State's accession to or ratification of the American Convention; it depends only on its justiciability before the organs of the inter-American system. In this respect, the obligations of respect and guarantee are not conditional obligations because they derive from human dignity.

Consequently, we consider that the answer to the first part of the second question is that the State obligations to respect and guarantee human rights, in general, and the human right not to be subjected to discriminatory treatment or unequal treatment before the law, in particular, cannot be interpreted as conditioning the content of such obligations to a person's regular migratory status in the territory of a State. Migratory status is not a necessary condition for a State to respect and guarantee the human rights contained in Articles 2(1) of the Universal Declaration, II of the American Declaration, 2 and 26 of the International Covenant on Civil and Political Rights, and 1 and 24 of the American Convention.

The second part of the second question should be answered bearing in mind the human right not to be subjected to discriminatory treatment or unequal treatment before the law, which the State is obliged to respect and guarantee. Accordingly, the State may not deny a worker one or more of his labor rights based on his irregular migratory status, since if it did so, it would be failing to comply with its obligation to guarantee those rights and could be attributed with this act of denial under international law.

*Regarding the third question (supra para. 4):*

The source of the obligation to respect and guarantee human rights is international law; consequently, in accordance with the Vienna Convention on the Law of

Treaties, domestic norms cannot be alleged to try and justify non-compliance with this obligation. Moreover, this generic obligation is enforceable with regard to all human rights.

Notwithstanding the generalized practice of most States, the pre-eminence of international law over domestic law is not determined by the latter. In application of the *pro homine* principle, international human rights law accords prevalence to the norm intended to protect human dignity (the one that provides a more comprehensive recognition of human rights), regardless of the source of the obligation in question. Hence, the laws of a State are valid insofar as they are congruent with human rights.

The answer to the third question is that no State is authorized to use its domestic law to interpret the human rights resulting from a source of international law, when this will diminish the degree to which such rights are recognized. An interpretation of this type is not valid and cannot produce legal effects. However, a State may develop an interpretation of the human rights deriving from a source of international law using its domestic law, when the result of this interpretation will give preference to the option that provides the most extensive degree of recognition.

*Regarding the fourth question (supra para. 4):*

There is no finite list of *jus cogens* norms, because, there appear to be no criteria that allow them to be identified. It is the courts that determine whether a norm can be considered *jus cogens*, "for the purposes of invalidating a treaty." Such norms establish limits to the will of States; consequently, they create an international public order (*ordre public*), and thus become norms of enforceability *erga omnes*. Owing to their transcendence, human rights norms are norms of *jus cogens* and, consequently, a source of the legitimacy of the international legal system. All human rights must be respected equally, because they are rooted in human dignity; therefore, they must be recognized and protected based on the prohibition of discrimination and the need for equality before the law.

The answer to the first part of the fourth question is that, owing to the progressive development of international human rights law, the principle of non-discrimination and the right to the equal and effective protection of the law must be considered norms of *jus cogens*. They are norms of peremptory international law, which create an international public order that cannot be opposed validly by other norms of

international law, and particularly by the domestic legislation of States. Norms of *jus cogens* rank higher than other legal norms, so that the validity of the latter depends on their congruency with the former.

An OAS member State which is a party to the International Covenant on Civil and Political Rights is obliged to respect and guarantee the rights recognized therein and also in the American Declaration, because "human rights form a single, indivisible, interrelated and interdependent *corpus iuris*."

The answer to the second part of the fourth question is that, in the case of the American States, the legal effect of the recognition of the principle of non-discrimination and the right to equal and effective protection of the law as norms of *jus cogens* is that any act of the State that conflicts with this principle and right has no legal effect or validity.

*Jorge A. Bustamante,  
Juridical Research  
Institute, Universidad  
Nacional Autónoma de  
México (UNAM):*

*In his written and oral statements, indicated that:*

The legal framework for evaluating the actual situation of Mexican migrants in both their own country and the United States, as the recipient State of almost all international Mexican migrants, should be considered in two different analytical contexts: the international context, deriving from the international nature of migration (analysis of the State which receives immigration and the relationship of the migrants with the State and the society that receives them); and the national context (analysis of the migrants as subjects of human rights in their State of origin).

The vulnerability that affects the human rights of international migrants is of a structural nature and arises from the way in which most States define nationals and aliens in their Constitutions. Most States afford nationals a certain priority in their legislation with regard to aliens, so that the structural situation of the vulnerability of migrants as subjects of human rights is equal to the social inequality between them and the nationals of the recipient State.

The vulnerability of migrants as subjects of human rights in their national context arises from the ideological association that the members of civil society in their State of origin make between the social definition of a migrant and any other socially undervalued condition (woman, girl/boy child, indigenous person, disabled person, member of a religious order, etc.) or any other condition which society in the State of origin considers inferior to the

rest of the non-migrants in that society. This association has an ideological dimension and a historical context that is different for each State, in the same way as the degree to which this situation of inferiority is assigned to migrants varies.

There is an objective dimension of vulnerability, according to which the greater the distance between a migrant and his home, the greater his vulnerability as a subject of human rights. Although this hypothesis may be valid for all migrants, it is more so in the national context of internal migrants than for the international context of migration.

There is an asymmetry of power that is transformed into a context of social relations between nationals and aliens-migrants, that is confirmed by the State through the establishment of differential access to public resources for the two categories; this gives rise to a legal framework of social relations that enters into contradiction with the more extensive concept of human rights.

In this asymmetry of power, it is probable that the alien will find himself in a position of subordination to the national. This results in a situation of structural vulnerability for aliens.

The position of subordination imposed on aliens/migrants is something that the recipient State "confirms." Here, the vulnerability is potentially supplemented by the role of the State, either by act or omission, but always in the context of this differential treatment that the recipient State grants to nationals compared to aliens.

The asymmetries of power between the States of origin and the States that receive international migrants may be clearly seen by the limited number of recipient States that have ratified the International Convention on the Rights of all Migrant Workers and Members of their Families.

"[T]he integration of migrants/aliens as equals of nationals before the law and the State implies a legal authorization or empowerment of aliens/migrants, which would result in the disappearance of the vulnerability of the migrants as subjects of human rights." This "empowerment" is associated with the pre-eminence of human rights in the domestic law of the recipient State, based on which aliens/migrants may defend themselves from discrimination and the abuse of their human rights, by acquiring conditions of equality with nationals before

the law and the State.

The death of almost two thousand Mexican and some Central American migrants is the strongest evidence that the United States has violated and continues to violate human rights by maintaining the so-called "Operation Guardian." This thesis is strengthened by the fact that a report of the United States General Accounting Office expressly recognized the link between "Operation Guardian" and the deaths of migrants. The State has the obligation to repair the harm caused by the acts that it has planned, implemented and maintained, by the payment that corresponds to the next of kin for the loss of life of a productive member of their family. "It is very strange that the Government of Mexico has not filed any claim," establishing the relationship between: the planning, implementation and continuity of "Operation Guardian" and State responsibility arising from these governmental acts.

One factor that prevents Mexico from being able to formulate this claim against the United States for the latter's responsibility in the deaths of Mexican migrants on its border, is the absence of Mexico's express recognition of its co-responsibility in those deaths, arising from the fact that its economic policy has caused Mexicans to migrate in search of employment in the United States. This migratory phenomenon is the result of the interaction of factors on both sides of the border; namely, the interaction between a demand for migrant manpower in the United States and an offer of manpower from Mexico. The causal relationship between Mexico's economic policy and the generation of the factors that produce this supply of manpower, give rise to "State responsibility" with regard to migration and, hence, to the co-responsibility of Mexico in the deaths of migrants on the border with the United States.

The recognition of responsibility by Mexico should be considered an element in the bilateral negotiation of an agreement on migrant workers between the two Governments. In this context, negotiations could be based on Mexico's express recognition of co-responsibility for the deaths of the migrants and co-participation in the payment of compensation to repair the harm arising from those deaths and the agreement of the United States to suspend "Operation Guardian."

### **III COMPETENCE**

48. This request for an advisory opinion was submitted to the Court by Mexico, in exercise of the faculty granted to it by article 64(1) of the Convention, which establishes that:

[t]he member states of the Organization may consult the Court regarding the interpretation of this Convention or of other treaties concerning the protection of human rights in the American states. Within their spheres of competence, the organs listed in Chapter X of the Charter of the Organization of American States, as amended by the Protocol of Buenos Aires, may in like manner consult the Court.

49. This faculty has been exercised in compliance with the following requirements established in the Court's Rules of Procedure: precise formulation of the questions on which the Court's opinion is sought; identification of the norms to be interpreted; presentation of the considerations giving rise to the request; name and address of the Agent (Article 59 of the Rules of Procedure), and indication of the international treaties other than the American Convention to be interpreted (Article 60(1) of the Rules of Procedure).

50. Compliance with the regulatory requirements for formulating a request does not imply that the Court is obliged to respond to it. In this respect, the Court must bear in mind considerations that go beyond the merely formal aspects related to the generic limits that the Court has recognized to the exercise of its advisory function<sup>1</sup>. These considerations will be examined in the following paragraphs.

51. The application submits four questions to the consideration of the Court regarding the "[...] deprivation of the enjoyment and exercise of certain labor rights [of migrant workers,] and its compatibility with the obligation of the American States to guarantee the principles of legal equality, non-discrimination and equal and effective protection of the law embodied in international instruments for the protection of human rights; and also with the subordination or conditioning of the observance of the obligations imposed by international human rights law, including those of an *erga omnes* nature, to the attainment of certain domestic policy objectives of an American State." The request also deals with "the status that the principles of legal equality, non-discrimination and equal and effective protection of the law have achieved in the context of the progressive development of international human rights law and its codification."

52. Specifically, Mexico has asked the following questions:

In the context of the principle of equality before the law embodied in Article II of the American Declaration, Article 24 of the American Convention, Article 7 of the Universal Declaration and Article 26 of the [International] Covenant [on Civil and Political Rights],

1) Can an American State establish in its labor legislation a distinct treatment from that accorded legal residents or citizens that prejudices undocumented migrant workers in the enjoyment of their labor rights, so that the migratory status of the workers impedes *per se* the enjoyment of such rights?

2.1) Should Article 2, paragraph 1, of the Universal Declaration, Article II of the American Declaration, Articles 2 and 26 of the [International] Covenant [on Civil and

<sup>1</sup> Cf. *Legal Status and Human Rights of the Child*. Advisory Opinion OC-17/02 of August 28, 2002. Series A No. 17, para. 19; *The Right to Information on Consular Assistance in the Framework of the Guarantees of Due Process of Law*. Advisory Opinion OC-16/99 of October 1, 1999. Series A No. 16, para. 31; *Reports of the Inter-American Commission on Human Rights* (Art. 51 of the American Convention on Human Rights). Advisory Opinion OC-15/97 of November 14, 1997. Series A No.15, para. 31; and "*Other treaties*" subject to the *Advisory Jurisdiction of the Court* (Art. 64 of the American Convention on Human Rights). Advisory Opinion OC-1/82 of September 24, 1982. Series A No. 1, para. 13.

Political Rights] and Articles 1 and 24 of the American Convention be interpreted in the sense that an individual's legal residence in the territory of an American State is a necessary condition for that State to respect and ensure the rights and freedoms recognized in these provisions to those persons subject to its jurisdiction?

2.2) In the light of the provisions cited in the preceding question, can it be considered that the denial of one or more labor right, based on the undocumented status of a migrant worker, is compatible with the obligations of an American State to ensure non-discrimination and the equal, effective protection of the law imposed by the above-mentioned provisions?

Based on Article 2, paragraphs 1 and 2, and Article 5, paragraph 2, of the International Covenant on Civil and Political Rights,

3) What would be the validity of an interpretation by any American State which, in any way, subordinates or conditions the observance of fundamental human rights, including the right to equality before the law and to the equal and effective protection of the law without discrimination, to achieving migration policy goals contained in its laws, notwithstanding the ranking that domestic law attributes to such laws in relation to the international obligations arising from the International Covenant on Civil and Political Rights and other obligations of international human rights law that have an *erga omnes* character?

In view of the progressive development of international human rights law and its codification, particularly through the provisions invoked in the instruments mentioned in this request,

4) What is the nature today of the principle of non-discrimination and the right to equal and effective protection of the law in the hierarchy of norms established by general international law and, in this context, can they be considered to be the expression of norms of *ius cogens*? If the answer to the second question is affirmative, what are the legal effects for the OAS Member States, individually and collectively, in the context of the general obligation to respect and ensure, pursuant to Article 2, paragraph 1, of the [International] Covenant [on Civil and Political Rights], compliance with the human rights referred to in Articles 3 (l) and 17 of the OAS Charter?

53. From these questions, it is evident that the requesting State requires an interpretation of the American Convention, as well as of other international treaties and declarations. The Court has established some guidelines on the interpretation of international norms other than the American Convention. Principally, it has considered that Article 64(1) of the Convention, when referring to the authority of the Court to provide an opinion on "other treaties concerning the protection of human rights in the American States," is broad and non-restrictive. In other words:

[...] the advisory jurisdiction of the Court can be exercised, in general, with regard to any provision dealing with the protection of human rights set forth in any international treaty applicable in the American States, regardless of whether it be bilateral or multilateral, whatever be the principal purpose of such a treaty, and whether or not non-Member States of the inter-American system are or have the right to become parties thereto.<sup>2</sup>

54. In this respect, the Court has established that it can "examine the interpretation of a treaty provided that the protection of human rights in a member State of the inter-American system is directly involved"<sup>3</sup>, even though the said instrument does not belong to the regional system of protection<sup>4</sup>, and that:

<sup>2</sup> "Other treaties" subject to the Advisory Jurisdiction of the Court, *supra* note 1, first operative paragraph.

<sup>3</sup> *Legal Status and Human Rights of the Child*, *supra* note 1, para. 22; and *cf. The Right to Information on Consular Assistance in the Framework of the Guarantees of Due Process of Law*, *supra* note 1, para. 36; *International Responsibility for the Promulgation and Enforcement of Laws in violation of the Convention* (Arts. 1 and 2, American Convention on Human Rights). Advisory Opinion OC-14/94 of

[n]o good reason exists to hold, in advance and in the abstract, that the Court lacks the power to receive a request for, or to issue, an advisory opinion, about a human rights treaty applicable to an American State merely because non-American States are also parties to the treaty or because the treaty has not been adopted within the framework or under the auspices of the inter-American system.<sup>5</sup>

55. Therefore, the Court considers that it is competent to rule on the questions posed by Mexico which also requests the interpretation of the American Declaration, the American Convention, the Universal Declaration and the International Covenant on Civil and Political Rights, all of them instruments that protect human rights and that are applicable to the American States.

56. With regard to the Charter of the Organization of American States, in another opinion, the Court indicated, referring to the American Declaration, that:

[...]Article 64(1) of the American Convention authorizes [it], at the request of a member state of the OAS [...] to render advisory opinions interpreting the American Declaration of the Rights and Duties of Man, provided that in doing so the Court is acting within the scope and framework of its jurisdiction in relation to the Charter and Convention or other treaties concerning the protection of human rights in the American States.<sup>6</sup>

Moreover, at the same time, the Court has indicated that "the Charter of the [OAS] cannot be interpreted and applied, as far as human rights are concerned, without relating its norms, consistent with the practice of the organs of the OAS, to the corresponding provisions of the [American] Declaration."<sup>7</sup>

57. This means that the Court has competence to render advisory opinions on the interpretation of the OAS Charter, taking into consideration the relationship of the Charter to the inter-American system for the protection of human rights, specifically within the framework of the American Declaration, the American Convention, or other treaties on the protection of human rights in the American States.

58. Nevertheless, should the Court restrict its ruling to those States that have ratified the American Convention, it would be difficult to separate this Advisory Opinion from a specific ruling on the legislation and practices of States that have not ratified the Convention with regard to the questions posed. The Court considers that this would restrict the purpose of the advisory proceeding, which, as has been

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December 9, 1994. Series A No. 14, para. 21; and "Other treaties" subject to the Advisory Jurisdiction of the Court, *supra* note 1, para. 21.

<sup>4</sup> *The Right to Information on Consular Assistance in the Framework of the Guarantees of Due Process of Law*, *supra* note 1, paras. 71 and 109; and "Other treaties" subject to the Advisory Jurisdiction of the Court, *supra* note 1, para. 38.

<sup>5</sup> "Other treaties" subject to the Advisory Jurisdiction of the Court, *supra* note 1, para. 48. See also, paras. 14, 31, 37, 40 and 41.

<sup>6</sup> *The Right to Information on Consular Assistance in the Framework of the Guarantees of Due Process of Law*, *supra* note 1, para. 36; and *Interpretation of the American Declaration of the Rights and Duties of Man Within the Framework of Article 64 of the American Convention on Human Rights*. Advisory Opinion OC-10/89 of July 14, 1989. Series A No. 10; sole operative paragraph and *cf.* para.44.

<sup>7</sup> *Interpretation of the American Declaration of the Rights and Duties of Man Within the Framework of Article 64 of the American Convention on Human Rights*, *supra* note 6, para. 43.



mentioned, "is designed [...] to enable OAS Member States and OAS organs to obtain a judicial interpretation of a provision embodied in the Convention or other human rights treaties in the American States."<sup>8</sup>

59. Likewise, if the opinion only encompassed those OAS Member States that are parties to the American Convention, the Court would be providing its advisory services to a limited number of American States, which would not be in the general interest of the request.

60. Consequently, the Court decides that everything indicated in this Advisory Opinion applies to the OAS Member States that have signed either the OAS Charter, the American Declaration, or the Universal Declaration, or have ratified the International Covenant on Civil and Political Rights, regardless of whether or not they have ratified the American Convention or any of its optional protocols.

61. Following its practice in advisory matters, the Court must determine whether rendering the opinion might "have the effect of altering or weakening the system established by the Convention in a manner detrimental to the individual human being."<sup>9</sup>

62. The Court may use various factors when considering this matter. One of them, which coincides with much of the international jurisprudence in this area,<sup>10</sup> refers to the problem that, a ruling on an issue or matter that might eventually be submitted to the Court in the context of a contentious case could be obtained prematurely, using a request for an opinion.<sup>11</sup> However, this Court has noted subsequently that the existence of a difference concerning the interpretation of a provision does not, *per se*, constitute an impediment for exercise of the advisory function.<sup>12</sup>

63. In the exercise of its advisory function, the Court is not called on to resolve questions of fact, but to determine the meaning, purpose and reason of international

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<sup>8</sup> *The Right to Information on Consular Assistance in the Framework of the Guarantees of Due Process of Law*, *supra* note 1, para. 36, para. 40; and *Restrictions to the Death Penalty* (Arts. 4(2) and 4(4) American Convention on Human Rights). Advisory Opinion OC-3/83 of September 8, 1983. Series A No. 3; para. 22.

<sup>9</sup> *Legal Status and Human Rights of the Child*, *supra* note 1, para. 31; *The Right to Information on Consular Assistance in the Framework of the Guarantees of Due Process of Law*, *supra* note 1, para. 43; *Reports of the Inter-American Commission on Human Rights*, *supra* note 1, para. 31; and "Other treaties" subject to the Advisory Jurisdiction of the Court, *supra* note 1, second operative paragraph.

<sup>10</sup> *Cf. Applicability of Article VI, Section 22, of the Convention on the Privileges and Immunities of the United Nations*, Advisory Opinion, I.C.J. Reports 1989, p. 177, para 29-36; *Legal Consequences for States of the Continued Presence of South Africa in Namibia (South West Africa) notwithstanding Security Council Resolution 276 (1970)*, Advisory Opinion, I.C.J. Reports 1971, p. 16, para. 27-41; *Western Sahara*, Advisory Opinion, I.C.J. Reports 1975, p. 12; *Reservations to the Convention on Genocide*, Advisory Opinion, I.C.J. Reports 1951, p. 15, (19, 20); and I.C.J.: *Interpretation of Peace Treaties*, Advisory Opinion, I.C.J. Reports 1950, p. 65 (71, 72).

<sup>11</sup> *Cf. Legal Status and Human Rights of the Child*, *supra* note 1, para. 32; *The Right to Information on Consular Assistance in the Framework of the Guarantees of Due Process of Law*, *supra* note 1, para. 45; and *Reports of the Inter-American Commission on Human Rights*, *supra* note 1, paras. 37 and 40.

<sup>12</sup> *Cf. Legal Status and Human Rights of the Child*, *supra* note 1, para. 32; *The Right to Information on Consular Assistance in the Framework of the Guarantees of Due Process of Law*, *supra* note 1, para. 45; and *Compatibility of Draft Legislation with Article 8(2)(h) of the American Convention on Human Rights*. Advisory Opinion OC-12/91 of December 6, 1991. Series A No. 12, para. 28.

human rights norms. In this context, the Court fulfills an advisory function<sup>13</sup>. On several occasions, the Court has upheld the distinction between its advisory and contentious competence. In Advisory Opinion OC-15/97 on *Reports of the Inter-American Commission on Human Rights*, it indicated that:

[t]he advisory jurisdiction of the Court differs from its contentious jurisdiction in that there are no "parties" involved in the advisory procedure nor is there any dispute to be settled. The sole purpose of the advisory function is "the interpretation of this Convention or of other treaties concerning the protection of human rights in the American states." The fact that the Court's advisory jurisdiction may be invoked by all the Member States of the OAS and its main organs defines the distinction between its advisory and contentious jurisdictions.

[...] The Court therefore observes that the exercise of the advisory function assigned to it by the American Convention is multilateral rather than litigious in nature, a fact faithfully reflected in the Rules of Procedure of the Court, Article 62(1) of which establishes that a request for an advisory opinion shall be transmitted to all the "Member States", which may submit their comments on the request and participate in the public hearing on the matter. Furthermore, while an advisory opinion of the Court does not have the binding character of a judgment in a contentious case, it does have undeniable legal effects. Hence, it is evident that the State or organ requesting an advisory opinion of the Court is not the only one with a legitimate interest in the outcome of the procedure.<sup>14</sup>

64. When affirming its competence in this matter, the Court recalls the broad scope of its advisory function, unique in contemporary international law, which "enables the Court to perform a service to all the members of the inter-American system, and is designed to assist them in fulfilling their international human rights commitments,"<sup>15</sup> and

to assist states and organs to comply with and to apply human rights treaties without subjecting them to the formalism and the sanctions associated with the contentious judicial process.<sup>16</sup>

65. The Court observes that the use of examples serves the purpose of referring to a specific context and illustrates the different interpretations that could be given to the legal issue raised in the advisory opinion in question, without implying that the Court is rendering a legal ruling on the situation described in such examples<sup>17</sup>. Likewise, the latter allow the Court to show that its advisory opinion is not mere

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<sup>13</sup> *Legal Status and Human Rights of the Child*, supra note 1, para. 33; *The Right to Information on Consular Assistance in the Framework of the Guarantees of Due Process of Law*, supra note 1, para. 47; and cf. *International Responsibility for the Promulgation and Enforcement of Laws in violation of the Convention*, supra note 3, para. 23.

<sup>14</sup> *Reports of the Inter-American Commission on Human Rights*, supra note 1, paras. 25 and 26.

<sup>15</sup> *Legal Status and Human Rights of the Child*, supra note 1, para. 34; *The Right to Information on Consular Assistance in the Framework of the Guarantees of Due Process of Law*, supra note 1, para. 64; and "Other treaties" subject to the Advisory Jurisdiction of the Court, supra note 1, para. 37 and 39.

<sup>16</sup> *Legal Status and Human Rights of the Child*, supra note 1, para. 34; *The Right to Information on Consular Assistance in the Framework of the Guarantees of Due Process of Law*, supra note 1, para. 64; and cf. *Compatibility of Draft Legislation with Article 8(2)(h) of the American Convention on Human Rights*, supra note 12, para. 20.

<sup>17</sup> *Legal Status and Human Rights of the Child*, supra note 1, para. 35; *The Right to Information on Consular Assistance in the Framework of the Guarantees of Due Process of Law*, supra note 1, para. 49; and cf. *Judicial Guarantees in States of Emergency* (Arts. 27(2), 25 and 8 American Convention on Human Rights). Advisory Opinion OC-9/87 of October 6, 1987. Series A No. 9, para. 16.

academic speculation and is justified by its potential benefit for the international protection of human rights and for strengthening the universal juridical conscience<sup>18</sup>. When tackling the respective issue, the Court acts as a human rights tribunal, guided by the international instruments that regulate its advisory competence and makes a strictly juridical analysis of the questions submitted to it.

66. In view of the foregoing, the Court considers that it should examine the matters set out in the request and issue the corresponding opinion.

#### IV STRUCTURE OF THE OPINION

67. The Court is empowered to structure its rulings as it considers best suited to the interests of justice and the purposes of an advisory opinion. Accordingly, the Court takes into account the basic issues that underlie the questions posed in the request for an opinion and examines them in order to reach general conclusions that can, in turn, be extended to the specific points mentioned in the request itself and related issues<sup>19</sup>. On this occasion, the Court has decided to start by drawing up a glossary in order to define the conceptual scope of the words used in this Opinion. Once this conceptual framework has been established, the Court will proceed to examine the specific matters submitted to its consideration and, to this end, will reply to the questions it has been asked in the order it considers most appropriate, with a view to the coherence of the Opinion. Pursuant to the power inherent in all courts to give their rulings the logical structure they consider most adequate to the interest of justice,<sup>20</sup> the Court will consider the questions raised as follows:

- a) Obligation to respect and guarantee the human rights and fundamental nature of the principle of equality and non-discrimination (Questions 2(1) and 4);
- b) Application of the principle of equality and non-discrimination to migrants (Question 2(1));
- c) Rights of undocumented migrant workers (Questions 2(2) and 1); and
- d) State obligations in the determination of migratory policies in light of the international instruments for the protection of human rights (Question 3).

68. The Court will now consider each of the points mentioned above in the sequence indicated.

#### V GLOSSARY

69. For the purposes of this Advisory Opinion, the Court will use the following words with the meaning indicated:

- a) to emigrate or migrate** or To leave a State in order to transfer to another and establish oneself there.

<sup>18</sup> Cf. *Legal Status and Human Rights of the Child*, supra note 1, para. 35; *The Right to Information on Consular Assistance in the Framework of the Guarantees of Due Process of Law*, supra note 1, para. 49; and *Reports of the Inter-American Commission on Human Rights*, supra note 1, para. 32.

<sup>19</sup> Cf. *Legal Status and Human Rights of the Child*, supra note 1, para. 37.

<sup>20</sup> *The Right to Information on Consular Assistance in the Framework of the Guarantees of Due Process of Law*, supra note 1, para. 66.

- b) emigrant** A person who leaves a State in order to transfer to another and establish himself there.
- c) to immigrate** To enter another State in order to reside there.
- d) immigrant** A person who enters another State in order to reside there.
- e) migrant** A generic word that covers both emigrants and immigrants.
- f) migratory status** Legal status of a migrant, in accordance with the domestic legislation of the State of employment.
- g) worker** A person who is to be engaged, is engaged or has been engaged in a remunerated activity.
- h) migrant worker** A person who is to be engaged, is engaged or has been engaged in a remunerated activity in a State of which he is not a national.<sup>21</sup>
- i) documented migrant worker or migrant worker in a regular situation** A person who is authorized to enter, stay and engage in a remunerated activity in the State of employment, pursuant to the law of the State and international agreements to which that State is a party.<sup>22</sup>
- j) undocumented migrant worker or migrant worker in an irregular situation** A person who is not authorized to enter, stay and engage in a remunerated activity in the State of employment, pursuant to the law of the State and international agreements to which that State is a party and who, despite this, engages in the said activity.<sup>23</sup>
- k) State of origin** State of which the migrant worker is a national.<sup>24</sup>
- l) State of employment** State in which the migrant worker is to be engaged, is

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<sup>21</sup> Cf. ILO, Convention No. 97 concerning Migrant Workers (revised) of 1949 and Convention No. 143 concerning Migrant Workers (Supplementary Provisions) of 1975, Article 11 of which defines a migrant worker as "a person who migrates or has migrated from one country to another with a view to being employed otherwise than on his own account and includes any person regularly admitted as a migrant worker."

<sup>22</sup> Cf. U.N., International Convention on the Protection of the Rights of All Migrant Workers and Members of their Families of 18 December 1990. Article 5 indicates that migrant workers and their families "are considered as documented or in regular situation if they are authorized to enter, to stay and to engage in a remunerated activity in the State of employment, pursuant to the law of the State and international agreements to which that State is a party."

<sup>23</sup> Cf. U.N., International Convention on the Protection of the Rights of All Migrant Workers and Members of their Families of 18 December 1990. Article 5 indicates that migrant workers and their families "are considered non-documented or in an irregular situation if they do not comply with the conditions provided for in subparagraph (a) of the present article."

<sup>24</sup> Cf. U.N., International Convention on the Protection of the Rights of All Migrant Workers and Members of their Families of 18 December 1990. Article 6(a) indicates that "[t]he term 'State of origin' means the State of which the person concerned is a national."

**or recipient State** engaged or has been engaged in a remunerated activity.<sup>25</sup>

**VI**  
**OBLIGATION TO RESPECT AND GUARANTEE HUMAN RIGHTS**  
**AND THE FUNDAMENTAL NATURE OF THE PRINCIPLE OF**  
**EQUALITY AND NON-DISCRIMINATION**

70. With regard to the general obligation to respect and guarantee human rights, the following norms are cited in the request:

- a) Article 1 of the American Convention, which states that:
  - 1. The States Parties to this Convention undertake to respect the rights and freedoms recognized herein and to ensure to all persons subject to their jurisdiction the free and full exercise of those rights and freedoms, without any discrimination for reasons of race, color, sex, language, religion, political or other opinion, national or social origin, economic status, birth, or any other social condition.
  - 2. For the purposes of this Convention, "person" means every human being.
- b) Article 2 of the International Covenant on Civil and Political Rights, which stipulates that:
  - 1. Each State Party to the present Covenant undertakes to respect and to ensure to all individuals within its territory and subject to its jurisdiction the rights recognized in the present Covenant, without distinction of any kind, such as race, colour, sex, language, religion, political or other opinion, national or social origin, property, birth or other status.
  - 2. Where not already provided for by existing legislative or other measures, each State Party to the present Covenant undertakes to take the necessary steps, in accordance with its constitutional processes and with the provisions of the present Covenant, to adopt such legislative or other measures as may be necessary to give effect to the rights recognized in the present Covenant.
  - 3. Each State Party to the present Covenant undertakes:
    - a) To ensure that any person whose rights or freedoms as herein recognized are violated shall have an effective remedy, notwithstanding that the violation has been committed by persons acting in an official capacity;
    - b) To ensure that any persons claiming such a remedy shall have his right thereto determined by competent judicial, administrative or legislative authorities, or by any other competent authority, provided for by the legal system of the State, and to develop the possibilities of judicial remedy;
    - c) To ensure that the competent authorities shall enforce such remedies when granted.

71. With regard to the principle of equality and non-discrimination, the norms mentioned in the request are:

- a) Articles 3(l) and 17 of the OAS Charter, which indicate that:

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<sup>25</sup> Cf. U.N., International Convention on the Protection of the Rights of All Migrant Workers and Members of their Families of 18 December 1990. Article 6(b) indicates that "[t]he term 'State of employment' means a State where the migrant worker is to be engaged, is engaged or has been engaged in a remunerated activity, as the case may be."

The American States proclaim the fundamental rights of the individual without distinction as to race, nationality, creed, or sex.

Each State has the right to develop its cultural, political, and economic life freely and naturally. In this free development, the State shall respect the rights of the individual and the principles of universal morality.

- b) Article 24 of the American Convention, which determines that:

All persons are equal before the law. Consequently, they are entitled, without discrimination, to equal protection of the law.

- c) Article II of the American Declaration, which states that:

All persons are equal before the law and have the rights and duties established in this Declaration, without distinction as to race, sex, language, creed or any other factor.

- d) Article 26 of the International Covenant on Civil and Political Rights, which stipulates that:

All persons are equal before the law and are entitled without any discrimination to the equal protection of the law. In this respect, the law shall prohibit any discrimination and guarantee to all persons equal and effective protection against discrimination on any ground such as race, colour, sex, language, religion, political or other opinion, national or social origin, property, birth or other status.

- e) Article 2(1) of the Universal Declaration, which indicates that:

Everyone is entitled to all the rights and freedoms set forth in this Declaration, without distinction of any kind, such as race, colour, sex, language, religion, political or other opinion, national or social origin, property, birth or other status.

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### *Obligation to Respect and Guarantee Human Rights*

72. The Court now considers it pertinent to refer to the general State obligation to respect and guarantee human rights, which is of the highest importance, and will then examine the principle of equality and non-discrimination.

73. Human rights must be respected and guaranteed by all States. All persons have attributes inherent to their human dignity that may not be harmed; these attributes make them possessors of fundamental rights that may not be disregarded and which are, consequently, superior to the power of the State, whatever its political structure.

74. The general obligation to respect and ensure human rights is enshrined in various international instruments<sup>26</sup>.

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<sup>26</sup> Some of these international instruments are: American Convention on Human Rights (Articles 1 and 2), Additional Protocol to the American Convention on Human Rights in the Area of Economic, Social and Cultural Rights "Protocol of San Salvador" (Article 1), Charter of the United Nations (Article 55(c)), Universal Declaration of Human Rights (Preamble), International Covenant on Civil and Political Rights (Article 2(1) and 2(2)), International Covenant on Economic, Social and Cultural Rights (Article 2(2)), International Convention on the Protection of the Rights of All Migrant Workers and Members of their Families (Article 7), International Convention on the Elimination of All Forms of Racial Discrimination (Preamble), European Convention for the Protection of the Human Rights and Fundamental Freedoms (Article 1), European Social Charter (Preamble), African Charter of Human and People's Rights "Banjul Charter" (Article 1), and the Arab Charter of Human Rights (Article 2).

75. The supervisory bodies of the American Convention and the International Covenant on Civil and Political Rights, the instruments indicated by Mexico in the questions of the request for an advisory opinion examined in this chapter, have ruled on the said obligation.

76. In this respect, the Inter-American Court has indicated that:

Article 1(1) is essential in determining whether a violation of the human rights recognized by the Convention can be imputed to a State Party. In effect, that article charges the States Parties with the fundamental duty to respect and guarantee, the rights recognized in the Convention. Any impairment of those rights which can be attributed to the action or omission of any public authority constitutes an act imputable to the State, which assumes responsibility in the terms provided by the Convention.

According to Article 1(1), any exercise of public power that violates the rights recognized by the Convention, is illegal. Whenever a State organ, official or public entity violates one of those rights, this constitutes a failure of the duty to respect the rights and freedoms set forth in the Convention.

This conclusion is independent of whether the organ or official has contravened provisions of domestic law or overstepped the limits of his authority. Under international law, a State is responsible for the acts of its agents undertaken in their official capacity and for their omissions, even when those agents act outside the sphere of their authority or violate domestic law.<sup>27</sup>

77. The Inter-American Court has also stated that:

In international law, a customary norm establishes that a State which has ratified a human rights treaty must introduce the necessary modifications to its domestic law to ensure the proper compliance with the obligations it has assumed. This law is universally accepted, and is supported by jurisprudence. The American Convention establishes the general obligation of each State Party to adapt its domestic law to the provisions of this Convention, in order to guarantee the rights that it embodies. This general obligation of the State Party implies that the measures of domestic law must be effective (the principle of *effet utile*). This means that the State must adopt all measures so that the provisions of the Convention are effectively fulfilled in its domestic legal system, as Article 2 of the Convention requires. Such measures are only effective when the State adjusts its actions to the Convention's rules on protection.<sup>28</sup>

78. Likewise, the Court has declared that:

[t]he general duty set forth in Article 2 of the American Convention implies the adoption of measures on two fronts. On the one hand, the suppression of rules and practices of any kind that entail the violation of the guarantees set forth in the Convention. On the other hand, the issuance of rules and the development of practices leading to the effective observation of the said guarantees<sup>29</sup>.

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<sup>27</sup> "Five Pensioners" case. Judgment of February 28, 2003. Series C No. 98, para. 163; and *cf. The case of the Mayagna (Sumo) Awas Tingni Community*. Judgment of August 31, 2001. Series C No. 79, para. 154; and *Baena Ricardo et al. case*. Judgment of February 2, 2001. Series C No. 72, para. 178.

<sup>28</sup> "Five Pensioners" case, *supra* note 27, para. 164; and *cf. Cantos case*. Judgment of November 28, 2002. Series C No. 97, para. 59; and *Hilaire, Constantine and Benjamin et al. case*. Judgment of June 21, 2002. Series C No. 94, para. 213; and *cf. also "principe allant de soi"; Exchange of Greek and Turkish populations*, Advisory Opinion, 1925, P.I.C.J., Collection of Advisory Opinions. Series B. No. 10.

<sup>29</sup> *Cf. "Five Pensioners" case, supra* note 27, para. 165; *Baena Ricardo et al. case, supra* note 27, para. 180; and *Cantoral Benavides case*. Judgment of August 18, 2000. Series C No. 69, para. 178.

79. With regard to the provisions of Article 2 of the International Covenant on Civil and Political Rights, the Human Rights Committee has observed that:

[...] article 2 of the Covenant generally leaves it to the States parties concerned to choose their method of implementation in their territories within the framework set out in that article. It recognizes, in particular, that the implementation does not depend solely on constitutional or legislative enactments, which in themselves are often not per se sufficient. The Committee considers it necessary to draw the attention of States parties to the fact that the obligation under the Covenant is not confined to the respect of human rights, but that States parties have also undertaken to ensure the enjoyment of these rights to all individuals under their jurisdiction. This aspect calls for specific activities by the States parties to enable individuals to enjoy their rights. [...]

In this connection, it is very important that individuals should know what their rights under the Covenant (and the Optional Protocol, as the case may be) are and also that all administrative and judicial authorities should be aware of the obligations which the State party has assumed under the Covenant<sup>30</sup>.

80. Likewise, the European Court of Human Rights has indicated that:

The Convention does not merely oblige the higher authorities of the Contracting States to respect for their own part the rights and freedoms it embodies; as is shown by Article 14 (art. 14) and the English text of Article 1 (art. 1) ("shall secure"), the Convention also has the consequence that, in order to secure the enjoyment of those rights and freedoms, those authorities must prevent or remedy any breach at subordinate levels.<sup>31</sup>

81. As can be seen from the above, both the international instruments and the respective international case law establish clearly that States have the general obligation to respect and ensure the fundamental rights. To this end, they should take affirmative action, avoid taking measures that restrict or infringe a fundamental right, and eliminate measures and practices that restrict or violate a fundamental right.

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### *The principle of equality and non-discrimination*

82. Having established the State obligation to respect and guarantee human rights, the Court will now refer to the elements of the principle of equality and non-discrimination.

83. Non-discrimination, together with equality before the law and equal protection of the law, are elements of a general basic principle related to the protection of human rights. The element of equality is difficult to separate from non-discrimination. Indeed, when referring to equality before the law, the instruments cited above (*supra* para. 71) indicate that this principle must be guaranteed with no discrimination. This Court has indicated that "[r]ecognizing equality before the law, [...] prohibits all discriminatory treatment."<sup>32</sup>

<sup>30</sup> U.N., Human Rights Committee, General Comment 3, Application of the International Covenant on Civil and Political Rights at the National Level (Article 2), 29 July 1981, CCPR/C/13, paras. 1 and 2.

<sup>31</sup> *Eur. Court H.R., Case of Ireland v. the United Kingdom, Judgment of 18 January 1978, Series A No 25, para. 239.*

<sup>32</sup> *Proposed Amendments to the Naturalization Provisions of the Constitution of Costa Rica. Advisory Opinion OC-4/84 of January 19, 1984. Series A No. 4, para. 54.*



84. This Advisory Opinion will differentiate by using the terms distinction and discrimination. The term distinction will be used to indicate what is admissible, because it is reasonable, proportionate and objective. Discrimination will be used to refer to what is inadmissible, because it violates human rights. Therefore, the term "discrimination" will be used to refer to any exclusion, restriction or privilege that is not objective and reasonable, and which adversely affects human rights.

85. There is an inseparable connection between the obligation to respect and guarantee human rights and the principle of equality and non-discrimination. States are obliged to respect and guarantee the full and free exercise of rights and freedoms without any discrimination. Non-compliance by the State with the general obligation to respect and guarantee human rights, owing to any discriminatory treatment, gives rise to its international responsibility.

86. The principle of the equal and effective protection of the law and of non-discrimination is embodied in many international instruments.<sup>33</sup> The fact that the principle of equality and non-discrimination is regulated in so many international instruments is evidence that there is a universal obligation to respect and guarantee the human rights arising from that general basic principle.

87. The principle of equality before the law and non-discrimination has been developed in international case law and legal writings. The Inter-American Court has understood that:

[t]he notion of equality springs directly from the oneness of the human family and is linked to the essential dignity of the individual. That principle cannot be reconciled with

<sup>33</sup> Some of these international instruments are: OAS Charter (Article 3(1)); American Convention on Human Rights (Articles 1 and 24); American Declaration on the Rights and Duties of Man (Article 2); Additional Protocol to the American Convention on Human Rights in the Area of Economic, Social and Cultural Rights "Protocol of San Salvador" (Article 3); Charter of the United Nations (Article 1(3)); Universal Declaration of Human Rights (Articles 2 and 7); International Covenant on Economic, Social and Cultural Rights (Articles 2(2) and 3); International Covenant on Civil and Political Rights (Articles 2 and 26); International Convention on the Elimination of All Forms of Racial Discrimination (Article 2); Convention on the Rights of the Child (Article 2); Declaration on the Rights of the Child (Principle 1); International Convention on the Protection of the Rights of All Migrant Workers and Members of their Families (Articles 1, 7, 18(1), 25, 27, 28, 43, 45(1), 48, 55 and 70); Convention on the Elimination of All Forms of Discrimination against Women (Articles 2, 3, 5 to 16); Declaration on the Elimination of All Forms of Intolerance and Discrimination Based on Religion or Beliefs (Articles 2 and 4); Declaration of the International Labor Organization (ILO) concerning the Fundamental Principles and Rights in Work and their Monitoring (2(d)); Convention No. 97 of the International Labor Organization (ILO) concerning Migrant Workers (revised) (Article 6); Convention No. 111 of the International Labor Organization (ILO) concerning Discrimination with regard to Employment and Occupation (Articles 1 to 3); Convention No. 143 of the International Labor Organization (ILO) concerning Migrant Workers (supplementary provisions) (Articles 8 and 10); Convention No. 168 of the International Labor Organization (ILO) concerning Promotion of Employment and Protection against Unemployment (Article 6); Proclamation of Teheran, the Teheran International Conference on Human Rights, May 13, 1968 (paras. 1, 2, 5, 8 and 11); Vienna Declaration and Programme of Action, World Conference on Human Rights, 14 to 25 June 1993 (I.15; I.19; I.27; I.30; II.B.1, Articles 19 to 24; II.B.2, Articles 25 to 27); Declaration on the Rights of Persons Belonging to National or Ethnic, Religious and Linguistic Minorities (Articles 2, 3, 4(1) and 5); World Conference against Racism, Racial Discrimination, Xenophobia and Related Forms of Intolerance, Programme of Action (paragraphs 1, 2, 7, 9, 10, 16, 25, 38, 47, 48, 51, 66 and 104 of the Declaration); Convention against Discrimination in Education (Article 3); Declaration on Race and Racial Prejudice (Articles 1, 2, 3, 4, 5, 6, 7, 8 and 9); Declaration on the Human Rights of Individuals Who are not Nationals of the Country in which They Live (Article 5(1)(b) and 5(1)(c)); Charter of the Fundamental Rights of the European Union (Articles 20 and 21); European Convention for the Protection of Human Rights and Fundamental Freedoms (Articles 1 and 14); European Social Charter (Article 19(4), 19(5) and 19(7)); Protocol No.12 to the European Convention for the Protection of Human Rights and Fundamental Freedoms (Article 1); African Charter of Human and People's Rights "Banjul Charter"(Articles 2 and 3); Arab Charter of Human Rights (Article 2); and Cairo Declaration of Human Rights in Islam (Article 1).

the notion that a given group has the right to privileged treatment because of its perceived superiority. It is equally irreconcilable with that notion to characterize a group as inferior and treat it with hostility or otherwise subject it to discrimination in the enjoyment of rights that are accorded to others not so classified. It is impermissible to subject human beings to differences in treatment that are inconsistent with their unique and congenerous character.<sup>34</sup>

88. The principle of equality and non-discrimination is fundamental for the safeguard of human rights in both international and domestic law. Consequently, States have the obligation to combat discriminatory practices and not to introduce discriminatory regulations into their laws.

89. Nevertheless, when examining the implications of the differentiated treatment that some norms may give to the persons they affect, it is important to refer to the words of this Court declaring that "not all differences in treatment are in themselves offensive to human dignity."<sup>35</sup> In the same way, the European Court of Human Rights, following "the principles which may be extracted from the legal practice of a large number of democratic States," has held that a difference in treatment is only discriminatory when "it has no objective and reasonable justification."<sup>36</sup> Distinctions based on *de facto* inequalities may be established; such distinctions constitute an instrument for the protection of those who should be protected, considering their situation of greater or lesser weakness or helplessness.<sup>37</sup> For example, the fact that minors who are detained in a prison may not be imprisoned together with adults who are also detained is an inequality permitted by law. Another example of these inequalities is the limitation to the exercise of specific political rights owing to nationality or citizenship.

90. In this respect, the European Court has also indicated that:

"It is important, then, to look for the criteria which enable a determination to be made as to whether or not a given difference in treatment, concerning of course the exercise of one of the rights and freedoms set forth, contravenes Article 14 (art. 14). On this question the Court, following the principles which may be extracted from the legal practice of a large number of democratic States, holds that the principle of equality of treatment is violated if the distinction has no objective and reasonable justification. The existence of such a justification must be assessed in relation to the aim and effects of the measure under consideration, regard being had to the principles which normally prevail in democratic societies. A difference of treatment in the exercise of a right laid down in the Convention must not only pursue a legitimate aim: Article 14 (art. 14) is likewise violated when it is clearly established that there is no reasonable relationship of proportionality between the means employed and the aim sought to be realised.

In attempting to find out in a given case, whether or not there has been an arbitrary distinction, the Court cannot disregard those legal and factual features which characterise the life of the society in the State which, as a Contracting Party, has to

<sup>34</sup> *Legal Status and Human Rights of the Child*, *supra* note 1, para. 45; and *Proposed Amendments to the Naturalization Provisions of the Constitution of Costa Rica.*, *supra* note 32, para. 55.

<sup>35</sup> *Legal Status and Human Rights of the Child*, *supra* note 1, para. 46; and *Proposed Amendments to the Naturalization Provisions of the Constitution of Costa Rica.*, *supra* note 32, para. 56.

<sup>36</sup> Cf. *Eur. Court H.R., Case of Willis v. The United Kingdom, Judgement of 11 June 2002, para. 39; Eur. Court H.R., Case of Wessels-Bergervoet v. The Netherlands, Judgement of 4 June 2002, para. 46; Eur. Court H.R., Case of Petrovic v. Austria, Judgment of 27 March 1998, Reports 1998-II, para. 30; Eur. Court H.R., Case "relating to certain aspects of the laws on the use of languages in education in Belgium" v. Belgium, Judgment of 23 July 1968, Series A 1968, para. 10.*

<sup>37</sup> *Legal Status and Human Rights of the Child*, *supra* note 1, para. 46.

answer for the measure in dispute. In so doing it cannot assume the rôle of the competent national authorities, for it would thereby lose sight of the subsidiary nature of the international machinery of collective enforcement established by the Convention. The national authorities remain free to choose the measures which they consider appropriate in those matters which are governed by the Convention. Review by the Court concerns only the conformity of these measures with the requirements of the Convention."<sup>38</sup>

91. Likewise, the Inter-American Court has established that:

[n]o discrimination exists if the difference in treatment has a legitimate purpose and if it does not lead to situations which are contrary to justice, to reason or to the nature of things. It follows that there would be no discrimination in differences in treatment of individuals by a state when the classifications selected are based on substantial factual differences and there exists a reasonable relationship of proportionality between these differences and the aims of the legal rule under review. These aims may not be unjust or unreasonable, that is, they may not be arbitrary, capricious, despotic or in conflict with the essential oneness and dignity of humankind.<sup>39</sup>

92. The United Nations Committee on Human Rights has defined discrimination as:

[...] any distinction, exclusion, restriction or preference which is based on any ground such as race, colour, sex, language, religion, political or other opinion, national or social origin, property, birth or other status, and which has the purpose or effect of nullifying or impairing the recognition, enjoyment or exercise by all persons, on an equal footing, of all rights and freedoms.<sup>40</sup>

93. Likewise, this Committee has indicated that:

[...] the enjoyment of rights and freedoms on an equal footing, however, does not mean identical treatment in every instance.<sup>41</sup>

94. The Human Rights Committee has also stated that:

[...] each State party must ensure the rights in the Covenant to "all individuals within its territory and subject to its jurisdiction" [...]. In general, the rights set forth in the Covenant apply to everyone, irrespective of reciprocity, and irrespective of his or her nationality or statelessness. [...]

Thus, the general rule is that each one of the rights of the Covenant must be guaranteed without discrimination between citizens and aliens. Aliens receive the benefit of the general requirement of non-discrimination in respect of the rights guaranteed in the Covenant, as provided for in article 2 thereof. This guarantee applies to aliens and citizens alike. Exceptionally, some of the rights recognized in the Covenant are expressly applicable only to citizens (art. 25), while article 13 applies only to aliens. However, the Committee's experience in examining reports shows that in a number of countries other rights that aliens should enjoy under the Covenant are denied to them or are subject to limitations that cannot always be justified under the Covenant. [...]

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<sup>38</sup> *Eur. Court H.R., Case "relating to certain aspects of the laws on the use of languages in education in Belgium" v. Belgium, Judgment of 23 July 1968, Series A 1968, para. 10.*

<sup>39</sup> *Legal Status and Human Rights of the Child, supra note 1, para. 47; and Proposed Amendments to the Naturalization Provisions of the Constitution of Costa Rica, supra note 32, para. 57.*

<sup>40</sup> U.N., Human Rights Committee, General Comment 18, Non-discrimination, 10/11/89, CCPR/C/37, para. 7.

<sup>41</sup> U.N., Human Rights Committee, General Comment 18, Non-discrimination, 10/11/89, CCPR/C/37, para. 8.

The Covenant gives aliens all the protection regarding rights guaranteed therein, and its requirements should be observed by States parties in their legislation and in practice as appropriate. [...]

Aliens are entitled to equal protection by the law. There shall be no discrimination between aliens and citizens in the application of these rights. These rights of aliens may be qualified only by such limitations as may be lawfully imposed under the Covenant.<sup>42</sup>

95. With regard to the principle of equality and non-discrimination, the African Commission of Human and Peoples' Rights has established that this:

[m]eans that citizens should expect to be treated fairly and justly within the legal system and be assured of equal treatment before the law and equal enjoyment of the rights available to all other citizens. The right to equality is important for a second reason. Equality or lack of it affects the capacity of one to enjoy many other rights.<sup>43</sup>

96. In accordance with the foregoing, States must respect and ensure human rights in light of the general basic principle of equality and non-discrimination. Any discriminatory treatment with regard to the protection and exercise of human rights entails the international responsibility of the State.

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*The fundamental nature of the principle of equality and non-discrimination*

97. The Court now proceeds to consider whether this is a *jus cogens* principle.

98. Originally, the concept of *jus cogens* was linked specifically to the law of treaties. As *jus cogens* is formulated in Article 53 of the Vienna Convention on the Law of Treaties, "[a] treaty is void if, at the time of its conclusion, it conflicts with a peremptory norm of general international law." Likewise, Article 64 of the Convention refers to *jus cogens superviniente*, when it indicates that "[i]f a new peremptory norm of general international law emerges, any existing treaty which is in conflict with that norm becomes void and terminates." *Jus cogens* has been developed by international case law and legal writings.<sup>44</sup>

99. In its development and by its definition, *jus cogens* is not limited to treaty law. The sphere of *jus cogens* has expanded to encompass general international law, including all legal acts. *Jus cogens* has also emerged in the law of the international responsibility of States and, finally, has had an influence on the basic principles of the international legal order.

<sup>42</sup> U.N., Human Rights Committee, General Comment 15, The situation of aliens in accordance with the Covenant, 11/04/86, CCPR/C/27, paras. 1, 2, 4, 7, 8 and 9.

<sup>43</sup> *African Commission of Human and Peoples' Rights, Communication No: 211/98 - Legal Resources Foundation v. Zambia, decision taken at the 29th Ordinary Session held in Tripoli, Libya, from 23 April to 7 May 2001, para. 63.*

<sup>44</sup> *Cf. I.C.T.Y., Trial Chamber II: Prosecutor v. Anto Furundzija, Judgment of 10 December 1998, Case No. IT-95-17/1-T, paras. 137-146, 153-157; Application of the Convention on the Prevention and Punishment of the Crime of Genocide, Preliminary Objections, Judgment, I.C.J. Reports 1996, p. 595; Barcelona Traction, Light and Power Company, Limited, Judgment, I.C.J. Reports 1970, p. 3, and Reservations to the Convention on Genocide, Advisory Opinion: I.C.J. Reports 1951, p. 15.*

100. In particular, when referring to the obligation to respect and ensure human rights, regardless of which of those rights are recognized by each State in domestic or international norms, the Court considers it clear that all States, as members of the international community, must comply with these obligations without any discrimination; this is intrinsically related to the right to equal protection before the law, which, in turn, derives "directly from the oneness of the human family and is linked to the essential dignity of the individual."<sup>45</sup> The principle of equality before the law and non-discrimination permeates every act of the powers of the State, in all their manifestations, related to respecting and ensuring human rights. Indeed, this principle may be considered peremptory under general international law, inasmuch as it applies to all States, whether or not they are party to a specific international treaty, and gives rise to effects with regard to third parties, including individuals. This implies that the State, both internationally and in its domestic legal system, and by means of the acts of any of its powers or of third parties who act under its tolerance, acquiescence or negligence, cannot behave in a way that is contrary to the principle of equality and non-discrimination, to the detriment of a determined group of persons.

101. Accordingly, this Court considers that the principle of equality before the law, equal protection before the law and non-discrimination belongs to *jus cogens*, because the whole legal structure of national and international public order rests on it and it is a fundamental principle that permeates all laws. Nowadays, no legal act that is in conflict with this fundamental principle is acceptable, and discriminatory treatment of any person, owing to gender, race, color, language, religion or belief, political or other opinion, national, ethnic or social origin, nationality, age, economic situation, property, civil status, birth or any other status is unacceptable. This principle (equality and non-discrimination) forms part of general international law. At the existing stage of the development of international law, the fundamental principle of equality and non-discrimination has entered the realm of *jus cogens*.

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#### *Effects of the principle of equality and non-discrimination*

102. This general obligation to respect and guarantee human rights, without any discrimination and on an equal footing, has various consequences and effects that are defined in specific obligations. The Court will now refer to the effects derived from this obligation.

103. In compliance with this obligation, States must abstain from carrying out any action that, in any way, directly or indirectly, is aimed at creating situations of *de jure* or *de facto* discrimination. This translates, for example, into the prohibition to enact laws, in the broadest sense, formulate civil, administrative or any other measures, or encourage acts or practices of their officials, in implementation or interpretation of the law that discriminate against a specific group of persons because of their race, gender, color or other reasons.

104. In addition, States are obliged to take affirmative action to reverse or change discriminatory situations that exist in their societies to the detriment of a specific

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<sup>45</sup> *Legal Status and Human Rights of the Child*, supra note 1, para. 45; *Proposed Amendments to the Naturalization Provisions of the Constitution of Costa Rica*, supra note 32, para. 55.

group of persons. This implies the special obligation to protect that the State must exercise with regard to acts and practices of third parties who, with its tolerance or acquiescence, create, maintain or promote discriminatory situations.

105. Because of the effects derived from this general obligation, States may only establish objective and reasonable distinctions when these are made with due respect for human rights and in accordance with the principle of applying the norm that grants protection to the individual.

106. Non-compliance with these obligations gives rise to the international responsibility of the State, and this is exacerbated insofar as non-compliance violates peremptory norms of international human rights law. Hence, the general obligation to respect and ensure human rights binds States, regardless of any circumstance or consideration, including a person's migratory status.

107. One of the results of the foregoing is that, in their domestic laws, States must ensure that all persons have access, without any restriction, to a simple and effective recourse that protects them in determining their rights, irrespective of their migratory status.

108. In this respect, the Inter-American Court has indicated that:

[...] the absence of an effective remedy to violations of the rights recognized by the Convention is itself a violation of the Convention by the State Party in which the remedy is lacking. In that sense, it should be emphasized that, for such a remedy to exist, it is not sufficient that it be provided for by the Constitution or by law or that it be formally recognized, but rather it must be truly effective in establishing whether there has been a violation of human rights and in providing redress. A remedy which proves illusory because of the general conditions prevailing in the country, or even in the particular circumstances of a given case, cannot be considered effective. That could be the case, for example, when practice has shown its ineffectiveness: when the Judicial Power lacks the necessary independence to render impartial decisions or the means to carry out its judgments; or in any other situation that constitutes a denial of justice, as when there is an unjustified delay in the decision; or when, for any reason, the alleged victim is denied access to a judicial remedy<sup>46</sup>.

109. This general obligation to respect and ensure the exercise of rights has an *erga omnes* character. The obligation is imposed on States to benefit the persons under their respective jurisdictions, irrespective of the migratory status of the protected persons. This obligation encompasses all the rights included in the American Convention and the International Covenant on Civil and Political Rights, including the right to judicial guarantees. In this way, the right of access to justice for all persons is preserved, understood as the right to effective jurisdictional protection.

110. Finally, as regards the second part of the fourth question of the request for an advisory opinion (*supra* para. 4), the contents of the preceding paragraphs are applicable to all the OAS Member States. The effects of the fundamental principle of equality and non-discrimination encompass all States, precisely because this principle, which belongs to the realm of *jus cogens* and is of a peremptory character,

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<sup>46</sup> "Five Pensioners" case, *supra* note 27, para. 136; and *cf.* The case of the Mayagna (Sumo) Awajitjngni Community, *supra* note 27, para. 113; *Ivcher Bronstein case*. Judgment of February 6, 2001. Series C No. 74, paras. 136 and 137; and *Judicial Guarantees in States of Emergency*, *supra* note 17, para. 24.

entails obligations *erga omnes* of protection that bind all States and give rise to effects with regard to third parties, including individuals.

## **VII APPLICATION OF THE PRINCIPLE OF EQUALITY AND NON-DISCRIMINATION TO MIGRANTS**

111. Now that the *jus cogens* character of the principle of equality and non-discrimination and the effects that derive from the obligation of States to respect and guarantee this principle have been established, the Court will refer to migration in general and to the application of this principle to undocumented migrants.

112. Migrants are generally in a vulnerable situation as subjects of human rights; they are in an individual situation of absence or difference of power with regard to non-migrants (nationals or residents). This situation of vulnerability has an ideological dimension and occurs in a historical context that is distinct for each State and is maintained by *de jure* (inequalities between nationals and aliens in the laws) and *de facto* (structural inequalities) situations. This leads to the establishment of differences in their access to the public resources administered by the State.

113. Cultural prejudices about migrants also exist that lead to reproduction of the situation of vulnerability; these include ethnic prejudices, xenophobia and racism, which make it difficult for migrants to integrate into society and lead to their human rights being violated with impunity.

114. In this respect, the resolution on "Protection of migrants" of the General Assembly of the United Nations is pertinent, when it indicates that it is necessary to recall "the situation of vulnerability in which migrants frequently find themselves, owing, *inter alia*, to their absence from their State of origin and to the difficulties they encounter because of differences of language, custom and culture, as well as the economic and social difficulties and obstacles for the return to their States of origin of migrants who are non-documented or in an irregular situation."<sup>47</sup> The General Assembly also expressed its concern "at the manifestations of violence, racism, xenophobia and other forms of discrimination and inhuman and degrading treatment against migrants, especially women and children, in different parts of the world."<sup>48</sup> Based on these considerations, the General Assembly reiterated:

the need for all States to protect fully the universally recognized human rights of migrants, especially women and children, regardless of their legal status, and to provide humane treatment, particularly with regard to assistance and protection [...].<sup>49</sup>

115. The Court is aware that, as the General Assembly of the United Nations also observed, "among other factors, the process of globalization and liberalization, including the widening economic and social gap between and among many countries and the marginalization of some countries in the global economy, has contributed to

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<sup>47</sup> United Nations General Assembly, Resolution A/RES/54/166 on "Protection of migrants" of February 24, 2000.

<sup>48</sup> United Nations General Assembly, Resolution A/RES/54/166 on "Protection of migrants" of 24 February 2000.

<sup>49</sup> United Nations General Assembly, Resolution A/RES/54/166 on "Protection of migrants" of 24 February 2000.

large flows of peoples between and among countries and to the intensification of the complex phenomenon of international migration.”<sup>50</sup>

116. With regard to the foregoing, the Programme of Action of the International Conference on Population and Development held in Cairo in 1994 indicated that:

International economic imbalances, poverty and environmental degradation, combined with the absence of peace and security, human rights violations and the varying degrees of development of judicial and democratic institutions are all factors affecting international migration. Although most international migration flows occur between neighbouring countries, interregional migration, particularly that directed to developed countries, has been growing.<sup>51</sup>

117. In accordance with the foregoing, the international community has recognized the need to adopt special measures to ensure the protection of the human rights of migrants.<sup>52</sup>

118. We should mention that the regular situation of a person in a State is not a prerequisite for that State to respect and ensure the principle of equality and non-discrimination, because, as mentioned above, this principle is of a fundamental nature and all States must guarantee it to their citizens and to all aliens who are in their territory. This does not mean that they cannot take any action against migrants who do not comply with national laws. However, it is important that, when taking the corresponding measures, States should respect human rights and ensure their exercise and enjoyment to all persons who are in their territory, without any discrimination owing to their regular or irregular residence, or their nationality, race, gender or any other reason.

119. Consequently, States may not discriminate or tolerate discriminatory situations that prejudice migrants. However, the State may grant a distinct treatment to documented migrants with respect to undocumented migrants, or between migrants and nationals, provided that this differential treatment is reasonable, objective, proportionate and does not harm human rights. For example, distinctions may be made between migrants and nationals regarding ownership of some political rights. States may also establish mechanisms to control the entry into and departure from their territory of undocumented migrants, which must always be applied with strict regard for the guarantees of due process and respect for human dignity. In this respect, the African Commission on Human and Peoples’ Rights has indicated that it:

does not wish to call into question nor is it calling into question the right of any State to take legal action against illegal immigrants and deport them to their countries of origin, if the competent courts so decide. It is however of the view that it is unacceptable to

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<sup>50</sup> United Nations General Assembly, Resolution A/RES/54/212 on “International migration and development” of 1 February 2000.

<sup>51</sup> United Nations, A/CONF.171/13, 18 October 1994, Report on the International Conference on Population and Development held in Cairo from 5 to 13 September 1994, Programme of Action, Chapter X.A.10.1.

<sup>52</sup> Cf. United Nations, World Summit on Social Development held in Copenhagen in March 1995, Programme of Action, paras. 63, 77 and 78; United Nations, A/CONF.171/13, 18 October 1994, Report on the International Conference on Population and Development held in Cairo from 5 to 13 September 1994, Programme of Action, Chapter X.A.10(2) to 10(20); United Nations General Assembly, A/CONF. 157/23, 12 July 1993, World Conference on Human Rights held in Vienna, Austria, from 14 to 25 June 1993, Declaration and Programme of Action, I.24 and II.33-35.



deport individuals without giving them the possibility to plead their case before the competent national courts as this is contrary to the spirit and letter of the Charter [the African Charter of Human and Peoples' Rights] and international law.<sup>53</sup>

120. When dealing with the principle of equality and non-discrimination, the continuing development of international law should be borne in mind. In this respect, the Inter-American Court has indicated, in its Advisory Opinion OC-16/99 on *The Right to Information on Consular Assistance within the Framework of the Guarantees of Due Process of Law*, that:

The *corpus juris* of international human rights law comprises a set of international instruments of varied content and juridical effects (treaties, conventions, resolutions and declarations). Its dynamic evolution has had a positive impact on international law in affirming and building up the latter's faculty for regulating relations between States and the human beings within their respective jurisdictions. This Court, therefore, must adopt the proper approach to consider this question in the context of the evolution of the fundamental rights of the human person in contemporary international law.<sup>54</sup>

121. Due process of law is a right that must be ensured to all persons, irrespective of their migratory status. In this respect, in the above-mentioned Advisory Opinion on *The Right to Information on Consular Assistance within the Framework of the Guarantees of Due Process of Law*, this Court indicated that:

[...] for "the due process of law" a defendant must be able to exercise his rights and defend his interests effectively and in full procedural equality with other defendants. It is important to recall that the judicial process is a means to ensure, insofar as possible, an equitable resolution of a difference. The body of procedures, of diverse character and generally grouped under the heading of the due process, is all calculated to serve that end. To protect the individual and see justice done, the historical development of the judicial process has introduced new procedural rights. An example of the evolutive nature of judicial process are the rights not to incriminate oneself and to have an attorney present when one speaks. These two rights are already part of the laws and jurisprudence of the more advanced legal systems. And so, the body of judicial guarantees given in Article 14 of the International Covenant on Civil and Political Rights has evolved gradually. It is a body of judicial guarantees to which others of the same character, conferred by various instruments of international law, can and should be added.

and that:

To accomplish its objectives, the judicial process must recognize and correct any real disadvantages that those brought before the bar might have, thus observing the principle of equality before the law and the courts and the corollary principle prohibiting discrimination. The presence of real disadvantages necessitates countervailing measures that help to reduce or eliminate the obstacles and deficiencies that impair or diminish an effective defense of one's interests. Absent those countervailing measures, widely recognized in various stages of the proceeding, one could hardly say that those who have the disadvantages enjoy a true opportunity for justice and the benefit of the due process of law equal to those who do not have those disadvantages.<sup>55</sup>

<sup>53</sup> *African Commission of Human and Peoples' Rights, Communication No: 159/96 - Union Inter-Africaine des Droits de l'Homme, Federation Internationale des Ligues des Droits de l'Homme, Rencontre Africaine des Droits de l'Homme, Organisation Nationale des Droits de l'Homme au Sénégal and Association Malienne des Droits de l'Homme au Angola, decision of 11 November, 1997, para. 20.*

<sup>54</sup> *The Right to Information on Consular Assistance in the Framework of the Guarantees of Due Process of Law, supra note 1, para. 115.*

<sup>55</sup> *The Right to Information on Consular Assistance in the Framework of the Guarantees of Due Process of Law, supra note 1, para. 117 and 119; and cf. Legal Status and Human Rights of the Child, supra note 1, paras. 97 and 115; and Hilaire, Constantine and Benjamin et al. case, supra note 28, para. 146.*

122. The Court considers that the right to due process of law should be recognized within the framework of the minimum guarantees that should be provided to all migrants, irrespective of their migratory status. The broad scope of the preservation of due process applies not only *ratione materiae* but also *ratione personae*, without any discrimination.

123. As this Court has already indicated, due legal process refers to the:

all the requirement that must be observed in the procedural stages in order for an individual to be able to defend his rights adequately vis-à-vis any [...] act of the State that could affect them. That it to say, due process of law must be respected in any act or omission on the part of the State bodies in a proceeding, whether of an administrative, punitive or jurisdictional nature.<sup>56</sup>

124. Likewise, the Court has observed<sup>57</sup> that the list of minimum guarantees of due legal process applies when determining rights and obligations of "civil, labor, fiscal or any other nature."<sup>58</sup> This shows that due process affects all these areas and not only criminal matters.

125. In addition, it is important to establish, as the Court has already done, that "[i]t is a human right to obtain all the guarantees which make it possible to arrive at fair decisions, and the administration is not exempt from its duty to comply with this obligation. The minimum guarantees must be observed in administrative processes whose decision may affect the rights of persons."<sup>59</sup>

126. The right to judicial protection and judicial guarantees is violated for several reasons: owing to the risk a person runs, when he resorts to the administrative or judicial instances, of being deported, expelled or deprived of his freedom, and by the negative to provide him with a free public legal aid service, which prevents him from asserting the rights in question. In this respect, the State must guarantee that access to justice is genuine and not merely formal. The rights derived from the employment relation subsist, despite the measures adopted.

127. Now that the Court has established what is applicable for all migrants, it will examine the rights of migrant workers, in particular those who are undocumented.

### **VIII RIGHTS OF UNDOCUMENTED MIGRANT WORKERS**

128. As established in the glossary (*supra* para. 69), a migrant worker is any persons who is to be engaged, is engaged or has been engaged in a remunerated activity in a State of which he or she is not a national. This definition is embodied in the International Convention on the Protection of the Rights of all Migrant Workers and Members of their Families (Article 2(1)).

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<sup>56</sup> *Baena Ricardo et al. case, supra* note 27, para. 124; and *cf. Ivcher Bronstein case, supra* note 46, para. 102; *the Constitutional Court case*. Judgment of January 31, 2001. Series C No. 71, para. 69; and *Judicial Guarantees in States of Emergency, supra* note 17, para. 27.

<sup>57</sup> *Cf. Ivcher Bronstein case, supra* note 46, para. 103; *Baena Ricardo et al. case, supra* note 27, para. 125; and *the Constitutional Court case, supra* note 56, para. 70.

<sup>58</sup> *Cf.* Article 8.1 of the American Convention on Human Rights.

<sup>59</sup> *Cf. Baena Ricardo et al. case, supra* note 27, para. 127.

129. Migrant workers who are documented or in a regular situation are those who have been "authorized to enter, stay and engage in a remunerated activity in the State of employment"<sup>60</sup> pursuant to the law of the State and to international agreements to which that State is a party."<sup>61</sup> Workers who are undocumented or in an irregular situation do not comply with the conditions that documented workers do; in other words, they are not authorized to enter, stay and engage in a remunerated activity in a State of which they are not nationals.

130. In continuation, the Court will rule on undocumented migrant workers and their rights.

131. The vulnerability of migrant workers as compared to national workers must be underscored. In this respect, the preamble to the International Convention on the Protection of the Rights of all Migrant Workers and Members of their Families refers to "the situation of vulnerability in which migrant workers and members of their families frequently find themselves owing, among other things, to their absence from their State of origin and to the difficulties they may encounter arising from their presence in the State of employment."

132. Nowadays, the rights of migrant workers "have not been sufficiently recognized everywhere"<sup>62</sup> and, furthermore, undocumented workers "are frequently employed under less favorable conditions of work than other workers and [...] certain employers find this an inducement to seek such labor in order to reap the benefits of unfair competition."<sup>63</sup>

133. Labor rights necessarily arise from the circumstance of being a worker, understood in the broadest sense. A person who is to be engaged, is engaged or has been engaged in a remunerated activity, immediately becomes a worker and, consequently, acquires the rights inherent in that condition. The right to work, whether regulated at the national or international level, is a protective system for workers; that is, it regulates the rights and obligations of the employee and the employer, regardless of any other consideration of an economic and social nature. A person who enters a State and assumes an employment relationship, acquires his labor human rights in the State of employment, irrespective of his migratory status, because respect and guarantee of the enjoyment and exercise of those rights must be made without any discrimination.

134. In this way, the migratory status of a person can never be a justification for depriving him of the enjoyment and exercise of his human rights, including those related to employment. On assuming an employment relationship, the migrant acquires rights as a worker, which must be recognized and guaranteed, irrespective

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<sup>60</sup> U.N., International Convention on the Protection of the Rights of All Migrant Workers and Members of their Families of 18 December 1990, Article 6(b), according to which, the employer State is "a State where the migrant worker is to be engaged, is engaged or has been engaged in a remunerated activity [...]."

<sup>61</sup> U.N., International Convention on the Protection of the Rights of All Migrant Workers and Members of their Families of 18 December 1990, Article 5(a).

<sup>62</sup> U.N., International Convention on the Protection of the Rights of All Migrant Workers and Members of their Families of 18 December 1990, Preamble.

<sup>63</sup> U.N., International Convention on the Protection of the Rights of All Migrant Workers and Members of their Families of 18 December 1990, Preamble.

of his regular or irregular status in the State of employment. These rights are a consequence of the employment relationship.

135. It is important to clarify that the State and the individuals in a State are not obliged to offer employment to undocumented migrants. The States and individuals, such as employers, can abstain from establishing an employment relationship with migrants in an irregular situation.

136. However, if undocumented migrants are engaged, they immediately become possessors of the labor rights corresponding to workers and may not be discriminated against because of their irregular situation. This is very important, because one of the principal problems that occurs in the context of immigration is that migrant workers who lack permission to work are engaged in unfavorable conditions compared to other workers.

137. It is not enough merely to refer to the obligations to respect and ensure the labor human rights of all migrant workers, but it should be noted that these obligations have different scopes and effects for States and third parties.

138. Employment relationships are established under both public law and private law and, in both spheres, the State plays an important part.

139. In the context of an employment relationship in which the State is the employer, the latter must evidently guarantee and respect the labor human rights of all its public officials, whether nationals or migrants, documented or undocumented, because non-observance of this obligation gives rise to State responsibility at the national and the international level.

140. In an employment relationship regulated by private law, the obligation to respect human rights between individuals should be taken into consideration. That is, the positive obligation of the State to ensure the effectiveness of the protected human rights gives rise to effects in relation to third parties (*erga omnes*). This obligation has been developed in legal writings, and particularly by the *Drittwirkung* theory, according to which fundamental rights must be respected by both the public authorities and by individuals with regard to other individuals.

141. As of the first contentious cases on which it ruled, the Inter-American Court has outlined the application of the effects of the American Convention in relation to third parties (*erga omnes*), having indicated that:

Thus, in principle, any violation of rights recognized by the Convention carried out by an act of public authority or by persons who use their position of authority is imputable to the State. However, this does not define all the circumstances in which a State is obligated to prevent, investigate and punish human rights violations, or all the cases in which the State might be found responsible for an infringement of those rights. An illegal act which violates human rights and which is initially not directly imputable to a State (for example, because it is the act of a private person or because the person responsible has not been identified ) can lead to international responsibility of the State, not because of the act itself, but because of the lack of due diligence to prevent the violation or to respond to it as required by the Convention.<sup>64</sup>

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<sup>64</sup> *Velásquez Rodríguez case*. Judgment of July 29, 1988. Series C No. 4, para. 172; and *cf. Godínez Cruz case*. Judgment of January 20, 1989. Series C No. 5, paras. 181, 182 and 187.

142. Likewise, by means of provisional measures, this Court has ordered the protection of members of communities and persons that provide services to them, from threats of death and harm to personal safety allegedly caused by the State and third parties.<sup>65</sup> Likewise, on another occasion, it ordered the protection of persons detained in prison, owing to deaths and threats in that prison, many of which were allegedly perpetrated by the prisoners themselves.<sup>66</sup>

143. The European Court of Human Rights recognized the applicability of the European Convention for the Protection of Human Rights and Fundamental Freedoms to relationships between individuals, when it declared that the State had violated this Convention because it had restricted freedom of association, by establishing that membership in determined trade unions was a necessary condition for the petitioners in the case to be able to continue their employment in a company, since the restriction imposed was not "necessary in a democratic society."<sup>67</sup> In another case, the European Court considered that, although the object of Article 8 of this Convention (the right to respect of private and family life) was essentially that of protecting the individual against arbitrary interference by the public authorities, the State must abstain from such interference; in addition to this obligation to abstain, there are positive obligations inherent in effective respect for private or family life that may involve the adoption of measures designed to secure respect for private life even in the sphere of the relations of individuals among themselves. In this case, the European Court found that the State had violated the right to private and family life of a young mentally disabled woman who had been sexually assaulted, because she could not file criminal proceedings against her aggressor due to a vacuum in the criminal legislation.<sup>68</sup>

144. The United Nations Committee on Human Rights has considered that the right to freedom and personal safety, embodied in article 9 of the International Covenant on Civil and Political Rights, imposes on the State the obligation to take adequate steps to ensure the protection of an individual threatened with death. In other words, an interpretation of this article that authorized States parties to ignore threats against the life of persons subject to their jurisdiction, even though they have not been detained or arrested by State agents, would deprive the guarantees established in the Covenant of any effectiveness.<sup>69</sup> The Committee also considered that the State has the obligation to protect the rights of members of minorities against attacks by individuals. Likewise, in its General Comments Nos. 18 and 20 on non-discrimination and article 7 of the said Covenant, the Committee has indicated that States parties must punish public officials, other persons acting in the name of the State, and individuals, who carry out torture and cruel, inhuman or degrading

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<sup>65</sup> Cf. *Case of the Peace Community of San José de Apartadó*, Provisional Measures. Order of the Inter-American Court of June 18, 2002. Series E No. 3; and *Case of the Communities of the Jiguamiandó and the Curbaradó*, Provisional Measures. Order of the Inter-American Court of March 6, 2003.

<sup>66</sup> *Urso Branco Prison case*, Provisional Measures. Order of the Inter-American Court of June 18, 2002.

<sup>67</sup> *Eur. Court H.R., Case of Young, James and Webster v. The United Kingdom, (Merits) Judgement of 13 August 1981, Series A no. 44, paras. 48 to 65.*

<sup>68</sup> *Eur. Court H.R., Case of X and Y v. The Netherlands, (Merits) Judgement of 26 March 1985, Series A no. 91, para. 23.*

<sup>69</sup> Cf. U.N., Human Rights Committee. *Delgado Páez v. Colombia*. Decision of 12 July 1990. No. 195/85, para. 5.5.

treatment or punishment, and should also “take affirmative action in order to diminish or eliminate conditions which cause or help to perpetuate discrimination prohibited by the Covenant.”

145. In addition, in a decision on the obligation to investigate acts of racial discrimination and violence against persons of another color or ethnic origin committed by individuals, the Committee for the Elimination of Racial Discrimination indicated that “when threats of racial violence are made, and especially when they are made in public and by a group, it is incumbent upon the State to investigate with due diligence and expedition.”<sup>70</sup>

146. In this way, the obligation to respect and ensure human rights, which normally has effects on the relations between the State and the individuals subject to its jurisdiction, also has effects on relations between individuals. As regards this Advisory Opinion, the said effects of the obligation to respect human rights in relations between individuals is defined in the context of the private employment relationship, under which the employer must respect the human rights of his workers.

147. The obligation to respect and guarantee the human rights of third parties is also based on the fact that it is the State that determines the laws that regulate the relations between individuals and, thus, private law; hence, it must also ensure that human rights are respected in these private relationships between third parties; to the contrary, the State may be responsible for the violation of those rights.

148. The State is obliged to respect and ensure the labor human rights of all workers, irrespective of their status as nationals or aliens, and not to tolerate situations of discrimination that prejudice the latter in the employment relationships established between individuals (employer-worker). The State should not allow private employers to violate the rights of workers, or the contractual relationship to violate minimum international standards.

149. This State obligation arises from legislation that protects workers – legislation based on the unequal relationship between both parties – which therefore protects the workers as the more vulnerable party. In this way, States must ensure strict compliance with the labor legislation that provides the best protection for workers, irrespective of their nationality, social, ethnic or racial origin, and their migratory status; therefore they have the obligation to take any necessary administrative, legislative or judicial measures to correct *de jure* discriminatory situations and to eradicate discriminatory practices against migrant workers by a specific employer or group of employers at the local, regional, national or international level.

150. On many occasions migrant workers must resort to State mechanisms for the protection of their rights. Thus, for example, workers in private companies have recourse to the Judiciary to claim the payment of wages, compensation, etc. Also, these workers often use State health services or contribute to the State pension system. In all these cases, the State is involved in the relationship between

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<sup>70</sup> Cf. U.N., Committee on the Elimination of Racial Discrimination, Communication No. 4/1991, *L.K. v. The Netherlands*, paras. 6.3 and 6.6; and also *cf., inter. alia*, International Convention on the Elimination of All Forms of Racial Discrimination; Convention on the Elimination of All Forms of Discrimination against Women; Convention No. 111 concerning Discrimination in respect of Employment and Occupation of the International Labor Organization (ILO).

individuals as a guarantor of fundamental rights, because it is required to provide a specific service.

151. In labor relations, employers must protect and respect the rights of workers, whether these relations occur in the public or private sector. The obligation to respect the human rights of migrant workers has a direct effect on any type of employment relationship, when the State is the employer, when the employer is a third party, and when the employer is a natural or legal person.

152. The State is thus responsible for itself, when it acts as an employer, and for the acts of third parties who act with its tolerance, acquiescence or negligence, or with the support of some State policy or directive that encourages the creation or maintenance of situations of discrimination.

153. In summary, employment relationships between migrant workers and third party employers may give rise to the international responsibility of the State in different ways. First, States are obliged to ensure that, within their territory, all the labor rights stipulated in its laws – rights deriving from international instruments or domestic legislation – are recognized and applied. Likewise, States are internationally responsible when they tolerate actions and practices of third parties that prejudice migrant workers, either because they do not recognize the same rights to them as to national workers or because they recognize the same rights to them but with some type of discrimination.

154. Furthermore, there are cases in which it is the State that violates the human rights of the workers directly. For example, when it denies the right to a pension to a migrant worker who has made the necessary contributions and fulfilled all the conditions that were legally required of workers, or when a worker resorts to the corresponding judicial body to claim his rights and this body does not provide him with due judicial protection or guarantees.

155. The Court observes that labor rights are the rights recognized to workers by national and international legislation. In other words, the State of employment must respect and guarantee to every worker the rights embodied in the Constitution, labor legislation, collective agreements, agreements established by law (*convenios-ley*), decrees and even specific and local practices, at the national level; and, at the international level, in any international treaty to which the State is a party.

156. This Court notes that, since there are many legal instruments that regulate labor rights at the domestic and the international level, these regulations must be interpreted according to the principle of the application of the norm that best protects the individual, in this case, the worker. This is of great importance, because there is not always agreement either between the different norms or between the norms and their application, and this could prejudice the worker. Thus, if a domestic practice or norm is more favorable to the worker than an international norm, domestic law should be applied. To the contrary, if an international instrument benefits the worker, granting him rights that are not guaranteed or recognized by the State, such rights should be respected and guaranteed to him.

157. In the case of migrant workers, there are certain rights that assume a fundamental importance and yet are frequently violated, such as: the prohibition of obligatory or forced labor; the prohibition and abolition of child labor; special care for women workers, and the rights corresponding to: freedom of association and to

organize and join a trade union, collective negotiation, fair wages for work performed, social security, judicial and administrative guarantees, a working day of reasonable length with adequate working conditions (safety and health), rest and compensation. The safeguard of these rights for migrants has great importance based on the principle of the inalienable nature of such rights, which all workers possess, irrespective of their migratory status, and also the fundamental principle of human dignity embodied in Article 1 of the Universal Declaration, according to which "[a]ll human beings are born free and equal in dignity and rights. They are endowed with reason and conscience and should act towards one another in a spirit of brotherhood."

158. This Court considers that the exercise of these fundamental labor rights guarantees the enjoyment of a dignified life to the worker and to the members of his family. Workers have the right to engage in a work activity under decent, fair conditions and to receive a remuneration that allows them and the members of their family to enjoy a decent standard of living in return for their labor. Likewise, work should be a means of realization and an opportunity for the worker to develop his aptitudes, capacities and potential, and to realize his ambitions, in order to develop fully as a human being.

159. On many occasions, undocumented migrant workers are not recognized the said labor rights. For example, many employers engage them to provide a specific service for less than the regular remuneration, dismiss them because they join unions, and threaten to deport them. Likewise, at times, undocumented migrant workers cannot even resort to the courts of justice to claim their rights owing to their irregular situation. This should not occur; because, even though an undocumented migrant worker could face deportation, he should always have the right to be represented before a competent body so that he is recognized all the labor rights he has acquired as a worker.

160. The Court considers that undocumented migrant workers, who are in a situation of vulnerability and discrimination with regard to national workers, possess the same labor rights as those that correspond to other workers of the State of employment, and the latter must take all necessary measures to ensure that such rights are recognized and guaranteed in practice. Workers, as possessors of labor rights, must have the appropriate means of exercising them.

## **IX STATE OBLIGATIONS WHEN DETERMINING MIGRATORY POLICIES IN LIGHT OF THE INTERNATIONAL INSTRUMENTS FOR THE PROTECTION OF HUMAN RIGHTS**

161. The Court will now refer to State obligations when determining migratory policies solely in light of international instruments for the protection of human rights.

162. In this section of the Advisory Opinion, the Court will consider whether the fact that the American States subordinate and condition the observance of human rights to their migratory policies is compatible with international human rights law; it will do so in light of the international obligations arising from the International Covenant on Civil and Political Rights and other obligations of an *erga omnes* nature.



163. The migratory policy of a State includes any institutional act, measure or omission (laws, decrees, resolutions, directives, administrative acts, etc.) that refers to the entry, departure or residence of national or foreign persons in its territory.

164. In this respect, the Durban Declaration and Programme of Action adopted by the World Conference against Racism, Racial Discrimination, Xenophobia and Related Intolerance urged all States to “[t]o review and, where necessary, revise their immigration laws, policies and procedures with a view to eliminating any element of racial discrimination and make them consistent with State obligations by virtue of international human rights instruments.”<sup>71</sup> Likewise, in paragraph 9 of the Commission on Human Rights resolution 2001/5 on racism, racial discrimination, xenophobia and related intolerance, “States were asked to review and, where necessary, revise any immigration policies which are inconsistent with international human rights instruments, with a view to eliminating all discriminatory policies and practices against migrants.”

165. This Court considers it essential to mention the provisions of Article 27 of the Vienna Convention on the Law of Treaties, which, when referring to domestic law and the observance of treaties, provides that: “[a] party may not invoke the provisions of its internal law as justification for its failure to perform a treaty.”

166. In other words, when ratifying or acceding to an international treaty, States manifest their commitment in good faith to guarantee and respect the rights recognized therein. In addition, the States must adapt their domestic law to the applicable international law.

167. In this regard, the Inter-American Court has indicated that the general obligation set forth in Article 2 of the American Convention implies the adoption of measures to eliminate norms and practices of any nature that entail the violation of the guarantees set forth in the Convention, and the issuance of norms and the development of practices leading to the effective observance of the said guarantees.<sup>72</sup> In this respect, the Court has indicated that:

Under the law of nations, a customary rule prescribes that a State that has concluded an international agreement must introduce in its domestic laws whatever changes are needed to ensure execution of the obligations it has undertaken. This principle has been accepted universally, and is supported by case law. The American Convention establishes the general obligation of each State Party to adapt its domestic laws to the provisions of the said Convention, so as to guarantee the rights embodied therein. This general obligation of the State Party implies that measures of domestic law must be effective (the “*effet utile*” principle). This means that the State must adopt all necessary measures to ensure that the provisions of the Convention are complied with effectively in its domestic laws, as required by Article 2 of the Convention. Such measures are only effective when the State adapts its actions to the protective norms of the Convention.<sup>73</sup>

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<sup>71</sup> Cf. Declaration and Programme of Action of the World Conference against Racism, Racial Discrimination, Xenophobia and Related Forms of Intolerance, held in Durban South African, from August 31 to September 8, 2001, paras. 38 y 30.b), respectively.

<sup>72</sup> Cf. “*Five Pensioners*” case, *supra* note 27, para. 165; *Baena Ricardo et al. case*, *supra* note 27, para. 180; and *Cantoral Benavides case*, *supra* note 29, para. 178.

<sup>73</sup> “*Five Pensioners*” case, *supra* note 27, para. 164; and cf. “*The Last Temptation of Christ*” case (*Olmedo Bustos et al.*). Judgment of February 5, 2001. Series C No. 73, para. 87; *Baena Ricardo et al. case*, *supra* note 27, para. 179; *Durand and Ugarte case*. Judgment of August 16, 2000. Series C No. 68, para. 136; and cf. also “*principe allant de soi*”; *Exchange of Greek and Turkish populations*. Advisory Opinion. 1925, P.I.C.J., Collection of Advisory Opinions. Series B. No. 10.

168. The goals of migratory policies should take into account respect for human rights. Likewise, migratory policies should be implemented respecting and guaranteeing human rights. As indicated above (*supra* paras. 84, 89, 105 and 119), the distinctions that the States establish must be objective, proportionate and reasonable.

169. Considering that this Opinion applies to questions related to the legal aspects of migration, the Court deems it appropriate to indicate that, in the exercise of their power to establish migratory policies, it is licit for States to establish measures relating to the entry, residence or departure of migrants who will be engaged as workers in a specific productive sector of the State, provided this is in accordance with measures to protect the human rights of all persons and, in particular, the human rights of the workers. In order to comply with this requirement, States may take different measures, such as granting or denying general work permits or permits for certain specific work, but they must establish mechanisms to ensure that this is done without any discrimination, taking into account only the characteristics of the productive activity and the individual capability of the workers. In this way, the migrant worker is guaranteed a decent life, he is protected from the situation of vulnerability and uncertainty in which he usually finds himself, and the local or national productive process is organized efficiently and adequately.

170. Therefore, it is not admissible for a State of employment to protect its national production, in one or several sectors by encouraging or tolerating the employment of undocumented migrant workers in order to exploit them, taking advantage of their condition of vulnerability in relation to the employer in the State or considering them an offer of cheaper labor, either by paying them lower wages, denying or limiting their enjoyment or exercise of one or more of their labor rights, or denying them the possibility of filing a complaint about the violation of their rights before the competent authority.

171. The Inter-American Court has established the obligation of States to comply with every international instrument applicable to them. However, when referring to this State obligation, it is important to note that this Court considers that not only should all domestic legislation be adapted to the respective treaty, but also State practice regarding its application should be adapted to international law. In other words, it is not enough that domestic laws are adapted to international law, but the organs or officials of all State powers, whether the Executive, the Legislature or the Judiciary, must exercise their functions and issue or implement acts, resolutions and judgments in a way that is genuinely in accordance with the applicable international law.

172. The Court considers that the State may not subordinate or condition the observance of the principle of equality before the law and non-discrimination to achieving the goals of its public policies, whatever these may be, including those of a migratory nature. This general principle must be respected and guaranteed always. Any act or omission to the contrary is inconsistent with the international human rights instruments.

## **X OPINION**

173. For the foregoing reasons,

**THE COURT,****DECIDES**

unanimously,

that it is competent to issue this Advisory Opinion.

**AND IS OF THE OPINION**

unanimously,

1. That States have the general obligation to respect and ensure the fundamental rights. To this end, they must take affirmative action, avoid taking measures that limit or infringe a fundamental right, and eliminate measures and practices that restrict or violate a fundamental right.

2. That non-compliance by the State with the general obligation to respect and ensure human rights, owing to any discriminatory treatment, gives rise to international responsibility.

3. That the principle of equality and non-discrimination is fundamental for the safeguard of human rights in both international law and domestic law.

4. That the fundamental principle of equality and non-discrimination forms part of general international law, because it is applicable to all States, regardless of whether or not they are a party to a specific international treaty. At the current stage of the development of international law, the fundamental principle of equality and non-discrimination has entered the domain of *jus cogens*.

5. That the fundamental principle of equality and non-discrimination, which is of a peremptory nature, entails obligations *erga omnes* of protection that bind all States and generate effects with regard to third parties, including individuals.

6. That the general obligation to respect and guarantee human rights binds States, regardless of any circumstance or consideration, including the migratory status of a person.

7. That the right to due process of law must be recognized as one of the minimum guarantees that should be offered to any migrant, irrespective of his migratory status. The broad scope of the preservation of due process encompasses all matters and all persons, without any discrimination.

8. That the migratory status of a person cannot constitute a justification to deprive him of the enjoyment and exercise of human rights, including those of a labor-related nature. When assuming an employment relationship, the migrant acquires rights that must be recognized and ensured because he is an employee, irrespective of his regular or irregular status in the State where he is employed. These rights are a result of the employment relationship.

9. That the State has the obligation to respect and guarantee the labor human rights of all workers, irrespective of their status as nationals or aliens, and not to

tolerate situations of discrimination that are harmful to the latter in the employment relationships established between private individuals (employer-worker). The State must not allow private employers to violate the rights of workers, or the contractual relationship to violate minimum international standards.

10. That workers, being possessors of labor rights, must have all the appropriate means to exercise them. Undocumented migrant workers possess the same labor rights as other workers in the State where they are employed, and the latter must take the necessary measures to ensure that this is recognized and complied with in practice.

11. That States may not subordinate or condition observance of the principle of equality before the law and non-discrimination to achieving their public policy goals, whatever these may be, including those of a migratory character.

Judges Cañado Trindade, García Ramírez, Salgado Pesantes and Abreu Burelli informed the Court of their Concurring Opinions, which accompany this Advisory Opinion.

Done at San José, Costa Rica, on September 17, 2003, in the Spanish and the English language, the Spanish text being authentic.

Antônio A. Cañado Trindade  
President

Sergio García-Ramírez

Hernán Salgado-Pesantes

Oliver Jackman

Alirio Abreu-Burelli

Carlos Vicente de Roux-Rengifo

Manuel E. Ventura-Robles  
Secretary

So ordered,

Antônio A. Cañado Trindade  
President

Manuel E. Ventura-Robles  
Secretary

## CONCURRING OPINION OF JUDGE A.A. CANÇADO TRINDADE

1. I vote in favour of the adoption of the present Advisory Opinion of the Inter-American Court of Human Rights, which in my view constitutes a significant contribution to the evolution of the International Law of Human Rights. Four years ago, the Inter-American Court delivered the historical Advisory Opinion n. 16, on *The Right to Information on Consular Assistance in the Framework of the Guarantees of the Due Process of Law* (of 01.10.1999), truly pioneering, which has served as inspiration for the international case-law *in statu nascendi* on the matter<sup>74</sup>. Today, in the same line of reasoning oriented to the needs and imperatives of protection of the human person, and at the end of an advisory procedure which has generated the greatest mobilization of all its history<sup>75</sup>, the Inter-American Court adopts another Advisory Opinion, of great transcendence and again pioneering, on *The Juridical Condition and the Rights of the Undocumented Migrants*, becoming the first international tribunal to pronounce on this matter as a central theme.

2. Even more significant is the fact that the matter dealt with in the present Advisory Opinion, requested by Mexico and adopted by the Court by unanimity, is of direct interest of wide segments of the population in distinct latitudes, - in reality, of millions of human beings<sup>76</sup>, - and constitutes in our days a legitimate preoccupation of the whole international community, and - I would not hesitate to add, - of the humanity as a whole. Given the transcendental importance of the points examined by the Inter-American Court in the present Advisory Opinion, I feel obliged to leave on the records, as the juridical foundation of my position on the matter, the reflections which I allow myself to develop in this Concurring Opinion, particularly in relation with the aspects which appear to me to deserve special attention.

3. Such aspects correspond to those which I see it fit to name as follows: a) the *civitas maxima gentium* and the universality of the human kind; b) the disparities of the contemporary world and the vulnerability of the migrants; c) the reaction of the

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<sup>74</sup>. The Inter-American Court, by means of its Advisory Opinion n. 16 referred to, - delivered at the end of an advisory procedure which generated a wide mobilization (with eight intervening States, besides the Inter-American Commission of Human Rights and several non-governmental organizations and individuals), - was in fact the first international tribunal to warn that non-compliance with Article 36(1)(b) of the Vienna Convention on Consular Relations of 1963 took place to the detriment not only of a State Party to such Convention but also to the affected human beings.

<sup>75</sup>. Besides a considerable volume of written documents, such procedure counted on two public hearings, the first one having taken place at the headquarters of the Inter-American Court in San José of Costa Rica, in February 2003, and the second one having been held for the first time in its history outside its headquarters, in Santiago of Chile, in June 2003. The procedure counted on the participation of twelve accredited States (among which five intervening States in the public hearings), the Inter-American Commission of Human Rights, one agency of the United Nations (the United Nations High Commissioner for Refugees - UNHCR), and nine entities of civil society and of the Academy of several countries in the region, besides the Central American Council of Attorneys-General (*Procuradores*) of Human Rights.

<sup>76</sup>. According to the International Organization for Migrations (I.O.M.), from 1965 to 2000 the total of migrants in the world more than doubled, raising from 75 millions to 175 millions of persons; and the projections for the future are in the sense that this total will increase even much further in the following years; I.O.M., *World Migration 2003 - Managing Migration: Challenges and Responses for People on the Move*, Geneva, I.O.M., 2003, pp. 4-5; and cf. also, in general, P. Stalker, *Workers without Frontiers*, Geneva/London, International Labour Organization (I.L.O.)/L. Rienner Pubs., 2000, pp. 26-33.

universal juridical conscience; d) the construction of the individual subjective right of asylum; e) the position and the role of the general principles of Law; f) the fundamental principles as *substratum* of the legal order itself; g) the principle of equality and non-discrimination in the International Law of Human Rights; h) the emergence, the content and the scope of the *jus cogens*; e i) the emergence and the scope of the obligations *erga omnes* of protection (their horizontal and vertical dimensions). I proceed to present my reflections on each of those aspects.

### **I. The *Civitas Maxima Gentium* and the Universality of the Human Kind.**

4. The consideration of a question such as the one with which the present Advisory Opinion is concerned cannot make abstraction of the teachings of the so-called founding fathers of International Law, in whose thinking one can find reflections which remain remarkably up-to-date, and are of importance to the legal settlement also of contemporary problems. Francisco de Vitoria, for example, in his pioneering and decisive contribution to the notion of prevalence of the *rule of law*, upheld, in his acclaimed *Relecciones Teológicas* (1538-1539), that the legal order binds everyone - both the rulers as well as the ruled ones, and that the international community (*totus orbis*) has primacy over the will of each individual State<sup>77</sup>. In the conception of Vitoria, the great preacher of Salamanca, the *droit des gens* rules an international community constituted of human beings organized socially in States and coextensive with humanity itself<sup>78</sup>; the reparation of the violations of (human) rights reflects an international necessity fulfilled by the *droit des gens*, with the same principles of justice applying both to the States and to the individuals or peoples who form them<sup>79</sup>.

5. In the outlook of Francisco Suárez (author of the treatise *De Legibus ac Deo Legislatore*, 1612), the *droit des gens* reveals the unity and universality of the human kind; the States have necessity of a legal system which regulates their relations, as members of the universal society<sup>80</sup>. To Suárez, the *droit des gens* comprised, besides the nations and the peoples, the human kind as a whole, and the law fulfilled the needs of regulation of all the peoples and human beings. Both Suárez and Vitoria formulated the bases of the international duties of the States *vis-à-vis* also the foreigners, in the framework of the general principle of the freedom of circulation and of communications, in the light of the *universality of the human kind*<sup>81</sup>. The human sociability and solidarity

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<sup>77</sup>. Cf. Francisco de Vitoria, *Relecciones - del Estado, de los Indios, y del Derecho de la Guerra*, México, Porrúa, 1985, pp. 1-101; A. Gómez Robledo, *op. cit. infra* n. (15), pp. 30-39; W.G. Grewe, *The Epochs of International Law*, Berlin, W. de Gruyter, 2000, pp. 189-190.

<sup>78</sup>. Cf., in particular, Francisco de Vitoria, *De Indis - Relectio Prior* (1538-1539), in: *Obras de Francisco de Vitoria - Relecciones Teológicas* (ed. T. Urdanoz), Madrid, BAC, 1960, p. 675.

<sup>79</sup>. A.A. Cançado Trindade, "Co-existence and Co-ordination of Mechanisms of International Protection of Human Rights (At Global and Regional Levels)", 202 *Recueil des Cours de l'Académie de Droit International de La Haye* (1987) p. 411; J. Brown Scott, *The Spanish Origin of International Law - Francisco de Vitoria and his Law of Nations*, Oxford/London, Clarendon Press/H. Milford - Carnegie Endowment for International Peace, 1934, pp. 282-283, 140, 150, 163-165 and 172.

<sup>80</sup>. Cf. Association Internationale Vitoria-Suarez, *Vitoria et Suarez - Contribution des Théologiens au Droit International Moderne*, Paris, Pédone, 1939, pp. 169-170.

<sup>81</sup>. Cf. *ibid.*, pp. 40-46, and cf. pp. 5-6 and 11-12.

were present in the whole doctrinal construction and the contribution of the Spanish theologians to the formation of the *droit des gens*.

6. In its turn, the conception of the *jus gentium* of Hugo Grotius - whose work, above all the *De Jure Belli ac Pacis* (1625), lies in the origins of the international law, as the discipline came to be known, - was always attentive to the role of civil society. To Grotius, the State is not an end in itself, but rather a means to secure the social order in conformity with human intelligence, so as to improve the "common society which embraces all mankind"<sup>82</sup>. In Grotian thinking, every legal norm - whether of domestic law or of the law of nations - creates rights and obligations for the persons to whom they are directed; the forerunning work of Grotius, already in the first half of the XVIIth century, thus admits the possibility of the international protection of human rights against the State itself<sup>83</sup>.

7. Pursuant to the Grotian outlook, the human being and his welfare occupy a central position in the system of international relations; the standards of justice apply *vis-à-vis* both the States and the individuals<sup>84</sup>. To Grotius, natural law derives from human reason, is a "dictate of the *recta ratio*", and imposes limits to the "unrestricted conduct of the rulers of the States"<sup>85</sup>. The States are subjected to Law, and International Law has "an objective, independent foundation, and above the will of the States"<sup>86</sup>. The considerations of justice thus permeate the legal rules and foster their evolution<sup>87</sup>.

8. Even before Grotius, Alberico Gentili (author of *De Jure Belli*, 1598) sustained, by the end of the XVIth century, that it is Law that governs the relationship among the members of the universal *societas gentium*<sup>88</sup>. Samuel Pufendorf (author of *De Jure*

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<sup>82</sup>. P.P. Remec, *The Position of the Individual in International Law according to Grotius and Vattel*, The Hague, Nijhoff, 1960, pp. 216 and 203. The subjects have rights *vis-à-vis* the sovereign State, which cannot demand obedience from its citizens in an absolute way (imperative of the common good); thus, in the vision of Grotius, the *raison d'État* has limits, and the absolute conception of this latter becomes applicable in the international as well as internal relations of the State. *Ibid.*, pp. 219-220 and 217.

<sup>83</sup>. *Ibid.*, pp. 243 and 221. One has, thus, to bear always in mind the true legacy of the Grotian tradition of international law. The international community cannot pretend to base itself on the *voluntas* of each State individually. In face of the historical necessity to regulate the relations of the emerging States, Grotius sustained that international relations are subject to legal norms, and not to the "*raison d'État*", which is incompatible with the very existence of the international community: this latter cannot do without Law. (Cf., in this respect, the classical study by Hersch Lauterpacht, "The Grotian Tradition in International Law", 23 *British Year Book of International Law* (1946) pp. 1-53).

<sup>84</sup>. Hersch Lauterpacht, "The Law of Nations, the Law of Nature and the Rights of Man", 29 *Transactions of the Grotius Society* (1943) pp. 7 and 21-31.

<sup>85</sup>. E. Jiménez de Aréchaga, "El Legado de Grocio y el Concepto de un Orden Internacional Justo", in *Pensamiento Jurídico y Sociedad Internacional - Libro-Homenaje al Profesor A. Truyol y Serra*, vol. I, Madrid, Universidad Complutense de Madrid, 1986, pp. 608 and 612-613.

<sup>86</sup>. *Ibid.*, p. 617.

<sup>87</sup>. *Ibid.*, pp. 619-621.

<sup>88</sup>. A. Gómez Robledo, *Fundadores del Derecho Internacional*, Mexico, UNAM, 1989, pp. 48-55.



*Naturae et Gentium*, 1672), in his turn, defended "the subjection of the legislator to the higher law of human nature and of reason"<sup>89</sup>. On his part, Christian Wolff (author of *Jus Gentium Methodo Scientifica Pertractatum*, 1749), pondered that just as the individuals ought, in their association in the State, promote the common good, in its turn the State has the correlative duty to seek its perfection<sup>90</sup>.

9. Regrettably, the reflections and the vision of the so-called founding fathers of international law, which conceived it as a truly universal system<sup>91</sup>, were to be overtaken by the emergence of legal positivism, which, above all as from the XIXth century, personified the State conferring upon it a "will of its own", reducing the rights of the human beings to those that the State "granted" to them. The consent or the "will" of the States (voluntarist positivism) became the criterion predominant in international law, denying *jus standi* to the individuals, to the human beings<sup>92</sup>. This rendered difficult the understanding of the international society, and debilitated the International Law itself, reducing it to an inter-State law, no more *above* but *between* sovereign States<sup>93</sup>. The disastrous consequences of this distortion are widely known.

10. The great legacy of the juridical thinking of the second half of the XXth century, in my view, has been, by means of the emergence and evolution of the International Law of Human Rights, the rescue of the human being as subject of both domestic and international law, endowed with international juridical capacity<sup>94</sup>. But this advance comes together with new needs of protection, to require new answers on the part of the *corpus juris* of protection itself. This is the case, in our days, of the persons affected by the problems raised in the present advisory procedure before the Inter-American Court of Human Rights.

11. To face these problems, one has, in my understanding, to keep in mind the most valuable legacy of the founding fathers of International Law. Already in the epoch of the elaboration and dissemination of the classic works by F. Vitoria and F. Suárez (*supra*), the *jus gentium* had liberated itself from its origins of private law (of Roman law), so as to apply universally to all human beings: the *societas gentium* was expression of the fundamental unity of the human kind, forming a true *societas ac communicatio*, as no

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<sup>89</sup>. *Ibid.*, p. 26.

<sup>90</sup>. César Sepúlveda, *Derecho Internacional*, 13th. ed., Mexico, Ed. Porrúa, 1983, pp. 28-29. Wolff beheld the nation-States as members of a *civitas maxima*, a concept which Emmerich de Vattel (author of *Le Droit des Gens*, 1758), subsequently, invoking the necessity of "realism", intended to replace by a "society of nations" (a less advanced concept); cf. F.S. Ruddy, *International Law in the Enlightenment - The Background of Emmerich de Vattel's Le Droit des Gens*, Dobbs Ferry/N.Y., Oceana, 1975, p. 95; for a criticism to this step backwards (incapable of providing the foundation of the principle of *obligation* in international law), cf. J.L. Briery, *The Law of Nations*, 6th. ed., Oxford, Clarendon Press, pp. 38-40.

<sup>91</sup>. C. Wilfred Jenks, *The Common Law of Mankind*, London, Stevens, 1958, pp. 66-69; and cf. also René-Jean Dupuy, *La communauté internationale entre le mythe et l'histoire*, Paris, Economica/UNESCO, 1986, pp. 164-165.

<sup>92</sup>. P.P. Remec, *The Position of the Individual...*, *op. cit. supra* n. (9), pp. 36-37.

<sup>93</sup>. *Ibid.*, p. 37.

<sup>94</sup>. A.A. Cançado Trindade, *Tratado de Direito Internacional dos Direitos Humanos*, vol. III, Porto Alegre/Brazil, S.A. Fabris Ed., 2003, pp. 447-497.

State was self-sufficient<sup>95</sup>. The new *jus gentium*, thus conceived also to fulfil human needs, paved the way to the conception of a universal international law<sup>96</sup>.

12. The belief came to prevail - expressed in the work of H. Grotius - that it was possible to capture the content of this law by means of reason: natural law, from which the law of nations derived, was a dictate of reason<sup>97</sup>. In the framework of the new universalist conception the *jus communicationis* was affirmed, as from F. Vitoria, erecting the freedom of movement and of commercial exchange as one of the pillars of the international community itself<sup>98</sup>. The controls of the ingress of aliens were to become manifest only in a much more recent historical epoch (cf. par. 35, *infra*), *pari passu* with the great migratory fluxes and the development of the law of refugees and displaced persons<sup>99</sup>.

## II. The Disparities of the So-Called "Globalized" World, the Forced Displacements and the Vulnerability of the Migrants.

13. Nowadays, in an era of great migrations, an increasingly greater distance from the universalist ideal of the *societas gentium* of the founding fathers of International Law can regrettably be found. The migrations and the forced displacements, intensified in the decade of the nineties<sup>100</sup>, have been characterized particularly by the disparities in the conditions of living between the place of origin and that of destiny of the migrants. Their causes are multiple: economic collapse and unemployment, collapse in the public services (education, health, among others), natural disasters, armed conflicts, repression and persecution, systematic violations of human rights, ethnic rivalries and xenophobia, violence of distinct forms, personal insecurity<sup>101</sup>.

14. The migrations and forced displacements, with the consequent uprootedness of so many human beings, bring about traumas: suffering of the abandonment of home (at times with family separation or disruption), loss of the profession and of personal goods, arbitrarinesses and humiliations imposed by frontier authorities and security officers, loss of the mother tongue and of the cultural roots, cultural shock and

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<sup>95</sup>. P. Guggenheim, "Contribution à l'histoire des sources du droit des gens", 94 *Recueil des Cours de l'Académie de Droit International de La Haye* (1958) pp. 21-22.

<sup>96</sup>. J. Moreau-Reibel, "Le droit de société interhumaine et le *jus gentium* - Essai sur les origines et le développement des notions jusqu'à Grotius", 77 *Recueil des Cours de l'Académie de Droit International de La Haye* (1950) pp. 506-510.

<sup>97</sup>. G. Fourlanos, *Sovereignty and the Ingress of Aliens*, Stockholm, Almqvist & Wiksell, 1986, p. 17.

<sup>98</sup>. *Ibid.*, pp. 19-23, and cf. pp. 79-81.

<sup>99</sup>. Cf. *ibid.*, pp. 160-161 and 174-175.

<sup>100</sup>. The forced displacements of the nineties (after the so-called end of the cold war) encompassed roughly nine million persons; UNHCR, *The State of the World's Refugees - Fifty Years of Humanitarian Action*, Oxford, UNHCR/Oxford University Press, 2000, p. 9.

<sup>101</sup>. N. Van Hear, *New Diasporas - The Mass Exodus, Dispersal and Regrouping of Migrant Communities*, London, UCL Press, 1998, pp. 19-20, 29, 109-110, 141, 143 y 151-252, and cf. p. 260; F.M. Deng, *Protecting the Dispossessed - A Challenge for the International Community*, Washington D.C., Brookings Institution, 1993, pp. 3-20.

permanent feeling of injustice<sup>102</sup>. The so-called "globalization" of the economy has been accompanied by the persistence (and in various parts of the world of the aggravation) of the disparities within nations and in the relations among them, it being found, e.g., a remarkable contrast between the poverty of the countries of origin of the migrations (at times clandestine ones) and the incomparably greater resources of the countries sought by the migrants.

15. Migrants, - particularly the undocumented ones, - as pointed out by the Inter-American Court in the present Advisory Opinion n. 18 (pars. 112-113 and 131-132), - are often in a situation of great vulnerability, in face of the risk of precarious employment (in the so-called "informal economy"), of labour exploitation, of unemployment itself and the perpetuation in poverty (also in the receiving country)<sup>103</sup>. The "administrative fault" of indocumentation has been "criminalized" in intolerant and repressive societies, aggravating even further the social problems which they suffer. The drama of the refugees and the undocumented migrants can only be effectively dealt with amidst a spirit of true human solidarity towards the victimized<sup>104</sup>. Definitively, only the firm determination of the reconstruction of the international community on the basis of human solidarity can lead to the overcoming of all those traumas.

16. In times of the so-called "globalization" (the misleading and false neologism which is *en vogue* in our days), the frontiers have been opened to the capitals, goods and services, but have sadly closed themselves to human beings. The neologism which suggests the existence of a process which would comprise everyone and in which everyone would participate, in reality hides the fragmentation of the contemporary world, and the social exclusion and marginalization of increasingly greater segments of the population. The material progress of some has been accompanied by the contemporary (and clandestine) forms of labour exploitation of many (the exploitation of undocumented migrants, forced prostitution, traffic of children, forced and slave labour), amidst the proven increase of poverty and social exclusion and marginalization<sup>105</sup>.

17. As aggravating circumstances, the State abdicates from its ineluctable social function, and irresponsibly handles to the "market" the essential public services (education and health, among others), transforming them in merchandises to which the access becomes increasingly more difficult for the majority of the individuals. These latter come to be regarded as mere agents of economic production<sup>106</sup>, amidst the sad

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<sup>102</sup>. As Simone Weil warned already in the mid-XXth century, "to be rooted is perhaps the most important and least recognized need of the human soul. It is one of the hardest to define"; S. Weil, *The Need for Roots*, London/N.Y., Routledge, 1952 (reprint 1995), p. 41; and cf. also the considerations by H. Arendt, *La tradition cachée*, Paris, Ch. Bourgeois Éd., 1987 (ed. orig. 1946), pp. 58-59 and 125-127.

<sup>103</sup>. H. Domenach and M. Picouet, *Les migrations*, Paris, PUF, 1995, pp. 58-61, 66 and 111, and cf. pp. 48 and 82-85.

<sup>104</sup>. J. Ruiz de Santiago, "Derechos Humanos, Migraciones y Refugiados: Desafíos en los Inicios del Nuevo Milenio", *Memoria del III Encuentro de Movilidad Humana: Migrante y Refugiado*, San José of Costa Rica, ACNUR/IIDH, 2001, pp. 37-72.

<sup>105</sup>. Cf., e.g., M. Lengellé-Tardy, *L'esclavage moderne*, Paris, PUF, 1999, pp. 8-13, 21-32 and 73-98.

<sup>106</sup>. Already in the mid-XXth century, distinct trends of the philosophical thinking of the time rebelled themselves against the dehumanization of social relations and the depersonalization of the human being,

mercantilization of human relations. Moreover, one detects today, together with an aggravation of the intolerance and xenophobia, a regrettable erosion of the right of asylum<sup>107</sup> (cf. *infra*, pars. 36-42). All these dangerous developments point towards a new world without values, which adheres to, without further reflection, to an unsustainable model.

18. Within the Inter-American Court of Human Rights, in my Concurring Opinion in the case of the *Haitians and Dominicans of Haitian Origin in the Dominican Republic* (Provisional Measures of Protection, Resolution of 18.08.2000) I pointed out that, in this beginning of the XXIst century, "the human being has been placed by himself in a scale of priority inferior to that attributed to the capitals and goods, - in spite of all the struggles of the past, and of all the sacrifices of the previous generations" (par. 4). With the uprootedness, - I proceeded, - one loses his spontaneous means of expression and of communication with the outside world, as well as the possibility of developing a *project of life*: "it is, thus, a problem which concerns the whole human kind, which encompasses the totality of human rights, and, above all, which has a spiritual dimension which cannot be forgotten, with all more reason in the dehumanized world of our days" (par. 6).

19. And, on this first aspect of the problem, I concluded that "the problem of uprootedness ought to be considered in a framework of action oriented towards the eradication of social exclusion and extreme poverty, - if one indeed wishes to reach its causes and not only to fight its symptoms. One ought to develop responses to the new needs of protection, even if they are not literally contemplated in the international instruments in force of protection of the human being" (par. 7). I added my understanding to the effect that "the question of the uprootedness ought to be dealt with not in the light of State sovereignty, but rather as a problem of a truly *global* dimension that it is (requiring a concert at universal level), bearing in mind the obligations *erga omnes* of protection" (par. 10).

20. In spite of the uprootedness being "a problem which affects the whole *international community*", - I kept on warning, -

"continues to be treated in an atomized way by the States, with the outlook of a legal order of a purely inter-State character, without apparently realizing that the Westphalian model of such international order is, already for a long time, definitively exhausted. It is precisely for this reason that the States cannot exempt themselves from responsibility in view of the global character of the uprootedness, since they continue to apply to this latter their own criteria of domestic legal order. (...) The State ought, thus, to respond for the consequences of the practical application of the norms and public policies that it adopts in the matter of migration, and in particular of the procedures of deportations and expulsions" (pars. 11-12).

### **III. The Reaction of the *Universal Juridical Conscience (Opinio Juris Communis)*.**

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generated by the technocratic society, which treats the individual as a simple agent of material production; cf., e.g., *inter alia*, Roger Garaudy, *Perspectivas do Homem*, 3rd. ed., Rio de Janeiro, Ed. Civilização Brasileira, 1968, pp. 141-143 and 163-165.

<sup>107</sup>. Cf., e.g., F. Crepeau, *Droit d'asile - de l'hospitalité aux contrôles migratoires*, Bruxelles, Bruylant/Éd. Univ. de Bruxelles, 1995, pp. 17-353; Ph. Ségur, *La crise du droit d'asile*, Paris, PUF, 1998, pp. 5-171; A.A. Cançado Trindade and J. Ruiz de Santiago, *La Nueva Dimensión de las Necesidades de Protección del Ser Humano en el Inicio del Siglo XXI*, 2nd. ed., San José of Costa Rica, UNHCR, 2003, pp. 23-123.

21. On this last point, it may be recalled that, in 1986, the International Law Association adopted (in its 62nd. session, in Seoul), by consensus, the Declaration of Principles of International Law on Mass Expulsion, in which, *inter alia*, it expressed its "deep concern" with "the vulnerabilidad and precarious position of many minorities", including migrant workers (preamble). It sustained that the principle of *non-refoulement*, as the "cornerstone of the protection of refugees", is applicable, even if these latter have been legally admitted in the receiving State, and independently of having arrived individually or massively (principle 12). And it urged the States to put an end to any expulsion of a massive character and to establish systems of "early warning" (principle 19)<sup>108</sup>. Four years later, the International Convention on the Protection of the Rights of All Migrant Workers and Members of Their Families (1990) came to prohibit measures of collective expulsion, and to determine that each case of expulsion should be "examined and decided individually", in accordance with the law (Article 22).

22. Moreover, one ought to underline that the common denominator of the cycle of the World Conferences of the United Nations of the end of the XXth century<sup>109</sup> has been precisely the special attention dedicated to the *conditions of living* of the population (particularly of the vulnerable groups, in special necessity of protection, which certainly include the undocumented migrants), it resulting therefrom the universal recognition of the necessity to place human beings, definitively, in the centre of all process of development<sup>110</sup>. In the present Advisory Opinion n. 18, the Inter-American Court has taken into account the final documents of two of those Conferences (pars. 116 and 164), namely, the Programme of Action of the International Conference on Population and Development (Cairo, 1994), and the Declaration and Programme of Action of the World Conference against Racism, Racial Discrimination, Xenophobia and Related Intolerance (Durban, 2001).

23. The final documents of the recent World Conferences of the United Nations (held in the period from 1992 until 2001) reflect the reaction of the universal juridical conscience to the attempts against, and affronts to, the dignity of the human person all over the world. In reality, the aforementioned cycle of World Conferences has consolidated the recognition of "the legitimacy of the concern of the whole international community with the violations of human rights everywhere and at any moment"<sup>111</sup>. As I saw it fit to point out in my Concurring Opinion in the Advisory Opinion n. 16 of the Inter-American Court of Human Rights on *The Right to Information on Consular Assistance in the Framework of the Guarantees of the Due Process of Law* (1999),

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<sup>108</sup>. The Declaration referred to was to relate mass expulsion in given circumstances to the concept of "international crime" (principle 9).

<sup>109</sup>. United Nations Conference on Environment and Development, Rio de Janeiro, 1992; II World Conference on Human Rights, Vienna, 1993; International Conference on Population and Development, Cairo, 1994; World Summit for Social Development, Copenhagen, 1995; IV World Conference on Women, Beijing, 1995; II United Nations Conference on Human Settlements, Habitat-II, Istanbul, 1996. To these followed, more recently, the Rome Conference on the Statute of the International Criminal Court, 1998; and the World Conference against Racism, Racial Discrimination, Xenophobia and Related Intolerance, Durban, 2001.

<sup>110</sup>. A.A. Cançado Trindade, "Desarrollo Humano y Derechos Humanos en la Agenda Internacional del Siglo XXI", in *Memoria - Foro Desarrollo Humano y Derechos Humanos* (August 2000), San José of Costa Rica, UNDP/Inter-American Court of Human Rights, 2001, pp. 25-42.

<sup>111</sup>. A.A. Cançado Trindade, *El Derecho Internacional de los Derechos Humanos en el Siglo XXI*, Santiago, Editorial Jurídica de Chile, 2001, p. 413, and cf. p. 88.

"the very emergence and consolidation of the *corpus juris* of the International Law of Human Rights are due to the reaction of the *universal juridical conscience* to the recurrent abuses committed against human beings, often warranted by positive law: with that, the Law (*el Derecho*) came to the encounter of the human being, the ultimate addressee of its norms of protection" (pars. 3-4).

24. Further on, in the aforementioned Concurring Opinion in the Advisory Opinion n. 16, I mentioned the recognition, in our days, of the necessity to reconstitute to the human being the central position, "as *subject of domestic as well as international law*" (par. 12), and added:

- "With the dismythification of the postulates of voluntarist positivism, it became evident that one can only find an answer to the problem of the foundations and the validity of general international law in the *universal juridical conscience*, starting with the assertion of the idea of an objective justice. As a manifestation of this latter, the rights of the human being have been affirmed, emanating directly from international law, and not subjected, thereby, to the vicissitudes of domestic law" (par. 14).

25. In fact, the atrocities and abuses which have victimized in the last decades millions of human beings everywhere, increasing the contingents of refugees, displaced persons and undocumented migrants in search of survival, have definitively awakened the *universal juridical conscience* for the pressing need to reconceptualize the very bases of the international legal order. But it is urgently necessary, in our days, to stimulate this awakening of the *universal juridical conscience* to intensify the process of humanization of contemporary international law<sup>112</sup>. Also in the case *Bámaca Velásquez versus Guatemala* (Judgment as to the merits, of 25 November 2000), I saw it fit to insist on the point; in my Separate Opinion, I reaffirmed that:

"(..) the existence of a *universal juridical conscience* (corresponding to the *opinio juris comunis*) (...) constitutes, in my understanding, the *material source par excellence* (beyond the formal sources) of the whole law of nations (*droit des gens*), responsible for the advances of the human kind not only at the juridical level but also at the spiritual one" (par. 16, and cf. par. 28).

26. There is pressing need to seek, therefrom, the reconstruction of the law of nations, in this beginning of the XXIst century, on the basis of a new paradigm, no longer State-centered, but rather placing the human being in a central position<sup>113</sup> and bearing in mind the problems which affect the humanity as a whole. The existence of the human person, which has its root in the spirit, was the point of departure, e.g., of the reflections of Jacques Maritain, to whom the true progress meant the *ascent of conscience*, of the equality and communion of all in human nature, thus accomplishing

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<sup>112</sup>. As I stressed in my already mentioned Concurring Opinion in the case of the *Haitians and Dominicans of Haitian Origin in the Dominican Republic* (Provisional Measures of Protection, 2000) before the Inter-American Court (par. 12).

<sup>113</sup>. It is a true reconstruction; more than half a century ago, Maurice Bourquin warned that "ni au point de vue de son objet, ni même au point de vue de sa structure, le droit des gens ne peut se définir comme un droit inter-étatique. (...) L'être humain (...) y occupe une place de plus en plus considérable"; M. Bourquin, "L'humanisation du droit des gens", in *La technique et les principes du Droit public - Études en l'honneur de Georges Scelle*, vol. I, Paris, LGDJ, 1950, pp. 53-54.

the common good and justice<sup>114</sup>. The conceptual evolution examined herein gradually moved, as from the sixties, from the *international* to the *universal* dimension, under the great influence of the development of the International Law of Human Rights itself. The recognition of certain fundamental *values*, on the basis of a sense of objective justice, has much contributed to the formation of the *opinio juris communis*<sup>115</sup> in the last decades of the XXth century, which one ought to keep on developing in our days in order to face the new necessities of protection of the human being.

27. Despite the fact that the international legal order of this beginning of the XXIst century is, in fact, far too distant from the ideals of the founding fathers of the *droit des gens* (*supra*), instead of capitulating before this reality, one has rather to face it. It could be argued that the contemporary world is entirely distinct from that of the epoch of F. Vitoria, F. Suárez and H. Grotius, who supported a *civitas maxima* ruled by the *droit des gens*, the new *jus gentium* reconstructed by them. But even if one is before two different world scenarios (no one would deny it), the human aspiration is the same, that is, that of the construction of an international order applicable both to the States (and international organizations) and to human beings (the *droit des gentes*), in conformity with certain universal standards of justice, without whose observance there cannot be social peace. One has, thus, to endeavour in a true *return to the origins* of the law of nations, whereby the current historical process of *humanization* of International Law will be fostered.

28. If it is certain that the drama of the numerous refugees, displaced persons and undocumented migrants presents today an enormous challenge to the labour of international protection of the rights of the human person, it is also certain that the reactions to the violations of their fundamental rights are today immediate and forceful, by virtue precisely of the awakening of the universal juridical conscience for the necessity of prevalence of the dignity of the human person in any circumstances. The emergence and assertion of *jus cogens* in contemporary International Law (cf. *infra*) constitute, in my view, an unequivocal manifestation of this awakening of the universal juridical conscience.

29. In the course of the procedure before the Inter-American Court of Human Rights pertaining to the present Advisory Opinion, the requesting State, Mexico, singled out with pertinence the importance of the so-called *Martens clause* as an element of interpretation of Law (above all humanitarian), which could also provide support to the migrants. In this respect, I believe it possible to go even further: at least one trend of the contemporary legal doctrine has come to characterize the Martens clause as *source* of general international law itself<sup>116</sup>; and no one would dare today to deny that the

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<sup>114</sup>. J. Maritain, *Los Derechos del Hombre y la Ley Natural*, Buenos Aires, Ed. Leviatan, 1982 (reprint), pp. 12, 18, 38, 43 and 94-96, and cf. p. 69. The liberation from material servitudes was necessary, for the development above all of the life of the spirit; in his vision, humankind only progresses when it advances towards human emancipation (*ibid.*, pp. 50 and 105-108). In affirming that "the human person transcends the State", as it has "a destiny superior to time", he added that "each human person has the right to decide by herself as to what concerns her personal destiny (...)" (*ibid.*, pp. 79-82, and cf. p. 104).

<sup>115</sup>. Maarten Bos, *A Methodology of International Law*, Amsterdam, North-Holland, 1984, p. 251, and cf. pp. 246 and 253-255.

<sup>116</sup>. F. Münch, "Le rôle du droit spontané", in *Pensamiento Jurídico y Sociedad Internacional - Libro-Homenaje al Profesor Dr. A. Truyol Serra*, vol. II, Madrid, Universidad Complutense, 1986, p. 836.

"laws of humanity" and the "dictates of the public conscience" invoked by the Martens clause belong to the domain of *jus cogens*<sup>117</sup>. The aforementioned clause, as a whole, has been conceived and reiteratedly affirmed, ultimately, to the benefit of the whole human kind, remaining thus quite up-to-date. It can be considered, - as I have affirmed in a recent work, - as expression of the *raison de l'humanité* imposing limits to the *raison d'État*<sup>118</sup>.

30. One of the significant contributions of the present Advisory Opinion n. 18 on *The Juridical Condition and the Rights of the Undocumented Migrants* lies in its determination of the wide scope of the due process of law (par. 124). In its earlier Advisory Opinion n. 16 on *The Rights to Information on Consular Assistance in the Framework of the Guarantees of the Due Process of Law*, the Inter-American Court underlined the historical evolution of the due process of law in the sense of its expansion *ratione materiae* (pars. 117 and 119), whilst, in the present Advisory Opinion n. 18, it examines such expansion *ratione personae*, and determines that "the right to the due process ought to be recognized in the framework of the minimal guarantees which ought to be granted to every migrant, irrespective of its migratory status" (par. 122). The correct conclusion of the Court, in the sense that "the wide scope of the intangibility of the due process comprises all matters and all persons, without any discrimination" (resolatory point n. 7), fulfills effectively the exigencies and the imperatives of the common good.

### III. The Construction of the Individual Subjective Right to Asylum.

31. The very notion of the common good ought to be considered not in relation to a social *milieu in abstracto*, but rather to the totality of human beings who compose it, irrespectively of the political or migratory status of each one. Human rights much transcend the so-called "rights of the citizenship", "granted" by the State. The common good, as Jacques Maritain used to rightly sustain, is erected upon the *human person* herself (rather than individuals or citizens), and the concept of personality encompasses the deepest dimension of the being or of the spirit<sup>119</sup>. The common good is "common" because it projects and reflects itself in the *human persons*<sup>120</sup>. If it were require of certain individuals to capitulate before the social whole, to deprive themselves of the rights which are inherent to them (as a result, e.g., of their political or migratory status), to entrust their destiny entirely to the artificial social whole, in such circumstances the very notion of common good would completely disappear<sup>121</sup>.

<sup>117</sup>. S. Miyazaki, "The Martens Clause and International Humanitarian Law", *Études et essais sur le Droit international humanitaire et sur les principes de la Croix-Rouge en l'honneur de J. Pictet* (ed. Christophe Swinarski), Genève/La Haye, ICRC/Nijhoff, 1984, pp. 438 and 440.

<sup>118</sup>. A.A. Cançado Trindade, *Tratado de Direito Internacional...*, *op. cit. supra* n. (21), vol. III, p. 509, and cf. pp. 497-509.

<sup>119</sup>. J. Maritain, *The Person and the Common Good*, Notre Dame, University of Notre Dame Press, 2002 [reprint], pp. 29-30, 40 and 105.

<sup>120</sup>. *Ibid.*, pp. 49, 76 and 103-104. Any understanding to the contrary would most probably lead to abuses (proper of authoritarianism and of the repressive regimes) and violations of human rights; *ibid.*, p. 50, and cf. pp. 95-97.

<sup>121</sup>. Cf. *ibid.*, pp. 92-93.



32. In spite of the recognition nowadays of the right to *emigrate*, as a corollary of the right to freedom of movement, the States have not yet recognized the correlative right to *immigrate*, creating thus a situation which has generated incongruencies and arbitrarinesses, very often affecting negatively the due process of law<sup>122</sup>. In perpetuating, in this way, the uncertainties and inconsistencies, the States responsible for this situation have failed to act at the level of their responsibilities as subjects of International Law, the *droit des gens*. And have created more problems not only for numerous individuals directly affected but also, ultimately, for themselves, in contributing indirectly to the formation of the fluxes of "illegal" immigrants.

33. On the other hand, there are also the States which have sought solutions to the problem. The fact that 12 accredited States participated in the advisory procedure before the Inter-American Court which preceded the adoption of the present Advisory Opinion on *The Juridical Condition and the Rights of the Undocumented Migrants* is symptomatic of the common purpose of the search for such solutions. From the analysis of the arguments presented, throughout the procedure referred to, by Mexico, Honduras, Nicaragua, El Salvador, Costa Rica and Canada, one detects, in a reassuring way, as common denominator, the recognition that the States have the obligation to respect and to ensure respect for the human rights of all persons under their respective jurisdictions, in the light of the principle of equality and non-discrimination, irrespectively of whether such persons are nationals or foreigners.

34. Moreover, in the same procedure before the Inter-American Court pertaining to the present Advisory Opinion, the United Nations High Commissioner for Refugees (UNHCR), in emphasizing the situation of vulnerability of the migrants, referred to the existing link between migration and asylum, and added with lucidity that the nature and complexity of the contemporary displacements render it difficult to establish a clear line of distinction between refugees and migrants. This situation, encompassing millions of human beings<sup>123</sup>, reveals a new dimension of the protection of the human being in certain circumstances, and underlines the capital importance of the fundamental principle of equality and non-discrimination, to which I shall refer further on (cf. pars. 58-63, *infra*).

35. It is, in reality, a great challenge to the safeguard of the rights of the human person in our days, at this beginning of the XXIst century. In this respect, it is not to pass unnoticed that, as already pointed out, the *jus communicationis* and the freedom of movement, proclaimed since the XVIth and XVIIth centuries, lasted for a long time, and only in a much more recent historical epoch restrictions to them began to manifest themselves (cf. par. 9, *supra*). In fact, only in the second half of the XIXth century, when *immigration* definitively penetrated in the sphere of *domestic* law, it came to suffer successive and systematic restrictions<sup>124</sup>. Hence the growing importance of the prevalence of certain rights, as the right of access to justice (the right to justice *lato sensu*), the right to private and family life (comprising family unity), the right not to be subjected to cruel, inhuman and degrading treatment; this is a theme which transcends

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<sup>122</sup>. A.A. Cançado Trindade, *Elementos para un Enfoque de Derechos Humanos del Fenómeno de los Flujos Migratorios Forzados*, *op. cit. infra* n. (105), pp. 15-16 and 18.

<sup>123</sup>. Cf. notes (3) and (27), *supra*.

<sup>124</sup>. F. Rigaux, "L'immigration: droit international et droits fondamentaux", in *Les droits de l'homme au seuil du troisième millénaire - Mélanges en hommage à P. Lambert*, Bruxelles, Bruylant, 2000, pp. 693-696.

the purely State or inter-State dimension<sup>125</sup>, and that has to be approached in the light of the fundamental human rights of the migrant workers, including the undocumented ones.

36. Nor is it to pass unnoticed, in the present context, the more lucid doctrine which led, in the past, to the configuration of the institute of the territorial asylum. In fact, the *historia juris* of the institute of asylum has been marked by the tension between its characterization as a discretionary faculty of the State, or rather as a subjective individual right. It is not my purpose to begin to examine in depth this institute in the present Concurring Opinion, but rather to refer to a pertinent aspect of the matter object of the present Advisory Opinion of the Inter-American Court. In recent years, with the growing restrictions in the use by the States of the self-attributed faculty of migratory control, it is the first trend which seems *de facto* to prevail<sup>126</sup>, to the detriment of the thesis of the subjective individual right.

37. One may recall that the frustrated Conference of the United Nations on Territorial Asylum, held in Geneva in 1977, did not succeed to obtain a universal consensus as to the asylum as an individual right, and, ever since, State unilateralism has become synonymous of the precariousness of asylum<sup>127</sup>. The "protectionist" measures of the industrialized States (in relation to "undesirable" migratory fluxes) have moved away from the best legal doctrine and generated distortions in the practice relating to the institute of asylum<sup>128</sup>.

38. Nevertheless, the International Law of Human Rights has reacted to respond to the new necessities of protection. And it is perfectly possible that we are witnessing the beginnings of formation of a true *human right to the humanitarian assistance*<sup>129</sup>. We are before two distinct approaches to the international legal order, one centered in the State, the other (which I firmly sustain) centred in the human person. It would be in conformity with this latter the characterization of the right of asylum as a subjective individual right. The *corpus juris* of the International Law of Human Rights contains, in

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<sup>125</sup>. *Ibid.*, pp. 707-708, 710-713, 717-720 and 722.

<sup>126</sup>. In this, as in other areas of the international legal order, an underlying and recurring tension has persisted between the conventional obligations in force, undertaken by the States and the insistence of these latter on keeping on searching for themselves the satisfaction of their own interests, as perceived by them. Cf., e.g., J.-G. Kim and J.M. Howell, *Conflict of International Obligations and State Interests*, The Hague, Nijhoff, 1972, pp. 68 and 112.

<sup>127</sup>. Ph. Ségur, *La crise du droit d'asile*, *op. cit. supra* n. (34), pp. 107 and 140. - On the frustrated Conference on Territorial Asylum of 1977, cf. the report "Diplomatic Conference on Territorial Asylum", 18 *Review of the International Commission of Jurists* (June 1977) pp. 19-24; and cf. P. Weis, "The Present State of International Law on Territorial Asylum", 31 *Schweizerisches Jahrbuch für internationales Recht/Annuaire suisse de Droit international* (1975) pp. 71-96.

<sup>128</sup>. F. Crepeau, *Droit d'asile - de l'hospitalité aux contrôles migratoires*, *op. cit. supra* n. (34), pp. 306-317, 324-330 and 335-339.

<sup>129</sup>. Cf. Inter-American Court of Human Rights, case of the *Communities of the Jiguamiandó and of the Curbaradó*, Provisional Measures of Protection of 06.03.2003, Concurring Opinion of Judge A.A. Cançado Trindade, par. 6.

fact, elements which can lead to the construction (or rather the reconstruction) of a true individual right to asylum<sup>130</sup>.

39. It ought to be kept in mind that the institute of asylum is much wider than the meaning attributed to asylum in the ambit of Refugee Law (i.e., amounting to refuge). Furthermore, the institute of asylum (general kind to which belongs the type of territorial asylum, in particular) precedes historically for a long time the *corpus juris* itself of Refugee Law. The *aggiornamento* and a more integral comprehension of territorial asylum, - which could be achieved as from Article 22 of the American Convention on Human Rights, - could come in aid of the undocumented migrant workers, putting an end to their clandestine and vulnerable situation. To that end, it would have to be (or again to become) recognized precisely as a subjective individual right<sup>131</sup>, and not as a discretionary faculty of the State.

40. Likewise, as to the refugees, one "recognizes", rather than "grants", their statute; it is not a simple "concession" on the part of the States. Nevertheless, the terminology nowadays commonly employed is a reflection of the steps backwards which we regrettably witness. For example, there are terms, like "temporary protection", which seem to imply a relativization of the integral protection granted in the past. Other terms (e.g., "refugees in orbit", "displaced persons in transit", "safe havens", "convention plus") seem to be endowed with a certain degree of surrealism, appearing frankly open to all sorts of interpretation (including the retrograde one), instead of attaching to that which is essentially juridical and to the conquests of law in the past. It is perhaps symptomatic of our days that one has to invoke the conquests of the past in order to stop or avoid even greater steps backwards in the present and in the future. At this moment - of shadows, rather than light - in which we live, one has at least to preserve the advances achieved by past generations in order to avoid a greater evil.

41. It is not to be forgotten, thus, that there have been doctrinal manifestations which sustain the process of gradual formation of the individual right of asylum, at the same time that they affirm the character of *jus cogens* of the principle of *non-refoulement*<sup>132</sup>. This posture appears in accordance with the thinking of the founding fathers of International Law: while Francisco de Vitoria sustained the *jus communicationis*, Francisco Suárez, in the same line of thinking, visualized a "subjective

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<sup>130</sup>. Cf., e.g., Universal Declaration of Human Rights, Article 14(1); American Convention on Human Rights, Article 22(7); OAU Convention (of 1969) Governing Specific Aspects of the Refugee Problems in Africa, Article II(1) and (2).

<sup>131</sup>. In the same year of the adoption of the Universal Declaration of Human Rights of 1948, whilst discussions within the *Institut de Droit International* were taking place as to whether asylum was a right of the State or of the individual (cf. *Annuaire de l'Institut de Droit International* (1948) pp. 199-201 and 204-205), in face of the uncertainties manifested G. Scelle commented that "asylum had become a question of universal *ordre public*" (*ibid.*, p. 202). Two years later, the theme was again discussed in the same *Institut* (in the debates of 07-08.09.1950): on the basis of the impact of human rights in International Law (cf. *Annuaire de l'Institut de Droit International* (1950)-II, p. 228), the possibility was raised of the establishment *de lege ferenda* of an obligation of the States to grant asylum. Despite a certain opposition to the idea, fortunately there were those jurists who supported the establishment of such State obligation, or at least who took it seriously; cf. *ibid.*, pp. 204 and 221 (F. Castberg), p. 200 (H. Lauterpacht), pp. 204-205 (P. Guggenheim), and p. 225 (A. de La Pradelle).

<sup>132</sup>. G. Furlanos, *Sovereignty and the Ingress of Aliens*, *op. cit. supra* n. (24), pp. 143-144, 146, 149 and 172-173.

natural right", proper of the *jus gentium*, in a sense comparable to that utilized in our days<sup>133</sup> in the conceptual universe of the International Law of Human Rights.

42. There will of course always be the "realists" who will object that the subjective individual right of asylum is an utopia. To them I would retort that the alternative to utopia is desperation. More than three decades ago (and the situation of the millions of uprooted persons has only aggravated ever since) L. Legaz y Lacambra warned that:

"The existence of 'proletarian peoples' amounts to a nonsense if the idea of an international community is affirmed; and, above all, it constitutes an injustice when there already are peoples who have achieved a phase of maximum development and economic, social and cultural level, which sharply contrasts with the situation of misery of so many others. [...There is an] obligation of the international community towards their more destitute and needed members who, in this dimension, embody also the idea of the humanity as subject of Law.

Thus, in the evolution of Law, a human - humanist and humanitarian (...) - sense becomes evident: it ceases to be a coercive order of the State and it incorporates more and more some forms of social life open to the growing communication between all men (...). All that, and only that, is what gives meaning to the juridical personalization and subjectivization of humankind"<sup>134</sup>.

43. In his biography of Erasmus of Rotterdam (1467-1536), Stefan Zweig, one of the more lucid writers of the XXth century, singled out, in the precious legacy of the great humanist, the tolerance, to put and end, without violence, to the conflicts which divide the human beings and the peoples. Erasmus, pacifist and defender of the freedom of conscience, identified in the intolerance the hereditary evil of human society, which should be eradicated. Although the ideal of Erasmus has not been accomplished until now, it was not thereby devoid of value. In the penetrating words of S. Zweig,

"An idea which does not come to be materialized is, for that reason, invincible, since it is no longer possible to prove its falseness; that which is necessary, even though its realization is delayed, not therefore is less necessary; quite on the contrary, only the ideals which have not become worn-out and committed by the realization continue acting in each generation as an element of moral impulse. Only the ideas which have not been complied with return eternally. (...) What Erasmus, the disillusioned old man, and, notwithstanding, not excessively disillusioned, left to us as legacy (...) was not anything else but the renewed and dreamed of very old wish of all the religions and myths of a future and continued humanization of humanity and of a triumph of the reason (...). And even if the cautious and cold calculating persons can turn to demonstrate always the lack of future of erasmism, and even if the reality seems to give them each time the reason, those spirits will always be necessary who point out that which links among themselves the peoples beyond that which separates them and that renews faithfully, in the heart of humankind, the idea of a future age of a higher human feeling"<sup>135</sup>.

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<sup>133</sup>. *Ibid.*, p. 23.

<sup>134</sup>. L. Legaz y Lacambra, "La Humanidad, Sujeto de Derecho", in *Estudios de Derecho Internacional Público y Privado - Homenaje al Profesor L. Sela Sampil*, vol. II, Oviedo, University of Oviedo, 1970, pp. 558-559.

<sup>135</sup>. S. Zweig, *Triunfo y Tragedia de Erasmo de Rotterdam*, 5th. ed., Barcelona, Ed. Juventud, 1986, pp.

#### IV. The Position and Role of the General Principles of Law.

44. Every legal system has fundamental principles, which inspire, inform and conform their norms. It is the principles (derived etymologically from the Latin *principium*) that, evoking the first causes, sources or origins of the norms and rules, confer cohesion, coherence and legitimacy upon the legal norms and the legal system as a whole. It is the general principles of law (*prima principia*) which confer to the legal order (both national and international) its ineluctable axiological dimension; it is they that reveal the values which inspire the whole legal order and which, ultimately, provide its foundations themselves. This is how I conceive the presence and the position of the principles in any legal order, and their role in the conceptual universe of Law.

45. The general principles of law entered into the legal culture, with historical roots which go back, e.g., to Roman law, and came to be linked to the very conception of the democratic State under the rule of law (*Estado democrático de Derecho*), above all as from the influence of the enlightenment thinking (*pensée illuministe*). Despite the apparent indifference with which they were treated by legal positivism (always seeking to demonstrate a "recognition" of such principles in the positive legal order), and despite the lesser attention dispensed to them by the shallow and reductionist legal doctrine of our days, nevertheless we will never be able to prescind from them.

46. From the *prima principia* the norms and rules emanate, which in them find their meaning. The principles are thus present in the origins of Law itself. The principles show us the legitimate ends to seek: the common good (of all human beings, and not of an abstract collectivity), the realization of justice (at both national and international levels), the necessary primacy of law over force, the preservation of peace. Contrary to those who attempt - in my view in vain - minimize them, I understand that, if there are no principles, nor is there truly a legal system. Without the principles, the "legal order" simply is not accomplished, and ceases to exist as such.

47. The identification of the basic principles has accompanied *pari passu* the emergence and consolidation of all the domains of Law, and all its branches (civil, civil procedural, criminal, criminal procedural, administrative, constitutional, and so forth). This is so with Public International Law<sup>136</sup>, with the International Law of Human Rights, with International Humanitarian Law<sup>137</sup>, with the International Law of Refugees<sup>138</sup>, with International Criminal Law<sup>139</sup>. However circumscribed or specialized a legal regime may

205-207; S. Zweig, *Érasme - Grandeur et décadence d'une idée*, Paris, Grasset, 2002 (reed.), pp. 183-185.

<sup>136</sup>. E.g., principle of the prohibition of the use or threat of force, principle of the peaceful settlement of international disputes, principle of non-intervention in inter-State relations, principle of the juridical equality of the States, principle of the equality of rights and the self-determination of peoples, principle of good faith in the compliance with the international obligations, principle of international cooperation. Cf. A.A. Cançado Trindade, *O Direito Internacional em um Mundo em Transformação*, Rio de Janeiro, Edit. Renovar, 2002, pp. 91-140.

<sup>137</sup>. Principle of humanity, principle of proportionality, principle of distinction (between combatants and the civil population), principle whereby the election of methods or means of combat is not illimited, principle which requires avoiding unnecessary sufferings or superfluous evils.

<sup>138</sup>. Principle of *non-refoulement*, principle of humanity.

<sup>139</sup>. Principle of legality (*nullum crimen sine lege, nulla poena sine lege*), principle of individual penal

be, its basic principles can there be found, as, e.g., in International Environmental Law<sup>140</sup>, in the Law of the Sea<sup>141</sup>, in the Law of Outer Space<sup>142</sup>, among many others. As pointed out before the Inter-American Court of Human Rights during the procedure pertaining to the present Advisory Opinion on *The Legal Condition and the Rights of the Undocumented Migrants*, the International Labour Organization (ILO) itself has sought to identify the "fundamental principles and rights in work", by means of a Declaration adopted in June 1998.

48. Some of the basic principles are proper of certain areas of Law, others permeate all areas. The *corpus* of legal norms (national or international) operates moved by the principles, some of them ruling the relations themselves between human beings and the public power (as the principles of natural justice, of the rule of law [*Estado del Derecho*], of the rights of the defence, of the right to the natural judge, of the independence of justice, of the equality of all before the law, of the separation of powers, among others). The principles enlighten the path of the legality and the legitimacy. Hence the continuous and eternal "rebirth" of natural law, which has never disappeared.

49. It is no longer a return to the classic natural law, but rather the affirmation or restoration of a standard of justice, heralded by the general principles of law, whereby positive law is evaluated<sup>143</sup>. In sustaining that *opinio juris* is above the will of the State, F. Castberg has correctly pondered that:

"the experiences of our own age, with its repellent cruelties and injustice under cover of positive law, have in fact confirmed the conviction that something - even though it is only certain fundamental norms - must be objectively valid. This may consist of principles which appear to be valid for every human community at any time (...). The law can and should itself move forward in the direction of greater expedience and justice, and to a higher level of humanity"<sup>144</sup>.

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responsibility, principle of the presumption of innocence, principle of non-retroactivity, principle of a fair trial.

<sup>140</sup>. E.g., principle of precaution or due diligence, principle of prevention, principle of the common but differentiated responsibility, principle of intergenerational equity, polluter-pay principle.

<sup>141</sup>. E.g., principle of the common heritage of mankind (ocean floors), principle of the peaceful uses of the sea, principle of the equality of rights (in the high seas), principle of the peaceful settlement of disputes, principles of the freedom of navigation and of innocent passage, principles of equidistance and of special circumstances (delimitation of maritime spaces).

<sup>142</sup>. E.g., principle of non-appropriation, principle of the peaceful uses and ends, principle of the sharing of benefits in space exploration.

<sup>143</sup>. C.J. Friedrich, *Perspectiva Histórica da Filosofia do Direito*, Rio de Janeiro, Zahar Ed., 1965, pp. 196-197, 200-201 and 207; and cf., in general, e.g., Y.R. Simon, *The Tradition of Natural Law - A Philosopher's Reflections* (ed. V. Kuic), N.Y., Fordham Univ. Press, 2000 [reprint], pp. 3-189; A.P. d'Entrèves, *Natural Law*, London, Hutchinson Univ. Library, 1972 [reprint], pp. 13-203.

<sup>144</sup>. F. Castberg, "Natural Law and Human Rights", 1 *Revue des droits de l'homme / Human Rights Journal* (1968) p. 37, and cf. pp. 21-22.

This "eternal return" to jusnaturalism has been, thus, recognized by the jusinternationalists themselves<sup>145</sup>, much contributing to the affirmation and consolidation of the primacy, in the order of the values, of the obligations pertaining to human rights, *vis-à-vis* the international community as a whole<sup>146</sup>. What is certain is that there is no Law without principles, which inform and conform the legal norms and rules.

50. To the extent that a new *corpus juris* is formed, one ought to fulfill the pressing need of identification of its principles. Once identified, these principles ought to be observed, as otherwise the application of the norms would be replaced by a simple rhetoric of "justification" of the "reality" of the facts; if there is truly a legal system, it ought to operate on the basis of its fundamental principles, as otherwise we would be before a legal vacuum, before the simple absence of a legal system<sup>147</sup>.

51. The general principles of law have contributed to the formation of normative systems of protection of the human being. The recourse to such principles has taken place, at the substantive level, as a response to the new necessities of protection of the human being. No one would dare to deny their relevance, e.g., in the historical formation of the International Law of Refugees, or, more recently, in the emergence, in recent years, of the international normative framework pertaining to the (internally) displaced persons<sup>148</sup>. No one would dare to deny their incidence - to quote another example - in the legal regime applicable to foreigners. In this respect, it has been suggested that certain general principles of law apply specifically or predominantly to foreigners, e.g., the principle of the unity of the family, and the principle of the prohibition of extradition whenever this latter presents risks of violations of human rights<sup>149</sup>.

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<sup>145</sup>. Cf., e.g., L. Le Fur, "La théorie du droit naturel depuis le XVIIe. siècle et la doctrine moderne", 18 *Recueil des Cours de l'Académie de Droit International de La Haye* (1927) pp. 297-399; A. Truyol y Serra, "Théorie du Droit international public - Cours général", 183 *Recueil des Cours de l'Académie de Droit International de La Haye* (1981) pp. 142-143; A. Truyol y Serra, *Fundamentos de Derecho Internacional Público*, 4th. rev. ed., Madrid, Tecnos, 1977, pp. 69 and 105; J. Puente Egido, "Natural Law", in *Encyclopedia of Public International Law* (ed. R. Bernhardt/Max Planck Institute), vol. 7, Amsterdam, North-Holland, 1984, pp. 344-349.

<sup>146</sup>. J.A. Carrillo Salcedo, "Derechos Humanos y Derecho Internacional", 22 *Isegoría - Revista de Filosofía Moral y Política* - Madrid (2000) p. 75.

<sup>147</sup>. G. Abi-Saab, "Cours général de Droit international public", 207 *Recueil des Cours de l'Académie de Droit International de La Haye* (1987) p. 378: "soit il existe un système normatif, et dans ce cas il doit être apte à remplir sa tâche, soit il n'y a pas de système de tout".

<sup>148</sup>. Cf. W. Kälin, *Guiding Principles on Internal Displacement - Annotations*, Washington D.C., ASIL/Brookings Institution, 2000, pp. 6-74; and cf. F.M. Deng, *Protecting the Dispossessed - A Challenge for the International Community*, Washington D.C., Brookings Institution, 1993, pp. 1-148.

<sup>149</sup>. C. Pierucci, "Les principes généraux du droit spécifiquement applicables aux étrangers", 10 *Revue trimestrielle des droits de l'homme* (1999) n. 37, pp. 8, 12, 15, 17, 21, 24 and 29-30. Among such principles, applicable to foreigners, there are those set forth initially at international level (e.g., in the framework of the law of extradition, and the law of asylum and or refuge) which have projected at the level of domestic law; cf. *ibid.*, pp. 7-32, esp. pp. 8, 15-21 and 30-32.

## V. The Fundamental Principles as *Substratum* of the Legal Order Itself.

52. The general principles of law have thus inspired not only the interpretation and the application of the legal norms, but also the law-making process itself of its elaboration. They reflect the *opinio juris*, which, in its turn, lies on the basis of the formation of Law<sup>150</sup>, and is decisive for the configuration of the *jus cogens*<sup>151</sup> (cf. *infra*). Such principles mark presence at both national and international levels. If, in the framework of this latter, one has insisted, in the chapter of the (formal) "sources" of international law on the general principles "recognized" *in foro domestico*, this was due to an endeavour to proceed with juridical security<sup>152</sup>, as such principles are present in every and any legal system (cf. *supra*), at national or international levels. In sum, in every legal system (of domestic or international law) the general principles mark presence, assuring its coherence and disclosing its axiological dimension. When one moves away from the principles, one incurs into distortions, and grave violations of the legal order including the positive one.

53. There are general principles of law which appear truly *fundamental*, to the point of identifying themselves with the very foundations of the legal system<sup>153</sup>. Such fundamental principles reveal the values and ultimate ends of the international legal order, guide it and protect it against the incongruencies of the practice of States, and fulfill the necessities of the international community<sup>154</sup>. Such principles, as expression of the "idea of justice", have a universal scope; they do not emanate from the "will" of the States, but are endowed with an objective character which impose them to the observance of all the States<sup>155</sup>. In this way, - as lucidly points out A. Favre, - they secure the unity of Law, as from the idea of justice, to the benefit of the whole humanity<sup>156</sup>.

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<sup>150</sup>. On the wide scope of the *opinio juris* in the formation of contemporary International Law, cf. A.A. Cançado Trindade, "A Formação do Direito Internacional Contemporâneo: Reavaliação Crítica da Teoria Clássica de Suas `Fontes'", 29 *Curso de Derecho Internacional Organizado por el Comité Jurídico Interamericano* (2002) pp. 54-57, and cf. pp. 51-65.

<sup>151</sup>. B. Simma, "International Human Rights and General International Law: A Comparative Analysis", 4 *Collected Courses of the Academy of European Law - Florence* (1993)-II, pp. 226-229.

<sup>152</sup>. *Ibid.*, p. 224.

<sup>153</sup>. G. Cohen-Jonathan, "Le rôle des principes généraux dans l'interprétation et l'application de la Convention Européenne des Droits de l'Homme", in *Mélanges en hommage à L.E. Pettiti*, Bruxelles, Bruylant, 1998, pp. 192-193; F. Sudre, "Existe t-il un ordre public européen?", in *Quelle Europe pour les droits de l'homme?*, Bruxelles, Bruylant, 1996, pp. 57-59.

<sup>154</sup>. M. Koskenniemi, "General Principles: Reflexions on Constructivist Thinking in International Law", in *Sources of International Law* (ed. M. Koskenniemi), Aldershot, Ashgate/Dartmouth, 2000, pp. 360-365, 377, 381, 387, 390 and 395-398.

<sup>155</sup>. A. Favre, "Les principes généraux du droit, fonds commun du Droit des gens", in *Recueil d'études de Droit international en hommage à Paul Guggenheim*, Genève, IUHEI, 1968, pp. 374-374, and cf. p. 369.

<sup>156</sup>. *Ibid.*, pp. 375-376, and cf. p. 379.



54. It is evident that these principles of law do not depend on the "will", nor on the "agreement", nor on the consent, of the subjects of law; the fundamental rights of the human person being the "necessary foundation of every legal order", which knows no frontiers, the human being is *titulaire* of inalienable rights, which do not depend on his statute of citizenship or any other circumstance<sup>157</sup>. In the domain of the International Law of Human Rights, an example of general principles of law lies in the *principle of the dignity of the human being*; another lies in that of the *inalienability of the rights inherent to the human being*. In the present Advisory Opinion on *The Juridical Condition and the Rights of the Undocumented Migrants*, the Inter-American Court has expressly referred to both principles (par. 157).

55. Moreover, in its *jurisprudence constante*, the Inter-American Court, in interpreting and applying the American Convention, has also always resorted to the general principles of law<sup>158</sup>. Among these principles, those which are endowed with a truly fundamental character, which I here refer to, in reality form the *substratum* of the legal order itself, revealing the *right to the Law* of which are *titulaires* all human beings<sup>159</sup>, independently of their statute of citizenship or any other circumstance. And it could not be otherwise, as human rights are universal and inherent to all human beings, while the rights of citizenship vary from country to country and encompass only those which the positive law of the State considers citizens, not protecting, thus, the undocumented migrants. As vehemently proclaimed, in a rare moment of enlightenment, the Universal Declaration of Human Rights of 1948 (Article 1),

- "All human beings are born free and equal in dignity and rights. They are endowed with reason and conscience and should act towards one another in a spirit of brotherhood".

56. The safeguard and prevalence of the principle of respect of the dignity of the human person human are identified with the end itself of Law, of the legal order both national and international. By virtue of this fundamental principle, every person ought to be respected by the simple fact of belonging to the human kind, independently of her condition, of her statute of citizenship, or any other circumstance<sup>160</sup>. The principle of the inalienability of the rights inherent to the human being, in its turn, is identified with a basic premise of the construction of the whole *corpus juris* of the International Law of Human Rights.

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<sup>157</sup>. *Ibid.*, pp. 376-380, 383, 386 and 389-390.

<sup>158</sup>. Cf. Inter-American Court of Human Rights (IACtHR), case of the *Five Pensioners versus Peru* (Judgment of 28.02.2003), par. 156; IACtHR, case *Cantos versus Argentina* (Prel. Obj., Judgment of 07.09.2001), par. 37; IACtHR, case *Baena Ricardo and Others versus Panama* (Judgment of 02.02.2001), par. 98; IACtHR, case *Neira Alegría versus Peru* (Prel. Obj., Judgment of 11.12.1991), par. 29; IACtHR, case *Velásquez Rodríguez versus Honduras* (Judgment of 29.07.1988), par. 184; and cf. also IACtHR, Advisory Opinion n. 17, on the *Juridical Condition and Human Rights of the Child* (of 28.08.2002), pars. 66 and 87; IACtHR, Advisory Opinion n. 16, on *The Right to Information on Consular Assistance in the Framework of the Guarantees of the Due Process of Law* (of 01.10.1999), pars. 58, 113 and 128; IACtHR, Advisory Opinion n. 14, on the *International Responsibility for the Promulgation and Enforcement of Laws in Violation of the American Convention on Human Rights* (of 09.12.1994), par. 35.

<sup>159</sup>. A.A. Cançado Trindade, *Tratado de Direito Internacional dos Direitos Humanos*, op. cit. supra n. (21), vol. III, pp. 524-525.

<sup>160</sup>. B. Maurer, *Le principe de respect de la dignité humaine et la Convention Européenne des Droits de l'Homme*, Paris, CERIC/Univ. d'Aix-Marseille, 1999, p. 18.

57. There can be no doubts as to the extent of the fundamental principles referred to, and, if by chance there were doubts, it is the function of the jurist to clarify them and not to perpetuate them, so that Law may accomplish its fundamental function of giving justice<sup>161</sup>. It is here that the ineluctable recourse to the general principles of Law can help to dispel any doubt which may be raised as to the scope of the individual rights. It is certain that the norms are the ones juridically binding, but when they move away from the principles, their application leads to breaches of individual rights and to serious injustices (e.g., the discrimination *de jure*).

58. In reality, when we recognize the fundamental principles which conform the *substratum* of the legal order itself, we enter into the domain of the *jus cogens*, of the peremptory law (cf. *infra*). In fact, it is perfectly possible to visualize the peremptory law (the *jus cogens*) as identified with the general principles of law of material order which are guarantors of the legal order itself, of its unity, integrity and cohesion<sup>162</sup>. Such principles are indispensable (the *jus necessarium*), are prior and superior to the will; in expressing an "idea of objective justice" (the natural law), they are consubstantial to the international legal order itself<sup>163</sup>.

## **VI. The Principle of Equality and Non-Discrimination in the International Law of Human Rights.**

59. In the ambit of the International Law of Human Rights, another of the fundamental principles, although not sufficiently developed by doctrine to date, but which permeates its whole *corpus juris*, is precisely the principle of equality and non-discrimination. Such principle, set forth, as recalled by the Inter-American Court in the present Advisory Opinion (par. 86), in numerous international instruments of human rights, assumes special importance in relation with the protection of the rights of the migrants in general, and of the undocumented migrant workers in particular. Besides the constitutive element of equality, - essential to the rule of law (*Estado de Derecho*) itself<sup>164</sup>, - the other constitutive element, that of non-discrimination, set forth in so many international instruments<sup>165</sup>, assumes capital importance in the exercise of the protected rights. The discrimination is defined, in the sectorial Conventions aiming at its

<sup>161</sup>. M. Chemillier-Gendreau, "Principe d'égalité et libertés fondamentales en Droit international", in *Liber Amicorum Judge Mohammed Bedjaoui* (eds. E. Yakpo and T. Boumedra), The Hague, Kluwer, 1999, pp. 659-669.

<sup>162</sup>. R. Kolb, *Théorie du jus cogens international*, Paris, PUF, 2001, p. 98.

<sup>163</sup>. *Ibid.*, pp. 104-105 and 110-112.

<sup>164</sup>. G. Pellissier, *Le principe d'égalité en droit public*, Paris, LGDJ, 1996, p. 17.

<sup>165</sup>. Universal Declaration of Human Rights, Article 2; Covenant on Civil and Political Rights, Articles 2(1) and 26; Covenant on Economic, Social and Cultural Rights, Article 2; European Convention of Human Rights, Article 14; American Convention on Human Rights, Article 1(1); African Charter on Human and Peoples Rights, Article 2; International Convention on the Protection of the Rights of All Migrant Workers and Members of Their Families, Articles 1(1) and 7; besides the *corpus juris* of the Convention on the Elimination of All Forms of Racial Discrimination, of the Convention on the Elimination of All Forms of Discrimination against Women, of the ILO Convention on Discrimination in Matter of Employment and Occupation (1958), of the UNESCO Convention against Discrimination in Education (1960), as well as of the Declaration of the United Nations on the Elimination of All Forms of Intolerance and Discrimination Based on Religion or Beliefs (1981).

elimination, essentially as any distinction, exclusion, restriction or limitation, or privilege, to the detriment of the human rights enshrined therein<sup>166</sup>. The prohibition of discrimination comprises both the totality of those rights, at substantive level, as well as the conditions of their exercise, at procedural level.

60. On this point the contemporary doctrine is settled, in considering the principle of equality and non-discrimination as one of the pillars of the International Law of Human Rights<sup>167</sup>, and also as an element integrating general or customary international law<sup>168</sup>. Ultimately, the *corpus juris* of International Law, "must, by definition, be the same for all subjects of the international community"<sup>169</sup>. It is not my intention to dwell into greater depth, in this Concurring Opinion, upon the international case-law on the matter, as it is already analyzed in details in one of my works<sup>170</sup>. I here limit myself, thus, to point out, in sum, that the case-law of the organs of international supervision of human rights has oriented itself, in a general way, - like the present Advisory Opinion n. 18 of the Inter-American Court (pars. 84 and 168), - in the sense of considering discriminatory any distinction which does not have a legitimate purpose, or an objective and reasonable justification, and which does not keep a relation of proportionality between its purpose and the means employed.

61. Under the Covenant on Civil and Political Rights of the United Nations, the Human Rights Committee has effectively pointed out the wide scope of Article 26 of the Covenant, which sets forth the basic principle of equality and non-discrimination: in its *general comment n. 18* (of 1989), the Committee sustained, on that principle, the understanding in the sense Article 26 of the Covenant provides for an "autonomous right", and the application of that principle contained in it is not limited to the rights stipulated in the Covenant<sup>171</sup>. This posture advanced by the Human Rights Committee,

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<sup>166</sup>. Cf., e.g., Convention on the Elimination of All Forms of Racial Discrimination, Article 1(1); Convention on the Elimination of All Forms of Discrimination against Women, Article 1; International Convention on the Protection of the Rights of All Migrant Workers and Members of Their Families, Article 7; Inter-American Convention on the Elimination of All Forms of Discrimination against Persons with Disabilities (of 1999), Article 1(2); among others.

<sup>167</sup>. A. Eide and T. Opsahl, *Equality and Non-Discrimination*, Oslo, Norwegian Institute of Human Rights (publ. n. 1), 1990, p. 4, and cf. pp. 1-44 (study reproduced in T. Opsahl, *Law and Equality - Selected Articles on Human Rights*, Oslo, Notam Gyldendal, 1996, pp. 165-206). And, for a general study, cf. M. Bossuyt, *L'interdiction de la discrimination dans le droit international des droits de l'homme*, Bruxelles, Bruylant, 1976, pp. 1-240.

<sup>168</sup>. Y. Dinstein, "Discrimination and International Human Rights", 15 *Israel Yearbook on Human Rights* (1985) pp. 11 and 27.

<sup>169</sup>. H. Mosler, "To What Extent Does the Variety of Legal Systems of the World Influence the Application of the General Principles of Law within the Meaning of Article 38(1)(c) of the Statute of the International Court of Justice?", in *International Law and the Grotian Heritage* (Hague Commemorative Colloquium of 1983 on the Occasion of the Fourth Centenary of the Birth of Hugo Grotius), The Hague, T.M.C. Asser Instituut, 1985, p. 184.

<sup>170</sup>. A.A. Cançado Trindade, *Tratado de Direito Internacional dos Direitos Humanos*, vol. II, Porto Alegre/Brazil, S.A. Fabris Ed., 1999, pp. 76-82.

<sup>171</sup>. Paragraph 12 of the *general comment general n. 18*; the Committee underlined the fundamental character of that principle (pars. 1 and 3); cf. text reproduced in: United Nations, *Compilation of General*

added to the determination by the European Court of Human Rights of a violation of Article 14 of the European Convention on Human Rights in the *Gaygusuz versus Austria* case (1996), as well as the requisites established in the legal doctrine that the "distinctions" ought to be reasonable and in accordance with justice (so as not to incur into discriminations), have led to the suggestion to the emergence and evolution of a true *right to equality*<sup>172</sup>.

62. But despite the search, by international doctrine and case-law, of the identification of illegitimate bases of discrimination, this does not appear sufficient to me; one ought to go beyond that, as discrimination hardly occurs on the basis of a sole element (e.g., race, national or social origin, religion, sex, among others), being rather a complex mixture of several of them (and there also being cases of discrimination *de jure*). Moreover, when the clauses of non-discrimination of the international instruments of human rights contain a list illegitimate bases referred to, what they really aim at thereby is to eliminate a *whole discriminatory social structure*, having in mind the distinct component elements<sup>173</sup>.

63. It is perfectly possible, besides being desirable, to turn the attentions to all the areas of discriminatory human behaviour, including those which have so far been ignored or neglected at international level (e.g., *inter alia*, social status, income, medical state, age, sexual orientation, among others)<sup>174</sup>. In reality, the causes of forced migrations (in search of survival, work and better conditions of living - cf. *supra*) are not fundamentally distinct from those of population displacement, and it is not merely casual that the basic principle of equality and non-discrimination occupies a central position in the document adopted by the United Nations in 1998 containing the *Guiding Principles on Internal Displacement*<sup>175</sup>.

64. The basic idea of the whole document is in the sense that the internally displaced persons do not lose the rights which are inherent to them as human beings as a result of their displacement, and are protected by the norms of the International Law of Human Rights and of International Humanitarian Law<sup>176</sup>. In the same line of reasoning, the basic idea underlying the International Convention on the Protection of

*Comments and General Recommendations Adopted by Human Rights Treaty Bodies*, U.N. doc. HRI/GEN/1/Rev.3, of 1997, pp. 26-29.

<sup>172</sup>. Cf. A.H.E. Morawa, "The Evolving Human Right to Equality", 1 *European Yearbook of Minority Issues* (2001-2002) pp. 163, 168, 190 and 203.

<sup>173</sup>. E.W. Vierdag, *The Concept of Discrimination in International Law with Special Reference to Human Rights*, The Hague, Nijhoff, 1973, pp. 129-130.

<sup>174</sup>. D. Türk (special *rapporteur* of the U.N. Sub-Commission on Prevention of Discrimination and Protection of Minorities), *The Realization of Economic, Social and Cultural Rights - Final Report*, U.N. doc. E/CN.4/Sub.2/1992/16, of 03.07.1992, p. 48, and cf. p. 55; and cf. also, e.g., T. Clark and J. Niessen, "Equality Rights and Non-Citizens in Europe and America; The Promise, the Practice and Some Remaining Issues", 14 *Netherlands Quarterly of Human Rights* (1996) pp. 245-275.

<sup>175</sup>. Cf. ONU, document E/CN.4/1998/L.98, of 14.04.1998, p. 5; cf. principles 1(1), 4(1), 22 and 24(1). Principle 3(2), in its turn, affirms the right of the internally displaced persons to *humanitarian assistance*.

<sup>176</sup>. R. Cohen and F. Deng, *Masses in Flight: The Global Crisis of Internal Displacement*, Washington D.C., Brookings Institution, 1998, p. 74.

the Rights of All Migrant Workers and Members of Their Families (1990) is in the sense that all the workers qualified as migrants under their provisions ought to enjoy their human rights irrespectively of their juridical situation; hence the central position occupied, also in this context, by the principle of non-discrimination<sup>177</sup>. In sum, the migrant workers, including the undocumented ones, are *titulaires* of the fundamental human rights, which are not conditioned by their legal situation (irregular or not)<sup>178</sup>. In conclusion on this point, to the fundamental principle of equality and non-discrimination is reserved, from the Universal Declaration of 1948, a truly central position in the ambit of the International Law of Human Rights.

### VII. Emergence, Content and Scope of the *Jus Cogens*.

65. In the present Advisory Opinion on *The Juridical Condition and the Rights of the Undocumented Migrants*, the Inter-American Court has significantly recognized that the aforementioned fundamental principle of equality and non-discrimination, in the present stage of evolution of International Law, "has entered into the domain of the *jus cogens*"; on such principle, which "permeates every legal order", - has correctly added the Court, - "rests the whole juridical structure of the national and international public order" (par. 101, and cf. resolatory points ns. 2 and 4). The Court, moreover, has not abstained itself from referring to the evolution of the concept of *jus cogens*, transcending the ambit of both the law of treaties and of the law of the international responsibility of the States, so as to reach general international law and the very foundations of the international legal order (pars. 98-99). In support of this important pronouncement of the Court I see it fit to add some reflections.

66. The emergence and assertion of *jus cogens* in contemporary International Law fulfill the necessity of a minimum of verticalization in the international legal order, erected upon pillars in which the juridical and the ethical are merged. The *jus cogens* was definitively incorporated to the conceptual universe of contemporary international law as from the inclusion, among the bases of invalidity and termination of treaties, of the peremptory norms of general international law, in Articles 53 and 64 of the Vienna Convention of 1969 on the Law of Treaties<sup>179</sup>. The Convention set forth the concept of *jus cogens*, without thereby adopting the thesis - defended in the past by A. McNair<sup>180</sup> - that a treaty could generate a regime of objective character *erga omnes* in derogation

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<sup>177</sup>. Such as enunciated in its Article 7.

<sup>178</sup>. A.A. Cançado Trindade, *Elementos para un Enfoque de Derechos Humanos del Fenómeno de los Flujos Migratorios Forzados*, Guatemala City, OIM/IIDH (Cuadernos de Trabajo sobre Migración n. 5), 2001, pp. 13 and 18.

<sup>179</sup>. More than three decades earlier, the expression "*jus cogens*" was utilized by Judge Schücking, in his well-known Separate Opinion in the *Oscar Chinn* case (United Kingdom versus Belgium); Permanent Court of International Justice (PCIJ), Series A/B, n. 63, 1934, pp. 148-150, esp. p. 149. One year later, in his course at the Hague Academy of International Law, Alfred Verdross also utilized the expression "*jus cogens*", and referred himself to the aforementioned Separate Opinion of Judge Schücking; cf. A. Verdross, "Les principes généraux du Droit dans la jurisprudence internationale", 52 *Recueil des Cours de l'Académie de Droit International de La Haye* (1935) pp. 206 and 243.

<sup>180</sup>. Cf. A.D. McNair, «Treaties Producing Effects `Erga Omnes'», *Scritti di Diritto Internazionale in Onore di T. Perassi*, vol. II. Milano, Giuffrè, 1957, pp. 23-36.

of the classic principle *pacta tertiis nec nocent nec prosunt*<sup>181</sup>. The concept seems to have been recognized by the Vienna Convention of 1969 as a whole; if this latter did not adopt the notion of treaties establishing "legal regimes of objective character", on the other hand it set forth the concept of *jus cogens*<sup>182</sup>, i.e., of peremptory norms of general international law<sup>183</sup>. The provisions on *jus cogens* became the object of analysis of a wide specialized bibliography<sup>184</sup>.

67. One and a half decades later, the concept of *jus cogens* was again set forth in the Vienna Convention on the Law of Treaties between States and International Organizations or between International Organizations (1986); in my intervention in the United Nations Conference which adopted it, I saw it fit to warn for the manifest incompatibility with the concept of *jus cogens* of the voluntarist conception of

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<sup>181</sup>. S. Rosenne, «Bilateralism and Community Interest in the Codified Law of Treaties», *Transnational Law in a Changing Society - Essays in Honour of Ph. C. Jessup* (ed. W. Friedmann, L. Henkin, and O. Lissitzyn), N.Y./London, Columbia University Press, 1972, p. 207; and cf. Ph. Cahier, «Le problème des effets des traités à l'égard des États tiers», 143 *Recueil des Cours de l'Académie de Droit International de La Haye* (1974) pp. 589-736. - During the *travaux préparatoires* of the Convention undertaken by the International Law Commission of the United Nations, the notion of «community interest» was made present: at first utilized by J.-M. Yepes in 1950, the idea was later to appear in the 1st. report by J.L. Brierly (the first *rapporteur* on the subject), in the 1st. report by H. Lauterpacht (the second *rapporteur*), becoming absent from the reports by G. Fitzmaurice (the third *rapporteur*), and reappeared at last in the 2nd. report by H. Waldock (the fourth and last *rapporteur* on the matter); S. Rosenne, *op. cit. supra*, pp. 212-219.

<sup>182</sup>. For a historical account of the concept, going back to the old Roman law, but reappearing mainly as from the XIXth century, cf. Jerzy Sztucki, *Jus Cogens and the Vienna Convention on the Law of Treaties - A Critical Appraisal*, Viena, Springer-Verlag, 1974, pp. 6-11 and 97-108.

<sup>183</sup>. The term, as such, appeared for the first time in the 3rd. report by G. Fitzmaurice, and was again to appear in the 2nd. report by H. Waldock; J. Sztucki, *op. cit. supra* n. (98), pp. 104-105 and 108. - In the preparatory work - of the debates of 1963 and 1966 of the VI Commission of the General Assembly of the United Nations, the necessity was pointed out of the establishment of criteria for the determination of the rules of International Law which could constitute *jus cogens*. Cf. I.M. Sinclair, «Vienna Conference on the Law of Treaties», 19 *International and Comparative Law Quarterly* (1970) pp. 66-69; I.M. Sinclair, *The Vienna Convention on the Law of Treaties*, Manchester, University Press/Oceana, 1973, pp. 124-129, and cf. pp. 129-131.

<sup>184</sup>. Cf., e.g., Ch.L. Rozakis, *The Concept of Jus Cogens in the Law of Treaties*, Amsterdam, North Holland Publ. Co., 1976, pp. 1ss.; Ch. de Visscher "Positivism et *jus cogens*", 75 *Revue générale de Droit international public* (1971) pp. 5-11; M. Virally, «Réflexions sur le *jus cogens*», 12 *Annuaire français de Droit international* (1966) pp. 5-29; A. Verdross, "*Jus dispositivum* and *Jus Cogens* in International Law", 60 *American Journal of International Law* (1966) pp. 55-63; J.A. Barberis, "La liberté de traiter des États et le *jus cogens*", 30 *Zeitschrift für ausländisches öffentliches Recht und Völkerrecht [Z.f.a.o.R.u.V.]* (1970) pp. 19-45; U. Scheuner, "Conflict of Treaty Provisions with a Peremptory Norm of International Law", 27 and 29 *Z.f.a.o.R.u.V.* (1967 y 1969) pp. 520-532 and 28-38, respectively; H. Mosler, "*Ius cogens* im Völkerrecht", 25 *Schweizerisches Jahrbuch für internationales Recht* (1968) pp. 1-40; K. Marek, "Contribution à l'étude du *jus cogens* en Droit international", *Recueil d'études de Droit International en hommage à P. Guggenheim*, Geneva, I.U.H.E.I., 1968, pp. 426-459; M. Schweitzer, "*Ius cogens* im Völkerrecht", 15 *Archiv des Völkerrechts* (1971) pp. 197-223; G. Gaja, "*Jus Cogens* beyond the Vienna Convention", 172 *Recueil des Cours de l'Académie de Droit International de La Haye* (1981) pp. 279-313; L. Alexidze, "Legal Nature of *Jus Cogens* in Contemporary International Law", in *ibid.*, pp. 227-268; and other sources referred to in notes (109), (115), (123), (124), (125) and (131).

International Law<sup>185</sup>, which appeared incapable to explain even the formation of rules of general international law and the incidence in the process of formation and evolution of contemporary International Law of elements independent of the free will of the States<sup>186</sup>. With the assertion of *jus cogens* in the two Vienna Conventions on the Law of Treaties (1969 and 1986), the next step consisted in determining its incidence beyond the law of treaties.

68. On my part, I have always sustained that it is an ineluctable consequence of the affirmation and the very existence of *peremptory* norms of International Law their not being limited to the conventional norms, to the law of treaties, and their being extended to every and any juridical act<sup>187</sup>. Recent developments point out in the same sense, that is, that the domain of the *jus cogens*, beyond the law of treaties, encompasses likewise general international law<sup>188</sup>. Moreover, the *jus cogens*, in my understanding, is an open category, which expands itself to the extent that the universal juridical conscience (material source of all Law) awakens for the necessity to protect the rights inherent to each human being in every and any situation.

69. The evolution of the International Law of Human Rights has emphasized the absolute character of the *non-derogable* fundamental rights. The absolute prohibition of the practices of torture, of forced disappearance of persons, and of summary and extra-legal executions, leads us decidedly into the *terra nova* of the international *jus cogens*<sup>189</sup>. In the case *A. Furundzija* (Judgment of 10.12.1998), the *ad hoc* International Criminal Tribunal for the Former Yugoslavia (*Trial Chamber*) sustained that the prohibition of torture, established in an absolute way by International Law, both conventional (under certain human rights treaties) as well as customary, had the character of a norm of *jus cogens* (pars. 137-139, 144 and 160)<sup>190</sup>. This occurred by virtue of the importance of the protected values (par. 153). Such absolute prohibition of

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<sup>185</sup>. Cf. U.N., *United Nations Conference on the Law of Treaties between States and International Organizations or between International Organizations* (Vienna, 1986) - *Official Records*, vol. I, N.Y., U.N., 1995, pp. 187-188 (intervention by A.A. Cançado Trindade).

<sup>186</sup>. A.A. Cançado Trindade, "The Voluntarist Conception of International Law: A Re-Assessment", 59 *Revue de droit international de sciences diplomatiques et politiques* - Geneva (1981) pp. 201-240.

<sup>187</sup>. Cf. A.A. Cançado Trindade, *Tratado de Direito Internacional...*, *op. cit. supra* n. (97), vol. II, pp. 415-416.

<sup>188</sup>. For the extension of *jus cogens* to all possible juridical acts, cf., e.g., E. Suy, «The Concept of *Jus Cogens* in Public International Law», in *Papers and Proceedings of the Conference on International Law* (Langonissi, Greece, 03-08.04.1966), Geneva, C.E.I.P., 1967, pp. 17-77.

<sup>189</sup>. A.A. Cançado Trindade, *Tratado de Direito Internacional...*, *op. cit. supra* n. (97), vol. II, p. 415.

<sup>190</sup>. The Tribunal added that such prohibition was so absolute that it had incidence not only on actual, but also potential, violations (above all as from the Judgment of the European Court of Human Rights in the case *Soering versus United Kingdom*, 1989), thus impeding the expulsion, the return or the extradition of a person to another State in which he could run the risk of being subjected to torture; *ibid.*, pars. 144 and 148. - In this respect, on the practice under the Covenant on Civil and Political Rights of the United Nations, cf. F. Pocar, "Patto Internazionale sui Diritti Civili e Politici ed Estradizione", in *Diritti dell'Uomo, Estradizione ed Espulsione - Atti del Convegno di Ferrara (1999) per Salutare G. Battaglini* (ed. F. Salerno), Padova, Cedam, 2003, pp. 89-90.

torture, - added the Tribunal, - imposes on the States obligations *erga omnes* (par. 151); the *jus cogens* nature of this prohibition renders it "one of the most fundamental standards of the international community", incorporating "an absolute value from which no one should divert himself" (par. 154).

70. The concept of *jus cogens* in fact is not limited to the law of treaties, and is likewise proper to the law of the international responsibility of the States. The Articles on the Responsibility of the States, adopted by the International Law Commission of the United Nations in 2001, bear witness of this fact. Among the passages of such Articles and their comments which refer expressly to *jus cogens*, there is one in which it is affirmed that "various tribunals, national and international, have affirmed the idea of peremptory norms in contexts not limited to the validity of treaties"<sup>191</sup>. In my understanding, it is in this central chapter of International Law, that of the international responsibility (perhaps more than in the chapter on the law of treaties), that the *jus cogens* reveals its real, wide and profound dimension, encompassing all juridical acts (including the unilateral ones), and having an incidence (including beyond the domain of State responsibility) on the very *foundations* of an international law truly universal.

71. To the international *objective* responsibility of the States corresponds necessarily the notion of *objective illegality*<sup>192</sup> (one of the elements underlying the concept of *jus cogens*). In our days, no one would dare to deny the objective illegality of acts of genocide<sup>193</sup>, of systematic practices of torture, of summary and extra-legal executions, and of forced disappearance of persons, - practices which represent crimes against humanity, - condemned by the universal juridical conscience<sup>194</sup>, parallel to the application of treaties. Already in its Advisory Opinion of 1951 on the *Reservations to the Convention against Genocide*, the International Court of Justice pointed out that the humanitarian principles underlying that Convention were recognizedly "binding on States, even without any conventional obligation"<sup>195</sup>.

72. Just as, in the ambit of the International Law of Refugees, the basic principle of *non-refoulement* was recognized as being of *jus cogens*<sup>196</sup>, in the domain of the International Law of Human Rights the character of *jus cogens* of the fundamental principle of equality and non-discrimination was likewise recognized (cf. *supra*). The objective illegality is not limited to the aforementioned acts and practices. As the *jus cogens* is not a closed category (*supra*), I understand that no one either would dare to

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<sup>191</sup>. J. Crawford, *The International Law Commission's Articles on State Responsibility - Introduction, Text and Commentaries*, Cambridge, University Press, 2002, p. 188, and cf. pp. 246 and 127-128.

<sup>192</sup>. In its Advisory Opinion of 21.06.1971 on *Namibia*, the International Court of Justice in fact referred itself to a situation which it characterized as "illegal *erga omnes*"; *ICJ Reports* (1971) p. 56, par. 126.

<sup>193</sup>. In its Judgment of 11 July 1996, in the case concerning the *Application of the Convention against Genocide*, the International Court of Justice affirmed that the rights and obligations set forth in that Convention were "rights and duties *erga omnes*"; *ICJ Reports* (1996) p. 616, par. 31.

<sup>194</sup>. Inter-American Court of Human Rights, case *Blake versus Guatemala* (Merits), Judgment of 24.01.1998, Separate Opinion of Judge A.A. Cançado Trindade, par. 25, and cf. pars. 23-24.

<sup>195</sup>. ICJ, Advisory Opinion of 28 May 1951, *ICJ Reports* (1951) p. 23.

<sup>196</sup>. Cf. J. Allain, "The *Jus Cogens* Nature of *Non-Refoulement*", 13 *International Journal of Refugee Law* (2002) pp. 538-558.



deny that the slave work, and the persistent denial of the most elementary guarantees of the due process of law would likewise affront the universal juridical conscience, and effectively collide with the peremptory norms of the *jus cogens*. This is particularly significant for the safeguard of the rights of the undocumented migrant workers. All this doctrinal evolution points to the direction of the crystallization of the obligations *erga omnes* of protection (cf. *infra*). Without the consolidation of such obligations one will advance very little in the struggle against the violations of human rights.

73. The manifestations of international *jus cogens* mark presence in the very manner whereby human rights treaties have been interpreted and applied: the restrictions, foreseen in them, to the human rights they set forth, are restrictively interpreted, safeguarding the *État de Droit* (*Estado de Derecho*), and demonstrating that human rights do not belong to the domain of *jus dispositivum*, and cannot be considered as simply "negotiable"<sup>197</sup>; on the contrary, they permeate the (national and international) legal order itself. In sum and conclusion on the point under examination, the emergence and assertion of *jus cogens* evoke the notions of international public order and of a hierarchy of legal norms, as well as the prevalence of the *jus necessarium* over the *jus voluntarium*; *jus cogens* presents itself as the juridical expression of the very international community as a whole, which, at last, takes conscience of itself, and of the fundamental principles and values which guide it<sup>198</sup>.

#### **VIII. Emergence and Scope of the Obligations *Erga Omnes* of Protection: Their Horizontal and Vertical Dimensions.**

74. In the present Advisory Opinion on *The Juridical Condition and the Rights of the Undocumented Migrants*, the Inter-American Court has pointed out that the fundamental principle of equality and non-discrimination, for belonging to the domain of *jus cogens*, "brings about obligations *erga omnes* of protection which bind all States and generate effects with regard to third parties, including individuals (private persons)" (par. 110, and cf. resolutive point n. 5)<sup>199</sup>. Also on this particular point I see it fit to present some reflections, in support of what was determined by the Inter-American Court. It is widely recognized, in our days, that the peremptory norms of *jus cogens* effectively bring about obligations *erga omnes*.

75. In a well-known *obiter dictum* in its Judgment in the case of the *Barcelona Traction* (Second Phase, 1970), the International Court of Justice determined that there are certain international obligations *erga omnes*, obligations of a State *vis-à-vis* the international community as a whole, which are of the interest of all the States; "such obligations derive, for example, in contemporary International Law, from the outlawing

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<sup>197</sup>. J.A. Pastor Ridruejo, "La Convención Europea de los Derechos del Hombre y el 'Jus Cogens' Internacional", in *Estudios de Derecho Internacional - Homenaje al Profesor Miaja de la Muela*, tomo I, Madrid, Ed. Tecnos, 1979, pp. 581-590. - On the possibility of the incidence of *jus cogens* in the elaboration itself of drafts of international instruments, cf. discussion in G.M. Danilenko, "International *Jus Cogens*: Issues of Law-Making", 2 *European Journal of International Law* (1991) pp. 48-49 and 59-65.

<sup>198</sup>. A. Gómez Robledo, *El Jus Cogens Internacional (Estudio Histórico Crítico)*, Mexico, UNAM, 1982, pp. 20-21, 222-223 and 226, and cf. p. 140; and cf. also R.St.J. Macdonald, "Fundamental Norms in Contemporary International Law", 25 *Annuaire canadien de Droit international* (1987) pp. 133-134, 140-142 and 148.

<sup>199</sup>. And cf. also par. 146.

of acts of aggression, and of genocide, and also from the principles and rules concerning the basic rights of the human person, including protection from slavery and racial discrimination. Some of the corresponding rights of protection *have entered into the body of general international law (...)*; others are conferred by international instruments of a universal or quasi-universal character<sup>200</sup>. The prohibitions mentioned in this *obiter dictum* are not exhaustive: to them new prohibitions are added, such as the ones referred to in paragraphs 71-72 of the present Concurring Opinion, precisely for not being the *jus cogens* a closed category (*supra*).

76. In the construction of the international legal order of the new century, we witness, with the gradual erosion of reciprocity, the emergence *pari passu* of superior considerations of *ordre public*, reflected in the conceptions of the peremptory norms of general international law (the *jus cogens*) and of the obligations *erga omnes* of protection (owed to everyone, and to the international community as a whole). The *jus cogens*, in bringing about obligations *erga omnes*, characterizes them as being endowed with a necessarily objective character, and thereby encompassing all the addressees of the legal norms (*omnes*), both those who integrate the organs of the public power as well as the individuals.

77. In my view, we can consider such obligations *erga omnes* from *two dimensions, one horizontal and the other vertical*, which complement each other. Thus, the obligations *erga omnes* of protection, in a horizontal dimension, are obligations pertaining to the protection of the human beings due to the international community as a whole<sup>201</sup>. In the framework of conventional international law, they bind all the States Parties to human rights treaties (obligations *erga omnes partes*), and, in the ambit of general international law, they bind all the States which compose the organized international community, whether or not they are Parties to those treaties (obligations *erga omnes lato sensu*). In a vertical dimension, the obligations *erga omnes* of protection bind both the organs and agents of (State) public power, and the individuals themselves (in the inter-individual relations).

78. For the conformation of this vertical dimension have decisively contributed the advent and the evolution of the International Law of Human Rights. But it is surprising that, until now, these horizontal and vertical dimensions of the obligations *erga omnes* of protection have passed entirely unnoticed from contemporary legal doctrine. Nevertheless, I see them clearly shaped in the legal regime itself of the American Convention on Human Rights. Thus, for example, as to the vertical dimension, the general obligation, set forth in Article 1(1) of the American Convention, to respect and to ensure respect for the free exercise of the rights protected by it, generates effects

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<sup>200</sup>. ICJ, Judgment of 05 February 1970, *ICJ Reports* (1970) p. 32, pars. 33-34 (emphasis added). - The same Court had a unique opportunity to develop these considerations years later, in the *East Timor* case, but wasted it: in the Judgment of 30.06.1995, in which it reaffirmed the existence of the obligations *erga omnes* (in relation to the right of self-determination of peoples), it nevertheless related such obligations which something which is its antithesis, the consent of a third State (Indonesia); from a bilateralist and voluntarist perspective, it thus failed, unfortunately, to extract the consequences of the existence of such obligations *erga omnes*; cf. ICJ, *East Timor* case (Portugal versus Australia), *ICJ Reports* (1995) pp. 90-106.

<sup>201</sup>. IACtHR, case *Blake versus Guatemala* (Merits), Judgment of 24.01.1998, Separate Opinion of Judge A.A. Cançado Trindade, par. 26, and cf. pars. 27-30.

*erga omnes*, encompassing the relations of the individual both with the public (State) power as well as with other individuals (*particuliers*)<sup>202</sup>.

79. In their turn, the obligations *erga omnes partes*, in their horizontal dimension, find expression also in Article 45 of the American Convention, which foresees the mechanism (not yet utilized in the practice of the inter-American system of human rights), of inter-State complaints or petitions. This mechanism, - as I pointed out in my Concurring Opinion (par. 3) in the case of the *Community of Peace of San José of Apartadó* (Provisional Measures of Protection of 18.06.2002), - constitutes not only a mechanism *par excellence* of action of collective guarantee, but also a true embryo *actio popularis* in International Law, in the framework of the American Convention. In any case, these dimensions, both horizontal and vertical, reveal the wide scope of the obligations *erga omnes* of protection.

80. The crystallization of the obligations *erga omnes* of protection of the human person represents, in reality, the overcoming of a pattern of conduct erected on the alleged autonomy of the will of the State, from which International Law itself sought gradually to liberate itself in giving expression to the concept of *jus cogens*<sup>203</sup>. By definition, all the norms of *jus cogens* generate necessarily obligations *erga omnes*. While *jus cogens* is a concept of material law, the obligations *erga omnes* refer to the structure of their performance on the part of all the entities and all the individuals bound by them. In their turn, not all the obligations *erga omnes* necessarily refer to norms of *jus cogens*.

81. One ought to secure a follow-up to the endeavours of greater doctrinal and jurisprudential development of the peremptory norms of international law (*jus cogens*) and of the corresponding obligations *erga omnes* of protection of the human being<sup>204</sup>, moved above all by the *opinio juris* as a manifestation of the universal juridical conscience, to the benefit of all human beings<sup>205</sup>. By means of this conceptual development one will advance in the overcoming of the obstacles of the dogmas of the past and in the creation of a true international *ordre public* based upon the respect for,

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<sup>202</sup>. Cf., in this respect, in general, the resolution adopted by the *Institut de Droit International* (I.D.I.) at the session of Santiago de Compostela of 1989 (Article 1), in: I.D.I., 63 *Annuaire de l'Institut de Droit International* (1989)-II, pp. 286 and 288-289.

<sup>203</sup>. Cf. A.A. Cançado Trindade, "The International Law of Human Rights at the Dawn of the XXIst Century", 3 *Cursos Euromediterráneos Bancaja de Derecho Internacional* - Castellón (1999) pp. 207-215.

<sup>204</sup>. On the relationship between *jus cogens* and *erga omnes* obligations of protection, cf.: M. Ragazzi, *The Concept of International Obligations Erga Omnes*, Oxford, Clarendon Press, 1997, pp. 135, 201-202 and 213; Y. Dinstein, "The *Erga Omnes* Applicability of Human Rights", 30 *Archiv des Völkerrechts* (1992) pp. 16-37; A.J.J. de Hoogh, "The Relationship between *Jus Cogens*, Obligations *Erga Omnes* and International Crimes: Peremptory Norms in Perspective", 42 *Austrian Journal of Public and International Law* (1991) pp. 183-214; C. Annacker, "The Legal Regime of *Erga Omnes* Obligations in International Law", 46 *Austrian Journal of Public and International Law* (1994) pp. 131-166; M. Byers, "Conceptualising the Relationship between *Jus Cogens* and *Erga Omnes* Rules", 66 *Nordic Journal of International Law* (1997) pp. 211-239; J. Juste Ruiz, "Las Obligaciones 'Erga Omnes' en Derecho Internacional Público", in *Estudios de Derecho Internacional - Homenaje al Profesor Miaja de la Muela*, vol. I, Madrid, Tecnos, 1979, p. 228.

<sup>205</sup>. IACtHR, case *Blake versus Guatemala* (Merits), Judgment of 24.01.1998, Series C, n. 36, Separate Opinion of Judge A.A. Cançado Trindade, par. 28; IACtHR, case *Blake versus Guatemala* (Reparations), Judgment of 22.01.1999, Series C, n. 48, Separate Opinion of Judge A.A. Cançado Trindade, par. 40.

and observance of, human rights. Such development will contribute, thus, to a greater cohesion of the organized international community (the *civitas maxima gentium*), centred on the human person.

82. As I saw it fit to point out in my Separate Opinion in the case *Las Palmeras* (Preliminary Objections, 2000, pars. 13-14) and in my Concurring Opinions in the case of the *Community of Peace of San José of Apartadó* (Provisional Measures of Protection, 18.06.2002, pars. 2-9) and in the case of the *Communities of the Jiguamiandó and of the Curbaradó* (Provisional Measures of Protection, 06.03.2003, pars. 4-6), at a more circumscribed level, the American Convention on Human Rights itself contains mechanisms for application of the conventional obligations of protection *erga omnes partes*. This is endowed with particular relevance at both conceptual and operative levels. The general obligation, set forth in Article 1(1) of the American Convention, to respect and to ensure respect for the free exercise of the rights protected by it, has a character *erga omnes*<sup>206</sup>.

83. In my understanding, the obligations *erga omnes partes* are not to be minimized, nor at the conceptual level, as, by means of the exercise of collective guarantee, such obligations can serve as guide, or pave the way, for the crystallization, in the future, of the obligations *erga omnes lato sensu*, due to the international community as a whole. And, at the operative level, the obligations *erga omnes partes* under a human rights treaty such as the American Convention also assume special importance, in face of the current diversification of the sources of violations of the rights enshrined into the Convention, which requires the clear recognition of the effects of the conventional obligations *vis-à-vis* third parties (the *Drittwirkung*), including individuals (e.g., in labour relations).

84. A minimum of conventional protection can thereby be promptly secured, for example, to the undocumented migrant workers, in their relations not only with the public power but also with other individuals, in particular their employers. One can, thus, sustain that migrant workers, including the undocumented ones, are *titulaires* of fundamental rights *erga omnes*. Ultimately, the State has the obligation to take positive measures to impede the unscrupulous labour exploitation, and to put an end to it. The State has the duty to secure the prevalence of the fundamental principle of equality and non-discrimination, which, as rightly establishes the present Advisory Opinion of the Inter-American Court, is a principle of *jus cogens* (par. 101, and resolutive point n. 4). To have clarified this basic point constitutes a valuable contribution of the present Advisory Opinion n. 18 of the Court.

85. The State is bound by the *corpus juris* of the international protection of human rights, which protects every human person *erga omnes*, independently of her statute of citizenship, or of migration, or any other condition or circumstance. The fundamental rights of the migrant workers, including the undocumented ones, are opposable to the public power and likewise to the private persons or individuals (e.g., employers), in the inter-individual relations. The State cannot prevail itself of the fact of not being a Party to a given treaty of human rights to evade the obligation to respect the fundamental principle of equality and non-discrimination, for being this latter a principle of general

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<sup>206</sup> Cf., in this sense, the resolution adopted by the *Institut de Droit International* (I.D.I.) at the session of Santiago de Compostela of 1989 (Article 1), in: I.D.I., 63 *Annuaire de l'Institut de Droit International* (1989)-II, pp. 286 and 288-289.

international law, and of *jus cogens*, which thus transcends the domain of the law of treaties.

### **IX. Epilogue.**

86. The fact that the concepts both of the *jus cogens* and of the obligations (and rights) *erga omnes* already integrate the conceptual universe of International Law discloses the reassuring and necessary opening of this latter, in the last decades, to certain superior and fundamental values. This significant evolution of the recognition and assertion of norms of *jus cogens* and *erga omnes* obligations of protection ought to be fostered, seeking to secure its full practical application, to the benefit of all human beings. Only thus shall we rescue the universalist vision of the founding fathers of the *droit des gens*, and shall we move closer to the plenitude of the international protection of the rights inherent to the human person. These new conceptions impose themselves in our days, and, of their faithful observance, in my view, will depend in great part the future evolution of the present domain of protection of the human person, as well as, ultimately, of the International Law itself as a whole.

87. It is not function of the jurist simply to take note of what the States do, particularly the most powerful ones, which do not hesitate to seek formulas to impose their "will", including in relation to the treatment to be dispensed to the persons under its jurisdiction. The function of the jurist is to show and to tell what the Law is. In the present Advisory Opinion n. 18 on *The Juridical Condition and the Rights of the Undocumented Migrants*, the Inter-American Court of Human Rights has determined, firmly and with clarity, what the Law is. This latter does not emanate from the inscrutable "will" of the States, but rather from human conscience. General or customary international law emanates not so much from the practice of States (not devoid of ambiguities and contradictions), but rather from the *opinio juris communis* of all the subjects of International Law (the States, the international organizations, and the human beings). Above the will is the conscience.

88. The fact that, despite all the sufferings of past generations, persist in our days new forms of exploitation of man by man, - such as the exploitation of the labour force of the undocumented migrants, forced prostitution, the traffic of children, forced and slave labour, amidst a proved increase of poverty and social exclusion and marginalization, the uprootedness and family disruption, - does not mean that "regulation is lacking" or that Law does not exist. It rather means that Law is being ostensibly and flagrantly violated, from day to day, to the detriment of millions of human beings, among whom the undocumented migrants all over the world. In reacting against these generalized violations of the rights of the undocumented migrants, which affront the juridical conscience of humankind, the present Advisory Opinion of the Inter-American Court contributes to the current process of the necessary *humanization* of International Law.

89. In so doing, the Inter-American Court bears in mind the universality and unity of the human kind, which inspired, more than four and a half centuries ago, the historical process of formation of the *droit des gens*. In rescuing, in the present Advisory Opinion, the universalist vision which marked the origins of the best doctrine of International Law, the Inter-American Court contributes to the construction of the new *jus gentium* of the XXIst century, oriented by the general principles of law (among which the fundamental principle of equality and non-discrimination), characterized by the intangibility of the due process of law in its wide scope, crystallized in the recognition of *jus cogens* and instrumentalized by the consequent obligations *erga omnes* of

protection, and erected, ultimately, on the full respect for, and guarantee of, the rights inherent to the human person.

Antônio Augusto Cançado Trindade  
Judge

Manuel E. Ventura-Robles  
Secretary

**REASONED CONCURRING OPINION OF  
JUDGE SERGIO GARCÍA RAMÍREZ  
IN RELATION TO ADVISORY OPINION OC-18/03 ON  
"LEGAL STATUS AND RIGHTS OF UNDOCUMENTED MIGRANTS"  
OF SEPTEMBER 17, 2003  
ISSUED BY THE INTER-AMERICAN COURT OF HUMAN RIGHTS**

1. The Inter-American Court rendered *Advisory Opinion OC-18/03* on September 17, 2003, under the heading "*Legal Status and Rights of Undocumented Migrants.*" Consequently, it covers a wide spectrum of situations regarding undocumented migrants in general; that is, those persons who leave a State to migrate to another State and stay there, but who do not have authorization to do so from the State in which they seek to reside. This description is clear from the "Glossary" in Chapter V of the *Advisory Opinion* (para. 69). Many individuals are in this situation, regardless of the motive for their move, their particular conditions, and the activity they perform or wish to perform.

2. One specific category within this spectrum corresponds to undocumented migrant *workers*; that is, persons who are not authorized to enter the State of employment and engage in a remunerated activity there, according to the laws of the State and the international agreements to which that State is a party, but who, nevertheless, engage in that activity, as the 1990 International Convention on the Protection of the Rights of all Migrant Workers and Members of their Families has understood, and as is recognized in the "Glossary" cited in the preceding paragraph. It is with regard to the latter, working in urban and rural areas, that the request submitted by the United Mexican States to the Inter-American Court of Human Rights refers principally – although not exclusively. It is necessary to examine the rights of millions of human beings, women and men, who have migrated or who migrate in all parts of the world – and especially in the countries of the Americas – moved by different factors, but all driven by the same expectation: to earn their living outside the country in which they were born.

3. This issue is extremely important and, consequently, has merited prominent mention in the request for the opinion and in the briefs of the States and individuals who intervened in the consultation process – the latter as *amici curiae*. It is also underscored in the answers of the Inter-American Court, which could have been grouped under another heading emphasizing the universe that concerns the requesting State and the participants and is being examined by the Inter-American Court: "*Legal status and rights of undocumented migrant workers*".

4. The issue to which this *Advisory Opinion* refers is of fundamental importance today. The increasing interrelation between nations, the process of globalization that has an impact in diverse areas, and the different conditions of the national, regional and global economies have been determining factors in the appearance and growth of migratory flows that have particular characteristics and require coherent solutions. In its resolution on "*International migration and development*" (A/RES/54/212, of 1 February 2000) – mentioned in *OC-18*, the General Assembly of the United Nations indicated that "among other factors, the process of globalization and liberalization, including the widening economic and social gap between and among many countries and the marginalization of some countries in the global economy, has contributed to large flows of peoples between and among countries and to the intensification of the complex phenomenon of international migration."

5. In a recent publication, it is recalled that “most individuals migrate in order to improve their living conditions, seek new opportunities or escape poverty”; although we should not overlook other reasons, such as: family reunion, war and other conflicts, human rights violations, expulsion, and discrimination. At the “end of the 20th century, there were an estimated 175 million international migrants, nearly 3% of the world’s people and twice the number in 1975. Some 60% of the international migrants, about 104 million, are in developing countries” (Commission on Human Security, *Human Security*, New York, 2003, p. 41).

6. The new migratory flows, which are the focal point of *Advisory Opinion OC-18/2003*, reflect the situation of the economy in the countries of origin and destination of migrants. In the latter there is a factor of attraction that requires the contribution of the labor of those workers, who play a role in wealth creation and – as those who study these processes have acknowledged – make a very significant contribution to the welfare and development of the receiving countries. A study on this issue by the International Labour Office (ILO) – cited in the brief submitted by the Center for Justice and International Law (CEJIL) – mentions, with regard to a universe of 152 countries, that between 1970 and 1990 the number of countries classified as major recipients of immigrants seeking work increased from 39 to 67, while the number of those considered major originators of migrants increased from 29 to 55. The conditions in which some of these processes occur and their results produce a form of subsidy for the most developed economies, in addition to their importance as a source of income for the migrants who provide their services in those economies and for their families who reside in their countries of origin.

7. These processes cannot – or rather, should not – be exempt from scrupulous respect for the human rights of migrants. This is the central thesis of *Advisory Opinion OC-18/2003*, which extends to the different areas it covers. It is a thesis that corresponds to the best expressions of the guiding principle of contemporary national and international law, to legal writings and practice of the rule of law in a democratic society, and to the principles that govern international human rights law and the implementation of its norms by the States that compose the legal community and the corresponding international jurisdictions.

8. Evidently, it is not possible to reduce a phenomenon of this nature to a question of border policy, or approach it from the simple perspective of the legal or illegal, regular or irregular status of the residence of aliens in a specific territory. This viewpoint does not permit us to understand and regulate rationally and constructively the offer of licit and creative work and the demand that keeps the economic processes operating, to the benefit of those who provide their services and to those who employ them. The phenomenon goes beyond these reductionist perspectives, which often lead to the adoption of inadmissible and harmful measures for migrant workers, and even for the economy in which they are established. Moreover, this limited and flawed vision frequently entails problems in relations with neighboring countries.

9. Those who form part of these migratory flows are very often almost totally helpless, owing to their lack of social, economic and cultural knowledge of the country in which they work, and to the lack of instruments to protect their rights. In these circumstances, they constitute an extremely vulnerable sector that has suffered the consequences of this vulnerability by the implementation of laws, the adoption and execution of policies, and the proliferation of discriminatory and abusive practices in their labor relations with the employers who use their services



and the authorities of the country where they reside. This vulnerability is structural in character. Its cultural aspect, of an endogenous nature, is associated – as the *amicus curiae* brief presented by an academic of the Juridical Research Institute of the Universidad Nacional Autónoma de México states – with “conditions that are sufficient to result in extreme impunity for those who violate the human rights of aliens/ immigrants.”

10. It is well known that there have been many cases of aggression against undocumented migrants by public authorities, who fail to comply with or distort the exercise of their attributes, and by individuals who take advantage of the vulnerable situation of undocumented migrants and subject them to ill-treatment or convert them into victims of crimes. The latter include different kinds of violent crime and arbitrary treatment, which regularly remain unpunished or are only penalized by light measures, utterly disproportionate to the gravity of the illegal acts that have been committed. In a resolution on “*Protection of migrants*” (A/RES/54/166, of 24 February 2000) – mentioned in the *Advisory Opinion* – the General Assembly of the United Nations expressed its concern for “the manifestations of violence, racism, xenophobia and other forms of discrimination and inhuman and degrading treatment to which migrants are subjected, particularly women and children, in different parts of the world.”

11. The vulnerability of migrant workers increases, reaching dramatic extremes that move the universal moral conscience, when they lack official authorization to enter and remain in a country and, consequently, form part of the category of those persons who are instantly identified as “undocumented,” “irregular” or, worse still “illegal,” workers. What should be an administrative description with well-defined effects becomes a “label” that results in many disadvantages and exposes the bearer to innumerable abuses. This sector is grouped under a significant heading: it is a “suspected category,” as the Inter-American Commission on Human Rights indicates – another *amicus curiae* brief alludes to “suspect category” – a concept elaborated on the basis of European case law and comparative law. In brief, it refers to “persons under suspicion,” with all that this implies and, furthermore, with all that it suggests and even allows.

12. Although it should be borne in mind, I will not go into detail about the nature of the treatment usually meted out to undocumented workers. It includes abuse and arbitrariness of different kinds in the workplace, but also outside of it, because of the lack of security that they endure, the treatment they receive, and other very diverse aspects of their personal and family life, even its most intimate and delicate aspects. Reports on this situation, which observers of different countries provide from time to time on conditions prevailing on different continents, illustrate this matter amply.

13. This is the situation in which millions of persons live, work and suffer in many countries in the world, some of which have historically been in the forefront of human rights and democracy. Thus, when alluding to the problem of undocumented migrant workers, the focus of *OC-18/2003*, reference is being made to a large number of human beings in different countries, as noted in the statistical contributions made by those who took part, as representatives of States or *amici curiae*, in the process of reflection which led to this *Advisory Opinion*.

14. *OC-18/2003* is based on the acceptance of the human rights recognized to all persons and required of all States. This corresponds, moreover, to the basic concept of fundamental rights in the words used in national declarations as of the eighteenth century and in the most important international instruments of the twentieth

century. This recognition, which is based on human dignity and transcends all political borders, is the most relevant moral, juridical and political fact in the current stage of law. The violations committed during the last century and in the one which is just beginning do not diminish the contemporary status of the individual, product of a long and eventful evolution, nor eliminate the enforceability of human rights before all States. To the contrary, they reinforce a concern shared by innumerable persons and underline the need to continue the struggle to ensure to everyone the most extensive enjoyment and exercise of those rights. We may add that this is the philosophy that sustains the major international organizations, such as the United Nations and the Organization of American States, in the words of their Charters, and it therefore binds the States that form part of them and have accepted their values and the commitments that the latter represent.

15. Thinking behind the declarations of rights and their contemporary expression cites the freedom and equality of all human beings. This entails, first implicitly, then explicitly in numerous documents – as indicated in this *Advisory Opinion* – the most complete and conclusive rejection of discrimination whatever the motive. This profound conviction is the source of the historic struggles of the individual against different forms of oppression – struggles that have culminated in the establishment of a successive series of fundamental rights – and the foundation on which the modern legal system is built.

16. Equality before the law and rejection of all forms of discrimination is at the forefront of texts that stipulate, regulate and guarantee human rights. They could be said to represent reference points, constructive elements, interpretation criteria, and options for the protection of all rights. Because of the degree of acceptance they have achieved, they are clear expressions of *jus cogens*, with the peremptory nature that this has over and above general or specific conventions, and with its effects for the determination of obligations *erga omnes*.

17. That idea, stated in *OC-18/2003*, was expressed during the preparatory work. Thus, the *amicus curiae* participation of the Central American Council of Ombudsmen, with the support of its Technical Secretariat, the Inter-American Institute of Human Rights, mentions, in its brief, that “owing to the progressive development of international human rights law, the principle of non-discrimination and the right to equal and effective protection of the law, must be considered norms of *jus cogens* and, in this respect, they are norms of peremptory international law that form part of an international public order (*ordre public*) which cannot be validly opposed by the other norms of international law, and much less the domestic norms of States.” Finally, in the absence of the embodiment and exercise of equality before the law and the rejection of discrimination, it would not be possible to understand human development and assess the present development of law.

18. True equality before the law is not measured by the mere declaration of equality in the law, but must take into account the true conditions of those who are subject to the law. There is no equality when, for example, in order to enter an employment relationship, an agreement is reached by an employer, who has ample resources and knows that he is supported by the law, and the worker, who only has his hands and perceives – or knows perfectly well – that the law does not offer him the support it provides to his counterpart. There is no equality either when there is a powerful defendant, armed with the means to defend himself, and a weak litigant, who lacks instruments to prove and argue his defense, regardless of the reasons and rights that support their respective claims.

19. In such cases, the law must introduce compensation or correction factors. This is what the Inter-American Court stated when, for the purposes of *Advisory Opinion OC-16/99*, it examined the concept of due process – which upholds setting those who are unequal for other reasons on an equal footing and permits just solutions to be reached in both material and procedural relations. I believe that it would be useful to quote a phrase of Francisco Rubio Llorente here, which can be applied to the point that I am making, without detriment to its more general scope. According to this Spanish scholar, all “law is intended to be fair and it is the idea of justice that leads directly to the principle of equality which, in some ways, constitutes its essential content.” Nevertheless, “equality is not a point of departure, but a an end” (“La igualdad en la jurisprudencia del Tribunal Superior,” in *La forma del poder (Estudios sobre la Constitución)*, Centro de Estudios Constitucionales, Madrid, 1993, pp. 644 and 656). The laws that regulate relationships between parties that are socially or economically unequal and the norms and practices of all aspects of judicial proceedings should tend towards and respond to this end.

20. The prohibition to discriminate does not admit exceptions or areas of tolerance that would shelter violations; discrimination is always rejected. In this respect, it is does not matter that the prohibition relates to rights that are considered fundamental, such as those that refer to life, physical integrity or personal freedom, or to rights to which some assign a different ranking or a different importance. It is discriminatory to establish different sanctions for the same offences because the authors belong to determined social, religious or political groups. It is discriminatory to deny access to education to members of an ethnic group and to provide it to members of another group; and it is discriminatory – following the same reasoning – to provide some individuals with all measures of protection that the performance of lawful work merits and deny such measures to other individuals who perform the same activity, on grounds that are unrelated to the work itself, such as those arising from their migratory status.

21. The principles of equality before the law and non-discrimination are put to the test when there is contact between different human groups, that are called on to take part in legal and economic relationships which imperil the rights of those who are weakest or least well equipped, owing to their circumstances and the way in which such relationships are established and developed. This has been seen – and is still seen – in many cases, for the most diverse reasons. Nationals and aliens, men and women, adults and minors, ethnic, cultural, political and religious majorities and minorities, winners and losers in domestic and international conflicts, deeply-rooted groups and displaced groups, are only some examples. This occurs among those who form part of the workforce in their own country and those who participate in the same economic processes alongside them, but lack the status of nationals. This status is a protective shield for some; and its absence is frequently the factor that leads to the exclusion or harm of others.

22. The permanent and uncompromising purpose of the human rights system, and also the ideas on which it is based and the goals it seeks, is to eliminate distances, combat abuses, and guarantee rights; in brief, to establish equality and see that justice is done, not merely for ethical reasons, which would in themselves be relevant, but also in strict compliance with the peremptory norms that do not admit exceptions and oblige all States: *jus cogens* and obligations *erga omnes*. In some cases, valuable although insufficient progress has been made; for example, legal equality between men and women – even though this is not yet a reality for all

– and, in others, such as the area of labor relations, where national and alien workers are involved, there is still much to be done.

23. *OC-18/2003* rejects the opinion suggesting there should be restrictions and reductions in the rights of the individual when he crosses the borders of his own country and moves abroad, as if this journey eroded his human condition and took away a migrant's dignity and, therefore, his rights and freedoms. The United Nations Inter-governmental Working Group of Experts on the Human Rights of Migrants – cited in the *amicus curiae* brief of the Center for Legal and Social Studies (CELS), the Ecumenical Service for the Support and Orientation of Refugees and Immigrants (CAREF) and the Legal Clinic for the Rights of Immigrants and Refugees of the Law School of the Universidad de Buenos Aires – pointed out that “[a]ll persons, regardless of their place of residence, have a right to the full enjoyment of all the rights established in the Universal Declaration of Human Rights. States must respect the fundamental human rights of migrants, irrespective of their legal status.” It added: “[a] basic principle of human rights is the fact of entering a foreign country, violating the immigration laws of that country, does not lead to losing the human rights of an immigrant with an irregular status; nor does it eliminate the obligation of a Member State (in an international instrument) to protect them.” However, this is not always acknowledged. To the contrary, as the representative of the United Nations High Commissioner for Refugees (UNHCR) indicated in his *amicus curiae* statement, when a person is classified as a migrant, “this means that he has no rights and therefore the State, exercising its sovereignty, may expel him, deport him, or violate his basic rights.”

24. This *Advisory Opinion* does not deny the possibility of establishing differences between categories of subjects: reasonable differences, based on objective information, with a view to attaining lawful objectives by legitimate means. Evidently, when regulating access to its territory and permanence in it, a State may establish conditions and requirements that migrants must fulfill. Non-compliance with migratory provisions would entail the relevant consequences, but should not produce effects in areas that are unrelated to the matter of the entry and residence of migrants.

25. In view of the above, it would be unacceptable, for example, to deprive an undocumented person of freedom of thought and expression, merely because he is undocumented. Likewise, it is unacceptable to punish non-compliance with migratory provisions by measures relating to other areas, disregarding the situations created in those areas and the potential effects, completely unrelated to the migratory offence. Taking any other course would, as has indeed occurred, deprive a person of the benefits of work already performed, alleging administrative errors: an expropriation, *lato sensu*, of what the worker has obtained for his work – through an agreement entered into with a third party, which has already produced certain benefits to the latter – which would become undue profit if the different forms of remuneration for the work performed are eliminated.

26. Taking into consideration the characteristics of the general obligations of States under general international law and international human rights law, specifically, with regard to these extremes of *jus cogens*, States must develop, as stated in *OC-18/2003*, specific actions of three mutually complementary types: a) they must ensure, by legislative and other measures – in other words, in every sector of State attributes and functions – the effective (and not only nominal) exercise of the human rights of workers on an equal footing and without any

discrimination; b) they must eliminate provisions, whatever their scope and extent, that lead to undue inequality or discrimination; and c) lastly, they must combat public or private practices that have this same consequence. Only then, can it be said that a State complies with its obligations of *jus cogens* in this area, which, as we have said, does not depend on the State being a party to a specific international convention; and only then would the State be protected from international responsibility arising from non-compliance with international obligations.

27. *OC-18/2003* focuses on rights arising from employment and thus concerning workers. Such rights belong to the category of "economic, social and cultural rights, which some scholars have classified as "second-generation" rights. Nevertheless, whatever their status, bearing in mind their subject matter and also the moment in which they were included, first in constitutional and then in international texts, the truth is they have the same status as the so-called "civil and political" rights. Mutually dependent or conditioned, they are all part of the contemporary statute of the individual; they form a single extensive group, part of the same universe, which would disintegrate if any of them were excluded.

28. Among these rights, the only difference relates to their subject matter, the identity of the property they protect, and the area in which they emerge and prosper. They have the same rank and demand equal respect. They should not be confused with each other; however, it is not possible to ignore their interrelationship, owing to circumstances. For example, let us say that, although the right to work cannot be confused with the right to life, work is a condition of a decent life, and even of life itself: it is a subsistence factor. If access to work is denied, or if a worker is prevented from receiving its benefits, or if the jurisdictional and administrative channels for claiming his rights are obstructed, his life could be endangered and, in any case, he would suffer an impairment of the quality of his life, which is a basic element of both economic, social and cultural rights, and civil and political rights.

29. The human rights of workers, namely, the fundamental labor rights, arise from two sources, which function together: a) the human condition of the owner, which, as I have already said, excludes inadmissible inequalities and discriminations; and b) the employment relationship established between the owner of those rights and the legal person, individual or group, to which he will provide, is about to provide or has provided his services; a relationship that arises from the very fact of providing, being about to provide or having provided a service, regardless of what has been formalized in a contract, which does not exist in many – probably, most – cases, although if it exists – and this is what is really important – it is the determining factor of the employment relationship, which is also a source of rights and obligations.

30. It is necessary to draw attention to these considerations with regard to all those who engage in activities in exchange for remuneration, but principally – since it is the issue being examined in *OC-18/2003* – with regard to those classified as workers, according to the usual description of this category in labor law: persons who provide dependent and subordinate services, and who form part of the most extensive sector of the vulnerable group owing to their migratory status, principally undocumented migrants.

31. The different international instruments, as well as the most progressive national texts, contain lists of labor rights that must be respected and guaranteed;

for example, the Universal Declaration of Human Rights, the American Declaration on the Rights and Duties of Man, the Additional Protocol to the American Convention on Human Rights in the Area of Economic, Social and Cultural Rights (Protocol of San Salvador), the International Convention on the Protection of the Rights of all Migrant Workers and Members of their Families, and the ILO Declaration on Fundamental Principles and Rights at Work (86th Session, Geneva, 1998).

32. These and other instruments coincide in establishing the international standards for labor rights cited in this *Advisory Opinion* and applicable to the law and practice of States, according to this Opinion. Such standards are the product of constant and well-documented development, express the shared opinion of the members of the international juridical community, and are therefore doubly important owing to this circumstance and to the nature of the instruments in which they are enshrined.

33. Certain rights mentioned in the considerations of *OC-18/2003* are particularly important because they are the ones that are generally included in national and international norms, often constitute conditions or elements of other labor rights and, owing to their characteristics, determine the general framework for the provision of services and for the protection and welfare of those who provide them. The corresponding list – which is not exhaustive – includes the prohibition of obligatory or forced labor, the elimination of discriminations in the provisions of labor, the abolition of child labor, the protection of women workers and the rights corresponding to remuneration, the working day, rest and holidays, health and security in the workplace, association to form trade unions and collective negotiation.

34. In the “*Programme of Action*” issued by the World Conference against Racism, Racial Discrimination, Xenophobia and Related Intolerance (Durban, 2001) States were urged to ensure the full equality of migrants in the law, “including labor legislation”, and “to eliminate barriers, where appropriate, to their participation in vocational training, collective bargaining, employment, contracts and trade union activity; access to judicial and administrative tribunals dealing with grievances; seeking employment in different parts of their country of residence; and working in safe and healthy conditions” (*Programme* para. 28). They were also urged to “take all possible measures to promote the full enjoyment by all migrants of all human rights, including those related to fair wages and equal remuneration for work of equal value without distinction of any kind, and to the right to security in the event of unemployment, sickness, disability, widowhood, old age or other lack of livelihood in circumstances beyond their control, social security, including social insurance, access to education, health care, social services and respect for their cultural identity” (*Programme*, para. 30(g)).

35. The mention of these rights in *Advisory Opinion OC-18* is not intended to establish a specific ranking of the human rights of workers, as one group of rights that could constitute the “hard core” and another that might have another nature, in some way secondary or non-essential. The *Opinion* merely highlights certain rights that are important for the employment relationship and for the needs and expectations of undocumented migrant workers and to which special attention should be paid to ensure that they are respected and guaranteed, without lessening the attention that should be paid to other rights not mentioned in the list.

36. Announcing rights without providing guarantees to enforce them is useless. It becomes a sterile formulation that sows expectations and produces frustrations.

Therefore, guarantees must be established that permit: demanding that rights should be recognized, claiming them when they have been disregarded, re-establishing them when they have been violated, and implementing them when their exercise has encountered unjustified obstacles. This is what the principle of equal and rapid access to justice means; namely, the real possibility of access to justice through the means that domestic law provides to all persons, in order to reach a just settlement of a dispute; in other words, formal and genuine access to justice.

37. This access is facilitated by due process, which the Inter-American Court of Human Rights has examined fully in the exercise of its advisory and contentious competence. Strictly speaking, due process is the means to ensure the effective exercise of human rights that is consistent with the most advanced concept of such rights: a method or factor to ensure the effectiveness of law as a whole and of subjective rights in specific cases. Due process – a dynamic concept guided and developed under a guarantee model that serves individual and social interests and rights, and also the supreme interest of justice – is a guiding principle for the proper resolution of legal actions and a fundamental right of all persons. It is applied to settle disputes of any nature – including labor disputes – and to the claims and complaints submitted to any authority: judicial or administrative.

38. Due process, for the purpose that interests us in *OC-18/2003*, entails, on the one hand, the greatest equality – balance, “equality of weapons” – between the litigants, and this is particularly important when on one side of the dispute is the vulnerable migrant worker and on the other the employer endowed with ample and effective rights, an equality that is only obtained – in most cases that reflect the true dimension of the collective problem – when the public authorities incorporate the elements of compensation or correction that I have mentioned above, through laws and criteria for interpretation and implementation; and, on the other hand, clear and flexible compliance with the State’s obligation to provide a service of justice without distinction, much less discrimination, which would entail the defeat of the weaker party at the very outset.

39. The clarifications in *OC-18/2003* have particular relevance. Indeed, undocumented workers usually face severe problems of effective access to justice. These problems are due not only to cultural factors and lack of adequate resources or knowledge to claim protection from the authorities with competence to provide it, but also to the existence of norms or practices that obstruct or limit delivery of justice by the State. This happens because the request for justice can lead to reprisals against the applicants by authorities or individuals, measures of coercion or detention, threats of deportation, imprisonment or other measures that, unfortunately, are frequently experienced by undocumented migrants. Thus, the exercise of a fundamental human right – access to justice – culminates in the denial of many rights. It should be indicated that even where coercive measures or sanctions are implemented based on migratory provisions – such as deportation or expulsion – the person concerned retains all the rights that correspond to him for work performed, because their source is unrelated to the migratory problem and stems from the work performed.

40. The *Advisory Opinion*, with which I agree in this *separate opinion*, deals with the issue of public policies posed in the questions raised by the requesting State. In this respect, it is acknowledged that States have the authority to adopt public policies – which are expressed in laws, regulations and other norms, plans, programs and different acts – in order to achieve legitimate collective goals. These policies

include those relating to demographic processes, which involve migratory issues, in addition to those relating to the management of the economy, the use of the workforce, the promotion of certain productive activities, the protection of specific sectors of agriculture, industry, commerce and services, and others.

41. There is a problem, however, when some specific aspects of State policy enter into conflict with the human rights of a certain sector of the population. Obviously, this should never occur. It is one of the State's functions – which responds to its democratic vocation and recognizes and guarantees the human rights of its inhabitants – to implement the various public policies so that these rights are preserved and, at the same time, the legitimate objectives for which those policies were designed are achieved. Let me repeat that achieving a commendable end does not justify using unlawful means. In such cases, the State's essential commitment to human rights prevails, because the guarantee of human rights is an underlying principle of the political structure, as has been stated constantly in the principal political texts of the modern era, produced by the major rebel and revolutionary movements of the United States and France in the latter part of the eighteenth century. If this is the essential ethical and legal basis of politics, a State cannot violate the human rights of the persons subject to its jurisdiction on the basis of specific policies.

42. On these grounds, *Advisory Opinion OC-18/2003* refers to several agreements of the international community – evidently based on profound convictions – with regard to migratory policies, the subject of the request submitted by the United Mexican States. In this respect, the “*Declaration*” and the “*Programme of Action*” resulting from the Durban Conference, and the corresponding resolution of the United Nations Human Rights Commission (Res. 2001/5) should be underscored; they are all mentioned by the Inter-American Court in the *Advisory Opinion*. The Declaration affirms the right of States to adopt their own migration policies and also that “these policies should be consistent with applicable human rights instruments, norms and standards” (*Declaration*, para. 47).

43. It would be unrealistic to believe that the opinion of a jurisdictional body – even though it is supported by the convictions and decisions of States representing hundreds of millions of individuals in this hemisphere – and the trend towards progress with justice that inspires many men and women of good will, could, in the short-term, reverse obsolete tendencies that are rooted in deep prejudices and sizeable interests. However, when combined, these forces can play their role in man's effort to move mountains. Making this effort and succeeding requires the adoption – as was said in Durban – of strategies, policies, programs and measures that are part of the “responsibility of all the States, with the full participation of civil society, at the national, regional and international level” (*Declaration*, para. 122). *OC-18/2003* fulfills its particular mandate in this effort. It does so, as corresponds to this Court, from its own specific position: the legal one, based on the principles that are at the root of the international human rights system.

Sergio García-Ramírez  
Judge



Manuel E. Ventura-Robles  
Secretary

## CONCURRING OPINION OF JUDGE HERNÁN SALGADO PESANTES

This Advisory Opinion, requested by the State of Mexico and enhanced by the opinions of other States and the intellectual contribution of non-governmental organizations, allowed us to reflect on numerous issues, some of which I would like to take up again in support of the opinions expressed therein.

1. In light of the interrelation and indivisibility of human rights, equality and non-discrimination are rights that form a platform on which others are erected, particularly economic, social and cultural rights, whose content cannot omit the former. The same is true in the case of freedom.

2. Non-discrimination is inseparable from equality and determines the scope of the former. At the current stage in the development of human rights, I believe that equality and non-discrimination are two rights with an autonomous content that have a separate existence within this framework of indivisible interrelation.

3. In recognition of the diversity of human beings, it is acknowledged that equality accepts and promotes certain distinctions, provided they tend to increase rather than prevent the enjoyment and exercise of all rights, including equality itself. Consequently, such distinctions do not affect the right to non-discrimination; nor do they restrict the concept of equality.

4. In the context of this Opinion, the Court has differentiated between distinction and discrimination (paragraph 84) and has indicated the characteristic elements of the former, on which I would like to insist.

5. The concept of distinction refers to a treatment that is different from the one generally applied; in other words, a specific situation is singularized for certain reasons. To ensure that distinction does not become discrimination, the following requirements, established by human rights case law and theory, must be fulfilled.

6. It should pursue a legitimate goal and it should be objective, in the sense that there is a substantial and not merely formal difference, because, as this Court has indicated, distinction in treatment should be founded on "*substantial factual differences and [...] a reasonable relationship of proportionality between these differences and the aims of the legal rule under review.*"<sup>207</sup>

7. In addition, the difference must be relevant, have sufficient importance to justify a different treatment, and be necessary and not merely convenient or useful. For example, the difference between a man and a woman is not sufficient to impose a different treatment in the workplace, but the fact of pregnancy and maternity is.

8. There must be proportionality between the factual and juridical difference, between the chosen means and the ends; disproportion between the content of the different treatment and the proposed goal leads to discrimination. For example, in order to sustain a labor policy, it is decided that undocumented workers should be stripped of their fundamental rights.

9. Together with proportionality, appropriateness and relevance are usually

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<sup>207</sup> ICourTHR., *Proposed Amendments to the Naturalization Provisions of the Constitution of Costa Rica*. Advisory Opinion OC-4/84 of January 19, 1984. Series A No. 4, para. 57.

indicated, as regards the desired juridical consequences of the differentiated treatment, taking into account the concrete and actual circumstances in which the distinction will be applied.

10. But there is a common denominator with regard to the preceding elements, which fine tunes the content and scope of the other elements, and that is reasonableness. The use of these elements allows us to identify the presence of discrimination in a "suspect category," represented in this case by the undocumented migrant workers.

11. Undocumented migrant workers have – as has any human being – the rights to equality before the law and not to be discriminated against.

12. Equality before the law means that they must be treated in the same way as documented migrants and nationals before the law of the receiving country. The prohibition to work has to be considered in this context. The condition of undocumented worker can never become grounds for not having access to justice and due process of law, for failing to receive earned salaries, for not having social security benefits and for being the object of various forms of abuse and arbitrariness.

13. Such situations illustrate the existence of a series of discriminatory treatments that those responsible seek to found on the distinction between documented and undocumented.

14. As the Advisory Opinion states, this difference in treatment is neither justified, necessary nor proportionate, and its effects are not reasonable; it is at odds with the State's main function, which is to respect and ensure the rights of every individual who, for labor-related reasons, and with or without documents, is subject to its jurisdiction.

15. It should be borne in mind that grave violations of rights, as in the case of the undocumented migrant workers, end up by seriously affecting the right to life. In this respect, the Inter-American Court has stated that life includes, "*not only the right of every human being not to be deprived of his life arbitrarily, but also the right that he will not be prevented from having access to the conditions that guarantee a dignified existence.*"<sup>208</sup>

16. It is worth emphasizing that, as in the case of the other rights, the obligation to respect and ensure equality and non-discrimination embodied in international human rights law – with its treaties and case law – is also a non-derogable obligation in the domestic law of constitutional and democratic States.

17. I consider that an extremely important point in this Advisory Opinion is that of establishing clearly the effectiveness of human rights with regard to third parties, in a horizontal conception. These aspects, as is acknowledged, have been amply developed in German legal writings (*Drittwirkung*) and are contained in current constitutionalism.

18. It is not only the State that has the obligation to respect human rights, but

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<sup>208</sup> ICourtHR., the *Case of the "Street Children" (Villagrán Morales et al.)*. Judgment of November 19, 1999. Series C No. 63, para. 144.

also individuals in their relationships with other individuals. The environment of free will that prevails in private law cannot become an obstacle that dilutes the binding effectiveness *erga omnes* of human rights.

19. The possessors of human rights – in addition to the State (the public sphere) – are also third parties (the private sphere), who may violate such rights in the ambit of individual relationships. For the purposes of this Opinion, we are limiting ourselves basically to the workplace where it has been established that the rights to equality and non-discrimination are being violated.

20. Labor rights as a whole acquire real importance in relationships between individuals; consequently, they must be binding with regard to third parties. To this end, all States must adopt legislative or administrative measures to impede such violations and procedural instruments should be effective and prompt.

21. At the level of international responsibility, any violation of rights committed by individuals will be attributed to the State, if the latter has not taken effective measures to prevent such violation or tolerates it or permits the authors to remain unpunished.

22. The foregoing signifies that international human rights instruments also produce binding effects with regard to third parties. Likewise, the responsibility of the individual has a bearing on and affects that of the State.

I have participated in this Advisory Opinion, like my colleagues, aware of its importance for the countries of our hemisphere.

Hernán Salgado-Pesantes  
Judge

Manuel E. Ventura-Robles  
Secretary

## CONCURRING OPINION OF JUDGE ALIRIO ABREU BURELLI

While being of the same opinion as the other judges of the Inter-American Court of Human Rights in rendering this Advisory Opinion, I wish to submit the following considerations separately:

### I

On this occasion, the Court has defined the scope of the obligation of the member States of the Organization of American States to respect and guarantee the labor rights of undocumented migrant workers, irrespective of their nationality, by establishing that the principle of equality and non-discrimination, which is fundamental for the safeguard of those rights, belongs to *ius cogens*<sup>209</sup>.

This definition also leads the Court to declare that, regardless of whether or not States are party to a specific international treaty, they are obliged to protect the right to equality and non-discrimination and that this obligation has effects *erga omnes*, not only with regard to the States, but also with regard to third parties and individuals. Consequently, States must respect and guarantee the labor rights of workers, whatever their migratory status and, at the same time, must prevent private employers from violating the rights of undocumented migrant workers and the employment relationship from violating minimum international standards. For the protection of the labor rights of undocumented migrants to be effective, such workers must be guaranteed access to justice and due process of law<sup>210</sup>.

A State's observance of the principle of equality and non-discrimination and the right to due process of law cannot be subordinated to its policy goals, whatever these may be, including those of a migratory character.

By voting in favor of the adoption of this Opinion, I am aware of its particular importance in endeavoring to provide legal answers, in international law, to the grave problem of the violation of the human rights of migrant workers. In general, despite their non-contentious nature, Advisory Opinions have indisputable effects on both the legislative and administrative acts of States and on the interpretation and application of laws and human rights treaties by judges, owing to their moral authority and the principle of good faith on which the international treaties that authorize them are based.

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<sup>209</sup> According to the European Court of Human Rights, the affirmation that the principle of equality and non-discrimination belongs to the domain of *ius cogens* has several legal effects: recognition that the norm ranks higher than any norm of international law, except other norms of *ius cogens*; in case of dispute, the norm of *ius cogens* would prevail over any other norm of international law, and the provision that contradicts the peremptory norm would be null or lack legal effects. (Taken from the arguments of the Legal Clinics of the College of Jurisprudence of the Universidad San Francisco, Quito).

<sup>210</sup> In Advisory Opinion OC-16/99 of October 1, 1999, the Inter-American Court of Human Rights indicated that "for 'the due process of law' a defendant must be able to exercise his rights and defend his interests effectively and in full procedural equality with other defendants. It is important to recall that the judicial process is a means to ensure, insofar as possible, an equitable resolution of a difference. The body of procedures, of diverse character and generally grouped under the heading of the due process, is all calculated to serve that end. To protect the individual and see justice done, the historical development of the judicial process has introduced new procedural rights. An example of the evolutive nature of judicial process are the rights not to incriminate oneself and to have an attorney present when one speaks. These two rights are already part of the laws and jurisprudence of the more advanced legal systems. And so, the body of judicial guarantees given in Article 14 of the International Covenant on Civil and Political Rights has evolved gradually. It is a body of judicial guarantees to which others of the same character, conferred by various instruments of international law, can and should be added.

## II

In this Opinion, the Court has ruled on the rights that States must recognize and apply to workers who, due to different circumstances, emigrate from their countries in search of economic well-being, and who, because they do not have legal migratory status, may become victims of violations of such rights as their labor rights, and their rights to decent treatment, equality and non-discrimination. In this respect, the State that requested the Court to render an Opinion referred specifically to the fact that almost six million Mexican workers are outside national territory; and, of these, approximately two and a half million are undocumented migrant workers. It added that "in less than five months (in 2002), the Government of Mexico had to intervene, through its consular representatives, in the defense of the human rights of Mexican nationals in approximately 383 cases, in order to protect migrant workers with regard to employment-related discrimination, unpaid wages, and compensation for occupational illnesses and accidents, among others matters."

Likewise, Judge Antonio Cançado Trindade, in a study on enforced migratory flows, indicated that "... migrants seeking work and better living conditions amount to 80 million human beings today... The causes of forced migrations are basically no different from those of population displacement. In a 1992 analytical report on internally displaced persons, the Secretary General of the United Nations identified natural disasters, armed conflict, generalized violence and systematic human rights violations among the causes of massive involuntary migrations within State borders."<sup>211</sup>

According to Judge Cançado Trindade, other causes of massive migrations are, "the multiple internal conflicts, of an ethnic and religious nature, repressed in the past but set in motion in recent years. These are supplemented by the increase in chronic poverty, which, according to the United Nations Development Programme, today affects more than 270 million persons in Latin America alone... ." According to a report of the United Nations human rights body<sup>212</sup>, the causes of contemporary migrations in search of work are fundamentally poverty and the inability to earn or produce enough for personal or family subsistence in the country of origin. These reasons characterize not only migration from poor States to rich ones; poverty also encourages movement from developing countries to other countries where the work prospects appear to be better, at least from a distance. According to this report, there are other reasons that explain the departure abroad in search of work. War, civil conflict, insecurity or persecution derived from discrimination due to race, ethnic origin, color, religion, language or political opinions are all factors that contribute to the flow of migrant workers.

## III

Limited to the strictly juridical sphere, established by regulatory, statutory and convention-related instruments that govern its proceedings, in exercise of its competence, the Court cannot go beyond the interpretation and application of legal norms in its judgments and advisory opinions. However, it is impossible to prevent the human tragedy underlying the cases it hears from being reflected in the Court's proceedings and reports. Frequently, the statements of the victims or of their next

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<sup>211</sup> Cançado Trindade, Antônio A. "Elementos para un Enfoque de Derechos Humanos del Fenómeno de los Flujos Migratorios Forzados". Publication of the International Organization for Migrations and the Inter-American Institute of Human Rights. Guatemala 2001, p. 11.

<sup>212</sup> Cited by Antônio Cançado Trindade, ob. cit., p. 12.

of kin, who resort to the Court seeking justice, have moved the judges profoundly. The arbitrary death of children, of youth or, in general, of any person; enforced disappearance; torture; illegal imprisonment, and other human rights violations, submitted to the Court's consideration and decision, cannot be resolved by mere legal concepts; not even bearing in mind the Court's efforts to try and provide reparations for the damages suffered by the victims that go beyond monetary compensation. It continues to be an ideal – whose achievement depends on the development of a new collective conception of justice – that these violations should never be repeated and that, if they are, their authors should be severely punished. In this Opinion, stated in concrete legal – but also humanistic – terms, and taking into account the international obligations assumed by States, the Court has defined the conduct that States should observe in order to respect and guarantee the rights of undocumented migrants, to prevent them from becoming victims of exploitation or discrimination in the enjoyment and exercise of their labor rights. It is a ruling of the Court on the interpretation and application of norms that are in force and that are universally accepted because they are grounded on principles of *ius cogens*, that obliges all States equally; however, this ruling also contains an implicit call for social justice and human solidarity.

#### IV

In particular – and due to the possibility of doing so in this separate opinion – I consider that the tragedy represented in each case of forced migration, whatever its cause, cannot be bypassed for mere juridical considerations. Thus, the tragedy of all those who, against their will, abandon their country of origin, their home, their parents, their spouse, their children, their memories, in order to confront generally hostile conditions and become the target of human and labor exploitation owing to their particularly vulnerable situation, should give us cause for reflection. In addition to trying to repair the consequences of forced migrations, through instruments of international law, the creation of courts, migratory policies and administrative or other measures, the international community should also concern itself with investigating the real causes of migration and ensure that people are not forced to emigrate. In this way, it would be discovered that, apart from inevitable natural events, on many occasions migrations are the result of the impoverishment of countries, due to erroneous economic policies, which exclude numerous sectors of the population, together with the generalized fact of corruption. Other factors include dictatorships or populist regimes; irrational extraction from poor countries of raw materials for processing abroad by transnational companies, and the exploitation of workers with the tolerance and complicity of Governments; vast social and economic imbalances and injustice; lack of national educational policies that cover the entire population, guaranteeing professional development and training for productive work; excessive publicity which leads to consumerism and the illusion of well-being in highly developed countries; absence of genuine international cooperation in the national development plans; and macro-economic development policies that ignore social justice.

Faced with the magnitude of these problems, proposals have been formulated, some addressed at the construction of a new international order based on justice and the strengthening of democracy. In his book "El derecho Internacional de los Derechos Humanos en el siglo XXI", Judge Cançado Trindade considers that "... according to recent information from UNDP and CEPAL, the current phenomenon of *impoverishment*, and of the significant growth of contingents of "new poor" in so many Latin American countries, reveals the failure to observe, and even the

generalized violation of, economic, social and cultural rights. Certain rights, of an economic and social nature, such as the rights not to be submitted to forced labor or to discrimination in relation to employment, and also freedom of association to form labor unions, are closely linked to the so-called civil liberties... The 1992 Human Development Report of the United Nations Development Programme (UNDP) indicates that 'democracy and freedom depend on much more than the vote'. The expansion of democracy has been complemented by a greater acknowledgment of human rights. In brief, there are no human rights without democracy, as there is no democracy without human rights... Participative democracy and, in the final analysis, human development itself, are only possible within the framework of human rights... Today, the concept of democracy embraces both political democracy (with an emphasis on formal democratic processes) and "development democracy; in the latter, 'civil and political rights are considered vehicles for the advancement of the equality of conditions, and not merely opportunities.' ...The interrelation of human rights and democracy nowadays finds expression in the provisions of general human rights instruments at the global and regional level."<sup>213</sup>

In Advisory Opinion OC-9/87 of October 6, 1987, the Court indicated, as it had in previous Opinions (OC-5/85, OC-6/86, OC-8/87), that the rule of law, democracy and personal freedom are consubstantial with the regime of human rights protection contained in the Convention and added: "In a democratic society, the rights and freedoms inherent in the human person, the guarantees applicable to them and the rule of law form a triad. Each component thereof defines itself, complements and depends on the others for its meaning."

It is possible that the establishment of a just society begins with the strengthening of a genuine democracy that fully guarantees the dignity of the human being.

Alirio Abreu-Burelli  
Judge

Manuel E. Ventura-Robles  
Secretary

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<sup>213</sup> Cançado Trindade, Antônio A. "El Derecho Internacional de los Derechos Humanos en el siglo XXI", Editorial Jurídica de Chile, 2001.



## **LEGAL AUTHORITY CA-81**

**IN A NAFTA ARBITRATION UNDER THE UNCITRAL ARBITRATION RULES**

**S.D. Myers, Inc.**  
**(Claimant)**

**-and-**

**Government of Canada**  
**(Respondent)**

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**PARTIAL AWARD**

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## **CHAPTER I**

### **PREFACE**

#### **The parties**

1. The Claimant S.D. Myers, Inc. (“SDMI”) is a privately held corporation established and existing in the State of Ohio, United States of America (“USA”).
2. SDMI has its principal place of business at 180 South Avenue, Tallmadge, Ohio 44278, USA.
3. The Respondent is the Government of Canada (“CANADA”), having its address for service at the Office of the Deputy Attorney-General of Canada, Justice Building, 248 Wellington Street Ottawa, Ontario, KIA OH8, Canada.
4. CANADA is a Party to the North American Free Trade Agreement (the “NAFTA”).

#### **The Existence of a Dispute**

5. SDMI claims that it was an “Investor” in Canada and that it owned an “Investment” in Canada as defined in the NAFTA.
6. CANADA denies that SDMI was an “Investor” or that it owned an “Investment”.
7. SDMI claims that it has suffered loss or damage as a result of one or more breaches by CANADA of its obligations under Chapter 11 of the NAFTA.

8. CANADA denies that it was in breach of its obligations under the NAFTA or that SDMI suffered any loss or damage.

### **The Disputes Resolution Provisions**

9. Part B of Chapter 11 of the NAFTA (Articles 1115 to 1138) contains the relevant disputes resolution provisions.
10. On July 22, 1998 SDMI delivered a Notice of Intent to Submit a Claim to Arbitration under Part B of Chapter 11 of the NAFTA.
11. Pursuant to Article 1120 of the NAFTA, SDMI elected to submit its claims under the UNCITRAL Arbitration Rules 1976 (the “Rules”).
12. On October 30, 1998 SDMI delivered a Notice of Arbitration pursuant to Article 3 of the Rules. The arbitration is deemed to have been “commenced” on that date pursuant to Article 3.1 of the Rules.
13. By letter dated November 6, 1998 CANADA notified SDMI that Ms. Valerie Hughes was appointed as CANADA’s representative pursuant to Article 4 of the Rules.

### **The Tribunal**

14. On January 11, 1999 SDMI nominated Professor Bryan Schwartz of Winnipeg, Manitoba, to be the arbitrator appointed by it pursuant to Article 1123 of the NAFTA.
15. On January 27, 1999 CANADA nominated Mr. Bob Rae of Toronto, Ontario, to be the arbitrator appointed by it pursuant to Article 1123 of the NAFTA.

16. By letter dated February 16, 1999 the Disputing Parties jointly invited Professor J. Martin Hunter of London, England to accept appointment as the third and presiding arbitrator. On March 2, 1999 Professor Hunter and the representatives of the Disputing Parties held a telephone conference.
17. By letter dated March 4, 1999 Professor Hunter formally confirmed to the Disputing Parties' representatives his acceptance of appointment as presiding arbitrator.
18. The Tribunal was thus duly constituted and became seized of the arbitration on March 4, 1999.

### **Abbreviations**

19. The following abbreviations are adopted in this award:

BITs	Bilateral Investment Treaties
Basel Convention Hazardous Waste and Their Disposal	convention on the Control of Transboundary Movements of Hazardous Waste and Their Disposal (adopted 1989, in force May 5, 1992, ratified by CANADA August 29, 1992, in force for Canada November 26, 1992)
CANADA	The Government of CANADA
CCME	Canadian Council of Ministers of the Environment
CEPA	Canadian Environmental Protection Act 1995
Chem-Security	Chem-Security (Alberta) Ltd.
Disputing Parties	SDMI and CANADA
FIRA	The Foreign Investment Review Act
GATT	General Agreement on Tariffs and Trade
ICSID	International Centre for the Settlement of Investment Disputes
MEXICO	The United States of Mexico
Myers Canada	S.D. Myers (Canada), Inc.
NAAEC	The North American Agreement on Environmental Co-operation
NAFTA	The North American Free Trade Agreement

OECD	Organization for Economic Co-operation and Development
Parties	CANADA, MEXICO and the USA
PCB	Polychlorinated biphenyl
PCO	Privy Council Office of CANADA
PO	Procedural Order
Rules	UNCITRAL Arbitration Rules 1976
SDMI	S.D. Myers, Inc.
TCSA	Toxic Controlled Substances Act
Transboundary Agreement	CANADA-USA Transboundary Agreement on Hazardous Waste
UNCITRAL	United Nations Commission on International trade Law
US EPA	United States Environmental Protection Agency
U.S. or USA	The United States of America
WTO	The World Trade Organization

**CHAPTER II**  
**HISTORY OF THE PROCEEDINGS**

20. By letter dated March 8, 1999 CANADA requested the consent of the Tribunal to its constitution and membership being made public. By letter dated March 24, 1999 the Tribunal confirmed that it had no objection to the existence of the arbitration and the names of its members being placed in the public domain.
21. By the same letter dated March 24, 1999 the Tribunal sent an “agenda of procedural matters” to the Disputing Parties in order to ascertain the extent that they were agreed on the overall procedural structure for the arbitration.
22. By letter dated April 19, 1999, having considered the replies of the Disputing Parties to the Tribunal’s agenda of procedural matters, the Tribunal informed the Disputing Parties that there appeared to be some unresolved fundamental procedural issues between them and that a meeting between the Tribunal and the Disputing Parties should be held before the Tribunal made an order designed to establish the procedural structure for the arbitration.
23. By letter dated April 22, 1999 the Tribunal notified the Disputing Parties that it would hold a first case management meeting with them in Toronto, on May 20, 1999.
24. By letter dated May 3, 1999 the Tribunal sent a provisional draft Procedural Order No. 1 to the Disputing Parties to act as an agenda for the first case management meeting.
25. By letter dated May 11, 1999 SDMI, while not alleging actual bias, submitted a challenge under Article 12.1 of the Rules to the Secretary-General of ICSID (in his capacity as appointing authority), objecting to the continued participation of Mr. Rae as a member of the Tribunal on the ground of an appearance of lack of independence because Mr. Rae was a registered lobbyist.



26. On May 20, 1999 the first case management meeting was held, in Toronto.
27. By letter dated May 28, 1999 the Tribunal issued Procedural Order No. 1 (establishing an overall procedural framework for the arbitration) and Procedural Order No. 2 (dealing with the confidentiality of certain documents prepared by the Disputing Parties in connection with the arbitration).
28. By letter dated June 2, 1999 the Secretary-General of ICSID informed the Tribunal and the Disputing Parties that he would uphold the challenge of Mr. Rae unless he discontinued his activities as a registered lobbyist in connection with the Softwood Lumber Agreement between the USA and CANADA.
29. By letter dated June 3, 1999 Mr. Rae notified his resignation from the Tribunal to the Secretary-General of ICSID.
30. By letter dated June 10, 1999 the Tribunal issued Procedural Order No. 3, which amended Procedural Order No. 2 at the request of CANADA.
31. By letter dated June 18, 1999 CANADA (having been granted a short extension of time) submitted its Statement of Defence pursuant to Article 19 of the Rules. (SDMI had delivered its Statement of Claim under Article 18 of the Rules, with its Notice of Arbitration on October 30, 1998, before the Tribunal had been established.)
32. By letter dated June 24, 1999 CANADA notified the Tribunal and SDMI that it designated Mr. Edward C. Chiasson Q.C. of Vancouver, British Columbia, as the arbitrator to replace Mr. Bob Rae pursuant to Article 13 of the Rules. The newly constituted Tribunal determined pursuant to Article 4 of the Rules that it would not be necessary to repeat any part of the proceedings.

33. By letter dated July 6, 1999 the Tribunal issued Procedural Order No. 4, which extended the period of time for which Procedural Order No. 3 would remain effective.
34. By letter dated July 20, 1999 SDMI submitted its Memorial and its Reply to CANADA's Statement of Defence.
35. On July 28, 1999 the Tribunal held a telephone conference call with the representatives of the Disputing Parties for the purpose of hearing argument on issues that had arisen between them as to the scope of the documents to be produced pursuant to requests made under the relevant provisions of Procedural Order No. 1.
36. On the same day, July 28, 1999, after deliberations, the Tribunal issued Procedural Order No. 5. This Order established a procedure for the determination of disputes arising from the requests for document production under the provisions of Procedural Order No. 1.
37. On September 2, 1999 a second case management meeting was held, in Toronto.
38. By letter dated September 4, 1999 the Tribunal issued Procedural Order No. 6 concerning matters arising from requests for the production of documents and certain other matters arising out of procedural Order No. 1.
39. By letter dated September 17, 1999 the Clerk of the Privy Council of CANADA notified the Tribunal that CANADA claimed Crown privilege<sup>1</sup> in respect of certain documents ordered to be produced by Procedural Order No. 6.
40. By letter dated September 19, 1999 with the consent of the Disputing Parties, the Tribunal wrote to the other NAFTA Parties (MEXICO and the USA) to:

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<sup>1</sup> In the international context this is equivalent to state or cabinet privilege.

*...enquire whether your Government wishes to make any submissions to the Tribunal in this arbitration; and, if so, to establish an appropriate procedure that will ensure the orderly and expeditious future conduct of the proceedings*

41. By letter dated September 23, 1999 CANADA sought certain urgent procedural directions from the Tribunal.
42. By letter dated October 4, 1999 the Tribunal issued Procedural Order No. 7, which contained determinations on the outstanding procedural issues.
43. By letter dated October 5, 1999 following a request by CANADA, the Tribunal communicated to the Disputing Parties a summary of its reasons for the decisions contained in Procedural Order No. 7.
44. By letter dated October 8, 1999 MEXICO notified the Tribunal that it would send representatives to the third case management meeting scheduled for October 28, 1999 and by letter of the same date, the USA notified the Tribunal that it also would send representatives to the third case management meeting.
45. On October 28, 1999 a third case management meeting was held in Toronto. Representatives of MEXICO and the USA were present in addition to the representatives of the Disputing Parties.
46. By letter dated October 31, 1999 the Tribunal issued Procedural Order No. 8 and also confirmed that the Tribunal accepted the basis for calculation of arbitrators' fees proposed by the Disputing Parties.
47. By letter dated November 1, 1999 the Tribunal confirmed to MEXICO and the USA the procedural arrangements it proposed in respect of their participation in the arbitration.

48. By letter dated November 4, 1999 the Tribunal issued Procedural Order No. 9, which gave further directions concerning document production, witness testimony and an option to the parties to deliver Supplemental Memorials.
49. By letter dated November 11, 1999 the Tribunal issued Procedural Order No. 11 concerning confidentiality in materials produced in the arbitration.
50. By letter dated November 16, 1999 the Tribunal sent to the Disputing Parties Procedural Order No. 10 concerning CANADA's claims in respect of Crown privilege, together with an explanatory note.
51. By letter dated November 26, 1999 the Tribunal issued Procedural Order No. 12, concerning written questions to be addressed to certain witnesses.
52. By letter dated December 10, 1999 CANADA delivered the affidavits of Messrs. Plummer, Mayne and Fosbrooke, as directed by Procedural Order No. 12.
53. By letter dated December 10, 1999 the Clerk of the Privy Council of Canada notified the Tribunal that CANADA claimed Crown privilege in relation to the documents listed in a schedule attached to his letter.
54. By letter dated December 13, 1999 CANADA delivered to SDMI a list of "severed documents" as well as the documents themselves. By the same letter CANADA confirmed its belief that it had by that date fully complied with the Procedural Orders Nos. 9 and 10.
55. By letter dated December 14, 1999 SDMI delivered its Supplemental Memorial.
56. By letter dated December 14, 1999 CANADA delivered its Supplemental Memorial.

57. By letter dated December 22, 1999 CANADA requested the Tribunal to give directions for the exchange of reports of expert witnesses on U.S. law and their examination at the hearing.
58. By letter dated December 22, 1999 SDMI objected to the introduction of expert testimony at this stage of the proceedings.
59. By letter dated December 23, 1999 CANADA replied to SDMI's objections concerning the introduction of expert testimony on U.S. law.
60. By letter dated December 31, 1999 the Tribunal notified the Disputing Parties that it expected to receive argument on U.S. law issues through counsel (or co-counsel) at the hearing rather than through expert witnesses and in Procedural Order No. 13 gave the Tribunal's directions for the exchange of "Memoranda on U.S. Law Issues".
61. By letter dated January 14, 2000 MEXICO delivered its Submission pursuant to Article 1128 of the NAFTA.
62. By letter dated January 14, 2000 CANADA's U.S. co-counsel, Garvey, Schubert & Barer, delivered CANADA's Memorandum on U.S. Law Issues.
63. By letter dated January 18, 2000 CANADA notified SDMI and the Tribunal that neither of the disputing parties in the NAFTA Chapter 11 Arbitral Tribunal in *Metalclad -v- MEXICO* arbitration objected to the release to SDMI of the Notice of Claim in that case, and attached a copy of that document.
64. By letter dated January 24, 2000 the Tribunal issued Procedural Order No. 14, notifying the Disputing Parties of certain detailed directions for the conduct of the hearing.

65. By a further letter dated January 24, 2000, in reply to certain questions raised by the Disputing Parties, the Tribunal issued Procedural Order No. 16 giving supplementary directions concerning the duration of the hearing, time limits for cross-examination and counsels' opening statements.
66. By letter dated January 24, 2000 SDMI delivered its Pre-Hearing Memorandum pursuant to paragraph 22 of Procedural Order No. 1 and a brief reply to CANADA's Supplemental Memorial pursuant to paragraph 13 of Procedural Order No. 9.
67. By letter dated January 24, 2000 CANADA delivered its Pre-Hearing Memorandum pursuant to paragraph 22 of Procedural Order No. 1.
68. By letter dated January 25, 2000 CANADA requested further directions concerning the cross-examination of witnesses, including the unavailability of Mr. Roy Hickman to be present in person.
69. By letter dated January 28, 2000 SDMI delivered a Response to MEXICO's Submission dated January 14, 2000.
70. By letter dated January 31, 2000 the Tribunal issued further directions concerning the matters raised by CANADA in its letter of January 25 2000, introducing those directions with the following paragraph:

*The Tribunal considers that the general principle to be applied is that, where written direct testimony is submitted with a memorial as evidence on which the relevant party relies, the witness in question should be offered for oral examination at the witness hearings unless the opposing party states that his or her presence is not required. Where a party fails or refuses to produce any such witness the written testimony will not be ruled inadmissible, but the Tribunal is likely to attach little or no weight to the written testimony concerned to the extent that it is not corroborated by other documentary or witness evidence. However, exceptional circumstances may justify exceptional measures, especially where the*

*Tribunal itself wishes to have the benefit of hearing a particular witness 'live'. Applying this principle to the present circumstances the Tribunal directs as follows:...*

71. By letter dated February 4, 2000 SDMI raised certain matters concerning the directions given in Procedural Order No. 16.
72. By letter dated February 4, 2000 CANADA raised certain matters concerning MEXICO's Submission.
73. By letter dated February 4, 2000 SDMI replied to the matters raised by CANADA concerning MEXICO's Submission and also raised certain matters concerning the confidentiality of material prepared for and submitted in the arbitration.
74. By letter dated February 6, 2000 CANADA raised certain matters concerning the requests for the examination of witnesses at the hearing.
75. By letter dated February 7, 2000 SDMI delivered its Reply Memorandum on U.S. Law Issues pursuant to Procedural Order No. 13.
76. By letter dated February 8, 2000 the Tribunal replied to the parties' several letters dated February 4, 6 and 7, 2000 in order to resolve certain "eleventh hour" procedural matters raised by the parties.
77. By letter dated February 11, 2000 MEXICO notified the Tribunal that Messrs. Luis Ernesto Gonzalez Rojas and J. Cameron Mowatt would attend the hearing.
78. By letter dated February 11, 2000 the USA notified the Tribunal that Ms. Andrea J. Mcnaker would attend the hearing.

79. The substantive hearing took place in Toronto on February 14, 15 and 16, 2000. SDMI was represented by Mr. Barry Appleton and his colleagues, I. Laird, R. Sharma and T. Weiler. CANADA was represented by Mr. Joseph de Pencier and his colleagues B. Evernden, S. Tabet, E. Leroux and F. Fracassi as well as U.S. co-counsel.

80. After short opening statements from counsel for each party the following witnesses were heard:

Rev Michael Valentine  
Mr. Seth Myers  
Mr. Dana Myers  
Mr. John Mylicki  
Mr. Vic Shantora

(listed in order of appearance)

81. Closing statements by counsel for the Disputing Parties, CANADA's U.S. co-counsel and an oral statement by Mr. Cameron Mowatt on behalf of MEXICO were heard on February 16, 2000.

82. A verbatim transcript of the hearing was prepared and forms part of the record in the arbitration, together with all the other written submissions and documentary and witness evidence presented to the Tribunal during the proceedings.

83. The Tribunal started its deliberations on February 17, 2000 and thereafter deliberated on several occasions.

84. By letter dated July 4, 2000 CANADA delivered to the Tribunal a redacted copy of an Interim Award of the NAFTA Chapter 11 Arbitral Tribunal in *Pope & Talbot v. Government of Canada* together with a request that the Tribunal should give procedural directions for the Disputing Parties and the Parties to have an opportunity to make further written submissions.



85. By letter dated July 6, 2000 SDMI stated that while it had no objection to the Tribunal reading and taking account of this award (or any other international decision), SDMI did object to the Tribunal's deliberations being disrupted by further argument.
  
86. By letter dated August 14, 2000 the Tribunal sent to the Disputing Parties Procedural Order No. 18 concerning CANADA's request for an opportunity to deliver further written argument.
  
87. Where this award is not unanimous, the Tribunal so states and expresses in summary form the views of the minority.

**CHAPTER III**  
**THE FACTUAL BACKGROUND**

88. By the end of the 20th Century Tallmadge, Ohio, had a population of around 15,000. It is not a large community by modern standards. It is situated about 50 kilometres South East of Cleveland, in the suburban environs of Akron, and is approximately 100 kilometres South of that part of the U.S./Canadian border that runs through Lake Erie.
89. Mr. Stanley Myers founded his business in Tallmadge in 1965. At that time he was engaged primarily in maintaining and repairing transformers and other industrial electrical equipment. In due time, the business flourished and became one of the two largest employers in Tallmadge. Later, Stanley Myers handed over ownership of the business to his four sons leaving the eldest, Dana, with 51% of the share capital of the principal company within the group. At the time of the events that gave rise to this arbitration Mr. Dana Myers was chief executive officer of SDMI, which by then had an annual turnover of some \$25 million.
90. Historically, SDMI's core businesses were transformer oil testing, oil reclaiming, and rewinding, rebuilding, manufacturing transformers. It returned to these businesses in 1999 when its PCB remediation activities in the USA were sold. This aspect of the Claimant's business had begun in earnest in the 1980's.<sup>2</sup>
91. PCB remediation in this context consists of analysing equipment and oil to assess the level of contamination, the transportation of the oil or equipment to a facility and the extraction of the PCBs from the materials so transported. The decontaminated components of the equipment and the oil are recycled. The extracted PCBs and PCB waste material then is destroyed.<sup>3</sup>

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<sup>2</sup> Transcript, February 15, 2000, q.475.

<sup>3</sup> Valentine affidavit, paras. 7-12.

92. SDMI's interest in Canada developed in the 1990's as the U.S. market declined. Mr. Dana Myers testified that SDMI went into the Canadian market because *...that's going to extend the usefulness of our facility. It's going to extend our business.*<sup>4</sup> The PCB remediation business was working its way out of existence, because no new PCBs were being manufactured and the world's stockpiled inventory was decreasing as SDMI and its competitors did their work.<sup>5</sup>
93. Although SDMI did give consideration to developing a treatment facility in Canada, the focus of the Canadian project was to obtain PCB waste for treatment by SDMI in its U.S. facility.<sup>6</sup> It was envisaged that Canadian entities would contract for the treatment of their waste in the USA and that Myers Canada would receive a percentage of the contract as its remuneration. The business was done by marketing, customer contact, testing and assessment of oil and other like services. SDMI personnel from the USA participated in these activities.
94. The term "PCB" is an abbreviation for a synthetic chemical compound known as polychlorinated biphenyl. This compound consists of chlorine, carbon and hydrogen and has a combination of properties that provide an inert, fire-resistant and insulating material. This makes the compound suitable for insulation. PCBs were used mainly in electrical equipment and to a lesser extent in other products. PCBs biodegrade slowly and remain in the environment for a long time. To eliminate them from the environment, PCBs must be disposed of through either a process of thermal destruction at high temperatures or by chemical processing. Landfilling is also used as a means of disposal, but this method merely contains the material in a relatively safe manner and does not result in the removal of the substance from the environment.

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<sup>4</sup> Transcript, February 15, 2000, q.475

<sup>5</sup> Ibid.

<sup>6</sup> Mr. Jeff Smith, then employed as a political assistant to the Minister of the Environment, was asked if CANADA would be willing to provide funds to SDMI for the purpose of constructing a treatment facility in Canada. The answer was 'No'.

95. The most widely used technique for destroying PCBs is high temperature incineration, typically at temperatures of about 1200 degrees Centigrade. Most incinerators can accept the full range of PCB wastes, including high and low concentration PCB liquids, PCB contaminated soils and electrical equipment. Before incineration, electrical equipment is either shredded or pre-cleaned with heat or solvents to facilitate metal recycling and to reduce the amount of material to be incinerated.
96. Air pollution control equipment is used to clean the incinerator stack gases by removing hydrogen chloride gas, particulate matter and other compounds, such as dioxins and furans. These are by-products of the incineration process and are highly toxic. When properly conducted, incineration is a highly efficient means of destroying PCBs and is used in many countries throughout the world, but a poorly operated incinerator can be a major source of air pollution.
97. Chemical treatment is often used to destroy PCBs found at concentrations of less than 1000 parts per million. Such concentrations are sometimes found in oil from transformers that has been inadvertently contaminated when the transformers were serviced.
98. By the early 1970s PCBs had become recognised as highly toxic substances that harmed both human and animal health. Since that time PCBs have been the subject of increasingly strict regimes of regulation both in Canada and internationally.
99. In February 1973 the OECD, of which CANADA is a member, adopted a Council Decision urging member countries to limit the use of PCBs and to control them in a manner designed to minimise risk to human health and the environment. Thereafter, together with other nations, the USA and CANADA banned future production of PCBs and joined the international community in attempting to determine the best way of resolving the substantial environmental problem caused by existing PCBs.

100. In 1977 CANADA added PCBs to the toxic substances listed under the Environmental Contaminants Act and prohibited the use of PCBs in new products manufactured in or imported into Canada. This legislation was later replaced by the CEPA which came into force on June 30, 1988. The regime imposed by the CEPA were in turn supplemented by the PCB Waste Export Regulations 1990, which effectively banned the export of PCB waste from Canada to all countries other than the USA. Under these regulations exports to the USA were permitted with the prior approval of the US EPA.
101. The position in the USA was not dissimilar. In 1980 the USA closed its borders to the import and export of PCBs and PCB waste for disposal. Since then the U.S.-Canadian border has been closed so far as PCBs are concerned. It was open to imports from CANADA from November 15, 1995 to July 20, 1997.<sup>7</sup>
102. In the USA PCBs primarily are regulated under the federal TCSA, which imposes restrictions on the manufacture, sale, use, import, export, and disposal of PCBs and PCB contaminated waste. The US EPA may grant an operator exemption for one year if it were satisfied that the activity would not result in unreasonable risk to human health or the environment and that the applicant has made good faith efforts to develop a substitute that does not represent an unreasonable risk.
103. At the international level, in 1986 CANADA and the USA entered into the Transboundary Agreement, which contemplated the possibility of cross-border activity. The recitals contain the following passage:

*Recognizing that the close trading relationship and the long common border between the United States and CANADA engender opportunities for a generator of hazardous waste to benefit from using the nearest appropriate disposal facility, which may involve the transboundary shipment of hazardous waste:*

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<sup>7</sup> There were exceptions for U.S. military PCB's and a few minor enforcement discretions.

104. During the arbitration CANADA took the position that this agreement did not cover PCBs because PCB wastes have never been classified as a “hazardous waste” in the USA. SDMI responded that, pursuant to the terms of the Transboundary Agreement, it was not necessary for PCBs to be so classified.<sup>8</sup>
105. In March 1989 a number of countries including CANADA signed the Basel Convention. This convention deals with international traffic in PCBs and other hazardous wastes. It was developed under the auspices of the United Nations Environment Programme. Although the USA signed the Basel Convention it had not ratified it by the time of the events under review in this arbitration.
106. State parties to the Basel Convention accept the obligation to ensure that hazardous wastes are managed in an environmentally sound manner. The Basel Convention establishes rules and procedures to govern the transboundary movement of hazardous wastes and their disposal. Amongst other things, it prohibits the export and import of hazardous wastes from and to states that are not party to the Basel Convention (Article 4(5)), unless such movement is subject to bilateral, multilateral or regional agreements or arrangements whose provisions are not less stringent than those of the Basel Convention (Article 11).
107. The Basel Convention also requires appropriate measures to ensure the availability of adequate disposal facilities for the environmentally sound management of hazardous wastes that are located within it (Article 4(2)(b)). It also requires that the transboundary movement of hazardous wastes be reduced to the minimum consistent with the environmentally sound and efficient management of such wastes and be conducted in a manner that will protect human health and the environment (Article 4(2)(d)).
108. Following signature of the Basel Convention, but before it came into force, the CCME, which includes the Federal and provincial ministers responsible for the environment, agreed

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<sup>8</sup> Investor’s Supplemental Memorial, paras. 78-79.

that the destruction of PCBs should be carried out to the maximum extent possible within Canadian borders. At the same time, CANADA confirmed its policy that PCB wastes from Federal sites would not be exported for disposal in other countries.

109. This was the regulatory and policy background that confronted SDMI in 1990 when it began its efforts to obtain the necessary approvals to import electrical transformers and other equipment containing PCB wastes into the USA from Canada. By this time SDMI had become one of the most prominent operators in the PCB disposal industry in the USA. It also had expanded into Australia, MEXICO and South Africa and was looking for other markets in which its expertise could be deployed.
110. SDMI possessed full details of the PCBs inventory in Canada, because a computerised database was available freely. It also knew that it could compete successfully against the Canadian hazardous waste disposal industry, which was virtually non-existent in 1990.
111. In 1993, Myers Canada was incorporated under the Canada Business Corporations Act.
112. Even by 1993, when SDMI entered the Canadian market, there was only one credible Canadian competitor: Chem-Security, which was located in Swan Hills, Alberta. As the majority of the Canadian PCB inventory was in Ontario and Quebec - several thousand kilometres from Alberta - SDMI possessed a significant cost advantage as against Chem-Security and, indeed, as against many of its U.S. competitors.
113. SDMI started a lobbying campaign which involved making numerous petitions to the US EPA in the USA (there were two in August 1993 alone) and many representations to Environment Canada. In Canada, SDMI enlisted the assistance of several potential Canadian customers who were under pressure to dispose of their PCB waste and wanted to have it done as cost-effectively as possible.

114. Research carried out by CANADA for the purposes of the arbitration indicated that SDMI's lobbying ...involved at least 2 mayors, 6 Congressmen, 2 Senators, a County Executive, the US Chamber of Commerce... and others.
115. The position was clearly moving towards a critical point in the USA during the spring and summer of 1995. All the players were expecting a significant development. Whichever way the USA moved there would be considerable publicity. A number of participants had much to gain and much to lose.
116. The position in Canada was equally sensitive. In answer to a parliamentary question on July 9, 1995, the then Minister for the Environment is recorded by Hansard as saying:

*It is still the position of the government that the handling of PCBs should be done in Canada by Canadians* [emphasis added]

This may have reflected a movement from the 1989 policy, referred to above, that CANADA's policy (in line with the Basel Convention), was simply that disposal of PCBs should take place in Canada.

117. The Tribunal received a substantial amount of evidence concerning SDMI's activities during the period 1990 to the Fall of 1995. In summary, SDMI through its employees and the employees of Myers Canada, contacted Canadian PCB holders with the objective of having their PCBs remediated by SDMI using its facilities in the USA. Marketing initiatives were undertaken and assessments made of PCB contaminated equipment. Equipment was drained and transportation organized.
118. That evidence may be relevant to other questions that arise in the case, but no more need be said about it for the purposes of this narrative of the events giving rise to the measure taken by CANADA to close the border to the transit of PCBs. For present purposes, it is sufficient to record that on October 26, 1995 the US EPA issued an enforcement discretion



to SDMI, valid from November 15, 1995 to December 31, 1997, for the purpose of importing PCBs and PCB waste from Canada into the USA for disposal.

119. The term “enforcement discretion” is not defined in U.S. law, but apparently means that the US EPA would not to enforce the U.S. regulations banning importation of PCBs against SDMI, provided that SDMI met the detailed conditions that were attached to the US EPA’s October 26, 1995 letter (which included “no landfilling”). The import ban itself would remain in place and any imports to the USA technically would be contrary to U.S. law. Following the decision relating to SDMI, the US EPA (as predicted in its October 26, 1995 letter) granted further enforcement discretions to about nine other U.S. companies, permitting them to import PCBs and PCB waste from Canada for disposal.

120. From early 1995 CANADA was well aware that the US EPA was likely to take action to open the border within a relatively short period, but the Tribunal accepts that CANADA’s ministers and their officials were taken by surprise by the lack of government-to-government consultation, the timing and the method used by the US EPA to achieve this result.

121. A period of intensive activity followed, both inside and outside Canadian government circles. Within government, a number of meetings took place and a number of memoranda were circulated. Undoubtedly, there were legitimate concerns. These were listed in CANADA’s Counter Memorial as follows:

- *whether the enforcement discretion fully complied with U.S. law;*
- *whether exports of PCB wastes to the U.S., a non-party, would comply with the Basel Convention;*
- *whether PCBs would be disposed of in the U.S. in an environmentally sound manner;*
- *compliance with CANADA’s 1989 policy to destroy Canadian PCBs in CANADA;*
- *the long-term viability of domestic PCB disposal facilities; and*

- *what would happen in the event that U.S. disposal facilities subsequently became unavailable, or if the U.S. border was closed again, as eventually happened.*

122. Simultaneously, the fledgling Canadian PCB disposal industry started a vigorous lobbying campaign designed to persuade CANADA to maintain the closed status of the border. For example, on November 1, 1995 a letter written by the General Manager of Chem-Security to the Minister of the Environment stated:

*I am writing to reaffirm your commitment to assist the Canadian hazardous waste industry by removing the exemption which allows export of PCB waste to the United States and to underline the urgency of the situation currently facing the industry...*

*You should be aware that EPA estimates that it will take only approximately 30 days to import the entire Canadian PCB inventory.*

*You will recall that we stressed the fact that the inventory is a finite resource which is vital to our industry's growth and our ability to provide capital for the export of our technology. Any delay in the Canadian response to the EPA action could have serious repercussions.*

123. On November 16, 1995 the Minister of the Environment signed an Interim Order that had the effect of banning the export of PCBs from Canada. This order was defective for procedural reasons and, after the procedural defect had been remedied, on November 20, 1995 the Minister approved and signed the following Interim Order which was in the same terms:

*INTERIM ORDER RESPECTING THE  
PCB WASTE EXPORT REGULATIONS*

*WHEREAS PCB's are substances specified on the list of Toxic Substances in Schedule 1 to the Canadian Environmental Protection Act;*

*AND WHEREAS the Minister of the Environment and the Minister of National Health believe that PCBs are not adequately regulated and that immediate action is required to deal with a significant danger to the environment and to human life and health;*

*THEREFORE, the Minister of the Environment, pursuant to subsection 35(1) of the Canadian Environmental Protection Act, hereby makes the annexed Interim Order respecting the export of PCB wastes.*

*Ottawa, in the National Capital Region, November 20, 1995*

*The annexed Interim Order stated as follows:*

*INTERIM ORDER RESPECTING THE PCB WASTE EXPORT REGULATIONS*

*Short title:*

*This Order may be cited as the PCB Waste Export Interim Order*

*Amendment*

*Section 4 of the PCB Waste Export Regulations is replaced by the following:*

*“4. Section 3 does not apply to a person who exports:*

*(a) to the United States, any PCB waste from United States agencies operating in CANADA where the Environmental Protection Agency has given prior consent in respect of the export or*

*(b) any product that is in good working order and has a capacitor that contains not more than 500 µg of PCB and is an Integral part of the product where the capacitor is necessary for the operation of the producer.*

*EXPLANATORY NOTE*

*(This note is not part of the Order)*

*On becoming aware of information indicating that the U.S. Environmental Protection Agency is allowing PCB imports into the U.S. from CANADA for destruction, the Minister of the Environment made this Interim Order to Amend the PCB Waste Export Regulations on November 20, 1995. The purpose of the Interim Order is to ensure that Canadian PCB Wastes are managed in an environmentally sound manner in CANADA and to prevent any possible significant danger to the environment or to human life or health.*

124. Under Canadian law the Interim Order had to be approved by the Privy Council within fourteen days. This requirement led to further intensive activity within the government.

Among this activity two meetings were held at the offices of the Canadian Privy Council, at which several government departments were represented. These meetings are referred to in more detail later in this award.

125. The Interim Order was confirmed by the Canadian Privy Council on November 28, 1995 in the following terms:

*ORDER IN COUNCIL DEPARTMENT OF THE ENVIRONMENT*

*Interim Order Respecting the PCB Waste Export Regulations*

*P.C. 1995 2013 November 28, 1995*

*Whereas, pursuant to subsection 35(1) of the Canadian Environmental Protection Act, the Minister of the Environment, on November 20, 1995, made the annexed Interim Order respecting the PCB Waste Export Regulations to deal with a significant danger to the environment or to human life or health;*

*Whereas the Minister of the Environment has, within 24 hours after making the Order, offered to consult the governments of all the affected provinces to determine whether they are prepared to take sufficient action to deal with the significant danger;*

*Whereas the Minister of the Environment has consulted with other Ministers of the Crown in right of CANADA to determine whether any action can be taken under any other Act of Parliament to deal with the significant danger;*

*And whereas less than 14 days have elapsed since the Order was made;*

*Therefore, His Excellency the Governor General in Council on the recommendation of the Minister of the Environment pursuant to subsection 35(3) of the Canadian Environmental Protection Act, is pleased hereby to approve the annexed Interim Order respecting the PCB Waste Export Regulations, made by the Minister of the Environment on November 20, 1995.*

*INTERIM ORDER RESPECTING THE PCB WASTE EXPORT REGULATIONS*

*Whereas PCBs are substances specified on the List of Toxic Substances in Schedule 1 to the Canadian Environmental Protection Act;*

*And whereas the Minister of the Environment and the Minister of the National Health and Welfare believe that PCBs are not adequately regulated and that immediate action is required to deal with a significant danger to the environment and to human life and health;*

*Therefore, the Minister of the Environment pursuant to subsection 35(1) of the Canadian Environmental Protection Act, hereby makes the annexed Interim Order respecting the export of PCB wastes.*

*Ottawa, in the National Capital Region, November 20, 1995*

*SHEILA COPPS*

*Minister of the Environment*

126. On February 26, 1995, by means of an Order in Council of the Governor General amending the PCB Waste Export Regulations, CANADA turned the Interim Order into a Final Order banning the commercial export of PCB waste for disposal. This Order was in the following terms:

*WHEREAS, on November 20, 1995, the Minister of the Environment made, pursuant to subsection 35(1) of the Canadian Environmental Protection Act, the PCB Waste Export Interim Order.*

*WHEREAS, by Order in Council P.C. 1995 2013 of November 28, 1995 the Governor in Council approved the Interim Order pursuant to subsection 35(3) of the Act;*

*AND WHEREAS, pursuant to subsection 35(5) of the Act, the Minister of the Environment and the Minister of National Health and Welfare within ninety days after approval of the Interim Order by the Governor in Council, recommended to the Governor in Council that the PM Waste Export Regulations be amended under section 34 of the Act to have the same effect as the Interim Order,*

*THEREFORE HIS EXCELLENCY THE GOVERNOR GENERAL IN COUNCIL on the recommendation of the Minister of the Environment and the Minister of National Health and Welfare pursuant to subsection 35(5) of the Canadian Environmental Protection Act is pleased hereby to accept the recommendation of the Minister of the Environment and the Minister of National Health and Welfare that the PCB Waste Export Regulations be amended under section 34 of the Act to have the same effect as the PCB Wage Export Interim Order.*

127. In February 1997 CANADA opened the border by a further amendment to the PCB Waste Export Regulations. The border was closed (for the cross-border movement of PCBs and PCB waste) by regulations introduced by CANADA for a period of approximately 16 months, from November 20, 1995 to February 1997. Thereafter, the border was open and there were seven contracts pursuant to which PCBs and PCB waste material was exported from CANADA to the USA for processing by SDMI.
128. In July 1997 the border once again was closed to PCBs and PCB wastes as a result of a decision of the Ninth Circuit of the U.S. Court of Appeals. The overall effect of these events in Canada and the USA was that the border was only open for cross-border shipment of the materials in question from February to July 1997 – a period of approximately five months.

## CHAPTER IV

### SUMMARY OF THE POSITIONS OF THE PARTIES

#### SDMI's Claims

129. SDMI claims that CANADA failed to comply with its obligations under the NAFTA in four respects, as described in the following paragraphs.

#### Article 1102 – National Treatment

130. The NAFTA Article 1102 sets out the NAFTA's national treatment obligation for investment. SDMI contend that under Article 1102(2) the investments of investors of other NAFTA Parties must be given the best in jurisdiction treatment with respect to the establishment, acquisition, expansion, management, conduct, operation and sale or other disposition of investments in like circumstances to the investments of Canadian investors.<sup>9</sup> SDMI claims that, when read substantively, the national treatment obligation ensures that all companies, whether domestic or foreign, are treated equally and without discrimination. SDMI says that the PCB Waste Export Interim Order and Final Order constituted disguised discrimination aimed at SDMI and its investment in Canada contrary to Article 1102.

131. SDMI asserts that the Interim Order discriminated against U.S. waste disposal operators who sought to operate in Canada by preventing them from exporting PCB contaminated waste for processing in the USA. U.S. waste disposal companies were not permitted to operate in Canada in the same fashion as Canadian PCB waste disposal companies. CANADA limited SDMI's ability to carry out its operations on an arbitrary and discriminatory basis. SDMI claims that, by granting better treatment to Canadian waste

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<sup>9</sup> This is a direct reference to SDMI's Statement of Claim. A more accurate description of the obligation is the provision of the same in-jurisdiction treatment.

disposal companies, CANADA breached its national treatment obligation under the NAFTA.

132. SDMI claims that, when preparing and effecting the measure, CANADA was well aware that SDMI had been operating in Canada and had been seeking to process, distribute and treat PCB contaminated wastes in the USA. SDMI claims that, on November 20, 1995 when CANADA issued the Interim Order, it was clear that CANADA knew that its export ban specifically would affect SDMI and its investment in Canada. SDMI says that the Interim Order was a clear and direct government measure aimed at prohibiting the export of Canadian PCB wastes to the USA by a U.S. PCB waste disposal company. SDMI claims that this was discrimination against it as a U.S. investor actively operating and competing within the Canadian marketplace.

133. SDMI asserts that the Interim Order was intended to curtail its operations and its investment in Canada. SDMI claims that while it was prohibited from conducting its business of exporting PCB contaminated wastes, Canadian based companies were given better treatment by being permitted to conduct their business in Canada without interference.

#### **Article 1105 - Minimum Standard of Treatment**

134. Article 1105 of the NAFTA requires the Parties to treat investors of another Party in accordance with international law, including fair and equitable treatment. Article 1105 imports into the NAFTA the international law requirements of due process, economic rights, obligations of good faith and natural justice.

135. SDMI claims that in the making export bans, CANADA failed to accord to it and its Investment, treatment in accordance with international law in violation of Article 1105.



136. SDMI claims that the promulgation of the export ban by CANADA was done in a discriminatory and unfair manner that constituted a denial of justice and a violation of good faith under international law.

#### **Article 1106 - Performance Requirements**

137. The NAFTA Article 1106(1) prohibits a number of specific governmental activities collectively referred to as performance requirements. Under Article 1106(1), a Party must not impose or enforce a “requirement, commitment or undertaking” in connection with the establishment, acquisition, expansion, management, conduct or operation of an investment of an investor.

138. Under subparagraph (1)(b) of Article 1106, a Party may not require investors to include in their products or services an amount of goods or services that originate within the territory of that Party.

139. Under subparagraph (1)(c) of Article 1106, the Parties may not require investors to give any preferential treatment to any products or services made domestically. Investors cannot be required to acquire or use goods or services that originate within a Party.

140. SDMI claims that the Interim Order operated effectively to force it to dispose of PCB contaminated waste in Canada, if such disposal were to occur at all. SDMI says that this resulted in a performance requirement requiring PCB disposal operators to accord preference to Canadian goods and services and to achieve a given level of domestic content contrary to CANADA’s obligations under Article 1106.

141. SDMI claims that CANADA’s measures affecting the operations of PCB waste exporters were applied in an arbitrary and unjustifiable manner that also constituted a disguised restriction on international trade or investment.

## Article 1110 - Expropriation

142. SDMI claims that Article 1110 of the NAFTA obliges the Parties to pay fair market value in the case of an expropriation or a measure tantamount to the expropriation of the property of an investor of another Party. The NAFTA does not define the term “expropriation”, but SDMI claims that Article 1110 clearly is designed to protect against direct and indirect measures by extending its coverage to “measures tantamount to expropriation”. Under international law, expropriation refers to the act by which governmental authority is used to deny some benefit of property. This denial can be actual or constructive.
143. SDMI contends that international law and the NAFTA both impose standards on the treatment of those whose property has been expropriated. Article 1110 does not prevent regulatory actions by governments. It merely requires governments to compensate investors for interference with their property rights. SDMI claims that CANADA has not paid any compensation to SDMI for this expropriation despite the requirement of Article 1110.

## Losses Suffered by SDMI

144. SDMI claims that it has suffered or will suffer losses in the following categories as a result of CANADA’s breaches of its obligations under the NAFTA:

- i Lost sales and profits since the date of introduction of the measures;*
- ii Loss of its investment in its joint venture with Myers CANADA*
- iii The cost of reducing operations in CANADA;*
- iv Fees and expenses of professional services incurred to defend itself NAFTA inconsistent measure.*
- v Tax consequences of the award to maintain the integrity of the award.*

## **CANADA's Claims**

145. CANADA claims that the Interim Order was not a measure that related to an investor or an investment in Canada.
146. Canada asserts that even if SDMI were to have had an investment in Canada, the Interim Order and Final Order did not breach any NAFTA Chapter 11 obligation owed to SDMI or to any investment it had in Canada.
147. CANADA claims that it has demonstrated its full compliance with its obligations under Chapter 11 and that, in any event, SDMI is not entitled to recover damages under the heads of damage or in the amounts claimed.
148. CANADA contends that if SDMI were to be successful it would require inflating the scope and application of Chapter 11 out of all proportion and that a proper construction of the provisions in question must result in dismissal of this claim.
149. CANADA says that, as the complaining party, SDMI bears the burden of proving its claim and that SDMI has not done so.
150. CANADA's position is that SDMI's construction of Chapter 11 is inconsistent with Canada's other international obligations, including the Basel Convention and Transboundary Agreement and that these prevail over Chapter 11 obligations in the circumstances to the extent of the inconsistency.
151. CANADA asserts that it was necessary for it to pass the Interim Order because the legality of the Enforcement Discretion was uncertain and it did not know whether PCBs were covered by the Transboundary Agreement.

152. CANADA says that the measure was made because CANADA believed PCBs are a significant danger to health and the environment when exported without appropriate assurances of safe transportation and destruction.
153. The Disputing Parties acknowledge that PCBs are highly toxic and harmful to human health and the environment. CANADA claims that the sudden and surprising US EPA decision to grant the enforcement discretion effectively opened the U.S. border and required prompt action on CANADA's part. Given the circumstances, CANADA had no duty to consult. CANADA's actions were in compliance with its domestic laws and with its international obligations. CANADA claims that there was no bad faith on its part in the making or implementation of the Interim Order.
154. CANADA claims that the Interim Order neither imposed nor enforced a prohibited performance requirement contrary to Article 1106(1)(b) or (c) of the NAFTA. The Interim Order imposed no requirement to buy Canadian goods or services or to achieve a certain level of Canadian content. The NAFTA lists all prohibited performance requirements. CANADA says that export bans are not a prohibited performance requirement.
155. CANADA claims that, even if the Interim Order were to have violated Article 1106, the Article's exception applies because it is a measure necessary to protect human, animal or plant life or health or was necessary for the conservation of living or non-living exhaustible natural resource.
156. CANADA says that the Interim Order did not expropriate or constitute a measure tantamount to an expropriation of an investment contrary to Article 1110 of the NAFTA. Myers Canada continued operations in Canada while the Interim Order remained in force and afterwards; so did SDMI. There is no evidence that Myers Canada or SDMI sustained any loss while the Interim Order remained in force. Any losses sustained thereafter occurred as a consequence of events for which CANADA was not responsible. These events

included, but may not be restricted to, the closing of the U.S. border to PCB waste exports by the US EPA in 1997.

157. CANADA claims that, as a result, SDMI is not entitled to the compensation or damages claimed, or any compensation or damages and that SDMI's claim is grossly exaggerated.
158. CANADA asserts that if Chapter 11 were interpreted with the result that it was violated by the Interim Order, Chapter 11 would be inconsistent with Chapter 3 of the NAFTA (Trade in Goods). In the event of inconsistency between Chapter 11 and another Chapter of NAFTA, Article 1112 requires Chapter 11 to give way. SDMI's claim would have to be dismissed.
159. CANADA adopts the positions taken by MEXICO which include the contention that because SDMI and Myers Canada were engaged in the provision of a service, Chapter 11 does not apply.
160. CANADA claims that it is entitled to the costs it has incurred in this arbitration.

**CHAPTER V**  
**THE EXPORT BAN**

161. The intent of government is a complex and multifaceted matter. Government decisions are shaped by different politicians and officials with differing philosophies and perspectives. Each of the many persons involved in framing government policy may approach a problem from a variety of different policy objectives and may sometimes take into account partisan political factors or career concerns. The Tribunal can only characterize CANADA's motivation or intent fairly by examining the record of the evidence as a whole.
162. The evidence establishes that CANADA's policy was shaped to a very great extent by the desire and intent to protect and promote the market share of enterprises that would carry out the destruction of PCBs in Canada and that were owned by Canadian nationals. Other factors were considered, particularly at the bureaucratic level, but the protectionist intent of the lead minister in this matter was reflected in decision-making at every stage that led to the ban. Had that intent been absent, policy makers might have reached a conclusion in November 1995 that would have been consistent with the conclusion reached by CANADA when the ban was lifted in February 1997. CANADA's view in 1997 was that the opening of the U.S. border should be welcomed in the interests of expediting the elimination of PCBs from the environment, provided that any risks associated with exporting PCB waste to the U.S. was minimised through proper regulations and safeguards.
163. In order to explain the Tribunal's assessment of the events that took place some of the facts that appeared in the evidentiary record are set out in the paragraphs that follow.
164. On August 2, 1994 a briefing note prepared by Mr. John Hilborn and two other officials in the Department of the Environment stated that the US EPA might approve the import of PCBs from Canada. This briefing note concluded by advising that federal and provincial policies should be changed so as to open the border from the Canadian side, because such a

policy would represent ...*a technically and environmentally sound solution to the destruction of some of Canada's PCBs.*<sup>10</sup>

165. A policy memorandum to the Minister of the Environment in the autumn of 1994, signed by Mr. H.A. Clarke, Assistant Deputy Minister, Environmental Protection Service, refers to a current policy that PCB waste be managed in Canada, but calls for a review of the policy based on the following factors.

- *Our domestic destruction capacity, either short term or long term, has seen limited development;*
- *CANADA's position at Basel Convention meetings has been to support the use of regional capacity;*
- *The U.S. EPA is considering a change to their PCB policy and may permit selected Canadian PCB imports;*
- *The U.S. ban has effectively allowed CANADA to restrict PCB shipments to the U.S. in the absence of authority in CEPA to do so.*<sup>11</sup>

166. In March 1995, federal and provincial officials discussed the issue of PCB waste shipments to the USA. According to a letter from the Minister of the Environment of the Province of Manitoba, dated December 18, 1995 ...*the open border concept was specifically discussed and supported by all the jurisdictions. Environment CANADA's position was that the U.S. closed the border and it was the U.S. who could open it. Now, without prior consultation, the Interim Order [banning exports to the U.S., issued by the Minister of the Environment] seems to reverse the federal position.*<sup>12</sup>

167. The Deputy Minister of the Environment<sup>13</sup> expressed support for the principle of opening the border at a meeting with Mr. Cloghesy in 1995.<sup>14</sup>

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<sup>10</sup> Joint Book of Documents, vol. 3, tab 86.

<sup>11</sup> Loc. Cit., tab 80.

<sup>12</sup> Op. Cit., vol. 4, tab 101.

<sup>13</sup> Unless otherwise stated, references to "minister" and "ministries" are to those of the Federal Government.

168. In July 1995 senior officials of two Canadian operators of hazardous waste facilities, Chem-Security and Cintec, met the Minister of the Environment in her office. They warned that the US EPA might respond positively to lobbying to permit the import of PCB waste from Canada for disposal. It is clear from the account of Mr. Mathes, who attended that meeting on behalf of Chem-Security, that the arguments of the Canadian companies focused on the contention that U.S. competition would threaten the economic viability of their own operations. In addition to the account of the meeting by Mr. Mathes, there is on record a letter from him dated March 14, 1995, invoking ... *the economic benefits of maintaining the current Canadian policy*. Also in attendance at the meeting on behalf of Chem-Security was Mr. Jeff Smith, who earlier had been a staff member in the Minister's office.<sup>15</sup>
169. Mr. Mathes said that, at that meeting, the Minister stated it was CANADA's policy that PCB waste should be disposed of ... *in Canada by Canadians*.<sup>16</sup>
170. CANADA did not make formal submissions to the US EPA at its hearings in Washington on SDMI's application. CANADA was well aware of the hearings, because it monitored them. Indeed the Deputy Minister suggested to Mr. Cloghesy that he should say to the US EPA hearing that the Department (of the Environment) favoured an open border with the USA.<sup>17</sup>
171. On June 9, 1995 the Minister of the Environment repeated her ...*in Canada by Canadians*... statement in the House of Commons. A statement by the lead Minister in the House of Commons with respect to government policy on an issue is ordinarily to be accepted at face value as stating official government policy and the rationale behind it.<sup>18</sup>

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<sup>14</sup> Joint Book of Documents, vol. 2, tab 43.

<sup>15</sup> Op. Cit., vols. 2 and 3, tabs 39 and 81.

<sup>16</sup> This evidence is from the cross-examination of Mr. Mates on an affidavit filed in other proceedings.

<sup>17</sup> Joint Book of Documents, vol. 3, tab 43.

<sup>18</sup> Op. Cit., vol. 1, tab 17.



172. On July 13, 1995 a Department of Environment note on the Minister's "business week" recalled that the Minister had promised the Canadian industry that she would close the border from the Canadian side if the US EPA opened it from the U.S. side. This note referred to concerns over the NAFTA and attached a *...paper that Chem-Security...* had prepared on this. Chem-Security's paper does not appear on the record in this case.<sup>19</sup>
173. On August 2, 1995 Messrs. Hilborn, Dave Campbell, and Hugh Dibbs, three Department of the Environment officials, prepared a briefing note on the potential opening of the border from the U.S. side. They recommended that federal policy be changed to support the US EPA proposal *...because it represents a technically and environmentally sound solution for the destruction of some of Canada's PCBs.*<sup>20</sup>
174. An undated draft letter from the Deputy Minister of the Environment thanked Mr. Smith for a memorandum of September 1, 1995, concerning a possible opening of the border by the US EPA. This draft recalls the promise that the Minister had made to Chem-Security and Cintec officials earlier in the summer. The reference to that promise is crossed out by hand, with the explanatory note *...I don't want to put the commitment down on paper.*<sup>21</sup>
175. On September 7, 1995 Mr. Hilborn prepared a briefing note on PCB waste management policy. It was essentially identical to what Mr. Clark had written in the autumn of 1994.<sup>22</sup>
176. On October 27, 1995 Mr. Hilborn prepared a memorandum at the request of the Associate Deputy Minister. He stated that *...an interim order to amend the PCB Waste Export Regulations quickly is not a viable option because it cannot be demonstrated that closing the border is required to deal with a significant danger to the environment or to human health.* This memorandum noted that the Minister had told the House of Commons that

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<sup>19</sup> Op. Cit., vol. 2, tab 59.

<sup>20</sup> Op. Cit., vol. 3, tab 86.

<sup>21</sup> Op. Cit., vol. 2, tab 56.

<sup>22</sup> Op. Cit., vol. 3, tab 80.

PCB Waste should be destroyed in Canada and suggested that banning exports to the USA would be consistent with ...*current policy*... and would mean that ...*the Commitment to the Canadian PCB destruction industry*... would be fulfilled.<sup>23</sup>

177. The October 27, 1995 memorandum also outlines the case against banning exports. It notes that:

*PCBs destroyed in either country is positive for the environment. PCB owners may have lower destruction costs due to competition and more incentive to destroy PCBs, but offset by liability insurance costs if U.S. option is selected.*

178. On October 30, 1995 Mr. George Cornwall, Director of the Hazardous Waste Branch, wrote a note referring to the Minister's possible immediate action on PCB wastes. She would pass an interim order that would close the border from the Canadian side and make a public statement that an open border with the USA was contrary to her ...*long standing position that Canadian PCBs should be destroyed in this country*. Mr. Cornwall cited as the only "pro" factor in favour of this decision was that *the Canadian environmental industry investment, i.e., Chem-Security is protected by a secure supply of PCBs for their facility in Swan Hills*.<sup>24</sup>

179. In the same note of October 30, 1995 Mr. Cornwall outlined the "cons" of the Minister's possible closing of the border as follows:

*Interim orders are design [sic] to provide immediate action to resolve 'significant danger' to the environment and/or human health. It can be argued that the opening of the U.S. border poses no such significant danger.*<sup>25</sup>

*S.D. Myers will certainly seek redress through NAFTA intervention, since they have invested/lobbied heavily to get the border opened. The company*

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<sup>23</sup> Op. Cit., vol. 1, tab 6.

<sup>24</sup> Loc. Cit., tab 30.

<sup>25</sup> Ibid.

*can be expected to object formally to any action taken under CEPA to close the border;*

*It will be difficult to argue that the transportation of PCBs to the U.S.A. poses a greater danger than transporting PCBs to Swan Hills, Alberta.*

*Industry Canada and Foreign Affairs are likely to object to the closing of the Canadian border because it will appear to be an unjustifiable restriction on international trade.*

*Current practice of returning U.S. owned PCBs in Canada to their originators in the U.S. will be jeopardized if the Canadian border is completely shut. An 'escape hatch' will have to be provided.*

180. On November 9, 1995 Mr. Cornwall sent a note to Mr. Clarke. It refers to serious legal problems with an interim order to close the border from the Canadian side. It suggests that a note from the Department of Justice might make it easier for the Minister of the Environment to accept contrary advice. Mr. Cornwall suggested that officials were looking at a means to at least delay PCB exports along these lines:

*(i) We could ask an (independent?) consultant to assess that the disposal facilities in the U.S. that would be handling/disposing of Canadian PCB wastes in an environmentally acceptable way. U.S. EPA did this before accepting stables (??);*

*(ii) We need to satisfy ourselves that U.S. consents are all adequate vis-a-vis our export-import of hazardous waste (eihw) regulations;<sup>26</sup>*

181. On November 10, 1995 Mr. Smith sent a letter to the Deputy Minister of the Environment suggesting points that could be used as a "justification" for an interim ban. The Deputy Minister appears to have passed the note on to Messrs. Victor Shantora and Hilborn, two department officials, with the comment that *...this letter makes some interesting arguments which could be used as its basis for the Minister's justification.* Mr. Smith's letter does not appear in the record in the arbitration.<sup>27</sup>

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<sup>26</sup> Op. Cit., vol. 2, tab 58.

<sup>27</sup> Loc. Cit., tab 35.

182. On November 15, 1995 Mr. Hilborn prepared a note entitled *...justification for the interim order*. He stated that:

*Export of PCB waste from CANADA to the U.S. is consistent with the CANADA-U.S.A. Agreement on the Transboundary Movement of Hazardous Waste. Furthermore, the Canadian position at the Third Conference of the parties to the Basel Convention was to use facilities in other OECD countries where we could be sure that hazardous wastes would be managed in an environmentally sound manner for final disposal.*<sup>28</sup>

183. In that same note Mr. Hilborn also noted that a draft opinion from the Department of Foreign Affairs and International Trade *...indicates the closing the Canadian border would likely be found by a NAFTA panel to be a restriction on trade*. The first consideration listed by Mr. Hilborn in his review of the considerations for or against an interim order was the Minister's statement in the House that *...the handling of PCBs in CANADA should be done in Canada by Canadians.*<sup>29</sup>

184. On the morning November 16, 1995 the Minister signed an "interim order" that prohibited PCB exports to the USA unless they were PCBs in CANADA owned by U.S. agencies. The Minister relied on her authority under the CEPA to issue such an order *...where there is a significant danger to the environment and to human life and health*.

185. In a speech to the Canadian Bar Association Environmental Section later on the same day the Minister stated that:

*We are meeting our obligations under the Basel Convention to dispose of our own PCBs. And this kind of action was supported by provincial and territorial environment ministers when they met in Charlottetown in 1989. The handling of PCBs should be done in Canada by Canadians. We have to take care of our own problems.*

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<sup>28</sup> Loc. Cit., tab 42.

<sup>29</sup> Ibid.

186. On November 16, 1995 Mr. Hilborn revised the note he had written on the previous day. The second version omitted the references to the Transboundary Agreement. It referred to the fact that CANADA has signed the Basel Convention, which imposed obligations upon CANADA to ensure that it had adequate destruction facilities within its borders and to ensure that it reduced the transboundary movement of PCBs to a minimum: *...consequently, the federal government's policy is that Canadian PCBs should be destroyed in this country. There was ...no confirmatory evidence at this time to assure ourselves that Canadian PCBs would be managed in an environmentally sound manner.* There were also uncertainties, the note said, about assured long term access to U.S. facilities, and the US EPA's granting of an enforcement discretion might be challenged in the courts.<sup>30</sup>
187. The Minister of Health was required by CEPA to concur in the issuance of the interim order. There was no evidence before the Tribunal that the Minister of Health personally directed her mind to the issue. There also was no evidence that her Department made an independent evaluation of whether any health risk existed. On the contrary, such evidence as there was suggested that the Department simply accepted the Department of the Environment's assertion that a risk existed.
188. On November 20, 1995 the Interim Order was re-issued.
189. Shortly afterwards a meeting of officials from various departments was held to discuss the position. It was attended, among others, by Mr. Aharon Mayne, a Department of Foreign Affairs and International Trade official. His responsibilities included cross-border transportation issues involving the USA, including PCB wastes. He had not heard of any proposed ban prior to it being imposed. He recalled that some officials at the meeting thought the ban was ill-conceived: *...some of them thought it was not being done on the merits, but rather for 'political reasons' that had nothing to do with the substance of the*

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<sup>30</sup> Op. Cit., vol. 1, tab 29.

*issue. Some Environment Canada officials were not happy with the Order and were quite 'expressive' on this point.*<sup>31</sup>

190. On December 6, 1995, CANADA sent a diplomatic note to the USA asking whether PCBs were defined as hazardous waste under U.S. legislation and implementing regulations, and whether PCBs were covered by the Transboundary Agreement. On January 23, 1996, the USA confirmed that the answer to both questions was "yes". CANADA's concerns could have been investigated long before the Enforcement Discretion was issued. It was well aware of the possibility that the border might open.
191. CANADA sought to establish in this arbitration that the Enforcement Discretion, which ultimately was set aside in U.S. court litigation, was not lawful. The Tribunal makes no determination on this issue because in this case the Disputing Parties acted on the basis of the law as it then appeared to exist. CANADA passed the Interim and Final Orders and did not challenge the legality of the Enforcement Discretion. Once the border was re-opened, SDMI arranged for the importation of PCBs and a quantity did cross the border.
192. On December 12, 1995, Mr. Dana Myers wrote to the Minister of the Environment to propose that SDMI should be required by CANADA to satisfy any possible environmental concerns by making it a condition of allowing the cross-border movement that the waste should be destroyed or recycled in the USA (rather than landfilled).<sup>32</sup> The evidentiary record does not contain a reply from the Minister.
193. Having reviewed all the documentary and testimonial evidence before it, the Tribunal is satisfied that the Interim Order and the Final Order favoured Canadian nationals over non-nationals. The Tribunal is satisfied further that the practical effect of the Orders was that

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<sup>31</sup> Op. Cit., vol. 3, tab 84.

<sup>32</sup> Op. Cit., vol. 10, tab 186. In fact, it was a condition of the US EPA's permission to SDMI that imported PCB wastes should not be landfilled. SDMI did not use landfill methods.

SDMI and its investment were prevented from carrying out the business they planned to undertake, which was a clear disadvantage in comparison to its Canadian competitors.

194. Insofar as intent is concerned, the documentary record as a whole clearly indicates that the Interim Order and the Final Order were intended primarily to protect the Canadian PCB disposal industry from U.S. competition. CANADA produced no convincing witness testimony to rebut the thrust of the documentary evidence.

195. The Tribunal finds that there was no legitimate environmental reason for introducing the ban.<sup>33</sup> Insofar as there was an indirect environmental objective - to keep the Canadian industry strong in order to assure a continued disposal capability - it could have been achieved by other measures.

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<sup>33</sup> The Tribunal has noted that there were other equally effective means of encouraging the development and maintenance of a Canadian based PCB's remediation industry.

**CHAPTER VI**  
**INTERPRETATION OF THE NAFTA**

**Introduction**

196. The NAFTA provides internal guidance for its interpretation in a number of provisions. In the context of a Chapter 11 dispute, it is appropriate to begin with the Preamble to the treaty, which asserts that the Parties are resolved, *inter alia*, to ...*Create an expanded and secure market for the goods and services produced in their countries... to ensure a predictable commercial framework for business planning and investment... and to do so in a manner consistent with environmental protection and conservation.*
197. Article 102(2) obliges the Parties to ...*interpret and apply the provisions of [the] Agreement in the light of its objectives set out in paragraph 1 and in accordance with the applicable rules of international law.*
198. The objectives specified in Article 102(1) are to:
- (a) *promote conditions of fair competition in the free trade area;*
  - (c) *increase substantially investment opportunities in the territories of the Parties;*
  - (d) *provide adequate and effective protection and enforcement of intellectual property rights in each Party's territory;*
  - (e) *create effective procedures for the implementation and application of this Agreement, for its joint administration and for the resolution of disputes; and*
  - (f) *establish a framework for further trilateral, regional and multilateral co-operation to expand and enhance the benefits of this Agreement.*



199. Furthermore, Chapter 11 arbitrators are required by Article 1131(1) to ...*decide the issues in dispute in accordance with [the] Agreement and applicable rules of international law*".<sup>34</sup> Pursuant to Article 1112(1), in the event of inconsistency between Chapter 11 and another chapter of the NAFTA, the other chapter prevails ...*to the extent of the inconsistency*.

200. It is appropriate for the Tribunal to examine the international law rules of interpretation. The first port of call is the *Vienna Convention on the Law of Treaties*.

### **The Vienna Convention**

201. Article 31 of the Vienna Convention states:

*A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose.*

*The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:*

*(a) Any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;*

*(b) Any instrument which was made by one or more of the parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.*

202. In interpreting the NAFTA the Tribunal must start by identifying the plain and ordinary meaning of the words in the context in which they appear and also must take due account of the object and purpose of the treaty. The context for the purpose of interpretation of a treaty includes its preamble and any annexes.

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<sup>34</sup> The Tribunal does not suggest that national law is irrelevant, as it may be relevant in various ways; but the general principle of interpretation is clear.

203. The Vienna Convention also contains, in Article 27, a general principle that ...*A party may not invoke the provisions of its own internal law as justification for its failure to perform a treaty.*

204. The next step is for the Tribunal to review the other international agreements to which the Parties adhere. The first is the Transboundary Agreement. This agreement recognizes the possibility of achieving both economic efficiencies and the effective management of hazardous waste by cross-border shipments.

### **The Transboundary Agreement**

205. The preamble of the Transboundary Agreement states:

*Recognizing that the close trading relationship and the long common border between the United States and Canada engender opportunities for a generator of hazardous waste to benefit from using the nearest appropriate disposal facilities, which may involve the transboundary shipment of hazardous waste.*

*Recognizing that the most effective and efficient means of achieving environmentally sound management procedures for hazardous waste crossing the United States - Canada border is through cooperative efforts and controlled regulatory schemes.*

206. Article 2 of the Transboundary Agreement provides that:

*The parties shall permit the export, import and transit of hazardous waste across their common border for treatment, storage or disposal pursuant to the terms of their domestic laws, regulations and administration practices, and the provisions of this agreement.*

*The parties will cooperate in monitoring and spot-checking shipments of hazardous waste to ensure, to the extent possible, that such shipments conform to the requirement of the applicable legislation and of this Agreement.*

*To the extent that any implementing regulations are necessary to comply with this Agreement, the parties will act expeditiously to issue such*

*regulations consistent with domestic law. Pending such issuance, the parties will make their best efforts to provide notification in accordance with this Agreement where current regulatory authority is insufficient. The parties will provide each other with a diplomatic note upon the issuance and the coming into effect of any such regulation.*

207. Article 11 states:

*The provisions of this Agreement shall be subject to the applicable laws and regulations of the Parties.*

208. Article 11 does not give a party to the Transboundary Agreement absolute freedom to exclude the import or export of hazardous waste simply by enacting whatever national laws it chooses.<sup>35</sup>

209. Chronologically, the next instrument to be reviewed is the Basel Convention.

210. The Basel Convention came into force in May 1992, when twenty states had ratified it. CANADA became a party to it. The U.S. has not.

211. The Basel Convention commits its participants to:

- reduce the production of hazardous waste (Article 4(2)(a));
- ensure the availability of adequate disposal facilities, to the extent possible, within its own boundaries (Article 4(2)(b));
- ensure that the transboundary movement of hazardous wastes and other waste is reduced to the minimum consistent with the environmentally sound and efficient management of such wastes and is conducted in a manner which will protect human health and the environment against the adverse effects which may result from such movement (Article 4(2)(d)).

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<sup>35</sup> Insofar as CANADA did refer to its domestic legal regime, it anchored its position on the contention that the measure was necessary to protect health and the environment.

212. The Basel Convention is not as explicit as the Transboundary Agreement in emphasizing the potential benefits of cross-border movement of toxic wastes in achieving economies and better protecting the environment. Article 4(2)(d) of the Basel Convention acknowledges that the environmentally sound and efficient management of waste is not necessarily accomplished by avoiding cross-border shipments.
213. Article 11 expressly allows parties to enter into bilateral or multilateral agreements for the cross-border movement of waste, provided that these agreements do not undermine the Basel Convention's own insistence on environmentally sound management. So far as CANADA and the USA were concerned, Article 11 clearly permitted the continuation of the Transboundary Agreement with its emphasis on including cross-border movements as a means to be considered in achieving the most cost-effective and environmentally sound solution to hazardous waste management.<sup>36</sup>
214. The drafters of the NAFTA evidentially considered which earlier environmental treaties would prevail over the specific rules of the NAFTA in case of conflict. Annex 104 provided that the Basel Convention would have priority if and when it was ratified by the NAFTA Parties.
215. Even if the Basel Convention were to have been ratified by the NAFTA Parties, it should not be presumed that CANADA would have been able to use it to justify the breach of a specific NAFTA provision because *...where a party has a choice among equally effective and reasonably available alternatives for complying....with a Basel Convention obligation,*

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<sup>36</sup> NAFTA's Commission for Environmental Cooperation issued a report in June 1996 on the Status of PCB Management in North America. Its discussion of the various agreements notes that "Although NAFTA is designed to promote free, uninhibited trade between the three countries, it also recognizes the supremacy of the Basel Convention, the 1986 Agreement between CANADA and the U.S. and the 1983 La Paz Agreement between the United States and MEXICO in case of any inconsistency between NAFTA and these environmental agreements. In fact, the CANADA - U.S. - MEXICO hazardous waste agreements are predicated upon the free movement of hazardous waste between the parties subject to prior notice and consent by the importing country. The Basel Convention principles that disposal facilities be established within the country generating waste and that transboundary movement of waste shall be reduced to the minimum do not apply to bilateral movements of hazardous waste between the U.S. and MEXICO or CANADA because these would be governed by the principle of the freedom of movement, subject to notification and consent of the country of import." [Authorities, tab 4].

*it is obliged to choose the alternative that is ...least inconsistent... with the NAFTA.* If one such alternative were to involve no inconsistency with the Basel Convention, clearly this should be followed.

216. The next international instrument to be considered is a “side agreement” to the NAFTA on the environment, the NAAEC.

### **The NAAEC**

217. The NAAEC’s Statement of Objectives include both:

- Article 1(d) - support for the environmental goals and objectives of the NAFTA, and
- Article 1(e) - avoidance of new barriers of distortions in cross-border trade .

218. Article 3 of the NAAEC states that:

*Recognizing the right of each Party to establish its own levels of domestic environmental protection and environmental development policies and priorities, and to adopt or modify accordingly its environmental laws and regulations, each Party shall ensure that its laws and regulations provide for high levels of environmental protection and shall strive to continue to improve those laws and regulations.*

219. The NAAEC mandates the creation of a Commission for Environmental Cooperation. The Council of the Commission is authorized to strengthen cooperation on environmental laws and regulations. Without reducing levels of environmental protections, the Council is to consider ways to render technical requirements more compatible (NAAEC, Article 93).

220. The Preamble to the NAFTA, the NAAEC and the international agreements affirmed in the NAAEC suggest that specific provisions of the NAFTA should be interpreted in light of the following general principles:

- Parties have the right to establish high levels of environmental protection. They are not obliged to compromise their standards merely to satisfy the political or economic interests of other states;
- Parties should avoid creating distortions to trade;
- environmental protection and economic development can and should be mutually supportive.

221. In the Tribunal's view, these principles are consistent with the express provisions of the Transboundary Agreement and the Basel Convention. A logical corollary of them is that where a state can achieve its chosen level of environmental protection through a variety of equally effective and reasonable means, it is obliged to adopt the alternative that is most consistent with open trade. This corollary also is consistent with the language and the case law arising out of the WTO family of agreements.

## CHAPTER VII

### WAS SDMI AN INVESTOR? WAS THERE AN INVESTMENT?

222. SDMI's claim is advanced pursuant to Article 1116.<sup>37</sup> It is a claim by SDMI itself as an "investor" on its own behalf. It is a dispute in relation to SDMI's alleged investment in Canada and is for damages arising out of the alleged breach by CANADA of its obligations under Section A of Chapter 11. SDMI asserts that it ... *has suffered economic harm to its Investment through interference with its operations, lost contracts and opportunities in CANADA.* [emphasis added].<sup>38</sup> That is, that it has sustained damages because its *investment* in Canada has suffered harm.
223. The issue is one of standing. To sustain a claim, SDMI must meet the qualifying requirements of Chapter 11.
224. Chapter 11 covers claims by investors against a host Party. In the context of this case, SDMI contends that it is an investor which is a national of a Party ...*that seeks to make, is making or has made an investment.* It is common ground that SDMI is a national of a Party, but CANADA asserts that it did not have an investment in Canada.
225. Two of the definitions set out in Section C of Chapter 11 are of consequence in considering CANADA's contention. First:

*investment* means:

- (a) *an enterprise;*
- (b) *an equity security of an enterprise;*
- (c) *a debt security of an enterprise*

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<sup>37</sup> SDMI's Notice of Arbitration, Section C.

<sup>38</sup> Ibid. Section E.

- (i) *where the enterprise is an affiliate of the investor, or*
- (ii) *where the original maturity of the debt security is at least three years,*

*but does not include a debt security, regardless of original maturity, of a state enterprise;*

(d) *a loan to an enterprise*

- (i) *where the enterprise is an affiliate of the investor, or*
- (ii) *where the original maturity of the loan is at least three years,*

*but does not include a loan, regardless of original maturity, to a state enterprise;*

(e) *an interest in an enterprise that entitles the owner to share in income or profits of the enterprise;*

(f) *an interest in an enterprise that entitles the owner to share in the assets of that enterprise on dissolution, other than a debt security or a loan excluded from subparagraph (c) or (d);*

(g) *real estate or other property, tangible or intangible, acquired in the expectation or used for the purpose of economic benefit or other business purposes; and*

(h) *interests arising from the commitment of capital or other resources in the territory of a Party to economic activity in such territory, such as under*

- (i) *contracts involving the presence of an investor's property in the territory of the Party, including turnkey or construction contracts, or concessions, or*
- (ii) *contracts where remuneration depends substantially on the production, revenues or profits of an enterprise;*

*but an investment does not mean,*



- (i) *claims to money that arise solely from*
  - (i) *commercial contracts for the sale of goods or services by a national or enterprise in the territory of a Party to an enterprise in the territory of another Party, or*
  - (ii) *the extension of credit in connection with a commercial transaction, such as trade financing, other than a loan covered by subparagraph (d); or*
- (j) *any other claims to money,*

*that do not involve the kinds of interests set out in subparagraphs (a) through (h);*

second:

*investment of an investor of a Party means an investor other than an investor of a Party, that seeks to make, is making or had made an investment;”*

[emphasis in original]

226. During the proceedings there was considerable debate concerning whether Myers Canada fitted into any of the categories under the definition of “investment”. Evidence was presented to demonstrate that SDMI lent money to Myers Canada and that SDMI had an expectation that it would share in the income or profit if there were any. In fact, some payments for services were made by Myers Canada to SDMI.<sup>39</sup>

227. At the relevant time Myers Canada was undoubtedly an “enterprise”,<sup>40</sup> but CANADA submitted that it was not owned or controlled directly or indirectly by SDMI. This is because the shares of Myers Canada were owned not by SDMI, but equally by four members of the Myers family. They also owned the shares in SDMI, but in different proportions. As noted previously, Mr. Dana Myers owned 51% of that company. His was

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<sup>39</sup> See generally the evidence of Dana Myers, Transcript, February 15, 2000.

<sup>40</sup> Article 1139 refers incorporates the definition in article 201 which says that *enterprise means any entity constituted or organized under applicable law...*

the authoritative voice in SDMI and the evidence of his brother, Mr. Scott Myers, was that Dana Myers was the authoritative voice in Myers Canada.<sup>41</sup>

228. Mr. Dana Myers explained the basis on which the Claimant carried on its international operations at the relevant time:

*“Q. Now, just to return for a moment, and I understand it was in your capacity as an official with SDMI that you were involved in the operations in Australia, Saudi Arabia and MEXICO. And I wanted to clarify from what perspective you were operating in this sense: Were you providing direction as the Chief Executive of SDMI or were you providing direction as an officer of those companies in those locations?”*

*A. Okay. Here’s how we operate. S.D. Myers was the big portion of our business. We were trying to expand into other countries, and so we would set up these other companies because it’s better to have a local presence in these companies countries. I’m sorry.*

*Specifically, I think it was my position as President of S.D. Myers, Inc. that I exercised control over all these other places because all these other places were basically just an offshoot or an outpost of S.D. Myers, Inc. to do business around the world.*

*Q. Now, but in each of those cases, they were corporations with their own directors and their own shareholders?”*

*A. Correct.*

*Q. And their own corporate officers?”*

*A. Correct.*

*Q. Were you a corporate officer of any of those concerns in Australia?”*

*A. Yeah. Yes.*

*Q. And the same is true of Saudi Arabia and MEXICO?”*

*A. Yes, yes.*

*Q. All right. Now you also told us, I believe it was in connection with MEXICO, but it may have been in connection with Saudi Arabia, as well, that you signed some papers*

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<sup>41</sup> Transcript, February 14, 2000, qq. 34, 117.

A. *Okay.*

*Q. in respect of those operations.*

*Were those papers that related to your arrangement with individuals within those companies or those countries, rather, for the delivery of PCB disposal services?*

A. *No. What it would have been was we had 51 per cent. My brothers and I had 51 per cent of the operation in MEXICO and the Mexican owner had 49 per cent. So we had a document that laid out what he was going to provide and what we were going to provide.*

*Q. And that's what you would characterize as a joint venture, a joint venture agreement?*

A. *Yes.*

*Q. Did you have a similar agreement in respect of Australia?*

A. *At the beginning, because we were dealing with a guy named Neil Richter and I forget the other guy's name. So we had something. Then we bought them out and then basically there wouldn't have been an agreement because it was just all within the family.*

*Q. So, in fact, in Australia, you did as well have*

A. *To begin with.*

*Q. a joint venture agreement?*

A. *For a year or two.*

*Q. All right. And that document set out the respective responsibilities and obligations of the participants?*

A. *Correct.*

*Q. And indicated the extent to which they would share in the success of the venture?*

A. *Correct.*

*Q. Now, in respect of Myers CANADA, was there such a document ever signed by you or anybody else for your company?*

*A. Because it was all in the family, no.*<sup>42</sup>

229. Taking into account the objectives of the NAFTA, and the obligation of the Parties to interpret and apply its provisions in light of those objectives, the Tribunal does not accept that an otherwise meritorious claim should fail solely by reason of the corporate structure adopted by a claimant in order to organise the way in which it conducts its business affairs. The Tribunal's view is reinforced by the use of the word "indirectly" in the second of the definitions quoted above.
230. The uncontradicted evidence before the Tribunal was that Mr. Stanley Myers had transferred his business to his sons so that it remained wholly within the family and that he had chosen his son Mr. Dana Myers to be the controlling person in respect of the entirety of the Myers family's business interests.
231. On the evidence and on the basis of its interpretation of the NAFTA, the Tribunal concludes that SDMI was an "investor" for the purposes of Chapter 11 of the NAFTA and that Myers Canada was an "investment".
232. The Tribunal recognizes that there are a number of other bases on which SDMI could contend that it has standing to maintain its claim including that (a) SDMI and Myers Canada were in a joint venture, (b) Myers Canada was a branch of SDMI, (c) it had made a loan to Myers Canada, and (d) its market share in Canada constituted an investment. It is not necessary to address these matters in this context and the Tribunal does not do so, although they may be relevant to other issues in the case. Insofar as they are, they will be dealt with at the appropriate time.

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<sup>42</sup> Transcript, February 15, 2000, qq. 139-152.

## CHAPTER VIII

### DID THE MEASURE RELATE TO AN INVESTMENT?

233. Article 1101 of the NAFTA states:

*Scope and Coverage*

*This Chapter applies to measures adopted or maintained by a Party relating to:*

- (a) investors of another Party;*
- (b) investments of investors of another Party in the territory of the Party; and*
- (c) with respect to Articles 1106 and 1114, all investments in the territory of the Party.*

234. In this case, the requirement that the import ban be “in relation” to SDMI and its investment in Canada is easily satisfied. It was the prospect that SDMI would carry through with its plans to expand its Canadian operations that was the specific inspiration for the export ban. It was raised to address specifically the operations of SDMI and its investment.

235. That is sufficient to dispose of the “relating to” requirement for the immediate purpose of determining liability in this case.

236. CANADA also took the position that the requirement was not met because the measure concerned trade in goods. This contention is dealt with separately in the context of the relationship between Chapter 11 and other chapters of the NAFTA.

## CHAPTER IX

### DID CANADA COMPLY WITH ITS NAFTA CHAPTER 11 OBLIGATIONS?

237. In this Chapter the Tribunal reviews the merits of SDMI's claims under four separate provisions of Chapter 11 of the NAFTA.

#### Article 1102 (National Treatment)

238. SDMI claims that CANADA denied it "national treatment", contrary to Article 1102. Article 1102(1) states:

*Each Party shall accord to investors of another Party treatment no less favorable than it accords, in like circumstances, to its own investors, with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments.*

239. Article 1102(2) is identical, except that it refers to "investments", rather than "investors":

*Each Party shall accord to investments of investors of another Party treatment no less favorable than it accords, in like circumstances, to investments of its own investors with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments.*

240. Article 1102(3) addresses the obligations of "sub-national" authorities - local states or provinces - and states that in that context the relevant comparison is between the treatment accorded to an investment or an investor and the best treatment accorded to investments or investors within the jurisdiction of the sub-national authority:

*The treatment accorded by a Party under paragraphs 1 and 2 means, with respect to a state or a province, treatment no less favorable than the most favorable treatment accorded, in like circumstances, by that state or*

*province to investors, and to the investments of investors, or the Party of which it forms a part.*<sup>43</sup>

241. CANADA argues that the Interim Order merely established a uniform regulatory regime under which all were treated equally. No one was permitted to export PCBs, so there was no discrimination. SDMI contends that Article 1102 was breached by a ban on the export of PCBs that was not justified by *bona fide* health or environmental concerns, but which had the aim and effect of protecting and promoting the market share of producers who were Canadians and who would perform the work in Canada.
242. CANADA's submission is one dimensional and does not take into account the basis on which the different interests in the industry were organized to undertake their business.

#### **“Like Circumstances”**

243. Articles 1102(1) and 1102(2) refer to treatment that is accorded to a Party's own nationals “in like circumstances”. The phrase “like circumstances” is open to a wide variety of interpretations in the abstract and in the context of a particular dispute.
244. WTO dispute resolution panels, and its appellate body, frequently have been required to apply the concept of “like products”. The case law has emphasized that the interpretation of “like” must depend on all the circumstances of each case. The case law also suggests that close attention must be paid to the legal context in which the word “like” appears; the same word “like” may have different meanings in different provisions of the GATT. In *Japan - Alcoholic Beverages*, WT/DS38/AB/R, the Appellate Body stated at paragraphs 8.5 and 8.6:

*[the interpretation and application of “like”] is a discretionary decision that must be made in considering the various characteristics of products*

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<sup>43</sup> Article 1102(4) appears to be of little relevance to the current discussion. It confirms that a state cannot require that a minimum level of equity in an enterprise in its territory be held by its own nationals, and that an investor of another Party cannot be required to sell or otherwise dispose of its investment in the territory of the Party.

*in individual cases. No one approach to exercising judgment will be appropriate for all cases. The criteria in [an earlier case], Border Tax Adjustments should be examined, but there can be no one precise and absolute definition of what is “like”. The concept of “likeness” is a relative one that evokes the image of an accordion. The accordion of “likeness” stretches and squeezes in different places as different provisions of the WTO Agreement are applied. The width of the accordion in any one of those places must be determined by the particular provision in which the term “like” is encountered as well as by the context and the circumstances that prevail in any given case to which the provisions may apply.*

245. In considering the meaning of “like circumstances” under Article 1102 of the NAFTA, it is similarly necessary to keep in mind the overall legal context in which the phrase appears.

246. In the GATT context, a *prima facie* finding of discrimination in “like” cases often takes place within the overall GATT framework, which includes Article XX (General Exceptions). A finding of “likeness” does not dispose of the case. It may set the stage for an inquiry into whether the different treatment of situations found to be “like” is justified by legitimate public policy measures that are pursued in a reasonable manner.

247. The Tribunal considers that the legal context of Article 1102 includes the various provisions of the NAFTA, its companion agreement the NAAEC and principles that are affirmed by the NAAEC (including those of the Rio declaration). The principles that emerge from that context, to repeat, are as follows:

- states have the right to establish high levels of environmental protection. They are not obliged to compromise their standards merely to satisfy the political or economic interests of other states;
- states should avoid creating distortions to trade;
- environmental protection and economic development can and should be mutually supportive.

248. As SDMI noted in its Memorial, all three NAFTA partners belong to the OECD. OECD practice suggests that an evaluation of “like situations” in the investment context should



take into account policy objectives in determining whether enterprises are in like circumstances. The OECD Declaration on International and Multinational Enterprises, issued on June 21, 1976, states that investors and investments should receive treatment that is ...*no less favorable than that accorded in like situations to domestic enterprises*. In 1993 the OECD reviewed the “like situation” test in the following terms:

*As regards the expression ‘in like situations’, the comparison between foreign-controlled enterprises is only valid if it is made between firms operating in the same sector. More general considerations, such as the policy objectives of Member countries could be taken into account to define the circumstances in which comparison between foreign-controlled and domestic enterprises is permissible inasmuch as those objectives are not contrary to the principle of national treatment.*

249. The Supreme Court of Canada has explored the complexity of making comparisons as it has developed its line of decisions on discrimination against individuals. In the *Andrews* case, the Court stated that the question of whether or not discrimination exists cannot be determined by applying a purely mechanical test whether similarly situated individuals are treated in the same manner. Whether individuals are “similarly situated”, and have been treated in a substantively equal manner, depends on an examination of the context in which a measure is established and applied and the specific circumstances of each case.<sup>44</sup>
250. The Tribunal considers that the interpretation of the phrase “like circumstances” in Article 1102 must take into account the general principles that emerge from the legal context of the NAFTA, including both its concern with the environment and the need to avoid trade distortions that are not justified by environmental concerns. The assessment of “like circumstances” must also take into account circumstances that would justify governmental regulations that treat them differently in order to protect the public interest. The concept of “like circumstances” invites an examination of whether a non-national investor complaining of less favourable treatment is in the same “sector” as the national investor. The Tribunal

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<sup>44</sup> [1989] 1 S.C.R. 143, at paragraphs 27 to 31. Decisions of U.S. courts are to a similar effect. Although domestic law is not controlling in Chapter 11 disputes, it is not inappropriate to consider how the domestic laws of the parties to the dispute address an issue.

takes the view that the word “sector” has a wide connotation that includes the concepts of “economic sector” and “business sector”.

251. From the business perspective, it is clear that SDMI and Myers Canada were in “like circumstances” with Canadian operators such as Chem-Security and Cintec. They all were engaged in providing PCB waste remediation services. SDMI was in a position to attract customers that might otherwise have gone to the Canadian operators because it could offer more favourable prices and because it had extensive experience and credibility. It was precisely because SDMI was in a position to take business away from its Canadian competitors that Chem-Security and Cintec lobbied the Minister of the Environment to ban exports when the U.S. authorities opened the border.

**National treatment and protectionist motive or intent.**

252. The Tribunal takes the view that, in assessing whether a measure is contrary to a national treatment norm, the following factors should be taken into account:

- whether the practical effect of the measure is to create a disproportionate benefit for nationals over non nationals;
- whether the measure, on its face, appears to favour its nationals over non-nationals who are protected by the relevant treaty.

253. Each of these factors must be explored in the context of all the facts to determine whether there actually has been a denial of national treatment.

254. Intent is important, but protectionist intent is not necessarily decisive on its own. The existence of an intent to favour nationals over non-nationals would not give rise to a breach of Chapter 1102 of the NAFTA if the measure in question were to produce no adverse effect on the non-national complainant. The word “treatment” suggests that practical impact is required to produce a breach of Article 1102, not merely a motive or intent that is in violation of Chapter 11.

255. CANADA was concerned to ensure the economic strength of the Canadian industry, in part, because it wanted to maintain the ability to process PCBs within Canada in the future. This was a legitimate goal, consistent with the policy objectives of the Basel Convention. There were a number of legitimate ways by which CANADA could have achieved it, but preventing SDMI from exporting PCBs for processing in the USA by the use of the Interim Order and the Final Order was not one of them. The indirect motive was understandable, but the method contravened CANADA's international commitments under the NAFTA. CANADA's right to source all government requirements and to grant subsidies to the Canadian industry are but two examples of legitimate alternative measures. The fact that the matter was addressed subsequently and the border re-opened also shows that CANADA was not constrained in its ability to deal effectively with the situation.

256. The Tribunal concludes that the issuance of the Interim Order and the Final Order was a breach of Article 1102 of the NAFTA.

257. The consequences of the Tribunal's determination in relation to Article 1102 of the NAFTA are considered later.

### **Article 1105**

258. SDMI submits that CANADA treated it in a manner that was inconsistent with Article 1105(1) of the NAFTA. Entitled "Minimum Standard of Treatment", it reads as follows:

*Each Party shall accord to investments of investors of another Party treatment in accordance with international law, including fair and equitable treatment and full protection and security.*

259. The minimum standard of treatment provision of the NAFTA is similar to clauses contained in BITs. The inclusion of a "minimum standard" provision is necessary to avoid what might otherwise be a gap. A government might treat an investor in a harsh, injurious and unjust manner, but do so in a way that is no different than the treatment inflicted on its own

nationals. The “minimum standard” is a floor below which treatment of foreign investors must not fall, even if a government were not acting in a discriminatory manner.

260. The US-Mexican Claims Commission noted in the *Hopkins* case that:

*It not infrequently happens that under the rules of international law applied to controversies of an international aspect a nation is required to accord to aliens broader and more liberal treatment than it accords to its own citizens under its municipal laws...The citizens of a nation may enjoy many rights which are withheld from aliens, and conversely, under international law, aliens may enjoy rights and remedies which the nation does not accord to its own citizens.*<sup>45</sup>

261. When interpreting and applying the “minimum standard”, a Chapter 11 tribunal does not have an open-ended mandate to second-guess government decision-making. Governments have to make many potentially controversial choices. In doing so, they may appear to have made mistakes, to have misjudged the facts, proceeded on the basis of a misguided economic or sociological theory, placed too much emphasis on some social values over others and adopted solutions that are ultimately ineffective or counterproductive. The ordinary remedy, if there were one, for errors in modern governments is through internal political and legal processes, including elections.

262. Article 1105(1) expresses an overall concept. The words of the article must be read as a whole. The phrases *...fair and equitable treatment...* and *...full protection and security...* cannot be read in isolation. They must be read in conjunction with the introductory phrase *...treatment in accordance with international law.*

263. The Tribunal considers that a breach of Article 1105 occurs only when it is shown that an investor has been treated in such an unjust or arbitrary manner that the treatment rises to the level that is unacceptable from the international perspective. That determination must be made in the light of the high measure of deference that international law generally extends to

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<sup>45</sup> *The USA on behalf of George W. Hopkins v. The United Mexican States* (Docket No. 39), 21 American Journal

the right of domestic authorities to regulate matters within their own borders. The determination must also take into account any specific rules of international law that are applicable to the case.

264. In some cases, the breach of a rule of international law by a host Party may not be decisive in determining that a foreign investor has been denied “*fair and equitable treatment*”, but the fact that a host Party has breached a rule of international law that is specifically designed to protect investors will tend to weigh heavily in favour of finding a breach of Article 1105.
265. The breadth of the “*minimum standard*”, including its ability to encompass more particular guarantees, was recognized by Dr. Mann in the following passage:

*...it is submitted that the right to fair and equitable treatment goes much further than the right to most-favored-nation and to national treatment....so general a provision is likely to be almost sufficient to cover all conceivable cases, and it may well be that provisions of the Agreements affording substantive protection are not more than examples of specific instances of this overriding duty.<sup>46</sup>*

266. Although modern commentators might consider Dr Mann’s statement to be an over-generalisation, and the Tribunal does not rule out the possibility that there could be circumstances in which a denial of the national treatment provisions of the NAFTA would not necessarily offend the minimum standard provisions, a majority of the Tribunal determines that on the facts of this particular case the breach of Article 1102 essentially establishes a breach of Article 1105 as well.
267. Mr. Chiasson considers that a finding of a violation of Article 1105 must be based on a demonstrated failure to meet the fair and equitable requirements of international law. Breach of another provision of the NAFTA is not a foundation for such a conclusion. The language of the NAFTA does not support the notion espoused by Dr. Mann insofar as it is

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of International Law 160, at 166-167 (1926).

<sup>46</sup> F.A. Mann, “*British Treaties for the Promotion and Protection of Investments*”, (1981) 52 Brit. Y.B. Int’l L.

considered to support a breach of Article 1105 that is based on a violation of another provision of Chapter 11. On the facts of this case, CANADA's actions come close to the line, but on the evidence no breach of Article 1105 is established.

268. By a majority, the Tribunal determines that the issuance of the Interim and Final Orders was a breach of Article 1105 of the NAFTA. The Tribunal's decision in this respect makes it unnecessary to review SDMI's other submissions in relation to Article 1105.

269. The consequences of the Tribunal's determination in relation to Article 1105 of the NAFTA are considered in the next chapter.

#### **Article 1106 – Performance Requirements**

270. SDMI contends that CANADA's export ban breached Article 1106 of NAFTA because, in effect, SDMI was required, as a condition of operating in Canada, to carry out a major part of its proposed business, the physical disposal of PCB waste in Canada. In doing so, SDMI effectively would have been required to consume goods and services in Canada.

271. Article 1106 states:

*No party may imposed or enforce any of the following requirements, or enforce any commitment or undertaking, in connection with the establishment, acquisition, expansion, management, conduct or operation of an investment of an investor of a Party or a non Party in its territory:*

*(b) to achieve a given level or percentage of domestic content*

*(c) to purchase, use or accord a preference to goods produced or services provided in its territory or to purchase goods or services from persons in its territory;*

272. Article 1106(5) states:

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241 at p. 243.

*Paragraphs 1 and 3 do not apply to any requirement other than the requirements set out in those paragraphs*

273. The export ban imposed by CANADA was not cast in the form of express conditions attached to a regulatory approval but, in applying Article 1106 the Tribunal must look at substance, not only form.
274. The 1947 GATT agreement contained no specific provisions on performance requirements. One dispute was brought before a GATT panel. The USA challenged CANADA's FIRA. Under that statute, non-Canadian investors in some circumstances had to obtain regulatory approval before operating or expanding in CANADA. The regulator could attach conditions to its approval. For example, a factory operator might be required to purchase 50% of its supplies from local suppliers, rather than from abroad. The GATT panel accepted some aspects of the U.S. complaint and rejected others, but the GATT panel looked at the substance of the measure notwithstanding the fact that the GATT did not contain any express provision equivalent to Article 1106 of the NAFTA.
275. Although the Tribunal must review the substance of the measure, it cannot take into consideration any limitations or restrictions that do not fall squarely within the "requirements" listed in Articles 1106(1) and (3).
276. The only part of the definition that might apply to the current situation is *...conduct or operation of an investment...* but in the opinion of the majority of the Tribunal, subparagraph (b) clearly does not apply and, neither does subparagraph (c).
277. Looking at the substance and effect of the Interim Order, as well as the literal wording of Article 1106, the majority of the Tribunal considers that no "requirements" as defined were imposed on SDMI that fell within Article 1106. Professor Schwartz considers that the effect of the Interim Order was to require SDMI to undertake all of its operations in Canada and that this amounted to a breach of subparagraph (b).

278. By a majority, the Tribunal concludes that this is not a “performance requirements” case.

### **Article 1110 – Expropriation**

279. SDMI claims that the Interim Order and the Final Order were “tantamount” to an expropriation and violated Article 1110 of the NAFTA.

280. The term “expropriation” in Article 1110 must be interpreted in light of the whole body of state practice, treaties and judicial interpretations of that term in international law cases. In general, the term “expropriation” carries with it the connotation of a “taking” by a governmental-type authority of a person’s “property” with a view to transferring ownership of that property to another person, usually the authority that exercised its *de jure* or *de facto* power to do the “taking”.

281. The Tribunal accepts that, in legal theory, rights other than property rights may be “expropriated” and that international law makes it appropriate for tribunals to examine the purpose and effect of governmental measures. The Interim Order and the Final Order were regulatory acts that imposed restrictions on SDMI. The general body of precedent usually does not treat regulatory action as amounting to expropriation. Regulatory conduct by public authorities is unlikely to be the subject of legitimate complaint under Article 1110 of the NAFTA, although the Tribunal does not rule out that possibility.

282. Expropriations tend to involve the deprivation of ownership rights; regulations a lesser interference. The distinction between expropriation and regulation screens out most potential cases of complaints concerning economic intervention by a state and reduces the risk that governments will be subject to claims as they go about their business of managing public affairs.



283. An expropriation usually amounts to a lasting removal of the ability of an owner to make use of its economic rights although it may be that, in some contexts and circumstances, it would be appropriate to view a deprivation as amounting to an expropriation, even if it were partial or temporary.
284. In this case the closure of the border was temporary.<sup>47</sup> SDMI's venture into the Canadian market was postponed for approximately eighteen months. Mr. Dana Myers testified that this delay had the effect of eliminating SDMI's competitive advantage. This may have significance in assessing the compensation to be awarded in relation to CANADA's violations of Articles 1102 and 1105<sup>48</sup>, but it does not support the proposition on the facts of this case that the measure should be characterized as an expropriation within the terms of Article 1110.
285. SDMI relied on the use of the word "tantamount" in Article 1110(1) to extend the meaning of the expression "tantamount to expropriation" beyond the customary scope of the term "expropriation" under international law. The primary meaning of the word "tantamount" given by the Oxford English Dictionary is "equivalent". Both words require a tribunal to look at the substance of what has occurred and not only at form. A tribunal should not be deterred by technical or facial considerations from reaching a conclusion that an expropriation or conduct tantamount to an expropriation has occurred. It must look at the real interests involved and the purpose and effect of the government measure.
286. The Tribunal agrees with the conclusion in the Interim Award of the *Pope & Talbot* Arbitral Tribunal<sup>49</sup> that something that is "equivalent" to something else cannot logically encompass more. In common with the *Pope & Talbot* Tribunal, this Tribunal considers that the drafters of the NAFTA intended the word "tantamount" to embrace the concept of so-called

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<sup>47</sup> The fact that the border was closed again on the U.S. side in July 1997 cannot be laid at CANADA's door.

<sup>48</sup> This is a matter for argument at a later stage of the proceedings.

<sup>49</sup> Award of June 26, 2000, para. 104.

“creeping expropriation”, rather than to expand the internationally accepted scope of the term expropriation.

287. In this case, the Interim Order and the Final Order were designed to, and did, curb SDMI’s initiative, but only for a time. CANADA realized no benefit from the measure. The evidence does not support a transfer of property or benefit directly to others. An opportunity was delayed.

288. The Tribunal concludes that this is not an “expropriation” case.

## CHAPTER X

### IS SDMI's CLAIM BARRED BY OTHER CHAPTERS OF THE NAFTA?

289. CANADA and MEXICO contend that SDMI's claim is met or circumscribed by either or both of Chapters 3 and 12 of the NAFTA. The former deals with trade in goods and the latter with cross-border trade in services.

#### The Claim

290. As noted previously, the claim advanced by SDMI is that it has suffered economic harm to its investment through interference with its operations, lost contracts and opportunities in Canada. SDMI submits its claims pursuant to Article 1116 of the NAFTA. That is, SDMI alleges that it has incurred loss or damage by reason of conduct that caused economic harm to its investment in Canada.

#### Chapter 3

291. In *Korea – Definitive Safeguard Measure on Imports of Certain Dairy Products*, the Panel summarized the line of WTO cases as follows, at paragraph 738 of its report:<sup>50</sup>

*It is now well established that the WTO Agreement is a “Single Undertaking” and therefore all WTO obligations are generally cumulative and Members must comply with all of them simultaneously unless there is a formal “conflict” between them.*

292. The chapters of the NAFTA are part of a “single undertaking”. There appears to be no reason in principle for not following the same preference as in the WTO system for viewing different provisions as “cumulative” and complementary.

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<sup>50</sup> Wt/396/R.

293. The WTO Panel in the *Korean Dairy Products* case adopted the definition of “conflict” in several earlier cases, including the report of the Appellate Body of the WTO in *Guatemala Cement*, at paragraph 65.<sup>51</sup> The latter case suggests that provisions of agreements in the WTO system should be read as complementary unless there were a conflict in the sense that adherence to one provision would cause a violation of the other.
294. The view that different chapters of the NAFTA can overlap and that the rights it provides can be cumulative except in cases of conflict, was accepted by the decision of the Arbitral Tribunal in *Pope and Talbot*. The reasoning in the case is sound and compelling. There is no reason why a measure which concerns goods (Chapter 3) cannot be a measure relating to an investor or an investment (Chapter 11).
295. Chapter 3 deals with items of trade – namely, “goods”. A measure that relates to goods can relate to those who are involved in the trade of those goods and who have made investments concerning them. The thrust of a dispute under Chapter 11 is that the impugned measure relates to an investor or an investment. If it were to do so, it would be covered by Chapter 11 unless excluded. If it were not to do so, it would not be covered.
296. On the facts of this case there is a clear causal link between the Interim Order and the Final Order and the activities of SDMI. It is common ground that the Orders were passed in response to the Enforcement Discretion granted to SDMI by the US EPA. It was designed to prevent the export of PCBs for processing by SDMI. Insofar as SDMI can otherwise establish the requirements for it to be classified as an investor and can show that the measure related to it or its investment, Chapter 11 is engaged.

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<sup>51</sup> The Dispute Settling Panel, at footnote 422 to the quoted passage, elaborates:

*The principle of interpretation against conflict has been confirmed by the Appellate Body in Canada - Certain Measures Concerning Periodicals adopted on 30 July 1997, WT/DS31/AB/R, (“Canada Periodicals”), page 19; in EC Bananas, paras. 219-222; in Guatemala Cement, para. 65; and by the panel in Indonesia - Certain Measures Affecting the Automobile Industry, adopted 23 July 1998, WT/DS54, 55, 59 and 64/R (not appealed) (“Indonesia Autos”), para. 14.28. For a definition of conflict, see for instance the Appellate Body statement in Guatemala Cement, para. 65 or the Panel Report on Indonesia Autos, para. 14.28.*

297. CANADA argued that Chapter 3 is inconsistent with Chapter 11 on the facts of this case. It contended that even if the export ban appears to contravene Chapter 11, it would also be an export ban with respect to goods and controlled by Chapter 3. CANADA appears to contend that insofar as the measure concerns the export of goods it was driven by proper environmental concerns. That proposition has been rejected by the Tribunal, but the contention also is not sustainable on a proper interpretation of the NAFTA.
298. The NAFTA Parties properly wanted to ensure that Chapter 11 could not be used to impugn government measures that are protected by other specific aspects of the NAFTA, but the Orders are not protected by either Article XX(b) (Human, Animal or Plant Life) or Article XX(e) (Conservation) of GATT. The measures taken by CANADA would not satisfy the requirements of the *chapeau* of Article XX (General Exceptions). CANADA could have satisfied any health or environmental concerns it had in a manner that did not impair open trade. As CANADA implicitly agreed when it subsequently lifted the ban, it would have better served the cause of a safe environment if it had kept the Canadian border open, but put in place safeguards.

## **Chapter 12**

299. Consideration of the relationship between Chapters 11 and 12 is more complex. Insofar as the focus is merely on the fact that the two chapters may relate to the same activity, the Tribunal's observations concerning Chapter 3 are apt, but it may be that the question is not whether there is a conflict between Chapters 11 and 12, but whether the cross-border supply of services involves an "investment".
300. This latter issue has not been addressed fully by the Disputing Parties and may be of more significance to a consideration of damages. The Tribunal finds it not relevant to liability in this case.

## CHAPTER XI

### THE PRINCIPLES ON WHICH COMPENSATION SHOULD BE AWARDED

301. The Tribunal has determined that CANADA's ban on PCB exports to the USA was a breach of CANADA's obligations under Articles 1002 and 1005 Chapter 11 of the NAFTA. Insofar as this conduct caused harm to SDMI by injuring its investment, Myers Canada, CANADA must pay compensation to SDMI.

302. Paragraph 1 of Procedural Order No. 1 stated as follows:

#### ***Bifurcation***

*As a first stage of the proceedings the Tribunal will determine (in a partial award) liability issues and issues as to the principles on which damages (if any) should be awarded, leaving the calculation of the quantification of such damages, if any, to a second stage.*

303. This stage of the arbitration is concerned solely with the principles on which damages should be awarded. Quantification is to be the subject of a second stage of the proceedings.

304. Article 1131 provides that Chapter 11 tribunals shall decide *...in accordance with [the NAFTA] and applicable international law*. Article 1135 provides that an investor may submit to arbitration a claim that *...the enterprise has incurred loss or damage by reason of, or arising out of, that breach*. Article 1135 also provides that an arbitral tribunal has the authority to award only *...monetary damages and any applicable interest or restitution of property*.

305. So far as the NAFTA is concerned, the only guidance on the principles to be adopted in awarding compensation is contained in Article 1110, which concerns expropriation. The relevant provisions are as follows:

*1110(1). No Party may directly or indirectly nationalize or expropriate an investment of an investor or another Party in its territory or take a measure tantamount to nationalization or expropriation of such an investment (“expropriation”), except:*

- (a) For a public purpose;*
- (b) On a non-discriminatory basis;*
- (c) In accordance with due process of law and Article 1105(1); and*
- (d) On payment of compensation in accordance with paragraphs 2 through 6.*

*1110(2) Compensation shall be equivalent to the firm market value of the expropriated investment immediately before the expropriation took place (“date of expropriation”) and shall not reflect any change in value occurring because the intended expropriation had become known earlier. Valuation criteria shall include going concern value, asset value, including declared tax value of tangible property, and other criteria, as appropriate, to determine fair market value.*

306. SDMI suggested in its Memorial that Chapter 11 tribunals are likely to find that the standard set out in Article 1110(2) applies also to breaches of other Articles of Chapter 11. The Tribunal doubts that Article 1110(2) supplies the appropriate standard when a Party has breached one of the other provisions of Chapter 11.

307. The drafters of the NAFTA did not state that the “fair market value of the asset” formula applies to all breaches of Chapter 11. They expressly attached it to expropriations.<sup>52</sup>

308. Expropriations that take place in accordance with the framework of Article 1110 – that is, expropriations that are conducted for a public purpose, on a non-discriminatory basis and in accordance with due process of law - are “lawful” under Chapter 11 provided that compensation is paid in accordance with the *...fair market value of the asset...* formula.

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<sup>52</sup> According to some commentators, that express provision was intended to resolve a long standing difference of opinion between the USA and MEXICO over compensation in expropriation cases. The latter contended that in the case of a lawful expropriation, a lower standard of compensation might be appropriate than all of the economic loss sustained.

Under other provisions of Chapter 11, the liability of the host Party arises out of the fact that the government has done something that is contrary to the NAFTA and is “unlawful” as between the disputing parties. The standard of compensation that an arbitral tribunal should apply may in some cases be influenced by the distinction between compensating for a lawful, as opposed to an unlawful, act. Fixing the fair market value of an asset that is diminished in value may not fairly address the harm done to the investor.<sup>53</sup>

309. By not identifying any particular methodology for the assessment of compensation in cases not involving expropriation, the Tribunal considers that the drafters of the NAFTA intended to leave it open to tribunals to determine a measure of compensation appropriate to the specific circumstances of the case, taking into account the principles of both international law and the provisions of the NAFTA. In some non-expropriation cases a tribunal might think it appropriate to adopt the “fair market value” standard; in other cases it might not. In this case the Tribunal considers that the application of the fair market value standard is not a logical, appropriate or practicable measure of the compensation to be awarded.
310. There being no relevant provisions of the NAFTA other than those contained in Article 1110 the Tribunal turns for guidance to international law.
311. The principle of international law stated in the *Chorzow Factory (Indemnity)* case is still recognised as authoritative on the matter of general principle:

*The essential principle contained in the actual notion of an illegal act is that reparation must, as far as possible, wipe-out all the consequences of the illegal act and reestablish the situation which would, in all probability, have existed if that act had not been committed. Restitution in kind or, if this is not possible, payment of a sum corresponding to the value which a restitution in kind would bear; the award, if need be, of damages for loss sustained which would not be covered by restitution in kind or payment in place of it - such are the principles which should serve to determine the amount of compensation for an act contrary to international law.*

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<sup>53</sup> The Tribunal does not suggest that punitive damages may be awarded, as these are expressly prohibited by NAFTA.



312. The *Draft Articles on State Responsibility* under consideration by the International Law Commission at the date of this award similarly propose that in international law, a wrong committed by one state against another gives rise to a right to compensation for the economic harm sustained.
313. It was not suggested to the Tribunal by either of the parties that the *Chorzow* principle is somehow inapplicable because the claim in this case is brought directly by SDMI. Under international law, a wrong done to an investor is usually viewed as a wrong done to its home state and it is the state that brings the claim against the host state, not the investor directly.
314. The Tribunal agrees with CANADA that it would be premature at this stage to attempt to set out detailed, exclusive, principles for calculating the compensation payable. The disputing parties should have the opportunity to make further factual and legal submissions on the question of the precise methodology to be used.
315. The Tribunal already has suggested that whatever precise approach is taken, it should reflect the general principle of international law that compensation should undo the material harm inflicted by a breach of an international obligation.
316. CANADA has submitted, and the Tribunal accepts, that the following principles also apply:
- the burden is on SDMI to prove the quantum of the losses in respect of which it puts forward its claims;
  - compensation is payable only in respect of harm that is proved to have a sufficient causal link with the specific NAFTA provision that has been breached; the economic losses claimed by SDMI must be proved to be those that have arisen from a breach of the NAFTA, and not from other causes;
  - damages for breach of any one NAFTA provision can take into account any damages already awarded under a breach of another NAFTA provision; there must be no “double recovery”.

317. In summary, the Tribunal will assess the compensation payable to SDMI on the basis of the economic harm that SDMI legally can establish.
318. When both Article 1102 and 1105 have been breached, as the Tribunal has found in this case, the usual principle to be applied is that rights and remedies under trade agreements are cumulative unless there is actual conflict between different provisions. The fact that a host Party has breached both Articles 1102 and 1105 cannot be taken to mean that the investor is entitled to less compensation than if only Article 1102 were breached. A host Party does not reduce the extent of its liability by breaching more than one provision of the NAFTA.
319. On the facts of this case, the Tribunal is satisfied that the damages to which SDMI is entitled arising out of CANADA's breach of Article 1102 are neither increased nor diminished by its breach of Article 1105.

## CHAPTER XII

### CONCLUSIONS AND DISPOSITIVE PROVISIONS OF THE AWARD

#### **The Tribunal's conclusions**

320. The Interim Order and the Final Order did “relate to” an “investor” of a Party and its “investment”

321. SDMI was an “investor” and it had an “investment” in Canada at the relevant time.

322. The Interim Order and the Final Order were in breach of Articles 1102 and 1105 of the NAFTA.

323. The Interim Order and the Final Order were not in breach of Articles 1106 or 1110 of the NAFTA.

324. SDMI's claim is not barred by any inconsistencies between Chapter 11 and any other provisions of the NAFTA.

#### **Dispositive Provisions of the Award**

325. CANADA shall pay to SDMI compensation for such economic harm as is established legally by SDMI to be directly as a result of CANADA's breach of its obligations under Articles 1102 or 1105 of the NAFTA.

326. Such compensation shall be quantified in accordance with the principles set out in this Partial Award, at the second stage of the arbitration as contemplated by paragraph 1 of Procedural Order No. 1.

327. All questions concerning the parties' claims in respect of costs under Articles 38 and 40 of the UNCITRAL Arbitration Rules are postponed to the Tribunal's Final Award.

MADE at the City of Toronto, Ontario, Canada.

SIGNED:

signed – BPS

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Bryan P. Schwartz

signed - ECC

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Edward C. Chiasson, Q.C.

signed - MH

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J. Martin Hunter

November 13, 2000

## **LEGAL AUTHORITY CA-82**

INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES

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In the Matter of the Arbitration between

**EL PASO ENERGY INTERNATIONAL COMPANY**

Claimant

and

**THE ARGENTINE REPUBLIC**

Respondent

**ICSID Case No. ARB/03/15**

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**AWARD**

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***Members of the Tribunal:***

Prof. Lucius Caflisch

Prof. Piero Bernardini

Prof. Brigitte Stern

***Secretary of the Tribunal:*** Ms. Natalí Sequeira

***Representing the Claimant:***

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Mr. José Martínez de Hoz (h)  
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***Representing the Respondent:***

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*Date of dispatch to the Parties:* 31 October 2011

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## **LEGAL AUTHORITY CA-83**

## I. PROCEDURAL BACKGROUND

### A. REGISTRATION OF THE REQUEST FOR ARBITRATION

1. On 6 June 2003, the International Centre for Settlement of Investment Disputes (hereinafter the “Centre”) received a request for arbitration (hereinafter the “Request”) submitted by El Paso Energy International Company (hereinafter “El Paso” or “the Claimant”), a company organised under the laws of the State of Delaware (United States of America) against the Republic of Argentina (hereinafter “Argentina,” “the Respondent,” “the respondent State,” “the respondent Government” or “GOA”).
2. On the same date, in accordance with Rule 5 of the ICSID Rules of Procedure for the Institution of Conciliation and Arbitration Proceedings (“Institution Rules”), the Acting Secretary-General of the Centre acknowledged receipt of the Claimant’s Request.
3. In the Request, the Claimant submitted that Argentina had violated the 1991 Treaty Concerning the Reciprocal Encouragement and Protection of Investment between the Republic of Argentina and the United States of America (hereinafter “the BIT”)<sup>1</sup>, as well as other Argentinian and international law instruments.
4. The Request was registered by the Centre on 12 June 2003, pursuant to Article 36(3) of the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (“the ICSID Convention” or “the Washington Convention”)<sup>2</sup> and Rules 6(1)(a) and 7(a) of the Institution Rules. On the same date, the Acting Secretary-General notified the Parties of the registration and invited them to constitute an arbitral tribunal as soon as possible.

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<sup>1</sup> Treaty between United States of America and the Republic of Argentina concerning the Reciprocal Encouragement and Protection of Investment of 14 November 1991 (entered into force on 20 October 1994), available at: [http://www.unctad.org/sections/dite/ia/docs/bits/argentina\\_us.pdf](http://www.unctad.org/sections/dite/ia/docs/bits/argentina_us.pdf) (hereinafter 1991 BIT).

<sup>2</sup> The Convention on the Settlement of Investment Disputes between States and Nationals of Other States [hereinafter ICSID Convention or the Washington Convention] of 18 March 1965 (entered into force on 14 October 1966).

## B. PARTIES

5. The present dispute is between El Paso International Energy Company and the Republic of Argentina. It raises the question of whether Argentina has breached the Treaty between the United States and Argentina of 14 November 1991 concerning the Reciprocal Encouragement and Protection of Investment as regards investments made by the Claimant in Argentina.
6. El Paso is a United States company incorporated in the State of Delaware. It had that quality “on the date on which the parties consented to submit such dispute to ... arbitration” (Article 25(2)(b) of the ICSID Convention), *i.e.* when it accepted the jurisdiction of the International Centre for Settlement of Investment Disputes (hereinafter “ICSID”).
7. As indicated by its name, the Claimant is an energy company. It alleges that, up until 2003, it owned indirect and non-controlling shareholdings in a number of Argentinian entities: Compañías Asociadas Petroleras (CAPSA) and CAPEX SA (El Paso contends that it held a 45% indirect interest in CAPSA which, in turn, owned 60.36% of the shares of CAPEX); Central Costanera SA (Costanera), in which El Paso claims to have acquired a 12.335% indirect interest; and Gasoducto del Pacífico SA (Pacífico), in which its indirect interest was said to amount to approximately 13.4% (preferred shares), and 11.8% (ordinary shares) respectively. These four entities have been collectively referred to, in the present proceedings, as the “Argentinian companies.” El Paso further alleged an indirect controlling interest (99.92%) in SERVICIOS El Paso, another entity incorporated in Argentina, and a 61.6% interest in the Triunion Energy Company.
8. The respondent State argued, however, that these direct and indirect interests had not been proved by the Claimant. The latter had, shortly after filing its Reply, submitted an amended version of paragraphs 314-326 of that document to the Arbitral Tribunal. According to the respondent State, a comparison between the amended text and the original one yielded serious discrepancies.
9. Thus, the Claimant had alleged, in its original Reply, ownership of a 61.6% interest in Triunion, whereas the amended text referred to 71.968%. In the

original Reply, it had also been asserted that 0.0084% of Gasoducto del Pacifico (Argentina) S.A. was owned by Gasoducto del Pacifico (Cayman) Ltd., while the amended Reply spoke of 87.5%. In the initial Reply, there had been a question of El Paso holding 21.799% of Gasoducto del Pacífico (Argentina) S.A., a figure that was subsequently corrected to 12.5% (common shares) and 21.8% (preferred shares). Further discrepancies appeared in connection with Agua del Cajón (Cayman), the Reply's original text having alleged a 100% ownership of that company by El Paso, the subsequent one reducing that figure to 50%, the latter figure also appearing in documents filed by the Claimant with the United States Securities and Exchange Commission. Finally, the Claimant asserted that, through the sale of its interests in the Argentinian companies, it secured an additional equity interest of 6.3% in Gasoducto del Pacífico (Argentina) S.A., an assertion which has remained unproven as well.<sup>3</sup>

10. In April 1997, El Paso acquired, through KLT Power Inc., an indirect non-controlling shareholding of 12.335% in Costanera. The latter, a local company engaged in the generation and sale of electricity, with a total capacity of 2311 megawatt-hour (MWh), is the largest thermal generator in Argentina. It owns approximately 10% of the installed generation capacity in the country, with a plant that includes two state-of-the-art combined cycle units located in the city of Buenos Aires.
11. In January 1998, El Paso acquired an indirect non-controlling interest in Pacifico, which owns and operates a natural gas pipeline linking Argentina to the Chilean city of Cochabamba. That interest amounted to 13.4% of the preferred shares and 11.8% of the ordinary shares of Pacifico.<sup>4</sup>
12. Further observations are in order regarding SERVICIOS, Costanera and Pacifico. SERVICIOS was established by El Paso as an Argentinian subsidiary in March 1998 and entered thereafter into an agreement with an Argentinian branch of the Bank of Boston to lease a gas processing plant located on the

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<sup>3</sup> Respondent's Rejoinder on the Merits [hereinafter Rejoinder] of 12 March 2007, §§ 86-92.

<sup>4</sup> See *supra* § 7.



Agua de Cajón field in Neuquén Province. Pursuant to a ten-year gas processing agreement with CAPEX, SERVICIOS transformed gas produced at CAPEX's facilities into liquid petroleum gas (LPG) by-products that were sold by CAPEX.

13. It is alleged that, from 1997 to 2001, El Paso invested US\$ 336 million in the Argentinian companies, and that its parent company guaranteed around US\$ 24 million of SERVICIOS' lease obligations. El Paso sold its interest in the companies' shares in two sales, one in June 2003 – in CAPSA (consequently in CAPEX) and in SERVICIOS – another in October 2003 – in Costanera.
14. The Respondent is the Republic of Argentina.

#### C. CONSTITUTION OF THE ARBITRAL TRIBUNAL AND COMMENCEMENT OF THE PROCEEDINGS

15. The Parties agreed that the Tribunal would consist of three arbitrators, one to be appointed by each Party and the third and presiding arbitrator to be appointed by the Chairman of the Administrative Council of the Centre.
16. Accordingly, the Claimant appointed Professor Piero Bernardini (Italian) as an arbitrator and the Respondent appointed Professor Brigitte Stern (French) as an arbitrator. The Chairman of the Administrative Council of ICSID, with the agreement of the Parties, appointed Professor Lucius Caflisch (Swiss) as President of the Arbitral Tribunal.
17. Pursuant to Rule 6(1) of the ICSID Rules of Procedure for Arbitration Proceedings ("Arbitration Rules"), the Centre informed the Parties that all arbitrators having accepted their appointment, the Tribunal was deemed to have been constituted and the proceedings to have commenced on 6 February 2004. In accordance with ICSID Administrative and Financial Regulation 25, the Parties were also notified that Ms. Gabriela Alvarez-Avila, Senior Counsel, ICSID, would serve as Secretary of the Arbitral Tribunal.
18. After consultation with the Parties, the first session of the Tribunal was held on 21 April 2004 in Geneva. The Claimant was represented at the session by Mr. R. Doak Bishop and Mr. José Alfredo Martínez de Hoz (Jr.). The

Respondent was represented by Mr. Jorge Barraguirre and Ms. María Vallejos Meana of the Procuración del Tesoro de la Nación, who were present at the session on behalf of the Procurador del Tesoro de la Nación, Dr. Horacio Daniel Rosatti.

19. At the first session, the Parties agreed that the Tribunal had been properly constituted and that they had no objection to any of the members of the Tribunal. It was agreed that the proceedings would be conducted under the Arbitration Rules in force since 1 January 2003.
20. It was decided that the Claimant would file its Memorial on the Merits within 90 days of the date of the first session, that the Respondent would file its Counter-Memorial on the Merits within 90 days of the date of receipt of the Memorial, that the Claimant's Reply would be filed within 45 days of the date of receipt of the Counter-Memorial, and that the Respondent's Rejoinder would be filed within a further 45 days of the receipt of the Reply. It was further agreed that the Respondent had the right to raise any objections it might have to jurisdiction no later than 45 days from its receipt of the Claimant's Memorial. If such objections to jurisdiction were made by the Respondent, the Claimant would have 45 days to file its Counter-Memorial on Jurisdiction from its receipt of the Respondent's Memorial on Jurisdiction. The Tribunal would decide at a later stage, after having consulted the Parties, whether a second round of pleadings on jurisdiction would be necessary.

#### D. JURISDICTIONAL PHASE OF THE PROCEEDINGS

21. In accordance with the agreed schedule, the Claimant filed its Memorial on the Merits on 20 August 2004. The Respondent filed its Memorial on Jurisdiction on 19 October 2004 and the Claimant filed its Counter-Memorial on Jurisdiction on 13 December 2004.
22. After having considered the views of the Parties, the Tribunal decided on 3 February 2005 that a second round of pleadings on jurisdiction was not necessary and fixed the date for the hearing on jurisdiction on 7 April 2005. On 25 February 2005, the Tribunal announced that the hearing on jurisdiction was re-scheduled for 8 April 2005.

23. The hearing on jurisdiction was held at the seat of the Centre in Washington, D.C. on 8 April 2005. The Claimant was represented by Mr. R. Doak Bishop, Mr. José Alfredo Martínez de Hoz (Jr.), Mr. Tomasz J. Sikora, Mr. Craig S. Miles, Ms. Valeria Macchia and Ms. Angolie Singh. The Respondent was represented by Mr. Jorge Barraguirre, Ms. Gisela Makowski, and Ms. Cintia Yaryura from the Procuración del Tesoro de la Nación.
24. During the hearing, counsel for the Parties made presentations to the Tribunal, and *as per* the Respondent's request, Mr. Ed Sereno's testimony was heard. The Claimant briefly presented the witness; this was followed by cross-examination from the Respondent and redirect from the Claimant. The Tribunal then asked the witness some questions. Verbatim transcripts of the hearing were drawn up in English and Spanish and were distributed to the Tribunal and the Parties.
25. During the hearing on jurisdiction, the Tribunal requested some documents from both Parties. By letter of 14 April 2005, the Claimant responded to the request regarding the sale of its shares in Compañías Asociadas Petroleras S.A. (CAPSA), CAPEX S.A. and SERVICIOS El Paso S.R.L. On 6 May 2005, the Respondent provided certain documents to the Tribunal regarding the financial structure of Transportadora Gas del Norte and Metrogas, as well as the taxes imposed on the gas sector. In the same letter, the Respondent asked for the production by the Claimant of documents regarding its investment and the sale of its shares in the above-mentioned companies. On 10 June 2005, the Claimant objected to the Respondent's request of 6 May 2005. The Respondent answered the Claimant's objections by a letter of 27 June 2005.
26. By Procedural Order No. 1 of 28 July 2005, the Tribunal decided that "the information in possession of the Tribunal [was] sufficient to decide the jurisdictional issues raised by the Respondent and that if the proceedings were to reach the merits of the dispute, it [would] be open to the Respondent to reiterate the above request for production of documents".
27. In its Decision on Jurisdiction of 27 April 2006, the Tribunal decided that the dispute was within the jurisdiction of the Centre and within the competence of

the Tribunal. On the same date, it issued Procedural Order No. 2 by which the Tribunal confirmed the calendar agreed upon during the first session. Accordingly, the Respondent's Counter-Memorial on the Merits was due within 90 days from the date of Procedural Order No. 2, the Claimant's Reply within 45 days from its receipt of the Respondent's Counter-Memorial, and the Respondent's Rejoinder within 45 days from its receipt of the Claimant's Reply.

#### E. MERITS PHASE OF THE PROCEEDINGS

28. By letter of 6 June 2006, the Respondent requested the Tribunal (i) to order the Claimant to produce a number of additional documents related to its claim; (ii) to suspend the filing of the Respondent's Counter-Memorial on the Merits until the requested documents were submitted; and (iii) to extend the deadline for the filing of the Counter-Memorial on the Merits by 60 days.
29. By letter of 21 June 2006, the Claimant produced a number of the documents requested by the Respondent and objected to the production of some others, as well as to the suspension and extension for the filing of the Respondent's Counter-Memorial.
30. On 5 July 2006, the Tribunal decided to grant a 30-day extension for the filing of the Respondent's Counter-Memorial and requested the Respondent to make its observations on the Claimant's letter of 21 June 2006. By letter of 5 July 2006, the Respondent repeated its requests. On 11 July 2006, the Respondent asked the Tribunal to (i) order the Claimant to produce four sets of documents; and (ii) extend the time-limit for the filing of its Counter-Memorial on the Merits by the number of days taken by the Claimant to produce all such documents. By letter of 13 July 2006, the Claimant produced additional documents and objected to the Respondent's request for an additional extension of the time-limit.
31. On 26 July 2006, the Tribunal issued Procedural Order No. 3, by which it ordered the Claimant to produce by 3 August 2006 documents demonstrating how El Paso acquired its direct participation in Gasoducto del Pacífico (Argentina) S.A., in order to have a complete picture of El Paso's ownership in

Triunion Energy Co., Cayman. The Tribunal also took note of the Claimant's explanation of 13 July 2006 regarding CAPSA's financial statement of 2003 and invited the Claimant to make that statement available. The remaining requests submitted by the Respondent for production of documents were denied and the Tribunal fixed 1 September 2006 as the date for the filing of the Counter-Memorial on the Merits. In accordance with the schedule set by the Tribunal in its Procedural Order No. 3, the Respondent submitted its Counter-Memorial on the Merits on that date.

32. By letter of 25 September 2006, the Claimant requested a 30-day extension for the filing of its Reply. This request was objected to by the Respondent in a letter of 26 September 2006. On 4 October 2006, the Tribunal informed the Parties that it granted the requested extension and therefore fixed 28 November 2006 as the date for the filing of the Claimant's Reply.
33. By letter of 12 October 2006, the Respondent also requested a 30-day extension for the filing of its Rejoinder and a suspension of the schedule of the proceedings during January 2007. By letter of 19 October 2006, the Claimant agreed to the requested extension but objected to the suspension of the procedural schedule. On 26 October 2006, the Tribunal informed the Parties that it decided not to grant the suspension requested by the Respondent but to grant the 30-day extension for the filing of the Respondent's Rejoinder. Therefore, the Respondent's Rejoinder was due within 75 days from the receipt of the Spanish translation of the Claimant's Reply and accompanying documentation. The Claimant submitted the electronic copy of its Reply Memorial on the Merits on 28 November 2006, while the hard copy of the Claimant's Reply and the accompanying documentation were dispatched by a courier company on 29 November 2006.
34. By letter of 14 December 2006, the Respondent requested the Tribunal to disregard the Claimant's Reply because it was filed late. The Tribunal carefully examined the Respondent's request as well as the Claimant's letter of 18 December 2006 and the Respondent's observations of 20 December 2006.

35. By letter of 3 January 2007, the Tribunal decided not to disregard the filing; however – in view of the circumstances – it granted the Respondent until 12 March 2007 to file its Rejoinder. The Respondent filed its Rejoinder on that date.
36. By the Claimant's letters of 23, 25 and 26 April 2007 and the Respondent's letters of 24 and 25 April 2007, the Parties submitted their preliminary views about the conduct of the hearing on the merits scheduled for June 2007. By letter of 8 May 2007, the Tribunal confirmed that the hearing would be held from 4 through 13 June 2007 (including Saturday 9 June 2007). It decided to grant each Party equal time to present factual witnesses and experts and to make their Opening and Closing Statements. Since the Parties failed to reach agreement on the order of appearance of factual witnesses and experts, the Tribunal decided that they were to be presented in the following order: (i) the Claimant's factual witnesses; (ii) the Respondent's factual witnesses; (iii) the Claimant's experts; and (iv) the Respondent's experts.
37. The hearing on the merits was held at the seat of the Centre in Washington, D.C. from 4 to 13 June 2007. The Claimant was represented by Mr. R. Doak Bishop, Mr. Craig Miles, Mr. Adam Schiffer, Mr. Roberto Aguirre-Luzi, and Mrs. Sarah Zagata (King & Spalding); Mr. José A. Martínez de Hoz (Jr.), Ms. Valeria Macchia, Ms. Jimena Vega Olmos and Ms. Florencia Mónica Celasco (Pérez Alati, Grondona Benites, Arntsen & Martínez de Hoz); and Mr. Tomasz J. Sikora, in-house counsel of El Paso Energy. The Respondent was represented by Mr. Osvaldo César Guglielmino (Procurador del Tesoro de la Nación Argentina), Mr. Ignacio Pérez Cortés, Mr. Gabriel Bottini, Ms. Gisela Makowski, Ms. Silvina González Napolitano, Mr. Tomás Braceras, Mr. Jorge Barraguirre, Ms. Alejandra Etchegorry, Ms. Leticia Sierra Lobos, Mr. Nicolás Duhalde, Mr. Javier Gallo Mendoza, Mr. Juan Pablo Tarelli, Mr. Luciano Lombardi, Mr. Rodrigo Ruiz Esquide and Mr. Ignacio Torterola. Counsel for the Parties gave their oral presentations before the Tribunal and examined the factual witnesses and experts.
38. Verbatim transcripts of the hearing on the merits were prepared and distributed to the Tribunal and the Parties. The Tribunal invited the Parties to submit a

joint document with both Parties' corrections to the transcripts of the hearing in order to facilitate the Tribunal's review and reading of the transcripts.

39. Further to the receipt of the Claimant's letters of 20 May, 11 July and 8 September 2008, and the Respondent's letter dated 19 August 2008, the Tribunal informed the Parties that any filings made by the Parties and not expressly authorised by the Tribunal would be disregarded.
40. By letters of 21 November 2007 and 13 December 2007, it was confirmed that the members of the Tribunal had decided to retain an independent expert, who would assist them in the review of the expert reports filed by the Parties. The Tribunal requested the ICC International Centre for Expertise to provide a list of names from its database of experts.
41. The Tribunal reviewed the *curricula vitae* of a number of possible candidates and submitted their names to the Parties. Upon receipt of both Parties' observations, by 21 May 2008, the Tribunal appointed Mr. François Savagner as its independent valuation expert.
42. By letter of 12 September 2008, the Tribunal informed the Parties that it had not been able to reach an agreement with Mr. Savagner on the amount of fees that the Tribunal considered reasonable for his assignment. It invited the Parties to submit their observations on the expert's estimate to decide whether they authorised or not the continuation of the expert's appointment.
43. By letter of 30 September 2008, the Tribunal informed the Parties that since they had not reached an agreement with respect to the acceptance of the estimate, it would terminate the expert's assignment. The expert had already agreed to renounce claims to any fees and or expenses incurred before that decision.
44. By letter of 7 January 2009, the Tribunal submitted the name of another possible expert and solicited the Parties' observations. Upon receipt of the Parties' observations on 23 January 2009, the Tribunal invited each Party to submit a list of four candidates along with their *curricula vitae*. The list of each Party was to be communicated to the other Party. If there were one or more

common names on both lists, the Tribunal would proceed to make an appointment.

45. The Tribunal informed the Parties that if there were no common names on both lists, each Party was invited to comment on the other Party's list within eight days of the receipt of that list. Upon receipt of the Parties' comments, the Tribunal informed the Parties that it would make a final decision either on the basis of the lists or at its own discretion. The Parties submitted their proposals and exchanged their comments on each other's lists.
46. By letter of 15 June 2009, the Tribunal appointed Professor Patrice Geoffron as its independent expert. By letter of October 27, 2009, the Centre transmitted to the Parties an order to provide additional documentation to the expert as well as a confidentiality undertaking signed by Professor Geoffron. As ordered by the Tribunal, both Parties submitted the requested additional documentation to the expert. The Expert's Preliminary Report was circulated to the Parties on 14 April 2010. The Tribunal invited both Parties to submit any observations regarding the expert's Preliminary Report at the latest by May 14, 2010. In addition, the Tribunal invited the Claimant to submit, along with the above-mentioned observations, its answers to some further questions. By letter of May 19, 2010, the Tribunal granted an extension to the Parties for submitting their observations on the Preliminary Report. Both Parties submitted their observations on June 1, 2010. By letter of 22 November, 2011, the Tribunal circulated the Expert's July Report and a Complementary Note dated 10 July 2010, followed by the Final Report (October Report) dated 12 October 2010 and invited the Parties to submit their observations on both documents by 24 December, 2010. By letter of December 15, 2010 the Tribunal granted an extension for the Parties to submit their observations on the Expert's Final Report at the latest by 27 December, 2010. Both Parties submitted their observations on the date set by the Tribunal.
47. By letters of 22 November and 15 December 2010, the Tribunal invited the Parties to present their statement on costs, which were received on 27 December 2010. By letter dated 5 May 2011, the Tribunal declared the closure of the proceedings pursuant to Arbitration Rule 38. On June 1, 2011 the



Tribunal invited the Parties to submit their final statements of costs pursuant to ICSID Arbitration Rule 28(2). The Respondent submitted its final statement of costs on June 15, 2011, and the Claimant on 16 June 2011.

## II. FACTUAL BACKGROUND

### A. THE ORIGINS OF THE DISPUTE

48. The facts summarised hereafter are those considered and debated in the Parties' written pleadings and oral arguments.
49. CAPSA produces oil and, *via* CAPEX, generates electric power in Argentina; it also markets propane, butane and gasoline. From December 2001 onward, the GOA took a series of measures which, according to the Claimant, caused considerable harm to the latter, breached undertakings assumed by the respondent State when the investments were made, rendered the investments worthless, particularly those in CAPSA and CAPEX, and prevented these companies from functioning independently. These measures were alleged to be in violation of provisions of the 1991 BIT, *i.e.* those on expropriation, on discriminatory treatment, on fair and equitable treatment, and on full protection and security.<sup>5</sup>
50. These assertions were vigorously objected to by the Government which argued that the measures taken by it, even if they had been contrary to provisions of the 1991 BIT, were justified under Article XI of that Treaty which allows the States Parties to take measures needed for the maintenance of public order, for the fulfilment of their obligations regarding the maintenance or the restoration of international peace or security, or for the protection of their own essential security interests.<sup>6</sup>

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<sup>5</sup> Claimant's Memorial on the Merits [hereinafter Memorial] of 20 August 2004, §§ 30-33 and 37-38.

<sup>6</sup> Respondent's Post-Hearing Brief [hereinafter RPHB] of 2 August 2007, §§ 119-211.

## B. THE LEGAL SITUATION AT THE TIME OF THE INVESTMENT

### 1. *History and General Context*

51. Prior to 1990, most of Argentina's essential economic activities were State-run. The infrastructures were unsatisfactory, however, and the public debt was high, particularly regarding the production of energy, *i.e.* electricity and hydrocarbons. This led the GOA to introduce, in 1989, a bill which was to become the State Reform Law, announcing a privatisation programme encompassing incentives as well as monetary and structural measures to promote foreign investment and to stabilise the country's economy.
52. Prior to these reforms, the electricity market had been dominated by the State. Public enterprises controlled the production, transmission and distribution of energy. In addition, some provinces ran their own energy companies. The system was flawed by insufficient funding, rife with inefficiency and was in deficit. In 1988/1989, rolling black-outs were organised owing to limited power-generating capacity.
53. The oil and gas sector, too, was essentially in the hands of the State, with private business playing a secondary role. It was characterised by low productivity, excess demand and significant deficits for the State-owned companies.
54. Laws Nos. 23,696 and 23,697, referred to respectively as the "State Reform Law" and the "Economic Emergency Law," brought a radical change by de-regulating the economy and offering some public companies for sale. In addition, Law No. 23,928, the "Convertibility Law," complemented by Decree No. 529/1991, pegged the peso to the dollar at a fixed rate of 1:1, and no increase in the domestic monetary supply would henceforth be permitted without a corresponding increase in the Central Bank's foreign currency holdings. As a consequence, inflation abated and the economy grew during the period from 1991 to 1997.

55. The State Reform Law, with its measures of liberalisation and improvement of the public sector, and the call for foreign investment, aimed at the privatisation of State companies to improve production.
56. A reform of the legislation on foreign investment was mainly brought about by Decree No. 1853/1993. That Decree encouraged foreign investment by removing various restrictions, notably the three-year waiting period for the repatriation of foreign capital, allowing for such repatriation at any time; and by opening domestic credit facilities to both foreign and national businesses on an equal footing.
57. Further to improve the domestic context, Argentina concluded about 50 bilateral investment treaties (BITs), one of which was the 1991 BIT with the United States.
58. Finally, to protect investors' long-term interests, regulatory regimes were established for the electricity and hydrocarbon sectors. Together these regimes, the Electricity and the Hydrocarbons Regulatory Frameworks, formed the new "Energy Regulatory Framework."

## ***2. Electricity Regulatory Framework***

59. To improve the supply of electricity, the GOA allowed foreign investors a dominant role in the production, transmission and distribution of electric energy. They could acquire facilities and equity interests and also proceed to direct investments. Investments had to be made within the legal framework provided by Law No. 24,065 (the "Electricity Law"), by Regulatory Decree No. 1398/1992 and related regulations, and by Resolution No. 61/1992.
60. The objectives of the Electricity Law were the promotion of private investments in the production, transmission and distribution of electrical power, the setting of appropriate rates in order to further such activities, the efficient use of electricity, and the stimulation of competition.
61. Within the Electricity Regulatory Framework, a competitive system, the Wholesale Electricity Market (WEM), was established in order to organise the

sale of energy by its generators. The two markets established within the WEM were: (i) the term market, where producers and buyers could freely agree on sales, conditions and prices; and (ii) the spot market, where energy was supplied, on an hourly basis, for a uniform price linked to the short-term marginal cost of the energy produced.

62. Distributors were, however, entitled to buy energy at a “seasonal price” fixed by the Compañía Administradora del Mercado Mayorista Eléctrico SA (CAMMESA) and approved by the GOA’s Energy Secretariat. This was achieved by establishing a fixed monthly charge which was to remain stable for the first three months of the six-month seasonal price; that price was based on predictions of demand and supply in the seasonal period. After three months, adjustments would have to be made if the seasonal price, instead of reflecting the average spot-market price, significantly differed from it. This was to be done by providing compensation out of a “Seasonal Stabilisation Fund,” yet another measure to protect investors.
63. The Electricity Regulatory Framework was managed by three agencies. The first was the GOA’s Secretariat of Energy, endowed with regulatory powers to implement the Framework. It was to govern dispatch within the WEM and to set seasonal prices. The scheduling and physical dispatch by generators and the management of the WEM were handled by CAMMESA, an independent entity representing all WEM agents but subject to the veto of the Energy Secretariat. Thirdly, there was the Ente Nacional Regulador de la Electricidad (ENRE), an independent governmental body with regulatory and jurisdictional power over the electricity industry.
64. The spot price was the price paid at any hour to all participants in the WEM. It was uniform, based on the short-term marginal cost incurred by the least efficient generator dispatched at any given hour. This Variable Cost of Production (VCP) had to be indicated in US dollars. The most efficient producer, *i.e.* that with the lowest VCP, was dispatched first and enjoyed the largest profit, as the spot price would be set on the basis of the VCP of the last generator dispatched. Accordingly, the spot price determined by CAMMESA was not arbitrary: the most efficient generator’s VCP was below the spot price,

and the difference between that price and the VCP incurred by the last generator dispatched was the margin of the most efficient producer. In other words, not all producers enjoyed the same margin.

65. The competitive system described above rewarded efficient power generators such as CAPEX and Costanera by the manner in which spot prices and margins were fixed. This, together with the security offered by the Electricity Regulatory Framework, provided an incentive for El Paso to invest.
66. By contrast, contractual energy sales could be freely negotiated. As a rule, they were made in US dollars and for one year, prices being set proportionally to the spot price and somewhat above it.
67. In addition to the sales proceeds, since 1994 power generators received “capacity payments” amounting to 10 US dollars per megawatt-hour (MWh). These payments were intended to encourage operators to upgrade and expand the electricity system. Capacity payments, with the proceeds from the sales, were the two pillars of the new Framework; according to the Claimant, the capacity payments received by CAPEX and Costanera amounted to about 27 and 92 million US dollars per year, respectively.<sup>7</sup> The Claimant also alleged that, on the basis of these payments, investors could legitimately expect that if a devaluation of the peso were to occur, capacity payments would continue to be paid in US dollars or, if paid in pesos, be adjusted to attain the same value;<sup>8</sup> and that adjustments would also be made in the pricing system.
68. The Claimant’s assertions were vigorously objected to by the respondent State.<sup>9</sup> According to the latter, the establishment of capacity payments, and their decrease in terms of US dollars, did not, from the legal and economic viewpoint, entail an undue prejudice. The Electricity Law, while providing for such payments, left the determination of the currency and of the mode of calculation to Argentina’s Department of Energy. Initially, in 1992, capacity

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<sup>7</sup> Memorial, §§ 146-147.

<sup>8</sup> *Ibid.*, § 152.

<sup>9</sup> Rejoinder, §§ 111-126.

payments were fixed at US\$ 5 dollars/MWh, this figure being subsequently raised to US\$ 10 dollars. In 2002, payments decreased to AR\$ 10 pesos, to be raised again to AR\$ 12 pesos three months later. At the same time, the Energy Secretariat detached payment from actual dispatch, a measure favourable to the producers. There were not, accordingly, any vested rights in those respects.

69. Nor was there any undue prejudice from an economic point of view. The value of the capacity payments determined by the Secretary of Energy was, according to the GOA, compatible with the operation of the electricity market in the context of the crisis and with what would have happened, in that context, in a competitive market, given the macroeconomic circumstances prevailing at the time in the Argentine economy. At that time, a significant decrease in the demand for reliability of the electricity supplies was expected as a result of the drop of the economy's gross product and household income: "if an income drop occurs, a lower quality product at a lower price is preferred."<sup>10</sup>
70. At the beginning of the crisis, the electricity generation system enjoyed a high reserve margin. Despite the fact that, during the last years, no new producers had appeared, the existing ones were capable of satisfying a 12.3% increase in the peak demand. This shows that the system had excess capacity; accordingly, the reduction of capacity made perfect sense in a competitive market.
71. The Claimant considered that the capacity payment had to cover their capital costs and that the reduction in it to an amount equivalent to four dollars did not fulfill that requirement. The GOA rejected El Paso's arguments<sup>11</sup> linking the Claimant's capacity payments to its capital costs: there was no rule under which the main ground for capacity payments was the protection of capital costs or the recovery of investments, and in fact such payments distorted the operation of the WEM; there was no document justifying economically that the payment had to be 10 US dollars and to remain at that level; if capacity payments were to

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<sup>10</sup> Rejoinder, § 118.

<sup>11</sup> Claimant's Reply on the Merits [hereinafter Reply] of 26 November 2006, §§ 99-108.

defray capital costs, they should have been detached from dispatch, which was not what happened in the past decade.

72. The alleged link between the reduction of capacity payments and the lack of investments after 2001 was also belied by the fact that the last decision to invest in the field of power generation was taken in 1996, five years before the crisis, when capacity payments still amounted to 10 US dollars/MWh.
73. Accordingly, the decline of investments in power generation resulted from the performance of the economy as such and, more specifically, from the conditions of the energy market, explained by the crisis of emerging economies followed by the economic crisis of Argentina in 2001. Thus, it cannot be maintained that, despite the crisis, the electricity market would have continued to receive investments if the capacity payments had remained at the same level.

### *3. Hydrocarbon Regulatory Framework*

74. Initially, the hydrocarbon trade in Argentina was governed by Law No. 17,319 of 1967, which allowed for the grant of concessions to private businesses. Until 1990, this possibility was not used, however, and the near-totality of crude oil and gas production remained in the hands of Yacimientos Petrolíferos Fiscales (YPF), a State company.
75. This changed in 1989 with the adoption of a privatisation programme, which brought many changes and offered private entrepreneurs the opportunity to conduct activities in new, unexplored areas as well as in areas formerly exploited by YPF. Deregulation was implemented by a series of legislative acts, including Decrees Nos. 1055/1989 of 10 October 1989, 1212/1989 of 8 November 1989 and 1589/1989 of 27 December 1989.
76. These acts removed import and export restrictions on crude oil, and abolished withholdings and duties. At the end of 1991, the domestic oil industry was deregulated, including prices, and at the beginning of 1994 natural gas prices were deregulated as well.

77. The centre-piece of the de-regulation process was the right “freely to dispose” of extracted resources, on domestic and foreign markets, and the exemption from export duties or withholdings.
78. Additional regulation in the hydrocarbon sector included Decree No. 2411/1991 (“Reconversion Decree”), Decree No. 2178/1991, as amended by Decree No. 1271/1992 (“Plan Argentina”), Law No. 24,076 (“Gas Law”) and implementing Decree No. 1738/1992. These texts, together with those cited above in paragraph 75, formed the “Hydrocarbon Regulatory Framework.”
79. The Gas Law made it possible to privatise “Gas del Estado” (GdE). Practically all of that company’s assets were transferred to eight distribution and two transportation companies, a majority participation in each being sold to a consortium of private companies. These measures were intended to promote competition and to stimulate foreign investment in the oil and gas industry.
80. Regarding incentives for obtaining investments, the following rights and advantages were offered to entities such as CAPSA/CAPEX: (i) the right to export crude oil without the GOA’s prior approval; (ii) an exemption from fees and duties, except royalties; (iii) the right to negotiate hydrocarbon sales in the open market; (iv) the constitutional protection of investments as property or contractual rights, including those of CAPSA/CAPEX, for the sale of liquid hydrocarbons; (v) the duty, for the Federal Executive, to give twelve months’ notice before restricting the export of crude oil, and the requirement that the producer receive a price not below that of similar, imported crude oil and petroleum products; and (vi) the freedom for producers to sell their production.

#### 4. *Argentina’s Drive to Attract Foreign Investment*

81. The GOA made it clear that the new Energy Regulatory Framework was aimed at attracting investments, especially foreign investments. Argentina was prepared to provide certain guarantees to domestic and foreign investors. The privatisation policy in the energy sector was carried out, on the federal level, by the Executive and Legislative Powers which agreed that foreign investors were important to achieve privatisation successfully.



82. That result was reached by emphasising three principles – credibility, certainty and legal stability – the core requirement for attracting foreign investment being foreseeability, to be obtained especially through legal stability.
83. The privatisation drive of the Menem administration and its Energy Secretariat was supported by intergovernmental agencies such as the World Bank (IBRD), the International Finance Corporation (IFC), the UN Development Programme (UNDP), and the Inter-American Development Bank (IADB) through loans and measures of technical assistance. This institutional support obviously encouraged private foreign investment.
84. With the help of its Energy Secretariat, of its Privatisation Under-Secretariat and the above-mentioned intergovernmental organisations, the GOA thus actively invited investments from abroad and, to that end, organised seminars and other promotional meetings (“road shows”) in the United States, in Europe and in South-East Asia; at least part of them were financed by the UNDP. In these meetings, the new-found openness of Argentina’s economy and the stability of the new investment framework were emphasised. Potential investors were led to assume that prices would be determined by market mechanisms and that costs and capacity payments be denominated in dollars.
85. The privatisation of the energy sector was successful. The electricity industry was modernised, power production almost doubled, and domestic demand rose by more than one half; equipment was renewed and upgraded; power and transmission failures became rare; and transmission lines for power export to Chile and Brazil were installed.
86. The same can be said of the hydrocarbon industry: crude oil and natural gas outputs rose by half or more, and so did the reserves of hydrocarbons. Despite the increase in production, the known natural gas reserves also rose by one third. Exports of crude oil grew from almost nothing to 15.6 million m<sup>3</sup>, and exports of natural gas from zero to about 9.3 million m<sup>3</sup> per day. Energy exports now amounted to 13% of Argentina’s total exports, the country thus being transformed from an energy importer into an exporter. The distribution

network was improving as well, pipelines being installed to connect Argentina with Chile, Brazil and Uruguay.

87. The Claimant argued that the privatisation drive, the circumstances surrounding it and its consequences were evidence of the GOA's intention to establish a stable framework for attracting foreign investment to the energy sector, thereby raising legitimate expectations. This view was contested by the GOA which pointed out that, whatever efforts may have been deployed by it to develop the energy sector, such development, and the rights allegedly infringed, arose not from contracts but from Argentinian law. Law is not immutable, however, be it in the field of investment or elsewhere; and States are entitled, on the strength of their sovereignty, to change them. This is particularly true in emergency situations such as that in which Argentina found herself in 2001.<sup>12</sup>
88. As pointed out earlier, in paragraph 57, another element in the GOA's investment strategy was the conclusion of some 50 BITs, among which was the Treaty with the United States of 14 November 1991. While such treaties are meant to cover investments of both sides, the 1991 BIT with the United States could, of course, have been viewed as an additional protection for investments to be made in the energy sector of Argentina.

## C. THE ECONOMIC CRISIS AND THE MEASURES TAKEN BY ARGENTINA IN THE ENERGY SECTOR

### 1. *The Advent of the Crisis*

89. The years between 1991 and 1998 were good for Argentina. They brought a growth of the GDP averaging close to 6% and an important influx of capital. When deterioration began to set in, the International Monetary Fund (IMF) identified both external and internal causes therefore, including a sharp rise of the public debt from 1999 onward. This led to solvency problems which were aggravated by the rise of the US dollar and the drop of capital flows to

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<sup>12</sup> Rejoinder, §§ 407-428.

developing market economies. Despite exceptional financial assistance by the IMF, confidence was not restored.

90. Beginning in Spring of 2001, the GOA took a series of measures: elaboration of a plan to switch the convertibility regime from the dollar to a basket of US dollars and euros; tax-exemption measures to assist the economic sectors most affected by the recession; and a “mega-swap” of outstanding government bonds for instruments with longer periods of maturation. These measures had little effect: capital flight and deposit runs generated a partial deposit freeze. When Argentina failed to comply with the fiscal targets set, the IMF declined to make a payment for December 2001.
91. At the end of 2001, savings were massively withdrawn from the banks. In order to control the situation, the Government issued Decree No. 1570/01, known as “*Corralito*,” on 1 December 2001, restricting bank withdrawals and prohibiting any transfer of currency abroad. The situation led to demonstrations and tens of deaths in December 2001, and these, in turn, brought about the resignation of President de la Rúa on 20 December 2001. It can be noted that within a period of less than ten days, Argentina had a succession of five Presidents, who resigned one after the other. According to the GOA, “Argentina seemed to be on the brink of anarchy and the abyss.”<sup>13</sup> The situation was indeed critical, and at the end of that month Argentina partly defaulted on its international obligations and abandoned the convertibility regime, replacing it by a dual exchange-rate system.
92. Argentina’s crisis of 2001-2002 resulted in a massive default regarding the public debt on the domestic as well as the international level. The real gross domestic product decreased by about 10% in 2002, the cumulative decline since 1998 amounting to 20%; and inflation rose to approximately 10% in April 2002, but eventually reached 40% for that entire year. More generally, due to the over-valuation of the peso and the deterioration in the economy’s competitiveness, the Buenos Aires stock market lost more than 60% between

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<sup>13</sup> Respondent’s Counter-Memorial on the Merits [hereinafter Counter-Memorial] of 1 September 2006, § 7.

1998 and 2002; conversely, unemployment rose to over 20% in 2002. Fifty-four percent of the urban population now lived on the “poverty level,” while the population on an “indigence level” reached 25%; private consumption dropped by 20%. So alarming was the situation that the United Nations General Assembly resolved to reduce Argentina’s membership dues on account of the crisis, which was the first case in history.

93. The above description is purely factual. The Arbitral Tribunal does not intend, at this stage, to go into the question of the inevitability of the crisis, to assign responsibility for it, or to decide on the applicability or otherwise of Article XI of the 1991 BIT to the measures taken by the GOA. These issues will be addressed later in this award §§ 627-670.

## ***2. The Measures Taken by Argentina: Overview***

94. The specific measures complained of by El Paso were adopted by Argentina in the context described above and were aimed at overcoming the crisis. Most of them were related, in one way or another, to the convertibility regime and its demise.
95. A first measure consisted in freezing bank deposits and introducing foreign exchange controls. This was achieved, initially, by Decree No. 1570 of 1 December 2001, followed by the Public Emergency Law No. 25,561 of 6 January 2002 and by implementing measures. The Public Emergency Law: (i) abolished the parity of the US dollar and the peso; (ii) converted US dollar obligations into pesos at the rate of 1:1, a measure known as “pesification”; (iii) effected the conversion, on that basis, of dollar-denominated tariffs into pesos; (iv) eliminated adjustment clauses established in US dollars or other foreign currencies as well as indexation clauses or mechanisms for public service contracts, including tariffs for the distribution of electricity and natural gas; (v) required electricity and gas companies to continue to perform their public contracts; and (vi) authorised the GOA to impose withholdings on hydrocarbon exports.
96. These measures, according to the Claimant, turned the electric power sector into a strictly regulated industry operating with price caps and other

requirements which made it difficult to earn a profit and even to retrieve investments. The Government, moreover, moved large sums of US dollars from the energy to the banking sector, which was particularly affected by the crisis, a measure which the Claimant considered discriminatory.<sup>14</sup> To answer this contention, the respondent State pointed to the “[t]he non-discrimination principle ... [which] requires the State to treat equally investments that are in like situations,”<sup>15</sup> such situations arising within the same business or economic sector, and not among different sectors. But from El Paso’s point of view, there was an intention to discriminate on the part of the State. However, from the Government’s point of view, the discrimination must produce actual harm which the GOA did not assume to have occurred, and there were reasonable grounds for making the distinction complained of.

97. It will now be convenient to turn to the specific measures taken in each of the two sectors examined in the present case.

### *3. The Electricity Sector*

98. Following the enactment of the Public Emergency Law and of Decree No. 214/2002, CAMMESA resolved to pesify the Electricity Regulatory Framework and, with it, the contracts existing on 6 January 2002 and the transactions on the spot market after that date. By a series of resolutions, the GOA’s Energy Secretariat then extended pesification to all values in that Framework. While under the latter, VCPs, capacity payments and other values had been calculated in US dollars, power generators now had to express their VCPs in pesos at an exchange rate of 1:1, which accounted for substantially lower spot prices; electric power export agreements were, however, excluded from pesification.
99. The same was to be done for calculating the fuel reference price which determined the maximum allowable variable price on the spot market. A price

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<sup>14</sup> Memorial, § 223.

<sup>15</sup> *Champion Trading Company Ameritrade International Inc. v. Arab Republic of Egypt*, [hereinafter *Champion Trading*], (ICSID Case No. ARB/02/9), Award of 27 October 2006, § 125.

cap was established which, according to the Claimant,<sup>16</sup> could prevent some participants from recuperating even their VCPs. This was why CAMMESA would now also dispatch producers whose VCPs were above the cap, these generators receiving the difference between that cap and the actual spot price. For generators such as CAPEX and Costanera, it no longer mattered whether they operated efficiently or not. Accordingly, the idea that the spot price would be the same for all generators, and be based on the costs incurred by the last generator dispatched, was abandoned; new price caps were imposed on the basis of new calculation methods applied by CAMMESA.

100. Another change concerned capacity payments: as reported earlier,<sup>17</sup> these payments initially amounted to 5 US dollars, and had been increased to 10 US dollars per MWh, which was the amount at the time of the measures. Their calculation at the rate of one dollar to one peso amounted to a decrease to almost one third of their value. Later on, they were increased from 10 to 12 pesos, a sum which, at the relevant time, was roughly equivalent to 4 (instead of 10) US dollars.
101. Regarding the legality of the measures thus taken by the respondent State, the GOA pointed out that ever since the reform of the electricity sector, the agents of and participants in the WEM were to operate under the regulations issued by the Energy Department; participants in the market were aware of the risk of changes which, however, had to be in conformity with the guidelines set by the Electricity Law (No. 24,065). There were and had been continuous adjustments in the sector. According to the GOA, this shows that “the legitimate expectations of any investor entering the market had to include the true possibility of changes and amendments to the Procedures.”<sup>18</sup>
102. Moreover, according to the respondent State, the adjustments made were reasonable and allowed for adaptation to the new context. There was no reason to exclude the electricity industry from the pesification of the whole Argentine

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<sup>16</sup> Memorial, § 235.

<sup>17</sup> See *supra* §§ 67-73.

<sup>18</sup> Counter-Memorial, §§ 267-276.

economy; nor was there any legal obstacle to the Energy Department's order to state costs in this or that currency. In addition, the Energy Department took account of the effect of the mega-devaluation of the peso on generators' costs. The adjustment of capacity payments was, as discussed earlier,<sup>19</sup> appropriate, reasonable and consistent with a competitive market.

103. The GOA further argued that the measures taken by the Energy Department to calculate spot prices were not exceptional: (a) because the exclusion of certain machines from the spot-price calculation was practised during as well as prior to the crisis; (b) because there always were price caps in the spot market; and (c) because the replacement of the formula "reference prices + 15%," substituted by that of generators' actual costs, was intended to protect producers.
104. Finally, CAPEX and Costanera had agreed to the measures later objected to by El Paso. In 2002 and 2003, before the sale of the holdings in the Argentinian companies, CAPEX challenged some of the measures taken by the respondent State. These challenges were dismissed in the federal court of Argentina, and these decisions were not appealed by CAPEX. A further challenge became moot when CAPEX – voluntarily according to the GOA – resolved, together with most participants in the WEM, to participate in the FONINVEMEM, a system created by the GOA to normalise the service and to make the necessary investment in power generation. "El Paso cannot contradict the own acts of the companies on behalf of which it is claiming."<sup>20</sup> The Claimant objected that the local companies' consent did not bind it and that these companies had acted under duress.<sup>21</sup>

#### 4. *The Hydrocarbon Sector*

105. As indicated in paragraph 95, export withholdings were imposed on the hydrocarbons sector to compensate the banking sector for the imbalance

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<sup>19</sup> See *supra* §§ 67-73.

<sup>20</sup> Counter-Memorial, §§ 267-325; RPHB, §§ 5-7, 9-14.

<sup>21</sup> Claimant's Post-Hearing Brief [hereinafter CPHB] of 2 August 2007, §§ 105-114, 122-129.

generated by the mandatory conversion of dollar-denominated deposits and credits *as per* Decree 310/2002 of 13 February 2002.

106. Decree No. 310/2002 prescribed a 20% withholding on crude oil and LPG exports, according to El Paso, or 16.67% according to Argentina,<sup>22</sup> the withholding on the latter being subsequently reduced to 5%<sup>23</sup> according to El Paso, or 4.76 according to Argentina.<sup>24</sup> On 13 May 2002, the Government raised export withholdings on crude oil and LPG to 25% and 20%, respectively. In August 2004, additional withholdings on crude oil, on a sliding scale, were decreed for the event that the crude oil price would reach or exceed a certain level. Such withholdings affected hydrocarbons sales abroad and depressed domestic prices by increasing the local availability of such products.<sup>25</sup> It must be added here that CAPEX requested and obtained, from Argentina's federal courts, a preliminary injunction suspending the restrictions on exports, and that the latter were subsequently repealed by the GOA's Secretary of Energy.<sup>26</sup>
107. Some withholding measures seem to have persisted for a long time, CAPSA's and CAPEX's revenues suffering as a result on both the international and domestic levels, until El Paso, in 2003, sold its shares in the Argentinian companies (on this issue, see below, paragraphs 114-120).
108. Another measure taken in the Hydrocarbon Sector was, of course, the pesification of contracts under the Public Emergency Law and Decree No. 214/2002, *i.e.* of the existing dollar-denominated obligations and claims, at the rate of 1:1. That measure had, in particular, a negative impact on CAPSA's and CAPEX's dollar-denominated crude oil sales and purchase contracts. Regarding liquid hydrocarbons, the Public Emergency Law obliged the parties to existing sales contracts to re-negotiate them, and the two companies had to accept price reductions. Agreements for the transportation of natural gas for export were not, however, affected by pesification.

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<sup>22</sup> Counter-Memorial, §§ 200-201.

<sup>23</sup> Memorial, § 330.

<sup>24</sup> Counter-Memorial, §§ 202-208.

<sup>25</sup> Memorial, §§ 200-202; Counter-Memorial, §§ 196-222; Rejoinder, §§ 246-288; RPHB, §§ 52-55.

<sup>26</sup> Rejoinder, §§ 246-252; RPHB, §§ 17-18.



109. To insulate domestic consumers from the rise of the price of crude oil on the international market, the GOA directed producers and refiners to enter into special sales agreements. This was done and there were, according to the respondent State, over 20 such agreements executed by it and El Paso's Argentinian companies. As it had done for the electricity sector,<sup>27</sup> the GOA highlighted that fact to show that the measures taken by it had been acquiesced in by the companies.<sup>28</sup> Again the Claimant challenged the argument mainly by asserting that the companies' consent did not engage El Paso, their foreign shareholder, and that the agreements were concluded under duress.<sup>29</sup> As of 1 January 2003, the reference sales price from producers to refiners was 28.50 US dollars. The barrel price of crude oil in the world market was, however, significantly higher and has risen further since then. For the depressed price prescribed, the producers were to be compensated by the refiners should the world market price remain above 28.50 US dollars for a long time, though a cap was set at 36 US dollars per barrel, which limited the duty to compensate. Nothing happened, however, and no compensation was paid.
110. The measures taken in the hydrocarbon sector spawned, among the parties, much the same discussions and controversies as over the electricity sector. These arguments, having been summarised above in paragraphs 101-104, do not need to be repeated here.

##### *5. The Tax Depreciation Issues*

111. With the depreciation of investments a tax issue arose. Under Argentina's Income Tax Law, assets were depreciated annually by prorating them according to their estimated life expectancy. The Public Emergency Law repealed the Convertibility Law, and the GOA took measures causing both a devaluation of the peso and inflation, thus reducing the amount of permissible depreciation and decreasing the tax relief the Argentinian companies could claim.

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<sup>27</sup> See *supra* § 103.

<sup>28</sup> RPHB, §§ 1-9.

<sup>29</sup> CPHB, §§ 105-114, 122-129.

112. Regarding the losses suffered by hydrocarbon producers and investors, the Public Emergency Law provided that losses resulting from the new exchange rate which affected dollar-denominated liabilities could only be deducted in five yearly instalments of 20%.

6. *The Energy Crisis in Argentina*

113. The above-described measures, prompted by the 2001-2002 crisis, resulted in depressed electricity and gas prices, which brought increased consumption. These prices, together with the reduction of capacity payments, dissuaded generators of electricity from investing in new power plants, and gas producers from exploring and drilling for further resources. As a consequence, shortages were likely and did in fact occur.

D. THE SALE OF THE CLAIMANT'S SHARES IN THE ARGENTINIAN COMPANIES

114. According to El Paso, the sale of its investment in the Argentinian companies was due to the destruction of their value by the measures of the GOA and their lack of prospects.<sup>30</sup> The respondent State pointed out, however, that the sale was a consequence, not of its own conduct, but of a decision made by El Paso to concentrate on its core business world-wide in order to improve its liquidity,<sup>31</sup> which had suffered through inadequate policies pursued by the Claimant.

115. The first phase of the sale took place on 23 June 2003. El Paso sold its interest in CAPSA (45%) (and, consequently, in CAPEX) to Wild SA, the majority shareholder of CAPSA, for 24 million US dollars. The transaction was made contingent on a stock swap with CAPEX International Business Co. (CIBCO), an entity controlled by CAPSA, by which El Paso transferred to CIBCO its interest in SERVICIOS in exchange for CIBCO's 38.4% interest in Triunion, another company of the El Paso group.

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<sup>30</sup> Reply, §§ 37-43.

<sup>31</sup> Counter-Memorial, § 263; RPHB, § 63.

116. The second phase occurred on 3 October 2003: El Paso sold its interest in Costanera (12,335%) to Empresa Nacional de Electricidad, a Chilean company, for a cash price of 4.5 million US dollars.
117. The respondent State alleged that the sale was prompted by reasons alien to the Argentinian crisis.<sup>32</sup> It was, moreover, an unwise move, for while El Paso had purchased its investment at a time when the Argentinian economy had reached a peak, it sold that investment when the economy hit bottom. To borrow from the GOA's colourful language, El Paso bought its investment "at the sound of the trumpets" and sold it "at the sound of the cannons."<sup>33</sup>
118. In reply, the Claimant asserted that the sale resulted from the Argentinian crisis, the measures taken by the respondent State, the uncertainty generated by them, and reasons of good and prudent stewardship.<sup>34</sup>
119. The respondent State also expressed doubts about the 24 million US dollars collected by El Paso.<sup>35</sup> That was the sum paid by Wild to EPEC, a company fully owned by El Paso and, also, holding 45% of CAPSA's shares on behalf of El Paso. Of these 45%, 38.5% went to Wild (via EPEC) for the above-mentioned sum of 24 million US dollars; the remaining 6.5% was handed over to Deutsche Bank for 14.1 million US dollars. This caused the GOA to doubt the reality of the price charged to Wild, the price paid by Deutsche Bank being 400% higher.
120. The Claimant explained that the 6.5% of CAPSA's shares went to Deutsche Bank, not on the basis of a sale of stock but as a guarantee for a loan of 14 million US dollars extended by the Bank to enable Wild to buy CAPSA's shares.<sup>36</sup> In other words, the transaction questioned by the GOA was not a straightforward sale but a loan agreement guaranteed by a security. What

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<sup>32</sup> Counter-Memorial, §§ 61-89; RPHB, § 217.

<sup>33</sup> Rejoinder, § 38; RPHB, § 217.

<sup>34</sup> Reply, §§ 37-46.

<sup>35</sup> Counter-Memorial, §§ 97-99; Rejoinder, §§ 60-71.

<sup>36</sup> Reply, §§ 385-396.

determined the amount paid to Deutsche Bank was not the value of the shares but the amount of the loan.

#### E. THE FINAL SUBMISSIONS OF THE PARTIES

121. The final submissions of the Claimant read as follows:<sup>37</sup>

“For the reasons stated herein, in its Memorials, and at the hearing, Claimant respectfully requests an award granting it the following relief:

1. A finding and declaration that the Argentine Republic violated the BIT;
2. An order that the Argentine Republic compensate Claimant for all damages it has suffered, plus interest compounded quarterly until the date of payment, and
3. An order that the Argentine Republic pay the costs of these proceedings, including the Tribunal’s fees and expenses, the cost of Claimant’s legal representation, and other costs.”

122. The respondent State’s final submissions were the following:<sup>38</sup>

“Based on the arguments and evidence of the case, the Argentine Republic hereby requests this Tribunal to dismiss Claimant’s claim in all its aspects and to require Claimant to pay for all the expenses and legal costs deriving from this arbitration.”

### III. LEGAL BACKGROUND

#### A. APPLICABLE LAW

##### 1. *The Parties’ Positions*

###### *(i) The Claimant’s Position*

123. Under the first sentence of Article 42(1) of the ICSID Convention, “the Tribunal shall decide a dispute in accordance with such rules as may be agreed by the Parties.” Since the Parties consented to arbitrate the dispute under the

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<sup>37</sup> CPHB, § 186.

<sup>38</sup> RPHB, § 232.

1991 BIT, the latter, as interpreted and applied in accordance with general principles of international law, constitutes the “rules of law” to which the parties “agreed.” Customary international law, which is explicitly incorporated by the BIT in its provisions, has a double role: (1) to clarify the terms of the BIT; and (2) to establish a floor for the treatment of investments.

124. The BIT and international law are also governing under the second sentence of Article 42(1), which provides that the Tribunal “shall apply the law of the Contracting State Party to the dispute ... and such rules of international law that may be applicable.” In fact, Argentina has incorporated the BIT and international law into its domestic law and the second sentence creates a duty to apply international law. Argentinian law is irrelevant for determining whether Argentina is internationally liable for its conduct, the role of such law being to “inform the content of commitments” made by Argentina to the Claimant.

125. The Claimant relies on a certain number of decisions of ICSID tribunals on the subject, including the decision adopted on 3 July 2002 by the Annulment Committee in *Vivendi Universal v. Argentina*, stating that:

“ ... the inquiry which the ICSID tribunal is required to undertake is one governed by the ICSID Convention, by the BIT and by applicable international law. Such an inquiry is neither in principle determined, nor precluded, by any issue of municipal law, including any municipal law agreement of the parties.”<sup>39</sup>

*(ii) The Respondent’s Position*

126. Argentina asserts that “there is no agreement between Argentina and El Paso with respect to the law governing the dispute.” The fact that the agreement between States is regulated by international law is not related to the law applicable to a dispute in which such an agreement should be applied. Whenever a treaty provides that in a specific dispute the provision of such treaty and domestic law will be applied, domestic legislation is considered to be

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<sup>39</sup> *Compañía de Aguas del Aconquija S.A. and Vivendi Universal S.A. v. Argentine Republic* [hereinafter *Vivendi Annulment*], (ICSID Case No. ARB/97/3), First Decision on Annulment of 3 July 2002, § 102.

“law” (and not a “fact”), applicable on the same level as international law (unless otherwise stated).

127. To decide whether Argentina is internationally responsible under the BIT, the rights that El Paso would allegedly have acquired under Argentina law have to be determined under such law, this being the legal system to which the investor has voluntarily become subject. It is not enough for the Claimant to establish that Argentina violated legal or contractual provisions, it must also show that its behaviour implied a violation of the BIT. As stated in the Decision on Jurisdiction, purely contractual claims not amounting to claims for violation of the BIT cannot be entertained.

## 2. *The Tribunal’s Analysis*

128. Despite the diverging views expressed by the Parties, both have extensively relied on the BIT, international law and Argentinian law in support of their respective claims and defences. Argentina is right when calling attention to the circumstance that in the absence of an agreement between the Parties on the law governing the dispute, under Article 42(1), second sentence, of the ICSID Convention both the law of Argentina and international law are applicable. The Claimant is also right in emphasising the relevance of the BIT and international law, given the nature of the claims involved in the dispute.
129. The Tribunal shares the view that both systems – the BIT supplemented by international law as well as Argentinian law – have a role to play. The issue is to determine the role of each system for the decision on the merits, given the context of a dispute arising under an investment treaty. The advent of treaty arbitration has brought about a departure from the typical situation where the contract between the investor and the host State is the basis for the consent to ICSID jurisdiction. The basis for consent in treaty arbitration is the treaty itself, in our case the BIT, such consent covering as a rule only claims arising under the BIT (“treaty claims,” as opposed to “contract claims”). The specific context characterising treaty arbitration permits in our case to define the role of the BIT and international law, on the one hand, and Argentina law, on the other.

130. The Claimant relies on Argentina’s responsibility for the violation of various provisions of the BIT. According to the ILC Articles on State Responsibility,<sup>40</sup> “every internationally wrongful act of a State entails the international responsibility of the State.” (Article 1) Further, “the characterization of an act of a State as internationally wrongful is governed by international law. Such characterization is not affected by the characterization of the same act as lawful by internal law.” (Article 3) Accordingly, the primary governing law in this case is the BIT, supplemented by international law to which the BIT itself makes reference in various provisions.
131. The application of the treaty as the prevailing source as well as the national law of the host State in the case of a dispute under a bilateral investment treaty has been upheld by various ICSID tribunals which have also noted the relation of the treaty to the law of the host State. In *Asian Agricultural Products Ltd v. Sri Lanka*,<sup>41</sup> the ICSID tribunal noted that

“the prior choice-of-law referred to in the first part of Article 42 of the ICSID Convention could hardly be envisaged in the context of an arbitration case directly instituted in implementation of an international obligation undertaken between two States in favour of their respective nationals investing within the territory of the other Contracting State.”<sup>42</sup>

Accordingly, the tribunal noted that both Parties acted in a manner that demonstrated their mutual agreement that the Sri Lanka-UK BIT be the primary source of the applicable legal rules and concluded that the Sri Lanka-UK BIT, as *lex specialis*, provides the applicable law in the case of a British (Hong Kong) national asserting violations of that treaty by the Sri Lanka

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<sup>40</sup> *Responsibility of States for Internationally Wrongful Acts*, 2001 [hereinafter ILC Articles], (text adopted by the International Law Commission (ILC) at its fifty-third session, in 2001, and submitted to the General Assembly as a part of the Commission’s Report. The Report, which also contains commentaries on the Draft Articles, appears in *Yearbook of the International Law Commission*, 2001, Vol. II (Part Two)). Text reproduced as it appears in the annex to General Assembly Resolution 56/83 of 12 December 2001, and corrected by document A/56/49(Vol. I)/Corr.4.), available at:

[http://untreaty.un.org/ilc/texts/instruments/english/draft%20articles/9\\_6\\_2001.pdf](http://untreaty.un.org/ilc/texts/instruments/english/draft%20articles/9_6_2001.pdf)

<sup>41</sup> *Asian Agricultural Products Ltd v. Sri Lanka* [hereinafter *AAPL*] (ICSID Case No. ARB/87/3), Award of 27 June 1990.

<sup>42</sup> *Ibid.*, § 19.

Government. The tribunal added, however, that the agreement of the parties on the application of the BIT did not exclude the application of other rules, as

“the Bilateral Investment Treaty is not a self-contained closed legal system limited to provide for substantive material rules of direct applicability, but has to be envisaged within a wider juridical context in which rules from other sources are integrated through implied incorporation methods, or by direct reference to certain supplementary rules, whether of national law character or of domestic law nature.”<sup>43</sup>

132. The ICSID tribunal in *Compañía del Desarrollo de Santa Elena S.A. v. Costa Rica* concluded that Costa Rican law was “generally consistent with the accepted principles of public international law on the same subject,” noting that “[t]o the extent that there may be any inconsistency between the two bodies of law, the rules of public international law must prevail.”<sup>44</sup> In *Wena Hotels Limited v. Arab Republic of Egypt*, the Annulment Committee stated the following:

“What is clear is that the sense and meaning of the negotiation leading to the second sentence of Article 42(1) allowed for both legal orders to have a role. The law of the host State can indeed be applied in conjunction with international law if this is justified. So too international law can be applied by itself if the appropriate rule is found in this other ambit.”<sup>45</sup>

133. The Committee then affirmed the original tribunal’s reliance on the Egypt-UK BIT as the primary governing law, stating: “This treaty law and practice evidences that when a tribunal applies the law embodied in a treaty to which Egypt is a party it is not applying rules alien to the domestic legal system of this country.”<sup>46</sup>

134. Authoritative scholars have expressed the same view. Thus, Professor Prosper Weil has observed:

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<sup>43</sup> *Ibid.*, § 21.

<sup>44</sup> *Compañía del Desarrollo de Santa Elena S.A. v. Costa Rica* [hereinafter *Santa Elena*] (ICSID Case No. ARB/96/1), Award of 17 February 2000, § 64.

<sup>45</sup> *Wena Hotels Limited v. Arab Republic of Egypt* [hereinafter *Wena*], (ICSID Case No. ARB/98/4), Decision on Annulment of 5 February 2002, § 40.

<sup>46</sup> *Ibid.*, § 44.



“Even where the investment instrument – be it a contract or a unilateral act – provides that the relationship between the host State and the foreign investor is entirely or partly subject to the domestic law of the host State, the existence of a Bilateral Investment Treaty raises the question of compliance with the rights and obligations contained therein to the level of a matter under international law, with respect not only to relations between the States parties to the treaty but also to relations between the host State and the investor.”<sup>47</sup>

135. The fact that the BIT and international law govern the issue of Argentina’s responsibility for violation of the treaty does not exclude that the domestic law of Argentina has a role to play too. The Tribunal agrees with the Claimant that this role is to inform the content of those commitments made by Argentina to Claimant that the latter alleges to have been violated. Thus, in order to establish which rights have been recognised by Argentina to the Claimant as a foreign investor, resort will have to be had to Argentina’s law. However, whether a modification or cancellation of such rights, even if legally valid under Argentina’s law, constitutes a violation of a protection guaranteed by the BIT is a matter to be decided solely on the basis of the BIT itself and the other applicable rules of international law.
136. The above approach, according to which the BIT and international law as well as Argentinian law have to be applied, is consistent with decisions of ICSID tribunals and annulment committees in disputes involving Argentina under the same BIT. Thus, in *CMS Gas Transmission Company v. Argentine Republic*,<sup>48</sup> the tribunal, referring to the passage of the Annulment Committee in the *Wena* decision quoted above in paragraph 132, held:

“This is the approach this Tribunal considers justified when taking the facts of the case and the arguments of the parties into account. Indeed, there is here a close interaction between the legislation and the regulations governing the gas privatization, the Licenses and international law, as embodied both in the Treaty and in customary

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<sup>47</sup> Prosper Weil, “The State, the Foreign Investor, and International Law: The No Longer Stormy Relationship of a Ménage à Trois”, 15 *ICSID Rev.– Foreign Inv’t L. J.* 401, 411-412 (2000).

<sup>48</sup> *CMS Gas Transmission Company v. The Argentine Republic* [hereinafter *CMS*], (ICSID Case No. ARB/01/8), Award of 12 May 2005, § 117. See also Decision of the Tribunal on Objections to Jurisdiction of 17 July 2003 and Decision of the *ad hoc* Committee on the Application for Annulment of 25 September 2007.

international law. All of these rules are inseparable and will, to the extent justified, be applied by the Tribunal.”<sup>49</sup>

137. In *Azurix Corporation v. Argentine Republic*, the tribunal stated:

“Azurix’s claim has been advanced under the BIT and, as stated by the Annulment Committee in *Vivendi II*, the Tribunal’s inquiry is governed by the ICSID Convention, by the BIT and by applicable international law. While the Tribunal’s inquiry will be guided by this statement, this does not mean that the law of Argentina should be disregarded. On the contrary, the law of Argentina should be helpful in the carrying out of the Tribunal’s inquiry into the alleged breaches of the Concession Agreement to which Argentina’s law applies, but it is only an element of the inquiry because of the treaty nature of the claims under consideration.”<sup>50</sup>

138. In *LG&E Capital Corp. and LG&E International Inc. v. Argentine Republic*, the tribunal held:

“The fact that there is no contract between the Argentine Republic and LG&E favours in the first place the application of international law, inasmuch as we are dealing with a genuine dispute in matters of investment which is especially subject to the provisions of the Bilateral Treaty complemented by the domestic law.”<sup>51</sup>

139. In *Enron Corporation and Ponderosa Assets L.P. v. Argentine Republic*, the tribunal had this to say:

“While on occasion writers and decisions have tended to consider the application of domestic law or international law as a kind of dichotomy, this is far from being the case. In fact, both have a complementary role to perform and this has begun to be recognised.

It must be noted also that the very legal system of treaties of the Argentine Republic, like many modern systems, provides for a prominent role of treaties under both Article 27 and 31 of the Constitution. Treaties are constitutionally recognized among the sources considered ‘the supreme law of the Nation.’ It follows that in

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<sup>49</sup> *Ibid.*, § 117.

<sup>50</sup> *Azurix Corp. v. The Argentine Republic* [hereinafter *Azurix*], (ICSID Case No. ARB/01/12), Award of 14 July 2006, § 67.

<sup>51</sup> *LG&E Energy Corp., LG&E Capital Corp. and LG&E International Inc. v. Argentine Republic* [hereinafter *LG&E*], (ICSID Case No. ARB/02/1), Decision on Liability of 3 October 2006, § 98.

case of conflict between a treaty rule and an inconsistent rule of domestic law, the former will prevail.”<sup>52</sup>

140. In *Sempra Energy International v. Argentine Republic*,<sup>53</sup> the arbitral tribunal has held that the role of Argentinian law is not limited to the determination of factual questions and has a broader role to play,<sup>54</sup> but that international law holds a prominent role, both Parties having invoked it in respect of a number of matters.<sup>55</sup> In case of inconsistency between Argentinian law and international law, the latter shall prevail.<sup>56</sup> The tribunal has then concluded that:

“In accordance with the above considerations, the Tribunal will consider both Argentine law and international law to the extent each is relevant to a determination on liability.”<sup>57</sup>

141. Accordingly, this Tribunal will apply to the merits of the case the BIT and international law, when applicable, as well as the Argentinian law, each in its role as defined above.

## B. DEFINITION OF THE INVESTMENT

142. It is well known that in order to qualify for protection under the ICSID/BIT mechanism, an investment has to satisfy the requirements of the definition of an investment both under the Washington Convention and the BIT. Although there is no definition of an “investment” in the ICSID Convention, case-law has emerged to allow for determination of what constitutes an investment. One of the central purposes of ICSID arbitration is the protection of foreign investments. In order for this Tribunal to entertain a claim, the latter must be related to a legal dispute arising directly out of an investment. The existence of an investment is therefore an essential requirement, and the Tribunal will ascertain what the substance of the protected investment is in this case.

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<sup>52</sup> *Enron Corporation and Ponderosa Assets L.P. v. Argentine Republic* [hereinafter *Enron*], (ICSID Case No. ARB/01/3), Award of 22 May 2007, §§ 207-208.

<sup>53</sup> *Sempra Energy International v. Argentine Republic* [hereinafter *Sempra*], (ICSID Case No. ARB/02/16), Award of 28 September 2007.

<sup>54</sup> *Ibid.*, § 235.

<sup>55</sup> *Ibid.*, § 236.

<sup>56</sup> *Ibid.*, §§ 237-238.

<sup>57</sup> *Ibid.*, § 240.

1. *Introduction*

143. Article I(1)(a) of the BIT provides:

“For the purposes of this Treaty,

(a) ‘investment’ means every kind of investment in the territory of one Party owned or controlled directly or indirectly by nationals or companies of the other Party, such as equity, debt and service and investment contracts; and includes without limitation:

(i) tangible and intangible property, including rights such as mortgages, liens and pledges;

(ii) a company or shares of stock or other interests in the assets thereof;

(iii) a claim to money or a claim to performance having economic value and directly related to an investment;

(iv) intellectual property which includes, *inter alia*, rights relating to:

literary and artistic works, including sound recordings,

inventions in all fields of human endeavour, industrial designs, semiconductor mask works, trade secrets, know-how, and confidential business information, and

trademarks, service marks, and trade names; and

(v) any right conferred by law or contract, and any licenses and permits pursuant to law.”

144. The question to be answered is that of the extent of the “investment” or “investments” made by the Claimant, *i.e.* whether the rights protected by the BIT are limited to those pertaining to the shares held by the Claimant in the Argentinian companies, or whether they include other items, such as legal and contractual rights belonging to the Argentinian companies. The Parties disagree on this issue. Before examining the matter and expressing the present Tribunal’s views thereon, it may be convenient to recall that in its Decision on Jurisdiction, the Tribunal rejected, *inter alia*, an objection of the Respondent to the effect that the Claimant lacked *jus standi*.<sup>58</sup>

145. That objection had been based on two arguments: (i) the investments in question had been sold by the Claimant, and claimants must retain their

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<sup>58</sup> Decision on Jurisdiction of 27 April 2006 [hereinafter Decision on Jurisdiction], § 139.

investor's status throughout the examination of their claim; and (ii) the Claimant had but a minority shareholding in the Argentinian companies.

146. Regarding the first argument, the Tribunal found that no rule prescribing continuous ownership of the investment could be deduced from the ICSID Convention and the BIT or from the relevant case-law.<sup>59</sup> All that was required was ownership of the claim at the time of consent to arbitration as well as at the time of the registration of the claim, and these conditions were met in the instant case.
147. As to the second argument, the Arbitral Tribunal considered that it had been presented too late. But even if it had been timely, pursued the Tribunal, it would have been of little help to the Respondent for reasons similar to those mentioned by the Decision on Jurisdiction in *LG&E*.<sup>60</sup> In that decision it is said that foreign claimants' shares in local companies "are the investment within the meaning of Article 1(1)(a)(ii) of the Bilateral Treaty"<sup>61</sup> and that "it is irrelevant whether the shares are majority or minority shares."<sup>62</sup>
148. Accordingly, the Tribunal recognised the *jus standi* of the Claimant. It remains to be seen, on the merits of the present case, what exactly the Claimant's investment consists of: the shares of the Argentinian companies only or other elements as well?

## 2. *The Parties' Positions*

### (i) *The Claimant's Position*

149. In its Post-Hearing Brief, the Claimant asserts that the term "investment" used in the BIT between Argentina and the United States includes elements other than shareholdings.<sup>63</sup> That term must be read as including not only shareholders' rights, but also investment contracts and legal or contractual

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<sup>59</sup> *Ibid.*, § 135.

<sup>60</sup> *LG&E*, *supra* note 51, Decision on Jurisdiction of 30 April 2004.

<sup>61</sup> *Ibid.*, § 50.

<sup>62</sup> *Ibid.*

<sup>63</sup> CPHB, § 57.

rights owned or controlled, directly or indirectly, by the investor. This means, according to the Claimant, that since CAPSA and CAPEX were

“ ... the investment vehicles through which El Paso invested in Argentina’s hydrocarbon sector, the vested and contractual rights belonging to those entities indirectly belonged to El Paso within the terms of this Treaty [the BIT].”<sup>64</sup>

150. Moreover, according to the Claimant,

“ ... the actions of the local operating companies – whether they choose to enter into settlement agreements, renegotiations, or seek relief in local courts – cannot waive the rights of a shareholding investor (minority or majority) under an applicable treaty; only the investor can give its consent to waive such rights.”<sup>65</sup>

151. The above views are confirmed by the experts commissioned by the Claimant and their testimony in this Tribunal’s hearings. Thus, in his Opinion of August 2004, Professor Reisman stated:

“... in addition to the expropriation of specific contract and legal rights and frustration of legitimate expectations that resulted from the measures taken ..., the cumulative effect of the measures ... accomplished an indirect expropriation of El Paso’s investment.”<sup>66</sup>

152. In the present context, what is of interest in the above passage is not so much what it says about expropriation, but the fact that “it includes specific contract and legal rights” of the Argentinian companies within El Paso’s investment and, hence, in the object of the alleged expropriation. This view is confirmed by an exchange that took place between the expert and counsel for the respondent State during the hearing on the merits:

“Q. Were the legal and contractual rights of the Argentine companies El Paso’s investment?”

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<sup>64</sup> *Ibid.*, § 104.

<sup>65</sup> *Ibid.*, § 114.

<sup>66</sup> *Expert Opinion of Professor W. Michael Reisman* [hereinafter Reisman Report] of August 2004, p. 50, Memorial Legal Authority No. 29.

A. Yes.”<sup>67</sup>

A few moments later, the following dialogue between counsel for Argentina and Professor Reisman was recorded:

“Q. ... Now, under the definition of investments in the bilateral investment treaty, in addition to the shares that El Paso had in the Argentine companies, would the specific contractual and legal rights held by those companies with the government qualify as protected investments under the treaty?

A. In my opinion it would.

Q. And in your view are specific legal and contractual rights susceptible to expropriation independent from the business of the company as a whole?

A. Of course. It’s such an obvious point that I needn’t try to give examples, but there are some.”<sup>68</sup>

153. These views were confirmed by Professor Schreuer, another expert consulted by the Claimant.<sup>69</sup> In his Opinion, Professor Schreuer asserted that Argentina had abrogated essential rights of the Claimant resulting from the latter’s investment by taking, not physical assets but rights under the Electricity and Hydrocarbon Regulatory Frameworks – rights guaranteed by laws, decrees, resolutions and concession agreements – thereby depriving El Paso of a reasonably expected economic return.<sup>70</sup> This expert later asserted

“ ... that specific rights that El Paso enjoyed under the Electricity and Hydrocarbons Regulatory Frameworks are covered by the definition of investment in the BIT and that these rights were taken from El Paso. This means that any ‘right conferred by law or contract’ upon El Paso is protected by the BIT.”<sup>71</sup>

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<sup>67</sup> Hearing on the Merits, 4 through 13 June 2007 [hereinafter Hearing Transcript in English], Day 3, p. 784.

<sup>68</sup> *Ibid.*, pp. 808-809.

<sup>69</sup> *Legal Opinion of Christoph Schreuer, The Question of Breaches of the Bilateral Investment Treaty between Argentina and the United States of America* [hereinafter C. Schreuer Report] of 3 November 2006, Reply Exhibit No. 254.

<sup>70</sup> *Ibid.*, § 89, p. 30.

<sup>71</sup> *Ibid.*, § 143, pp. 48-49.

154. A confirmation of the above may be found in the conclusions of Professor Schreuer's Opinion:

“The term ‘investment’ is defined in Article I(1) of the BIT. That definition includes ‘a claim to money or a claim to performance having economic value and directly related to an investment’ as well as ‘any right conferred by law or contract, and any licenses and permits pursuant to law.’ Therefore, contracts and public concessions are included in the definition of investments. This also squarely covers the rights enjoyed by El Paso under the Electricity Regulatory Framework and under the Hydrocarbons Regulatory Framework. It follows that the rights of El Paso under the Electricity Regulatory Framework and under the Hydrocarbons Regulatory Framework as well as the rights arising under permits and contracts based on these legal frameworks are covered by the BIT’s provisions protecting United States investors from expropriation and measures tantamount to expropriation.”<sup>72</sup>

155. In his testimony before the Tribunal, Professor Schreuer was asked whether he would be surprised if he were told that the Regulatory Frameworks for Electricity and for Hydrocarbons do not grant any rights to El Paso. Here is the expert's answer:

“Yes, I would be, unless you mean ‘directly,’ of course. If you mean they granted rights to the Argentinian Companies in which El Paso invested, then I would not be surprised; but, if you say it did not grant any directly or indirectly, then I would be surprised.”<sup>73</sup>

156. All in all, the Claimant and its experts clearly are of the view that the expression “investment” used in Article I(1)(a) of the BIT between Argentina and the United States must be interpreted as including both El Paso's shares in the domestic companies and the contractual and legal rights directly owned by those entities.

*(ii) The Respondent's Position*

157. The Respondent's view is that the legal and contractual rights of the Argentinian companies belong to the latter and not to El Paso, a foreign entity that has invested in them. Accordingly, El Paso can claim for the loss allegedly

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<sup>72</sup> *Ibid.*, § 487, p. 159.

<sup>73</sup> Hearing Transcript in English, Day 6, pp. 1709-1710.



caused unlawfully by the Respondent to its shares in said companies but not for allegedly unlawful damage caused to rights belonging to the latter. In its Rejoinder, the GOA asserts that

“the claim by the foreign investor whose investment is an interest in a local company may only be founded on the detriment to the investment itself when it is in breach of the BIT, rather than on the detriment to the local company’s rights.”<sup>74</sup>

158. Similarly, in its Closing Statement, the GOA points out that

“[a] shareholder may not claim compensation in connection with a measure concerning the rights of the company where the shareholder holds a participating interest.”<sup>75</sup>

159. The Government’s views on this issue were further developed by Professor Sornarajah,<sup>76</sup> one of its experts. His Opinion begins with the finding that the lack of diplomatic protection for foreign shareholders in local companies under the *Barcelona Traction* doctrine<sup>77</sup> became increasingly cumbersome when developing countries targeting foreign investment began to require that such investment be made through domestic companies in which foreign shareholders would usually hold minority participations.<sup>78</sup> This, according to the expert, is why some protection has been extended to foreign shareholders by the BITs.

160. But this protection, according to the same expert, will come to bear only if it is the shares as such which have been affected by measures such as forcible divestment or expropriation of the company; if the latter “continued to function and the shares were intact, the need for such protection would not arise.”<sup>79</sup> The measures decided by the State thus were issues to be taken up on the domestic level by the company itself. Professor Sornarajah then points out that

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<sup>74</sup> Rejoinder, § 342.

<sup>75</sup> RPHB, § 11.

<sup>76</sup> *Legal Opinion of M. Sornarajah* attached to Argentina’s Rejoinder [hereinafter Sornarajah Report] of 5 March 2007.

<sup>77</sup> *Barcelona Power, Light and Traction Co., Ltd. (Belgium v. Spain)* (Second Phase) [hereinafter *Barcelona Traction*], Judgment of 5 February 1970, I.C.J. Reports 1970, p. 3.

<sup>78</sup> Sornarajah Report, *supra* note 76.

<sup>79</sup> *Ibid.*, § 8, p. 9.

“[t]he mere fact that the shares had depleted in value does not give a cause of action to a minority shareholder under an investment treaty. Had the company been expropriated, the situation would have been different as the minority shareholder has a right to compensation for the extent of his share in the value of the company.”<sup>80</sup>

161. The expert pursues his analysis by asserting that in international law the understanding always was that “the shares in a company incorporated in a host country are not usually affected by any measures” taken by that country. In such situations, the company itself is the victim. The domestic company as such does not have the personality required to seek protection under a BIT. This finding cannot be subverted merely by showing that the protected foreigners hold minority shareholdings. The situation is different when the company itself ceases to exist, in which case foreign shareholders can claim the value of their shares.<sup>81</sup>
162. According to the *Barcelona Traction* ruling, customary international law does not allow for diplomatic protection by the national State of foreign shareholders. The change to this ruling brought about by the BITs is that shareholders are now given the possibility to protect shares, whether “directly or indirectly held.” This can be taken to mean: (i) that the intention was to protect the shares of majority shareholders and their value when the company was expropriated, especially in States making the entry of foreign investment dependent on local incorporation; and (ii) that there was no intention to protect shares of functioning companies.<sup>82</sup>
163. While it is true that the Tribunal recognised the *jus standi* of the Claimant as a minority shareholder in the Argentinian companies,<sup>83</sup> this was a *prima facie* finding. The remaining question is whether “the investment treaty protects shareholder rights beyond the protection of their rights as shareholders and

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<sup>80</sup> *Ibid.*

<sup>81</sup> *Ibid.*, § 9, p. 9.

<sup>82</sup> *Ibid.*, § 9, p. 10; § 16, p. 16.

<sup>83</sup> See *supra* § 148.

includes the protection of the rights of the companies in which such shares are held.”<sup>84</sup>

164. The problem dealt with next by the Respondent’s expert is whether *minority* shareholders qualify as owners of a “protected investment” under Article I(1)(a) of the BIT. Such shareholders “own and control” their shares but not the company itself. Investments owned or controlled “directly or indirectly,” as referred to in Article I.1 of the Treaty, is a term describing shares owned or controlled by their holders or someone higher up in the chain. It does not “extend downward” to the local company serving as a vehicle of the investment. The latter’s property remains unprotected,<sup>85</sup> and its assets cannot benefit from the diplomatic protection of the shareholders’ national State. All the BIT aims for is to transfer the object of the diplomatic protection from the foreign State to the foreign individual investor; it does not enlarge the definition of the objects protected.<sup>86</sup>
165. The Respondent’s expert then comments on views that contractual and legal rights of the domestic companies are not protected as rights of the latter’s foreign shareholders.<sup>87</sup> Wherever such claims were successful, this was because specific commitments had been made *directly* to the foreign investors guaranteeing these rights *via* permits or contracts. Such was the case in *CMS*,<sup>88</sup> where there was a license granted by decree, and in *Revere Copper v. Jamaica*,<sup>89</sup> where a stabilisation contract “involved a specific contractual commitment.”<sup>90</sup>
166. The legal and contractual rights under discussion are based on Argentinian law, which brought them to life. Professor Sornarajah points out that<sup>91</sup> they are not enlarged at the international level but remain co-terminous with the rights as

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<sup>84</sup> Sornarajah Report, *supra* note 76, § 10, p.11.

<sup>85</sup> *Ibid.*, § 17, p.17.

<sup>86</sup> *Ibid.*, § 17, p.18.

<sup>87</sup> *Ibid.*, § 11, p.12; § 12, pp.12-13; § 18, pp.18-19.

<sup>88</sup> *CMS*, Decision on Jurisdiction, *supra* note 48.

<sup>89</sup> *Revere Copper & Brass Incorporated, v. Overseas Private Investment Corporation (OPIC)* [hereinafter *Revere Copper v. OPIC*], AAA Award of 24 August 1978.

<sup>90</sup> Sornarajah Report, *supra* note 76, § 18, p. 18, note 17.

<sup>91</sup> *Ibid.*, § 19, pp. 19-20.

they stand on the domestic level: “foreign investment rights under the investment treaty can exist only to the extent permitted by the host State’s law at the time of the entry.”<sup>92</sup>

167. It is, therefore, to Argentinian law that one must turn to establish whether specific rights have been attributed to the Claimant.<sup>93</sup> In the case at hand, there were no such rights. Regarding the Electricity Sector,<sup>94</sup> changes had to be expected and, in fact, frequently occurred; changes were foreseen in the Regulatory Framework and, indeed, were accepted voluntarily by the local companies; it was the foreign minority shareholders who complained. In the Hydrocarbons Sector,<sup>95</sup> the situation is similar:

“... to the extent that the measures taken during the economic crisis are reasonable within the regulatory structure, they cannot create any impact or any external system of investment protection for a wrongful infringement of treaty rights.”<sup>96</sup>

168. Professor Sornarajah finally turns to the permanent sovereignty over natural resources, which he considers to be a principle of *jus cogens*. This means that, with the fluctuations of what can be considered as being the public interest, an element of paramount importance in this matter, the rights granted to operators and investors may fluctuate as well; entrants to the field cannot but be aware of that possibility. Pursuant to the *jus cogens* argument, what may have been possible at a given time under the angle of the *jus cogens* principle of permanent sovereignty over natural resources will no longer be at another point in time. In technical terms, this means that a supervening impossibility of performance may occur under Article 61 of the Vienna Convention on the Law of Treaties.<sup>97</sup> In such situations, the Respondent’s expert concludes, “a

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<sup>92</sup> *Ibid.*, § 19, p. 20.

<sup>93</sup> *Ibid.*, § 20, p. 21.

<sup>94</sup> *Ibid.*, § 21, pp. 21-23.

<sup>95</sup> *Ibid.*, §§ 22-25, pp. 23-26.

<sup>96</sup> *Ibid.*, § 23, p. 25.

<sup>97</sup> Vienna Convention of the Law of Treaties [hereinafter Vienna Convention 1969] of 23 May 1969, United Nations Treaty Series, Vol. 1155, p. 331.

recovery of sovereignty is permissible.”<sup>98</sup> According to the Respondent’s expert, all BITs are subject to that limitation.

(iii) *A Summary of the Discussion*

169. El Paso holds the view that it may claim, not only on the basis of its shareholdings in the Argentinian companies, but also based on the legal and contractual rights of those entities.
170. The respondent Government holds that the fundamental rules to be used to define the content of foreign shareholders’ rights on the international level are those governing diplomatic protection. In principle, such protection can be granted to foreign shareholders only if their personal, *i.e.* direct, rights have suffered at the hands of the State: annulment or confiscation of its shares, refusal of the right to participate in shareholders’ meetings or to receive a dividend, and so on. To this, one may add, at least for majority shareholders, the expropriation of the company, especially by States making the entry of foreign investment contingent on local incorporation. By contrast, shares of functioning companies remain unprotected.
171. This was, according to the Respondent, the situation prevailing up to the *Barcelona Traction* case.<sup>99</sup> The only thing that changed with the advent of BITs is that, whereas in the past such claims had to be made through the channel of diplomatic protection, they can, today, be presented directly by the foreign investor. The BITs do not, however, enlarge the content of the rights protected in any way; they do not, in particular, extend to legal and contractual rights of domestic companies, except if specific commitments were made directly guaranteeing these rights to the foreign investor. Another point made was that minority shareholdings do not qualify for BIT protection.
172. The above suggests that the two essential questions to be addressed by the Tribunal are: (i) Should Article I(1)(a) of the Argentina-US BIT be construed

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<sup>98</sup> Sornarajah Report, *supra* note 76, § 25, p. 27.

<sup>99</sup> *Barcelona Traction*, *supra* note 77.

narrowly, as reflecting, so far as foreign shareholders' rights are concerned, the situation prevailing in the field of diplomatic protection? and (ii) Is the protection offered by that provision limited to foreign majority shareholders?

3. *The Tribunal's Analysis*

173. In the present case, El Paso's right to claim is not in dispute. Being an entity incorporated in the State of Delaware, it is unquestionably a US company and, thus, placed under ICSID jurisdiction pursuant to Article 25(2)(b) of the ICSID Convention. What is in dispute is whether, in addition to El Paso's shares in the Argentinian companies, which the Parties agree qualify as "investment" according to Article I(1)(a) of the BIT, the term "investments" as defined by said Article includes other elements.
174. El Paso's basic contention is that Article I of the BIT between Argentina and the United States uses very broad language and can therefore encompass both its shareholdings in the Argentinian companies and the legal and contractual rights of which those entities had allegedly been deprived in violation of the BIT. This line of argument appears contradictory: either the domestic companies enjoy an independent legal existence, in which case it is they who own said legal and contractual rights, this meaning that the foreign investors' losses can be measured only by the diminished value of their shares in the companies. Or the domestic companies' legal existence is but a fiction, at least on the international level, and can therefore be disregarded, which would mean that the investment can practically be characterised as a direct one, the consequence being that the foreign investor may claim, as the owner of the local companies, the legal and contractual rights in question, but not its losses as a shareholder.
175. In the Tribunal's eyes, the above two views are irreconcilable, so that it is indispensable to opt for the one or the other. As things are, the Claimant's contentions in their present form do not seem viable because they amount to claiming twice for damage caused by the same events: once for the taking of the rights of the Argentinian companies and once for the diminution in value of the shares of those companies held by El Paso. That the loss of share value is

linked to the taking of the rights belonging to the local company appears obvious.

176. The Respondent's thesis appears flawed as well. It is based on the assumption that the only change from the *Barcelona Traction*<sup>100</sup> situation brought on by the BITs is that diplomatic protection will no longer be required because the individual foreign investor may now bring claims on the international level. Otherwise, it is argued, nothing has changed; in particular, the content of the claimable rights remains the same.
177. To remove any doubt and to ensure that its analysis is exhaustive, the Tribunal will first confirm that interests repeatedly invoked by the Claimant as having been interfered with are not investments protected by the BIT: this holds true for the licenses and other contracts granted to the Argentinian companies, as well as for purported investment agreements that would belong to El Paso. After this negative approach, the Tribunal will turn to a positive approach and concentrate on the definition of what does constitute El Paso's investment in Argentina, *i.e.* its shares in different Argentinian companies, thus giving an answer to the questions under paragraph 172 above. It seems however apposite, before entering into the analysis of the substance of El Paso's investment, to recall what the Claimant considers as its investment in its submissions. In its Memorial, El Paso's investment is described as follows, on the basis of Article 1(1)(a) of the BIT:

“Applying these standards, Claimant's claims clearly arise directly out of an ‘*investment*.’ Claimant's investment directly and indirectly include: (i) equity interests in the Argentine Companies; (ii) the ownership and control of legal rights under the Energy Regulatory Framework, including concession and contract rights, such as those arising under the Concessions and crude oil, LPG and energy supply agreements; (iii) a substantial amount of Dollars invested by Claimant in Argentina; and (iv) claims to money and performance having economic value under Claimant's Concession, contract and legal rights.”<sup>101</sup>

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<sup>100</sup> *Ibid.*

<sup>101</sup> Memorial, § 57.

*(i) What Is Not El Paso's Investment?*

*(a) The Licenses and Other Contracts Granted to the Argentinian Companies Are Not Protected Investments*

178. Although the Claimant has not asserted that the Argentinian companies as such are its investment, it has claimed violation of rights belonging to these companies and can therefore be considered to have implicitly considered the Argentinian companies either as protected investors or protected investments. The Tribunal therefore deems it necessary to clarify whether the Argentinian companies are or are not protected investors and whether the Claimant can therefore claim for rights belonging to them.

179. In its Article 25(2), the ICSID Convention gives a definition of the companies that can be considered nationals of a given State:

“... (2) ‘National of another Contracting State’ means:

... (b) any juridical person which had the nationality of a Contracting State other than the State party to the dispute on the date on which the parties consented to submit such dispute to conciliation or arbitration and any juridical person which had the nationality of the Contracting State party to the dispute on that date and which, because of foreign control, the parties have agreed should be treated as a national of another Contracting State for the purposes of this Convention.”

180. In the BIT, Article I gives the following definition of a “company”:

“b) ‘company’ of a Party means any kind of corporation, company, association, state enterprise, or other organization, legally constituted under the laws and regulations of a Party or a political subdivision thereof whether or not organized for pecuniary gain, and whether privately or governmentally owned.”

181. A first point can be dealt with quite quickly: it is not contested that CAPSA, CAPEX, Costanera and SERVICIOS are Argentinian companies under these definitions, as they are incorporated under the laws of Argentina and registered in that country.



182. The second question to be asked is whether, although they have the nationality of the Contracting State Party to the dispute – *i.e.* the nationality of Argentina – the Parties have agreed that, because of foreign control, these companies should be treated as United States nationals, and therefore their rights considered as protected investments, for the purposes of the ICSID Convention and this arbitration. It should be noted that Argentina has indeed agreed to treat the Argentinian Companies as foreign companies under Article VII(8) of the BIT for purposes of Article 25(2)(b) of the ICSID Convention, on condition of a foreign (U.S.) control over such entities.
183. For Costanera, there is clearly no control, as El Paso holds only an indirect non-controlling interest of about 12% in Costanera. The same is true for CAPSA and, through the latter, CAPEX, as there is no control by the American company El Paso over these two Argentinian entities: El Paso has only indirect non-controlling shareholdings in CAPSA and CAPEX; more precisely, El Paso owns a 45% interest in CAPSA, the latter having a 60.36% interest in CAPEX.<sup>102</sup> The analysis is different for SERVICIOS: both the first condition for considering it as a foreign company – El Paso owned a 99.2 % controlling shareholding in that company – and the second condition – the agreement by Argentina to consider SERVICIOS as a US company because of control – are met. However, SERVICIOS has signed no contracts or other agreements with Argentina. The conclusion is that the rights of the four mentioned Argentinian companies in which El Paso has invested cannot be considered rights enjoying the protection of the Argentina-US BIT by application of Article 25(2)(b) of the ICSID Convention.
184. A similar situation was found to exist in *CMS*.<sup>103</sup> That company was complaining about the treatment it received as a foreign investor during the Argentinian crisis, its investment being a minority shareholding in TGN (Transportadora de Gas del Norte), an Argentinian company to which the GOA had granted a concession for the transportation of natural gas. The Claimant,

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<sup>102</sup> This amounts to a 28.06% indirect interest of El Paso in CAPEX.

<sup>103</sup> *CMS*, *supra* note 48, Decision on Jurisdiction.

the Respondent and the Tribunal made the same analysis of the situation, considering that TGN was not a protected investor. The Respondent's position, as summarised by the tribunal in the Decision on Jurisdiction, was the following:

“In its view, while the acquisition of shares qualifies as an investment under the Treaty, neither TGN, as an Argentine corporation, nor the License qualify as an investment under the BIT. TGN, the argument follows, has its own assets, including the License; because these assets do not constitute an investment under the Treaty, CMS's claims, based on the alleged breach of TGN's rights under the License cannot be considered to arise directly from an investment.”<sup>104</sup>

185. The claimant did not disagree with this analysis, as highlighted again by the tribunal:

“CMS shares the view that TGN is not an investor under the Treaty, and that it has not been agreed to treat this company as a non-Argentine national because of foreign control. Neither is the License an investment under the Treaty. However, CMS adds, its 29.42% share in TGN qualifies as an investment covered under the Treaty ...”<sup>105</sup>

186. The tribunal concluded along the same lines and accepted jurisdiction, not on the basis of any rights of TGN or any rights relating to the License, which were not protected investments, but on account of the existence of the shareholding of CMS in the Argentinian company:

“Because ... the rights of the Claimant can be asserted independently from the rights of TGN and those relating to the License, and because the Claimant has a separate cause of action under the Treaty in connection with the protected investment, the Tribunal concludes that the present dispute arises directly from the investment made and that therefore there is no bar to the exercise of jurisdiction on this count.”<sup>106</sup>

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<sup>104</sup> *Ibid.*, § 66.

<sup>105</sup> *Ibid.*, § 67.

<sup>106</sup> *Ibid.*, § 68.

187. The conclusion is therefore unavoidable: the Argentinian companies – CAPSA, CAPEX, Costanera and SERVICIOS – do not qualify as protected investors under the ICSID Convention and the BIT, and the Tribunal so holds.
188. The Argentinian companies not being protected investors, their rights and licenses cannot be considered protected investments. Throughout its submissions, the Claimant complains about interferences with “its contractual rights.” A few examples can be given: in its Memorial, it mentions that “El Paso was stripped of legal and *contractual rights* and associated revenues.”<sup>107</sup> In its Reply, the Claimant asserts that the GOA interfered with electricity sale contracts “[i]n violation of express provisions of the Electricity Law that guaranteed the right of generators to freely negotiated *contracts*,”<sup>108</sup> that it mandatorily converted “all Dollar denominated payments in PPAs into Pesos at a confiscatory exchange rate,”<sup>109</sup> that “the GOA unilaterally interfered with *contractual rights* arising from the *sale agreements*, contravening express assurances granted to CAPSA and CAPEX under the Hydrocarbon Deregulation Decrees and Decree N° 43/1991 that granted the CAPEX Concession”;<sup>110</sup> also, as stated by the Claimant in the same submission, “the currency conversion imposed by Law N° 25,561 and Decree N° 214 severely impacted CAPSA and CAPEX’s *contracts*.”<sup>111</sup>
189. However, this Tribunal considers that El Paso owns no contractual rights to be protected, as it has signed no contract with Argentina. In so doing, it agrees with the analysis of the tribunal in the *CMS* case, as evidenced by the references to the licenses in the citation from the Decision on Jurisdiction in paragraph 186. It is thus the conclusion of the Tribunal that none of the contracts the interference with which is complained of by the Claimant are protected investments under the ICSID Convention and the BIT.

*(b) No Investment Agreement Protected by the BIT Was Entered into*

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<sup>107</sup> Memorial, § 31. Emphasis added by the Tribunal.

<sup>108</sup> Reply, § 112.

<sup>109</sup> *Ibid.*

<sup>110</sup> *Ibid.*, § 238. Emphasis added by the Tribunal.

<sup>111</sup> *Ibid.*, § 246. Emphasis added by the Tribunal.

*between Argentina and El Paso*

190. In its Decision on Jurisdiction, the Tribunal considered that it could accept *prima facie* the contention of the Claimant that there might be some investment agreements in this case, although that notion is not defined in the BIT. It is worth mentioning that while the BIT involved here fails to supply a complete definition of “investment agreements,” the following definition of that notion has been given in BITs and free trade agreements concluded by the US since 1994:

“ ... a written agreement between the national authorities of a Party and a covered investment or a national or company of the other Party that (i) grants rights with respect to natural resources or other assets controlled by the national authorities and (ii) the investment, national or company relies upon in establishing or acquiring a covered investment.”

191. According to the Claimant, the concessions granted to the Argentinian companies could be so characterised because they constitute written agreements between those companies and the Government; they grant the companies rights to natural resources belonging to the host State; and they establish investment obligations for the companies towards the Government. For example, in its Reply, the Claimant asserts that “each of the Concessions qualifies as an ‘investment agreement’.”<sup>112</sup> According to the Respondent, on the contrary, “[i]n the case under analysis, there is no investment agreement because the requirements for it to exist have not been met: (a) El Paso did not enter into an agreement with the Argentine Government; and (b) the concessions invoked by Claimant lack the elements that may internationalise them because they are governed by Argentine law, are subject to domestic courts and have been granted to Argentine Companies.”<sup>113</sup>

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<sup>112</sup> Reply, § 613.

<sup>113</sup> Rejoinder, § 302.

192. The Tribunal, in its Decision on Jurisdiction, considered that “[a]ccording to this Tribunal, the Claimant has made out a *prima facie* case that there is indeed an investment agreement as that notion may be generally understood.”<sup>114</sup>
193. As the Tribunal is now at the merits phase, it has to re-consider its initial characterisation. The Hydrocarbon Concession and Contracts could indeed have been considered “investment agreements” if they had been signed between Argentina and a foreign investor, as results from the plain wording of Article VII(1) of the BIT which provides for the competence of arbitral tribunals over “investment disputes.” That term is defined in Article VII(1) as “a dispute between a Party and a national or company of the other Party arising out of or relating to (a) *an investment agreement between that Party and such national or company.*”<sup>115</sup>
194. As has been pointed out, CAPSA and CAPEX cannot be considered US companies. The inescapable conclusion is that the Hydrocarbon Concession and Contracts do not legally qualify as “investment agreements” under the relevant BIT. The disputes related to these agreements are therefore not, as such, investment disputes falling under the jurisdiction of this Tribunal.
195. This conclusion is corroborated *a contrario* by the decision in *Lanco International, Inc. v. Argentina*,<sup>116</sup> where the tribunal decided that the concessions were investment agreements, stating that “insofar as Lanco is a party to [the concession agreement, the latter] can be characterised as an investment agreement.”<sup>117</sup> This conclusion was based on the fact that Lanco was not only a shareholder of the concession holder but also a party to the concession agreement, which is not the situation in the present case, where El Paso was not a party to the concession agreements, nor to any other contract with Argentina for that matter. It is also in line with the decision in *Occidental*

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<sup>114</sup> *CMS*, *supra* note 58, Decision on Jurisdiction, § 114.

<sup>115</sup> Emphasis added by the Tribunal.

<sup>116</sup> *Lanco International, Inc. v. The Argentine Republic* [hereinafter *Lanco*], (ICSID Case No. ARB/97/6), Preliminary Decision on Jurisdiction of 8 December 1998.

<sup>117</sup> *Ibid.*, § 16.

*Exploration and Production Co. v. Ecuador*,<sup>118</sup> where the tribunal, faced with the interpretation of an exclusion of tax matters similar to that found in Article XII of the BIT, had to determine whether or not an investment agreement was involved. As in *Lanco*, the tribunal found that there was indeed such an agreement, but that, as in *Lanco*, this was so because the contract was directly signed between the foreign investor and Petroecuador in the name of Ecuador:

“In 1999, OCCIDENTAL EXPLORATION AND PRODUCTION COMPANY (“OEPC” or “the Company”), a company registered under the laws of California, *entered into a participation contract* (“the Contract” or “Modified Participation Contract”) with Petroecuador, a State-owned corporation of Ecuador, to undertake exploration for and production of oil in Ecuador.”<sup>119</sup>

“Investments were made by OEPC *under the Contract* in pursuance of its obligation and exclusive right to carry out the exploration and exploitation activities in the assigned area.”<sup>120</sup>

196. This being the description of the contract, the tribunal in *Occidental Exploration and Production Company v. Ecuador*, partly relying on *Lanco*, held that such a contract had to be considered an investment agreement:

“The Tribunal must note ... that ... the Modified Participation Contract qualifies as an ‘investment agreement’ under the Treaty. On this point the Tribunal believes that Ecuador’s argument is consistent with the *Lanco* Preliminary Award in so far as this decision identified a concession contract, albeit structured in a more complex manner, with an investment agreement between the State and the foreign investor under the Argentine-United States bilateral investment treaty.”<sup>121</sup>

197. The present case has nothing to do with these two precedents as there never was a contract signed between El Paso and Argentina, nor was there a concession granted to El Paso by Argentina. The Tribunal considers that the concessions, having been granted to Argentinian companies and not to El Paso, do not qualify as investment agreements. It is only in partial agreement, therefore,

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<sup>118</sup> *Occidental Exploration and Production Company v. The Republic of Ecuador* [hereinafter *Occidental VAT*], UNCITRAL Arbitration, Final Award of 1 July 2004, LCIA Case No. UN 3467.

<sup>119</sup> *Ibid.*, § 1. Emphasis added by the Tribunal.

<sup>120</sup> *Ibid.*, § 28. Emphasis added by the Tribunal.

<sup>121</sup> *Ibid.*, § 44.

with the Claimant, when the latter states in its Reply that “[t]he equity interest in CAPSA/CAPEX and the Concessions are covered investments under the BIT. Thus, the definition of investment includes Claimant’s interest in CAPSA/CAPEX and the concessions they hold.”<sup>122</sup> If indeed Claimant’s shareholding in CAPSA/CAPEX is a protected investment, the contrary holds true for the concessions, which do not qualify as protected investments under the BIT entered into by Argentina and the United States.

198. The Tribunal therefore concludes that no investment agreement protected by the BIT was concluded between Argentina and El Paso and that, as a consequence, the concession agreements entered into by the Argentinian companies cannot give rise to an ICSID claim as protected investments.

*(ii) What Is El Paso’s Investment?*

*(a) The Protection of the Shares under the ICSID Convention and under Article I(1)(a) of the BIT*

199. In the present case, El Paso’s right to claim for interference with its shares under the ICSID Convention is not in dispute.
200. The Tribunal now turns to Article I(1)(a)<sup>123</sup> to address this issue in the context of the Argentina-United States BIT and the case at hand. The text of the provision is formulated in a somewhat circular way in that “investments” are defined as being “investments.” There are, however, further elements making that expression more precise.
201. First, as suggested by the Claimant, the expression “investments” is conceived broadly, witness the qualifier “every kind of.” Second, the investment made in one Contracting State must be “owned or controlled directly or indirectly” by nationals or companies of the other Contracting State. Hence, an investment is protected only if it is owned or controlled by such nationals or companies. The words “owned or controlled,” read in conjunction with the words “directly or

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<sup>122</sup> Reply, § 504.

<sup>123</sup> See *supra* § 143.

indirectly,” suggest that the “investment” may be one made by a foreign national or a company incorporated under the laws of the host State but wholly or partly controlled by persons of the other Contracting State; in addition, such control may shift from persons of one foreign State to persons of another.<sup>124</sup> Third, “investments” may, in particular, consist of “equity, debt, and service and investment contracts,” as well as “tangible and intangible property” and – this is crucial – companies “or shares of stock or other interests in the assets thereof.” Other categories of “investments” mentioned are claims to money or to performance having economic value and directly related to an investment, intellectual property, and – this is important equally in the present case – “any right conferred by law or contract, and any licenses and permits pursuant to law.”

202. The circular character of the initial definition of the term “investments” is amply made up for by the above elements. “Investment” covers almost any kind of economic input. It expressly includes “shares of stock” in companies, notably in entities which are incorporated under the laws of the receiving State. There is no limitation regarding the quantity of stock needed, nor are there restrictions regarding the situation of the company (in full operation, expropriated, in the process of liquidation, wound up) or the character of the claims (taking of the shares, right to a dividend, right to participate in stockholders’ meetings, claims for losses in the value of shares). All this is clear evidence that the BIT, as asserted in its preamble, aims at facilitating private investment, promoting the flow of capital and creating conditions of fair and equitable treatment for investments.
203. The Respondent asserts that, according to the text of the BIT, the Parties intended to transfer to the BIT, lock, stock and barrel, the regime practised in the area of diplomatic protection and that the only change brought by the BITs was that the individual investors were now being given direct access to an international dispute settlement mechanism. This “intention” is not, however,

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<sup>124</sup> *Vivendi Annulment*, *supra* note 39, § 50.



attested to by anything and the respondent State has not even attempted to prove it.

204. It is of course true, as the Claimant observes, that the term “investment” used in Article I(1)(a)(v) includes, “without limitation,” “any right conferred by law or contract, and any licences and permits pursuant to law.” But, as shown above in paragraph 175, investors cannot have their cake and eat it too. The loss of value of El Paso’s shares is due, to a large extent, to the measures taken against the legal and contractual rights of the Argentinian companies. To allow claims of El Paso on both counts, for the loss of value of its shares in the companies *and* for the prejudice suffered by the latter, would amount to compensating the Claimant twice.

(b) *International Practice*

205. A spate of decisions of ICSID tribunals deals with the interpretation to be given to Article I(1)(a) of the Argentina-United States BIT or similar clauses of other BITs: *Lanco International, Ltd. v. Argentine Republic*,<sup>125</sup> *Goetz v. Republic of Burundi*,<sup>126</sup> *Maffezini v. Spain*,<sup>127</sup> *Genin v. Estonia*,<sup>128</sup> *CMS v. Argentina* (Decision on Jurisdiction and Decision of the Annulment Committee),<sup>129</sup> *Azurix v. Argentina*,<sup>130</sup> *LG&E v. Argentina*,<sup>131</sup> *Enron and Ponderosa Assets v. Argentina*,<sup>132</sup> *Siemens v. Argentina*.<sup>133</sup> and *Pan American Energy v. Argentina*.<sup>134</sup>

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<sup>125</sup> *Lanco*, *supra* note 116, § 10.

<sup>126</sup> *Antoine Goetz and others v. Republic of Burundi* [hereinafter *Goetz*], (ICSID Case No. ARB/95/3), Award of 10 February 1999, § 89.

<sup>127</sup> *Emilio Agustin Maffezini v. The Kingdom of Spain* [hereinafter *Maffezini*], (ICSID Case No. ARB/97/7), Decision on Jurisdiction of 25 January 2000, §§ 65-70.

<sup>128</sup> *Alex Genin and others v. The Republic of Estonia* [hereinafter *Genin*], (ICSID Case No. ARB/99/2), Award of 25 June 2001, § 324.

<sup>129</sup> *CMS*, *supra* note 48, Decision on Jurisdiction and Decision on Annulment,.

<sup>130</sup> *Azurix*, *supra* note 50, Decision on Jurisdiction of 8 December 2003.

<sup>131</sup> *LG&E*, *supra* note 51, Decision on Objections to Jurisdiction of 30 April 2004, § 89.

<sup>132</sup> *Enron*, *supra* note 52, Decision on Jurisdiction (Ancillary Claim) of 2 August 2004, §§ 28-32.

<sup>133</sup> *Siemens A.G. v. The Argentine Republic* [hereinafter *Siemens*], (ICSID Case No. ARB/02/8), Decision on Jurisdiction of 3 August 2004, §§ 136-144.

<sup>134</sup> *Pan American v. The Argentine Republic*, and *BP America v. Argentine Republic* [hereinafter *Pan American*], Decision on Preliminary Objections of 27 July 2006, §§ 209-221.

206. With the exception of *Goetz* – which only deals with the specific circumstances of that case, *i.e.* the presence of foreign majority shareholders – these precedents, taken collectively, yield the following conclusions:

- the situation envisaged here is not one of diplomatic protection, as in *Barcelona Traction* and *ELSI*,<sup>135</sup> and the practice reflected in those cases is not necessarily relevant here;
- what is relevant is Article I(1)(a) of the Argentina-United States BIT as well as comparable provisions of other instruments, read according to their text and the preamble of the BIT;
- these instruments protect the rights of foreign shareholders in domestic companies, more precisely their own rights as shareholders (right to the shares, right to a dividend, participation in stockholders' meetings, etc.), including the right to compensation for loss of value of stocks imputable to measures taken by the host State;
- that protection is not limited to foreign majority shareholdings but encompasses minority holdings.

This last conclusion has been forcefully approved by the Annulment Committee in the case of *CMS*:

“The Committee observes that, as regards shareholder equity, the BIT contains nothing which indicates that the investor in capital stock has to have a majority of the stock or control over the administration of the company. Investments made by minority shareholders are covered by the actual language of the definition, as also recognized by ICSID arbitral tribunals in comparable cases.”<sup>136</sup>

To this summary of the international practice, the Tribunal will now add further observations.

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<sup>135</sup> *Eletronica Sicula S.p.A. (United States of America v. Italy)* [hereinafter *ELSI*], Judgement of 20 July 1989, ICJ Rep. 1989, p. 15.

<sup>136</sup> *CMS*, *supra* note 48, Decision on Annulment, § 73.

207. The problem of the admissibility of claims by foreign shareholders has produced a steady trickle of international practice. According to that practice, the national States of foreign shareholders owning shares and the rights flowing therefrom – as defined in the preceding paragraph – are entitled to claim those rights regardless of the quantity or value of the shares held. It has generally been assumed that, as long as the company’s home State was in a position to claim on the international level, by way of diplomatic protection, the shareholders’ national States could not claim for any infringement of the rights of the company, or could do so only if the shareholders’ rights had become immediate rights against the host State as a result of the disappearance of the company itself.
208. International practice, however, shows a clear tendency also to protect the interests of foreign shareholders where the company itself belongs to the respondent State, especially where incorporation in that State is a condition for making investments. In such instances, it is thought desirable to protect such interests, for otherwise there would be no protection at all. The *ELSI* case decided by a Chamber of the International Court of Justice<sup>137</sup> attests to that tendency.
209. Moreover, the present instance must be viewed, not from the angle of general international law, as the International Court of Justice did in *Barcelona Traction*, but from that of treaty law, specifically Article 25 of the ICSID Convention and Article I(1)(a) of the BIT between Argentina and the United States. An examination of those provisions and of the relevant international practice show that they deviate from *Barcelona Traction* and that they were intended to do so. This has also been acknowledged by the *CMS* Annulment Committee when it stated that “[s]uch treaties [BITs] and in particular the ICSID Convention must be applied as *lex specialis*.” (§ 69).
210. Whether it can be asserted that, today, the *lex specialis* thus developed is “so prevalent that it can now be considered the general rule,” as stated by the ICSID

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<sup>137</sup> *ELSI*, *supra* note 135, p. 15.

tribunal in *CMS*,<sup>138</sup> is a difficult question which the present Tribunal will not have to go into, however, since the case before it is governed by the *lex specialis* anyway.

211. Another issue regarded as unsolved by some is whether the foreign shareholding, to be protected, must be of some importance. The ICSID case-law recited earlier<sup>139</sup> shows that, regarding the rights of foreign shareholders, no majority is required; a minority will suffice. That raises the further question of whether that minority must be a substantial one or whether even a single share could give rise to a claim. Some concern has indeed been voiced by international tribunals that not any minor portion of indirectly owned shares should necessarily be considered an investment. In *Enron*, the Claimants had a 35.263% indirect ownership of the shares of an Argentinian company through a complex corporate structure. The tribunal considered this an investment, while adding a *caveat*:

“The Tribunal notes that while investors can claim in their own rights under the provisions of the treaty, there is indeed a need to establish a cut-off point beyond which claims would not be permissible as they would only have a remote connection to the affected company.”<sup>140</sup>

212. In the present instance, El Paso’s shareholding interest in the Argentinian companies is undoubtedly substantial in nature, which is why the question does not have to be answered.

(iii) *Summary*

213. BITs do not concern situations such as that addressed in *Barcelona Traction*: they do not pertain to diplomatic protection, nor do they reflect the rules of general international law in matters of investment protection. Interpreted in conformity with the canons of treaty law, they prescribe that rights and interests of foreign shareholders, *in casu* El Paso’s shareholdings in the Argentinian

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<sup>138</sup> *CMS*, *supra* note 48, Decision on Jurisdiction, § 48.

<sup>139</sup> *See supra* §§ 205-206.

<sup>140</sup> *Enron*, *supra* note 52, Decision on Jurisdiction of 14 January 2004, § 52.

companies, are protected regardless of whether they are majority or minority participations.

214. The Tribunal has come to the clear conclusion that the investment protected by the BIT was constituted by the shares in the Argentinian companies that belonged to El Paso. The Claimant in fact has itself admitted this conclusion of the Tribunal, if one looks at its Memorial, where it is stated that “[i]n summary, El Paso owned certain investments in Argentina, which include indirect non-controlling shareholdings in CAPSA, CAPEX and Costanera and an indirect controlling shareholding in SERVICIOS.”<sup>141</sup> The overall conclusion related to the definition of the protected investment could be: what is protected are “the shares, all the shares, but only the shares.”

#### IV. THE ALLEGED VIOLATIONS

215. As stated by the Claimant in its Memorial,

“[t]his dispute arises out of a series of laws, decrees, orders and resolutions of the GOA, mostly enacted during and since 2002, through which it fundamentally breached the *explicit and implicit obligations* it had assumed towards investors by abrogating and repudiating legal and contractual rights and radically altering the very economic, regulatory and legal frameworks that had been specifically designed to induce investment, and upon which El Paso had relied in making its investments in Argentina.”<sup>142</sup>

216. The Respondent has a totally different approach to the events and considers that what happened was a terrible economic crisis affecting all economic actors and that El Paso was necessarily caught in these economic disturbances:

“Isolating the foreign investor from the crisis through the ICSID is distorting the nature and purpose of the protection granted by treaties to investors only to turn them into privileged subjects that may appear before such World Bank agency seeking protection against structural crises as the one undergone by the Argentine economy. Bilateral

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<sup>141</sup> Memorial, § 48.

<sup>142</sup> *Ibid.*, § 20. Emphasis added by the Tribunal.

treaties are not good business insurance or a protection against a crisis.”<sup>143</sup>

217. The Tribunal does not see exactly what the Claimant means by “implicit” obligations, unless this is a mere formula to extend State liability. It will therefore concentrate on the explicit obligations towards American investors undertaken by Argentina when ratifying the Argentina-US BIT, to establish whether any of these obligations have been violated. If the answer is positive, the Tribunal will still have to verify whether there are circumstances, according to the BIT or general international law, under which these acts cannot be qualified as BIT violations.
218. Before examining whether the violation of the Claimant’s rights amounts to a breach of one or more BIT standards, it is necessary for the Tribunal to have a full picture of the rights alleged by the Claimant which the latter considers to have been violated. These rights were stated first in the Request for Arbitration, and no new right was asserted thereafter. A distinction has to be drawn between the Electricity Sector and the Hydrocarbon Sector.
219. In the **Electricity Sector**, the following rights are said to have been violated in the Request for Arbitration:<sup>144</sup>
- Right to receive Capacity Payments in dollars.
  - Right to have Spot Market Prices set at a uniform rate based on the marginal production cost of the system.
  - Right to have Spot Prices calculated in dollars.
  - Right to collect payments for spot energy supplies in accordance with pre-established conditions.<sup>145</sup>

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<sup>143</sup> Counter-Memorial, § 316.

<sup>144</sup> *El Paso Energy International Company v. Argentine Republic*, Request for Arbitration of 6 June 2003. [hereinafter Request for Arbitration], §§ 55, 56, 58 and 60.

<sup>145</sup> In the Claimant’s Memorial, the power generation dispute is described as an alteration of the electricity market involving the following measures, all considered as a violation of the investor’s rights:

1. Alteration of Spot Price Setting Mechanisms;
2. Pesification of VCPs at an Artificial Exchange Rate;
3. Caps on Spot Prices;

220. In the **Hydrocarbon Sector**, the following rights are alleged to have been breached in the Request for Arbitration:<sup>146</sup>

- Right to have hydrocarbon exports exempted from export taxes and withholdings.
- Right to export freely.
- Right to dollar-denominated sale and purchase agreements.<sup>147</sup>

221. It is worth underscoring that El Paso does not claim that the devaluation *per se* constitutes a violation of the BIT. In fact, El Paso's core claim, really consists in claiming the violation of its right to earn a reasonable return on its investments, as appears, for example, from its own conclusion of the analysis of the measures adopted in the Electricity Sector which is found in its Memorial and where it is stated that:

“El Paso's most fundamental right with respect to CAPEX and Costanera was the right to operate within an Electricity Regulatory Framework that would permit them to receive capacity payments sufficient to cover their investment costs, and energy prices sufficient to recover their costs of production, while also earning a reasonable return on the investment.”<sup>148</sup>

In the same submission, it is also claimed, more generally, that “El Paso was deprived of the reasonably-to-be-expected economic benefit of its investment in the Argentine Companies.”<sup>149</sup>

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4. Reduction in Value of Capacity Payments;
  5. Additional Alterations of the Electricity Regulatory Framework;
  6. Mandatory Currency Conversion of Power, LPG and Crude Oil Sale Contracts;
  7. GOA's Interference in Generators' Ability to Collect Bills.

The list seems longer but it is only more detailed and refers always to the same four rights invoked in the Request for Arbitration.

<sup>146</sup> Request for Arbitration, §§ 68-70.

<sup>147</sup> In the Claimant's Memorial, the oil and gas dispute is described as a violation of the Hydrocarbon Regulatory Framework, implying a violation of the three same rights as listed in the Request for Arbitration:

1. Violation of the Right to Export Hydrocarbons Free of Export Withholdings;
2. Imposition of Restrictions on Exports;
3. The Right to Dollar-denominated Purchase and Sale Agreements Violated by Pesification.

<sup>148</sup> Memorial, § 324.

<sup>149</sup> Memorial, § 450.

222. El Paso recognises that the BIT does not protect foreign investors and their investments against devaluation. The Tribunal takes note of this position and takes this opportunity to point out that devaluation pertains to the monetary and fiscal sovereignty of the State and to indicate its agreement with the *dictum* of the tribunal in *Continental v. Argentina* relating to the question of devaluation:

“The fixing of an exchange rate and deciding the mechanism by which the national currency may be exchanged for foreign currency and its conditions, including the possibility of maintaining accounts and deposits denominated in a foreign currency within the country, pertain to the monetary sovereignty of each State. These policies ... do not render the State liable for the burden or losses that may be suffered by those affected, provided there is no discrimination or unfairness in their application.”<sup>150</sup>

223. It should also be mentioned here that throughout its submissions, El Paso has complained about measures adopted after the sale of its investments.<sup>151</sup> The Tribunal must however note that these measures cannot – from a logical point of view alone – be taken into account to evaluate whether the sale of El Paso’s shares was or was not entirely forced by Argentina’s measures, or whether these measures played, among other factors, a significant role in the sale.

224. Before it begins to evaluate the facts and contentions of the Parties in this case, in order to ascertain whether or not they show violations of the international standards of protection of foreign investments, the Tribunal wishes to insist on the specificity of the facts of each case and considers it appropriate to identify the legal framework within which the factual aspects can and must be examined. As stated in *Continental*,

“each case addressing Argentina’s crisis, with its different parties, claims and legal texts, raises its own special issues and particular considerations. Guided by the issues in the present case, the Tribunal

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<sup>150</sup> *Continental Casualty Company v. Argentine Republic* [hereinafter *Continental*], (ICSID Case No. ARB/03/9), Award of 5 September 2008, § 278. This case arose after the Parties had made their submissions, and for this reason, the Tribunal does not rely on it for its decision, but it considers it interesting to point to some convergences of the reasoning in that case with the one adopted by this Tribunal.

<sup>151</sup> Memorial, § 327: “Furthermore, the situation in the electricity market, particularly for power generators, has deteriorated progressively and significantly since El Paso sold its investments in CAPSA/CAPEX in June 2003 and in COSTANERA in October 2003.”



has made its own analysis and has arrived at its own conclusions based upon the materials presented by the Parties in these proceedings.”<sup>152</sup>

Once ascertained, the facts as they result from the record have to be analysed taking due account of the applicable rules. It is therefore of utmost importance to try to identify the content and scope of the different standards of protection benefitting foreign investors under the BIT.

#### A. GENERAL OBSERVATIONS ON THE DIFFERENT STANDARDS OF PROTECTION

225. The standards of protection applicable to foreign investments, in addition to the protection against expropriation provided for in Article IV (1), are stated in Article II(2)(a) and (b).

Article IV (1) of the BIT prescribes:

“Investments shall not be expropriated or nationalized either directly or indirectly through measures tantamount to expropriation or nationalization (“expropriation”) except for a public purpose; in a non-discriminatory manner; upon payment of prompt, adequate and effective compensation; and in accordance with due process of law and the general principles of treatment provided for in Article II(2).”

Article II(2)(a) and (b) provides that:

“(a) Investment shall at all times be accorded fair and equitable treatment, shall enjoy full protection and security and shall in no case be accorded treatment less than that required by international law.

(b) Neither Party shall in any way impair by arbitrary or discriminatory measures the management, operation, maintenance, use, enjoyment, acquisition, or disposal of investments. For the purposes of dispute resolution under Articles VII and VIII, a measure may be arbitrary or discriminatory, notwithstanding the opportunity to review such measure in the courts or administrative tribunals of a Party.”

226. ICSID case-law has developed in a way that generates some confusion and overlap between these different standards of protection found in most BITs. In

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<sup>152</sup> *Continental*, *supra* note 150, § 103.

view of this situation, which is not conducive to security of the legal framework and predictability of its application to foreign investments, the Tribunal will endeavour to clarify as much as possible the scope of the different standards of protection, for it is convinced that they should not be used indifferently one for the other. Before doing so, it thinks it appropriate to give a few examples of the prevailing confusion which, in its view, justifies its approach.

227. There is not always a clear distinction between *indirect expropriation* and *violation of legitimate expectations*, as can be seen from an excerpt of the Claimant's Memorial stating that "measures that are inconsistent with an investor's legitimate expectations constitute an expropriation"<sup>153</sup> or of the Claimant's Reply, where it is asserted that

"[s]everal other ICSID cases have held that an indirect expropriation occurs when the State repudiates fundamental commitments in frustration of an investor's legitimate expectations deriving from the rights granted in contracts, law or decrees (which, under the BIT, clearly are "investments" protected against any form of expropriation)."<sup>154</sup>

According to this Tribunal, the violation of a legitimate expectation should rather be protected by the fair and equitable treatment standard.

228. Sometimes, there is also *no distinction between the fair and equitable treatment (FET) and the full protection and security (FPS) standards*. This has been the position adopted by the tribunal in *Azurix*:

"The Tribunal is persuaded of the interrelationship of fair and equitable treatment and the obligation to afford the investor full protection and security ... when the terms 'protection and security' are qualified by 'full' and no other adjective or explanation, they extend, in their ordinary meaning, the content of this standard beyond physical security. To conclude, the Tribunal, having held that the Respondent failed to provide fair and equitable treatment to the investment, finds

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<sup>153</sup> Memorial, § 432.

<sup>154</sup> Reply, § 451.

that the Respondent also breached the standard of full protection and security under the BIT.”<sup>155</sup>

Another example of this confusion can be found in the so-called VAT arbitration, *Occidental Exploration and Production Company v. Ecuador*, where the tribunal declared that “treatment that is not fair and equitable automatically entails an absence of full protection and security of the investment.”<sup>156</sup> The Claimant in our case takes the same position and assimilates FET and FPS, alleging that the FPS has been breached because Argentina has adopted laws interfering with the Claimant’s investment:

“The GOA not only failed to protect the investment of El Paso, but affirmatively disregarded the terms of the Electricity Regulatory Framework, the Hydrocarbons Regulatory Framework and the Concessions, and destroyed the very protections and security provided by law. In Law N° 25,561 and its progeny, the GOA nullified essential vested rights it offered and promoted to investors. Thus, the GOA failed to provide full security and protection to El Paso’s investments.”<sup>157</sup>

229. Sometimes there is *no distinction between several standards of treatment*, which are all amalgamated, as was done by the tribunal in *Noble Ventures*, stating that:

“Considering the place of the fair and equitable treatment standard at the very beginning of Art.II(2), one can consider this to be a more general standard which finds its specific application in *inter alia* the duty to provide full protection and security, the prohibition of arbitrary and discriminatory measures and the obligation to observe contractual obligations towards the investor.”<sup>158</sup>

230. The distinction seems also often difficult *between arbitrary or discriminatory treatment and violation of the FET*. It must of course be emphasised that it is quite non-controversial that an arbitrary or discriminatory treatment is necessarily a violation of the FET as well, as mentioned for example in *CMS*:

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<sup>155</sup> *Azurix*, *supra* note 50, § 408.

<sup>156</sup> *Occidental VAT*, *supra* note 118, § 187.

<sup>157</sup> Memorial, § 562.

<sup>158</sup> *Noble Ventures, Inc. v. Romania* [hereinafter *Noble Ventures*], (ICSID Case No. ARB/01/11), Award of 12 October 2005, § 182.

“The standard of protection against arbitrariness and discrimination is related to that of fair and equitable treatment. Any measure that might involve arbitrariness or discrimination is in itself contrary to fair and equitable treatment.”<sup>159</sup>

This is of course true, but the reverse might not necessarily be, as violations of the fair and equitable treatment standard could result from types of situations other than arbitrariness or discrimination. The difference should be sufficient to prevent an assimilation of the two categories of violations. It is, in fact, the Tribunal’s view that FET is designed to guarantee that, in situations where the other more precise standards are not violated, but where there is an unreasonable interference bringing about an unjust result regarding an investor’s expectations, that investor can claim a violation of the FET and obtain reparation therefore.

231. In conclusion, it seems to the Tribunal that, in order not to engage in redundant analyses, interferences with a foreign investment should be analysed successively with reference to the different standards of protection in a sequential order, proceeding from expropriation to violation of the FPS. In other words, the Tribunal will examine first whether there is an indirect expropriation, second whether there is arbitrary or discriminatory treatment, third whether there is a violation of the FET, and fourth whether there is a breach of the FPS.

## B. ARTICLE IV: INDIRECT EXPROPRIATION

232. The Tribunal will first address the complaints of El Paso concerning acts of the GOA, other than tax measures, which the Claimant considers as expropriatory. It will then deal with the tax measures complained of, which only enter into the Tribunal’s jurisdiction if they amount to expropriation. Before scrutinising the facts, the Tribunal will set the applicable analytical framework.

### 1. *Indirect Expropriation in General*

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<sup>159</sup> CMS, *supra* note 48, § 290.

*(i) The Tribunal's Legal Analysis of the Applicable Principles*

233. Much has been said about the concept of indirect expropriation in the written and oral submissions of the Parties in this case, as well as in contemporary legal writings. The Tribunal will endeavour to clarify that concept and present first its analysis in a nutshell, before developing it in more detail. In summary, it is the Tribunal's view that:

1. Some general regulations can amount to indirect expropriation

a. As a matter of principle, general regulations do not amount to indirect expropriation.

b. By exception, unreasonable general regulations can amount to indirect expropriation.

2. A necessary condition for expropriation is the neutralisation of the use of the investment

a. This means that at least one of the essential components of the property rights must have disappeared.

b. This means also, *a contrario*, that a mere loss in value of the investment, even an important one, is not an indirect expropriation.<sup>160</sup>

*(a) Some General Regulations Can Amount to Indirect Expropriation*

234. No absolute position can be taken in such delicate matters, where contradictory interests have to be reconciled. In this sense, the Tribunal subscribes to the decisions which have refused to hold that a general regulation issued by a State and interfering with the rights of foreign investors can *never* be considered expropriatory because it should be analysed as an exercise of the State's sovereign power or of its police powers. This Tribunal is, for example, in agreement with the following statement made in *Tecmed*:

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<sup>160</sup> Charles Leben summarised the practice of ICSID tribunals in relation to indirect expropriation in the following manner: "1. *Les éléments essentiels du droit de propriété doivent avoir disparu.* 2. *Une simple perte de valeur de l'investissement ne peut être assimilée à une expropriation.*" See "La liberté normative de l'Etat et la question de l'expropriation indirecte," in Ch. Leben (ed.), *Le contentieux arbitral international relatif à l'investissement*, Louvain-la-Neuve, Arthemis, 2006, 163, at 173-174.

“ ... we find no principle stating that regulatory administrative actions are *per se* excluded from the scope of the Agreement, even if they are beneficial to society as a whole – such as environmental protection – particularly if the negative economic impact of such actions on the financial position of the investor is sufficient to neutralize in full the value, or economic or commercial use of its investment without receiving any compensation whatsoever.”<sup>161</sup>

235. By the same token, the Tribunal shares the view expressed by the tribunal in *Pope & Talbot*, when it declares that “... a blanket exception for regulatory measures would create a gaping loophole in international protections against expropriation.”<sup>162</sup> The same idea was expressed in *Saluka v. The Czech Republic*, where the tribunal listed the exceptions to the principle that general regulations do not as a rule amount to expropriation:

“These exceptions do not, in any way, weaken the principle that certain takings or deprivations are non-compensable. They merely remind the legislator, or, indeed, the adjudicator, that the so-called ‘police power exception’ is not absolute.”<sup>163</sup>

236. Therefore, in order to differentiate between situations where a general regulation can be considered tantamount to expropriation and situations where it cannot, the Tribunal has to start from the principle and then look at the exceptions. It considers that the most appropriate approach is to admit that, as a matter of principle, a general regulation – whose object is not the taking of property as in the case of direct expropriation – does not amount to an indirect expropriation (a). This evident proposition finds support in State practice, doctrine and arbitral case-law. Of course, the general principle suffers exceptions and has to be set aside in some circumstances on account of the content of the regulations (b).

#### *1. As a Matter of Principle, General Regulations Do Not Amount to Indirect Expropriation*

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<sup>161</sup> *Técnicas Medioambientales Tecmed, S.A. v. The United Mexican States* [hereinafter *Tecmed*], (ICSID Case No. ARB(AF)/00/2), Award of 29 May 2003, § 121.

<sup>162</sup> *Pope & Talbot Inc. v. The Government of Canada* [hereinafter *Pope & Talbot*], UNCITRAL (NAFTA), Interim Award of 26 June 2000, § 99.

<sup>163</sup> *Saluka Investments BV v. The Czech Republic* [hereinafter *Saluka*], UNCITRAL, Partial Award of 17 March 2006, § 258.

237. The above principle is accepted both by writers and arbitral case-law.

238. Thus, Professor Ian Brownlie has stated that:

“State measures, prima facie a lawful exercise of powers of government, may affect foreign interests considerably without amounting to expropriation. Thus foreign assets and their use may be subjected to taxation, trade restrictions involving licenses and quotas, or measures of devaluation. While special facts may alter cases, in principle such measures are not unlawful and do not constitute expropriation.”<sup>164</sup>

The same principle is clearly stated in the *Third Restatement of the Foreign Relations Law of United States* 1987,<sup>165</sup> which is often quoted as a formula of reference and which many consider as reflecting customary international law on this point.<sup>166</sup>

“A state is not responsible for loss of property or for other economic disadvantage resulting from bona fide general taxation, regulation, forfeiture for crime, or other action of the kind that is commonly accepted as within the police power of states, if it is not discriminatory.”

239. Several arbitral tribunals have also restated this fundamental principle. In *Feldman v. Mexico*, the ICSID arbitral tribunal said that:

“Governments must be free to act in the broader public interest through protection of the environment, new or modified tax regimes, the granting or withdrawal of government subsidies, reductions or increases in tariff levels, imposition of zoning restrictions and the like. Reasonable governmental regulation of this type cannot be achieved if any business that is adversely affected may seek compensation, and it is safe to say that customary international law recognizes this.”

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<sup>164</sup> Ian Brownlie, *Principles of Public International Law*, supra note 293, p. 532. This principle has not been only considered in international legal scholars' opinions but it has also been included in several international instruments. See, for example, Additional Protocol to the Convention for the Protection of Human Rights and Fundamental Freedoms, 4 November 1950, 213 U.N.T.S. 262, section 1; Harvard Draft Convention on the International Responsibility of States for Injuries to Aliens, in L.B. Sohn / R. R. Baxter, “Responsibility of States for Injuries to the Economic Interests of Aliens”, 55 *Am. J. Int'l L.* 545 (1961), at 554.

<sup>165</sup> *Restatement of the Law Third*, American Law Institute (1987), Vol. 2, Section 712, commentary g.

<sup>166</sup> See in this sense, *Marvin Roy Feldman Karpa v. United Mexican States* [hereinafter *Feldman*], (ICSID Case No. ARB(AF)/99/1), Award of 16 December 2002, §§ 103 and 105.

...

“... not all government regulatory activity that makes it difficult or impossible for an investor to carry out a particular business, change in the law or change in the application of existing laws that makes it uneconomical to continue a particular business, is an expropriation ... Governments, in their exercise of regulatory power, frequently change their laws and regulations in response to changing economic circumstances or changing political, economic or social considerations ... those changes may well make their activities less profitable or even uneconomic to continue.”<sup>167</sup>

A similar general statement is found in *Tecmed*:

“The principle that the State’s exercise of its sovereign powers within the framework of its police power may cause economic damage to those subject to its powers as administrator without entitling them to any compensation whatsoever is indisputable.”<sup>168</sup>

But the clearest and strongest assertion of the principle can be found in the *Saluka* award, an UNCITRAL investment arbitration under a BIT:

“It is now established in international law that States are not liable to pay compensation to a foreign investor when, in the normal exercise of their regulatory powers, they adopt in a non-discriminatory manner bona fide regulations that are aimed at the general welfare.”<sup>169</sup>

240. In sum, a general regulation is a lawful act rather than an expropriation if it is non-discriminatory, made for a public purpose and taken in conformity with due process. In other words, *in principle, general non-discriminatory regulatory measures, adopted in accordance with the rules of good faith and due process, do not entail a duty of compensation.*

## 2. *By Exception, Unreasonable General Regulations Can Amount to Indirect Expropriation*

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<sup>167</sup> *Ibid.*, §§ 103 and 112. See also *Ronald S. Lauder v. The Czech Republic* [hereinafter *Lauder*], UNCITRAL, Award (Final) of 3 September 2001 §§ 200-201; *Middle East Cement Shipping and Handling Co. S.A. v. Arab Republic of Egypt* [hereinafter *Middle East Cement*], (ICSID Case No. ARB/99/6), Award of 12 April 2002, § 153.

<sup>168</sup> *Tecmed*, *supra* note 161, § 119.

<sup>169</sup> *Saluka*, *supra* note 163, § 255.



241. If general regulations are unreasonable, *i.e.* arbitrary, discriminatory, disproportionate or otherwise unfair, they can, however, be considered as amounting to indirect expropriation if they result in a neutralisation of the foreign investor's property rights. The need for reasonableness and proportionality of State measures interfering with private property has been stressed by the tribunal in *LG&E*:

“With respect to the power of the State to adopt its policies, it can generally be said that the State has the right to adopt measures having a social or general welfare purpose. In such a case, the measure must be accepted without any imposition of liability, except in cases where the State's action is obviously disproportionate to the need being addressed.”<sup>170</sup>

242. The Claimant itself cites the Harvard Draft Convention on the International Responsibility of States for Injuries to Aliens<sup>171</sup> which provides that a taking of property may include any

“*unreasonable interference* with the use, enjoyment or disposal of property as to justify an inference that the owner thereof will not be able to *use, enjoy, or dispose of the property* within a reasonable period of time after the inception of such interference.”<sup>172</sup>

In the Claimant's Memorial, indirect expropriation is precisely said to result from “unreasonable interference that significantly deprives an owner of the control, use, or reasonably-to-be-expected economic benefits of property, rights or interests.”<sup>173</sup>

243. The Tribunal will now review some examples where such general regulations have been considered as possible expropriations. A first example is that of an *intentionally discriminatory regulation* or an *objectively discriminatory regulation*. Although it did not find that in the case under review there had

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<sup>170</sup> *LG&E*, *supra* note 51, Decision on Liability, § 195.

<sup>171</sup> Memorial, § 422.

<sup>172</sup> Draft Convention on the International Responsibility of States for Injuries to Aliens, Article 10(3)(a), in L.B. Sohn /R. R. Baxter, “Responsibility of States for Injuries to the Economic Interests of Aliens”, 55 *Am. J. Int'l L.* 545, at 553 (1961). Emphasis added by the Tribunal.

<sup>173</sup> Memorial, § 430.

been an indirect expropriation, the tribunal in the *Methanex* case clearly distinguished discriminatory regulations from non-discriminatory ones:

“In the Tribunal’s view, Methanex is correct that an intentionally discriminatory regulation against a foreign investor fulfils a key requirement for establishing expropriation. But as a matter of general international law, a non-discriminatory regulation for a public purpose, which is enacted in accordance with due process and, which affects, *inter alia*, a foreign investor or investment is not deemed expropriatory and compensable unless specific commitments had been given by the regulating government to the then putative foreign investor contemplating investment that the government would refrain from such regulation.”<sup>174</sup>

Another example would be a *disproportionate regulation*, meaning a regulation in which the interference with the private rights of the investors is disproportionate to the public interest. In other words, proportionality has to exist between the public purpose fostered by the regulation and the interference with the investors’ property rights, as recognised in *Tecmed*:

“After establishing that regulatory actions and measures will not be initially excluded from the definition of expropriatory acts, in addition to the negative financial impact of such actions or measures, the Arbitral Tribunal will consider, in order to determine if they are to be characterized as expropriatory, whether such actions or measures are proportional to the public interest presumably protected thereby and to the protection legally granted to investments, taking into account that the significance of such impact has a key role upon deciding the proportionality ... There must be a reasonable relationship of proportionality between the charge or weight imposed to the foreign investor and the aim sought to be realized by any expropriatory measure.”<sup>175</sup>

In other words, discriminatory or disproportionate general regulations have the potential to be considered as expropriatory if there is a sufficient interference with the investor’s rights, as will be explained now.

## **2. A Necessary Condition for Expropriation: The Neutralisation of the use of the Investment**

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<sup>174</sup> *Methanex v. United States* [hereinafter *Methanex*], UNCITRAL (NAFTA), Final Award of 3 August 2005, § 7 of Part IV - Chapter D.

<sup>175</sup> *Tecmed*, *supra* note 161, § 122.

244. Etymologically, “ex-propropriation” refers to the taking of property or property rights. In *S.D. Myers v. Canada*, a clear distinction was drawn between deprivation amounting to expropriation and interference with property by regulations not amounting to expropriation:

“Expropriations tend to involve the deprivation of ownership rights; regulations a lesser interference. The distinction between expropriation and regulation screens out most potential cases of complaints concerning economic intervention by a state and reduces the risk that governments will be subject to claims as they go about their business of managing public affairs.”<sup>176</sup>

*(i) At Least One of the Essential Components of the Property Rights Must Have Disappeared*

245. The Tribunal considers that at least one of the essential components of the property rights must have disappeared for an expropriation to have occurred. It emphasises that the overwhelming majority of investment arbitration cases stand for the proposition that an expropriation usually implies a “removal of the ability of an owner to make use of its economic rights.”<sup>177</sup> It is generally accepted that the decisive element in an indirect expropriation is the “*loss of control*” of a foreign investment, in the absence of any physical taking.

246. In the case of *Pope & Talbot*, Canada stated that “mere interference is not expropriatory; rather, a significant degree of deprivation of fundamental rights of ownership is required”,<sup>178</sup> and the tribunal accepted this approach when it said that “the test is whether that interference is sufficiently restrictive to support a conclusion that the property has been ‘taken’ from the owner.”<sup>179</sup> In the case of *Tecmed*, the same approach was adopted, the tribunal holding that there is an indirect expropriation when “the economic value of the use,

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<sup>176</sup> *S.D. Myers, Inc. v. Government of Canada* [hereinafter *S.D. Myers*], UNCITRAL (NAFTA), First Partial Award of 13 November 2000, § 282.

<sup>177</sup> *Ibid.*, § 283.

<sup>178</sup> *Pope & Talbot*, *supra* note 162, § 99.

<sup>179</sup> *Ibid.*, § 102.

enjoyment or disposition of the assets or rights affected by the administrative action or decision have been neutralized or destroyed.”<sup>180</sup>

247. This approach has also been adopted in several of the Argentinian cases resulting from the crisis which brought about the present litigation. In *CMS*, the tribunal first mentioned the general criterion to be applied in order to ascertain whether there has been an expropriation:

“The essential question is therefore to establish whether the enjoyment of the property has been effectively neutralized. The standard that a number of tribunals have applied in recent cases where indirect expropriation has been contended is that of substantial deprivation.”<sup>181</sup>

248. Then, applying this test to the case at hand, the tribunal considered that the measures adopted by the State did not deprive the investor of control over its investment and therefore concluded that there was no expropriation. In *Enron*<sup>182</sup> as well as in *Sempra*,<sup>183</sup> the tribunals held that for expropriation to exist there must be a substantial deprivation and that such a deprivation occurs when the investor is forced to lose control over the investment. If the measures do not interfere with the control of the property, there can be no expropriation. This has been confirmed more recently by the award in another Argentinian case, *Continental*, where an indirect expropriation was defined as amounting to

“ ... limitations and hampering with property, short of outright suppression or deprivation, interfering with one or more key features, such as management, enjoyment, transferability, which are considered as tantamount to expropriation, because of their substantial impact on the effective right of property.”<sup>184</sup>

*(ii) A Mere Loss in Value of the Investment, even though Important, Is Not an Indirect Expropriation*

249. In the Tribunal’s view, a mere loss in value of the investment, even if important, is not an indirect expropriation. This was also stated, for example, in

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<sup>180</sup> *Tecmed*, *supra* note 161, § 116.

<sup>181</sup> *CMS*, *supra* note 48, § 262.

<sup>182</sup> *Enron*, *supra* note 52, § 245.

<sup>183</sup> *Sempra*, *supra* note 53, § 285.

<sup>184</sup> *Continental*, *supra* note 150, § 276.

the *Waste Management* case where the tribunal explicitly pointed out that “the loss of benefits or expectations is not a sufficient criterion for an expropriation, even if it is a necessary one.”<sup>185</sup> The Tribunal is, of course, aware of some cases or general *dicta* that might seem to support the idea that a substantial deprivation of the value of an investment can also be viewed as an expropriation. But a careful scrutiny of those cases, some of which were cited by the Claimant, does not support such a conclusion, as will be shown now.

250. In *Middle East Cement v. Egypt*, relied on by the Claimant,<sup>186</sup> an ICSID tribunal found that Egypt had violated the provision on expropriation of the Egypt-Greece BIT. In that case, the Egyptian General Authority for Investment and Free Zones had granted a 10-year license to a Greek bulk cement importer for the importation and storage of cement. Some years later, Egypt issued a decree prohibiting the importation of certain types of cement. This decree, which on its face did not purport to take the investor’s property or affect the investor’s import license, nevertheless paralysed the investor’s operations. In the ensuing arbitration proceedings, the foreign investor argued that, although the license technically remained in effect after the decree, the latter destroyed the economic benefit of the investment. The tribunal concluded that there was an expropriation, although the decree remained in force for only four months, with the following explanation:

“As also Respondent concedes that, at least for a period of 4 months, Claimant was deprived, by the Decree, of rights it had been granted under the License, there is no dispute between the Parties, that in principle, a taking did take place. When measures are taken by a State the effect of which is to deprive the investor of the use and benefit of its investment even though it may retain nominal ownership of the respective rights being the investment, the measures are often referred to as ‘creeping’ or as ‘indirect’ expropriation, or, as in the BIT, as measures the effect of which is tantamount to expropriation. As a

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<sup>185</sup> *Waste Management, Inc. v. The United Mexican States* [hereinafter *Waste Management II*], (ICSID Case No. ARB(AF)/00/3), Award of 30 April 2004, § 159.

<sup>186</sup> Memorial, § 434; Reply, § 451. See also *Middle East Cement*, *supra* note 167.

matter of fact, the investor is deprived by such measures of parts of the value of its investment.”<sup>187</sup>

The Tribunal wishes to point to the fact that, if indeed a reference is made to the deprivation of the benefit of the investment, the formula used by the tribunal in *Middle East Cement* refers more precisely to the deprivation of “the use and benefit.” The loss of benefit is a result of the impossibility to use the investment – equivalent to a loss of control over the investment – and not an expropriation *per se*.

251. In *Goetz and Others v. Republic of Burundi*, another case invoked by the Claimant,<sup>188</sup> the tribunal held:

“Since ... the revocation of the Minister for Industry and Commerce of the free zone certificate forced them to halt all activities ... , which deprived their investments of all utility and deprived the claimant investors of the benefit which they could have expected from their investments, the disputed decision can be regarded as a ‘measure having similar effect’ to a measure depriving of or restricting property within the meaning of Article 4 of the Investment Treaty.”<sup>189</sup>

In this case also, there is a reference to the deprivation of the expected benefit, but this was a result of the cancellation by the State of a free-zone certificate which prevented the investor from continuing any economic activity, which is indeed a situation where it can be said that the investor was expropriated as it completely lost the use of its property.

252. *Metalclad* is often mentioned, and was cited by the Claimant,<sup>190</sup> in support of the proposition that a mere loss in value of an investment is an expropriation. It is true that the tribunal in this case used a very general formulation, which could be misconstrued if it were truncated:

“Thus, expropriation under NAFTA includes not only open, deliberate and acknowledged takings of property, such as outright seizure or

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<sup>187</sup> *Middle East Cement, ibid.*, § 107.

<sup>188</sup> Memorial, § 435; Reply, § 463, citing *Goetz, supra* note 126.

<sup>189</sup> *Goetz, supra* note 126, § 124 (translation by the Tribunal).

<sup>190</sup> Memorial, § 436; Reply, § 448 and § 455, citing *Metalclad Corporation v. United Mexican States* [hereinafter *Metalclad*], (ICSID Case No. ARB(AF)/97/1), Award of 30 August 2000.

formal or obligatory transfer of title in favour of the host State, but also covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the host State.”<sup>191</sup>

Two remarks are worth making here. First, as in the former examples, *the loss of benefits is a result of a deprivation of the use* of the investment. Second, considering the facts and not the mere broad language, it is evident that the tribunal in *Metalclad* did not hold that there was an expropriation because the benefits of the investor were not as expected, but decided that there was an expropriation of the investment because, after the investor was granted the federal permit to exploit the landfill, and given assurances that it would receive the municipal permit to the same effect, the latter was not granted, rendering the whole project impossible to pursue: it was because there was a complete neutralisation of the investment project that an expropriation was found.

253. Nor does another case cited by the Claimant, in the Tribunal’s view, support the idea that a loss in value is an expropriation. In *Tecmed*,<sup>192</sup> the claims were related to an investment in land, buildings and other assets relating to a controlled landfill operation with hazardous industrial waste. A resolution cancelling the authorisation to run the waste landfill operation was adopted, among other reasons, because of the strong opposition of the local population. The tribunal had to study the resolution cancelling the permit. In order to decide on the existence of an indirect expropriation, the tribunal made the following analysis:

“To establish whether the Resolution is a measure equivalent to an expropriation under the terms of section 5(1) of the Agreement, it must be first determined if the Claimant, due to the Resolution, was radically deprived of the economical use and enjoyment of its investments, as if the rights related thereto – such as the income or benefits related to the Landfill or to its exploitation – had ceased to exist. In other words, if due to the actions of the Respondent, the assets involved have lost their value or economic use for their holder

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<sup>191</sup> *Metalclad, ibid.*, § 103.

<sup>192</sup> Memorial, § 437; Reply, § 454, citing *Tecmed, supra* note 161.

and the extent of the loss. This determination is important because it is one of the main elements to distinguish, from the point of view of an international tribunal, between a regulatory measure, which is an ordinary expression of the exercise of the state's police power that entails a decrease in assets or rights, and a *de facto* expropriation that deprives those assets and rights of any real substance.”<sup>193</sup>

Here again, it was not just a loss of benefits that was considered to be expropriatory; it was the cancellation of the permit which neutralised the whole investment, as no other activity could be performed on the landfill. This was underscored by the tribunal, according to which there is an indirect expropriation when “the economic value of the use, enjoyment or disposition of the assets or rights affected by the administrative action or decision have been neutralized or destroyed.”<sup>194</sup>

254. Even in *Consortium R.F.C.C. v. Morocco*, also cited sometimes to support the idea that loss of value is sufficient to find an indirect expropriation, careful reading shows that in fact the tribunal based its reasoning on the necessity of a neutralisation of property rights. The tribunal started by referring to the fact that for an expropriation to exist, the measures taken by the State must have

“ ... [s]ubstantial effects of a definite intensity that decrease and/or make disappear the benefits that can be legitimately expected from the exploitation of the rights that were the object of the measure to such an extent that they render the possession of those rights useless.”<sup>195</sup>

In the preceding paragraph, the tribunal had been quite clear that this disappearance of benefits had to be the result of a loss of control or access to the property rather than of a change in the assets' value:

“The expropriation of an asset or a right is characterised by the disappearance, for the expropriated person, if not of the title to property at least of the enjoyment of the said property or of the access to it.”<sup>196</sup>

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<sup>193</sup> *Tecmed, ibid*, § 115.

<sup>194</sup> *Ibid.*, § 116.

<sup>195</sup> *Consortium R.F.C.C. v. Kingdom of Morocco* [hereinafter *Consortium v. Morocco*], (ICSID Case No. ARB/00/6), Award of 22 December 2003, § 69. Translation by the Tribunal.

<sup>196</sup> *Ibid.*, § 68. Translation by the Tribunal.



255. Finally, it is worth mentioning that in all the Argentinian cases decided so far, the loss in value of the investment was not considered a sufficient basis for a finding of expropriation, even where the loss was quite significant and comparable to the losses claimed in the present case by El Paso. In *LG&E*, for example, although according to the claimant the value of LG&E's holdings in the licenses had been reduced by more than 90% as a result of Respondent's abrogation of the principal guarantees of the tariff system, the tribunal did not find an expropriation, as the measures themselves did not interfere "with the investment's ability to carry on its business,"<sup>197</sup> even though the profits were drastically diminished. Regulations that reduce the profitability of an investment but do not shut it down completely and leave the investor in control will generally not qualify as indirect expropriations even though they might give rise to liability for violation of other standards of treatment, such as national treatment or fair and equitable treatment.
256. In conclusion, the Tribunal, consistently with mainstream case-law, finds that for an expropriation to exist, the investor should be substantially deprived not only of the benefits, but also of the use of his investment. A mere loss of value, which is not the result of an interference with the control or use of the investment, is not an indirect expropriation.

*(iii) The Parties' Positions on the Existence of an Expropriation*

257. According to the Claimant, "[t]he Argentine Republic expropriated Claimant's investments directly, indirectly or by measures tantamount to expropriation."<sup>198</sup> The list of the expropriatory acts presented by the Claimant is the following: abrogation and repudiation of contractual rights of the Argentinian companies; violation of the right to collect payments as promised, which constitutes a taking of CAPEX's and Costanera's rights, legitimate expectations and revenues without compensation; pesification of capacity payments at an artificial exchange rate, which amounts to an expropriation of legal rights, legal

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<sup>197</sup> *LG&E*, *supra* note 51, § 191.

<sup>198</sup> Memorial, § 468.

expectations and significant revenues from CAPEX and Costanera; fundamental alteration of the price-setting mechanism for electrical generators, which resulted in the expropriation of the legal rights, legitimate expectations and specific revenues of CAPEX and Costanera; pesification of VCPs at an artificial exchange rate which constitutes a taking of El Paso's rights, legitimate expectations and revenues; violation of the right to freely dispose of production, which interfered in the business decisions and management of CAPSA and CAPEX; and violation of the right freely to dispose of production, which constituted a direct taking of CAPSA's and CAPEX's revenues.<sup>199</sup>

258. More generally, it is the Claimant's contention that it was expropriated because, due to all the adverse measures taken against the Argentinian companies in which it had invested, it was "forced" to sell its shares in those companies at a considerable loss. In its Reply, the Claimant states that expropriation results from measures

" ... destroying 100% of the equity value of SERVICIOS, 83% of the equity value of CAPSA/CAPEX, and 91% of the equity value of COSTANERA and compelling El Paso to sell its interests in the Argentine Companies for less than 15% of what would have been their value in the absence of the measures."<sup>200</sup>

259. According to Argentina, none of the rights invoked by El Paso are rights protected under the BIT. The measures adopted in the context of the crisis did not amount to expropriation. Argentina argues that: the pesification of the whole economy was not an expropriation and benefited the Argentinian companies; the restrictions on oil and gas exports were not expropriations; nor were the measures adopted to make electric power generation consistent with the new context. Neither on account of their effect nor in view of their nature can these measures be considered expropriatory.

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<sup>199</sup> Memorial, §§ 470-497.

<sup>200</sup> Reply, § 422.

260. First, it is Argentina's position that these measures did not interfere substantially with rights possessed by the Claimant. According to the Respondent:

"In effect, the *pesification* of the whole economy and the measures adopted in connection with the oil and electric power generation industries did not substantially deprive the Claimant from the use and profits of its investment [paraphrasing the tribunal in the *Otis Elevator* case]. On the contrary, the Argentine Companies continued and continue operating and obtaining profits despite the crisis."<sup>201</sup>

261. Second, the Respondent contends that the measures challenged by El Paso were non-discriminatory regulatory decisions taken in good faith and included in the police power of the State. Therefore, no compensation would be due.

262. Third, Argentina affirms that, contrary to what the Claimant pretends, the sale of El Paso was not forced by Argentina but provoked by the Claimant's own problems. These problems are addressed both in the Counter-Memorial<sup>202</sup> and the Rejoinder,<sup>203</sup> and are summarised in the former in the following way:

"Unlike El Paso's allegation, the Argentine crisis was not the cause why it decided to sell its assets in Argentina but this was the global situation of the company itself.

The energy crisis in California, the link with Enron's policies, the accusations of questionable accounting and business practices, an unfavourable court decision related to illegal practices, the strong fall in the value of its shares, the accumulation of a major debt, liquidity issues, the lack of market confidence, the resignation (and even suicide) of top executives, among others, were the events that led to the serious crisis in El Paso."<sup>204</sup>

263. The analysis of all these elements brings the Respondent to the conclusion that there is no causal link between the measures adopted by Argentina to face the crisis and the sale of El Paso's shares in the Argentinian companies:

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<sup>201</sup> Counter-Memorial, § 582. Emphasis by the Respondent.

<sup>202</sup> Counter-Memorial, §§ 61-89.

<sup>203</sup> Rejoinder, §§ 1-59. It is to be noted that this was the very first argument developed by the Respondent in its Rejoinder.

<sup>204</sup> Counter-Memorial, §§ 100-101.

“The only cause of the damages, the compensation for which is claimed in this arbitration, is El Paso’s global situation that forced it to sell its interests around the world, including those located in Argentina. The fact that Argentina was in the midst of a crisis had a negative impact on the price collected by El Paso on account of the sale of its assets in Argentina, but it was not what determined that the transaction had to be carried out.”<sup>205</sup>

264. In other words, the sale was not due to Argentina’s measures but to a reasoned decision taken by El Paso, in light of its financial difficulties all over the world, to focus on its traditional business, natural gas transportation and production.<sup>206</sup>

*(iv) The Tribunal’s Analysis of the Alleged Expropriation of El Paso’s Property Rights*

265. Although the Claimant has complained about direct expropriation, it can be declared by the Tribunal from the outset, without extensive reasoning, that no such expropriation occurred. It is enough here to recall the definition given to direct expropriation by Professor Sacerdoti: “the coercive appropriation by the State of private property, usually by means of individual administrative measures.”<sup>207</sup> In direct expropriation, there is a formal transfer of the title of ownership from the foreign investor to the State engaged in the expropriation or to a national company of that State, and it has never been asserted that the shares of El Paso in the Argentinian companies have been transferred by the State to itself or to another public or private company.
266. Thus the only question which remains is whether there has been an indirect expropriation, which concept will be considered as including “measures tantamount to expropriation.”<sup>208</sup>

*(a) Analysis of the Claim of the Alleged Expropriation of Legal and Contractual Rights of the Argentinian Companies*

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<sup>205</sup> Counter-Memorial, § 105.

<sup>206</sup> Counter-Memorial, § 3.

<sup>207</sup> Giorgio Sacerdoti, “Bilateral Treaties and Multilateral Instruments on Investment Protection”, 269 *Collected Courses, Hague Academy of International Law* (1997), at p. 379.

<sup>208</sup> Counter-Memorial, §§ 530, 533, 535.

267. According to the Claimant,

“ ... the GOA undertook a policy that ... effectively expropriated CAPEX’s and COSTANERA’s contractual right to receive Dollar-denominated prices for their sale of electricity and liquid hydrocarbons ... The GOA measures also expropriated SERVICIOS’ rights to receive Dollar-denominated payments under the Gas Processing Agreement.”<sup>209</sup>

The Claimant reiterated that position later in its Memorial, when stating that “the GOA’s measures deprived CAPSA, CAPEX and Costanera of the exercise of their vested legal and contractual rights, which were abrogated and repudiated by the GOA.”<sup>210</sup> The Tribunal does not need to decide if this could be an expropriation, as it has no jurisdiction over the Argentinian companies and can only rule on an expropriation of the foreign investor’s rights.

268. The same reasoning must apply to the claim that sums owed to CAPEX and CAPSA were in fact transformed into contributions to the Stabilization Fund, and subsequently into stock of a new power plant to be financed with the proceeds to this Fund, which plant will be operated by the Government. El Paso considers this as “a forceful novation of the receivables owed by CAMMESA to the generators, which amounts to a confiscatory action that interferes with the ability of the generators to operate their own business.”<sup>211</sup> These are rights belonging to the Argentinian companies, over which the Tribunal has no jurisdiction, and not to El Paso. In addition, the Tribunal is inclined to consider that a change in the form of a credit cannot amount to a confiscation.

269. The Tribunal wishes to emphasise next that, if this point had to be decided, it would certainly be difficult to find an expropriation of the rights of the Argentinian companies. In effect, the impugned measures adopted in connection with the oil and electric power generation industries did not substantially deprive the Claimant of the use of and profits from its investment.

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<sup>209</sup> Memorial, § 305.

<sup>210</sup> Memorial, § 416.

<sup>211</sup> Memorial, § 320.

On the contrary, the Argentinian companies continue operating and earning profits despite the crisis. For example, CAPSA had income in the amount of over ARS 111 million in 2003.<sup>212</sup> CAPSA, CAPEX, Costanera and Gasoducto del Pacífico are still operating on the Argentine market and their survival is not in danger. SERVICIOS was absorbed by CAPEX, which is still profitable in the LPG processing business. According to the Respondent's Rejoinder, CAPSA's Financial Statements show that "[i]ncome in 2006 is more than 10 time higher [in US\$] than the company's income in 1997, when El Paso acquired interests in CAPSA."<sup>213</sup>

*(b) Analysis of the Sale of El Paso's Shares in the Argentinian Companies as an Alleged Expropriation*

270. The Tribunal must ascertain a last point, which is whether the sale was or was not the automatic consequence, *i.e.* the only and unavoidable consequence, of the measures taken by the GOA, so as to be equivalent to an outright expropriation, as contended by the Claimant in its Memorial:

"These measures *amount to an expropriation* of El Paso's investment, violate commitments to Claimant and constitute unfair and inequitable treatment in violation of the BIT, international law and Argentina law. Due to these measures, *El Paso was forced to sell* its investments in the Argentina Companies at prices that represented less than 10% of El Paso's investment."<sup>214</sup>

In its Reply, the Claimant reverts to this idea under the title "Argentina Expropriated Claimant's Investment:"

"In its Memorial, Claimant demonstrated the various ways in which Argentina's measures violated the BIT's prohibition against expropriating without compensation, whether directly or indirectly by measures tantamount to expropriation. These include: ... (iii) taking measures ... compelling El Paso to sell its interests in the Argentine

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<sup>212</sup> See Claimant's Document Production of 3 August 2006, Annex C, CAPSA's 2003 Financial Statements, p. 5.

<sup>213</sup> Rejoinder, § 52.

<sup>214</sup> Memorial, § 36. Emphasis added by the Tribunal.

Companies for less than 15% of what would have been their value in the absence of the measures.”<sup>215</sup>

271. The Respondent, on the contrary, insists that causes other than the Argentinian measures explain the sale of the shares of El Paso:

“The cause for El Paso’s losses is not related in any way to the measures but to the time in which it was forced (due to its own issues) to sell its assets in Argentina. Had it not faced the serious issues that it underwent globally, El Paso would have profited from the gradual improvement in Argentina’s conditions, by the increase in oil and gas prices around the world, and by the *normalisation* of the Argentine economy.”<sup>216</sup>

272. The Tribunal has thus to examine the question of whether the sale was “freely” entered into or whether it was effectively “compulsory,” intrinsically linked to Argentina’s measures, in such a way that it was the only possible consequence of these measures. Only if the sale was the only possible consequence of the Argentinian measures could one consider that these measures were expropriatory as they entailed a loss of control directly attributable to Argentina. In order to answer the question raised by the contradictory views of the Parties on that issue, the Tribunal will scrutinise the context of the sale and look into contemporary or subsequent public statements emanating from El Paso. The Tribunal has closely examined the different documents contemporaneous with the sale or subsequent to it in order to ascertain the causes of the sale, among others the reports to the United States Securities and Exchange Commission (SEC), usually considered as one of the main sources of information for the market relating to companies.

273. A first point to be made is that the measures adopted after the sale of El Paso’s shares, of which the Claimant repeatedly complains, cannot be considered as a cause of such sale, being subsequent to it. Therefore, the Tribunal will not take into account, for ascertaining the causes of the sale, the numerous measures adopted after the sale complained of by El Paso, among which a few can be

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<sup>215</sup> Reply, § 422.

<sup>216</sup> Counter-Memorial, § 12. Emphasis added by the Respondent.

mentioned: Resolution SE N° 826/2004, which invited the power generators to a mandatory conversion of their unpaid receivables for energy sales and future gross margins into either (i) equity in two new power plants or (ii) a Government monetary commitment that would become payable in 10-year instalments from the revenues of the two new power plants once they become operational; Law N° 26,095, dated 26 April 2006, which authorises the Executive Branch to apply “charges” to electricity and gas distribution tariffs to finance “new” investments in the energy sector; Law No. 26,217, published on 16 January 2007, which extended the export taxes through 2012;<sup>217</sup> various measures imposed on the electricity sector after 2003; and export withholdings imposed and extended on various dates from 2004-2007.

274. It is worth noting that in its 2005 Annual Report filed with the SEC, no mention was made by the Claimant itself either of the deterioration in the economic conditions of Argentina nor of any adverse regulatory changes in Argentina to explain the restructuring of El Paso and the sale of the shares in the Argentinian companies.<sup>218</sup> In its 2004 Report,<sup>219</sup> the focus was also on general problems, with no specific mention of any adverse measures taken by the GOA.
275. It is true that in the 2002 and 2003 Reports to SEC, El Paso mentioned the economic situation of Argentina, but only the Argentinian economic crisis, more specifically “the deteriorating economic conditions” in the country, with no specific reference made to measures adopted by the Government, in contrast to what was done for other countries, and more specifically for its power generators in Australia, where the Claimant explained its divestiture by “regulatory difficulties.” In the same 2003 Report, a world-wide change in strategy of El Paso was announced.

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<sup>217</sup> CPHB, § 79.

<sup>218</sup> Counter-Memorial, § 63, citing EDGARonline, Excerpt from a 10-K/A SEC Filing, filed by EL PASO CORP/DE on 4/8/2005. Available at: <http://sec.edgar-online.com/el-paso-corpde/10-ka-amended-annual-report/2005/04/08/section3.aspx>. Respondent’s Exhibit RA 174.

<sup>219</sup> El Paso Corporation, 2003 Annual Report pursuant to Section 13 or 15(D) of the Securities Exchange Act of 1934 filed at the United States Securities and Exchange Commission [hereinafter 2003 El Paso Report filed with the SEC]. Respondent’s Exhibit RA 144, p. 48.



276. The Tribunal has taken note of the fact that, according to Argentina, “[i]t was the Claimant’s decision to sell its assets in the country in the worst time of the Argentine crisis, in the need for facing its own global crisis, which caused the damage alleged by El Paso.”<sup>220</sup> Indeed, it appears from the file that El Paso has sold assets worldwide in 2002 and 2003, among others:

(a) all the businesses related to electric power generation in the United States;<sup>221</sup>

(b) all the assets and investments in the electric power generation business around the world, except for Brazil;<sup>222</sup>

(c) all of El Paso’s petroleum businesses;<sup>223</sup>

(d) all the business related to LNG development;<sup>224</sup>

(e) the assets located in Canada, Indonesia, and Hungary;<sup>225</sup>

(f) El Paso’s interest in GulfTerra and all the assets related to processing and storage in the south of Texas;<sup>226</sup>

(g) the storage units located in Wyoming;<sup>227</sup>

(h) the *midstream* assets located in the Mid-Continent and Northern Louisiana regions;<sup>228</sup>

(i) the long-haul and metro dark fiber business;<sup>229</sup>

(j) the asphalt business;<sup>230</sup> and

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<sup>220</sup> Counter-Memorial, § 788.

<sup>221</sup> 2003 El Paso Report filed with the SEC, *supra* note 219, p. 3.

<sup>222</sup> *Ibid.*, p. 3 n.1.

<sup>223</sup> *Ibid.*, p. 20.

<sup>224</sup> El Paso Corporation, 2002 Annual Report Pursuant to Section 13 or 15(D) of the Securities Exchange Act of 1934 filed at the United States Securities and Exchange Commission [hereinafter 2002 El Paso Report filed with the SEC]. Respondent’s Exhibit RA 79, p. 56.

<sup>225</sup> 2003 El Paso Report filed with the SEC, *supra* note 219, p. 11.

<sup>226</sup> *Ibid.*, p. 21.

<sup>227</sup> *Ibid.*, p. 59.

<sup>228</sup> *Ibid.*

<sup>229</sup> *Ibid.*, p. 70.

<sup>230</sup> News Release, El Paso Corporation. El Paso Corporation announces It Has Exceeded Fifty Percent of Its 2003 Non-Core Asset Sales Goal, (27 March 2003), available at:

(k) El Paso's interest in the ECK generation project in the Czech Republic.<sup>231</sup>

277. It is not reasonable to assume that, with such an overall picture of divestment, the decision to sell in Argentina was unrelated to the situation of El Paso in the rest of the world and was solely due to the measures taken by Argentina. In the Tribunal's view, the global situation of El Paso worldwide as well as that of the Argentine economy and the measures taken by Argentina are elements to be taken into account to explain the sale.
278. The Tribunal notes that El Paso did not suffer any interference with its property, as is shown by the fact that it could decide what to do with it and chose to sell its shares. Argentina did not confiscate the Claimant's shareholdings in the Argentinian companies. It is therefore the Tribunal's conclusion that El Paso did not suffer any major interference with its property rights, as is evidenced by the fact that it decided to sell its shares; thus the Tribunal cannot find that there was an indirect expropriation.
279. The fact that no direct automatic causal link is recognised by the Tribunal between Argentina's measures and the sale has important consequences for the evaluation of possible damages owed to El Paso. More precisely, although the sale, in other words the quasi-total loss of El Paso's investment, was not an unavoidable and direct consequence of Argentina's measures, and cannot be the basis of a claim for expropriation, it must still be ascertained whether, if the measures breach another standard of protection of the BIT, compensation should be granted for the contribution of those measures to the loss of value of the shares at the time of the sale, if it is demonstrated that they had a detrimental effect on that value. If some of the impugned measures violating BIT standards made the sale less profitable, the Tribunal considers that the Claimant should receive compensation.

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<http://investor.elpaso.com/phoenix.zhtml?c=97166&p=irol-newsArticle&ID=394930&highlight=>  
Respondent's Exhibit RA 156.

<sup>231</sup> *Ibid.*

280. It must be noted, therefore, that it is indeed quite possible to consider, in the Tribunal's view, that the sale of El Paso's investments in Argentina was not an expropriation, as it was not exclusively determined by Argentinian measures, and yet to conclude that those measures were the prevailing cause of the sale and, therefore, if the Tribunal finds this to be a violation of the FET, that the Respondent can be held responsible for damage resulting from this violation.

## C. INDIRECT EXPROPRIATION IN RELATION TO ARTICLE XII ON TAX MATTERS

### 1. *The Parties' Positions*

281. It is worth noting that at first sight the Claimant's Memorial looks as if El Paso had not included the tax withholdings among the expropriatory acts of Argentina. This is what results from the table of contents, under the heading "The GOA's Expropriatory Acts":

- (i) Abrogation and repudiation of contractual rights
- (ii) Withholdings of hydrocarbon exports
- (iii) Violation of right to collect payments as promised
- (iv) Pesification of capacity payments at an artificial exchange rate
- (v) Fundamental alteration of the price-setting mechanism for electrical generators
- (vi) Pesification of VCPs at an artificial exchange rate
- (vii) Violation of right to dispose freely of production
- (viii) Failure to mitigate impact of Law N° 25,561
- (ix) Restrictions on deductions for losses from Law N° 25,561
- (x) Interference with crude oil sales.

However, the tax measures enacted from 2002 onward are complained of under three of these headings.

282. Firstly, under the heading “Withholdings of hydrocarbon exports,” El Paso is in fact complaining about “Withholdings on hydrocarbon exports,” alleging that violation of the right to *export freely* hydrocarbons *includes* the right to *export hydrocarbons free of export withholdings*. And the Claimant concludes that “Export Withholdings on crude oil constitute (i) a direct taking of export revenues of CAPSA and CAPEX and (ii) an indirect taking from [*sic*] by artificially depressing domestic crude oil and LPG prices.”<sup>232</sup>
283. Secondly, under the heading “Failure to mitigate impact of Law N° 25,561,” El Paso explains that, with the devaluation of the peso and the inflation deriving therefrom - that reached 118% in 2002 -, the non-recognition of inflation for tax depreciation purposes was unreasonable and confiscatory. As a result, there has been an expropriation: according to the Claimant, the policy of the Government “artificially diluted the amount of depreciation that the CAPEX [*sic*] and COSTANERA are allowed to claim for tax purposes, thus resulting in confiscatory taxation and a taking of revenues.”<sup>233</sup>
284. Thirdly, under the heading “Restrictions on deductions for losses from Law N° 25,561,” El Paso also complains about tax measures. More specifically it states that “[t]he GOA unreasonably limited the tax deductions of the Argentine Companies in light of the significant losses caused by the devaluation of the Peso.”<sup>234</sup>
285. The two last claims of expropriation are based on the idea that a foreign investor has a right to certain tax deductions. This was asserted by the Claimant when it stated that

“[w]hile it is fair and reasonable for an investor to expect that no inflation adjustment be used in a low inflation environment, it is also reasonable that the same investor can expect that inflation will be

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<sup>232</sup> Memorial, § 474.

<sup>233</sup> Memorial, § 493.

<sup>234</sup> Memorial, § 494.

recognized for tax depreciation purposes in the context of high inflation such as occurred in 2002.”<sup>235</sup>

286. According to Argentina, the claims regarding tax issues in the BIT are limited to assumptions of expropriation, transfers, or investment agreements. Analysing the question of whether there could be a finding of expropriation, Argentina states first the general principle according to which a State is free to modify its tax regime. Only if excessive taxes with a confiscatory effect equivalent to an expropriation are imposed may international law be deemed to have been violated. Following this general approach, the Respondent argues that

“[t]he creation of export duties on oil and gas within the context of the crisis is a reasonable governmental regulation. The regulations issued in connection with income tax [and those not issued] are also a part of Argentina’s freedom to *act in the broader public interest through new or modified tax regimes.*”<sup>236</sup>

Moreover, in the view of Argentina, the limited impact of the taxes could by no means be equivalent to an expropriation:

“Exports duties of 16.67% on oil and gas did not deprive El Paso from the benefits of its investment *completely or in a significant portion.* On the contrary, the increase in international oil and gas prices and the fall in costs resulting from the mega-devaluation of the peso allowed oil and gas producing companies to increase their benefits *significantly*, even when paying export duties.”<sup>237</sup>

287. As far as the deductions from taxations are concerned, Argentina stresses that a decision was taken in 1992, well before the Emergency Law, which simply did not modify the existing arrangement. This is acknowledged by the Claimant in its Memorial, where it admits that:

“Law N° 24,073, enacted on February 4, 1992, froze all applicable indices and provisions for inflation adjustment purposes, including those related to tax depreciation, as from April 1, 1992. This was a

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<sup>235</sup> Memorial, § 369.

<sup>236</sup> Counter-Memorial, § 486. Emphasis by the Respondent.

<sup>237</sup> Counter-Memorial, § 495. Emphasis by the Respondent.

reasonable measure at the time there was hardly any inflation in Argentina.”<sup>238</sup>

What El Paso complains about, therefore, is not a change in the law but a change in the economic circumstances:

“Law N° 24,073 ceased to be appropriate in January 2002 when Law N° 25,561 repealed the Convertibility Law and the GOA took a number of measures that caused a huge devaluation of the Peso ... This sudden and unexpected change of circumstances materially altered the context in which the freezing of inflation indices for tax purposes had been issued pursuant to Law N° 24,073.”<sup>239</sup>

Argentina contends that it is not possible for El Paso to demand “an economic compensation because the applicable tax system has not been modified since 2002 according to what it considers convenient.”<sup>240</sup> Moreover, the two claims related to deductions from the tax basis were only brought for CAPEX and Costanera, and according to Argentina, neither of these two companies paid taxes in the years before the sale of El Paso’s shares.<sup>241</sup>

288. The Respondent’s conclusion is thus that, there being no expropriation, the tax measures do not come under the Tribunal’s jurisdiction according to the BIT. This has far-reaching consequences, according to Argentina, as it contends that 93% of the claims are based on export withholdings.<sup>242</sup>

## 2. *The Tribunal’s Analysis*

### *(i) The Tribunal’s Legal Analysis of the Applicable Principles*

289. Article XII of the BIT provides:

“1. With respect to its tax policies, each Party should strive to accord fairness and equity in the treatment of investment of nationals and companies of the other Party.

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<sup>238</sup> Memorial, § 366

<sup>239</sup> Memorial, § 367.

<sup>240</sup> Counter Memorial, § 450.

<sup>241</sup> Counter-Memorial, §§ 459 and 477. See also § 32: “CAPSA does not pay income tax because it would be exempt therefrom since 1999.”

<sup>242</sup> RPHB, § 162.

2. Nevertheless, the provisions of this Treaty, and in particular Articles VII and VIII, shall apply to matters of taxation only with respect to the following:

(a) expropriation, pursuant to Article IV;

(b) transfers, pursuant to Article V; or

(c) the observance and enforcement of terms of an investment agreement or authorization as referred to in Article VII (1) (a) or (b), to the extent they are not subject to the dispute settlement provisions of a Convention for the avoidance of double taxation between the two Parties, or have been raised under such settlement provisions and are not resolved within a reasonable period of time.”

290. The tax policy of a country is a matter relating to the sovereign power of the State and its power to impose taxes on its territory. The Tribunal agrees that the State has a sovereign right to enact the tax measures it deems appropriate at any particular time. Every year, governments around the world propose the adoption of tax measures which constitute either new initiatives or amendments to the existing fiscal legislation. There is a presumption of validity in favour of legislative measures adopted by a State, and it is up to those who challenge such measures to demonstrate their invalidity. This idea has been embodied in Article XII of the BIT, the effect of which is to only limit slightly the State’s power to levy taxes.

291. As Article XII grants an important margin of freedom to the host State in relation to its fiscal policy towards foreign investors, the States Parties indicate in paragraph 2 of Article XII that this policy should not be unfair or inequitable. Considering both the language used – “each Party should strive” – and the fact that Article XII (2) excludes, except in specific and limited cases, any review of a possible violation of the fair and equitable treatment standard, the Tribunal concludes that Article XII (1) creates only a best-effort obligation.

292. In its Decision on Jurisdiction, the present Tribunal has already decided that the duties imposed on exports “are a tax measure,”<sup>243</sup> and this conclusion is reiterated here. The Tribunal also found that it had limited jurisdiction over only three issues:

“The Tribunal concludes that it has jurisdiction over tax matters, but only insofar as the tax measures complained of are linked with: (a) expropriation, pursuant to Article IV; (b) transfers, pursuant to Article V; or (c) the observance and enforcement of terms of an investment agreement or authorization as referred to in Article VII(1)(a) or (b). In other words, the only claims that the Tribunal can consider at the merits stage are the tax claims based on the existence of an expropriation and on the violation of an investment agreement or authorization. Everything else is beyond the competence of the Tribunal.”<sup>244</sup>

293. Since El Paso did not file any claim in connection with transfers (point b), and since the Tribunal has already decided<sup>245</sup> that there is no investment agreement benefiting El Paso (point c), the only issue which remains to be addressed is whether such taxes could qualify as an expropriation (point a).

*(ii) The Tribunal’s Analysis of the Facts of the Case*

294. A significant portion of El Paso’s claims are related to tax issues. These issues include the claims related to the export duties established by the Emergency Law and the deductions on income tax. Like any other activity, foreign investments are subject to taxes imposed by the host State and “the foreign investor has neither the right nor any legitimate expectation that the tax regime will not change ... during the period of the investment,”<sup>246</sup> even though that may reduce its economic benefits, except if a stabilisation of the tax regime (at least for certain taxes) was agreed on by the State.

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<sup>243</sup> Decision on Jurisdiction, *supra* note 58, § 112.

<sup>244</sup> *Ibid.*, § 116.

<sup>245</sup> See *supra* §§ 190-198.

<sup>246</sup> *EnCana Corporation v. Republic of Ecuador* [hereinafter *EnCana*], UNCITRAL, LCIA Case No. UN3481, Award of 3 February 2006, § 173.



295. The Tribunal will examine the different tax measures complained of and will summarily dismiss the claims against the regime of tax deductions which was in place since 1992, as there were no complaints from the Claimant during ten years. In this arbitration, the Claimant does not complain about a change of the law; it complains about “no change in the law.” The only claim here is that the State has not modified its laws in order to alleviate the economic problems resulting for the economic actors from the new economic situation. Without needing to enter into a discussion on this point, the Tribunal seriously doubts that, as alleged by the Claimant, “[i]nvestors have a reasonable and legitimate expectation to be able to adjust their fixed assets for tax purposes in periods of high inflation.”<sup>247</sup> A State cannot be considered to have a duty to adapt its tax regime to the best interests of foreign investors. An unfavourable calculation of taxes cannot be equated with an expropriation, especially as the Claimant has not quantified its alleged losses.

296. The Tribunal will now look into the export-tax withholdings in order to decide whether they can be considered an expropriation. Before analysing them, it is appropriate to recall the content of the impugned measures. First, the Emergency Law adopted on 6 January 2002 decided on the principle of such a tax, known as withholding on oil and gas:

“The Executive Branch of Government shall be entitled to establish compensatory measures to avoid the unbalancing of financial institutions resulting from the provisions set forth in the preceding paragraph. These measures may include the issue of guaranteed national public bonds in foreign currency. For purpose of funding such guarantee, *an export tax on hydrocarbons is hereby created* for the term of FIVE (5) years, and the Executive Branch of Government shall be entitled to determine the corresponding tax rate.”<sup>248</sup>

Then, as far as *crude oil exports* were concerned, on 13 February 2002, the GOA enacted Decree N° 310/2002, which placed a 20% withholding on crude

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<sup>247</sup> Memorial, § 362.

<sup>248</sup> Law No. 25,561 (Emergency Law), Title IV, Chapter I, Art. 6 § 2. Emphasis added by the Tribunal.

oil exports: this amounts to a 16.67% export duty on crude oil exports<sup>249</sup>, as in Argentina the withholding is included in the amount used to calculate export duties and, therefore, a 20% export duty implies an actual 16.67% withholding.<sup>250</sup> Such export duty began to be levied on 1 March 2002 and was still effective when El Paso sold its equity interests in the Argentinian companies.

Regarding *LPG exports*, a new tax was imposed on 13 May 2002: during a term of fifteen days in 2002 (from 14 May through 31 May 2002), a 20% export duty was also applied to LPG exports,<sup>251</sup> which implies, for the same reason as stated above, a 16.67% export withholding. From 1 June 2002 onward, the duty was reduced to 4.76% as a result of the Agreement for the Stabilisation of the Liquefied Petroleum Gas Wholesale Price in the Argentine Market (hereinafter: the LPG Price Stabilisation Agreement). This Agreement was entered into in July 2002 between the Minister of Economy and the main LPG producers in Argentina. One of the companies that signed the agreement was CAPEX. From the execution of the LPG Price Stabilisation Agreement until May 2004, the LPG export duty remained at 4.76%. El Paso sold its equity interests in CAPSA – and, consequently, in CAPEX – in mid-2003, and in Costanera in autumn 2003. This reduced export duty was therefore still effective at the moment of the two sales in June and September 2003.

297. Turning now to the analysis of these measures, the Tribunal considers, first, that the creation of export duties on oil and gas is *a reasonable governmental regulation within the context of the crisis*. According to the Respondent's expert Roubini, "it made total economic sense to have a 'compensated devaluation' by relying on export taxes to raise revenues in the sectors that had most benefited from the devaluation."<sup>252</sup> The devaluation of the peso entailed

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<sup>249</sup> See Presidential Decree No. 310/2002 of 13 February 2002, Section 1. See also Presidential Decree No. 809/02, Section 3. The tariff positions established in regulations are defined in the Mercosur (Southern Common Market) Common Nomenclature, approved by Presidential Decree No. 2.275/94.

<sup>250</sup> This was acknowledged by LECG. See LECG Report, n. 69. See also MacroConsulting Report, § 178.

<sup>251</sup> See Presidential Decree No. 809/02 of 13 May 2005, Sections 2 and 3.

<sup>252</sup> Counter Memorial, § 153, citing the Expert Report by Nouriel Roubini [hereinafter Roubini Report] of 24 August 2006, § 42.

extraordinary revenues for the exporting sectors which did not arise from increased efficiency but from the devaluation. It is thus logical to establish a tax on exports to be levied on a portion of this extraordinary income. By mid-2002, the Argentine peso had lost 200% against the US dollar. At the same time, the price of oil climbed; as stated by Argentina,

“[f]rom mid-1998 (when recession started in Argentina) to mid-2003 (when El Paso sold its share in CAPSA and in Servicios), the WTI crude oil barrel rose from below USD 13/bbl to over USD 30/bbl, even peaking over USD 35/bbl.”<sup>253</sup>

Faced with this new economic situation, the export duties imposed on oil and gas amounted to only between 4.76% and 16.67%. According to the Tribunal, this may be regarded as reasonable. Therefore, the tax on unexpected income, resulting from the mega-devaluation of the Argentine peso and the increase in the international price of oil cannot be considered an expropriation. In this sense, the Tribunal is supported in its analysis by the approach followed in *Aminoil v. Kuwait*,<sup>254</sup> where the tribunal noted that it was acceptable to impose taxes on the oil industry in connection with unexpected income attributable to the “explosion” of oil prices rather than to efforts made by the concession holders.

298. Second, the tax measures had only a *limited impact on Claimant’s property rights*. On crude oil, the withholdings were fixed at 20% (16.67%). On LPG, the rate, first established at 20% (16.67%), was later reduced to 5% (4.46%). Only after El Paso’s sale, on 13 May 2004, did Argentina increase the export withholdings imposed on crude oil from 20% to 25% and on LPG exports from 5% to 20%, and reinstated the previously abolished withholdings on exports of gasoline and other by-products at a rate of 5%. A first remark is that the export withholdings imposed in May 2004 cannot have caused a forced sale constituting an expropriation of El Paso’s shares in the Argentinian companies subjected to these withholdings, or constitute an expropriation by themselves.

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<sup>253</sup> Counter-Memorial, § 423.

<sup>254</sup> *American Independent Oil Company (Aminoil) v. Kuwait*, [hereinafter *Aminoil*], Award of 24 March 1982, 66 *ILR* 518 (1984).

A second remark is that, without needing to enter into sophisticated reasoning or calculations, it is obvious that a tax of such a percentage is by no means an unreasonable measure that could be deemed expropriatory: under no circumstances may a tax of under 20% on exports be characterised as expropriation of an investment. The impact of the imposition of export withholdings, at a rate of 4.76% for LPG and a rate of 16.67% for oil, on El Paso's shares cannot be deemed to be expropriatory.

299. In conclusion, the Tribunal, having analysed the different tax measures, does not consider that they amount to indirect expropriation, as they were reasonable and did not result in the neutralisation of the property rights of the Claimant.

#### D. ARTICLE II(2)(B): DISCRIMINATORY AND ARBITRARY TREATMENT

300. Article II(2)(b) of the 1991 BIT states:

“Neither Party shall in any way impair by arbitrary or discriminatory measures the management, operation, maintenance, use, enjoyment, acquisition, expansion, or disposal of investments. For the purposes of dispute resolution under Articles VII and VIII, a measure may be arbitrary or discriminatory notwithstanding the opportunity to review such measure in the courts or administrative tribunals of a Party.”

##### 1. *Discriminatory Treatment: Has El Paso Been Discriminated Against?*

###### (i) *The Parties' Positions*

301. According to the Claimant's Memorial, the energy companies were discriminated against:

“... the GOA's measures have been designed to benefit other sectors of the economy at the expense of energy companies, thus constituting a politically-motivated and discriminatory transfer of wealth from energy companies to other sectors of the economy;”<sup>255</sup>

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<sup>255</sup> Memorial, § 35.

“ ... in an obvious display of discrimination, the GOA effectively took billions of Dollars from the energy sector and transferred that money to other economic groups;”<sup>256</sup>

“... [t]he Energy Secretariat’s acts were driven by the GOA’s decision to manipulate energy prices in order to disproportionately distribute the damage caused by the GOA’s alterations to the system so that generators shouldered a larger burden than other participants.”<sup>257</sup>

The same position was taken in the Claimant’s Reply:

“ ... the measures adopted by the GOA regarding the energy sector were not a mere result of Argentina’s economic condition, but part of a specific policy adopted by the GOA to discriminate against the energy sector, abrogating fundamental rights and assurances granted under the Energy Regulatory Framework.”<sup>258</sup>

302. And the discrimination is described as follows:

“Many of Argentina’s measures had a *disproportionate effect* on foreign investors in the energy sector and thus constitute a clear case of *de facto* discrimination ... Essentially, Argentina forced the energy sector to bear a disproportionate brunt of Argentina’s financial difficulties in order to cross-subsidize the rest of its economy by US\$ 10.7 billion.”<sup>259</sup>

303. The Respondent presented a different view of what constituted unauthorised discrimination. The GOA considered that the measures were not discriminatory and expressed the following view on the conditions for measures to be discriminatory:

“The differential treatment between national and foreign investors does not necessarily lead to the violation of international law standards. In order for a State’s action or measure to be discriminatory in the sense that it is prohibited under international law, two requirements should be present. In the first place, the measure must result in actual damages to the foreign investor; in the second place, the action or measure must have been taken to harm the foreign investor. If these

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<sup>256</sup> *Ibid.*, § 223.

<sup>257</sup> *Ibid.*, § 237.

<sup>258</sup> Reply, § 353.

<sup>259</sup> *Ibid.* § 670. Emphasis by the Claimant.

requirements are not present, there will be no discriminatory action by the State that is protected by international law.”<sup>260</sup>

304. In addition to this abstract view of what constitutes discrimination, Argentina contended that, according to the facts of the case, the energy and oil and gas companies had not been concretely discriminated against. According to the Respondent,

“[a]ll the sectors of the economy were impacted by the crisis and had to adapt to the new context. El Paso has filed a claim for investments related to electric power generation and oil and gas production. Although these sectors could not remain alien to the crisis, they were not, at any rate, among the most disfavoured ones.”<sup>261</sup>

*(ii) The Tribunal’s Analysis*

305. On the one hand, the Tribunal does not agree with Argentina’s contention that discriminatory intent is necessary for a measure to be discriminatory. It is sufficient that, objectively, two similar situations are not treated similarly. As stated by the ICSID tribunal in *Goetz v. Burundi*, “discrimination supposes a differential treatment applied to people who are in similar situations.”<sup>262</sup> Professor Kenneth Vandeveldel further explains that anti-discrimination provisions in BITs prohibit measures that are “discriminatory in effect as well as those which are intentionally discriminatory,”<sup>263</sup> which implies that while discriminatory intent gives rise to a finding of discrimination, the discriminatory effect of a measure is sufficient for such a finding. On the other hand, the Tribunal can also not accept the Claimant’s view according to which any discrimination against an investor is a violation of the BIT. The Claimant has cited many authorities and stated that, according to Professor A. F. M. Maniruzzaman,

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<sup>260</sup> Counter-Memorial, § 659.

<sup>261</sup> Counter-Memorial, § 9.

<sup>262</sup> *Goetz, supra* note 129, Award of 10 February 1999, § 121 : “*Une discrimination suppose un traitement différentiel appliqué à des personnes se trouvant dans des situations semblables.*”

<sup>263</sup> Kenneth J. Vandeveldel, *United States Investment Treaties: Policy and Practice*, Boston, Kluwer Law and Taxation, 1992, p. 77.

“[t]he concept of discrimination entails two elements: first, the measures directed against a particular party must be for reasons unrelated to the substance of the matter, for example, the company’s nationality. Second, discrimination entails like persons being treated in an inequivalent manner.”<sup>264</sup>

306. The protection against discrimination in the BIT is a protection against discrimination of foreign investors as such. In the Tribunal’s view, the standard of the BIT according to which *foreign investors* are protected against discrimination does not entail the far-reaching consequence that a State cannot treat differently the economic actors in different sectors of the economy, as long as this differential treatment applies equally to national and foreign investors. None of the impugned measures adopted to face the economic crisis differentiated in legal terms between Argentinian nationals or companies, on the one hand, and foreigners or foreign or foreign-owned companies, on the other. It appears moreover from the file that, in practice, no foreign investor has received treatment different from that granted to its Argentinian counterparts, and El Paso has received the same treatment as other investors in the same sector.

307. The Tribunal has not been convinced by the Claimant allegation that

“ ... the measures adopted by the GOA regarding the energy sector were not a mere result of Argentina’s economic condition, but part of a specific policy adopted by the GOA to discriminate against the energy sector, abrogating fundamental rights and assurances granted under the Energy Regulatory Framework.”<sup>265</sup>

308. The conclusion of this Tribunal is that no *de jure* discrimination between national and foreign investors, or different foreign nationals, resulted from the measures adopted to face the crisis.

309. The question that remains is whether there has been *de facto* discrimination. According to the Claimant, the banks are mainly Argentinian and the oil and

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<sup>264</sup> Memorial, § 556, citing A. F. M. Maniruzzaman, “Expropriation of Alien Property and the Principle of Non-Discrimination in International Law of Foreign Investment: An Overview”, 8 J. *Transnat’l L. & Pol’y* 57 (1998) (footnote omitted). Claimant’s Legal Authority No.133.

<sup>265</sup> Reply, § 353.

gas sector companies mainly foreign-owned: as the banking sector and the energy sector have not been treated in the same manner, there has been *de facto* discrimination according to the Claimant.

310. It has been said, and is indeed confirmed by the text of the relevant law, that the export withholdings were established to compensate for the difficulties of the Argentinian banking sector. According to the Claimant,

“ ... [t]he mandatory conversion of Dollar-denominated bank deposits and bank credits created an imbalance in the system that was termed *asymmetrical pesification*. This imbalance occurred because Decree N° 214 converted Dollar-denominated bank deposits into Pesos at a rate of US\$ 1 = per Arg.\$1.40, while Dollar-denominated bank loans were converted into Argentine currency at a rate of US\$ 1 = Arg\$ 1. According to Law N° 25,561, the hydrocarbon export withholding was created to compensate the banking sector for this imbalance.”<sup>266</sup>

It is not denied that the banking and the hydrocarbon sectors were not subject to the same measures, but the Tribunal thinks that the measures concerning each of these sectors were reasonable and did not discriminate against either of them. On the contrary, the overall scheme adopted by the Argentine Government had the objective of balancing for each sector the advantages and disadvantages of the general economic situation.

311. The banking sector was at a disadvantage because the Government had imposed an asymmetrical pesification, the loans being pesified at a lower exchange rate than the deposits, which created a greater loss for the banking system than symmetrical pesification would have. This was acknowledged by the tribunal in the award in *Continental* when it analysed the same Decree:

“The Government intervened massively to support the banks in the asymmetric pesification. This scheme would have brought the banks otherwise to bankruptcy, since they had to ‘pay back’ to depositors 1.40 pesos for each dollar, while their credits were converted at 1:1.”<sup>267</sup>

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<sup>266</sup> Memorial, § 329.

<sup>267</sup> *Continental*, *supra* note 150, § 144.



This is a very specific application of pesification which placed the banks in a situation that cannot be considered as similar or comparable to that of the oil and gas companies but, on the contrary, was less favourable. The GOA practised discrimination in favour of the banks and then a sort of reverse discrimination to equalise the playground. In other words, what Decree N° 214 and Law N° 25,561 did was what is called in another context “*inégalité compensatrice*”<sup>268</sup> and does not amount to discriminatory treatment of foreign investors.

312. The same analysis was made in *Metalpar v. Argentina*, where the claimants – two companies which had invested in Argentinian companies engaged in the manufacturing of bus bodies – alleged that Argentina, through Law No. 25,561, Law No. 25,789, and Presidential Decree No. 905/2002, had discriminated against them in favour of the financial sector, just as El Paso claims to have been discriminated against in favour of the banking sector. The answer of the tribunal was simple and is shared by this Tribunal:

“The Tribunal considers that a State’s power to create its legal system – through its competent authorities – allows it to establish different rules to govern different subjects. If Claimants neither were nor are financial institutions, they cannot argue that the Argentine Government should have treated them as such.”<sup>269</sup>

313. Moreover, as far as the Hydrocarbon Sector was concerned, the exports being expressed in dollars and the costs in Argentina being sustained in pesos, the hydrocarbon companies seemed to be in a more favourable position than those

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<sup>268</sup> At the time of the New International Economic Order (NIEO), the idea was to give advantages to developing countries in order to foster a more balanced relationship with developed countries. The idea was for example expressed in Article 18 of the Charter for Economic Rights and Duties of States, embodied in General Assembly Resolution 3182 of December 1974, which reads: “Developed countries should extend, improve and enlarge the system of generalized non-reciprocal and non-discriminatory tariff preferences to the developing countries consistent with the relevant agreed conclusions and relevant decisions as adopted on this subject, in the framework of the competent international organizations. Developed countries should also give serious consideration to the adoption of other differential measures, in areas where this is feasible and appropriate and in ways which will provide special and more favourable treatment, in order to meet the trade and development needs of the developing countries. In the conduct of international economic relations, the developed countries should endeavour to avoid measures having a negative effect on the development of the national economies of the developing countries, as promoted by generalized tariff preferences and other generally agreed differential measures in their favour.”

<sup>269</sup> *Metalpar S.A. and Buen Aire S.A. v. Argentine Republic* [hereinafter *Metalpar*], (ICSID Case No. ARB/03/5), Award of 6 June 2008, § 161.

which did not export. Argentina argued that “[w]ithholdings captured only one portion of the extraordinary profitability obtained by exporters, who had suddenly benefited as a result of the mega-devaluation of the local currency.”<sup>270</sup>

The Tribunal here refers to a statement by Mr. Fernandez, who declared in February 2004, when he was Chief of Cabinet:

“We are referring to various sectors of the economy which shall bear the cost of this increase, most of them are exporters who have enjoyed the possibility to export their products in dollars while paying a very low tariff for gas and electricity in pesos.”<sup>271</sup>

314. The Tribunal also takes note of a statement made by the Claimant itself, making the same analysis when saying that “those who export their production ... benefited from the devaluation of the Peso since the Peso equivalent value of their exports tripled.”<sup>272</sup> It was thus reasonable for the Government to institute a tax on the unexpected profits made by the oil and gas companies to re-balance the situation of the banking sector. Far from being discriminatory, this measure aimed at equalising the playground of the different economic actors, by distributing more equitably the burden of the country’s economic crisis among all those affected. This idea was indeed spelled out in Section 11 of the Emergency Law, which pointed to “the principle of shared efforts.” To these considerations one should add that it was common knowledge that at the time of the Argentine crisis the international price of oil increased tremendously, which was all to the benefit of the exporting companies. Argentina explained that

“[i]n the oil and gas sector, export duties were established levied only on a minor portion of the extraordinary profits generated by the mega devaluation of the Argentine peso for tradable goods producing sectors. The increase in the international price of crude oil was an additional issue that also benefited the sector dramatically. Domestic oil and gas prices increased at a pace that exceeded domestic inflation

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<sup>270</sup> Rejoinder, § 255.

<sup>271</sup> Statement during a press conference given on 13 February 2004, by the Chief of Cabinet, Mr. Fernandez, Minister of Federal Planning, Public Investment and Service, Mr. De Vido, and the Secretary of Energy, Mr. Cameron. Claimant’s Exhibit No.125.

<sup>272</sup> Memorial, § 244.

and converted this sector into one of the most favoured ones within the context of the crisis.”<sup>273</sup>

Therefore, as stated by Mr. Roubini, expert for the Respondent, “it made total economic sense to have a ‘compensated devaluation’ by relying on export taxes to raise revenues in the sectors that had most benefited from the devaluation and the sectors that were most able to afford an increased tax imposition.”<sup>274</sup>

315. It is this Tribunal’s view that a differential treatment based on the existence of a different factual and legal situation does not breach the BIT’s standard. Here the Tribunal is in line with the approach of other tribunals already cited and finds itself in agreement with the tribunal in *Enron*, which found no discrimination between the different sectors of the economy, although they were indeed treated differently, as there was no “capricious, irrational or absurd differentiation in the treatment accorded to the Claimant as compared to other entities or sectors.”<sup>275</sup> The Tribunal finds that the Claimant has not proved any improper differentiation.

316. Last but not least, the Tribunal recalls that the application of standards in the BIT other than that of protection from expropriation is excluded for tax matters. The question that was discussed in the preceding paragraphs is therefore somewhat academic, although, if it had had to decide the issue, the Tribunal would have considered it important to state that, for the reasons presented, it held that there had been neither *de jure* nor *de facto* discrimination against El Paso during the Argentine crisis.

## 2. *Arbitrary Treatment: Has El Paso Been Treated Arbitrarily?*

### (i) *The Parties’ Positions*

317. The Claimant argues in its Memorial that the decisions of the Argentinian authorities were arbitrary, but without really saying more than that “the GOA

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<sup>273</sup> Counter-Memorial, § 10.

<sup>274</sup> Counter-Memorial, § 153, citing the Roubini Report, *supra* note 253, § 47.

<sup>275</sup> *Enron*, *supra* note 52, § 282.

took a series of politically-motivated measures,”<sup>276</sup> without elaborating on the possible political motives behind these measures. Later on, some explanation was given of this idea of political motivation in the testimony of Mr. Bastos, the former Secretary of Energy: “the changes that have been introduced are political ones aimed mainly at preventing an increase in the price of energy ...”<sup>277</sup>

318. The Respondent considers that the measures were not arbitrary and were designed to improve the global economic situation. They were adopted after extensive discussions in the Government and the ministries, and their sole aim was to face the crisis in the best way possible.

*(ii) The Tribunal’s Analysis*

319. *Black’s Law Dictionary* defines the word “arbitrary” as “not governed by any fixed rules or standard,” “performed without adequate determination of principle,” “without cause based upon the law,” or resulting from a “failure to exercise honest judgment.”<sup>278</sup> In addition, “arbitrary and capricious” is defined as “characterization of a decision or action taken by an administrative agency . . . [as] wilful and unreasonable action without consideration or in disregard of facts or law or without determining principle.”<sup>279</sup> According to international law, “[a]rbitrariness is not so much something opposed to a rule of law, as something opposed to the rule of law . . . It is a wilful disregard of due process of law, an act which shocks, or at least surprises, a sense of juridical propriety.”<sup>280</sup>

320. The Tribunal sees no arbitrariness in Argentina’s reaction to the crisis. Of course, if one is faced with a difficult economic situation, there are always several methods for dealing with it, depending on the circumstances, the political constraints incumbent on governments and their economic analyses. It

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<sup>276</sup> Memorial, § 21.

<sup>277</sup> Memorial, § 377, citing the Bastos Report.

<sup>278</sup> *Black’s Law Dictionary*, 6th ed. (1990), p. 104.

<sup>279</sup> *Ibid.*, p. 105.

<sup>280</sup> *ELSI*, *supra* note 135, § 128.

is clear that neither the causes of, nor the answers to, Argentina's economic crisis at the end of 2001 have been the object of unanimous appraisal.

321. The Tribunal has heard various experts, all knowledgeable, having opposite perceptions of the same reality. Some experts stated that the pesification was the only solution; others said that dollarisation would have been much preferable.<sup>281</sup>

There is no common analysis of the origin of the crisis, as was pointed out by the tribunal in the *CMS* case, which was dealing with the same crisis:

“This crisis ... stemmed basically from economic conditions that made it impossible to maintain the fixed exchange rate and which gradually led to the greatest default on foreign debt in history and the collapse of the Argentine financial markets. Some tend to fault foreign investors and put the blame on excessive privatization and globalization, while others see in it the result of not having carried out the liberalization program in its entirety and having allowed major governmental interferences in the functioning of the economy.”<sup>282</sup>

It cannot be denied also that the reactions to the crisis could have been different, as stated by the tribunal in *LG&E*:

“ ... Argentina faced severe economic and social hardships from 2001 onwards and had to react to the circumstances prevailing at the time. Even though the measures adopted by Argentina may not have been the best, they were not taken lightly, without due consideration.”<sup>283</sup>

322. The Tribunal thinks that the GOA certainly tried to take the best measures to cope with the situation. Judging whether the measures taken were or were not the best is very difficult as shown by the diverging views expressed on the

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<sup>281</sup> See for example, Reply, § 747, Claimant's developments on the subject: “An additional alternative available to Argentina was “dollarization.” Argentina could have adopted the Dollar as legal tender, as other countries (such as Ecuador and Panama) did. Under this option, the Central Bank of Argentina could have used its Dollar reserves to exchange all pesos in circulation for dollars, and all Peso-denominated obligations would have been transformed into dollar-denominated obligations at the exchange rate of 1:1, which was the exchange rate in force during the currency board system. The peso was already pegged to the Dollar under the currency board system, and the Argentine Central Bank possessed the dollar reserves necessary to maintain that peg. ‘Dollarization’ was thus an obvious and logical alternative that was frequently discussed in 2001. It had the support of senior US officials, making it “highly likely that had Argentina opted for dollarization, both the Bush Administration and the multilateral institutions would have supported the policy.” (footnotes omitted.)

<sup>282</sup> *CMS*, *supra* note 48, § 153.

<sup>283</sup> *LG&E*, *supra* note 51, § 162.

subject by commentators of the Argentinian crisis of 2001. Something had to be done. The only item to be verified by the Tribunal is whether the measures were taken arbitrarily. In view of the extensive file before it, which it has studied exhaustively, it appears to the Tribunal that the measures adopted in the context of the crisis were not arbitrary but reasonable and consistent with the aim pursued. They were intended to face the extremely serious crisis that Argentina was going through and emanated from the police power regularly exercised by governments.

323. It is also apposite to note that all measures were taken in the framework of the existing constitutional order, as stressed by the tribunal in *Continental*:

“It is worth noting that ultimately the crisis did not affect the functioning of the democratic constitutional order of Argentina beyond emergency measures enacted on the basis of the Constitution. Civil liberties were not restricted, nor constitutional guarantees suspended. This is apparent now; but it certainly could not be assumed in late 2001 and 2002.”<sup>284</sup>

324. It could moreover be said that the subsequent evolution of the Argentinian economy might give some confirmation of the adequacy of the policy followed.<sup>285</sup> The Claimant itself has recognised this positive evolution more than once. For example, in its Closing Statement, it was indicated that the GDP growth was the following: + 8.83 for 2003; + 9.03 for 2004; + 9.18 for 2005; + 8.46 for 2006; and approximately + 7.5 for 2008. Moreover, in a letter dated 20 May 2008 sent by its counsel to the Tribunal, the Claimant recognised the positive effects of Argentina’s policies, stating that “Argentina’s economy has been growing at record rates since 2003.” According to the Embassy of Argentina in Washington, D.C., “Argentina’s economy has been growing at a fast pace since 2003 (9% average during 2004-2006), having overcome its major crisis in modern history.” In her first annual address to the Argentine

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<sup>284</sup> *Continental*, *supra* note 150, § 153. Footnote omitted.

<sup>285</sup> See for example, an article published in the French economic newspaper “Les Echos”, 22-23 February 2008, with the Title “Cinquième année de forte croissance en Argentine,” in which one can read: “... The dynamism and the willpower for revenge of Argentina, which recovered with a spectacular velocity from the terrible financial crisis that brought it down at the end of 2001, cannot be denied.” Translation by the Tribunal.

Congress, President Cristina Kirchner characterised Argentina’s record growth as “the greatest growth period in Argentina in the last 100 years.”

325. The conclusion of the Tribunal is that the measures taken by Argentina were based on a reasoned scheme to answer a major crisis and effectively had the desired result, which means that they cannot be considered as tainted by arbitrariness.

E. ARTICLE II(2)(a): FAIR AND EQUITABLE TREATMENT

326. Article II(2)(a) of the BIT prescribes:

“Investment shall at all times be accorded fair and equitable treatment, shall enjoy full protection and security and shall in no case be accorded treatment less than that required by international law.”

327. Two main issues are raised by the application of the fair and equitable treatment (FET) standard in an arbitration case: the first concerns the relation of FET with general international law, whereas the second is the determination of its content and scope.

1. *The Parties’ Positions*

328. The Claimant has an all-encompassing conception of FET, as is shown by the summary of the development of this concept given in its Memorial:

“In summary, government measures violate the fair and equitable treatment standard when they are inconsistent with the reasonable and legitimate expectations of the parties. It is both reasonable and legitimate for investors to expect that a government will conform its conduct to accepted standards such as its own treaties, constitution, laws, regulations, customary international law, and general usage that falls into the category of a norm. Indeed, this is the essence of the rule of law. It is also unfair and inequitable for a government to violate the principles of honesty and good faith, to act in a non-transparent manner, to act in a manner inconsistent with representations and inducements offered to attract foreign investment, to revoke or alter arbitrarily or for political reasons regulatory approvals or conditions upon which the investor relied, to abuse its legal rights or its discretionary powers, to interfere with property rights unreasonably and to unforeseeably change the essential rules of the game upon which investors relied in such a way as to frustrate the very purpose of the investment. These standards are all fundamental and well

accepted. They encompass the most elementary principles of fairness and economic morality, and in a practical sense, they are necessary preconditions for the confidence based upon the stability and predictability that comes with respect for the rule of law that is so necessary both to attract foreign investment and for any economy to prosper and grow.”<sup>286</sup>

Without wishing to analyse at this stage the details of this conception of FET, the Tribunal notes that, in the Claimant’s view as expressed in this excerpt, any violation by a State of any of its laws or its regulations is a violation of FET. In its Reply, the Claimant examined the relation between the concept of FET and general international law and contended that fair and equitable treatment as prescribed in the BIT established a different and higher standard than that prevailing in customary international law.<sup>287</sup>

329. The Respondent began its discussion of FET by stating that “[t]he treatment standards are provided by the international customary law minimum standard. This is thus established by the BIT, practice and international legal scholars.”<sup>288</sup> As far as the content of the notion is concerned, Argentina points out that FET cannot be interpreted to mean that no change in the legal framework may be made if circumstances so require. In the GOA’s Counter-Memorial, it is thus stated that

“[c]ountries with unstable economies – such as Argentina – did not undertake to refrain from undergoing economic crises again. If El Paso’s interpretation of the standard were allowed, bilateral investment treaties would only be used to worsen the crisis when making the country in trouble compensate the investors affected and thus keep them isolated from the crisis.”<sup>289</sup>

## 2. *The Tribunal’s Analysis of the Legal Standard*

330. The Tribunal will address in turn the two issues raised by the FET.

### *(i) The Relation of Fair and Equitable Treatment with the International*

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<sup>286</sup> Memorial, § 525.

<sup>287</sup> Reply, §§ 540-552.

<sup>288</sup> Counter-Memorial, § 604; see also Rejoinder, § 389 and its footnotes.

<sup>289</sup> Counter-Memorial, § 631.



### *Minimum Standard*

331. As far as the relation between FET and the minimum standard of international law is concerned, two main approaches have been adopted by ICSID tribunals, to which one may add an intermediate, undecided position.
332. Under the first approach, FET has to be equated with the minimum standard of treatment provided for by general international law. This has been, for example, the position adopted by the *CMS* tribunal:

“In fact, the Treaty standard of fair and equitable treatment and its connection with the required stability and predictability of the business environment, founded on solemn legal and contractual commitments, is *not different from the international law minimum* standard and its evolution under customary law.”<sup>290</sup>

333. The second approach deals with FET as an autonomous concept, considered in general as more demanding and more protective of investors’ rights than the minimum standard of treatment provided for by general international law. The *Azurix* tribunal, for example, took this position:

“The clause, as drafted, permits to interpret fair and equitable treatment and full protection and security as *higher standards than required by international law*. The purpose of the third sentence is to set a floor, not a ceiling in order to avoid a possible interpretation of these standards below what is required by international law.”<sup>291</sup>

However, after this statement of principle, the *Azurix* tribunal contradicted it, or at least emptied it of any significance, when it added that:

“... the Tribunal does not consider that it is of material significance for its application of the standard of fair and equitable treatment to the facts of the case. As it will be explained below, the minimum requirement to satisfy this standard has evolved and the Tribunal considers that its content is *substantially similar* whether the terms are interpreted in their ordinary meaning, as required by the Vienna Convention, or in accordance with customary international law.”<sup>292</sup>

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<sup>290</sup> *CMS*, *supra* note 48, § 284. Emphasis added by the Tribunal.

<sup>291</sup> *Azurix*, *supra* note 50, § 361. Emphasis added by the Tribunal.

<sup>292</sup> *Ibid.* Emphasis added by the Tribunal.

334. Between these two approaches, some tribunals chose not to decide. This was the case of the tribunal in *BG v. Argentina* which adopted the following position:

“For the reasons set out below, this Tribunal has concluded that the measures adopted by Argentina fall below the minimum standard and it is consequently not necessary for this award to examine whether the Argentine-UK BIT provides a more generous independent standard of protection.”<sup>293</sup>

335. The Tribunal considers this discussion to be somewhat futile, as the scope and content of the minimum standard of international law is as little defined as the BITs’ FET standard, and as the true question is to decide what substantive protection is granted to foreign investors through the FET. The issue is not one of comparing two undefined or weakly defined standards; it is to ascertain the content and define the BIT standard of fair and equitable treatment.

336. This being said, it is the view of the Tribunal that the position according to which FET is equivalent to the international minimum standard is more in line with the evolution of investment law and international law<sup>294</sup> and with the identical role assigned to FET and to the international minimum standard. The Tribunal wishes to emphasise what is, in its view, the specific role played by both the general international minimum standard and the FET standard as found in BITs. The role of these similar standards is to ensure that the treatment of foreign investments, which are protected by the national treatment and the most-favoured investors’ clauses, do not fall below a certain minimum, in case the two mentioned standards do not live up to that minimum. As stated by Ian Brownlie, “[s]ince the beginning of the present century, legal doctrine has opposed an ‘international minimum standard,’ ‘a moral standard for civilized states,’ to the principle of national treatment.”<sup>295</sup> This has been highlighted

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<sup>293</sup> *BG Group Plc v. Argentina*, UNCITRAL [hereinafter *BG*], Award of 24 December 2007, § 291.

<sup>294</sup> Although this is not applicable to our case, one may note that in the FTA between the United States and Chile it was held that the fair and equitable treatment and full protection and security standards included in Article 10(4) and Chapter 10 on Investments “do not require treatment in addition to or beyond that which is required by that standard, and do not create additional substantive rights.” Free Trade Agreement between Chile and the United States of 6 June 2003, Article 10.4(2).

<sup>295</sup> Ian Brownlie, *Principles of Public International Law*, 4<sup>th</sup> ed., Oxford, Clarendon Press, 1990, p. 524.

already in two arbitral awards. In *Genin*, it was asserted by the tribunal that, under international law, this requirement is generally understood to “provide a basic and general standard which is detached from the host State’s domestic law.”<sup>296</sup> Then, in *Saluka*, the same idea was elaborated on:

“ ... the ‘fair and equitable treatment’ standard requires the Contracting States to accord to foreign investors treatment which does not fall below a certain minimum, this minimum being in any case detached from any lower minimum standard of treatment that may prevail in the domestic laws of the Contracting States.”<sup>297</sup>

337. In conclusion, it is the Tribunal’s view that the FET is not to be viewed with reference to national law – in which case it could be lower than required by international law – but has to be interpreted with reference to international law, the result being that it cannot go below what is required by international law, which is the standard to be applied. But if national law or the treatment accorded to some foreigners exceeds this minimum international standard, it is one of the former that has to be applied. In a sense, it could be said that the foreign investor is entitled to the most favourable treatment, be it national law, rules applied to some foreigners or the international minimum standard embodied in FET. The Tribunal thus considers that the FET of the BIT is the international minimum standard required by international law, regardless of the protection afforded by the national legal orders.

*(ii) The Content and Scope of Fair and Equitable Treatment*

338. The true problem is in fact to establish the content and scope of the FET. In most BITs the term “fair and equitable treatment” is not defined. Pursuant to the 1969 Vienna Convention on the Law of Treaties, a treaty is to be interpreted “in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose.” At the

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<sup>296</sup> *Genin*, *supra* note 128, § 367.

<sup>297</sup> *Saluka*, *supra* note 163, § 295.

outset, the Tribunal wishes to cite a general comment made by the *ad hoc* Annulment Committee in the *CMS* case,<sup>298</sup> with which it cannot but agree fully:

“The Committee would only note that the fair and equitable standard has been invoked in a great number of cases brought to ICSID arbitration and that there is some variation in the practice of arbitral tribunals in this respect.”

339. The Tribunal can also agree with a general description of the FET given by the Claimant in its Memorial in the following citation, although it cannot approve all aspects of this standard as they are presented later in the same submission, quoted in paragraph 328 of this Award:

“The contours of fair and equitable treatment have gradually come into focus in the past few years. It has become clear that the basic touchstone of fair and equitable treatment is to be found in the legitimate and reasonable expectations of the parties, which derive from the obligation of good faith.”<sup>299</sup>

340. Within this general acceptable definition, some tribunals have however extended the scope of the FET to a point where, according to this Tribunal, the sovereign power of the State to regulate its economy is negated, as will be developed below.

### 3. *The Different Conceptions Used by Arbitral Tribunals*

341. One of the broadest conceptions of FET is that the State has *a duty to adopt a proactive behaviour in favour of the foreign investment*. This has been stated for example in the case of *MTD*, where the tribunal, although referring to *Tecmed*, seems to have even expanded on it, when it said:

“In terms of the BIT, fair and equitable treatment should be understood to be treatment in an even-handed and just manner, conducive to fostering the promotion of foreign investment. Its terms are framed as a proactive statement – ‘to promote,’ ‘to create,’ ‘to stimulate’ – rather

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<sup>298</sup> *CMS*, *supra* note 48, Decision on Annulment, footnote 86.

<sup>299</sup> Memorial, § 506.

than prescriptions for a passive behavior of the State or avoidance of prejudicial conduct to the investors.”<sup>300</sup>

342. Sometimes, the description of what FET implies looks like *a programme of good governance that no State in the world is capable of guaranteeing at all times*. The exigencies of FET have been detailed in *Tecmed* in the following manner:

“To provide to international investments treatment that does not affect the basic expectations that were taken into account by the foreign investor to make the investment. The foreign investor expects the host State to act in a consistent manner, free from ambiguity and totally transparently in its relations with the foreign investor, so that it may know beforehand any and all rules and regulations that will govern its investments, as well as the goals of the relevant policies and administrative practices or directives, to be able to plan its investment and comply with such regulations. Any and all State actions conforming to such criteria should relate not only to the guidelines, directives or requirements issued, or the resolutions approved thereunder, but also to the goals underlying such regulations. The foreign investor also expects the host State to act consistently, i.e. without arbitrarily revoking any preexisting decisions or permits issued by the state that were relied upon by the investor to assume its commitments as well as to plan and launch its commercial and business activities. The investor also expects the state to use the legal instruments that govern the actions of the investor or the investment in conformity with the function usually assigned to such instruments, and not to deprive the investor of its investment without the required compensation.”<sup>301</sup>

343. It is, according to this Tribunal, interesting to note that the *ad hoc* Annulment Committee in the *MTD* case distanced itself from the very broad definition in *Tecmed* on which the *MTD* tribunal had relied. It did so in the following terms:

“According to the Respondent, ‘the *TecMed* programme for good governance’ is extreme and does not reflect international law. The *TECMED* dictum is also subject to strenuous criticism from the Respondent’s experts, Mr. Jan Paulsson and Sir Arthur Watts ...

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<sup>300</sup> *MTD Equity Sdn. Bhd. & MTD Chile S.A. v. Republic of Chile* [hereinafter *MTD*], (ICSID Case No. ARB/01/7), Award of 25 May 2004, § 113.

<sup>301</sup> *Tecmed*, *supra* note 161, § 154.

The Committee can appreciate some aspects of these criticisms. For example the *TECMED* Tribunal's apparent reliance on the foreign investor's expectations as the source of the host State's obligations (such as the obligation to compensate for expropriation) is questionable. The obligations of the host State towards foreign investors derive from the terms of the applicable investment treaty and not from any set of expectations investors may have or claim to have."<sup>302</sup>

The *ad hoc* Committee goes on to take a closer look at the definition of FET given by the *MTD* tribunal and expresses some concerns about the scope of States' obligations under that definition:

"... a standard formulated in the terms of paragraph 113 is defensible. No doubt the extent to which a State is obliged under the fair and equitable treatment standard to be pro-active is open to debate, but that is more a question of application of the standard than it is of formulation. *In any event the emphasis in the Tribunal's formulation is on 'treatment in an even-handed and just manner.'*"<sup>303</sup>

344. Another only slightly less far-reaching conception implies that the State is under *an obligation to stabilise the legal and business framework* in which the foreign investment was made. For example, in the VAT case of *Occidental Exploration and Production Co. v. Ecuador*, the tribunal stated:

"Although fair and equitable treatment is not defined in the Treaty, the Preamble clearly records the agreement of the parties that such treatment 'is desirable in order to maintain a stable framework for investment and maximum effective utilization of economic resources.' The stability of the legal and business framework is thus an essential element of fair and equitable treatment."<sup>304</sup>

The Tribunal further stressed this point by saying that "there is certainly an obligation not to alter the legal and business environment in which the investment has been made."<sup>305</sup>

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<sup>302</sup> *MTD*, *supra* note 300, Decision on Annulment of 21 March 2007, §§ 66-67.

<sup>303</sup> *Ibid.*, § 71. Emphasis added by the Tribunal.

<sup>304</sup> *Occidental VAT Award*, *supra* note 118, § 183.

<sup>305</sup> *Ibid.*, § 185.

345. This conception was also followed by ICSID tribunals in some of the already decided Argentinian cases by relying on the Preamble in order to identify the object and purpose of the treaty. The *CMS* tribunal turned to the Preamble of the Argentina-US BIT to clarify the standard of fair and equitable treatment:

“The Treaty Preamble makes it clear, however, that one principal objective of the protection envisaged is that fair and equitable treatment is desirable ‘to maintain a stable framework for investments and maximum use of economic resources.’ There can be no doubt, therefore, that a stable legal and business environment is an essential element of fair and equitable treatment.”<sup>306</sup>

346. Similarly, the tribunal in *LG&E* referred to the Preamble of the same BIT to determine the object and purpose of FET, and concluded:

“In considering the context within which Argentina and the United States included the fair and equitable treatment standard, and its object and purpose, the Tribunal observes in the Preamble of the Treaty that the two countries agreed that ‘fair and equitable treatment of investment is desirable in order to maintain a stable framework for investment and maximum effective use of economic resources.’ . . . In light of these stated objectives, this Tribunal must conclude that stability of the legal and business framework is an essential element of fair and equitable treatment in this case . . . .”<sup>307</sup>

347. But there are also much narrower conceptions of FET, which come closer to the *Neer* test.<sup>308</sup> Such an approach, which considers that FET is only violated by *wilful bad faith behaviour of the State*, has been used by the tribunal in *Genin*:

“While the exact content of this standard is not clear, the Tribunal understands it ... [as] a *minimum* standard. Acts that would violate this minimum standard would include acts showing a wilful neglect of duty, an insufficiency of action falling far below international standards, or even subjective bad faith.”<sup>309</sup>

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<sup>306</sup> *CMS*, *supra* note 48, § 274.

<sup>307</sup> *LG&E*, *supra* note 51, § 124. It should be mentioned that if a tribunal states that, if FET is desirable in order to maintain a stable framework for investment and maximum effective use of economic resources, this implies that a stable framework is an essential element of FET, it should also be concluded that the maximum effective use of economic resources should be considered an essential element of that standard.

<sup>308</sup> *LFH Neer & Pauline Neer (USA) v. United Mexican States*, (1926) IV RIAA 60.

<sup>309</sup> *Genin*, *supra* note 128, § 367.

348. As can be seen, there is a broad range of conceptions of FET emerging from ICSID case-law. However, the legitimate expectations of the investors have generally been considered central in the definition of FET, whatever its scope. There is an overwhelming trend to consider the touchstone of fair and equitable treatment to be found in the legitimate and reasonable expectations of the Parties, which derive from the obligation of good faith. This has been aptly stated by the tribunal in *Waste Management II*: “In applying this standard it is relevant that the treatment is in breach of representations made by the host State which were reasonably relied on by the claimant.”<sup>310</sup> And the tribunal in *Saluka* reiterated the same idea, when stating: “The standard of ‘fair and equitable treatment’ is therefore closely tied to the notion of legitimate expectations which is the dominant element of that standard.”<sup>311</sup>
349. The Tribunal will now present its own understanding of this standard of protection of foreign investors.

#### 4. *The Tribunal’s Understanding of Fair and Equitable Treatment*

350. In the Tribunal’s view, if the often repeated formula to the effect that “the stability of the legal and business framework is an essential element of fair and equitable treatment” were true, legislation could never be changed: the mere enunciation of that proposition shows its irrelevance. Such a standard of behaviour, if strictly applied, is not realistic, nor is it the BITs’ purpose that States guarantee that the economic and legal conditions in which investments take place will remain unaltered *ad infinitum*. Such an outcome based on the holdings of some tribunals has been criticised by Professor Vaughan Lowe, when he analysed some of the cases based on this kind of conception, in the following terms: “The tenor of the cases suggests that it is now regarded as ‘unfair’ or ‘inequitable’ for a state to make material changes in the business environment that prevailed when the investor committed itself to its

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<sup>310</sup> *Waste Management II*, *supra* note 185, § 98.

<sup>311</sup> *Saluka*, *supra* note 163, § 302.



investment.”<sup>312</sup> The Claimant itself did accept the view that things cannot remain unaltered.

351. Indeed, in its Reply, El Paso stated that:

“Claimant does not call into question Argentina’s right to change its laws or regulations. It has never been Claimant’s position that the BIT imposes an absolute obligation not to alter the regulatory framework.”<sup>313</sup>

adding however that

“... [i]t is certainly foreseeable that a government will adapt the regulatory framework to the needs of the country. But the complete alteration of the regulatory framework in a manner that does not reasonably protect existing capital investments promoted by the government necessarily frustrates the legitimate expectations of investors.”<sup>314</sup>

352. In other words, the Tribunal cannot follow the line of cases in which fair and equitable treatment was viewed as implying the stability of the *legal* and *business framework*. Economic and legal life is by nature evolutionary.

353. Some of the specific claims of El Paso show that, if pushed to its logical consequences, this conception of FET cannot be tenable. In its Reply, the Claimant asserted the following claims:

“Claimant seeks compensation for BIT violations resulting from the abrogation and repudiation by Argentina of approximately *12 key rights* that were granted to investors (such as Claimant) under the Electricity Law, the Energy Regulatory Framework, the Hydrocarbon Regulatory Framework, and the Concessions, which include:

- a uniform Spot Price for sales of electricity to the WEM that reflect the economic costs of the system;
- the payment by electricity distributors of a uniform energy price plus transmission costs sufficient to cover

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<sup>312</sup> Memorial, § 523 citing Vaughan Lowe, “Regulation or Expropriation?”, 55 Current Legal Problems (2002), p. 447, at p. 455, Claimant’s Legal Authority No. 116.

<sup>313</sup> Reply, § 570.

<sup>314</sup> *Ibid.*, § 572.

the prevailing Spot Price;

- electricity distribution tariffs payable by end users that reflect the full cost of the energy they purchase in the WEM;
- variable costs of production (VCPs) based upon reference prices of fuel that reflect their undistorted market prices;
- natural gas distribution tariffs calculated in Dollars and natural gas distribution tariff adjustments in Dollars;
- market-driven electricity and natural gas wellhead prices;
- capacity payments during 90 hours a week of US\$ 10 per megawatt per hour (*i.e.*, US\$ 900 per week per MW);
- the right to export crude oil without prior government consent;
- exports of hydrocarbons exempt from any existing or *future* fees, duties, rights or withholdings, and no taxes, whether federal, provincial or municipal, on CAPSA's production of liquid hydrocarbons;
- the commitment of the GOA to give 12 months' prior notice before imposing restrictions on crude oil exports. In the event such restrictions are imposed, producers are entitled to receive, in respect of each production unit, a price not lower than that of crude oil in similar conditions;
- the right of hydrocarbon producers to freely sell their production and the right to freely dispose of the percentage of foreign exchange sale proceeds set forth in the relevant contract, bidding or renegotiation document, set at 70%; and
- the right to enter into electricity and hydrocarbon sale contracts with distributors, large users, marketers and refiners, and freely agree contractual terms, including price and currency."<sup>315</sup>

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<sup>315</sup> Reply, § 21. Emphasis added by the Tribunal.

354. Suffice it here to take two examples to understand why it is inconceivable that a foreign investor would benefit forever, because there is a BIT, of “capacity payments during 90 hours a week of US\$ 10 per megawatt per hour.” In the same manner, can it really be seriously contended, as the Claimant does, that the latter benefits from an internationally protected right that variable costs of production (VCPs) would be based upon reference prices for fuel that reflect their undistorted market prices, and that that right was violated because “Resolution SE 240/2003 excluded from the VPC used to determine the spot market price the cost paid by generators using more expensive liquid fuels”?<sup>316</sup>
355. The Tribunal, for its part, is inclined to accept the overwhelming jurisdictional trend mentioned above, which considers that the concept of fair and equitable treatment must be analysed with due consideration of the legitimate expectations of the Parties, but it will elaborate on the interpretation to be given to such a statement. If legitimate expectations of the foreign investors are to be taken into account at all, it has to be stressed that of course all the elements that the investors would like to rely on in order to maximise their benefits, if they are indeed expectations, cannot be considered legitimate and reasonable. The Tribunal will thus endeavour to specify what it thinks can be viewed as legitimate and reasonable expectations.

*(i) The Linkage of Fair and Equitable Treatment with Objective Legitimate and Reasonable Expectations of Foreign Investors*

356. On the one hand, if this Tribunal indeed agrees that FET can be linked to foreign investors’ legitimate and reasonable expectations, it insists, on the other hand, that these expectations, as well as their violation, have to be examined *objectively*. It must be emphasised that, as aptly stated by the *CMS* Annulment Committee,

“[a]lthough legitimate expectations might arise by reason of a course of dealing between the investor and the host State, these are not, as

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<sup>316</sup> CPHB, § 38.

such, legal obligations, though they may be relevant to the application of the fair and equitable treatment clause contained in the BIT.”<sup>317</sup>

The Tribunal considers that the notion of “legitimate expectations” is an objective concept, that it is the result of a balancing of interests and rights, and that it varies according to the context.

*(a) Legitimate Expectations Can Be Breached even in the Absence of Subjective Bad Faith of the State*

357. This means, firstly, that the Tribunal considers that a violation can be found even if there is a mere objective disregard of the rights enjoyed by the investor under the FET standard, and that such a violation does not require subjective bad faith on the part of the State. This approach of the Tribunal has been followed in several earlier arbitral awards.

In *Loewen*, the tribunal clearly explained this point:

“Neither State practice, the decisions of international tribunals nor the opinion of commentators support the view that bad faith or malicious intention is an essential element of unfair and inequitable treatment or denial of justice amounting to a breach of international justice. Manifest injustice in the sense of a lack of due process leading to an outcome which offends a sense of judicial propriety is enough, even if one applies the interpretation according to its terms.”<sup>318</sup>

Likewise, in *CMS*, the tribunal said:

“The Tribunal believes this is an objective requirement unrelated to whether the Respondent has had any deliberate intention or bad faith in adopting the measures in question. Of course, such intention and bad faith can aggravate the situation but are not an essential element of the standard.”<sup>319</sup>

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<sup>317</sup> *CMS*, *supra* note 48, Decision on Annulment, § 89.

<sup>318</sup> *The Loewen Group, Inc. and Raymond L. Loewen v. United States of America* [hereinafter *Loewen*], (ICSID Case No. ARB(AF)/98/3), Award of 26 June 2003, § 132.

<sup>319</sup> *CMS*, *supra* note 48, § 280.

This analysis was also followed in *LG&E*, where the tribunal declared that it was “not convinced that bad faith or something comparable would ever be necessary to find a violation of fair and equitable treatment.”<sup>320</sup>

*(b) Legitimate Expectations Result from a Confrontation of the Objective Expectations of Investors and the Right of the State to Regulate*

358. This means also, secondly, that legitimate expectations cannot be solely the subjective expectations of the investor, but have to correspond to the objective expectations than can be deduced from the circumstances and with due regard to the rights of the State. In other words, a balance should be established between the legitimate expectation of the foreign investor to make a fair return on its investment and the right of the host State to regulate its economy in the public interest. The *Saluka* tribunal insisted on this necessary equilibrium and concluded:

“In order to determine whether frustration of the foreign investor’s expectations was justified and reasonable, the host State’s legitimate right subsequently to regulate domestic matters in the public interest must be taken into consideration as well.”<sup>321</sup> ... “a foreign investor protected by the Treaty may in any case properly expect that the [Government] implements its policies *bona fide* by conduct that is, as far as it affects the investor’s investment, reasonably justifiable by public policies and that such conduct does not violate the requirements of consistency, transparency, even-handedness and non-discrimination.”<sup>322</sup>

In other words, an interpretation of the fair and equitable treatment standard in the light of the object and purpose of the BIT may not exclusively rely on the interests of foreign investors. The Tribunal refers here to the father of the ICSID Convention who had said that:

“The purpose of the Convention is to promote private foreign investment by improving the investment climate for investors and States alike. The drafters have taken great care to make it a balanced

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<sup>320</sup> *LG&E*, *supra* note 51, § 129.

<sup>321</sup> *Saluka*, *supra* note 163, § 305.

<sup>322</sup> *Ibid.*, § 307.

instrument *-serving the interests of the host States as well as investors.*”<sup>323</sup>

(c) *Legitimate Expectations Necessarily Vary with the Circumstances*

359. Moreover, according to this Tribunal, legitimate expectations necessarily vary with the surrounding circumstances, as stated in *Noble Ventures, Inc. v. Romania*, where the tribunal explained that:

“Although in this respect Art. II(2)(a) mirrors standard clauses in BITs and other international instruments and courts and tribunals have been concerned with violations of fair and equitable treatment standards, the question whether those standards have been violated has to be considered in the light of the circumstances of each case.”<sup>324</sup>

360. It has thus been recognised that legitimate expectations might differ between an economy in transition such as that of Ukraine and a more developed one. As the tribunal in *Generation Ukraine v. Ukraine* pointed out:

“The Claimant was attracted to the Ukraine because of the possibility of earning a rate of return on its capital in significant excess to the other investment opportunities in more developed economies. The Claimant thus invested in the Ukraine on notice of both the prospects and the potential pitfalls.”<sup>325</sup>

361. It was also observed by a tribunal that an investor cannot pretend to have legitimate expectations of stability of environmental regulations in a State such as California, where concern for the protection of the environment and of sustainable development are high:

“Methanex entered a political economy in which it was widely known, if not notorious, that governmental environmental and health protection institutions at the federal and state level, operating under the vigilant eyes of the media, interested corporations, non-governmental organizations and a politically active electorate, continuously

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<sup>323</sup> Aron Broches, “The Convention on the Settlement of Investment Disputes between States and Nationals of Other States”, 136 *Collected Courses, Hague Academy of International Law*, (1972-II) at p. 335 and p.348. Emphasis added by the Tribunal.

<sup>324</sup> *Noble Ventures, supra* note 158, § 181. See also, *Waste Management II, supra* note 185, § 99; “... the standard is to some extent a flexible one which must be adapted to the circumstances of each case.”

<sup>325</sup> *Generation Ukraine Inc. v. Ukraine* [hereinafter *Generation Ukraine*], (ICSID case No. ARB/00/9), Award of 16 September 2003, § 20.37.

monitored the use and impact of chemical compounds and commonly prohibited or restricted the use of some of those compounds for environmental and/or health reasons. Indeed, the very market for MTBE in the United States was the result of precisely this regulatory process. Methanex appreciated that the process of regulation in the United States involved wide participation of industry groups, non-governmental organizations, academics and other individuals, many of these actors deploying lobbyists. Methanex itself deployed lobbyists. Mr Wright, Methanex's witness, described himself as the government relations officer of the company ... Methanex entered the United States market aware of and actively participating in this process. It did not enter the United States market because of special representations made to it.”<sup>326</sup>

362. More recently, the tribunal in *Continental* insisted on the importance of taking account of circumstances when evaluating a violation of FET:

“ ... the content of the obligation incumbent upon the host State to treat a foreign investor in a fair and equitable manner, even when applicable ‘at all times’ as specified in Art. II(2)(a) of the BIT, varies in part depending on the circumstances in which the standard is invoked: the concept of fairness being inherently related to *keeping justice in variable factual contexts*.”<sup>327</sup>

363. It is this Tribunal's view that, if the circumstances change completely, any reasonable investor should expect that the law also would drastically change. It is reasonable to foresee that a small change in circumstances might entail minor changes in the law, while a complete change might entail major changes in the law. This has been underscored by the Iran-US Claims Tribunal in *Starrett*:

“... investors in Iran, like investors in all other countries, have to assume a risk that the country might experience strikes, lock-outs, disturbances, changes of the economic and political system and even revolution. That any of these risks materialized does not necessarily mean that property rights affected by such events can be deemed to have been taken.”<sup>328</sup>

364. In sum, the Tribunal considers that FET is linked to the objective reasonable legitimate expectations of the investors and that these have to be evaluated

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<sup>326</sup> *Methanex*, *supra* note 174, § 9 of Part IV - Chapter D.

<sup>327</sup> *Continental*, *supra* note 150, § 255. Emphasis added by the Tribunal.

<sup>328</sup> *Starrett Housing Corporation v. Islamic Republic of Iran* [hereinafter *Starrett v. Iran*], 4 Iran-U.S. Cl. Trib. Rep. 122, 154 (1983), 156.

considering all circumstances. As a consequence, *the legitimate expectations of a foreign investor can only be examined by having due regard to the general proposition that the State should not unreasonably modify the legal framework or modify it in contradiction with a specific commitment not to do so*, as will be shown below.

*(ii) The Definition of Fair and Equitable Treatment*

*(a) Fair and Equitable Treatment Implies that there Is No Unreasonable or Unjustified Modification of the Legal Framework*<sup>329</sup>

365. A preliminary point to be emphasised by the Tribunal is that, despite the standard reference to “the stability of the legal and business framework,” this cannot mean that when concluding a BIT a State gives any guaranty to foreigners concerning its economic health and the maintenance of the economic conditions for business prevailing at the time of the investment. This Tribunal shares the views of the tribunal in *Saluka*, which stated that

“ ... while it subscribes to the general thrust of these and similar statements [referring to the stability of the business and legal framework], it may be that, if their terms were to be taken too literally, they would impose upon host States obligations which would be inappropriate and unrealistic.”<sup>330</sup>

366. Firstly, *economic stability* cannot be a legitimate expectation of any economic actor, as stated quite clearly at the beginning of the last century by the Permanent Court of International Justice (PCIJ), whose *dictum* still rings true today:

“No enterprise – least of all a commercial or transport enterprise, the success of which is dependent on the fluctuating level of prices and rates – can escape from the changes and hazards resulting from general economic conditions. Some industries may be able to make large

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<sup>329</sup> See Christoph Schreuer, for whom the FET “is not absolute and does not amount to a requirement for the host state to freeze its legal system for the investor’s benefit. A general stabilization requirement would go beyond what the investor can legitimately expect. It is clear that a reasonable evolution of the host state’s law is part of the environment with which investors must contend.” “Fair and Equitable Treatment in Arbitral Practice”, 6, *Journal of World Investment & Trade*, 357, at 374 (2005).

<sup>330</sup> *Saluka*, *supra* note 163, § 304.



profits during a period of general prosperity, or else by taking advantage of a treaty of commerce or of an alteration in customs duties; but they are also exposed to the danger of ruin or extinction if circumstances change.”<sup>331</sup>

367. Secondly, it is inconceivable that any State would accept that, because it has entered into BITs, it can no longer modify pieces of legislation which might have a negative impact on foreign investors, in order to deal with modified economic conditions and must guarantee absolute *legal stability*.

368. In the Tribunal’s understanding, FET cannot be designed to ensure the immutability of the legal order, the economic world and the social universe and play the role assumed by stabilisation clauses specifically granted to foreign investors with whom the State has signed investment agreements. The same approach was followed recently by the ICSID tribunal in *Parkerings*:

“It is each State’s undeniable right and privilege to exercise its sovereign legislative power. A State has the right to enact, modify or cancel a law at its own discretion. Save for the existence of an agreement, in the form of a stabilisation clause or otherwise, there is nothing objectionable about the amendment brought to the regulatory framework existing at the time an investor made its investment.”<sup>332</sup>

369. It will be noted, that in the two cases mentioned earlier (in §§ 345-346), the reference to the Preamble said that its object and purpose was to maintain “a stable framework for investment and maximum effective use of economic resources;” however, in determining what these purposes implied for the interpretation of FET, the tribunals in these two cases only retained the first purpose, in order to conclude that a stable legal and business environment is an essential element of fair and equitable treatment, without taking into account the goal that any State has to pursue as well, which is to guarantee to its population maximum effective use of its economic resources.

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<sup>331</sup> *Oscar Chinn (United Kingdom v. Belgium)* [hereinafter *Oscar Chinn*], Judgement of 12 December 1934, 1934 P.C.I.J. Rep., Serie A/B, No. 63, p. 88.

<sup>332</sup> *Parkerings-Compagniet AS v. Republic of Lithuania* [hereinafter *Parkerings*], (ICSID Case No. ARB/05/8), Award of 11 September 2007, § 332.

370. The idea that the foreign investor is not protected against reasonable changes was also put forward by the tribunal in the Argentinian case *Continental*, where it was stated that “the fair and equitable standard is aimed at assuring that the normal law-abiding conduct of the business activity by the foreign investor is not hampered without good reasons by the host government and other authorities.”<sup>333</sup>

371. The State has to be able to make the reasonable changes called for by the circumstances and cannot be considered to have accepted a freeze on the evolution of its legal system. This has indeed been acknowledged by the tribunal in *CMS*, but mainly as a general statement of principle with no legal practical consequences on the settlement of the case:

“It is not a question of whether the legal framework might need to be frozen as it can always evolve and be adapted to changing circumstances, but neither is it a question of whether the framework can be dispensed with altogether when specific commitments to the contrary have been made. The law of foreign investment and its protection has been developed with the specific objective of avoiding such adverse legal effects.”<sup>334</sup>

The same point concerning a State’s regulatory power was made in *Enron*, where the tribunal noted “that the stabilisation requirement does not mean the freezing of the legal system or the disappearance of the regulatory power of the State.”<sup>335</sup>

372. Under a FET clause, a foreign investor can expect that the rules will not be changed without justification of an economic, social or other nature. Conversely, it is unthinkable that a State could make a general commitment to all foreign investors never to change its legislation whatever the circumstances, and it would be unreasonable for an investor to rely on such a freeze. This point was also made by the tribunal in *Continental*:

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<sup>333</sup> *Continental*, *supra* note 150, § 254.

<sup>334</sup> *CMS*, *supra* note 48, § 277.

<sup>335</sup> *Enron*, *supra* note 52, § 261.

“ ... it would be unconscionable for a country to promise not to change its legislation as time and needs change, or even more to tie its hands by such a kind of stipulation in case a crisis of any type or origin arose. Such an implication as to stability in the BIT’s Preamble would be contrary to an effective interpretation of the Treaty; reliance on such an implication by a foreign investor would be misplaced and, indeed, unreasonable.”<sup>336</sup>

373. In other words, fair and equitable treatment is a standard entailing reasonableness and proportionality. It ensures basically that the foreign investor is not unjustly treated, with due regard to all surrounding circumstances. FET is a means to guarantee justice to foreign investors.<sup>337</sup>

374. There can be no legitimate expectation for anyone that the legal framework will remain unchanged in the face of an extremely severe economic crisis. No reasonable investor can have such an expectation unless very specific commitments have been made towards it or unless the alteration of the legal framework is total.

*(b) Fair and Equitable Treatment Implies that there Is No Modification of the Legal Framework when Contrary Specific Commitments Have Been Made towards the Investor*

375. A reasonable general regulation can be considered a violation of the FET standard if it violates a specific commitment towards the investor. The Tribunal considers that a special commitment by the State towards an investor provides the latter with a certain protection against changes in the legislation, but it needs to discuss more thoroughly the concept of “specific commitments.” In the Tribunal’s view, no general definition of what constitutes a specific commitment can be given, as all depends on the circumstances. However, it seems that two types of commitments might be considered “specific”: those

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<sup>336</sup> *Continental*, *supra* note 150, § 258.

<sup>337</sup> The same idea is expressed in *PSEG Global, Inc., The North American Coal Corporation, and Konya Ingin Elektrik Uretim ve Ticaret Limited Sirketi v. Republic of Turkey*, [hereinafter PSEG], (ICSID Case No. ARB/02/5), Award of 19 January 2007, § 239: “Because the role of fair and equitable treatment changes from case to case, it is sometimes not as precise as would be desirable. Yet, it clearly does allow for justice to be done in the absence of the more traditional breaches of international law standards.”

specific as to their addressee and those specific regarding their object and purpose.

376. First, in order to prevent a change in regulations being applied to an investor or certain behaviour of the State, there can indeed exist *specific commitments directly made to the investor* – for example in a contract or in a letter of intent, or even through a specific promise in a person-to-person business meeting – and not simply general statements in treaties or legislation which, because of their nature of general regulations, can evolve. The important aspect of the commitment is not so much that it is legally binding – which usually gives rise to some sort of responsibility if it is violated without a need to refer to FET – but that it contains a specific commitment directly made to the investor, on which the latter has relied.
377. Second, a commitment can be considered specific if its *precise object was to give a real guarantee of stability to the investor*. Usually general texts cannot contain such commitments, as there is no guarantee that they will not be modified in due course. However, a reiteration of the same type of commitment in different types of general statements could, considering the circumstances, amount to a specific behaviour of the State, the object and purpose of which is to give the investor a guarantee on which it can justifiably rely.<sup>338</sup>
378. The tribunal in *Continental* addressed the question of what can be considered a special commitment giving “reasonable legitimate expectations” to the foreign investor with care and insight. It insisted on “the specificity of the undertaking” that can give rise to reasonable legal expectations, and for that purpose distinguished:<sup>339</sup>

- Political statements which can – “regrettably but notoriously” says the tribunal – create no legal expectations;

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<sup>338</sup> These two aspects seem to have been implicitly taken into account in *Continental*, *supra* note 150, where the tribunal examined both general legislation and contractual commitments, both capable of giving rise to some expectations, the force of which would depend on the circumstances.

<sup>339</sup> *Continental*, *supra* note 150, § 261.

- general legislative statements which “engender reduced expectations;”
- contractual undertakings by governments which can create more legitimate expectations and “deserve clearly more scrutiny,” as “they generate as a rule legal rights and therefore expectations of compliance.” But even there, the tribunal says, whether the FET standard has been violated will depend on “the context, reasons and effect” of the unilateral modification.

379. The Tribunal will follow the same logic for deciding whether El Paso can be considered to have had legitimate expectations that the Regulatory Frameworks for oil and electricity would not be modified during the full course of its investment. It considers that special commitments have to be carefully analysed as a coherent behaviour from the State, the purpose of which was to have the foreign investor expect that it would be protected against overly drastic changes.

#### F. THE TRIBUNAL’S APPLICATION OF THE FAIR AND EQUITABLE TREATMENT STANDARD TO THE FACTS OF THE CASE

380. Before the end of the 1990s, the Argentinian economy was mainly State-owned or -controlled: in the Electricity Sector, thermal and hydroelectric generating facilities, transmission lines and the most important electricity distribution utilities were all controlled by State-owned companies; and in the Oil and Gas Sector, approximately 95% of the exploration and production of crude oil and gas were carried out by Yacimientos Petrolíferos Fiscales (YPF), a State-owned company. This scheme was modified at the end of the 1990s, in both sectors, to deregulate the market and to attract foreign investors. The legal framework adopted at the end of the 1990s in both sectors was modified during the Argentinian economic crisis. It is precisely the measures adopted then by Argentina that are impugned by the Claimant as a breach of its right to fair and equitable treatment under the BIT.

##### *1. The Parties’ Positions*

###### *(i) The Violation of the Fair and Equitable Treatment Standard by the*

*Measures Enacted in the Electricity Sector*

381. The Electricity Sector was reorganised in 1989. In that Sector, as stated in the Request for Arbitration,

“[g]eneration was reorganized as a competitive market, in which independent generators, such as CAPEX and Costanera, could sell the power that they produce both in the spot market and under bilateral contracts in the term market.”<sup>340</sup>

The Claimant explained that “[a] competitive market known as the Wholesale Electricity Market (the WEM) was established so that generators could sell the power that they produced.”<sup>341</sup> This did not mean, however, that the Government which, before the structural reforms of the electricity market in the 1990s, owned and operated the generation, transmission and distribution sectors in a vertically integrated organisation, did not keep some important regulatory powers in such a sensitive sector. The existence of these powers is duly acknowledged by El Paso in its Memorial:

“The structure of the Electricity Regulatory Framework was established through three interrelated agencies. The first agency is the Secretariat of Energy (“SE”), a governmental body with authority to issue rules and regulations to implement the Electricity Regulatory Framework. The SE governs the technical and economic dispatch of the WEM. It also sets the Seasonal Prices for the distribution companies based on calculations made by CAMMESA.

Second, the scheduling and physical dispatch of the generating units and management of the WEM is carried out by CAMMESA, an entity that was intended to be quasi-independent from the Government (although the Energy Secretariat always maintained veto power over CAMMESA) and represents all agents of the WEM.

Third, the Ente Nacional Regulador de la Electricidad (“ENRE”) was created as an independent governmental body of the GOA with both regulatory and jurisdictional power over the power industry. These

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<sup>340</sup> Request for Arbitration, § 36.

<sup>341</sup> *Ibid.*, § 107.

last two bodies were created as part of the new regulatory framework.”<sup>342</sup>

The main features of the electricity market established at the end of the 90s were: payments based on Spot Prices based on variable costs of production (VCP, expressed in dollars), favouring the most efficient actors and payments based on freely negotiated contracts denominated in dollars, plus capacity payments in dollars to induce investors to upgrade the system.

382. The Claimant considers that the changes introduced at the end of 2001 and the beginning of 2002 to cope with the crisis transformed the existing system into a completely different one. This amounted to unfair and inequitable treatment of the economic actors in the electricity market:

“In summary, through several laws, decrees and resolutions, the GOA has severely and unfairly intervened into a competitive market, distorting a previously established set of rules in a manner that interferes with El Paso’s legitimate and reasonable expectations, depriving it of duly acquired rights.”<sup>343</sup>

More specifically, El Paso claims that it had a legitimate expectation that the devaluation would have no effect on the capacity payments:

“Since the Electricity Regulatory Framework set capacity payments in Dollars, and since such capacity payments were designed to encourage investments and ensure adequate levels of generation capacity availability, investors also had legitimate expectations that *if a devaluation of the Peso occurred, capacity payments would be kept in Dollars at their original value* or, alternatively, adjusted in Pesos proportionally to the devaluation. Since investment costs are essentially and foreseeably incurred in foreign currency, a devaluation of the Peso should not change their Dollar value.”<sup>344</sup>

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<sup>342</sup> Memorial, §§ 118-120.

<sup>343</sup> Memorial, § 322.

<sup>344</sup> *Ibid.*, § 153. Emphasis added by the Tribunal.

More generally, El Paso claims that there had been assurances that “the variables impacting its business were not dependent on changes in the foreign exchange policy.”<sup>345</sup>

383. The Respondent insists on the fact that, although deregulated, the electricity market was subject to the State’s regulatory power, as was indeed acknowledged by the Claimant:

“The generation of electric power is a considerably deregulated activity that is carried out within the context of a regulatory structure that has been modified since the creation of the WEM, while the Executive Branch has not assumed any commitment not to amend such regulations.”<sup>346</sup>

As a result, Argentina contends that El Paso had no “right not to have the electric power generation system changed or adjusted, and no right not to be subject to the general pesification of the Argentine economy.”<sup>347</sup> According to the GOA, El Paso “cannot invoke a right not to have WEM regulations changed because that was an intrinsic characteristic of the sector.”<sup>348</sup> To illustrate this statement, it has indicated in its Counter-Memorial that, from their creation to the enactment of the Emergency Law in January 2002, the procedures in the WEM had already been modified many times. According to Argentina:

“Since the enactment of the Electricity Law in 1991, the Energy Department Secretary issued several resolutions that modified the WEM operation. For instance, the Energy Department modified the available capacity payment in 1992 and the method to calculate the spot price in 1995, among many other amendments. In 2001, before the crisis, the Argentine Executive Branch issued a presidential decree that also introduced significant changes to the sector.

... In late 2001, when the crisis began, the Procedures had already been modified by the Energy Department 131 times.”<sup>349</sup>

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<sup>345</sup> *Ibid.*, § 157.

<sup>346</sup> Counter-Memorial, § 259.

<sup>347</sup> *Ibid.*, § 266.

<sup>348</sup> *Ibid.*, § 270.

<sup>349</sup> *Ibid.*, §§ 271 and 273.



This leads the Respondent to the conclusion that “the legitimate expectations of any investor entering the market had to include the true possibility of changes and amendments to the Procedures.”<sup>350</sup>

*(ii) The Violation of the Fair and Equitable Treatment Standard by the Measures Enacted in the Oil and Gas Sector*

384. In the Oil and Gas Sector, the Claimant explains that, at the end of the 90s, private companies were allowed to conduct operations in new and unexplored areas as well as in those oil fields that had been exploited only by YPF, and could freely own and sell their production, either locally or abroad, due to the abolition of hydrocarbon import/export restrictions and the elimination of duties and withholdings on exports and imports of hydrocarbons guaranteed to them. El Paso complains about some restrictions on exports but mainly about the withholding taxes on exports, relying in particular on Article 3 of Decree 1589/1989 providing that “[e]xports of hydrocarbons shall be exempt from any existing or future fees, duties, rights or withholdings” and on Article 403 of Law 12,161 prescribing that “except for royalties, no other taxes, whether federal, provincial or municipal, shall be imposed on the production of liquid hydrocarbons.” Moreover, the Claimant considers that its right to dollar-denominated purchase and sale agreements was violated by the mandatory pesification at the artificial and confiscatory exchange rate of US\$ 1 = 1 Peso.
385. The Respondent, for its part, holds that none of the rights invoked by El Paso existed, and that the oil and gas Framework implied a right of the State to regulate the market in the general public interest. The GOA asserts that there is no right to the non-application of restrictions on oil and gas exports, no right to the non-creation of export duties, and no right for anyone to be excluded from the effects of the *pesification* of the whole Argentine economy.
386. Concerning the *general regulatory power*, the Government retained, as it did in the Electricity Sector, some regulatory powers: for example, according to

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<sup>350</sup> *Ibid.*, § 276.

Article 6 of Decree 1589/1989, it could impose restrictions on crude oil exports, on twelve-month prior notice. It is also provided in the Hydrocarbons Law of 1967 that the concessionaires shall own the oil and gas they extract and may transport, market, industrialise and trade the related derivatives, “in compliance with such regulations as the Executive Branch may issue, on reasonable technical-economic bases that consider the needs of the domestic market and seek to encourage oil and gas exploration and exploitation.”<sup>351</sup>

387. As far as *exports* are concerned, the Respondent explains that,

“[a]s the primary aim of the oil policy is to supply the Argentine market, oil and gas exports are subject to self-supply, the application of reasonable prices and the Executive Branch’s prior authorization.”<sup>352</sup>

Indeed, Section 6 §4.4 of the Hydrocarbons Law provides:

“The Executive Branch shall allow exporting oil and gas or derivatives not required to satisfy adequately domestic needs, provided that these exports are made at reasonable commercial prices and, in that case, the criteria that shall govern the domestic market operations may be established to allow all producers in the country to participate therein on a rational and equitable basis.”

388. As for *withholdings* on exports, Argentina explains that whether one looks at the Mining Code or the Hydrocarbons Law applicable to CAPSA’s concessions, or at the Presidential Decree No. 43/91 of 7 January 1991 granting CAPEX its concession, as well as the different regulatory decrees, there was no vested right to tax stabilisation, the State having explicitly retained its fiscal regulation power towards both companies.

389. Finally, as far as *pesification* is concerned, the Respondent considers that, on the one hand, the crude oil producers and refiners voluntarily adjusted their contracts to the new context and that, on the other hand, and in any case, the Argentinian companies benefited from the pesification process.

## 2. *The Tribunal’s Analysis: General Approach*

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<sup>351</sup> Hydrocarbons Law, 1967, section 6 § 1.

<sup>352</sup> Counter-Memorial, § 353.

390. The Tribunal does not doubt that

“[t]he legal rights granted by the Government of Argentina through the Electricity Regulatory Framework, the Hydrocarbons Regulatory Framework and the BIT were very important to El Paso’s decision to invest in Argentina,”<sup>353</sup>

but this does not *ipso facto* grant El Paso a right to have this framework unaltered throughout the years, whatever the economic circumstances. The Claimant does not seem to question the sovereign right of a government to adopt new rules; in its Reply, the Claimant acknowledges that “[o]f course, the Government can alter its laws and regulations at any time in the public interest,”<sup>354</sup> but adds immediately that “there are and must be some limits.”<sup>355</sup> And El Paso indeed finds that Argentina’s measures go beyond the limits authorised by the BIT: in its view, the decisions and regulations in issue did not result from a normal exercise of regulatory powers but, in reality, were measures that brought a radical alteration of key rules, effectively eviscerated the existing regulatory frameworks, and therefore exceeded normal regulatory powers. This emerges, for example, from the following passage in its Memorial: “... the totality of the GOA’s actions has radically changed the regulatory regime so that the electricity generators are forced to suffer the consequences of the Argentine crisis.”<sup>356</sup> But why and on what legal basis should El Paso have been immune from the severe economic crisis faced by Argentina at the end of 2001? The Respondent asserts that it adopted reasonable measures to deal with the serious economic circumstances prevailing at the end of 2001 and insists that, knowing the economic history of Argentina, El Paso could not have had reasonable expectations of guaranteed stability of all the parameters in place when it decided on its investment:

“When the Claimant invested in the oil and electric power industries in Argentina, it knew that such economy was under development and that

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<sup>353</sup> Memorial, § 201.

<sup>354</sup> Reply, § 4.

<sup>355</sup> *Ibid.*, See also *ibid.*, § 570: “Claimant does not call into question Argentina’s right to change its laws or regulations. It has never been Claimant’s position that the BIT imposes an absolute obligation not to alter the regulatory framework.”

<sup>356</sup> Memorial, § 324.

it had a long history of growth cycles followed by serious crises. Investing in these types of economies permits to obtain higher profits than in stabler economies, but there are also higher risks. The Claimant was aware of these advantages and risks.”<sup>357</sup>

The Claimant mentions that, in order to promote investments in the Electricity Sector and to explain the Regulatory Framework, the Government had organised road shows, conferences and seminars to explain the main features of the Framework and to give assurance to investors that their rights would be protected.

391. The Tribunal will try to ascertain what El Paso could reasonably have expected when it decided to invest in Argentina and whether there were any commitments on the part of that State not to change the basic tenets of the Regulatory Frameworks put in place.
392. At the beginning of the 1990s, the GOA aggressively targeted foreign investors and conducted several road shows in the United States, Europe and Southeast Asia to promote privatisation; US investors were the focal points of these trips. The Claimant asserts that strong legal value should be attached to such unilateral declarations of Argentina, comparing them to those made by France in the *Nuclear Tests* cases<sup>358</sup> between Australia and New Zealand, on the one hand, and France, on the other, where France in her pleadings, had presented unilateral declarations before the World Court and the ICJ had concluded that these declarations created binding obligations for France. It is the Tribunal’s view, however, that what is involved here are two totally different types of unilateral declarations – one made before the highest judicial body in the world, the other in commercial meetings – and that no lesson can be drawn from the *Nuclear Tests* cases to give legal weight to investment-promoting road shows. In the Tribunal’s view, such political and commercial incitements cannot be equated with commitments capable of creating reasonable expectations protected by the international mechanism of the BIT.

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<sup>357</sup> Counter-Memorial, § 644.

<sup>358</sup> *Nuclear Tests* cases (*Australia v. France*), Judgment of 20 December 1974, ICJ Reports 1974, p. 253.

393. The Tribunal will next consider the position of the Claimant, which has laid much emphasis on legal or political representations made to foreign investors and attesting to the good intentions of the GOA regarding the stability of its regulations. Statements contained in Argentina's legislation or made by the President of the Republic as the country's highest authority were relied on by the Claimant, especially:

- the preamble of Decree No. 1589/1989, which stated that the Decree had been enacted "to set clear and definitive rules that guarantee the legal stability for the contractual arrangements in the hydrocarbon sector;"

- the message of Carlos Menem, President of the Republic, made jointly with the Minister of Economy, Domingo Cavallo, delivered at the National Congress on 13 June 1991 regarding the Electricity Regulatory Framework Law. This message asserts that the enactment of the Electricity Law "give[s] the required legal certainty to the process of transformation of the electricity sector, thus preventing the ancient lack of stability of the rules of the game."

394. The Tribunal however cannot consider that any rule or even clear commitment embodied in a general piece of legislation or regulation – as in Decree No. 1589/1989 – is in itself a special commitment towards the foreign investors,<sup>359</sup> as such a conclusion would again immobilise the legal order and prevent any adaptation to circumstances. These items might only raise reduced expectations which do not guarantee complete stability and have to be analysed in relation to other undertakings and with due regard to all circumstances.

395. Moreover, a declaration made by the President of the Republic clearly must be viewed by everyone as a political statement, and this Tribunal is aware, as is every individual, of the limited confidence that can be given to such political

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<sup>359</sup> *PSEG*, *supra* note 337, where the Tribunal said: "Legitimate expectations by definition require a promise of the administration on which the Claimants rely to assert a right that needs to be observed." § 241.

statements in all countries of the world. It might well be that these representations contributed to inducing potential investors to invest in the sectors concerned, as many of them – including El Paso – actually did. But it is one thing to be induced by political proposals to make an economic decision, and another thing to be able to rely on these proposals to claim legal guarantees.

396. The Tribunal does not consider that the GOA made a specific commitment to foreign investors not to modify the existing framework, which was designed to attract them. It seems uncontested that the Executive was endowed with broad regulatory powers over the Electricity Sector and the Oil and Gas Sector.
397. In the *Electricity Sector*, El Paso complains about the changes introduced in the WEM. The question is whether it had a legitimate expectation that such changes would never occur. The Argentinian Electric Power Sector is regulated by Laws Nos. 15,336 and 24,065 (Electricity Law), as well as by the administrative orders based thereon. According to Sections 35 and 36 of the Electricity Law, the Secretary of the Energy Department is in charge of regulating the WEM.<sup>360</sup> The Tribunal notes that Presidential Decree No. 186/95, Section 6, established that “the agents and participants of the wholesale electric market (WEM) shall operate pursuant to the regulations issued for such purpose by the Energy Department.”<sup>361</sup> As a consequence, it is clear that the Secretary of the Energy Department Secretary could introduce changes in the functioning of the WEM.
398. In other words, it is the Tribunal’s view that the legitimate expectations of any investor entering the energy market had to include the real possibility of reasonable changes and amendments to the procedures governing the WEM.
399. The same can be said of the *Oil and Gas Sector*. Section 6 of the Hydrocarbons Law of 1967 provided that concessionaires shall own the oil and gas they extract and may transport, market, industrialise and trade the related

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<sup>360</sup> See Law N° 24,065 (the “Electricity Law”), published in the Official Gazette on 16 January 1992. Claimant’s Exhibit No. 37.

<sup>361</sup> Presidential Decree 186/95 of July 25, 1995, Respondent’s Exhibit RA 43, cited in the Counter-Memorial, § 267.

derivatives, “in compliance with such regulations as the Executive Branch may issue, on reasonable technical-economic bases that consider the needs of the domestic market and seek to encourage oil and gas exploration and exploitation.” In order to meet these objectives, the Government may use any relevant tool: as asserted by the Respondent, “[t]he self-supply at reasonable prices may therefore be subject to established export quotas, export duties or other instruments that the Government may deem appropriate for the circumstances undergone by the country.”<sup>362</sup>

400. It is therefore also the view of the Tribunal that the legitimate expectations of any investor entering the oil and gas market had to include the real possibility of reasonable changes and amendments in the legal framework, made by the competent authorities within the limits of the powers conferred on them by the law.

401. As a general statement, the Tribunal agrees with the Republic of Argentina that

“[i]solating the foreign investor from the crisis through the ICSID is distorting the nature and purpose of the protection granted by treaties to investors only to turn them into privileged subjects that may appear before such World Bank agency seeking protection against structural crises as the one undergone by the Argentine economy. Bilateral treaties are not good business insurance or a protection against a crisis.”<sup>363</sup>

The same concern was expressed by Professor Ian Brownlie in his Separate Opinion on the Final Award in *CME Czech Republic B.V. v. Czech Republic*, where he stated:

“It would be strange indeed, if the outcome of acceptance of a bilateral investment treaty took the form of liabilities ‘likely to entail catastrophic repercussions for the livelihood and economic well-being of the population’ ....”<sup>364</sup>

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<sup>362</sup> *Ibid.*, § 368.

<sup>363</sup> Respondent's Counter Memorial, § 316. See also, *Maffezini*, *supra* note 127, § 64; *Azurix*, *supra* note 50, § 291.

<sup>364</sup> *CME Czech Republic B.V. v. The Czech Republic* [hereinafter *CME*], UNCITRAL, Separate Opinion on Final Award of 14 March 2003, § 78.

402. The Tribunal will thus consider whether any of the measures complained of by El Paso can be considered as adopted outside *the acceptable margin of change* that must be taken into account by any investor and therefore be characterised as unfair and inequitable treatment, before considering the issue of a possible violation of the FET standard by the accumulation of all the measures complained of. The question is therefore whether the measures adopted exceeded the normal regulatory powers of the State and violated the legitimate expectations of the Claimant.

### 3. *The Tribunal's Analysis of the Measures Adopted in the Electricity Sector*

#### *(i) General Remark*

403. It has been stated by the Tribunal that the FET standard can be breached if there is a violation of a special commitment.

404. It is a fact that El Paso never entered into any concession contract with the GOA embodying a stabilisation clause. There is no contractual relationship whatsoever with the State resulting in rights capable of being invoked by El Paso. There was no particular relationship between El Paso and the GOA before this arbitration, and no special commitment on which El Paso could reasonably rely. The legitimate expectations of any investor entering the electric power generation market of Argentina had therefore to include the possibility of changes in the procedures regulating the WEM. The Tribunal will however, for the sake of completeness, also examine whether there were any specific commitments in the concessions granted to CAPEX and CAPSA, of which El Paso was an indirect shareholder.

#### *(ii) Presentation of the Wholesale Electricity Market*

405. Power generators obtained their revenues from three main sources: (i) sales to the Spot Market at Spot Prices through the WEM; (ii) sales through the WEM to the Term Market by means of power purchase agreements (PPAs) at contractual prices; and (iii) capacity payments.



406. In the WEM, the price was determined on an hourly basis, taking into consideration the marginal cost of the least efficient generator who was dispatched at any given hour. It was fixed on an hourly basis, taking into account the (marginal) cost of generating one additional megawatt-hour (MWh) to supply such possible increase in the system's demand at that time. This price was known as the Spot Price or Market price, which could undergo significant variations from hour to hour.
407. Electricity distributors may purchase electric power at the Spot Price, but also through a stabilised (or seasonal) price system. With respect to the latter, every quarter, and based on CAMMESA's estimates, the Energy Department established in advance the seasonal energy price applicable to such period. This was the price at which distribution companies would buy in the Spot Market. The differences between both prices (hourly spot and seasonal prices) were accumulated in a special account called the Stabilisation Fund. This system benefited efficient generators since it enabled them to receive larger gross margins (that is, the difference between the Spot Price and the generator's actual variable costs of production (VCP)).

Power generators could also enter into PPAs, in which the price was freely determined. Typically, term contracts were concluded for one year and denominated in dollars.

408. In addition to the price thus received, generators were entitled to "capacity payments" which were designed to encourage investors to expand and upgrade generation facilities. These payments were mainly designed to cover the fixed costs (*i.e.* investments and financing), since the competitive energy Spot Price system basically only remunerated variable (*i.e.* operating) costs. Capacity payments were set in dollars because investment costs would essentially and foreseeably be incurred in foreign currency. Originally, these payments were

set at 5 US dollars per megawatt/capacity-compensation hour; later on, they doubled and were set at 10 dollars<sup>365</sup> before the impugned measures were taken.

409. On the basis of the Electricity Law, the electricity market was regulated by the Department of Energy. Article 35 of that Law provided:

“The Department of Energy shall determine the rules applicable to the DNDC<sup>366</sup> for the performance of its duties, which shall guarantee the transparency and fairness of decisions, according to the following principles:

...

b) To dispatch the required demand, based on the acknowledgment of prices of energy and capacity set forth in the following article, to which market players shall expressly commit, in order to be entitled to supply or receive electricity not freely agreed-upon by the parties.”

Article 36 of the Law established uniform Spot Prices for electricity generators:

“The Department of Energy shall issue a resolution containing the economic dispatch rules for energy and capacity transactions included in article 35(b) to be applied by the DNDC. Said rule shall provide that generators be paid such rate in each location of delivery as established by the DNDC for the energy sold by them, which rate shall be the same for every generator and based on the economic cost of the system.”

*(iii) Were the Measures Changing the Functioning of the WEM in Breach of the Fair and Equitable Treatment Standard?*

410. The Claimant considers that the changes introduced at the end of 2001 and at the beginning of 2002 to cope with the crisis transformed the existing deregulated system into a completely different one, amounting to unfair and inequitable treatment of the economic actors in the electricity market.

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<sup>365</sup> Resolution SE N° 61/1992, Section 2.5.2.1 of 1 May 1994.

<sup>366</sup> This is the Argentine Load Dispatch, an agency in the form of a corporation “whose majority shareholding shall be initially held by the Energy Secretariat, and where the various participants in the WEM will be entitled to hold shares.”

411. It has to be clear that the Claimant does not explicitly seek damages due to the devaluation, *i.e.* the abrogation of the Convertibility Law, but bases its claims on the consequences drawn by the Government from this abrogation in the electricity market: “The alteration of the rules governing the Spot Market cannot be attributed to the repeal of the Convertibility Law.”<sup>367</sup> However, if the issue is examined closely, it appears to the Tribunal that many of the claims are implicitly based on damage caused by devaluation more than by the regulatory measures.

412. For example, caps on Spot Prices for deficit situations have resulted in damage, not because of the cap which was set in pesos – as it always was – but because the pesos thus earned could no longer be converted into dollars at the market rate but had to be converted at the rate of one to one. The Claimant explains this quite clearly in its Memorial:

“The Energy Secretariat has also converted into Pesos, at an artificial rate of US\$1 = Arg.\$1, caps that are to be placed on the Spot Price when deficits occur due to system failures. Depending on the deficit level, the following caps have been imposed on the price of electricity in hours of unsupplied demand: Arg.\$120MW/h, Arg.\$170MW/h, Arg.\$240MW/h and Arg.\$1500MW/h. The Electricity Regulatory Framework set similar values, but in Dollars not Pesos. *As a consequence of the conversion of those Dollar values into Pesos* at an artificial rate of exchange of US\$1 = Arg.\$1, the energy payments that a power generator can receive in deficit situations have been reduced to 1/3 of their original value and are artificially low.”<sup>368</sup>

413. The mechanism of setting the Spot Price and the Seasonal Price was also altered, but the Tribunal does not consider that such changes were unfair and inequitable, as the unpaid balances due to the creditors in the electricity market were consolidated and either repaid when the Seasonal Stabilization Fund had funds available or transformed into shares of a new company or bonds payable in energy.

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<sup>367</sup> Memorial, § 241.

<sup>368</sup> *Ibid.*, § 256. Emphasis added by the Tribunal.

414. The Claimant equally complains about the exclusion of machines using liquid fuels instead of natural gas due to the shortage of the latter. But the Tribunal notes that this measure was decided in the second half of 2003. Therefore, it could not affect El Paso's investment in CAPEX since, a few months before the measure was adopted, the Claimant sold its interest in CAPSA and, consequently, also in CAPEX; and its impact on El Paso's interest in Costanera would have been minimal as that company was sold a month and a half afterwards. Such a minor change cannot amount to a violation of the FET standard.
415. More generally, according to Argentina, the new method for calculating the Spot Price was adopted in order to alleviate the problems raised by the new financial situation resulting from the devaluation:
- “The increase in periodicity, the replacement of the *reference price + 15%* method for the declaration of each VPC component (and not only the fuel price) and the consideration of the variation in the foreign exchange rate implied higher revenues for generators than the ones that would have been earned with the original mechanism.”<sup>369</sup>
416. In sum, the Tribunal cannot see in the measures taken to adapt the WEM to the new economic circumstances anything but direct consequences of the devaluation, which is not impugned as such by the Claimant, or technical adaptations of a sophisticated pricing system that did not fundamentally change its structure and its functioning. Therefore, the measures adapting the functioning of the WEM cannot be characterised, *in isolation*, as a violation of the FET standard.

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<sup>369</sup> Counter-Memorial, § 165.

*(iv) Was the Change in the Amount of Capacity Payment a Violation of the Fair and Equitable Treatment Standard?*

417. The Claimant in fact asserts a right to a 10-dollar capacity payment or its equivalent in pesos, stating that such a right was conferred on it by law,<sup>370</sup> and considers therefore that any lower amount would breach the FET standard.
418. As to the capacity payments, they were set in dollars in order to cover capital investment costs that were dollar-denominated. Thus, it can be argued that there was a kind of necessary link between the dollar value or a peso value equivalent to the dollar value, so that the foreign investors, having made their equipment investments and paid for them in dollars, could be guaranteed to recoup their investments. The question therefore is whether the change in value was such as to amount to unfair and inequitable treatment.
419. A first observation that can be made is that, contrary to the Claimant's contention, the law does not provide for capacity payments to be stated in dollars. A second observation is that if the parameters for deciding the level of the capacity payments were indeed provided by the law, no amount was fixed in it, again contrary to what the Claimant contends, and the parameters of reference left a margin of appreciation which has been used by the administration. As an indication of this necessary flexibility, it is possible to quote a Selling Memorandum emanating from the Ministry of Economy, Public Works and Utilities of the Republic of Argentina for the privatisation of the generator Hidroeléctrica Norpatagonica presented by the Claimant in its Exhibits and quoted by the Respondent in its Closing Statement:

“The Secretary of Energy is responsible for setting the capacity payment. The value of capacity has been set at US\$ 5 per MW per hour for the period from November 1, 1992 to April 30, 1994. It has been decided to increase the value of capacity to US\$ 10 per MW per

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<sup>370</sup> See expert statement by Carlos Bastos to the effect that “... the 10 dollar capacity payment is a computation provided by law.” Hearing Transcript in English, Day 5, p. 1211.

hour from April 30, 1994 and it currently is expected that the value will remain at this level over the medium term.”<sup>371</sup>

This language is by no means an indication of an immutable value, written in stone.

420. There have been many submissions and exchanges concerning the figure of 10 dollars. The Claimant’s damages expert, LECG, seems to differentiate between what a non-expropriating government could have done and what Argentina has done:

“LECG admits that the Secretary of Energy not only had the authority to modify the amount of the capacity payment but also that, within the framework of the crisis, a non-expropriatory government would have reduced such amount.”

In this respect, LECG stated:

“The changes in relative prices in the economy following the devaluation of the peso would naturally provide an opportunity for a *non-expropriatory Government* to re-examine the appropriateness of the level of capacity payments.”<sup>372</sup>

Having concluded that a *non-expropriatory government* would have reduced the levels of capacity payments, LECG affirmed that the “appropriate” level was, in 2002, a little over USD 5.<sup>373</sup> However, there is no evidence showing that this amount is more appropriate than ARS 12 (approximately USD 4). Anyhow, the Claimant’s expert itself confirmed that a capacity payment of USD 5 could not be considered expropriatory. It would thus be difficult to assert that a one-dollar difference would amount to a violation of the FET standard.

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<sup>371</sup> Respondent’s Closing Statement during the Hearing on the Merits, p. 33.

<sup>372</sup> *Damages Expert Report of Pablo T. Spiller and Manuel A. Abdala* (hereinafter LECG Report) of 18 August 2004, § 322, Claimant’s Exhibit No.12. See also *ibid.*, Graph XX; Hearing Transcript in English, Day 6, pp. 1643-1644, 1689-1691.

<sup>373</sup> LECG Report, Graph XX, Flows Sheet “Electricity Rev. CAPEX,” cell H79; Hearing Transcript in English, *id.*, pp. 1644-1646, 1689-1691.

421. The Tribunal concludes that in the new economic circumstances, a capacity payment equivalent to 4 dollars was not, *in isolation*, a violation of the FET standard.
422. In conclusion, none of the measures adopted in the electricity sector is considered by the Tribunal, *per se*, as a violation of the WEM, nor a violation of FET.

4. ***The Tribunal's Analysis of the Measures Adopted in the Oil and Gas Sector***

*(i) Presentation of the Overall Regulation of the Hydrocarbon Sector*

423. CAPSA is governed by the Mining Code first passed in 1887 and updated by Law No 12,161 enacted in 1935. CAPEX is governed by Law No. 17,319, the Hydrocarbons Law enacted in 1967, which to date governs all hydrocarbon-related activities that are not subject to the Mining Code. These two laws established the general principles and the legal system applicable to the exploration, exploitation, industrialisation, transportation and trading of oil and gas, before the reforms at the end of the 90s and the new measures adopted during the economic crisis. At the end of the 90s, the oil and gas sector was privatised and liberalised, and the monopoly of the State-owned company ended. Private entities were generally allowed to conduct operations in oil fields and could freely own and sell their production, locally or abroad. This reform, effected by the State Reform Law of 28 August 1989, was mainly enacted through what has come to be known as the “Hydrocarbon Deregulation Decrees,” *i.e.* Presidential Decrees N° 1055/1989, 1212/1989 and 1589/1989, published in the Official Gazette on 12 October 1989, 14 November 1989 and 4 January 1990.<sup>374</sup> These Decrees allow investors freely to dispose of their hydrocarbons and to export them, within the parameters of Argentina’s legislation. The scope of the rights granted and the extent of the State powers have been hotly disputed between the Parties and will be thoroughly examined by the Tribunal.

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<sup>374</sup> Presidential Decrees Nos. 1055/1989, 1212/1989 and 1589/1989 published in the Official Gazette on 12 October 1989, 14 November 1989 and 4 January 1990. Claimant’s Exhibit No. 46.

*(ii) Was the Restriction of the Right to Export Freely a Violation of the Fair and Equitable Treatment Standard?*

*(a) The Extent of the Right to Export Freely*

424. The Claimant argued that it had a vested right to dispose freely of its hydrocarbon production, including the right to export freely liquid hydrocarbons. This right has been provided for in three Deregulation Decrees, more precisely in Article 15 of Presidential Decree No. 1055/89, Articles 4 and 9 of Presidential Decree No. 1212/89, and Article 5 of Presidential Decree No. 1589/89.

425. Argentina, on the other hand, explains that

“[t]his free availability provided for by the Deregulation Decrees entailed setting aside the policy implemented by the mid-80s according to which the Argentine Government (through YPF) was the only producer enjoying the free availability of crude oil and the other producers were obliged to sell their whole production to the state.”<sup>375</sup>

According to the GOA, there is no absolute right freely to export hydrocarbons, as such exports are subject to restrictions by the Government in accordance with Article 377 of the Mining Code and Article 6 of the Hydrocarbons Law.

426. The Tribunal will examine successively the possible entitlement of the two Argentinian companies of which El Paso was a shareholder to a vested right of free availability of hydrocarbons.

427. As far as CAPSA is concerned, this right of free availability was first stated in Law No. 12,161, incorporated into the Mining Code in 1935 and into the three Deregulation Decrees mentioned above, none of which could be incorporated as contractual rights in the mining concession granted to CAPSA before 1925. This right of free availability appears not to have been considered as unlimited. Section 377 of the Mining Code expressly provides that the Executive Branch

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<sup>375</sup> Rejoinder, § 197.



may restrict or ban fluid oil and gas exports. Also, section 6 of the Hydrocarbons Law provides that:

“Permit holders and concessionaires shall be the owners of any hydrocarbons extracted by them and, as a result, they may transport, sell and industrialize them, as well as sell their by-products, in accordance with the regulations enacted by the Executive Branch, based on reasonable technical and economic considerations which shall bear in mind the best interest of the domestic market and attempt to promote the exploration and exploitation of hydrocarbons.

During periods in which the national production of liquid hydrocarbons is not enough to meet domestic needs, the use in the country of all available hydrocarbons of national origin shall be mandatory, except in cases where it is not convenient due to sufficient technical reasons. As a result, the new refineries or extensions shall adapt to the rational use of national oils.

If during such a period the Executive Branch sets the prices for selling crude oil in the domestic market, such prices shall be equal to those set for the relevant state-owned company, but not lower than the price levels for imported oils of similar characteristics. Where the prices of imported oils significantly increase due to special circumstances, they shall not be taken into consideration when fixing the sales price in the domestic market and, in that case, they may be set on the basis of the actual exploitation costs of the state-owned company, such amortization as may be technically appropriate, and a reasonable interest rate on the updated and depreciated investments made by such state-owned company. If the executive sets the prices for by-products, they shall be consistent with the oil prices calculated on the basis of the above criteria.

The Executive Branch shall allow the export of hydrocarbons or by-products which are not required for properly satisfying domestic needs, provided that such exports are carried out at reasonable commercial prices. In such case, it may establish the criteria that shall govern transactions in the domestic market, in order to allow all of the country's producers to participate in it in a reasonable and equitable manner.

The natural gas produced may be used, first, to satisfy the needs characteristic of the exploitation of the fields from which it is extracted and of other fields in the area, whether or not they belong to the concessionaire and in pursuance of the provisions of section 31. Any state-owned company providing public gas distribution services shall be given preference in the acquisition, within acceptable terms, of the amounts remaining after the abovementioned use at agreed-upon prices

which may ensure a fair return on the relevant investment, bearing in mind the specific characteristics and conditions of the field.

With the approval of the enforcement authority, the concessionaire may decide on the destination and terms of use of the gas not employed in the manner indicated above.

The sale and distribution of gaseous hydrocarbons shall be subject to the regulations enacted by the Argentine Executive Branch,”<sup>376</sup>

428. As far as CAPEX is concerned, the concession of Agua del Cajón was granted by Presidential Decree No. 43/91 in January 1991. Regarding free availability, Article 6 of that Decree establishes the following:

“The concession holder shall have the free availability of hydrocarbons produced in such area, pursuant to the provisions of Articles 6 and 94 of Law No. 17,319, Article 15 of Presidential Decree No. 1055/89, and Articles 5 and 6 of Presidential Decree No. 1589/89, *the terms of which are incorporated to this concession.*”<sup>377</sup>

429. In other words, the Hydrocarbons Law and the Deregulation Decrees apply to CAPSA as general legislation and to CAPEX as contractual commitments. Before considering whether this entails a difference in the conclusions to be reached by the Tribunal relating to the claimed violations of El Paso’s rights, the Tribunal considers it necessary to analyse the content of the rules that were incorporated in CAPEX’s concession.

Article 6 of Law 17,319 of 1967<sup>378</sup> prescribes:

“Permit holders and concessionaires shall have the ownership of the hydrocarbon which they produce, and consequently, they may transport, market and refine the same and market the products manufactured therefrom, subject to such reglamentation as may be dictated by the Executive Power upon reasonable technical and economic bases, in the benefit of the domestic market and of stimulating the exploration and exploitation of hydrocarbons.

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<sup>376</sup> Hydrocarbons Law, Respondent’s Exhibit RA 10.

<sup>377</sup> Presidential Decree No. 43/91 of 7 January 1991. Respondent’s Exhibit No. 243. Emphasis added by the Tribunal.

<sup>378</sup> Article 94 is irrelevant, as it deals with the obligations of State-owned enterprises.

...

The Executive Branch shall allow exporting oil and gas or derivatives not required to satisfy adequately domestic needs, provided that these exports are made at reasonable commercial prices and, in that case, the criteria that shall govern the domestic market operations may be established to allow all producers in the country to participate therein on a rational and equitable basis.”

The objective of satisfying the country’s need for hydrocarbons explains why Article 6 grants free disposal of the oil and gas in Argentina but, on the contrary, calls for an authorisation in case of exportation.

430. Article 15 of Presidential Decree No. 1055/89 provides that:

“Free availability of the hydrocarbons ... will be governed by the following rules:

a) They may be freely commercialized both in the domestic and foreign market *within the framework of the rules in force.*”<sup>379</sup>

Article 6 of Presidential Decree No. 1589/89 states that:

“... Concerning export restrictions. If the Executive Branch were to establish restrictions on exports of crude oil and by-products, Article 6 of Law N° 17,319 shall apply, by virtue of which producers, refiners and exporters, shall be entitled to receive per unit of production a value that is not lower than the one of petroleum and by-products of similar condition.”

The conclusion to be drawn from a reading of the rules incorporated in the CAPEX concession is that no absolute right of free availability existed but, rather, a right contingent on limitations that could be decided by the Government.

431. The Tribunal therefore concludes that CAPSA – of which El Paso was an indirect shareholder – had a right to the free disposal of its hydrocarbons recognised by law, while CAPEX – of which El Paso was also an indirect

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<sup>379</sup> Emphasis added by the Tribunal.

shareholder – had a vested right to the free disposal of its hydrocarbons, including the right to export freely, incorporated in its concession agreement, both within the framework of the rules in force. It cannot be denied that the regulatory framework in force included the Argentine Mining Code and the Hydrocarbons Law, which expressly provided for the possibility of limiting or prohibiting hydrocarbon exports to satisfy domestic needs.

*(b) Has the Right to Export Freely Been Violated?*

432. Were these rights to free disposal, respectively granted to CAPSA by law and to CAPEX by contract, violated by Argentina’s measures? It is the Tribunal’s view that the rights arising from a concession must be clearly distinguished from the rights flowing from the regulatory framework applicable to a concession.
433. Concerning CAPSA, in the Tribunal’s view, the right to export freely that was granted by law was not unrestricted. As any right, it was subject to reasonable restrictions decided by the Government for reasons of public interest, for example in order to satisfy the domestic market. This was provided for by Article 377 of the Mining Code of 1887, incorporated in Law 12,161 of 1 April 1935, applicable to CAPSA’s concessions:

“The Executive Branch *may restrict or ban the import or export of fluid oil and gas when, in urgency cases, this is advisable for public interests reasons, which shall be reported, when appropriate, to Congress.*”<sup>380</sup>

434. The Hydrocarbons Law No 17,319 of 30 June 1967 also ensured the power of the Government to regulate the Hydrocarbon Sector in all aspects. Article 2 provides:

“Activities related to exploration, exploitation, manufacturing, transportation and marketing of hydrocarbons shall be entrusted to State-owned enterprises, and private or mixed enterprises, in accordance with the rulings of this present law and with any relevant relementation that may be dictated by the Executive power.”

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<sup>380</sup> Emphasis added by the Tribunal.

Nothing is said in this Article about free disposal, but there is a clear insistence on the fact that all activities entrusted to concessionaires in the field of hydrocarbons will be subject to that Law and to any future executive regulation.

Along the same line, Article 3 of Law No 17,319 prescribes:

“The National Executive Power shall establish the national policy of the activities mentioned in the preceding Article 2, in deference to the primordial objective of satisfying the country’s need for hydrocarbons with the output from the country’s natural deposits.”

435. According to this Tribunal, it is only if the regulations were unreasonable, for example not adapted to the purpose of satisfying the national market, that a violation could be found. The Tribunal, however, does not consider it necessary to examine the issue of the reasonableness of the measures adopted, for reasons that will shortly be explained.
436. The question which has to be asked is whether a somewhat different analysis is needed of the right to export freely granted by Argentina to CAPEX in the concession agreement. The answer must be in the negative, as the texts granting powers of regulation to the State were also incorporated in the concession.
437. Irrespective of whether the right of free disposal was granted by law or incorporated in a contract, the Tribunal does not deem it necessary to examine the question of a possible violation of the FET standard, since the restrictions on crude oil export were effective for less than 60 days.<sup>381</sup> More precisely, during the first half of 2002, it was noted that there might be problems to supply the domestic market with hydrocarbons. Therefore, the President of Argentina issued Presidential Decree No. 867/2002 on 23 May 2002 adopting certain measures to regulate the export of oil and gas:

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<sup>381</sup> Resolution SE 341/02, 26 July 2002, published in the Official Gazette No. 29,951, 30 July 2002. Respondent’s Exhibit No. 124.

“It declared the emergency in the oil and gas supply in the whole Argentine territory until 30 September 2002”<sup>382</sup>

“It empowered the Energy Department ... to determine the domestic production volume of crude oil and LPG that should be used to supply the domestic market.”<sup>383</sup>

Moreover, in June 2002, the Energy Department imposed certain limitations on the export of crude oil to ensure domestic supply.<sup>384</sup> Twenty-three days afterwards, these measures became more flexible.<sup>385</sup> Less than sixty days after the measures had been taken, on 25 July 2002, they were abrogated.<sup>386</sup> The limitations on the exports of crude oil lasted only from 30 May to 31 July 2002.

438. The Tribunal notes – and this confirms its analysis – that in the recitals of Presidential Decree No. 867/02, in which a state of emergency regarding hydrocarbons supply was declared throughout the Republic of Argentina, the following was stated:

“This measure does not impair the essence of the right to freely dispose, *i.e.* the right of producers to dispose of the product at freely agreed upon price, in the domestic and foreign market, and in the latter case, in compliance with the provisions of Article 6 of Law No. 17,319.”

439. The Tribunal considers that the short-term restrictions on the right freely to export hydrocarbons cannot amount, *in isolation*, to a violation of the FET standard.

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<sup>382</sup> Presidential Decree No. 867/2002 of 23 May 2002, Article 1, published in the Official Gazette No. 29,905, 24 May 2002. Claimant’s Exhibit No. 87; Respondent’s Exhibit No. 107.

<sup>383</sup> *Ibid.*, Article 3.

<sup>384</sup> Resolution SE 140/02 of 30 May 2002, published in the Official Gazette No. 29,912, 3 June 2002. Respondent’s Exhibit No. 111.

<sup>385</sup> Resolution SE 166/02 of 31 July 2002, published in the Official Gazette No. 29,928, 26 June 2002. Respondent’s Exhibit No. 116.

<sup>386</sup> Resolution SE 341/02, *supra* note 381.

*(iii) Was the Enactment of Export Withholding Taxes a Breach of the Fair and Equitable Treatment Standard?*

440. To find a violation of the FET standard under this heading, the following conditions should be fulfilled: first, the Tribunal must have jurisdiction over tax matters; second, there must be a violation of a right belonging to the Claimant which could result from a confiscatory law providing for an excessive tax, or a violation of a contractual right to tax exemption on exports, in other words of a tax stabilisation clause if such a clause is found to have been granted to the foreign investor.
441. There have been extensive discussions between the Parties on the question of whether or not a stabilisation clause was included in the concession contracts of CAPSA and CAPEX.
442. As far as *CAPSA's concessions* are concerned, two legislative provisions concerning taxes and withholdings were cited by both Parties, Law N° 12,161 of 1935 integrated into the Mining Code and Article 3 of Decree N° 1589/1989. First, Article 403 of Law N° 12,161 establishes that “[e]xcept for royalties, no other tax, whether federal, provincial or municipal, shall be imposed on the production of liquid hydrocarbons.” Second, Article 3 of Decree N° 1589/89, which applies to all hydrocarbons concessions, provides that “[e]xports and imports of hydrocarbons and by-products are authorised, which shall be exempt from all existing or future duties, rights or withholdings.”
443. The Parties hold diverging views on different aspects of these rules. First, they disagree on the applicability of Article 403 to CAPSA: for Argentina, “this Section was added to the Argentine Mining Code several years after CAPSA was granted the Concessions;”<sup>387</sup> for the Claimant, “Article 403 was immediately applicable to the Concession under Argentine law as soon as it was enacted.”<sup>388</sup> The Parties also have different views on the interpretation of Article 403, the Claimant saying that it was all-encompassing and included

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<sup>387</sup> Counter-Memorial, § 401.

<sup>388</sup> Reply, § 179.

exports, the Respondent contending that the reference to “production” has to be interpreted as relating only to production, thus excluding exports. The Parties further disagree on the consequence of Article 403: for the Claimant, it is a vested right which could not be interfered with, for Argentina it is a right given by law which can be modified by a new legislative enactment. More specifically, the Claimant says that “[o]nce Article 403 was enacted, it took on the status of a vested right that has express legal recognition under Argentine law, and since it is still in full force and effect,<sup>389</sup> it is binding under Argentine law and the BIT.”<sup>390</sup> The Respondent, on the contrary, considers that, “like any other law within the legal framework, this regulation can be repealed or modified with no responsibility attached.”<sup>391</sup> Moreover, the Parties’ views diverge on the applicability of Article 3 of Decree N° 1589/1989, taking the same positions as those adopted in relation to Article 403.

444. The debate was even more heated over the *CAPEX concession*: that concession was governed by Article 7 of Presidential Decree No. 43/91 and Article 3 of Presidential Decree No. 1589/89. The question discussed was whether the right in question was or was not incorporated into CAPEX’s concession and, thereby, transformed into a contractual right.

Article 7 of Presidential Decree No. 43/91 granting the concession to CAPEX provides:

*“The concession holder shall be subject to the general tax laws that may be applicable to it, and such holders shall not be subject to any provisions that may impose taxes, discriminately or specifically on the person, legal condition or activity of the holders or the property devoted to the execution of the relevant tasks.”*<sup>392</sup>

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<sup>389</sup> Law No. 17,319 (“Hydrocarbons Law”), 30 June 1967. Claimant’s Exhibit No. 45 and Respondent’s Exhibit RA 10. Article 8 expressly maintains in full force the provisions of the Mining Code and provides: “Mining properties of hydrocarbons already in the possession of private enterprises before the date of enforcement of this law shall continue to be governed by the rules whereby they were awarded, without prejudice to the rights of the holders thereof to claim the benefits of this present law, in accordance with the procedure which shall be established by the Executive Power.”

<sup>390</sup> Reply, § 179.

<sup>391</sup> Counter-Memorial, § 402.

<sup>392</sup> Emphasis added by the Tribunal.



445. According to Argentina, contrary to what happened with the right to export freely, where legislative and executive rules were incorporated into CAPEX's concession, there is no incorporation of the right to be exempt of tax withholding granted to the investors by Article 3 of Presidential Decree No. 1589/89, quoted in paragraph 442. On the contrary, according to the Claimant, this right, like the right freely to dispose of hydrocarbons, was incorporated into the concession.
446. There were also sophisticated discussions on the hierarchy of the different Argentinian enactments, but the Tribunal does not consider it necessary to summarise them, as this would unduly complicate the Award by considerations which are of no relevance for the outcome of the case.
447. There is certainly, in the Tribunal's view, room for discussion of these divergences between the Parties. However, considering the restrictions on the Tribunal's jurisdiction in relation to tax matters and the Tribunal's previous conclusion that the tax withholdings did not amount to an indirect expropriation, it is clear that the Tribunal cannot entertain a claim that the establishment of tax withholdings – whether or not in conformity with a right deriving from a law, a decree or a contract – amounts to a violation of the FET standard. It does not, therefore, have to settle the controversy between the Claimant and the Respondent over the extent of the commitment not to raise any new taxes allegedly received by El Paso from Argentina; in particular, it does not need to rule on the interpretation of Article 403 of the Mining Code,<sup>393</sup> nor does it have to decide whether, when mentioning the “exploitation of liquid hydrocarbons mines,” it also refers to the export of the same. Nor does it need to rule on the incorporation of a general tax exemption into the different concessions.
448. Decisions on these controversies might have been necessary in the absence of Article XII of the BIT. But the violation of a contractual commitment not to

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<sup>393</sup> It can be recalled that Article 403 of the Mining Code provides that except for royalties “no other tax, whether federal, provincial or municipal, shall be imposed on the exploitation of liquid hydrocarbons mines.”

impose new taxes, in other words the breach of a fiscal stabilisation clause, could only be discussed, unless the amount of the tax were totally confiscatory, as a violation of the FET standard and not as an expropriation. If considered as a breach of the FET standard, the impugned measures are excluded from the Tribunal's analysis by virtue of Article XII. It is therefore unnecessary and even outside the Tribunal's jurisdiction to settle the controversy between the Parties over the existence of fiscal stabilisation clauses or over any other issue raised by this claim, such as the possible invocation by El Paso of a fiscal stabilisation clause benefiting not directly El Paso but companies whose shares are indirectly owned by it.

449. In sum, even if the enactment of the withholding tax were in violation of the FET standard, either because of its excessively high amount or because of a contractual commitment not to levy such taxes, the Tribunal would have no jurisdiction over such claim.

5. *The Tribunal's Analysis of the Pesification in Both Sectors*

450. Another claim presented by El Paso results from the compulsory pesification of the contracts entered into by the Argentinian companies. On 3 February 2002, Decree No. 214/2002 provided the "conversion into PESOS of all obligations to pay money ... expressed in dollars" at one to one.
451. Before the crisis, some elements were valued in Argentine pesos and some in dollars, and the system was workable as the peso was pegged to the dollar through a currency board. With the devaluation, a huge imbalance would have been introduced into the economy if the Government had omitted to decide what it did decide, *i.e.* pesification. According to the pesification scheme, despite the devaluation, the existing contracts in dollars had to be transformed into contracts in pesos, at the rate of 1 peso to 1 dollar. What happened was a mandatory de-dollarisation, *i.e.* a pesification of contracts, deposits, debts and utility tariffs. It appears that, from an economic viewpoint, if this had not been done after a devaluation of the peso of more than 300%, the prices of electricity and energy would have increased and been multiplied by three. The question

here is whether the pesification of contracts amounted to a violation of the FET standard.

452. In fact, CAPEX and CAPSA re-negotiated their contracts but El Paso, as their indirect shareholder, considers that they did not do this freely and that the fact that they were forced by the Government to participate in such re-negotiation amounts to a violation of the FET due to El Paso.
453. The Tribunal wishes to state at the outset that many contracts were excluded from pesification and that it is important to give a full picture of the contracts affected by pesification.
454. First, the emergency decree which was enacted for the application of the Emergency Law excluded from pesification the agreements for the export of fuel power and associated electric power.<sup>394</sup> Generators of electricity, with export agreements, among them Costanera in which El Paso was a stockholder, were favoured by such a measure because, while many of their costs decreased in terms of US dollars, as a result of the devaluation, their revenues remained in dollars. In this regard, El Paso stated, in its Memorial, that Costanera was better able to withstand the impact of the crisis due to its agreements with Brazil to export electricity, under which it received payments for capacity and the sale of electricity in US dollars.<sup>395</sup>
455. Second, the pesification of the whole economy did not affect oil and gas exports. In early 2002, the Executive Branch excluded from pesification the export agreements entered into, including oil and gas export agreements.<sup>396</sup> Therefore, so far as the Argentinian companies were concerned, the agreements to export CAPSA's crude oil and CAPEX's LPG were not pesified. In the same manner, the agreements to transport natural gas for export were not

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<sup>394</sup> See Presidential Decree No. 1491/02 of 16 August 2002, Articles 1-3, published in the Official Gazette, No. 29, 965, 20 August 2002. The Decree had retroactive effect to 6 January 2002. Respondent's Exhibit No. 127.

<sup>395</sup> Memorial, note 16.

<sup>396</sup> See Decree No. 410/2002 of 1 March 2002, Section 1(a), (e) and (g), published in the Official Gazette of 8 March 2002. Claimant's Exhibit No. 80. Amended by Presidential Decree No. 704/02 of 30 April 2002, published in the Official Gazette, No. 29,889, 2 May 2002. Respondent's Exhibit No. 102. See also Decree No. 689/02 of 26 April 2002, published in the Official Gazette, No. 29,889, 2 May 2002. Respondent's Exhibit No. 100.

affected by pesification. In April 2002, the President of Argentina excluded such agreements from pesification.<sup>397</sup>

456. The narrow impact of pesification on the Argentinian companies is acknowledged by El Paso. In the Claimant's Reply, it is stated that:

“Claimant's hydrocarbon claim does not relate in any way to the pesification of oil and gas exports, which in any case were not affected by pesification but only by the imposition of export withholdings. Claimant's claim involves the pesification of CAPSA's and CAPEX domestic supply agreements and SERVICIOS' Gas Processing Agreement.”<sup>398</sup>

As far as the pesified contracts are concerned, the Respondent has insisted on the fact that “the *pesification* of credits and debts in US dollars provided for in the Emergency Law was advantageous for the Argentine Companies.”<sup>399</sup>

Interestingly, the same conclusion can be drawn from the report of the Claimant's expert, LECG, in which the following table can be found:

(in million USD)	<b>CAPSA</b>	<b>Capex</b>	<b>COSTANERA</b>
<i>Pesified credits</i>	14.3	3.1	-
<i>Pesified debts</i>	48.0	15.7	58.4
Benefits of <i>pesification</i>	27.8	7.5	29.6
Prejudice of <i>pesification</i>	5.4	1.2	-
<b>Net Benefit</b>	<b>22.4</b>	<b>6.3</b>	<b>29.6</b>

457. Both the Respondent and the Claimant being in agreement on the fact that the pesification did not damage the Argentinian companies, CAPSA, CAPEX and Costanera, the Tribunal cannot see any basis on which a breach of the FET standard could be asserted in relation to these companies.

458. In conclusion, it appears from the file that pesification has not caused any damage to the Argentinian companies of which El Paso was a shareholder and cannot therefore be considered as having created a damage of which the Claimant can complain. The Tribunal thus considers that no claim for violation

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<sup>397</sup> See Presidential Decree No. 689/02, *supra* note 396, section 3.

<sup>398</sup> Reply § 258.

<sup>399</sup> Rejoinder, § 97. Emphasis by the Respondent. See also Counter-Memorial, §§ 440-446 and 550-563.

of the FET standard can be derived from the mandatory pesification of contracts.

6. *The Tribunal's Analysis of the Cumulative Effect of those Measures*

459. The fact that none of the measures analysed – that were not outside the Tribunal's jurisdiction or not excluded from consideration by the Tribunal because they did not result in any significant damage – were regarded, *in isolation*, as violations of the FET standard does not prevent the Tribunal from taking an overall view of the situation and to analyse the consequences of the general behaviour of Argentina. In order to obtain an overall picture, the Tribunal has to revisit the causes of El Paso's sale of shares. It has already held that the transaction was not an automatic and unavoidable consequence of Argentina's measures, and this prevented it from finding an expropriation. But this does not mean, of course, that the impugned measures did not play an important role in the sale; and the Tribunal will thus successively assess the overall role of Argentina's measures in the sale of El Paso's shares and their overall impact with regard to the FET standard.

*(i) The Overall Role of the Argentinian Measures in the Sale of El Paso's Shares*

460. The Parties' positions regarding expropriation have been described in paragraphs 270-271. Argentina has invoked a series of circumstances which, in its view, caused the sale of El Paso shares, to which El Paso has objected. In particular, El Paso has objected to Argentina's argument that the sale was not a consequence of the GOA's measures but the result of a decision taken by El Paso's parent company to concentrate on its "core business," divesting assets not related to that business, in order to increase liquidity.<sup>400</sup> Before the Tribunal addresses the Parties diverging views on the causes of the sale of El Paso, it has first to deal with the existence and exact nature of this sale which has been the subject of heated controversies between the Parties.

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<sup>400</sup> Reply, § 336.

(a) *The sale by El Paso of its interest in the Argentinian Companies*

461. As previously mentioned (*supra*, §§ 115-116), El Paso sold the shares in the Argentinian companies in two steps, one in June 2003 and another in October 2003.
462. The first transaction occurred in June 2003 and concerned the sale of El Paso's interests in CAPSA, CAPEX and SERVICIOS. In exchange for the sale of its interest in SERVICIOS, El Paso received a 6.3% interest in GASODUCTO, allegedly worth about Arg. \$19.3 million, and US\$ 29 million in cash, but had to pay US\$ 20 million to exercise the option to purchase SERVICIOS' lease for the LPG plant ultimately transferred to CAPEX.<sup>401</sup> The second transaction occurred in October 2003 and concerned the sale of El Paso's equity interest in Costanera for a cash price of US\$ 4.5 million.<sup>402</sup>
463. The Claimant's indirect participating interest in CAPSA was sold under a Share Purchase Agreement dated 23 June 2003 by the Claimant, as Seller, to Wild S.A., as Purchaser.<sup>403</sup> By virtue of this Agreement, the Claimant sold 100% of the share capital it owned in EPEC Energy Argentina S.A. ("EPEC Argentina"). EPEC Argentina in turn owned 45% of the share capital of CAPSA, the remaining 55% being held by the Purchaser. Since CAPSA owned 60.3% of CAPEX' share capital, by selling its entire participation in EPEC Argentina, the Claimant sold all of its investments in CAPSA and CAPEX to Wild, for a total price of US\$ 24 million (Section 2.1 of the Share Purchase Agreement).
464. The Claimant's indirect controlling interest in SERVICIOS was sold under a Share Exchange Agreement made by and between Agua del Cajón (Cayman) Company and Capex International Business Company ("CIBCO") on 23 June 2003.<sup>404</sup> The Agreement in question records in its relevant part the sale by

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<sup>401</sup> Memorial, § 51; LECG Report, *supra* note 373. In the LECG Report of 23 November 2006, Table IX on p. 92, the amounts received or paid by Claimant are different.

<sup>402</sup> *Ibid.*

<sup>403</sup> Share Purchase Agreement between El Paso Energy International Company and Wild S.A. dated 23 June 2003, Claimant's Exhibit No. 21.

<sup>404</sup> Share Exchange Agreement by and between Agua del Cajón (Cayman) Company and Capex International Business Company dated 23 June 2003, Claimant's Exhibit No. 21

Agua del Cajón of its entire participation in SERVICIOS, equal to “one hundred percent (100%) of the total issued and outstanding quotas of SEP,” *i.e.* SERVICIOS (Recital A) to CIBCO in exchange for the transfer by CIBCO to Agua del Cajón of 38.4% of the total issued and outstanding shares of Triunion Energy Company (“Triunion) (Section 2.1 of the Share Exchange Agreement). The Agreement provides that, after the Closing, CIBCO would pay an “Adjustment Amount” to Agua del Cajón to adjust for the difference between the Working Capital of SERVICIOS and the Working Capital of Triunion (Section 2.4 (a) of the Share Exchange Agreement).

465. Under a Termination and Set-Off Agreement dated 23 June 2003 by and between Bank Boston N.A., Servicios El Paso S.r.l., Fleet National Bank, El Paso Corporation and Agua del Cajón (Cayman) Company,<sup>405</sup> SERVICIOS, as Lessee under a Lease Agreement with Bank Boston, Lessor, covering the lease of the LPG plant operated by SERVICIOS, agreed to pay to Bank Boston an Agreed Purchase Price equal to US\$ 11,797,910.85 (Section 1.2 of the Termination and Set-Off Agreement), plus VAT, to exercise the purchase option on the lease for the LPG plant and to terminate the Lease Agreement.<sup>406</sup>
466. The Claimant’s indirect participating interest in Costanera was sold under a Share Purchase Agreement dated 3 October 2003 by and between KLT Power Inc., as Seller, and Empresa Nacional de Electricidad S.A., as Purchaser.<sup>407</sup> Under the Agreement, Seller sold to Purchaser its participating interest in Costanera, equal to 11% of the latter’s capital stock, and its 100% participation in KLT Power (Bermuda) Ltd., the latter owning a 1.35% participation in Costanera (Recital B, C and D and Sections 1.1 and 2.1 of the Share Purchase Agreement). The Purchase Price for all share participations made subject to the sale was US\$ 4,500,000.00 (Section 2.2(b) of the Share Purchase Agreement).

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<sup>405</sup> Termination and Set-Off Agreement between Bank Boston NA Buenos Aires Branch, Servicios El Paso SRL, Fleet National Bank, El Paso Corporation and Agua del Cajón Cayman Company dated 23 June 2003, Claimant’s Exhibit No. 21.

<sup>406</sup> According to LECG, an amount of US\$20 million was ultimately paid. LECG Report, *supra* note 377, § 176.

<sup>407</sup> Share Purchase Agreement of 3 October 2003 between KLT Power Inc. and Empresa Nacional de Electricidad S.A., Claimant’s Exhibit No. 21.

467. The respondent State argued that the Claimant had not sufficiently proven the interests it claimed in the Argentinian companies.<sup>408</sup> In its Reply, the Claimant submitted arguments and additional evidence in response to Argentina's contestation.<sup>409</sup> This response and the related evidence were amended and integrated by the Claimant in its submissions on 5 December 2006.<sup>410</sup>
468. In its Rejoinder, the respondent State emphasised the differences between the Claimant's description of its participating interests in the Argentinian companies in the original Reply as compared to the amended Reply,<sup>411</sup> concluding that "El Paso failed to adequately prove its participating interest in the companies for which it claims."<sup>412</sup>
469. Having carefully reviewed and analysed the evidence proffered by the Claimant and the respondent State's critical arguments, the Tribunal is satisfied that adequate proof has been given by the Claimant evidencing the level of its direct participating interest in the Argentinian companies or, when such interest was held indirectly, the corporate relations with the seller of an interest in the Argentinian companies under each transaction. The analysis has included the Claimant's corporate relation to EPEC Argentina,<sup>413</sup> Agua del Cajón and Triunion<sup>414</sup> and KLT Power.<sup>415</sup> It has not considered GASODUCTO since the sales of El Paso's shares in 2003 did not involve this Company. These corporate relations at the time of the sales are evidenced by the Officer Certificate filed by the Claimant on 5 December 2006 (Exhibit No. 223).
470. As to Agua del Cajón and Triunion, the Officer Certificate shows that Claimant:

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<sup>408</sup> Counter-Memorial, §§ 49-59.

<sup>409</sup> Reply, §§ 314-329

<sup>410</sup> Enclosing Officer's Certificate dated December 5, 2006, Claimant's Exhibit No. 223, and Supplemental Witness Statement of Cristian Bussio, Claimant's Exhibit No. 221.

<sup>411</sup> Rejoinder, §§ 86-92.

<sup>412</sup> *Ibid.*, § 92.

<sup>413</sup> As per the Agreement described in § 646.

<sup>414</sup> As per the Agreement described in §§ 647-648.

<sup>415</sup> As per the Agreement described in § 649.



- (a) owned a 100% participation in Agua del Cajón through the intermediary of four 100% owned subsidiaries and that Agua del Cajón owned 99.92% of SERVICIOS (Annex A);
- (b) owned a 23.2% interest in Triunion through the intermediary of two 100% owned subsidiaries and another 38.4% interest in Triunion through the intermediary of three 100% owned subsidiaries (Annexes B and C).

471. The Officer Certificate does not record the corporate relations between the Claimant and EPEC Argentina, on the one side, and KLT Power, on the other. However, the following may be noted in that regard. The Claimant's 100% ownership of EPEC Argentina is indicated in the Share Purchase Agreement between the Claimant and Wild,<sup>416</sup> and is confirmed in documents annexed to such Agreement. It is only logical to assume that the Purchaser had satisfied itself of the 100% ownership by the Claimant of 100% of EPEC Argentina shares since this was the object of its purchase. No further inquiry appears therefore necessary. Ownership of KLT Power was acquired by the Claimant under a Stock Purchase and Sale Agreement made on 2 July 1998 by and between KLT Inc., as Seller, and the Claimant, as Purchaser.<sup>417</sup> The Respondent has not challenged the Claimant's 100% ownership of KLT Power.

472. According to the Claimant and its accounting expert, the result of the various transactions on 23 June 2003, including the value of the 6.3% interest acquired in GASODUCTO, allegedly worth about US\$ 19.3 million, was "a net divestiture price for El Paso of US\$ 28.2 million in current dollars."<sup>418</sup> According to the Respondent, there are doubts regarding the amount of the sale transactions in June 2003. Specifically, GOA has contended that the party that bought 45% of the Claimant's indirect interest in CAPSA had sold in that month 6.5% of that company's share for an amount exceeding 400% of the price agreed for the purchase by Wild.<sup>419</sup> The level and value of the

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<sup>416</sup> *Supra* § 646, Recital A.

<sup>417</sup> Claimant's letter of 21 June 2006, Annex D.

<sup>418</sup> Memorial, § 51; LECG Report, *supra* note 377, § 176.

<sup>419</sup> Counter-Memorial, §§ 97-98; Rejoinder, §§ 60-79.

participating interest acquired in GASODUCTO are uncertain,<sup>420</sup> while the amount paid by El Paso as a termination fee in the context of the sale of the interest in SERVICIOS, allegedly equal to US\$ 20 million, is not proven.<sup>421</sup> Argentina's contentions will be examined below.

473. The Respondent's doubts regarding the sale price of the participating interest in CAPSA are based on the circumstance that the purchaser had sold to Deutsche Bank, during the same month, 6.5 % of CAPSA's shares for a price in pesos equivalent to US\$ 14.1 million at the then current exchange rate. That price was 400% higher than that of US\$ 24 million reported by the Claimant, which should have been US\$ 94.4 million.<sup>422</sup>
474. The Claimant does not deny the existence of a second transaction between EPEC Argentina and Deutsche Bank nor the price agreed on for the 6.5% of CAPSA's shares, but contends that the operation was not a sales transaction but one of collateral financing and a contingent loan arrangement.<sup>423</sup> The 6.5% of CAPSA's shares was received by Deutsche Bank as a security in the context of the financing of the purchase price to be paid by Wild of EPEC Argentina, and the price thereof was fixed without any reference to the market value of those shares at the time of the transfer.<sup>424</sup> Such financing consisted in (i) a loan to Wild for a US\$ 14 million from EPEC Argentina (which, in turn, had received the same amount as a loan from Deutsche Bank), and (ii) a direct loan of US\$ 10 million from Deutsche Bank to Wild.<sup>425</sup>
475. According to the Claimant, the repayment of the loan of US\$ 14 million was secured by: (i) a put option granted by Wild to Deutsche Bank to transfer to Wild 6.5% of CAPSA's shares at a price equal to the amount of the loan; (ii) the assignment to Deutsche Bank by EPEC Argentina of its rights against Wild under the loan agreement pursuant to which it had reloaned to Wild the US\$ 14

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<sup>420</sup> *Ibid.*, § 92.

<sup>421</sup> *Ibid.*, §§ 94-95.

<sup>422</sup> *Ibid.*, §§ 97-98; Rejoinder, §§ 60-79.

<sup>423</sup> Reply, §§ 385-396.

<sup>424</sup> *Ibid.*, § 388.

<sup>425</sup> *Ibid.*, § 389.

million; (iii) the endorsement to Deutsche Bank of the promissory note evidencing the amount of the EPEC Loan Agreement with Wild; (iv) the assignment by Wild of 55% of CAPSA's shares to a trust created for the benefit of Deutsche Bank; and (v) a pledge on 51% of CAPSA's shares for the benefit of Deutsche Bank, to become effective upon notice to CAPSA of the transfer of the 6.5% of its shares to Deutsche Bank.<sup>426</sup>

476. Having thoroughly analysed the various documents to which the Parties have made reference as evidence in support of their respective positions, the Tribunal is satisfied that the transaction regarding the 6.5% of CAPSA's shares is in the nature of a financing arrangement to secure to the purchaser Wild a portion of the amount of the purchase price equivalent to US\$ 14 million. This conclusion is based on the following reasons.
477. The contract by which Wild acquired 6.5% of CAPSA's shares from EPEC Argentina, dated 23 June 2003, is a contract of sale and rightly was so recorded in a number of documents in the file of these proceedings on which the GOA relies to assert that a sale was the true nature of this transaction. However, in the Tribunal's view, this contract must not be considered in isolation but as part and parcel of a more complex contractual arrangement consisting of various instruments, including but not limited to the contract in question.
478. As a matter of fact, that contract was part of a Trust Agreement dated 23 June 2003 between Wild, the Claimant, Deutsche Bank, EPEC Argentina and First Trust of New York.<sup>427</sup> Following the Respondent's request of 23 March 2007 and the Tribunal's direction of 26 March 2007, by letter of 9 April 2007, the Claimant filed the exhibits to the Trust Agreement, all dated 23 June 2003.
479. The exhibits so filed consist of:

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<sup>426</sup> *Ibid.*, §§ 390-391.

<sup>427</sup> Trust Agreement of 23 June 2003, between Wild S.A., El Paso Energy, Deutsche Bank S.A., EPEC Energy Argentina S.A. and First Trust of New York [hereinafter Trust Agreement], Claimant's Exhibit No. 246.

- Exhibit A, *Contrato de Compraventa de Acciones* between EPEC Argentina, as seller, and Wild, as purchaser, relating to the sale of the 6.5% of CAPSA's shares;
- Exhibit B, Model of *Contrato de Préstamo* between EPEC Argentina and Wild (the "EPEC Loan Agreement"), whereby EPEC Argentina loans to Wild an amount equivalent to US\$ 14 million to finance the payment of a portion of the purchase price to be paid by Wild under the Share Purchase Agreement relating to the sale by the Claimant of 100% of EPEC Argentina's shares;
- Exhibit C, Model of *Contrato de Cesión de Derechos y Asunción de Deuda Eventual* between EPEC Argentina, as assignee, Wild, as Assigned Debtor, First Trust New York as Assignor, and Deutsche Bank.

480. The content of these various agreements is consistent with the Claimant's description of the various guarantees provided to Deutsche Bank for the repayment by Wild of the loan of US\$ 14 million.<sup>428</sup>

481. Were the transaction relating to 6.5% of CAPSA's shares just a sale between EPEC Argentina and Deutsche Bank, there would be no reasonable explanation why: (i) all the contractual instruments described above were concluded on the same day as the Share Purchase Agreement between EPEC Argentina and Wild, 23 June 2003; (ii) in addition to the sale of 6.5% of CAPSA's shares, Deutsche Bank had to be guaranteed by a number of securities of different nature and extent; (iii) the amount for the exercise of the put option granted to Deutsche Bank under the Trust Agreement was the same as the amount paid by Deutsche Bank for 6.5% of CAPSA's shares, *i.e.* US\$ 14 million, thus protecting Deutsche Bank from any risk that at the time of exercise of the put option the value of the 6.5% of CAPSA's shares would be lower than US\$ 14 million while permitting Deutsche Bank to retain said shares should their value increase

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<sup>428</sup> See *supra*, § 655.

in the meantime above US\$ 14 million;<sup>429</sup> (iv) clauses 1.1. and 1.3 of the Contrato de Compraventa de Acciones<sup>430</sup> provide for a condition (“*condición resolutoria*”) by virtue of which this contract would become null and void if Wild did not pay to the Claimant, by a fixed date, the price for the purchase of 100% of EPEC Argentina’s shares; (v) the 6.5% of CAPSA’s shares sold to Wild were not delivered to the latter but were transferred to First Trust of New York as “*Fiduciario*,”<sup>431</sup> subject to the “*condición resolutoria*” mentioned under (iv) above.

482. The foregoing analysis leads the Tribunal to conclude that:

- (a) the transaction between EPEC Argentina and Wild under the Contrato de Compraventa de Acciones was a sales transaction covering 6.5% of CAPSA’s shares, subject to a reversionary right in favour of EPEC Argentina of such shares upon occurrence of the condition subsequently provided therein;
- (b) when viewed not in isolation but as part and parcel of a more complex scheme under the Trust Agreement and all its exhibits, the transaction reveals its true nature as a loan arrangement to secure the financing to Wild of a portion of the purchase price, equal to US\$ 14 million, that Wild had to pay to the Claimant for the purchase of 100% of EPEC Argentina’s shares.

483. The respondent State has cast doubt on the percentage of equity interest acquired by El Paso as a result of the transaction regarding SERVICIOS and the value of such interest.<sup>432</sup> For the Claimant’s expert, LECG, the percentage amounts to 6.3% and is worth about US\$ 19.3 million according to GASODUCTO financial statements of June 2003.<sup>433</sup>

484. As to the percentage interest acquired in GASODUCTO as a result of the Share Exchange Agreement, the following may be noted. Under that Agreement CIBCO transferred to Agua del Cajón (a 100% subsidiary of the Claimant)

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<sup>429</sup> For example, as a result of a sharp increase of crude oil prices in the international market.

<sup>430</sup> Exhibit A to Trust Agreement, *supra* § 660, § 19.

<sup>431</sup> *Ibid.*, Recital III; Contrato de Compraventa de Acciones, Article 1.4.

<sup>432</sup> See *supra*, § 653.

<sup>433</sup> LECG Report, *supra* note 373, § 176.

38.4% of Triunion's shares, the latter owning indirectly 21.8% of GASODUCTO's shares.<sup>434</sup> Accordingly, the percentage interest should be 8.4%, as contended by the respondent State, not 6.3%, as indicated by the Claimant. Following the Tribunal's request for clarifications, by letter dated 1 June 2010, Claimant has documented that the interest actually acquired is equal to 6.1%, considering that a portion of the 8.4% interest, equal to 2.3%, was already (indirectly) owned by Claimant through its indirect holding in Capex.<sup>435</sup> Having reviewed Claimant's position and the evidence to which it refers, the Tribunal is satisfied that the percentage acquired in GASODUCTO is equal to 6.1%.

485. As to the value of the participation so acquired in GASODUCTO, the Claimant confirms in its letter of 1 June 2010 that the book value of the 6.1% interest transferred to El Paso, based on GASODUCTO's and Gasoducto del Pacífico (Argentina) S.A.'s 30 June 2003 financial statements, is equal to US\$ 19,271,152. Having reviewed the said financial statements,<sup>436</sup> the Tribunal accepts that the value of GASODUCTO's shares acquired indirectly by the Claimant, equal to 6.1%, is equal to US\$ 19,271,152.

486. The Claimant alleges that it paid US\$ 20 million for the termination of the lease agreement for the LPG plant operated by SERVICIOS.<sup>437</sup> According to the GOA, this amount is not proven.<sup>438</sup>

487. Under the Termination and Set-Off Agreement, the price to be paid for the purchase option was US\$ 11,797,910.85,<sup>439</sup> to which the value-added-tax for ARS 6.9 million must be added.<sup>440</sup> After converting the amount in ARS into US dollars at the rate of ARS 2.79 for one US dollar prevailing in June 2003, the total is equal to US\$ 14,271,029. As indicated in the Claimant's letter of 1

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<sup>434</sup> Reply, §§ 322-326 and footnote 550; Officer's Certificate, *supra* note 410; see also CIBCO's Financial Statements 2003, p. 31.

<sup>435</sup> Claimant's letter of 1 June 2010, point 1, pp. 1-3.

<sup>436</sup> GASODUCTO's and Gasoducto del Pacífico (Argentina) S.A.'s 30 June 2003 unaudited financial statements have been annexed by Claimant as Annex 1 to its letter of 1 June 2010.

<sup>437</sup> Memorial, § 51; LECG Report, *supra* note 373.

<sup>438</sup> Counter-Memorial, §§ 94-95.

<sup>439</sup> *Supra*, § 602, Section 1.2.

<sup>440</sup> *Ibid.*, Section 2.2.

June 2010, under the Compensation Agreement of 23 June 2003 between Fleet National Bank and the Claimant, the latter had to pay to Fleet National Bank the amount of US\$ 5,619,531.22 in connection with the purchase option.<sup>441</sup> The aggregate price paid by the Claimant for the termination of SERVICIOS' Lease Agreement amounts therefore to US\$ 19,895,003.35.<sup>442</sup> This amount is accepted by the Tribunal based on the available evidence.

*(b) The Argentinian measures were the prevailing reason of the sale*

488. The Tribunal shall address the Parties' diverging views regarding the causes of El Paso's sales in 2003 by focusing on two issues which are at the root of the debate, namely, El Paso's liquidity problems since late 2001<sup>443</sup> and that company's "core business" at the time of the sales, since, as alleged by the Respondent and denied by the Claimant, to face its liquidity problems El Paso was led into divesting its "non-core" assets.<sup>444</sup> The Tribunal has already decided that the measures were not the unique cause of El Paso's sale entailing a finding of expropriation; it has now to deal with the Respondent's view that the Argentinian measures did not contribute at all to the decision to sell El Paso's Argentinian assets.

489. The existence of liquidity problems since late 2001 is not denied by El Paso. The 2002 Report filed with the US Security and Exchange Commission (SEC) by El Paso Corporation on 31 March 2003 mentions that:

"In response to industry events, the credit ratings agencies, including Moody's and Standard and Poor's, re-evaluated the ratings of companies involved in energy trading activities. As a result, the ratings of many of the largest participants in the energy trading industry, *including us*, were downgraded to below investment grade."<sup>445</sup>

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<sup>441</sup> Claimant's Exhibit No. 220, Section 1.1.

<sup>442</sup> As indicated in the Reply, § 309.

<sup>443</sup> Counter-Memorial, §§ 82-85.

<sup>444</sup> Reply, § 334.

<sup>445</sup> 2002 El Paso Report filed with the SEC, *supra* note 224, p. 33. Respondent's Exhibit RA 79. Emphasis added by the Tribunal. See also Counter-Memorial, §§ 15, 26, 63.

The downgrading of El Paso Corporation's credit ratings had a significant impact on that company's liquidity.

490. The Claimant contends that, in order to meet its liquidity problems, an orderly disposition of certain assets was planned in a time-frame of three to five years but that "the Argentine assets of El Paso were not sold either because they were considered non-core assets or to increase El Paso's Corporation's liquidity."<sup>446</sup> The Tribunal shares this position for the following reasons.

491. First, El Paso's 2002 Report filed with the SEC indicates that several steps had been taken since the last quarter of 2001 "to address the issues affecting us" and that significant progress had been made "to meet the demands on our liquidity and to strengthen our capital structure."<sup>447</sup> The Report lists nine different steps taken for that purpose, among which only one refers to the divestiture of assets, in terms that suggest the orderly disposition of such assets.<sup>448</sup> The 2003 Report filed by El Paso with the SEC enumerates the resources available to El Paso Corporation to increase its liquidity, in addition to the sale of assets (which was therefore only one of the various resources available):

"We rely on cash generated from our internal operations as our primary source of liquidity, as well as available credit facilities, project and bank financing ... and the issuance of long-term debt, preferred securities and equity securities."<sup>449</sup>

It is on record that a large number of assets were divested by El Paso Corporation in 2002-2004, although the divestiture of individual assets apparently did not entail the level of losses experienced by the sale of El Paso's investment in Argentina.<sup>450</sup>

492. Second, the contribution of the sales of its Argentinian assets by El Paso was so marginal (US\$ 33 million) as to make it unlikely that the decision to sell in

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<sup>446</sup> Reply, § 337 (relying on Baker's Witness Statement, §§ 9, 22).

<sup>447</sup> 2002 El Paso Report filed with the SEC, *supra* note 224, p. 33.

<sup>448</sup> "The establishment of an exit strategy for our trading business, including the planned orderly liquidation of our existing trading portfolio" (*id.*, pp. 33-34).

<sup>449</sup> 2003 El Paso Report filed with the SEC, *supra* note 219, p. 38.

<sup>450</sup> See the list in § 276 *supra*.



Argentina was motivated by the liquidity problems of El Paso's parent company. As mentioned by the Claimant, had the liquidity problems been the cause of the divestiture of such assets, El Paso Corporation would have chosen to divest its investments in the power sector in Brazil, worth approximately US\$ 2 billion in 2003 (which investments were kept).<sup>451</sup>

493. Third, it is not correct that, as asserted by the Respondent, only non-core business assets were divested in Argentina to meet liquidity problems, while core-business assets were kept.<sup>452</sup> Evidence before the Tribunal shows that core-business assets were also sold by El Paso in July and October 2003. This issue is analysed below based on evidence showing what the core business of El Paso was immediately before the sales of its Argentinian assets.

494. By a News Release of 5 February 2003, El Paso announced its 2003 business plan based upon five key principles:

- “- Preserve and enhance the value of the company's core business
- Exit non-core business quickly, but prudently
- Strengthen and simplify the balance sheet while maximizing liquidity
- Aggressively pursue additional cost reductions
- Continue to work diligently to resolve litigation and regulatory matters

El Paso is committed to:

- Preserving and enhancing the value of its core business – natural gas pipelines, production, midstream and non-merchant power. The

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<sup>451</sup> Reply, § 339.

<sup>452</sup> Counter-Memorial, § 82: “In late 2001, El Paso decided to focus on its core business (natural gas production and transportation) and to sell *quickly* all the assets not related thereto so as to reduce its debt significantly.” Emphasis by the Respondent. The Respondent relies on two documents to assert that natural gas production and transportation was El Paso's core business in late 2001. The first document (EDGARonline, El Paso Corp., Filing Date, 30 September 2004, Respondent's Exhibit RA 231) mentions that in late 2001 El Paso's focus changed by, *i.e.*, “returning to our core natural gas business,” which does not mean that natural gas was the only core business. The other (an article by Kenneth Betz dated 25 June 2002, Respondent's Exhibit RA 115) does not deal at all with El Paso's core business.

company will continue to invest efficiently in these businesses to maintain its leadership positions. The company's capital expenditure plan reflects that commitment with 87 percent of 2003 capital devoted to the pipeline and production businesses.

- Exiting non-core business quickly, but prudently..."<sup>453</sup>

495. In its 2002 Report filed with the SEC on 31 March 2003, El Paso, after confirming the above plan, states:

"We will also continue to focus on winding down our non-core business including energy trading and petroleum markets as well as other capital intensive businesses such as liquefied natural gas (LNG) operations."<sup>454</sup>

The Report states that the divestiture plan focused on "those businesses and operations that were not core to our long-term objectives or *that were not performing consistently with the expectations we had for them at the time we made the investment.*"<sup>455</sup>

The Report then indicates the four primary business segments into which El Paso operations are divided: "Pipelines," "Production," "Field Services" and "Merchant Energy," which were all considered to be "strategic business units that provide a variety of energy products and services."

496. The "Production" segment is described by the Report as covering "our natural gas and oil exploration and production activities."<sup>456</sup> The "Merchant Energy" segment consisted in 2002 of three primary divisions: "global power," "petroleum" and "energy trading."<sup>457</sup> The "global power division included ownership and operation of domestic and international power generation facilities," the commercial focus being "to develop projects in which new long-term power purchase agreements allow for an acceptable return on capital."<sup>458</sup>

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<sup>453</sup> Press Release, El Paso Corporation, *El Paso Corporation Announces 2003 Operational and Financial Plan*, 5 February 2003, Respondent's Exhibit RA 256, p. 1.

<sup>454</sup> 2002 El Paso Report filed with the SEC, *supra* note 224, p. 2.

<sup>455</sup> Quoted in Counter-Memorial, footnote 89. Emphasis by the Respondent.

<sup>456</sup> 2002 El Paso Report filed with the SEC, *supra* note 224, p. 2.

<sup>457</sup> *Ibid.*, p. 3; See also Rejoinder, § 31.

<sup>458</sup> 2002 El Paso Report filed with the SEC, *supra* note 224, p. 18.

CAPEX/CAPSA was included in the “global power” division, as shown by the list of power plant projects existing as at 31 December 2002.<sup>459</sup> The Report mentions that “as part of our 2003 Operational and Financial Plan, we have announced the planned sales of some of these power generation assets.”<sup>460</sup> “Petroleum,” as one of the divisions of the “Merchant Energy” segment, presumably covered areas other than those included in the “Production” segment.

497. In the 2003 Report filed with the SEC on 30 September 2004,<sup>461</sup> El Paso’s purpose is described as follows:

“Over this two-year period [2002-2003] we refocused on our natural gas assets and divested or otherwise sold our interest in a significant number of assets,”<sup>462</sup> indicating the sales of CAPSA/CAPEX and COSTANERA in the Section ‘Divestitures,’ under the ‘Merchant Energy’ segment<sup>463</sup> as part of the ‘global power’ division.”

498. El Paso’s “Long Range Plan” was announced after the sale of El Paso’s Argentinian assets had been completed,<sup>464</sup> following the change in the Corporation’s management. This Plan’s objective was to turn El Paso into “a strong natural gas provider.”

499. The above analysis makes it possible to conclude that El Paso’s core business prior to the sales in 2003 comprised natural gas and oil exploration and production activities (the “Production” segment), while the non-core business during the same period included power generation facilities, petroleum markets, energy trading and LNG.

500. Confronting El Paso’s sales of 2003 with the above-defined core- and non-core businesses of El Paso, it may be concluded that:

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<sup>459</sup> *Ibid.*

<sup>460</sup> *Ibid.*, p. 18.

<sup>461</sup> 2003 El Paso Report filed with the SEC, *supra* note 219.

<sup>462</sup> *Ibid.*, p. 2.

<sup>463</sup> *Ibid.*, p. 122.

<sup>464</sup> Press Release, El Paso Corporation, *El Paso Corporation Announces Long-Range Plan*, 15 December 2003. Respondent’s RA 264.

- (a) the sale of CAPSA, a company mainly engaged in oil exploration and production, was not consistent with the idea of focusing on the core business;
- (b) the sale of CAPEX was also not consistent with the idea of focusing on the core business, to the extent to which that company was engaged, in addition to electric power generation, in natural gas production. Since CAPSA owned a 60.36% interest in CAPEX, the sale by El Paso of the former's shares entailed the sale of its indirect participation in the latter; however, had CAPSA been profitable in 2003, it would have been kept by El Paso in view of its core-business activity, even if this had meant keeping the electric power generation activity of CAPEX (a non-core business but on the same assumption a profitable one), as was done in Brazil;
- (c) the sale of SERVICIOS (a company engaged in LNG production and sale) was consistent with the programme of exiting non-core business;
- (d) the sale of Costanera, a company engaged in the generation and sale of electricity, was consistent with the plan of divesting power generation projects that did not meet expectations;
- (e) keeping PACIFICO (a company engaged in natural gas transportation) and even increasing indirect shareholding in this company on the occasion of the sale of June 2003 was consistent with the programme of preserving and enhancing the value of core business.

501. While the sale of Costanera and SERVICIOS was thus in line with the objective of exiting non-core business, the sale of CAPSA/CAPEX was not. It is therefore to be assumed that such sale was due to other reasons. One such reason can only have been the perceived lack of prospects of recovery from the loss of value suffered by the two companies in 2002 and until the date of their sale. PACIFICO was not sold since it was part of the core business and, not having been economically prejudiced by the GOA measures, was performing consistently with expectations.

502. It is interesting to note that in the 2003 Report filed with the SEC, El Paso defines the year ending on 31 December 2003 as "a year of significant change

in our business strategy and our financial conditions.”<sup>465</sup> The Report continues by stating that in 2003:

“We completed the sale of a number of assets and investments including production properties ... Total proceeds from these sales were approximately \$3.3 billion;

a. We completed a number of financial transactions that allowed us to maintain our access to needed capital to meet our cash requirements, simplify our capital structure, and eliminate a significant amount of off-balance sheet obligations and preferred securities;

b. We implemented a cost reduction program ...;

c. We completed the Western Energy Settlement which became effective in June 2004, resolving a substantial uncertainty arising from the California energy crisis in 2001; and

d. We announced our Long-Range Plan that, among other things, defines our core business, establishes a timeline for debt reductions, sets a timetable for existing non-core business and assets and sets financial goals for the company.”<sup>466</sup>

This confirms that the sale of assets was just one of various measures taken by El Paso Corporation to meet the problems that had emerged in the preceding period, including the liquidity issues. It is doubtful that the sale of the Argentinian assets, due to the modest price, was intended to contribute to the solution of these problems.

503. The Tribunal has considered the Respondent’s contention that “[i]t was the Claimant’s decision to sell its assets in the country in the worst time of the Argentine crisis, in the need for facing its own global crisis, what caused the damage alleged by El Paso.”<sup>467</sup> It has been mentioned that El Paso Corporation’s policy was based on the orderly disposition of assets. With specific reference to the Argentinian assets, it is on record that El Paso had received an offer to buy part of those assets (the 45% indirect interest in

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<sup>465</sup> 2003 El Paso Report filed with the SEC, *supra* note 219, p. 36.

<sup>466</sup> *Ibid.*

<sup>467</sup> Counter-Memorial, § 788.

CAPSA/CAPEX) as early as in November 2002, at a price equal to US\$ 24 million.<sup>468</sup> El Paso's reply of 21 November 2002 was non-binding and made subject to conditions,<sup>469</sup> which shows that El Paso was not under pressure to sell. The Tribunal shares the Claimant's view that the fact that the sales were made later in 2003, one and a half years after the measures were adopted, is indicative of a prudent decision,<sup>470</sup> aimed at mitigating future damage in the presence of a scenario which, at that time, was far from being predictable.<sup>471</sup>

504. The Tribunal has considered the further contention by the Respondent that there is no official document from which it may be inferred that the sale by El Paso was due to the GOA's measures.<sup>472</sup> The Respondent points to the Reports filed with the SEC by El Paso Corporation for the years 2002 and 2003, which state that the cause of the losses suffered as a result of the sale of its assets in Argentina was the economic crisis, with no mention of the GOA measures.<sup>473</sup> By contrast, concerning the sale of the power generation investments in Australia, the 2003 Report states that the losses were due to regulatory difficulties.<sup>474</sup>
505. Regarding the above contention, it may be noted that the SEC filings by El Paso, although important,<sup>475</sup> do not exhaust the range of circumstances that may be taken into account by the Tribunal to form its judgment. It has been shown that, contrary to the Respondent's assumptions, the sale of the Argentinian assets was neither made to assist in improving El Paso's liquidity and solving

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<sup>468</sup> Letters from Enrique Götz to EPEC Energy Argentina dated 14 and 28 November 2002, Annex G to Claimant's 21 June 2006 filing.

<sup>469</sup> Response letters from El Paso dated 21 November and 6 December 2002, Annex G to Claimant's 21 June 2006 filing.

<sup>470</sup> Reply, § 374.

<sup>471</sup> As shown by the continuing validity of the GOA measures and the adoption of further measures (including the increase of the withholding tax up to 45%).

<sup>472</sup> Rejoinder, § 26.

<sup>473</sup> *Ibid.*, § 18.

<sup>474</sup> *Ibid.*, § 20.

<sup>475</sup> It may be noted that the 2002 Report covers the year preceding the sales of El Paso assets in Argentina, so that its relevance is doubtful. The page of the 2003 Report quoted by the Respondent (Rejoinder, footnotes 31 and 32) contains a chart allegedly recording "our impairment charges and gains and losses on sales of equity investments during 2003, 2002 and 2001," where CAPSA/CAPEX are shown as having been sold in 2002 (at a loss of \$262 million) due to "weak economic conditions in Argentina." The reference to a sale of CAPSA/CAPEX in 2002 shows a lack of accuracy in the Report.

other problems; nor did it involve non-core business only. The decision was made at a time when, according to the Claimant's evaluation, the financial conditions of the Argentinian companies (except for PACIFICO) had deteriorated to the extent of a loss of value of about 90% and when "the prospects for the near and mid-term future appeared bleak."<sup>476</sup>

506. In conducting its evaluation, the Tribunal has also considered that other energy and utilities companies have divested their investments in Argentina following the enactment of the Respondent's measures,<sup>477</sup> losing approximately 90% of their investment according to the Claimant, although others did not divest their investments while faced with the same economic measures.
507. In the light of the preceding analysis and after due consideration of the Parties' arguments and the evidence in the file, the Tribunal concludes that the GOA measures were, if not the only, certainly the prevailing reason for El Paso's sales in 2003. It remains to determine the consequences to be drawn from that conclusion. This point will be addressed hereafter.
508. The Claimant has asserted that since the GOA measures "forced" it to sell, this was evidence of discriminatory and arbitrary treatment of its investment, in breach of Article II(2)(b) of the BIT which protects the investor if the effect of this kind of measures is to "impair ... the disposal of investments."<sup>478</sup> The Tribunal has already decided that the GOA measures do not amount to discriminatory or arbitrary treatment of El Paso's investment.<sup>479</sup> No discrimination or arbitrariness having been found in the measures taken by the Respondent, no breach of the above-mentioned provision of the BIT can derive from the sales made by El Paso, even if they were in part caused by these measures.
509. Now that it has been found that Argentina's measures can be considered a contributory cause of the losses suffered by El Paso, it remains to be seen

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<sup>476</sup> Reply, § 369.

<sup>477</sup> A list of these companies is contained in the Chart contained in the Memorial, § 618; see also Reply, § 363.

<sup>478</sup> Reply, § 380. Emphasis by the Claimant.

<sup>479</sup> See *supra*, §§ 315 and 325, respectively.

whether these measures can, by their cumulative effect, be considered a violation of the FET standard.

*(ii) The Overall Cumulative Impact of the Measures with Regard to the Fair and Equitable Treatment Standard*

510. According to the Claimant, “[a]n investor will never invest if it expects that the rules of the game will be completely altered in a manner it cannot predict.”<sup>480</sup> It asserts that there were commitments by the GOA that it would not be affected by a new crisis in that country because all the main parameters were either in dollars or linked to the dollar: the electricity Spot Price was connected with the US PPI, adjusted bi-annually (a kind of *de facto* dollarisation); the VPCs were declared in dollars bi-annually; and the capacity payments were in dollars. According to El Paso, as a foreign company investing money in Argentina’s economy, it relied on the overall setting of the legal framework, which was clearly aimed at protecting the foreign investor from a devaluation of the dollar. These features were of the utmost importance due to the economic history of Argentina.
511. For example, the fact that capacity payments would be in the same currency as the investment, so that they would be immune from devaluation, was a strong incentive to invest in Argentina despite the frequent crises that had occurred throughout the country’s history. The dollar calculation was intended to protect the investor from devaluation. According to Robert L. Perez, an expert witness for the Claimant, the existence of capacity payments made investments in companies such as CAPEX and Costanera attractive to potential investors such as El Paso because they could make the investment, knowing that they would be able to upgrade the plant without the risk of losing their capital costs:

“These capacity payments would be in U.S. Dollars because investors would only be able to capitalize their investment in U.S. Dollar terms (including loans, equity, etc.... since it was highly unlikely that Argentine banks could supply the amounts needed by investors to upgrade facilities. Thus, the declarations of variable production costs

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<sup>480</sup> Reply § 91.



and the denomination of capacity payments in U.S. Dollars was significant to potential foreign investors like El Paso. When El Paso made its decision to enter Argentina's electricity sector, it fundamentally relied on the assurance of these capacity payments in assuring that CAPEX would be able to service US Dollar debt and be able to provide a reasonable return to us."<sup>481</sup>

512. The problem, therefore, was not so much whether the capacity payment should be at 4, 5 or 10 dollars; it was the calculation in US dollars that mattered to the foreign investor. But the GOA disregarded the very reason for which capacity payments were created, which was to attract investment to expand capacity by allowing generators to recover their capital expenditures in US dollars, in destroying the link between capacity payments and computation in dollars.
513. In the same manner, based on the assurances generally contained in the Electricity Regulatory Framework, investors such as El Paso could reasonably expect that a devaluation of the peso would not substantially alter the dollar value of Spot Prices.
514. The fact that the contracts were in US dollars could also be viewed as a special commitment towards the companies in which El Paso invested, and the pesification as entailing a violation of freely agreed terms and conditions.
515. Although they may be seen in isolation as reasonable measures to cope with a difficult economic situation, the measures examined can be viewed as cumulative steps which individually do not qualify as violations of FET, as pointed out earlier by the Tribunal, but which amount to a violation if their cumulative effect is considered. It is quite possible to hold that Argentina could pesify, put a cap on the Spot Price, etc., but that a combination of all these measures completely altered the overall framework.
516. According to the Tribunal, this series of measures amounts to a composite act, as suggested by the International Law Commission in its Articles on State

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<sup>481</sup> *Witness Statement of Robert L. Perez* [hereinafter *Perez Witness Statement*], 17 August 2004, §§ 50-52, Claimant's Exhibit No. 8.

Responsibility (Article 15).<sup>482</sup> Such an analysis is not without precedent. The tribunal in *Société Générale*, for example, referred to the concept of composite act and stated clearly that acts that are not illegal can become such by accumulation:

“While normally acts will take place at a given point in time independently of their continuing effects, and they might at that point be wrongful or not, it is conceivable also that there might be situations in which each act considered in isolation will not result in a breach of a treaty obligation, but if considered as a part of a series of acts leading in the same direction they could result in a breach at the end of the process of aggregation ...”<sup>483</sup>

517. It cannot be denied that in the matter before this Tribunal the cumulative effect of the measures was a total alteration of the entire legal setup for foreign investments, and that all the different elements and guarantees just mentioned can be analysed as a special commitment of Argentina that such a total alteration would not take place. As stated by the tribunal in *LG&E*, when evaluating the same events, “here, the Tribunal is of the opinion that Argentina went too far by completely dismantling the very legal framework constructed to attract investors.”<sup>484</sup>

518. The Tribunal considers that, in the same way as one can speak of *creeping expropriation*, there can also be creeping violations of the FET standard. According to the case-law, a creeping expropriation is a process extending over time and composed of a succession or accumulation of measures which, taken separately, would not have the effect of dispossessing the investor but, when viewed as a whole, do lead to that result. A *creeping violation of the FET standard* could thus be described as a process extending over time and

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<sup>482</sup> The General Assembly of the United Nations took note of the Articles on Responsibility of States for Internationally Wrongful Acts, presented by the International Law Commission, and commended them to the attention of governments, in a resolution adopted on 12 December 2001, UN Doc. A/RES/56/83; see also *Report of the International Law Commission on the Work of its Fifty-third Session* (2001), UNGA Official Records, Suppl. No. 10, A/56/10, pp. 43-365. For a number of general comments, see James Crawford, *The International Law Commission's Articles on State Responsibility. Introduction, Text and Commentaries*, Cambridge, Cambridge U. Press (2002).

<sup>483</sup> *Société Générale v. The Dominican Republic* [hereinafter *Société Générale*], LCIA Case No. UN7927, Award on Preliminary Objections to Jurisdiction of 19 September 2008, § 91.

<sup>484</sup> *LG&E*, *supra* note 51, § 139.

comprising a succession or an accumulation of measures which, taken separately, would not breach that standard but, when taken together, do lead to such a result.

519. The Tribunal, taking an all-encompassing view of consequences of the measures complained of by El Paso, including the contribution of these measures to its decision to sell its investments in Argentina, concludes that, by their cumulative effect, they amount to a breach of the fair and equitable treatment standard.

## G. FULL PROTECTION AND SECURITY

### 1. *The Parties' Positions*

520. According to the Claimant, the full protection and security (FPS) provision of the BIT is, like FET, a standard different from and higher than the full protection and security required by international law:

“The duty to provide full protection and security creates an independent treaty obligation that is distinct from a state’s obligation under customary international law.”<sup>485</sup>

The Claimant considers that FPS imposes obligations of due diligence and vigilance on Argentina and is not limited to physical security or the performance of its basic police functions by the State. For the Claimant, the FPS standard is sufficiently broad “to provide protection against the measures taken by the GOA;”<sup>486</sup> and in its view, “by its ordinary meaning, the phrase ‘full protection and security’ must include the ‘full’ security provided through legal and regulatory frameworks, not mere physical security.”<sup>487</sup> As a consequence of this broad interpretation, the Claimant asserts in its Reply that “Argentina, acting in its sovereign capacity, failed to provide full protection and security to El Paso’s investment by, *inter alia*:

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<sup>485</sup> Reply, § 630.

<sup>486</sup> *Ibid.*, § 633.

<sup>487</sup> *Ibid.*, § 634.

- disregarding and violating numerous key provisions of the Electricity Law;
- transforming the electricity sector from a competitive, market-based system to a fully-regulated industry characterized by government intervention and price manipulation;
- radically altering the Spot Price setting mechanism by creating Spot Price caps and artificially lowering the Maximum Recognized VCP through the market price of various fuels from the setting of the Spot Price and the generators' VCPs that exceeded the VCPs allowed by the Energy Secretariat;
- converting capacity payments from Dollars, as offered by the GOA in the Electricity Regulatory Framework in order to attract investments, to Argentine Pesos at a rate that decreased such payments to 40% of their original value;
- locking generators into frozen and depressed electricity prices by freezing the Seasonal Price at the nominal value in Pesos and failing to fund the Seasonal Stabilization Fund;
- imposing Export Withholdings on crude oil and LPG exports through Article 6 of Law N° 25,561 and Decree N° 310/2002, in violation of the stabilization provisions of the Mining Code and the Hydrocarbon Deregulation Decrees that enjoy legislative status, and the Concessions;
- violating CAPSA's, CAPEX's and COSTANERA's contractual rights by imposing a mandatory conversion of Dollar-denominated energy, LPG, and crude oil term contracts with third parties to Pesos at an artificially-low and confiscatory exchange rate;
- violating SERVICIOS' contractual rights by pesifying its Gas Processing Agreement at an artificially-low exchange rate;
- imposing quotas on LPG and crude oil exports in direct violation of Decrees N° 1589/1989, N° 1055/1989 and N° 1212/1989, which guarantee the right to export freely; and
- coercing CAPSA and CAPEX to renegotiate and enter into new LPG and crude oil supply agreements."<sup>488</sup>

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<sup>488</sup> *Ibid.*, § 647. Footnotes omitted.

521. According to the Respondent, on the contrary, “like the fair and equitable treatment standard, the protection and security standard relates to the international law minimum standard.”<sup>489</sup> In order to give content to that standard, Argentina contends that:

“In conformity with this interpretation, the protection and security standard is no more than the traditional obligation to protect aliens under international customary law. It is a residual obligation provided for the cases in which the challenged acts may not be in themselves attributed to the Government, but to a third party. In these assumptions, the Government must act diligently to prevent and penalize illegitimate acts by third parties damaging aliens.”<sup>490</sup>

The obligation of due diligence implies a certain number of consequences, among which the most important is that the State authorities are “obliged to protect aliens from acts not attributable to themselves, but stemming from third parties.”<sup>491</sup> In light of this first condition, the Respondent points out that, in the present case, none of the measures challenged by El Paso stems from a third party; all of them were taken by the State itself. Consequently, according to the Respondent, such measures should only be examined in the light of the other standards of the BIT and not under the full protection and security standard.

## 2. *The Tribunal’s Analysis*

522. The BIT requires that Argentina provide “full protection and security” to El Paso’s investment.<sup>492</sup> The Tribunal considers that the full protection and security standard is no more than the traditional obligation to protect aliens under international customary law and that it is a residual obligation provided for those cases in which the acts challenged may not in themselves be attributed to the Government, but to a third party. The case-law and commentators generally agree that this standard imposes an obligation of vigilance and due

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<sup>489</sup> Rejoinder, § 466.

<sup>490</sup> *Ibid.*, § 467.

<sup>491</sup> *Ibid.*, § 469.

<sup>492</sup> BIT, Article II(2)(a).

diligence upon the government.<sup>493</sup> The *AAPL* decision quotes with approval Professor Freeman's definition of due diligence:

"The 'due diligence' is nothing more nor less than the reasonable measures of prevention which a well-administered government could be expected to exercise under similar circumstances."<sup>494</sup>

And in the *AMT* case, the tribunal explained:

"These treatments of protection and security of investment required by the provisions of the BIT of which AMT is beneficiary must be in conformity with its applicable national laws and must not be any less than those recognized by international law. For the Tribunal, this last requirement is fundamental for the determination of the responsibility of Zaire. It is thus an objective obligation which must not be inferior to the minimum standard of vigilance and of care required by international law."<sup>495</sup>

523. The minimum standard of vigilance and care set by international law comprises a duty of prevention and a duty of repression. A well-established aspect of the international standard of treatment is that States must use "due diligence" to prevent wrongful injuries to the person or property of aliens caused by third parties within their territory, and, if they did not succeed, exercise at least "due diligence" to punish such injuries. If a State fails to exercise due diligence to prevent or punish such injuries, it is responsible for this omission and is liable for the ensuing damage. It should be emphasised that the obligation to show "due diligence" does not mean that the State has to prevent each and every injury. Rather, the obligation is generally understood as requiring that the State take reasonable actions within its power to avoid injury when it is, or should be, aware that there is a risk of injury. The precise degree of care, of what is "reasonable" or "due," depends in part on the circumstances.

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<sup>493</sup> See, e.g., *American Manufacturing & Trading, Inc. (AMT) v. Democratic Republic of Congo* (earlier referred to as Republic of Zaire) [hereinafter *AMT*], (ICSID Case No. ARB/93/1), Award of 21 February 1997, § 6.05; *AAPL*, *supra* note 41, § 50. See also: Rudolf Dolzer and Margrete Stevens, *Bilateral Investment Treaties*, The Hague, Kluwer Law International, 1995, pp. 60-61.

<sup>494</sup> *AAPL*, *supra* note 41, § 77.

<sup>495</sup> *AMT*, *supra* note 493 § 6.06.

524. However, El Paso does not complain about a violation by Argentina of an obligation of prevention or repression. In the *Tecmed* case, the tribunal made the same interpretation as this Tribunal and said the following:

“The Arbitral Tribunal considers that the Claimant has not furnished evidence to prove that the Mexican authorities, regardless of their level, have encouraged, fostered, or contributed their support to the people or groups that conducted the community and political movements against the Landfill ...”<sup>496</sup>

El Paso did not specify or determine the duty to act against a third party that has allegedly been breached by Argentina under the BIT: all the impugned acts that allegedly violate the FPS standard are directly attributable to the GOA and not to any third party. In the present case, none of the measures challenged by El Paso were taken by a third party; they all emanated from the State itself. Consequently, these measures should only be assessed in the light of the other BIT standards and cannot be examined from the angle of full protection and security.

525. The conclusion is that there is no trace of a violation of the full protection and security standard by any of the GOA’s measures impugned by the Claimant.

#### H. ARTICLE II(2)(c): THE UMBRELLA CLAUSE

526. The so-called umbrella clause contained in Article II(2)(c) provides as follows:

“Each Party shall observe any obligation it may have entered into with regard to investments.”

##### 1. *The Parties’ Positions*

527. According to the Claimant, the Respondent violated the BIT by failing to observe its obligations under Article II(2)(c).<sup>497</sup> In particular, the breach of some contractual rights of the Argentinian companies was complained of under

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<sup>496</sup> *Tecmed*, *supra* note 161, § 176.

<sup>497</sup> Memorial, §§ 539-546.

that provision. The Claimant asserted that under Article II(2)(c) Argentina had assumed an obligation, *inter alia*:

“To respect the terms of the Concessions that provide fiscal stability and not impose in the future either Export Withholdings nor discriminatory taxes.

To respect the right of power generators and hydrocarbon producers, like CAPSA, CAPEX and COSTANERA, to freely sell their production and agree on the terms governing its sale, including price and currency.

...

To respect the license agreements with gas distribution companies and power distributors to pass through to their tariffs the market price of the gas and electricity they acquire from gas producers and power generators.”<sup>498</sup>

These are all contractual rights belonging to the Argentinian companies, CAPSA, CAPEX and Costanera.

528. The Respondent’s answer can be summarised as follows: According to Argentina, the umbrella clause only applies to investment agreements entered into with foreign investors, not to hydrocarbon concessions granted by the State to national companies. In other words, there are no contractual commitments directly between the Claimant and Argentina, as any such commitments were made to CAPSA and CAPEX *via* the concessions and are not protected rights under the BIT.<sup>499</sup>

529. In its Reply, the Claimant has added to its initial analysis the idea that even if they are not elevated to the rank of treaty claims under Article II(2)(c), the contractual claims should still be seen as having led to a violation of this provision, as the concessions can be characterised as “investment agreements”:

“Nonetheless, even if Argentina’s characterization of the scope of the Umbrella Clause were correct, which it is not, Argentina’s abrogation

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<sup>498</sup> *Ibid.*, § 545; see also Reply, § 602.

<sup>499</sup> Counter-Memorial, §§ 669-705.



and repudiation of its commitments in the Concessions, the CAPSA Hydrocarbon Regulatory Framework, the Hydrocarbon Regulatory Framework, and the Electricity Regulatory Framework would still violate the Umbrella Clause because each of the Concessions qualifies as an ‘investment agreement’ under the BIT.”<sup>500</sup>

And there follows a list of alleged contractual breaches of these investment agreements:

“The GOA violated the Umbrella Clause by:

- unilaterally interfering in the contracts of private parties (*i.e.*, the electricity and hydrocarbon sale contracts of CAPEX, COSTANERA and CAPSA and SERVICIOS’ Gas Processing Agreement) by decreeing that their price terms be converted from Dollars to Pesos at the artificially low exchange rate of US\$ 1 - to - Arg. 1;
- breaching the CAPEX Concession (which had generally incorporated the provisions of Decree N° 1589/1989) and the CAPSA Concessions that benefited from the tax exemption established by Article 403 of the Mining Code by imposing Export Withholdings;
- breaching the license agreements of gas and electricity distributors by pesifying them and abrogating their US price index and US Dollar terms, which had a direct and immediate financial impact on electricity generators.”<sup>501</sup>

530. The Respondent again rejected this line of argument, stating that

“[t]he Argentine Republic did not violate the umbrella clause [because] ... (a) the scope of the umbrella clause is limited to the commitments assumed in an investment agreement; (b) there is no investment agreement in the present case.”<sup>502</sup>

In order to explain why no “investment agreement” was at stake here, Argentina explained that

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<sup>500</sup> Reply, § 613.

<sup>501</sup> *Ibid.*, § 627.

<sup>502</sup> Rejoinder, § 488.

“CAPSA and CAPEX concessions may never be put at the same level as an investment agreement since:

(a) they were not concluded between Argentina and a foreign investor, but granted by the Argentine Republic to local companies;

(b) they are governed by Argentine law and subject to Argentine courts; and

(c) they do not have any element internationalising it or provision linking them – not even indirectly – to the investment protection system provided for in bilateral investment treaties.”<sup>503</sup>

## 2. *The Tribunal’s Analysis*

531. In its Decision on Jurisdiction, the Tribunal rejected the argument that the so-called umbrella clause included in Article II(2)(c) could elevate any contract claim to the level of a treaty claim:

“In other words, the Tribunal, endorsing the interpretation first given to the so-called ‘umbrella clause’ in the Decision *SGS v. Pakistan*, confirms what it mentioned above, namely, that it has jurisdiction over treaty claims and cannot entertain purely contractual claims, which do not amount to a violation of the standards of protection of the BIT. It adds that, in view of Article VII(1) of the US-Argentina BIT, a violation of an investment agreement entered into by the State as a sovereign and an American national or company is deemed to be also a violation of the Treaty and can thus give rise to a treaty claim.”<sup>504</sup>

532. This means that a contract claim is not transformed into a treaty claim by the umbrella clause, while an “investment agreement” claim can be viewed as a treaty claim by virtue of a combination of Articles VII(1) and II(2)(c): “[m]oreover, Article II, read in conjunction with Article VII(1), also considers as treaty claims the breaches of an investment agreement between Argentina and a national or company of the United States.”<sup>505</sup> In other words, although in general a contract claim is not a treaty claim, the violation of an investment

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<sup>503</sup> *Ibid.*, § 501.

<sup>504</sup> Decision on Jurisdiction, *supra* note 58, § 85.

<sup>505</sup> *Ibid.*, § 84.

agreement can be considered a treaty claim as it is an obligation entered into with regard to investments under Article VII(1).

533. The Tribunal has already decided that El Paso has no contract claim based on contracts or licenses (see *supra* §§ 178-189) and that there is no investment agreement entered into by El Paso (see *supra* §§ 190-198). As a consequence, the question of their elevation to the level of a treaty claim does not arise.

534. The Tribunal wishes to add that this position finds support in the Annulment Decision in the *CMS* case.<sup>506</sup> It may be recalled that the ICSID tribunal dealing with that case had concluded in its Award of 12 May 2005 that there was a violation of the so-called umbrella clause included in Article II(2)(c):

“ ... the obligation under the umbrella clause of Article II(2)(c) of the treaty has not been observed by the Respondent to the extent that legal and contractual obligations pertinent to the investment have been breached and have resulted in the violation of the standards of protection under the Treaty.”<sup>507</sup>

In particular, this finding applied to two aspects of the commitments that the claimant *CMS* considered to have been made by Argentina in its favour, *i. e.*

“ ... two stabilization clauses contained in the License that have significant effect when it comes to the protection extended to them under the umbrella clause. The first is the obligation undertaken not to freeze the tariff regime or subject it to price controls. The second is the obligation not to alter the basic rules governing the License without TGN’s written consent.”<sup>508</sup>

535. The *ad hoc* Committee criticised the tribunal’s findings concerning the violation of the umbrella clause, stating that it was “impossible for the reader to follow the reasoning on this point,”<sup>509</sup> and therefore annulled this part of the decision for failure to state reasons. At the same time, it tried to reconstruct the possible reasoning of the Tribunal and, while doing so, gave some hints as to what could, in its view, be the possible meaning of an umbrella clause or, to be

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<sup>506</sup> *CMS*, *supra* note 48, Decision on Annulment.

<sup>507</sup> *CMS*, *supra* note 48, § 303.

<sup>508</sup> *Ibid.*, § 302.

<sup>509</sup> *CMS*, *supra* note 48, Decision on Annulment, § 97.

more precise, as to what could not be the meaning of an umbrella clause. Thus, two points were made clear by the *ad hoc* Committee.

536. First, according to that Committee, the umbrella clause, if it had any meaning – a question on which it did not take a position – could only concern consensual obligations and not general obligations:

“In speaking of ‘any obligations it may have *entered into* with regard to investment,’ it seems clear that Article II(2)(c) is concerned with consensual obligations arising independently of the BIT ... They do not cover general requirements imposed by law.”<sup>510</sup>

537. Second, the *ad hoc* Committee also made it clear that, in its view, a contractual obligation towards a non-protected investor cannot be transformed by the magic of the so-called umbrella clause into a treaty obligation towards a protected investor:

“The effect of the umbrella clause is not to transform the obligation which is relied on into something else; the content of the obligation is unaffected, as is its proper law. If this is so, it would appear that the *parties* to the obligation (*i.e.* the persons bound by it and entitled to rely on it) are likewise not changed because of the umbrella clause.”<sup>511</sup>

538. It is evident that the Tribunal cannot find any violation of a right pertaining to El Paso under the so-called umbrella clause, for the reason that the so-called umbrella clause cannot not elevate any contract claims to the status of treaty claims as El Paso cannot claim a contractual right of its own in this case.

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<sup>510</sup> *Ibid.*, § 95. Emphasis added by the *ad hoc* Committee.

<sup>511</sup> *Ibid.*, § 95. Emphasis added by the *ad hoc* Committee.

**V. CAN THE VIOLATIONS COMMITTED BY ARGENTINA BE PREVENTED OR EXCUSED?**

**A. CAN THE VIOLATIONS COMMITTED BY ARGENTINA BE EXCUSED ON ACCOUNT OF THE CONSENT ALLEGEDLY GIVEN THROUGH THE SIGNATURE OF AGREEMENTS?**

*1. The Parties' Positions*

*(i) The Respondent's Position*

539. The Republic of Argentina contends that El Paso's argument is inconsistent with the very actions of the Argentinian companies it is now claiming for. As a matter of fact, both CAPSA and CAPEX (together with many other companies in the same sector) entered into at least eight agreements with the GOA during the years 2002 and 2003 by which they recognised the Government's power to impose export duties on oil and gas and to take other measures. Through these agreements, the companies obtained advantages which, naturally, proved beneficial to their shareholders. In its damages estimate, El Paso omitted to consider these benefits.
540. Even if El Paso was a non-controlling shareholder of the companies in question and not a party to the various agreements with the Government, the fact remains that the companies entered into agreements by which the GOA's powers were recognised. Furthermore, there is no evidence that these agreements were concluded under duress, as alleged by El Paso, nor has any producer in the last five years challenged the voluntary nature of these agreements.
541. All the measures contested by El Paso (except for the export restrictions and the pesification) were expressly consented to by the Argentinian companies. A shareholder may not claim compensation for a measure concerning the rights of a company in which it holds a participating interest when the company in question has consented to such a measure. As a minority shareholder, El Paso should address its claim to the majority shareholder, not to the GOA.

*(ii) The Claimant's Position*

542. The Claimant contends that it was not a Party to the agreements with the Government, the latter having been signed by the Argentinian companies together with other oil companies. In addition, El Paso was a minority, non-controlling shareholder, and therefore not in a position to determine the decisions of the companies.
543. The Claimant also disputes the purported voluntary nature of these agreements, arguing that they were signed under duress. In fact, the GOA had threatened to impose higher export duties or artificially to depress domestic prices in the event of a failure to accept the agreements. Thus, to sign them was a way to mitigate damages.
544. Regarding the Crude Oil Special Arrangements, in the absence of Government pressures, no rational crude oil producer would have agreed to a US\$ 28.50 reference value for which the producers received nothing in exchange. Similar pressure was exercised regarding the LPG Price Stabilisation Agreement, which was concluded under the Government's threat to depress domestic prices artificially.
545. None of the agreements signed by CAPSA, CAPEX or Costanera, while El Paso was a shareholder, contains any acquiescence to the export withholdings or any waiver of legal rights, express or implied. In international law, waivers require a clear and unambiguous expression of consent.
546. In any event, as shown in *CMS* and *LG&E*, the presence of duress will not only invalidate a waiver but, in addition, confirm that the State has breached the BIT.
547. No objections were filed by El Paso before the courts of Argentina for a number of reasons, including the risk that raising a claim before the local courts could trigger the "fork-in-the-road" clause of the BIT (Articles VII (2) and (3)).

548. The Respondent's waiver claim assumes that El Paso is bound by the signing of the special agreements by CAPSA, CAPEX and Costanera. This, according to the Claimant, is wrong. As illustrated by *GAMI Investments v. Mexico*,<sup>512</sup> the decision of the local company (in that case, to pursue domestic remedies) cannot affect the right of a minority shareholder to claim under the applicable treaty. The same conclusion was reached by the *LG&E*, *Enron* and *Azurix* tribunals in their awards against the Republic of Argentina.

## 2. *The Tribunal's Analysis*

549. As noted by the Tribunal in its Decision on Jurisdiction when referring to the Decision on Jurisdiction in the *LG&E* case, the shares owned by El Paso in the Argentinian companies constitute the Claimant's investment in Argentina within the meaning of Article I (1)(a)(ii) of the BIT. This has been reiterated in paragraph 214 of the present Award. A clear distinction must therefore be made between the Claimant as an investor under the BIT and the Argentinian companies in which the Claimant participated and which operated in Argentina under local laws and regulations. Bearing in mind this distinction, the Respondent's contention that El Paso consented to export withholdings or other measures taken by the GOA by not objecting to the signing by CAPEX, CAPSA and Costanera of a number of agreements with the Government may not be shared. El Paso may not, in fact, be equated to the companies in which it was only a minority, non-controlling shareholder. Actions by the Argentinian companies cannot affect El Paso's rights as an investor under the BIT, except to the extent to which it has consented to such actions. However, there is no evidence of such consent.

550. Contrary to the Respondent's allegation, El Paso is not claiming *for* the Argentinian companies; nor is it acting for their benefit or on their behalf. The claims filed by El Paso in these proceedings are those of an investor requesting compensation for the breach by the State of a certain number of guarantees

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<sup>512</sup> *GAMI Investments Corp. v. The Government of the United Mexican States* [hereinafter *GAMI*], UNCITRAL (NAFTA), Final Award of 15 November 2004, § 38.

provided by the BIT, an international treaty. El Paso is therefore claiming in its own right, not in somebody else's. The fact that El Paso as a shareholder may have derived benefits from the agreements entered into by the companies and that such advantages have to be considered when evaluating its damages does not contradict this conclusion. The shareholding in the companies being the investment made by El Paso in Argentina, the damage to that investment caused by the breach of the BIT must obviously be calculated by taking into account any benefits accruing from the agreements in question or from the Government's measures.

551. This being the nature of El Paso's claims, and in the absence of any consent to the Argentinian companies entering into the agreements with the Government, no waiver of rights and claims accruing under the BIT may be imputed to El Paso. The Argentinian companies' decisions and their agreements with the GOA therefore have no impact on El Paso's rights under the BIT, the breach of which is the cause of action in these proceedings.

**B. CAN THE VIOLATIONS COMMITTED BY ARGENTINA HAVE BEEN PREVENTED OR BE EXCUSED ON ACCOUNT OF THE EXISTENCE OF A STATE OF NECESSITY?**

552. The Tribunal will first examine the defense allegedly provided by Article IV (3) of the BIT. It will then address the two other Articles invoked by Argentina to avoid any responsibility for the measures taken to face the economic crisis, Article XI of the BIT and Article 25 of the ILC Articles on State Responsibility. The Tribunal will concentrate on the arguments based on Article XI first because, as was also stated by the tribunal in the case of *Continental*, "the application of Art. XI in the present case (if warranted) may be such as to render superfluous a detailed examination of the defense of necessity under general international law applied to the particular facts of the present dispute."<sup>513</sup> Of course, Article XI has to be interpreted taking into account general principles of international law, some of those being embodied in Article 25, as mentioned below in paragraph 590. And only if Article XI is found by

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<sup>513</sup> *Continental*, *supra* note 150, § 162.



the Tribunal not to apply in the case would an analysis of Article 25 be performed. Article XI is the *lex specialis*, Article 25, the *lex generalis*. As the Tribunal will consider Article XI of the BIT to apply to the case, it can dispense to fully analyse and to apply as such Article 25 of the ILC Articles.

553. It is however appropriate for the Tribunal to emphasise the difference between the two defences based on Article XI of the BIT and on Article 25 in general international law. Under Article XI, measures necessary “for the maintenance of the public order” or for “the protection of essential security interests” are not in breach of the relevant BIT, and therefore it would have been appropriate for the Tribunal to analyse the existence of a situation of necessity under Article XI even before evaluating the different measures adopted. On the contrary, if the rules of general international law regarding necessity apply, this is a ground for precluding the wrongfulness of an act not in conformity with an international obligation and thus implies that the acts be analysed first. This difference was clearly emphasised in a statement found in the Annulment Decision in *CMS*:

“Article XI is a threshold requirement: if it applies, the substantive obligations under the Treaty do not apply. By contrast, Article 25 is an excuse which is only relevant once it has been decided that there has otherwise been a breach of those substantive obligations.”<sup>514</sup>

554. In other words, in order to analyse the consequences of Article XI, the first question to answer is whether there was a situation of emergency as defined by that Article. If the answer is in the affirmative, all the acts considered necessary by the Tribunal to cope with this situation are excluded from the scope of the BIT, the contrary being true of the acts not considered necessary by the Tribunal. If the answer is in the negative, the Tribunal has to examine the different measures taken in order to determine whether or not they are in violation of one of the BIT standards of treatment of foreign investments. To analyse the consequences of Article 25, the reverse approach is required. The Tribunal should first analyse whether or not the measures constitute a violation of the standards of treatment of the BIT. If the answer is no, this marks the end

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<sup>514</sup> *CMS*, *supra* note 48, Decision on Annulment, § 129.

of the inquiry. If the answer is in the affirmative, the Tribunal has to consider whether the illegality can be set aside on account of a state of necessity.

555. However, in order to analyse the consequences of Article XI, the Tribunal has chosen to proceed as follows. It will first answer the question whether by its behaviour the State has contributed to endangering its public order or essential security interests. If the answer is in the affirmative, the defence under Article XI shall not apply since the challenged measures would fail to qualify as “necessary” under that Article. If the answer is in the negative, the Tribunal has to examine whether there was a situation of emergency as defined by Article XI, in which case, in the affirmative, all acts considered necessary by the Tribunal to cope with that situation are excluded from the scope of the BIT.”

*1. Can the Violations Committed by Argentina Be Excused on the Basis of Article IV(3)?*

556. Article IV (3) of the BIT provides:

“Nationals or companies of either Party whose investments suffer losses in the territory of the other Party owing to war or other armed conflict, revolution, state of national emergency, insurrection, civil disturbance or other similar events shall be accorded treatment by such other Party no less favorable than that accorded to its own nationals or companies or to nationals or companies of any third country, whichever is the more favorable treatment, as regards any measures it adopts in relation to such losses.”

*(i) The Parties’ Positions*

557. According to the Claimant, “[i]n reality, Article IV(3) of the BIT is completely irrelevant to Argentina’s defense of necessity.”<sup>515</sup> As explained by El Paso, that provision deals with possible measures taken by a State to compensate losses that have occurred due, for example, to war or civil disturbances. It does not apply as an excuse based on necessity or emergency: “Since Article IV(3) relates to compensatory measures rather than acts that cause an investor’s loss,

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<sup>515</sup> Reply, § 806.

it provides no guidance as to whether such acts are excusable in a given context.”<sup>516</sup>

558. The Respondent has a different interpretation of Article IV(3), arguing that the emergency measures challenged are indeed authorised by that provision:

“The BIT expressly mentions the adoption of emergency measures by a state, which may generate losses to the investments of the other contracting party. Not only does it point out this possibility, but it also legitimises the act from Government [*sic*]....”<sup>517</sup>

In fact, Argentina equates “measures adopted in relation to losses due to an emergency situation” with “measures to be adopted to mitigate the crisis or emergency”<sup>518</sup> and then concludes that the only obligation of a State during a period of emergency is to accord foreign investors’ treatment that is not discriminatory. Stating that “upon the state of emergency, El Paso received the same treatment as the other national and foreign companies that were engaged in the provision of similar services,”<sup>519</sup> it concludes that Argentina fully complied with its obligations towards the foreign investor. The position of the GOA is that “Article IV(3) provides for a special solution in the event of an exceptional situation, which proves that the general obligations contained in the treaty are only applicable in ‘normal’ circumstances.”<sup>520</sup>

*(ii) The Tribunal’s Analysis*

559. The Tribunal cannot accept the Respondent’s interpretation, which goes against the plain meaning of the text, and it agrees with the Claimant that Article IV(3) applies to measures adopted in response to a loss, not to measures that cause a loss. The plain meaning of the provision is that the standards of treatment of the BIT – national treatment and most favoured nation treatment – have to be applied when a State tries to mitigate the consequences of war or other

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<sup>516</sup> *Ibid.*, § 816.

<sup>517</sup> Counter-Memorial, § 724.

<sup>518</sup> *Ibid.*, § 724.

<sup>519</sup> *Ibid.*, § 731.

<sup>520</sup> Rejoinder, § 527.

emergency. This is in line with the analysis of the same provision made by the tribunal in *CMS* when it pointed out that:

“The plain meaning of the Article is to provide a floor treatment for the investor in the context of the measures adopted in respect of the losses suffered in the emergency, not different from that applied to nationals or other foreigners. The Article ... ensures that any measures directed at offsetting or minimizing losses will be applied in a non-discriminatory manner.”<sup>521</sup>

560. It is therefore the conclusion of the Tribunal that the violations committed by Argentina cannot be excused by Article IV (3), as that provision does not deal with the matter at hand.

## 2. *Can the Violations Committed by Argentina be Excused on the Basis of Article XI?*

561. In its written and oral presentations, Argentina has justified its conduct by invoking Article XI of the 1991 Argentina-US BIT. That provision reads:

“This Treaty shall not preclude the application by either Party of measures necessary for the maintenance of public order, the fulfilment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests.”

This is obviously an important provision, as recognised by Professor Michael Reisman, an expert called by the Claimant, who stated during the hearing that:

“Obviously the Parties felt that this assurance was critical to them. Whether this could have been available as a matter of general international law to the Parties is another matter. But by establishing this particular regime in Article 11 the Parties indicated that customary international law that might otherwise govern would not govern, and that this would be the provision for those circumstances, what we generally refer to as necessity.”<sup>522</sup>

562. This provision raises the following questions: Who is entitled to interpret Article XI authoritatively? Do the provisions of that Article apply to the

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<sup>521</sup> *CMS*, *supra* note 48, § 375.

<sup>522</sup> Hearing Transcript in English, Day 3, p. 752.

present dispute? If so, does its applicability exonerate Argentina from any duty to pay compensation?

*(i) The Question of Whether Article XI Is Self-judging: Who Is Entitled to Interpret Article XI?*

*(a) The Respondent's Position*

563. In its pleadings, Argentina, partly basing itself on expert legal opinions,<sup>523</sup> contended that each Contracting Party was entitled to interpret the terms of Article XI of the Argentina-US Treaty with final effect, subject only to the principle of good faith. Argentina's thesis can be summarised as follows.

564. It is true that, unlike the provisions of other treaties, such as Article XXI of the GATT,<sup>524</sup> Article XI of the 1991 Argentina-US BIT does not expressly state that it is self-judging. It nevertheless exhibits that characteristic because this is the position of both Contracting Parties: that of the United States since 1986, when it argued, in the *Nicaragua* case, that the International Court of Justice (hereinafter: ICJ) had to examine<sup>525</sup> whether a similar provision contained in the Treaty of Friendship, Commerce and Navigation (hereafter: FCN) concluded on 21 January 1956 between the US and Nicaragua<sup>526</sup> was self-judging in character; this was the position of Argentina was well.

565. The self-judging character of Article XI of the BIT can, according to the respondent State, be deduced from its text, read in its context, and from the object and purpose of the Treaty, the preparatory work and the circumstances surrounding its conclusion.<sup>527</sup> This character also results from the position

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<sup>523</sup> Rejoinder, §§ 533-546; *Witness Statement of Anne-Marie Slaughter and William Burke-White* [hereinafter Slaughter/Burke-White Report] of 4 March 2007; Respondent's Rejoinder, Annexes, §§ 15, 18-36; Sornarajah Report, *supra* note 76, §§ 107-109.

<sup>524</sup> Article XXI of the GATT 1947 (United Nations Treaty Series, Vol. 55, p. 187) provides that "[n]othing in the Agreement shall be construed ... (b) to prevent any Contracting Party from taking any action which it considers necessary for the protection of its essential security interests."

<sup>525</sup> *Case concerning Military and Paramilitary Activities in and against Nicaragua* (hereinafter *Nicaragua v. United States*), Merits, Judgment of 27 June 1986, ICJ Reports 1986, p. 14.

<sup>526</sup> Slaughter/Burke-White Report, *supra* note 523, §§ 18-36. For the text of the FCN, see [http://untreaty.un.org/unts/1\\_60000/10/37/00019817.pdf](http://untreaty.un.org/unts/1_60000/10/37/00019817.pdf)

<sup>527</sup> *Ibid.*, § 16. Article 31 of the 1969 Vienna Convention of the Law of Treaties runs as follows:

taken by the US Department of State at the time of the BIT's approval by the US Senate, which amounts to an interpretative declaration in the sense of Article 31 of the 1969 Vienna Convention on the Law of Treaties.<sup>528</sup>

566. Regarding the texts of Articles XXI of the GATT and XXI of the Nicaragua-US FCN, they are not, according to Argentina, relevant for interpreting the Argentina-US BIT; they are not, in particular, part of that instrument's context in the sense of Article 31 of the 1969 Vienna Convention on the Law of Treaties. The same can be said of Article XX(1)(d) of the Iran-US Treaty of Amity, Economic Relations and Consular Relations, of 15 August 1955.<sup>529</sup>
567. So far as the ruling of the ICJ in the *Nicaragua* case is concerned, Argentina considers it to have no bearing on the present arbitration because: (i) at the time when that case was decided, the evidence for ascertaining the Parties' positions was insufficient, and the US began to make statements on the matter precisely on the basis of that case; (ii) Nicaragua and the US held conflicting views in the *Nicaragua* case, the former contending that the contested provision was not self-judging, the latter holding the opposite view, whereas in the present arbitration the States involved are of the same opinion, namely, that Article XI of the 1991 BIT is self-judging; and (iii) the circumstances surrounding the two cases are different, the US having invoked the self-judging character of the relevant clause in *Nicaragua* to legitimise the use of force against another State, whereas, in the present instance, Argentina does so to justify domestic

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"1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.

2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:

(a) any agreement relating to the treaty which was made between all the parties in connexion with the conclusion of the treaty;

(b) any instrument which was made by one or more parties in connexion with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.

3. There shall be taken into account together with the context:

(a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;

(b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;

(c) any relevant rules of international law applicable in the relations between the parties.

4. A special meaning shall be given to a term if it is established that the parties so intended."

<sup>528</sup> Slaughter/Burke-White Report, *supra* note 523, § 16.

<sup>529</sup> *Ibid.*, § 33.

economic measures “sought to pacify the country, maintain public order and national security.”<sup>530</sup>

568. According to the respondent State, there is evidence showing that both the US and Argentina considered Article XI of their BIT to be self-judging. One evidential element is the fact that in August 1992, barely one year following the conclusion of the Treaty but prior to its ratification, the US Department of State submitted five BITs and a model BIT to the US Senate for approval. Each provision of the Model BIT was accompanied by commentaries; and the commentary on Article X – whose text is identical to Article XI of the Argentina-US BIT – explained that the provision was self-judging and that this feature was carefully recorded by the US State Department in each negotiation.<sup>531</sup>
569. In *LG&E*,<sup>532</sup> the tribunal considered the date of conclusion of the Argentina-US BIT rather than that of ratification to be relevant for ascertaining the meaning of treaty clauses, says Argentina. But, in view of the declaration by the US Senate,<sup>533</sup> there are strong reasons to believe that even at the time of concluding their BIT, both the US and Argentina believed its Article XI to be self-judging. Further, when Argentina ratified the BIT in 1994, it was well aware of the position taken by the United States in 1992.
570. It may be presumed, always according to Argentina, that all bilateral investment treaties concluded by the US follow the 1992 Model Treaty, unless the State Department, in its letter accompanying the text of treaties on the occasion of their submission to the Senate, indicates otherwise, which is not the case here. As no contrary evidence has been presented by the Claimant, Article XI of the Argentina-US BIT must be deemed self-judging.
571. The same obtains on the side of Argentina, the other Contracting Party. True, when the BIT between the US and Russia was being negotiated, it was the

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<sup>530</sup> Rejoinder, § 537.

<sup>531</sup> *Ibid.*, § 538.

<sup>532</sup> *LG&E*, *supra* note 51.

<sup>533</sup> Rejoinder, § 539; Slaughter/Burke-White Report, *supra* note 523, § 20.

Russian negotiators who wished to specify that the Treaty's provision corresponding to Article XI of the Argentina-US Treaty was self-judging. This cannot, however, be taken to mean, *a contrario*, that Article XI, for the United States, does not have that characteristic as well.

572. The United States view, while it has grown more explicit, has not changed at least since 1984, when it was put forth in the *Nicaragua* case. An inevitable consequence of that view is, as explained by the US Government to the US Senate, that self-judging clauses in BITs could also be invoked, on the basis of reciprocity, by the other Contracting Party, to the detriment of US investors, this being the price to pay for the United States' freedom of action under the BITs.
573. Argentina concludes its arguments by asserting that the self-judging nature of provisions such as Article XI of the Argentina-US BIT promotes, rather than undermines, international law. It confirms the contractual freedom of States within the mandatory framework of *jus cogens* and, accordingly, strengthens the concept of sovereignty. Another restriction based on the power of self-judging clauses is that recourse to such a clause is limited by the principle of good faith.

(b) *The Claimant's Position*

574. The Claimant contends that Article XI of the Argentina-US BIT is not self-judging.<sup>534</sup> It begins its argument by pointing out that the evidence adduced by Argentina to establish the self-judging character of Article XI exclusively pertains to the "essential security interests" element in that provision, and that there is no evidence showing that the US Government has considered self-judging the "public order" element or the reference to international peace and security contained in that same Article.
575. Moreover, says the Claimant, in reality the "essential security interest" feature of Article XI is not self-judging. As a rule, treaty provisions are self-judging

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<sup>534</sup> Reply, §§ 827-850.



only if the States Parties to the treaty clearly say so, which is not the case here. Article XI is phrased in the same objective manner as the other provisions of the BIT, the review of which is the object of a compulsory adjudication procedure.

576. There is, according to the Claimant, no ambiguity in the text of Article XI. In the absence of any contrary indication, it is up to this Tribunal to review the existence of necessity under that Article, as it is within its competence to interpret the BIT by virtue of Article VII of that Treaty and the acceptance of the Tribunal's jurisdiction by the Parties. Adjudication being the mode of review established by the BIT, the existence of a self-judging mechanism for a given provision must be attested to by explicit language, such as that found in Article XXI of the GATT. The difference of language in that instrument and in Article XI of the 1991 BIT is striking: "action which *it* [the State] *considers* necessary" in Article XXI of the GATT, as compared to "measures necessary" in Article XI of the BIT.
577. According to the Claimant, a similar situation arose in the *Nicaragua* case, where the ICJ had to establish the meaning to be attributed to Article XXI(1) of the 1956 Treaty of Friendship, Commerce and Navigation (FCN) between Nicaragua and the US. The provision in question prescribed that "the present Treaty shall not preclude the application of measures ... (d) ... necessary to protect essential security interests." The Court concluded that the reference to "essential security interests" in Article XXI(1) of the 1956 Treaty fell within the Court's jurisdiction as defined in the dispute settlement provision of Article XXIV of the same Treaty. The Court then compared the language of Article XXI(1) of the 1956 Treaty of FCN ("necessary") to that of Article XXI of the GATT ("which it [the State] considers necessary"). The latter provision, the Court explained, constituted an exception to the "normal implementation" of the General Agreement by allowing a Contracting Party to take action which it "considers necessary for the protection of its essential security interests" in fields such as nuclear fission and arms, whereas Article XXI of the 1956 Treaty

“speaks simply of ‘necessary’ measures, not of those considered by a Party to be such.”<sup>535</sup>

578. Is it believable, asks the Claimant, that the United States did not learn from the ICJ’s judgment that self-judging provisions must be identified by explicit language? Could the US have thought it possible, a mere five years after the *Nicaragua* judgment, to make the reference to “essential security interests” in Article XI self-judging, without any explicit indication to that effect? According to the Claimant, it could not.
579. To this, the Claimant adds that in the wake of the *Nicaragua* case, the United States showed that it knew how to draft a self-judging clause when necessary. The Protocol appended to the BIT with Russia,<sup>536</sup> negotiated in the same period as that with Argentina, states that “the Parties confirm their mutual understanding that whether a measure is undertaken by a Party to protect its essential security interests is self-judging.”<sup>537</sup> No similar statement was made in connection with the 1991 Argentina-US BIT; and whereas the Protocol accompanying the latter does comment on Article XI, it says nothing about its alleged self-judging character, as it surely would have done had the Parties intended to give it such a character. This is especially so since, in subsequent BITs with El Salvador and Bahrain, the US saw to it that the “which it *considers* necessary” formula suggested in the *Nicaragua* judgment found its way into their texts.<sup>538</sup>
580. Turning to the evidence of Argentina’s legal experts, the Claimant asserts that not a single word uttered in the 1991 Treaty or any element in its context denotes any intent on the part of the United States or Argentina to confer self-judging status on Article XI of the Treaty.

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<sup>535</sup> *Ibid.*

<sup>536</sup> Treaty Concerning the Encouragement and Reciprocal Protection of Investment of 17 June 1992, International Legal Materials (I.L.M.), Vol. 31, 1992, p. 799.

<sup>537</sup> *Ibid.*, p. 809, point 8.

<sup>538</sup> *Ibid.*

581. Next, the Claimant turns to unilateral assertions made by the United States, in connexion with other BITs, in the course of internal debates. Specifically it refers to exchanges between the US Department of State and the US Senate in 1988 and 1992 relating to the “essential security interests” clause in other BITs and in the 1992 Model Treaty.<sup>539</sup> These exchanges, the Respondent argued, were evidence of the American attitude regarding the Model Treaty and suggested that the US position on Article XI of the 1991 BIT must have been the same during that period; and, since there is no contrary evidence, Argentina must have shared that attitude. According to the Claimant, there is no reason to have recourse to supplementary means of interpretation.

582. Indeed, the text of Article XI of the Argentina-US BIT, read in its context and in light of the Treaty’s purpose, is “quite clear.” In such situations, the 1969 Vienna Convention on the Law of Treaties does not authorise the use of supplementary means of interpretation. And, even if it did, and if Article 31(4) of the Vienna Convention<sup>540</sup> were relied on to establish that the treaty terms in issue have a special meaning, inconsistent with that resulting from the application of Article 31(1) of the Vienna Convention, such a meaning would have to be established “conclusively” and by “decisive” proof.<sup>541</sup> All the respondent State has to offer are internal statements which dwell on other treaties and do not support the idea that the US silently willed Article XI of the 1991 BIT to be self-judging. Moreover, says the Claimant, given Argentina’s history of economic emergencies, it is unlikely that the US would have intended to clothe Article XI with self-judging character. Even if it had wished to do so, it would have had to inform Argentina and to obtain its consent.

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<sup>539</sup> Article XIV(1) of the Treaty between the Government of the United State of America and the Government of the Republic of El Salvador concerning the Encouragement and Reciprocal Protection of Investment, signed at San Salvador on March 10, 1999; Article 14(1) of the Treaty between the Government of the United State of America and of the State of Bahrain concerning the Encouragement and Reciprocal Protection of Investment, signed on September 29, 1999.

<sup>540</sup> Reply, § 847.

<sup>541</sup> *Ibid.*, § 839, referring to the Sofaer Opinion [note 500 below], § 31, citing Sir Humphrey Waldock’s *Third Report on the Law of Treaties*, Yearbook of the International Law Commission 1964, Vol. II, p. 5. That provision, it will be recalled, specifies that “[a] special meaning shall be given to a term if it is established that the parties so intended.”

583. In other words, according to the Claimant, the Argentinian legal experts have failed to show the Parties' *mutual* intention to vest Article XI of the 1991 Treaty with self-judging character; nor can such an intention be derived from that instrument's context. According to Article 31(2) of the Vienna Convention on the Law of Treaties, the "context" includes, in addition to the text proper, the preamble and the annexes, (a) any agreement relating to the treaty "made between all the Parties in connection with the conclusion of the treaty," and (b) any instrument "made by one or more Parties in connection with the conclusion of the treaty and accepted by the other Parties as an instrument related to the treaty." It follows from this that what the US may have intended with regard to Article XI, according to the Respondent, would not be relevant context. The status of relevant context would be limited to intentions *agreed upon* by the Parties, and there is no evidence of agreement on this point. Treaty interpretation does not consist in looking for the unilateral and silent wishes of a Party.
584. In the absence of relevant contextual elements, the interpreter should stick to the "ordinary meaning" of Article XI and to the Treaty's "object and purpose."<sup>542</sup> As pointed out already, the ordinary meaning of the relevant provision is that, like other Articles of the Treaty, it is of an objective rather than self-judging nature. This view is buttressed by the fact that the Treaty's object and purpose is to protect investments made by investors of one Party on the territory of the other. A self-judging interpretation of Article XI of the 1991 Treaty would enable Argentina to interfere almost limitlessly with US investments, subject only to a good faith standard.
585. To justify a departure from the above reasoning, Argentina would have to show that *both* Parties intended to give Article XI of the 1991 Treaty a special meaning under Article 31(4) of the Vienna Convention on the Law of Treaties. There is no evidence, however, that they did. Consequently, the ordinary

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<sup>542</sup> *Opinion of Abraham D. Sofaer* [hereinafter *Sofaer Opinion*] of 14 November 2006, § 31. Claimant's Exhibit No. 302.

meaning of the text of the provision, viewed in the context of its object and purpose, must prevail.

586. The question of the self-judging nature of Article XI of the 1991 BIT came up, and was answered in the negative by the tribunal in *CMS*.<sup>543</sup> Accordingly, that tribunal's task was not limited to establishing whether the plea of necessity had been invoked and whether the challenged measures were taken in good faith. The tribunal was called upon to examine whether, as a matter of substance, Argentina's recourse to Article XI was justified. The *LG&E* tribunal<sup>544</sup> reached the same conclusion.
587. Finally, according to the Claimant, even if one were to decide otherwise, and if the self-judging power allegedly inherent in Article XI of the 1991 BIT were limited only by a good faith standard, Argentina's views could not prevail. Indeed, the continuous repudiation of the Claimant's rights, on the basis of an emergency that had long ceased to exist, is inconsistent with the good faith standard invoked by the respondent State.

*(c) The Tribunal's Analysis*

588. The Tribunal will ascertain the meaning of Article XI of the 1991 Argentina-US BIT by applying Articles 31 and 32 of the 1969 Vienna Convention on the Law of Treaties. Before doing so, it wishes to point out, as the Claimant has done,<sup>545</sup> that the evidence presented by the Respondent relates to a single element of Article XI, "essential security interests." That Article, however, mentions two other possible justifications: the maintenance of public order and the fulfilment of the State's obligations regarding the maintenance or restoration of international peace or security. This could be taken to suggest that the self-judging character of Article XI is, at any rate, limited to "essential security interests" and cannot extend to the other elements, in particular the maintenance of public order. At first glance, the present case does not,

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<sup>543</sup> *CMS*, *supra* note 48, §§ 370, 373.

<sup>544</sup> *LG&E*, *supra* note 51, §§ 207-214.

<sup>545</sup> See *supra*, § 574.

however, seem to concern (external) security interests but possibly the maintenance of (internal) public order, which would not be a self-judging matter at all under Article XI of the BIT.

589. It is not necessary to pursue this line of argument, however, since the Tribunal believes that Article XI contains no self-judging elements, as it will now show by examining the content of that provision in the light of the canons of treaty interpretation of Articles 31 and 32 of the 1969 Vienna Convention on the Law of Treaties.
590. The Tribunal considers that, pursuant to Article 31(1) of the Vienna Convention, any interpretation has to begin with an examination of the *terms* of the treaty taken in their ordinary meaning. The wording of the treaty is deemed to express the intention common to the Parties, and what the Parties effectively agreed to, even though a Party might have wished otherwise on one or another point. As long as such wishes are not expressed, the content of the treaty's provisions is paramount, and what is not there cannot be read into them. This prompts the further conclusion that in principle treaty rules must be regarded as being objective in nature, which means that, unless the contrary is specified, they are not self-judging: a State Party is not entitled to interpret unilaterally the terms of a treaty in an authoritative manner.
591. In principle, the ordinary meaning of a treaty provision is that given to its terms at the time of its conclusion, in the present case in 1991, as was pointed out by the tribunal in *LG&E*.<sup>546</sup> Changes occurring elsewhere, at a later stage, for instance when other, similar treaties are being negotiated or when a model treaty is being submitted to a national authority for approval, even if they happened before the treaty to be interpreted is ratified or comes into force, are irrelevant for establishing the meaning to be given to it. This means that Argentina cannot rely on the BITs negotiated after 1991 or on the 1992 Model Treaty.

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<sup>546</sup> *LG&E*, *supra* note 51, §122.

592. Treaty provisions allowing for exceptions to the rights guaranteed in the same treaty must be attributed the ordinary meaning resulting from their text, without reading self-judging clauses into them, especially when the treaty contains compromissory clauses, as is the case here. This clearly results from the case-law and from international practice.
593. In this respect, *Nicaragua* is evidently the leading case, where the ICJ was confronted with an “essential security interests” clause found in Article XXI of the 1956 Nicaragua-US Treaty of FCN (“the present Treaty shall not preclude the application of measures ... (d) ... necessary to protect its essential security interests”). That same Treaty also contained a compromissory clause placing disputes pertaining to the interpretation and application of its provisions under the ICJ’s jurisdiction. The ICJ thought that the above clause was not self-judging and found that it had jurisdiction to determine whether the essential security interests clause was applicable – a question it answered in the negative. In this precedent, the Court establishes that, in the absence of qualifying language, the text of the relevant provision must be interpreted as it is, according to its ordinary meaning. To buttress its conclusion, the ICJ cites, *a contrario*, Article XXI of the GATT, which does contain qualifying language (“Nothing in this Agreement shall be construed ... (b) To prevent any Contracting Party from taking any action which it considers necessary for the protection of its essential security interests”).
594. The above precedent is of particular relevance in the present instance because it relates to a treaty which, though not a BIT, also defines and protects rights of individuals of one Party on the territory of the other and because the 1991 Argentina-US BIT, like the Nicaragua-US Treaty of FCN, contains a compromissory clause. The *Nicaragua* judgment was rendered in 1986; the Argentina-US BIT was concluded in 1991, barely five years later. It is most unlikely that within this short time-span the US could have forgotten the lesson of *Nicaragua* which amounted to saying that if one wishes a treaty clause to be self-judging, one has to say so and to obtain the other Party’s assent. The conclusion emerging from these elements is that at the relevant time, the US did not seek to attribute self-judging character to Article XI of the 1991 BIT.

595. This conclusion is supported by two decisions of ICSID tribunals bearing on the very same provision, *i.e.* Article XI of the 1991 BIT. In *CMS*, the tribunal said:

“The Tribunal is convinced that when States intend to create for themselves a right to determine unilaterally the legitimacy of extraordinary measures importing [*sic*] non-compliance with obligations assumed in a treaty, they do so expressly.”<sup>547</sup>

The arbitral tribunal then explained that if measures taken by Argentina are considered justified by that State under Article XI of the BIT, it is not up to Argentina to determine unilaterally that such justification is legitimate. It is not sufficient, in other words, merely to invoke Article XI and to assert that the State’s measures were taken in good faith. It is also necessary to show that those measures were effectively covered by the language of Article XI.<sup>548</sup>

596. The above views were shared by the arbitral tribunal in *LG&E*. In its decision, that tribunal said:

“Based on the evidence before the Tribunal regarding the understanding of the Parties in 1991 at the time the Treaty was signed, the Tribunal decides and concludes that the provision [Article XI] is not self-judging.”<sup>549</sup>

The passage just cited is of particular interest because it emphasises what has been said earlier,<sup>550</sup> namely, that what matters is the Parties’ common intention at the time of signature in 1991, when negotiations had been concluded, rather than subsequent events.

597. The case-law reported above is particularly persuasive because the US has been one of the champions of self-judging clauses, a device which it has used at least since the end of World War II, witness the so-called Connally amendment embodied in the declaration made by the United States on 26 August 1946 under Article 36(2) of the Statute of the ICJ. In that declaration,<sup>551</sup> the US

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<sup>547</sup> *CMS*, *supra* note 48, § 370.

<sup>548</sup> *Ibid.*, §§ 367-374.

<sup>549</sup> *LG&E*, *supra* note 51, § 212.

<sup>550</sup> See *supra* § 564.

<sup>551</sup> See ICJ Yearbook 1985-1986, p. 60.



accepted the Court's compulsory jurisdiction, except for matters falling within its domestic jurisdiction "as determined by the United States." Surely the inclusion of that clause – which only ceased to exist when the US withdrew its declaration in 1985 – shows that the possibility of introducing a self-judging mechanism, coupled with the necessity of doing so explicitly, had been known to the US for many years and that the *Nicaragua* judgment did not, on this point, come as a surprise, even though, in that case, the ICJ did examine whether, implicitly, Article XXI of the Nicaragua-US Treaty of FCN of 1956 had a self-judging character.

598. Article 15 of the 1950 European Convention on Human Rights<sup>552</sup> allows States Parties, in time of war or other public emergency threatening the life of the nation, to derogate from their obligations under the Convention – except regarding Articles 2, 3, 4(1) and 7 – to the extent strictly required by the exigencies of the situation, provided that such derogations are not inconsistent with the Parties' other obligations under international law. A similar clause can be found in Article 27 of the 1969 American Human Rights Convention.<sup>553</sup> The case-law of the European Court of Human Rights shows that these provisions, despite their being emergency clauses, are far from being self-judging. In concrete cases brought before the Court and involving derogations formulated on the basis of those provisions, it is the European Court which determines whether they meet the conditions provided for in Article 15.<sup>554</sup>
599. According to Article 31(1) of the 1969 Vienna Convention, the terms of a treaty must be interpreted *in their context* (Article 31(1)). That notion is defined by Article 31(2) of the Convention as including, besides the body of the treaty, its preamble and its annexes – the "narrow" context – as well as (a) "agreements"

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<sup>552</sup> Council of Europe, *Convention for the Protection of Human Rights and Fundamental Freedoms as amended by Protocol No. 11, with Protocols Nos. 1, 4, 6, 7, 12 and 13*, available at:

<http://www.echr.coe.int/nr/ronlyres/d5cc24a7-dc13-4318-b457-5c9014916d7a/0/englishanglais.pdf>

<sup>553</sup> Organization of American States (OAS), *American Convention on Human Rights, "Pact of San Jose, Costa Rica,"* available at: <http://www.oas.org/Juridico/english/treaties/b-32.html>.

<sup>554</sup> Human Rights in International Law. Collected Texts, 2nd ed., Strasbourg, Council of Europe Publishing, 2000, p. 453. See, for example, *Brannigan and McBride v. United Kingdom*, Judgment of 26 May 1993, ECHR Reports, Series A, No. 258-B, §§ 38-74; *Aksoy v. Turkey*, Judgment of 18 December 1996, ECHR, Reports 1996-VI, §§ 68-87; and *Demir and Others v. Turkey*, Judgment of 23 September 1998, ECHR Reports 1998-VI, §§ 42-58.

relating to the treaty made by all its Parties in connection with its conclusion; and (b) instruments “made” by one or several Parties to the treaty and accepted as such by the other Parties to the treaty. These agreements and instruments form what may be called the “wide” context.

600. So far as the 1991 BIT between Argentina and the US is concerned, it may be argued that its preamble and the body of the text show that this Treaty aims at creating a stable and prosperous investment climate in both countries. That aim could not be attained if the exceptions allowed by Article XI were considered self-judging. Remaining within the “wide” context, one may note that there are no “agreements” relating to the treaty made by all Parties in connection with its conclusion (Article 31(2)(a) of the Vienna Convention), nor are there any “instruments” emanating from one or more Treaty Parties, accepted by the other Parties and “connected with the conclusion of the treaty.” Whatever may be and has been invoked by the respondent State – other BITs, the 1992 Model Treaty, etc. – is certainly not “connected *with the conclusion*” of the 1991 BIT between Argentina and the US.
601. Article 31(3) of the Vienna Convention does, however, mention elements *not connected with the conclusion of the treaty* and subsequent to the latter, *i.e.* (a) subsequent agreements between the Parties to the treaty regarding the interpretation or application of the latter’s provisions; (b) any subsequent practice which establishes the agreement of the Parties regarding its interpretation; and (c) any relevant rules of international law applicable in the relations between the Parties.
602. While the above-mentioned sub-paragraphs (a) and (c) of Article 31(3) of the Vienna Convention do not appear relevant here, a closer look at sub-paragraph (b) – any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation – seems necessary. Indeed, it has been contended by Argentina that the views of the US on self-judging provisions of BITs and other agreements changed in 1992 and that Argentina accepted the change, the aggregate amounting to a subsequent agreement on the interpretation of Article XI of the 1991 Argentina-US BIT. There is, to be sure, a “subsequent practice” consisting in a changed negotiating

position; Argentina did not, however, have to approve or disapprove it since it did not relate to the interpretation of the 1991 BIT but to the American attitude in future negotiations with other States.

603. Even if this were not so, internal exchanges between the organs of one Contracting State, coupled with the silence of the other State, are not sufficient to produce an agreed practice of interpretation; at least *some* communication must be shown to have occurred, which is not the case here. According to the respondent State, the Argentinian “agreement” consists, *inter alia*, in Argentina’s “awareness” that in its argument before the ICJ in the *Nicaragua* case, the US had alleged that the exception embodied in Article XXI of the US-Nicaragua Treaty of FCN – essential security interests – was self-judging and that, this being the case, the idea of self-judgment was also implicit in Article XI of the 1991 BIT between Argentina and the US. This line of argument seems far-fetched, and there is no evidence to support it. The provision in issue in the *Nicaragua* case defined the ICJ’s jurisdiction in matters covered by the treaty and an exception thereto, related to “essential security interests,” while the 1991 Argentina-US BIT pertains to substantive rights of individuals and companies and, moreover, contains not one but three exceptions in its Article XI (essential security interests, performance of obligations for the maintenance or restoration of international peace and security, maintenance of public order). Furthermore, the argument wholly overlooks the judgment in the case, which refuses self-judging character to a provision not unlike Article XI of the 1991 BIT. In reality, the signal received by both Argentina and the US in *Nicaragua* is likely to have been that no provision is self-judging unless the Parties clearly say so, which is not the case for Article XI. Finally, the “awareness” of Argentina seems to be of recent origin, having made its first appearance in the written pleadings on the substance of the present dispute.

604. A further element of interpretation to be examined is the *object and purpose* of the treaty (Article 31(1) of the Vienna Convention of the Law of Treaties). The purpose of BITs such as the present one is to establish a climate inducing investors of one State to invest on the territory of the other by creating, for both sides, reasonable conditions for the making of investments and for their

protection. The three elements embodied in Article XI of the 1991 Argentina-US BIT – and in similar provisions of other BITs – are part and parcel of the balance that must exist in such treaties. That balance would be disrupted if the legality of invoking one of the three elements present in Article XI were to be interpreted unilaterally by the State on whose territory the investments have been made. One could of course reply that the balance is restored by the fact that the recognition of a power of self-judgment for one Party entails the same power for the other Party on the basis of reciprocity. Would this re-adjust the balance? Not quite. BITs are about funds invested by foreign nationals, not about direct relationships between States. Therefore, self-judging exceptions such as that allegedly introduced into Article XI of the Argentina-US BIT by tacit consent would give extremely large powers to the State on whose territory the investment was made – the reference to good faith is of little help – and expose the investors to large risks.

605. The Vienna Convention on the Law of Treaties however departs from the rules in paragraphs 1 to 3 of Article 31 by stating, in its paragraph 4, that “[a] *special meaning* shall be given to a term if it is established that the Parties so intended.” Article 31(4) must be read in conjunction with Article 32 of the Convention according to which recourse may be had to “supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion,” if the interpretation obtained from the elements listed in Article 31: (a) leaves the meaning of a provision ambiguous or obscure; or (b) leads to a result which is manifestly absurd or unreasonable. Article 32 of the Vienna Convention adds that the supplementary means of interpretation mentioned by it – preparatory work, circumstances surrounding the treaty’s conclusion – may also be used to confirm an interpretation already obtained *via* the elements listed in Article 31, which carries the implication that said supplementary means may equally be used to invalidate that interpretation.

606. To sum up, supplementary means of interpretation may be used:

- to establish a special meaning;
- to confirm or invalidate interpretations obtained by applying the elements listed in Article 31;

- to correct results so obtained if they are ambiguous, obscure, manifestly absurd or unreasonable.
607. Despite opinions according to which the supplementary means of interpretation cannot normally be resorted to – and this also seems to be the Claimant’s view – the above explanations show that in practice it is always possible to have recourse to them.
608. The next question to consider is thus whether the results of the interpretation of Article XI of the 1991 BIT obtained by the application of Article 31 of the Vienna Convention are confirmed or invalidated if one turns to the supplementary means of interpretation mentioned in Article 32 of that Convention.
609. The Tribunal is not aware of any element suggesting that the interpretation of Article XI based on Article 31(1) to (3) of the Vienna Convention is wrong, ambiguous, obscure, manifestly unreasonable or absurd. On the contrary, insofar as any of the elements mentioned in Article 32 of the Convention can be identified, their use would confirm or at least not contradict the conclusion previously reached, *i.e.* that Article XI does not have self-judging character. Indeed, no *travaux préparatoires* to the contrary have been identified – declarations made in connection with other BITs or the 1992 Model Treaty do not qualify as preparatory work related to the present Treaty – and the same is true for the circumstances surrounding the latter’s conclusion. The ICJ’s Judgment in the *Nicaragua* case makes it clear that, to render a treaty provision self-judging, the intention to do so must be explicitly stated – which it was not – particularly where the treaty is equipped with a dispute-settlement mechanism, as is the case of the 1991 BIT.
610. For all these reasons, the Tribunal considers that Article XI of the 1991 Argentina-US BIT is not self-judging. In other words, it is the duty of the Tribunal first to interpret Article XI and then to decide whether or not the situation that prevailed in Argentina at the time of the impugned measures can be subsumed under the exceptions listed in that Article.

*(ii) The Interpretation of Article XI: a General Approach*

611. As far as the interpretation of Article XI is concerned, the Tribunal wishes to emphasise that a state of emergency can be of an economic nature, as stated by other ICSID tribunals in the Argentinian cases.
612. It will also be noted that no compensation must be awarded for damage suffered during the period of emergency, as the BIT does not apply in such a period, except if the State has substantially contributed to create it, while damages might be awarded for measures taken during the state of emergency and not cancelled when the state of emergency has ceased to exist.

*(iii) The Interpretation of Article XI: Admissibility of the State's Defence under Article XI*

613. As any other provision of the BIT, Article XI is interpreted on the basis of the Vienna Convention on the Law of Treaties. Further, as also recognised in *Continental*,<sup>555</sup> concepts used in Article 25 of the ILC Articles on the Responsibility of States for Internationally Wrongful Acts<sup>556</sup> “assist in the interpretation of Article XI itself.” When interpreted in light of the above principles, the requirement under Article XI that the measures must be “necessary” presupposes that the State has not contributed, by acts or omissions, to creating the situation which it relies on when claiming the lawfulness of its measures.
614. Article 31 (3) of the Vienna Convention provides that the terms of a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to those terms in their context and in the light of the object and purpose of the treaty. As indicated in the preamble, the object and purpose of the BIT between Argentina and the US is to promote and improve the investment climate between the Contracting Parties, notably by establishing some stability regarding the status of investments.

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<sup>555</sup> *Continental*, *supra* note 150, § 168.

<sup>556</sup> ILC Articles, *supra* note 40.

615. That such stability cannot be total is stating the obvious. The world changes and so does the environment for foreign investment, especially when extraordinary circumstances appear. The host State is generally not responsible for the consequences of a state of emergency. It will be responsible, however, for the consequences of a state of emergency if it has significantly contributed to that situation. Holding otherwise would mean that Article XI of the Argentina-US BIT is not being interpreted in the light of its object and purpose, for that Treaty cannot possibly allow for the possibility that if the host State itself has caused or significantly helped to cause, intentionally or by omission, the situation and the consequences complained of, that State may shirk its obligations under the BIT by invoking Article XI. This conclusion is supported by other elements.
616. According to Article 31 (3) of the Vienna Convention, the interpretation of treaty rules should take into account, *inter alia*, “any relevant rules of international law applicable in the relations between the Parties.” This approach to the interpretation of a treaty has also been adopted by the Iran-US Claims Tribunal in the *Amoco* case, where it stated:
- “As a *lex specialis* in the relations between the two countries, the Treaty supersedes the *lex generalis*, namely customary international law. This does not mean, however, that the latter is irrelevant in the instant Case. On the contrary, the rules of customary international law may be useful in order to fill in possible lacunae of the Treaty, to ascertain the meaning of undefined terms in its text or, more generally, to aid interpretation and implementation of its provisions.”<sup>557</sup>
617. Surely one of those general rules of international law is that codified in Article 25(2) of the ILC’s Articles on the Responsibility of States, which provides, in part, that: “In any case, necessity may not be invoked by a State as a ground for precluding wrongfulness if: ... (b) The State has contributed to the situation of necessity.”

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<sup>557</sup> *Amoco v. Iran*, Case No. 56, Chamber 3, Award No. 310-65-3 of 14 July 1987, § 112.

618. In its commentary on the above provision, the Commission points out, however, that “the [State’s] contribution to the situation of necessity must be sufficiently substantial and not merely incidental or peripheral.”<sup>558</sup> That this rule, as framed by the Commission, forms part of general international law is shown by the case-law of the International Court of Justice. Indeed, in its Judgment in the case of the *Gabčíkovo-Nagymaros Project*, the Court held that:

“Hungary would not have been permitted to rely on that state of necessity in order to justify its failure to comply with its treaty obligations, as it had helped, by act or omission, to bring it about.”<sup>559</sup>

619. The rule in question has also been applied in interpreting Article XI of the Argentina-US BIT. As mentioned by the arbitral tribunal in *LG&E*,

“[i]t seems logical that if the State has contributed to cause the emergency, it should be prevented from invoking the state of necessity. If there is fault by the State, the exception disappears, since in such case the causal relationship between the State’s act and the damage is produced.”<sup>560</sup>

And in *Continental*, the arbitral tribunal said, in connection with “essential security interests,” which, under Article XI of the Argentina-US BIT, allows recourse to that Article, that

“ ... if a Contracting Party to the BIT has contributed to endangering its essential security interest, for the protection of which it has then adopted the challenged measures, those measures may fail to qualify as ‘necessary’ under Article XI, since that Party could have pursued some other policy that would have rendered them unnecessary.”<sup>561</sup>

620. The general applicability of the rule barring the invocation of necessity when the State concerned itself has created that necessity or has significantly contributed to it is also supported by other provisions of the ILC Articles

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<sup>558</sup> James Crawford, *The International Law’s Commission Articles on State Responsibility – Introduction, Text and Commentaries*, Cambridge, Cambridge University Press 2002, p. 185.

<sup>559</sup> *Gabčíkovo-Nagymaros Project* [hereinafter *Gabčíkovo-Nagymaros*], (Hungary v. Slovakia), Judgment of 25 September 1997, ICJ Reports 1997, p. 43, § 57 *in fine*.

<sup>560</sup> *LG&E*, *supra* note 51, § 256. The award refers to the state of necessity under Article 25 of the ILC’s Draft Articles, but its finding reflects a principle of general application.

<sup>561</sup> *Continental*, *supra* note 150, § 234.



dealing with the preclusion of wrongfulness. Thus, Article 23 (1) of that text, dealing with *force majeure*, provides that to invoke the latter, the event creating the necessity must have been “beyond the control of the State.” Article 24(2)(a), for its part, relates to “distress” and rules out the preclusion of wrongfulness “if the State has contributed to the situation of distress.” Thus, the rule expressed in Article 25(2)(b) of the ILC Articles concerns but one type of situation where “contributory behaviour” on the part of the State involved precludes reference to necessity.

621. So far, this Tribunal has limited itself to examining the question of whether the above-mentioned precept is a rule of general international law, applicable between the Parties to the BIT and, hence, a rule which may be used to interpret Article XI of the latter. It has reached an affirmative conclusion on this point. One could also ask whether the rule exists as a “general principle of law recognised by civilised nations” in the sense of Article 38 (1) (c) of the Statute of the ICJ.
622. Volumes have been written on the subject of “general principles.” Some authors consider that the latter must meet requirements similar to those applied to customary rules (general practice and *opinio juris*), which suggests that in reality this category is not an autonomous one.<sup>562</sup> The mainstream view seems to be, however, that “general principles” are rules largely applied *in foro domestico*, in private or public, substantive or procedural matters, provided that,

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<sup>562</sup> Thus, B. Conforti, *Diritto internazionale. Manuali per l'Università Napoli*, Editoriale Scientifica, 2006, writes on pp. 40-41: “A nostro avviso due condizioni o requisiti debbono sussistere perchè principi statali possano essere applicati a titolo di principi generali di diritto internazionale. Occorre anzitutto che essi esistano e siano uniformemente applicati nella *più gran parte* degli Stati; in secondo luogo, e questa è la condizione più caratterizzante, occorre che essi siano sentiti come obbligatori o necessari anche dal punto di vista del diritto internazionale, che essi cioè perseguano dei valori e impongano dei comportamenti che gli Stati considerino come perseguiti ed imposti o almeno necessari anche sul piano internazionale.” Emphasis in the text. “There are two conditions for principles of domestic law to be applied as general principles of international law. It is first of all necessary that they exist and are uniformly applied in the *great majority* of States; secondly, and this is the most characterising condition, they must be perceived as obligatory or necessary also from the point of view of international law, *i.e.* as upholding values and prescribing behaviour that States consider as pursued or prescribed or at least as necessary also at the international level.” (Translation by the Tribunal.)

after adaptation, they are suitable for application on the level of public international law.<sup>563</sup>

623. That there is a general principle on the preclusion of wrongfulness in certain situations can hardly be doubted, as is confirmed by the UNIDROIT Principles on International Commercial Contracts, a sort of international restatement of the law of contracts reflecting rules and principles applied by the majority of national legal systems.<sup>564</sup> Article 6(2)(2) of these Principles, dealing with “hardship,” provides that events causing hardship must be “beyond the control of the disadvantaged Party.” Article 7(1)(6) on “exemption clauses” prescribes that a party may not claim exemption from liability “if it would be grossly unfair to [exempt it] having regard to the purpose of the contract.” Finally, Article 7(1)(7), relating to “force majeure” (*vis maior*) excuses non-performance of a contract

“... if that Party proves that the non-performance was due to an impediment beyond its control and that it could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome its consequences.”<sup>565</sup>

Exemption from liability for non-performance or other forms of relief are therefore excluded under the UNIDROIT Principles if the Party claiming it was “in control” of the situation or if it would be “grossly unfair” to allow for such exemption.

624. It follows from the above that: (i) there is a rule of general international law which provides that necessity may not be invoked as a ground for precluding wrongfulness if the State concerned has significantly contributed to creating that necessity; (ii) there also seems to be a general principle of law recognised

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<sup>563</sup> On this matter, and on the distinction between “general principles of law recognised by civilised nations” and “general principles of international law,” see, e.g., H. Mosler, “General Principles of Law,” in: R. Bernhardt (ed.), *Encyclopedia of Public International Law*, Vol. II (E-I), Amsterdam, 1995, North-Holland, pp. 511-527.

<sup>564</sup> M. J. Bonell, *An International Restatement of Contract Law - The UNIDROIT Principles of International Commercial Contracts*, Transnational Publishers, Inc., Irvington, NY, 3rd ed. 2005.

<sup>565</sup> International Institute for the Unification of Private Law (UNIDROIT), *UNIDROIT Principles of International Commercial Contract 2004*, available at: <http://www.unidroit.org/english/principles/contracts/principles2004/integralversionprinciples2004-e.pdf>.

by civilised nations that necessity cannot be recognised if a Party to a contract has contributed to it. This means that the rule or principle in question may be used, under Article 31 (3) of the Vienna Convention, to ascertain the meaning of Article XI of the Argentina-US BIT. Accordingly, that Article may be taken to mean that necessity cannot be invoked by a Party having itself created such necessity or having substantially contributed to it.

625. Before examining whether Argentina has contributed to creating the situation on which it relies under Article XI, it is necessary to determine which Party bears the burden of proof in that regard. The Respondent appears to accept that it has to prove the defence it advances, namely, its entitlement to relying on “necessity”, since in its view the events of 2001 required emergency measures.<sup>566</sup> The Claimant concurs but suggests that it is up to Argentina also “to demonstrate that the alleged economic situation was not self-inflicted.”<sup>567</sup>
626. It is the Tribunal’s view that the existence of the conditions for the application of Article XI, *i.e.* whether: (a) public order or essential security interests are at stake, and (b) whether the measures are necessary to maintain the former or protect the latter, is to be proved by the Respondent since it relies on such facts to preclude a finding that the measures breached the BIT.<sup>568</sup> Conversely, it is incumbent upon the Claimant to prove Respondent’s contribution to bringing about the necessity of the measures since it relies on such a contribution as a defence against the application of Article XI.<sup>569</sup>

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<sup>566</sup> Counter-Memorial, §§ 106-139 (the issue of Argentina’s contribution to the crisis is examined in §§ 755-761).

<sup>567</sup> Reply, §§ 687 and 707 (including footnote 1103).

<sup>568</sup> Bing Cheng, *General Principles of Law Applied by International Courts and Tribunals*, Cambridge, Cambridge University Press 2006, § 987, p. 334: “the burden of proof rests upon the party alleging the fact....”

<sup>569</sup> In *LG&E*, the tribunal held that the burden of proof was on the Claimants: “Claimants have not proved that Argentina has contributed to cause the severe crisis faced by the country.” *LG&E*, *supra* note 51, § 256.

(iv) *The Application of Article XI: The Parties' Positions on the State's Contribution to the Economic Crisis of 2001*

(a) *The Claimant's Position*

627. The Claimant contends that “Argentina’s economic ‘emergency’ of 2001 was almost entirely a result of the economic policy failures of the Argentine authorities.”<sup>570</sup> In order to substantiate its position, the Claimant has produced a report by a macroeconomic expert, Professor Sebastian Edwards, dated 26 November 2006 and accompanied by many exhibits (“Edwards Report”). The Tribunal will therefore examine the Edwards Report as detailing the Claimant’s position on the issue.

628. The Edwards Report asserts that “[t]he Argentine economic crisis of 2001-2002 was primarily self-induced”<sup>571</sup> and explains that a significant portion of Argentina’s responsibility for its economic and currency crisis of 2001 is related to the failure to implement structural reforms that the currency board system (*i.e.* the currency system that pegged the Argentinian Peso to the US dollar) needed in order to succeed. For Argentina’s currency board to work properly and remain viable over the medium or long term, there were at least four broad categories of supporting measures that Argentina needed to implement:

- Achieve and maintain fiscal discipline. In the absence of balanced fiscal accounts, a currency board would not be credible, and the public would end up withdrawing deposits from the banking sector. This would restrict liquidity and result in higher interest rates, which in turn would provoke a decline of investment and economic growth. Furthermore, during economic expansion, the public sector should run surpluses and build up

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<sup>570</sup> Reply, § 679. Claimant’s Memorial addresses this issue by pointing to the requirement, under Article 25 of the ILC Draft Articles, that “... the GOA did not contribute to the situation of alleged necessity,” Memorial, § 569, relying on the *Gabčíkovo-Nagymaros* Judgment, *supra* note 559, Memorial, § 574.

<sup>571</sup> *Expert Report of Professor Sebastian Edwards* [hereinafter Edwards Report] of 26 November 2006, § 5 and § 41. Claimant’s Exhibit No. 212.

fiscal reserves in order to provide a cushion during economic downturns and to enable the economy to face adverse international shocks.<sup>572</sup>

- Achieve and maintain labour market flexibility. In the absence of exchange rate flexibility, an economy needs labour market flexibility in order to accommodate external shocks. Competitiveness must therefore be achieved through a reduction in labour costs. However, if the labour market is heavily regulated and inflexible, labour costs will not decline and competitiveness will not improve; this will result in a higher rate of unemployment.<sup>573</sup>
- Open its economy by reducing barriers to foreign trade. If a currency board economy has a low degree of openness to international trade, even a modest external shock will result in a large decline in growth, since the GDP is forced to contract significantly in order to bring about a modest reduction in imports. However, in a currency board economy that is open to trade, even a large external shock will have a minor impact on economic activity.<sup>574</sup>
- Show firm governmental resolve to maintain the currency peg. If the credibility of the government's resolve to maintain the currency peg wanes, the public will begin to withdraw deposits. As deposits decline, bank liquidity diminishes, which leads to higher interest rates and a decline in economic activity. As the economy slumps, credibility and deposits are likely to decline further.<sup>575</sup>

629. Recommendations to that effect were made repeatedly by the IBRD, the IMF and others. In short, the GOA knew precisely what it needed to do to make the currency board work. It also fully understood that if it did not implement the required reforms, Argentina's economy would remain highly vulnerable, and a future currency crisis would be inevitable.<sup>576</sup> Despite this knowledge, Argentina's leaders never had the political will to implement the measures

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<sup>572</sup> *Ibid.*, § 37.

<sup>573</sup> *Ibid.*

<sup>574</sup> *Ibid.*

<sup>575</sup> *Ibid.*

<sup>576</sup> *Ibid.*, §§ 38-39.

required. Fiscal responsibility, labour market flexibility and an open-trade policy each entailed a political price, and the Government simply never mustered the political will to pay that price. In the fiscal arena, Argentina ran large and increasing deficits throughout the 1992-2000 period. During many of the “good years,” GDP growth was strong, and Argentina could have run surpluses to build up reserves as a cushion for a future economic downturn.<sup>577</sup>

630. Although the GOA could have implemented a variety of measures during the 90s to strengthen fiscal discipline, one of the most obvious and significant steps that it could have taken, according to the Claimant – but did not take – was to reduce provincial spending. Doing so would have required the Government fundamentally to reform Argentina’s “Co-Participation Law” of 1988, which created strong incentives for fiscal indiscipline on the part of the country’s provincial governments. The Co-Participation Law provided for large transfers of tax revenues from the Federal Government to the provincial governments, and these transfers accounted for a significant portion of Argentina’s total public sector expenditure.<sup>578</sup>
631. By 2001, Argentina’s economic condition had further declined, and the pressures on the currency board had grown. Nevertheless, Argentina still took no serious action to implement the structural reforms so desperately needed by its economy, such as the fundamental reform of the highly destabilising and perverse Co-Participation Law, the curtailment of aggressive public sector spending, the reform of the onerous and highly inefficient system of union-run social services (“*obras sociales*”) and the elimination of protectionist trade practices.<sup>579</sup> Instead, the GOA embarked on a series of short-term manoeuvres such as the “Zero-Deficit” policy based on measures (such as the reduction in Government employees’ salaries and pensions) that further reduced credibility, signalling a lack of commitment to the Convertibility Law.<sup>580</sup>

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<sup>577</sup> *Ibid.*, §§ 48-49.

<sup>578</sup> *Ibid.*, §§ 52-53.

<sup>579</sup> *Ibid.*, § 65.

<sup>580</sup> *Ibid.*, §§ 67 and 69.

632. One of the most important policy mistakes of 2001, according to the Claimant, was postponing fiscal and provincial adjustments until after the elections of October 2001. The Minister of the Economy, Domingo Cavallo, actively discussed the serious need to reform the Co-Participation Law and reduce provincial spending. That discussion, however, was put off until mid-October 2001. The governing coalition was concerned about the congressional elections of 14 October 2001, and provincial governors were spending heavily in support of their senatorial candidates. The day after the elections, Minister Cavallo proposed to reform the Co-Participation Law, to reduce the size of the public sector and to restructure provincial debts, but once again politics prevailed and the governors rejected the proposals. As a result of “quick-fix” measures taken in 2001, as well as the almost massive issuance of “*quasi-monies*” by the provinces and the refusal to reform the Co-Participation Law, confidence in the currency board and the stability of the banking system and of the currency board regime was increasingly at risk. The Argentinian public as well as the international financial community drew the obvious conclusion that Argentina’s political leadership would not undertake the serious reforms required by the currency board. In November 2001, Standard & Poor lowered Argentina’s long-term sovereign rating to “selective default.”<sup>581</sup>
633. Contrary to what was suggested by the GOA and its expert, Professor Roubini, external shocks played a limited role in Argentina’s economic crisis. However, misguided internal policies significantly *amplified*<sup>582</sup> the effects of external shocks on the Argentine economy. Many Latin-American countries experienced more severe external shocks than Argentina, yet did not suffer a major crisis. Moreover, most of the external shocks affecting Argentina (such as the decline in export prices, the increase of international interest rates and the growing strength of the U.S. dollar in international markets) were temporary phenomena that reversed in late 2001.<sup>583</sup>

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<sup>581</sup> *Ibid.*, §§ 70-72.

<sup>582</sup> *Ibid.*, §§ 10 and 170.

<sup>583</sup> *Ibid.*, §§ 12 and 172.

(b) *The Respondent's Position*

634. In its Counter-Memorial, the Respondent, referring to Article 25 of the ILC Articles, denies having contributed to the occurrence of the state of necessity. Argentina relies on the requirement that any such contribution must be sufficiently substantial, not merely incidental or peripheral, to disregard the existence of a state of necessity.<sup>584</sup>
635. If the requirement of a lack of contribution were to be interpreted in such an extensive way, it would be impossible for a State to invoke the state of necessity as a circumstance precluding wrongfulness.<sup>585</sup> Quoting its experts, the Respondent suggests that “it strains credulity to think that Argentina intentionally sought to cause the financial collapse of 2000-2001.”<sup>586</sup> Still relying on its experts, the GOA points to the considerable bearing that external factors, such as IMF policies and the state of the global economy, had on Argentinian economic policies.<sup>587</sup>
636. Regarding the defence of necessity, in the Rejoinder, Argentina deals separately with Article XI and Article 25 of the ILC Draft Articles. However, the Respondent refers essentially to Article 25 when dealing with the issue of “non-contribution.”<sup>588</sup> It addresses issues raised by the Edwards Report by invoking essentially the Report by Professor Nouriel Roubini of 24 August 2006 presented with the Counter-Memorial (the “Roubini Report”), and the Report by Professors Robert Frenkel and Mario Damill, undated but appended to the Rejoinder (the “Frenkel-Damill Report”). The Roubini Report pre-dates the Edwards Report but deals with some of the issues considered by the latter. The Frenkel-Damill Report is in part a response to the Edwards Report, as evidenced by its title: “Diagnosis of the Crisis and Measures of the Argentine Government and Reply to Professor Sebastian Edwards’ Report.” These

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<sup>584</sup> Counter-Memorial, §§ 755-756.

<sup>585</sup> Rejoinder, § 563.

<sup>586</sup> Slaughter/Burke-White Report, *supra* note 523, § 102 (quoted in Counter-Memorial, § 757).

<sup>587</sup> Counter-Memorial, §§ 758-760.

<sup>588</sup> Rejoinder, §§ 559-565.



Reports will be analysed hereafter to the extent to which they deal with Argentina's contribution to the crisis.

637. According to Professor Roubini, Argentina's fixed-exchange-rate regime was not sustainable as it was inconsistent with economic and macroeconomic fundamentals, and was worsened by domestic and external shocks. When this regime became unsustainable, there was a run on the reserves of the Central Bank; and when these reserves were exhausted, there would be a currency collapse and a depreciation/devaluation of the currency. After this occurred in Argentina, the only economically sensible option was to abandon convertibility, to repeal the currency board and to move to a floating exchange rate, the experience of Argentina being the rule rather than an exception among emerging market economies.<sup>589</sup>

638. The following macroeconomic factors made it unavoidable for Argentina to abandon the currency board regime:

“i) a series of shocks to the economy; ii) large fiscal imbalances and debt accumulation; iii) structural vulnerabilities; iv) currency overvaluation and large and eventually unsustainable external imbalances and loss of competitiveness.”<sup>590</sup>

639. Several external shocks were identified by Professor Roubini, including (but not limited to): a “sudden stop” of capital inflows in 1998 and 1999, making the cost of borrowing in the international market higher and the quantity of funds more limited; the sharp devaluation of the Brazilian currency; the general strengthening of the US dollar against the euro and other major currencies between 1998 and 2001, causing Argentina to lose competitiveness in European and other markets since the peso was tied to the appreciated US dollar. The combination of these shocks slowed GDP growth in the second half of 1998 and produced an increasing recession until 2001.<sup>591</sup>

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<sup>589</sup> Roubini Report, *supra* note 252, §§ 12, 13 and 15.

<sup>590</sup> *Ibid.*, § 17.

<sup>591</sup> *Ibid.*, §§ 18-19.

640. Fiscal deficits and debt accumulation worsened after 1998 because of a fall in revenues, a cyclical increase in spending and the sharp increase in interest payments resulting from the sharp increase in the foreign debt sovereign spread and domestic interest rates. Fiscal deficit and debt accumulation were exacerbated by an increase in nominal and interest rates for Argentina after 1998, due partly to the worsening domestic fiscal position and the successive Governments' inability to achieve sufficient surpluses.<sup>592</sup>
641. Other structural vulnerabilities included: the reduced openness of the economy due to a long history of inward-oriented trade policies; labour market rigidities; a very large external debt-to-exports ratio; and an enormous currency mismatch due to the fact that almost the entire domestic and external Government debt was denominated in dollars.<sup>593</sup>
642. According to Professor Roubini, these factors made the fixed exchange rate regime inconsistent with economic fundamentals and led to a currency crisis. Argentina's macroeconomic hands were tied since it could not adjust its currency peg without bankrupting many firms while its high existing debt prevented it from running a counter-cyclical fiscal policy.<sup>594</sup>
643. In their rebuttal of the Edwards Report, Professors Frenkel and Damill contend, first, that since macroeconomics are not an experimental science, the views put forward by Professor Edwards are only his own.<sup>595</sup> They are of the opinion that external factors were the proximate cause of the crisis (the decline of export prices, the US dollar revaluation, the massive drop in the prices of emerging market bonds, the subsequent rise of country risk premium and interest rates after the Eastern Asia crisis, and the devaluation of the Brazilian currency). Regarding individual issues raised by the Edwards Report, the following is noted by Damill and Frenkel:

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<sup>592</sup> *Ibid.*, §§ 21-22.

<sup>593</sup> *Ibid.*, § 24.

<sup>594</sup> *Ibid.*, §§ 30-31.

<sup>595</sup> Mario Damill and Roberto Frenkel, *Diagnosis of the Crisis and Measures of the Argentine government, and reply to Professor Sebastian Edwards Report* [hereinafter Damill and Frenkel Report], § 171. Annex to the Rejoinder.

- (a) a high level of wages, reducing the competitiveness of the economy: reforms were implemented in the 1990's which, according to Professor Edwards, were not sufficient to solve the problem; to reach the required labour market flexibility, however, would have meant an increase in the unemployment rate, thus worsening the problem;<sup>596</sup>
- (b) as to the measures which, according to Professor Edwards, should have been adopted in 2001 to avoid the devaluation, the default by the public debt and the pesification, they were: (i) exchanging bonds for bonds with longer maturity and, possibly, a lower interest rate: this took place in June 2001 through a voluntary debt swap (megaswap), but with no result;<sup>597</sup> (ii) "dollarisation": this was not feasible since the Central Bank would not have had available the amount of liquid US dollars needed to implement the measure; furthermore, it would have meant a dollarisation by the GOA of private contracts in order to change their currency from Argentine Pesos to US dollars, with the same effects that were complained of for the pesification, without the withdrawal of bank deposits being prevented.<sup>598</sup>

644. Regarding the fiscal evolution, Professor Edwards selectively quoted figures from secondary sources.<sup>599</sup> According to Professor Edwards' sources, Argentina's fiscal performance, improved during 1992-1996, declined in 1997 (2.1% of the GDP), climbed to 3.7% in 1998 and 6.6% in 1999. Professors Damill's and Frenkel's figures, based on more reliable sources, are different, showing a deficit of just 0.56% of the GDP in the 1991-1994 period. The difference is due to the fact that Edwards' secondary source considers debts incurred before the introduction of the currency board as expenditures. Between 1995 and 1997, the fiscal situation deteriorated because of the pension system reform implemented from 1994 onward.<sup>600</sup> Fiscal surplus in any case is

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<sup>596</sup> *Ibid.*, §§ 179-181.

<sup>597</sup> *Ibid.*, §§ 186-187.

<sup>598</sup> *Ibid.*, §§ 188-191.

<sup>599</sup> *Ibid.*, § 204.

<sup>600</sup> *Ibid.*, §§ 207-210.

not synonymous with immunity to crisis. The fiscal situation significantly deteriorated from 1997 on, when the economy was affected by external shocks.<sup>601</sup>

645. As to the role of the Provinces in the deterioration of fiscal accounts during the development of the crisis, Professor Edwards, according to Frenkel and Damill, fails to consider that a reform in this area would have involved major institutional problems (Argentina being a federal State) and taken a lot of time. After all, the provincial deficit had a limited influence on the increase in the aggregate imbalance of public accounts during the crisis.<sup>602</sup>
646. As to external shocks being only “temporary,” this fails to consider that even though temporary, they may have lasting effects. The Brazilian crisis caused extensive damage to the Argentine economy.<sup>603</sup>
647. As to Argentina’s economy being “closed,” Frenkel and Damill point out that Argentina initiated more open trade at the beginning of the 90s. However, the ratio between international and domestic trade flows depends not only on such governmental policies but also on the behaviour of individuals. The degree of openness rose until 1997, dropped in 1998-2001, to rise again thereafter. So, trade protectionism did not frustrate the design of Argentina’s economic policy.<sup>604</sup>
648. During the hearing, Professors Damill and Frenkel mentioned that a financial system may collapse “if [the process is] not arrested in time and if measures are not taken to arrest it, if the State does not intervene to break those trends.”<sup>605</sup> There was an improvement in Argentina’s fiscal policy due to measures adopted during 1998-2001, but it was not sufficient to prevent contagion by the

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<sup>601</sup> *Ibid.*, § 213.

<sup>602</sup> *Ibid.*, § 214.

<sup>603</sup> *Ibid.*, § 217.

<sup>604</sup> *Ibid.*, Table 6 on p. 72 and § 224.

<sup>605</sup> Hearing Transcript in English, *supra* note 67, Day 7, p. 1904.

Southeast Asia crisis which increased the risk premium and interest rate, thus increasing public indebtedness.<sup>606</sup>

*(v) The Application of Article XI: The Tribunal's Analysis of the State's Contribution to the Economic Crisis of 2001*

649. In addressing the question of whether Argentina contributed to the situation of necessity on which it relies to assert the lawfulness of the measures taken by it, the Tribunal will be guided essentially by two considerations. On the one hand, it acknowledges Argentina's right as a sovereign State to choose the economic policy best suited to the needs of the population. In that respect, the Tribunal is far from suggesting that actions by Argentina were specifically intended to hurt foreign investors or some of them, as Argentina appears to understand the Claimant's position.<sup>607</sup> On the other hand, it will take due account of the fact that the protection offered by the BIT to the Claimant's investment is suspended to the extent that Article XI is applicable, which makes it necessary to analyse carefully all the conditions for the application of that Article.

650. In conducting this analysis, the Tribunal shall not adopt a restrictive interpretation of necessity and its consequences under Article XI, as has been done by other tribunals in connection with the state-of-necessity defence under Article 25 of the ILC's Articles.<sup>608</sup> As mentioned in its Decision on Jurisdiction in the present dispute,

“[t]his Tribunal considers that a balanced interpretation is needed, taking into account both State sovereignty and the State's responsibility to create an adapted and evolutionary framework for the development of economic activities, and the necessity to protect foreign investment and its continuing flow.”<sup>609</sup>

It will rely on the evidence made available by the Parties in these proceedings, with very limited consideration of prior decisions in other cases involving

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<sup>606</sup> *Ibid.*, p. 1914.

<sup>607</sup> See *supra*, § 635.

<sup>608</sup> United Nations, *Report of the International Law Commission, Fifth-Third (53th) Session, Fifty-Sixth Session, Supplement No. 10 (A/56/10)*, 2001, § 20 (p. 205): “necessity needs to be more narrowly confined.”

<sup>609</sup> Decision on Jurisdiction, *supra* note 58, § 70.

Argentina since the arguments and evidence placed before each tribunal are not the same in every case. Finally, the Tribunal will take account of the fact that, as already mentioned,<sup>610</sup> the Claimant bears the burden proving the facts regarding Argentina's contribution to the economic crisis of 2001.

651. The review of the experts' reports conducted by the Tribunal allows it to single out a few aspects on which there is some convergence of opinions.
652. Argentina's expert, Professor Roubini, acknowledges the significant role that Argentina's fiscal deficits and debt accumulation played in provoking the currency crisis of 2001. Although maintaining that the country's fiscal problems were partly aggravated by recession and external interest rates after 1998, his report suggests that the GOA's lack of fiscal control was already a problem by that time, as is shown by the following quotations:

"Argentina's fiscal deficits and debt accumulation worsened after 1998";

"... while for the first few years the currency board was viable based upon economic fundamentals, starting in 1998 it became increasingly vulnerable and eventually not viable because of: . . . large fiscal imbalances and debt accumulation ...;"

"Fiscal deficits and debt accumulation – partly worsened by recession and external interest rate shocks – made the pegged parity fragile and vulnerable to a speculative attack;"

"In Argentina, persistent fiscal deficits ... led to an accumulation of a growing stock of public debt, particularly as the economy began to shrink and interest rates rose after 1998."<sup>611</sup>

Professor Edwards also considers the absence of fiscal discipline as one of the causes of the economic and currency crisis of 2001.<sup>612</sup>

653. Professor Roubini equally concurs with Professor Edwards' view that Argentina's failure to liberalise labour markets and trade policies played a

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<sup>610</sup> See *supra* § 626.

<sup>611</sup> Roubini Report, *supra* note 252, §§ 16-17 and 21-23.

<sup>612</sup> Compare with the Edwards Report, *supra* note 571, § 14.

significant role in bringing about the 2001 currency crisis. He concedes that Argentina’s “inward-oriented trade policies” and “labour market rigidities” “made the fixed-rate regime fragile and vulnerable to shocks.”<sup>613</sup>

654. The experts diverge in their analysis of responsibility for causing the Argentina economic and currency crisis. While the Edwards Report considers such crisis to have been primarily self-induced by Argentina,<sup>614</sup> Professor Roubini generally attributes the currency collapse to macroeconomic factors as including external shocks, although he concedes that “slippages of fiscal policy”<sup>615</sup> occurred, an expression suggesting a reduced level of attention or performance.<sup>616</sup>
655. Professors Frenkel and Damill’s rebuttal of the Edwards Report is rather polemical and only in part based on data from external sources;<sup>617</sup> no evidence is provided by the two experts in support of their various contentions. This is striking, considering that the Frenkel-Damill Report was meant to rebut that of Professor Edwards, a comprehensive, very detailed and well-documented work.<sup>618</sup> The remark that Professor Edwards expressed only personal opinions therefore appears misguided.
656. It is clear from the evidence filed in the present proceedings that both internal and external factors were at the root of the economic crisis that occurred in Argentina at the end of 2001. Having fully considered the Parties’ arguments and the evidence before it, a majority of the Tribunal has reached the conclusion that Argentina’s failure to control several internal factors, in

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<sup>613</sup> Roubini Report, *supra* note 252, § 24; title of Section V.

<sup>614</sup> *See supra*, § 404.

<sup>615</sup> A lively debate took place at the hearing during the cross-examination of Professor Roubini regarding his use of the expression “slippages of fiscal policy.” See Hearing Transcript in English, Day 2, pp. 344-346. The same expression was used by Professor Roubini during the hearing in the *Enron* case, see the relevant transcript shown by Mr. Schiffer (for the Claimant) to Professor Roubini during his cross-examination. Argentina objected to the document being shown at the hearing but the Chairman allowed the examination of Professor Roubini to continue. See Hearing Transcript in English, Day 2, pp. 342-343.

<sup>616</sup> The word “slippage” is given, among others, the meaning of “a decline in level, performance or achievement” by *The American Heritage Dictionary of the English Language*, 4th ed., 2006.

<sup>617</sup> Such as the rate of openness of Argentina’s economy, Table 6 of Damill and Frenkel Report, *supra* note 595, p. 72.

<sup>618</sup> The Edwards Report, *supra* note 571, is accompanied by 166 exhibits.

particular the fiscal deficit debt accumulation and labour market rigidity, substantially contributed to the crisis. The progressive worsening of internal factors diminished Argentina's ability to respond adequately to external shocks, unlike what happened in other South American countries.

657. The Tribunal's conclusion finds support in independent and authoritative sources. Reference may be made to the IMF Independent Evaluation Office's (IEO) Evaluation Report of 2004: "The IMF and Argentina, 1991-2001."<sup>619</sup> That Report contains a comprehensive analysis of Argentina's situation in that period. The Report was examined and presumably approved by the Argentinian authorities and benefited from substantive contributions by Nouriel Roubini, Argentina's expert in the present proceedings.<sup>620</sup>

The following passages of the IEO Executive Summary are significant:

"The crisis resulted from the failure of Argentina policymakers to take necessary corrective measures sufficiently early, particularly in the consistency of fiscal policy with their choice of exchange rate regime. The IMF on its part erred in the precrisis period by supporting the country's weak policies too long, even after it had become evident in the late 1990s that the political ability to deliver the necessary fiscal discipline and structural reform was lacking."

"While fiscal policy improved substantially from previous decades, the initial gains were not sustained, and the election-driven increase in public spending led to a sharp deterioration in fiscal discipline in 1999. As a result, the stock of public debt steadily increased, diminishing the ability of the authorities to use countercyclical fiscal policy when the recession deepened."

"Insufficient attention was paid to the provincial finances, the sustainable level of public debt for a country with Argentina's economic characteristics was overestimated, and debt sustainability issues received limited attention."

"The IMF correctly identified structural fiscal reforms, social security reform, labour market reform, and financial sector reform as essential

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<sup>619</sup> *Ibid.*, Claimant's Exhibit No. 34. IMF, Independent Evaluation Office, *The IMF and Argentina 1991-2001, 2004* [hereinafter IMF Evaluation Report].

<sup>620</sup> IMF Evaluation Report, p. vii.



to enhancing the medium-term viability of the convertibility regime, by promoting fiscal discipline, flexibility and investment.”

“Some gains were made in the early years, but the long-standing political obstacles to deeper reforms proved formidable. Little progress was made in later years, and the earlier reforms were even reversed in some cases.”<sup>621</sup>

658. A considerable number of statements made by Argentina in official documents, by its own witnesses and by qualified international experts have been placed in evidence in the present proceedings; they confirm the substance of the Edwards Report as well as the analysis and conclusions of the IEO Report. The following statement made in Argentina’s SEC Filing (2004) may be quoted here:

“The sustainability of Argentina’s economic growth during the 1990s was *undermined by the Government’s inability to maintain fiscal discipline*. Instead of capitalizing on periods of sustained growth and rising revenues to balance its budget and pay down its debt, the Government continued to incur overall fiscal deficits. This resulted primarily from inability to achieve political consensus about needed reforms, failure to reform revenue-sharing arrangements with the provinces, increasing debt service obligations and a widening gap between the Government’s social security revenues and social security outlays attributable to the privatization of the social security system. The Government’s inability to set its finance on a more sustainable course also undermined confidence in Argentina among foreign investors, increasing the Government’s borrowing costs and threatening the capital inflows on which the country had come to depend.”<sup>622</sup>

659. According to the former Argentine Minister of the Economy and Finance, Domingo Cavallo,

“[t]he most important lesson to be learned from the Argentine experience relates to the importance of fiscal policy and, particularly, of fiscal discipline during good times. In my 1994 interview, I emphasized the role of fiscal balance as a precondition for stability. However, stability requires more than just that. During periods of

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<sup>621</sup> *Ibid.*, p. 4.

<sup>622</sup> Amendment No. 3 to Registration Statement Under Schedule B of the Securities Act of 1933, The Republic of Argentina (registrant), as filed with the Securities and Exchange Commission on 28 September 2004, p. 14. Claimant’s Exhibit No. 373. Emphasis added by the Tribunal.

rapid growth and favorable external conditions, it is necessary to generate fiscal surplus as a cushion for the negative external shocks that may show up unexpectedly at any moment. Argentina should have done this between 1991 and 1994, and again between 1996 and 1998, but it did not. Therefore, at the time of external shocks, it depended on foreign financing precisely at a time when foreign expectations turned sour.”<sup>623</sup>

660. Alieto Guadagni, a witness for Argentina and Secretary for Energy in 2002, stated, in an article published in April 2002, that:

“Convertibility proved to be a simple and efficient regime. Yet it failed because it was not supported by a State that would observe the reasonable restrictions on progressive fiscal deficit accumulation, which worked to blow up the colourful balloon of public debt year after year. In January 2002, the balloon finally burst, and the two Ds’ (devaluation and default) started walking the path of uncertainty.”<sup>624</sup>

661. And, on 2 July 2004, Eduardo Duhalde, President of Argentina at the time of the crisis, wrote in the *Financial Times* that:

“In the case of Argentina, no one bears more of the blame for the crisis than Argentina itself. We spent more than we earned; we failed to complete the full cycle of economic reforms; and we tied ourselves to the most productive economy in the world without building our own productivity. Of course, this was compounded by the global decline in commodity prices, by protectionism in key markets and by shifts in global capital flows. *Yet Argentina’s crisis is largely home grown.*”<sup>625</sup>

662. In 2002, Professor Gary Becker, 1992 Nobel Economist of the University of Chicago, found that “[t]he current [2002] crisis again is mainly due to politicians who continued to borrow on the international capital market to finance large and growing budget deficits.”<sup>626</sup>

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<sup>623</sup> Domingo Cavallo, “Eleven Years Later: What Went Wrong in Argentina, 2003 – 2006,” Vol 27, *Harv. Int’l Rev.* 42, 45 (Fall 2005). Claimant’s Exhibit No. 273, p. 4.

<sup>624</sup> Alieto Guadagni, “El fin de una ilusión: la crisis argentina de 2002” *Revista de Occidente* No. 251, Madrid, April 2002, p. 63. Exhibit 10 to Witness Statement of Alieto Aldo Guadagni.

<sup>625</sup> Eduardo Duhalde, *Argentina Regrets*, *Financial Times* (FT.com), 12 July 2004. Claimant’s Exhibit No. 271. Emphasis added by the Tribunal.

<sup>626</sup> Gary S. Becker, *Deficit Spending Got Argentina Into This Mess*, *Business Week* 26, No. 3769, 11 February 2002, p. 1. Claimant’s Exhibit No. 149.

663. The same Professor S. Becker concluded three years later that the GOA's lack of fiscal discipline led to the eventual crisis: "the Argentina problem arose because spending by the government, including the provinces, was very excessive and was not controlled."<sup>627</sup>
664. In an article published on 25 March 2002, Michael Moussa, Senior Fellow, Institute for International Economics in Washington, D.C., wrote:
- "Enumerating the many things that contributed to Argentina's tragedy, however, should not obscure the critical failure of *Argentina's economic policy* that was the fundamental cause of disaster – namely the chronic inability of the Argentinian authorities to run a responsible fiscal policy. This is an old and a sad story for Argentina."<sup>628</sup>
665. It is true, as has been said, that, "qualified observers remain in disagreement as to the exact causes of the crisis and the mix of measures that might have avoided it."<sup>629</sup> However, having found that Article XI is not "self-judging," the Tribunal has the power and duty to make sure that all conditions for its application are satisfied, including the absence of a substantial contribution by Argentina to the crisis of 2001. While accepting that "in economic matters, the analysis of causation ... does not lend itself to the same scientific analysis as in the domain of the so-called exact sciences and of natural phenomenon,"<sup>630</sup> the evidence presented by the Claimant regarding the actions and omissions by Argentina until the end of 2001, and Argentina's own admission of its "inability to maintain a fiscal discipline," support the conclusion of a majority of the Tribunal that Argentina contributed to the crisis to a substantial extent, so that Article XI cannot come to its rescue.
666. Arbitrator Stern, while she agrees, as a matter of principle, with the theoretical analysis of the role played by the contribution by a State to a situation of

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<sup>627</sup> Gary S. Becker, *Falta mucho para la recuperación argentina dice Gary S. Becker: Reflexiones del Nobel de Economía 1992*, La Nación, 17 August 2005, p. 2: "El problema argentino surgió porque el gasto del gobierno, incluyendo a las provincias, fue muy excesivo y no fue controlado." Claimant's Exhibit No. 274

<sup>628</sup> Mussa, Michael, *Argentina and The Fund: From Triumph to Tragedy*, Institute for International Economics, Washington, D.C., 25 March 2002, p.6, Annex 5 to the Edwards Report, *supra* note 571.

<sup>629</sup> *Continental*, *supra* note 150, § 224.

<sup>630</sup> *Ibid.*, footnote 357, pp. 105-106.

necessity as expressed in paragraphs 613-626, does not consider that, on the concrete level, the contribution of a State to an economic crisis should be lightly assumed – should the US be held responsible of the worldwide sub-prime crisis as it contributed to it, because the SEC did not monitor the banks closely enough? Moreover, she is of the view that, considering the facts of this case, the substantial contribution of the Argentine authorities to the crisis has not been sufficiently proven by strong and uncontroverted evidence presented by the Claimant.

667. Arbitrator Stern disagrees with the far-reaching conclusion by the majority, which is not based, in her view, on an in-depth understanding of the intricacies of economic development. It should not lightly be assumed that a State is responsible for an economic collapse in a liberal market economy, where the invisible hand of the market is more powerful than the hand of the State. The majority, after having presented the experts' evidence on both sides and concluded that the latter diverged on the analysis for the responsibilities of the economic crisis, the Claimant expert considering, not surprisingly, that the crisis was primarily self-induced and the Respondent's expert holding, unsurprisingly too, that the essential factors of the crisis were external shocks. The experts have presented contradictory analyses. The IMF itself recognised that it made mistakes in monitoring Argentina's problems, as can be seen in the citation of one of its reports in paragraph 657 of this Award, where it is recognised that "the IMF on its part erred in the precrisis period."
668. Economics is a complicated science or, better, a complicated art; the mere reading of the analyses of the experts of both Parties show that there is little certainty. In Arbitrator Stern's view, the conclusion reached by the majority is based essentially on a comparative analysis of the expert reports, the Edwards' Report being described as "comprehensive, very detailed and well documented," while the Frenkel/Damil report is said to be "rather polemical and only in part based on data from external sources." In her view, the situation of the Argentine economy was extremely serious and *out of control* by any definition. Many publicly well known events support this conclusion, and there is no reason to doubt the statement, made by Argentina, that it was "the worst

economic crisis (which later became a political and institutional crisis) ever experienced by the Argentine Republic as from its onset in 1810.”<sup>631</sup> A serious clue to the gravity of the crisis was the decrease of Argentina’s contribution to the United Nations:

“In May 2002, the critical situation caused the United Nations Organization General Assembly to reduce Argentina’s contribution to such organization. It was *the first time in history* that the organization decreased the contribution to be made by a member state and the decision was taken unanimously by its members.”<sup>632</sup>

669. Moreover, according to Arbitrator Stern, the measures adopted were necessary to prevent the crisis from resulting in anarchy and social disintegration and they constituted a suitable means to overcome the chaos. It should also be recorded that the policies followed by Argentina before the crisis were generally supported by the World Bank and that the measures taken to address the crisis had the support and encouragement of the IMF. This has been stressed, for example, in *Continental*:

“In its *Second Review* of January 2001, the IMF staff noted that “the external environment worsened in the subsequent months, with external financing to emerging markets nearly drying up. This was compounded by domestic political uncertainties, which raised doubts about the political governability of the country. (...) The authorities have responded to these adverse developments by strengthening the growth orientation of their economic program, through measures aimed at promoting a recovery of investment, and an accelerated implementation of structural reforms.... “*In view of the staff, this strategy is appropriate, and deserves the increased financial support of the international community ... A recovery of confidence hinges, in turn, not only on a relatively benign international environment, but perhaps more importantly, on a demonstrated, unwavering commitment by the authorities to a rapid and full implementation of their announced policies.*”<sup>633</sup>

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<sup>631</sup> Counter-Memorial, § 108.

<sup>632</sup> Counter-Memorial, § 120 referring to Report of the Committee on Contributions, U.N. GAOR, 57th Session, Supplement No. 11, U.N. Document A/57/11 (2002) of 3 June 2002. Respondent’s RA No. 112. Emphasis added.

<sup>633</sup> *Continental*, *supra* note 150, § 112. Emphasis by the *Continental* tribunal.

670. In other words, Argentina adopted mainstream policies, following the Washington consensus, and earned praise for its conduct from the international financial community. Therefore, Arbitrator Stern is inclined to adopt the same conclusion as in *Continental*, *i.e.* that the evidence is insufficient to conclude that the policies adopted by the GOA before the crisis were mainly responsible for the crisis. More could be said on the period during which a state of emergency existed, but this seems unnecessary, considering the decision of the majority. If needed, however, she would adopt dates essentially similar to those adopted by the *LG&E* tribunal, *i.e.* from 1 December 2001 to 26 April 2003.<sup>634</sup> As a result of such an approach, the consequences of the measures on the decision to sell taken between 6 January 2002 and 23 April 2003 should not have been considered. However, the minority Arbitrator, being in agreement with the other analyses of the Tribunal, did not consider it necessary to append a dissenting opinion, as the divergence on the application of Article XI does not have far-reaching consequences on the material aspects of the final disposal of the case.

## VI. THE CLAIMANT'S DAMAGES

### A. CAUSATION

671. The Tribunal has concluded (*supra*, § 492) that the Respondent breached the fair and equitable treatment standard under Article II(2)(a) of the BIT and that such breach cannot be excused by reference to Article IV(3) (*supra*, § 533) or – by majority – by reference to Article XI (*supra*, § 638). Prior to assessing the amount of damages owed the Claimant for breach of the BIT, the Tribunal will examine the issue of causation as discussed by the Parties.<sup>635</sup>

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<sup>634</sup> In *LG&E*, *supra* note 51, the Tribunal considered that a state of emergency existed from 1 December 2001 to 26 April 2003, stating: “These dates coincide, on the one hand, with the Government’s announcement of the measure freezing funds, which prohibited bank account owners from withdrawing more than one thousand pesos monthly and, on the other hand, with the election of President Kirchner. The Tribunal marks these dates as the beginning and end of the period of extreme crisis in view of the notorious events that occurred during this period.” § 230.

<sup>635</sup> Counter-Memorial, §§ 778-792; Reply, §§ 873-883; Rejoinder, §§ 601-618; RPHB, §§ 212-216.

## 1. *The Parties' Positions*

### (i) *The Claimant's Position*

672. Argentina's argument that losses were due to macroeconomic conditions and that the Claimant "*bought high*" in 1997 and "*sold low*" in 2003, so that it cannot recover for the "business risk" inherent in such divestiture, is misplaced for a number of reasons.
673. El Paso sold its investment in Argentina not at the "worst possible" time but at a time when equity prices and certain rates also used by Macroconsulting coincided with the historic average of the period January 1992 – April 2006. The claim is not for losses due to a business risk or a perceived "bad investment" but rather for the loss of value of the investment due to the GOA measures violating the Claimant's legal and contractual rights.<sup>636</sup>
674. The discounted cash flow ("DCF") method adopted by the Claimant's expert, LECG, removes from the damages analysis losses due to macroeconomic conditions in Argentina by capturing only those that result directly from the GOA measures.<sup>637</sup>
675. The only reason for Macroconsulting's comparables approach showing damages different from LECG's method is that the actual equity value of CAPEX and Costanera was substantially higher than LECG's due to the arbitrary reduction by 35% of their debts as of 31 December 2001. This means that by simply correcting this aspect, the two valuations are very similar, thus showing the soundness of LECG's work.<sup>638</sup>
676. Therefore, LECG's valuation methodology takes into account only the measures and not the macroeconomic situation, but nothing but the measures, considered to be the sole cause of the sale, the consequences of the crisis having been eliminated from the calculation.

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<sup>636</sup> Reply, §§ 877-879. Emphasis by the Claimant.

<sup>637</sup> *Ibid.*, §§ 874 and 880, referring to LECG's Damage Valuation Update of 23 November 2006 ("Updated Report"), §§ 144-147.

<sup>638</sup> Reply, § 883.

*(ii) The Respondent's Position*

677. Argentina contends that there is no causal connection between the alleged breach and the losses that El Paso alleges to have incurred. For such connection to exist, the internationally wrongful act must be the proximate cause of the loss, which is not denied by the Claimant.<sup>639</sup>
678. According to Argentina, two criteria have been applied by international courts to determine such proximate cause, one objective (the damage must be the natural and normal result of the wrongful act) and one subjective (the damage was a reasonably foreseeable consequence of that act or was so intended by the perpetrator).<sup>640</sup> Not only has the Claimant not proven the causality link; it has, rather, confirmed having caused the losses by its own acts.
679. None of the GOA measures constitutes the proximate cause of the damage alleged by the Claimant, regardless of whether the objective or the subjective criterion is applied, since they result from the macroeconomic, social and political situation suffered by Argentina as of late 2001. The damage allegedly suffered by El Paso were caused by the latter's decision to sell its assets in the worst time of the crisis in Argentina, as confirmed by the 2003 Report to the SEC and by Macroconsulting's comparables method.<sup>641</sup> Should it be held that there is a causal connection between the GOA measures and the Claimant's damage, the Claimant should bear part of such damage, having decided to sell at the time when the country's macroeconomic conditions had considerably reduced the value of its investment.<sup>642</sup>
680. Contrary to the comparables method used by Macroconsulting, the DCF method is a sophisticated device that requires much information and makes

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<sup>639</sup> Counter-Memorial, § 781; Rejoinder, § 601.

<sup>640</sup> Counter-Memorial, §§ 782-784.

<sup>641</sup> Counter-Memorial, §§ 785-792; Rejoinder, §§ 602-607; RPHB, §§ 212-216.

<sup>642</sup> Rejoinder, §§ 619-621.



assumptions regarding several variables, so that this device can be easily manipulated by the party using it.<sup>643</sup>

681. Argentina's primary position is that its measures played no role at all in the decision of El Paso to sell its shares, its secondary position being that the decision to sell in 2003 resulted also from economic considerations by the Claimant, with the consequence that the latter's decision played a role in the damage suffered by it.

## 2. *The Tribunal's Analysis*

682. The Tribunal shares the view expressed by other investment treaty tribunals that the test of causation is whether there is a sufficient link between the damage and the treaty violation.<sup>644</sup>

683. In essence, the Respondent contends that there is no causal connection between the GOA measures and the damage allegedly suffered by the Claimant since the latter decided to sell at the worst possible time of the financial crisis, the country's macroeconomic conditions at that time being the cause of the reduced value of its investment.<sup>645</sup>

684. It cannot be denied that the general economic situation was taken into account by El Paso when deciding the sale in question.<sup>646</sup> However, contrary to what is mentioned by Argentina,<sup>647</sup> there is no contribution by the Claimant to a loss it suffered due to its own conduct, in the absence of wilful or negligent action by the Claimant.<sup>648</sup> The Tribunal does not view the sale by the Claimant of its

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<sup>643</sup> *Ibid.*, § 608.

<sup>644</sup> *S.D. Myers*, *supra* note 176, § 315 (referring to "harm that is proved to have sufficient causal link" with the specific breach); *LG&E v. Argentina*, *supra* note 51, § 50; *BG v. Argentina*, *supra* note 293, § 428. See also the Report of the International Law Commission to the UN General Assembly on the Articles on Responsibility of States for Internationally Wrongful Acts, 2001: "Various terms are used to describe the link which must exist between the wrongful act and the injury in order for the obligation of reparation to arise. For example, reference may be made to losses attributable [to the wrongful act] as a proximate cause, or to damage which is too indirect, remote and uncertain to be appraised." (Commentary to Article 31, § 10, p. 227).

<sup>645</sup> Rejoinder, §§ 619-621.

<sup>646</sup> *Supra*, § 505.

<sup>647</sup> Rejoinder, §§ 619-621.

<sup>648</sup> Article 39 of ILC Articles on Responsibility of States for Internationally Wrongful Acts ("Contribution to the injury"): "In the determination of reparation, account shall be taken of the contribution to the injury by wilful or

investment in the Argentinian companies as a wilful or negligent action, “*i.e.* an action which manifests a lack of due care on the part of the victim of the breach for his or her own property or right.”<sup>649</sup> The Tribunal has examined the relationship between the sale of El Paso’s shares in the Argentinian companies and the GOA measures in the context of determining whether such measures may be considered a violation of the FET standard, concluding that the measures were the prevailing cause of the sale.<sup>650</sup>

685. The Tribunal is satisfied that LECG has calculated the Claimant’s damage under its DCF valuation method by considering only damage directly attributable to the GOA measures, to the exclusion of damage which might be attributable to the financial crisis. As explained by LECG:

“In our DCF Approach (both the 2004 and the 2006 update we discuss below), the macroeconomic indicators, as well as all available ex-post company performance information are included in the building of cash flows from January 2002 onwards. Thus, the DCF analysis is based on actual sales volumes and costs that fully reflect all the *actual* macroeconomic conditions in which the companies have been operating in Argentina since January 2002 to date. This is true for both the *but for* and *actual* scenarios, so as to make the comparison between the two scenarios compatible and avoid attributing damages to factors other than the Government measures. In other words, volumes and costs reflect the impact of the 2002 recession, and of the dramatic economic recovery of 2003 onwards.”<sup>651</sup>

686. The circumstance that the valuation of the Claimant’s damage, based on LECG’s DCF method, refers only to the impact of the measures on the value of its investment is confirmed by the Tribunal’s Expert, Professor Geoffron, in his Report of 6 April 2010.<sup>652</sup> The Respondent has criticised the use of the DCF

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negligent action or omission of the injured State or any person or entity in relation to whom reparation is sought.”

<sup>649</sup> To use the words of the International Law Commission Report to the UN General Assembly, 2002, § 5, p. 276.

<sup>650</sup> *Supra*, § 507.

<sup>651</sup> LECG’s Updated Report, § 145. Emphasis in the original.

<sup>652</sup> The Report explains that it is to be “aimed at assessing whether and to what extent El Paso Energy International Company interests in Argentina have been damaged by the measures taken by the Government ...” (§ 33).

method<sup>653</sup> but has not disputed the fact that LECG's has only considered the effect of the GOA measures on the value of the Claimant's investment when evaluating the latter's damage.

687. The Tribunal has held previously that the Respondent's measures were a contributory cause of the damage suffered by the Claimant for the loss of value of its investment in the Argentinian companies.<sup>654</sup> The Tribunal concludes that a causal connection exists between the GOA measures and the Claimant's damage.

## B. COMPENSATION

### 1. *The Parties' Positions*

688. What follows is a summary of each Party's position regarding compensation due to the Claimant for breach of the BIT. More will be said on the subject when analysing the Tribunal's Expert's reports discussing the position of the Parties' accounting experts on the various issues relating to the damages assessment.

#### *(i) The Claimant's Position*

689. El Paso claims damages based on the loss of value of its investment due to GOA measures taken in violation of its legal and contractual rights and not, as alleged by the Respondent, because it sold in bad macroeconomic conditions.<sup>655</sup>

690. The amount claimed is estimated by LECG on the basis of two alternative valuation methodologies, the DCF and the transactions methods.<sup>656</sup> Both methods are reasonable and valid means to calculate the damage inflicted by the GOA measures on the Claimant.<sup>657</sup> LECG's Updated Report demonstrates that

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<sup>653</sup> As discussed later in this decision, the DCF method is accepted by the Tribunal as the most appropriate valuation method in this case, *infra*, § 705.

<sup>654</sup> *Supra*, § 509.

<sup>655</sup> Reply, §§ 873 and 875.

<sup>656</sup> A third method, unjust enrichment, proposed initially by the Claimant (LECG's 1<sup>st</sup> Report, Section V.10), is not mentioned in the Reply and in LECG's Updated Report.

<sup>657</sup> Reply, § 857.

as of 31 December 2006 the Claimant suffered damage amounting to US\$ 147 million under the DCF method and US\$ 210 million under the transactions method.<sup>658</sup> The amount under the DCF method is increased in LECG's Report of 22 March 2007 to US\$ 228.2 million (including export withholding taxes up to February 2012).

691. The DCF model takes into account the conditions prevailing after the sales made in 2003 (such as current crude oil prices) since it assumes that El Paso would not have sold its investments in the absence of the GOA measures. The transactions method measures the Claimant's damage by comparing what a reasonable buyer would have paid for the assets in mid-2003 in the absence of the GOA measures to El Paso's actual sale proceeds in the light of the measures, therefore not using post-sale information.<sup>659</sup>
692. Contrary to Argentina's contention that the DCF method has "a high degree of uncertainty and includes an uncertain loss of profits",<sup>660</sup> that method is the most recognised and applied, as shown by other cases involving the Argentinian measures at issue in the present case.<sup>661</sup> El Paso is not claiming lost profits but rather the reduction of the market value of its Argentinian assets as a result of the GOA measures, even if a key component of the DCF method is future cash flows, which is analogous to accounting profits.<sup>662</sup>

*(ii) The Respondent's Position*

693. As already mentioned (*supra*, § 672), Argentina contends that even if it were found liable for breach of the BIT, the damage asserted by El Paso would not be the proximate consequence of that breach.<sup>663</sup> It asserts further that the sale by El

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<sup>658</sup> *Ibid.*, § 876.

<sup>659</sup> Reply, § 875.

<sup>660</sup> Counter-Memorial, § 798.

<sup>661</sup> Reply, § 885.

<sup>662</sup> Reply, § 886.

<sup>663</sup> Rejoinder, § 601.

Paso took place at one of the worst moment of the Argentinian economy and that the sales were due to El Paso's own problems.<sup>664</sup>

694. Always according to Argentina, it is unreasonable to take into account post-sale conditions (such as current crude oil prices) in the damages assessment since, on the one side, El Paso cannot benefit from the increase in the price of the assets marketed following the sale of its investments<sup>665</sup> and, on the other side, this contradicts Article IV(1) of the BIT under which “compensation shall be equivalent to the fair market value of the expropriated investment *immediately before the expropriatory action was taken* ....”<sup>666</sup>
695. The DCF method embodies a wide range of inherently speculative elements, as stated by the International Law Commission (“ILC”) and by arbitral awards.<sup>667</sup> The Claimant's statement that the damages claimed is not uncertain since it does not include any loss of profits is incorrect, considering that with the DCF method *lucrum cessans* becomes the sole element of compensation, as held by the *Amoco v. Iran* tribunal.<sup>668</sup>
696. According to the Claimant, the compensation standard should be the same as that applicable in cases of expropriation, namely fair market value. This is wrong, since the compensation applying in cases of expropriation cannot be obtained for the lower responsibility threshold of other Treaty violations.<sup>669</sup> Additionally, damage deriving from the export withholdings on hydrocarbons cannot be included in the calculation of damages.<sup>670</sup>
697. LECG's assessment of damages presents serious errors regarding its methodology and the assumptions made, as stated in the Counter-Memorial and the Macroconsulting's reports.<sup>671</sup> There are also doubts regarding the sum

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<sup>664</sup> *Ibid.*, §§ 603 and 605.

<sup>665</sup> *Ibid.*, § 609.

<sup>666</sup> *Ibid.*, § 611. Emphasis by the Respondent.

<sup>667</sup> Rejoinder, § 624.

<sup>668</sup> *Ibid.*, § 625.

<sup>669</sup> *Ibid.*, §§ 627-630.

<sup>670</sup> *Ibid.*, § 631.

<sup>671</sup> *Ibid.*, § 632.

obtained from the sale of El Paso's investment in CAPSA, so that LECG's use of that sum to assess the damages is also suspicious.<sup>672</sup>

## 2. *The Tribunal's Analysis*

698. The Tribunal has duly considered the reports and testimonies of the experts retained by each Party, Dr. Manuel Abdala and Dr. Pablo T. Spiller of LECG (for the Claimant), Dr. Martín Rodríguez Pardina of Macroconsulting (for the Respondent). In view of the number and complexity of the accounting issues relating to the damages assessment, as evidenced by the diverging views given on many relevant questions by the Parties' experts, the Tribunal, with the agreement of the Parties, has appointed its own expert in the person of Professor Patrice Geoffron, Professor of Economics at the University Paris-Dauphine (the "Expert").
699. The Report produced by the Expert on 6 April 2010 (the "April Report") was transmitted to the Parties on 14 April 2010. The Expert answered the observations made by the Parties on 21 May 2010 on the April Report, as directed by the Tribunal, by a "Complementary Note" of 10 July 2010 (the "July Report"), followed by a Final Revision of 12 October 2010 (the "October Report"). Both the July and October Reports were transmitted to the Parties on 22 November 2010 and comments thereon were filed by the Parties on 27 December 2010. The Expert's Reports and the Parties' comments shall be examined by the Tribunal in the context of determining the damages due to the Claimant. This will be done after establishing the principles that should govern the valuation of the damages in the present case.

### *(i) The Indemnification Standard*

700. The BIT does not specify the standard for evaluating damages to which the investor is entitled in case of breach of a standard of treatment, such as that of fair and equitable treatment (as in the present case). Only in the event of lawful expropriation, which is not a treaty breach, Article IV (1) of the BIT refers to

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<sup>672</sup> *Ibid.*, § 639.

the “fair market value” immediately before expropriation. In the absence of an agreed criterion, the appropriate standard of reparation under international law is compensation for the losses suffered by the party affected, as established by the Permanent Court of International Justice (“PCIJ”) in the *Factory of Chorzów* case (“*Chorzów Factory*”) in 1928:

“The essential principle contained in the actual notion of an illegal act – a principle which seems to be established by international practice and in particular by the decisions of arbitral tribunals – is that reparation must, as far as possible, wipe out all the consequences of the illegal act and re-establish the situation which would, in all probability, have existed if that act had not been committed.”<sup>673</sup>

701. Many tribunals have applied this principle in deciding on damages due for breach of the standard of fair and equitable treatment.<sup>674</sup> As noted by the tribunal in *SD Myers v. Canada*, the silence of the treaty indicates the intention of the drafters “to leave it open to tribunals to determine a measure of compensation appropriate to the specific circumstances of the case,”<sup>675</sup> adding that “whatever precise approach is taken, it should reflect the general principle of international law that compensation should undo the material harm inflicted by a breach of an international obligation.”<sup>676</sup>
702. In cases involving Argentina where, absent a finding of expropriation, a breach of the fair and equitable treatment standard under the BIT was found, other tribunals have held that damage should compensate for the difference in the “fair market value” of the investment resulting from the Treaty breach.<sup>677</sup> Fair market value has been so defined:

“the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm’s length in an open

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<sup>673</sup> *Chorzów Factory*, Judgment No. 13 (Claim for Indemnity – The Merits) of 13 September 1928, ICJ Reports 1928, P.C.I.J., Series A, No. 17, p. 47.

<sup>674</sup> *S.D. Myers*, *supra* note 176, §§ 311-315; *Metalclad* *supra* note 190, § 122; *MTD*, *supra* note 300, § 238; *CMS* *supra* note 48, § 400; *Azurix*, *supra* note 50, § 409; *Enron*, *supra* note 52, § 359; *Sempra*, *supra* note 53, § 400.

<sup>675</sup> *S.D. Myers*, *supra* note 176, § 309.

<sup>676</sup> *Ibid.*, § 315.

<sup>677</sup> *CMS*, *supra* note 48, § 410; *Azurix*, *supra* note 50, § 424; *Enron*, *supra* note 52, § 361.

and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.”<sup>678</sup>

703. The Tribunal shares this approach. The “fair market value” standard shall therefore be adopted to determine the value of the loss suffered by the Claimant by comparing the fair market value of El Paso’s investment with and without the GOA measures (respectively, the *actual* and the *but for* scenarios).
704. Fair market value is the valuation standard adopted by the BIT to calculate compensation due in case of lawful expropriation under Article IV(1). However, in the present case; the Tribunal is not confronted with a lawful expropriation but with a breach of the BIT. The majority of the Tribunal takes account of the difference between the two situations and of the fact that, as established by the *dictum* in the *Chorzów Factory* case, “reparation must, as far as possible, wipe out all the consequences of the illegal act.” The fair market value in the *but for* scenario shall be calculated considering also data and information which became known after 1 January 2002, including after El Paso’s sales in 2003, to the extent they are representative of financially assessable damages.<sup>679</sup> Arbitrator Stern considers that a fair market value evaluation of damage resulting from a violation of FET should only take into account what a willing buyer and a willing seller could foresee at the time of the interference with the investor’s rights. However, as, for reasons explained in paragraph 736, the Tribunal finally relies on a valuation taking into account the prices of oil as foreseen in 2003, at the time of the sale, she does not expand on the theoretical aspects of the question of the indemnification standard and the time of valuation.
705. These valuation criteria are in keeping with principles of public international law. It is worth reproducing the relevant passage of the Judgment in the *Chorzów Factory* case:

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<sup>678</sup> *International Glossary of Business Valuation Terms*, American Society of Appraisers, ASA website, 6 June 2001, p. 4.

<sup>679</sup> To use the words of Article 36 of ILC Articles on Responsibility of States for Internationally Wrongful Acts, *infra*, § 703.



“Restitution in kind, or, if this is not possible, payment of a sum corresponding to the value which a restitution in kind would bear; the award, if need be, of damages for loss sustained which would not be covered by restitution in kind or payment in place of it – such are the principles which should serve to determine the amount of compensation due for an act contrary to international law ... The dispossession of an industrial undertaking ... then involves the obligation to restore the undertaking and, if this be not possible, *to pay its value at the time of the indemnification*, which value is designed to take the place of restitution which has become impossible.”<sup>680</sup>

*(ii) The Valuation Date*

706. To pay the value of the property “*at the time of indemnification*”, as stated by the above *dictum*, means that the property (in our case, El Paso’s participation in the Argentinian companies) is to be evaluated by reference not to the time of the dispossession, as in the case of a lawful expropriation, but to the time when compensation is paid. Compensation is in fact in lieu of restitution that “has become impossible”, so that it should correspond “to the value which a restitution in kind would bear” (as stated by the *Chorzów Factory* Judgment in the passage cited).
707. In the *Amco Asia v. Indonesia* Resubmitted Case, the respondent State was found by the ICSID tribunal responsible for an unlawful interference with the Claimant’s rights to develop and operate a hotel complex in Indonesia. The tribunal emphasised the difference of the standard of damages after an unlawful act, which should be based on the principle of full reparation, and the standard of compensation after a lawful expropriation:

“It may, on one view, be the case that in a lawful taking, Amco would have been entitled to the fair market value of the contract at the moment of dispossession. In making such a valuation, a Tribunal in 1990 would necessarily exclude factors subsequent to 1980. But if Amco is to be placed as if the contract had remained in effect, then

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<sup>680</sup> *Chorzów Factory*, *supra* note 673, pp. 47-48. Emphasis added by the Tribunal.

subsequent known factors bearing on that performance are to be reflected in the valuation technique ...”<sup>681</sup>

708. The tribunal emphasised the reasons why developments up to the time of the award had to be taken into account:

“Foreseeability not only bears on causation rather than on quantum, but it would anyway be an inappropriate test for damages that approximate to restitution in integrum. The only subsequent factors relevant to value which are not to be relied on are those attributable to the illegality itself.”<sup>682</sup>

709. In making its assessment of damages, the tribunal further stated:

“But as to valuation techniques for 1980-1989 the tribunal will not use the perspective of what the reasonable businessman in 1980 could foresee, because for this period it can use known data for relevant factors.”<sup>683</sup>

710. Article 36 (“Compensation”) of the ILC Articles on Responsibility of States for Internationally Wrongful Acts provides the following:

“1. The State responsible for an internationally wrongful act is under an obligation to compensate for the damage caused thereby, insofar as such damage is not made good by restitution.

2. The compensation shall cover any financially assessable damage, including loss of profits insofar as it is established.”

After considering the above *dictum* in the *Chorzów Factory* case, the ILC’s Commentary of this Article concludes that “the function of compensation is to address *the actual losses* incurred as a result of the internationally wrongful act.”<sup>684</sup> The reference to “*loss of profits*” in Article 36(2) confirms that the

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<sup>681</sup> Amco Asia Corporation and others v. Republic of Indonesia (ICSID Case No. ARB/81/1), Award of 5 June 1990, § 186.

<sup>682</sup> *Ibid.*

<sup>683</sup> *Ibid.*, § 196. Other tribunals have adopted the same approach to assess damages caused by the GOA measures. The tribunal in *CMS* relied on actual post-2001 events, such as the peso-dollar exchange rate, cost of equity, natural gas demand and other factors, *supra* note 48, §§ 442-463). In *Siemens*, it was held that “under customary international law, Siemens is entitled not just to the value of its enterprise as of May 18, 2001, the date of expropriation, but also to any greater value that the enterprise has gained up to the date of this Award, plus any consequential damages.”, *supra* note 133, Award of 6 February 2007, § 352.

<sup>684</sup> ILC Commentary, Article 36, page 245. Emphasis added by the Tribunal.

value of the property should be determined with reference to a date subsequent to that of the internationally wrongful act, provided the damage is “*financially assessable*”, therefore not speculative. The Tribunal shares this position.

*(iii) The Valuation Method*

711. The Expert’s opinion is that “the Transaction approach presents uncertain reliability for assessing economic damages in the context of the Argentine crisis,”<sup>685</sup> while the Comparable method, proposed by Macroconsulting, is not favored by financial practitioners “due to the restricted reliability of sounds sets of comparables in the local market.”<sup>686</sup> The DCF method is preferred, as being “by far the most widely used as a primary valuation tool.”<sup>687</sup>
712. The Tribunal endorses the choice of the DCF method as being the most appropriate in the circumstances, considering also its consistency with the Expert’s chosen valuation standard. The method has been used widely, including by numerous arbitral tribunals in similar circumstances.<sup>688</sup> It makes it possible to assess the loss of value of El Paso’s investment due solely to the GOA measures, including the Argentinian companies’ capacity, as going concerns, to generate returns.

*(iv) The Tribunal’s Findings*

713. Having established the valuation standard to be applied and the methodology to be used, the Tribunal shall now examine the Expert’s Reports insofar as they also respond to the Parties’ comments. This will allow the Tribunal to establish to what extent the Expert’s findings and conclusions may be shared as to individual issues bearing on the quantum determination. The Tribunal’s analysis shall be concluded by the assessment of the amount of compensation

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<sup>685</sup> April Report, § 65.

<sup>686</sup> *Ibid.*, § 77.

<sup>687</sup> *Ibid.*

<sup>688</sup> The DCF method has been adopted by other awards in cases involving Argentina in relation to the measures taken as of January 2002: *CMS*, *supra* note 48 § 416; *Enron*, *supra* note 52, § 385; *Sempra*, *supra* note 53, § 416.

due to the Claimant for the breach of the fair and equitable treatment standard under the BIT.

714. The DCF method having been chosen, it is correct to take LECG's DCF model as the basis for damages assessment, as was done by the Expert. Macroconsulting having chosen another method, LECG's model is the only DCF model available.
715. The Tribunal has analysed LECG's DCF model with the Expert's assistance and is satisfied that it conforms to the principles that are to be applied to assess El Paso's damages in the frame of the chosen valuation standard. Reference is made in particular to LECG's explanations of the chosen methodology and to how cash flows have been built.<sup>689</sup>
716. The Tribunal has initially submitted to the Expert a number of questions under the "Terms of Reference for the Independent Expert Appointed by the Tribunal".<sup>690</sup> Six issues have been examined by the Expert's Reports in answer to the Tribunal's questions<sup>691</sup>:

(a) the WAAC

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<sup>689</sup> LECG's Updated Report, §§ 145-147, footnotes omitted. "In our DCF Approach (both the 2004 and the 2006 update we discuss below), the macroeconomic indicators, as well as all available ex-post company performance information is included in the building of cash flows from January 2002 onwards. Thus, the DCF analysis is based on actual sales volumes and costs that fully reflect all the actual macroeconomic conditions in which the companies have been operating in Argentina since January 2002 to date. This is true for both the but for and actual scenarios, so as to make the comparison between the two scenarios compatible and avoid attributing damages to factors other than the Government measures. In other words, volumes and costs reflect the impact of the 2002 recession, and of the dramatic economic recovery of 2003 onwards.

Consider, for example, the calculation of the companies' operating costs. All cost components such as labor, as well as other costs that are not linked to revenue or output levels are the same in the but for and actual scenarios and are invariant to the Government measures.

The only cost component that is attributable to the Government measures (the cost of natural gas for Central Costanera) is modelled differently between the but for and the actual. In this way, we strictly capture damages that are solely attributable to the measures, and not due to any other differences between scenarios.

Furthermore, in our DCF analysis we assumed domestic sales were affected by the economic crisis. Indeed, in both the actual and but for scenarios, El Paso's electricity generation companies' output declined in 2002, immediately after the crisis. The reduction in output reflects the impact of the recession on electricity sales, which affected Capex (a reduction of 10% as compared to 2001 output) and Central Costanera (a 36% reduction). Our damage analysis fully takes this impact into account, by subjecting both the but for and the actual scenario to the same macroeconomic shock. Thus, all effects from the devaluation of 2002 as well as the macroeconomic factors surrounding it are fully taken into account in our damage analysis in a way that is consistent with the computation of damages attributable to the Government measures only."

<sup>690</sup> April Report, Appendix 8.1.

<sup>691</sup> *Ibid.*, § 83.

- (b) the debt discount
- (c) the withholding tax
- (d) the oil prices
- (e) the benefits accruing to El Paso from the pesification and other measures
- (f) the value collected by El Paso for the sale of the Argentinian companies.

717. The Tribunal is satisfied that, by dealing with these issues, the Expert's Reports answer adequately the questions submitted to him.

*(a) The WAAC*

718. The Parties' experts have proposed widely divergent discount rates regarding the WAAC. Macroconsulting's rate averages 35%, while LECG's rate averages 12-13%. The April Report criticises both rates, the former as not reflecting a fair market value since it attributes "all the value variation to the economic crisis" while the latter is "too low to reflect the increasing risk to private investors in December 31<sup>st</sup>, 2001", so as to be "strangely 'immune' from the economic crisis."<sup>692</sup>

719. In discussing what should be the appropriate discount rate for 31 December 2001, the April Report underlines that, contrary to LECG's analysis, private investors are not immune from the consequences of a sovereign default, being indirectly exposed to Argentina's sovereign credit risk.<sup>693</sup> This leads the Expert to "upgrade" the discount rate proposed by LECG, the latter being consistent with a risk assessment in November 2001 but not reflecting the increasing threat to private investors in December 2001.

720. This consideration leads the Expert to re-evaluate the discount rate proposed by LECG according to the change in the country risk between November and December 2001. Following the Claimant's expert's remark, the final WAAC's

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<sup>692</sup> April Report, §§ 5 and 88.

<sup>693</sup> *Ibid.*, § 93.

values retained by the Expert are 15.45% for electricity and 15.43% for hydrocarbons.<sup>694</sup>

721. The Tribunal shares the Expert's view that the discount rate, in a situation such as that confronting Argentina at the end of 2001, must consider the increase in the country risk between November and December 2001. The Expert's measure of LECG's WAACs is reasonable, as is confirmed by the result of the calculation which, while accounting for the increased country risk, does not make the new WAACs incompatible with fair market value. The re-evaluated WAACs are therefore accepted.

*(b) The Debt Discount*

722. Here again the Parties' experts have expressed widely divergent views. LECG states that no discount should be applied to the debts of Costanera (US\$ 383 million) and CAPEX (US\$ 285 million) since the book value of the two companies' debts before and after the GOA measures were similar due to the implementation of debt restructuring agreements with the lenders. Applying a discount to such value would therefore, according to LECG, not make sense economically. Macroconsulting, on the contrary, stresses that the completion of the debt restructuring in 2005 is not relevant to the debt values in December 2001 and that account should be taken of the economic crisis of the period.
723. The Expert opines that keeping unchanged the book value of the debts in a turbulent period such as that characterising Argentina's economy in December 2001 would not be in line with the dominant view in the literature. He proposes to apply a debt discount that is not to be ascribed entirely to the economic crisis, as proposed by Macroconsulting, but that reflects the negative and continued impacts of both the GOA measures and the crisis in the *actual* scenario and only the impact of the crisis in the *but for* scenario.<sup>695</sup>

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<sup>694</sup> July Report, § 55.

<sup>695</sup> April Report, § 146.

724. By following an approach inspired by the reasoning adopted to re-evaluate the WAACs, the Expert proposes a debt discount of 35% in the *actual* scenario and of 26.25% in the *but for* scenario.<sup>696</sup> This assessment was subsequently confirmed by the Expert.<sup>697</sup>
725. The Tribunal agrees with the Expert that keeping the value of Costanera's and CAPEX' debts unchanged in the turbulent period experienced by Argentina's economy in December 2001 would not reflect the real value of the debts. A discount should therefore be applied to reconcile their value with the market value. The Tribunal also agrees that a debt discount should be separately calculated for the *but for* scenario and for the *actual* scenario, as proposed by the Expert and accepts the two figures proposed by the Expert.

*(c) The Withholding Tax*

726. The April Report distinguishes between a direct effect of the withholding tax (external effect) and an indirect effect (internal effect).<sup>698</sup> The direct effect of the withholding tax is the normal operation and effect of a tax, in this case the direct appropriation by the State of revenues accruing to CAPSA and CAPEX from the export of crude oil and LPG; while the indirect effect consists in artificially depressing domestic crude oil and LPG price.<sup>699</sup>
727. The Tribunal has already excluded its jurisdiction regarding the withholding tax, holding that the tax imposed by Argentina on the export of crude oil and LPG in 2002 and thereafter is a tax measure under Article XII (2) of the BIT.<sup>700</sup> The Expert has correctly removed from LECG's DCF model the direct effect of the withholding tax by excluding from the damages calculation the lost

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<sup>696</sup> *Ibid.*, § 157.

<sup>697</sup> July Report, § 58.

<sup>698</sup> April Report, §§ 167 and 169.

<sup>699</sup> The distinction between direct and indirect effect of the withholding tax is made by the Claimant: "Export Withholding on crude oil constitute (i) a direct taking of export revenues of CAPSA and CAPEX and (ii) an indirect taking from by artificially depressing domestic crude oil and LPG prices" (Memorial, § 474).

<sup>700</sup> *Supra*, §§ 281-298.

revenues for CAPSA (on crude oil exports) and CAPEX (on crude oil and LPG exports) due to the withholding tax.<sup>701</sup>

728. The indirect effect of the withholding tax requires more developments by the Tribunal. The starting point is the precise identification of this effect. This is described as follows by the Claimant:

”On the other hand, Export Withholdings have the effect of artificially depressing domestic prices for those products that are subject to these levies. This is because the Export Withholdings produce what is known as the “export parity.” Buyers in the domestic market will predictably refrain from paying a price to the producer that is higher than the net price the producer would receive (after deducting export costs, including any Export Withholdings) if the product is exported. Consequently, due to the Export Withholdings, CAPSA and CAPEX were forced to accept prices for their domestic sales of crude oil and LPG that were significantly lower than those prices that would have prevailed in the domestic market in the absence of the Export Withholdings.”<sup>702</sup>

729. May the indirect effect of the withholding tax be deemed to fall within the scope of Article XII(2) of the BIT, so that the Tribunal’s lack of jurisdiction extend to any consideration or ruling regarding this effect? The Tribunal believes this to be the case, for the following reasons.

730. Article XII(2) of the BIT, when interpreted “in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose”,<sup>703</sup> is meant to preserve the State’s sovereign power in “matters of taxation”, the latter being clearly an attribute of sovereignty. Contracting States agreed therefore to exclude matters of taxation from the system of guarantees and protections of foreign investments established by the BIT in order to preserve their full sovereignty in that regard. This being the

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<sup>701</sup> April Report, § 183 and Figure 20 (compared to Figure 19).

<sup>702</sup> Memorial, § 339. Footnotes omitted.

<sup>703</sup> Vienna Convention on the Law of Treaties, Article 31(1).



object and purpose of Article XII(2), it is for this reason that the Tribunal has declined jurisdiction regarding the withholding tax.<sup>704</sup>

731. Is the export parity effect described by the Claimant a “*matter of taxation*” within the meaning of Article XII(2), interpreted as mentioned above? The answer is in the affirmative. In its ordinary meaning, the expression “*matters of taxation*” is not limited to the levy and collection by the State of the specific tax but includes all effects of the tax on the taxpayer. The Tribunal shares the Respondent’s view that not only the withholding tax as such falls within the scope of Article XII(2) of the BIT but also its indirect effects.<sup>705</sup>
732. The export parity effect (the indirect effect of the withholding tax) should therefore be excluded from the damages calculation. Having been so directed by the Tribunal, the Expert, in the October Report, has excluded any withholding tax effects, both local and external.<sup>706</sup>

*(d) The Oil Prices*

733. The Tribunal has decided that the valuation standard to be applied for the calculation of El Paso’s damages enables it to consider data and information which became known subsequent to the date of the first GOA measures, 1 January 2002.<sup>707</sup> Crude oil prices have been taken into consideration by LECG in the DCF model submitted by the Claimant in support of the claim for damages by using crude oil futures as of 2004<sup>708</sup> and as of 2006.<sup>709</sup>

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<sup>704</sup> *Supra*, § 289: “The tax policy of a country is a matter relating to the sovereign power of the State and the State’s power to impose taxes within its territory. The Tribunal must emphasise the sovereign right of a State to enact tax measures it deems appropriate in any particular time.”

<sup>705</sup> Observations of the Republic of Argentina on Prof. Geoffron’s Report of 1 June 2010, § 74.

<sup>706</sup> October Report, Section 4.2 on p. 12 and § 28. The external effect of the export withholding tax had already been excluded in the April Report.

<sup>707</sup> *Supra*, § 704.

<sup>708</sup> LECG’s Report, note 373 and § 191. “Crude oil prices from August 2004 onwards are forecasted using NYMEX future prices for WTI adjusted by a differential for quality and transportation” (*ibid.*, § 194(a)). NYMEX (New York Mercantile Exchange) is the main world market for petroleum futures.

<sup>709</sup> LECG’s Updated Report, § 210: “We updated crude oil prices up to September 2006 and from then onwards we use a WTI Future prices that converge to US \$ 50 per barrel in 2012.” Historical price data for WTI (West Texas Intermediate, a type of crude oil) are publicly available.

734. LECG's damages assessment based on said crude oil futures is consistent with the valuation standard adopted by the Tribunal to determine the fair market value of El Paso's investment in the *but for* scenario. Crude oil prices during the period are reported internationally so that a loss of profits based on such prices is financially assessable and not speculative.<sup>710</sup>
735. Consistent with the above, the Expert's reduction of the LECG's damages assessment by considering only information available in 2002<sup>711</sup> was not accepted by the Tribunal. The Expert was directed to prepare two alternative solutions, one applying the 2003 oil prices, the other integrating oil prices to include future prices. The October 2010 Report accordingly presents two different valuations, the first (Valuation 1) applying the "2003 futures / oil prices" and the other (Valuation 2) applying oil prices up to 2020, both valuations excluding the withholding tax effects.<sup>712</sup>
736. In the Tribunal's view, Valuation 2 is more problematic since it is based on oil prices that, by projecting the calculation up to 2020, make the result financially not assessable on safe grounds, thus providing to be speculative. The Tribunal's choice is therefore for the more reliable results of Valuation 1.

*(e) The Benefits Accruing to El Paso from the Pesification and Other Measures*

737. The Expert confirms that the positive impact of the pesification has been integrated by LECG in its DCF model,<sup>713</sup> adding that this specific issue is not mentioned by Macroconsulting in its Second Report.<sup>714</sup> No benefits from other measures are mentioned.
738. The Tribunal is satisfied that benefits accruing to El Paso as a result of the GOA measures have been duly considered by the Claimant's expert reports.

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<sup>710</sup> *Supra*, § 704.

<sup>711</sup> April Report, § 209. Figure 26 of the April Report shows the amount of reduction in El Paso's total damages by considering oil prices in 2003 only.

<sup>712</sup> October Report, Sections 3.1 and 4.1.

<sup>713</sup> April Report, § 218.

<sup>714</sup> *Ibid.*, § 221.

*(f) The Value Collected by El Paso for the Sale of the Argentinian Companies*

739. Based on LECG's reports, the total price collected by El Paso for the sale of its interest in Argentina in 2003 is equal to US\$ 32.7 million.<sup>715</sup> Contrary to the Claimant's contention,<sup>716</sup> the Respondent asserts that there are serious doubts on the price actually received by El Paso and that there is no trace of the 2003 transactions in the DCF damages assessment under LECG's DCF model.<sup>717</sup>
740. Having initially considered that the price so collected by El Paso should be deducted from the DCF damages,<sup>718</sup> following further analysis the Expert has concluded that the price collected by El Paso for the sale of its participation in the Argentinian companies in 2003 should not be deducted to determine the damages amount since the DCF damages calculation assumes that the Claimant continues to keep its shareholding in said companies.<sup>719</sup>
741. Following the Parties' observations of 27 December 2010, the Tribunal has requested the Expert to express his final opinion regarding the damages assessment based on Valuation 1. This has led the Expert to recommend to the Tribunal the following modifications to the October Report:
- (a) the increase of the damages for CAPSA by US\$ 14.2 million by accepting LECG's suggested correction to withdraw CAPSA's negative damages;<sup>720</sup>
  - (b) the deduction of US\$ 2.15 million regarding CAPEX and US\$ 0.69 million regarding Costanera, for a total of US\$ 2.84 million, suggested by MacroConsulting as correction on the electricity spot prices.<sup>721</sup>

The Expert's recommendations are accepted by the Tribunal.

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<sup>715</sup> LECG's Report, Exhibit 12 to the Memorial, §§ 176-177.

<sup>716</sup> CPHB, § 183.

<sup>717</sup> RPHB, § 222.

<sup>718</sup> April Report, § 232.

<sup>719</sup> July Report, § 48.

<sup>720</sup> LECG's Comments on Prof. Geoffron's Reports of July and October 2010, Annex A to the Claimant's letter of 27 December 2010, § 33 and Table II.

<sup>721</sup> MacroConsulting's Analysis of the Complementary Note and the Final Revisions of Prof. Geoffron's Valuation of Damages on the Value of El Paso's Investments in Argentina of 23 December 2010 attached to Argentina's Observations on Prof. Geoffron's Supplementary Report of 27 December 2010, § 51.

742. As a result of all modifications of the initial damages assessment under the April Report accepted by the Tribunal, El Paso's total damages amount to US\$ 43.03 million. The compensation due by Argentina to El Paso is therefore fixed by the Tribunal to the amount of US\$ 43.03 million.

## C. INTEREST

### 1. *The Parties' Positions*

743. The Claimant has requested interest "at commercially reasonable rate from the date of expropriation", as provided by Article IV of the BIT, to be compounded quarterly through the date of the award.<sup>722</sup> In reply to the Respondent's contention that only simple interest should be awarded, the Claimant, referring to LECG, notes that compound interest "merely reflects the economic reality that a dollar foregone could otherwise have been invested and that income on that investment could have been reinvested so that funds grow at a compound rate."<sup>723</sup> In its last written submission, the Claimant, relying on the *Enron* award, has requested that interest be awarded at the LIBOR plus 2% rate until the date of payment.<sup>724</sup>

744. Relying on the alleged general position of international courts and tribunals as well as of most authors, Argentina has asserted that simple interest should be granted.<sup>725</sup>

### 2. *The Tribunal's Analysis*

745. The Tribunal notes that LIBOR plus 2% is the rate of interest used by other awards involving Argentina regarding the same economic crisis as that considered in the present.<sup>726</sup> Such a rate appears less speculative than other rates of interest granted by other awards involving Argentina. This rate is, therefore, accepted by this Tribunal.

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<sup>722</sup> Memorial, §§ 629-633.

<sup>723</sup> Reply, §§ 903-904.

<sup>724</sup> CPHB, § 184.

<sup>725</sup> Counter-Memorial, § 820; Rejoinder, § 640.

<sup>726</sup> *Enron*, *supra* note 52, § 452; *Continental*, *supra* note 150, §§ 313-314.

746. Compound interest is generally recognised by arbitral tribunals in the field of investment protection, including all awards in the Argentine cases.<sup>727</sup> The Tribunal shares the view expressed by these awards that compound interest reflects economic reality and will therefore better ensure full reparation of the Claimant's damage. Interest shall be compounded semi-annually, for the same reason.
747. Interest shall run from 1 January 2002, being the date to which the amount of compensation is discounted back in the Expert's Report, until full payment of the amount due.

## VII. COSTS OF THE PROCEEDING

748. According to Article 61(2) of the ICSID Convention and Rule 47(1)(j) of the Arbitration Rules, the Tribunal has to decide, as part of the award, the apportionment of the expenses incurred by the Parties in connection with the proceedings as well as of the fees and expenses of the members of the Tribunal and the charges for the use of the facilities and services of the Centre.
749. Each Party has asked the Tribunal that its costs in connection with these proceedings, including the advances made to ICSID for the Centre's charges and the expenses and fees of the arbitrators, be reimbursed to it by the other Party.<sup>728</sup> The Claimant has quantified its costs in the amount of US\$ 7,950,823 besides ICSID fees and expenses.<sup>729</sup> The Respondent has quantified its costs, net of ICSID fees and expenses, in the amount of US\$ 546,456.71.<sup>730</sup>
750. The Convention and the Arbitration Rules give ICSID tribunals broad discretion in awarding costs. The practice in apportioning costs has sometimes followed the principle "the loser pays" while in many other cases the decision has been that the Parties were to bear their own costs and share equally the fees

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<sup>727</sup> *CMS*, *supra* note 48, § 471; *Azurix*, *supra* note 50, § 440; *Enron*, *supra* note 52, § 452; *LG&E*, *supra* note 51, § 103; *BG*, *supra* note 293, § 455; *Continental*, *supra* note 150, § 309.

<sup>728</sup> CPHB, § 186(3); RPHB, § 232.

<sup>729</sup> El Paso's letter of 16 June 2011.

<sup>730</sup> Argentina's letter of 15 June 2011.

and expenses of the arbitrators as well as the charges for the use of the Centre's facilities and services.

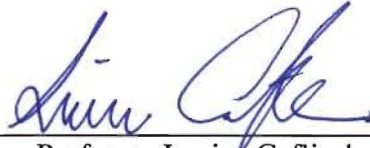
751. Regarding the present case, the Tribunal notes that the Claimant has been successful on the jurisdictional issue but only in part as to the merits of the case and the damages claimed. There are therefore good reasons to decide, as is hereby decided, that each Party shall bear its own costs connected with the proceedings as well as half of the fees and expenses of the arbitrators and the charges for the use of the Centre's facilities and services.

## VIII. **DECISION OF THE TRIBUNAL**

752. For the foregoing reasons, the Tribunal decides as follows:

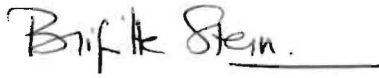
- A) Argentina breached Article II(2)(a) of the BIT by failing to accord fair and equitable treatment to El Paso's investment.
- B) Argentina's defence of necessity to El Paso's claims is rejected.
- C) Within 30 (thirty) days of the date of dispatch to the Parties of this Award, Argentina shall pay to El Paso compensation in the sum of US \$ 43.03 million, increased by semi-annually compounded interest on that amount at the rate of LIBOR plus 2% from January 1, 2002 until the date of payment in full of this Award.
- D) The Parties shall bear all their own legal costs and expenses, without recourse to each other.
- E) The Parties shall bear equally the costs and expenses of the Tribunal and ICSID.

All other claims by either Party are rejected



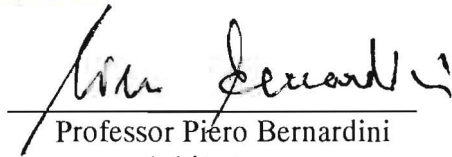
Professor Lucius Caflisch  
President

Date: 27 October 2011



Professor Brigitte Stern  
Arbitrator

Date: 3 October 2011



Professor Piero Bernardini  
Arbitrator

Date: 25 October 2011

## **LEGAL AUTHORITY CA-83**



**INTERNATIONAL CENTRE FOR SETTLEMENT  
OF INVESTMENT DISPUTES**

WASHINGTON, D.C.

IN THE PROCEEDINGS BETWEEN

LG&E ENERGY CORP.

LG&E CAPITAL CORP.

LG&E INTERNATIONAL INC.

(CLAIMANTS)

AND

ARGENTINE REPUBLIC

(RESPONDENT)

ICSID Case N° ARB/02/1

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**DECISION ON LIABILITY**

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*Members of the Tribunal:*

Dr. Tatiana B. de Maekelt, President

Judge Francisco Rezek, Arbitrator

Professor Albert Jan van den Berg, Arbitrator

*Secretary of the Tribunal:*

Claudia Frutos-Peterson

Date: 3 October 2006

*Representing the Claimants*

Mr. Eugene D. Gulland  
Mr. Oscar M. Garibaldi  
Mr. Eric D. Brown  
Ms. Karin L. Kizer  
Mr. Miguel López Forastier  
Covington & Burling  
Washington, D.C.  
United States of America

Ms. Dorothy O'Brien  
LG&E Energy LLC.

and

Dr. Horacio J. Ruiz Moreno  
Dr. Gustavo Cedrone  
Dr. Leonardo Orlanski  
Hope, Duggan & Silva  
Buenos Aires  
Argentina

*Representing the Respondent*

H.E. Osvaldo César Guglielmino  
Procurador del Tesoro de la Nación  
Procuración del Tesoro de la Nación  
Buenos Aires  
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## I. THE PARTIES

1. Claimants, LG&E Energy Corp. and LG&E Capital Corp. are corporations created and existing under the laws of the Commonwealth of Kentucky, in the United States of America, with domestic and foreign operations.<sup>1</sup> LG&E International Inc. is a corporation organized and existing under the laws of the State of Delaware, United States of America. Claimants hereinafter will be referred to collectively as “LG&E” or “Claimants.”
2. LG&E has a shareholding interest in three local, gas distributing companies in Argentina created and existing under the laws of Argentina by commandment of the Argentine Government: Distribuidora de Gas del Centro (“Centro”), Distribuidora de Gas Cuyana S.A. (“Cuyana”) and Gas Natural BAN S.A. (“GasBan”), hereinafter collectively referred to as “the licensees”. LG&E owns a controlling equity interest in Centro and minority equity interests in GasBan and Cuyana.
3. Respondent is the Argentine Republic, which along with the United States of America, is a party to the Convention on the Settlement of Investment Disputes between States and Nationals of other States (“ICSID Convention” or “Convention”), ratified by the Argentine Republic in 1994 and by the United States of America in 1966. The Bilateral Investment Treaty between the United States of America and the Argentine Republic Concerning the Reciprocal Encouragement and Protection of Investments was signed on 14 November 1991 (“BIT”, “the Bilateral Treaty” or the “Treaty”) (and entered into force on 20 October 1994).

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<sup>1</sup> Until 1 December 2005, Claimants were LG&E Energy Corp., LG&E Capital Corp. and LG&E International Inc. However, on 26 January 2006, Claimants informed the Tribunal that the name of two of the companies had been modified: LG&E Energy Corp. is now E.ON.US LLC and LG&E Capital Corp. is now E.ON.US. Capital Corp. LG&E International Inc. kept its name. Upon request by the Tribunal, LG&E submitted documents that, in the Tribunal’s opinion, only prove the change of name but not its effects. Respondent remained silent on this issue.

## II. THE ARBITRAL TRIBUNAL

4. On 31 January 2002 the Centre's Secretary-General registered Claimants' Request for Arbitration in accordance with Article 36(3) of the ICSID Convention. In accordance with Rule 7 of the Rules of Procedure for the Institution of Conciliation and Arbitration Proceedings ("the Institution Rules"), the Secretary-General gave notice to the parties of the registration of Claimants' Request and invited them to constitute an Arbitral Tribunal as soon as possible.
5. Forthwith, the parties agreed that the Arbitral Tribunal should be formed by three arbitrators, one appointed by the Claimants, another by the Argentine Republic and the third one, called to preside over the Tribunal, would be appointed by the Centre's Secretary-General in accordance with the method agreed upon by the parties.
6. On 20 June 2002, the Claimants appointed Professor Albert Jan van den Berg, a national of the Netherlands, as an arbitrator for this case. Said appointment was ratified by the Claimants by letters to the Centre dated 15 and 28 August 2002. The Argentine Republic, by letter dated 26 August 2002, appointed Judge Francisco Rezek, a Brazilian citizen, as an arbitrator. On 7 November 2002, the Centre's Secretary-General, with the parties' agreement, appointed Dr. Tatiana B. de Maekelt, a citizen of Venezuela, as the Arbitral Tribunal's President.
7. On 13 November 2002, the ICSID's Secretariat, in accordance with Rule 6(1) of the Rules of Procedure for Arbitration Proceedings ("Arbitration Rules"), notified the parties that all the arbitrators had accepted their appointments and that the Tribunal was deemed to be constituted and the proceeding deemed to begun as from that date. On this same day, in accordance with Rule 25 of the ICSID Administrative and Financial Regulations, the parties were informed that Dr. Claudia Frutos-Peterson would act as the Tribunal's Secretary.

### III. PROCEDURAL BACKGROUND

8. On 28 December 2001, ICSID received from LG&E a request for arbitration dated 21 December 2001 against the Argentine Republic.
9. By letter dated 24 January 2002 the Claimants filed with ICSID a supplement to their request for arbitration. Claimants asserted that Respondent had committed further violations of the BIT as a result of the enactment by the Government of the Public Emergency and Currency Exchange Law (“Emergency Law”), which allegedly adversely affected Claimants’ investment in Argentina.
10. In accordance with Arbitration Rule 13, the Tribunal held its first session with the parties at the seat of the Centre in Washington D.C. on 19 December 2002. The parties agreed to set the following schedule for the written procedure: Claimants were to file a Memorial on 31 March 2003. Upon receipt of Claimants’ Memorial, Respondent could choose to file an answer within either 60 or 90 days. In its answer, Respondent was entitled to file exceptions on jurisdiction, and to the extent it deemed necessary, could respond to Claimants’ arguments on the merits. In the event that the Respondent filed a Memorial on Jurisdiction, the Claimants were to file their Counter-Memorial on Jurisdiction within 30 days from their receipt of the Respondent’s Memorial on Jurisdiction, followed by Respondent’s Reply on Jurisdiction within 20 days following receipt of Claimants’ Counter-Memorial on Jurisdiction, and Claimants’ Rejoinder on Jurisdiction to be filed 20 days from receipt of the Respondent’s Reply on Jurisdiction.
11. With respect to oral procedure, it was also agreed during the first session to set the following schedule based on the written submissions. In the event that Respondent filed its answer within 60 days and if the Tribunal decided so, there was to be a hearing on jurisdiction between 22 and 23 September 2003. In the event that Respondent filed its answer within 90 days, the hearing on jurisdiction, if the Tribunal were in agreement, was to be held on 20 and 21

October 2003. The hearing on the merits was scheduled for 8 through 12 March 2004.

12. The Claimants filed their Memorial on 31 March 2003.
13. Subsequently, under covenant, the parties decided to amend the schedule of proceedings concerning the objections to jurisdiction. Respondent and Claimants informed the ICSID Secretariat of this amendment on 1 and 2 July 2003, respectively. Under the new schedule, Respondent's Memorial on Jurisdiction was to be filed on 21 July 2003; Claimants' Counter-Memorial on Jurisdiction, on 29 August 2003; Respondent's Reply on Jurisdiction, on 22 September 2003, and Claimants' Rejoinder on Jurisdiction, on 13 October 2003. It was also agreed that the hearing on jurisdiction was to be held on 20 and 21 October 2003, but subsequently, the Tribunal, in joint agreement with the parties, decided that the hearing on jurisdiction should be held between 20 and 21 November 2003, at The Hague, Netherlands.
14. In accordance with the terms set, on 21 July 2003, Respondent formally filed objections to ICSID's jurisdiction. In its Memorial on Jurisdiction, Respondent presented the grounds upon which it based said objections and attached documents in support of its arguments. On 29 August 2003, Claimants filed their Counter-Memorial on Jurisdiction. On 22 September 2003, the Argentine Republic filed its Reply on Jurisdiction, and on 14 October 2003, Claimants filed their Rejoinder on Jurisdiction.
15. On 30 October 2003, Respondent filed a motion to suspend the proceedings and requested, as an alternative measure, a stay of the hearing on jurisdiction. On 31 October 2003, the President of the Tribunal asked Claimants to submit their comments on said motion by 3 November 2003. On 3 November 2003, the Claimants filed an objection to the stay motion. On 5 November 2003, the members of the Arbitral Tribunal deliberated on the Argentine Republic's motion and denied Respondent's motions to suspend these proceedings and stay the hearing on jurisdiction scheduled for



20 and 21 November 2003.

16. The hearing on jurisdiction was held on the date set, at the seat of the Permanent Court of Arbitration in The Hague, the Netherlands. Messrs. Eugene D. Gulland and Oscar M. Garibaldi of the law firm of Covington & Burling from Washington, D.C. acted as counsel for the Claimants. Also present at the hearing were Ms. Dorothy O'Brien, Deputy General Counsel for LG&E Energy Corp. and Mr. S. Bradford Rives, Chief Financial Officer of LG&E Energy Corp.
17. Messrs. Carlos Ignacio Suárez Anzorena and Ignacio Pérez Cortés, on behalf of Dr. Horacio Daniel Rosatti, the then-Procurador del Tesoro de la Nación Argentina, attended the hearing on behalf of the Respondent.
18. During the hearing, the parties presented their arguments on the jurisdictional issues. The Tribunal posed questions to the parties in accordance with Rule 32(3) of the Arbitration Rules.
19. On 30 April 2004, the Tribunal issued its Decision on Objections to Jurisdiction, holding that the present dispute is within the jurisdiction of the Centre and the competence of the Tribunal. In so holding, the Tribunal considered the following criteria:
  - a. That the dispute should be between a Contracting State and a national of another Contracting State and that Claimants should have *jus standi* to act in these proceedings;
  - b. That the issue should be a dispute of a legal nature arising directly from an investment;
  - c. That the parties should have given their consent, in writing, to submit to arbitration and, specifically to the ICSID arbitration; and
  - d. That all the other requirements of both the ICSID Convention and the Bilateral Treaty should be met in order to submit a dispute to arbitration.

20. With respect to criteria (a), regarding *jus standi*, the Tribunal was of the opinion that, for purposes of the ICSID Convention and the Bilateral Treaty, Claimants should be considered foreign investors, even though they did not directly operate the investment in the Argentine Republic, but acted through companies constituted for that purpose in its territory (Decision on Jurisdiction, ¶ 63).
21. With respect to criteria (b), which requires that the issues before the Tribunal be a dispute of a legal nature arising directly from an investment, the Tribunal concluded that, at the jurisdictional phase, it was to be presumed that Claimants' claims were based on alleged breaches of the Bilateral Treaty affecting Claimants' investments within the meaning of the ICSID Convention and the Bilateral Treaty (Decision on Jurisdiction, ¶ 66).
22. With respect to criteria (c), requiring the consent of the parties to submit the dispute to ICSID arbitration, the Tribunal was of the opinion that the Argentine Republic's consent was given through Article VII(4) of the Bilateral Treaty. In turn, when Claimants resorted to ICSID, they decided to submit their investment disputes to the Centre's jurisdiction. It is noteworthy, in this case, that Claimants did not submit the dispute to the Argentine courts or to any other dispute settlement mechanism mentioned in Article VII of the Bilateral Treaty. For this reason, no question regarding the "fork in the road" provision arises in the present case (Decision on Jurisdiction, ¶ 69 *et. seq.*).
23. Finally, with respect to criteria (d), concerning verification of the other requirements of the ICSID Convention and the Bilateral Treaty, the Tribunal concluded that the claims are not time barred, and that the claims asserted in the additional request filed by Claimants are sufficiently sequential to the originally stated claims as to permit their review by this Tribunal for the sake of efficiency. The fact that the license holders may have begun negotiations with Respondent is outside this arbitral proceeding, inasmuch as the license holders, which are different legal entities, are pursuing that process from

their own (corporate) perspective. Thus, in view of the fact that more than six months elapsed from the date on which the dispute arose, i.e. 24 January 2002, there is no bar in initiating the arbitral proceedings (Decision on Jurisdiction, ¶ 80 *et. seq.*).

24. Based on these considerations, the Tribunal:
  - a. Held that the present dispute is within the jurisdiction of the Centre and the competence of the Tribunal;
  - b. Dismissed all of the Respondent's objections as to the admissibility of the dispute and all of the Respondent's objections to the jurisdiction of ICSID and the competence of this Tribunal;
  - c. Ordered, pursuant to Rule 41(4) of the Arbitration Rules, the continuation of the proceeding;
  - d. Reserved all questions concerning the costs and expenses of the Tribunal and the parties for future determination.
25. In accordance with Procedural Order No. 1 dated 4 May 2004, Respondent filed its Counter-Memorial on the merits on 18 June 2004, seeking dismissal of LG&E's claims. On 6 August 2004, Claimants filed their Reply.
26. Respondent filed its Rejoinder on the merits on 27 September 2004, in which it asked the Tribunal, among other legal and factual arguments, to exclude Claimants' witness, Mr. Patricio Perkins, from the hearing on the merits on grounds of an alleged conflict of interest. Claimants objected to Respondent's motion to exclude the witness on 1 November 2004.
27. By means of Procedural Order No. 3, dated 23 November 2004, the Arbitral Tribunal decided (i) to admit the witness depositions offered by Respondent; (ii) to grant Claimants the opportunity to offer additional evidence regarding the witness depositions produced by Respondent in its Rejoinder, at the latest on 20 December 2004 and to cross-examine said witnesses during the hearing on the merits; (iii) to admit the testimony of Mr. Patricio Perkins,

subject to cross-examination by Respondent.

28. In accordance with Procedural Orders Nos. 4 and 5, dated 13 and 18 January 2005, respectively, the hearing on the merits was held between 23 and 29 January 2005, at the seat of the Centre in Washington, D.C. The following persons were present at that hearing:

*Arbitral Tribunal:*

Tatiana B. de Maekelt, President

Francisco Rezek, Arbitrator

Albert Jan van den Berg, Arbitrator

*Secretary of the Tribunal:*

Claudia Frutos-Peterson

*Counsel for Claimants:*

Oscar M. Garibaldi (Covington & Burling, Washington, D.C.)

Eugene D. Gulland (Covington & Burling, Washington, D.C.)

Eric D. Brown (Covington & Burling, Washington, D.C.)

Miguel López Forastier (Covington & Burling, Washington, D.C.)

Karin Kizer (Covington & Burling, Washington, D.C.)

Warda Henning (Covington & Burling, Washington, D.C.)

Harris Bor (Covington & Burling, Washington, D.C.)

Matthew Chester (Covington & Burling, Washington, D.C.)

Jadranka Poljak (Covington & Burling, Washington, D.C.)

Alma Ramírez (Covington & Burling, Washington, D.C.)

Karin Lui (Covington & Burling, Washington, D.C.)

Horacio Ruiz Moreno (Rosso Alba, Francia & Ruiz Moreno Abogados,  
Buenos Aires, Argentina)

Leonardo Orlanski (Rosso Alba, Francia & Ruiz Moreno Abogados, Buenos  
Aires, Argentina)

*Also present on behalf of Claimants:*

Dorothy O'Brien (LG&E Energy LLC)

Chris Hermann

Leonardo Massimino

Donaldo Sloog

Gabriel Wilkinson

*Counsel for Respondent:*

Oswaldo Guglielmino (Procurador del Tesoro de la Nación Argentina, Buenos Aires, Argentina)

Gustavo Adolfo Scrinzi (Subprocurador del Tesoro de la Nación Argentina, Buenos Aires, Argentina)

Ana Badillos (Procuración del Tesoro de la Nación Argentina, Buenos Aires, Argentina)

Luz Moglia (Procuración del Tesoro de la Nación Argentina, Buenos Aires, Argentina)

Gabriel Bottini (Procuración del Tesoro de la Nación Argentina, Buenos Aires, Argentina)

Ignacio Pérez Cortés (Procuración del Tesoro de la Nación Argentina, Buenos Aires, Argentina)

Gastón Rosenberg (Procuración del Tesoro de la Nación Argentina, Buenos Aires, Argentina)

*Also present on behalf of Respondent:*

Carlos Garber (Ministerio de Relaciones Exteriores, Comercio Internacional y Culto, Buenos Aires, Argentina)

Alicia Federico (Ente Nacional Regulador del Gas (ENARGAS), Buenos Aires, Argentina)

Charles Joseph Masano (Secretaría de Energía, Buenos Aires, Argentina)

Marcelo Masonni: (Embassy of the Argentine Republic, Washington, D.C.)

*Court Reporters:*

David A. Kasdan

Dante Rinaldi

29. The hearing commenced, as scheduled on Sunday, 23 January 2005 at 8:45 a.m. After a brief introduction by the Tribunal's President, Claimants' counsel, Messrs. Eugene Gulland and Oscar Garibaldi, made their oral presentation to the Tribunal, referring to the arguments indicated in their briefs. They also presented their witnesses for oral examination: Messrs. S. Bradford Rives, Eduardo A. Hurtado, Patricio Carlos Perkins, Rudolf Dolzer, Eduardo Schwartz, Carlos Lapuerta, Antoni Peris Mingot, and Jose E. Álvarez.
30. Thereafter, Messrs. Osvaldo César Guglielmino, Ignacio Pérez Cortés and Gabriel Bottini made their submissions on behalf of the Argentine Republic. The following witnesses testified on behalf of Respondent: Ms. Anne-Marie Slaughter and Messrs. Eduardo A. Ratti, Jorge G. Simeonoff, Cristian Folgar, Nouriel Roubini and Fabián Bello.
31. On 28 February 2005, the parties submitted Post-Hearing Briefs.
32. By letter dated 18 May 2005, the Tribunal informed the parties of its decision to appoint an independent expert to assist the Tribunal in evaluating the expert financial evidence. By letter of 14 September 2005, the ICSID Secretariat transmitted the report on the findings of the independent expert to the parties and invited them to comment on the report by 5 October 2005. The parties filed their observations with the Tribunal on that date.

#### **IV. FACTUAL BACKGROUND**

33. Before considering the merits of the dispute, the Tribunal deems it necessary to set forth the facts that it considered relevant for its decision.

##### **A. LATE 1980S AND 1990S**

34. The present claims are to be viewed against the historic background and

especially the economic upheaval in Argentina and the Government's reaction to the several economic crises suffered by the country in the late 1980s and 1990s.

35. In the late 1980s, Argentina underwent an economic crisis characterized by deep recession and hyperinflation. As part of its economic recovery plan, the Government began an ambitious privatization program with the enactment of the State Reform Law in August 1989. Within this framework, large Government-owned businesses and entities were privatized or granted on concession (Respondent's Counter-Memorial, ¶121).
36. One March 27, 1991, Argentina enacted Law No. 23,928, referred to as the *Convertibility Law*, which ordered the implementation of a fixed exchange rate, pegging the *austral* (the then-Argentine currency) to the United States dollar.<sup>2</sup> The Convertibility Law also banned price or value indexation.
37. One of the primary goals of the Government's plan was the privatization of *Gas del Estado S.E.*, the national natural-gas transport and distribution monopoly. Pursuant to the Government's privatization plan, investors could purchase shares in newly-formed, licensed private corporations that would offer gas transport and distribution services. Such shares were available to domestic and foreign investors.
38. To implement its plan, the Government enacted in June 1992, the *Ley del Gas* ("Gas Law"), which established a comprehensive regulatory structure for the provision of natural-gas transport and distribution services, and created a public agency, called *Ente Nacional Regulador del Gas* (ENARGAS) to oversee the industry.
39. The Gas Law adopted a tariff structure under which ENARGAS would collect tariffs on the price of gas paid by consumers. Under the provisions of

the Gas Law, ENARGAS was required to set the transport and distribution tariffs at fair and reasonable levels that would allow licensed utility providers to recoup a “reasonable rate of return,” after accounting for costs, defined as a rate similar to that applied to activities of similar risk and adequately related to the level of efficiency and satisfactory performance of the transport or distribution service. Profitability was to be measured against other activities of comparable risk.

40. ENARGAS was to set maximum tariffs for a period of five years. At the end of the five-year period, the tariffs were to be reviewed and adjusted based on international market indicators that reflected changes in the value of the goods and services representative of the activities of service providers.
41. The Gas Law was implemented by regulations adopted on 28 September 1992 by Decree No. 1738/92. Pursuant to these regulations, transport and distribution tariffs were to be calculated in U.S. dollars and then expressed in Argentine pesos, and the Government could not rescind or modify the licenses without the consent of the licensees.
42. On 7 December 1992, the Government adopted Decree No. 2255/92, called *Reglas Básicas de la Licencia* (Basic Rules of the License), which supplemented the Gas Law and the above-mentioned regulation and approved prototype licenses for natural-gas transport and distribution. The prototype licenses included a schedule of the maximum tariffs for the first five-year period (1993-1997) of service. The Basic Rules of the License obligated the Government to compensate the licensees fully for any losses resulting from changes to the guaranteed tariff system. The Basic Rules of the License also implemented the semi-annual tariff review based on the U.S. Producer Price Index (“PPI”), to be conducted in January and June of each year (“PPI adjustment”).

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<sup>2</sup> The *austral* later was replaced by the *peso* at the rate of 1,000 *australs* to 1 *peso*.



43. Under this framework comprised of the Gas Law, its regulations and Basic Rules of the License, the five-year review was to be a comprehensive review of the method used to calculate tariffs.
44. By Decree No. 1189/92, published on 17 July 1992, Argentina approved the procedure for the privatization of *Gas del Estado S.E.* It was restructured into two distinct transport business units and eight separate distribution business units, each responsible for a geographic region of the country. Each of the ten business units were transferred to the newly-created companies, which were to operate with a license under the legal framework in force.
45. An international bidding process was set in place by Resolution No. 874/92 issued by the Ministry of Public Works and Services and conducted pursuant to the *Pliego de Bases y Condiciones para la Licitación* (“Bidding Rules”). Under these Bidding Rules, both foreign and domestic investors were free to bid on the shares. The purpose of the Bidding Process was the purchase and sale of the majority interest in each of the licensed companies created by Decree No. 1189/92. Three of those majority interests were sold during that bidding process: 60% of Cuyana’s shares, 70% of GasBan’s shares, and 90% of Centro’s shares.
46. In December 1992, the Argentine Government awarded the contracts for the purchase of the majority of shares in the ten newly-formed licensees into which *Gas del Estado S.E.* had been restructured. The licenses relevant to this dispute were approved by Decrees Nos. 2454/92 for Centro, 2460/92 for GasBan and 2453/92 for Cuyana, and became effective on 22 December 1992.
47. The blocks of shares of Centro, GasBan and Cuyana that were subject to privatization were awarded to private investors: 90% of the shares of Centro were awarded to a consortium formed by *Società Italiana Per Il Gas S.p.A.* (“Italgas”), an Italian company, and *Sideco Americana S.A.*, an Argentine company (“Sideco”); 70% of the shares of GasBan were awarded to a

consortium formed by *Gas Natural SdG S.A.*, a Spanish company, *Compañía General de Combustibles S.A.* and *Manra S.A.*, both Argentine companies; and 60% of the shares of Cuyana were awarded to a consortium formed by Italgas and Sideco.

48. Three Argentine investment companies were created as vehicles for the acquisitions: (i) *Inversora de Gas del Centro S.A.* to acquire the privatized shares of Centro; (ii) *Invergas S.A.* to acquire the privatized shares of GasBan; and (iii) *Inversora de Gas Cuyana S.A.* to acquire the privatized shares of Cuyana. The successful bidders or their affiliates became shareholders of the respective investment companies, which then entered into Transfer Agreements with the Respondent concerning the shares subject to this arbitration.
49. The privatization scheme created by Respondent targeted foreign investors because foreign capital was deemed essential for the successful operation of the Government's economic recovery plan. Foreign investors were encouraged to purchase shares with guarantees, such as tariffs calculated in U.S. dollars, automatic and periodic adjustments to the tariffs based on the PPI, a clear legal framework that could not be unilaterally modified, and the granting of "licenses" instead of "concessions" with a view to offering the highest degree of protection to prospective investors.
50. As part of its marketing efforts, Argentina distributed an Information Memorandum in foreign markets, including the United States and Europe. The Information Memorandum summarized the legal framework governing the privatization, the terms and conditions for the bidding, the bidding process and the legal and the regulatory framework that would apply to the new industry after privatization. The information in the memorandum concerning the privatization, prepared and distributed by investment banks, contained descriptive information and included disclaimers to discourage investors from relying solely on the information therein.

51. During this period, Argentina undertook to provide enhanced legal protection to investors so as to attract foreign investment in support of its privatization scheme. The Respondent ratified several treaties relating to international investment obligations, such as the ICSID Convention and a great number of bilateral investment treaties, including the Argentina-U.S. Bilateral Investment Treaty at issue in this dispute. As mentioned above, the Convertibility Law, which pegged the peso to the U.S. dollar, was also enacted at this time.
52. In reliance on the legal guarantees offered by the Argentine Government for the privatized energy industry, and based on its positive prior experience investing in the privatized Argentine gas market in 1992, Claimants chose to purchase shares of three licensed companies in the gas-distribution market. In February 1997, LG&E purchased a 45.9% interest in Centro and a 14.4% interest in Cuyana. In March 1999, LG&E purchased a 19.6% interest in GasBan.
53. From 1993 until the end of 1999, Claimants agree that the gas-distribution licensees and Respondent abided by their respective obligations under the licenses and law governing the privatization scheme. According to Claimants, the licensees invested heavily in Argentina's natural-gas-distribution infrastructure. GasBan invested about US\$372 million in a new plant and equipment, even though originally required to invest US\$90.9 million; Centro invested US\$92 million, although originally required to invest US\$10 million; and Cuyana invested more than US\$120 million, although originally required to invest US\$10 million. In return, Argentina honored the provisions of the licenses and other legal obligations, including the semi-annual tariff adjustment under the PPI indicator, and calculation of the tariffs in U.S. dollars.

## **B. ECONOMIC CRISIS AND THE EMERGENCE OF THE DISPUTE – 1999-2001**

54. A new economic crisis developed in Argentina in the late 1990s. In the third

quarter of 1998, the Argentine economy plunged into a period of recession that was to last four years and triggered, in Respondent's opinion, the worst economic crisis since Argentina's inception in 1810 (Respondent's Counter-Memorial, ¶ 782).

55. In 1999, Argentina's Gross Domestic Product ("GDP") decreased causing a dramatic fall in domestic prices. Private consumption and investments began falling in August 1998 and Argentina entered a deflationary period. The period was marked by widespread decline in the value of assets located in Argentina. By the end of the 1990s, many economists considered the peso as overvalued, and predicted that the currency board would have to be abandoned, which would inevitably devalue the peso. Argentina's country risk premium increased, gradually excluding the country from the international credit market. These economic indicators were accompanied by social problems –unemployment, poverty and indigence levels began to increase. On 10 December 1999, Mr. Fernando de la Rúa took office as the President of Argentina. His administration tried to maintain the peg of the Argentine peso to the U.S. dollar as mandated by the Convertibility Law.
56. Against this background, public services rates, as specified in the contracts, were due to be adjusted in January 2000 based on the PPI. At the time, the United States was experiencing a high inflationary period, while Argentina was experiencing a significant deflationary period. As established in the Gas Law, the tariffs were to be adjusted to reflect changes in the cost structure of utility providers (Gas Law, Article 41). Argentina considered that the pending tariff adjustments based on the U.S. rate were unreasonable because they would result in a significant increase in utility rates within a recessionary and deflationary context.
57. Argentina met with the gas-distribution licensees to discuss a temporary suspension of the semi-annual tariff adjustments. Two agreements that the Government and the licensees entered in 2000 formed part of Claimants' original claim submitted to this arbitration.

58. On 6 January 2000, the Government and the licensees entered an agreement (*Acta Acuerdo*) whereby the licensees agreed to a one-time, six-month postponement of the tariff adjustment due in January 2000. Pursuant to the agreement, the tariffs would be recovered with interest from 1 July 2000 to 30 April 2001. Therefore, through resolutions published on 10 January 2000, ENARGAS approved the tariff effective as from 1 January 2000 without the PPI adjustment. The ENARGAS resolutions provided that the legal regime governing the tariffs would remain intact.
59. During the first six months of 2000, the situation in the Argentine economy continued to deteriorate. The semi-annual PPI adjustment would have forced a second tariff increase in a continued deflationary period. Although the licensees had agreed to only one-time tariff adjustment postponement, the Government urged the gas-distribution licensees to accept a second postponement of the tariff adjustments; including the previously postponed adjustments that were scheduled to be recovered beginning on 1 July 2000 in accordance with the *Acta Acuerdo* of 6 January 2000.
60. On 17 July 2000, by Decree No. 669/00, effective 4 August 2000, the licensees and the Government agreed to a second postponement of the tariff adjustments until 30 June 2002. Pursuant to the agreement, a stabilization fund would be created to recover the postponed amounts, subject to certain ceilings and floors, with interest. As with the previous agreement, this agreement reaffirmed the Government's commitments and guarantees provided to the licensees and their investors under the legal structure created for the privatization of the gas industry, specifically recognizing the enforcement of Argentina's bilateral investment treaties and the semi-annual PPI adjustments as an integral component of the tariff system.
61. On 3 August 2000, the Argentine National Ombudsman filed a lawsuit in an Argentine Federal Court, seeking an injunction against the operation of Decree No. 669/00. On 18 August 2000, the Court issued an order provisionally enjoining the application of Decree No. 669/00 and of the

agreement of 17 July 2000. On 5 October 2001, the Court of Appeal ratified the order and the case is presently pending before the Supreme Court (Respondent's Counter-Memorial, ¶ 255).

62. ENARGAS declared in November 2001 that no further adjustments to the tariffs would be approved until final judgment in the lawsuit. No further adjustments to the tariffs have occurred to date.

### **C. THE EMERGENCY LAW – 6 JANUARY 2002**

63. Argentina's crisis deepened at the end of 2001. The Government experienced increased difficulties in repaying its foreign debt. As poverty and unemployment soared, Argentines feared that the Government would default on its debt and immobilize bank deposits. Therefore, savings were massively withdrawn from the banks. In response, the Government issued Decree No. 1570/01, known as "*Corralito*," on 1 December 2001, restricting bank withdrawals and prohibiting any transfer of currency abroad. Amid widespread discontent and public demonstrations, including violence that claimed tens of lives, President De la Rúa and his Cabinet resigned on 20 December 2001. A succession of presidents took office and quickly resigned.
64. Finally, President Eduardo Duhalde took office and implemented a new economic plan, which contained measures that form the additional claim submitted by Claimants. On 6 January 2002, Congress enacted Law No. 25,561, the Public Emergency and Foreign Exchange System Reform Law (known as "the Emergency Law"). The Emergency Law abrogated the Convertibility Law so that the one-to-one peg of the Argentine peso to the United States dollar no longer existed. The Emergency Law provided for the switch into Argentine pesos of debts owed to the banking system, debts arising from management contracts governed by public law, and debts under private agreements. The law further provided for the renegotiation of private and public agreements to adapt them to the new exchange system.

65. The Emergency Law adopted measures modifying public-service contracts, such as establishing that tariffs and prices for public services were to be calculated in pesos, instead of U.S. dollars; abolishing all clauses calling for tariff adjustments in U.S. dollars or other foreign currencies; eliminating all indexing mechanisms; and directing the Executive Branch to renegotiate all public-service contracts.
66. By Presidential Decree No. 214 of 3 February 2002, the Government adopted a currency conversion scheme under which all obligations payable in dollars existing on the date of enactment of the Emergency Law would be converted into pesos at the fixed one-to-one exchange rate.
67. The switch into Argentine pesos, also called “pesification,” which affected the entire Argentine economy, was characterized by Respondent as a necessary process to return the country to the path of economic stability.

#### **D. RENEGOTIATION OF THE PUBLIC SERVICE CONTRACTS**

68. On 12 February 2002, Argentina announced the renegotiation of all public service contracts. By Decree No. 293/02, licenses for transport and distribution of natural gas were subject to mandatory renegotiation by a Renegotiation Committee within the Ministry of Economy. Under the Decree, the Government could either sign a renegotiated agreement or rescind the contract. By Resolution No. 38/02, issued on 9 March 2002, ENARGAS was ordered to discontinue all tariff reviews and to refrain from adjusting tariffs or prices in any way.
69. After enactment of the Emergency Law, the licensees and the Argentine Executive launched three initiatives to implement an emergency increase in the natural gas and electricity tariffs. Each of these initiatives was successfully challenged by consumer organizations and ombudspersons in the Argentine judiciary and consequently did not become effective. The Argentine Government attempted twice more in 2003 to obtain tariff

increases through Presidential Decrees but both these efforts were also quashed by the judiciary.

70. On 25 May 2003, a new Argentine President, Dr. Néstor Kirchner, took office after a popular election was held on 26 April 2003, replacing the transition authorities that had been appointed by the Argentine Congress. Respondent states that with the new administration, a period of institutional stabilization at the federal level began (Respondent's Counter-Memorial, 317).
71. By Presidential Decree No. 311/03, published on 4 July 2003, and Law No. 25,790, passed on 22 October 2003, the Argentine Government extended the renegotiation process. Centro, Cuyana and GasBan have been involved in the renegotiation process under threat of rescission of contract. During the renegotiation process, the Government has not offered to restore the legal guarantees that were eliminated by the Emergency Law, or compensate Claimants for any losses incurred.

#### **E. REQUEST FOR RELIEF**

72. Bearing in mind the background already described, Claimants request the following relief (Request for Arbitration, ¶ 111 as revised in Claimants' Memorial at ¶ 208):
  - (i) Declaring that the Respondent has breached its obligations under Article II(2)(c) of the Bilateral Treaty by failing to observe obligations that it entered into with regard to the Claimants' investment;
  - (ii) Declaring that the Respondent has breached its obligations under Article II(2)(a) of the Bilateral Treaty by failing to accord to the Claimants' investment fair and equitable treatment and by according treatment less than that required by international law;
  - (iii) Declaring that the Respondent has breached its obligations under Article II(2)(b) of the Bilateral Treaty by taking



arbitrary and discriminatory measures that impair the use and enjoyment of the Claimants' investment;

- (iv) Declaring that the Respondent has breached Article IV(1) of the Bilateral Treaty by indirectly expropriating the Claimants' investment without complying with the requirements of the Bilateral Treaty, including observance of due process of law and payment of prompt, adequate, and effective compensation;
- (v) Ordering the Respondent to pay the Claimants full compensation in the amounts set forth in the Memorial, plus pre- and post-award compound interest;
- (vi) Ordering the Respondent to pay all costs and expenses of this arbitration proceeding, including the fees and expenses of the Tribunal and the cost of the Claimants' legal representation, plus interest thereon in accordance with the Bilateral Treaty; and
- (vii) Such other or additional relief as may be appropriate under the Bilateral Treaty or may otherwise be just and proper.

73. According to Claimants' Reply (¶ 287), the relief they seek is stated as follows:

1. Finding the Argentine Republic to be in breach of its obligations under the Treaty;
2. Ordering the Argentine Republic to pay LG&E: (i) compensation in the amounts specified in Part VI of [the] Reply; (ii) all costs and fees of the arbitration, including reasonable attorneys' fees; and (iii) compound interest on the monetary award from the date of the award until the date of actual payment; and
3. Ordering such additional relief as may be appropriate under the applicable law or otherwise just and proper.

74. The monetary relief sought by Claimants is US\$ 248 million or, if the Tribunal concludes that there was expropriation, US\$ 268 million, plus compound pre-award and post-award interest and costs.

75. Respondent denies that it has violated the Treaty and seeks an order from

this Tribunal dismissing LG&E's claims and holding LG&E liable for costs. In asserting its defense, Respondent contends in the alternative that the circumstances warrant application of the state of necessity defense, thus exempting it from liability for any Treaty violations.

## V. PRELIMINARY MATTERS

76. In the analysis below, the Tribunal has not only considered the positions of the parties as summarized in the various sections above, but also their numerous detailed arguments in support of those positions as well as the arguments made at the hearing. To the extent that these arguments are not referred to expressly, they must be deemed to be subsumed in the analysis below.

### A. JUS STANDI

77. With respect to *jus standi*, the Tribunal re-affirms its conclusions adopted in the Decision on Objections to Jurisdiction of 30 April 2004. As determined in the Decision on Jurisdiction, the Centre has jurisdiction over LG&E's claims and this Tribunal is competent to decide on Claimants' claims.

78. Argentina continues to argue that this Tribunal shall only have jurisdiction if Argentina's non-compliance with an international obligation is verified (Respondent's Rejoinder, ¶ 521(a)). Pursuant to the Tribunal's Decision on Jurisdiction issued on 30 April, 2004, the Tribunal deems that all the obligations in discussion are international because they relate to the Treaty. Thus, LG&E's minority-shareholder status has no bearing on its standing to bring these claims or on the Tribunal's competence to rule upon them.

79. It should be pointed out that, as this Tribunal stated in the Decision on Jurisdiction, the subject matter of this arbitration focuses on the investments made by LG&E in the Argentine licensees. Accordingly, the Tribunal has insisted on the independent treatment of LG&E regarding the licensees, both from the point of view of the legal personality of each entity and from the

actions of each. This does not mean, however, that certain actions of the licensees, by the fact that they are the investment's beneficiaries, may have, in some cases, effects on the investment itself. For such reasons, on occasion, the Tribunal shall be bound to refer to the licensees and their actions without implying a reference to LG&E. One should bear in mind that the recognition of the independence among these entities was the basis on which the jurisdiction of the Centre and the competence of the Tribunal were supported.

## **B. LAW APPLICABLE**

### **1. Parties' Positions**

80. The Claimants argue that their claims asserted arise under the Treaty. The law that applies to the dispute is therefore the Treaty and general international law. Claimants contend that this approach comports with the first part of Article 42(1) of the ICSID Convention. In Claimants' view, Argentine law merely establishes a factual predicate for the claims under the Treaty and general international law (Claimants' Memorial, ¶¶ 155-56).
81. Respondent does not deny the application of the Bilateral Treaty to this dispute, but argues that in the absence of an agreement on the applicable law, the relationship between LG&E and the Argentine Government should be subject to the second part of Article 42(1) of the ICSD Convention, which establishes the precedence of sources of law; therefore, the Argentine law should be applied first. Respondent asserts that "where an investor makes an investment in a State it is subject –as are local investors– to the laws of the country where the investment is made" (Respondent's Counter-Memorial, ¶ 25). Argentina stresses the insufficiency of the Treaty to govern the dispute at issue, particularly in light of the substantive framework regarding the foreign investment's treatment under Argentine law.

## 2. Tribunal's Analysis

82. In accordance with Article 42(1) of the ICSID Convention:

“(1) The Tribunal shall decide a dispute in accordance with such rules of law as may be agreed by the parties. In the absence of such agreement, the Tribunal shall apply the law of the Contracting State party to the dispute (including its rules on the conflict of laws) and such rules of International Law as may be applicable.”

83. This rule grants the parties' autonomy in choosing the law applicable to the substance of the dispute in an arbitration administered by ICSID. If no applicable law is chosen, the Tribunal must resort to the second sentence of Article 42(1).

84. It is evident that the parties hereto had not agreed on the applicable law in this dispute. This is usually found in the investment agreement, though this does not hold in this case. Nor is there any express reference to the applicable law in other documents related to the investment by LG&E, a fact that would result in the application of the second part of Article 42(1).

85. It is to be noted that the Argentine Republic is a signatory party to the Bilateral Investment Treaty, which may be regarded as a tacit submission to its provisions in the event of a dispute related to foreign investments. In turn, LG&E grounds its claim on the provisions of the Treaty, thus presumably choosing the Treaty and the general international law as the applicable law for this dispute. Nevertheless, these elements do not suffice to say that there is an implicit agreement by the Parties as to the applicable law, a decision requiring more decisive actions. Consequently, the dispute shall be settled in accordance with the second part of Article 42(1).<sup>3</sup>

86. In addition to the indication of the applicable law, there are two other

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<sup>3</sup> Schreuer, Christoph, *The ICSID Convention: A Commentary*, Cambridge University Press, 2001, p. 573.

concepts embedded in the second part of Article 42(1) which deserve comment—the references to private international law and to the rules of international law “as may be applicable”.

87. As to the reference to the private international law, the Tribunal has not found in the ICSID records any case in which the Arbitral Tribunal has resorted to the rules of conflict of law of the State party to the dispute. It has been so observed in the *Amco v. Indonesia* case, in which the Arbitral Tribunal, presided by Berthold Goldman, affirmed that it did not deem it necessary to enter into a discussion on the rules of conflict, inasmuch as the parties make constant references to the law of the State party in the dispute and, moreover in “the dispute before the Tribunal relating to an investment in Indonesia, there is no doubt that the substantive municipal rules of law to be applied by the Tribunal are to drawn from Indonesian Law.”<sup>4</sup> The Tribunal in this case shares the same criterion.
88. With reference to the rules of international law and, particularly, to the language “as may be applicable,” found in Article 42(1) of the ICSID Convention, the Tribunal holds the view that it should not be understood as if it were in some way conditioning application of international law. Rather, it should be understood as making reference, within international law, to the competent rules to govern the dispute at issue.<sup>5</sup> This interpretation could find support in the ICSID Convention’s French version that refers to the rules of international law “*en la matière*.”<sup>6</sup>

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<sup>4</sup> *Amco Asia Corporation and others v. Republic of Indonesia*, Award of 20 November 1984, 1 ICSID Rep. 413 (1993).

<sup>5</sup> “It simply means that the relevant rules of international law are to be applied.” Schreuer, Cristoph, *The ICSID Convention...op.cit.*, p. 622.

<sup>6</sup> *Convention CIRDI, Art. 42*: “(1) (1) Le Tribunal statue sur le différend conformément aux règles de droit adoptées par les parties. Faute d'accord entre les parties, le Tribunal applique le droit de l'Etat contractant partie au différend—y compris les règles relatives aux conflits de lois—ainsi que les principes de droit international **en la matière**” (emphasis added). In: <http://www.worldbank.org/icsid/basicdoc-fra/partA-chap04.htm#s03>.

89. Likewise, applying the rules of international law is to be understood as comprising the general international law, including customary international law, to be used as an instrument for the interpretation of the Treaty. For example, where a term is ambiguous, or where further interpretation of a Treaty provision is required, the Tribunal will turn to its obligations under Articles 31 and 32 of the Vienna Convention on the Law of Treaties, signed in 1969.
90. Having made this part clear, the Tribunal proceeds to analyze the extension of the remission to the domestic law contained in the second part of Article 42(1), whereby the Tribunal shall apply “the law of the Contracting State Party to the dispute...” The Argentine doctrine contributes to gaining insight into the remission’s scope: “the situation is much clearer by virtue of the incorporation of the international law to the Argentine law and the hierarchical relation conferred by the 1994 constitutional reform to international treaties in Article 75, paragraph 22,<sup>7</sup> of the National Constitution.”<sup>8</sup>
91. The Tribunal notes that as part of the Argentine legal system, the Bilateral Treaty prevails over domestic law, “especially, inasmuch as in most of the Bilateral Treaty’s assumptions there is an express mention of international law, be it when referring to the treatment to be given to investments, or to the compensation in the event of expropriation or any other like measure, etc.”<sup>9</sup>
92. This interpretation has been accepted in Argentina “as long as the litigation is linked to the violation of the BIT [bilateral investment treaty] and of international law and not to the mere pretensions of infringement of a local

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<sup>7</sup> “... the treaties and concordats are hierarchically superior than laws ...”

<sup>8</sup> Tawil, Guido Santiago, *Los conflictos en materia de inversión, la jurisdicción del CIADI y el Derecho aplicable: a propósito de las recientes decisiones en los casos “Vivendi”, “Wena” y “Maffezini”*, in *RAP*, October 2002 Year XXV, N° 239, pp. 241 *et seq.*, especially pp. 256-257.

contract and as the parties should have not provided expressly the law applicable to the first of said disputes, the decision shall be governed by the ICSID Convention, by the BIT and applicable international law. Thus, the BIT becomes the *lex specialis* regarding disputes appearing in matters of investment between the foreign investor and the Host State.”<sup>10</sup>

93. It is this Tribunal’s opinion that obviating application of international law, specifically of the ICSID Convention and the Bilateral Treaty, would entail ignoring the fact that “international treaties move away from the principle according to which foreign investment is subject to the law and jurisdiction of the host state and seek international solution of conflicts.”<sup>11</sup> This thesis, held by part of the Argentine doctrine, indicates that when submitting the settlement of a dispute to an Arbitral Tribunal acting within the framework of an international agreement, like ICSID, the dispute falls under public international law; thus its rules are to be applied.<sup>12</sup> However, the problem is more complex as has been admitted by several scholars, who are of the opinion that it is necessary to “balance the weight that domestic law and international law should have upon the settlement of the dispute”<sup>13</sup>, this is, to establish an order of precedence of the sources.
94. International law overrides domestic law when there is a contradiction since a State cannot justify non-compliance of its international obligations by asserting the provisions of its domestic law.
95. If this contradiction does not exist, it is not an easy task to establish the relationship between international law and domestic law. In the original draft of the ICSID Convention, the conjunction “and” was not present in the rule,

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<sup>9</sup> *Idem*, p. 256. The author bases his opinion on the *Vivendi* case.

<sup>10</sup> *Ibidem*.

<sup>11</sup> See *Investment for foreigners in Argentina*: [www.enplenitud.com/](http://www.enplenitud.com/)

<sup>12</sup> Grigera Naón, Horacio, *Choice of Law Problems in International Commercial Arbitration*, J.C.B. Mohr (Paul Siebeck) Tübingen, Germany, 1992, p. 115.

<sup>13</sup> Vives Chillida, Julio, *El Centro Internacional de Arreglos de Diferencias Relativas a Inversiones*

but rather the conjunction “or” was in its place, so that it read, “The Arbitral Tribunal shall decide the dispute submitted to it in accordance with such rules of law, whether national or international as it shall determine to be applicable.”<sup>14</sup> The intention in the language of the original draft was not to establish an order of preference, but rather to establish the possibility of alternatives. Initially, scholarly authorities and some ICSID Tribunals admitted that the conjunction “and” meant that “and in case of lacunae, or should the law of the Contracting State be inconsistent with international law.”<sup>15</sup> However, any limitation to the role of international law under these terms would imply accepting that international law may be subordinate to domestic law and would obviate the fact that there are a growing number of arbitrations initiated on the basis of bilateral or multilateral investment treaties.

96. It is this Tribunal’s opinion that “and” means “and,” so that the rules of international law, especially those included in the ICSID Convention and in the Bilateral Treaty as well as those of domestic law are to be applied. In the *Wena Hotels Limited v. Arab Republic of Egypt* case, the Tribunal affirmed that “and means and”, but accepted the supremacy of international law.<sup>16</sup>
97. The Tribunal concludes, as the tribunal concluded in the *Asian Agricultural Products, Ltd, (AAPL) v. Democratic Socialist Republic of Sri Lanka*, Award of June 27, 1990, that the Treaty “is not a self-contained closed legal system limited to provide for substantive material rules of direct applicability, but it has to be envisaged within a wider juridical context in which rules from other sources are integrated through implied incorporation methods, or by

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(*CIADI*), Madrid, McGraw Hill, 1998, p. 195.

<sup>14</sup> Schreuer, Christoph, *The ICSID Convention... op. cit.*, p. 623.

<sup>15</sup> Gaillard, Emmanuel and Banifetami, Yas, *The Meaning of “and” in Article 42(1), second sentence, of the Washington Convention: The Role of International Law in the ICSID choice of the law process*, ICSID Review, Foreign Investment Law Journal, 2003, Vol. 12, No. 2, pp. 375 et seq., especially pp. 381-382. See also: Schreuer, Christoph, *op. cit.*, p. 263.

<sup>16</sup> *Wena Hotels Limited v. Arab Republic of Egypt*, ICSID Case N° ARB/98/4, Decision on Application



direct reference to certain supplementary rules, whether of international law character or of domestic law nature.”<sup>17</sup>

98. In short, one must also recall that between Argentina and LG&E there is no binding contractual agreement. The existence of such relationship would have allowed the parties to agree on stabilization clauses in the event of changes in certain circumstances. But, in the absence of such agreement, one is bound to resort to a legal system regulating those events. The fact that there is no contract between the Argentine Republic and LG&E favors in the first place, the application of international law, inasmuch as we are dealing with a genuine dispute in matters of investment which is especially subject to the provisions of the Bilateral Treaty complemented by the domestic law.

### **3. Tribunal’s Conclusion**

99. In order to settle this controversy, the present Tribunal shall apply first the Bilateral Treaty; second and in the absence of explicit provisions therein, general international law, and, third, the Argentine domestic law, particularly the Gas Law that governs the natural gas sector. The latter is applicable in view of its relevance for determining the Argentine Republic’s liability and the defenses to which it may resort vis-à-vis the allegations made by Claimants.

## **VI. LIABILITY**

### **A. ARTICLE II(2)(a): FAIR AND EQUITABLE TREATMENT**

#### **1. Parties’ Positions**

100. Based on the circumstances of this case as described in Section IV above,

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for Annulment, Feb. 5, 2002, 41 ILM 933 (2002).

<sup>17</sup> *Asian Agricultural Products Ltd. (AAPL) v. Democratic Socialist Republic of Sri Lanka*, ICSID Case No. ARB/87/3, Final Award, June 27, 1990, 6 ICSID Review 533 (1991).

LG&E claims that the Argentine Republic breached Article II(2)(a) of the Bilateral Treaty, which guarantees that LG&E's investment in Argentina will at all times be accorded fair and equitable treatment.

101. In Claimants' view, by committing itself to the Treaty, Argentina made promises to the United States as to how it would treat the investments of U.S. nationals in Argentina. In Article II, Argentina agreed to maintain an investment environment that is even-handed towards all investors, foreign and domestic alike, free of arbitrary and discriminatory laws and regulations, and ultimately fair and equitable, offering full protection and security to the investments of U.S. nationals.

102. Claimants explain that fair and equitable treatment in the context of this Treaty, requires a stable and predictable legal framework for the investment. Claimants support their interpretation of the standard on the basis of the Preamble of the Treaty, which sets forth the object and purpose of the Treaty and specifically the provision on fair and equitable treatment, as well as three recent opinions of arbitral tribunals considering the question in a similar context.<sup>18</sup> Claimants contend that, under this standard, a State cannot grant treatment that affects the basic expectations that were taken into account by the foreign investor to make the investment. Considering that the Treaty's objective was to promote foreign investment, Claimants argue that the stability and predictability of the legal framework that laid the foundations for their investment and granted protection to its value are particularly important.

103. With respect to Respondent's reliance on the *Genin* case, Claimants argue

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<sup>18</sup> *Técnicas Medioambientales Tecmed S.A. v. The United Mexican States*, ICSID Case No. ARB (AF)/00/02 Award ¶ 154 (29 May 2003); *MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Republic of Chile*, ICSID Case No. ARB/01/7 Award ¶ 113 (25 May 2004); *Occidental Exploration and Production Company v. The Republic of Ecuador*, LCIA Case No. UN 3467 Final Award (1 July 2004).

that as the *Genin*<sup>19</sup> case is merely a standard for evaluating the fairness and equity of State procedures, such a standard should be evaluated in light of more recent cases.

104. Claimants also contend that the extent to which the fair and equitable standard relates to the minimum standard of treatment under customary international law makes no difference in this case because that standard has evolved since the *Mondev*<sup>20</sup> case to include the reasonable expectations of the investor.
105. Under this articulation of the standard, Claimants state that Argentina treated LG&E's investment in an unfair and inequitable manner. *First*, Argentina repudiated the guarantees that it had offered to the foreign investors at the time it induced them to invest in Argentina. *Second*, Argentina singled out the gas-distribution industry and other public utility industries, for treatment that was less favorable than the treatment granted to all other sectors of the economy. *Third*, Argentina publicized unfounded charges against the foreign investors and coerced the gas-distribution companies to waive their rights under the licenses and renegotiate the licenses. *Fourth*, Argentina held the licensees responsible for strict compliance with the terms of the licenses while the Government froze the gas-distribution tariffs. *Finally*, Claimants allege that Argentina foreclosed the licensees from pursuing judicial or arbitral remedies (Claimants' Memorial, ¶ 171).
106. Argentina had attracted Claimants with the guarantees derived from the Treaty and the legal framework for privatization, under which its laws and regulations guaranteed how Argentina would treat LG&E's investment. In making their decision to invest in Argentina, Claimants relied on Argentine

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<sup>19</sup> *Alex Genin, Eastern Credit Limited, Inc. and A.S. Baltoil v. The Republic of Estonia*, ICSID Case No. ARB/99/2 Award, ¶ 367 (25 June 2001).

<sup>20</sup> *Mondev International Ltd. v. United States of America*, ICSID Case No. ARB(AF)99/2, Award, ¶ 116 (October 11, 2002).

laws that granted protection against currency fluctuation and inflation, while providing for adjustment of utility rates, thus ensuring reasonable rates of return and that the Argentine Government would not freeze utility rates, but rather maintain a dynamic tariff system, regulated by an expert agency.

107. Claimants did not expect their investment to be free of risk, or that Article II of the Bilateral Treaty should protect them from all risks associated with their investment. But they insist that the gas regulatory framework that Argentina put in place made their investment free from risk of regulatory alterations or changes in the rules in which they had invested. LG&E understood that it would bear what it calls “commercial risks,” such as industry demand, recession and substitution of natural gas by alternative fuels (Hearing on the Merits, Perkins, 24 January, 2005, Spanish Transcript, p. 369; Claimants’ Post-Hearing Brief, ¶ 8).
108. Claimants allege that, during the economic crisis, Argentina abandoned the guarantees that it made to investors in the gas-distribution sector. In January 2002, the Emergency Law swept away the protection against inflation. Argentina forced licensees to enter into two agreements postponing the PPI adjustments, after which an Argentine court issued an order that ENARGAS interpreted as an injunction against the PPI adjustment. The Emergency Law permanently abolished the PPI adjustment.
109. The Emergency Law also abandoned the protection against currency fluctuations. The Gas Law had guaranteed that the tariffs would be calculated in dollars and converted into pesos. In reliance on this protection against any sharp devaluation of the peso, Claimants decided to invest in the licensees.
110. In light of these prior measures, Claimants argue that Argentina repudiated its guarantee that generally prohibited the freezing or control of tariffs (Claimants’ Post-Hearing Brief, ¶¶ 15-31).
111. While Claimants acknowledge that the material used by Respondent in order

to make the offer was not binding, the laws and promises referenced therein were (Claimants' Post-Hearing Brief, ¶ 9). Claimants add that if establishing the tariffs had been left to the State, investors would have never invested.

112. Respondent objects to the definition given to fair and equitable treatment. In Respondent's view, the standard should be defined by impartial and objective rather than personal and arbitrary criteria. They conclude that Claimants' interpretation of the standard is so vague as to ignore the parties' obligations and rights (Respondent's Counter-Memorial, ¶ 603-604).
113. Citing *Alex Genin, Eastern Credit Limited, Inc. and A.S. Baltoil v. The Republic of Estonia*<sup>21</sup> and *Robert Azinian, Kenning Davitian & Ellen Baca v. The United Mexican States*<sup>22</sup>, Respondent concludes that the fair and equitable treatment principle refers to the international minimum standard of treatment owed to an investor, and as such, constitutes a minimum pattern for substantive justice (Respondent's Counter-Memorial, ¶ 620). Respondent also contends, citing *S.D. Myers Inc. v. The Government of Canada*<sup>23</sup> that a violation of the fair and equitable standard "occurs only when it is shown that an investor has been treated in such an unjust or arbitrary manner that the treatment rises to the level that is unacceptable from the international perspective" (Respondent's Counter-Memorial, ¶¶ 621-622).
114. Regarding the list of guarantees cited by Claimants, Respondent contends that the Gas Law does not provide for what Claimants call "exchange protection" (Respondent's Post-Hearing Brief, ¶ 74a). Respondent points out that, in fact, when Claimants' witnesses were examined, they were not able to identify where any such "protection" had been established. Respondent also asserts that the tariff calculation in U.S. dollars was linked to the

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<sup>21</sup> See *Genin*, footnote No. 19 *supra*.

<sup>22</sup> *Robert Azinian and others v. United Mexican States*, ICSID Case No. ARB(AF)/97/2, Award, ¶¶ 83 and 87, (1 November 1999).

<sup>23</sup> *S.D. Myers, Inc. v. Government of Canada*, NAFTA Arbitration under UNCITRAL Rules, Partial

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existing fixed rate of exchange between the peso and the U.S. dollar as established by the Convertibility Law. None of Claimants' witnesses was able to prove the opposite. Respondent adds that maintaining tariffs linked to the U.S. dollar after the convertibility system was abandoned lacks any economic logic. Respondent points out that none of the Government's guarantees address the abandonment of convertibility.

115. With respect to the tariff guarantee, Respondent argues that it is possible that the Argentine authorities had considered guaranteeing the calculation of the tariffs in U.S. dollars regardless of the Convertibility Law, but such plan was rejected due to the fact that the Government concluded that the Convertibility Law provided sufficient protection to the investment (Respondent's Post-Hearing Brief, ¶ 26).
116. With respect to the PPI adjustments, Respondent argues that from mid-1998, application of the PPI as the rate adjustment index became unreasonable and failed to fulfill the goal it was conceived for – namely, reflecting the changes in the value of the goods and services involved in the activity of service providers (Respondent's Post-Hearing Brief, ¶ 44). Additionally, Respondent states that the measure did not cause loss to the licensees. Citing the opinions of Schwartz and Lapuerta, Respondent contends that suspension of the PPI adjustment would have affected tariffs only by approximately 2% between August 2000 and October 2002 (Respondent's Post-Hearing Brief, ¶ 46).
117. Respondent agrees that the tariffs must be fair and sufficient, yet not abusive, something that would occur if the Claimants' position were sustained (Respondent's Post-Hearing Brief, ¶ 74c).
118. Regarding the claim that the Claimants were "induced" to invest in the Argentine Republic, Respondent argues that there is no proof of such

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Award, ¶ 263, (13 November 2000).

inducement (Respondent’s Counter-Memorial, ¶ 647). Respondent points out that the Claimants rely on non-binding documents, such as reports and minutes without any legal relevance. According to Respondent, these documents were irrelevant to the laws that should have been considered in deciding whether or not to invest in the Argentine gas-distribution market (Respondent’s Post-Hearing Brief, ¶ 17).

**2. Tribunal’s Conclusion Concerning Argentina’s Guarantees to Investors**

119. The Tribunal concludes that the Gas Law and its implementing regulations made four guarantees to investors in the gas transport and distribution centers:

1. Article 41.1 of Decree No. 1738/92,<sup>24</sup> and Section 9.2 of the Basic Rules of the License<sup>25</sup> mandated that the tariffs would be calculated in U.S. dollars before conversion into pesos.
2. Section 9.4.1.1 of the Basic Rules of the License guaranteed that the tariffs would be subject to semi-annual adjustments according to the PPI.<sup>26</sup>
3. Article 38 of Law No. 24,076 provided that tariffs were to provide an income sufficient to cover all costs and a reasonable rate of return.<sup>27</sup>

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<sup>24</sup> Article 41.1 provides: “Transportation and Distribution rates shall be calculated in United States dollars. The resulting Rate Schedule shall be stated in Argentine pesos and shall be convertible as stated in Law No. 23,928, using for the retranslation into Argentine pesos the parity set forth in Article 3 of Argentine Presidential Decree No. 2,128/91.”

<sup>25</sup> Section 9.2 provides: “The tariff has been calculated in U.S. dollars. The adjustments referred to in point 9.3 will be calculated in U.S. dollars.”

<sup>26</sup> Section 9.4.1.1 provides: “Distribution tariffs will be adjusted semiannually according to the variation operated in the PPI.”

<sup>27</sup> Article 38 provides: “The services rendered by distributors will be offered at tariffs in line with the following principles:

a) To provide distributors who operate economically and prudently the opportunity to obtain sufficient income to meet all reasonable operating costs applicable to the service, taxes, amortization, and a

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4. Section 9.8 of the Basic Rules of the License guaranteed that the tariff system would not be subject to freezing or price controls without compensation.<sup>28</sup>
120. The Tribunal also finds that as a matter of fact, the Emergency Law, passed on 6 January 2002, declared that the tariffs would no longer be calculated in U.S. dollars but directly in pesos (Article 8), and that there would be no further semi-annual tariff adjustments according to the PPI (Article 8). The Tribunal notes that since July 1999, there have not been any PPI adjustments in the tariffs relating to the licensees and the five-year review due in 2002 was not conducted – both affecting the level of the tariffs in the gas-distribution sector and, as a consequence, Claimants’ rate of return on their investment. Argentina took these steps without compensating Claimants and forcing Claimants to renegotiate (a process in which an Argentine official recommended that investors waive their claims against the Government relating to the licenses) or face rescission of the licenses. (Decree No. 293/02, Article 2 and Claimants’ Memorial ¶¶ 120 *et seq*).

### **3. Tribunal’s Analysis**

121. The question before the Tribunal is whether the measures implemented by Argentina violated Argentina’s obligation under Article II(2)(a) of the Treaty to give fair and equitable treatment to LG&E’s investment.
122. The Treaty does not define what is meant by fair and equitable treatment. In these circumstances, the Tribunal must interpret this provision in good faith, in accordance with the ordinary meaning to be given to the terms in their context, and in light of its object and purpose, as required by Article 31(1) of

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reasonable rate of return, as determined in the following article.”

<sup>28</sup> Section 9.8 provides: “Licensee’s tariff system will not be subject to freezing, administration and/or price control. If, in spite of this stipulation, Licensee is forced to adapt to a price control system establishing a lower level than that arising from the Tariff, Licensee will have the right to be compensated by the Government in an equivalent amount.”



the Vienna Convention.

123. The Treaty, following the general trend with investment treaties, provides for treatment applicable to investors in the host State through the establishment of a series of internationally recognized standards.<sup>29</sup> Due to the fact that such international standards have a generic nature and that their interpretation varies with the course of time and with the circumstances of each case, it becomes difficult to establish an unequivocal and static concept of these notions.
124. In considering the context within which Argentina and the United States included the fair and equitable treatment standard, and its object and purpose, the Tribunal observes in the Preamble of the Treaty that the two countries agreed that “fair and equitable treatment of investment is desirable in order to maintain a stable framework for investment and maximum effective use of economic resources.” In entering the Bilateral Treaty as a whole, the parties desired to “promote greater economic cooperation” and “stimulate the flow of private capital and the economic development of the parties”. In light of these stated objectives, this Tribunal must conclude that stability of the legal and business framework is an essential element of fair and equitable treatment in this case, provided that they do not pose any danger for the existence of the host State itself.
125. Several tribunals in recent years have interpreted the fair and equitable treatment standard in various investment treaties in light of the same or

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<sup>29</sup> The notion of a standard appeared for the first time in a 1948 treaty, the Havana Charter for an International Trade Organization, and it was considered a protection against state actions violating internationally-accepted rules. In the 1960s it was related to the protection given to foreign properties. In international case law, the standard existed pursuant to the interpretation provided in the 1920s in the emblematic *Neer* case, which required that State conduct be deemed outrageous, wrongful, open injustice, an atrocity, bad faith or voluntary negligence of duty for a violation to be found. That interpretation is not the same that is given today. What was considered an “atrocity” in 1926 might not be so today, and what may be considered “violent” now, may not have been at that time. See “*Fair and Equitable Treatment Standard in International Investment Law*”, OECD, Working Paper on

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similar language as the Preamble of the Argentina – U.S. BIT.<sup>30</sup> These tribunals have repeatedly concluded based on the specific language concerning fair and equitable treatment, and in the context of the stated objectives of the various treaties, that the stability of the legal and business framework in the State party is an essential element in the standard of what is fair and equitable treatment.<sup>31</sup> As such, the Tribunal considers this interpretation to be an emerging standard of fair and equitable treatment in international law.

126. Although the Chile - Malaysia BIT does not include express reference in its Preamble with respect to fair and equitable treatment, the tribunal in *MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Republic of Chile* referred to the objectives of the Treaty set forth in the Preamble, and concluded that in light of these objectives, fair and equitable treatment meant treatment in an “even-handed and just manner, conducive to fostering the promotion of foreign investment.”<sup>32</sup>
127. In addition to the State’s obligation to provide a stable legal and business environment, the fair and equitable treatment analysis involves consideration of the investor’s expectations when making its investment in reliance on the protections to be granted by the host State. Indeed, this view is reflected in the *Tecmed* decision, that has been adopted by a succession of tribunals:

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International Investment, November 2003/4.

<sup>30</sup> See, e.g., *CMS Gas Transmission Company v. The Argentine Republic*, ICSID Case No. ARB/01/8 Award (12 May 2005) (Argentina-U.S. BIT); *Occidental Exploration and Production Company v. The Republic of Ecuador*, LCIA Case No. UN 3467 Final Award (1 July 2004) (U.S.-Ecuador BIT – almost identical language); *MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Republic of Chile*, ICSID Case No. ARB/01/7 Award ¶ 113 (25 May 2004) (Malaysia-Chile BIT); *Metalclad Corporation v. United Mexican States*, ICSID Case No. ARB(AF)/97/1 Award ¶ 75 (30 August 2000). (An underlying objective of Article 102(1) of NAFTA is “to promote and increase cross-border investment opportunities and ensure the successful implementation of investment initiatives”).

<sup>31</sup> *CMS*, ¶ 274; *Occidental*, ¶183. See also *Metalclad*, ¶ 99 (“Mexico failed to ensure a transparent and predictable framework for Metalclad’s business planning and investment”).

<sup>32</sup> *MTD*, ¶ 113.

“The Arbitral Tribunal considers that this provision of the [BIT], in light of the good faith principle established by international law, requires the Contracting Parties to provide to international investments treatment that does not affect the basic expectations that were taken into account by the foreign investor to make the investment. The foreign investor expects the host State to act in a consistent manner, free from ambiguity and totally transparently in its relations with the foreign investor, so that it may know beforehand any and all rules and regulations that will govern its investments, as well as the goals of the relevant policies and administrative practices or directives, to be able to plan its investment and comply with such regulations.”<sup>33</sup>”

128. Similarly, the tribunal in *Waste Management, Inc. v. The United Mexican States*, interpreting the fair and equitable treatment standard under NAFTA Article 1105(1) concluded that in applying the fair and equitable treatment standard, “it is relevant that the treatment is in breach of representations made by the host State which were reasonably relied on by the claimant.”<sup>34</sup> This means that violations of the fair and equitable treatment standard may arise from a State’s failure to act with transparency –that is, all relevant legal requirements for the purpose of initiating, completing and successfully operating investments made, or intended to be made under an investment treaty should be capable of being readily known to all affected investors.<sup>35</sup>
129. The Tribunal is not convinced that bad faith or something comparable would ever be necessary to find a violation of fair and equitable treatment. The tribunal in *Alex Genin, Eastern Credit Limited, Inc. and A.S. Baltoil v. The Republic of Estonia*,<sup>36</sup> did not reach this conclusion either. The tribunal merely stated: “Acts that would violate this minimum standard would

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<sup>33</sup> *Técnicas Medioambientales Tecmed S.A. v. The United Mexican States*, ICSID Case No. ARB(AF)/00/02, Award ¶ 154 (29 May 2003); cited in e.g., *MTD*, ¶ 114; *Occidental*, ¶ 185; *CMS*, ¶ 279.

<sup>34</sup> *Waste Management, Inc. v. The United Mexican States*, ICSID Case No. ARB(AF)/00/3, Award ¶ 98 (30 April 2004).

<sup>35</sup> See e.g., *Tecmed*, ¶ 154; *CMS*, ¶¶ 278-79 and *Occidental*, ¶ 185 (citing the *Tecmed* and *Metalclad* passages referring to transparency).

*include* acts showing a willful neglect of duty . . . or even subjective bad faith” (emphasis added).<sup>37</sup> The tribunal concluded that bad faith was not a requirement for a finding of a violation of fair and equitable treatment.<sup>38</sup>

130. It can be said that the investor’s fair expectations have the following characteristics: they are based on the conditions offered by the host State at the time of the investment; they may not be established unilaterally by one of the parties; they must exist and be enforceable by law; in the event of infringement by the host State, a duty to compensate the investor for damages arises except for those caused in the event of state of necessity; however, the investor’s fair expectations cannot fail to consider parameters such as business risk or industry’s regular patterns.
131. Thus, this Tribunal, having considered, as previously stated, the sources of international law, understands that the fair and equitable standard consists of the host State’s consistent and transparent behavior, free of ambiguity that involves the obligation to grant and maintain a stable and predictable legal framework necessary to fulfill the justified expectations of the foreign investor.

#### **4. Tribunal’s Conclusion**

132. In light of the foregoing, the Tribunal concludes that Argentina violated the fair and equitable treatment provision in the Bilateral Treaty for the following reasons.
133. Emerging from the economic crisis of the late 1980s, Argentina created an

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<sup>36</sup> *Genin*, ¶ 367.

<sup>37</sup> *Ibidem*.

<sup>38</sup> See, e.g., *Mondev*, ¶ 116 October 11, 2002 (“To the modern eye, what is unfair or inequitable need not equate with the outrageous or the egregious. In particular, a State may treat foreign investment unfairly and inequitably without necessarily acting in bad faith.”); see also *Occidental*, ¶ 63 (“this is an objective requirement that does not depend on whether the Respondent has proceeded in good faith or not.”); see also *Tecmed*, ¶ 153 (relying on *Mondev*); *Waste Management*, ¶ 93 (rejecting the standard set forth in the *Neer* case involving willful neglect of duty and bad faith).

economic recovery plan mainly dependent upon foreign capital. Argentina prepared with the investment banks an attractive framework of laws and regulations that addressed the specific concerns of foreign investors with respect to the country risks involved in Argentina. In light of these risks, Claimants relied upon certain key guarantees in the Gas Law and implementing regulations, such as calculation of the tariffs in U.S. dollars before their conversion into pesos, the semi-annual PPI adjustments, tariffs set to provide sufficient revenues to cover all the costs and a reasonable rate of return, and compensation in the event that the Government altered the tariff scheme. Having created specific expectations among investors, Argentina was bound by its obligations concerning the investment guarantees vis-à-vis public utility licensees, and in particular, the gas-distribution licensees. The abrogation of these specific guarantees violates the stability and predictability underlying the standard of fair and equitable treatment.

134. Specifically, it was unfair and inequitable to pass a law discarding the guarantee in Decree No. 1738/92 that the tariffs would be calculated in U.S. dollars and then converted into pesos. As pointed out by Claimants, this was not merely an economic and monetary policy of the Argentine Government which materialized through the Convertibility Law. Rather, it was a guarantee laid down in the tariff system. This guarantee was very important to investors to protect their investment, which was made in dollars, from a subsequent devaluation of the peso.
135. Argentina also acted unfairly and inequitably in the manner in which it abrogated the guarantees of the Gas Law and its implementing regulations, adversely affecting the gas-distribution sector but not affecting other sectors of the economy. For example, certain contracts, such as those in the export industry, were excluded from the forced conversion to pesos regulation, or the conversion was performed at a more favorable rate to the individual or company.

136. Argentina acted unfairly and inequitably when it prematurely abandoned the PPI tariff adjustments and essentially froze tariffs prior to the onset of the public disorder and threats to its essential security in December 2001, and when it refused to resume adjustments when conditions had normalized in April 2003, forcing instead the licensees to renegotiate.<sup>39</sup> History has shown that the PPI adjustments that initially were supposed to be postponed have been abandoned completely and are now being “negotiated” away.
137. Argentina also has acted unfairly and inequitably in forcing the licensees to renegotiate public service contracts, and waive the right to pursue claims against the Government, or risk rescission of the contracts. Even though the Gas Law provided for the renegotiation of public service contracts, in practice there was no real renegotiation, but rather the imposition of a process.
138. Likewise, the Government’s Resolution No. 38/02 issued on 9 March 2002, which ordered ENARGAS to discontinue all tariff reviews and to refrain from adjusting tariffs or prices in any way, also breaches the fair and equitable treatment standard.
139. The Tribunal nevertheless recognizes the economic hardships that occurred during this period, and certain political and social realities that at the time may have influenced the Government’s response to the growing economic difficulties. Certainly, LG&E was aware of the risks inherent in investing in a foreign State. But here, the Tribunal is of the opinion that Argentina went too far by completely dismantling the very legal framework constructed to attract investors.

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<sup>39</sup> As described more fully below, Argentina is excused from liability for the measures taken during the extreme circumstances of December 2001 until April 2003 in order to maintain public order and protect its essential interests. It was fair that during this period of time, Argentina suspended the guarantees of the Gas Law and postponed the PPI tariff adjustments until such time as the Government could manage to resume its obligations.

## **B. ARTICLE II(2)(b): DISCRIMINATORY AND ARBITRARY TREATMENT**

### **1. Discriminatory Treatment**

#### **(i) Parties' Positions**

140. Claimants contend that the Argentine Government adopted measures that discriminated against the downstream gas sector (transport and distribution) compared to upstream businesses (production), large industrial customers, and other sectors not dominated by foreign investors, such as alternative energy and the public. In their view, such discrimination violates Article II(2)(b) of the Bilateral Treaty, which provides that “[n]either Party shall in any way impair by arbitrary or discriminatory measures the management, operation, maintenance, use, enjoyment, acquisition, expansion, or disposal of investments.”
141. Claimants state that, from the time of the first PPI adjustment until the enactment of the Emergency Law of 6 January 2002, the gas industry received treatment different from that accorded to similarly situated public utilities, including electricity and water distribution companies. These other public utilities continued to enjoy the PPI adjustment until the enactment of the Emergency Law.
142. Claimants also support their contention by pointing out that, following enactment of the Emergency Law on 6 January 2002, the Government subjected most of the privatized public-utility sector, including the gas-distribution industry, to the least favorable of several regimes devised for the conversion of dollar obligation into pesos. Within the public-utility sector, Claimants also allege that the Government discriminated against the gas-distribution industry by excluding other public-service companies from the conversion of tariffs into pesos. The Government imposed upon the privatized gas-distribution companies what was considered the worst exchange and tariff system during the Argentine crisis.

143. Claimants stress that if one compares the measures that affected sectors such as gas production, alternative energy sources or even those of the public sector, with those affecting gas transportation or distribution, the Tribunal can only conclude that the Argentine Government discriminated against the gas distribution and transportation sectors. The alleged discrimination is particularly obvious in Claimants' view by the fact that most of the investors in the gas-distribution sector are foreigners.
144. Respondent argues that the measures it adopted were not discriminatory because they were general measures without any unreasonable distinction. Respondent questions whether Argentina's measures can be considered discriminatory, if one acknowledges, as Claimants have, that other industries related to public services were affected by the measures adopted regarding the PPI (Respondent's Counter-Memorial, ¶ 700).
145. Respondent explains that each public service is regulated by its own set of tariff rules, and for that reason, the effect may not have been exactly the same for all sectors, including the field of public services. Respondent alleges that "[i]t is irrational and illegitimate to compare one utility to a different one, subject to different rules, different agreements and different characteristics, and then hold that it is discriminatory to treat differently the different utilities at stake" (Respondent's Counter-Memorial, ¶ 703, emphasis omitted).

**(ii) Tribunal's Analysis**

146. In the context of investment treaties, and the obligation thereunder not to discriminate against foreign investors, a measure is considered discriminatory if the intent of the measure is to discriminate or if the measure has a discriminatory effect.<sup>40</sup> As stated in the *ELSI Elettronica*

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<sup>40</sup> See Vandevelde, Kenneth J., *United States Investment Treaties: Policy and Practice*, Kluwer Law



*Sicula SpA case (United States of America v. Italy)*, ICJ Report 1989 RLA 56 at 61-62 (20 July 1989), in order to establish when a measure is discriminatory, there must be (i) an intentional treatment (ii) in favor of a national (iii) against a foreign investor, and (iv) that is not taken under similar circumstances against another national.

**(iii) Tribunal's Conclusion**

147. While the Tribunal concludes that based on the evidence presented, Respondent treated the gas-distribution companies in a discriminatory manner, imposing stricter measures on the gas-distribution companies than other public-utility sectors, Claimants have however not proven that these measures targeted Claimants' investments specifically as foreign investments.
  
148. Certainly, all the gas-distribution companies were affected by the economic crisis and by the Government's measures like all other companies within the public-utility sector. However, Argentina suspended PPI adjustments for the gas industry two years before enacting the Emergency Law. It did not take the same action with respect to the public-utility companies such as the electricity and water distribution companies, in which case it continued to adjust their tariffs until enactment of the Emergency Law. Instead, the gas-distribution companies were subjected to unfavorable regimes devised for the conversion of dollar obligations and tariffs into pesos. Even though it was not proved that these measures had been adopted with the purpose of causing Claimants' foreign investments damage, discrimination against gas distribution companies vis-à-vis other companies, such as water supply and electricity companies, is evident.

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and Taxation, 1992, p. 77.

## 2. Arbitrary Treatment

### (i) Parties' Positions

149. Claimants characterize Argentine Government's course of conduct towards the gas-distribution licensees as arbitrary in violation of Article II(2)(b) of the Bilateral Treaty. Claimants articulate the standard for what constitutes an "arbitrary" act as "disregard for the rule of law" (Claimants' Memorial, ¶ 176).
150. Claimants argue that, in taking measures against the gas-distribution licensees and other public utilities, the Argentine Government acted in disregard for the rule of law. According to Claimants, the Government acted under the trappings of laws, decrees, resolution, regulations and court decisions, but by willfully repudiating the commitments it made to the gas-distribution licensees and their shareholders, the Government followed "the rule of power, not the rule of law" (Claimants' Post-Hearing Brief, ¶ 44). In Claimants' view, the Government's wholesale repudiation of the tariff system was unnecessary to achieve the stated aims of the PPI suspension or those of the Emergency Law, since the the tariff system was sufficiently flexible to allow Respondent to reduce tariffs unilaterally, for any reason, as long as it paid compensation to the licensees. Instead, the Government chose to dismantle the whole tariff system without granting due compensation (Claimants' Memorial, ¶ 176).
151. Claimants argue that when Respondent's Bilateral Treaty obligations and the promises made to the foreign investors became politically and economically inconvenient, Respondent ignored its obligations and repudiated the Gas Law's key provisions. These measures, they assert, not only surprise but also contradict any sense of Respondent's ownership of its legal obligations, and accordingly they are arbitrary in nature. Claimants refute as without evidence any assertion by Respondent that if the guarantees had not been abolished, tariffs would have tripled or quadrupled in price (Claimants' Post-

Hearing Brief, ¶ 44).

152. In its defense, Respondent contends that the measures were not arbitrary; on the contrary, they were reasonable and proportionate to the end pursued. In Argentina's view, the tariff system was not dismantled. Rather, it was modified by the measures that the Government was forced to put in place during the economic crisis. Respondent suggests that under the circumstances, the deferment of the PPI adjustment in the year 2000 was a reasonable measure. This position, as Respondent views it, is supported by both a decision of a court of first instance and by the Federal Court of Appeal (Cámara Federal de Apelaciones), which concluded that the adjustment at issue was unreasonable within the recessive economic context endured by the Argentine Republic. The stability that Claimants argue should characterize the legal system does not mean that the system will exist in perpetuity, immutability or immobility. Any requirement of "freezing the law" without considering the social and economic circumstances under which the laws were enacted, is transforming the Argentine legal system into a "frivolous rite" (Respondent's Counter-Memorial, ¶¶ 638-639).
153. Respondent contends that linking the tariff adjustments to the peso (pesificación) is not arbitrary or discriminatory. Had there been no link to the peso, many customers could not have had access to the gas service, which would have resulted in the collapse of the distribution industries themselves, and tariffs would have been no longer fair but abusive.
154. In Respondent's view, none of the measures adopted by the Argentine Government may be qualified as arbitrary or discriminatory. On the contrary, they were proportionate and reasonable under the circumstances and accordingly, not a violation of Article II(2)(b) of the Bilateral Treaty (Respondent's Post-Hearing Brief, ¶ 112).

**(ii) Tribunal's Analysis**

155. Article II(2)(b) of the Bilateral Treaty provides that "[n]either Party shall in

any way impair by arbitrary or discriminatory measures the management, operation, maintenance, use, enjoyment, acquisition, expansion, or disposal of investments.”

156. The term “arbitrary” is left undefined by the Bilateral Treaty. Thus, the Tribunal looks to its plain meaning for international law to determine whether the measures adopted by Argentina could be classified as arbitrary.
157. According to international law, arbitrariness has been described as “a willful disregard of due process of law, an act which shocks, or at least surprises, a sense of juridical propriety.”<sup>41</sup> The tribunal in *Ronald S. Lauder v. The Czech Republic*, referring to the Black’s Law Dictionary, defined the term as “depending on individual discretion; (...) founded on prejudice or preference rather than on reason or fact.”<sup>42</sup>
158. It is apparent from the Bilateral Treaty that Argentina and the United States wanted to prohibit themselves from implementing measures that affect the investments of nationals of the other Party without engaging in a rational decision-making process. Such process would include a consideration of the effect of a measure on foreign investments and a balance of the interests of the State with any burden imposed on such investments. Certainly a State that fails to base its actions on reasoned judgment, and uses abusive arguments instead, would not “stimulate the flow of private capital.”<sup>43</sup>
159. The *Genin* case quoted by Respondent provides a good example of a State measure upholding a guarantee similar to the prohibition in the Estonia – U.S. BIT against arbitrary treatment. There, the tribunal concluded that the Bank of Estonia’s annulment of a license occurred in the course of

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<sup>41</sup> *Elettronica Sicula S.p.A. (ELSI) (United States of America v. Italy)*, 1989 I.C.J. 15, 76 (Judgment of 20 July).

<sup>42</sup> *Ronald S. Lauder v. The Czech Republic*, Final Award ¶ 221 (3 September 2001) (citing Black’s Law Dictionary 100 (7<sup>th</sup> ed. 1999)).

<sup>43</sup> Preamble, Argentina – U.S. BIT (1994).

exercising its statutory obligations to regulate the Estonian banking sector, and therefore was not arbitrary.<sup>44</sup> In so concluding, the tribunal accepted Estonia's explanation that the circumstances of political and economic transition prevailing in Estonia at the time justified heightened scrutiny of the banking sector, and that such regulation by a State reflects "a clear and legitimate public purpose."<sup>45</sup>

160. In contrast, the *Lauder* tribunal determined that the acts of the Czech Republic's Media Council were arbitrary. Such acts consisted in forcing a private investor in the newly-privatized company that held the state television license to exchange a direct participation in the company for a contractual relationship.<sup>46</sup> The tribunal reasoned that the act was motivated by fear of the political implications of having a foreigner influencing Czech television broadcasts.<sup>47</sup>

**(iii) Tribunal's Conclusion**

161. This case lands between the two cases mentioned above, but ultimately the Tribunal concludes that the acts of Argentina were not arbitrary, and therefore did not violate Article II(2)(b) for the following reasons.
162. While Claimants have alleged Argentina's political motivation to use foreign investors in the public utility sector as an excuse to justify the economic mistakes committed in the country, Argentina has explained that the Government's motivation was its desire to avoid its full economic collapse. To this end, it entered into agreements with the licensees in 2001, in addition to other actions taken. Bearing in mind the Tribunal's analysis, characterizing the measures as not arbitrary does not mean that such measures are characterized as fair and equitable or regarded as not having

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<sup>44</sup> *Genin*, ¶ 370.

<sup>45</sup> *Ibidem*.

<sup>46</sup> *Lauder*, ¶ 222-32.

affected the stability of the legal framework under which gas transportation companies in Argentina operated. On the contrary, this means that Argentina faced severe economic and social hardships from 2001 onwards and had to react to the circumstances prevailing at the time. Even though the measures adopted by Argentina may not have been the best, they were not taken lightly, without due consideration. This is particularly reflected in the PPI adjustments which, before deciding on their postponement, Argentina negotiated with the investors. The Tribunal concludes that the charges imposed by Argentina to Claimants' investment, though unfair and inequitable, were the result of reasoned judgment rather than simple disregard of the rule of law.

163. Likewise, it was not arbitrary, though unfair and inequitable, not to restore the Gas Law or the other guarantees related to the gas distribution sector and to implement the contract renegotiation policy.

### **C. ARTICLE II(2)(c): THE UMBRELLA CLAUSE**

#### **1. Parties' Positions**

164. LG&E claims that Argentina violated Article II(2)(c) of the BIT when it assumed certain fundamental obligations with regard to investments in its gas-distribution sector and the foreign investors and then repudiated each of these legal commitments without compensating Claimants for their loss.
165. As LG&E explains it, Argentina used foreign capital investment as the cornerstone of its economic recovery plan in the early 1990s. Respondent designed the privatization of *Gas del Estado S.E.* as an international bidding process, in which the conditions for bidding on local enterprises could be met only by a consortium involving foreign investors. Argentina wooed foreign investors with promises of return on investment that would always

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<sup>47</sup> *Lauder*, ¶¶ 229, 232.

be reasonable, protections against currency exchange and inflation, adjustment of rates pursuant to international indexes, no unilateral changes and no price controls without indemnification. Argentina bound itself to these promises in the form of legal obligations.

166. According to Claimants, these are the promises that the umbrella clause is meant to address. The Tribunal need not decide that every commitment regarding investments embodied in general legislation or regulations gives rise to obligations that must be observed under that clause. Rather, liability derives from this article of the Treaty when in the particular circumstances of this case, Respondent failed to observe its obligations.
167. The problem with LG&E's claim, according to Respondent, is that it assumes that general legislation relating to the natural gas distribution and transportation industry falls within Article II(2)(c)'s parameter. Respondent suggests that such promises do not qualify as specific representations that make the umbrella clause effective.
168. Respondent also asserts that LG&E's claims are nothing more than claims of contractual breaches, which are to be considered under the specific jurisdictional clauses of the contract and not adjudicated in an international forum under application of the umbrella clause.

## **2. Tribunal's Analysis**

169. Article II(2)(c) of the Treaty provides that "[e]ach party shall observe any obligation it may have entered into with regard to investments."
170. Such clause, referred to as an "umbrella clause," is a general provision included in a fairly large number of bilateral treaties that creates a requirement for the host State to meet its obligations towards foreign investors, including those that derive from a contract. Hence such obligations receive extra protection by virtue of their consideration under the bilateral treaty.

171. In many cases it has been considered that the umbrella clause is activated not by obligations set forth in municipal law, but in contracts between the State and the investor.<sup>48</sup> Several of those tribunals have concluded that the breach of a contractual obligation in a contract between the State and the investor gives rise to a claim under the umbrella clause.<sup>49</sup>
172. The issue for the Tribunal's consideration is whether the provisions of the Gas Law and its implementing regulations constitute (i) "obligations" (ii) "with regard to" LG&E's capacity as a foreign investor (iii) with respect to its "investment," such that abrogation of the guarantees set forth in the Gas Law and its implementing regulations give rise to a violation of the Treaty.
173. In this case, it will be necessary to establish whether LG&E's claims fall under the umbrella clause's protection.
174. In order to determine the applicability of the umbrella clause, the Tribunal should establish if by virtue of the provisions of the Gas Law and its regulations, the Argentine State has assumed international obligations with respect to LG&E and its investment. To this end, it is necessary to remember that the provisions of the Gas Law and its regulation fixed and regulated the tariff scheme ensuring the value of Claimants' investment; that the purpose of Claimants' investment was to increase the value of its shares in the Licensees through a fragile balanced management of profits and costs, represented by the tariffs fixed by Argentina in light of the already mentioned Gas Law and its regulation. In view of the statements above, the Tribunal concludes that these provisions were not legal obligations of a general nature.<sup>50</sup> On the contrary, they were very specific in relation to

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<sup>48</sup> See e.g., *CMS*, ¶300 (citing cases).

<sup>49</sup> *CMS*, ¶ 303; *SGS v. Republic of the Philippines*, Decision on Jurisdiction, ICSID Case No. ARB/02/6 (29 January 2004), ¶¶ 127-28.

<sup>50</sup> *SGS v. Philippines*, ¶ 121 ("For [the umbrella clause] to be applicable, the host State must have assumed a legal obligation, and it must have been assumed vis-à-vis the specific investment – not as a matter of the application of some legal obligation of a general character.").



LG&E's investment in Argentina, so that their abrogation would be a violation of the umbrella clause.

**3. Tribunal's Conclusion**

175. As such, Argentina's abrogation of the guarantees under the statutory framework – calculation of the tariffs in dollars before conversion to pesos, semi-annual tariff adjustments by the PPI and no price controls without indemnification – violated its obligations to Claimants' investments. Argentina made these specific obligations to foreign investors, such as LG&E, by enacting the Gas Law and other regulations, and then advertising these guarantees in the Offering Memorandum to induce the entry of foreign capital to fund the privatization program in its public service sector. These laws and regulations became obligations within the meaning of Article II(2)(c), by virtue of targeting foreign investors and applying specifically to their investments, that gave rise to liability under the umbrella clause.

**D. CONSIDERATIONS ON INDIRECT EXPROPRIATION**

**1. Parties' Positions**

176. LG&E seeks a declaration from this Tribunal that Argentina expropriated LG&E's investment in the Argentine gas-distribution sector without compensation in violation of Article IV of the Treaty, which provides, in part:

“1. Investments shall not be expropriated or nationalized either directly or indirectly through measures tantamount to expropriation or nationalization (“expropriation”) except for a public purpose; in a non-discriminatory manner; upon payment of prompt, adequate and effective compensation; and in accordance with due process of law and the general principles of treatment provided for in Article II(2).”

177. LG&E articulates its expropriation claim as one of indirect expropriation. In other words, LG&E argues that the Argentine Government's treatment of Claimants' investment in the Licensees constitutes an indirect expropriation

of the investments because the value of LG&E's holdings in the Licenses has been reduced by more than 90% as a result of Respondent's abrogation of the principal guarantees of the tariff system (Claimants' Memorial, ¶ 180).

178. LG&E contends that, pursuant to Article IV of the Bilateral Treaty, it is entitled to compensation equivalent to the fair market value of the expropriated investment immediately before the expropriation was committed. Claimants pinpoint the date of expropriation in this case as the date on which Respondent's course of conduct finally resulted in the virtual destruction of the value of the investment –not later than August 2000, when the Argentine court enjoined implementation of the 17 July 2000 agreement and any further PPI adjustments (Claimants' Memorial, ¶ 181).

179. Under Claimants' theory, indirect expropriation occurs when government action substantially impairs the value of an investment (Claimants' Post-Hearing Brief, ¶ 53 *citing* Dolzer Reb., ¶ 56). In this case, the Claimants consider that the Argentine Government's actions had a substantial effect on LG&E's shares in the Licensees, which are an investment protected under Article I(1)(a) of the Treaty. The value of LG&E's investment was based on a tariff system and depended on the Respondent respecting the system. The value of LG&E's shares in the Licensees now fluctuates according to general speculation around the future tariff relief that Argentina may or may not grant (Claimants' Post-Hearing Brief, ¶ 53).

180. Claimants add that when it comes to establishing whether there was effectively an indirect expropriation, there is no relevance to the fact that the Licensees continue to operate or control their gas-distribution business, or as to whether Claimants hold title to the shares. In the case of indirect expropriation, it does not matter whether title to the licenses has been transferred to the State. It is enough to show that their investment has been impaired as a result of government action, which they claim is the case here as there allegedly has been a substantial appropriation of value by the State and transfer of wealth from the gas industry to gas consumers, especially

large industrial consumers (Claimants' Post-Hearing Brief, ¶¶ 53-54).

181. The Respondent denies that any expropriation under Article IV of the Bilateral Treaty has occurred. Respondent contends that, in order for the Argentine Government to have either directly or indirectly expropriated Claimants' investment, the measures at issue would have had to have been designed to transfer title to the investment to the State. The sole difference between direct and indirect expropriation in this case, according to Respondent, is that with indirect expropriation, no formal transfer of title is required, since its purpose is that of "masking, disguising the expropriating event and of eluding the resulting liability" (Respondent's Post-Hearing Brief, ¶ 103).
182. Respondent argues that Claimants have not proven that the PPI's suspension constitutes an expropriating event. Respondent contends that the suspension of the PPI adjustments would have affected tariffs by approximately 2%, and states that under no circumstance could a tribunal conclude that such a small loss qualifies as an expropriation subject to compensation.
183. Argentina argues that in any event there could not have been any expropriation during the economic crisis. The fact that the licensees may have been affected by the crisis, along with everyone else, does not lead to the conclusion that their investment was expropriated. Respondent denies any causal link between the measures adopted by the Argentine State during this time and the fluctuations in the value of LG&E's shares in the licensees. In its opinion, the fluctuation in the value of LG&E's investment is attributable to the "macroeconomic conditions affecting the Argentine Republic", rather than the measures adopted by the Argentine State (Respondent's Post-Hearing Brief, ¶ 109). Argentina points out that between 1997 and 2000, LG&E earned higher income than expected through its investments in the licensees.
184. Finally, after objecting the expropriation claim because the company

remains de facto and by law the owner of the investment, Respondent alleges that, in fact, the share prices of Claimants' investment have increased in value from the period immediately preceding the suspension of the PPI adjustments. As such, Respondent argues that where property is worth more today than it was prior to the measures' adoption, the property may not be deemed expropriated (Respondent's Post-Hearing Brief, ¶¶ 110-111).

## **2. Tribunal's Analysis**

185. In order to establish the sustainability of an indirect expropriation, the Tribunal must define the concept. Generally, bilateral treaties do not define what constitutes an expropriation –they just make an express reference to “expropriation” and add the language “any other action that has equivalent effects.” Likewise, Article IV of the Bilateral Treaty does not define the term “expropriation” and does not establish which measures, actions or conduct would constitute acts “tantamount to expropriation.” Therefore, the Tribunal shall look to international law in determining the relevant criteria for evaluating this claim.
186. A State may, at its discretion, under Article IV of the Bilateral Treaty and in accordance with general principles of international law, make use of its sovereign power to expropriate private property with the purpose of satisfying a public interest. However, expropriation in any of its modalities requires due process and compensation under international law.
187. Although in scholarly authority two kinds of expropriation are known, we will obviously skip the direct one, understood as the forcible appropriation by the State of the tangible or intangible property of individuals by means of administrative or legislative action. The parties admit that the claim at issue does not involve a direct expropriation. In the case of the Argentine Republic, one could not say that it appropriated Claimants' investment, which is the indispensable requirement if one is to talk of direct expropriation. Instead, we shall limit ourselves to the assumption of the

indirect expropriation, one qualified by the Bilateral Treaty itself as “measures tantamount to expropriation.”

188. Generally, the expression “equivalent to expropriation” or “tantamount to expropriation” found in most bilateral treaties, may refer both, to the so-called “creeping expropriation” and to the *de facto* expropriation. Their common point rests in the fact that the host State’s actions or conduct do not involve “overt taking” but the taking occurs when governmental measures have “effectively neutralize[d] the benefit of property of the foreign owner.”<sup>51</sup> Ownership or enjoyment can be said to be “neutralized” where a party no longer is in control of the investment, or where it cannot direct the day-to-day operations of the investment.<sup>52</sup> As to the differences, it is usual to say that indirect expropriation may show itself in a gradual or growing form—creeping expropriation— or through a sole and unique action, or through actions being quite close in time or simultaneous—*de facto* expropriation.
189. In order to establish whether State measures constitute expropriation under Article IV(1) of the Bilateral Treaty, the Tribunal must balance two competing interests: the degree of the measure’s interference with the right of ownership and the power of the State to adopt its policies.
190. In evaluating the degree of the measure’s interference with the investor’s right of ownership, one must analyze the measure’s economic impact – its interference with the investor’s reasonable expectations – and the measure’s duration.
191. In considering the severity of the economic impact, the analysis focuses on whether the economic impact unleashed by the measure adopted by the host State was sufficiently severe as to generate the need for compensation due to expropriation. In many arbitral decisions, the compensation has been denied

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<sup>51</sup> *CME Czech Republic v. Czech Republic*, Partial Award, ¶ 604 (13 September 2001).

when it has not affected all or almost all the investment's economic value. Interference with the investment's ability to carry on its business is not satisfied where the investment continues to operate, even if profits are diminished.<sup>53</sup> The impact must be substantial in order that compensation may be claimed for the expropriation.

192. The tribunal in *Tecmed* required a finding that Claimant had been “radically deprived of the economical use and enjoyment of its investments, as if the rights related thereto –such as the income or benefits related to the [investment...]- had ceased to exist.”<sup>54</sup> In other words, if due to the actions of the Respondent, the assets involved have lost their value or economic use for the Claimants and the extent of the loss.<sup>55</sup>
193. Similarly, one must consider the duration of the measure as it relates to the degree of interference with the investor's ownership rights. Generally, the expropriation must be permanent, that is to say, it cannot have a temporary nature, unless the investment's successful development depends on the realization of certain activities at specific moments that may not endure variations.
194. There is no doubt that the facts relating to the severity of the changes on the legal status and the practical impact endured by the investors in this case, as well as the possibility of enjoying the right of ownership and use of the investment are decisive in establishing whether an indirect expropriation is said to have occurred. The question remains as to whether one should only take into account the effects produced by the measure or if one should consider also the context within which a measure was adopted and the host State's purpose. It is this Tribunal's opinion that there must be a balance in

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<sup>52</sup> *Pope & Talbot Inc. v. Canada*, Interim Award, ¶ 100 (26 June 2000).

<sup>53</sup> *Pope & Talbot*, ¶¶ 101-02.

<sup>54</sup> *Tecmed*, ¶ 115.

<sup>55</sup> *Ibidem*.

the analysis both of the causes and the effects of a measure in order that one may qualify a measure as being of an expropriatory nature. It is important not to confound the State's right to adopt policies with its power to take an expropriatory measure. "This determination is important because it is one of the main elements to distinguish, from the perspective of an international tribunal between a regulatory measure, which is an ordinary expression of the exercise of the state's police power that entails a decrease in assets or rights, and a *de facto* expropriation that deprives those assets and rights of any real substance."<sup>56</sup>

195. With respect to the power of the State to adopt its policies, it can generally be said that the State has the right to adopt measures having a social or general welfare purpose. In such a case, the measure must be accepted without any imposition of liability, except in cases where the State's action is obviously disproportionate to the need being addressed. The proportionality to be used when making use of this right was recognized in *Tecmed*, which observed that "whether such actions or measures are proportional to the public interest presumably protected thereby and the protection legally granted to investments, taking into account that the significance of such impact, has a key role upon deciding the proportionality."<sup>57</sup>

196. As is observed by *The American Law Institute's Restatement (Third) of the Foreign Relations Law of the United States*, "a state is not responsible for loss of property or for other economic disadvantage resulting from *bona fide* general taxation, regulation, forfeiture for crime, or other action of the kind that is commonly accepted as within the police power of the states, if it is not discriminatory..."<sup>58</sup>. This criterion was used by the Tribunal of Iran-United

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<sup>56</sup> *Ibidem*.

<sup>57</sup> *Tecmed*, ¶122.

<sup>58</sup> *Restatement (Third) of the Foreign Relations Law of the United States*, American Law Institute,

States of America claims in the *Too v. Greater Modesto Insurance Associates*.<sup>59</sup>

197. As was stated in the *Oscar Chinn* affair of 1934, adopted by the Permanent Court of International Justice:

“No enterprise... can escape from the chances and hazards resulting from general economic conditions. Some industries may be able to make large profits during a period of general prosperity, or else by taking advantages of a treaty of commerce or of an alteration in customs duties; but they are also exposed to the danger of ruin or extinction if circumstances change. Where this is the case, no vested rights are violated by the State.”<sup>60</sup>

### 3. Tribunal’s Conclusion

198. In the circumstances of this case, although the State adopted severe measures that had a certain impact on Claimants’ investment, especially regarding the earnings that the Claimants expected, such measures did not deprive the investors of the right to enjoy their investment. As in *Pope & Talbot*, the true interests at stake here are the investment’s asset base, the value of which has rebounded since the economic crisis of December 2001 and 2002.
199. Further, it cannot be said that Claimants lost control over their shares in the licensees, even though the value of the shares may have fluctuated during the economic crisis, or that they were unable to direct the day-to-day operations of the licensees in a manner different than before the measures were implemented.
200. Thus, the effect of the Argentine State’s actions has not been permanent on the value of the Claimants’ shares’, and Claimants’ investment has not ceased to exist. Without a permanent, severe deprivation of LG&E’s rights

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Volume 1, 1987, Section 712, Comment g.

<sup>59</sup> *Too v. Greater Modesto Insurance Associates*, 23 Iran-United States Cl. Trib. Rep. 378, Award of 29 December 1989.

<sup>60</sup> *Oscar Chinn* affair, P.C.I.J., 1934, Ser A/B, Case No. 63.



with regard to its investment, or almost complete deprivation of the value of LG&E's investment, the Tribunal concludes that these circumstances do not constitute expropriation.

## **E. STATE OF NECESSITY**

### **1. Parties' Positions**

201. Respondent contends in the alternative that, if Argentina would have breached its Treaty obligations, the state of political, economic and social crisis that befell Argentina allowed it to take action contrary to the obligations it had assumed with respect to the gas-distribution licensees. Thus, even if the measures adopted by the State in order to overcome the economic crisis suffered during the years 1998 through 2003, resulted in a violation of the rights guaranteed under the Treaty to foreign investments, such measures were implemented under a state of necessity and therefore, Argentina is excused from liability during this period.
202. Respondent pleads its defense as a "state of necessity" defense, available under Argentine law, Treaty in Articles XI and IV(3), as well as customary international law.
203. Claimants reject Respondent's contentions regarding the alleged state of necessity defense. Claimants contend that Article XI is not applicable in the case of an economic crisis because the public order and essential security interests elements are intentionally narrow in scope, limited to security threats of a physical nature.

### **2. General Comments on Article XI**

#### **(i) Preliminary Considerations**

204. Article XI of the Bilateral Treaty provides:

"This Treaty shall not preclude the application by either Party of measures necessary for the maintenance of public order, the

fulfillment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests.”

205. The Tribunal’s analysis to determine the applicability of Article XI of the Bilateral Treaty is twofold. First, the Tribunal must decide whether the conditions that existed in Argentina during the relevant period were such that the State was entitled to invoke the protections included in Article XI of the Treaty. Second, the Tribunal must determine whether the measures implemented by Argentina were necessary to maintain public order or to protect its essential security interests, albeit in violation of the Treaty.<sup>61</sup>
206. The Tribunal reiterates that to carry out the two-fold analysis already mentioned, it shall apply first, the Treaty, second, the general international law to the extent that is necessary and third, the Argentine domestic law. The Tribunal underscores that the claims and defenses mentioned derive from the Treaty and that, to the extent required for the interpretation and application of its provisions, the general international law shall be applied (See section V. B *supra*).

(ii) **The Question of Whether Article XI is Self-Judging**

207. Before turning to its substantive analysis of Article XI, the Tribunal must determine whether Article XI is *self-judging*.
208. Respondent has argued that because Article XI is a self-judging provision, it is for the State to make a good faith determination as to what measures are necessary for the maintenance of public order, or the protection of its essential security interests. According to Respondent, under this self-judging exception, the Tribunal must decide only whether Argentina acted in good faith or not.

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<sup>61</sup> Respondent has not relied upon the third element of Article XI, “the fulfillment of its obligations with respect to the maintenance or restoration of international peace or security.”

209. Respondent considers Article XI is ambiguous and characterizes such ambiguity as a “strategic ambiguity” on the part of the United States, since it does not clearly define who should determine if the measures to maintain public order or protect essential security interests are necessary. Respondent recognizes that the United States’ 1987 Model BIT, upon which the Argentina–U.S. BIT was based, does not clarify the United States’ position, nor does any of the documentation related to the negotiation or ratification of the Argentina-U.S. BIT. However, Respondent contends that subsequent to the conclusion of the Argentina-U.S. BIT, the United States shifted its position permanently with regard to essential security clauses, stating in 1992 that the United States considered such clauses to be self-judging, presently and retroactively (Slaughter Witness Statement, ¶¶ 12-31).
210. Claimants disagree that Article XI is self-judging, and argue instead that its application requires that the Tribunal conduct its own analysis of whether the conditions necessitated measures to maintain public order or protect Argentina’s essential security interests within the meaning of Article XI.
211. Claimants contend that neither the plain meaning of Article XI, nor the context or purpose of the Treaty suggest that Article XI is self-judging, and that the position of the United States at the time the parties signed the Treaty was that such clauses were not self-judging (Hearing on the Merits, 28 January 2005, Alvarez, Spanish Transcript, p. 925 *et seq.*). Claimants argue that Respondent has not proven that the parties to the Treaty intended Article XI to be self-judging, which they characterize as “an exceptional thing.” (Hearing on the Merits, 28 January 2005, Alvarez, Spanish Transcript, p. 932 *et seq.*). Claimants contend that the United States did not consider essential security clauses as self-judging until the Russia-U.S. BIT of 1992 and the 1992 U.S. Model BIT, both of which post-date the Argentina-U.S. BIT, and both of which noted explicitly the change in the United States’ policy that these provisions were to be self-judging.
212. Certainly, the language of the BIT does not specify who should decide what

constitutes essential security measures –either Argentina itself, subject to a review under a good faith standard, or the Tribunal. Based on the evidence before the Tribunal regarding the understanding of the Parties in 1991 at the time the Treaty was signed, the Tribunal decides and concludes that the provision is not self-judging.

213. The provisions included in the international treaty are to be interpreted in conformity with the interpretation given and agreed upon by both parties at the time of its signature, unless both parties agreed to its modification. In that case, the date to be considered is November 1991. It is not until 1992, with the ratification of the Russia – US BIT, that the United States begins to consider that the application of the essential security measures are *self judging*; both instruments post-date the bilateral treaty between the United States and the Argentine Republic and, in both cases, this change was explicitly clarified.
214. Were the Tribunal to conclude that the provision is self-judging, Argentina’s determination would be subject to a good faith review anyway, which does not significantly differ from the substantive analysis presented here.

**(iii) Necessary Nature of the Measures Adopted**

**a. Parties’ Positions**

215. Argentina defends the measures it implemented as necessary to maintain public order and protect its essential security interests. It contends that under any interpretation, the financial crisis, riots and chaos of the years 2000 through 2002 in Argentina constitute a national emergency sufficient to invoke the protections of Article XI (Slaughter Witness Statement, ¶ 45).
216. Concerning “public order”, Respondent reinforces its arguments on the necessary nature of the measures it had implemented by pointing to numerous reports of waves of sudden economic catastrophe, massive strikes involving millions of workers, fatal shootings, the shut down of schools,

businesses, transportation, energy, banking and health services, demonstrations across the country, and a plummeting stock market, culminating in a “final massive social explosion” in which five presidential administrations resigned within a month (Slaughter Witness Statement, ¶¶ 46-49). Under these circumstances, Argentina argues that price controls by the Argentine Government would have been fully justifiable under the public order provisions of Article XI. Additionally, Respondent argues that actions to freeze price increases in the gas-distribution sector were justifiable to maintain the country’s basic infrastructure, which was dependent on natural gas energy.

217. Argentina also defends its measures as necessary to protect its essential security interests. Argentina asserts that Article XI’s “essential security interests” element encompasses economic and political interests, as well as national military defense interests. Respondent cites several United States’ officials who have propounded a broad interpretation of “essential security interests” (Slaughter Witness Statement, ¶ 38).
218. Respondent attacks Claimants’ basis for asserting that the clause is narrow, reserved only for military actions. Furthermore, in all of the cases cited by Claimants, the point was whether the use of military force was justifiable under international law – a narrow reading of essential security clauses in these cases would be expected.
219. Because economic stability, in Respondent’s view, falls within a State’s essential security interests, Respondent defends the measures it took as necessary to protect its economic interests. Respondent argues that during the crisis period, the health, safety and security of the Argentine State and its people were threatened, and that the economic melt-down had the potential to cause catastrophic state failure. Thus, the public emergency that Argentina declared and the Emergency Law the Government passed altering its financial arrangements were necessary to protect the State’s essential security interests.

220. Claimants identify the four measures at issue here –suspension and abolishment of the PPI adjustment, freezing the gas-distribution tariffs, and abandonment of the calculation of the tariffs in dollars, all taken unilaterally– and contend that Respondent must prove that each measure was necessary in order to maintain public order and protect Argentina’s essential security interests (Reply, ¶ 209). By the term “necessary,” Claimants contend that these measures must have been the only option available to Argentina in order to invoke protection under Article XI.
221. Claimants define public order measures as “actions taken pursuant to a state’s police powers, particularly in respect of public health and safety”. Based on this definition, Claimants state that the measures in dispute in this case were not aimed at bringing calmness to the collapse that was threatening the country. Consequently, such measures cannot be deemed necessary to maintain public order.
222. With respect to “essential security interests,” Claimants reiterate that such interests do not include economic interests –only defense or military concerns. They compare a State’s interest in essential security to a national security threat, while a “national emergency,” the alleged circumstance in which Respondent invokes the protection, has an entirely different meaning. In Claimants’ view, economic crises should not be elevated to an essential security interest, and that doing so would disregard the object and purpose of the Treaty. They argue that an economic crisis is precisely when investors need the protections offered by a BIT.
223. Claimants argue that in any event, Article XI does not relieve Argentina of its obligations to compensate Claimants for damages suffered as a result of breaches of the Treaty.
224. Claimants also reject the possibility of applying the rule provided by Article IV(3) of the Treaty. They are of the opinion that this provision does not apply to economic crises, and it does not authorize the host State to revoke

or suspend the protections given to foreign investors (Reply, ¶ 229).

225. Claimants invoke Article 27 of the International Law Commission's Draft Articles on State Responsibility. Claimants contend that even if the state of necessity defense is available to Argentina under the circumstances of this case, Article 27 of the Draft Articles makes clear that Argentina's obligations to Claimants are not extinguished and Argentina must compensate Claimants for losses incurred as a result of the Government's actions. Article 27 provides that "invocation of a circumstance precluding wrongfulness in accordance with this chapter is without prejudice to (a) compliance with the obligation in question... (b) the question of compensation for any material loss caused by the act in question" (Reply, ¶¶ 226-228).

**b. Tribunal's Analysis**

226. In the judgment of the Tribunal, from 1 December 2001 until 26 April 2003, Argentina was in a period of crisis during which it was necessary to enact measures to maintain public order and protect its essential security interests.
227. The Tribunal does not consider that the initial date for the state of necessity is the effective date of the Emergency Law, 6 January 2002, because, in the first place, the emergency had already started when the law was enacted. Second, should the Tribunal take as the initial date the day when the Emergency Law became effective, it might be reasonable to take as its closing date the day when the state of emergency is lifted by the Argentine State, a fact that has not yet taken place since the law has been extended several times.
228. It is to be pointed out that there is a factual emergency that began on 1 December 2001 and ended on 26 April 2003, on account of the reasons detailed below, as well as a legislative emergency, that begins and ends with the enactment and abrogation of the Emergency Law, respectively. It should be borne in mind that Argentina declared its state of necessity and has

extended such state until the present. Indeed, the country has issued a record number of decrees since 1901, accounting for the fact that the emergency periods in Argentina have been longer than the non-emergency periods. Emergency periods should be only strictly exceptional and should be applied exclusively when faced with extraordinary circumstances. Hence, in order to allege state of necessity as a State defense, it will be necessary to prove the existence of serious public disorders. Based on the evidence available, the Tribunal has determined that the situation ended at the time President Kirchner was elected.

229. Thus, Argentina is excused under Article XI from liability for any breaches of the Treaty between 1 December 2001 and 26 April 2003. The reasons are the following:
230. These dates coincide, on the one hand, with the Government's announcement of the measure freezing funds, which prohibited bank account owners from withdrawing more than one thousand pesos monthly and, on the other hand, with the election of President Kirchner. The Tribunal marks these dates as the beginning and end of the period of extreme crisis in view of the notorious events that occurred during this period.
231. Evidence has been put before the Tribunal that the conditions as of December 2001 constituted the highest degree of public disorder and threatened Argentina's essential security interests. This was not merely a period of "economic problems" or "business cycle fluctuation" as Claimants described (Claimants' Post-Hearing Brief, ¶ 14). Extremely severe crises in the economic, political and social sectors reached their apex and converged in December 2001, threatening total collapse of the Government and the Argentine State.
232. All of the major economic indicators reached catastrophic proportions in December 2001. An accelerated deterioration of Argentina's Gross Domestic Product (GDP) began in December 2001, falling 10 to 15 percent faster than



the previous year. Private consumption dramatically dropped in the fourth quarter of 2001, accompanied by a severe drop in domestic prices. Argentina experienced at this time widespread decline in the prices and in the value of assets located in Argentina. The Merval Index, which measures the share value of the main companies of Argentina listed on the Buenos Aires Stock Exchange, experienced a dramatic decline of 60% by the end of December 2001. By mid-2001, Argentina's country risk premium was the highest premium worldwide, rendering Argentina unable to borrow on the international markets, and reflecting the severity of the economic crisis.

233. At this time, capital outflow was a critical problem for the Government. In the fourth quarter of 2001, the Central Bank of Argentina lost US\$ 11 billion in liquid reserves, amounting to 40%. The banking system lost 25% of its total deposits.
234. While unemployment, poverty and indigency rates gradually increased from the beginning of 1998, they reached intolerable levels by December 2001. Unemployment reached almost 25%, and almost half of the Argentine population was living below poverty. The entire healthcare system teetered on the brink of collapse. Prices of pharmaceuticals soared as the country plunged deeper into the deflationary period, becoming unavailable for low-income people. Hospitals suffered a severe shortage of basic supplies. Investments in infrastructure and equipment for public hospitals declined as never before. These conditions prompted the Government to declare the nationwide health emergency to ensure the population's access to basic health care goods and services. At the time, one quarter of the population could not afford the minimum amount of food required to ensure their subsistence. Given the level of poverty and lack of access to healthcare and proper nutrition, disease followed. Facing increased pressure to provide social services and security to the masses of indigent and poor people, the Government was forced to decrease its per capita spending on social services by 74%.

235. By December 2001, there was widespread fear among the population that the Government would default on its debt and seize bank deposits to prevent the bankruptcy of the banking system. Faced with a possible run on banks, the Government issued on 1 December 2001 Decree of Necessity and Emergency No. 1570/01. The law triggered widespread social discontent. Widespread violent demonstrations and protests brought the economy to a halt, including effectively shutting down transportation systems. Looting and rioting followed in which tens of people were killed as the conditions in the country approached anarchy. A curfew was imposed to curb lootings.
236. By 20 December 2001, President De la Rúa resigned. His presidency was followed by a succession of presidents over the next days, until Mr. Eduardo Duhalde took office on 1 January 2002, charged with the mandate to bring the country back to normal conditions.
237. All of these devastating conditions –economic, political, social– in the aggregate triggered the protections afforded under Article XI of the Treaty to maintain order and control the civil unrest.
238. The Tribunal rejects the notion that Article XI is only applicable in circumstances amounting to military action and war. Certainly, the conditions in Argentina in December 2001 called for immediate, decisive action to restore civil order and stop the economic decline. To conclude that such a severe economic crisis could not constitute an essential security interest is to diminish the havoc that the economy can wreak on the lives of an entire population and the ability of the Government to lead. When a State’s economic foundation is under siege, the severity of the problem can equal that of any military invasion.
239. Claimants contend that the necessity defense should not be applied here because the measures implemented by Argentina were not the only means available to respond to the crisis. The Tribunal rejects this assertion. Article XI refers to situations in which a State has no choice but to act. A State may

have several responses at its disposal to maintain public order or protect its essential security interests. In this sense, it is recognized that Argentina's suspension of the calculation of tariffs in U.S. dollars and the PPI adjustment of tariffs was a legitimate way of protecting its social and economic system.

240. The Tribunal has determined that Argentina's enactment of the Emergency Law was a necessary and legitimate measure on the part of the Argentine Government. Under the conditions the Government faced in December 2001, time was of the essence in crafting a response. Drafted in just six days, the Emergency Law took the swift, unilateral action against the economic crisis that was necessary at the time (Hearing on the Merits, 25 January 2005, Ratti, Spanish Transcript, pp. 415-419).

241. In drafting the Emergency Law, the Government considered the interests of the foreign investors, and concluded that it "could not leave sectors of the economy operating with the brutally dollarized economy –[the] system was in crisis, so we had to cut off that process, and we had to establish a new set of rules for everybody." (Hearing on the Merits, 25 January 2005, Ratti, Spanish Transcript, p. 417). Argentina's strategy to deal with the thousands of public utility contracts that could not be individually assessed during the period of crisis was to implement "across-the-board solutions" and then renegotiate the contracts (Hearing on the Merits, 26 January 2005, Roubini, Spanish Transcript, p. 635). The Tribunal accepts the necessity of approaching enactment of a stop-gap measure in this manner and therefore rejects Claimants' objection that Argentina's unilateral response was not necessary.

242. The Tribunal accepts that the provisions of the Emergency Law that abrogated calculation of the tariffs in U.S. dollars and PPI adjustments, as well as freezing tariffs were necessary measures to deal with the extremely serious economic crisis. Indeed, it would be unreasonable to conclude that during this period the Government should have implemented a tariff increase pursuant to an index pegged to an economy experiencing a high inflationary

period (the United States). The severe devaluation of the peso against the dollar renders the Government's decision to abandon the calculation of tariffs in dollars reasonable. Similarly, the Government deemed that freezing gas tariffs altogether during the crisis period was necessary, and Claimants have not provided any reason as to why such measure would not provide immediate relief from the crisis.

243. The Tribunal will now turn to Article IV(3) of the Treaty, which provides:

“Nationals or companies of either Party whose investments suffer losses in the territory of the other Party owing to war or other armed conflict, revolution, *state of national emergency*, insurrection, civil disturbance or other similar events shall be accorded treatment by such other Party no less favorable than that accorded to its own nationals or companies or to nationals or companies of any third country, whichever is the more favorable treatment, as regards any measures it adopts in relation to such losses.” (Emphasis added)

244. Article IV(3) of the Treaty confirms that the States Party to the Bilateral Treaty contemplated the state of national emergency as a separate category of exceptional circumstances. That is in line with the Tribunal's interpretation of Article XI of the Treaty. Furthermore, the Tribunal has determined, as a factual matter that the grave crisis in Argentina lasted from 1 December 2001 until 26 April 2003. It has not been shown convincingly to the Tribunal that during that period the provisions of Article IV(3) of the Treaty have been violated by Argentina. On the contrary, during that period, the measures taken by Argentina were “across the board.”

245. In the previous analysis, the Tribunal has determined that the conditions in Argentina from 1 December 2001 until 26 April 2003 were such that Argentina is excused from liability for the alleged violation of its Treaty obligations due to the responsive measures it enacted. The concept of excusing a State for the responsibility for violation of its international obligations during what is called a “state of necessity” or “state of emergency” also exists in international law. While the Tribunal considers

that the protections afforded by Article XI have been triggered in this case, and are sufficient to excuse Argentina's liability, the Tribunal recognizes that satisfaction of the state of necessity standard as it exists in international law (reflected in Article 25 of the ILC's Draft Articles on State Responsibility) supports the Tribunal's conclusion.<sup>62</sup>

246. In international law, a state of necessity is marked by certain characteristics that must be present in order for a State to invoke this defense. As articulated by Roberto Ago, one of the mentors of the Draft Articles on State Responsibility, a state of necessity is identified by those conditions in which a State is threatened by a serious danger to its existence, to its political or economic survival, to the possibility of maintaining its essential services in operation, to the preservation of its internal peace, or to the survival of part of its territory.<sup>63</sup> In other words, the State must be dealing with interests that are essential or particularly important.<sup>64</sup>

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<sup>62</sup>Article 25 of the Draft Articles on Responsibility of States for Internationally Wrongful Acts provides:

1. "Necessity may not be invoked by a State as a ground for precluding the wrongfulness of an act not in conformity with an international obligation of that State unless the act:
  - a) Is the only way for the State to safeguard an essential interest against a grave and imminent peril; and
  - b) Does not seriously impair an essential interest of the State or States towards which the obligation exists, or of the international community as a whole.
2. In any case, necessity may not be invoked by a State as a ground for precluding wrongfulness if:
  - a) The international obligation in question excludes the possibility of invoking necessity; or
  - b) The State has contributed to the situation of necessity."

The ILC's Draft Articles, after some debate regarding the original prepared under the auspices of the Society of Nations in 1930, was abandoned and then resumed by the General Assembly in 1963. Its definitive version, due mainly to the works of Mssrs. Roberto Ago, Willem Riphagen and Gaetano Arangio-Ruiz, was approved in 1981 and subject to a revision in 1998, which was approved in 2001, during the 85<sup>th</sup> plenary session of the United Nations' General Assembly. (Session dated 12 December 2001, during the fifty-sixth session, Agenda item 162 of the Program, A/RES/56/83).

<sup>63</sup> United Nations, Report A/CN.4/318/ADD.5, p. 3.

<sup>64</sup> Strupp. K., *Les règles générales du Droit de la paix*, RECUEIL DES COURS, 1934 I, T. 47, pp. 259-595, especially p. 568. Similarly, the ILC has defined the state of necessity as that situation where the only means of safeguarding an essential interest of the State against a grave and imminent peril is an act that is not in conformity with an international obligation binding that State with another State. In shaping the concept of state of necessity, one must make a compulsory reference to the Russian seal furs case. There, the Russian government banned the hunting of seals near the Russian shorelines,

247. The United Nations Organization has understood that the invocation of a state of necessity depends on the concurrent existence of three circumstances, namely: a danger to the survival of the State, and not for its interests, is necessary; that danger must not have been created by the acting State; finally, the danger should be serious and imminent, so that there are no other means of avoiding it.
248. The concept of state of necessity and the requirements for its admissibility lead to the idea of prevention: the State covers itself against the risk of suffering certain damages. Hence, the possibility of alleging the state of necessity is closely bound by the requirement that there should be a serious and imminent threat and no means to avoid it. Such circumstances, in principle, have been left to the State's subjective appreciation, a conclusion accepted by the International Law Commission. Nevertheless, the Commission was well aware of the fact that this exception, requiring admissibility, has been frequently abused by States, thus opening up a very easy opportunity to violate the international law with impunity. The Commission has set in its Draft Articles on State Responsibility very restrictive conditions to account for its admissibility, reducing such subjectivity.<sup>65</sup>
249. James Crawford, who was rapporteur of the Draft Articles approved in 2001, noted that when a State invokes the state of necessity, it has full knowledge of the fact that it deliberately chooses a procedure that does not abide an

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including international waters and founded such decision on the absolute need to adopt immediate provisional measures. In a communication addressed, on the occasion of this incident, by the Russian foreign Minister, Chickline, to the British Ambassador, Morier, the main elements of the state of necessity were established: the absolutely exceptional nature of the alleged situation; the imminent character of the threat against an important State interest; the impossibility of avoiding the risk with other means, and the necessarily temporary nature of this justification, linked to the due danger's persistence. *See* United Nations, Report of the International Law Commission on the work performed during its 32<sup>nd</sup> session, p. 87.

<sup>65</sup> United Nations, Report A/CN.4/315, p. 78.

international obligation.<sup>66</sup> This deliberate action on the part of the State is therefore subject to the requirements of Article 25 of the Draft Articles, which must concur jointly and without which it is not possible to exclude under international law the wrongfulness of a State's act that violates an international obligation.

250. Taking each element in turn, Article 25 requires first that the act must be the only means available to the State in order to protect an interest. According to S.P. Jagota, a member of the Commission, such requirement implies that it has not been possible for the State to “avoid by any other means, even a much more onerous one that could have been adopted and maintained the respect of international obligations. The State must have exhausted all possible legal means before being forced to act as it does.”<sup>67</sup> Any act that goes beyond the limits of what is strictly necessary “may not be considered as no longer being, as such, a wrongful act, even if justification of the necessity may have been admitted.”<sup>68</sup>

251. The interest subject to protection also must be essential for the State. What qualifies as an “essential” interest is not limited to those interests referring to the State's existence. As evidence demonstrates, economic, financial or those interests related to the protection of the State against any danger seriously compromising its internal or external situation, are also considered essential interests. Roberto Ago has stated that essential interests include those related to “different matters such as the economy, ecology or other.”<sup>69</sup> Julio Barboza affirmed that the threat to an essential interest would be identified by considering, among other things, “a serious threat against the existence of the State, against its political or economic survival, against the

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<sup>66</sup> Crawford, James, *Second Report on State Responsibility*, UN General Assembly, International Law Commission, 51<sup>st</sup> Session, Geneva, 23 July 1999, A/CN.4/498/Add 2, p. 27-28.

<sup>67</sup> United Nations, Report A/CN.4/SER.A/1980, pp. 155 and 175.

<sup>68</sup> *Ibidem*.

<sup>69</sup> United Nations, Report A/CN.4/SER.A/1980, p.174.

maintenance of its essential services and operational possibilities, or against the conservation of internal peace or its territory's ecology.”<sup>70</sup>

252. James Crawford has stated that no opinion may be offered *a priori* of “essential interest,” but one should understand that it is not the case of the State’s “existence”, since the “purpose of the positive law of self-defense is to safeguard that existence.”<sup>71</sup> Thus, an interest’s greater or lesser essential, must be determined as a function of the set of conditions in which the State finds itself under specific situations. The requirement is to appreciate the conditions of each specific case where an interest is in play, since what is essential cannot be predetermined in the abstract.<sup>72</sup>
253. The interest must be threatened by a serious and imminent danger. The threat, according to Roberto Ago, “must be ‘extremely grave’ and ‘imminent.’”<sup>73</sup> In this respect, James Crawford has opined that the danger must be established objectively and not only deemed possible.<sup>74</sup> It must be imminent in the sense that it will soon occur.
254. The action taken by the State may not seriously impair another State’s interest. In this respect, the Commission has observed that the interest sacrificed for the sake of necessity must be, evidently, less important than the interest sought to be preserved through the action.<sup>75</sup> The idea is to prevent against the possibility of invoking the state of necessity only for the safeguard of a non-essential interest.
255. The international obligation at issue must allow invocation of the state of

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<sup>70</sup> *Ibidem.*

<sup>71</sup> Crawford, James, *Second Report on State Responsibility, op. cit.*, p. 30.

<sup>72</sup> *Ibidem.*

<sup>73</sup> United Nations, Report A/CN.4/318/ADD.5-7. p. 20.

<sup>74</sup> Crawford, James, *Second Report on State Responsibility op. cit.*, p. 31. In fact, this is so reflected in Principle 15 of the Rio Declaration on Environment and Development, adopted by the United Nations’ Conference on Environment and Development in 1992.

<sup>75</sup> United Nations, Report A/CN.4/318/ADD.5-7. p. 20.



necessity. The inclusion of an article authorizing the state of necessity in a Bilateral Investment Treaty constitutes the acceptance, in the relations between States, of the possibility that one of them may invoke the state of necessity.

256. The State must not have contributed to the production of the state of necessity. It seems logical that if the State has contributed to cause the emergency, it should be prevented from invoking the state of necessity. If there is fault by the State, the exception disappears, since in such case the causal relationship between the State's act and the damage caused is produced. The Tribunal considers that, in the first place, Claimants have not proved that Argentina has contributed to cause the severe crisis faced by the country; secondly, the attitude adopted by the Argentine Government has shown a desire to slow down by all the means available the severity of the crisis.
257. The essential interests of the Argentine State were threatened in December 2001. It faced an extremely serious threat to its existence, its political and economic survival, to the possibility of maintaining its essential services in operation, and to the preservation of its internal peace. There is no serious evidence in the record that Argentina contributed to the crisis resulting in the state of necessity. In this circumstances, an economic recovery package was the only means to respond to the crisis. Although there may have been a number of ways to draft the economic recovery plan, the evidence before the Tribunal demonstrates that an across-the-board response was necessary, and the tariffs on public utilities had to be addressed. It cannot be said that any other State's rights were seriously impaired by the measures taken by Argentina during the crisis. Finally, as addressed above, Article XI of the Treaty exempts Argentina of responsibility for measures enacted during the state of necessity.
258. While this analysis concerning Article 25 of the Draft Articles on State Responsibility alone does not establish Argentina's defense, it supports the

Tribunal's analysis with regard to the meaning of Article XI's requirement that the measures implemented by Argentina had to have been necessary either for the maintenance of public order or the protection of its own essential security interests.

259. Having found that the requirements for invoking the state of necessity were satisfied, the Tribunal considers that it is the factor excluding the State from its liability vis-à-vis the damage caused as a result of the measures adopted by Argentina in response to the severe crisis suffered by the country.
260. With regard to Article 27 of the United Nations' Draft Articles alleged by Claimants, the Tribunal opines that the article at issue does not specifically refer to the compensation for one or all the losses incurred by an investor as a result of the measures adopted by a State during a state of necessity. The commentary introduced by the Special Rapporteur establishes that Article 27 "*does not attempt to specify in what circumstances compensation would be payable*".<sup>76</sup> The rule does not specify if compensation is payable during the state of necessity or whether the State should reassume its obligations. In this case, this Tribunal's interpretation of Article XI of the Treaty provides the answer.
261. Following this interpretation the Tribunal considers that Article XI establishes the state of necessity as a ground for exclusion from wrongfulness of an act of the State, and therefore, the State is exempted from liability. This exception is appropriate only in emergency situations; and once the situation has been overcome, i.e. certain degree of stability has been recovered; the State is no longer exempted from responsibility for any violation of its obligations under the international law and shall reassume them immediately.

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<sup>76</sup>Crawford, James, *The International Law Commission's Articles on State Responsibility*, Cambridge University Press, 2002, p. 178 *et seq.*

(iv) **Consequences of the State of Necessity**

262. Three relevant issues arise with respect to the Tribunal's finding Argentina is entitled to invoke the state of necessity as contemplated by Article XI, and general international law.
263. The first issue deals with the determination of the period during which the state of necessity occurred. As previously indicated, in the view of the Tribunal, the state of necessity in this case began on 1 December 2001 and ended on 26 April 2003, when President Kirchner was elected (*see* the Tribunal's Analysis). All measures adopted by Argentina in breach of the Treaty before<sup>77</sup> and after the period during which the state of necessity prevailed, shall have all their effects and shall be taken into account by the Tribunal to estimate the damages.
264. The second issue related to the effects of the state of necessity is to determine the subject upon which the consequences of the measures adopted by the host State during the state of necessity shall fall. As established in the Tribunal's Analysis, Article 27 of ILC's Draft Articles, as well as Article XI of the Treaty, does not specify if any compensation is payable to the party affected by losses during the state of necessity. Nevertheless, and in accordance with that expressed under paragraphs 260 and 261 *supra*, this Tribunal has decided that the damages suffered during the state of necessity should be borne by the investor.
265. The third issue is related to what Argentina should have done, once the state of necessity was over on 26 April 2003. The very following day (27 April), Argentina's obligations were once again effective. Therefore, Respondent should have reestablished the tariff scheme offered to LG&E or, at least, it should have compensated Claimants for the losses incurred on account of the

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<sup>77</sup> The period before the state of necessity initiates with the injunction issued by the Argentine Court on 18 August 2000.

measures adopted before and after the state of necessity.

(v) **Conclusions of the Tribunal**

266. Based on the analysis of the state of necessity, the Tribunal concludes that, first, said state started on 1 December 2001 and ended on 26 April 2003; second, during that period Argentina is exempt of responsibility, and accordingly, the Claimants should bear the consequences of the measures taken by the host State; and finally, the Respondent should have restored the tariff regime on 27 April 2003, or should have compensated the Claimants, which did not occur. As a result, Argentina is liable as from that date to Claimants for damages.

**VII. DECISION OF THE TRIBUNAL ON LIABILITY**

267. For the foregoing reasons, the Tribunal renders its decision, partially granting LG&E's claims, as follows:
- a. The claim for expropriation of the investment is hereby dismissed.
  - b. Argentina breached the standard of fair and equitable treatment, no less favorable treatment than that to be accorded under the international law, and adopted discriminatory measures, causing damage to LG&E. Argentina's abrogation of the guarantees under the statutory framework, as indicated under paragraph 175 *supra*, violated its obligations to Claimants' investments, giving rise to liability under the umbrella clause.
  - c. The standard prohibiting the adoption of arbitrary measures is not deemed to have been violated.
  - d. Between 1 December 2001 and 26 April 2003, Argentina was in a state of necessity, for which reason it shall be exempted from the payment of compensation for damages incurred during that period.

- e. The Argentine Republic is liable for damages to Claimants for the aforementioned violations, except during the period of the state of necessity, which damages, including interest, as well as specification of the periods during which Respondent has incurred in violation of its international obligations, shall be determined in a next phase of the arbitration and in respect of which the Tribunal retains jurisdiction.
- f. Any decision on the costs of the arbitration is reserved.

Made in Washington, D.C., in English and Spanish, both versions equally authentic.

*(signed)*

Professor Albert Jan van den Berg

Arbitrator

Date: 19 September 2006

*(signed)*

Judge Francisco Rezek

Arbitrator

Date: 21 September 2006

*(signed)*

Dr. Tatiana B. de Maekelt

President

Date: 26 September 2006

**LEGAL AUTHORITY CA-84**

INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES  
WASHINGTON, D.C.

In the Proceeding Between

**JOSEPH CHARLES LEMIRE**  
(Claimant)

and

**UKRAINE**  
(Respondent)

**(ICSID CASE NO. ARB/06/18)**

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**DECISION ON JURISDICTION AND LIABILITY**

---

*Members of the Tribunal:*

Professor Juan Fernández-Armesto, *President*  
Mr. Jan Paulsson, *Arbitrator*  
Dr. Jürgen Voss, *Arbitrator*

*Secretary of the Tribunal:*

Mr. Ucheora Onwuamaegbu

*Representing Claimant:*

Dr. Hamid G. Gharavi  
Mr. Julien Fouret  
Ms. Nada Sader  
*Derains & Gharavi*  
Paris, France

*Representing Respondent:*

Mr. John S. Willems  
Mr. Michael A. Polkinghorne  
Ms. Olga Mouraviova  
*White & Case LLP*  
Paris, France

Mr. Sergii Svyryba  
Ms. Marta Khomyak  
Ms. Olha Yaniutina  
*Magisters*  
Kyiv, Ukraine



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## GLOSSARY

2000 Award	Award dated September 18, 2000 finalizing the First Arbitration
Arbitration Clause	Dispute resolution provision contained in the Settlement Agreement which provides that all the disputes arising from or in connection with the Settlement Agreement shall be resolved through arbitration
BIT	Treaty between the United States of America and Ukraine concerning the Encouragement and Reciprocal Protection of Investment which entered into force on November 16, 1996
Centre	International Centre for Settlement of Investment Disputes
Claimant	Mr. Joseph Charles Lemire
FET	Fair and Equitable Treatment
First Arbitration	An investment arbitration proceeding filed with ICSID on November 14, 1997 between Claimant and Respondent, which was finalized by the 2000 Award
Gala	CJSC “Radiocompany Gala”
ICSID	International Centre for Settlement of Investment Disputes
ICSID Convention	Convention on the Settlement of Investment Disputes between States and Nationals of other States, done at Washington on March 18, 1965.
Institution Rules	ICSID Rules of Procedure for the Institution of Conciliation and Arbitration Proceedings
LNC	Law on National Television and Radio Council of Ukraine last amended in 2006
LTR	Ukrainian Law on Television and Radio Broadcasting last amended in 2006
Mirakom	CJSC “Mirakom Ukraina”
NAFTA	North American Free Trade Agreement entered into force in 1994
National Council	Ukrainian National Council for Television and Radio Broadcasting
Request	Claimant’s request for arbitration against Respondent dated September 6, 2006
Respondent	Ukraine
Settlement Agreement	Agreement dated March 20, 2000 between Claimant and Respondent on the settlement of the First Arbitration
State Centre	Ukrainian State Centre of Radio Frequencies
State Committee	Ukrainian State Committee on Communications and Information Technology
UCRF	Ukrainian State Centre of Radio Frequencies
Umbrella Clause	Clause contained in Article II.3 (c) of the US-Ukraine BIT which permits a breach of contract to be characterized as a breach of the BIT
UNIDROIT	International Institute for the Unification of Private Law
UNIDROIT Principles	Principles of International Commercial Contracts adopted by UNIDROIT

## I. PROCEDURE

1. On September 11, 2006, the International Centre for Settlement of Investment Disputes (“ICSID” or the “Centre”) received from Joseph Charles Lemire (“Mr. Lemire” or “Claimant”), a citizen of the United States, a request for arbitration (the “Request”) dated September 6, 2006, against Ukraine (“Respondent”).
2. On September 12, 2006, the Centre, in accordance with Rule 5 of the ICSID Rules of Procedure for the Institution of Conciliation and Arbitration Proceedings (the “Institution Rules”) acknowledged receipt of the Request and on the same day transmitted a copy thereof to Ukraine with a copy to its Embassy in Washington, D.C.
3. The Request, as supplemented by Claimant’s letter of November 14, 2006, was registered by the Centre on December 8, 2006, pursuant to Article 36(3) of the ICSID Convention. By letter of the same day, the Secretary-General of ICSID, in accordance with Rules 6 and 7 of the Institution Rules, notified the parties of the registration and invited them to proceed to constitute an Arbitral Tribunal as soon as possible.
4. The parties not having reached agreement on the number of arbitrators and the method of their appointment more than 60 days after the registration of the Request, Claimant invoked Article 37(2)(b) of the ICSID Convention by letter of February 8, 2007. Article 37(2)(b) prescribes a Tribunal consisting of three arbitrators, one appointed by each party and the third, who shall be the President of the Tribunal, appointed by agreement of the parties.
5. On February 22, 2007, Claimant appointed Mr. Jan Paulsson of France as arbitrator and on March 7, 2007, Respondent appointed Dr. Jürgen Voss of Germany as arbitrator, each of whom the parties had also appointed in the earlier concluded ICSID Additional Facility case *Joseph C. Lemire v. Ukraine* (ICSID Case No. ARB(AF)/98/1).
6. The Tribunal not having been constituted 90 days after the registration of the request, Claimant requested by letters of March 9, 2007, and March 20, 2007, that the Chairman of the ICSID Administrative Council designate an arbitrator to be the President of the Tribunal, pursuant to ICSID Arbitration Rule 4(1).
7. On June 6, 2007, the Chairman of the ICSID Administrative Council, in consultation with the parties, designated Professor Juan Fernández-Armesto, a national of Spain, as the presiding arbitrator.
8. All three arbitrators having accepted their appointments, the Secretary-General of ICSID, by letter of June 14, 2007, informed the parties that a Tribunal consisting of Professor Juan Fernández-Armesto, Mr. Jan Paulsson and Dr. Jürgen Voss, had been constituted and that the proceeding was deemed to have commenced on that day, pursuant to ICSID Arbitration Rule 6(1).

9. At the time of the filing of the Request, Claimant was represented by the law firm of Salans. From December 2008 to December 2009, Claimant was represented by the law firm of Derains Gharavi & Lazareff in Paris, France, and, subsequently, by the law firm of Derains & Gharavi.
10. By letters of June 25, 2007 and July 9, 2007, Respondent notified the Centre of the appointment of the law firm of White & Case LLP in Paris, France, and of the law firm of Magisters in Kyiv, Ukraine, as its legal representatives in this matter.
11. The first session of the Tribunal was held on July 23, 2007, at the World Bank's offices in Paris, and various aspects of procedure were determined at the session. Present at the session were:

Members of the Tribunal

Prof. Juan Fernández-Armesto, *President*  
Mr. Jan Paulsson, *Arbitrator*  
Dr. Jürgen Voss, *Arbitrator*

Secretary of the Tribunal

Mr. Ucheora Onwuamaegbu (*by video conference*)

Attending for Claimant

Mr. Joseph C. Lemire, *Claimant*  
Mr. Sergey Denisenko, *Executive at Gala*  
Ms. Julia Tumash, *Executive at Gala*  
Mr. Hamid G. Gharavi, *Salans*  
Ms. Brenda Horrigan, *Salans*  
Mr. William Kirtley, *Salans*

Attending for Respondent

Mr. Sergiy Beketov, *Ministry of Justice of Ukraine*  
Mr. John S. Willems, *White & Case LLP*  
Mr. Michael Polkinghorne, *White & Case LLP*  
Ms. Olga Mouraviova, *White & Case LLP*  
Ms. Anna-Marta Khomyak, *Magisters*

12. On November 12, 2007, Claimant filed its Memorial on the Merits.
13. On February 25, 2008, Respondent filed a Memorial in Support of Its Objections to Jurisdiction and, on February 26, 2008, Respondent filed its Counter-Memorial on the Merits, dated February 25, 2008.
14. On March 17, 2008, Claimant filed observations on Respondent's Memorial in Support of its Objections to Jurisdiction.
15. On March 26, 2008, the Tribunal notified the parties that it had decided to join the issue of jurisdiction to the merits.

16. Also on March 26, 2008, the parties filed their respective requests for production of documents and, on April 18, 2008, exchanged responses on their respective requests for production of documents. On May 13, 2008, the Tribunal issued Procedural Order No. 1 concerning the requests for production of documents.
17. On July 31, 2008, Respondent filed a further request for production of documents. On August 8, 2008, Claimant filed observations on Respondent's request, and on August 13, 2008, Respondent filed a response to Claimant's observations of August 8, 2008. Claimant answered Respondent's request on August 28, 2008.
18. On August 15, 2008, Claimant filed a request for provisional measures, concerning Ukraine's decision to charge a certain fee for the renewal of Gala's broadcasting licence.
19. On August 20, 2008, Claimant filed its Reply on the Merits.
20. On August 29, 2008, Respondent filed a proposal for the disqualification of Mr. Jan Paulsson as arbitrator, and the proceeding was suspended in accordance with ICSID Arbitration Rule 9(6). Existing deadlines and schedule of the proceeding remained in effect and continued to run during the period of suspension of the proceeding.
21. On September 2, 2008, Respondent filed observations on Claimant's request for provisional measures.
22. On September 10, 2008, Claimant filed a response to Respondent's observations on Claimant's request for provisional measures.
23. On September 23, 2008, the Centre notified the parties that in accordance with Article 58 of the ICSID Convention and ICSID Arbitration Rule 9(4), the proposal for the disqualification of Mr. Jan Paulsson had been decided by the other members of the Tribunal, Prof. Juan Fernández-Armesto and Dr. Jürgen Voss. The proposal for disqualification of Mr. Paulsson was dismissed and the suspension of the proceeding was lifted as of the date of the notification. The reasoned Decision on Respondent's proposal for the disqualification was communicated to the parties on September 29, 2008.
24. On October 22, 2008, Claimant withdrew the request for provisional measures of August 15, 2008.
25. On November 6, 2008, Respondent filed a Rejoinder on the Merits.
26. On November 13 and November 18, 2008, Claimant filed requests for production of witnesses, and on November 14, 2008, the parties filed witness statements.
27. On November 19, 2009, the President of the Tribunal held a pre-hearing conference by telephone with the parties.

28. On November 25, 2008, Respondent filed observations on Claimant's requests of November 13 and 18, 2008, for production of witnesses.
29. On December 1, 2008, the parties filed rebuttal witness statements and on December 3, 2008, the President of the Tribunal held a further pre-hearing conference by telephone with the parties.
30. The hearing on jurisdiction and the merits was held from December 8, 2008 to December 12, 2008, at the at the World Bank's offices in Paris. Present at the hearing were:

Members of the Tribunal

Prof. Juan Fernández-Armesto, *President*

Mr. Jan Paulsson, *Arbitrator*

Dr. Jürgen Voss, *Arbitrator*

Assistant to the Tribunal

Ms. Deva Villanúa Gómez

Attending for Claimant

Mr. Joseph C. Lemire, *Claimant's witness*

Mr. Hamid G. Gharavi, *Derains Gharavi & Lazareff*

Mr. Nabil Lodey, *Derains Gharavi & Lazareff*

Mr. Julien Fouret, *Derains Gharavi & Lazareff*

Ms. Nada Sader, *Derains Gharavi & Lazareff*

Mr. Sergiy Koziakov, *Derains Gharavi & Lazareff*

Mr. Eric Degand, *witness*

Mr. Viktor Petrenko, *Claimant's witness*

Mr. Pavol Shylko, *witness*

Mr. Piotr Jalowiec, *witness*

Mr. Sergey Denisenko, *witness*

Dr. Andre Wiegand, *expert*

Dr. Klaus Goldhammer, *expert*

Attending for Respondent

Mr. John S. Willems, *White & Case LLP*

Mr. Michael Polkinghorne, *White & Case LLP*

Ms. Olga Mouraviova, *White & Case LLP*

Mr. Sergii Svyryba, *Magisters*

Ms. Nathalie Makowski, *White & Case LLP*

Ms. Olga Boltenko, *White & Case LLP*

Ms. Olga Glukhovska, *Magisters*

Ms. Olga Ianiutina, *Magisters*

Mr. Markkian Kliuchkovskiy, *Magisters*

Ms. Tuuli Timonen, *White & Case LLP*

Ms. Renee Bissell, *White & Case LLP*

Ms. Ludmila Zaporozhets, *National Television and Radio  
Broadcasting Council of Ukraine*

Mr. Vitaliy Shevchenko, *witness*

Mr. Ihor Kurus, *witness*



Mr. Volodymyr Kirichenko, *witness*  
Mr. Iulian Leliukh, *witness*  
Mr. Viktor Petrenko, *Respondent's witness*  
Mr. Vladyslav Lyasovskyi, *witness*  
Ms. Olena Volska, *expert*

31. As decided at the hearing, the parties filed their respective post-hearing briefs on March 4, 2009 and their respective statements of costs on March 20, 2009.
32. Members of the Tribunal deliberated using various means of communication.

## II. BASIC FACTS

33. This dispute was submitted to ICSID by Claimant against Respondent under (1) the Treaty between the United States of America and Ukraine Concerning the Encouragement and Reciprocal Protection of Investment, done in Kyiv on October 17, 1996 (the “BIT”) and (2) an agreement between Claimant and Respondent on the settlement of a dispute, dated March 20, 2000 (the “Settlement Agreement”), which was recorded as an award on agreed terms on September 18, 2000 (ICSID No. ARB (AF) 98/1 (the “2000 Award”).
34. Article VI of the BIT entitles any national of a State party to the BIT to submit to ICSID any dispute with the other State party to the BIT relating to either “*an investment agreement between that Party and such national*” or “*an alleged breach of any right conferred or created by this Treaty with respect to an investment*”.
35. On November 14, 1997, Claimant filed with ICSID a first arbitration request (the “First Arbitration”) against Respondent, with regard to the same investments that underlie the present arbitration. This First Arbitration eventually led to the Settlement Agreement, which was then recorded in the 2000 Award. Paragraph 31 of the Settlement Agreement provides for the resolution of all disputes arising from or in connection with the Agreement by ICSID Arbitration in accordance with the ICSID Additional Facility Arbitration Rules.

### III. THE PARTIES

36. Claimant, Mr. Joseph Charles Lemire, is a national of the United States of America residing at 91 Saksagansko St., Office 8,01032 Kiev, Ukraine. Claimant is a majority shareholder, through CJSC “Mirakom Ukraina” (“Mirakom”) of CJSC “Radiocompany Gala” (“Gala”), a closed joint stock company constituted in 1995 under the laws of Ukraine with its principal office located at the same address as Mr. Lemire’s residence. Gala is a music radio station in Ukraine currently licenced to broadcast on various frequencies in Ukraine.
37. Respondent is the State of Ukraine. With respect to the events giving rise to the present arbitration, Respondent has acted through its President, Prime Minister, Parliament, Ministry of Defence, the National Council for Television and Radio Broadcasting (the “National Council”), the Ukrainian State Centre of Radio Frequencies (the “State Centre”), the State Committee on Communications and Information Technology (the “State Committee”), all of which are organs for which Ukraine is responsible under international law.

#### IV. RELIEF SOUGHT

38. Claimant seeks relief for alleged breaches of the Settlement Agreement/2000 Award and for alleged breaches of the BIT following the 2000 Award. More specifically, Claimant seeks<sup>1</sup>:
- a) a decision declaring that Respondent has breached the 2000 Award and the BIT;
39. b) a decision ordering Respondent to pay Claimant damages in the amount of 55,173 million USD on account of its breaches of the 2000 Award and the BIT which had the effect of preventing Claimant from developing Gala into a full national network as of January 1, 2001 and from establishing two other national networks (an FM radio network as of January 1, 2002 and an AM network as of July 1, 2004); or
- alternatively ordering Respondent to pay Claimant damages in the amount of 51,277 million USD on account of its breaches of the 2000 Award and the BIT which blocked Claimant from developing Gala into a full national network as of January 1, 2004 and developing a second FM national network as of January 1, 2002; or
  - alternatively ordering Respondent to pay Claimant damages in the amount of 34,732 million USD on account of its breaches of the 2000 Award and the BIT which blocked Claimant from developing Gala into a full national network as of January 1, 2001;
- c) a decision ordering Respondent to pay Claimant damages in the amount of one million USD for Respondent's failure to take reasonable measures to correct interference with Gala's 100 FM frequency, in breach of the Award and the BIT from the year 2000 to August 2008;
  - d) a decision ordering Respondent to pay Claimant damages in the amount of 958,000 USD representing loss of profits for Respondent's enactment of the Law on Television and Radio Broadcasting (the "LTR") and/or application thereof in breach of the BIT;
  - e) a decision ordering Respondent to pay Claimant moral damages in the amount of three million USD for Respondent's harassment of Claimant, in breach of the BIT;
  - f) the costs of this arbitration, including all expenses that Claimant has incurred, legal counsel, experts and consultants, as well as Claimant's internal costs in pursuing this arbitration, all of the fees and expenses of the arbitrators, fees for use of the facilities of the Centre;

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<sup>1</sup> Claimant's Post-Hearing Memorial, para. 151.

- g) compound interest at a rate of LIBOR + 3, compounded semi-annually, to be established on the above amounts as of the date these amounts are determined to have been due to Claimant; and
- h) any such other and further relief as the Arbitral Tribunal shall deem appropriate.

40. Respondent seeks<sup>2</sup>:

- a) a decision dismissing all Claimant's claims, or a substantial part thereof, for lack of jurisdiction;
- b) a decision dismissing Claimant's claims in their entirety; and
- c) a decision awarding to Respondent its fees, costs and expenses in connection with this proceeding.

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<sup>2</sup> Respondent's Rejoinder, para. 252; Respondent's Post-Hearing Memorial, para. 653.

## V. JURISDICTION

41. The Tribunal has decided to join Respondent's objections on jurisdiction to the merits of the dispute, in accordance with Article 41(2) of the ICSID Convention.

### V.1. POSITIONS OF CLAIMANT AND RESPONDENT

42. Claimant's basic allegations in this arbitration are twofold:

- first, that Respondent's actions constitute a breach of the Settlement Agreement; and
- second, that Respondent has breached the BIT by subjecting Claimant to unfair, inequitable, arbitrary and discriminatory treatment, harassment and creeping expropriation and by enacting a new law in violation of Article II.6 of the BIT.

43. Respondent raises a number of jurisdictional objections<sup>3</sup>:

- that the Centre lacks jurisdiction for claims arising out of the Settlement Agreement;
- that there is no investment underlying the claims related to the tenders for additional frequencies;
- that Claimant's capital invested did not emanate from abroad as required;
- that Claimant has not made out a *prima facie* case of expropriation.

44. Claimant denies these jurisdictional objections and affirms the Centre's jurisdiction and the Tribunal's competence to decide all claims raised.

### V.2. DECISION OF THE TRIBUNAL

45. In order for the Centre to have jurisdiction and for the Tribunal to have competence with regard to these claims, four well known conditions must be met, three deriving from Article 25 of the ICSID Convention and a fourth resulting from the general principle of law of non-retroactivity:

- first, a condition *ratione personae*: the dispute must oppose a Contracting State and a national of another Contracting State;
- second, a condition *ratione materiae*: the dispute must be a legal dispute arising directly out of an investment;
- third, a condition *ratione voluntatis*: the Contracting State and the investor must consent in writing that the dispute be settled through ICSID arbitration;
- fourth, a condition *ratione temporis*: the ICSID Convention must have been applicable at the relevant time.

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<sup>3</sup> Respondent's Memorial in Support of its Objections to Jurisdiction; Respondent's Rejoinder, paras. 146-256.

46. The jurisdictional requirements of Article 25 of the ICSID Convention must be read in conjunction with those of the BIT. The relevant provisions are Article VI.1 and VI.4 of the BIT, which read as follows:

*“VI.1. For purposes of this Article, an investment dispute is a dispute between a Party and a national or company of the other Party arising out of or relating to (a) an investment agreement between that Party and such national or company; (b) an investment authorization granted by that Party’s foreign investment authority to such national or company; or (c) an alleged breach of any right conferred or created by this Treaty with respect to an investment.*

*[...]*

*VI.4. Each Party hereby consents to the submission of any investment dispute for settlement by binding arbitration in accordance with the choice specified in the written consent of the national or company under paragraph 3. Such consent, together with the written consent of the national or company when given under paragraph 3 shall satisfy the requirement for:*

*(a) written consent of the parties to the dispute for purposes of chapter II of the ICSID Convention (Jurisdiction of the Centre) and for purposes of the Additional Facility Rules; and*

*(b) an “agreement in writing” for purposes of Article II of the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, done at New York, June 10, 1958.”*

47. In addition, Article I.1(a) of the BIT defines the term “investment”:

*“I.1. For the purposes of this Treaty,*

*(a) “investment” means every kind of investment in the territory of one Party owned or controlled directly or indirectly by nationals or companies of the other Party, such as equity, debt, and service and investment contracts; ...”*

48. Jurisdiction *ratione temporis* has not been challenged and the Tribunal will not analyze it. It will focus on jurisdiction *ratione personae* (V.3), *materiae* (V.4) and *voluntatis* (V.5).

### **V.3. JURISDICTION *RATIONE PERSONAE***

49. Claimant is, and at all relevant times has been, a national of the United States and thus a “*national of another Contracting State*” under Article 25 of the ICSID Convention as well as a “*national of a Party*” under the BIT. Ukraine, since July 7, 2000, is a State Party to both the ICSID Convention and to the BIT.

50. The requirements for ICSID jurisdiction *ratione personae* are hence satisfied.

#### V.4. JURISDICTION *RATIONE MATERIAE*

51. Article 25(1) of the ICSID Convention further requires a “*legal dispute arising directly out of an investment*”. Claimant submits that he has made investments in Gala Radio and that he is Gala’s major shareholder. It is undisputed that the present dispute is a legal dispute and that it arose directly out of these investments.

##### Claimant’s investment

52. Gala was not founded by Mr. Lemire – in fact, Ukrainian legislation requires that radio broadcasters be founded by Ukrainian nationals<sup>4</sup>. The law however authorizes foreign investments in the broadcasting sector (Article 12.3 of LTR). Mr. Lemire bought participations in Gala, an existing company, which already had a radio licence, and which had been promoted by a Ukrainian citizen, Mr. Gliub Maliutin<sup>5</sup>, and founded by a Ukrainian company called Provisen. On June 8, 1995, two Investment Agreements were signed by Mr. Lemire providing (somewhat diffusely) for contributions in cash and in kind amounting to 290,000 USD plus 3,000,000 USD<sup>6</sup>.

53. The actual amount contributed by Mr. Lemire is disputed. Respondent’s expert acknowledges that at least 141,000 USD were invested by Mr. Lemire<sup>7</sup> and Respondent has accepted an investment of 236,000 USD<sup>8</sup>. Claimant himself states that his investment amounts to well over 5,000,000 USD<sup>9</sup>. This number seems to include real estate held in Mr. Lemire’s name, and let rent free to Gala, and payments made directly by him on behalf of the company<sup>10</sup>. No document has actually been produced in this arbitration, giving a precise breakdown of Mr. Lemire’s contributions. It seems, moreover, that for accounting purposes, the expenditures made directly by Mr. Lemire on behalf of Gala are not recorded in Gala’s books<sup>11</sup>.

54. Summing up the evidence, the Tribunal has no doubt that Mr. Lemire actually made an investment in Ukraine, although the undisputed total amount is only 236,000 USD. Respondent has not challenged that Mr. Lemire is – at least since 2006 – indirect owner of 100% of the share capital of Gala. The evidence shows that Mr. Lemire has made payments with his own moneys on behalf of Gala. But the record of the actual amounts paid has not been produced, and that the total exceeds 5,000,000 USD is nothing more than affirmation<sup>12</sup>.

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<sup>4</sup> Article 13 of the 1993 Law on Television and Broadcasting

<sup>5</sup> Respondent has presented a Witness Statement from Mr. Maliutin.

<sup>6</sup> Annex F of EBS Expert Report.

<sup>7</sup> EBS Expert Report, p. 5.

<sup>8</sup> Respondent’s Exhibit at the hearing RH-1, p. 23.

<sup>9</sup> Mr. Lemire, Hearing Transcript 1, p. 279, at 10.

<sup>10</sup> Mr. Lemire, Hearing Transcript 1, p. 281, at 14.

<sup>11</sup> Mr. Lemire, Hearing Transcript 1, p. 286, at 23.

<sup>12</sup> Mr. Lemire, Hearing Transcript, p. 285, para. 20 and p. 304, para. 9.



55. It is immaterial that Claimant holds his controlling stake in Gala through Mirakom. Article I.1(a) of the BIT accords treaty protection to “*every kind of investment in the territory of one Party owned or controlled directly or indirectly by nationals...of the other Party*”.

Transfer of funds from abroad

56. Respondent further submits that Claimant has failed to prove the transfer of his invested funds into Ukraine from abroad. However, neither the BIT nor the ICSID Convention includes an origin-of-capital requirement. Nor is such a requirement to be inferred from the purposes of the BIT and/or the ICSID Convention.
57. In setting out the purposes of the BIT, the Preamble emphasises the promotion of investments of nationals of one party in the territory of the other, without any reference to the origin of the funds invested; and Article I.3 of the BIT implies that reinvested earnings qualify as investments under the BIT; these earnings by definition originate within the host country.
58. Moreover, Claimant’s certificate of registration dated September 18, 1995 shows that at least part of his investment capital originates from abroad; this suffices for jurisdictional purposes.
59. Hence, the requirements for ICSID jurisdiction are also satisfied *ratione materiae*.

**V.5. JURISDICTION *RATIONE VOLUNTATIS***

60. A singular feature of this arbitration is that consent to ICSID arbitration was formalized in two different legal instruments: the Settlement Agreement and the BIT. Each will be analyzed separately.

**A) Jurisdiction With Respect to Claims Based on an Alleged Breach of the Settlement Agreement/2000 Award**

61. The Settlement Agreement contains the following dispute resolution provision in clause 31 (the “Arbitration Clause”):

*“All the disputes arising from or in connection with this Agreement shall be settled by negotiations. In the event no solution is achieved within 60 days from the date of beginning of negotiations, either party may address to the ICSID its application for settlement under the ICSID Additional Facility Arbitration Rules.”*

62. Respondent however objects to the Tribunal’s jurisdiction for alleged claims under the Settlement Agreement on two grounds, namely the fact that (a) the Settlement Agreement was recorded as an award, and (b) the Arbitration Clause refers, for settlement of disputes under the Agreement, to the ICSID Additional Facility Arbitration Rules, rather than the ICSID Arbitration Rules.

a) Settlement Agreement as an award

63. Respondent argues that the parties voluntarily transformed the Settlement Agreement into an enforceable award, in order to benefit from the jurisdictional effect of such measure. Claimant thus waived his right to the dispute resolution mechanism contained in the original accord<sup>13</sup>. Awards under the ICSID Additional Facility must be enforced through the New York Convention – there is no scope for enforcement through the arbitration clause inserted in the Settlement Agreement.
64. The Tribunal disagrees with Respondent’s theory. It is not supported by the text of the ICSID Convention or applicable arbitration rules, and it is based on a misunderstanding of the differences between disputes arising out of a contract and enforcement of an award.
65. The Settlement Agreement is first and foremost a contract, product of consent expressed by both parties. Settlement agreements, like all contracts, may give rise to disputes. In the Settlement Agreement Mr. Lemire and Ukraine agreed that disputes arising “*from or in connection*” with this contract should be settled by arbitration.
66. After executing the Settlement Agreement both parties requested, and the Tribunal in the First Arbitration agreed that “the Tribunal shall record the settlement in the form of an award” (as authorized by Article 49(2) of the ICSID Additional Facility Arbitration Rules).
67. The precise text of the 2000 Award is as follows:
- “Accordingly the Tribunal orders unanimously that the said agreement between the Parties as set forth below shall be recorded verbatim as an award on agreed terms”.*
- And then the award copies *ad pedem literae* the full text of the Settlement Agreement, including the Arbitration Clause.
68. Respondent’s basic argument is that, by accepting that the Settlement Agreement be recorded as an award, Claimant was waiving his right to the Arbitration Clause.
69. The Tribunal disagrees. There is no hint that, by requesting the Tribunal to issue the consent award, Claimant proposed and Respondent accepted neutralisation of the Arbitration Clause.
70. It is very telling that the 2000 Award reproduces the complete text of the Settlement Agreement, including the Arbitration Clause. The parties could have requested that the Arbitration Clause be excluded from the 2000 Award. They did not. What the 2000 Award proves is that as of the date of the request of its issuance, each party reiterated its consent that all disputes arising from or in connection with the Settlement Agreement be solved by arbitration.

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<sup>13</sup> Respondent’s Rejoinder, para. 155.

71. In fact, the purpose and meaning of the consent award is very transparent. What the parties were seeking when they asked for the 2000 Award was twofold:
- on the one hand, they wished to have the possibility of recognition and enforcement of the Settlement Agreement through the New York Convention; i.e. that a Court recognise the legal force and effect of the award and ensure that it is carried out in accordance with its terms;
  - on the other, if any dispute arose from or in connection with the Settlement Agreement, the parties reiterated their agreement that disputes should be resolved by arbitration.
72. With regard to the Settlement Agreement, the relief sought by Claimant in this arbitration is a declaration that Respondent has breached its obligations and an order for payment of damages. The thrust of Claimant's argument is that during the execution of the Settlement Agreement, Respondent has defaulted. Respondent denies such accusation. Consequently, a dispute regarding the execution of the Settlement Agreement has arisen.
73. This dispute can and must be submitted to arbitration in accordance with Clause 31 of the Settlement Agreement:
- first, because that is what the parties bargained for in the Arbitration Clause; and
  - second, because a procedure under the New York Convention before a national Court can only result in the recognition and enforcement of the award, not in resolving a dispute related to the breach of obligations and the determination of damages; if Claimant had submitted the relief sought in this procedure to a national Court, Respondent could have validly raised the defence of Article II.3 of the New York Convention<sup>14</sup>, and requested that the judge refer the dispute to arbitration.
- b) Reference to ICSID Additional Facility Arbitration Rules
74. The Arbitration Clause provides for "*settlement under the ICSID Additional Facility Arbitration Rules*" of "*all the disputes arising from or in connection with this Agreement*".
75. When the Settlement Agreement was signed on March 20, 2000 Ukraine had not ratified the ICSID Convention, and consequently the Centre could only administer arbitrations involving Ukraine under the Additional Facility Rules (Article 2(a)). Things moved quickly thereafter. On July 7, 2000 the ICSID Convention entered into force in Ukraine. With the effectiveness in Ukraine of the ICSID Convention, the Additional Facility became unavailable and was superseded by arbitration under ICSID Rules. Notwithstanding this fact, the

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<sup>14</sup> Article II.3 of the New York Convention provides that: "*The Court of a Contracting State, when seized of an action in a matter in respect of which the parties have made an agreement within the meaning of this Article, shall, at the request of one of the parties, refer the parties to arbitration, unless it finds that the said agreement is null and void, inoperative or incapable of being performed*".

parties requested, and on September 18, 2000 the Tribunal in the First Arbitration issued the 2000 Award, with an unchanged Arbitration Clause.

76. Claimant argues that the reference to the Additional Facility in the Arbitration Clause implicitly includes a reference to ICSID proper, once it became available<sup>15</sup>.
77. Respondent objects and refers to the clear, unambiguous terms of the Arbitration Clause<sup>16</sup>.
78. On this issue the Tribunal sides with Claimant.
79. The Arbitration Clause states that “*either party may address to the ICSID its application for settlement*”, and then adds “*under the ICSID Additional Facility Arbitration Rules*”. These Rules were available when the Clause was signed, but no longer once the Clause was incorporated into the 2000 Award, and since then they have ceased to be available. They have been superseded by the ICSID Arbitration Rules.
80. Imprecise arbitration clauses are a frequent occurrence in commercial arbitration. They must be interpreted by the arbitrators, in order to restore the true intention of the parties, distorted by the parties’ ignorance of the mechanics of arbitration, error in designating the correct institution or rules, or, as here, supervening legal developments<sup>17</sup>.
81. In our case, the true intent of the parties is very clear: the Arbitration Clause explicitly says that “*either party may address to ICSID its application for the settlement*” of the dispute. The very wording of the Arbitration Clause evidences the parties’ wish that disputes arising from the Settlement Agreement be settled through arbitration administered by ICSID, and not through any other dispute settlement mechanism, nor by any national Court.
82. Where the parties were unclear is not in the description of the dispute settlement mechanism which they preferred, but in an ancillary point: the precise rules which the institution entrusted with the administration of the arbitration should apply. The parties correctly referred to the Rules which were applicable at the time the Settlement Agreement was executed – the ICSID Additional Facility Arbitration Rules. And when the Settlement Agreement was recorded as an award a couple of months later, they did not take into account that in the meantime Ukraine had ratified the ICSID Convention, that the applicable arbitration rules now were the ICSID Arbitration Rules, and that the rules which they were referring to– the ICSID Additional Facility Rules – were in fact no longer available.

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<sup>15</sup> Claimant’s letter dated March 17, 2008, paras. 13 and 14; Claimant’s Reply Memorial, paras. 39-43.

<sup>16</sup> Respondent’s Memorial in Support of its Objections to Jurisdiction, para. 19.

<sup>17</sup> This is not controversial: see e.g. Fouchard/Gaillard/Goldman, “International Commercial Arbitration” (1999), p. 263.

83. The ambiguity elided by the parties when they recorded the Settlement Agreement as an award is purely technical and ancillary, and cannot distort the real intent: that any dispute arising from or in connection with the Settlement Agreement be settled by arbitration administered by ICSID, and governed by the appropriate rules approved by the Centre: before Ukraine had ratified the ICSID Convention, the ICSID Additional Facility Arbitration Rules; thereafter, the ordinary ICSID Arbitration Rules.

**B) Jurisdiction With Respect to Claims Based on an Alleged Violation of the BIT**

84. By Article VI.3 of the BIT, Ukraine agreed that investment disputes with American investors be submitted to arbitration administered by the Centre. Claimant accepted the offer by filing this arbitration. Respondent objects to the Centre's jurisdiction and the Tribunal's competence, but not with regard to the claims *in toto*, but only with regard to some specific claims.

85. These claims, and the reasons for objecting to jurisdiction, are explained in the following paragraphs.

a) Claims related to tenders for frequencies and broadcasting licences

86. Respondent objects to the Tribunal's competence with respect to claims arising out of Claimant's failure in tenders for additional frequencies on the ground that such tenders precede investments and that pre-investment activities fall outside the ICSID Convention. Respondent, however, seems to concede that such pre-investment activities are within the scope of the BIT<sup>18</sup>.

87. Claimant disagrees<sup>19</sup>, arguing that Mr. Lemire established investments in radio networks in Ukraine, and that they were harmed by Respondent's acts and omissions.

88. The Tribunal sides with Claimant.

Pre-investment activities

89. Mr. Lemire's claim related to tenders for frequencies and broadcasting licences does not refer to, and cannot be considered as, a pre-investment activity. Pre-investment activities are those which precede the actual investment. Whether pre-investment activities merit treaty protection is debatable. But it is irrelevant for the purpose of adjudicating Claimant's claims in this arbitration, since the Tribunal has already established that Mr. Lemire has made investments in Gala Radio and is Gala's sole shareholder, and that these investments qualify for protection under the BIT.

90. If an investor claims that his investment, once made, was subsequently denied frequencies and broadcasting licences in violation of Ukraine's obligations as assumed in the BIT, this claim constitutes an "investment dispute" for the

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<sup>18</sup> Respondent's Rejoinder, para. 184.

<sup>19</sup> Claimant's Reply Memorial, para. 52.

purposes of Article VI of the BIT; the Centre has jurisdiction and the Tribunal competence to adjudicate it.

91. This conclusion is confirmed by the text of the BIT. The BIT expressly extends protection to “*associated activities*” which include “*access to ... licences, permits and other approvals...*” (see Articles I.1 (e) and II.11 (b) of the BIT). Article II.3 (b) moreover provides that “*Neither Party shall in any way impair by arbitrary or discriminatory measures the . . . expansion . . . of investments*”. The allocation of frequencies was a condition for Claimant’s ability to expand his investment. Claimant’s allegations related to tenders for frequencies and licences thus fall within the scope of the BIT.

Article 25(1) of the ICSID Convention

92. Respondent submits that disputes related to the allocation of new frequencies, while arguably within the ambit of the BIT, do not arise “*directly*” out of an investment and therefore fall short of the requirements of Article 25(1) of the ICSID Convention. In Respondent’s view, moreover, the narrower definition in the ICSID Convention prevails over the broader definition in the BIT.
93. The Tribunal sees the force in Respondent’s submission that bilateral treaties cannot extend the scope of the multilateral ICSID Convention. However, where the ICSID Convention is open to interpretation, such interpretation should seek compatibility rather than contradiction.
94. The Tribunal must therefore determine whether disputes related to the allocation of frequencies and issuance of broadcasting licences may be considered as “*arising directly out of an investment*” within the meaning of Article 25(1) of the ICSID Convention. For this purpose, Claimant’s case must be distinguished from the scenario where an applicant intends to enter a market for the first time. In such scenario, the application for frequencies and licences indeed is a step towards facilitating a planned investment, because no investment exists at the time of the allocation process.
95. In the present case, Claimant had already invested in Gala Radio; and Gala was a going concern at the time of the tenders. The applications for additional frequencies and licences formed an integral part of Gala’s business operations. They were intended to defend and expand Gala’s market share against growing competition and thus enhance the sustainability and profitability of Claimant’s investment. Disputes affecting these objectives thus are directly related to Claimant’s investment as controlling shareholder of Gala.
96. In accordance with the purposes of the ICSID Convention and consistent with its wording, the Tribunal therefore affirms its jurisdiction for disputes arising out of Gala’s treatment in tender proceedings for additional frequencies and licences.
97. For this conclusion, it is immaterial whether the receipt of additional frequencies had already been envisaged in Claimant’s initial business plan and whether Respondent had made any commitment to support such a business

plan. It suffices that the additional frequencies were sought by Gala as part of its strategy to defend and/or expand its market share.

98. It is furthermore immaterial whether additional frequencies were sought to extend the reach of Gala's existing program or to access new audiences with newly designed programs. In either case, the applications were part of Gala's business strategy to maintain and enhance its position in the Ukrainian market. They formed an integral part of Gala's overall business operation. The Tribunal's assumption of competence thus extends to applications by Gala for frequencies with a view to creating new networks for young and mature audiences<sup>20</sup>.

b) Claimant has failed to establish a *prima facie* case of expropriation

99. Respondent has raised the issue that there is an initial threshold that must be crossed by any claimant arguing expropriation: that the facts adduced show at least *prima facie* the legal requirements of expropriation under international law<sup>21</sup>. And in Ukraine's opinion, the very facts alleged by Claimant are not capable of constituting expropriation, and consequently the Tribunal should dismiss this claim for lack of jurisdiction – as did the Tribunal in the *Telenor v. Hungary* case<sup>22</sup>.

100. Claimant countered Respondent's objection arguing that for jurisdictional purposes the *prima facie* test was in fact easily met. As Claimant explained<sup>23</sup>, he was presenting claims for:

- expropriation of a beauty salon;
- expropriation of the rights to the Energy trademark; and
- creeping expropriation of the Gala Radio network, a process that yet has to be completed but which, in Claimant's submission, appears imminent.

101. In the course of the procedure, Claimant has however dropped the claims for expropriation of the beauty salon and of the Energy trademark<sup>24</sup>, and the creeping expropriation of the Gala Radio network is subsumed in the allegation of harassment and a request for moral damages (see paragraph 500 below).

102. Respondent's allegation consequently has become moot.

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<sup>20</sup> Respondent's Rejoinder, paras.189 and 202.

<sup>21</sup> Respondent's Rejoinder, para. 239.

<sup>22</sup> *Telenor Mobile Communication A.S. v. The Republic of Hungary*, ICSID Case No.ARB/04/15, Award of 13 September 2006.

<sup>23</sup> Respondent's Rejoinder, para. 88.

<sup>24</sup> See Claimant's Post-Hearing Memorial.

## **VI. ALLEGED BREACHES OF THE SETTLEMENT AGREEMENT**

103. In the Settlement Agreement of March 20, 2000, Respondent assumed the following obligations:

- Clause 13(a):

*“By April 15, 2000 the Commission of experts, appointed by the Respondent, shall examine the quality of broadcasting within the radio frequencies band of FM 100-108. Based on the conclusions of the Commission, the Respondent will take necessary, reasonable among others, technical measures to remove the obstacles (if any) for radio broadcasting of Gala Radio on FM 100 in Kiev by June 1, 2000”.*

- Clause 13(b):

*“By May 15, 2000 the Respondent in person of the State Committee on Communications and Information Technology, agrees to use its best possible efforts to consider in a positive way the application of Gala Radio to provide it with the licences for radio frequencies (provided there are free frequencies bands) in the following cities: [...]*

*The Claimant can apply for the radio channels in the above cities to the National Council for TV and Radio Broadcasting (hereinafter called “the National Council”) in a due course in accordance with the current legislation after the National Council has been fully personally formed under the existing law of Ukraine. The Respondent, within the limits of its powers, will assist for the positive consideration of this issue at the National Council.*

*The granting of licences for radio frequencies and broadcasting channels will be made in accordance with the requirements of Ukrainian legislation upon payment of the licence fees”.*

104. Claimant alleges that Respondent has defaulted on both sets of obligations. Respondent’s position, on the contrary, is that it has fully complied with these obligations.

105. Before analysing the parties’ allegation, it is necessary to establish the law applicable to the Settlement Agreement (VI.1), and the criteria to be applied in its construction (VI.2).

### **VI.1. APPLICABLE LAW**

106. Clause 30 of the Settlement Agreement provides that the applicable law shall be that determined by “*Article 55 of the ICSID Additional Facility Arbitration Rules*”. The relevant article in the Additional Facility Rules is in fact Article 54. The mistake is an obvious typographical error, and the Tribunal has no doubt that the common intent of the parties was to refer to Article 54. In accordance with this rule the Tribunal shall apply “(a) *the law determined by the conflict of laws rules which it considers applicable and (b) such rules of international law as the Tribunal considers applicable*”.



107. Should the Tribunal make use of this authorization to apply not only a municipal law, determined through conflict of laws rules, but also the “*rules of international law ... the Tribunal considers applicable*”?
108. The Settlement Agreement contains an extensive chapter called “*Principles of Interpretation and Implementation of the Agreement*”, which includes Clauses 20 through 26. These Clauses were reproduced, with very light linguistic adjustments, from the 1994 UNIDROIT Principles<sup>25</sup>.
109. It is impossible to place the UNIDROIT Principles – a private codification of civil law, approved by an intergovernmental institution – within the traditional sources of law. The UNIDROIT Principles are neither treaty, nor compilation of usages, nor standard terms of contract. They are in fact a manifestation of transnational law.
110. As the Preamble to the Principles states, they “*shall be applied when the parties have agreed that their contract be governed by them*” and they “*may be applied when the parties have agreed that their contract be governed by ‘general principles of law’, the ‘lex mercatoria’ or the like*”.
111. When negotiating the Settlement Agreement, the parties evidently gave thought to the issue of applicable law, and were apparently unable to reach an agreement to apply either Ukrainian or US law. In this situation, what the parties did was to incorporate extensive parts of the UNIDROIT Principles into their agreement, and to include a clause which authorises the Tribunal either to select a municipal legal system, or to apply the rules of law the Tribunal considers appropriate. Given the parties’ implied negative choice of any municipal legal system, the Tribunal finds that the most appropriate decision is to submit the Settlement Agreement to the rules of international law, and within these, to have particular regard to the UNIDROIT Principles.

## **VI.2. INTERPRETATION**

112. The parties have discussed the principles of interpretation to be applied to the Settlement Agreement. This issue is extensively dealt with in Clauses 20 through 26 of the Agreement.
113. Claimant has emphasized Clauses 20 (“*good faith and fair dealing in international business*”), 22 (“*common intent of the Parties*”), 23 (especially reference to “*preliminary negotiations*”) and 26 (non-performance to include “*improper performance or late performance*”) as well as Articles 1.7 and 4.1 of the 1994 UNIDROIT Principles. Respondent has referred to Clause 27 of the Settlement Agreement, pursuant to which the Settlement Agreement “*constitutes the entire agreement between the Parties on the subject matter hereof and supersedes all prior correspondence, negotiations and understandings between them with respect to the matters covered herein*”. Ukraine also relies on Article 5.5 of the 1994 UNIDROIT Principles (“*the way*”).

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<sup>25</sup> The 1994 UNIDROIT Principles have now been superseded by the 2004 edition.

*in which the obligation is expressed in the contract*") as the primary factor in determining the scope of an obligation.

114. The Tribunal agrees with Claimant that the "common intent" of the parties determines the scope of contractual obligations. However, the analysis of the common intent must start from the wording of the contract; and it must be presumed that the wording, as understood by a reasonable impartial person, properly reflects the common intent. While this presumption may be rebutted, the party doing so bears the burden of proof that the common intent differs from the wording. "Good faith" and "fairness in the market place" arguments are appropriate for interpreting ambiguous wording and filling lacunae in the text, but they can scarcely prevail against the clear wording of a contractual provision.
115. In accordance with Clause 23 of the Settlement Agreement, preliminary negotiations must – among other factors - be taken into account "for interpreting this Agreement". But Clause 27 provides that the Settlement Agreement "supersedes all prior correspondence, negotiations and understandings". Read together, these Clauses require that expectations raised during the negotiations of the Settlement Agreement must be reflected in the text of the Agreement. The text of the Settlement Agreement is the only source of obligations. The fact that an undertaking was discussed, or even orally agreed to during the negotiation phase, is not enough. The obligation must have been recorded in the Settlement Agreement. If the Settlement Agreement does include an obligation, then the scope of the undertaking can be construed in accordance with the expectations of the parties during the negotiation. Without support in the text, expectations nurtured by Claimant do not give rise to contractual obligations of Respondent.

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116. Claimant argues that Respondent has breached its obligations under the Settlement Agreement to correct interferences (VI.3.) and to award 11 FM frequencies (VI.4). Each allegation will be examined separately.

### **VI.3. RESPONDENT'S FAILURE TO CORRECT INTERFERENCES**

117. Clause 13(a) of the Settlement Agreement sets out Respondent's undertaking on this matter as follows:

*"By April 15, 2000 the Commission of experts, appointed by the Respondent, shall examine the quality of broadcasting within the radio frequencies band of FM 100-108. Based on the conclusions of the Commission, the Respondent will take necessary, reasonable among others, technical measures to remove the obstacles (if any) for radio broadcasting of Gala Radio on FM 100 in Kiev by June 1, 2000".*

118. Claimant argues that Respondent defaulted on its obligations under the above provision by failing to<sup>26</sup>:
- appoint a Commission of experts;
  - examine the quality of broadcasting on FM 100 between March 20, 2000 (execution of the Settlement Agreement) and April 15, 2000; and
  - cure interference with Gala's FM 100 frequency by June 1, 2000.
119. According to Claimant, such interference "*has continued unabated from prior to the time of the Settlement Agreement until today*"<sup>27</sup> (August 2008), and "*there was ongoing work between UCRF personnel and engineers from Gala Radio to attempt to cure the problem and Claimant had indeed continually complained about the existing interference on Gala's 100 FM frequency*"<sup>28</sup>.
120. Respondent counters that the function of the "Commission of Experts" was performed by the State Centre, which under Ukrainian law was in charge of detecting interferences with radio frequencies and was adequately equipped for that task. Between January 1999 and March 2000, the State Centre carried out a series of measurements and tests regarding alleged interference with FM 100; and tests on March 9 and 10, 2000 showed that no interference existed at that time with Gala's FM 100.
121. According to Respondent, there was no interference with FM 100 between March 20 (the date of the execution of the Settlement Agreement) and June 1, 2000 (the final date for remedial measures against any interference under Clause 13(a))<sup>29</sup>. Only a total of seven complaints about interferences were received from Claimant, the first on January 30, 2002 and the other between July 2004 and June 2007; no complaint was received in 2000 and 2001. The complaints in January 2002 and thereafter related to incidents that had arisen long after June 2000 and were thus outside the scope of the Settlement Agreement. Claimant consistently cooperated with the State Centre on the matter of interference and, before the institution of the present arbitral proceedings, Claimant never insisted on the appointment of an *ad hoc*-expert commission for examining interferences with Gala's FM 100.
122. Claimant has presented three specific breaches by Respondent of its obligations under Clause 13(a):
- the State Centre is not the appropriate "Commission of Experts" (A);
  - the interferences were not examined as provided for in the Settlement Agreement (B); and
  - insufficient measures were taken to correct interferences (C).
123. These contentions will be analysed in the following sections.

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<sup>26</sup> Claimant's Post-Hearing Memorial, para. 54.

<sup>27</sup> Claimant's Reply Memorial, para. 125.

<sup>28</sup> Claimant's Post-Hearing Memorial, para. 46.

<sup>29</sup> Respondent's Rejoinder, para. 291.

**A) The State Centre as the “Commission of Experts”**

124. Clause 13(a) of the Settlement Agreement entrusts the duty to examine the interferences to “*the Commission of experts, appointed by the Respondent*”. It does not require that the commission be constituted *ad hoc*.
125. Furthermore, Clause 13(a) clearly states that the Commission be appointed exclusively by Respondent, without participation of Claimant in the appointment process. The provision does not include any requirements for the composition of the commission, such as a representation of several agencies, or the inclusion of independent experts. Respondent was therefore free to entrust the tasks under Clause 13(a) to any group of experts with the technical skills to do the job.
126. Respondent chose the State Centre as the “Commission of Experts” with the duty to perform the examinations required under Clause 13(a). Claimant has not pleaded that the State Centre was unfit to examine the alleged interferences. In fact, the State Centre is the public entity which in accordance with Ukrainian legislation supervises interferences in radio frequencies, and it is adequately equipped to perform this task. To the Tribunal, the choice of the State Centre is appropriate, given the wording of the Settlement Agreement, and reasonable, given its experience and scope of activity.
127. There is one further argument: the record shows that Claimant never challenged the State Centre’s role as expert commission before instituting this arbitration, i.e. for some seven years. To the contrary, he has co-operated with the State Centre and addressed his complaints to it. He has thus acquiesced to the role of the State Centre.
128. The Tribunal can hence not find a violation of Clause 13(a) in Respondent’s assignment of the State Centre as expert commission.

**B) Examination of Interferences**

129. Pursuant to Clause 13(a), the examination of interferences should have taken place by April 15, 2000. In fact, such examinations were carried out between January 1999 and March 10, 2000, i.e. before execution of the Settlement Agreement on March 20, 2000. Claimant argues that these pre-agreement examinations are not sufficient to comply with the undertaking assumed by Ukraine in Clause 13(a) of the Settlement Agreement.
130. In Respondent’s opinion, the March 2000 tests proved the absence of any interference with Gala’s FM 100, so that any further tests were pointless. The Settlement Agreement had been negotiated since November 1999, and during these negotiations, and as a sign of goodwill, Respondent carried out the examinations required by Clause 13(a), even before the Settlement Agreement was signed and came into force. The Settlement Agreement signed on March 20, 2000 provided that the examination of the quality of broadcasting be performed “*by April 15, 2000*”. In fact, the examination had thus already been performed, before the signing of the Settlement Agreement.

131. Does this pre-agreement examination imply a default of Clause 13(a)?
132. One begins with the literal wording of the Clause, which requires that the examination be performed “*by April 15, 2000*”. An examination on March 10, 2000 evidently meets that requirement. But a literal interpretation is just a first approach. In accordance with Clauses 20 and 22 of the Agreement, the guiding principles of any interpretation shall be the common intent of the parties and good faith.
133. Did the common intent of the parties require that the examination be carried out after the signature of the Settlement Agreement? There is a very revealing fact: Claimant never requested that a second examination be performed after the signature of the Settlement Agreement. If he had, good faith would have precluded Respondent from refusing the request. But Mr. Lemire never did so. He accepted, at least tacitly, that the pre-agreement examination complied with the requirements of the Settlement Agreement.
134. Article 1.8 of the 2004 UNIDROIT Principles prohibits inconsistent behaviour:
- “A party cannot act inconsistently with an understanding it has caused the other party to have and upon which that other party reasonably has acted in reliance to its detriment”.*
135. Mr. Lemire did not require a second examination, and Ukraine reasonably understood that Claimant felt satisfied with the first examination, and consequently did not carry out a second one. Mr. Lemire cannot now retrace and argue that Respondent defaulted on its contractual obligations.

### **C) Adoption of Technical Measures To Remove Interferences**

136. Clause 13(a) of the Settlement Agreement obliges Respondent to “*take ... technical measures to remove the obstacles (if any) for radio broadcasting of Gala Radio on FM 100 ... by June 1, 2000*”. This language clearly limits the scope of the obligation to obstacles that existed before June 1, 2000; obstacles that might have arisen after this date fall outside the scope of the Settlement Agreement. (As to Respondent’s alleged duty to cure such obstacles under the BIT, see paragraph 493 below).
137. To find a breach of the Settlement Agreement, it is therefore crucial that interferences with Gala’s FM 100 preexisted June 1, 2000. Claimant has pleaded this by alleging that interference “*has continued unabated from prior to the time of the Settlement Agreement until today*”<sup>30</sup>. Respondent, on the other hand, argues that no interference occurred between March 10 and June 1, 2000 and that any interference which occurred long after June 1, 2000 was isolated and cannot be traced back to a cause pre-existing on June 1, 2000<sup>31</sup>.

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<sup>30</sup> Claimant’s Reply Memorial, para. 125.

<sup>31</sup> Respondent’s Rejoinder, para. 291-293.

138. As evidence for his assertion, Claimant presented a DVD of July 30, 2008<sup>32</sup> and witness statements on interferences of Messrs. Lemire<sup>33</sup> and Denisenko<sup>34</sup> (a manager of Gala). The witness statements, while confirming several interferences after June 2000, do not prove that the cause of such interferences pre-dated June 2000.
139. Claimant has submitted seven letters to the State Centre or the National Council complaining about interferences with FM 100<sup>35</sup>. However, these letters date from January 2002 to June 2007; they do not offer any indication, let alone evidence, that the cause pre-dated June 2000. Respondent, on the other hand, has submitted some eighty documents with test results showing that at different times after June 2000, there was no interference with Gala's FM 100<sup>36</sup>.
140. If interferences with FM 100 had been observed between March and June 2000, Claimant could at that time have requested the examinations and remedial measures foreseen in Clause 13(a) of the Settlement Agreement. Yet, there is no record of any complaint or other action of Claimant in this respect during the period March 2000 through January 30, 2002.
141. On the basis of the above record and in light of the language of Clause 13(a), the Tribunal concludes that Claimant has failed to prove a violation of the Settlement Agreement in this respect.

#### **VI.4. ALLOCATION OF FREQUENCIES**

142. The second allegation presented by Claimant refers to the granting of frequencies to Gala. Under Clause 13(b) of the Settlement Agreement, Respondent assumed several obligations with respect to the allocation of radio frequencies and broadcasting licences to Gala in 11 cities. The Clause reads as follows:

*“By May 15, 2000 the Respondent, in the person of the State Committee on Communications and Information Technology, agrees to use its best possible efforts to consider in a positive way the application of Gala Radio to provide it with the licences for radio frequencies (provided there are free frequencies bands) in the following cities: Kharkiv, Lviv, Donetsk, Zaporizhyya, Lugansk, Simpheropol, Dniepropetrovsk, Odessa, Vynnytsya, Kryviy Rog, Uzhgorod.*

*The Claimant can apply for the radio channels in the above cities to the National Council for TV and Radio Broadcasting (hereinafter called “the National Council”) in a due course in accordance with the current*

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<sup>32</sup> Claimant's Exhibit CM-96.

<sup>33</sup> Claimant's Witness Statement of Mr. Joseph Lemire dated 14 November 2008, p. 18 *et seq.*

<sup>34</sup> Claimant's Witness Statement of Mr. Sergey Denisenko dated 14 November 2008, pp. 7 and 8.

<sup>35</sup> Claimant's Exhibits CM-24, CM-63, CM-88, CM-114, CM-115 and CM-154; Respondent's Exhibit R-82.

<sup>36</sup> See Respondent's Exhibits R-29, R-63, R-87, R-88, R-104, R-140, R-141, R-146, R-149, R-155, R-205, R-314, R-315, R-316, R-317, R-318, R-322, R-326, R-347, R-369 and R-396.

*legislation after the National Council has been fully personally formed under the existing law of Ukraine. The Respondent, within the limits of its powers, will assist for the positive consideration of this issue at the National Council.*

*The granting of licences for radio frequencies and broadcasting channels will be made in accordance with the requirements of Ukrainian legislation upon payment of the licence fees”.*

#### Summary of facts

143. Under Ukrainian law, broadcasting requires both (i) a “radio frequency licence” from the State Committee on Communications and Information Technology and (ii) a “broadcasting licence” from the National Council. The National Council is a regulatory body established directly by law<sup>37</sup>, independent of the Government and reporting to both the President and the Parliament of Ukraine.

#### Delivery of the licences required

144. Claimant obtained all the licences mentioned in Clause 13(b) by October 9, 2002, i.e. within a period of some thirty months from the date of the Settlement Agreement.
145. The 11 radio frequency licences from the State Committee were obtained relatively expeditiously – two of them prior to the Settlement Agreement, four on April 14, 2000, another four on June 13, 2000, and the last on September 1, 2000.
146. The broadcasting licences suffered longer delays: two were received prior to the Settlement Agreement, seven on September 18, 2001, one on March 26, 2002, and the last on October 9, 2002.
147. Two broadcasting licences had already been awarded by the National Council prior to the Settlement Agreement. Thereafter, the National Council was temporarily inoperative. It was reconstituted in June 2000. After building the necessary administrative capacities, it resumed issuance of broadcasting licences in January 2001. Under the Ukrainian Law on Television and Radio Broadcasting, such licences were awarded on the basis of competitive tenders.
148. At its first meeting after its reconstitution on January 1, 2001, the National Council focused on issuing broadcasting licences to companies which were broadcasting on frequencies allocated to them by the State Committee during the time when the National Council was inoperative. Claimant was excluded from this tender. Shortly thereafter, on March 22, 2001, the National Council announced a tender, including eight of the nine frequencies still expected by Claimant under Clause 13(b) of the Settlement Agreement. The broadcasting licences for seven of these frequencies were granted to Gala on September 18,

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<sup>37</sup> Article 5, Law on Television and Radio Broadcasting dated December 21, 1993.

2001. In March and October 2002, Claimant received the last two outstanding broadcasting licences.

149. Four of the 11 frequencies allocated to Claimant under the Settlement Agreement were subsequently contested by the Armed Forces of Ukraine. These challenges were eventually resolved in 2008.

Violations asserted by Claimant

150. Claimant alleges seven violations of Clause 13(b) of the Settlement Agreement:

- late issuance of frequency licences by the State Committee (A);
- late constitution of the National Council (B);
- award of licences to other companies at National Council's first meeting in January 2001 (C);
- failure of National Council promptly to acknowledge the Settlement Agreement as binding (D);
- late award of broadcasting licences by National Council (E);
- allocation of low powered frequencies (F); and
- allocation of four frequencies which were contested by the Armed Forces of Ukraine (G).

151. Respondent denies all of the alleged violations.

152. Each alleged breach will be analysed *seriatim*.

**A) Issuance of Radio Frequencies by the State Committee**

153. Under Clause 13(b), paragraph 1 of the Settlement Agreement, “*by May 15, 2000 the Respondent, in the person of the State [Committee] agrees to use its best possible efforts to consider in a positive way the application of Gala Radio to provide it with the licences for [11] radio frequencies [...]*”. In accordance with the express terms of this contractual provision, Respondent undertook only to apply its best efforts, so that the applications from Gala to the State Committee would be granted by May 15, 2000 – not to achieve that result.

154. Article 5.1.4 of the 2004 UNIDROIT Principles defines the duty of best efforts in the following terms:

*“[...] To the extent that an obligation of a party involves a duty of best efforts in the performance of an activity, that party is bound to make such efforts as would be made by a reasonable person of the same kind in the same circumstances”.*

155. For Claimant to establish a violation of this best efforts obligation, it is not sufficient to prove that by May 15, 2000 the 11 radio frequency licences had not been granted – the required test is that he produce evidence showing that



Ukraine has failed to make such efforts as would be made by a reasonable government in the same circumstances.

156. What is the factual situation?
157. In accordance with the Settlement Agreement Ukraine had to use its best efforts to grant the frequency licences within two months of signature (signature was on March 20, and the deadline was May 15). Of the 11 licences envisaged, six were granted by the State Committee before the May 15, 2000 deadline, another four by June 13, 2000 (i.e. within one month of May 15) and the last one on September 1, 2000 (within 2 ½ months of the deadline).
158. Ukraine's efforts to induce its State Committee to grant the licences resulted in 11 of the 12 licences being issued within one month of the deadline. One licence was then granted with 2 ½ months delay.
159. In the Tribunal's opinion, these delays do not amount to a violation of Ukraine's best efforts obligation. There is often a gap between political decision and bureaucratic compliance. Paragraph 3 of Clause 13(b) explicitly requires that "*the granting of licences ... will be made in accordance with the requirements of Ukrainian legislation*". There is no evidence that Ukraine abated its pressure on the State Committee to perform. The State Committee issued the licences within time limits which are not unreasonable in the context of Ukrainian administrative practices.

**B) Late Constitution of the National Council**

160. It is undisputed that the National Council – which had been founded in 1993 – became inoperative in March 1999, because its members were not appointed. It remained inoperative until it was reconstituted in June 2000.
161. Claimant argues that the time period while the National Council was inoperative was abnormal and could not legitimately be expected<sup>38</sup>. This constitutes, in Claimant's opinion, a violation of the Settlement Agreement, and specifically of Respondent's obligation of good faith and fair dealing (Clause 20 of the Settlement Agreement).
162. The Tribunal is unconvinced.
163. The Settlement Agreement lacks any obligation to reconstitute the National Council, nor even an indication of when this could happen. To the contrary, Clause 13(b), paragraph 2, specifically states that applications for broadcasting licences must be made "*after the National Council has been fully personally formed*", without referring to any time frame – an explicit acceptance by Claimant that he was aware that the National Council was not operative at the time, and that the political decision to designate new members had to be implemented before the granting of the licences.

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<sup>38</sup> Claimant's Post-Hearing Memorial, para. 57.1.

164. The National Council was in fact reconstituted in June 2000, three months after the signature of the Settlement Agreement. Nothing in the Settlement Agreement legitimizes an expectation on the part of Claimant of a faster rehabilitation of the National Council. The absence of any time frame, and the explicit warning in Clause 13(b), paragraph 2, that Gala's applications will have to wait for the reconstitution of the National Council, point to the contrary.

**C) Failure of National Council To Promptly Acknowledge the Settlement Agreement as Binding**

165. When the National Council was eventually reconstituted in June 2000, Claimant immediately made numerous attempts to contact its members and to establish the process for obtaining the frequencies. In Claimant's opinion, the National Council's lack of reaction violated Ukraine's duties to act in good faith (Clause 20) and to cooperate (Clause 24)<sup>39</sup>.

166. Claimant's argument is not totally accurate.

167. It is undisputed that on March 20, 2001 the National Council adopted its Resolution No. 36 in which it decided to "*recognize priority position of CJSC Radio Company Gala*" in the allocation of broadcasting licences for the cities listed in Clause 13(b). It is immaterial whether the National Council's decision thus acknowledged a legal obligation, or whether it followed political considerations. In any case, it implies an acknowledgement of the Settlement Agreement and it granted Claimant the best position that he could expect.

168. Was this acknowledgement by the National Council unduly late?

169. The National Council had just started in January 2001 the process of organizing tenders for broadcasting licences. Given the complexities surrounding the Gala decision (reconciling "*positive consideration*" of Claimant's interests under the Settlement Agreement with the independence of the National Council and competing interests of other applicants), the March 20, 2001 decision cannot be considered as unduly late.

**D) Award of Licences to Other Companies at National Council's First Meeting in January 2001**

170. The Settlement Agreement regulates the issuance of broadcasting licences by the National Council in subparagraphs II and III of Clause 13(b) (reproduced above). These provisions create an obligation by Ukraine to "*assist [Claimant] for the positive consideration of this issue [the awarding of licences] by the National Council*". This obligation is not absolute, but subject to important caveats:

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<sup>39</sup> Claimant's Post-Hearing Memorial, para. 57.3.

- first of all, there is no time limit for the awarding of the licences (the May 15, 2000 deadline only works for the licences from the State Committee);
- second, Ukraine's obligation to assist is qualified with the words "*within the limits of [Respondent's] power*" – thus acknowledging that, in accordance with the law, the National Council is an independent public entity;
- third, Claimant could apply "*in a due course ... after the National Council has been fully personally formed*";
- fourth, application and granting of the licences were to be "*in accordance with the requirements of Ukrainian legislation*"; Clause 16 specifically added that "*the Agreement shall not be treated as a document granting any rights, benefits or privileges which are different or additional to the ordinary rights and obligations of a foreign investor in Ukraine in accordance with the Ukrainian laws and international treaties to which Ukraine is a party*".

171. The National Council held its first tender in January 2001, i.e. some six months after its reconstitution. This time was used by the National Council to build the logistics and administrative capacities for proper tender procedures. No fault can be found in the fact that the National Council gave first priority to creating the enabling logistics and administrative capacities for such proceedings.

172. In its first tender in January 2001, the National Council did not include any of the frequencies for which Gala had received frequencies from the State Committee. Rather, the National Council focused only on frequencies on which radio stations had been broadcasting without a valid broadcasting licence at that time.

173. Claimant submits that the organization of this first tender, from which Gala was excluded, implied a breach of the Settlement Agreement on two different counts:

- first, the National Council should have taken the opportunity of the first meeting to act on the licences for Gala; and
- second, the very existence of the first tender proves that radio stations existed which were broadcasting only with a licence from the State Committee, but without a licence from the National Council; since Gala already had licences from the State Committee, it should have been authorized to broadcast straight away.

174. The Tribunal disagrees with Claimant's first argument. Nothing in the Settlement Agreement implies that the National Council was bound to give first priority to Claimant. The National Council decided first to regularize broadcasting outside the law, which had developed during the time when it had been inoperative. This prioritization cannot be challenged under the Settlement Agreement. (As to the claim for violation of the Fair and Equitable Treatment ("FET") standard defined in the BIT, see paragraph 410 below).

175. The second argument merits a more in-depth analysis. Respondent itself has acknowledged that during the period when the National Council became inoperative, “*the State [Committee] became the central authority of the executive power, administering communications and radio frequencies of Ukraine and it developed the practice of granting licences for use of radio frequencies before the tenders for frequencies were announced*”<sup>40</sup>. What happened was illegal: under Ukrainian law, a radio station could not start broadcasting until it had obtained the necessary authorization from the National Council. Notwithstanding the legal requirements, during the 15-month period when the National Council was inoperative, certain Ukrainian companies were *de facto* awarded frequencies and authorized to broadcast, although they had only received the authorization from the State Committee.
176. Given this factual situation, Claimant argues that it could and should have been awarded frequencies and authorized to broadcast, once it had obtained the authorization from the State Committee in the summer of 2000, without having to wait for the reconstitution of the National Council and its formal tender procedure. And that, by not having done so, Ukraine violated its obligations under the Settlement Agreement.
177. After due consideration and some hesitation, the Tribunal rejects Claimant’s argument. In the Settlement Agreement, Ukraine could not undertake to perform acts contrary to Ukrainian law nor to authorise Claimant to operate new frequencies without the licence from the National Council; this would have violated the LTR. And Clause 13(b) specifically refers to the need for the National Council to be reconstituted and to issue the necessary licences.
178. But while it was agreed between Claimant and Respondent to act as required by Ukrainian law, Ukraine *de facto* authorized domestic radio companies to start broadcasting without the necessary authorizations. This situation was then cured in the first tender organized by the National Council after its reconstitution. While these actions do not constitute a violation of the Settlement Agreement, their status under the BIT will be analysed as such *below* at paragraph 410.

**E) Late Award of Broadcasting Licences by National Council**

179. The facts regarding the issuance of the broadcasting licences by National Council can be summarized as follows.

Facts

180. On March 1, 2000 (i.e. before the Settlement Agreement had actually been signed), the Minister of Economy of Ukraine wrote a proposal to the Cabinet of Ministers in order to “*entrust the [State Committee] and the [National Council] to allocate to CJSC RC “Gala” the following frequency assignments ...*”<sup>41</sup>. The frequencies referred to were five of those mentioned in the Settlement Agreement. Respondent has not provided any similar proposal for

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<sup>40</sup> Respondent’s Post-Hearing Memorial, para. 207.

<sup>41</sup> Respondent’s Exhibit R-27.

the remaining six frequencies promised in the Settlement Agreement, nor has Respondent submitted any decision from the Cabinet of Ministers approving the proposal of the Minister of Economy.

181. The record shows no further documents relating to the National Council, before a letter dated February 22, 2001 sent by Mr. Lemire to the Ministry of the Economy<sup>42</sup>. In the meantime, the State Committee had issued its licences, and the National Council had been reconstituted. Mr. Lemire's letter starts by stating that "*we have practically reached finalization of performance of the terms of the Dispute settlement Agreement*". This recital is important, because it shows that, at that moment, Claimant was convinced that Ukraine had not breached its obligations. Mr. Lemire then goes on, stating that a "*serious problem*" has arisen with the National Council because "*now this authority says that our frequencies are subject to a tender that will begin in some weeks*". He adds "*we understand that such situation has arisen due to the fact that the National Council is not properly informed*" and asks the Ministry of the Economy to intervene.
182. The record does not show the actions adopted by the Ministry of the Economy, but some advice must have been transmitted from the Ministry of the Economy because it is a fact that three weeks later, on March 20, 2001, the National Council decided to "*recognize priority position of CJSC Radio Company Gala*" in the allocation of broadcasting licences for the cities listed in Clause 13(b)<sup>43</sup>.
183. Claimant has argued that in a meeting on March 19, 2001 the Chairman of the National Council, Mr. Kholod, did not consider the Settlement Agreement as binding, stating that the National Council is a "*constitutional independent body, not subordinated to the government*" and "*that the government cannot adopt any act influencing the development of TV/radio broadcasting in Ukraine*". Claimant has produced a transcript of the meeting, which Mr. Lemire prepared at that time<sup>44</sup>. Mr. Kholod's statement has not been challenged and the Tribunal is inclined to accept it as true. But what is undeniable is that one day after the meeting, the National Council approved an official decision recognizing Gala's priority position to receive the frequencies promised in the Settlement Agreement.
184. Not only that, on March 22, 2001, i.e. only two days after this decision in favour of Gala, the National Council announced a new tender for frequencies, which included eight of the 11 frequencies mentioned in Clause 13(b) of the Settlement Agreement. In meetings in June and July 2001, the National Council decided to allocate seven of these frequencies to Gala; and the seven broadcasting licences were issued on September 18, 2001. Two other licences had already been issued on October 9, 1997 (long before the Settlement Agreement)<sup>45</sup>. Two remained pending – those in Dniepropetrovsk and Lviv - and were eventually issued on March 26 and October 9, 2002, respectively.

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<sup>42</sup> Respondent's Exhibit R-39.

<sup>43</sup> Respondent's Exhibit R-40.

<sup>44</sup> Claimant's Exhibit CM-101.

<sup>45</sup> In Kryviy Rog and Uzhgorod.

185. The frequency in Dnipropetrovsk was put to tender on July 26, 2001, but because of accumulated workload of the National Council, it was not approved until March 2002. As regards Lviv, the frequency under discussion had already been granted to other radio companies, whose rights had first to be cancelled, and this justifies the delay.
186. Summing up, in the end the National Council eventually granted to Gala all 11 broadcasting licences mentioned in Clause 13(b). Two had been issued before the Settlement Agreement, seven were issued in September 2001, one in March 2002 and the final one in October 2002.
187. Claimant alleges that this late performance of the Settlement Agreement is tantamount to non-performance, and asks the Tribunal to declare that Ukraine has breached the terms of the Settlement Agreement.

Ukraine's alleged breach

188. The Tribunal acknowledges that there were delays in the issuance of the broadcasting licences by the National Council. But this is not really the point under discussion. What is relevant is whether Ukraine has breached the terms of the Settlement Agreement and for this, it is paramount to look at the actual text of what was agreed.
189. As noted above, Clause 13(b) of the Settlement Agreement does not establish obligations of the National Council, nor does it create a deadline for the National Council to issue its decisions. It simply states Ukraine's commitment to "*assist for the positive consideration of this issue at the National Council*".
190. The difference between Clause 13(a) and Clause 13(b) is striking. The first Clause creates a best efforts obligation to issue the State Committee's authorization within an agreed time frame. It proves that when the parties wanted to establish obligations and time limits, they were perfectly capable of doing so in clear and unambiguous terms. Clause 13(b), however, lacks any specific time frame, and only refers to Ukraine's commitment to "*assist*" Mr. Lemire in his endeavours vis-à-vis the National Council.
191. Did Ukraine comply with its part of the bargain, assisting Claimant "*within the limits of its power*" and "*in accordance with the requirements of Ukrainian legislation*" in the obtaining of the licences?
192. The record suggests that the Ministry of the Economy's assistance was helpful indeed. Mr. Lemire wrote for the first time complaining on February 22, 2001. The National Council's initial attitude had been rather negative, as proven by the meeting with its Chairman. This was overcome, undoubtedly because of advice from the Government. On March 19, 2001 – one month after Mr. Lemire's first complaint – the National Council reversed its opinion and acknowledged Claimant's rights to the licences. Two days later, the first

tender was launched and nine of the 11 frequencies were duly awarded by September 2001 – not bad a record for an agency which had been recently reconstituted. The two other licences were delayed – one just because of bureaucratic delays, the other because of underlying problems with the entitlement to the frequency.

193. The facts proven in this arbitration do not substantiate Claimant’s claim that Ukraine failed to assist Claimant in his endeavour to obtain the broadcasting licences required from the National Council. In hindsight, it is unfortunate for Claimant that he only bargained for such a weak commitment from the counterparty. But the terms agreed are *lex contractus*, and it is those terms which the Tribunal must apply.

**F) Allocation of Low-Powered Frequencies**

194. The power of frequencies allocated to Gala ranged from 0.1 to 4kW with an average of 1,17 kW. On all its frequencies combined, Gala reaches some 22% of the population of Ukraine.

195. Claimant complains that the power of the frequencies allocated to Gala under the Settlement Agreement was far below his legitimate expectations and failed to meet his business purposes<sup>46</sup>. He alleges that in the negotiations of the Settlement Agreement as well as in pre-settlement communications with the National Council and other agencies of Respondent, much higher powers had been envisaged. In this respect, Claimant refers to correspondence between the National Council and State Inspection of Electric Communication of July 18 and October 18, 1995 which suggested the availability of much higher powered frequencies for Claimant<sup>47</sup>.

196. The Settlement Agreement, in any case, is silent on the power of frequencies sought by Claimant. Nor does it include any reference to Claimant’s business purposes – e.g. his desire to cover the whole territory of Ukraine - from which a minimum power could be inferred. While the preliminary negotiations between the parties and the purpose of the Settlement Agreement are to be taken into account in determining the common intent of the parties (per Clauses 23(a) and (d) of the Settlement Agreement), Clause 27 provides that the Settlement Agreement “*constitutes the entire agreement between the Parties on the subject matter hereof and supersedes all prior correspondence, negotiations and understandings...*”. This disqualifies prior correspondence and negotiations as a basis of obligations deliberately not mentioned in the Settlement Agreement. Claimant can therefore not derive a claim from pre-Settlement Agreement correspondence and negotiations.

197. Furthermore, the power of the frequencies awarded to Claimant was not abnormally low. Claimant has acknowledged that the average power of the frequencies allocated to him matched that of frequencies allocated to major competitors<sup>48</sup>. If Mr. Lemire felt that he was entitled to higher powered

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<sup>46</sup> Claimant’s Post-Hearing Memorial, para. 57.12.

<sup>47</sup> Claimant’s Exhibits CM-1 and CM-2.

<sup>48</sup> Claimant’s Post-Hearing Memorial, para. 57.12.

frequencies than his competitors, he would have had to include such entitlement in the Settlement Agreement. That has not happened.

198. Finally, Claimant learned the actual power of the frequencies allocated to him by September 1, 2000, when Gala received the licences from the State Committee. He thus knew the power of the frequencies on September 20, 2000 when the Settlement Agreement was recorded as the 2000 Award. Claimant did not seek any amendment of the Settlement Agreement, nor did he reserve his position.
199. The power of the frequencies was specified in the announcement of the tenders by the National Council. Claimant applied for these frequencies without complaining about the power. Thus, even if Claimant had been entitled to higher powered frequencies (which in the Tribunal's opinion does not derive from the Settlement Agreement), he acquiesced with the power of the allocated frequencies. To claim now that this lack of power gives rise to a breach of the Settlement Agreement denotes inconsistent behaviour, contrary to Article 1.8 of the 2004 UNIDROIT Principles.

**G) Allocation of Four Frequencies Which Were Contested by the Armed Forces of Ukraine**

200. Claimant finally complains that four of the frequencies allocated to him were contested by the Armed Forces of Ukraine<sup>49</sup>. In Claimant's opinion, Ukraine failed to de-conflict with the Army the frequencies awarded to Gala.
201. Respondent counters that the contests were prompted by Gala itself, which decided to change the location of its radio transmitters in three cities, by a distance of between 4.6 and 1.87 km, and increased the height of its antenna from 55 to 70 m in another<sup>50</sup>. These changes require the approval of the State Centre, which issues such authorization only with the approval by the General Headquarters of the Armed Forces. What happened in these four cases is that the General Headquarters of the Armed Forces refused to approve the changes. Refusal however did not mean that the frequencies became contested – Gala Radio in fact continued to broadcast on them. Gala was required only to change the locations and/or parameters of the transmitters following the recommendations of the State Centre, and obtained all required permits in 2008.
202. In the Tribunal's opinion, the difficulties incurred by Claimant with regard to these four frequencies do not constitute a breach of Respondent's obligations under the Settlement Agreement.
203. Under Clause 13(b) paragraph 2 Ukraine is bound to “assist” Claimant “*within the limits of its powers*” to obtain the authorization of the National Council. There is no express reference to the Armed Forces. But in an interpretation based on good faith, and bearing in mind that Clause 24 creates an obligation for each party to cooperate with the other, the Tribunal is prepared to admit

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<sup>49</sup> Claimant's Post-Hearing Memorial, para. 57.13.

<sup>50</sup> Respondent's Post-Hearing Memorial, para. 271.



that the obligation to assist should be extended to encompass not only the National Council, but also any other institution controlled by Ukraine. Consequently, in accordance with the Settlement Agreement, Respondent was under an obligation to assist Mr. Lemire in obtaining or maintaining the necessary authorizations from the Armed Forces.

204. Did Respondent fail to do so?

205. Claimant has argued that a senior manager of the State Centre admitted that Ukraine failed to de-conflict the four frequencies and apologized for the mistake by stating that “*unfortunately we failed to coordinate with military department*”<sup>51</sup>. An analysis of the evidence submitted by Claimant to prove this allegation does not support the conclusion. Claimant has presented a summary, prepared by his own officers, of a meeting on February 21, 2005 with Mr. Zhebrodski, a senior manager of the State Centre<sup>52</sup>. The exact exchange of words which, in accordance with that summary, took place between the officer of Gala and Mr. Zhebrodski is the following:

*“[...] Dima: Also, we have had interferences for the past few months and we have uncertain situation with Donetsk...”*

*Zhebrodski: I am going to call military department in Donetsk, what happened is back in 2000 we had a straight order to give you licence in Donetsk (107,2 fm) and unfortunately we failed to coordinate it with military dpt. Are they complaining?*

*Dima: No complaints so far, we have been working there for quite awhile.*

*Zhebrodski: Good. I am sure we can sort it out at least I am gonna try [...]”.*

206. The exchange of words between the officer of Gala and the senior manager of the Centre does not prove a breach by Ukraine of its obligation to assist Claimant. Quite to the contrary. What it shows is that, up to that moment (2005), the Army had not complained about the changes in Donetsk, that Gala was broadcasting there and that the State Centre was offering its help if a problem with the Army eventually arises. The problem afterwards materialized, and it was then, it appears, satisfactorily settled by 2008.

207. Summing up, the Tribunal is of the opinion that the problems which Gala encountered with the Army regarding four frequencies, which were eventually solved, do not amount to a default by Ukraine of its obligations under the Settlement Agreement.

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208. For the reasons explained above, the Tribunal concludes that, although Claimant encountered difficulties and delays in the obtaining of the frequencies expected under the Settlement Agreement, and although the end

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<sup>51</sup> Claimant’s Post-Hearing Memorial, para. 57.13.

<sup>52</sup> Claimant’s Exhibit CM-143.

result may not have satisfied all the expectations harboured by Claimant, Respondent did not breach any of the obligations it had assumed in that Agreement.

## VII. ALLEGED VIOLATIONS OF THE BIT

209. The Tribunal will first summarize Claimant's general allegations (VII.1), then Respondent's (VII.2), before analyzing and deciding the claims:
- in first instance, the Tribunal will study the alleged violation of the FET standard in the awarding of frequencies, and will effectively come to the conclusion that certain actions of Respondent are not compatible with this standard (VII.3);
  - a second section will be devoted to the alleged continuous harassment of Claimant, and his request for moral damages (VII.4);
  - in the next sections the Tribunal will reject Claimant's additional allegations, regarding an alleged violation of the FET standard by other actions performed by Ukraine (VII.5) and the applicability of the "Umbrella Clause" (VII.6); and
  - the Tribunal will then decide whether the 2006 amendment of the LTR and in particular the 50% Ukrainian music requirement amounts to a violation of the BIT (VII.7), and finally devote a short section to other allegations submitted by Claimant (VII.8).

### VII.1. CLAIMANT'S GENERAL ALLEGATIONS

210. Claimant's starting point is that, after having made the investment in Gala Radio, he had a legitimate expectation that he would be authorized to increase the size and audience of his radio company, and to establish three radio networks in Ukraine aimed at three different age groups. This plan had been discussed with the National Council members and encouraged by them.
211. As evidence of his expectations, Claimant especially relies on three documents, namely:
- a letter of July 18, 1995 from the Chairman of the National Council to the Chairman of the State Inspection on Electric Communications. This letter advises that "*the National Council...considers possibility to issue a licence to radio company GALA*" and requests the State Inspection "*to consider a possibility to give the company the frequency channels*" in 13 cities "*up to*" a specified power<sup>53</sup>;
  - a letter from the Chairman of the State Inspection on Electronic Communications to Claimant of October 18, 1995 informing of the availability of high power frequencies in the cities concerned and advising that the requisite permissions would be issued after Gala had received the pertinent broadcasting licences from the National Council<sup>54</sup>; and

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<sup>53</sup> Claimant's Exhibit CM-1; the English translation by mistake does not include the words "*up to*" which appear in the Ukrainian original.

<sup>54</sup> Claimant's Exhibit CM-2.

- a “Plan of Measures” negotiated between Claimant and the National Council in 1997 envisaging the allocation of frequencies to set up the Gala networks.
212. The main thrust of Claimant’s submission is that his legitimate expectations were thwarted by Ukraine’s actions in violation of the BIT. Claimant divides his allegations regarding these violations into four different sections<sup>55</sup>.
213. (i): In the first section, Claimant argues that Ukraine has violated the FET standard applicable to protected investments, and the prohibition of arbitrary and discriminatory measures, established in Article II.3. (a) and (b) of the BIT. Respondent’s specific actions, which have resulted in violation, can be divided in two groups:
- denial by the National Council of nearly 300 applications for frequencies submitted by Gala or Energy (a company also owned by Claimant), and illegal award of frequencies to companies other than Gala, during the period when the National Council was not operative; and
  - other actions performed by Respondent, like failure to correct the interferences on Gala’s 100 FM frequency, failure of the National Council to acknowledge its obligations under the Settlement Agreement; allocation of low powered frequencies to Gala; allocation of frequencies contested by the Army.
214. Of the alleged violations, the first one, the systematic denial of applications, is by far the most important one. Claimant argues that the Ukrainian legal procedure for allocation of frequencies is in itself unfair, inequitable, discriminatory and arbitrary. The procedure was moreover applied by the National Council in an unfair, inequitable and discriminatory fashion. It was tainted by interferences from other political organs of Respondent, including the President of Ukraine. The National Council’s aim was to preclude Gala from establishing multiple networks with national coverage. And it was successful in achieving this.
215. Claimant specifically refers to six tenders for frequencies, from 2002 through 2008, which in his view demonstrate Respondent’s practice in breach of the BIT.
216. (ii): In the second section, Claimant asserts that Respondent is submitting Gala to continuous harassment, in violation of Article II.3 (a) of the BIT. Respondent attempted to rely on the “founder” principle to deny Gala Radio an extension of its licence beyond the expiry date of September 18, 2008. Furthermore, there have been concerted efforts by the National Council to force Claimant out of the radio industry through ongoing actions of harassment and the issuance of unlawful warnings.
217. Claimant acknowledges that Respondent, after a few years of costly and lengthy litigation, ultimately cancelled the warnings, renewed the broadcasting

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<sup>55</sup> Claimant’s Post-Hearing Memorial, para. 64.

licence and applied the correct fee. But this eventual acceptance of Claimant's rights does not provide Ukraine with immunity from paying damages. Claimant alleges that Respondent's harassment since the Award has inflicted significant moral harm for which Respondent should be held liable in an amount of three million USD.

218. (iii): In the third section, Claimant submits that the 50% local music requirement in the LTR implies a violation of Article II.6 of the BIT, namely of the prohibition to "*impose performance requirements ... which specify that goods and services must be purchased locally, or which impose any other similar requirements*". Respondent has tried to justify the local music requirement on public policy grounds. In Claimant's opinion, the argument can at best justify an expropriation subject to the payment of the corresponding damages. The abnormal high level of the requirement and its abrupt incorporation caused Claimant to suffer loss for 2008 of advertising revenue, and such loss will continue until the expiration of the licence in 2015.
219. (iv): Finally, Claimant submits that, as a consequence of the Umbrella Clause contained in Article II.3 (c) of the BIT, all the contractual breaches of the Settlement Agreement have also been transformed into violations of the BIT, which entitle Claimant to be compensated for the damages suffered.

## **VII.2. RESPONDENT'S GENERAL ALLEGATIONS**

220. Respondent submits that its legal procedures for tenders involving radio frequencies are consistent with the requirements of the BIT; the implementation of these procedures also conforms with the BIT requirements.
221. The procedures for allocation of frequencies meet the standards of due process and procedural fairness, including the right to be heard. Frequencies are awarded by means of tenders announced in the press; prospective participants may submit their applications within one month of the notice. Such applications must include an information package. Thereafter, the National Council reviews the requests applying statutory criteria, and especially valuing the programming content proposed by each applicant. The meetings of the National Council are public, and the National Council holds briefings with representatives of the radio industry. A frequency is awarded to a radio company if the application receives at least five of the votes of the eight members of the National Council. All decisions of the National Council are published on the National Council's official website. Finally, the decisions of the National Council are subject to judicial review.
222. The National Council is an independent body. Each of its members exercises his or her judgment without external pressure, and Claimant's allegations of corruption and undue pressure are unsupported by any evidence. Furthermore, the LTR was amended in 2006, and since then members may be removed from their functions only by a joint decision from the Parliament and the President. Claimant's allegations of political influence were not corroborated during the hearing. No member of the National Council has been impeached, no one

associated with the National Council has been prosecuted for corruption, and no one has been convicted of wrongdoing.

223. Gala Radio was treated in a fair and equitable manner and was not discriminated against during the tenders. Claimant lost the four tenders which were analyzed during the hearing for objective reasons. There is no proof of unfair, inequitable, arbitrary and discriminatory treatment against Claimant.
224. Respondent also addresses Claimant's allegations regarding harassment. In Respondent's opinion, the procedure and practice of monitoring radio companies is consistent with Ukraine's obligations under the BIT. The results of any inspection are reviewed in a meeting of the National Council, where its members listen to a presentation of one of them, review a set of documents, listen to oral explanations from the representative of the radio company, and only thereafter take a decision.
225. All radio stations are continuously monitored. Those inspected and sanctioned are publicly mentioned in the Annual Report of the National Council. None of Gala's inspections was conducted in an unfair, inequitable or abusive manner. The warning issued against Gala on October 5, 2005 sanctioned Gala's refusal to produce documents and materials required for the inspection. This warning was successfully challenged before the Ukrainian Courts. On November 23, 2005 a second warning was issued for violating the quota of broadcasting in Ukrainian, the law on advertising, and the terms of its licence. The second warning was also cancelled by the Kiev Court. In May 2006 a third inspection was carried out. Since Gala had significantly improved its business activities, compared to previous periods, the National Council decided not to issue a third warning. There were subsequent inspections in March and June 2008, but they did not lead to any sanction, although Gala Radio admitted that by accident it had committed violations of the election legislation.
226. Other radio companies have also been inspected and received warnings - some of them three, and the National Council has started court proceedings in five cases in order to cancel the broadcasting licence.
227. The 2006 LTR had been debated by members of Parliament for more than three years, and its purpose was to make Ukrainian Law comply with European requirements. In Respondent's opinion, the LTR must be considered as part of the State's legitimate right to organize broadcasting. The 50% Ukrainian music requirement, which requires that either the author, the composer and/or the performer of 50% of the music broadcast be Ukrainian, was neither abrupt, nor excessive nor unfair. Gala Radio signed in August 2006 a Memorandum proposed by the National Council for the progressive implementation of the 50% requirement, and Gala Radio and all its competitors are presently in compliance. There is no link between the 50% Ukrainian music quota and the decline in Gala Radio's ratings.
228. Respondent finally makes three additional allegations:
- Claimant did not behave as a diligent businessman;

- Gala Radio did not take advantage of available remedies; and
- Claimant abused his position as a foreign investor.

### **VII.3. CLAIMANT’S FIRST ALLEGATION: THE VIOLATION OF THE FET STANDARD IN THE AWARDING OF FREQUENCIES**

229. The main thrust of Claimant’s allegation is that Ukraine has failed to provide fair and equitable treatment to its investment in Gala, and subjected it to arbitrary or discriminatory measures. Ukraine rejects both allegations. The Tribunal will analyze this dispute – which is the basic issue submitted to its adjudication - in a short introduction and three separate sections:

- the first devoted to the concept of FET standard, as defined in the BIT (VII.3.2);
- the second to the procedures for awarding frequencies under Ukrainian law (VII.3.3); and
- the third to the facts surrounding Gala’s applications for frequencies (VII.3.4).

#### **VII.3.1. INTRODUCTION**

##### Claimant

230. Claimant, Mr. Joseph Charles Lemire, is an American citizen residing in Ukraine. By profession, Mr. Lemire is a lawyer, although he also has experience in accounting. He is the owner and chairman of Gala, a closed joint stock company constituted in 1995 under the laws of Ukraine. His participation in Gala is held through another Ukrainian company, Mirakom. He initially purchased 30% of Gala, but since 2006 he indirectly owns 100% of the company<sup>56</sup>. The proven amount of his investment is 236,000 USD. There is circumstantial evidence that Mr. Lemire has made payments with his own monies on behalf of Gala. But the record of the actual amounts paid has not been produced, and Mr. Lemire’s statement that the total exceeds 5,000,000 USD<sup>57</sup> has not been locked up with hard evidence. The personal assets of Mr. Lemire and those of Gala appear to some extent commingled<sup>58</sup>.

##### Gala

231. Gala is a company which since 1995 operates a contemporary music radio station. It holds a licence to broadcast on two frequencies in Kyiv and on 12 other frequencies in nine areas of Ukraine. Gala Radio applied for and received a licence recognizing its status as a national broadcaster on October 17, 2007<sup>59</sup>. In the late 1990’s, Gala ranked amongst the most popular radio stations in Ukraine. Claimant acknowledges that its market share has declined – and attributes this decline to Respondent’s actions.

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<sup>56</sup> Mr. Lemire, Hearing Transcript 1, p. 283, at14.

<sup>57</sup> Mr. Lemire, Hearing Transcript 1, p. 285, at 20 and p. 304, at 9.

<sup>58</sup> Mr. Lemire, Hearing Transcript 1, p. 288, at 25.

<sup>59</sup> Respondent’s Exhibit R-153.

232. Gala has been a reasonably successful company. Its revenues have gone up from 600,000 USD in the year 2000 to 1.369,000 USD in the year 2007 (with a profit of 121,000 USD)<sup>60</sup>. As Respondent's expert witness says, "*while being small business in a competitive market and risky environment, it is obvious that Gala has become a successful national radio station, and as investor, Joseph Charles Lemire has achieved reasonably good results and revenue growth*<sup>61</sup>".
233. On a qualitative basis, Claimant has alleged and Respondent has accepted that Gala won the Radio Company of the year award for brand recognition in 1999, won an award for the best radio program on Olympic News from the Golden Pen competition organized by journalists and that four of the top 10 disk jockeys in Ukraine work for Gala, including the well-known DJ Pascha (the alias of Mr. Pavel Shylko), who testified in this arbitration<sup>62</sup>.

#### Mr. Lemire's relationship with the National Council

234. Respondent has insisted, throughout the procedure, that Mr. Lemire abused his position as foreign investor and harassed the National Council with rude, disrespectful and to some extent even aggressive conduct<sup>63</sup>. Respondent argues that Mr. Lemire has sent scores of hostile letters to the National Council, copying the former President of Ukraine, the current President of Ukraine, the Vice President of the United States, the US Ambassador and others. He also video-recorded meetings of the National Council.
235. The relation between Mr. Lemire and the National Council was not always tense. At the outset of the investment, in 1995, the relationship seems to have been friendly, and the National Council supported Mr. Lemire's efforts to invest in the Ukrainian radio sector. Suddenly the relationship soured in 1996, for no obvious reason. Asked by the Tribunal why his relationships with the National Council became hostile, Mr. Lemire has declared under oath that the reason was that "*at one point I was asked for a bribe and I said I would not pay*<sup>64</sup>". No further evidence of this alleged request for bribes has been produced.
236. What is undisputed is that in 1996 Gala Radio sued the National Council before the Ukrainian Courts, because Gala had been removed from the air by a decision of the National Council. On February 26, 1997, the Supreme Arbitration Court of Ukraine ruled in Gala's favor<sup>65</sup>. In 1997, Mr. Lemire initiated the First Arbitration against Ukraine, which eventually led to the Settlement Agreement and 2000 Award. In 2006 Gala challenged before the

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<sup>60</sup> EBS Expert Report, p. 6.

<sup>61</sup> EBS Expert Report, p. 5.

<sup>62</sup> Claimant's Memorial, para. 117.

<sup>63</sup> Respondent's Counter Memorial, para. 83.

<sup>64</sup> Mr. Lemire, Hearing Transcript 1, p. 309, at 3.

<sup>65</sup> Mr. Lemire, Hearing Transcript 1, p. 166, at 5.

Ukrainian Courts, and again successfully, two decisions of the National Council to issue warnings<sup>66</sup>. Finally, Mr. Lemire of course started this arbitration, accusing the National Council of having treated him in “*an unfair, inequitable, arbitrary and discriminatory manner in breach of its BIT obligations*”.

237. The fact that Mr. Lemire challenged a number of decisions of the National Council before the Ukrainian Courts and filed two successive investment arbitrations against Ukraine cannot have helped to improve the climate between Gala Radio, a company acting in a highly regulated and supervised legal environment, and the National Council, its regulator and supervisor. The existence of successive court actions may have been one of the reasons for deterioration of the relationship. The Tribunal is also convinced that on certain occasions, Mr. Lemire felt threatened, and that he was afraid that Gala would be taken off the air by the authorities. There were at least two incidents – the third inspection, which could have led to a third warning and revocation of the licence, and the difficulties in obtaining a renewal of Gala Radio’s licence – where Mr. Lemire’s reaction shows real worry. Mr. Lemire’s tactics vis-à-vis Gala’s regulator and supervisor may seem high handed and sometimes even aggressive, but they may have been the only method available to a small, private radio company in Ukraine owned by a foreigner, to draw attention to its situation.

#### Respondent

238. Respondent in this arbitration is the Republic of Ukraine. The actions and omissions on which Claimant bases his claims were carried out by the National Council, the State Centre and the State Committee, all of which are organs of Ukraine, for which under international law the Republic is responsible.
239. As Respondent has explained to the Tribunal, Ukraine became an independent State on August 24, 1991, and after independence its political, economic and legal systems underwent a substantial transformation<sup>67</sup>. Ukraine has acknowledged that in the initial years of independence, constant political battles and economic instability caused a lack of coordination in the activities of state bodies and hampered their ability to create an effective system of government.
240. Ukraine is an independent and sovereign state, governed by a Constitution, which entrusts to Parliament, elected by general democratic vote, the task of promulgating laws. The Arbitral Tribunal naturally respects the legislative function of the Ukrainian Parliament. It certainly is not the task of this Arbitral Tribunal, constituted under the ICSID Convention, to review or second-guess the rules which the representatives of the Ukrainian people have promulgated. The powers of this Tribunal are much more limited: they only encompass the authority to decide on a case-by-case basis whether Ukraine has violated

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<sup>66</sup> Claimant’s Exhibit CM-50 and Respondent’s Exhibit R- 353.

<sup>67</sup> Respondent’s Memorial, para.18.



certain guarantees, offered to American investors under the BIT, and to establish the appropriate remedies.

241. The respect for Ukraine's sovereignty is reinforced by the sector in which Claimant made his investment: radio broadcasting. In all jurisdictions, Radio and TV are special sectors subject to specific regulation. There are two reasons for this:

- first, radio frequencies are by technical nature scarce assets, and consequently the law must articulate systems for allocating licences to prospective bidders;
- but there is also a second reason: when regulating private activity in the media sector, States can, and frequently do, take into consideration a number of legitimate public policy issues; thus, media companies can be subject to specific regulation and supervision in order to guarantee transparency, political and linguistic pluralism, protection of children or minorities and other similar factors.

242. The exceptional character of media companies, and specifically of radio broadcasting companies, is accepted in the BIT itself. In its Annex, both the United States and Ukraine reserve the right to make or maintain limited exceptions to the national treatment principle (provided for in Article II.1 of the BIT) with regard to radio broadcasting stations. The exception does not affect the principles which are being pleaded by Claimant in this procedure, but it proves the special sensitivity towards the media shown by both States when approving the BIT.

### **VII.3.2. THE FET STANDARD AS DEFINED IN THE BIT**

243. The purpose of this section is to determine the general scope and meaning of the FET standard defined in the BIT.

244. Article II.3 (a) and (b) of the BIT reads as follows:

*“3. (a) Investment shall at all times be accorded fair and equitable treatment, shall enjoy full protection and security and shall in no case be accorded treatment less than that required by international law.*

*(b) Neither Party shall in any way impair by arbitrary or discriminatory measures the management, operation, maintenance, use, enjoyment, acquisition, expansion, or disposal of investments. For purposes of dispute resolution under Articles VI and VII, a measure may be arbitrary or discriminatory notwithstanding the fact that a Party has had or has exercised the opportunity to review such measure in the courts or administrative tribunals of a Party”.*

245. The origin of Article II.3 (a) and (b) can be traced to the 1992 and 1994 US Model BIT, which proposed the following wording:

*“Investments shall at all times be accorded fair and equitable treatment, shall enjoy full protection and security and shall in no case be accorded*

*treatment less than that required by international law. Neither Party shall in any way impair by arbitrary and discriminatory measures the management, operation, maintenance, use, enjoyment, acquisition, expansion or disposal of investments. Each Party shall observe any obligation it may have entered into with regard to investments”<sup>68</sup>.*

246. Article II.3 of the BIT was thus taken literally from the US Model BIT which was in force at the time when the BIT was negotiated, with only the addition of the phrase referring to judicial review. It is a rule of Delphic economy of language, which manages in just three sentences to formulate a series of wide ranging principles: FET standard, protection and security standard, international minimum standard and prohibition of arbitrary or discriminatory measures.

#### **A) Customary International Law Minimum Standard and FET Standard**

247. A classic debate in investment arbitration law is whether the FET standard established by bilateral or multilateral investment treaties coincides with or differs from the international minimum standard of protection for aliens imposed by customary international law.

248. The starting point of this debate is the very definition of the international minimum standard – a question which is fraught with difficulties<sup>69</sup>. For claims arising from administrative or legislative acts of Governments – which are the type of claims typically submitted in investment disputes – the historic leading case seems to be *Roberts*<sup>70</sup>, issued by the United States – Mexico General Claims Commission in 1926, which defined the minimum treatment as that required “*in accordance with ordinary standards of civilization*”. Mr. Roberts, a US citizen, had been imprisoned in Mexico in what he held to be inhumane conditions. Mexico had argued that Mexicans were held in identical conditions. And the Tribunal decided:

*“Facts with respect to equality of treatment of aliens and nationals may be important in determining the merits of a complaint of mistreatment of an alien. But such equality is not the ultimate test of the propriety of the acts of authorities in the light of international law. That test is, broadly speaking, whether aliens are treated in accordance with ordinary standards of civilization. We do not hesitate to say that the treatment of Roberts was such as to warrant an indemnity on the ground of cruel and inhumane imprisonment”.*

249. *Roberts* is understood to stand for the propositions that a certain treatment may give rise to international responsibility notwithstanding that it affects citizens and aliens alike, and that administrative and legislative actions may amount to

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<sup>68</sup> As quoted in I. Tudor, “The Fair and Equitable Standard in the International Law of Foreign Investment” (2008) p. 28.

<sup>69</sup> For a *status quaestionis* see Paulsson/Petrochilos: “*Neer-ly Mised?*” ICSID Review: Foreign Investment Law Journal (2007), vol.22.2, pp. 242-257.

<sup>70</sup> *Harry Roberts (U.S.A.) v. United Mexican States*; November 2, 1926; U.N. Report of International Arbitral Awards, IV, p. 71.

a violation of the customary minimum treatment even if the State did not act in bad faith or with willful neglect of duty<sup>71</sup>.

250. The relationship between FET and customary minimum standard has been the subject of much debate, especially in NAFTA based arbitrations, and has led the NAFTA Free Trade Commission to issue a binding interpretation on July 31, 2001. According to this interpretation:

*“2. Minimum Standard of Treatment in Accordance with International Law*

*1. Article 1105(1) prescribes the customary international law minimum standard of treatment of aliens as the minimum standard of treatment to be afforded to investments of investors of another Party.*

*2. The concept of ‘fair and equitable treatment’ and ‘full protection and security’ do not require treatment in addition to or beyond that, which is required by the customary international law minimum standard of treatment of aliens. [...]”.*

251. The same proposition, that the FET standard should be reduced to the customary international law minimum standard, was afterwards adopted in the new 2004 US Model BIT. Article 5 of this model provides<sup>72</sup>:

*“Article 5: Minimum Standard of Treatment”<sup>73</sup>*

*1. Each Party shall accord to covered investments treatment in accordance with customary international law, including fair and equitable treatment and full protection and security.*

*2. For greater certainty, paragraph 1 prescribes the customary international law minimum standard of treatment of aliens as the minimum standard of treatment to be afforded to covered investments”.*

252. Is this principle of assimilation between customary minimum standard and FET standard also applicable to the US – Ukraine BIT?

253. The answer must be in the negative. The BIT was adopted in 1996, and was based on the standard drafting then proposed by the US. The words used are clear, and do not leave room for doubt: *“Investments shall at all times be accorded fair and equitable treatment ... and shall in no case be accorded treatment less than that required by international law”*. What the US and Ukraine agreed when they executed the BIT, was that the international customary minimum standard should not operate as a ceiling, but rather as a floor. Investments protected by the BIT should in any case be awarded the level of protection offered by customary international law. But this level of

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<sup>71</sup> While for claims based on denial of justice, aggravating circumstances like outrage, bad faith, willful neglect of duty or other egregious behavior are required; see *L.F.H. and P.E. Neer (U.S.A) v. United Mexican States*; October 7, 1926; U.N. Report of International Arbitral Awards, IV, p. 60

<sup>72</sup> Quoted in I. Tudor, “The Fair and Equitable Standard in the International Law of Foreign Investment” (2008) p. 57.

<sup>73</sup> Footnote omitted.

protection could and should be transcended if the FET standard provided the investor with a superior set of rights<sup>74</sup>.

254. In view of the drafting of Article II.3 of the BIT, the Tribunal finds that actions or omissions of the Parties may qualify as unfair and inequitable, even if they do not amount to an outrage, to willful neglect of duty, egregious insufficiency of State actions, or even in subjective bad faith.
255. This leads to the next question: what is the exact meaning of the FET standard acknowledged by the BIT?

## **B) Meaning of Article II.3 of the BIT**

256. The words used by the Article II.3. are the following: “*Investments shall at all times be accorded fair and equitable treatment [...] Neither party shall in any way impair by arbitrary or discriminatory measures the management, operation, maintenance, use, enjoyment, acquisition, expansion or disposal of investments*”.
257. These general principles require interpretation in order to give them specific content and this interpretation must comply with the requirements of Article 31.1. of the Vienna Convention – it must be done “*in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose*”<sup>75</sup>”.
- a) Ordinary meaning
258. An inquiry into the ordinary meaning of the expression “fair and equitable treatment” does not clarify the meaning of the concept. “Fair and equitable treatment” is a term of art, and any effort to decipher the ordinary meaning of the words used only leads to analogous terms of almost equal vagueness.
259. The literal reading of Article II.3 of the BIT is more helpful. In accordance with the words used, Ukraine is assuming a positive and a negative obligation: the positive is to accord FET to the protected foreign investments, and the negative is to abstain from arbitrary or discriminatory measures affecting such investments. Any arbitrary or discriminatory measure, by definition, fails to be fair and equitable. Thus, any violation of subsection (b) seems *ipso iure* to also constitute a violation of subsection (a). The reverse is not true, though. An action or inaction of a State may fall short of fairness and equity without being discriminatory or arbitrary<sup>76</sup>. The prohibition of arbitrary or discriminatory measures is thus an example of possible violations of the FET standard.
260. The literal interpretation also shows that for a measure to violate the BIT it is sufficient if it is either arbitrary or discriminatory; it need not be both.

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<sup>74</sup> In agreement: I. Tudor, “The Fair and Equitable Standard in the International Law of Foreign Investment” (2008) p. 29.

<sup>75</sup> Emphasis added.

<sup>76</sup> *LG&E Energy Corp., LG&E Capital Corp. and LG&E International Inc. v. Argentina*, ICSID Case No.ARB/02/1, Decision on Liability of 3 October 2006, para. 162.

261. Discrimination, in the words of pertinent precedents, requires more than different treatment. To amount to discrimination, a case must be treated differently from similar cases without justification<sup>77</sup>; a measure must be “*discriminatory and expose[s] the claimant to sectional or racial prejudice*”<sup>78</sup>; or a measure must “*target[ed] Claimant’s investments specifically as foreign investments*”<sup>79</sup>.
262. Arbitrariness has been described as “*founded on prejudice or preference rather than on reason or fact*”<sup>80</sup>; “*...contrary to the law because...[it] shocks, or at least surprises, a sense of juridical propriety*”<sup>81</sup>; or “*wilful disregard of due process of law, an act which shocks, or at least surprises a sense of judicial propriety*”<sup>82</sup>; or conduct which “*manifestly violate[s] the requirements of consistency, transparency, even-handedness and non-discrimination*”<sup>83</sup>. Professor Schreuer has defined (and the Tribunal in *EDF v. Romania*<sup>84</sup> has accepted) as “arbitrary”:
- a. *a measure that inflicts damage on the investor without serving any apparent legitimate purpose;*
  - b. *a measure that is not based on legal standards but on discretion, prejudice or personal preference;*
  - c. *a measure taken for reasons that are different from those put forward by the decision maker;*
  - d. *a measure taken in wilful disregard of due process and proper procedure.”*
263. Summing up, the underlying notion of arbitrariness is that prejudice, preference or bias is substituted for the rule of law.

b) Context

264. Words used in treaties must be interpreted through their context. The context of Article II.3 is to be found in the Preamble of the BIT, in which the contracting parties state “*that fair and equitable treatment of investment is desirable in order to maintain a stable framework for investment...*”. The FET standard is thus closely tied to the notion of legitimate expectations - actions or omissions by Ukraine are contrary to the FET standard if they frustrate

<sup>77</sup> *Saluka Investments BV v. Czech Republic PCA*, UNCITRAL, Partial Award of 17 March 2006, para. 313.

<sup>78</sup> *Waste Management Inc. v. United Mexican States*, ICSID Case No. ARB (AF)/00/3, Award of 30 April 2004, para. 98, confirmed in *Methanex Corporation v. United States of America*, UNCITRAL, Award of 3 August 2005, para. 274.

<sup>79</sup> *LG&E Energy Corp., LG&E Capital Corp. and LG&E International Inc. v. Argentina*, ICSID Case No. ARB/02/1, Decision on Liability of 3 October 2006, para. 147.

<sup>80</sup> *Ronald S. Lauder v. Czech Republic*, UNCITRAL, Award of 3 September 2001, para. 221.

<sup>81</sup> *Tecnicas Medioambientales Tecmed SA v. United Mexican States*, ICSID Case No. ARB(AF)/00/2, 29 May 2003, para. 154.

<sup>82</sup> *Loewen Group Inc and Raymons L. Loewen v. United States of America*, ICSID Case No. ARB(AF)98/3, Award of 26 June 2003, para. 131.

<sup>83</sup> *Saluka Investments BV v. Czech Republic*, UNCITRAL, Partial Award of 17 March 2006, para. 307.

<sup>84</sup> See *EDF (Services) Limited v. Romania*, ICSID Case No. ARB/05/13, Award of 8 October 2009, para. 303; Professor Schreuer acted as expert and his opinion was quoted and accepted by the Tribunal.

legitimate and reasonable expectations on which the investor relied at the time when he made the investment<sup>85</sup>.

#### Legitimate expectations

265. Which were the legitimate expectations of Claimant at the time he made his investment?
266. It must be recalled that when in 1995 Mr. Lemire made his first investment and acquired a controlling stake in Gala Radio, this was a small company in a nascent industry. Historically, before independence and political change, the radio industry in Ukraine had been in the hands of the State. In the mid 1990s the sector began to be privatized, a first Law on TV and Radio having been approved on December 21, 1993. All these factors had a bearing on Claimant's legitimate expectations.
267. On a general level, Claimant could expect a regulatory system for the broadcasting industry which was to be consistent, transparent, fair, reasonable, and enforced without arbitrary or discriminatory decisions. It is true that Ukraine and the United States, when accepting the BIT, had reserved their right to make or maintain limited exceptions to the national treatment in the radio sector<sup>86</sup>. Under this exception, Ukraine could e.g., validly require that the founders of broadcasting companies be Ukrainian nationals. But Mr. Lemire could equally expect that, once he had been awarded the necessary administrative authorization to invest in the Ukrainian radio sector, there would be a level playing field, and the administrative measures would not be inequitable, unfair, arbitrary or discriminatory.
268. And on a more specific and personal level, Mr. Lemire undoubtedly had the legitimate expectation that Gala, which at that time was only a local station in Kyiv, would be allowed to expand, in parallel with the growth of the private radio industry in Ukraine.
269. The actual level of anticipated expansion has been the object of much discussion by the parties. Mr. Lemire has submitted that his intention at that time was to create three radio networks, two in FM, and one in AM, centered around three different age groups<sup>87</sup>. Respondent has challenged this statement, and has referred to the absence of any formal business plan setting out the intended business structure.
270. In the Tribunal's opinion, the available evidence shows that what Mr. Lemire had in mind when he bought into Gala Radio in June 1995, was to convert Gala into a national broadcaster and to create a second AM channel. The idea to create a third radio network – called "Energy" – seems to have been an

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<sup>85</sup> The relationship between FET and legitimate expectations has been established in a number of decisions: *Saluka Investments BV v. Czech Republic PCA*, UNCITRAL, Partial Award of March 17, 2006, para. 302 which then quotes *Tecnicas Medioambientales Tecmed SA v. United Mexican States*, *CME v. Czech Republic* and *Waste Management v. United Mexican States*.

<sup>86</sup> See Annex to BIT.

<sup>87</sup> Mr. Lemire, Hearing Transcript 1, p. 121, at 17.

afterthought. At the time of the acquisition of Gala, Claimant must have approached the National Council, and asked whether a national licence for Gala and an AM licence could be obtained. The National Council reacted in positive terms, as proven by a letter addressed to the State Centre, in which the National Council states that it is “*considering the possibility*” of issuing to Gala licences for a nationwide FM channel and for a second AM Band, and enquires whether the frequencies would be available. There is no reference to a third channel<sup>88</sup>. The State Centre reacted positively<sup>89</sup>.

271. Respondent has insisted that Claimant has not been able to produce a formal business plan<sup>90</sup>. That is true. But the Tribunal does not attach too much weight to this omission. Formal business plans are customary in sizeable investments in settled economic and business environments. None of these characteristics applied to Mr. Lemire’s investment in Gala Radio: a small amount was involved and the situation of Ukraine was anything but settled.

c) Object and purpose

272. The object and purpose of the BIT - the third interpretive criterion - is defined in its Preamble: the parties “*desir[e] to promote greater economic cooperation between them, with respect to investment by nationals and companies of one Party in the territory of the other Party*” and recognize that the BIT “*will stimulate the flow of private capital and the economic development of the Parties*”. The main purpose of the BIT is thus the stimulation of foreign investment and of the accompanying flow of capital.

273. But this main purpose is not sought in the abstract; it is inserted in a wider context, the economic development for both signatory countries. Economic development is an objective which must benefit all, primarily national citizens and national companies, and secondarily foreign investors. Thus, the object and purpose of the Treaty is not to protect foreign investments *per se*, but as an aid to the development of the domestic economy. And local development requires that the preferential treatment of foreigners be balanced against the legitimate right of Ukraine to pass legislation and adopt measures for the protection of what as a sovereign it perceives to be its public interest.

**C) Pursuit of Local Remedies**

274. Respondent has submitted that Gala Radio, although it asserts a list of errors concerning the tenders, never challenged any of the decisions before the Ukrainian Courts<sup>91</sup>. In Respondent’s opinion, Claimant should have taken advantage of the available local remedies that would have been capable of correcting the alleged administrative wrong. Claimant did so when confronted with the warnings issued by the National Council, and successfully challenged two decisions before the Ukrainian Courts. Respondent draws the Tribunal’s attention to the *Generation Ukraine* award, which stressed the need for the

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<sup>88</sup> Claimant’s Exhibit CM-1.

<sup>89</sup> Claimant’s Exhibit CM-2.

<sup>90</sup> Claimant’s Post-Hearing Memorial, para. 90.

<sup>91</sup> Respondent’s Post-Hearing Memorial, para. 625.

investor to make a reasonable effort to obtain the legal correction of an administrative fault:

*“[...]In such instances, an international tribunal may deem that the failure to seek redress from national authorities disqualifies the international claim, not because there is a requirement of exhaustion of local remedies but because the very reality of conduct tantamount to expropriation is doubtful in the absence of a reasonable – not necessarily exhaustive – effort by the investor to obtain correction<sup>92</sup>”.*

275. The question which the Tribunal must answer is whether, given the fact that Gala Radio has not challenged the decisions of the National Council, it is now precluded from presenting its claim in this arbitration.

276. The starting point of the Tribunal’s analysis must be the text of the BIT. The BIT – unlike other Treaties – does not include any clause requiring the initiation or exhaustion of local remedies before the filing of an investment arbitration. Quite the contrary: Article II.3 deviates from the standard US Model BIT in only one point, the insertion of the following phrase:

*“[...] For purposes of dispute resolution under Articles VI and VII, a measure may be arbitrary or discriminatory notwithstanding the fact that a Party has had or has exercised the opportunity to review such measure in the courts or administrative tribunals of a Party”.*

277. The literal meaning of this phrase could not be clearer: even if a party has had (and has not exercised), or has exercised (with whichever outcome) the right to judicial review, such action or omission is irrelevant in an investment arbitration deciding whether the measure is arbitrary or discriminatory. The consequence is that in an arbitration under the US-Ukrainian BIT, the possibility to file a claim against a specific measure, is not burdened by any requirement to previously appeal to the national Courts.

278. This does not mean that an investor can come before an ICSID tribunal with any complaint, no matter how trivial, about any decision, no matter how routine, taken by any civil servant, no matter how modest his hierarchical place. In this case, however, the claim is raised against the conduct of the National Council, that is to say the highest regulatory organ for the broadcasting industry. On this basis, the Tribunal considers that there should be no impediment to Claimant seeking to hold Ukraine accountable for an alleged breach of the BIT.

279. Given the clear language of the BIT, the Tribunal rejects Respondent’s submission that Claimant is precluded from pursuing his claims in the present arbitration, due to his failure to appeal the tender decisions of the National Council.

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<sup>92</sup> *Generation Ukraine Inc. v. Ukraine*, ICSID Case No. ARB/00/9, Award of 16 September 2003, para. 20.30.



Generation Ukraine

280. The Tribunal would like to add that – even if Article II.3 of the BIT had lacked a specific reference to local remedies – the present case has significant differences with *Generation Ukraine*. In *Generation Ukraine*, the claim filed by Claimant was based on expropriation, and the appropriate level of compensation - a type of claim which could have been submitted to and decided by the local Courts. In the present arbitration, the situation is quite different: the claim is for damages arising from the violation of the BIT standards, and such claim can only be filed before an international arbitration tribunal.
281. It is true that under Article 30.4 of the LTR, Gala Radio would have had the opportunity to challenge the decisions of the National Council awarding frequencies to other companies. But those claims would only have succeeded in setting aside the National Council’s decision, and forcing that the tender be repeated. Gala Radio would never be certain that in this repeat tender it would be successful. The practical result of an appeal against a tender decision of the National Council is very limited – if the procedure is unfair or the administrative body biased, it could again decide to grant the licence to another contender and not to Gala. The effect is quite different from that of an appeal against a warning – in this case the Court’s decision provokes the immediate setting aside of the measure.
282. The test proposed by *Generation Ukraine* is based on reasonableness. Claimant is only required to put in a reasonable effort to obtain correction of the wrong decision. In the circumstances of the present case, it would have been unreasonable to require Claimant to have fought in the Ukrainian Courts the National Council’s decisions adjudicating frequencies.
283. The Tribunal is not thereby suggesting that a breach occurs if the National Council makes a decision which is different from the one the arbitrators would have made if they were the regulators. The arbitrators are not superior regulators; they do not substitute their judgment for that of national bodies applying national laws. The international tribunal’s sole duty is to consider whether there has been a treaty violation. A claim that a regulatory decision is materially wrong will not suffice. It must be proven that the State organ acted in an arbitrary or capricious way. A regulatory organ charged with the attribution of licences on a competitive basis plainly violates essential notions of fairness if it refuses to consider the information provided by a qualified applicant, or if it engages in favouritism. And the State itself breaches its obligations under the treaty if it exercises undue influence over the decision-making of regulatory bodies.

**D) Summary**

284. The FET standard defined in the BIT is an autonomous treaty standard, whose precise meaning must be established on a case-by-case basis. It requires an action or omission by the State which violates a certain threshold of propriety, causing harm to the investor, and with a causal link between action or omission and harm. The threshold must be defined by the Tribunal, on the basis of the wording of Article II.3 of the BIT, and bearing in mind a number of factors, including among others the following:

- whether the State has failed to offer a stable and predictable legal framework;
- whether the State made specific representations to the investor;
- whether due process has been denied to the investor;
- whether there is an absence of transparency in the legal procedure or in the actions of the State;
- whether there has been harassment, coercion, abuse of power or other bad faith conduct by the host State;
- whether any of the actions of the State can be labeled as arbitrary, discriminatory or inconsistent.

285. The evaluation of the State's action cannot be performed in the abstract and only with a view of protecting the investor's rights. The Tribunal must also balance other legally relevant interests, and take into consideration a number of countervailing factors, before it can establish that a violation of the FET standard, which merits compensation, has actually occurred:

- the State's sovereign right to pass legislation and to adopt decisions for the protection of its public interests, especially if they do not provoke a disproportionate impact on foreign investors;
- the legitimate expectations of the investor, at the time he made his investment;
- the investor's duty to perform an investigation before effecting the investment;
- the investor's conduct in the host country.

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286. Once the scope and meaning of the FET standard has been defined in the abstract, the Tribunal must establish the facts and decide whether they constitute a violation of such standard. This will be achieved by reviewing the legal procedure created by Ukrainian law for the awarding of licences in the broadcasting sector (VI.3.3), then by analyzing in detail the facts surrounding the allocation of frequencies which affected Gala (VI.3.4).

### VII.3.3. PROCEDURE FOR THE AWARDING OF LICENCES IN THE BROADCASTING SECTOR UNDER UKRAINIAN LAW

287. Two fundamental laws regulate the Ukrainian radio sector:

- the Law on National Television and Radio Council of Ukraine (“LNC”), originally issued on September 30, 1998<sup>93</sup>, amended on a number of occasions, the last on January 12, 2006; the scope of this law is the designation and scope of responsibilities of the National Council;
- the Law on Television and Radio Broadcasting (“LTR”), originally issued on December 21, 1993, amended significantly a number of times, lastly on March 1, 2006<sup>94</sup>, and which provides the general rules regarding the functioning of radio and TV in Ukraine.

#### A) The National Council

288. The LNC establishes the National Council as a “*constitutional permanent collegiate agency*”<sup>95</sup>. Its activities “*shall be based upon the principles of legality, independence, impartiality, transparency...*”<sup>96</sup>. The eight members of the National Council are appointed in parity by the President and the Parliament respectively, for five-year terms with the possibility of a single reappointment<sup>97</sup>. Until 2006, the President and the Parliament could at any time disqualify any of their appointees from office. That was no empty threat: on February 2, 2004 the Parliament’s Committee on Freedom of Speech and Information approved a resolution, recommending that Parliament carry out a “*credibility impeachment*” of all the members of the National Council<sup>98</sup>.

289. Since 2006 the situation has improved because the LNC has been amended, and the National Council *in toto* can be dismissed only upon a vote of no confidence carried by Parliament and confirmed by the President<sup>99</sup>.

290. The National Council derives its status and mandate directly from a constituent law. Its independence and impartiality is expressly guaranteed by that law. Formally, it thus is independent. The appointment of independent regulators by Parliament and/or the Head of State follows wide-spread practice. Before 2006, the power of the President and the Parliament, respectively, to remove their appointees from office indeed represented a threat to Council members’ independence. With the requirement of a concurring decision of both the President and the Parliament for removing the Council *in toto* from office, a safeguard against undue political pressure was introduced.

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<sup>93</sup> Claimant’s Exhibit CM-2; the Tribunal used Claimant’s translation, to which Respondent has not made any objection.

<sup>94</sup> Claimant’s Exhibit CM-3; the Tribunal will quote from the translation prepared by Claimant, to which Respondent has made no objection.

<sup>95</sup> Article 1 of the LNC.

<sup>96</sup> Article 3.1 of the LNC.

<sup>97</sup> Article 4 of the LNC.

<sup>98</sup> See Claimant’s Exhibit CM-31.

<sup>99</sup> Article 16.5 of the LNC.

291. The level of political interference with the decisions of the National Council is difficult to gauge from the outside. The only incident which is proven beyond any doubt is the interference of the President of Ukraine with the tender of October 19, 2005, which was awarded to the bidder mentioned in the President's letter to the National Council (which will be analyzed in detail below). During the hearing, Mr. Lyasovsky, a member of the National Council, was directly asked whether National Council members follow the instructions of the political establishment. His answer, under oath, was the following<sup>100</sup>:

*“Well, we’re very accustomed to hearing this kind of language, I’ll be honest and frank. Yes, there have been – there are attempts at putting pressure on the council. However, due to the specifics of how the council is formed, such attempts are ineffective, especially since recently, since amendments were made, passed in 2006. Indeed, we now are an independent body and we’re not subject, or rather we’re immune to pressure”.*

292. The answer acknowledges that pressure has been exercised on the National Council, but expresses the contention that since 2006 – when the LNC was amended and the Council was given a higher level of independence – the situation has been improving.

#### **B) The Administrative Procedure for the Issuances of Licences**

293. The LTR is an extensive law, comprising 75 articles, regulating the creation, licensing, functioning, supervision and sanctioning of companies operating in the TV and radio sectors. Section III of the Law, as it now stands, is devoted to the rules governing the tender procedure and the issuance of broadcasting licences.

294. From a historical perspective, the system for granting radio licences has gone through four phases:

- in a first phase, between 1993 and 1995, licences were issued by the National Council under Article 14 of the 1993 LTR, upon individual application of persons interested in setting up a radio station;
- after 1995, radio frequencies were awarded by means of tender announced in the press<sup>101</sup>;
- the third phase began on December 15, 1998, when the National Council became inoperative because it ceased to have five duly designated members, and consequently could not validly carry decisions; during this interregnum, radio frequencies were awarded directly by the State Committee, in clear violation of the LTR<sup>102</sup>. The situation was solved in June 2000, when the National Council regained all its members, and a

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<sup>100</sup> Mr. Lyasovsky, Hearing Transcript 2 p. 73, at 24.

<sup>101</sup> Mr. Petrenko, Hearing Transcript 4, p. 81, at 25.

<sup>102</sup> See Claimant's Exhibit CM-11, letter of National Council member S. Aksenenko to the Vice Prime Minister of Ukraine.

first tender in accordance with the LTR was then organized on January 1, 2001;

- since January 2001, licences have all been awarded by way of tenders supervised by the National Council.

295. The LTR contains detailed rules with regard to the organization of tenders. The decision to launch a tender for new frequencies is adopted by the National Council, then published in the press. Prospective bidders have a one-month period to present their applications, which must include information required by Article 24 of the LTR. Applications are then reviewed by the individual members of the National Council. The criteria of review are now those established in Article 25.14 of the LTR:

*“While considering the applications the National Council shall prefer TV/radio organization that:*

- a) is capable to fulfill the licence conditions to the best extent;*
- b) prefers socially important programs (informational, social and political, children, etc.), satisfies informational needs of national minorities and secures freedom of speech;*
- c) has an advantage in financial and economical as well as professional and technical capabilities for TV/radio broadcasting;”*

296. The system for deciding the winner of the tender is simple: the National Council holds a formal meeting, the various applications for each frequency are presented, each member of the National Council expresses a vote and the licence is awarded to the applicant supported by at least five members of the National Council<sup>103</sup>. If no applicant reaches this threshold, the frequency is not awarded, although it may be put again to tender on a future occasion.

297. The voting system gives rise to three different issues:

- a) Publicity of the vote

298. The first is the publicity of the vote.

299. The LTR contains no provision regarding the formal requirements of the National Council’s decision. Practices seem to have developed. It is undisputed that in an initial phase, the votes would be cast in a private meeting of the Council, behind closed doors, and that there was no transparency of how each member of the National Council had voted. The parties have debated when this phase ended. Claimant has submitted that the change occurred in 1995<sup>104</sup>; while Respondent’s position is that this happened in 2000<sup>105</sup>. The evidence submitted by Respondent in order to support its position are minutes of National Council meetings which took place from December 24, 2003 onwards. These minutes list representatives of participating radio companies as “invited persons” present during the discussions.

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<sup>103</sup> This is not controversial; see Respondent’s Post-Hearing Memorial, para. 350.

<sup>104</sup> Claimant’s Reply Memorial, para.104.

<sup>105</sup> Respondent’s Rejoinder, para. 511.

300. The Tribunal concludes that from the end of 2003 onwards, the practice of the National Council has been to “invite” interested parties to attend its meetings. This constitutes a significant improvement in the transparency of the decision procedure.

b) Reasoning of the vote

301. The second issue is the reasoning underlying the votes.

302. The LTR does not require that the votes of each member of the National Council, or the National Council’s decision as such, be reasoned. This derives clearly from the drafting of Article 25 of the LTR.

303. In paragraph 8 of this provision, the law specifically establishes that if the National Council is to exclude a person from participating in a tender, such decision must be “*reasoned*”. In the documents presented in this arbitration there is at least one example of a decision excluding a participant in the tender, and that decision is duly reasoned<sup>106</sup>.

304. The situation is different as regards decision for the awarding of frequencies. Paragraph 13 of the same article describes the procedure for awarding the licence to the winner of the tender:

*“A decision on the winner of a tender and on broadcast licence issuance shall be made by the National Council within a 30-day period after application period is finished”.*

305. It is very telling that for this decision of awarding frequencies the law omits the requirement that it be “*reasoned*” – a requirement which the same article of the Law specifically requires for exclusion of applicants.

306. The administrative practice of the National Council when awarding frequencies adhered to the principle established in the LTR. Respondent has presented a great number of minutes of decisions taken by the National Council. These minutes simply state in favour of whom each member is casting his vote. And if a participant received five votes, the frequency was awarded to him. The minutes do not include any discussion among the members or the reasoning of the decision.

307. The evidence presented in this arbitration does not indicate that before the National Council’s meeting, either the administrative staff of the Council, or its members, prepared a reasoned and researched report with a valuation and ranking of the applications submitted. This is surprising, since Article 25.14 of the LTR orders that in considering the application, the National Council “*shall prefer*” radio organizations that offer socially important programs, satisfy minorities, secure freedom of speech, have better financial resources or professional or technical capabilities. The evidence submitted seems to show

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<sup>106</sup> See Respondent’s Exhibit R-350, regarding the exclusion of NBCU from two tenders.

that the National Council made no formal effort to measure to what extent each application complied with the requirements of the Law<sup>107</sup>.

308. Respondent has acknowledged that “*the members of the National Council are not obliged by the existing legislation to explain the details of their reasoning during the voting process*”<sup>108</sup>. But Respondent has added that in practice the members of the National Council did explain their reasoning at the meeting, during debates with the candidates and during the discussions with other members of the National Council, and after the meetings at briefings with the press. In the opinion of the Arbitral Tribunal, these informal explanations, which started in 2004, although certainly a step forward, do not off-set the absence of any reasoning justifying the vote of each Council Member, and the corporate decision of the National Council as a body.
309. The absence of reasoning of the decision represents a significant weakness in the administrative procedure for the issuance of licences.
310. Thus, a participant who has lost cannot ascertain why his application was rejected, how he was ranked with regard to other participants, and what he could do to improve his chances to be successful in the next bidding.
311. The absence of reasoning also jeopardizes the possibilities of public scrutiny and of judicial review. A Court cannot judge the reasonableness of the National Council’s decision to award the tender to one participant or the other, if there is no formal explanation of the reasons which prompted the decision. Absence of reasoning *de facto* reduces the causes of judicial review to procedural irregularities during the tender.
312. In April 2007, three Deputies from the parliamentary majority proposed to Parliament the creation of an Investigating Committee centred on the activities of the National Council, including the “*transparency and publicity of broadcasting licences issuing and renewal*”<sup>109</sup>. Although the proposal of the three Deputies may also have had political motivations, the mere fact that it was presented – it is unclear from the record if the Committee was actually set up<sup>110</sup> – proves the existence of significant unease with the degree of transparency and publicity of the procedure for awarding broadcasting licences.

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<sup>107</sup> Respondent has submitted that in order to help members of the National Council, an “informational passport” for each region of Ukraine was prepared by National Council Staff (Post-Hearing Memorial, para. 347); but this passport did not include any valuation of the various applications submitted.

<sup>108</sup> Respondent’s Rejoinder, para. 512.

<sup>109</sup> Claimant’s Exhibit CM-86.

<sup>110</sup> In Claimant’s Post-Hearing Memorial, para. 71.3, Claimant submits that it was created; in Claimant’s Memorial, para. 32 and Claimant’s Reply Memorial, para. 170, the assertion is that it was proposed.

c) Lack of knowledge of ultimate owners

313. A third characteristic of the system for allocation of frequencies is that participants were under no obligations to disclose the ultimate owners of their companies. While the direct controlling owners of companies bidding for frequencies were registered with the National Council, the owners of the owners were not. The Council members, who deposed as witnesses, when asked on several occasions by counsel to Claimant and by the Tribunal, were not able to provide any information regarding the beneficial owners of the radio companies to whom they had awarded significant numbers of licences<sup>111</sup>.
314. Politically influential individuals are thus able to beneficially own radio stations, which participate in tenders for new frequencies, and to hide behind “ownership chains”, so that their interest in the decision remains undisclosed. This lack of transparency clearly represents a shortcoming of the system. The LTR does not require information about ultimate owners, and the National Council apparently never asked any of the participants to disclose the names of their controlling shareholders. This is especially troubling, since the legal criteria which National Council should apply when selecting the winner must include freedom of speech and financial and economic capability of the applicants – criteria difficult to apply if there is no transparency regarding beneficial owners of radio stations. It also makes it difficult for the public – and for judicial bodies – to determine whether there has been undue influence.

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315. The Tribunal has already stated its respect for Ukraine’s sovereignty and for Ukraine’s right to promulgate the laws which its Parliament deems are best suited to further the Nation’s public interest. The powers of this Tribunal are limited to judging whether Respondent has acted in ways that affect Claimant and breach the FET standard enshrined in the BIT. But in order to value specific measures, the Tribunal must analyze the general legal framework within which specific conduct took place. That analysis has revealed that the procedure presents some shortcomings, which in essence affect:
- the independence of members of the National Council;
  - the existence of an interregnum, during which licences were awarded without tender procedure;
  - the absence of formal valuation of the applications for licences against clearly established criteria;
  - the absence of reasoning for National Council decisions, whether collectively or for individual votes; and
  - the lack of transparency of ultimate owners of radio companies.
316. While none of the above features alone stigmatizes the entire tender process as arbitrary, there is a risk that the shortcomings may end up mutually reinforcing each other. Members of the National Council, by virtue of the designation

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<sup>111</sup> Mr. Lyasovski, Hearing Transcript 2, p. 52, at 17; Mr. Shevchenko, Hearing Transcript 3, p. 13, at 1; Mr. Kurus, Hearing Transcript 4, p. 7.



system, tend to have political affiliations and interests. Deficient disclosure and transparency requirements ease the misuse of discretionary powers by Council members to accommodate political or personal interests. In sum, the procedure for allocating frequencies by the National Council is fraught with shortcomings that facilitate arbitrary decision making.

317. A final note is important: Ukraine gained its independence only in 1991 and still is in the process of developing its institutional framework. During this formative period, legal imperfections are to be expected. Ukrainian law has improved, and after the 2006 amendments of the LTR, a significant number of weaknesses have been ameliorated.

#### **VII.3.4 GALA'S APPLICATIONS FOR ADDITIONAL FREQUENCIES**

318. In the preceding section the Tribunal has concluded that the tender procedure for the issuance of licences presents certain shortcomings, which although falling short of disqualifying the entire system as arbitrary, remain relevant for the assessment of the National Council's measures. In this section the Tribunal will establish the facts surrounding Gala's applications for additional frequencies, and will decide whether the actions or omissions of Respondent amount to a violation of the FET standard guaranteed in the BIT to protected investors.

##### **A) Overview of Gala's Participation in Tenders for Additional Frequencies**

319. It is undisputed that between 2001 and 2007 Gala Radio participated in a great number of tenders for broadcasting licences, additional to those that were awarded to Gala pursuant to the Settlement Agreement. The exact number of frequencies for which Gala applied, however, is debated. Claimant states that the number of applications amounts to more than 200 for Gala, plus 100 more for Energy (a second chain of radio stations which Claimant tried to create)<sup>112</sup>. Respondent accepts 180 applications for Gala<sup>113</sup> and 71 for Energy<sup>114</sup>.
320. What is not disputed is that all those applications were unsuccessful – with one exception: Claimant was awarded the frequency in Chechelnyk, a village of 5,000 inhabitants without any satellite receiver (which implies that the station cannot be linked to Gala's network). It is undisputed that the business relevance of this frequency is minimal. Claimant adds that the National Council's decision to reward Gala's continuing efforts with the awarding of this local frequency in a remote, unconnected village was intended to rub salt in the wound<sup>115</sup>.

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<sup>112</sup> Respondent's Reply, para. 167; see also Claimant's Exhibit CM-99 with a list of the applications.

<sup>113</sup> Respondent's Exhibit R 344-A.

<sup>114</sup> Respondent's Post-Hearing Memorial, paras. 434 and 453.

<sup>115</sup> Claimant's Reply, para. 168.

### Claimant's argument

321. Claimant argues that Gala's dismal record in receiving frequencies stands in stark contrast with that of its competitors, all controlled by powerful and well-connected personalities. Claimant gives the following examples<sup>116</sup>:
- Radio Era applied for 93 frequencies and was awarded 38 (41% success rate); the station is allegedly owned by Mr. Derkach, who is said to be a supporter of the current President of Ukraine;
  - Hit Radio applied for 139 frequencies and was awarded 42 (30%); Claimant alleges that it is owned by Mr. Bagrayev, a Deputy (i.e. member of Parliament) and member of the National Council 2000-2002;
  - NBM Radio applied for 205 frequencies and was awarded 56 (27%); it is allegedly owned by Mr. Poroshenko, also an ally of the current President;
  - Russkoe Radio applied for 111 and was awarded 31 (28%); allegedly also owned by Mr. Bagrayev<sup>117</sup>.
322. Claimant has produced circumstantial evidence to substantiate that these radio chains are actually owned by the above-mentioned individuals<sup>118</sup>. During the hearing, Claimant asked the members of the National Council who deposed, to clarify the ownership structure of these radio stations. They all declined, in essence arguing that information regarding beneficial owners is not available to the National Council. The Tribunal also notes that Respondent has not produced any evidence contradicting Claimant's allegations.

### Respondent's arguments

323. Respondent's main argument is that Claimant cannot assert a breach of the BIT while remaining at a "macro-statistical" level. Each tender is different from the next, and each applicant is different from the rest. As regards the statistics themselves, Respondent submits that of the 180 frequencies Gala applied for, only 68 were destined for broadcasting a music format that could be similar to Gala Radio's program concept<sup>119</sup>. Respondent also states that in some tenders which it eventually lost, Gala received the favourable votes of some of the Council members – but it never received the five votes necessary for the awarding of the licence.
324. The main thrust of Respondent's argument is that Gala Radio did not win tenders because it "*is an average radio station*"<sup>120</sup> and that it is not at the top level of the overall Ukrainian broadcasting market. Its programming concept is no longer as popular and innovative as it used to be. This would, in Respondent's assertion, justify the National Council's decision to deny new licences to Gala.

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<sup>116</sup> Claimant's Exhibit CM-129.

<sup>117</sup> Claimant's Post-Hearing Memorial, para.106.

<sup>118</sup> Claimant's Exhibits CM-105, CM-116 and CM-124 and Mr. Lemire's Witness Statement, para. 123.

<sup>119</sup> Respondent's Post-Hearing Memorial, para. 438.

<sup>120</sup> Respondent's Post-Hearing Memorial, para. 447.

### The Tribunal's position

325. The Tribunal agrees with Respondent that mere statistics are insufficient for maintaining a claim for violation of the FET standard. But on the other side, statistics do give an overview of how the facts have developed and may provide valuable insight into patterns of behaviour.
326. If an impartial bystander looks at the gross, macro-statistical numbers, an impact cannot be avoided. In six years Gala Radio, a radio company in good standing, although it tried insistently, has not been able to obtain additional frequencies (except in a small village in rural Ukraine and except for the frequencies allocated pursuant to the Settlement Agreement). Whether one takes Claimant's numbers (200 applications for all types of frequencies) or Respondent's (68 applications for music format frequencies similar to Gala's) is really irrelevant. Respondent's number is in fact even more striking, because it refers to cases where the National Council denied Gala an additional frequency for the type of programming it was already offering, and with good success.
327. It is undisputed that Gala's main competitors – Era, Hit, NMB, Russkoe – were much more successful than Gala: they received between 38 and 56 frequencies. Respondent has tried to justify this differential treatment stating that Gala “*is an average radio station*”, that its programming concept is stale and that other competitors offer better broadcasting.
328. The problem with Respondent's argument is that, since the National Council does not reason or explain its decisions, it is totally impossible for a third party (be it a local judge or this Tribunal) to verify whether Gala's applications were rejected because its programming concept was worse than that of its competitors (as Respondent now submits), or due to some other cause, and whether this cause was good, arbitrary or discriminatory.
329. A suspicion in any case remains: if Gala, as Respondent readily admits, “*is an average radio station*”, the natural consequence would seem to be that Gala should have had an average success rate in its tenders. And the record shows that it had a success rate which was much below average.
330. Summing up, the Tribunal feels that the macro-statistical analysis cannot provide conclusive evidence that Respondent has violated the FET standard; but the overall numbers, the absence of any reasonable explanation, the strikingly different success rates of Gala and of its competitors, the impossibility of verifying the reasons why Gala was rejected, are all factors which cast doubts on the decisions of the National Council.
331. In order to substantiate these doubts, it is necessary that the Tribunal analyze each of the tenders in particular. This will be done in the next sections.

**B) The Tender of October 19, 2005 and the Interference of the President of Ukraine**

Undisputed facts

332. On July 2004 the National Council announced a tender for 15 frequencies, with the special condition that the channel thus created be used solely for “informational broadcasting”. Radio channels which exclusively or predominantly broadcast music, like Gala or Kiss, are of limited political relevance. Informational channels, however, are politically more sensitive, since they represent important elements for the formation of public opinion.
333. It is an undisputed fact that on July 20, 2004, i.e. four days after the announcement of the tender, the President of Ukraine sent a “Doruchennya” to Mr. Shevchenko, the Chairman of the National Council, which literally stated as follows<sup>121</sup>:

*“DORUCHENNYA OF THE UKRAINIAN PRESIDENT*

*...  
To: O. SHEVCHENKO  
O. GAJDUK*

*In accordance with the set procedure to consider the matter relating to the allocation of the frequency resource to “Radio Era” and “Radio Kokhannya”  
Signed V. YUSCHENKO”.*

334. The “Doruchennya” included a further paragraph, addressed to top officials of the Ukrainian Government and the City of Kiev, asking for support for the activities of TRC “Era” and “Radio Era”.
335. Radio Era was an already existing talk radio, broadcasting informational programs. Claimant has alleged that Radio Era (and Radio Kokhannya) are widely reported to be owned by Mr. Derkach, a political ally and supporter of the current President of the Ukraine.
336. There has been some discussion about the precise translation of the word “Doruchennya”. During the hearing the Chairman of the National Council Mr. Shevchenko was questioned regarding the precise meaning, and it was agreed that the best English translation would be “instruction”, not “order”<sup>122</sup>.
337. The “Instruction” was followed up by a letter sent on August 2, 2005, in which the “First Deputy State Secretary of Ukraine” asked Chairman Shevchenko to “*inform the Secretariat of the President of Ukraine of status of the task commissioned by the Head of the State*”<sup>123</sup>.

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<sup>121</sup> Claimant’s Exhibit CM-45.

<sup>122</sup> Mr. Shevchenko, Hearing Transcript 3, p. 161, at 19; Claimant has accepted the translation; see Claimant’s Post-Hearing Memorial, fn. 271.

<sup>123</sup> Claimant’s Exhibit CM-108.

338. The record shows no letter from either Mr. Shevchenko or the National Council reacting either to the “Instruction” or to the Secretariat’s reminder.
339. On October 19, 2005 the National Council decided to award the 15 frequencies on tender to Radio Era. It is undisputed that during the discussion which led to the Council’s decision, a deputy of the Ukrainian Parliament called Derkach attended the meeting. Radio Kokhannya was later on awarded 12 frequencies more.

#### Claimant’s position

340. In Claimant’s view, Gala lost the tender to Radio Era due to the President’s intervention and then later due to the physical presence of a Parliamentary Deputy at the tender meeting itself. The tender was procedurally improper, and the outcome was unfair, inequitable, arbitrary and discriminatory. As a consequence of these measures, Claimant lost the opportunity to establish a separate talk radio format in an FM format that solely focused on news, informational programs, culture, education and sports<sup>124</sup>.

#### Respondent’s position

341. Respondent asserts<sup>125</sup> that the channel was awarded to Radio Era in view of the latter’s supremacy in information broadcasting. The message of the President, in Respondent’s view, did not constitute an order. Deputy Derkach does not own Radio Era and did not intervene in the National Council’s deliberation. Thus, no undue influence was exercised on the National Council’s tender decision.

#### The Tribunal’s position

342. The National Council was established by the LNC as a “*constitutional permanent collegiate agency*”; and its activities “*shall be based on the principles of legality, independence, impartiality, transparency...*” (Articles 1 and 3 of the LNC). Decisions on the allocation of radio frequencies in particular are to be made in accordance with a tender process and tender evaluation criteria prescribed by law (see Article 25 of the LTR). Independence and impartiality of National Council members from other State bodies is pivotal to the integrity of the system.
343. Any interference by a State body in the statutory tender process and the supposedly independent and impartial evaluation of tenders must therefore be considered as violating both the LNC and the LTR. This applies especially to any interference by the President, who appoints and reappoints half of the members of the National Council. It must also be remembered that at the time of the Instruction, members of the National Council could be removed by a decision of the President.

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<sup>124</sup> Claimant’s Post-Hearing Memorial, para. 92.

<sup>125</sup> Respondent’s Post-Hearing Memorial, para. 398.

344. Taken literally, the “Instruction” of the President only states that the Chairman of the National Council shall “*in accordance with the set procedure [...] consider the matter relating to the allocation of the frequency resource to “Radio Era” and “Radio Kokhannya”*”. Respondent, supported by the deposition of Messrs. Shevchenko and Kurus, tries to depict the message as a routine call by the President on the National Council to do its job.
345. The Tribunal does not have to decide whether the message qualified as a Presidential order which must be obeyed. As noted before, it is sufficient if it constituted an interference with the independent and impartial decision-making process of the National Council, i.e. an indication of the President’s expectations with respect to the pertinent decisions.

Impact of the “Instruction”

346. Did the “Instruction” from the President amount to interference?
347. Respondent submits that the “Instruction” should be construed exclusively on the basis of its plain language, and that it amounts to no more than an admonition to the National Council to do its job. No explanation has, however, been given why the National Council needs such an admonition. In the hearings of the present case, National Council members Shevchenko and Kurus could not refer to any similar action of the President, before or after this incident. Its singularity draws attention to the Presidential message and heightens its potential to influence decision making.
348. Moreover, the message was written in the context of an instruction to other State officials to “*remove obstacles*” to Radio Era’s activities and “*report on the measures taken*” within seven days. The different language used for addressing these officials, who do not enjoy independence guaranteed by law, and the National Council Chairman, respectively, shows the President’s awareness of the National Council’s independence. Yet, it also reflects the President’s standing in support of Radio Era.
349. An additional factor to be borne in mind is that within two weeks of the Presidential “Instruction”, but before the pertinent tender decision, the Secretariat enquired on the status of the “*task commissioned*” by the President. This letter is a clear indication of the President’s support of Radio Era’s offer and his expectation that his message would be duly taken into account in the process.
350. In these circumstances, the attendance at the decisive National Council meeting on October 19, 2005 by Deputy Derkach is clearly more than a routine participation of a deputy in a Council meeting. It appears as a demonstration of vigilance, intended to remind Council members that their decisions are watched.

### Deputy Derkach

351. It has proven impossible for the Tribunal to ascertain whether Mr. Derkach actually owns or is somehow connected to Era Radio, as alleged by Claimant. Specifically asked by the Tribunal, Chairman Shevchenko could not confirm whether Mr. Derkach was the owner of Era Radio, nor could he give any information regarding the person or persons who controlled this radio station<sup>126</sup>. It is highly implausible that the Chairman of the National Council, who had been twice elected as a Parliamentary Deputy, who had received an “Instruction” from the President to consider Era’s application favourably, and who voted in favour of awarding Era the licences to strengthening it as a leading broadcaster in Ukraine, should remain completely unaware of the ownership structure of this company.
352. In any case, for present purposes it suffices to record that, as documented by Claimant, Mr. Derkach has been reported in the media as being associated with Era Radio<sup>127</sup>, so that his presence at the National Council meeting must have been perceived as a supporter of this radio station. It can also remain open whether he has expressed his support by his body language, as maintained by Claimant. His mere attendance at this meeting in conjunction with his publicly reported association with Radio Era constitutes an action in support of this applicant.

### Respondent’s counter-argument

353. Respondent has asserted that the President’s “Instruction” was inconsequential, because the channel of frequencies in question had been reserved for informational broadcasting and Radio Era was the national champion in this market segment. Even Claimant concedes that according to a market survey (the so-called “SIREX Report”) Radio Era was the national leader on information broadcasting, with an established track record, while Gala intended to set up a new “talk format radio network” in order to satisfy the tender condition. Claimant adds, however, that in accordance with the SIREX Report Gala was number two (after Radio Era) in news broadcasting, and Radio Era’s closest competitor<sup>128</sup>.
354. The Arbitral Tribunal is again confronted with the impossibility of reviewing the reasons underlying the National Council’s decision. A decision in favour of the established leader in the relevant field over a newcomer may under certain circumstances be appropriate. But Article 25.14 (b) of the LTR also orders the National Council to take into account the objective of “*securing freedom of speech*”. Since Radio Era already had a radio network, pluralism could arguably be better served if the new channel was awarded to a different company. Gala had a realistic prospect of winning this tender against Radio Era, and such opportunity was taken away by the Presidential interference.

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<sup>126</sup> Mr. Shevchenko, Hearing Transcript 3, p. 172.

<sup>127</sup> Claimant’s Exhibits CM 105 and CM 124; Claimant’s Post-Hearing Memorial, para. 81.

<sup>128</sup> Claimant’s Post-Hearing Memorial, para. 91.

355. The President’s “Instruction” referred not only to the tender applications of Radio Era, but also to those of Radio Kokhannya. It is undisputed that radio Kokhannya received 12 frequencies from July 2005 through January 2006<sup>129</sup>, in tenders in which Gala also participated.

#### Decision

356. In light of the aforementioned circumstances, the Tribunal concludes that the President’s “Instruction” amounted to interference with the independent and impartial decision of the National Council in favour of two of Claimant’s competitors – Radio Era and Radio Kokhannya. It thus constituted a violation of applicable Ukrainian legislation, namely the LNC and LTR, which meets the *Saluka* test, since it “*manifestly violate[s] the requirements of consistency, transparency, even-handedness and non-discrimination*” and thus amounts to an “*arbitrary or discriminatory measure*” within the meaning of Article II.3 (b) of the BIT. Furthermore, the apparently politically motivated preference for one competitor represents a discrimination against Claimant, who was applying in the same tender processes for the same frequencies.
357. In conclusion, the Tribunal determines that when the National Council at the meeting of October 19, 2005 granted 15 frequencies for an information broadcasting channel to Radio Era, and subsequently awarded 12 frequencies to Radio Kokhannya, such decisions violated the FET standard established by Art II.3 of the BIT.

#### **C) The Tender of May 26, 2004 for an AM Frequency**

358. In May 2004 Gala applied for an AM frequency for Kiev, together with two competitors (Odessa Legal Academy and Charity Public Fund Radio). In the National Council meeting on May 26, 2004, the two competitors received each four votes and Gala secured one vote. As no application was supported by the requisite five votes, the National Council cancelled this tender, convened a new tender and awarded the frequency to NART TV.
359. Gala has been broadcasting on FM frequencies, which are appropriate for a program based fundamentally on music. The AM frequency is not suitable for music programs but only for talk and information programs.

#### Claimant’s position

360. Claimant submits that with the AM frequency for which it was applying, Gala had intended to establish a new talk radio format<sup>130</sup>. Gala was the only qualified applicant in the May 26, 2004 tender, as its competitors lacked the necessary financial resources, radio experience and management capability. Notwithstanding Gala’s qualifications, in an arbitrary and *discriminatory* decision the National Council decided not to award the frequency to Claimant, to retender it and to issue to NART TV, a company which had the correct political connections.

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<sup>129</sup> See Mr. Lyasovski, Hearing Transcript 2, p. 81, at 23.

<sup>130</sup> Claimant’s Post-Hearing Memorial, para. 114.



### Respondent's position

361. Respondent contests Gala's assertion that it was the only qualified applicant in the May 26, 2004 tender<sup>131</sup>. In Respondent's view, Gala's competitors did have adequate resources and capabilities and Gala's failure can be explained by the lack of experience in informational talk programs and the perception by Council members that Gala was a music channel, without an information broadcasting concept.

### The Tribunal's position

362. The Tribunal has already established (see paragraph 271 *above*) that Mr. Lemire's expectations, when in 1995 he started his investments in the Ukrainian radio sector, were to create two channels, one in FM and the other in AM. The concepts for both programs would have been different: the FM channel would be based on music, the AM channel structured as a talk radio (because AM technically is not appropriate to broadcast music in a quality format).
363. In May 2006 the National Council put to tender an AM frequency in Kiev with 50 kW. This was an important tender, since AM frequencies are powerful and have an extensive range of coverage. Claimant has asserted<sup>132</sup> that the frequency to be awarded actually covered a radius of 800 to 1000 km around Kyiv, i.e. the entire Ukrainian territory. Whoever won the tender for this frequency would be able to create a talk radio network, and broadcast news and information to the entire nation.
364. It is undisputed that the only participants in the tender, in addition to Gala, were the Odessa Legal Academy (a University) and Charity Fund Radio. In its meeting of May 26, 2006 the National Council rejected all three applications. The reasons for the Tribunal's decision have never been made public. The only document in the file referring to the decision is the minutes (not the transcript) of the meeting of the National Council<sup>133</sup>. These minutes state only that the two other applicants received four votes each and Gala only one. There is no explanation of the decision, not even a summary of the presentations made by the applicants.
365. During the hearing Chairman Schevchenko was expressly asked about the reasons underlying the National Council's decision. His explanation was very vague<sup>134</sup>:

*"But in this particular case, I must say that Gala Radio had fewer chances to become a winner of this contest because in many indicators was lagging behind the other contestants. Therefore the results of this voting is not accidental. I can explain to you my motives in voting this way, but it did not win this competition due to objective reasons".*

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<sup>131</sup> Respondent's Post-Hearing Memorial, para. 460.

<sup>132</sup> Claimant's Memorial, para. 173.

<sup>133</sup> Respondent's Exhibit R-79.

<sup>134</sup> Mr. Shevchenko, Hearing Transcript 3, p. 102, at 18.

366. In its Post-Hearing Memorial, Respondent justifies the National Council's decision by saying that the National Council was under the impression that Gala intended to broadcast music on the AM frequency, since Gala never presented to the National Council a different concept. As evidence of this assertion, Respondent only relies on a statement from Chairman Shevchenko. Claimant has submitted that it presented a talk radio proposal for the AM channel<sup>135</sup>. In the Tribunal's opinion, Claimant's position is more plausible. It makes no business sense to broadcast a music program through an AM channel, and it seems unlikely that Mr. Lemire, an experienced radio operator, would be proposing such a business plan. Unfortunately, with the evidence presented by Respondent in this procedure, it is impossible to ascertain what Mr. Lemire actually told the National Council with regard to his plans. Mr. Lemire had the opportunity to speak at the Council's meeting, but Respondent has only produced the minutes, not the transcripts of this meeting.
367. Summing up, the Tribunal accepts as proven that Gala proposed to create a radio channel with talk radio format, and that for reasons which have not been explained, the National Council decided not to award the frequency to Claimant.
368. There is a second important factual element: the National Council decided, in the same meeting in which it rejected Gala's bid, to retender the same frequency (and this decision was carried unanimously). Only four months thereafter, in September 2004, the new tender was announced. The frequency was awarded on December 21, 2004 to NART TV, through a tender in which Gala did not participate. Claimant has asserted, and has presented circumstantial evidence<sup>136</sup> proving that NART TV is associated with Mr. Tretwakov, the head of financial affairs in the campaign of President Yuschenko<sup>137</sup>. After obtaining the frequency, NART TV never used it. The National Council cancelled it and announced new tenders in 2007 and 2008, in which Gala did not participate.

### Decision

369. The Tribunal must decide whether the National Council's decision in May 26, 2004, denying Gala the AM frequency in Kyiv, and then immediately thereafter retendering the frequency, and awarding it in December 2004 to NART TV, violates the FET standard, by constituting an arbitrary or discriminatory measure. After due consideration, and not without some hesitation, the Tribunal comes to the conclusion that there is a preponderance of evidence showing that the National Council's decisions indeed were arbitrary and discriminatory.
370. The decisions of the National Council in May/December 2004, to reject Claimant's application and award the frequency to NART TV, must be viewed together with the decision of October 2005, denying Gala's application for a FM channel, and granting it to Radio Era. Both decisions affected talk radio

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<sup>135</sup> Claimant's Reply Memorial, para. 204.

<sup>136</sup> Claimant's Exhibit CM-106.

<sup>137</sup> Claimant's Reply Memorial, para. 206.

channels devoted to information. In both, Claimant was denied the licence, and in both the licence was awarded to radio companies which – in accordance with circumstantial evidence – are owned by or associated with persons closely connected with the Government. The Tribunal has already decided that the October 2005 decision, in which 15 FM frequencies were granted to Radio Era, violated the FET standard. The same consideration must be extended to the decision of the National Council affecting the AM frequency and adopted in the period May/December 2004.

371. The *Saluka* test requires that the National Council’s decision “*manifestly violate[s] the requirements of consistency, transparency, even-handedness and non-discrimination*”. The Tribunal finds that the National Council’s decisions to award the AM frequency to NART TV and to deny it to Gala, meets these requirements. In reaching this conclusion, the Tribunal relies on the following factors:

- Claimant’s expectation that it would be awarded an AM licence and that it would be granted the possibility of setting up a talk radio channel;
- the utter absence of any reasoning justifying why the National Council denied Claimant’s request to be awarded the AM frequency in the initial tender;
- the immediate decision of the National Council of retendering of the frequency, the announcement of the new tender four months thereafter and the subsequent issuance of the licence in favour of NART TV; and
- the total lack of official information regarding the ultimate ownership of NART TV.

372. The findings of the Tribunal are not affected by Claimant’s failure to participate in the second tender. In his deposition, Mr. Lemire explained that he had decided not to participate, because he deemed the effort futile<sup>138</sup>. The justification is reasonable. Given that Gala had been unsuccessful in the first tender, in which the other participants were weak and inexperienced operators, its chances of succeeding in the retender, in which a high profile company like NART TV participated, were likely nonexistent. The arbitrary and discriminatory nature of the Council’s decisions arises from the rejection of Claimant’s initial application, the immediate retender and the awarding of the channel to a politically influential applicant. Whether Claimant participated or not in the second tender is immaterial for the Tribunal’s decision.

**D) The Tender of February 6, 2008 With 40% Ukrainian Language Requirement**

373. The tender of February 6, 2008 had a singular characteristic: the frequencies to be awarded were subject to an additional language requirement, namely that 40% of the program had to be in the Ukrainian language (this being in addition to the 50% Ukrainian music requirement under the 2006 LTR).

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<sup>138</sup> Mr. Lemire, Hearing Transcript 1, p. 273, at 25.

### Claimant's position

374. Claimant submits that Gala competed with Kiss FM radio (the station whose ultimate owner allegedly is Mr. Bagrayev) for a number of frequencies in this tender<sup>139</sup>. At that time, Gala was broadcasting 37% of its program in Ukrainian language and thus fell 3% short of the tender condition. (Additionally Gala was meeting a second requirement introduced by the 2006 amendment to the LTR: in more than 50% of the music broadcast, the author, the composer or the performer were Ukrainian). When in the February 6, 2008 meeting of the National Council Mr. Lemire tried to explain how Gala would reach compliance with the 40% tender condition, he was cut off by Council member Kurus with the words: *"It's very straightforward, I must say. According to the tender requirements, you must have no less than 40 percent"*. Mr. Lemire was not allowed to give any further explanation.
375. During the same meeting, a member of the National Council Secretariat reported the corresponding figures of Kiss: share of songs in Ukrainian language 1%, share of music by Ukrainian authors and performers 11%. Nevertheless, Kiss received three frequencies in the February 6, 2008 tender, and Gala received none.
376. When National Council Chairman Shevchenko, in the December 8 – 12, 2008 hearings of the present case, was confronted with the transcript of the February 6, 2008 Council meeting, he explained that applicants were not required to comply before the tender with the 40% Ukrainian language condition, but that they had to demonstrate how they would meet this condition in the future (*"what they had before the competition doesn't matter"*). In Claimant's interpretation, Mr. Shevchenko, who voted for Kiss FM, has admitted that his decision was pre-determined before the National Council meeting discussed the case.

### Respondent's position

377. Respondent, without refuting Claimant's allegations in detail, argues that Mr. Shevchenko's testimony as relied on by Claimant with respect to the February 8, 2008 tender *"is of no probative value"*<sup>140</sup>. In Respondent's view, Claimant confused Mr. Shevchenko by referring him to parts of the transcript relating to tenders other than those won by Kiss. Kiss FM had won the tender for the frequency 89.0 for Ternopil against 14 competitors, while Mr. Shevchenko had been referred to the discussions of the tenders for frequencies for Sumy and Ivano-Frankivsk. Notably the record of Kiss FM was reported in the context of Ivano-Frankivsk. As Mr. Shevchenko's testimony did not relate to the discussion of a tender won by Kiss FM, it cannot provide the basis for a comparison of the treatment of Kiss and Gala, respectively.

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<sup>139</sup> Claimant's Post-Hearing Memorial, para.105.

<sup>140</sup> Respondent's Post-Hearing Memorial, para. 433.

378. Respondent does not, however, explicitly refute Claimant's allegation that all tenders discussed in the February 8, 2008 meeting were equally subject to the 40% Ukrainian language condition.

The Tribunal's position

379. Since there are divergencies between the parties regarding the facts, it is important that, as a preliminary step, the Tribunal establish as precisely as possible what actually happened.

380. On February 6, 2008 the National Council met, in order to award a large number of frequencies. Mr. Kurus, a member of the National Council, has deposed during the hearing that every frequency to be issued during that meeting was subject to the requirement that at least 40% of its programming be broadcast in Ukrainian<sup>141</sup>.

381. An official transcript of the meeting, prepared by the National Council itself, and consequently of high probative value<sup>142</sup>, reveals the following incidents:

- Mr. Lemire was asked to speak during the tender for the frequencies in Sumy Oblast; although Gala had applied for a number of frequencies, the transcript shows that not all participants were invited to speak at each of the tenders; this tender was the only occasion when Mr. Lemire was authorized to speak; he explained that Gala Radio was complying with the 50% Ukrainian music requirement, and that the Ukrainian language percentage was 37%. He was interrupted by Mr. Kurus, a member of the National Council, who said: *"It is very straight forward, I must say. According to the tender requirements you must have no less than 40%"*;
- during the tender for Ivano-Frankivsk – in which Gala, Kiss and many other radio stations participated – President Shevchenko requested Mr. Sokur, a civil servant from the National Council, to provide the relevant statistics for Kiss (the official name of which is Utar TV and Radio Broadcasting UC); his answer was the following: *"We have statistics for Utar TV and Radio Broadcasting UC as a competitor. And the figures are the worst. The share of music by national authors and performers is only 11% and the share of songs in Ukrainian 1%"*;
- during the hearing, Chairman Shevchenko was cross examined with regard to this statement; he accepted that statistic prepared by National Council staff were correct<sup>143</sup> and that if it were proven that Kiss was only broadcasting 11% Ukrainian music, this would constitute a violation of the law<sup>144</sup>; as regards the 1% Ukrainian language content, his explanation was that the percentage before the tender was irrelevant,

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<sup>141</sup> Mr. Kurus, Hearing Transcript 4, p 42, at 12; Mr. Shevchenko, when asked the same question, answered that there *"could be different conditions for different frequencies"* (Tr. 3, p. 138, 6); the Tribunal, after reviewing the transcript of the National Council meeting, coincides with Mr. Kurus' opinion, because references to the 40% requirement appear repeatedly when discussing various frequencies.

<sup>142</sup> Respondent's Exhibits R-351 and R-352.

<sup>143</sup> Mr. Shevchenko, Hearing Transcript 3, p 81, at 16.

<sup>144</sup> Mr. Shevchenko, Hearing Transcript 3, p. 89, at 11.

what was important was that the bidder had a good program concept, and in future could reach the 40% threshold<sup>145</sup>.

382. There has been some discussion among the parties regarding which radio company won which frequencies during the February 6, 2008 National Council meeting. It is undisputed that Kiss won the frequency for Ternopil with seven of the eight votes, because a copy of the official transcript clearly states so<sup>146</sup>. Claimant submits that Kiss won two additional tenders. Respondent has not provided clear evidence for this fact (because the transcript is not complete). It is undisputed that Gala was awarded no frequency.
383. At the core of Claimant's grievance is the unequal treatment of Gala and Kiss with respect to the Ukrainian language tender condition. This condition applied to all tenders – including the tender for Ternopil won by Kiss FM and all the tenders lost by Gala. But it was interpreted in a completely different way when applied to Gala as compared to Kiss. Respondent has tried to defend the National Council's record, stressing that the different interpretations were voiced in different tenders. The argument is unconvincing, because all tenders had the same basic requirement. And the fact remains that Kiss has been awarded (at least) a frequency, despite its nearly nil Ukrainian language record and its violation of the 50% Ukrainian music requirement (known to the National Council), while Gala has been disqualified on the basis of a much stronger record.
384. As noted before, a measure violates Article II.3 (b) of the BIT if it is either “discriminatory” or “arbitrary”. It is readily apparent from the record that Gala and Kiss were treated differently in a similar case (i.e. on the same issue in the same tender proceeding, although not necessarily for the same frequency) without justification and, worse, in violation of applicable tender conditions. According to Article 25.14 (a) of the LTR, in its tender decisions the National Council must prefer applicants “capable to fulfil the licence conditions to the best extent”. The Ukrainian language requirement was a highly relevant condition for all the tenders, and Gala's capability of fulfilling that condition was far superior to that of Kiss. While Kiss won at least a tender, Gala's record was pretextually discounted in order to exclude it from further consideration.
385. Although not every violation of domestic law necessarily translates into an arbitrary or discriminatory measure under international law and a violation of the FET standard, in the Tribunal's view a blatant disregard of applicable tender rules, distorting fair competition among tender participants, does. In conclusion, the Tribunal considers that when the National Council at its meeting of February 6, 2008 decided to award at least a frequency to Kiss, and to deny all applications submitted by Gala, such decision violated the FET standard required by Article II.3 of the BIT.

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<sup>145</sup> Mr. Shevchenko, Hearing Transcript. 3, p. 82, at 23

<sup>146</sup> Respondent's Exhibit R-352, p. 10.

**E) The Tender of November 20, 2002 in Which Claimant Was the Only Applicant**

386. On November 20, 2002, the National Council denied Gala's application for a frequency for the city of Zhytomir, although Gala was the only applicant in this tender. The National Council's decision to reject Claimant's application for Zhytomir was not reasoned. Without providing further specifics, Claimant regards this decision as a violation of the FET standard<sup>147</sup>.

The Tribunal's position

387. Claimant is only alleging two circumstances in order to prove the arbitrary or discriminatory character of the National Council's decision to reject the Zhytomir application:

- that Gala was the only applicant; and
- that the decision was not reasoned.

Factual situation

388. Before analyzing these circumstances in more detail, it is important to stress that the factual situation asserted by Claimant with respect to this tender was quite different from that pleaded and decided in section C). In the case of the AM channel, what happened was that Claimant's application was denied, and immediately thereafter the same frequency was assigned to a competitor, who apparently enjoyed privileged political connections. In the Zhytomir decision there is no allegation that the channel was afterwards retendered and awarded to a third party, in circumstances which could represent a violation of applicable rules. Nor does Claimant make any other indication of impropriety with regard to the actions of the National Council.

389. The starting point of the Tribunal's analysis must be whether the Zhytomir decision violated Ukrainian Law. In accordance with the practice of the National Council, which conforms with the LNC (Article 26.4), every allocation of a broadcasting licence required the affirmative vote of a majority of members, i.e. five. The same rule applied for tenders with only one participant. The single applicant had to secure five supportive votes in order to win the tender; otherwise the frequency was not allocated at all.

390. The lack of reasoning does not by itself constitute a violation of the LTR. As has already been explained (see paragraph 303 above), the LTR only requires reasoning for the National Council's decisions not to allow a company to participate in a tender (Article 25.8) – but not for the decision to award or deny the frequency (Article 25.13).

391. Against these rules, Gala's position as the single applicant did not *ipso iure* entitle it to the Zhytomir frequency, but only to an unbiased consideration of the application in accordance with the statutory guidelines. The burden of

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<sup>147</sup> Claimant's Post-Hearing Memorial, para. 118.

proof that the decision was discriminatory or arbitrary (or otherwise violated the FET standard) lies with Claimant.

The National Council's decision

392. The National Council's decision denying Gala's application could never be considered discriminatory, because in this case no third party existed which benefited from it.
393. It could nevertheless be arbitrary.
394. After due consideration, the Tribunal rejects Claimant's assertion, for want of sufficient evidence. Under Ukrainian law, the National Council was entitled to deny a licence, even if the applicant was the only entity applying, and Ukrainian law does not require that decisions be reasoned. The Tribunal has already indicated that the absence of reasoning represents a significant weakness in the administrative procedure for the issuance of licences (see paragraph 312 above). But this weakness does not imply *ipso iure* that all unreasoned decisions of the National Council are arbitrary. For a decision to be considered arbitrary, an additional element of lack of probity must have been pleaded and proven. Claimant has not succeeded to do so in the case of the Zhytomir frequency, and consequently Claimant's challenge to the National Council's decision fails.

**F) The Tender of October 19, 2005 in Favour of NMB Radio**

395. On July 16, 2005 the National Council announced a tender for 29 frequencies grouped in a channel, which was to broadcast in Ukrainian only, with 100% Ukrainian language content. On October 19, 2005, NBM Radio was awarded this channel in a tender with 14 applicants, including Gala.

Claimant's position

396. According to Claimant, NBM Radio is owned by Mr. Poroshenko, a friend and political ally of the President. Claimant asserts<sup>148</sup> that the outcome of the tender was pre-determined and that the channel of 29 frequencies was specifically calculated for NBM Radio, as evidenced by the fact that NBM Radio was the only one of the 14 applicants for this channel that had no overlap in its coverage with the frequencies allocated for tender. Claimant has also produced minutes of a meeting in Gala on February 21, 2003 where Mr. Zhebrodki, a manager of the State Centre, allegedly stated that the State Centre had received applications for frequencies from NBM and had "*to do something about it, since Mr. Poroshenko has become a National Security Advisor*"<sup>149</sup>.

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<sup>148</sup> Claimant's Post-Hearing Memorial, para. 98.

<sup>149</sup> Claimant's Exhibit CM-143.



### Respondent's position

397. Respondent pleads ignorance regarding Mr. Poroshenko's ownership of NBM Radio<sup>150</sup> and submits that some 15 companies had participated in the tender (rather than 14 as alleged by Claimant), that these applications were discussed in meetings of the National Council during October 19 – 26, 2005, and that Radio NBM was awarded the channel because it best promised compliance with a key tender condition. This condition was to broadcast in Ukrainian language only with a 100% "Ukrainian content". While Claimant in the hearing of the National Council had criticized this tender condition, NBM Radio had promised full compliance and referred to its already superior record in this respect.

### The Tribunal's position

398. Claimant submits that the October 19, 2005 National Council decision awarding 29 frequencies in favour of NMB Radio was arbitrary and discriminatory; the evidence presented is the following:

- (i) NMB Radio is owned by Mr. Poroshenko, a close ally of the President;
- (ii) the channel was specifically calculated to fit with NMB's present coverage;
- (iii) a statement from Mr. Zhebrodki, Manager of the State Centre; and
- (iv) a threat of prosecution from the National Council against Mr. Lemire.

399. The Tribunal will analyse each piece of evidence separately.

### Valuation of the evidence

400. (i): As regards the ownership of NMB Radio, the Tribunal has again been unable to ascertain the ultimate owner because all the members of the National Council have deposed that they lack this information<sup>151</sup>. The deposition is so implausible, that the Tribunal – in the absence of any convincing evidence to the contrary - is prepared to accept the circumstantial evidence presented by Claimant and assume that Mr. Pereshenko is indeed the owner of NMB Radio. But even if this is assumed, and also that he is an ally of the President of Ukraine, these circumstances give rise to some suspicion but, in the absence of any further evidence of political interference, fall short of indicating a manipulation of the tender process.
401. (ii) and (iii): Claimant further alleges that the channel of 29 frequencies had been specifically calculated for NBM Radio to enhance its national coverage. The only evidence submitted to prove this point is the statement from Mr. Zhebrodski (a manager of the State Centre)<sup>152</sup>. This statement was apparently made during a private meeting at Gala's premises held with certain

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<sup>150</sup> Respondent's Post-Hearing Memorial, para. 408.

<sup>151</sup> See Respondent's Post-Hearing Memorial, para. 410.

<sup>152</sup> Claimant's Post-Hearing Memorial, para. 101.

officers of the company, identified simply as “Natalie, Dima, Kid”. Neither Natalie, Dima nor Kid have appeared as witnesses in this arbitration or even submitted a witness statement. Then, after the meeting, some unidentified person prepared a transcript, translating what undoubtedly was spoken in Ukrainian into English. This two page English transcript is what has been presented, and there Mr. Zhebrodski is quoted as saying. “*Right now we have applications from NMB and Channel 5 and we have to do something about it, since Poroshenko has become a National Security Advisor*”<sup>153</sup>.

402. This evidence is weak. There is no certainty that Mr. Zhebrodski actually used these words, that they were correctly recorded and then correctly translated into English. But even if *arguendo* the quotation is accepted as true, Mr. Zhebrodski only indicates that the prominent position of Mr. Pereshenko (not necessarily his relationship with the President) added some sense of urgency for the State Centre to perform its duties (i.e. to calculate frequencies in the presence of applications); it did not necessarily imply any manipulation.
403. (iv): Finally, there is the alleged threat of prosecution by the National Council. What happened is that on September 15, 2005, Mr. Lemire sent a letter to the National Council, asking for a general suspension of tenders in view of allegations of corruption against the Ukrainian Government and also against the National Council<sup>154</sup>. As a reaction to this letter, on September 21, 2005, the National Council adopted a decision declaring Mr. Lemire’s allegations “*groundless and far-fetched*” and “*consider[ing] them as the tool of exerting pressure on the National Council management*”, and informing the public of the “*blackmail efforts*” undertaken<sup>155</sup>.
404. The documentary record does not evidence any threat of prosecution from the National Council. What seemed to have happened is that Claimant sent a strongly worded letter (to use an understatement) to the National Council, with copies to the President and the Prime Minister and to the American Ambassador, and that the National Council reacted with a decision, also drafted in strong terms, rejecting the accusations and describing Claimant’s behaviour as blackmail.
405. Summing up, the Tribunal considers that each piece of evidence submitted by Claimant, by itself, is not sufficient to support an allegation that the tender decision was arbitrary or discriminatory. The Tribunal has finally considered whether the evidence in the aggregate might establish conclusive evidence of a manipulation of the tender process, even if none of these circumstances did so by itself. Such a conclusion might be appropriate in the absence of a plausible explanation for the result of the tender decision. Thus, it is necessary that the Tribunal analyse the details of the National Council’s decision.

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<sup>153</sup> Claimant’s Exhibit CM-143.

<sup>154</sup> Claimant’s Exhibit 30 to Request of Arbitration.

<sup>155</sup> Claimant’s Exhibit CM-39.

The decision to award the frequencies

406. The record of this arbitration includes the transcript of the meeting of the National Council on October 19, 2006, in which both Gala and NBM (among various others) made presentations to defend their applications<sup>156</sup>. NMB spoke first, explaining that NBM Radio had started 10 years ago, and that it was the first radio station that conducted and continued to conduct the broadcasting exclusively in Ukrainian<sup>157</sup>. Gala, who spoke afterwards, accepted that the tender *“is an entirely different format, not the format of Gala radio Company<sup>158</sup>”* and declared that it would comply with the requirements of the National Council *“that all DJ’s must speak Ukrainian, there should be Ukrainian music, and thus shape and form Ukrainian culture”*. Mr. Lemire finally added a phrase which could be understood to express some challenge to the National Council’s determination that the channel should be 100% Ukrainian: *“We should allow the audience to determine what it wants and we think that since Ukraine is seeking the status of a country with a market-economy, it should not introduce Ukrainian culture by force – it needs to be developed<sup>159</sup>”*.
407. The National Council had defined as a fundamental condition for the new channel that it be 100% in Ukrainian. This was a legitimate decision, based on a public interest choice to extend the use of Ukrainian in the media. When awarding licences, the first criterion which the National Council must take into consideration is whether the winner will be able to fulfil the conditions to the best extent (Article 25.14 (a) of the LTR). Applying this criterion to the present tender, it seems both plausible and legitimate that NMB’s and Gala’s different experience and attitude towards broadcasting 100% in Ukrainian, swayed the Council members’ votes in favour of Radio Era.
408. Against the satisfactory explanation of the tender decision, the four circumstances alleged by Claimant cannot be accepted as evidence of a manipulation of the tender process amounting to a violation of the FET standard defined in Article II.3 of the BIT.

**G) The Award of Frequencies During the Time When the National Council Was Not Operative**

409. The National Council became inoperative in March 1999, because its members were not appointed, and remained in this situation until June 2000<sup>160</sup>. Claimant submits that during this period, Respondent developed the practice of illegally awarding frequencies to companies other than Gala. The National Council then held its first tender on January 1, 2001, at which Claimant was not authorized to participate, and at which preferential treatment was given to the companies which had been illegally given licences during the National Council’s black out period.

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<sup>156</sup> Respondent’s Exhibit R-279.

<sup>157</sup> Respondent’s Exhibit R-279, p. 3.

<sup>158</sup> Respondent’s Exhibit R-279, p. 10.

<sup>159</sup> Respondent’s Exhibit R-279, p. 10.

<sup>160</sup> Claimant’s Post-Hearing Memorial, para. 67.3.

### The Tribunal's position

410. It is undisputed that between March 16, 1999 and June 9, 2000 the National Council did not function, because its members had not been appointed. After Parliament appointed its members on May 18, 2000 and the President made his appointment on June 9, 2000, a newly constituted National Council was able to resume its functions. It is also undisputed that on January 1, 2001 the first tender organized by the new National Council was held, and that Gala was not permitted to participate, because it was reserved for companies who had been affected by the National Council's black-out period.
411. There is an important dispute among the parties regarding the precise scope of companies which had access to this special tender.
412. Respondent submits that the tender was reserved to broadcasters whose licence had expired while the National Council was inoperative<sup>161</sup>. Claimant's explanation is totally different: during the interregnum Ukraine had developed the practice that the State Committee grant licences for radio broadcasting, in violation of the LTR, through a non-transparent and closed procedure that was not available to Claimant<sup>162</sup>. And the first tender was organized to legitimize these beneficiaries.
413. There is strong evidence that Claimant's explanation is the correct one.
414. First of all, the renewal of licences under the LTR does not require a tender (Article 24.9). Extension is a "*right*" of the licence holder, and the National Council can reject the application for extension only in very limited circumstances (Article 33.7). Respondent's explanation of what happened seems a legal impossibility, and is at any rate entirely implausible.
415. Secondly, there is a letter sent on September 28, 1999 by S. Aksenenko, a member of the National Council, to the Vice Prime Minister of Ukraine<sup>163</sup>, in which Mr. Aksenenko protests that other institutions of the executive branch are usurping the National Council's powers, taking advantage of the fact that it is not operative.
416. Finally, Mr. Lemire has presented the transcript of a meeting held on March 19, 2001 with Mr. Koholod, the then chairman of the National Council, who acknowledged that during the interregnum "*some bad things [were] happening*" and that the State Committee, and not the National Council, had been issuing the licences<sup>164</sup>.
417. The Tribunal concludes that during the period between March 16, 1999 and June 9, 2000, when the National Council was not operative, Respondent developed the practice that certain licences for radio broadcasting were issued directly by the executive branch of Government, without transparency or

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<sup>161</sup> Respondent's counsel, Hearing Transcript 1, p. 71, at 16.

<sup>162</sup> Claimant's Post-Hearing Memorial, para. 57.2.

<sup>163</sup> Claimant's Exhibit CM-11.

<sup>164</sup> Claimant's Exhibit CM-101; Respondent has not challenged the accuracy of the transcript.

publicity and without meeting the requirements of or following the procedures established in the LTR. The *de facto* situation was then legalized through the first tender, convened by the National Council exclusively with this purpose. Claimant was excluded from this procedure.

418. In the opinion of the Tribunal, Respondent's above described practice constitutes a violation of the FET standard established in Article II.3 of the BIT, because it facilitates the secret awarding of licences, without transparency, with total disregard of the process of law and without any possibility of judicial review. The practice must be considered arbitrary, since it meets the *Saluka* test of "*manifestly violat[ing] the requirements of consistency, transparency, even-handedness and non-discrimination*"<sup>165</sup>. The lack of propriety is such that – as the test was articulated in *Tecmed* and *Loewen* - the practice also "*shocks, or at least surprises, a sense of juridical propriety*"<sup>166</sup>.

### VII.3.5. CONCLUSIONS REGARDING THE AWARDING OF RADIO LICENCES

419. As a starting point the Tribunal has studied the administrative procedure defined in Ukrainian Law for the issuance of radio frequencies. The conclusion reached by the Tribunal is that the procedure was marred by significant shortcomings (although these have been ameliorated after the 2006 amendment to the LTR). These weaknesses facilitated arbitrary or discriminatory decision-taking by the National Council.
420. In six years Gala Radio, although it tried insistently, and presented more than 200 applications for all types of frequencies, was only able to secure a single licence (in a small village in rural Ukraine). Gala's main competitors were much more successful and each received between 38 and 56 frequencies. Although this macro-statistical analysis does not provide conclusive evidence that Respondent, when awarding radio licences, has been violating the FET standard, there are factors (the strikingly different success rates of Gala and of its competitors, the inexistence of any information regarding the real owners of the competing stations, the impossibility of verifying the reasons why Gala was rejected) which can be construed as indications that at least some of the decisions of the National Council when it awarded frequencies were arbitrary and/or discriminatory.
421. To confirm or reject these indications, the Tribunal then looked in detail at five tenders for radio frequencies and at the administrative practice for awarding licences in the interregnum while the National Council was not operative between 1999 and 2000. The Tribunal came to the conclusion that the following decisions did not meet the FET standard provided for in the BIT:

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<sup>165</sup> *Saluka Investments BV v. Czech Republic PCA*, UNCITRAL, Partial Award of 17.March 2006, para 307.

<sup>166</sup> See *Tecnicas Medioambientales Tecmed SA v. United Mexican States*, ICSID Case No. ARB (AF)/00/2, Award of 29 May 2003, para. 154 and *Loewen Group Inc and Raymons L. Loewen v. United States of America*, ICSID No. ARB(AF)98/3, Award of 26 June 2003, para. 131.

- the National Council's decision adopted on October 19, 2005 granting an FM information channel to Radio Era, and the subsequent decisions to award 12 frequencies to radio Kokannya;
- the National Council's decision of May 26, 2004 denying Gala Radio the licence for an AM channel, and the decision of December 21, 2004 granting such licence to NART TV;
- the National Council's decision of February 6, 2008 denying Gala's application and accepting the application of Kiss Radio;
- Respondent's practice of awarding radio licences while the National Council's was not operative between March 16, 1999 and June 9, 2000, and the National Council's decision of January 1, 2001 to legalize the licences illegally granted during the interregnum.

422. On the other hand, the Tribunal is unconvinced by Claimant's allegation that the National Council's decisions of November 20, 2002 and of October 19, 2005 represented a breach of the FET standard.

### **VII.3.6 POSTPONEMENT OF DECISION REGARDING DAMAGES**

423. Claimant has presented extensive allegations regarding damages, and an expert report prepared by Goldmedia. Respondent has submitted a counter report prepared by EBS. Both experts deposed during the hearing.

424. In its Post-Hearing Memorial, Respondent has added<sup>167</sup> that the damage reports were prepared in the summer of 2008, that since then the economic basis has completely changed, and that the Ukrainian economy has shifted from a high growth rate to a sharp drop. There have also been significant changes in the parity of the UAH vis-à-vis the USD. Ukraine asserts that its economy "*has been devastated by the worldwide economic crisis*" and that it will shrink dramatically in the future. These changes in the overall economic climate, according to Ukraine have a significant impact on the DCF analysis presented by the experts.

425. The Tribunal agrees with Respondent that the changes suffered by the Ukrainian and the world economy since the dates when the expert reports were prepared, and its effects on the *quantum* of the damage, require further investigation. Furthermore, the assumptions underlying the experts' reports do not coincide with the conclusions reached by the Tribunal in this Decision, and the quantum evidence therefore requires recalibration in accordance with the present decision. Consequently, the question of the appropriate redress of the breach, including the quantification of the damages, will be addressed in a short second phase of this arbitration. After hearing the parties, the Tribunal will issue a Procedural Order for the continuation of the procedure.

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<sup>167</sup> Respondent's Post-Hearing Memorial, para. 646.

## **VII.4. CLAIMANT’S SECOND ALLEGATION: THE CONTINUOUS HARASSMENT BY RESPONDENT AND THE REQUEST FOR MORAL DAMAGES**

### **VII.4.1. CLAIMANT’S ALLEGATIONS**

426. Claimant submits<sup>168</sup> that the National Council, in a concerted effort to force Claimant out of the radio industry, has:
- abusively monitored and inspected Gala from 2005 through 2008;
  - issued two warnings to Gala and threatened issuance of a third warning with the purpose of revoking Gala’s licence;
  - threatened Gala with non-renewal of its licence on the basis of the 2006 LTR disqualifying foreigners as “founders” of radio stations;
  - delayed the decision on the renewal of Gala’s licence with a view to imposing a tenfold licence fee under a newly enacted formula; and
  - allowed only an unrealistically short period for payment for an exorbitant licence fee.
427. Claimant adds that Gala was the first radio company which complied with the 50% Ukrainian music requirement, despite the negative effects on its ratings. This notwithstanding, in September 2005 the National Council inspected Gala and, as a result, issued a first warning on October 5, 2005. This warning was voided on April 4, 2006 by the Kyiv Economic Court, with the National Council’s appeal dismissed on September 26, 2006.
428. In October and November 2005, Gala was again repeatedly monitored and inspected, with a second warning (dated November 23, 2005) as a result. Due process defence against this warning was denied to Claimant. Upon Gala’s redress, the second warning was also voided by the Kyiv Economic Court and the National Council’s appeal against that decision was again dismissed on February 15, 2007.
429. In May/June 2006 Gala was monitored and inspected yet again; and on July 19, 2006, the National Council met to decide on a third warning. Under the new 2006 LTR, a third warning would have enabled the National Council to institute court proceedings for revoking Gala’s licence. Against this threat, the meeting was attended by five Gala executives, Gala’s local and international attorneys, and the First Secretary of the US Embassy in Ukraine. In view of this presence, the National Council shied away from issuing a third warning.
430. The two warnings and the threat of a third, terminal warning were based on frivolous grounds. Claimant refers to other radio stations which were rarely inspected and did not receive warnings despite graver violations.
431. Claimant further submits that the Chairman and other representatives of the National Council have repeatedly threatened to reject the renewal of Gala’s broadcasting licence, which expired on September 18, 2008. They referred to Claimant’s US citizenship and to Article 12(2) of the LTR, which prohibited

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<sup>168</sup> Claimant’s Post-Hearing Memorial, para. 125.

the “*foundation*” of TV/radio stations by “*foreign legal entities and physical persons*”, although a similar prohibition already existed in the historic 1993 LTR. Besides the National Council representatives knew that Claimant had acquired his controlling share in Gala from the Ukrainian company Provisen and thus had not been Gala’s founder.

432. While Gala had applied for an extension of its licence on March 13, 2008, the National Council delayed its final decision until July 19, 2008. It then applied a new formula for calculating the licence fee, which had been adopted by the Council of Ministers just on July 9, 2008. To make matters worse, the new formula was applied wrongly to Gala’s detriment. As a result, Gala was invoiced a renewal fee of the equivalent of 1,039 million USD, more than ten times the fee that would have been due under the previous formula. Gala was allowed only 16 days for payment of this unexpectedly high fee. Other radio companies (e.g., HIT FM and Russkoye Radio owned by Mr. Bagrayev, a political ally of the President) had applied for a renewal of their licence later than Gala, but received the renewal before Gala, at a fee calculated under the previous formula.
433. On August 15, 2008, Claimant requested a Provisional Measure from the Tribunal, suspending ultimate payment of the renewal fee until the Final Award in this arbitration. On August 19, 2008, Respondent requested that Mr. Paulsson resign as an arbitrator in the present case, due to the involvement of his law firm in another case with Respondent as a party; this request and a subsequent official challenge by Respondent to Mr. Paulsson’s impartiality, delayed the Tribunal’s decision on the requested Provisional Measures.
434. The National Council finally reassessed the renewal fee to the amount expected by Claimant. This reassessment was prompted by an advice from the Ministry of Justice that the previous formula (rather than the new formula) was applicable to Gala’s renewal fee.
435. Claimant acknowledges that the harassment finally has not been successful, because the broadcasting licences have been extended with the payment of the correct fees, Gala has not been fined and the warnings have been quashed by the Ukrainian Courts. But Claimant submits that this does not provide Claimant with immunity from paying damages for the harassment and moral harm that Ukraine’s malicious acts have caused. Invoking the precedent of *DLP v. Yemen*<sup>169</sup>, Claimant requests that Respondent “*be held to be liable to reparation for the injury suffered by Claimant, whether bodily, moral or material in nature*”. Respondent’s harassment has inflicted significant moral harm, including anxiety, pain and suffering, for which Respondent should be held liable in the amount of three million USD.

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<sup>169</sup> *Desert Line Projects LLC v. Yemen*, ICSID Case No. ARB/05/17, Award of 6 February 2008.



#### VII.4.2. RESPONDENT'S ALLEGATIONS

436. Respondent denies<sup>170</sup> that the National Council had any intention, let alone concerted action strategy, to shut down Gala and force Claimant out of the radio industry in Ukraine. All monitoring, inspections and other actions advanced by Claimant were performed by the National Council in the exercise of its regulatory and supervisory responsibilities as per the parameters and guidance provided in applicable legislation.
437. Statistics refute Claimant's allegation that Gala had been targeted for excessive monitoring and inspections. During 2004 – 2008, the National Council ordered a total of 1438 inspections and issued a total of 288 warnings. The five inspections of and two warnings to Gala are not egregious. Other broadcasters similarly had experienced between three and six inspections; and five broadcasters had even received three warnings and presently face court proceedings for cancellation of their licences.
438. The procedures for monitoring and inspections are not inequitable, arbitrary or discriminatory, and are equally applied to all broadcasters under the jurisdiction of the National Council. As a matter of administrative routine, broadcasters are continuously monitored to check whether they comply with applicable legislation and with their licences. Monitoring is based on an evaluation of the programmes broadcast; it does not involve the companies and does not interrupt their business. Inspections are ordered by the National Council if monitoring reveals indications of violations; they are carried out at the premises of the radio station and last one business day at most. Inspection reports are immediately shared with the broadcasters concerned and submitted for decision to the National Council. If the inspection reveals violations of either applicable legislation or the terms of a broadcaster's licence, the National Council may impose sanctions. These range from warnings (lightest sanction) and monetary penalties to court proceedings and revocation of licence. Sanctions imposed can be appealed to Ukrainian Courts.
439. Gala was monitored in September 2005, together with several other broadcasters, in accordance with the normal administrative process. Since violations of applicable legislation were detected (with respect to Ukrainian language and advertising rules), the National Council by letter of September 27, 2005 informed Gala of its decision to conduct a first inspection on September 30, 2005. When the National Council experts tried to perform this inspection, Gala representatives denied them access to Gala's premises. The National Council thereupon issued a first warning on October 5, 2005 and, at the same time, decided to repeat the inspection within two weeks. On April 4, 2006 this first warning was quashed by the Kiyv Economic Court, on the ground that the National Council had failed to prove receipt by Gala of the Council's aforementioned letter of September 27, 2005.

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<sup>170</sup> Respondent's Post-Hearing Memorial, para. 516.

440. Gala was inspected again on October 19, 2005. This inspection detected violations of broadcasting and advertising legislation, and of the terms of Gala's licence regarding children's and educational programs. On November 2, 2005 the National Council discussed the inspection results with Gala and gave it two weeks to cure the violations. After negative results of a subsequent monitoring, the National Council issued a second warning on November 23, 2005, requiring Gala to cure the violations within six months. This second warning was also quashed by the Kiev Economic Court, on the ground that it was based on an inspection prompted by the first warning, which had been voided previously by the Court.
441. On May 27, 2006, i.e. six months after the second warning, a monitoring revealed that Gala had not ceased in its violations. Thereupon, a third inspection was carried out on June 2, 2006. It confirmed continuing violations as per the monitoring report, but also noted that Gala had rectified its previous violations regarding broadcasting in Ukrainian language. In view of this improvement, the National Council abstained from issuing a third warning.
442. In 2008, Gala was inspected twice, in April as a routine matter in advance of the pending renewal of Gala's licence and on June 3 after monitoring detected a violation of Ukrainian election legislation. The April inspection was inconsequential, while the June inspection confirmed the violation. Nevertheless, the National Council, in its meeting on June 18 accepted Claimant's explanation that the violation was accidental, did not issue a warning but rather proceeded with the renewal of Gala's licence.
443. National Council representatives have never threatened to deny the renewal of Gala's licence due to Claimant's US citizenship.
444. The licence was renewed on July 19, 2008 in due time before its expiry on September 18, 2008. The processing time was required for clarification of outstanding issues.
445. The renewal fee had initially been calculated under the new formula on the National Council's understanding that the Cabinet decree had entered into force at the date of its receipt by the National Council on July 11, 2008. Since the renewal had been granted thereafter (July 16), the Council had applied the new formula in good faith. Nevertheless, the National Council had sought the guidance of the Cabinet of Ministers on the issue as early as August 11, 2008, i.e. before Claimant's request for Provisional Measures challenging the fee. The Cabinet had referred the matter to the Ministry of Justice, which on September 15, 2008 advised the National Council that the formula entered into force only with the publication of the decree in the Official Bulletin of Ukraine on July 18, 2008, i.e. after the renewal of Gala's licence on July 16. In light of this advice, the National Council promptly recalculated the fee under the previous formula, more advantageous to Claimant, and informed the Tribunal accordingly.

446. The challenge of Mr. Paulsson as an arbitrator in the present proceeding had been prompted by disagreements between Claimant and Respondent regarding implications of the issue for the status of the final award. It had nothing to do with Claimant's request for provisional measures and/or the calculation of the renewal fee.
447. The fact that the two warnings against Gala have been set aside by Ukrainian Courts shows, in Respondent's view, that the Ukrainian system provided adequate redress against administrative error, in compliance with the FET standard under the BIT.
448. Claimant had suffered no harm as a result of the National Council's actions wrongly described by Mr. Lemire as harassment. All inspections together have taken at most four business days over a four-year period. Claimant is still operating a profitable business – a fact which according to Respondent precludes any claim on the basis of "*creeping expropriation*" or violation of "*full protection and security*".

#### **VII.4.3. THE TRIBUNAL'S DECISION**

##### **A) Introduction**

449. Claimant's basic line of reasoning is that, behind the individual facts of this case, an overall aim appears: the Ukrainian authorities' desire to get rid of an annoying American investor, by systematically denying any application for further frequencies, thwarting plans to create new channels, and harassing him with irregular inspections and difficulties for the renewal of his licence.
450. Respondent has vehemently denied the accusation. Chairman Shevchenko has stated that the National Council never resorted to procedures aimed at any revocation of the Gala Radio licence and has not even contemplated such steps<sup>171</sup>.
451. The Tribunal has already come to the conclusion that Respondent's practice regarding the allocation of frequencies is not compatible with the FET standard defined in the BIT. As a consequence of the violation of the BIT Claimant is entitled to be indemnified for the economic damages he has suffered. As has already been stated (see paragraph 426 above), this issue will be addressed in a subsequent phase of this arbitration.
452. Claimant is now asking that the Tribunal decide whether the harassment which he allegedly suffered, entitles him to receive an additional indemnification, further to the economic loss, for the moral damage suffered. The harassment in itself cannot constitute additional violations of the BIT because, as Claimant himself acknowledges, in the end the inspections led to no sanctions and the licence was correctly extended. For this reason, Claimant restricts his prayer for relief to a request that the Tribunal indemnify Claimant for the moral harm he has suffered, caused by Respondent's continuing harassment.

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<sup>171</sup> Respondent's Rebuttal Witness Statement of Mr. Shevchenko dated 2 December 2008, p.31.

453. In order to decide this claim, the Tribunal has to analyze the two separate issues submitted by Claimant, the inspection of Gala Radio (B) and the renewal of the licence (C), leading to the Tribunal's conclusions (D).

**B) The Inspection of Gala Radio**

454. The National Council is the supervisor and regulator of the TV and radio sector in Ukraine (Articles 13 and 14 of the LNC). As such, the Council has the power to monitor and inspect radio companies, including Gala Radio. The procedure of inspection is defined in Articles 70 to 75 of the LTR, and in an Instruction of the National Council, issued in 2003 and amended in subsequent years<sup>172</sup>. Monitoring is a process of recording and analyzing the broadcasting of a radio company, and is done directly by the National Council, without involvement of the radio station. An inspection is a more serious review, which requires access to the company's premises. Inspections can be scheduled – i.e. in accordance with a plan approved by the National Council – or unscheduled – i.e. motivated by some exceptional circumstance.

455. The results of an inspection are formalized in an inspection report; the affected company has access to the report, and is entitled to give explanations, to provide evidence and to file claims (Article 73.3 of the LTR). The inspection report, prepared by the National Council staff, is submitted to the National Council which has the right either to close the file without sanction, or to issue a warning, to impose a penalty or to appeal to a Court in order to revoke the licence (Article 72.6 of the LTR). The practice of the National Council is to listen during the meeting to an oral explanation of the representative of the radio company<sup>173</sup>.

456. It is undisputed that until 2005 Gala was never inspected. Since then, Gala has suffered five inspections, four of which were unscheduled<sup>174</sup>.

The first warning

457. The first inspection took place on September 28, 2005, and it has been described in detail in the report prepared by the inspectors<sup>175</sup>. The day before the inspection, the inspectors had sent a fax to Radio Gala, announcing their visit for the next day. When they arrived, a female employee told them that the management of the company was outside Kyiv, and would not return until October 17, 2005. The employee stated that she “*was not authorized to provide any information or documents*”.

458. A week later, on October 5, 2005 the National Council decided to issue a warning to Gala because the personnel of Gala Radio “*prevented [National Council representatives] from carrying out their legitimate actions*”<sup>176</sup>, by

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<sup>172</sup> Respondent's Exhibit RLA-15 (original text) and RLA-64 (amended text).

<sup>173</sup> Inspector Iulian Leliukh, Hearing Transcript 4, p.103, at 15.

<sup>174</sup> Mr. Denisenko, Hearing Transcript 2, p. 209, at 16.

<sup>175</sup> Respondent's Exhibit R-270.

<sup>176</sup> Respondent's Exhibit R-272.

refusing to produce the documents and materials required for conducting the inspection. The decision was abusive, because the inspectors' report did not reflect any refusal to cooperate, only the absence of management, and because the advance notice had been unreasonably short. Besides, there is no evidence that Gala was heard before the decision was adopted, and the LTR does not typify the refusal to produce documents as a sanctionable wrong. Gala successfully challenged the warning before the Kyiv Economic Court, and it was set aside by this Court on April 11, 2006. The National Council appealed, the appeal was rejected on February 14, 2008.

#### The second warning

459. On October 14, 2005 the National Council informed Gala that an inspection would be performed on October 19, 2005. The inspection took place on this date, in the presence of Mr. Lemire, who refused to sign the inspection report<sup>177</sup>. The inspection report reflects the following:

- the language of programs is Ukrainian;
- the language of commercials is predominantly Ukrainian, although two commercials were in Russian, which represents a violation of the Law on Advertising;
- there is one instance where a commercial was not separated from other elements of the program, in violation of the Law on Advertising;
- the air time devoted to information programs, to educational programs and to children programs were significantly less than the figures mentioned in the licence.

460. On November 2, 2005 the National Council met, heard representatives of Gala, and decided to postpone their vote for two weeks<sup>178</sup>. On November 23, the National Council met again and issued a warning against Gala, for the reasons set forth in the inspectors' report. The warning was cancelled by the Kyiv Economic Court on February 15, 2007, because the Court considered the inspection illegal<sup>179</sup>.

#### The June 2006 inspection

461. With two warnings against Gala in the appeal Courts, on May 29, 2006 Chairman Shevchenko ordered the Control and Monitoring Department of the National Council to conduct a new inspection, which was carried out on June 2, 2006. Inspector Leliukh has declared that the inspection was conducted in a hostile environment, and that Mr. Lemire was accompanied by four lawyers and a representative of the American Embassy. The inspection report came to the following conclusions<sup>180</sup>:

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<sup>177</sup> Respondent's Exhibit R-276.

<sup>178</sup> Respondent's Exhibit R-282; Respondent submits that the two weeks delay was to permit Gala to cure the irregularities; this does not derive from the transcript.

<sup>179</sup> See Claimant's submission to the Court in Respondent's Exhibit R-312.

<sup>180</sup> Respondent's Exhibit R-298.

- the advertising exceeded the 20% legal maximum per hour (i.e. 12 minutes maximum) in four hourly time periods: from 9 am to 10 am, by 18 seconds, from 12 pm to 1 pm, by 14 seconds, from 1 pm to 2 pm, by 3 seconds and from 5 pm to 6 pm by 12 seconds;
- Gala was basically complying with the licence conditions, it had broadcast 6.36 h. of cultural programs, when the licence required 3.50 h.; Gala had however failed to broadcast children's programs, as required by the licence;
- Gala was complying with the 50% Ukrainian music percentage;
- language is 100% Ukrainian, including advertisements;
- two advertisements were not clearly separated from the other elements of the program.

462. Claimant asserts that the inspection team, headed by Inspector Leliukh, included in its submission to the National Council a proposal that a third warning be issued. A third warning would have blocked the renewal process for the licence, which was then under discussion and might have triggered an action to revoke Claimant's licence (although this is not a must: the LTR does not require that a third warning triggers a procedure of licence revocation). Claimant was sufficiently worried about the prospect of a third warning and its consequences that he asked for the assistance of US Embassy officials and of his international lawyers at the meeting of July 19, 2006 to lobby against the issuance of the third warning.

463. Inspector Leliukh, asked by the Tribunal if he had recommended issuing a third warning, answered: "*I do not remember whether or not I recommended a warning*<sup>181</sup>". And under cross examination, asked whether the draft resolution would be in the record of the National Council, he stated that "*as a rule a draft resolution is not maintained – resolutions themselves are archived, not draft resolutions*<sup>182</sup>".

464. Although Inspector Leliukh does not remember, there is clear evidence in the file showing that a third warning was indeed proposed. Respondent has submitted the transcript of the July 19, 2006 session<sup>183</sup>, and there it is clearly stated that Shevchenko put the draft decision for issuing a warning to the vote. The decision received one vote in favour (from Chairman Shevchenko) and five members abstained, and consequently it was rejected. Immediately thereafter, a new decision was tabled and carried unanimously. This decision states that the National Council:

- takes knowledge of the report resulting from Gala's inspection;
- obligates the management of Gala to bring its activities in line with the licence, Deputy Chairman Kurus being in charge of control of this obligation; and
- informs the founders of Gala that in accordance with Article 12 of the LTR foreigners are prohibited from being the founders of radio stations.

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<sup>181</sup> Inspector Iulian Leliukh, Hearing Transcript 4, p. 111, at 8.

<sup>182</sup> Inspector Iulian Leliukh, Hearing Transcript 4, p. 116, at 7.

<sup>183</sup> Respondent's Exhibit R-306, p. 2070.

465. The reference to the founding of Gala, and to Article 12 of the LTR, is especially troubling. In accordance with the records, which must have been available to the National Council, Gala Radio had not been founded by Mr. Lemire, but by Provisen, an Ukrainian company, and Claimant subsequently bought a controlling stake in the company. The prohibition of foreign foundership of radio stations was already included in Article 13 of the 1993 LTR, and was then taken over into Article 12 of the 2006 LTR. Consequently, it existed when the National Council authorized Mr. Lemire's purchase of the control in Gala.
466. The July 19, 2006 decision of the National Council "*informs*" the founders of Gala that foreigners are prohibited from being founders of radio stations. This statement is difficult to understand, because:
- it seems incongruous in a decision regarding the imposition of a sanction to Gala;
  - it is unnecessary, if it is just a reminder of a legal rule which had existed since 1993;
  - it is without purpose, because a company can never retroactively change its founders;
  - if it purports to be an anticipation of what the National Council would decide in the future (the licence will not be renewed, because Mr. Lemire is American), it is legally incorrect, because Mr. Lemire is not the founder and his investment had been duly authorized.

#### The 2008 inspections

467. In April 2008 Gala was subject to a further, scheduled inspection, which resulted in a conclusion that there was no irregularity.
468. Then, in June 3, 2008 an additional unscheduled inspection took place, which led to a decision of the National Council on June 18, 2008. What had happened was that on the day of the Municipal Elections, a candidate had spoken on Gala Radio, starting his words by saying "*I will not promote myself ... I will not advertise either. All I wanted to say is that everyone has to come*". Hereafter, he made a short presentation why citizens should vote in his favour. The inspection report prepared by the National Council inspection team stated that the broadcasting of these declarations violated the Ukrainian Election Law which requires that "*campaigning*" cease 24 hours before the vote<sup>184</sup>.
469. During the session of the National Council on June 18, 2008<sup>185</sup>, a member of the National Council acknowledged that all TV channels show interviews with various candidates during the ballot casting. Gala explained at the hearing that they had committed a mistake. Respondent submits that the National Council decided not to issue a warning<sup>186</sup>.

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<sup>184</sup> Respondent's Exhibit R-373.

<sup>185</sup> Respondent's Exhibit R-375 (transcript of the meeting).

<sup>186</sup> Respondent's Post-Hearing Memorial, para. 548; not contradicted by Claimant; the transcript of the meeting, however, is not clear; Chairman Shevchenko's last words are: "*But they admit their fault, saying*

### **C) Renewal of the Licence**

470. Gala Radio's licence was due for renewal on September 18, 2008. Claimant applied for renewal on March 13, 2008. The National Council reacted with a number of documentary requests, to which Gala duly responded<sup>187</sup>. The licence was eventually issued on July 16, 2008, on the last possible meeting of the National Council.
471. On July 25, 2008 Gala received an invoice for more than one million USD, which represented a 10 fold increase with regard to the renewal fee which would have been applicable in accordance with the guidelines approved in 1995. The new methodology for calculating had been approved by the National Council on November 22, 2006, but required a confirmation decision from the Cabinet of Ministers. On July 9, 2008 the Cabinet adopted the necessary decree, and the National Council at its meeting of July 16, 2008 declared that the new methodology would be used to calculate its fees – the same meeting which approved the extension of Gala's licence.
472. In Claimant's opinion, the National Council on purpose delayed the application process, in order to be able to charge the higher fee<sup>188</sup>. Claimant further alleges that Russkoie Radio and Hit FM – both allegedly owned by Mr. Bagrayev, National Council member until 2002 - applied for their renewal after Gala, but were awarded their licence on May 28, 2008, seven weeks before Gala<sup>189</sup>. This statement has not been denied by Respondent.
473. Claimant finally was only required to pay the lower, historic fee. The reason for this is that when the National Council issued the one million USD plus invoice, it failed to take into consideration, that on the date of Gala' renewal the decree had not yet been published in the Official Bulletin, and consequently it had not entered into force and could not be applied to the Gala licence renewal.
474. Claimant filed a request for interim measures in this arbitration, Ukraine eventually accepted Claimant's arguments and modified the licence renewal fee to the historic figure, which Claimant accepted and duly paid, desisting from the Request.

### **D) Decision of the Arbitral Tribunal**

475. The Tribunal is in this case confronted with a request for moral damages, which Claimant allegedly has suffered as a consequence of harassment by the National Council. The moral damages – as alleged by Claimant – include anxiety, pain and suffering, and they are estimated at three million USD, a figure which is deemed "*very conservative ... in light of the long duration,*

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*that it was all by accident, and we agree with this point, advising the company to take this fact into account as a warning"*

<sup>187</sup> See Claimant's Exhibits CRIM-5, 6, 7, 8 and 9.

<sup>188</sup> Claimant's Reply Memorial, para. 248.

<sup>189</sup> Claimant's Reply Memorial, para. 253.



*intensive and diverse harassment to which Respondent has subjected Claimant*<sup>190</sup>”.

Moral damages in investment arbitrations

476. In most legal systems, damages which can be recovered by the aggrieved include not only the *damnum emergens* and *lucrum cessans*, but also moral damages. The Tribunal shares the conclusions reached in *Desert Line Projects*<sup>191</sup>:

*“Even if investment treaties primarily aim at protecting property and economic values, they do not exclude, as such, that a party may, in exceptional circumstances, ask for compensation for moral damages”.*

477. The circumstances in *Desert Line Projects* were very exceptional indeed. Claimant had been subject to physical duress and suffered a siege by the armed forces of Respondent.

478. Can moral damages be applied in the factual situation of this case in which Claimant is not making any allegation of physical duress?

479. Claimant in essence is submitting that the National Council incurred in systemic bias against Gala Radio. Not only did the National Council reject the 200 applications made by the radio station for new frequencies, jeopardizing Gala’s plans to expand its activities, but it also maliciously subjected Gala to a series of inspections, with the hidden agenda to close it down, and then in bad faith delayed the renewal of the licence, until a new regulation had come into force, which increased the renewal fee by 10.

480. Claimant’s accusations are very grave indeed.

481. The National Council is Radio Gala’s lawful supervisor and regulator, entrusted by Ukrainian law with authorizing, monitoring, inspecting and sanctioning TV and radio stations. Agencies with powers analogous to those of the National Council exist in most jurisdictions, because they have proven necessary in order to guarantee correct assignment of scarce frequencies, protection of rights of viewers and listeners and defence of liberty of information and plurality of opinions. Regulatory agencies, provided by law with wide powers to intervene, must act with absolute independence and impartiality. And regulated entities have an obligation to cooperate with their supervisor, to follow their supervisor’s instructions and to comply with applicable rules.

482. In all jurisdictions regulated entities are also required to respect and cooperate with their lawful regulatory agencies. Mr. Lemire’s behaviour vis-à-vis the National Council, and his extensive use of the Courts to obtain redress for his grievances and of the American Embassy to secure protection, may have

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<sup>190</sup> Claimant’s Post-Hearing Memorial, para. 147.

<sup>191</sup> *Desert Line Projects LLC v. The Republic of Yemen*, ICSID Case No. ARB/05/17, Award of 29 January 2008, para. 289.

looked rude and disrespectful to the Ukrainian authorities. But the personal behaviour of the regulated should never impair on the impartiality of the supervisor.

483. Another important aspect to bear in mind is whether the Ukrainian legal system affords an efficient system for appealing the regulator's decisions before a Court. That right also exists in Ukraine, and it has worked. The Courts have twice quashed (in first instance and then on appeal) illegal decisions of the National Council. And in the case of the renewal fees, the Ministry of Justice has sided with Claimant against the National Council.
484. The Tribunal has analyzed in detail the relationship between Gala Radio and the National Council and certain facts stand out:
- Gala was never inspected until 2005, and in the next three years it was the object of five inspections, of which four were unscheduled;
  - the first warning issued by the National Council against Gala was clearly abusive, and was correctly set aside by the Ukrainian Courts;
  - the second warning was issued for alleged infractions which to an impartial bystander look petty; this warning was again set aside by the Courts;
  - the draft resolution of the National Council proposed the issuance of a third warning, and Chairman Shevchenko voted in favour; the underlying inspection report showed that most of the infractions which led to the second warning had been cured, and only found some very minor infringements;
  - the third warning was rejected, but the National Council adopted a decision which seemed to imply that Mr. Lemire, as an American, was prohibited by law from being the rightful owner of Gala;
  - the facts which led to the 2008 inspection probably did not merit the commencement of an inspection procedure, since similar actions had been committed by other TV and radio stations, which were not inspected;
  - Gala's application for extension of its licence was delayed in comparison with other applications; it was approved in the same session when the National Council approved a 10 fold increase in the renewal fees.
485. If these facts are added to the National Council's rejection of all (bar one) of Gala's applications for new licences, the resulting overall picture is that Gala has received a one-sided treatment from its regulator. Gala's reaction, consisting in a vehement defence of its rights, presence of US Embassy officials, protest before the National Council and successive appeals to the Ukrainian Courts, seem to have exacerbated the National Council's stance.
486. Since the Tribunal has already decided that certain of Respondent's actions related to awarding radio frequencies are not compatible with the FET standard defined in the BIT, Claimant will in any case be entitled to an economic indemnification. Whether the facts of the case constitute "*exceptional circumstances*", which merit the awarding of moral damages, is a question which the Tribunal will decide in a future phase of this procedure

when it may have the benefit of further insights, notably into context and causation.

#### **VII.5. CLAIMANT'S THIRD ALLEGATION: THE VIOLATION OF THE FET STANDARD BY OTHER ACTIONS PERFORMED BY RESPONDENT**

487. Claimant's main allegation is that the allocation of frequencies has given rise to a violation of the FET standard. In addition, Claimant submits an ancillary claim: that a number of other actions or omissions, which primarily constitute a breach of the Settlement Agreement, are also unfair, inequitable, arbitrary or discriminatory<sup>192</sup>. In Claimant's opinion these actions or omissions constitute not only a breach of the Settlement Agreement, but also a violation of the FET standard defined in the BIT.

488. The actions alleged by Claimant are the following:

- (i) the failure of the National Council to acknowledge its obligations under the Settlement Agreement<sup>193</sup> or to acknowledge the Settlement Agreement as legal or binding<sup>194</sup>;
- (ii) the State Centre's decision to allocate low powered and contested frequencies<sup>195</sup>; and
- (iii) Respondent's failure to correct interferences.

489. The Tribunal has already analysed whether these actions and omissions represented defaults under the Settlement Agreement, and come to the conclusion that they did not. It will now review, albeit rather summarily, whether these actions conceivably could imply an international law delinquency of Ukraine and a violation of the BIT.

##### First and second claim

490. (i) and (ii): Since the Tribunal has come to the conclusion that Respondent did not breach its obligations under the Settlement Agreement, and that frequencies allocated were appropriate (see paragraph 209 above), Claimant's allegation that the failure to acknowledge the Settlement Agreement or the allocation of frequencies could conceivably constitute an international wrong has no chance of succeeding.

491. Claimant's first and second claims are dismissed.

##### Failure to correct interferences

492. (iii): There is a final type of action or failure to act, which Claimant submits amounts to a violation of the FET standard, and which merits a more in-depth analysis. This is Respondent's alleged failure to correct the interferences on Gala 100 FM. Such failure would have related to interferences that occurred

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<sup>192</sup> Claimant's Post-Hearing Memorial, para. 67.

<sup>193</sup> Claimant's Post-Hearing Memorial, para. 67.4.

<sup>194</sup> Claimant's Post-Hearing Memorial, para. 67.6.

<sup>195</sup> Claimant's Post-Hearing Memorial, para. 67.7 and 67.8.

after the conclusion of the Settlement Agreement and would thus not have been affected by the Tribunal's decision that Respondent has performed its obligations under the Settlement Agreement.

493. Claimant's argument runs as follows<sup>196</sup>: Respondent, as the host state and as issuing authority and regulator of frequencies, has the duty to ensure that any investor can enjoy the normal operation and use of his investment. This includes – in Claimant's assertion - an obligation to provide a frequency that is free of interference, however caused, and an obligation to monitor and regulate other radio companies.
494. The Tribunal disagrees with Claimant's reasoning.
495. Interference occurs when other radio stations which are also broadcasting do not remain within the prescribed deviation level. The record shows that Claimant on seven occasions between 2000 and 2007 complained to the State Centre, protesting that Gala's signal was suffering interference. The complains were made in 2002, 2004, 2005, 2006 (2) and 2007 (2)<sup>197</sup>. The record shows that the State Centre reacted, at least trying to solve the problems. On August 17, 2004 the State Centre ordered two radio stations which were causing interference to cease doing so<sup>198</sup>. The State Centre monitored the 100 FM frequencies during the year 2007, and found no interference<sup>199</sup>. Finally, as Claimant acknowledges, after an extensive period of monitoring during the autumn 2008, the problem has now been – to use Claimant's words - "*significantly reduced*"<sup>200</sup>.
496. Claimant's allegation that Ukraine's conduct with regard to the interferences constitutes a violation of the BIT is bound to fail. The State Centre may have been performing the public service of monitoring and supervising radio frequencies with more or less diligence; the solution adopted in 2008 probably could have been anticipated; but even if Claimant's allegations were accepted to be true, they would never give rise to an international delinquency of Ukraine, nor amount to the violation of the FET and full protection standards defined in the BIT. Not every malfunctioning of a public service, suffered by a foreign investor, not every lack of diligence by a supervisory authority opens the door to a claim under the BIT. As has already been explained, the violation of the FET standard requires significantly more, namely that the actions of the State trespass a certain standard of propriety. The evidence does not support that in this instance the threshold has been surpassed.

#### **VII.6. CLAIMANT'S FOURTH ALLEGATION: THE "UMBRELLA CLAUSE"**

497. Article II.3 (c) of the BIT includes the so called Umbrella Clause:

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<sup>196</sup> Claimant's Post-Hearing Memorial, para. 67.1.

<sup>197</sup> Respondent's Post-Hearing Memorial, para. 170.

<sup>198</sup> Respondent's Exhibits R-84 and R-85.

<sup>199</sup> Respondent's Exhibit R-146.

<sup>200</sup> Claimant's Post-Hearing Memorial, para. 48.

*“Each party shall observe any obligation it may have entered into with regard to investments”.*

498. The Tribunal agrees with Claimant’s submission that Article II.3 (c) of the BIT brings the Settlement Agreement into the ambit of the BIT, so that any violation of the private law agreement becomes *ipso iure* a violation of the international law BIT. This, however, exhausts the effect of the Umbrella Clause; the Umbrella Clause has no impact on the meaning or scope of the Settlement Agreement. In other words, any violation of the Umbrella Clause presupposes a breach of the Settlement Agreement. Since the Arbitral Tribunal has already come to the conclusion that Respondent has not breached its obligations under the Settlement Agreement, the Umbrella Clause of the BIT is moot and Respondent cannot have violated the BIT on this footing.

## **VII.7. CLAIMANT’S FIFTH ALLEGATION: THE PROHIBITION OF LOCAL PURCHASE**

### **A) Allegation of the Parties**

499. Claimant’s final allegation<sup>201</sup> is that the 2006 LTR, by imposing a 50% Ukrainian music requirement, breaches Article II.6 of the BIT which does not allow the host state to “*impose performance requirements as a condition ...*” Claimant acknowledges that Respondent has tried to justify the legal imposition on public policy grounds. Yet, even assuming its validity, this argument can, in Claimant’s opinion, at best justify the breach, subject to the payment of the corresponding damages. And the damages sustained by Gala were significant, because its program concept is based 100% on hits. The high level of the local source requirement and its abrupt incorporation caused Claimant to lose advertising revenue, resulting in a damage of 958,000 USD.
500. Respondent disagrees<sup>202</sup>. A change in the host’s State’s regulatory framework does not equate with a breach of the BIT. The protection of the legitimate expectations must be balanced with the need to maintain a reasonable degree of regulatory flexibility on the part of the host State in order to respond to changing circumstances in the public interest. The imposition of a Ukrainian music requirement is neither abrupt, excessive nor unfair, and did not breach Claimant’s legitimate expectations.

### **B) Decision of the Tribunal**

501. The facts of this allegation are rather straightforward. Article 9.1 of the 2006 LTR required that “*... music produced in Ukraine shall constitute at least 50% of general broadcasting time of each ... radio organization*”. This requirement applies to all broadcasters in Ukraine, not only to Gala Radio. “*Music produced in Ukraine*” includes any music where the author, the composer and/or the performer is Ukrainian.

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<sup>201</sup> Claimant’s Post-Hearing Memorial, para. 148.

<sup>202</sup> Respondent’s Post-Hearing Memorial, para. 570.

502. The implementation of this new requirement was not immediate, but in steps. On July 21, 2006 the National Council and certain radio companies signed a memorandum<sup>203</sup>, which provided that the requirement would be implemented in stages from October 1, 2006 through February 1, 2007. Gala adhered to this memorandum in August 2006.
503. Gala's basic criticism<sup>204</sup> with regard to the new Ukrainian music requirement is that there are too few hits of Ukrainian music, and since its formula is 100% hits, it must continuously replay the same few Ukrainian hits. In Claimant's opinion, the 50% Ukrainian music requirement violates Article II.6 of the BIT, which provides as follows:
- “Neither party shall impose performance requirements as a condition of establishment, expansion or maintenance of investments, which require or enforce commitments to export goods produced, or which specify that goods and services must be purchased locally, or which impose any other similar requirements”.*
504. The Tribunal disagrees with Claimant's contention.
505. As a sovereign State, Ukraine has the inherent right to regulate its affairs and adopt laws in order to protect the common good of its people, as defined by its Parliament and Government. The prerogative extends to promulgating regulations which define the State's own cultural policy. The promotion of domestic music may validly reflect a State policy to preserve and strengthen cultural inheritance and national identity. The *“high measure of deference that international law generally extends to the right of domestic authorities to regulate matters within their own borders”*<sup>205</sup> is reinforced in cases when the purpose of the legislation affects deeply felt cultural or linguistic traits of the community.
506. The desire to protect national culture is not unique to Ukraine. France requires that French radio stations broadcast a minimum of 40% of French music<sup>206</sup>, Portugal has a 25 – 40% Portuguese music quota<sup>207</sup> and a number of other countries impose similar requirements<sup>208</sup>. The Tribunal in *Plama* reasoned that a rule cannot be said to be unfair, inadequate, inequitable or discriminatory, when it has been adopted by many countries around the world<sup>209</sup>. If one adds that the 50% Ukrainian music rule is applied to all broadcasters, the necessary conclusion is that it is compatible with the FET standard defined in the BIT.

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<sup>203</sup> Respondent's Exhibit R-131.

<sup>204</sup> Claimant's Memorial, para. 207.

<sup>205</sup> *S.D. Myers Inc. v. Canada*, UNCITRAL, First Partial Award of 13 November 2000, para. 263.

<sup>206</sup> Article 12 I *Loi n° 86-1067 du 30 septembre 1986 relative à la Liberté de Communication*, amended by *Loi n° 94-88 du 1er février 1994*.

<sup>207</sup> Article 44 A 1 *Lei 7/2006 de 3 de março*.

<sup>208</sup> See K. Bhattacharjee: *“Local Content Rules in Broadcasting”*, reproduced as Respondent's Exhibit RLA-41.

<sup>209</sup> See *Plama Consortium Limited v. Republic of Bulgaria*, ICSID Case No. ARB/03/02, Award of 27 August 2008, para 269.

507. But this conclusion is really *obiter dicta*, because Claimant challenges the 50% Ukrainian music requirement not as a violation of the FET standard, but rather as a breach of the local content rule contained in Article II.6 which prohibits “*performance requirements ... which specify that goods or services must be purchased locally*”. Is this rule applicable to a cultural restriction like the 50% Ukrainian music requirement?
508. The answer to this question requires that Article II.6 be interpreted “*in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose*” (Article 31.1. Vienna Convention)<sup>210</sup>.
509. The ordinary meaning of the terms used by a treaty provides the first criterion of interpretation. The BIT prohibits that local law specify that “*goods or services ... must be purchased locally*”. It can be argued that the LTR does not fall foul of this rule: the law does not specify that radio stations must purchase any goods or services locally, but rather that a certain percentage of the music broadcast should be authored, composed or produced by Ukrainian artists. The argument, however, is not decisive, because it might be reasoned *de adverso* that although the LTR does not prohibit radio stations from obtaining Ukrainian music from non-Ukrainian sources, *de facto* the market for Ukrainian-authored, -composed or -produced music is located in Ukraine.
510. The object and purpose of Article II.6 sheds more light on its correct interpretation. The object of the BIT is to “*promote greater economic cooperation*” between the Parties (Preamble II). And the purpose of Article II.6 is trade-related: to avoid that States impose local content requirements as a protection of local industries against competing imports. When in 2006 Ukraine amended the LTR, the underlying reasons were not to protect local industries and restrict imports, but rather to promote Ukraine’s cultural inheritance, a purpose which is compatible with Article II.6 of the BIT.
511. In conclusion, the Tribunal finds that Article 9.1 of the 2006 LTR, which requires that “[...] *music produced in Ukraine shall constitute at least 50% of general broadcasting time of each ... radio organization*” does not amount to a violation of the local content rule contained in Article II. 6 of the BIT which prohibits “*performance requirements ... which specify that goods or services must be purchased locally*”.

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<sup>210</sup> Emphasis added.

## **VII.8. OTHER ALLEGATIONS**

512. In his Memorial, Claimant included alleged additional violations of the BIT, referring to affiliation agreements, trademarks and the expropriation of a beauty salon. This last claim has been specifically withdrawn, and the other two have not been addressed either at the hearing or in the Post-Hearing Memorial, and seem to have been tacitly dropped. To the extent that these claims may still be alive, the Tribunal finds that Respondent's conduct with regard to Gala's affiliation agreements or to its request for trademark protection does not amount to a violation of the BIT.



## VIII. DECISION

513. In view of the foregoing reasons, the Tribunal unanimously as regards Sections I through VI, and by majority as regards some aspects and conclusions of Section VII, decides as follows:
1. to dismiss Respondent's objections to the jurisdiction of the Centre and the competence of the Tribunal;
  2. to declare that Respondent has not breached any obligations assumed in the Settlement Agreement;
  3. to declare that Respondent, in the manner in which it dealt with the award of radio frequencies as described in paragraph 422 of this Decision, breached Article II.3 of the BIT; and
  4. to dismiss all other claims regarding the merits submitted by Claimant.
514. The question of the appropriate redress of the breach, including questions of *quantum*, will be addressed in a second phase of this arbitration, for which the Tribunal retains jurisdiction. The Tribunal will issue a Procedural Order for the continuation of the procedure. The question of costs is reserved until the Award.

*[signed]*

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Mr. Jan Paulsson  
*Arbitrator*

*[signed]*

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Dr. Jürgen Voss  
*Arbitrator*

*[signed]*

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Professor Juan Fernández-Armesto  
*President*

*[January 14, 2010]*

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Date

## **LEGAL AUTHORITY CA-85**



# UNITED NATIONS PROCUREMENT MANUAL

DEPARTMENT OF OPERATIONAL SUPPORT  
OFFICE OF SUPPLY CHAIN MANAGEMENT  
PROCUREMENT DIVISION

REF. NO.: DOS/2020.9  
30 JUNE 2020

## Preface

The Procurement Manual details the UN Secretariat's (UN) procurement procedures and processes and provides further guidance for carrying out procurement activities for the UN effectively and efficiently in compliance with the UN's Financial Regulations and Rules, and other applicable administrative issuances, such as the Review Committee on Contracts ST/AI (ST/AI/2011/8).

This document is available online at <https://www.un.org/Depts/ptd/about-us/procurement-manual>. It has been published in electronic format to limit the use of paper, ink, and transport.

The Procurement Division in the Office of Supply Chain Management, Department of Operational Support will update this Manual from time to time.

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# 1. Introduction

## 1.1 Purpose, Application and Structure

This Procurement Manual (PM) serves as operational guidance for all staff members involved in any stage of the procurement process by describing procurement (and related) processes and procedures. The PM is expected to be applied with professional discretion and expertise by procurement practitioners and other offices involved in the acquisition and procurement process in accordance with the applicable regulations, rules and policies of the Organization. Regulations, rules and policies of the Organization that are applicable to the procurement process are set out in the various Secretary-General's bulletins (for example, the United Nations Financial Regulations and Rules and Secretary-General's bulletin on the delegation of authority in the administration of the Financial Regulations and Rules, including the applicable delegation of authority instrument, establishes the authority of staff members granted procurement delegation. In addition, various administrative instructions prescribe the instructions and procedures for the implementation of the Financial Regulations and Rules, the Staff Regulations and Rules, and Secretary-General's bulletins applicable to the procurement process. For the sake of clarity, nothing in this Manual shall bind the United Nations to any particular process, outcome or course of action in relation to any particular procurement process or otherwise.

The PM is divided into fifteen (15) chapters and follows the structure – with minor deviations – of the standardized table of contents for United Nations procurement manuals, as endorsed by the High-Level Committee Management, Procurement Network (HLCM-PN), with the purpose of harmonizing procurement practices and increasing collaboration among UN entities.

There are three overall sections:

- a. Chapters 1 to 3 cover, respectively: introduction, organization of procurement, and vendor registration and management.
- b. Chapters 4 to 13 cover the steps of the acquisition process.
- c. Chapter 14 covers cooperation topics and Chapter 15 addresses cross-cutting topics, such as the United Nations Global Compact, emergency procurement procedures, and risk management.

Each chapter ends with a resources section, which references relevant policies, guidance materials, and templates.

## 1.2 Update and Maintenance

The PM will be updated from time to time to ensure that it remains relevant to UN operations and up to date with best practices in public procurement.

Comments or suggestions for improvement should be directed to the Procurement Division (PD, Office of Supply Chain Management (OSCM)) at UNHQ via email at [dos-pd@un.org](mailto:dos-pd@un.org).

## 1.3 Procurement Framework

Staff members are bound to comply with the Charter of the United Nations, the Staff Regulations and Rules, the Financial Regulations and Rules and all other relevant administrative issuances.

Requests for clarifications to any of the provisions of the PM shall be referred to the Director, PD.

This PM replaces and supersedes entirely all the previous versions of the Procurement Manual.

## 1.4 Procurement Principles and Client Centricity

As a steward of the funds entrusted to its care by the Member States, it is necessary for the UN to achieve Best Value for Money (BVM) in procuring goods, services, and works, according to mandates given to the UN by the General Assembly. It must do so, and be seen to be doing so, with fairness, integrity, and transparency. These principles are the foundation of UN procurement. Staff members are expected to comply with these procurement principles in performing their work with a high level of care and professionalism.

Financial Regulation 5.12 requires that the following general principles shall be given due consideration:

- a. Best Value for Money
- b. Fairness, integrity, and transparency
- c. Effective international competition
- d. The interest of the UN

In addition to the principles contained in Financial Regulation 5.12, Procurement Officials must also ensure that the procurement actions they undertake are taken in a manner that always strives to meet the needs of the client in the most efficient and effective manner possible. Accordingly, client orientation and the adoption of a client service approach are key principles that must guide how Procurement Officials conduct and organize their work daily (see section 1.4.5).

The following chapters provide an outline of each principle and the related expectations towards those involved in the procurement process and its principles.

### 1.4.1 Best Value for Money

'Best Value for Money' shall be understood as the optimization of the total cost of ownership and quality needed to meet the user's requirements, while taking into consideration potential risk factors and resources available. The Best Value for Money solution may not necessarily offer the lowest cost.

In order to obtain Best Value for Money, Requisitioners and Procurement Officials should:

- a. Plan for demand in a timely manner and define an acquisition strategy based on an analysis of the demand and supply market;
- b. Strive to maximize competition;
- c. Conduct the procurement exercise after good planning and pursuant to clear specifications;
- d. Carefully establish the evaluation criteria prior to the issuance of the solicitation document (in order to select the offer to meet needs in accordance with the evaluation parameters set forth in the solicitation documents);
- e. Ensure that all costs are considered within the total cost of ownership, including transportation costs, installation costs, operating costs, maintenance costs, disposal costs, etc.;
- f. Ensure that benefits are optimized, and financial and operational risks and any other adverse impacts are minimized;
- g. Ensure impartial and comprehensive evaluation of offers, in a timely manner and in accordance with the pre-established criteria;
- h. Ensure that the vendor whose offer is considered can satisfy the requirements.

### 1.4.2 Fairness, Integrity and Transparency

To achieve BVM, the procurement process must protect the Organization from proscribed practices and be conducted on the basis of clear and appropriate regulations, rules, and procedures that are applied consistently to all potential vendors. Further, the way the procurement process is

undertaken must provide all internal and external stakeholders of the Organization with assurances that the process is fair and transparent, and that integrity has been maintained.

Application of the **fairness** principle means, among other things, that the UN must offer equal opportunities to all bidders by sharing the same information with all bidders at the same time and communicating the same contents on a specific procurement. In the context of public procurement, a fair process is free from favoritism, self-interest, or preference in judgment.

**Integrity** requires an Organization or individual to exhibit probity in their actions. Probity means having strong moral principles and honesty and decency in dealing with others. Integrity is reflected in truthfulness that is apparent in professional and personal undertakings and adherence to commonly accepted moral and ethical standards.

**Transparency** for the purpose of this Manual means that all information on procurement policies, procedures, opportunities, and processes is clearly defined, made public, and/or provided to all interested parties concurrently. A transparent system has clear mechanisms to ensure compliance with established rules (unbiased specifications, objective evaluation criteria, standard solicitation documents, equal information to all parties, the confidentiality of offers, etc.). Those mechanisms include records that are open, as appropriate, to inspection by auditors. Unsuccessful vendors for eligible bids can be briefed on the strengths and weaknesses of their own offers. Award information, as determined by the UN, is disclosed publicly. Transparency ensures that any deviations from fair and equal treatment are detected early in the process, making such deviations less likely and thus protecting the integrity of the process and the interests of the Organization.

#### 1.4.3 Effective International Competition

By fostering effective international competition among vendors, the UN applies the principles of fairness, integrity, and transparency to achieve Best Value for Money.

Effective international competition is concerned with ‘right time, right quality, and right price’, meaning:

- a. Adequate notification should be given to as geographically broad as possible vendor community to ensure that there is sufficient time to participate in the procurement processes;
- b. There should be no restriction of competition through over-specification (e.g. the inclusion of unjustified or unrealistic requirements in the specifications and/or Terms of Reference (TOR) or Statement of Work (SOW)) or under-specification (e.g. the omission of essential information in the specifications and/or TOR/SOW);
- c. Economies of scale (i.e., quantity/volume discounts, fewer resources invested, and reduced administrative costs) can be achieved when procurement volumes for identical or similar requirements are consolidated in a single solicitation.

For more details see [section 6.2.1](#).

#### 1.4.4 Best Interest of the United Nations

All procurement activities will be carried out in compliance with the applicable legislative framework. In this regard, the [Financial Regulations and Rules](#) (Financial Regulation 5.12) require that due consideration be given, among others, to the interest of the United Nations when exercising the procurement functions of the United Nations. The best interest of the United Nations shall be determined by the professional judgment of the appropriate official with the authority to make such a determination.

#### 1.4.5 Client Centricity

At their core, all procurement activities serve to meet ongoing and future requirements of the United Nations. Accordingly, Procurement Officials must ensure that they always adopt a client service approach and maintain proper client orientation throughout the procurement process. While recognizing the procedures for proper segregation of duties and the need to maintain the confidentiality of information, Procurement officials must ensure that clients are informed of, and where necessary, involved in all key decisions as well outcomes thereof. In return, procurement Officials must ensure that they are fully informed of the client's needs and objectives and that they always foster close cooperative relationships. As a result, Procurement Officials empower the United Nation's supply chain to deliver what clients need, where they need it at the best possible price.

### 1.5 Ethical Standards

All procurement transactions must be conducted in a professional manner and in accordance with the highest ethical standards. When fraudulent and corrupt practices occur, the damage extends far beyond financial losses, posing serious threats to the Organization's credibility and to its ability to achieve its operational and programmatic objectives.

#### 1.5.1 Standards of Conduct

Staff members must demonstrate the highest standards of efficiency, competence, and integrity. Integrity includes, but is not limited to, probity, impartiality, fairness, honesty, and truthfulness in all matters affecting their work and status. In accordance with the [Charter of the United Nations](#), the [Staff Rules and Regulations](#) and the Standards of Conduct for the International Civil Service, staff members should refrain from any action which might adversely reflect on their status as international civil servants responsible only to the Organization or on the integrity, independence, and impartiality that are required by that status.

Each UN staff member must take an [Oath of Office](#) to the Organization, to "[...] solemnly declare and promise to exercise in all loyalty, discretion and conscience the functions entrusted [...] as an international civil servant of the United Nations, to discharge these functions and regulate conduct with the interests of the United Nations only in view, and not to seek or accept instructions in regard to the performance of duties from any Government or other source external to the Organization." Furthermore, staff members "[...] also solemnly declare and promise to respect the obligations [...] set out in the Staff Regulations and Rules."

All staff members must observe the highest ethical standards throughout the procurement process. The process must allow all bidders to compete on an equal and transparent basis. All staff members that are associated with the acquisition process are responsible for protecting the integrity and fairness of the process.

Procurement Officials must mitigate the risks of conflicts of interest, fraud, and corrupt practices at all stages of the acquisition process. To do so, they must implement measures to identify conflicts of interest, fraudulent and corrupt practices, and deploy appropriate responses to prevent these improprieties. All staff members whose principal duties involve the procurement of goods and services for the Organization are required to participate in the United Nations Financial Disclosure Programme. During the pre-solicitation phase, staff members involved in the acquisition process must not allow bidders access to specific, privileged information of a technical, financial, or other nature, before it is publicly available to the business community at large. In the preparation of solicitation documents, such as the SOW or TOR, staff members should not use restrictive specifications that may discourage competition. Staff members may not disclose proprietary and



source selection information, directly or indirectly, to any individual who is not authorized to receive such information at any time prior to or after the selection and contracting process.

Proper standards of conduct must be enforced during emergency situations, where the pressure to achieve rapid results may increase the risks of actual or possible conflicts of interest, fraud, or corruption.

Further guidance on the ethical and professional obligations of UN staff members may be obtained from the following sources:

- a. Staff Rules & Regulations ([ST/SGB/2018/1](#));
- b. [Standards of Conduct](#);
- c. Status, Basic Rights and Duties of United Nations Staff Members ([ST/SGB/2016/9](#));

### 1.5.2 Conflict of Interest

Staff Regulations 1.2(m) and 1.2(n) and Staff Rule 1.2(q) outline the duties of staff members regarding the management of actual or possible conflicts of interest. In order to avoid conflicts of interest, staff members who have a financial interest in a bidder are prohibited from involvement in any procurement process involving such bidder. Financial interest includes, but is not limited to, interest in a business consisting of any stock, stock option, or similar ownership interest, but excludes any interest solely by means of investment in a business through a mutual, pension, or other institutional investment fund over which the staff member does not exercise control. Financial interest also includes the receipt of, or the right or expectation to receive, any income in one or more of the following forms: consulting fees, honoraria, salary, allowance, forbearance, debt forgiveness, interest in real or personal property, dividends, royalties derived from the licensing of technology or other processes or products, rent, or capital gains, job offers to family members, etc. A staff member who is involved in his or her official capacity in any matter relating to a profit-making business or other concern in which s/he holds a financial interest, directly or indirectly, should disclose that interest to the Head of Office and have the conflict of interest resolved in the best interests of the Organization.

The staff member should either dispose of that financial interest or formally recuse himself/herself from the procurement matter which might give rise to the conflict of interest, in accordance with Staff Regulation 1.2(m) and Staff Rule 1.2(q).

Staff members with a personal or professional interest in a bidder are also prohibited from any involvement in the acquisition process. Personal or professional interests include, but are not limited to, affiliations with any organization or enterprise over which the staff member, alone or together with an immediate family member (i.e., employee's spouse or domestic partner, and dependent children), exercises a controlling interest. These interests may also involve any corporation, partnership, sole proprietorship, firm, franchise, association, organization, holding company, joint-stock company, receivership, business or real estate trust, or any other nongovernmental legal entity organized for-profit, non-profit, or charitable purposes. Interest may also involve any executive position or membership on the bidder's board regardless of compensation, or any position that includes responsibilities for a significant segment of the bidder's operation or management of a business.

Staff members involved in the acquisition process should promptly notify the Head of Office of any case where a conflict of interest may arise. They may also seek confidential advice from the Ethics Office. The Head of Office must review the facts and determine whether the staff member may perform any functions related to the solicitation. When in doubt, heads of office are advised to consult with the Ethics Office on any case where a conflict of interest may arise. To prevent a conflict of interest, vendors, contractors, and consultants are prohibited from bidding for procurement

contracts if they, or their affiliates, provided consulting services for the preparation and implementation of a project.

Staff members should not be actively associated with the management of, or hold a financial interest in, any profit-making business or other concern if it were possible for the staff member or the profit-making business or other concern to benefit from such association or financial interest by reason of his or her UN position.

In accordance with Staff Rules 1.2(j) and 1.2(k) and ST/AI/2010/1 on Reporting, Retaining, and Disposing of Honours, Decorations, Favours, Gifts or Remuneration from Governmental and Non-governmental Sources, staff members must not accept any honour, decoration, favour, or gift from a Government. If the refusal of an unexpected honour, decoration, favour, or gift from a Government would cause embarrassment to the Organization, the staff member may receive it on behalf of the Organization and then report and entrust it to the Secretary-General. The Secretary-General will either retain it for the Organization or arrange for its disposal for the benefit of the Organization or for a charitable purpose.

UN staff members who perform any function in the acquisition process should not accept any form of hospitality; gifts; inducements, including bribes; or incentives such as free or discounted goods and private services. The UN operates a zero-tolerance policy in this regard.

Staff members must fully respond to requests for information from the Organization, including staff members and other officials of the Organization who are authorized to investigate the possible misuse of funds, waste or abuse.

Collusion between UN staff members or between UN personnel and vendors may influence UN personnel to restrict the list of vendors or otherwise manipulate the procurement process in order to obtain illegal financial rewards, including kickbacks or bribes. To mitigate these risks, UN personnel should not perform critical steps of the procurement process alone, including negotiating with vendors, attending bidders' conferences, or evaluating technical criteria.

When different vendors have the same owners or are otherwise associated, competition may not be meaningful or fair. Improper granting of 'sole vendor' status reduces competition. To promote genuine competition, it is important to ensure a large pool of competitive vendors and minimize exceptions to the requirement for competitive bidding or waiver cases, especially on a 'sole sourcing' basis. In many supply markets, there may be limited sources, which pose a risk to competition. In such cases, staff members should perform a thorough and carefully documented supply market analysis.

### 1.5.3 Ethical Behavior of Vendors

#### 1.5.3.1 Ethical Behavior of Vendors and the Supplier Code of Conduct

The UN expects all vendors who wish to do business with the Organization to comply with the United Nations Supplier Code of Conduct, which reflects the core values outlined in the Charter of the United Nations. As such, an acknowledgment of the United Nations [Supplier Code of Conduct](#) is a requirement to register as a vendor in the United Nations Global Marketplace (UNGM). The United Nations Supplier Code of Conduct includes principles of the United Nations Global Compact on Labour, Human Rights, Environment and Ethical Conduct (see [Chapter 15.1 The United Nations Global Compact](#)), and sets the minimum requirements expected by vendors across their supply chain.

Vendors have the obligation to comply with the UN General Conditions of Contracts, which contain specific prohibitions on mines, child labour, sexual exploitation, and the fundamental rights of workers. The UN General Conditions of Contracts form an integral part of every contract between the UN and a vendor.

### 1.5.3.2 Proscribed Practices by Vendors and Vendor Sanctions

The UN strives to promote the public good in the area of peace and security. In spending public funds, the UN aims to meet the highest standards of integrity and competency and demands no less from those who wish to work with the UN.

The UN shall impose sanctions on vendors that have engaged or attempted to engage in proscribed practices, as set forth in [Chapter 3.5](#) of this Procurement Manual.

### 1.5.3.3 Vendor Conflict of Interest

To avoid any distortion of competition and ensure a fair process, the UN requires that vendors participating in a procurement process shall not have a conflict of interest.

Vendors must disclose any actual or potential conflict of interest in their bid submissions, which renders them ineligible for that procurement process unless the conflict of interest is resolved in a manner acceptable to the UN. Failure to disclose any actual or potential conflict of interest may lead to the vendor being sanctioned.

## 2. Organization of Procurement

### 2.1 Overview of the Procurement Process

#### 2.1.1 Definition of Procurement

Procurement is defined in Financial Regulation 5.12 as all actions necessary for the acquisition, by purchase or lease, of property, including products and real property, and of services, including works.

For the purpose of this PM, and unless specifically mentioned, the term 'procurement' is limited to the acquisition of goods, services, works, or real property via competitive bidding or through the exceptions outlined in Financial Rules 105.16 and 105.17, including but not limited to sole sourcing, standardization, cooperation (including Letters of Assist), use of administrative project or programme support services from UN entities outside of the UN Secretariat, and informal methods of solicitation. This PM also covers income-generating contracts, with income deriving from the sale of assets or other commercial arrangements such as PX and catering contracts.

#### 2.1.2 Outline of the Procurement Process

Practitioners should note that the procurement process is part of the overall acquisition process, which in turn, is a key component of end-to-end supply chain management. The acquisition process refers to the steps necessary to acquire goods and services, inter alia, through identification and development of requirements, planning, budgeting, conducting solicitations, obtaining approvals, entering into contract negotiations, and carrying out contract fulfillment.

The acquisition process entails, amongst other elements:

- a. The gathering and analyzing of initial demand data;
- b. Acquisition planning;
- c. Design of specifications;
- d. The procurement action;
- e. Delivery/freight forwarding;
- f. Receipt & Inspection (R&I);
- g. Payment;
- h. Contract management and contract administration.

This document is designed to provide practical guidance and support on all aspects related to the acquisition process. This manual constitutes authoritative guidance on functions and elements for the procurement process and provides a summary overview of the associated steps that are part of the broader acquisition process. Other manuals and policy documents may be available, including as part of the Supply Chain Operational Guidance (SCOG). For those areas outside of the actual procurement process, such other guidance documents shall prevail over the guidance provided in this PM.

The provisions in this PM are to be considered and applied by procurement practitioners with professional expertise and discretion. The PM also provides guidance to Requisitioners, Tender Opening Committee (TOC) members, Vendor Review Committee/ electronic Special Approval Committee (e-SAC) members, and any other involved stakeholders.

#### 2.1.3 Category Management

Category Management (CM) is a concept in which the range of goods and services an entity acquires is divided into groups of similar or related products called categories. It defines a systematic approach to managing those goods and services with a much greater understanding of client needs

and those specific supply markets. The implementation of CM is a key pillar of the UN Secretariat's new integrated supply chain management (SCM) strategy and will deliver long-term value for the organization by making the acquisition and delivery of goods and services more effective, agile, cost-effective and by delivering innovative solutions for clients (e.g. takeback inclusion).

CM consists of three core elements:

- a. Segmentation of SCM operations into discrete categories of goods and services (e.g. Aviation, Medical, Ground Transport, etc.);
- b. A process of developing and implementing individual strategies tailored to a specific category (there is no one size fits all);
- c. Establishing multi-functional category teams to leverage the best market knowledge and technical and procurement expertise.

Category strategies typically include a tailored acquisition process and incorporate technology and innovation or waste-minimization considerations (e.g. improved packaging and production, take back schemes), as well as the most cost-effective delivery methods with solutions that deliver Best Value for Money, now and in the future. CM is an ongoing process involving continuous updates and reassessment of the supply market and the organization's needs. In order to succeed, category managers must:

- a. Have a clear view on spend categories and volumes;
- b. Engage in regular analysis of user needs and supply markets;
- c. Keep their focus on value creation to improve the total cost of ownership and consider quality, innovation, the safety of supply, and risk management;
- d. Adopt a proactive stance in the development of category strategies;
- e. Assign clear responsibilities and processes for category strategy development, implementation of such strategies, stakeholder involvement, and vendor management.

Category Managers will have responsibility for defining the relevant strategies for their categories, and these will be executed either centrally or locally, dependent upon the category. Effective category management is built on relevant multi-functional teams collaborating across the Organization as well as other United Nations entities.

## 2.2 Responsibilities of Organizational Units and Key Roles for the Procurement Process

The following are key organizational units and roles that relate to the procurement function of the UN Secretariat:

- a. Under-Secretary-General, Department of Operational Support (DOS);
- b. Assistant Secretary-General, OSCM;
- c. Director, PD;
- d. PD: Under the authority of its Director, PD shall be responsible for:
  - i. Overall strategic management of UN procurement activities;
  - ii. Articulating operational strategy, formulating guidance, and proposing innovative solutions for procurement, including the development of category management strategies and implementation of approved strategies, jointly with the technical experts such as Logistics Division (LD), Office of Information and Communications Technology (OICT), etc.;
  - iii. Managing procurement in a transparent, accountable, and efficient manner in order to execute the Organization's supply chain management strategy and support its mandates;

- iv. Establishing and maintaining instructions, procedures, processes, control mechanisms, and supporting guidance on procurement activities;
- v. Making the Procurement Manual, processes, and tools available to Procurement Officials at UNHQ and in other entities, analyze instances in which such guidance and processes have been disregarded or not properly implemented, and provide advice on any required changes;
- vi. Providing the necessary guidance so that Technical Experts, Category Managers, Requisitioners, and other stakeholders in the procurement process act consistently with the procurement framework outlined in [Chapter 1.3](#);
- vii. Enabling the operationalization and managerial oversight of the UN's procurement activities through appropriate systems and reports;
- viii. Supporting the identification and development of opportunities for the provision of procurement services for clients and other UN organizations, and ensure appropriate modalities for service delivery;
- ix. Strengthening the knowledge, skills, and career development of procurement practitioners, including identifying mandatory training and setting standards for internal and external certification;
- x. Providing clearance for personnel at UNHQ and for all procurement officers in other UN Secretariat entities prior to recruitment in order to facilitate recruitment and to create a roster of procurement profiles;
- xi. Establishing and maintaining proper entry points and mechanisms to address complaints from or against vendors.
- e. Procurement Official: see a detailed description of responsibilities under [Chapter 2.3 Procurement Official](#) below;
- f. Requisitioner: see a detailed description of responsibilities under [Chapter 2.4 Requisitioner](#) below.

In addition to the above, the following functions and roles are important in conducting, reviewing, and/or evaluating the proper conduct of acquisitions and procurement processes:

**Review Committees on Contracts:** Further to Financial Rule 105.13 (b), the Under-Secretary-General for the Department of Management Strategy, Policy and Compliance (DMSPC) has established review committees, at Headquarters and other locations, to render written advice on procurement actions leading to the award or amendment of procurement contracts, including agreements or other written instruments that involve income to the United Nations. The composition and the terms of reference of such review committees are defined in ST/AI/2011/8<sup>1</sup>. Refer to [Chapter 9](#) for further details, including the scope of review and monetary thresholds.

**DMSPC/Business Transformation and Accountability Division (BTAD), Monitoring and Evaluation Service (MES)** is responsible for managing delegations of authority to heads of entity, monitoring the exercise of delegated authorities under the Staff Regulations and Rules and the Financial Regulations and Rules, reporting on organizational performance and developing self-evaluation tools for use across the UN Secretariat. MES formulates or reviews proposals for policy enhancements to meet organizational needs and provides advice to heads of entity in order to support them in discharging their delegated authorities correctly. MES works in close collaboration with relevant stakeholders to ensure that policies are aligned with the operational aspects and support delivery in the area of procurement.

**DOS, Enabling and Outreach Service (EOS) in OSCM:** this Service includes several functions which are critical to support the end-to-end supply chain management process, including elements of the

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<sup>1</sup> This ST/AI/2011/8 is due to be superseded by a new ST/AI shortly. The link will be updated as soon as it is promulgated.

procurement process, such as vendor registration, outreach, operational reporting, performance management, and the tender opening function.

**Vendor Review Committee** (see [Chapter 3.3](#)).

**Award Review Board** (see [Chapter 10.2.3](#)).

## 2.3 Procurement Official

Procurement activities can only be undertaken by Procurement Officials, as the staff members responsible for the procurement process. The dedicated procurement of goods and services is carried out by professional staff with proper training, knowledge, and experience, or by administrative staff with the appropriate procurement expertise, training, and qualifications if approved by the ASG, OSCM. Only the relevant classified job descriptions should be utilized to recruit procurement officials, unless otherwise approved by the ASG, OSCM in advance.

The Procurement Official, in conjunction with the Requisitioner, is also responsible for ensuring that the category management process is carried out in a manner that achieves economies of scale, innovative approaches to meeting client needs from a supply market perspective, consolidation of requirements where possible, and segregation of duties (see [Chapter 2.9](#)).

The responsibilities of a Procurement Official in a procurement process are the following:

- a. Defining solicitation strategies in collaboration with the Requisitioner, upon review of the acquisition plan and in alignment with the respective category management strategy;
- b. Reviewing the requirements and evaluation criteria and ensuring that they are appropriate from a procurement perspective;
- c. Leading the sourcing process and conducting supply market analysis, including issuing Requests for Expression of Interest (REOI);
- d. Developing pricing structures and commercial evaluation models that allow for transparency in costs and effective competition;
- e. Preparing solicitation documents, as well as facilitating and managing the solicitation process;
- f. Reviewing the technical evaluation to ensure that it was conducted in accordance with the pre-established technical evaluation criteria and that the narrative of the report corresponds with the matrix and the scoring/rating;
- g. Carrying out the commercial evaluation of bids as per pre-defined evaluation criteria;
- h. Preparing the recommendation for an award and submitting the case to the committee on contracts, if applicable;
- i. Preparing and issuing contracts and purchase orders;
- j. Requesting and ensuring the safeguarding and return of any performance securities, as applicable;
- k. Performing contract administration duties in coordination with the Requisitioner and staff responsible for contract management, as applicable, in support of the Requisitioner;
- l. Performing contract closeout activities.

To be considered “qualified” in the context of this delegation instrument, completion of relevant procurement training is required (<https://procuretrainingcampus.dfs.un.org/login/index.php>), in addition to meeting requirements in the relevant classified job descriptions. As of 1 January 2021, all Procurement Officials (excluding the Director/Chief of Mission Support/Administration or equivalent) must be professionally certified by an internationally recognized procurement certification authority (such as CIPS Level 4 or equivalent) to the required level, as authorized by the Under-Secretary-General for Operational Support.



## 2.4 Requisitioner

A Requisitioner is an individual who initiates a request for a requisition/shopping cart in UMOJA, the UN's Enterprise Resource Planning (ERP) system, i.e., a request for goods and/or services. A Requisitioner has primary responsibility for capturing demand data, consolidating needs from end-users and stakeholders, defining generic and clear specifications, and managing resources.

Within the category management framework, a Requisitioner may hold the role of the Category Manager. Please refer to [Chapter 2.1.3](#).

Responsibilities of a Requisitioner in the procurement process (some of these can be delegated to other personnel) are as follows:

- a. Preparing the demand plan, ensuring that proposed expenditures are in accordance with the mandate of the relevant entity, and ensuring that sufficient time is available to undertake a procurement exercise;
- b. Drafting the requirements in the form of specifications, SOWs, or TORs, as well as associated technical evaluation criteria;
- c. Raising and approving shopping carts in UMOJA, unless this is being undertaken by the Acquisition Management function in certain entities;
- d. Ensuring that sufficient funds are available for the requirement. The Requisitioner is responsible for securing specific funding allocated only to the applicable procurement, both at the time of contract award and during the entire life of the contract;
- e. Conducting technical evaluations of Submissions received if appointed to the technical evaluation committee;
- f. Accepting goods and/or services delivered by vendors, and creating Receiving and Inspection reports in UMOJA;
- g. Leading contract management duties including vendor performance evaluation, where appropriate, in coordination with the end-user, if applicable.

All Requisitioners must complete the mandatory UMOJA training courses designed for this role and are strongly encouraged to complete the following courses in the UN Procurement Training Campus before assuming responsibilities in the acquisition process (available at <https://procuretrainingcampus.dfs.un.org/login/index.php>):

- a. Fundamentals of Procurement
- b. Best Value for Money
- c. Ethics & Integrity in Procurement
- d. Acquisition Planning and Contract Management

## 2.5 Procurement Approving Authority

A Procurement Official who has been formally issued a delegation of authority for procurement (DOA) will be referred to as a Procurement Approving Authority, up to the threshold of delegated procurement authority applicable to their grade, level, or position. Procurement Approving Authorities must exercise their duties and responsibilities under their designated Delegation of

### IMPORTANT NOTE

**Under no circumstances shall requirements be split (or contract terms be reduced) to circumvent the procurement or review process. If an overall requirement amount exceeds delegated authorities, the requirement shall be submitted for procurement action through the established procedures and appropriate review process.**



Authority (DOA) with the utmost care, efficiency, impartiality, and integrity. They are responsible for:

- a. Approving procurement activities within their designated DOA level (noting that the approving authority in UMOJA may be unlimited for certain senior procurement officers as stipulated in the [“Document Processing and Approval Matrix”](#) included in the delegation instrument);
- b. Ensuring, prior to any commitment being made, that the procurement activity strictly complies with the UN Procurement Framework documents as outlined in [Chapter 1.3](#);
- c. Providing reports in accordance with their DOA and as stipulated in this Procurement Manual.

## 2.6 Procurement Authority

### 2.6.1 Delegation of Authority

The delegation framework effective 1 January 2019 provides an enhanced level of flexibility to support client mandates. Delegations were issued directly by the Secretary-General to heads of entity, on the basis of guidance from the DMSPC, in consultation with the DOS.

The Secretary-General has delegated to Heads of Entity and other appropriate officials the procurement authority allowing them to perform procurement functions (referred to as Authorized Officials). The responsibilities of an Authorized Official in a procurement process include, but are not limited to, approving or rejecting recommendations of a Review Committee, where applicable, putting in place measures to identify fraudulent and corrupt practices, and deploying appropriate responses to prevent these improprieties.

### 2.6.2 Exercise of DOA

Delegation for non-Strategic Goods and Services is unlimited for formal methods of solicitations under Financial Rule 105.15. However, it is contingent upon the entity having adequate procurement capacity.

The Director, PD, must technically clear Procurement Officers prior to selection.

## RESOURCES

### Annex 1—Document Processing and Approval Matrix (Annex B)

#### 2.6.3 Procuring Agent

If adequate procurement capacity and infrastructure, as detailed above, does not exist in the entity, another UN Secretariat entity may be assigned by the USG, DOS in consultation with USG, DMSPC and the head of entity, to undertake procurement on the entity's behalf.

In this case, the sub-delegation of procurement authority to the tasked entity (Procuring Agent) is not required. The Procuring Agent shall undertake the procurement activity, and the resulting Review Committee Minutes shall be submitted for review/approval of the Authorized Official in the Procuring Agent.

#### 2.6.4 Local Procurement Authority (LPA)

Under the new DOA framework, certain goods and/or services have been classified as strategic (Strategic Goods and Services Matrix). The Strategic Goods and Services fall into one of the two following categories:

1. Goods and/or services that fall, for reasons such as safety and security, within the scope of a center-led approach (e.g., aviation, ammunition, counter rocket and artillery radars, information, surveillance and reconnaissance systems, food rations or body armor etc.) and for which the authority to undertake procurement is retained by the Department of Operational Support for requirements of any amount (above the threshold for Low Value Acquisitions).
2. Goods and/or services needed by a broad range of clients to meet commonly required, high volume needs, which lend themselves to center-led procurement for reasons of economies of scale, standardization or other reasons, and that are usually available under Long Term Agreements. These goods and/or services can be procured by any UN Secretariat entity up to the threshold stated in the Strategic Goods and Services Matrix. Product and process economic considerations are advised to be applied when purchasing outside of such Long Terms Agreements, which is a decision that is at the sole discretion of each entity, to obtain the best value for the Organization. To arrive at a completely transparent cost comparison, factors to consider include the price of the good or service, installation, maintenance and freight costs, as well as internal administrative costs associated with the acquisition process, from development of requirements to contract management. Over the threshold stated in the Strategic Goods and Services Matrix , the authority to undertake procurement for this type of goods and/or services is retained by the Department of Operational Support.

The Strategic Goods and Services Matrix also provides guidance for those Information and Communication Technology goods and/or services included in such Matrix that require technical clearance from OICT prior to the commencement of any procurement action by a UN Secretariat entity.

The Strategic Goods and Services Matrix may be revised from time to time.

All entities are free to undertake procurement for goods and/or services which are either below the thresholds of the goods and/or services listed in the Strategic Goods and Services Matrix and for any goods and/or services not included in the Strategic Goods and Services Matrix. Local Procurement Authority is only required in cases where entities wish to pursue local procurement of goods and/or services classified as strategic in accordance to the paragraphs above.

The single most important factor in eliminating ad-hoc LPA requests is the active participation by each entity into Organization-wide planning. The planning process needs to be a deeply collaborative exercise resulting in a jointly agreed upon sourcing plan, which eliminates the need for LPA once a sourcing option has been identified as local procurement for the duration of the planning/budget cycle. Entities should aim to identify their requirements in a timely fashion and include them in their Annual Supply Chain Plan in order to minimize ad-hoc LPA requests. The Annual Global Supply Chain Acquisition Plan as authorized by the ASG OSCM is valid for the relevant annual planning cycle.

LPAs can also be requested at the time an ad-hoc requirement emerges as described below.

**Actions to be taken by the requesting entity:** The requesting entity is accountable to self-certify the justification for the request and to provide the necessary background documentation. Entities must ensure that the information contained in the self-certification is accurate. The self-certification of the requesting entity must be submitted electronically in Unite Self Service using catalogue item "Request for Local Procurement Authority (LPA) - Ad-hoc Request" which is available under Client Service Centre, Source to Acquire, Procurement and include at a minimum

- a. The rationale for requesting an LPA (an explanation of the requirements/circumstances that make the strategic good or the service - if it is available in existing local inventory, existing commercial contracts and/or through noncommercial contracts -unsuitable);
- b. The estimated total cost of the potential award (in US\$);
- c. Anticipated duration of the contract, if applicable;
- d. Confirmation of funds availability;
- e. Detailed definition of the requirement (SOR/SOW, technical requirement, technical evaluation criteria, design drawings, etc.) compliant with established, relevant UN (technical) standards and policies;
- f. Confirmation of technical capacity relevant to the strategic category within the requesting office to carry out the procurement process;
- g. Confirmation of availability of (or access to) procurement capacity and infrastructure, including the following: Bid receiving and safeguarding; Tender Opening Committee; Local Committee on Contracts; At least two fully dedicated, trained and qualified United Nations Procurement Officials of which one staff shall be a Procurement Officer or a United Nations official as otherwise cleared to conduct procurement functions at the appropriate level for the potential award;
- h. Identification of the envisaged financial rule for the resulting award. In case of exceptions to the use of formal methods of solicitation, the justification for such exception;
- i. Confirmation that the entity has not been in receipt of audit reports with rating "unsatisfactory" in the last three (3) years.

The requesting entity must attach to the following documents to their Request for LPA in Unite Self Service:

- a. Annex A -Scope of Requirements (SOR/SOW), Technical Evaluation Criteria, design drawings, etc. compliant with established technical standards and policies;
- b. Annex B -Cost Breakdown.

**Actions to be taken by UNGSC:**

Upon receipt of the ad-hoc request for LPA, UNGSC will conduct an initial review of the submission. This review will include the following:

- a. Confirm that LPA is required. If the requirement does not require LPA, the client entity will be informed accordingly and the RFS and associated work orders will be closed, indicating the reason for closure within one working day. UNGSC shall inform PD electronically;
- b. Confirm that submission, including the above mentioned supporting self-certified information, is complete. If the submission is not complete, the requesting entity will be informed accordingly and the RFS and associated work orders will be closed, indicating the reason for closure within one working day. UNGSC shall inform PD electronically;
- c. Verify that alternative sourcing options of the requirements have been fully explored, including global surplus and stocks reserve, where feasible to fulfil the requirement.

Based on this check:

- (i) If it is determined that the requirement cannot be met from global surplus and stocks reserves, UNGSC shall inform PD electronically by closing the work order assigned to UNGSC within one working day.
- (ii) if it is determined that the requirement(s) can be met from global surplus and stocks reserve, UNGSC shall inform electronically within one working day, the requesting entity of the available options. The client entity shall respond within three working days.
  - If the offered solution is accepted, UNGSC shall inform the technical offices, PD and the client entity of the outcome of the review and close the RFS and associated work orders. The client entity will update their annual supply chain plan;
  - If the requesting entity confirms that the LPA is still the preferred option, UNGSC will complete the review and submit its recommendation (concurrence or non-approval) to PD electronically by closing the work order assigned to UNGSC with a brief explanation within one working day of the receipt of the entity's response;
  - In the absence of a response from the requesting entity, the RFS and associated work orders will be closed, indicating the reason for the closure.

In addition, UNGSC will provide assistance to the requesting entity, also in case of non-approval, and monitor the implementation of the LPA within the context of the Integrated Business Planning (IBP).

**Actions to be taken by PD:** Upon receipt of UNGSC's concurrence to the request for LPA, PD will:

- a. Analyze if the requirement can be met through any other sourcing options (in addition to the ones analyzed by UNGSC), including ways of potentially meeting the requirement through the category management approach, cooperation between United Nations system entities as well as other sourcing capacities available in the Secretariat;
- b. Benchmark the cost reasonableness of the requested amount for the desired goods and services; and,
- c. Undertake a risk assessment, if warranted/indicated, including areas such as audit ratings and observations, the basis for the request as well as for the exception to competition, capacity in terms of the number of formal solicitations handled by the perspective case officer, DMSPC inputs, etc.

Upon conclusion of the review, and no later than 2 working days upon receipt of the UNGSC concurrence, Director, PD (or another Procurement Official authorized by Director, PD to perform this task) will inform all parties of her/his decision to grant or reject the request for LPA. In case the

LPA is granted, its validity for other requirements for the same nature will extend to the end of the planning cycle. Should the LPA not be approved, the client entity and PD will work together on how to best meet the requirement.

**Actions to be taken by the expert technical office:** Upon approval of an LPA, expert technical offices will provide initial technical advice to the client entity within two (2) working days of the issuance of the LPA. In the case of highly complex requirements, technical offices may request a longer time for providing technical advice. Such expert technical offices may be in Headquarters or away from Headquarters, in accordance to the corresponding category management strategy. The client entity will be informed by technical offices in advance on exactly how many days are requested and the reason why.

For cases under F.R. 105.16 (a) (vii) Exigency (as defined in General Assembly decision 54/468, “an exceptional compelling and emergent need, not resulting from poor planning or management or from concerns over the availability of funds, that will lead to serious damage, loss or injury to property or persons if not addressed immediately”), LPA is not required for Strategic Goods and Services

Entities have unlimited authority to place call off orders against systems contracts established by the UN Secretariat regardless of the nature of the requirement.

Authority to enter into cooperation with a Government, non-Governmental organization or other non-UN public international organizations for the provision of goods and services under FR 105.17 (b) is retained by DOS.

## RESOURCES

Annex 2 - Strategic Goods and Services Matrix  
Annex 3 - SCOG SR4 concerning the LPA process

## 2.7 Delegation for Amendments

### 2.7.1 Increase of the NTE Subsequent to Review Committee (20% Rule)

The procurement delegation instrument provides that the relevant delegation holders (see Document Processing and Approval Matrix (Annex B) to the Delegation of Authority in the Administration of Financial Regulations and Rules) have the authority to increase the Not-to-Exceed (NTE) amount for contracts previously reviewed by a Review Committee by 20% or by US \$500,000, whichever is lower. The intention of the 20% rule is to allow some flexibility in addressing changes in requirements, unexpected delays during the tender process, or operational urgencies not due to poor planning. Please refer to [Chapter 9 Review by Committee on Contracts](#).

### 2.7.2 Extension of Duration of a Contract Subsequent Review Committee (8-Month Rule)

The procurement delegation instrument provides that the relevant delegation holders (See Document Processing and Approval Matrix (Annex B) to the Delegation of Authority in the Administration of Financial Regulations and Rules) have the authority to extend contracts previously

reviewed by a Review Committee for up to 8 months, subject to the limitations set forth in [Chapter 9 Review by Committee on Contracts](#).

The 8-month and 20% Rules can be used separately or combined, as outlined above and in the table below. Both rules can be applied to all written contracts including Letters of Assist.

Modification	Requires Review Committee?
Extension by up to 8 months	No
Increase of NTE up to 20% or US\$ 500,000.00 (whichever is lower)	No
Extension by up to 8 months and simultaneous increase of NTE up to 20% or US\$ 500,000.00 (whichever is lower)	No
Extension by more than 8 months	Yes
Increase of NTE by more than 20% or US\$ 500,000.00 (whichever is lower)	Yes

FIGURE 1: REVIEW COMMITTEE REQUIREMENTS

### 2.7.3 Contract Awards

An award means the authorization is given by the Authorized Official (following Review Committee recommendation if required) or the Procurement Approving Authority, as applicable, to establish a contractual commitment on behalf of the UN. It includes the issuance of contracts, Long Term Agreements (LTAs), Letters of Assist (LOAs), purchase orders, or amendments thereof.

### 2.7.4 Calculation of Cumulative Amounts for Assessment of Required DOA

For a contract or series of contracts, including amendments thereof, awarded to the same vendor for the same requirement or a series of related requirements or purpose, the cumulative amount for the entire period of the proposed award must be considered when determining the level of DOA required for approval.

The ‘same requirement’ means the award of a contract or series of contracts to the same vendor, including amendments thereof, in the context of/resulting from a single solicitation process. Therefore, the amount of all contracts, purchase orders, or amendments resulting from the same solicitation process for the same purpose must be accumulated for the purpose of determining the relevant Procurement Approving Authority.

## 2.8 Accountability

All UN personnel involved in the procurement process are accountable to the Secretary-General for the actions undertaken by them in the course of their official duties. UN personnel who take any action that is contrary to the Financial Regulations and Rules or to other relevant legislative instruments or policies and procedures may be held personally responsible and financially liable for the consequences of such action.

As the UN utilizes public funds in the procurement process, these funds must be applied solely for their intended use. Individuals holding a DOA must be particularly careful to ensure their actions, or those undertaken by persons under their supervision, comply with the Financial Regulations and Rules and other relevant legislative instruments.

## 2.9 Segregation of Duties

Segregation of duties is an internal control mechanism used to assure that no single individual or organizational unit is given responsibility for more than one related function within a single process.

There are two areas where segregation of duties is applied in the acquisition process as part of internal controls: The first area refers to authorities for various functions in the acquisition process in UMOJA:

- a. Budgeting Authority— responsibility for managing the resources being spent, normally performed by the Requisitioner or end-user;
- b. Requisitioning Authority— responsibility to raise a requisition (shopping cart) and convey such requisition to the procurement function;
- c. Procurement Approving Authority— approval of purchase orders after the Procurement Official has created them;
- d. Disbursing Authority— approval of the payment of invoices.

Personnel are granted profiles in UMOJA consistent with their roles, and the following segregation of duties measures are enforced by the system:

- a. Personnel that create purchase orders cannot approve them;
- b. Personnel that create requisitions/shopping carts cannot approve them;
- c. Personnel that approve requisitions/shopping carts and personnel that approve purchase orders cannot approve payments;
- d. The Procurement Official cannot undertake the receipt of goods and services pursuant to purchase orders or contracts;
- e. Personnel that create or modify vendor records cannot approve them. The right to approve new vendors in the system is separated from the procurement function and performed by the vendor registration function in the EOS, OSCM and the Master Data Management team in UNGSC in Brindisi;
- f. Any justified combination of roles is to be documented and approved by the ASG, OSCM.

The second area refers to steps in the procurement process outside UMOJA. The following segregation of duties applies:

- a. 'Needs definition' authority— the responsibility to define a requirement in the form of a Statement of Requirement and convey such need to the procurement function; a process which is undertaken by the Requisitioner or Technical Expert Category Manager;
- b. Opening of offers for formal solicitations must be conducted by at least one official who has no involvement in the subsequent stages of the procurement process;
- c. An evaluation committee is formed hereof (as per [Chapter 8.2](#));
- d. The Procurement Approving Authority shall not award contracts or purchase orders or amendments thereto in instances where the Procurement Approving Authority has directly and personally conducted the procurement process. In such cases, all contract documents and purchase orders must be referred upwards to the next DOA level.

Notwithstanding the above, Procurement Officials may exercise the remaining activities under their delegated authorities (e.g. approve the List of Invitees, sign solicitation documents) in instances where they have undertaken responsibility for the procurement process.

### 3. Vendor Registration and Management

The UN Secretariat maintains two vendor databases: The UNGM ([www.ungm.org](http://www.ungm.org)), which includes vendors that are interested in doing business with the UN, and the UMOJA database, which includes vendors that have been registered as Business Partners.

In order to maximize economy and efficiency, Procurement Officials and staff in EOS OSCM should continually strive to identify new technically and financially sound vendors. In particular, the UN shall actively work to increase its sources of supply from developing countries and countries with economies in transition.

#### 3.1 Vendor Registration

UNGM acts as a single-window through which potential vendors may register with the entities of the United Nations system, including the UN Secretariat. The vendor registration function in EOS is responsible for any aspects related to vendor registration, establishment and maintenance of



vendor files, and assistance to vendors and Procurement Officials in related matters. The Master Data Management Team in UNGSC is responsible for synchronizing the UNGM vendor registration data into UMOJA as Business Partners. VRO/EOS may also synchronize UNGM vendor registration data into UMOJA as Business Partners.

### 3.1.1 Registration in UNGM

Vendors wishing to participate in solicitation exercises conducted by the UN Secretariat must have completed the process of self-registration at the Basic Level in the UNGM portal, including confirmation of the acknowledgment of the United Nations Supplier Code of Conduct. Unless otherwise indicated in the Request for Expression of Interest (REOI) or solicitation instructions, a completed registration at the Basic Level suffices to participate in UN Secretariat solicitation exercises.

Vendors that are not registered at the Basic Level in UNGM or have been suspended (even if they are in the process of being reinstated) shall not be invited to participate in solicitation exercises and shall not be eligible to submit a bid or even receive the solicitation materials.

Furthermore, vendors are required to be registered at the appropriate level prior to contract award. Contracts shall only be awarded to eligible vendors that are registered with the United Nations Global Marketplace, unless specific exceptions apply (please see [Chapter 3.1.4](#)).

The UN evaluates vendor applications to determine whether the application complies with established UN requirements as set forth below and whether vendors are thus eligible for registration. Successful and eligible applicants are duly registered as UN Secretariat vendors.

Under exceptional circumstances (e.g. the vendor cannot access UNGM or has insufficient knowledge of any of the languages supported by UNGM) or as requested by the Director, PD or Chief, Enabling and Outreach Service, the UN may assist a vendor in completing the registration process in UNGM. In such instances, a signed vendor registration form shall be obtained from the vendor, including an Eligibility Form and statement that the vendor accepts the Supplier Code of Conduct and the UN payment terms.

### 3.1.2 Synchronization in UMOJA

Information about a vendor in UNGM, as maintained by the vendor, is replicated in UMOJA when required. Authorized staff members initiate the replication manually, and the information is thereafter replicated automatically from UNGM to UMOJA. This action is typically taken when Procurement Officials have determined that vendors not yet replicated in UMOJA need to be added to the List of Invitees.

### 3.1.3 Overview of Registration Levels

The UN's vendor registry consists of three (3) levels, each with distinct risk profiles and registration requirements: Basic Level, Level 1 and Level 2.

Vendor Registration Level	Award Amount
Basic Level	< US\$ 150,000
Level 1	≥ US\$ 150,000 and ≤ US\$ 500,000
Level 2	> US\$ 500,000

**FIGURE 2: UN VENDOR REGISTRATION LEVELS**

Registration at the Basic Level is a fully automated process in UNGM and can be completed online by the vendor. This allows the vendor to be invited to participate in solicitations. To be synchronized

in UMOJA, at the Basic Level, the UN reviews compliance of the vendor with the Pre-requisites for Eligibility.

It is only at the time of contract award that the vendor under consideration needs to be registered at registration Level 1 or 2 for awards above US\$ 150,000. However, no vendor may participate in any solicitation exercise unless it is fully registered, at a minimum, at the Basic Level, at the time of the issuance of the solicitation. If within a period of time following the issuance of the solicitation, a vendor registers at Basic Level, the Procurement Official may, at his/her sole discretion, include the vendor in the List of Invitees. With regards to joint ventures, please refer to [Chapter 3.1.4.1](#).

Registrations at Levels 1 and 2 shall be initiated by the vendor but require evaluation by the UN before they come into effect.

Registration as a vendor is subject to the following:

- a. All information provided to the UN must be certified as true and correct. The UN may unilaterally seek at any time to clarify and/or conduct further research on any concern it may have regarding the eligibility of a vendor and to take such action that it may deem appropriate under the circumstances.
- b. Registration of a vendor in UNGM indicates that the vendor is eligible to participate in UN Secretariat tender activities (subject to evaluation of eligibility criteria). Registration does not guarantee an invitation to a solicitation exercise or contract award.

### 3.1.4 Criteria for Vendor Registration

#### 3.1.4.1 Pre-Requisites for Eligibility

To become registered vendors to be able to participate in UN solicitation exercises and receive solicitation materials, applicants are required to declare that:

- a. They are not a company, or associated with a company or individual, under procurement prohibition by the United Nations, including but not limited to prohibitions derived from the [Compendium of United Nations Security Council Sanctions Lists](#);
- b. They are not currently removed from the registered vendor list or suspended as registered vendors by the United Nations or any other entity of the UN system including the World Bank;
- c. They are not under formal investigation, nor have been sanctioned within the preceding three (3) years, by any national authority of a United Nations Member State for engaging or having engaged in proscribed practices, including but not limited to: corruption, fraud, coercion, collusion, obstruction, or any other unethical practice;
- d. They have not declared bankruptcy, are not involved in bankruptcy or receivership proceedings, and there is no judgment or pending legal action against them that could impair their operations in the foreseeable future;
- e. They do not employ, or anticipate employing, any person(s) who is or has been a UN staff member within the last one year (12 months), if said UN staff member has or had prior professional dealings with the vendor in his/her capacity as UN staff member within the last three years (36 months) of service with the UN (in accordance with UN post-employment restrictions contained in [ST/SGB/2006/15](#)); and
- f. They undertake not to engage in proscribed practices (including but not limited to: corruption, fraud, coercion, collusion, obstruction, or any other unethical practice) with respect to the UN or any other party, and to conduct business in a manner that averts any financial, operational, reputational or other undue risk to the UN.

When a consortium or joint venture submit a joint proposal as a single bidder on behalf of all of its members, all of the members of the consortium/joint venture must meet the criteria requirements described in this chapter. If in the judgment of the Procurement Official an award is considered, the

Procurement Official shall submit a request for special approval of the joint venture to the e-SAC. In addition, should the contract be awarded to the consortium/joint venture, risk mitigation measures in the form of liability provisions, warranties, and/or other assurances are to be included into the contract as appropriate, in consultation with OLA. It preferred and strongly recommended that contracts be signed with a prime vendor. Any partners acting as subcontractors in joint ventures can give rise to legal risk. If a joint venture is considered for an award, it is necessary for the Director PD or CPO - who may consult the Office of Legal Affairs (OLA) - to provide advice before a decision is taken.

In the case that a vendor's situation changes with regard to any of the statements listed under paragraphs 3.1.4.1 a-f, the vendor shall immediately inform the UN Secretariat (e-mail to [register@un.org](mailto:register@un.org)).

#### 3.1.4.2 Registration Levels

To be registered at a certain level, vendors must provide the following information and documents:

##### **Basic Level registration:**

- a. Vendor information such as officially registered company name, owners, address, contact information, telephone, e-mail, etc.;
- b. Declaration of meeting the Pre-requisites for Eligibility;
- c. Acceptance of UN Supplier Code of Conduct;
- d. Selection of United Nations Standard Products and Services Code (UNSPSC) Commodity Codes of goods/services offered.

##### **Level 1 registration**

- a. Basic registration criteria;
- b. Proof that the vendor has been in business for a minimum of 3 years<sup>2</sup>;
- c. Current certificate of incorporation or equivalent document verifying legal status;
- d. Identification of at least three (3) independent, non-affiliated clients/companies with whom the vendor has conducted business over the previous 12 months, including details of the projects (client name and contact details, description of the project/work undertaken, start and completion date, and if feasible, the contract value of the project);
- e. Name of owner(s) and principals (including the parent company, subsidiaries/affiliates, CEO/Managing Director, and those with controlling interest, if applicable, including under any former corporate incarnation; and
- f. The names of intermediaries, agents and/or consultants (if any) employed in relation to United Nations contracts or bids/proposals.

##### **Level 2 registration**

- a. Basic and Level 1 registration criteria;
- b. Audited / Certified financial statements for the previous three financial cycles, consisting of Audit Report / Review Report (Statement of Opinion) by independent and accredited Audit / Accounting firm, Income Statement, and Balance Sheet. For privately held companies who do not have audited financial statements, the VRO will request certified financial statements (consisting of Income Statement and Balance Sheet accompanied by Review Report by independent / accredited Accounting firm) with a statement of opinion or a

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<sup>2</sup> Vendors that have not been in incorporated for a minimum of three years but were incorporated as a different entity (e.g. under a different name) prior to the date of incorporation of the current company, shall provide sufficient proof thereof. The Vendor Review Officer (VRO) may accept such application, provided that both the current and the prior company meet the pre-requisites for eligibility and other requirements for registration at a specific level.

compilation report which will be considered in exceptional circumstances for review by the e-SAC; and

- c. Three reference letters from non-affiliated clients/companies with whom the vendor has conducted business with over the past year (12 months). The letters must be on the Reference company's letterhead and signed by an authorized official of the Reference company.

#### 3.1.4.3 Special Considerations and Requirements for Specific Vendor Types

##### 3.1.4.3.1 Air Operators

The United Nations only awards contracts for long-term air charter requirements and short-term passenger movements to air operators in a possession of an Air Operator Certificate (AOC) authorizing them to operate in the area of interest to the UN, with all types of aircraft required by the UN. Prospective contractors for such aircraft charter services are required to demonstrate their ability to comply with the requirements of the United Nations and have sufficient technical and financial resources to conduct safe operations.

The process to become a registered Air Operator of the UN Secretariat for the services described above consists of two-steps: a technical application and an administrative/commercial application. A technical evaluation of each vendor to determine the potential contractor's capabilities to perform the services is required and is typically conducted by OSCM. As is the case for all vendors, the administrative/commercial application is submitted and conducted online through the UNGM platform where Air Operators must register at Level 2. The review of administrative/commercial applications will be conducted for those vendors whose technical application is considered to be compliant.

Air transportation companies interested in participating in solicitations and being considered for UN contracts must comply with relevant air operator registration requirements. (<https://www.un.org/Depts/ptd/aviation>).

The technical aviation vendor registration team reserves the right to impose additional aviation safety risk-mitigating measures on air operators applying for UN flight service vendor registration, and technically cleared flight service vendors. This is to benefit aviation safety in UN air transport services and to limit the Organization's exposure to potential legal, financial, reputational and other liabilities.

Registered Air Operator vendors must maintain full compliance with the technical and administrative/commercial requirements for registration as Air Operators with the United Nations Secretariat. EOS/VRO, upon determination that a vendor has failed to remain in full compliance with the technical and/or administrative/commercial criteria may approve and carry out the removal from the list of registered United Nations Air Operators prequalified to participate in UN solicitations, and such status will be reflected in the corresponding Umoja and UNGM records; EOS/VRO shall notify the vendor accordingly. This shall render the Air Operator ineligible to participate in or be invited to future solicitations and awards until such time that full reinstatement efforts in line with relevant compliance requirements have been made by the vendor and the respective UN offices endorses the reinstatement.

##### 3.1.4.3.2 Sole Proprietorships

Due to exposure of sole proprietors to personal liability, the United Nations typically does not enter into a contractual relationship with this type of legal entity.

In cases where local business practices and/or the nature of relevant requirements demands, sole proprietorships applying for registration at the Basic Level shall be approved by the Chief, VRO

based on a written justification from the Procurement Official, in view of local business practices and the nature of goods and/or services solicited.

In cases where local business practices and/or the nature of requirements demands, sole proprietorships applying for registration above the Basic Level shall be referred to the e-SAC for special consideration of approval. Sole Proprietors require a BP in Umoja.

Sole proprietorships cannot be contracted to provide consulting services.

#### 3.1.4.3.3 Low Value Acquisition Vendors

Low value acquisition vendors for requirements of up to US \$10,000 are not required to be registered in UNGM, however they are checked against the list of UN sanctioned vendors and require a commercial BP in Umoja.

#### 3.1.4.3.4 Special Commercial Categories

When not feasible, Hotels/conference centers and utility companies are not required to be registered in UNGM, however other appropriate commercially prudent verifications are to be conducted and they are also to be checked against the list of UN sanctioned vendors prior to establishing a commercial BP in Umoja.

Individual landlords are not required to be registered in UNGM, however other appropriate commercially prudent verifications are to be conducted and they are also to be checked against the list of UN sanctioned vendors prior to establishing a commercial BP in Umoja.

## 3.2 Vendor Management

The Chief, EOS shall designate Vendor Registration Officers (VRO/VROs) who are responsible to evaluate vendor registration applications, create and maintain vendor records, and provide support service to the UN Secretariat for matters involving vendor registration.

### 3.2.1 Evaluation of Vendor Registration Applications

The evaluation of vendor registration applications is conducted by the VRO based on the criteria stated in this chapter. The VRO either approves the registration application, requests additional information/documentation as deemed necessary to complete the review process or denies the application.

Registrations at Level 2 require a thorough review of the applicant's financial status (i.e., revenue, profitability and liquidity). During the review, the VRO analyses information from documents submitted by the vendor (i.e., financial statements), information obtained through business information services and other sources as appropriate. The VRO shall use the standard financial review methodology as established by the Chief, EOS.

The VRO, using established financial assessment criteria, shall evaluate whether a vendor registering at Level 2 is in sound financial condition. Failure to submit the required financial data shall disqualify the vendor for registration at Level 2.

Exceptionally, an applicant may be registered as a UN Secretariat vendor despite not meeting all registration criteria. In such cases, the Procurement Official may submit a request to the VRO for 'special approval' if in the professional judgment of the Procurement Official such request is warranted. The VRO shall submit the case for the review of the e-SAC (see [Chapter 3.6](#) below).

## RESOURCES

### Annex 4— Special Approval Request Form for Registration

#### 3.2.2 Vendor Registration Maintenance and Updating of Vendor Documentation

Following the evaluation and uploading of vendor documentation into UNGM, the VRO shall maintain documentation in an electronic platform, which shall be available upon request for review by Procurement Officials. Performance Evaluation Reports received from the Requisitioner should be submitted/forwarded by Procurement Officials to the VROs to be maintained in their respective vendor files.

#### 3.2.3 Updating of Vendor Information

All registered vendors are required to update UNGM and inform the UN immediately - in writing - of any material change in the information or documentation provided to the UN, setting out all relevant details. All vendors must immediately update their online application in UNGM, uploading additional documentation. A follow-up communication or alert may be in the form of an online application update, letter, fax or email, and shall include all relevant documentation.

Upon the UN's request, which may occur as part of a pre-qualification or solicitation exercise or through UNGM automated periodical notifications, registered vendors are required to submit their updated financial statements and other relevant documentation.

If a vendor undergoes a legal name change, the vendor is required to upload to the UNGM certified true copies of all legal documents relevant to the transactions that led to the name change, including new certificate of incorporation, or documents relevant to a merger, takeover, etc.

All exchange of information and documentation in support of the vendor registration should be conducted online through UNGM. The vendor is likewise informed of the status of their application through the UNGM e-mail notification system.

The VRO, shall review compliance with the Pre-requisites for Eligibility and related documentation, to assess the continued eligibility of vendors both at the time of registration and after they have been registered with the UN Secretariat.

### 3.3 Vendor Review Committee

The Vendor Review Committee (VRC) is an internal administrative body tasked with making recommendations to the Under-Secretary-General for the DMSPC regarding possible sanctions against, and possible reinstatement of, vendors following the review of cases related to:

- a. Vendors who may have engaged or attempted to engage in proscribed practices (including but not limited to corruption, fraud, coercion, collusion, obstruction, sexual exploitation or any other unethical or anti-competitive practice);
- b. Vendors who have failed to perform in accordance with the terms and conditions of their contract(s) with the UN to the extent that it would warrant suspension;
- c. Prior to registration, a failure to (a) meet any of the applicable "Pre-Requisites for Eligibility" set forth in [Chapter 3.1.4](#) above, (b) submit a Declaration of Eligibility, or (c) accept the UN Supplier Code of Conduct;

- d. Following registration, non-compliance with (a) any of the applicable “Pre-Requisites for Eligibility” set forth in [Chapter 3.1.4](#) above, (b) statements made in the Declaration of Eligibility, or (c) the undertakings contained in the UN Supplier Code of Conduct;
- e. Vendors who requested reinstatement and have satisfactorily completed the reinstatement process.

The VRC will recommend to the USG, DMSPC whether to censure, suspend, remove, accept or reject registration or reinstate a previously suspended or removed vendor.

The VRC has a quorum when three members, including the Chairperson, are present. The membership of the VRC is comprised as follows:

- a. Director, BTA, DMSPC, or her/his officer-in-charge, who serves as Chairperson;
- b. A representative from the Office of Programme Planning, Finance and Budget, who will also act as alternate chair in the absence of the Chairperson;
- c. A representative from DOS;
- d. A representative from the Department of Economic and Social Affairs.

Representatives of the procurement office responsible for the administration of the associated contract(s), the requisitioning office responsible for the management of the associated contract, or a representative of Office of Internal Oversight Services (OIOS), OLA or the Ethics Office may be invited to attend meetings of the VRC in an *ex officio* capacity.

The VRC will be supported by a secretariat responsible for preparing and presenting the case to the VRC members, taking minutes of meetings, circulating minutes and related documents for clearance of the members and signature by USG, DMSPC. The secretariat is a supportive function of the VRC and does not participate in the substantive discussions of the VRC.

The VRC does not communicate or meet directly with vendors. The decision of the USG, DMSPC is communicated to the vendor once taken, by Chief, EOS.

### 3.4 Review by the Vendor Review Committee

Where the UN has received evidence that one of the instances described in [Chapter 3.3](#) a (i)-(v) has occurred, the secretariat of the VRC will be requested to submit the case for review by the VRC. Upon receipt of a case presentation from the secretariat, the VRC reviews the information and documentation and may seek additional expert advice from relevant, substantive UN offices, such as OLA or the Ethics Office. The deliberations of the VRC and the decision of the USG, DMSPC are recorded in writing and kept in the vendor file in the form of approved minutes.

Evidence of a vendor’s failure to perform under a contract with the UN should not automatically result in a submission to the VRC with a recommendation to sanction such vendor. Instances of performance issues that do not, in the UN’s view, materially affect the vendor’s compliance with the contract or otherwise warrant suspension should be handled in accordance with [Chapter 13](#).

Upon examination, the VRC makes a recommendation to the USG, DMSPC on whether to sanction or reinstate a vendor in UNGM, seek clarifications and consultation, accept or reject a vendor’s registration or take no action. The VRC may also determine specific conditions under which a suspension can be lifted.

If the VRC recommends that the vendor be sanctioned, the period of time and any associated conditions recommended for such sanction should be clearly defined.

The VRC meets in person (which includes video links) to deliberate on the case presented.



All VRC recommendations to the USG, DMSPC are made in writing. The VRC secretariat maintains a repository of the minutes of the VRC and written decisions of the USG, DMSPC in the applicable vendor file. A copy of such decisions and minutes will be communicated by the VRC secretariat to the Chief, Enabling and Outreach Service, the Director, Procurement Division, the relevant requisitioner, and the procurement office responsible for the administration of the associated contract(s), immediately upon signature.

### 3.5 Vendor Sanctions

The Model Policy Framework (MPF) on Vendor Sanctions is the set of policies and guidelines that UN organizations follow in order to sanction vendors in the UNGM that have been involved in proscribed practices such as fraud, corruption, collusion, coercion, unethical practices, and obstruction. The MPF allows UN agencies and entities to establish sanction procedures that meet their specific requirements while at the same time allowing for the harmonization of efforts throughout the UN system.

Each UN organization nominates an officer to the role of Ineligibility List Administrator (ILA) to administer, maintain and update the list of ineligible vendors. For the UN Secretariat, this role will be performed by the Secretary of the VRC.

Upon receipt of the recommendation of the VRC, the USG, DMSPC decides whether to sanction a vendor. The vendor shall be notified in writing as appropriate by Chief, EOS.

The USG, DMSPC, upon recommendation by the Vendor Review Committee, may impose any of the following sanctions or a combination of them:

- a. **Censure:** A reprimand in relation to a vendor's conduct. Censure does not affect the vendor's eligibility, but its existence will be an aggravating factor for imposing sanctions in future proceedings.
- b. **Suspension:** A decision that, for a period of time determined by the UN, a vendor has become ineligible to: be awarded UN contracts; partake in UN procurement solicitations; conduct new business with the UN as agent, representative or subcontractor of other vendors; partake in entering into direct negotiations with the UN regarding new contracts. At the conclusion of the set time period, the vendor's status will be reviewed by the VRC, and a recommendation made to the USG, DMSPC that the vendor either be reinstated (with or without conditions), the suspension period be extended, or the vendor removed from the UN vendor register.
- c. **Removal:** A decision that a vendor shall be removed from the register and rendered ineligible to participate in any aspect of UN procurement including to: be awarded UN contracts; partake in UN procurement solicitations; conduct new business with the UN as an agent, representative or subcontractor of other vendors; partake in entering into direct negotiations with the UN regarding new contracts. A vendor that has been removed from the register may apply for reinstatement if the conditions giving rise to the removal have materially changed. It is within the UN's sole purview to determine the veracity of such a claim and determine the action to be taken.
- d. **Other Sanctions:** Any other sanctions that the VRC finds appropriate under the circumstances of a case, including but not limited to, a recommendation that would subject existing or future contracts to special conditions, etc. These other sanctions may be imposed in addition to or in place of censure or suspension or removal.

The notice of sanction advises the vendor of the UN's decision to sanction them, either for a specific period of time or by its removal from the UN vendor register and specifies the reasons for the decision. In addition, the notice informs the vendor that it may request a review of the decision. If



applicable, the notice also should list any relevant corrective action that the vendor must take in order to be considered for reinstatement.

Notices are sent by mail, with return receipt requested, or by email with a confirmation of transmission requested. A copy of the return receipt or confirmation of transmission is kept in the vendor's file. The vendor is entitled to a maximum period of 30 days following the UN's receipt thereof to request a review of a UN decision imposing a sanction. Upon receipt of the vendor's request for review, the VRC makes a recommendation to the USG, DMSPC, who determines whether to maintain, reverse, or amend the decision.

In cases where the VRC recommends suspension of a vendor that has an ongoing contractual relationship with the UN, the recommendation will specify whether to terminate or allow continuation of an existing contract(s), to ensure that the best interests of the UN, including but not limited to operational needs and the security of UN personnel and property, are duly protected. In such cases, the USG, DMSPC, shall take note of the VRC recommendation in relation to the existing contract(s), and may decide to refer the recommendation on such contracts to the relevant Authorized Official for decision.

The Requisitioner is notified of such cases and shall consult with PD on action to be taken, such as termination of the contract. PD or the CPO, as appropriate, and in consultation with OLA, ensures that the interests of the UN are duly protected in connection with any termination of a contract, taking into account considerations including but not limited to operational needs and the security of UN personnel and property.

If a vendor requests reinstatement, whether following a finite period of suspension or in other instances, the VRC shall review the request. This review includes but is not limited to evaluating whether any special conditions, if applicable, have been met and if sufficient evidence is presented to support the vendor's request. In addition, the VRC may recommend additional conditions in order for the vendor to be considered for reinstatement.

Upon receipt of the recommendation of the VRC, the USG, DMSPC also decides whether a vendor which has been subject to a sanction should be reinstated. Any such decisions by USG DMSPC will be communicated to the vendor in writing by Chief EOS.

## RESOURCES

[SOP on Vendor Review Committee Review Process](#)

### 3.6 Electronic Special Approval Committee (e-SAC)

The e-SAC reviews cases related to vendors that do not meet the registration criteria required for the respective level of registration. This Committee is an internal body within OSCM tasked to evaluate and determine the eligibility of a vendor to be registered as or remain registered at the desired qualification level.

The review of the e-SAC is directed towards an exceptional special approval of a vendor at the desired qualification level when the vendor does not meet all necessary criteria for the appropriate

registration level. The reasons for such special approval will subsequently be documented in the vendor registration file maintained by EOS.

**e-SAC Review Process.** As soon as a recommendation of award is evident, in case the vendor is not registered at the appropriate level the Procurement Official, as needed, will draft and submit to the VRO a request for special approval based on the template attached in [Chapter 3.2.1](#). The VRO will review the request and seek clarification, if any, with the Procurement Official. The case for consideration of the e-SAC for special approval will be submitted by the VRO to all members of the e-SAC via email, with a recommendation pertaining to the registration level of a vendor. The e-SAC is an internal review body and does not communicate or meet directly with vendors. The e-SAC's deliberations are conducted electronically, and the e-SAC's recommendation(s) take full effect only upon approval from the Chief, EOS.

The e-SAC has a quorum with three voting members present, including the Chairperson. The membership of the e-SAC is comprised as follows:

- a. Chairperson of e-SAC (Chief of Service, PD);
- b. a representative from the PD;
- c. a representative from a requisitioning office.

Representatives from PD and the requisitioning office will serve on a rotating basis and will not be invited to the e-SAC for those cases where they or their section are involved.

A vendor's failure to meet or continue to meet the criteria for the respective level of registration, as based on substantial and documented evidence, will give cause for consideration whether to grant special approval for a level of registration and adjust the respective level of the vendor's registration in UNGM.

The e-SAC reviews the case and recommends whether to either accept or reject the vendor's registration level or accept the vendor's registration level for a specific contract(s) only, taking into consideration the published criteria for registration and other factors including the potential financial risk to the Organization. The e-SAC makes certain that the standards are set at reasonable levels to ensure that small and medium-sized applicants from developing countries and countries with economies in transition are not unduly rejected, while all measures must be taken to mitigate risk for the Organization. Any special approvals of registration for a specific contract shall detail if it includes all optional extensions. Any subsequent extensions beyond those originally submitted to the e-SAC shall be submitted for its review.

Upon receipt of a case presentation from the VRO for the review of a vendor's registration status, the e-SAC reviews all relevant evidence, taking the factors above into consideration. The e-SAC may recommend granting special approval for a vendor for multiple or single solicitations and/or award(s). Once a determination is made by Chief, EOS for special approval of a vendor, the vendor relevant data in UMOJA will be enriched to reflect the approved level. The vendor's registration level in UNGM will remain unchanged.

## RESOURCES

SOP on Special Approval of Vendor Registration Level

## 4. Demand Planning, Acquisition Planning, Procurement Strategy and Requirements Definition

### 4.1 Demand Planning and Acquisition Planning

Acquisition planning is an essential phase in the overall acquisition process and a necessary prerequisite to the procurement process. It seeks to effectively and systemically forecast the Organization's requirements, based on demand plans generated by the end-user/requisitioner. Acquisition planning supports the timely and efficient fulfillment of mandates.

Acquisition planning necessarily includes procurement forecasting geared towards the timely delivery of goods and services. It requires that consideration be given to logistics, finance and resource management. Requisitioners are responsible for developing acquisition plans in cooperation with Procurement Officials in a timely manner. Ideally, acquisition plans should be developed in advance of each budgetary cycle to allow the concerned procurement office the necessary lead time to develop its procurement strategies, including the consolidation of requirements to leverage economies of scale.

Requisitioners may perform short-term acquisition planning for requirements to be fulfilled in the current budgetary period. In order to ensure that the UN obtains high-quality goods and/or services at competitive prices and within the time frame required, Requisitioners need to ensure the optimal use of funds throughout the budgetary period.

In the case of emergencies, such as natural disasters or other situations where there is a risk of injury or loss of life, the timing and sequencing of procurement activities may be modified in order to deal with the emergency (see [Chapter 15.4 Emergency Procurement Procedures](#)).

Requisitioners and Procurement Officials shall meet at least annually to review acquisition plans for the forthcoming budgetary period(s) and typically update the acquisition plans on a quarterly basis as required. In certain UN Secretariat entities, such review may be conducted between the Acquisition Management Section or the Supply Chain Planning Service at UNHQ, together with Requisitioner and the Procurement Official through regular Integrated Business Planning (IBP) meetings. The relevant procurement office shall advise on what can be realistically achieved during the acquisition plan period.

The demand plan shall contain the following information:

- a. Item number. (i.e., a numerical identifier);
- b. Type of goods or services, using nomenclature according to the UNSPSC;
- c. Estimated quantity (number of units) or term (number of months or years);
- d. Estimated value in US dollars, funding source, and budget reference;

- e. Delivery date or quarter when the goods are required to be delivered or the services are required to commence and be completed;
- f. Any other relevant information, including locations where goods or services are required if different from the Requisitioner's location.

The planning function of an entity is responsible for the consolidated acquisition plan and will issue appropriate instructions for action. Further, the planning function will initiate and facilitate acquisition planning by establishing a planning template. The acquisition plan is based on estimates of requirements to be procured in the next twelve months. It is understood that some procurement needs cannot be anticipated, and sometimes plans may not be entirely accurate. Nonetheless, entities are expected to provide their best estimates based on available information at the time of reporting.

The Supply Chain Planning Service in LD at UNHQ and equivalent functions in other at UN entities shall be responsible for: i) preparing the operational guidance that drives the formulation of the demand, source and delivery plans, by identifying resource priorities and fit-for-purpose sourcing solutions; ii) compiling and analyzing the data in order to confirm or determine optimal courses of action; iii) enabling the review of such information by the respective procurement and requisitioning offices and taking appropriate action, in alignment with the category management strategy for the respective goods and services. To alert the vendor community of forthcoming procurement requirements and to uphold the basic procurement principles, the consolidated annual acquisition plan will be uploaded to the UNPD website.

## PROCUREMENT STRATEGY & CATEGORY MANAGEMENT

**Category management will focus on supply market capabilities to improve the total cost of ownership. The strategic approach for each category organizes procurement (and technical) resources to focus on specific areas of spend-and-supply**

### 4.2 Procurement Strategy

Developing a strategic approach to procurement is a key element for the successful acquisition of goods and services and is necessary for the timely implementation of projects or operations. It requires an understanding of the nature of the requirements, the capacity of the contractors, the complexity of the operating environment, the risks involved, and the available internal UN capacities and resources. Enabling an effective procurement process requires professional judgment as well as an understanding of the above factors.

Procurement planning is the process of scheduling procurement activities per identified procurement strategies and in alignment with the relevant category management strategy. As such, procurement strategy, category strategy development, acquisition planning and procurement planning are closely linked.

### 4.3 Procurement Planning and Source Selection Plan

Procurement planning for an individual procurement activity includes establishing the timelines required to perform each step of the procurement process per the identified solicitation method, contract type, and method of solicitation. Advantages of procurement planning include:

- a. Improved sourcing, ensuring appropriately qualified vendors and an adequate number of vendors, leading to increased competition, and, potentially stronger offers at lower prices;
- b. Less waste of resources on last-minute actions;

- c. Early identification and management of risks;
- d. Reduction of delays and lead times due to the ability to perform tasks proactively;
- e. Better planning and monitoring of procurement activities;
- f. Identification of time periods when a high percentage of procurement actions are required (which can be useful in planning and distributing the workload);
- g. Early consideration of logistics aspects and factors for the procurement of goods and equipment.

Planning for a single procurement exercise, formal or informal, should be reflected in the corresponding Source Selection Plan (SSP). The SSP describes critical components of the sourcing process and provides justification for sourcing decisions in order to achieve Best Value for Money. It also provides an objective approach to the methodology of selecting the best source to fulfill the established need. (See sample Source Selection Plan in Annex 5).

For complex requirements, procurement planning should begin at least six months before the goods or services are required. Accordingly, Requisitioners and Procurement Officials should communicate with each other early in the planning process.

The SSP is an internal and collaborative document, under the leadership of the Procurement Official, which describes critical components of the procurement process and provides justification for sourcing and procurement decisions in order to achieve the Best Value for Money principle. It documents assumptions, decisions, and justifications and provides an objective approach to the methodology of selecting the best source to fulfill the established need. The Procurement Official and the Requisitioner are jointly responsible for contributing to, preparing, finalizing, and obtaining any required approvals for the SSP before the solicitation documents are issued. The Procurement Official must ensure that the SSP is approved prior to the issuance of any solicitation (excluding LVAs). Amendments or changes to the SSP after signature must be duly justified and placed in the case file.

Depending on the complexity of the procurement, the SSP may be summarized in a few lines or consist of detailed and precise descriptions of the steps of the evaluation necessary to ensure Best Value for Money. The estimated value of the requirement may be an indication for the complexity of the procurement, which would require a more detailed SSP; the technical complexity or nature of the requirement may also warrant a more detailed SSP. The following are elements that would be appropriate to include in the SSP:

- a. Description of the requirement (including operational circumstances, timeline, etc.);
- b. Solicitation Method and justification thereof;
- c. Method for identifying vendors (particular attention should be given to attract vendors from developing countries and from countries with economies in transition) and details thereof of the UNSPSC;
- d. The contractual instrument to be used;
- e. Evaluation Committees responsible for commercial and technical evaluation;
- f. Evaluation Criteria for commercial and technical evaluation and reasonable minimum criteria, such as minimum passing score and mandatory requirements, as well as how optional requirements will be evaluated;
- g. Weighting (i.e., the relative importance of each of the Evaluation Criteria), if applicable;
- h. Market conditions;
- i. Planning and procurement activity schedule;
- j. Rating and scoring system;
- k. Required level of expertise and Requisitioner resource capacity;
- l. Risk factors that should be assessed during the evaluation and potential remedies;
- m. Any relevant information with regard to the forthcoming contract management capacity and expertise, staff training, equipment maintenance, after-sale service, disposal, etc.

The evaluation criteria in the SSP shall not unduly disqualify vendors from developing countries and countries with economies in transition and should be based on the principles of fairness and equity. Any rating system for the evaluation of submissions, both commercial and technical, shall include all relevant details determined appropriate by the Procurement Official and Requisitioner.

As the basis of a procurement strategy, the SSP shall be made available to the Headquarters Committee on Contracts (HCC) and/or the relevant Local Committee on Contracts (LCC) for all cases submitted for the Committees' review. It is therefore critical for Procurement Officials to develop expertise in drafting Source Selection Plans and engage the Requisitioner to fully contribute to this exercise. Please refer to Annex 5 for a sample SSP.

When procurement planning is consolidated for more than one procurement activity, other strategic initiatives can be enacted towards the aim of economies of scale and reductions in transaction costs, such as:

- a. Consolidating various requirements into a single tender;
- b. Establishing Blanket Purchase Orders (BPOs), or LTAs;
- c. Undertaking joint procurement initiatives with other United Nations organizations pursuant to Financial Rule 105.17(a).

## RESOURCES

Annex 5 – Sample Source Selection Plan

### 4.4 Requirements Definition

Requirements definition is a systematic approach to define the procurement requirements included in the requisition and/or shopping cart, which should be in the form of a Statement of Work, Terms of Reference, with technical specifications outlining the needs of the Organization.

It is the first step in the implementation of procurement activity and an integrated step in its planning. However, it is often done in parallel with sourcing and supply-market research, which includes the assessment of market conditions and industry practices, in order to allow such information to help develop the requirements definition. Significant deviations from standard industry practices shall be justified and documented in the case file. Requirements definition and market research and analysis are also known as pre-solicitation activities.

The Requisitioner carries the sole responsibility for defining the requirements, while the Procurement Official is responsible for the procurement process, the assessment of the requirements, and the evaluation criteria, to ensure that they are generic and appropriate from a competition perspective, unless exceptions apply (e.g. branding without justification, over-specification, unrealistic delivery dates, and restricted competition should not be included in the requirement). Where necessary, the Procurement Official must clearly communicate to the Requisitioner that an adequate SOW/TOR should be provided in order to allow the solicitation exercise to be conducted. Where necessary, the Procurement Official shall advise the Requisitioner of possible better solutions to meet the stated need through the category management approach or other modalities. To incorporate environmental considerations when applicable, the Requisitioner shall consult with the relevant environmental official within their entity, as well as the

Environmental Technical Support Unit (ETSU) in UNGSC, when defining the appropriate technical specifications and selection criteria (see [Chapter 15.2](#)). To provide an inclusive environment for persons with disabilities, the Requisitioner shall ensure, within reason, that accessibility considerations are factored into the requirements definition and that new acquisitions do not create new barriers.

In addition, if the solicitation process is being undertaken for the purpose of establishing an LTA) or a BPO, it should be explained in the SOW, TOR, SSP or in the Special Instructions as appropriate.

Statement of Works/Requirements may include:

- a. Technical specifications, SOWs, and TORs. Depending on the nature of the procurement activity, the requirements are stated in the form of technical specifications, SOWs, and TORs (for guidance on writing requirements, see [Chapter 4.4.2 Characteristics of Well-Defined Requirements](#)).
- b. In order to prevent misunderstandings and disagreements with vendors at the time of contract execution, it is important to clearly state and describe the performance expected from the vendor, including any Key Performance Indicators (KPIs) that will be measured during contract execution. Ambiguous performance requirements may also lead to increased costs, as bidders may have to factor into their bid/proposal a contingency or risk buffer.
- c. A confirmed delivery date for goods or starting/completion/mobilization dates for the provision of services/ works if firm requirements exist or time is of the essence.
- d. When procuring goods, the destination(s) and mode(s) of transport shall be included. For services and works, destination/location shall be specified.
- e. When purchasing goods, a copy of the relevant packing and shipping instructions may be included with the solicitation documents. The packing and shipping instructions are important to the vendor when bidding, as they include instructions about packaging, marking and numbering of the shipment, notification of shipment, documentation required for customs clearance and payment purposes, and invoicing. Where the solicitation is for goods of different size and shape, the vendor shall be asked to provide weight, dimensions and volume of each item which does not require packaging. Vendors should be requested to include the number of items and total weight to be loaded in a 20ft container. For packaged items, the vendor shall provide weight, dimensions and volume of the outer package. Containerization, volume and weight details shall be then reflected in the contract to easily estimate freight requirements;
- f. Delivery terms: Incoterms 2010 shall be used to specify the responsibilities regarding the delivery of goods procured by the UN (see [Chapter 12 Logistics](#)).

## IMPORTANCE OF WELL-DEFINED REQUIREMENTS

The clear definition of requirements by Requisitioners is crucial in every procurement activity. Requirements form the basis for the solicitation and set the goals of the procurement action. It also informs potential vendors of the product requirements necessary in order to fulfill the UN's needs. The definition of requirements has a lasting and substantial effect throughout the entire procurement process.

### 4.4.1 The Purpose of Requirements Definition

All requirements that are determining factors in the evaluation of offers must be clearly stated in the solicitation documents.

All applicable technical, financial, commercial, legal, and operational factors must be stated in the solicitation documents and must be in accordance with the approved SSP.

#### 4.4.2 Characteristics of Well-Defined Requirements

In order to define requirements, there should be an analysis of the goods, and services that are to be procured and of their purpose, performance requirements, characteristics, objectives, and/or expected output.

All requirements definitions should describe the needs without over-specification. Over-specification may increase prices and/or decrease the number of offers, as it leads to offers for more advanced products than those needed. The converse is true of under-specification, and therefore, it is essential for the cost-effective use of funds that the requirements define the minimum requirements considered essential in a manner that provides certainty to the prospective vendors whilst maximizing competition.

Requirements must be generic and defined with the aim of engendering competition; no specific brands, unless for standardization purposes, or other unnecessary restrictions can be requested. However, if brand names are necessary to define functional, performance, and/or conformance requirements, they must only be used to define the required product standard. Further, brand names must never be used without also specifying the minimum requirements of the brand. Finally, the specification should clearly invite offers of equivalent products, i.e., products meeting similar functional, performance, and/or technical standards. In the event that the requirement specifies a particular brand for the purpose of standardization or is related to a requirement for spare parts for existing equipment, the rationale for this requirement should be briefly stated in the solicitation document in order to avoid negative perceptions of any bias on the part of the UN.

Where possible, requirements should include KPIs to be monitored during contract management stage (see [Chapter 13 Contract Management and Contract Administration](#)). KPIs and/or Service Level Agreements (SLAs) are essential tools to express and measure performance against agreed targets, and these are particularly recommended for complex contracts of goods and services, including long-term agreements. These have to be identified at the requirements definition stage, in order to be incorporated in the solicitation documents and then into the contract. This will enable monitoring of the KPIs at the contract management stage.

Examples of KPIs for goods and services include:

##### **Delivery/Performance**

- a. Delivery of goods/services on time;
- b. Delivery of goods/services in full;

##### **Quality**

- a. Quality of goods/services delivered (in accordance with specifications/TOR);
- b. Technical competence;
- c. Adherence to warranty provisions;

##### **Communication**

- a. Responsiveness of vendor (requests, complaints, etc.);
- b. Appropriate handling and timely submission of documents (reports, invoices, shipping documents, etc.);
- c. Introduction of innovative solutions;
- d. Cost savings to the UN initiated by the contractor;



## Compliance with Contract Requirements

- a. Environmental indicators (e.g. compliance with environmental principles to maximize resources efficiency and minimize risk, waste diverted from landfill via reduction in waste volume, periodic checks on chemicals being used and maintenance of records, reduction in packaging and avoidance of plastic packaging, proportion of recycled/ recyclable / re-usable content, product reuse or take back, minimize use of hazardous substances, reduced air emissions, etc.);
- b. Labour indicators (e.g. compliance with minimum wage, etc.).

### Best practices in setting up KPIs include:

- a. Requisitioner, in consultation with Procurement Official, shall determine KPIs during requirements definition stage;
- b. Requisitioner, in consultation with Procurement Official, shall ensure KPIs are SMART (Specific, Measurable, Achievable, Relevant, Time-bound);
- c. When issuing the contract, Procurement Official ensures inclusion of KPI targets, as well as performance credits associated (where possible) with such KPIs;
- d. Development of KPIs should be specific to a solicitation and the contract should be aligned with the overall Supply Chain Management Performance Management Framework, as developed and maintained by EOS in OSCM.

### 4.4.3 Technical Specifications

Technical specifications are mainly used for the procurement of goods, but may also apply to straightforward, quantifiable services. Specifications are typically the description of the technical requirements for a material or product. They usually refer to defined requirements for materials or products, but in some instances can also relate to requirements for services. Specifications give a description of what the Organization wants to buy and what the vendor is required to provide. Specifications can be simple or complex, depending on the need.

The specification forms part of the invitation to bid, request for proposal, or request for quotation.

Three types of defining needs (or a combination of the three) can be included in the specification:

- a. Functional specifications, defining what the goods/services are required to do;
- b. Performance specifications, defining the output of the goods/services; or
- c. Conformance specifications, defining the physical characteristics and dimensions of the goods.

### 4.4.4 Terms of Reference (TOR)

A TOR is a description of the scope of work for services, generally indicating the work to be performed, the level of quality and effort, the timeline, and the deliverables. TORs are mostly used to define the performance requirements for expert and advisory services, which are not easily quantified, e.g. where a solution to a requirement is offered.

The TOR is often the vendor's first and main introduction to the requirements. Clear, uncontradictory TORs will limit the risks to the vendor and enable them to prepare a clear and detailed proposal. This should lead to successfully implemented projects and limit the risk of dispute or claims.

The TOR typically includes the following information:

- a. Background for requesting the service;
- b. The objective of the service and overall impact;
- c. Expected and clearly defined output from the service;

- d. Activities required to reach this output;
- e. Inputs required to perform activities;
- f. Deliverables;
- g. Timelines.

#### 4.4.5 Statement of Work (SOW)

The SOW is a requirement specification for work assignments outlining the specific services, and/or goods a contractor is expected to provide, generally indicating the type, level, and quality of service, as well as the time schedule. The SOW usually includes detailed requirements for the goods and the services to be provided.

### 4.5 Shopping Cart

A Shopping Cart is a written or computerized requisition in UMOJA from an internal user/customer for the fulfillment or procurement of goods and/or services. It is mandatory to initiate all procurement activities with a shopping cart unless the Procurement Official with DOA grants a special case-by-case waiver to issue the solicitation for a justified reason (emergency, etc.).

A requisition/shopping cart must at a minimum include:

- a. A detailed description of the goods, or services being sought;
- b. Product ID (This is critical to ensure quality of data and reporting);
- c. Confirmation of funds availability for the requested purchase;
- d. Quantity to be procured;
- e. Required delivery date or start-up/completion date;
- f. Delivery location or location of services to be performed;
- g. Estimated price;
- h. Any additional information (e.g. standardization, the preferred method of shipment).

The Requisitioner bears the responsibility for requesting new UMOJA product IDs. Please click on this link ( [https://iseek-external.un.org/departmental\\_page/master-data-maintenance-0](https://iseek-external.un.org/departmental_page/master-data-maintenance-0)) for additional guidance on how to submit requests for new product IDs, and when an indication of Product Categories suffices.

## 5. Sourcing

### 5.1 Sourcing of Vendors

Sourcing is the process of identifying suitable suppliers, including vendors, that could provide the required goods or services. The sourcing process also provides valuable information about products and specifications.

Sourcing is carried out using several main methodologies, as described below.

Supply market research and analysis, including through internal and external sources;

Advertisement of business opportunities through sourcing methods, such as Request for Information (RFI), REOI, and pre-qualification.

Vendors Recommended by Requisitioners:

- a. As a general rule, Requisitioners, substantive offices, and consultants engaged by Requisitioners or substantive offices may not recommend vendors for inclusion on the List of Invitees, as such practice may be perceived as undermining the principle of segregation of responsibilities between requisitioning and procurement entities. However, it is recommended that staff involved in procurement activities encourage vendors to register with the UNGM;
- b. If vendor recommendations are received, Procurement Officials shall carefully evaluate the desirability and propriety of including the recommended vendor on the invitee list. However, unless the Procurement Official is fully satisfied that the recommended vendor will bring special knowledge or expertise that will be beneficial to the proposed procurement, the recommended vendor should be excluded but may be encouraged to register for future or other solicitations;
- c. If the Procurement Official believes that a vendor should be invited to tender, then the concurrence of the Director, PD or CPO must first be obtained, and the individual recommending the vendor will have to ensure and declare that there is no potential conflict of interest between the vendor and him/herself;
- d. A consultant engaged to prepare or review technical specifications, TOR, or SOW and/or to assist in the evaluation of Bids or Proposals concerning a requirement shall not be allowed to submit a Bid or a Proposal for the same requirement;
- e. If a Vendor approaches the Requisitioner for inclusion on the List of Invitees, the Requisitioner shall direct the Vendor to the Procurement Official concerned.

### 5.2 Market Research

Market research is the process of collecting and analyzing information about industry sector capabilities and overall market supply. It helps to identify goods, services, and vendors, assists in the development of technical specifications, TORs, SOWs and allows the collection of product and pricing information on available technology, solutions, etc. Market research is an essential exercise conducted by the Procurement Official in the quest to satisfy the Organization's needs and is instrumental for any successful sourcing process, particularly if the goods or services have not been procured previously. When done through means such as seminars or events, market research may also be considered an outreach activity which assists the UN in disseminating information about its requirements and identifying new sources of supply.

Market research can be done through the use of external and/or internal sources. Market research should not rely solely on any one of the below sources, as several can be used in conjunction before

deciding on the solicitation approach. The outcome of the market research, i.e. a list of suitable vendors, types of products available, etc. should be documented in the procurement case file and shared with the Requisitioner.

The following external sources are valuable sources of information in the search for potential vendors:

- a. UNGM ([www.ungm.org](http://www.ungm.org));
- b. Other UN organizations/lead agencies specialized in the procurement of goods or services within a particular field if this constitutes Best Value for Money and more efficient use of resources (e.g. UNHCR for refugee supplies, UNICEF for vaccines, UNFPA for contraceptives, WHO for pharmaceuticals and medical equipment, UNEP for environmental technologies and services);
- c. Commercial/specialized journals and magazines;
- d. Chambers of commerce, trade delegations, embassies;
- e. End-users, clients;
- f. Business seminars, vendor catalogs, professional journals, trade publications, or the Internet.

The following internal sources can also be a good starting point in the search for potential vendors:

- a. Existing LTAs, BPO and, if existing for a certain need, pre-qualified lists of vendors;
- b. Vendors who have had prior contracts with the UN;
- c. Previous lists of invitees within the same field;
- d. Consultation with other Procurement Officials;
- e. Available communication platforms and other mailing lists.

Furthermore, care should be taken to ensure that small- and medium-sized enterprises (SMEs), not-for-profit, minority-, women-owned businesses, and/or disability-inclusive suppliers are not excluded from the market research. Due consideration should be given to communication channels in the local language(s) to reach this specific audience and ensure effective international competition.

It is important to periodically reassess the market, particularly for products and services that are rapidly evolving in certain geographical areas and industries. During the development of Category Strategies as part of Category Management, extensive market research is conducted which can be drawn upon for individual solicitations where relevant.

### 5.3 Advertisement for Business Opportunities

Advertisement for business opportunities can be done by either one of the below methods:

- a. RFI – see [Chapter 5.4 Request for Information](#)
- b. REOI – see [Chapter 5.5 Request for Expression of Interest \(REOI\)](#), which may entail pre-qualification of vendors, if applicable and suitable (see [Chapter 5.6 Pre-Qualification of Vendors](#))

Business opportunities over US\$ 150,000, must be advertised on UNGM and PD's website unless a waiver is granted by the corresponding Procurement Approving Authority for reasons of, for example, maintaining the confidentiality of information concerning sensitive requirements or security concerns. They should be advertised or distributed as appropriate, in a manner that would lead to the most beneficial responses according to the nature and circumstances of the required product, such as announcements on local or regional radio, advertisement on websites of other organizations, in local or regional newspapers, or in specialized journals.

## 5.4 Request for Information (RFI)

The RFI is an instrument to conduct a market survey to obtain information that can be used to identify available or potential solutions/suppliers to fulfill identified needs. RFIs may include information on cost and delivery times and are generally executed prior to finalizing the Statement of Works, Terms of Reference, or technical specifications.

The information received in response to an RFI is not used for the purpose of qualifying vendors. Primarily, it helps identify generic descriptions of available or potential alternatives for fulfilling a defined requirement or outcome, as well as the possible costs and delivery time. The RFI is oriented toward seeking a technical alternative, option, solution, or cost estimate, rather than a direct response in the form of an offer from the market or industry.

An RFI is an effective and efficient tool to help identify a possible solution for a specific requirement and to gauge the commercial environment for the requirement. RFIs are also used to identify potential vendors.

The RFI shall be advertised on the entity's website, UNPD website, UNGM, and in any other media considered appropriate by the Procurement Official. It should be advertised or distributed in a manner that, depending on the nature and complexity of the requirement would lead to the most beneficial responses.

### RESOURCES

[Annex 6 - Request for Information - HQ template](#)

[Annex 7 - Request for Information - Mission Template](#)

## 5.5 Request for Expression of Interest (REOI)

A Request for EOI is an advertisement prepared by the Procurement Official, in consultation with the Requisitioner, to identify vendors that wish to participate in a solicitation. Vendors are requested to express interest by a specified deadline by submitting the detailed information requested in the REOI, for example, to demonstrate experience and qualifications in provision of the relevant goods/services. The information provided by interested vendors is assessed, and vendors are considered for inclusion on the List of Invitees.

An REOI is a cost-effective method to identify suitable vendors. However, it requires the allocation of additional time, as vendors should be given a sufficient interval to respond to the REOI. Depending on the complexity and nature of the goods or services being procured, a recommended minimum of ten working days should be granted for responses. When shorter deadlines are specified, or when the Procurement Approving Authority waives the posting of an REOI for Request for Proposals (RFPs) and Invitations to Bid (ITBs), the reasons must be properly explained and documented in the case file.

Evaluation of REOI responses must be performed by the Requisitioner and/or a Procurement Official. As appropriate. In addition, the Procurement Official may actively approach potential vendors, identified through analysis of the supply market or registered in the UNGM database, to seek their interest to participate in the forthcoming solicitation.

The REOI shall be advertised on the entity's website, UNPD website, UNGM, and in any other media considered appropriate by the Procurement Official. It should be advertised or distributed in a manner that, depending on the nature and complexity of the required need, would lead to the most beneficial responses.

## RESOURCES

Annex 8— Request for Expression of Interest and Vendor Response - UN HQ

Annex 9— Request for Expression of Interest and Vendor Response - Missions

### 5.6 Pre-Qualification of Vendors

Pre-qualification is a formal method of assessing vendors against pre-determined criteria, and only vendors that meet established criteria are invited to a tender (shortlist). Therefore, pre-qualification exercises should be applied only in such instances where the need to limit the List of Invitees has been clearly determined and the Procurement Approving Authority has authorized the pre-qualification exercise. This is done through the REOI process. The use of a pre-qualification exercise should be noted in the Source Selection Plan of the relevant solicitation, including the rationale for using the pre-qualification exercise.

The process guarantees that solicitation documents are issued only to vendors with adequate capabilities and resources. Adequate time must be allowed for potential vendors to prepare responsive applications. The period between the invitation for pre-qualification and the deadline for submission of a response shall be no less than ten working days unless a written justification has been provided and approved by the Director, PD or the Chief Procurement Officer. Such approval shall be kept in the procurement case file. Invitations for pre-qualification must be advertised on the UNGM and PD website and any other relevant media. Pre-qualification is a formal process where vendor appraisal is done prior to issuing the solicitation documents. If prequalification is done for a specific procurement activity, all vendors submitting applications and meeting the prequalification criteria shall be invited to tender. Pre-qualification does not preordain a contract award.

Pre-qualification is recommended when:

- a. The high costs of preparing detailed bids could discourage competition (such as custom-designed equipment, design and build projects, or specialized services).
- b. The requirement involves complex technical components for which the vendor needs to have minimum technical capability and capacity to complete the works to the required quality standard such as construction works;
- c. As determined necessary to achieve the best outcome for the procurement process for highly complex or otherwise appropriate needs, subject to approval by the Director, PD or Chief Procurement Officer. The criteria for the prequalification, the process, and the staff involved in the prequalification evaluation shall be established before the REOI is advertised. It shall be outlined in a separate document, and signed and dated by the Requisitioner, and cleared and signed by the Procurement Official.

## 5.7 Creation of Lists of Invitees

The identification of vendors using the tools described above enables the creation of the list of potential vendors eligible to receive the solicitation documents.

Generally, the Procurement Official should invite all vendors that expressed interest through an REOI, and that are registered at least at the basic level in UNGM at the time of issuance of the solicitation. The UN is under no obligation to invite all companies who expressed interest through a request for EOI or having replied to an RFI; such decision shall be documented in the SSP. Similarly, there is no obligation for the UN to limit the List of Invitees to companies that expressed interest or replied to an RFI. Where additional companies are added, the evaluation committee should assess the same information for each vendor as was requested in the EOI or RFI.

If there is only a limited number of vendors in the market (e.g. oligopoly market conditions) and/or the Procurement Official has not been able to otherwise identify the minimum required number of invitees specified below despite adequate market research, this should be clearly documented and explained to the Procurement Approving Authority not below the Chief of Section in a procurement office or to the CPO when requesting approval of the List of Invitees.

Otherwise, the List of Invitees for formal methods of solicitation should normally include (depending on the industry and nature of the requirement) a minimum required number of ten (10) invitees for tenders below US\$ 1,000,000 and fifteen (15) invitees for tenders estimated at a value above US\$ 1,000,000. For Request for Quotations (RFQs), a minimum of five invitees is required, however the Procurement Official shall ensure sufficient number of invitees to generate more than five quotations but no less than a minimum of three quotations (see Chapter 6.3.3).

If a pre-qualification stage has been undertaken, vendors that are ineligible must not be included in the List of Invitees. In such cases, the minimum recommended number of vendors do not apply.

## 5.8 Approval of List of Invitees

The List of Invitees must include all vendors who will be invited to tender. If the minimum recommended number of vendors, as per [Chapter 5.7](#), cannot be achieved, the rationale should be justified in writing in the procurement file and must be authorized by the appropriate Procurement Approving Authority based on the value of the procurement exercise, up to the threshold of the Director, PD or Chief Procurement Official. This justification may be written in or attached to the List of Invitees. The solicitation document can be issued only after this justification has been provided.

## 5.9 Amendment of List of Invitees

Amendments to the List of Invitees may be made by removing or adding vendors who will be invited to tender. Vendors may be added to the List of Invitees upon approval of the Procurement Approving Authority. The decision is based on the professional judgment of the Procurement Official at the CPO level or Chief of Section as to whether the vendor may be reasonably expected to provide a competitive bid and is duly registered in UNGM. In the case of additions to correct omissions and errors in distribution by the UN, an extension to the bid submission deadline may be considered.

### INTERNATIONAL COMPETITION

One of the core principles of procurement, international competition aims to solicit offers from a wide and diverse range of vendors and provides equal access and fair opportunity to compete for contracts for required goods or services.

Requests from invited vendors to revise the entity included in the List of Invitees, to reflect such things as subsidiary structures or joint venture engagements, shall be considered on the basis of professional judgment of the Procurement Official at the CPO level or Chief of Section and subsequent approval by the Procurement Approving Authority (see also [Chapter 3.1.4.1 \(b\)](#) on joint ventures). In such cases, the Procurement Official shall ensure that such entities are registered at the basic level in UNGM at the time of invitation.

## 6. Solicitation

### 6.1 Overview

After requirements have been clearly and completely defined (see [Chapter 4.4 Requirements Definition](#)) and sourcing of vendors has been undertaken (see [Chapter 5 Sourcing](#)), the next step in the procurement process is a solicitation. The solicitation process is the method used to communicate a procurement requirement and request an offer from potential vendors.

Further to the market and vendor information identified in the sourcing process, Procurement Officials should ensure consistent alignment of the solicitation with the existing category



management strategy. Unless exceptions to the use of formal methods of solicitation are justified, procurement contracts shall be awarded based on competition, which includes:

- a. Acquisition planning for developing an overall procurement strategy and methodology, an analysis of demand and supply market data, in alignment with an existing category management strategy (if applicable);
- b. Market research for identifying a potential vendor;
- c. Formal methods of solicitation or informal methods of solicitation;
- d. Consideration of prudent commercial practices.

## 6.2 Competition

### 6.2.1 Effective International Competition

Ensuring effective competition is a core principle of UN procurement. Competition should be internationally based. A key purpose of international competition is to provide a wide and diverse range of potential vendors. Procurement Officials must comply with the UN's principle of encouraging international competition and, in doing so, should encourage equal access and fair opportunity for all qualified vendors globally to compete for UN contracts for goods or services.

The following conditions are conducive to achieving effective international competition:

- a. Market analysis and advertisement is conducted to identify prospective bidders;
- b. Requirements are specified in a generic manner, allowing for competition between multiple bidders;
- c. A sufficient number of prospective contractors are identified and effectively invited to compete;
- d. Prospective contractors are from as wide a geographical distribution as possible and practicable;
- e. Prospective vendors act independently of each other;
- f. Prospective vendors compete for the same business opportunity under the same conditions.

A low number of offers received from prospective contractors in response to a solicitation is not necessarily an indication of an absence of effective international competition, given that industries, geographical markets, and individual requirements may have idiosyncrasies that affect the number of viable and responsive competitors.

Financial Rule 105.14 provides that the UN's procurement contracts shall be awarded on the basis of effective competition unless exceptions to the use of formal methods of solicitation pursuant to Financial Rule 105.16 are justified. To that end, the competitive process requires:

- a. Acquisition planning for developing an overall procurement strategy and procurement methodologies;
- b. Market research for identifying potential vendors;
- c. Consideration of prudent commercial practices;
- d. Formal methods of solicitation, utilizing ITBs or requests for proposals on the basis of the advertisement or direct solicitation of invited vendors, or informal methods of solicitation, such as requests for quotations.

### 6.2.2 Special Considerations for List of Invitees

While international competition should be pursued in principle, there are some circumstances where limiting the pool of vendors may be appropriate. This may apply when the solicitation process is restricted to a shortlist of vendors selected in a nondiscriminatory manner from rosters (e.g. list of authorized resellers), pre-qualifications, market research, or other means of sourcing.

For example, limited tendering may be considered in the following circumstances:

- a. When the requirement is in a national context and it is not reasonably possible that international vendors would be able to address it (e.g. advertising services in national newspapers, local licenses required to operate, etc.);
- b. For reasons of safety and security;
- c. When the estimated value of the requirement is less than US\$ 150,000;
- d. Any other equivalent, exceptional reason that prevents international competition.

If the Procurement Official, using professional judgment, believes that limiting the pool of vendors should be applied to a particular solicitation process, then the use of a limited pool must be approved by a Procurement Approving Authority at or above the CPO level (if not at UNHQ) or the Section Chief level (if at UNHQ). Such approval must be given at the time of shortlisting approval (by signing the corresponding field in the List of Invitees). Furthermore, the basis for the decision to limit international competition must be justified in writing by the Procurement Approving Authority responsible for approving the solicitation document and recorded in the applicable procurement case file.

### 6.2.3 Risk of Collusion

To ensure good and fair competition in the solicitation process, Procurement Officials should do their best to identify any circumstances that may indicate risk of collusion by potential vendors (i.e., vendors uniting for common profit and defeating the purpose of competition).

## 6.3 Solicitation Methods

### 6.3.1 Formal Methods and Informal Methods

Unless exceptions to formal methods of solicitation are justified in accordance with the Financial Regulations and Rules, formal methods of solicitation must be used. See Financial Rule 105.15 (*Formal methods of solicitation*) and Financial Rule 105.16 (*Exceptions to the use of formal methods of solicitation*).

The table below summarizes the four primary methods of solicitation. A more detailed explanation of the four methods is set forth in the immediately following chapters.

Solicitation Method	Estimated Value	Requirement	Evaluation Method	Envelope System
<b>LVA (informal)</b>	≤US\$ 10,000	Off-the-shelf goods, standard specification, simple services	Lowest priced, technically acceptable offer	No requirement for sealed offers
<b>RFQ (informal)</b>	≤US\$ 150,000	Goods or services which are clear and specific	Lowest priced, technically acceptable offer	No requirement for sealed offers. Upon introduction of e-tendering, offers will be secured until the deadline for all Submissions. Procurement Officials should undertake their best efforts to ensure that 5 or more quotations are received. However, should fewer than 3 quotations be received, the Director, PD or CPO must authorize the release of the quotations received. In an entity without a CPO, the approval of

				the official with the highest delegated procurement authority shall be sought.
<b>ITB (formal)</b>	> US\$ 150,000	Goods or services which are clearly and completely specified	Lowest priced, substantially conforming bid	One envelope
<b>RFP (formal)</b>	> US\$ 150,000	Goods or services that cannot be expressed quantitatively and qualitatively, or complex requirements that may be met in a variety of ways	Cumulative/weighted analysis; award based on the most responsive proposal	Two envelopes

The four main solicitation methods are ITBs, RFPs, RFQs, or LVAs. These four methods of solicitation, as well as other exceptions to formal methods of solicitation, are discussed in detail below.

ITBs and RFPs are “formal” methods of solicitation. ITBs and RFPs are governed by Financial Rule 105.15.

Low Value Acquisitions (LVAs) and RFQs are “informal” methods of solicitation. LVAs and RFQs are exceptions to the use of formal methods and are governed by Financial Rule 105.16.

Several factors, such as market conditions, the complexity and nature of the requirement (i.e., goods, services, or works), an estimated monetary value, influence the choice of solicitation method. Location and urgency might also influence the choice of solicitation method and the procedures followed.

### 6.3.2 Low Value Acquisition (LVA)

An LVA is a direct form of purchasing undertaken by the Requisitioner or a Procurement Official and not conducted via a formal solicitation. An LVA is used for procuring readily available, off-the-shelf or standard specification goods or services up to or equal to US\$ 10,000, or simple works or services up to or equal to the value of US\$ 10,000.

#### 6.3.2.1 Criteria of an LVA

LVAs are awarded based on the ‘lowest-priced, technically acceptable offer’ and are approved by a Procurement Official or a Certifying Officer (CO), subject to the following conditions:

- a. Under no circumstances shall the requirements be split into multiple solicitations or combined between RFQs and LVAs for the same or related requirement to avoid a formal method of solicitation. If the estimated value of the requirements exceeds US\$ 10,000 (or the equivalent amount, as per UN Operational Rates of Exchange on the quotation date), the requirement shall be submitted for procurement action through the established procedures;
- b. The LVA must comply with the four principles stated in Financial Regulation 5.12 (i.e., Best Value for Money; fairness, integrity and transparency; effective international competition; the interest of the United Nations);
- c. The LVA should not be used to buy goods or services that are recurring requirements in the procurement pipeline, unless it is required to cater for unforeseen requirements or if UN stock is unavailable, or it is used to order from an established BPO;

- d. Should an entity identify that LVAs are being used repeatedly within the same year to buy similar requirements by the same office or several offices pertaining to such entity, efforts should be made to aggregate the requirements and conduct a bidding exercise, with the aim to replace the use of LVAs with a Contract or a Blanket Purchase Order as soon as possible.
- e. specifications used to describe the requirement shall be generic in nature. For proprietary goods or services (e.g. spare parts), or for goods or services that cannot be described in a generic manner due to operational requirements (e.g. size-specific items to fit in an existing structure), the Requisitioner shall provide a written justification and obtain the CO's approval prior to seeking quotations. The CO's approval not to use generic specifications is to be uploaded in UMOJA;
- f. LVAs for non-[standardized](#) software/hardware require the technical review from OICT<sup>3</sup>. LVAs for standardized software/hardware do not require technical review;
- g. Regarding LVAs and purchase orders for software, the LVAs or purchase order (PO) instrument must clearly indicate that only the [United Nations General Terms and Conditions of Contract](#) (UNGCC) are to apply and that no additional terms or changes to UNGCC are to be accepted. Provisions that may be included on vendors' websites, product schedules or other ordering documents, or in 'shrink wrap/click-wrap' agreements, are not to be incorporated into the LVA or PO instruments because such provisions may conflict with the terms of the UNGCC. In this context, LVAs and purchase orders for software shall be accompanied by the language contained in the attached Annex 10 (LVA Guidelines) when sent to vendors. In case of objections from a vendor, such language may be negotiated only with the assistance of a Procurement Official;
- h. LVAs cannot be used for blood or blood products;
- i. **No Existing Contracts:** LVAs should not be used to purchase goods or services that are available (e.g. with a similar or equivalent function) in a current global or local systems contract or, if subject to UN standardization, unless it can be demonstrated that such purchase constitutes Best Value for Money. The Procurement Official or the Requisitioner must record such an assessment in a written note in UMOJA including any required technical review note as per paragraph e. and g. above. If an LVA is used to purchase from an existing system contract, the LVA should be linked to the relevant system contract in UMOJA and be consistent with terms and conditions of the system contract;
- j. The Procurement Official or the Requisitioner shall obtain a minimum of three quotations from vendors, via phone, e-mail, fax, in person, or online. If a Requisitioner or Procurement Official is not able to produce at least three quotations despite its best efforts, a written explanation of the reasons must be recorded in UMOJA for the approval of the CO or Procurement Approving Authority. The quotations must be sought from competitive vendors for a quantitatively and qualitatively similar requirement. Quotation via phone or in person shall be obtained only when it is not possible to obtain written quotations;
- k. Quotations should cover price, quantity, quality (using generic specifications, unless authorized by the CO), delivery place and time, warranties, after-sale support, and any other reasonable requirements, as applicable. In all but the most exceptional circumstances, quotations must be in writing from the vendors. If quotations are not in writing, the Requisitioner or Procurement Official shall prepare a written record thereof;
- l. Quotations should allow a like-for-like comparison to achieve Best Value for Money by selecting the lowest quotation. If the Requisitioner or Procurement Official determines that the quotation offering Best Value for Money does not constitute the lowest cost, a written explanation must be recorded in UMOJA for the CO's or Procurement Approving Authority's approval. Quotations must be uploaded in UMOJA;

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<sup>3</sup> All UN Secretariat offices, except missions, can contact the OICT offices at [https://iseek-external.un.org/departmental\\_page/technical-clearance-low-value-aquisitions](https://iseek-external.un.org/departmental_page/technical-clearance-low-value-aquisitions).

- m. Cash advances should not be made. Advance payment terms should not be accepted unless normal commercial practice or the interest of the United Nations requires it. Approval from the delegation holder in accordance with Financial Rule 105.19 is necessary;
- n. Ex post facto cases should be rare exceptions, and when they occur, written justification shall be provided to explain the reasons why timely submission of the case was not possible. Such justification should identify the reasons for the ex post facto situation and propose how to address the root cause in order to avoid reoccurrence

Requisitioners or Procurement Officials shall not enter into any LVA commitments with vendors unless the LVA's PO is approved by the CO or Procurement Approving Authority.

All LVA purchases should be in writing (stating price, quantity, brand/model, delivery place/time, warranties, after-sale support, etc., as applicable), with receipts obtained. Receipt, inspection, and payment shall follow the normal process as for goods/services acquired via a formal procurement exercise.

COs and Procurement Officials must ensure that an audit trail is recorded in UMOJA. In case of doubt, the COs or Procurement Officials should consult with PD or their respective Chief Procurement Officer.

## RESOURCES

Annex 10 – Language to accompany LVAs and purchase orders for software

### 6.3.2.2 Exceptions to LVAs

The following requirements cannot be purchased through an LVA and shall be processed via procurement, regardless of value:

- a. Firearms and ammunition;
- b. Blood or blood products;
- c. Software to be run in data centres.

For easy reference, click the link to the “Business Partner Commercial Companies” to create UMOJA LVA vendors: [https://iseek-newyork.un.org/departamental\\_page/master-data-maintenance-0](https://iseek-newyork.un.org/departamental_page/master-data-maintenance-0).

IPSAS Compliance: LVAs for goods that are considered “assets” as defined by IPSAS must be properly identified in Shopping Carts in order to allow the appropriate downstream process in relation to capitalizing cost, inventory, etc. (see training material “SC318 – UMOJA Requisitioning”, and User Guide “UMOJA Requisitioning”).

### 6.3.3 Request for Quotation (RFQ)

An RFQ is an informal method of solicitation. It is used for low-value procurement (equal to or below US\$ 150,000) where the requirement for goods or services is clear and specific, and the estimated value is up to US\$ 150,000. The RFQ process shall comply with the four principles stated in Financial Regulation 5.12.

RFQs are awarded based on the technically acceptable offer that is the lowest price. RFQs are subject to the following conditions:

- a. Under no circumstances shall the requirement be split into multiple solicitations or combined with other RFQs or LVAs for the same or related, in order to avoid a formal method of solicitation. The RFQ solicitation process can only be conducted by a qualified Procurement Official who was delegated such authority;
- b. Prior to commencing the RFQ, the Procurement Official will estimate the total value of the goods and/or services and substantiate such estimate in the Source Selection Plan.
- c. A minimum of five invitees to an RFQ is required. However, the Procurement Official shall ensure that sufficient number of invitees are invited to generate more than five quotations but no less than a minimum of three quotations. Should it not be possible to invite five vendors, the reason must be recorded in writing and signed by the Procurement Official;
- d. Procurement Officials should undertake their best efforts to ensure that 5 or more quotations are received. An RFQ should generate a minimum of three offers. If a Procurement Official is not able to obtain at least three (3) quotations despite his/her best efforts, a written explanation of the reasons must be recorded in the relevant system for the approval by the Director, PD or the CPO, to allow award based on lower number of offers;
- e. The use of the RFQ templates is mandatory in all cases, except when there is a justifiable reason not to use them (such as when the RFQ is issued in a language for which a template does not exist). RFQs must have a clearly defined submission deadline, which must be specified in the RFQ document and communicated to all prospective bidders. Quotations in response to an RFQ must be received in writing to a centralized, dedicated e-mail address as established by each Procurement Office and released to the Procurement Official simultaneously. Gradually, the e-tendering process will be expanded to RFQ requirements;
- f. Quotations should be uploaded in UMOJA for monitoring and audit purposes. Alternatively, quotations may also be filed electronically, e.g. in sharepoint, as long as monitoring and audit requirements will be met;
- g. Should the RFQ process result in a contract value exceeding the threshold for informal methods of solicitation, the Procurement Approving Authority shall consider and determine on a case-by-case basis whether to re-issue the solicitation under the appropriate solicitation method. If the final contract value exceeds the threshold by a significant amount, or if the contract is not urgently needed, preference should be given to rebid the requirement under the appropriate solicitation method unless there are justifiable reasons not to.
- h. Awards are made based on the “lowest-priced, technically acceptable offer” evaluation methodology and based on Financial Rule 105.16 (a)(x) (see [Chapter 8 Evaluation of Submissions](#)).

#### 6.3.4 Invitation to Bid (ITB)

An ITB is a formal method of solicitation where vendors are invited to submit a bid for the provision of goods or services. It is normally used when the requirements for goods/services are i) simple and straightforward, ii) can be expressed well quantitatively and qualitatively at the time of solicitation, and iii) can be provided in a straightforward way. For UN procurements above US\$ 150,000, one of the two formal methods of solicitation (i.e. ITB or RFP) must be used unless there is an exception to the normal process, in accordance with Financial Rule 105.16. ITB can also be used for lower value procurement equal to or below US\$ 150,000 if the Procurement Official determines it appropriate to the particularities of the requirement.

Criteria of an ITB: ITBs are awarded based on the technically acceptable offer that is the lowest price. ITBs are subject to the following conditions:

- a. The use of the ITB templates is mandatory in all cases. ITBs must have a clearly defined submission deadline, which must be specified in the ITB document and communicated to all prospective bidders. Bids in response to an ITB must be received in writing;
- b. ITBs are based on a one-envelope system, i.e., the financial and the technical components of a bid are combined in one single document. ITBs are subject to the bid receipt and opening procedures outlined in [Chapter 7: Management of Submissions](#);
- c. An ITB can either define the minimum requirements to be met, or outline a range of acceptable requirements. During the evaluation, a bid is compliant based on pass/fail criteria;
- d. Applicable Financial Rule: Awards are based on the lowest-priced, substantially conforming bid evaluation methodology, including delivery terms, and any other technical requirements stated in the ITB Financial Rule 105.15 (a) ([See Chapter 8: Evaluation of Submissions](#)).

#### 6.3.5 Request for Proposal (RFP)

An RFP is a formal method of solicitation. It is used for procurement of goods and services when requirements cannot be expressed quantitatively and qualitatively (e.g. consulting or similar services) at the time of solicitation or for the purchase of complex goods and/or services where the requirements may be met in a variety of ways and, accordingly, an evaluation based on cumulative/weighted analysis is most appropriate. In this case, the UN prepares Solicitation Documents, which describe the Requirement for goods/services and requests that vendors submit proposals with solutions and associated pricing for the goods/services that the UN is requiring. For UN procurements above US \$150,000, one of the two formal methods of solicitation (i.e., ITB or RFP) must be used (unless there is an exception to the normal process in accordance with Financial Rule 105.16). An RFP is only required for procurement above US\$ 150,000 but can also be used for lower value procurement (equal to or below US\$ 150,000) if requirements are complex or if the Procurement Official otherwise determines it appropriate.

Criteria of an RFP: RFPs are subject to the following conditions:

- a. An RFP requests that bidders submit a technical proposal that offers a solution to the requirements specified in the solicitation documents. Bidders are also to submit a separate financial proposal indicating all costs that the bidder will charge in carrying out the technical proposal. In response to an RFP, vendors must submit the technical and financial proposals in separate sealed envelopes (two-envelope system). The purpose of the two-envelope system is to make sure the technical evaluation focuses solely on the contents of the technical proposals, without influence from the financial proposals.
- b. RFPs are subject to the bid receipt and opening procedures outlined in Chapter 7, including the requirement for separate opening sessions for technical proposals (all proposals received) and financial proposals (only for those whose proposals are deemed technically compliant after evaluation).



- c. The evaluation criteria for an RFP are to be expressly stated in the SSP and in the Solicitation Documents. Both the technical and the financial (i.e. commercial) evaluation factors shall be described. Mandatory evaluation criteria (if any) must also be described.
- d. The weight of technical factors versus financial factors must also be indicated.

Proposals are evaluated, ranked, and awarded according to the 'cumulative/weighted analysis' evaluation methodology, defining best value as the paramount overall benefit when considering technical and financial factors. The contract is awarded to the qualified vendor whose proposal is considered to be most responsive to the requirements in the solicitation and offers the best value (technical and financial) (Financial Rule 105.15 (b)).

To give bidders a sense of what the UN deems important in the evaluation process, the technical and commercial criteria shall be listed in the RFP Solicitation Documents in priority order of their weight. However, the exact weights of each technical and financial sub-criterion may not be disclosed to bidders in the Solicitation Documents or otherwise.

In order to further assist bidders in determining the appropriate quality of goods or services that the UN seeks, the Procurement Official may choose to include estimates of personnel and other input required in order to reach the expected results. In exceptional circumstances, it also can be envisaged to include an indication of the available budget; however, the potential drawback is that information about the available budget may lead bidders to align their financial proposals to the budget disclosed. Such disclosure may be only done upon approval from the Director, PD or the CPO.

The weighting of technical proposal vs. financial proposal should be considered as follows:

- a. The applicable balance between the technical and commercial evaluation criteria must be established before the RFP is issued, and expressly stated in the SSP and in the Solicitation Documents. Weighting needs to be considered on a case-by-case basis to achieve the appropriate balance.
- b. Weightings of technical and financial proposals can be in the proportion of either 80%-20%, 70%-30%, 60%-40%, or 50%-50%, or as deemed appropriate by the Procurement Official, depending on whether the technical elements or the financial element have been determined to have higher importance. The lower the complexity of the technical requirements, the higher the weight that should be given to the financial element. If the financial element is difficult to reliably foresee or control over the course of the contract, then the weight given to the financial element may be lower.
- c. Each technical and commercial evaluation criterion needs to have a pre-established weight unless the criterion is a mandatory requirement (If it is a mandatory requirement, then the bidders' compliance with the criterion will be evaluated on a pass/fail basis).

## TIPS FOR RFP

**Weighting of technical and financial proposals needs to be considered on a case-by-case basis to achieve the appropriate balance.**

**The technical and commercial criteria in the RFP shall be listed in the priority order of their weight, while the exact weights of each technical and financial sub-criterion may not be disclosed in the solicitation document.**

**Each technical and commercial evaluation criterion needs to have a pre-established weight, unless they are**



In the SSP and in the RFP, a minimum passing threshold in terms of percentage of the total points of the technical proposal (normally 60% or 70% of total points) must be indicated. If a bidder's technical proposal passes this minimum threshold and meets all mandatory requirements, the proposal will be deemed technically compliant to the RFP. If it is technically responsive, then the bidder's financial proposal will be subject to the financial evaluation. If it is not deemed technically compliant, then the bidder's proposal will not be further considered for purposes of being awarded a contract pursuant to the RFP.

#### 6.3.5.1 Multi-Stage RFPs

A multi-stage RFP procurement process may be chosen in exceptional cases and only upon approval by the ASG, OSCM or his or her designate, as the method of solicitation.

**Two-Step Process:** The multi-stage RFP is similar to a standard RFP process. However, in a multi-stage RFP procurement process, bidders are to submit interim proposals. Prior to submission of their interim proposals for evaluation, the UN enters into discussion/dialogue with all prequalified bidders. The evaluation may result either in all bidders being permitted to the next stage or some bidders being eliminated from further consideration if their proposals are deemed clearly unsuitable for the needs of the UN. On an individual basis, the UN will enter into discussion/dialogue with those bidders that passed the interim evaluation to enable them to submit final proposals in response to the RFP.

**Prototypes or Proof-of-Concept Elements:** Pursuant to the SSP, the RFP may require the proposals to include prototypes or proof of concept elements. The interim proposals and, if applicable, the prototype/proof of concepts will be evaluated based on pre-established technical criteria that are clearly indicated in the SSP. The technical criteria should not be changed during the solicitation process. Please note that prototypes or proof-of-concepts may be incorporated into normal RFPs as well as multi-stage RFPs.

**Amendments to the RFP:** In connection with the evaluation of the interim proposals and the subsequent dialogues, the RFP may be amended to clarify the terms of the requirements. The amended RFP should be issued to all remaining bidders. It should be noted, however, that the requirements outlined in the original RFP cannot be materially changed. Furthermore, the technical and financial evaluation criteria cannot be materially changed at this stage.

**Criteria:** The multi-stage RFP is an exceptional process which may be selected if

- i. The means of delivering the requirement of the UN cannot be met without adaptation of readily available solutions.
- ii. The UN's needs are for complex and innovative solutions that cannot be defined in sufficient detail in a SOW; and
- iii. Other methods of solicitation do not allow for the required level of collaboration between the UN and bidders to develop a suitable solution (i.e., the use of a standard RFP has been assessed and determined to be not appropriate or constitutes an unacceptable level of high risk).

The fact that the requirement entails aspects of innovation does not in itself justify the use of a multi-stage RFP.

**Resource-intensive Process:** The multi-stage RFP process is a detailed, resource-intensive process that needs to be properly managed for its benefits to be fully realized while maintaining the principles of fairness and integrity. Its use and suitability for a specific requirement should be justified in the SSP.

Negotiations: Procurement Officials should note that the use of multi-stage RFPs does not preclude negotiations with the vendor recommended for award. However, the technical criteria as well as the requirement should not be changed during negotiations.

Probity Monitor: To ensure that the multi-stage RFP process is done consistent with the applicable UN Financial Regulations and Rules and recognized best practices, an independent Probity Monitor may be appointed by the ASG, OSCM to provide probity assurance services throughout the process. The Probity Monitor should not have any decision-making role in the RFP process. The Probity Monitor should be an independent party and should not report to Procurement or the Requisitioning Office; it should report to ASG, OSCM.

## RESOURCES

Terms of Reference (TOR) Probity Monitor

### 6.4 Solicitation Documents

#### 6.4.1 Overview

UN standard solicitation templates should be used when soliciting offers from vendors through RFQs, ITBs, or RFPs and which will contain all information necessary to prepare a suitable offer. The standard solicitation documents are templates that include mandatory requirements, terms and conditions customized to fit the specific requirements (goods/services), and the procurement method undertaken (informal/formal). The templates are to be completed with the details applicable to each solicitation process.

While the details and complexity of solicitation documents may vary according to the nature and value of the requirements, each set of solicitation documents must contain all information and appropriate provisions that are necessary for bidders to understand the UN's needs and to prepare a competitive offer. Thus, the solicitation documents must include all information concerning a specific solicitation process and be as concise as possible. New requirements cannot be introduced, and existing ones cannot be changed after the solicitation documents have been issued unless amended in line with [Chapter 6.6](#).

The standard paragraphs of the solicitation documents, including the annexes, cannot be amended except for Annex B, which includes the SOW or TOR. Furthermore, solicitation documents should not include any text, requirements, or conditions that contradict the UNGCC.

UN solicitation documents usually consist of the following components:

- a. Letter of Invitation (main tender document);
- b. Acknowledgment Letter;
- c. Statement of Works/Requirements;
- d. Special Instructions and Evaluation Criteria;
- e. Performance Security Form (if applicable);
- f. Form of Contract and relevant UNGCC.

The following articles ([Chapters 6.4.2 through 6.4.9](#)) describe the information that is typically part of each of the components mentioned above. However, in some cases, the Procurement Official

may alter the composition of some of the components if, in the professional judgment, the documents provide a clear and complete description of the requirements and instructions to bidders.

#### 6.4.2 Letter of Invitation

The solicitation documents should include on the first page a letter (a “Letter of Invitation”) inviting vendors to submit quotations/bids/proposals. The Letter of Invitation should include the following, among other elements:

- a. A reference to the specific procurement activity (title and reference number);
- b. A list of the sections that make up the solicitation documents and the supporting documents to be issued as part of the solicitation documents;
- c. Name and contact details of the UN Procurement Official in charge of the solicitation and for the clarifications process. Alternatively, it can include a generic email address from the procurement unit or the mechanism by which clarifications are handled on an e-tendering system (if the solicitation process is done via e-tendering);
- d. The solicitation documents should stipulate that any additional information, clarification, correction of errors, or modifications of bidding documents will be distributed and detailed in a written notification to bidders prior to the deadline for receipt, in order to enable bidders to take appropriate actions;
- e. Similarly, all vendors should be informed of the right to modify or make corrections to quotations, bids, or proposals, provided that any such modification or corrections are received by the UN in writing prior to the deadline for Submissions in the same manner of submission, as instructed in the Letter of Invitation;
- f. Vendors should be requested to keep their offers valid for a specified number of days, allowing time for evaluation of offers and award of contract. Typically, a vendor should be requested to keep its offer valid for a period of 60 or 180 days for ITBs and RFPs, and for 30-60 days for RFQs, but the timeframe could be reduced if the price of the good/service to be procured fluctuates rapidly (e.g. raw materials, petroleum products, etc.);
- g. The Letter of Invitation shall indicate in which currency the prices of the offer should be quoted or if vendors can determine the currency. Further, the instructions should state that the contract will be issued in the currency determined by the UN in the bidding document or in the bidder’s offer (as the case may be), and the payment will be issued in the currency of the contract;
- h. If receipt of offers is permitted in another currency, the UN shall convert prices to a single currency using the United Nations operational rate of exchange, applicable on the deadline date for receipt of offers;
- i. Article II, Section 7 of the [Convention on the Privileges and Immunities](#) provides, inter alia, that the United Nations is exempt from all direct taxes, except charges for public utility services, and is exempt from customs restrictions, duties, and charges of a similar nature, in respect of articles imported or exported for its official use;
- j. The solicitation document should state that all bids shall be submitted net of any direct taxes and any other taxes and duties payable for the purpose of bid evaluation. Therefore, the Delivered Duty Paid (DDP) Incoterm must not be used in solicitation documents for goods and OLA or an entity’s Legal Advisor must approve exceptions to this rule;
- k. The Special Instructions shall indicate whether Bid Security is to be required. If Bid Security is required, then the amount and form of the Bid Security should be indicated. (See [Chapter 6.4.8](#) for more information on Bid Security requirements);
- l. The solicitation documents shall stipulate that the bidder must identify any subcontractors that will be material to the vendor’s performance under the contract. The use of subcontractors does not relieve the vendor with whom the UN has a contract of its responsibility to fulfill the terms and conditions of the contract. The UN reserves the right

- to obtain from the subcontractors the same level of information as from the prime contractor, for the sake of due diligence (security, capacity, financial strength, etc.). However, it must be clear that the UN will not enter into a contractual relationship with any subcontractors, and as such, holds no liability to subcontractors. Once a contract is awarded, the UN's consent is required to replace subcontractors;
- m. The solicitation documents, as well as the offers, are to be prepared in English and/or official UN languages, as needed and subject to the capacity of the office;
  - n. Translation of the solicitation documents into a local language may be necessary and is encouraged to facilitate access to business opportunities by local vendors if deemed appropriate. If such need and corresponding capacity exist, optional translations into other languages may be undertaken. Regardless of whether a translated version of the solicitations documents is provided for convenience purposes, the English version of the solicitation documents (including the UNGCC and the model form of contract, included as part of the solicitation document) alone shall govern the contractual relations between the UN and the bidder. The translated version(s) is provided for convenience only and is not to be relied upon as having any force and effect for contractual purposes. A statement to this effect should be included in any document that is translated;
  - o. **Deadline:**
    - i. The date, time and place for submission of offers must be clearly stated, together with the location, date, and time for the opening of offers (if public);
    - ii. The deadline for submission should allow a vendor a sufficient number of days to prepare and submit an offer. Consult the below table for the recommended minimum solicitation periods (excluding the issue date but including the closing date);
    - iii. If due cause exists, the Procurement Approving Authority can authorize a shorter solicitation period. However, the Procurement Official must justify the decision for waiving the minimum period requirement in a note to the file that describes the reasons and explains how the requirement for the competition will be met, despite the shortened solicitation period. The note to the file must also confirm the availability of the evaluation committee members immediately after the end of the solicitation period. Such note must be included in the procurement case file;

Solicitation Method	Requirement	Minimum Solicitation Period (in calendar days)
<b>RFQ</b>	All	5
<b>ITB</b>	Goods	21 (15 days without a requirement for samples)
<b>ITB and RFP</b>	Works or services	21

**TABLE 2: GUIDELINES FOR THE RECOMMENDED MINIMUM SOLICITATION PERIOD**

- p. In order to convey all relevant instructions governing the preparation and submission of offers, the solicitation documents must include a list of documents required to form a complete offer, as well as notice to bidders that non-compliant offers may be rejected. A compliant offer is one that meets the formal criteria by conforming substantially to all terms, conditions, and specifications in the solicitation documents. Further, the Invitation Letter should always include:
- i. Mode of submission (email, fax, hand-delivered, mail, UN e-tendering system);
  - ii. Address/fax number/email;
  - iii. Instructions on offer packaging, (e.g. sealed, number of copies, the requirement in RFPs to submit technical and financial offers separately (two-envelope system), etc.).
- q. Information will be included about whether a public tender opening of bids will be held, and, if so, details for the same (date, time, venue). For details, refer to [Chapter 7 Management of Submissions](#);
- r. The Letter of Invitation will indicate whether Performance Security is required. If Performance Security is required, then the amount and form of the Performance Security should be indicated. (See [Chapter 6.4.8 Bid/ Advance Payment/ Performance Security Forms and Requirements](#) for more information on Performance Security requirements.);
- s. The solicitation documents must specify the payment terms:
- i. The payment terms are usually net 30 days upon receipt of invoice with all required documents deemed to be satisfactory by the UN, as well as receipt and acceptance of goods or services, or upon receipt of required shipping documentation, depending on the Incoterm used (see [Chapter 13: Contract Management and Contract Administration](#));
  - ii. No advance payments should be made, except when the conditions outlined in Financial Rule 105.19 apply. The Procurement Official shall record the reasons for advance or progress payments in the procurement case file. Under certain conditions, the UN may agree to pay for partial delivery of the goods or upon completion of clearly defined milestones for services or works, provided adequate security for the advance or progress payment is established. In such cases, the Procurement Official should consider establishing specially developed payment terms, taking payment flows into consideration, provided such terms are approved by the Director, PD or the CPO and are tailored to the specific procurement. Where advance payments are necessary the approval thresholds of the relevant DOA must be complied with;
  - iii. Lease payments paid in the same month to which they relate, regardless if they are paid on the first or last day of the month, are not considered advance payments. However, lease payments paid prior to the month to which they relate are considered advance payments.

#### 6.4.3 Annex A: Acknowledgment Letter

The Acknowledgment Letter serves as a notification by the vendors, advising the Procurement Official whether they intend to submit a proposal/bid and/or attend the public tender opening.

#### 6.4.4 Annex B: Scope of Work/Requirements

The Scope of Work for the Requirements should be included so that the bidders have all information necessary to prepare a responsive and meaningful offer (See [Chapter 4.4 Requirements Definition](#)). The Scope of Work and the Form of Contract are drafted in a way that they are coherent with each other.

#### 6.4.5 Annex C: Special Instructions and Evaluation Criteria

Annex C is the 'Special Instructions and Evaluation Criteria' Annex. It is intended to give the bidders a detailed overview of the solicitation process, including a description of how bids are to be evaluated. The components of the Special Instructions are described below. The components of the Evaluation Criteria are described in the next chapter (i.e., [Chapter 6.4.6 Evaluation Criteria \(i.e., Part of Annex C\)](#)).

##### 6.4.5.1 Pricing Requirements

Annex C shall include price information and additional information, such as whether a contract will be signed based on fixed price/lump-sum, or cost reimbursement in suitable cases (such as for travel/DSA).

Commodities: If the price of the commodities is likely to fluctuate over time, (e.g. petroleum products, metal products) and it is the UN's intention to issue a contract based on a price formula that may include variable components (such as the Platts Index or London Metal Exchange), then the price formula should be clearly specified in Annex C; the wording for the same may be cleared in advance by OLA or a Legal Advisor.

UN Right to Change Quantities of Goods or Services: If applicable, it should be stated, in Annex C and in the Form of Contract, that the UN reserves the right to increase or decrease the quantity of goods and/or services originally specified in the solicitation documents, without any change from bidders in the unit prices or conditions. Alternatively, the solicitation documents may also specify that the quantities of goods and services are estimates, and that no obligation to buy a minimum quantity exists for the UN.

##### 6.4.5.2 Site Visits and Bidders' Conferences

The Special Instructions Annex in the solicitation documents should communicate to the bidders any information about the location, date, and time of any bidders' conference or site-visits that will be conducted for the tender. If a solicitation contemplates site visits as well as a bidders' conference, the site visits should generally take place prior to the bidders' conference, to allow bidders to include any questions about the sites.

Site Visits: The purpose of site visits is to enhance the understanding of the requirement by allowing bidders to examine the physical sites where they are being asked to provide services.

- a. Attendance of the site visits may be mandatory or non-mandatory. The Procurement Official, in consultation with the Requisitioner, will apply sound judgment to establish when site visits are necessary and if participation should be mandatory for all participating bidders;
- b. Participation in site visits should only be mandatory in those cases in which the Procurement Official, in consultation with relevant Requisitioner, deems that the bidders could not understand the scope and breadth of the requirement based only on the information shared in the solicitation documents, or in those cases in which it has been determined that the quality of the Submissions would greatly improve by providing a forum for bidders to observe the actual conditions on the ground;
- c. In the case that site visits are non-mandatory and the bidder chooses not to attend, the bidder is implicitly renouncing all the benefits of a better knowledge of the physical conditions on the ground. For that reason, lack of knowledge of such conditions will not be accepted as grounds not to comply with any of the contractual obligations of the resulting contract;
- d. Site visits can be guided and/or non-guided. The solicitation documents will clearly indicate which type of site visits the UN will allow in each case, and the procedures to follow to participate:

- i. Guided Site Visits: The UN will organize an itinerary and an agenda, which will be shared with all bidders prior to the start of the site visits. Bidders are requested to fully comply with the agenda and itinerary in order for their attendance to be certified;
- ii. Non-Guided Site Visits: The UN will provide a time window of a few days in which the bidder, at its own initiative, may visit the site. The bidder must announce its visit in advance for security purposes, as detailed in the solicitation documents. Unguided site-visits will not be facilitated by any of the UN personnel directly involved in the solicitation, but by other personnel on the site. No information will be shared in such visits other than a tour of the facilities, so the bidder can observe the conditions on the ground. All bidders will be afforded the same tour;
- e. In cases when site visits are not practical, or when otherwise the Procurement Official, in consultation with relevant Requisitioner, deems it appropriate, the Procurement Official may consider the use of videos or other electronic means during the bidders' conference. This is especially recommended for non-mandatory site visits;
- f. Prospective bidders shall bear all costs related to their participation in site visits;
- g. See sub-clause (iii) below regarding additional requirements applicable to mandatory site visits and mandatory bidders' conferences.

Bidders' Conferences: The purpose of a bidders' conference is to enhance the understanding of the requirement among the participating bidders in a solicitation:

- a. The Procurement Official, in consultation with relevant requisitioner, should apply sound judgment to establish when a bidders' conference is necessary and if participation should be mandatory for all participating bidders. Participation in bidders' conferences should only be mandatory in those cases in which the Procurement Official, in consultation with the relevant Requisitioner, deems that the bidders could not understand the scope and breadth of the requirement based only on the information shared in the solicitation documents, or in those cases in which it has been determined that the quality of the Submissions would greatly improve by providing a forum for bidders' to interact with the UN. In all other cases, which include most solicitations for the provision of standard goods, participation in bidders' conferences, if any, should be left to the prerogative of the bidder (e.g. non-mandatory);
- b. The Procurement Official is encouraged to use electronic means to organize bidders' conferences, as it makes it easier for bidders, from a time and economic perspective, to participate. This is especially recommended for non-mandatory bidders' conferences;
- c. Bidders should be requested to send questions and comments about the solicitation documents in writing prior to the bidders' conference so they can be addressed in an orderly fashion. The Procurement Official may, at his or her own discretion, allow for further questions and comments spontaneously raised during the bidders' conferences or encourage discussions, if those may contribute to clarify the requirement and are aligned with the purpose of the bidders' conference;
- d. Information shared during the bidders' conferences is for informational purposes only. If any information is shared that modifies or provides further details on any of the conditions of the solicitation documents, such modification and/or clarification is only valid if it is confirmed via a formal amendment to the solicitation documents;
- e. The Procurement Official is not obligated to address all questions raised during a bidders' conference, only those that, in his or her opinion, in consultation with the relevant Requisitioner, are helpful to clarify the Requirement. All questions formally submitted in writing within the stipulated time frame prior to the bidders' conference must be formally answered to all bidders in writing. In some cases, the Procurement Official may allow more questions to be submitted in writing after the bidders' conference;
- f. In case of non-mandatory bidders' conferences, the Procurement Official will also keep in the file a record of which bidders attended:



- i. Only bidders that are sent a Letter of Invitation directly by the UN (see Chapter 6.4.1) have permission to attend bidders' conferences. The Procurement Official may, on an exceptional basis, allow other bidders to attend if a revised List of Invitees including such additional bidders is submitted to the Approval Authority for approval prior to the bidders' conference. A bidder must specify which person(s) is/are designated an employee or representative to attend the bidders' conference on its behalf. A single representative may not represent two or more companies at a bidders' conference. The Procurement Official may allow for an exception if two companies are two subsidiaries of the same group (e.g. the parent company and the local subsidiary). The Procurement Official may limit the number of participants per bidder for reasons of space and logistics;
- ii. Prospective bidders shall bear all costs related to their participation in bidders' conferences;
- iii. See sub-clause (iii) below regarding additional requirements applicable to mandatory site visits and mandatory bidders' conferences.

**Mandatory Site Visits and Mandatory Bidders' Conferences:** In case of bidders' conferences or site visits for which participation is mandatory, the following will apply:

- a. Participation of all sessions of the bidders' conference or site visits is mandatory. Bidders that miss one session (e.g. the first morning, the last day, etc.) will not be marked as having attended. Arriving slightly delayed to one or more sessions will not be considered as non-participation;
- b. It is the bidders' sole responsibility to arrive at the bidders' conference and the site visits. The UN cannot take any responsibility for any event that may preclude the bidder from participating, such as missed flights, problems with visas, problems with security clearance, etc. Bidders are encouraged to plan in advance in order to minimize the risks of non-attendance;
- c. For an in-person bidders' conference, all participants must sign an attendance sheet per session/day, which must be kept on file by the Procurement Official. For electronic bidders' conferences, other means may be used to certify attendance;
- d. In some cases, and if requested by the bidder well in advance, the United Nations may be able to facilitate a letter to the bidder for the purpose of obtaining visas from the host country to attend the bidder's conference. However, this is not an obligation for the UN, and the bidder should rely on its own means to obtain the necessary visas;
- e. Bidders that did not participate in mandatory site visits and/or bidders' conferences and who therefore are not eligible for the award will be excluded from any further communication about the solicitation, such as amendments to the solicitation process or notices.

## SPLIT AWARDS

**If the requirements are divided into several lots, the solicitation documents should indicate the UN's right to award the contract to the vendor offering the best offer for all lots or per lot.**

**Requirements cannot be split into separate tenders to avoid thresholds for formal competition.**

**The appropriate Procurement Approving Authority must approve the issuance of separate tenders for a related or linked requirement for the cumulative estimated value of the total requirement.**



#### 6.4.5.3 Partial Bids/Split Award

Information about whether partial offers, often segregated in the solicitation document into so-called "lots", are acceptable should be included in the solicitation document.

If the requirements are divided into several components or lots, the solicitation should indicate (i) whether bidders must submit bids on all of the lots or whether bidders have the right to submit proposals/bids on just some of the lots (i.e., partial bids) and (ii) whether the UN will be awarding one contract to the bidder that has the best overall bid with respect to all components/lots or whether the UN has the right to award multiple contracts to more than one bidder based on the best proposal/bid submitted per component/lot (i.e., split award).

When determining whether to split the award, possible savings from purchasing items at a lower price should be considered and the resource requirements for administering and placing several contracts and the supply chain, logistical and other risks related to having multiple contracts in place should be considered.

Requirements cannot be split into separate solicitation processes to avoid thresholds for formal competition. Equally, awards following a single solicitation process should not be split with the sole purpose of avoiding the review by a Review Committee or approval by an appropriate Procurement Approving Authority. The appropriate Procurement Approving Authority for the cumulative estimated value of the total requirement must approve the issuance of separate tenders for a related or linked requirement.

#### 6.4.5.4 Advance Payment Security

The UN does not agree to pay advance payments (i.e., payments in advance of the contractor's performance under a contract) unless the conditions of Financial Rule 105.19 apply, and, as provided in Financial Rule 105.19, the decision to make an advance payment has been recorded in writing. If the UN has decided to inform bidders to a solicitation process that the UN has decided to allow for advance payment(s) for the contract that is to be awarded, then the Procurement Official should indicate in Annex C whether the winning bidder will be required to deliver to the UN a guarantee of performance security instrument in connection with the UN's advance payment(s) as a condition for the awarding of the contract. If an Advance Payment Security is required, then bidders would need to factor this into the pricing of their proposals/bids. In addition, a guarantee for advance payment can be requested by the UN when the vendor requests an advance payment and this request has exceptionally been approved as per Financial Rule 105.19 by the appropriate Procurement Approving Authority.

#### 6.4.5.5 Other

If there are elements to the solicitation process that are either not obvious from the SOW or are worthy of highlighting, then they should be clarified in Annex C (e.g. the need for samples or inspections prior to contract signature). For example, if the solicitation process is being undertaken to establish an LTA or BPO, the Procurement Official could choose to highlight this in Annex C.

If samples of goods are required for the evaluation, the solicitation documents shall state the number, size and other detailed specifications of the required samples, as well as a description of the tests that will be performed. The solicitation documents shall specify that failure to provide the required samples renders the Submission non-compliant and will lead to its rejection. If a vendor voluntarily provides samples without being requested, the samples shall either be disregarded or, if considered of value to the evaluation, all invited vendors shall be requested to provide samples. The solicitation documents shall state that samples shall be provided by the invited vendors free of charge with no guarantee that they will be returned by the UN unless the vendor agrees to take them back in "as-is" condition and pays for their return. The UN shall give no guarantee as to the condition of the samples upon completion of the designated tests and technical evaluation. If any

sample is not returned, it shall become part of the regular UN inventory. The UN may require that the vendors give a demonstration of offered goods as part of the evaluation. The solicitation documents shall state the scope of such demonstrations. Such demonstrations shall be provided free of charge, and the UN shall not accept any liability for any damage to or loss of the goods in connection with such demonstrations.

#### 6.4.6 Evaluation Criteria (i.e., Part of Annex C)

Annex C is the 'Special Instructions and Evaluation Criteria' Annex. It is intended to give the bidders a detailed overview of the solicitation process, including a description of how bids are to be evaluated. The components of the evaluation criteria are described below. The components of the special instructions are described in the chapter above (i.e., [Chapter 6.4.5 Annex C: Special Instructions and Evaluation Criteria](#)).

Overview: Annex C of the solicitation documents must state the evaluation method, according to the solicitation method designated in the SSP (i.e., RFQ, ITB, or RFP). In addition, the solicitation documents must state the evaluation criteria, including as applicable:

- a. Preliminary Screening resulting in a compliant bid;
- b. Mandatory criteria;
- c. Technical criteria;
- d. Financial criteria.

The evaluation criteria shall be appropriate to the type, nature, market conditions, and complexity of what is being procured, and should be clearly specified in detail in the solicitation document. Evaluation criteria should be designed to enable the UN to achieve Best Value for Money.

The evaluation must be carried out pursuant to the formal criteria specified in the solicitation documents and the SSP. Should there be the need to make changes to solicitation documents during the solicitation process and before the closing date and time, any such amendments will be made in accordance to [Chapter 6.6 Amendments to Solicitation Documents](#), and amendments to the SSP are to be issued accordingly.

##### 6.4.6.1 Preliminary Screening

During preliminary screening (see [Chapter 8.5 Preliminary Screening](#)), the Procurement Official shall review the compliance of the submission with the solicitation documentation and related criteria.

Examples of such formal criteria are:

- a. The offer is accompanied by the required documentation, including the bid submission form, with signatures in the key portion of the bid form when this is clearly specified in the tender;
- b. The offer is accompanied by the required securities, when applicable;
- c. In cases of RFPs, the offer is submitted in two separate envelopes: one containing the technical proposal and the other containing the financial proposal;
- d. The offer covers the requirement in full or in part, specifically for partial bids;
- e. The offer includes evidence of acceptance of other important conditions specified in the solicitation documents (e.g. performance security);
- f. The bidder does not have a conflict of interest, as defined in [Chapter 1.5.3.3 Vendor Conflict of Interest](#);
- g. The bidder is included in the List of Invitees.

##### 6.4.6.2 Mandatory and Technical Criteria

Mandatory and technical criteria are evaluated during technical evaluation.

Mandatory Criteria:

- a. Mandatory criteria when included in a solicitation document are evaluated on a pass/fail basis, regardless whether the solicitation process is an RFQ, ITB or RFP.
- b. The extent of the mandatory criteria must have a rational basis related to the fundamental purpose of the requirement. Also, in deciding whether there should be mandatory criteria, the Procurement Official, together with the Requisitioner, should consider the value of the contract and the complexity of the solicitation process. The Procurement Official should ensure that mandatory criteria are not used to limit competition. The following aspects are examples of factors that could be considered mandatory criteria:
  - i. Legal and regulatory requirements such as registration certificates, licenses, standards, etc.;
  - ii. Minimum requirements regarding the value of previous contracts;
  - iii. Availability of after-sales services or agents in the country of delivery;
  - iv. Qualification and experience of proposed personnel;
  - v. No adverse reports of any aspect considered relevant to the requirement in a specified last number of years;
  - vi. Evidence that, during a number of years prior to the tender opening date, the bidder is in continuous business of providing similar goods/ services to those offered;
  - vii. Institutional and workload capability, such as capacity and availability of production site, staff, etc.;
  - viii. Financial capability, such as annual sales turnover of a minimum amount during one/multiple past years and minimum financial profitability and liquidity ratios.
- c. A bidder must meet all mandatory criteria for the respective lot for which it is recommended for award. The UN will award each of the lots in a manner which achieves the best overall value-for-money combination for the UN.

#### Technical Criteria:

- a. Technical criteria are developed for evaluation according to a pass/fail basis, regarding the compliance to the specifications and other requirements (in RFQs and ITBs) and/or the cumulative weighted analysis evaluation method (in RFPs);
- b. The cumulative weighted analysis evaluation method consists of allocating points using weighted criteria. When using the cumulative weighted analysis evaluation method, technical evaluation criteria are related to the approach and methodology proposed to reach the expected results or solve the identified problem, as described in the requirement definition (TOR or SOW). In these cases, the SSP must clearly state the breakdown of percentages or points allocated to each overall criterion (e.g. experience: [xx] points, approach and methodology: [xx] points, qualifications and competence of proposed personnel: [xx] points). In the solicitation documents, the technical criteria should be listed in order of priority given their allocated scores and weights (i.e., the technical criteria with the highest maximum points should be listed first, without identifying the weight given to each criterion);
- c. In addition, with respect to RFPs, the UN may consider including a number of technical points for interviews/oral presentations for all bidders or those that have achieved a minimum number of points upon evaluation of the documentation submitted. This should be done only when it is of relevance to determine the overall quality of the proposal and where it is normal commercial practice. The criteria for the interview need to be pre-established and objective in nature. It is important to manage the process properly and ensure the RFP includes wording on the purpose of the interview/oral presentations. Normally, the purpose of the interviews/oral presentations is to validate the information provided by the bidders in their proposal and to test the bidder's understanding of the

requirement. It is encouraged to state in the solicitation documents the approximate dates when such interviews/oral presentations will take place if the date can be reasonably estimated.

#### Rating Each Technical Criterion

- a. The Requisitioner, in consultation with the Procurement Official, shall establish a rating system as part of the SSP that can be used to evaluate the submission in an objective manner. The scored technical evaluation criteria should, within reason and where possible, be established in a way that allows bidder's responses to be assessed by measurable and quantifiable indicators. The rating system shall be relevant to the requirement and involve numerical scoring, and it shall be accompanied by a description of the rating defined in narrative form, supplemented by an explanation of such scoring;
- b. As an example, the following rating system could be used:

Score	Narrative/Description
10	More than 10 years of experience in providing the requirements
7	Between 6-10 years of experience in providing the requirements
4	Between 3-5 years of experience in providing the requirements
0	Less than 3 years of experience in providing the requirements

**TABLE 3: SAMPLE NUMERICAL SCORING SYSTEM**

#### 6.4.6.3 Financial Criteria

Price is an important evaluation criterion, but the weight of the price depends on the chosen evaluation methodology (see [Chapter 8.4 Evaluation Methodologies](#)). It is important to clearly state in the solicitation documents which price factors will be used for evaluation. Various factors such as freight cost, operational cost, incidental or start-up costs, as well as life cycle costs, can be taken into consideration.

In all cases, required breakdown of pricing, as well as evaluation criteria, should be clearly stated in the solicitation documents.

Only the factors stated in the solicitation documents will be considered in the financial evaluation.

In order to further assist bidders in determining the appropriate quality of goods or services, the UN may choose to include estimates of personnel and other input required in order to reach the expected results. However, it is strongly recommended that the UN not disclose the available budget for the contract. Such disclosure may be only done upon approval from the Director, PD or the CPO.

#### Life-Cycle Costs:

- a. The UN may state in the solicitation document that the financial evaluation will consider the full life-cycle cost. The full life-cycle cost of a product typically considers costs associated with the purchase and use of the product and may include:
  - i. Product cost (initial cost);
  - ii. Freight cost;
  - iii. Operational cost over the useful life of the product (e.g. electricity, fuel, consumables);
  - iv. Installation and training cost;

- v. Maintenance cost over the useful life of the product (e.g. after-sales services, repair, spare parts, human resources);
- vi. Disposal cost (including handling and treatment and takeback if included) or residual value at the end of use.

Life cycle costing should be included in the financial evaluation when the costs of operation and/or maintenance over the specified life of the goods are estimated to be considerable, in comparison with the initial cost and may vary among different offers received. Selection of the lowest-priced offer based on life cycle costing analysis can lead to win-win situations when cost savings go hand-in-hand with better overall sustainability.

When using life cycle costing, the solicitation document shall specify:

- a. A minimum number of years for the life cycle cost consideration, (i.e., the number of years that the product or service is expected to be used);
- b. The methodology to be used for calculating the operational, maintenance costs, including the information to be provided by bidders in their offers.

#### Freight Costs:

- a. When including freight in the requirements, an evaluation must be made on the total cost delivered to the final destination (“landed cost”) and may require bidders to quote prices on FCA/FOB/EXW [Incoterms](#) basis, with freight cost quoted separately, and CPT/DAT/DAP Incoterms basis prices. In cases where the UN requests prices on FCA/FOB/EXW basis, the UN reserves the right to seek freight quotations from its freight forwarders with which there is an LTA in place and to issue the award to the bidder whose landed cost is lowest after adding their FCA/FOB/EXW price to the freight quotation obtained by the UN;
- b. For more information on Incoterms please refer to [Chapter 12 Logistics](#);

#### 6.4.6.4 Evaluation Criteria for Joint Ventures

A bidder may submit an offer in association with other entities, particularly with an entity in the country where the goods and/or services are to be provided. It is the preference and strong recommendation that contracts be signed with a prime vendor and for any partners to act as subcontractors, as joint ventures can give rise to legal risks. In the case of a joint venture or consortium,

- a. All parties of a joint venture or consortium shall be jointly and severally liable to the UN for any obligations arising from their offer and the contract that may be awarded to them as a result of the solicitation process;
- b. The offer shall clearly identify the entity designated to act as the contact point to deal with the UN, as detailed in the bid/proposal. Such entity shall have the authority to make binding decisions upon the joint venture or consortium during the solicitation process, and any such authority shall not be altered during the solicitation process (and, with respect to the winning bidder, during the term of the contract) without the prior consent of the UN;
- c. The composition or the constitution of the joint venture or consortium shall not be altered without the prior consent of the UN.

Where joint ventures are anticipated in a solicitation process, the solicitation document should state how each evaluation criterion would be applied. In particular, it should be clear regarding each criterion whether:

- a. All joint venture members combined must meet it;
- b. Each joint venture member must meet it;
- c. At least one of the joint venture members must meet it.

Normally, mandatory criteria, such as specific experience requirements and turnover requirements, refer to all joint venture partners combined, whilst eligibility criteria are per each joint venture partner (non-inclusion in ineligibility lists, etc.).

#### 6.4.7 Requisite Forms/Schedules for Bidders

The solicitation document should include specific forms/schedules to be filled out by bidders and included in the bidders' bids/proposals. The number and specific forms/schedules to be included should be in accordance with the complexity of the requirements and solicitation method selected.

Once the bidders have completed the requested information as specified in the solicitation document and a contract has been awarded, the information contained in the bid/proposal and in these schedules of the successful bidder will be extracted from the bid/proposal and incorporated into the contract to be signed. The bid/proposal itself is not ordinarily to be included in the contract as an attachment.

#### 6.4.8 Bid/Advance Payment/Performance Security Form and Requirements

If applicable, Procurement Officials shall include in the solicitation documents the appropriate forms for Bid Security or Advance Payment Security, if required pursuant to the SSP. If performance security is required of the winning bidder, then the form of performance security also should be included in the solicitation documents. The Procurement Officials shall ensure that, as part of their offers, bidders accept the provision of such security.

##### Bid Security Form and Requirements

The purpose of Bid Security is to discourage frivolous and irresponsible offers with an adverse impact on the procurement process, which may lead to additional cost for re-tendering and evaluation, and/or possible delays in implementation of mandates. Bid/proposal securities can be requested by the UN to mitigate the following bidder-related risks:

- a. Withdrawal or modification of a bid or proposal after the bid receipt deadline;
- b. Failure to sign the contract;
- c. Failure to provide the required security for the performance under the contract after a bid or proposal has been accepted;
- d. Failure to comply with any other conditions specified in the solicitation documents, prior to signing the contract.

Bid Security is not always required for a solicitation exercise. It is recommended to require bid security in the following circumstances:

- a. The high value of goods/services to be purchased;
- b. The urgency of the request (e.g. goods must be in the country or construction works must be performed before the rainy season);
- c. Emergencies (i.e., life and death situations);
- d. High risk of offer withdrawal due to market conditions, increasing raw material prices, country instability, etc.;
- e. The contract cannot be placed within a relatively short period).

The obligation to furnish a bid security may be a deterring factor preventing bidders from doing business with the United Nations, especially for awards estimated in low amounts, therefore Procurement Officials may exercise discretion in determining when it is advisable to request it.

If Bid Security is required, the amount and form of the bid security shall be specified in the solicitation documents. Furthermore, the bid security shall remain valid for a period that provides

sufficient time to the UN in the event the security has to be cashed (i.e., until the date of expected contract signature).

Bid security shall be released to unsuccessful bidders once the contract has been signed with the winning bidder.

Calculation of the value of Bid Security should consider various elements, amongst them the costs of evaluating offers and re-tendering and the estimated value of the contract. For reference purposes, the value of the Bid Security could range between 0.5% and 4% of the expected contract amount; however, the Bid Security must always be stated as a specific lump sum rather than as a percentage of the bid amount (to avoid signaling the budget estimate), except for solicitation processes with multiple lots, if this approach is not practical. Bid security represents a cost to the bidder, and therefore, it is essential that the bid security is set at a level that will not discourage participation in the solicitation process. The bid security is normally in the form of a bank guarantee. Other forms of bid security (e.g. a bond, demand draft, cashier's cheques, or irrevocable cheques certified by a bank) may be used either with prior review by OLA or a Legal Advisor or upon approval by the Director, PD or the Chief Procurement Officer. The acceptable formats should be indicated in the solicitation document along with relevant templates.

In UN office locations where it is difficult for bidders to obtain Bid Security or it is not a normal market requirement, it can be replaced by a 'bid securing declaration', which is a non-monetary statement committing the bidder to sign the contract if awarded. In these cases, a standard template must be used, and PD's guidance sought prior to using it in that template in the first solicitation exercise, and approval must be obtained from the relevant Procurement Approving Authority.

#### Performance Security Requirements

Performance security may be requested in solicitation documents by the UN from the winning bidder as a requirement to be provided, following an award, in order to mitigate the risk of non-performance and breach of contractual obligations (such as the delivery of all equipment, services rendered, and works completed as per the contract).

The performance security is normally to be in the form of an unconditional and irrevocable on-demand bank guarantee. Other forms of performance security (e.g. a bond, a demand draft, cashier's cheques, or irrevocable cheques certified by a bank) may be used with prior review by OLA or a Legal Advisor. The acceptable formats should be indicated in the solicitation document along with relevant templates.

The value of the performance security may vary, depending on the nature, risk, and magnitude of the services or goods to be provided under the contract (e.g. large variety of products to be covered under the contract with a risk of failure to deliver or delicate products with a high risk of damage during handling). The performance security should reflect the value of the assessed risk and subsequent loss to the UN should the contractor fail to fully perform under the respective contract. This would be dependent on the market, situation, local conditions, and/or political and economic situation of the location of the end-user. It is recommended that the total value of the performance security should normally not exceed ten percent (10%) of the contract value. The higher the percentage, the less attractive may be for bidders to participate in the tender exercise, to the point that it may become a deterrent for some prospective bidders; also, the bidders' financial proposals are likely to cost more if the performance security is higher.

#### 6.4.9 Form of Contract and UN General Conditions of Contract

A copy of the applicable Form of Contract and the relevant UNGCC should either be included with the solicitation documents or else reference should be made to the UNGCC, available on the UNPD's



public website. Including a form of contract allows bidders to know the terms and conditions of the specific agreement before submitting a bid/proposal and allows them to understand what they would be expected to sign if selected as the winning bidder. Several forms of model contracts can be found on the OLA website. For complex requirements for which the standard UN model contracts might need some tailoring to meet the needs of the Requirement, the Procurement Official may wish to consult with OLA.

The solicitation documents should state that bidders are requested to accept the UNGCC and the applicable form of the contract included in the solicitation document. The solicitation documents should further provide that if a bidder has any comments or reservations to the UNGCC or form contract, they must submit such comments or reservations with their bids. Failure to submit such comments or reservations will be deemed by the UN as acceptance of all contract terms. Submission of comments or reservations does not, however, mean that the UN will automatically accept them should they be awarded the contract. The solicitation documents should specify whether a bidder's failure to accept the UNGCC and the form contract, as is, may lead to the bidder's disqualification or affect the bidder's weighted score.

In any specific procurement action in which modifications are proposed to the UNGCC, the proposals should be carefully reviewed and only undertaken upon review and advice of the applicable UN Legal Advisor. If necessary, OLA should be consulted prior to reaching any agreement to modify the standard terms and conditions of the UNGCC. The Procurement Official must obtain such clearance prior to issuance of the solicitation documents or signature of a contract. Any such modifications should be considered as applying to the specific procurement action in question only and should not be regarded as setting a precedent for other procurement actions or as a reformulation of the specific provisions of the UNGCC.

Whenever changes are required to be made to the UNGCC, such changes should be reflected in the main agreement and not on the form of the UNGCC themselves

## 6.5 Invitation of Vendors

After the solicitation documents have been prepared and completed, the following steps must be undertaken before the documents are distributed.

### Approval of Solicitation Documents

The solicitation documents must be approved by the Procurement Approving Authority at the appropriate level, with the corresponding level of delegated procurement authority, prior to issuance and each time they are amended.

### Distribution of Solicitation Documents

The solicitation documents shall be issued and distributed simultaneously to all potential vendors included in the List of Invitees, duly signed by the Procurement Approving Authority at the appropriate level with the corresponding level of delegated procurement authority so that all bidders are given the same opportunity to respond. The list should be comprised of vendors identified during market research, via EOI, prequalification, or other means of supply market analysis. They may also be made available to all interested vendors upon request if the request is made within a reasonable time prior to bid closing and would not lead to a delay (i.e., an extension of the bid closing deadline), provided they register at the basic level before the solicitation documents are issued to them.

If the solicitation documents are issued electronically, the Procurement Official should ensure that the documents are issued in limited editing format. In addition, the solicitation document must



include a clause stating that the UN takes no responsibility for effective delivery of the electronic document.

A signed copy of the solicitation documents and List of Invitees must be kept on file by the Procurement Official together with documentation on where and how long it was posted (e.g. printouts of screenshots from e-tendering solution), and to whom it was issued (e.g. fax receipts, copies of emails, courier receipts, etc.) to facilitate an audit of the process.

#### Confidentiality of the List of Invitees:

In order to safeguard the principle of competition, the UN shall not disclose the names of any invited companies.

## 6.6 Amendments to Solicitation Documents

At any time before the deadline for submission of offers, the UN may, for any reason, whether on its own initiative or following a request for clarification by a vendor, modify the solicitation documents by issuing a formal amendment to the solicitation.

Questions submitted by bidders in writing by the established deadline and their corresponding answers, as well as any relevant documents shared with the vendors during the bidders' conference, shall be included into the solicitation and considered an integral part of it via formal solicitation amendment. The appropriate Procurement Approving Authority must approve amendments to solicitation documents.

The amendment must be made within a reasonable time before the deadline for submission of offers, in order for vendors to address changes in their offers. In certain cases, amendments may justify an extension of the submission deadline. This should be assessed on a case-by-case basis.

In order to ensure that all vendors have the same information, amendments of solicitation documents must be sent simultaneously in writing to all invited vendors.

Bidders that did not attend a mandatory bidders' conference, and are therefore not eligible for an award, are not required to receive the amendments to the solicitation unless a new opportunity to attend is provided for through an amendment.

Should the amendment to the solicitation include the introduction of new requirements or a substantial change to the nature of the requirements, the Procurement Official will give due consideration to cancelling the procurement process and issuing a new one, as allowed by the operational environment, as a change of requirements may potentially have an impact on the interest of the market for the solicitation.

## 6.7 Cancellation of the Solicitation Process

The UN reserves the right to cancel a solicitation without recourse at any time prior to the contract award. The relevant Procurement Approving Authority must approve all cancellations. Conditions that may give rise to cancellation are:

- a. The justification for the initial solicitation is no longer valid;
- b. The requirements require material revision.

In the event a solicitation exercise is cancelled, all bidders must receive written notification and offers will be made available for collection by the respective bidder. The UN shall reserve the right to discard such offers unopened without further notice to the bidders. The UN shall not bear any costs associated with returning offers to bidders. The Procurement Official must make sure that all bid securities are returned to the bidders.

## 6.8 Direct Contracting Under Sole Source

When direct contracting under sole sourcing is justified, an offer is requested only by the appropriate Procurement Official from only one vendor following approval by the appropriate Procurement Approving Authority, in accordance with Financial Rule 105.16(a).

Although the direct contracting modality waives the competitive process, this method does not diminish the responsibilities and accountabilities of personnel involved in the procurement process. Under the direct contracting modality, a contract must still be awarded to a vendor whose offer substantially conforms to the requirements at a reasonable price.

The following procurement actions shall still be required:

- a. Seeking the necessary approvals to commence the procurement action under the relevant Financial Rule;
- b. Writing the requirements definition;
- c. An advertisement of a synopsis of the requirement should be posted in the form of a request for EOI. If the Procurement Official decides not to post a request for EOI because the circumstances of the case do not warrant it, s/he shall document the reasons in a note to the case file;
- d. Soliciting an offer from the selected vendor based on the requirements definition, the applicable Form of Contract, and the UNGCC;
- e. Evaluating the offer (see [Chapter 8.8 Further Aspects of Evaluation](#)) and carrying out negotiations, if applicable (see [Chapter 8.9 Negotiations](#));
- f. Awarding the contract at the level of the Procurement Approving Authority, including prior review by a committee on contracts, as applicable.

Since there is no competition in a direct contracting approach, the use of standard solicitation documents (RFQ, RFP, ITB,) when requesting an offer is not necessary. However, to facilitate the evaluation process, Procurement Officials should request the vendor to provide information that would allow for a comprehensive assessment of its offer based on pre-established evaluation criteria and ensure that it meets the needs of the UN.

## 6.9 Solicitation of Offers Against LTAs

If a long-term agreement (LTA) has been established by the UN (see [Chapter 11.6 Long-Term Agreement \(LTA\)](#)) for the goods or services required in a specific case, offers should be solicited as follows from vendors, depending on the LTA's set-up:

Single-Vendor LTA, or Multiple-Vendor LTA Without Secondary Bidding: Procurement Officials shall contact the contractor directly to confirm the call-off in accordance with the prices and other terms and conditions of the LTA and inquire about shipping costs, if applicable. (See [Chapter 11](#) regarding Call-Off Orders).

Multiple-vendor LTA with secondary bidding: for all secondary bidding exercises, the following shall apply:

### DIRECT CONTRACTING

Although the direct contracting modality waives the competitive process, this method does not diminish the responsibilities and accountabilities of personnel involved in the procurement process. Under the direct contracting modality, a contract must still be awarded to a vendor whose offer substantially conforms to the requirements at a reasonable price.

- a. It is highly recommended to use a standard template (which could be a simplified version of the standard RFQ template for goods and services);
- b. The item description should include the item reference, as included in the LTA;
- c. Offers resulting from a secondary bidding exercise do not need to be submitted to a secure email/fax number or sent in a sealed envelope, regardless of their value, unless so decided by the Procurement Official;
- d. A note to the file, signed by the relevant Procurement Official, justifying the final selection decision should be included in the file to document the approval of the resulting call-off order(s).

LTAs can be used only for ordering the goods or services specified in that LTA. If other goods or services are required from that vendor, then other solicitation methods must be followed, unless a sole source decision can be justified. Extending the scope of the LTA in order to meet additional requirements (such as new licenses to replace depreciated version) requires either an award issued pursuant to a new solicitation or a properly justified sole-source decision.

## 6.10 Communication with Vendors

During the tender period, no communication regarding the contents of the solicitation documents or proposals is permitted between vendors and the UN Procurement Official, except through the methods of handling queries, as described below, and seeking clarifications from bidders during the evaluation process.

Queries from vendors must be handled through written correspondence and/or by a bidders' conference, followed up by written minutes made available to all potential bidders. Vendors requiring clarifications to the solicitation documents must submit their queries in writing to the UN to the point of contact indicated in the solicitation documents. The UN will prepare and dispatch written replies to such queries and make all replies known, together with the text of the queries, to all vendors at the same time, without referencing the source of the queries.

Furthermore, meetings with vendors, as well as attendance to conferences, trade exhibitions or similar, should be carried out in consultation with procurement officials.

Requisitioners may contact contractors (i.e., awarded vendors) for matters relating to the execution and management of an existing contract within the scope of that contract. Requisitioners should keep Procurement Officials informed, as appropriate, of their communications with contractors and keep records thereof, in case of any future disputes. On the other hand, Procurement Officials shall undertake all actions related to contract administration, as defined in [Chapter 13.1.2](#) below.

Any requests to the contractor that amends the terms of a contract must be negotiated by Procurement Officials and formally agreed via a contract amendment signed by the authorized Procurement Official, to avoid claims resulting from the Requisitioner's apparent authority to amend the contract.

## 6.11 Exceptions to Formal Methods of Solicitation

Financial Rule 105.16 sets forth the circumstances in which the Procurement Approving Authority may determine, for a particular procurement action, that using formal methods of solicitation is not in the best interest of the UN. Those reasons are set forth below, along with further analysis and examples. The examples provided for invoking each of the exceptions are not exhaustive and may include other situations that can be justified under such exceptions. Before commencing a procurement action under Financial Rule 105.16, the Procurement Official shall obtain approval from the relevant Procurement Approving Authority or Authorized Official, as the case may be, in accordance with the DOA Annex B.

For exceptions under Financial Rules 105.16(a)(iii) and 105.17, please refer to [Chapter 14](#).

### 6.11.1 No Competitive Marketplace

There can be an exception to using formal methods of solicitation when there is no competitive marketplace for the requirement, such as where a monopoly exists, where prices are fixed by legislation or government regulation, or where the requirement involves a proprietary product or service (Financial Rule 105.16(a)(i)).

### 6.11.2 Fixed Prices or Rates

If fixed prices/rates are the justification why formal methods of solicitation are not to be employed, the Procurement Official should document the name of the regulatory body or law that controls rates or established prices within the request for award for designated vendor and, if available, a current price/rate schedule should be provided in the request for approval.

### 6.11.3 Proprietary Product or Service

Proprietary product or service refers to situations where only one source can reasonably meet the needs of the UN, such as:

- a. Proprietary items subject to legal restrictions (i.e., patents and copyrights) are to be procured;
- b. Matters involving defense or security render single-source procurement the most appropriate method of procurement;
- c. The goods or services are available only from a particular vendor or contractor, or a particular vendor or contractor has exclusive rights in respect of the goods or services and no reasonable alternative or substitute exists.

If there is to be an exemption to using formal methods of solicitation for reasons of no competitive marketplace, fixed prices or proprietary product/service, then the Procurement Official must document the reasons, including demonstration of reasonableness of price (e.g. comparison with previous purchase prices).

### 6.11.4 Previous Determination or need for Standardization

An exception to using formal methods of solicitation can be made when there has been a previous determination, or when there is a need to standardize the requirement (Financial Rule 105.16(a)(ii)).

Previous determination means the product to be purchased is determined by a previous purchase, e.g. a piece of equipment was previously purchased and components that can only be obtained from the manufacturer must now be replaced, or complex services were purchased from a vendor and only the vendor who performed the initial services can realistically provide the required additional services.

Standardization shall be acceptable when identical goods, equipment, or technology have recently been purchased from an existing or previous UN contractor, and it is determined that there is a need for compatibility with existing goods, equipment or technology, or works. The effectiveness of the original procurement in meeting the needs of the UN, the limited size of the proposed procurement in relation to the original procurement, the reasonableness of the price, and the unsuitability of alternatives to the goods in question shall always be considered and justified. In any case, an appropriate technical authority, such as the ICTB, shall officially establish standardization.

## MUTUAL RECOGNITION

**If the proposed procurement contract is a call-off order against another UN organization's LTA pursuant to Financial Rule 105.17(a), no further review of the procurement process leading to the original**

Branding alone is not necessarily a justification for exceptions. A competitive process should be undertaken if multiple sources of supply exist.

If there is to be an exemption to using formal methods of solicitation for reasons of previous determination or standardization, then the Procurement Official must document the rationale for this exception, including, as applicable, the previous determination or reasons for requiring standardization, the terms of the standardization signed by the appropriate technical authority (e.g. the ICTB), and reasonableness of prices (e.g. comparison with previous purchase prices and comparison with prices of equipment from other vendors equivalent in performance).

#### 6.11.5 Cooperation

The proposed procurement contract is the result of cooperation with other organizations of the United Nations system, pursuant to Financial Rule 105.17(a) or governments and organizations other than those of the United Nations system, pursuant to Financial Rule 105.17(b).

The Procurement Approving Authority for Financial Rule 105.16(a)(iii), in conjunction with Financial Rule 105.17(a), may, in appropriate cases, authorize cooperation with a United Nations organization in respect of procurement activities. Please refer to [Chapter 14](#).

Should the requirement to be sourced through cooperation relate to Strategic Goods and Services, a request for LPA shall be sought from the Director, PD as per section 2.6.4.

#### 6.11.6 Identical Requirements

There can be an exception to using formal methods of solicitation when offers for identical requirements have been obtained competitively within a reasonable period, and the prices and conditions offered by the bidders remain competitive (Financial Rule 105.16(a)(iv)). The reasonable period in relation to the use of a previous competitive method of solicitation should not exceed one (1) year after the contract signature date unless otherwise justified, considering the specific market.

For goods where the price fluctuates rapidly (raw material, petroleum products, some IT equipment, etc.), the competitiveness of the price should always be properly justified.

This provision may not be applied if the respective offer has been obtained using Emergency Procurement Procedures (“EPP”), unless the new requirement is for a follow-on requirement for the original emergency, or is a requirement supporting a response to a new emergency (see [Chapter 15.4](#) regarding EPP).

If there is to be an exception to using formal methods of solicitation for reasons of identical Requirements, then the Procurement Official must document the use of a previous formal method of solicitation and its outcome, and the reasonableness of price and prevalent market rates in the area.

#### 6.11.7 No Satisfactory Results from Previous Formal Methods of Solicitation

There can be an exception to using formal methods of solicitation when a formal solicitation has not produced satisfactory results within a reasonable prior period (Financial Rule 105.16(a)(v)).

The ‘prior period’ refers to the time elapsed since the closing date for Submissions of the failed competitive solicitation process and shall be limited to six months. In relying on this clause, the Procurement Official should ensure that market research was done and be fully satisfied that a new solicitation process, again using formal methods of solicitation, will not yield satisfactory results.

If there is to be an exception to using formal methods of solicitation for reasons of unsatisfactory results from formal methods, then the Procurement Official is to document the failed competitive process and its outcome, the rationale as to why using formal methods again will not yield

satisfactory results, the reasonableness of price, and the applicable prevalent market rates for the requirement.

#### 6.11.8 Real Estate

There can be an exception to using formal methods of solicitation when the proposed procurement contract is for the purchase or lease of real estate property (Financial Rule 105.16(a)(vi)).

Selection of location is based on security considerations.

It should be noted that, technically, “leasing” does not include occupying hotel rooms. The correct term for occupying hotel rooms is “licensing”. However, because of reasons such as security, the interpretation of “lease” in the context of Financial Rule 105.16 is extended to include the right to occupy hotel rooms, as it is unrealistic to expect hotels to take part in a formal bidding process for hotel occupancy arrangements.

If there is to be an exception to using formal methods of solicitation for reasons of real estate, the Procurement Official, in justifying the choice of the premises, is to document the reasonableness of price (e.g. contacting companies specialized in commercial real estate services); demonstrate that a market survey or similar evaluation has been conducted; confirm MOSS compliance, clearance from UNDSS, etc.; provide evidence of market research into available premises; evidence Best Value for Money for the selected real estate.

#### 6.11.9 Exigency

There can be an exception to using formal methods of solicitation when there is an exigency for the requirement (Financial Rule 105.16(a)(vii)).

The exigencies of the requirement must be beyond the control of the UN. An exigency is an exceptional, compelling, and emergent need, not resulting from poor planning or management or from concerns over the availability of funds. An exigency exists if the lack of action will lead to serious damage, loss, or injury to property or persons if not addressed immediately, (i.e., emergency situations or force majeure, or other compelling circumstances which are not due to lack of planning or slow administrative process within the UN). The requirement must fit the definition of exigency situations as per General Assembly decision 54/468. Please refer to [Chapter 15.4 Emergency Procurement Procedures \(EPP\)](#) for instructions relating to the solicitation process under EPP.

If there is to be an exception to using formal methods of solicitation for reasons of exigency, then the Procurement Official must document how exceptions to formal methods of solicitation will meet the schedule and the adverse impact, such as damage, loss, or injury to property or persons if formal solicitation was to take place. The Procurement Official should also confirm the reasonableness of price (e.g. through comparing prices with previous purchase prices, etc.) and the justification for selecting a particular vendor over any other.

#### 6.11.10 Services Cannot Be Evaluated Objectively

There can be an exception to using formal methods of solicitation when the proposed procurement contract relates to obtaining services that cannot be evaluated objectively (Financial Rule 105.16(a)(viii)).

This exemption can be applied to the requirement for research, experiment, study, or development leading to the procurement of a prototype, except where the requirement includes the production of goods in quantities sufficient to establish their commercial viability or to recover research and development costs.

This exemption can be applied to the requirement for services of specific vendors to obtain cutting-edge technology or other new methodologies where there is no means of determining a basis for reliable comparison.

If there is to be an exception to using formal methods of solicitation for reasons of inability to evaluate the desired services objectively, then the Procurement Official is to document to why this specific requirement can only be obtained via this exception and why there is no possibility to evaluate those services objectively. In addition, the Procurement Official should document either a benchmark for the price quoted or how the reasonableness of price has been established.

#### 6.11.11 Formal Methods Will Not Produce Satisfactory Results

There can be an exception to using formal methods of solicitation when the authorized official with the corresponding delegated authority otherwise determines that a formal solicitation will not produce satisfactory results (Financial Rule 105.16(a)(ix)).

Reasons for such exceptions shall be included and due diligence conducted.

#### 6.11.12 Below Monetary Threshold

There can be an exception to using formal methods of solicitation when the value of the procurement is below a specified monetary threshold established for formal methods of solicitation (Financial Rule 105.16(a)(x)).

For requirements up to the monetary threshold of US\$ 150,000, an informal method of solicitation may be used.



## 7. Management of Submissions

### 7.1 Tender Opening Committee

A Tender Opening Committee (TOC) is an entity responsible for the handling of submissions in response to formal solicitation exercises. Their responsibilities shall include the receiving, recording, and safeguarding of Submissions, as well as conducting formal tender opening meetings. In case of informal solicitation exercises conducted through e-tendering, the TOC will also be responsible of releasing offers to the Procurement Officials.

To ensure the integrity of the procurement process, a TOC must consist of a minimum of two appointed staff members who are not otherwise involved in the procurement process.

As of 1 January 2019, the Chief of the Enabling and Outreach Service, OSCM will appoint the TOC members at UN Headquarters. At all other United Nations Secretariat duty stations, the TOC members are appointed, in writing, by the Chief of Administration/Director of Administration or the Chief Mission Support/Director Mission Support (CMS/DMS) or equivalent function.

Tender Opening Committees may be established and staffed permanently, or they may be designated temporarily to serve during a limited time (e.g. assigned to a specific tender).

No substantive information, except for Solicitation Documents, amendments thereto, questions, clarifications, and answers to vendor inquiries, shall be disclosed by the TOC or any other UN staff members to any individual or otherwise made public, unless otherwise explicitly written in this chapter.

### 7.2 Receipt and Safeguarding of Submissions

It is the responsibility of vendors to ensure that offers are submitted to the UN in accordance with the stipulations in the solicitation documents.

The solicitation documents shall clearly indicate the chosen method of delivery and time of receipt. Submissions may be received by hand delivery, courier service, mail, facsimile, e-mail, or e-tendering system, as specified in the solicitation documents. Submissions that are not received in strict accordance with instructions as specified in the solicitation documents may be rejected.

Receipt and safeguarding of submissions, in response to formal solicitation exercises, shall be performed by TOC members. In order to facilitate receipt of submissions, the Procurement Official shall provide in advance (i.e., immediately following the issuance of a solicitation to the invitees) to the TOC a summary of the solicitation details, which shall contain, inter alia, the tender closing and opening dates, tender reference and title, solicitation method, list of invited vendors, and bid abstract in case of an ITB. Upon receipt of a Submission, the TOC member must record time of receipt and ensure that satisfactory evidence of the time of receipt is secured (e.g. hand delivery receipt signed by both parties, courier tracking information, facsimile/e-tendering log files). All hard copies of tenders should be recorded with a date and time stamp.

Immediately upon receipt, submissions must be secured in a restricted area, where they shall remain sealed until the formal opening time. From the time of receipt until the time of their formal opening, only the designated individuals (i.e., TOC members) shall have access to the restricted area where the submissions are stored. Exceptional access required by others (e.g. maintenance personnel) shall be limited in time and under escort by a TOC member. TOC members shall take all necessary measures to ensure the confidentiality of the Submissions received.



A submission that is inadvertently opened before the submission opening date and time shall be brought to the attention of the Director PD or CPO and shall be noted in the procurement file. If the Director, PD or CPO decides to accept the submission, it shall immediately be placed in a sealed envelope and be marked.

### 7.3 Receipt and Safeguarding of Submissions Delivered by Hand, Courier or Mail

The TOC shall ensure that Submissions by hand delivery, courier, or mail can be received during the duty station's normal business hours and in accordance with tender instructions. Submissions shall be delivered in a sealed envelope with the name of the vendor, tender number, and tender opening date and time marked on the outside. For Submissions delivered by hand, the vendor representative shall be provided with a copy of the receipt time-stamped and signed by both parties.

Prior to securing a submission in a restricted area, the TOC shall review the envelope to ensure it is marked completely and verify the vendor's eligibility to participate in the tender by checking the list of invited vendors and marking date and time of receipt as well as any security instruments (e.g. bid bonds) received as part of the Submission.

The TOC shall ensure that all security instruments are carefully recorded, tracked, and securely stored as would be typically required for instruments with monetary value. The Procurement Official shall submit the original bid bonds to the TOC through the Bid Bond form detailing all bid bonds received in relation to the solicitation for onward safekeeping with Treasury.

### 7.4 Receipt and Safeguarding of Facsimile Submissions

Facsimile Submissions shall be received on a dedicated fax line only accessible to TOC members, preferably located in the same restricted area where tender Submissions are securely stored until opening.

Facsimile Submissions must be treated with the same degree of control as other Submissions. The TOC will check the list of invited vendors to ensure participation eligibility and mark the date and time Submissions have been received against the List of Invitees. The Submission shall be placed in a sealed envelope(s) with tender reference number, vendor name, date/time received, the tender opening date and time, and the TOC member's initials marked on the outside of the envelope. The TOC will not issue an acknowledgment of receipt for facsimile Submissions.

If the fax is incomplete or illegible, the TOC will issue a memorandum to the appropriate Approving Authority to decide whether to accept/reject the submission and/or request the vendor to resubmit via facsimile or alternate means.

### 7.5 Receipt and Safeguarding of E-tendering or E-mail Submissions

E-tendering is a system that enables Procurement Officials and vendors to manage the tender process and the associated exchange of documents online through the Internet.

Electronic Submissions are legally binding as long as they are signed off by the authorized representative of the bidder and are submitted in a file format, as determined by the UN, in the tender documentation.

Electronic submissions received via e-mail shall only be received on a dedicated email account, accessible to TOC members only, to be accessed only from a dedicated terminal located in the restricted area where tender Submissions are securely stored till their opening.

While the UN Secretariat shall take every reasonable step to ensure that it does not upload corrupt or unsafe tender documents, bidders should check any documents downloaded from the e-tendering system for viruses prior to opening them. The UN will not be liable or responsible for the loss, damage, destruction, corruption, or illegibility of documents in any electronic submission, however caused. The UN is also not able to consider electronic documents that are corrupt, infected, or otherwise unreadable.

The TOC shall ensure that e-Submissions are not opened until the time of the tender opening. It is important to note that the tender submission deadline stated in the solicitation document applies equally to hard copy and electronic tender Submissions. In the case of Submissions via electronic means, the receipt timestamp is the date and time the submission has been received, as indicated by the log files of the relevant IT platform(s). It is the sole responsibility of bidders to ensure that the UN Secretariat receives their Submission on or before the prescribed deadline.

Electronic means of data interchange are permitted, provided that the electronic means uphold the procurement principles and allow for an adequate audit trail of the procurement process.

In case of informal methods of solicitations conducted through e-tendering that resulted in less than three (3) offers, the TOC shall release submissions only following the written approval of the Director, PD or CPO. In an entity without a CPO, the approval of the official with the highest delegated procurement authority shall be sought.

## 7.6 Modification of Submissions

Submissions may be modified by bidders in writing prior to the closing date and time of the solicitation.

In the case of modified Submissions, the latest submitted offer prior to the Submission deadline is the binding one. The modification shall be submitted as per the original Submission instructions as stated in the solicitation documents and shall be treated like any other offer.

If the modified Submission is received after the Submission closing date and time, it shall not be considered, and the Procurement Official will notify the bidder in writing. The UN is not responsible for errors in price made by the vendor, and the vendor is bound by the prices provided. If there are discrepancies between totalling prices and unit prices, unit prices shall govern unless it is clear that the unit prices contain a typographical error or mistake.

If it is considered to be in the best interest of the Organization, the Procurement Official, in consultation with the Procurement Approving Authority, may request any missing documentation/data/information (See [Chapter 8.8.1](#) for details). If the bidder does not furnish the documentation/data/information within a specified period of time after it has been requested, normally five (5) UN business days, the submission may be rejected, and the bidder shall be notified accordingly in writing.

## 7.7 Withdrawal of Submissions

Submissions may be withdrawn by bidders in writing prior to the closing date and time of the solicitation. Withdrawal of a submission by a bidder can only be accepted if the UN is notified in writing prior to the announced deadline for submission of offers. Immediately after receipt of the formal withdrawal by a vendor, the TOC shall separate the withdrawn offer from the other submissions and ensure that the withdrawn offer is not opened during the opening ceremony. After receiving agreement in writing from bidder and Procurement Official, the TOC shall destroy the unopened submission or return it to the bidder at its cost, if so requested.

## 7.8 Modification or Withdrawal of Submissions After Closing

If received after the submission deadline, the UN Secretariat should not honour withdrawal of, or modifications to, submissions and shall open the submission together with the other submissions and shall notify the vendor in writing.

If the bidder has furnished bid security with the submission, the UN Secretariat shall withhold that bid security, with the intention to invoke the security instrument in case the submission is selected after evaluation and the bidder is not willing to provide the goods/services offered in its Submission. The Procurement Official shall ensure the bid security remains valid. If no bid security was requested, the issue should be resolved through negotiations. OLA's advice should be sought as appropriate before taking action on the bid security as needed. The procedures of [Chapter 3.3](#) on the VRC may be applicable.

If the bidder can justify the withdrawal of its submission, the UN may accept a withdrawal after the submission deadline. It should be considered whether it is in the interest of the UN to hold the vendor to its Submission after the request for withdrawal. The appropriate Procurement Approving Authority up to the level of Director, PD or CPO, should make this consideration prior to the final decision.

Any bid security instruments provided in connection to a withdrawn bid can be cashed in full by the Organization

## 7.9 Late Submissions

It is the responsibility of the bidder to ensure timely delivery and receipt of their Submissions. Submissions received after the submission deadline need not be accepted by the Organization.

Submissions received after the designated date and time should be rejected and noted as such in the tender opening report by the TOC, unless a decision is made to accept the submission or offer based on a holistic evaluation of the circumstances that led to the late delivery and the best interests of the Organization. When deciding to accept or reject a late submission, the following circumstances shall be duly considered, among other considerations:

- a. The extent of the delay;
- b. There is clear evidence to establish that it was received at the tender opening location of the UN Secretariat entity or under the UN Secretariat's physical control prior to the tender closing deadline;
- c. If an emergency or other event interrupts normal UN Secretariat processes and operations so that submissions cannot be received at the designated location by the closing deadline;  
or
- d. Whether best efforts were made by the vendor to provide the submission or offer in time.

Acceptance of late Submissions shall be on a case-by-case basis. In case of late receipt, the Director, PD or the CPO may accept Submissions received after the closing date specified in the tender document as long as it is received prior to initiation of the evaluation process by the evaluation team. This is only permissible where it is established that the delay was not under the control of the vendor and the acceptance of the submission does not create the appearance of, or an actual, unfair advantage to the vendor.

The TOC must submit immediately, for consideration by the Director, PD or the CPO, the relevant details of any late submission and keep a record of the Director, PD or the CPO's decision, which will subsequently be communicated to the bidder by the Procurement Official.

Submissions that have been rejected shall remain unopened and shall be forwarded to the Procurement Official. The bidder shall be officially notified in writing of the rejection upon such decision. The submission shall be destroyed or returned to the bidder at the bidder's own cost, is so requested.

## 7.10 Unsolicited Submissions

Unsolicited Submissions from vendors that the UN has not invited shall be rejected by the Director, PD or the CPO, and the vendor shall be advised of such rejection in writing unless a decision is made to accept the submission on an exceptional basis, as further described below. Such unsolicited Submissions shall remain unopened and shall be destroyed or returned by the TOC to the vendor, at its own cost, if so requested.

Submissions from vendors whose names are not on the List of Invitees but appear to be related to a vendor included in the List of Invitees, should be brought to the attention of the Procurement Official, who shall contact the original invitee to seek clarification.

In cases where Submissions were made by vendors that are related business entities of the original invitees, due to their business arrangements in place, Submissions from such vendors may be accepted upon documented and supporting evidence of the corporate relationship. Submissions from vendors who are appointed by the original invitee as sales, export, or local representatives of the original invitees, and are not financially and legally affiliated with the original invitee in terms of ownership, may be accepted, provided that the invitees inform the UN Secretariat of their appointment in advance with a proof of appointment prior to the submission deadline. Such acceptance is subject to approval by the most senior Procurement Official in an office.

Unsolicited submissions may be accepted at the discretion of the Director, PD or CPO where professional judgment leads to the belief that doing so would be in the interest of the Organization. A decision to accept or reject an unsolicited submission shall rely on professional judgment and a holistic analysis of the potential benefits of the submission.

Proper care should be taken to identify how the submitting vendor obtained information relating to the solicitation. It is important that the Procurement Official, in collaboration with the Vendor Registration and TOC function, ascertains that the vendor is a bona fide vendor and meets all the registration prerequisites and status.

## 7.11 Opening and Recording of Submissions

Submissions for ITBs or RFPs shall be opened by the TOC consisting of duly authorized personnel.

## 7.12 Attendance at Tender Openings

Tender openings of ITBs and RFPs are conducted during a formal meeting at a time and location specified in the solicitation instructions. It may be transmitted via webcast for those bidders who have submitted an offer. Only those vendors who have submitted an offer (i.e., bidder) may designate one representative to attend, in an observing capacity, the tender opening of a specific ITB or RFP. The representative may be an employee or agent of the bidder, a local representative designated by the bidder, including appointed personnel from a law firm, or an officer of a Permanent Mission to the UN, a Trade Office of a UN Member State, or other diplomatic office.

The bidders shall advise the TOC in advance of the names of its representatives who will be attending the tender opening meeting using the tender acknowledgment letter.

Every individual attending the meeting shall have his or her name, title, and proper representation for a submitting vendor verified and recorded prior to the start of the tender opening meeting.

The appropriate Procurement Approving Authority may authorize other parties to attend tender openings in an observing capacity.

The bidders' representatives and other parties attending the tender opening shall act solely as observers and not as active participants in the opening process. At no time during the tender opening can UN staff or attending parties engage in discussions or other forms of information exchange other than the formal announcement of opening proceedings and results by the TOC.

### 7.13 Opening of Bids (ITBs)

All bids received in response to an ITB shall be opened and recorded by the TOC during a tender opening meeting at the time and location specified in the solicitation instructions.

During the meeting, the TOC shall record and announce for each bid the bidders' names and, in the case of an ITB, may also include the grand total price of each bid. At the discretion of the TOC, more detailed pricing information at the subcategory or line-level may be announced and recorded.

Submissions cannot be rejected or invalidated at the time of opening by the Tender Opening Committee. The TOC shall reflect any inconsistencies (e.g. late Submissions) in the tender opening report and mention during the public tender opening that inconsistencies are brought forward to the Director, PD or the CPO for deciding how to proceed.

After the conclusion of the tender opening meeting, one member of the TOC shall escort the bidders' representatives and other parties attending the meeting out of the meeting room. All TOC members shall certify the tender opening procedure by signing the tender opening report. All paper submissions shall be marked or perforated with an indication of the tender reference number and opening date.

### 7.14 Opening of Proposals (RFPs)

Only the technical proposals received in response to an RFP shall be opened and recorded by the TOC during a tender opening meeting at the time and location specified in the solicitation instructions. The financial proposals shall remain sealed and the contents undisclosed until after the technical evaluation of the proposals has been completed<sup>4</sup>.

During the meeting, the TOC shall record and announce, for each bid, the bidder's name.

Submissions cannot be rejected or invalidated at the time of opening by the TOC. The TOC shall reflect any inconsistencies (e.g. late Submissions) in the tender opening report and mention during the public tender opening that inconsistencies are brought forward to the Director, PD or the CPO for deciding how to proceed.

After the conclusion of the tender opening meeting, one member of the TOC shall escort the bidders' representatives and other parties attending the meeting out of the meeting room. All TOC members shall certify the tender opening procedure by signing the tender opening report. All paper documents contained in the technical Submissions, except catalogues and brochures, shall be marked or perforated with an indication of the tender reference number and opening date.

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<sup>4</sup> For RFPs for movement services for COE, Financial and Technical Proposals are opened simultaneously, as an exception to the Opening procedures for RFPs.

## 7.15 Rejection of Submissions

The UN shall reserve the right to reject any or all Submissions received which do not comply with the Solicitation Documents instructions, or whenever such rejection is in the interest of the Organization in accordance with Financial Rule 105.15(c).

## 7.16 Post-Opening of Bids

Following the tender opening for ITBs, Submissions shall be kept secure and their access limited to authorized TOC members only, until formal handover of Submissions to the Procurement Official. The original tender opening report and all Submissions shall be handed over to the Procurement Official who signs for receipt. The TOC shall retain a copy of the tender opening report.

## 7.17 Post-Opening of Proposals

Following the tender opening for RFPs, the original tender opening report and all technical Submissions shall be handed over to the Procurement Official who signs for receipt. The financial Submissions shall be kept sealed in a secure location under the custody of the TOC, pending completion of the technical evaluation.

Upon receipt of confirmation from the Procurement Official that the technical evaluation has been completed, the TOC shall open the financial envelopes of those Submissions that have been found to be technically compliant. In the case of a paper-based solicitation exercise, the TOC shall mark or perforate with the tender number and the date of the request said financial proposals and hand over to the Procurement Official both the aforementioned financial submissions and sealed financial envelopes of technically non-compliant Submissions. The Procurement Official then signs for receipt of the Submissions. In the case of an e-tendering solicitation exercise, only the financial files of technically compliant Submissions are handed over to the Procurement Official in the system. For Submissions received through dedicated secured e-mail address, the TOC shall forward the financial Submissions to the Procurement Official and save an electronic copy with the TOC for audit trail.

## 7.18 Other Post-Opening Procedures

The Procurement Official shall provide the appointed evaluation committees with relevant Submission documents to conduct the evaluation of the ITB or RFP.

The tender opening reports for ITBs and RFPs shall be available for consultation by vendors for a period of thirty (30) days from the tender opening date. A vendor may consult only those tender opening reports for which the vendor has submitted a tender.

The Procurement Official shall verify the vendor registration status of all bidders that submitted a bid or proposal in response to the solicitation. In case that any bidder does not have the appropriate registration level for the upcoming award, the Procurement Official will send a reminder to the bidder to submit all required information in UNGM. The Procurement Official will advise Vendor Registration Officials of the upcoming registration requests.

## SOP on Management of Submissions in Response to Formal Solicitations

## 8. Evaluation of Submissions

### 8.1 Overview

Evaluation is the process of assessing and comparing Submissions in accordance with the evaluation methodology and criteria in the solicitation documents and in the SSP. The aim is to determine the offer that best fits the evaluation criteria and thus represents the best value for the UN. An objective, fair, and well-executed evaluation process is critical, as it results in a recommendation and a request for an award of contract.

In general, the UN evaluates all offers based on the principles enshrined in Financial regulation 5.12 including the principle of Best Value for Money, i.e., the ideal combination of technical and financial factors.

Upon receipt and opening of offers, the evaluation of offers must be conducted according to the evaluation criteria and method defined in the SSP and clearly established in the solicitation documents. New or revised evaluation criteria cannot be introduced during the evaluation of offers nor can the method of evaluation be changed.

The evaluation process comprises the following main steps (described later in this chapter):

- a. Preliminary screening (see [6.4.6.1](#));
- b. Technical evaluation;
- c. For RFPs: completion of the technical evaluation report and opening of financial proposals;
- d. Financial evaluation, including justification of reasonableness of price (if applicable);
- e. Clarifications, if required;
- f. Finalization of the evaluation report.

As offers must be valid at the time of contract issuance, evaluation of offers must be completed before the validity of the offers expire. Procurement Officials should also take into account the time required for obtaining approval and for issuing the contract. In the event that these conditions are unlikely to be met, Procurement Officials may request bidders in writing to extend the validity of their bid or proposal.

### 8.2 Evaluation Committees

The purpose of the Evaluation Committees is to verify that vendors and their offers satisfy the requirements of the solicitation documents and to evaluate offers according to the evaluation criteria predefined in the SSP. The SSP describes critical components of the Sourcing process and provides justification for Sourcing decisions in order to achieve Best Value for Money. It provides an objective approach to the methodology of selecting the best source to fulfil the established need.

The Evaluation Committees are divided into a Technical Evaluation Committee, responsible for the technical evaluation, and a Financial Evaluation Committee (or Procurement Official), responsible for the financial evaluation. The decision of who participates as a member of the technical and financial evaluation committees rests with the requisitioning and the procurement functions, respectively; this decision is to be documented in the SSP.

The Evaluation Committees are responsible for assessing the ability of the potential vendors to meet the UN's stated minimum requirements and provides a basis for determining the relative merits of competing bids and proposals based on predetermined evaluation criteria.

To conduct a fair and unbiased evaluation of Submissions, the SSP shall include the formation of the Technical Evaluation Committee consisting of at least two (2) members (i.e., at least one of whom



shall be from the Requisitioner's office, and the other(s) shall be qualified UN staff members). A superior and subordinate may not serve together on the Technical Evaluation Committee. To ensure a clear segregation of duties, Procurement Officials cannot serve as members of a Technical Evaluation Committee, unless, exceptionally, they are acting as Requisitioners for a specific case, in which case they cannot act as Procurement Officials for that solicitation. The actual number of people on the evaluation team will depend on the nature, complexity, and value of the procurement activity, but should normally not exceed five (5) members.

The Technical Evaluation Committee is a collegial body that shall always endeavor to achieve a consensus in their final decision. Where a consensus cannot be achieved despite all efforts, the chairperson may call a simple majority vote to settle an issue or disagreement. Should the votes be equally divided, the average of the scores will be applied. Once a final decision is achieved, the members shall uphold the final decision achieved by the team.

In particularly complicated procurement processes (e.g. complex specifications, high value bids, complex pre-qualification criteria, etc.), external subject-matter experts may be contracted onto the evaluation committee as observers in an *ex-officio* non-scoring advisory capacity. If deemed appropriate, members of the oversight bodies (OIOS, Board of Auditors, Joint Inspection Unit) external to the procurement process may participate as independent observers in technical evaluations and record their observations in writing. Committee members and observers must immediately indicate if they are in a potential conflict of interest situation with any of the vendor (e.g. owning shares in the company, family relationship with vendors, etc.), in which case they shall be replaced.

#### Main Tasks of the Chairperson During the Technical Evaluation:

- a. Perform a facilitative role in the technical evaluation committee, strive for consensus, and settle any issues or disagreements (if applicable), and
- b. Remind the Technical Evaluation Committee that its deliberations are strictly confidential. Information about the content of the Submissions or the evaluation process is not to be revealed outside the evaluation committee. In particular, (i) during the evaluation, access to offers is restricted to the evaluation committee and to observers, and (ii) correspondence with bidders must be through the Procurement Official and must not be shared outside the evaluation committee.

#### Main Tasks of the Technical Evaluation Committee:

- a. Conduct the technical evaluation and prepare a written report thereof, describing the score of the competing Submissions and ranking the Submissions from best to worst, in order to establish a competitive range of most responsive Submissions
- b. The report shall also set forth:
  - i. The basis of evaluation (i.e., the SSP as applied to the evaluation criteria and their relative weight);
  - ii. An analysis of whether Submissions are technically acceptable and, if unacceptable, the reasons thereof, including an assessment of each vendor's ability to satisfy the technical requirement(s) and a description of each Submission's strengths and weaknesses;
  - iii. A summary of the findings, matrix, or quantitative ranking of each technical proposal relative to the best rating possible;
  - iv. Observations made by independent observers, if applicable.

#### Main Tasks of the Financial Evaluation Committee/Procurement Official During the Evaluation Process:

- a. Obtain signatures of affidavits of confidentiality and no conflict of interest from the technical evaluation committee;
- b. Brief the Technical Evaluation Committee about its role and ensure its familiarity with the solicitation process and evaluation criteria;
- c. Prepare financial evaluation matrix;
- d. Manage requests for clarifications with bidders, if applicable;
- e. Upon receipt of the technical evaluation report, the Procurement Official or the Financial Evaluation Committee shall conduct and review the financial evaluation, make a final comparison of the competing proposals in accordance with the terms of the solicitation documents and the SSP, record its findings, and advise the Evaluation Committee of the recommendation of award.

### 8.3 Evaluation Criteria

Evaluation criteria are divided into the following categories, which are explained in [Chapter 6 Solicitation](#) and which are assessed during the evaluation process:

- a. Formal criteria (see [Chapter 6.4.6.1 Evaluation Criteria](#)) – assessed during preliminary screening (see [Chapter 8.5 Preliminary Screening](#))
- b. Mandatory and Technical Criteria (see [Chapter 6.4.6.2 Mandatory and Technical Criteria](#)) – assessed during technical evaluation (see [Chapter 8.6 Technical Evaluation](#)), and
- c. Financial Criteria (see [Chapter 6.4.6.3 Financial Criteria](#)) – assessed during financial evaluation (see [Chapter 8.7 Financial Evaluation](#))

### 8.4 Evaluation Methodologies

There are three (3) different evaluation methodologies that can be utilized depending on the solicitation method selected, as summarized in the below Table.

Solicitation method	Evaluation method
LVA	Lowest priced, technically acceptable
RFQ	Lowest priced, technically acceptable
ITB	Lowest priced, substantially conforming bid
RFP	Cumulative weighted analysis, award based on the most responsive proposal

**TABLE 4: SOLICITATION METHODS AND CORRESPONDING EVALUATION METHODS**

#### 8.4.1 Lowest Priced, Technically Acceptable Offer

This method of evaluation is used when the solicitation is made through informal methods: LVA or RFQ (see [Chapter 4.5 Shopping Cart](#) and [Chapter 6.3.3 Request for Quotation](#)).

To provide a more flexible method for selecting vendors for procurement of relatively low value (equal to or below US\$ 150,000), the evaluation methodology allows various considerations to be taken into account. The lowest-priced, technically acceptable offer methodology consists of the following steps (These apply mostly to RFQ. As for LVA, all these steps are compressed):

- a. Preliminary screening of quotations, including an assessment of whether quotations comply with the formal and eligibility criteria stated in the solicitation document;
- b. Technical evaluation of quotations, determining which are compliant to the mandatory criteria (if included in the solicitation document), and substantially compliant to the technical criteria;
- c. For financial evaluation, quotations that are found to be technically compliant shall be evaluated based on the lowest price;

- d. The selection of a vendor other than the one offering the lowest priced option requires proper justification. This must be documented and attached in UMOJA for monitoring and audit purposes, and reasons for not choosing the lowest pricing option must be included in the request for award signed by the appropriate Procurement Official (or CO, in the case of LVA).

#### 8.4.2 Lowest Priced, Substantially Conforming Bid

This method of evaluation is used when the solicitation is conducted through an ITB (see [Chapter 6.3.4 Invitation to Bid](#)), and price serves as the overriding evaluation criterion upon which to award a contract. The lowest-priced, substantially conforming bid methodology consists of the following steps:

- a. Preliminary screening of bids, including an assessment of whether bids comply with the formal and eligibility criteria stated in the solicitation document. All bids substantially compliant at this stage will go through the evaluation of technical and financial aspects;
- b. Technical evaluation of bids, determining which are compliant with the mandatory criteria (if included in the solicitation document) and substantially conforming with the technical criteria, and rejecting non-compliant bids. Only bids meeting or exceeding the criteria shall be considered substantially conforming;
- c. Financial evaluation of bids, by selecting for award the lowest priced bid among the substantially compliant bids, as per financial criteria in the solicitation document. Nevertheless, since an ITB is a one-envelope procedure, the financial evaluation shall include all prices of both compliant and non-compliant bids to be presented to the Procurement Approving Authority.

#### 8.4.3 Cumulative/Weighted Analysis

This method of evaluation is used when the solicitation is made through an RFP (see [Chapter 6.3.5 Request for Proposal](#)) and the evaluation is based on criteria other than price in order to ensure Best Value for Money. The combined analysis methodology consists of the following steps:

- a. Preliminary screening of proposals, including an assessment of whether proposals comply with the formal and eligibility criteria stated in the solicitation documents. All proposals deemed compliant at this stage will go through the technical evaluation step;
- b. Technical evaluation (mandatory criteria), determining which proposals are compliant with the mandatory criteria (if included in the solicitation document) and rejecting non-compliant proposals. Only proposals meeting or exceeding the mandatory criteria shall be considered compliant;
- c. Technical evaluation (technical criteria) determining the technical points achieved by each proposal as per the maximum points assigned per criterion included in the solicitation document and in the SSP. Only proposals that meet the minimum technical threshold indicated in the solicitation document (normally 60% or 70%) shall be deemed compliant;
- d. The Financial Evaluation Committee/Procurement Official shall review the technical evaluation report for accuracy and ensure it was conducted in line with the pre-established criteria and complies with procurement principles under Financial Regulation 5.12. Any discrepancies shall be communicated to the Technical Evaluation Committee for amendment of the report (see [Chapter 8.7 Financial Evaluation](#));
- e. Upon acceptance of the technical evaluation report, the Procurement Official shall request the TOC to open the financial proposals of the offers that achieved the minimum technical threshold. The maximum number of points for the financial proposals, as stated in the solicitation document and the SSP, will be allocated to the lowest price financial proposal;
- f. Combined analysis, whereby the proposal obtaining the overall highest score after combining the scores of the technical and the financial proposals may be considered to

constitute Best Value for Money. However, the recommendation for the award shall not be solely dependent on the total number of points, but also consider risk factors, quality considerations, and other suitable factors.

## 8.5 Preliminary Screening

To avoid spending further resources on the evaluation of invalid offers, offers containing material deviation may be rejected at an early stage of the evaluation process by performing a preliminary examination of offers against the formal criteria stipulated in the solicitation document.

Examples of formal compliance criteria are included in Chapter 6.4.6.1.

Offers may be rejected in the following situations (see [Chapters 8.8.1 Clarifications from Vendors](#) and [Chapter 8.8.2 Material Deviations](#): Material Deviations, in particular regarding the types of missing information that the bidder could be given the opportunity to provide):

- a. Absence of required bid/proposal security when applicable, or if it has been determined it is not compliant in terms of amount or validity period. A change in wording that is consistent with the prescribed format is not a material deviation. If there are concerns about the authenticity of the bid/proposal security, the Procurement Official should contact the issuing bank directly. If the issuing bank is unable to confirm the validity and/or authenticity of the document submitted as security, the chairperson of the evaluation committee must immediately report it to the Procurement Official, who shall in turn report to the VRC;
- b. Absence of bid or proposal submission form or lack of signature of the bid or proposal when this is clearly specified in the tender document as a requirement. Change in the wording that is consistent with the prescribed format is not a material deviation. A duly authorized signatory must sign the vendor's offer for it to be legally binding. If the bid or proposal do not contain the required signature, and provided that the signature of an authorized representative appears on a letter of transmittal or on another document attached thereto, and in the case of ITBs, the signature appears on the document where the total price of bid is stipulated, the UN shall assume that the omission was unintentional. However, the Procurement Official shall ask the duly authorized signatory to immediately confirm that the offer is legally binding and obtain the required signature. If the confirmation and signature is provided as requested, the UN may then accept the offer;
- c. Substantial financial information is included in the technical proposal envelope when conducting an RFP, and such information is related to the financial proposal unless approval from Director, PD or CPO has been obtained to accept the proposal.

Bidders can be held ineligible further to the provisions in [Chapter 3](#).

## 8.6 Technical Evaluation

All Submissions found compliant with the formal and eligibility criteria under [Chapter 8.5 Preliminary Screening](#) will go through to technical evaluation, which consists of two sub-steps: (i) evaluation of mandatory criteria (if included in the solicitation document) and (ii) evaluation of technical criteria.

### Evaluation of Mandatory Criteria:

If the solicitation included mandatory criteria, they must be evaluated at this stage. This is to ensure that the bidder is qualified and capable of successfully completing the contract, i.e., the entity meets legal and regulatory requirements, has the required minimum technical capability and experience, and is financially capable. Mandatory criteria, when included in a solicitation document, are evaluated on a pass/fail basis, regardless of whether these are included in an RFQ, ITB, or RFP.

### Technical Evaluation of Bids:

Bids received in response to an ITB must be assessed against the technical criteria specified in the solicitation document (specifications, TOR, SOW, and other requirements) on a pass/fail basis and must be rejected when they contain material deviation, i.e., when the specifications of the items quoted vary in one or more significant aspect(s) from the minimum required technical specifications and other requirements.

### Technical Evaluation of Proposals:

Proposals received in response to an RFP must be rated as per the criteria specified in the SSP and solicitation document. The technical proposal submitted by any bidder will be disqualified if the proposal does not obtain the minimum required number of points to qualify, as per the threshold stated in the solicitation document and the SSP. The corresponding financial proposal shall be retained unopened in the procurement file. However, any bid security or guarantee must be returned. The Procurement Official in charge of the solicitation exercise should ensure that the bid security contained in any unsuccessful submission is returned to the bidder promptly, following a contract award to the selected bidder.

## RESOURCES

Annex 11— Request for Technical Evaluation

### 8.7 Financial Evaluation

All proposals deemed technically compliant with the mandatory and technical criteria will go through to financial evaluation. Financial evaluation is the process of comparing the offers with the financial criteria stipulated in the solicitation document and determining the price upon which to base the evaluation.

Price is an important financial evaluation criterion, but the weight of the price depends on the evaluation methodology and financial criteria stated in the solicitation document, which may include life-cycle-cost analysis.

Taxes and duties should not be taken into account for the purpose of financial evaluation, unless included in the solicitation documents.

The Procurement Official, prior to financial evaluation, shall correct mathematical errors with the intent to arrive at the most accurate and reasonable interpretation through, e.g., professional judgment, correction of typographical errors and omissions, and through clarifications from the vendor. Such errors should be clarified with the bidder through official written communications authorized by the Procurement Approving Authority. While the correction of errors may lead to revised totals, the vendor may not use the opportunity to increase or lower prices, but rather to reflect the correct prices and totals as intended in the initial submission. Bidders shall be given a reasonable amount of time to respond to such clarifications.

In the case of an ITB, if there is a discrepancy between the unit price and the line item total that is obtained by multiplying the unit price by the quantity, the unit price shall prevail and the line item total shall be corrected, unless, in the opinion of the UN there, is an obvious misplacement of the

decimal point in the unit price. In such a case, the line item total as quoted shall govern, and the unit price shall be corrected.

After price correction has been completed, discounts, when applicable, should be evaluated; currency conversion into one base currency (as specified in the solicitation document) should also be completed.

Quantity discounts may be considered in the evaluation where quantities can be estimated with reasonable reliability in advance. The final price comparison, in one single currency, must consider corrected errors, quantity discounts, and any required adjustments.

For the procurement of goods, if offers were received under both FCA and other Incoterms, the evaluation report should explain how the evaluation team established that the selected Incoterm for the award is the most advantageous for the UN.

During the financial evaluation, a deviation would be considered material in any of the following situations:

- a. The bidder, during requests for clarifications by the Procurement Official, does not accept the required price correction, as per the condition of the solicitation document;
- b. The bidder offers less quantity than is required unless the tender allows for split awards and allows quotations in lots.

In the case of an RFP, generally the proposal with the lowest overall price receives the maximum score allocated to the financial evaluation. Other proposals receive a financial score that is pro-rated, in comparison with the lowest cost proposal.

#### Assessment of the Reasonableness of Quoted Prices:

In general, an assessment of the reasonableness of quoted prices is always recommended to establish Best Value for Money. However, it is mandatory when the response rate or rate of technical compliance is abnormally low. This is to ensure the price comparison is done between adequate comparators; for example, prices would tend to be lower from bidders that are not compliant (i.e., lower quality goods or services, longer delivery times than requested, etc.).

Several comparators can be used to determine whether the price is fair and reasonable, such as:

- a. Comparison with market price (i.e., prices offered by other vendors of the same or similar product or service);
- b. Comparison with valid LTA prices;
- c. Historical price (i.e., compare the current price to a price paid in the past for the same or a similar product, taking market trends into consideration);
- d. If the offer is custom-built, whether the cost breakdown of the offer shows that the price is fair and reasonable.

If, after price/cost analysis, the evaluation team does not consider the price to be fair and reasonable, the UN may seek to re-solicit the requirement or negotiate with the vendor(s) in an attempt to lower the price.

Generally, if a Submission is found to be technically non-compliant, the financial proposal is neither opened nor evaluated. However, in some circumstances, in order to ensure that the Organization is obtaining Best Value for Money, it may be prudent to open the financial proposal of a non-compliant Submission to undertake further due diligence and mitigate risk. For example, if only a low number of Submissions have been found to be technically compliant, then the Procurement Official may open one or more financial proposals of non-compliant Submissions in order to establish pricing benchmarks and verify that the pricing offered by the technically compliant Submission is fair and reasonable and provides Best Value for Money. The results of such a

benchmark can be used in making a decision to cancel and rebid the solicitation or seeking negotiations with the bidders with technically compliant bids. In this situation, the Procurement Official should also consider whether to review the technical specifications with the Requisitioner and other sources of technical expertise to ascertain whether the technical specifications are excessive or otherwise unnecessarily stringent. Opening of a technically non-compliant Submission's financial proposal may only be done on an exceptional basis, after obtaining authorization, in writing, to do so from the Director, PD or the CPO and providing an explanation of the reasons for requesting the exemption. If such authorization is granted, the opening should also be disclosed to the Contracts Committee, together with documented rationale.

## 8.8 Further Aspects of Evaluation

Only the Procurement Official shall be authorized to seek clarifications from bidders during evaluation. Direct contact between Requisitioners and bidders is prohibited and may give cause to cancel the solicitation process or reject the related bids.

### 8.8.1 Clarifications from Vendors

Offers shall be evaluated based upon the information provided in the offer. However, after the Submission of offers and upon preliminary examination, clarifications to the offers are sometimes required from bidders to conduct a proper evaluation process.

The Procurement Official shall apply professional judgment as to when clarification is warranted and when it is not. On the one hand, it is in the interest of the Organization to ensure that as many offers as possible are compliant with the needs of the UN for effective competition. On the other hand, the principle of fairness to bidders that presented good and timely offers must be observed.

Clarification requests should aim to:

- a. Clarify ambiguous aspects of an offer;
- b. Modify minor mistakes or oversights in offers;
- c. Ensure that administrative errors do not cause the disqualification of an otherwise potentially good offer;
- d. Rectify statements made in the offer that do not reflect the spirit of the solicitation documents;
- e. Request missing information.

Examples of when the Procurement Official may consider that a request for clarification is warranted are:

- a. When the bid bond was not found in the offer;
- b. When the bid bond contains language that deviates from the standard bid bond language required in the solicitation;
- c. When the technical proposal contains financial information, however, such information does not seem likely to be part of the financial proposal (e.g. pricing of ancillary equipment is mentioned in the technical proposal; however, it is not clear that it is the price offered to the UN as part of the financial proposal);
- d. When a bidder does not include proof of some important elements (e.g. a quality standard), while it is stated in their proposal that they are in the possession of such element;
- e. When a bidder does not include some specific self-contained piece of information that makes them miss a mandatory requirement or lose a significant number of points in the technical evaluation, and it could be easily obtained (e.g., within five (5) business days). Examples of this could be a missing CV of the project manager, a missing reference of a client, etc.;
- f. When a bidder does not "check a box" or omits to provide a confirmation statement;

- g. When a bidder includes statements in the financial proposal that go against the spirit of the solicitation and it would cause the disqualification of its proposal. For example, the solicitation may require fixed prices, and the bidder may state in their financial proposals that prices will depend on the cost of raw materials. To make a comparison to other offers, the bidder may be requested to clarify whether the offer is in compliance with the instructions in the solicitation;
- h. When it is in the UN's interest to eliminate minor irregularities, informalities, or apparent clerical mistakes in the Submission.

However, clarification requests should not be aimed at allowing bidders a second chance to resubmit significant parts of their offer after the submission deadline, since this would not be fair to bidders that submitted a complete proposal in time.

Examples of when a Procurement Officer should not request clarification from a bidder:

- a. When a significant part of the bidder's offer is missing, the bidder should not be given the chance to supplement such significant part after the closing time;
- b. When the offer is manifestly lacking in many aspects, it should be avoided to send multiple clarification requests covering a multitude of aspects.

To ensure that clarifications remain focused on specific aspects and do not become overly general, a limited time to respond should be given to the bidder. In no case should the bidder be allowed more than five (5) business days to respond to the request for clarification. Should the bidder respond after the deadline set by the Procurement Official, their response should generally not be taken into consideration unless exceptional circumstances apply.

Clarifications should be sought and preferably received via formal communication since they will become part of the bidder's offer. Any communications with bidders during the solicitation process must be kept in the case file. All correspondence with vendors will be in writing (email is acceptable but should be authorized by the Procurement Approving Authority that signed the solicitation documents or by his/her authorized designee) and must form part of the procurement record.

### 8.8.2 Material Deviations

The UN must maintain fairness and transparency and ensure that offers are rejected only when a deviation from the requirements is material. In some cases, a substantially conforming or technically compliant offer could contain non-material deviations. To achieve Best Value for Money, it is important not to disqualify offers solely for non-material (minor) deviation(s). A material deviation is one that:

- a. Would affect in any substantial way the scope, quality, or performance of the goods and related services specified in the contract;
- b. Would limit in any substantial way, by contradicting the bidding documents, the UN's rights or the bidder's obligations under the contract;
- c. If rectified, would unfairly affect the competitive position of other bidders presenting substantially responsive bids.

To this end, the Technical Evaluation Committee chairperson and the Procurement Official responsible for the respective procurement exercise must have a clear understanding of what represents a material deviation. During the evaluation of the offers, consistency must be applied when determining whether a deviation is a material. The evaluation report must identify any deviations encountered during each step of the evaluation process.



### 8.8.3 Apparent Errors in Price

The UN is not responsible for errors in price made by bidders. However, the UN shall verify prices in cases where it believes there is an error (e.g. a specific item price that is very high or very low). The vendor shall then be informed that revision of the original price is prohibited, and that non-compliance shall result in rejection of the offer. If the vendor confirms that the original price is correct, the evaluation can proceed. Should the vendor acknowledge that the price is incorrect and the price is material to the selection of the vendor, the offer may be rejected in order to adhere to the principle of fair and equal treatment of all vendors, unless the Procurement Approving Authority considers it in the best interest of the UN to accept such bid/proposal; otherwise, the offer shall be rejected. The communication with the vendor and any internal decisions must be in writing and kept on file for the record to facilitate audits.

### 8.8.4 Abnormally Low Offers or Submissions

An abnormally low offer or submission is one where the price, in relation to the scope, methodology, technical solution, and requirements, appears so unreasonably low that it raises concerns regarding the bidder's ability to perform the contract successfully.

When an abnormally low offer or submission is identified, the Procurement Official shall seek written clarifications from the bidder, including detailed price analysis of how its financial offer or submission correlates with the scope, proposed methodology, schedule, and allocation of risks and responsibilities, without changing the original submission.

After the evaluation of the information and detailed price analyses presented by the bidder, the Procurement Official may:

- a. Accept the offer or submission;
- b. If appropriate, require that the amount of the performance security be increased at the expense of the bidder to a level sufficient to protect the UN against financial loss in the event of default of the successful bidder under the contract;
- c. Reject the offer or submission.

### 8.8.5 Evaluation by Lots

Where the solicitation document states in the Special instructions and evaluation criteria that evaluation will be done by lot, the evaluation must be done as per the provisions stated under the evaluation criteria section of the SSP and the solicitation document. The SSP and the special instructions and evaluation criteria shall include details on how the UN will award lots. Such criteria shall allow evaluation of each lot(s).

### 8.8.6 Review of Offers Received in Situations of Direct Contracting or Sole Sourcing

When direct contracting under sole sourcing is justified and an offer has been requested further to [Chapter 6.9](#), such offer should be evaluated. In order to facilitate the evaluation process, Procurement Officials should request the vendor to provide information that would allow for a comprehensive assessment of its offer based on pre-established evaluation criteria and that would ensure it meets the needs of the UN.

The purpose of such evaluation is to assess whether the offer is of acceptable quality at a justifiable price. To ensure the quality of the offer, it should be evaluated as compliant/non-compliant, and the offer should only be accepted if considered compliant. The evaluation must be carried out by technical and financial evaluation committees composed of technical experts and Procurement Officials, respectively.

Further to the evaluation process, negotiations are usually recommended in direct contracting situations to ensure Best Value for Money. See [Chapter 8.9 Negotiations](#) for details.

### 8.8.7 Complaints and Representations

Replies to representations and complaints made by bidders during (and after) the evaluation process must be in line with what may or may not be disclosed, as stated in the solicitation document. Depending on the nature of the complaints and representations received, the Procurement Official should consider seeking advice from OLA or a Legal Advisor before replying. Whenever a complaint warrants senior management's attention, the Procurement Official should always send the complaints immediately to the procurement head of the relevant UN Secretariat entity, with a copy to Director, PD. These complaints and representations are to be distinguished from procurement challenges submitted following a solicitation process, in accordance with [Chapter 10](#) on procurement challenges.

### 8.8.8 Indications of Potential Proscribed Practices

While conducting an evaluation of Submissions, the technical evaluation committee and the Procurement Official should satisfy itself that there is no indication of fraud, collusion, or suspicious actions by some bidders, including those that might point to the existence of a cartel.

The following are typical 'red flags' indicating risks of potential proscribed practices.

#### Patterns of Potential Fraud:

- a. Bid/proposal securities submitted show apparent irregularities (e.g. logos or names or issuing banks);
- b. Registration certificates show inconsistencies, e.g. in terms of dates, registration institution, etc., or frequent changes of the company name;
- c. Quality certificates are issued by dubious providers;
- d. Bank account information provided on the vendor form is under the name of an individual and not a company;
- e. Staff members are involved in the bidder's corporate structure or are named as beneficiaries of related bank accounts.

Patterns of collusion are hard to detect because agreements are secret in nature. These may include bid-rigging (competitors agree in advance who will submit the winning bid) and price-fixing (agreement by competitors to raise, fix, or maintain the price for goods or services), as detailed below.

#### Patterns of Potential Bid Rigging:

- a. The same vendors submit bids and each company seems to take a turn being the successful bidder;
- b. Some bids are much higher than published price lists, previous bids by the same firms, or cost estimates;
- c. A company appears to be bidding substantially higher on some bids than on other bids, with no apparent cost differences to account for the disparity;
- d. Bid prices drop whenever a new or infrequent bidder submits a bid;
- e. A successful bidder subcontracts work to competitors that submitted unsuccessful bids for the same project;
- f. A company withdraws its successful bid and subsequently is subcontracted work by the new winning contractor;
- g. Schedules are split between bidders (i.e., one bidder is lowest for schedule one, the other for schedule two, or one bidder quoted for schedule one only, another bidder for schedule two only, etc.);
- h. Bank guarantees submitted by different bidders have been issued by the same bank and have almost identical reference numbers (e.g. A-123 and A-124);

- i. Details regarding ownership and management in respect of several bidders show that these bidders have the same key personnel, such as directors, partners, owners, etc.

#### Patterns of Potential Price Fixing:

- a. Prices of multiple bidders are identical, especially when prices stay identical for long periods of time and prices were previously different;
- b. Price increases do not appear to be supported by increased costs;
- c. Discounts are eliminated, especially in a market where discounts historically were given;
- d. The proposals or bid forms submitted by different bidders contain irregularities, such as identical calculations or spelling errors, similar handwriting, or similar stationery. This may indicate that the designated low bidder may have prepared all or part of the losing bidder's offer;
- e. Bid or price documents contain white-outs or other physical alterations indicating last-minute price changes;
- f. A company submits a bid when it is incapable of successfully performing the contract (likely a complementary bid).

When there is an indication of potential proscribed practice, Procurement Officials must report this immediately to the Director, PD or the CPO with a copy to the VRC and OIOS. Unless the alleged proscribed practice is completely evident, the Procurement Official should not reject bids received until OIOS does a first assessment of the case. If OIOS decides to carry out a formal investigation (because there is sufficient evidence to substantiate the allegations), then the Procurement Official shall seek the decision of the Director, PD or the Chief Procurement Official whether to reject such bids, without waiting for the outcome of the full OIOS investigation and the VRC's determination.

#### 8.8.9 Best and Final Offer (BAFO)

The "Best and Final Offer" (BAFO) is an optional step in the selection of offers that has the objective of enhancing competition and thus ensuring Best Value for Money for the UN. BAFO shall be applied only once during the solicitation process.

Sound professional judgment should be applied when determining the circumstances in which the use of BAFO is justified. In such cases, approval must be sought from a Procurement Approving Authority. This will usually be the same authority that approved the issuance of the solicitation documents. The request for approval will specify the reasons why a BAFO is justified and will be kept on file.

Bidders are cautioned to propose their best possible offers at the outset of the original proposal process, as there is no guarantee that any offer will be allowed an opportunity to submit a Best and Final Offer. When submitting their offers in response to a solicitation, bidders should not rely on BAFO being requested by the UN at a later stage, as this may or may not happen for reasons that are outside of the bidders' control. Procurement Officials should be aware that excessive use of BAFO might encourage bidders to regularly keep a margin of safety in their initial offers. A BAFO shall be used sparingly for the reasons indicated below.

There are two scenarios in which BAFOs may be used:

#### Two or More Offers are "Commercially Tied":

The Procurement Official will apply sound judgment to determine when two offers are commercially tied; such determination will greatly depend on the type of commodity/market for each requirement. Offers may be considered "commercially tied" when either (i) the financial evaluations or (ii) the Best Value for Money calculation (a reflection of the value of the offer) are within a very close range of 5%. Where industry characteristics, recent changes in the market or past experiences with solicitations in the same industry give reason to believe that a BAFO would meaningfully

improve the outcome of the solicitation, a BAFO may also be considered in situations where the Best Value for Money calculation or price differentials exceed 5%.

In this scenario:

- a. Only bidders that are considered to be 'commercially tied' will be invited to participate in the BAFO;
- b. Bidders will be requested to submit only an updated financial proposal; the technical proposal will continue being valid;
- c. The BAFO shall state that Bidders may only decrease prices, increase discounts, or provide other benefits to the UN, or leave prices all unaltered;
- d. An extended bid validity may be requested.

There are changes in the conditions of the solicitation that require bidders to refine their offers:

Sometimes, in the course of a solicitation, the Procurement Official may be informed of changes in the underlying assumptions of the scope of requirements (e.g. a change in the estimated number of required units, of the required delivery terms, etc.). In rare circumstances, it may be required to request supplemental information from bidders to address some changes in the requirements that could not be contemplated at the time of issuance of the solicitation. In addition, there may be a need to correct factual errors in the solicitation documents or clarify the requirements.

Should those changes affect the scope of the requirements substantially, the solicitation should be cancelled and re-tendered. However, in the case that the changes do not substantially affect the scope of requirements, in the interest of time, the Procurement Official may consider the use of BAFO prior to finalizing the solicitation upon the approval of the Director, PD or CPO. The Procurement Official will be mindful, though, that this use of BAFO shall not be utilized to limit competition.

Prior to issuing a BAFO, the Procurement Official will determine how the offers will be assessed to determine Best Value for Money, in line with the methodology established in the SSP. As such, the Procurement Officer will determine if the Technical Evaluation Committee may need to reconvene in order to refine the Technical Evaluation Report in light of the newly provided information, or if this is not necessary. The method of evaluation, as stipulated in the SSP, will continue to apply.

The following principles apply:

- a. All bidders that may have a reasonable chance of winning the award will be invited to participate in the BAFO. This may be limited to technically compliant bidders only or may be extended to all bidders that submitted offers at the judgment of the Procurement Official;
- b. Bidders will be informed of the documents that they need to submit.

The BAFO request will establish a new closing date and time for the Best and Final Offers. The receipt of the Best and Final Offers will be done by the Tender Opening Committee, which will disclose all offers to the Procurement Official at the same time, after the closing time. BAFO openings are not public, and the UN may use electronic means to receive them in the interest of time (e.g. to a dedicated e-mail TOC address).

The Procurement Official may not receive the responses to BAFO on his or her personal e-mail. In case of receipt of a BAFO by a Procurement Official, it will be communicated promptly to the Procurement Approving Authority that approved the issuance of the solicitation. This may lead to disqualification of the bidder or the offer at the sole discretion of the UN.

Procurement Officials should take the following into account:

- a. BAFO may only be used once for each competitive process to avoid the impression among bidders that the procedure is being used to favour any vendor. In the extremely rare

- circumstance that a second BAFO round may be strictly necessary, the Procurement Official may consider other options, such as initiating a rebid or requesting to enter into direct negotiations;
- b. Bidders are not obligated to alter their proposals as a result of the request of BAFO;
  - c. The Procurement Official will not disclose the reasons why a BAFO is being requested, the number of bidders from which it is being requested, or any information about the technical or financial evaluation of each bid;
  - d. The Procurement Official will keep the results of the financial evaluation strictly confidential during the BAFO process;
  - e. Letters of regret for bidders that were not invited to the BAFO will be issued at the same time as all other letters of regret, following signature of the awarded contract.

## 8.9 Negotiations

Negotiations are discussions with a potential vendor after consideration for award recommendation, either:

- a. Following HCC/LCC review leading to a rejection of bids under Financial Rule 105.15(c) by the Authorized Official;
- b. Following the rejection of bids by the Procurement Approving Authority under Financial Rule 105.15(c);
- c. In instances in which negotiations would be justified, such as sole source or Letters of Assist (see [Chapter 6.8](#) and [Chapter 14.3.1](#)). Approval to enter into negotiations needs to be obtained from the appropriate Procurement Approving Authority as per FR 105.16(a) or Authorized Official;
- d. In case of a need to amend a contract, such as extensions or increase in NTE amount under Financial Rule 105.13(b). ;
- e. When following a recommendation for an award in the professional judgment of the Procurement Official, more advantageous terms to the United Nations could be achieved that are not material to the award decision. In such a case, the recommendation of the Review Committee or approval of the Authorized Official to negotiate is not necessary. The Financial Rule used for the award will, therefore, remain Financial Rules 105.15(a) or 105.15(b), as the case may be;
- f. Following HCC/LCC review leading to an award where there is an additional recommendation to conduct negotiations.

The following procedures should be followed when conducting negotiations:

- a. It is recommended that in complex cases, prior to the start of negotiations, the negotiation team prepares a strategy and plan with a brief outline of the expected negotiation outcomes (not to be shared with the bidder) and that each individual is given specific roles and responsibilities in the process (see [Chapter 8.9.2](#));
- b. While negotiations are usually conducted in person or telephonically, in some cases, the Procurement Official may determine that it is in the best interest of the United Nations to obtain written offers as the starting point of the negotiations. The Procurement Official may request vendors to follow certain formats to submit their offers;
- c. In cases in which negotiations are conducted with more than one vendor, it is recommended that offers be received through the dedicated e-mail address of the Tender Opening Committee. The TOC will release all offers to the Procurement Official at the same time;
- d. The Procurement Official may conduct as many rounds of negotiations as necessary until the efforts seem to be exhaustive;

- e. UN staff members should treat all vendors involved in a negotiation process fairly and in an equitable manner;
- f. Negotiations are confidential between the UN and the vendor, and neither party may reveal information relating to the negotiations. Vendors should be informed of the same upon initiating the negotiations;
- g. When physical meetings or teleconferences are required, a minimum of two UN staff must be involved. Amongst the two personnel, one must be the Procurement Official;
- h. The Procurement Official shall lead the negotiations. Other participants may be required to attend, depending on the envisaged character of the negotiations. Such participants may include technical experts, legal officers, etc.;
- i. Meetings shall be recorded in writing; the minutes should be placed in the case file, and the results of the negotiations must be recorded in a note to the file or similar document.

#### 8.9.1 Negotiations in Case of Sole Source

In instances where direct contracting is justified, negotiations are normally recommended in order to ensure Best Value for Money. Since no competitive solicitation process has been carried out, the UN has no immediate evidence that the product offers acceptable price and quality. Therefore, the UN needs to make every effort to justify the selection and ensure the reasonableness of price by attempting to obtain the most favourable terms and conditions for every aspect of the vendor's offer. Proper costing studies, market research, expert consultations, and verification of client references are key activities to be performed prior to such negotiations. Please refer also to [Chapter 6.8](#).

#### 8.9.2 Negotiation Strategy

In complex cases, prior to negotiations, the Procurement Official may establish the negotiation strategy in a document, which should be marked "Commercially in Confidence" and must be restricted only to the Procurement Official, Requisitioner, and legal officer involved in the case, to ensure the integrity of the process. Such a document may include the following information:

- a. List of vendors invited to the negotiations;
- b. List of UN staff participating in the negotiations;
- c. The objectives of the negotiations, including the desired outcomes in order of importance;
- d. The scope of the negotiations (financial, technical, legal, etc.);
- e. The timelines for negotiations;
- f. The techniques that will be used to obtain the desired results;
- g. The Best Alternative to a Negotiated Agreement;
- h. The decision-making criteria that will be considered for the award, if negotiations are being conducted with more than one bidder;
- i. Other relevant information.

### 8.10 Final Evaluation and Recommendation for Award

The results of the technical evaluation shall be documented in a technical evaluation report. The level of detail of the technical evaluation report should be commensurate with the complexity of the process. Although the use of evaluation tables is best practice, it is not mandatory for informal methods of solicitation, such as LVA and RFQ. When evaluation tables are used, a signed copy of the filled in technical evaluation table must be submitted to the Procurement Official with the submission date and the tender number clearly identified. The submission must be signed by the Chairperson of the technical evaluation committee or the Section Chief or other official that signed the SSP.

The technical evaluation report must be dated, identify the tender number and description of the goods and/or services to which it relates, and the name of each technical evaluation member must be printed under the signature. It shall be signed by all the members of the technical evaluation committee, initialed on every page by at least two members of an evaluation team, and kept on file for future reference. The report shall describe the application of the technical evaluation criteria stipulated in the SSP in relation to each bidder's submission. This should include narratives for each criterion evaluated, whether scored or assessed on a pass/fail basis. The narrative must sufficiently outline the rationale for the decision taken by the Technical Evaluation Committee.

Upon receipt of the technical evaluation report, the Procurement Official or the Financial Evaluation Committee shall perform the financial evaluation, make a final comparison of the competing proposals in accordance with the terms of the solicitation documents and the SSP, record its findings, and advise the Evaluation Committee of the recommendation of award.

The findings will later be used as the basis for the recommendation of award. The recommendation for the award shall contain a summary of the evaluation process, as well as details of the evaluation steps performed and key criteria therein (i.e., preliminary examination, technical and financial evaluation). When the solicitation method is an RFP, the technical evaluation section must include a clear narrative supporting the points allocated to each technical proposal. Any rejection, non-compliance, and clarifications of offers must be clearly stated, including a list with the final ranking of the offers and the reasoning behind the selection of the winning offer.

All unsuccessful bids should be retained in the procurement file. However, any bid security or guarantee must be returned. The Procurement Official in charge of the solicitation exercise must ensure that the bid security contained in any unsuccessful submission be returned to the bidder promptly following contract award to the selected bidder.

Unsuccessful bidders will be notified only after the contract is awarded and all contract documents are duly executed.

In the case when the evaluation methodology is "lowest-priced technically acceptable offer" or "lowest-priced substantially conforming offer," attention should be given to ensure that the reasons for disqualifying offers with prices lower than the selected offer are clearly stated in the technical evaluation report and in the case presentation.

## RESOURCES

Annex 12— Additional Guidelines for Implementing Best Value for Money



## 9. Review by Committees on Contracts

### 9.1 Mandate of Committee on Contracts

Pursuant to the provisions of Financial Rule 105.13 (b), Review Committees on contracts are established at Headquarters (HQ) and other locations to render written advice on proposed procurement actions. In accordance with Financial Rule 105.13 (c), where the advice of a Review Committee is required, no final action leading to the award or amendment of a procurement contract may be taken before such advice is received. The terms of reference and the rules for the composition, work, and authority of review committees on contracts are set forth in the applicable administrative issuance.

The primary responsibility of the Review Committees is to ensure that proposed procurement actions are based, *inter alia*, on compliance with the Financial Rules and Regulations, relevant Secretary-General's Bulletins and Administrative Instructions taking into consideration the guidance provided by the Procurement Manual. The Review Committees are not responsible for reviewing or providing advice on the adequacy or necessity of the requirement being met under the proposed procurement action, but may ask questions and make observations, on the adequacy or necessity of the requirements of the proposed procurement action.

### 9.2 Thresholds for the Headquarters Committee on Contracts (HCC)

In any of the following cases, irrespective of whether the procurement action originated at HQ or in another UN Secretariat entity, in accordance with the Financial Regulations and Rules, the recommendation of the HCC, and the approval of the relevant Authorized Official shall be obtained prior to any contractual commitment being made:

- a. Any award to a single contractor in respect of a single requisition or a series of related requisitions that exceeds US\$ 1,000,000 based on the contract value or gross revenue to the contractor during the term of the contract including any optional extension periods;
- b. Any contract or series of related contracts that involve income to the Organization, including contracts for the disposal of UN property through sale, that during the term of the contract including any optional extension periods exceed US\$ 1,000,000 based on the income to the Organization;
- c. Any LOAs with the Member States where the value exceeds US\$ 1,000,000 during the term of the agreement<sup>5</sup>;
- d. Any amendment, modification, or renewal of a contract previously reviewed by the HCC where the modification increases the originally approved contract value or gross revenue to the contractor by more than 20% or US\$ 500,000, whichever amount is lower;
- e. Any amendment, modification, or renewal of a contract previously reviewed by the HCC that involve income to the Organization, including contracts for the disposal of UN property through sale, where the modification decreases the originally approved income to the Organization by more than 20% or US\$ 500,000, whichever amount is lower;
- f. Any amendment, modification, or renewal of a contract, including contracts that involve income to the Organization and the disposal of UN property through sale, previously reviewed by the HCC where the modification increases the originally approved contract duration by more than eight months;
- g. In the case that both the contract value (including approved revenue to the contractor and income to the Organization) and the duration of the contract are modified, either simultaneously or sequentially, review by the HCC is not required when the (cumulative)

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<sup>5</sup> LOAs are contracts and their amendment or extension subject to the same review process as any other procurement contract.



- increase (or decreased in the case of income to the Organization) in value does not change the originally approved value by more than 20% or US\$ 500,000, whichever amount is lower, and the (aggregated) extension period does not exceed the originally approved contract duration by more than eight months. If either of these thresholds is exceeded, the review of the HCC is required;
- h. Once the originally approved contract value of a contract previously reviewed by the HCC (including approved revenue to the contractor and income to the Organization) has been amended by more than 20% or US\$ 500,000, whichever amount is lower, and/or the originally approved contract duration has been extended by more than 8 months, no further amendments can be made without review by the HCC;
  - i. Any outcome of the negotiations resulting from the HCC recommendation to reject all bids and negotiate in accordance with the Financial Rule 105.15 (c), where the proposed contract award exceeds US\$ 1,000,000;
  - j. Any amendment, modification, or renewal of a contract, including contracts that involve income to the Organization and disposal of UN property through sale, not previously reviewed by the HCC where the aggregate contract value (including approved revenue to the contractor and income to the Organization) now exceeds US\$ 1,000,000;
  - k. Any amendment, modification, or renewal of a contract, including contracts that involve income to the Organization and disposal of the UN property through sale, previously reviewed by the HCC where, in the judgment of the Director, PD or CPO, such amendment would have significantly affected the procurement process that led to the original contract award, the criteria on which the original award was made, or the original contractual terms. The committee shall review such proposed modification with reference to the criteria on which the original award was approved;
  - l. Any other matter referred by an authorized official relating to a contract award or modification;
  - m. Any contract or amendments thereof established under Financial Rule 105.17(a) shall not be subject to the review by the HCC except in cases of common procurement actions carried out together by the United Nations and other organizations where the United Nations acts as a lead agency.

### 9.3 Thresholds for Local Committees on Contracts

In any of the following cases, in accordance with the [Financial Regulations and Rules](#), the recommendation of the LCC and the approval of the relevant Authorized Official shall be obtained prior to any contractual commitment being made:

- a. Any award to a single contractor in respect of a single requisition or a series of related requisitions that exceeds the delegation of authority of the CPO based on the contract value or gross revenue to the contractor during the term of the contract including any optional extension periods but does not exceed US\$ 1,000,000;
- b. Any contract or series of related contracts that involve income to the Organization, including contracts for the disposal of UN property through sale, that exceeds the delegation of authority of the CPO during the term of the contract including any optional extension periods based on the income to the Organization but does not exceed US\$ 1,000,000;  
For cases requiring review by the HCC, Authorized Officials at their sole discretion may request prior review by an LCC;
- c. Any amendment, modification, or renewal of a contract previously reviewed by the LCC where the modification increases the originally approved contract value or gross revenue to the contractor by more than 20% or the delegation of authority of the CPO, whichever amount is lower;

- d. Any amendment, modification, or renewal of a contract previously reviewed by the LCC that involves income to the Organization, including contracts for the disposal of UN property through sale, where the modification decreases the originally approved income to the Organization by more than 20% or the delegation of authority of the CPO, whichever amount is lower;
- e. Any amendment, modification or renewal of a contract, including contracts that involve income to the Organization and the disposal of UN property through sale, previously reviewed by the LCC where the modification increases the originally approved contract duration by more than eight months;
- f. In the case that both the contract value (including approved revenue to the contractor and income to the Organization) and the duration of the contract are modified, either simultaneously or sequentially, review by the LCC is not required when the (cumulative) increase (or the decrease in case of income to the Organization) in value does not change the originally approved value by more than 20% or the delegation of authority of the CPO, whichever amount is lower, and the (aggregated) extension period does not exceed the originally approved contract duration by more than eight months. If either of these thresholds is exceeded, the review of LCC is required;
- g. Once the originally approved contract value of a contract previously reviewed by the LCC (including approved revenue to the contractor and income to the Organization) has been amended by more than 20% or the delegation of authority of the CPO, whichever amount is lower, and/or the originally approved contract duration has been extended by more than 8 months, no further amendments can be made without the review by the LCC ;
- h. Any outcome of the negotiations resulting from the LCC recommendation to reject all bids and negotiate in accordance with the Financial Rule 105.15 (c), where the proposed contract award exceeds the delegation of authority of the CPO;
- i. Any amendment, modification, or renewal of a contract, including contracts that involve income to the Organization and disposal of the UN property through sale, not previously reviewed by the LCC where the aggregate contract value (including approved revenue to the contractor and income to the Organization) now exceeds the delegation of authority of the CPO;
- j. Any amendment, modification, or renewal of a contract, including contracts that involve income to the Organization and disposal of the UN property through sale, previously reviewed by the LCC where, in the judgment of the CPO, such amendment would have significantly affected the procurement process that led to the original contract award, the criteria on which the original award was made, or the original contractual terms. The committee shall review such proposed modification with reference to the criteria on which the original award was approved;
- k. Any other matter referred by an Authorized Official relating to a contract award or modification;
- l. Any contract or amendments thereof established under Financial Rule 105.17(a) shall not be subject to the review by the LCC except in cases of common procurement actions carried out together by the United Nations and other organizations where the United Nations acts as a lead agency.

#### 9.4 Submission to Review Committees on Contracts

For all procurement actions that require review by a Review Committee, the Director, PD, or the Chiefs of Service in PD, or the CPOs, or their duly designated representative, in consultation with the relevant Requisitioners, shall submit cases through an electronic submission system to the respective Review Committee by the established deadline. Such deadline shall be established by each Review Committee and communicated to the Director PD, or the CPOs as appropriate.

The Chairperson of a Review Committee may, at his/her sole discretion and in accordance with guidelines established by the Review Committee, accept the late submission of presentations (i.e., after the established time for submission of cases for regularly scheduled meetings) for procurement actions arising out of an emergency, exigent situations, or unforeseen operational urgency. Such Submissions are usually referred to as “Walk-In” cases. The terms of reference and responsibilities set forth in this chapter regarding normally submitted cases apply equally to “Walk-In” submissions. Justification shall be provided in writing to the Chairperson of the Review Committee from the relevant requisitioner in consultation with the Director PD or the CPO. A complete submission in accordance with standard requirements shall be presented to the Review Committee for any “Walk-In” cases.

Procurement Officials shall ensure that submissions to a Review Committee are comprehensive, factually accurate, and clear to facilitate the review of the procurement action. Procurement Officials shall also ensure that the recommended vendor is registered at the required level before submission of the case to a Review Committee. Submissions shall be in sufficient detail to enable the Review Committee to obtain an accurate and complete description of the procurement actions taken and the basis for the proposed award.

The Director, PD, or the CPOs and the requisitioning office shall ensure that relevant procurement and requisitioning staff are present at the Review Committee’s meetings to answer questions and provide clarifications when required.

In case of urgent procurement actions, the requisitioning office may request the Chairperson of the Review Committee that the minutes of the Review Committee recommendations be issued on an expedited basis. This request may be accepted or rejected at the sole discretion of the Chairperson of the Review Committee.

In cases of split awards, the entire procurement process and all awards, including those that individually do not exceed the threshold that requires submission to a Review Committee (LCC or HCC), shall be referred only to one Review Committee (either LCC or HCC) based on the recommended award with the highest NTE amount. Following the recommendation rendered by the Review Committee, the Authorized Official approves all award(s) deriving from the same procurement process, including those that fall below the threshold for Review Committees.

Field Missions, OAHs, Regional Commissions or Tribunals, or other UN Secretariat entities may be given LPA to undertake the procurement of Strategic Goods and Services. Procurement actions for Strategic Goods and Services with a value in excess of US\$ 1,000,000 shall be reviewed by the HCC and the Authorized Official shall send the case to the Director, PD for PD’s review before the case is forwarded to the HCC’s attention. The Director, PD or his/her duly designated representative, may request the CPO to provide clarifications and will submit the presentation to the HCC with PD’s comments. The CPO, the Requisitioner or their duly designated representative in the field, and the Procurement Official from Headquarters shall jointly present such cases to the HCC.

After the HCC’s review of such cases, the recommendations of the HCC will be submitted for the consideration of the Head of Entity of the requisitioning office.

## 9.5 Facilitation of the Review by the HCC/LCC

Procurement Officials are responsible for the following:

- a. Ensuring, in cooperation with the requisitioner, accurate, timely, and comprehensive presentations to the Review Committee, including a written justification for the proposed award(s) and a brief description of the purpose of the goods or services to be acquired. Presentations to Review Committees shall include, at a minimum, the documents set forth in Annex 13 (PD SOP No. 001 Quality Assurance Programme for HCC Presentations

- implemented at UN/PD) as appropriate. The Review Committees may also request additional documents, as they may deem appropriate;
- b. Providing to the Review Committees, upon request and in a timely manner, clarifications and/or additional information in connection with a case presentation in consultation with the Requisitioner as appropriate;
  - c. Ensuring that the procurement action is undertaken in accordance with the Financial Rules and Regulations, established procurement practices and procedures, applicable SGBs, and AIs.

## RESOURCES

Annex 13 (PD SOP No. 001 Quality Assurance Programme for HCC Presentations implemented at UN/PD)

### 9.6 Ex Post Facto Presentations to Review Committees

A submission to the Review Committee may be ex post facto in the following two cases, namely, (a) fully “ex post facto” cases and (b) partially “ex post facto” cases, defined as follows:

- a. Fully Ex Post Facto Case: A procurement action, whether a written contractual instrument exists or not, in which the UN entered into a commitment for the provision of goods and/or services in full prior to submission of the procurement action to the relevant Review Committee(s) for its recommendation to the Authorized Official;
- b. Partially Ex Post Facto Case: A procurement action, whether a written contractual instrument exists or not, in which the UN entered into a commitment for the provision of goods or services in part prior to submission of the procurement action to the relevant Review Committee(s) for its recommendation to the Authorized Official.

Although ex post facto cases are not specifically addressed in the Financial Rules and Regulations, they may be accepted by the Organization under exceptional circumstances, provided all other UN procurement practices and procedures have been followed. However, ex post facto cases should be rare exceptions, and when they occur, written justification shall be provided in the case presentation to explain the reasons why timely submission of the case was not possible. Such justification should identify the reasons for the ex post facto situation and propose how to address the root cause in order to avoid reoccurrence.

Procedures for Ex Post Facto Cases Submitted to the HCC:

- a. Ex post facto presentations submitted to the Review Committee shall be submitted in accordance with the procedures set forth in [Chapter 9.4](#);
- b. If PD determines that the presentation for Strategic Goods and Services is ex post facto and not presented as such by a UN Secretariat entity, PD may reject the case or accept the case and inform the HCC of such. The HCC may reject the presentation as non-compliant or note and forward the submission to the Authorized Official for a decision on how to proceed. The breakdown of the recommended amount shall detail the ex post facto portion;
- c. The Review Committee may take note of ex post facto cases submitted to it, or not take note and request clarification, and issue observations on the propriety of the action taken.



## 10. Awards

### 10.1 Award and Finalization

Contracts are awarded by the relevant Procurement Approving Authority and, when applicable, following the approval of the appropriate Authorized Official given subsequent to recommendations by a Review Committee as may be required. Refer to Chapter 2.6.1 Delegation of Authority and Chapter 9 Review by Committees on Contracts. Approvals for awards cannot be made by the Procurement Approving Authority or by the Authorized Official to vendors that are not registered at the appropriate Level with the UN Secretariat and/or are otherwise sanctioned, with the exception of joint ventures whose incorporation is reliant on the award, all in accordance with Chapter 3.

An award may be made following the approval by the appropriate Authorized Official, further to Review Committee recommendation, as applicable. The UN can enter into a contractual obligation with a vendor only after official award of a contract by the relevant Authorized Official (in case of Review Committee recommendation) or Procurement Approving Authority and fulfillment of any conditions to that award, such as a successful prototype inspection, request for parent guarantee, etc.

Contracts shall be awarded within the offer validity period. If it is not possible to award the contract within the original period of offer validity, an extension of the offer validity period must be requested from all bidders. A bidder may refuse the request without forfeiting its bid/proposal security. Bidders agreeing to the request will not be permitted to modify their bids/proposals but will be required to extend the validity of their bid/proposal securities (if applicable) for the period of the extension. As such, extensions should be requested as early as possible to allow bidders sufficient time to produce a new valid bid/proposal security before the expiration of the original.

The relevant Procurement Official must keep a note to the file or a Statement of Award on file for future reference, including the signed award decision or the justification not to award, as applicable. For cases reviewed by a Review Committee, minutes of the relevant Review Committee meeting and signed recommendations by the Authorized Official must be kept in accordance with established records retention policy (see [Chapter 13.9 Maintenance of Files](#)).

Although ex post facto cases are not specifically addressed in the Financial Rules and Regulations, they may be accepted by the Organization under exceptional circumstances, provided all other UN procurement practices and procedures have been followed. However, ex post facto cases should be rare exceptions, and when they occur, written justification shall be provided in the case presentation to explain the reasons why timely submission of the case was not possible. Such justification should identify the reasons for the ex post facto situation and propose how to address the root cause in order to avoid reoccurrence.

#### 10.1.1 Prototype Inspections

In the case where the complexity or type of goods so requires, a prototype or a first unit inspection prior to the signature of the contract may be conducted.

The purpose of this risk-mitigating measure is to ensure that the representations made by the bidder in its written technical proposal correspond to their actual product, quality assurance plan, or manufacturing environment, among other considerations. In such cases, therefore, prototype inspections should not be conducted as part of the Technical Evaluation but following a final review of the relevant Review Committee and approval by the Authorized Official. Prototype inspections should take place prior to contract signature to limit the legal exposure to the UN.

If a prototype inspection is relevant for a certain requirement, the Source Selection Plan and the solicitation documents shall indicate so. Bidders should be requested to assume all costs related to the construction of the prototype for inspection, while the UN will incur the related costs of the appointed inspectors.

Inspections of prototypes/first units shall be conducted by the Requisitioner or a third party hired by the UN in the presence of a Procurement Official, as needed. Such inspections shall be documented in detail with all information and pictures, including subcomponents, etc. so that the same can be used by Receipt and Inspection Units to ensure the compliance of the goods throughout the life of the contract.

If during the inspection it is found that minor deviations between the written technical proposal and the actual product exist, but at the UN's sole discretion such deviations can be easily and quickly rectified, the bidder may be given the opportunity to do so in a timely manner prior to contract signature.

If on the other hand, the deviations are numerous or critical in nature, the UN may, at its sole discretion, disqualify the bidder from further consideration and reconsider its recommendation of award. In such a case, a new recommendation for the award should be submitted to the relevant Review Committee or Procurement Approving Authority. When the bidder fails to pass the inspection, the UN reserves the right to claim damages from the bidder for any costs incurred (e.g. third-party inspector, travel costs, etc.) and to refer the bidder to the VRC for consideration of suspension as a UN vendor.

## RESOURCES

Annex 14— Statement of Award

## 10.2 Vendor Notification, Debriefing and Protest

### 10.2.1 Posting of Awarded Contracts

The UN posts on its website (<https://www.un.org/Depts/ptd/>, under the "Awards" link) information about all awarded contracts and purchase orders resulting from formal methods of solicitation for UN Secretariat entities. The notice of awarded contracts should contain a brief description of the contract, a reference to the solicitation number, the contract or NTE amount, the date of the contract/award, and the name and country of the vendor.

Procurement Officials shall issue written notification to the unsuccessful bidders, informing them of their unsuccessful submission ("Letter of Regret").

## RESOURCES

Annex 15— Sample Letter of Regret

## 10.2.2 Debrief Procedures

The UN Secretariat offers UN vendors who participated in solicitations resulting in awards above US\$ 200,000 an opportunity to obtain additional information on their unsuccessful proposals or bids through the debrief process described below.

The debrief is not an adversarial proceeding; rather, it is a collaborative learning opportunity for unsuccessful bidders and for the UN to exchange additional information on the reasons why the bid/proposal was not successful.

The purpose of the debrief is to discuss the unsuccessful bidder's submission in response to the solicitation documents and the applied evaluation process and procedure. It is not a forum to discuss the submissions of other bidders. In addition, it is not a forum for other issues or complaints, which the bidder may raise according to the provisions in [Chapter 8.8](#).

The scope of the debrief is to identify the strengths, deficiencies, or weaknesses of the bidder's bid/proposal. Debriefings do not discuss the following:

- a. Trade secrets or other proprietary information, including the methodology or approach of other bidders;
- b. Financial or cost information about other bidders;
- c. Other bidders' details.

An unsuccessful bidder may request a debrief in writing within a period of ten (10) business days after receipt of the Letter of Regret only. Upon timely receipt of such request, the UN will notify the bidder of the scope of the debrief as well as the date, time, and place for the debrief.

A debrief is a one-time event. Bidders will receive only one debrief per eligible solicitation. This will normally last for a maximum of up to one (1) hour, and no follow-up debriefs will take place.

The debrief meeting is generally conducted in person but can also be held via teleconference or videoconference. The debrief will be conducted in English, but translators and other special arrangements will be considered, if requested by the bidder and deemed necessary by the UN, as long as the bidder pays for any associated costs and arrangements.

In the case a solicitation has been issued by PD, the written request should be addressed to:

United Nations Procurement Division  
To the attention of: Director, Procurement Division  
United Nations Headquarters, New York, NY-10017, USA

Or by email: [dos-pd@un.org](mailto:dos-pd@un.org).

For other procurement offices, the letter of request for a debrief shall be addressed to the CPO of the respective entity.

The Procurement Official will invite and inform the unsuccessful bidder of the administrative details for the debrief. Should an invitation from the Procurement Official arrive later than ten (10) days after receipt of the request for debrief, the UN will ensure that a debrief is scheduled as a matter of priority. A delay does not entitle the bidder to submit a procurement challenge without a prior debrief meeting.

Bidders who have been formally debriefed and remain unsatisfied may file a procurement challenge within ten (10) business days of the debrief meeting. If the challenge is received later than ten (10) business days after the meeting, it is not receivable.



Procurement challenges are defined in this context as any complaint made post-award and post-official debrief by a bidder with respect to the technical and/or financial evaluation of their offer by the UN. A procurement challenge must not contain allegations against the successful vendor. A procurement challenge is not the right instrument to allege ethical violations. Such allegations should be directly reported to the Head of an Entity, the Director, PD, or OIOS and will be pursued outside of the scope of the Award Review Board.

### 10.2.3 Award Review Board

The Award Review Board (ARB) will review procurement challenges by unsuccessful bidders. The ARB is a UN administrative board that renders independent advice to the Under-Secretary-General for Management Strategy, Policy and Compliance (DMSPC).

The Registrar of the ARB will make an initial assessment of the procurement challenge and determine its receivability and eligibility for a review by the ARB. The Registrar's determination is final and not subject to appeal by any party.

Following a review of the case and upon receipt of the recommendation by the ARB, the USG, DMSPC takes a final decision, which is final and not subject to appeal by any party. Further details on the scope, composition of the ARB, its Secretariat, and any further rights and remedies are outlined in the TORs for the ARB (Annex 16).

It should be noted that the only financial compensation that may be granted to an unsuccessful bidder whose procurement challenge is deemed justified is the reimbursement of reasonable costs of the procedure (excluding legal costs, which shall not be compensated) up to a maximum of US \$50,000.

Should a procurement challenge be sustained, the awarded contract will not be suspended but may be limited in duration in case it is a multi-year contract. Further potential remedies are outlined in the TOR of the ARB. All bidders must be informed of the possibility to submit a procurement challenge in the solicitation documents.

## RESOURCES

Annex 16 - Terms of Reference for Award Review Board  
Annex 17a— Debrief Guidelines for UN staff  
Annex 17b— Debrief Guidelines for UN staff - Amendment 1  
Annex 18— Notice of Award of Contract  
Annex 19— Notice of Award for Purchase Order

## 11. Contract Finalization and Issuance Contractual Instruments

### 11.1 Contract Finalization and Issuance

A contract is a written, legally binding agreement between the UN and a contractor, which establishes the terms and conditions, including the rights and obligations of the Organization and the contractor.

### 11.1.1 Contract Preparation

After a solicitation process in which the UN has defined the requirements, a vendor may be selected based on an offer, and such vendor will be required to enter into a contract by the UN.

UN Standard Form of Contracts based on model templates approved by OLA should be attached in the solicitation as well as used for contract formation, which shall be completed using contract-specific data.

Modifications and/or additions to the UN Form of Contracts, including annexes, should be made after consultation with OLA or a Legal Advisor for legal terms and the Procurement Official for financial terms. Care must be taken not to include any requirements or conditions that contradict the [UNGCC](#) or the standard text of any of the documents.

Further to Financial Rule 105.18, written procurement contracts shall be used to formalize any award following a procurement activity.

### 11.1.2 Letter of Intent

A Letter of Intent (LOI) is a written statement of the intention to enter into a formal agreement and may be exceptionally used to allow vendors to mobilize for contract implementation before signature of the final contract can be affixed.

The LOI is a contractual instrument that entails substantial risk and must, therefore, be used only after a careful risk assessment and only by Procurement Officials with substantial and relevant contracting experience, in cooperation with Requisitioners with significant technical experience. Responsibility for risk assessment rests with the Procurement Approving Authority, which shall be held accountable. Advice on assessing the risk may be sought from the ASG, OSCM, OLA, or a Legal Advisor.

If an LOI is intended for use, the LOI must be cleared by OLA, limiting the UN's responsibility and allowing the UN to withdraw from the LOI with minimum legal and financial consequences.

An LOI shall only be issued after an award has been approved, and only when all financial terms have been completely agreed upon with the vendor and all contract costs are known to the UN. Thus, an LOI can only be used to initiate work while allowing additional time to finalize contract details, such as detailed timeline, details of personnel, negotiation of non-financial contract clauses, etc.

### 11.1.3 Contract Finalization Discussions with Vendors

The purpose is to clarify any remaining issues that are not defined by the requirements in the solicitation documents or by the vendor's offer, but which are essential for proper implementation of the contract(s). Contract discussions should result in a clear understanding of terms and conditions agreed upon by the parties and their respective responsibilities under the contract.

Certain key areas, such as detailed delivery plan, milestones, and in certain cases, special terms and conditions, may form part of the contract discussions. However, this should not be confused with negotiations, as these should be conducted prior to award, according to [Chapter 8.9](#).

There are no strict rules as to how to discuss pending details to be included in contracts. It is important to note that the UN should inform the vendor it discusses or negotiates with that the UN only accepts offers in writing. Else, by law, the results of verbal contract negotiations could form a contract and the vendor could begin performance.

No negotiations of significant contract terms and conditions should take place following contract award, as the modification of certain material provisions (e.g. limitation of liability, insurance, and liquidates damages) may disadvantage other bidders and expose the UN to bid protests.

#### 11.1.4 Advance or Progress Payments

No advance payments should be made, except when the conditions outlined in Financial Rule 105.19 apply. The Procurement Official shall record the reasons for advance or progress payments in the procurement case file.

Under certain conditions, the UN may agree to pay for partial delivery of the goods or upon completion of clearly defined milestones for services or works, provided adequate security for the advance or progress payment is established. In such cases, the Procurement Official should consider establishing specially developed payment terms taking payment flows into consideration, provided such terms are approved by the Director, PD or the CPO and are tailored to the specific procurement.

Lease payments paid in the same month to which they relate are not considered advance payments, regardless of whether they are paid on the first or last day of the month. However, lease payments paid prior to the month to which they relate are considered advance payments.

#### 11.2 Performance Securities

Performance securities can be requested by the UN from the selected vendor in order to mitigate the risk of vendor non-performance and breach of contractual obligations (such as the delivery of all equipment, services rendered, and works completed, as per the contract). Securities and guarantees are normally issued in the form of an unconditional and irrevocable on-demand bank guarantee. However, bonds, demand drafts, cashier's cheques, or irrevocable cheques certified by a bank can be accepted in lieu of guarantees if approved by OLA. This should be specified in the tender documents, along with UN templates for the same, if applicable.

If performance security is required, the vendor shall provide security for performance of the contract within a specified period of time of contract signature, in an amount that usually corresponds with a percentage of the total contract value (normally 5-10%). The proceeds of the security (an established amount) shall become payable to the UN in the event of the vendor's failure to perform.

Upon receipt of performance security, the Procurement Official will provide the security to the TOC together with the form attached as Annex 20 (Request for Safekeeping of Performance Bond). Subsequently, the TOC official shall submit the security to the Treasury to be kept in custody.

The UN shall return the performance security to the vendor after certification by Requisitioner or Final User of completion of the vendor's performance obligations under the contract, including any warranty obligations, if applicable.

A bank guarantee received on bank letter headed paper should follow the OLA-approved form and include the following:

- a. A definition of the parties involved: Principal, Issuing Bank, and Beneficiary;
- b. A reference to the underlying transaction/contract;
- c. The guarantee amount: the maximum amount payable and the currency in which it is payable;
- d. The period of validity;
- e. Documentation: Any demand for payment under the guarantee should be in writing and in addition to other documents that may be specified in the guarantee;
- f. Effective Clause: A guarantee enters into effect on the date of issuance unless the terms of the guarantee expressly provide that such entry into effect is to be at a later date or is subject to conditions specified in the guarantee and determinable by the Guarantor. In Advance Payment Guarantees, there should be a condition that allows for the guarantee to come into effect when the Principal/Applicant has received the advance payment;

- g. Reference to Applicable Rules: [ICC Uniform Rules for Demand Guarantees \(URDG758\)](#), [ICC International Standard Practices \(ISP98\)](#);
- h. Conditions for a Bank Guarantee Exercise, in particular: disbursement upon initial request (initially) without any objections; being irrevocable; being unconditional; being non-transferable;
- i. A form of exercise of the beneficiary to the guarantee (bank), namely a written request (beneficiary's affirmation), sent as a registered letter;
- j. Information that a partial and multiple fulfilments is allowed, up to the maximum amount of the sum guaranteed;
- k. There are no unauthorized provisions;
- l. The guarantee is signed by authorized signatories.

## RESOURCES

Annex 20 - Request for Safekeeping of Performance Bond

### 11.3 Signature, Issuance and Documentation

All contracts must be signed by a Procurement Approving Authority on behalf of the UN and by a duly authorized individual on behalf of the vendor. A contract will come into force once both contracting parties have signed it in writing.

The contract should be issued to the vendor, and the vendor should be instructed to return a signed scanned copy to the UN. The relevant official with the appropriate level of delegation of procurement authority shall countersign the copies, and the UN will send one copy to the vendor. The signed contract must be kept on record for future reference.

All pages of all the documents forming part of a contract or agreement to which the UN is a party, including all attachments, need to be initialed by duly authorized representatives of the parties, except for the page that contains the full signature block, which shall be signed by such representatives.

In all cases, care must be taken to ensure that the signatories to the contract are legal persons for the purposes of contractual relations and have the ability to represent and capacity to bind the respective contracting parties to the obligations thereunder.

Once a contract has been signed, it may be amended only if the contract provisions allow modifications and if additional related goods and/or services are to be provided/rendered by the same vendor in furtherance of the execution of the original contract. Each contract amendment must be in writing and must comply with applicable contractual terms and conditions and the UN's procurement procedures. All other situations call for a new solicitation process and establishment of a new contract.

### 11.4 Standard Contract Elements

A contract for goods or services between the UN and a vendor must, at a minimum, include:

- a. An instrument of agreement;

- b. UNGCC for goods, services, or goods and services as appropriate;
- c. Technical specifications, TOR, SOW, pricing (fees and rates, as applicable) and payment terms, template for performance securities, delivery requirements, etc. as well as any special conditions that may be required.

#### 11.4.1 Instrument of Agreement

The instrument of agreement must contain the following elements:

- a. Identification of the parties contracted, as well as the person authorized to act on behalf of the contracted party, including name, address, and contact details. In the event that the contract is the result of a joint offer, the UN will usually contract with one entity, which should always be the lead entity;
- b. Scope of the goods/ services being procured, and the quantity being provided, as well as entry into force and time limits of the contract;
- c. A reference to the contract documents (i.e., Special Conditions, UNGCC, etc.);
- d. Price and payment terms. Contracts should be denominated in the currency indicated in the bidder's offer, provided it was allowed for in the solicitation document. It is important to establish tangible indicators for payments, linked to milestones in the delivery of services or completion of works. For service contracts involving works, it is common to have interim progress payments based on a regular measure of the works completed. Final payment must always be based upon acceptance of documentation for completion of services or works or delivery of goods;
- e. A 'lump sum' contract is used whenever it is possible to determine with sufficient precision the quantity and scope of the goods/services required from the contractor;
- f. The 'unit price' contract should be used only when the nature of the services/ goods makes it impossible to determine, with sufficient precision, the quantity of the services/ goods required from the contractor. In this case, the contract sets a maximum amount for both the total amount and the provision of each component of the services (e.g. rate per workday, cost of each round-trip, etc.), and establishes the applicable unit price. The maximum amount cannot be exceeded.

Contracts valid over a longer period (over 12 months) may contain price adjustments linked to officially published price indices to cover changes in work rates. The increase may also be estimated and incorporated as a fixed rate over the entire life of the contract. Contracts for commodities whose price may fluctuate over time (e.g. petroleum products, metal products, etc.) may be based on commodities/mercantile exchange prices (e.g. Platts index or LME), provided this is clearly specified in the solicitation document. For such contracts, it is good practice to specify in the contract that the final price shall not exceed a specified maximum amount and that the contractor should adjust the quantity accordingly so that the contract amount is not exceeded. However, where possible, it is strongly recommended to avoid using price escalation; this is the default setting for all UN contracts for works, specifically.

Duration of the Contract: Starting and completion dates, as well as milestones for successful performance, must be precisely defined. Contracts for goods and services also should specify the name of key personnel and their input in terms of estimated man-days/weeks/months.

As for any litigious matters arising out of contract execution, the parties shall first attempt to resolve their dispute amicably through negotiations. If the dispute cannot be resolved amicably, the matter shall be resolved in accordance with the current [UNCITRAL arbitration rules](#). No choice of law-clause shall be included in the contract documents unless special authorization is provided by OLA. Instead, the arbitration provision shall state that in deciding the dispute, the arbitral tribunal shall be guided by general principles of international commercial law.

As a mandatory condition of doing business with the UN, it is necessary that vendors, as well as their subsidiaries, agents, intermediaries, and principals, cooperate with the OIOS, as well as with other investigative bodies authorized by the UN as and when required. Such cooperation shall include, but not be limited to, the following: access to all employees, representatives, agents, and assignees of the vendor, as well as the production of all documents requested, including financial records. Failure to fully cooperate with investigations will be considered sufficient grounds to allow the UN to repudiate and terminate the contract and to debar and remove the vendor from the UN's list of registered vendors.

#### 11.4.2 General Conditions of Contract (UNGCC)

The UN has developed UNGCC for goods, services, goods and services, and works (depending on the nature of the procurement), establishing a legal framework that forms part of every contract. The UNGCC may not be changed. If modifications or additions are required, those shall be made in the form of particular conditions in consultation with OLA.

The UNGCC contain specific provisions on mines, child labour, sexual exploitation, and the fundamental rights of workers. Vendors signing UN contracts automatically agree to abide by these conditions. Procurement Officials should bring these clauses to the attention of the vendor at the time of signing the contract.

The UNGCC apply to all UN contracts and form part of the contractual agreement between the UN and the vendor.

The UN generally does not agree to the use of the general terms and conditions of the other party. If requested to do so, please refer to [Chapter 6.4.9](#).

## RESOURCES

### **UN General Conditions of Contract (De Minimus Field Contracts)**

[https://www.un.org/Depts/ptd/sites/www.un.org.Depts.ptd/files/files/attachment/page/pdf/general\\_condition\\_field\\_contracts.pdf](https://www.un.org/Depts/ptd/sites/www.un.org.Depts.ptd/files/files/attachment/page/pdf/general_condition_field_contracts.pdf)

### **UN General Conditions of Contract (provision of goods and services)**

[https://www.un.org/Depts/ptd/sites/www.un.org.Depts.ptd/files/files/attachment/page/pdf/general\\_condition\\_goods\\_services.pdf](https://www.un.org/Depts/ptd/sites/www.un.org.Depts.ptd/files/files/attachment/page/pdf/general_condition_goods_services.pdf)

### **UN General Conditions of Contract (provision of goods)**

[https://www.un.org/Depts/ptd/sites/www.un.org.Depts.ptd/files/files/attachment/page/pdf/general\\_condition\\_goods.pdf](https://www.un.org/Depts/ptd/sites/www.un.org.Depts.ptd/files/files/attachment/page/pdf/general_condition_goods.pdf)

### **UN General Conditions of Contract (provision of services)**

[https://www.un.org/Depts/ptd/sites/www.un.org.Depts.ptd/files/files/attachment/page/pdf/general\\_condition\\_services.pdf](https://www.un.org/Depts/ptd/sites/www.un.org.Depts.ptd/files/files/attachment/page/pdf/general_condition_services.pdf)

### **UN General Conditions for Aircraft Charter**

[https://www.un.org/Depts/ptd/sites/www.un.org.Depts.ptd/files/files/attachment/page/pdf/general\\_conditions\\_air.pdf](https://www.un.org/Depts/ptd/sites/www.un.org.Depts.ptd/files/files/attachment/page/pdf/general_conditions_air.pdf)

#### 11.4.3 Technical Specifications, TOR, SOW

Technical specifications, TORs, SOWs, and other specifications should always be attached as an Annex to the contract or their contents included in the contractual document.

Care must be taken that the content of the annexes is consistent with the general and particular conditions of the contract.

#### 11.5 Purchase Order (PO)

A PO is a type of contract that documents the purchase of goods and/or services. The standard PO originated from UMOJA should always be used.

A PO is accompanied by a copy of the relevant packing and shipping instructions, as well as the UNGCC for goods and/or services (or reference is made to the UNGCC on the UN website).

#### 11.6 Long-Term Agreement (LTA)

An LTA is a written agreement between an organization of the United Nations system and a vendor that is established for a defined period of time for specific goods or services at prescribed prices or pricing provisions and with no legal obligation to order any minimum or maximum quantity. LTAs are used to safeguard a reliable source of supply for goods and services at a competitive price, in accordance with pre-defined terms and conditions. Goods and/or services available under LTAs serve a broad range of clients to meet commonly required, high-volume needs in the most time and cost-efficient manner (e.g., generators, uniforms, freight forwarding, etc.). Product and process



economic considerations are advised to be applied when purchasing outside of such Long Terms Agreements, which is a decision that is at the sole discretion of each entity, to obtain the best value for the Organization. To arrive at a completely transparent cost comparison, factors to consider include the price of the good or service, installation, maintenance and freight costs, as well as internal administrative costs associated with the acquisition process, from development of requirements to contract management. Such costs will vary on a case by case basis, but concepts like the cost of inspecting prototypes, conducting a solicitation, staff time, etc. can be considered as appropriate by each Entity.

The below provisions apply to LTAs issued by the UN Secretariat (which may also be referred to as systems contracts). Please refer to Chapter 14 for guidance on utilization of LTAs issued by other UN system organizations.

Since procurement through LTAs is a very efficient way to carry out procurement, all Procurement Officials should keep abreast of existing LTAs and assess if an LTA could be used for requirements. An [online catalogue](#) of existing LTAs (including managed turnkey contracts) has been developed by the Office of Supply Chain Management.

In addition, Procurement Officials should always consider whether the procurement actions they are undertaking themselves could potentially be the basis of an LTA. When establishing an LTA further to formal methods of solicitation, the tender document must make it clear that an LTA will be established as well as cover the following points: type of LTA and geographical or other coverage, description of the goods and/or services, duration, price adjustment methods (if applicable), and the award methodology, especially when it is expected to award more than one vendor.

#### 11.6.1 Benefits and Risks of Establishing LTAs

LTAs can achieve significant benefits, including:

**Competitive prices:** Aggregating the volume over the life of the LTA may lead to lower prices for some types of goods/services, based on the principle of economies of scale. LTAs can enable the UN to fully leverage its market position, taking advantage of its size, procurement volume, and geographical presence in order to obtain Best Value for Money. For instance, LTAs might include a provision that vendors must pass on any price reductions obtained through bulk purchase to the UN. The same may apply to pre-defined discount schemes in the contract once the UN has purchased a certain volume.

**A simplified business process leading to reduced transaction cost:** An LTA established by a single procurement process allows call-off orders at any time during the life of the LTA, thus avoiding the time and resources needed for repetitive procurement actions for the same set of goods or services.

**Consistency in quality and reliability of the source of supply:** By having established quality standards in the LTA, the time spent on inspection and possibility of rejection of goods/outputs are reduced.

**Standardization of requirements:** Promotes standardization of requirements across offices, which could contribute to a reduction in operation and maintenance costs and other efficiencies.

## BENEFITS OF LTAS

LTAs offer benefits such as competitive prices through economies of scale and consolidation, simplified processes, consistency in quality and reliability of supply, and standardization of requirements, as well as reduced lead-time.

They are also useful in start-up and emergency scenarios.

LTAs that are well set-up from a quality delivery timeline and cost perspective will also offer value to other organizations in the UN System, thus fostering cooperation.



Reduced delivery lead-time: As many aspects are pre-agreed and specified in the LTA, the lead-time between the call-off and delivery is significantly shortened, and this is particularly relevant during emergencies. LTAs are particularly useful for goods that can be stocked, or services set up for immediate mobilization or deployment.

### 11.6.2 Types of LTAs

There are three (3) main types of LTAs:

(i) Single-Vendor LTA: One vendor is supplying the total requirements for a given type of goods/services.

(ii) Multiple-Vendor LTAs Without Secondary Bidding: Two or more vendors are supplying the same requirements. Among others, the reasons for having multiple LTAs in place can be related to securing supplies at times of high demand through several sources, geographical location of the vendor (landed costs, shorter transit time, etc.), ability to provide after-sales service and support of the goods, or provision of the services at the specified location, etc.

Wherever the UN has established multiple LTAs with different vendors for the same product or services, Procurement Officials shall make sure they select the LTA which best suits the specific requirement in the respective area of operations. Such a decision should be consistent with the four principles of procurement under Financial Regulation 5.12.

The reasons for selecting a specific LTA for the issuance of call-off orders shall be documented in the procurement file including value for money assessment.

(iii) Multiple-Vendor LTAs With Secondary Bidding: Two or more vendors are supplying similar or identical requirements, and the final placement of each call-off is determined through secondary bidding. If secondary bidding is considered, it shall only apply to those components of a requirement with prices that are not fixed in the LTA (e.g. freight) or that are subject to ceiling prices. Other aspects, such as vendor capacity, delivery time, and mobilization time at the time of the request, may also be subject to secondary bidding.

Note: Some LTAs might include a combination of types (ii) and (iii) above, i.e., particular items, locations, or conditions where orders can either be placed directly to one of the LTA holders or be subject to secondary bidding. Instructions for usage of these types of LTAs must be clearly laid out.

The above types of LTAs can be further classified based on their geographical coverage:

- a. Country-Specific LTA: established for use by a specific entity to procure goods or services required in a specific country only. The LTA is set up and managed by the respective entity in that country. An LTA that has been set up in one country for goods and services sourced from within that country should not be used in another country, as the market conditions may vary between the two countries and usage across countries may not reflect value for money;
- b. Regional LTA: for use by several entities in a specific region of the UN's operation, to procure goods or services required in a specific region. Such LTAs may be set up and managed either by PD, a Regional Centre or an entity within that region;
- c. Global LTA: for use by all UN entities. Such LTAs are normally created and managed centrally by PD.

For the use of other UN Entity's LTAs, please refer to [Chapter 14.1 Cooperation with UN Organizations](#).

### 11.6.3 Establishment of a New LTA

The suitability of an LTA shall be considered during the category management strategy development and implemented at the procurement planning stage.

PD must be informed about upcoming LTAs that go beyond a local scope in advance (i.e., prior to initiating the procurement process) and, as necessary, will provide guidance on establishing the LTAs. As an LTA is created for a long duration and requires both upfront and long-term resources and expertise to set up and manage effectively, the decision to create an LTA should be based on a brief business case, which should outline the following elements:

- a. Description of goods/services required;
- b. Type of LTA and geographical coverage;
- c. Past spend data in the category and planned spend;
- d. Expected duration of the LTA(s);
- e. Price adjustment method, if any;
- f. Expected benefits and risks of the LTA;
- g. Results of market research: number of potential vendors, location, etc.;
- h. Procurement strategy: solicitation method, type of competition;
- i. Procurement process timelines.

### 11.6.4 Duration of LTAs

To ensure fairness and competitive terms and conditions, LTAs are typically valid for a period of three (3) years. LTAs may be extended for an additional period of up to 24 months, if provided for in the contract and subject to satisfactory vendor performance (to be documented in a vendor performance evaluation [see Chapter 13](#)), continuing requirement of the goods and services covered, and if the prices offered are within the current market range (e.g. the cost of IT equipment often falls over time and it might not be in the best interest of the organization to extend such an agreement). Foreseen durations beyond this maximum period of five (5) years (3+2) should be outlined in the business case and/or SSP, along with a justification of the need for such extended period, and be approved in advance by the Director, PD or the CPO.

### 11.6.5 Call-Off Orders Against an LTA

A call-off order refers to an order issued against an existing LTA. Call-off orders are not subject to review and recommendation by a Review Committee; however, such orders require approval by the relevant Procurement Approving Authority with the corresponding level of delegation. It is to be noted that the principles of cumulative/aggregate amounts do not apply to call-off orders.

In addition to ensuring that the Procurement Approving Authority has the required authority to approve the call-off order, she/he should also be satisfied that the instructions related to the applicability of the LTA have been followed. In particular:

- a. If the issuance of the call-off order is the result of a secondary bidding exercise, the Procurement Official must ensure that the ceiling prices specified in the LTA have not been exceeded;
- b. If the issuance of the call-off order is further to a multiple vendor LTA without secondary bidding, that value for money is achieved;
- c. The Procurement Official should be satisfied that any specific conditions of the LTA are met, such as the existence of maximum value for call-off orders, the maximum cumulative value per year, etc.;
- d. If the LTA, whether established by the UN or by another United Nations entity, is based on an exception to formal methods of solicitation, the Procurement Official should verify at the time of reviewing the call-off order that valid reasons exist for standardization, accelerated delivery, etc.

Call-off orders must state the details of the relevant LTA, such as the LTA reference number or other specifics that facilitate future reference.

## 11.7 Blanket Purchase Order

Upon request, the Procurement Office may arrange for certain departments and offices to order limited quantities of specified products and services through a BPO. The BPO is basically a simplified form of LTA. This instrument is usually reserved for repetitive orders up to a maximum total amount of US\$ 100,000 per year when items of low-value are not held in stock by the UN, services are required on short notice, or prices conform to a set pattern in the trade (e.g. prices found in catalogs). BPOs should not be used for large volumes of items even when they are of low value. All efforts should be made to use (or replace BPOs with) local systems contracts (with discounts on catalogs, if necessary) or service contracts (including applicable mechanisms for pricing services, e.g. repairs) with pre-agreed price structures and terms.

The Procurement Official shall establish BPOs on an annual basis for specific items based on Requisitions received from the departments or offices concerned. The procedures described in [Chapter 5](#) and [Chapter 6](#) shall be followed in selecting vendors to participate.

To prevent exceeding the BPO threshold, the same vendor should not be awarded more than one BPO at the time.

BPOs for goods and/or services can be entered into with multiple vendors. The UN has less cost control over the Vendor when using a BPO in that the initial market survey only gives a relative indication of prices for a representative sample of goods or services in a category. Essentially, the vendor may charge as it sees fit at the time an actual order is placed. Therefore, BPOs should only be used to purchase items that are difficult to specifically identify and quantify. Examples include spare parts, electrical components, engineering workshops components such as nails, bolts, etc. BPOs shall include a specified term (duration), a maximum NTE contract amount, instructions about procedures/authorization for ordering against the BPO, specifications about delivery procedures and terms of payment, provisions for possible price escalations, and other appropriate terms and conditions. UMOJA product category contracts may be used if a UMOJA catalog cannot be created due to a large number of items required.

The Requisitioner must identify the types of goods or services that may be needed under the BPO. The requirements should include a sample "shopping list" indicating as wide a range of products or services as possible, maximum delivery lead time, and, if appropriate, relative maximum quantities of those items. The Procurement Office will use the sample "shopping list" to perform a market survey, the result of which will be used to select a Vendor. The Requisitioner is not locked into ordering the items on the sample "shopping list" but may place orders for any item that falls into the product/service category covered by BPO.

The Procurement Official shall evaluate each BPO at the end of the year to determine whether it should be renewed. The Section Chief/ Director, PD or the CPO may approve the issuance of a BPO to the same Vendor, if so requested by the departments or offices concerned, for up to three consecutive years without having a new Solicitation for the items or services covered by the BPO.

Requirements for technical review and LPA shall continue to apply.

In Writing: All BPOs shall be in writing (stating price, quantity, brand/model, delivery place/time, warranties, after-sale support, etc., as applicable), with receipts obtained. Receipt, inspection and payment shall follow the usual UN terms/UNGCC.

## 11.8 Call-Off Orders Against a BPO

After a BPO has been issued in UMOJA by the Procurement Official through a regular Shopping Cart issued by the Requisitioner, the departments or offices concerned may proceed to order from the selected vendor, in accordance with the terms of the BPO, by issuing LVA Purchase Orders. All such orders must include the BPO number, the Product ID for each item, and the terms and conditions of the BPO shall govern the purchase in all respects. The CO is required to check that the goods/services ordered meet the UN's requirement at fair and reasonable prices. In such cases, the CO (or the Procurement Official as applicable) is responsible to link all such LVA Purchase Orders to the correct UMOJA BPO contract and to verify that orders are in accordance with agreed prices and other contract terms. A call-off order against a BPO shall be used by a Procurement Official in case its overall value exceeds US \$10,000.

In order to maintain proper administrative and financial controls, it is strongly recommended that authorization of LVAs be limited to the CO responsible for that cost centre. It is the responsibility of the Requisitioner to keep records of expenditures against, and the unspent balance of, a BPO.

Invoices against a BPO should reference both the BPO contract number and the Work Order/Task Order number. In most other respects, the ordering and administrative procedures, including receiving and inspection, property control, and inventory and invoice processing are the same for a BPO as they are for other forms of Contracts and Purchase Orders.

The total sum drawn upon a BPO shall be limited to a maximum of US \$100,000 per year and shall not exceed the face value of the BPO. The BPO shall specify the term for which it is valid. In order to replace an expired BPO, a new BPO shall be issued.

## 12. Logistics

### 12.1 Aviation & Other Transport

Transport is the movement of passengers and/or goods from one location to another. To this end, the UN charters aircraft and vessels, contracts freight forwarders, vehicles, and other logistics providers, with the purpose of providing logistics solutions in support of the mandate(s) of UN Secretariat entities, particularly field missions. The mode of transport depends on a variety of factors, including the urgency of the requirement, geography, infrastructure, and cost considerations. The procurement of transport services shall be conducted in compliance with UN Financial Regulations and Rules, as well as relevant international regulations, such as ICAO, Incoterms, etc., and is often characterized by tight schedules requiring special procurement practices, as follows. Such services are listed in the Strategic Goods and Services Matrix under the category of Aviation & Transportation.

#### 12.1.1 Air Transportation Services

Air transportation is a critical component of field support to UN peacekeeping and special political missions and provides logistical assistance to other entities of the UN System. Due to its highly specialized and strategic nature, as well as aviation safety considerations, air transportation services are procured centrally at UNHQ.

#### 12.1.2 Air Operator Vendor Registration (AOVR)

Please refer to [Chapter 3.1.4.3.1](#) of this PM.

#### 12.1.3 Short-Term Air Charter

Short-term air charter requirements fall under the Strategic Movement element of the Movement Control operations of Peacekeeping Operations. The Movement Control Manual defines Strategic Movements as the worldwide movement of personnel and/or their equipment between their home country's national mounting base and/or their (sea and) airports of embarkation to or from the UN mission Area of Operations (AO). The procurement of short-term air charter services, inter alia, facilitates such movements.

For passenger short-term air charters, only Air Operator Vendor Registration vendors are eligible to participate in solicitation exercises.

A separate vendor list is maintained for cargo AOC holders. These carriers, plus brokers and freight forwarders, are invited to participate in solicitations for cargo air charter services.

A standing REOI for both air passenger and cargo requirements should be maintained publicly (e.g. on the PD website and UNGM).

#### 12.1.4 Long-Term Air Charter

Field missions conduct day-to-day air operations using a wide range of fixed-wing and rotary-wing aircraft operated by civil air operators under commercial contracts. These commercially chartered planes and helicopters (complemented by military aircraft under Letters of Assist) make up an extensive long-term fleet of aircraft continuously supporting UN operations worldwide.

Typical air transportation services to be provided include logistical re-supply, passenger flights, VIP liaison, aeromedical/casualty evacuation (MEDEVAC/CASEVAC), troop deployment/rotations, and transportation of cargo and equipment. Air operators providing air transport services to the UN are required to continuously adhere to the UN Aviation Standards for Peacekeeping and Humanitarian Air Transport Operations ([UN AVSTADS](#)), which are published on the PD website.

UN air charter contracts are based on standard Forms of Contracts developed for such requirements by OLA. Contractors are typically required to provide aircraft, crew, maintenance, and insurance. For air transport services provided within the operations area of a UN field mission, the UN normally provides aviation fuel (Jet A-1) and ground support services. When performing flights for the UN outside of a mission area, air operators are required to be self-sufficient.

UN contracting modalities for air transportation services include full-time/dedicated long-term air charter contracts, as well as on-call/standby air charter contracts.

#### 12.1.5 Military Aviation

In achieving their mandates, UN peacekeeping missions may require military aviation support, provided by Troop Contributing Countries (TCCs) under LOAs. Military aviation units include light-armed helicopters, light, medium, or heavy utility helicopters, as well as attack helicopters and tactical transport fixed-wing aircraft.

LOA terms and conditions shall be based on a reasonable and justifiable reimbursement for the use of the military aircraft, to be agreed upon between the UN and the TCC, which are intended to cover the direct operating costs (i.e., excluding capital investment or expenses that would be incurred regardless of the contribution to UN peacekeeping). PD shall always be involved in negotiating the financial terms and conditions of LOAs.

Aviation LOA reimbursement is normally on a per-flight-hour basis with no minimum guaranteed hours. As an exception, attack helicopters are reimbursed on a monthly rental basis, due to the unique role of such aircraft whose availability alone serves as deterrence and show of force and, as such, benefits UN peacekeeping operations with specialized military mandates. Aviation LOAs may include ancillary reimbursement items to cover other costs incurred by the TCC that are not covered by the related Memorandum of Understanding (MOU).

## 12.2 Freight Forwarding & Third-Party Logistics (3PL)

The UN Secretariat procures a wide range of freight forwarding services in support of UN operations worldwide. These services include, inter alia, multimodal freight of United Nations Owned Equipment (UNOE) and Contingent Owned Equipment (COE). Generally, shipments are conducted via multimodal sea/surface freight, airfreight, or air cargo charters.

Multimodal Sea/Surface freight forwarding services are further defined as the movement of UNOE or COE from Origin (Door or Port) to Destination (Door or Port) via sea/surface freight. This may include full vessel charter, part cargo, liner service, etc., as well as inland transportation, inland ground waterway transportation, etc., as needed.

Air Cargo Charters are further defined as the movement of UNOE or COE from Origin to Destination via full aircraft charter.

Airfreight is defined as follows as the booking of UNOE freight on commercial or freighter aircraft.

PD maintains a roster of pre-approved freight forwarders who are invited to bid on all freight solicitations for shipment of both UNOE and COE processed by PD. A standing REOI form for entry into the PD "Freight Forwarding Vendor Roster" (FFVR) is posted on both the UNPD website and the UNGM. Interested companies must first register as vendors with UNGM ([www.ungm.org](http://www.ungm.org)) and then complete the REOI. The FFVR is updated on a quarterly basis, and UNPD reserves the right to remove any company from the FFVR that is deemed inactive.

## 12.3 Strategic Movements – Contingent Owned Equipment (COE)

COE refers to the actual equipment provided by the troop-contributing countries to carry out their day-to-day peacekeeping operations. It includes vehicles (trucks, trailers, armored vehicles, etc.), dangerous cargo of various classes, generators, road-making equipment, drilling equipment, etc. The nature and configuration of the COE dictate the type of vessel required. Most ships are designed to carry specific cargo and to load and unload in a particular way. For example, a Roll-On/Roll-Off is required to transport large numbers of vehicles. In addition, due to the military nature of COE and its political considerations, direct sailing without transshipment is usually required.

The COE Manual and the Movement Control Manual regulate requirements for Strategic Movements of COE and passengers. Strategic Movements include shipments of COE by surface transport (road, sea, and river) and air (short-term air charter), plus short-term transportation of passengers by air and road. Requirements for Strategic Movements are generally time-sensitive and are based on the tempo of the peacekeeping operations.

RFPs are typically used for the procurement of movement services for COE. As process turnaround times (and validities of vendors' proposals) can be as short as 24 hours, technical and financial proposals are opened simultaneously, as an exception to the Opening procedures for RFPs. In addition, the Director, PD has special approval authority for these procurement cases.

Movement of COE and passengers are critical strategic components necessary for the successful execution of UN Peacekeeping operations, as both operations entail the transportation of peacekeepers (troops) and their equipment into the theatre of operations.

## 12.4 Strategic Movements – UN Owned Equipment (UNOE)

UNOE is defined as commercial goods that are either purchased from a UN commodity vendor for delivery to a UN entity or goods that are already in the possession of the UN (e.g., mission-to-mission cargo transfers). The Incoterm indicated in the commodity Purchase Order shall guide the procurement of freight services for UNOE commodities (see [Chapter 12.5](#), below).

Procurement of freight-forwarding services for shipment of UNOE can be undertaken either on an individual shipment basis or through the establishment of non-exclusive freight forwarding systems contracts with a select number of freight forwarders.

## 12.5 Incoterms

International Commercial Terms ([Incoterms](#)) are prepared by the International Chamber of Commerce and are standardized, widely recognized trade terms to be included, by agreement of the parties, in contracts for the sale of goods. Their objective is to provide standard contractual provisions for contracts for the sale of goods by clarifying the costs, risks, and responsibilities of the parties to the contract, particularly in relation to the shipment and delivery of the goods from sellers

### USE OF INCOTERMS

**The Requisitioner and the Procurement Official shall jointly make the determination and selection of the appropriate Incoterms to use. The chosen Incoterm shall be appropriate to the goods, to the means of transport, to the desired level of risk acceptable to the UN, and to whether the parties intend to put additional obligations on the vendor or the UN.**



to buyers. Incoterms do not apply to the contracts of carriage (e.g. freight forwarding) but only to the delivery of goods under a sales contract.

The Requisitioner and the Procurement Official shall jointly make the determination and selection of the appropriate Incoterms to use. The chosen Incoterm shall be appropriate to the goods, to the means of transport, to the desired level of risk acceptable to the UN, and to whether the parties intend to put additional obligations (e.g. the obligation to organize carriage or insurance) on the seller or the buyer.

When establishing systems contracts for commodities, Procurement Officers shall use FCA, FOB or EXW as the default Incoterm, with DAP/DAT included on an exceptional basis, unless it is a turnkey contract. Due to the typically higher costs associated with DAP/DAT shipments, the usage of DAP/DAT under a subsequent commodity Purchase Order should also be undertaken on an exceptional basis only, with FCA/FOB/EXW the preferred Incoterm. Approved category strategies may also indicate the preferred incoterm based on a thorough analysis conducted during the strategy development process.

## 12.6 Global Cargo Insurance

The UN Secretariat maintains a global cargo insurance policy that covers organizational shipments of UNOE and COE up to the limits set forth in the policy. For information regarding coverage limitations, PD's Freight Forwarding experts can be consulted at [forwarding@un.org](mailto:forwarding@un.org).

Due to the existence of this global cargo insurance policy, it is generally not necessary to purchase additional insurance from a freight forwarder, except in the rare instances whereby the value of the cargo exceeds the coverage outlined in the global cargo insurance policy. As such, solicitations for freight forwarding services shall not request additional insurance. However, any UN-appointed freight forwarder must maintain their own liability insurance to cover losses/damages due to their negligence. A copy of the insurance policy/certificate to cover the loss and/or damage of the contracted cargo in accordance with Clause 6 of the UNGCC shall be kept in the case file by the UN entity ordering the freight forwarding services.

In the event that an insurance claim is necessary, all relevant shipping documentation (airway bill, bill of lading, packing list, UN freight, and commodity purchase orders, etc.) shall be maintained in the case file by the UN entity ordering the freight forwarding services. Procedures for Filing Cargo Claims for Organizational Shipments are attached in Annex 21.

## RESOURCES

Annex 21 — Procedures for Filing Cargo Claims for Organizational Shipments

## 12.7 Goods Inbound to UNHQ

Goods arriving at UNHQ for UN official use ("Inbound Goods") must complete a multi-step customs clearance process in coordination with the host government of the United States of America. The Freight Forwarding (FF) experts in the PD facilitate this process. However, each UN Secretariat entity is responsible for ensuring that its commodity Purchase Order(s) covers delivery to "Door" of their



New York office. For airfreight shipments, the importing UN entity should immediately provide the FF experts in PD with shipping documents required for clearance (commercial invoice, air waybill, and arrival notice) upon arrival of the cargo. The process for clearance generally takes four to seven (4-7) business days. As such, appointed freight forwarders should be instructed to move cargo upon arrival to a Container Freight Station (CFS) to minimize storage charges. For sea shipments, Importer Security Filing (ISF) must be completed prior to the shipment departing the origin point to avoid possible penalties from US Customs & Border Protection (CBP) or other similar authorities. For information related to Inbound Goods, the Procurement Division's Freight Forwarding experts can be consulted at [forwarding@un.org](mailto:forwarding@un.org).

## 13. Contract Management and Contract Administration

### 13.1 Overview

This chapter describes the key activities required for effective contract management and administration.

#### 13.1.1 Contract Management

Contract Management refers to all actions undertaken after the award of a contract and covers activities such as vendor performance monitoring, payments, contract closure, record retention, and maintenance of the contract file. The primary goal of contract management is to ensure that quality goods and services, in the right quantity, are delivered on time and in accordance with the agreed-upon contract terms.

Depending on the nature of the contract, the Contract Management function is the responsibility of either staff directly assigned to oversee and manage the implementation of the contract, the Requisitioner, or the end-user (hereinafter collectively referred to as “responsible contract management staff” or RCMS). The RCMS is responsible for monitoring the performance of the contractor and for receiving, accepting, and approving the deliverables specified in the contract.

The responsible Procurement Official should be informed by the RCMS of any not-accepted deliverable to ensure proper recording in the procurement case file and to permit action on any necessary contract administration matters.

Acceptance is carried out as follows, per type of requirement:

- a. Goods: Upon receipt of the procured goods, the RCMS will record the goods receipt, along with a Receipt and Inspection report (R&I), in UMOJA. This confirms receipt of all goods as per the packing list, as well as documenting, in detail, the condition of the goods received and their compliance with the stated specifications. The applicable UMOJA forms for receipt of goods must be used for this purpose.
- b. Services: If services have been satisfactorily received, the RCMS must record in UMOJA that the services have been satisfactorily completed in accordance with the terms specified in the contract.

Delivery has different meanings depending on the type of purchase (i.e., goods, services, or works). Furthermore, with goods, delivery is recognized at different points of time and place depending on the Incoterm used in the contract. RCMS are reminded to consider the relevant Incoterms and contract terms to determine whether delivery is considered complete.

#### 13.1.2 Contract Administration

The Contract Management function is supported by the contract administration activities undertaken by the Procurement Official in charge of the procurement process. Contract Administration is comprised of all actions undertaken by Procurement Officials following the award of a contract that relate to the administrative aspects of the contract, such as contract amendment or extension, contract closure, record retention, maintenance of the contract file, handling security instruments (e.g. Performance Security), and liaising with OLA on any contractual disputes or claims. Issues relating to the interpretation of contract provisions shall be referred by the RCMS to the Procurement Official that issued the contract. Moreover, if the RCMS are not able to resolve a dispute with the vendor, they shall inform the Procurement Official thereof promptly. The Procurement Official shall act in accordance with [Chapter 13.3](#) when seeking to resolve such disputes.

## 13.2 Vendor Performance Evaluation

The RCMS should conduct an evaluation of the vendor's performance, supported by the Procurement Official if necessary. The evaluation must consider the experience with the vendor during the entire contract period. It is important to carefully document contract performance and to be able to produce evidence of same in the event of disputes, in order to form an institutional memory, and for audit purposes.

There are five types of Vendor Performance Rating (VPR) forms:

- a. Short-Form Specialist Report (Annex 22);
- b. Supplier Performance Report (Annex 23);
- c. Contractor Performance Report (Annex 24). This form is used for contracts that exceed US\$ 200,000 or long-term contracts of two or more years in duration where performance reports are required once a year;
- d. Contractor Performance Report for Short-Term Air Charter Services (Annex 25);
- e. Contractor Performance Report for Short-Term Sea Transport Services (Annex 26).

In order to ensure contract compliance, the RCMS is expected to monitor performance on an ongoing basis through reports, meetings, and, if applicable, inspections. The following topics can be addressed in evaluating performance:

- a. Fulfillment of delivery schedule/timely delivery;
- b. Quality of goods or services provided in accordance with the contract;
- c. Compliance with contractual terms and conditions (including the Supplier code of conduct when issues arise);
- d. Adherence to warranty provisions;
- e. Timely response to UN requests;
- f. Undue delay of the performance under the contract;
- g. Any frivolous claims against the UN;
- h. Failure to disclose information relevant to performance and vendor eligibility, which should then be raised with the responsible officials for vendor registration (e.g. bankruptcy, ongoing litigation, etc.).

Depending on the nature of the procurement, a process to evaluate vendor performance may include the following approaches:

- a. Using questionnaires, which require a sound knowledge of what will be measured to ensure the relevance of the result;
- b. Undertaking site visits;
- c. Using metrics and key performance indicators for contracts;
- d. Developing and using supplier scorecards to measure the cost of poor quality, customer social responsibility, etc.;
- e. Measuring performance against SLAs.

If a contractor has shown significant or persistent deficiencies in performance that led to early termination, application of damages, or similar actions, the RCMS may, in consultation with the Procurement Official, refer the case of such contractor for potential sanctioning to the VRC, along with supporting documentation and justification explaining such performance failures.

The RCMS shall ensure that contract management is conducted as follows:

- a. The RCMS shall develop the performance measurement criteria, which should be included in the solicitation documents and in the contract;

- b. The RCMS shall monitor and evaluate the vendor's performance against the agreed performance measurement criteria or contract milestones;
- c. The RCMS shall notify the vendor promptly in case the performance does not meet the agreed performance standard(s) and shall request remedial action. RCMS shall also apply for performance credits as described in the contract to the vendor's invoices/payments. In case of recurring or continuing a sub-standard performance, the RCMS shall notify the concerned Procurement Official and provide documented proof of such performance and any remedial actions taken;
- d. The RCMS shall complete the Vendor Performance Rating (VPR) form/report, notify the Procurement Official as to whether the vendor is performing adequately, and submit a copy of the VPR form to the Procurement Official and Vendor Registration and Outreach Section in DOS.

The Procurement Official shall administer the VPR form/report as follows:

- a. The Procurement Official shall ensure that a copy of any VPR form/report is included in the procurement case file;
- b. In case the Procurement Official is notified of a vendor's sub-standard performance, he/she shall assess the situation based on the information received from the RCMS and shall recommend an appropriate action to be taken. Depending on the situation, possible actions may include further escalation, dispute resolution, use of remedies, (temporary) suspension, exclusion from future solicitations, or any other remedial action deemed appropriate for the specific situation. Recommended actions shall be submitted to the Director, PD or CPO for approval, who shall request a review by the VRC;
- c. The Procurement Official shall notify the staff in charge of Vendor Management and/or the VRC of any non-compliance or poor performance issues in writing.

Procurement Officials and RCMS should ensure that a VPR form is on file before processing any extension to an existing Contract. If the VPR does not show a satisfactory result, plans should be made to address the performance shortcomings or to retender the requirement.

## RESOURCES

Annex 22 - Short-Form Specialist Report  
Annex 23 - Supplier Performance Report  
Annex 24 - Contractor Performance Report  
Annex 25 - Contractor Performance Report for Short-Term Air Charter Services  
Annex 26 - Contractor Performance Report for Short-Term Sea Transport Services

### 13.3 Dispute Resolution

Contracts should be clear, and the responsibilities and obligations of the parties clearly stated therein. However, no matter how well a contract is drafted and its performance managed, disputes may arise. The United Nations is committed to fair, orderly, and prompt resolution of disputes with vendors. Moreover, the United Nations is required to make provisions for appropriate modes of settlement of disputes arising out of contracts or other disputes of a private law character to which the United Nations is a party (see [1946 Convention on the Privileges and Immunities of the United Nations](#)).

Contractual disputes are to be addressed as follows:

Amicable Settlement: With a view to providing appropriate means of settlement of disputes, UN contracts provide for a resolution of disputes by way of amicable settlement (e.g. direct discussion between the parties to the contract). Consultation with the OLA or, if the entity is away from headquarters, the Legal Adviser within the entity is required when such amicable settlement results in agreeing to make payment for costs outside the scope of the contract).

Seeking Legal Advice: When it becomes apparent that a dispute with a vendor has arisen and cannot be resolved by the RCMS and/or by the Procurement Official, the Procurement Official shall send a memorandum to OLA or the applicable Legal Advisor seeking their advice. The memorandum shall include, but not be limited to, a detailed description of the vendor's claims and all relevant information concerning the dispute, including a fully signed version of the applicable contract and all signed amendments, a chronology of events, the status of the dispute, possible consequences of the dispute if it is not settled (e.g. financial, operational, political, reputation/image of the UN), and all applicable correspondence between the contractor and the United Nations in relation to the claim. The memorandum shall also include copies of all relevant documentation and, if the matter is urgent, the reasons for the urgency therefore, should be communicated to OLA or the Legal Adviser.

Conduct of Amicable Settlement: Following receipt of the legal opinion, the relevant Procurement Official authorized to conduct discussions with the vendor shall ensure that any preliminary agreement reached considers the legal opinion. Any discussions shall be conducted by a minimum of two Procurement Officials, at least one of whom is experienced and senior in grade, and minutes should be made of such discussions for UN internal purposes. The Requisitioner should be requested to participate in any discussions involving operational issues. If the vendor requests to have legal representation present in negotiations, the Organization must have legal representation (i.e., OLA or the entity's Legal Advisor). If an amicable agreement is reached with the vendor, its terms shall be transmitted to the Director, PD for contracts established by PD, and to the CPO for contracts established by entities; who shall review it and seek the relevant approvals. The vendor shall be advised that any agreement reached is subject to UN internal approvals.

Authority to Settle Commercial Claims: The amicable settlement of commercial claims up to the equivalent of US \$50,000 is the responsibility of the Authorized Official of the procuring entity, after consultation with OLA<sup>6</sup>. If the amount of the dispute exceeds the equivalent of US \$50,000, the Head of Entity shall refer the case to Under-Secretary-General for Operational Support<sup>7</sup>, after consulting with the Office of Legal Affairs. The Under-Secretary-General for Management Strategy, Policy and Compliance has delegated authority to settle commercial claims above US\$ 50,000 upon the recommendation of the Under-Secretary-General for Operational Support<sup>8</sup>. ASG for Supply Chain Management is the designated authorized representative of the Under-Secretary-General for Operational Support for the review of commercial claims<sup>9</sup>.

Settlement and Release Agreement: Upon receipt of all required approvals, the Procurement Official shall consult with OLA in the preparation of a settlement and release agreement. The Procurement Official shall forward the draft settlement and released agreement to the vendor for signature, following which the official with the appropriate authority shall countersign the agreement.

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<sup>6</sup> See paragraph 14 of Section V. "Use of Funds" of "Delegation of Authority from the Secretary-General to Head of Entity", issued pursuant to [ST/SGB/2019/2](#).

<sup>7</sup> *Ibid.*

<sup>8</sup> *Ibid.*

<sup>9</sup> *Ibid.*, see footnote 3.

Arbitration: In the absence of an amicable settlement, the contractor may seek to arbitrate the matter in accordance with the UNCITRAL Arbitration Rules, as provided for in the UNGCC. Should a Notice of Arbitration be received from a vendor, such Notice must be brought to the immediate attention of the Office of Legal Affairs.

File Management: The RCMS and Procurement Official are each responsible for ensuring that the respective case file contains a description of their dispute resolution activities stating exactly what was discussed and how the dispute was resolved, including any executed settlement and release agreement.

## 13.4 Payments

Payment entails the timely payment of invoices consistent with the terms of the contract.

The Finance Officer shall ensure that the terms and conditions of payment are consistent with those specified in the contract document. The following examples contain standard payment terms for goods, works, and services, but the specific payments terms are outlined in each contract.

It is a standard contractual provision unless otherwise amended by the parties of the contract, that the UN is obligated to pay for goods or services net thirty (30) days upon the vendor's satisfactory completion of its delivery obligations, in accordance with the delivery terms (e.g. Incoterms). When a normal commercial practice or the interests of the UN so require, payment or payment on account in advance may be agreed upon in accordance with Financial Rule 105.19(a) (e.g. for real estate leasing, subscription-type services, etc.). It is a general practice that progress payments are implemented in accordance with Financial Rule 105.19(b). Thus, under certain conditions, the UN may agree to pay progress or advance payments for delivery of the goods/services or upon completion of clearly defined milestones for goods/services, provided adequate security for the advance or progress payment is established. In such cases, the Procurement Officer should consider establishing specially-developed payment terms that take payment flows into consideration, provided such terms are approved by the Director, PD or the CPO and are tailored to the specific procurement.

It is important to be aware of the specific payment terms applicable to each contract. The contracts should also include details of all documentation that must be submitted before any payments are made.

The payment request is transmitted through UMOJA, and the responsible person shall effect the payment in order to uphold the segregation of duties between procuring personnel conducting the procurement process and personnel effecting the payment. This separation of the procuring and payment functions is a key factor in the principle of segregation of duties (see [Chapter 2.9 Segregation of Duties](#)) and must be adhered to for all payments.

### 13.4.1 Third-Party Payments

The general and normal practice is that the UN does not make any third-party payments (i.e., payment to parties other than the entity that holds the contract).

### 13.4.2 Taxes

Article II, Section 7 of the Convention on the Privileges and Immunities of the United Nations provides, inter alia, that the United Nations, including its subsidiary organs, is exempt from all direct taxes (except charges for public utility services) and is exempt from customs restrictions, duties, and charges of a similar nature in respect of articles imported or exported for its official use. In the event any governmental authority refuses to recognize the exemptions of the United Nations from such taxes, restrictions, duties, or charges, the contractor should be required to immediately

consult with the United Nations to determine a mutually acceptable procedure. Under the relevant contract, the contractor should be required to authorize the UN to deduct from the contractor's invoices any amount representing such taxes, duties, or charges, unless the contractor has consulted with the UN before the payment thereof and the UN has, in each instance, specifically authorized the contractor to pay such taxes, duties, or charges under written protest. In that event, the contractor should be required to provide the UN with written evidence that payment of such taxes, duties, or charges has been made and appropriately authorized, and the UN should reimburse the contractor for any such taxes, duties, or charges so authorized by the UN and paid by the contractor under written protest.

#### 13.4.3 Advance Payments

Please refer to [Chapter 11.1.4](#) for details.

### 13.5 Amendments, Extensions and Renewal

The contract modification is the handling of changes that arise following contract execution, typically involving variations in prices or requirements that were not originally anticipated.

It is the responsibility of Procurement Officials as part of their contract administration duties, in consultation with the Requisitioner, to:

- a. Negotiate the appropriate contract changes regarding price, schedule, quality, and performance, and ensure that the contract is amended so that, at all times, it defines the agreed expectations of both parties under the contract;
- b. Ensure that the change conditions are reasonable and justifiable in terms of price, time, and quality;
- c. Any such amendment should be requested, reviewed, approved, and signed prior to the expiry date of the original contract. Retroactive contract extensions after contract expiry are not possible.

The amendments must be approved by the corresponding Procurement Approving Authority in accordance with the DOA and documented in the contract file.

In some cases, contract amendments may require prior review by a Review Committee in accordance with the DOA. The following contract amendments require a waiver from formal methods of solicitation from the relevant Authorized Official prior to presenting the contract amendment to a Review Committee or to engaging in formal negotiations with the vendor with the aim of amending the contract:

- a. Contracts originally established after a formal solicitation process or under FR 105.16 after obtaining an exception to the use of formal methods of solicitation from the Procurement Approving Authority, if the amendment will change the scope of the contract, extend its duration for more than 8 months or increase the NTE for more than 20% or \$500,000, whichever is lower (see Chapters 9.2 (d), (h), (j) and 9.3 (c), (g) and (i)).

### 13.6 Use of Subcontractors

Article 5 of the UNGCC provides that contractors shall obtain prior written approval and clearance from the UN for all subcontractors, with the understanding that such approval and clearance does not relieve the contractor of any of its obligations under its contract with the UN. Subcontractors shall only be approved where their use reflects standard business practice or is otherwise justified by the nature of the goods, services, or works to be delivered. UN Staff (Procurement, Requisitioner, RCMS) responsible for Contract Administration and Management should not deal directly with

subcontractors, given that the UN's contractors are solely responsible for all services and obligations performed by its subcontractors.

## 13.7 Contract Completion

Contract completion includes the confirmation that all obligations have been met, identification of any residual obligations and completion steps, settlement of final payments, assessment of contractor, and the administrative closing of files.

Procurement Officials should verify that the following activities have been carried out:

- a. All products and/or services required have been provided to the Requisitioner;
- b. Documentation in the contract file adequately shows the receipt and formal acceptance of all contract items;
- c. No claims or investigations are pending on the contract;
- d. All actions related to contract price revisions and changes have been concluded;
- e. All outstanding subcontracting issues have been settled;
- f. If a partial or complete termination was involved, the action is complete;
- g. The final invoice has been submitted and all invoices paid;
- h. Any security (e.g. Performance Security) shall be returned in accordance with the terms of the Contract and the security instrument. In addition, any equipment or unused material supplied by the UN must be promptly returned to the UN.

## 13.8 Property Disposal

### 13.8.1 Property Survey Boards

Financial Rule 105.22 states: "Sales of supplies, equipment, or other property declared surplus or unserviceable shall be based on competitive bidding unless the relevant Property Survey Board (See Financial Rule 105.21 a.) Estimates that the sales value is less than an amount to be specified by the Under-Secretary-General, Department of Management; b.) Considers that the exchange of property in partial or full payment for replacement equipment or supplies is in the best interest of the Organization; c.) Deems it appropriate to transfer surplus property from one project or operation for use in another and determines the fair market value at which the transfer(s) shall be effected; d.) Determines that the destruction of the surplus or unserviceable material will be more economical or is required by law or by the nature of the property; e.) Determines that the interests of the United Nations will be served through the disposal of the property by gift or sale at a nominal price to an intergovernmental organization, a Government or governmental agency, or some other non-profit organization".

Such sale shall be on the basis of payments on or before delivery to the purchaser, except as otherwise provided for in Financial Rules 105.22 and 105.23.

### 13.8.2 Disposal of Property through Sales— Procedures

**Development of Solicitation Documents:** The Procurement Officer shall issue Solicitation Documents to prospective purchasers, ensuring adequate competition. Generally, the minimum number of invitees to the solicitation should be established using the guidelines set forth in [Chapter 5.7](#). Such Solicitation Documents shall refer to the relevant approved Property Survey Board (PSB) recommendation that authorizes disposal through a sale.

In order to maximize the return for the UN, the Property may be sold individually or in lots.

At a minimum, the Solicitation Documents shall include:



- a. An itemized list of the Property;
- b. A complete description of the Property;
- c. The location of the Property and place of inspection to encourage the potential purchaser to inspect the Property;
- d. The condition of the Property (i.e., whether it is damaged, useable, serviceable, in need of repairs, etc.);
- e. Reference to the relevant approved Property Survey Board recommendation;
- f. Terms of the solicitation (see Sample Sale of Surplus Property Form attached as Annex 27);
- g. Date and time of Tender opening;
- h. A statement that the Property shall be sold on an “as -is, where-is” basis and without recourse or warranties, express or implied, of any kind;
- i. The requirement to deposit, upon submission of an offer, an amount of no less than ten percent (10%) of the total offer value, which, if such deposit exceeds US\$ 1,000, must be in the form of a certified check;
- j. The time period within which the invoice issued to the successful Bidder shall be settled;
- k. The time period within which the successful Bidder shall remove the Property;
- l. Any other relevant matters.

## RESOURCES

Annex 27 - Sample Sale of Surplus Property Form

### 13.8.3 Treatments of Offers

The UN shall treat offers for the purchase of Property in the same manner as Submissions for the purchase of goods by the UN. [Chapter 10](#) of this PM applies to purchases of Property, subject to appropriate changes as the context may require.

The offers shall be itemized, and the Property shall be sold to the Bidder offering the best value to the Organization.

Successful Bidders shall be notified in writing, and items awarded shall be listed in a contractual sale instrument.

### 13.8.4 Review by the Committees on Contracts

Prior to the issuance of the contractual instrument, the relevant Review Committees shall review the proposed awards based on the applicable thresholds. Please refer to the [Chapter 9 Review by Committees on Contracts](#).

### 13.8.5 Contractual Instruments for the Sale of Goods

The disposal by sale shall be affected by the issuance of a Contract for the sale of goods. The Contract for the sale of goods shall, inter alia, list and describe the Property to be sold, the agreed price, and any deposit paid.

The UN may elect to enter into a Systems Contract if it foresees a continuing sale of items over a period of time, provided that this is advantageous to the Organization. In that case, the contractor shall be tasked in writing for each underlying sale, with a reference to the applicable Systems Contract. Please also refer to [Chapter 11.6 Long-Term Agreement \(LTA\)](#).

### 13.8.6 Exceptions to Solicitation

Negotiation or "Spot Sales": When the sales value is estimated to be under the threshold amount for an LVA, which is currently up to or equal to US \$10,000, the sale can take place without formal issuance of Solicitation Documents. Prospective Bidders can be invited to survey the Property and thereafter submit Bids, either oral or written, within a set time limit. The awarded contractor shall be notified in writing of the sale.

Trade-In: If there is an offer to exchange Property in partial or in full payment for the UN Property, the disposal may be effected by the issuance of a Contract for the sale of goods by the UN or Contract for the Procurement of Replacement Goods, provided it is in the best interest of the Organization, as provided for in Financial Rule 105.22 (b).

### 13.8.7 Deposits

Bidders shall be required to deposit an amount of no less than 10% of the total offer value with the submission of any offer. Any deposit exceeding US \$1,000 must be submitted to the UN in the form of a certified check.

Upon acceptance of an offer by the UN, the deposit shall not be returned to the Bidder except with the written approval of the Director, PD or CPO. The return of the deposit shall take place after full payment for the goods has been received and the Bidder has completed all contractual obligations.

All deposits received from unsuccessful bidders shall be returned with a letter indicating that the Bidder was not successful.

### 13.8.8 Notice of Award Billing

The Director, PD or the CPO shall sign the Purchase Order or applicable contractual instrument (e.g. Bill of Sale) recording the sale and the final bill, which are then issued to the successful Bidder. Such bill shall be settled no later than five (5) business days after the notice unless otherwise set forth in the Solicitation Documents.

### 13.8.9 Removal of Property

A limited time, usually five (5) business days, shall be allowed following the sale for removal of the Property unless otherwise set forth in the Solicitation Documents.

### 13.8.10 Disposition of Assets of Peacekeeping Operations

United Nations Financial Regulation 5.14 states: "Following the liquidation of a peacekeeping operation, equipment and other property shall be disposed of in accordance with the Financial Regulations and Rules and the manner indicated below:

- a. Equipment in good condition that conforms to established Standardization or is considered compatible with existing equipment will be redeployed to other peacekeeping operations or will be placed in reserve to form start-up kits for use by future missions;
- b. Equipment not required for current or future peacekeeping operations may be redeployed to other United Nations activities funded from assessed contributions, provided that there is a demonstrated need for the equipment;
- c. Equipment not required for current or future peacekeeping operations, or other United Nations activities funded from assessed contributions, but which may be useful for the operations of other United Nations agencies, international organizations or non-governmental organizations may be sold to such agencies or organizations;
- d. Any equipment or property not required or which it is not feasible to dispose of in accordance with subparagraphs (b), (c) or (d) above or which is in poor condition will be

- subject to commercial disposal in accordance with the procedures applicable to other United Nations equipment or property;
- e. Any assets that have been installed in a country and which, if dismantled, would set back the rehabilitation of that country, shall be provided to the duly recognized Government of that country in return for compensation in a form to be agreed by the Organization and the Government. This refers in particular to airfield installations and equipment, buildings, bridges, and mine-clearing equipment. Where such assets cannot be disposed of in this manner, or otherwise, they will be contributed free of charge to the Government of the country concerned. Such contributions require the prior approval of the General Assembly;
  - f. A report on the final disposition of assets for each such liquidated peacekeeping operation shall be submitted to the General Assembly.”

#### 13.8.11 Sale of Real Property

Any proposed sale of real or immovable property owned by the United Nations shall be authorized in accordance with the delegation of authority in property management

### 13.9 Handling and Maintenance of Files

For both contract management and contract administrations purposes, the responsible officials (RCMS and Procurement Officials, respectively) must ensure that all documents containing commercial information are treated with confidentiality, that such documents are classified accordingly as confidential material and that such documents are handled in accordance with [ST/SGB/2007/6](#).

Responsible officials and Procurement Officials must also establish and maintain a file for each contract. In addition to information documenting the procurement process, the file must include all information required to successfully administer/manage the contract. Any issues of clarification or change of the contract must be fully documented in this file.

In line with the procurement principles of transparency and accountability, and in order to facilitate internal and external audits of UN operations, every step in the contract management process shall be documented and kept on file (hard copy or electronic).

A standard filing system, as well as a numbering system to enable tracking of files, should be established in every contract management and contract administration offices in order to create an audit trail.

Procurement Officials must open a procurement file for each case, either physically or electronically. Procurement files must be retained in accordance with the applicable retention policy.

The good administration and maintenance of the procurement file are required to assure clarity over actions taken during the course of the contract. Procurement Officials should document events that occur during the life of the contract, which may affect, at a later date, any decision or revision of the contract. A good audit records trail is critical to prevent confusion in the management of files due to the dynamic nature of the procurement function and the mobility of the Procurement Staff. In addition, staff should adopt and maintain discipline in the filing and indexing of contract files, which may be done in physical or electronic filing systems. The file shall at a minimum contain the documents (inclusive of relevant correspondence) relating to the following phases of the procurement process (if relevant):

- a. Pre-Solicitation: Specifications (inclusive of TOR, SOW, RFI/REOI, Market Research, Evaluation Criteria, and weighting), SSP, and provisional registration/special approval form;
- b. Solicitation: signed List of Invitees, RFQ/ITB/RFP, clarifications/amendments to RFQ/ITB/RFP, and inquiries;

- c. Submissions: acknowledgments, Submission Opening attendance register, the record of Submission receipt, technical proposals, financial proposals, and copies of Bid Security;
- d. Evaluation: Request for technical evaluation, technical evaluation, financial evaluation, approved presentation to a Review Committee and agenda, Review Committee minutes containing recommendations, Dunn & Bradstreet report, and relevant correspondence;
- e. Award: Notice of Award, Regret Letters, vendor's signed acceptance of Award, documents related to Contract preparation, and copy of Performance Security (originals to be kept in the safe);
- f. Post-award: Signed contracts, copies of insurance certificates and guarantees provided for in the contract;
- g. Contract Administration documents: amendments, Statements of Award, and Vendor Performance Report/Evaluation/ checklist for closed files.

Contract management files must be kept after contract closure for the period required in accordance with the applicable retention policy. Typically, contract management files will include the following relevant information/documentation:

- a. Signed contract/purchase order;
- b. Minutes of the concerned Review Committee meeting and decision on its award, recommendations by the concerned Authorized Official (e.g. ASG, OSCM);
- c. Copies of any advance payment guarantee or performance security received from the vendor;
- d. Correspondence with the contractor (e.g. emails, meeting minutes) regarding the management of the contract;
- e. Signed notes from meetings, phone calls, etc.;
- f. Amendments to contracts/POs with relevant Review Committee minutes when applicable;
- g. The documented decision regarding claims, disputes including amicable resolution, conciliation, mediation, or arbitration;
- h. Any required progress reports and/or other proof of delivery of milestones as provided for in the contract;
- i. Insurance claims;
- j. Proof of payment;
- k. Completed vendor performance evaluation form and meeting minutes, including compliance with KPIs and SLAs.

## 14. Cooperation

Cooperation in procurement among organizations of the UN system can result in significant benefits due to economies of scale, reduced transaction costs, agility and improved relations with suppliers. It can also be instrumental in supporting the UN Secretariat's operations in areas of the world where no or little internal procurement capacity exists and, vice versa, support other UN organizations with their requirements.

Utilizing cooperation to meet the UN's requirements does not release Procurement Officials from ensuring that the transaction represents the best value for money and is fully in line with the principles enshrined in Financial Regulation 5.12. Accordingly, cooperation is an alternative sourcing option which must be duly justified as an alternative to carrying out a competitive solicitation or a sole-source decision by the Organization itself.

In the context of this chapter, the term **UN Organization** refers to any organization of the UN system (excluding UN Secretariat entities).

Financial Rule 105.16(a)(iii), in conjunction with Financial Rule 105.17 (Cooperation), provides the following possibilities for cooperation, which are covered in [Chapter 14.1](#) and [Chapter 14.2](#).

### 14.1 Cooperation with UN Organizations

"Delivering as One" and other UN reform initiatives have accelerated efforts among organizations of the UN system to collaborate and cooperate on procurement. The High-level Committee on Management's Procurement Network (HLCM-PN) has also endorsed specific guidance to facilitate collaborative procurement. Moreover, the issuance of the "Mutual Recognition" statement in 2019 formalizes the commitment of organizations of the UN system to use or rely on other organizations of the UN system's policies, procedures, system contracts and related operational mechanisms for the implementation of activities without further evaluation checks or approvals being required, to the greatest extent practicable.

The purpose of this section of the Manual is to provide the guiding principles for the UN Secretariat's procurement cooperation with other UN Organizations.

The Procurement Approving Authority for Financial Rule 105.16(a)(iii) in conjunction with Financial Rule 105.17(a) may determine that cooperation with other UN Organizations is appropriate to meet the procurement requirements of a UN Secretariat Entity and may authorize it in writing.

Cooperation may be considered appropriate to, inter alia, obtain volume discounts or achieve process or operational efficiencies. In taking a decision to make an award under FRR 105.17 (a), the Procurement Approving Authority shall ensure that both the decision and the justification for such decision are recorded in writing.

Cooperation with UN Organizations may take the following forms, in accordance with Financial Rule 105.17 (a):

- a. Carrying out common procurement actions together, i.e. establishing and using joint LTAs and contracts (joint solicitation, lead agency agreement);
- b. The UN Secretariat entering into a contract relying on a procurement decision of another UN Organization (using LTAs or contracts of other UN Organizations, i.e. piggybacking);
- c. Requesting another UN Organization to carry out procurement activities on behalf of the UN Secretariat (using procurement services of other UN Organizations).

Should the requirement to be sourced through cooperation relate to Strategic Goods and Services, a request for LPA shall be sought the Director, PD (see section 2.6.4).

#### 14.1.1 Carrying out common procurement actions together with other UN Organization(s)

A UN Secretariat entity may undertake joint procurement activities with one or more UN Organizations if so approved by the Procurement Approving Authority for Financial Rule 105.16(a)(iii) in conjunction with Financial Rule 105.17(a). This method of cooperation ensures that the business volumes and requirements of all participating Organizations are taken in consideration at the solicitation stage, so it is preferable over piggybacking. UN Secretariat Entities should plan joint procurement exercises with sufficient time to allow for coordination of requirements and business volumes across UN Organizations.

Generally, one organization will lead the solicitation process under its own financial regulations and rules. Cooperating UN Organizations will jointly agree on the Solicitation documents and evaluation criteria and may jointly evaluate the Submissions. The Solicitation documents should clearly specify the expected contractual form for effecting the procurement. Joint Solicitations are subject to the review requirements of the lead UN Organization only, except in those cases where the applicable evaluation criteria or the resulting award differs from that of the lead UN Organization.

The Procurement Official should ensure that the resulting contract drafted by the Lead UN Organization contains all the information required for the UN Secretariat to be able to order and obtain goods and/or services as per the contract. Alternatively, the Procurement Official may choose to draft a separate contract for the UN Secretariat based on the results of the joint solicitation, if there are reasons to believe that this would be advantageous despite the additional efforts and administrative costs.

#### 14.1.2 The UN Secretariat entering into a contract relying on a procurement decision of another UN Organization (using LTA or contracts of other UN Organizations and/or using other UN Organization's solicitation results – piggybacking)

A UN Secretariat entity may use a contract (including purchase orders and/or long-term agreements) concluded by another UN Organization, provided that the contract satisfies the UN Secretariat entity's requirements, specifically in terms of value for money and fit-for-purpose. Such an assessment should be determined and guided by the following:

- a. The value of the UN Secretariat entity's requirement is less than or equal to the value of the contract of the UN Organization. A contract should not be used to order disproportionately higher volumes than intended, especially for goods/services with volume discounts not reflected in the contract; and

- b. The vendor offers goods or services to the UN Secretariat entity at the same (or lower) price than in the contract and with the same terms and conditions. Procurement Officials shall conduct price negotiations as applicable; and
- c. The UN Secretariat entity's requirements are equivalent to those included in the contract;

For each procurement requirement, approval to commence procurement action shall be sought from the Procurement Approving Authority for Financial Rule 105.16(a)(iii) in conjunction with Financial Rule 105.17(a)

The Procurement Official shall ensure that Best Value for Money is obtained when piggybacking on a contract already established by another UN Organization. In terms of the time lapsed from the procurement action of the UN Organization, the UN Secretariat entity may consider piggybacking on said contract, if either one of the two following conditions are met:

- a. The contract of the UN Organization is valid;
- b. The award by the UN Organization was made within the 12 months prior to the proposed award by the UN Secretariat entity. For some categories, like freight forwarding, fuel requirements, etc. the reasonable time lapsed from the award by the UN Organization may in practice be more limited and Procurement Officials shall exercise due diligence to ensure that the UN Secretariat is obtaining Best Value for Money when piggybacking.

If the UN Secretariat entity is satisfied that the financial regulations and rules of the UN Organization are consistent with that of the UN and that the contract has been established in accordance with the procedures established in the respective UN Organization, a review of the award by a UN Secretariat Review Committee shall not be required. The UN Secretariat entity shall ensure that:

- a. The UN Organization has authorized in writing the use of its contract by the UN Secretariat entity (e.g. through a signed HLCM-PN-endorsed LTA information sheet (see Annex 28)). In addition, the UN Secretariat entity must obtain a signed copy of the UN Organization's contract (including purchase orders or LTA).
- b. The vendor on the UN Organization's contract is eligible with respect to the UN Secretariat's requirements on vendor eligibility and registered at the correct level;
- c. The vendor accepts the UNGCC.

A separate agreement, typically in the format of a purchase order or a contract, must be signed and counter-signed between the vendor and the UN Secretariat entity. The approval of the Procurement Approving Authority in the UN Secretariat under Financial Rule 105.17(a) shall be obtained prior to signature of the separate agreement; its term should not exceed the term of the UN Organization's contract.

LTAs of other UN Organizations are available at [www.ungm.org](http://www.ungm.org), and more specifically under the following link: <https://www.ungm.org/UNUser/LongTermAgreement/SearchLTAs>.

#### 14.1.3 Another UN Organization to carry out procurement activities on behalf of the UN Secretariat Entity

Under certain circumstances it may be advantageous or necessary to request a UN Organization to carry out certain procurement activities on behalf of a UN Secretariat entity. Those activities should be carried out on the basis of an appropriate legal instrument. For each procurement requirement, approval to commence procurement action shall be sought from the Procurement Approving Authority for Financial Rule 105.16(a)(iii) in conjunction with Financial Rule 105.17(a). Such engagement of another UN Organization to carry out procurement activities on behalf of the UN Secretariat entity may be considered in the following situations:

- a. **Expertise.** When the UN Secretariat entity acknowledges the existence and validity of the particular expertise of another UN Organization in the procurement of specific goods, works

or services, the Procurement Approving Authority may authorize such UN Organization to carry out procurement activities for the specific goods, works or services and designate such UN Organization as the procurement agent for the UN Secretariat entity.

- b. **Procurement / Administrative Capacity.** When the UN Secretariat entity does not have the necessary procurement and/or administrative capacity in a country nor the UN Secretariat can provide the necessary support locally, from PD or from a DOS-assigned service provider, procurement actions may be undertaken on behalf of the UN Secretariat entity by the representative of a UN Organization with the necessary procurement and administrative capacity (e.g. representative of the local United Nations Development Programme), in accordance with the regulations and rules of that UN Organization.

## RESOURCES

Annex 28 - Long Term Agreement Information Sheet

### 14.2 Cooperation with Governments and Non-UN Organizations

In accordance with Financial Rule 105.17(b), “the UN “may, to the extent authorized by the General Assembly, cooperate with a Government, nongovernmental organization or other public international organization in respect of procurement activities and, as appropriate, enter into agreements for such purposes.”

### 14.3 Other Contractual Instruments

Any other contractual instruments used under the provisions of Financial Rule 105.17(b), such as Memoranda of Understanding, Letters of Assist involving payment to a government or to a non-governmental organization or other public international organizations for goods and/or services has to follow the procurement principles outlined in Financial Regulation 5.12.

Procurement delegation for such instruments under Financial Rule 105.17(b) lies with the Director, PD for any instruments issued up to a value of US\$ 1,000,0000 and with the ASG, OSCM for those exceeding US\$ 1,000,0000 only.

#### 14.3.1 Letters of Assist

Letters of Assist can only be considered if a commercial sourcing solution cannot meet the requirements, and cover the following:

- a. Goods with associated services of a strictly uniformed capability nature or use;
- b. Goods and/or services not strictly of uniformed capability nature or use but unavailable through commercial solutions, existing stock;
- c. Transportation services for the movement of UN uniformed personnel and/or goods to or from a Mission area which are provided by the respective Troop/Police Contributing Countries at the Member States prerogative, subject to compliance with the operational



- requirements, including timeline and deployment location, and at a rate not to exceed what it would cost the Organization to conduct through commercial, or other competitive means;
- d. Dietary or other requirements unique to a contingent that are available only from the country of the individual contingent, and procurement of which is facilitated or expedited by procurement through the government of the contingent, provided that the cost to the UN of such procurement is not higher than the cost of the same items if procured through commercial sources;
  - e. Ammunition, if a commercial solution is not available or feasible;
  - f. The financial negotiations for the terms and conditions of LOAs shall always involve the PD. A submission to the HCC is required for all LOA cases exceeding US\$ 1,000,000. The use of LOAs shall be discontinued when circumstances or conditions that gave rise to their use no longer exist.

## 15. Transverse Topics

### 15.1 The United Nations Global Compact

Procurement Officials and Requisitioners should be aware that the United Nations encourages vendors to participate in the UN Global Compact. The UN Global Compact is a voluntary international corporate network established to support the participation of both private and public-sector actors in advancing responsible corporate citizenship and universal social and environmental principles to meet the challenges of globalization.

The Ten Principles of the UN Global Compact are as follows:

#### **Human Rights**

Principle 1. Businesses should support and respect the protection of internationally proclaimed human rights;

Principle 2. Make sure that they are not complicit in human rights abuses.

#### **Labour**

Principle 3. Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining;

Principle 4. The elimination of all forms of forced and compulsory labour;

Principle 5. The effective abolition of child labour;

Principle 6. The elimination of discrimination in respect of employment and occupation.

#### **Environment**

Principle 7. Businesses should support a precautionary approach to environmental challenges; Principle 8. Undertake initiatives to promote greater environmental responsibility;

Principle 9. Encourage the development and diffusion of environmentally friendly technologies.

#### **Anti-Corruption**

Principle 10. Businesses should work against all forms of corruption, including extortion and bribery.

The UN strongly encourages all vendors to actively participate in the UN Global Compact. To that end, the UN Supplier Code of Conduct has been developed with recognition of the importance of the Ten Principles of the UN Global Compact, and it is viewed as an important means of integrating the Compact's principles into the operations of the UN.

## **RESOURCES**

[The Ten Principles of the UN Global Compact](#)

## 15.2 Sustainability Considerations

Given the scale of its procurement activities, the UN has the potential, within its existing legislative framework and procurement guiding principles, to motivate markets to innovate and contribute to achieving global goals. The UN itself has been encouraged by the Member States to integrate sustainable development practices into its operations in support of the sustainable development agenda.

Requisitioners and Procurement Officials should be aware of the [Sustainable Development Goals](#) (SDGs) and inter-agency initiatives on procurement practices that incorporate the social, economic and environmental principles of sustainable development in support of SDG 12 and target 12.7.

Integrating the economic dimension of the sustainable agenda means to strive for the best value for money and, in particular, the whole life costs of a product or service, as well as for wider support for economic development.

Considering its environmental dimension is to strive for reduction of the negative environmental impact a product or service has over its whole life-cycle, including issues such as water, land and air pollution, waste generation and disposal options, environmental risks from wastewater and hazardous waste, and greenhouse gas emissions that contribute to climate change, preservation of natural ecosystems, waste reduction and management, and air and water pollution.

The social dimension of the sustainable agenda considers the promotion of human rights, elimination of child labour, fair labour conditions, gender equality, and wider ethical issues in the supply chain. For instance, to enable the implementation of the Convention on the Rights of Persons with Disabilities, as well as the achievement of the Sustainable Development Goals, the United Nations Disability [Inclusion](#) Strategy calls for specific action to raise the standards of the United Nations performance on disability inclusion across its operations, such as the inclusion of accessibility considerations into relevant procurement activities.

A number of General Assembly and Security Council resolutions have requested the Organization to address and minimize the environmental impact of its operations, including through the establishment of Environmental Management Systems (EMSs). The main priorities of the EMSs are improved waste and water management, increased energy efficiency, the progressive transition to renewable energy and an overall reduction of greenhouse gas emissions.

Factoring sustainability considerations at the requirements definition stage can provide added value to the Organization, by promoting resource efficiency, leveraging innovation and advancing the SDGs. Requirements must be transparent, measurable and proportionate to what the market can reasonably offer and must not restrict international competition. Category Strategies may also provide guidance on incorporating sustainability considerations into the sourcing solutions for certain goods and services.

In general, Requisitioners, Procurement Officials and contract managers are expected to encourage UN vendors to adopt sustainable and socially responsible policies aligned with the UN Global Compact's ten principles in the areas of human rights, labour, the environment, and anti-corruption in accordance with the UN Supplier Code of Conduct.

Any integration of sustainability considerations must be undertaken within existing legislative frameworks, particularly Financial Regulation 5.12.

## 15.3 Risk Management

Risk Management can be defined as the set of policies, procedures, and practices involved in the identification, analysis, assessment, control, avoidance, minimization, or elimination of unacceptable risks. The following UN policies address risk management elements and are particularly relevant to procurement:

- a. [UN Financial Regulations and Rules](#);
- b. Staff Regulations and Rules of the United Nations ([ST/SGB/2018/1](#));
- c. Financial Disclosure Programme ([ST/SGB/2006/6](#));
- d. ST/AI on Review Committees (to be issued shortly);
- e. This Procurement Manual;
- f. [Enterprise Risk Management and Internal Control Policy \(issued May 2011\)](#);
- g. Anti-Fraud and Anti-Corruption Framework ([ST/IC/2016/25](#));
- h. Delegations of Authority in the administration of the Staff Regulations and Rules and the Financial Regulations and Rules ([ST/SGB/2019/2](#));
- i. Debrief Guidelines; and
- j. ARB Terms of Reference.

The above policies and this PM provide for, amongst others, the following risk management measures:

- a. Framework for delegation of authority in procurement (see [Chapter 2.6 Procurement Authority](#));
- b. Identification of other critical roles in the procurement process and linkages of these roles to specific procurement training requirements;
- c. Review of procurement processes by Review Committees;
- d. Procedures for an independent internal investigation of fraud and other proscribed practices by OIOS, and mechanisms to determine sanctions for vendors;
- e. Bid protest/procurement challenge mechanisms for vendors (see [Chapter 10.2.2 Debrief Procedures](#));
- f. Solicitation and contract templates adjusted to critical requirements, such as food, fuel, aviation, etc.;
- g. Risks in procurement can originate in any stage of the procurement process. At the procurement process level, the Requisitioner should work closely with the Procurement Official in identifying potential risks, assessing impact and probability to understand the consequences, and putting in place appropriate mitigation measures. The table below shows some examples of procurement risks, their possible consequences, and potential risk mitigation actions to be put in place.

Stage	Risk	Possible Consequences	Risk Mitigation Actions
Planning and Strategy	Delay in procuring critical requirements for the project	Delay in project outputs and outcomes, impacting other stakeholders Higher prices	Early planning of procurement processes Adoption of appropriate strategies, including usage of LTAs if appropriate
Requirements Definition	Restrictive requirements definition	Limited vendor response Claims by vendors of unfairness and lack of transparency	Improved product and market understanding through market research Include generic functional and performance specifications

Solicitation	Low interest in the procurement process	Delays (if need to re-tender) Higher prices (if perceived there is no competition)	Publish tender widely and with ample tender period Conduct pre-bid meeting
Evaluation	Selecting vendors with unethical past conduct	Damage UN reputation	Check all vendors against ineligibility lists Conduct background check on recommended vendor, prior to award
<b>Contract Management</b>	<b>Failure of vendor to perform the contract</b>	<b>Contract disputes</b> <b>Inadequate quality of goods, services, or works</b> <b>Delays</b>	<b>Include adequate evaluation criteria in solicitation document</b> <b>Employ active contract management actions</b> <b>Conduct regular inspections and progress reports</b>

**TABLE 5: PROCUREMENT RISK, POTENTIAL CONSEQUENCES & RISK MITIGATION ACTIONS**

## RESOURCES

[UN Financial Regulations and Rules;](#)  
[Staff Regulations and Rules of the United Nations \(ST/SGB/2018/1\);](#)  
[Financial Disclosure Programme \(ST/SGB/2006/6\);](#)  
[ST/AI on Review Committees \(to be issued shortly\);](#)  
 This Procurement Manual;  
[Enterprise Risk Management and Internal Control Policy \(issued May 2011\);](#)  
[Anti-Fraud and Anti-Corruption Framework \(ST/IC/2016/25\);](#)  
[Framework for Delegations of Authority \(ST/SGB/2019/2\);](#)  
[Debrief Guidelines;](#)  
[ARB Terms of Reference.](#)

### 15.4 Emergency Procurement Procedures

In 2016, in response to the recommendations of the High-level Independent Panel on Peace Operations, the Secretary-General established standing administrative measures for start-up and crisis situations to achieve faster deployment and more agile support to field operations. The Secretary-General, on the advice of the relevant senior officials, can activate the standing administrative measures, which apply for six months on a renewable basis, upon the establishment of a peace operation or certification of a crisis or emergency in the field. These measures are intended to enable the Organization and managers to respond quickly and accountably, as required in each specific situation, to extraordinary requirements through increased levels of delegation of authority, piggybacking on any contracts established by other Secretariat offices or other UN entities while remaining in full compliance with Regulations and Rules of the Organization.

Other mechanisms available to respond to exigent procurement situations are the personal delegation of procurement authority for emergency situations to the Director, PD in the amount of US \$10 million and the application of the Financial Rule 105.16(vii) – when there is an exigency for

the requirement. The personal delegation of procurement authority for emergency situations to the Director, PD needs to be activated by the ASG, OSCM or USG, DOS.

All UN procurement must be undertaken in compliance with the Financial Regulations and Rules, other relevant applicable legislative instruments, and this PM. The EPP allows the UN to use simplified processes to facilitate rapid response during an emergency situation without compromising the principles of Financial Regulation 5.12. The use of EPPs is limited to only those defined under this [Chapter 15.4](#).

All other situations of importance and urgency must be dealt with through the application of regular procurement procedures.

Financial Regulations and Rules allow exceptions where the exigencies of UN operations do not permit procurement to be undertaken through formal methods of solicitation. However, reasonable efforts should be made during an emergency situation to still follow a process wherein several offers are compared to ensure Best Value for Money for the UN.

The EPP described in the following sections permit a solicitation process using RFQs and associated procedures.

Definition of Emergency Situation: For the purposes of this chapter, emergencies are defined as “urgent situations in which there is clear evidence that an event or a series of events has occurred which imminently threatens human life/lives or livelihoods, and where the event or a series of events produces disruption in the life of a community on an exceptional scale.” The event or a series of events can comprise any of the following:

- a. Sudden calamities such as earthquakes, floods, locust infestations, and similar unforeseen disasters;
- b. Human-made emergencies resulting in an influx of refugees or the internal displacement of populations, or in the suffering of otherwise affected populations;
- c. Drought, crop failures, pests, and diseases that result in an erosion of communities and vulnerable populations’ capacity to meet their basic needs;
- d. Sudden economic shocks, market failures, or economic collapse resulting in an erosion of communities’ and vulnerable populations’ capacity to meet their basic needs;
- e. A complex emergency for which the government of the affected country or the Head of Agency of a UN organization has requested the support of the UN;
- f. Other event(s) that, in the opinion of the ASG, OSCM or USG, DOS, would fall under the definition of a genuine emergency situation.

Approval of the Use of Emergency Delegation of Procurement Authority:

Request for approval of the activation of Special Delegation for Emergencies must be presented by the Director, PD to the ASG, OSCM and shall include the background information and justification for its use, as well as a description, approximate value, quantity, and requirements of the estimated procurement needs under the specific operation. Approval requests must also provide justification that none of the discretionary authority of the respective Procurement Approving Authority will achieve the procurement needs of the emergency operation.

The approval for use of EPP is time-bound, limited to a specific operation, and may also be limited to the procurement of defined products in relation to a specific operation. This delegation, when activated, is envisaged exclusively for the Director, PD. However, Heads of Entity are fully empowered to take action in accordance with financial rule 105.16 (a) (vii) in cases of exigency as defined by the General Assembly decision 54/468 (see section 6.11.9). Such action can be undertaken regardless of the strategic nature of the goods and/or services and, where justified by the circumstances at hand, without any prior approval.

### Reporting and Monitoring:

- a. The UN monitors the use of EPP and keeps a record of its use, which will be audited regularly;
- b. The Director, PD shall submit a report of all procurement conducted under the emergency delegation of authority every week from its issuance to the ASG, OSCM with a copy to HCC Chairperson. The obligation to report every week holds even if no purchases have been executed during the previous seven calendar days. All cases exceeding the usually delegated authority of Director, PD shall be submitted to the HCC for review on an ex post facto basis;
- c. PD shall submit a report on the status of each requirement to the Requisitioners or to the Emergency Task Force (as the case may be) on a periodic basis, depending on the severity of the emergency and the reporting requirements of the Emergency Task Force or management;
- d. If there is a need to issue purchase orders and/or contracts outside of UMOJA, Procurement Officials shall record such purchase orders/contracts into a consolidated report. At the earliest of the (i) conclusion of the emergency period or (ii) when funds become available in UMOJA and upon issuance of a Shopping Cart by the Requisitioner, the Procurement Official shall issue the purchase order/contract in UMOJA.

### Strategic Planning of Emergency Procurement:

By definition, emergencies are often caused by unforeseen events, and therefore procurement needs may change and cannot be anticipated. However, proactive measures can be taken to ensure preparedness to carry out emergency operations. Planning for emergencies is an important part of UN regular procurement planning. The following activities are examples of proactive measures that can facilitate EPP:

- a. Advance identification and registration of suitable vendors of products frequently requested in emergency operations, including confirmation by vendors of willingness to respond to solicitations on short notice;
- b. Development of standard specifications/TORs/SOWs for goods, services, or works typically requested in emergency operations;
- c. Establishment of LTAs with vendors of products typically requested in emergency operations, and specifying in LTAs the need for stock availability and emergency preparedness;
- d. Identification of relevant LTAs from other United Nations organizations.

PD will work continuously on the above in order to help ensure that the organization is prepared for emergency situations. To make strategic planning relevant, it is of the utmost importance that UN Procurement Officials involved in emergencies provide input and lessons learned after each emergency operation. Strategic planning measures as listed above are also relevant in certain decentralized UN offices.

#### 15.4.1 Emergency Task Force

In all emergency situations, the business unit concerned should liaise with the Director, PD in order to guarantee early information exchange and proactive measures to be taken. Further, lessons learned should be codified, as they form crucial input to process improvements and help better the management of future emergency situations.

### Emergency Procurement Procedures:

During emergency operations, Procurement Officials may alter the regular procurement procedures as outlined in this section. When faced with an emergency procurement activity, Procurement Officials should, as feasible:

- a. Conduct backward planning, i.e., plan procurement activities starting from the time the goods have to be delivered, counting backward to determine the maximum length of time required for each procurement step (solicitation, evaluation, award, contract issuance, etc.);
- b. Determine proactively the likely availability of team members for evaluation;
- c. Issue urgent notifications to relevant stakeholders involved in the process so that they can be prepared to respond faster (e.g. Chairperson of HCC, ASG OSCM, etc.).

Emergency Procurement Procedures (EPP) are less formal and offer more flexibility than the regular procurement procedures applicable in non-emergency situations. At the discretion of the Director, Procurement Division, more conservative procedures might be imposed through the issuance of written instructions to the business unit. For example, this might include requiring the transmittal of receipt of offers to a secure email address or fax number, if available.

#### 15.4.2 Funds and Issuance of Solicitations

In emergency situations, it will often be necessary to initiate solicitation processes prior to receiving the funds. However, in emergency situations, the severe impact of delays may justify the commencement of the process prior to the confirmation of the availability of funds. The market must be informed of the UN right to cancel the solicitation and reject all offers received.

Similarly, in such situations, it may be necessary to issue purchase orders and sign contracts outside UMOJA.

Under no circumstances should an order be placed, or a contract signed prior to the confirmation of funds by the Requisitioner.

#### 15.4.3 Needs Assessment and Requirement Definition

The assessment of the functions, performance requirements, characteristics, objectives, and/or expected outputs of the product to be procured are no less important when procured under EPP. To the extent possible, the regular procedures for requirements definition specified in [Chapter 4.4](#) of this PM should be followed. However, since emergency procurement is often done under time constraints and the RFQ method of solicitation allows more flexibility, less formality can be accepted for requirement definition in emergency situations. The following points should be considered:

The use of brand names in requirement specifications, which is generally not allowed under the regular procedures, may be used in emergency procurement if it aids description of the required product. To avoid restricting competition, the words 'or equivalent' should be added unless a particular brand is required for standardization purposes. It should also be stated that the equivalent brand name products would be accepted. Standardization is particularly sensitive in emergencies: requirement of a specific brand might delay the delivery, while other brands could be readily available or ex-stock;

Product instructions and standard specifications/TOR previously developed and available through the UN;

Existing LTAs can provide useful specifications and should also be checked for compliance with the current need. If LTAs exist for the requested product, and the LTA can adequately cover the need in terms of stock availability and delivery times, orders should be placed against the existing LTA.

#### 15.4.4 Sourcing

Under EPP, priority should be given to vendors experienced in supplying the UN system in emergency operations in order to reduce lead-times and the risk of contract failure. Strategic sourcing undertaken upfront by the PD should always be checked, as it could provide useful input.



For solicitations undertaken through the use of the RFQ method of solicitation, there are no specific requirements to prepare a shortlist. However, in order to comply with basic audit requirements, the procurement file must contain a brief explanation as to which vendors were considered and why.

While vendors do not have to be registered in UNGM at the Basic Level to participate in a solicitation during the emergency period, the Procurement Official shall ensure that vendors are registered in UNGM at the appropriate Level at the time of contract signature. In case where a vendor registration at the appropriate level requires Special Approval, Chief, EOS may decide to waive such review by the e-SAC and approve the registration of the vendor, considering the due diligence performed by the VRO. In particular, in cases of high-value contract, appropriate diligence shall be exercised.

Chief, EOS shall report such Special Approvals to ASG, OSCM on a weekly basis during the period of the emergency.

#### 15.4.5 Solicitation Method

Under EPP, an RFQ may be used for the solicitation of offers, regardless of the value of the procurement, and shall be deemed to be a formal method of solicitation. Procurement Officials should ensure competition by requesting at least three quotations, if feasible.

##### Solicitation

- a. RFQs can be used regardless of the value of emergency procurement. When using an RFQ in emergency situations, no absolute deadline or specific template is required (except for procurement for works). However, vendors should be given a realistic timeframe to respond to the request. The request should contain enough information to enable vendors to give an informative quote, meaning all requirements should be communicated clearly and in the same manner to all vendors along with the method of evaluation. If feasible, the Director, PD or CPO, may decide that a submission deadline be set. The Director, PD or CPO may determine in their sole discretion whether the offers will be submitted through the TOC;
- b. If time allows, RFQs shall be issued by using the corporate templates, as this supports the transparency of the process by ensuring that all vendors receive the same information at the same time;
- c. Additional Considerations of RFQs under EPP:
  - i. Additional vendors may be added at any stage of the process;
  - ii. It is always advisable to check multiple markets for fallback options and to reconfirm availability before placing an order;
  - iii. The vendor offering the lowest-priced, technically acceptable offer might not be able to supply all requested goods or the full quantity requested. Therefore, the possibility and option to make split orders should always be made clear in an RFQ for emergencies. Split orders can ensure availability of all requested items and safeguard economy by placing a partial order with the vendor offering the lowest price for the respective item. In cases where the full quantity requested cannot be provided by one vendor, an additional order can be placed with the vendor offering the second-lowest priced.

##### Tender Opening Procedures:

- a. **Bid/proposals submissions:** Depending on the situation, the UN may decide to only solicit submissions of bid and proposals via electronic means. This may be implemented in one or more offices depending on the emergency. The solicitation documents issued by

Procurement Officials of the UN Secretariat will identify such mode of submission. In such case the UN will only accept such submissions received via electronic means.

- b. **Public Bid (Tender) Openings:** Depending on the situation, the UN may decide to cancel all public bid openings. In such case upon request from vendors who submitted bids as a result of Invitation to Bids, the UN will provide the Bid Abstract Sheet (which includes the List of Vendors who submitted bids and the total price of their bids) within 30 days from the date of the Tender opening via email to [pdbidsubmission@un.org](mailto:pdbidsubmission@un.org). Similarly, upon request from vendors who submitted proposals as a result of a Request for Proposals, the UN will provide the List of Vendors who submitted proposals within 30 days from the date of the Tender opening via email to [pdbidsubmission@un.org](mailto:pdbidsubmission@un.org).

Evaluation:

- a. Offers received based on an RFQ during an emergency operation should be assessed against the requirements stated in the RFQ. At least two (2) individuals should be involved in the evaluation of offers, one on the technical side and a Procurement Official on the financial side. Contracts are awarded according to the 'lowest-priced, technically acceptable offer' evaluation methodology, and an evaluation report should be prepared. When using this methodology, price serves as the overriding evaluation criterion upon which to award a contract.
- b. However:
  - i. The technical advantages offered by a higher-priced quotation may in certain cases justify the selection of an offer other than the lowest priced;
  - ii. Further, the RFQ modality allows selection of the most technically acceptable offer in cases where none of the offers fully meet the requirement specification (where regular formal methods of solicitation would require retendering);
- c. The selection of a vendor other than the one offering the lowest priced option requires proper justification be documented and kept on file. See [Chapter 8 Evaluation of Submissions](#) for further guidance. The following points should be considered:
  - i. Whilst evaluation is conducted according to the 'lowest-priced, technically acceptable' methodology, and no exact evaluation criteria should be determined in the RFQ, Procurement Officials still have an obligation to present all vendors with the same information regarding UN requirements, delivery dates, and any other factors that will be assessed during evaluation and selection;
  - ii. With a lack of firm evaluation criteria, particular emphasis should be placed on creating a written record of the evaluation process and the justification for vendor selection;
  - iii. The evaluation team shall have the right, for reasons of expediency and subject to equal treatment of bidders, to decide not to ask bidders for missing documents;
  - iv. Given the time constraints and thus limited extent to which background checks can be performed, Procurement Officials may request performance security from the vendor. The willingness of bidders to provide performance security is a positive indication regarding the financial position of the company. This is not a mandatory requirement;
  - v. RFQs issued during an emergency operation constitute a formal method of solicitation. Hence, negotiations can be undertaken with a potential vendor, after selection of the vendor and in accordance with [Chapter 8.9 Negotiations](#).

#### 15.4.6 Award

The Procurement Approving Authority with the delegated authority (DOA) for the value of the procurement activity (see [Chapter 2.6.1 Delegation of Authority](#)) will award contracts further to an

EPP activity. Where the ASG, OSCM or USG, DOS has granted authorization to use EPP, the use of an RFQ process shall be deemed to constitute a 'formal method of solicitation' for the purposes of Financial Rule 105.15. The resulting award to the winning offer is made on the basis of the use of formal methods of solicitation and respective DOA thresholds for awards apply.

#### 15.4.7 Contracts

Due to the risk involved, the procedures for contract preparation and issuance, as well as contract administration, remain the same as under normal conditions. Standard UN Forms of Contracts are used when contracting vendors during emergency operations. The UN requires written contracts to be signed for all procurement activities with values equal to or above US \$2,500.

The UN never enters into oral contracts. Each UN contract must be in writing and duly signed by the parties, as set forth in this manual. Care must be taken to avoid exposing the UN to the risk of inadvertently entering into a binding oral agreement (see [Chapter 11 Contract Finalization and Issuance and Contractual Instruments](#)).

#### 15.4.8 Contract Administration

Contract administration of emergency contracts is a combined responsibility of the procuring unit and the personnel responsible for emergency operations (see [Chapter 13 Contract Management and Contract Administration](#) for further guidance).

Proper documentation of the procurement process in a procurement file is a requirement for each procurement exercise. The use of the EPP allows more flexibility in the procurement process than UN regular procedures. This increases the responsibility of Procurement Officials, as well as involved managers, to document that the procurement has been conducted consistent with the procurement principles and in accordance with the Financial Regulations and Rules. Procurement Officials are reminded that proper filing also protects the individual undertaking the procurement activity from undue suspicion and ensures that actions can be justified to auditors.

In order to document the EPP and to justify decisions and choices made when selecting the vendor and awarding contract, all steps in the process must be documented in the procurement file. In the event of a dispute, the file is critical: it documents the procedure, establishes an institutional memory, forms the basis of a lessons learned process, and is essential for audit purposes.

Please refer to [Chapter 13.9 Maintenance of Files](#) for filing requirements. In addition to documents identified therein, for processes under EPP, the file should also include the request for approval, as well as approval of the use of EPP.

## 16. Glossary

This section contains a glossary of relevant terms within this procurement manual. Terms in the glossary that have a commonly used abbreviation in this manual are marked with an asterisk (\*) and defined in the Abbreviations table below.

<b>Accountability</b>	The obligation to:  a) Demonstrate that work has been conducted in accordance with agreed rules and standards; b) Report fairly and accurately on performance results vis-à-vis mandated roles and/or plans.
<b>Acquisition Plan</b>	The work plan regulating the acquisition activities over the course of a year.
<b>Acquisition Process</b>	The steps necessary to acquire goods and services, inter alia, through identification and development of requirements, planning, budgeting, conducting solicitations, obtaining approvals, entering into contract negotiations and carrying out contract fulfilment.
<b>Administrative Instruction (AI)*</b>	An administrative instrument used by the UN to establish instructions, procedures, and business process maps for implementation of superior United Nations legislation applicable to the UN.
<b>Award Review Board (ARB)</b>	The Award Review Board is a UN administrative board which independently reviews complaints by unsuccessful bidders who challenge contracts awards made by the UN.
<b>Audit Trail</b>	Clear and concise documentation in a suitable format, normally a written log, describing the actions and decisions taken throughout the handling of a case, thereby enabling a reviewer of the case to establish that it has been handled in accordance with the applicable regulations, rules and procedures.
<b>Authorized Official</b>	An individual who has been delegated procurement authority and who is overall responsible for the procurement function of an entity, either at Headquarters or other locations. This may be a head of the entity or head of a department.
<b>Award</b>	The authorization given by an Authorized Official following Review Committees recommendation or by a Procurement Approving Authority, as applicable, to establish a commitment.
<b>Bank Guarantee for Advance Payment</b>	An unconditional and on-demand bank guarantee from the contractor to the UN for advance payment enabling the contractor to commence works. Such advances arrive at first interim payment.

<b>Bank Guarantee for Performance</b>	A bank guarantee obtained from the contractor to protect the UN from non-performance by the contractor of its contractual obligations. It is a promise from a bank that it will pay the UN the amount of the guarantee if the contractor fails to perform any of the terms, provisions, or conditions of the contract.
<b>Best Value for Money</b>	The optimization of total cost of ownership and quality needed to meet the user's requirements, while taking into consideration potential risk factors and resources available.
<b>Best and Final Offer (BAFO)*</b>	A negotiation tool that can be used during the final evaluation phase of the procurement process.
<b>Bid/Proposal/Offer</b>	a) An offer in response to a method of solicitation; b) A response to a solicitation from a vendor or supplier
<b>Bid Security (Bid Bond)</b>	A security from a supplier securing obligations, resulting from a Submission with the intention to avoid (i) the withdrawal or modification of an offer after the deadline for submission of such documents, (ii) failure to sign the contract or failure to provide the required security for the performance of the contract after an offer has been accepted, or (iii) failure to comply with any other conditions precedent to signing the contract specified in the solicitation documents.
<b>Bidder/Proposer/Offeror</b>	An entity that submits an offer in response to a solicitation. Normally, the term 'bidder' is used to refer to the entity responding to an EOI, RFI, ITB, RFQ, or RFP.
<b>Bid Protest/Procurement Challenge</b>	A post-award complaint against the methods employed or decisions made by the UN in a process leading to the award of a contract.
<b>Bill of Lading</b>	A carrier's contract and receipt for goods; it agrees to transport from one place to another and to deliver to a designated recipient (consignee).
<b>Blanket Purchase Order (BPO) *</b>	BPOs are typically issued at the local level to satisfy straightforward, low-value, and recurring operational requirements of a support nature.
<b>Business Partner (BP)</b>	A person or an organization that has a business interest with the UN. A BP can be a commercial vendor that supplies goods and/or services to the UN but also a UN agency, Member or staff members, etc.
<b>Call-Off Orders/Purchase Orders</b>	Orders against an established long-term agreement.
<b>Cartel</b>	A small group of competing producers/suppliers of a good or a service who agree to regulate the production, price, and/or marketing in an effort to control or manipulate the market.

<b>Catalogue</b>	An organized list of goods or services specifying the description, price, unit of measure, and other attributes. A catalogue may be available as a document or in an electronic format.
<b>Certifying Officer (CO)</b>	See Financial Rule 105.5. The CO is the UN official responsible for managing the utilization of resources, in accordance with the purposes for which those resources were approved and the principles of efficiency, effectiveness and the Financial Regulations and Rules. CO review the requests issued by the Requisitioner, ensure that the technical specifications are generic and that funds are available for the procurement. Certifying authority and responsibility are assigned on a personal basis and cannot be delegated. A CO cannot exercise the approving function under Financial Rule 105.6.
<b>Closing Date</b>	The deadline for all bid/proposal submissions.
<b>Collaborative Procurement/Common Procurement</b>	A procurement arrangement in which several UN organizations combine their efforts to undertake procurement in cooperation or share the outcome of a procurement process, thereby achieving benefits for the group in its entirety. The objective of collaborative procurement is to achieve reduced price or better service through economies of scale and to reduce inefficiency and duplication across the UN organizations.
<b>Commitment</b>	The anticipated or contingent liability against funds allocated for the current or future year(s).
<b>Competitive Bidding</b>	A procurement method in which offers from competing suppliers are invited by open advertisement and provided with the scope, specifications, and terms and conditions of the proposed contract, as well as the criteria by which the offers will be evaluated. The objectives of competitive bidding are to obtain goods or services at the lowest cost or best value through open and fair competition.
<b>Contract</b>	In the context of UN procurement, a contract is a written, legally-binding agreement between the organization and a supplier that establishes the terms and conditions, including the rights and obligations of the organization and the supplier. A contract may take many different forms (e.g. agreement, purchase order, memorandum of understanding, letters of assist).
<b>Contract Administration</b>	All actions undertaken after the award of a contract relating to the administrative aspects of the contract, such as contract amendment, contract closure, record retention, maintenance of the contract file, handling disputes or claims, and handling of security instruments (e.g. performance security).

<b>Contract Management</b>	The ongoing monitoring and management of the supplier's performance regarding the promised goods or services, as well as assuring compliance with all other terms and conditions of a contract, such as a price and discounts. It includes managing the relationship between the supplier, the procuring unit, the requisitioner, and/or the end-user, as well as feedback to the supplier regarding its performance if necessary.
<b>Contract Modification</b>	Any written change in the terms of the contract. Contract modifications only become effective when executed in writing by both parties through a contract amendment.
<b>Contractor</b>	Any party to a procurement contract with the organization. A contractor may take various forms, including an individual person, a company (whether privately or publicly held), a partnership, or a government agency.
<b>Cost Estimate</b>	An approximate calculation of charges or costs to supply goods and/or services.
<b>Default</b>	A failure by a contracting party to meet one or more of its obligations under the contract.
<b>Delegation of Authority (DOA)*</b>	The written instruments stating the conditions, procedures, and terms for a delegate to exercise authority in the respective area.
<b>Delivery Time</b>	The time taken to deliver goods from the date of order to the time when the supplier makes the goods available to the buyer at the agreed place as per the delivery terms.
<b>Disposal</b>	The process of removing something from a location, typically the removal of scrap, surplus, excess, obsolete and waste items from an organization's premises.
<b>E-tendering</b>	Electronic procurement that occurs when the activities of the purchasing process are conducted electronically, typically over the Internet, to shorten the cycle time and lower the transaction costs of the acquisition process.
<b>Exigency</b>	An exceptional, compelling, and emergent need or situation of force majeure, not resulting from poor planning or management or from concerns over the availability of funds, that will lead to serious damage, loss, or injury to property or persons, if not addressed immediately.
<b>Expression of Interest (EOI)*</b>	A response to a Request for Expression of Interest (REOI) expressing interest in participating in a

	solicitation.
<b>Incoterms</b>	Incoterms rules are standardized and widely-recognized trade terms, prepared by the International Chamber of Commerce (ICC), to be included in contracts for the sale of goods and to provide standard contractual provisions that clarify the costs, risks, and responsibilities of the parties to the contract, particularly in relation to the shipment and delivery of the goods from sellers to buyers. Refer to the ICC website ( <a href="http://www.iccwbo.org">www.iccwbo.org</a> ) for more information about these terms and their definitions, which are copyrighted by the ICC.
<b>Internal Control</b>	A process carried out by the UN's management and other personnel, designed to provide reasonable assurance regarding robust risk management and the achievement of objectives and goals. This process aims to increase the effectiveness and efficiency of operations, the reliability of financial reporting, and compliance with applicable laws and regulations.
<b>Invitation to Bid (ITB)*</b>	A formal method of solicitation where prospective suppliers are requested to submit a bid for the provision of goods or services. An ITB is normally used when the requirements are clearly and completely specified and the basis for the award is the lowest cost.
<b>Invoice</b>	Supplier's demand for payment setting out the amount for payment by the buyer with respect to goods delivered or services rendered.
<b>Lease</b>	A contract whereby, in return for a payment or series of payments, the lessor conveys to the lessee the right to use an asset for an agreed-upon period of time. There are two types of leases, namely, (i) a finance lease, which transfers substantially all risks and rewards incident to ownership of an asset while the title may or may not be eventually transferred, and (ii) an operating lease, which is a lease other than a finance lease.
<b>Legal Obligation</b>	An obligation that derives from:  a) A contract (through its explicit or implicit terms); b) Legislation;/or c) Other operation of law.
<b>Liability</b>	Any obligation incurred as a result of law, rule, or agreement; being legally obliged and responsible; a debt or an obligation to another party.
<b>Life Cycle Cost/Whole Life Cost/Total Cost of Ownership</b>	The sum of all recurring and one-time (non-recurring) costs over the full life span or specified period of a good, service, structure, or system. It includes purchase price, installation cost, operating costs,



	maintenance and upgrade costs, and remaining residual or salvage value at the end of ownership or its useful life.
<b>Logistics</b>	The process of planning, implementing and controlling the efficient, cost-effective flow and storage of goods and related information from point of origin to point of consumption for the purpose of conforming to customer requirements.
<b>Long-Term Agreement (LTA)*</b>	A written agreement between an organization of the United Nations system and a supplier that is established for a defined period of time for specific goods or services at prescribed prices or pricing provisions.
<b>Offer/Submission</b>	A generic term for bids, quotations, and proposals received from a supplier in response to solicitation documents.
<b>Price Escalation</b>	The practice of having a mechanism to increase unit prices throughout the contract life that should reflect inflation, usually on large contracts in areas with significant inflation.
<b>Procurement</b>	The acquisition by purchase or lease of goods, services, real property, and works.
<b>Procurement Approving Authority</b>	A Procurement Official who has been formally delegated authority for procurement (DOA) and will be referred to as a Procurement Approving Authority, up to their level of delegated authority.
<b>Procurement Authority</b>	The delegation from the Secretary-General to Heads of Entity and other appropriate officials to perform procurement functions.
<b>Procurement Official</b>	Procurement staff dedicated for procuring goods and services, with proper training, knowledge, and experience, or administrative staff with the appropriate procurement expertise, training, and qualification, if approved by the ASG, OSCM.
<b>Procuring Agent</b>	Another UN Secretariat entity that may be assigned by the USG, DOS in consultation with USG, DMSPC and the head of entity, to undertake procurement on the entity's behalf if the entity does not have sufficient procurement capacity.
<b>Product</b>	The use of the word 'product' in the context of this manual is used to cover goods, works, and services.
<b>Proposal</b>	An offer in response to an RFP.
<b>Purchase Order (PO)*</b>	A type of contract that documents the purchase of goods and/or services.

<b>Quotation</b>	An offer in response to a Request For Quotation. However, if it is in response to an enquiry, it is simply a statement of price and availability.
<b>Request for Expression of Interest (REOI)*</b>	An advertisement to identify suppliers that wish to participate in a forthcoming solicitation (see also 'expression of interest (EOI)').
<b>Request for Information (RFI)*</b>	An instrument to conduct a market survey in order to obtain information from the market that can be used to identify potential vendors, as well as available or potential solutions for fulfilling identified needs that may also include information on cost and delivery time.
<b>Request for Proposal (RFP)*</b>	A formal method of solicitation where prospective suppliers are requested to submit a proposal for the provision of goods, works, or services, based on the specifications, statement of work (SOW), or terms of reference (TOR) included in the solicitation documents. An RFP is normally used in cases where the requirements are complex and/or cannot be clearly or completely specified, where detailed technical evaluations are to be performed, and/or where pricing or cost may not be the sole basis of the award.
<b>Request for Quotation (RFQ)*</b>	An informal method of solicitation whereby suppliers are requested to submit a quotation for the provision of goods or services. An RFQ is normally used for standard, off-the-shelf items where the value of the procurement falls below the established threshold for formal methods of solicitation.
<b>Requisition/Shopping Cart</b>	A written or computerized request from an internal user/customer for the fulfilment or procurement of goods, services, or works.
<b>Requisitioner</b>	A UN staff initiating a purchase requisition (i.e., a request for goods, works or services).
<b>Review Committees*</b>	HCC and LCCs are committees (committees on contracts) to review procurement processes, thus verifying whether procurement has been undertaken in accordance with established procedures and in line with the Financial Regulations and Rules.
<b>Sealed Offer</b>	An offer that has been submitted in a sealed envelope to prevent its contents from being revealed or known before the deadline for the submission and opening of all offers.
<b>Security Instruments</b>	Financial instruments that are intended to provide the UN with security against expenses and losses that result from a failure by a supplier to perform its obligations. They are intended to ensure that funding is available to compensate the UN for such failure and are not intended as a punishment. The main security

	instruments are (i) bid security and (ii) performance security. Security can take the form of bank guarantees, surety bonds, standby letters of credit, and cheques on which a bank is primarily liable.
<b>Segregation of Duties</b>	An internal control mechanism used to assure that no single individual or organizational unit is given responsibility for more than one related function.
<b>Solicitation</b>	Generic term for a request to vendors to offer a quotation, bid, or proposal.
<b>Solicitation Documents</b>	Documents issued by the UN to describe procurement requirements and to invite vendors to submit a bid, quotation, or proposal.
<b>Solicitation Method</b>	The method used to solicit offers from vendors. ITB, RFP, RFQ, and LVAs are methods of solicitation.
<b>Source Selection Plan (SSP)*</b>	The SSP describes critical components of the procurement process and provides justification for the decision in order to achieve Best Value for Money. It provides an objective approach to the methodology of selecting the best source to fulfil the established need.
<b>Sourcing</b>	The process of identifying suitable suppliers that could provide the required products or services for the acquiring organization.
<b>Specifications</b>	A description of the technical requirements for a material, product, or service. Specifications usually refer to the defined requirements for materials or products but can also relate to the requirements for services (terms of reference (TOR)).
<b>Standardization</b>	The process of agreeing on a standard specification for a specific product or line of products. This is usually conducted to achieve economies of scale, compatibility with other products, facilitation of operation, maintenance and repair of already purchased goods, etc. Standardization could result in sole or limited source situations; this should be a consideration in the decision for standardization.
<b>Statement of Award</b>	A written record of the basis on which an award was made.
<b>Statement of Work (SOW)*</b>	Requirement specifications for work assignments outlining the specific services a contractor is expected to perform, generally indicating the type, level, and quality of service, as well as the time schedule required.
<b>Submission</b>	Along with 'offer', this is a generic term for bids, quotations, and proposals received from a supplier in response to solicitation documents.

<b>Supplier/Vendor</b>	An entity that potentially or actually provides goods or other products (including intellectual property), services, and/or works to the organization. For the purpose of this manual, the terms 'supplier' and 'vendor' are considered equivalent and used interchangeably.
<b>Tender</b>	A term for bids, quotations, and proposals received from a supplier in response to solicitation documents.
<b>Tender Opening Committee /Member</b>	The committee or TOC member who has been delegated authority to receive and open submissions.
<b>Terms of Reference (TOR)*</b>	A description of the scope of work for services generally indicating the work to be performed, the level of quality and effort, the timeline, and the deliverables.
<b>UMOJA</b>	UN Secretariat ERP system.
<b>United Nations General Terms and Conditions of Contract (UNGCC)*</b>	The UN general conditions of contract (sometimes referred to as 'general terms and conditions') are a set of standard contractual provisions that are incorporated into virtually every commercial contract that the UN, including its funds and programmes, concludes. The general conditions of contract cover a range of issues, including the contractor's status vis-à-vis the Organization, the use of sub-contractors, indemnification, intellectual property rights, use of the name, emblem or seal of the United Nations, termination and events of force majeure, dispute settlement, privileges and immunities, standards of conduct, and amendments.
<b>United Nations Global Compact</b>	Voluntary international corporate citizenship network initiated by the Secretary-General to support the participation of both the private sector and other social actors; the UN Global Compact aims to advance responsible corporate citizenship and universal social and environmental principles to meet the challenges of globalization. It is based on 10 principles related to human rights, labour, environment, and anti-corruption. See <a href="http://www.unglobalcompact.org">http://www.unglobalcompact.org</a> for more information.
<b>United Nations Global Marketplace (UNGM)*</b>	Internet portal used by more than twenty-five (25) United Nations agencies, including the UN Secretariat. The UNGM includes, among other types of information, tender notices and an inter-agency vendor registration system. See <a href="http://www.ungm.org">http://www.ungm.org</a> for more information.
<b>UNSPSC*</b>	The United Nations Standard Products and Services Code, a coding system for classifying products (e.g. goods, works and services).
<b>UNCITRAL*</b>	The United Nations Commission on International Trade Law.

<b>Vendor</b>	See definition of 'supplier' above.
<b>Vendor Registration Officer (VRO)</b>	The staff that are responsible for evaluating vendor registration applications, creating and maintaining vendor records, and providing support service to the UN Secretariat for matters involving vendor registration.
<b>Warranty</b>	An assurance (expressed or implied) by the supplier that the material, product, or workmanship being sold is as represented or promised (e.g. free of defects or will be repaired or replaced free of charge) or according to conditions set out in the warranty.

## 17. Abbreviations

<b>AI</b>	Administrative Instruction
<b>BAFO</b>	Best and Final Offer
<b>BPO</b>	Blanket Purchase Order
<b>BTA</b>	Business Transformation and Accountability Division
<b>CPO</b>	Chief Procurement Officer
<b>DMS</b>	Director of Mission Support
<b>DMSPC</b>	Department of Management Strategy, Policy and Compliance
<b>DOA</b>	Delegation of Authority
<b>DOS</b>	Department of Operational Support
<b>EOI</b>	Expression of Interest
<b>ERP</b>	Enterprise Resource Planning
<b>FRR</b>	Financial Regulations and Rules
<b>HCC</b>	Headquarters Committee on Contracts
<b>HQ</b>	Headquarters
<b>ITB</b>	Invitation to Bid
<b>LCC</b>	Local Committee on Contracts
<b>LOA</b>	Letter of Assist
<b>LOI</b>	Letter of Intent
<b>LTA</b>	Long-Term Agreement
<b>MDM</b>	Master Data Management
<b>MoU</b>	Memorandum of Understanding
<b>OIOS</b>	Office of Internal Oversight Services
<b>PO</b>	Purchase Order
<b>REOI</b>	Request for Expression of Interest
<b>RFI</b>	Request for Information
<b>RFP</b>	Request for Proposal
<b>RFQ</b>	Request for Quotation
<b>SOW</b>	Statement of Work
<b>SSP</b>	Source Selection Plan
<b>SGB</b>	Secretary-General's Bulletin
<b>TOC</b>	Tender Opening Committee
<b>TOR</b>	Terms of Reference
<b>UNGCC</b>	United Nations General Conditions of Contract
<b>UNGM</b>	United Nations Global Market
<b>UNGSC</b>	United Nations Global Service Center
<b>UNSPSC</b>	United Nations Standard Products and Services Code
<b>UNCITRAL</b>	United Nations Commission on International Trade Law
<b>VRC</b>	Vendor Review Committee
<b>UN/PD (or PD)</b>	United Nations Secretariat Procurement Division
<b>VRO</b>	Vendor Registration Officer

## 18. List of Annexes and Publicly Available Resources

These Annexes are UN internal documents and available to UN staff only.

Other documents listed under Publicly Available Resources are available externally in the public domain, accessible via the corresponding links provided.

### 18.1 Annexes

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Annex 2	Strategic Goods and Services Matrix
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Annex 6	Request for Information - HQ template
Annex 7	Request for Information - Mission Template
Annex 8	Request for Expression of Interest and Vendor Response - UN HQ
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Annex 10	Language to accompany LVAs and purchase orders for software
Annex 11	Request for Technical Evaluation
Annex 12	Additional Guidelines for Implementing Best Value for Money
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Annex 16	Terms of Reference for Award Review Board
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Annex 17b	Debrief Guidelines for UN staff - Amendment 1
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Annex 19	Notice of Award for Purchase Order
Annex 20	Request for Safekeeping of Performance Bond
Annex 21	Procedures for Filing Cargo Claims for Organizational Shipments
Annex 22	Short-Form Specialist Report
Annex 23	Supplier Performance Report
Annex 24	Contractor Performance Report
Annex 25	Contractor Performance Report for Short-Term Air Charter Services
Annex 26	Contractor Performance Report for Short-Term Sea Transport Services

Annex 27	Sample Sale of Surplus Property Form
Annex 28	Long Term Agreement Information Sheet

## 18.2 Publicly Available Resources

UN General Conditions of Contract (De Minimus Field Contracts)	<a href="https://www.un.org/Depts/ptd/sites/www.un.org.Depts.ptd/files/files/attachment/page/pdf/general_condition_field_contracts.pdf">https://www.un.org/Depts/ptd/sites/www.un.org.Depts.ptd/files/files/attachment/page/pdf/general_condition_field_contracts.pdf</a>
UN General Conditions of Contract (provision of goods and services)	<a href="https://www.un.org/Depts/ptd/sites/www.un.org.Depts.ptd/files/files/attachment/page/pdf/general_condition_goods_services.pdf">https://www.un.org/Depts/ptd/sites/www.un.org.Depts.ptd/files/files/attachment/page/pdf/general_condition_goods_services.pdf</a>
UN General Conditions of Contract (provision of goods)	<a href="https://www.un.org/Depts/ptd/sites/www.un.org.Depts.ptd/files/files/attachment/page/pdf/general_condition_goods.pdf">https://www.un.org/Depts/ptd/sites/www.un.org.Depts.ptd/files/files/attachment/page/pdf/general_condition_goods.pdf</a>
UN General Conditions of Contract (provision of services)	<a href="https://www.un.org/Depts/ptd/sites/www.un.org.Depts.ptd/files/files/attachment/page/pdf/general_condition_services.pdf">https://www.un.org/Depts/ptd/sites/www.un.org.Depts.ptd/files/files/attachment/page/pdf/general_condition_services.pdf</a>

UN Financial Regulations and Rules	<a href="https://hr.un.org/handbook/index/8254">https://hr.un.org/handbook/index/8254</a>
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Delegation of authority in the administration of the Staff Regulations and Rules and the Financial Regulations and Rules	<a href="https://undocs.org/en/ST/SGB/2019/2">https://undocs.org/en/ST/SGB/2019/2</a>
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## **LEGAL AUTHORITY CA-86**

# UNCITRAL Model Law on Public Procurement



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UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW

# UNCITRAL Model Law on Public Procurement



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## NOTE

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# **General Assembly resolution 66/95 of 9 December 2011**

*[on the report of the Sixth Committee (A/66/471)]*

## **66/95. United Nations Commission on International Trade Law Model Law on Public Procurement**

*The General Assembly,*

*Recalling* its resolution 2205 (XXI) of 17 December 1966, by which it established the United Nations Commission on International Trade Law with the purpose of furthering the progressive harmonization and unification of the law of international trade in the interests of all peoples, in particular those of developing countries,

*Noting* that procurement constitutes a significant portion of public expenditure in most States,

*Recalling* its resolution 49/54 of 9 December 1994 recommending the use of the United Nations Commission on International Trade Law Model Law on Procurement of Goods, Construction and Services,<sup>1</sup>

*Observing* that the 1994 Model Law, which has become an important international benchmark in procurement law reform, sets out procedures aimed at achieving competition, transparency, fairness, economy and efficiency in the procurement process,

*Observing* also that, despite the widely recognized value of the 1994 Model Law, new issues and practices have arisen since its adoption that have justified revision of the text,

*Recognizing* that at its thirty-seventh session, in 2004, the Commission agreed that the 1994 Model Law would benefit from being updated to reflect new practices, in particular those resulting from the use of electronic communications in public procurement, and the experience gained in the use of the 1994 Model Law as a basis for law reform, not departing, however, from the basic

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<sup>1</sup>*Official Records of the General Assembly, Forty-ninth Session, Supplement No. 17 and corrigendum (A/49/17 and Corr.1), annex I.*

principles behind it and not modifying the provisions whose usefulness had been proved,

*Noting* that the revisions to the 1994 Model Law were the subject of due deliberation and extensive consultations with Governments and interested international organizations, and that thus it can be expected that the revised Model Law, to be called the “United Nations Commission on International Trade Law Model Law on Public Procurement”, would be acceptable to States with different legal, social and economic systems,

*Noting also* that the revised Model Law is expected to contribute significantly to the establishment of a harmonized and modern legal framework for public procurement that promotes economy, efficiency and competition in procurement and, at the same time, fosters integrity, confidence, fairness and transparency in the procurement process,

*Convinced* that the revised Model Law will significantly assist all States, in particular developing countries and countries with economies in transition, in enhancing their existing procurement laws and formulating procurement laws where none presently exist, and will lead to the development of harmonious international economic relations and increased economic development,

1. *Expresses its appreciation* to the United Nations Commission on International Trade Law for developing and adopting the draft United Nations Commission on International Trade Law Model Law on Public Procurement;<sup>2</sup>
2. *Requests* the Secretary-General to transmit the text of the Model Law to Governments and other interested bodies;
3. *Recommends* that all States use the Model Law in assessing their legal regimes for public procurement and give favourable consideration to the Model Law when they enact or revise their laws;
4. *Calls for* closer cooperation and coordination among the Commission and other international organs and organizations, including regional organizations, active in the field of procurement law reform, in order to avoid undesirable duplication of efforts and inconsistent, incoherent or conflicting results in the modernization and harmonization of public procurement law;
5. *Endorses* the efforts and initiatives of the secretariat of the Commission aimed at increasing the coordination of, and cooperation on, legal activities concerned with public procurement reform.

*82nd plenary meeting  
9 December 2011*

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<sup>2</sup> *Ibid.*, Sixty-sixth Session, Supplement No. 17 (A/66/17), para. 192 and annex I.

# UNCITRAL Model Law on Public Procurement

(United Nations document, A/66/17, annex I)

**(As adopted by the United Nations Commission on International Trade Law on 1 July 2011)**

## *Preamble*

WHEREAS the [Government] [Parliament] of ... considers it desirable to regulate procurement so as to promote the objectives of:

- (a) Maximizing economy and efficiency in procurement;
- (b) Fostering and encouraging participation in procurement proceedings by suppliers and contractors regardless of nationality, thereby promoting international trade;
- (c) Promoting competition among suppliers and contractors for the supply of the subject matter of the procurement;
- (d) Providing for the fair, equal and equitable treatment of all suppliers and contractors;
- (e) Promoting the integrity of, and fairness and public confidence in, the procurement process;
- (f) Achieving transparency in the procedures relating to procurement.

Be it therefore enacted as follows:

## CHAPTER I. GENERAL PROVISIONS

### *Article 1. Scope of application*

This Law applies to all public procurement.

## Article 2. Definitions

For the purposes of this Law:

(a) “Currency” includes the monetary unit of account;

(b) “Direct solicitation” means solicitation addressed directly to one supplier or contractor or a restricted number of suppliers or contractors. This excludes solicitation addressed to a limited number of suppliers or contractors following pre-qualification or pre-selection proceedings;

(c) “Domestic procurement” means procurement limited to domestic suppliers or contractors pursuant to article 8 of this Law;

(d) “Electronic reverse auction” means an online real-time purchasing technique utilized by the procuring entity to select the successful submission, which involves the presentation by suppliers or contractors of successively lowered bids during a scheduled period of time and the automatic evaluation of bids;

(e) “Framework agreement procedure” means a procedure conducted in two stages: a first stage to select a supplier (or suppliers) or a contractor (or contractors) to be a party (or parties) to a framework agreement with a procuring entity, and a second stage to award a procurement contract under the framework agreement to a supplier or contractor party to the framework agreement:

- (i) “Framework agreement” means an agreement between the procuring entity and the selected supplier (or suppliers) or contractor (or contractors) concluded upon completion of the first stage of the framework agreement procedure;
- (ii) “Closed framework agreement” means a framework agreement to which no supplier or contractor that is not initially a party to the framework agreement may subsequently become a party;
- (iii) “Open framework agreement” means a framework agreement to which a supplier (or suppliers) or a contractor (or contractors) in addition to the initial parties may subsequently become a party or parties;
- (iv) “Framework agreement procedure with second-stage competition” means a procedure under an open framework agreement or a closed framework agreement with more than one supplier or contractor in which certain terms and conditions of the procurement that cannot be established with sufficient precision when the framework agreement is concluded are to be established or refined through a second-stage competition;

- (v) “Framework agreement procedure without second-stage competition” means a procedure under a closed framework agreement in which all terms and conditions of the procurement are established when the framework agreement is concluded;
- (f) “Pre-qualification” means the procedure set out in article 18 of this Law to identify, prior to solicitation, suppliers or contractors that are qualified;
- (g) “Pre-qualification documents” means documents issued by the procuring entity under article 18 of this Law that set out the terms and conditions of the pre-qualification proceedings;
- (h) “Pre-selection” means the procedure set out in paragraph 3 of article 49 of this Law to identify, prior to solicitation, a limited number of suppliers or contractors that best meet the qualification criteria for the procurement concerned;
- (i) “Pre-selection documents” means documents issued by the procuring entity under paragraph 3 of article 49 of this Law that set out the terms and conditions of the pre-selection proceedings;
- (j) “Procurement” or “public procurement” means the acquisition of goods, construction or services by a procuring entity;
- (k) “Procurement contract” means a contract concluded between the procuring entity and a supplier (or suppliers) or a contractor (or contractors) at the end of the procurement proceedings;
- (l) “Procurement involving classified information” means procurement in which the procuring entity may be authorized by the procurement regulations or by other provisions of law of this State to take measures and impose requirements for the protection of classified information;
- (m) “Procurement regulations” means regulations enacted in accordance with article 4 of this Law;
- (n) “Procuring entity” means:

### *Option I*

- (i) Any governmental department, agency, organ or other unit, or any subdivision or multiplicity thereof, that engages in procurement, except ...; [and]

### *Option II*

- (i) Any department, agency, organ or other unit, or any subdivision or multiplicity thereof, of the [Government] [*other term used to refer to the national Government of the enacting State*] that engages in procurement, except ...; [and]

- (ii) *[The enacting State may insert in this subparagraph and, if necessary, in subsequent subparagraphs other entities or enterprises, or categories thereof, to be included in the definition of “procuring entity”];*

(o) “Socio-economic policies” means environmental, social, economic and other policies of this State authorized or required by the procurement regulations or other provisions of law of this State to be taken into account by the procuring entity in the procurement proceedings. *[The enacting State may expand this subparagraph by providing an illustrative list of such policies.];*

(p) “Solicitation” means an invitation to tender, present submissions or participate in request-for-proposals proceedings or an electronic reverse auction;

(q) “Solicitation document” means a document issued by the procuring entity, including any amendments thereto, that sets out the terms and conditions of the given procurement;

(r) “Standstill period” means the period starting from the dispatch of a notice as required by paragraph 2 of article 22 of this Law, during which the procuring entity cannot accept the successful submission and during which suppliers or contractors can challenge, under chapter VIII of this Law, the decision so notified;

(s) “A submission (or submissions)” means a tender (or tenders), a proposal (or proposals), an offer (or offers), a quotation (or quotations) and a bid (or bids) referred to collectively or generically, including, where the context so requires, an initial or indicative submission (or submissions);

(t) “Supplier or contractor” means, according to the context, any potential party or any party to the procurement proceedings with the procuring entity;

(u) “Tender security” means a security required from suppliers or contractors by the procuring entity and provided to the procuring entity to secure the fulfilment of any obligation referred to in paragraph 1 (f) of article 17 of this Law and includes such arrangements as bank guarantees, surety bonds, standby letters of credit, cheques for which a bank is primarily liable, cash deposits, promissory notes and bills of exchange. For the avoidance of doubt, the term excludes any security for the performance of the contract.

*Article 3. International obligations of [this State] relating to procurement [and intergovernmental agreements within [this State]]<sup>3</sup>*

To the extent that this Law conflicts with an obligation of this State under or arising out of any:

<sup>3</sup>The text in brackets in this article is relevant to, and intended for consideration by, federal States.

(a) Treaty or other form of agreement to which it is a party with one or more other States; [or]

(b) Agreement entered into by this State with an intergovernmental international financing institution[,] [; or]

[(c) Agreement between the federal Government of [name of federal State] and any subdivision or subdivisions of [name of federal State] or between any two or more such subdivisions,]

the requirements of the treaty or agreement shall prevail, but in all other respects the procurement shall be governed by this Law.

#### *Article 4. Procurement regulations*

The [name of the organ or authority authorized to promulgate the procurement regulations] is authorized to promulgate procurement regulations to fulfil the objectives and to implement the provisions of this Law.

#### *Article 5. Publication of legal texts*

1. This Law, the procurement regulations and other legal texts of general application in connection with procurement covered by this Law, and all amendments thereto, shall be promptly made accessible to the public and systematically maintained.

2. Judicial decisions and administrative rulings with precedent value in connection with procurement covered by this Law shall be made available to the public.

#### *Article 6. Information on possible forthcoming procurement*

1. Procuring entities may publish information regarding planned procurement activities for forthcoming months or years.

2. Procuring entities may also publish an advance notice of possible future procurement.

3. Publication under this article does not constitute a solicitation, does not oblige the procuring entity to issue a solicitation and does not confer any rights on suppliers or contractors.



## Article 7. Communications in procurement

1. Any document, notification, decision or other information generated in the course of a procurement and communicated as required by this Law, including in connection with challenge proceedings under chapter VIII or in the course of a meeting, or forming part of the record of procurement proceedings under article 25 of this Law shall be in a form that provides a record of the content of the information and that is accessible so as to be usable for subsequent reference.
2. Direct solicitation and communication of information between suppliers or contractors and the procuring entity referred to in article 16, paragraph 1 (*d*) of article 17, paragraphs 6 and 9 of article 18, paragraph 2 (*a*) of article 41 and paragraphs 2 to 4 of article 50 of this Law may be made by means that do not provide a record of the content of the information, on the condition that immediately thereafter confirmation of the communication is given to the recipient of the communication in a form that provides a record of the content of the information and that is accessible so as to be usable for subsequent reference.
3. The procuring entity, when first soliciting the participation of suppliers or contractors in the procurement proceedings, shall specify:
  - (a) Any requirement of form;
  - (b) In procurement involving classified information, if the procuring entity considers it necessary, measures and requirements needed to ensure the protection of classified information at the requisite level;
  - (c) The means to be used to communicate information by or on behalf of the procuring entity to a supplier or contractor or to any person, or by a supplier or contractor to the procuring entity or other entity acting on its behalf;
  - (d) The means to be used to satisfy all requirements under this Law for information to be in writing or for a signature; and
  - (e) The means to be used to hold any meeting of suppliers or contractors.
4. The procuring entity may use only those means of communication that are in common use by suppliers or contractors in the context of the particular procurement. In any meeting held with suppliers or contractors, the procuring entity shall use only those means that ensure in addition that suppliers or contractors can fully and contemporaneously participate in the meeting.
5. The procuring entity shall put in place appropriate measures to secure the authenticity, integrity and confidentiality of information concerned.

### *Article 8. Participation by suppliers or contractors*

1. Suppliers or contractors shall be permitted to participate in procurement proceedings without regard to nationality, except where the procuring entity decides to limit participation in procurement proceedings on the basis of nationality on grounds specified in the procurement regulations or other provisions of law of this State.
2. Except when authorized or required to do so by the procurement regulations or other provisions of law of this State, the procuring entity shall establish no other requirement aimed at limiting the participation of suppliers or contractors in procurement proceedings that discriminates against or among suppliers or contractors or against categories thereof.
3. The procuring entity, when first soliciting the participation of suppliers or contractors in the procurement proceedings, shall declare whether the participation of suppliers or contractors in the procurement proceedings is limited pursuant to this article and on which ground. Any such declaration may not later be altered.
4. A procuring entity that decides to limit the participation of suppliers or contractors in procurement proceedings pursuant to this article shall include in the record of the procurement proceedings a statement of the reasons and circumstances on which it relied.
5. The procuring entity shall make available to any person, upon request, its reasons for limiting the participation of suppliers or contractors in the procurement proceedings pursuant to this article.

### *Article 9. Qualifications of suppliers and contractors*

1. This article applies to the ascertainment by the procuring entity of the qualifications of suppliers or contractors at any stage of the procurement proceedings.
2. Suppliers or contractors shall meet such of the following criteria as the procuring entity considers appropriate and relevant in the circumstances of the particular procurement:
  - (a) That they have the necessary professional, technical and environmental qualifications, professional and technical competence, financial resources, equipment and other physical facilities, managerial capability, reliability, experience and personnel to perform the procurement contract;

- (b) That they meet ethical and other standards applicable in this State;
- (c) That they have the legal capacity to enter into the procurement contract;
- (d) That they are not insolvent, in receivership, bankrupt or being wound up, their affairs are not being administered by a court or a judicial officer, their business activities have not been suspended and they are not the subject of legal proceedings for any of the foregoing;
- (e) That they have fulfilled their obligations to pay taxes and social security contributions in this State;
- (f) That they have not, and their directors or officers have not, been convicted of any criminal offence related to their professional conduct or the making of false statements or misrepresentations as to their qualifications to enter into a procurement contract within a period of ... years [*the enacting State specifies the period of time*] preceding the commencement of the procurement proceedings, or have not been otherwise disqualified pursuant to administrative suspension or debarment proceedings.

3. Subject to the right of suppliers or contractors to protect their intellectual property or trade secrets, the procuring entity may require suppliers or contractors participating in procurement proceedings to provide appropriate documentary evidence or other information to satisfy itself that the suppliers or contractors are qualified in accordance with the criteria referred to in paragraph 2 of this article.

4. Any requirement established pursuant to this article shall be set out in the pre-qualification or pre-selection documents, if any, and in the solicitation documents and shall apply equally to all suppliers or contractors. A procuring entity shall impose no criterion, requirement or procedure with respect to the qualifications of suppliers or contractors other than those provided for in this Law.

5. The procuring entity shall evaluate the qualifications of suppliers or contractors in accordance with the qualification criteria and procedures set out in the pre-qualification or pre-selection documents, if any, and in the solicitation documents.

6. Other than any criterion, requirement or procedure that may be imposed by the procuring entity in accordance with article 8 of this Law, the procuring entity shall establish no criterion, requirement or procedure with respect to the qualifications of suppliers or contractors that discriminates against or among suppliers or contractors or against categories thereof, or that is not objectively justifiable.

7. Notwithstanding paragraph 6 of this article, the procuring entity may require the legalization of documentary evidence provided by the supplier or contractor presenting the successful submission so as to demonstrate its qualifications for the particular procurement. In doing so, the procuring entity shall not impose any requirements as to the legalization of the documentary evidence other than those provided for in the laws of this State relating to the legalization of documents of the type in question.

8. (a) The procuring entity shall disqualify a supplier or contractor if it finds at any time that the information submitted concerning the qualifications of the supplier or contractor was false or constituted a misrepresentation;

(b) A procuring entity may disqualify a supplier or contractor if it finds at any time that the information submitted concerning the qualifications of the supplier or contractor was materially inaccurate or materially incomplete;

(c) Other than in a case to which subparagraph (a) of this paragraph applies, a procuring entity may not disqualify a supplier or contractor on the ground that information submitted concerning the qualifications of the supplier or contractor was inaccurate or incomplete in a non-material respect. The supplier or contractor may, however, be disqualified if it fails to remedy such deficiencies promptly upon request by the procuring entity;

(d) The procuring entity may require a supplier or contractor that was pre-qualified in accordance with article 18 of this Law to demonstrate its qualifications again in accordance with the same criteria used to pre-qualify such supplier or contractor. The procuring entity shall disqualify any supplier or contractor that fails to demonstrate its qualifications again if requested to do so. The procuring entity shall promptly notify each supplier or contractor requested to demonstrate its qualifications again as to whether or not the supplier or contractor has done so to the satisfaction of the procuring entity.

*Article 10. Rules concerning description of the subject matter of the procurement and the terms and conditions of the procurement contract or framework agreement*

1. (a) The pre-qualification or pre-selection documents, if any, shall set out a description of the subject matter of the procurement;

(b) The procuring entity shall set out in the solicitation documents the detailed description of the subject matter of the procurement that it will use in the examination of submissions, including the minimum requirements that submissions must meet in order to be considered responsive and the manner in which those minimum requirements are to be applied.

2. Other than any criterion, requirement or procedure that may be imposed by the procuring entity in accordance with article 8 of this Law, no description

of the subject matter of a procurement that may restrict the participation of suppliers or contractors in or their access to the procurement proceedings, including any restriction based on nationality, shall be included or used in the pre-qualification or pre-selection documents, if any, or in the solicitation documents.

3. The description of the subject matter of the procurement may include specifications, plans, drawings, designs, requirements, testing and test methods, packaging, marking or labelling or conformity certification, and symbols and terminology.

4. To the extent practicable, the description of the subject matter of the procurement shall be objective, functional and generic. It shall set out the relevant technical, quality and performance characteristics of that subject matter. There shall be no requirement for or reference to a particular trademark or trade name, patent, design or type, specific origin or producer unless there is no sufficiently precise or intelligible way of describing the characteristics of the subject matter of the procurement and provided that words such as “or equivalent” are included.

5. (a) Standardized features, requirements, symbols and terminology relating to the technical, quality and performance characteristics of the subject matter of the procurement shall be used, where available, in formulating the description of the subject matter of the procurement to be included in the pre-qualification or pre-selection documents, if any, and in the solicitation documents;

(b) Due regard shall be had for the use of standardized trade terms and standardized conditions, where available, in formulating the terms and conditions of the procurement and the procurement contract or the framework agreement to be entered into in the procurement proceedings, and in formulating other relevant aspects of the pre-qualification or pre-selection documents, if any, and solicitation documents.

#### *Article 11. Rules concerning evaluation criteria and procedures*

1. Except for the criteria set out in paragraph 3 of this article, the evaluation criteria shall relate to the subject matter of the procurement.

2. The evaluation criteria relating to the subject matter of the procurement may include:

(a) Price;

(b) The cost of operating, maintaining and repairing goods or of construction; the time for delivery of goods, completion of construction or provision of

services; the characteristics of the subject matter of the procurement, such as the functional characteristics of goods or construction and the environmental characteristics of the subject matter; and the terms of payment and of guarantees in respect of the subject matter of the procurement;

(c) Where relevant in procurement conducted in accordance with articles 47, 49 and 50 of this Law, the experience, reliability and professional and managerial competence of the supplier or contractor and of the personnel to be involved in providing the subject matter of the procurement.

3. In addition to the criteria set out in paragraph 2 of this article, the evaluation criteria may include:

(a) Any criteria that the procurement regulations or other provisions of law of this State authorize or require to be taken into account;

(b) A margin of preference for the benefit of domestic suppliers or contractors or for domestically produced goods, or any other preference, if authorized or required by the procurement regulations or other provisions of law of this State. The margin of preference shall be calculated in accordance with the procurement regulations.

4. To the extent practicable, all non-price evaluation criteria shall be objective, quantifiable and expressed in monetary terms.

5. The procuring entity shall set out in the solicitation documents:

(a) Whether the successful submission will be ascertained on the basis of price or price and other criteria;

(b) All evaluation criteria established pursuant to this article, including price as modified by any preference;

(c) The relative weights of all evaluation criteria, except where the procurement is conducted under article 49 of this Law, in which case the procuring entity may list all evaluation criteria in descending order of importance;

(d) The manner of application of the criteria in the evaluation procedure.

6. In evaluating submissions and determining the successful submission, the procuring entity shall use only those criteria and procedures that have been set out in the solicitation documents and shall apply those criteria and procedures in the manner that has been disclosed in those solicitation documents. No criterion or procedure shall be used that has not been set out in accordance with this provision.

*Article 12. Rules concerning estimation of the value of procurement*

1. A procuring entity shall neither divide its procurement nor use a particular valuation method for estimating the value of procurement so as to limit competition among suppliers or contractors or otherwise avoid its obligations under this Law.
2. In estimating the value of procurement, the procuring entity shall include the estimated maximum total value of the procurement contract or of all procurement contracts envisaged under a framework agreement over its entire duration, taking into account all forms of remuneration.

*Article 13. Rules concerning the language of documents*

1. The pre-qualification or pre-selection documents, if any, and the solicitation documents shall be formulated in [*the enacting State specifies its official language or languages*] [and in a language customarily used in international trade, unless decided otherwise by the procuring entity in the circumstances referred to in paragraph 4 of article 33 of this Law].
2. Applications to pre-qualify or for pre-selection, if any, and submissions may be formulated and presented in the language of the pre-qualification or pre-selection documents, if any, and solicitation documents, respectively, or in any other language permitted by those documents.

*Article 14. Rules concerning the manner, place and deadline for presenting applications to pre-qualify or applications for pre-selection or for presenting submissions*

1. The manner, place and deadline for presenting applications to pre-qualify or for pre-selection shall be set out in the invitation to pre-qualify or for pre-selection and in the pre-qualification or pre-selection documents, as applicable. The manner, place and deadline for presenting submissions shall be set out in the solicitation documents.
2. Deadlines for presenting applications to pre-qualify or for pre-selection or for presenting submissions shall be expressed as a specific date and time and shall allow sufficient time for suppliers or contractors to prepare and present their applications or submissions, taking into account the reasonable needs of the procuring entity.
3. If the procuring entity issues a clarification or modification of the pre-qualification, pre-selection or solicitation documents, it shall, prior to the

applicable deadline for presenting applications to pre-qualify or for pre-selection or for presenting submissions, extend the deadline if necessary or as required under paragraph 3 of article 15 of this Law in order to afford suppliers or contractors sufficient time to take the clarification or modification into account in their applications or submissions.

4. The procuring entity may, at its absolute discretion, prior to a deadline for presenting applications to pre-qualify or for pre-selection or for presenting submissions, extend the applicable deadline if it is not possible for one or more suppliers or contractors to present their applications or submissions by the deadline initially stipulated because of any circumstance beyond their control.

5. Notice of any extension of the deadline shall be given promptly to each supplier or contractor to which the procuring entity provided the pre-qualification, pre-selection or solicitation documents.

#### *Article 15. Clarifications and modifications of solicitation documents*

1. A supplier or contractor may request a clarification of the solicitation documents from the procuring entity. The procuring entity shall respond to any request by a supplier or contractor for clarification of the solicitation documents that is received by the procuring entity within a reasonable time prior to the deadline for presenting submissions. The procuring entity shall respond within a time period that will enable the supplier or contractor to present its submission in a timely fashion and shall, without identifying the source of the request, communicate the clarification to all suppliers or contractors to which the procuring entity has provided the solicitation documents.

2. At any time prior to the deadline for presenting submissions, the procuring entity may for any reason, whether on its own initiative or as a result of a request for clarification by a supplier or contractor, modify the solicitation documents by issuing an addendum. The addendum shall be communicated promptly to all suppliers or contractors to which the procuring entity has provided the solicitation documents and shall be binding on those suppliers or contractors.

3. If as a result of a clarification or modification issued in accordance with this article, the information published when first soliciting the participation of suppliers or contractors in the procurement proceedings becomes materially inaccurate, the procuring entity shall cause the amended information to be published in the same manner and place in which the original information was published and shall extend the deadline for presentation of submissions as provided for in paragraph 3 of article 14 of this Law.



4. If the procuring entity convenes a meeting of suppliers or contractors, it shall prepare minutes of the meeting containing the requests submitted at the meeting for clarification of the solicitation documents and its responses to those requests, without identifying the sources of the requests. The minutes shall be provided promptly to all suppliers or contractors to which the procuring entity provided the solicitation documents, so as to enable those suppliers or contractors to take the minutes into account in preparing their submissions.

*Article 16. Clarification of qualification information and of submissions*

1. At any stage of the procurement proceedings, the procuring entity may ask a supplier or contractor for clarification of its qualification information or of its submission, in order to assist in the ascertainment of qualifications or the examination and evaluation of submissions.

2. The procuring entity shall correct purely arithmetical errors that are discovered during the examination of submissions. The procuring entity shall give prompt notice of any such correction to the supplier or contractor that presented the submission concerned.

3. No substantive change to qualification information or to a submission, including changes aimed at making an unqualified supplier or contractor qualified or an unresponsive submission responsive, shall be sought, offered or permitted.

4. No negotiations shall take place between the procuring entity and a supplier or contractor with respect to qualification information or submissions, nor shall any change in price be made pursuant to a clarification that is sought under this article.

5. Paragraph 4 of this article shall not apply to proposals submitted under articles 49, 50, 51 and 52 of this Law.

6. All communications generated under this article shall be included in the record of the procurement proceedings.

*Article 17. Tender securities*

1. When the procuring entity requires suppliers or contractors presenting submissions to provide a tender security:

(a) The requirement shall apply to all suppliers or contractors;

(b) The solicitation documents may stipulate that the issuer of the tender security and the confirmer, if any, of the tender security, as well as the form and terms of the tender security, must be acceptable to the procuring entity. In cases of domestic procurement, the solicitation documents may in addition stipulate that the tender security shall be issued by an issuer in this State;

(c) Notwithstanding the provisions of subparagraph (b) of this paragraph, a tender security shall not be rejected by the procuring entity on the grounds that the tender security was not issued by an issuer in this State if the tender security and the issuer otherwise conform to requirements set out in the solicitation documents, unless the acceptance by the procuring entity of such a tender security would be in violation of a law of this State;

(d) Prior to presenting a submission, a supplier or contractor may request the procuring entity to confirm the acceptability of a proposed issuer of a tender security or of a proposed confirmer, if required; the procuring entity shall respond promptly to such a request;

(e) Confirmation of the acceptability of a proposed issuer or of any proposed confirmer does not preclude the procuring entity from rejecting the tender security on the ground that the issuer or the confirmer, as the case may be, has become insolvent or has otherwise ceased to be creditworthy;

(f) The procuring entity shall specify in the solicitation documents any requirements with respect to the issuer and the nature, form, amount and other principal terms and conditions of the required tender security. Any requirement that refers directly or indirectly to the conduct of the supplier or contractor presenting the submission may relate only to:

- (i) Withdrawal or modification of the submission after the deadline for presenting submissions, or before the deadline if so stipulated in the solicitation documents;
- (ii) Failure to sign a procurement contract if so required by the solicitation documents; and
- (iii) Failure to provide a required security for the performance of the contract after the successful submission has been accepted or failure to comply with any other condition precedent to signing the procurement contract specified in the solicitation documents.

2. The procuring entity shall make no claim to the amount of the tender security and shall promptly return, or procure the return of, the security document after the earliest of the following events:

(a) The expiry of the tender security;

(b) The entry into force of a procurement contract and the provision of a security for the performance of the contract, if such a security is required by the solicitation documents;

- (c) The cancellation of the procurement;
- (d) The withdrawal of a submission prior to the deadline for presenting submissions, unless the solicitation documents stipulate that no such withdrawal is permitted.

### *Article 18. Pre-qualification proceedings*

1. The procuring entity may engage in pre-qualification proceedings with a view to identifying, prior to solicitation, suppliers and contractors that are qualified. The provisions of article 9 of this Law shall apply to pre-qualification proceedings.
2. If the procuring entity engages in pre-qualification proceedings, it shall cause an invitation to pre-qualify to be published in the publication identified in the procurement regulations. Unless decided otherwise by the procuring entity in the circumstances referred to in paragraph 4 of article 33 of this Law, the invitation to pre-qualify shall also be published internationally, so as to be widely accessible to international suppliers or contractors.
3. The invitation to pre-qualify shall include the following information:
  - (a) The name and address of the procuring entity;
  - (b) A summary of the principal required terms and conditions of the procurement contract or the framework agreement to be entered into in the procurement proceedings, including the nature, quantity and place of delivery of the goods to be supplied, the nature and location of the construction to be effected or the nature of the services and the location where they are to be provided, as well as the desired or required time for the supply of the goods, the completion of the construction or the provision of the services;
  - (c) The criteria and procedures to be used for ascertaining the qualifications of suppliers or contractors, in conformity with article 9 of this Law;
  - (d) A declaration as required by article 8 of this Law;
  - (e) The means of obtaining the pre-qualification documents and the place where they may be obtained;
  - (f) The price, if any, to be charged by the procuring entity for the pre-qualification documents and, subsequent to pre-qualification, for the solicitation documents;
  - (g) If a price is to be charged, the means of payment for the pre-qualification documents and, subsequent to pre-qualification, for the solicitation documents, and the currency of payment;
  - (h) The language or languages in which the pre-qualification documents and, subsequent to pre-qualification, the solicitation documents are available;

(i) The manner, place and deadline for presenting applications to pre-qualify and, if already known, the manner, place and deadline for presenting submissions, in conformity with article 14 of this Law.

4. The procuring entity shall provide a set of pre-qualification documents to each supplier or contractor that requests them in accordance with the invitation to pre-qualify and that pays the price, if any, charged for those documents. The price that the procuring entity may charge for the pre-qualification documents shall reflect only the cost of providing them to suppliers or contractors.

5. The pre-qualification documents shall include the following information:

(a) Instructions for preparing and presenting pre-qualification applications;

(b) Any documentary evidence or other information that must be presented by suppliers or contractors to demonstrate their qualifications;

(c) The name, functional title and address of one or more officers or employees of the procuring entity who are authorized to communicate directly with and to receive communications directly from suppliers or contractors in connection with the pre-qualification proceedings without the intervention of an intermediary;

(d) References to this Law, the procurement regulations and other laws and regulations directly pertinent to the pre-qualification proceedings, and the place where those laws and regulations may be found;

(e) Any other requirements that may be established by the procuring entity in conformity with this Law and the procurement regulations relating to the preparation and presentation of applications to pre-qualify and to the pre-qualification proceedings.

6. The procuring entity shall respond to any request by a supplier or contractor for clarification of the pre-qualification documents that is received by the procuring entity within a reasonable time prior to the deadline for presenting applications to pre-qualify. The procuring entity shall respond within a time period that will enable the supplier or contractor to present its application to pre-qualify in a timely fashion. The response to any request that might reasonably be expected to be of interest to other suppliers or contractors shall, without identifying the source of the request, be communicated to all suppliers or contractors to which the procuring entity has provided the pre-qualification documents.

7. The procuring entity shall take a decision with respect to the qualifications of each supplier or contractor presenting an application to pre-qualify. In reaching that decision, the procuring entity shall apply only the criteria and

procedures set out in the invitation to pre-qualify and in the pre-qualification documents.

8. Only suppliers or contractors that have been pre-qualified are entitled to participate further in the procurement proceedings.

9. The procuring entity shall promptly notify each supplier or contractor presenting an application to pre-qualify whether or not it has been pre-qualified. It shall also make available to any person, upon request, the names of all suppliers or contractors that have been pre-qualified.

10. The procuring entity shall promptly communicate to each supplier or contractor that has not been pre-qualified the reasons therefor.

### *Article 19. Cancellation of the procurement*

1. The procuring entity may cancel the procurement at any time prior to the acceptance of the successful submission and, after the successful submission is accepted, under the circumstances referred to in paragraph 8 of article 22 of this Law. The procuring entity shall not open any tenders or proposals after taking a decision to cancel the procurement.

2. The decision of the procuring entity to cancel the procurement and the reasons for the decision shall be included in the record of the procurement proceedings and promptly communicated to any supplier or contractor that presented a submission. The procuring entity shall in addition promptly publish a notice of the cancellation of the procurement in the same manner and place in which the original information regarding the procurement proceedings was published, and return any tenders or proposals that remain unopened at the time of the decision to the suppliers or contractors that presented them.

3. Unless the cancellation of the procurement is a consequence of irresponsible or dilatory conduct on the part of the procuring entity, the procuring entity shall incur no liability, solely by virtue of its invoking paragraph 1 of this article, towards suppliers or contractors that have presented submissions.

### *Article 20. Rejection of abnormally low submissions*

1. The procuring entity may reject a submission if the procuring entity has determined that the price, in combination with other constituent elements of

the submission, is abnormally low in relation to the subject matter of the procurement and raises concerns with the procuring entity as to the ability of the supplier or contractor that presented that submission to perform the procurement contract, provided that the procuring entity has taken the following actions:

(a) The procuring entity has requested in writing from the supplier or contractor details of the submission that gives rise to concerns as to the ability of the supplier or contractor to perform the procurement contract; and

(b) The procuring entity has taken account of any information provided by the supplier or contractor following this request and the information included in the submission, but continues, on the basis of all such information, to hold concerns.

2. The decision of the procuring entity to reject a submission in accordance with this article, the reasons for that decision, and all communications with the supplier or contractor under this article shall be included in the record of the procurement proceedings. The decision of the procuring entity and the reasons therefor shall be promptly communicated to the supplier or contractor concerned.

*Article 21. Exclusion of a supplier or contractor from the procurement proceedings on the grounds of inducements from the supplier or contractor, an unfair competitive advantage or conflicts of interest*

1. A procuring entity shall exclude a supplier or contractor from the procurement proceedings if:

(a) The supplier or contractor offers, gives or agrees to give, directly or indirectly, to any current or former officer or employee of the procuring entity or other governmental authority a gratuity in any form, an offer of employment or any other thing of service or value, so as to influence an act or decision of, or procedure followed by, the procuring entity in connection with the procurement proceedings; or

(b) The supplier or contractor has an unfair competitive advantage or a conflict of interest, in violation of provisions of law of this State.

2. Any decision of the procuring entity to exclude a supplier or contractor from the procurement proceedings under this article and the reasons therefor shall be included in the record of the procurement proceedings and promptly communicated to the supplier or contractor concerned.

*Article 22. Acceptance of the successful submission and entry into force of the procurement contract*

1. The procuring entity shall accept the successful submission unless:

(a) The supplier or contractor presenting the successful submission is disqualified in accordance with article 9 of this Law;

(b) The procurement is cancelled in accordance with paragraph 1 of article 19 of this Law;

(c) The submission found successful at the end of evaluation is rejected as abnormally low under article 20 of this Law; or

(d) The supplier or contractor presenting the successful submission is excluded from the procurement proceedings on the grounds specified in article 21 of this Law.

2. The procuring entity shall promptly notify each supplier or contractor that presented submissions of its decision to accept the successful submission at the end of the standstill period. The notice shall contain, at a minimum, the following information:

(a) The name and address of the supplier or contractor presenting the successful submission;

(b) The contract price or, where the successful submission was ascertained on the basis of price and other criteria, the contract price and a summary of other characteristics and relative advantages of the successful submission; and

(c) The duration of the standstill period as set out in the solicitation documents and in accordance with the requirements of the procurement regulations. The standstill period shall run from the date of the dispatch of the notice under this paragraph to all suppliers or contractors that presented submissions.

3. Paragraph 2 of this article shall not apply to awards of procurement contracts:

(a) Under a framework agreement procedure without second-stage competition;

(b) Where the contract price is less than the threshold amount set out in the procurement regulations; or

(c) Where the procuring entity determines that urgent public interest considerations require the procurement to proceed without a standstill period. The decision of the procuring entity that such urgent considerations exist and the reasons for the decision shall be included in the record of the procurement proceedings.

4. Upon expiry of the standstill period or, where there is none, promptly after the successful submission was ascertained, the procuring entity shall dispatch the notice of acceptance of the successful submission to the supplier or contractor that presented that submission, unless the [name of court or courts] or the [name of the relevant organ designated by the enacting State] orders otherwise.

5. Unless a written procurement contract and/or approval by another authority is/are required, a procurement contract in accordance with the terms and conditions of the successful submission enters into force when the notice of acceptance is dispatched to the supplier or contractor concerned, provided that the notice is dispatched while the submission is still in effect.

6. Where the solicitation documents require the supplier or contractor whose submission has been accepted to sign a written procurement contract conforming to the terms and conditions of the accepted submission:

(a) The procuring entity and the supplier or contractor concerned shall sign the procurement contract within a reasonable period of time after the notice of acceptance is dispatched to the supplier or contractor concerned;

(b) Unless the solicitation documents stipulate that the procurement contract is subject to approval by another authority, the procurement contract enters into force when the contract is signed by the supplier or contractor concerned and by the procuring entity. Between the time when the notice of acceptance is dispatched to the supplier or contractor concerned and the entry into force of the procurement contract, neither the procuring entity nor that supplier or contractor shall take any action that interferes with the entry into force of the procurement contract or with its performance.

7. Where the solicitation documents stipulate that the procurement contract is subject to approval by another authority, the procurement contract shall not enter into force before the approval is given. The solicitation documents shall specify the estimated period of time following dispatch of the notice of acceptance that will be required to obtain the approval. A failure to obtain the approval within the time specified in the solicitation documents shall not extend the period of effectiveness of submissions specified in the solicitation documents or the period of effectiveness of the tender security required under article 17 of this Law, unless extended under the provisions of this Law.

8. If the supplier or contractor whose submission has been accepted fails to sign any written procurement contract as required or fails to provide any required security for the performance of the contract, the procuring entity may either cancel the procurement or decide to select the next successful



submission from among those remaining in effect, in accordance with the criteria and procedures set out in this Law and in the solicitation documents. In the latter case, the provisions of this article shall apply *mutatis mutandis* to such submission.

9. Notices under this article are dispatched when they are promptly and properly addressed or otherwise directed and transmitted to the supplier or contractor or conveyed to an appropriate authority for transmission to the supplier or contractor by any reliable means specified in accordance with article 7 of this Law.

10. Upon the entry into force of the procurement contract and, if required, the provision by the supplier or contractor of a security for the performance of the contract, notice of the procurement contract shall be given promptly to other suppliers or contractors, specifying the name and address of the supplier or contractor that has entered into the contract and the contract price.

*Article 23. Public notice of the award of a procurement contract or framework agreement*

1. Upon the entry into force of the procurement contract or conclusion of a framework agreement, the procuring entity shall promptly publish notice of the award of the procurement contract or the framework agreement, specifying the name of the supplier (or suppliers) or contractor (or contractors) to which the procurement contract or the framework agreement was awarded and, in the case of procurement contracts, the contract price.

2. Paragraph 1 is not applicable to awards where the contract price is less than the threshold amount set out in the procurement regulations. The procuring entity shall publish a cumulative notice of such awards from time to time but at least once a year.

3. The procurement regulations shall provide for the manner of publication of the notices required under this article.

*Article 24. Confidentiality*

1. In its communications with suppliers or contractors or with any person, the procuring entity shall not disclose any information if non-disclosure of such information is necessary for the protection of essential security interests of the State or if disclosure of such information would be contrary to law, would impede law enforcement, would prejudice the legitimate commercial interests of the suppliers or contractors or would impede fair competition,

unless disclosure of that information is ordered by the [*name of the court or courts*] or the [*name of the relevant organ designated by the enacting State*] and, in such case, subject to the conditions of such an order.

2. Other than when providing or publishing information pursuant to paragraphs 2 and 10 of article 22 and to articles 23, 25 and 42 of this Law, the procuring entity shall treat applications to pre-qualify or for pre-selection and submissions in such a manner as to avoid the disclosure of their contents to competing suppliers or contractors or to any other person not authorized to have access to this type of information.

3. Any discussions, communications, negotiations or dialogue between the procuring entity and a supplier or contractor pursuant to paragraph 3 of article 48 and to articles 49 to 52 of this Law shall be confidential. Unless required by law or ordered by the [*name of the court or courts*] or the [*name of the relevant organ designated by the enacting State*], no party to any such discussions, communications, negotiations or dialogue shall disclose to any other person any technical, price or other information relating to these discussions, communications, negotiations or dialogue without the consent of the other party.

4. Subject to the requirements in paragraph 1 of this article, in procurement involving classified information, the procuring entity may:

(a) Impose on suppliers or contractors requirements aimed at protecting classified information; and

(b) Demand that suppliers or contractors ensure that their subcontractors comply with requirements aimed at protecting classified information.

#### *Article 25. Documentary record of procurement proceedings*

1. The procuring entity shall maintain a record of the procurement proceedings that includes the following information:

(a) A brief description of the subject matter of the procurement;

(b) The names and addresses of suppliers or contractors that presented submissions, the name and address of the supplier (or suppliers) or contractor (or contractors) with which the procurement contract is entered into and the contract price (and, in the case of a framework agreement procedure, the name and address of the supplier (or suppliers) or contractor (or contractors) with which the framework agreement is concluded);

(c) A statement of the reasons and circumstances relied upon by the procuring entity for the decision as regards means of communication and any requirement of form;

(d) In procurement proceedings in which the procuring entity, in accordance with article 8 of this Law, limits the participation of suppliers or contractors, a statement of the reasons and circumstances relied upon by the procuring entity for imposing such a limit;

(e) If the procuring entity uses a method of procurement other than open tendering, a statement of the reasons and circumstances relied upon by the procuring entity to justify the use of such other method;

(f) In the case of procurement by means of an electronic reverse auction or involving an electronic reverse auction as a phase preceding the award of the procurement contract, a statement of the reasons and circumstances relied upon by the procuring entity for the use of the auction and information about the date and time of the opening and closing of the auction;

(g) In the case of a framework agreement procedure, a statement of the reasons and circumstances upon which it relied to justify the use of a framework agreement procedure and the type of framework agreement selected;

(h) If the procurement is cancelled pursuant to paragraph 1 of article 19 of this Law, a statement to that effect and the reasons and circumstances relied upon by the procuring entity for its decision to cancel the procurement;

(i) If any socio-economic policies were considered in the procurement proceedings, details of such policies and the manner in which they were applied;

(j) If no standstill period was applied, a statement of the reasons and circumstances relied upon by the procuring entity in deciding not to apply a standstill period;

(k) In the case of a challenge or appeal under chapter VIII of this Law, a copy of the application for reconsideration or review and the appeal, as applicable, and a copy of all decisions taken in the relevant challenge or appeal proceedings, or both, and the reasons therefor;

(l) A summary of any requests for clarification of the pre-qualification or pre-selection documents, if any, or of the solicitation documents and the responses thereto, as well as a summary of any modifications to those documents;

(m) Information relative to the qualifications, or lack thereof, of suppliers or contractors that presented applications to pre-qualify or for pre-selection, if any, or submissions;

(n) If a submission is rejected pursuant to article 20 of this Law, a statement to that effect and the reasons and circumstances relied upon by the procuring entity for its decision;

(o) If a supplier or contractor is excluded from the procurement proceedings pursuant to article 21 of this Law, a statement to that effect and the reasons and circumstances relied upon by the procuring entity for its decision;

(p) A copy of the notice of the standstill period given in accordance with paragraph 2 of article 22 of this Law;

(q) If the procurement proceedings resulted in the award of a procurement contract in accordance with paragraph 8 of article 22 of this Law, a statement to that effect and of the reasons therefor;

(r) The contract price and other principal terms and conditions of the procurement contract; where a written procurement contract has been concluded, a copy thereof. (In the case of a framework agreement procedure, in addition a summary of the principal terms and conditions of the framework agreement or a copy of any written framework agreement that was concluded);

(s) For each submission, the price and a summary of the other principal terms and conditions;

(t) A summary of the evaluation of submissions, including the application of any preference pursuant to paragraph 3 (b) of article 11 of this Law, and the reasons and circumstances on which the procuring entity relied to justify any rejection of bids presented during the auction;

(u) Where exemptions from disclosure of information were invoked under paragraph 1 of article 24 or under article 69 of this Law, the reasons and circumstances relied upon in invoking them;

(v) In procurement involving classified information, any requirements imposed on suppliers or contractors for the protection of classified information pursuant to paragraph 4 of article 24 of this Law; and

(w) Other information required to be included in the record in accordance with the provisions of this Law or the procurement regulations.

2. The portion of the record referred to in subparagraphs (a) to (k) of paragraph 1 of this article shall, on request, be made available to any person after the successful submission has been accepted or the procurement has been cancelled.

3. Subject to paragraph 4 of this article, or except as disclosed pursuant to paragraph 3 of article 42 of this Law, the portion of the record referred to in subparagraphs (p) to (t) of paragraph 1 of this article shall, after the decision on acceptance of the successful submission has become known to them, be made available, upon request, to suppliers or contractors that presented submissions.

4. Except when ordered to do so by the [name of court or courts] or the [name of the relevant organ designated by the enacting State], and subject to the conditions of such an order, the procuring entity shall not disclose:

(a) Information from the record of the procurement proceedings if its non-disclosure is necessary for the protection of essential security interests of the State or if its disclosure would be contrary to law, would impede law enforcement, would prejudice the legitimate commercial interests of the suppliers or contractors or would impede fair competition;

(b) Information relating to the examination and evaluation of submissions, other than the summary referred to in subparagraph (t) of paragraph 1 of this article.

5. The procurement entity shall record, file and preserve all documents relating to the procurement proceedings, according to procurement regulations or other provisions of law of this State.

### *Article 26. Code of conduct*

A code of conduct for officers or employees of procuring entities shall be enacted. It shall address, inter alia, the prevention of conflicts of interest in procurement and, where appropriate, measures to regulate matters regarding personnel responsible for procurement, such as declarations of interest in particular procurements, screening procedures and training requirements. The code of conduct so enacted shall be promptly made accessible to the public and systematically maintained.

## CHAPTER II. METHODS OF PROCUREMENT AND THEIR CONDITIONS FOR USE; SOLICITATION AND NOTICES OF THE PROCUREMENT

### **Section I. Methods of procurement and their conditions for use**

#### *Article 27. Methods of procurement<sup>4</sup>*

1. The procuring entity may conduct procurement by means of:

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<sup>4</sup>States may choose not to incorporate all the methods of procurement listed in this article into their national legislation, although an appropriate range of options, including open tendering, should be always provided for. On this question, see the *Guide to Enactment of the UNCITRAL Model Law on Public Procurement*. States may consider whether, for certain methods of procurement, to include a requirement for high-level approval by a designated organ. On this question, see the *Guide to Enactment*.

- (a) Open tendering;
- (b) Restricted tendering;
- (c) Request for quotations;
- (d) Request for proposals without negotiation;
- (e) Two-stage tendering;
- (f) Request for proposals with dialogue;
- (g) Request for proposals with consecutive negotiations;
- (h) Competitive negotiations;
- (i) Electronic reverse auction; and
- (j) Single-source procurement.

2. The procuring entity may engage in a framework agreement procedure in accordance with the provisions of chapter VII of this Law.

*Article 28. General rules applicable to the selection of a procurement method*

1. Except as otherwise provided for in articles 29 to 31 of this Law, a procuring entity shall conduct procurement by means of open tendering.
2. A procuring entity may use a method of procurement other than open tendering only in accordance with articles 29 to 31 of this Law, shall select the other method of procurement to accommodate the circumstances of the procurement concerned and shall seek to maximize competition to the extent practicable.
3. If the procuring entity uses a method of procurement other than open tendering, it shall include in the record required under article 25 of this Law a statement of the reasons and circumstances upon which it relied to justify the use of that method.

*Article 29. Conditions for the use of methods of procurement under chapter IV of this Law (restricted tendering, requests for quotations and requests for proposals without negotiation)*

1. The procuring entity may engage in procurement by means of restricted tendering in accordance with article 45 of this Law when:

- (a) The subject matter of the procurement, by reason of its highly complex or specialized nature, is available only from a limited number of suppliers or contractors; or

(b) The time and cost required to examine and evaluate a large number of tenders would be disproportionate to the value of the subject matter of the procurement.

2. A procuring entity may engage in procurement by means of a request for quotations in accordance with article 46 of this Law for the procurement of readily available goods or services that are not specially produced or provided to the particular description of the procuring entity and for which there is an established market, so long as the estimated value of the procurement contract is less than the threshold amount set out in the procurement regulations.

3. The procuring entity may engage in procurement by means of request for proposals without negotiation in accordance with article 47 of this Law where the procuring entity needs to consider the financial aspects of proposals separately and only after completion of examination and evaluation of the technical, quality and performance characteristics of the proposals.

*Article 30. Conditions for the use of methods of procurement under chapter V of this Law (two-stage tendering, requests for proposals with dialogue, requests for proposals with consecutive negotiations, competitive negotiations and single-source procurement)*

1. A procuring entity may engage in procurement by means of two-stage tendering in accordance with article 48 of this Law where:

(a) The procuring entity assesses that discussions with suppliers or contractors are needed to refine aspects of the description of the subject matter of the procurement and to formulate them with the detail required under article 10 of this Law, and in order to allow the procuring entity to obtain the most satisfactory solution to its procurement needs; or

(b) Open tendering was engaged in but no tenders were presented or the procurement was cancelled by the procuring entity pursuant to paragraph 1 of article 19 of this Law and where, in the judgement of the procuring entity, engaging in new open-tendering proceedings or a procurement method under chapter IV of this Law would be unlikely to result in a procurement contract.

2. [Subject to approval by the *[name of the organ designated by the enacting State to issue the approval]*],<sup>5</sup> a procuring entity may engage in procurement by means of request for proposals with dialogue in accordance with article 49 of this Law where:

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<sup>5</sup>The enacting State may consider enacting the provisions in brackets if it wishes to subject the use of this procurement method to a measure of ex ante control.

(a) It is not feasible for the procuring entity to formulate a detailed description of the subject matter of the procurement in accordance with article 10 of this Law, and the procuring entity assesses that dialogue with suppliers or contractors is needed to obtain the most satisfactory solution to its procurement needs;

(b) The procuring entity seeks to enter into a contract for the purpose of research, experiment, study or development, except where the contract includes the production of items in quantities sufficient to establish their commercial viability or to recover research and development costs;

(c) The procuring entity determines that the selected method is the most appropriate method of procurement for the protection of essential security interests of the State; or

(d) Open tendering was engaged in but no tenders were presented or the procurement was cancelled by the procuring entity pursuant to paragraph 1 of article 19 of this Law and where, in the judgement of the procuring entity, engaging in new open-tendering proceedings or a procurement method under chapter IV of this Law would be unlikely to result in a procurement contract.

3. A procuring entity may engage in procurement by means of request for proposals with consecutive negotiations in accordance with article 50 of this Law where the procuring entity needs to consider the financial aspects of proposals separately and only after completion of examination and evaluation of the technical, quality and performance characteristics of the proposals, and it assesses that consecutive negotiations with suppliers or contractors are needed in order to ensure that the financial terms and conditions of the procurement contract are acceptable to the procuring entity.

4. A procuring entity may engage in competitive negotiations, in accordance with the provisions of article 51 of this Law, in the following circumstances:

(a) There is an urgent need for the subject matter of the procurement, and engaging in open-tendering proceedings or any other competitive method of procurement, because of the time involved in using those methods, would therefore be impractical, provided that the circumstances giving rise to the urgency were neither foreseeable by the procuring entity nor the result of dilatory conduct on its part;

(b) Owing to a catastrophic event, there is an urgent need for the subject matter of the procurement, making it impractical to use open-tendering proceedings or any other competitive method of procurement because of the time involved in using those methods; or

(c) The procuring entity determines that the use of any other competitive method of procurement is not appropriate for the protection of essential security interests of the State.



5. A procuring entity may engage in single-source procurement in accordance with the provisions of article 52 of this Law in the following exceptional circumstances:

(a) The subject matter of the procurement is available only from a particular supplier or contractor, or a particular supplier or contractor has exclusive rights in respect of the subject matter of the procurement, such that no reasonable alternative or substitute exists, and the use of any other procurement method would therefore not be possible;

(b) Owing to a catastrophic event, there is an extremely urgent need for the subject matter of the procurement, and engaging in any other method of procurement would be impractical because of the time involved in using those methods;

(c) The procuring entity, having procured goods, equipment, technology or services from a supplier or contractor, determines that additional supplies must be procured from that supplier or contractor for reasons of standardization or because of the need for compatibility with existing goods, equipment, technology or services, taking into account the effectiveness of the original procurement in meeting the needs of the procuring entity, the limited size of the proposed procurement in relation to the original procurement, the reasonableness of the price and the unsuitability of alternatives to the goods or services in question;

(d) The procuring entity determines that the use of any other method of procurement is not appropriate for the protection of essential security interests of the State; or

(e) [Subject to approval by the [*name of the organ designated by the enacting State to issue the approval*] and,] following public notice and adequate opportunity to comment, procurement from a particular supplier or contractor is necessary in order to implement a socio-economic policy of this State, provided that procurement from no other supplier or contractor is capable of promoting that policy.

### *Article 31. Conditions for use of an electronic reverse auction*

1. A procuring entity may engage in procurement by means of an electronic reverse auction in accordance with the provisions of chapter VI of this Law, under the following conditions:

(a) It is feasible for the procuring entity to formulate a detailed description of the subject matter of the procurement;

(b) There is a competitive market of suppliers or contractors anticipated to be qualified to participate in the electronic reverse auction, such that effective competition is ensured; and

(c) The criteria to be used by the procuring entity in determining the successful submission are quantifiable and can be expressed in monetary terms.

2. A procuring entity may use an electronic reverse auction as a phase preceding the award of the procurement contract in a procurement method, as appropriate under the provisions of this Law. It may also use an electronic reverse auction for award of a procurement contract in a framework agreement procedure with second-stage competition in accordance with the provisions of this Law. An electronic reverse auction under this paragraph may be used only where the conditions of paragraph 1 (c) of this article are satisfied.

*Article 32. Conditions for use of a framework agreement procedure*

1. A procuring entity may engage in a framework agreement procedure in accordance with chapter VII of this Law where it determines that:

(a) The need for the subject matter of the procurement is expected to arise on an indefinite or repeated basis during a given period of time; or

(b) By virtue of the nature of the subject matter of the procurement, the need for that subject matter may arise on an urgent basis during a given period of time.

2. The procuring entity shall include in the record required under article 25 of this Law a statement of the reasons and circumstances upon which it relied to justify the use of a framework agreement procedure and the type of framework agreement selected.

## **Section II. Solicitation and notices of the procurement**

*Article 33. Solicitation in open tendering, two-stage tendering and procurement by means of an electronic reverse auction*

1. An invitation to tender in open tendering or two-stage tendering and an invitation to an electronic reverse auction under article 53 of this Law shall be published in the publication identified in the procurement regulations.

2. The invitation shall also be published internationally, so as to be widely accessible to international suppliers or contractors.

3. The provisions of this article shall not apply where the procuring entity engages in pre-qualification proceedings in accordance with article 18 of this Law.

4. The procuring entity shall not be required to cause the invitation to be published in accordance with paragraph 2 of this article in domestic procurement and in procurement proceedings where the procuring entity decides, in view of the low value of the subject matter of the procurement, that only domestic suppliers or contractors are likely to be interested in presenting submissions.

*Article 34. Solicitation in restricted tendering, request for quotations, competitive negotiations and single-source procurement: requirement for an advance notice of the procurement*

1. (a) When the procuring entity engages in procurement by means of restricted tendering on the grounds specified in paragraph 1 (a) of article 29 of this Law, it shall solicit tenders from all suppliers and contractors from which the subject matter of the procurement is available;

(b) When the procuring entity engages in procurement by means of restricted tendering on the grounds specified in paragraph 1 (b) of article 29 of this Law, it shall select suppliers or contractors from which to solicit tenders in a non-discriminatory manner, and it shall select a sufficient number of suppliers or contractors to ensure effective competition.

2. Where the procuring entity engages in procurement by means of request for quotations in accordance with paragraph 2 of article 29 of this Law, it shall request quotations from as many suppliers or contractors as practicable, but from at least three.

3. Where the procuring entity engages in procurement by means of competitive negotiations in accordance with paragraph 4 of article 30 of this Law, it shall engage in negotiations with a sufficient number of suppliers or contractors to ensure effective competition.

4. Where the procuring entity engages in single-source procurement in accordance with paragraph 5 of article 30 of this Law, it shall solicit a proposal or price quotation from a single supplier or contractor.

5. Prior to direct solicitation in accordance with the provisions of paragraphs 1, 3 and 4 of this article, the procuring entity shall cause a notice of the procurement to be published in the publication identified in the procurement regulations. The notice shall contain at a minimum the following information:

(a) The name and address of the procuring entity;

(b) A summary of the principal required terms and conditions of the procurement contract or the framework agreement to be entered into in the

procurement proceedings, including the nature, quantity and place of delivery of the goods to be supplied, the nature and location of the construction to be effected or the nature of the services and the location where they are to be provided, as well as the desired or required time for the supply of the goods, the completion of the construction or the provision of the services;

- (c) A declaration pursuant to article 8 of this Law; and
- (d) The method of procurement to be used.

6. The requirements of paragraph 5 of this article shall not apply in cases of urgent need as referred to in paragraphs 4 (a), 4 (b) and 5 (b) of article 30 of this Law.

### *Article 35. Solicitation in request-for-proposals proceedings*

1. An invitation to participate in request-for-proposals proceedings shall be published in accordance with paragraphs 1 and 2 of article 33 of this Law, except where:

(a) The procuring entity engages in pre-qualification proceedings in accordance with article 18 of this Law or in pre-selection proceedings in accordance with paragraph 3 of article 49 of this Law;

(b) The procuring entity engages in direct solicitation under the conditions set out in paragraph 2 of this article; or

(c) The procuring entity decides not to cause the invitation to be published in accordance with paragraph 2 of article 33 of this Law in the circumstances referred to in paragraph 4 of article 33 of this Law.

2. The procuring entity may engage in direct solicitation in request-for-proposals proceedings if:

(a) The subject matter to be procured is available from only a limited number of suppliers or contractors, provided that the procuring entity solicits proposals from all those suppliers or contractors;

(b) The time and cost required to examine and evaluate a large number of proposals would be disproportionate to the value of the subject matter to be procured, provided that the procuring entity solicits proposals from a sufficient number of suppliers or contractors to ensure effective competition and selects suppliers or contractors from which to solicit proposals in a non-discriminatory manner; or

(c) The procurement involves classified information, provided that the procuring entity solicits proposals from a sufficient number of suppliers or contractors to ensure effective competition.

3. The procuring entity shall include in the record required under article 25 of this Law a statement of the reasons and circumstances upon which it relied to justify the use of direct solicitation in request-for-proposals proceedings.

4. The procuring entity shall cause a notice of the procurement to be published in accordance with the requirements set out in paragraph 5 of article 34 of this Law when it engages in direct solicitation in request-for-proposals proceedings.

## CHAPTER III. OPEN TENDERING

### Section I. Solicitation of tenders

#### *Article 36. Procedures for soliciting tenders*

The procuring entity shall solicit tenders by causing an invitation to tender to be published in accordance with the provisions of article 33 of this Law.

#### *Article 37. Contents of invitation to tender*

The invitation to tender shall include the following information:

- (a) The name and address of the procuring entity;
- (b) A summary of the principal required terms and conditions of the procurement contract to be entered into as a result of the procurement proceedings, including the nature, quantity and place of delivery of the goods to be supplied, the nature and location of the construction to be effected or the nature of the services and the location where they are to be provided, as well as the desired or required time for the supply of the goods, the completion of the construction or the provision of the services;
- (c) A summary of the criteria and procedures to be used for ascertaining the qualifications of suppliers or contractors, and of any documentary evidence or other information that must be submitted by suppliers or contractors to demonstrate their qualifications, in conformity with article 9 of this Law;
- (d) A declaration pursuant to article 8 of this Law;
- (e) The means of obtaining the solicitation documents and the place where they may be obtained;

- (f) The price, if any, to be charged by the procuring entity for the solicitation documents;
- (g) If a price is to be charged for the solicitation documents, the means and currency of payment;
- (h) The language or languages in which the solicitation documents are available;
- (i) The manner, place and deadline for presenting tenders.

### *Article 38. Provision of solicitation documents*

The procuring entity shall provide the solicitation documents to each supplier or contractor that responds to the invitation to tender in accordance with the procedures and requirements specified therein. If pre-qualification proceedings have been engaged in, the procuring entity shall provide a set of solicitation documents to each supplier or contractor that has been pre-qualified and that pays the price, if any, charged for those documents. The price that the procuring entity may charge for the solicitation documents shall reflect only the cost of providing them to suppliers or contractors.

### *Article 39. Contents of solicitation documents*

The solicitation documents shall include the following information:

- (a) Instructions for preparing tenders;
- (b) The criteria and procedures, in conformity with the provisions of article 9 of this Law, that will be applied in the ascertainment of the qualifications of suppliers or contractors and in any further demonstration of qualifications pursuant to paragraph 5 of article 43 of this Law;
- (c) The requirements as to documentary evidence or other information that must be presented by suppliers or contractors to demonstrate their qualifications;
- (d) A detailed description of the subject matter of the procurement, in conformity with article 10 of this Law; the quantity of the goods; the services to be performed; the location where the goods are to be delivered, construction is to be effected or services are to be provided; and the desired or required time, if any, when goods are to be delivered, construction is to be effected or services are to be provided;
- (e) The terms and conditions of the procurement contract, to the extent that they are already known to the procuring entity, and the form of the contract, if any, to be signed by the parties;

(f) If alternatives to the characteristics of the subject matter of the procurement, the contractual terms and conditions or other requirements set out in the solicitation documents are permitted, a statement to that effect and a description of the manner in which alternative tenders are to be evaluated;

(g) If suppliers or contractors are permitted to present tenders for only a portion of the subject matter of the procurement, a description of the portion or portions for which tenders may be presented;

(h) The manner in which the tender price is to be formulated and expressed, including a statement as to whether the price is to cover elements other than the cost of the subject matter of the procurement itself, such as any applicable transportation and insurance charges, customs duties and taxes;

(i) The currency or currencies in which the tender price is to be formulated and expressed;

(j) The language or languages, in conformity with article 13 of this Law, in which tenders are to be prepared;

(k) Any requirements of the procuring entity with respect to the issuer and the nature, form, amount and other principal terms and conditions of any tender security to be provided by suppliers or contractors presenting tenders in accordance with article 17 of this Law, and any such requirements for any security for the performance of the procurement contract to be provided by the supplier or contractor that enters into the procurement contract, including securities such as labour and material bonds;

(l) If a supplier or contractor may not modify or withdraw its tender prior to the deadline for presenting tenders without forfeiting its tender security, a statement to that effect;

(m) The manner, place and deadline for presenting tenders, in conformity with article 14 of this Law;

(n) The means by which, pursuant to article 15 of this Law, suppliers or contractors may seek clarification of the solicitation documents and a statement as to whether the procuring entity intends to convene a meeting of suppliers or contractors at this stage;

(o) The period of time during which tenders shall be in effect, in conformity with article 41 of this Law;

(p) The manner, place, date and time for the opening of tenders, in conformity with article 42 of this Law;

(q) The criteria and procedure for examining tenders against the description of the subject matter of the procurement;

(r) The criteria and procedure for evaluating tenders in accordance with article 11 of this Law;

(s) The currency that will be used for the purpose of evaluating tenders pursuant to paragraph 4 of article 43 of this Law and either the exchange rate that will be used for the conversion of tender prices into that currency or a statement that the rate published by a specified financial institution and prevailing on a specified date will be used;

(t) References to this Law, the procurement regulations and other laws and regulations directly pertinent to the procurement proceedings, including those applicable to procurement involving classified information, and the place where those laws and regulations may be found;

(u) The name, functional title and address of one or more officers or employees of the procuring entity who are authorized to communicate directly with and to receive communications directly from suppliers or contractors in connection with the procurement proceedings without the intervention of an intermediary;

(v) Notice of the right provided under article 64 of this Law to challenge or appeal decisions or actions taken by the procuring entity that are allegedly not in compliance with the provisions of this Law, together with information about the duration of the applicable standstill period and, if none will apply, a statement to that effect and the reasons therefor;

(w) Any formalities that will be required, once a successful tender has been accepted, for a procurement contract to enter into force, including, where applicable, the execution of a written procurement contract and approval by another authority pursuant to article 22 of this Law, and the estimated period of time following the dispatch of the notice of acceptance that will be required to obtain the approval;

(x) Any other requirements established by the procuring entity in conformity with this Law and the procurement regulations relating to the preparation and presentation of tenders and to other aspects of the procurement proceedings.

## **Section II. Presentation of tenders**

### *Article 40. Presentation of tenders*

1. Tenders shall be presented in the manner, at the place and by the deadline specified in the solicitation documents.
2. (a) A tender shall be presented in writing, signed and:
  - (i) If in paper form, in a sealed envelope; or
  - (ii) If in any other form, according to the requirements specified by the procuring entity in the solicitation documents, which shall ensure at least a similar degree of authenticity, security, integrity and confidentiality;



(b) The procuring entity shall provide to the supplier or contractor a receipt showing the date and time when its tender was received;

(c) The procuring entity shall preserve the security, integrity and confidentiality of a tender and shall ensure that the content of the tender is examined only after it is opened in accordance with this Law.

3. A tender received by the procuring entity after the deadline for presenting tenders shall not be opened and shall be returned unopened to the supplier or contractor that presented it.

*Article 41. Period of effectiveness of tenders; modification and withdrawal of tenders*

1. Tenders shall be in effect during the period of time specified in the solicitation documents.

2. (a) Prior to the expiry of the period of effectiveness of tenders, the procuring entity may request suppliers or contractors to extend the period for an additional specified period of time. A supplier or contractor may refuse the request without forfeiting its tender security;

(b) Suppliers or contractors that agree to an extension of the period of effectiveness of their tenders shall extend or procure an extension of the period of effectiveness of tender securities provided by them or provide new tender securities to cover the extended period of effectiveness of their tenders. A supplier or contractor whose tender security is not extended, or that has not provided a new tender security, is considered to have refused the request to extend the period of effectiveness of its tender.

3. Unless otherwise stipulated in the solicitation documents, a supplier or contractor may modify or withdraw its tender prior to the deadline for presenting tenders without forfeiting its tender security. The modification or notice of withdrawal is effective if it is received by the procuring entity prior to the deadline for presenting tenders.

### **Section III. Evaluation of tenders**

*Article 42. Opening of tenders*

1. Tenders shall be opened at the time specified in the solicitation documents as the deadline for presenting tenders. They shall be opened at the place and in accordance with the manner and procedures specified in the solicitation documents.

2. All suppliers or contractors that have presented tenders, or their representatives, shall be permitted by the procuring entity to participate in the opening of tenders.
3. The name and address of each supplier or contractor whose tender is opened and the tender price shall be announced to those persons present at the opening of tenders, communicated on request to suppliers or contractors that have presented tenders but that are not present or represented at the opening of tenders, and included immediately in the record of the procurement proceedings required by article 25 of this Law.

### *Article 43. Examination and evaluation of tenders*

1. (a) Subject to subparagraph (b) of this paragraph, the procuring entity shall regard a tender as responsive if it conforms to all requirements set out in the solicitation documents in accordance with article 10 of this Law;

(b) The procuring entity may regard a tender as responsive even if it contains minor deviations that do not materially alter or depart from the characteristics, terms, conditions and other requirements set out in the solicitation documents or if it contains errors or oversights that can be corrected without touching on the substance of the tender. Any such deviations shall be quantified, to the extent possible, and appropriately taken account of in the evaluation of tenders.

2. The procuring entity shall reject a tender:

- (a) If the supplier or contractor that presented the tender is not qualified;
- (b) If the supplier or contractor that presented the tender does not accept a correction of an arithmetical error made pursuant to article 16 of this Law;
- (c) If the tender is not responsive;
- (d) In the circumstances referred to in article 20 or 21 of this Law.

3. (a) The procuring entity shall evaluate the tenders that have not been rejected in order to ascertain the successful tender, as defined in subparagraph (b) of this paragraph, in accordance with the criteria and procedures set out in the solicitation documents. No criterion or procedure shall be used that has not been set out in the solicitation documents;

- (b) The successful tender shall be:
  - (i) Where price is the only award criterion, the tender with the lowest tender price; or

- (ii) Where there are price and other award criteria, the most advantageous tender ascertained on the basis of the criteria and procedures for evaluating tenders specified in the solicitation documents in accordance with article 11 of this Law.

4. When tender prices are expressed in two or more currencies, for the purpose of evaluating and comparing tenders, the tender prices of all tenders shall be converted to the currency specified in the solicitation documents according to the rate set out in those documents, pursuant to subparagraph (s) of article 39 of this Law.

5. Whether or not it has engaged in pre-qualification proceedings pursuant to article 18 of this Law, the procuring entity may require the supplier or contractor presenting the tender that has been found to be the successful tender pursuant to paragraph 3 (b) of this article to demonstrate its qualifications again, in accordance with criteria and procedures conforming to the provisions of article 9 of this Law. The criteria and procedures to be used for such further demonstration shall be set out in the solicitation documents. Where pre-qualification proceedings have been engaged in, the criteria shall be the same as those used in the pre-qualification proceedings.

6. If the supplier or contractor presenting the successful tender is requested to demonstrate its qualifications again in accordance with paragraph 5 of this article but fails to do so, the procuring entity shall reject that tender and shall select the next successful tender from among those remaining in effect, in accordance with paragraph 3 of this article, subject to the right of the procuring entity to cancel the procurement in accordance with paragraph 1 of article 19 of this Law.

*Article 44. Prohibition of negotiations with suppliers or contractors*

No negotiations shall take place between the procuring entity and a supplier or contractor with respect to a tender presented by the supplier or contractor.

## CHAPTER IV. PROCEDURES FOR RESTRICTED TENDERING, REQUESTS FOR QUOTATIONS AND REQUESTS FOR PROPOSALS WITHOUT NEGOTIATION

*Article 45. Restricted tendering*

1. The procuring entity shall solicit tenders in accordance with the provisions of paragraphs 1 and 5 of article 34 of this Law.

2. The provisions of chapter III of this Law, except for articles 36 to 38, shall apply to restricted-tendering proceedings.

*Article 46. Request for quotations*

1. The procuring entity shall request quotations in accordance with the provisions of paragraph 2 of article 34 of this Law. Each supplier or contractor from which a quotation is requested shall be informed whether any elements other than the charges for the subject matter of the procurement itself, such as any applicable transportation and insurance charges, customs duties and taxes, are to be included in the price.

2. Each supplier or contractor is permitted to give only one price quotation and is not permitted to change its quotation. No negotiations shall take place between the procuring entity and a supplier or contractor with respect to a quotation presented by the supplier or contractor.

3. The successful quotation shall be the lowest-priced quotation meeting the needs of the procuring entity as set out in the request for quotations.

*Article 47. Request for proposals without negotiation*

1. The procuring entity shall solicit proposals by causing an invitation to participate in the request-for-proposals-without-negotiation proceedings to be published in accordance with paragraph 1 of article 35 of this Law, unless an exception provided for in that article applies.

2. The invitation shall include:

(a) The name and address of the procuring entity;

(b) A detailed description of the subject matter of the procurement, in conformity with article 10 of this Law, and the desired or required time and location for the provision of such subject matter;

(c) The terms and conditions of the procurement contract, to the extent that they are already known to the procuring entity, and the form of the contract, if any, to be signed by the parties;

(d) The criteria and procedures to be used for ascertaining the qualifications of suppliers or contractors and any documentary evidence or other information that must be presented by suppliers or contractors to demonstrate their qualifications, in conformity with article 9 of this Law;

(e) The criteria and procedures for opening the proposals and for examining and evaluating the proposals in accordance with articles 10 and 11 of this Law,

including the minimum requirements with respect to technical, quality and performance characteristics that proposals must meet in order to be considered responsive in accordance with article 10 of this Law, and a statement that proposals that fail to meet those requirements will be rejected as non-responsive;

(f) A declaration pursuant to article 8 of this Law;

(g) The means of obtaining the request for proposals and the place where it may be obtained;

(h) The price, if any, to be charged by the procuring entity for the request for proposals;

(i) If a price is to be charged for the request for proposals, the means and currency of payment;

(j) The language or languages in which the request for proposals is available;

(k) The manner, place and deadline for presenting proposals.

3. The procuring entity shall issue the request for proposals:

(a) Where an invitation to participate in the request-for-proposals-without-negotiation proceedings has been published in accordance with the provisions of paragraph 1 of article 35 of this Law, to each supplier or contractor responding to the invitation in accordance with the procedures and requirements specified therein;

(b) In the case of pre-qualification, to each supplier or contractor pre-qualified in accordance with article 18 of this Law;

(c) In the case of direct solicitation under paragraph 2 of article 35 of this Law, to each supplier or contractor selected by the procuring entity;

that pays the price, if any, charged for the request for proposals. The price that the procuring entity may charge for the request for proposals shall reflect only the cost of providing it to suppliers or contractors.

4. The request for proposals shall include, in addition to the information referred to in subparagraphs (a) to (e) and (k) of paragraph 2 of this article, the following information:

(a) Instructions for preparing and presenting proposals, including instructions to suppliers or contractors to present simultaneously to the procuring entity proposals in two envelopes: one envelope containing the technical, quality and performance characteristics of the proposal, and the other envelope containing the financial aspects of the proposal;

(b) If suppliers or contractors are permitted to present proposals for only a portion of the subject matter of the procurement, a description of the portion or portions for which proposals may be presented;

(c) The currency or currencies in which the proposal price is to be formulated and expressed, the currency that will be used for the purpose of evaluating proposals and either the exchange rate that will be used for the conversion of proposal prices into that currency or a statement that the rate published by a specified financial institution and prevailing on a specified date will be used;

(d) The manner in which the proposal price is to be formulated and expressed, including a statement as to whether the price is to cover elements other than the cost of the subject matter of the procurement itself, such as reimbursement for transportation, lodging, insurance, use of equipment, duties or taxes;

(e) The means by which, pursuant to article 15 of this Law, suppliers or contractors may seek clarification of the request for proposals, and a statement as to whether the procuring entity intends to convene a meeting of suppliers or contractors at this stage;

(f) References to this Law, the procurement regulations and other laws and regulations directly pertinent to the procurement proceedings, including those applicable to procurement involving classified information, and the place where those laws and regulations may be found;

(g) The name, functional title and address of one or more officers or employees of the procuring entity who are authorized to communicate directly with and to receive communications directly from suppliers or contractors in connection with the procurement proceedings without the intervention of an intermediary;

(h) Notice of the right provided under article 64 of this Law to challenge or appeal decisions or actions taken by the procuring entity that are allegedly not in compliance with the provisions of this Law, together with information about the duration of the applicable standstill period and, if none will apply, a statement to that effect and the reasons therefor;

(i) Any formalities that will be required, once the successful proposal has been accepted, for a procurement contract to enter into force, including, where applicable, the execution of a written procurement contract and approval by another authority pursuant to article 22 of this Law, and the estimated period of time following the dispatch of the notice of acceptance that will be required to obtain the approval;

(j) Any other requirements that may be established by the procuring entity in conformity with this Law and the procurement regulations relating to the preparation and presentation of proposals and to the procurement proceedings.

5. Before opening the envelopes containing the financial aspects of the proposals, the procuring entity shall examine and evaluate the technical, quality and performance characteristics of proposals in accordance with the criteria and procedures specified in the request for proposals.

6. The results of the examination and evaluation of the technical, quality and performance characteristics of the proposals shall immediately be included in the record of the procurement proceedings.
7. The proposals whose technical, quality and performance characteristics fail to meet the relevant minimum requirements shall be considered to be non-responsive and shall be rejected on that ground. A notice of rejection and the reasons for the rejection, together with the unopened envelope containing the financial aspects of the proposal, shall promptly be dispatched to each respective supplier or contractor whose proposal was rejected.
8. The proposals whose technical, quality and performance characteristics meet or exceed the relevant minimum requirements shall be considered to be responsive. The procuring entity shall promptly communicate to each supplier or contractor presenting such a proposal the score of the technical, quality and performance characteristics of its respective proposal. The procuring entity shall invite all such suppliers or contractors to the opening of the envelopes containing the financial aspects of their proposals.
9. The score of the technical, quality and performance characteristics of each responsive proposal and the corresponding financial aspect of that proposal shall be read out in the presence of the suppliers or contractors invited, in accordance with paragraph 8 of this article, to the opening of the envelopes containing the financial aspects of the proposals.
10. The procuring entity shall compare the financial aspects of the responsive proposals and on that basis identify the successful proposal in accordance with the criteria and the procedure set out in the request for proposals. The successful proposal shall be the proposal with the best combined evaluation in terms of: (a) the criteria other than price specified in the request for proposals; and (b) the price.

## CHAPTER V. PROCEDURES FOR TWO-STAGE TENDERING, REQUESTS FOR PROPOSALS WITH DIALOGUE, REQUESTS FOR PROPOSALS WITH CONSECUTIVE NEGOTIATIONS, COMPETITIVE NEGOTIATIONS AND SINGLE-SOURCE PROCUREMENT

### *Article 48. Two-stage tendering*

1. The provisions of chapter III of this Law shall apply to two-stage-tendering proceedings, except to the extent that those provisions are derogated from in this article.

2. The solicitation documents shall call upon suppliers or contractors to present, in the first stage of two-stage-tendering proceedings, initial tenders containing their proposals without a tender price. The solicitation documents may solicit proposals relating to the technical, quality or performance characteristics of the subject matter of the procurement, as well as to contractual terms and conditions of supply and, where relevant, the professional and technical competence and qualifications of the suppliers or contractors.

3. The procuring entity may, in the first stage, engage in discussions with suppliers or contractors whose initial tenders have not been rejected pursuant to provisions of this Law concerning any aspect of their initial tenders. When the procuring entity engages in discussions with any supplier or contractor, it shall extend an equal opportunity to participate in discussions to all suppliers or contractors.

4. (a) In the second stage of two-stage-tendering proceedings, the procuring entity shall invite all suppliers or contractors whose initial tenders were not rejected in the first stage to present final tenders with prices in response to a revised set of terms and conditions of the procurement;

(b) In revising the relevant terms and conditions of the procurement, the procuring entity may not modify the subject matter of the procurement but may refine aspects of the description of the subject matter of the procurement by:

- (i) Deleting or modifying any aspect of the technical, quality or performance characteristics of the subject matter of the procurement initially provided and adding any new characteristics that conform to the requirements of this Law;
- (ii) Deleting or modifying any criterion for examining or evaluating tenders initially provided and adding any new criterion that conforms to the requirements of this Law, only to the extent that the deletion, modification or addition is required as a result of changes made in the technical, quality or performance characteristics of the subject matter of the procurement;

(c) Any deletion, modification or addition made pursuant to subparagraph (b) of this paragraph shall be communicated to suppliers or contractors in the invitation to present final tenders;

(d) A supplier or contractor not wishing to present a final tender may withdraw from the tendering proceedings without forfeiting any tender security that the supplier or contractor may have been required to provide;

(e) The final tenders shall be evaluated in order to ascertain the successful tender as defined in paragraph 3 (b) of article 43 of this Law.



### *Article 49. Request for proposals with dialogue*

1. The procuring entity shall solicit proposals by causing an invitation to participate in the request-for-proposals-with-dialogue proceedings to be published in accordance with paragraph 1 of article 35 of this Law, unless an exception provided for in that article applies.
2. The invitation shall include:
  - (a) The name and address of the procuring entity;
  - (b) A description of the subject matter of the procurement, to the extent known, and the desired or required time and location for the provision of such subject matter;
  - (c) The terms and conditions of the procurement contract, to the extent that they are already known to the procuring entity, and the form of the contract, if any, to be signed by the parties;
  - (d) The intended stages of the procedure;
  - (e) The criteria and procedures to be used for ascertaining the qualifications of suppliers or contractors and any documentary evidence or other information that must be presented by suppliers or contractors to demonstrate their qualifications, in conformity with article 9 of this Law;
  - (f) The minimum requirements that proposals must meet in order to be considered responsive in accordance with article 10 of this Law and a statement that proposals that fail to meet those requirements will be rejected as non-responsive;
  - (g) A declaration pursuant to article 8 of this Law;
  - (h) The means of obtaining the request for proposals and the place where it may be obtained;
  - (i) The price, if any, to be charged by the procuring entity for the request for proposals;
  - (j) If a price is to be charged for the request for proposals, the means and currency of payment;
  - (k) The language or languages in which the request for proposals is available;
  - (l) The manner, place and deadline for presenting proposals.
3. For the purpose of limiting the number of suppliers or contractors from which to request proposals, the procuring entity may engage in pre-selection proceedings. The provisions of article 18 of this Law shall apply *mutatis mutandis* to the pre-selection proceedings, except to the extent that those provisions are derogated from in this paragraph:

(a) The procuring entity shall specify in the pre-selection documents that it will request proposals from only a limited number of pre-selected suppliers or contractors that best meet the qualification criteria specified in the pre-selection documents;

(b) The pre-selection documents shall set out the maximum number of pre-selected suppliers or contractors from which the proposals will be requested and the manner in which the selection of that number will be carried out. In establishing such a limit, the procuring entity shall bear in mind the need to ensure effective competition;

(c) The procuring entity shall rate the suppliers or contractors that meet the criteria specified in the pre-selection documents according to the manner of rating that is set out in the invitation to pre-selection and the pre-selection documents;

(d) The procuring entity shall pre-select suppliers or contractors that acquired the best rating, up to the maximum number indicated in the pre-selection documents but at least three, if possible;

(e) The procuring entity shall promptly notify each supplier or contractor whether it has been pre-selected and shall, upon request, communicate to suppliers or contractors that have not been pre-selected the reasons therefor. It shall make available to any person, upon request, the names of all suppliers or contractors that have been pre-selected.

#### 4. The procuring entity shall issue the request for proposals:

(a) Where an invitation to participate in the request-for-proposals-with-dialogue proceedings has been published in accordance with the provisions of paragraph 1 of article 35 of this Law, to each supplier or contractor responding to the invitation in accordance with the procedures and requirements specified therein;

(b) In the case of pre-qualification, to each supplier or contractor pre-qualified in accordance with article 18 of this Law;

(c) Where pre-selection proceedings have been engaged in, to each pre-selected supplier or contractor in accordance with the procedures and requirements specified in the pre-selection documents;

(d) In the case of direct solicitation under paragraph 2 of article 35 of this Law, to each supplier or contractor selected by the procuring entity;

that pays the price, if any, charged for the request for proposals. The price that the procuring entity may charge for the request for proposals shall reflect only the cost of providing it to suppliers or contractors.

5. The request for proposals shall include, in addition to the information referred to in paragraphs 2 (a) to (f) and (l) of this article, the following information:

(a) Instructions for preparing and presenting proposals;

(b) If suppliers or contractors are permitted to present proposals for only a portion of the subject matter of the procurement, a description of the portion or portions for which proposals may be presented;

(c) The currency or currencies in which the proposal price is to be formulated and expressed, the currency that will be used for the purpose of evaluating proposals and either the exchange rate that will be used for the conversion of proposal prices into that currency or a statement that the rate published by a specified financial institution and prevailing on a specified date will be used;

(d) The manner in which the proposal price is to be formulated and expressed, including a statement as to whether the price is to cover elements other than the cost of the subject matter of the procurement itself, such as reimbursement for transportation, lodging, insurance, use of equipment, duties or taxes;

(e) The means by which, pursuant to article 15 of this Law, suppliers or contractors may seek clarification of the request for proposals and a statement as to whether the procuring entity intends to convene a meeting of suppliers or contractors at this stage;

(f) Any element of the description of the subject matter of the procurement or term or condition of the procurement contract that will not be the subject of dialogue during the procedure;

(g) Where the procuring entity intends to limit the number of suppliers or contractors that it will invite to participate in the dialogue, the minimum number of suppliers or contractors, which shall be not lower than three, if possible, and, where appropriate, the maximum number of suppliers or contractors and the criteria and procedure, in conformity with the provisions of this Law, that will be followed in selecting either number;

(h) The criteria and procedure for evaluating the proposals in accordance with article 11 of this Law;

(i) References to this Law, the procurement regulations and other laws and regulations directly pertinent to the procurement proceedings, including those applicable to procurement involving classified information, and the place where those laws and regulations may be found;

(j) The name, functional title and address of one or more officers or employees of the procuring entity who are authorized to communicate directly with and to receive communications directly from suppliers or contractors in connection with the procurement proceedings without the intervention of an intermediary;

(k) Notice of the right provided under article 64 of this Law to challenge or appeal decisions or actions taken by the procuring entity that are allegedly not in compliance with the provisions of this Law, together with information about the duration of the applicable standstill period and, if none will apply, a statement to that effect and the reasons therefor;

(l) Any formalities that will be required, once the successful offer has been accepted, for a procurement contract to enter into force, including, where applicable, the execution of a written procurement contract and approval by another authority pursuant to article 22 of this Law, and the estimated period of time following dispatch of the notice of acceptance that will be required to obtain the approval;

(m) Any other requirements that may be established by the procuring entity in conformity with this Law and the procurement regulations relating to the preparation and presentation of proposals and to the procurement proceedings.

6. (a) The procuring entity shall examine all proposals received against the established minimum requirements and shall reject each proposal that fails to meet these minimum requirements on the ground that it is non-responsive;

(b) Where a maximum limit on the number of suppliers or contractors that can be invited to participate in the dialogue has been established and the number of responsive proposals exceeds that limit, the procuring entity shall select the maximum number of responsive proposals in accordance with the criteria and procedure specified in the request for proposals;

(c) A notice of rejection and the reasons for the rejection shall be promptly dispatched to each respective supplier or contractor whose proposal was rejected.

7. The procuring entity shall invite each supplier or contractor that presented a responsive proposal, within any applicable maximum, to participate in the dialogue. The procuring entity shall ensure that the number of suppliers or contractors invited to participate in the dialogue, which shall be at least three, if possible, is sufficient to ensure effective competition.

8. The dialogue shall be conducted by the same representatives of the procuring entity on a concurrent basis.

9. During the course of the dialogue, the procuring entity shall not modify the subject matter of the procurement, any qualification or evaluation criterion, any minimum requirements established pursuant to paragraph 2 (f) of this article, any element of the description of the subject matter of the procurement or any term or condition of the procurement contract that is not subject to the dialogue as specified in the request for proposals.

10. Any requirements, guidelines, documents, clarifications or other information generated during the dialogue that is communicated by the procuring entity to a supplier or contractor shall be communicated at the same time and on an equal basis to all other participating suppliers or contractors, unless such information is specific or exclusive to that supplier or contractor or such communication would be in breach of the confidentiality provisions of article 24 of this Law.

11. Following the dialogue, the procuring entity shall request all suppliers or contractors remaining in the proceedings to present a best and final offer with respect to all aspects of their proposals. The request shall be in writing and shall specify the manner, place and deadline for presenting best and final offers.

12. No negotiations shall take place between the procuring entity and suppliers or contractors with respect to their best and final offers.

13. The successful offer shall be the offer that best meets the needs of the procuring entity as determined in accordance with the criteria and procedure for evaluating the proposals set out in the request for proposals.

*Article 50. Request for proposals with consecutive negotiations*

1. The provisions of paragraphs 1 to 7 of article 47 of this Law shall apply mutatis mutandis to procurement conducted by means of request for proposals with consecutive negotiations, except to the extent that those provisions are derogated from in this article.

2. Proposals whose technical, quality and performance characteristics meet or exceed the relevant minimum requirements shall be considered to be responsive. The procuring entity shall rank each responsive proposal in accordance with the criteria and procedure for evaluating proposals as set out in the request for proposals and shall:

(a) Promptly communicate to each supplier or contractor presenting a responsive proposal the score of the technical, quality and performance characteristics of its respective proposal and its ranking;

(b) Invite the supplier or contractor that has attained the best ranking, in accordance with those criteria and procedure, for negotiations on the financial aspects of its proposal; and

(c) Inform other suppliers or contractors that presented responsive proposals that their proposals may be considered for negotiation if negotiations with the supplier (or suppliers) or contractor (or contractors) with a better ranking do not result in a procurement contract.

3. If it becomes apparent to the procuring entity that the negotiations with the supplier or contractor invited pursuant to paragraph 2 (b) of this article will not result in a procurement contract, the procuring entity shall inform that supplier or contractor that it is terminating the negotiations.
4. The procuring entity shall then invite for negotiations the supplier or contractor that attained the second-best ranking; if the negotiations with that supplier or contractor do not result in a procurement contract, the procuring entity shall invite the other suppliers or contractors still participating in the procurement proceedings for negotiations on the basis of their ranking until it arrives at a procurement contract or rejects all remaining proposals.
5. During the course of the negotiations, the procuring entity shall not modify the subject matter of the procurement; any qualification, examination or evaluation criterion, including any established minimum requirements; any element of the description of the subject matter of the procurement; or term or condition of the procurement contract other than financial aspects of proposals that are subject to the negotiations as specified in the request for proposals.
6. The procuring entity may not reopen negotiations with any supplier or contractor with which it has terminated negotiations.

#### *Article 51. Competitive negotiations*

1. Paragraphs 3, 5 and 6 of article 34 of this Law shall apply to the procedure preceding the negotiations.
2. Any requirements, guidelines, documents, clarifications or other information relative to the negotiations that is communicated by the procuring entity to a supplier or contractor before or during the negotiations shall be communicated at the same time and on an equal basis to all other suppliers or contractors engaging in negotiations with the procuring entity relative to the procurement, unless such information is specific or exclusive to that supplier or contractor or such communication would be in breach of the confidentiality provisions of article 24 of this Law.
3. Following completion of negotiations, the procuring entity shall request all suppliers or contractors remaining in the proceedings to present, by a specified date, a best and final offer with respect to all aspects of their proposals.
4. No negotiations shall take place between the procuring entity and suppliers or contractors with respect to their best and final offers.

5. The successful offer shall be the offer that best meets the needs of the procuring entity.

### *Article 52. Single-source procurement*

Paragraphs 4 to 6 of article 34 of this Law shall apply to the procedure preceding the solicitation of a proposal or price quotation from a single supplier or contractor. The procuring entity shall engage in negotiations with the supplier or contractor from which a proposal or price quotation is solicited unless such negotiations are not feasible in the circumstances of the procurement concerned.

## CHAPTER VI. ELECTRONIC REVERSE AUCTIONS

### *Article 53. Electronic reverse auction as a stand-alone method of procurement*

1. The procuring entity shall solicit bids by causing an invitation to the electronic reverse auction to be published in accordance with article 33 of this Law. The invitation shall include:

- (a) The name and address of the procuring entity;
- (b) A detailed description of the subject matter of the procurement, in conformity with article 10 of this Law, and the desired or required time and location for the provision of such subject matter;
- (c) The terms and conditions of the procurement contract, to the extent they are already known to the procuring entity, and the form of the contract, if any, to be signed by the parties;
- (d) A declaration pursuant to article 8 of this Law;
- (e) The criteria and procedures to be used for ascertaining the qualifications of suppliers or contractors and any documentary evidence or other information that must be presented by suppliers or contractors to demonstrate their qualifications in conformity with article 9 of this Law;
- (f) The criteria and procedure for examining bids against the description of the subject matter of the procurement;
- (g) The criteria and procedure for evaluating bids in accordance with article 11 of this Law, including any mathematical formula that will be used in the evaluation procedure during the auction;

(h) The manner in which the bid price is to be formulated and expressed, including a statement as to whether the price is to cover elements other than the cost of the subject matter of the procurement itself, such as any applicable transportation and insurance charges, customs duties and taxes;

(i) The currency or currencies in which the bid price is to be formulated and expressed;

(j) The minimum number of suppliers or contractors required to register for the auction in order for the auction to be held, which shall be sufficient to ensure effective competition;

[(k) If any limit on the number of suppliers or contractors that can be registered for the auction is imposed in accordance with paragraph 2 of this article, the relevant maximum number and the criteria and procedure, in conformity with paragraph 2 of this article, that will be followed in selecting it;]

(l) How the auction can be accessed, including appropriate information regarding connection to the auction;

(m) The deadline by which suppliers or contractors must register for the auction and the requirements for registration;

(n) The date and time of the opening of the auction and the requirements for identification of bidders at the opening of the auction;

(o) The criteria governing the closing of the auction;

(p) Other rules for the conduct of the auction, including the information that will be made available to the bidders in the course of the auction, the language in which it will be made available and the conditions under which the bidders will be able to bid;

(q) References to this Law, the procurement regulations and other laws and regulations directly pertinent to the procurement proceedings, including those applicable to procurement involving classified information, and the place where those laws and regulations may be found;

(r) The means by which suppliers or contractors may seek clarification of information relating to the procurement proceedings;

(s) The name, functional title and address of one or more officers or employees of the procuring entity who are authorized to communicate directly with and to receive communications directly from suppliers or contractors in connection with the procurement proceedings before and after the auction without the intervention of an intermediary;

(t) Notice of the right provided under article 64 of this Law to challenge or appeal decisions or actions taken by the procuring entity that are allegedly not in compliance with the provisions of this Law, together with information about the duration of the applicable standstill period and, if none will apply, a statement to that effect and the reasons therefor;



(u) Any formalities that will be required after the auction for a procurement contract to enter into force, including, where applicable, ascertainment of qualifications or responsiveness in accordance with article 57 of this Law and the execution of a written procurement contract pursuant to article 22 of this Law;

(v) Any other requirements established by the procuring entity in conformity with this Law and the procurement regulations relating to the procurement proceedings.

[2. The procuring entity may impose a maximum limit on the number of suppliers or contractors that can be registered for the electronic reverse auction only to the extent that capacity constraints in its communications system so require, and shall select the suppliers or contractors to be so registered in a non-discriminatory manner. The procuring entity shall include a statement of the reasons and circumstances upon which it relied to justify the imposition of such a maximum limit in the record required under article 25 of this Law.]

3. The procuring entity may decide, in the light of the circumstances of the given procurement, that the electronic reverse auction shall be preceded by an examination or evaluation of initial bids. In such case, the invitation to the auction shall, in addition to information listed in paragraph 1 of this article, include:

(a) An invitation to present initial bids, together with instructions for preparing initial bids;

(b) The manner, place and deadline for presenting initial bids.

4. Where the electronic reverse auction has been preceded by an examination or evaluation of initial bids, the procuring entity shall promptly after the completion of the examination or evaluation of initial bids:

(a) Dispatch the notice of rejection and reasons for rejection to each supplier or contractor whose initial bid was rejected;

(b) Issue an invitation to the auction to each qualified supplier or contractor whose initial bid is responsive, providing all information required to participate in the auction;

(c) Where an evaluation of initial bids has taken place, each invitation to the auction shall also be accompanied by the outcome of the evaluation, as relevant to the supplier or contractor to which the invitation is addressed.

*Article 54. Electronic reverse auction as a phase preceding the award of the procurement contract*

1. Where an electronic reverse auction is to be used as a phase preceding the award of the procurement contract in a procurement method, as appropriate,

or in a framework agreement procedure with second-stage competition, the procuring entity shall notify suppliers or contractors when first soliciting their participation in the procurement proceedings that an auction will be held, and shall provide, in addition to other information required to be included under provisions of this Law, the following information about the auction:

(a) The mathematical formula that will be used in the evaluation procedure during the auction;

(b) How the auction can be accessed, including appropriate information regarding connection to the auction.

2. Before the electronic reverse auction is held, the procuring entity shall issue an invitation to the auction to all suppliers or contractors remaining in the proceedings, specifying:

(a) The deadline by which the suppliers or contractors must register for the auction and requirements for registration;

(b) The date and time of the opening of the auction and requirements for the identification of bidders at the opening of the auction;

(c) Criteria governing the closing of the auction;

(d) Other rules for the conduct of the auction, including the information that will be made available to the bidders during the auction and the conditions under which the bidders will be able to bid.

3. Where an evaluation of initial bids has taken place, each invitation to the auction shall also be accompanied by the outcome of the evaluation as relevant to the supplier or contractor to which the invitation is addressed.

*Article 55. Registration for the electronic reverse auction and the timing of the holding of the auction*

1. Confirmation of registration for the electronic reverse auction shall be communicated promptly to each registered supplier or contractor.

2. If the number of suppliers or contractors registered for the electronic reverse auction is insufficient to ensure effective competition, the procuring entity may cancel the auction. The cancellation of the auction shall be communicated promptly to each registered supplier or contractor.

3. The period of time between the issuance of the invitation to the electronic reverse auction and the auction shall be sufficiently long to allow suppliers or contractors to prepare for the auction, taking into account the reasonable needs of the procuring entity.

*Article 56. Requirements during the electronic reverse auction*

1. The electronic reverse auction shall be based on:

(a) Price, where the procurement contract is to be awarded to the lowest-priced bid; or

(b) Price and other criteria specified to suppliers or contractors under articles 53 and 54 of this Law, as applicable, where the procurement contract is to be awarded to the most advantageous bid.

2. During the auction:

(a) All bidders shall have an equal and continuous opportunity to present their bids;

(b) There shall be automatic evaluation of all bids in accordance with the criteria, procedure and formula provided to suppliers or contractors under articles 53 and 54 of this Law, as applicable;

(c) Each bidder must receive, instantaneously and on a continuous basis during the auction, sufficient information allowing it to determine the standing of its bid vis-à-vis other bids;

(d) There shall be no communication between the procuring entity and the bidders or among the bidders, other than as provided for in subparagraphs (a) and (c) of this paragraph.

3. The procuring entity shall not disclose the identity of any bidder during the auction.

4. The auction shall be closed in accordance with the criteria specified to suppliers or contractors under articles 53 and 54 of this Law, as applicable.

5. The procuring entity shall suspend or terminate the auction in the case of failures in its communication system that put at risk the proper conduct of the auction or for other reasons stipulated in the rules for the conduct of the auction. The procuring entity shall not disclose the identity of any bidder in the case of suspension or termination of the auction.

*Article 57. Requirements after the electronic reverse auction*

1. The bid that at the closure of the electronic reverse auction is the lowest-priced bid or the most advantageous bid, as applicable, shall be the successful bid.

2. In procurement by means of an auction that was not preceded by examination or evaluation of initial bids, the procuring entity shall ascertain after the auction the responsiveness of the successful bid and the qualifications of the supplier or contractor submitting it. The procuring entity shall reject that bid if it is found to be unresponsive or if the supplier or contractor submitting it is found unqualified. Without prejudice to the right of the procuring entity to cancel the procurement in accordance with paragraph 1 of article 19 of this Law, the procuring entity shall select the bid that was the next lowest-priced or next most advantageous bid at the closure of the auction, provided that that bid is ascertained to be responsive and the supplier or contractor submitting it is ascertained to be qualified.

3. Where the successful bid at the closure of the auction appears to the procuring entity to be abnormally low and gives rise to concerns on the part of the procuring entity as to the ability of the bidder that presented it to perform the procurement contract, the procuring entity may follow the procedures described in article 20 of this Law. If the procuring entity rejects the bid as abnormally low under article 20, it shall select the bid that at the closure of the auction was the next lowest-priced or next most advantageous bid. This provision is without prejudice to the right of the procuring entity to cancel the procurement in accordance with paragraph 1 of article 19 of this Law.

## CHAPTER VII. FRAMEWORK AGREEMENT PROCEDURES

### *Article 58. Award of a closed framework agreement*

1. The procuring entity shall award a closed framework agreement:

(a) By means of open-tendering proceedings, in accordance with provisions of chapter III of this Law, except to the extent that those provisions are derogated from in this chapter; or

(b) By means of other procurement methods, in accordance with the relevant provisions of chapters II, IV and V of this Law, except to the extent that those provisions are derogated from in this chapter.

2. The provisions of this Law regulating pre-qualification and the contents of the solicitation in the context of the procurement methods referred to in paragraph 1 of this article shall apply *mutatis mutandis* to the information to be

provided to suppliers or contractors when first soliciting their participation in a closed framework agreement procedure. The procuring entity shall in addition specify at that stage:

(a) That the procurement will be conducted as a framework agreement procedure, leading to a closed framework agreement;

(b) Whether the framework agreement is to be concluded with one or more than one supplier or contractor;

(c) If the framework agreement will be concluded with more than one supplier or contractor, any minimum or maximum limit on the number of suppliers or contractors that will be parties thereto;

(d) The form, terms and conditions of the framework agreement in accordance with article 59 of this Law.

3. The provisions of article 22 of this Law shall apply *mutatis mutandis* to the award of a closed framework agreement.

#### *Article 59. Requirements for closed framework agreements*

1. A closed framework agreement shall be concluded in writing and shall set out:

(a) The duration of the framework agreement, which shall not exceed the maximum duration established by the procurement regulations;

(b) The description of the subject matter of the procurement and all other terms and conditions of the procurement established when the framework agreement is concluded;

(c) To the extent that they are known, estimates of the terms and conditions of the procurement that cannot be established with sufficient precision when the framework agreement is concluded;

(d) Whether, in a closed framework agreement concluded with more than one supplier or contractor, there will be a second-stage competition to award a procurement contract under the framework agreement and, if so:

(i) A statement of the terms and conditions of the procurement that are to be established or refined through second-stage competition;

(ii) The procedures for and the anticipated frequency of any second-stage competition, and envisaged deadlines for presenting second-stage submissions;

(iii) The procedures and criteria to be applied during the second-stage competition, including the relative weight of such criteria and the manner in which they will be applied, in accordance with articles 10

and 11 of this Law. If the relative weights of the evaluation criteria may be varied during the second-stage competition, the framework agreement shall specify the permissible range;

(e) Whether the award of a procurement contract under the framework agreement will be to the lowest-priced or to the most advantageous submission; and

(f) The manner in which the procurement contract will be awarded.

2. A closed framework agreement with more than one supplier or contractor shall be concluded as one agreement between all parties unless:

(a) The procuring entity determines that it is in the interests of a party to the framework agreement that a separate agreement with any supplier or contractor party be concluded;

(b) The procuring entity includes in the record required under article 25 of this Law a statement of the reasons and circumstances on which it relied to justify the conclusion of separate agreements; and

(c) Any variation in the terms and conditions of the separate agreements for a given procurement is minor and concerns only those provisions that justify the conclusion of separate agreements.

3. The framework agreement shall contain, in addition to information specified elsewhere in this article, all information necessary to allow the effective operation of the framework agreement, including information on how the agreement and notifications of forthcoming procurement contracts thereunder can be accessed and appropriate information regarding connection, where applicable.

#### *Article 60. Establishment of an open framework agreement*

1. The procuring entity shall establish and maintain an open framework agreement online.

2. The procuring entity shall solicit participation in the open framework agreement by causing an invitation to become a party to the open framework agreement to be published following the requirements of article 33 of this Law.

3. The invitation to become a party to the open framework agreement shall include the following information:

(a) The name and address of the procuring entity establishing and maintaining the open framework agreement and the name and address of any other

procuring entities that will have the right to award procurement contracts under the framework agreement;

(b) That the procurement will be conducted as a framework agreement procedure leading to an open framework agreement;

(c) The language (or languages) of the open framework agreement and all information about the operation of the agreement, including how the agreement and notifications of forthcoming procurement contracts thereunder can be accessed and appropriate information regarding connection;

(d) The terms and conditions for suppliers or contractors to be admitted to the open framework agreement, including:

(i) A declaration pursuant to article 8 of this Law;

[(ii) If any maximum limit on the number of suppliers or contractors that are parties to the open framework agreement is imposed in accordance with paragraph 7 of this article, the relevant number and the criteria and procedure, in conformity with paragraph 7 of this article, that will be followed in selecting it;]

(iii) Instructions for preparing and presenting the indicative submissions necessary to become a party to the open framework agreement, including the currency or currencies and the language (or languages) to be used, as well as the criteria and procedures to be used for ascertaining the qualifications of suppliers or contractors and any documentary evidence or other information that must be presented by suppliers or contractors to demonstrate their qualifications in conformity with article 9 of this Law;

(iv) An explicit statement that suppliers or contractors may apply to become parties to the framework agreement at any time during the period of its operation by presenting indicative submissions, subject to any maximum limit on the number of suppliers or contractors and any declaration made pursuant to article 8 of this Law;

(e) Other terms and conditions of the open framework agreement, including all information required to be set out in the open framework agreement in accordance with article 61 of this Law;

(f) References to this Law, the procurement regulations and other laws and regulations directly pertinent to the procurement proceedings, including those applicable to procurement involving classified information, and the place where those laws and regulations may be found;

(g) The name, functional title and address of one or more officers or employees of the procuring entity who are authorized to communicate directly with and to receive communications directly from suppliers or contractors in connection with the procurement proceedings without the intervention of an intermediary.

4. Suppliers or contractors may apply to become a party or parties to the framework agreement at any time during its operation by presenting indicative submissions to the procuring entity in compliance with the requirements of the invitation to become a party to the open framework agreement.
5. The procuring entity shall examine all indicative submissions received during the period of operation of the framework agreement within a maximum of ... working days [*the enacting State specifies the maximum period of time*], in accordance with the procedures set out in the invitation to become a party to the open framework agreement.
6. The framework agreement shall be concluded with all qualified suppliers or contractors that presented submissions unless their submissions have been rejected on the grounds specified in the invitation to become a party to the open framework agreement.
- [7. The procuring entity may impose a maximum limit on the number of parties to the open framework agreement only to the extent that capacity limitations in its communications system so require, and shall select the suppliers or contractors to be parties to the open framework agreement in a non-discriminatory manner. The procuring entity shall include in the record required under article 25 of this Law a statement of the reasons and circumstances upon which it relied to justify the imposition of such a maximum limit.]
8. The procuring entity shall promptly notify the suppliers or contractors whether they have become parties to the framework agreement and of the reasons for the rejection of their indicative submissions if they have not.

#### *Article 61. Requirements for open framework agreements*

1. An open framework agreement shall provide for second-stage competition for the award of a procurement contract under the agreement and shall include:
  - (a) The duration of the framework agreement;
  - (b) The description of the subject matter of the procurement and all other terms and conditions of the procurement known when the open framework agreement is established;
  - (c) Any terms and conditions of the procurement that may be refined through second-stage competition;
  - (d) The procedures and the anticipated frequency of second-stage competition;



(e) Whether the award of procurement contracts under the framework agreement will be to the lowest-priced or the most advantageous submission;

(f) The procedures and criteria to be applied during the second-stage competition, including the relative weight of the evaluation criteria and the manner in which they will be applied, in accordance with articles 10 and 11 of this Law. If the relative weights of the evaluation criteria may be varied during second-stage competition, the framework agreement shall specify the permissible range.

2. The procuring entity shall, during the entire period of operation of the open framework agreement, republish at least annually the invitation to become a party to the open framework agreement and shall in addition ensure unrestricted, direct and full access to the terms and conditions of the framework agreement and to any other necessary information relevant to its operation.

#### *Article 62. Second stage of a framework agreement procedure*

1. Any procurement contract under a framework agreement shall be awarded in accordance with the terms and conditions of the framework agreement and the provisions of this article.

2. A procurement contract under a framework agreement may be awarded only to a supplier or contractor that is a party to the framework agreement.

3. The provisions of article 22 of this Law, except for paragraph 2, shall apply to the acceptance of the successful submission under a framework agreement without second-stage competition.

4. In a closed framework agreement with second-stage competition and in an open framework agreement, the following procedures shall apply to the award of a procurement contract:

(a) The procuring entity shall issue a written invitation to present submissions, simultaneously to:

- (i) Each supplier or contractor party to the framework agreement; or
- (ii) Only to those suppliers or contractors parties to the framework agreement then capable of meeting the needs of that procuring entity in the subject matter of the procurement, provided that at the same time notice of the second-stage competition is given to all parties to the framework agreement so that they have the opportunity to participate in the second-stage competition;

(b) The invitation to present submissions shall include the following information:

- (i) A restatement of the existing terms and conditions of the framework agreement to be included in the anticipated procurement contract, a statement of the terms and conditions of the procurement that are to be subject to second-stage competition and further detail regarding those terms and conditions, where necessary;
- (ii) A restatement of the procedures and criteria for the award of the anticipated procurement contract, including their relative weight and the manner of their application;
- (iii) Instructions for preparing submissions;
- (iv) The manner, place and deadline for presenting submissions;
- (v) If suppliers or contractors are permitted to present submissions for only a portion of the subject matter of the procurement, a description of the portion or portions for which submissions may be presented;
- (vi) The manner in which the submission price is to be formulated and expressed, including a statement as to whether the price is to cover elements other than the cost of the subject matter of the procurement itself, such as any applicable transportation and insurance charges, customs duties and taxes;
- (vii) Reference to this Law, the procurement regulations and other laws and regulations directly pertinent to the procurement proceedings, including those applicable to procurement involving classified information, and the place where those laws and regulations may be found;
- (viii) The name, functional title and address of one or more officers or employees of the procuring entity who are authorized to communicate directly with and to receive communications directly from suppliers or contractors in connection with the second-stage competition without the intervention of an intermediary;
- (ix) Notice of the right provided under article 64 of this Law to challenge or appeal decisions or actions taken by the procuring entity that are allegedly not in compliance with the provisions of this Law, together with information about the duration of the applicable standstill period and, if none will apply, a statement to that effect and the reasons therefor;
- (x) Any formalities that will be required once a successful submission has been accepted for a procurement contract to enter into force, including, where applicable, the execution of a written procurement contract pursuant to article 22 of this Law;
- (xi) Any other requirements established by the procuring entity in conformity with this Law and the procurement regulations relating to the preparation and presentation of submissions and to other aspects of the second-stage competition;

(c) The procuring entity shall evaluate all submissions received and determine the successful submission in accordance with the evaluation criteria and the procedures set out in the invitation to present submissions;

(d) The procuring entity shall accept the successful submission in accordance with article 22 of this Law.

*Article 63. Changes during the operation of a framework agreement*

During the operation of a framework agreement, no change shall be allowed to the description of the subject matter of the procurement. Changes to other terms and conditions of the procurement, including to the criteria (and their relative weight and the manner of their application) and procedures for the award of the anticipated procurement contract, may occur only to the extent expressly permitted in the framework agreement.

## CHAPTER VIII. CHALLENGE PROCEEDINGS<sup>6</sup>

*Article 64. Right to challenge and appeal*

1. A supplier or contractor that claims to have suffered or claims that it may suffer loss or injury because of the alleged non-compliance of a decision or action of the procuring entity with the provisions of this Law may challenge the decision or action concerned.

2. Challenge proceedings may be made by way of [an application for reconsideration to the procuring entity under article 66 of this Law, an application for review to the [*name of the independent body*] under article 67 of this Law or an application or appeal to the [*name of the court or courts*]].

[3. A supplier or contractor may appeal any decision taken in challenge proceedings under article 66 or 67 of this Law in the [*name of the court or courts*]].

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<sup>6</sup>Certain options are presented in this Chapter in square brackets. See the *Guide to Enactment of the UNCITRAL Model Law on Public Procurement* for guidance on those options.

### Article 65. *Effect of a challenge*

1. The procuring entity shall not take any step that would bring into force a procurement contract or framework agreement in the procurement proceedings concerned:

(a) Where it receives an application for reconsideration within the time limits specified in paragraph 2 of article 66;

(b) Where it receives notice of an application for review from the [name of the independent body] under paragraph 5 (b) of article 67; or

(c) Where it receives notice of an application or of an appeal from the [name of the court or courts].

2. The prohibition referred to in paragraph 1 shall lapse ... working days [the enacting State specifies the period] after the decision of the procuring entity, the [name of the independent body] or the [name of the court or courts] has been communicated to the applicant or appellant, as the case may be, to the procuring entity, where applicable, and to all other participants in the challenge proceedings.

3. (a) The procuring entity may at any time request the [name of the independent body] or the [name of the court or courts] to authorize it to enter into the procurement contract or framework agreement on the ground that urgent public interest considerations so justify;

(b) The [name of the independent body], upon consideration of such a request [, or of its own motion,] may authorize the procuring entity to enter into the procurement contract or framework agreement where it is satisfied that urgent public interest considerations so justify. The decision of the [name of the independent body] and the reasons therefor shall be made part of the record of the procurement proceedings, and shall promptly be communicated to the procuring entity, to the applicant, to all other participants in the challenge proceedings and to all other participants in the procurement proceedings.

### Article 66. *Application for reconsideration before the procuring entity*

1. A supplier or contractor may apply to the procuring entity for a reconsideration of a decision or an action taken by the procuring entity in the procurement proceedings.

2. Applications for reconsideration shall be submitted to the procuring entity in writing within the following time periods:

(a) Applications for reconsideration of the terms of solicitation, pre-qualification or pre-selection or decisions or actions taken by the procuring entity in pre-qualification or pre-selection proceedings shall be submitted prior to the deadline for presenting submissions;

(b) Applications for reconsideration of other decisions or actions taken by the procuring entity in the procurement proceedings shall be submitted within the standstill period applied pursuant to paragraph 2 of article 22 of this Law, or, where none has been applied, prior to the entry into force of the procurement contract or the framework agreement.

3. Promptly after receipt of the application, the procuring entity shall publish a notice of the application and shall, not later than three (3) working days after receipt of the application:

(a) Decide whether the application shall be entertained or dismissed and, if it is to be entertained, whether the procurement proceedings shall be suspended. The procuring entity may dismiss the application if it decides that the application is manifestly without merit, the application was not submitted within the deadlines set out in paragraph 2 of this article or the applicant is without standing. Such a dismissal constitutes a decision on the application;

(b) Notify all participants in the procurement proceedings to which the application relates about the submission of the application and its substance;

(c) Notify the applicant and all other participants in the procurement proceedings of its decision on whether the application is to be entertained or dismissed;

(i) If the application is to be entertained, the procuring entity shall in addition advise whether the procurement proceedings are suspended and, if so, the duration of the suspension;

(ii) If the application is to be dismissed or the procurement proceedings are not suspended, the procuring entity shall in addition advise the applicant of the reasons for its decision.

4. If the procuring entity does not give notice to the applicant as required in paragraphs 3 (c) and 8 of this article within the time-limit specified in paragraph 3 of this article, or if the applicant is dissatisfied with the decision so notified, the applicant may immediately thereafter commence proceedings [in the *[name of the independent body]* under article 67 of this Law or in the *[name of the court or courts]*]. Where such proceedings are commenced, the competence of the procuring entity to entertain the application ceases.

5. In taking its decision on an application that it has entertained, the procuring entity may overturn, correct, vary or uphold any decision or action taken in the procurement proceedings to which the application relates.

6. The decision of the procuring entity under paragraph 5 of this article shall be issued within ... working days [*the enacting State specifies the period*] after receipt of the application. The procuring entity shall immediately thereafter communicate the decision to the applicant, to all other participants in the challenge proceedings and to all other participants in the procurement proceedings.

7. If the procuring entity does not communicate its decision to the applicant in accordance with the requirements of paragraphs 6 and 8 of this article, the applicant is entitled immediately thereafter to commence proceedings [in the [*name of the independent body*] under article 67 of this Law or in the [*name of the court or courts*]]. Where such proceedings are commenced, the competence of the procuring entity to entertain the application ceases.

8. All decisions of the procuring entity under this article shall be in writing, shall state the action taken and the reasons therefor, and shall promptly be made part of the record of the procurement proceedings, together with the application received by the procuring entity under this article.

#### *Article 67. Application for review before an independent body*

1. A supplier or contractor may apply to the [*name of the independent body*] for review of a decision or an action taken by the procuring entity in the procurement proceedings, or of the failure of the procuring entity to issue a decision under article 66 of this Law within the time limits prescribed in that article.

2. Applications for review shall be submitted to the [*name of the independent body*] in writing within the following time periods:

(a) Applications for review of the terms of solicitation, pre-qualification or pre-selection or of decisions or actions taken by the procuring entity in pre-qualification or pre-selection proceedings shall be submitted prior to the deadline for presenting submissions;

(b) Applications for review of other decisions or actions taken by the procuring entity in the procurement proceedings shall be submitted:

(i) Within the standstill period applied pursuant to paragraph 2 of article 22 of this Law; or

(ii) Where no standstill period has been applied, within ... working days [*the enacting State specifies the period*] after the time when the applicant became aware of the circumstances giving rise to the application or when the applicant should have become aware of those circumstances, whichever is earlier, but not later than ...

working days [*the enacting State specifies the period*] after the entry into force of the procurement contract or the framework agreement [or a decision to cancel the procurement];

(c) Notwithstanding subparagraph (b) (i) of this paragraph, a supplier or contractor may request the [*name of the independent body*] to entertain an application for review filed after the expiry of the standstill period, but not later than ... working days [*the enacting State specifies the period*] after the entry into force of the procurement contract or the framework agreement [or a decision to cancel the procurement], on the ground that the application raises significant public interest considerations. The [*name of the independent body*] may entertain the application where it is satisfied that significant public interest considerations so justify. The decision of the [*name of the independent body*] and the reasons therefor shall promptly be communicated to the supplier or contractor concerned;

(d) Applications for review of the failure of the procuring entity to issue a decision under article 66 of this Law within the time limits prescribed in that article shall be submitted within ... working days [*the enacting State specifies the period*] after the decision of the procuring entity should have been communicated to the applicant in accordance with the requirements of paragraphs 3, 6 and 8 of article 66 of this Law, as appropriate.

3. Following receipt of an application for review, the [*name of the independent body*] may, subject to the requirements of paragraph 4 of this article:

[(a)] Order the suspension of the procurement proceedings at any time before the entry into force of the procurement contract; [and

(b) Order the suspension of the performance of a procurement contract or the operation of a framework agreement that has entered into force;]

if and for as long as it finds such a suspension necessary to protect the interests of the applicant unless the [*name of the independent body*] decides that urgent public interest considerations require the procurement proceedings[, the procurement contract or the framework agreement, as applicable,] to proceed. The [*name of the independent body*] may also order that any suspension applied be extended or lifted, taking into account the aforementioned considerations.

4. The [*name of the independent body*] shall:

(a) Order the suspension of the procurement proceedings for a period of ten (10) working days where an application is received prior to the deadline for presenting submissions; and

(b) Order the suspension of the procurement proceedings [or the performance of a procurement contract or the operation of a framework agreement,

as the case may be] where an application is received after the deadline for presenting submissions and where no standstill period has been applied; unless the [*name of the independent body*] decides that urgent public interest considerations require the procurement proceedings[, the procurement contract or the framework agreement, as applicable,] to proceed.

5. Promptly upon receipt of the application, the [*name of the independent body*] shall:

(a) Suspend or decide not to suspend the procurement proceedings [or the performance of a procurement contract or the operation of a framework agreement, as the case may be] in accordance with paragraphs 3 and 4 of this article;

(b) Notify the procuring entity and all identified participants in the procurement proceedings to which the application relates of the application and its substance;

(c) Notify all identified participants in the procurement proceedings to which the application relates of its decision on suspension. Where the [*name of the independent body*] decides to suspend the procurement proceedings [or the performance of a procurement contract or the operation of a framework agreement, as the case may be], it shall in addition specify the period of the suspension. Where it decides not to suspend them, it shall provide the reasons for its decision to the applicant and to the procuring entity; and

(d) Publish a notice of the application.

6. The [*name of the independent body*] may dismiss the application and shall lift any suspension applied, where it decides that:

(a) The application is manifestly without merit or was not presented in compliance with the deadlines set out in paragraph 2 of this article; or

(b) The applicant is without standing.

The [*name of the independent body*] shall promptly notify the applicant, the procuring entity and all other participants in the procurement proceedings of the dismissal and the reasons therefor and that any suspension in force is lifted. Such a dismissal constitutes a decision on the application.

7. The notices to the applicant, the procuring entity and other participants in the procurement proceedings under paragraphs 5 and 6 of this article shall be given no later than three (3) working days after receipt of the application.

8. Promptly upon receipt of a notice under paragraph 5 (b) of this article, the procuring entity shall provide the [*name of the independent body*] with



effective access to all documents relating to the procurement proceedings in its possession, in a manner appropriate to the circumstances.

9. In taking its decision on an application that it has entertained, the [*name of the independent body*] may declare the legal rules or principles that govern the subject matter of the application, shall address any suspension in force and shall take one or more of the following actions, as appropriate:

(a) Prohibit the procuring entity from acting, taking a decision or following a procedure that is not in compliance with the provisions of this Law;

(b) Require the procuring entity that has acted or proceeded in a manner that is not in compliance with the provisions of this Law to act, to take a decision or to proceed in a manner that is in compliance with the provisions of this Law;

[(c) Overturn in whole or in part an act or a decision of the procuring entity that is not in compliance with the provisions of this Law [other than any act or decision bringing the procurement contract or the framework agreement into force];

(d) Revise a decision by the procuring entity that is not in compliance with the provisions of this Law [other than any act or decision bringing the procurement contract or the framework agreement into force];

(e) Confirm a decision of the procuring entity;

(f) Overturn the award of a procurement contract or a framework agreement that has entered into force in a manner that is not in compliance with the provisions of this Law and, if notice of the award of the procurement contract or the framework agreement has been published, order the publication of notice of the overturning of the award;]

(g) Order that the procurement proceedings be terminated;

(h) Dismiss the application;

(i) Require the payment of compensation for any reasonable costs incurred by the supplier or contractor submitting an application as a result of an act or decision of, or procedure followed by, the procuring entity in the procurement proceedings that is not in compliance with the provisions of this Law, and for any loss or damages suffered[, which shall be limited to the costs of the preparation of the submission or the costs relating to the application, or both]; or

(j) Take such alternative action as is appropriate in the circumstances.

10. The decision of the [*name of the independent body*] under paragraph 9 of this article shall be issued within ... working days [*the enacting State specifies the period*] after receipt of the application. The [*name of the independent body*]

shall immediately thereafter communicate the decision to the procuring entity, to the applicant, to all other participants in the application for review and to all other participants in the procurement proceedings.

11. All decisions of the [*name of the independent body*] under this article shall be in writing, shall state the action taken and the reasons therefor and shall promptly be made part of the record of the procurement proceedings, together with the application received by the [*name of the independent body*] under this article.

#### *Article 68. Rights of participants in challenge proceedings*

1. Any supplier or contractor participating in the procurement proceedings to which the application relates, as well as any governmental authority whose interests are or could be affected by the application, shall have the right to participate in challenge proceedings under articles 66 and 67 of this Law. A supplier or contractor duly notified of the proceedings that fails to participate in such proceedings is barred from subsequently challenging under articles 66 and 67 of this Law the decisions or actions that are the subject matter of the application.

2. The procuring entity shall have the right to participate in challenge proceedings under article 67 of this Law.

3. The participants in challenge proceedings under articles 66 and 67 of this Law shall have the right to be present, represented and accompanied at all hearings during the proceedings; the right to be heard; the right to present evidence, including witnesses; the right to request that any hearing take place in public; and the right to seek access to the record of the challenge proceedings subject to the provisions of article 69 of this Law.

#### *Article 69. Confidentiality in challenge proceedings*

No information shall be disclosed in challenge proceedings and no public hearing under articles 66 and 67 of this Law shall take place if so doing would impair the protection of essential security interests of the State, would be contrary to law, would impede law enforcement, would prejudice the legitimate commercial interests of the suppliers or contractors or would impede fair competition.





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**LEGAL AUTHORITY CA-87**

# Revised Agreement on Government Procurement and WTO related legal instruments

*Text of the GPA as amended on 30 March 2012*

**Cover photo:** South building of the Centre William Rappard, WTO headquarters. Dhinaut 2014©OMC. This new WTO building (inaugurated in 2013) is an example of green and sustainable building. It is MINERGIE P certified, a high level designation for buildings in Switzerland. The image reflects the fact that the revised GPA contains a new provision (Art.X:6) providing greater certainty over the possibility of using "technical specifications to promote the conservation of natural resources or protect the environment". The image also reflects the fact that the Committee on Government Procurement launched a specific work programme on sustainable procurement in 2014.



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# REVISED AGREEMENT ON GOVERNMENT PROCUREMENT

## Preamble

The Parties to this Agreement (hereinafter referred to as "the Parties"),

*Recognizing* the need for an effective multilateral framework for government procurement, with a view to achieving greater liberalization and expansion of, and improving the framework for, the conduct of international trade;

*Recognizing* that measures regarding government procurement should not be prepared, adopted or applied so as to afford protection to domestic suppliers, goods or services, or to discriminate among foreign suppliers, goods or services;

*Recognizing* that the integrity and predictability of government procurement systems are integral to the efficient and effective management of public resources, the performance of the Parties' economies and the functioning of the multilateral trading system;

*Recognizing* that the procedural commitments under this Agreement should be sufficiently flexible to accommodate the specific circumstances of each Party;

*Recognizing* the need to take into account the development, financial and trade needs of developing countries, in particular the least developed countries;

*Recognizing* the importance of transparent measures regarding government procurement, of carrying out procurements in a transparent and impartial manner and of avoiding conflicts of interest and corrupt practices, in accordance with applicable international instruments, such as the United Nations Convention Against Corruption;

*Recognizing* the importance of using, and encouraging the use of, electronic means for procurement covered by this Agreement;

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*Desiring* to encourage acceptance of and accession to this Agreement by WTO Members not party to it;

Hereby *agree* as follows:

## Article I

### Definitions

For purposes of this Agreement:

- a) **commercial goods or services** means goods or services of a type generally sold or offered for sale in the commercial marketplace to, and customarily purchased by, non-governmental buyers for non-governmental purposes;
- b) **Committee** means the Committee on Government Procurement established by Article XXI:1;
- c) **construction service** means a service that has as its objective the realization by whatever means of civil or building works, based on Division 51 of the United Nations Provisional Central Product Classification (CPC);
- d) **country** includes any separate customs territory that is a Party to this Agreement. In the case of a separate customs territory that is a Party to this Agreement, where an expression in this Agreement is qualified by the term "national", such expression shall be read as pertaining to that customs territory, unless otherwise specified;
- e) **days** means calendar days;
- f) **electronic auction** means an iterative process that involves the use of electronic means for the presentation by suppliers of either new prices, or new values for quantifiable non-price elements of the tender related to the evaluation criteria, or both, resulting in a ranking or re-ranking of tenders;

- g) **in writing** or **written** means any worded or numbered expression that can be read, reproduced and later communicated. It may include electronically transmitted and stored information;
- h) **limited tendering** means a procurement method whereby the procuring entity contacts a supplier or suppliers of its choice;
- i) **measure** means any law, regulation, procedure, administrative guidance or practice, or any action of a procuring entity relating to a covered procurement;
- j) **multi-use list** means a list of suppliers that a procuring entity has determined satisfy the conditions for participation in that list, and that the procuring entity intends to use more than once;
- k) **notice of intended procurement** means a notice **published** by a procuring entity inviting interested suppliers to submit a request for participation, a tender, or both;
- l) **offset** means any condition or undertaking that encourages local development or improves a Party's balance-of-payments accounts, such as the use of domestic content, the licensing of technology, investment, counter-trade and similar action or requirement;
- m) **open tendering** means a procurement method whereby all interested suppliers may submit a tender;
- n) **person** means a natural person or a juridical person;
- o) **procuring entity** means an entity covered under a Party's Annex 1, 2 or 3 to Appendix I;
- p) **qualified supplier** means a supplier that a procuring entity recognizes as having satisfied the conditions for participation;
- q) **selective tendering** means a procurement method whereby only qualified suppliers are invited by the procuring entity to submit a tender;

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- r) **services** includes construction services, unless otherwise specified;
  - s) **standard** means a document approved by a recognized body that provides for common and repeated use, rules, guidelines or characteristics for goods or services, or related processes and production methods, with which compliance is not mandatory. It may also include or deal exclusively with terminology, symbols, packaging, marking or labelling requirements as they apply to a good, service, process or production method;
  - t) **supplier** means a person or group of persons that provides or could provide goods or services; and
  - u) **technical specification** means a tendering requirement that:
    - i. lays down the characteristics of goods or services to be procured, including quality, performance, safety and dimensions, or the processes and methods for their production or provision; or
    - ii. addresses terminology, symbols, packaging, marking or labelling requirements, as they apply to a good or service.

## Article II Scope and Coverage

### *Application of Agreement*

1. This Agreement applies to any measure regarding covered procurement, whether or not it is conducted exclusively or partially by electronic means.
2. For the purposes of this Agreement, covered procurement means procurement for governmental purposes:
  - a) of goods, services, or any combination thereof:
    - i. as specified in each Party's annexes to Appendix I; and



- ii. not procured with a view to commercial sale or resale, or for use in the production or supply of goods or services for commercial sale or resale;
  - b) by any contractual means, including: purchase; lease; and rental or hire purchase, with or without an option to buy;
  - c) for which the value, as estimated in accordance with paragraphs 6 through 8, equals or exceeds the relevant threshold specified in a Party's annexes to Appendix I, at the time of publication of a notice in accordance with Article VII;
  - d) by a procuring entity; and
  - e) that is not otherwise excluded from coverage in paragraph 3 or a Party's annexes to Appendix I.
3. Except where provided otherwise in a Party's annexes to Appendix I, this Agreement does not apply to:
- a) the acquisition or rental of land, existing buildings or other immovable property or the rights thereon;
  - b) non-contractual agreements or any form of assistance that a Party provides, including cooperative agreements, grants, loans, equity infusions, guarantees and fiscal incentives;
  - c) the procurement or acquisition of fiscal agency or depository services, liquidation and management services for regulated financial institutions or services related to the sale, redemption and distribution of public debt, including loans and government bonds, notes and other securities;
  - d) public employment contracts;
  - e) procurement conducted:
    - i. for the specific purpose of providing international assistance, including development aid;

- 
- ii. under the particular procedure or condition of an international agreement relating to the stationing of troops or relating to the joint implementation by the signatory countries of a project; or
  - iii. under the particular procedure or condition of an international organization, or funded by international grants, loans or other assistance where the applicable procedure or condition would be inconsistent with this Agreement.

4. Each Party shall specify the following information in its annexes to Appendix I:

- a) in Annex 1, the central government entities whose procurement is covered by this Agreement;
- b) in Annex 2, the sub-central government entities whose procurement is covered by this Agreement;
- c) in Annex 3, all other entities whose procurement is covered by this Agreement;
- d) in Annex 4, the goods covered by this Agreement;
- e) in Annex 5, the services, other than construction services, covered by this Agreement;
- f) in Annex 6, the construction services covered by this Agreement; and
- g) in Annex 7, any General Notes.

5. Where a procuring entity, in the context of covered procurement, requires persons not covered under a Party's annexes to Appendix I to procure in accordance with particular requirements, Article IV shall apply *mutatis mutandis* to such requirements.

## Valuation

6. In estimating the value of a procurement for the purpose of ascertaining whether it is a covered procurement, a procuring entity shall:

- a) neither divide a procurement into separate procurements nor select or use a particular valuation method for estimating the value of a procurement with the intention of totally or partially excluding it from the application of this Agreement; and
- b) include the estimated maximum total value of the procurement over its entire duration, whether awarded to one or more suppliers, taking into account all forms of remuneration, including:
  - i. premiums, fees, commissions and interest; and
  - ii. where the procurement provides for the possibility of options, the total value of such options.

7. Where an individual requirement for a procurement results in the award of more than one contract, or in the award of contracts in separate parts (hereinafter referred to as "recurring contracts"), the calculation of the estimated maximum total value shall be based on:

- a) the value of recurring contracts of the same type of good or service awarded during the preceding 12 months or the procuring entity's preceding fiscal year, adjusted, where possible, to take into account anticipated changes in the quantity or value of the good or service being procured over the following 12 months; or
- b) the estimated value of recurring contracts of the same type of good or service to be awarded during the 12 months following the initial contract award or the procuring entity's fiscal year.

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8. In the case of procurement by lease, rental or hire purchase of goods or services, or procurement for which a total price is not specified, the basis for valuation shall be:

- a) in the case of a fixed-term contract:
  - i. where the term of the contract is 12 months or less, the total estimated maximum value for its duration; or
  - ii. where the term of the contract exceeds 12 months, the total estimated maximum value, including any estimated residual value;
- a) where the contract is for an indefinite period, the estimated monthly instalment multiplied by 48; and
- b) where it is not certain whether the contract is to be a fixed-term contract, subparagraph (b) shall be used.

## Article III

### Security and General Exceptions

1. Nothing in this Agreement shall be construed to prevent any Party from taking any action or not disclosing any information that it considers necessary for the protection of its essential security interests relating to the procurement of arms, ammunition or war materials, or to procurement indispensable for national security or for national defence purposes.

2. Subject to the requirement that such measures are not applied in a manner that would constitute a means of arbitrary or unjustifiable discrimination between Parties where the same conditions prevail or a disguised restriction on international trade, nothing in this Agreement shall be construed to prevent any Party from imposing or enforcing measures:

- a) necessary to protect public morals, order or safety;
- b) necessary to protect human, animal or plant life or health;

- c) necessary to protect intellectual property; or
- d) relating to goods or services of persons with disabilities, philanthropic institutions or prison labour.

## Article IV

### General Principles

#### *Non-Discrimination*

1. With respect to any measure regarding covered procurement, each Party, including its procuring entities, shall accord immediately and unconditionally to the goods and services of any other Party and to the suppliers of any other Party offering the goods or services of any Party, treatment no less favourable than the treatment the Party, including its procuring entities, accords to:

- a) domestic goods, services and suppliers; and
- b) goods, services and suppliers of any other Party.

2. With respect to any measure regarding covered procurement, a Party, including its procuring entities, shall not:

- a) treat a locally established supplier less favourably than another locally established supplier on the basis of the degree of foreign affiliation or ownership; or
- b) discriminate against a locally established supplier on the basis that the goods or services offered by that supplier for a particular procurement are goods or services of any other Party.

#### *Use of Electronic Means*

3. When conducting covered procurement by electronic means, a procuring entity shall:

- a) ensure that the procurement is conducted using information technology systems and software, including those related to

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authentication and encryption of information, that are generally available and interoperable with other generally available information technology systems and software; and

- b) maintain mechanisms that ensure the integrity of requests for participation and tenders, including establishment of the time of receipt and the prevention of inappropriate access.

### ***Conduct of Procurement***

4. A procuring entity shall conduct covered procurement in a transparent and impartial manner that:

- a) is consistent with this Agreement, using methods such as open tendering, selective tendering and limited tendering;
- b) avoids conflicts of interest; and
- c) prevents corrupt practices.

### ***Rules of Origin***

5. For purposes of covered procurement, a Party shall not apply rules of origin to goods or services imported from or supplied from another Party that are different from the rules of origin the Party applies at the same time in the normal course of trade to imports or supplies of the same goods or services from the same Party.

### ***Offsets***

6. With regard to covered procurement, a Party, including its procuring entities, shall not seek, take account of, impose or enforce any offset.

### ***Measures Not Specific to Procurement***

7. Paragraphs 1 and 2 shall not apply to: customs duties and charges of any kind imposed on, or in connection with, importation; the method of levying such duties and charges; other import regulations or formalities and measures affecting trade in services other than measures governing covered procurement.

## Article V

### Developing Countries

1. In negotiations on accession to, and in the implementation and administration of, this Agreement, the Parties shall give special consideration to the development, financial and trade needs and circumstances of developing countries and least developed countries (collectively referred to hereinafter as "developing countries", unless specifically identified otherwise), recognizing that these may differ significantly from country to country. As provided for in this Article and on request, the Parties shall accord special and differential treatment to:

- a) least developed countries; and
- b) any other developing country, where and to the extent that this special and differential treatment meets its development needs.

2. Upon accession by a developing country to this Agreement, each Party shall provide immediately to the goods, services and suppliers of that country the most favourable coverage that the Party provides under its annexes to Appendix I to any other Party to this Agreement, subject to any terms negotiated between the Party and the developing country in order to maintain an appropriate balance of opportunities under this Agreement.

3. Based on its development needs, and with the agreement of the Parties, a developing country may adopt or maintain one or more of the following transitional measures, during a transition period and in accordance with a schedule, set out in its relevant annexes to Appendix I, and applied in a manner that does not discriminate among the other Parties:

- a) a price preference programme, provided that the programme:
  - i. provides a preference only for the part of the tender incorporating goods or services originating in the developing country applying the preference or goods or services originating in other developing countries in respect of which the developing country applying the preference has an obligation to provide national treatment under a preferential agreement, provided that where the other

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developing country is a Party to this Agreement, such treatment would be subject to any conditions set by the Committee; and

- ii. is transparent, and the preference and its application in the procurement are clearly described in the notice of intended procurement;
  - b) an offset, provided that any requirement for, or consideration of, the imposition of the offset is clearly stated in the notice of intended procurement;
  - c) the phased-in addition of specific entities or sectors; and
  - d) a threshold that is higher than its permanent threshold.
4. In negotiations on accession to this Agreement, the Parties may agree to the delayed application of any specific obligation in this Agreement, other than Article IV:1(b), by the acceding developing country while that country implements the obligation. The implementation period shall be:
- a) for a least developed country, five years after its accession to this Agreement; and
  - b) for any other developing country, only the period necessary to implement the specific obligation and not to exceed three years.
5. Any developing country that has negotiated an implementation period for an obligation under paragraph 4 shall list in its Annex 7 to Appendix I the agreed implementation period, the specific obligation subject to the implementation period and any interim obligation with which it has agreed to comply during the implementation period.
6. After this Agreement has entered into force for a developing country, the Committee, on request of the developing country, may:
- a) extend the transition period for a measure adopted or maintained under paragraph 3 or any implementation period negotiated under paragraph 4; or



- b) approve the adoption of a new transitional measure under paragraph 3, in special circumstances that were unforeseen during the accession process.
7. A developing country that has negotiated a transitional measure under paragraph 3 or 6, an implementation period under paragraph 4 or any extension under paragraph 6 shall take such steps during the transition period or implementation period as may be necessary to ensure that it is in compliance with this Agreement at the end of any such period. The developing country shall promptly notify the Committee of each step.
8. The Parties shall give due consideration to any request by a developing country for technical cooperation and capacity building in relation to that country's accession to, or implementation of, this Agreement.
9. The Committee may develop procedures for the implementation of this Article. Such procedures may include provisions for voting on decisions relating to requests under paragraph 6.
10. The Committee shall review the operation and effectiveness of this Article every five years.

## Article VI

### Information on the Procurement System

1. Each Party shall:
  - a) promptly publish any law, regulation, judicial decision, administrative ruling of general application, standard contract clause mandated by law or regulation and incorporated by reference in notices or tender documentation and procedure regarding covered procurement, and any modifications thereof, in an officially designated electronic or paper medium that is widely disseminated and remains readily accessible to the public; and
  - b) provide an explanation thereof to any Party, on request.

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2. Each Party shall list:
    - a) in Appendix II, the electronic or paper media in which the Party publishes the information described in paragraph 1;
    - b) in Appendix III, the electronic or paper media in which the Party publishes the notices required by Articles VII, IX:7 and XVI:2; and
    - c) in Appendix IV, the website address or addresses where the Party publishes:
      - i. its procurement statistics pursuant to Article XVI:5; or
      - ii. its notices concerning awarded contracts pursuant to Article XVI:6.
  3. Each Party shall promptly notify the Committee of any modification to the Party's information listed in Appendix II, III or IV.

## **Article VII**

### **Notices**

#### ***Notice of Intended Procurement***

1. For each covered procurement, a procuring entity shall publish a notice of intended procurement in the appropriate paper or electronic medium listed in Appendix III, except in the circumstances described in Article XIII. Such medium shall be widely disseminated and such notices shall remain readily accessible to the public, at least until expiration of the time-period indicated in the notice. The notices shall:
  - a) for procuring entities covered under Annex 1, be accessible by electronic means free of charge through a single point of access, for at least any minimum period of time specified in Appendix III; and
  - b) for procuring entities covered under Annex 2 or 3, where accessible by electronic means, be provided, at least, through links in a gateway electronic site that is accessible free of charge.

Parties, including their procuring entities covered under Annex 2 or 3, are encouraged to publish their notices by electronic means free of charge through a single point of access.

2. Except as otherwise provided in this Agreement, each notice of intended procurement shall include:

- a) the name and address of the procuring entity and other information necessary to contact the procuring entity and obtain all relevant documents relating to the procurement, and their cost and terms of payment, if any;
- b) a description of the procurement, including the nature and the quantity of the goods or services to be procured or, where the quantity is not known, the estimated quantity;
- c) for recurring contracts, an estimate, if possible, of the timing of subsequent notices of intended procurement;
- d) a description of any options;
- e) the time-frame for delivery of goods or services or the duration of the contract;
- f) the procurement method that will be used and whether it will involve negotiation or electronic auction;
- g) where applicable, the address and any final date for the submission of requests for participation in the procurement;
- h) the address and the final date for the submission of tenders;
- i) the language or languages in which tenders or requests for participation may be submitted, if they may be submitted in a language other than an official language of the Party of the procuring entity;

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- j) a list and brief description of any conditions for participation of suppliers, including any requirements for specific documents or certifications to be provided by suppliers in connection therewith, unless such requirements are included in tender documentation that is made available to all interested suppliers at the same time as the notice of intended procurement;
  - k) where, pursuant to Article IX, a procuring entity intends to select a limited number of qualified suppliers to be invited to tender, the criteria that will be used to select them and, where applicable, any limitation on the number of suppliers that will be permitted to tender; and
  - l) an indication that the procurement is covered by this Agreement.

### **Summary Notice**

3. For each case of intended procurement, a procuring entity shall publish a summary notice that is readily accessible, at the same time as the publication of the notice of intended procurement, in one of the WTO languages. The summary notice shall contain at least the following information:

- a) the subject-matter of the procurement;
- b) the final date for the submission of tenders or, where applicable, any final date for the submission of requests for participation in the procurement or for inclusion on a multi-use list; and
- c) the address from which documents relating to the procurement may be requested.

### **Notice of Planned Procurement**

4. Procuring entities are encouraged to publish in the appropriate paper or electronic medium listed in Appendix III as early as possible in each fiscal year a notice regarding their future procurement plans (hereinafter referred to as "notice of planned procurement"). The notice of planned procurement should include the subject-matter of the procurement and the planned date of the publication of the notice of intended procurement.

5. A procuring entity covered under Annex 2 or 3 may use a notice of planned procurement as a notice of intended procurement provided that the notice of planned procurement includes as much of the information referred to in paragraph 2 as is available to the entity and a statement that interested suppliers should express their interest in the procurement to the procuring entity.

## Article VIII

### Conditions for Participation

1. A procuring entity shall limit any conditions for participation in a procurement to those that are essential to ensure that a supplier has the legal and financial capacities and the commercial and technical abilities to undertake the relevant procurement.

2. In establishing the conditions for participation, a procuring entity:

- a) shall not impose the condition that, in order for a supplier to participate in a procurement, the supplier has previously been awarded one or more contracts by a procuring entity of a given Party; and
- b) may require relevant prior experience where essential to meet the requirements of the procurement.

3. In assessing whether a supplier satisfies the conditions for participation, a procuring entity:

- a) shall evaluate the financial capacity and the commercial and technical abilities of a supplier on the basis of that supplier's business activities both inside and outside the territory of the Party of the procuring entity; and
- b) shall base its evaluation on the conditions that the procuring entity has specified in advance in notices or tender documentation.

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4. Where there is supporting evidence, a Party, including its procuring entities, may exclude a supplier on grounds such as:

- a) bankruptcy;
- b) false declarations;
- c) significant or persistent deficiencies in performance of any substantive requirement or obligation under a prior contract or contracts;
- d) final judgments in respect of serious crimes or other serious offences;
- e) professional misconduct or acts or omissions that adversely reflect on the commercial integrity of the supplier; or
- f) failure to pay taxes.

## **Article IX**

### **Qualification of Suppliers**

#### ***Registration Systems and Qualification Procedures***

1. A Party, including its procuring entities, may maintain a supplier registration system under which interested suppliers are required to register and provide certain information.

2. Each Party shall ensure that:

- a) its procuring entities make efforts to minimize differences in their qualification procedures; and
- b) where its procuring entities maintain registration systems, the entities make efforts to minimize differences in their registration systems.

3. A Party, including its procuring entities, shall not adopt or apply any registration system or qualification procedure with the purpose or the effect of creating unnecessary obstacles to the participation of suppliers of another Party in its procurement.

## **Selective Tendering**

4. Where a procuring entity intends to use selective tendering, the entity shall:

- a) include in the notice of intended procurement at least the information specified in Article VII:2(a), (b), (f), (g), (j), (k) and (l) and invite suppliers to submit a request for participation; and
- b) provide, by the commencement of the time-period for tendering, at least the information in Article VII:2 (c), (d), (e), (h) and (i) to the qualified suppliers that it notifies as specified in Article XI:3(b).

5. A procuring entity shall allow all qualified suppliers to participate in a particular procurement, unless the procuring entity states in the notice of intended procurement any limitation on the number of suppliers that will be permitted to tender and the criteria for selecting the limited number of suppliers.

6. Where the tender documentation is not made publicly available from the date of publication of the notice referred to in paragraph 4, a procuring entity shall ensure that those documents are made available at the same time to all the qualified suppliers selected in accordance with paragraph 5.

## **Multi-Use Lists**

7. A procuring entity may maintain a multi-use list of suppliers, provided that a notice inviting interested suppliers to apply for inclusion on the list is:

- a) published annually; and
- b) where published by electronic means, made available continuously, in the appropriate medium listed in Appendix III.

8. The notice provided for in paragraph 7 shall include:

- a) a description of the goods or services, or categories thereof, for which the list may be used;

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- b) the conditions for participation to be satisfied by suppliers for inclusion on the list and the methods that the procuring entity will use to verify that a supplier satisfies the conditions;
  - c) the name and address of the procuring entity and other information necessary to contact the entity and obtain all relevant documents relating to the list;
  - d) the period of validity of the list and the means for its renewal or termination, or where the period of validity is not provided, an indication of the method by which notice will be given of the termination of use of the list; and
  - e) an indication that the list may be used for procurement covered by this Agreement.

9. Notwithstanding paragraph 7, where a multi-use list will be valid for three years or less, a procuring entity may publish the notice referred to in paragraph 7 only once, at the beginning of the period of validity of the list, provided that the notice:

- a) states the period of validity and that further notices will not be published; and
- b) is published by electronic means and is made available continuously during the period of its validity.

10. A procuring entity shall allow suppliers to apply at any time for inclusion on a multi-use list and shall include on the list all qualified suppliers within a reasonably short time.

11. Where a supplier that is not included on a multi-use list submits a request for participation in a procurement based on a multi-use list and all required documents, within the time-period provided for in Article XI:2, a procuring entity shall examine the request. The procuring entity shall not exclude the supplier from consideration in respect of the procurement on the grounds that the entity has insufficient time to examine the request, unless, in exceptional cases, due to the complexity of the procurement, the entity is not able to complete the examination of the request within the time-period allowed for the submission of tenders.



## ***Annex 2 and Annex 3 Entities***

12. A procuring entity covered under Annex 2 or 3 may use a notice inviting suppliers to apply for inclusion on a multi-use list as a notice of intended procurement, provided that:

- a) the notice is published in accordance with paragraph 7 and includes the information required under paragraph 8, as much of the information required under Article VII:2 as is available and a statement that it constitutes a notice of intended procurement or that only the suppliers on the multi-use list will receive further notices of procurement covered by the multi-use list; and
- b) the entity promptly provides to suppliers that have expressed an interest in a given procurement to the entity, sufficient information to permit them to assess their interest in the procurement, including all remaining information required in Article VII:2, to the extent such information is available.

13. A procuring entity covered under Annex 2 or 3 may allow a supplier that has applied for inclusion on a multi-use list in accordance with paragraph 10 to tender in a given procurement, where there is sufficient time for the procuring entity to examine whether the supplier satisfies the conditions for participation.

## ***Information on Procuring Entity Decisions***

14. A procuring entity shall promptly inform any supplier that submits a request for participation in a procurement or application for inclusion on a multi-use list of the procuring entity's decision with respect to the request or application.

15. Where a procuring entity rejects a supplier's request for participation in a procurement or application for inclusion on a multi-use list, ceases to recognize a supplier as qualified, or removes a supplier from a multi-use list, the entity shall promptly inform the supplier and, on request of the supplier, promptly provide the supplier with a written explanation of the reasons for its decision.

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## Article X

# Technical Specifications and Tender Documentation

### *Technical Specifications*

1. A procuring entity shall not prepare, adopt or apply any technical specification or prescribe any conformity assessment procedure with the purpose or the effect of creating unnecessary obstacles to international trade.
2. In prescribing the technical specifications for the goods or services being procured, a procuring entity shall, where appropriate:
  - a) set out the technical specification in terms of performance and functional requirements, rather than design or descriptive characteristics; and
  - b) base the technical specification on international standards, where such exist; otherwise, on national technical regulations, recognized national standards or building codes.
3. Where design or descriptive characteristics are used in the technical specifications, a procuring entity should indicate, where appropriate, that it will consider tenders of equivalent goods or services that demonstrably fulfil the requirements of the procurement by including words such as "or equivalent" in the tender documentation.
4. A procuring entity shall not prescribe technical specifications that require or refer to a particular trademark or trade name, patent, copyright, design, type, specific origin, producer or supplier, unless there is no other sufficiently precise or intelligible way of describing the procurement requirements and provided that, in such cases, the entity includes words such as "or equivalent" in the tender documentation.
5. A procuring entity shall not seek or accept, in a manner that would have the effect of precluding competition, advice that may be used in the preparation or adoption of any technical specification for a specific

procurement from a person that may have a commercial interest in the procurement.

6. For greater certainty, a Party, including its procuring entities, may, in accordance with this Article, prepare, adopt or apply technical specifications to promote the conservation of natural resources or protect the environment.

### ***Tender Documentation***

7. A procuring entity shall make available to suppliers tender documentation that includes all information necessary to permit suppliers to prepare and submit responsive tenders. Unless already provided in the notice of intended procurement, such documentation shall include a complete description of:

- a) the procurement, including the nature and the quantity of the goods or services to be procured or, where the quantity is not known, the estimated quantity and any requirements to be fulfilled, including any technical specifications, conformity assessment certification, plans, drawings or instructional materials;
- b) any conditions for participation of suppliers, including a list of information and documents that suppliers are required to submit in connection with the conditions for participation;
- c) all evaluation criteria the entity will apply in the awarding of the contract, and, except where price is the sole criterion, the relative importance of such criteria;
- d) where the procuring entity will conduct the procurement by electronic means, any authentication and encryption requirements or other requirements related to the submission of information by electronic means;
- e) where the procuring entity will hold an electronic auction, the rules, including identification of the elements of the tender related to the evaluation criteria, on which the auction will be conducted;

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- f) where there will be a public opening of tenders, the date, time and place for the opening and, where appropriate, the persons authorized to be present;
  - g) any other terms or conditions, including terms of payment and any limitation on the means by which tenders may be submitted, such as whether on paper or by electronic means; and
  - h) any dates for the delivery of goods or the supply of services.

8. In establishing any date for the delivery of goods or the supply of services being procured, a procuring entity shall take into account such factors as the complexity of the procurement, the extent of subcontracting anticipated and the realistic time required for production, de-stocking and transport of goods from the point of supply or for supply of services.

9. The evaluation criteria set out in the notice of intended procurement or tender documentation may include, among others, price and other cost factors, quality, technical merit, environmental characteristics and terms of delivery.

10. A procuring entity shall promptly:

- a) make available tender documentation to ensure that interested suppliers have sufficient time to submit responsive tenders;
- b) provide, on request, the tender documentation to any interested supplier; and
- c) reply to any reasonable request for relevant information by any interested or participating supplier, provided that such information does not give that supplier an advantage over other suppliers.

### **Modifications**

11. Where, prior to the award of a contract, a procuring entity modifies the criteria or requirements set out in the notice of intended procurement or tender documentation provided to participating suppliers, or amends or

reissues a notice or tender documentation, it shall transmit in writing all such modifications or amended or re-issued notice or tender documentation:

- a) to all suppliers that are participating at the time of the modification, amendment or re-issuance, where such suppliers are known to the entity, and in all other cases, in the same manner as the original information was made available; and
- b) in adequate time to allow such suppliers to modify and re-submit amended tenders, as appropriate.

## Article XI Time-Periods

### *General*

1. A procuring entity shall, consistent with its own reasonable needs, provide sufficient time for suppliers to prepare and submit requests for participation and responsive tenders, taking into account such factors as:

- a) the nature and complexity of the procurement;
- b) the extent of subcontracting anticipated; and
- c) the time necessary for transmitting tenders by non-electronic means from foreign as well as domestic points where electronic means are not used.

Such time-periods, including any extension of the time-periods, shall be the same for all interested or participating suppliers.

### *Deadlines*

2. A procuring entity that uses selective tendering shall establish that the final date for the submission of requests for participation shall not, in principle, be less than 25 days from the date of publication of the notice of intended procurement. Where a state of urgency duly substantiated by the

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procuring entity renders this time-period impracticable, the time-period may be reduced to not less than 10 days.

3. Except as provided for in paragraphs 4, 5, 7 and 8 a procuring entity shall establish that the final date for the submission of tenders shall not be less than 40 days from the date on which:

- a) in the case of open tendering, the notice of intended procurement is published; or
- b) in the case of selective tendering, the entity notifies suppliers that they will be invited to submit tenders, whether or not it uses a multi-use list.

4. A procuring entity may reduce the time-period for tendering established in accordance with paragraph 3 to not less than 10 days where:

- a) the procuring entity has published a notice of planned procurement as described in Article VII:4 at least 40 days and not more than 12 months in advance of the publication of the notice of intended procurement, and the notice of planned procurement contains:
  - i. a description of the procurement;
  - ii. the approximate final dates for the submission of tenders or requests for participation;
  - iii. a statement that interested suppliers should express their interest in the procurement to the procuring entity;
  - iv. the address from which documents relating to the procurement may be obtained; and
  - v. as much of the information that is required for the notice of intended procurement under Article VII:2, as is available;
- b) the procuring entity, for recurring contracts, indicates in an initial notice of intended procurement that subsequent notices will provide time-periods for tendering based on this paragraph; or

- c) a state of urgency duly substantiated by the procuring entity renders the time-period for tendering established in accordance with paragraph 3 impracticable.
5. A procuring entity may reduce the time-period for tendering established in accordance with paragraph 3 by five days for each one of the following circumstances:
- a) the notice of intended procurement is published by electronic means;
  - b) all the tender documentation is made available by electronic means from the date of the publication of the notice of intended procurement; and
  - c) the entity accepts tenders by electronic means.
6. The use of paragraph 5, in conjunction with paragraph 4, shall in no case result in the reduction of the time-period for tendering established in accordance with paragraph 3 to less than 10 days from the date on which the notice of intended procurement is published.
7. Notwithstanding any other provision in this Article, where a procuring entity purchases commercial goods or services, or any combination thereof, it may reduce the time-period for tendering established in accordance with paragraph 3 to not less than 13 days, provided that it publishes by electronic means, at the same time, both the notice of intended procurement and the tender documentation. In addition, where the entity accepts tenders for commercial goods or services by electronic means, it may reduce the time-period established in accordance with paragraph 3 to not less than 10 days.
8. Where a procuring entity covered under Annex 2 or 3 has selected all or a limited number of qualified suppliers, the time-period for tendering may be fixed by mutual agreement between the procuring entity and the selected suppliers. In the absence of agreement, the period shall not be less than 10 days.

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## Article XII

### Negotiation

1. A Party may provide for its procuring entities to conduct negotiations:
  - a) where the entity has indicated its intent to conduct negotiations in the notice of intended procurement required under Article VII:2; or
  - b) where it appears from the evaluation that no tender is obviously the most advantageous in terms of the specific evaluation criteria set out in the notice of intended procurement or tender documentation.
2. A procuring entity shall:
  - a) ensure that any elimination of suppliers participating in negotiations is carried out in accordance with the evaluation criteria set out in the notice of intended procurement or tender documentation; and
  - b) where negotiations are concluded, provide a common deadline for the remaining participating suppliers to submit any new or revised tenders.

## Article XIII

### Limited Tendering

1. Provided that it does not use this provision for the purpose of avoiding competition among suppliers or in a manner that discriminates against suppliers of any other Party or protects domestic suppliers, a procuring entity may use limited tendering and may choose not to apply Articles VII through IX, X (paragraphs 7 through 11), XI, XII, XIV and XV only under any of the following circumstances:

- a) where:
  - i. no tenders were submitted or no suppliers requested participation;
  - ii. no tenders that conform to the essential requirements of the tender documentation were submitted;



iii. no suppliers satisfied the conditions for participation; or

iv. the tenders submitted have been collusive,

provided that the requirements of the tender documentation are not substantially modified;

- b) where the goods or services can be supplied only by a particular supplier and no reasonable alternative or substitute goods or services exist for any of the following reasons:
  - i. the requirement is for a work of art;
  - ii. the protection of patents, copyrights or other exclusive rights; or
  - iii. due to an absence of competition for technical reasons;
- c) for additional deliveries by the original supplier of goods or services that were not included in the initial procurement where a change of supplier for such additional goods or services:
  - i. cannot be made for economic or technical reasons such as requirements of interchangeability or interoperability with existing equipment, software, services or installations procured under the initial procurement; and
  - ii. would cause significant inconvenience or substantial duplication of costs for the procuring entity;
- d) insofar as is strictly necessary where, for reasons of extreme urgency brought about by events unforeseeable by the procuring entity, the goods or services could not be obtained in time using open tendering or selective tendering;
- e) for goods purchased on a commodity market;
- f) where a procuring entity procures a prototype or a first good or service that is developed at its request in the course of, and for, a particular contract for research, experiment, study or original development.

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Original development of a first good or service may include limited production or supply in order to incorporate the results of field testing and to demonstrate that the good or service is suitable for production or supply in quantity to acceptable quality standards, but does not include quantity production or supply to establish commercial viability or to recover research and development costs;

- g) for purchases made under exceptionally advantageous conditions that only arise in the very short term in the case of unusual disposals such as those arising from liquidation, receivership or bankruptcy, but not for routine purchases from regular suppliers; or
- h) where a contract is awarded to a winner of a design contest provided that:
  - i. the contest has been organized in a manner that is consistent with the principles of this Agreement, in particular relating to the publication of a notice of intended procurement; and
  - ii. the participants are judged by an independent jury with a view to a design contract being awarded to a winner.

2. A procuring entity shall prepare a report in writing on each contract awarded under paragraph 1. The report shall include the name of the procuring entity, the value and kind of goods or services procured and a statement indicating the circumstances and conditions described in paragraph 1 that justified the use of limited tendering.

## Article XIV

### Electronic Auctions

Where a procuring entity intends to conduct a covered procurement using an electronic auction, the entity shall provide each participant, before commencing the electronic auction, with:

- a) the automatic evaluation method, including the mathematical formula, that is based on the evaluation criteria set out in the tender documentation and that will be used in the automatic ranking or re-ranking during the auction;

- b) the results of any initial evaluation of the elements of its tender where the contract is to be awarded on the basis of the most advantageous tender; and
- c) any other relevant information relating to the conduct of the auction.

## **Article XV**

### **Treatment of Tenders and Awarding of Contracts**

#### ***Treatment of Tenders***

1. A procuring entity shall receive, open and treat all tenders under procedures that guarantee the fairness and impartiality of the procurement process, and the confidentiality of tenders.
2. A procuring entity shall not penalize any supplier whose tender is received after the time specified for receiving tenders if the delay is due solely to mishandling on the part of the procuring entity.
3. Where a procuring entity provides a supplier with an opportunity to correct unintentional errors of form between the opening of tenders and the awarding of the contract, the procuring entity shall provide the same opportunity to all participating suppliers.

#### ***Awarding of Contracts***

4. To be considered for an award, a tender shall be submitted in writing and shall, at the time of opening, comply with the essential requirements set out in the notices and tender documentation and be from a supplier that satisfies the conditions for participation.

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5. Unless a procuring entity determines that it is not in the public interest to award a contract, the entity shall award the contract to the supplier that the entity has determined to be capable of fulfilling the terms of the contract and that, based solely on the evaluation criteria specified in the notices and tender documentation, has submitted:

- a) the most advantageous tender; or
- b) where price is the sole criterion, the lowest price.

6. Where a procuring entity receives a tender with a price that is abnormally lower than the prices in other tenders submitted, it may verify with the supplier that it satisfies the conditions for participation and is capable of fulfilling the terms of the contract.

7. A procuring entity shall not use options, cancel a procurement or modify awarded contracts in a manner that circumvents the obligations under this Agreement.

## **Article XVI**

### **Transparency of Procurement Information**

#### ***Information Provided to Suppliers***

1. A procuring entity shall promptly inform participating suppliers of the entity's contract award decisions and, on the request of a supplier, shall do so in writing. Subject to paragraphs 2 and 3 of Article XVII, a procuring entity shall, on request, provide an unsuccessful supplier with an explanation of the reasons why the entity did not select its tender and the relative advantages of the successful supplier's tender.

#### ***Publication of Award Information***

2. Not later than 72 days after the award of each contract covered by this Agreement, a procuring entity shall publish a notice in the appropriate paper or electronic medium listed in Appendix III. Where the entity publishes the notice only in an electronic medium, the information shall remain readily

accessible for a reasonable period of time. The notice shall include at least the following information:

- a) a description of the goods or services procured;
- b) the name and address of the procuring entity;
- c) the name and address of the successful supplier;
- d) the value of the successful tender or the highest and lowest offers taken into account in the award of the contract;
- e) the date of award; and
- f) the type of procurement method used, and in cases where limited tendering was used in accordance with Article XIII, a description of the circumstances justifying the use of limited tendering.

### ***Maintenance of Documentation, Reports and Electronic Traceability***

3. Each procuring entity shall, for a period of at least three years from the date it awards a contract, maintain:

- a) the documentation and reports of tendering procedures and contract awards relating to covered procurement, including the reports required under Article XIII; and
- b) data that ensure the appropriate traceability of the conduct of covered procurement by electronic means.

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## ***Collection and Reporting of Statistics***

4. Each Party shall collect and report to the Committee statistics on its contracts covered by this Agreement. Each report shall cover one year and be submitted within two years of the end of the reporting period, and shall contain:

- a) for Annex 1 procuring entities:
  - i. the number and total value, for all such entities, of all contracts covered by this Agreement;
  - ii. the number and total value of all contracts covered by this Agreement awarded by each such entity, broken down by categories of goods and services according to an internationally recognized uniform classification system; and
  - iii. the number and total value of all contracts covered by this Agreement awarded by each such entity under limited tendering;
- b) for Annex 2 and 3 procuring entities, the number and total value of contracts covered by this Agreement awarded by all such entities, broken down by Annex; and
- c) estimates for the data required under subparagraphs (a) and (b), with an explanation of the methodology used to develop the estimates, where it is not feasible to provide the data.

5. Where a Party publishes its statistics on an official website, in a manner that is consistent with the requirements of paragraph 4, the Party may substitute a notification to the Committee of the website address for the submission of the data under paragraph 4, with any instructions necessary to access and use such statistics.

6. Where a Party requires notices concerning awarded contracts, pursuant to paragraph 2, to be published electronically and where such notices are accessible to the public through a single database in a form permitting analysis of the covered contracts, the Party may substitute a notification to the Committee of the website address for the submission of the data under paragraph 4, with any instructions necessary to access and use such data.

## Article XVII

### Disclosure of Information

#### *Provision of Information to Parties*

1. On request of any other Party, a Party shall provide promptly any information necessary to determine whether a procurement was conducted fairly, impartially and in accordance with this Agreement, including information on the characteristics and relative advantages of the successful tender. In cases where release of the information would prejudice competition in future tenders, the Party that receives the information shall not disclose it to any supplier, except after consulting with, and obtaining the agreement of, the Party that provided the information.

#### *Non-Disclosure of Information*

2. Notwithstanding any other provision of this Agreement, a Party, including its procuring entities, shall not provide to any particular supplier information that might prejudice fair competition between suppliers.

3. Nothing in this Agreement shall be construed to require a Party, including its procuring entities, authorities and review bodies, to disclose confidential information where disclosure:

- a) would impede law enforcement;
- b) might prejudice fair competition between suppliers;
- c) would prejudice the legitimate commercial interests of particular persons, including the protection of intellectual property; or
- d) would otherwise be contrary to the public interest.

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## Article XVIII

### Domestic Review Procedures

1. Each Party shall provide a timely, effective, transparent and non-discriminatory administrative or judicial review procedure through which a supplier may challenge:

- a) a breach of the Agreement; or
- b) where the supplier does not have a right to challenge directly a breach of the Agreement under the domestic law of a Party, a failure to comply with a Party's measures implementing this Agreement, arising in the context of a covered procurement, in which the supplier has, or has had, an interest. The procedural rules for all challenges shall be in writing and made generally available.

2. In the event of a complaint by a supplier, arising in the context of covered procurement in which the supplier has, or has had, an interest, that there has been a breach or a failure as referred to in paragraph 1, the Party of the procuring entity conducting the procurement shall encourage the entity and the supplier to seek resolution of the complaint through consultations. The entity shall accord impartial and timely consideration to any such complaint in a manner that is not prejudicial to the supplier's participation in ongoing or future procurement or its right to seek corrective measures under the administrative or judicial review procedure.

3. Each supplier shall be allowed a sufficient period of time to prepare and submit a challenge, which in no case shall be less than 10 days from the time when the basis of the challenge became known or reasonably should have become known to the supplier.

4. Each Party shall establish or designate at least one impartial administrative or judicial authority that is independent of its procuring entities to receive and review a challenge by a supplier arising in the context of a covered procurement.

5. Where a body other than an authority referred to in paragraph 4 initially reviews a challenge, the Party shall ensure that the supplier may appeal the



initial decision to an impartial administrative or judicial authority that is independent of the procuring entity whose procurement is the subject of the challenge.

6. Each Party shall ensure that a review body that is not a court shall have its decision subject to judicial review or have procedures that provide that:

- a) the procuring entity shall respond in writing to the challenge and disclose all relevant documents to the review body;
- b) the participants to the proceedings (hereinafter referred to as "participants") shall have the right to be heard prior to a decision of the review body being made on the challenge;
- c) the participants shall have the right to be represented and accompanied;
- d) the participants shall have access to all proceedings;
- e) the participants shall have the right to request that the proceedings take place in public and that witnesses may be presented; and
- f) the review body shall make its decisions or recommendations in a timely fashion, in writing, and shall include an explanation of the basis for each decision or recommendation.

7. Each Party shall adopt or maintain procedures that provide for:

- a) rapid interim measures to preserve the supplier's opportunity to participate in the procurement. Such interim measures may result in suspension of the procurement process. The procedures may provide that overriding adverse consequences for the interests concerned, including the public interest, may be taken into account when deciding whether such measures should be applied. Just cause for not acting shall be provided in writing; and
- b) where a review body has determined that there has been a breach or a failure as referred to in paragraph 1, corrective action or compensation for the loss or damages suffered, which may be limited to either the costs for the preparation of the tender or the costs relating to the challenge, or both.

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## **Article XIX**

### **Modifications and Rectifications to Coverage**

#### ***Notification of Proposed Modification***

1. A Party shall notify the Committee of any proposed rectification, transfer of an entity from one annex to another, withdrawal of an entity or other modification of its annexes to Appendix I (any of which is hereinafter referred to as "modification"). The Party proposing the modification (hereinafter referred to as "modifying Party") shall include in the notification:

- a) for any proposed withdrawal of an entity from its annexes to Appendix I in exercise of its rights on the grounds that government control or influence over the entity's covered procurement has been effectively eliminated, evidence of such elimination; or
- b) for any other proposed modification, information as to the likely consequences of the change for the mutually agreed coverage provided for in this Agreement.

#### ***Objection to Notification***

2. Any Party whose rights under this Agreement may be affected by a proposed modification notified under paragraph 1 may notify the Committee of any objection to the proposed modification. Such objections shall be made within 45 days from the date of the circulation to the Parties of the notification, and shall set out reasons for the objection.

#### ***Consultations***

3. The modifying Party and any Party making an objection (hereinafter referred to as "objecting Party") shall make every attempt to resolve the objection through consultations. In such consultations, the modifying and objecting Parties shall consider the proposed modification:

- a) in the case of a notification under paragraph 1(a), in accordance with any indicative criteria adopted pursuant to paragraph 8(b), indicating

the effective elimination of government control or influence over an entity's covered procurement; and

- b) in the case of a notification under paragraph 1(b), in accordance with any criteria adopted pursuant to paragraph 8(c), relating to the level of compensatory adjustments to be offered for modifications, with a view to maintaining a balance of rights and obligations and a comparable level of mutually agreed coverage provided in this Agreement.

### ***Revised Modification***

4. Where the modifying Party and any objecting Party resolve the objection through consultations, and the modifying Party revises its proposed modification as a result of those consultations, the modifying Party shall notify the Committee in accordance with paragraph 1, and any such revised modification shall only be effective after fulfilling the requirements of this Article.

### ***Implementation of Modifications***

5. A proposed modification shall become effective only where:
- a) no Party submits to the Committee a written objection to the proposed modification within 45 days from the date of circulation of the notification of the proposed modification under paragraph 1;
  - b) all objecting Parties have notified the Committee that they withdraw their objections to the proposed modification; or
  - c) 150 days from the date of circulation of the notification of the proposed modification under paragraph 1 have elapsed, and the modifying Party has informed the Committee in writing of its intention to implement the modification.

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## ***Withdrawal of Substantially Equivalent Coverage***

6. Where a modification becomes effective pursuant to paragraph 5(c), any objecting Party may withdraw substantially equivalent coverage. Notwithstanding Article IV:1(b), a withdrawal pursuant to this paragraph may be implemented solely with respect to the modifying Party. Any objecting Party shall inform the Committee in writing of any such withdrawal at least 30 days before the withdrawal becomes effective. A withdrawal pursuant to this paragraph shall be consistent with any criteria relating to the level of compensatory adjustment adopted by the Committee pursuant to paragraph 8(c).

## ***Arbitration Procedures to Facilitate Resolution of Objections***

7. Where the Committee has adopted arbitration procedures to facilitate the resolution of objections pursuant to paragraph 8, a modifying or any objecting Party may invoke the arbitration procedures within 120 days of circulation of the notification of the proposed modification:

- a) Where no Party has invoked the arbitration procedures within the time-period:
  - i. notwithstanding paragraph 5(c), the proposed modification shall become effective where 130 days from the date of circulation of the notification of the proposed modification under paragraph 1 have elapsed, and the modifying Party has informed the Committee in writing of its intention to implement the modification; and
  - ii. no objecting Party may withdraw coverage pursuant to paragraph 6.
- b) Where a modifying Party or objecting Party has invoked the arbitration procedures:
  - i. notwithstanding paragraph 5(c), the proposed modification shall not become effective before the completion of the arbitration procedures;

- ii. any objecting Party that intends to enforce a right to compensation, or to withdraw substantially equivalent coverage pursuant to paragraph 6, shall participate in the arbitration proceedings;
- iii. a modifying Party should comply with the results of the arbitration procedures in making any modification effective pursuant to paragraph 5(c); and
- iv. where a modifying Party does not comply with the results of the arbitration procedures in making any modification effective pursuant to paragraph 5(c), any objecting Party may withdraw substantially equivalent coverage pursuant to paragraph 6, provided that any such withdrawal is consistent with the result of the arbitration procedures.

### **Committee Responsibilities**

8. The Committee shall adopt:
- a) arbitration procedures to facilitate resolution of objections under paragraph 2;
  - b) indicative criteria that demonstrate the effective elimination of government control or influence over an entity's covered procurement; and
  - c) criteria for determining the level of compensatory adjustment to be offered for modifications made pursuant to paragraph 1(b) and of substantially equivalent coverage under paragraph 6.

## **Article XX**

### **Consultations and Dispute Settlement**

1. Each Party shall accord sympathetic consideration to and shall afford adequate opportunity for consultation regarding any representation made by another Party with respect to any matter affecting the operation of this Agreement.

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2. Where any Party considers that any benefit accruing to it, directly or indirectly, under this Agreement is being nullified or impaired, or that the attainment of any objective of this Agreement is being impeded as the result of:

- a) the failure of another Party or Parties to carry out its obligations under this Agreement; or
- b) the application by another Party or Parties of any measure, whether or not it conflicts with the provisions of this Agreement,

it may, with a view to reaching a mutually satisfactory solution to the matter, have recourse to the provisions of the Understanding on Rules and Procedures Governing the Settlement of Disputes (hereinafter referred to as "the Dispute Settlement Understanding").

3. The Dispute Settlement Understanding shall apply to consultations and the settlement of disputes under this Agreement, with the exception that, notwithstanding paragraph 3 of Article 22 of the Dispute Settlement Understanding, any dispute arising under any Agreement listed in Appendix 1 to the Dispute Settlement Understanding other than this Agreement shall not result in the suspension of concessions or other obligations under this Agreement, and any dispute arising under this Agreement shall not result in the suspension of concessions or other obligations under any other Agreement listed in Appendix 1 of the Dispute Settlement Understanding.

## **Article XXI**

### **Institutions**

#### ***Committee on Government Procurement***

1. There shall be a Committee on Government Procurement composed of representatives from each of the Parties. This Committee shall elect its own Chairman and shall meet as necessary, but not less than once a year, for the purpose of affording Parties the opportunity to consult on any matters relating to the operation of this Agreement or the furtherance of its objectives, and to carry out such other responsibilities as may be assigned to it by the Parties.

2. The Committee may establish working parties or other subsidiary bodies that shall carry out such functions as may be given to them by the Committee.
3. The Committee shall annually:
  - a) review the implementation and operation of this Agreement; and
  - b) inform the General Council of its activities, pursuant to Article IV:8 of the Marrakesh Agreement Establishing the World Trade Organization (hereinafter referred to as "WTO Agreement"), and of developments relating to the implementation and operation of this Agreement.

### **Observers**

4. Any WTO Member that is not a Party to this Agreement shall be entitled to participate in the Committee as an observer by submitting a written notice to the Committee. Any WTO observer may submit a written request to the Committee to participate in the Committee as an observer, and may be accorded observer status by the Committee.

## **Article XXII Final Provisions**

### ***Acceptance and Entry into Force***

1. This Agreement shall enter into force on 1 January 1996 for those governments<sup>1</sup> whose agreed coverage is contained in the Annexes of Appendix I of this Agreement, and which have, by signature, accepted the Agreement on 15 April 1994, or have, by that date, signed the Agreement subject to ratification and have subsequently ratified the Agreement before 1 January 1996.

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<sup>1</sup> For the purpose of this Agreement, the term "government" is deemed to include the competent authorities of the European Union.

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## ***Accession***

2. Any Member of the WTO may accede to this Agreement on terms to be agreed between that Member and the Parties, with such terms stated in a decision of the Committee. Accession shall take place by deposit with the Director-General of the WTO of an instrument of accession that states the terms so agreed. This Agreement shall enter into force for a Member acceding to it on the 30<sup>th</sup> day following the deposit of its instrument of accession.

## ***Reservations***

3. No Party may enter a reservation in respect of any provision of this Agreement.

## ***Domestic Legislation***

4. Each Party shall ensure, not later than the date of entry into force of this Agreement for it, the conformity of its laws, regulations and administrative procedures, and the rules, procedures and practices applied by its procuring entities, with the provisions of this Agreement.

5. Each Party shall inform the Committee of any changes to its laws and regulations relevant to this Agreement and in the administration of such laws and regulations.

## ***Future Negotiations and Future Work Programmes***

6. Each Party shall seek to avoid introducing or continuing discriminatory measures that distort open procurement.

7. Not later than the end of three years from the date of entry into force of the Protocol Amending the Agreement on Government Procurement, adopted on 30 March 2012, and periodically thereafter, the Parties shall undertake further negotiations, with a view to improving this Agreement, progressively reducing and eliminating discriminatory measures, and achieving the greatest possible extension of its coverage among all Parties on the basis of mutual reciprocity, taking into consideration the needs of developing countries.



8. a) The Committee shall undertake further work to facilitate the implementation of this Agreement and the negotiations provided for in paragraph 7, through the adoption of work programmes for the following items:
- i. the treatment of small and medium-sized enterprises;
  - ii. the collection and dissemination of statistical data;
  - iii. the treatment of sustainable procurement;
  - iv. exclusions and restrictions in Parties' Annexes; and
  - v. safety standards in international procurement.
- b) The Committee:
- i. may adopt a decision that contains a list of work programmes on additional items, which may be reviewed and updated periodically; and
  - ii. shall adopt a decision setting out the work to be undertaken on each particular work programme under subparagraph (a) and any work programme adopted under subparagraph (b)(i).
9. Following the conclusion of the work programme to harmonize rules of origin for goods being undertaken under the Agreement on Rules of Origin in Annex 1A to the WTO Agreement and negotiations regarding trade in services, the Parties shall take the results of that work programme and those negotiations into account in amending Article IV:5, as appropriate.
10. Not later than the end of the fifth year from the date of entry into force of the Protocol Amending the Agreement on Government Procurement, the Committee shall examine the applicability of Article XX:2(b).

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## ***Amendments***

11. The Parties may amend this Agreement. A decision to adopt an amendment and to submit it for acceptance by the Parties shall be taken by consensus. An amendment shall enter into force:

- a) except as provided for in subparagraph (b), in respect of those Parties that accept it, upon acceptance by two thirds of the Parties and thereafter for each other Party upon acceptance by it;
- b) for all Parties upon acceptance by two thirds of the Parties if it is an amendment that the Committee, by consensus, has determined to be of a nature that would not alter the rights and obligations of the Parties.

## ***Withdrawal***

12. Any Party may withdraw from this Agreement. The withdrawal shall take effect upon the expiration of 60 days from the date the Director-General of the WTO receives written notice of the withdrawal. Any Party may, upon such notification, request an immediate meeting of the Committee.

13. Where a Party to this Agreement ceases to be a Member of the WTO, it shall cease to be a Party to this Agreement with effect on the date on which it ceases to be a Member of the WTO.

## ***Non-application of this Agreement between Particular Parties***

14. This Agreement shall not apply as between any two Parties where either Party, at the time either Party accepts or accedes to this Agreement, does not consent to such application.

## ***Appendices***

15. The Appendices to this Agreement constitute an integral part thereof.

### ***Secretariat***

16. This Agreement shall be serviced by the WTO Secretariat.

### ***Deposit***

17. This Agreement shall be deposited with the Director-General of the WTO, who shall promptly furnish to each Party a certified true copy of this Agreement, of each rectification or modification thereto pursuant to Article XIX and of each amendment pursuant to paragraph 11, and a notification of each accession thereto pursuant to paragraph 2 and of each withdrawal pursuant to paragraphs 12 or 13.

### ***Registration***

18. This Agreement shall be registered in accordance with the provisions of Article 102 of the Charter of the United Nations.



## ADDITIONAL LEGAL TEXTS

### Decision on Arbitration Procedures pursuant to Article XIX:8 of the revised GPA\*

The Committee on Government Procurement ("the Committee"),

*Noting* that Article XIX:8 of the Revised Agreement on Government Procurement ("the Agreement") requires the Committee to develop arbitration procedures to facilitate resolution of objections under Article XIX:2 of the Agreement; and

*Confirming* the importance of Article XIX:8(b) and (c) of the Agreement to these arbitration procedures and reiterating the Parties' commitment to adopt decisions pursuant to Article XIX:8(b) and (c) of the Agreement.

*Hereby adopts* the following arbitration procedures to facilitate the resolution of objections under Article XIX:2 of the Agreement:

#### **Invocation of Arbitration Procedures**

1. Pursuant to Article XIX:7 of the Agreement, where the modifying Party and an objecting Party are unable to resolve an objection to a proposed modification under Article XIX:1 of the Agreement, the modifying Party or any objecting Party may refer the proposed modification to arbitration, stating the reasons for its request, by notifying the Committee no earlier than 45 days after the date of circulation of the notification of the proposed modification under Article XIX:1 of the Agreement.
2. Where two or more Parties refer the same proposed modification to arbitration prior to the appointment of all the arbitrators, the modifying Party and all objecting Parties shall agree to a single arbitration addressing all objections to the same proposed modification. If additional referrals on the same proposed modification are made after the appointment of all the arbitrators, the modifying Party and all objecting Parties shall agree to a single arbitration whenever feasible.

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\* Decision of the Committee of 22 June 2016 (GPA/139, of 23 June 2016).

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## ***Appointment of the Arbitrators***

3. Arbitration shall be carried out by arbitrators. Unless the Parties to the arbitration otherwise agree, there shall be three arbitrators. Arbitrators shall meet the requirements set out for panelists under Articles 8(1), 8(2), and 8(9) of the Understanding on Rules and Procedures Governing the Settlement of Disputes.

4. The Secretariat of the Committee shall on request from a Party to the arbitration, propose nominations for the arbitrators. The Parties to the arbitration shall not oppose nominations except for compelling reasons. Citizens of the Parties to the arbitration and government officials of the third Parties shall not be appointed as arbitrators, unless otherwise agreed by the Parties to the arbitration.

5. Where the Parties to the arbitration cannot agree on who should be appointed as arbitrators within 20 days after referring the proposed modification to arbitration, at the request of a Party to the arbitration, the Director-General shall appoint the arbitrators within 10 days, after consulting Parties to the arbitration and the Chair of the Committee.

## ***Third Party Participation***

6. Any Party to the Agreement having a substantial interest in a proposed modification brought to arbitration and having notified its interest to the Committee (referred to herein as "third Party") within 10 days after the proposed modification being referred to arbitration shall be invited to make a written submission, attend substantive meetings of the arbitrators with the Parties to the arbitration, make oral statements, and be entitled to respond to questions from the arbitrators.

## **Procedures**

7. In its proceedings, the arbitrators shall apply the relevant provisions of the Agreement and be guided by the decision adopted by the Committee in accordance with Article XIX:8(b) of the Agreement, once it is adopted. In addition, the following working procedures shall apply:

- a) The Secretariat of the Committee shall promptly transmit to the arbitrators the applicable notification and objection under paragraph 1 or 2 of Article XIX of the Agreement. Within 10 days of the appointment of the arbitrators, and after consultations with the Parties to the arbitration, the arbitrators shall adopt a timetable for the conduct of the arbitration proceedings. The timetable should be based on the timetable included in the Annex to this Decision.
- b) Unless the Parties to the arbitration agree that it is unnecessary, the arbitrators shall hold a substantive meeting with the Parties to the arbitration. Before the substantive meeting, the Parties to the arbitration shall transmit to the arbitrators written submissions in which they present the facts of the case and their arguments.
- c) Where a Party to the arbitration submits information that it has designated as confidential to the arbitrators, the arbitrators, the other Parties to the arbitration and third Parties shall treat that information as confidential. Upon request of a Party to the arbitration, the arbitrators shall establish additional procedures necessary to preserve the confidentiality of such information.”
- d) Where a Party to the arbitration designates information in its written submissions as confidential, the Party shall, on request of another Party to the arbitration or a third Party, provide a non-confidential summary of the information contained in its submission that could be disclosed to the public.
- e) At the substantive meeting, the arbitrators shall ask the Party that has requested arbitration to present its case by making an oral submission. The Party against which the arbitration has been brought shall then be asked to present its point of view by making an oral submission.

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- f) The substantive meetings of the arbitrators shall be open to the public, except where a Party to the arbitration requests that the meeting be closed to protect information designated as confidential.
  - g) The arbitrators may, at any time, put questions to the Parties to the arbitration and third Parties and ask them for explanations either in the course of the meeting or in writing.
  - h) The written submissions of the Parties to the arbitration, including any responses to questions put by the arbitrators, shall be made available to the other Party or Parties to the arbitration as well as to the third Parties. The Parties to the arbitration shall submit a written version of their oral statements made at the meeting with the arbitrators to the arbitrators, the other Party or Parties to the arbitration and to the third Parties.
  - i) The written submissions, responses to questions, and written versions of oral statements of the third Parties shall be made available to the arbitrators, the Parties to the arbitration and other third Parties, and shall be reflected in the arbitrators' report.
  - j) The deliberations of the arbitrators shall be kept confidential.
  - k) The arbitrators may seek information from any relevant source and may consult experts. The arbitrators shall provide to the Parties to the arbitration and third Parties any information provided to or received from experts. The Parties to the arbitration shall have an opportunity to comment on any input received from experts.
  - l) Any additional procedures specific to the arbitration shall be determined by the arbitrators in consultation with the Parties to the arbitration.
  - m) Subject to paragraph 7.c., nothing in these procedures shall preclude a Party to the arbitration or a third Party from disclosing statements of its own positions to the public.

8. *The Rules of Conduct for the Understanding on Rules and Procedures Governing the Settlement of Disputes* shall apply to each person serving as an arbitrator under these procedures and, as specified in the *Rules of Conduct*



and the relevant provisions of the Staff Regulations, to those members of the Secretariat called upon to assist the arbitrators.

9. Where Parties to the arbitration reach a mutually agreed solution to objections to the proposed modification, they shall promptly notify the arbitrators. Upon receipt of the notification, the arbitrators shall terminate the proceedings for those Parties. The details of any mutually agreed solution shall be notified to the Committee, where any Party to the Agreement may comment.

### ***Arbitrators' Determination***

10. The terms of reference for the arbitrators shall require the arbitrators to determine:

- a) in the case of a proposed withdrawal under Article XIX:1(a) of the Agreement, whether government control or influence over the covered procurement of the entity proposed to be withdrawn has been effectively eliminated; or
- b) in the case of any other proposed modification under Article XIX:1(b), whether the proposed modification maintains a balance of rights and obligations and a comparable level of mutually agreed coverage provided in the Agreement and, where appropriate, the level of compensatory adjustment.

11. The arbitrators shall issue a report containing its reasoned determination to the Parties to the arbitration within 90 days or, in the event that the timetable is modified by the arbitrators, no later than 120 days of:

- a) the appointment of the arbitrators where an arbitration is conducted pursuant to paragraph 1.; or
- b) the request where an arbitration is conducted pursuant to paragraph 12.

The time period set out in this paragraph may be extended by mutual agreement of the Parties to the arbitration. The Secretariat of the Committee shall promptly circulate the report to the Parties to the Agreement following translation.

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12. Where the arbitrators make a negative determination under paragraph 10.a., and where the arbitrators made no determination of compensatory adjustment under paragraph 10.b., any Party to the arbitration may request after 30 days and no later than 60 days following the circulation of the arbitrators' report that the same arbitrators, where available, shall determine the level of compensatory adjustment that would result in a comparable level of coverage and maintain the balance of rights and obligations under the Agreement. In doing so, the arbitrators shall be guided by the decision adopted by the Committee in accordance with Article XIX:8(c) of the Agreement, once it is adopted. Where any of the original arbitrators are not available, a replacement shall be appointed in accordance with paragraphs 3. to 5.

### ***Implementation***

13. The Parties to the arbitration shall accept the arbitrators' determination as final.

14. For the purposes of Article XIX:7(b)(i) of the Agreement, the arbitration procedures are completed:

- a) when a report under paragraph 11. that does not give rise to the right to further proceedings under paragraph 12. is circulated to the Parties to the Agreement; or
- b) where Parties to the arbitration do not exercise a right available to them under paragraph 12., upon the expiration of the time period set out in that paragraph.

## Annex

### *Proposed timetable for arbitration*

The arbitrators shall base the timetable adopted under paragraph 7.a. on the following:

- a) Receipt of written submissions of the Parties to the arbitration:
  - (1) Requesting Party: ----- 2 weeks
  - (2) Responding Party: ----- 2 weeks
- b) Receipt of third party submissions: ----- 1 week
- c) Substantive meeting with the arbitrators: ----- 1-2 weeks
- d) Responses to questions to Parties and third Parties to the arbitration: ----- 1-2 weeks
- e) Issuance and circulation of the arbitrators' report on its determination: ----- 4 weeks

Consistent with the provisions of paragraph 11., the arbitrators may change the above timetable and may schedule additional meetings with the Parties to the arbitration after consulting them.



# General Agreement on Tariffs and Trade (GATT 1994)

## Article III\*

### *National Treatment on Internal Taxation and Regulation*

1. The contracting parties recognize that internal taxes and other internal charges, and laws, regulations and requirements affecting the internal sale, offering for sale, purchase, transportation, distribution or use of products, and internal quantitative regulations requiring the mixture, processing or use of products in specified amounts or proportions, should not be applied to imported or domestic products so as to afford protection to domestic production.\*\*

2. The products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products. Moreover, no contracting party shall otherwise apply internal taxes or other internal

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\* Any internal tax or other internal charge, or any law, regulation or requirement of the kind referred to in paragraph 1 which applies to an imported product and to the like domestic product and is collected or enforced in the case of the imported product at the time or point of importation, is nevertheless to be regarded as an internal tax or other internal charge, or a law, regulation or requirement of the kind referred to in paragraph 1, and is accordingly subject to the provisions of Article III.

\*\* The application of paragraph 1 to internal taxes imposed by local governments and authorities with the territory of a contracting party is subject to the provisions of the final paragraph of Article XXIV. The term "reasonable measures" in the last-mentioned paragraph would not require, for example, the repeal of existing national legislation authorizing local governments to impose internal taxes which, although technically inconsistent with the letter of Article III, are not in fact inconsistent with its spirit, if such repeal would result in a serious financial hardship for the local governments or authorities concerned. With regard to taxation by local governments or authorities which is inconsistent with both the letter and spirit of Article III, the term "reasonable measures" would permit a contracting party to eliminate the inconsistent taxation gradually over a transition period, if abrupt action would create serious administrative and financial difficulties.

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charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1.<sup>\*\*\*</sup>

3. With respect to any existing internal tax which is inconsistent with the provisions of paragraph 2, but which is specifically authorized under a trade agreement, in force on April 10, 1947, in which the import duty on the taxed product is bound against increase, the contracting party imposing the tax shall be free to postpone the application of the provisions of paragraph 2 to such tax until such time as it can obtain release from the obligations of such trade agreement in order to permit the increase of such duty to the extent necessary to compensate for the elimination of the protective element of the tax.

4. The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use. The provisions of this paragraph shall not prevent the application of differential internal transportation charges which are based exclusively on the economic operation of the means of transport and not on the nationality of the product.

5. No contracting party shall establish or maintain any internal quantitative regulation relating to the mixture, processing or use of products in specified amounts or proportions which requires, directly or indirectly, that any specified amount or proportion of any product which is the subject of the regulation must be supplied from domestic sources. Moreover, no contracting party shall otherwise apply internal quantitative regulations in a manner contrary to the principles set forth in paragraph 1.<sup>\*\*\*\*</sup>

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<sup>\*\*\*</sup> A tax conforming to the requirements of the first sentence of paragraph 2 would be considered to be inconsistent with the provisions of the second sentence only in cases where competition was involved between, on the one hand, the taxed product and, on the other hand, a directly competitive or substitutable product which was not similarly taxed.

<sup>\*\*\*\*</sup> Regulations consistent with the provisions of the first sentence of paragraph 5 shall not be considered to be contrary to the provisions of the second sentence in any case in which all of the products subject to the regulations are produced domestically in substantial quantities. A regulation cannot be justified as being consistent with the provisions of the second sentence on the ground that the proportion or amount allocated to each of the products which are the subject of the regulation constitutes an equitable relationship between imported and domestic products.

6. The provisions of paragraph 5 shall not apply to any internal quantitative regulation in force in the territory of any contracting party on July 1, 1939, April 10, 1947, or March 24, 1948, at the option of that contracting party; Provided that any such regulation which is contrary to the provisions of paragraph 5 shall not be modified to the detriment of imports and shall be treated as a customs duty for the purpose of negotiation.

7. No internal quantitative regulation relating to the mixture, processing or use of products in specified amounts or proportions shall be applied in such a manner as to allocate any such amount or proportion among external sources of supply.

8. (a) The provisions of this Article shall not apply to laws, regulations or requirements governing the procurement by governmental agencies of products purchased for governmental purposes and not with a view to commercial resale or with a view to use in the production of goods for commercial sale.

(b) The provisions of this Article shall not prevent the payment of subsidies exclusively to domestic producers, including payments to domestic producers derived from the proceeds of internal taxes or charges applied consistently with the provisions of this Article and subsidies effected through governmental purchases of domestic products.

9. The contracting parties recognize that internal maximum price control measures, even though conforming to the other provisions of this Article, can have effects prejudicial to the interests of contracting parties supplying imported products. Accordingly, contracting parties applying such measures shall take account of the interests of exporting contracting parties with a view to avoiding to the fullest practicable extent such prejudicial effects.

10. The provisions of this Article shall not prevent any contracting party from establishing or maintaining internal quantitative regulations relating to exposed cinematograph films and meeting the requirements of Article IV.





# General Agreement on Trade in Services

## Article II

### *Most-Favoured-Nation Treatment*

1. With respect to any measure covered by this Agreement, each Member shall accord immediately and unconditionally to services and service suppliers of any other Member treatment no less favourable than that it accords to like services and service suppliers of any other country.
2. A Member may maintain a measure inconsistent with paragraph 1 provided that such a measure is listed in, and meets the conditions of, the Annex on Article II Exemptions.
3. The provisions of this Agreement shall not be so construed as to prevent any Member from conferring or according advantages to adjacent countries in order to facilitate exchanges limited to contiguous frontier zones of services that are both locally produced and consumed.

## Article XIII

### *Government Procurement*

1. Articles II, XVI and XVII shall not apply to laws, regulations or requirements governing the procurement by governmental agencies of services purchased for governmental purposes and not with a view to commercial resale or with a view to use in the supply of services for commercial sale.
2. There shall be multilateral negotiations on government procurement in services under this Agreement within two years from the date of entry into force of the WTO Agreement.

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## Article XVI

### Market Access

1. With respect to market access through the modes of supply identified in Article I, each Member shall accord services and service suppliers of any other Member treatment no less favourable than that provided for under the terms, limitations and conditions agreed and specified in its Schedule.<sup>1</sup>

2. In sectors where market-access commitments are undertaken, the measures which a Member shall not maintain or adopt either on the basis of a regional subdivision or on the basis of its entire territory, unless otherwise specified in its Schedule, are defined as:

- (a) limitations on the number of service suppliers whether in the form of numerical quotas, monopolies, exclusive service suppliers or the requirements of an economic needs test;
- (b) limitations on the total value of service transactions or assets in the form of numerical quotas or the requirement of an economic needs test;
- (c) limitations on the total number of service operations or on the total quantity of service output expressed in terms of designated numerical units in the form of quotas or the requirement of an economic needs test;<sup>2</sup>
- (d) limitations on the total number of natural persons that may be employed in a particular service sector or that a service supplier may employ and who are necessary for, and directly related to, the

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<sup>1</sup> If a Member undertakes a market-access commitment in relation to the supply of a service through the mode of supply referred to in subparagraph 2(a) of Article I and if the cross-border movement of capital is an essential part of the service itself, that Member is thereby committed to allow such movement of capital. If a Member undertakes a market-access commitment in relation to the supply of a service through the mode of supply referred to in subparagraph 2(c) of Article I, it is thereby committed to allow related transfers of capital into its territory.

<sup>2</sup> Subparagraph 2(c) does not cover measures of a Member which limit inputs for the supply of services.

supply of a specific service in the form of numerical quotas or the requirement of an economic needs test;

- (e) measures which restrict or require specific types of legal entity or joint venture through which a service supplier may supply a service; and
- (f) limitations on the participation of foreign capital in terms of maximum percentage limit on foreign shareholding or the total value of individual or aggregate foreign investment.

## Article XVII

### *National Treatment*

1. In the sectors inscribed in its Schedule, and subject to any conditions and qualifications set out therein, each Member shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favourable than that it accords to its own like services and service suppliers.<sup>3</sup>

2. A Member may meet the requirement of paragraph 1 by according to services and service suppliers of any other Member, either formally identical treatment or formally different treatment to that it accords to its own like services and service suppliers.

3. Formally identical or formally different treatment shall be considered to be less favourable if it modifies the conditions of competition in favour of services or service suppliers of the Member compared to like services or service suppliers of any other Member.

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<sup>3</sup> Specific commitments assumed under this Article shall not be construed to require any Member to compensate for any inherent competitive disadvantages which result from the foreign character of the relevant services or service suppliers.



# Understanding on Rules and Procedures Governing the Settlement of Disputes

## Article 1

### *Coverage and Application*

1. The rules and procedures of this Understanding shall apply to disputes brought pursuant to the consultation and dispute settlement provisions of the agreements listed in Appendix 1 to this Understanding (referred to in this Understanding as the "covered agreements"). The rules and procedures of this Understanding shall also apply to consultations and the settlement of disputes between Members concerning their rights and obligations under the provisions of the Agreement Establishing the World Trade Organization (referred to in this Understanding as the "WTO Agreement") and of this Understanding taken in isolation or in combination with any other covered agreement.

2. The rules and procedures of this Understanding shall apply subject to such special or additional rules and procedures on dispute settlement contained in the covered agreements as are identified in Appendix 2 to this Understanding. To the extent that there is a difference between the rules and procedures of this Understanding and the special or additional rules and procedures set forth in Appendix 2, the special or additional rules and procedures in Appendix 2 shall prevail. In disputes involving rules and procedures under more than one covered agreement, if there is a conflict between special or additional rules and procedures of such agreements under review, and where the parties to the dispute cannot agree on rules and procedures within 20 days of the establishment of the panel, the Chairman of the Dispute Settlement Body provided for in paragraph 1 of Article 2 (referred to in this Understanding as the "DSB"), in consultation with the parties to the dispute, shall determine the rules and procedures to be followed within 10 days after a request by either Member. The Chairman shall be guided by the principle that special or additional rules and procedures should be used where possible, and the rules and procedures set out in this Understanding should be used to the extent necessary to avoid conflict.

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## Article 2

### *Administration*

1. The Dispute Settlement Body is hereby established to administer these rules and procedures and, except as otherwise provided in a covered agreement, the consultation and dispute settlement provisions of the covered agreements. Accordingly, the DSB shall have the authority to establish panels, adopt panel and Appellate Body reports, maintain surveillance of implementation of rulings and recommendations, and authorize suspension of concessions and other obligations under the covered agreements. With respect to disputes arising under a covered agreement which is a Plurilateral Trade Agreement, the term "Member" as used herein shall refer only to those Members that are parties to the relevant Plurilateral Trade Agreement. Where the DSB administers the dispute settlement provisions of a Plurilateral Trade Agreement, only those Members that are parties to that Agreement may participate in decisions or actions taken by the DSB with respect to that dispute.

2. The DSB shall inform the relevant WTO Councils and Committees of any developments in disputes related to provisions of the respective covered agreements.

3. The DSB shall meet as often as necessary to carry out its functions within the time-frames provided in this Understanding.

4. Where the rules and procedures of this Understanding provide for the DSB to take a decision, it shall do so by consensus.<sup>4</sup>

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<sup>4</sup> The DSB shall be deemed to have decided by consensus on a matter submitted for its consideration, if no Member, present at the meeting of the DSB when the decision is taken, formally objects to the proposed decision.

# Appendix 1

## ***Agreements covered by the Understanding***

- (A) Agreement Establishing the World Trade Organization
- (B) Multilateral Trade Agreements
  - Annex 1A: Multilateral Agreements on Trade in Goods
  - Annex 1B: General Agreement on Trade in Services
  - Annex 1C: Agreement on Trade-Related Aspects of Intellectual Property Rights
  
  - Annex 2: Understanding on Rules and Procedures Governing the Settlement of Disputes
- (C) Plurilateral Trade Agreements
  - Annex 4: Agreement on Trade in Civil Aircraft  
Agreement on Government Procurement  
International Dairy Agreement  
International Bovine Meat Agreement

The applicability of this Understanding to the Plurilateral Trade Agreements shall be subject to the adoption of a decision by the parties to each agreement setting out the terms for the application of the Understanding to the individual agreement, including any special or additional rules or procedures for inclusion in Appendix 2, as notified to the DSB.

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## Appendix 2

### ***Special or additional rules and procedures contained in the covered agreements***

#### ***Agreement Rules and Procedures***

Agreement on the Application of Sanitary and Phytosanitary Measures	11.2
Agreement on Textiles and Clothing	2.14, 2.21, 4.4, 5.2, 5.4, 5.6, 6.9, 6.10, 6.11, 8.1 through 8.12
Agreement on Technical Barriers to Trade	14.2 through 14.4, Annex 2
Agreement on Implementation of Article VI of GATT 1994	17.4 through 17.7
Agreement on Implementation of Article VII of GATT 1994	19.3 through 19.5, Annex II.2(f), 3, 9, 21
Agreement on Subsidies and Countervailing Measures	4.2 through 4.12, 6.6, 7.2 through 7.10, 8.5, footnote 35, 24.4, 27.7, Annex V
General Agreement on Trade in Services	XXII:3, XXIII:3
Annex on Financial Services	4
Annex on Air Transport Services	4
Decision on Certain Dispute Settlement Procedures for the GATS	1 through 5



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The list of rules and procedures in this Appendix includes provisions where only a part of the provision may be relevant in this context.

Any special or additional rules or procedures in the Plurilateral Trade Agreements as determined by the competent bodies of each agreement and as notified to the DSB.



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Integrated Government Procurement Market Access Information (e-GPA):  
<https://e-gpa.wto.org/> 

**Editorial note:** The 1994 Agreement on Government Procurement was amended through the Protocol Amending the Agreement on Government Procurement, done at Geneva on 30 March 2012, which entered into force on 6 April 2014 (Appendix 1 to GPA/113 of 2 April 2012). This volume only reproduces the amended version of this Agreement.

**LEGAL AUTHORITY CA-88**

# Bank Policy

## Procurement in IPF and Other Operational Procurement Matters

### **Bank Access to Information Policy Designation**

Public

### **Catalogue Number**

OPSVP5.05-POL.144

### **Issued**

November 7, 2017

### **Effective**

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### **Last Revised On**

November 2, 2017

### **Content**

Sets out Bank Policy governing procurement activities financed by IPF, the Bank's support to Borrowers in the area of building procurement capacity, and other operational procurement matters

### **Applicable to**

IBRD,IDA

### **Issuer**

Vice President, OPSVP

### **Sponsor**

Chief Procurement Officer, OPSPR

## SECTION I – PURPOSE AND APPLICATION

1. This Policy sets out a vision, the key principles, and policy requirements governing the procurement of goods, works, non-consulting services, and consulting services financed by the Bank (in whole or in part) through IPF operations, excluding procurement under Bank guarantees and under Bank-financed loans made by eligible financial intermediaries, for which the final recipient of loan funds is a private borrower.
2. This Policy applies to the Bank.

## SECTION II – DEFINITIONS AND ACRONYMS

As used in this Policy, the capitalized terms and acronyms have the meanings set out below.

1. **Anti-Corruption Guidelines:** the [“Guidelines on Preventing and Combating Fraud and Corruption in Projects Financed by IBRD Loans and IDA Credits and Grants.”](#)
2. **APA:** alternative procurement arrangements.
3. **Bank:** IBRD and IDA (whether acting in its own capacity or as administrator of trust funds funded by other donors).
4. **Board:** the Executive Directors of IBRD or IDA, or both, as applicable.
5. **Borrower:** a borrower or recipient of the IPF, and any other entity involved in the implementation of the project financed by the IPF.
6. **Core Procurement Principles:** the principles set out in Section III.C of this Policy.
7. **CPO:** Chief Procurement Officer.
8. **Financing:** a loan, credit, or grant made by the Bank from its resources or from trust funds funded by other donors and administered by the Bank, or a combination of these.
9. **IBRD:** International Bank for Reconstruction and Development.
10. **IDA:** International Development Association.
11. **IFC:** International Finance Corporation.
12. **Investment Project Financing (IPF):** Bank Financing described in paragraph 1 of Section III of the IPF Policy.
13. **IPF Policy:** Bank Policy, [“Investment Project Financing.”](#)
14. **Management:** the President or a Manager of the Bank, or a chief officer whose functions and responsibilities include the authority to issue P&P Documents as set out by Management through terms of reference or a delegation of authority, or some or all of these persons, as applicable.

15. **Manager:** a person identified as a manager in the Bank’s human resources system.
16. **MIGA:** Multilateral Investment Guarantee Agency.
17. **OPCS:** Operations Policy and Country Services.
18. **OPSVP:** Operations Policy Vice President.
19. **P&P Document:** a document defined in Section II.10 of the Bank Policy, “[Policy and Procedure Framework](#).”
20. **Procurement Framework:** a framework consisting of this Policy and other procurement requirements and procurement guidance adopted by Management.
21. **Project Procurement Strategy for Development (PPSD):** a strategy referred to in Section III.G of this Policy.
22. **Procurement Plan:** a plan referred to in Section III.G of this Policy.
23. **Procurement Process:** a process covering all the stages of procurement.
24. **WBG:** IBRD, IDA, IFC, MIGA.
25. **WBG Sanctions Framework:** a framework consisting of WBG Policy, “[Sanctions for Fraud and Corruption](#)”, and other related P&P Documents adopted by Management.

## SECTION III – SCOPE

### A. Vision

Procurement in IPF operations supports Borrowers to achieve value for money with integrity in delivering sustainable development. To achieve this vision, the Bank seeks assurance from Borrowers that acceptable procurement arrangements are applied to the financial resources it provides to Borrowers, and supports Borrower countries in enhancing and implementing sound procurement systems and institutions. The Bank may support country capacity building at the level of the project or as part of the country dialogue, using a range of measures—funding, technical support, and hands-on expanded implementation support (in selected cases)—depending on the specific context of the country, sector, agency, or project.

### B. Preamble

This Policy is based on and, with other Bank fiduciary rules and practices, fulfils the requirements of the IBRD Articles of Agreement (Article III, Section 5(b) and IDA Articles of Agreement (Article V, Section 1(g)) to ensure that the proceeds of Bank Financing are used only for the purposes for which the Financing was granted, with due attention to considerations of economy and efficiency, without regard to political or other non-economic influences or considerations.



## C. Core Procurement Principles

All procurement actions under this Policy are governed by and are consistent with the following Core Procurement Principles.

1. **Value for money.** The principle of value for money means the effective, efficient, and economic use of resources, which requires an evaluation of relevant costs and benefits, along with an assessment of risks, and non-price attributes and/or life cycle costs, as appropriate. Price alone may not necessarily represent value for money.
2. **Economy.** The principle of economy takes into consideration factors such as sustainability, quality, and non-price attributes and/or life cycle cost as appropriate, that support value for money. It permits integrating into the Procurement Process economic, environmental, and social considerations that the Bank has agreed with the Borrower. It also permits augmenting identified sustainability criteria with specific criteria in support of the Borrower's own sustainable procurement policy.
3. **Integrity.** The principle of integrity refers to the use of funds, resources, assets, and authority according to the intended purposes and in a manner that is well informed, aligned with the public interest, and aligned with broader principles of good governance. The Bank therefore requires that all parties involved in the Procurement Process, including without limitation, Borrowers and sub-Borrowers (and other beneficiaries of Bank Financing); bidders, consultants, contractors, and suppliers; any sub-contractors, sub-consultants, service providers or suppliers; any agents (whether declared or not); and any of their personnel, observe the highest standard of ethics during the Procurement Process of Bank-financed contracts, and refrain from fraud and corruption, as that term is defined in the Anti-Corruption Guidelines.
4. **Fit for Purpose.** The principle of fit for purpose applies both to the intended outcomes and the procurement arrangements in determining the most appropriate approach to meet the project development objectives and outcomes, taking into account the context and the risk, value, and complexity of the procurement.
5. **Efficiency.** The principle of efficiency requires that Procurement Processes be proportional to the value and risks of the underlying project activities. Procurement arrangements are generally time-sensitive and strive to avoid delays.
6. **Transparency.** The principle of transparency requires that the Borrower and the Bank enable appropriate review of the procurement activities, supported by appropriate documentation and disclosure. Transparency requires (i) that relevant procurement information be made publicly available to all interested parties, consistently and in a timely manner, through readily accessible and widely available sources at reasonable or no cost; (ii) appropriate reporting of procurement activities; and (iii) the use of confidentiality provisions in contracts only where justified.
7. **Fairness.** The principle of fairness refers to (i) equal opportunity and treatment for bidders and consultants; (ii) equitable distribution of rights and obligations between Borrowers and suppliers, bidders, consultants, and contractors; and (iii) credible mechanisms for addressing procurement-related complaints and providing recourse. Open competitive procurement is the Bank's preferred procurement approach, whenever possible, to maximize fairness of

opportunity to bid. Whenever possible, the Bank requires that eligible individuals and firms be given the same opportunities to compete for Bank-financed activities.

#### **D. Governance**

1. **Accountability.** The concept of accountability, as it applies to the Bank and Borrowers, combines the requirements of transparency and responsibility, and holds those involved in the Procurement Process accountable for their actions (or inactions).
2. **Conflict of Interest.** The Bank requires that all parties involved in the Procurement Process not have a conflict of interest, unless such a conflict has been resolved in a manner acceptable to the Bank.
3. **Eligibility.** The Bank permits firms and individuals from all countries to offer goods, works, non-consulting services, and consulting services for Bank-financed projects, subject to other Bank rules on eligibility and participation.
4. **Complaints and Contract-related Communications.** Procurement-related complaints and communications related to contractual matters may be brought to the attention of the Borrower or the Bank at the appropriate stage of the Procurement Process. They make every effort to address such complaints and other communications objectively and in a timely manner, with transparency and fairness.
5. **Noncompliance.** If the Borrower or other parties involved in the Procurement Process do not comply with the applicable procurement requirements, the Bank may, in addition to the contractual remedies set out in the relevant legal agreement, take other appropriate actions consistent with the terms and conditions of the legal agreement and the Bank's implementation support and monitoring role.

#### **E. Roles and Responsibilities**

The Bank's and Borrower's roles and responsibilities, including in the area of procurement, are set out in paragraphs 19 and 21 of Section III of the IPF Policy. In seeking to ensure that funds are used only for the purposes for which the Financing was granted, the Bank carries out its procurement functions, including procurement oversight, under a risk-based approach.

#### **F. Alternative Procurement Arrangements**

1. Subject to paragraph 2 of this Section III.F, at the Borrower's request, the Bank may agree to (a) rely on and apply the procurement rules and procedures of another multilateral or bilateral agency or organization, and may agree to such a party taking a leading role in providing the implementation support and monitoring of project procurement activities; and (b) rely on and apply the procurement rules and procedures of an agency or entity of the Borrower.
2. The alternative procurement arrangements referred to in paragraph 1 of this Section III.F are consistent with the provisions set out in Section III.C and Section III.D of this Policy, and ensure that the WBG Sanctions Framework and Anti-Corruption Guidelines, contractual remedies set out in its legal agreements with the Borrower, and other terms and conditions necessary to address the particular circumstances of the proposed APA apply.

## **G. Project Procurement Strategy for Development and Procurement Plan**

The Bank requires the Borrower to develop a Project Procurement Strategy for Development and a Procurement Plan for each IPF operation. The PPSD describes how the project procurement activities support the development objectives of the project. The scope and details of the PPSD take into account, and are proportional to, the relevant market, scale, risk, value, and country circumstances, including, when applicable, situations of urgent need of assistance or capacity constraints, and the specific economic, environmental, and social objectives of the project. The Procurement Plan is based on the PPSD and sets out the selection methods to be followed by the Borrower during project implementation in the procurement of goods, works, non-consulting services, and consulting services financed by the Bank.

## **H. Interpretation and Modification of the Policy**

The Executive Directors of the Bank interpret and, as necessary, modify this Policy. Management also interprets this Policy, and recommends to the Executive Directors any necessary Policy modifications.

### **SECTION IV – WAIVER**

The provisions of this Policy may be waived in accordance with the Bank Policy “[Operational Policy Waivers](#)”; and the Bank Procedure “[Operational Policy Waivers and Waivers of Operational Requirements](#).”

### **SECTION V – EFFECTIVE DATE**

This Policy is effective on July 1, 2016.

### **SECTION VI – ISSUER**

The issuer of this Policy is the OPSVP.

### **SECTION VII – SPONSOR**

The sponsor of this Policy is the CPO, OPCS.

### **SECTION VIII – RELATED DOCUMENTS**

Bank Directive, “[Guidelines on Preventing and Combating Fraud and Corruption in Projects Financed by IBRD Loans and IDA Credits and Grants](#).”

Bank Directive, “[Policy and Procedure Framework](#).”

Bank Directive, “[Procurement in IPF and Other Procurement Operational Matters](#).”

Bank Policy, [“Investment Project Financing.”](#)

Bank Policy, [“Operational Policy Waivers.”](#)

Bank Procedure, [“Policy and Procedure Framework.”](#)

Bank Procedure, [“Procurement in IPF and Other Operational Procurement Matters.”](#)

Bank Procedure, [“Working Arrangements among the Global Practices, the Regions, INT and OPCS Concerning Fraud and Corruption.”](#)

Bank Procedure, [“Small Recipient-Executed Trust Fund Grants.”](#)

Board Paper, [“Procurement in World Bank Investment Project Financing Phase II: The New Procurement Framework,”](#) R2015-0120, dated June 17, 2015.

[“Instructions: Additional Financing for Investment Project Financing.”](#)

[“Instructions: Investment Project Implementation Support to Project Completion.”](#)

[“Instructions: Preparation of Investment Project Financing \(Track 1\)”](#)

[“Instructions: Preparation of Investment Project Financing \(Track 2\)”](#)

[“Instructions: Preparation of Investment Project Financing - Situations of Urgent Need of Assistance or Capacity Constraints.”](#)

[“Instructions for Suspension, Cancellation and Placement of Bank Loans in Nonperforming Status.”](#)

[“World Bank Procurement Regulations for IPF Borrowers.”](#)

[WBG Sanctions Framework.](#)

## SECTION IX – REVISION HISTORY

November 1, 2017: This updates the Procurement Policy issued on June 28, 2016 to reflect new nomenclature of the IPF framework, retrofitted into the Bank Policy, Policy and Procedure Framework.

Questions about this Policy should be addressed to the CPO, OPCS.

## **LEGAL AUTHORITY CA-89**



**MAPS**

Methodology for Assessing  
Procurement Systems

# METHODOLOGY FOR ASSESSING PROCUREMENT SYSTEMS (MAPS)

2018







# METHODOLOGY FOR ASSESSING PROCUREMENT SYSTEMS (MAPS)

## FOREWORD

**Public procurement is a crucial component of public services delivery, good governance and sustainable economies with inclusive growth.** Governments around the world spend approximately USD 9.5 trillion in public contracts every year. This fact means that on average, public procurement constitutes around 12%-20% of a country's GDP.<sup>1</sup> The strengthening of public procurement systems is thus central for achieving concrete and sustainable results and to build effective institutions.

The Methodology for Assessing Procurement Systems (MAPS) was initially developed in 2003/2004, thanks to the collective efforts of many stakeholders. Its goal was to assess and improve public procurement systems by providing a common tool for analysing information on key aspects of any system. **MAPS has been widely used to assess the quality and effectiveness of public procurement systems** and, based on the strengths and weaknesses identified, to develop strategies and implement reforms. These efforts typically focused on creating the foundation for a well-functioning public procurement system by establishing a legal, regulatory and institutional framework.

This revision to the original MAPS reflects a modern understanding of public procurement, taking account of global developments and improvements suggested by the wide array of users and stakeholders. **The new MAPS is a universal tool that aims to catalyse and accelerate the implementation of modern, efficient, sustainable and more inclusive public procurement systems in all countries.** MAPS assessments highlight where reforms are most needed and indicate how reforms can be best carried out.

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<sup>1</sup> 12% in OECD countries and 18%-20% in the European Union; this percentage may be higher in some developing countries.



The MAPS revision was guided by several considerations:

- **Value for money**, reflecting the basic goal that every procurement system should be providing the required goods, works and services in an economic, efficient, effective and sustainable way.
- **Transparency**, reflecting the basic and commonly agreed-upon principle of disclosure to make policies, legal and institutional frameworks and information related to decisions available to the public in a comprehensible, accessible and timely manner.
- **Fairness**, reflecting the ambition that the public procurement process should be free from bias, ensure equal treatment and take decisions accordingly, thus ensuring integrity.
- **Good governance**, recognising the importance of the wider governance context on the way public procurement is conducted and how reforms to procurement are implemented. This aspect includes reflection of horizontal procurement goals, policy considerations and integrity principles.

**Contextual elements have been integrated to ensure that the application of MAPS helps contribute to effectiveness.** Among those considerations are national policy objectives, including targets on sustainability, support for the private sector, civil service reform, etc., as well as other factors that create an enabling environment for a well-functioning procurement system, such as good public financial management, accountability, legal certainty and workforce capacity.

The new version of MAPS is timely in the wake of the launch of the Sustainable Development Goals (SDGs). **Like the SDGs, MAPS will be relevant for all countries, irrespective of income level or development status.** MAPS is related to Goal 12, which calls for the promotion of sustainable procurement practices in line with national priorities and policies, and Goal 16, which calls for effective and accountable institutions. In addition, MAPS is anchored in the 2015 Organisation for Economic Co-operation and Development (OECD) Recommendation of the Council on Public Procurement and is reflective of leading international procurement frameworks such as the United Nations Commission on International Trade Law (UNCITRAL) Model Law on Public Procurement (2011), the European Union (EU) Directives on Public Procurement (2014), and the procurement frameworks used by multilateral development banks, countries and implementing institutions. It provides a holistic assessment framework, establishing the criteria of an effective and efficient procurement system that all countries should strive to achieve.

The MAPS revision process was a co-operative effort that included countries and partners alike. The draft revised MAPS methodology was open to public consultations and was further vetted in a testing and piloting phase involving a diverse set of countries spanning various income categories and development situations, to ensure broad participation and contributions from the public and private sector as well as civil society.

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# SECTION I – USER’S GUIDE

## Introduction

### Objective of the User’s Guide

1. This User’s Guide aims to facilitate a consistent approach to the application of the Methodology for Assessing Procurement Systems (MAPS), focusing on how the findings can be most effectively translated into reforms.

### Purpose and use of the methodology

2. MAPS is intended to provide a harmonised tool for use in the assessment of public procurement systems. The methodology is designed to enable a country, with or without the support of external partners, to conduct an assessment of its procurement system in order to determine its strengths and weaknesses. The resulting information can serve as the basis for harmonised system development and reform initiatives<sup>2</sup> that can improve capacity and address any weaknesses. The assessment also provides the country with information it can use to monitor the performance of its system and evaluate the success of the reform initiatives in improving performance. By identifying weaknesses in a country’s current system, it also offers external partners information that can help them determine risks to the funds they provide to partner countries.
3. MAPS is a universal tool. It aims to lay the foundation for a well-governed public procurement system that helps meet policy objectives, increase public trust, enhance well-being and build more prosperous and inclusive societies. It is guided by the principles value for money, transparency, fairness and good governance. The 2017 version of MAPS embodies high aspirational standards and serves as a guide toward reform, rather than setting out minimum standards that countries are universally required to attain. Depending on the conditions in a given country, for example in the case of fragile states that are vulnerable to conflict, these aspirational standards may only be achievable over a longer period.
4. The MAPS assessment is neither an audit of a procurement system, nor intended as a substitute for a fiduciary assessment by the country, a donor or other external partners, if required. It aims to provide a common assessment tool for countries and for the international community, irrespective of geographical application.

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2 The terms “reform initiatives” and “system development” are used interchangeably in this methodology.

# Analytical Framework (Overview)

## Building blocks

5. The MAPS analytical framework consists of a core assessment methodology and a number of supplementary modules.
6. The MAPS core methodology described in this document provides a comprehensive approach for assessing procurement systems. It defines the structure for conducting a country context analysis, presents a refined indicator system for assessing the quality and performance of the system in terms of outcomes and results, and describes the key elements of the assessment process.
7. Supplementary modules are progressively being developed to complement the core assessment methodology. They focus on specific policy areas of public procurement and can be used by countries depending on their needs.

## Analysis of country context

8. Section II, “Analysis of country context”, presents a structured approach for analysing the local environment, to ensure that the assessment is anchored in a country’s specific needs and that the different elements of the MAPS analytical framework are applied appropriately.
9. The context analysis draws on easily accessible information and existing data, and focuses on a number of factors essential for procurement reform. These include the country’s economic situation, its national policy objectives, the public procurement reform environment, and the relationship between the public procurement system, the public finance management and the public governance systems. The context analysis also identifies key stakeholders formally and informally linked to public procurement structures.

## Indicator system

10. The MAPS indicator system is described in detail in Section III, “Assessment of public procurement systems”. It rests on four pillars: i) the existing legal and policy framework regulating procurement in the country; ii) the institutional framework and management capacity; iii) the operation of the system and competitiveness of the national market; and iv) the accountability, integrity and transparency of the procurement system.
11. Each pillar has a number of indicators and sub-indicators to assess. The indicator system has a total of 14 indicators and 55 sub-indicators, which, taken together, present the criteria for a snapshot comparison of the system against the stated principles. The indicators are expressed in qualitative and/or quantitative terms, as appropriate. Figure 1 (below) outlines the overall structure of MAPS.

Figure 1. Overview of MAPS



12. The indicators often refer to the procurement law and to the legal framework. The reference to the procurement law is to the supreme legal instrument governing public procurement in the country. The form or nature of the supreme law varies depending on a country's legal system (common law, civil law, etc.) and on tradition.<sup>3</sup> In general, this document assumes an over-arching supreme legal instrument, then proceeds to the regulations that provide further detailed legal interpretation and detailed procedures for administering them. In some instances, legal obligations related to public procurement may also derive from memberships in international and/or regional associations or treaties. Other national laws, including on budget, construction or competition, may also impose obligations that guide public procurement. The entire set of legal instruments relating to public procurement is designated as the "legal framework".

### Application of indicators

13. Each indicator and sub-indicator is preceded by a short text that outlines the elements that the sub-indicator attempts to assess and describes the nature and importance of the item in question. This aims to guide the assessor to the relevant aspects to be reviewed and to specified principles or standards. The criteria to be considered under each sub-indicator are then presented in a table titled "Assessment criteria". The assessment criteria establish the basis on which the system will be assessed (qualitative indicators). A set of quantitative indicators offers the opportunity to substantiate the assessment of several sub-indicators by taking performance-related data into account.

<sup>3</sup> Some countries have laws and others may have acts, decrees, circulars or regulations.

14. Each sub-indicator should be assessed using the following three-step approach:
- i) review of the system, applying assessment criteria expressed in qualitative terms;
  - ii) review of the system, applying a defined set of quantitative indicators;<sup>4</sup>
  - iii) identification of substantive or material gaps (gap analysis).

### **Step 1: Review of the system applying assessment criteria expressed in qualitative terms**

15. Step 1 of the assessment is based on a qualitative review of the existing regulatory and policy framework, as well as institutional and operational arrangements, to determine whether or not the prescribed standard has been attained. Certain indicators do not lend themselves to assessment through hard evidence (i.e. facts and figures) and may require surveys or interviews with stakeholders and participants in public procurement, such as professional associations, representatives of civil society, independent media or well-recognised and respected investigative journalists, and government officials, as indicated in this guide.
16. A narrative report should provide detailed information on this comparison (that is, on the actual situation in relation to the assessment criteria) and on changes that may be under way. This narrative will enable the assessors to analyse the strengths and weaknesses of the system.

### **Step 2: Review of the system applying a defined set of quantitative indicators**

17. Step 2 of the assessment focuses on the application of a (minimum) set of 15 quantitative indicators. These are closely related to the prevailing procurement practices in the country and are therefore often referred to as performance indicators. Quantitative indicators are useful for demonstrating results, for example by examining a sample of procurement transactions and other relevant information deemed representative of the performance of the system.
18. The narrative report should provide the detailed findings of this analysis. In countries where the necessary data is unavailable or unreliable, the particular circumstances should be explained in the narrative report.
19. Quantitative indicators are not benchmarked against set standards but can be used by the country to define baselines, set national targets and measure progress over time. Additional quantitative indicators are recommended for optional use as appropriate (refer to “Recommended quantitative indicators”).

### **Step 3: Analysis and determination of substantive or material gaps (gap analysis)**

20. The assessment findings are further analysed and interpreted (Step 3) to identify the areas that show material or substantial gaps and require action to improve the quality and performance of the system.
21. A substantive or material gap exists when any of the following situations arises:
- The system exhibits less than substantial achievement of the stated criteria.
  - Any of the essential elements of the indicator (e.g. independence, objectivity, timeliness) are missing.
  - There is enough evidence that a provision in the legal/regulatory framework is not working as intended (i.e. factual evidence or conclusive outcome from interviews or from the analysis of procurement practices).
22. To substantiate the gaps identified in Steps 1 and 2 of the assessment, an analysis in greater depth may be conducted. This can be achieved by a more comprehensive qualitative review of existing arrangements and/or through an expanded analysis of public procurement practices (e.g. by increasing the sample size of procurement cases analysed).
23. If substantiated, the sub-indicator should be clearly marked as exhibiting a “substantive gap”, to demonstrate the need to develop adequate actions to improve the quality and performance of the system. Any deeper analysis that is

<sup>4</sup> The workflows for steps 1 and 2 can be organised in parallel.

conducted should be fully explained in the detailed assessment report, to ensure consistency and comparability of assessments. Additional evidence and conclusions should be reflected in the report.

24. Should the assessor identify factors likely to prevent appropriate action to improve the public procurement system, “red flags” should be assigned. These are used to highlight any element that could significantly impede the main goals of public procurement and that cannot be mitigated directly or indirectly. Such factors could also lie outside the sphere of public procurement, for example:
- Assessors/government do not agree on the assessment results (e.g. substantive gaps).
  - Other national laws or regional/international agreements impose conflicting obligations.
  - Other factors prevent improvement of the public procurement system (e.g. political economy; jurisdiction; interdependence of problems/complexity, etc.).

### **Limits of indicator application**

25. The indicators alone cannot give a full picture of a procurement system, which is by nature complex. They should be seen as a vehicle for identifying the strengths and weaknesses of the system in broad terms. The indicators also serve as support for a more thorough analysis to be carried out by the assessor, as indicated above.
26. The application of indicators allows for professional judgements by the assessor. Subjectivity should be reduced to a minimum to ensure that assessments carried out by different assessors maintain reasonable consistency and comparability for analytical purposes. This is one of the main objectives of the methodology and of this guide. The assessor should also bear in mind that there is no single model for a procurement system and that different models have been developed world wide that may work well in one political, institutional or cultural setting, but not in another.
27. The decision on the scope of performance measurement and data collection should be made specific to the country and be based on the availability of data and the country’s objectives. The decision should consider cost effectiveness as well as the sustainability of data collection and analysis to ensure the long-term monitoring of procurement performance.
28. The application of Indicator 9 includes an analysis of selected procurement cases (“sample cases”). One of the most important steps in planning the assessment is to carefully consider the sample of cases that will be assessed. This selected review of actual procurement proceedings provides an additional means of evaluation, while recognising that a sample always represents a selected perception of reality and never the reality in its entirety. The sample should thus provide enough information to arrive at conclusions that can be regarded as valid at an aggregate level. Sampling strategies and sampling sizes need to be carefully considered, and how representative they are and their level of certainty should be clearly defined. Depending on the circumstances and the country’s strategic objectives, sampling could, for example, focus on top-spending procuring entities or, alternatively, cut across different levels of government, to cover a number of national and sub-national procuring entities. Details of the sampling approach should be disclosed in the assessment report.
29. All quantitative indicators have been aligned with procurement data required in Public Expenditure and Financial Accountability (PEFA) assessments (PEFA Performance Indicator PI-24)<sup>5</sup> for consistency in assessments and policy formulation.

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5 PEFA Performance Measurement Framework (2016): PI-24 ([www.pefa.org](http://www.pefa.org)).



# Assessment Process

## Planning and preparing the assessment

30. Advanced planning is needed to appropriately scope and time the assessment, define management arrangements, set up the assessment team, arrange for the collection of the information required and identify stakeholders to be interviewed or surveyed. Advance planning is especially important if the assessment will be jointly sponsored by the government and interested external partners. Planning will enable co-ordination of the work and the agreement to be reached on critical aspects of the assessment. Peer reviews, where representatives from other governments, agencies or relevant international organisations take part in the assessment exercise, can complement a MAPS exercise. Whether or not an assessment should be conducted as a peer review or whether it should involve other forms of third-party quality assurance (for example, by the MAPS secretariat) should also be decided in advance.
31. To ensure a demand-driven assessment process, the country should consider preparing a concept note covering the following questions:
- What is the primary objective(s) of conducting a MAPS assessment?
  - Are there specific issues to focus on?
  - Which parts of the government need to be covered?
  - Which parts of the MAPS methodology (core tool/supplementary modules) need to be applied to deliver the desired outcomes?
  - Who is leading the assessment and what are the different roles of the members of the assessment team?
  - Was there a MAPS assessment in the past, and what were its results?
  - Are other assessments related to public procurement available (e.g. PEFA assessment reports, political economy analyses)?
  - Which information sources are available to gather the required information?
  - Which quantitative indicators will be used for performance measurement?
  - Who are the key stakeholders who should be involved in the assessment?
  - To what extent should the assessment include the review of actual procurement cases (see Indicator 9)?
  - How will the sample be designed, and which agencies will be included?
  - How will the findings be validated and recommendations be discussed? Should the assessment involve peers/ external experts to review the assessment (refer to paragraph 39)?
  - How will the assessment results be communicated/published and used?
  - How much time, external support and budget will be needed?
32. The government can demonstrate high-level political commitment by establishing strong leadership arrangements for the assessment. To ensure cross-departmental co-operation and openness, the government should consider establishing a time-bound MAPS Assessment Steering Committee.
33. Identifying a qualified team of assessors is critical to the credibility and reliability of the exercise. Assessors should preferably be seasoned public procurement practitioners with ample knowledge of the legal, institutional and operational aspects of the subject and of internationally accepted procurement practice. They should be well-informed on the recommended use of the tool, to enhance shared understanding and to encourage consistency in its application. Assessors external to the government should work with a counterpart team from the government to facilitate access to information and logistical support. Assessors should be free of conflicts of interest that could arise from their current or previous roles.
34. Successful reforms depend on actively and appropriately engaging stakeholders throughout the process. In the early stages of the assessment, stakeholders should be engaged through appropriate communication (on the objectives, scope, process, timelines, lead entity, etc.) and targeted interviews. The “Analysis of country context” will help identify the key stakeholders that are formally and informally linked to the public procurement structures in the country.

35. It is recommended that the following categories of stakeholders be engaged: the authority in charge of the assessment (typically the regulatory authority, ministry, or centre of government), the procurement normative/regulatory body, the procurement appeals body, a selected number of procuring entities, representatives of the private sector (including the banking sector involved in financing public sector investment projects) and civil society, authorities responsible for budgeting/payment/internal controls, audit authorities, anti-corruption agencies, competition bodies, international partners engaged in the country, training institutions, the professional bodies, academia, research institutions and media.

## Conducting the assessment

36. The assessment should clarify its objectives, identify the current situation and engage key stakeholders.
37. The assessment should establish a clear timetable for the following steps: data collection; analysis of findings (determination of strengths and weaknesses); and, as applicable, developing recommendations for a prioritised reform strategy intended to address any weaknesses identified.

## Validation of findings

38. To ensure that the assessment process is valid and credible, it is recommended that a validation exercise involving key stakeholders be conducted. This provides an opportunity to agree on the findings of the assessment, on reform priorities and on a shared strategy for addressing key weaknesses in the system.
39. A more robust quality-assurance approach involves a review of compliance with the assessment process and assessment report with the MAPS methodology and the quality review of assessment results by the MAPS Secretariat and a designated MAPS Technical Advisory Group. This more comprehensive quality-assurance mechanism has been designed to allow for the external certification of MAPS assessments.<sup>6</sup>

## Assessment Report

40. One of the main goals of carrying out an assessment based on the methodology in this document is to provide a tool that countries can use to formulate reforms, improve their national procurement systems and align them with internationally accepted good practice. The assessment process also provides a unique opportunity to learn and increase capacity for governments and partners alike. A narrative analytical report is useful to the involved governments and their external partners interested in supporting and strengthening programs. A report of this kind gives context to the assessment, providing the assessor’s evaluation of the system as a whole and of progress on the individual items assessed.
41. The suggested outline of the report is as follows:
- an executive summary of the report, with an overview of the assessment results against the four pillars mentioned in paragraph 10. The executive summary should highlight the strengths and weaknesses of the system, their relative importance, the major risks identified and their likely consequences for the efficiency of the system.
  - an introductory section that presents the background of the assessment, its scope and nature, the limitations encountered in the assessment, and any other matters essential for understanding the context and circumstances under which the assessment was carried out.
  - a section that describes the country context (see Section II, “Analysis of country context”, for further details), including:
    - i) a brief review of the most relevant aspects of the country’s political, economic and geostrategic situation;

<sup>6</sup> For further details refer to the following website: [mapsinitiative.org](http://mapsinitiative.org).

- ii) the public procurement system and its relationship with the systems of public finance management and public governance;
  - iii) national policy objectives, with a focus on issues that influence public procurement;
  - iv) public procurement reform, including government ownership, reform priorities, key stakeholders, incentives and challenges that may influence the success of reforms.
- a section that discusses the findings of the assessment in relation to each of the pillars and indicators. This should also describe any existing government programmes or initiatives or those that are at an advanced stage of consideration. As appropriate, it should also consider how suitable they are for possible support by international partners. Finally, the section should describe any progress that has been made, or, alternatively, any deterioration in the system since the last assessment was carried out.
  - a section on the assessment of outstanding weaknesses in the procurement system, classifying them into categories by the risk they may pose to the system and offering suggestions as to how to keep these risks at an acceptably low level.<sup>7</sup> These suggestions may be used as the basis for a prioritised reform strategy to address any weaknesses identified.
  - the relevant sections and chapters that should be added to the report, if the report is to go beyond simply assessing the system and will propose an action plan or a reform strategy (see below, section on “Strategic planning and monitoring to prepare reforms”).
  - a section of the report providing an account of the steps taken to validate the assessment’s findings, and describing any other elements that could influence the quality of the assessment, such as references on assessors, the time frame available for the assessment, information sources, etc.
  - an annex including detailed assessment results and any evidence documenting the findings. Areas (i.e. sub-indicators) should be clearly highlighted if they exhibit less than full or less than substantial achievement of the described standard and require further action to improve the quality and performance of the system (substantive gaps).<sup>8</sup>

## Strategic Planning and Monitoring to Prepare Reforms

42. The findings of the assessment inform the strategic planning process for future public procurement reform or system development. After the assessment, strategic thinking to clarify the vision, goals and time frame for improving the public procurement system should be developed. The subsequent strategic plan should take this into account and outline a range of possible solutions and indicate how they can be carried out.
43. The strategy should be realistic, aligned with other reform initiatives, ensure a balance of perspectives, and include a good mix of “quick wins”, as well as medium and long-term initiatives. A strategic plan should help guide implementation. The strategic plan should assign roles and responsibilities, define the processes of change, specify allocation of resources, timelines, a results framework, monitoring and evaluation agreements, and the preparation and communication of the strategic planning document.
44. The set of indicators applied in the MAPS assessment could form a useful basis for constructing the results framework for public procurement reforms. A few high-level indicators relating to the strategic goals of the public procurement reform should be identified. In addition, indicators for any of the initiatives included as part of the strategic plan for reform should be identified on two or even three levels: outputs, outcomes and impact.
45. Each indicator needs a baseline and a target. The baseline data is used as the starting point for measuring pro-

<sup>7</sup> Different dimensions of risks should be considered, e.g. fiduciary risks, development risks and reputational risks. Risks can be classified into the following categories: high, medium or low, or alternatively: high, substantial, moderate or low, depending on the risk classification system the country uses. The classification should be based on the standard dimensions of occurrence (probability) and the severity of the consequences (impact).

<sup>8</sup> An electronic assessment tool is being prepared to facilitate data collection, analysis and documentation of detailed assessment results, including supporting documents. In the meantime, an Excel file is available and should be used to present the detailed assessment results and the evidence documenting the findings.

gress. The targets may be either short-term, medium-term or long-term, with interim milestones. Monitoring progress should allow for refinement of the initiatives and potentially the design of new initiatives to address evolving needs.

46. A full update of a MAPS assessment should be performed whenever major changes in legislation occur or other substantive elements of the system change and/or affect the performance of the system (whether positively or negatively).

## Further Information and Support

### **MAPS Secretariat**

47. The MAPS Secretariat offers support to all users of the MAPS methodology upon request, including:
  - advice to country teams for planning and management of a MAPS assessment, including quality review of Concept Notes and Terms of References for MAPS assessments;
  - advice to MAPS assessment teams on the MAPS methodology;
  - quality review of MAPS assessment reports (in collaboration with the MAPS Technical Advisory Group), to provide certification of assessments that meet the quality standards specified.
48. Further information, templates and guidance on applying the MAPS methodology and transforming public procurement systems are available on the following website: [mapsinitiative.org](http://mapsinitiative.org)



# SECTION II – ANALYSIS OF COUNTRY CONTEXT

## Objectives and Scope

This section aims to ensure that the MAPS assessment is based on a better understanding of the context in which public procurement institutions and other stakeholders operate in a particular country. During the assessment and in developing responses to the findings, the political and institutional environment can be considered, to ensure that reforms reflect the country's needs.

For optimum efficiency, this macro-level analysis should be brief. It should draw on easily accessible information and existing data and focus on a limited number of potentially important factors for procurement reform. These factors are: i) the country's political, economic, and geostrategic situation; ii) links between the public procurement system and the public finance management and the public governance systems, iii) national policy objectives affecting public procurement and iv) the public procurement reform environment.

The context analysis should provide a thorough mapping of key stakeholders formally and informally linked to public procurement structures. This will help to engage stakeholders as part of the assessment and as part of future reform processes. Stakeholder engagement in general helps to illuminate how interests, incentives, values and ideas are shaped by formal and informal rules. It can support the development and prioritisation of actions that are feasible and realistic to implement.

The contextual information gathered at this stage can also be used to ensure a targeted application of the MAPS tool. For example, the identification of national policy objectives and key challenges helps scope the MAPS assessment, in particular for the potential application of supplementary modules.

# Structure

The analysis of country context should be structured as follows:<sup>9</sup>

## Analysis of country context

### 1. Political, economic and geostrategic situation of the country:

- i)* economic structures (e.g. population, national income level, resources at the government's disposal vs. debt, geographic location, geopolitical situation, main challenges for growth and development)
- ii)* political structures, nature of the political governance system (e.g. type of government, history/legacies in the form of government, federalism vs. centralisation/roles of the national government and sub-national governments, distinctive features in the allocation of political power, marginalised groups, levels of crime and informality, aspects of fragility or conflict, level of perception of corruption, etc.)<sup>9</sup>
- iii)* international obligations (e.g. international/regional treaties and memberships, including information on potential/pending memberships)

### 2. The public procurement system and its links with the public finance management and public governance systems:

- i)* nature and scope of public procurement (e.g. procurement as a proportion of GDP/government expenditures)
- ii)* key institutions (formal and informal) and their roles in operating the procurement system, including its controls
- iii)* mapping of key external stakeholders formally and informally linked to public procurement structures, their interests and avenues for engagement.

### 3. National policy objectives and sustainable development goals:

- i)* general reform initiatives with a focus on issues that influence public procurement
- ii)* horizontal policy objectives.

### 4. Public procurement reform:

- i)* public procurement reform in the past (brief history/legacies; lessons learned)
- ii)* public procurement priorities, policies, strategies and goals/targets, and their links with public sector/governance/other related reforms
- iii)* incentives that can drive reforms; challenges that can impact the success of reforms.

<sup>9</sup> Further information on how to conduct context/political economy analyses can be found in: UNDP (2012), "Institutional and Context Analysis – Guidance Note", [http://www.undp.org/content/undp/en/home/librarypage/democratic-governance/oslo\\_governance\\_centre/Institutional\\_and\\_Context\\_Analysis\\_Guidance\\_Note/](http://www.undp.org/content/undp/en/home/librarypage/democratic-governance/oslo_governance_centre/Institutional_and_Context_Analysis_Guidance_Note/); Overseas Development Institute (ODI) (2005), "Analytical Framework for Conducting Political Economy Analysis in Sectors", <http://www.odi.org/sites/odi.org.uk/files/odi-assets/publications-opinion-files/3898.pdf>.

<sup>10</sup> Fragility can go beyond the categorisation of "fragile states". The OECD has defined the following five dimensions: i) violence (peaceful societies); ii) access to justice for all (including control of corruption); iii) effective, accountable and inclusive institutions; iv) economic foundations and v) capacity to adapt to social, economic and environmental shocks and disasters. OECD (2015), *States of Fragility 2015: Meeting Post-2015 Ambitions*, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264227699-en>.

## Information Sources

The list of sources to be consulted is as follows:

- national statistics (e.g. Ministry of Finance, etc.),
- national development plans,
- indices, e.g. Doing Business project (World Bank), Government at a Glance (OECD), Country Classifications (World Bank and others), GDP growth rates, Corruption Perception Index, Global Competitiveness Report (World Economic Forum), Human Development Index (UN), etc.,
- databases on international memberships and treaties (e.g. General Agreement on Trade and Tariffs (GATT)/ Agreement on Government Procurement; OECD; regional organisations and trade agreements; signatories to the United Nations Convention against Corruption, etc.),
- previous studies/assessments,
- interviews with relevant experts or sources; critics in media.





# SECTION III – ASSESSMENT OF PUBLIC PROCUREMENT SYSTEMS

## Pillar I. Legal, Regulatory and Policy Framework

Pillar I assesses the existing legal, regulatory and policy framework for public procurement. It identifies the formal rules and procedures governing public procurement and evaluates how they compare to international standards. The practical implementation and operation of this framework is the subject of Pillars II and III. The indicators within Pillar I embrace recent developments and innovations that have been increasingly employed to make public procurement more efficient. Pillar I also considers international obligations and national policy objectives to ensure that public procurement lives up to its important strategic role and contributes to sustainability.

Pillar I refers to four elements of the legal, regulatory and policy framework:

- i)* the supreme legal instrument governing public procurement (laws, acts, decrees)
- ii)* regulations and other instruments that are of a more administrative nature
- iii)* procurement-related provisions in other national laws (e.g. laws governing public private partnerships and concessions, trade and competition, access to information, anti-corruption, alternative dispute resolution, state-owned enterprises, etc.)
- iv)* obligations deriving from international agreements to ensure consistency and policy coherence.

### Indicator 1. The public procurement legal framework achieves the agreed principles and complies with applicable obligations.

The indicator covers the different legal and regulatory instruments established at varying levels, from the highest level (national law, act, regulation, decree, etc.) to detailed regulation, procedures and bidding documents formally in use. This indicator is divided into 12 sub-indicators (a-l), which are individually assessed.

#### **Sub-indicator 1(a) – Scope of application and coverage of the legal and regulatory framework**

The purpose of this sub-indicator is to determine: i) the structure of the regulatory framework governing public procurement; ii) the extent of its coverage; and iii) the public access to the laws and regulations.

The assessor should evaluate the adequacy of the structure of the legal framework, its clarity and the precedence of the different instruments. It is important that the legal framework is differentiated and distinguishes between laws, regulations and procedures and that precedence be firmly established, to minimise inconsistencies in application. Higher-level instruments should normally be less detailed and more stable, since their modification requires higher levels of authority. The higher a provision is placed in the hierarchy of the legal framework, the more stable it is. This means that lower-level instruments should be chosen to regulate more detailed procedures for implementation that require some flexibility (e.g. thresholds).

The assessor should evaluate the extent to which the legal framework applies to all procurement undertaken using public funds (goods, works and services, including consulting services). In addition, the assessor should assess the extent to which national legislation applies to all public bodies and sub-national governments and entities, when national budget funds are used either directly or indirectly.

One aspect to evaluate is whether the laws or regulations exclude particular agencies or areas of public expenditure from the provisions of the law (i.e. the army, defence or similar expenditures, autonomous or specialised state-owned enter-

prises, as well as utility companies with special or exclusive rights). This also includes assessing whether these exclusions are established by law or can be made administratively without public oversight. The assessor should also evaluate whether the public procurement law or other national laws support and regulate the contracting of other forms of public service delivery that are closely related to public procurement, such as public/private partnerships (PPPs), including concessions. (Specific characteristics are assessed under sub-indicator 1(l)).

Uniformity and universality of coverage contribute to predictability and savings in the operation of the procurement system. Access to the rules and regulations contribute to transparency, which results in more economic procurement.

Laws and policies can be made accessible by keeping them in places that are easily accessible to the public. Preferably, the information should be published on line on a single, freely accessible online portal (refer to sub-indicator 7(a)). If the information is primarily posted on the Internet, the assessor should verify whether the information is accessible to the public and regularly updated.

#### Assessment criteria

The legal and regulatory body of norms complies with the following conditions:

- (a) Is adequately recorded and organised hierarchically (laws, decrees, regulations, procedures), and precedence is clearly established.
- (b) It covers goods, works and services, including consulting services for all procurement using public funds.
- (c) PPPs, including concessions, are regulated.
- (d) Current laws, regulations and policies are published and easily accessible to the public at no cost.<sup>10</sup>

### Sub-indicator 1(b) – Procurement methods

This sub-indicator assesses whether the legal framework includes: i) a clear definition of the permissible procurement methods; and ii) the circumstances under which each method is appropriate.

The legal framework should provide an appropriate range of procurement methods comprising competitive and less competitive procedures, when appropriate.<sup>12</sup>

The law and regulations should define the situations in which open tendering or alternatives procurement methods can be used and ensure that acceptable justification and approval levels are clearly specified. The application of procurement methods and processes should be proportional to the value and risks of the underlying project activities. This means that in procurement projects with low value or lower risks, lighter methods – such as restricted tendering, request for quotations, etc. – can be applied, when the benefits of some “process-heavier” methods are not evident or necessary. Although open (competitive) tendering should be the standard procurement method, the choice of the method should also depend on the time it takes to follow through on the procedure and strive to avoid delays.

The use of direct awards (single-source procurement) should be analysed and its justifications understood. It is also important to understand how the justifications to avoid more competitive procedures are being used in general. For example, urgency is often an excuse not to use open tendering. However, justifying single-source procurement on the grounds

11 PEFA PI-24.3 (1)

12 The UNCITRAL Model Law on Public Procurement (2011), for example, provides terms, model definitions and procedures for different options (Refer to Chapters II-VII). When specific procurement methods are mentioned in this document, the terms established by UNCITRAL are used.

of an emergency should be permitted only in the exceptional circumstances of a catastrophic event, where there is an extremely important need and where any other method of procurement would be impractical given the time constraints. It should not, however, be used simply because of poor planning.

Fractioning of contracts to avoid open competition should be prohibited, when it aims at circumventing competitive rules.

The legal framework should restrict individual agencies' or procurement officials' discretion. This should result in minimal use of procurement methods that limit competition.

#### Assessment criteria

The legal framework meets the following conditions:

- (a) Procurement methods are established unambiguously at an appropriate hierarchical level, along with the associated conditions under which each method may be used.
- (b) The procurement methods prescribed include competitive and less competitive procurement procedures and provide an appropriate range of options that ensure value for money, fairness, transparency, proportionality and integrity.
- (c) Fractioning of contracts to limit competition is prohibited.
- (d) Appropriate standards for competitive procedures are specified.

#### Sub-indicator 1(c) – Advertising rules and time limits

This sub-indicator assesses whether: i) the legal framework includes requirements to publish procurement opportunities as a matter of public interest and to promote transparency; ii) there is wide and easily accessible publication of business opportunities; and iii) there is adequate time provided between publication of opportunities and the submission date, consistent with the method and complexity of the procurement, to prepare and submit proposals.

Time between publication of the invitation for prequalification applications, or for an open tender and the submission of proposals, depends on the complexity of the procurement and the level of competition expected. If foreign bidders are expected to compete, this is a factor to consider. The law and regulations should establish the criteria for setting the minimum time between the call for proposals and their submission. The timelines may be shortened in case of electronic transmission of procurement notices and bidding documents.

**Assessment criteria**

The legal framework meets the following conditions:

- (a) The legal framework requires that procurement opportunities are publicly advertised, unless the restriction of procurement opportunities is explicitly justified (refer to indicator 1(b)).
- (b) Publication of opportunities provides sufficient time, consistent with the method, nature and complexity of procurement, for potential bidders to obtain documents and respond to the advertisement. The minimum time frames for submission of bids/proposals are defined for each procurement method, and these time frames are extended when international competition is solicited.
- (c) Publication of open tenders is mandated in at least a newspaper of wide national circulation or on a unique Internet official site where all public procurement opportunities are posted. This should be easily accessible at no cost and should not involve other barriers (e.g. technological barriers).
- (d) The content published includes enough information to allow potential bidders to determine whether they are able to submit a bid and are interested in submitting one.

**Sub-indicator 1(d) – Rules on participation**

This sub-indicator assesses the policies that regulate participation and selection, to ensure that they are non-discriminatory. As a general principle, firms, including qualified foreign firms, should not be excluded from participating in a procurement process for reasons other than lack of qualifications, and only in accordance with clearly specified rules on eligibility and exclusions.

There may be cases in which the legal framework will allow restrictions that require purchasing from or associating with domestic firms, or that mandate the inclusion of a minimum of locally manufactured content. Many countries also allow price preferences for domestic firms. Such local content requirements or preferences should be in line with the country's international obligations (e.g. the World Trade Organization-Agreement on Government Procurement, association agreements or free-trade agreements ratified by the country). Excessive price preferences or other concessions for certain groups of bidders can deter competition and reduce efficiency. The assessor should evaluate whether the provisions are adequate and justified, and make sure that they do not undermine the economy and efficiency of the system. The regulatory framework should not oblige foreign firms to associate with local firms or to establish subsidiaries in the country as a condition of bidding. These conditions may promote oligopolistic or monopolistic conditions, rather than promoting the development of local industry, and can become a de facto barrier to competition.

Registration should not be a barrier to participation in a procurement process.

The law should provide for exclusions for criminal or corrupt activities, debarment, subject to due process, and for the prohibition of commercial relations in cases of criminal activity. Firms or individuals that have been the subject of a conviction by final judgment for one of the following reasons should be excluded from participation: participation in a criminal organisation; corruption as defined in the national law of the contracting authority or the firm/individual; fraud; terrorist offences or offences linked to terrorist activities, or inciting or aiding or abetting or attempting to commit such an offence; money laundering or terrorist financing; child labour; and all forms of trafficking in human beings.

The process for reaching decisions on administrative debarment (e.g. failure to perform in earlier contracts, etc.) should be clearly defined, including the process related to any possible appeals. Other legitimate exclusions (e.g. prohibition of commercial relations by law or adherence to UN Security Council sanctions) should be prescribed. Additionally, there may be international agreements that limit participation to members of the agreements.

Participation of state-owned enterprises should be governed by rules that create a level playing field for all competitors

and should not be granted preferential treatment in the form of subsidies or tax exemptions, etc.

The legal framework should detail the procedures that can be used to assess a bidder’s eligibility and ability to perform a specific contract. This assessment can be combined with the procurement documents as part of the specific procurement, or it can be initiated as a separate exercise that is conducted before full offers are requested.

In highly complex procurement, use of multi-stage procedures (for example, pre-qualification or competitive dialogue) can make the procurement more efficient by ensuring that only eligible and qualified participants are included. It can also save money by limiting the number of participants that incur the expense of putting together a comprehensive bid. The circumstances under which multi-stage procedures may be used should be clearly defined, to ensure that they are not abused or used as a method for limiting competition by overstating the qualification requirements. .

#### Assessment criteria

The legal framework meets the following conditions:

- (a) It establishes that participation of interested parties is fair and based on qualification and in accordance with rules on eligibility and exclusions.
- (b) It ensures that there are no barriers to participation in the public procurement market.
- (c) It details the eligibility requirements and provides for exclusions for criminal or corrupt activities, and for administrative debarment under the law, subject to due process or prohibition of commercial relations.
- (d) It establishes rules for the participation of state-owned enterprises that promote fair competition.
- (e) It details the procedures that can be used to determine a bidder’s eligibility and ability to perform a specific contract.

### Sub-indicator 1(e) – Procurement documentation and specifications

The sub-indicator assesses the degree to which the legal framework specifies the content of procurement documents, to enable suppliers to understand clearly what is requested from them and how the procurement process is to be carried out.

Procurement documents should contain sufficient information to enable the submission of responsive tenders/bids/proposals and to establish the basis for a transparent evaluation and award process. Details of the requirements included in the procurement documents should be neutral and refer to international standard specifications where possible or other officially recognised norms that are essentially equivalent to the ones specified. The legal framework should permit and encourage the use of output-based (functional) specifications to promote innovation, when appropriate.

It is important that the content requirements for procurement documents are relevant to making an award decision. Information that is not needed for the process should not be required as part of the submission. Excessive information and documentation requirements are considered to cost money and can reduce competition or lead to disqualification of potential bidders on grounds of unnecessary requirements.

**Assessment criteria**

The legal framework meets the following conditions:

- (a) It establishes the minimum content of the procurement documents and requires that content is relevant and sufficient for suppliers to respond to the requirement.
- (b) It requires the use of neutral specifications, citing international norms when possible, and provides for the use of functional specifications where appropriate.
- (c) It requires recognition of standards that are equivalent, when neutral specifications are not available.
- (d) Potential bidders are allowed to request a clarification of the procurement document, and the procuring entity is required to respond in a timely fashion and communicate the clarification to all potential bidders (in writing)

**Sub-indicator 1(f) – Evaluation and award criteria**

This sub-indicator assesses: i) the quality and sufficiency of the legal framework provisions in respect to the objectivity and transparency of the evaluation process; and, ii) the degree of confidentiality maintained during the process, to minimise the risk of undue influences or abuse.

Pre-disclosed and objective criteria are essential for efficiency, fairness and transparency in the evaluation of bids and proposals. Objectivity means that there is little room for subjective interpretation of the criteria by the evaluator. Vague criteria (e.g. an award to the bid/proposal most convenient for the interests of the state) are not acceptable.

Evaluating and considering the price alone does not in all cases ensure value for money. The principle of value for money requires the evaluation of relevant costs and benefits, along with an assessment of risks and non-price attributes and/or life cycle costs, as appropriate. The legal framework should therefore permit the use of price and non-price attributes and/or the consideration of life cycle costs and environmental/social characteristics, as appropriate in the relevant procurement to ensure value-for-money decisions.

The procuring entity needs to identify the bidders that meet the qualification criteria stipulated in the procurement document, in accordance with applicable rules on eligibility and exclusions. The submitted bid/proposal needs to be substantially responsive. The contract should be awarded to the bidder whose bid/proposal has been determined to offer the lowest evaluated price/cost (if price/cost is the sole criterion) or whose bid/proposal has been determined to be the best evaluated bid/proposal based on the award criteria defined in the procurement document.<sup>13</sup>

Technical capacity and quality are usually key criteria for selection of a large number of procurement processes, including complex procurement, infrastructures, framework agreements or consulting services. While technical qualifications can be assessed by a pass/fail review, in some cases, a scored evaluation of technical qualification against stated criteria is considered necessary to select the most advantageous proposal. The law should specify how this aspect is to be considered. The law should also lay out the conditions under which selection of consulting services may be based exclusively on technical capacity and when price and quality considerations are appropriate.

For cases in which a combination of price/cost and technical capacity or other requirements is permitted by law, the law or regulations should require that the procurement documents state: i) the relative weight to be allocated to the criteria; and ii) the manner in which these criteria are combined. When life-cycle costing is used, the method by which the contracting entity will determine the life-cycle costs (e.g. the consideration of net present value) and the data the bidders

13 Some legal frameworks use the term “most economically advantageous tender” (MEAT).

should provide to make this determination, should be specified. The regulatory framework should prohibit the use of evaluation and award criteria different from those set out in the procurement documents.

Confidentiality and regulated communications with the bidders during the pre-tendering, tendering and evaluation period are necessary to avoid abuse and undue interference in the process. The pre-tendering and tendering include the corresponding clarifications, and the evaluation period runs from the conclusion of the bid opening to the point at which the award of the contract is decided and announced.

Information related to the evaluation process and results should be disclosed to interested parties after the evaluation is complete. There should be rules of disclosure that protect information provided by bidders that is of proprietary nature, or commercially or financially sensitive.

#### **Assessment criteria**

The legal framework mandates that:

- (a) The evaluation criteria are objective, relevant to the subject matter of the contract, and precisely specified in advance in the procurement documents, so that the award decision is made solely on the basis of the criteria stipulated in the documents,
- (b) The use of price and non-price attributes and/or the consideration of life cycle cost is permitted as appropriate to ensure objective and value-for-money decisions.
- (c) Quality is a major consideration in evaluating proposals for consulting services, and clear procedures and methodologies for assessment of technical capacity are defined.
- (d) The way evaluation criteria are combined and their relative weight determined should be clearly defined in the procurement documents.
- (e) During the period of the evaluation, information on the examination, clarification and evaluation of bids/proposals is not disclosed to participants or to others not officially involved in the evaluation process.

### **Sub-indicator 1(g) – Submission, receipt and opening of tenders**

This sub-indicator assesses how the legal framework regulates the reception of tenders<sup>14</sup> and tender opening. Public opening of tenders is a means of increasing the transparency of an open tendering exercise. In cases in which the law prescribes public opening of tenders, bidders or their representatives should be permitted to attend, as well as others with a legitimate interest in the outcome (e.g. representatives of civil society organisations). Opening immediately after the deadline for submission of tenders reduces the possibility of loss or alteration of proposals or submissions.

The exception to this rule may be opening of pre-qualification submissions, including expressions of interest or opening of technical proposals for consulting services (which are not priced), in which case they may be opened privately, followed by a simple notification to all participants of the list of submissions.

14 In this context, the term “tender” is used interchangeably with “bids” or “proposals”.



The law or regulations should establish the information that should be read and recorded for open tendering:

- names and addresses of the bidders
- date and condition the tender was received (to determine compliance with formal requirements)
- tender prices
- any withdrawals or modifications to tenders duly submitted
- any alternative offers requested or permitted (name of bidder, tender prices).

Records should be retained and be available for review and audit purposes.

Clarity on how bids are submitted is critical in minimising rejection of otherwise compliant proposals. The law and the regulations should set out clear provisions in this respect. For example, the number of copies, the sealing and marking of envelopes and in the case of electronic bidding, the security and confidentiality requirements should all be specified.

The bids should be kept secure and confidential prior to bid opening and until after contract award. Publication requirements notwithstanding (refer to sub-indicator 7(a)), the system should at all times take into account the legitimate needs for protection of trade secrets and proprietary information and other privacy concerns, as well as the need to avoid disclosing information that can be used by interested parties to distort competition in the procurement process. The legal framework should include definitions and provisions to unambiguously identify and protect specific sensitive information.

#### Assessment criteria

The legal framework provides for the following provisions:

- (a) Opening of tenders in a defined and regulated proceeding, immediately following the closing date for bid submission.
- (b) Records of proceedings for bid openings are retained and available for review.
- (c) Security and confidentiality of bids is maintained prior to bid opening and until after the award of contracts.
- (d) The disclosure of specific sensitive information is prohibited, as regulated in the legal framework.
- (e) The modality of submitting tenders and receipt by the government is well defined, to avoid unnecessary rejection of tenders.

### Sub-indicator 1(h) – Right to challenge and appeal

The purpose of this indicator is to assess whether the legal framework establishes: i) the right to challenge<sup>15</sup> decisions or actions and to appeal; ii) the matters that are subject to review; iii) the time frame for such reviews; and iv) the different stages in the review process.

Confidence in a procurement system is a powerful incentive to competition. A fundamental part of this is the establishment of the right to challenge decisions or actions by initiating a review of procurement decisions and to appeal by an efficient and functionally independent process. Even though the first review is normally carried out by the procurement entity, there should be an administrative/judicial review body that is independent of the procuring entity. This means that this body has no direct interest in the procurement process, does not report to the procuring entity, and, ideally, is a separate agency or entity.

The legal framework should provide for the right of a participant in a procurement proceeding to challenge decisions or actions

<sup>15</sup> The terms used in this document (“challenge/reviews” and “appeal mechanism”) are interchangeable with terms used in other international procurement instruments such as complaints or protests and review mechanisms or remedies, respectively.

by a procuring entity. This can be done by asking for a review if the participant believes he/she is entitled to claim that he/she has suffered or may suffer loss or injury because of the alleged noncompliance of a decision or action with the provisions of the law.

Applications for a review (challenge) should be submitted to the institution in charge<sup>16</sup> within defined time periods. If the challenges relate to the terms of the solicitation, pre-qualification or pre-selection, they should be submitted prior to the deadline for presenting bids. Challenges relating to other decisions or actions should be submitted prior to the entry into force of the procurement contract, or within the standstill period following the notification of award, if applicable.

The institution in charge of the review should be required to take appropriate actions within a defined time frame (e.g. decide if the application shall be entertained or dismissed and if procurement proceedings shall be suspended; notify the applicant and other participants in the procurement proceedings; take and issue its decision).

The legal framework should provide for the right to appeal a decision following a first review to an independent body (appeals body) within specified timelines. This right should extend to cases in which the institution in charge of the review has failed to issue a decision. The appeals body should have the authority to order the suspension of procurement proceedings, dismiss an application where it decides that it is without merit or was not presented within the specified deadlines, and take and issue decisions appropriate in the circumstances. This should include the authority to confirm, overturn or revise a decision taken by the procuring entity or to prohibit the procuring entity from following a procedure that is not in compliance with the provisions of the law observing defined time frames. The legal framework should specify the range of available remedies in compliance with good international practice.<sup>17</sup>

Appeals to and decisions by the independent appeals body should be public by law and posted in easily accessible places, preferably on a central online platform within specified timelines. The publication of decisions allows interested parties to be better informed as to the consistency and fairness of the process. Publications should be in line with legislation protecting sensitive information.

This sub-indicator is closely linked to Indicator 13 (Efficiency of appeals mechanism).

**Assessment criteria**

The legal framework provides for the following:

- (a) Participants in procurement proceedings have the right to challenge decisions or actions taken by the procuring entity.
- (b) Provisions make it possible to respond to a challenge with administrative review by another body, independent of the procuring entity that has the authority to suspend the award decision and grant remedies, and also establish the right for judicial review.
- (c) Rules establish the matters that are subject to review.
- (d) Rules establish time frames for the submission of challenges and appeals and for issuance of decisions by the institution in charge of the review and the independent appeals body.
- (e) Applications for appeal and decisions are published in easily accessible places and within specified time frames, in line with legislation protecting sensitive information.
- (f) Decisions by the independent appeals body can be subject to higher-level review (judicial review).

16 In many countries, the procuring entity is in charge of responding to an application for a first review (challenge). In some countries, complaints may be sent directly to the independent appeals body.

17 For example, the UNCITRAL Model Law on Public Procurement (2011), Chapter VIII. Challenge proceedings, Article 9, describes the range of actions that should be at the disposal of an appeals body.

### Sub-indicator 1(i) – Contract management

The purpose of this sub-indicator is to assess whether the legal framework establishes the following: i) functions and responsibilities for managing contracts; ii) methods to review, issue and publish contract amendments in a timely manner; iii) requirements for timely payment; and iv) dispute resolution procedures that provide for an efficient and fair process to resolve disputes during the performance of the contract.

To ensure complete and timely implementation of the contract, the following functions and responsibilities for managing contracts should be defined in the legal and regulatory framework:

- monitoring the timely delivery of goods, works and services, including consulting services (“products”)
- inspection, quality control, supervision of civil works and final acceptance of products;
- monitoring of contract performance clauses designed to ensure social or environmental standards, e.g. compliance with International Labour Organization core conventions, application of specific environmental management measures for construction works, etc.
- review, issuance and publication of contract amendments
- examination of invoices and timely processing of payments, including administration of guarantees
- handling of disputes/termination of contracts.

The legal framework should determine the conditions for contract amendments and extensions, to ensure economy and avoid the arbitrary limitation of competition. The legal framework should also define suppliers’ rights in case of late payment.

Disputes during the performance of a contract are a common occurrence. Naturally, disputes can be resolved through judicial proceedings. In some countries, however, litigation may take years to conclude, and the costs may be prohibitive. To avoid long delays in resolving disputes, it should be the policy of the country to accept alternative dispute resolution (ADR). Methods of ADR refer to any means of settling disputes outside the courtroom. Arbitration and mediation are two major forms of ADR.

A framework should be in place that provides for fair and timely resolution, including procedures to enforce the final outcome of a dispute resolution process. For example, there should be an Arbitration Law in the country and the law should be consistent with generally accepted practices for neutrality of arbitrators, due process, expediency and enforceability. The country could accept as a matter of course international arbitration as appropriate. The following are some proposed examples providing for enforcement of the final outcome of an arbitration process: i) the country is a member of the New York Convention on enforcement of international arbitration awards; and ii) the country has procedures to enable the winner in a dispute to seek enforcement of the outcome by going to the courts.

#### Assessment criteria

The legal framework provides for the following:

- (a) Functions for undertaking contract management are defined and responsibilities are clearly assigned,
- (b) Conditions for contract amendments are defined, ensure economy and do not arbitrarily limit competition.
- (c) There are efficient and fair processes to resolve disputes promptly during the performance of the contract.
- (d) The final outcome of a dispute resolution process is enforceable.

### Sub-indicator 1(j) – Electronic procurement (e-Procurement)

This sub-indicator assesses the extent to which the legal framework addresses, permits and/or mandates the use of

electronic methods and instruments for public procurement. The more sophisticated the use of electronic technologies, the more specific are the standards needed to ensure consistent application of the technology, provide for unrestricted and full access to the system, and ensure privacy and security of data and authentication. The use of electronic methods requires standardised formats, technical equipment and connection arrangements, and procedures to grant unrestricted and full access to the e-Procurement system.

An important part of using electronic methods in procurement is the requirement for governments to inform potential bidders which parts of the processes will be managed electronically (e.g. availability of procurement documents, communication, bid submission, contract awards, billing and payments, etc.). The legal framework also needs to clarify whether conventional paper-based procurement is still allowed, whether in parallel or as an alternative to the electronic procurement proceedings.

#### Assessment criteria

The legal framework meets the following conditions:

- (a) The legal framework allows or mandates e-Procurement solutions covering the public procurement cycle, whether entirely or partially.
- (b) The legal framework ensures the use of tools and standards that provide unrestricted and full access to the system, taking into consideration privacy, security of data and authentication.
- (c) The legal framework requires that interested parties be informed which parts of the processes will be managed electronically.

*Further analysis: MAPS Module e-Procurement*

### Sub-indicator 1(k) – Norms for safekeeping of records, documents and electronic data

The ability to look at implementation performance depends on the availability of information and records that track each procurement action. This information is also important for the functioning of both internal and external control systems, as it provides the basis for review.

A system for safekeeping of records and documents should cover the entire procurement process, including contract management, and, at a minimum, include either physical and/or electronic:

- public notices of procurement opportunities
- the procurement method, including justification
- a complete set of bidding/selection documents, including clarifications and any amendments
- bid/proposal opening records
- evaluation reports, including clarifications sought and provided during the evaluation process
- award decisions, including all elements on which the decision was based
- award notices (if applicable)
- formal challenges (requests for review and appeals) by bidders and outcomes
- final signed contract documents and amendments
- contract variations, modifications and changes
- certificates and reports of inspection, quality control and acceptance
- claims and dispute resolutions
- payments
- disbursement data (as required by the country's financial management system)
- any correspondence, meeting notes and minutes, including contract negotiations (if applicable).

There should be a document retention policy that is compatible with the statute of limitations in the country for investigat-

ing and prosecuting cases of fraud and corruption and with the audit cycles. There should also be established security protocols to protect records, either physical or electronic.

#### Assessment criteria

The legal framework provides for the following:

- (a) A comprehensive list is established of the procurement records and documents related to transactions including contract management. This should be kept at the operational level. It should outline what is available for public inspection including conditions for access.
- (b) There is a document retention policy that is both compatible with the statute of limitations in the country for investigating and prosecuting cases of fraud and corruption and compatible with the audit cycles.
- (c) There are established security protocols to protect records (physical and/or electronic).

### Sub-indicator 1(l) – Public procurement principles in specialised legislation

Many countries have adopted specialised legislation governing procurement by entities in the utilities sector, such as water, energy, transport, postal services, etc., and/or regulating the selection and award of concession contracts and other forms of PPPs. This sub-indicator assesses whether public procurement principles (e.g. competitive procedures, transparency, fairness, value-for-money decisions) and related laws apply across the entire spectrum of public service delivery as appropriate.

It is important to understand the competition policies that apply to different sectors and what the specific conditions for conducting public procurement processes in these sectors are. Given the possibility that special or exclusive rights may exist governing the supply or operation of these entities, the market in which these entities operate may be restricted. The range of available procurement methods, the situation in which they can be used, the thresholds, advertising rules and time limits, transparency requirements, risk allocation, challenge and appeals mechanisms and so on, may be regulated in a manner specific to the sector.

Similar questions apply to the selection and contracting of concessions and/or other forms of PPPs. The assessor should describe the government's policy related to PPPs and evaluate to what extent public procurement principles and laws apply in the process of establishing partnerships with private firms. Alternative or supplementary legislation/regulation should be described. Responsibilities for developing policies and supporting the implementation of PPPs should be clearly assigned.

#### Assessment criteria

The legal and regulatory body of norms complies with the following conditions:

- (a) Public procurement principles and/or the legal framework apply in any specialised legislation that governs procurement by entities operating in specific sectors, as appropriate.
- (b) Public procurement principles and/or laws apply to the selection and contracting of public private partnerships (PPP), including concessions as appropriate.
- (c) Responsibilities for developing policies and supporting the implementation of PPPs, including concessions, are clearly assigned.

*Further analysis: MAPS Module on Public Private Partnerships (PPP)*

## Indicator 2. Implementing regulations and tools support the legal framework.

This indicator verifies the existence, availability and quality of implementing regulations, operational procedures, handbooks, model procurement documentation and standard conditions of contract. Ideally the higher-level legislation provides the framework of principles and policies that govern public procurement. Lower-level regulations and more detailed instruments supplement the law, make it operational and indicate how to apply the law to specific circumstances. This indicator consists of four sub-indicators (a-d).

### Sub-indicator 2(a) – Implementing regulations to define processes and procedures

This sub-indicator aims at verifying the existence, clarity, accessibility and comprehensiveness of regulations to the law that further detail and clarify its application. Regulations are an important aspect of a procurement system, as they provide the detail that explains and enables the application of the legal framework in a variety of applications. Regulations should be available to the public in a single accessible place.

#### Assessment criteria

- (a) There are regulations that supplement and detail the provisions of the procurement law, and do not contradict the law.
- (b) The regulations are clear, comprehensive and consolidated as a set of regulations readily available in a single accessible place.
- (c) Responsibility for maintenance of the regulations is clearly established, and the regulations are updated regularly.

### Sub-indicator 2(b) – Model procurement documents for goods, works and services

Model documents of good quality create level playing fields, improve overall procurement standardisation, promote competition and increase confidence in the system. Potential suppliers are more willing to participate when they are familiar with the documents and their interpretation. Model documents should contain the basic required clauses that will be incorporated into contracts. This enables participants to evaluate the cost and risk of mandatory clauses when fulfilling a contract for the government. Model documents should also refer to the standstill period, if applicable, and address the right to challenge decisions or actions and to appeal. If model documents are not available, there should be, at a minimum, a set of standard and mandatory clauses and templates that will help in the formulation of the procurement documents.

#### Assessment criteria

- (a) There are model procurement documents provided for use for a wide range of goods, works and services, including consulting services procured by public entities.
- (b) At a minimum, there is a standard and mandatory set of clauses or templates that reflect the legal framework. These clauses can be used in documents prepared for competitive tendering/bidding.
- (c) The documents are kept up to date, with responsibility for preparation and updating clearly assigned.

### Sub-indicator 2(c) – Standard contract conditions

This sub-indicator focuses on standard contract conditions for public sector contracts covering goods, works and services, including consulting services that set forth the basic provisions that will be included in a contract with the government. Standard contract conditions, also often referred to as general contract conditions (GCC), are based on the laws in the country and generally reflect the commercial codes that deal with contracts between parties. Contract conditions often influence pricing. It is thus important that participants in procurement proceedings know the conditions under which they will perform a contract before they submit a price. The standard contract conditions provide information that enables participants to understand the allocation of risk between parties to a contract as well as other obligations that the signatories to the contract will incur.

It is important that the government establish standard contract conditions that are fair and balanced and reflect laws that impact contracts and their performance. Standard contract conditions should also cover some practical aspects of contract implementation, e.g. general conditions on inspection, quality control and final acceptance of products, and general procedures relating to invoicing and payment. Standard contract conditions should also include provisions on dispute resolution. Alternative Dispute Resolution (ADR), specifically through arbitration, should conform to international standard wording and be used as appropriate. Contract templates can provide an additional source of predictability for participants.

Standard contract conditions need to be mandatory in their use and not subject to negotiations on terms and conditions of contract.

#### Assessment criteria

- (a) There are standard contract conditions for the most common types of contracts, and their use is mandatory.
- (b) The content of the standard contract conditions is generally consistent with internationally accepted practice.
- (c) Standard contract conditions are an integral part of the procurement documents and made available to participants in procurement proceedings.

### Sub-indicator 2(d) – User’s guide or manual for procuring entities

This sub-indicator covers the existence of a user’s guide or manual for procuring entities. This is an important implementation tool that can help provide staff with information that incorporates the law, policy and procedures and helps turn policy into practice. Such tools are more important as a system becomes more decentralised. Creating a manual or user’s guide is often a function of a normative/regulatory body and can help create a consistency of application within the government procurement system. Although not a substitute for training, a manual can contribute to building and maintaining capacity and provides an easy reference for users. Guidance should be specific and comprehensive.

#### Assessment criteria

- (a) There is (a) comprehensive procurement manual(s) detailing all procedures for the correct implementation of procurement regulations and laws.
- (b) Responsibility for maintenance of the manual is clearly established, and the manual is updated regularly.

### Indicator 3. The legal and policy frameworks support the sustainable development of the country and the implementation of international obligations.

This indicator assesses whether horizontal policy objectives, such as goals aiming at increased sustainability, support for certain groups in society, etc., and obligations deriving from international agreements, are consistently and coherently reflected in the legal framework, i.e. whether the legal framework is coherent with the higher policy objectives of the country. The indicator is broken down into two sub-indicators (a-b), which are individually assessed.

#### Sub-indicator 3(a) – Sustainable Public Procurement (SPP)

The 2030 Agenda for Sustainable Development promotes public procurement practices that are sustainable in accordance with national policies and priorities (Sustainable Development Goal 12.7).<sup>18</sup> Following up on more general information gathered in the analysis of the country context (Section II), this sub-indicator assesses whether:

- i)* the country has adopted a policy and an implementation plan to implement Sustainable Public Procurement (SPP)<sup>19</sup> in support of national policy objectives
- ii)* the legal and regulatory framework includes provisions on the inclusion of sustainability criteria in public procurement
- iii)* those provisions require a well-balanced application of sustainability criteria to ensure value for money.

To be effective, SPP should be incorporated in programmes that are part of the country's sustainable development strategy, and their objectives should be consistent with the objectives of public procurement, such as economy, efficiency and transparency, as articulated in Pillar I. An in-depth assessment determining the status quo as well as opportunities for SPP should be conducted to inform the strategic planning process for SPP. The strategic plan should include objectives, indicators and targets in support of national policy objectives. Implementation of SPP should take into account the capacity and training/development needs of the procurement workforce, the development and application of new tools and techniques, prioritisation of measures, impact assessment methodologies to measure the effectiveness of SPP, and the provision of guidance material. It is also necessary to decide which institution is best suited to manage and oversee the nationwide deployment of SPP and/or whether new institutions need to be established (e.g. certification institutions or product-testing facilities).

#### Assessment criteria

- (a) The country has a policy/strategy in place to implement SPP in support of broader national policy objectives.
- (b) The SPP implementation plan is based on an in-depth assessment; systems and tools are in place to operationalise, facilitate and monitor the application of SPP.
- (c) The legal and regulatory frameworks allow for sustainability (i.e. economic, environmental and social criteria) to be incorporated at all stages of the procurement cycle.
- (d) The legal provisions require a well-balanced application of sustainability criteria to ensure value for money.

18 United Nations General Assembly: "Transforming our World: The 2030 Agenda for Sustainable Development", Resolution 70/1 adopted by the General Assembly on 25 September 2015. A/RES/70/1. Goal 12.7: "Promote public procurement practices that are sustainable, in accordance with national policies and priorities." <https://sustainabledevelopment.un.org/post2015/transformingourworld>.

19 Sustainable Public Procurement (SPP) promotes the integration of the three pillars of sustainable development: economic development, social development and environmental protection. Goals of SPP typically focus on reducing demand for resources and minimising any negative impact of goods, works or services across their life cycle. They also aim to ensure fair terms of contracts, including ethical, human rights and employment standards, and to promote diversity and equality throughout the supply chain, for example by providing opportunities for small and medium-sized enterprises or by supporting training and skill development. SPP can also include methods that support innovation.



*Further analysis: MAPS Module on Sustainable Public Procurement (SPP)*

### **Sub-indicator 3(b) – Obligations deriving from international agreements**

Membership in international and/or regional associations or binding international/regional agreements may result in legal obligations relating to public procurement and may shape a country's procurement system. Based on the general information gathered in Section II on the country context, this indicator assesses i) the existence of procurement-related provisions in binding international agreements and ii) the consistent reflection of those obligations in national procurement laws and regulations.

A recognition of the international context is necessary for understanding the presence of certain provisions in the national law and, in some cases, might explain a lack of compliance with certain parameters laid out in this methodology. As noted in Section I, "User's Guide", procurement systems are based on different models. The focus in assessing this indicator is thus to provide clarity on international obligations that impact public procurement in a country and to determine whether relevant provisions have been consistently adopted in the national legal and policy framework for procurement.

#### **Assessment criteria**

Public procurement-related obligations deriving from binding international agreements are:

- (a) clearly established
- (b) consistently adopted in laws and regulations and reflected in procurement policies.

## Pillar II. Institutional Framework and Management Capacity

Pillar II assesses how the procurement system defined by the legal and regulatory framework in a country is operating in practice, through the institutions and management systems that make up overall governance in its public sector.

Pillar II evaluates how effective the procurement system is in discharging the obligations prescribed in the law, without gaps or overlaps. It assesses: i) whether it is adequately linked with the country's public finance management system; ii) whether institutions are in place in charge of necessary functions; and iii) whether the managerial and technical capacities are adequate to undertake efficient and transparent public procurement processes.

### Indicator 4. The public procurement system is mainstreamed and well integrated with the public financial management system.

This indicator focuses on how well integrated the procurement system is with the public financial management system. Two sub-indicators (a-b) are assessed under Indicator 4, given the direct interaction between procurement and financial management, from budget preparation to planning treasury operations for payments.

#### Sub-indicator 4(a) – Procurement planning and the budget cycle

Formulation of annual or multi-annual budgets is based on the outcomes or outputs that the government and its agencies expect to achieve in a given period. Overall government or sector strategies are the basis for this exercise. These determine the multi-year planning, the associated operating plans for each fiscal period and the procurement of goods, works and services necessary to implement the plans. Proper preparation of budgets needs reliable cost data and timetables for planned procurement. Multi-year budgeting and financing should be encouraged, since this offers opportunities for optimising the procurement cycle.

Procurement plans need to be periodically updated, as the budget may be updated and revised to reflect changes in the timing of contracts. Empirical data, such as the actual cost of goods, works and services, provide excellent information for predicting their costs in future budget years. Understanding the timing of major contracts can also help predict cash-flow needs within the government, help make timely payments, and reduce the extra costs associated with delaying completion of contracts and not having adequate funds to finance full performance.

A feedback mechanism should be set up to ensure that the budgetary and financial management systems are providing timely information on contracts covering major budget expenditures, to support the overall financial management system.

#### Assessment criteria

The legal and regulatory framework, financial procedures and systems provide for the following:

- (a) Annual or multi-annual procurement plans are prepared, to facilitate the budget planning and formulation process and to contribute to multi-year planning.
- (b) Budget funds are committed or appropriated in a timely manner and cover the full amount of the contract (or at least the amount necessary to cover the portion of the contract performed within the budget period).
- (c) A feedback mechanism reporting on budget execution is in place, in particular regarding the completion of major contracts.

### Sub-indicator 4(b) – Financial procedures and the procurement cycle

This sub-indicator assesses whether budget laws and financial procedures adequately support the procurement process, i.e. the preparation and timely solicitation and award of contracts, contract execution and timely payments. The systems for procurement, budget and financial management should interact closely: once procurement decisions are made, corresponding actions should be initiated on the budget and financial side. On the other hand, there should be safeguards in the system precluding initiation of procurement actions unless funds have been allocated to the procurement in question.

#### Assessment criteria

The legal and regulatory framework, financial procedures and systems should ensure that:

- (a) No solicitation of tenders/proposals takes place without certification of the availability of funds.
- (b) The national regulations/procedures for processing of invoices and authorisation of payments are followed, publicly available and clear to potential bidders.\*

#### \* Quantitative indicator to substantiate assessment of sub-indicator 4(b) assessment criterion (b):

- invoices for procurement of goods, works and services paid on time (in % of total number of invoices).

Source: PFM systems.<sup>20</sup>

## Indicator 5. The country has an institution in charge of the normative/regulatory function.

This indicator refers to the normative/regulatory function in the public sector and its proper discharge and co-ordination. The assessment of the indicator focuses on the existence, independence and effectiveness of these functions and the degree of co-ordination between responsible organisations. Depending on the institutional set-up chosen by a country, one institution may be in charge of all normative and regulatory functions. In other contexts, key functions may have been assigned to several agencies, e.g. one institution might be responsible for policy, while another might be in charge of training or statistics. As a general rule, the normative/regulatory function should be clearly assigned, without gaps and overlaps. Too much fragmentation should be avoided, and the function should be performed as a well-co-ordinated joint effort. Four sub-indicators (a-d) are to be assessed.

### Sub-indicator 5(a) – Status and legal basis of the normative/regulatory function

The normative/regulatory function and its responsibilities are created by the legal and regulatory framework. This is to ensure that the institution entrusted with the functional responsibilities has an appropriate level of authority, which enables it to function effectively. Alternatively, the legal and regulatory framework may assign the key functions described in sub-indicator 5(b) to different agencies on a clearly defined basis.

#### Assessment criteria

- (a) The legal and regulatory framework specifies the normative/regulatory function and assigns appropriate authorities formal powers to enable the institution to function effectively, or the normative/regulatory functions are clearly assigned to various units within the government.

<sup>20</sup> In case comprehensive data is not available, this quantitative indicator should be applied when reviewing a sample of procurement cases. Refer to sub-indicator 9(c).

### **Sub-indicator 5(b) – Responsibilities of the normative/regulatory function**

The normative/regulatory institution or the institutions entrusted with the normative/ regulatory tasks should have a defined set of responsibilities that include but are not limited to the following:

#### **Assessment criteria**

The following functions are clearly assigned to one or several agencies without creating gaps or overlaps in responsibility:

- (a) providing advice to procuring entities
- (b) drafting procurement policies
- (c) proposing changes/drafting amendments to the legal and regulatory framework
- (d) monitoring public procurement
- (e) providing procurement information
- (f) managing statistical databases
- (g) preparing reports on procurement to other parts of government
- (h) developing and supporting implementation of initiatives for improvements of the public procurement system
- (i) providing tools and documents, including integrity training programmes, to support training and capacity development of the staff responsible for implementing procurement
- (j) supporting the professionalisation of the procurement function (e.g. development of role descriptions, competency profiles and accreditation and certification schemes for the profession)
- (k) designing and managing centralised online platforms and other e-Procurement systems, as appropriate.

### **Sub-indicator 5(c) – Organisation, funding, staffing, and level of independence and authority**

The normative/regulatory function needs to have a high level and authoritative standing in government to be effective, including a degree of independence to enable it to carry out its responsibilities without interference. Adequate funding is necessary to ensure proper staffing and resources to keep the services at the level of quality required.

The head of the normative/regulatory function needs to command sufficient authority within the governance structure to enable the function to exercise its responsibilities.

**Assessment criteria**

- (a) The normative/regulatory function (or the institutions entrusted with responsibilities for the regulatory function if there is not a single institution) and the head of the institution have a high-level and authoritative standing in government.
- (b) Financing is secured by the legal/regulatory framework, to ensure the function's independence and proper staffing.
- (c) The institution's internal organisation, authority and staffing are sufficient and consistent with its responsibilities.

**Sub-indicator 5(d) – Avoiding conflict of interest**

The normative/regulatory function should be free from possible conflicts of interest. Even the appearance of a conflict of interest may undermine confidence in the system and will need to be resolved. The function's responsibilities should therefore provide for separation of duties and clarity, i.e. be structured so as to avoid conflicts of interest. Some functions are not compatible. In particular, individuals or a group of individuals should not be in a position both to perpetrate and to conceal errors or fraud in the normal course of their duties. Individuals should not be directly involved in procurement operations (e.g. as members of evaluation committees), and at the same time be in charge of monitoring/auditing procurement practices or acting on behalf of an appeals body (refer to sub-indicator 12(b)).

This sub-indicator is linked to sub-indicator 14(a).

**Assessment criteria**

- (a) The normative/regulatory institution has a system in place to avoid conflicts of interest.\*

**\* Recommended quantitative indicator to substantiate assessment of sub-indicator 5(d) assessment criterion (a):**

- Perception that the normative/regulatory institution is free from conflicts of interest (in % of responses).

Source: Survey.

**Indicator 6. Procuring entities and their mandates are clearly defined.**

This indicator assesses: i) whether the legal and regulatory framework clearly defines the institutions that have procurement responsibilities and authorities; ii) whether there are provisions for delegating authorities to procurement staff and other government officials to exercise responsibilities in the procurement process, and iii) whether a centralised procuring entity exists. There are two sub-indicators (a-b) to be assessed.

**Sub-indicator 6 (a) – Definition, responsibilities and formal powers of procuring entities**

The legal and regulatory framework should clarify which institutions (or set of institutions) are legally defined as procuring entities. In a centralised system, this may be a centralised procurement body and/or national-level ministries, public bodies and state-owned enterprises or utilities with special or exclusive rights granted by the state. In a decentralised system, procuring entities may cut across all levels of government (e.g. provincial level ministries and public bodies, local communities, etc.). Some countries have established hybrid systems.

The legal and regulatory framework should clearly define the responsibilities of procuring entities. Responsibilities typi-

cally range from procurement planning to managing all stages of the procurement process in accordance with the law. Responsibilities should also include the requirement to establish a designated, specialised procurement function with the necessary management structure, capacity and capability to undertake its duties and responsibilities efficiently and effectively and to assess the results of procurement processes.

There should be provisions in the legal and regulatory framework for delegating decision-making authority (e.g. awarding and executing contracts; acceptance of contractual obligations and initiating payments). Delegation of authority to procuring entities and accordingly to procurement staff and other government officials is a key to a well-functioning system, especially when procurement is decentralised. Without delegation, the system tends to function inefficiently, which can lead to an excessive concentration of decision making under a few individuals without the training or knowledge to make procurement decisions. Decision-making authority should be delegated to the lowest competent levels consistent with the risks associated and the monetary sums involved. Procurement officers should be immune from political interference and should act as the lead in procurement issues.

#### Assessment criteria

The legal framework provides for the following:

- (a) Procuring entities are clearly defined.
- (b) Responsibilities and competencies of procuring entities are clearly defined.
- (c) Procuring entities are required to establish a designated, specialised procurement function with the necessary management structure, capacity and capability.\*
- (d) Decision-making authority is delegated to the lowest competent levels consistent with the risks associated and the monetary sums involved.
- (e) Accountability for decisions is precisely defined.

**\* Quantitative indicator to substantiate assessment of sub-indicator 6(a) assessment criterion (c):**

- procuring entities with a designated, specialised procurement function (in % of total number of procuring entities).

Source: Normative/regulatory function.

### Sub-indicator 6 (b) – Centralised procurement body

Establishing a centralised procurement body (central procuring entity) may enhance the efficiency and effectiveness of a decentralised procurement system. A centralised procurement body might be in charge of consolidating the procurement needs of several public entities; soliciting and concluding framework agreements from which all public entities could call upon according to their needs (e.g. based on electronic catalogues); managing complex procurement, or procurement requiring specialised legal or technical expertise, etc.

If a country establishes a centralised procurement body, the legal and regulatory framework should clearly define the body's responsibilities, formal powers and accountabilities. Processes should be clearly described to ensure an efficient workflow and appropriate communication with the "client" institution (public entity) responsible for service delivery.

In small countries or in countries emerging from conflict situations, procurement capacity is stretched. Here, it may be best to have a centralised procurement body that is responsible for all government procurement, capable of assuring consistency, standardisation and professionalism of the procurement function.

**Assessment criteria**

- (a) The country has considered the benefits of establishing a centralised procurement function in charge of consolidated procurement, framework agreements or specialised procurement.
- (b) In case a centralised procurement body exists, the legal and regulatory framework provides for the following:
  - Legal status, funding, responsibilities and decision-making powers are clearly defined.
  - Accountability for decisions is precisely defined.
  - The body and the head of the body have a high-level and authoritative standing in government.
- (c) The centralised procurement body's internal organisation and staffing are sufficient and consistent with its responsibilities.

## Indicator 7 – Public procurement is embedded in an effective information system.

The objective of this indicator is to assess the extent to which the country or entity has systems to publish procurement information, to efficiently support the different stages of the public procurement process through application of digital technologies, and to manage data that allows for analysis of trends and performance of the entire public procurement system.

The indicator captures the availability, accessibility, integration and reliability of public procurement information systems. Digital technologies, such as online portals and more comprehensive e-Procurement systems, have the potential to significantly increase the efficiency, effectiveness and transparency of public procurement. They support the creation of a state-of-the-art public procurement system, strengthen the accountability framework, and establish the technical foundation for performance measurement. The indicator also assesses the extent to which the system works in practice, by determining the share of public procurement information published and by measuring the uptake of e-Procurement and the availability of statistical information.

There are three sub-indicators (a-c) to be assessed.

### Sub-indicator 7(a) – Publication of public procurement information supported by information technology

The objective of this sub-indicator is to determine:

- i)* the existence and capacity of the procurement information system in the country
- ii)* the accessibility of the information system
- iii)* the coverage of the information system
- iv)* whether the system provides one-stop-service (to the extent feasible) where those interested can find information on procurement opportunities and outcomes.

Public access to procurement information is essential to transparency and creates a basis for social audit by interested stakeholders. Public information should be easy to find, comprehensive and user friendly, providing information of relevance. The assessor should be able to verify easy access and the content of information made available to the public.

In particular, the system should provide for the publication of annual or multi-annual procurement plans, information related to specific procurement such as advertisements or notices of procurement opportunities, procurement method, contract awards including amendments, payments and appeals decisions, linkages to rules and regulations and other information that is relevant to promote competition and transparency (e.g. the law on access to information). For practical purposes, the collection and dissemination of information should focus on procurement above a set value that reflects established thresholds for use of competitive procedures.

The concept of open contracting requires that the government provide an adequate and timely degree of transparency in each phase of the procurement process to stakeholders. This includes specific procurements and the performance of the entire public procurement system, including visibility of the flow of public funds. To support this vision of open contracting in the procurement system, the information system should be extended to include the full set of bidding documents, evaluation reports (or summaries thereof), full contract documents including technical specifications as well as implementation details, in accordance with the legal and regulatory framework, including legislation protecting specific sensitive information (refer to sub-indicator 1(g)).

Information should be consolidated in one place. A centralised online portal should be created for this purpose if the technology is available in the country. Commitment, backed by requirements in the legal/regulatory framework, should ensure that procuring entities duly post the information required on a timely basis. To facilitate searches, information should be published in an open and structured, machine-readable format using unique identifiers and classifications (open data format).

#### Assessment criteria

The country has a system that meets the following requirements:

- (a) Information on procurement is easily accessible in media of wide circulation and availability. Information is relevant, timely and complete and helpful to interested parties to understand the procurement processes and requirements and to monitor outcomes, results and performance.
- (b) There is an integrated information system (centralised online portal) that provides up-to-date information and is easily accessible to all interested parties at no cost.
- (c) The information system provides for the publication of: \*
  - procurement plans
  - information related to specific procurements, at a minimum, advertisements or notices of procurement opportunities, procurement method, contract awards and contract implementation, including amendments, payments and appeals decisions
  - linkages to rules and regulations and other information relevant for promoting competition and transparency.
- (d) In support of the concept of open contracting, more comprehensive information is published on the online portal in each phase of the procurement process, including the full set of bidding documents, evaluation reports, full contract documents including technical specification and implementation details (in accordance with legal and regulatory framework).
- (e) Information is published in an open and structured machine-readable format, using identifiers and classifications (open data format).\*
- (f) Responsibility for the management and operation of the system is clearly defined.



**\* Quantitative indicators to substantiate assessment of sub-indicator 7(a) assessment criterion (c):**

- procurement plans published (in % of total number of required procurement plans)<sup>21</sup>
- key procurement information published along the procurement cycle (in % of total number of contracts)<sup>22</sup>:
- invitation to bid (in % of total number of contracts)
- contract awards (purpose, supplier, value, variations/amendments)
- details related to contract implementation (milestones, completion and payment)
- annual procurement statistics
- appeals decisions posted within the time frames specified in the law (in %).

Source: Centralised online portal.

**\* Recommended quantitative indicator to substantiate assessment of sub-indicator 7(a) assessment criterion (e):**

- Share of procurement information and data published in open data formats (in %).

Source: Centralised online portal.

**Sub-indicator 7(b) – Use of e-Procurement**

This sub-indicator assesses:

- i)* the extent to which e-Procurement is currently used in the country's public sector
- ii)* the capacity of government officials to manage and use e-Procurement systems, and/or
- iii)* the existence of a country strategy to implement e-Procurement.

As a starting point, the assessor should evaluate to what extent and in which form e-Procurement has been implemented in the country. The narrative report should summarise the findings.

e-Procurement is usually implemented gradually and can take different forms. Countries typically start by establishing centralised online portals, used to publish general information related to public procurement (laws, regulations, manuals, templates, etc.). These portals often develop into more refined applications, providing for the publication of procurement plans, bidding opportunities, contract awards, decisions on procurement challenges and appeals, training courses, etc., and can enable sharing reusable open data on public procurement.

More advanced applications include supplier registries and transaction-based e-Procurement systems, which electronically support the entire procurement and contract implementation process (e.g. e-Tendering, e-Catalogues, e-Reverse Auctions, e-Contract Management). These systems deliver a wealth of data necessary for performance measurement and procurement statistics.

Applications can also provide the full procure-to-pay cycle, enabling the integration of the e-Procurement system with financial systems. Other systems as tax, information management or business intelligence systems can also be integrated with e-Procurement systems.

The sub-indicator also assesses whether government officials are adequately skilled to plan, develop and manage e-Procurement systems and reliably and efficiently use them in practice. Suppliers need to be enabled and to have incentives to participate in e-Procurement solutions. In low-technology environments, additional efforts on the part of the government may be necessary to ensure that all companies (including micro, small and medium-sized enterprises) have equal access to a public procurement market increasingly dominated by digital technology. For example, creating decentralised entrepreneurial centres could be considered. These could provide free Internet access, training and support in using the e-Procurement system, significantly improving companies' chances of doing business with public entities.

21 PEFA PI-24.3 (2).

22 PEFA PI-24.3 (3, 4, 5, 6).

If e-Procurement has not yet been implemented, it should be assessed whether the government has adopted an e-Procurement roadmap based on an e-Procurement readiness assessment.

#### Assessment criteria<sup>23</sup>

- (a) e-Procurement is widely used or progressively implemented in the country at all levels of government.\*
- (b) Government officials have the capacity to plan, develop and manage e-Procurement systems.
- (c) Procurement staff is adequately skilled to reliably and efficiently use e-Procurement systems.
- (d) Suppliers (including micro, small and medium-sized enterprises) participate in a public procurement market increasingly dominated by digital technology.\*
- (e) If e-Procurement has not yet been introduced, the government has adopted an e-Procurement roadmap based on an e-Procurement readiness assessment.

#### \* Quantitative indicators to substantiate assessment of sub-indicator 7(b) assessment criterion (a):

- uptake of e-Procurement
- number of e-Procurement procedures in % of total number of procedures
- value of e-Procurement procedures in % of total value of procedures

**Source: e-Procurement system.**

#### \* Recommended quantitative indicators to substantiate assessment of sub-indicator 7(b) assessment criterion (d):

- bids submitted online (in %)
- bids submitted online by micro, small and medium-sized enterprises (in %)

**Source: e-Procurement system.**

*Further analysis: MAPS Module on e-Procurement*

### Sub-indicator 7(c) – Strategies to manage procurement data

Statistical information on procurement is essential to evaluate the policies and the operation of the system. Statistics also provide a means for monitoring performance of the system and compliance with the legal and regulatory framework. Statistical information can also be a tool for procurement planning and market analysis. To ensure comprehensiveness and efficiency, the system should be based on data available in e-Procurement or other information technology systems.

#### Assessment criteria

- (a) A system is in operation for collecting data on the procurement of goods, works and services, including consulting services, supported by e-Procurement or other information technology.
- (b) The system manages data for the entire procurement process and allows for analysis of trends, levels of participation, efficiency and economy of procurement and compliance with requirements.
- (c) The reliability of the information is high (verified by audits).
- (d) Analysis of information is routinely carried out, published and fed back into the system. \*

23 The application of a centralised online portal is assessed under indicators 1(a), 1(h), 7(a), 7(b) and 13(c).

**\* Quantitative indicators to substantiate assessment of sub-indicator 7(c) assessment criterion (d):**

- total number and value of contracts<sup>24</sup>
- public procurement as a share of government expenditure and as share of GDP
- total value of contracts awarded through competitive methods in the most recent fiscal year.<sup>25</sup>

**Source: Normative/regulatory function/e-Procurement system.**

## Indicator 8. The public procurement system has a strong capacity to develop and improve.

This indicator focuses on the strategies and ability of the public procurement systems to develop and improve. Three aspects should be considered:

- i)* whether strategies and programmes are in place to develop the capacity of procurement staff and other key actors involved in public procurement
- ii)* whether procurement is recognised as a profession in the country's public service
- iii)* whether systems have been established and are used to evaluate the outcomes of procurement operations and develop strategic plans to continuously improve the public procurement system.

There are three sub-indicators (a-c) to be assessed.

### Sub-indicator 8(a) – Training, advice and assistance

The purpose of this sub-indicator is to verify existence of permanent and relevant training programmes for new and existing staff in government procurement. These programmes are essential for maintaining the supply of qualified procurement staff to procuring entities. Another objective is to assess the existence and quality of advisory services on procurement matters for public entities, potential suppliers and the general public.

The evaluator should look at the curricula of the existing programmes and judge their relevance, nature, scope and sustainability. A well-functioning system should be:

- i)* based on a “skills gap inventory” to match the needs of the system
- ii)* be sufficient in terms of content and frequency
- iii)* provide for evaluation of the training programme and monitoring of progress in addressing capacity issues.

The assessment should include verification of advisory services or help desks that offer advice to public or private sector parties on application and interpretation of policy and rules.

The training strategy should be closely linked to and integrated with other measures intended to develop the capacity of other key actors involved in public procurement. In particular, refer to the following sub-indicators: 8(b): Professionalisation of the procurement function; 10(a): Programmes to build capacity in the private sector; 11(a): Programmes to build the capacity of civil society; and 14(d): Integrity training programmes for the procurement workforce.

24 PEFA PI-24.1.

25 PEFA I-24.2.

### Assessment criteria

There are systems in place that provide for:

- (a) substantive permanent training programmes of suitable quality and content for the needs of the system.
- (b) routine evaluation and periodic adjustment of training programmes based on feedback and need.
- (c) advisory service or help desk function to resolve questions by procuring entities, suppliers and the public.
- (d) a strategy well-integrated with other measures for developing the capacity of key actors involved in public procurement.

### Sub-indicator 8(b) – Recognition of procurement as a profession

Public procurement is often performed by civil servants of varying educational and professional backgrounds. Ideally, procurement officers are considered specialised professionals, rather than officials with a purely administrative function. The purpose of this sub-indicator is to determine whether procurement is recognised as a profession in the country's public service. This includes designating specific functions for procurement positions at various professional and management levels. Job descriptions should be in place for these positions and the qualifications and competencies specified. Remuneration and career progression should reflect the particular professional status, and appointments and promotions should be competitive and based on qualifications and professional certification. Ongoing professional development, policies and programmes for staff development and training should be carried out. Staff performance should be evaluated on a regular and consistent basis.

### Assessment criteria

The country's public service recognises procurement as a profession:

- (a) Procurement is recognised as a specific function, with procurement positions defined at different professional levels, and job descriptions and the requisite qualifications and competencies specified.
- (b) Appointments and promotion are competitive and based on qualifications and professional certification.
- (c) Staff performance is evaluated on a regular and consistent basis, and staff development and adequate training is provided.

*Further analysis: MAPS Module on Professionalisation*

### Sub-indicator 8(c) – Monitoring performance to improve the system

The evaluation of the effectiveness of the public procurement system, from individual procurements to the system as a whole, can be a major driver of performance improvements. The results of procurement processes should periodically and consistently be assessed to measure the performance, effectiveness and savings of the procurement system. While procuring entities themselves should be at the forefront of performance measurement and continuous improvement programmes at the entity level, the procurement normative/regulatory institution should support these efforts as well. This institution can harmonise, monitor and evaluate the performance of the procurement system as a whole.

Performance management frameworks should be developed that focus on both quantitative and qualitative aspects. The quantitative indicators included in MAPS provide a good starting point for a performance measurement system that addresses both levels and can evolve over time. Additional and more specific impact assessment methodologies may need

to be developed depending on the country's development objectives.

The analysis of data and the planning of improvements require specific competencies. A strategic plan (or action plan) should be developed to structure reform initiatives. A results framework should supplement it to monitor the implementation of the planned reforms. A results framework typically includes goals, actions, indicators with baselines and targets, and timelines for reform. Performance targets should be presented in a format that is clear about what is being measured and how it is being measured (method of calculation and data sources). Responsibilities and necessary resources need to be defined.

#### **Assessment criteria**

- (a) The country has established and consistently applies a performance measurement system that focuses on both quantitative and qualitative aspects.
- (b) The information is used to support strategic policy making on procurement.
- (c) Strategic plans, including results frameworks, are in place and used to improve the system.
- (d) Responsibilities are clearly defined.

## Pillar III. Public Procurement Operations and Market Practices

This Pillar looks at the operational efficiency, transparency and effectiveness of the procurement system at the level of the implementing entity responsible for managing individual procurements (procuring entity). In addition, it looks at the market as one means of judging the quality and effectiveness of the system in putting procurement procedures into practice. This Pillar focuses on how the procurement system in a country operates and performs in practice.

### Indicator 9. Public procurement practices achieve stated objectives.

The objective of this indicator is to collect empirical evidence on how procurement principles, rules and procedures formulated in the legal and policy framework are being implemented in practice. It focuses on procurement-related results that in turn influence development outcomes, such as value for money, improved service delivery, trust in government and achievement of horizontal policy objectives.

The assessment of Indicator 9 requires the selection and review of a sample of actual procurement transactions (files). Sampling methods and size determine the representativeness of the assessment results (refer to Section I – User's Guide, paragraph 28). If the sample is small but strategically targeted, the assessment can still provide a useful snapshot or illustration of how procurement operates and performs on the ground. In any case, the assessment findings need to be analysed and interpreted with caution, to ensure credibility and fairness of the process and to achieve a better understanding of the country's procurement system as a whole.

For a more comprehensive assessment of procurement practices targeted specifically at a procuring entity level, refer to the MAPS Module for Entity Level Assessments.

#### Sub-indicator 9(a) – Planning

During the planning stage of procurement, the basic conditions governing the entire procurement process are established. It is at the onset of the procurement process that the influence on achieving defined objectives is highest. This step of the procurement process is usually performed in close collaboration with the internal client.

Sub-indicator 9(a) assesses whether a thorough needs analysis has been conducted, followed by market research, to inform the development of optimal procurement strategies (in particular for major procurement). It evaluates whether the desired results have been defined and if this entailed economic and/or environmental or social impacts aligned with national policy objectives. It should be assessed whether requirements and/or desired outcomes of the individual procurement have been clearly described, either in tight product/service specifications or through an output/outcome-based definition of requirements (functional specifications).<sup>26</sup>

#### Assessment criteria

- (a) Needs analysis and market research guide a proactive identification of optimal procurement strategies.
- (b) The requirements and desired outcomes of contracts are clearly defined.
- (c) Sustainability criteria, if any, are used in a balanced manner and in accordance with national priorities, to ensure value for money.

<sup>26</sup> In comparison, sub-indicator 4(a) focuses on the preparation of annual or multi-annual procurement plans to support budget planning and cash flow of procurement operations. Once the budget has been formulated, during the planning stage of an individual procurement transaction, the basic conditions governing the entire procurement process need to be established.

## Sub-indicator 9(b) – Selection and contracting

This sub-indicator focuses on the objective of achieving value for money through appropriate determination of procurement methods and approaches, competition, transparency and fairness in selecting suppliers, including the quality of procurement documents and process efficiency.

The sub-indicator assesses the extent to which procurement has followed a competitive procedure (or not). It provides specific information on the use of procurement methods authorised in the law. The sub-indicator also assesses whether procedures for bid submission, receipt and opening have resulted in an appropriate level of competition.

Moreover, the sub-indicator assesses whether appropriate and fair techniques have been applied in the bid evaluation and award stage to determine best value for money, and whether the entire selection process has been carried out effectively, efficiently and in a transparent way.

### Assessment criteria

- (a) Multi-stage procedures are used in complex procurements to ensure that only qualified and eligible participants are included in the competitive process.
- (b) Clear and integrated procurement documents, standardised where possible and proportionate to the need, are used to encourage broad participation from potential competitors.
- (c) Procurement methods are chosen, documented and justified in accordance with the purpose and in compliance with the legal framework.
- (d) Procedures for bid submission, receipt and opening are clearly described in the procurement documents and complied with. This means, for instance, allowing bidders or their representatives to attend bid openings, and allowing civil society to monitor bid submission, receipt and opening, as prescribed.
- (e) Throughout the bid evaluation and award process, confidentiality is ensured.
- (f) Appropriate techniques are applied, to determine best value for money based on the criteria stated in the procurement documents and to award the contract.
- (g) Contract awards are announced as prescribed.
- (h) Contract clauses include sustainability considerations, where appropriate.
- (i) Contract clauses provide incentives for exceeding defined performance levels and disincentives for poor performance.
- (j) The selection and award process is carried out effectively, efficiently and in a transparent way. \*

### \*Recommended quantitative indicators to substantiate assessment of sub-indicator 9(b) assessment criterion (j):

- average time to procure goods, works and services
- number of days between advertisement/solicitation and contract signature (for each procurement method used)
- average number (and %) of bids that are responsive (for each procurement method used)
- share of processes that have been conducted in full compliance with publication requirements (in %)
- number (and %) of successful processes (successfully awarded; failed; cancelled; awarded within defined time frames)

**Source for all: Sample of procurement cases.**

## Sub-indicator 9(c) – Contract management in practice

This sub-indicator assesses the extent to which goods, works or services, including consulting services procured, are delivered according to the contract agreement in terms of time, quality, cost and other conditions stated in the contract, for the efficient and effective delivery of public services. The sub-indicator assesses cost and time overruns, including for payments to be made to suppliers. The sub-indicator also reviews whether opportunities for the improvement of procurement practices are analysed based on both metrics and stakeholder feedback.

### Assessment criteria

- (a) Contracts are implemented in a timely manner.\*
- (b) Inspection, quality control, supervision of work and final acceptance of products is carried out.\*
- (c) Invoices are examined, time limits for payments comply with good international practices, and payments are processed as stipulated in the contract.
- (d) Contract amendments are reviewed, issued and published in a timely manner.\*
- (e) Procurement statistics are available and a system is in place to measure and improve procurement practices.
- (f) Opportunities for direct involvement of relevant external stakeholders in public procurement are utilised.\*
- (g) The records are complete and accurate, and easily accessible in a single file.\*

#### \* Quantitative indicators to substantiate assessment of sub-indicator 9(c) assessment criterion (g):

- share of contracts with complete and accurate records and databases (in %)<sup>27</sup>

**Source:** Sample of procurement cases

#### \* Recommended quantitative indicators to substantiate assessment of sub-indicator 9(c) linked to different assessment criteria above as follows:

- For assessment criterion (a): time overruns (in %; and average delay in days)
- For assessment criterion (b): quality-control measures and final acceptance are carried out as stipulated in the contract (in %)
- For assessment criterion (c): invoices for procurement of goods, works and services are paid on time (in % of total number of invoices).
- For assessment criterion (d): contract amendments (in % of total number of contracts; average increase of contract value in %)
- For assessment criterion (f): percentage of contracts with direct involvement of civil society: planning phase; bid/proposal opening; evaluation and contract award, as permitted; contract implementation)<sup>28</sup>

**Source for all:** Sample of procurement cases.

*Further analysis: MAPS Module on Entity Level Assessments*

## Indicator 10. The public procurement market is fully functional.

The objective of this indicator is primarily to assess the market response to public procurement solicitations. This response may be influenced by many factors, such as the general economic climate, policies to support the private sector

27 PEFA Indicator PI-24.1

28 Preferably split into the different process phases, to cover the concept of open contracting more specifically.



and a good business environment, strong financial institutions, the attractiveness of the public system as a good, reliable client, the kind of goods or services being demanded, etc. There are three sub-indicators (a-c) to be assessed.

### **Sub-indicator 10(a) – Dialogue and partnerships between public and private sector**

Public procurement depends on the partnership that should exist between the government and the private sector. This partnership creates the public procurement marketplace in which the government is the buyer and the private sector is the supplier of the needed goods, works or services. Dialogue between the government and the private sector is thus imperative, and the voice of the private sector needs to be heard with regard to national procurement objectives, changes to the legal and institutional framework and practices by the government that may undermine the competitive effectiveness of the private sector. This sub-indicator reviews whether there are forums for dialogue between the government and the private sector.

Information and training programmes on public procurement should be regularly offered for the private sector, either by the government or in co-operation with private institutions. These programmes should include approaches tailored to the needs of small businesses, to support supplier diversity, and should include a module on ethics and integrity in public procurement.

Sub-indicator 10(a) is closely linked to Indicator 11 (Disclosure of information and civil society engagement).

#### **Assessment criteria**

- (a) The government encourages open dialogue with the private sector. Several established and formal mechanisms are available for open dialogue through associations or other means, including a transparent and consultative process when formulating changes to the public procurement system. The dialogue follows the applicable ethics and integrity rules of the government.\*
- (b) The government has programmes to help build capacity among private companies, including for small businesses and training to help new entries into the public procurement marketplace.

#### **\* Recommended quantitative indicator to substantiate assessment of sub-indicator 10(a) assessment criterion (a):**

- perception of openness and effectiveness in engaging with the private sector (in % of responses).

Source: Survey.

### **Sub-indicator 10(b) – Private sector's organisation and access to the public procurement market**

This sub-indicator looks at the capacity within the private sector to respond to public procurement in the country. An important aspect to assess is the organisational capacity of the small and medium-sized enterprises (SMEs)<sup>29</sup> and the access they have to information and other services (including information technology) to promote their participation. A well-organised and competitive private sector should result in keen competition, better prices and an equitable distribution of business. Competition for large contracts should not be concentrated in a relatively small number of firms.

There should be no major systemic constraints (e.g. inadequate access to financing, contracting practices, etc.) inhibiting the private sector's capacity to access the procurement market.

Participation in competition for public contracts depends on many conditions, including some that are controlled by or

29 In some countries, the scope includes micro enterprises (MSMEs).

within the control of the government. Examples for measures that can improve access by the private sector to the government marketplace are:

- i) access to financing
- ii) procurement methods and procedures that are proportionate to the risk and value in question
- iii) reasonable contracting provisions that are seen to fairly distribute risks associated with performance of contracts
- iv) fair payment provisions that help offset the cost of doing business with the government
- v) effective appeals mechanism and dispute resolution
- vi) user-friendly and easily accessible e-Procurement systems.

Alternatively, when the conditions are difficult for the private sector, the degree of competition will suffer. A survey of private sector participants should be carried out to help assess this. The narrative of the assessment should describe the main constraints.

#### Assessment criteria

- (a) The private sector is competitive, well-organised, willing and able to participate in the competition for public procurement contracts.\*
- (b) There are no major systemic constraints inhibiting private sector access to the public procurement market.

#### \* Recommended quantitative indicator to substantiate assessment of sub-indicator 10(b) assessment criterion (a):

- number of registered suppliers as a share of total number of suppliers in the country (in %)
- share of registered suppliers that are participants and awarded contracts (in % of total number of registered suppliers)
- total number and value of contracts awarded to domestic/foreign firms (and in % of total)

Source: e-Procurement system/Supplier Database.

#### \* Recommended quantitative indicator to substantiate assessment of sub-indicator 10(b) assessment criterion (b):

- perception of firms on the appropriateness of conditions in the public procurement market (in % of responses).<sup>30</sup>

Source: Survey.

### Sub-indicator 10(c) – Key sectors and sector strategies

The public procurement market is usually very broad, covering numerous sectors with different needs and interests. Performing a sector market analysis helps to determine sector-related risks (in terms of expenditure, competition, environmental impact, socio-economic risks, etc.) and the government's scope to influence specific market segments.

Based on the government's priority spending areas, key sectors associated with the procurement of goods, works, and services should be identified. This information can be utilised to conduct targeted assessments of relevant sector markets and to secure collaboration with sector market participants in a specific and meaningful way, e.g. to strengthen integrity, sustainability and/or innovation in public procurement.

<sup>30</sup> Survey on appropriateness of conditions should cover: access to credit, procurement methods and procedures, contracting provisions, fair payment provisions, and effective appeals mechanisms and dispute resolution as described above.

**Assessment criteria**

- (a) Key sectors associated with the public procurement market are identified by the government.
- (b) Risks associated with certain sectors and opportunities to influence sector markets are assessed by the government, and sector market participants are engaged in support of procurement policy objectives.

*Further analysis: MAPS Module on Sector Market Analysis*

## Pillar IV. Accountability, Integrity and Transparency of the Public Procurement System

Pillar IV includes four indicators that are considered necessary for a system to operate with integrity, that has appropriate controls that support the implementation of the system in accordance with the legal and regulatory framework, and that has appropriate measures in place to address the potential for corruption in the system. It also covers important aspects of the procurement system, which include stakeholders, including civil society, as part of the control system. This Pillar takes aspects of the procurement system and governance environment to ensure they are defined and structured to contribute to integrity and transparency.

### Indicator 11. Transparency and civil society engagement strengthen integrity in public procurement.

Civil society, in acting as a safeguard against inefficient and ineffective use of public resources, can help to make public procurement more competitive and fair, improving contract performance and securing results. Governments are increasingly empowering the public to understand and monitor public contracting. This indicator assesses two mechanisms through which civil society can participate in the public procurement process: i) disclosure of information and ii) direct engagement of civil society through participation, monitoring and oversight. There are three sub-indicators to be assessed (a-c).

#### Sub-indicator 11(a) – An enabling environment for public consultation and monitoring

This indicator assesses the following: i) whether a transparent and consultative process is followed when changes are formulated to the public procurement system, ii) whether programmes are in place to build the capacity of civil society organisations to support participatory public procurement, and iii) whether effective feedback and redress mechanisms are in place for matters related to public procurement.

#### Assessment criteria

- (a) A transparent and consultative process is followed when formulating changes to the public procurement system.
- (b) Programmes are in place to build the capacity of relevant stakeholders to understand, monitor and improve public procurement.
- (c) There is ample evidence that the government takes into account the input, comments and feedback received from civil society.

#### Sub-indicator 11(b) – Adequate and timely access to information by the public

The right of the public to access information has been fully integrated in the MAPS indicator system. The following aspects have been highlighted in the sub-indicators referenced below:

- The laws, regulations, and policies governing public procurement are published and easily accessible to the public at no cost (sub-indicator 1(a));
- All stakeholders have adequate and timely access to information in each phase of the public procurement process related to specific procurements (in accordance with legal provisions protecting specific sensitive information) and access to other information that is relevant to promote competition and transparency (refer to sub-indicator 7(a));
- Free access to this information is preferably provided through a centralised online portal and open data standards (sub-indicator 7(a)).

The assessors should revisit the indicators referenced above to conclude whether the separately assessed, multifaceted requirements, in combination with identified actual procurement practices in the country, result in a conclusive and coherent picture in terms of adequate disclosure. The information disclosed should promote a meaningful understanding of the matter as a precondition for effective participation. This sub-indicator assesses whether overall, the amount and nature of transparency and available information supports the integrity of public procurement, including the visibility of the flow of public funds.

#### Assessment criteria

- (a) Requirements in combination with actual practices ensure that all stakeholders have adequate and timely access to information as a precondition for effective participation.

### Sub-indicator 11(c) – Direct engagement of civil society

This sub-indicator assesses the extent to which i) the laws, regulations, and policies enable the participation of citizens in terms of consultation, observation, and monitoring and ii) whether the government promotes and creates opportunities for public consultation and monitoring of public contracting.

The legal and regulatory framework might establish the obligation or an opportunity for the government to consult the public in the planning process, e.g. prior to large-scale or environmentally or socially sensitive procurements. In some countries, citizens are, under clearly specified conditions and subject to signing a statement of confidentiality, permitted or encouraged to act as observers in procurement proceedings. Citizens could also be permitted to be officially involved in the monitoring of performance and contract completion, for example through the application of innovative techniques such as geotagging or in the context of social audits. The assessor should describe in detail the rights and conditions stipulated in the law.

Assessors should take into account the evidence provided through the review of procurement practices (Indicator 9) when evaluating assessment criteria (b) below.

#### Assessment criteria

- (a) The legal/regulatory and policy framework allows citizens to participate in the following phases of a procurement process, as appropriate:
- the planning phase (consultation)
  - bid/proposal opening (observation)
  - evaluation and contract award (observation), when appropriate, according to local law
  - contract management and completion (monitoring).
- (b) There is ample evidence for direct participation of citizens in procurement processes through consultation, observation and monitoring.

## Indicator 12. The country has effective control and audit systems.

The objective of this indicator is to determine the quality, reliability and timeliness of the internal and external controls. Equally, the effectiveness of controls needs to be reviewed. For the purpose of this indicator, “effectiveness” means the expediency and thoroughness of the implementation of auditors’ recommendations. The assessors should rely, in addition to their own findings, on the most recent public expenditure and financial accountability assessments (PEFA) and other analyses that may be available. This indicator has four sub-indicators (a-d) to be assessed.

## Sub-indicator 12(a) – Legal framework, organisation and procedures of the control system

This sub-indicator assesses i) whether the country's laws and regulations provide for a comprehensive control framework, ii) whether the institutions, policies and procedures as defined in the law are in place and operational, and iii) whether the existing control framework adequately covers public procurement operations.

National legislation establishes which agencies are responsible for oversight of the procurement function. Even though there is no universal model, it is important that the basic principles of oversight and control exist in the legal and regulatory framework of the country and that they are applied globally. This sub-indicator looks at the institutional set-up of the control framework to assess the existence of a functioning control framework for public procurement. The following are key elements of a functioning control framework:

- i)* There should be provisions to establish internal control and management procedures that focus on checks and balances for processing procurement transactions, on payment controls and on expenditure commitment controls. Expenditure commitment controls ensure that the procuring entity's payment obligations, arising from contracts, remain within the limits of budget allocations.<sup>31</sup>
- ii)* Regular and adequate feedback to management on the adequacy and effectiveness of the internal control systems is provided through an internal audit function (or internal audit institution). Among other things, this function scrutinises the reliability and integrity of financial and operational information, the effectiveness and efficiency of operations and programmes, and compliance with laws, regulations and contracts.<sup>32</sup>
- iii)* A high-quality external audit is a required for ensuring accountability and creating transparency in the use of public funds. The Supreme Audit Institution (SAI) should be independent from the executive branch, and its mandate should enable the SAI to carry out a full range of audit activities, specifically financial, compliance and performance audits. Adherence to international auditing standards should ensure a focus on significant and systemic PFM issues in reports as well as, among other tasks, providing an opinion on the functioning of internal control and procurement systems.<sup>33</sup>
- iv)* Internal audit and internal control systems assist external auditors and enable performance audit techniques to be used that look at the effectiveness and application of internal control procedures, instead of looking at individual procurement actions.
- v)* The legislature (or other body responsible for public finance governance) should review and act on the findings of the SAI.<sup>34</sup>

The assessor should verify that the institutions, policies and procedures as defined in the law are in place and operational. The assessment should determine whether the existing controls framework pays sufficient attention to public procurement, e.g. by addressing specialised procurement audits.

31 PEFA covers internal controls on nonsalary expenditure in PI-25.

32 Refer to PEFA PI-26.

33 Refer to PEFA PI-8 and PI-30.

34 Refer to PEFA PI-31.

**Assessment criteria**

The system in the country provides for:

- (a) laws and regulations that establish a comprehensive control framework, including internal controls, internal audits, external audits and oversight by legal bodies
- (b) internal control/audit mechanisms and functions that ensure appropriate oversight of procurement, including reporting to management on compliance, effectiveness and efficiency of procurement operations
- (c) internal control mechanisms that ensure a proper balance between timely and efficient decision-making and adequate risk mitigation
- (d) independent external audits provided by the country's Supreme Audit Institution (SAI) that ensure appropriate oversight of the procurement function based on periodic risk assessments and controls tailored to risk management
- (e) review of audit reports provided by the SAI and determination of appropriate actions by the legislature (or other body responsible for public finance governance)
- (f) clear mechanisms to ensure that there is follow-up on the respective findings.

**Sub-indicator 12(b) – Co-ordination of controls and audits of public procurement**

This sub-indicator assesses whether internal controls, internal audits and external audits are well defined, co-ordinated, sufficiently resourced and integrated to ensure the consistent application of procurement laws, regulations and policies and the monitoring of performance of the public procurement system, and that they are conducted with sufficient frequency.

Internal control routines, procedures and standards should be clearly defined (ideally in an internal control manual) and complied with. There should also be written standards for the internal audit unit (or function), to perform both compliance and performance audits related to procurement and to convey issues to management, depending on the urgency of the matter. A regular periodic reporting to management should take place throughout the year to provide timely information and enable management action.

Sufficient information needs to be retained to allow auditors to verify that the written internal control procedures are adhered to. Internal and external audit plans should be co-ordinated, at least annually, to ensure adequate oversight and a reduction of duplication. Written procedures and standards (e.g. a manual) for conducting procurement audits (both on compliance and on performance) should be formulated to ensure that internal and external audits are harmonised and mutually reinforcing. Audits should be carried out at least annually.

This sub-indicator also assesses the existence of clear and reliable reporting lines to relevant oversight bodies. This includes the reporting of credible suspicions of breaches of laws and regulations to the competent authorities, without fear of reprisals. Imprecise or lax controls and inadequate reporting impact the enforcement of the laws and regulations and create ample risk for fraud and corruption.

**Assessment criteria**

- (a) There are written procedures that state requirements for internal controls, ideally in an internal control manual.
- (b) There are written standards and procedures (e.g. a manual) for conducting procurement audits (both on compliance and performance) to facilitate co-ordinated and mutually reinforcing auditing.
- (c) There is evidence that internal or external audits are carried out at least annually and that other established written standards are complied with.\*
- (d) Clear and reliable reporting lines to relevant oversight bodies exist.

**\* Recommended quantitative indicator to substantiate assessment of sub-indicator 12(b) assessment criterion (c):**

- number of specialised procurement audits carried out compared to total number of audits (in %).
- share of procurement performance audits carried out (in % of total number of procurement audits).

Source: Ministry of Finance/Supreme Audit Institution.

**Sub-indicator 12(c) – Enforcement and follow-up on findings and recommendations**

The purpose of this indicator is to review the extent to which internal and external audit recommendations are implemented within a reasonable time. This may be expressed as the percentage of recommendations implemented within the time frames established in the law or within six months, a year, more than a year or never implemented.

Reasons should be documented in case certain recommendations were not implemented.

**Assessment criteria**

- (a) Recommendations are responded to and implemented within the time frames established in the law.\*
- (b) There are systems in place to follow up on the implementation/enforcement of the audit recommendations.

**\* Recommended quantitative indicator to substantiate assessment of sub-indicator 12(c) assessment criterion (a):**

- Share of internal and external audit recommendations implemented within the time frames established in the law (in %).

Source: Ministry of Finance/Supreme Audit Institution.

**Sub-indicator 12 (d) – Qualification and training to conduct procurement audits**

The objective of this indicator is to confirm that there is a system in place to ensure that auditors working on procurement audits are adequate to the task. They should receive adequate training and they should be selected following criteria that explicitly require that they demonstrate sufficient knowledge of the subject to conduct high-quality procurement audits, including performance audits. Auditors should normally receive formal training on procurement requirements, principles, operations, laws and regulations and processes. Alternatively, they should have extensive experience in public procurement or be supported by procurement specialists or consultants. Auditors, including external resources, should be selected in a fair and transparent way and be fully independent.



**Assessment criteria**

- (a) There is an established programme to train internal and external auditors to ensure that they are qualified to conduct high-quality procurement audits, including performance audits.\*
- (b) The selection of auditors requires that they have adequate knowledge of the subject as a condition for carrying out procurement audits; if auditors lack procurement knowledge, they are routinely supported by procurement specialists or consultants.
- (c) Auditors are selected in a fair and transparent way and are fully independent.

**\* Recommended quantitative indicator to substantiate assessment of sub-indicator 12(d) assessment criterion (a):**

- number of training courses conducted to train internal and external auditors in public procurement audits.

Source: Ministry of Finance/Supreme Audit Institution.

**\* Recommended quantitative indicator to substantiate assessment of sub-indicator 12(d) assessment criterion (a):**

- share of auditors trained in public procurement (as % of total number of auditors).

Source: Ministry of Finance/Supreme Audit Institution.

## Indicator 13. Procurement appeals mechanisms are effective and efficient.

Pillar I covers aspects of the appeals mechanism as it pertains to the legal framework, including creation and coverage. This indicator further assesses the appeals mechanisms for a range of specific issues regarding efficiency in contributing to the compliance environment in the country and the integrity of the public procurement system. There are three sub-indicators (a-c) to be assessed.

### Sub-indicator 13(a) – Process for challenges and appeals

This sub-indicator looks at the process that is defined for dealing with challenges or appeals and sets out some specific conditions that provide for fairness and due process.

- i)* Decisions are rendered on the basis of available evidence submitted by the parties.
- ii)* The first review is carried out by the entity specified by law.
- iii)* The appeals body (or authority) has enough authority to enforce its decisions.
- iv)* The time frames specified for the submission and review of challenges/appeals and issuing of decisions do not unduly delay the procurement process or make an appeal unrealistic.

**Assessment criteria**

- (a) Decisions are rendered on the basis of available evidence submitted by the parties.
- (b) The first review of the evidence is carried out by the entity specified in the law.
- (c) The body or authority (appeals body) in charge of reviewing decisions of the specified first review body issues final, enforceable decisions. \*
- (d) The time frames specified for the submission and review of challenges and for appeals and issuing of decisions do not unduly delay the procurement process or make an appeal unrealistic.

**\* Quantitative indicator to substantiate assessment of sub-indicator 13(a) assessment criterion (c):**

- number of appeals.

Source: Appeals body.

**\* Recommended quantitative indicator to substantiate assessment of sub-indicator 13(a) assessment criterion (c):**

- number (and percentage) of enforced decisions.

Source: Appeals body.

## Sub-indicator 13(b) – Independence and capacity of the appeals body

This indicator<sup>35</sup> assesses the degree of autonomy that the appeals body has from the rest of the system, to ensure that its decisions are free from interference or conflict of interest. It is crucial that the body is not involved in any capacity in procurement transactions or in the process leading to contract award decisions. The body should not charge fees that inhibit access by concerned parties.

The indicator assesses the efficiency and capacity of the appeals body and its ability to enforce the remedy imposed. The assessors should review whether the conditions and time frames for review and decisions are precise and reasonable, and whether processes for submission and resolution of challenges are clearly defined and followed by the appeals body. They should also be publicly available.

Assessors should evaluate whether the appeals body i) exercises its authority to suspend procurement proceedings, ii) applies the full range of remedies specified by law, iii) issues decisions within the time frame specified in the law/regulations, and iv) issues decisions that are binding on all parties (without precluding subsequent access to judicial process). The appeals body needs to be adequately resourced and staffed to fulfil its functions.

### Assessment criteria

The appeals body:

- is not involved in any capacity in procurement transactions or in the process leading to contract award decisions
- does not charge fees that inhibit access by concerned parties
- follows procedures for submission and resolution of complaints that are clearly defined and publicly available
- exercises its legal authority to suspend procurement proceedings and impose remedies
- issues decisions within the time frame specified in the law/regulations\*
- issues decisions that are binding on all parties
- is adequately resourced and staffed to fulfil its functions.

**\* Quantitative indicator to substantiate assessment of sub-indicator 13(b) assessment criterion (c):**

- appeals resolved within the time frame specified in the law/exceeding this time frame/unresolved (Total number and in %).

Source: Appeals body.

35 This indicator is fully aligned with PEFA PI-24.4.

### Sub-indicator 13(c) – Decisions of the appeals body

The appeals system needs to be seen as operating in a fair manner. The system should require that decisions be rendered only on relevant and verifiable information presented. In addition, such decisions need to be unbiased, reflecting the consideration of the evidence presented and the applicable requirements in the legal/regulatory framework.

It is also important that the remedy imposed in the decision be consistent with the findings of the case and with the available remedies provided for in the legal/regulatory framework. Decisions of the appeals body should deal specifically with process issues, and the remedies should focus on corrective actions needed to comply with the process.

Decisions should be published in a timely manner and as stipulated in the law. Preferably, decisions should be published on the centralised online portal mentioned in sub-indicator 7(b).

#### Assessment criteria

Procedures governing the decision making process of the appeals body provide that decisions are:

- (a) based on information relevant to the case.
- (b) balanced and unbiased in consideration of the relevant information.\*
- (c) result in remedies, if required, that are necessary to correcting the implementation of the process or procedures.\*
- (d) decisions are published on the centralised government online portal within specified timelines and as stipulated in the law.\*

#### \*Quantitative indicator to substantiate assessment of sub-indicator 13(c) assessment criterion (d):

- share of appeals decisions posted on a central online platform within timelines specified in the law (in %).

Source: Centralised online portal.

#### \* Recommended quantitative indicator to substantiate assessment of sub-indicator 13(c) assessment criterion (b):

- share of suppliers that perceive the challenge and appeals system as trustworthy (in % of responses).

Source: Survey.

- share of suppliers that perceive appeals decisions as consistent (in % of responses).

Source: Survey.

#### \* Recommended quantitative indicator to substantiate assessment of sub-indicator 13(c) assessment criterion (c):

- outcome of appeals (dismissed; decision in favour of procuring entity; decision in favour of applicant) (in %).

Source: Appeals body.

## Indicator 14. The country has ethics and anti-corruption measures in place.

This indicator assesses i) the nature and scope of anti-corruption provisions in the procurement system and ii) how they are implemented and managed in practice. This indicator also assesses whether the system strengthens openness and balances the interests of stakeholders and whether the private sector and civil society support the creation of a public procurement market known for its integrity. There are seven sub-indicators (a-g) contributing to this indicator.

### Sub-indicator 14(a) – Legal definition of prohibited practices, conflicts of interest, and associated responsibilities, accountabilities and penalties

This indicator assesses the existence of legal provisions that define fraudulent, corrupt and other prohibited practices (“prohibited practices”) and set out the responsibilities and sanctions for government employees, individuals or firms indulging in such practices.

The legal provisions should also address issues concerning situations involving conflicts of interest and incompatibility. Provisions should include mechanisms to identify and declare where conflict of interests exist, to mitigate risks and make this information easily accessible to decision makers. The law should prohibit the intervention of active public officials and former public officials for a reasonable period after leaving office (cooling-off period) in procurement matters in ways that benefit them, their relatives and business or political associates, financially or otherwise.

Sanctions should include the exclusion of firms or individuals that have been the subject of a conviction by final judgment for fraud, corruption or other prohibited practices, as defined in the national law of the procuring entity or the firm/individual (refer to sub-indicator 1(d)).

There may be cases where there is a separate anti-corruption law (e.g. anti-corruption legislation) that contains such provisions. This arrangement is appropriate insofar as the effects of the anti-corruption law are the same as if they were in the procurement law.<sup>36</sup>

The legal, regulatory and policy framework should be consistent with obligations deriving from legally binding international anti-corruption agreements, e.g. the United Nations Convention Against Corruption (UNCAC).

#### Assessment criteria

The legal/regulatory framework provides for the following:

- (a) definitions of fraud, corruption and other prohibited practices in procurement, consistent with obligations deriving from legally binding international anti-corruption agreements.
- (b) definitions of the individual responsibilities, accountability and penalties for government employees and private firms or individuals found guilty of fraud, corruption or other prohibited practices in procurement, without prejudice of other provisions in the criminal law.
- (c) definitions and provisions concerning conflict of interest, including a cooling-off period for former public officials.

### Sub-indicator 14(b) – Provisions on prohibited practices in procurement documents

This sub-indicator assesses the extent to which the law and the regulations compel procuring agencies to include references on fraud, corruption and other prohibited practices, conflict of interest and unethical behaviour, as defined in the law in the procurement and contract documents. Instructions could include a requirement for bidders to issue a self-declaration assuring that the bidder has not engaged in any prohibited practices and has not been prosecuted or convicted of fraud, corruption or other prohibited practices. This sub-indicator is related to sub-indicator 2(b) on Content for model documents, but is not directly addressed in that sub-indicator.

The assessment should verify the existence of the provisions in the procurement and contract documents and enforceability of such provision through the legal/regulatory framework. The procurement and contract documents should include

<sup>36</sup> Prohibitions against bribery could be contained in a country’s penal code, specific anti-corruption legislation, or other legislation, such as competition legislation. In addition, prohibitions against bribery by companies (“legal persons”) are sometimes contained in the same legislation as the prohibitions against natural persons, or separate legislation on corporate liability for corruption offences and sometimes other economic offences as well (e.g. money laundering).

the definitions of what is considered fraud and corruption and other prohibited practices, and the consequences of committing such acts.

#### Assessment criteria

- (a) The legal/regulatory framework specifies this mandatory requirement and gives precise instructions on how to incorporate the matter in procurement and contract documents.
- (b) Procurement and contract documents include provisions on fraud, corruption and other prohibited practices, as specified in the legal/regulatory framework.

### Sub-indicator 14(c) – Effective sanctions and enforcement systems

This indicator concerns the enforcement of the law and the ability to demonstrate this by actions taken. Evidence of enforcement is necessary to demonstrate to the citizens and other stakeholders that the country is serious about fighting corruption.

Assessors should determine whether procuring entities are required to report allegations of fraud, corruption and other prohibited practices to the law enforcement authorities, and whether there is a clear procedure in place for doing this.

Assessors should review whether the procedure is systematically applied in practice, and whether reports pursuant to such a procedure are consistently followed up by the law enforcement authorities.

The assessor should verify that systems and procedures are in place to suspend/debar firms and individuals from participating in procurement proceedings (refer to sub-indicator 1(d)). The assessor should evaluate whether the procedures ensure due process and whether they are consistently applied. For example, the system should include a register of debarred firms and individuals that is easily accessible to all procuring entities. Procuring entities should be required to consult this register and consistently exclude debarred firms and individuals from participation in a procurement process.

The assessor should also be able to obtain at least some evidence of prosecution and punishment for fraudulent, corrupt or other prohibited practices. The assessor should retrieve figures on the number of cases reported through the system, and number of cases prosecuted. If the ratio of cases prosecuted to cases reported is low, the narrative should explain the possible reasons.

#### Assessment criteria

- (a) Procuring entities are required to report allegations of fraud, corruption and other prohibited practices to law enforcement authorities, and there is a clear procedure in place for doing this.
- (b) There is evidence that this system is systematically applied and reports are consistently followed up by law enforcement authorities.
- (c) There is a system for suspension/debarment that ensures due process and is consistently applied.
- (d) There is evidence that the laws on fraud, corruption and other prohibited practices are being enforced in the country by application of stated penalties.\*

**\* Recommended quantitative indicator to substantiate assessment of sub-indicator 14(c) assessment criterion (d):**

- Firms/individuals found guilty of fraud and corruption in procurement: number of firms/individuals prosecuted/convicted; prohibited from participation in future procurements (suspended/debarred).

Source: Normative/regulatory function/anti-corruption body.

- Government officials found guilty of fraud and corruption in public procurement: number of officials prosecuted/convicted.

Source: Normative/regulatory function/anti-corruption body.

- Gifts to secure public contracts: number of firms admitting to unethical practices, including making gifts in (in %).

Source: Survey.

### **Sub-indicator 14(d) – Anti-corruption framework and integrity training**

This sub-indicator attempts to verify whether an anti-corruption framework is in effect, and if so, its extent and nature and any other special measures in place, such as integrity training programmes that can help prevent and/or detect fraud and corruption specifically associated with public procurement.

A comprehensive anti-corruption framework normally includes all the stakeholders in the procurement system, assigns clear responsibilities to all of them, and assigns a high-level body or organisation (e.g. and anti-corruption commission) with sufficient standing and authority to be responsible for co-ordinating and monitoring the programme. The functions assigned to the anti-corruption body will differ from country to country. For example, anti-corruption bodies could be in charge of providing secure channels for reporting suspected corruption, have investigative powers, and collect and disclose information on beneficial ownership, following good international practice.

The procuring entities are responsible for running and monitoring a transparent and efficient system and for providing public information to promote accountability and transparency. To strengthen awareness and to clarify responsibilities and reporting requirements and channels in case of attempted or suspected fraud or corruption in procurement, integrity training programmes should be developed and offered as a co-ordinated effort (involving procuring entities, the anti-corruption body and normative/regulatory institutions). The procurement workforce should be obliged to participate in this training on a regular basis.

The control organisations (supreme audit authority) and the legal oversight bodies (e.g. the parliament or congress) are responsible for detecting and denouncing irregularities or corruption. The civil society organisations are responsible for social audits and for monitoring of procurement to protect the public interest. These may include NGOs, academia, unions, chambers of commerce and professional associations, and the press. The judiciary also participates, often in the form of special anti-corruption courts and dedicated investigative bodies that are responsible for investigating and prosecuting cases of corruption. There are normally government public education and awareness campaigns as part of efforts to change social behaviour in respect to corrupt practices and tolerance. Anti-corruption strategies usually include the use of modern technology to promote e-Procurement and e-government services, to minimise the risk of facilitation payments, identify “red flag” situations, indicate potential corruption, and support annual reporting to enhance awareness and open dialogue.

The assessor should assess the extent to which all or some of these actions are organised as a co-ordinated effort. This also includes sufficient resources, commitment by the government and the public, the extent to which they are mostly isolated and left to the initiative of individual agencies or organisations.

**Assessment criteria**

- (a) The country has in place a comprehensive anti-corruption framework to prevent, detect and penalise corruption in government that involves the appropriate agencies of government with a level of responsibility and capacity to enable its responsibilities to be carried out.\*
- (b) As part of the anti-corruption framework, a mechanism is in place and is used for systematically identifying corruption risks and for mitigating these risks in the public procurement cycle.
- (c) As part of the anti-corruption framework, statistics on corruption-related legal proceedings and convictions are compiled and reports are published annually.
- (d) Special measures are in place for the detection and prevention of corruption associated with procurement.
- (e) Special integrity training programmes are offered and the procurement workforce regularly participates in this training.

**\* Recommended quantitative indicator to substantiate assessment of sub-indicator 14(d) assessment criterion (a):**

- percentage of favourable opinions by the public on the effectiveness of anti-corruption measures (in % of responses).

Source: Survey.

### **Sub-indicator 14(e) – Stakeholder support to strengthen integrity in procurement**

This indicator assesses the strength of the public and the private sector in maintaining a sound procurement environment. This may be made manifest in the existence of respected and credible civil society groups that have a procurement focus within their agendas and/or actively provide oversight and exercise social control. Civil society organisations can only play a meaningful role as third-party monitors when they have government guarantees to function and when their work is generally promoted and accepted by the public. Media, where free and well-informed, can also play an active role in addressing integrity and ethical behaviour in public procurement.

Assessors should also evaluate whether business associations promote anti-corruption frameworks to be implemented by suppliers. The supply side can become an active partner in supporting integrity, by establishing internal compliance measures. Programmes could for example focus on codes of ethics, integrity training for staff and/or improved internal control measures.

The welcoming and respectful attitude of the government and the quality of the debate and the contributions of all interested stakeholders are an important part of creating an environment where integrity and ethical behaviour is expected and deviations are not tolerated.

**Assessment criteria**

- (a) There are strong and credible civil society organisations that exercise social audit and control.
- (b) There is an enabling environment for civil society organisations to have a meaningful role as third-party monitors, including clear channels for engagement and feedback that are promoted by the government.
- (c) There is evidence that civil society contributes to shape and improve integrity of public procurement.\*
- (d) Suppliers and business associations actively support integrity and ethical behaviour in public procurement, e.g. through internal compliance measures.\*

**\* Recommended quantitative indicator to substantiate assessment of sub-indicator 14(e) assessment criterion (c):**

- number of domestic civil service organisations (CSOs), including national offices of international CSOs actively providing oversight and social control in public procurement.

Source: Survey/interviews.

**\* Recommended quantitative indicator to substantiate assessment of sub-indicator 14(e) assessment criterion (d):**

- number of suppliers that have internal compliance measures in place (in %).

Source: Supplier database.<sup>37</sup>

### **Sub-indicator 14(f) – Secure mechanisms for reporting prohibited practices or unethical behaviour**

This sub-indicator assesses the following: i) whether the country provides, through its legislation and institutional set-up, a system for reporting fraudulent, corrupt or other prohibited practices or unethical behaviour; and ii) whether such legislation and systems provide for confidentiality and the protection of whistle-blowers. The system should be seen to react to reports, as verified by subsequent actions taken to address the issues reported. In case a reporting intake system is established and data is generated indicating the number of investigations conducted and actions taken, this information should be taken into account.

#### **Assessment criteria**

- (a) There are secure, accessible and confidential channels for reporting cases of fraud, corruption or other prohibited practices or unethical behaviour.
- (b) There are legal provisions to protect whistle-blowers, and these are considered effective.
- (c) There is a functioning system that serves to follow up on disclosures.

### **Sub-indicator 14(g) – Codes of conduct/codes of ethics and financial disclosure rules**

The country should have in place a code of conduct/ethics that applies to all public officials. In addition, special provisions should be in place for those involved in public procurement. Financial disclosure requirements for public officials have proven very useful in helping to prevent unethical or corrupt practices. Regular training programmes should be conducted for all public officials, to raise and sustain awareness of the requirements and ensure the effective implementation of these measures.

37 Disclosure of such details is generally not a requirement. Supplier database should include filing details on compliance.



**Assessment criteria**

- (a) There is a code of conduct or ethics for government officials, with particular provisions for those involved in public financial management, including procurement.\*
- (a) The code defines accountability for decision making, and subjects decision makers to specific financial disclosure requirements.\*
- (a) The code is of mandatory, and the consequences of any failure to comply are administrative or criminal.
- (a) Regular training programmes are offered to ensure sustained awareness and implementation of measures.
- (a) Conflict of interest statements, financial disclosure forms and information on beneficial ownership are systematically filed, accessible and utilised by decision makers to prevent corruption risks throughout the public procurement cycle.

**\* Recommended quantitative indicator to substantiate assessment of sub-indicator 14(g) assessment criterion (a):**

- share of procurement entities that have a mandatory code of conduct or ethics, with particular provisions for those involved in public financial management, including procurement (in % of total number of procuring entities).

Source: Normative/regulatory function.

**\* Recommended quantitative indicator to substantiate assessment of sub-indicator 14(g) assessment criterion (b):**

- officials involved in public procurement that have filed financial disclosure forms (in % of total required by law).

Source: Normative/regulatory function.

# ANNEXES

## Annex 1 – MAPS Indicator System

Pillar I – Legal, Regulatory and Policy Framework	
<b>1</b>	<b>The public procurement legal framework achieves the agreed principles and complies with applicable obligations.</b>
	<ul style="list-style-type: none"> <li>1(a) – Scope of application and coverage of the legal and regulatory framework</li> <li>1(b) – Procurement methods</li> <li>1(c) – Advertising rules and time limits</li> <li>1(d) – Rules on participation</li> <li>1(e) – Procurement documentation and specifications</li> <li>1(f) – Evaluation and award criteria</li> <li>1(g) – Submission, receipt and opening of tenders</li> <li>1(h) – Right to challenge and appeal</li> <li>1(i) – Contract management</li> <li>1(j) – Electronic Procurement (e-Procurement)</li> <li>1(k) – Norms for safekeeping of records, documents and electronic data.</li> <li>1(l) – Public procurement principles in specialised legislation</li> </ul>
<b>2</b>	<b>Implementing regulations and tools support the legal framework.</b>
	<ul style="list-style-type: none"> <li>2(a) – Implementing regulations to define processes and procedures</li> <li>2(b) – Model procurement documents for goods, works and services</li> <li>2(c) – Standard contract conditions</li> <li>2(d) – User’s guide or manual for procuring entities</li> </ul>
<b>3</b>	<b>The legal and policy frameworks support the sustainable development of the country and the implementation of international obligations.</b>
	<ul style="list-style-type: none"> <li>3(a) – Sustainable Public Procurement (SPP)</li> <li>3(b) – Obligations deriving from international agreements</li> </ul>

Pillar II – Institutional Framework and Management Capacity	
<b>4</b>	<b>The public procurement system is mainstreamed and well integrated with the public financial management system.</b>
	4(a) – Procurement planning and the budget cycle 4(b) – Financial procedures and the procurement cycle
<b>5</b>	<b>The country has an institution in charge of the normative/regulatory function.</b>
	5(a) – Status and legal basis of the normative/regulatory institution function 5(b) – Responsibilities of the normative/regulatory function 5(c) – Organisation, funding, staffing, and level of independence and authority 5(d) – Avoiding conflict of interest
<b>6</b>	<b>Procuring entities and their mandates are clearly defined.</b>
	6(a) – Definition, responsibilities and formal powers of procuring entities 6(b) – Centralised procurement body
<b>7</b>	<b>Public procurement is embedded in an effective information system.</b>
	7(a) – Publication of public procurement information supported by information technology 7(b) – Use of e-Procurement 7(c) – Strategies to manage procurement data
<b>8</b>	<b>The public procurement system has a strong capacity to develop and improve.</b>
	8(a) – Training, advice and assistance 8(b) – Recognition of procurement as a profession 8(c) – Monitoring performance to improve the system
Pillar III – Procurement Operations and Market Practices	
<b>9</b>	<b>Public procurement practices achieve stated objectives.</b>
	9(a) – Planning 9(b) – Selection and contracting 9(c) – Contract management in practice
<b>10</b>	<b>The public procurement market is fully functional.</b>
	10(a) – Dialogue and partnerships between public and private sector 10(b) – Private sector's organisation and access to the public procurement market 10(c) – Key sectors and sector strategies

<b>Pillar IV – Accountability, Integrity and Transparency of the Public Procurement System</b>	
<b>11</b>	<b>Transparency and civil society engagement strengthen integrity in public procurement.</b>
	<p>11(a) – Enabling environment for public consultation and monitoring</p> <p>11(b) – Adequate and timely access to information by the public</p> <p>11(c) – Direct engagement of civil society</p>
<b>12</b>	<b>The country has effective control and audit systems.</b>
	<p>12(a) – Legal framework, organisation and procedures of the control system</p> <p>12(b) – Co-ordination of controls and audits of public procurement</p> <p>12(c) – Enforcement and follow-up on findings and recommendations</p> <p>12(d) – Qualification and training to conduct procurement audits</p>
<b>13</b>	<b>Procurement appeals mechanisms are effective and efficient.</b>
	<p>13(a) – Process for challenges and appeals</p> <p>13(b) – Independence and capacity of the appeals body</p> <p>13(c) – Decisions of the appeals body</p>
<b>14</b>	<b>The country has ethics and anti-corruption measures in place.</b>
	<p>14(a) – Legal definition of prohibited practices, conflicts of interest, and associated responsibilities, accountability and penalties</p> <p>14(b) – Provisions on prohibited practices in procurement documents</p> <p>14(c) – Effective sanctions and enforcement systems</p> <p>14(d) – Anti-corruption framework and integrity training</p> <p>14(e) – Stakeholder support to strengthen integrity in procurement</p> <p>14(f) – Secure mechanisms for reporting prohibited practices or unethical behaviour</p> <p>14(g) – Codes of conduct/codes of ethics and financial disclosure rules</p>

## Annex 2 – MAPS Assessment Criteria Expressed in Quantitative Terms

Indicator		Quantitative Indicators (minimum)	Additional recommended quantitative indicators
4(b)	Financial procedures and the procurement cycle	To substantiate assessment criterion (b): Invoices paid on time (in %). <i>Source:</i> PFM systems.	
5(d)	Avoiding conflict of interest		To substantiate assessment criterion (a): Perception that the normative/regulatory institution is free of conflicts (in % of responses). <i>Source:</i> Survey.
6(a)	Definition, responsibilities and formal powers of procuring entities	To substantiate assessment criterion (c): Procuring entities with a designated, specialised procurement function (in % of total number of procuring entities). <i>Source:</i> Normative/regulatory function.	
7(a)	Publication of public procurement information supported by information technology	To substantiate assessment criterion (c): Procurement plans published (in % of total number of procurement plans required). <sup>38</sup>  Key procurement information published along the procurement cycle <sup>39</sup> (in % of total number of contracts): invitation to bid; contract awards (purpose, supplier, value; amendments/variations); details related to contract implementation (milestones, completion and payment); annual procurement statistics.  Appeals decisions posted within the time frames specified in the law (in %). <i>Source:</i> Centralised online portal.	To substantiate assessment criterion (e): Share of procurement information and data published in open data formats (in %). <i>Source:</i> Centralised online portal.

38 PEFA PI-24.3 (2).

39 PEFA PI-24.3 (3, 4, 5, 6).

7(b)	Use of e-Procurement	<p>To substantiate assessment criterion (a):</p> <p>Uptake of e-Procurement</p> <ul style="list-style-type: none"> <li>- number of e-Procurement procedures in % of total number of procedures</li> <li>- value of e-Procurement procedures in % of total value of procedures</li> </ul> <p>Source: e-Procurement system.</p>	<p>To substantiate assessment criterion (d):</p> <p>Bids submitted online (in %)</p> <p>Bids submitted on line by micro, small and medium-sized enterprises (in %).</p> <p>Source: e-Procurement system.</p>
7(c)	Strategies to manage procurement data	<p>To substantiate assessment criterion (d):</p> <p>Total number of contracts</p> <p>Total value of contracts;</p> <p>Public procurement as a share of government expenditure and as a share of GDP.</p> <p>Total value of contracts awarded through competitive methods in most recent fiscal year.<sup>40</sup></p> <p>Source: Normative/regulatory function/e-Procurement system.</p>	
9(b)	Selection and contracting		<p>To substantiate assessment criterion (h):</p> <p>Average time to procure goods, works and services: number of days between advertisement/solicitation and contract signature (for each procurement method used)</p> <p>Average number (and %) of bids that are responsive (for each procurement method used)</p> <p>Share of processes that have been conducted in full compliance with publication requirements (in %)</p> <hr/> <p>To substantiate assessment criterion (j):</p> <p>Number (and %) of successful processes:</p> <ul style="list-style-type: none"> <li>- successfully awarded;</li> <li>- failed; or</li> <li>- cancelled</li> <li>- awarded within time frames</li> </ul> <p>Source for all: Sample of procurement cases.</p>

40 PEFA Indicator PI-24.2.

9(c)	Contract management in practice	To substantiate assessment criterion (g): Share of contracts with complete and accurate records and databases <sup>41</sup>	To substantiate assessment criterion (a): Time overruns (in %; and average delay in days)
			To substantiate assessment criterion (b): Quality-control measures and final acceptance is carried out as stipulated in the contract (in %)
			To substantiate assessment criterion (d): Contract amendments (in % of total number of contracts; average increase of contract value in %)
			To substantiate assessment criterion (f): Percentage of contracts with direct involvement of civil society: - planning phase - bid/proposal opening - evaluation and contract - award, as permitted - contract implementation  <i>Source for all:</i> Sample of procurement cases.
10(a)	Dialogue and partnerships between public and private sector		To substantiate assessment criterion (a): Perception of openness and effectiveness in engaging with the public and private sector (in % of responses).  <i>Source:</i> Survey.

41 PEFA Indicator PI-24.1.

10(b)	Private sector organisations and access to the public procurement market		<p>To substantiate assessment criterion (a):</p> <p>Number of registered suppliers as a share of total number of suppliers in the country (in %)</p> <p>Share of registered suppliers that are awarded public contracts (in % of total number of registered suppliers)</p> <p>Total number and value of contracts awarded to domestic/foreign firms (and in % of total)</p> <p><i>Source:</i> e-Procurement system/supplier database.</p> <hr/> <p>To substantiate assessment criterion (b):</p> <p>Perception of firms on the appropriateness of conditions in the public procurement market (in % of responses).</p> <p><i>Source:</i> Survey.</p>
12(b)	Co-ordination of controls and audits of public procurement		<p>To substantiate assessment criterion (c):</p> <p>Number of specialised procurement audits carried out compared to total number of audits (in %).</p> <p>Share of procurement performance audits carried out (in % of total number of procurement audits).</p> <p><i>Source:</i> Ministry of Finance/Supreme Audit Institution.</p>
12(c)	Enforcement and follow-up on findings and recommendations		<p>To substantiate assessment criterion (a):</p> <p>Share of internal and external audit recommendations implemented within the time frames established in the law (in %).</p> <p><i>Source:</i> Ministry of Finance/Supreme Audit Institution.</p>
12(d)	Qualification and training to conduct procurement audits		<p>To substantiate assessment criterion (a):</p> <p>Number of training courses conducted to train internal and external auditors in public procurement audits.</p> <p>Share of auditors trained in public procurement (in % of total number of auditors).</p> <p><i>Source:</i> Ministry of Finance/Supreme Audit Institution.</p>
13(a)	Process for challenges and appeals	<p>To substantiate assessment criterion (c):</p> <p>Number of appeals (in % of contracts awarded).</p> <p><i>Source:</i> Appeals body.</p>	<p>To substantiate assessment criterion (c):</p> <p>Number (and percentage) of enforced decisions.</p> <p><i>Source:</i> Appeals body.</p>



13(b)	Independence and capacity of the appeals body	<p>To substantiate assessment criterion (e):</p> <p>Appeals resolved within the time frame specified in the law/exceeding this time frame/unresolved (total numbers and in %).</p> <p><i>Source:</i> Appeals body.</p>	
13(c)	Decisions of the appeals body	<p>To substantiate assessment criterion (d):</p> <p>Share of appeals decisions posted on a central online platform within timelines specified in the law (in %).</p> <p><i>Source:</i> Centralised online portal.</p>	<p>To substantiate assessment criterion (b):</p> <p>Share of suppliers that perceive the challenge and appeals system as trustworthy (in % of responses).</p> <p>Share of suppliers that perceive appeals decisions as consistent (in % of responses).</p> <p><i>Source:</i> Survey.</p> <hr/> <p>To substantiate assessment criterion (c):</p> <p>Outcome of appeals (dismissed; in favour of procuring entity; in favour of applicant) (in %).</p> <p><i>Source:</i> Appeals body.</p>
14(c)	Effective sanctions and enforcement systems		<p>To substantiate assessment criterion (d):</p> <p>Firms and individuals found guilty of fraud and corruption in procurement:</p> <p>Number of firms/individuals prosecuted/convicted; prohibited from participation in future procurements (suspended/debarred).</p> <p>Government officials found guilty of fraud and corruption in public procurement: number of officials prosecuted/convicted.</p> <p><i>Source:</i> Normative/regulatory function.</p> <p>Gifts to secure public contracts; number of firms admitting to unethical practices, including making gifts (in %).</p> <p><i>Source:</i> Survey.</p>
14(d)	Anti-corruption framework and integrity training		<p>To substantiate assessment criterion (a):</p> <p>Percentage of favourable opinions by the public on the effectiveness of anti-corruption measures.</p> <p><i>Source:</i> Survey.</p>

14(e)	Stakeholder support to strengthen integrity in procurement		<p>To substantiate assessment criterion (c):</p> <p>Number of domestic CSOs (including national offices of international CSOs) actively providing oversight and social control in public procurement.</p> <p><i>Source:</i> Survey/Interviews.</p>
			<p>To substantiate assessment criterion (d):</p> <p>Number of suppliers that have internal compliance measures in place (in %).</p> <p><i>Source:</i> Supplier database.</p>
14(g)	Codes of conduct/ codes of ethics and financial disclosure rules		<p>To substantiate assessment criterion (a):</p> <p>Share of procurement entities that have a mandatory code of conduct or ethics with particular provisions for those involved in PFM, including procurement (in % of total number of procuring entities).</p> <p><i>Source:</i> Normative/regulatory function.</p>
			<p>To substantiate assessment criterion (b):</p> <p>Officials involved in public procurement who have filed financial disclosure forms (in % of total).</p> <p><i>Source:</i> Normative/regulatory function.</p>

# GLOSSARY

<b>Accountability (in public management)</b>	Managers are held responsible for carrying out a defined set of duties or tasks, and for conforming with rules and standards applicable to their posts.
<b>Appeals body</b>	Independent body in charge of reviewing decisions of a specified first review body. The appeals body may be an administrative or judicial review body. The appeals body needs to be independent from the procuring entity and should not be involved in any capacity in procurement transactions or in the process leading to contract award decisions.
<b>Budget</b>	A comprehensive statement of government financial plans, which include expenditures, revenues, deficit or surplus and debt. The budget is the government's main economic policy document, demonstrating how the government plans to use public resources to meet policy goals and to some extent, indicating where its policy priorities lie.
<b>Capability</b>	The skills-based ability for an individual, group or organisation to meet obligations and objectives; also referred to as "know-how".
<b>Capacity</b>	The ability to meet obligations and objectives based on existing administrative, financial, human and infrastructure resources.
<b>Civil servant</b>	An employee of the state who would continue to be a state employee if the government changes. In addition, civil servants are employees covered under a specific public legal framework or other specific provisions.
<b>Civil society organisation (CSO)</b>	The multitude of associations around which society voluntarily organises itself and which represent a wide range of interests and ties. These can include community-based organisations, indigenous people's organisations and nongovernment organisations.
<b>Competition</b>	<p>A situation in a market in which firms or sellers independently strive for the patronage of buyers to achieve a particular business objective, e.g. profits, sales and/or market share.</p> <p>Competition in this context is often equated with rivalry. Competitive rivalry between firms can occur when there are two firms or many firms. This rivalry may take place in terms of price, quality, service or combinations of these and other factors that customers may value.</p> <p>Competition is viewed as an important process by which firms are forced to become efficient, offering a greater choice of products and services at lower prices. It gives rise to increased consumer welfare and allocative efficiency. It includes the concept of "dynamic efficiency", by which firms engage in innovation and encourage technological change and progress.</p>
<b>Competition bodies</b>	Government agencies, which formulate competition policies and/or regulate and enforce competition laws.
<b>Corruption</b>	Abuse of public or private office for personal gain.
<b>Effectiveness</b>	The extent to which the activities' stated objectives have been met
<b>Efficiency</b>	Achieving maximum output from a given level of resources used to carry out an activity.
<b>e-Procurement</b>	The integration of digital technologies in the replacement or redesign of paper-based procedures throughout the procurement process

<b>Good governance</b>	Governance characterised by participation, transparency, accountability, rule of law, effectiveness, equity, etc. Good governance refers to the management of government in a manner that is essentially free of abuse and corruption and with due regard for the rule of law.
<b>Governance</b>	The exercise of political, economic and administrative authority
<b>Gross domestic product (GDP)</b>	The standard measure of the value of the goods and services produced by a country during a given period. Specifically, it is equal to the sum of the gross value added of all resident institutional units engaged in production (plus any taxes, and minus any subsidies, on products not included in the value of their outputs). The sum of the final uses of goods and services (all uses except intermediate consumption) measured in purchasers' prices, less the value of imports of goods and services, or the sum of primary incomes distributed by resident producer units.
<b>Horizontal policy objectives</b>	Any of a variety of objectives of an economic, environmental and social nature (such as sustainable green growth, the development of small and medium-sized enterprises, innovation, standards for responsible business conduct or broader industrial policy objectives), which governments increasingly pursue through use of procurement as a policy lever (sometimes referred to as "secondary" policies, in contrast with the so-called "primary" objectives of delivering goods and services in a timely, economical and efficient manner).
<b>Indicator</b>	A quantitative or qualitative measure derived from a series of observed facts that can reveal relative positions in a given area.
<b>Innovation</b>	The implementation of a new or significantly improved product, good, service or process, or a new organisational method.
<b>Integrity</b>	The use of funds, resources, assets and authority according to the intended official purposes, and in a manner that is well informed and aligned with the public interest and broader principles of good governance.
<b>PEFA</b>	Public Expenditure and Financial Accountability (PEFA) Performance Measurement Framework ( <a href="http://www.pefa.org">www.pefa.org</a> )
<b>Performance</b>	The ability of an entity to acquire resources economically and use those resources efficiently and effectively in achieving performance targets.
<b>Performance Information</b>	Performance information can be generated by both government and nongovernmental organisations, and can be both qualitative and quantitative. Performance information refers to metrics/indicators/general information on the inputs, processes, outputs and outcomes of government policies/programmes/organisations, and can be ultimately used to assess their effectiveness, cost effectiveness and efficiency. Performance information can be found in statistics; the financial and/or operational accounts of government organisations; performance reports generated by government organisations; evaluations of policies, programmes or organisations; or spending reviews, for instance.

<b>Policy</b>	A consistent course of action designed to meet a goal or objective and respond to an issue or problem identified by the state as requiring action or reform. It is implemented by a public body (ministry, agency, etc.), although elements may be delegated to other bodies. Examples include a public policy to tackle climate change, educational reform, or support for entrepreneurship. A public policy is, or should be, linked to the government programme and its strategic planning. It is often given a formal framework through legislation and/or secondary regulations, especially in countries with a system of civil law. It is given practical effect through a defined course of action, programmes and activities. It is, as necessary, funded from the state budget. A priority policy is a policy that matters more than others for the achievement of the government's strategic objectives. The responsibility for taking forward a public policy may rest with the relevant line ministry, or, in the case of policies that cut across ministerial boundaries, may be shared by relevant ministries.
<b>Procurement document</b>	A document issued by the procuring entity that sets out the terms and conditions of the given procurement. Invitation to participate in procurement proceedings (e.g. invitation to tender, participate in request for proposal proceedings or an electronic reverse auction). Alternative terms: solicitation document or tender document.
<b>Procuring entity</b>	A public entity (agency) conducting procurement in compliance with the applicable law. The terms "procuring agency" or "procurement body" are often used synonymously. Procuring entities can belong to any level of government (national, provincial or municipal level). They can represent different arms of government (branches, ministries, departments, etc.) or they could be constituted as state-owned enterprises or bodies.
<b>Public procurement</b>	The process of identifying what is needed; determining who the best person or organisation is to supply this need; and ensuring that what is needed is delivered to the right place, at the right time and for the best price; and that all this is done in a fair and open manner;
<b>Public procurement cycle</b>	The sequence of related activities, from needs assessment through competition and award to payment and contract management, as well as any subsequent monitoring or auditing.
<b>Public servant</b>	A term used to identify those who are employed by government-funded organisations. Some countries use both "public servant" and "civil servant" when describing government-funded employees, with "public servant" having a broader application (e.g. encompassing doctors, teachers, local government officials, etc.) than "civil servant", which would include employees working in the central government.
<b>Public services</b>	Services that are performed for the benefit of the public or its institutions. Public services are provided by government to its citizens, either directly (through the public sector) or by financing private provision of services. The term is associated with a social consensus that certain services should be available to all, regardless of income. Even where public services are neither publicly provided nor publicly financed, for social and political reasons, they are usually subject to regulation that extends beyond the regulation applying to most economic sectors.
<b>Public (open) tender</b>	Refers to the process whereby a procuring entity invites bids that should be submitted within a finite deadline. It is often used for a bidding process that is open to all qualified bidders (open tender) and where sealed bids are opened in public for scrutiny and are chosen on the basis of stated award criteria. In the context of sub-indicator 1(g), the term "tender" is used interchangeably with "bids" or "proposals".
<b>Public-private partnership</b>	A contract (institutional relationship) between public and private actors for the co-operative provision of a public good or service. The essential element is some degree of private participation in the delivery of goods or services traditionally in the public domain. Private actors may include both for-profit and not-for-profit organisations.

<b>Regulation</b>	The term regulation covers the diverse set of instruments by which governments impose requirements on enterprises and citizens. Regulations include all primary laws, formal and informal orders, subordinate regulations, administrative formalities and rules issued by nongovernmental or self-regulatory bodies to whom governments have delegated regulatory powers.
<b>Specific sensitive information</b>	Refers to legitimate needs for protection of trade secrets and proprietary information and other privacy concerns, as well as the need to avoid disclosing information that can be used by interested parties to distort competition in the procurement process. The country's legal framework should include definitions and provisions to unambiguously identify and prohibit the disclosure of specific sensitive information.
<b>State-owned enterprise</b>	Countries have different definitions of state-owned enterprises. The OECD offers the following definition for comparative purposes: "any corporate entity recognised by national law as an enterprise, and in which the state exercises ownership" (OECD, 2015, OECD Guidelines on Corporate Governance of State-Owned Enterprises, 2015 Edition, OECD Publishing, Paris. <a href="http://dx.doi.org/10.1787/9789264244160-en">http://dx.doi.org/10.1787/9789264244160-en</a> .)
<b>Supplier</b>	A party that supplies goods, works, or services, i.e. in this context, "supplier" implies contractors and service providers that include consulting firms or others.
<b>Sustainability</b>	(a) Use of the biosphere by present generations while maintaining its potential yield (benefit) for future generations; and/or  (b) non-declining trends of economic growth and development that might be impaired by natural resource depletion and environmental degradation.
<b>Sustainable development</b>	Development "that meets the needs of the present without compromising the ability of future generations to meet their own needs", World Commission on Environment and Development (1987), Our Common Future, <a href="http://www.un-documents.net/our-common-future.pdf">http://www.un-documents.net/our-common-future.pdf</a> .
<b>Sustainable Public Procurement (SPP)</b>	A "process whereby organisations meet their needs for goods, services, works and utilities in a way that achieves value for money on a whole life basis in terms of generating benefits not only to the organisation, but also to society and the economy, whilst minimising damage to the environment", Department for Environment, Food and Rural Affairs (2006), "Procuring the Future: Sustainable Action Plan: Recommendations from the Sustainable Procurement Task Force", London, in: <a href="http://collections.europarchive.org/tna/20080530153425/http://www.sustainable-development.gov.uk/publications/procurement-action-plan/documents/full-document.pdf">http://collections.europarchive.org/tna/20080530153425/http://www.sustainable-development.gov.uk/publications/procurement-action-plan/documents/full-document.pdf</a> .
<b>Transparency</b>	An environment in which the objectives of policy, its legal, institutional and economic framework, policy decisions and their rationale, data and information related to policies, and the terms of agencies' accountability, are provided to the public in a comprehensible, accessible and timely manner.
<b>Trust</b>	Trust is broadly understood as holding a positive perception about the actions of an individual or an organisation. Trust gives us confidence that others will act as we might expect in a particular circumstance. While trust may be based on actual experience, in most cases, trust is a subjective phenomenon, reflected in the eyes of the beholder.
<b>Value for money</b>	Value for money is a term used in different ways to convey the effective, efficient and economic use of resources. In the context of public procurement, it can be defined as the most advantageous combination of cost, quality and sustainability to meet defined requirements. Cost means consideration of the whole life cost and risks; quality means meeting a specification which is fit for purpose and sufficient to meet the requirements; and sustainability comprises economic, social and environmental benefits.

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[www.mapsinitiative.org](http://www.mapsinitiative.org)

## **LEGAL AUTHORITY CA-90**

Date of dispatch to the parties: February 6, 2007

INTERNATIONAL CENTRE FOR SETTLEMENT  
OF INVESTMENT DISPUTES  
WASHINGTON, D.C.

IN THE PROCEEDING BETWEEN

SIEMENS A.G.  
(CLAIMANT)

AND

THE ARGENTINE REPUBLIC  
(RESPONDENT)

ICSID CASE No. ARB/02/8

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AWARD

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*Members of the Tribunal*

Dr. Andrés Rigo Sureda, President  
Judge Charles N. Brower, Arbitrator  
Professor Domingo Bello Janeiro, Arbitrator

*Secretary of the Tribunal*

Ms. Claudia Frutos-Peterson

*Representing the Claimant*

Dr. Guido Santiago Tawil  
M. & M. Bomchil  
Buenos Aires  
Argentina

and

Dr. Peter Gnam  
Siemens A.G.

*Representing the Respondent*

H.E. Osvaldo César Guglielmino  
Procurador del Tesoro de la Nación Argentina  
Procuración del Tesoro de la Nación Argentina  
Buenos Aires  
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## **I. Procedural History**

1. On May 23, 2002, the International Centre for Settlement of Investment Disputes (“ICSID” or the “Centre”) received from Siemens A.G. (“Siemens” or “Claimant”) a request for arbitration against the Argentine Republic (“Respondent”, “Argentina” or “Government”). On June 7, 2002, the Centre acknowledged receipt of the request in accordance with Rule 5 of the ICSID Rules of Procedure for the Institution of Conciliation and Arbitration Proceedings (“Institution Rules”) and informed the Claimant that it would not take further action until it had received the prescribed lodging fee as provided by Institution Rule 5(1)(b). On June 13, 2002, the Centre acknowledged receipt of the prescribed lodging fee by the Claimant and transmitted a copy of the request to Argentina and to the Argentine Embassy in Washington, D.C. in accordance with Institution Rule 5(2).

2. According to Article 36(3) of the Convention on the Settlement of Investment Disputes between States and Nationals of other States (“the Convention”), the Secretary-General of the Centre registered the request for arbitration on July 17, 2002. In accordance with Institution Rule 7, the Secretary-General notified the parties on the same date of the registration of the request and invited them to proceed to constitute an Arbitral Tribunal as soon as possible.

3. On August 7, 2002, the parties agreed that the Arbitral Tribunal would consist of three arbitrators, one arbitrator to be appointed by each party and the third, who shall serve as the President of the Tribunal, to be appointed by the agreement of the parties. The Claimant appointed Judge Charles N. Brower, a U.S. national, and the Respondent appointed Professor Domingo Bello Janeiro, a Spanish national. However, the parties failed to agree on the appointment of the third, presiding arbitrator. On October 21, 2002, the Claimant requested that the third, presiding arbitrator be appointed in accordance with Article 38 of the Convention and Rule 4 of the ICSID Rules of Procedure for Arbitration Proceedings (“Arbitration Rules”).

4. After consulting the parties, Dr. Andrés Rigo Sureda, a national of Spain, was appointed by the Centre as the third, presiding arbitrator. In accordance with Rule 6(1) of the Arbitration Rules, on December 19, 2002, the Secretary-General notified the parties that all three arbitrators accepted their appointment and that the Arbitral Tribunal was deemed to be constituted and the proceedings to have begun on that date. On the same date, pursuant to ICSID Administrative and Financial Regulation 25, the parties were informed that Mr. Gonzalo Flores, Senior Counsel, ICSID, would serve as Secretary of the Arbitral Tribunal. The Tribunal held its first session with the parties in Washington, D.C. on February 13, 2003.

5. Mr. Guido Santiago Tawil of M. & M. Bomchil and Mr. Peter Gnam of Siemens A.G. represent the Claimant. Messrs. Tawil and Gnam represented the Claimant at the first session. Mr. Osvaldo César Guglielmino, Procurador del Tesoro de la Nación Argentina, represents the Respondent. Messrs. Ignacio Suárez Anzorena and Carlos Lo Turco, acting on instructions from the then Procurador del Tesoro de la Nación Argentina, and Mr. Osvaldo Siseles, from the Ministerio de Economía, represented the Respondent at the first session.

6. During the first session, the parties agreed that the Tribunal had been properly constituted in accordance with the ICSID Convention and the Arbitration Rules and that they did not have any objections to any members of the Tribunal. It was also noted that the proceedings would be conducted under the Arbitration Rules in force since September 26, 1984.

7. During the first session, the parties also agreed on several other procedural matters, which were later set forth in the written minutes signed by the President and the Secretary of the Tribunal. Regarding the written submissions, the Tribunal, after consulting with the parties, fixed the following time limits for the presentation of the parties' pleadings: The Claimant would file a Memorial within 90 (ninety) days from the date of the first session; the Respondent would file a Counter-Memorial within 90 (ninety) days from its receipt of the Claimant's Memorial; the Claimant would file a Reply within 60 (sixty) days from its receipt of the Respondent's Counter-Memorial, and the Respondent would file a Rejoinder within 60 (sixty) days from its receipt of the Claimant's Reply.

8. The Tribunal further noted that, according to the Arbitration Rules, the Respondent has the right to raise any objections to jurisdiction no later than the expiration of the time limit fixed for the filing of its Counter-Memorial, and that, in the event that the Respondent would raise objections to jurisdiction, the following schedule would apply: the Claimant would file its Counter-Memorial on jurisdiction within the same number of days used by Argentina to file its objections to jurisdiction, but in any event, the Claimant would have a minimum of 60 (sixty) days to file its Counter-Memorial on jurisdiction; the Respondent would file its Reply on jurisdiction within 30 (thirty) days from its receipt of the Claimant's Counter-Memorial on jurisdiction; and the Claimant would file its Rejoinder on jurisdiction within 30 (thirty) days from its receipt of the Respondent's Reply on jurisdiction. It was also agreed that, if the Respondent would raise any objections to jurisdiction and proceedings would be resumed following the filing of such objections (because the Tribunal dismisses the objections or because it decides to join them with the merits of the dispute), the calendar agreed for the merits would recommence, and the Respondent would have the remaining number of days at the date of the filing of its objections to jurisdiction for the filing of its Counter-Memorial on the merits.

9. On March 14, 2003, the Claimant filed its Memorial on the merits and accompanying documentation.

10. On March 24, 2003, Ms. Claudia Frutos-Peterson, ICSID, Counsel, replaced Mr. Flores as the Secretary of the Tribunal.

11. On April 8, 2003, the parties agreed that the hearing on jurisdiction would take place on January 20-22, 2004, in Washington, D.C.

12. By letter of June 10, 2003, the Argentine Republic requested an extension of time due to the institutional succession in the Argentine Government to file its Counter-Memorial on the merits and/or to raise any objections to the jurisdiction of the Centre until August 4, 2003. By letter of June 18, 2003, the Claimant objected to the extension requested by the Respondent.

13. On June 23, 2003, due to the particular circumstances, the Tribunal granted the extension sought by Argentina and informed the parties that if Argentine filed its Counter-Memorial without objecting to jurisdiction, the Claimant, if requested, would be granted a similar extension of time to file its



Reply on the merits. The Tribunal further noted that if the Argentine Republic filed any objections to jurisdiction, the Claimant would have the same number of days used by the Argentine Republic to file such objections for the filing of its Counter-Memorial on jurisdiction.

14. On July 1, 2003, Mr. Horacio Daniel Rosatti informed the Tribunal that he had been appointed Procurador del Tesoro de la Nación Argentina.

15. In accordance with Arbitration Rule 41(1), on August 4, 2003, the Respondent filed a Memorial raising objections to the jurisdiction of the Centre and the competence of the Tribunal. In its Memorial on jurisdiction, Argentina requested the Tribunal for a 45 (forty-five) day extension of the time limit to file its Counter-Memorial on the merits in the event that the Tribunal would declare that it has competence over this matter.

16. Pursuant to Arbitration Rule 41(3), on August 7, 2003, the Tribunal suspended the proceedings on the merits.

17. After inviting the Claimant to present any observations on the time limit extension requested by the Respondent, the Tribunal informed the parties on August 21, 2003, that it was premature to decide on the extension of the time limit to file the Counter-Memorial on the merits requested by Argentina.

18. On October 16, 2003, the Claimant filed its Counter-Memorial on jurisdiction. On November 17, 2003, the Respondent filed its Reply on jurisdiction.

19. On December 10, 2004, the Respondent requested to postpone the hearing on jurisdiction scheduled for January 20-22, 2004 until February 15, 2004. On December 11, 2004, the Tribunal invited the Claimant to present any observations to the Respondent's request. On the same date, the Claimant presented its observations asking the Tribunal to reject the Respondent's request and to maintain the previous agreed schedule for the hearing on jurisdiction.

20. After considering the Respondent's request to postpone the hearing on jurisdiction, the Claimant's observations thereon, the fact that the development of the proceeding would not be affected due to the brevity of the postponement requested, the availability of the parties, and the agreement of the same to have a two-day hearing, the Tribunal, by letter of December 19, 2003,

informed the parties of its decision to schedule the hearing on jurisdiction on February 3 and 4, 2004.

21. On December 24, 2003, the Claimant filed its Rejoinder on jurisdiction.

22. As previously decided by the Tribunal, the hearing on jurisdiction took place in Washington, D.C. on February 3 and 4, 2004. At the hearing, the Claimant was represented by Mr. Guido Santiago Tawil, Mr. Peter Gnam, Mr. Stephan Signer and Ms. María Inés Corrá. Messrs. Tawil and Gnam addressed the Tribunal on behalf of the Claimant. The Respondent was represented by Ms. Andrea Gualde, Ms. Ana Badillos, and Mr. Jorge Barraguirre from the Procuración del Tesoro de la Nación Argentina, as well as by Messrs. Osvaldo Siseles from the Ministerio de Economía, and Mr. Roberto Hermida from the Embassy of Argentina in Washington, D.C. Ms. Gualde and Mr. Barraguirre addressed the Tribunal on behalf of the Respondent. During the hearing, the Tribunal also questioned to the parties in accordance with Arbitration Rule 32(3).

23. On July 2, 2004, the Respondent requested to extend its 45-day extension request to file its Counter-Memorial on the merits to 75 days, in the event that the Tribunal would declare that it had jurisdiction.

24. On August 3, 2004, the Tribunal issued its Decision on Jurisdiction, which is part of this Award, declaring that the dispute was within the jurisdiction of the Centre and the competence of the Tribunal.

25. On that same date, the Tribunal issued Procedural Order No. 1, establishing the timetable for the continuation of the proceeding, after taking into consideration the reasons expressed by the Respondent in its requests for an extension of the time limit to file its Counter-Memorial on the merits and the observations of the Claimant. The timetable was decided as follows: the Respondent was to file its Counter-Memorial on the merits within 60 (sixty) days, counting from the date of that Procedural Order; the Claimant was to file its Reply within 60 (sixty) days from its receipt of the Respondent's Counter-Memorial, and the Respondent was to file its Rejoinder within 60 (sixty) days from its receipt of the Claimant's Reply. Two alternate dates were set for the hearing on the merits, and the parties were asked to inform the Secretariat on the number of days needed for the hearing.

26. On August 10, 2004, both parties requested the hearing on the merits to be held on April 4-15, 2005. Additionally, the Claimant reserved its right to request an extension, if needed, to file its Reply, in the understanding that such an extension should not change the hearing dates already set.

27. On August 16, 2004, Argentina notified the appointment of Mr. Osvaldo César Guglielmino as Procurador del Tesoro de la Nación Argentina.

28. On August 19, 2004, the Tribunal confirmed that the hearing on the merits was to be held on April 4-15, 2005, and that, if needed, the Tribunal would additionally be available on April 18-19, 2005. (Later on the parties confirmed to the Tribunal that there would be no need to extend the hearing to April 18-19, 2005).

29. On September 24, 2004, Argentina requested an additional extension of 15 (fifteen) days of the time limit to file its Counter-Memorial on the merits due to the recent appointment of Mr. Osvaldo César Guglielmino as Procurador del Tesoro de la Nación Argentina. By letter of September 29, 2004, the Claimant objected to the extension requested by the Respondent. After considering the Respondent's request and the Claimant's observations, the Tribunal, by letter also of September 29, 2004, granted the 15 day extension requested by the Respondent to file its Counter-Memorial on the merits, on the understanding that a similar extension, if requested, would be granted to the Claimant, and informed the parties that no further extensions would be authorized. The Tribunal also invited the parties to directly exchange their filings in Buenos Aires to avoid further delays.

30. In accordance with the Tribunal's decision, the Respondent filed its Counter-Memorial on the merits on October 19, 2004. In its Counter-Memorial, the Respondent requested the production of certain documents by the Claimant: (i) forward contract in US dollars ("dollars or "\$"), (ii) financial statements of Siemens IT Services, S.A. ("SITS") from its commencement of business in Argentina, and (iii) financial statements of Siemens for the same period with respect to the registration of all operations transacted between SITS-Siemens and the rest of the affiliates of the Claimant parent corporation. By letter of December 1, 2004, the Claimant informed the Tribunal that it would submit, together with its Reply, a copy of SITS' financial statements for the fiscal years

ended September 30 of 1997 to 2003 and the Annual Reports of Siemens for the fiscal years ended September 20 of 1997 to 2003.

31. On December 1, 2004, the Respondent filed an application to disqualify the President of the Tribunal under Article 57 of the Convention. On December 7, 2004, in accordance with Arbitration Rule 9(6), the two co-arbitrators informed the parties that the proceedings were suspended and that the schedule for the parties' submissions and the date for the hearing on the merits were to be maintained.

32. On December 14, 2004, the Claimant requested a 15-day extension to file its Reply on the merits, which was due on December 20, 2004. By letter of December 21, 2004, the two co-arbitrators granted the extension requested by the Claimant, in accordance with the Tribunal's letter of September 29, 2004. Accordingly, the Claimant was to file its Reply on the merits no later than January 4, 2005. The Claimant filed its Reply on the merits on December 27, 2004. However, due to the suspension of the proceedings, the Claimant's Reply was circulated neither to the Tribunal nor to Argentina. After considering several communications exchanged by the parties regarding whether to provide a copy of the Claimant's Reply to the Respondent, the co-arbitrators decided, with the agreement of the parties, that a copy of the Claimant's Reply be delivered directly to the Respondent in Buenos Aires and that the Respondent was to file its Rejoinder within 60 (sixty) days from the receipt of the Claimant's Reply, i.e., no later than March 14, 2005.

33. By letter of February 3, 2005, the co-arbitrators, having considered the parties' request to delay for some days the hearing on the merits, granted such request.

34. On March 2, 2005, the Respondent requested a 15-day extension to file its Rejoinder due to translation difficulties. On March 3, 2005, the Claimant expressed its opposition to granting the extension.

35. On March 10, 2005, the Secretariat sent the parties Judge Brower's and Professor Bello Janeiro's separate opinions concerning Argentina's proposal for disqualification. In accordance with Arbitration Rule 9, the proceeding was to remain suspended pending a decision on the disqualification proposal, and, therefore, the date for the hearing on the merits was postponed

indefinitely. In addition, the 15-day extension requested by the Respondent to file its Rejoinder was granted, which was then to be filed no later than March 29, 2005.

36. On March 16, 2005, the Deputy Secretary-General of ICSID informed the parties that in accordance with Article 58 of the ICSID Convention, the Chairman of the Administrative Council was to decide on the Respondent's proposal for disqualification as the other members of the Tribunal were divided on the proposal. In addition, the Deputy Secretary-General also informed the parties that, because the President of the Tribunal had been a staff member of the World Bank and as proceeded in an earlier similar ICSID case, the request would be sent to the Secretary-General of the Permanent Court of Arbitration ("PCA") at The Hague to provide his recommendation on the disqualification proposal.

37. As directed, on March 29, 2005, the Respondent filed its Rejoinder on the merits.

38. On April 8, 2005, the parties were informed that the PCA would not hold a hearing with the parties, as requested by Argentina, but that it had agreed to receive any additional written information from the parties, besides that already filed by them and provided by ICSID to the PCA. Accordingly, the parties were informed on April 11, 2005, that considering Argentina's intention to send such additional information, the decision by the Secretary-General of the PCA on the disqualification proposal was postponed until April 15, 2005. On such a date, the Secretary-General of the PCA sent his recommendation to ICSID. Based on that recommendation, the Secretary-General of ICSID informed the parties on April 15, 2005 that the disqualification proposal was not sustained. In accordance with Arbitration Rule 9, the proceeding was resumed with the composition of the Arbitral Tribunal unchanged.

39. On April 15, 2005, two letters from the Respondent, dated December 7, 2004 and February 25, 2005, that had been received while the proceedings were suspended, were circulated. In its letters, the Respondent insisted on its request for the production of evidence by the Claimant of: (i) a copy of the "forward" contract, and (ii) a copy of SITS' financial statements and

Siemens' annual reports for the periods therein indicated. The Respondent also requested a 30-day period for the examination of such documents.

40. On April 18 2005, the Claimant requested that the hearing on the merits be scheduled to take place at the earliest possible time.

41. By letter of April 25, 2005, the Claimant, by invitation of the Tribunal, filed its observations on the Respondent's letters of December 7, 2004 and February 25, 2005.

42. On April 26, 2005, the Tribunal informed the parties that the hearing on the merits would be held on October 10-21, 2005, in Washington, D.C.

43. Between June 7, 2005 and July 28, 2005, the parties exchanged multiple communications regarding the Respondent's document request. The Tribunal granted the Claimant and the Respondent, respectively, time to present observations with respect to the Respondent's document request, as well as with respect to the different documents presented by the Claimant in this regard, (Tribunal's letters of June 7 and 27, 2005, and July 15 and 26, 2005). On September 2, 2005, after taking note of the Respondent's letter of August 17, 2005, objecting to the documents provided by the Claimant in connection with the Respondent's document request, as well as the Claimant's response of August 22, 2005, the Tribunal informed the parties that the information filed by the Claimant was not the information that the Tribunal had requested on July 15, 2005. Consequently, the Tribunal ordered the Claimant to furnish the requested information no later than September 8, 2005.

44. On September 2, 2005, the parties filed a document with their comments on the Tribunal's directives concerning the organization of the hearing on the merits. In addition, the parties requested the Tribunal to fix a time limit in order for the parties to file additional documents to be used during the hearing. According to the agreement of the parties, such documents were to be limited to: (i) new issues brought up by the Respondent, its experts or witnesses in its Rejoinder; (ii) documents in support of the examination of witnesses and experts, and (iii) documents related to events that occurred after the parties' pleadings.

45. As instructed by the Tribunal, on September 9, 2005, the Claimant filed accounting information in connection with Siemens Nixdorf

Informationssysteme A.G. (“SNI”)’s investment in SITS. The Tribunal, by letter of September 12, 2005, invited the Respondent to make any observations on the documents filed by the Claimant no later than September 29, 2005.

46. Between September 9, 2005 and September 15, 2005, in accordance with the Tribunal’s instructions of September 2, 2005, the parties informed the Tribunal of the names of the witnesses and experts that they were planning to examine and cross examine during the hearing as well as their agreement on the order of appearance for the witnesses and experts. (Respondent’s letters of September 9 and September 14, 2006, and Claimant’s letter of September 15, 2006).

47. On September 15, 2005, the Tribunal set September 23, 2005 as a deadline for the parties to object to the additional documents that were to be filed respectively by the Claimant and the Respondent.

48. As instructed by the Tribunal, the parties filed their respective additional documents on September 16, 2005, and on September 21, 2005, the Claimant submitted further information with respect to the capital contributions made by SNI in SITS.

49. On September 27, 2005, following the Tribunal’s invitation of that same date, the Respondent made certain observations with regard to the information filed by the Claimant on September 9 and 21, 2005 in connection with SNI’s investment in SITS.

50. On September 28, 2005, the Claimant rebutted the observations made by the Respondent by letter of September 23, 2005, with regard to the additional documents that had been filed by the Claimant on September 16, 2005.

51. In connection with the Respondent’s observations filed on September 27, 2005, the Claimant, by letter of October 3, 2005, offered, among other things, to submit, if the Tribunal so requested, a copy of SITS’s books related to its expenditures, as well as any other additional documentary information that the Tribunal may consider appropriate.

52. On October 4, 2005, having taken into account the parties’ communications with regard to their additional documents, the Tribunal informed the parties of its decision to: (i) reject certain additional documents filed by the

Respondent, which referred to an issue that had been known to the Respondent since 1998, and had not been previously raised; (ii) request explanations from both parties with regard to certain additional documents; (iii) admit other additional documents filed by the Claimant for the reasons stated by the Claimant's letter of September 28, 2005; and (iv) subject the admission of certain exhibits filed by the Claimant to the timely submission of further explanations from the Claimant in such respect. The Tribunal set October 6, 2005 as the deadline for the parties to provide the information therein requested, and the parties did so.

53. By letter of October 4, 2005, the Claimant agreed to the modification of the schedule for the appearance of the witnesses and experts during the hearing requested by the Respondent by a letter of that same date.

54. On October 5, 2005, following the Tribunal's invitation of October 3, 2005, the Respondent filed observations with regard to the Claimant's objections raised on September 30, 2005 to the inclusion of Mr. Claudio Antonio Michalina as a member of Argentina's delegation to the hearing on the merits. According to the Claimant, Mr. Michalina was not part of the legal team, but rather an assistant to one of the Respondent's witnesses, Mr. Daniel Eduardo Martín.

55. All the pending matters raised before the Tribunal were decided on October 7, 2005, before the hearing on the merits took place. The Tribunal ratified the rejection of the Respondent's submission of certain additional documents, because they had been known to the Respondent since 1998. The Tribunal also decided that Mr. Michalina could attend the hearing because each party decides who attends the hearings in its representation. Regarding the Claimant's accounting information requested by the Respondent, the Tribunal decided to accept the information provided by the Claimant, to take note of the Claimant's willingness to submit SITS' accounting books, should the Tribunal need them, and to declare that the Claimant had complied with the filing of the supporting documents in connection with SNI's investment in SITS.

56. On October 7, 2005, the Respondent, referring to the Claimant's letter of September 28, 2005, ratified its objections of September 23, 2005 to the new evidence filed by the Claimant.



57. The hearing on the merits took place on October 10-17, 2005, in Washington, D.C., present at the hearing were:

*Members of the Tribunal*

Andrés Rigo Sureda, President

Charles N. Brower, Arbitrator

Domingo Bello Janeiro, Arbitrator

*ICSID Secretariat*

Claudia Frutos-Peterson, Secretary of the Tribunal

Mercedes Cordido-Freytes de Kurowski, Consultant

*On behalf of the Claimant*

Peter Gnam (Siemens A.G.)

Stephan Signer (Siemens A.G.)

Rubén Daniel Slame (Siemens A.G.)

Guido Santiago Tawil (M. & M. Bomchil)

Rafael Mariano Manóvil (M. & M. Bomchil)

María Inés Corrá (M. & M. Bomchil)

Ignacio Minorini Lima (M. & M. Bomchil)

Federico Campolieti (M. & M. Bomchil)

Agustín García Sanz (M. & M. Bomchil)

*On behalf of the Respondent*

Oswaldo César Guglielmino (Procurador del Tesoro de la Nación Argentina)

Jorge Alberto Barraguirre (Procuración del Tesoro de la Nación Argentina)

Fabián Rosales Markaida (Procuración del Tesoro de la Nación Argentina)

José Luis Cassinerio (Procuración del Tesoro de la Nación Argentina)

María Luz Moglia (Procuración del Tesoro de la Nación Argentina)

Adriana Lilian Busto (Procuración del Tesoro de la Nación Argentina)

Luis Eduardo Rey Vásquez (Procuración del Tesoro de la Nación Argentina)

Martín Guillermo Moncayo von Hase (Procuración del Tesoro de la Nación Argentina)

Claudio Antonio Michalina (Procuración del Tesoro de la Nación Argentina)

Philippe Sands, Q.C.

Helen Mountfield

58. As per request of the Tribunal, the Claimant filed during the hearing SITS's accounting books ("Mayor", "Caja" and "IVA") for the relevant periods.

59. As instructed by the Tribunal, on November 23, 2005, the parties filed their post-hearing briefs.

60. On November 23, 2005, the Respondent filed certain observations concerning the additional accounting information provided by the Claimant during the hearing and, on November 30, 2005, filed a report with accompanying documentation on the accounting documents provided by the Claimant, as well as on "the assessment conducted and Siemens A.G.'s claim for damages". The Respondent's letter of November 23, 2005 was contested by the Claimant on December 21, 2005. The Tribunal invited the Respondent to present any observations on this letter by January 14, 2006.

61. On January 17, 2006, the Claimant noted that the Respondent had not filed observations on the Claimant's letter of December 21, 2005 before the deadline set by the Tribunal, and requested the Tribunal to declare the proceeding closed pursuant to Arbitration Rule 38(1).

62. On January 26, 2006, the Respondent informed the Tribunal that it had not received the Tribunal's letter of December 27, 2005, and rejected the Claimant's request for the closure of the proceeding.

63. On January 30, 2006, the Claimant sent a letter reiterating that the deadline established by the Tribunal for the Respondent to file any

observations on its letter of December 27, 2005 had lapsed, and insisted on its request to the Tribunal to declare the proceedings closed.

64. On February 1, 2006, the Respondent sent its observations on the Claimant's letter of December 21, 2005, as well as supporting documentation to justify why they had not received the Tribunal's letter of December 27, 2005.

65. On February 16, 2006, the Tribunal, after considering the Respondent's communications of January 26 and February 1, 2006, and that of the Claimant of January 30, 2006, decided: (i) to accept the explanations given by the Respondent with regard to its delay in filing observations to the Claimant's letter of December 21, 2005; (ii) to admit the Respondent's letter of February 1, 2006; and (iii) to invite the Claimant to make, no later than February 23, 2006, any observations it might have. The Claimant filed its observations on February 17, 2006.

66. On March 1, 2006, the Respondent sent a letter in reply to the Claimant's letter of February 17, 2006, to which the Claimant answered on March 9, 2006. On March 13, 2006, the Tribunal informed the parties of its decision to disregard such communications because they had not been requested by the Tribunal, and the parties had already had several occasions to raise the observations they had deemed pertinent in such regard (Respondent's letters of November 23 and 30, 2005, January 26 and February 1, 2006, and Claimant's letters of December 21, 2005, January 17, 30, and February 17, 2006).

67. On March 31, 2006, the Respondent requested the Tribunal to reconsider its decision of March 13, 2006. On April 13, 2006, the Tribunal confirmed its decision of March 13, 2006 for the reasons there established.

## **II. The Jurisdiction of the Tribunal**

68. Argentina has invited the Tribunal to review its finding on jurisdiction in light of recent decisions in the cases of *Plama Consortium Ltd. v. Republic of Bulgaria*<sup>1</sup> and *Salini Costruttori, S.p.A. & Italstrade, S.p.A. v. Hashemite Kingdom of Jordan*<sup>2</sup> on the application of the most-favored-nation

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<sup>1</sup> *Plama Consortium Ltd. v. Republic of Bulgaria*, ICSID Case No. ARB/03/24, Decision on Jurisdiction (February 8, 2005).

<sup>2</sup> *Salini Costruttori, S.p.A. & Italstrade, S.p.A. v. Hashemite Kingdom of Jordan*, ICSID Case No. ARB/02/13, Decision on Jurisdiction (November 29, 2004).

clause (“MFN clause”). The Claimant has for its part referred to the decision of the tribunal in *Gas Natural SDG S.A. v. the Argentine Republic*<sup>3</sup> which reaches similar conclusions as *Emilio Agustín Maffezini v. Kingdom of Spain*<sup>4</sup> and the Tribunal on the scope of the MFN clause. The Tribunal will not review what it has already decided; it is inappropriate at this stage of the proceedings and the Tribunal has no doubt about its findings. The Tribunal will limit itself to observe that the cases adduced by the Respondent deal with the application of the MFN clause to situations not akin to the instant case. Indeed, in *Plama* and *Salini v. Jordan*, tribunals faced extensions of the MFN clause to situations widely different from the facts considered by the Tribunal or for that matter considered in *Maffezini* or *Gas Natural*. The Claimant in *Salini* sought to include, through the application of a MFN clause, an umbrella clause where the basic treaty had none. In *Plama*, there was no ICSID clause in the basic treaty. There had never been any question that the parties to these proceedings agreed to ICSID jurisdiction and the issue was avoidance, through the MFN clause, of a procedural requirement that Argentina has consistently dispensed within the investment treaties it has concluded since 1994.

### **III. Applicable Law**

#### **1. Positions of the Parties**

69. Siemens argues that the Treaty on the Mutual Protection and Promotion of Investments between the Federal Republic of Germany and the Argentine Republic, dated July 9, 1991 (“Treaty”), contains an explicit choice of law in Article 10(5) which mandates the Tribunal to decide the merits of the dispute “on the basis of this Treaty, and, as the case may be, on the basis of other treaties in force between the Contracting Parties, the internal law of the Contracting Party in whose territory the investment was made, including its rules of private international law, and on the general principles of international law”. Siemens then refers to Article 42(1) of the Convention which directs the Tribunal to look first to the rules agreed by the parties. In this case, the rules agreed by

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<sup>3</sup> *Gas Natural SDG S.A. v. the Argentine Republic*, ICSID Case No. ARB/03/10, Decision on Jurisdiction (June 17, 2005).

<sup>4</sup> *Emilio Agustín Maffezini v. Kingdom of Spain*, ICSID Case No. ARB/97/7, Decision on Jurisdiction (January 25, 2000).

the parties are the provisions of the Treaty that constitute a special bilateral regime with respect to the matters regulated by it.

70. Siemens argues further that, in the case of *lacunae*, general international law applies and it has a corrective role in the sense that it controls and prevails over domestic law. In this respect, Siemens refers to Professor Weil's statement on the relationship between domestic law and international law under Article 42(1) of the Convention, to wit: "[...] no matter how domestic law and international law are combined, under the second sentence of Article 42(1), international law always gains the upper hand and ultimately prevails."<sup>5</sup> Siemens also refers to the Draft Articles on Responsibility of States adopted by the International Law Commission ("ILC") ("Draft Articles"), which state: "The characterization of an act of a State as internationally wrongful is governed by international law. Such characterization is not affected by the characterization of the same act as lawful by internal law."<sup>6</sup>

71. Siemens contends that this conclusion is reinforced by Article 7(1) of the Treaty which provides:

"If the laws and regulations of either Contracting Party or obligations under international law existing at present or established hereafter between the Contracting Parties in addition to this Treaty contain a regulation, whether general or specific, entitling investments by nationals or companies of the other Contracting Party to a treatment more favorable than is provided for by the Treaty, such regulation shall to the extent that it is more favorable prevail over this Treaty."

Therefore, the Claimant argues that Argentine law may prevail over the provisions of the Treaty only to the extent that it provides treatment to the investment more favorable than the Treaty. Conversely, those provisions of domestic law that may be less favorable are not applicable.

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<sup>5</sup> P. Weil, *The State, the Foreign Investor, and International Law: The No Longer Stormy Relationship of a Ménage à Trois*, 15 ICSID Review – FILJ (2000), p. 409.

<sup>6</sup> Article 3 of the *Draft Articles on Responsibility of States for Internationally Wrongful Acts*, adopted by the International Law Commission. Claimant's LA No. 49.

72. In any case, according to Siemens, the host State's domestic law is relevant only with respect to factual issues as held by the doctrine and the International Court of Justice ("ICJ") in *Case Concerning Certain German Interests in Polish Upper Silesia (Germany v. Poland)*:

"From the standpoint of International Law and of the Court which is its organ, municipal laws are merely facts which express the will and constitute the activities of States, in the same manner as do legal decisions or administrative measures. The Court is certainly not called upon to interpret the Polish Law as such; but there is nothing to prevent the Court's giving judgment on the question whether or not, in applying that law, Poland is acting in conformity with its obligations towards Germany under the Geneva Convention."<sup>7</sup>

73. Furthermore, Siemens points out that, as held by the Annulment Committee in *Compañía de Aguas del Aconquija S.A. and Vivendi Universal v. the Argentine Republic*<sup>8</sup> and the tribunal in *Técnicas Medioambientales TECMED, S.A. v. the United Mexican States*<sup>9</sup>, governmental measures that are lawful under domestic law are not necessarily in conformity with international law. Siemens concludes that domestic law is only relevant as evidence of Argentina's measures and conduct and needs to be analyzed through the lens of international law.

74. Argentina contends that there is no express agreement between the parties as to the law applicable to the dispute and that the Treaty does not indicate the law to be applied and, therefore, the Tribunal should apply the municipal law of Argentina. In this respect, Argentina affirms that the constitutional law of Argentina is the first source of law to be applied, and explains that the Argentine Constitution recognizes the right to property and the right of the State to regulate it provided it is done by law and subject to principles

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<sup>7</sup> *Case Concerning Certain German Interests in Polish Upper Silesia (Germany v. Poland)*, Judgment No.7, May 25, 1926, 1 World Court Reports (1934), 510, Claimant's Legal Authorities No. 31.

<sup>8</sup> *Compañía de Aguas del Aconquija S.A. and Vivendi Universal v. the Argentine Republic*, ICSID Case No. ARB/97/3, Decision on Annulment (July 3, 2002).

<sup>9</sup> *Técnicas Medioambientales TECMED, S.A. v. the United Mexican States*, ICSID Case No. ARB(AF)/00/2, Award (May 29, 2003).

of reasonableness and equality. As further explained by Argentina, these principles mean that restrictions on individual rights must be warranted by the facts and meet a social necessity or convenience and the limitation must be in line with the ends sought. Argentina further points out that, under Article 75(22) of the Constitution, treaties rank above the law and, under Article 27, treaties must conform to the principles of public law set by the Constitution.

75. Argentina draws to the Tribunal's attention that the constitutional reform of 1994 recognized a number of international instruments on human rights to have constitutional rank. Argentina claims that the human rights so incorporated in the Constitution would be disregarded by recognizing the property rights asserted by the Claimant given the social and economic conditions of Argentina.

## **2. Considerations of the Tribunal**

76. The Tribunal has been established under the provisions of the Treaty and the ICSID Convention. Under Article 42(1) of the Convention, the Tribunal is obliged to apply the rules of law agreed by the parties. The Treaty provides that a tribunal established under the Treaty shall decide on "the basis of this Treaty, and, as the case may be, on the basis of other treaties in force between the Contracting Parties, the internal law of the Contracting Party in whose territory the investment was made, including its rules of private international law, and on the general principles of international law." By accepting the offer of Argentina to arbitrate disputes related to investments, Siemens agreed that this should be the law to be applied by the Tribunal. This constitutes an agreement for purposes of the law to be applied under Article 42(1) of the Convention.

77. In regards to the arguments whether international law is referred to in the Treaty or the Convention as a corrective to municipal law or as a filler of *lacunae* in that law, the Tribunal refers to the finding of the Annulment Committee in *Wena Hotels Limited v. Arab Republic of Egypt* in the sense that: "The law of the host State can indeed be applied in conjunction with international law if this is

justified. So too international law can be applied by itself if the appropriate rule is found in this other ambit.”<sup>10</sup>

78. The Tribunal has found that it has jurisdiction over breaches of the Treaty and will review the conduct of Argentina as a State party to the Treaty in respect of the commitments undertaken in the Treaty. In so doing, and as stated by the *Ad Hoc* Committee in *Vivendi II*, the Tribunal’s inquiry is governed by the Convention, by the Treaty and by applicable international law. Argentina’s domestic law constitutes evidence of the measures taken by Argentina and of Argentina’s conduct in relation to its commitments under the Treaty.

79. In any case, the Treaty is not a document foreign to Argentine law. As explained by Argentina, the Constitution and treaties entered into by Argentina with other States are the supreme law of the nation, and treaties have primacy over domestic laws.<sup>11</sup> In this respect, the Tribunal notes the reference made by Argentina to international human rights law ranking at the level of the Constitution after the 1994 constitutional reform and implying that property rights claimed in this arbitration, if upheld, would constitute a breach of international human rights law. This argument has not been developed by Argentina. The Tribunal considers that, without the benefit of further elaboration and substantiation by the parties, it is not an argument that, *prima facie*, bears any relationship to the merits of this case.

80. The allegations of the parties will require that the Tribunal interpret the Treaty. In this respect and as a general matter, the Tribunal recalls that the Treaty should be interpreted in accordance with the norms of interpretation established by the Vienna Convention on the Law of Treaties of 1969 (“Vienna Convention”). The Vienna Convention is binding on the parties to the Treaty. Article 31(1) of the Vienna Convention requires that a treaty be “interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.”

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<sup>10</sup> *Wena Hotels Limited v. Arab Republic of Egypt*, ICSID Case No. ARB/98/4, *Ad Hoc* Committee Decision on Application for Annulment (February 5, 2002), 41 *ILM* (2002), p. 941.

<sup>11</sup> Section 31 and Article 75(22) of the Argentine Constitution.



#### IV. The Facts

81. On August 26, 1996, Argentina called for bids on the provision of an integral service for the implementation of an immigration control (“the DNM<sup>12</sup> sub-system”), personal identification (“the RNP<sup>13</sup> sub-system”) and electoral information (“the DNE<sup>14</sup> sub-system”) system (“the System” or “the Project”), including the provision of all equipment necessary for data processing and the intercommunication of such equipment, start-up, technical support and maintenance services, and preparation, printing and home delivery of national identity cards (“DNIs”).

82. For the purpose of participating in the bidding, Siemens, acting through SNI, a company legally integrated into Siemens, created SITS, a domestic Argentine company as required by the Bidding Terms and Conditions. SITS was organized as a special purpose company and used by Siemens for the exclusive purpose of investing in the Project.

83. SITS submitted a bid which included, as required by Argentina, a statement declaring that: (i) SNI had been integrated into Siemens since 1992, Siemens being the owner of 100% of SNI’s stock; (ii) SNI was controlled by Siemens, which appointed SNI’s directors and instructed them in relation to SNI’s activities and projects; and (iii) as a result of SNI’s integration into Siemens, the latter was jointly and severally liable for SNI’s obligations towards third parties.

84. Argentina selected SITS’ bid taking into consideration Siemens’ credentials and financial soundness. The contract for the provision of the System (“the Contract”) was awarded to SITS by Decree No. 199/98. The Contract between SITS and Argentina was executed on October 6, 1998 and approved by Decree 1342/98. The Contract took effect on November 21, 1998.

85. The compensation for the services to be provided under the Contract consisted of the price of each DNI issued, including home delivery and DNI updates, the fees for the immigration proceedings processed through the System and the price for printing the voting rolls. All prices in the Contract were

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<sup>12</sup> *Dirección Nacional de Migraciones.*

<sup>13</sup> *Registro Nacional de las Personas.*

<sup>14</sup> *Dirección Nacional Electoral.*

denominated in Argentine pesos (“pesos” or “AR\$”). At the time, pesos were convertible into dollars at par pursuant to the Convertibility Law.

86. The Contract had a six-year term as from its effective date – November 21, 1998 - and was automatically renewable twice for a three-year term, i.e., for a total of twelve years, unless a notice of intent to the contrary had been given by either party. However, the parties had agreed to give such notice only if the purpose of the Contract had been fully met.

87. The execution of the Project had two stages: a System engineering stage, which consisted of designing the System specifications and acquiring the computer hardware, software and telecommunications networks necessary for its implementation, and a System operation stage, to be managed by the Government. SITS would receive compensation only during this second stage.

88. Production of DNIs was scheduled to begin in August 1999 and extend to the whole country. To this effect, it was necessary for the Argentine government to reach agreements with the Provinces and the City of Buenos Aires (“the External Circuit”).

89. In August 1999, Argentina requested SITS to postpone production of the new DNIs. According to the minutes signed by SITS and the Government, the postponement was due to an extraordinary increase in demand for DNIs because of the short period left before the elections scheduled on October 24, 1999, and to the fear that the introduction of the new mechanisms under such circumstances would burden the public with inconveniences that should be avoided.<sup>15</sup> Thus DNIs production was postponed to October 1, 1999 for foreign residents’ DNIs and November 1, 1999 for Argentine citizens’ DNIs. Production of the respective DNIs started on those dates.

90. In the October election, Mr. Fernando de la Rúa became President-elect. The new authorities took office on December 10, 1999.

91. The DNM sub-system started to operate on February 1, 2000 and its operation was halted on February 2, 2000. On that date, SITS requested an

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<sup>15</sup> Minutes dated August 18, 1999, approved by Decree No. 1054/99. Exhibit 40 to the Memorial.

explanation for the interruption. On February 7, SITS was informed that the operation of the sub-system required a governmental authorization. The sub-system continued to be interrupted indefinitely.

92. On February 24, 2000, Argentina suspended the production, printing and distribution of all new DNIs because, in the case of foreigners' DNIs, the RNP sub-system printed the left thumbprint at the place reserved for the right thumbprint. Argentina prohibited SITS from introducing any modification to the System to correct this problem.

93. These two suspensions occurred in the context of statements made by Government officers to SITS and Siemens in January 2000 to the effect that the Government would seek to renegotiate the DNIs price, and increase the number of free-of-charge DNIs.

94. In March 2000, the Government set up a special commission under the Ministry of the Interior to review the Contract and propose a course of action ("the Commission"). During the negotiations that ensued, Siemens made several proposals and agreement was reached with the Commission on a proposal on November 10, 2000. The Commission sent the negotiated proposal to the Government and the Government gave Siemens a "Contract Restatement Proposal" identical in its terms to the proposal submitted by the Commission for the Government's approval.

95. Siemens' representatives met with the President of Argentina on December 19, 2000. Allegedly he promised to issue the decree approving the negotiated terms of the Contract Restatement Proposal by December 31, 2000. When the decree was not issued, Siemens addressed several notes in February 2001 to the Minister of the Interior expressing concern over the delay.<sup>16</sup> The Minister replied on March 12, 2001 and attributed the delay to the required intervention of controlling agencies.<sup>17</sup>

96. In November 2000, the Argentine Congress approved the Economic-Financial Emergency Law ("the 2000 Emergency Law") which

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<sup>16</sup> Exhibit 57 to the Memorial.

<sup>17</sup> Exhibit 58 to the Memorial.

empowered the President to renegotiate public sector contracts. This law became effective two days before the Contract Restatement Proposal was submitted by the Commission to the Minister of the Interior. The Government proposed to include the Contract under the provisions of the 2000 Emergency Law and Siemens did not object, in the belief, according to Siemens, that this step would speed up the approval of the Contract Restatement Proposal.

97. The Minister of the Interior was replaced and, in March 2001, the new Minister, Mr. Mestre, claimed to be unaware of the Contract Restatement Proposal. On May 3, 2001, SITS received a new Draft Proposal from the Government which differed from the Contract Restatement Proposal. On May 8, 2001, SITS replied commenting on the new terms, and requesting the exhibits to the proposal which had not been enclosed. The Minister informed Siemens that the new proposal was not negotiable and, on May 18, 2001, the Contract was terminated by Decree 669/01 under the terms of the 2000 Emergency Law. SITS filed an administrative appeal which was rejected by Decree 1205/01.

## **V. Allegations of the Parties**

98. The Tribunal will now describe at length the allegations of the parties as they relate to the facts of the dispute.

### **1. Memorial**

99. In its Memorial, Siemens has framed its claim in the context of the Treaty, the Convertibility Law of 1991, Decree No. 2128/91, and the State Reform Law of 1989. Siemens contends that it entered into the Project based on the assurance of the authorities' commitment and the legal security framework provided by these instruments.

100. Siemens explains that significant investments were made during 1999 and further investments were made in 2000, due to Argentina's requirements as a prerequisite for resuming income-generating operations, for an aggregate amount of \$284 million up to May 18, 2001. Additional expenses exceeding \$9.1 million were incurred after termination of the Contract and until September 2002.

101. Siemens claims that the following results were achieved:

- (i) as regards the DNM sub-system, establishment of the immigration information center, and the immigration flows and border control systems at three locations; the Government first hindered this component from becoming operational and later hindered its functioning, but Argentina has nonetheless benefited from better processing, follow-up and control of immigration proceedings, and the generation of single, non-duplicate files for each alien, containing all identification data, which reduced tampering possibilities;
- (ii) as regards the RNP sub-system, the engineering stage was completed by August 1999 and it became operational by August 19, 1999, the electronic loading of the Remaining Human Potential File (“Back Record Conversion” or “BRC”) was performed (by December 1999, 45.8 million individual records had been digitalized), an ID personalization center was completed, hardware and software were acquired, buildings were fitted, the communications network was implemented, training courses were held, more detailed and demanding System applications were developed, and a pilot test not required under the Contract was performed. However, because of the measures taken by Argentina, only 3,189 DNIs were issued over a period of 147 days as opposed to 12,000 DNIs foreseen as the initial daily average;
- (iii) as regards the DNE sub-system, the electoral information component was completed by August 1999, and SITS carried out the processing, printing and distribution of provisional lists and final voting rolls for the national elections of October 24, 1999; and
- (iv) physical and IT security equipment and technical support were provided by SITS to the three implementation agencies.

102. Siemens explains that the investments were financed through capital contributions by Siemens through SNI in the amount of \$27 million, through loans made by one of the wholly owned subsidiaries or in minor amounts

by local financial institutions (later refinanced by Siemens directly or through SNI and totaling approximately \$242 million), and through non-financial funding by the Siemens Group in the amount of \$15 million approximately up to May 18, 2001. Siemens further explains that the investments were exclusively applied to the Project since SITS was a special purpose company used by Siemens only for the execution of the Project.

103. Siemens alleges that, during the first year of the Contract, Argentina failed to make budgetary provision for the obligations it had undertaken under the Contract, to provide facilities for Project development, to assign appropriate personnel to fill the different positions and take the corresponding training courses. Siemens also alleges that Argentina delayed approval of the Functional Operational Model (“FOM”) during seven months notwithstanding its relevance, failed to execute with the provincial authorities the agreements to carry out production of the new DNIs throughout the country, failed to adopt the measures necessary to replace the existing DNIs by those issued through the System, and failed to discontinue the manual system of issuing DNIs. Siemens observes that these breaches of the contractual obligations were noted by the independent auditor hired by the Government.

104. Siemens recalls that in the context of these failures, in August 1999, Argentina requested SITS, on account of the October elections, to postpone commencement of the new DNIs production until October 1, 1999 for foreign residents and November 1, 1999 for Argentine citizens. Later Argentina requested that the discontinuation of the old DNIs be postponed to November 30, 1999, except for certain jurisdictions for which a new deadline of January 31, 2000 was established.

105. According to Siemens, after the October elections, the new authorities failed to make budgetary provision for the second year of the Project and to enter into agreements with the provincial authorities. Argentina also delayed providing the technical definitions essential to complete the immigration component and, as a result, it did not start to operate until February 1, 2000.

106. Siemens refers to the suspension of the DNM sub-system on February 2, 2000, allegedly because of lack of authorization to operate the sub-system given that public funds were at issue. According to Siemens, the requirement of such authorization was not provided for in the Contract and was not required for the border control component of the DNM sub-system. Siemens alleges that SITS never got an adequate response and was never paid for the documents actually processed.

107. Regarding the suspension of production of DNIs on February 24, 2001, Siemens affirms that this is a technical inconsistency that could have been quickly solved by modifying one sentence in the printing software. Siemens recalls that Article 17 of the Contract established a procedure in the event that errors were detected but, instead of respecting it, the Argentine authorities prohibited SITS from introducing any correction while the Contract was in effect.

108. According to Siemens, since January 2000 the newly elected authorities had made public announcements reported in the press indicating their intention to renegotiate the Contract to obtain a reduction in the DNI price, a larger number of free DNIs and a postponement of the discontinuation of the manual system. Siemens submits that the actions taken in February 2000 by Argentina suspending the two income-generating activities of the Project had the objective of pressuring SITS to re-negotiate the Contract at the point at which most of the investment for the Project had been made.

109. Siemens explains that, during the renegotiation of the Contract with the Commission from March to November 2000, each proposal made by SITS was rejected and resumption of the operation of the System was subject to ever more demanding economic concessions. In November 2000, as explained by Siemens, the parties agreed on the basic terms on which the Contract would be reinstated and the immediate System operation would be resumed, namely, a \$5 reduction in the price of the DNIs (in part to be compensated by a \$3 increase in airport passengers' fees to be passed on to SITS), an increase in the annual free-of-charge DNIs from 75,000 to 250,000, and a reduction in the immigration and voting roll printing fees. Siemens draws to the attention of the Tribunal that the Ministry of Finance authorities opined favorably on the new terms as also did

the RNP, DNM and DNE. The restated terms were set forth in the Contract Restatement Proposal provided by the Government to Siemens on November 30, 2000 with the understanding that this proposal would now be formalized by the Government.

110. Siemens explains that the 2000 Emergency Law was published on November 21, 2000 and that, in order to facilitate the approval of the terms agreed, the Commission proposed to include the Contract under the provisions of the 2000 Emergency Law in a note to the Minister of the Interior dated November 23, 2000.<sup>18</sup> The Minister declared the Contract subject to the 2000 Emergency Law by Resolution No. 1779 of December 6, 2000.<sup>19</sup>

111. Siemens alleges that, when in March 2001 a new Minister of the Interior was appointed, he claimed to be unaware of the agreement reached between the two parties and the undertaking made by the President. The new Minister ordered, on April 6, 2001, the inclusion in the administrative file of the minutes, dated October 30, 2000, of a meeting of Directors of Provincial Registry Offices rejecting the Contract continuation. According to Siemens, he also instructed Sindicatura General de La Nación (“SIGEN”), RPN, DNM and DNE to re-analyze matters related to the Contract and these agencies reached different conclusions from when they reviewed the Contract Restatement Proposal.

112. Siemens refers to the new Draft Proposal presented to Siemens on May 3, 2001 with terms significantly different from those negotiated, mainly, reduction of the number of DNIs to be issued to almost one half as it did the effective term of the Contract, and elimination of the obligation to discontinue issuance of the old DNIs. Siemens points out that the exhibits referred to in the Proposal were not furnished to SITS. According to Siemens, the only purpose of this proposal was to trigger a rejection and create an excuse to terminate the Contract. In its Reply on May 8, Siemens recalled that the parties had already reached an agreement and certain aspects had already been implemented, and that the changes indicated above were unacceptable because they changed completely the economic-financial equation, and requested the missing exhibits

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<sup>18</sup> Exhibit 55 to the Memorial.

<sup>19</sup> Exhibit 60 to the Memorial.



to complete the evaluation. The Minister responded immediately indicating that failure to accept such proposal as a whole would result in early termination of the Contract. In fact, even when the proposal was presented to Siemens as a draft, the instruction of the Minister was that the Proposal was to be notified for acceptance or rejection.<sup>20</sup>

113. Siemens argues that such a proposal was only an illegitimate tool to avoid liability for frustrating the Contract. In this respect, *inter alia*, Siemens points out a number of irregularities in the proceedings for the Contract termination, such as the failure to obtain the Ministry of Economy's consent to subject the Contract to the 2000 Emergency Law and factual inaccuracies, e.g. the covering letter from the Minister of the Interior to the President submitting Decree 669/01 stated that the Contract costs were beyond the capabilities of the Government notwithstanding that there were no supporting budgetary reports and in November 2000 the Ministry of Economy had opined otherwise,<sup>21</sup> and the Government had approved the budget for the proposed restated terms of the Contract which in turn had been approved by Congress on December 12, 2000 and the President on December 29, 2000.<sup>22</sup> Siemens also points out that said letter reports errors in the System without supporting evidence (errors which were disregarded by the President), it uses the Provinces' opposition to the Project notwithstanding that the Contract was undertaken by Argentina itself within its exclusive powers,<sup>23</sup> and it exaggerates deliberately the costs based on RPN's analysis.

114. Siemens points out that the Contract was terminated on the sole grounds of the 2000 Emergency Law, which termination was ratified by Decree No. 1205/01 rejecting SITS's appeal against Decree 669/01. Siemens recalls that Argentina denied SITS access to the administrative file for purposes of filing the appeal and presenting evidence in support of its claims. Siemens alleges that the administrative file was not made available until Siemens reported the secret handling of the file and Siemens had filed the claim under the Treaty. After

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<sup>20</sup> Exhibit 66 to the Memorial.

<sup>21</sup> Exhibit 53 to the Memorial.

<sup>22</sup> Exhibit 70 to the Memorial.

<sup>23</sup> Article 2 of Law No. 17,671. Exhibit 35 to the Memorial.

Contract termination, Siemens claims that Argentina caused delays in the transfer and reception of equipment and in the assessment of the compensation, and never returned the performance bond, which had lost its purpose once Argentina terminated the Contract unilaterally. According to Siemens, SITS continued to provide technical support, train personnel as agreed in cases of Contract termination, assigned to the Government ownership of the computer hardware, the installed communications equipment and fittings and the non-exclusive licenses for use of application software, and requested the Ministry of the Interior to arrange for the transfer of the satellite links.

115. Siemens points out the passivity of the Government during the months that followed the termination of the Contract and that in November 2001, the Ministry of the Interior called the SITS' sub-contractors to conduct a test and assess the possibility of resuming production of the DNIs without Siemens. According to Siemens, the tests conducted in *Casa de Moneda* were satisfactory and *Casa de Moneda* proposed to produce DNIs through the System provided by SITS.

## **2. Counter-Memorial**

116. In its Counter-Memorial, Argentina alleges that Siemens raised false expectations by the statements made in the bid for the Contract. Siemens had stressed its experience and that of its sub-contractors in high-performance secure systems to meet automated data and image-capturing requirements for issuing passports, foreign resident documents, drivers licenses, visas, frequent traveler cards, health plan cards and DNIs, but in reality neither Siemens nor SNI had been involved in projects of a similar size because no country in the world had undertaken a project of the complexity, size and significance of the Project. According to Argentina, Siemens and SNI lacked the technical expertise to provide a comprehensive service involving the operation and support of a secure and reliable personal identification, migration control and electoral information system.

117. As regards Siemens' claim that Argentina delayed the approval of the FOM and it is at fault for the non-implementation of the External Circuit,

Argentina argues that Siemens presents a traditional notion of contracts with the parties' obligations bearing a relationship of interdependence and does not take into account the particularities and complexities surrounding the procurement of information technology products and services. Argentina explains that the Contract is a turnkey information technology contract including tailored software development and it is inevitable that there will be some uncertainty as to the actual completion date of the work.

118. Argentina alleges that in this type of contract the reporting and advisory duties of the information technology service provider and product supplier play a key role in maintaining the balance between the parties. Argentina recognizes that it received assistance from technical personnel who participated in the guideline-setting stages for the technical definition of the System, but this is not sufficient, argues Argentina, to eliminate the imbalance in technical expertise level between the parties.

119. As regards the approval of the FOM, Argentina describes how, a few days before the deadline for the presentation of the FOM, it requested SITS to deliver the working papers so that RNP's technical staff could advance with the examination of the FOM. SITS never provided the documentation requested. Argentina refers to a number of communications sent to SITS that show the delay in the acceptance of the FOM by Argentina was due to inconsistencies in the FOM proposed by SITS. To further support its argument, Argentina refers to two reports prepared by RNP on the weaknesses of the FOM submitted by SITS and the security of the FOM. In brief terms, several items in the FOM submitted by SITS did not comply with applicable law, were defined on a general or incomplete basis, or failed to provide specifications for the security, audit, and quality and management control of the System. Argentina infers from the foregoing that SITS' technical qualifications were not sufficient to perform the Contract and that it used the Project to gain experience.

120. As regards the External Circuit, Argentina explains that SITS and Argentina through RNP agreed that the proposed model could not be implemented as described in the Contract and SITS was requested to design an External Circuit taking into account the following general guidelines: (i) flexible

terms for a gradual regional implementation; (ii) installation of computers in the Manual Data Capture Centers under the charge of SITS to facilitate form scanning; (iii) set-up of scanning and quality control centers in every provincial capital, for purposes of resolving any possible rejection of the applications in the applicant's location; and (iv) the maintenance by the contractor of the investment levels that had originally been agreed.

121. Argentina further explains that it is not surprising that the Provinces were not interested in signing framework agreements for the External Circuit since they were not advantageous from an economic point of view; under them, the Provinces would receive lower compensation while the expenses they had to incur for the System to work efficiently were higher. Argentina also refers to the nature of its federal system of government where the Government cannot oblige the Provinces to enter into agreements to cooperate in the performance of functions that belong to the Federal Government.

122. Argentina argues that SITS was aware of the circumstances of the country, it had admitted that the design of the External Circuit was not consistent with the social reality of Argentina and it was necessary to do a comprehensive review of the design, the External Circuit could not be implemented until the FOM was approved on condition that SITS fulfilled certain requirements, and, in the agreement signed between Argentina and SITS on November 26, 1999, the Coordinator of the Project at RNP and the SITS' Project Director were empowered to introduce amendments to the System set-up schedules and in the size of the Electronic Data Capture Centers.

123. Argentina also argues that, given the long presence of Siemens in the country and as a product and service provider to the public sector, SITS should have been aware of the political issues that would necessarily have an impact on the performance of some stages of the Contract and compliance with its obligations.

124. Argentina alleges that data capture for the External Circuit could not be set up in the Provinces because of the suspension of manufacturing, printing and distribution of DNIs on February 24, 2000. Argentina alleges also

non-compliance by SITS with its obligation to deposit the source codes in escrow and transfer them to the Government upon completion of the Contract. Argentina affirms that without the source codes it could not properly operate the System after termination of the Contract. Furthermore, Argentina had detected errors in the System and the source codes were necessary to correct SITS' work.

125. Argentina contends that, contrary to Siemens' claim that Argentina did not comply with the schedule provided for in the Contract to cease issuing DNIs manually, SITS had agreed to reformulate the terms of the Contract applicable to begin issuing new DNIs and consented to the extension of the term for the discontinuation of manual DNI issuance.

126. Argentina explains that the Contract did not amend the law regulating when DNIs are issued and updated. The law requires that a DNI be issued when a baby is born and this document is updated when the child reaches school age. Then a photograph is added to the identity document and the right thumb fingerprint is stamped on the document. This DNI is replaced when a person turns sixteen and a new photograph is taken. Then this DNI is updated when a person turns thirty. In order to determine whether the Project was economically advantageous, SITS should have calculated the number of DNIs that had to be replaced.

127. According to Argentina, the RNP sub-system was the most important undertaking since the revenues it would generate would guarantee the expected return on the investment made by Siemens, and it was precisely in the design of this sub-system that SITS failed to comply with its obligations. On February 23, 2000, the RNP head of the Aliens Division reported that federal police officers had discovered that on two DNIs belonging to foreigners the fingerprint was incorrectly identified, e.g., the left thumbprint was identified as the right thumbprint. Argentina explains that the technical report states that the fingerprint experts verified that the fingerprints had been correctly taken by RNP staff. The head of the RNP Aliens Division concluded that the error was in the design of the System which was entrusted exclusively to the Claimant, which defeated the purpose of implementing an information technology system to avoid the risk of human error.

128. Argentina contests that Article 17 of the Contract was applicable in that situation. Argentina explains that such article is intended to regulate the parties' conduct in the event of any possible physical error of the identity document and not an error involving the inappropriate design.

129. Argentina then turns to the 2000 Emergency Law and points out that this law provided that the events of *force majeure* foreseen in sections 53 and 54 of Law No. 13,064 were considered to have occurred, that within 30 days the Government should determine the contracts subject to the provisions of the 2000 Emergency Law, that government contracts would not be terminated if the continuation of the works or the performance of the contract was possible on the basis of the "shared sacrifice" principle, and that compensation payable in the case of those contracts revoked on grounds of convenience, merit and advisability would not include lost profit or unproductive expenses.

130. Argentina further points out that in no circumstances did the Contract entail the privatization of the System's operation and that the goal of the Commission established by Resolution No. 263/00 was to find a solution ensuring the continuity of the Contract given the crisis in Argentina. Argentina explains the doctrine of unforeseeability that would apply in the emergency situation:

"There is certainly no obligation for the Government to compensate the contractor as the events causing the contractual imbalance are totally beyond the Government's control. There is nothing that would prevent the strict and specific application of the contract provisions and thus the termination of the contract [...] However, no benefit for the public interest can be derived from this situation; quite the contrary, the public interest will not be satisfied by the abrupt interruption of the service provision. Thus, the doctrine of unforeseeability or unforeseeable risk may be applied to these cases. According to the doctrine, the Government has to provide assistance to the concessionaire, sharing the risks that

unpredictability might have arisen for purposes of avoiding a total collapse of the licensed service.”<sup>24</sup>

131. Argentina further explains that it is obliged to revoke a public contract when the public need that would be satisfied by the contract disappeared or new public demands require that it be terminated. Revocation by reason of public interest is one of the cases of a Government’s liability for lawful actions and entails the obligation to compensate the contractor whose individual right is sacrificed for the sake of the public, but compensation shall not include lost profits or unproductive expenses.

132. Argentina disputes Siemens’ affirmation that the Government took advantage of the passing of the 2000 Emergency Law allegedly to accelerate the implementation of the agreement concluded with Siemens. Argentina explains that it is correct that SITS participated in the report prepared by the Commission, but it is not correct that such report had to be considered by the Government and SITS as a formal and final renegotiation proposal. According to Argentina, the report was an initial contract renegotiation proposal which included the Contractor’s point of view.

133. Argentina also questions the position taken by Siemens in respect of the role of SIGEN and its refusal to furnish the cost structure of SITS’ services. According to Argentina, SIGEN was unable to determine the reasonableness of compensation to SITS because it had not access to conclusive information about the cost of the services. Argentina disputes the allegation that the reduction of the original DNIs price reflected SITS’ share of the sacrifice to continue with implementation of the Contract. Argentina recalls in this respect that Article 4.6.2 of the Contract required disclosure of SITS’ cost structure where extraordinary and unforeseeable events materially and adversely affect the original economic and financial equation of the Contract.

134. Argentina also takes issue with the characterization by the Claimant of the 2000 Emergency Law as an instrument devised to hurt the Claimant. Argentina also contests the truthfulness of the assertion by Siemens

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<sup>24</sup> E. García-Enterría and T. Ramón Fernández, *Curso de Derecho Administrativo* (1997), vol. I, p. 732. Counter-Memorial, para. 555.

that it has been penalized by pursuing this arbitration and lists a number of public sector contracts won by Siemens in recent years. According to Argentina, Siemens continued to do business with the Government and with other public sector players and provided new services after the termination of the Contract.

135. Argentina describes the steps involved in the reception of SITS' assets to justify the delay, which it also ascribes to lack of cooperation by SITS at that stage. Indeed, according to Argentina, SITS refused to participate in the asset verification process because the inventories already submitted by SITS included all necessary specifications for asset identification. In fact, according to Argentina, SITS' inventories in most cases referred to total quantities without a breakdown that would permit actual verification of the assets' existence and their relevance to the System. Argentina claims that, in contrast, the Notary General's Office recorded the asset verification proceedings, including a list of the assets present in the various agencies belonging to the System and unequivocal information regarding each and every asset.<sup>25</sup>

136. Argentina also refers to the issue of the verification of certain computer equipment stored at the Siemens National Route 8 plant in San Martin County in the Province of Buenos Aires. Argentina claims that the Government was only informed of the existence of such equipment in a presentation made by SITS to the Asset Reception Committee on September 4, 2001. Argentina explains the difficulties that this revelation presented for the Government as, among other matters, it was uncertain whether these assets were part of the assets to be transferred under Article 10.7 of the Contract and, if they were, it was unclear whether or not the Government should actually receive them because of SITS' refusal to transfer title to those assets until payment was made to SITS. The Asset Reception Committee decided to accept the National Route 8 assets on December 17, 2001 and that on December 20, 2001, both parties should agree on a procedure to receive them. The serious events that happened on that date led to the worst ever political and institutional crisis in Argentina, but once the new authorities were in place in Argentina, the Asset Reception

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<sup>25</sup> Exhibit 144 to the Counter-Memorial.



Committee continued with its work and requested the Tribunal de Tasaciones de la Nación (“TTN”) to appraise the assets.

137. Then Argentina describes the performance tests of the various sub-systems at RPN, DNE and DNM and affirms that in all three cases the technicians concluded that the sub-systems were not operative. Argentina explains that SITS was invited to attend the tests but refused the invitation. Furthermore, the tests had to be carried out without access to the source codes that SITS should have turned over to Argentina at Contract termination. According to Argentina, without the source codes it was not possible to determine the degree of progress by SITS regarding the purpose of the Contract and it was not possible to conduct an accurate appraisal.

138. Argentina provides the breakdown of the appraisal conducted by the TTN, which in the aggregate amounts to AR\$71,735,510, and explains that the items appraised would be valuable only if, among other matters, SITS would deliver the source codes, the licenses for basic software and databases, and the use of SITS’ software licenses. Argentina reports that the TTN pointed out that it was not certain that all licenses could be transferred as their respective contracts did not provide for such possibility.

139. As regards the performance bond, Argentina argues that it ends on termination of the Contract, provided that the Contractor has fulfilled its obligations under the Contract, which has not been the case. Argentina in this respect particularly emphasizes the fact that the source codes and the software licenses have not been delivered by SITS to the Government.

### **3. Reply**

140. In its Reply, the Claimant notes that Argentina recognizes the fundamental facts of the case and the events that frustrated Siemens’ investment. The Claimant takes issue with the argument that Argentina was the weaker party because of an alleged technology gap. The Claimant points out this cannot be true when Argentina had designed the Bidding Terms and Conditions, defined the characteristics of the service, and reserved the right to control and manage the tasks during Contract performance.

141. Siemens disputes that there was a mutually agreed renegotiation process. According to Siemens, the Government took advantage of the sunk cost of Siemens' investment to impose a renegotiation process not provided for in the Contract. Siemens also questions the arguments based on security concerns. Siemens first points out that lack of security or reliability of the System was not the subject of any discussion between the parties during the performance of the Contract, that these arguments were developed after the Contract termination, and that the only audit report issued during the term of the Contract on the security of the System was submitted to the authorities by the external security auditor appointed by the Government, which audit report concluded that the System reasonably complied with the security standards required by the Contract. According to Siemens, this is confirmed by the termination of the Contract with no finding of fault on the part of the Contractor (Decree 669/01) and the ratification of the termination in September 2001 after the SIGEN reports had been issued (Decree 1205/01).

142. Siemens also points out that the security concerns of the old system which motivated the tender (Decree 1310/94) for a new system are still valid, while the security and reliability of the System was never questioned before this arbitration. Siemens surmises that if the real concern had been security, then the logical course of action would have been to allow the Contract's performance, instead of discontinuing the Project and preserving the system that caused the documentary emergency from which Argentina is still suffering.

143. Siemens argues that Argentina distorts reality and deliberately intends to confuse the situation that led to the passage of the 2000 Emergency Law with the economic and political crisis that resulted in the enactment of Emergency Law No. 25,561 in 2002. Siemens explains that, contrary to the description made by Argentina, the 2000 Emergency Law only declared the fiscal accounts in emergency and empowered the new administration to repudiate certain contracts concluded by its predecessor. According to Siemens, the emergency was not related to "extraordinary and unforeseeable" events unrelated to the State as claimed by Argentina, because public deficits fail to

meet such qualifications: the events that led to the enactment of the 2000 Emergency Law were attributable exclusively to the State itself.

144. Siemens contests Argentina's allegations regarding its technical qualifications. Siemens recalls that in the bidding process SITS was allocated the best ratings in terms of experience in the implementation and or administration of the System, and in project integration and capacity to handle the Project. Siemens recalls that Argentina holds Siemens in such high regard that it has repeatedly requested its intervention in other public projects, even after the Contract's termination.

145. Siemens dismisses Argentina's allegations regarding defects in the Contract and recalls that, in compliance with Decree No. 1310/94, the Ministry of the Interior approved the Bidding Terms of Conditions through Resolution No. 2183/96, stating in the whereas clauses that RPN, DNM, DNE, the Ministry of the Interior, the Attorney General's office and SIGEN had been involved in their preparation. RPN, DNM and DNE prepared reports for the Technical Evaluation Committee which concluded: "it may be inferred from the technical reports received, from which contents this Committee finds no reasons to depart,"<sup>26</sup> that the bidders have complied with all the provisions referring to the items and amounts tendered, and that "it is appropriate to share the conclusions reached by the Technical Agencies consulted [RNP, DNM, DNE], that SIEMENS IT's rating is 13.03% higher than the rating [...]."<sup>27</sup> Furthermore, it is Siemens' contention that:

"Only Argentina was in a position to identify its own political, economic and social needs involved in the System. It was also the one that had the duty to set the requirements consistent with its own capabilities and limitations. Contrary to its claims, it was Argentina and not the Contractor that had the duty to inform its contractual party of the economic, political or social limitations that could be encountered in the design, implementation and subsequent development of the Project."<sup>28</sup>

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<sup>26</sup> Reply, para. 137.

<sup>27</sup> *Ibid.*, para. 138.

<sup>28</sup> *Ibid.*, para. 142.

146. As regards the delayed approval of the FOM and the allegation by Argentina that SITS lacked the technical capacity to perform the Contract, Siemens asserts that the reasons that delayed FOM approval were not of a technical nature that could be ascribed to SITS, but originated in the indolent attitude of the Government and its lack of cooperation with SITS.

147. Siemens contests the presentation made by Argentina on the failure of implementing the External Circuit and the implication that it was Siemens that designed this circuit and determined its need. According to Siemens, the model incorporating the External Circuit was created by Argentina taking into account the country's geographical extent and the rules applicable to its personal identification and registration activity. Furthermore, Argentina has justified not making the necessary budget allocations on the basis of ignorance of the characteristics required for the buildings allocated to the External Circuit. Siemens claims that this is not a valid reason because Argentina had all the information to purchase the properties and prepared a budget estimate months later when the System was paralyzed.

148. As regards the failure to discontinue the production of the old manually produced DNIs, Siemens recalls that the "cut-over" criterion was a basic commitment of Argentina under the Contract and an essential component of the Project, that, in any case, Argentina did not meet the new deadlines agreed reluctantly by SITS, and that the error detected by the police occurred several months after the original date of the "cut-over" and after the new deadlines.

149. Siemens contends that the decision to suspend the for-profit-operations of the System were arbitrary. In the case of the fingerprint error, Siemens insists that it originated in a mistaken software sentence found in the programming of one of the applications. According to Siemens, SITS acknowledged the error and offered to correct it immediately, but the Government decided to suspend provisionally the processing of DNIs for Argentine nationals and foreigners throughout the System. The decision remained in effect until the termination of the Contract.

150. Siemens contests the interpretation given by Argentina to Article 17 of the Contract. This Article does not distinguish between design errors and errors related to individual documents; it simply refers to a DNI that may have errors resulting from any cause, whether attributable to SITS or the Government.

151. Siemens recalls that the services provided by SITS to the DNM and DNE were accepted by the relevant agencies and that, in the case of the DNM sub-system, its operation was suspended because of the alleged lack of formal authorization for the launch of the sub-system after one day of operation and not because of the flaws that Argentina now points out, supported by a report of SIGEN of September 2001, four months after termination of the Contract and eighteen months after the suspension of the sub-system operation. According to Siemens, the sub-system is in use by DNM to this date.

152. Siemens questions the use of the technical studies presented by Argentina in this arbitration when the Government did not consider that SITS had committed breaches to allow the Contract's termination, nor did it ever notify SITS of the serious breaches now invoked in accordance with the procedures provided for in the Contract, nor imposed any sanctions whatsoever based on the alleged inconsistencies of the System. According to Siemens, SIGEN produced its reports months after the System had started to operate with express approval of RPN, and after the authorities had already decided to terminate the Contract. Siemens claims that Argentina did not convey the reports or their recommendations to SITS or Siemens and refers to Article 10.2 of the Contract, which provides that:

“Following Systems implementation, but prior to their being put into operation, the security and high degree of inviolability of the Systems shall be tested and certified by a world-class auditor appointed by mutual agreement of the parties. The inexistence of observations from the State's Security Officer shall imply the acceptance of the Systems' security and inviolability test results.”

153. Siemens affirms that the only auditing reports provided for in the Contract determined the reasonable accomplishment of the System's security

standards, including the initial stage, SITS' compliance with its contractual obligations, and the Government's non-compliance with theirs. Siemens points out that these reports were ignored by the Government and excluded from the administrative files, probably, Siemens surmises, because their outcome was deemed unfavorable to Argentina.

154. Siemens recalls that two months prior to the creation of the Commission, and days before the suspension of for-profit operations, the new authorities declared publicly before informing SITS of their intentions that the Contract had to be reviewed. Siemens also recalls that the technical aspects were irrelevant in the discussions to renegotiate the Contract, and that the issues discussed were limited to the reduction in the number of DNIs, migration proceedings prices, the redesign of the External Circuit, the progressive discontinuance of the manual system as opposed to the "cut-over", an increase in the amount of free-of-charge DNIs, etc. Siemens submits that these were not "external circumstances" or an "extraordinary and unforeseeable event that materially affected the equilibrium of the relationship", but reflected the opposition of the new Administration to the obligations undertaken by its predecessor. Siemens notes that, with a high degree of political opportunism, the Government took advantage of the fact that by then most of the investment for the Project had been made.

155. Siemens questions the correctness of the *ius variandi* as understood by Argentina. First, Siemens refers to the acknowledgement by Argentina that the power of the Government to vary the terms may be exercised only to the extent to which the economic balance of the contract is preserved. However, Siemens points out that Argentina neglects to mention the limitations to the *ius variandi*. Indeed, the authority of the State to modify the terms and conditions of the contract does not affect those provisions pertaining to compensation and financial advantages, since it would be contrary to the principle of good faith and to business security to allow the State to modify the contract unilaterally and reduce compensation. Siemens refers to the limitations imposed by the Argentine Constitution and law, in particular the property safeguard (Article 17 of the Constitution), the proportionality principle (Article 28

of the Constitution), the *pacta sunt servanda* rule (Article 1197 of the Civil Code) and the principle of good faith (Article 1198 of the Civil Code).

156. Siemens argues that, when Argentina called for foreign investment to carry out its public sector transformation in 1990, Argentina assumed that some of the legal features of the public contract could discourage investors and deliberately self-limited its public powers and prerogatives. Siemens points out that one of the most important limitations was directed at preventing the unilateral modification or termination of contracts, even if ostensibly in the ‘public interest.’<sup>29</sup> Thus Article 33.6 of the Contract provides that, “Any change or amendment to this Contract shall be agreed upon by the parties and set forth in writing.” Article 26.1 limits early termination by the State to cases of SITS’ fault, and Article 3.5.2 limits early termination by the State until all existing DNIs issued as of the date of the Contract had been replaced.

157. Siemens submits that “if the State does not comply with the previously described limitations, it would be in breach of its duties and it should be accountable for its wrongful acts by fully compensating the contractor for having deprived it of its vested rights and/or having frustrated its legitimate expectations (as appropriate).”<sup>30</sup> Siemens also points out that Argentina does not specify any new events that would justify a different assessment of the public interest as it was when the Contract was awarded; a change of Administration is not a valid legal ground. The renegotiation of the Contract was initiated, not as an exercise of Argentina’s discretionary powers, but as an attempt to depart from its contractual obligations.

158. Siemens insists that there was “no mutual will to renegotiate following a change in circumstances, but a coerced process involving substantial alterations of the initial conditions to the detriment of SITS, strongly conditioned by the fact that – the investment already being made – the State suspended the operations of the income generating systems [sub-systems] [...]”<sup>31</sup>

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<sup>29</sup> *Ibid.*, para. 225.

<sup>30</sup> *Ibid.*, para. 229.

<sup>31</sup> *Ibid.*, para. 242.

159. Siemens recalls the Argentine Supreme Court constitutionality test for emergency measures that restrict individual rights, namely, they may last only as long as necessary to allow the cause of the measures to disappear, and “Even where a more intense exercise of police power is recognized in emergency circumstances, the Supreme Court has repeatedly held that an individual’s own property cannot be taken without a declaration of public use and prior compensation.”<sup>32</sup> The application of the 2000 Emergency Law to terminate the Contract was a political decision and not, as alleged by Argentina, the result of events “absolutely alien and independent from the administrative activity.”<sup>33</sup>

160. Siemens contends that the disclosure of SITS’ cost structure was necessary only at a later stage and points out that, during the 14 months of negotiations prior to SIGEN’s report in March 2001, this issue was never raised. Furthermore, the Contract was based on a price cap and the cost to Argentina did not depend on SITS’ cost structure, the conditions of Article 4.6.2 of the Contract had not been met and the 2000 Emergency Law did not trigger them, and even the Draft Proposal of May 2001 did not require any disclosure.

161. Siemens notes that there was no “shared sacrifice” and that the burden was exclusively on SITS is particularly evident in the May 2001 Draft Proposal intended to provoke a rejection from SITS and to justify the termination of the Contract on the basis of the 2000 Emergency Law. Siemens asserts that its reply to the proposal was not a rejection, but that it only insisted on the need to reach a solution that would respect the parties’ rights and previous commitments, and requested the missing annexes for a correct assessment of the proposal.

162. Siemens recalls that the new Minister of the Interior ordered new reports from RNP, DNM and DNE and that these agencies issued reports in April 2001 that differ from those issued in December 2000, particularly in the case of RNP. The proposal of May 2001 shows that technical issues were not relevant and the disclosure of the cost structure was not required by the State at the time of formulating such proposal. The State had not required it as a condition of the

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<sup>32</sup> *Ibid.*, para. 259.

<sup>33</sup> *Ibid.*, para. 262.



Contract when it was awarded nor was it part of the November 2000 Contract Restatement Proposal.

163. Siemens points out that it was denied access to the administrative file until August 2001 –three months after termination of the Contract – and then it realized that: the file had been started on December 13, 2000, it included documents dated from as early as January 2000, and reports favorable to the Contract's continuation were absent. According to Siemens, such reports apparently had been included in the file and then removed without indicating the reason; notably, the SWIPCO reports were missing and were also ignored in the Counter-Memorial.

164. Siemens then refers to the contracts that Argentina has reported in the Counter-Memorial to have been terminated under the 2000 Emergency Law to respond to the claim of discrimination, and argues that these contracts were not comparable, that main contracts involving foreign investments had been formally excluded, that most of them had been renegotiated and not terminated and that the two public works terminated were in the end terminated because of the contractors' fault. Siemens points out that a passport contract between a local company and the State is not included in the list presented by Argentina, and was not subject to the 2000 Emergency Law notwithstanding how expensive it was.

165. Siemens claims that, after termination of the Contract, the behavior of Argentina was as arbitrary as before, namely, it denied access of SITS to the administrative file, subjected SITS' compensation to the performance and to the physical tests of the System after it had been in the power of the State since its transfer and over which SITS had lost control a long time before, excluded SITS from the tests at *Casa de Moneda*, and issued reports unfavorable to SITS without notifying SITS or including them in the administrative file. Siemens claims that Argentina's lack of good faith is confirmed by bringing before this Tribunal a large number of contractual breaches absent any actual decision of the Government pertaining to the Contract.

166. Siemens affirms that SITS took every possible action to overcome the difficulties placed in its way by Argentina and to avoid the expropriation of the Contract and recover its investment.

167. Siemens points out that it took Argentina 28 months to receive the assets transferred from SITS. Siemens recalls how Argentina did not take measures for the orderly transfer of the non-exclusive licenses for the use of the applications software or the contract for the supply of satellite link services, and all links between SITS' help desk and the System were cut in May 2001. Siemens claims that the passive behavior of Argentina caused losses and jeopardized the System. Hence, SITS could not agree to any physical, performance or functionality test carried out by the Government after its damaging attitude.

168. Siemens notes the positive results of the test at *Casa de Moneda* in order to verify the overall operation of the System. Siemens refers to the following statement in a letter provided by the President of *Casa de Moneda* to the Under-Secretary of the Interior reporting on the test results:

“As per your request, I would like to inform you the positive result of the verification test of the operativity [*sic*] of the General Persons Identification System that forms part of the Argentine and International Public Bidding Process No. 01/96, the contract of which was terminated by Decree 669/01.

[...]

Therefore, it has been verified that it is possible to print identity documents at the plant.”<sup>34</sup>

169. Siemens also points out that SITS' sub-contractors who were present at the tests reported that they “[...] evidenced the successful operation of the systems set up for the production of DNIs, and that pursuant to Section 2 of Decree No. 669/2001 those systems were received by the Government.”<sup>35</sup> Siemens refers to press reports on the satisfactory functioning of the System

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<sup>34</sup> *Ibid.*, para. 341, emphasis added by the Claimant.

<sup>35</sup> *Ibid.*, para. 342, quotation from a note from Imaging Automation.

notwithstanding attempts by officials of RNP to prevent its operation to the extent that floppy disks and software applications containing important information for the issuance of the DNIs mysteriously were lost.<sup>36</sup>

170. Siemens maintains that the source code issue lacks any merit. First, source codes were excluded from the Contract. The Government, prompted by a question of SITS seeking confirmation that the only right to be acquired by the Ministry of the Interior over the software would be a non-exclusive use license, replied: “The requirement included in the bidding terms and conditions related to the software is that the Ministry of the Interior be transferred a permanent and non-exclusive use license”, and “the bidder or contractor may assign all or a portion of the ownership rights over the software if it so accepted.”<sup>37</sup> Siemens affirms that there is no reference in the Contract to software source codes and, to have access to them, Argentina would need to negotiate directly with the software copyright owners.

171. Siemens recalls that software and source codes are protected by Argentine law and international law and that no third party has the right to access, reproduce, execute, adapt and modify them without the copyright holder’s express authorization.

172. Siemens notes that the Respondent never demanded compliance with Article 10.12 of the Contract prior to this arbitration. As the evidence attached to the Counter-Memorial shows, this article was invoked by Argentina for the first time in April 2002, nearly a year after Contract termination and after the provision had lost its effect. Furthermore, the allegation made by Argentina that defects had been detected in the System that require access to the source codes to be corrected is an argument first made by Argentina in its Counter-Memorial.

#### **4. Rejoinder**

173. In its Rejoinder, Argentina points out that it is striking that, notwithstanding the contractual concerns expressed by Siemens in this

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<sup>36</sup> *Ibid.*, paras. 344-345 and footnotes 402 and 403.

<sup>37</sup> *Ibid.*, para. 353, emphasis added by the Claimant.

arbitration, it never saw fit to initiate the dispute settlement provisions set out in Article 30 of the Contract. Argentina emphasizes the seriousness of the breaches of the Contract by SITS, and that Siemens agreed to renegotiate the Contract and to the application of the 2000 Emergency Law to the renegotiation. Siemens was aware of the consequences of renegotiating under that law. Argentina explains that the final proposal was prepared after receiving the opinions of the General Department of Legal Affairs of the Ministry of the Interior and of SIGEN. Argentina also points out that the delay in compensation can be attributed to institutional changes but also to the lack of cooperation of SITS with the Asset Reception Committee.

174. Argentina clarifies that it is true that Siemens won the bid on the basis of Siemens' qualifications as technology leader but the System failed to perform the task identifying and registering individuals pursuant to Law No. 17,671. Argentina affirms that the FOM was never approved and hence the System never existed, only some functions worked.

175. Argentina questions the political motivations alleged by the Claimant at each step of the way. Argentina points out that the FOM approval process already showed before the change of Government that SITS lacked the technical expertise required. The FOM was approved on November 26, 1999, subject to the observations made by RNP, and Argentina allowed SITS to start printing the DNIs beforehand so that SITS could recover its investment. As regards the External Circuit, Argentina clarifies that it was refused by the Provinces because of economic reasons, that it would have been irresponsible to oblige the Provinces considering how onerous the model was and the impossibility of continuing efficiently with the development of the Project, and that SITS agreed with the Government on November 26, 1999 to empower the project coordinator of RNP and the project manager of SITS, together with the Provincial Directors of Vital Records, to amend the schedules of implementation, composition and size of the Electronic Data Collection Centers and established December 20, 1999 as the deadline for implementation.

176. Argentina dismisses the contention that no budgetary allocations were made and refers to pertinent provisions of the budget laws for 1999, 2000

and 2001, and alleges that it would have been irresponsible on the part of Argentina to use the budget to develop a faulty product.

177. Argentina maintains that the manual system to issue DNIs could not be suspended because the System as such never worked. The mistake detected by Argentine police officers was not a minor mistake; it was a major design error in the sub-system. The DNM component also failed; it was installed in less than 10% of the places and presented gross validation mistakes. Argentina argues that SITS failed to bring any action against the measures taken and only objected to Decree 669/01 and then for reasons different from those adduced here.

178. Argentina insists that Article 17 of the Contract referred only to errors related to the physical support and not to the design of the software, that it was essential for the Government to secure the continuation of the System, that the interruption was not a penalty, and that the mistake in the fingerprint did not give rise to the revision of the Contract.

179. Argentina observes that Siemens has not objected to any of the safety-related questions in the report of SIGEN; it simply asserts that it was not notified. In respect of the date when the report was issued, Argentina dismisses the point made by Siemens since surely a report needs some time to be prepared and the date of the report is the date of its completion. Furthermore, Argentina notes that SITS was aware of the preparation of the report since its representatives attended the audit meetings organized by SIGEN.

180. Argentina asserts that at no time has it affirmed that the Contract was rescinded by the Contractor's fault. The reports of the various agencies were used to revise the Contract but the rescission was done under the 2000 Emergency Law. Argentina alleges that it did not inform SITS of any breaches nor imposed any sanctions because it was its intention to preserve the Contract and affirms that at all times it acknowledged that the rescission was a consequence of the economic and financial emergency.

181. Argentina affirms that it does not confuse the emergency of 2000 with that of 2002; the circumstances detected in 1999, which gave rise to the

2000 Emergency Law, are the background to the crisis that burst in December 2001. Argentina asserts that the two crises are linked, contrary to the argument made by Siemens.

182. Argentina explains that the Commission had no power to reach agreement with SITS and, therefore, it could not commit or oblige the State. Argentina describes the Contract Restatement Proposal prepared by the Commission as an internal preparatory document indicating SITS' point of view.

183. Argentina further explains that the report of SIGEN was an internal report of the Administration, and that due to their importance and effects some documents are published on its website. Thus there is nothing surprising that SITS learned of its existence that way rather than through a formal notice. Argentina understands the business reasons for SITS' disagreement with the changes resulting from SIGEN's report, but it does not understand the refusal of SITS to reveal its cost structure which would have assisted the Government in finding a more rapid and favorable solution for the parties.

184. Argentina takes issue with the statements by Siemens that only Siemens was required to do its part in aid of the shared sacrifice principle. To maintain the Contract as Argentina tried to do, adapting it to the economic circumstances of Argentina and its population represented a cost to Argentina over simply letting the Contract collapse.

185. Argentina argues that, when the Claimant did not accept 10 of the 21 points in the Draft Proposal, Argentina concluded that the points accepted by SITS were not sufficient to meet its savings expectations, and that Siemens may not argue now that it did not reject the proposal and that the State frustrated the Contract. Argentina recalls that SITS was informed that the 2000 Emergency Law had passed and that the Contract should not be excluded from it since the Contract was not a privatization contract, and affirms that the purpose of Argentina, when it included the Contract under the 2000 Emergency Law, was not to rescind the Contract but rather to reach an agreement that guaranteed its survival. According to Argentina, Resolution MI No. 1779/00 was clear in stating that the proposal made to the Contractor could be modified by the Contractor, but

in such case the Government could reject the modification and rescind the Contract.

186. Argentina recalls that the System never reached the C2 Security Level required under Annex II, Appendix I of the Contract for the configuration installed in the Document Production Centre (“DPC”) and the Central Scanning Center. Argentina explains that SIGEN security reports in respect of the RPN and DNM were started by SIGEN on December 21, 2000, and February 21, 2001, respectively. The reports show that the Contract needed to be revised and redrafted not only because of errors in the design related to printing of fingerprints but also because of failures in IT security. Argentina explains that, because the Contract was rescinded under the 2000 Emergency Law and not for non-performance reasons, it was not necessary to have the final conclusions of the three audits carried out by SIGEN. On the other hand, according to Argentina, the SIGEN audits are a relevant element to bear in mind for the appraisal of property and equipment delivered by SITS upon termination of the Contract.

187. Argentina argues that the scope of the audit conducted by Pistrelli was limited because of its terms and the time when it took place, and may not be used validly to refute the recourse to SIGEN. Pistrelli’s audit was in the nature of desk work and could analyze the System only in a preliminary phase because it had not started to operate as a whole. On the other hand, affirms Argentina, SIGEN carried out an integral audit after the System operated and the Project was halted due to a mistake in its design. Argentina recalls that RPN criticized the Pistrelli audit and requested elaboration of a number of points and that, as of April 17, 2000, the authorities had not been able to prove whether the security changes requested by RPN had been incorporated.

188. Argentina observes that SITS refused to participate every time tests were carried out in spite of several invitations made by the Government. Argentina also points out that SITS refused to participate in the asset reception process notwithstanding official invitations to this effect. Thus SITS did not participate in the physical cross-checking, operative cross-checking or performance cross-checking because: (i) the inventories of assets already

furnished contained accurate specifications, and (ii) since termination of the Contract it had not been in charge of the operation of the System, did not have access to the equipment and did not know the physical and operative situation.

189. Argentina acknowledges that SITS has the right to compensation and that it has taken all the measures leading to satisfy it.

190. Argentina confirms that the contractual performance bond has not been returned because there has been no compliance of SITS with Article 10.12 of the Contract regarding deposit of the source codes and with Article 10.7 regarding the delivery of licenses for the use of applications software. According to Argentina, the return of the performance bond is not required until the Asset Reception Committee issues a decision as to compliance by SITS with its contractual obligations.

191. Argentina maintains that the agreements between SITS and the sub-contractors have been transferred to the State and that the amount to be paid is included in the amount of compensation assessed by the TTN.

192. Argentina takes exception to the allegation that it has not been diligent in respect of the transfer of the non-exclusive licenses and the satellite links. Argentina contends that the licenses have not been delivered because delivery was subject by SITS to prior payment by the Government. As regards the assignment of satellite links, it was the choice of Argentina to continue or not with the same provider.

193. Argentina rebuts the statements of Siemens on the test of *Casa de Moneda*. In the first place, the test was conducted outside the asset reception process and there was no reason to invite SITS since the Contract by then had been terminated. Furthermore, Argentina affirms that the test was not as successful as the Claimant pretends since documents were printed only and not produced and, even with the assistance of sub-contractors, it was not possible to make the System work appropriately.

194. Argentina then turns to the source codes issue and re-affirms that the codes were necessary for the purpose of determining the extent of compliance by SITS with its obligations within the framework of the 2000



Emergency Law and Resolution ME No. 3/2001. Argentina also questions the statement of Siemens that Argentina had never raised the issue of compliance with Article 10.12. Argentina in fact requested the source codes at the request of the TTN and SITS breached Article 10.12 by not providing them. Argentina explains that the value of the source codes has been included in the assessment carried out by the TTN.

## **VI. Merits of the Dispute**

195. Argentina has based its defense on its submission that the claim of Siemens is grounded on issues of contractual performance, while Siemens maintains that its claim is based on breaches of the Treaty, including the breach of the umbrella clause – Article 7(2) of the Treaty. The Tribunal will address this question first and, before turning its attention to the other specific claims related to expropriation, fair and equitable treatment, and arbitrary and discriminatory measures, it will consider the relevance of SITS’ and Siemens’ agreement to the Contract Restatement Proposal and alleged agreement of SITS and Siemens to include the revision of the Contract under the framework of the 2000 Emergency Law.

### **1. Umbrella Clause**

#### **a) Positions of the Parties**

196. The Tribunal will start by recalling the specific arguments of the parties on the meaning of Article 7(2) of the Treaty. This article reads as follows:

“Each Contracting Party shall observe any other obligation it has assumed with regard to investments by nationals or companies of the other Contracting Party in its territory.”

197. Siemens argues that Argentina breached Article 7(2) of the Treaty by failing to comply with its obligations with regard to Siemens’ investment. According to Siemens, such obligations may be contractual obligations in agreements between States and investors or broader undertakings contained in the States’ national investment legislation. The effect of Article 7(2) is to protect investments against interferences with contractual rights and licenses elevating

them to violations of the Treaty regardless of breaches of Articles 2 and 4. Siemens observes that this conclusion is even more compelling if the State does so in bad faith, for political reasons and lacking public purpose. Siemens also finds that this conclusion is confirmed by Article 10(1), which covers all “[d]isputes concerning investments in the sense of this Treaty between a Contracting Party and a national or company of the other Contracting Party [...]”

198. In its Counter-Memorial, Argentina reviews the history of the umbrella clauses and in particular refers to the concept of the essential base of the claim introduced in *Woodruff v. Venezuela*<sup>38</sup> and used in *Vivendi II* for purposes of determining the validity of the forum choice in the contract. Argentina finds further support in its argumentation in *Ronald S. Lauder v. the Czech Republic*<sup>39</sup>, *Alex Genin, Eastern Credit Limited, Inc. and A.S. Baltoil v. the Republic of Estonia*<sup>40</sup>, *CMS Gas Transmission Company v. Argentine Republic*<sup>41</sup> and *SGS Société Générale de Surveillance S.A. v. Islamic Republic of Pakistan*.<sup>42</sup> In the latter case, Argentina points out that the tribunal insisted that the text of the clause has to be unambiguous and that there must be clear and convincing evidence of the purpose of the umbrella clause to elevate contractual claims to treaty claims. Argentina also finds support in *SGS Société Générale de Surveillance S.A. v. Republic of the Philippines* since both SGS tribunals were moved by the goal of preventing the transformation of contractual claims into international claims.

199. Argentina points out that the tribunal in *SGS v. Philippines* restricts the commitments to which the clause is applicable: “For Article X(2) to be applicable, the host State must have assumed a legal obligation, and it must have been assumed vis-à-vis the specific investment – not as a matter of the application of some legal obligation of a general character. This is very far from

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<sup>38</sup> *Woodruff v. Venezuela*, RIAA, Vol. IX, p. 213, AL RA No. 72.

<sup>39</sup> *Ronald S. Lauder v. the Czech Republic*, Award (September 3, 2001), published in [www.mfcr.cz/Arbitraz/en/FinalAward.doc](http://www.mfcr.cz/Arbitraz/en/FinalAward.doc), Siemens LA No. 6.

<sup>40</sup> *Alex Genin, Eastern Credit Limited, Inc. and A.S. Baltoil v. the Republic of Estonia*, ICSID Case No. ARB/99/2, Award (June 25, 2001), AL RA No. 73.

<sup>41</sup> *CMS Gas Transmission Company v. Argentine Republic*, ICSID Case No. ARB/01/8, Award (May 12, 2005), AL RA No. 64.

<sup>42</sup> *SGS Société Générale de Surveillance S.A. v. Islamic Republic of Pakistan*, ICSID Case No. ARB/01/13, Decision on Objections to Jurisdiction, 18 ICSID Review 307, para. 163, AL RA No. 74.

elevating to the international level all ‘the municipal, legislative or administrative or other unilateral measures of a Contracting Party.’<sup>43</sup> Furthermore, according to Argentina, if there is an exclusive contractual forum selection clause, the forum specified in the contract is the forum with jurisdiction over contractual matters.

200. Applying these considerations to the instant case, Argentina argues that “the clause can only be invoked *vis-à-vis* an Investment Agreement in the case of breach of the Agreement and not *vis-à-vis* a concession contract governed by domestic administrative law and containing an agreed upon forum clause. Siemens intentionally confuses the Investment Agreement with the investment, terms that are not equivalent and cannot be merged.”<sup>44</sup>

201. In its Reply, Siemens affirms that Article 7(2) includes obligations arising from a contract. Siemens finds that the attempt by Argentina to distinguish between an investment agreement and domestic utility contracts has no support under the terms of investment treaties or in their ordinary meaning. Siemens points out that Articles 7(2) and 10(1) use the term “investments”, which is broadly defined and that claims raised under an umbrella clause are additional to and independent of claims based on the other protections under the Treaty. According to Siemens, under an umbrella clause, “any violation of a contract thus covered, becomes a violation of the BIT. The consequence is that the BIT’s clause on dispute settlement becomes applicable to a claim arising from the breach of the contract.”<sup>45</sup>

202. Siemens argues that case law supports its claims under article 7(2) of the Treaty. First, it refers to the criticism of the *SGS v. Pakistan* in *SGS v. Philippines* which termed that decision unconvincing because it failed to give any clear meaning to the umbrella clause. Siemens points out that the facts of the instant case are different because *SGS v. Pakistan* did not involve any allegation of sovereign interference with the Contract. Second, Siemens recalls the conclusion of the tribunal in the Philippines case: “[the umbrella clause] makes it

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<sup>43</sup> *SGS Société Générale de Surveillance S.A. v. Republic of the Philippines*, ICSID Case No. ARB/03/10, Decision on Objections to Jurisdiction (January 29, 2004), para. 121, cited in the Counter-Memorial, para. 1039.

<sup>44</sup> Counter-Memorial, para. 1047.

<sup>45</sup> Reply, para. 591, citing Professor Schreuer’s legal opinion.

a breach of the BIT for the host state to fail to observe binding commitments, including contractual commitments, which it has assumed with regard to specific investments.”<sup>46</sup> Third, Siemens rebuts the argument of Argentina that a more specific provision shall take precedence over a more general one. Relying on the opinion of Professor Christoph Schreuer, Siemens contends that this argument in fact favors Siemens’ position:

“The dispute settlement clause in the BIT is merely a standing offer to investors. By accepting that offer an investor perfects a specific arbitration agreement. The ICSID arbitration agreement, as perfected through the institution of proceedings, applies only to the specific dispute. By contrast, the dispute settlement clause in the Contract refers to any dispute arising from the Contract. It follows that the ICSID arbitration agreement is the more specific one. The principle *generalia specialibus non derogant*, should work against the contractual forum selection clause and in favor of ICSID.”<sup>47</sup>

Fourth, Siemens rejects the arguments on the essential claim base and the contractual forum clause for having been already rejected by the Tribunal in its decision jurisdiction.

203. Argentina in its Rejoinder denies as a primary submission that there were any breaches of its obligations towards the Claimant and, if the Tribunal would consider otherwise, then these would be a contractual matter to be determined by the proper law of the Contract and not international law. Furthermore, Argentina contests the meaning attributed by the Claimant to the umbrella clause, and points out that, in the case of *SGS v. Philippines*, the wording of the clause was different and it referred to “specific” investments, and that, in any case, the tribunal found that the umbrella clause did not “convert the issue of the extent or content of such obligations into an issue of international law.”<sup>48</sup> Argentina explains that the case law provides very little authority to

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<sup>46</sup> *SGS v. Philippines*, para. 128, quoted in the Reply, para. 599.

<sup>47</sup> Legal opinion of Professor Schreuer, quoted in the Reply, para. 603.

<sup>48</sup> *SGS v. Philippines*, para. 128, quoted in the Rejoinder, para. 667.

support the approach embraced by the Claimant and that *SGS v. Pakistan* and *Salini v. Jordan*<sup>49</sup> are evidence of the unwillingness of arbitral tribunals to embark on the resolution of contractual disputes. Argentina concludes by reminding the Tribunal that the approach proposed by the Claimant would re-write the Treaty, depart from the classical approach to the arbitral function under international law, and bring into play the provisions of Article 52 of the Convention.

**b) Considerations of the Tribunal**

204. The Tribunal considers that Article 7(2) has the meaning that its terms express, namely, that failure to meet obligations undertaken by one of the Treaty parties in respect to any particular investment is converted by this clause into a breach of the Treaty. Whether an arbitral tribunal is the tribunal which has jurisdiction to consider that breach or whether it should be considered by the tribunals of the host State of the investor is a matter that this Tribunal does not need to enter. The Claimant is not a party to the Contract and SITS is not a party to these proceedings.

205. In regards to the scope of Article 10(1), the Tribunal concurs with the submission that reference to disputes related to investments would cover contractual disputes for purposes of the consent of the parties to arbitration given the wide meaning of the term “investments” and the terms of Article 7(2). However, to the extent that the obligations assumed by the State party are of a contractual nature, such obligations must originate in a contract between the State party to the Treaty and the foreign investor as, for instance, in the *SGS* cases.

206. The Tribunal does not subscribe to the view of the Respondent that investment agreements should be distinguished from concession agreements of an administrative nature. Such distinction has no basis in Article 7(2) of the Treaty which refers to “any obligations”, or in the definition of “investment” in the Treaty. Any agreement related to an investment that qualifies as such under the Treaty would be part of the obligations covered under the

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<sup>49</sup> *SGS v. Islamic Republic of Pakistan*, quoted in the Rejoinder, para. 673; *Salini v. Kingdom of Jordan*, ICSID Case No. ARB/02/13, Award (January 31, 2006), quoted in the Rejoinder, para. 673.

umbrella clause. The Tribunal does not find significant, for purposes of the ordinary meaning of this clause, that it does not refer to “specific” investments. The term “investment” in the sense of the Treaty, linked as it is to “any obligations”, would cover any binding commitment entered into by Argentina in respect of such investment.

## **2. Consent of Siemens and SITS**

207. The positions of the parties related to the argument advanced by Argentina to the effect that SITS or Siemens agreed to the measures taken by Argentina have already been described. The Tribunal recalls that such argument is based on the fact that SITS and Siemens agreed to the Contract Restatement Proposal in November 2000, that no administrative appeal was filed by SITS except with respect to Decree 669/01, and that they did not object to the ministerial Resolution placing the Contract under the regime of the 2000 Emergency Law.

208. As regards the agreement to the Contract Restatement Proposal, Argentina itself contends that it was a preliminary agreement that was not binding. In any case, Argentina modified the proposal and SITS did not accept certain terms of the revised proposal. Thus it is difficult to understand how it can be held that SITS or Siemens have agreed to the Contract Restatement Proposal if its terms were not an agreement but, as argued by Argentina, an internal document in which the views of the private party were expressed and Argentina did not accept them.

209. The argument on the consent of Siemens and SITS to the application of the 2000 Emergency Law to the Contract is even more puzzling to the Tribunal. It is expected that individuals and companies will obey the law; it is not a question of choice, as would be the option to accept a negotiated proposal.

210. It is a matter of dispute between the parties as to whether Siemens or SITS did not object to the application of the 2000 Emergency Law regime to the Contract because they were led to believe by the Respondent that this would speed up the administrative processing of the Contract Restatement Proposal. Whatever the reasons for not objecting, Argentina always had the

power to apply the 2000 Emergency Law to the Contract, irrespective of the position of Siemens or SITS on the matter, and it did. It is clear from the evidence that the expectation of Siemens was that the Contract Restatement Proposal would not be modified even if this may have been possible under the 2000 Emergency Law. It would lack logic that a high official of Siemens would be received by President de la Rúa to plead that a decree be issued on terms different from those negotiated.

211. To conclude, the Tribunal considers that, for purposes of evaluating the measures taken by Argentina in light of its commitments under the Treaty, the allegations based on the consent of Siemens or SITS are not relevant.

212. The Tribunal will now turn to the other specific commitments under the Treaty alleged by Siemens to have been breached by Argentina. Since the parties understand these commitments differently, not only as they apply to the facts of this case but also in their meaning, the Tribunal will describe first in respect of each commitment the arguments made by the parties on its scope and meaning.

### **3. Expropriation**

#### **a) Positions of the Parties**

213. Siemens argues that its investment has been expropriated indirectly as a result of measures taken by Argentina. According to Siemens, whether or not Argentina intended to expropriate its investment is irrelevant, what is of essence is the actual effect of the measures on the investors' property: "measures that indirectly, but effectively, deprive an investor of the use or enjoyment of its investment, including the deprivation of the whole or a significant part of the economic benefit of property, are as expropriatory as the seizure of an investor's formal title to its property."<sup>50</sup>

214. Siemens further argues that contractual rights and the right to complete a project are part of the property rights that may be expropriated and that government measures that frustrate such assurances and substantially

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<sup>50</sup> Memorial, para. 248.

deprive investors of their rights to have them respected amount to an expropriation.

215. According to Siemens, irrespective of whether or not the purpose of a State measure affects its legality, it does not affect the State's obligation to compensate the investor promptly, adequately and effectively; as plainly stated in Article 4(2) of the Treaty, the public purpose of expropriatory measures by either State party in no way alters the legal obligation to compensate investors affected by those measures. Failure to provide prompt, adequate and effective compensation renders the expropriation unlawful whether or not it is for a public purpose.

216. Siemens claims that the acts and omissions of Argentina were expropriatory measures that substantially deprived Siemens of the use and enjoyment of its investment, and significantly reduced its value without payment of any compensation. Siemens relied on the following assurances given and obligations undertaken by Argentina: (i) replacement of all DNIs previously issued by new DNIs issued through the System; (ii) discontinuation of the issuance of manual DNIs; (iii) implementation of the System on a nationwide basis; (iv) processing of immigration proceedings through the System and payment of the corresponding fees; and (v) adoption of all measures necessary to fulfill the obligations under the Contract and regular collection of SITS' revenues resulting from the fees and prices paid by the users.

217. According to Siemens, these assurances constituted essential conditions of its investment and Argentina was aware of its meaning as recognized in the report of the Commission:

“Progressive replacement of all DNIs [...] is actually the State's guarantee rather than an obligation of the contractor, and defines the value of the contract [...]

[...] the contract term, which is defined as a six-year term that may be extended for two three-year periods, prescribes a mechanism that guarantees returns on the investment made; this relates to the need to have all existing DNIs replaced by the ones dealt with in the contract



[...].”<sup>51</sup>

218. Siemens affirms that the acts and omissions of Argentina qualify as “measures” under Article 4(2) of the Treaty. According to Siemens, the term “measures” is an all encompassing term for any actions attributable to a State that may affect an investment and includes acts performed by its different organs and subdivisions. In the case of its investment, Siemens refers to the following measures that resulted eventually in its expropriation:

(i) From the date of execution of the Contract and up to August 1999 Argentina failed to meet the obligations it had undertaken to allow the performance of the Contract on schedule; it did not make the necessary budget allocations, it did not provide the funds and human resources necessary to make the system operational, it delayed approval of the FOM, it failed to execute agreements with the Provinces, and it did not adopt the statutory and executive measures necessary to carry out the replacement of existing DNIs by those issued through the System.

(ii) Argentina pressed SITS into postponing the initial date for DNI production because of the then upcoming elections and into agreeing to postpone until January 31, 2000 discontinuation of the manual issuance of DNIs.

(iii) Argentina failed: (A) to adopt alternative measures to implement the System throughout its territory even when the RNP had the exclusive power to issue the DNIs and gather the information to produce them, (B) to provide budget allocations for the Project for the year 2000, (C) to provide the technical definitions to complete implementation of the immigration proceedings system and the imposition of new requirements not included in the new Project, and (D) to provide the facilities to implement the External Circuit to extend the System throughout the national territory.

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<sup>51</sup> Quoted in para. 277 of the Memorial.

(iv) Argentina notified Siemens in January 2000 that it intended to reduce the originally agreed-upon prices in the Contract and that agreement to the reduction was a condition for the continuation of the Contract and, in February 2000, unjustifiably halted immigration processing and DNI production through the System.

(v) The negotiations that ensued were concluded in November 2000 with the promise that the System's revenue-generating operations would immediately resume, and to speed approval of the new contractual terms the Contract was subjected to the Emergency Law of 2000. Notwithstanding assurances of the President of the Republic that a decree would be issued approving the new terms before the end of the year, the new terms were never approved.

(vi) New terms were proposed by Argentina in May 2001 on a take it or leave it basis without providing the basic elements for an evaluation of the proposal. The new proposal was not acceptable to SITS, which indicated its willingness to consider alternatives. Argentina terminated the Contract on May 18, 2001 invoking the power granted under the 2000 Emergency Law and without reference to any technical or other reason related to the fulfillment of the Contract by SITS.

(vii) After termination of the Contract, Argentina failed to pay compensation, although it had acknowledged its obligation to do so, denied the right of defense to SITS when SITS filed an appeal against Decree 669/01, failed to receive the equipment, facilities and instruments used in Project execution, and refused to return the Contract performance bond although it was mandatory to return it at Contract termination.

(viii) Siemens' investment was the only foreign investment expropriated under the 2000 Emergency Law and the public purpose invoked to terminate the Contract was merely an excuse to legitimize the measure adopted by the Government for political convenience, since economic studies carried out by the Ministry of Economy had recommended renegotiation of the terms agreed by the parties.

219. Siemens concludes by affirming that the aggregate of these measures amounts to a creeping expropriation of its investment and submits that, notwithstanding that Argentina's conduct constitutes a case of creeping expropriation, it seems reasonable to consider May 18, 2001, the date of Decree 669/01, as the date of expropriation for valuation purposes. Siemens adds that the Treaty states that the value of an investment for purposes of compensation is determined by reference to the date before the intention to expropriate became known, and, therefore, the effects of the taking itself and any act related to the taking, including threats to take the asset concerned, that may have diminished the value of the property or enterprise on the date of the taking, shall not be considered in the valuation and that Siemens is entitled to compensation for any loss suffered before or after May 18, 2001 caused by Argentina's creeping expropriation.

220. In its Counter-Memorial, Argentina denies that it expropriated Siemens' investment and draws the Tribunal's attention to the following sentence of Article 4(2) of the Treaty: "The legality of the expropriation, nationalization or similar measure, and the amount of the indemnification should be reviewable through ordinary legal proceedings." Based on this sentence, Argentina asserts that it is entitled to apply this review option to any future decision of the Tribunal in connection with the alleged expropriation.

221. Argentina challenges the qualification of events by Siemens. It is Argentina's contention that for events to lead to an expropriation each one of them should affect the investment adversely. However, when the main feature of a contract is to provide one set of goods -the System in the instant case-, it is not possible to speak of successive acts, either the Contract is thwarted or not. Argentina argues that Siemens is unable to provide evidence that the alleged expropriatory events affected the investment adversely. In this respect, Argentina refers to the statement of Siemens that it agreed to renegotiate the Contract not only to save it but also because the Government had promised to resume the System's operation. This means, according to Argentina, that the Contract would not have been thwarted and there could not be a creeping expropriation. Argentina finds support for its line of argument in *Generation Ukraine, Inc. v.*

*Ukraine*, which admitted difficulty in finding many cases that fall under the creeping expropriation category and stated:

“A plea of creeping expropriation must proceed on the basis that the investment existed at a particular point in time and that subsequent acts attributable to the State have eroded the investor’s rights to its investment to an extent that is violative of the relevant international standard of protection against expropriation.”<sup>52</sup>

222. Argentina then develops the argument that Siemens’ claim is a purely contractual claim and international law does not include regulations on contracts, as acknowledged in *Saudi Arabia v. Arabian American Oil Company (Aramco)*, *Robert Azinian, Kenneth Davitian & Ellen Baca v. The United Mexican States*<sup>53</sup>, and by Professor Brownlie<sup>54</sup>. Furthermore, Siemens has not contributed evidence showing, as stated by the Annulment Committee in *Vivendi II*, clear conduct contrary to the relevant standard in the circumstances of the case. Argentina disputes the relevance of the Iran-US Claims Tribunal case law because the law applicable to the cases before that tribunal is different from the law applicable in this arbitration. That tribunal has to rule on contractual disputes, can apply commercial usages and has highly discretionary powers in deciding the applicable law. Argentina reminds the Tribunal that the applicability of the legal principles developed by the Iran-US Claims Tribunal was explicitly rejected in *Pope & Talbot, Inc. v. Canada*<sup>55</sup> and *S.D. Myers, Inc. v. The Government of Canada*<sup>56</sup>. Argentina also argues in detail the inapplicability to the instant case of holdings by the tribunals adduced by Siemens regarding acquired international rights: (i) *Aramco* was concerned with the application of international law to a contract that included its own stabilization clause, (ii) *Revere Cooper & Brass*,

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<sup>52</sup> *Generation Ukraine, Inc. v. Ukraine*, ICSID Case No. ARB/00/9, Award (September 16, 2003), para. 20.26, quotation in the Counter-Memorial, para. 911.

<sup>53</sup> *Saudi Arabia v. Arabian American Oil Company (Aramco)*, 27 I.L.R. 117, 165, AL RA No. 45; *Robert Azinian, Kenneth Davitian & Ellen Baca v. The United Mexican States*, ICSID Case No. ARB (AF)/97/2, Award (November 1, 1999), ICSID Review, Foreign Investment Journal 1, 25, AL RA No. 47, cited in the Claimant’s Memorial, para. 917, 919.

<sup>54</sup> I. Brownlie: *Principles of Public International Law*, Oxford University Press, 5<sup>th</sup> ed., 1998, 550, 551, AL RA No. 46, cited in the Claimant’s Memorial, para. 918.

<sup>55</sup> *Pope & Talbot, Inc. v. Canada*, Interim Award (September 13, 2001), AL RA No. 50, cited in the Counter-Memorial, para. 926.

<sup>56</sup> *S.D. Myers, Inc. v. The Government of Canada*, Partial Award (November 13, 2000), cited in the Counter-Memorial, para. 926.

*Inc. v. Overseas Private Investment Corporation*<sup>57</sup> was a classic investment agreement protecting the investment differently from an investment treaty and it was internationalized by a stabilization clause, (iii) *Antoine Goetz et consorts v. Republic of Burundi*<sup>58</sup> was concerned with the revocation of a permit to operate in a free trade zone, (iv) *CME Czech Republic B.V. (the Netherlands) v. The Czech Republic*<sup>59</sup> was not concerned with contractual guarantees by a State, and (v) the findings of *CME* were contradicted by *Lauder*.

223. Argentina questions how Siemens has drawn the line to delimit the State's legitimate actions from actions entitling an investor to compensation. Argentina argues that, if the effect of depriving a person of its property is the criterion for this purpose, then any regulation would be expropriatory because regulations have a damaging effect on regulated parties. Argentina refers to the proportionality test advanced by *Tecmed* between the measures taken and the public interest pursued by them, and to the deference due to the State when it defines issues of public policy. Thus this requires a more complex analysis than proposed by Siemens.

224. Argentina finds support in recent arbitral awards - *Consortium RFCC v. Royaume du Maroc*<sup>60</sup>, *Waste Management, Inc. v. United Mexican States*<sup>61</sup>, *Generation Ukraine, SGS v. Philippines* - for arguing that a breach of treaty is not a breach of contract, it is not enough to qualify a contractual breach as a treaty violation, there should be a reasonable effort by the investor to obtain compensation through the domestic channels under the law applicable to the contract, and the State should not have used its sovereign powers to amend pre-existing legal situations and the parties' rights and obligations. In this respect, Argentina affirms that:

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<sup>57</sup> *Revere Copper and Brass, Inc. v. Overseas Private Investment Corporation*, Award (August 24, 1978).

<sup>58</sup> *Antoine Goetz et consorts v. Republic of Burundi*, ISCID Case No. ARB/95/3, Award (September 2, 1998).

<sup>59</sup> *CME Czech Republic B.V. (The Netherlands) v. The Czech Republic*, Partial Award (September 13, 2001).

<sup>60</sup> *Consortium RFCC v. Royaume du Maroc*, ICSID Case No. ARB/00/6, Award (December 22, 2003), para. 38 (AL RA 60), cited in the Counter-Memorial, para. 972.

<sup>61</sup> *Waste Management, Inc. v. United Mexican States*, ICSID Case No. ARB(AF)/00/3, Award (April 30, 2004), para. 171 (AL RA 61).

“(a) it did not act under its *ius imperii* powers; (b) it terminated the contract with SITS under the habitual and ordinary forms provided therefor by Argentine law; (c) such act did not thwart any right granted to the investor or its affiliate under the law of the Contract; and (d) after the termination of the Contract it was not engaged in any acts aimed at thwarting the rights agreed upon with SITS for the termination.”<sup>62</sup>

225. Argentina also affirms that, like the Philippines in the *SGS* case, it had “not issued any act (law or decree in sovereign function) aimed at disregarding the possible contractual rights of SITS. Should there be any debt, it would still exist.”<sup>63</sup>

226. Argentina requests the Tribunal to focus on two aspects of *Generation Ukraine*. First, arbitral tribunals do not exercise the function of an administrative review agency. Second, arbitral tribunals should consider the changes in the economy of the State hosting the investments when assessing the investor’s legitimate expectations. Argentina also calls the attention of the Tribunal to the holding in *Waste Management II*, to the effect that international expropriation law is not meant to eliminate the ordinary risk assumed by foreign investors, and to the fact that, under the Contract, SITS took responsibility for the business risk.

227. Argentina denies that it gave Siemens any warranty or profitability assurance, and claims that Siemens agreed to revise the Contract when faced with the failure of the essential features of the System and the substantial alteration of the economic conditions under which the Contract was intended to be carried out. Argentina contends that Siemens must comply with the Contract before requesting its fulfillment and lists as breaches of the Contract concealed from the Tribunal the following: delay in the design of the FOM and the Security Operating Model, the imperfect designs for the Security Operating Model, the External Data Capture Circuit and fingerprint taking, ignorance of the Argentine personal identification system, failure to deliver the source codes, vulnerability of

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<sup>62</sup> Counter-Memorial, para. 969.

<sup>63</sup> *Ibid.*, para. 986.

the System, and the hindrances placed by SITS during the entire reception process, including its refusal to participate.

228. In any case, pleads Argentina, even if the arguments of Argentina were rejected, the mere “effect” criterion applied by the Iran-US Claims Tribunal would not result in an expropriatory effect of the alleged actions of Argentina under Argentine law applicable to the Contract.

229. In its Reply, Siemens rejects the allegation of Argentina that, under Article 4(2), it has the right to submit to review before the local courts the potential award of this Tribunal. Siemens explains that this Article grants the investor, who is the only party affected by the expropriation measures, the right to challenge the legality of the expropriation and the amount of the compensation in ordinary judicial proceedings.

230. Siemens then questions the definition of expropriation used by Argentina in its allegations, namely, that expropriation may occur only directly or through measures that autonomously and independently affect the investment adversely, that deprivation of or substantial interference with contractual rights does not constitute an expropriation under international law, and that the effect of the measure should completely thwart the investment or be unreasonable,

231. Siemens notes that the Treaty includes measures tantamount to expropriation and explains that provisions on indirect expropriation are usually generic statements given the great variety of possible measures. Siemens refers to the findings by the tribunals in *Compañía del Desarrollo de Santa Elena S.A. v. The Republic of Costa Rica*,<sup>64</sup> *CME, Metalclad Corporation v. The United Mexican States*,<sup>65</sup> *Tippetts, Abbett, McCarthy, Stratton v. TAMS-AFFA Consulting Engineers of Iran*,<sup>66</sup> *Middle East Cement Shipping and Handling Co.*

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<sup>64</sup> *Compañía del Desarrollo de Santa Elena S.A. v. The Republic of Costa Rica*, ICSID Case No. ARB/96/1, Award (February 17, 2000).

<sup>65</sup> *Metalclad Corporation v. The United Mexican States*, ICSID Case No. ARB(AF)/97/1, Award (August 30, 2000).

<sup>66</sup> *Tippetts, Abbett, McCarthy, Stratton v. TAMS-AFFA Consulting Engineers of Iran*, Case No. 7, Award No. 141-7-2- (June 22, 1984), 6 IRAN-U.S. C.T.R. (1986), 219, at pa. 225, Legal Authorities No. 23, cited in the Memorial, para. 243.

*S.A. v. Arab Republic of Egypt*<sup>67</sup> and *Tecmed* to show the endorsement of the notion of indirect expropriation by arbitral tribunals; such expropriation takes place by a variety of measures that by themselves would not necessarily be expropriatory or adversely affect the investment, nor would they need to be intended to be expropriatory. Siemens refers to scholarly opinion on the notion of creeping expropriation:

“In some, if not most other, creeping expropriations, however, that intent [to expropriate], though possibly present at some level of the host state’s government, will be difficult, if not impossible to discern. Discrete acts, analyzed in isolation rather than in the context of the overall flow of events, may, whether legal or not in themselves, seem innocuous vis-à-vis a potential expropriation. Some may not be expropriatory in themselves. Only in retrospect will it become evident that those acts comprised part of an accretion of deleterious acts and omissions, which in the aggregate expropriated the foreign investor’s property rights.”<sup>68</sup>

232. Siemens alleges that an analysis of *Biloune and Marine Drive Complex Ltd. v. Ghana Investments Centre*,<sup>69</sup> *Tradex Hellas S.A. v. Republic of Albania*,<sup>70</sup> *Santa Elena*, *Tecmed*, *Generation Ukraine* and Iran-US Claims Tribunal jurisprudence shows that expropriatory measures that take place step by step should be analyzed in their aggregate effects and not “autonomously and independently” as argued by Argentina. Siemens concludes that the termination of the Contract was not the only expropriatory step but the last of a clear chain of measures taken by Argentina since 1999 that destroyed the value of Siemens’ investment.

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<sup>67</sup> *Middle East Cement Shipping and Handling Co. S.A. v. Arab Republic of Egypt*, ICSID Case No. ARB/99/6, Award (April 12, 2002).

<sup>68</sup> M. Reisman *et al*, “*Indirect Expropriation and its Valuation in the BIT Generation*”, 74 *BYIL* (2003) pp. 123-124, cited in the Reply, para. 422, emphasis added by the Claimant.

<sup>69</sup> *Biloune and Marine Drive Complex Ltd. v. Ghana Investments Centre*, Award on Jurisdiction and Liability (October 27, 1989), 95 *Int’l Law Reports* (1994), 184, at pa. 210-11, Claimant’s Legal Authorities No. 35, cited in the Memorial, para. 372.

<sup>70</sup> *Tradex Hellas S.A. v. Republic of Albania*, ICSID Case, No. ARB/94/2, Award (April 29, 1999).



233. Siemens disputes Argentina's assertion that there cannot be expropriation following contractual breaches and repudiation of the Contract. Siemens refers to the opinion of Professor Schreuer, who states that:

"[...] the mere fact that the investment was made on the basis of a contract does not preclude a violation of the BIT [the Treaty]. Nor does an allegation of contract violations mean that a BIT claim cannot arise from the same facts. The standards are simply different. It is incumbent upon the Claimant to demonstrate a violation of the BIT. This task is not made impossible or more onerous by the simultaneous existence of contract violations."<sup>71</sup>

234. Siemens further disputes the argument that, when a contract is subject to a domestic legal system, expropriation of rights under the contract would be precluded. Siemens maintains that the law governing a particular contract and whether contractual rights may be expropriated are two distinct and unrelated questions; contractual rights may be expropriated as tangible property may be expropriated. Siemens also questions the argument that a contract cannot be governed by international law unless it contains a stabilization clause: "the decisive point is that the absence of a stabilization clause does not mean that the contract cannot be the object of an expropriation. The expropriation of rights under a contract containing a stabilization clause would merely give rise to an additional claim for violation of that clause."<sup>72</sup>

235. Siemens recalls that Article 1 of the Treaty defines as protected investments "every kind of asset" and specifically "rights to funds used to create economic value or to any performance with an economic value" and "concessions conferred by public law entities." Siemens alleges that judicial practice unanimously supports a wide concept of property that includes rights under contract, e.g., the decisions in *Rudloff*<sup>73</sup>, *Norwegian Shipowners*<sup>74</sup>, *Factory at Chorzów*<sup>75</sup>, and the case law of the Iran-US Claims Tribunal.

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<sup>71</sup> Reply, para. 433.

<sup>72</sup> *Ibid.*, para. 438, quotation from Professor Schreuer's legal opinion.

<sup>73</sup> *Rudloff Case*, Interlocutory Decision, 1903, 9 Reports of International Arbitral Awards (RIAA) 244, 250 (1959), Legal Authorities 40, quoted in the Reply, para. 442.

236. According to Siemens, a breach of contract or actions affecting contract rights may constitute an expropriation when: (i) the breach consists of one or part of a series of acts that combine to effect a creeping expropriation; (ii) the breach is of such fundamental nature that it goes to the heart of the promised performance and adversely affects the continuance of the project concerned; (iii) regulatory conduct denies contract rights or requires their alteration; (iv) specific contract rights or rights under a contract as a whole are repudiated, and (iv) a stabilization clause is breached. Siemens affirms that most of these situations apply in the instant case.

237. As regards the argument that Argentina did not act in its sovereign capacity, Siemens finds the argument implausible given termination of the Contract by decree, rejection of the appeal by decree, and termination based not on contractual grounds but on the 2000 Emergency Law. Furthermore, Argentina has argued that a decisive reason for the termination was that a substantial number of Provinces refused to participate in the implementation of the Project.

238. Siemens explains that the purpose of the measures is not a criterion to determine whether an expropriation has occurred. Under Article 4(2) of the Treaty, public purpose is a criterion for the expropriation's legality, "Similarly, proportionality and reasonableness may play a role in assessing whether the power to expropriate has been exercised properly. But these criteria do not affect the question whether an expropriation exists or not."<sup>76</sup> Commenting on the cases relied on by Argentina, Siemens observes that they relate to regulatory takings, while Siemens was deprived of its investment through measures taken directly against it and not through regulatory measures.

239. Siemens rejects the argument that it needed to seek prior recourse through domestic channels and observes that this is an attempt to reintroduce an argument already put forward at the jurisdictional stage. Siemens

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<sup>74</sup> *Norwegian Shipowners' Claims (Norway v. United States)*, Award (October 13, 1922), 1 *RIAA* 307, p. 325.

<sup>75</sup> *Certain German Interests in Polish Upper Silesia (Germany v. Poland)*, Judgment (May 25, 1926), *PCIJ Series A, No. 7*, p. 44.

<sup>76</sup> Reply, para. 465, quotation from Professor Schreuer's legal opinion.

explains that, under Article 26 of the Convention, the Contracting Parties waive the local remedies rule unless they state otherwise, which Argentina has not done and, in any case, SITS and the Claimant made every reasonable effort to obtain correction of Argentina's measures through domestic means, including an administrative appeal against Decree 669/01. Contrary to the factual situation in the cases of *Waste Management II* and *Generation Ukraine* adduced by Argentina, in the instant case Siemens' loss is persistent, irreparable, caused by the Government and not by low-level officials whose acts of maladministration might easily be corrected.

240. Siemens also dismisses the argument that it may not be entitled to claim under the Treaty because it allegedly failed to perform its own obligations. Siemens observes that Article 4(2) does not impose any duty with regard to the investor; there is no defense based on the failure to comply with the other party's duties.

241. Argentina in its Rejoinder affirms that Siemens fails to draw the line between a contractual breach and the expropriation of an agreement, and clarifies that it referred to *Waste Management II* in its argument because the tribunal in that case established criteria for expropriation of an agreement, namely, an effective repudiation of the property rights of the investor which prevents it from exercising them entirely or to a substantial extent, and not redressed by remedies available to the claimant. Argentina emphasizes the reasonableness of the measures taken as part of the expropriation concept and as held by the European Court of Human Rights and *Tecmed*.

242. Argentina contends that the measures were taken under the usual and ordinary forms of terminating an agreement and Siemens failed to reply to its arguments and focused instead on whether the measures were taken in the exercise of its *ius imperium*. Argentina insists that there is a requirement of making a reasonable effort on the part of the investor to obtain correction in the domestic jurisdiction, and that this is a substantive requirement to distinguish between an act of maladministration from an act which constitutes an expropriation, "not because there is a requirement of *exhaustion* of local remedies but because the very reality of conduct tantamount to expropriation is

doubtful in the absence of a *reasonable* – not necessarily exhaustive – effort by the investor to obtain correction.”<sup>77</sup> In this respect, Argentina argues that SITS failed to comply with its essential duties and agreed to re-negotiate the Contract to conform to the fiscal possibilities of the State and the pocketbook of the people.

243. Argentina takes issue with the contention of Siemens that the defense of non-performance does not apply because investors may assert their rights under the Treaty. Argentina argues that the exception *non adimpleti contractus* is equally a principle of international law. Argentina maintains that the conditions set in *Waste Management II* for contract expropriation are not met in this case. According to Argentina, the actions taken before Decree 699/01 were in response to technical errors and failures to deliver on the part of SITS and its sub-contractors. Argentina insists that the termination of the Contract by Decree 669/01 was not only based on economic considerations but also on technical grounds after receiving independent advice. Therefore, Decree 669/01 was a legitimate, rational and proportionate response to a disappointing and inadequate performance of SITS’ contractual obligations; it was not an expropriatory measure since “[i]t left intact the Claimant’s contractual rights, and in particular the ability to have recourse to the national courts of Argentina to challenge acts of its contractual partner which it considered to have breached the Contract.”<sup>78</sup>

244. Argentina further develops the argument that investment treaties are not a guarantee of profits to foreign investors and contends that if Decree 669/01 were to be considered expropriatory by the Tribunal, then the expropriation is a lawful expropriation because “it was a reasonable and proportionate response to a national fiscal crisis; it was carried out for a public purpose; it was not discriminatory on national or any grounds; and the decree contained within its terms provision for compensating SITS for cancellation of the Contract.”<sup>79</sup> Argentina explains that there were at least two major public policy reasons for the termination of the Contract: the massive fiscal crisis which necessitated cutting back projects involving a high level of public expenditure,

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<sup>77</sup> *Generation Ukraine*, para. 20.30, quoted in Rejoinder para. 544.

<sup>78</sup> Rejoinder, para. 571.

<sup>79</sup> *Ibid.*, para. 572.

and the inability or unwillingness of a substantial number of Provinces to participate in the Project given the fiscal crisis.

**b) Considerations of the Tribunal**

245. Before considering the arguments dealing with expropriation proper, the Tribunal will address the issue of contractual claims as opposed to treaty claims which has been argued by the parties in the context of the asserted breach of Article 4(2) and also of Article 7(2) (the umbrella clause). Subsequently, the Tribunal will discuss whether under Article 4(2) the findings of this Tribunal are subject to review by the ordinary courts, whether each individual measure in a creeping expropriation needs to be considered autonomously, whether the proper law of the Contract is relevant for purposes of expropriation, whether intent of the State to expropriate is necessary or only the effects of the State's measures need to be considered, whether an expropriation has taken place, and, if so, whether it conformed with the Treaty requirements.

**i) Treaty claims and Contract Claims**

246. Argentina has argued that at no time in the course of the dispute with SITS it took measures that could be regarded as an exercise of its police powers as a State, including when it terminated the Contract under the 2000 Emergency Law. The Tribunal considers that Argentina's view of when a State acts *iure imperii* is exceedingly narrow and inconsistent with the arguments advanced by Argentina itself.

247. The distinction between acts *iure imperii* and *iure gestionis* has its origins in the area of immunity of the State under international law and it differentiates between acts of a commercial nature and those which pertain to the powers of a State acting as such. Usually States have been restrictive in their understanding of which activities would not be covered by their immunity in judicial proceedings before the courts of another State. Here we have the reverse situation where the State party posits a wide content of the notion of *iure gestionis*.

248. In applying this distinction in the realm of investor-State arbitration, arbitral tribunals have considered that, for the behavior of the State as

party to a contract to be considered a breach of an investment treaty, such behavior must be beyond that which an ordinary contracting party could adopt and involve State interference with the operation of the contract:

“ Pour qu’il y ait droit à compensation il faut que la personne de l’exproprié prouve qu’il a été l’objet de mesures prises par l’Etat agissant non comme cocontractant mais comme autorité publique. Les décisions aux cas d’expropriation indirecte mentionnent toutes l’ ‘interférence’ de l’Etat d’accueil dans l’exercice normal, par l’investisseur, de ses droits économiques. Or un Etat cocontractant n’ ‘interfère’ pas, mais ‘exécute’ un contrat. S’il peut mal exécuter ledit contrat cela ne sera pas sanctionné par les dispositions du traité relatives a l’expropriation ou à la nationalisation à moins qu’il ne soit prouvé que l’Etat ou son émanation soit sorti(e) de son rôle de simple cocontractant(e) pour prendre le rôle bien spécifique de Puissance Publique. ”<sup>80</sup>

249. *Waste Management II* distinguished a number of categories to determine whether it was faced with a matter of contract non-performance or expropriation. In the first category are those cases “where a whole enterprise is terminated or frustrated because its functioning is simply halted by decree or executive act, usually accompanied by other conduct.”<sup>81</sup> In the second category fall instances of “acknowledged taking of property, and associated contractual rights are affected in consequence.”<sup>82</sup> The third category includes cases “where the only right affected is incorporeal.”<sup>83</sup> In the latter cases, “the mere non-performance of a contractual obligation is not to be equated with a taking of property, nor (unless accompanied by other elements) is it tantamount to expropriation. Any private party can fail to perform its contracts, whereas nationalization and expropriation are inherently governmental acts.”<sup>84</sup>

250. The tribunal in *SGS v. Philippines* excluded as a treaty claim the debt owed to SGS because there had not been a “law or decree enacted by the

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<sup>80</sup> *Consortium R.F.C.C. v. Kingdom of Morocco*, ICSID Case No.ARB/00/6, Award (December 22, 2003), para. 65.

<sup>81</sup> *Waste Management II*, para. 172.

<sup>82</sup> *Ibid.*, para. 173.

<sup>83</sup> *Ibid.*, para. 174.

<sup>84</sup> *Idem.*

Philippines attempting to expropriate or annul the debt, nor any action tantamount to an expropriation [...] A mere refusal to pay a debt is not an expropriation of property, at least where remedies exist in respect of such a refusal.”<sup>85</sup>

251. In the *Jalapa Railroad* case, the US-Mexican Mixed Claims Commission decided: “Here the Government of Veracruz stepped out of the role of contracting party and sought to escape vital obligations under its contract by exercising its superior governmental power.”<sup>86</sup>

252. In *Salini v. Jordan*, the tribunal held:

“Only the State, in the exercise of its sovereign authority (*puissance publique*), and not as a Contracting Party, has assumed obligations under the bilateral agreement. [...] In other words, an investment protection treaty cannot be used to compensate an investor deceived by the financial results of the operation undertaken, unless he proves that his deception was a consequence of the behavior of the receiving State acting in breach of the obligations which it had assumed under the treaty.”<sup>87</sup>

253. What all these decisions have in common is that for the State to incur international responsibility it must act as such, it must use its public authority. The actions of the State have to be based on its “superior governmental power”. It is not a matter of being disappointed in the performance of the State in the execution of a contract but rather of interference in the contract execution through governmental action.

254. In the instant case, what actions did Argentina take to step out of its role as a contractual party? In the first place, Argentina issued Decree 669/01 on the basis of the 2000 Emergency Law. Argentina has advanced the argument that termination of the Contract by Decree 669/01 was based not only on the fiscal emergency but also on the failures of the Contractor. This is not a credible argument inasmuch as Decree 669/01 and Decree 1205/01 did not provide for

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<sup>85</sup> *SGS v. Philippines*, para. 161.

<sup>86</sup> Referred to in Professor Schreuer’s legal opinion, p. 50. Whiteman, *Digest of International Law* (1976), vol. 8, pp. 908-909.

<sup>87</sup> *Salini v. Jordan*, para. 155.

termination based on non-performance and Argentina itself has manifested in these proceedings that at no time had it affirmed that the Contract was rescinded by the Contractor's fault.<sup>88</sup>

255. Argentina itself has argued that the Tribunal should defer to Argentina in deciding what is in the public interest of Argentina, and should consider the measures taken by Argentina – the 2000 Emergency Law and Decree 669/01 - as a response by the State to the impending financial and social crisis. The Tribunal has no intention of second guessing the considerations that led Argentina to declare a fiscal emergency in 2000. At this stage, the Tribunal simply notes that this argument is not consistent with the submission that Decree 669/01 was a measure taken as a simple contracting party. Whether Decree 669/01 is a measure in breach of the Treaty is a question that the Tribunal will address later.

256. In the view of the Tribunal, Decree 669/01 is not the only measure that can be attributed to Argentina as a State. Argentina used its governmental authority on other occasions. First, Argentina interfered in the contractual relationship with SITS by requiring changes in the economic equation when the change of Government occurred and nearly a year before the fiscal emergency was declared. Argentina has claimed that, as a State, it has a right under administrative law to request changes in a contract. The Tribunal considers that, irrespective of whether the changes requested were or were not within the *ius variandi* of the State (a disputed matter between the parties), this is a right that Argentina claims as a State in order to control the deteriorating fiscal situation in the country. This is an assessment by the State related to the public interest and not one that would pertain to a regular contractual party.

257. Second, Argentina failed to enter into the agreements with the Provinces related to the External Circuit. The Tribunal considers this matter to be beyond a contractual breach because Argentina relies on its political structure to excuse itself from the obligation undertaken and because it relied on it as a matter of policy for terminating the Contract. As a State, Argentina should know

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<sup>88</sup> Paras. 222 and 232 of the Rejoinder.



what is possible for it to do (or not to do) with respect to its Provinces and the extent to which it may honor its commitments because of its own political structure.

258. Third, the *permanent* suspension of the two main components of the Project –the RPN sub-system and the DNM sub-system – also falls in the non-contractual category. The fact that an authorization was needed and never given for the immigration component is clearly a governmental act which had no basis in the Contract and its need came to light only when the DNM sub-system started to operate and in the context of Argentina expressing its intention to renegotiate the Contract. The alleged authorization requirement is suspect because the Contract had been drafted by Argentina and all the agencies that were involved later when the Contract was in effect had previously reviewed the terms of the Contract. The “provisional” suspension of the RPN sub-system is reasonable in terms of checking and correcting errors; what exceeds the contractual role and does not fit with Argentina’s legitimate security concerns is that SITS was not allowed to correct the error and that the manual system is still in effect as it was when the Contract was open for bids. During the Contract renegotiation, the resumption of the RPN sub-system was not linked to security concerns.

259. Fourth, Decree 669/01 provides for compensation to be paid. Argentina has not paid compensation, using arguments that go beyond its rights under the Contract. We refer to the issue of the source codes. SITS may or may not have complied with Article 10.12. At this stage it is immaterial because the Contract has been terminated and this article only required that the source codes be deposited with a notary public until the termination of the Contract. There is no provision of the Contract that requires delivery of the source codes to Argentina at Contract termination. There are provisions covering delivery of non-exclusive licenses but not of source codes. This is such an important matter in the technology field, as Argentina itself has argued, that it could not have been left to interpretation and guesswork. If it had been really intended *ab initio* that the source codes would have to be delivered to Argentina, the Contract would have specifically provided for this obligation. This is confirmed by the answer given by

the Ministry of the Interior to Question No. 48 of SITS during the bidding stage of the Contract. The Minister had been asked to confirm that, under Article 95 of the Contract, the Ministry of the Interior's only right in respect of the software would be a non-exclusive license to its use. The Minister replied that the Bidding Terms and Conditions required that a permanent and non-exclusive license of use of the software be transferred to the Ministry. The Minister added: "This notwithstanding the bidder or the contractor may transfer in full or in part the property rights to the software if it would be acceptable [to the bidder or the contractor]." <sup>89</sup>

260. The Tribunal concludes that, in the actions listed above, Argentina acted in use of its police powers rather than as a contracting party even if it attempted at times to base its actions on the Contract. As to the other allegations made by Siemens, they relate to delays, non-budgetary allocations, or continuation of the manual system to issue DNIs and are actions that, in the context, could be construed as acts of a contractual party or of the sovereign acting as such. They are not essential to a finding of expropriation and the Tribunal will not consider them.

**ii) Ordinary Courts' Review of the Legality of the Expropriation and of the Amount on Account of the Compensation under Article 4(2) of the Treaty**

261. Article 4(2) provides that the legality of the expropriation, nationalization or equivalent measure, and the amount of compensation, may be subject to review by the ordinary courts. Argentina has reserved its right to apply this review option to any future decision of the Tribunal in connection with the expropriation. The context of the sentence does not support any right of Argentina in that respect. Article 4(2) is concerned with expropriation, nationalization or measures tantamount to either taken by the parties to the Treaty, and with the compensation paid. It is that expropriation or nationalization or compensation that is subject to the review of the ordinary courts, not a

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<sup>89</sup> Exhibit 94 to the Memorial, emphasis added by the Tribunal. Translation by the Tribunal.

decision by this Tribunal. The objective of the sentence in question is to ensure that the investor has access to the ordinary local courts to review actions by the Government. It is a right that the parties accord to the investor, not to themselves, in relation to decisions of this Tribunal.

### **iii) Autonomy of the Measures constituting Creeping Expropriation**

262. Argentina has argued that each measure alleged by the Claimant to be part of the process that results in a creeping expropriation must have an adverse effect on the investment, and that in the instant case it is not possible to speak of successive acts because if agreement had been reached on the renegotiated Contract, the Contract would not have been thwarted, to use Argentina's own words.

263. By definition, creeping expropriation refers to a process, to steps that eventually have the effect of an expropriation. If the process stops before it reaches that point, then expropriation would not occur. This does not necessarily mean that no adverse effects would have occurred. Obviously, each step must have an adverse effect but by itself may not be significant or considered an illegal act. The last step in a creeping expropriation that tilts the balance is similar to the straw that breaks the camel's back. The preceding straws may not have had a perceptible effect but are part of the process that led to the break.

264. We are dealing here with a composite act in the terminology of the Draft Articles. Article 15 of the Draft Articles provides the following:

“(1) The breach of an international obligation by a State through a series of actions or omissions defined in aggregate as wrongful occurs when the action or omission occurs which, taken with the other actions or omissions, is sufficient to constitute the wrongful act”.

265. As explained in the ILC's Commentary on the Draft Articles:

“Paragraph 1 of Article 15 defines the time at which a composite act 'occurs' as the time at which the last action or omission occurs which,

taken with the other actions or omissions, is sufficient to constitute the wrongful act, without it necessarily having to be the last of the series.”

266. The concept could not be better explained.

#### **iv) Expropriation of Contractual Rights and Proper Law of the Contract**

267. Argentina has linked the argument about expropriation of contractual rights and the law applicable to the Contract and assumes that unless a contract is internationalized through a stabilization clause, it is not susceptible of expropriation. The fact that the Contract is subject to Argentine law does not mean that it cannot be expropriated from the perspective of public international law and under the Treaty. The two issues are unrelated. The Contract falls under the definition of “investments” under the Treaty and Article 4(2) refers to expropriation or nationalization of investments. Therefore, the State parties recognized that an investment in terms of the Treaty may be expropriated. There is nothing unusual in this regard. There is a long judicial practice that recognizes that expropriation is not limited to tangible property. The Tribunal will refer, for the sake of brevity, to the findings of the Permanent Court of Arbitration (“PCA”) in the case of the *Norwegian Shipowners’ Claims* and the Permanent Court of International Justice (“PCIJ”) in the *Factory at Chorzów Case*.

268. The PCA held that “[...] whatever the intentions may have been, the United States took, both in fact and in law, the contracts under which the ships in question were being or were to be constructed.”<sup>90</sup> The PCIJ found that:

“[...] it is clear that the rights of the Bayerische to the exploitation of the factory and to the remuneration fixed by the contract for the management of the exploitation and for the use of its patents, licenses, experiments, etc., have been directly prejudiced by the taking over of the factory by Poland. As these rights related to the Chorzów factory and were, so to speak, concentrated in that factory, the prohibition contained in the last

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<sup>90</sup> *Norwegian Shipowners’ Claims (Norway v. United States)*, p. 325.

sentence of Article 6 of the Geneva Convention applies in all respects to them.”<sup>91</sup>

269. These findings on the issue are conclusive and have been followed by ICSID and NAFTA tribunals, and the Iran-US Claims Tribunal. The Respondent has taken exception to the relevance of cases decided by the latter tribunal on the basis of the law applicable to those cases. The Tribunal considers that the findings of that tribunal are significant in that they show the consistency of approach on this matter by different international jurisdictions.

#### **v) Intent to Expropriate**

270. Argentina has argued against taking into consideration only the effect of measures for purposes of determining whether an expropriation has taken place. The Tribunal recalls that Article 4(2) refers to measures that “a sus efectos” (in its Spanish original) would be equivalent to expropriation or nationalization. The Treaty refers to measures that have the effect of an expropriation; it does not refer to the intent of the State to expropriate. The quotation of the finding of the PCA in *Norwegian Shipowners* refers to “whatever the intentions”<sup>92</sup> of the US were when the US took the contracts. A different matter is the purpose of the expropriation, but that is one of the requirements for determining whether the expropriation is in accordance with the terms of the Treaty and not for determining whether an expropriation has occurred.

#### **vi) Was the Investment Expropriated?**

271. The Tribunal has identified a series of measures that Argentina took which cannot be considered as measures based on the Contract but on the exercise of its public authority. Of all these measures, Decree 669/01 by itself and independently can be considered to be an expropriatory act. It was not based on the Contract but on the 2000 Emergency Law, it was a permanent measure and the effect was to terminate the Contract. Had it not been for Decree

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<sup>91</sup> *Certain German Interests in Polish Upper Silesia (Germany v. Poland)*, Judgment (May 25, 1926), *PCIJ Series A, No. 7*, p. 44.

<sup>92</sup> *Norwegian Shipowners' Claims*, p. 325.

669/01, and if a revised contract proposal had been agreed, the measures taken previously by themselves might not have had the effect and permanence required to be considered expropriatory, but, as no agreement was reached and the measures were never revoked, they stand as part of a gradual process which, with the issuance of Decree 669/01, culminated in the expropriation of Siemens' investment.

272. Contrary to the facts of the cases adduced by Argentina, the acts identified by the Tribunal as measures leading to the expropriation are acts of Argentina, decided at the highest levels of government, and not "simple acts of maladministration by low level officials." For that reason, Argentina's argument that simple acts of maladministration by low-level officials should be pursued in the local courts lacks validity in the circumstances of the instant case.

**vii) Was the expropriation in accordance with the Treaty?**

273. The Treaty requires that the expropriation be for a public purpose and compensated. The Tribunal finds that there is no evidence of a public purpose in the measures prior to the issuance of Decree 669/01. It was an exercise of public authority to reduce the costs to Argentina of the Contract recently awarded through public competitive bidding, and as part of a change of policy by a new Administration eager to distance itself from its predecessor. On the other hand, the public purpose of the 2000 Emergency Law was to face the dire fiscal situation of the Government. This is a legitimate concern of Argentina and the Tribunal defers to Argentina in the determination of its public interest. However, while the Tribunal would be satisfied in finding that an expropriation has occurred based only on Decree 669/01, and that the public purpose pursued by this Decree, in the context of Argentina's fiscal crisis and the 2000 Emergency Law, would be sufficient to meet the public purpose requirement of expropriation under the Treaty, the Tribunal cannot ignore the context in which Decree 669/01 was issued, nor separate this Decree from the other measures taken by Argentina in respect of the investment that culminated in its issuance. Decree 669/01 became a convenient device to continue the process started more than a year earlier long before the onset of the fiscal crisis. From this perspective, while

the public purpose of the 2000 Emergency Law is evident, its application through Decree 669/01 to the specific case of Siemens' investment and the public purpose of same are questionable. In any case, compensation has never been paid on grounds that, as already stated, the Tribunal finds that are lacking in justification. For these reasons, the expropriation did not meet the requirements of Article 4(2) and therefore was unlawful. The Tribunal will examine the issues of compensation after addressing the alleged breaches of other obligations of Argentina under the Treaty.

#### **4. Fair and equitable treatment**

##### **a) Positions of the Parties**

274. Siemens argues that the obligation to treat an investment fairly and equitably requires arbitral tribunals to take into account the totality of the circumstances in each case. The proposition that investments shall have fair and equitable treatment and full protection and security constitutes the “overriding obligation”, and other standards must be applied as part of this general one. According to Siemens, fair and equitable treatment and full protection and legal security are intended to accord foreign investors broad protection, including a stable and predictable investment environment. Predictability is an essential element of stability, the rules and practices that affect investments must be predictable. A State violates the fair and equitable treatment standard when it fails to respect the specific assurances that it had given to investors as an inducement to invest and on which investors relied in making the investment

275. Siemens contends that Argentina provided assurances that SITS would be allowed to complete the Project and obtain the earnings that were the price of the System in an investment environment that was and would remain stable and predictable. To induce Siemens to invest in the Project, Argentina granted SITS the right to implement the complete and integral provision of the System and to issue all the DNIs to replace those existing on the date of the Contract, and all new DNIs and their renewals after the System entered into operation. The investment logically had to be made before the System startup

and the return on the investment was dependent on the issuance of the DNIs and the processing of immigration proceedings.

276. According to Siemens, the acts and omissions previously described destroyed irreparably the legal framework for Siemens' investment, and at all times prior to the unilateral termination of the Contract Argentina promised that the Project would continue and the operation of the System would be resumed. Furthermore, due to Siemens' claim for compensation, Siemens has faced serious problems in other activities in Argentina.

277. Siemens argues that the standard of just and equitable treatment requires stable investment environments by ensuring transparency and predictable rules and practices, which in turn mean that the investor may rely on the undertakings made by the State to the investor. Additionally, fair and equitable treatment means freedom from coercion and harassment, due process and good faith. According to Siemens, RNP interposed serious obstacles to the regular performance of the DNI sub-system, the new authorities after the elections abused the vulnerable position of SITS and the renegotiation process announced in January 2000 was carried out under the threat of the early cancellation of the Contract. Siemens claims that Argentina committed gross procedural improprieties by interrupting the income generating activities, by denying SITS' access to the administrative records, by denying SITS the right to be heard on the May 2001 proposal and withholding information necessary for the decision of SITS on the proposal, by failing to meet the core requirements for terminating the Contract under the 2000 Emergency Law, and by removing administrative files pointing to the Government's failures. Furthermore, after termination of the Contract, SITS was denied information on the background of Decree 669/01 and evidence in support of its position, internal reports were issued without notice to SITS or without recording them in the administrative file, and SITS was excluded from the DNI sub-system test carried out together with SITS' former sub-contractors.

278. According to Siemens, the actions referred to above show also lack of good faith in the conduct of Argentina; in particular, the May 2001 proposal was done in bad faith to trigger the Contract's termination. Siemens



adds non-payment of compensation, keeping the Contract performance bond, not taking responsibility for the sub-contractors' claims and the fact that all the alleged contractual breaches on which Argentina bases its defense were never notified to SITS or Siemens.

279. In its Counter-Memorial, as regards the violation of the full protection and security obligation, Argentina argues that the Claimant has failed to allege how this breach had taken place and affirms that this obligation refers only to physical damage. Then Argentina objects to the concept of fair and equitable treatment advanced by Siemens. Argentina argues that fair and equitable treatment means no more than the minimal treatment afforded by international law. It certainly does not mean that it gives arbitral tribunals the power to decide on the basis of equity. Argentina refers approvingly to the interpretation on this point by the NAFTA Free Trade Commission ("FTC"), recent investment treaties signed by the US and the findings of tribunals in *Genin, S.D. Myers* and *Azinian*.

280. Argentina disagrees with Siemens on the application of the standard of just and equitable treatment to the facts of the case. Argentina refers to the principle of good faith enshrined in this standard, how this standard applies equally to investors and States and how Siemens breached it during the failed negotiation that led to the rescission of the Contract. Thus Siemens systematically refused to reveal its cost structure; and "[i]n a demonstration of bad faith, Siemens went along with negotiations with the Commission named by the Argentine Government, by successive reductions in the final price of IDs."<sup>93</sup> Siemens also accepted the inclusion of the Contract in the 2000 Emergency Law and is prevented now by the doctrine of *estoppel* to claim that it was unaware of the implications, for "if its intention was to save the contract, it should have undertaken to bear the consequences that resulted from this emergency and adjust its expectations and claims so as to reach the shared burden of sacrifice" established by this law.<sup>94</sup> The need for shared sacrifice, according to Argentina, stems from the good faith that the parties owe each other, and fair and equitable

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<sup>93</sup> Counter-Memorial, para. 1079.

<sup>94</sup> *Ibid.*, para. 1080.

treatment “in essence constitutes a guarantee of appropriate and reasonable treatment and that this should be viewed and analyzed taking into consideration the concrete and specific historical circumstances of the treatment. Fair and equitable treatment contains elements of good faith, consistency and reasonableness, which should be evaluated always bearing in mind the events that originated this arbitration.”<sup>95</sup>

281. Argentina also contends that the System did not provide the intended security and refers the Tribunal to the multiple security deficiencies pointed out in the audit performed by the Argentine authorities. In this respect, Siemens is responsible for SITS’ failures. It is not possible to make a claim for events affecting the subsidiary and at the same time avoid the legal consequences of the subsidiary’s acts.

282. As a final argument under this heading, Argentina alleges that SITS and Siemens consented to the 2000 Emergency Law in a case of normative acquiescence. Argentina refers in this respect to the *Preah Vihear Temple* case where the ICJ found: “It is an established rule that the plea of error cannot be allowed as an element vitiating consent if the party advancing it contributed by its own conduct to the error, or could have avoided it, or if the circumstances were such as to put that party on notice of a possible error.”<sup>96</sup> Argentina argues that Thailand, the party pleading error, can be substituted by the Claimant and SITS, which “accepted the emergency and their incorporation to the emergency legal system.”<sup>97</sup>

283. In its Reply, Siemens affirms that the allegation of Argentina that the conduct of SITS or Siemens lacks good faith because of the failure to reveal the cost structure is misplaced. Indeed, Article 2(1) addresses the duties of the State to the investors and not the reverse, and neither the Contract nor the 2000 Emergency Law required such disclosure. As for the doctrines of *estoppel* and acquiescence invoked by Argentina, Siemens points out that both doctrines had their origins in inter-State relations and it is doubtful that they can be extended to

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<sup>95</sup> *Ibid.*, para. 1082.

<sup>96</sup> *Temple of Preah Vihear (Cambodia v. Thailand)*, ICJ Reports (1962) p. 26, cited in para. 1090 of Counter-Memorial.

<sup>97</sup> *Ibid.*, para. 1092.

the area of investor-State relations. Siemens claims that there is no statement of fact by Siemens on which Argentina could have relied to its own detriment, and as regards acquiescence to the law, Siemens observes that the applicability of legislation does not depend on the assent or protest of foreign investors or of any other party subject to the law, and the fact that SITS did not take legal action against Resolution No. 1779/00 of the Ministry of the Interior does not mean that Siemens waived its rights under the Treaty against an uncompensated expropriation or other actions violating the Treaty's substantive standards.

284. Siemens denies that the protection accorded by the standard of fair and equitable treatment is the minimum required of States under international law:

“An interpretation that is in accordance with the BIT’s object and purpose would also have to give some independent meaning to the fair and equitable treatment standard. An interpretation that reduces its meaning to standards that are contained already in customary international law would deprive it of any independent meaning and would make the provision redundant. The application of the general principles of international law is already mandated by Article 10, paragraph 5 of the BIT. If Article 2(1) of the BIT providing for fair and equitable treatment is to have an independent meaning it must be in addition to the general principles of international law.”<sup>98</sup>

285. Siemens points out that the *Neer* standard has been rejected consistently in recent decisions: (i) in *ELSI*, the ICJ considered that to be a breach of the standard State conduct needs to show “a willful disregard of the process of law, an act which shocks, or at least surprises, a sense of judicial propriety”, (ii) in *Mondev Intl. Ltd. v. The United States of America* and *Loewen Group, Inc. and Raymond L. Loewen v. the United States of America*, the tribunals used the adjectives “improper and discreditable”, (iii) in *Loewen, Waste Management* and *MTD*, the tribunals considered discrimination against foreigners an important indicator of failure to respect fair and equitable treatment,

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<sup>98</sup> Reply, para. 504, quotation of Professor Schreuer’s legal opinion.

and (iv) in *Waste Management* and *MTD* the tribunals used terms such as arbitrariness, idiosyncrasy, injustice, lack of good faith, lack of due process and proportionality.<sup>99</sup>

286. As regards the views of Argentina on the scope of “full protection and security”, Siemens observes that the Treaty goes further than most investment treaties when it refers to “legal” security and this reference is “a strong indication that the provision, as contained in the BIT [Treaty], goes beyond mere physical violence and extends to the investor’s legal position.”<sup>100</sup> Siemens refers to the following measures or omissions that deprived it of its protection and legal security: failure to make the budgetary allocations, suspension of the income-generating activities, renegotiation of the Contract under extreme pressure, and abusive use of the 2000 Emergency Law to terminate the Contract.

287. In its Rejoinder, Argentina argues that, given the failure of SITS to perform its obligations under the Contract and the circumstances of fiscal stringency, the issuance of Decree 669/01 could not be considered an arbitrary, grossly unfair, idiosyncratic measure, nor did it involve lack of due process. Argentina contests the broad interpretation of fair and equitable treatment by Siemens and takes issue with the approach taken by *Tecmed* and *MTD* in applying this standard of protection. Argentina considers that the standard applied by these tribunals does not reflect an accurate international standard. Argentina submits that fair and equitable treatment does not encompass the protection of legitimate expectations and the establishment of a stable investment environment.

288. Argentina also submits that, even if the Tribunal were to apply an expanded concept of fair and equitable treatment, there was no violation of this

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<sup>99</sup> Reply, para. 506, quotation of Professor Schreuer’s legal opinion, para. 299 et seq., where reference is made to: (1) *Neer v. Mexico*, Opinion, United States-Mexico, General Claims Commission, October 15, 1926, 21 AJIL 555 (1927); (2) *Eletronica Sicula S.p.A.* (ELSI) (United States of America v. Italy), International Court of Justice, Judgment, July 20, 1989, ICJ Reports 1989; (3) *Mondev Intl. Ltd. v. The United States of America*, Award, October 11, 2002, 42 ILM85 (2003); (4) *Loewen Group, Inc. and Raymond L. Loewen v. the United States of America*, Award, (June 26, 2003);

<sup>100</sup> *Ibid.*, para. 559, quotation from Professor Schreuer’s legal opinion, emphasis added by the Claimant.

standard by Argentina. Argentina refers to the fact that the Claimant had never raised the political motivation of Argentina's acts before this arbitration and had consented to the acts that it now questions. Argentina submits that Siemens agreed on the laws that it now questions and that is, among other reasons, why there was no violation of the Treaty by Argentina. Argentina wonders what legitimate expectation can be affected by acts of the State to which the investor has consented.

**b) Considerations of the Tribunal**

289. The parties' allegations raise issues about the scope of standard of fair and equitable treatment and full protection and security and its relevance in this case. As regards the scope, the parties hold different views on whether the obligation to treat an investment fairly and equitably refers to the minimum standard of treatment of aliens under customary international law or requires from the State a higher standard of conduct more in consonance with the objective of the Treaty. They also differ on whether "security" refers to physical security or to security in a wider sense. The Tribunal will first address these two issues.

290. In their ordinary meaning, the terms "fair" and "equitable" mean "just", "even-handed", "unbiased", "legitimate".<sup>101</sup> As expressed in the Treaty preamble, it is the intention of the State parties to intensify their economic cooperation, and their purpose to create favorable conditions for the investments of the nationals of a party in the territory of the other, while recognizing that the promotion and protection of such investments by means of a treaty may serve to stimulate private initiative and improve the well being of both peoples. It follows from the ordinary meaning of "fair" and "equitable" and the purpose and object of the Treaty that these terms denote treatment in an even-handed and just manner, conducive to fostering the promotion and protection of foreign investment and stimulating private initiative. The parties to the Treaty show by their intentions and objectives a positive attitude towards investment. Terms such as "promote" or "stimulate" are action words that indicate that it is the intention of

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<sup>101</sup> *The Oxford English Dictionary*. Similarly defines these terms *Diccionario de la Lengua Española*, 22nd edition, at [www.rae.es](http://www.rae.es).

the parties to adhere to conduct in accordance with such purposes. This understanding is confirmed by Article 2(1) of the Treaty, whereby each party even undertakes to promote the investments of nationals or companies of the other party.

291. The specific provision of the Treaty on fair and equitable treatment is found also in Article 2(1) after the commitment to promote and admit investments in accordance with the law and regulations and as an independent sentence: “In any case [the parties to the Treaty] shall treat investments justly and fairly (“En todo caso tratará las inversiones justa y equitativamente”).”<sup>102</sup> There is no reference to international law or to a minimum standard. However, in applying the Treaty, the Tribunal is bound to find the meaning of these terms under international law bearing in mind their ordinary meaning, the evolution of international law and the specific context in which they are used.

292. Argentina has indicated its support for the interpretation of Article 1105 of NAFTA by the FTC. The Tribunal observes first that this article bears the heading “Minimum Standard of Treatment.” Paragraph 1 of this article states: “Each Party shall accord to investments of investors of another Party treatment in accordance with international law, including fair and equitable treatment and full protection and security.” As interpreted by the FTC and as indicated in the title of the article, the standard of treatment is the minimum required under customary international law.

293. The question whether fair and equitable treatment is or is not additional to the minimum treatment requirement under international law is a question about the substantive content of fair and equitable treatment. In 1927, the US-Mexican Mixed Claims Commission considered in the *Neer* case that a State has breached the fair and equitable treatment obligation when the conduct of the State could be qualified as outrageous, egregious or in bad faith or so below international standards that a reasonable and impartial person would easily recognize it as such. This description of conduct in breach of the fair and equitable treatment standard has been considered as the expression of

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<sup>102</sup> Article 2(1) of the Treaty.

customary international law at that time. For the Tribunal the question is whether, at the time the Treaty was concluded, customary international law had evolved to a higher standard of treatment.

294. It will be useful for this purpose to review the cases referred to by the parties in support of their differing positions. Argentina has particularly relied on *Genin*. In that case, the tribunal without engaging in a textual analysis of the fair and equitable treatment clause in the US-Estonia BIT considered this requirement to be an international minimum standard, which could only be breached by “a wilful neglect of duty, an insufficiency of action falling far below international standards, or even subjective bad faith.”<sup>103</sup> That tribunal found that, in the circumstances of the case, Estonia did not breach the duty of fair and equitable treatment; however, it hoped that the “Bank of Estonia will exercise its regulatory and supervisory functions with greater caution regarding procedure in the future,”<sup>104</sup> and observed that “the awkward manner by which the Bank of Estonia revoked EIB’s license, and in particular the lack of prior notice of its intention to revoke EIB’s license and of any means for EIB or its shareholders to challenge that decision prior to its being formalized, cannot escape censure.”<sup>105</sup>

295. After the interpretation of the FTC, several tribunals established under NAFTA have held that the customary international law to be applied is the customary international law as it stood when that treaty was concluded and not in 1927. In *Mondev*, the tribunal held that “the content of the minimum standard today cannot be limited to the content of customary international law as recognized in arbitral decisions in the 1920s.”<sup>106</sup> The same tribunal noted that the State party in the dispute agreed that the international standard of treatment has evolved as all customary international law has, and that the two other State parties to NAFTA also agreed with this point.<sup>107</sup> Therefore, that tribunal considered that:

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<sup>103</sup> *Genin*, para. 367.

<sup>104</sup> *Ibid.*, para. 372.

<sup>105</sup> *Ibid.*, para. 381.

<sup>106</sup> *Mondev Intl. Ltd. v. United States of America*, ICSID Case No. ARB(AF)/99/2, Award (October 11, 2002), para. 123.

<sup>107</sup> *Ibid.*, para. 124.

“the FTC interpretations incorporate current international law, whose content is shaped by the conclusion of more than two thousand bilateral investment treaties and many treaties of friendship and commerce. Those treaties largely and concordantly provide for ‘fair and equitable’ treatment of, and for ‘full protection and security’ for, the foreign investor and his investments.”<sup>108</sup>

And found that “To the modern eye, what is unfair or inequitable need not equate with the outrageous or the egregious. In particular, a State may treat foreign investment unfairly and inequitably without necessarily acting in bad faith.”<sup>109</sup>

296. The tribunal in *Loewen* came to a similar conclusion: “Neither State practice, the decisions of international tribunals nor the opinion of commentators support the view that bad faith or malicious intention is an essential element of unfair and inequitable treatment or denial of justice amounting to a breach of international justice.”<sup>110</sup>

297. After reviewing arbitral awards under NAFTA, the tribunal in *Waste Management II* reached the conclusion that:

“the minimum standard of treatment of fair and equitable treatment is infringed by conduct attributable to the state and harmful to the claimant if the conduct is arbitrary, grossly unfair, unjust or idiosyncratic, is discriminatory and exposes the claimant to sectional or racial prejudice, or involves a lack of due process leading to an outcome which offends judicial propriety – as might be the case with a manifest failure of natural justice in judicial proceedings or a complete lack of transparency and candour in an administrative process. In applying this standard it is

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<sup>108</sup> *Ibid.*, para. 125.

<sup>109</sup> *Ibid.*, para. 116. The tribunal in *ADF* affirmed the same point: “what customary international law projects is not a static photograph of the minimum standard of treatment of aliens as it stood in 1927 when the Award in the *Neer* case was rendered. For both customary international law and the minimum standard of treatment of aliens it incorporates, are constantly in a process of development.” *ADF Group, Inc. v. United States of America*, ICSID Case No. ARB(AF)/00/1, Award (January 9, 2003), para. 179.

<sup>110</sup> *Loewen*, párr. 132.



relevant that the treatment is in breach of representations made by the host State which were reasonably relied on by the claimant.”<sup>111</sup>

298. The parties have also referred to *Tecmed*, which describes just and equitable treatment as requiring:

“treatment that does not affect the basic expectations that were taken into account by the foreign investor to make the investment. The foreign investor expects the host State to act in a consistent manner, free from ambiguity and totally transparently in its relations with the foreign investor, so that it may know beforehand any and all rules and regulations that will govern its investments, as well as the goals of the relevant policies and administrative practices or directives, to be able to plan its investment and comply with such regulations.”<sup>112</sup>

299. It emerges from this review that, except for *Genin*, none of the recent awards under NAFTA and *Tecmed* require bad faith or malicious intention of the recipient State as a necessary element in the failure to treat investment fairly and equitably, and that, to the extent that it has been an issue, the tribunals concur in that customary international law has evolved. More recently in *CMS*, the tribunal confirmed the objective nature of this standard “unrelated to whether the Respondent has had any deliberate intention or bad faith in adopting the measures in question. Of course, such intention and bad faith can aggravate the situation but are not an essential element of the standard.”<sup>113</sup> That tribunal also understood that the conduct of the State has to be below international standards but not at their level in 1927 and that, as in *Tecmed* and *Waste Management II*, the current standard includes the frustration of expectations that the investor may have legitimately taken into account when it made the investment.

300. The Tribunal has already noted that the standards of conduct agreed by the parties to the Treaty indicate a favorable disposition to foreign investment. The purpose of the Treaty is to promote and protect investments. It

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<sup>111</sup> *Waste Management II*, para. 98.

<sup>112</sup> *Tecmed*, para. 154. Unofficial translation from the Spanish original published by ICSID on its web site.

<sup>113</sup> *CMS*, para. 280.

would be inconsistent with such commitments and purpose and the expectations created by such a document to consider that a party to the Treaty has breached its obligation of fair and equitable treatment only when it has acted in bad faith.

301. The Tribunal will now turn to the question of the meaning of full protection and security. According to Argentina, “security” refers only to physical security while the Claimant attributes to this term a wider meaning, in particular because the Treaty refers to “legal security.”

302. The Tribunal first notes that, although the parties have argued the application of this standard as a single standard, the Treaty provides for the fair and equitable treatment and full protection and security under two different Articles. The parties do not seem to have found this separation to be significant and the Tribunal will not dwell further on this point. The Tribunal also notes that Argentina in its arguments did not address the fact that security was qualified by “legal” in this instance.

303. As a general matter and based on the definition of investment, which includes tangible and intangible assets, the Tribunal considers that the obligation to provide full protection and security is wider than “physical” protection and security. It is difficult to understand how the physical security of an intangible asset would be achieved. In the instant case, “security” is qualified by “legal”. In its ordinary meaning “legal security” has been defined as “the quality of the legal system which implies certainty in its norms and, consequently, their foreseeable application.”<sup>114</sup> It is clear that in the context of this meaning the Treaty refers to security that it is not physical. In fact, one may question given the qualification of the term “security”, whether the Treaty covers physical security at all. Arguably it could be considered to be included under “full protection”, but that is not an issue in these proceedings.

304. Based on this understanding of fair and equitable treatment and full protection and legal security, the Tribunal will now consider whether the

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<sup>114</sup> *Diccionario de la lengua española*, 22<sup>nd</sup> edition, at [www.rae.es](http://www.rae.es). Translation by the Tribunal. The original text in Spanish reads as follows: “cualidad del ordenamiento jurídico que implica la certeza de sus normas y, consiguientemente, la previsibilidad de su aplicación.”

actions of Argentina, identified by the Tribunal as actions taken by Argentina acting as a State, constitute a breach of this obligation.

305. Argentina has argued that Siemens and its subsidiary, for whose conduct Siemens is responsible, acted in bad faith because they accepted the laws of Argentina and alleged before this Tribunal political motives which were never denounced during the long lasting re-negotiation of the Contract. Siemens has argued likewise that it was never notified under the Contract of all the failures that have been alleged by Argentina in these proceedings. The parties' response to these arguments is similar: both parties were intent on reaching a renegotiated agreement that ultimately proved elusive.

306. The Tribunal considers that neither party may hold against the other positions that it may have taken during a good faith negotiation.<sup>115</sup> In any case, acceptance of laws or regulations should not be held against a company which has accepted them by the Government that adopted them. As stated elsewhere by the Tribunal, to comply with the law is not understood to be an optional matter. In this respect, the arguments advanced by Argentina on acquiescence and *estoppel* are misplaced and have already been dealt with by the Tribunal.

307. On the other hand, the Tribunal finds without merit the argument made by Siemens that since filing its claim Siemens has encountered difficulties to operate in Argentina. This statement is contradicted by the affirmation in Siemens' Reply that Argentina holds Siemens in such high regard that it has repeatedly requested its intervention in other public projects, even after the Contract's termination

308. To conclude, the Tribunal finds that the initiation of the renegotiation of the Contract for the sole purpose of reducing its costs, unsupported by any declaration of public interest, affected the legal security of Siemens' investment. The Tribunal also finds that when a government awards a

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<sup>115</sup> In the *Factory at Chorzów* case, the PCIJ pointed out that it could not "take into account declarations, admissions or proposals which the Parties may have made during direct negotiations between themselves, when such negotiations have not led to a complete agreement." *Merits, PCIJ, Series A* (1928), p. 51.

contract, which includes among its critical provisions an undertaking of that government to conclude agreements with its provinces, the same government can not argue that the structure of the State does not permit it to fulfill such undertaking. This runs counter to the principle of good faith underlying fair and equitable treatment. The arguments made to justify delay in paying compensation without basis in the Contract or Decree 669/01 and the denial of access to the administrative file for purposes of filing the appeal against Decree 669/01 show lack of transparency of Argentina in respect of the investment, particularly when Argentina itself has manifested in these proceedings that at no time had it affirmed that the Contract was rescinded due to the Contractor's fault.<sup>116</sup>

309. For these reasons, the Tribunal finds that the full protection and legal security and fair and equitable treatment obligations under the Treaty have been breached by Argentina.

## **5. Arbitrary and Discriminatory Measures**

### **a) Positions of the Parties**

310. Siemens argues that, based on the plain meaning of "arbitrary", the measures adopted towards Siemens' investment meet the test of arbitrariness: "not governed by any fixed rules or standard", "performed without adequate determination of principle and one not founded in nature of things", "without cause based upon the law", or "failure to exercise honest judgment", "characterization of a decision or action taken by an administrative agency [...] [as] willful and unreasonable action without consideration or in disregard of facts or law or without determining principle."<sup>117</sup>

311. According to Siemens, the intentional frustration of the performance of the Contract when all the investment had been made to put the System into operation was arbitrary. The measures were unreasonable, taken unilaterally without due cause or justification. They caused serious damage to Siemens for which it has not been compensated. The measures were also

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<sup>116</sup> Rejoinder, paras. 222 and 232.

<sup>117</sup> Memorial, para. 337, citing *Black's Law Dictionary*, 1990, sixth edition, p. 104.

discriminatory in intent and effect. No other investor was treated like Siemens, no measures such as those imposed on Siemens' investment were adopted by Argentina concerning contracts or investments of similar importance, in particular, no other public contract was terminated by Argentina under the 2000 Emergency Law and compensation has never been paid. These discriminatory measures impaired Siemens' ability to manage, use and enjoy its investment.

312. In its Counter-Memorial, Argentina argues that the measures it adopted were reasonable in proportion to their purpose and of general application. Thus, they were neither arbitrary nor discriminatory. Argentina refers to the concept of arbitrariness defined by the ICJ in *ELSI*: "It is a willful disregard of due process of law, an act which shocks, or at least surprises, a sense of juridical propriety;"<sup>118</sup> and the arbitral tribunal in *Genin*: "any procedural irregularity that may have been present would have to amount to bad faith, a willful disregard of due process of law or an extreme insufficiency of action."<sup>119</sup> According to Argentina, the measures it took were in defense of vital security of the State, to keep the data on its inhabitants secure since otherwise it would violate rights enshrined in international treaties on the protection of human rights.

313. Argentina also questions the qualification as arbitrary of the delay in approving the FOM. The FOM presented by SITS was not in a condition to be approved and Argentina showed diligence by requesting in advance information that would have helped in speeding up the approval process and that SITS did not provide. According to Argentina, a government may not be accused of being arbitrary when it tries to protect and preserve the confidentiality of the data on its inhabitants.

314. As to the meaning of "discriminatory", Argentina contends, based on *ELSI* and *S.D. Myers*, that, for a measure to be discriminatory, the measure has to be harmful, favor a national against a foreign investor and be intended to discriminate. Argentina argues that the measures it took were intended to protect its citizens and as such could not be considered discriminatory. Furthermore, the measures taken in relation to Siemens' investment had nothing to do with any

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<sup>118</sup> *Genin*, Counter-Memorial, para. 1108 citing *ELSI*, *ICJ Reports* (1989), para. 128.

<sup>119</sup> *Ibid.*, para. 1110 citing *Genin*, para. 371.

differential treatment vis-à-vis any other investor group in the same situation because Siemens was in a unique situation.

315. In its Reply, Siemens insists that in terms of Article 2(3) of the Treaty actions are arbitrary if they are opposed to the rule of law or surprise a sense of juridical propriety, or if a measure harming an investor cannot be justified in terms of rational reasons that are related to the facts. Siemens contests the argument of “voluntary consent” or “acquiescence” by SITS and affirms that what occurred was an abusive exercise of the State’s authority that left SITS powerless. According to Siemens, Argentina’s measures were “arbitrary because they dismantled the entire legal framework that had led Siemens to conduct its investment, contrary to the expectations of any reasonable and impartial person. The political motivation behind Argentina’s actions only serves to emphasize the arbitrariness of the measures adopted.”<sup>120</sup>

316. As regards discriminatory treatment, according to Siemens, the criterion is whether the foreign investor has been treated less favorably than domestic investors or investors of other nationalities; *de facto* discrimination is sufficient even without violation of the host State’s domestic law. Siemens argues that the measures taken towards Siemens’ investment were not of a general nature; the Contract is the only significant contract terminated which involved a foreign investor and the only foreign investment terminated unilaterally under the 2000 Emergency Law.

317. In its Rejoinder, Argentina recalls that the Contract was unique in terms of its scope, importance, duration and expense. Argentina explains how the Contract could not be compared to the passport issuance contract that the Claimant adduced as evidence of discrimination. Passports are not obligatory, while DNIs are. In the face of an economic crisis, Argentina had a right to protect its interests and those of its citizens. The measures taken by Argentina in response to “the fiscal emergency were of general operation, for a public purpose and did not introduce unreasonable discrimination.”<sup>121</sup> Argentina further explains that the fact that public utilities were excluded from the 2000 Emergency law

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<sup>120</sup> Reply, para. 571.

<sup>121</sup> Rejoinder, para. 643.

does not mean that the crisis did not impact their rights, e.g., foreign companies that invested in the natural gas transport and distribution agreed to defer adjustment of their fees as permitted in their contracts sixteen months before the termination of the contract. Argentina concludes by asserting that, given the enormous costs of the Contract, “it cannot be said that the measures taken to terminate it early were unfair, unjust or disproportionate to the extent of the problem in hand.”<sup>122</sup>

### **b) Considerations of the Tribunal**

318. In its ordinary meaning, “arbitrary” means “derived from mere opinion”, “capricious”, “unrestrained”, “despotic.”<sup>123</sup> *Black’s Law Dictionary* defines this term as “fixed or done capriciously or at pleasure; without adequate determining principle”, “depending on the will alone”, “without cause based upon the law.” There is also abundant case law on the interpretation of this term to which the parties have referred. The Tribunal considers that the definition in *ELSI* is the most authoritative interpretation of international law and it is close to the ordinary meaning of the term emphasizing the willful disregard of the law. The element of bad faith added by *Genin* does not seem to find support either in the ordinary concept of arbitrariness or in the definition of the ICJ in *ELSI*.

319. In the instant case, certain measures taken by Argentina do not seem to be based on reason. Argentina has explained that an authorization was needed to start the operation of the DNM sub-system, but has failed to explain why the authorization was never given after the investment was made and the DNM sub-system had started to operate. Similarly, the Tribunal does not question the importance to the vital interests of Argentina to have secure identification of individuals, but applied to the suspension of the RPN sub-system such argument would have justified requiring an immediate correction of the error. No evidence has been submitted that the error could not be corrected. Instead, SITS was denied the possibility of correcting the error. While the Tribunal could accept that there may have been reasons to justify the temporary

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<sup>122</sup> *Ibid.*, para. 657.

<sup>123</sup> *The Oxford English Dictionary*. This term is similarly defined in the *Diccionario de la Lengua Española*, 22<sup>nd</sup> edition, at [www.rae.es](http://www.rae.es).

suspension of the DNM and RPN sub-systems, the Tribunal finds its permanent suspension arbitrary.

320. As to discriminatory measures, under Article 3(1) and (2) of the Treaty, the parties undertook to treat each other's nationals and companies not less favorably than they treat their own investors or those of a third party. Whether intent to discriminate is necessary and only the discriminatory effect matters is a matter of dispute. In *S.D. Myers*, the tribunal considered intent "important" but not "decisive on its own."<sup>124</sup> On the other hand, the tribunal in *Occidental Exploration and Production Company v. Republic of Ecuador* found intent not essential and that what mattered was the result of the policy in question.<sup>125</sup> The concern with the result of the discriminatory measure is shared in *S.D. Myers*: "The word 'treatment' suggests that practical impact is required to produce a breach of Article 1102, not merely a motive or intent." The discriminatory results appear determinative in *Marvin Roy Feldman Karpa v. United Mexican States*,<sup>126</sup> where the tribunal considered different treatment on a *de facto* basis to be contrary to the national treatment obligation under Article 1102 of NAFTA.

321. The Tribunal concurs that intent is not decisive or essential for a finding of discrimination, and that the impact of the measure on the investment would be the determining factor to ascertain whether it had resulted in non-discriminatory treatment. The Claimant has based its arguments mainly on the fact that the Contract was the only major contract, and the only contract with a foreign investor, terminated under the 2000 Emergency Law, while the contract of the Government with an Argentine national to issue passports was allowed to stand notwithstanding the high costs associated with it. The Respondent has explained to the Tribunal that the Contract was unique and that the mandatory nature of DNI justified the difference in treatment. The Tribunal considers that, while there are aspects in the actions of Argentina that seem discriminatory, the allegations of the Claimant have not been fully substantiated. Given the holdings

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<sup>124</sup> *S.D. Myers*, para. 254.

<sup>125</sup> *Occidental Exploration and Production Company v. Republic of Ecuador*, LCIA case No. UN3467, Award (July 1, 2004), para. 177.

<sup>126</sup> *Marvin Roy Feldman Karpa v. United Mexican States*, ICSID Case No. ARB(AF)/99/1, Award (December 16, 2002), para. 184.



of the Tribunal under other protections of the Treaty, the Tribunal finds it unnecessary to determine whether Argentina breached the non-discriminatory treatment obligation.

## **VII. Compensation**

### **1. Positions of the Parties**

322. Siemens claims that it is entitled to receive full and comprehensive compensation for the breaches of the Treaty and to recover the fair market value of its wrongfully expropriated investment, calculated for valuation purposes immediately before the date of expropriation of May 18, 2001; the loss of profits or *lucrum cessans* and the additional damage caused as a result of the expropriatory measures and acts, including those damages claimed by subcontractors and suppliers of Siemens and/or SITS regarding the Project and caused by Argentina's expropriation. In addition, Siemens claims pre and post-award interest of 6% compounded annually.

323. Siemens argues that the expropriation was unlawful because it did not meet the conditions of the Treaty and international law, namely, it did not serve a public purpose, it did not satisfy the formal and substantive requirements of due process, it did not comply with the legal standards of treatment set forth in the Treaty and no compensation was paid. Based on the *Factory at Chorzów* case, Siemens pleads that an illegal dispossession leads to a twofold obligation: first, the obligation to restore the property in question or, if this is not possible, to pay compensation corresponding to its value; and second, there is an obligation to pay damages for any additional losses sustained as a consequence of the taking.

324. Siemens observes that the value of the asset expropriated is not affected by whether or not an expropriation is lawful, but the amount of compensation due to an investor may be significantly affected. In the instant case, Siemens claims that the value of the property at the moment of the taking plus interest to the day of payment is a legal floor, and calls upon the Tribunal to add any potential consequential damages so as to "wipe out all the

consequences of the illegal act and reestablish the situation which would, in all probability, have existed if that act had not been committed.”<sup>127</sup>

325. Siemens considers as appropriate the definition of fair market value in *Starrett Housing Corp. v. The Islamic Republic of Iran*: “[T]he price that a willing buyer would pay to a willing seller in circumstances in which each had good information, each desired to maximize his financial gain, and neither was under duress or threat.”<sup>128</sup>

326. Siemens argues that the fair market value includes the lost future profits that the enterprise would have gained had it been allowed to continue to operate, points out that SITS was a single project company, and affirms that its future revenues and profits were ascertainable on the basis of the commitments made by Argentina. Siemens refers to *Norwegian Shipowners, LETCO* and the concurring opinion of Judge Brower in *Amoco International Finance Corporation*, which stated that “[...] where the expropriated property consists of contract rights, the compensation must be defined by the anticipated net earnings that would have been realized, as well as one can judge, had the contract been left in place until completion.”<sup>129</sup>

327. Siemens claims that SITS, as a single project company, had foreseeable and ascertainable revenues and profits based on the commitments made by Argentina. Furthermore, any negative effect of the taking itself or the measures related to the taking must be excluded from the valuation. According to Siemens, a State may not reduce its obligation to pay compensation simply by creating a situation in which expropriation is to be feared before it occurs or by breaching contractual obligations or other duties to the foreign investor.

328. According to Siemens, the appropriate method of valuation is the book value method in its variant of actual investments. Based on this method, Siemens claims that, as of May 17, 2001, the value of its investment amounts to US\$283,859,710. Siemens affirms that this amount is comparable to the

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<sup>127</sup> Memorial, para. 392 citing the *Factory at Chorzów* case, *Merits, PCIJ, Series A*, 1928, p. 47,

<sup>128</sup> *Ibid.*, para. 394, citing *Starrett Housing Corp. v. the Islamic Republic of Iran*, Case No. 24, Final Award No. 314-24-1, (August 14, 1987), Claimant’s Legal Authorities No. 52.

<sup>129</sup> *Ibid.*, para. 402.

amounts that could be obtained with the application of other alternative methods of valuation. In addition, Siemens claims to be entitled to US\$124,541,000 on account of *lucrum cessans*.

329. Siemens also claims additional damages based on the unlawful nature of the expropriation measures and the behavior of Argentina prior to and after the date of expropriation. On this account, Siemens claims: (i) the costs incurred for maintaining a skeleton operation in Argentina to allow the conclusion of the Project, (ii) storage costs because of a 20-month delay in the transfer of assets to the Government, (iii) training costs and costs of technical support services provided by SITS during a period in excess of 75 days after May 18, 2001 pursuant to Article 26.3 of the Contract, (iv) damages claimed or that may be claimed by subcontractors involved in the Project's execution as a result of the expropriation, (v) unpaid invoiced services of SITS to the DNE agency in 1999, and (vi) the costs of this arbitration and of counsel. According to Siemens, subcontractors' damages amount to US\$44,678,462 and the aggregate amount of the other items is US\$9,397,899.

330. Siemens claims pre-award compounded interest at the rate of 6% per annum so that it is fully compensated for the loss suffered and considers that May 18, 2001 should be the date of expropriation for valuation purposes, including for the assessed value of the lost profits. In the case of the additional damages, interest shall be applied from the dates in which they have been caused.

331. Argentina argues in its Counter-Memorial that Siemens is not entitled to the compensation it has claimed: First, the Treaty in Article 4(2) states that compensation shall correspond to the value of the investment expropriated. Argentina interprets the reference to "value" of the investment – as opposed to "fair market value" - to exclude future profits. To support this point, Argentina reviews its own treaty practice and offers examples in four categories ranging from compensation on the basis of fair market value of the investment to the classical Hull formula, or a partial Hull formula or "the value" of the investment as in the case of the Treaty. Argentina alleges that there is no uniformity in the doctrine on the level of compensation.

332. Argentina questions the cases relied on by Siemens to argue the extent of the damages claimed. According to Argentina, in *Maffezini*, neither *lucrum cessans* nor future profits were redressed, and full compensation awarded in the *Factory at Chorzów* case does not correspond to fair market value. Argentina requests the Tribunal to apply the principles of *Tecmed*, a case that Argentina finds strikingly similar to this case and quotes approvingly its reasoning under Mexican law. Argentina affirms that Argentine law applicable to this case and the 2000 Emergency Law to which Siemens consented do not grant the compensatory right claimed by Siemens.

333. Argentina also questions the currency of the claimed compensation. Argentina argues that it did not guarantee the value of the investment in terms of dollars. Argentina points out that the Contract was not a dollar contract and that Siemens entered into a forward dollar contract to secure US\$190 million, the same amount of the alleged loans made by the parent company to its Argentine affiliate. The existence of such contract, according to Argentina, proves that Siemens never intended to enter into a contract with Argentina in a foreign currency.

334. Argentina explains that under Decree 669/01 for Siemens to be compensated in the amount calculated by the Appraisals Tribunal in accordance with the Contract, the applicable law and the Treaty, Siemens has to deliver real assets in condition to be used, otherwise Argentina would not receive any consideration for its compensation. To achieve this objective, the Appraisals TTN established the following conditions: delivery of the source codes, executable programs correctly set up and approved, delivery of the licenses for base software, databases and other necessary utilities, delivery of the licenses for application software of the sub-contractors, delivery of documentation related to applications, systems and training proved as to its usefulness, and ability to use the Contractor's software licenses.

335. Argentina criticizes the valuation carried out by Siemens' expert. Argentina points out that: (i) he did just office work and had not checked the market values to confirm that the amounts charged by suppliers to SITS reflect the usual market practices, (ii) he did not consider whether the intra-Siemens

Group transfers were carried out at arm's length, (iii) he did not carry out the task personally and did not perform any due diligence, (iv) he accepted all of Siemens' assumptions at face value without verifying them, (v) he affirms to have applied the book value method when he never analyzed where the alleged funds of Siemens were invested and the same analysis should have been done in respect of SITS' liabilities, (vi) he maintains that the book value method and the discounted cash flow analysis reach the same result when the figures are different, and (vii) he made a number of mistakes in calculating future income. Furthermore, the supporting documentation of the valuation is lacking.

336. In its Reply, Siemens argues that it is entitled to full compensation and that "investment value" has to be given its plain and ordinary meaning. Siemens points out that: (i) the Treaty does not qualify the reference to investment value, (ii) "value" in its ordinary meaning is defined as "[t]he monetary worth or price of something; the amount of goods, services, or money that something will command in an exchange," and (iii) in a free market economy the exchange is conducted on the market. Therefore, "the plain and ordinary meaning of 'value' is what one may expect to obtain in exchange for something, that is to say its 'fair market value.'"<sup>130</sup>

337. Siemens observes that the legal authorities referred to by Argentina relate to the general debate on the extent of compensation under customary international law and not to the interpretation of the Treaty which contains a clear standard of full compensation. Siemens refers to *CME* where the tribunal, drawing its conclusions from the *Factory at Chorzów* case, ruled that "genuine value" in Article 5 of the Netherlands-Czech Republic BIT meant the fair market value of the investment. Siemens also refers to *Biloune* which held that the fair market value, which takes into account future profits, is the most accurate measure of value of the expropriated property.

338. On the issue of future profits, Siemens draws the attention of the Tribunal to how the ILC has expressed the principle that lost profits are awarded where there is a reliable basis for the expectation of future income:

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<sup>130</sup> Reply, para. 620.

“In cases where lost future profits have been awarded, it has been where an anticipated income stream has attained sufficient attributes to be considered a legally protected interest of sufficient certainty to be compensable. This has normally been achieved by virtue of contractual arrangements or, in some cases, a well-established history of dealings.”<sup>131</sup>

According to Siemens, the contractual provisions concerning the production, issuance and price of the DNIs and other fees constituted a “legally protected interest of sufficient certainty.”<sup>132</sup>

339. Siemens points out that Argentina refers to documents which are 30 and 45 years old and pertain to debates already settled. Furthermore, in *Tecmed*, and contrary to what Argentina has alleged, the tribunal awarded compensation in accordance with the provisions of the relevant investment treaty, on the basis of the market value of the assets concerned, lost profits and compound interest.

340. Siemens argues that, for purposes of Siemens’ claim of expropriation under international law, the domestic law of Argentina and the provisions of the 2000 Emergency Law are irrelevant.

341. Siemens also contends that, in any case, it is entitled to fair market value on the basis of the Treaty’s most-favored-nation clause and other investment treaties signed by Argentina that specifically provide for such valuation of expropriated assets.

342. Siemens contests the affirmation by Argentina that there was no unlawful expropriation and affirms that the requirements of public benefit, compensation and compliance with the general principles of treatment provided for in the Treaty had not been respected by Argentina. Siemens insists on full damages and, given the unlawful nature of the expropriation, consequential damages all paid in dollars. In this respect, Siemens recalls that the investment was made in dollars and argues that the forward contract itself proves this point. Siemens adds that it is entitled to the value of the investment immediately before

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<sup>131</sup> *Ibid.*, para. 632.

<sup>132</sup> *Ibid.*, para. 633.

the date of the taking when the peso had parity with the dollar. Siemens also recalls that, as it explained at the jurisdictional stage, its right to compensation under the Treaty is distinct from SITS' rights under the Contract and domestic law, and that Argentina never offered nor even approved any compensation under the 2000 Emergency Law.

343. Siemens points out the shortcomings of the valuation report of the TTN, among others: (i) it was never submitted to SITS for consideration, (ii) it was prepared long after termination of the Contract and a long time after SITS lost control and supervision of the System, (iii) it evaluated items individually rather than the System as a whole, and (iv) it was not done in the currency of the investment. According to Siemens, the appraisal done by the TTN does not even reflect the compensation due to SITS under the 2000 Emergency Law.

344. Siemens further points out that Argentina fails to provide a proper response for the sub-contractors' claims and the excuses for withholding the performance bond under the Contract are unsustainable and constitute another arbitrary measure taken by Argentina.

345. As regards Argentina's criticisms of the valuation report prepared by Siemens' expert, Siemens argues that Argentina has misunderstood the task of the expert, which was to evaluate the loss suffered by Siemens on the investment and not to evaluate SITS' loss under the Contract under Argentine law. According to Siemens, it was not the task of this expert to value individual assets: "Valuing hardware and software on a part by part basis, when the very condition of those items are now the result of the expropriation, would provide no support in valuing Siemens A.G.'s investment in the contractual right to operate the System and to generate revenue and return on its investment."<sup>133</sup> Siemens adds that Argentina ignores the fact that the financial statements and accounting records relied on by the expert had been audited by a leading auditing firm – KPMG -, and refers to case law showing the appropriateness of the use of audited accounting records to carry out a valuation task. According to Siemens, Argentina also ignores the fact that SITS was a single project company, which

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<sup>133</sup> Reply, para. 699. Quotation from Expert Lemar's Rebuttal Report.

should answer the criticism that the expert never examined where the alleged funds of Siemens were invested. Regarding the costs of the investment, Siemens contends that, if Siemens' global price was the lowest in the bidding for the Contract, the individual cost and prices of the components would also be lowest or extremely competitive compared to other tenders.

346. In its Rejoinder, Argentina argues that the fair market value of an expropriated property as the measure of compensation for an expropriated investment is not always applicable when an expropriation becomes necessary for social policy reasons. If this would not be the case, it would be a serious limitation on State sovereignty, and no social or economic reforms could be accomplished by poorer nations. Argentina maintains that it had effectively become bankrupt, and that to maintain that an expropriation is only lawful if full market compensation is payable is incompatible with the principle of self-determination. Argentina refers in this respect to professor Brownlie's statement that: "The principle of nationalization unsubordinated to a full compensation rule may be supported by reference to principles of self-determination, independence, sovereignty and equality."<sup>134</sup> Argentina also refers to the statement of the European Court of Human Rights in *James v. UK*, which held that Article 1 of the First Protocol does not "guarantee a right to full compensation in all circumstances. Legitimate objectives of 'public interest' such as pursued in measures of economic reform or measures designed to achieve greater social justice, may call for less than reimbursement of full market value."<sup>135</sup>

347. Argentina affirms that these considerations are applicable to the situation in Argentina and are entirely consistent with the Treaty. Argentina concludes that, even if there was an expropriation, the Claimant would not be entitled to more than the direct losses and not to the *lucrum cessans*.

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<sup>134</sup> Rejoinder, para. 575.

<sup>135</sup> *James v. UK*, *European Court of Human Rights*, 1986, 8, EHRR 123, para. 48, Respondent's Legal Authorities No. AL RA 86, quotation in the Rejoinder, para. 577. Emphasis added by the Respondent.



## 2. Considerations of the Tribunal

348. The Tribunal will address the following issues raised by the parties: applicable law for purposes of determining compensation, the meaning of “value” of the investment, currency of compensation, whether compensation should include *lucrum cessans* and consequential damages, on what evidence it should be based, the amount of compensation, the applicable rate of interest, and whether it should be simple or compound interest.

### a) Applicable Law

349. The Tribunal has found that Argentina took measures that had the effect of expropriating the investment and that such expropriation is in breach of the Treaty, and hence unlawful. The Tribunal has also found that the Respondent breached its obligations to provide fair and equitable treatment and full protection and security and that it adopted arbitrary measures in respect of the investment. The law applicable to the determination of compensation for a breach of such Treaty obligations is customary international law. The Treaty itself only provides for compensation for expropriation in accordance with the terms of the Treaty.

350. The Draft Articles are currently considered to reflect most accurately customary international law on State responsibility. Article 36 on “Compensation” provides:

“1. The State responsible for an internationally wrongful act is under an obligation to compensate for the damage caused thereby, insofar as such damage is not made good by restitution.

2. The compensation shall cover any financially assessable damage including loss of profits insofar as it is established.”

351. This Article relies on the statement of the PCIJ in the *Factory at Chorzów* case on reparation:

“The essential principle contained in the actual notion of an illegal act – a principle which seems to be established by international practice and in particular by the decisions of arbitral tribunals – is that reparation must, so far as possible, wipe out all the consequences of the illegal act and

reestablish the situation which would, in all probability, have existed if that act had not been committed.”<sup>136</sup>

352. The key difference between compensation under the Draft Articles and the *Factory at Chorzów* case formula, and Article 4(2) of the Treaty is that under the former, compensation must take into account “all financially assessable damage” or “wipe out all the consequences of the illegal act” as opposed to compensation “equivalent to the value of the expropriated investment” under the Treaty. Under customary international law, Siemens is entitled not just to the value of its enterprise as of May 18, 2001, the date of expropriation, but also to any greater value that enterprise has gained up to the date of this Award, plus any consequential damages.

**b) Value of the Investment**

353. In the *Factory at Chorzów* case, the PCIJ asked the experts to calculate the value of the undertaking as of the date of the taking and as of the later date of its prospective judgment, and such value to include the lands, buildings, equipment, stocks and process, supply and delivery contracts, goodwill and future prospects. It is only logical that, if all the consequences of the illegal act need to be wiped out, the value of the investment at the time of this Award be compensated in full. Otherwise compensation would not cover all the consequences of the illegal act. While the Tribunal has determined that the Treaty does not apply for purposes of determining the compensation due to Siemens, which is governed by customary international law as reflected in *Factory at Chorzów*, it is worth noting that the PCIJ, as the Treaty itself, refers to the value of the investment without qualification. To reach its conclusion, the PCIJ did not need to have “value” qualified by “full”. The Tribunal is satisfied that the term “value” does not need further qualification to mean not less than the full value of the investment. Having reached this conclusion, it is unnecessary for the Tribunal to discuss the argument advanced by the Claimant that it is entitled to

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<sup>136</sup> *Factory at Chorzów, Merits, PCIJ, Series A, No. 17, 1928, p. 47.*

the fair market value of its investment on the basis of the MFN clause in the Treaty.

354. Argentina has pleaded that, when a State expropriates for social or economic reasons, fair market value does not apply because otherwise this would limit the sovereignty of a country to introduce reforms in particular of poor countries. Argentina has not developed this argument, nor justified on what basis Argentina would be considered a poor country, nor specified the reforms it sought to carry out at the time. Argentina in its allegations has relied on *Tecmed* as an example to follow in terms of considering the purpose and proportionality of the measures taken. The Tribunal observes that these considerations were part of that tribunal's determination of whether an expropriation had occurred and not of its determination of compensation. The Tribunal further observes that Article I of the First Protocol to the European Convention on Human Rights permits a margin of appreciation not found in customary international law or the Treaty.

**c) Method of Valuation**

355. The Claimant has proposed that compensation be calculated on the book value of the investment and that *lucrum cessans* be arrived at through discounting an estimate of profits calculated as a percentage of the revenues that SITS would have received if the Project would have run its course on the basis of the prices for its services set forth in the Contract. Usually, the book value method applied to a recent investment is considered an appropriate method of calculating its fair market value when there is no market for the assets expropriated. On the other hand, the DCF method is applied to ongoing concerns based on the historical data of their revenues and profits; otherwise, it is considered that the data is too speculative to calculate future profits. Normally the two methods are regarded as alternative means of valuing the same object. Here, however, Siemens's expert has applied the two in tandem because, under the terms of the Contract, all Siemens' costs would be incurred before the first peso of revenue would be realized. Therefore, Siemens has calculated its claimed loss of profits by applying a notional profit percentage to its projected future net revenues under the Contract, and then discounting those claimed profits to their present value via the DFC method, to which it then has added the

book value of its costs actually incurred, i.e., its “sunk costs”, which due to the actions of Argentina never will be able to produce the projected (or any) revenues. In other words, Siemens claims: (i) the present value of its estimated lost profits or *lucrum cessans*, plus (ii) the costs it actually incurred, which were “wasted” in the effort to produce the revenues from which those profits would have been derived.

356. Siemens has defended its approach on the basis that SITS had already by May 18, 2001 incurred most Project development costs, the future costs could be estimated with reasonable certainty based on existing service contracts, and the prices for the delivery of SITS’ services were known as were the number of DNIs to be produced. For these reasons, Siemens has argued that an estimate of the present value of future profits could be calculated to complement the book value of the investment. In this respect, the Lemar Report uses the rate of profits on sales projections presented to the board of Siemens at the time the Project was proposed for approval. At that time, the estimated profit rate was 18%. Expert Lemar reduces it to 16% because of developments during the first year of the Contract. Furthermore, Siemens’ expert compares this estimated profit rate to other companies operating in Argentina with prices subject to State regulation, substantial upfront infrastructure investment cost to deliver the service, and the intention of the Government that they would produce a reasonable return to the owners of the investment.<sup>137</sup> For this purpose, the expert uses information from the Argentine *Comisión Nacional de Valores*, Bloomberg Services and the National Gas Authority of Argentina. Mr. Lemar arrives at a cross-sector average profit rate of 16%.<sup>138</sup> Thus similar to that projected by Siemens as adjusted.

357. While the Tribunal understands the reasons for the admittedly unusual approach followed by Siemens and considers that it has merit in the particular circumstances of this case, it has some concerns, as later explained, about how the valuation has been calculated, including the valuation of the *lucrum cessans*.

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<sup>137</sup> Expert Lemar Report attached to the Memorial (“Lemar Report”), p. 23.

<sup>138</sup> *Ibidem*.

**d) Evidence**

358. The parties have taken different approaches in respect of what is the adequate evidence of Siemens' investment. For the Claimant, the audited financial statements of SITS are sufficient evidence of the amounts invested. For Argentina, there is a need to show how each dollar or peso was spent and relate each dollar or peso to the item financed with it. Argentina has insisted that the Tribunal use an expert to analyze the accounts of SITS and ensure that the amounts spent by SITS were spent for purposes of carrying out the Project.

359. The Claimant has pointed out that the Project consisted of a made-to-order integrated system to be carried out by a single purpose company –SITS- as required by Argentina itself. Siemens contends that the financial statements properly audited are sufficient evidence of Siemens' investments, that the financial statements of SITS were audited by KPMG, and that no evidence has been presented to question KPMG's audit.

360. The approach advanced by Argentina responds to the need to assess the value to Argentina of Siemens' investment for purposes of applying Decree No. 669/01. The Tribunal has to apply customary international law. Accordingly, the value of the investment to be compensated is the value it has now, as of the date of this Award, unless such value is lower than at the date of expropriation, in which event the earlier value would be awarded. It is not the value of the investment to Argentina but the value of the investment in terms of the sums invested in the Project. The Project had started to operate and no convincing evidence has been submitted showing that the funds intended for the Project made available to SITS, as loans or equity, were not used for the intended purpose. The valuation made by the Respondent was made from a perspective different from that required under customary international law months after the Contract was terminated. For these reasons, the Tribunal saw no merit in prolonging the proceedings and engaging an expert to analyze the accounts of SITS and where the funds had been invested.

**e) Currency of Compensation**

361. Argentina has argued that the Contract is denominated in pesos and that it had not guaranteed to Siemens the parity of the peso in effect at the time it entered into the Contract. This assertion is correct but it has to be considered in the context of the requirement that the consequences of the illegal act be wiped out. It would be hardly so if the parity of the currency would be added as yet another risk to be taken by the investor after it has been expropriated. In the instant case, the Claimant has pleaded that the Tribunal accept May 18, 2001 as the date of expropriation. The Tribunal has considered that the issuance of Decree 669/01 was determinant for purposes of its finding of expropriation and it is also the date that would be in consonance with Article 15 of the Draft Articles on the date of occurrence of a composite act. On May 18, 2001, the peso was at par with the dollar. If such obligation would have been met, the Claimant would have been compensated in pesos convertible at that rate. Therefore, the Tribunal concludes that compensation shall be paid in dollars.

**f) Amount of Compensation**

362. Siemens claims \$283,859,710 as the book value of the investment to May 17, 2001.

363. Under the Contract (Annex VIII), SITS committed itself to invest \$201,486 million ("Plan de Inversiones" dated June 25, 1998 ("the Investment Plan")) and the variable costs such as satellite links, distribution costs of documents, overheads and operational expenses listed in page 2, paragraph 1.1 of Annex VIII. It is clear from the Contract that the total investment would include the items for which an amount is specified in the Investment Plan and those variable costs for which no estimated amount is given.

364. At the time of the 2000 SWIPCO audit, financed by SITS but carried out for the account of the Respondent, SITS had spent 126,235,000 pesos compared with the 241,486,000 envisaged in the Investment Plan. Both figures are exclusive of the variable costs for which no amount was specified in the Investment Plan.

365. After termination of the Contract and for purposes of the valuation carried out by the TTN, SITS claimed to have invested AR\$158,106,542. As explained in the report of the TTN of December 27, 2002,<sup>139</sup> AR\$47,237 pesos of that amount correspond to subcontractors' invoices and the remainder to invoices of companies in the Siemens group. In addition, SITS claimed "non-productive expenses" (AR\$44,452,193), interest on investments and "non-productive expenses" (AR\$25,260,008 and AR\$8,332,985, respectively), capital contributions (AR\$27 million), close-down costs (AR\$31 million), certain paid and unpaid invoices (AR\$13,100,000), subcontractors' claims (AR\$40 million) and *lucrum cessans* (AR\$254,942,070), for a total in excess of AR\$444 million. The TTN considered, pursuant to the terms of Decree 669/01, only the AR\$158,106,542 on account of investments and valued them at AR\$72,161,510.

366. Argentina in its comments of November 23, 2005 on the accounting information provided by Siemens asserts that the investment made reached AR\$107,472,398.23. The Claimant disputes the amount and currency of the latest value attributed to the investment by Argentina, and of the valuation of the TTN. The Claimant also points out, *inter alia*, that "non-productive expenses" and interest have been excluded, notwithstanding the submission of the related invoices by SITS to the Ministry of the Interior on July 22, 2001.

367. Mr. Lemar, the Siemens' expert, has concentrated on the financing of SITS and has calculated the book value by adding Siemens' capital contributions, the loans made to SITS and the corresponding interest, as recorded in SITS's financial statements for 2001. Mr. Lemar concludes that the book value of Siemens' investment at May 17, 2001 was \$283,859,710.

368. The Tribunal observes, that except for Mr. Lemar's, none of the valuations listed above respond to the criteria that need to be applied by the Tribunal and, as explained forthwith, the Tribunal has difficulty in accepting the value of the investment as calculated by Mr. Lemar. The Tribunal will use as a starting point SITS' audited financial statements. They have been audited by a highly qualified firm of independent auditors, which confirmed the reliability of the

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<sup>139</sup> Exhibit 161 to the Counter-Memorial.

accounting records, and no evidence has been submitted to the Tribunal which proves otherwise. Mr. Lemar has capitalized all interest paid by SITS. *Prima facie*, capitalization of interest during the development phase of an investment is normal practice. However, the financing of the Project was highly leveraged. Siemens paid-in 27 million pesos in equity and financed the rest primarily by three-month credit at 12.08% in 1999, twelve-month credit at 9% in 2000 and again with three-month credit at 14% in 2001. The high interest charged to the Project and the short-term nature of the credit raise the issue of the extent to which it is appropriate to recognize the full amount of interest claimed as part of the value of the investment since it is a way of building into book value what otherwise would have to be earned as profits. The Tribunal considers that it is appropriate to capitalize interest on loans made to SITS for the Project, but in case of loans made by Siemens or its subsidiaries such interest should reflect the actual cost of funds to Siemens because the Tribunal's task is to determine the loss of Siemens itself. Therefore, the Tribunal will proceed to calculate<sup>140</sup> the respective percentage of loans made to SITS by third parties, and Siemens and its subsidiaries and the costs of funds to the latter.

369. According to the funding data in the table in paragraph 3.7 of the Lemar Report, total loan funding by Siemens and its subsidiaries was AR\$224,906,029 and loan funding by others AR\$12,194,531 up to April 30, 2001, and AR\$225,726,812 and AR\$17,241,306 up to May 31, 2001. The Tribunal has adjusted these figures to May 17, 2001 by assuming that debt funding by Siemens, its subsidiaries and third parties increased at a steady daily rate during the month of May. The result is debt funding to May 17 of AR\$225,356,136 by Siemens and its subsidiaries, and AR\$14,962,117 by third parties. Therefore, Siemens and its subsidiaries provided 93.8% of all loans made to SITS and third parties provided 6.2%.

370. For purposes of determining an appropriate interest rate on loans made by Siemens or its subsidiaries, the Tribunal observes that, as a general matter, corporations of Siemens' size and creditworthiness hedge a substantial portion of the interest rate risk inherent in their fixed rate borrowings through

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<sup>140</sup> Amounts have been rounded to the nearest integer.



floating interest rate swaps. Hence, the cost of borrowing that should be taken into account is the floating rate that Siemens could have achieved using interest rate swaps during the life of the Contract from November 26, 1998 to May 17, 2001. The average of such interest rate during this period was 2.35%.<sup>141</sup>

371. Now the Tribunal turns to the percentage of interest payments made to Siemens and its subsidiaries that would be appropriate to capitalize based on the assumed cost of funds to Siemens in addition to interest payments paid to third parties. To arrive at such percentage, it is necessary to calculate the ratio of 2.35% to the annual average interest rate charged to SITS as reflected in SITS' financial statements.<sup>142</sup> Thus, 2.35% is: (i) 18.35% of 12.08% (the average interest rate charged in fiscal year 1998-1999), (ii) 26.11% of 9% (the average interest rate charged in fiscal year 1999-2000), and (iii) 16.78% of 14% (the average interest rate charged in fiscal year 2000-2001). Therefore, the percentage of interest payments to be capitalized out of payments made to Siemens and its subsidiaries is 18.35% in 1998-1999, 26.11% in 1999-2000 and 16.78% in 2000-2001.

372. As recorded in its financial statements, SITS paid on account of interest: AR\$150,828 in fiscal year 1997-1998, AR\$1,383,596 in fiscal year 1998-1999, AR\$12,156,499 in fiscal year 1999-2000 and AR\$16,950,704 up to May 17, 2001,<sup>143</sup> for a total of AR\$30,642,627. Of that amount, 93.8% would correspond to payments made to Siemens and its subsidiaries: AR\$1,297,813 in fiscal year 1998-1999,<sup>144</sup> AR\$11,402,796 in fiscal year 1999-2000 and AR\$15,899,760 in fiscal year 2000-2001 up to May 17, 2001, for a total of AR\$28,600,639. The remainder AR\$2,041,988 was paid by SITS to third parties. The Tribunal will now apply to the amounts paid by SITS to Siemens and its

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<sup>141</sup> Calculation based on data published by Bloomberg.

<sup>142</sup> Annex C of the financial statements.

<sup>143</sup> During the full fiscal year 2000-2001 SITS paid AR\$27,017,497 on account of interest. This amount needs to be adjusted to May 17, 1991 because SITS' fiscal year ran until September 30. For this purpose, the Tribunal has assumed that interest accrued at the same rate each day, divided the amount of interest payments made by 365, multiplied the daily rate by the number of days between May 17 and September 30 -136 days- and deducted the result -AR\$10,066,793- from the amount of interest paid that fiscal year. This brings the amount of interest payments between October 1, 2000 and May 17, 2001 to AR\$16,950,704.

<sup>144</sup> No interest payments to Siemens and its subsidiaries are recorded in the financial statements for fiscal year 1997-1998.

subsidiaries the yearly percentages arrived at in the preceding paragraph with the following results: AR\$234,255 represents 18.35% of the interest paid to Siemens and its subsidiaries in fiscal year 1998-1999, AR\$2,977,270 represents 26.11% of such payments made in fiscal year 1999-2000 and AR\$2,667,979 represents 16.78% of those made in fiscal year 2000-2001 up to May 17, 2001. These three items add up to AR\$5,879,504. The Tribunal will allow that amount of interest paid to Siemens and its subsidiaries plus AR\$2,041,988 paid to third parties for a total of AR\$7,921,492 to be capitalized for purposes of the calculation of the book value of Siemens' investment. Therefore, the book value calculated by Siemens' expert Lemar should be reduced by the difference between the aggregate amount of interest payments made to Siemens and its subsidiaries - AR\$28,600,369 - and AR\$5,879,504, namely, AR\$22,720,865.

373. The book value calculation by Mr. Lemar includes two other items that the Tribunal finds inappropriate. First, in note 5 to SITS' financial statements for fiscal year 2000-2001 under the heading of "Resultados extraordinarios", there is an entry on "Constitución previsión de otros créditos" with an amount of AR\$42,253,305. This item cross-refers to note 4.5, which explains that this amount corresponds to tax credits that have been provisioned in full because of the uncertainty regarding their recoverability and have been charged as extraordinary losses. The Tribunal holds the opinion that it is incorrect to include this amount in the book value of SITS for purposes of compensation. Indeed, the tax credits had not been realized because of SITS' lack of revenues. Hence, the amount of AR\$42,253,305 should also be subtracted from the calculation of the book value.

374. Second, the Tribunal refers again to note 5 to the financial statements of SITS for fiscal year 2000-2001 and to the item on "Constitución previsión para riesgos relacionados con la rescisión del contrato" under the heading of "Resultados extraordinarios." An entry of AR\$10,445,000 is listed on that account. Since the Tribunal has allowed compensation for consequential damages, as explained later, the provisioning for risks related to Contract termination would lead to double counting and is disallowed for purposes of the book value calculation.

375. To conclude the book value calculation, the Tribunal decides that such value is the value claimed by Siemens minus the amounts disallowed above on account of excessive interest rates, tax credits and risks associated with Contract termination. The amounts corresponding to these items add up to AR\$75,419,170, which when subtracted from AR\$283,859,710 claimed by Siemens reduce the book value of the investment to AR\$208,440,540.

376. As the Tribunal has noted, it has been a matter of controversy whether to use funds invested as a measure of the value of the investment or how these funds have been used. The Tribunal has looked into the use of funds as recorded in the financial statements themselves and the result of such examination confirms the adjusted book value set forth above. The Tribunal has taken into account the items in the financial statements that correspond to the Project as such, “bienes de uso”, intangible assets and “project cost”. It emerges from note 5 to SITS’ 2001 audited financial statements (“Estado de resultados” under the heading of “Resultados extraordinarios”) that, in 2001 and because of the termination of the Contract, SITS wrote off AR\$39,777,220 of intangible assets, AR\$49,678,876 of “bienes de uso” and AR\$123,127,297 of “project costs”. These three items add up to AR\$212,583,393.

377. The audited financial statements reflect the financial situation of SITS on September 30, 2001 and the Tribunal has the task to value the investment of Siemens at May 17, 2001. Therefore, the Tribunal has considered it appropriate to compare the aggregate amount of funds applied to “bienes de uso”, intangible assets and “project cost” between September 2000 and September 2001, to assume that these funds were applied at the same daily rate through the period, and to subtract from the difference the amount corresponding to the 136 days between May 17 and September 30, 2001. These assumptions correspond, *mutatis mutandis*, to those applied by expert Lemar to the sources of funds to calculate the value of the investment to May 17, 2001. The financial statements for 2001 show that SITS spent AR\$20,741,994 in “project cost” during the year and AR\$8,973,678 on “bienes de uso” (no funds were applied to intangible assets). These two items add up to AR\$29,715,672. This amount prorated by 365 days results in a daily application of funds to such items of

AR\$81,412.8, which multiplied by 136 is equal to AR\$11,072,140. The subtraction of this amount from AR\$212,583,393 (the sum expended on account of “bienes de uso”, intangible assets and “project cost”) results in AR\$201,511,253, which the Tribunal considers a reasonable approximation to the amount applied to “bienes de uso”, intangible assets and “project cost” up to May 17, 2001. When the allowed capitalized interest of AR\$7,921,492 is added to this amount we arrive at AR\$209,432,745. A result slightly higher than the book value, which can be explained by the adjustments that need to be made to reflect the value of the investment on May 17, 2001.

378. Siemens further claims \$124,541,000 on account of loss profits before taxes.

379. The Tribunal considers that the amount claimed on account of lost profits is very unlikely to have ever materialized for the following reasons:

380. First, in considering the estimated rate of profit on sales, the Tribunal recalls that the calculation of the Claimant assumes the issuance of 33 million DNI. The Tribunal considers that this amount is excessive taking into account that the Claimant accepted to make the investment with a guaranteed minimum of 24 million DNI (Article 16(b) of the Contract).<sup>145</sup> Therefore, the estimated amount of revenues of AR\$889,147,000 calculated by the Claimant needs to be reduced by AR\$270 million (30 pesos per each DNI multiplied by 9 million) to AR\$619,147,000.

381. Second, the amount of AR\$619,147,000 includes a 21% value added tax (Article 4.4 of the Contract) equal to AR\$107,455,000, which needs to be subtracted and results in AR\$511,692,000. Applying to this amount the 16% profit rate results in profits before applicable taxes of AR\$81,870,000 over the life of the Contract.

382. Third, the discount rate to be applied to the estimated profits should reflect the cost of money and the country and business risks. According to Siemens' own expert, this should be a rate within a range of 11% and 15%. Mr.

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<sup>145</sup> The TTN points out in its report that the license of Printrak that SITS held to print DNIs was valid for printing only 24 million documents. Exhibit 161 to the Counter-Memorial, folio 15.

Lemar himself has offered a calculation using a rate in the middle of such range - 13%. The Tribunal considers this rate appropriate taking into account the country and business circumstances of the operation and the cost of funds.

383. Fourth, Siemens' expert has discounted the profits over the expected life of the Contract assuming that it would not be extended. It was possible for the Contract to be extended for an additional six years. It would not be unreasonable to assume that delays would have occurred in the normal course of Project operation given the novelty and complexity of the Project; it is undisputed by the parties that it was the first of its kind. Furthermore, the analysis performed by Mr. Lemar to take into account the three-month delay in Project start-up shows the sensitivity of profits to delays in the timing of revenues. A delay of three months resulted in a drop of 2% in the profit rate notwithstanding the addition of AR\$29 million in revenues for printing of electoral roles which had been underestimated in an earlier calculation. An extension of the Contract to 9 or 12 years would have had devastating effects on the profit rate.

384. Fifth, the profits would have been subject to a corporate profits tax.

385. For these reasons, the Tribunal concludes that Siemens is not entitled to any compensation on account of profit loss.

386. Additionally, Siemens has claimed \$9,178,000 for post-expropriation costs incurred by SITS in continuing a skeleton operation, \$219,899 for unpaid invoices by the Government in relation with the voters list of 1999, \$44,678,462 for sub-contractors' claims, and the return of the performance bond.

387. The Tribunal considers that the claim on account of post-expropriation costs is justified in order to wipe out the consequences of the expropriation. As regards the sub-contractors' claims, Argentina has affirmed to have taken the necessary measures to ensure that these claims are transferred to Argentina. The Tribunal acknowledges this affirmation and decides that Argentina shall hold the Claimant, its subsidiaries and affiliates, wherever located, harmless from, and indemnify same in respect of, any claims heretofore

or hereafter asserted against any of them by any of the following subcontractors to SITS in relation to the Contract: Boldt S.A., Correo Argentino S.A., Printrak International/Printrak de Argentina S.R.L., Imaging Automation Inc., Impsat S.A., SWIPCO Argentina S.A., Mojacar S.A., Indra Spain and Indra Argentina, and Oracle.

388. Since the Contract was terminated on grounds other than performance, it is congruent that the performance bond be returned promptly to Siemens or SITS, as its agent for this purpose. Should the bond not have been returned 30 days after the date of this Award, Argentina shall pay the Claimant the amount of the bond.

389. As for the amount claimed on account of services rendered and unpaid, the Tribunal considers that, since such amount is not disputed and would normally be considered an asset forming part of the value of the investment, the Respondent shall compensate Siemens for the full amount claimed.

**g) Interest**

390. The Claimant has requested that the Tribunal award compound interest at the rate of 6% per annum and that interest accrue as from May 18, 2001 for compensation on account of the expropriated investment and as from the date costs were incurred in the case of compensation for additional damages. The Lemar Report takes into account a number of options before arriving at the conclusion that 6% would be an appropriate rate to apply based on the consideration that this is the rate that Siemens used as its average corporate borrowing rate in appraising investments and in considering funding costs in 2001-2003. The rate of 6% has also been advanced in Professor Schreuer's opinion on the basis of arbitral practice.

391. In its Counter-Memorial, the Respondent does not comment on the issue of the applicable rate of interest. In its Rejoinder, Argentina simply disputes the rate of interest claimed since the Treaty provides that interest be paid at "the usual bank rate." No alternative interest rate is proposed nor is any reason adduced to question how the Claimant has arrived at that rate. Argentina

seems to presume that “the usual bank rate” would be different but without specifying what this bank rate should be.

392. In its Rejoinder, the Respondent objects to the award of compound interest, it considers that this is an inappropriate case for awarding compound interest without offering reasons why this would be so, and responds to the Claimant’s assertion that compounding of interest is in line with the principle of full damages as follows:

“That may theoretically be the case if in fact the investor has borrowed elsewhere to make good the loss of the money which it is said it should have received. But nowhere is it claimed that this Claimant was obliged to make good any financial losses by itself borrowing money at compound interest rates from banks. Thus, the claim for loss of the interest on interest which it is said would have been earned is unfounded in fact as well as being entirely speculative. This element of the Claim amounts to an attempt by the Claimant to unjustly enrich itself in the circumstances of this case.”<sup>146</sup>

393. Argentina further objects to the date of May 18, 2001 as the date from which interest would accrue. It argues that, since the Treaty is silent on this point, it would be artificial to attribute most losses as from that date and speculative and complex to establish dates when the additional damages occurred.

394. The Tribunal will address first the applicable rate of interest, then turn to the questions of the date as from which interest should accrue and whether interest should be simple or compounded.

395. As an expression of customary international law, Article 38 of the Draft Articles states:

“1. Interest on any principal sum payable under this Chapter shall be payable when necessary in order to ensure full reparation. The interest rate and mode of calculation shall be set so as to achieve that result.

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<sup>146</sup> Rejoinder, para. 727. Footnote deleted.

2. Interest runs from the date when the principal sum should have been paid until the date the obligation to pay is fulfilled.”

396. Thus, in determining the applicable interest rate, the guiding principle is to ensure “full reparation for the injury suffered as a result of the internationally wrongful act.”<sup>147</sup> The Tribunal considers that the rate of interest to be taken into account is not the rate associated with corporate borrowing but the interest rate the amount of compensation would have earned had it been paid after the expropriation. Since the awarded compensation is in dollars, the Tribunal considers that the average rate of interest applicable to US six-month certificates of deposit is an appropriate rate of interest. The average of such rate from May 18, 2001 to September 30, 2006 is 2.66%.<sup>148</sup>

397. For purposes of erasing the effects of the expropriation, interest should accrue from the date the Tribunal has found that expropriation occurred, namely, May 18, 2001, in respect of the book value of the investments made for the Project up to that date. Compensation for post-expropriation costs incurred after May 18, 2001 should accrue interest as from the date on which they were incurred. Since this would not be practical for calculation purposes given the multiple dates involved, the Tribunal considers that interest on post-expropriation costs shall accrue as of January 1, 2002, date by which most of these costs had been incurred (\$9,339,863 out of a total claimed of \$9,807,638). As for interest on unpaid Government bills, interest should accrue from January 1, 2000 since they relate to services rendered in 1999.

398. In the eventuality that Siemens or any of its affiliates or subsidiaries would be held liable for any of the claims of the sub-contractors related to the Contract, interest shall accrue from the date of payment of any such claim. Furthermore, in the eventuality that the performance bond is not returned by the Respondent within 30 days of the dispatch of this Award to the parties, interest shall accrue on the amount of the bond as from 30 days after the

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<sup>147</sup> J. Crawford, *The International Law Commission's Articles on State Responsibility. Introduction, Text and Commentaries* (2002) p. 239.

<sup>148</sup> Calculated on the basis of data published by Bloomberg.



date of dispatch of this Award to the parties and until such amount has been fully paid.

399. As regards compounding of interest, the question is not, as argued by Argentina, whether Siemens had paid compound interest on borrowed funds during the relevant period but whether, had compensation been paid following the expropriation, Siemens would have earned interest on interest paid on the amount of compensation. It is in this sense that tribunals have ruled that compound interest is a closer measure of the actual value lost by an investor. As expressed by the tribunal in *Santa Elena*:

“[w]here an owner of property has at some earlier time lost the value of his asset but has not received the monetary equivalent that then became due to him, the amount of compensation should reflect, at least in part, the additional sum that his money would have earned, had it, and the income generated by it, been reinvested each year at generally prevailing rates of interest.”<sup>149</sup>

400. Similarly have held the tribunals in *Metalclad* and *Wena Hotels*. The *Ad Hoc* Committee in *Wena Hotels* decided that it was within the tribunal’s power to take the option of compound interest as an alternative compatible with the objectives of prompt, adequate and effective compensation and compensation that reflects the market value of the investment immediately before the expropriation.<sup>150</sup>

401. For these reasons, the Tribunal concludes that interest shall be compounded and be compounded annually.

### **VIII. Costs**

402. In order to take into account that the Claimant has not fully prevailed in these proceedings, the Tribunal determines that each party shall bear its own legal costs, and that Argentina and Siemens shall be responsible for 75% and 25%, respectively, of the fees and expenses of the Tribunal and the costs of the ICSID Secretariat.

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<sup>149</sup> *Santa Elena*, para. 104.

<sup>150</sup> *Wena Hotels*, paras. 52-53.

## **IX. Decision**

403. Having carefully considered the parties' arguments in their written pleadings and oral submissions and for the reasons above stated the Tribunal unanimously decides:

1. that the Respondent breached Article 4(2) of the Treaty by expropriating Claimant's investment without complying with its terms;
2. that the Respondent breached Articles 2(1) and 4(1) of the Treaty by failing to accord fair and equitable treatment and full protection and legal security to the investment of the Claimant;
3. that the Respondent has breached Article 2(3) of the Treaty by the arbitrary measures taken in respect of the investment of the Claimant;
4. that the Respondent shall pay forthwith to the Claimant compensation in the amount of \$208,440,540 on account of the value of its investment, \$9,178,000 on account of consequential damages and \$219,899 on account of unpaid bills for services rendered by SITS to the Government;
5. that the Respondent shall forthwith, and in no event later than thirty (30) days from the date of dispatch of this Award to the parties, deliver to Claimant (or SITS as its agent for this purpose) the Contract performance bond provided by SITS (insurance policy No. 000589772) for an amount of \$20 million);
6. that the Respondent shall hold the Claimant, its subsidiaries and affiliates, wherever located, harmless from, and indemnify same in respect of, any claims heretofore or hereafter asserted against any of them by any of the following subcontractors to SITS in relation to the Contract: Boldt S.A., Correo Argentino S.A., Printrak International/Printrak de Argentina S.R.L., Imaging Automation Inc., Impsat S.A.,

SWIPCO Argentina S.A., Mojacar S.A., Indra Spain and Indra Argentina, and Oracle;

7. that the Respondent shall pay to the Claimant interest compounded annually on the sums listed in point 4 of this decision at the rate of 2.66%, which is the average rate applicable to US six-month certificates of deposit from May 18, 2001 to September 30, 2006; such interest to accrue as from May 18, 2001 in the case of compensation on account of the value of the investment, January 1, 2000 in the case of compensation on account of unpaid bills by the Government, and January 1, 2002 in the case of compensation on account of consequential damages, all until the date of dispatch of this Award to the parties;
8. that, in the eventuality that the Respondent had not paid in full the sums referred to in this decision thirty (30) days after the date of dispatch of this Award to the parties, the Respondent shall pay to the Claimant interest compounded annually on the unpaid sum at the rate set forth in point 7 of this decision; such interest to accrue as from thirty (30) days after the date of dispatch of this Award to the parties until such amount has been fully paid;
9. that the Respondent shall, in the eventuality that the Respondent has not delivered the bond referred to in point 5 of this decision to the Claimant (or SITS as its agent) thirty (30) days after the date of dispatch of this Award to the parties, forthwith pay to the Claimant the full amount of the bond. Such amount to bear interest compounded annually at the rate set forth in point 7 of this decision until fully paid;
10. that the Respondent shall, in the eventuality that Siemens or any of its affiliates or subsidiaries would be held liable for any claims of the sub-contractors listed above, pay interest

compounded annually at the rate set forth in point 7 of this decision on any amount paid to satisfy such liability; such interest to accrue from the date of payment of any such amount;

11. that any funds to be paid pursuant to this decision shall be paid in dollars and into an account outside Argentina indicated by the Claimant and net of any taxes and costs;
12. that each party shall bear its own costs and counsel fees;
13. that the Respondent and the Claimant shall be responsible for 75% and 25%, respectively, of the fees and expenses of the arbitrators and the costs of the ICSID Secretariat; and
14. that all other claims are dismissed.

Made in Washington, D.C., in English and Spanish, both versions equally authentic.

*(signed)*  
Judge Charles N. Brower  
Arbitrator

Date: 4 Jan. 2007

*(signed)*  
Professor Domingo Bello Janeiro  
Arbitrator

Date: 11 enero 2007

*(signed)*  
Dr. Andrés Rigo Sureda  
President

Date: January 17, 2007

## **LEGAL AUTHORITY CA-91**

**PARKERINGS-COMPAGNIET AS**

**Claimant**

**v.**

**REPUBLIC OF LITHUANIA**

**Respondent**

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**AWARD**

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**TRIBUNAL**

Dr. Julian Lew Q.C., *Arbitrator*

The Hon. Marc Lalonde P.C., O.C., Q.C., *Arbitrator*

Dr. Laurent Lévy, *President*

**Secretary of the Tribunal**

Ms. Martina Polasek

Date of dispatch to the parties: September 11, 2007

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## 1. THE PARTIES

### 1.1 THE CLAIMANT

1. Parkerings-Compagniet AS (“Parkerings” or “the Claimant”) is a corporation organized and existing under the laws of Norway.
2. Parkerings’ principal business activity consists in the development and operation of public and private parking facilities, including the collection of parking fees and the enforcement of parking regulations.
3. Its corporate headquarters are located at:

Økernveien 145, 9. etg.  
PO Box 158 Økern  
N-0509 Oslo, Norway

4. The Claimant is represented in this arbitration by:

Mr. David W. Rivkin  
Mr. Gaetan J. Verhoosel  
Mr. William H Taft V  
Debevoise & Plimpton LLP  
919 Third Avenue  
New York, NY 10022  
USA

Mr. Zilvinas Kvietkus  
Norcous & Partners  
A. Goštauto str. 12 A  
01108 Vilnius  
Lithuania

Ms. Carita Wallgren  
Roschier Holmberg, Attorneys Ltd.  
Keskuskatu 7A  
00100 Helsinki  
Finland

### 1.2 THE RESPONDENT

5. The Respondent is the Republic of Lithuania (“Lithuania” or “the Respondent”).
6. The Respondent is represented in this arbitration by:

Mr. Petras Baguska, Minister of Justice  
Mr. Paulius Koverovas, State Secretary of the Ministry of Justice  
Ministry of Justice

Gedimino pr. 30/1  
011104 Vilnius  
Lithuania

Mr Alexander Yanos  
Freshfields Bruckhaus Deringer LLP  
520 Madison Avenue, 34th floor  
New York NY 10022  
USA

Ms. Lucy Reed  
Mr. Constantine Partasides  
Mr Noah Rubins  
Freshfields Bruckhaus Deringer LLP  
2, rue Paul Cézanne  
75008 Paris  
France

Ms. Renata Beržanskienė  
Law Office Adamonis, Beržanskienė and partners Sorainen Law Offices  
Jogailos 4  
01116 Vilnius  
Lithuania

## **2. THE ARBITRAL TRIBUNAL**

### **2.1 CO-ARBITRATOR NOMINATED BY THE CLAIMANT**

7. Nominated by the Claimant in its Request for Arbitration dated 11 March 2005:

Dr Julian D. M. Lew, Q.C.  
20 Essex Street  
London WC2R 3AL  
United Kingdom

### **2.2 CO-ARBITRATOR NOMINATED BY THE RESPONDENT**

8. Nominated by the Respondent by letter dated 9 September 2005:

The Honorable Marc Lalonde P.C., O.C., Q.C.  
1155 René-Levesque Blvd West  
33<sup>rd</sup> floor  
Montreal, QC H3B 3V2  
Canada

## 2.3 CHAIRMAN OF THE ARBITRAL TRIBUNAL

9. Jointly appointed by the parties by letter dated 3 October 2005:

Dr. Laurent Lévy  
Schellenberg Wittmer  
15 bis, rue des Alpes  
P.O. Box 2088  
1211 Geneva 1  
Switzerland

## 3. SUMMARY OF THE ARBITRAL PROCEEDINGS

### 3.1 INITIATION OF THE ARBITRATION AND CONSTITUTION OF THE ARBITRAL TRIBUNAL

10. On 11 March 2005, the Claimant filed its Request for Arbitration with the Secretary-General of the International Centre for Settlement of Investment Disputes (“ICSID”). With respect to the “*method of appointment of the Tribunal and appointment of arbitrator,*” ¶¶ 72 of the Request set forth the following:

*The Treaty does not set forth any particular method of appointment of the Tribunal. Having regard to Article 37 of the Convention and Rule 2 of the ICSID Arbitration Rules, Parkerings proposes that the Tribunal consist of three arbitrators, one appointed by each party and the President of the Tribunal appointed by agreement of the parties.*

11. Under ¶¶ 73 of the Request for Arbitration, the Claimant appointed as its arbitrator Dr. Julian D. M. Lew, Q.C. On 21 June 2005, ICSID informed the parties that Dr. Lew had accepted his appointment as arbitrator.
12. On 17 March 2005, ICSID addressed to the Respondent a copy of the Request for Arbitration.
13. On 22 April 2005, ICSID requested, in accordance with Rule 2(1)(c) of the Rules of Procedure for the Institution of Conciliation and Arbitration Proceedings (Institution Rules), that the Claimant communicate to the Centre, on the one hand, “*information concerning the consent of Parkerings-Compagniet AS to submit the dispute with the Republic of Lithuania to ICSID,*” and, on the other hand, “*evidence of entry into force of the bilateral investment treaty between the Government of the Republic of Lithuania and the Government of the Kingdom of Norway of June 16, 1992.*” The Claimant provided the requested information by letter dated 29 April 2005.
14. On 16 May 2005, the Secretary-General of ICSID issued a “Notice of Registration,” stating that the Request for Arbitration, as supplemented by counsel for the Claimant’s letter of 29 April 2005, had been registered in the Arbitration Register. He also invited the parties to “*communicate [...] any provisions agreed by them regarding the number of arbitrators and the method of their appointment.*”

15. By letter dated 27 May 2005, the Respondent informed ICSID that *“it raises no objection to the Parkerings-Compagniet AS proposal regarding the Arbitral Tribunal consisting of three arbitrators.”*
16. By letter dated 8 August 2005, the Respondent requested an extension of the 15 August 2005 deadline for the constitution of the Tribunal to 15 September 2005. By letter dated 12 August 2005, the Claimant declared that it did not object to such time extension.
17. By letter dated 9 September 2005, counsel for the Respondent appointed the Honorable Marc Lalonde P.C., O.C., Q.C. as arbitrator. On 15 September 2005, ICSID informed the parties that Mr. Lalonde had accepted his appointment.
18. On 3 October 2005, counsel for the parties jointly informed ICSID of the parties’ agreement to appoint Dr Laurent Lévy as President of the Tribunal. By letter dated 10 October 2005, Dr Lévy accepted his appointment.
19. On 12 October 2005, ICSID informed the parties that all three arbitrators had accepted their appointment and that the Arbitral Tribunal was deemed to have been constituted and the proceedings to have begun on that same day.

### **3.2 FIRST SESSION OF THE TRIBUNAL**

20. The Arbitral Tribunal held a first session on 25 November 2005 in London, UK. In addition to the Members of the Tribunal and the Secretary, the following persons attended the hearing:
  - (i) Representing Parkerings:
    - Ms. Carita Wallgren, Roschier Holmberg, Attorneys Ltd.,
    - Mr. Gaetan J. Verhoosel, Debevoise Plimpton LLP, and
    - Mr. Zilvinas Kvietkus, Norcous & Partners.
  - (ii) Representing Lithuania:
    - Mr. Paulius Koverovas, State Secretary of the Ministry of Justice of the Republic of Lithuania,
    - Mr. Constantine Partasides, Freshfields Bruckhaus Deringer LLP,
    - Mr. Noah Rubins, Freshfields Bruckhaus Deringer LLP, and
    - Ms. Renata Beržanskienė, Law Office Adamonis, Beržanskienė and partners Sorainen Law Offices.

21. A sound recording was made of the hearing, copies of which were sent to the parties. The Secretary also prepared summary minutes of the session, a certified copy of which was sent to the parties on 18 January 2006.
22. At the outset of the hearing, a number of procedural issues were dealt with. In particular, it was agreed that, pursuant to Article 44 of the ICSID Convention, the proceedings would be conducted in accordance with the ICSID Arbitration Rules in force since 1 January 2003. It was also agreed that the place of the proceedings would be Paris, France, and that, in accordance with Article 22 of the ICSID Arbitration Rules, the language of the proceeding would be English. During the course of the session, the parties acknowledged that the Tribunal has been duly constituted.
23. The Arbitral Tribunal and the parties agreed on the following time table:

*The Claimant shall file its memorial on the merits by February 10, 2006;*

*The Respondent shall file its counter-memorial on the merits, any jurisdictional objections and any request for bifurcation of the proceeding by June 12, 2006;*

*The Claimant shall file its observations on the Respondent's request for bifurcation, if any, by July 3, 2006;*

*A pre-hearing conference limited to pending procedural questions will be held in Paris on August 28, 2006; and*

*A hearing on the merits or on jurisdiction or on both will be held in Paris on November 6-10, 2006.*

### **3.3 PRE-HEARING WRITTEN PHASE**

24. On 17 January 2006, the Claimant filed a request for the production of documents.
25. On 20 January 2006, the Respondent acknowledged receipt of the Claimant's document production request, and filed its comments thereon.
26. On 24 January 2006, the President of the Tribunal invited, on the one hand, the Claimant to submit its reply to the Respondent's observations within four days, and, on the other hand, the Respondent to submit its rejoinder within four days of the reply. The President of the Tribunal also invited the Respondent to gather and communicate to the Claimant all the documents that it accepted to produce without awaiting a decision from the Tribunal.
27. By letter dated 27 January 2006, counsel for the Claimant informed the Tribunal that the parties had agreed upon the following production schedule, subject to the agreement of the Tribunal:

*1. By February 6, 2006, Respondent shall: (i) produce to Claimant the documents responsive to categories (a), (b), (d), (e), (f), (g), and (h) of the Application; and (ii) inform Claimant whether and, if so by when, it expects to be in a position to produce to Claimant the documents responsive to categories (c), (i), (j), (k), (l), and (m) of the Application.*

*2. If by February 6, 2006, Respondent confirms a schedule for the production of the documents responsive to categories (c), (i), (j), (k), (l), and (m), the parties shall endeavor to reach an agreement on any adjustments to the schedule of the arbitral proceedings required by such proposed schedule, on the understanding that: (i) any such adjustments*

*shall not affect the August 28, 2006 pre-hearing conference or the evidentiary hearing scheduled for November 6-10, 2006; (ii) Claimant's Memorial shall be due by a date no earlier than February 17, 2006; and (iii) any extension accorded to Claimant, at a minimum, shall not diminish the amount of time allotted to Respondent for the submission of its Counter-Memorial.*

*3. Should the parties have any dispute over the scope or schedule of production proposed by Respondent by February 6, 2006 in accordance with ¶¶ 1 or 2 above, they shall promptly submit such dispute to the Tribunal for resolution. The parties agree that, should such a dispute arise, Claimant's Memorial shall be due by a date no earlier than February 17, 2006, and the parties shall consult to agree on a mutually acceptable schedule for submissions, again with the understanding that the August 28, 2006 pre-hearing conference and the evidentiary hearing scheduled for November 6-10, 2006 shall not be affected and that such schedule, at a minimum, shall not diminish the amount of time allotted to Respondent for the submission of its Counter-Memorial.*

28. Counsel for the Claimant added that *"in light of the [...] agreed Schedule, Claimant withdraws the Application at this time. Claimant's right to revive the Application in whole or in part is reserved in accordance with ¶ 3 of the Schedule."*

29. By letter dated 17 February 2006, counsel for the Claimant informed the Tribunal that the parties had agreed on the following further adjustments to the schedule of the arbitral proceedings, subject to the agreement of the Tribunal:

- *Claimant shall submit its Memorial on February 24, 2006.*
- *Respondent shall submit its Counter-Memorial on June 26, 2006.*
- *Claimant shall file its observations on Respondent's request for bifurcation, if any, by July 17, 2006;*

*The dates scheduled for the pre-hearing conference (August 28, 2006) and the evidentiary hearing (November 6-10, 2006) remain unchanged.*

30. On 17 February 2006, the Secretary wrote to the parties to confirm the new schedule for the submission of written pleadings as agreed upon by the parties.

31. On 27 February 2006, the Secretary received the Claimant's Memorial, with accompanying documentation (two witness statements, one expert report, exhibits numbered CE 1 through CE 259, and authorities numbered CA 1 through CA 57), under cover of a letter dated 24 February 2006

32. By letter dated 5 June 2006, the Claimant filed, in agreement with the Respondent, the following additional documents to complement its submission of 24 February 2006:

- (i) a supplemental statement by Mr. Carlos Lapuerta responding to corrected parking revenue data provided by Respondent following submission of Mr. Lapuerta's expert report on February 24, 2006;*
- (ii) four new exhibits (CE 260-263) consisting of documents produced by Respondent on May 22, 2006 in response to a supplemental document request by Claimant, including excerpted translations; and*
- (iii) in accordance with Arbitration Rule 25, the annexed list of corrections of accidental errors in Claimant's February 24, 2006 submission, as well as corrected versions of four exhibits submitted with Claimant's Memorial and/or their translations (CE 21, 54, 70 and 247). This list and these corrected exhibits were previously provided to Respondent on May 4, 2006.*



33. By letter dated 27 June 2006, counsel for the Respondent sought “*the Tribunal’s approval of the parties’ agreement to grant the Republic an extension for the filing of its Counter-Memorial until July 24, 2006, subject to the following two conditions: (i) the Republic’s commitment not to seek any bifurcation of the proceedings; and (ii) the maintenance of the remainder of the schedule as agreed at the procedural hearing (including the dates of the August 2006 pre-hearing/preliminary conference on procedural questions and the November 2006 hearing on the merits).*” Counsel for the Respondent further confirmed that “*the Republic will comply with the above conditions and will be filing its Counter-Memorial within the agreed deadline.*”
34. By email of 28 June 2006 and letter dated 30 June 2006, the Secretary informed the parties of the Tribunal’s approval of their agreement to extend the time limit for the filing of the Counter-Memorial until 24 July 2006.
35. On 25 July 2006, counsel for the Respondent filed its Counter-Memorial and accompanying documents (two witness statements, one expert report, exhibits numbered RE 1 through RE 94, and authorities numbered RA 1 through RA 49).
36. On 28 August 2006, the Tribunal, the parties, and the Secretary held a pre-hearing telephone conference, at the close of which the President of the Tribunal issued directions regarding the parties’ opening statements and the evidence that counsel for the parties would wish to present during the hearing. The President of the Tribunal further authorized the Claimant to file, by 15 September 2006 at the latest, two additional statements of new witnesses as well as new exhibits, provided that the issues discussed in the additional witness statements and the new exhibits be strictly limited to rebuttal of allegations made by the Respondent in its written submission or by the Respondent’s witnesses, and do not pertain to allegations already made by the Claimant or contemplated by its witnesses in prior submissions. The President also authorized the Respondent to file, by 20 October 2006 at the latest, additional statements of new witnesses (in principle, no more than two) or supplemental statements of existing witnesses, as well as additional exhibits, provided that the facts discussed in these additional/supplemental witness statements and exhibits be strictly limited to rebuttal of allegations made by the Claimant’s new witnesses or of the contents of the Claimant’s additional exhibits. The President of the Tribunal invited the parties to inform the Tribunal, by 27 October 2006 at the latest, which additional witness(es) would be called for oral examination and which adjustments would need to be made with respect to the sequence and timing of witness examination. Finally, the President of the Tribunal issued the following additional directions:
- *Witnesses will be allowed in the hearing room at any time (i.e before and after their examination). Either party may, however, apply for the exclusion of one or more witnesses from the hearing room, at certain or all times. To avoid wasting time on procedural issues during the hearing week, counsel are invited to confer before filing any such application.*
  - *The issue whether counsel shall have the opportunity to make oral closing statements and/or to file post-hearing briefs shall be discussed at the hearing. The Tribunal shall issue a determination in this respect by Wednesday 12 November 2006 at the latest, upon request from the parties, if not ex officio.*

- *Upon agreement between the parties, the hearing shall end on Friday at 1:30 p.m. at the latest.*

37. On 15 September 2006, Parkerings filed:

- two additional statements of new witnesses (Björn Öberg and Sigitas Burnickas);
- two new legal authorities that had allegedly only been issued and become available after Parkerings' submission of 24 February 2006 (CA 58 and CA 59); and
- 37 new exhibits (CE 264-CE 300).

38. On 20 October, Lithuania filed:

- two additional statements of new witnesses (Jonas Endriukaitis and Ingrida Simonyte);
- two new legal authorities (RA 50 and RA 51); and
- 9 new exhibits (RE 95-RE 103).

39. On the same date, Parkerings filed five additional documents (CE 301-CE 305).

40. On 30 October 2006, Lithuania wrote that it had no objection to the Claimant's submission of Exhibits 301-305. On the same date, Lithuania filed additional documents (RE 104 – RE 108). The Claimant did not object to the new exhibits.

### **3.4 THE EVIDENTIARY HEARING**

41. On 27 October 2006, the Claimant addressed to the Tribunal a letter regarding the witnesses it would put forward at the hearing. On 30 October 2006, the Respondent filed a similar communication in this respect.

42. The evidentiary hearing was held in Paris on 6, 7, 8, 9 and 10 November 2006, in the course of which the following witnesses and experts were heard:

1. Mr. Bjørn Havnes
2. Mr. Sigitas Burnickas
3. Mr. Jonas Tamulis
4. Mr. Björn Oberg
5. Professor Gintautas Bartkus
6. Mr. Robertas Staskevicius
7. Mr. Raivydas Rukstele

8. Mr. Jonas Endriukaitis
  9. Ms. Ingrida Šimonytė
  10. Mr. Carlos Lapuerta
  11. Mr. Tim Giles
43. During the hearing, the Claimant filed additional documents (CE 306 – CE 311) and two additional authorities (CA 60 and CA 61)
  44. Shortly after the hearing, the Arbitral Tribunal and the parties agreed on the procedural follow-up to the hearing. In particular, they agreed that the parties would file simultaneous post-hearing briefs on 8 December 2006; the parties would file simultaneous reply post-hearing briefs consisting in a short letter response within one week of the first submission; and the parties would submit their respective statements on costs jointly with their post-hearing briefs and a statement summarizing the costs by 22 December 2006.

### **3.5 THE POST-HEARING BRIEFS**

45. The parties simultaneously filed their first post-hearing briefs on 8 December 2006.
46. On 15 December 2006, Parkerings sent a letter to the Tribunal which identified errors in Lithuania's Counter-memorial and Lithuania's post-hearing brief.
47. On 22 December 2006, the parties filed their statement of costs.
48. On 19 January 2007, the Tribunal informed the parties that it did not find necessary to hold an additional hearing.
49. On 9 May 2007, Parkerings filed a revised statement of costs.
50. On 25 May 2007, the Tribunal declared the proceedings closed in accordance with Rule 38(1) of the Arbitration Rules.

## **4. MAIN FACTS RELATING TO THE MERITS OF THE DISPUTE**

### **4.1 THE TENDER**

51. Following Lithuania's gradual transition between 1991 and 1997 from a Soviet Republic to a candidate for EU membership and a market economy, the Municipality of the City of Vilnius decided to create a modern, integrated parking system for the City of Vilnius, in order to control traffic and protect the integrity of the City's historic Old Town.
52. The Municipality announced a tender (the "Vilnius Tender") for the purpose of obtaining private investment in connection with the design and operation of this parking system, including the construction of two multi-storey car parks ("MSCP").

53. On 13 November 1997, the “Organisation of Investment Development Tender Regulations” was approved by the Board of Vilnius City by Decision No. 1819V (**RE 7**). The Mayor charged the “Commission on Organization of Tenders for the Lease of Land Plots” with the organization of investment development tenders, and appointed his advisor, Robertas Staskevicius, as “head of the working party” (**RE 7**). The Commission retained the services of a Dutch consulting firm, Tebodin Consultants and Engineers (“Tebodin”), for technical advice on the tender process.

#### 4.1.1 The Bidders

54. Of the seven potential bidders which responded to the City’s tender and expressed an interest in the construction of MSCP (**RE 8**), only two returned signed letters of intent to the City (**RE 9** and **RE 10**). These two bidders (the “Bidders”) were Egapris, a Lithuanian waste management company, and the “Getras Consortium” composed of Getras, a French investor acting through its Lithuanian subsidiary, UAB Getras Lietuva, and three Lithuanian partners, namely AB Ekinsta, Bank Hermis, and UAB Savy.
55. Together with a Swiss company, Egapris submitted a proposal (“Investment Project Vilnius Parking System”) to construct “*automated car parking lots and garages.*” More specifically, according to Egapris’ proposal, the funds were to be invested, *inter alia*, in ticket machines, MSCP, and various equipments and tools (**RE 13**).
56. The Getras Consortium, on the other hand, proposed, in its business plan on the “*development and exploitation of car parking lot system in Vilnius city,*” the construction of two underground parking lots near the Opera and Ballet Theatre, on the one hand, and the Railroad Station, on the other hand. The Getras Consortium predicted that the construction of the facilities could be completed within six years (**RE 12**).
57. On 7 July 1998, Tebodin issued an “*Evaluation of Proposals for the Parking System in Vilnius – Final Report*” (**RE 16**). In this Final Report, Tebodin concluded that “*the Egapris proposal generates higher risk to Vilnius Municipality. The quality provided to Vilnius’ residents a[n]d other system users will be lower and the risk of inconvenience is therefore higher. The parking offered by GETRAS may be constructed without any increased risk, following the rules for parking design (by the European Parking Association).*[...]”
58. A new commission created by the City, known as the “Investment Development Commission” (the “Commission”), in turn, issued the following recommendation:
- Considering evaluation done by international experts, to suggest to Vilnius city Board to approve consortium Vilniaus miesto urbanistinis vystymas (enterprise Getras, share company Ekinsta, private limited liability company Savy, share company bank Hermis, Lietuvos vystymo bankas) as a further negotiation partner in the contest of Investment Development regarding creation of Vilnius city parking lots system [(RE 16)].*
59. The City thereafter instructed that a second stage of negotiations take place with the above-mentioned two entities (Egapris and the Getras Consortium) under the existing tender. Indeed, on 10 September 1998, the Board of Vilnius City issued the following Decision No. 1709V:

1. *To approve the consortium Vilniaus miesto urbanistinis vystymas (company Getras, public company Ekinsta, private company Savy, share company bankas Hermis, Lithuanian Development Bank) and private company Egapris as further partners of negotiations in the Investment development tender for the development of Vilnius city car parking system.*
  2. *To obligate the commission for organization of investment development tenders to select, by 10 October 1998, one object at a time from the 1st stage of Multi-storey parking investment project program for technical planning in the following manner: 1) consortium Vilniaus urbanistinis vystymas, 2) private company Egapris [(RE 19)].*
60. The City then transferred the responsibility of the tender process to the Commission and replaced Tebodin with a German firm, MAS Consult, which was to provide services with respect to further submissions by Egapris and the Getras Consortium (RE 22).
61. In the course of a meeting held in March 1999, the Bidders advised the City that they did *“not agree to construct multi-storey parking lots without being entitled to manage the on-street parking system”* (RE 24). The City agreed to grant to the Bidders the management of the on-street parking system as well.

#### 4.1.2 Parkerings

62. Parkerings was established in 1996. The founder and managing director of Parkerings since 1999 is Roger Skaug. Parkerings' majority shareholder, through the majority holding in Indre by Eindom AS, is Skips AS Tudor (“Skips”), an investment firm with a diversified industrial portfolio ultimately controlled by Mr. Wilhelm Wilhelmsen. Mr. Wilhelmsen is a well-known Norwegian entrepreneur and chairman of the Wilh. Wilhelmsen Group, a publicly listed conglomerate and a global leader in the car carrier industry. Skips acquired its participation in Eindom AS/Parkerings from Conceptor, a Norwegian development company, in December 2000.
63. With a view to participating in the Vilnius Tender, Parkerings incorporated Baltijos Parkingas UAB (“BP”), its wholly-owned Lithuanian subsidiary (CE 195).
64. On 8 April 1999, Egapris informed the City that BP would join the Egapris bid. A power of attorney signed on that date indicated that Egapris authorized, *inter alia*, “Mr. Jonas Tamulis – the consultant of UAB ‘Baltijos Parkingas’, ” and “Mr. Roger Skaug – the director of ‘Parkerings – Compagnies AS” to “lead negotiations regarding ‘Vilnius City on-street parking and construction of multi-storey car parks and creation of a unified system’ conducted by the municipality” (RE 25). A consortium agreement (the “Consortium Agreement”) was signed by Egapris and BP on 14 April 1999. Egapris and BP thereafter formed the “Egapris Consortium” (RE 26). The Consortium Agreement provided, *inter alia*, the following:
1. *By this agreement the Parties agree to establish a consortium and to participate jointly as consortium in the tender for the design, establishment and implementation of Vilnius City parking system announced by Vilnius City municipality, in such a way broadening financial and technical possibilities to satisfy the tender requirements.*
  2. *The Parties agree that from now on the Consortium shall participate in the tender, shall render offers and carry on negotiations as indivisible person, instead of UAB*

*“Egapris”, all the rights and obligations whereof related with the participation in the tender, shall be transferred to the Consortium.*

3. *The Parties undertake to jointly participate in negotiations with the representatives of Vilnius City municipality, taking into account the possibilities and aims of each other, by giving the preference to reasonable agreement to render efforts to the municipality only after agreement on the joint implementation, financial and technical sources thereof. The negotiations shall be carried out by the joint negotiation group [...].*
4. *The shareholders of UAB “Baltijos parkingas” – Parkerings Compagniet AS, a Norwegian enterprise, shall render technical consultations to consortium and provide the consortium with know-how, necessary for the successful completion of negotiations and implementation of the agreement with the City. UAB “Baltijos parkingas” shall be responsible for preparing all information and proposal as required by Vilnius City Municipality. UAB “Egapris” shall provide all required information on the company and technical information on equipment planned to be used. [...] [(RE 26)]*

65. In April 1999, UAB Savy left the Getras Consortium.

#### **4.1.3 The Award of the Bid to the Egapris Consortium**

66. On 25 May 1999, the Getras Consortium, on the one hand, and the Egapris Consortium, on the other hand, submitted summary letters outlining the terms of their final proposals.

67. The proposal prepared by the Getras Consortium read as follows:

6. *Investment obligations*
  - 6.1 *The construction of multi-storey car parks:*
    - 6.1.1 *The Consortium obliges to construct approximately 14 multi-storey car parks, i.e. to create approximately 5300 multi-storey parking places, taking into consideration the prepared Vilnius city parking plan.*
    - 6.1.2 *The Consortium obliges to project and construct not less than a minimal number (2) of multi-storey car parks within one year from the beginning of the construction works.*
    - 6.1.3 *The Consortium obliges to construct approximately 14 multi-storey car parks within 8 years from the beginning of the construction of the first two car parks, taking into consideration the prepared Vilnius city parking plan and the commercial validity.*
    - 6.1.4 *The Consortium obliges to invest necessary funds, not less than 120 million Litas, into the construction of multi-storey car parks during the defined period.*
    - 6.1.5 *The Consortium obliges to perform all necessary investments and works related to the construction of multi-storey car parks under the approved parking plan and schedule.*
  - 6.2 *The Consortium obliges to install ticket machines, serving for on-street parking places in Vilnius city under the plan and requirements, approved by the Municipality.*
    - 6.2.1 *The Consortium obliges to install 1 ticket machine for 15 on-street parking places. Ticket machines will be installed within 3 months after the signing of the Agreement, after interception of parking activities from SP UAB “Komunalinis ūkis”. [(emphasis added)]*

- 6.2.2 *The Consortium obliges to perform all other investments related to on-street parking under the parking plan, approved by the Municipality.*
- 6.2.3 *The Consortium obliges to invest not less than 1800 Litass for one available and to be created in the future on-street parking place.*
- 6.3 *The Consortium obliges to invest into the development of car parks, transferred under the exploitation agreement.*
- 6.4 *All investments into the development of the parking system, established in the Agreement, will be performed by declaring contests (including for constructional works and machinery supply).*

[...] [(RE 27)]

68. In turn, the proposal dated 25 May 1999, prepared by the Egapris Consortium read as follows:

- 6. *Investment obligations*
  - 6.1 *Construction of multi-storey car parks:*
    - 6.1.1 *The Consortium undertakes to construct not less than 10 multi-storey car parks, i.e. to develop not less than 3000 multi-storey parking places.*
    - 6.1.2 *The Consortium undertakes to start designing a minimum number (2) of multi-storey car parks immediately after the Signature of this Agreement and to commence their construction immediately after receipt or permits from relevant institutions and the Municipality.*
    - 6.1.3 *The Consortium undertakes to construct not less than two multi-storey car parks each year starting from 2000, subject to the general parking plan.*
    - 6.1.4 *During a defined period of time, the Consortium undertakes to invest in the construction of multi-storey car parks not less than LTL 140 million. This period will depend on the terms for approval of the general parking plan, the results of the pre-project works and the possibility to obtain requisite building permits from relevant institutions.*
    - 6.1.5 *The Consortium undertakes to make all necessary investments and to perform the works all in connection with the constitution of multi-storey parking lots according to the approved parking plan.*
  - 6.2 *The Consortium undertakes to install ticket machines serving the on-street parking places in the city of Vilnius according to the requirements approved by the Municipality, ensuring the possibility to make settlements in cash and by different types of cards.*
    - 6.2.1 *The Consortium undertakes to install, within 6 months as from the signature date of the Agreement, requisite number of ticket machines in the currently existing on-street parking places.*
    - 6.2.2 *The Consortium undertakes to install in Vilnius city, within 24 months as from the signature date of the Agreement, not less than 350 ticket machines according to the parking plan approved by the Municipality.*
    - 6.2.3 *The Consortium undertakes to install in total not less than 350 ticket machines in Vilnius city and to place 1100 parking signs according to the parking plan approved by the Municipality, upon receipt of relevant permits from the Municipality, the Police and other institutions.*
    - 6.2.4 *The Consortium undertakes to make other investments relating to the on-street parking according to the parking plan approved by the Municipality.*
    - 6.2.5 *The Consortium undertakes to invest not less than LTL 10,3 million in the on-street parking.*

6.2.6 *The Consortium will seek to build not less than 6000 on-street parking lots within the 5 years period.*

6.3 *All investment in the development of the parking system contemplated in this Agreement will be made by way of tender (Including tenders for construction and equipment supply works).*

[...] [(RE 28)]

69. MAS Consult thereafter issued a report recommending that the City refrain from naming a winner (RE 29). With respect to the technical aspects of the project, MAS Consult stated that *“it is foreseen that the awarded tender will have to construct and develop 3,000 multi-storey parking spaces, as well as to automate and manage 6,000 on-street parking spaces (the data may be corrected in the process of preparation of the parking layout)”* (RE 29).
70. On 6 June 1999, the Commission, on the other hand, *“approve[d] the position suggested by the negotiation group to orientate in further negotiations to a 10-year agreement validity term [...]”* (RE 30). The Commission concluded that *“taking into consideration the agreement validity terms suggested by the consortium of UAB Egapris and UAB Baltijos parkingai and the consortium Vilniaus miesto urbanistinis vystymas [...], and having adopted the initial position regarding the agreement validity term [mentioned above], the proposal of the consortium of UAB Egapris and UAB Baltijos parkingai [was] more favourable to Vilnius City Municipality”* (RE 30). The Commission therefore resolved to *“recommend to the committees of Vilnius City Council and the Board of Vilnius City to consider the possibility of negotiations on the conditions of the agreement with the consortium of UAB Egapris and UAB Baltijos parkingai, and to familiarize them with the proposals made by the consortium Vilniaus miesto urbanistinis vystymas”* (RE 30).
71. On 29 July 1999, the Egapris Consortium sent to the City a first draft agreement (the “First Draft” ). Article 7.3 read: *“The Municipality undertakes to insure the investments of the Consortium partners against political risk”* (RE 33).
72. By decision No. 1478V issued on 19 August 1999, the Board of the City of Vilnius *“approve[d] the Consortium of UAB Egapris and UAB Baltijos parkingas as further partner of negotiations regarding the creation of conditions for development of Vilnius city parking system”* (RE 35), thus awarding the bid to the Egapris Consortium.

## **4.2 THE AGREEMENT BETWEEN THE EGAPRIS CONSORTIUM AND THE VILNIUS MUNICIPALITY**

### **4.2.1 The Negotiations Regarding the Agreement**

73. In the course of a negotiation meeting held on 19 October 1999, the representatives of the Municipality, UAB Komunalinis ūkis, MAS Consult, and the Egapris Consortium discussed the issue of the *“collection of parking fee and distribution thereof between the Municipality and the Consortium”* (RE 36). According to the minutes of this meeting, it was *“proposed to divide the parking fee in pay parking places into two parts – local charges for the Municipality and the fee for the Consortium; the relative part of the local charge, as compared to the total fee, will be defined in further stages of*



*negotiation; it will be approved by Vilnius City Council; [...]* (RE 36). The solution proposed for the on-street parking concession was thus that of a hybrid fee, according to which the parking fee would be divided into a local parking fee component, on the one hand, which the Egapris Consortium would collect for the City and give to the latter in its entirety, and a service fee component, on the other hand, which would not be a parking fee and which the Egapris Consortium would therefore be entitled to keep.

74. During meetings held on 23 and 28 October 1999, the issue of the “*mechanism and legal grounds for granting land to the Consortium for construction of multi-storey car parks*” was discussed (RE 37 and RE 38).
75. According to the minutes of the meeting of 23 October 1999, it was resolved that “*the negotiation group of VCM [“Vilnius City Municipality”] [would] analyse the draft ‘Basic provisions of the Joint Venture Agreement’ submitted by the Consortium, defining the proposals of the latter regarding granting of land for the construction of multi-storey car parks, and [would] submit its comments and recommendations*” (RE 37).
76. At the meeting of 28 October 1999 regarding the “*use of land plots intended for multi-storey car parks and the obligations of VCM and the Consortium relating thereto,*” “*VCM propose[d] that all multi-storey car parks be considered as infrastructure objects and that formation of land plots in the location of the parking lots be postponed until the expiry of the agreement with the Consortium. The Consortium [, in turn] wishe[d] that VCM prepared a project anticipating the mechanism of such land use, which would be analysed by the Consortium and which would be discussed in the course of further negotiations*” (RE 38).
77. On 20 December 1999, MAS Consult issued a “*Report on negotiations with the Consortium of UAB Egapris and UAB Baltijos Parkingas*”. The report provided that (RE 39):

2.3.1 *The Consortium shall:*

- *work out the parking plan on the basis whereof the parking system will be developed;*
- *develop the parking system in the manner defined in the Agreement and the parking plan as approved by the Municipality:*
  - *Building at least 450 ticket machines;*
  - *Building of at least 10 multi-storey car parks*
  - *Co-ordination of all actions with the Municipality and performance thereof in the manner prescribed by the European Standards;*

2.3.2 *The Municipality shall:*

- *consider and determine the changes in the level of public parking order and the fees, consider and adopt the decisions regarding the normative acts and issues relating to parking, adopt the decision on the approval of the parking plan;*
- *provide the Consortium with the full information requisite for the preparation of the parking plan, as well as the information concerning the existing parking system, give necessary assistance and ensure participation of its employees in the preparation of the parking plan;*

- *transfer the right to the Consortium allowing to collect local charges in the street parking place and set the limits of the extra fee that can be collected by the Consortium for the parking.*

78. On 28 December 1999, the Sorainen Law Office issued, at the City's request, a legal opinion (the "Sorainen Memo"), based on the "legal acts of the Republic of Lithuania which were in effect on December 27, 1999" (CE 11). This Memo discussed, in particular, the issue of the legality of the hybrid fee, stating, in substance, that Lithuanian courts were likely to view both components of the parking fee as a unitary whole and, therefore, to consider them as being regulated by the Law on Fees and Charges. According to the Sorainen Memo, if the fee were to be treated as a unitary whole, then the collection of money by the Egapris Consortium would be contrary to the law, due to the fact that the initial tender did not provide for such payment to be made to the concessionaire by the City. Indeed, with respect to this issue, the Sorainen Memo opined the following:

*[...] In view of the provisions of Article 5.1.3 of the Agreement, a conclusion should be drawn that the local fee, which, in accordance with Articles 2 and 3 of the Law on [sic] of the Republic of Lithuania on Local Fees, may be fixed for the time vehicles were parked in the on-street parking places designated by the Vilnius City Council, will be comprised partly for the vehicle parking time in the public on-street parking places designated by the Vilnius City Council. In this instance, the legal basis of the remaining part of the fee for the vehicle parking time in the on-street parking places designated by the Vilnius City Council, which in accordance to Article 5.1.3 of the Agreement goes to the Consortium, becomes questionable.*

*We are of the opinion that any tax, fee or payment of any kind, which is paid or is demanded to be paid, including the exceptions applied to certain person categories, for the vehicle parking time in on-street parking places designated by the Vilnius City Council, is the regulatory subject-matter of the aforementioned Law on the Republic of Lithuania on Local Fees, and should be considered the local fee, as it is defined in Article 2 of the same Law with all the ensuing consequences (Article 7 of the aforementioned Law).*

*While analyzing the legality of the commitment of the Municipality to transfer the right to collect a fee for vehicle parking time and for violations of the Parking Regulations for on-street parking places designated by the Vilnius City Council, we draw the conclusion that the legal acts of the Republic of Lithuania do not create any legal obstacles to make such a commitment and exercise its existing right, which is a precondition of such obligation.*

*Whereas the legal basis of the fee, which goes to the Consortium according to articles 5.1.3-5.1.7 of the Agreement for the vehicle parking time for on-street parking places designated by the Municipality Council, raises doubts. Such conclusion shall be drawn due to the following reasons, listed hereinafter:*

- 1) *Vehicle parking lots are the property, which belongs to the Municipality by the Public property right, which was obtained by basis of the Law on State property transfers to the property of Municipalities based on Law or created anew;*
- 2) *The Consortium does not obtain ownership of vehicle parking lots on the grounds of the Law on Lease or other grounds to administrate the property, for the usage of which the arbitrary fee may be collected from users of parking places.*
- 3) *Any fee or other payment for vehicle on-street parking places designated by the Vilnius City Council, in our opinion, is the regulatory subject-matter of the Law of the Republic of Lithuania on Local Fees, and should be considered a local fee, as it is defined in Article 2 of the same Law.*

*In view of what was presented in clause 3 hereinbefore, we would take the view that the legal acts of the Republic of Lithuania and contractual deeds and obligations, indicated in*

*the Agreement of the Municipality and the Consortium, do not create sufficient and clear legal ground for the Consortium to have a right to collect a portion of the fee for vehicle parking time for on-street parking places designated by the Municipal Council, which is derived from the entire fee, established in Article 5.1.3, less local charges approved by the Municipality Council. [...] [(CE 11)]*

79. On the other hand, a legal opinion prepared of 29 December 1999 by Lideika, Petrauskas, Valiūnas ir Partneriai (or “Lawin” firm), the Lithuanian legal counsel of the Egapris Consortium, provided that the hybrid fee was in accordance with the law. Indeed, this opinion provided the following:

*Following your request, we would like to comment the legal situation relating to collection of payment for car parking in places designated by the Municipality (streets and squares). The agreement between Vilnius City Municipality and the Consortium establishes that such payment will consist of local charges and the portion of payment falling on the Consortium.*

*The portion of payment falling on the Consortium is to be legally qualified as payment for service, which will be rendered by the Consortium to car drivers. The scope of this service is the development of parking system in the city and its administering. Car parking in pay place is to be qualified as a behaviour of a driver expressing his/her will to use the service rendered by the Consortium and to pay for it according to the rate set by the Consortium [(RE 40)].*

80. On 29 December 1999, the Vilnius City Council adopted Decision No. 482, approving the draft agreement between the parties, and authorizing Mayor Imbrasas to sign the agreement with the Egapris Consortium on behalf of the Municipality (CE 12). On the same day, the City also adopted Decision No. 483 regarding the performance of the Agreement (RE 41).

#### **4.2.2 The Agreement**

81. On 30 December 1999, the Egapris Consortium and the Municipality signed an agreement (“the Agreement”)(CE 13). The Agreement was signed by each of the Egapris Consortium members. According to the Agreement, BP and Egapris were jointly and severally liable for the Egapris Consortium’s performance of the Agreement (Article 1.2 of the Agreement).
82. The Agreement pertained to the creation, development, maintenance and enforcement of the public parking system in the City of Vilnius. More specifically, the Agreement provided for an exclusive concession to operate the city’s street parking and to operate ten MSCP.
83. The Consortium was granted an exclusive right to act as a “sole partner of the Municipality” for the organization, maintenance, development and enforcement of the public parking system in the areas of the City of Vilnius designated by the Agreement. Article 1.2 of the Agreement defined the terms “sole partner of the Municipality” as “a person, that is granted the exclusive rights to collect local charges and penalties for violation of parking regulations in the streets and squares as established in the city Council, and to construct multi-storey car parks in the locations specified in Annex No. 1 to this Agreement.”

84. Thus, the Egapris Consortium was granted an exclusive thirteen-year right to operate all the street parking, that is specifically to collect the parking fees, and to enforce the parking regulations namely through the clamping of vehicles. With respect to the Consortium's right to enforce parking regulations through clamping, the Agreement foresaw the transition to a fine system as soon as the applicable legislation would have been passed (Article 5.3.4 of the Agreement).

85. With respect to the parties' liability, Article 7.2.1 of the Agreement provided the following:

*The liability of the Parties deriving from the terms and conditions of the present Agreement is understood as responsibility for the actions of the Party itself or failure to perform such actions due to which the undertakings of the Party will not be properly, fully and in due time fulfilled. Neither Party shall be liable and no sanctions shall be imposed on it if the breaches of this Agreement will occur due to the actions or failure to act by the other Party or any other third party, as well as due to irresistible forces (force majeure), as defined in the Government Resolution No. 840 "On the Approval of Rules for Release from Liability due to Irresistible Forces (force majeure)" dated 15 July, 1996.*

86. The latter Resolution provided the following:

1. *The term "force majeure" shall serve to define extraordinary circumstances that cannot be foreseen or avoided, or removed by using any means.*

[...]

2. *A party shall not be financially held liable for failure to perform any of its obligations if it is capable of proving that:*

2.1 *it has failed to fulfill the obligations due to the obstacle being beyond its control;*

2.2 *it cannot be anticipated that at the moment of entering into the contract the party could have foreseen that obstacle or its [e]ffect on the ability to perform the obligations;*

2.3 *it could not avoid or overcome the obstacle or at least its effect;*

3. *The obstacles, mentioned in clause 2 hereof, may arise as a result of the following events below:*

[...]

3.5 *lawful or unlawful acts of state government institutions (except for those acts which, pursuant to other contractual provisions, were taken by a party requesting release from liability [...]) [(RE 5)].*

#### **4.2.2.1 The Consortium's Obligations under the Agreement**

87. Under the Agreement, the Consortium was to comply, *inter alia*, with the following main obligations.

88. First, the Consortium was to "*initiate, prepare, co-ordinate and submit to Vilnius city Council for approval a plan of public parking system in Vilnius city [(the "Parking Plan")]* [...]" (Article 1.4.2 of the Agreement; see also Article 2.1.1 of the Agreement). The Parking Plan was to "*include parking signs, parking zones, the recommended fee structure, parking control and regulations, and conditions and priorities for construction of multi-storey car parks. Upon preparation and approval of the Parking plan the*

*Parties [were to] agree upon its implementation schedule” (Article 1.4.2 of the Agreement). “ The objective of the Parties [was] to design a plan which [could] provide the basis for a detailed regulation of traffic flow and parking” (Article 2.1.3 of the Agreement).*

89. The Consortium was to create, manage and operate the “*public parking system for Vilnius city, including installation of ticket machines and construction of multi-storey car parks, complying with the Standards; [...] invest into the present parking system in order to establish the public parking system and structure of Vilnius city in accordance with the approved plan, terms and conditions of this Agreement; [and] plan and design the modifications of the current parking system in accordance with the Agreement and the approved Parking plan and carry out the investments related thereto*” (Article 1.4.2 of the Agreement).
90. The key elements of the so-called “Investment Program” were the following:
- *the Consortium constructs multi-storey car parks – no less than 10 in total;*
  - *the Consortium improves the current street parking system (purchases and installs equipment, trains the employees, purchases other equipment, including IT hardware, vehicles etc.);*
  - *the Consortium installs 450 new ticket machines with the terms established in the schedule of implementation of the Parking plan;*
  - *the Consortium installs new parking signs and traffic flow control signs – approximately 1050 signs;*
  - *the Consortium creates integrated parking information system;*
  - *the Consortium develops the street parking system according to the Standards and this Agreement;*
  - *the Consortium develops the street infrastructure according to this Agreement, the Joint Activity Agreement and the approved Parking plan (Sub-Clause 4.1.1 of the Agreement). (CE 13, Article 4.1.1)*
91. With respect to MSCP, the Consortium had to “*plan, design, and construct multi-storey car parks in accordance with the laws and regulations of the Republic of Lithuania and in a line with this Agreement, the Parking plan and its implementation schedule in order to develop an adequate car parking structure and capacity*” (Sub-Clause 1.4.2 of the Agreement). The Consortium was to construct no less than ten MSCP in the city of Vilnius, “*two [...] every year during the life-time of this Agreement, except for the first year*” (Article 4.4.5 of the Agreement), in the locations specified in Annex No. 1 to the Agreement. The full ownership of the MSCP was to be retained by the Consortium (**CE 13**).
92. The Agreement provided the following with respect to the planning and construction process of the MSCP:
- 4.4.2 After the Municipality issues the full collection of the design conditions, in each individual case the parties shall sign the Joint Activity Agreement, [...] in the form of Annex No. 8. [setting forth the time allocated for the design and construction of the MSCP] [...].*

4.4.3 *Not later than within 9 months after the Joint Activity Agreement is signed, unless the shorter term is established in the Joint Activity Agreement, the Consortium shall prepare and co-ordinate the design project of a multi-storey car park [which] shall be submitted to the Municipality. After the design projects are approved, the Municipality, with the participation of the Consortium, shall obtain construction permits in the name of itself and/or the Consortium, or the Consortium, with the participation of the Municipality, shall obtain construction permits in the name of itself and/or the Municipality.*

4.4.4 *After the Municipality obtains the construction permits in the name of the Municipality and/or Consortium [...], the [latter] shall construct said car parks in accordance with this Agreement and the Joint Activity Agreement [...], and shall ensure that the multi-storey car parks are constructed and made ready for use pursuant to the Procedure for Approving of the Constructions for Use STR.1 1.01:1996, approved by Order No. 108 of the Ministry of Construction and Urban Development as of 23 August 1996, and not later than within 24 months after the construction permits were issued, unless the Joint Activity Agreement provides for the shorter period.*

[...]

4.4.8 *Within [twenty] one day after the date of this Agreement, the Consortium shall evaluate the preliminary locations for construction of multi-storey car parks specified in Annex No. 1, and shall indicate two locations for which the detailed plans are already prepared and shall file applications for the issue of design conditions. The Municipality of Vilnius City shall, upon receipt of the application submitted by the Consortium, issue to the Consortium the collections of the design conditions for the specified locations, whereupon the Consortium shall commence the design works under the terms of this Agreement.*

93. *With respect to street parking, “the Consortium [undertook] to install 450 new ticket machines within the period established in the schedule of implementation of the Parking plan in the spaces of the streets and squares of Vilnius City which locations are defined by the Decision of the Vilnius city Council and correspond to the parking program. [...] The additional locations of the streets and squares where the Consortium shall be granted the right to collect payments for the parking of vehicles, shall be established by the Decision of the Vilnius City Council in accordance with the Parking plan approved according to the established procedure after the ticket machines in the above mentioned places are installed by the Consortium accordingly with the schedule of implementation of the parking plan” (Articles 4.3.1 and 4.3.2 of the Agreement).*

#### **4.2.2.2 The Municipality’s Obligations under the Agreement**

94. *Article 1.5.1 of the Agreement provided that “in order to achieve its aims and create favourable conditions for the Consortium to fulfill its obligations under this Agreement, the Municipality shall, within the [?] time limits of its competence, undertake the following:”*

- *to consider and establish the public parking order in the city and the adjustments of parking fee level taking into account suggestions and recommendations made by the Consortium and the needs of the city’s population;*
- *to refrain from any amendments to the present city parking order that would deteriorate the Consortium’s possibilities and conditions for implementing of its obligations hereunder. This obligation does not include the adjustments to local duties if such adjustments are made before March 1, 2000, in accordance with the conditions of this Agreement;*

- *to assign to the Consortium the right to collect local charges established by the Vilnius city Municipality Council, including penalties imposed for the violation of the parking order, in the streets and squares as defined by the Vilnius city Council in accordance with the conditions of this Agreement and the approved parking plan;*
- *within one month from the date of coming into force of the Agreement to hand over to the Consortium all necessary information (agreements for use of the parking spaces) related to the parking in the streets and squares specified in Annex No. 4 to this Agreement [(Annex No.4: list of streets and squares in which car-parks have been equipped pursuant to the established procedure and in which the Consortium, consisting of UAB Baltijos parkingas and UAB Egapris, will have the right to collect local duty, clamp vehicles for the non-observance of the provisions relating to the Collection of Charges established for the owners of the vehicles (drivers) for the use by the latter of watched car-parks in the streets and squares of Vilnius and to collect charges for the unclamping of the vehicles)];*
- *timely and in accordance with appropriate procedure to consider legislative and regulatory issues related to parking, including parking signs, penalty level and structure (clamping, other means of blocking of the vehicle or a fine charge notice);*
- *in accordance with the terms and conditions of this Agreement and valid legal acts to consider and make decisions regarding the approval of the public parking system plan as worked out by the Consortium;*
- *to ensure the way of use of the land plots, permits and approvals necessary for the construction of multi-storey car parks in accordance with the conditions of the Joint Activity Agreement attached as Annex No. 8 hereto;*
- *to consider and determine the fee structure and fee rates for street and ground parking in accordance with the conditions and procedure established by this Agreement;*
- *to ensure the service rendering according to the city maintenance and cleaning rules;*
- *to use all its efforts in order to ensure that the necessary decisions of the institutions not subordinated to the Municipality are taken for successful development of the parking system (including appropriate modifications of the laws and other statutory acts, relevant traffic signs, fee levels and structure, use of land and other relevant issues);*
- *to provide the Consortium with all information necessary for drawing up of the Parking plan which information is defined in Annex No. 3, or provide with a possibility to get access to such information and photocopy it, and to ensure the participation of appropriate Municipality's subdivisions within the limits of their competence in the process of the drawing up of such plan. The Parties understand that the Municipality does not possess all the information necessary for the drawing up of the plan and that this may affect the quality of the Parking plan;*
- *not to extend agreements concluded prior to the Agreement, if that does not constitute the breach of such agreement, and to refrain from making any new agreements that would impede creation of the unified parking system in the city according to the conditions of this Agreement;*
- *to provide the Consortium with the possibility to use the city GIS in the process of drawing up the Parking plan;*
- *to fulfill all other obligations under this Agreement.*

95. The Agreement specifically provided, under Article 1.5.2 *in fine*, that “*undertakings of the Municipality shall be limited to the scope of its competence, or the competence of institutions subordinated to it.*”

#### **4.2.2.3 Revenue Sharing Mechanism under the Agreement**

96. The Consortium - which had to prepare the Parking Plan - was responsible for the equity and debt financing for the construction of the MSCP and the establishment of the Parking Plan. In order to ensure that the Consortium would obtain a reasonable return on its investments, Article 5 of the Agreement provided that the proceeds of the maintenance and enforcement of the Vilnius public parking system would be shared among the parties to the Agreement. The Consortium was entitled to three different income streams.
97. First, in accordance with its exclusive right to operate for thirteen years all the street parking in the city, collect the parking fees, and enforce the parking regulations through the clamping of vehicles, the Consortium was entitled to a service fee portion of the public parking fee that it was to collect. The public parking fee indeed consisted contractually of two elements: a local charge for the Municipality and a service fee for the Consortium.
98. With respect to the determination of the local charge and the service fee, Articles 5.1.1, 5.1.2, and 5.1.3 of the Agreement provided that *“the Consortium shall collect charges established by the Vilnius City Council for the duration of parking in the places of streets and squares that are determined by the Municipality Council, and shall transfer such charges to the account indicated by the Vilnius City Municipality. [...] The local charges for the parking time of the vehicles in the places of streets and squares that are determined by the Municipality Council shall be fixed by the Vilnius City Council according to the Law On Local Charges for the Republic of Lithuania. [...] The local charges constitute a part of the parking fee for the parking time in the places of streets and squares that are determined by the Vilnius City Council. The other part of the parking fee falls upon the Consortium.”* The part of the fee that was allowed to the Consortium thus depended on the amount of the local charge for one hour of parking established by the Vilnius City Council, its ceiling being fixed in the Agreement under Article 5.1.3.
99. The service fee was to be fixed either by the Consortium, in which case it was to be calculated in accordance with the provisions of Articles 5.1.3.1 through 5.1.3.5 of the Agreement, or by separate agreement between the parties, in which case it was to be calculated in accordance with Article 5.1.4 of the Agreement. The Consortium was to collect the entire amount and then transfer the portion corresponding to the local charges to the Municipality.
100. Second, the Consortium was entitled to the full amount of the parking fees it would collect in MSCP.
101. In this respect, Article 3.1.5 of the Agreement provided that *“multi-storey car parks constructed shall not be transferred to the Municipality, and they will remain the property of the Consortium or its members. All rights regarding management and operation of the multi-storey car parks shall be retained by the Consortium or the companies established by it.”* According to the Agreement, there was no time limitation



on the right to operate MSCPs. Furthermore, Article 5.1.9 of the Agreement stipulated that “*the parking fee for the parking time in the multi-storey car parks owned by the Consortium shall be fixed by the Consortium.*”

102. Third, the Consortium was entitled to seventy percent of unclamping charges. It was the Consortium’s right to enforce parking regulations thus generating an independent revenue stream. Indeed, the Agreement granted to the Consortium the right to collect “clamping fees” for the release of each clamped vehicle, seventy per cent of which the Consortium was entitled to keep, the remaining thirty per cent going to the Municipality.

103. In this respect, Articles 5.1.11, 5.1.12, and 5.1.13 of the Agreement provided the following:

*The Consortium shall as from the day it is granted the right to collect local charges in accordance with Item 5.1.6, be obliged to clamp the vehicle by technical means or limit the usage of the vehicle by other means established by statutory acts, if the vehicle owner has failed to pay according to the established procedure prescribed for parking in the payable parking places or has parked the vehicle in violation of the rules of parking established for the places specified in Annex No. 4 to this Agreement. The Consortium shall, as from the day on which it is entitled to collect legal charges according to Item 5.1.6 hereof, collect the fee from vehicle owners in the streets and squares as indicated in Annex No. 4 to this Agreement for unclamping of the vehicles, which fee shall be based on tariffs approved by the Vilnius City Council [...]. The Consortium shall be obliged to transfer 30 per cent of the collected fee for unclamping to the account indicated by the Vilnius City Municipality for every month in arrears until the tenth day of the next month.*

104. The Agreement provided that the transition to a fining system would occur “*as soon as there is a legal base and the technical means of state authorities create appropriate conditions*” (Article 5.3.4 of the Agreement).

105. In accordance with the above, the Consortium thus undertook to pay to the City:

- a fixed fee of LTL 200,000 (EUR 57,924) to be paid in equal monthly installments (Article 5.1.14 of the Agreement);
- thirty percent of the fees collected by the Consortium in connection with the unclamping of vehicles that would have failed to pay the parking fees;
- Additionally, Article 5.1.15 of the Agreement provided that

*In case the aggregated sum of the revenues received in the financial year by the Municipality under Items 5.1.1, 5.1.13 and 5.1.14 of this Agreement is less than 1.000.000 Litas, the fixed amount established in Item 5.1.14 shall be increased by such amount that the annual revenue of the Municipality received under Items 5.1.13 and 5.1.14 equals to 1.000.000 Litas. The consortium undertakes within 30 days after the end of the financial year to transfer to the account indicated by the Vilnius City Municipality the sum equal to the amount by which the fixed amount established in Item 5.1.14 is increased.*

#### **4.2.3 The incorporation of the Operator**

106. According to the Agreement, the Consortium was to establish a management company that would run the street parking concession.

107. Article 1.2 of the Agreement defined the “management company” as

*a private company incorporated by the Consortium in accordance with Item 3.1.3 of [the] Agreement that shall own the ticket machines installed in accordance with the Agreement, integrated management information system and other resources needed for operation of the parking system and collection of the local charge for the public parking of vehicles in the city of Vilnius.*

108. On 28 January 2000, BP and Egapris entered into an Agreement on Business Principles (the “ABP,” **CE 14**) to allocate to each of the Consortium members the functions, responsibilities and liabilities related to the exercise of the Consortium’s rights and obligations under the Agreement. One of the purposes of the ABP was to provide a determination on the issue of ownership of the above-mentioned management company.

109. The ABP granted BP the right to incorporate and operate the project management company that would be responsible for the performance of all of the obligations of the Egapris Consortium under the Agreement, except the construction of MSCP. The Consortium’s rights and duties relating to the construction of the MSCP were to be equally shared by its members. Once duly delivered, all the MSCP would be leased to the project management company.

110. It was agreed in the ABP that BP would incorporate the management company Vilniaus Parkavimo Kompanija (“VPK”).

111. Pursuant to Sub-Clause 1.3 of the ABP,

*With effect from the date of the Company’s registration and up until the execution by EGAPRIS of the Call Option referred in clause 2 below, BP shall be sole and lawful successor to all the rights and obligations assumed by Consortium under the Agreement with Municipality in respect to management operation of the Management Company.*

112. It was agreed that Egapris would have the right to purchase 49 percent of VPK from BP for LTL 1,960,000 (EUR 567,655) (Call Option) (Article 2.4 of the ABP).

113. Egapris could also waive its right to purchase the VPK shares in exchange for a payment from BP of LTL 4,000,000 (EUR 1,200,000) (Article 2.11 of the ABP). Article 2.12 of the ABP further provided that, should BP fail to pay Egapris the amount due in case of waiver of Egapris’ right to participate, “*out of 1 000 000 (one million) Litass initially contributed by BP for the shares of the Company, 500 000 (five hundred thousand) Litass will be deemed as a penalty for non-performance and will count as having been made for the benefit of Egapris as its contribution/payment for 50% of the shares in the Company. Notwithstanding the above, the rights of the shareholder holding 50% (fifty percent) of the shares in the Company will be granted to Egapris only upon contribution by BP and Egapris in equal sums – 1 500 000 (one million five hundred thousand) Litass each – of the remaining Company’s share issue price.*”

114. On 17 February 2000, BP registered VPK as the project management company in accordance with the “Articles of Association of the Private Company ‘Vilniaus

Parkavimo Kompanija” (the “Articles of Association of VPK,” **CE 23**), paying LTL 4 million into VPK’s capital.

115. On 1<sup>st</sup> February 2000, Egapris notified that it irrevocably and unconditionally waived its right to claim compensation under Article 2.11 of the ABP and also irrevocably declared its decision not to elect to exercise its Call Option provided under Article 2.2 of the ABP (**RE 43**).
116. In January 2001, Egapris purported to exercise the call option. BP however refused to tender the shares. The dispute was taken to court, and on 19 November 2003, the Vilnius district court ruled as follows:

*The court, upon hearing the case,*

*(...)*

*DECIDED:*

*Not to examine a part of the law suit where the Claimant requested:*

- 1) to acknowledge a non performance by the Defendant UAB Baltijos Parkingas of the obligations set forth in Clauses 2.5, 2.10, 2.11 and 2.12 of the Agreement on Business principles made between UAB Egapris and UAB Baltijos Parkingas on January 28, 2000, for which reason the said Agreement was not implemented;*
- 2) to obligate the Defendant to perform the obligations set forth in Clause 2 of the Agreement on Business Principles to execute the agreement on purchase-sale of 50% of the shares of UAB Vilniaus Parkavimo Kompanija;*
- 3) to restitute the violated rights of UAB Egapris to acquire 50% of the shares of UAB Vilniaus Parkavimo Kompanija;*
- 4) to repeal the Loan Agreement No. 144000902069/22 and pledge of 50% of shares of UAB Vilniaus Parkavimo Kompanija, which transactions were made in violation of the Agreement on Business Principles between UAB Egapris and UAB Baltijos Parkingas, as of January 28, 2000.*

*To reject the remaining part of the law suit.*

*[...]*

*This Decision may be appealed against before the Lithuanian Court of Appeals by appeal filed via this court within 30 days [(CE 187)].*

117. On 1 July 2004, however, the Court of Appeals repealed the decision of the court of first instance, and instructed “*Defendant UAB ‘Baltijos parkingas’ [...] to perform the obligation, i.e. to conclude the agreement with Plaintiff UAB ‘Egapris’ [...] regarding sale-purchase of fifty percent (50%) of shares in UAB ‘Vilniaus parkavimo kompanija’ [...] in accordance with the terms laid down in clauses 3.12 and 2.13 of the Agreement on Business Principles (made between UAB ‘Egapris’ and UAB ‘Baltijos parkingas’ on January 28, 2000) and in exchange of consideration of LTL 1 500 000*” (**CE 216**).
118. On 1 March 2000, the Municipality adopted Decision No. 519, determining “*that the collection of local fees and charges shall be effected by UAB Vilniaus Parkavimo Kompanija, established by the Consortium, constituted by UAB Baltijos Parkingas and UAB Egapris,*” and that “*the collection of fees and charges shall be executed by the employees of UAB Vilniaus Parkavimo Kompanija holding the certificates of UAB Vilniaus Parkavimo Kompanija*” (**CE 25**).

### 4.3 LEGALITY OF THE AGREEMENT AND MODIFICATIONS OF LAWS

#### 4.3.1 The legality of the parking fee

119. By letter dated 8 February 2000, the local representative of the National Government in Vilnius<sup>1</sup> (the “Government Representative”) wrote to Mayor Imbrasas, stating that “*certain provisions of the [...] Agreement approved by Vilnius City Council’s Decision No 482 [were] in contradiction with effective laws and regulatory acts*” (CE 17). This Government Representative therefore requested that at the next meeting of the Vilnius City Council, the issue of the amendment or revocation of Decision No 482, which approved the Agreement, be discussed (CE 17; see also CE 18). More specifically, the Government Representative raised the following three issues and provided the following explanations:

*[...] Income received on local fees and charges must be accounted for in the Municipal budget item as “other payments”. However, under the approved Agreement, the Consortium is granted the right to collect a local charge, fixed by the Vilnius City Council, for the duration of parking. Local charge is treated as a constituent element comprising the tax for the duration of parking in the places specified by the Municipality. Another portion of the tax goes to the Consortium; the portion of the tax is defined by the Consortium itself. However, the Law of the Republic of Lithuania on Local Fees and Charges does not provide for the possibility that collection of local charges might be delegated to enterprises; moreover, it does not provide for the possibility that enterprises shall fix the portion of the local charge that goes to them.*

*[...]*

*Under the Agreement on Joint Activity, the Municipality undertakes to ensure that any free plots of state-owned land located in the construction place of the infrastructure object will not be formulated and those plots of land will not go to land sales or lease auctions following the procedure established by the Government Resolution No 692 “On Sales and Lease of New Plots of State-owned Land Designated for Non-agricultural Purposes (activity)” as of 2 June 1999, and none of the third persons will be authorized to use land in the above area or to hindrance management and use of the mentioned land. In addition, the Municipality undertakes to provide the Consortium with a possibility to construct the infrastructure object in the specified place. The Law of the Republic of Lithuania on Construction prescribes that the right of the builder shall be exercised in cases when the builder owns a plot of land or holds and uses it on other grounds established by the laws of the Republic of Lithuania, and the builder has a prepared, in a prescribed manner, and approved design documentation of a construction work, and builder has a construction permit issued in the prescribed manner. Since the Municipality will not formulate new plots of land, and construction permits are issued by the Inspection of Construction of a Construction Work of Administration of County Governor, it might be maintained that construction of multi-storey car parks is in general impossible [(emphasis added)].*

*The main Agreement prescribes that the Consortium shall be sole partner of the Municipality, which is entitled with an exclusive right to collect a local charge and be engaged in construction of multi-storey car parks in the places specified by the Municipality. However, the Law of the Republic of Lithuania on Competition prescribes that any arrangement with the purpose to restrict competition or any arrangement which restricts or might restrict competition shall be prohibited and therefore null and void [(emphasis added)]. [...][(CE 17)]*

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<sup>1</sup> The Government Representative has the constitutional authority and duty to supervise the legality of all municipal acts. Specifically, the Government Representative has to ensure consistency of municipal acts with Lithuanian laws and decrees and protect the rights of individuals and organizations.

120. In the course of a meeting held on 11 February 2000, the Vilnius City Council rejected the Government Representative's request and voted to uphold Decision No. 482 (CE 19). By letter dated 25 February 2000, Mayor Imbrasas informed the Government Representative of the Vilnius City Council's decision to uphold Decision No 482 (CE 24).
121. This decision was supported by a report issued by the Municipality's legal counsel (CE 20).
122. On 8 March 2000, notwithstanding the decision of 11 February 2000 of the Vilnius City Council, the Ministry of Justice of the Republic of Lithuania stated the following in a letter to the Government of the Republic of Lithuania:

*[...] it is assumed that a fee/charge and a tax by nature are different categories. Consequently, local fee/charge cannot be treated as a constituent element of tax. Moreover, the laws do not grant private legal entities the right to collect local fees/charges defined by the Municipal Council. Granting of exclusive rights normally restricts competition within a certain field of activity. Therefore, it is maintained that granting of exclusive rights should neither be in contradiction with the interests of other economic entities nor restrict competition. Therefore, the statements of the Government Representative in Vilnius County, produced in presentation No 2T as of 8 February 2000, with respect to treating a local charge as a constituent element comprising the tax, with respect to delegating to a private legal entity the right to collect local charges, with respect to granting a private legal entity exclusive rights, in our opinion are based on the Law on Local Fees and Charges and the Law on Competition [(emphasis added)] [(CE 27)].*

123. Arguing that "certain provisions of the Contract approved by Vilnius City Municipal Council Decision No. 482 are inconsistent with the applicable laws and secondary legislation," the Government Representative filed, on 9 March 2000, a complaint with the Administrative Court of Vilnius District, requesting that the latter "satisfy the complaint and [...] recognis[e] as invalid and repeal Decision of 29 December 1999 of Vilnius City Council" (CE 28). The Government Representative reiterated the explanations provided in his letter of 8 February 2000, as follows:

*[...] the approved Contract grants the right to the Consortium to collect the local charge established by Vilnius City Municipal Council for car parking time. The local charge is treated as a component part of the fee for car parking time in the areas established by the Council of the Municipality. The other part of the charge is received by the Consortium who determines on its own discretion the amount of charge due to it. However, the Republic of Lithuania Law on Fees and Charges does not provide for the possibility to delegate the collection of local charges to companies, let alone the right to determine the amount of such local charge by such companies themselves.*

*[...] The Law of the Republic of Lithuania promulgates that the builder's right shall be realized after the available land plot acquired by right ownership, lease of any other right provided for by law is prepared, the construction project is coordinated and a construction authorization is acquired in the established manner. In view of the fact that the Municipality will not form new land plots, and authorizations are issued by the Constructions Building Inspectorate of the County Governor's Administration, in general, construction of multi-storey parking areas should be considered as not possible.*

*According to the Framework Contract, the Consortium will be a single partner of the Municipality enjoying exclusive right to collect local charge and construct multi-storey parking areas on the sites designated by Vilnius City Council. The Republic of Lithuania Law on Competition promulgates that all agreements aimed at limiting competition or*

*which limit or might limit competition, shall be prohibited and recognized as null and void as from the moment of their drafting. [...] [(CE 28)]*

124. On 19 May 2000, the Vilnius District Administrative Court issued a decision in which it “resolved [...] to satisfy petition by Government’s Representative in Vilnius District in part [and] repeal the Decision No. 482 of Vilnius City Council as of 29 December 1999 Regarding Approval of the Agreement between Vilnius City Municipality and Consortium formed between UAB Baltijos Parkingas and UAB Egapris to the extent approving Paragraphs 2.4.1, 5.1.3, 5.1.3.1, 5.1.3.2, 5.1.3.3, 5.1.3.4, 5.1.3.5, 5.1.4 and 5.1.13 of the Agreement, as well as paragraph 1 of Article 5 of Joint Activity Agreement under Annex No. 8 hereof” (CE 33).
125. Although this Court rejected the Government Representative’s claim that Lithuanian law prevented the Municipality from giving the parking fee collection service into private concession (the Court stressed that Articles 4.2 and 6.1 of the Law on Local Fees and Charges grant the Municipal Council the right to delegate collection of local charges to other entities), the Court found the hybrid parking fee to be inconsistent with existing laws and regulations. The Court consequently annulled Decision No 482 to the extent that it authorized the Municipality to include in the Agreement provisions considered inconsistent with Lithuanian law, on the basis of the following considerations:

*Under the Agreement between Vilnius City Municipality and Consortium a local charge is treated as a component part of the fee (tax) for car parking time in the areas established by the Council of the Municipality. Such treatment does not correspond to the provisioning of the Law on Tax Administration and the Law on Local Fees and Charges. [...]*

*The Law on Local Fees and Charges does not provide for a possibility to split a local charge into two means of payment – local charge and parking fee (tax) – [and paragraph 4 of Article 3 of the said law] treats the local charge as a single and indivisible. [Besides, according to Article 7] of the said law, income received from local fees and charges shall be credited to the item of other payments of the budget of the municipality. Therefore, a part of Paragraph 2.4.1 of the Agreement establishing transfer from the municipality to the Consortium of the right to collect parking fees, as well as a part of Paragraph 5.1.3 establishing that a local charge is a component part of the parking fee (tax) and that the other part of the charge is received by the Consortium who determines in its own discretion the amount of charge due to it, as well as Paragraphs 5.1.3.1, 5.1.3.2, 5.1.3.3, 5.1.3.4, 5.1.3.5 and 5.1.4 establishing ratio between the local charge due to the municipality and the fee due to the Consortium are not compatible with the law.*

*[...] the said fee for unclamping shall be treated as a variety of the local charge and shall be subject to collection and accounting rules governing local charges. Therefore, Paragraph 5.1.13 of the Agreement, to the extent establishing contribution of 30 per cent of the collected fee for unclamping to the account of municipality, is not compatible with the Law on Tax Administration and the Law on Local Fees and Charges. [...] [(CE 33)]*

126. The Municipality appealed the decision of the Vilnius District Administrative Court, which was repealed in April 2001 by the Supreme Administrative Court, for lack of jurisdiction of the lower court. The Supreme Administrative Court decided to “repeal the Decision passed by Vilnius Administrative Court and hand over the case for a hearing by Vilnius First County Court” (CE 85).

### 4.3.2 The new Law on Fees and Charges

127. On 13 June 2000, the Parliament adopted a new Law on Fees and Charges (the “new Law on Fees and Charges”), which replaced the 1996 Law (see Article 18 of the new Law on Fees and Charges) (**CE 136**). The new Law on Fees and Charges provided, in its Article 11(2) – authorizations subject to local fees and charges – that “*a payer of local fees and charges may not be required to pay for an object on which local fees or charges are levied in any other way than by paying a local fee or charge*”. This new Law further provided, in its Article 13.2, that “*the rates of local fees and charges shall be established in LTL in round numbers.*”

### 4.3.3 The new Law on Clamping

128. On 5 September 2000, the Government passed Decree No. 1056 Regarding Authority to Define and Approve Procedures for Forced Removal or Clamping of Vehicles Using Clamping Devices. This Decree “*authorize[d] the Ministry of Interior to define and approve before the 1<sup>st</sup> of October 2000, the Procedures for Forced Removal or Clamping of Vehicles Using Clamping Devices.*” Decree No. 1056 nullified the Decree of 29 July 1991 Regarding Approval of Regulations of Forced Removal or Clamping of Vehicles (**CE 41**).
129. On 24 November 2000, the Mayor of the Municipality of Vilnius wrote to the Government of the Republic of Lithuania (**CE 56**): “*Upon the entering into force of the present Resolution [the decree No. 1056], municipalities lose their legal basis to block vehicle running gear in cases of paid parking rules violations; rights and functions of municipalities, defined by the Law on Local Fees [...] are violated*”. The Municipality requested the Government to re-authorize the municipalities to regulate clamping on their territory.
130. On 27 November 2001, the Government adopted Decree No. 1426 (**CE 97**). This Decree re-authorized clamping, provided that clamping be done in the presence of a police officer. Indeed, Article 14 of the Decree provided that “*in cases specified in paragraph 13.1 above the vehicles shall be clamped by the police officer using clamping devices, and in cases specified in paragraph 13.2 – by police officer together with the person authorized so by municipality by taking use of the clamping devices provided by municipality.*”
131. On 3 December 2001, BP alleged that it was losing substantial amounts of money as a result of this change in the regulatory system. BP characterized the legislative changes with respect to clamping as a *force majeure* (**CE 98**).
132. On 10 April 2002, the Vilnius City Council implemented Decree No. 1426 through its Decision No. 542 Regarding Partial Amendment of the Vilnius City Council’s Decision No. 151 of 11 September 1996 Regarding Imposition on Vehicle Owners (Drivers) of Duty for the Use of Pay Car Parking Spaces and Parking Lots (**CE 115**). Article 12 of this Decision provided that “*vehicles ignoring the pay parking regulations [...] shall be clamped using mechanical devices. Clamping of vehicles shall be undertaken by a*

*police officer, acting concertedly with an employee of UAB Vilniaus Parkavimo Kompanija possessing a special authorization certificate [...].”*

#### **4.3.4 The amendment of the Law on Self-Government**

133. On 12 October 2000, the Law on Self-Government was amended (**CE 47**). Until then, this Law did not establish, at least not expressly, any restrictions on the ability of municipalities to enter into Agreements on Joint Activity (JAAs) with private entities. Article 9 of the October 2000 version of the Law on Self-Government reads as follows:

1. *Municipalities may exercise other State functions (public administration and public service rendering), which are not provided for in this Law, under contracts concluded with State institutions or agencies. A municipality may conclude such contracts only in the event that the municipal council gives its consent. [...]*
2. *For general purposes a municipality may conclude joint activity contracts or public procurement contracts with State institutions and (or) other municipalities.*

134. Thus, in this new version, the Law on Self-Government restricted the right of municipal authorities to conclude JAAs to other public counterparties only.

#### **4.4 THE PERFORMANCE OF THE AGREEMENT**

##### **4.4.1 The submission of Parking Plans**

135. In the course of a meeting held on 28 January 2000, the Consortium submitted to the Municipality a “*list of information necessary to draft the parking plan*” (**CE 15**).

136. Also in January 2000, “*the Consortium submitted a tender to the Vilnius Development Department of the Vilnius Municipality tender on issuing the technical requirements of construction of the underground parking lot next to the Opera and Ballet Theatre*” (**CE 15**). Each Consortium partner proposed its first site for the construction of a MSCP. BP proposed a site near the Pergales Movie Theatre (the “Pergales MSCP”) and asked the Municipality to issue a list of the conditions for the design (**CE 30**). Egapris proposed another location for its own MSCP.

137. The Municipality’s Development Department asked BP to start planning work for a second MSCP in Gedimino site instead of the Pergales MSCP.

138. On 24 August 2000, BP addressed to the Municipality a draft Parking Plan (**CE 37**) and on 1<sup>st</sup> September 2000, completed draft parking plans were officially submitted (**CE 40**).

139. On 6 October 2000, the Municipal Enterprise Vilniaus Planas proposed that (**CE 44**) “*the draft in essence could be approved provided certain supplements and adjustments were made [...]*”.

140. On 11 October 2000, the Municipality’s Energy and Facility Department suggested that the draft should be adjusted. The Department observed that (**CE 45**) “[...] *some*



*elements in terms of scope of the parking plan as defined an Annex 2 of the Agreement between Vilnius city municipality and the consortium [...] were missing [...].*

141. On 13 October 2000, the Municipality's Transport Council discussed the Plans and resolved (**CE 48**):

- 1.1 *Reconstruction of Pylimo street as a segment comprising the Old City ring under the draft Vilnius City Parking Plan, by introducing two-ways traffic is not supported by any calculations. [...] Calculation should be produced that would substantiate advantages of the proposed alterations of the traffic organisation when compared with current situation.*
- 1.2 *The street net and traffic organisation provided in the draft is not quite definite. Detailed planning of the street net is necessary.*
- 1.3 *The draft should be supplemented by a scheme of public transport communication system.*

142. On 20 October 2000, the National Monument Protection Commission ("NMPC") objected to the parking plan. The NMPC decided to object to the project of construction of the parking for the following reason (**CE 49**):

*Projects of such type and scale like the project of the construction of planned underground garages in the Old Town of Vilnius should be developed concurrently taking into consideration the possible direct and indirect environmental impact of planned works and also the impact on cultural properties. In the opinion of the State Monumental Protection Commission, the planned garages [...] would change the character of the Old Town of global value; destroy large areas of unexplored cultural layer. Also, the intensity of traffic and air pollution in the Old Town is likely to increase. The Old Town might become less attractive in terms of tourism and to the residents and visitor, and this would be a great loss.*

143. On 24 November 2000, the Environmental Protection Department of Vilnius Region stated that (**CE 57**):

*The plan does not contain the assessment of consequences of solutions from the viewpoint of environment.*

*Based on the first assessment, we do not approve of the construction of underground garages in Sereikiskiu Park. Their need in this place is not sufficiently grounded, and the territory is unique and valuable both from environmental and other aspects. [...]*

*Opinion: We do not in essence object to the Vilnius city car parking plan. In further project-making stages, to assess environmental impact, project the means of compensation for cutting down greenery and built-up squares.*

144. On 12 December 2000, the Vilnius Urban Development Department stated (**CE 60**) that *"the division approves of the main ideology stated by the preparers of the plan with regard to the organisation and management of the traffic in the city's historical centre, vehicle parking on the streets, and the necessity of construction of underground (multi-storey) garages, and, essentially, to their positioning as specified in the plan."*

145. On 22 December 2000, the Vilnius Territorial Division underlined that (**CE 61**):

- 1.1 *the solutions presented in the referred documents directly affect a cultural monument old city of Vilnius [...];*

1.2 *the delivered document was drafted without having obtained under the established procedure the conditions with regard to special planning document formulation issued by the Department of Cultural Heritage protection (Vilnius Territorial Division) and without having implemented the requirements established by the procedures and rules with respect of special planning documents formulation as prescribed by relevant laws of the Republic of Lithuania and other legal acts, i.e.:*

1.2.1 *the requirements with respect of formulation of certain purpose special planning as prescribed by the Law on the Territorial Planning;*

1.2.2 *the requirement with respect to formulation of certain purpose special planning laid down in the general regulations for formulation, coordination and approval of special planning documents;*

1.2.3 *the requirements with respect to formulation of certain purpose special planning laid down in the regulations for formulation and issue of the conditions with respect to territorial planning documents. [...]*

146. Despite all the oppositions, the Municipality decided, on 4 January 2001, to “*permit to the UAB to design an underground parking lot on the Gedimino Ave. section from Jogailos Str. to Katedros SQ*” (CE 67). On 26 January 2001, the Mayor of Vilnius City Arturas Zuokas (CE 70) “*approves the construction of the underground garage in Gedimino Avenue between Odmiiniu and Savivadybes Squares and notifies that the Municipality will provide the required assistance to realize this project*”.

147. However, on 12 March 2001, the State Monument Protection Commission of the Republic of Lithuania issued unfavorable opinions regarding the project and stressed that (CE 81) “*upon installation of garages, a big portion of archaeological heritage of the old city of Vilnius will be destroyed; use of multiple up-to-date materials and technologies will damage the authenticity of the old city of Vilnius [...]*”. Nevertheless, the Ministry of Environment of the Republic of Lithuania wrote that (CE 84) “*while being well-aware of the importance of the Old Town of Vilnius and the need to preserve the cultural and natural heritage, we are of the opinion that it’s too early to declare the loss of authenticity of the Old Town of Vilnius. Similar parking areas have been constructed in the centres of many cities throughout Europe while reconciling the needs of heritage, modern economy and social development*”. [...]

148. Finally, the Municipality changed its mind and decided, on 22 March 2001, to develop exclusively the Pergales MSCP (see RE 63).

149. Two weeks after the decision to abandon the Project of MSCP on Gedimino Avenue, the Mayor Arturas Zuokas, in a letter of 27 April 2001, reminded BP that the first Parking Plan (near the Pergales Theater) “*after coordination, public debate and checking by the territorial planning supervisory authority had to be furnished to the Council of Vilnius on 11 08 2000*” (CE 86).

150. The Mayor added “[w]e hereby propose the 6-month term calculated from the receipt of this official letter for furnishing the parking Plan coordinated, deliberated and checked in the established manner for approval to the council of Vilnius city. In the Event of the failure to submit the Parking Plan by the specified deadline, the Municipality or Vilnius City will terminate the Contract with the consortium [...]

151. During a meeting of 19 June 2001 with the Vilnius City Development Department Commission for the Construction of Underground Garages, BP argued that **(CE 87)** *on the initiative of the heads of the City it was decided to implement the project of Gedimino Avenue which did not justify itself, and, as a result realization of the project for construction of multi-storey underground parking areas was delayed.*
152. In September 2001 **(CE 90)**, BP submitted its second Parking Plan.
153. During a meeting of the Working Group (see ¶ 161) on 22 November 2001, the City accused BP of non-compliance with its contractual obligation, that is the delivery of concrete plans for the construction of the Pergales MSCP as stated on 27 April 2001 **(CE 96 and RE 70)**. In its letter dated 3 December 2001, BP alleged that the delay was also due to the City's delay in taking the necessary action to procure the necessary land and in the delivery of the design conditions for the Pergales Parking **(CE 98)**.
154. In February 2002, Mayor Zuokas requested BP to *“provide written reasons of the failure to submit within the established deadlines the parking plan”* **(CE 106)**.
155. On 20 March 2002, BP wrote to Mayor Zuokas **(CE 108)**. In its letter, BP explained that

*“the main reasons to the delayed approval of the parking plan are as follows:*

- a) the city had not all the necessary information, and it had to be collected separately;*
- b) the technical task was submitted to the company with a long delay;*
- c) discussions of the plan in committees were not properly organized;*
- d) terms of heritage preservation were submitted just in March 2001;*
- e) the Municipality changed its position regarding the car parks under Gedimino Avenue and car parks in the Old Town in March 2001;*
- f) the Municipality has still not made a clear decision on the ways of solution of parking problems (construction of car parks) in the Old Town.*

*We would like to draw your attention to that the approved parking plan is the company's concern first of all, and very important one. The plan is necessary for the company in order to plan a proper and effective parking system, to know and evaluate the business development, the required investments, terms and return. [...]*

*We are enclosing the prepared parking plan to this letter once again. In the plan, you find two alternative versions, basically of the uncertainty concerning the Old Town”.*

156. In his response of 19 April 2002, Mayor Zuokas stated that *“delayed preparation of the Parking Plan may not be substantiated by absence of the technical task, because legal acts regulating territorial planning establishes that the technical task is not necessary for the preparation of the special plan. Provisions of the Contract and Law on Territorial Planning require furnishing the Municipality with the Parking Plan after its coordination, public debates and verification by the territorial planning supervisory authority. The Municipality is not obligated to deliberate the Parking Plan which does not satisfy this requirement, and submission of such plan may not be considered a proper discharge of the Consortium's obligation. The term of the preparation of the Parking Plan should not be influenced by the Municipality's position on the construction of multi-storey parking areas in the sites other than those specified in Annex No.1 to the Contract. By virtue of*

*Clause 2.2.2 of the Contract, the Parking Plan shall be prepared in observance of sites specified in the Annex. No.1 for the construction of multi-storey parking areas and their detailed plans. Neither decision of the Municipality regarding the ways of settlement of parking problems in the Old Town of public transport system development strategy is an obstacle for the discharge of the consortium's obligation to prepare the Parking Plan" [(CE 16)].*

#### **4.4.2 The Joint Activity Agreement**

157. A form of Agreement on Joint Activity ("JAA") was appended to the Agreement as Annex No. 8 (CE 13). The JAA pertained among others to the transfer to the Consortium of land for the construction of the MSCP.

158. On 26 March 2002, Mayor Arturas Zuokas sent to the Consortium a draft of Joint Activity Agreement for the Pergales parking (CE 110) emphasizing:

*Construction of over ground building with commercial functions [...] is not a priority of the Municipality of the City of Vilnius, is not foreseen in the Main Agreement and existing detailed plans of sites, and should not be foreseen in the joint activity agreements on multi-storey underground parking constructions.*

159. On 9 April 2002, BP sent a revised draft of Joint Activity Agreement in which all references to construction above the Pergales parking were deleted (CE 113).

160. However, the Municipality refused to sign the Joint Activity Agreement, given that, in the meantime, the legislation of Lithuania seemed to have taken a negative view of JAAs with private parties (see CE 104; the Republic of Lithuania's Counter-Memorial, ¶¶ 121-122 and the Claimant's Memorial, ¶¶ 107-108). On 5 July 2002, the Mayor Zuokas wrote to BP (CE 126):

*Construction of the multi-storey parking lots is one of the major obligations of the Consortium consisting of UAB Baltijos Parkingas and UAB Egapris foreseen by the agreement signed on 30 December 1999 by the Municipality and the Consortium. The agreement foresees that the multi-storey parking lots will be constructed on the basis of joint activity agreements. However, according to the Local Autonomy Law of the Republic of Lithuania (edition of 12 October 2000) Article 9 Part 2 the Municipality can make joint activity agreements or common public purchase agreements with the state institutions and (or) other municipalities for common purposes. This provision of the law is still not interpreted unanimously and there is a great probability that the joint activity agreement signed by the Municipality will be contested in court as contradicting the above mentioned provision of law. It also could be impeded by the fact that the multi-storey parking lots will be private property, not the Municipality's. Considering this factor we suggest, in the short run, considering the possibility of amending the agreement signed on 30 December 1999 rejecting the Consortium's obligation to construct multi-storey parking lots foreseen by the agreement and respectively the Municipality's obligation to ensure the method of land use for the Consortium, organisation of permissions and co-ordination according to the provisions of the joint activity agreement. According to the amended agreement of 30 December 1999, as suggested the Consortium would preserve the right and obligations connected with providing parking services and charging local fees on overground parking lots, also, considering the decreased volumes of investments into development of parking infrastructure, correcting the expiry date of the Agreement and revenue allocation between the Consortium and the Municipality.*

161. Thus, on 29 July 2002, Mayor Zuokas established a Working Group for reconsideration of the Agreement of 30 December 1999 (**CE 127**).
162. On 5 September 2002, BP proposed the conversion of the Joint Activity Agreement into a Cooperation Agreement as the Municipality had done with the Company Pinus Proprius (see ¶¶ 167-171) (**CE 133**).
163. On 9 September 2002, the Working Group decided to (**CE 134**) “*conclude partnership agreements instead of joint activity agreements on the construction of multi-storied car parks [...]*”.
164. On 24 February 2003, the Vilnius District Court decided to (**CE 155**) “*nullify [...] annex 8 [the form of JAA] of the Agreement made between Vilnius City Municipality and UAB “Baltijos parkingas” and UAB “Egapris”, which Agreement was approved by Decision No. 482 [...]*”.
165. On 6 May 2003, the Director of the Administration of the Municipality of Vilnius, Raivydas Rukštelė wrote to the Government Representative that (**CE 169**)

*[d]uring the meeting of the representatives of the Parties held on 9 September 2002, on proposal of the Municipality it was decided to sign cooperation agreements instead of joint activity agreement. However, changing only the title of the contract and of the designation of the Parties’ obligations might be insufficient for eliminating the inconsistencies. Therefore, it would be very important to the Municipality to know the opinion of the Government Representative, as of the authority supervising the legitimacy of the legal acts passed by the Municipality [...]*

166. On 22 May 2003 (**CE 168**), the Lithuanian Court of Appeals decided to “*uphold the Decision passed by Vilnius District Court on 24 February 2003, and reject the Appeal*”.

#### **4.4.3 The Pinus Proprius Project**

167. In April 2001, the City discussed the possibility of building a Parking under Gedimino Avenue and southern part of Municipality Square with the company Pinus Proprius UAB. Pinus Proprius was proposing the development of property it owned partly while the City owned the rest. Pinus Proprius owns a building on Gedimino Avenue and was planning the renovation of the building into a hotel (**RE 56**).
168. On 24 October 2001, the Municipality approved, by Decision No. 417, the signing of a Joint Activity Agreement with Pinus Proprius (**CE 95**). However, on 18 January 2002, the Representative of the Government, Gintautas Jakimavicius, requested the Vilnius District Administrative Court to revoke the Decision No. 417 on the approval of the JAA:

*a conclusion should be made that the Law does not provide for the right for municipalities to conclude joint venture agreement with private persons and that Vilnius City Municipality Council having passed the decision No.417 of 24 October 2001 and by Clause 1 thereof approved the draft joint venture agreement with Pinus Proprius UAB exceeded the scope of competence of public authorities [(CE 104)].*

169. The Vilnius District Administrative Court sent the case to the Vilnius District Court, which was within its jurisdiction.

170. On 27 March 2002, the Vilnius City Council decided (Decision No. 530) to approve a Cooperation Agreement between the Municipality on Vilnius and Pinus Proprius. On 19 April 2002, the Government Representative, Gintautas Jakimavicius, wrote the Vilnius District Court (**CE 117**):

*The Vilnius city Council on March 27, 2002, issued decision No. 530 "On the Approval of the Cooperation Agreement" whereby item 1 approved the Cooperation Agreement between the Municipality of the City of Vilnius and Joint Stock Company "Pinus Proprius." By this decision the Vilnius City Council actually changed decision No. 417 of 10/24/01 "On Approval of the Partnership Agreement," i.e. it became out of force. Since the decision became out of force, the legal issue also disappeared. Consequently, the case was dismissed.*

*Considering the presented circumstances [...] I withdraw the claim and therefore ask the Court: To dismiss the case [...].*

171. Thus, on 20 August 2002, the City of Vilnius concluded a Cooperation Agreement with Pinus Proprius (**CE 128**).

#### **4.4.4 The modification of the Agreement of 30 December 1999**

172. The Agreement of 1999 provided that the multi-storey parking lots will be constructed on the basis of a Joint Activity Agreement. However, the Municipality considered that, by virtue of the 12 October 2000 amendment of the Law on Self-Government, it had become impossible to conclude such kind of contracts with private companies, namely with persons other than State institutions or municipalities (see ¶ 168). Thus, with the avowed purpose of ensuring the lawfulness of the Agreement, the Municipality decided to establish a working group in order to bring the Agreement in conformity with the revised Law on Self-Government.

173. During the meeting of 9 September 2002, the representatives of the City of Vilnius and the representatives of BP agreed (**CE 134**):

1. *To exclude the provisions of the Agreement on the rights and obligations of the Consortium to collect parking fees and fines for violation of parking rules. To appeal to the Government of the Republic of Lithuania with the request to issue a consent granting the right to Vilnius city Municipality to carry out public procurement from the single source. [...]*
3. *To conclude partnership agreements instead of joint activity agreements on the construction of multi-storied car parks. [...]*

174. However, on 2 October 2002, Mayor Zuokas and Bjorn Avnes, a representative of Parkerings, discussed also the opportunity to cancel the Agreement. Following this discussion, Bjorn Avnes addressed a letter dated 11 October 2002 to Mayor Zuokas summarizing the remarks made during the meeting of 2 October 2002 (**CE 137**):

*The unexpected obstacles, that have been met during the implementation of the Agreement, might prove that the step was a bit too brave. We have suffered serious economical losses and setbacks in the development of the project. I am therefore prepared to meet with your request to renegotiate the Agreement, in order to arrive at a mutually acceptable solution.*

*As we discussed, there are two main options available to us:*

- (a) *The Municipality cancels the Agreement.*

- (b) *the Agreement is renegotiated on all terms, basically so that the Municipality takes back the right to the land for construction of car parks as requested in your letter dated 5<sup>th</sup> July 2002 [CE 126], and our company becomes the subcontractor to the City solely for street parking and parking house management.*

*Alternative (a) is regulated under the Agreement and would imply that we are reimbursed for our expenses (investments and losses) plus ten percent, and the Municipality retains all rights and obligations, but also including the parking house close to the market place, parking plan and operational systems.*

*According to my knowledge, the amount would be in the order of 15 millions LITAS, including the ten percent.*

*Alternative (b) is more elaborate. As we would be giving up the real-estate opportunities present in the Agreement at this time, this will need to be economically compensated. [...]*

*Making a reasonable assumption on the outcome of a renegotiation as outlined above, the total cost to the Municipality to regain major parts of the Agreement would be in the order of 11 million LITAS. [...]*

175. On 8 November 2002, Mayor Arturas Zuokas replied to Bjorn Avnes:

*[...] This Agreement is very important to Vilnius Municipality. I entirely agree with you that both partners must cooperate in seeking the way out of the difficult situation we are in now. [...]*

*Therefore, I would like to stress the main points determining Municipality's decision on the issue, once again:*

- *The object of the competition that took place in 1997 and was followed by competitive negotiations and by signing the Agreement with Consortium in 1999, was the construction of parking lots – not any other real estate development projects which could be profitable even if separate from the whole parking system. This meant to us and to both competitors that a part of the parking fees collected in public places should cover the expenses of construction of parking lots. [...]*

*[...] I may only express serious doubts about the amounts of funds, indicated in you letter as desired compensations for the member of Consortium in case of changing or terminating the Agreement.*

*Implementation, renegotiation or termination of the Agreement is a complex problem. Possible ways of solving it should be pointed out by the specialists representing both partners. Therefore I suggest you to present your proposals, considering the change and termination of the Agreement, for the negotiations which are being carried out by specially appointed representatives. [...]* [(CE 140)]

176. Regardless of the correspondence between Bjorn Avnes and Mayor Arturas Zuokas, the Working group continued the negotiation. On 27 November 2002, during a meeting of the Working Group, BP asked the representatives of the Municipality why (CE 142):

*[...] despite an agreement reached between the Parties, Vilnius City Municipality does not implement the decision adopted by the working groups to apply to the Government with regard to the permission granting the right to carry service procurement from the single source. [...] In the opinion of BP representatives, the decision of the working groups was not influenced by any other additional circumstances and its implementation lies exclusively within the competence of the Mayor of the Municipality. BP representatives outlined that inactivity of responsible authorities of the Municipality poses a threat to the continuity of the Agreement of 30 December 1999 and raises doubts about the effectiveness of initiated negotiations.*

177. The representatives of the Municipality responded (CE 142) that there were [...] “two reasons due to which no application was submitted to the Government: [...] the

*Consortium hasn't yet implemented an obligation set forth in point 5.1.15 of the Agreement regarding the payment of the sum of LTL 626,187 for the year 2001 to the Municipality and hasn't yet provided information indicated in points 3.2 and 3.3 of the Agenda" [...]. Thus, a dispute was arising over BP's performance of the Agreement especially over its payment.*

178. In its letter dated 28 November 2002, Skips AS Tudor (Parkerings' parent corporation) underlined the failure by Vilnius Municipality to address the Lithuanian Government for permission to carry out public procurement of the Consortium's parking service. Skips AS Tudor also argued that the Agreement [of December 1999] allowed commercial development on the top of the multi-storey car parks (**CE 143**). Moreover, concerning the payment of the amount set forth in point 5.1.15 of the same Agreement, Skips AS Tudor emphasized that (**CE 143**):

*As you may know, the key source of the consortium's income are originating from the two contractual rights - the right to collect parking fees and the right to collect re-clamping penalties - which rights have been temporarily assigned to us by Vilnius Municipality by virtue of the Agreement, made in 1999. As a consequence of force majeure situation, resulting from the actions of the Government and the Parliament, one of those rights and related income streams was vanished, and the other one was significantly reduced. Accordingly, the total income of the consortium was adversely affected and we have suffered a serious financial loss. The Agreement defines the revenue sharing scheme that is based on the income, not on profit. Therefore, once force majeure had a direct impact on the income, it had a direct impact on overall revenue sharing. We cannot understand how Vilnius Municipality, having lost the right that was temporarily assigned to the consortium, still requests the same amount of the revenue originating from such right.*

179. On 3 February 2003, during a meeting with the Working Group, both parties maintained the same position. BP representatives proposed to submit the dispute concerning the payment of the sum under point 5.1.15 of the Agreement to a court or to any other impartial authority. However, the parties agreed to continue the negotiation (**CE 150**).

*During the next meeting of the Working Group on 13 February 2003, the Municipality representatives informed BP that (**CE 153**) "the Municipality is preparing to appeal to the court regarding the fulfillment of the obligation provided for in point 5.1.15."*

180. On 24 February 2003, the Vilnius District Court ruled in favour of a challenge to the hybrid fee structure brought by the Government Representative under the New Law on Fees and Charges (see ¶ 124 and **CE 155**). As a result, the parking fee provision of the Agreement of December 1999 was cancelled. This decision was confirmed on 22 May 2003 by the Lithuanian Court of Appeals (**CE 168**).

181. By letter dated 25 March 2003, the Mayor of the City of Vilnius proposed to the Consortium various actions, especially the termination of the Agreement that had become incompatible with applicable law and the conclusion of a new contract for fee collection service (**CE 156**).

182. On 16 May 2003, BP made a counter proposal, consisting in a direct agreement with VPK, namely the Operator, that is the management company for the BP-Egapris Consortium for the collection of local fees and charges, and a second and separate agreement with BP for the construction of the Multi-storied Parking (**CE 166**).



183. On 24 October 2003, VPK submitted its proposal for a renegotiated agreement for collection of parking fees (**CE 180**):

- 1.1 *VPK shall provide the following service to the Municipality:*
  - a) *operate and develop the car parking system of the Municipality [...];*
  - c) *collect parking charges [...];*
- 2.1 *The contract shall be valid for 20 years, and VPK shall have the right of option to extend it by 10 years.*
- 3.1 *The Municipality shall pay to VPK the consideration for services [...] on a monthly basis. The amount of payment shall be calculated as a percentage from collected income. [...]*

184. On 17 November 2003, a provisional agreement was concluded between the Municipality and VPK (**CE 186**), to ensure the continued collection of parking charges pending negotiation.

185. On 9 December 2003, the Municipality responded to the VPK proposal of 24 October 2003 with a counter-proposal for an agreement with a duration of four years, at the end of which all shares of VPK would be transferred to the Municipality free of charge (**CE 190**).

186. On 18 December 2003, VPK responded to the Municipality counter-proposal of 9 December 2003. In substance, VPK proposed either a 15-year agreement without the construction of the multi-storey parking or a 10-year agreement with VPK's rights and obligations to construct multi-storey parking (**CE 192**).

187. The Municipality responded on 15 January 2004 (**CE 204**):

*Due to the amended legal acts, further implementation of the Agreement concluded [...] on December 1999 is no longer possible and there are no legal preconditions for revising this Agreement.*

*The conditions specified in the written proposal submitted by VPK on 18 December 2003 regarding the establishment of new legal relations with Vilnius City Municipality are not acceptable to Vilnius City Municipality. We remind you that a proposal from Vilnius City Municipality of 9 December 2003 regarding the conclusion of the Agreement with VPK and the fulfillment of the obligations set in the Agreement of 30 December 1999 has already been submitted to you.*

*[...] [W]e also would like to remind you that the deadline set by Vilnius City Municipality Council for negotiations expires on 27 January 2004. Upon the expiry of this term and in case of failure to conclude a new Agreement, VPK will be deprived of its right to collect local charges for parking in Vilnius City.*

#### **4.4.5 The termination of the Agreement by the Municipality**

188. By decision N° I-221 dated 21 January 2004, the Municipality of Vilnius decided to terminate the Agreement between the Municipality of the City of Vilnius and the Consortium Formed by UAB Baltijos Parkingas and UAB Egapris dated 30 December 1999 with effect from 1 March 2004 (**CE 206**).

189. By another decision N° I-222 date 21 January 2004, the Municipality of Vilnius decided to annul the local regulations that allowed VPK to collect the parking fee (**CE 207**).

190. The notice of termination of the Agreement was sent to the parties on 27 January 2004. In substance, the reasons for termination were the followings (**CE 210**):

*The Agreement dated 30 December 1999 is terminated [...] by reason of material breach on the part of the Consortium formed by UAB Baltijos Parkingas and UAB Egapris of the following provisions of the Agreement:*

- 1) *Omission to draw up, coordinate and submit for approval by the Vilnius City Council of the Parking Plan introducing the public parking system in the Vilnius City within the time-limits defined in the Agreement [...];*
- 2) *Failure to ensure to the Municipality [...] the availability of, and direct and real time access to, all information specified [...];*
- 3) *Failure to make investments defined in the Agreement, including failure to build and equip multi-storey car parks within the time-limits defined in the Agreement [...];*
- 4) *Failure to pay to the Municipality of the City of Vilnius the amounts due under the Agreement [...];*

191. Moreover, the Municipality requested the immediate and gratuitous transfer of 100 percent of the shares of VPK.

192. Following the Agreement's repudiation, the Municipality sued BP and VPK in recovery of the Clause 5.1.15 amount (see ¶¶ 179). On 29 June 2005, the Vilnius Regional Court decided that (**CE 234**):

*The consortium was deprived of the right to collect from the owners of cars a fee for unblocking road wheels and thus lost one of contractual sources of income. Plaintiff [the Municipality] indicates that the increase of the fixed fee under Clause 5.1.15 of the Agreement is unconditional and not subject to any circumstances. However, such argument of Plaintiff is not recognized as grounded. Defendants [BP] substantially show that if such argument of Plaintiff is accepted, it should be recognized that LTL 1,000,000 must be paid even if the consortium's right to collect local charge is annulled by a certain legal regulation. The court decides that such interpretation of the Agreement would obviously conflict with the principles of good faith and common sense in general and would mean breach of such principles while interpreting this particular Agreement.*

193. The decision of the Vilnius Regional Court was confirmed on appeal on 20 October 2005 (**CE 235**).

## **5. POSITION OF THE PARTIES**

### **5.1 THE CLAIMANT**

#### **5.1.1 On jurisdiction**

194. As set out in fuller summary in Section 7.2.1 below, Claimant argues that the Tribunal has jurisdiction.

### **5.1.2 On the merits**

195. Parkerings contends that it is an investor subject to the protection of the Agreement between the Government of the Republic of Lithuania and the Government of the Kingdom of Norway on the Promotion and Mutual Protection of Investments dated 16 June 1992 (hereinafter the “Treaty” or “BIT”).
196. The Claimant alleges that through the acts and omissions of its municipal and national authorities, Lithuania has violated Parkerings’ investors rights under the Treaty and must be held responsible.
197. Parkerings has thus based its claim on a three-pronged argumentation:
- (i) Lithuania has violated its duty to grant the investment equitable and reasonable treatment and protection under Article III of the Treaty;
  - (ii) Lithuania has violated its duty under Article IV of the Treaty to afford the investment protection no less favourable than that afforded to investors from a third State;
  - (iii) Lithuania has violated its duty not to indirectly expropriate without compensation under Article VI of the Treaty.

#### ***5.1.2.1 Breach of the duty to grant equitable and reasonable treatment***

198. According to the Claimant, the Treaty obligation to grant “equitable and reasonable treatment” holds Lithuania to a stricter standard of conduct than the “fair and equitable treatment” standard more commonly found in other bilateral investment treaties. A showing of breach of Article III of the Treaty therefore requires less than a showing of breach of the standard of “fair and equitable treatment” (see ¶ 272 below).
199. The Claimant submits that Lithuania’s conduct falls within the concept of unfair, inequitable or unreasonable treatment prohibited by the Treaty. Through the acts and omissions of its central and municipal authorities, Lithuania did:
- (i) Engage in grossly unfair and discriminatory conduct (see Section 8.1.2.1 below);
  - (ii) Engage in arbitrary and opaque conduct (see Section 8.1.3.1 below);
  - (iii) Frustrate Parkerings’ legitimate expectations (see Section 8.1.4.1 below);
200. In light of the above, the Claimant submits that Lithuania breached Article III of the Treaty beyond any possible doubt.

#### ***5.1.2.2 Breach of the obligation of protection***

201. The Claimant alleges that the Respondent failed to protect its investment in violation of Article III of the BIT (see full summary in Section 8.2.1 below).

### **5.1.2.3 Breach of the duty to afford no less favourable treatment**

202. The Claimant argues that the core of Lithuania's obligation under Article IV of the Treaty is to provide Norwegian nationals engaging in commercial activities the same standard of treatment as nationals from any other State (see Section 8.3.1 below).
203. According to the Claimant, Lithuania has treated Pinus Proprius, an investment of Litprop Holding BV, a Dutch investor, more favourably than BP. The Claimant submits that Lithuania breached Article IV of the Treaty.

### **5.1.2.4 Breach of the duty not to expropriate without compensation**

204. The Claimant alleges that Lithuania destroyed BP's value by undermining and then terminating the Agreement. The Claimant argues that Lithuania indirectly expropriated Parkerings' ownership interest in BP. By failing to provide compensation, Lithuania breached its obligations under Article VI of the Treaty (see full summary in Section 8.4.1 below).

### **5.1.2.5 Damages**

205. The Claimant argues that Parkerings is entitled to full compensation for all injuries arising out of Lithuania's violations of the Treaty. The purpose is to eliminate all consequences of the violations and reinstate the situation which would have likely existed in the absence of any violation.
206. Pursuant to Article VI (2) of the Treaty, the appropriate measure of compensation in cases of lawful expropriation is the market value of the investment immediately before the date of expropriation. While this provision requires the expropriation to be lawful, Parkerings contends that it also provides the relevant standard for determining the appropriate measure of compensation for Lithuania's violations of the Treaty, which entailed the destruction of BP.
207. The definition of fair market value has been established under international law as being the price a buyer would be willing to pay the seller under circumstances in which each party had reliable information in order to maximize its financial gain and neither party was under duress or threat. Fair market value should be measured at the time the investor suffered the injury that gave rise to a right to compensation, that is 21 January 2004 in the present case, *i.e.* the date on which the Municipality decided to terminate the Agreement in breach of the Treaty.
208. According to the Claimant, the fair market value compensation must take into account the future profitability of BP, given that continued demand for its services was guaranteed in the relevant market. In other words, the fair market value of BP in January 2004 would reflect the strong demand for its service and the predictability of revenue streams guaranteed by the Agreement. Accordingly, BP's value should be determined by reference to the company's reasonably anticipated profitability using the discounted cash flow (DCF) method.

209. Tribunals have long accepted that forecasting future cash flows will necessarily implicate some degree of uncertainty but that the mere existence of such uncertainty does not warrant preclusion of compensation for future profitability. The use of a DCF valuation in the present case is particularly appropriate for two reasons:
- (i) first, the parking business stands out for its stability, low risk, and predictability, which reduces the margin of uncertainty to a minimum. In BP's case, predictability was enhanced by the nature of its contractual rights under the Agreement, in that it was to be the sole partner of the Municipality in the design, development and operation of the integrated parking system;
  - (ii) second, several buyers (e.g. NCC and Skanska) made arms-length offers for a stake in BP in 2000 and 2001 using the DCF method to establish their offer price, which is consistent with general valuation practice in the parking industry.
210. The Claimant further argues that any diminution of value attributable to or associated with Lithuania's conduct should be discarded. The purpose of this rule is to preclude the host State from using its executive, legislative or judicial branches to progressively reduce the value of an asset and then expropriate it. This is of particular importance in the present case where Lithuania gradually eroded the value of BP, first by litigating and legislating away the legal framework of the investment, then by refusing to either perform or renegotiate the Agreement in good faith, and finally by unlawfully terminating the Agreement. Thus, full compensation of the fair market value of BP on 21 January 2004 requires the Tribunal to disregard any diminution in the value of BP that might have been caused by each of these various steps leading up to the destruction of BP.
211. In light of the above, the Claimant contends that its expert, Mr. Lapuerta, has correctly valued BP as of January 2004 in the amount of EUR 38.5 million taking into account the following assumptions:
- (i) BP would build the five MSCPs assigned to Egapris under the ABP, given that BP and Egapris were jointly and severally liable and that the latter had no prospect of carrying out the work itself pursuant to its insolvency;
  - (ii) Egapris was not able to enforce its call option under the ABP for 50% of the shares in VPK.
212. After deduction of the projected investment in the construction of 10 MSCPs that BP was unable to make due to Lithuania's breach, as well as of the returns BP could have made using these funds elsewhere, Mr. Lapuerta reaches the amount of EUR 20.4 million (NOK 176.4 million at the exchange rate on 21 January 2004) as compensation owed to Parkerings for the destruction of BP, in addition to the interest computed thereupon.

### 5.1.3 Prayers for relief

213. Based upon all the above submissions, Parkerings requests the following relief:<sup>2</sup>

*Parkerings respectfully requests that the Tribunal:*

- (a) *Declare that Lithuania has breached its obligations under the Treaty and international law;*
- (b) *Award Parkerings damages in the amount of NOK 176.4 million as the fair market value of BP as of January 21, 2004;*
- (c) *Award Parkerings interest at the NIBOR rate, compounded monthly for the period January 22, 2004 through the day of payment;*
- (d) *Direct Lithuania to pay all of Parkerings' costs and expenses, including legal fees, incurred in connection with this arbitration; and*
- (e) *Order any such further relief as may be available and appropriate in the circumstances.*

## 5.2 THE RESPONDENT

### 5.2.1 On jurisdiction

214. As set out in fuller summary in Section 7.2.2 below, the Respondent argues that most of Parkerings' claims are groundless and fall outside the scope of the Tribunal's jurisdiction under the Treaty. Therefore, Lithuania submits that the claims should be dismissed for lack of jurisdiction.

### 5.2.2 On the merits

215. According to the Respondent, all of the Claimant's claims must fail on the following grounds.

#### ***5.2.2.1 Lithuania has not frustrated Claimant's legitimate expectations***

216. The Respondent argues that the Claimant's attempt to lower the standard for a violation of the duty to treat the investment fairly and equitably is meritless (see ¶¶ 282 *et seq.*).

217. The Respondent argues that a claim based upon the frustration of legitimate expectations due to governmental action requires the investor to show that such action frustrated expectations that the host State created or reinforced through its own conduct. In the present case, Lithuania cannot be held responsible for Parkerings' failure to conduct the required due diligence prior to signing the Agreement nor its failure to obtain other guarantees that investors typically demand in agreements with States or their agencies (see Section 8.1.4.1 below).

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<sup>2</sup> See Claimant's Memorial, ¶ 272

218. Concerning Claimant's allegation of arbitrary conduct, the Respondent alleges that it clearly explained during the negotiations that the Agreement was untested and was subject to legal challenges. Moreover, the Respondent argues that the claims set out by the Claimant are only allegations of contract breach (see Section 8.1.3.1 below)

**5.2.2.2 There has been no expropriation by Lithuania**

219. The Respondent submits that Parkerings cannot bring a claim for expropriation on the basis of the alleged wrongful termination of the Agreement.

220. The Respondent also argues that Parkerings has not been substantially deprived of its ownership of BP.

221. Furthermore, a claim of contract breach cannot form the basis of an expropriation claim where, as here, the Claimant, pursuant to the Agreement, could seek redress before the Lithuanian courts (see Section 8.4.1 below).

**5.2.2.3 Lithuania has not violated its duty to grant Claimant protection**

222. According to the Respondent, protection within the meaning of the Treaty is not intended to generate an all-encompassing duty for the host State. The Respondent alleges that the guarantee of protection is characterized by the standard of due diligence.

223. As to Parkerings' specific argument that the Government should have backed up BP in its contractual dispute with the Municipality and challenge the termination of the Agreement, the Respondent argues that it is inconsistent with the purpose of the Treaty (see Section 8.2.1 below).

224. Therefore, the Respondent argues that it has not violated its duty to protect the Claimant.

**5.2.2.4 The Claimant was not subject to any discrimination**

225. The Respondent alleges that in order to make out a claim for discrimination, that is to say a violation of the Treaty's Equitable and Reasonable Treatment provision and/or a violation of the Treaty's Most Favored Nation's provision (MFN), the Claimant must show that two separate investors were similarly situated and that the two investors were treated differently.

226. The Respondent contends that the Claimant did not show that a third investor was similarly situated and treated differently (see full summary in Section 8.1.2.1 and 8.3.1 below).

**5.2.2.5 The Claimant is not entitled to compensation**

227. The Respondent has shown that Parkerings' claims are meritless. Accordingly, no compensation can be claimed.

228. Further, Parkerings' claim for damages is entirely speculative and flawed on several grounds, namely:

- (i) The Claimant has not established any causation between the alleged Treaty violations and the damages it seeks. The Claimant is only entitled to damages with respect to harm that was the direct result of the State's unlawful acts. The specific provision on expropriation of which the Claimant avails itself cannot provide any guidance on the measure of compensation for other Treaty violations;
- (ii) The Claimant's claim for damages based upon an estimation of BP's future profits had it built all 10 MSCPs and operated them until 2012 is equivalent to a claim for lost profits. No tribunal has awarded lost profits where as here, the claiming party has not made the investment which would give rise to the cash flow claimed. On the contrary, tribunals have adopted a cautious approach to the use of the DCF method.

229. It is undisputed that the Claimant's integrated parking system never became operational. Parkerings never made any investment in any of the MSCPs nor did it begin construction of a single one. As a result, the parking project never existed as required in the DCF model.

230. According to the Respondent, damages should be limited to proven net out-of-pocket expenditures. However, the Claimant has made no submissions in this respect and has not met the onus of proving its damages accordingly. The Respondent submits that Parkerings actually never made any significant investment expenditures. At any rate, any investment costs that the Claimant incurred must be reduced by the benefit that it received from BP.

231. Furthermore, the claim for lost profits *per se* is erroneous for the following reasons:

- the valuation date is not 21 January 2004, as it overlooks the preceding four years during which many intervening factors could have altered BP's value. The only reliable date for calculation is the year 2000, which is closer to the alleged detrimental State actions and thus minimizes any speculation about the ensuing period;
- BP and VPK are not devoid of any value. On the contrary, BP's assets are worth at least LTL 188'590 and BP further owns all shares of VPK, a fully operational company;
- Mr. Lapuerta's analysis is overstated, as it should not have (1) included a corruption-risk related discount, (2) excluded expenditures or revenues for 2000 and 2001, (3) disregarded Egapris' call option upon VPK's shares, or (4) included an eleventh MSCP (*i.e.* the Turgaus MSCP) in the calculation. As a matter of fact, the net present value (NPV) of Claimant's investment was near zero, whether valued in 2000 or 2004: it was negative in 2000 and below EUR 0.95 million as of 2004;



- the two arms-length offers the Claimant refers to do not provide any indication as to the fair market value of its investment. In any event, such offers made in 2000 and 2001 are only useful insofar as a DCF analysis is carried out for 2000 as opposed to 2004. Further, the Respondent points out that NCC and Skanska's offers were contingent upon certain events and conditions that were contrary to the assumptions made in Mr. Lapuerta's report (e.g. the right to develop additional MSCPs, the premium for project legality or the premium for the extinction of Egapris' call option).

### 5.2.3 Prayers for relief

232. Based upon all the above submissions, Lithuania requests the following relief:<sup>3</sup>

*For the foregoing reasons, the Respondent respectfully requests that the Tribunal:*

- DISMISS all of the Claimants' claims in their entirety; and*
- ORDER the Claimant to pay all of the costs and expenses of this arbitration, including the fees and expenses of the Republic's expert, Mr. Tim Giles, the fees and expenses of any experts to be appointed by the Tribunal, the fees and expenses of the Republic's legal representation in respect of this arbitration, and any other costs of this arbitration.*

## 6. ISSUES TO BE DETERMINED BY THE TRIBUNAL

233. In light of the facts and submissions of the parties set forth above, the questions arising for the Tribunal's determination are the following:

- Does the Tribunal have jurisdiction over Parkerings' claims? (see Section 7 below);
- What is the applicable standard for the duty of "equitable and reasonable treatment" within the meaning of Article III of the Treaty? (see Section 8.1 below) Has Lithuania violated Article III of the Treaty? In particular, did Lithuania engage in unfair and discriminatory or arbitrary and opaque conduct with respect to Parkerings' investment? (see Section 8.1.2 and 8.1.3 below) Did Lithuania frustrate Parkerings' legitimate expectations? (see Section 8.1.4 *et seq.* below);
- Has Lithuania violated its obligation of protection pursuant to Article III of the Treaty? (see Section 8.2 below);
- Has Lithuania violated its duty to afford no less favourable treatment under Article IV of the Treaty? (see Section 8.3 below);
- What is the applicable standard in terms of expropriation within the meaning of Article VI of the Treaty? (see Section 8.4 below) Has Lithuania breached its duty not to expropriate Parkerings' investment? (see Section 8.4.2 below);

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<sup>3</sup> *Idem*, ¶ 342.

- (vi) Is Parkerings entitled to any compensation and if so, what is the measure thereof? This question may be moot depending on the decision in the foregoing issues;
- (vii) What are the costs of this case and how should they be apportioned between the Parties?

## **7. JURISDICTION**

### **7.1 ISSUES FOR DETERMINATION**

234. The Tribunal's jurisdiction over the claims of the Claimant will be examined in light of the requirement of the ICSID Convention and the BIT.

235. Article 25(1) of the ICSID Convention provides as follows:

*The jurisdiction of the Centre shall extend to any legal dispute arising directly out of an investment between a Contracting State (or any constituent subdivision or agency of a Contracting State designated to the Centre by that State) and a national of another Contracting State, which the parties to the dispute consent in writing to submit to the Centre. When the parties have given their consent, no party may withdraw its consent unilaterally.*

236. Article IX of the BIT contains the following dispute settlement clause:

1. *Any dispute which may arise between an investor of one contracting party and the other contracting party in connection with an investment on the territory of that other contracting party shall be subject to negotiations between the parties in dispute.*
2. *If any dispute between an investor of one contracting party and the other contracting party continues to exist after a period of three months, the investor shall be entitled to submit the case:*
  - A. *Either to the International Centre of Settlement of Investment Disputes having regard to the applicable provisions of the Convention on the Settlement of investment disputes between States and Nationals of other States opened for signature at Washington D.C. on 18 March 1965,*
  - B. *or in case both contracting parties have not become parties to this Convention, to an arbitrator of International ad hoc Arbitral Tribunal established under the Arbitration Rules of the United Nations Commission on the International Trade Law. The parties to the dispute may agree in writing to modify these rules. The Arbitral Award shall be final and binding on both parties to the dispute.*

### **7.2 THE PARTIES' POSITION**

#### **7.2.1 Parkerings**

237. Parkerings contends that the Tribunal has jurisdiction.

238. The Claimant argues that it is a company incorporated under the laws of Norway and is an investor subject to the protection of the Treaty. The Claimant specifies that it owns

100 percent of the shares of the Lithuanian company BP, which constitutes an investment in Lithuania.

239. The Claimant contends that through the acts and omissions of its municipal and national authorities, Lithuania has violated the Treaty.<sup>4</sup>
240. The Claimant argues that Article IX of the Treaty, which governs the dispute between a contracting party and an investor, "*grants the Tribunal jurisdiction over any and all disputes in connection with an investment, including disputes arising out of breaches of contract or violation of domestic law*"<sup>5</sup>.
241. The Claimant underlines that it pleaded breaches of Lithuania's obligations under the Treaty and not breaches of the Agreement. The Claimant alleges that the Respondent cannot deny its Treaty claims arguing that some facts do not rise to the level of a Treaty breach.
242. Finally, the Claimant is opposed to the Respondent's opinion that the Lithuanian Courts were able to remedy to the present problems.<sup>6</sup>

### **7.2.2 The Republic of Lithuania**

243. The Respondent argues that Parkerings' claims fall outside the scope of the Tribunal's jurisdiction under the Treaty. Specifically, more than half of the claims concern alleged breaches of the Agreement; these commercial disputes cannot be the basis of a claim under the BIT. Furthermore, the Respondent argues that the Tribunal has no jurisdiction under the BIT on several grounds:

- (i) Parkerings is not a party to the Agreement and has no rights thereunder;<sup>7</sup>
- (ii) Lithuania as host State is not responsible on an international level for acts of its agencies. The conduct of State organs including municipalities is not attributable to the State, unless such conduct had legal effects on an international level<sup>8</sup>
- (iii) BP and the Municipality agreed to submit all disputes arising under the Agreement to the Lithuanian Courts. In order to observe this contractual choice, ICSID tribunals do not have jurisdiction over purely contractual claims which do not amount to claims for Treaty violations. Claims arising out of contracts between investors or their subsidiaries and the Government or its agencies do not constitute claims cognizable under bilateral investment treaties. Further, the Treaty does not, in the present case, contain an umbrella clause. However, the Respondent admits that where the foreign investor is denied a remedy for a contractual breach in a domestic forum, such breach of contract may constitute

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<sup>4</sup> See Claimant's Memorial, ¶ 190.

<sup>5</sup> See Claimant's Post-hearing Brief, p. 4.

<sup>6</sup> See Claimant's Post-hearing Brief, p. 6-7.

<sup>7</sup> See Respondent's Counter-memorial, ¶ 140.

<sup>8</sup> See Respondent's Counter-memorial, ¶¶ 148-151.

an international wrong. This is not the case here, given that the Agreement provided for dispute resolution before the Lithuanian Courts. The Respondent alleges that the Lithuanian Courts were perfectly able to protect Claimant's rights.<sup>9</sup>

244. Therefore, Lithuania submits that the following claims should be dismissed for lack of jurisdiction:<sup>10</sup>

- (a) *Claimant's allegation of breach of the Equitable and Reasonable Treatment Clause by virtue of the City's supposed failure to properly recognize an event of force majeure under Section 7.2.1 of the Agreement;*
- (b) *Claimant's allegation of breach of the Equitable and Reasonable Treatment Clause by virtue of the City's supposed failure to disclose material information during contract negotiations, as required under the good faith duty set out under Lithuanian law;*
- (c) *Claimant's allegation of breach of the Equitable and Reasonable Treatment Clause by virtue of the City's supposed failure to issue consistent directions to BP regarding its performance under the Agreement, as required under Section 1.5.1 of the Agreement;*
- (d) *Claimant's allegation of breach of the Equitable and Reasonable Treatment Clause by virtue of the City's supposed failure to defend the Agreement against measures adopted by the Government as required under Section 1.5.1 of the Agreement;*
- (e) *Claimant's allegation of breach of the Equitable and Reasonable Treatment Clause by virtue of the City's supposed failure to renegotiate in good faith as required under the good faith duty set out under Lithuanian law;*
- (f) *Claimant's allegation of breach of the Full Security and Protection Clause by virtue of the City's supposed failure to renegotiate in good faith as required under the good faith duty set out under Lithuanian law; and*
- (g) *Claimant's allegation of breach of the Expropriation Clause by virtue of the City's supposed termination of the Agreement on grounds that were not permitted under Article 7 of the Agreement.*

### **7.3 DISCUSSION ON THE TRIBUNAL'S JURISDICTION**

245. There is no doubt that the conditions *rationae personae* of the ICSID Convention are met, as the parties are, on the one hand, a national of the Kingdom of Norway, Parkerings, and on the other hand, the Republic of Lithuania.

246. The parties gave their consent to arbitration: the Republic of Lithuania, on 16 June 1992, by signing the BIT and Parkerings, on 11 March 2005, with its Request for Arbitration.

247. The Arbitral Tribunal notes that pursuant to Article IX of the BIT, any dispute in connection with an investment shall be subject to negotiations between the parties. If the dispute continues to exist after a period of three months, the investor is entitled to

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<sup>9</sup> See Respondent's Counter-memorial, ¶¶ 152-158 and Respondent Post-Hearing Brief, p.1.

<sup>10</sup> See Respondent's Counter-Memorial, pp. 56-57.

submit the case to an arbitral tribunal. In the absence of parties' determination on that matter, the Tribunal considers that the conditions of Article IX of the BIT are met.

248. Thus the first question for the Tribunal to resolve here is whether the Claimant is an investor in Lithuania.

### 7.3.1 The Claimant's Investment

249. In accordance with Article 25 of the ICSID Convention, an arbitral tribunal established pursuant to the ICSID Convention has jurisdiction *ratione materiae* over "any legal dispute arising directly out of an investment." No definition of "investment" is to be found in the ICSID Convention.

250. Article I of the BIT gives the definition of the term "Investment":

*The term "Investment" means every kind of asset invested in the territory of one contracting party in accordance with its laws and regulations by an investor of the other contracting party and includes in particular, though not exclusively:*

(...)

(II) Shares, debentures or any other forms of participation in companies.

251. UAB Baltijos Parkingas (BP) is a Lithuanian company, registered with the Lithuanian Company Register. Parkerings, which is a company registered in Norway, is "the owner of sixty five thousand (65,000) ordinary shares of the Company [BP] for the value of one hundred (100) Litas each, comprising 100% of the authorized capital of the Company."<sup>11</sup>

252. In the *Vivendi* case, the ICSID *ad hoc* Committee held that "[...] the foreign shareholding is by definition an investment and its holder an investor [...]"<sup>12</sup>.

253. In this case the Tribunal accepts the Claimant's contention that "Parkerings' direct 100 percent ownership interest in BP constitutes an investment in Lithuania within the meaning of the Treaty."<sup>13</sup>

254. The Arbitral Tribunal is therefore of the opinion that Parkerings is an investor in Lithuania for the purpose of the ICSID Convention and within the meaning of the BIT, since it owns the entirety of the shares of a Lithuanian company which is BP.

255. The issue is thus to determine whether the dispute arises in connection with such investment in Lithuania.

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<sup>11</sup> See Exhibit **C 195**.

<sup>12</sup> *Compañía de Aguas del Aconquija S.A and Vivendi Universal v. Argentine Republic*, ICSID Case No. ARB/97/3, Decision on Annulment, July 3, 2002, *reprinted in* 19 *ICSID Rev.—FILJ* 89 (2004), ¶ 50.

<sup>13</sup> See Claimant's Memorial p. 60; Exhibit **CE 195**.

### 7.3.2 Did the claims fall under the Treaty?

256. The Claimant asserts that its claims arise from action that the Republic of Lithuania undertook in violation of the BIT. The Claimant does not base its request on breaches of the Agreement.<sup>14</sup>
257. The Respondent, however, rightly distinguishes between disputes arising out of contract breaches and disputes under the BIT. In particular, the Respondent states that investor-state arbitration is only available to adjudicate rights contained in the Treaty.<sup>15</sup>
258. However, the issue lies elsewhere. It is uncontroversial that this dispute is between Parkerings and the Republic of Lithuania whilst the Agreement was entered into by two different entities, namely BP and the City of Vilnius, both of which are not parties to this arbitration. It is undisputed that States are responsible on an international level for acts of municipalities (and other State *constituent subdivisions*)<sup>16</sup> that are contrary to international law and that States are not liable internationally for acts of their agencies that are wrongful under domestic law. For instance, the *ad hoc* Committee in *Vivendi* held:

*[...] in the case of a claim based on a treaty, international law rules of attribution apply, with the result that the state of Argentina is internationally responsible for the acts of its provincial authorities. By contrast, the state of Argentina is not liable for the performance of contracts entered into by Tucumán, which possesses separate legal personality under its own law and is responsible for the performance of its own contracts.*<sup>17</sup>

259. In the present case, the Claimant alleges that the Republic of Lithuania itself, and not the City of Vilnius, violated its obligations under the BIT by virtue of the attribution to the State of the acts of the Municipality. As a result, the proper parties to the dispute are Parkerings and the Republic of Lithuania. That the Claimant was not a party to the Agreement is irrelevant as the Arbitral Tribunal is not ruling on breaches of the Agreement but on violation of the BIT. Put differently, the Claimant is alleging treaty violation and there is nothing convincing in the record that may lead to the suspicion of the Claimant having disguised contract claims with Treaty claims for the benefit of jurisdiction. Whether the Respondent did in fact violate the Treaty (or the international law) is a matter of substance and merit rather than of jurisdiction.

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<sup>14</sup> See Claimant's Memorial, p. 60 *et seq.*

<sup>15</sup> See Respondent's Counter-Memorial, p. 48-49.

<sup>16</sup> See *Generation Ukraine Inc. v. Ukraine*, ICSID Case No. ARB/00/9, Award, September 16, 2003, p. 39, reprinted in 44 *ILM* 404 (2005). See, e.g., Luigi Condorelli, *L'imputation à l'état d'un fait internationalement illicite: solutions classiques nouvelles tendances*, 1984 («sont attribués à l'Etat, d'après le droit international, tous les comportements de tous ceux qui, dans l'ordre interne de l'Etat concerné, exercent effectivement les prérogatives de la puissance publique»). Free translation: *The attribution to a State of an internationally wrongful fact: classical solution, new tendencies* ("According to international law, will be attributed to a State, all the conduct of those who, in the domestic body of law of the State, will actually exercise the prerogatives of sovereignty").

<sup>17</sup> See *Compañía de Aguas del Aconquija S.A and Vivendi Universal v. Argentine Republic*, ICSID Case No. ARB/97/3, Decision on Annulment, July 3, 2002, *supra* note 12 ¶¶ 96.

260. Furthermore, the Claimant is rightfully alleging that its claim is based on its investment that went sour. This is an adequate response to Respondent's argument that the Lithuanian Courts do have jurisdiction over claims based on the Agreement. As a matter of rights, the Arbitral Tribunal has no jurisdiction over the claims based on the Agreement.
261. The phrase "*any dispute [...] in connection with the investment*" as provided by Article IX (1) of the BIT is a general provision that provides the basis for an international Arbitral Tribunal's competence over any disputes related to an investment.
262. This is recognized in the decisions of past international tribunals.<sup>18</sup> For instance, in the case *SGS v. Republic of the Philippines*, the Arbitral Tribunal held that:

*[t]he term "dispute with respect to investments" is not limited by reference to the legal classification of the claim that is made. A dispute about an alleged expropriation contrary to Article VI of the BIT would be a "dispute with respect to investments".<sup>19</sup>*

263. In *Vivendi*, the *ad hoc* Committee stated that:

*it is not open to an ICSID tribunal having jurisdiction under a BIT in respect of a claim based upon a substantive provision of that BIT, to dismiss the claim on the ground that it could or should have been dealt with by a national court. In such a case, the inquiry which the ICSID tribunal is required to undertake is one governed by the ICSID convention, by the BIT and by applicable international law.<sup>20</sup>*

[...]

*It is not the Committee's function to form even a provisional view as to whether or not the Tucumán conduct involved a breach of the BIT, and it is important to state clearly that the Committee has not done so. But it is nonetheless the case that the conduct alleged by Claimants, if established could have breached the BIT. The claim was not simply reducible to so many civil or administrative law claims concerning so many individual acts alleged to violate the Concession Contract of the Administrative law of Argentina. It was open to Claimants to claim, and they did claim, that these acts taken together, or some of them, amounted to a breach of [...] the BIT.<sup>21</sup>*

264. The Arbitral Tribunal notes that the Claimant alleged exclusively violations of the BIT and particularly failure to afford its *investment equitable and reasonable treatment and protection, to accord its investment treatment no less favorable than the treatment accorded to investment by investors from a third State*, and last, a breach of its *obligation not to expropriate without compensation*.<sup>22</sup>
265. *Prima facie*, the conduct of the Republic of Lithuania through its subdivision constituent (the Municipality of the City of Vilnius) had an impact on the investment of the

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<sup>18</sup> The Tribunal is of the opinion that it must pay due consideration to earlier decisions of international tribunals.

<sup>19</sup> *SGS Société Générale de Surveillance S.A. v. Republic of the Philippines*, ICSID Case No. ARB/02/6, Decision of the Tribunal on Objections to Jurisdiction, January 29, 2004, *reprinted in 8 ICSID Rep.* 518 (2005), ¶ 131.

<sup>20</sup> See *Compañía de Aguas del Aconquija S.A and Vivendi Universal v. Argentine Republic*, ICSID Case No. ARB/97/3, Decision on Annulment, July 3, 2002, *supra* note 12, ¶ 102.

<sup>21</sup> *Idem*, ¶ 112.

<sup>22</sup> See Claimant's Memorial p. 60-77.

Claimant. The claims are therefore *in connection with the investment* and fall under the Treaty. The Arbitral Tribunal emphasizes that the substantive justification of the Claimant's claims is not a matter of jurisdiction but of merit. This question will be developed below.

266. As the claims fall under the Treaty, whether the Claimant should have submitted the dispute before the Lithuanian courts is not relevant at the stage of examination of the jurisdiction. The Arbitral Tribunal concludes that it has jurisdiction under Article IX of the Treaty.

## 8. MERITS

267. The Claimant's substantive claim under the BIT is, as stated in paragraph 197 above under three main headings:

- i Lithuania has violated its duty to grant the Claimant's investment in Lithuania "equitable and reasonable treatment and protection" as required under Article III of the Treaty;
- ii Lithuania has violated its duty to accord the Claimant's investment in Lithuania "treatment no less favourable than that accorded to investments made by investors of any third state as required under Article IV of the Treaty;
- iii Lithuania has violated its duty not to indirectly expropriate the Claimant's investment without compensation as required under Article VI of the Treaty.

### 8.1 CLAIMS FOR VIOLATION OF THE DUTY OF EQUITABLE AND REASONABLE TREATMENT (ARTICLE III OF THE TREATY)

268. Article III of the Agreement between the Government of the Republic of Lithuania and the Government of the Kingdom of Norway on the Promotion and Mutual Protection of Investments provides that:

*Each contracting party shall promote and encourage in its territory investments of investors of the other contracting party and accept such investments in accordance with its laws and regulations and accord them equitable and reasonable treatment and protection. Such investments shall be subject to the laws and regulations of the contracting party in the territory of which the investments are made.*

269. The Claimant alleges that Lithuania breached its obligation to accord Parkerings's investment *equitable and reasonable treatment*. The Claimant alleges:

- "*the Treaty accord equitable and reasonable treatment holds Lithuania to a stricter standard of conduct than the fair and equitable treatment standard more commonly found in other investment treaties*"<sup>23</sup> (see below 8.1.1);

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<sup>23</sup> See Claimant's Memorial, p.61



- “Lithuania subjected BP to grossly unfair and discriminatory treatment”<sup>24</sup> (see below 8.1.2);
- “Lithuania’s conduct was grossly arbitrary and opaque”<sup>25</sup> (see below 8.1.3);
- and finally, that: “Lithuania frustrated Parkerings’s legitimate expectations”<sup>26</sup> (see below 8.1.4).

270. The Arbitral Tribunal will examine each of these arguments separately.

### 8.1.1 The distinction between the notions of fair and reasonable

271. Unlike other BITs, the Treaty refers to “*equitable and reasonable*” in its Article III. This led to a discussion on the content of such standard and to whether it has the same meaning as “*fair and equitable*” standard.

272. Regarding the applicable standard, the Claimant alleges that “*the Treaty obligation to accord equitable and reasonable treatment holds Lithuania to a stricter standard of conduct than the fair and equitable treatment standard more commonly found in other investment treaties*”.

273. To support its opinion, Claimant relies on the French text of Olivier Corten that discusses the notion of “*équitable*” and “*raisonnable*”: what is “*reasonable*” could not be inequitable but an equitable solution might be unreasonable if it is insufficiently rational<sup>27</sup>.

274. The Respondent alleges that “*Claimant’s analysis does not comport with the dictates of the Vienna Convention on the Law of Treaties (the Vienna Convention) which governs the Treaty’s interpretation.*” The Respondent underlines that “*a Treaty should be interpreted “in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose.”*”<sup>28</sup> Moreover, the Respondent contends that the terms “*reasonable*” and “*fair*” are “*virtually synonymous*.”<sup>29</sup> The Respondent finally argues that “*the set of bilateral investment treaties signed by Norway, where the formulae “fair and equitable “ and “equitable and reasonable” seem to have been used indistinctively within the standard clause generally devoted to the promotion and protection of investments*” confirms that the two phrases are synonymous.”<sup>30</sup>

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<sup>24</sup> *Idem*, p. 64.

<sup>25</sup> *Idem*, p. 66.

<sup>26</sup> *Idem*, p. 68.

<sup>27</sup> See Oliver Corten, *L’utilisation du “raisonnable” par le juge international*, Editions de l’Université de Bruxelles, 1997.

<sup>28</sup> See Respondent’s Counter-Memorial, ¶ 167.

<sup>29</sup> *Idem*, ¶ 169.

<sup>30</sup> *Idem*, ¶ 171.

275. The Arbitral Tribunal considers that the interpretation of the Treaty is effectively governed by the Vienna Convention which provides that a Treaty should be interpreted, pursuant to Article 31, “*in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose.*”
276. The interpretation given by the Claimant, based on Corten’s interpretation of the terms equitable and reasonable, is not convincing. If the two phrases are given their plain meaning, it is far from apparent that they should differ in any way. Thus, under this approach, treatment is fair when it is “*free from bias, fraud or injustice; equitable, legitimate [...]*”; and, by the same token, equitable treatment is that which “*is characterized by equity or fairness, [...] fair , just , reasonable.*”<sup>31</sup>
277. The standard of “*fair and equitable treatment*” has been interpreted broadly by Tribunals and, as a result, a difference of interpretation between the terms “*fair*” and “*reasonable*” is insignificant. The Claimant did not show any evidence which could demonstrate that, when signing the BIT, the Republic of Lithuania and the Kingdom of Norway intended to give a different protection to their investors than the protection granted by the “*fair and equitable*” standard.
278. Thus the Arbitral Tribunal intends to identically interpret the notion “*equitable and reasonable*” and the standard “*fair and equitable.*”
279. The Claimant raises three issues that shall now be examined:
- Did Lithuania engage in unfair and discriminatory treatment?
  - Did Lithuania engage in arbitrary conduct?
  - Did Lithuania frustrate Parkerings’ legitimate expectations?

## **8.1.2 Was the Treatment “*unfair and discriminatory*”?**

### **8.1.2.1 The position of the parties**

280. The Claimant alleges that Lithuania subjected BP to grossly unfair and discriminatory treatment. The principle of *fair and equitable treatment* is violated where a host State’s conduct is grossly unfair or discriminatory. Discrimination is a significant element in determining whether the standard of fair and equitable treatment has been breached.
281. In the present case, the Claimant contends Lithuania subjected BP to the following unfair and discriminatory measures:
1. the Municipality instructed BP to relinquish the Gedimino MSCP on the grounds of cultural heritage concerns and public opposition in April 2001, at a time BP had already carried out important planning and design works. Further, in breach of the Agreement whereby BP was to be the sole partner of

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<sup>31</sup> Stephen Vascianne, in Bishop, Crawford and Reisman, *Foreign Investment Dispute*, ¶ 7, p. 1015.

the Municipality, the Mayor handed over the project to another contractor, Pinus, six months later;<sup>32</sup>

2. the Mayor chose to sign the JAA relevant to the Pergales site with the Municipality's newly selected contractor to the detriment of BP and advocated the validity of his decision in the local court litigation with the Government Representative;<sup>33</sup>
3. after VPK lost the clamping and part of the parking income, the Municipality claimed that BP should have foreseen the clamping prohibition, without, however, considering it as a *force majeure* event which should have released BP of its obligations under Clause 5.1.15 of the Agreement, as confirmed by the Lithuanian Courts. Further, when clamping resumed, the Municipality was receiving 40% of the fees whilst VPK was receiving nothing;<sup>34</sup>
4. the City of Vilnius refused to renegotiate the Agreement unless BP provided the payment of the amount of Clause 5.1.15 of the Agreement.<sup>35</sup>

282. The Respondent is of the opinion that “[i]n international law, the principle of non-discrimination encompasses both “most favored nation treatment” (between aliens) and “national treatment” (between aliens and nationals).”<sup>36</sup>

283. The Respondent argues that any discrimination claim must establish that similar situations were treated differently by the host State. In other words, the Claimant has not established a different treatment of Parkerings and Pinus under like circumstances..<sup>37</sup>

284. The facts relating to the MSCP built by Pinus and those relating to Parkerings are distinct. In particular, the MSCP projected by BP in Gedimino was significantly bigger than the MSCP built by Pinus Proprius and encroached into the City Old Town. The location of the MSCP built by Pinus Proprius outside of the Old Town entailed a different treatment of the two projects by the Cultural Heritage Commission.

285. The MSCP built by Pinus Proprius had to be sold to the City after construction was completed. The MSCP built by BP did not have to be sold to the City.

286. As to the Cooperation Agreement entered into between the Municipality and Pinus Proprius, it did not involve any transfer of land belonging to the City as opposed to any

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<sup>32</sup> See Claimant's Memorial, ¶ 201.

<sup>33</sup> *Idem*, ¶ 202.

<sup>34</sup> *Idem*, ¶ 203.

<sup>35</sup> *Idem*, ¶ 205.

<sup>36</sup> See Respondent's Counter-Memorial, ¶ 238.

<sup>37</sup> *Idem*, ¶ 241.

potential cooperation agreement with BP which would have required the lease or the sale of land through a public auction pursuant to the applicable law on land.<sup>38</sup>

### 8.1.2.2 Discussion

287. Various tribunals have held that a discriminatory conduct is a violation of the standard of the *fair and equitable treatment*. In CMS Gas Transmission Company v. The Argentine Republic, the Tribunal considered that:

*any measure that might involve arbitrariness or discrimination is in itself contrary to fair and equitable treatment. The standard is next related to impairment: the management, operation, maintenance, use, enjoyment, acquisition, expansion, or disposal of the investment must be impaired by the measures adopted.*<sup>39</sup>

288. In order to determine if there is discrimination in violation of the standard of *the fair and equitable treatment*, one has to make a comparison with another investor in a similar position (*like circumstances*). For instance, in the case Antoine Goetz et consorts c. République du Burundi (Award of 10 February 1999), the Tribunal stated that:

*[u]ne discrimination suppose un traitement différencié appliqué à des personnes se trouvant dans des situations semblables.*<sup>40</sup>

289. The Tribunal considers that the conduct of the City of Vilnius could possibly amount to a contractual breach of the Agreement. It should be noted, however, at the outset of the present dispute, that a possible breach of an agreement does not necessarily amount to a violation of a BIT.
290. As to arguments (3) and (4) (see above ¶ 280), even if a contractual breach had occurred, the evidence in the record does not show any comparison made by the Claimant with another investor which could bring under the BIT the actions mentioned in those arguments. The Tribunal is not in a position to determine if there had been a discriminatory measure against the Claimant as no comparison is possible with another investor. As a result, the arguments (3) and (4) are not evidence of discrimination within the meaning of Article III of the Treaty.
291. Concerning the arguments (1) and (2) (see above ¶ 280) the violations alleged by the Claimant and the position of the Respondent are substantially the same as those discussed under *Most-favoured-Nation Treatment* (MFN) (see below section 8.3) In certain situations where an MFN clause has been incorporated within a BIT, establishing a discrimination under the standard of *fair and equitable/reasonable treatment* is not necessary (see below ¶¶ 366 *et seq*). Consequently, the Arbitral Tribunal refers to the discussion of the *Most-Favoured-Nation Treatment* under section 8.3 below.

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<sup>38</sup> *Idem*, ¶¶ 247-250.

<sup>39</sup> CMS Gas Transmission Company v. Argentine Republic, ICSID Case No. ARB/01/08, Award, May 12, 2005; *reprinted in* 44 *ILM* 1205 (2005), ¶ 290; See also Stephen Vascianne, *The Fair and Equitable Treatment Standard in International Investment Law and Practice*, Brit. Y.B. Int'l L. 99, 133 (1999).

<sup>40</sup> See Antoine Goetz and others v. Republic of Burundi, ICSID Case No. ARB 95/3, Award, February 10, 1999, *reprinted in* 15 *ICSID Rev.—FILJ* 457 (2000), ¶ 121.

292. However, the Tribunal shall review the question whether the conduct of the Respondent was arbitrary.

### 8.1.3 Was the conduct of the Respondent “arbitrary”?

#### 8.1.3.1 *Position of the parties*

293. The Claimant alleges that the conduct of the Republic of Lithuania was grossly arbitrary and opaque in violation of Article III of the Treaty. According to the Claimant, it is well established that fair and equitable treatment inherently precludes arbitrary and capricious actions against investors. Inconsistency of State action and complete lack of transparency are a clear showing of arbitrariness. A foreign investor may expect the host State to act consistently, *i.e.* without arbitrarily revoking any pre-existing decisions or permits issued by the State, which were relied upon by the investor to assume its commitments, as well as to plan and launch its commercial and business activities.

294. The obligation to afford investments fair and equitable treatment also places the State under an affirmative obligation not to approve investments on terms that are inconsistent with Government policies or laws. A State cannot escape its international responsibility by requiring the investor to be more knowledgeable about its laws and regulations than its own authorities.

295. The Claimant submits that Lithuania subjected BP to arbitrariness and lack of transparency:<sup>41</sup> Lithuania failed to disclose to Parkerings information pertaining to the viability of the hybrid parking fee concept prior to the execution of the Agreement. Although the Municipality of Vilnius was in possession of a legal opinion (“*the Sorainen Memo*”) questioning the conformity of the parking fee with the Lithuanian law, it did not inform BP before the signing of the Agreement. The Municipality of the City of Vilnius failed to warn BP about the imminent changes to the applicable law.<sup>42</sup>

296. Examples of arbitrariness on the part of the Republic of Lithuania include:

- The Municipality of the City of Vilnius arbitrarily refused to acknowledge the existence of a force majeure event and insisted on full payment of Article 5.1.15 of the Agreement.<sup>43</sup>
- The Municipality and various public entities adopted a “*blatantly contradictory and ambiguous position in connection with the Parking Plan.*”<sup>44</sup>
- The Municipality changed its opinion several times concerning the first MSCP site.

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<sup>41</sup> See Claimant’s Memorial, p. 66 *et seq.* and Claimant’s Post-Hearing Brief, p. 60 *et seq.*

<sup>42</sup> See Claimant’s Post-Hearing Brief, p. 61

<sup>43</sup> *Idem*, p. 62.

<sup>44</sup> See Claimant’s Memorial, ¶ 210.

- The Municipality arbitrarily refused to issue the necessary design conditions and to enter into the necessary land-use agreement.
- The Municipality accused BP of failure to perform its construction obligation, refused to negotiate in good faith and then terminated unlawfully the Agreement.<sup>45</sup>

297. The Respondent states that the *Sorainen Memo* was disclosed to BP before the signing of the Agreement. The Respondent alleges that it made it clear that the measures set out in the Agreement were untested and could be subject to legal challenges.<sup>46</sup> For the Respondent, the State is not responsible for the consequence of “*unwise business decisions or for the lack of diligence of the investor.*”<sup>47</sup>

298. The Respondent underlines that BP was granted a force majeure claim by the Lithuanian Courts.<sup>48</sup>

299. The Respondent is of the opinion that the conduct alleged by the Claimant does not give rise to a claim under the Treaty and that the conduct alleged is “*nothing more than allegation of contract breach.*”<sup>49</sup>

### **8.1.3.2 Discussion**

#### **a) The Sorainen Memo**

300. It is not disputed by the parties that arbitrariness is incompatible with the standard of *fair and equitable treatment*.

301. Based on the facts as discussed by the Parties, the Tribunal finds that a memo (“*the Sorainen Memo*”) concerning the Law on Fees and Charges was effectively in possession of the City of Vilnius prior to the execution of the Agreement on 30 December 1999.<sup>50</sup> Indeed, the memorandum is dated 28 December 1999 and the Respondent does not allege that it received the document after 30 December 1999. Mr. Robertas Staskevicius confirmed that “[...] *it was before City Council. It was on 28<sup>th</sup> of December. When we’ve got this -- [Sorainen memo] it was immediate discussion of that because it was quite serious issue.*”<sup>51</sup>

302. The record does not convincingly show that any information contained in the *Sorainen Memo* and, *a fortiori*, a copy of the memorandum, was given to the Claimant by the City of Vilnius before the conclusion of the Agreement. Accordingly, the Tribunal assumes

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<sup>45</sup> See Claimant’s Post-Hearing Brief, p.81.

<sup>46</sup> See Respondent Counter-Memorial, p. 68.

<sup>47</sup> *Idem*, p. 72.

<sup>48</sup> See Respondent Post-Hearing Brief, p. 17.

<sup>49</sup> *Idem*, p. 11 *et seq.*

<sup>50</sup> See CE 11 ;

<sup>51</sup> See Robertas Staskevicius, Tr. 1307:17-21.

that Mr. Tamulis did not receive a copy of this memorandum and that the Claimant was unaware of its existence (up to April 2000).<sup>52</sup>

303. In substance, the *Sorainen Memo* contains a brief (5 pages) legal opinion regarding the draft of the Agreement between the Municipality of Vilnius and the Consortium. In its most relevant part, the Memorandum reads as follows:

*we would take the views that the legal acts of the Republic of Lithuania and contractual deeds and obligations, indicated in the Agreements of the Municipality and the Consortium, do not create sufficient and clear legal ground for the Consortium to have right to collect a portion of the fee for vehicle parking time for on-street parking places designated by the Municipality Council, which is derived from the entire fee, established in Article 5.1.3, less local charges approved by the Municipality Council.*

304. The information contained in the *Sorainen Memo* is characterized as the opinion of a law firm regarding the Agreement. The document does not provide any information which was not, at the time of its drafting, accessible to the public or at least to any other qualified law firm. The Claimant could have also obtained an opinion from another law firm.

305. It is not disputed that the Claimant did, in fact, receive a legal opinion dated 29 December 1999 from another law firm, namely the Lawin Firm. The opinion concluded that:

*“Following your request, we would like to comment the legal situation relating to collection of payment for car parking in places designated by the Municipality (streets and squares). The Agreement between Vilnius City Municipality and the Consortium establishes that such payment will consist of local charges and the portion of payment falling on the Consortium.*

*The portion of payment falling on the Consortium is to be legally qualified as payment for services, which will be rendered by the Consortium to car drivers. The scope of this service is the development of parking system in the city and its administering. Car parking in pay place is to be qualified as a behaviour of a driver expressing his/her will to use the service rendered by the Consortium and to pay for it according the rate set by the Consortium.”<sup>53</sup>*

306. Mr. Tamulis testified convincingly that such opinion was only a “*small piece of an exhibit from the legal opinion which we had from Lawin regarding the whole thing around the hybrid parking fee.*”<sup>54</sup> In the view of the Arbitral Tribunal, the Claimant, when it requested such opinion, was without doubt aware that the business environment, and especially various provisions of the Agreement, were not certain. In fact, it would have been foolish for a foreign investor in Lithuania to believe, at that time, that it would be proceeding on stable legal ground, as considerable changes in the Lithuanian political regime and economy were undergoing.

307. Another matter is whether, in itself, failing to disclose a legal opinion (such as the *Sorainen Memo*) to the counter-party before entering into an Agreement has

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<sup>52</sup> See Claimant’s Memorial, ¶ 45.

<sup>53</sup> See Exhibit R 40.

<sup>54</sup> See Jonas Tamulis Stmt, Tr. 514-515.

international consequences for a State party. Such a conduct is often considered as a breach of good faith or a “*culpa in contrahendo*”. However, such a conduct, while objectionable, does not, in itself, amount to a breach of international law. It would take unusual circumstances to decide otherwise; in particular, the Claimant has been unable to show that the Sorainen Firm (or the Municipality of Vilnius) was in possession of information unavailable to the public, especially to other legal experts.

308. In *MTD v. Republic of Chile*, the Tribunal noted that:

*[the State is not] responsible for the consequences of unwise business decisions or for the lack of diligence of the investor. Its responsibility is limited to the consequences of its own action to the extent they breached the obligation to treat the Claimants fairly and equitably.*<sup>55</sup>

309. The Tribunal concludes that the City of Vilnius did not act arbitrarily when it failed to disclose the *Sorainen Memo* and its content to BP. Whatever the effect of the non-production of the *Sorainen Memo* on the Claimant’s contractual rights is not a matter for this Tribunal.

**b) The Force majeure**

310. As already stated, breaching the Agreement will not automatically result in a violation of the Respondent’s international law obligations under the BIT. In the present instance, the Tribunal concludes that the force majeure (see ¶ 295) claim and any breaches of the Agreement do not reach the status of a BIT breach.

311. In fact this issue has been reviewed by the Lithuanian Courts. On 29 June 2005, a Lithuanian court ruled on the problem of *force majeure*:

*“[h]aving evaluated the arguments presented by the parties, the court decides that the grounds do exist to recognize that non-performance of the Defendant’s contractual obligations as a consequence of lost income from unblocking road wheels was conditioned by Force majeure events, i.e. Government Resolution no 1056, therefore there are ground to release Defendants [BP] from fulfilment of obligations related to such part of income”.*<sup>56</sup>

312. The Lithuanian Court of Appeals confirmed this decision and held that:

*“[...] upon adoption of Government Resolution No 1056, Defendants [BP] could not perform the obligation under Clause 5.1.1 of the Agreement. [...] Thus Defendants did not fulfil part of the monetary obligation under the Agreement for objective reasons and the court of first instance had sufficient grounds to release them from the part of the obligation the performance of*

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<sup>55</sup> MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Republic of Chile, ICSID Case No. ARB/01/7, Award, May 25, 2004, available at <http://www.asil.org/ilib/MTDvChile.pdf>, ¶ 167.

<sup>56</sup> See Exhibit C 234.



*which was directly related with the collection of the unclamping fee and its transfer to Plaintiff.*<sup>57</sup>

313. Two layers of Lithuanian Courts confirmed that the City of Vilnius acted wrongfully when it refused to recognise the existence of a force majeure situation. On that point, the Courts ruled in favour of BP. The fact that the Lithuanian Courts denied some of BP's claims is not relevant in the present proceedings; indeed subject to denial of justice, which is not at issue here, an erroneous judgment (if there should be one) shall not in itself run against international law, including the Treaty. On that matter, the Respondent did not act arbitrarily in contradiction with the provisions of the Treaty.

**c) The termination of the Agreement**

314. The Claimant alleges that the City of Vilnius (see ¶ 295) did not act in good faith during the contractual relationship, refused to renegotiate the Agreement in good faith, and finally, decided unilaterally to terminate the Agreement.
315. Fair and equitable treatment is denied when the investor is treated in such an unjust or arbitrary manner that the treatment is unacceptable from an international law point of view.<sup>58</sup> Indeed, many tribunals have stated that not every breach of an agreement or of domestic law amounts to a violation of a treaty. For instance, in the *Saluka v. Poland* case, the Tribunal stated:

*The Treaty cannot be interpreted so as to penalise each and every breach by the Government of the rules or regulations to which it is subject and for which the investor may normally seek redress before the courts of the host State. [...] something more than simple illegality or lack of authority under the domestic law of a State is necessary to render an act or measure inconsistent with the customary international law requirements. (¶¶ 442-443).*<sup>59</sup>

316. Under certain limited circumstances, a substantial breach of a contract could constitute a violation of a treaty. So far, case law has offered very few illustrations of such a situation. In most cases, a preliminary determination by a competent court as to whether the contract was breached under municipal law is necessary<sup>60</sup>. This preliminary determination is even more necessary if the parties to the contract have agreed on a specific forum for all disputes arising out of the contract. For the avoidance of doubt, the requirement is not dependent upon the parties to the contract being the same as the parties to the arbitration.

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<sup>57</sup> See Exhibit C 235.

<sup>58</sup> See S.D. Myers, Inc. v. Government of Canada, NAFTA UNCITRAL Arbitration, First Partial Award, November 13, 2000, available online at <http://www.dfait-maeci.gc.ca/>, p. 65.

<sup>59</sup> See UNCITRAL Arbitration, Partial Award, March 17, 2006; See also Azurix Corp. v. Argentine Republic, ICSID Case No. ARB/01/12, Award, July 14, 2006, available online at [http://www.worldbank.org/icsid/cases/pdf/ARB0112\\_Azurix-Award-en.pdf](http://www.worldbank.org/icsid/cases/pdf/ARB0112_Azurix-Award-en.pdf)

<sup>60</sup> See for instance, Generation Ukraine Inc. v. Ukraine, ICSID Case No ARB/00/9, Award, September 16, 2003, *supra* note 16, p. 91 and Waste Management, Inc. v. United Mexican States, ICSID Case No. ARB(AF)/00/3, Award, April 30, 2004, reprinted in 43 ILM 967 (2004), ¶¶ 114-115.

317. However, if the contracting-party is denied access to domestic courts, and thus denied opportunity to obtain redress of the injury and to complain about those contractual breaches, then an arbitral tribunal is in position, on the basis of the BIT, to decide whether this lack of remedies had consequences on the investment and thus whether a violation of international law occurred. In other words, as a general rule, a tribunal whose jurisdiction is based solely on a BIT will decide over the “treatment” that the alleged breach of contract has received in the domestic context, rather than over the existence of a breach as such.
318. In the case at hand, there is no doubt that BP had access to the Lithuanian Courts. In fact, neither BP nor the Claimant has challenged the alleged violation of the Agreement, with the exception of *force majeure* case, before the Lithuanian Courts as provided by the Agreement<sup>61</sup>(see above ¶ 310). The experts confirmed that the Lithuanian Courts are independent<sup>62</sup> and that levels of corruption had declined substantially.<sup>63</sup>.
319. Mr. Bjorn Havnes declared that “[t]o be honest with you, I don’t think it would stand a chance in the Lithuanian courts.”<sup>64</sup> However, again, this testimony seems to show the emotion of the witness rather than reflect the actual reliability of the Lithuanian judiciary. The failure to complain of the violation of the Agreement before the Lithuanian Court leads to two consequences. First, the Claimant failed to show that the Municipality of Vilnius terminated the Agreement wrongfully and therefore breached the Agreement. Second, even supposing that the Agreement has been wrongfully terminated, the Claimant failed to show that the right of BP to complain of the breach of the Agreement has been denied by the Republic of Lithuania and thus that its own investment was actually not accorded, by the Respondent, an equitable and reasonable treatment in such circumstances.
320. Given the above circumstances, the Arbitral Tribunal cannot reach the conclusion that Article III of the BIT was breached.

#### **8.1.4 Legitimate expectations**

##### **8.1.4.1 Position of the parties**

The Claimant contends that the Republic of Lithuania has violated its obligation to accord a *fair and equitable treatment* by frustrating its legitimate expectations. The standard of fair and equitable treatment requires the host State to treat international investments in a way that does not affect the basic expectations that were taken into account by the foreign investor in making its investment. Parkerings was therefore entitled to expect that Lithuania maintain a stable and

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<sup>61</sup> See CE 13, Article 7.3. of the Agreement.

<sup>62</sup> See Gintautas Barktkus, Tr. 908.

<sup>63</sup> See Expert Report of Carlos Lapuerta, p. 4.

<sup>64</sup> See Bjorn Havnes, Tr. 1072.

predictable legal and business framework, as well as act transparently in a consistent manner free from any ambiguity.

321. The Claimant principally alleges that:

- a) *“Lithuania frustrated Parkerings’s legitimate expectation that it would respect and protect the legal integrity of the Agreement*

The Municipality of Vilnius did not inform the Claimant of the existence of the “Sorainen memo” that questioned the consistency of a hybrid parking fee with the Lithuanian Laws<sup>65</sup>;

Moreover, modification of law had the effect to invalidate several decisive provisions of the Agreement. The Municipality did not object to the new law “even though it had contractually undertaken to use its best efforts to ensure that the Government’s laws and decrees furthered the successful development of the parking system”;

Claimant emphasizes that it “had a legitimate expectation that Lithuania would not employ its municipal and national instrumentalities to first induce investment by Parkerings on the false promise of a contractual armor for its investment, and then deliberately to perforate that legal armor to expose Parkerings to the arbitrariness of the Municipal authorities<sup>66</sup>;

- b) *“Lithuania frustrated Parkerings’s legitimate expectation that it would respect and protect the economic integrity of the Agreement”*:

Notwithstanding the modification of law, the Municipality continued to require the full performance of the Agreement by BP and notably the payment of the Clause 5.1.15;

The Municipality failed to deliver to BP the design conditions of MSCP and changed several times the site of the construction, but pretended that BP had breached the Agreement;

The Municipality refused to renegotiate in good faith the Agreement;

The Municipality repudiated unlawfully the Agreement.<sup>67</sup>

322. The Claimant alleges that it was “entitled to expect that Lithuania maintain a stable and predictable legal and business framework,”<sup>68</sup> and that “Lithuania was required to act in a consistent manner, free from ambiguity and totally transparently in its relation with Parkerings.”<sup>69</sup> The Claimant asserts that by frustrating its legitimate expectations, the Respondent violated Article III of the BIT.

323. The Respondent alleges that not every regulatory action that creates a business problem amounts to a treaty violation.<sup>70</sup> For the Respondent, the Claimant should prove that “the Government’s conduct frustrated the investor’s investment-backed

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<sup>65</sup> See Claimant’s Memorial, ¶ 215.

<sup>66</sup> *Idem*, ¶ 216.

<sup>67</sup> *Idem*, ¶ 217

<sup>68</sup> *Idem*, p. 68.

<sup>69</sup> *Idem*, ¶ 216.

<sup>70</sup> See Respondent Counter-Memorial, p. 65.

*expectations that the State created or reinforced through its own acts.*<sup>71</sup> The Respondent alleges that neither the City nor the Government of Lithuania induced Parkerings to invest by making representations as to the stability of the legal regime applicable to the Agreement.<sup>72</sup> On the contrary, Parkerings was aware that the arrangements set out in the Agreement were untested and could be subject to legal challenge.<sup>73</sup> Parkerings should have known the potential modification of law and the legal challenges of certain provisions of the Agreement.<sup>74</sup>

324. The Respondent noted that the Agreement does not contain a provision stabilizing the legal regime applicable to the Agreement, but contains a provision exempting the City from responsibility for actions taken by the Lithuanian Government.<sup>75</sup>

325. Finally, the Respondent argues that the claims consist only of possible breaches of the Agreement and therefore that the Claimant should have acted before the Lithuanian Courts.<sup>76</sup>

#### **8.1.4.2 Discussion**

326. The Tribunal notes that in this case a difference has to be made between: **a)** the obligations of the Republic of Lithuania not to modify the law, and **b)** the obligations of the Municipality of Vilnius to inform and protect the Claimant against the potential economic impact of such modification on the Agreement.

#### **a) Did Lithuania frustrate Parkerings' legitimate expectation that it would respect and protect the legal integrity of the Agreement?**

327. In 2000, subsequent to the signing of the Agreement of 29 December 1999, the Lithuanian Parliament amended several laws which affected the Agreement. The Law on Local Fees and Charges was modified on 13 June 2000,<sup>77</sup> the Decree on Clamping was amended on 5 September 2000<sup>78</sup> and finally, the Law on Self-Government was modified on 12 October 2000.<sup>79</sup>

328. The Agreement provided that the Consortium was granted the right to collect the parking fees and the clamping fees. The parties agree that the modification of the Law on Local Fees and Charges and the amendment of the Decree on Clamping prevented the Consortium from receiving an important part of its income.

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<sup>71</sup> *Ibidem.*

<sup>72</sup> See Respondent Post-Hearing Brief, p. 18.

<sup>73</sup> See Respondent Counter-Memorial, p. 68.

<sup>74</sup> *Ibidem.*

<sup>75</sup> *Idem*, ¶¶ 189-200.

<sup>76</sup> *Idem*, ¶¶ 201-206.

<sup>77</sup> See Exhibit CE 136.

<sup>78</sup> See Exhibit CE 41.

<sup>79</sup> See Exhibit CE 47.

329. The questions to be resolved are whether Parkerings had any legitimate expectation in the stability of the *legal system* and whether its expectation has been frustrated.
330. In order to determine whether an investor was deprived of its legitimate expectations, an arbitral tribunal should examine “[...] *the basic expectation that were taken into account by the foreign investor to make investment* [...]”<sup>80</sup>. In other words, the *Fair and Equitable Treatment* standard is violated when the investor is deprived of its legitimate expectation that the conditions existing at the time of the Agreement would remain unchanged.
331. The expectation is legitimate if the investor received an explicit promise or guaranty from the host-State, or if implicitly, the host-State made assurances or representation that the investor took into account in making the investment. Finally, in the situation where the host-State made no assurance or representation, the circumstances surrounding the conclusion of the agreement are decisive to determine if the expectation of the investor was legitimate.<sup>81</sup> In order to determine the legitimate expectation of an investor, it is also necessary to analyse the conduct of the State at the time of the investment.
332. It is each State’s undeniable right and privilege to exercise its sovereign legislative power. A State has the right to enact, modify or cancel a law at its own discretion. Save for the existence of an agreement, in the form of a *stabilisation* clause or otherwise, there is nothing objectionable about the amendment brought to the regulatory framework existing at the time an investor made its investment. As a matter of fact, any businessman or investor knows that laws will evolve over time. What is prohibited however is for a State to act unfairly, unreasonably or inequitably in the exercise of its legislative power.
333. In principle, an investor has a right to a certain stability and predictability of the legal environment of the investment. The investor will have a right of protection of its legitimate expectations provided it exercised due diligence and that its legitimate expectations were reasonable in light of the circumstances. Consequently, an investor must anticipate that the circumstances could change, and thus structure its investment in order to adapt it to the potential changes of legal environment.
334. In the present case, various modifications of laws occurred in Lithuania. It is not contested that these amendments had an impact on the investment expectations of the Claimant, as it was deprived of its right to receive part of its expected income.<sup>82</sup>

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<sup>80</sup> See *Técnicas Medioambientales Tecmed, S.A. v. United Mexican States*, ICSID Case No. ARB(AF)/00/2, Award, May 29, 2003, *reprinted in 19 ICSID Rev.—FILJ* 158 (2004), ¶ 154.

<sup>81</sup> See *Waste Management, Inc. v. United Mexican States*, ICSID Case No. ARB(AF)/00/3, Award, April 30, 2004, *supra* note 60. See also, *Técnicas Medioambientales Tecmed, S.A. v. United Mexican States*, ICSID Case No. ARB(AF)/00/2, Award, May 29, 2003, *supra* note 80, ¶¶ 152 *et seq.*; *CMS Gas Transmission Company v. Argentine Republic*, ICSID Case No. ARB/01/8, Award, May 12, 2005, *supra* note 39.

<sup>82</sup> See *The Republic of Lithuania Counter-Memorial*, ¶ 81: « *the Lithuanian Government had taken actions that, with respect to the On-Street parking Concession, prevented (or would eventually prevent) the concessionaire, VPK, from collecting the fee as provided under the Agreement and from penalizing drivers who failed to pay the fees provided under the Agreement* ».

Neither is it contested that the Republic of Lithuania gave no specific assurance or guarantee to Parkerings that no modification of law, with possible incidence on the investment, would occur. The legitimate expectations of the Claimant that the legal regime would remain unchanged are not based on or reinforced by a particular behaviour of the Respondent. In other words, the Republic of Lithuania did not give any explicit or implicit promise that the legal framework of the Agreement would remain unchanged.

335. In 1998, at the time of the Agreement, the political environment in Lithuania was characteristic of a country in transition from its past being part of the Soviet Union to candidate for the European Union membership. Thus, legislative changes, far from being unpredictable, were in fact to be regarded as likely. As any businessman would, the Claimant was aware of the risk that changes of laws would probably occur after the conclusion of the Agreement. The circumstances surrounding the decision to invest in Lithuania were certainly not an indication of stability of the legal environment. Therefore, in such a situation, no expectation that the laws would remain unchanged was legitimate.
336. By deciding to invest notwithstanding this possible instability, the Claimant took the *business risk* to be faced with changes of laws possibly or even likely to be detrimental to its investment. The Claimant could (and with hindsight should) have sought to protect its legitimate expectations by introducing into the investment agreement a stabilisation clause or some other provision protecting it against unexpected and unwelcome changes.
337. The record does not show that the State acted unfairly, unreasonably or inequitably in the exercise of its legislative power. The Claimant has failed to demonstrate that the modifications of laws were made specifically to prejudice its investment.
338. Consequently, in the case at hand, the Tribunal is not persuaded that the Claimant had any legitimate expectation that the Government of the Republic of Lithuania would not pass legislation and regulatory measures which could harm its investment. In that respect, the Tribunal considers that the Respondent did not violate Article III of the BIT.
- b) Did Lithuania, by the action and omission of the Municipality, frustrate Parkerings' legitimate expectation that it would respect and protect the economic and legal integrity of the Agreement?**
339. The Claimant contends that the City of Vilnius was aware of the existence of the proposals to amend the Law on Fees and Charges, the Decree on Clamping and the Law of Self-Government, but never informed the Claimant during the negotiation and prior to the signing of the Agreement
340. Concerning the amendment of the Decree on Clamping and the modification of the Law on Self-Government, the record confirms that Mayor Zuokas was a member of the

Board of the Association of Local Authorities in Lithuania.<sup>83</sup> On 22 October 1999, the Board of the Association of Local Authorities in Lithuania had to “*submit comments and proposals to the Seimas, Government and any other state authorities on the improvement of the legal base of local self-government and other laws related to the operation of the local authorities.*”<sup>84</sup>

341. Consequently, the City of Vilnius was in possession of information, prior to the conclusion of the Agreement, concerning possible modifications of the Law on Self-Government and omitted to advise the Claimant. It is evident that the Respondent, as mentioned above (see ¶ 335), had the contractual obligation to act and negotiate in good faith prior to the conclusion of the Agreement. By failing to do so, it may have breached the Agreement but that is not a matter for this Tribunal.
342. However, first, the record does not show that the Respondent deliberately neglected to advise the Claimant of the possible amendment of the law. Second, as described above (see ¶ 335), the political environment was changing at the time of the negotiation of the Agreement and the Claimant should have known that the legal framework was unpredictable and could evolve. Third, the fact that the City of Vilnius knew the intention of the legislator to modify certain laws, does not mean that the City of Vilnius knew the substance of the modification. Indeed, the record does not show that the City of Vilnius was in possession of any specific information which indicated that the Agreement would be affected by a modification of the law. Fourth, the Claimant failed to demonstrate that any investor or at least a qualified law firm was unable to get the information about the amendment process. Therefore, the Tribunal sees no reason why, in the circumstances, the alleged contractual obligation of the Municipality to inform BP of the future modification of the law is constitutive of a *legitimate expectation* for the Claimant.
343. The Claimant alleges a violation by the Municipality of Vilnius of its obligation to use its best efforts to ensure that the Government’s laws and decrees furthered the successful development of the parking system. The Claimant alleges that following the different modifications of laws, it was deprived of various sources of income in violation of the Agreement. Moreover, the Claimant accuses the Representative of the Municipality and notably the Mayor of failing to act in good faith to protect and respect the Agreement and especially the economic interest of the Claimant in the performance of the Agreement.
344. It is evident that not every hope amounts to an expectation under international law. The expectation a party to an agreement may have of the regular fulfilment of the obligation by the other party is not necessarily an expectation protected by international law. In other words, contracts involve intrinsic expectations from each party that do not amount to expectations as understood in international law. Indeed, the party whose *contractual expectations* are frustrated should, under specific conditions, seek redress before a national tribunal. As stated by the Tribunal in Saluka, “[t]he Treaty cannot be

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<sup>83</sup> See Exhibit CE 256, p. 3084.

<sup>84</sup> *Idem*, p. 3077.

*interpreted so as to penalise each and every breach by the Government of the Rules or regulations to which it is subject and for which the investor may normally seek redress before the courts of the host State.*<sup>85</sup>

345. In the case at hand, the Claimant alleges that the Municipality of Vilnius frustrated its legitimate expectation in violation of Article III of the Treaty (see ¶¶ 321 *et seq.*). However, the Tribunal considers that the Claimant's expectations are, in substance, of a contractual nature. The acts and omissions of the Municipality of Vilnius, in particular any failure to advise or warn the claimant of likely or possible changes to Lithuanian law, may be breaches of the Agreement but that does not mean they are inconsistent with the Treaty.
346. In conclusion, the Arbitral Tribunal finds that the Claimant has not been deprived of any legitimate expectation in violation of Article III of the Treaty.

## **8.2 CLAIMS FOR VIOLATION OF THE OBLIGATION OF PROTECTION (ARTICLE III OF THE TREATY)**

347. Pursuant to Article III of the BIT the contracting States also agreed to accord *protection* to the investor.

### **8.2.1 Position of the parties**

348. The Claimant alleges that the Respondent failed to protect its investment.<sup>86</sup>
- (a) When parking meters owned by VPK were destroyed, the Police did not identify any suspects, did not find any evidence.
  - (b) Claimant sought the protection of the Prime Minister against the action and omission of the Municipality but no such protection was given. Claimant alleged that *“the Government Representative failed to disclose that the Municipality was treating BP unfairly and engaging in discrimination by refusing to enter into a Cooperation Agreement”*.
  - (c) Claimant reproaches the Government Representative for its passiveness when the Municipality refused to sign a Cooperation Agreement with BP and then repudiated the Agreement.
349. The Claimant argues that the Republic of Lithuania, in order to comply with its obligation, *“must show that it took all measure of precaution to protect Parkerings’ investment and met the standard of due diligence. [...] Lithuania’s duty of protection extends to guarding against the action of both non-state actors and organs of government. [...] a state has a duty to protect aliens and their investment against unlawful acts committed by some of its citizens. If such acts are committed with the active assistance of state-organs a breach of International Law occurs. [...] If the wrong has been committed by a private individual or a state organ, Lithuania is under an obligation to punish the wrongdoer.”*<sup>87</sup>

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<sup>85</sup> See *Saluka Investment BV (The Netherlands) v. The Czech Republic*, UNICITRAL Case, ¶ 442.

<sup>86</sup> See Claimant's Memorial, p. 72 *et seq.* and Claimant's Post-Hearing Brief, p. 117.

<sup>87</sup> See Claimant's Memorial, ¶ 222.



350. The Claimant alleges that, by its failure to protect the investment, the Respondent has breached its obligation under Article III of the Treaty.
351. The Respondent contends that it granted the Claimant the *full protection and security* as provided by the Treaty. Under International Law, the guarantee of protection is characterized by the standard of due diligence. This standard requires “*the state to take reasonable steps to prevent hostile acts toward investors that it knew or should have known were about to take place.*”<sup>88</sup>
352. In the Respondent’s view, “*the guarantee of protection and security is not absolute and does not impose strict liability on the State that grants it.*”<sup>89</sup> “*The simple fact that Claimant is not pleased with the result of a state action does not constitute a basis for a claim under the protection clause, provided the state exercised due diligence.*”<sup>90</sup>
353. The Respondent alleges that Lithuania reacted reasonably within the parameter of due diligence of a democratic state to the various complaints lodged by Claimant and BP.<sup>91</sup> For the Respondent, the non-intervention of the Government’s Representative concerning the termination of the Agreement and the refusal of the City of Vilnius to sign a Cooperation Agreement do not amount to a violation of the Treaty. Indeed, the termination was not wrongful and, therefore, did not merit any legal challenge; Lithuania had no obligation to challenge an alleged breach of the Agreement if the contracting party had the right and the opportunity to challenge the breach itself.<sup>92</sup>

### 8.2.2 Discussion

354. Article III of the Treaty only mentions the term *protection*. In a number of decisions, Tribunals make reference to the standard of “*full protection and security.*” It is generally accepted that the variation of language between the formulation “*protection*” and “*full protection and security*” does not make a significant difference in the level of protection a host State is to provide.<sup>93</sup> Moreover, *in casu*, the Parties make systematically reference to the standard of “*full protection and security.*” Therefore, the Arbitral Tribunal intends to apply the standard of “*full protection and security.*”
355. A violation of the standard of *full protection and security* could arise in case of failure of the State to prevent the damage, to restore the previous situation or to punish the author of the injury.<sup>94</sup> The injury could be committed either by the host State, or by its agencies or by an individual.

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<sup>88</sup> See Respondent Counter-Memorial, p. 86.

<sup>89</sup> *Idem*, ¶ 228.

<sup>90</sup> See Respondent Counter-Memorial, ¶ 230.

<sup>91</sup> *Idem*, ¶ 232.

<sup>92</sup> *Idem*, ¶ 235.

<sup>93</sup> See for instance Rubins N., Kinsella S., *International Investment, Political Risk and Dispute Resolution*, New-York, 2005.

<sup>94</sup> See *Wena Hotels Limited v. Arab Republic of Egypt*, ICSID Case No. ARB/98/4, Award, December 8, 2000, reprinted in 41 *ILM* 896 (2002), ¶¶ 84-95.

356. The Claimant alleges damages to its materials due to vandalism. However, the Claimant does not show that such vandalism would have been prevented if the authorities had acted differently. The Claimant only contends that the police did not find the authors of this offence. Both parties agree that Lithuanian authorities started an investigation to find the authors of the vandalism.
357. The Arbitral Tribunal finds that the record does not show in which way the process of investigation amounted to a violation of the Treaty. In *Tecmed*, the Tribunal underlined that “*the guarantee of full protection and security is not absolute and does not impose strict liability upon the State that grants it.*”<sup>95</sup>
358. The Claimant criticized the alleged failure of the Prime Minister to protect its investment against the action and omission of the municipality. However, the record does not show that the Prime Minister did not act in any manner that should be incompatible with his function and duties. The Claimant failed also to demonstrate a negligence of the Prime Minister that could amount to a breach of the BIT.
359. The Claimant also criticized the Respondent for its passivity when the City of Vilnius breached the Agreement. However, the Arbitral Tribunal considers that the investment Treaty created no duty of due diligence on the part of the Respondent to intervene in the dispute between the Claimant and the City of Vilnius over the nature of their legal relationships.
360. The Respondent’s duty under the Treaty was, first, to keep its judicial system available for the Claimant to bring its contractual claims and, second, that the claims would be properly examined in accordance with domestic and international law by an impartial and fair court. There is no evidence - not even an allegation – that the Respondent has violated this obligation.
361. The Claimant had the opportunity to raise the violation of the Agreement and to ask for reparation before the Lithuanian Courts. The Claimant failed to show that it was prevented to do so. As a result, the Arbitral Tribunal considers that the Respondent did not violate its obligation of protection and security under the Article III of the BIT.

### **8.3 CLAIMS FOR VIOLATION OF THE OBLIGATION TO ACCORD TREATMENT NO LESS FAVORABLE THAN THE TREATMENT ACCORDED TO INVESTMENTS BY INVESTORS OF A THIRD STATE (ARTICLE IV OF THE TREATY)**

362. Article IV of the Treaty provides that

1. *[I]nvestments made by investors of one contracting party in the territory of the other contracting party, as also the returns therefrom, shall be accorded treatment no less favourable than that accorded to investments made by investors of any third state.*

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<sup>95</sup> See *Técnicas Medioambientales Tecmed, S.A. v. United Mexican States*, ICSID Case No. ARB(AF)/00/2, Award, May 29, 2003, *supra* note 80, ¶¶ 177.

### 8.3.1 Position of the parties

363. In substance, the Claimant alleges that the Respondent violated Article IV of the Treaty as follows:<sup>96</sup>

- (a) the City of Vilnius rejected the project of MSCP proposed by BP on the Gedimino site for cultural heritage concerns, because the project was situated in the Old Town of the City of Vilnius. However, the Municipality authorized another company (Pinus Proprius) to build a MSCP on the same site;
- (b) the City of Vilnius refused to sign a Joint Activity Agreement (JAA) with BP for the Gedimino MSCP and for the Pergales MSCP for legal reason, but signed a JAA with the Company Pinus Proprius;
- (c) Once the JAA signed with the Company Pinus Proprius has been declared unlawful, the City of Vilnius transformed it into a Cooperation Agreement. However, the City of Vilnius refused to conclude a similar Cooperation Agreement with BP as a substitute of the JAA.

364. In the Claimant's view, the Companies Pinus Proprius and BP were facing similar circumstances. The refusal of the City of Vilnius to sign a JAA or a Cooperation Agreement prevented BP from the construction of any MSCP in Vilnius and thus deprived it of the opportunity to carry out its investment as it was entitled to do under the Agreement.

365. The Respondent alleges that the situation of the MSCP built by Pinus Proprius on the Gedimino site was clearly different from the project proposed by the Claimant on the Gedimino site and the Pergales site.<sup>97</sup>

- (a) The MSCP built by Pinus Proprius on the Gedimino site was smaller than the MSCP project proposed by the Claimant. The proposed MSCP designed by the Claimant extended to the Odiminiu Square, which is part of the Old Town area as defined by the Annex No. 5 of the Agreement, but the one constructed by Pinus Proprius was not. The Respondent underlines that a construction in the Old Town needed the approval of the Government's Cultural heritage Commission.
- (b) The Joint Activity Agreement could not be signed with BP since the modification of the Article 9(2) of the Law on Self-Government which prohibited the conclusion of such agreement with private entities. The Respondent alleges that the Cooperation Agreement signed with Pinus Proprius was not a JAA. However, the conclusion of a similar Cooperation Agreement with BP was not possible for various reasons:
  - A transfer of land was necessary for the MSCP proposed by BP and not for the MSCP built by Pinus Proprius, as the latter was already the owner of part of the land where the MSCP was built. Consequently, a Public Auction was necessary for the transfer of state-owned land to BP<sup>98</sup>;
  - Pinus Proprius had the contractual obligation to transfer its own land to the State when the building would be achieved. Pinus Proprius also agreed to sell the MSCP to the City. On the contrary, BP could remain the owner of the MSCP built on the Gedimino site and on Pergales site and would have the possibility to lease the state-owned land or to buy it<sup>99</sup>.

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<sup>96</sup> See Claimant's memorial, p. 74 and Claimant's Post-Hearing Brief, p. 99.

<sup>97</sup> See Respondent Counter-Memorial, p. 90 and Respondent Post-Hearing Brief, p. 5

<sup>98</sup> See Respondent Counter-Memorial, ¶ 248.

<sup>99</sup> See Respondent Post-Hearing Brief, p. 6.

- The MSCP built by Pinus Proprius was under state-owned land that was not delineated by a land plot and, therefore, could never be owned or leased by Pinus Proprius. On the contrary, the project of MSCP on Pergales site proposed by BP was situated on a state-owned land delineated as a land plot and therefore required a Public Auction.<sup>100</sup>

366. Article IV of the Treaty is known as the standard of the “*Most-favoured-nation Treatment*”. *Most-favoured-nation (MFN)* clauses are by essence very similar to “*National Treatment*” clauses. They have similar conditions of application and basically afford indirect advantages to their beneficiaries, namely a treatment no less favourable than the one granted to third parties. Tribunals’ analyses of the *National Treatment* standard will therefore also be useful to discuss the alleged violation of the *MFN* standard.

367. *National treatment* and *Most-Favoured-Nation treatment* are treaty clauses that have the same substantive effect as the international treatment standard: foreigners should be afforded treatment no less favourable than the one granted to local citizens. The international law requirement in fact acts as a minimum requirement as it would be useless for the States party to a treaty to grant benefits less sweeping than customary law. In other words, all the requirements, be they national treatment, most favoured-nation-treatment or non-discrimination at large, will in effect bar discrimination against foreign national investing in the country concerned. All investors benefiting from a treaty will benefit of a treatment identical or better than nationals or third countries persons. There is, thus, no reason discretely to address the issue of non-discrimination: the two aspects, under most-favoured-nation requirements (Article IV of the Treaty) on the one hand and under international customary law on the other.

368. Discrimination is to be ascertained by looking at the circumstances of the individual cases. Discrimination involves either issues of law, such as legislation affording different treatments in function of citizenship, or issues of fact where a State unduly treats differently investors who are in similar circumstances. Whether discrimination is objectionable does not in the opinion of this Tribunal depend on subjective requirements such as the bad faith or the malicious intent of the State: at least, Article IV of the Treaty does not include such requirements. However, to violate international law, discrimination must be unreasonable or lacking proportionality, for instance, it must be inapposite or excessive to achieve an otherwise legitimate objective of the State. An objective justification may justify differentiated treatments of similar cases. It would be necessary, in each case, to evaluate the exact circumstances and the context.

369. The essential condition of the violation of a *MFN* clause is the existence of a different treatment accorded to another foreign investor in a similar situation.<sup>101</sup> Therefore, a

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<sup>100</sup> *Idem*, pp. 5-6.

<sup>101</sup> See Goetz and others v. Burundi, ICSID Case No. ARB/95/3, Award, February 10, 1999, *supra* note 40, ¶ 121.

comparison is necessary with an investor in *like circumstances*. The notion of *like circumstances* has been broadly analyzed by Tribunals<sup>102</sup>.

370. For example, in *Pope and Talbot Inc. v. Government of Canada*, the Tribunal held that:

*[i]n evaluating the implication of the legal context, the Tribunal believes that, as a first step, the treatment accorded a foreign owned investment protected [...] should be compared with that accorded domestic investment in the same business or economic sector.*<sup>103</sup> [...]

*Once it is established that a foreign and domestic investor are in the same business or economic sector, "[d]ifference in treatment will presumptively violate [the principle] unless they have a reasonable nexus to rational government policies that (1) do not distinguish, on their face or de facto, between foreign-owned and domestic companies, and (2) do not otherwise unduly undermine the investment liberalizing of NAFTA. [...] A formulation focusing on the like circumstances [...] will require addressing any difference in treatment, demanding that it be justified by showing that it bears a reasonable relationship to rational policies not motivated by preference of domestic over foreign-owned investment.*<sup>104</sup>

371. In order to determine whether Parkerings was in *like circumstances* with Pinus Proprius, and thus whether the MFN standard has been violated, the Arbitral Tribunal considers that three conditions should be met:

- (i) Pinus Proprius must be a foreign investor;
- (ii) Pinus Proprius and Parkerings must be in the same economic or business sector;
- (iii) The two investors must be treated differently. The difference of treatment must be due to a measure taken by the State. No policy or purpose behind the said measure must apply to the investment that justifies the different treatments accorded. *A contrario*, a less favourable treatment is acceptable if a State's legitimate objective justifies such different treatment in relation to the specificity of the investment.

372. With regard to the first condition **(i)**: The parties are not disputing the fact that the company Pinus Proprius is an investor in Lithuania. As Pinus Proprius is owned by the Dutch company Litprop Holding BV, it is a foreign investor within the meaning of the BIT.<sup>105</sup>

373. With regard to the second condition **(ii)**: BP and Pinus Proprius are engaged in similar activities. Both Pinus Proprius and BP are companies acting in the construction and management of parking garages. Both are competitors for the same MSCP project in

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<sup>102</sup> See for instance: Occidental Exploration and Production Company v. Republic of Ecuador, UNICITRAL Case No. UN 3467, Final Award, July 1, 2004, ¶¶ 173-176; Marvin Roy Feldman Karpa v. United Mexican States, ICSID Case No. AB(AF)/99/1, Award, December 16, 2002, *reprinted in* 18 *ICSID Rev.—FILJ* 488 (2003), ¶¶ 170 *et seq*; S.D. Myers, Inc v. The Government of Canada, NAFTA UNICITRAL Arbitration, First Partial Award, November 13, 2000, ¶¶ 248-250.

<sup>103</sup> See *Pope & Talbot Inc. v. The Government of Canada*, NAFTA Case, Award on the merits of phase 2, April 10, 2001, ¶ 78.

<sup>104</sup> *Idem*, ¶¶ 78-79.

<sup>105</sup> See Exhibit CE 249.

Gedimino. Thus, the Arbitral Tribunal finds that Pinus Proprius and BP are in a similar economic and business sector.

374. With regard to the last condition **(iii)**: The Claimant alleges that Pinus Proprius has been treated differently than BP, because, first, Pinus Proprius has been authorised to construct its MSCP in Gedimino, but BP's project also situated in Gedimino has been refused. Second, the Municipality of Vilnius refused to conclude a JAA or a Cooperation agreement with BP but accepted such a conclusion with Pinus Proprius.
375. However, the situation of the two investors will not be in *like circumstances* if a justification of the different treatment is established.
376. The Arbitral Tribunal will discuss separately the two alleged discriminatory measures, namely whether the Municipality wrongfully granted Pinus and denied BP an authorisation to build a MSCP under Gedimino Avenue (see below *the situation of the Gedimino MSCP*, section 8.3.2.1); and whether the Municipality wrongfully refused to enter into a Cooperation Agreement with BP, whilst it had concluded such a Cooperation Agreement with Pinus (see below *The Situation of the Pergales MSCP*, section 8.3.2.2).

#### **8.3.1.1 The situation of the Gedimino MSCP**

377. In order to determine if the two investors were *in like circumstances*, or if the measure taken by the Municipality was justified, the Arbitral Tribunal analyses below the situation of the two investors.
378. In substance, the Respondent argues that BP's MSCP project in Gedimino was *fundamentally different* from the MSCP built by Pinus Proprius. First, the MSCP project proposed by the Claimant was clearly bigger than the MSCP built by Pinus Proprius. Second, the proposed MSCP designed by the Claimant extended to the Odiminiu Square, which is part of the Old Town area as defined by Annex No. 5 of the Agreement, but the one constructed by Pinus Proprius did not. Finally, BP's project reached the Vilnius' historic Cathedral Square. The Respondent underlines that a construction in the Old Town needed the approval of the Government's Cultural Heritage Commission.
379. The record confirms that Claimant's proposed project on the Gedimino site and the MSCP built by Pinus Proprius were almost identically located in the sense that they are both situated in the Old Town. Indeed, the maps produced by the Respondent<sup>106</sup> show that the Pinus Proprius MSCP is partly superimposed with the MSCP project of BP.
380. However, the Claimant's project is considerably bigger than the MSCP constructed by Pinus Proprius<sup>107</sup>. All the maps clearly show that BP's MSCP extended under Gedimino Street as far as the Cathedral Square.<sup>108</sup> The Claimant's project involved the

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<sup>106</sup> See Exhibits RE 97, RE 102-103.

<sup>107</sup> See Respondent Counter-Memorial, p. 93; Exhibits RE 97 and RE 102-103.

<sup>108</sup> See Exhibits RE 97, RE 102-103.

construction of a garage comprising over 500 parking slots by comparison; the MSCP constructed by Pinus Proprius consists of only 233 parking slots.<sup>109</sup>

381. However, notwithstanding the difference of size, both Pinus Proprius MSCP and BP's MSCP project in Gedimino show obvious similarities. They are located in the Old Town district of the City of Vilnius as defined by the Administrative borders.<sup>110</sup> The Old Town as defined by the Administrative borders is protected territory as defined by the applicable laws and regulations.<sup>111</sup> The Old Town of Vilnius as defined by its administrative borders is considered to be practically the same as the area defined by UNESCO.<sup>112</sup>
382. The territory of the Old Town as defined by UNESCO is a protected area which requires the approval of various administrative Commissions in order, notably, to make any construction.<sup>113</sup> Mr Robertas Staskevicius agreed that "[t]he Department of Cultural Heritage Protection, their concern was over the administrative region in Vilnius designated by UNESCO as being the protected administrative region."<sup>114</sup> And that "they [the Department of Cultural Heritage Protection] would be concerned about an activity that took place within that zone [the administrative region in Vilnius designated by UNESCO]."<sup>115</sup>
383. The Tribunal understands that inside the Old Town as defined by UNESCO is located the Old Town as defined by Annex 5 of the Agreement.<sup>116</sup> Annex 5 of the Agreement supplies the contractual definition of the Old Town. Mr. Robertas Staskevicius confirmed that "the reason why that zone was identified in the contract with the consortium was to make sure that the consortium focused on solving the traffic and parking problems in that specific zone."<sup>117</sup> Mr. Robertas Staskevicius confirmed also that "as far as this department [the Department of Cultural Heritage Protection] within the Ministry of Culture of the Lithuanian Government was concerned, it didn't matter how the parties had defined a part of the Old Town in annex 5 of the Contract."<sup>118</sup> It is not immediately apparent why Annex 5, clearly a contractual document binding the Municipality of Vilnius and BP, should be relevant, as argued by the Respondent, in assessing whether Pinus Proprius was *in like circumstances* with Parkerings.
384. Nevertheless, *ex abundanti cautela*, it appears that after analysis of the maps furnished by the Respondent,<sup>119</sup> neither the MSCP built by Pinus Proprius nor the MSCP

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<sup>109</sup> See CE 39, CE 40 and CE 95.

<sup>110</sup> See Exhibits RE 97, RE 102, RE 103; See also Exhibit CE 294.

<sup>111</sup> See Exhibit CE 75 and CE 294 ; See Robert Staskevicius, TR 1350:19.

<sup>112</sup> See Robert Staskevicius, TR 1348:13.

<sup>113</sup> See for instance CE 81, CE 60, CE 69, CE 84.

<sup>114</sup> See Robert Staskevicius, TR 1348:13

<sup>115</sup> See Robert Staskevicius, TR 1348:20.

<sup>116</sup> See Exhibits CE 13, RE 97, RE 102, RE 103.

<sup>117</sup> See Robert Staskevicius, TR 1352:12.

<sup>118</sup> *Idem*, TR 1350:9.

<sup>119</sup> See Exhibits RE 97, RE 102-103

proposed by BP are situated in the Old Town District, as defined by Annex 5 of the Agreement.<sup>120</sup> The most recent maps furnished by the Respondent established that BP's project did not extend into the Annex 5 area<sup>121</sup>. Consequently, this argument is not useful for the Tribunal's determination.

385. Another feature does however call the Tribunal attention: the MSCP planned by BP extends significantly in the Old Town as defined by UNESCO and especially near the historical site of the Cathedral. The record shows that various administrative Departments and Commissions in Lithuania were opposed to the MSCP as planned by BP. On 20 October 2000, the State Monument Protection Commission of the Republic of Lithuania objected to the parking plan for the following reason:

*Projects of such type and scale like the project of the construction of planned underground garages in the Old Town of Vilnius should be developed concurrently taking into consideration the possible direct and indirect environmental impact of planned works and also the impact on cultural properties. In the opinion of the State Monumental Protection Commission, the planned garages [...] would change the character of the Old Town of global value; destroy large areas of unexplored cultural layer. Also, the intensity of traffic and air pollution in the Old Town is likely to increase. The Old Town might become less attractive in terms of tourism and to the residents and visitor, and this would be a great loss. [The State Monumental Protection Commission] resolves: to object the project of construction of the underground garages in the Old Town of Vilnius [...]*<sup>122</sup>.

386. On 4 December 2000, the Urban Development Department of the Vilnius Municipality stated its objection to BP's MSCP project under Gedimino:

*The city's humanitarian community would psychologically not accept this proposal. The final conclusions concerning the feasibility of construction of this garage would have to be supplied by detailed exploratory archaeological works, because this square [Odminiu] is a supposed site of the defensive installations of Vilnius Castle. In terms of the townscape, the site of the square is very important in the formation of the area of Cathedral Square. Clearance of the trees and extension and distortion of the Cathedral area is not architecturally acceptable. This site also remains the subject of the debate on the feasibility of construction – for the purpose of better formation of the area of Cathedral Square and creation of a site of particular public significance. Therefore, it would be purposeful to design the garage only together with a structure that would occupy the square, provided that construction of such a structure would be permitted. Currently, such construction is irrelevant*<sup>123</sup>.

387. On 22 December 2000, the Vilnius Territorial Division underlined:

*the solutions presented in the referred documents directly affect a cultural monument old city of Vilnius [...]*<sup>124</sup>.

388. Finally, on 12 March 2001, the State Monument Protection Commission of the Republic of Lithuania stated, concerning the MSCP project filed by BP:

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<sup>120</sup> See Exhibits RE 103 and RE 104.

<sup>121</sup> See Exhibits RE 97, RE 99, RE 100, RE 102, RE 103;

<sup>122</sup> Exhibit CE 49

<sup>123</sup> Exhibit CE 60.

<sup>124</sup> Exhibit CE 61.



*In case construction of underground garages in the old city of Vilnius embarked now, it can be stated that Lithuania failed to perform obligation undertaken upon signing in November 1999 of the Convention for the Protection of the Architectural heritage of Europe and the European Convention on the Protection of the Archaeological heritage. All legal acts concerning regulation of territorial planning, land relationship, heritage protection, environment protection and construction would be infringed [...].*

*Upon installation of garages, a big portion of archaeological heritage of the old city of Vilnius will be destroyed; use of multiple up-to-date materials and technologies will damage the authenticity of the old city of Vilnius<sup>125</sup>.*

389. In a letter to the City Development Committee dated 25 July 2001, Mr. Jonas Tamulis, member of the board of BP, wrote that

*[g]iven the suspension of solution in the Old Town territories (in the boundaries within which it is inscribed in the UNESCO List of World Heritage) for stage two we do not propose any sites in this territory. The second step should involve construction of parking areas in such sites according to the parking plan which should necessarily be independent form solution regarding the Old Town<sup>126</sup>.*

390. The Arbitral Tribunal considers, as described above (see ¶ 383), that the difference based on the alleged encroachment in the Old Town as defined by the Annex 5 of the Agreement is not relevant.
391. The difference in size of the two MSCPs also is, in and by itself, not decisive either to establish that the two investors were not *in like circumstances* but it may be one of the factors to take into consideration.
392. On the other hand, the fact that BP's MSCP project in Gedimino extended significantly more into the Old Town as defined by the UNESCO, is decisive. Indeed, the record shows that the opposition raised against the BP projected MSCP were important and contributed to the Municipality decision to refuse such a controversial project. The historical and archaeological preservation and environmental protection could be and in this case were a justification for the refusal of the project. The potential negative impact of the BP project in the Old Town was increased by its considerable size and its proximity with the culturally sensitive area of the Cathedral. Consequently, BP's MSCP in Gedimino was not similar with the MSCP constructed by Pinus Proprius.
393. That being said the Claimant failed to show that Pinus Proprius benefited of a more favourable treatment regarding the administrative requirements, *i.e.* that is was exempt of such requirements or obtained a clearance more easily. It is the Claimant's burden of proof to show that the foreign investor has been treated more favourably.
394. The Tribunal notes that the Pinus Proprius project was also situated in the Old Town as defined by the UNESCO and should have likely met the same administrative requirements as BP's. Indeed, the project had to be approved by, among others, the State Monument Protection Commission of the Republic of Lithuania, the Urban Development Department of the Vilnius Municipality and the Vilnius Territorial Division.

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<sup>125</sup> Exhibit CE 81.

<sup>126</sup> Exhibit CE 89.

However, there is no evidence that Pinus Proprius has been treated differently from BP in the discharge of the administrative requirements. For instance there is no evidence that Pinus Proprius failed to apply or did not receive the permission, from the State Monument Protection Commission of the Republic of Lithuania or the Urban Development Department of the Vilnius Municipality or the Vilnius Territorial Division, to construct its MSCP in the Old Town.

395. Moreover, the record does not evidence that Pinus Proprius faced the same objections and that its project had the same potential impact on the Old Town. On the contrary, the record shows that the Pinus Project did not extend near the Cathedral area which may have meant it was less controversial.
396. Nonetheless, despite similarities in objective and venue, the Tribunal has concluded, on balance, that the differences of size of Pinus Proprius and BP's projects, as well as the significant extension of the latter into the Old Town near the Cathedral area, are important enough to determine that the two investors were not *in like circumstances*. Furthermore, the Municipality of Vilnius was faced with numerous and solid oppositions from various bodies that relied on archaeological and environmental concerns. In the record, nothing convincing would show that such concerns were not determinant or were built up to reject BP's project. Thus the City of Vilnius did have legitimate grounds to distinguish between the two projects. Indeed, the refusal by the Municipality of Vilnius to authorize BP's project in Gedimino was justified by various concerns, especially in terms of historical and archaeological preservation and environmental protection. These concerns are peculiar to the extension of BP's project in the Old Town and thus could justify different treatment with Pinus Proprius. In the absence of convincing evidence that Pinus Proprius benefited from a more favourable treatment in terms of administrative requirement, the Arbitral Tribunal finds that the Claimant failed to demonstrate a discrimination concerning the Gedimino car park.
397. Finally, the Tribunal notes that, in April 2001, the Municipality of Vilnius ordered the Consortium to abandon the Gedimino project and to study the MSCP on the Pergales site.<sup>127</sup> BP accepted to start the planning for the site of Pergales and also agreed that the site of Gedimino was uncertain due to its location in the Old Town (see above ¶ 392)<sup>128</sup>. The record is insufficient to show that the Municipality of Vilnius unduly rejected the Gedimino project of MSCP proposed by BP. On the contrary, the Gedimino site was only one possibility among several other locations. The refusal of one site did not deprive BP of the possibility to propose other locations and finally to construct its ten MSCPs as agreed.<sup>129</sup>

#### **8.3.1.2 The situation of the Pergales MSCP**

398. As set out above (see ¶¶ 363-364) the Claimant alleges, first, that the Municipality refused to sign a Joint Activity Agreement (JAA) with BP but concluded a JAA with

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<sup>127</sup> See Exhibits R 63 and CE 89.

<sup>128</sup> See Exhibits CE 89.

<sup>129</sup> *Ibidem*

Pinus Proprius, and second, that once the JAAs had been declared unlawful under the Law on Self-Government, the Municipality refused to transform the JAA envisioned by BP into a Cooperation Agreement as it did with Pinus Proprius.

399. JAAs are used in Lithuania to embody private-public partnerships for construction, if the project is situated on state-owned land and if the constructor is neither the owner nor the lessee of the land.<sup>130</sup>

400. In his statement, Mr. Sigita Burnickas explained that:

*Under Lithuanian law, much of the land available for infrastructure development within the city of Vilnius was formally owned by the national government, and not the Municipality. This necessitated a two step process for each car park – first, the Municipality had to obtain the land from the State; second, the Municipality had to transfer that land to the consortium member responsible for developing that particular car park.*

*In accordance with applicable construction regulations the permits for the construction of car parks could be issued only if the developer had possession of the relevant land plot by proprietary right, by lease (or sublease), or by right of use. Under the land lease law of 1998, however, the state-owned land plots could only be leased to the consortium through an auction procedure. [...]*

*In the consortium's case, the joint activity agreement would work as follows. First, the Municipality would obtain the state-owned land plots by right of trust and apply, on its behalf or on behalf of the consortium member, for the construction permit. Second, the consortium member would finance and carry out the construction works on the state-owned land. Because of the joint activity agreement, there was no requirement for a lease of transfer of any kind during construction. Third, upon completion of construction, each of the parties received a defined share in the joint property. The division of property was agreed to in the model joint activity agreement: the consortium member would own the car park and the Municipality would receive the associated public infrastructure that the consortium member had constructed. Under the provision of the land lease law, the consortium member who owned the car park on the state-owned land could lease that land without having to go through an auction<sup>131</sup>.*

401. In summary, the Tribunal understands that a JAA or Cooperation Agreement is necessary to start the construction and permits to avoid the public auction as defined by Article 7 section 1 of the Law on leasing of Land.<sup>132</sup> Indeed, pursuant to Article 7 section 1 of the Law on leasing of Land:

*State-owned land, save for the case stipulated in paragraph 2 of this article, in the procedure set by the Government shall be leased in an auction for the person, whose bid for land lease fee is the highest. [...]<sup>133</sup>*

402. However, Article 7 section 2 of the same law provides that if the prospective lessee already owns a building on the said land, no public auction is necessary:

*In case state-owned land is developed with buildings owned or rented by natural or legal persons, it shall be leased without an auction in the procedure set by the Government.*

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<sup>130</sup> See Lithuania TR. 375:24-376:5.

<sup>131</sup> See Burnickas Stmt. ¶ 11.

<sup>132</sup> See Lithuania, Tr. 375:24-376:5.

<sup>133</sup> See Exhibits RE 11.

403. In the case at hand, it is not disputed that Pinus Proprius was the owner of a small part of the land on its MSCP building site.<sup>134</sup> BP was not the owner of the land on the MSCP building site and, consequently it needed a JAA in order to construct its MSCP. This was also the case for Pinus Proprius, at least for the part of the land it did not own.
404. However, on 12 October 2000, the Amendment of the Law on Self-Government precluded the public authorities from concluding JAA with a private entity. In substance, Article 9 Section 2 of the Law on Self-Government provides that “[f]or general purposes a municipality may conclude joint activity contracts or public procurement contracts with State institutions and (or) other municipalities.”<sup>135</sup> It is common ground that a municipality is thus authorized to enter into JAAs but exclusively with State constituent divisions to the exclusion of private entities.
405. On 24 October 2001, the Vilnius City Council decided to conclude a JAA with the Company Pinus Proprius.<sup>136</sup> However, on 18 December 2001, the Representative of the Government for Vilnius Region, Mr Gintautas Jakimavicius, suspended the enforcement of the decision of the Vilnius City Council pursuant to the Law on Local Self-Government,<sup>137</sup> and on 18 January 2002, requested the Vilnius District Administrative Court to revoke the decision of the Vilnius City Council. In substance, the Representative of the Government for Vilnius Region stated:

*a conclusion should be made that the Law does not provide for the right for municipalities to conclude joint venture agreement with private persons and that Vilnius City Municipality Council having passed the decision No.417 of 24 October 2001 and by Clause 1 thereof approved the draft joint venture agreement with Pinus Proprius UAB exceeded the scope of competence of public authorities*<sup>138</sup>.

406. On 27 March 2002, the Vilnius City Council agreed to modify the controversial JAA into a *Cooperation Agreement*.<sup>139</sup> Thus, the Representative of the Government for the Vilnius Region, Mr. Gintautas Jakimavicius, wrote to the Vilnius District Administrative Court:

*[t]he Vilnius City Council on March 27, 2002, issued decision No. 530 “on the Approval of the Cooperation Agreement” whereby item 1 approved the Cooperation Agreement between the Municipality of the City of Vilnius and the Joint Stock Company “Pinus Proprius.” By this decision the Vilnius City Council actually changed decision No. 417 of 10/24/01 “On approval of the Partnership Agreement,” i.e. it became out of force. Since the decision became out of force, the legal issue also disappeared. Consequently, the case was dismissed.*<sup>140</sup>

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<sup>134</sup> See Letter from Counsel for Respondent dated 9 November 2006; Rukstele 1517:6-23.

<sup>135</sup> Exhibit CE 47.

<sup>136</sup> Exhibit CE 95.

<sup>137</sup> Exhibit CE 99.

<sup>138</sup> Exhibit CE 104.

<sup>139</sup> See Exhibit CE 112 and CE 128.

<sup>140</sup> See Exhibit CE 117.

407. Finally, on 20 August 2002, the Vilnius City Municipality concluded a *Cooperation Agreement* with Pinus Proprius.<sup>141</sup> The record shows that the *Cooperation Agreement* and the JAA signed between Pinus Proprius and the City of Vilnius are in every respect similar.<sup>142</sup>
408. BP's situation evolved differently. Indeed, in March 2002, the Mayor of the Municipality of Vilnius, Mr. Zuokas, sent to BP a draft Joint Activity Agreement<sup>143</sup> and, in April 2002, BP sent a revised draft of the JAA.<sup>144</sup> However, the City of Vilnius never concluded the JAA with BP for the Construction of the MSCP on Pergales site.<sup>145</sup> It is not contested that the City of Vilnius also refused to conclude a *Cooperation Agreement* with BP similar to the one concluded with Pinus Proprius.
409. The Claimant alleges that BP and Pinus Proprius were *in like circumstances* and that by refusing to conclude a JAA or a Cooperation Agreement with BP, the Municipality of Vilnius gave a treatment more favourable to Pinus Proprius.
410. However, the Tribunal finds that in order to determine whether the claiming investor and another (most favoured) investor used as benchmark were in like circumstances, at least two elements were significantly different between the BP and Pinus Proprius projects and therefore different treatment could be justified.
411. Before addressing such two differences, the Tribunal wishes to comment on a significant difficulty the Claimant is facing. Entering into agreements is subject to party autonomy and no one may be forced to contract. Under conditions changing from one law to another, parties may conclude framework agreements and define conditions under which they will have to enter into such agreement. Even when the legislation recognizes the enforceability of such obligation to contract, party autonomy will still play its part in the negotiation and conclusion of the agreements. *In casu*, the City of Vilnius is a public entity and thus has to act with the defence of public interests as its main yardstick. Public interest does, of course, depend on the policy of the administration running the public entity at any particular time. Thus, it is a difficult endeavour to show discrimination in a public entity entering into an agreement with a certain person and refusing to conclude a similar agreement with another party. Apart from factors applying to individuals or companies (timing, financing, opportunities,...) a public entity may have legitimate motivation of its own at the time to exercise its discretion to contract or not to contract.
412. The two differences which the Tribunal considers relevant are (i) the substantive differences to the content of the agreements, and (ii) the existence and non-existence of a signed JAA with Pinus Proprius and BP respectively. These two differences are reviewed below.

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<sup>141</sup> See Exhibit CE 128.

<sup>142</sup> Exhibit CE 95 and CE 128.

<sup>143</sup> See Exhibit CE 110.

<sup>144</sup> See Exhibit CE 113.

<sup>145</sup> See for instance CE 116, CE 126,

413. **With regard to the first difference between the projects:** The substance of the Cooperation Agreement signed with Pinus Proprius was different from the proposed JAA with BP. Indeed, pursuant to Article 7.2 of the *Cooperation Agreement* between the City of Vilnius and Pinus Proprius, the parties

*agree on the following principles of apportionment in kind of their joint property, i.e. the Infrastructure Unit:*

*(a) title to the Underground Car Park A (including the internal service lines necessary for the operation of the car park) shall be vested in PINUS PROPRIUS;*

*(b) title to the remaining part of the Infrastructure (i.e. the service lines, transport communication, pavement, minor architectural structures, collectors to house service lines of the city, etc.) save the part indicated in paragraph (a) above, shall be vested in the Municipality.<sup>146</sup>*

414. This part of the Pinus Proprius Agreement was similar to the one contained in the BP draft JAA.

415. However, pursuant to Article 10.4.3. of the same Cooperation Agreement:

*Should the Municipality receive the Lithuanian Government's consent for purchase from the sole source of the Underground Car Park A or fulfil other requirements prescribed by laws as applicable in the event of purchase to this particular transaction, the parties undertake to enter into a leasing contract with respect to the Underground Car park A subject to the requisite conditions set forth below:*

*(i) transfer by PINUS PROPRIUS of the Underground Car Park A into the Municipality's possession and use on the stipulation that once the price quoted for the Underground Car Park A has been paid the Underground Car Park A will become the ownership of the Municipality;*

*(ii) the period of payment for the Underground Car Park A being 10 years as the of the date of signing the leasing contract;*

*(iii) PINUS PROPRIUS giving its consent to transfer by the Municipality against payment of the Underground Car park A to other third parties to be used for business needs;*

*(iv) no payment for use of the Underground Car Park A being effected to PINUS PROPRIUS<sup>147</sup>.*

416. In brief, Pinus Proprius had the contractual obligation to sell the MSCP to the Municipality of Vilnius upon completion of the construction.

417. On the other hand, pursuant to the form of JAA annexed to the Concession Agreement between the Municipality of Vilnius and BP:

*3.2.1. the multi-storey car park would belong by the right of ownership to the consortium or the consortium Member only;*

*3.2.2. the remaining part the Object if Infrastructure (engineering services, transport, communications, etc.), except those specified in sub-item 3.2.1. of part 3 of this Article, would belong by the right of ownership to the Municipality<sup>148</sup>.*

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<sup>146</sup> See Exhibit CE 128; see also Rukstele Tr. 1523:2-3.

<sup>147</sup> Exhibit CE 128.

<sup>148</sup> See Exhibit CE 13 and also project of Joint Activity Agreement, Articles 3.3.2.1. and 3.3.2.2., CE 113.

418. Neither the draft JAA annexed to the Concession Agreement, nor the draft JAA proposed by the Mayor Zuokas on 9 April 2002 contained a provision that obliged BP to sell the MSCP to the Municipality. Mr. Rukstele explained that:

*after BP-Egapris constructed car park, according to the condition of the joint activity agreements with them, particularly which is different from agreement of cooperation with Pinus Proprius. They [BP-Egapris] had the right to register even the beginnings of the construction to separate it from--to make it their own property and to apply for lease to purchase the land plot on which that construction is built. And this is not the case with Pinus Proprius<sup>149</sup>.*

*[...] there was an obligation on behalf of Pinus Proprius to sell the car park to municipality. It was not intending to be the owner of that car park to municipality<sup>150</sup>.*

419. The Claimant accepts that “[u]nlike Pinus, BP would lease the land on which it built its MSCPs. That was possible because of the above cited provision of Article 7(2) of the Land Lease Law that allows a private company to acquire a lease interest in publicly owned land if it already owns building on the land – clearly BP’s case.”<sup>151</sup>
420. In summary, BP’s draft JAA provided that the investor will be the owner of the MSCP and will lease or buy the publicly-owned land after completion of works. Unlike BP’s JAA, Pinus Proprius’ Cooperation Agreement provided that the investor will sell its MSCP to the Municipality (subject to the Lithuanian Government authorizing such a purchase) and therefore will not lease or buy the publicly-owned land. This dissimilarity is significant. It may very well be that the economic difference is limited or even non-existent. The record does not evidence that it is the case. Nevertheless, the legal situation is different: one investor remains the owner of the investment while the other must return it to the City. Whatever the compensation paid, the two situations are not the same.
421. Both BP and Pinus Proprius needed a JAA in order to construct the car parks. Once the construction would be completed, both investors would be the owners of the MSCP. On that matter, they are similar. However, Pinus Proprius would be obliged, subsequently, to sell its MSCP to the Municipality, if the latter was authorized to buy it. Therefore, the JAA or the Cooperation Agreement signed with Pinus Proprius was useful for the construction process but had neither the purpose nor the effect of avoiding the public auction (Article 7(1) of the Land Lease Law). BP needed a JAA or a Cooperation Agreement for the construction process, but more fundamentally, to avoid the public auction. This is a further difference.
422. In substance, a public auction has several objectives, and especially gives the assurance to the State that the highest price will be paid for the lease of the publicly-owned land. Moreover, the public auction guarantees the equality of treatment as all entities interested have the opportunity to apply for the lease.

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<sup>149</sup> See Rukstele Tr. 1527:2-14.

<sup>150</sup> *Idem*, Tr. 1527:20-24.

<sup>151</sup> Claimant’s Post-Hearing Brief, p.114.

423. In the case of Pinus Proprius, the public auction was not necessary because the investor was not to keep the MSCP and would not need to enter into a lease of the land. The Municipality would be the owner of the MSCP and the publicly-owned land would not be leased by another private entity.
424. On the other hand, BP had a right to own the MSCP and therefore to lease the publicly-owned land. Consequently, the public auction was an obligation, unless the Municipality and BP concluded a JAA. In the context of the legal uncertainty of the JAA and the Cooperation Agreement with regard to the Law on Self-Government, the Municipality of Vilnius could refuse the conclusion of such Agreement with BP and thus dispense with the obligation to organize a public auction.
425. In addition, the Cooperation Agreement concluded with Pinus Proprius afforded full power of self-determination to the Municipality of Vilnius after the construction of the MSCP. Indeed, the Municipality - once properly authorized by superior authorities - could decide, at its sole discretion, to buy the MSCP after completion of works. The consequences of the conclusion of JAA or Cooperation Agreement were, therefore, limited to the time of the construction process. The Agreement had no impact in this regard after the construction.
426. It was not the case with BP, which was contractually entitled to remain the owner of the MSCP and therefore had the right to lease the land. It is evident that the consequences of the conclusion of a Cooperation Agreement with Pinus Proprius were limited in terms of time and importance, while the conclusion of a JAA or Cooperation Agreement with BP had wider ranging effects.
427. BP and Pinus Proprius situations were different enough to justify a different treatment. Therefore, the Tribunal on balance has concluded that both investors were not *in like circumstances*.
428. **With regard to the second difference between the projects:** As described above (see ¶¶ 405-407) in October 2001, the City of Vilnius concluded a JAA with Pinus Proprius. A few months later, the Representative of the Government for the Vilnius Region challenged the validity of the JAA. Thus, the JAA was withdrawn and a Cooperation Agreement was concluded in its place. The Cooperation Agreement concluded in March 2002 was nothing more than a change of title of the existing JAA in order to avoid the decision of the Vilnius District Administrative Court on the legality of the JAA. In other words, the Municipality wanted to avoid that its decision to conclude a JAA be declared in violation of the Law on Self-Government.
429. In the case of BP, the situation was clearly different; BP never concluded any JAA with the Municipality of Vilnius. The conclusion of a Cooperation Agreement with BP would have required the conclusion of a new agreement and not the modification of an existing, possibly binding and enforceable agreement. It is therefore at least credible and understandable that the Municipality of Vilnius refused to conclude a new agreement with BP due to the uncertainty of the legality of JAA or Cooperation Agreements.



430. Under the circumstances, the Arbitral Tribunal concludes that Pinus Proprius' situation differed from BP's situation. As a result, the decision of the Municipality of Vilnius to refuse the conclusion of a JAA or a Cooperation Agreement with BP could be justified by the difference.

#### **8.4 EXPROPRIATION**

431. Article VI of the Treaty provides that:

*Investments made by investors of one contracting party in the territory of the other contracting party cannot be expropriated, nationalized or subjected to other measures having a similar effect (all such measure hereinafter referred to as "expropriation") except when the following conditions are fulfilled:*

- (I) The expropriation shall be done for public interest and under domestic legal procedures;*
- (II) It shall not be discriminatory;*
- (III) It shall be done only against compensation. [...]*

##### **8.4.1 Position of the parties**

432. The Claimant alleges that pursuant to Article VI of the Treaty, the investment cannot be expropriated, nationalized or subjected to measures having a similar effect except for a public purpose, in a non-discriminatory manner, upon payment of compensation and in accordance with domestic laws.
433. Claimant argues that by repudiating the Agreement, the Republic of Lithuania destroyed the value of BP and VPK. Moreover, the Claimant contends that the "Government's litigious, legislative, and administrative interference with the Agreement deprived BP of the legal security afforded by the Agreement."<sup>152</sup> By preventing the execution and demanding full performance of the Agreement at the same time, and then repudiating the Agreement, the Municipality of Vilnius destroyed BP. Thus, by taking the asset that was the sole purpose of BP's existence, Lithuania indirectly expropriated Parkering's ownership interest in BP.<sup>153</sup> BP became a "company with assets, but without business." By failing to provide compensation for this expropriation, Lithuania breached its obligation under Article VI of the Treaty.<sup>154</sup>
434. The Claimant contends that whether Lithuania benefited or not from the expropriation is irrelevant. On the contrary, whether the investor continues to enjoy the benefit of ownership is decisive.<sup>155</sup>
435. The Respondent alleges that the termination of a contract only amounts to an expropriation in limited cumulative circumstances. First, the termination must be wrongful; second, there must be no remedy under the contract for the wrongful

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<sup>152</sup> See Claimant's Memorial ¶ 237.

<sup>153</sup> *Idem*, ¶ 238

<sup>154</sup> *Idem* ¶ 239 and Claimant's Post-Hearing Brief, p. 123.

<sup>155</sup> *Idem* ¶ 235.

termination; and third the termination must give rise to a substantial deprivation of the investor's enjoyment of the property in question.<sup>156</sup>

436. The Respondent contends that the termination was lawful under the terms of the Agreement<sup>157</sup> and that, in any case, the Claimant never brought a claim before the contractually agreed forum, *i.e.* Lithuanian Courts. The Respondent underlines that the Lithuanian Courts were in position to give a fair and impartial hearing of the Claimant's case.<sup>158</sup> Finally, the Respondent alleges that the Claimant was not deprived of its property since it still owns and controls BP and because BP and VPK continue to develop their activities in Lithuania.<sup>159</sup>

#### 8.4.2 Discussion

437. The Treaty expressly contemplates *de facto* expropriation besides the formal or direct expropriation. *De facto* expropriation (or indirect expropriation) is not clearly defined in treaties, but can be understood as the negative effect of government measures on the investor's property rights, which does not involve a transfer of property but a deprivation of the enjoyment of the property.

438. As indicated in *Metalclad v. Mexico*, the Tribunal stated that

*expropriation [...] includes not only open, deliberate and acknowledged takings of property, such as outright seizure or formal or obligatory transfer of title in favour of the host State, but also covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the host State.*<sup>160</sup>

439. The parties are not challenging the fact that the expropriation can be direct or indirect and that, in the case at hand, the expropriation alleged by the Claimant is indirect. There is no mention of any direct expropriation.
440. In the present case, the expropriation results, according to the Claimant, of the wrongful termination of the Agreement between the City of Vilnius and BP. Undoubtedly, wrongful termination of an agreement amounts to a breach thereof. Whether contract rights may be expropriated is widely accepted by the case law and the legal authors. However, under limited circumstances, three cumulative conditions (which will be addressed below ¶¶ 443-456) should be met to elevate a breach of an agreement to the level of an indirect expropriation within the meaning of the Treaty.
441. Having said that, an expropriation does not necessarily amount to a violation of the Treaty. Indeed, pursuant to Article VI of the Treaty, the expropriation is *legitimate* if

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<sup>156</sup> See Respondent Counter-Memorial, p. 81.

<sup>157</sup> *Idem*, ¶¶ 210-212.

<sup>158</sup> *Idem*, ¶ 214.

<sup>159</sup> *Idem*, ¶ 218 and ¶¶ 220-224

<sup>160</sup> See *Metalclad Corporation v. United Mexican States*, ICSID Case No. ARF (AF)/97/1, Award, August 30, 2000, reprinted in 16 *ICSID Rev.—FILJ* 168 (2001), ¶ 103.

done for public interest and under domestic legal procedures; if not discriminatory; and if done against compensation.

442. Therefore, the Arbitral Tribunal will first determine if an indirect expropriation occurred (see ¶¶ 443-456). If the answer is positive, it will analyse if the expropriation is *legitimate*.
443. **First**, a breach of an agreement will amount to an expropriation only if the State acted not only in its capacity of party to the agreement, but also in its capacity of sovereign authority, that is to say using its *sovereign power*. The breach should be the result of this action. A State or its instrumentalities which simply breach an agreement, even grossly, acting as any other contracting party might have done, possibly wrongfully, is therefore not expropriating the other party.
444. The Tribunal agrees with the tribunal in *Azurix Corp. v. the Argentine Republic* which held that:

*contractual breaches by State party or one of its instrumentalities would not normally constitute expropriation. Whether one or series of such breaches can be considered to be measures tantamount to expropriation will depend on whether the State or its instrumentality has breached the contract in the exercise of its sovereign authority, or as a party to a contract. As already noted, a State or its instrumentalities may perform a contract badly, but this will not result in a breach of treaty provisions “unless it be proved that the state or its emanation has gone beyond its role as a mere party to the contract, and has exercised the specific functions of a sovereign.”<sup>161</sup>*

445. In the present case, on 27 January 2004, Mr. Artūras Zuokas, Mayor of the City of Vilnius, informed the Consortium that the Agreement dated 30 December 1999 was terminated. The reason invoked was a “*material breach on the part of the Consortium formed by UAB Baltijos Parkingas and UAB Egapris of [...] provisions of the Agreement.*”<sup>162</sup> The record does not show that the State, *i.e.* the Municipality, acted differently than another contracting party would have done. In other words, assuming that the Municipality of the City of Vilnius breached the Agreement, there is no evidence that it used its sovereign power in that respect.
446. It is thus unnecessary and irrelevant to ascertain whether the termination breached the Agreement.
447. Therefore, the termination of the Agreement by the City of Vilnius cannot be considered as an expropriation under the BIT due to the fact that the City of Vilnius did not act as a sovereign authority and did not use that authority to expropriate the rights of BP.
448. **Second**, a breach of contract, if there should be one is, in itself, not always sufficient to amount to an indirect expropriation within the meaning of the BIT. An investor faced with a breach of an agreement by the State counter-party should, as a general rule, sue that party in the appropriate forum to remedy the breach. Therefore, as already

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<sup>161</sup> See *Azurix Corp. v. Argentine Republic*, ICSID Case No. ARB/01/12, Award, July 14, 2006, *supra* note 59, ¶ 314.

<sup>162</sup> Exhibit CE 210.

stated (see ¶ 316), a preliminary determination of the existence of a contractual breach under domestic law is, in most cases, a prerequisite.

449. If the investor is deprived, legally or practically, of the possibility to seek a remedy before the appropriate domestic court, then the Arbitral Tribunal might decide on the basis of the BIT if international rights have been violated (see above ¶ 317). That would be the case, for instance, if a party is denied the possibility to complain about the wrongful termination of the agreement before the forum contractually chosen.

450. For instance, in the Waste Management case, the Tribunal concluded that:<sup>163</sup>

*it is one thing to expropriate a right under a contract and another to fail to comply with the contract. Non-compliance by a government with contractual obligations is not the same thing as, or equivalent or tantamount to, an expropriation. In the present case, the Claimant did not lose its contractual rights, which it was free to pursue before the contractually chosen forum.*

451. In Azinian and others v. the United Mexican States, the Tribunal noted that:

*[t]he problem is that Claimants' fundamental complaint is that they are the victims of a breach of the Concession Contract. NAFTA does not, however, allow investors to seek international arbitration for mere contractual breaches. Indeed, NAFTA cannot possibly be read to create such a regime, which would have elevated a multitude of ordinary transactions with public authorities into potential international disputes.*

The Tribunal added that "the Claimants have raised no complaints against the Mexican courts; they do not allege a denial of justice."<sup>164</sup>

452. In Generation Ukraine v. Ukraine, the Tribunal held that:

*an international tribunal may deem that the failure to seek redress from national authorities disqualifies the international claim, not because there is a requirement of exhaustion of local remedies but because the very reality of conduct tantamount to expropriation is doubtful in the absence of a reasonable – not necessarily exhaustive – effort by the investor to obtain correction.<sup>165</sup>*

453. In the case at hand, BP and possibly the Claimant had the opportunity to bring the case before the forum contractually chosen, *i.e.* Lithuanian Courts, in order to complain of the breach of the Agreement (see above ¶ 316). The record does not show any objective reason to question the Lithuanian Courts' ability to dispose of the case fairly, competently, impartially and within a reasonable period of time.<sup>166</sup> Nevertheless, neither BP nor the Claimant challenged the termination before the forum contractually chosen, *i.e.* the Lithuanian Courts.<sup>167</sup>

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<sup>163</sup> See Waste Management, Inc. v. United Mexican States, ICSID Case No. ARB (AF)/00/3, Award, April 30, 2004, *supra* note 60, ¶ 175.

<sup>164</sup> See Robert Azinian and others v. United Mexican States, ICSID Case No. ARB(AF)/97/2, Award, November 1, 1999, *reprinted in* 14 *ICSID Rev.—FILJ* 538 (1999), ¶ 87 and ¶ 100.

<sup>165</sup> See Generation Ukraine Inc. v. Ukraine, ICSID Case No. ARB/00/9, Award, September 16, 2003, *supra* note 16, p. 91.

<sup>166</sup> See Gintautas Barktkus, Tr. 908 and Expert Report of Carlos Lapuerta, p. 4.

<sup>167</sup> See Article 7.3 of the Agreement between the Municipality of Vilnius and the Consortium, CE 13.

454. It is not the mission of the present Arbitral Tribunal to decide on the alleged breach of the Agreement, entered into by a company which acted as vehicle of the investment of the Claimant. In the absence of any objective reason not to bring the case before national tribunals, it cannot be concluded, on the basis of the facts at hand, that the Claimant's investment has been indirectly expropriated.
455. **Third**, the breach of the Agreement, *in casu* the termination of the agreement, must give rise to a substantial decrease of the value of the investment.<sup>168</sup>
456. In the case at hand, the Arbitral Tribunal finds that it is not worth analysing the existence of a decrease of the value of the Claimant's investment as no other conditions for the existence of an expropriation developed above are met (see above ¶¶ 443-454). Thus it can be concluded that Parkerings has not been expropriated within the meaning of Article VI of the Treaty. Accordingly, the question whether the expropriation was *legitimate* is not relevant and does not need to be discussed here either.

## 9. THE ISSUE OF COSTS

457. Both parties sought the costs of this arbitration in the event that they were successful.
458. By letter dated 22 December 2006, Parkerings presented the Tribunal with a statement of costs and expenses of € 2,655,584.75 which included the sum of € 196,591.42 paid to ICSID as deposit towards the fees and expenses of the Arbitral Tribunal. By letter of 9 May 2007, Parkerings amended its statement of costs and expenses to € 2,655,584.75.
459. On the same date, the Republic of Lithuania presented the Tribunal with a submission of costs and expenses of € 1,340,716.10 which included the sum of € 196,591.42 paid to ICSID as deposit towards the fees and expenses of the Arbitral Tribunal.
460. The parties filed no additional comments on statements of costs.
461. It is unambiguous from Article 61(2) of the ICSID Convention and Rule 28 of the ICSID Arbitration Rules that the Arbitral Tribunal has discretion with regard to costs.
462. There is no rule in international arbitration that costs must follow the event. Thus, the question of costs is within the discretion of the Tribunal with regard, on the one hand, to the outcome of the proceedings and, on the other hand, to other relevant factors.
463. In the Tribunal's view, the proceedings were expeditiously and efficiently conducted by the representatives of both parties.

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<sup>168</sup> See *Técnicas Medioambientales Tecmed, S.A. v. United Mexican States*, ICSID Case No. ARB (AF)/00/2, Award, May 29, 2003, *supra* note 80, ¶ 115; see also *Telenor Mobile Communications AS v. Republic of Hungary*, ICSID Case No. ARB/04/15, Award, September 13, 2006, *available online at* [www.worldbank.org/icsid](http://www.worldbank.org/icsid), ¶¶ 65 *et seq.*

464. Even if no violation of the BIT or international law occurred, the conduct of the City of Vilnius was far from being without criticism. In such circumstances, the Arbitral Tribunal concludes that an equitable result would be that each party bears its own costs and expenses, and that the costs and expenses of the Tribunal be paid equally by both parties.

## 10. THE AWARD

465. Having heard and read all the submissions and evidence in this arbitration, and for the reasons set out above, the Tribunal unanimously decides that:

- a) the Tribunal has jurisdiction to hear and consider all the claims made by the Claimant in this case;
- b) the conduct of the Republic of Lithuania, which is the subject of the claims in this arbitration, did not involve a violation of the duty of equitable and reasonable Treatment (Article III of the Treaty);
- c) the conduct of the Republic of Lithuania as claimed in this arbitration did not involve a violation of the obligation of protection (Article III of the Treaty);
- d) the conduct of the Republic of Lithuania as claimed in his arbitration did not involve a violation of the obligation to accord treatment no less favorable than the Treatment accorded to investment by investor of a third State (Article IV of the Treaty);
- e) the conduct of the Republic of Lithuania as claimed in this arbitration did not involve a violation of the prohibition of expropriation (Article VI of the Treaty);
- f) Parkerings' claims are accordingly dismissed in their entirety;
- g) Each party shall bear its own costs and half of the costs and expenses of these proceedings.

[signature]

Dr. Julian Lew

Arbitrator

Date: August 13, 2007

[signature]

Dr. Laurent Lévy

*President*

Date: August 14, 2007

[signature]

The Hon. Marc Lalonde

Arbitrator

Date: August 9, 2007

## **LEGAL AUTHORITY CA-92**

OXFORD PUBLIC INTERNATIONAL LAW

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Transparency****Akira Kotera**

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## **(p. 617) Chapter 16 Regulatory Transparency**

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- (2) The Expansion of Transparency Obligations in IIAs 625**
- (3) Transparency and 'Fair and Equitable Treatment' 628**

### **Concluding Remarks 634**

(p. 618) Nowadays it is understood that transparency should be observed in numerous types of organizations, including in particular governments and other public bodies. In the contemporary field of international investment, transparency has begun to be characterized as a fundamental principle. Initially required of the host country, it may also come to be required of the home (investing) country and the investor (investing corporation), according to research conducted by the United Nations Conference on Trade and Development (UNCTAD).<sup>1</sup> The Declaration of the Doha Development Agenda of the World Trade Organization (WTO), which sought to draft a multilateral investment agreement in the section entitled 'Relationship between trade and investment', indicated that transparency would be one of the basic elements of future WTO Investment Rules. It stipulates as follows: 'In the period until the Fifth Session, further work in the Working Group on the Relationship Between Trade and Investment will focus on the clarification of: scope and definition; transparency; and non-discrimination ...'.<sup>2</sup>

However, early bilateral investment treaties (BITs) concluded in the late 1950s to 1960s did not contain a provision for transparency. Articles on transparency first appeared in the early US BITs, which were concluded in the 1980s. Furthermore, even recent books on investment treaties have neither a chapter on transparency nor do they include transparency as a term in the index.<sup>3</sup>

Furthermore, with respect to the international economic field, transparency is argued for not only in the area of investment but also in trade. As transparency is to be required widely in relation to the organization in general, it is natural that transparency is required in respect of the importing countries as the main addressee of obligations in the trade field.<sup>4</sup> Transparency is widely discussed, so we need to take its particular meaning into account in the context of investment.

The present chapter will offer an overview of transparency issues as follows. It begins with a discussion of the significance of the concept in the investment field, asking why transparency is being increasingly characterized as a fundamental (p. 619) principle and considering why it was neglected for a long time, bearing in mind early investment treaty practice. It then goes on to review the development of specialized transparency obligations in more recent international investment agreements (IIAs), highlighting their principal features. Thirdly, the chapter will analyse the interrelationship between the transparency obligations of the state and the principle of fair and equitable treatment, taking into account developments in international investment arbitrations in this regard. Finally, the chapter will conclude by considering the role that transparency has to play in investment protection more generally. The chapter does not cover issues of corporate transparency through disclosure rules, which is done elsewhere in this volume.<sup>5</sup>

### **(1) Significance of Transparency**

Transparency is covered in many WTO agreements and in the General Agreement on Trade in Services (GATS) is ranked as a basic principle alongside the principle of most-favoured-nation treatment.<sup>6</sup> One reason why transparency has obtained the position of a fundamental principle in the international economic field, including international investments, was the impact of its treatment in GATS. Transparency within the GATS treaty is covered in the preambles as follows.

Wishing to establish a multilateral framework of principles and rules for trade in services with a view to the expansion of such trade under conditions of *transparency* and progressive liberalization and as a means of promoting the economic growth of all trading

partners and the development of developing countries .... (Emphasis added)

In the text of GATS, transparency, which is stated as its main purpose in the preamble, is defined as a 'basic principle'.<sup>7</sup> The main obligations contained in Article 3 are as follows: (1) the obligation to make publicly available all relevant measures (p. 620) of general application, that are all relevant national laws, such as by their publication; (2) the obligation promptly to inform the Council for Trade in Services of the introduction of any new, or any changes to existing, laws and other regulations; (3) the obligation to respond promptly to all requests by other members for specific information on a member's measures of general application or international agreements and to establish enquiry points to provide specific information to other members.

Article 3 of GATS indicates that the core element of transparency is that all relevant measures of general application be made publicly available. To ensure this availability, importing countries need to meet the three obligations as stated above. It should be noted that this requirement of public availability does not always require the publication of these measures. Publication is one means by which the measures of relevant laws may be made publicly available. Furthermore, with respect to the exchange of information as the means of securing the public availability of all relevant laws, only the obligations to inform the Council for Trade in Services and to respond to all requests by other countries are included. The obligation to respond is not placed on any individual entity but only on countries themselves. The scope of information which is exchanged is more restricted than that which is to be publicly available.

Other WTO agreements in addition to the GATS emphasize transparency. For example in the following, though transparency is not designated as a basic principle, it is still addressed:

- Article 10 of GATT;
- Article 7 of the Agriculture Agreement;
- Article 7 of the SPS Agreement;
- Articles 2, 5 and 15 of the TBT Agreement;
- Article 6 of the TRIM Agreement;
- Article 12 of the Customs Evaluation Agreement;
- Article 2 of the Agreement on Preshipment Inspection; (p. 621)
- Articles 2(g) and 3(e) of the Agreement on Rules of Origin;
- Appendices 2 and 3 of the Understanding on Rules and Procedures Governing the Settlement of Disputes;
- Sections B and D of the Trade Policy Review Mechanism;
- Article 9 of the Agreement on Trade in Civil Aircraft; and
- Article 17 of the Agreement on Government Procurement.

The inclusion of transparency obligations in the WTO Agreements carries on the precedent set by the General Agreement on Tariffs and Trade (GATT) 1947. The ensuring of public availability of all relevant national laws applied as the basic element of transparency came into existence in Article 10 of the GATT, which provides obligations for the publication of laws, regulations, judicial decisions, and administrative rulings of general application. Article 10 of GATT does not include the obligation of information exchange which nowadays is one of the means of realizing transparency.<sup>8</sup> On the other hand, Article 3 includes other obligations which are not included in Article 3 of GATS. Those obligations are: (1) the obligation not to enforce a measure before such a measure has been officially published, (2) the obligation to administer in a uniform, impartial, and reasonable manner all its laws etc, as stated above (fair administration), (3) the obligation to maintain or institute independent judicial, arbitral, or administrative tribunals or procedures (independent tribunals). These last two obligations are common to the contemporary US criteria of transparency as stated below.

But it was not recognized that Article 10 of GATT included transparency as it was viewed only as a technical provision.<sup>9</sup> This means that this article was not considered important in the GATT. Therefore Article 10 cannot be characterized as the origin of the transparency obligation in current international economic regulations, although it might appear so on the surface when we compare Article 10 with the present provisions. Article 10 of GATT is only a forerunner to these present manifestations of transparency.

The concept of transparency came into existence in the GATT Tokyo Round codes. The Preamble to the Government Procurement Agreement reads, 'Recognizing that it is desirable to provide transparency of laws, regulations, procedures and practices regarding government procurement; ...'. On the other hand, in the text of the Agreement there is no article specifically entitled 'transparency'. Article 6, 'Information and Review', includes only the obligation to publish any law and procedure regarding government procurement but does not include the obligation of information exchange. We can presume that transparency in the preamble is used (p. 622) in connection with Article 6, but it is not clear whether or not it can be considered to be limited to the content contained in Article 6. However, in order to achieve national treatment and non-discrimination as the main purposes of the agreement on government procurement, open tendering procedures, as well as regulations of technical specifications, are stressed. The emphasis on open tendering procedures indicates the importance of transparency in this area.<sup>10</sup> In the history of the WTO and GATT, we have to realize that the concept of transparency emerged as an important principle at the time of the Tokyo Round and finds its most developed contemporary expression in the GATS.

In the field of trade, the importance of the general availability of relevant laws was formerly recognized, but it is only in recent times that it has been viewed as important from the standpoint of transparency. The initial practice of BITs did not include a specific transparency provision. The first BIT was between West Germany and Pakistan in 1959 and certain Western European countries followed this practice. The purpose of BITs at that time was to secure prompt, adequate, and effective compensation provided against expropriation by states. At that time, the notable case where the issue of expropriation and compensation emerged was the expropriation of natural resources-related investments in developing states. Developing states strongly argued that natural resources should be entirely controlled based upon the state in which they were located under the title of 'permanent sovereignty over natural resources', and the means of compensating for expropriation should be decided entirely by the states themselves. The initial BITs were in response to such a situation and were called 'investment protection agreements'. Such BITs did not include the principle of transparency, neither mentioning the word 'transparency' nor containing any provision concerning the general availability of laws of the countries concerned. Such agreements continue even today. One example is the most recent UK BIT with Vanuatu in 2004.<sup>11</sup> Thus, this type of investment protection attaches no importance to transparency.

On the other hand, in the late 1970s the prevailing opinion in the USA was that the conventional programme of freedom of commerce and navigation treaties (FCN) had not responded to the needs of investors and traders. First, as GATT regulations widely covered trade, the significance of disciplines imposed by FCN treaties was weakened. Secondly, with respect to international investment, it was recognized that FCN rules were not sufficient to respond to the needs of that time. The conventional FCN treaty did not include a clause covering issues such as the prohibition of (p. 623) performance requirements or the free entry of key foreign personnel in connection with the establishment and operation of an investment. Thirdly, as the FCN programme was built on the premise that partners were advanced states, it was difficult for developing states to commit to obligations that were capable of full compliance only for advanced states. Given this situation, much attention was paid by the USA to the European practice of concluding BITs and, in due course from the early 1980s, the US government constructed a BIT programme to conclude such treaties with developing countries.

The purpose and structure of the US BIT programme was, however, different from its European counterpart. Although the main purpose of European BITs was to guarantee adequate, prompt, and

effective compensation against expropriation, the US government set as its main aims the improvement of the investment environments of host states as well as investment protection. The improvement of the investment environment in host countries enabled the acquisition of national treatment or most-favoured-nation treatment. The securing of transparency was one form of treatment of investment for which improvement was sought.

Article 2 (Treatment of Investments), paragraph 9 of the first US Model BIT, drafted in 1983, states,

Each Party and its political subdivisions shall make public all laws, regulations, administrative practices and procedures, and adjudicatory decisions that pertain to or affect investments in its territory of nationals or companies of the other Party.<sup>12</sup>

This includes securing the public availability of relevant laws in the treatment of investments. The US BITs with Bangladesh and Haiti from the 1980s adopted this model to make publicly available the relevant laws of host states. Furthermore, the BITs with Turkey, Grenada, and Congo adopted the model of the 1984 or 1987 draft. (The BIT with Panama did not contain such a provision because in this case, in the view of the US Department of State, such public availability of relevant laws had already been realized.<sup>13</sup>) At that time, the US BIT included only the obligation of public availability of relevant laws of host states and did not use the concept of transparency. This obligation was characterized as one of the treatment of investment standards.

(p. 624) After the end of the Cold War, the USA began to conclude BITs with Eastern European countries. On the one hand, this was for the purpose of maintaining a market economy system after the collapse of the former socialist regimes and on the other hand it indicated to the wider world the change of economic regimes of the former socialist countries. One such pioneering agreement was the Treaty with Poland Concerning Business and Economic Relations, a comprehensive agreement that included not only investment but also trade. At that time, Poland was not a member of GATT. By Article VIII of that agreement,

## **Exchange of Information and Transparency**

- 1.** Each Party acknowledges the desirability of facilitating the collection and exchange of all non-confidential, non-proprietary information relating to investments and commercial activities within its territory.
- 2.** Each Party shall make publicly available all non-confidential, non-proprietary information which may be useful in connection with investment and commercial activities. In addition, each Party shall promptly make public all laws, regulations, administrative practices and procedures, and adjudicatory decisions having general application that pertain to or affect commercial activities or investments.
- 3.** The Parties shall disseminate to their respective business communities such information made available under paragraph 2 which will assist their nationals and companies in pursuing the most expeditious and equitable settlement of any dispute affecting them which may arise under this Treaty. Such information may be related to timeliness of decisions and vindication of rights under the Treaty.<sup>14</sup>

In this article, the word 'transparency' is applied clearly, which means securing the public availability of all laws with the added obligation to make information public and for information exchange. In this sense, this provision appears similar to Article 3 of GATS. However, the obligation to make information public was not specifically equated with publication as in GATS. With respect to information exchange, it mentions only its desirability. On this point, the obligations are less strict than those in GATS.

The Treaty on Business and Economic Relations with Poland had the political and economic functions of showing the transition of the former socialist regime beyond the mere improvement of investment environments through legal forms.<sup>15</sup> Such a document was highly symbolic of the

functions of the concept of transparency. Transparency was viewed as an inevitable requirement of a free market economy. From the historical viewpoint, transparency that ensured the public availability of relevant laws as its basic element was definitely born at that moment, and led to GATS.

## **(p. 625) (2) The Expansion of Transparency Obligations in IIAs**

NAFTA realized the next stage of transparency. The aim of NAFTA is included in Article 102, paragraph 1 as follows: 'The objectives of this Agreement, as elaborated more specifically through its principles and rules, including national treatment, most-favored-nation treatment and transparency, are to ...'. Herein transparency is positioned as a basic principle and rule on a par with national treatment and most-favored-nation treatment. As the concrete definition of transparency, Chapter 18, 'Publication, Notification and Administration of Laws', stipulates its core meaning as securing the public availability of relevant information on laws. The structure of Chapter 18 is as follows: Article 1801: Contact Points; Article 1802: Publication; Article 1803: Notification and Provision of Information; Article 1804: Administrative Proceedings; Article 1805: Review and Appeal. Chapter 18 of NAFTA stipulates the involvement of related parties in administrative procedures and obligations to establish an impartial review agent, such as a court, in addition to the public availability of information on relevant laws. However, it is not indicated in the text that transparency is to be secured by these articles. This point has been clearly demonstrated in US practice in the 21st century.

The new US Model BIT of 2004 includes the following transparency-related articles: Article 10, entitled 'Publication of Laws and Decisions Respecting Investment' and Article 11 entitled 'Transparency'.<sup>16</sup>

(p. 626) The concept of transparency was greatly expanded in the US Model BIT of 2004. First, the publication of laws and other regulations is separated from the principle of transparency itself. The term transparency covers the following items: (1) to make contact points for facilitation of communications; (2) to publish in advance any relevant measure that a Contracting Party proposes to adopt and to provide the opportunity to comment on proposed measures; (3) to respond to questions pertaining to any actual proposed measure; (4) to institute administrative proceedings; (5) to establish or maintain administrative tribunals or procedures for the purpose of the prompt review.

Transparency was expanded to include the institution of a prior comment upon the proposed laws and administrative decisions as stipulated in (1), that is, a commitment concerning the enactment of laws and administrative decisions beyond the mere provision of information of relevant laws to be publicly available and the review of the related administrative decisions by an impartial agent such as a court. Such broad transparency appeared in the US-Uruguay BIT.<sup>17</sup> In more recent US Free Trade Agreements with investment provisions, a commitment to transparency in (p. 627) administrative proceedings has been introduced.<sup>18</sup> In addition, in a number of other BITs a general right for any interested person to have available to them information on relevant laws, regulations, and procedures can be found, as well as permission to comment on proposed measures.<sup>19</sup>

Transparency was expanded in this way because its purpose had shifted from mere improvement of investment environments to public control of policy-making or of the implementation and dispute settlement process of host states. A new philosophy has emerged that transparency is to ensure the accountability of host states with a view to good and effective governance.<sup>20</sup> Transparency from the standpoint of accountability is compatible with that of the improvement of investment environments. Investors not only obtain merit from the public availability of information on relevant laws, but this can also reinforce the accountability of host states. Furthermore, the realization of such accountability guarantees good and effective governance in host states as a means of improving their investment environment.

Deep analysis of the purpose of transparency leads to an increase in the number of actors for

which transparency would be requested. The research on BITs by UNCTAD which positioned transparency as an emerging principle in international investment law examines transparency not only towards host countries but also towards home countries and investors themselves.<sup>21</sup> The basic philosophy of UNCTAD's research is that BITs should be desirable for all relevant actors, including host states, home states, and investors, and that home countries as well as investors should be requested to release relevant information on request. In practice, BITs have demanded transparency from neither home states nor investors. But it is important that such an idea on transparency has emerged. Currently, the basic purpose of transparency has been shifting from mere improvement of investment environments to pursuit of the accountability of all actors concerned.

This new philosophy on BITs, in practice, has been adopted only by the US government, which further has only applied such transparency to host states' measures. Governments other than the USA have not requested such transparency in making BITs.<sup>22</sup> Taking this situation into account, one may conclude that the (p. 628) currently prevailing idea is that transparency should be viewed only as securing public availability of information on relevant laws by their open release and information exchange in order to improve the investment environment. The transparency provided in the BITs and Economic Partnership Agreements concluded by Japan belong to such a category.<sup>23</sup> But it is necessary to pay attention to the new philosophy of transparency and the gradual increase in the number of its supporters.<sup>24</sup>

### **(3) Transparency and 'Fair and Equitable Treatment'**

Since around 1980 the number of BITs that include the obligation of fair and equitable treatment of investors by host states has been increasing. The purpose of this provision is to ensure a certain level of treatment of investors and investments by host states. The concept of fair and equitable treatment has not been clearly defined and the abstract views on the topic have been divided into two main factions. The first view is that it means the minimum standard that should be given to foreign investors under international customary law and the second is that it means a degree above the minimum standard.<sup>25</sup> We may suppose that transparency could be included in fair and equitable treatment, so such an idea should be discussed.

Whether such a relationship exists between fair and equitable treatment and transparency has been considered in a number of recent investment arbitrations. One of the most important legal grounds of claim alleged by investors in such cases has been a breach of the obligation of fair and equitable. As a result, the definition of fair and equitable treatment has come to attract attention.<sup>26</sup> In this process, arbitral awards have emerged where the relationship between fair (p. 629) and equitable treatment and transparency was the most controversial issue. The *Metalclad* case, based on NAFTA Chapter 11 (chapter on Investment), was the first of these recent cases in which fair and equitable treatment came into contact with issues of transparency.

In the *Metalclad* case,<sup>27</sup> the Metalclad Corporation had planned to operate a waste disposal facility in Mexico on the invitation of the Mexican government, but, faced with the opposition of local government authorities in Mexico, Metalclad abandoned its plan. In response, it brought the case to arbitration to pursue the responsibility of the Mexican government to provide compensation for the loss of investment. The arbitration tribunal considered that the Mexican government had not provided fair and equitable treatment to Metalclad, contrary to Article 1105 of NAFTA. The arbitration award states:

An underlying objective of NAFTA is to promote and increase cross-border investment opportunities and ensure the successful implementation of investment initiatives ... Prominent in the statement of principles and rules that introduces the Agreement is the reference to 'transparency' (NAFTA Article 102(1)). The Tribunal understands this to include the idea that all relevant legal requirements for the purpose of initiating, completing and successfully operating investments made, or intended to be made, under the

Agreement should be capable of being readily known to all affected investors of another Party .... Once the authorities of the central government of any Party (whose international responsibility in such matters has been identified in the preceding section) become aware of any scope for misunderstanding or confusion in this connection, it is their duty to ensure that the correct position is promptly determined and clearly stated so that investors can proceed with all appropriate expedition in the confident belief that they are acting in accordance with all relevant laws.<sup>28</sup>

The Mexican government's denial of a municipal construction permit was considered improper. Metalclad, relying on representations by Mexican government officials, acted in good faith and fully expected to be granted the permit. Therefore,

Mexico failed to ensure a transparent and predictable framework for Metalclad's business planning and investment. The totality of these circumstances demonstrates a lack of orderly process and timely disposition in relation to an investor of a Party acting in the expectation that it would be treated fairly and justly in accordance with the NAFTA.<sup>29</sup>

In the view of the arbitral tribunal, the policies of the Mexican Federal Government and local governments were not clearly made known to Metalclad, which created confusion and therefore the lack of transparency created Metalclad's hardships. The tribunal acknowledged the responsibility of the Mexican government.

(p. 630) Mexico sought judicial review of this award before the courts of Canada as the designated place of arbitration in this case.<sup>30</sup> With respect to the issue of fair and equitable treatment, the arbitration award was nullified by the judgment of the Supreme Court of British Columbia<sup>31</sup> on the grounds that the tribunal had read transparency into fair and equitable treatment:

In its reasoning the Tribunal discussed the concept of transparency after quoting Article 1105 and making reference to Article 102. It set out its understanding of transparency and it then reviewed the relevant facts. After discussing the facts and concluding that the Municipality's denial of the construction permit was improper, the Tribunal stated its conclusion which formed the basis of its finding of a breach of Article 1105; namely, Mexico had failed to ensure a transparent and predictable framework for Metalclad's business planning and investment. Hence, the Tribunal made its decision on the basis of transparency. This was a matter beyond the scope of the submission to arbitration because there are no transparency obligations contained in Chapter 11.<sup>32</sup>

It seems that the tribunal read transparency (Art 102 NAFTA) into fair and equitable treatment and made the award. In the view of the Supreme Court, the issues an investor can bring to arbitration were limited to Chapter 11 under NAFTA. Therefore, it was beyond the scope of NAFTA's authority for the tribunal to make a decision based on Article 102.

From the viewpoint of the arbitration tribunal, it can be argued that it did not have the intention of directly applying Article 102. Indeed, the tribunal acknowledged that the Mexican government lacked transparency and affirmed the responsibility of the Mexican side. Yet in the view of the tribunal, the investor suffered damages from the measures of the Mexican government which were contrary to the obligation of fair and equitable treatment. To define the measures of the Mexican government which lacked fair and equitable treatment in precise terms, the tribunal argued there was a lack of transparency. Article 102, which includes transparency, covers myriad fields, including investment, but is not found in Chapter 11 of NAFTA, which the arbitration between investors and states covers. To interpret the arbitral award in such a way is in effect to exclude any transparency obligation from the fair and equitable treatment standard in Article 1105 of NAFTA, which is what the decision of the Supreme Court of British Columbia did.

Such a narrow approach to the fair and equitable treatment standard was not accepted in the subsequent *Tecmed* case, where a different approach to interpretation was taken not involving

Article 102 of NAFTA. In the *Tecmed* case,<sup>33</sup> the tribunal (p. 631) considered that the fair and equitable treatment provision in the BIT between Spain and Mexico was an element of good faith recognized under international law and stated:

(T)his provision of the Agreement, in light of the good faith principle established by international law, requires the Contracting Parties to provide to international investments treatment that does not affect the basic expectations that were taken into account by the foreign investor to make the investment.

The foreign investor expects the host State to act in a consistent manner, free from ambiguity and totally transparently in its relations with the foreign investor, so that it may know beforehand any and all rules and regulations that will govern its investments, as well as the goals of the relevant policies and administrative practices or directives, to be able to plan its investment and comply with such regulations ....The foreign investor also expects the host State to act consistently, i.e. without arbitrarily revoking any preexisting decisions or permits issued by the State that were relied upon by the investor to assume its commitments as well as to plan and launch its commercial and business activities.<sup>34</sup>

The view of the tribunal was that investors held a certain expectation in concluding the BIT and that this led the definition of fair and equitable treatment to be one that ensures the protection of such investor expectations. The expectation held by investors, according to the tribunal, was that host states should act in a consistent manner, free from ambiguity and totally transparent in its relations with the foreign investor. This tribunal rephrased fair and equitable treatment in accordance with the principle of good faith and read transparency into it. Such an approach was also followed in the *Saluka* case.

The *Saluka* case<sup>35</sup> developed and clarified the *Tecmed* decision. In the *Saluka* case, the actions of the Czech government were the object of the complaint by Saluka Investments BV, a Netherlands-registered affiliate of the Japanese financial group Nomura. In the case, whether the actions taken by the Czech government violated the 'fair and equitable treatment' standard became an important issue. To interpret the 'fair and equitable treatment' standard, the tribunal examined first its ordinary meaning; secondly, the context, and finally, the object and purpose of the Czech Republic-Netherlands BIT. With regard to the ordinary meaning, the tribunal, quoting the *SD Myers* decision,<sup>36</sup> stated that 'the infringement of the standard requires treatment in such an unjust or arbitrary manner that the treatment rises to the level that is unacceptable from the international perspective'.<sup>37</sup> Regarding the context, this tribunal said that 'the "fair and equitable treatment" standard is linked directly to the stimulation of foreign investment and to the economic development of both (p. 632) Contracting Parties'.<sup>38</sup> Concerning the object and purpose, its overall aim is considered to be to encourage foreign investment, and extend and intensify the parties' economic relations. Based on these interpretations, the tribunal considered that the 'fair and equitable treatment' standard requires the host state to assume an obligation 'to treat foreign investors so as to avoid the frustration of investors' legitimate and reasonable expectations'.<sup>39</sup> Theoretically, a foreign investor may expect that the government's conduct does not manifestly violate the requirements of transparency as well as those of consistency, even-handedness, and non-discrimination as this tribunal said. Thus the tribunal connects the 'fair and equitable treatment' standard with transparency.<sup>40</sup>

Thus, transparency has been considered as an element of fair and equitable treatment in recent arbitration awards. Is this view compatible with the concept of fair and equitable treatment? With regard to fair and equitable treatment, there has been controversy over whether it would mean the minimum standard under customary international law or beyond the minimum, as stated above. Such controversy is related to the argument as to why transparency should be read into fair and equitable treatment standard in any case. Taking into account the current situation of developing states, and the prevailing view that each country is required to provide treatment for foreign investors that is equivalent to that for nationals,<sup>41</sup> it is difficult to say that transparency, even the



public availability of information of relevant laws, should be a minimum standard towards foreign investors under customary international law.

The arbitral tribunal of *Metalclad* assumed that an underlying objective of NAFTA is to promote and increase cross-border investment opportunities and interpreted the fair and equitable treatment not as a standard of international law but as a standard of NAFTA. The tribunal in the *Pope and Talbot* case<sup>42</sup> clearly stated that fair and equitable treatment should be a NAFTA standard beyond the minimum under customary international law in the language, '[a]nother possible interpretation of the presence of the fairness elements in Article 1105 is that they are *additive* to the requirements of international law. That is investors under NAFTA are entitled to the international law minimum *plus* the fairness elements'.<sup>43</sup> Such interpretations (p. 633) of fair and equitable treatment as a NAFTA standard exclude the idea that it should be a standard under customary international law. However, in later arbitration awards under NAFTA, the tribunals considered that fair and equitable treatment does not mean anything other than the minimum standard under international law and in fact dismissed the *Pope and Talbot* interpretation. The implication of this may be that transparency might not be an additional element to fair and equitable treatment in NAFTA as it goes beyond the minimum standard under customary international law.

On the other hand, the interpretation of the *Tecmed* tribunal uses a very subtle expression as follows: '(T)he commitment of fair and equitable treatment included in Article 4(1) of the Agreement is an expression and part of the *bona fide* principle recognized in international law'.<sup>44</sup> How should we interpret this expression? If fair and equitable treatment indicates the standard under customary international law, the fair and equitable treatment clause in a BIT has little significance as this obligation would be complied with by countries without the clause.

First, we should be reminded that fair and equitable treatment clauses differ from agreement to agreement. Accordingly, the purpose and interpretation of this clause will be different in each agreement. For example, Article 1105 of NAFTA provides as follows:

Each Party shall accord to investments of investors of another Party treatment in accordance with international law, including fair and equitable treatment and full protection and security.

Article 3.1 of the Czech Republic-Netherlands BIT, upon which *Saluka's* claim was brought, provides as follows:

Each Contracting Party shall ensure fair and equitable treatment to the investments of investors of the other Contracting Party ....

Comparing these two clauses, their styles are completely different. On the one hand, it might be appropriate for the fair and equitable standard of NAFTA to be interpreted under customary international law as it explicitly mentions international law. On the other hand, it might be reasonable that Article 3.1 of the Czech Republic-Netherlands BIT, which does not mention international law, should be interpreted as an autonomous standard as in the *Saluka* decision.

We have to note that as the same concept of fair and equitable treatment has been applied to different BITs, it is important to seek a common element in this concept. From this perspective, the *MTD Equity* case<sup>45</sup> gives us helpful guidance. In that case the tribunal states that it follows the *Tecmed* decision on this issue,<sup>46</sup> and borrows (p. 634) Professor Schwebel's words to indicate the meaning of fair and equitable treatment as 'a broad and widely-accepted standard encompassing such fundamental standards as good faith, due process, nondiscrimination, and proportionality'.<sup>47</sup> The tribunal then paraphrases, 'In their ordinary meaning, the terms "fair" and "equitable" used in Article 3(1) of the BIT mean "just", "even-handed", "unbiased", "legitimate"'.<sup>48</sup> The tribunal, upon such an assumption, concludes that the host state's approval of an investment which was clearly against its own urban development policy is a breach of the obligation of fair and equitable treatment. Thus 'minimum' is the common element of fair and equitable treatment and includes good faith, due process, non-discrimination, and proportionality. The *Tecmed* and *Saluka* decisions

have added transparency to this list of good governance criteria.

As the above-mentioned arbitration awards show, the common meaning of fair and equitable treatment is the minimum standard to act in good faith under customary international law or under each BIT. Its concrete meaning should be adapted according to both the contents of each BIT, such as the purpose of the BIT, and the political and economic situations of the host states to which it applies.<sup>49</sup> Based on applicable situations, transparent action might be required as a principle of good faith. In other words, even if a BIT does not contain a provision for transparency, the core element of transparency might emerge if a clause on the fair and equitable treatment obligation resides within it and its application calls for such a reading. Yet, we cannot define the concrete meaning of transparency as an element of fair and equitable treatment in each BIT by understanding the specific contents of the BIT and investment environments, although the obligation of public availability of information on relevant laws could be included in the meaning.

## Concluding Remarks

As stated above, transparency originated in the concept of the improvement of the investment environment, but it is not clear what relationship transparency should (p. 635) have with investment protection. One could presume that the obligation of transparency has no relation to the protection of investments. But to read transparency into fair and equitable treatment gives a basis for compensation towards investments that have suffered injuries, such as where an investor was led into making a bad decision to invest due to lack of information on relevant laws. Thus, transparency might have a significant bearing on the aspect of investment protection in this sense. Transparency may require the host state not only to secure the public availability of relevant laws but also to compensate investors who have suffered because of the lack of transparency by host states.<sup>50</sup> Indeed, depending on the particular interpretation that a tribunal might place on the precise meaning of fair and equitable treatment in a given case, transparency may be regarded as an element of fair and equitable treatment and so require a degree of accountability by host states.

In the 1980s, transparency came to be known as the securing of the public availability of information on relevant laws. This trend was followed by the WTO Agreements, which ranked transparency as a basic principle. Furthermore, transparency has developed in US BITs as a tool to pursue the accountability of host states and to charge host states with corresponding obligations so as to establish an impartial review mechanism. From the same viewpoint, it has come to be argued that accountability should also be required of investors and host states in BITs. This proposal indicates a change in the theoretical basis not only of transparency but also of the fundamental functions of BITs. Until now, BITs have been treaties that lay out obligations concerning areas such as investment protection or improvements in investment environments in host states in favour of investors and investments. But the new argument could intend to shift the obligations upon both investors and home states in favour of host states. In this sense, this argument proposes changing the paradigm of what BITs should be.

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## Footnotes:

\* I wish to express my heartfelt thanks to Ms Loretta Malintoppi, who improved my English considerably.

<sup>1</sup> See UNCTAD, *International Investment Agreements: Key Issues* (New York and Geneva, United Nations, 2004) ch 10, 'Transparency' at 281–314. Also published separately as UNCTAD, *Transparency*, Series on issues in international investment agreements (New York and Geneva, United Nations, 2004), available at <<http://www.unctad.org/ia>>.

<sup>2</sup> WTO, Ministerial Conference, Fourth Session, Doha, 9–14 November 2001, Ministerial Declaration, WT/MIN(01)/DEC/1. Negotiations over investment rules were dropped from the Doha Development Agenda (DDA) in 2004.

<sup>3</sup> See M Sornarajah, *The International Law on Foreign Investment* (Cambridge, Cambridge University Press, 2nd edn, 2004); Rudolf Dolzer and Margrete Stevens, *Bilateral Investment Treaties* (The Hague, Nijhoff, 1995). Muchlinski states, 'Among other, less common, specific standards to be found in BITs are: ... transparency obligations', citing the US-Uruguay BIT of 25 October 2004, Art 8: 44 ILM 268 (2005) and the above UNCTAD study (n 1), but he does not elaborate further: Peter T Muchlinski, *Multinational Enterprises and the Law* (Oxford, Oxford University Press, 2nd edn, 2007) at 693. But see below n 22.

<sup>4</sup> The main purpose of the trade facilitation negotiation now in progress in the DDA is enhancing transparency in trade.

<sup>5</sup> See further Peter Muchlinski, 'Corporate Social Responsibility', ch 17 below.

<sup>6</sup> National treatment and market access are also basic principles, but these are applied to matters

to which contracting states have made commitments. Therefore the ambit of the application of national treatment and market access is very restrictive. On the contrary, transparency and MFN are applied to all matters in principle. See General Agreement on Trade in Services 1994, available at <<http://www.wto.org>>.

**7** GATS Article III: Transparency:

- 1.** Each Member shall publish promptly and, except in emergency situations, at the latest by the time of their entry into force, all relevant measures of general application which pertain to or affect the operation of this Agreement. International agreements pertaining to or affecting trade in services to which a Member is a signatory shall also be published.
- 2.** Where publication as referred to in paragraph 1 is not practicable, such information shall be made otherwise publicly available.
- 3.** Each Member shall promptly and at least annually inform the Council for Trade in Services of the introduction of any new, or any changes to existing, laws, regulations or administrative guidelines which significantly affect trade in services covered by its specific commitments under this Agreement.
- 4.** Each Member shall respond promptly to all requests by any other Member for specific information on any of its measures of general application or international agreements within the meaning of paragraph 1. Each Member shall also establish one or more enquiry points to provide specific information to other Members, upon request, on all such matters as well as those subject to the notification requirement in paragraph 3. Such enquiry points shall be established within two years from the date of entry into force of the Agreement Establishing the WTO (referred to in this Agreement as the "WTO Agreement"). Appropriate flexibility with respect to the time-limit within which such enquiry points are to be established may be agreed upon for individual developing country Members. Enquiry points need not be depositories of laws and regulations.
- 5.** Any Member may notify to the Council for Trade in Services any measure, taken by any other Member, which it considers affects the operation of this Agreement.'

**8** See UNCTAD, above n 1 at 36–7.

**9** John H Jackson, *World Trade and the Law of GATT* (Indianapolis, Bobbs-Merill Company, 1969) 461. Nowadays Art 10 of GATT is interpreted as the obligation of transparency. See Petros C Mavroidis, *The General Agreement on Tariffs and Trade: A Commentary* (Oxford, Oxford University Press, 2005) 270–2.

**10** See Arie Reich, *International Public Procurement Law* (The Hague, Kluwer Law International, 1999) 117–25; Gilbert R Winham, *International Trade and the Tokyo Round Negotiations* (Princeton, Princeton University Press, 1986) 358.

**11** Agreement between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of Vanuatu for the Promotion and Protection of Investments (Port Vila, 22 December 2003) Vanuatu No. 1 (2004) (the Agreement is not in force) Cm 6169, available at <<http://www.fc.gov.uk/Files/kfile/Cm6169,0.pdf>>.

**12** See eg the US-Senegal BIT of 6 December 1983 entered into force 25 October 1990, <<http://www.state.gov/documents/organization/43585.pdf>>. Art II(10): 'Each party shall make public by existing official means all laws, regulations, administrative practices and procedures, and adjudicatory decisions that pertain to or affect investments in its territory of nationals or companies of the other Party. 11. The treatment accorded by a Party to nationals or companies of the other Party under the provisions of paragraphs 1 and 2 of this Article shall in any State, Territory, possession, or political or administrative subdivision of the Party be the treatment accorded therein to companies incorporated, constituted or otherwise duly organized in other States, Territories, possessions, or political or administrative subdivisions of the Party.'

- <sup>13</sup> US-Panama BIT of 27 October 1982, entered force 30 May 1991, available at <<http://www.state.gov/documents/organization/43582.pdf>>.
- <sup>14</sup> The Treaty between the Republic of Poland and the United States of America concerning Business and Economic Relations of 21 March 1990, available at <[http://tcc.export.gov/static/doc\\_exp\\_005367.asp](http://tcc.export.gov/static/doc_exp_005367.asp)> or <[http://www.unctad.org/sections/dite/ia/docs/bits/us\\_poland.pdf](http://www.unctad.org/sections/dite/ia/docs/bits/us_poland.pdf)>.
- <sup>15</sup> See Kenneth J Vandeveld, *United States Investment Treaties* (Deventer, Kluwer Law and Taxation Publishers, 1992) 235–44.
- <sup>16</sup> See US Model BIT of 2004 at <<http://ita.law.uvic.ca/documents/USmodelbitnov04.pdf>>:

## **‘Article 10 : Publication of Laws and Decisions Respecting Investment**

1. Each Party shall ensure that its: (a) laws, regulations, procedures, and administrative rulings of general application; and (b) adjudicatory decisions respecting any matter covered by this Treaty are promptly published or otherwise made publicly available.
2. For purposes of this Article, “administrative ruling of general application” means an administrative ruling or interpretation that applies to all persons and fact situations that fall generally within its ambit and that establishes a norm of conduct but does not include: (a) a determination or ruling made in an administrative or quasi-judicial proceeding that applies to a particular covered investment or investor of the other Party in a specific case; or (b) a ruling that adjudicates with respect to a particular act or practice.

## **Article 11 : Transparency**

### **1. Contact Points**

(a) Each Party shall designate a contact point or points to facilitate communications between the Parties on any matter covered by this Treaty. (b) On the request of the other Party, the contact point(s) shall identify the office or official responsible for the matter and assist, as necessary, in facilitating communication with the requesting Party.

### **2. Publication**

To the extent possible, each Party shall: (a) publish in advance any measure referred to in Article 10(1)(a) that it proposes to adopt; and (b) provide interested persons and the other Party a reasonable opportunity to comment on such proposed measures.

### **3. Provision of Information**

(a) On request of the other Party, a Party shall promptly provide information and respond to questions pertaining to any actual or proposed measure that the requesting Party considers might materially affect the operation of this Treaty or otherwise substantially affect its interests under this Treaty. (b) Any request or information under this paragraph shall be provided to the other Party through the relevant contact points. (c) Any information provided under this paragraph shall be without prejudice as to whether the measure is consistent with this Treaty.

## 4. Administrative Proceedings

With a view to administering in a consistent, impartial, and reasonable manner all measures referred to in Article 10(1)(a), each Party shall ensure that in its administrative proceedings applying such measures to particular covered investments or investors of the other Party in specific cases: (a) wherever possible, covered investments or investors of the other Party that are directly affected by a proceeding are provided reasonable notice, in accordance with domestic procedures, when a proceeding is initiated, including a description of the nature of the proceeding, a statement of the legal authority under which the proceeding is initiated, and a general description of any issues in controversy; (b) such persons are afforded a reasonable opportunity to present facts and arguments in support of their positions prior to any final administrative action, when time, the nature of the proceeding, and the public interest permit; and (c) its procedures are in accordance with domestic law.

## 5. Review and Appeal

(a) Each Party shall establish or maintain judicial, quasi-judicial, or administrative tribunals or procedures for the purpose of the prompt review and, where warranted, correction of final administrative actions regarding matters covered by this Treaty. Such tribunals shall be impartial and independent of the office or authority entrusted with administrative enforcement and shall not have any substantial interest in the outcome of the matter. (b) Each Party shall ensure that, in any such tribunals or procedures, the parties to the proceeding are provided with the right to: (i) a reasonable opportunity to support or defend their respective positions; and (ii) a decision based on the evidence and submissions of record or, where required by domestic law, the record compiled by the administrative authority. (c) Each Party shall ensure, subject to appeal or further review as provided in its domestic law, that such decisions shall be implemented by, and shall govern the practice of, the offices or authorities with respect to the administrative action at issue.'

<sup>17</sup> See the US-Uruguay BIT of 25 October 2005 in 44 ILM 265 (2005) Arts 10 and 11.

<sup>18</sup> See UNCTAD, *Investment Provisions in Economic Integration Agreements* (New York and Geneva, United Nations, 2006) at 88, citing the US-Singapore FTA Art 19.5. See too US-Chile FTA of 6 June 2003 Art 10.20, available at <<http://www.unctad.org/sections/dite/ia/docs/Compendium/en/290%20volume%2012.pdf>>.

<sup>19</sup> See eg the Canadian Model BIT 2004 Art 19, available at <<http://ita.law.uvic.ca/documents/Canadian2004-FIPA-model-en.pdf>>.

<sup>20</sup> OECD, *Public Sector Transparency and International Investment Policy* (Paris, OECD, 11 April 2003) at 5.

<sup>21</sup> UNCTAD, *Key Issues*, above n 1 at 285–9.

<sup>22</sup> See further UNCTAD, *Bilateral Investment Treaties 1995–2006: Trends in Investment Rulemaking* (New York and Geneva, United Nations, 2007) at 76–80. The study concludes: 'only a small—albeit growing—number of BITs of the last decade include provisions on transparency. However, to the extent that BITs deal with this issue, there have been significant developments concerning the content of the clause. Transparency is no longer perceived as a matter of the contracting parties exchanging investment-related information. In addition, a few recent BITs grant information rights to "all interested persons" and even allow them to comment upon draft legislation. Some BITs also enhance investor rights in administrative and judicial proceedings and provide for third-party participation'.

<sup>23</sup> See eg Japan-Vietnam BIT 2003 Art 7 in UNCTAD, above n 22 at 77.

- <sup>24</sup> Howard Mann, 'The IISD Model International Agreement on Investment for Sustainable Development: An Introductory Note', 20 ICSID Rev-FILJ 84 ff (2005).
- <sup>25</sup> See Stephen Vasciannie, 'The Fair and Equitable Treatment Standard in International Investment Law and Practice', 70 BYIL 99 (1999) at 102–5.
- <sup>26</sup> When the arbitration under NAFTA started in the 1990s, the issue whether damage to investments might arise from expropriation by host states was highly controversial. Following that, the definition of fair and equitable treatment has come to be a central topic of discussion as it has been shown that the theory of regulatory expropriation is not so easily confirmed: on which see further August Reinisch, Ch 11 above and Todd Grierson-Weiler and Ian A Laird, ch 8 above.
- <sup>27</sup> *Metalclad Corporation v The United Mexican States*, ICSID Case No. Arb(AF)/97/1, 40 ILM 36 (2001).
- <sup>28</sup> *Ibid* at paras 75–6.
- <sup>29</sup> *Ibid* at para 99.
- <sup>30</sup> See Patrick G Foy and Robert J Deane, 'Foreign Investment Protection under Investment Treaties: Recent Developments under Chapter 11 of the North American Free Trade Agreement', 16 ICSID Rev-FILJ 299 at 325–9 (2001).
- <sup>31</sup> *The United Mexican States v Metalclad Corporation*, 2001 BCSC 664.
- <sup>32</sup> *Ibid* at paras 70–2.
- <sup>33</sup> *Técnicas Medioambientales Tecmed, SA v United Mexican States*, ICSID Case No. Arb(AF)/00/2 (Spain/ Mexico BIT), Award, 29 May 2003, 43 ILM 133 (2004).
- <sup>34</sup> *Ibid* at para 154.
- <sup>35</sup> *Saluka Investments BV (The Netherlands) v The Czech Republic (Dutch/Czech BIT)*, Partial Award, 17 March 2006 at <<http://ita.law.uvic.ca/documents/Saluka-PartialawardFinal.pdf>>.
- <sup>36</sup> *Myers (SD) Inc v Canada*, NAFTA Arbitration, UNCITRAL Award of 12 November 2000, 40 ILM 1408 (2001) para 263.
- <sup>37</sup> *Saluka*, above n 35 at para 297.
- <sup>38</sup> *Ibid* at para 298.
- <sup>39</sup> *Ibid* at para 302.
- <sup>40</sup> According to the tribunal, 'A foreign investor whose interests are protected under the Treaty is entitled to expect that the Czech Republic will not act in a way that is manifestly inconsistent, non-transparent, unreasonable (*i.e.* unrelated to some rational policy), or discriminatory (*i.e.* based on unjustifiable distinctions). In applying this standard, the Tribunal will have due regard to all relevant circumstances.' *Ibid* at para 309.
- <sup>41</sup> Note Ian Brownlie, *Principles of Public International Law* (Oxford, Oxford University Press, 6th edn, 2003) at 501–2.
- <sup>42</sup> *Pope and Talbot v Canada*, UNCITRAL; Award on the Merits of Phase 2, 10 April 2001 at <<http://ita.law.uvic.ca/documents/PopeandTalbot-Merit.pdf>>.
- <sup>43</sup> *Ibid* at para 110.
- <sup>44</sup> *Tecmed*, above n 33 at para 153.
- <sup>45</sup> *MTD Equity Sdn Bhd & MTD Chile SA v Chile*, ICSID Case No. Arb/01/7 Final Award, 25 May 2004, 44 ILM 91 (2005).
- <sup>46</sup> *Ibid* at paras 114–15.
- <sup>47</sup> *Ibid* at para 109.
- <sup>48</sup> *Ibid* at para 113.
- <sup>49</sup> See eg *Genin v Estonia*, ICSID Case No. Arb/99/2 Award of 25 June 2001, 17 ICSID Rev-FILJ 395

(2002) where the reality of administering financial sector supervisory functions in a transitional economy was thought relevant to determining whether the investor had been unfairly and inequitably treated. Indeed, the tribunal noted that the investor had been less than fully transparent towards the regulatory authorities as to the precise ownership structure of their investment in that country, which led in part to their decision to revoke his licence to operate. See further Peter Muchlinski, “Caveat Investor?” *The Relevance of the Conduct of the Investor under the Fair and Equitable Treatment Standard*, 55(3) ICLQ 527 (2006) at 540–1.

**50** But note that the investor may also have responsibilities to act reasonably in assessing the commercial viability of the investment: see *MTD Equity*, above n 45 and Muchlinski, above n 49 at 542–7.



## **LEGAL AUTHORITY CA-93**

JUDGMENT OF THE COURT (First Chamber)

24 January 2008\*

In Case C-532/06,

REFERENCE for a preliminary ruling under Article 234 EC from the Simvoulio tis Epikratias (Greece), made by decision of 28 November 2006, received at the Court on 29 December 2006, in the proceedings

**Emm. G. Lianakis AE,**

**Sima Anonimi Techniki Eteria Meleton ke Epivlepseon,**

**Nikolaos Vlachopoulos**

v

**Dimos Alexandroupolis,**

**Planitiki AE,**

\* Language of the case: Greek.

**Ekaterini Georgoula,**

**Dimitrios Vasios,**

**N. Loukatos ke Synergates AE Meleton,**

**Eratosthenis Meletitiki AE,**

**A. Pantazis — Pan. Kyriopoulos ke syn/tes OS Filon OE,**

**Nikolaos Sideris,**

THE COURT (First Chamber),

composed of P. Jann (Rapporteur), President of Chamber, A. Tizzano, A. Borg Barthet, M. Ilešič and E. Levits, Judges,

Advocate General: D. Ruiz-Jarabo Colomer,  
Registrar: R. Grass,

after considering the observations submitted on behalf of:

- N. Loukatos ke Synergates AE Meleton, Eratosthenis Meletitiki AE, A. Pantazis — Pan. Kyriopoulos ke syn/tes OS Filon OE and Nikolaos Sideris, by E. Konstantopoulou and P.E. Bitsaxis, dikigori,
  
- the Commission of the European Communities, by M. Patakia and D. Kukovec, acting as Agents,

gives the following

### **Judgment**

- <sup>1</sup> This reference for a preliminary ruling concerns, in essence, the interpretation of Articles 23(1), 32 and 36 of Council Directive 92/50/EEC of 18 June 1992 relating to the coordination of procedures for the award of public service contracts (OJ 1992 L 209, p. 1), as amended by European Parliament and Council Directive 97/52/EC of 13 October 1997 (OJ 1997 L 328, p. 1) ('Directive 92/50').

- 2 The reference has been made in the context of two sets of proceedings brought by (1) the consortium of consultancy firms and experts comprising Emm. G. Lianakis AE (universal successor in title to Emm. Lianakis EPE), Sima Anonimi Techniki Eteria Meleton ke Epivlepseon and Nikolaos Vlachopoulos ('the Lianakis consortium') and (2) the consortium of Planitiki AE, Ekaterini Georgoula and Dimitrios Vasios ('the Planitiki consortium'), against Dimos Alexandroupolis (Municipality of Alexandroupolis) and the consortium of N. Loukatos ke Synergates AE Meleton, Eratosthenis Meletitiki AE, A. Pantazis — Pan. Kyriopoulos ke syn/tes (Filon OE) — Nikolaos Sideris ('the Loukatos consortium'), concerning the award of a contract to carry out a project in respect of the cadastre, town plan and implementing measure for part of the Municipality of Alexandroupolis.

### **Legal context**

- 3 Directive 92/50 coordinates the procedures for the award of public service contracts.
- 4 To that end, the Directive determines which contracts must be subject to an award procedure and the procedural rules to be followed, including, in particular, the principle of equal treatment of economic operators, the criteria for the qualitative selection for operators ('qualitative selection criteria') and the criteria for the award of contracts ('award criteria').
- 5 Thus, Article 3(2) of Directive 92/50 provides that '[c]ontracting authorities shall ensure that there is no discrimination between different service providers'.

6 Article 23(1) of the Directive provides that '[c]ontracts shall be awarded on the basis of the criteria laid down in Chapter 3 [namely Articles 36 and 37], taking into account Article 24, after the suitability of the service providers not excluded under Article 29 has been checked by the contracting authorities in accordance with the criteria referred to in Articles 31 and 32'.

7 According to Article 32 of the Directive:

'1. The ability of service providers to perform services may be evaluated in particular with regard to their skills, efficiency, experience and reliability.

2. Evidence of the service provider's technical capability may be furnished by one or more of the following means according to the nature, quantity and purpose of the services to be provided:

(a) the service provider's educational and professional qualifications and/or those of the firm's managerial staff and, in particular, those of the person or persons responsible for providing the services;

(b) a list of the principal services provided in the past three years, with the sums, dates and recipients, public or private, of the services provided:

...

- (c) an indication of the technicians or technical bodies involved, whether or not belonging directly to the service provider, especially those responsible for quality control;
  
- (d) a statement of the service provider's average annual manpower and the number of managerial staff for the last three years;
  
- (e) a statement of the tool, plant or technical equipment available to the service provider for carrying out the services;
  
- (f) a description of the service provider's measures for ensuring quality and his study and research facilities;

...'

8 Article 36 of Directive 92/50 provides:

'1. Without prejudice to national laws, regulations or administrative provisions on the remuneration of certain services, the criteria on which the contracting authority shall base the award of contracts may be:

- (a) where the award is made to the economically most advantageous tender, various criteria relating to the contract: for example, quality, technical merit, aesthetic

and functional characteristics, technical assistance and after-sales service, delivery date, delivery period or period of completion, price; or

(b) the lowest price only.

2. Where the contract is to be awarded to the economically most advantageous tender, the contracting authority shall state in the contract documents or in the contract notice the award criteria which it intends to apply, where possible in descending order of importance.'

### **The dispute in the main proceedings and the question referred for a preliminary ruling**

- 9 In 2004, the Municipal Council of Alexandroupolis issued a call for tenders for a contract to carry out a project in respect of the cadastre, town plan and implementing measure for the Palagia area, a part of Alexandroupolis with fewer than 2 000 inhabitants. The budget for the project was EUR 461 737.
- 10 The contract notice referred to the award criteria in order of priority: (1) the proven experience of the expert on projects carried out over the last three years; (2) the firm's manpower and equipment; and (3) the ability to complete the project by the anticipated deadline, together with the firm's commitments and its professional potential.



- 11 Thirteen consultancies responded to the call for tenders, including in particular the Lianakis and Planitiki consortia, and the Loukatos consortium.
- 12 During the evaluation procedure, in order to evaluate the tenderers' bids, the project award committee of the Municipality of Alexandroupolis ('the Project Award Committee') defined the weighting factors and sub-criteria in respect of the award criteria referred to in the contract notice.
- 13 Accordingly, it set weightings of 60%, 20% and 20% for each of the three award criteria referred to in the contract notice.
- 14 In addition, it stipulated that experience (first award criterion) should be evaluated by reference to the value of completed projects. Thus, for experience on projects worth up to EUR 500 000, a tenderer would be awarded 0 points; between EUR 500 000 and EUR 1 000 000, 6 points; between EUR 1 000 000 and EUR 1 500 000, 12 points; and so on up to a maximum score of 60 points for experience on projects worth over EUR 12 000 000.
- 15 A firm's manpower and equipment (second award criterion) were to be assessed by reference to the size of the project team. A tenderer would therefore be awarded 2 points for a team of 1 to 5 persons, 4 points for a team of 6 to 10 persons, and so on up to a maximum score of 20 points for a team of more than 45 persons.
- 16 Finally, the Project Award Committee decided that the ability to complete the project by the anticipated deadline (third award criterion) should be assessed by reference

to the value of the firm's commitments. Accordingly, a tenderer would be awarded the maximum score of 20 points for work worth less than EUR 15 000; 18 points for work worth between EUR 15 000 and EUR 60 000; 16 points for work worth between EUR 60 000 and EUR 100 000; and so on down to a minimum score of 0 points for work worth more than EUR 1 500 000.

17 In application of those rules, the Project Award Committee allocated first place to the Loukatos consortium (78 points), second place to the Planitiki consortium (72 points) and third place to the Lianakis consortium (70 points). Consequently, in its report of 27 April 2005, it proposed that the project be awarded to the Loukatos consortium.

18 By decision of 10 May 2005, the Municipal Council of Alexandroupolis approved the Project Award Committee's report and awarded the project to the Loukatos consortium.

19 The Lianakis and Planitiki consortia took the view that the Loukatos consortium could only have been awarded the project as a result of the Project Award Committee's subsequent stipulation of the weighting factors and sub-criteria in respect of the award criteria referred to in the contract notice, and challenged the decision taken by the Municipal Council of Alexandroupolis, initially before the Council itself and subsequently before the Simvoulio tis Epikratias (Greek Council of State; 'Simvoulio tis Epikratias') on the basis, in particular, of allegations of infringement of Article 36(2) of Directive 92/50.

20 In those circumstances, the Simvoulio tis Epikratias decided to stay the proceedings and to refer the following question to the Court of Justice for a preliminary ruling:

'If the contract notice for the award of a contract for services makes provision only for the order of priority of the award criteria, without stipulating the weighting factors

for each criterion, does Article 36 of Directive 92/50 allow criteria to be weighted by the evaluation committee at a later date and, if so, under what conditions?’

### **The question referred for a preliminary ruling**

- 21 By its question, the referring court asks in essence whether, in a tendering procedure, Article 36(2) of Directive 92/50 precludes the contracting authority from stipulating at a later date the weighting factors and sub-criteria to be applied to the award criteria referred to in the contract documents or contract notice.
- 22 The Commission submitted in its written observations that, before replying to the question referred, it is necessary to consider whether, in a tendering procedure, Directive 92/50 precludes the contracting authority from taking into account as ‘award criteria’ rather than as ‘qualitative selection criteria’ the tenderers’ experience, manpower and equipment, or their ability to perform the contract by the anticipated deadline.
- 23 In that regard, even if — formally — the national court has limited its question to the interpretation of Article 36(2) of Directive 92/50 in relation to a possible later change to the award criteria, that does not prevent the Court from providing the national court with all the elements of interpretation of Community law which may enable it to rule on the case before it, whether or not reference is made thereto in the question referred (see Case C-392/05 *Alevizos* [2007] ECR I-3505, paragraph 64 and the case-law cited).

24 Accordingly, it is necessary, first of all, to establish the lawfulness of the criteria chosen as ‘award criteria’, before considering whether it is possible for the weighting factors and sub-criteria in respect of the award criteria referred to in the contract documents or contract notice to be set at a later date.

*Criteria chosen as ‘award criteria’ (Articles 23 and 36(1) of Directive 92/50)*

25 It must be borne in mind that Article 23(1) of Directive 92/50 provides that a contract is to be awarded on the basis of the criteria laid down in Articles 36 and 37 of the Directive, taking into account Article 24, after the suitability of the service providers not excluded under Article 29 has been checked by the contracting authorities in accordance with the criteria referred to in Articles 31 and 32.

26 The case-law shows that, while Directive 92/50 does not in theory preclude the examination of the tenderers’ suitability and the award of the contract from taking place simultaneously, the two procedures are nevertheless distinct and are governed by different rules (see, to that effect, in relation to works contracts, Case 31/87 *Beentjes* [1988] ECR 4635, paragraphs 15 and 16).

27 The suitability of tenderers is to be checked by the authorities awarding contracts in accordance with the criteria of economic and financial standing and of technical capability (the ‘qualitative selection criteria’) referred to in Articles 31 and 32 of Directive 92/50 (see, as regards works contracts, *Beentjes*, paragraph 17).

28 By contrast, the award of contracts is based on the criteria set out in Article 36(1) of Directive 92/50, namely, the lowest price or the economically most advantageous tender (see, to that effect, in relation to works contracts, *Beentjes*, paragraph 18).

29 However, although in the latter case Article 36(1) of Directive 92/50 does not set out an exhaustive list of the criteria which may be chosen by the contracting authorities, and therefore leaves it open to the authorities awarding contracts to select the criteria on which they propose to base their award of the contract, their choice is nevertheless limited to criteria aimed at identifying the tender which is economically the most advantageous (see, to that effect, in relation to public works contracts, *Beentjes*, paragraph 19; Case C-19/00 *SIAC Construction* [2001] ECR I-7725, paragraphs 35 and 36; and, in relation to public service contracts, Case C-513/99 *Concordia Bus Finland* [2002] ECR I-7213, paragraphs 54 and 59, and Case C-315/01 *GAT* [2003] ECR I-6351, paragraphs 63 and 64).

30 Therefore, ‘award criteria’ do not include criteria that are not aimed at identifying the tender which is economically the most advantageous, but are instead essentially linked to the evaluation of the tenderers’ ability to perform the contract in question.

31 In the case in the main proceedings, however, the criteria selected as ‘award criteria’ by the contracting authority relate principally to the experience, qualifications and means of ensuring proper performance of the contract in question. Those are criteria which concern the tenderers’ suitability to perform the contract and which therefore do not have the status of ‘award criteria’ pursuant to Article 36(1) of Directive 92/50.

32 Consequently, it must be held that, in a tendering procedure, a contracting authority is precluded by Articles 23(1), 32 and 36(1) of Directive 92/50 from taking into account as ‘award criteria’ rather than as ‘qualitative selection criteria’ the tenderers’ experience, manpower and equipment, or their ability to perform the contract by the anticipated deadline.

*Subsequent stipulation of weighting factors and sub-criteria in respect of the award criteria referred to in the contract documents or contract notice*

33 It must be borne in mind that Article 3(2) of Directive 92/50 requires contracting authorities to ensure that there is no discrimination between different service providers.

34 The principle of equal treatment thus laid down also entails an obligation of transparency (see, to that effect, in relation to public supply contracts, Case C-275/98 *Unitron Scandinavia and 3-S* [1999] ECR I-8291, paragraph 31, and, in relation to public works contracts, *SIAC Construction*, paragraph 41).

35 Furthermore, it follows from Article 36(2) of Directive 92/50 that where the contract has to be awarded to the economically most advantageous tender, the contracting authority must state in the contract documents or in the contract notice the award criteria which it intends to apply, where possible in descending order of importance.

- 36 According to the case-law, Article 36(2), read in the light of the principle of equal treatment of economic operators set out in Article 3(2) of Directive 92/50 and of the ensuing obligation of transparency, requires that potential tenderers should be aware of all the elements to be taken into account by the contracting authority in identifying the economically most advantageous offer, and their relative importance, when they prepare their tenders (see, to that effect, in relation to public contracts in the water, energy, transport and telecommunications industries, Case C-87/94 *Commission v Belgium* [1996] ECR I-2043, paragraph 88; in relation to public works contracts, Case C-470/99 *Universale-Bau and Others* [2002] ECR I-11617, paragraph 98; and, in relation to public service contracts, Case C-331/04 *ATI EAC and Others* [2005] ECR I-10109, paragraph 24).
- 37 Potential tenderers must be in a position to ascertain the existence and scope of those elements when preparing their tenders (see, to that effect, in relation to public service contracts, *Concordia Bus Finland*, paragraph 62, and *ATI EAC and Others*, paragraph 23).
- 38 Therefore, a contracting authority cannot apply weighting rules or sub-criteria in respect of the award criteria which it has not previously brought to the tenderers' attention (see, by analogy, in relation to public works contracts, *Universale-Bau and Others*, paragraph 99).
- 39 That interpretation is supported by the purpose of Directive 92/50 which aims to eliminate barriers to the freedom to provide services and therefore to protect the interests of economic operators established in a Member State who wish to offer services to contracting authorities established in another Member State (see, in particular, Case C-380/98 *University of Cambridge* [2000] ECR I-8035, paragraph 16).

40 To that end, tenderers must be placed on an equal footing throughout the procedure, which means that the criteria and conditions governing each contract must be adequately publicised by the contracting authorities (see, to that effect, in relation to public works contracts, *Beentjes*, paragraph 21, and *SIAC Construction*, paragraphs 32 and 34; also, in relation to public service contracts, *ATI EAC and Others*, paragraph 22).

41 Contrary to the doubts expressed by the referring court, those findings do not conflict with the interpretation by the Court of Justice of Article 36(2) of Directive 92/50 in *ATI EAC and Others*.

42 In the case that gave rise to that judgment, the award criteria and their weighting factors, together with the sub-criteria of those award criteria had in fact been established beforehand and published in the contract documents. The contracting authority concerned had merely stipulated subsequently, shortly before the opening of the envelopes, the weighting factors to be applied to the sub-criteria.

43 In that judgment, the Court held that Article 36(2) of Directive 92/50 does not preclude proceeding in that way, provided that three very specific conditions apply, namely that the decision to do so:

- does not alter the criteria for the award of the contract set out in the contract documents;

- does not contain elements which, if they had been known at the time the tenders were prepared, could have affected that preparation; and



— was not adopted on the basis of matters likely to give rise to discrimination against one of the tenderers (see, to that effect, *ATI EAC and Others*, paragraph 32).

<sup>44</sup> It must be noted that in the case in the main proceedings, by contrast, the Project Award Committee referred only to the award criteria themselves in the contract notice, and later, after the submission of tenders and the opening of applications expressing interest, stipulated both the weighting factors and the sub-criteria to be applied to those award criteria. Clearly that does not comply with the requirement laid down in Article 36(2) of Directive 92/50 to publicise such criteria, read in the light of the principle of equal treatment of economic operators and the obligation of transparency.

<sup>45</sup> Having regard to the foregoing, the answer to the question referred must therefore be that, read in the light of the principle of equal treatment of economic operators and the ensuing obligation of transparency, Article 36(2) of Directive 92/50 precludes the contracting authority in a tendering procedure from stipulating at a later date the weighting factors and sub-criteria to be applied to the award criteria referred to in the contract documents or contract notice.

## Costs

<sup>46</sup> Since these proceedings are, for the parties to the main proceedings, a step in the action pending before the national court, the decision on costs is a matter for that court. Costs incurred in submitting observations to the Court, other than the costs of those parties, are not recoverable.

On those grounds, the Court (First Chamber) hereby rules:

**Read in the light of the principle of equal treatment of economic operators and the ensuing obligation of transparency, Article 36(2) of Council Directive 92/50/EEC of 18 June 1992 relating to the coordination of procedures for the award of public service contracts, as amended by European Parliament and Council Directive 97/52/EC of 13 October 1997, precludes the contracting authority in a tendering procedure from stipulating at a later date the weighting factors and sub-criteria to be applied to the award criteria referred to in the contract documents or contract notice.**

[Signatures]

## **LEGAL AUTHORITY CA-94**

## Dimensions of Transparency: The Building Blocks for a New Legal Principle?

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### Abstract

*This short article explores a number less well-known aspects of the principle of transparency in so far as it emerges in the relationship between public authorities and individuals. The debate about transparency was, until now, strongly focused on transparency in the sense of openness of government and access to EU documents. The phenomenon is, however, much broader, cutting across various fields and levels of EU. Are we facing a process of a new legal principle coming into being?*

### I Introduction

Ever since the 1990s transparency has gained considerable attention in the EU context. The most familiar and also the most developed dimension of transparency is openness in the decision-making process, and in particular access to documents. There are, indeed, other elements included in transparency, such as the clarity of procedures, clear drafting, the publication and notification of legislation/decisions and the duty to give reasons.

These elements manifest themselves on different levels. On the political – or perhaps constitutional – level they are often linked to the fundamental notions of democracy, legitimacy and accountability. There is, however, the more concrete level of administration and, arguably, transparency also plays a role between private individuals. As examples we could mention the extensive transparency and information obligations in EU financial markets regulation or, in a completely different area, the directive ‘on an employer’s obligation to inform employees of the conditions applicable to the contract or employment relationship.’<sup>1</sup> We are not going to address this dimension as we will confine ourselves to the relationships between public authorities and individuals (which may indeed be undertakings). To this, one may also add another distinction: the EU level and the level of the Member States. As

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\* The present short article is directly based on a more extensive study which is going to be published, in 2008, as a contribution to U. Bernitz, C. Cardner and J. Nergelius (eds.), *General Principles of Community Law in the Process of Development*, Kluwer Law International.

<sup>1</sup> Directive 91/533, OJ 1991 L 288/32.

we will show, EU law-inspired transparency is increasingly relevant on both levels.

The various elements of transparency are relatively open-ended and have to be honed down in the context of the more specific areas of application in order to produce some concrete results. Clarity of legislative texts, for instance, is something which is different from the clarity of an individual decision. Nevertheless, the question should be asked whether these elements do not constitute separate building blocks of an overarching principle of transparency. To some extent one may compare this with the right of defence, a general principle of Community law, which in fact is also 'built up' from a number of sub-principles, such as the right to be informed, the right to be heard, the right not to incriminate oneself, the right to legal assistance and legal privilege.<sup>2</sup>

An interesting phenomenon in this respect is that there is a considerable overlap of the various elements of transparency or the – often loosely used – notion of transparency itself with other principles. In many respects transparency or its elements seem rather to support other general principles of law, instead of having a self-standing meaning. We will illustrate this interplay with a number of examples. On the basis of this brief discussion, we will reflect on the question whether transparency is emerging as a new general principle of EU law.

## 2 Transparency and the Principle of Sound Administration

Transparency in the sense of access to a person's file, which may be considered as an individual manifestation of access to documents in general, is explicitly recognised in Article 41(2) of the Charter of Fundamental Rights as a part of the right to good administration. Although access to a file is often linked to the right of defence, in the Charter it was included under the broader heading of good administration.

The *Natural health* case<sup>3</sup> illustrates another aspect of transparency, namely the need to have clear procedures. At the same time it also provides a fine example of how the principle guides the interpretation of legislation, aiming, *inter alia*, at the avoidance of an outright conflict. This case concerned, as far as is relevant, the legality of a procedure, provided under Directive 2002/46<sup>4</sup>, to be followed when a decision has to be taken as to whether certain vitamins and minerals in food supplements may be placed

<sup>2</sup> Cf. Jans a.o. *Europeanisation of Public Law*, Europa Law Publishing, Groningen 2007, at p. 191-193.

<sup>3</sup> Joined Cases C-154/04 and C-155/04 *Natural Health* [2005] ECR I-6451.

<sup>4</sup> Directive 2002/46 (approximation of the laws of the Member States relating to food supplements), OJ 2002 L 183/51.

on the market, i.e. included in a so-called ‘positive list’. AG Geelhoed was of the opinion that the ‘procedure, in so far as it may exist and in so far as it may deserve this title, has the transparency of a black box: no provision is made for parties to be heard, no time-limits apply in respect of decision-making; nor, indeed, is there any certainty that a final decision will be taken.’<sup>5</sup> In his view, since the Directive lacked appropriate and transparent procedures for its application, it infringed the principle of proportionality and was, therefore, invalid.<sup>6</sup> The ECJ did not agree with this and found that the procedure was indeed legal. However, it did point out that ‘[I]t would, no doubt, have been desirable ... for the directive to have included provisions which in themselves ensured that that stage [*the critical stage of the procedure, including the consultation of the European Food Safety Authority (EFSA) – SP/MdL*] be completed transparently and within a reasonable time.’<sup>7</sup> The lack of such provisions had to be compensated by the Commission. By virtue of the implementing powers conferred on it by Directive 2002/46, it had to adopt, in accordance with the principle of sound administration, the measures necessary to ensure that the consultation stage with the EFSA is carried out transparently and within a reasonable time.

In the area of state aid, it follows from the legislation and the case law that decisions must be taken without delay and must be addressed to the Member States concerned in the interest of transparency and legal certainty.<sup>8</sup> Therefore, a failure to notify the Commission’s decision to the Member State concerned can in certain circumstances justify the annulment of an act of a Community institution.<sup>9</sup> However, in some cases the obligations of the Commission may extend further: according to the CFI, the Commission may be bound in accordance with its duty of ‘sound administration’ or ‘sound administration and transparency’ to inform the complainant of its decisions or its consequences.<sup>10</sup>

### 3 Transparency and the Principle of Legal Certainty

The marriage between legal certainty and transparency entails at least two different aspects. For a part it coincides with the requirements of the clarity and unambiguous nature of legal texts. In this respect,

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<sup>5</sup> Point 85 of the Opinion.

<sup>6</sup> Proportionality played a role in the sense that objectives of the Directive could have been achieved by less restrictive solutions than the approach taken by the Community legislature.

<sup>7</sup> Para. 81 of the judgment.

<sup>8</sup> Preamble 21 to Council Regulation 659/1999 (detailed rules for the application of Article 93 of the EC Treaty), OJ 1999 L 83/I.

<sup>9</sup> Case C-398/00 *Spain v. Commission* [2002] ECR I-5643, para. 33.

<sup>10</sup> See Case T-82/96 *ARAP v. Commission* [1999] ECR II-1889 and Case T-277/94 *AITEC v. Commission* [1996] ECR II-351.

together with the requirement of publication, it strongly supports the cognizability of the law. For another part, in so far as it militates in favour of policy rules and perhaps even their codification in binding acts, at a certain moment it helps to make policy action predictable in the case of broad discretionary powers. Here it serves as one of the safeguards against discretion ending up as arbitrariness.

According to well-established Luxembourg case law, Community legislation must be certain and its application must be foreseeable by individuals. It is here, in particular, that the principle of legal certainty requires every measure of the institutions having legal effects to be clear and precise and brought to the notice of the person concerned. The latter must be able to know the extent of the obligations which it imposes on him/her.<sup>11</sup> Although the required clarity, precision and notification or publication undoubtedly also pertain to transparency, as a rule they are treated as a matter of legal certainty. However, since more recent times, transparency seems to ‘sneak in’ discretely, either in the judgments or at least in the opinions of Advocates General.

In case C-110/03, *Belgium v. Commission*,<sup>12</sup> the Belgian government sought the annulment of (group) Regulation 2204/2002.<sup>13</sup> It argued that the fifth recital in the preamble to Regulation 994/98 (the enabling regulation) requires exemption regulations to increase transparency and legal certainty, but that Regulation 2204/2002 on aid to employment is completely lacking in clarity in terms of both context and content. The AG first noted that the preamble or introductory recitals are not binding, and therefore any failure to take the principle of transparency and legal certainty into account cannot lead to the annulment of the Regulation. However, according to the AG, “both the principle of transparency and legal certainty must be respected by the legislature as sources of Community law, and a failure to do so would, under article 230 EC constitute an infringement, irrespective of whether they are referred to in the preamble to Regulation 994/98”.<sup>14</sup> The AG subsequently analyzed whether the Regulation lacks transparency in the sense of “the quality of being clear, obvious and understandable without doubt or ambiguity”.<sup>15</sup> In the end he was satisfied that there was no breach.

The ECJ did not refer to the principle of transparency as it found that the Belgian argument as to the Regulation’s lack of clarity in reality concerned a breach of the general principle of legal certainty. From the case it can be deduced that the ECJ may, at most, consider transparency only as an element of the principle of legal certainty.

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<sup>11</sup> Cf. *inter alia* T-115/94 *Opel Austria* [1997] ECR II-2739, and long before this case e.g. Case 70/83 *Kloppenburg* [1984] ECR 1075.

<sup>12</sup> [2005] ECR I-2801.

<sup>13</sup> Commission Regulation 2204/2002 (on the application of Articles 87 and 88 of the EC Treaty to State aid for employment), OJ 2002 L 337/3.

<sup>14</sup> Point 36.

<sup>15</sup> Point 44

However, in Case C-149/96<sup>16</sup> the Court took a slightly different position. Portugal argued, in this case, that the principle of transparency had been breached “because the contested decision approves Memoranda of Understanding which [were] not adequately structured and [were] drafted in obscure terms which prevent a normal reader from immediately grasping all their implications, in particular as regards their retroactive application”.<sup>17</sup> The ECJ dismissed this argument, however, not because Portugal could not rely on the principle of transparency, but because it found the decision to be clear in every relevant aspect.

Similarly, in the case law on the proper implementation of directives, which is, as is well known, strongly influenced by the principle of legal certainty, transparency sometimes features as a separate requirement. Thus, for instance, according to Case C-417/99, provisions of directives must be implemented in national law “with precision, clarity and transparency required in order to comply fully with the requirement of legal certainty”.<sup>18</sup> Or the provisions must be “... capable of creating a situation which is sufficiently precise, clear and transparent to enable individuals to ascertain their rights and obligations”.<sup>19</sup> This case law also illustrates how transparency may also permeate the law at the national level.

As to the second aspect, the area of state aid and competition provides some good examples. In this field the Commission attaches – as it has done since the mid-1990s – great importance to the transparency and predictability of its policy. This has resulted in the adoption and publication by the Commission of numerous soft-law instruments such as notices, communications, frameworks, guidelines, and codes, but also legislation on the application of the rules in those sectors by the Commission.

For example, in the field of state aid the Commission has adopted guidelines concerning aid to employment.<sup>20</sup> The guidelines explained that their objective is to clarify the interpretation of Articles 92 and 93 (now articles 87 and 88) of the Treaty with regard to State aid in the field of employment in order to ensure *greater transparency* of notification decisions under Article 93 of the Treaty. In case C-310/99 the ECJ explained that such guidelines, setting out the approach that the Commission proposes to follow, help to ensure that it acts in a manner which is transparent, foreseeable and consistent with legal certainty.<sup>21</sup>

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<sup>16</sup> Case C-149/96 *Portugal v. Council* [1999] ECR I-8395.

<sup>17</sup> Para. 55.

<sup>18</sup> Case C-417/99 *Commission v. Spain* [2001] ECR I-6015, para. 40.

<sup>19</sup> Case C-177/04 *Commission v. France* [2006] ECR I-2461, para 48.

<sup>20</sup> OJ 1995 C 334/4. These guidelines have ceased to exist from the date of the entry into force of Commission Regulation 2204/2002 of 12 December 2002 on the application of articles 87 and 88 of the EC Treaty to state aid to employment, OJ 2002 L 337/3.

<sup>21</sup> Case C-310/99 *Italian Republic v. Commission* [2002] ECR I-2289.



Another illustration is the guidelines on the method of setting fines imposed pursuant to article 15(2) of Regulation 17/62 and article 65(5) ECSC in competition cases.<sup>22</sup> For many years the Commission has been criticised for the opaque manner in which it calculated fines in competition cases.<sup>23</sup> Before the adoption of the guidelines, undertakings were required to commence court proceedings to know the method for calculating fines imposed upon them. However, this lack of transparency did not, in the opinion of the ECJ, amount to a violation of the obligation to provide reasoned decisions.<sup>24</sup> It follows from the preamble to the guidelines that they were adopted with a view to ensuring the *transparency and impartiality* of the Commission's decisions in that area (recital 1). According to the ECJ, the guidelines also ensure legal certainty on the part of the undertakings themselves.<sup>25</sup> By making the criteria for the setting of fines public, the Commission shall impose similar fines on undertakings which violate competition rules in similar circumstances.

In other – more general – terms, by clearly setting out in what way the Commission shall exercise its discretionary powers, it makes this exercise visible, clear and understandable, i.e. transparent. In this way, it becomes possible to foresee the behaviour of the institution and to achieve legal certainty. The fact that many rules regarding the Commission's discretionary exercise of powers in the area of state aid and competition are laid down in soft-law instruments, such as guidelines, does not mean that the Commission can deviate there from whenever it pleases. The Court has ruled that the Commission, by adopting and publishing rules of conduct designed to produce external effects, has imposed a limit on the exercise of its discretion and cannot depart from those rules under pain of being found, where appropriate, to be in breach of the general principles of law, such as equal treatment or the protection of legitimate expectations.<sup>26</sup> By setting out in detail the procedural rules, it is prevented that the Commission acts in a

<sup>22</sup> OJ 1998 C 9/3. The guidelines have now been replaced by new ones adopted pursuant Regulation 1/2003. Guidelines on the method of setting fines imposed pursuant to Article 23(2)(a) of Regulation No. 1/2003, OJ 2006 C 210/3.

<sup>23</sup> See in particular Case T-148/89 *Tréfilunion v. Commission* [1995] ECR II-1063.

<sup>24</sup> See C-248/98 P *NV Koninklijke KNP BT v. Commission* [2000] ECR I-9641.

<sup>25</sup> See, for example, Case C-167/04 P *JCB Service v. Commission* [2006] ECR I-8935. The link between transparency, foreseeability and legal certainty has also been made by the ECJ in respect of the guidelines published by the Commission setting out the amount of lump-sum or penalty payments which it intends to propose to the Court that they should be calculated in the light of Article 228(2) EC. See C-177/04 *Commission v. French Republic* [2006] ECR I-2461.

<sup>26</sup> See Joined cases C-189/02 P, C-202/02 P, C-205/02 P to C-208/02 P and C-213/02 P *Dansk Rørindustri A/S and Others v. Commission* [2005] ECR I-5425, par. 211. This case concerned the Guidelines on setting fines.

partial and non-objective manner. Therefore, we submit that transparency here functions as a mechanism to prevent arbitrary behaviour on the part of the institution in question.

#### 4 Transparency and the Principle of Equal Treatment

Most clearly elaborated seems to be the relationship between transparency and non-discrimination, in particular where it aims to safeguard objectivity and non-discrimination in public procurement<sup>27</sup> and comparable – in particular public concessions – procedures.

The first contours of transparency in public procurement can be found in the judgment in Case C-87/94 *Commission v. Belgium*, in which the Court held, on the basis of the text of Directive 90/531, that the procedure for comparing tenderers had to comply at every stage with both the principle of the equal treatment of tenderers and the principle of transparency. The relationship between equality of treatment and transparency was elaborated in more detail in a number of cases, first in public procurement cases – on the national<sup>28</sup> and EU level<sup>29</sup> – but soon also in relation to concessions, which are outside the scope of the public procurement directives<sup>30</sup> or in cases which are below the thresholds of the procurement directives.<sup>31</sup> This ‘spillover’ from procurement to concessions was possible precisely because the link established between equal treatment or non-discrimination and transparency. As the ECJ pointed out, the principle of equal treatment underlies both the EC public procurement rules and the free movement rules of the internal market which govern, *inter alia*, the award of concessions.<sup>32</sup>

The relationship between equal treatment and transparency is not entirely clear. In some cases the principle of equal treatment and non-

<sup>27</sup> I.e. the four procurement directives are Directive 93/36 (supplies), OJ 1993 L 199/1, Directive 93/37 (works), OJ 1993 L 199/54, Directive 92/50 (services), OJ 1992 L 209/1 and Directive 93/38 (utility sectors), OJ 1993 L 199/84. These have been recently replaced by Directive 2004/18 (procedures for the award of public works contracts, public supply contracts and public service contracts), OJ 2004 L 134/114 and Directive 2004/17 (procurement procedures of entities operating in the water, energy, transport and postal services sectors), OJ 2004 L 134/1.

<sup>28</sup> See, for instance, Case C-275/98 *Unitron* [1999] ECR I-8291 and Case C-470/99 *Universale Bau* [2002] ECR I-11617.

<sup>29</sup> Cf. Joined Cases T-191/96 and T-106/97 *Succhi de frutta* [1999] ECR II-3181 and Case T-183/00 *Strabag Benelux NV* [2003] ECR II-135.

<sup>30</sup> Cf. Case C-324/98 *Telaustria* [2000] ECR I-10745 and Case C-231/03 *Coname* [2005] ECR I-7287.

<sup>31</sup> Case C-6/05 *Medipac*, judgment of 14 June 2007, nyr. in ECR.

<sup>32</sup> Cf. for instance Case C-470/99 *Universale-Bau* [2002] ECR I-11617, Case C-231/03 *Coname* [2005] ECR I-7287 and Case C-458/03 *Parking Brixen* [2005] ECR I-8612.

discrimination is said to imply an obligation of transparency.<sup>33</sup> The judgment in *Coname* clarifies that non-compliance with transparency requirements amounts to a violation of the rule against discrimination.<sup>34</sup> In *Succhi di Frutta* the principle of transparency is referred to as the ‘corollary’ of the principle of equal treatment between tenderers.<sup>35</sup> However, there are also cases which may suggest that transparency and equal treatment are to be considered as two separate principles which exist alongside each other.<sup>36</sup> In any case, while, on the one hand, there is a very close link between the principle of equal treatment and transparency, on the other transparency also has, in certain respects, a more specific meaning of its own. It requires, *inter alia*, the clear and unambiguous drafting of the conditions for and the rules on the award procedure. The selection and award criteria must be formulated in such a way as to allow all reasonably well-informed and normally diligent tenderers to interpret them in the same way.<sup>37</sup> The adjudicating authority must interpret the selection and award criteria in the same way throughout the entire procedure and must apply them objectively and uniformly to all tenderers.<sup>38</sup> The substantive and procedural conditions concerning participation in a contract, including criteria for selecting candidates and those for awarding the contract must be clearly defined in advance and made known to the persons concerned.<sup>39</sup> In principle, no new criteria or specifications may subsequently be taken into account.<sup>40</sup> There should be at least a certain degree of publicity or advertising in order to enable the market in question to be opened up to competition.<sup>41</sup>

<sup>33</sup> Cf. for instance Case C-19/00 *SIAC* [2001] ECR I-7725 and Case C-410/04 *ANAV* [2006] ECR I-3303.

<sup>34</sup> Case C-231/03 *Coname* [2005] ECR I-7287.

<sup>35</sup> Case C-496/99 *P Succhi di frutta* [2004] ECR I-3801; or principle transparency flows from principle of equal treatment: cf. C-340/02 *Commission v. France* [2004] ECR I-9845.

<sup>36</sup> For instance Case C-458/03 *Parking Brixen* [2005] ECR I-8612, para. 50 or Case C-448/01 *Wienstrom* [2003] ECR I-14527, para. 58.

<sup>37</sup> Case C-19/00 *SIAC* [2001] ECR I-7725 and Case C-448/01 *Wienstrom* [2003] ECR I-14527.

<sup>38</sup> Cf. Case C-19/00 *SIAC* [2001] ECR I-7725 and Case C-448/01 *Wienstrom* [2003] ECR I-14527. Case C-6/05 *Medipac*, judgment of 14 June 2007, nyr. in ECR goes in the same direction.

<sup>39</sup> For instance Case C-470/99 *Universale-Bau* [2002] ECR I-1617 and Joined Cases C-226/04 and C-228/04 *La Cascina* [2006] ECR I-1347.

<sup>40</sup> Cf. Case C-6/05 *Medipac*, judgment of 14 June 2007, nyr. in ECR (unless, for instance, the health and safety of patients is at stake, as was arguably the case in *Medipac*. Then, however, the appropriate procedures, where present, have to be followed).

<sup>41</sup> A question under discussion for some time now is how to flesh out the ‘sufficient degree of publicity’ since it can hardly be the purpose of this case law to oblige all contract awards to be publicly announced. For a discussion of this question see, for instance, the Opinion of AG Sharpston, of 18 January 2007, in Case C-195/04 *Commission v. Finland* and the Opinion of AG Stix-Hackl, of 14 September 2006, in case C-532/03 *Commission v. Ireland*. Cf. also the

The principle of equal treatment is said to imply an obligation of transparency for mainly two reasons. The first is the *creation* of equality of opportunity, thus to place all potential bidders on an equal footing. According to the ECJ transparency affords all interested parties equality of opportunity in formulating the terms of the applications for and participation in the tenders. The absence of any transparency may amount to indirect discrimination on the ground of nationality which is prohibited by the Treaty, in particular under Articles 43 and 39.<sup>42</sup>

The second reason is to facilitate the control of compliance with the principle of equal treatment. The ECJ stresses in its case law that transparency enables the contracting or concession-granting authorities to ensure that the principles of equal treatment and non-discrimination are complied with,<sup>43</sup> and the impartiality of procurement procedures are to be reviewed.<sup>44</sup> In other terms, as we understand it, such control must be possible *during* the award procedure and *ex post*. Without transparency, it is not very feasible for both the tenderers and the authorities to verify whether the principle of equal treatment has been complied with.<sup>45</sup>

The fact that transparency must make it possible to review whether the principle of non-discrimination has been observed illustrates, in our view, that transparency precedes non-discrimination and in this sense it can be separated from equal treatment. Another indication to consider transparency as a principle independent from equality and non-discrimination is that it is also 'intended to preclude any risk of favouritism or arbitrariness on the part of the contracting authority.'<sup>46</sup> In brief, in some respects transparency seems to extend beyond what non-discrimination requires. The – partly – independent nature of transparency also seems to be underlined in recent public procurement legislation. In two directives from 2004, transparency

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Commission's Interpretative [*and not entirely unambiguous- SP/MdL*] Communication on the Community law applicable to contract awards not or not fully subject to the provisions of the Public Procurement Directives, OJ 2006 C 179/2.

<sup>42</sup> Case C-231/03 *Coname* [2005] ECR I-7287, para. 17 and 18.

<sup>43</sup> Case C-458/03 *Parking Brixen* [2005] ECR I-8612, para. 49 and Case C-324/98 *Telaustria* [2000] ECR I-10745, para. 61.

<sup>44</sup> Case C-458/03 *Parking Brixen* [2005] ECR I-8612, para. 49 and Case C-324/98 *Telaustria* [2000] ECR I-10745, para. 62.

<sup>45</sup> Some cases may suggest that what is at stake is mainly control by the authorities. However, also tenderers have some interest in control. Indeed, such a broader interpretation seems to be the correct one. Cf. Case C-26/03 *Stadt Halle* [2005] ECR I-I, para. 39: "The obligation of transparency, to which the contracting authority is subject in order to make it possible to verify that the Community rules have been complied with (*HI*, paragraph 45), should be noted in this respect."

<sup>46</sup> Case C-496/99 P *Succhi di frutta* [2004] ECR I-3801, para. 111 and Case C-6/05 *Medipack*, judgment of 14 June 2007, nyr. in ECR, para. 53.

has been codified alongside the requirements of equal treatment and non-discrimination.<sup>47</sup>

An interesting aspect of the close link between transparency and the principles of equal treatment and non-discrimination is the potential to spread out to other areas of the law, beyond public procurement and concession contracts. Since equality of treatment and non-discrimination underpin the fundamental Treaty freedoms, it is not difficult to imagine that equal treatment may serve as a vehicle for extending the scope of transparency requirements. After all, the transparency requirements apply to concessions exactly because these are governed by the Treaty provisions on the free movement of services and establishment. The effects may and do, however, reach further, in particular where other aspects of market access are at issue.

In EU legislation, the coupling of transparency and non-discrimination can be found, for instance, in directives concerning liberalization of network sectors, such as Article 7(3) of Directive 2002/20 (authorisation of electronic communications networks and services),<sup>48</sup> Article 6 of Directive 2003/54 (common rules for the internal market in electricity),<sup>49</sup> Articles 9 and 11 of Directive 2002/21 (common regulatory framework for electronic communications networks and services – the Framework Directive)<sup>50</sup> or Article 9 Directive 97/67 (internal market for Community postal services).<sup>51</sup>

Another example of the codification of transparency in relation to market access in a more general fashion can be found in the Services Directive.<sup>52</sup> In so far as this Directive allows for authorisation schemes, justified by overriding reasons relating to public interest (Article 9), the latter must ‘be based on criteria which preclude the competent authorities from exercising their power of assessment in an arbitrary manner.’ (Article 10) According to Section 2 of Article 10, these criteria shall, *inter alia*, be ‘(a) non-discriminatory; ... (d) clear and unambiguous; ... (f) made public in advance; (g) transparent and accessible.’<sup>53</sup> Interesting in the Service Directive is also Article 12, which deals with a limited number of authorisations being available due to the scarcity of natural resources or technical capacity. The Member States are bound to apply a selection procedure to potential candidates which

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<sup>47</sup> Directive 2004/18 (procedures for the award of public works contracts, public supply contracts and public service contracts), OJ 2004 L 134/114, Article 2 and Directive 2004/17 (procurement procedures of entities operating in the water, energy, transport and postal services sectors), OJ 2004 L 134/1, Article 10.

<sup>48</sup> OJ 2002 L 108/21.

<sup>49</sup> OJ 2003 L 176/37.

<sup>50</sup> OJ 2002 L 108/33.

<sup>51</sup> OJ 1998 L 15/14.

<sup>52</sup> Directive 2006/123 (services in the internal market), OJ 2006 L 376/36.

<sup>53</sup> Indeed, one may here wonder what meaning is left for transparency itself where it features alongside the requirements of clarity and unambiguity, accessibility and being made public in advance.

‘provides full guarantees of impartiality and transparency, including, in particular, adequate publicity about the launch, conduct and completion of the procedure.’ Article 13(1) provides that authorization procedures and formalities shall be ‘clear, made public in advance and be such as to provide the applicants with a guarantee that their application will be dealt with objectively and impartially.’

## 5 Some Conclusions

Until now, only transparency in the sense of ‘access to documents’ has been generally considered as a serious nominee for being accepted as a general principle of Community law.<sup>54</sup> However, our brief exploration illustrates that transparency as a legal principle ‘in gestation’ may cover a much broader area of the law. In many respects it may be too early to recognize transparency as a self-standing principle of law. The various elements need to be crystallized in more detail and have to gain – partly in that same process – more autonomy.

To an extent it is possible to identify a number of recurring core elements of transparency, despite the different ‘colouring in’ depending on the context: clear language, physical access to information and, closely linked to that, publication or notification, the predictability of public authorities’ actions/behaviour, and consistency in the interpretation and application of the law. This may sometimes require the drafting of policy rules which curtail the use of the discretionary powers of the authority concerned. However, the very concrete meaning of the various elements are still very much in a process of taking shape, either in case law or in legislation. The still uncertain content of transparency may also explain why transparency is often linked to other well-established principles of law. The coupling of transparency with another principle also depends on the area or context in which transparency is invoked.

The moulding process which is discretely going on is particularly confusing in the sense that transparency emerges on so many levels. Sometimes it appears next to other legal principles or, occasionally, instead of an established principle. In other situations it is presented as an element of a principle of law, for instance, alongside clarity and precision when legal certainty is at stake. Yet, in other cases any reference to transparency is lacking. Again in other cases it is suggested that transparency includes clarity and precision.

In any case, transparency seems to overlap – partially or completely – with certain elements in other legal principles. How must we assess this? In part, transparency here builds upon existing legal values, such as legal

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<sup>54</sup> P. Craig and G. de Búrca, *EU Law: Text, Cases and Materials*, Fourth Edition, Oxford University Press, Oxford 2007, p. 567, referring to K. Lenaerts.

certainty and equality of treatment. At the same time it further elaborates these values. However, as it also leads to a new amalgamation of these elements, it provides a new – integrated – perspective and, potentially, new dynamics.

## **LEGAL AUTHORITY CA-95**



INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES  
WASHINGTON, D.C.

BOSH INTERNATIONAL, INC  
AND  
B & P LTD FOREIGN INVESTMENTS ENTERPRISE

*Claimants*

- AND -

UKRAINE

*Respondent*

ICSID Case No ARB/08/11

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AWARD

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*Members of the Tribunal*

**Dr Gavan Griffith QC, *President***

**Professor Philippe Sands QC, *Arbitrator***

**Professor Donald McRae, *Arbitrator***

*Secretary to the Tribunal*

**Ms Mercedes Cordido-Freytes de Kurowski**

*Legal Assistant to the Tribunal*

**Dr Chester Brown**

**Date of dispatch to the Parties: October 25, 2012**

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## **I. THE PARTIES**

1. The Claimants are Bosh International, Inc ('Bosh') and B&P Ltd Foreign Investments Enterprise ('B&P'). The first Claimant, Bosh, was incorporated under the laws of New Jersey, United States of America on 29 December 1992, and its registered address is 300 Glen Road, Woodcliff Lake, New Jersey. The second Claimant, B&P, was incorporated under the laws of Ukraine in May 1993. Bosh claims to hold a 94.5% shareholding in B&P.<sup>1</sup> The founder and owner of Bosh is Mr Leonis Shapsis, who owns 100% of the shares in Bosh. Mr Shapsis became a permanent resident of the United States in 1989 and acquired United States citizenship in 1995.<sup>2</sup>
2. The Claimants were originally represented by Mr Ari Gal Esq, of Law Offices of Ari Gal, 228 East 45<sup>th</sup> St, New York, New York 10017, United States of America; and Mr Richard Sillett, of William Z Schneider & Associates, PC, 1400 Avenue Z, Suite 402, Brooklyn, New York 11235, United States of America.
3. By letter dated 10 March 2011, the Claimants informed the Tribunal that Ari Gal and William Z Schneider & Associates had terminated their representation of the Claimants.
4. By letter dated 1 April 2011, the Claimants informed the Tribunal that they had retained Dr Todd Weiler, of #19 – 2014 Valleyrun Blvd, London, Ontario N6G 5N8, Canada, as well as Ms Martha Harrison, of Heenan Blaikie LLP, Bay Adelaide Centre, PO Box 2900, 333 Bay Street, Suite 2900, Toronto, Ontario M5H 2T4, Canada, to represent them in the arbitration.
5. The Respondent is Ukraine. At the First Session, the Respondent was represented by Ms Larysa Lischynska, Acting Head of Department, Department on Representation of Interests of the State in Courts of Ukraine and in Foreign Judicial Institutions, Ministry of Justice, 13, Horodetsкого Street, 01001 Kyiv, Ukraine. The Respondent's legal representatives are Mr John Willems, Mr Michael Polkinghorne, Ms Marily Paralika, and Ms Angélica André, of White & Case LLP, 11, boulevard de la Madeleine, 75001 Paris,

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<sup>1</sup> Claimants' Memorial, pp. 1-2.

<sup>2</sup> Claimants' Memorial, pp. 1-2.

France; and Mr Markiyan Kliuchkovskiy, Mr Serhii Sviriba, and Ms Olena Koltko, of Magisters (subsequently known as Egorov Puginsky Afanasiev & Partners), 38 Volodymyrska St, 01034 Kiev, Ukraine.

## **II. PROCEDURAL HISTORY**

6. By letter dated 3 December 2007, the Claimants submitted a Request for Arbitration to the International Centre for Settlement of Investment Disputes ('ICSID'), in which it claimed that ICSID had jurisdiction under the Treaty between the United States of America and Ukraine concerning the Encouragement and Reciprocal Protection of Investment, which was signed on 4 March 1994 and entered into force on 16 November 1996 ('the BIT'). By letter dated 15 February 2008, the Claimants submitted an Amended Request for Arbitration to ICSID.
7. On 22 August 2008, the Acting Secretary-General of ICSID registered the Claimants' Request for Arbitration.
8. The Parties then proceeded to constitute the Tribunal. By letter dated 15 September 2008, the Claimants informed ICSID that they had appointed Mr Jan Paulsson, of Swedish and French nationality, as arbitrator in this case. By letter dated 3 December 2008, ICSID confirmed that, in the absence of any agreement of the Parties, the procedure for constituting the Tribunal would be that set forth in Article 37(2)(b) of the ICSID Convention. ICSID then sought the acceptance by Mr Paulsson of his appointment.
9. By letter dated 4 December 2008, ICSID informed the Parties that the Respondent had appointed Professor Donald McRae, of Canadian and New Zealand nationality, as its arbitrator in this case. ICSID also informed the Parties that, in accordance with ICSID Arbitration Rule 5(2), it would proceed to seek Professor McRae's acceptance of his appointment. By letter dated 13 December 2008, ICSID informed the Parties that Professor McRae had accepted his appointment as arbitrator.
10. By letter dated 11 December 2008, ICSID reported that Mr Paulsson had failed to accept his appointment as arbitrator in this case.

11. By letter dated 2 February 2009, the Claimants informed ICSID of their appointment of Mr Gary Born, of US nationality, as their party-appointed arbitrator. By letter dated 3 February 2009, ICSID recalled that, in accordance with ICSID Arbitration Rule 1(3), where the Tribunal is to consist of three members (as is the case here), a national of either the Contracting State party to the dispute (i.e., Ukraine), or the Contracting State whose national is a party to the dispute (i.e., the United States) may not be appointed as arbitrator by a party without the agreement of the other party to the dispute. ICSID informed the parties that, as it understood that Mr Gary Born was a US national, his appointment could not be effective without the agreement of the parties to the dispute, and it invited the Parties to comment by 9 February 2009.
12. By letter dated 6 February 2009, the Respondent indicated that it did not agree to Mr Born's appointment. By letter dated 6 February 2009, ICSID invited the Claimants to appoint a new individual to serve as arbitrator in this case.
13. By letter dated 10 February 2009, the Claimants informed ICSID that they had appointed Professor Philippe Sands QC, of British and French nationality, as their party-appointed arbitrator. By letter dated 11 February 2009, ICSID informed the Parties that it was proceeding to seek Professor Sands' acceptance of his appointment. By letter dated 12 February 2009, ICSID informed the Parties that Professor Sands QC had accepted his appointment.
14. By letter dated 26 March 2009, the Respondent informed ICSID that the Parties had reached agreement on a process for appointing the President of the Tribunal. By letter dated 27 March 2009, ICSID asked the Claimants to confirm this agreement.
15. By letter dated 8 April 2009, the Claimants confirmed that the Parties had agreed to appoint Dr Gavan Griffith QC as President of the Tribunal. By letter also dated 8 April 2009, the Respondent confirmed that the party-appointed arbitrators had confirmed that Dr Griffith QC had accepted his appointment as President of the Tribunal. By letter also dated 8 April 2009, ICSID informed the Parties that it would proceed to seek the acceptance by Dr Griffith QC of his appointment.

16. By letter dated 22 April 2009, the Acting Secretary-General of ICSID, Mr Nassib Ziadé, informed the Parties that all of the arbitrators appointed in the case had accepted their appointments and that, in accordance with ICSID Arbitration Rule 6(1), the Tribunal was deemed to have been constituted and the proceeding to have begun on 22 April 2009. Mr Ziadé also informed the Parties that Dr Sergio Puig would serve as the Secretary of the Tribunal.
17. On 29 July 2009, the Tribunal held its First Session at the seat of ICSID in Washington DC. Among other things, it was agreed that the proceeding would be conducted in accordance with the ICSID Arbitration Rules of 2006 and that any issue of quantum be bifurcated from the proceeding on jurisdiction and liability. The Tribunal fixed an alternative timetable in case the Tribunal decided also to bifurcate the merits (liability) from jurisdiction.
18. On 1 December 2009, in accordance with the directions of the Tribunal made at the First Session, as amended by agreement of the Parties, the Claimants filed their Memorial on Jurisdiction and the Merits. Together with their Memorial, the Claimants filed witness statements of Mr Leonid Shapsis, the founder and President of Bosh; Mr Borys Boguslavskyy, the Chief Executive Officer of Bosh Gesellschaft für Wissenstransfer mbH, and President of B&P; Ms Iryna Gulida, the Chief Financial Officer and Vice-President of B&P; Ms Olga Romanchuk, the Chief Accounting Officer of B&P (1993-2006), and subsequently the Chief Executive Officer of B&P (from 2006 onwards); Ms Natalia Gulida, the Manager of the Science-Hotel Complex (2004-2006), and subsequently the Chief Administrator of the Science Hotel Complex (2006-2009); Ms Alina Popova, a senior administrator at the Science-Hotel Complex; and Mr Anatoliy Kaganovich, the former Chief Executive Officer of B&P (1998-2006), who then assumed the position of technical supervisor of B&P.
19. On 18 December 2009, in accordance with the timetable fixed at the First Session (as amended), the Respondent informed the Tribunal that it did not intend to request bifurcation of the proceeding on jurisdiction from the merits, but that it would raise jurisdictional objections in its Counter-Memorial.

20. On 29 April 2010, the Respondent filed its Counter-Memorial. Together with its Counter-Memorial, the Respondent also filed witness statements by Ms Larysa Komarova, the former Deputy Rector of Taras Shevchenko University for Administrative and Commercial Matters; Professor Leonid Huberskyi, the current Rector of Taras Shevchenko University; Mr Vitaliy Kyrylenko, the former Deputy Head of the Education Control Division of the General Control and Revision Office ('CRO') of Ukraine; and an expert report of Professor Volodymyr Luts, Professor of Civil Law at the National Academy of Municipal Management, and Academician of the National Academy of Sciences in Ukraine.
  
21. On 3 August 2010, the Claimants filed their Reply. Together with their Reply, the Claimants filed witness statements by Ms Ljudmyla Atamanchuk, Mr Mychailo Dmytrovych Krekin, and Ms Iryna Synkevych, all of whom were B&P's Ukrainian counsel; as well as witness statements by Ms Ludmila Sokolova, the Chief Architect of the Joint Venture 'MIC Ukraine'; Ms Olga Romanchuk; Ms Iryna Valkova, administrator and member of staff at the Science-Hotel Complex; Ms Svitlana Nikolaeva, former Chief Accountant of B&P; Ms Nataly Gulak, a member of staff at the Science-Hotel Complex; and an expert report of Professor Tai-Heng Cheng, Associate Professor at New York Law School.
  
22. By letter dated 4 August 2010, with the agreement of the Parties, the Tribunal appointed Dr Chester Brown as the Legal Assistant to the Tribunal.
  
23. By letter dated 19 November 2010, ICSID informed the Parties that due to a redistribution in the workload of ICSID, Ms Mercedes Cordido-Freytes de Kurowski was assigned to serve as Secretary of the Tribunal.
  
24. On 15 December 2010, the Respondent filed its Rejoinder. Together with its Rejoinder, the Respondent filed witness statements by Mr Vitaliy Kyrylenko; Ms Irina Salenko, Head of the Division on Support of Legal and Personnel Management, Taras Shevchenko University; and Ms Valentyna Nekrasova, Chief Accountant of Taras Shevchenko University.



25. A substantive hearing was held from 7 – 9 December 2011 at the seat of ICSID, 1818 H Street NW, Washington DC, 20433, United States of America. In attendance at the hearing were, on behalf of the Tribunal: Dr Gavan Griffith QC (President), Professor Philippe Sands QC, and Professor Donald McRae, as well as Ms Mercedes Cordido-Freytes de Kurowski (Tribunal Secretary), and Dr Chester Brown (Legal Assistant to the Tribunal); also present were Mr David Kasdan (Court Reporter), and Mr Yuri Somov, Ms Julia Karpeisky, and Mr Nikoli Sorokin (Interpreters).
26. In attendance on behalf of the Claimants were Dr Todd Weiler (London, Ontario), Mr Michael Woods, Ms Martha Harrison, and Ms Sabrina Bandali (Heenan Blaikie LLP, Toronto and Ottawa), and Mr Bevan Gray and Ms Heather Gray (Students-at-Law); as well as Mr Leonid Shapsis, Mr Boris Boguslavskyy, Ms Olga Romanchuk, Mr Anatolii Kaganovych, Ms Ljudmila Atamanchuk, and Ms Irina Gulida (representatives of the Claimants, and witnesses).
27. Representing the Respondent at the hearing were Mr John Willems, Ms Marily Paralika, and Ms Noor Davies (White & Case LLP, Paris); Mr Markiyany Kliuchkovskyy and Ms Krystyna Khripkova (Magisters, subsequently known as Egorov Puginsky Afanasiev & Partners, Kiev); Mr Denys Demchenko (Ministry of Foreign Affairs of Ukraine); Mr Oleksandr Bilous and Mr Herman Haluschenko (Ministry of Justice of Ukraine); Mr Vitaliy Kyrylenko (CRO) and Mr Valentyna Nekrasova (Taras Shevchenko National University of Kiev) (both witnesses).
28. On 20 April 2012, the Parties filed Post-Hearing Briefs. By letter dated 3 May 2012, the Respondent submitted certain comments on the Claimants' Post-Hearing Brief. By letter dated 4 May 2012, the Tribunal invited the Claimants to submit any response to the Respondent's letter, and also informed the Parties that it did not otherwise require any further submissions or comments. By letter dated 4 May 2012, the Claimants submitted their response to the Respondent's letter.
29. By letter dated 11 May 2012, the Respondent objected to the Claimants' reliance on certain additional legal authorities in their Post-Hearing Brief, arguing that such was inconsistent with the Parties' agreement as expressed in a joint letter to the Tribunal dated 25 August 2011. The Respondent accordingly requested that the Tribunal: (i) direct the

Claimants to indicate which of the legal authorities cited in their Post-Hearing Brief were new, and thereafter strike these new authorities from the record; or (ii) in the alternative, strike all of the legal authorities submitted with the Claimants' Post-Hearing Brief. By letter dated 11 May 2012, the Claimants provided their comments on the Respondent's application. By further letter dated 18 May 2012, the Respondent reiterated its request to the Tribunal.

30. With respect to the Respondent's application, the Tribunal agrees that any new authorities submitted by the Claimants for the first time with their Post-Hearing Brief were submitted late. However, the Tribunal does not consider that this affects its ability in this Award to take judicial notice of, refer to, or rely on, any relevant legal principles or judicial or arbitral decisions in accordance with the principle of *jura novit curia*.<sup>3</sup> The Tribunal also observes that, in any event, the disposition of the Respondent's application has been immaterial to the outcome.

31. On 21 May 2012, the Parties filed their Submissions on Costs.

32. The Tribunal conducted its deliberations in the form of in-person meetings in Washington DC on 9 December 2011 and in London on 28 April 2012, as well as by electronic communication.

### **III. FACTS OF THE DISPUTE**

#### **A. Introduction**

33. This dispute concerns an allegation by the Claimants, Bosh and B&P, that they made an investment in Kiev, the capital city of Ukraine, which consisted of a contract which B&P entered into on 29 January 2003 with the Taras Shevchenko National University of Kiev ('the University') to undertake a two-stage renovation and redevelopment of a property at the address 3 Chervonozorianyi Avenue. This project was to result in the creation of 'a

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<sup>3</sup> See also *RSM Production Corporation v Grenada* (ICSID Case No ARB/05/14), Decision on RSM Production Corporation's Application for a Preliminary Ruling of 7 December 2009, para. 23; see also Bin Cheng, *General Principles of Law as Applied by International Courts and Tribunals* (first published 1953, 1987 ed), p. 299.

facility comprising a hotel, a research training centre with conference and meeting rooms, dining facility, a garden and sporting facility’ which would be designed ‘to accommodate academic symposia, seminars and conferences’ (which is referred to as ‘the Project’, ‘the Science-Hotel Complex’, and the ‘Joint Activity’).<sup>4</sup> The Claimants further allege that, through conduct of the CRO, the Ukrainian courts, the Ministry of Justice, and the University – all of whose acts and omissions are attributable to Ukraine – the contract between B&P and the University was terminated, and B&P was subsequently evicted from the Science-Hotel Complex. The Claimants submit that the Respondent has, through the conduct of these entities, breached its obligations under the BIT, and that this has caused the Claimants to suffer loss.

## **B. Establishment of Bosh and B&P in Ukraine**

34. The owner of Bosh, Mr Shapsis, had first established Bosh in 1992 in order to operate a construction firm in Ukraine in order to take advantage of the opportunities that Ukraine’s newly achieved independence from the Soviet Union would provide for business.<sup>5</sup> Mr Shapsis had a background in construction and engineering, having graduated from the Poltava Engineer Construction Institution in Kiev.<sup>6</sup> Mr Shapsis also enlisted the collaboration of Mr Borys Boguslavskyy, who was living in Ukraine and who became the President of B&P.<sup>7</sup>

35. The University was founded in 1833, and was named the ‘Taras Shevchenko National University of Kiev’ in 1929, after a well-known Ukrainian poet and political activist.<sup>8</sup> It is a ‘multidisciplinary education and scientific complex’ and consists of ‘15 faculties and six institutes’, and employs around 2,000 academic staff.<sup>9</sup>

36. B&P had first become involved with the property at 3 Chervonozorianyi Avenue in 1996, when the University had engaged B&P to perform some repairs on the building.<sup>10</sup> After

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<sup>4</sup> Claimants’ Memorial, p. 4.

<sup>5</sup> Shapsis WS, p. 1.

<sup>6</sup> Claimants’ Memorial, p. 2.

<sup>7</sup> Shapsis WS, p. 1; Boguslavskyy WS, pp. 3-4.

<sup>8</sup> Respondent’s Counter-Memorial, para. 23.

<sup>9</sup> *Id.*

<sup>10</sup> Claimants’ Memorial, pp. 3, 5. The Claimants state that: ‘On April 26, 1996, the University and B&P entered into an agreement ... about common activity (relating to the building of a hostel for students without any change of status.’

the completion of this repair work, the City of Kiev decided to upgrade and renovate a city square close to the property at 3 Chervonozorianyi Avenue, and in the context of those works, the City of Kiev and the University discussed the future of the property.<sup>11</sup> At the time, a large part of the property was in a state of disrepair, and was partially occupied by squatters.<sup>12</sup> It was designated as for use as a dormitory for students at the University, but it was used for other purposes due to its inconvenient location for the University.<sup>13</sup> It was decided that a facility should be developed comprising a hotel, research training centre with conference and meeting rooms, dining facility, a garden and sporting facility which would be capable of holding academic symposia, seminars and conferences.<sup>14</sup>

37. The University contacted B&P to enquire as to its interest in undertaking the redevelopment project. The University recognised that it did not have the funds to finance the redevelopment, and that B&P would have to contribute capital and other resources to carry out the redevelopment project, and that in return, B&P would own a 50% share of the project for 25 years.<sup>15</sup>

38. B&P and the University then entered into negotiations, and in the course of these negotiations, B&P had many meetings with the Rector of the University, Mr V Skopenko, and other University officials. The Claimants state that they had to ‘comply with a multitude of legal and bureaucratic requirements to get the Project off the ground’,<sup>16</sup> such as the approval for the project of the Zalaiznichny District State Administration, the zoning of the property, the approval for the project of the Kiev State Administration, and the approval by the University of the design for the Science-Hotel Complex.<sup>17</sup> During the contractual planning process, the net present value of the project was estimated to be between USD 9 – USD 11 million.<sup>18</sup>

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<sup>11</sup> Claimants’ Memorial, p. 4.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> Claimants’ Memorial, pp. 4-5.

<sup>16</sup> Claimants’ Memorial, p. 5.

<sup>17</sup> Claimants’ Memorial, pp. 5-7.

<sup>18</sup> Claimants’ Memorial, p. 8.

### C. The 2003 Contract

39. On 29 January 2003, the University and B&P entered into ‘Contract 07-03-02’ for the redevelopment of the property (‘the 2003 Contract’). The subject of the 2003 Contract was the creation of the joint venture between B&P and the University to redevelop and operate the Science-Hotel Complex. The joint venture was to be an unincorporated joint venture, or a ‘joint activity without the creation of a legal entity partnership’, as it is known in Ukrainian law.<sup>19</sup>

40. In Article 2(1) of the 2003 Contract, the parties agreed the following:

‘The Parties to this Contract shall act jointly for the purpose of creation and operation of a research and hotel complex at 3 Chervonozorianyi Avenue, Kiev, hereinafter referred to as “the Object”. Taking into account the statute tasks of the University and the Company [B&P], the Parties for the purpose of creation and operation of the Object shall be engage [*sic*] in the following activities in accordance with the civil acts of Ukraine:

- Scientific activities;
- Educational activities;
- Organisation of conferences, presentations, meetings, competitions, television space bridges, internet space bridges, etc;
- Information services;
- Cultural and educational events;
- Hotel business with elements of customer services;
- Catering;
- Tourism;
- Sports and entertainment activities;
- Trade activities;
- External economic activities in the aforementioned directions.’<sup>20</sup>

41. In Article 9(1) of the 2003 Contract, the parties recorded their agreement on the services that would be provided by the Joint Activity:

‘Products that are the results of the Joint Activity shall be realised by creation, rendering and realisation of the following services and taking the following measures:

- realisation of joint educational programs;
- creation and modern operation of training centres;
- creation of possibilities of an additional training of the youth [...];
- creation of possibilities for an assistance in research, experimental and design activities in various industries of the national economy;
- [...]
- organisation of events in the field of science, tourism and recreation;

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<sup>19</sup> *Id.*

<sup>20</sup> 2003 Contract, Art 2(1) (Exhibit R-9); referred to in Respondent’s Counter-Memorial, para. 44.

- organisation and conducting of scientific-and-enlightener, educational, cultural and recreational, theatrical and other programs [...];
- organisation and holding of conferences, presentations, meetings, etc;
- organisation of after-sales services;
- performance of advertising and information activities;
- tourist and hotel activities [...];
- creation, operation and rent of premises for offices, presentations, conferences, meetings, etc;
- activities in the sphere of catering, creation of branded shops and cafes and performance of the trade activity;
- rendering services in the sphere of tourism and recreation;
- conducting expert and import transactions.<sup>21</sup>

42. In order to implement the 2003 Contract, the parties agreed that the University would provide the building at 3 Chervonozorianski Avenue, Kiev; that B&P would perform certain renovation and redevelopment works to the building; and that the building would then function as the Science-Hotel Complex.<sup>22</sup> It is relevant to set out salient parts of Article 7, which records the parties' agreement on the 'contributions and shares' of the parties.

43. Article 7(1) provided in part that the University's contribution to the Joint Activity would consist of 'tangible and intangible assets' in the form of:

7.1.1. The right of use of the building at 3 Chervonozorianski Avenue, Kiev, as of 1996 without the right of alienation for the reconstruction purposes. For the purposes of this Contract the right of use the building at 3 Chervonozorianski Avenue, Kiev ("the Object") without the right of alienation after the reconstruction has taken place. The amount of the mentioned contribution according to an expert opinion ... shall be UAH 6,449,000.

7.1.2. The cost for the use of premises were used by the general contracting company [...].

7.1.3. The cost for the use of premises that were used by the construction directorate [...].

7.1.4. Creation of the fixed assets by the performance of the second stage of operations related to the reconstruction of the Object in accordance with the procedure determined by this Contract [...].

7.1.7. The right to use the following items while conducting the joint activity:

- the name of Taras Shevchenko National University of Kiev;
- the right to render the services that the University is entitled to render in accordance with its Statute and the legal instruments;
- the right to use a business reputation of the University. ...<sup>23</sup>

<sup>21</sup> 2003 Contract, Art 9(1) (Exhibit R-9); Respondent's Counter-Memorial, para. 46.

<sup>22</sup> Respondent's Counter-Memorial, para. 47.

<sup>23</sup> 2003 Contract, Art 7.1.1 – 7.1.8 (Exhibit R-9).

44. Article 7(2) further provided that B&P's contribution to the joint activity would consist of 'tangible and intangible assets' in the form of the following:

7.2.1. Creation of the fixed assets of the first group in the form of construction-and-assembling operations of the first stage of reconstruction of the Object in accordance with the [approved] construction documents ... The said assets shall; be transferred to the University balance in accordance with Paragraph 14(1). The right of use the results of the reconstruction (the newly created value) of the Object. The amount of the mentioned contributions shall amount to UAH 6,449,000 in accordance with the expert opinion on the value of an object [*sic*] [...];

7.2.2. The value of the furniture, inventory and process equipment necessary for the functioning of the first stage of the Object reconstruction shall be determined by Annex No. 7 to this Contract;

7.2.3. Creation of fixed assets by the completion of the second stage of reconstruction of the Object in accordance with a procedure to be determined by the terms and conditions of this Contract [...];

7.2.5. Funds, namely a share contribution in the creation of the engineering transport infrastructure of Kiev [...];

7.2.6. Expenses on the maintenance of the building during the reconstruction of the Object [...];

7.2.7. Expenses related to repair work and arrangement of a service media of the premises intended for the allocation of the Directorate and the general contractor's organisation [...];

7.2.8. The Company's total contribution shall be UAH 8,399,590 ... and shall be determined in Consolidated Calculation No. 2 that shall be drawn up by virtue of Annexes Nos. 7 to 12 ... Hereby the Company's contribution shall be equal to 50 (fifty) percent of the joint contribution of the Parties.'<sup>24</sup>

45. Article 11(1) provided that the 2003 Contract would be 'valid from the moment it is signed by the parties until December 31, 2027',<sup>25</sup> meaning that the parties would have the benefit of the Contract for just under 25 years, although the Contract also provided for an early termination procedure in Article 11(3), which is set out below.

46. It is convenient to set out other relevant provisions of the 2003 Contract. Under Article 3(3):

'The joint activity of the Parties shall comply with the provisions of this Contract and shall meet the procedure, terms and conditions determined by this Contract and the current legislation acts that regulate the procedure of engaging into a joint activity.'<sup>26</sup>

47. Article 4(2) provided that:

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<sup>24</sup> 2003 Contract, Art 7.2.1-7.2.8 (Exhibit R-9).

<sup>25</sup> 2003 Contract, Art 11(1) (Exhibit R-9).

<sup>26</sup> 2003 Contract, Art 3(3) (Exhibit R-9).

‘The supreme management body shall be a Meeting of the Parties’ Representatives including the following persons: from the University – Rector of the University or a person authorised by him; from the Company – a person authorised by the Members of the Company who shall act by virtue of a resolution of the Members of the Company. The supreme management body shall be authorised to take decisions in any matters related to the joint activity that are not contrary to the current laws and do not belong to the exclusive competence of the parties’ heads.’<sup>27</sup>

48. Under Article 4(4):

‘The Company shall engage in the joint activity by virtue of a power of attorney which the University shall issue within five days from the moment of signing this Contract.’<sup>28</sup>

49. Article 4(6) required that:

‘Financial transactions related to the joint activity of the Parties shall be conducted by means of the joint activity settlement account which is opened after the registration of this Contract in accordance with the current laws of Ukraine.’<sup>29</sup>

50. Under Article 4(7):

‘The University shall be entitled to control the joint activity under this Contract by the means of examination of the account and other documents of the Company but only in respect to the joint activity.’<sup>30</sup>

51. As the Tribunal has observed above, the 2003 Contract contained an early termination procedure in Article 11(3):

‘The Parties shall be entitled to an early termination of this Contract on the grounds and in accordance with the procedure provided by the current legislation.’<sup>31</sup>

52. Article 11(4) – 11(6) contained a procedure for the allocation of the joint venture’s assets in the event of termination:

‘11(4). In case of termination of this Contract the remaining funds and property shall be distributed among the Parties in proportion to their contributions to the joint property. After the termination of this Contract the building shall remain in the property of the University. The property that is contributed by the Company to the

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<sup>27</sup> 2003 Contract, Art 4(2) (Exhibit R-9).

<sup>28</sup> 2003 Contract, Art 4(4) (Exhibit R-9).

<sup>29</sup> 2003 Contract, Art 4(6) (Exhibit R-9).

<sup>30</sup> 2003 Contract, Art 4(7) (Exhibit R-9).

<sup>31</sup> 2003 Contract, Art 11(3) (Exhibit R-9).



joint activity and can be ringfenced without causing any damage to the building shall remain in the property of the Company.

11(5). In case of termination of this Contract all improvements of the building that result from the reconstruction of the joint activity and cannot be detached without causing damage to the building shall become the property of the University at their residual value. The Company shall be subsequently compensated for the value of the tangible assets that cannot be detached from the building.

11(6). In case of termination of this Contract the contributions and the part of the joint property that can be detached from the building as well as the property rights contributed by the Parties shall be returned to the Parties in accordance with the procedure determined in the current legislation.<sup>32</sup>

53. Article 13(1), entitled 'Disputes Settlement Procedure', provided that:

'All disputes between the Parties in connection to which no agreement has been reached shall be settled in accordance to the Ukrainian legislation.'<sup>33</sup>

54. And Article 15(1) stated that:

'In cases provided for in this Contract the Parties are governed by the current legislation of Ukraine.'<sup>34</sup>

55. As was foreseen in Article 7(2) of the Contract, the Project was to proceed in two phases.

The first phase involved the redevelopment of the first four of the building's five floors (including the construction of living, dining and conference facilities.)<sup>35</sup> The second phase included the construction of additional rooms on the fifth floor, the installation of an elevator, and a renovation of the building's sports facilities and a garden.<sup>36</sup>

56. Construction works at the Science-Hotel Complex proceeded throughout 2003, and the first phase was completed.<sup>37</sup> The commencement of the second phase of the Project was however delayed, which the Claimant alleges was partly due to difficulties encountered in evicting illegal tenants from the building who had been there since 1999.<sup>38</sup>

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<sup>32</sup> 2003 Contract, Art 11(4)-11(6) (Exhibit R-9).

<sup>33</sup> 2003 Contract, Art 13(1) (Exhibit R-9).

<sup>34</sup> 2003 Contract, Art 15(1) (Exhibit R-9).

<sup>35</sup> Claimants' Memorial, p. 9.

<sup>36</sup> Claimants' Memorial, pp. 9-10.

<sup>37</sup> Claimants' Memorial, pp. 8-10.

<sup>38</sup> Claimants' Memorial, p. 10.

57. Despite these delays, the University and B&P agreed on 30 July 2005 that the Science-Hotel Complex would open on 1 August 2005, and begin operations.<sup>39</sup>

#### **D. Internal Audit by the University**

58. In October 2006, the University's Financial and Business Activity Control Department ('Control Department'), responsible for the inspection of the financial activity of the University, commenced an internal audit of the Joint Activity ('Internal Audit').<sup>40</sup> The purpose of the Internal Audit was to ascertain whether B&P was in compliance with the 2003 Contract for the period 2003 – 2006. The University's Control Department issued a report dated 29 December 2006 ('Internal Audit Report'), and found 'a number of irregularities' in B&P's performance of its contractual obligations.<sup>41</sup> These included a finding that B&P was not using the building in accordance with the terms of the 2003 Contract, including that it was not undertaking any 'joint educational activities with the University'.<sup>42</sup>

59. Although B&P had provided documentation to the Control Department to support its claims that the Science-Hotel Complex had hosted conferences, the Respondent has alleged that those conferences only made use of the accommodation facilities, rather than the conference rooms; that many of the organisations which had made use or planned to make use of the conference facilities were private companies, rather than educational institutions.<sup>43</sup> The Respondent has further noted that other events hosted by the Science-Hotel Complex were listed as 'Ukraine, Eurovision', 'Germany. World Football Championship', and 'Italy'.<sup>44</sup> The Control Department accordingly concluded that the Science-Hotel Complex had not hosted seminars, conferences or other university events, of the kind envisaged by the 2003 Contract.<sup>45</sup>

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<sup>39</sup> Claimants' Memorial, p. 8.

<sup>40</sup> Respondent's Counter-Memorial, paras. 59-60.

<sup>41</sup> Respondent's Counter-Memorial, paras. 62-63.

<sup>42</sup> Respondent's Counter-Memorial, para. 66.

<sup>43</sup> Respondent's Counter-Memorial, para. 68.

<sup>44</sup> Respondent's Counter-Memorial, para. 72.

<sup>45</sup> Respondent's Counter-Memorial, paras. 66, 74; see also Internal Audit Report of 29 December 2006 (Exhibit R-23).

60. The Control Department also found in the Internal Audit that B&P had failed to open a separate bank account for the Joint Activity in that it had conducted all the financial operations relating to the Joint Activity through one single bank account held by B&P.<sup>46</sup> Further, in the proceedings the Respondent asserted that ‘there were no separate balance sheets and no separate accounting books and ... the Joint Activity’s financial results appeared only on B&P’s balance sheets.’<sup>47</sup>

61. In addition, the Control Department found that the parties to the 2003 Contract had failed to ‘exchange available information ... on aspects of their mutual interests’, to ‘conduct joint meetings, mutual consultations on subjects of mutual activities’, and had also not held any meetings of the parties’ representatives, contrary to Articles 3 and 4 of the 2003 Contract.<sup>48</sup>

62. The Control Department also made findings of other breaches, including that B&P had:

- failed to keep an inventory of the Joint Activity’s assets, in breach of Article 8(2) of the 2003 Contract;<sup>49</sup>
- leased equipment ‘without having assigned inventory numbers on the leased equipment’;<sup>50</sup>
- recruited employees who were not aware that they were employed for the Joint Activity;<sup>51</sup>
- violated Ukrainian tax legislation;<sup>52</sup> and
- made use of the building for purposes not connected with the Joint Activity, including the sub-let of the fifth floor of the building to one of B&P’s contractors.<sup>53</sup>

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<sup>46</sup> Respondent’s Counter-Memorial, paras. 76-77; see also Internal Audit Report of 29 December 2006 (Exhibit R-23).

<sup>47</sup> Respondent’s Counter-Memorial, para. 77.

<sup>48</sup> Respondent’s Counter-Memorial, paras. 80-81; see also Internal Audit Report of 29 December 2006 (Exhibit R-23).

<sup>49</sup> Respondent’s Counter-Memorial, para. 82; see also Internal Audit Report of 29 December 2006 (Exhibit R-23).

<sup>50</sup> Respondent’s Counter-Memorial, para. 83; see also Internal Audit Report of 29 December 2006 (Exhibit R-23).

<sup>51</sup> Respondent’s Counter-Memorial, para. 84; see also Internal Audit Report of 29 December 2006 (Exhibit R-23).

<sup>52</sup> Respondent’s Counter-Memorial, paras. 85-86; see also Internal Audit Report of 29 December 2006 (Exhibit R-23).

<sup>53</sup> Respondent’s Counter-Memorial, paras. 87-90.

63. On the basis of these irregularities, the University Control Department concluded in the Internal Audit Report that B&P owed the University UAH 124,036.60.<sup>54</sup>

#### **E. Audit of the University by the General Control and Revision Office**

64. During November and December 2006, the General Control and Revision Office of the Ukraine Ministry of Finance ('CRO') carried out an audit of the University ('CRO Audit'), that included a 'Cross-Revision' of the Joint Activity ('Cross-Revision'), comprised of an inspection of B&P's documents relating to the Joint Activity'.<sup>55</sup>

65. In the proceedings, the Respondent describes the CRO as an 'independent financial control authority within the Ministry of Finance of Ukraine',<sup>56</sup> and its purpose is to ensure that 'the entities, institutions and organisations that receive state funding comply with the requirements of the laws of Ukraine regarding the use and accounting of budget funds and the use of state property'.<sup>57</sup>

66. According to the Respondent, in the course of its audit, the CRO decided that it was 'necessary to extend their inspection to the Joint Activity between the University and B&P', and proceeded to review records held by B&P relating to the Joint Activity ('the Cross-Revision').<sup>58</sup>

67. B&P claimed that it was not aware of the CRO Audit until it received the CRO's request for the production of copies of all documents relating to the Joint Activity.<sup>59</sup> In response, the Respondent explained that 'the CRO was not obliged to notify B&P of the scheduled audit', which is 'not provided for in the applicable regulations'.<sup>60</sup>

68. The CRO's inspection of B&P's documents took place from 8 to 15 December 2006.<sup>61</sup>

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<sup>54</sup> Respondent's Counter-Memorial, para. 91.

<sup>55</sup> Respondent's Counter-Memorial, para. 92.

<sup>56</sup> Respondent's Counter-Memorial, para. 94.

<sup>57</sup> *Id.*

<sup>58</sup> Respondent's Counter-Memorial, para. 101.

<sup>59</sup> Claimants' Memorial, p. 12.

<sup>60</sup> Respondent's Counter-Memorial, para. 100.

<sup>61</sup> Respondent's Counter-Memorial, para. 102.

69. In addition to its review of documents, the CRO requested that the University prepare a report on the physical measurements of the building.<sup>62</sup> This report stated that much of the building consisted of hotel rooms and commercial premises, and also that two families were living in the building.<sup>63</sup>

70. The report led the University's then Deputy-Rector to conclude that the building was being used mainly for commercial, rather than educational, purposes.<sup>64</sup>

71. On 15 December 2006, the CRO issued the Cross-Revision Report with the finding that B&P had failed to open a separate joint activity account, contrary to Article 4.6 of the 2003 Contract:

'the Company did not open a joint activity account. All business operations of the Company, including the joint activity, were carried out on the account current No 260083012307, MFO 300012, with the Main Operations Department of Prominvestbank in Kiev.'<sup>65</sup>

72. The CRO also found that B&P had failed to conduct the activities which it was required to carry out under the 2003 Agreement:

'Documents evidencing the joint activity of the University and the Company in the areas identified in [the 2003 Contract] ... *inter alia*, scientific activity, education activity, conferences, presentations, meetings, competitions, video- and inter-bridges; information services; cultural and educational activities, foreign trade activities in the selected areas, were not provided for collation.'<sup>66</sup>

73. B&P protested these findings and its Chief Executive Officer, Ms Olga Romanchuk, counter-signed the Cross-Revision Report under protest, stating that she disagreed with the conclusions.<sup>67</sup> B&P also sent letters of complaint to the CRO, the Ministry of Finance and the State Prosecutor's Office, but only received a *pro forma* reply from the Ministry of Finance.<sup>68</sup>

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<sup>62</sup> Respondent's Counter-Memorial, para. 103.

<sup>63</sup> Respondent's Counter-Memorial, paras. 105-109.

<sup>64</sup> *Id.*

<sup>65</sup> Respondent's Counter-Memorial, paras. 112-118; see also Cross-Revision Report of 15 December 2006 (Exhibit R-22), p. 5; and Claimants' Memorial, p. 12.

<sup>66</sup> Respondent's Counter-Memorial, paras. 119-121; see also Cross-Revision Report of 15 December 2006 (Exhibit R-22), p. 5; and Claimants' Memorial, p. 12.

<sup>67</sup> Claimants' Memorial, p. 13.

<sup>68</sup> *Id.*

74. The CRO issued its Audit Report ('the CRO Audit Report') on the University on 29 December 2006, in which it essentially adopted the findings made in the Cross-Revision Report, including those concerning B&P's failure to open a separate joint activity account and B&P's failure to carry out joint activities in a number of areas.<sup>69</sup>
75. On 10 May 2007, the CRO wrote to the University and confirmed that it had, in the course of the Audit, detected various instances of non-conformity with applicable Ukrainian law, and made 15 recommendations to the University which dealt with a range of issues, and which were expressed in mandatory terms.<sup>70</sup> One of the breaches identified by the CRO was B&P's operation of the Science-Hotel Complex. In the letter dated 10 May 2007, the CRO directed the University to do *inter alia* the following:

'The University shall:

1. Take effective measures to eliminate completely the established inconsistencies and to bring the guilty officials to responsibility with respect to these breaches.  
[...]

5. Consider the question of termination of joint activities with B&P, LTD as such as inconsistent with the University status being a [State] budget-maintained institution as well as return the assets to the above-mentioned company. Prevent violations of effective legislature by the University concerning the use of its assets (State property).<sup>71</sup>

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<sup>69</sup> Respondent's Counter-Memorial, paras. 123-128; CRO Audit Report of 29 December 2006 (Exhibit R-26).

<sup>70</sup> Claimants' Memorial, p. 11.

<sup>71</sup> Letter dated 10 May 2007 from the CRO to the University (Exhibit R-30); see also Claimants' Memorial, pp. 11-12; Respondent's Counter-Memorial, para. 130. The Claimants had submitted a non-certified translation (Exhibit C-51-1), which translated this passage slightly differently: 'The University shall comply with these: (1) Take effective measures to eliminate completely the established inconsistencies and to bring the guilty officials to accountability with respect to these breaches. [...] 5. The question of cessation of the B and P Ltd activities as such inconsistent with the University status being a state [*sic*] budget-maintained institution, as well as provision of the return of assets allowed for use by the said company. No instance of the breach of effective legislature on the University's part concerning the use of its assets (State property) shall be allowed to take place.' The Claimants subsequently presented a certified translation at the start of the oral hearing, which rendered the passage as follows: 'The University shall: (1) Take effective measures to fully rectify the violations discovered and bring the guilty officials to justice. [...] (5) Consider terminating joint activities with B&P LTD as failing to conform with the University's status as a State-funded institution as well as ensuring return of assets transferred to said company. The University must not be allowed to violate the provisions of current law regarding the use of its assets (State property)': reproduced in Claimants' Post-Hearing Brief, para. 103, fn. 120. The Tribunal does not consider that anything turns on which translation is to be preferred, but it sets out the competing translations for the sake of completeness.

## F. Termination of the 2003 Contract

76. As to rights to termination, the Respondent's submissions were that Ukrainian law provides that where there is a material breach of contract, there are two methods to seek termination of that contract, namely:

'(1) the parties can mutually agree on the termination of the contract; or (2) if the parties cannot agree on such termination, the interested party may request termination of the contract before the Ukrainian courts. However, one party cannot unilaterally terminate a contract, even in case of a material breach.'<sup>72</sup>

77. By letter dated 13 September 2007, the University requested that B&P agree to the termination of the 2003 Contract by reason of the various breaches by B&P identified by the CRO. In that letter, the University also stated that unless B&P agreed to the termination of the 2003 Contract it would be obliged to commence action before the Kiev Commercial Court.<sup>73</sup> By letter dated 21 September 2007, B&P refused the University's request and asserted that any disputes should be settled despite provisions of the BIT.<sup>74</sup> In a further letter dated 1 October 2007, B&P proposed a meeting on 17 October 2007 to discuss the issue. B&P claims that its representatives attended the office of the Rector for that meeting, but the Rector was not available to meet with them.<sup>75</sup>

78. On 2 October 2007, the University initiated proceedings in the Kiev Commercial Court by filing statement of claim No 03-101, in which it sought the termination of the 2003 Contract and the transfer of B&P's 50% interest in the joint venture to the University.<sup>76</sup> Each party made submissions to the Court.

79. B&P contended that as the dispute was an investment dispute within the meaning of the BIT and the ICSID Convention, it was invoking the jurisdiction of ICSID, and it argued that ICSID's jurisdiction was exclusive of the Ukrainian courts. In Ruling 05-6-6/1061 of 29 October 2007, Judge Kovtun agreed that the Kiev Commercial Court lacked

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<sup>72</sup> Respondent's Counter-Memorial, para. 131 (footnote omitted).

<sup>73</sup> Respondent's Counter-Memorial, paras. 134-137; Letter dated 13 September 2007 from the University to B&P (Exhibit R-31).

<sup>74</sup> Respondent's Counter-Memorial, para. 138; Letter dated 21 September 2007 from B&P to the University (Exhibit R-32).

<sup>75</sup> Claimants' Memorial, pp. 13-14.

<sup>76</sup> Respondent's Counter-Memorial, para. 142; see also the University's Statement of Claim No 03-101 of 2 October 2007 (Exhibit R-33).

jurisdiction to determine the case because it fell within the jurisdiction of ICSID. He therefore did not accept the University's claim.<sup>77</sup>

80. On 2 November 2007, the University commenced new proceedings in the Kiev Commercial Court, requesting the same relief.<sup>78</sup> The University filed the same statement of claim as it had filed in the proceedings it had initiated on 2 October 2007.<sup>79</sup>

81. On 8 November 2007, B&P filed its objections to the Kiev Commercial Court, referring to Ruling 05-6-6/1061 of Judge Kovtun. Nevertheless, on 23 November 2007, Judge Khrypun issued a Ruling in Case No 32/619, in which he accepted the statement of claim and invited B&P to submit a substantive response, and also scheduled a hearing for 3 December 2007.<sup>80</sup> B&P did not attend that hearing because – as Ms Romanchuk explained in her witness statement – it considered that the hearing was 'illegal' and constituted a violation of B&P's 'procedural rights'.<sup>81</sup> On 15 January 2008, B&P filed a written submission in which it objected to Judge Khrypun's Ruling of 23 November 2007 on jurisdictional grounds only, and it did not address the University's claim on the merits of terminating the 2003 Contract.<sup>82</sup>

82. On 16 January 2008, Judge Khrypun issued a judgment which terminated the 2003 Contract.<sup>83</sup> Judge Khrypun rejected B&P's submission that the BIT was applicable to the dispute between the parties, and concluded that the 2003 Contract was 'commercial'. It followed that he found that the dispute was subject to the jurisdiction of the Ukrainian courts, holding that: 'According to the Article 12 of the Code of Commercial Procedure of Ukraine, all the disputes arising upon amendment and termination of commercial contracts belong to the jurisdiction of commercial courts.'<sup>84</sup> On the merits issues, Judge

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<sup>77</sup> Claimants' Memorial, pp. 14-15; Respondent's Counter-Memorial, paras. 144-145; see also Kiev Commercial Court, Ruling No 05-6-6/1061 on Refusal to Accept the Statement of Claim (29 October 2007) (Exhibit RLA-115).

<sup>78</sup> Respondent's Counter-Memorial, paras. 146-155; see also the University's Statement of Claim No 03-101 of 2 October 2007 (Exhibit R-35).

<sup>79</sup> Claimants' Memorial, p. 15; Claimants' Post-Hearing Brief, paras. 201-203; see also the University's Statement of Claim No 03-101 of 2 October 2007 (Exhibit R-35).

<sup>80</sup> Respondent's Counter-Memorial, para. 148; see also Kiev Commercial Court (Case No 32/619), Ruling on Institution of the Proceedings of 23 November 2007 (Exhibit RLA-116).

<sup>81</sup> Romanchuk WS, p. 9; see also Respondent's Counter-Memorial, para. 149.

<sup>82</sup> Respondent's Counter-Memorial, para. 150.

<sup>83</sup> Kiev Commercial Court (Case No 32/619), Judgment of 16 January 2008 (Exhibit RLA-118).

<sup>84</sup> Kiev Commercial Court (Case No 32/619), Judgment of 16 January 2008 (Exhibit RLA-118), p. 3; Respondent's Counter-Memorial, para. 151.



Khrypun held that the B&P's acts and omissions amounted to a material breach of the 2003 Contract, which justified its termination by the Court.<sup>85</sup>

83. On 22 January 2008, B&P sought to appeal the judgment in Case No 32/619. Its appeal was rejected in the first instance by the Kiev Commercial Court of Appeal due to B&P's failure to pay the appropriate court fee.<sup>86</sup> B&P then refiled its appeal with the relevant court fee, which was accepted by the Kiev Commercial Court of Appeal.<sup>87</sup> On the Appeal itself, B&P argued that the Kiev Commercial Court of Appeal should overturn the decision of Judge Khrypun due to: (1) the inconsistent decision in Ruling No 05-6-6/1061; and (2) its submission that the dispute fell to be determined under the BIT and not by the Ukrainian courts.

84. On 3 June 2008, the Kiev Commercial Court of Appeal dismissed B&P's appeal and upheld the judgment in Case No 32/619.<sup>88</sup> As to ground (1), it rejected B&P's argument, based on Article 80 of the Commercial Code of Procedure of Ukraine, that a commercial court should discontinue a proceeding if a decision has already been issued in the same case, which involves the same parties,<sup>89</sup> and found that Article 80 of the Commercial Code of Procedure was only engaged where a court issues a 'judgment', which considers the merits of the dispute, but does not apply where a court issues a 'ruling' (as Judge Kovtun had done), which does not examine the merits.<sup>90</sup> As to ground (2), it also rejected B&P's argument that the dispute was within the jurisdiction of ICSID, including on the bases that the 2003 Contract had not been registered as a foreign investment agreement, that the 2003 Contract itself provided in Article 13(1) that disputes were to be settled by the Ukrainian courts, that Article 12 of the Commercial Code of Procedure of Ukraine provides that disputes concerning the termination of commercial agreements are subject to the jurisdiction of the Ukrainian commercial courts, and that B&P had, in any event, failed to provide any evidence that B&P and the University had entered into a written

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<sup>85</sup> Kiev Commercial Court (Case No 32/619), Judgment of 16 January 2008 (Exhibit RLA-118), p. 4; Respondent's Counter-Memorial, para. 152.

<sup>86</sup> Kiev Commercial Court of Appeal (Case No 32/619), Ruling of 4 March 2008 (Exhibit RLA-119); Respondent's Counter-Memorial, para. 156.

<sup>87</sup> Kiev Commercial Court of Appeal (Case No 32/619), Ruling of 8 April 2008 (Exhibit RLA-120); Respondent's Counter-Memorial, para. 157.

<sup>88</sup> Kiev Commercial Court of Appeal (Case No 32/619), Resolution of 3 June 2008 (Exhibit RLA-121); Respondent's Counter-Memorial, para. 158.

<sup>89</sup> Respondent's Counter-Memorial, para. 159.

<sup>90</sup> Kiev Commercial Court of Appeal (Case No 32/619), Resolution of 3 June 2008 (Exhibit RLA-121), p. 2; Respondent's Counter-Memorial, para. 159.

agreement to submit their dispute to ICSID, as is required by Article 25 of the ICSID Convention.<sup>91</sup>

85. Thereafter, B&P launched a further appeal to the High Commercial Court of Ukraine.<sup>92</sup>

A hearing, attended by B&P's legal representatives, was held on 9 September 2008. B&P maintained its contentions that the Kiev Commercial Court's judgment could not be upheld, because the dispute was subject to the dispute resolution procedures in the BIT; and it also repeated its submission that the matter had already been determined by Judge Kovtun's Ruling in Case No 05-6-6/1061.

86. On 19 September 2008, the High Commercial Court of Ukraine rejected B&P's arguments and upheld the judgment of the Kiev Commercial Court of Appeal.<sup>93</sup>

#### **G. B&P's Eviction from the Science-Hotel Complex**

87. On 28 March 2008, the University instituted a third set of proceedings before the Kiev Commercial Court and filed a statement of claim, requesting that the Court order B&P's eviction from the Science-Hotel Complex.<sup>94</sup> The University argued that as the Kiev Commercial Court had ordered the termination of the 2003 Contract B&P 'no longer had the right to continue to use the premises.'<sup>95</sup> B&P filed a statement of defence on 18 April 2008 and, after the hearing which took place on 21 April 2008, further statements of defence on 6 June 2008 and 9 June 2008.<sup>96</sup>

88. B&P again objected to the University's statement of claim on the two grounds noted above, namely that the dispute was an investment dispute under the BIT and therefore outside the Ukrainian courts' jurisdiction, and that the Kiev Commercial Court's order that the 2003 Contract be terminated was inconsistent with Ruling No 05-6-6/1061 of 29

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<sup>91</sup> Kiev Commercial Court of Appeal (Case No 32/619), Resolution of 3 June 2008 (Exhibit RLA-121), p. 2; Respondent's Counter-Memorial, para. 160.

<sup>92</sup> Respondent's Counter-Memorial, para. 163.

<sup>93</sup> High Commercial Court of Ukraine (Case No 32/619), Ruling for Procedural Decisions of 19 September 2008 (Exhibit RLA-124); Respondent's Counter-Memorial, para. 164.

<sup>94</sup> University's Statement of Claim dated 28 March 2008 (Case No 21/36) (Exhibit R-39); see also Claimants' Memorial, p. 16; Respondent's Counter-Memorial, para. 173.

<sup>95</sup> Respondent's Counter-Memorial, para. 173.

<sup>96</sup> B&P's Statements of Defence (Case No 21/36) of 21 April 2008 (Exhibit R-40), 6 June 2008 (Exhibit R-42), and 9 June 2008 (Exhibit R-43); Respondent's Counter-Memorial, paras. 174-176.

October 2007.<sup>97</sup> In its statement of defence of 6 June 2008, B&P also informed the Kiev Commercial Court that it had filed an application against Ukraine before the European Court of Human Rights.<sup>98</sup>

89. On 10 June 2008, the Kiev Commercial Court held that (as upheld by the Kiev Commercial Court of Appeal on 3 June 2008) the 2003 Contract had been validly terminated by the Court's judgment of 16 January 2008, and that B&P no longer had the right to use the building.<sup>99</sup> It ordered that B&P be evicted from the Science-Hotel Complex and ordered that the Complex be transferred to the possession of the University.<sup>100</sup>

90. B&P appealed the judgment of the Kiev Commercial Court, but did not appear at the hearing. On 11 December 2008, the Kiev Commercial Court of Appeal dismissed B&P's appeal.<sup>101</sup>

91. B&P then appealed that decision to the High Commercial Court of Ukraine.<sup>102</sup> On 2 April 2009, the High Commercial Court of Ukraine dismissed B&P's appeal and upheld the judgment of the Kiev Commercial Court of Appeal.<sup>103</sup>

92. In the meantime, on 13 January 2009, the Kiev Commercial Court had issued an order for the eviction of B&P from the Science-Hotel Complex, and the University had requested that the State Enforcement Office of Ukraine execute that order.<sup>104</sup> The State Enforcement Office wrote to B&P on 14 January 2009, requiring that it leave the Science-Hotel Complex by midday on 16 January 2009.<sup>105</sup> B&P failed to vacate the building by this deadline, and on the afternoon of 16 January 2009, representatives of the

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<sup>97</sup> Respondent's Counter-Memorial, paras. 174-176.

<sup>98</sup> Respondent's Counter-Memorial, para. 175.

<sup>99</sup> Kiev Commercial Court (Case No 21/36), Judgment of 10 June 2008 (Exhibit RLA-122); Respondent's Counter-Memorial, paras. 179-180.

<sup>100</sup> Kiev Commercial Court (Case No 21/36), Judgment of 10 June 2008), referred to in Respondent's Counter-Memorial, paras. 177-182.

<sup>101</sup> Kiev Commercial Court of Appeal (Case No 21/36), Resolution of 11 December 2008 (Exhibit RLA-128), referred to in Respondent's Counter-Memorial, para. 187.

<sup>102</sup> Claimants' Memorial, p. 17; Respondent's Counter-Memorial, para. 189.

<sup>103</sup> High Commercial Court of Ukraine (Case No 21/36), Ruling for Procedural Decisions (Exhibit RLA-130); Respondent's Counter-Memorial, paras. 189-192.

<sup>104</sup> Kiev Commercial Court (Case No 21/36), Ruling of 13 January 2009; Respondent's Counter-Memorial, para. 193.

<sup>105</sup> Respondent's Counter-Memorial, para. 194.

University and the State Enforcement Office presented themselves at the Science-Hotel Complex, but were told by B&P's employees that there were no representatives of B&P in the building, so no eviction could take place. By application on 16 January 2009, the University sought a clarification of the Kiev Commercial Court's Ruling of 13 January 2009, and on 19 January 2009, the Kiev Commercial Court ordered that 'B&P shall be evicted from the non-residential premises at 3, Chervonozorianyi Avenue, Kiev, by means of it being emptied of any persons and property.'<sup>106</sup> Over the course of the period 19-20 January 2009, representatives of the University and State Enforcement Office physically and forcibly carried out the eviction of B&P and its representatives from the premises.<sup>107</sup>

93. B&P subsequently challenged the State Enforcement Office's eviction order before the Kiev Commercial Court. That Court dismissed the challenge on 2 June 2009, and the Kiev Commercial Court of Appeal rejected B&P's appeal from that decision on 4 September 2009.<sup>108</sup>

## **H. Proceedings Regarding the Power of Attorney**

94. In a final set of court proceedings in the Ukraine, on 10 June 2008, the Kiev Commercial Court registered a claim by B&P in which it complained that the University had revoked the power of attorney it had previously granted to B&P in order for B&P to be able to carry out joint activities concerning the Science-Hotel Complex.<sup>109</sup> The Kiev Commercial Court issued a decision on 4 November 2008 in which it rejected B&P's claim, on the grounds that the 2003 Contract had been validly terminated as of the Kiev Commercial Court of Appeal's decision of 3 June 2008.<sup>110</sup>

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<sup>106</sup> Kiev Commercial Court (Case No 21/36), Ruling of 19 January 2009; referred to in Respondent's Counter-Memorial, para. 197.

<sup>107</sup> See e.g., Romanchuk WS, pp. 15-16; Iryna Gulida WS, pp. 23-25; Natalia Gulida WS, pp. 4-5; Popova WS, p. 3; Kaganovich WS, pp. 5-6; Transcript Day 2, p. 424, line 8 – p. 435, line 12 (Mr Kaganovich); see also Respondent's Counter-Memorial, para. 198.

<sup>108</sup> Kiev Commercial Court (Case No 21/36), Ruling of 2 June 2009 (Exhibit RLA-131); Kiev Commercial Court of Appeal (Case No 21/36), Resolution of 4 September 2009 (Exhibit RLA-132); Respondent's Counter-Memorial, para. 200.

<sup>109</sup> Kiev Commercial Court (Case No 21/81), Ruling of 10 June 2008 (Exhibit RLA-123); Respondent's Counter-Memorial, paras. 202-205.

<sup>110</sup> Kiev Commercial Court (Case No 21/81), Judgment of 4 November 2008 (Exhibit RLA-125), p. 2; Respondent's Counter-Memorial, para. 204.

95. B&P appealed this decision to the Kiev Commercial Court of Appeal, but it upheld the decision at first instance.<sup>111</sup>

## **I. Commencement of ICSID Arbitration**

96. As noted above, on 3 December 2007, the Claimants filed its Request for Arbitration with ICSID, and on 21 August 2008, ICSID registered the Request for Arbitration under Article 36(3) of the ICSID Convention.

97. It is not an unusual development in adjudication proceedings for the claims of the parties to evolve as the proceedings move on. As the Claimants' case has undergone substantial refinement during the course of this arbitration, the Tribunal takes the Claimants' final claims for determination as those which were presented at the substantive hearing and maintained in the Claimants' Post-Hearing Brief.

98. As reformulated, the Claimants requested that the Tribunal make the findings that:

1. the Tribunal has jurisdiction over the dispute;<sup>112</sup>
2. the Respondent is responsible for the conduct of the CRO, the Ukrainian courts, the Ministry of Justice, and the University;<sup>113</sup>
3. the Respondent has breached its obligations under the BIT in 'four material ways':
  - a. the manner in which the CRO 'conducted its audit and enforced its conclusions' was contrary to Articles II(3)(a) and III of the BIT;
  - b. the manner in which 'University officials failed to act in good faith towards B&P' by 'seeking to terminate the Agreement rather than working with B&P to improve its implementation' was contrary to Article II(3)(a) of the BIT;
  - c. the manner in which 'University officials committed a fundamental breach of the Agreement, contrary to Ukrainian municipal law' and contrary to the Respondent's obligations under Article II(3)(c) of the BIT; and

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<sup>111</sup> Kiev Commercial Court (Case No 21/81), Resolution of 11 December 2008 (Exhibit RLA-127), p. 5; Respondent's Counter-Memorial, para. 204.

<sup>112</sup> Claimants' Post-Hearing Brief, paras. 12-18, 69-85.

<sup>113</sup> Claimants' Post-Hearing Brief, paras. 19-68.

- d. the manner in which ‘the Ukrainian courts failed to act consistently with the *res judicata* principle’ was contrary to Article II(3)(a) of the BIT.<sup>114</sup>

99. In their Post-Hearing Brief the Claimants confirmed their withdrawal of their claims ‘with respect to the “full protection and security” standard contained in BIT Article II(3)(a) and the “arbitrary or discriminatory measures” standard contained in BIT Article II(3)(b).’<sup>115</sup>

100. The Respondent’s defence also evolved in response to the Claimants’ claims. In its Post-Hearing Brief, the Respondent requested that the Tribunal make the following findings:

1. the conduct of the University is not attributable to Ukraine;<sup>116</sup>
2. the CRO did not interfere with the Claimants’ investment in breach of Article II(3)(a) of the BIT;<sup>117</sup>
3. the Ukrainian court proceedings were fair and transparent, and did not amount to a breach of Article II(3)(a) of the BIT;<sup>118</sup>
4. the Respondent did not frustrate any legitimate expectations of the Claimants in breach of Article II(3)(a) of the BIT;<sup>119</sup>
5. the Claimants’ claims under Article II(3)(c) (the ‘umbrella clause’) should be rejected;<sup>120</sup> and
6. the Respondent did not expropriate the Claimants’ contractual rights contrary to Article III of the BIT.<sup>121</sup>

#### **IV. RELEVANT PROVISIONS OF THE BIT AND APPLICABLE LAW**

##### **A. Relevant Provisions of the BIT**

101. It is convenient to set out certain relevant provisions of the BIT.

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<sup>114</sup> Claimants’ Post-Hearing Brief, para. 86.

<sup>115</sup> Claimants’ Post-Hearing Brief, para. 100.

<sup>116</sup> Respondent’s Post-Hearing Brief, paras. 9-27.

<sup>117</sup> Respondent’s Post-Hearing Brief, paras. 28-64.

<sup>118</sup> Respondent’s Post-Hearing Brief, paras. 65-129.

<sup>119</sup> Respondent’s Post-Hearing Brief, paras. 130-148.

<sup>120</sup> Respondent’s Post-Hearing Brief, paras. 149-184.

<sup>121</sup> Respondent’s Post-Hearing Brief, paras. 185-196.

102. Article I(1)(a) contains the definition of ‘investment’, which provides that:

‘(a) “investment” means every kind of investment in the territory of one Party owned or controlled directly or indirectly by nationals or companies of the other Party, such as equity, debt, and service and investment contracts; and includes:

- (i) tangible and intangible property, including rights, such as mortgages, liens and pledges;
- (ii) a company or shares of stock or other interests in a company or interests in the assets thereof;
- (iii) a claim to money or a claim to performance having economic value, and associated with an investment;
- (iv) intellectual property which includes, inter alia, rights relating to:
  - literary and artistic works, including sound recordings,
  - inventions in all fields of human endeavour,
  - industrial designs,
  - semiconductor mask works,
  - trade secrets, know-how, and confidential business information, and
  - trademarks, service marks, and trade names; and
- (v) any right conferred by law or contract, and any licenses and permits pursuant to law.’

103. Article I(1)(b) provides the definition of ‘company’ as follows:

‘(b) “company” of a Party means any kind of corporation, company, association, partnership, or other organisation, legally constituted under the laws and regulations of a Party or a political subdivision thereof whether or not organised for pecuniary gain, or privately or governmentally owned or controlled’.

104. Article I(1)(f) contains the definition of ‘State enterprise’:

‘(f) “State enterprise” means an enterprise owned, or controlled through ownership interests, by a Party.’

105. Article II(2)(b) also deals with State enterprises, and states that:

‘(b) Each Party shall ensure that any State enterprise that it maintains or establishes acts in a manner that is not inconsistent with the Party’s obligations under this Treaty wherever such enterprise exercises any regulatory, administrative or other governmental authority that the Party has delegated to it, such as the power to expropriate, grant licenses, approve commercial transactions, or impose quotas, fees or other charges.’

106. Article II(3)(a) provides for the obligation on the Contracting Parties to accord fair and equitable treatment and full protection and security, as follows:

‘(a) Investment shall at all times be accorded fair and equitable treatment, shall enjoy full protection and security and shall in no case be accorded treatment less than that required by international law.’

107. The umbrella clause is contained in Article II(3)(c) of the BIT:

‘Each Party shall observe any obligation it may have entered into with regard to investments.’

108. Article III contains the BIT’s protection against expropriation, and provides in part as follows:

‘(1) Investments shall not be expropriated or nationalised either directly or indirectly through measures tantamount to expropriation or nationalisation (“expropriation”) except: for a public purpose; in a non-discriminatory manner; upon payment of prompt, adequate and effective compensation; and in accordance with due process of law and the general principles of treatment provided for in Article II(2). Compensation shall be equivalent to the fair market value of the expropriated investment immediately before the expropriatory action was taken or became known, whichever is earlier; be calculated in a freely usable currency on the basis of the prevailing market rate of exchange at that time; be paid without delay; include interest at a commercially reasonable rate, such as LIBOR plus an appropriate margin, from the date of expropriation; be fully realisable; and be freely transferable.’

109. Article VI contains the BIT’s investor-State dispute settlement procedure. This provides in part that:

‘(1) For purposes of this Article, an investment dispute is a dispute between a Party and a national or company of the other Party arising out of or relating to (a) an investment agreement between that Party and such national or company; (b) an investment authorisation granted by that Party’s foreign investment authority to such national or company; or (c) an alleged breach of any right conferred or created by this Treaty with respect to an investment.

(2) In the event of an investment dispute, the parties to the dispute should initially seek a resolution through consultation and negotiation. If the dispute cannot be settled amicably, the national or company concerned may choose to submit the dispute for resolution:

- (a) to the courts or administrative tribunals of the Party that is a party to the dispute; or
- (b) in accordance with any applicable, previously agreed dispute-settlement procedures; or
- (c) in accordance with the terms of paragraph 3.

(3)(a) Provided that the national or company concerned has not submitted the dispute for resolution under paragraph 2(a) or (b) and that six months have elapsed from the date on which the dispute arose, the national or company concerned may choose to



consent in writing to the submission of the dispute for settlement by binding arbitration:

(i) to the International Centre for the Settlement of Investment Disputes (“Centre”) established by the Convention on the Settlement of Investment Disputes between States and Nationals of other States, done at Washington, March 18, 1965 (“ICSID Convention”), provided that the Party is a party to such Convention; or

(ii) to the Additional Facility of the Centre, if the Centre is not available; or

(iii) in accordance with the Arbitration Rules of the United Nations Commission on International Trade Law (UNCITRAL); or

(iv) to any other arbitration institution, or in accordance with any other arbitration rules, as may be mutually agreed between the parties to the dispute.

(b) Once the national or company concerned has so consented, either party to the dispute may initiate arbitration in accordance with the choice so specified in the consent.

(4) Each Party hereby consents to the submission of any investment dispute for settlement by binding arbitration in accordance with the choice specified in the written consent of the national or company under paragraph 3. ...

[...]

(8) For purposes of an arbitration held under paragraph 3 of this Article, any company legally constituted under the applicable laws and regulations of a Party or political subdivision thereof but that, immediately before the occurrence of the event or events giving rise to the dispute, was an investment of nationals or companies of the other Party, shall be treated as a national or company of such other Party in accordance with Article 25(2)(b) of the ICSID Convention.’

## **B. Applicable Law**

110. It is also appropriate to consider the question of applicable law. The Claimants’ claims are presented under Article VI(3)(a)(i) of the BIT, which includes a reference to the ICSID Convention. Article 42(1) of the ICSID Convention provides that:

‘The Tribunal shall decide a dispute in accordance with such rules of law as may be agreed by the parties. In the absence of such agreement, the Tribunal shall apply the law of the Contracting State party to the dispute (including its rules on the conflict of laws) and such rules of international law as may be applicable.’

### *1. Position of the Claimants*

111. The Tribunal understands the Claimants’ position to be that the law principally governing the Claimants’ substantive investor protections is the BIT.<sup>122</sup> The expert report of Professor Cheng, submitted in support of the Claimants’ claims, acknowledges the provisions of Article 42(1) of the ICSID Convention, but asserts that both the Claimants

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<sup>122</sup> See, e.g., Cheng ER, p. 15.

and Ukraine ‘agree that this dispute is brought under [the BIT], to which Ukraine is a signatory. The Parties have thus agreed that the applicable rules of law are contained in the [BIT], satisfying Article 42(1) of the ICSID Convention.’<sup>123</sup>

## 2. *Position of the Respondent*

112. For its part, the Respondent does not agree that the BIT constitutes an agreement as to the applicable law within the meaning of Article 42(1) of the ICSID Convention. It submits that that the BIT ‘does not contain a provision as to the applicable law’, which means that, following Article 42(1) of the ICSID Convention, the Tribunal may have reference to the BIT, general principles of international law, and Ukrainian domestic law.<sup>124</sup>

## 3. *Determination of the Tribunal*

113. The Tribunal observes that the Claimants’ claims are expressed by reference to the substantive standards of protection in the BIT, and that the Respondent has defended those claims on this basis. In this respect, the Tribunal considers that the applicable law consists, for the most part, of the BIT, as interpreted in accordance with international law. However, the Tribunal agrees with the Respondent that, in addition to applying the provisions of the BIT, it will have to consider Ukrainian law, in particular as the Claimants’ claims are at least in part based on asserted contractual rights. In this respect, the Tribunal agrees with the view expressed by the ICSID tribunal in *Asian Agricultural Products v Sri Lanka*, which held that:

‘[I]t should be noted that the Bilateral Investment Treaty is not a self-contained closed legal system limited to provide for substantial material rules of direct applicability, but it has to be envisaged within a wider juridical context in which rules from other sources are integrated through implied incorporation methods, or by direct reference to certain supplementary rules, whether of international law character or of domestic law nature.’<sup>125</sup>

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<sup>123</sup> Cheng ER, pp. 15-17.

<sup>124</sup> Respondent’s Counter-Memorial, paras. 337-338.

<sup>125</sup> *Asian Agricultural Products Ltd v Sri Lanka* (ICSID Case No ARB/87/3), Award of 27 June 1990, para. 21; cited in Respondent’s Counter-Memorial, para. 339.

## **V. JURISDICTION AND ADMISSIBILITY**

### **A. Jurisdiction of the Tribunal over the Claimants' Claims**

#### *1. Position of the Claimants*

114. The Claimants assert that they are 'companies of a Party' (namely, the United States) which have an 'investment' in Ukraine that falls within the scope of protection of the BIT. They argue that 'Bosh is an enterprise incorporated under the laws of New Jersey', and that 'B&P, although incorporated under the law of Ukraine is, according to Article VI(8) of the Treaty, to be treated as a national of the other Contracting Party.'<sup>126</sup>

115. Article I(1)(b) of the BIT defines 'company' of a Party as meaning:

'any kind of corporation, company, association, partnership, or other organisation, legally constituted under the laws and regulations of a Party or a political subdivision thereof whether or not organised for pecuniary gain, or privately or governmentally owned or controlled.'<sup>127</sup>

116. The Claimants submit that Bosh is incorporated in New Jersey and, as such, qualifies as a 'company' of the United States.

117. As for the standing of B&P to present claims under the BIT, Article VI(8) of the BIT provides, in part, that:

'any company legally constituted under the applicable laws and regulations of a Party or political subdivision thereof but that, immediately before the occurrence of the event or events giving rise to the dispute, was an investment of nationals or companies of the other Party, shall be treated as a national or company of such other Party in accordance with Article 25(2)(b) of the ICSID Convention.'<sup>128</sup>

118. Also relevant to this provision is the definition of 'investment' in Article I(1)(a) of the BIT. This provides in part that the term 'investment' means:

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<sup>126</sup> Claimants' Memorial, p. 18.

<sup>127</sup> BIT, Art I(1)(b).

<sup>128</sup> BIT, Art VI(8).

‘every kind of investment in the territory of one Party owned or controlled directly or indirectly by nationals or companies of the other Party, such as equity, debt, and services and investment contracts; and includes: ... (b) a company or shares of stock or other interests in a company or interest in the assets thereof.’<sup>129</sup>

119. As B&P is incorporated under the laws of Ukraine, and because 94.5% of its shares in are owned by Bosh, the Claimants submit that B&P constitutes an ‘investment’ of Bosh, and therefore is to be treated as a company of the United States under Article VI(8).<sup>130</sup>

120. The Claimants also assert that they have an ‘investment’ in Ukraine within the meaning of the BIT, and which also satisfies the requirement under the ICSID Convention that the dispute arise directly out of an ‘investment’.<sup>131</sup>

121. ‘Investment’ is defined in Article I(1)(a) of the BIT in part as meaning:

‘every kind of investment in the territory of one Party owned or controlled directly or indirectly by nationals or companies of the other Party, such as equity, debt, and service and investment contracts, and includes:

- (i) tangible and intangible property, including rights, such as mortgages, lines and pledges;
- (ii) a company or shares of stock or other interests in a company or interests in the assets thereof;
- (iii) a claim to money or a claim to performance having an economic value, and associated with an investment;
- (iv) intellectual property which includes, inter alia, rights relating to:
  - literary and artistic works, including sound recordings,
  - inventions in all fields of human endeavour,
  - industrial designs,
  - semiconductor mask works,
  - trade secrets, know-how, and confidential business information,
  - and
  - trademarks, service marks, and trade names; and
- (v) any right conferred by law or contract, and any licences and permits pursuant to law.’<sup>132</sup>

122. The Claimants argue that their ‘investment’ included:

‘(i) the value of Bosh’s shareholdings in B&P ...; (ii) the rights conferred by the Contract and its value; (iii) [a] claim to performance having an economic value; (iv) goodwill and the technical processes and know-how made available to the Project

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<sup>129</sup> BIT, Art I(1)(a).

<sup>130</sup> Claimants’ Memorial, p. 18.

<sup>131</sup> *Id.*

<sup>132</sup> BIT, Art I(1)(a).

through B&P personnel; and (v) the tangible and intangible property of B&P's interest in the joint venture.'<sup>133</sup>

123. The Claimants also submit that they are entitled to invoke the BIT's investor-State dispute settlement procedure, which is contained in Article VI.

124. Article VI(1) provides that an 'investment dispute' is:

'a dispute between a Party and a national or company of the other Party arising out of or relating to (a) an investment agreement between that Party and such national or company; (b) an investment authorisation granted by that Party's foreign investment authority to such national or company; or (c) an alleged breach of any right conferred or created by this Treaty with respect to an investment.'<sup>134</sup>

125. Article VI(2) goes on to provide that in the event of an 'investment dispute', the parties to the dispute are to seek a resolution by negotiations. If the dispute cannot be settled amicably, the national or company concerned may choose to submit the dispute for resolution:

'(a) to the courts or administrative tribunals of the Party that is a party to the dispute; or  
(b) in accordance with any applicable, previously agreed dispute-settlement procedures; or  
(c) in accordance with the terms of paragraph 3.'<sup>135</sup>

126. Article VI(3) states that if 'the national or company concerned has not submitted the dispute for resolution under paragraph 2(a) or (b) and that six months have elapsed from the date on which the dispute arose', that national or company may 'consent in writing to the submission of the dispute for settlement by binding arbitration.'<sup>136</sup>

127. Three options are provided for the national or company, namely submission of the dispute to ICSID, provided that the Party is a party to the ICSID Convention; submission of the dispute to the ICSID Additional Facility, in the event that ICSID is not available; or submission of the dispute to UNCITRAL arbitration.<sup>137</sup>

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<sup>133</sup> Claimants' Memorial, p. 23.

<sup>134</sup> BIT, Art VI(1).

<sup>135</sup> BIT, Art VI(2).

<sup>136</sup> BIT, Art VI(3).

<sup>137</sup> BIT, Art VI(3).

128. The United States signed the ICSID Convention on 27 August 1965, and ratified it on 10 June 1966, to enter into force for the United States on 14 October 1966.<sup>138</sup> Ukraine signed the ICSID Convention on 3 October 1998, and ratified it on 7 June 2000 to enter into force for Ukraine on 7 July 2000. Hence, each of the United States and Ukraine is a party to the ICSID Convention, with the result that ICSID is available for the purposes of Article VI(3)(a)(i) of the BIT.

129. The Claimants submit that the Respondent has given its consent to ICSID arbitration by virtue of Article VI(4) of the BIT, in which ‘[e]ach Party hereby consents to the submission of any investment dispute for settlement by binding arbitration in accordance with the choice specified in the written consent of the national or company under paragraph 3’, namely the national or company’s submission of the dispute to international arbitration.<sup>139</sup>

130. The Claimants maintain that their claims are claims under the BIT, rather than claims under the 2003 Contract. They note that their claims concern not only the University’s alleged non-compliance with its contractual obligations, but also the conduct of the CRO and the Ukrainian courts.<sup>140</sup>

## *2. Position of the Respondent*

131. The Respondent does not contest the standing of Bosh and B&P to assert a claim under the BIT. Nor does the Respondent challenge the Claimants’ submission that they have made an ‘investment’ in Ukraine within the meaning of the BIT. Although the Respondent initially objected to the Tribunal’s jurisdiction on the basis that all of the claims were ‘fundamentally contractual’,<sup>141</sup> ultimately the Respondent did not pursue its objection that the Tribunal lacked jurisdiction due to the contractual nature of the claims, but rather asserted that the Claimants’ claims neither arose under the BIT nor amounted to ‘investment disputes’.

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<sup>138</sup> ICSID, ‘List of Contracting States and other Signatories of the Convention (as of July 25, 2012)’, Document ICSID/3, available at <[www.worldbank.org/icsid](http://www.worldbank.org/icsid)> (last accessed 29 August 2012).

<sup>139</sup> BIT, Art VI(4).

<sup>140</sup> Claimants’ Post-Hearing Brief, paras. 15-17.

<sup>141</sup> Respondent’s Counter-Memorial, paras. 216-235.

### 3. *Determination of the Tribunal*

132. The Tribunal finds that Bosh and B&P are ‘companies’ within the meaning of the BIT, that the Claimants have made an ‘investment’ in Ukraine, and that the Claimants are entitled to invoke the investor-State dispute settlement procedure in Article VI of the BIT.

## **B. Admissibility of the Claimants’ Claim under the Umbrella Clause**

### 1. *Position of the Claimants*

133. In the absence of other objections, the principal jurisdictional controversy between the parties concerns the claim asserted by the Claimants under the umbrella clause in Article II(3)(c) of the BIT. The Claimants concede that their previous counsel ‘should have elaborated upon this argument’ earlier in the arbitration, but the Claimants argue that they raised this claim in their Memorial and their Reply Memorial.<sup>142</sup> The Claimants explain that they ‘remedied this omission [in their] skeleton issues statement and addressed the relevant arguments in oral submissions’.<sup>143</sup> In any event, the Claimants argue that the Respondent has addressed the umbrella clause issue in its written submissions.<sup>144</sup>

### 2. *Position of the Respondent*

134. The Respondent maintains its objection to the Claimants’ claim under the umbrella clause in Article II(3)(c) of the BIT.<sup>145</sup> The Respondent’s objection is principally made on the basis that that claim was made too late and is ‘untimely’.<sup>146</sup>

135. The Respondent submits that although the Claimants referred to the umbrella clause in their Memorial and Reply, they had not identified ‘the contractual breaches complained of’, and had ‘made no attempt to establish these breaches under the governing law of the 2003 Agreement, i.e., Ukrainian law.’<sup>147</sup> The Respondent further notes that the Claimants had, in their Reply, merely sought to invoke the umbrella clause as ‘an

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<sup>142</sup> Claimants’ Post-Hearing Brief, para. 93.

<sup>143</sup> *Id.*

<sup>144</sup> Claimants’ Post-Hearing Brief, paras 94-99.

<sup>145</sup> Respondent’s Counter-Memorial, paras. 216-235; Respondent’s Rejoinder, paras. 169-178; Respondent’s Post-Hearing Brief, paras. 151-158.

<sup>146</sup> Respondent’s Post-Hearing Brief, paras. 151-158.

<sup>147</sup> Respondent’s Post-Hearing Brief, para. 151.

alternative ground for the Tribunal's jurisdiction over this dispute',<sup>148</sup> and that the Claimants' expert, Professor Tai-Heng Cheng, had not addressed the umbrella clause in his report.<sup>149</sup> Accordingly, the Respondent asserted in its Rejoinder that the Claimants appeared to have withdrawn their umbrella clause claim.<sup>150</sup> The Respondent observed that this claim was, first, ill-formulated (in the Claimants' Memorial), then seemingly abandoned (in the Claimants' Reply), such that the Respondent did not address these claims seriously (in its Counter-Memorial and Rejoinder), with the result that the Respondent has not had the opportunity to address those claims properly.<sup>151</sup> However, the umbrella clause claim had then resurfaced in the Claimants' skeleton outline of 2 December 2011 and opening oral submissions on 7 December 2011.<sup>152</sup> The Respondent's position is that, by reason of this confined pleading, the umbrella clause claims should 'be dismissed in their entirety without any further consideration of their merits.'<sup>153</sup>

### 3. Determination of the Tribunal

136. The Tribunal understands the Respondent's objection to the Claimants' umbrella clause claim as an objection to the admissibility of that claim, rather than as an objection to the Tribunal's jurisdiction to determine the claim. In this respect, the Tribunal agrees with the tribunal in *Chevron Corporation and Texaco Petroleum Company v Ecuador*, which explained the distinction between jurisdiction and admissibility as follows:

'An objection to the admissibility of a claim does not, of course, impugn the jurisdiction of a tribunal over the disputing parties and their dispute; to the contrary, it necessarily assumes the existence of such jurisdiction; and it only objects to the tribunal's exercise of such jurisdiction in deciding the merits of a claim beyond a preliminary objection.'<sup>154</sup>

137. In the present case, the Respondent does not contest the Tribunal's personal jurisdiction over the Claimants, nor the subject-matter jurisdiction of the Claimants' claims insofar as they fall within the umbrella clause (although the Respondent does

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<sup>148</sup> Respondent's Post-Hearing Brief, para. 152.

<sup>149</sup> Respondent's Post-Hearing Brief, paras. 153-154.

<sup>150</sup> Respondent's Post-Hearing Brief, para. 155.

<sup>151</sup> *Id.*

<sup>152</sup> Respondent's Post-Hearing Brief, para. 156.

<sup>153</sup> Respondent's Post-Hearing Brief, para. 158.

<sup>154</sup> *Chevron Corporation and Texaco Petroleum Company v Ecuador* (Third Interim Award on Jurisdiction and Admissibility of 27 February 2012), para. 4.91.



contest this latter point.) Nor does the Respondent seek to argue that the claim under the umbrella clause is outside the temporal scope of the Tribunal's jurisdiction. Rather, the Respondent's preliminary objection is essentially that as the Claimants failed to articulate their umbrella clause claim until the substantive hearing and their Post-Hearing Brief, the Tribunal should decline to determine the claim.<sup>155</sup>

138. The Tribunal agrees that the presentation of the Claimants' case with regard to the umbrella clause claim has lacked precision and consistency, and that this has given rise to a degree of confusion. Nevertheless, the pleadings show that the Claimants did advert to a claim under the umbrella clause, and that the Respondent's Counter-Memorial contains a section which deals with the umbrella clause.<sup>156</sup> In its Rejoinder, the Respondent reiterated these submissions,<sup>157</sup> and the Respondent made relevant submissions in its Post-Hearing Brief.<sup>158</sup> In the circumstances, the Tribunal is of the view that the Respondent cannot maintain that it was completely taken by surprise by the presentation of the Claimants' claim at the substantive hearing.

139. Although this may be close to the margin for appropriate pleading, the Tribunal finds that the Claimants' claim under the umbrella clause is within the Tribunal's jurisdiction, was not made in an untimely fashion, and that in all the circumstances of the pleadings, principles of fairness do not require that the claims be rejected.

140. Accordingly, the Tribunal determines that it has jurisdiction over all of the Claimants' claims, and none is inadmissible.

## **VI. ATTRIBUTION**

141. The Claimants next submit that the conduct of which it complains is attributable to Ukraine under the law of State responsibility. The Claimants' claims relate to the

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<sup>155</sup> See, e.g., Transcript, Day 1, p. 80, lines 21-22; p. 81, line 1 (Mr Willems); p. 151, line 7 – p. 153, line 6 (Mr Willems).

<sup>156</sup> Respondent's Counter-Memorial, paras. 236-246.

<sup>157</sup> Respondent's Rejoinder, paras. 179-189.

<sup>158</sup> Respondent's Post-Hearing Brief, paras. 149-184.

conduct of various entities; namely, the CRO, the Ukrainian courts, the Ministry of Justice, and the University.

## **A. The CRO, the Ukrainian Courts, and the Ministry of Justice**

### *1. Position of the Claimants*

142. The Claimants argue that the CRO, the Ukrainian courts, and the Ministry of Justice are all ‘State organs’ within the meaning of Article 4 of the Articles on State Responsibility of the International Law Commission (‘ILC’).<sup>159</sup> Article 4 provides that:

‘ARTICLE 4  
*Conduct of organs of a State*

1. The conduct of any State organ shall be considered an act of that State under international law, whether the organ exercises legislative, executive, judicial or any other functions, whatever position it holds in the organisation of the State, and whatever its character as an organ of the central government or of a territorial unit of the State.

2. An organ includes any person or entity which has that status in accordance with the internal law of the State.’<sup>160</sup>

143. The Claimants submit that the CRO and the Ministry of Justice are ‘administrative agencies’ of Ukraine (and as such ‘State organs’),<sup>161</sup> and the Ukrainian courts are the judicial arm of Ukraine (and also a ‘State organ’), within the meaning of Article 4 of the ILC Articles on State Responsibility.

### *2. Position of the Respondent*

144. The Tribunal does not understand that the Respondent contests that any of the CRO, the Ukrainian courts, and the Ministry of Justice are not ‘State organs’ within the meaning of Article 4 of the ILC Articles on State Responsibility, and that their conduct is not attributable to Ukraine.<sup>162</sup>

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<sup>159</sup> Claimants’ Post-Hearing Brief, para. 19.

<sup>160</sup> ILC Articles on State Responsibility, Art 4.

<sup>161</sup> Claimants’ Reply, para. 122; Claimants’ Post-Hearing Brief, para. 21.

<sup>162</sup> In the Respondent’s Counter-Memorial, para. 331, the Respondent accepted that ‘the CRO’s actions and the courts’ actions could in some circumstances be attributed to Respondent’, but argued that the actions of the CRO and the courts ‘could not give rise to any liability.’ The Respondent did not address this issue in its subsequent written submissions.

### 3. *Determination of the Tribunal*

145. The Tribunal also recalls that, on the Respondent's own description, the CRO is an 'independent financial control authority within the Ministry of Finance of Ukraine'.<sup>163</sup> Further, its purpose is to ensure that 'the entities, institutions and organisations that receive State funding comply with the requirements of the laws of Ukraine regarding the use and accounting of budget funds and the use of State property.'<sup>164</sup>

146. The Tribunal determines that the conduct of the CRO is plainly attributable to Ukraine.

147. The conduct of the Ukrainian courts, as the judicial arm of Ukraine, and the Ministry of Justice, as a government department, likewise is attributable to Ukraine.

## **B. The University**

### 1. *Position of the Claimants*

148. The Claimants contend that the conduct of the University is attributable to the State, as it is a 'State budget entity that receives funding from the national government and whose rector is appointed by the President of Ukraine and holds the rank of minister.'<sup>165</sup>

149. Although this position was later abandoned, the Claimants initially advanced the view that the University was a State organ within the meaning of Article 4 of the ILC Articles on State Responsibility.<sup>166</sup>

150. The Claimants' position, as put forward at the substantive hearing and in their Post-Hearing Brief, is that the conduct of the University is attributable to Ukraine either on the

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<sup>163</sup> Respondent's Counter-Memorial, para. 94.

<sup>164</sup> *Id.*

<sup>165</sup> Claimants' Reply, para. 122.

<sup>166</sup> See, e.g., Claimants' Memorial, p. 18, where the Claimants submitted that: 'Given its unique legal status under Ukrainian law, the University likewise qualifies as a State entity.'

basis of Article 5 of the ILC Articles on State Responsibility, or, alternatively, on the basis of Article II(2)(b) of the BIT.<sup>167</sup>

151. Article 5 of the ILC Articles on State Responsibility provides that:

‘ARTICLE 5  
*Conduct of persons or entities exercising elements of governmental authority*

The conduct of a person or entity which is not an organ of the State under Article 4 but which is empowered by the law of that State to exercise elements of the governmental authority shall be considered an act of the State under international law, provided the person or entity is acting in that capacity in the particular instance.’<sup>168</sup>

152. The Claimants call in aid the ILC’s commentary to Article 5, which states that Article 5 extends to such ‘autonomous institutions as exercise public functions of a legislative or administrative character’.<sup>169</sup> In its commentary, the ILC adds that:

‘of particular importance will be not just the content of the powers, but the way they are conferred on an entity, the purposes for which they are to be exercised, and the extent to which the entity is accountable to government for their exercise.’<sup>170</sup>

153. The Claimants also refer to the ICSID tribunal’s Decision on Jurisdiction in *Toto Construzioni Generali SpA v Lebanon*, in which the tribunal found that the conduct of an ‘independent entity’ with ‘financial and administrative autonomy’ could be attributed to the State.<sup>171</sup> The Claimants note that, as in the present case, in *Toto Construzioni*, the claimant ‘had contracted with the entity rather than with Lebanon.’<sup>172</sup>

154. The Claimants argue that the University is ‘funded by the Ukrainian State’; is ‘delegated control over State property to establish and maintain its campuses,’<sup>173</sup> is empowered by a ‘State charter’ and that the Rector of the University exercises authority ‘delegated to him under Ukrainian legislation.’<sup>174</sup> The power to appoint the Rector lay

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<sup>167</sup> Claimants’ Post-Hearing Brief, para. 20-22.

<sup>168</sup> ILC Articles on State Responsibility, Art 5.

<sup>169</sup> Claimants’ Post-Hearing Brief, para. 23; James Crawford, *The International Law Commission’s Articles on State Responsibility: Introduction, Text and Commentaries* (2002), pp. 100-101.

<sup>170</sup> Crawford, p. 101.

<sup>171</sup> *Toto Construzioni Generali SpA v Lebanon* (ICSID Case No ARB/07/12), Decision on Jurisdiction of 8 September 2009, para. 50; cited in Claimants’ Post-Hearing Brief, para. 24.

<sup>172</sup> Claimants’ Post-Hearing Brief, para. 24.

<sup>173</sup> Claimants’ Post-Hearing Brief, para. 26.

<sup>174</sup> *Id.*

initially with the Office of the President, and subsequently with the Cabinet.<sup>175</sup> The University is also subject to the control of the CRO.<sup>176</sup> Further, although the Respondent has argued that the Joint Activity was ‘commercial’ in nature, the Claimants also submit that this does not prevent the University’s conduct from being attributed to Ukraine.<sup>177</sup>

155. The alternative contention is that the University is a ‘State enterprise’ within the meaning of Article II(2)(b) of the BIT.<sup>178</sup>

‘Each Party shall ensure that any State enterprise that it maintains or establishes acts in a manner that is not inconsistent with the Party’s obligations under this Treaty wherever such enterprise exercises any regulatory, administrative or other governmental authority that the Party has delegated to it, such as the power to expropriate, grant licenses, approve commercial transactions, or impose quotas, fees or other charges.’<sup>179</sup>

156. The term ‘State enterprise’ is defined in Article I(1)(f) of the BIT as ‘an enterprise owned, or controlled through ownership interests, by a Party.’<sup>180</sup>

157. The Claimants submit that the University may be considered a ‘State enterprise’ for which the Respondent is responsible, because the term ‘State enterprise’ should be understood as including ‘a government-owned, chartered corporate entity such as the University.’<sup>181</sup> In support of this argument, the Claimants refer to the Law on Higher Education of Ukraine (Law No 2984-III), which provides in Article 17 that the State ‘implements State policy in the area of higher education’, and Article 3 of the Law on Higher Education of Ukraine provides that State policy is ‘determined by the Verkhova Rada of Ukraine’, being Ukraine’s Parliament.<sup>182</sup>

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<sup>175</sup> *Id.*

<sup>176</sup> *Id.*

<sup>177</sup> Claimants’ Post-Hearing Brief, paras. 28-31.

<sup>178</sup> Claimants’ Memorial, p. 48.

<sup>179</sup> BIT, Art II(2)(b).

<sup>180</sup> BIT, Art I(1)(f).

<sup>181</sup> Claimants’ Post-Hearing Brief, paras. 32, 35.

<sup>182</sup> Claimants’ Post-Hearing Brief, para. 34, citing Law on Higher Education of Ukraine (Law No 2984-III) of 17 January 2002, Arts 3,17 (Exhibit RLA-103).

## 2. Position of the Respondent

158. For its part, the Respondent argues that the University is ‘a separate and autonomous juridical entity which is not a party to the ICSID arbitration’, whose conduct ‘is not attributable to Ukraine’.<sup>183</sup>

159. The Respondent contends that the University is not an ‘organ of the State’ within the meaning of Article 4 of the ILC Articles on State Responsibility on the basis that the University is legally and financially distinct from the State,<sup>184</sup> and further, that the University is not a *de facto* organ of the State as it is ‘not part of the structure of any Ministry’ and does not act in that capacity.<sup>185</sup>

160. The Respondent separately argues that the University’s conduct is not attributable to Ukraine under Article 5 of the ILC Articles on State Responsibility. It argues that the Claimants have misstated the ‘functional’ test that applies to Article 5,<sup>186</sup> and contend that the Claimants must establish both that the University is empowered to exercise governmental authority, and that the University actually exercised such authority *vis-à-vis* the Claimants in deciding to terminate the 2003 Contract.<sup>187</sup> The Respondent draws support from the ILC’s commentary to Article 5, where the ILC explains that:

‘The generic term “entity” reflects the wide variety of bodies which, though not organs, may be empowered by the law of a State to exercise elements of governmental authority. They may include public corporations, semi-public entities, public agencies of various kinds and even, in special cases, private companies, provided that in each case the entity is empowered by the law of the State to exercise functions of a public character normally exercised by State organs, and the conduct of the entity relates to the exercise of the governmental authority concerned.’<sup>188</sup>

161. As to its first contention, the Respondent argues that ‘the University is not empowered under Ukrainian law to exercise elements of governmental authority’, for ‘the provision of education and the management of State property do not require the exercise of any

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<sup>183</sup> See, e.g., Respondent’s Counter-Memorial, paras. 281-335; Respondent’s Rejoinder, paras. 198-201; Respondent’s Post-Hearing Brief, paras. 9-27.

<sup>184</sup> Respondent’s Post-Hearing Brief, para. 13.

<sup>185</sup> Respondent’s Post-Hearing Brief, para. 14.

<sup>186</sup> Respondent’s Post-Hearing Brief, para. 20.

<sup>187</sup> *Id.*

<sup>188</sup> James Crawford, *The International Law Commission’s Articles on State Responsibility: Introduction, Text and Commentaries* (2002), p. 100.

public power’,<sup>189</sup> and in addition, ‘the University is not empowered to enter into commercial agreements on behalf of the State’, and ‘it did not do so’ in relation to the 2003 Contract.<sup>190</sup>

162. As to its second contention, the Respondent argues that, even if the University is empowered to exercise governmental authority, the termination of the 2003 Contract was not carried out in the exercise of such authority; it was simply the termination of a commercial agreement, rather than the carrying out of any sovereign act.<sup>191</sup>

### 3. *Determination of the Tribunal*

163. Although it was initially submitted by the Claimants that the conduct of the University was attributable to Ukraine under Article 4 of the ILC Articles, this position was later abandoned. For the avoidance of doubt, the Tribunal could not agree that the University is a ‘State organ’ within the meaning of Article 4 of the ILC Articles.

164. As for the question of attribution under Article 5 of the ILC Articles, the Tribunal agrees with the Respondent that in order for the University’s conduct to be attributable to Ukraine, it must be established both that:

- (1) the University is empowered by the law of Ukraine to exercise elements of governmental authority; and
- (2) the conduct of the University relates to the exercise of that governmental authority.<sup>192</sup>

165. As to the first of these two limbs, the question of the University’s authority to exercise elements of governmental authority raises complex issues concerning the University’s status under Ukrainian law.

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<sup>189</sup> Respondent’s Post-Hearing Brief, para. 22.

<sup>190</sup> Respondent’s Post-Hearing Brief, para. 23.

<sup>191</sup> Respondent’s Post-Hearing Brief, paras. 24-27, referring to *Maffezini v Spain* (ICSID Case No ARB/97/7, Decision on Jurisdiction of 25 January 2000), para. 80; and *Jan de Nul NV and Dredging International NV v Egypt* (ICSID Case No ARB/04/13, Award of 6 November 2008), paras. 167-171.

<sup>192</sup> James Crawford, *The International Law Commission’s Articles on State Responsibility: Introduction, Text and Commentaries* (2002), p. 100.

166. Each party has submitted largely uncontroversial evidence concerning the University's status under Ukrainian law.<sup>193</sup> The University's autonomous status was established by the Decree of the President No 1496/99 of 25 November 1999 (Decree on National Taras Shevchenko University),<sup>194</sup> and was confirmed in the University's Charter of 2000, and the current Charter of 2009. The Charter of 2000, which was effective from 14 January 2000 until 14 March 2007, included the following provision concerning its autonomy:

'The University has the self-governing (autonomous) status of a higher educational institution, which within the limits of the competences granted by laws and other regulatory-legal acts of Ukraine, independently resolves issues of the training and advanced training of highly-qualified specialists, the education of a nationally-conscious intelligentsia.'<sup>195</sup>

167. The Charter of 2009 also confirms that the University is a separate legal entity, in the following terms:

'The University shall be a legal entity, have separate property, be able to gain property and personal non-property rights and have obligations in its own name and can be a claimant and respondent in court ... shall have its own balance sheet, emblem, flag.'<sup>196</sup>

168. The 'Law on Higher Education' (Law No 2984-III) of 17 January 2002 enables the University, as an autonomous higher educational institution, to 'organise its own educational processes', 'hire faculty and other personnel', 'develop and implement educational and scientific programs', 'create structural subdivisions, including institutes, colleges, faculties, etc', 'engage in publishing activities', 'engage in joint activity with other education institutions, organisations and enterprises', 'participate in the work of international organisations', and 'make proposals to State organs of educational management regarding possible changes to existing regulatory acts in the area of

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<sup>193</sup> Claimants' Post-Hearing Brief, paras. 22-31; Respondent's Counter-Memorial, paras. 293-304; Respondent's Rejoinder, paras. 198-201.

<sup>194</sup> Decree of the President of Ukraine No 1496/99 (25 November 1999) (Exhibit RLA-96).

<sup>195</sup> Charter of 2000, Art 1.1 (Exhibit R-6); Respondent's Counter-Memorial, para. 27.

<sup>196</sup> Charter of 2009, Art 2 (Exhibit R-52); Respondent's Counter-Memorial, para. 28.



education.’<sup>197</sup> This Law also authorises the University to exercise control over State property to establish and maintain campuses.<sup>198</sup>

169. Although the University also receives income from other sources, such as ‘payments for educational and related services, as well as scientific activities, income from securities, leases of property, credit funds and charitable contributions,’<sup>199</sup> the Tribunal accepts that the University is largely funded by the State budget (from which around 60% of its income was derived for the years 2003-2006).<sup>200</sup>

170. The Rector of the University was until 2007 appointed by the President of Ukraine. In 2008-2009, the power to appoint the Rector was then transferred to the Cabinet of Ministers of Ukraine, but in June 2009, the method of appointing the Rector was again altered such that the Rector is now elected by ‘the Conference of the Labour Collective’, which is ‘the highest self-governing body of the University and is composed of employees of the University.’ The Rector’s appointment is now formally confirmed by order of the Ministry of Education and Science of Ukraine.<sup>201</sup>

171. The Charter of 2009 confirms that University has the right to pursue business activities and make use of property for such activities, as follows:

‘The autonomy of the University shall ... provide for:

The right of the University to make independent decisions and take relevant actions in its educational, scientific-research, instructional and production-business activities:

...

The independent use of property, transferred to the University, and which shall belong to it under operational management right, including for the execution of business activity, leasing it and allowing it to be used.’<sup>202</sup>

172. It is clear from the evidence on the record that the University is a separate legal entity, and also that it has a large degree of autonomy as a higher educational institution

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<sup>197</sup> Respondent’s Counter-Memorial, para. 29, citing the Ukraine Law on Higher Education (No 2984-III) of 17 January 2002, Art 29(2) (Exhibit RLA-103).

<sup>198</sup> Claimants’ Post-Hearing Brief, para. 26, citing the Ukraine Law on Higher Education (No 2984-III) of 17 January 2002, Art 63 (Exhibit RLA-103).

<sup>199</sup> Respondent’s Counter-Memorial, para. 30, referring to Charter of 2000, Art 11(3) (Exhibit R-6).

<sup>200</sup> See, e.g., Huberskyii WS, para. 19; Respondent’s Counter-Memorial, para. 30.

<sup>201</sup> Respondent’s Counter-Memorial, paras. 32-33, referring to Charter of 2000, Art 3.2-3.3 (Exhibit R-6); Charter of 2007, Art 15 (Exhibit R-28); Charter of 2009, Arts 14-17 (Exhibit R-52).

<sup>202</sup> Charter of 2009, Art 6 (Exhibit R-52); Respondent’s Counter-Memorial, para. 35.

concerning the manner in which it organises its educational curricula and develops and implements its various educational and scientific programmes.

173. Nonetheless, the Tribunal considers that the University remains an entity that is empowered by the law of Ukraine to exercise elements of governmental authority. In this regard, it is of no moment that the University has a large degree of autonomy, as the ILC commentary to Article 5 states, that provision also covers ‘autonomous institutions as exercise public functions of a legislative or administrative character.’<sup>203</sup> The Tribunal considers that the provision by the University of, *inter alia*, higher education services and the management of State-owned property in accordance with Presidential Decree No 1496/99 of 25 November 1999, the Law on Higher Education (Law No 2984-III), and the Charters of 2000 and 2009 (which were, respectively, adopted by an Order of the President of Ukraine, and an Order of the Minister of Education and Science of Ukraine)<sup>204</sup> constitute forms of governmental authority that the University is empowered by the law of Ukraine to exercise.

174. For these reasons, the Tribunal determines that the first limb of Article 5 of the ILC Articles on State Responsibility is satisfied.

175. As to the second limb, namely the requirement that the conduct of the University must relate to the exercise of that governmental authority, the Tribunal observes that the ILC commentary explains in this regard as follows:

‘If it is to be regarded as an act of the State for purposes of international responsibility, the conduct of an entity must accordingly concern governmental activity and not other private or commercial activity in which the entity may engage. Thus, for example, the conduct of a railway company to which certain police powers have been granted will be regarded as an act of the State under international law if it concerns the exercise of those powers, but not if it concerns other activities (e.g. the sale of tickets or the purchase of rolling stock.)’<sup>205</sup>

176. In accordance with the ILC’s commentary to Article 5, the Tribunal considers that it is only the ‘governmental activity’ of the University which is attributable to Ukraine

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<sup>203</sup> James Crawford, *The International Law Commission’s Articles on State Responsibility: Introduction, Text and Commentaries* (2002), p. 100.

<sup>204</sup> Respondent’s Counter-Memorial, paras. 26-27.

<sup>205</sup> James Crawford, *The International Law Commission’s Articles on State Responsibility: Introduction, Text and Commentaries* (2002), p. 100.

under Article 5, and not the University's 'private or commercial activity.' In other words, the question that falls for determination is whether the University's conduct in entering into and terminating the 2003 Contract with B&P can be understood or characterised as a form of 'governmental activity', or as a form of 'commercial activity.'

177. The Tribunal recalls that, under the Law on Higher Education (Law No 2984-III), the University has the right to 'engage in joint activity with other education institutions, organisations and enterprises',<sup>206</sup> and that it has the right to do so as an autonomous higher education institution. The University was entitled under its Charter to enter into the 2003 Contract in its own right, and without the need for any particular authorisation by Ukraine. In the Tribunal's view, the University's decision to enter into and subsequently terminate the 2003 Contract with B&P did not relate to the exercise of the University's governmental authority, but by reference to the nature and purpose of the 2003 Contract, as indicated for example in Articles 2(1) and 9(1) of the Contract, the terms of which are set forth above, was a private or commercial activity which was aimed to secure commercial benefits for both parties.

178. For these reasons, the Tribunal finds that the University's conduct in entering into and terminating the 2003 Contract is not attributable to Ukraine under Article 5 of the ILC Articles on State Responsibility.

179. This leaves the Claimants' argument that Ukraine is responsible for the University's conduct by virtue of Article II(2)(b) of the BIT, which provides that:

'Each Party shall ensure that any State enterprise that it maintains or establishes acts in a manner that is not inconsistent with the Party's obligations under this Treaty wherever such enterprise exercises any regulatory, administrative or other governmental authority that the Party has delegated to it, such as the power to expropriate, grant licenses, approve commercial transactions, or impose quotas, fees or other charges.'<sup>207</sup>

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<sup>206</sup> Law on Higher Education (No 2984-III) of 17 January 2002, Art 29(2) (Exhibit RLA-103).

<sup>207</sup> BIT, Art II(2)(b).

180. Although the point was first made by the Claimants in their Memorial,<sup>208</sup> in considering this argument the Tribunal has not had the benefit of submissions from the Respondent.

181. Article I(1)(f) of the BIT defines the term ‘State enterprise’ as ‘an enterprise owned, or controlled through ownership interests, by a Party.’ The Letter of Transmittal from the President of the United States to the Senate which accompanied the BIT merely states in relation to Article II(2)(b) that:

‘Paragraph 2 is designed to ensure that a Party cannot utilize State-owned or controlled enterprises to circumvent its obligations under the Treaty. To this end, it requires each Party to observe its treaty obligations even when it chooses, for administrative or other reasons, to assign some portion of its authority to a state enterprise, such as the power to expropriate, grant licenses, approve commercial transactions, or impose quotas, fees or other charges.’<sup>209</sup>

182. Consistent with the definition of ‘State enterprise’ in Article I(1)(f), Article II(2)(b) assumes that a State enterprise has separate legal personality from ‘the Party’ (here Ukraine).

183. The Tribunal does not agree with the Claimants that the effect of Article II(2)(b) is to render the conduct of the University attributable to Ukraine. Rather, it imposes a positive obligation on Ukraine to ensure that any ‘State enterprise’ that exercises governmental authority acts in a manner that is consistent with Ukraine’s obligations under the BIT. Thus, if a protected investor in Ukraine were to consider that Ukraine had not ensured, consistently with its obligation in Article II(2)(b), that any State enterprise had acted in conformity with Ukraine’s obligations under the BIT, that would give rise to a claim for breach of the BIT against Ukraine. But it does not have the effect of making the conduct of that State enterprise attributable to Ukraine under the law of State responsibility.

184. For these reasons, the Tribunal determines that the conduct of the University that is the subject of these proceedings is not attributable to Ukraine.

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<sup>208</sup> Claimants’ Memorial, p. 48.

<sup>209</sup> Letter of Transmittal from the President of the United States to the Senate, United States – Ukraine BIT (7 November 1994) (Claimants’ Hearing Book, Tab 2).

## **VII. THE CLAIMANTS' CLAIMS**

### **A. Claims for Breach of Articles II(3)(a) and III based on the Conduct of the CRO**

#### *1. Position of the Claimants*

185. The first of the four claims maintained by the Claimants is that the conduct of the CRO constituted a breach of Articles II(3)(a) and III of the BIT.<sup>210</sup>

186. Article II(3)(a) of the BIT provides that:

‘Investments shall at all times be accorded fair and equitable treatment, shall enjoy full protection and security and shall in no case be accorded treatment less than that required by international law.’<sup>211</sup>

187. Article III(1) of the BIT provides in part that:

‘Investments shall not be expropriated or nationalised either directly or indirectly through measures tantamount to expropriation of nationalisation (“expropriation”) except: for a public purpose; in a non-discriminatory manner; upon payment of prompt, adequate and effective compensation; and in accordance with due process of law and the general principles of treatment provided for in Article II(2).’<sup>212</sup>

188. In the Claimants’ submission, ‘the [CRO] ordered the University to terminate its relationship with B&P. This termination order ... substantially deprived Bosh of its enjoyment of its investment in Ukraine – i.e. its participation in the Joint Activity, through B&P.’<sup>213</sup> The Claimants also argue that ‘the process by which the [CRO] came to its decision did not afford fair and equitable treatment to B&P’ because its decision-making with respect to the CRO Audit and Cross-Revision was ‘marred by a lack of due process and it also led to a manifestly arbitrary result.’<sup>214</sup> It is convenient to set out the

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<sup>210</sup> Claimants’ Post-Hearing Brief, paras 86(a), 102-137. These claims were also presented, albeit somewhat differently, in the Claimants’ Memorial, pp. 31-41 (expropriation), and pp. 41-46 (fair and equitable treatment); as well as in the Claimants’ Reply, paras. 132-177 (fair and equitable treatment), and paras. 178-210 (expropriation).

<sup>211</sup> BIT, Art II(3)(a).

<sup>212</sup> BIT, Art III(1).

<sup>213</sup> Claimants’ Post-Hearing Brief, para. 102.

<sup>214</sup> *Id.*

details of the Claimants' claims for breach of the fair and equitable treatment standard (Article II(3)(a)) and for expropriation (Article III) separately.

189. *Fair and Equitable Treatment:* The Claimants submit that the CRO's conduct violated due process, in that the CRO's cross-revision exercise amounted to an audit of B&P's compliance with the 2003 Contract, which went further than what was authorised under Ukrainian law. The Claimants also submit that B&P was denied 'any meaningful opportunity ... to participate in the process, or to contest [the CRO's] findings',<sup>215</sup> and that these actions constitute a breach of the obligation to accord fair and equitable treatment under Article II(3)(a) of the BIT.<sup>216</sup>

190. In particular, the Claimants submit that the CRO's initially stated reason for the recommendation to terminate the 2003 Contract was that 'the Joint Activity was not consistent with Ukraine's State property and budget laws', and later the CRO stated that the reason for the recommendation was that B&P had failed to comply with its obligations under the 2003 Contract.<sup>217</sup> The Claimants submit the second of these reasons that they alleged were adopted by the Respondent after the commencement of the present arbitration proceedings constitutes 'an egregious expansion of the [CRO's] authority to conduct a cross-revision exercise.'<sup>218</sup>

191. The Claimants refer in this regard to the evidence of Mr Kyrylenko, who had given evidence that the purpose of the Cross-Revision of B&P was merely 'to clarify that such activities indeed took place and were correctly reflected in the accounting of the audited entity'.<sup>219</sup> The Claimants ask, if this was indeed the case, why the CRO then proceeded to engage in a 'painstaking, clause by clause compliance review of B&P's alleged performance under its Joint Activity Agreement with the University.'<sup>220</sup>

192. In addition, or in the alternative, the Claimants argue that the CRO did not accord fair and equitable treatment to the Claimants, as B&P was not afforded due process in the

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<sup>215</sup> Claimants' Post-Hearing Brief, para. 133.

<sup>216</sup> Claimants' Post-Hearing Brief, paras. 110-112, 133-135.

<sup>217</sup> Claimants' Post-Hearing Brief, para. 134.

<sup>218</sup> Claimants' Post-Hearing Brief, para. 135.

<sup>219</sup> Claimants' Post-Hearing Brief, para. 112.

<sup>220</sup> Claimants' Post-Hearing Brief, paras. 113-114.

CRO's Cross-Revision. In the Claimants' submission, these omissions breached the requirement that governmental decisions be put to the test of procedural propriety.<sup>221</sup>

193. In this regard, the Claimants refer to the Award of the ICSID tribunal in *ADC Affiliate Ltd and ADC & ADMC Management Ltd v Hungary*, in which the Tribunal held that:

'Some basic legal mechanisms, such as reasonable advance notice, a fair hearing and an unbiased and impartial adjudicator to assess the actions in dispute, are expected to be readily available and accessible to the investor to make such legal procedure meaningful. In general, the legal procedure must be of a nature to grant an affected investor a reasonable chance within a reasonable time to claim its legitimate rights and have its claims heard. If no legal procedure of such nature exists at all, the argument that "the actions are taken under due process of law rings hollow.'<sup>222</sup>

194. The Claimants further submit that it makes no difference that Ukrainian law does not entitle B&P to comment on drafts since it was not the entity being subjected to the audit (it was the University which was being audited),<sup>223</sup> for there is an international standard of due process with which the Respondent must comply. They also argue that B&P submitted written comments on the Cross-Revision process, but these letters were 'unacknowledged appendices' to the Cross-Revision Report.<sup>224</sup> In summary, it is contended that there was an 'evident lack of procedural fairness' in the manner in which the Claimants were treated by the CRO.<sup>225</sup>

195. *Expropriation*: As for the Claimants' claim of expropriation, the Claimants refer to the CRO's letter to the University dated 10 May 2007, to which reference has already been made. This stated in part that:

'The University shall:

1. Take effective measures to eliminate completely the established inconsistencies and to bring the guilty officials to responsibility with respect to these breaches.

[...]

5. Consider the question of termination of joint activities with B&P, LTD as such as inconsistent with the University status being a [State] budget-maintained institution as well as return the assets to the above-mentioned company. Prevent violations of

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<sup>221</sup> Claimants' Post-Hearing Brief, paras. 110-111, 137.

<sup>222</sup> *ADC Affiliate Ltd and ADC & ADMC Management Ltd v Hungary* (ICSID Case No ARB/03/16), Award of 27 September 2006, para. 435; cited in Claimants' Post-Hearing Brief, para. 111.

<sup>223</sup> Claimants' Post-Hearing Brief, para. 116.

<sup>224</sup> Claimants' Post-Hearing Brief, para. 124.

<sup>225</sup> Claimants' Post-Hearing Brief, para. 125.

effective legislature by the University concerning the use of its assets (State property).

[...]

In case of failure to comply with the requirements herein stated and put forward by the Chief Control and Inspection Administration as well as failure to take sufficient measures to remedy the drawbacks and financial and budgeting breaches, the Administration shall initiate the verification of consistency of the University's management with the held respective positions'.<sup>226</sup>

196. The Claimants submit that 'the documentary evidence ... supports only one conclusion: that the [CRO] effectively ordered senior University officials to immediately terminate the Joint Activity with B&P, or else find alternative means of personal employment.'<sup>227</sup> The Claimants submit that the effect of the CRO's demand is manifestly 'expropriatory',<sup>228</sup> because as a result of this 'order', 'University officials took all necessary steps to cease its relationship with B&P and to immediately terminate the [2003 Contract], without payment of prompt, adequate and effective compensation.'<sup>229</sup> This resulted in a 'complete deprivation of the value and utility of [the Claimants'] investment in Ukraine – because [CRO] officials decided it should be so.'<sup>230</sup>

197. The Claimants argue that the CRO's conduct leading to the termination of the 2003 Contract amounts to an uncompensated 'indirect expropriation' contrary to Article III of the BIT. The Claimants submit that expropriations include not only 'open, deliberate and acknowledged takings of property', but also 'covered or incidental [governmental] interference with the use of property, which has the effect of depriving the owner, in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the host State.'<sup>231</sup> The Claimants submit that the present case amounts to an 'indirect expropriation',<sup>232</sup> which is unlawful unless four conditions are met, which include 'the payment of prompt, adequate and effective compensation and compliance with due process of law'.<sup>233</sup> In the

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<sup>226</sup> Letter dated 10 May 2007 from the CRO to the University (Exhibit R-30); see also Claimants' Memorial, pp. 11-12; Respondent's Counter-Memorial, para. 130; and Claimants' Post-Hearing Brief, para. 103. See also discussion in above n 71.

<sup>227</sup> Claimants' Post-Hearing Brief, para. 108.

<sup>228</sup> Claimants' Post-Hearing Brief, para. 109.

<sup>229</sup> Claimants' Post-Hearing Brief, paras. 109, 126-133, referring *inter alia* to the NAFTA tribunal's Award in *Metalclad Corporation v Mexico* (ICSID Case No ARB(AF)/97/1), Award of 25 August 2000.

<sup>230</sup> Claimants' Post-Hearing Brief, para. 109.

<sup>231</sup> Claimants' Post-Hearing Brief, para. 127, citing *Metalclad Corporation v Mexico* (ICSID Case No ARB(AF)/97/1), Award of 25 August 2000, para. 103.

<sup>232</sup> Claimants' Post-Hearing Brief, para. 127.

<sup>233</sup> Claimants' Post-Hearing Brief, para. 130.



Claimants' submission, because the Respondent has not paid compensation to the Claimants, and because the process by which the CRO decided that the 2003 Contract should be terminated lacked due process, the Respondent is in breach of its obligations under Article III.<sup>234</sup>

## 2. *Position of the Respondent*

198. For its part, the Respondent rejects the Claimants' 'unsubstantiated theories' concerning the CRO.<sup>235</sup> The Respondent observes that the Claimants had had to abandon their complaints regarding 'conspiracy theories at the highest levels of Government' which they had advanced in their earlier submissions,<sup>236</sup> and notes that the Claimants' claims were based on an assertion that the CRO had discovered that the University had lacked the authority to enter into the [2003 Contract], and that a threat was made to 'dismiss the University's management if they did not act to terminate the [2003 Contract].'<sup>237</sup> The Respondent therefore rejects the Claimants' claims that the conduct of the CRO constitutes a breach of the fair and equitable treatment standard, as well as the claims that the same conduct amounts to an unlawful expropriation.

199. *Fair and Equitable Treatment*: First, the Respondent submits that the CRO's audit and the Cross-Revision were carried out in accordance with relevant law and procedures, including the Law of Ukraine 'On the State Control and Revision Service in Ukraine', which provides in part that the main function of the State Control and Revision Service is to 'exercise financial control over the use of State funds',<sup>238</sup> and the 'Procedure for Holding Inspections by the State Control and Revision Service'.<sup>239</sup> The Respondent notes that, in particular, the University was notified of the Audit on 4 May 2006, being several months in advance of the planned Audit; two officers of the CRO were appointed to carry out the Audit on 23 October 2006; B&P was notified of the Cross-Revision of the Joint Activity on 8 December 2006, and was invited to provide documents in relation to

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<sup>234</sup> *Id.*

<sup>235</sup> Respondent's Post-Hearing Brief, para. 28.

<sup>236</sup> Respondent's Post-Hearing Brief, para. 29.

<sup>237</sup> Respondent's Post-Hearing Brief, para. 30.

<sup>238</sup> Respondent's Post-Hearing Brief, para. 33; Law of Ukraine On the State Control and Revision Service in Ukraine (26 January 1993), Art 2 (Exhibit RLA-89).

<sup>239</sup> Respondent's Counter-Memorial, para. 95; Respondent's Post-Hearing Brief, para. 32; Procedure for Holding Inspections by the State Control and Revision Service (20 April 2006) (Exhibit RLA-109).

the Joint Activity; the CRO issued the Cross-Revision Report on 15 December 2006; the CRO issued its Audit Report on 29 December 2006, and the CRO issued instructions to the University on 10 May 2007. The Respondent submits that the Claimants have failed to demonstrate anything surrounding the Audit or the Cross-Revision Report that was at variance with the applicable laws and regulations.<sup>240</sup>

200. Second, the Respondent argues that the CRO's Audit and Cross-Revision were carried out transparently with B&P's participation, and that B&P was not denied 'due process' in relation to the Cross-Revision. In particular, the Respondent notes that B&P was aware of the Audit as early as October 2006, that B&P participated in the Cross-Revision exercise, and that B&P had an opportunity to contest the CRO's Cross-Revision Report, which it did by submitting comments to the CRO as well as by appealing to the General Prosecutor's Office.<sup>241</sup> B&P did not, however, challenge the legitimacy of the Cross-Revision Report before the Ukrainian courts, even though it was aware that it had the possibility of doing so.<sup>242</sup> Further, and in any event, the Respondent argues that the due process requirement in the context of administrative decisions is lower than the judicial due process requirement,<sup>243</sup> and that this was met. As the Respondent put it: 'B&P had notice of the Cross-Revision, it was given an opportunity to participate in the audit process, to review the findings before they were published and to contest the findings both to the [CRO] and to the General Prosecutor's Office.'<sup>244</sup>

201. Third, the Respondent argues that the CRO did not make any finding that the University did not have the requisite authority to enter into the 2003 Contract, and the Claimants made no attempt to corroborate their unsubstantiated claim with evidence.<sup>245</sup>

202. Fourth, the Respondent submits that the Claimants have no basis for suggesting that the CRO ordered or threatened the University to terminate the 2003 Contract.<sup>246</sup> The Respondent observes that the University had already been in discussions with B&P

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<sup>240</sup> Respondent's Post-Hearing Brief, paras. 31, 32-36.

<sup>241</sup> Respondent's Post-Hearing Brief, paras. 41-42.

<sup>242</sup> Respondent's Post-Hearing Brief, paras. 44-45.

<sup>243</sup> Respondent's Post-Hearing Brief, paras. 47-48, referring to *International Thunderbird Gaming Corporation v Mexico* (Award of 26 January 2006), para. 200; and *Genin v Estonia* (ICSID Case No ARB/99/2), Award of 25 June 2001, paras. 364-365.

<sup>244</sup> Respondent's Post-Hearing Brief, para. 49.

<sup>245</sup> Respondent's Post-Hearing Brief, paras. 50-53.

<sup>246</sup> Respondent's Post-Hearing Brief, para. 31.

regarding the implementation of the 2003 Contract prior to the Cross-Revision Report, and that if there had been any pressure, there is no reason why the University would have waited until 13 September 2007 to terminate the 2003 Contract.<sup>247</sup> Further, and in any event, the Respondent submits that the CRO's letter dated 10 May 2007 is misinterpreted by the Claimants.<sup>248</sup> The Claimants interpret the letter as a threat, but the relevant language in the CRO's letter (namely, that the University 'take effective measures to eliminate completely the established inconsistencies and to bring the guilty officials to responsibility with respect to these breaches') was only directed at those issues where the CRO had determined that there had been violations of Ukrainian law; and in relation to the 2003 Contract, the CRO had only recommended that the University 'consider the question' of termination.<sup>249</sup> This was confirmed in the testimony of Mr Kyrylenko, who explained that the University had the discretion to adopt appropriate measures to address the CRO's concerns with respect to the 2003 Contract.<sup>250</sup> For instance, Mr Kyrylenko said in his witness statement that:

'In the letter, the CRO asked the University to consider the possibility of terminating the [2003 Contract] as one of the measures that would allow the University to eliminate the violations discovered during the audit. Had the University discovered another way to eliminate violations related to the joint activity that would have also been acceptable to the CRO. In any case, this letter should not be construed to mean that the CRO ordered the University to terminate the [2003 Contract], because its purpose was only to notify the University of the discovered violations and to propose that the University take appropriate measures to remedy those violations.'<sup>251</sup>

203. In his reply witness statement, Mr Kyrylenko added that:

'I wish to emphasise that the CRO did not impose the means that the University had to use in order to remedy the violations. We did not "pressure" the University to take any action. The University had to decide by itself which measures to take in this regard.'<sup>252</sup>

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<sup>247</sup> Respondent's Post-Hearing Brief, paras. 55-56.

<sup>248</sup> Respondent's Post-Hearing Brief, paras. 54-64.

<sup>249</sup> Respondent's Counter-Memorial, paras. 60-63.

<sup>250</sup> Respondent's Post-Hearing Brief, paras. 58-63; Kyrylenko WS I, paras. 25, 51-52; Kyrylenko WS II, paras. 27, 32.

<sup>251</sup> Kyrylenko WS I, para. 52.

<sup>252</sup> Kyrylenko WS II, para. 32.

204. Mr Kyrlyenko also explained the position at the oral hearing.<sup>253</sup> Hence, the ultimate decision to terminate the 2003 Contract was made by the University, and not by the CRO.<sup>254</sup>

205. Further, the Respondent submits that the item 1 of the letter dated 10 May 2007, in which the CRO directed that the University ‘[t]ake effective measures to eliminate completely the established inconsistencies and to bring the guilty officials to responsibility with respect to these breaches’ did not apply to item 5, in which the CRO merely recommended that the University ‘consider the question of termination’ of the 2003 Contract.<sup>255</sup> As the Respondent submitted, because ‘item 5 did not order termination, the CRO could not impose any administrative sanction for any failure to seek termination of the 2003 Agreement.’<sup>256</sup>

206. *Expropriation:* As for the Claimants’ claims that the CRO’s letter dated 10 May 2007 amounted to an ‘expropriation’ of the Claimants’ rights under the 2003 Contract, the Respondent’s position is as stated above: namely, that the CRO only recommended that the University ‘consider the question’ of termination, and that the ultimate decision was made by the University, rather than by the CRO.<sup>257</sup>

### 3. *Determination of the Tribunal*

207. There are a number of issues to address in determining whether the conduct of the CRO constituted either:

- (1) a breach of the obligation to accord fair and equitable treatment contrary to Article II(2)(a); or
- (2) an expropriation contrary to Article III.

208. *Fair and Equitable Treatment:* The Claimants’ claim for breach of the obligation to accord fair and equitable treatment under Article II(3)(a) is primarily based on the allegations that the CRO’s Audit and Cross-Revision of the Joint Activity was not carried

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<sup>253</sup> Transcript, Day 3, p. 621, line 15 – p. 622, line 2.

<sup>254</sup> Respondent’s Counter-Memorial, para. 64.

<sup>255</sup> Letter from the CRO to the University dated 10 May 2007 (Exhibit R-30); Kyrlyenko WS I, para. 25; Respondent’s Post-Hearing Brief, paras. 59-62.

<sup>256</sup> Respondent’s Post-Hearing Brief, para. 62.

<sup>257</sup> Respondent’s Counter-Memorial, paras. 60-64, 427-431.

out in accordance with Ukrainian law; that B&P was denied due process in the CRO's Cross-Revision exercise; and that the CRO exceeded its mandate in directing the University to terminate the 2003 Contract.

209. The Respondent's defence is that the CRO's Audit and Cross-Revision of the Joint Activity was conducted in conformity with the applicable laws and regulations; that B&P was in fact afforded the right to participate in the Cross-Revision; and that the CRO did not order the termination of the 2003 Contract.

210. Before addressing the Claimants' complaints, the Tribunal makes some observations as to the content of the obligation on Ukraine to accord fair and equitable treatment. The Parties have referred to various arbitral awards and decisions concerning the content of this standard of treatment,<sup>258</sup> and there would not appear to be any major disagreement between the Parties on the content of the obligation. Rather, the Parties join issue on whether Ukraine is in breach of that obligation.

211. Although the Tribunal does not consider itself bound by past decisions of other arbitral tribunals, it recognises that it should pay due regard to the conclusions of such tribunals. In this respect, the Tribunal agrees with the views of the ICSID tribunal in *Bayindir Insaat Turizm Ticaret Ve Sanayi AS v Pakistan*, which stated that, 'unless there are compelling reasons to the contrary', tribunals 'ought to follow solutions established in a series of consistent cases, comparable to the case at hand, but subject of course to the specifics of a given treaty and of the circumstances of the actual case.'<sup>259</sup>

212. Having due regard to the decisions of other arbitral tribunals, the Tribunal records its agreement with the observations of the ICSID tribunal in *Joseph Charles Lemire v Ukraine*, which observed that in order to establish a breach of the obligation under Article II(3)(a) of the BIT, '[i]t requires an action or omission by the State which violates a

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<sup>258</sup> E.g., *Waste Management Inc v Mexico* (ICSID Case No ARB(AF)/00/3), Award of 30 April 2004, para. 98; *Mondev International Inc v United States* (ICSID Case No ARB(AF)/99/2), Award of 11 October 2002, para. 127; *MTD Equity Sdn Bhd and MTD Chile SA v Chile* (ICSID Case No ARB/01/7), Award of 25 May 2004, para. 109 (all cited by the Claimants); and *International Thunderbird Gaming Corporation v Mexico* (Award of 26 January 2004), para. 200; *Genin v Estonia* (ICSID Case No ARB/99/2), Award of 25 June 2001, paras. 364-365 (both cited by the Respondent).

<sup>259</sup> *Bayindir Insaat Turizm Ticaret Ve Sanayi AS v Pakistan* (ICSID Case No ARB/03/19), Award of 27 August 2009, para. 145.

certain threshold of propriety, causing harm to the investor, and with a causal link between action or omission and harm.’<sup>260</sup> The tribunal in that case set out relevant factors, including ‘whether the State made specific representations to the investor’; ‘whether due process has been denied to the investor’; ‘whether there is an absence of transparency in the legal procedure or in the actions of the State’; ‘whether there has been harassment, coercion, abuse of power or other bad faith conduct by the host State’; and ‘whether any of the actions of the State can be labelled as arbitrary, discriminatory or inconsistent.’<sup>261</sup>

213. Turning to the specific complaints of the Claimants, on the basis of the evidence before it, the Tribunal considers that there is nothing to indicate that the CRO’s Audit and Cross-Revision was not in fact carried out in accordance with the applicable Ukrainian laws and regulations. In particular, the Claimants have not established that the CRO’s Audit of the University was anything other than an audit conducted in accordance with the Law of Ukraine ‘On the State Control and Revision Service in Ukraine’, which states that the main task of the State Control and Revision Service is to exercise financial control over the use of State funds.<sup>262</sup> In this regard, the Tribunal accepts that the CRO’s Audit constituted a routine review of the University’s use and management of State funds, and there is no evidence demonstrating that B&P was targeted as a foreign investor.

214. The Tribunal also considers that B&P was entitled to, and was accorded, appropriate due process in the course of the CRO’s Cross-Revision. The evidential record establishes that B&P was informed of CRO’s Audit of the University in October 2006, was informed of the Cross-Revision in December 2006, and participated in the CRO’s Cross-Revision exercise. The record shows that B&P was entitled to, and did, comment on the CRO’s Cross-Revision, and had the opportunity to challenge the Report before the General Prosecutor’s Office (which it did) as well as before the Ukrainian courts (which it did not). Had B&P elected to bring proceedings before the Ukrainian courts, there is no evidence before the Tribunal to establish that the Ukrainian courts would not have afforded B&P a fair hearing.

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<sup>260</sup> *Joseph Charles Lemire v Ukraine* (ICSID Case No ARB/06/18), Decision on Jurisdiction and Liability of 14 January 2010, para. 284.

<sup>261</sup> *Joseph Charles Lemire v Ukraine* (ICSID Case No ARB/06/18), Decision on Jurisdiction and Liability of 14 January 2010, para. 284.

<sup>262</sup> Law of Ukraine On the State Control and Revision Service in Ukraine (26 January 1993), Art 2 (Exhibit RLA-89).

215. The Tribunal does not accept the Claimants' allegation that the CRO's letter dated 10 May 2007 constituted an unambiguous direction to the University to terminate the 2003 Contract. The letter made 15 recommendations, only one of which concerned the University's Joint Activity under the 2003 Contract with B&P. The sole recommendation concerning the Joint Activity was that the University 'consider the question of termination of joint activities with B&P, LTD as such as inconsistent with the University's status being a [State] budget-maintained institution as well as return the assets to the abovementioned company.'<sup>263</sup> This recommendation did not direct that the University terminate the 2003 Contract; rather, it invited the University to consider the possibility of such termination. On this issue, the Tribunal accepts the testimony of Mr Kyrylenko, who explained that the formulation of the recommendation in item 5 of the CRO's letter reserved to the University the discretion to choose how to address the CRO's concerns with regards to the 2003 Contract.<sup>264</sup> The recommendation to consider terminating the 2003 Contract was based on the CRO's findings that B&P was in breach of various obligations under the 2003, including in particular that B&P and the University had not engaged in any joint activities within the meaning of the 2003 Contract.<sup>265</sup>

216. In addition, the Tribunal does not accept that the recommendation made by the CRO in item 5 of the CRO's letter is within the reach of the first paragraph of the CRO's letter, where it was directed that the University shall 'take effective measures to eliminate completely the established inconsistencies and to bring the guilty officials to responsibility with respect to these breaches.'<sup>266</sup> The Tribunal accepts Mr Kyrylenko's testimony that this directive applied to 'the established inconsistencies' identified by the CRO in its Audit Report, but that its letter dated 10 May 2007 only required the University to 'consider the question of termination' of the 2003 Contract.<sup>267</sup>

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<sup>263</sup> Letter from the CRO to the University dated 10 May 2007 (Exhibit R-30).

<sup>264</sup> Kyrylenko WS I, paras. 25, 51-52; Kyrylenko WS II, paras. 27, 32; Transcript, Day 3, p. 618, line 22 – p. 619, line 6 (Mr Kyrylenko).

<sup>265</sup> Transcript, Day 3, p. 617, line 17 – p. 622, line 2 (Mr Kyrylenko).

<sup>266</sup> Letter from the CRO to the University dated 10 May 2007 (Exhibit R-30).

<sup>267</sup> Letter from the CRO to the University dated 10 May 2007 (Exhibit R-30); Kyrylenko WS I, para. 25; Respondent's Post-Hearing Brief, paras. 59-62.

217. For these reasons, the Tribunal rejects the Claimants' claim that the conduct of the CRO constituted a breach of the obligation to accord fair and equitable treatment under Article II(3)(a) of the BIT.

218. *Expropriation*: As for the Claimants' claim that the CRO's conduct constitutes an expropriation contrary to Article III of the BIT, the Tribunal observes that in order to amount to an expropriation, the Claimants must establish that the effect of the CRO's conduct was an interference that caused a substantial deprivation of the Claimants' rights under the 2003 Contract. In this connection, the Tribunal has had regard to the conclusions of the Tribunal in *Pope & Talbot, Inc v Canada*, which held that, in the context of a claim for expropriation contrary to Article 1110 of NAFTA:

'While it may sometimes be uncertain whether a particular interference with business activities amounts to an expropriation, the test is whether that interference is sufficiently restrictive to support a conclusion that the property has been "taken" from the owner. ... [U]nder international law, expropriation requires a "substantial deprivation".'<sup>268</sup>

219. The Tribunal considers that the Claimants' claim for breach of Article III suffers from the evidentiary difficulty surrounding the effect of the CRO's letter dated 10 May 2007. The Claimants assert that the CRO's letter was a direction to the University to terminate the 2003 Contract, but the consistent evidence of Mr Kyrylenko is that the CRO made no such direction to the University, and left it to the University to decide on the most appropriate means to eliminate any inconsistencies. The Tribunal accepts Mr Kyrylenko's explanation of the effect of the 10 May 2007 letter, which is consistent with a plain reading of that letter.

220. Consistent with its conclusions concerning the Claimants' claim for breach of the fair and equitable treatment obligations, the Tribunal thus decides that the CRO's actions did not terminate the 2003 Contract. Rather, the CRO carried out its functions in accordance with applicable Ukrainian law and regulations, and the final decision concerning termination was made by the University. Accordingly, the Tribunal rejects the Claimants' claim that the conduct of the CRO constituted a breach of the obligation not to expropriate investments contrary to Article III of the BIT.

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<sup>268</sup> *Pope & Talbot v Canada* (Interim Award of 26 June 2000), para. 102.



## **B. Claim for Breach of Article II(3)(a) of the BIT Based on the University's Conduct**

### *1. Position of the Claimants*

221. The Claimants' second claim is that the manner in which University officials acted constituted a failure to act in good faith towards B&P and was thus contrary to the obligation to accord fair and equitable treatment under Article II(3)(a), which provides as follows:

'Investment shall at all times be accorded fair and equitable treatment, shall enjoy full protection and security and shall in no case be accorded treatment less than that required by international law.'<sup>269</sup>

222. In particular, the Claimants argue that, rather than seeking to work with B&P to improve its implementation, the approach adopted by University officials, whereby they sought to terminate the 2003 Contract was a violation of the good faith standard embodied in Article II(3)(a), rather than seeking proper implementation of the Agreement.<sup>270</sup> The Claimants assert that University officials failed to enter into dialogue with B&P over its alleged breaches of the Agreement, failed to take any steps to bring themselves into compliance with the Agreement, and actively sought out excuses to justify termination.

223. The Claimants further submit that it was the 'legitimate expectation of each party [to the 2003 Contract] that B&P would benefit from the addition of the University-backed Joint Activity to its international business education network, and that the University would reap the programmatic and financial benefits from revitalisation of the Complex, participation in the Joint Activity and membership in B&P's international business education network.'<sup>271</sup>

224. However, in the Claimants' submission, once the CRO had made its recommendation in its letter dated 10 May 2007, the University adopted the position that the 2003 Contract was void *ab initio* as it was inconsistent with the Commercial Code of Ukraine and the

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<sup>269</sup> BIT, Art II(3)(a).

<sup>270</sup> Claimants' Post-Hearing Brief, para. 161.

<sup>271</sup> Claimants' Post-Hearing Brief, para. 143.

Civil Code of Ukraine, and therefore violated Ukraine's *ordre public*, and this position was advanced by the University in its pleadings before the Kiev Commercial Court.<sup>272</sup> The Claimants submit that the Respondent then chose to focus on B&P's alleged substantial breaches of the 2003 Contract, allegedly because 'anything less than a [substantial] breach would not provide grounds for termination under applicable Ukrainian law.'<sup>273</sup>

## 2. *Position of the Respondent*

225. For its part, the Respondent submits that the conduct of the University is not attributable to the Respondent. In any event, the Respondent contends that the University did not frustrate the Claimants' legitimate expectations with respect to the 2003 Contract.<sup>274</sup> The Respondent argues that the Claimants' legitimate expectations are inextricably linked with the rights under the 2003 Contract, and that accordingly, because the 2003 Contract could be terminated in accordance with its terms (as was recognised by Mr Boguslavskyy, the former CEO of B&P, in cross-examination),<sup>275</sup> the Claimants could not have had any expectation that the 2003 Contract would continue indefinitely.

226. The Respondent understands that the Claimants' alleged legitimate expectations include, first, the fact that the University was authorised to enter into the 2003 Contract, and second, an expectation that B&P would be compensated in the event of early termination.<sup>276</sup> In the Respondent's submission, the Claimants' claims that these legitimate expectations have been frustrated are misconceived.

227. As to the Claimants' first alleged legitimate expectation, the Respondent claims that the University validly entered into the 2003 Contract, and there is nothing on the record to say otherwise.<sup>277</sup> As to the second, the Respondent rejects the Claimants' suggestion that the University deprived B&P of its contractual rights to seek compensation for early termination of the 2003 Contract.<sup>278</sup> After the 2003 Contract was terminated,

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<sup>272</sup> Claimants' Post-Hearing Brief, para. 146-148.

<sup>273</sup> Claimants' Post-Hearing Brief, para. 149 (emphasis in original removed).

<sup>274</sup> Respondent's Post-Hearing Brief, paras. 130-148.

<sup>275</sup> Respondent's Post-Hearing Brief, paras. 131-132; Transcript, Day 1, p. 250, lines 15-18.

<sup>276</sup> Respondent's Post-Hearing Brief, paras. 133.

<sup>277</sup> Respondent's Post-Hearing Brief, paras. 134-135.

<sup>278</sup> Respondent's Post-Hearing Brief, para. 136.

negotiations were held between the University and B&P concerning the amount of compensation, and at the suggestion of B&P, the University obtained an independent valuation of B&P's contribution to the Joint Activity, but the proposed amount (UAH 1.485 million) was not accepted by B&P, although B&P failed to comment on the valuation, and nor did it present a competing valuation report.<sup>279</sup> Nor did B&P make any submissions concerning the non-payment of compensation in the various proceedings before the Ukrainian courts, even though B&P had ample opportunity to do so.<sup>280</sup> In the present arbitration, the Claimants now claim UAH 6,666,700, but this claimed amount includes compensation in respect of future lost profits, which are not covered by the 2003 Contract.<sup>281</sup>

### *3. Determination of the Tribunal*

228. As the Tribunal has determined that the conduct of the University that is the subject of these proceedings is not attributable to Ukraine under the international law of State responsibility for the reasons expressed in Part V(B) above, it rejects the Claimants' claims for breach of Article II(3)(a) on the basis of the University's conduct and dealings with B&P.

## **C. Claim for Breach of Article II(3)(c) of the BIT Based on the University's Alleged Substantial Breach of the 2003 Contract**

### *1. Position of the Claimants*

229. The Claimants argue that the Respondent is in breach of Article II(3)(c) of the BIT, the 'umbrella clause', because University officials had committed a substantial breach of the 2003 Contract Agreement contrary to Ukrainian municipal law.

230. Article II(3)(c) provides as follows:

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<sup>279</sup> Respondent's Post-Hearing Brief, paras. 138-141.

<sup>280</sup> Respondent's Post-Hearing Brief, paras. 144-147.

<sup>281</sup> Respondent's Post-Hearing Brief, para. 142, referring to Claimants' Skeleton Outline, p. 10.

‘Each Party shall observe any obligation it may have entered into with regard to investments.’<sup>282</sup>

231. The Claimants submit that the umbrella clause in the BIT permits them to assert their contractual claims under the BIT, for such provisions can have the effect of elevating contractual claims to the level of a treaty claim.<sup>283</sup>

232. The Claimants’ claim under the umbrella clause is based on the University’s alleged substantial breach of the 2003 Contract in seeking early termination of that Contract. As noted above, the Claimants referred to the procedure for the termination of contracts is provided for in Article 651(2) of the Ukrainian Civil Code:

‘A contract may be amended or terminated by the decision of a court, upon the demand of one of the parties, due to a substantial breach of the contract by the other party, and in other cases stipulated by the contract or the law. A breach of a contract by one of the parties is substantial when as a result of the damages suffered due to such breach, the other party becomes significantly deprived of the benefits anticipated at the time of conclusion of the contract.’<sup>284</sup>

233. The Claimants first argue that B&P did not commit a substantial breach of the 2003 Contract that gave the Respondent the right to seek early termination. The Respondent’s justifications for seeking termination of the 2003 Contract are that B&P had committed a substantial breach of the 2003 Contract for two reasons: first, it had failed to establish a separate bank account for the Joint Activity; and second, B&P had failed to conduct the activities described in the Agreement.<sup>285</sup>

234. On the first of these issues, the 2003 Contract provides in Article 4(6) that:

‘Financial transactions related to the joint activity of the Parties shall be conducted by means of the joint activity settlement account which is opened after the registration of this Contract in accordance with the current laws of Ukraine.’<sup>286</sup>

235. The Claimants contend that the Respondent incorrectly understands this as a requirement to open a bank account, but it only requires that a ‘settlement account’ (or

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<sup>282</sup> BIT, Art II(3)(c).

<sup>283</sup> Claimants’ Post-Hearing Brief, paras. 69-95, in which the Claimants refer to, e.g., *SGS Société Générale de Surveillance SA v Philippines* (ICSID Case No ARB/02/6), Decision on Jurisdiction of 29 January 2004.

<sup>284</sup> Ukrainian Civil Code, Art 651(2) (Exhibit RLA-81); Claimants’ Post-Hearing Brief, para. 189.

<sup>285</sup> Claimants’ Post-Hearing Brief, para. 173.

<sup>286</sup> 2003 Contract, Art 4(6) (Exhibit R-9).

‘accounting account’) be maintained,<sup>287</sup> which might also be described as a ‘book of accounts’, or ledger to record transactions.<sup>288</sup> To fulfil this obligation, Ms Romanchuk, the former Chief Accounting Officer, and later CEO, of B&P, kept a ‘settlement account’ to track the movement of funds concerning the Joint Activity funds.<sup>289</sup> On the basis of this evidence, the Claimants submit that the University could not maintain that B&P was in breach of Article 4(6) of the 2003 Contract.

236. As to the second of these issues, the Claimants submit that the 2003 Contract provides in Article 2(1) that the parties must act ‘jointly for the purpose and creation of the [Science-Hotel Complex] ... shall engage jointly in [activities].’<sup>290</sup> In the Claimants’ submission, this means that neither party is solely responsible for joint activities, but that the parties have to act jointly.<sup>291</sup> The Claimants reject the Respondent’s allegation that B&P failed to carry out ‘joint activities’ at the Science-Hotel Complex, and argue that the Science-Hotel Complex hosted educational conference, seminars and lectures which were of relevance to a business school, which were described by the Claimants’ witnesses.<sup>292</sup> In the course of the Cross-Revision exercise, B&P’s officers had provided the CRO with ‘all necessary documentation in response to their requests’, which ‘outlined the conferences, seminars, educational activities and other such events.’<sup>293</sup> The Claimants argue further that, in any event, even if there were a breach, this was not substantial so as to ‘substantially deprive the University of the benefits of the Agreement.’<sup>294</sup>

237. The Claimants claim that the University was in substantial breach of the 2003 Contract ‘when its officials took categorical steps to end the joint activities that were being maintained by B&P on behalf of the University’, and assert that the ‘line was crossed when the University obtained and enforced an eviction order from the Ukrainian courts against B&P’.<sup>295</sup> In addition, the Claimants also assert that the University had failed to comply with its contractual obligations by failing to remove squatters in the

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<sup>287</sup> Claimants’ Post-Hearing Brief, paras. 175-178; Transcript, Day 2, p. 338, line 1 – p. 348, line 20.

<sup>288</sup> Claimants’ Post-Hearing Brief, para. 176.

<sup>289</sup> Claimants’ Post-Hearing Brief, paras. 174-178.

<sup>290</sup> 2003 Contract, Art 2(1).

<sup>291</sup> Claimants’ Post-Hearing Brief, paras. 179-180.

<sup>292</sup> Claimants’ Post-Hearing Brief, paras. 181-182.

<sup>293</sup> Claimants’ Post-Hearing Brief, para. 183.

<sup>294</sup> Claimants’ Post-Hearing Brief, para. 186.

<sup>295</sup> Claimants’ Post-Hearing Brief, para 190.

Science-Hotel Complex, and had also failed to provide funds for the Phase II renovations.<sup>296</sup>

238. The Claimants argue that B&P's eviction from the Science-Hotel Complex had ended any possibility for B&P to mitigate its losses, which had been accruing since the Phase II renovations were stalled.<sup>297</sup> The University's conduct was a substantial breach on 21 January 2009, the day that B&P was denied physical access to the Complex.<sup>298</sup>

## 2. *Position of the Respondent*

239. In response, the Respondent argues that Ukraine is not a party to the 2003 Contract as the University is B&P's contractual counterparty, and reiterates that the University's conduct is not attributable to Ukraine.<sup>299</sup> The Respondent argues further that even if the University's conduct were attributable to Ukraine, the umbrella clause does not have the effect of elevating claims for breach of contract into claims for breach of treaty.<sup>300</sup>

240. In any event, the Respondent argues that the University did not breach the 2003 Contract. To the contrary, the Respondent contends that it was B&P that breached the 2003 Contract, and that the Ukrainian courts have confirmed that B&P's breaches were of such a character to justify the University's termination of the 2003 Contract, which the University had done under applicable Ukrainian law.<sup>301</sup>

## 3. *Determination of the Tribunal*

241. The Tribunal recalls that it has already determined that the conduct of the University that is the subject of these proceedings is not attributable to the Respondent, and in this sense, to the extent that the University has failed to comply with its obligations under the 2003 Contract, or committed a substantial breach of that contract, that conduct is not attributable to the Respondent.

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<sup>296</sup> Claimants' Post-Hearing Brief, para. 191.

<sup>297</sup> Claimants' Post-Hearing Brief, para. 192.

<sup>298</sup> *Id.*

<sup>299</sup> Respondent's Post-Hearing Brief, paras. 160-166.

<sup>300</sup> Respondent's Post-Hearing Brief, paras. 167-173, referring to, e.g., *SGS v Pakistan* (ICSID Case No ARB/01/13), Decision on Jurisdiction of 6 August 2003.

<sup>301</sup> Respondent's Post-Hearing Brief, para. 180.

242. It remains to be determined by the Tribunal whether the Respondent has assumed any obligations vis-à-vis the Claimants by virtue of the umbrella clause in Article II(3)(c), which provides:

‘Each Party shall observe any obligation it may have entered into with regard to investments.’<sup>302</sup>

243. The Tribunal observes that this obligation is incumbent on ‘each Party’ to the BIT to ‘observe any obligation it may have entered into with regard to investments.’ It is undisputed that Ukraine did not enter into the 2003 Contract with B&P, but that it was the University that entered into this contract. Nevertheless, the Tribunal considers it necessary to determine whether the term ‘Party’ in Article II(3)(c) is limited to the two States parties to the BIT or whether it also extends to entities that are controlled by ‘each Party.’

244. The Tribunal recalls that, as is confirmed by the Decree of the President No 1496/99 of 25 November 1999 (Decree on National Taras Shevchenko University), and as is also confirmed in the University’s Charter of 2000, and the current Charter of 2009, the University has an autonomous status. The Tribunal recalls further that it has concluded above that the University is authorised to exercise elements of governmental authority.

245. However, the Tribunal notes that the BIT contains the definition in Article I(1)(f) of the BIT provides that a ‘State enterprise’ is ‘an enterprise owned, or controlled through ownership interests, by a Party.’<sup>303</sup> Although the University is ‘owned, or controlled’ by a Party, a State enterprise is not included within the meaning of the term ‘Party’ for the purpose of the BIT (the Tribunal also noting that the preamble defines the term ‘Parties’ as referring to ‘the United States of America and Ukraine’). Leaving to one side the question of whether the University is in fact a ‘State enterprise’ within the meaning of the BIT, which the Tribunal does not determine, the Tribunal nonetheless considers it relevant to observe that the BIT draws a distinction between the term ‘Party’ as a legal entity, and the term ‘State enterprise’ as a legal entity. This leads the Tribunal to conclude that the University and the State should be regarded as separate entities.

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<sup>302</sup> BIT, Art II(3)(c).

<sup>303</sup> BIT, Art I(1)(f).

246. For these reasons, the Tribunal concludes that the term ‘Party’ in the umbrella clause refers to any situation where the Party is acting *qua* State. This means that where the conduct of entities can be attributed to the Parties (under, for instance, Articles 4, 5 or 8 of the ILC Articles on State Responsibility), such entities are considered to be ‘the Party’ for the purposes of Article II(3)(c). As the Tribunal has concluded above that the conduct of the University is not attributable to Ukraine, it follows that it cannot be said that Ukraine, as a ‘Party’, has entered into any obligations (in the 2003 Contract) with regard to investments. Rather, if the umbrella clause is to have the effect argued for by the Claimants, it could only do so in respect of obligations that have been assumed by the host State or by an entity whose conduct is attributable to the host State. In this regard, the Tribunal agrees with the conclusion of the ICSID tribunal in *Bureau Veritas, Inspection, Valuation, Assessment and Control BIVAC BV v Paraguay*, which, in relation to the particular facts of that case, including the terms of the umbrella clause in issue, stated that:

‘On a plain meaning, [umbrella clauses] are undoubtedly capable of being read to include a contractual arrangement entered into by BIVAC and the Ministry of Finance of Paraguay, whereby the alleged breaches of the Ministry are attributable to the State.’<sup>304</sup>

247. The Tribunal also agrees with the view of the ICSID tribunal in *SGS Société Générale de Surveillance SA v Philippines*, which held that although the umbrella clause in Article X(2) of the Switzerland-Philippines BIT made it a breach of the BIT for the host State ‘to fail to observe binding commitments, including contractual commitments, which it had assumed with regard to specific investments’, the umbrella clause did not have the effect of converting ‘the *extent* or *content* of such obligations into an issue of international law.’<sup>305</sup> Rather, the scope of the contractual obligations had to be determined in accordance with the contract.<sup>306</sup>

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<sup>304</sup> *Bureau Veritas, Inspection, Valuation, Assessment and Control BIVAC BV v Paraguay* (ICSID Case No ARB/07/9), Decision on Jurisdiction of 19 May 2009, para. 141.

<sup>305</sup> *SGS Société Générale de Surveillance SA v Philippines* (ICSID Case No ARB/02/6), Decision on Jurisdiction of 29 January 2004, para. 128 (emphasis in original).

<sup>306</sup> *SGS Société Générale de Surveillance SA v Philippines* (ICSID Case No ARB/02/6), Decision on Jurisdiction of 29 January 2004, para. 128.



248. Although the conclusion of the Tribunal that an umbrella clause might in principle be capable of making a claim under a contract justiciable under a BIT is fortified by a review of the cases cited by the Parties, as well as a number of others, which have involved claims brought under an umbrella clause, in none of these cases was the relevant contract entered into by the investor with an entity akin to the University.

1. In *SGS Société Générale de Surveillance SA v Pakistan*, the contract was concluded between the investor and the Government of Pakistan.<sup>307</sup>

2. In *SGS Société Générale de Surveillance SA v Philippines*, the contract in issue was concluded between the investor and the Government of the Philippines.<sup>308</sup>

3. In *Joy Mining Machinery Ltd v Egypt*, the contract was concluded between the investor and the General Organisation for Industrial and Mining Projects of Egypt, a State agency (although the tribunal did not decide the status of the General Organisation for Industrial and Mining Projects, which was contested by the Respondent.)<sup>309</sup>

4. In *Impregilo SpA v Pakistan*, the contract at issue was between the investing consortium (Ghazi Barotha Contractors, in which Impregilo SpA was a participant) and the Pakistani Water and Power Development Authority, an instrumentality of the Government of Pakistan (although the ICSID tribunal did not finally determine the question of Pakistan's responsibility for alleged breaches of the BIT by the Water and Power Development Authority.)<sup>310</sup>

5. In *CMS Gas Transmission Company v Argentine Republic*, the license contract was entered into between an Argentine company in which the investor directly or indirectly held shares, and the Government of the Argentine Republic.<sup>311</sup>

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<sup>307</sup> *SGS Société Générale de Surveillance SA v Pakistan* (ICSID Case No ARB/01/13), Decision on Jurisdiction of 29 August 2003, para. 11.

<sup>308</sup> *SGS Société Générale de Surveillance SA v Philippines* (ICSID Case No ARB/02/6), Decision on Jurisdiction of 29 January 2004, para. 13.

<sup>309</sup> *Joy Mining Machinery Ltd v Egypt* (ICSID Case No ARB/03/11), Award on Jurisdiction of 6 August 2004, para. 15.

<sup>310</sup> *Impregilo SpA v Pakistan* (ICSID Case No ARB/03/3), Decision on Jurisdiction of 22 April 2005, paras. 13, 210, 262, 266(a).

<sup>311</sup> *CMS Gas Transmission Company v Argentine Republic* (ICSID Case No ARB/01/8), Award of 12 May 2005, paras. 299-303; *CMS Gas Transmission Company v Argentine Republic* (ICSID Case No ARB/01/8), Decision on Jurisdiction of 17 July 2003, para. 19.

6. In *Eureko v Poland*, the contract was concluded between the investor and the State Treasury of Poland.<sup>312</sup>

7. In *Noble Ventures, Inc v Romania*, the contract was concluded between the investor and the Romanian State Ownership Fund, an instrumentality of the Government of Romania.<sup>313</sup>

8. In *El Paso Energy International Company v Argentine Republic*, the contracts were concluded between companies in which the investor indirectly owned shares and the Government of the Argentine Republic.<sup>314</sup>

9. In *Azurix Corporation v Argentine Republic*, the contract at issue was between the investor's Argentine subsidiary and the Province of Buenos Aires.<sup>315</sup>

10. In *LG&E Energy Corporation v Argentine Republic*, the license contract was concluded between three Argentine companies in which the investor directly or indirectly held shares, and the Government of the Argentine Republic.<sup>316</sup>

11. In *Siemens AG v Argentine Republic*, the contract was entered into between the investor's Argentine subsidiary and the Government of the Argentine Republic.<sup>317</sup>

12. In *Enron Corporation and Ponderosa Assets LP v Argentine Republic*, the contract was entered into between an Argentine company in which the investor directly or indirectly held shares, and the Government of the Argentine Republic.<sup>318</sup>

13. In *Sempra Energy International v Argentine Republic*, the contract was concluded between an Argentine company in which the investor indirectly held shares, and the Government of the Argentine Republic.<sup>319</sup>

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<sup>312</sup> *Eureko v Poland* (Partial Award of 19 August 2005), para. 41.

<sup>313</sup> *Noble Ventures, Inc v Romania* (ICSID Case No ARB/01/11), Award of 12 October 2005, para. 2.

<sup>314</sup> *El Paso Energy International Company v Argentine Republic* (ICSID Case No ARB/03/15), Decision on Jurisdiction of 27 April 2006, paras. 66-85; *El Paso Energy International Company v Argentine Republic* (ICSID Case No ARB/03/15), Award of 31 October 2011, paras. 178-198, 531-538.

<sup>315</sup> *Azurix Corporation v Argentine Republic* (ICSID Case No ARB/01/12), Award of 14 July 2006, para. 41.

<sup>316</sup> *LG&E Energy Corporation v Argentine Republic* (ICSID Case No ARB/02/1), Decision on Liability of 3 October 2006, paras. 34-52.

<sup>317</sup> *Siemens AG v Argentine Republic* (ICSID Case No ARB/02/8), Award of 17 January 2007, para. 84.

<sup>318</sup> *Enron Corporation and Ponderosa Assets LP v Argentine Republic* (ICSID Case No ARB/01/3), Award of 22 May 2007, paras. 43-44.

<sup>319</sup> *Sempra Energy International v Argentine Republic* (ICSID Case No ARB/02/16), Award of 28 September 2007, paras. 82-94.

14. In *Duke Energy Electroquil Partners & Electroquil SA v Ecuador*, the contract at issue was between one of the investors and INECEL, a State-owned entity under the Ministry of Natural Resources and Energy.<sup>320</sup>

15. In *Bureau Veritas, Inspection, Valuation, Assessment and Control BIVAC BV v Paraguay*, the contract was entered into between the investor and the Ministry of Finance of Paraguay.<sup>321</sup>

16. In *Toto Costruzioni Generali SpA v Lebanon*, the contract was entered into between the investor and the ‘Conseil Exécutif des Grands Projets’ of Lebanon (an entity attached to the Ministry of Public Works), which was subsequently replaced by the Council for Redevelopment and Reconstruction, both of which were considered by the tribunal to be entities whose conduct was attributable to Lebanon in accordance with Article 5 of the ILC Articles on State Responsibility.<sup>322</sup>

17. In *Al-Bahloul v Tajikistan*, the contracts were concluded between the investor, and a company owned by the investor, and the State Committee for Oil and Gas of the Republic of Tajikistan.<sup>323</sup>

18. In *Gustav F W Hamester GmbH & Co KG v Ghana*, the contract was entered into between the investor and the Ghana Cocoa Board, an entity exercising elements of governmental authority (although the ICSID tribunal ultimately decided that the conduct of the Ghana Cocoa Board in question was not attributable to Ghana under Article 5 of the ILC Articles on State Responsibility.)<sup>324</sup>

19. In *Burlington Resources Inc v Ecuador*, the contracts were between subsidiaries of the investor and the Government of Ecuador.<sup>325</sup>

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<sup>320</sup> *Duke Energy Electroquil Partners & Electroquil SA v Ecuador* (ICSID Case No ARB/04/19), Award of 18 August 2008, paras. 10, 16, 317-325.

<sup>321</sup> *Bureau Veritas, Inspection, Valuation, Assessment and Control BIVAC BV v Paraguay* (ICSID Case No ARB/07/9), Decision on Jurisdiction of 19 May 2009, para. 7.

<sup>322</sup> *Toto Costruzioni Generali SpA v Lebanon* (ICSID Case No ARB/07/12), Decision on Jurisdiction of 11 September 2009, paras. 16-17, 43-60.

<sup>323</sup> *Al-Bahloul v Tajikistan* (Partial Award on Jurisdiction and Liability of 2 September 2009), paras. 17, 256-270.

<sup>324</sup> *Gustav F W Hamester GmbH & Co KG v Ghana* (ICSID Case No ARB/07/24), Award of 10 June 2010, paras. 22, 189-197, 202-285, 291, 362(iii).

<sup>325</sup> *Burlington Resources Inc v Ecuador and Empresa Estatal Petróleos del Ecuador* (ICSID Case No ARB/08/5), Decision on Jurisdiction of 2 June 2010, paras. 8-17, 193.

20. In *SGS Société Générale de Surveillance SA v Paraguay*, the contract was between the investor and the Ministry of Finance of the Government of Paraguay.<sup>326</sup>

249. Insofar as the Claimants' claim under the umbrella clause relies on obligations on the University under the 2003 Contract, given that the Tribunal has decided that the conduct of the University that is the subject of these proceedings is not attributable to Ukraine under the international law of State responsibility, the Claimants' claim must fail.

250. In light of the conclusion reached above, it is unnecessary for the Tribunal to consider whether, even if the University's conduct in question were attributable to Ukraine, the Claimants' umbrella clause claim would succeed. Nevertheless, in view of the submissions of the Parties, and for the sake of completeness, the Tribunal has considered it appropriate to expand its analysis to decide this issue.<sup>327</sup> Having done so, the Tribunal has come to the conclusion that the Claimants' claim would nonetheless fail.

251. The Tribunal takes the position that in order to present a contractual claim under the umbrella clause in the BIT, the Claimants (here B&P) are required to have their rights and obligations under the 2003 Contract determined by the applicable dispute settlement forum, i.e., in accordance with Article 13(1) of the 2003 Contract, which refers the parties to dispute settlement 'in accordance to the Ukrainian legislation'.<sup>328</sup> In other words, B&P is obliged to follow the dispute settlement provision included in the 2003 Contract. The Tribunal agrees with the ICSID tribunal in *Bureau Veritas, Inspection, Valuation, Assessment and Control BIVAC BV v Paraguay*, which, in the context of the Netherlands – Paraguay BIT, stated that:

'Assuming that Article 3(4) does import the obligations under the Contract into the BIT, giving this Tribunal jurisdiction to interpret and apply the Contract as such, then it must have imported into the BIT all of the obligations owed by Paraguay to BIVAC under the Contract. This would include not only the obligation to make payment of invoices in accordance with the requirements of the Contract, but also the obligation (implicit if nothing else) to ensure that the Tribunals of the City of Asunción were

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<sup>326</sup> *SGS Société Générale de Surveillance SA v Paraguay* (ICSID Case No ARB/07/29), Award of 10 February 2012), para. 26.

<sup>327</sup> See also *Gustav F W Hamester GmbH & Co KG v Ghana* (ICSID Case No ARB/07/24), Award of 10 June 2010, paras. 313-315.

<sup>328</sup> 2003 Contract, Art 13(1).

available to resolve any “conflict, controversy or claim which arises from or is produced in relation to” the Contract.<sup>329</sup>

252. The present Tribunal agrees, and concludes that where a contractual claim is asserted under an umbrella clause, the claimant in question must comply with any dispute settlement provision included in that contract.

253. This conclusion is also consistent with that of the ICSID tribunal in *SGS Société Générale de Surveillance SA v Philippines*, which held that the Switzerland – Philippines BIT ‘did not purport to override the exclusive jurisdiction clause in the CISS Agreement, or to give SGS an alternative route for the resolution of contractual claims which it was bound to submit to the Philippine courts under that Agreement.’<sup>330</sup> The ICSID tribunal concluded that it

‘should not exercise its jurisdiction over a contractual claim when the parties have already agreed on how such a claim is to be resolved, and have done so exclusively. SGS should not be able to approbate and reprobate in respect of the same contract: if it claims under the contract, it should comply with the contract in respect of the very matter which is the foundation of its claim.’<sup>331</sup>

254. The Tribunal also agrees with the tribunals in *Bureau Veritas, Inspection, Valuation, Assessment and Control BIVAC BV v Paraguay* and *SGS Société Générale de Surveillance SA v Philippines* that the question whether the Claimants can submit contractual claims under the umbrella clause in Article II(3)(c) of the BIT will depend on an analysis of the contractual forum selection provision in question, namely Article 13(1) of the 2003 Contract.

255. As has been set out above, Article 13(1) provides that:

‘All disputes between the Parties in connection to which no agreement has been reached shall be settled in accordance to the Ukrainian legislation.’<sup>332</sup>

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<sup>329</sup> *Bureau Veritas, Inspection, Valuation, Assessment and Control BIVAC BV v Paraguay* (ICSID Case No ARB/07/9), Decision on Jurisdiction of 19 May 2009, para. 142.

<sup>330</sup> *SGS Société Générale de Surveillance SA v Philippines* (ICSID Case No ARB/02/6), Decision on Jurisdiction of 29 January 2004, para. 143.

<sup>331</sup> *SGS Société Générale de Surveillance SA v Philippines* (ICSID Case No ARB/02/6), Decision on Jurisdiction of 29 January 2004, para. 155.

<sup>332</sup> 2003 Contract, Art 13(1).

256. The Claimants have submitted that Article 13(1) should be interpreted as requiring the dispute between B&P and the University to be submitted for settlement under the BIT. This is because the BIT ‘forms part of the national legislation of Ukraine’, and that it did so in 2003, at the time of the conclusion of the 2003 Contract.<sup>333</sup> For its part, the Respondent rejects the Claimants’ position as ‘absurd’, and submits that under Article 12 of Ukraine’s Code of Commercial Procedure, the jurisdiction of the Ukraine courts extends to ‘cases on disputes arising out conclusion, amendment, denunciation and execution of commercial contracts.’<sup>334</sup> Further, the BIT only provides for the resolution of disputes where the investor is the claimant. This means that, if Article 13(1) of the 2003 Contract were interpreted as requiring any disputes under the Contract to be resolved in accordance with the BIT’s dispute settlement procedures, the University – one of the parties to the 2003 Contract – would have no standing to assert a claim, for the BIT does not cater for claims to be brought by the Contracting Parties against an investor, let alone by an entity such as the University.<sup>335</sup>

257. The Tribunal accepts the position of the Respondent, and finds that Article 13(1) of the 2003 Contract is an exclusive jurisdiction clause that requires any dispute arising under the Contract to be submitted to the Ukrainian courts. The Tribunal observes that this conclusion was also reached by three levels of Ukrainian courts in the litigation concerning the termination of the 2003 Contract, although it had initially been rejected.

258. Were it necessary to decide this issue, the Tribunal would accordingly find that in order to invoke the umbrella clause in Article II(3)(c) of the BIT, the Claimants would first have to submit their claims under the contract for settlement in accordance with the jurisdictional clause in Article 13(1) of the 2003 Contract, i.e., to the Ukrainian courts. On the facts of the present dispute, the dispute was, in fact, referred to the Ukrainian courts, albeit in the context of the University’s claim for termination of the 2003 Contract, rather than any claim by B&P that the University was in breach. The matter was considered by three levels of Ukrainian courts, which decided that they had jurisdiction over the dispute concerning the termination of the 2003 Contract, and terminated it in accordance with applicable Ukrainian legislation.

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<sup>333</sup> Claimants’ Post-Hearing Brief, paras. 63-65, referring, *inter alia*, to Law No 226/94/VR, which allegedly ‘absorbed’ the BIT into Ukraine’s domestic legislation.

<sup>334</sup> Code of Commercial Procedure, Art 12 (Exhibit RLA-83); Respondent’s Post-Hearing Brief, paras. 93-99.

<sup>335</sup> Respondent’s Post-Hearing Brief, paras. 93-99.

259. It is thus apparent that the extent and content of B&P's rights under the 2003 Contract have been determined in accordance with the applicable dispute settlement procedure, with the result being that the Ukrainian courts terminated the 2003 Contract. This having occurred, the Tribunal finds that the Claimants could not now claim that B&P has rights under the 2003 Contract that it can properly assert under the umbrella clause. Even assuming that the University's conduct was attributable to the Respondent, for these reasons, the Tribunal would reject the Claimants' claim for breach of Article II(3)(c).

#### **D. Claim for Breach of Article II(3)(a) Based on the Conduct of the Ukrainian Courts and the Ministry of Justice**

##### *1. Position of the Claimants*

260. The Claimants' fourth claim is that Ukraine is responsible for a breach of the obligation to accord fair and equitable treatment contrary to Article II(3)(a) because the Ukrainian courts failed to act consistently with the principle of *res judicata* during the Ukrainian court proceedings initiated by the University to terminate the 2003 Contract. The Claimants argue that, as a general principle of law, the principle of *res judicata* applies in Ukrainian law, and forms part of the fair and equitable treatment standard.<sup>336</sup>

261. The Claimants refer to a number of decisions of national and international courts and tribunals as well as learned writings on the principle of *res judicata* and its status as a general principle of law that is applicable within the Ukrainian legal order. The Claimants argue that '*res judicata* is composed of three cumulative elements: (1) identity of the parties to the dispute; (2) object of the claim; and (3) grounds for the claim.'<sup>337</sup>

262. As noted above, the factual basis of the Claimants' claim for breach of Article III(3)(a) is that on 4 October 2007 the University initiated proceedings in the Kiev Commercial Court by submitting a statement of claim (No 03-101) for termination of the 2003 Contract as well as the transfer of B&P's 50% interest in the joint venture to the

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<sup>336</sup> Claimants' Post-Hearing Brief, paras. 193-200.

<sup>337</sup> Claimants' Post-Hearing Brief, paras. 196-199, 200-201, 204, 209, referring, *inter alia*, to *Company General of the Orinoco Case (France v Venezuela)* (1905) 10 UNRIAA 184, 186.

University.<sup>338</sup> On 29 October 2007, Judge Kovtun held that the Kiev Commercial Court lacked jurisdiction to determine the case, because it fell within the jurisdiction of ICSID, thus accepting B&P's submissions. Judge Kovtun therefore did not accept the University's claim.<sup>339</sup>

263. Instead of appealing this decision, the University refiled the same statement of claim on 2 November 2007 before a different judge (Judge Khrypun), and despite B&P's objections, the matter was set down for trial by Judge Khrypun's Ruling of 23 November 2007.<sup>340</sup> On 16 January 2008, Judge Khrypun issued a judgment which terminated the 2003 Contract.<sup>341</sup> Judge Khrypun rejected B&P's submission that the BIT was applicable to the dispute between the parties, and concluded that the 2003 Contract was 'commercial'. For Judge Khrypun, it followed from this that the dispute was subject to the jurisdiction of the Ukrainian courts, holding that: 'According to the Article 12 of the Code of Commercial Procedure of Ukraine, all the disputes arising upon amendment and termination of commercial contracts belong to the jurisdiction of commercial courts.'<sup>342</sup> This judgment was clearly inconsistent with the Ruling of Judge Kovtun of 29 October 2007.

264. B&P appealed this decision, and through the subsequent appeals, B&P maintained its objection to this breach of the *res judicata* principle. Hence, B&P elected hereafter not to address the University's claim for Termination of the 2003 Contract.<sup>343</sup> After all appeals were exhausted, Judge Khrypun's decision stood, which had the effect of terminating the 2003 Contract, and led to the eviction of B&P from the Science-Hotel Complex.<sup>344</sup>

265. The Claimants submit that the conduct of the Ukrainian courts evidences a clear breach of the *res judicata* principle, which they describe as a fundamental procedural safeguard which forms part of the fair and equitable treatment standard. The Claimants observe that, as regards the proceedings initiated by the University on 2 October 2007

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<sup>338</sup> Respondent's Counter-Memorial, para. 142.

<sup>339</sup> Kiev Commercial Court, Ruling 05-6-6/1061 (29 October 2007); Claimants' Memorial, p. 15; Respondent's Counter-Memorial, paras. 144-145.

<sup>340</sup> Kiev Commercial Court, Ruling of 23 November 2007 (Case No 32/619).

<sup>341</sup> Kiev Commercial Court, Judgment of 16 January 2008 (Case No 32/619).

<sup>342</sup> Judgment of 16 January 2008, p. 3, cited in Respondent's Counter-Memorial, para. 151.

<sup>343</sup> Respondent's Counter-Memorial, para. 150.

<sup>344</sup> Claimants' Post-Hearing Brief, para. 10.



(which came before Judge Kovtun, who issued Ruling 05-6-6/1061 on 29 October 2007), and the proceedings commenced on 2 November 2007 (which came before Judge Khrypyn, who issued a Ruling on 23 November 2007, opening the case, and the judgment on 16 January 2008), it can be seen that the parties were identical (B&P and the University); the object of the University's claim in both cases was identical (namely, to obtain a determination that B&P had breached the 2003 Contract and to terminate the 2003 Contract), and the grounds for the claim were also identical (namely, B&P's alleged fundamental breach of the 2003 Contract). The Claimants also note that the documents submitted before both courts were, for all material purposes, identical.<sup>345</sup> In the Claimants' submission, '[t]his is a clear cut case of the same action being brought twice.'<sup>346</sup> The Claimants contend that the Ukraine Ministry of Justice also 'abetted' the Ukrainian courts' breach, because representatives of the Ministry of Justice appeared before the Ukrainian courts and permitted the non-observance of *res judicata* to go uncorrected.<sup>347</sup>

266. Finally, the Claimants argue that the obligation to accord fair and equitable treatment under Article II(3)(a) of the BIT should be interpreted in light of its context, which includes the 'effective means' standard in Article II(7),<sup>348</sup> which provides that each Party 'shall provide effective means of asserting claims and enforcing rights with respect to investment, investment agreements, and investment authorisations.'<sup>349</sup>

## 2. Position of the Respondent

267. The Respondent argues that the various proceedings before the Kiev Commercial Court were fair and transparent. In particular, in each of the proceedings, B&P had the right to be heard, on the merits, the opportunity to participate, and the right of appeal, and the proceedings followed the rule of law in all cases.<sup>350</sup> In the Respondent's submission, any prejudice that the Claimants suffered can be attributed to its own litigation strategy of maintaining its position that the BIT 'divested the Ukrainian courts of any jurisdiction to

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<sup>345</sup> Claimants' Post-Hearing Brief, para. 211.

<sup>346</sup> Claimants' Post-Hearing Brief, para. 213.

<sup>347</sup> Claimants' Post-Hearing Brief, para. 217.

<sup>348</sup> Claimants' Post-Hearing Brief, paras. 4, 218-220.

<sup>349</sup> BIT, Art II(7).

<sup>350</sup> Respondent's Post-Hearing Brief, para. 65.

hear claims related to the [2003 Contract], but without addressing the fall-back position of making defences on the merits to the University's claim for termination.'<sup>351</sup>

268. In consequence to the Claimants' claims concerning the courts' alleged non-compliance with the principle of *res judicata*, the Respondent submits that after Judge Kovtun had dismissed the University's statement of claim on 29 October 2007, the commencement of fresh proceedings by the University was consistent with Ukrainian law.<sup>352</sup> The Respondent asserts that under the Ukrainian Code of Commercial Procedure, 'a claim that is submitted to the courts is considered for preliminary review before the court officially "opens" the case', and prior to opening the case, 'the court must be satisfied that the materials presented by the plaintiff are "sufficient for acceptance of the claim for consideration".'<sup>353</sup> A statement of claim can be rejected on limited grounds, including, in Article 62(1) of the Code of Commercial Procedure, if the 'statement of claim is not subject to consideration by the commercial courts of Ukraine.'<sup>354</sup> Where this happens, the statement of claim is returned to the plaintiff with the ruling 'on the refusal to accept the statement of claim', and no case is opened.<sup>355</sup> But if the statement of claim is accepted by the court, it issues a ruling 'on the institution of court proceedings', and an official case number is given to the proceedings.<sup>356</sup>

269. The Respondent argues that the University's statement of claim which it filed on 2 October 2007 was rejected by Judge Kovtun on his Ruling of 29 October 2007 under Article 62(1) of the Code of Commercial Procedure. Accordingly, Judge Kovtun did not open a case, or assign an official number to the case.<sup>357</sup> Upon receiving Judge Kovtun's Ruling of 29 October 2007, Ms Salenko, the Head of the University's Legal Department, filed a duplicate of the statement of claim, rather than appealing Judge Kovtun's Ruling, because Ukrainian law does not prohibit refileing the statement of claim.<sup>358</sup>

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<sup>351</sup> Respondent's Post-Hearing Brief, para. 67.

<sup>352</sup> Respondent's Post-Hearing Brief, paras. 72-82.

<sup>353</sup> Respondent's Post-Hearing Brief, para. 72.

<sup>354</sup> Respondent's Post-Hearing Brief, para. 73.

<sup>355</sup> *Id.*

<sup>356</sup> Respondent's Post-Hearing Brief, para. 74.

<sup>357</sup> Respondent's Post-Hearing Brief, para. 75.

<sup>358</sup> Respondent's Post-Hearing Brief, para. 77.

270. The Respondent's submissions on the effect of Judge Kovtun's Ruling of 29 October 2007 were supported by the Expert Report of Professor Luts:

'The [Code of Commercial Procedure] prohibits the repeated submission of a claim in entirely different circumstances. The [Code of Commercial Procedure] distinguishes situations where the claim was not accepted for consideration by the court and the proceedings were not opened (dealt with in Article 62 of the [Code of Commercial Procedure]) and situations where the proceedings were opened upon a claim, but were, for specific reasons, terminated afterwards. In the latter case, [Code of Commercial Procedure] expressly stipulates that the claimant may not submit a claim related to the dispute between the same parties, over the same subject matter and based on the same grounds (see Article 80 of the [Code of Commercial Procedure]). Article 62 of the [Code of Commercial Procedure] contains no such stipulation.'<sup>359</sup>

Professor Luts' Expert Report was not challenged by the Claimants, and he was not called for cross-examination at the hearing. Nor did the Claimants provide any expert evidence of Ukrainian law of their own on this matter.<sup>360</sup>

271. The Respondent thus submits that there is a cardinal distinction between Articles 62 and 80 of the Ukrainian Code of Commercial Procedure. The provision in Article 80 of the Code of Commercial Procedure referred to by Professor Luts states that:

'[i]n case of termination of proceedings resubmission of an action to a commercial court in dispute between the same parties, on the same subject, under the same grounds shall not be accepted.'<sup>361</sup>

272. On the basis of these provisions of the Ukrainian Code of Commercial Procedure, the Respondent submits that Ukrainian courts' subsequent acceptance of the refiled statement of claim did not infringe the *res judicata* principle, for as a matter of Ukrainian civil procedure, *res judicata* does not attach to the dismissal of a statement of claim in a case that was never opened.<sup>362</sup> Accordingly, a ruling under Article 62 which refuses to accept a statement of claim is a procedural decision which does not conclusively determine any of the issues in dispute; but if a claim has been accepted for consideration and is later dismissed under Article 80, that claim cannot be reconsidered.<sup>363</sup> In addition, the

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<sup>359</sup> Luts ER, para. 47, cited in Respondent's Post-Hearing Brief, para. 80.

<sup>360</sup> Respondent's Post-Hearing Brief, para. 82.

<sup>361</sup> Code of Commercial Procedure, Art 80, cited in Respondent's Post-Hearing Brief, para. 84.

<sup>362</sup> Respondent's Post-Hearing Brief, para. 83.

<sup>363</sup> Respondent's Post-Hearing Brief, paras. 84-85.

Respondent submits that this is consistent with international practice, for only final judgments have preclusive effect.<sup>364</sup>

273. The Respondent further submits that the Ukrainian courts properly exercised jurisdiction over the dispute between the University and B&P. Article 13(1) of the 2003 Contract provided that: ‘All disputes between the Parties in connection to which no agreement has been reached shall be settled in accordance to the Ukrainian legislation.’ Article 15(1) further provided that: ‘In cases provided for in this Contract, the parties are governed by the current legislation of Ukraine.’<sup>365</sup>

274. The Respondent notes that under Article 12 of the Code of Commercial Procedure, the Kiev Commercial Court’s subject-matter jurisdiction includes ‘cases on disputes arising out conclusion, amendment, denunciation and execution of commercial contracts’,<sup>366</sup> and as the 2003 Contract was found by the Kiev Commercial Court to be a ‘commercial contract’, the University’s application for termination of the 2003 Contract is naturally within the jurisdiction of the Kiev Commercial Court. As has been noted above, the Respondent rejects the Claimants’ submission that the dispute between B&P and the University was falling within the scope of the BIT, and accordingly subject to the jurisdiction of ICSID, as ‘absurd’, for the BIT does not provide for the Respondent, as host State of the investment, to commence a claim against the Claimants. Rather, the BIT, like the vast majority of investment treaties, confers a right on the investor to bring a claim against the host State of the investment in international arbitration.<sup>367</sup> The Respondent also notes that the Claimants’ insistence on pursuing their argument that the Kiev Commercial Court lacked jurisdiction through the various proceedings and appeals in the Ukrainian courts, and their own strategic decision not to address the merits of the University’s termination of the 2003 Contract ‘serves to undermine all of their [fair and equitable treatment] claims regarding the conduct of the Ukrainian court proceedings.’<sup>368</sup> The Respondent further notes that, for the same reason, the Claimants cannot maintain any claim for breach of the ‘effective means’ obligation in Article II(7) of the BIT, whether in support of their claim for breach of the fair and equitable treatment standard,

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<sup>364</sup> Respondent’s Post-Hearing Brief, paras 87.

<sup>365</sup> 2003 Contract, Arts 13(1), 15(1), cited in Respondent’s Post-Hearing Brief, para. 93.

<sup>366</sup> Code of Commercial Procedure, Art 12, cited in Respondent’s Post-Hearing Brief, para. 94.

<sup>367</sup> Respondent’s Post-Hearing Brief, para. 96.

<sup>368</sup> Respondent’s Post-Hearing Brief, para. 99.

or as a stand-alone claim.<sup>369</sup> In the Respondent's submission, the Claimants failed to avail themselves fully of the remedies available before the Ukrainian courts, and that, in the absence of a denial of justice (which the Claimants have not substantiated), the Tribunal should not revisit the findings of the Ukrainian courts.<sup>370</sup>

275. Finally, the Respondent rejects the Claimants' suggestion that representatives of the Ministry of Justice 'abetted' the Ukrainian courts in any breach of Article II(3)(a) of the BIT is unsustainable, because the Ministry of Justice representatives 'did not in any way prevent B&P from presenting its case before the Ukrainian courts or otherwise dictate the outcome of the termination proceedings.'<sup>371</sup>

### 3. *Determination of the Tribunal*

276. The Tribunal notes that the Claimants' claim concerning the conduct of the Ukrainian courts and the Ministry of Justice in relation to the termination proceedings before the Ukrainian courts essentially concerns whether the initiation by the University of fresh proceedings on 2 November 2007, and the Kiev Commercial Court's acceptance of those fresh proceedings, amounted to a violation of the *res judicata* principle and consequently a breach of the obligation to accord fair and equitable treatment contrary to Article II(3)(a) of the BIT.

277. The Tribunal accepts the Claimants' submission that *res judicata* is a general principle of law.<sup>372</sup> The Respondent does not seek to contest this.

278. The principle of *res judicata* also is contained in the Ukrainian Code of Commercial Procedure. That Code draws a distinction between a ruling of a Ukrainian court that, for instance, 'the statement of claim is not subject to consideration by the commercial courts of Ukraine' (Article 62), in which case the court's ruling does not have the effect of opening a case, and the ruling does not have any preclusive effect; and a decision of a Ukrainian court that terminates proceedings (Article 80), to which *res judicata* would

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<sup>369</sup> Respondent's Post-Hearing Brief, paras. 109-112.

<sup>370</sup> Respondent's Post-Hearing Brief, paras. 113-129.

<sup>371</sup> Respondent's Post-Hearing Brief, para. 108.

<sup>372</sup> See, e.g., Bin Cheng, *General Principles of Law as Applied by International Courts and Tribunals* (first published 1953, 1987 ed), p. 336.

attach. Professor Luts' expert report in support of this position was not challenged by the Claimants.

279. The Tribunal accepts the testimony of Professor Luts, and finds that the Kiev Commercial Court's acceptance of the University's statement of claim, filed on 2 November 2007, did not violate the *res judicata* principle under applicable Ukrainian law.

280. The Claimants deny the relevance of Ukrainian law on the basis that 'the issue is governed by international law.'<sup>373</sup> However, the Tribunal considers that in order to determine whether the Respondent is in breach of the fair and equitable treatment standard, the Tribunal is required to assess, *inter alia*, whether the law applicable to the proceedings before the Ukrainian courts to which B&P was a party (namely Ukrainian municipal law) was properly and fairly applied. The Tribunal considers that this primarily is a question to be determined under Ukrainian law. It is only in a situation where those proceedings would '[offend] a sense of judicial propriety' that it would be open to the Tribunal to find that those proceedings did not meet international standards.<sup>374</sup> However, to apply a provision of Ukrainian law in a non-discriminatory fashion will rarely give rise to a breach of an international standard, such as the fair and equitable treatment obligation in Article II(3)(a). In this regard, the Tribunal is not assisted by Article II(7) of the BIT, which contains a separate substantive standard of protection.

281. The Tribunal has no reason to reject the testimony of Professor Luts. The application of the *res judicata* principle in Ukrainian civil procedure may or may not differ from that in other jurisdictions, but it does not at all reach the threshold for offending a sense of judicial propriety. Equally, the fact that certain legal systems recognise that it is only final judgments that attract the status of *res judicata*, rather than all procedural decisions made by a court or tribunal, also does not offend such a principle.<sup>375</sup>

282. For these reasons, it does not appear to the Tribunal that it has any ground to reject the decision of the Ukrainian courts as correctly stating the position under Ukrainian law on the *res judicata* issue.

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<sup>373</sup> Claimants' Post-Hearing Submissions, para. 215.

<sup>374</sup> See, e.g., *Loewen Group, Inc v United States* (ICSID Case No ARB(AF)/98/3), Award of 26 June 2003, para. 132; cited in Respondent's Counter-Memorial, para. 387.

<sup>375</sup> As was submitted by the Respondent: Respondent's Post-Hearing Brief, para. 87.

283. The Tribunal does not find that the Claimants were in any way denied due process in the various proceedings before the Ukrainian courts. To the contrary, B&P had every opportunity to present its case. Its submissions to jurisdictional defences that the subsequent proceedings were inconsistent with Judge Kovtun's Ruling of 29 October 2007 and the principle of *res judicata*, and its claim that the dispute arising out of the 2003 Contract was subject to ICSID jurisdiction, and was outside the jurisdiction of the Ukrainian courts. It might also have presented defences on merits issues, but elected not to do so.

284. In this regard, it seems to the Tribunal that the Claimants are bound by their litigation strategy and its consequences. The Claimants made a conscious election not to raise non-jurisdictional defences. Indeed, that position was maintained before the Tribunal and in post-hearing submissions. Having elected to proceed in that way, the Claimants cannot now contest the result.

285. Finally, the Tribunal observes that the evidence does not establish that the representatives of the Ministry of Justice in any way 'abetted' the Ukrainian courts in any breach of the BIT. The representatives of the Ministry of Justice did not hinder B&P's ability to appear and make submissions in the Ukrainian court proceedings, and even if they advanced a position consistent with that presented by the University, the Claimants have failed to demonstrate that this was a breach of Ukraine's obligation under Article II(3)(a).

286. Accordingly, the Tribunal rejects the Claimants' claims for breach of Article II(3)(a) arising out of the Ukrainian court proceedings.

## **VIII. COSTS**

287. The BIT does not contain a rule on the allocation of costs. The ICSID Convention provides in Article 61(2) that:

‘In the case of arbitration proceedings the Tribunal shall, except as the parties otherwise agree, assess the expenses incurred by the parties in connection with the proceedings, and shall decide how and by whom those expenses, the fees and expenses of the members of the Tribunal and the charges for the use of the facilities of the Centre shall be paid. Such decision shall form part of the award.’<sup>376</sup>

288. This provision, together with Rule 28(1) of the ICSID Arbitration Rules, gives the Tribunal broad discretion to decide on the allocation of costs. It does not contain a rule that ‘costs follow the event’, in the sense that the unsuccessful party is required to pay the successful party’s costs; nor does the broad body of arbitral practice suggest that this is the approach which should be followed in ICSID arbitration proceedings.

289. The Respondent’s stated costs, apart from ICSID fees of \$303,945, amount to USD 914,920 and UAH 17,331 (which the Tribunal understands to amount to \$2,101). The Claimants’ costs are in the order of USD 1,322,770 (exclusive of ICSID fees). It appears to the Tribunal that it may regard the costs of each party as having been reasonably incurred.

290. In the result, the Respondent has prevailed in this dispute. The Claimants’ claims have been rejected in their entirety. The Respondent has requested that the Tribunal order that the Claimants bear all of the costs incurred by the Respondent in this arbitration. It makes this request in view of the costs incurred in, *inter alia*, arranging better English language translations of exhibits referred to by the Claimants; the two delays in the scheduling of the hearing which were occasioned by the Claimants’ requests for extension of time to complete their Reply, and the Claimants’ subsequent change of counsel; the Claimants’ insistence that the hearing take place in Washington DC when most of the witnesses were located in Europe; and the work involved in preparing defences to various claims and arguments advanced by the Claimants which were later abandoned. For their part, the Claimants request that, in the event that their claims are dismissed, the parties should be ordered to bear their own costs.

291. The Tribunal notes that in some cases, where the unsuccessful claimant has engaged in some form of abusive conduct, arbitral tribunals have ordered that the claimant pay all

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<sup>376</sup> ICSID Convention, Art 61(2).



or a significant part of the respondent's costs.<sup>377</sup> The Tribunal does not consider, however, that the present case falls into this category. The Claimants had serious and credible claims under the BIT that were not presented in a way which raised questions of procedural propriety, and the Claimants' counsel represented their clients in a professional manner at the hearings. The Tribunal therefore rejects the Respondent's request that a 'costs follow the event' approach be applied in a blanket way in this case.

292. The Tribunal is conscious, however, that certain costs were incurred by the Respondent in responding to the Claimants' case as the arbitration progressed, as has been noted above, and that the substantive hearing in this arbitration had to be delayed twice due to requests from the Claimants. In all the circumstances, the Tribunal considers it is appropriate to order the Claimants to make a contribution to these additional costs that would not have been incurred but for the actions of the Claimants. The Tribunal determines that a reasonable sum in this respect, excluding the Respondent's share of ICSID's fees, is one-sixth of the Respondent's costs, rounded to the sum of USD 150,000.

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<sup>377</sup> See, e.g., *Europe Cement Investment & Trade SA v Turkey* (ICSID Case No ARB(AF)/07/2), Award of 13 August 2009, paras. 182-186; *Cementownia 'Nowa Huta' SA v Turkey* (ICSID Case No ARB(AF)/06/2), Award of 17 September 2009, paras. 173-178; *Libananco Holdings Co Limited v Turkey* (ICSID Case No ARB/06/8), Award of 2 September 2011, paras. 557-569; *Saba Fakes v Turkey* (ICSID Case No ARB/07/20), Award of 14 July 2010, paras. 150-155; *Rachel Grynberg, Stephen Grynberg, Miriam Grynberg and RSM Production Corporation v Grenada* (ICSID Case No ARB/10/6), Award of 7 December 2010, paras. 8.3.1-8.3.6; and *Phoenix Action Ltd v Czech Republic* (ICSID Case No ARB/06/5), Award of 15 April 2009, paras. 148-152.

## IX. DISPOSITIVE PART

The Tribunal determines as follows:

1. Each of the Claimants' claims is within the jurisdiction of the Tribunal, and the Claimants' claim under Article II(3)(c) is admissible.
2. The conduct of the Ukrainian Courts, the CRO and the Ministry of Justice is attributable to Ukraine, but the conduct of the University that is the subject of these proceedings is not attributable to Ukraine.
3. With regard to the Claimants' claims:
  - a. the Respondent has not breached its obligations under Article II(3)(a) or Article III of the BIT by the conduct of the CRO.
  - b. the Respondent has not breached Article II(3)(a) of the BIT through the conduct of the University.
  - c. the Respondent has not breached Article II(3)(c) of the BIT through the conduct of the University as regards the 2003 Contract.
  - d. the Respondent has not breached Article II(3)(a) of the BIT through the conduct of the Ukrainian courts and the conduct of the Ministry of Justice.
4. On the issue of costs, the Claimants are ordered to pay to the Respondent the amount of USD 150,000.

Dr Gavan Griffith QC

President

Date: 17. X. 2012

Professor Philippe Sands QC

Arbitrator

Date: 15 October 2012

Professor Donald McRae

Arbitrator

Date: 22 October 2012

## **LEGAL AUTHORITY CA-96**

**International Centre for  
Settlement of Investment Disputes  
(ICSID)**

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*ICSID Case No. ARB/06/1*

**SPYRIDON ROUSSALIS**

**v.**

**ROMANIA**

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**AWARD**

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**Rendered by an Arbitral Tribunal composed of:**

***Andrea Giardina, Arbitrator***  
***Michael Reisman, Arbitrator***  
***Bernard Hanotiau, President***

*Date of Dispatch to the Parties: December 7, 2011*

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## **CHAPTER I. THE PARTIES AND THE BACKGROUND OF THE DISPUTE**

1. The Claimant in this arbitration is Spyridon Roussalis (hereinafter “Claimant” or “Roussalis”), a Greek citizen. Claimant’s address is Mavrokordatou Street, 11, Pireu, Greece. Claimant is represented in this arbitration by Ms. Nina Hall of Global Arbitration Litigation Services Ltd., Mr. Doru Costea of Doru Costea Law Office and Mr. Doru Băjan.
2. The Respondent in this arbitration is the State of Romania (hereinafter “Respondent,” “Romania” or the “State”). It is represented in this arbitration by Mr. Mark N. Bravin of Morgan Lewis & Bockius LLP and Messrs. Gabriel Sidere and John Fitzpatrick of CMS Cameron McKenna SCA.
3. The Authority for State Assets Recovery (“AVAS” or the “State Property Fund”) is a government agency created to, *inter alia*, manage the privatization of state-owned enterprises.
4. S.C. CONTINENT MARINE ENTERPRISE IMPORT EXPORT S.R.L. (“Continent SRL”) is a Romanian legal entity, 100 percent owned by Claimant, having its registered office in Bucharest, 82 Timișoara Av., sector 6, registered to O.R.C.M.B. with n°J 40/4719/1997.
5. Until 1998, S.C. Malimp S.A. was a State-owned company. It had been partly privatized in 1991. Thirty percent of its shares were being held privately. AVAS owned the remaining 70 percent.
6. On September 4, 1998, AVAS issued an invitation to tender for its shares in S.C. Malimp S.A. Continent SRL won the tender process with an offer of ROL 32,591 per share and a proposed capital contribution of USD 1.4 million.
7. On October 23, 1998, Claimant entered into a Share Purchase Agreement n°732/23.10.1998 (the “Privatization Agreement” or the “SPA”) with AVAS to purchase, through Continent SRL, AVAS’s 70 percent interest in S.C. Malimp S.A., consisting of 372,523 shares. Following the acquisition, the company name was changed to S.C. CONTINENT MARINE ENTERPRISE S.A. (“Continent SA”).
8. Continent SRL agreed to make an additional post-purchase investment of USD 1.4 million from its own funds over a two-year period starting on January 1, 1999 and ending on December 31, 2000. As security for this post-purchase investment, Continent SRL agreed to grant and register a pledge of the 372,523 shares in Continent SA in favor of AVAS.
9. Claimant contends that Continent SRL complied with its post-purchase investment obligation. The shareholders of Continent SA approved a resolution declaring a share capital increase. This share capital increase was the basis for issuing 1,418,648 new shares in Continent SA to Continent SRL. The shareholders’ decision to issue the shares was duly approved by Romania’s Trade Registry. However, Respondent disputes that Continent SRL made the post-purchase investment.

10. Claimant asserts that his investments were subject to a series of malicious and unjustifiable acts taken by various agencies of the Romanian government. He alleges, *inter alia*, that the State agents' actions taken collectively or individually amount to an indirect expropriation, or at least substantial impairment, of his investments, in violation of the Agreement between the Government of Romania and the Government of the Hellenic Republic on the Promotion and Reciprocal Protection of Investments, which entered into force on May 23, 1997 (the "Treaty" or the "BIT"); that they also constitute violations of the fair and equitable treatment, the full protection and security and the non-impairment standards of the Treaty as well as of Article 6 of the European Convention on Human Rights and of Article 1 of the First Additional Protocol to the European Convention.
11. Claimant's allegations are strongly denied and disputed by Respondent.

## **CHAPTER II. THE PROCEDURE**

### **I. INSTITUTION OF THE PROCEEDINGS AND THE TRIBUNAL**

12. On May 13, 2004, ICSID received a Request from Roussalis for the institution of arbitration proceedings under the ICSID Convention (the "Request"), with accompanying documentation comprising 16 annexes.
13. On June 9, 2004, the ICSID Secretariat (the "Secretariat") transmitted copies of the Request and of its accompanying documentation to Romania in accordance with Rule 5(2) of the ICSID Institution Rules.
14. After a prolonged period during which Claimant supplemented his Request, on January 10, 2006, the Request was registered pursuant to Article 36(3) of the ICSID Convention.
15. On March 14, 2007, an Arbitral Tribunal was constituted in accordance with Articles 37(2)(b) and 38 of the ICSID Convention. The Tribunal consisted of Dr. Robert Briner (President, appointed by ICSID), Prof. Andrea Giardina (also appointed by ICSID), and Prof. W. Michael Reisman (appointed by Respondent). The ICSID Secretariat informed the Parties on the same date that Ms. Martina Polasek (Senior Counsel, ICSID), would serve as Secretary of the Tribunal (the "Secretary").
16. On July 29, 2009, Dr. Briner resigned as arbitrator from this case. Consequently, the Chairman of the ICSID Administrative Council appointed Prof. Bernard Hanotiau in order to fill the vacancy in accordance with Articles 38 and 40(1) of the ICSID Convention and Arbitration Rule 11(1). On September 3, 2009, Prof. Hanotiau accepted the appointment as President of the Tribunal and the Tribunal was thus reconstituted and the proceedings resumed on that date.
17. On January 18, 2010, the Parties approved the appointment of Ms. Erica Stein, associate of the President's firm, as assistant to the Tribunal in this case. Subsequently, on February 4, 2011, Ms. Stein was replaced by Ms. Alexandra De Roose, also associate of the President's firm.

## **II. PROCEDURAL RULES AND AGENDA: MINUTES OF THE FIRST SESSION**

18. By agreement of the Parties, the first session of the Arbitral Tribunal concerning the procedural rules and the agenda of the arbitration was held at the World Bank offices in Paris on May 4, 2007.
19. This first session addressed various procedural matters listed on the agenda circulated to the Parties by the Secretary on April 9, 2007 (attached to the Minutes as Annex 1). It also addressed matters contained in the Parties' Joint Proposal of May 3, 2007 (attached to the Minutes as Annex 2), which enumerated various points of agreement between the Parties regarding the procedure to be followed. The minutes of the first session, signed by the arbitrators and the Secretary of the Tribunal, were transmitted to the Parties on July 11, 2007.
20. Among other matters, it was agreed that the applicable arbitration rules would be the ICSID Arbitration Rules in force as of April 10, 2006, that the place of proceedings would be Paris and that the procedural language would be English. It was further agreed that substantive Romanian law would govern the arbitration, and that the BIT would be treated as part of Romanian law.

## **III. RESPONDENT'S FIRST REQUEST FOR PRODUCTION OF DOCUMENTS**

21. On March 7, 2008, Respondent submitted its Request for an Order Compelling the Production of Certain Documents by Claimant, comprising twenty-six Requests and two Supplemental Requests. Claimant submitted his reply on March 17, 2008.
22. On March 27, 2008, the Tribunal took note of Claimant's commitment to produce certain specified documents by March 31, 2008. The Tribunal also expressed its satisfaction regarding the explanations given by Claimant regarding the other Requests, noting that this would be sufficient for Respondent to draft its Counter-Memorial.

## **IV. RESPONDENT'S FIRST REQUEST FOR PROVISIONAL MEASURES**

23. On May 28, 2008, Respondent submitted a First Request for Provisional Measures requesting that Claimant refrain from selling certain properties until the conclusion of the arbitration proceedings. Pursuant to the Tribunal's invitation in accordance with ICSID Arbitration Rule 39(4), Claimant submitted his observations on the Request on June 13, 2008. Respondent filed its Reply on June 23, 2008, and Claimant filed his Rejoinder on June 30, 2008. On July 8, 2008, Respondent sent a letter to the Tribunal challenging a new allegation raised by Claimant in his Rejoinder. By letter dated July 10, 2008, Claimant replied to Respondent's letter of July 8, 2008.
24. On July 22, 2008, the Tribunal rendered its Decision on Provisional Measures, directing that Claimant does not sell or alienate any property belonging to Continent SA, without prejudice to all substantive issues in dispute.

## **V. RESPONDENT'S SECOND REQUEST FOR PRODUCTION OF DOCUMENTS**

25. On March 27, 2009, Respondent submitted a "Request for Documents" to Claimant. On April 27, 2009, Claimant objected to Respondent's Request.
26. On April 29, 2009, Respondent filed a Request for an order compelling Claimant to produce documents and preserve evidence for later production. Claimant submitted his Response to the request on May 19, 2009. Respondent submitted its Reply on July 24, 2009 and Claimant submitted his Response on October 7, 2009.
27. On October 14, 2009, the Tribunal issued its Decision on Document Production and Preservation of Evidence, rejecting Respondent's Request for Production and Preservation in its entirety.

## **VI. RESPONDENT'S SECOND REQUEST FOR PROVISIONAL MEASURES**

28. On May 12, 2009, Respondent submitted a Request for provisional measures seeking an order requiring the parties to refrain from pursuing non-ICSID remedies, namely a stay of pending Romanian court proceedings until such time as the Tribunal would issue an award. Claimant submitted his observations on May 19, 2009. Respondent then submitted its Reply on May 29, 2009 and Claimant a Rejoinder on June 23, 2009.
29. On July 2, 2009, the Tribunal issued a Decision on Provisional Measures ordering that Roussalis cause Continent SRL and Continent SA to take all necessary actions to seek, together with Romania and AVAS, a stay of two pending Romanian court proceedings until the rendering of this Award.

## **VII. PROCEDURAL RULES AND AGENDA: PRE-HEARING TELEPHONE CONFERENCE AND ADDITIONAL REQUESTS**

30. On January 27, 2010, a pre-hearing telephone conference was held between the Parties and the Tribunal in order to determine various procedural matters. Prior to the telephone conference, the Parties had submitted a written statement enumerating various points of agreement. On January 28, 2010, the Tribunal confirmed that it had no objection to the agreed points, and communicated its decisions regarding various outstanding issues. These included: (i) the availability of witnesses for examination and cross-examination at the hearing; (ii) the oral presentation of opening and closing statements; (iii) the order in which the various heads of claim were to be heard at the hearing; and (iv) the submission of post-hearing briefs. The Tribunal invited the Parties to submit a detailed schedule for the five-day hearing by mid-February.
31. On March 1, 2011, Claimant made a request to: (i) submit evidence from two witnesses at the hearing who had not previously submitted a witness statement or expert report; (ii) submit new rebuttal evidence; (iii) file certain new authorities relating to Romanian law; and (iv) amend the procedural schedule of the hearing. By letter of March 4, 2011,



Respondent stated its objections to the request. On March 8, 2011, the Tribunal rendered its directions in respect of Claimant's requests, by which it: (i) denied the Claimant's first request in accordance with the Parties' agreement set out in the Minutes of the First Session; (ii) allowed the submission of late rebuttal evidence in respect of one exhibit, but denied it in respect of five others, inviting limited rebuttal evidence from Respondent; (iii) approved the third request regarding the filing of the authorities relating to Romanian law; (iv) confirmed the sequence of arguments set out in its directions of January 28, 2010, but approved the Parties' agreement to hear the Ozias Tax Claim jointly with the Fiscal Claim.

#### **VIII. EXCHANGE OF WRITTEN PLEADINGS**

32. The time limits contained in the Minutes of the first session of the Arbitral Tribunal were extended several times by the Tribunal upon the Parties' requests. Each party filed its written submissions pursuant to the Tribunal's amended directions.
33. On October 2, 2007, Claimant filed his Memorial on the merits together with exhibits and legal authorities.
34. On June 2, 2008, Respondent filed its Counter-Memorial, including objections to jurisdiction and a Counterclaim, together with supporting documentation and five witness statements.
35. Claimant filed his Reply on jurisdiction and the merits on December 21, 2008, together with exhibits and legal authorities. On the same date, Claimant also submitted his Counter-Memorial to Respondent's Counterclaim.
36. On March 31, 2009, having considered the Parties' respective submissions on the issue, the Tribunal granted Respondent's request for bifurcation of the proceedings, directing that any damages concerning Respondent's Counterclaim be assessed in a second stage of the proceedings, should the Tribunal find for Respondent with respect to jurisdiction and liability.
37. On July 13, 2009, Respondent filed its Rejoinder on jurisdiction and the merits, including a Reply on the Counterclaim.
38. On November 13, 2009, the Claimant filed a Rejoinder on the Counterclaim.

#### **IX. ORAL PLEADINGS**

39. An oral Hearing on Jurisdiction and the Merits was held between March 14, 2011 and March 18, 2011 at the World Bank's offices, 66 Avenue d'Iéna, Paris. The hearing was audio recorded and transcribed by a court reporter, Ms. Emma White.
40. During the Hearing, the following witnesses of fact were heard in accordance with the agreed method (namely – direct, cross and re-direct examination, and questions from the Tribunal):

- Ms. Mariana Predescu (regarding the Investment Claim);
- Ms. Ana Lucia Chivu (regarding the Fiscal Claim and Ozias Claim);
- Ms. Oana Scrobota (regarding the Fiscal Claim and Ozias Claim);
- Mrs. Alexandra Stocia (regarding the Food Safety Claim);
- Mrs. Maria Dulgheriu (regarding the Food Safety Claim).

## **X. POST HEARING SUBMISSIONS**

41. The Parties submitted their Post-Hearing Briefs on June 7, 2011. On the same date, the Parties submitted their Statements of Costs. On June 21, 2011, Claimant submitted a supplementary submission on Costs.
42. On September 7, 2011, Respondent requested the admission of an additional exhibit. Following the Tribunal's invitation, on September 22, 2011, Claimant objected to Respondent's request, submitting a witness statement of Roussalis with approximately 90 pages of appendices in support of his objection. On September 28, 2011, the Arbitral Tribunal rejected the admissibility of the new documentary evidence.

## **CHAPTER III. JURISDICTION**

### **SECTION I. CLAIMANT'S POSITION ON JURISDICTION**

43. Claimant submits that the Arbitral Tribunal has jurisdiction over this case in accordance with the Treaty. Article 9 of the Treaty provides :

#### *Settlement of Disputes between an Investor and a Contracting Party*

1. *Disputes between an investor of a Contracting Party and the other Contracting Party concerning an obligation of the latter under this Agreement, in relation to an investment of the former, shall, if possible, be settled by the disputing parties in an amicable way.*
2. *If such disputes cannot be settled within six months from the date either party requested amicable settlement, the investor concerned may submit the dispute either to the competent courts of the Contracting Party in the territory of which the investment has been made or to international arbitration.*

*Each Contracting Party hereby consents to the submission of such dispute to international arbitration.*

3. *Where the dispute is referred to international arbitration the investor concerned may submit the dispute either to:*
  - a) *the International Centre for the Settlement of Investment Disputes, established under the Convention on the Settlement of Investment Disputes*

*between States and Nationals of Other States, opened for signature at Washington D.C. on 18 March 1965, for arbitration or conciliation, or*

*b) an ad hoc arbitral tribunal to be established under the arbitration rules of the United Nations Commission on International Trade Law (U.N.C.I.T.R.A.L).*

4. *The arbitral tribunal shall decide the dispute in accordance with the provisions of this Agreement and the applicable rules and principles of international law. The awards of arbitration shall be final and binding on both parties to the dispute. Each Contracting Party shall carry out without delay any such award and such award shall be enforced in accordance with domestic law.*

44. Article 1(3) of the Treaty provides that: “‘Investor’ shall comprise, in respect of either Contracting Party, nationals and legal persons or other legal entities constituted or otherwise duly organised in accordance with the laws of that Contracting Party and having their effective economic activities in the territory of that same Contracting Party.”

45. Article 1(4) of the Treaty provides that: “‘national’ means: b) In respect of the Hellenic Republic, any natural person having or acquiring Greek nationality in accordance with the Greek nationality code”.

46. Spyridon Roussalis is a Greek citizen with Passport series „O” n°3107555. Greece signed the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (the “ICSID Convention”) on March 16, 1966 and became an ICSID Member State on May 21, 1969.

47. Respondent, Romania, signed the ICSID Convention on September 6, 1974 and became an ICSID Member State on October 12, 1975.

48. Claimant made an investment in Romania when Roussalis entered, through Continent SRL, into the Privatization Agreement with AVAS and purchased a 70 percent interest in S.C. Malimp SA (now Continent SA).

49. In light of the foregoing, Spyridon Roussalis, a Greek citizen and the sole shareholder of Continent SRL, is an investor within the meaning of Article 1(3) of the Treaty.

50. Claimant further states that he fulfilled the “amicable settlement” preliminary procedure. Indeed, by registered letter dated December 9, 2003 (Claimant Exhibit n°3), he wrote to Romania’s Government seeking amicable settlement of the dispute. Romania’s Government did not reply.

51. Therefore, in accordance with Article 9 of the Treaty, Claimant, after the expiry of the six-month “amicable settlement term,” submitted the dispute to arbitration under the auspices of ICSID.

## **SECTION II. RESPONDENT'S POSITION ON JURISDICTION**

52. In its written pleadings, Respondent submitted that the Arbitral Tribunal does not have jurisdiction to hear this case since Claimant did not make an investment within the meaning of Article 9(1) of the Treaty.
53. Respondent argued that bilateral investment treaties do not offer protection to investments, such as Claimant's, that are fraudulent or otherwise illegal. Recognizing the existence of rights under BITs arising from illegal acts would violate "respect for the law," a fundamental principle of such treaties (*Inceysa Vallisoletana S.L. v. Republic of El Salvador*, ICSID Case No. ARB/03/26). Moreover, in the case at hand, Article 2(1) of the Treaty expressly provides that each Contracting Party admits investments by investors of the other Contracting Party *in accordance with its legislation*. Consequently, Claimant cannot rely on the Treaty as a basis for a claim that is premised on purported financial transactions which, under Romanian law, are void.
54. Respondent further submitted that Roussalis bears the burden of proving that his claimed investment was made, and that it was made in accordance with Romanian law; that he has proved neither and that accordingly, the Treaty provides no basis for Claimant's Investment Claim.
55. However, in its oral pleadings, counsel for Respondent amended their position and stated that: *"The only dispute is on the facts. So, for the purposes of jurisdiction, we believe that once you decide, as I think you must, because there is no dispute here, that you have jurisdiction to decide the investment claim, that will a fair and appropriate application of the convention, and the limited amount of case law that is out there, and the limited amount of commentary that is available to you"* (Transcript, Day 4, p.132, line 5).
56. Counsel for Respondent indicated that their contention as regards Claimant's unfulfilled post-purchase obligations under the SPA was on the merits, *inter alia* in support of Respondent's Counterclaim. Professor Reisman asked Respondent: *"So reference has been made from the first day to the investment not being made, I am to understand that that means [that] the post-investment portion?"* Counsel for Respondent answered: *"Yes, and I apologize, it is sloppiness on our side, but all of those references, if I can correct them by a global correction, are all meant to say, "The post-privatisation investment of US\$1.4 million was not made."*

## **SECTION III. DECISION OF THE ARBITRAL TRIBUNAL**

57. The Tribunal's jurisdiction is contingent upon the provisions of the BIT and the ICSID Convention.
58. The relevant provision of the ICSID Convention is Article 25(1), which reads as follows:  
*"The jurisdiction of the Centre shall extend to any legal dispute arising directly out of an investment between a Contracting State (or any constituent subdivision or agency of a Contracting State designated to the Centre by that State) and a national of another Contracting State, which the parties to the dispute consent in writing to submit to the*

*Centre. When the parties have given their consent, no party may withdraw its consent unilaterally.”*

59. The relevant provision of the BIT is its Article 9 (see above ¶43).
60. An analysis of the arguments raised by the Parties in connection with the jurisdiction of the Tribunal over the claims indicates that it is not disputed that Claimant made an investment in Romania when Roussalis entered, through Continent SRL, into the Privatization Agreement with AVAS and purchased a 70 percent interest in S.C. Malimp SA.
61. Respondent’s counsel recognised during the hearing that *“The Investor put in the money necessary to have the shares transferred into his possession, but then the Investor did not comply with the second half of the investment, so yes, there was an investment, you do have jurisdiction to decide the investment claim”* (Transcript, Day 3, p.129, line 12 *et seq.*). In particular, upon Professor Reisman’s question: *“(…) if I may restate it, it is the position of Respondent that the Claimant did make an investment and that investment comes under the protection of the BIT?”* Respondent’s counsel answered: *“Correct”* (Transcript, Day 3, p.131, line 23 *et seq.*). The following day, the Respondent confirmed once again its position: *“Obviously, there was an investment. This investor put up an initial 1-2 million dollars, more or less to acquire the shares and they were transferred to him.”* (Transcript, Day 4, page 128, lines 7 and 8).
62. In light of the foregoing, the Tribunal decides that the present dispute constitutes an investment within the jurisdiction of the tribunal. The other objections to the subject matter jurisdiction of four of the five claims will be addressed hereafter in the discussion of each of those respective claims.

#### **CHAPTER IV. THE CLAIMANT’S CLAIMS**

63. Claimant invokes the violation by Respondent of the of the BIT, of the European Convention on Human Rights and of the First Additional Protocol to the European Convention in relation to five claims:
  - The Investment Claim
  - The Fiscal Claim
  - The Interdiction Claim
  - The Food and Safety Claim
  - The Ozias Claim.
64. Claimant submits that a series of measures taken by the Romanian authorities in relation to Roussalis’s investment amount to a violation of Articles 2(2) and 4(4) of the Treaty, of Article 6 of the European Convention on Human Rights and of Article 1 of the First Additional Protocol to the European Convention.
65. The five claims are analyzed below. They are strongly disputed by Respondent.

66. In a nutshell, Claimant submits that in breach of the BIT – and of the European Convention on Human Rights and of its Additional Protocol – Romania failed to create a safe environment for the investor and the investment; it failed to protect the investor and his investment from arbitrary State measures and failed to treat the investor and the investment equitably and fairly. In particular, the lack of recognition given to the Claimant’s contractual rights and legitimate expectations to sell and/or dispose of his assets amounted to an expropriation.

## **SECTION I. THE INVESTMENT CLAIM**

### **SUB-SECTION I. CLAIMANT’S POSITION ON THE INVESTMENT CLAIM**

#### **§1. THE FACTS**

##### **I. AVAS’S JUDICIAL PROCEEDINGS FOR THE ENFORCEMENT OF THE SHARE PLEDGE**

###### **A. Claimant fulfilled his Contractual Obligations**

67. In accordance with the Privatization Agreement, Continent SRL agreed to make an additional post-purchase investment of USD 1.4 million over a two-year period from January 1, 1999 to December 31, 2000. Annex 4 to the Privatization Agreement specified that a capital contribution of USD 1.1 million must be made in 1999, with the remainder (USD 300,000) to be contributed in 2000.
68. This investment had to be carried out by the buyer “*from personal sources or sources attracted on its behalf*” (Claimant’s Memorial, ¶24).
69. The Privatization Agreement and Annex 4 thereto did not further stipulate the method by which the post purchase investments should be made. That decision was left to the buyer. The sole obligation was the financial result, namely that the investments should amount to USD 1,400,000.
70. As security for the post-purchase investment, Continent SRL also agreed to pledge in favor of AVAS the 372,523 shares that it had purchased.
71. Article 8.10.2 of the Privatization Agreement states that the capital contribution “is deemed to be performed on the date of the registration at the Trade Registry of the increase of [Continent SA’s] capital by the subscribed contribution and fully paid by [Continent SRL]”. In other words, in order for the capital investment to be “*deemed to be performed,*” Continent SRL had to demonstrate that Continent SA’s capital increase had been registered at the Trade Registry.
72. Claimant contends that Continent SRL complied with its post-purchase investment obligation by means of (i) undertaking construction works; (ii) making installations in buildings; and (iii) purchasing fixed assets.

73. An extraordinary general meeting of the shareholders of Continent SA was held on October 27, 2000. The items on the agenda included both the share capital increase by way of contribution in kind for a value of USD 1,400,000, and the appointment of an expert to draft the assessment report on the contribution in kind. The meeting also provided an opportunity for other shareholders, where applicable, to exercise their rights of pre-emption.
74. Claimant hired SC Expert Proiect L.B. S.R.L. (“Expert Proiect”) as the consulting firm to draft a technical expertise and an expert report assessing the value of the investment made under the Privatization Agreement. In particular, Expert Proiect had to determine (a) the value of the in kind contribution, as it has physically been presented to it, (b) the assets purchased and the manual labor for which invoices had been submitted, and (c) the updating of the amounts. The expert was not asked to establish the financing sources of the post-purchase investment.
75. Claimant points out that, contrary to Respondent’s contention, Expert Proiect’s registered office was not located in the same building as Continent SRL’s registered office. Its registered office is at 5, N. Balcescu Av., the Dunarea Block, staircase B, flat No. 42, Bucharest – 1<sup>st</sup> District.
76. Expert Proiect used legal assessment methods and confirmed that an investment was made amounting to lei 35,571,648,325, representing the equivalent amount of USD 1,404,162. The report concludes as follows (see Claimant’s Memorial, p. 19):
- “- lei 27,690,960,312– USD 1,093,079– investment realized for constructions and installations;*
- lei 4,370,272,799– USD 172,513– investment engaged for works in process [sic] on constructions and installations;*
- lei 3,510,415,214– USD 138,571– purchased fixed assets.*
- 
- lei 35,571,648,325 = USD 1,404,162 – the value effectively ascertained as invested by the Claimant so as to fulfill the obligation undertaken with respect to AVAS (former FPS)”.*
77. Claimant contests Respondent’s allegations that Expert Proiect had previously performed a preliminary valuation of the post-purchase investment and that it had not reached the value of USD 1,400,000. Claimant further denies that, subsequently, in order to reach this value, Claimant requested his personnel to forge invoices and other documents that would serve as basis for the issuing of the final valuation report. He submits that Respondent does not offer any proof of these serious allegations.
78. Moreover, Respondent’s allegations are based on a written statement given to the police in April 2001 by Continent SA and Continent SRL’s chief accountant, Ms. Angela Doanta. Claimant argues that Ms. Doanta’s statement should be excluded from the record as unreliable on the ground that, following a complaint made by Roussalis, Ms. Doanta was investigated, convicted, and sentenced to five years’ imprisonment for embezzlement

(Claimant's Reply Exhibit n°1). According to Claimant, Ms. Doanta's statement is obviously tendentious, untrue and motivated by revenge.

79. Claimant submits that the invoices on which Expert Proiect based its report show the material (physical) reality of the invoiced services and assets purchased. Respondent's allegation that some irregularities have been discovered in the invoice forms is not relevant as long as the invoiced assets and services have been effectively provided to Continent SA.
80. On November 29, 2000, Continent SA sent a notice to the Official Gazette announcing that a shareholders' meeting would be convened to approve the Expert Proiect report and to pass a resolution increasing Continent SA's share capital by USD 1,404,162.
81. On December 15, 2000, during an extraordinary general meeting, Continent SA's shareholders approved the Expert Proiect report. The share capital increase was also approved, increasing the number of shares by 1.418.648, with a face value amounting to ROL<sup>1</sup> 25,000 for each share and a total value amounting to ROL 35,466,200,000 (Claimant's Exhibit n°16).
82. The additional Act n°4933/15.12.2000, issued by the Mircea Elena Public Notary's Office, modified the company's Deed of Incorporation and mentioned the share capital increase by way of the buyer's contribution in kind.
83. The amendment of the company's Deed of Incorporation was registered with the National Trade Register Office ("O.R.C." or the "Trade Registry")<sup>2</sup> of the Bucharest Municipality (the "O.R.C.M.B") under n°146699/15.12.2000 (Claimant's Exhibit n°5). The shareholders' resolution and the expert report were presented to the judge at the Trade Registry. Claimant obtained approval for the increase in Continent SA's share capital by a judgment handed down by the designated Trade Registry judge (see Conclusion n°6962/20.12.2000, Claimant's Exhibit n°5).
84. On December 21, 2000, the day after the Trade Registry judge rendered a decision, Continent SRL informed AVAS that it had fulfilled its post-purchase investment obligation, in accordance with Article 8.10.1 of the Privatization Agreement, by way of a contribution in kind for a value of USD 1,400,000.
85. According to Article 6 of Law 26/1990 on the Trade Register Office, the Trade Registry approval of the capital increase could only be appealed within 15 days of the decision being rendered. Neither AVAS nor any state authority had any objection to the Trade Registry approval decision since they did not challenge it within the applicable time limit.

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<sup>1</sup> ROL is the currency abbreviation for the Old Romanian lei, the official Romanian currency until July 1, 2005.

<sup>2</sup> The Trade Registry is the Government agency tasked with registering and managing incorporations and modifications to a commercial entity's status. It is part of the Justice Ministry, with each of its 42 territorial offices attached to a tribunal whose judges take turns in reviewing registrations.



Therefore, the Trade Registry judge's decision became irrevocable. Even if the Tribunal would accept Respondent's contention that the 15-day period began to run upon publication of the approval of the capital increase in the Official Gazette, it remains that Article 5(2) of Law n°26/1990 provides that: "(2) *The person whose responsibility is to request a registration cannot oppose to third parties the not-registered acts or facts, unless he has fulfilled the burden of proof that they were familiar with these ones*" (sic., Claimant's Reply Memorial, ¶182). Therefore, since Claimant immediately informed AVAS that the registration had taken place, AVAS could have challenged the decision within the required time limit.

86. Claimant denies Respondent's allegation that Continent SA's letter of May 21, 2001 contradicts the allegation that Continent SRL had fulfilled its investment obligation by stating that "*a part of the investment has been made by Continent SA and not by Continent SRL*" (Respondent's Exhibit n°12). Indeed, the portion of the letter quoted by Respondent actually indicates that, due to chaotic keeping of accounts and aberrant economic management (by Ms. Doanta), regularization needed to be made. Such regularization was made, and as a consequence, "*all the amounts that were used to achieve the investment belong to [Continent SRL] or have been attracted by this one*" (Claimant's Reply, ¶140).
87. Claimant refutes Respondent's allegation that Continent SA's accounts were manipulated to make Continent SA's capital expenditures appear as if they should be credited to Continent SRL as qualifying investments. It denies that Roussalis used two companies that he owned, SC Continent Marine Trading SRL and SC Continent Construction SRL, to that end. Indeed, the assignment agreements entered into in June 2001 by these two companies (as assignors) and Continent SRL (as assignees) have actually been recorded in the accounting registers of the respective companies. These agreements have extinguished the debt for construction works that Continent SA had towards the two companies. The debt was transferred to Continent SRL and Continent SA never paid the invoices for construction works that the two companies had issued.
88. According to Claimant, it is only several months after the Trade Registry judge's decision became irrevocable that AVAS began to request the submission of supporting documents concerning the fulfillment of the obligations stipulated in the Privatization Agreement. AVAS was obviously trying to find reasons to pretend that Claimant had not fulfilled his contractual obligations.
89. Claimant asserts that, at the date it purchased S.C. Malimp SA, the price it paid for the shares was "sensibly lower" than the actual value of the acquired assets. Indeed, during the privatization process in Romania, acquisitions of marginally profitable state-owned companies were customarily made undervalue. For Claimant, the value of Continent SA's assets is the reason underlying the long history of aggression and application of abusive measures by the Government towards Claimant's investment. Such aggression began when the new government took office after the November 2000 election. The new Romanian government tried to recover land, covering as much as 40,000 sq. m., where the assets were located (warehouses, refrigerating warehouses, including 5 floored

buildings, platforms, etc) because the value of these assets, and more specifically of the land, had exponentially increased in Romania.

90. The existence of the post-purchase investment has been confirmed in the decision of 8 October 2007 of the 6<sup>th</sup> Commercial Section of the Bucharest Court of Appeal which Claimant reproduces *in extenso* in its Reply Memorial (§174), and which states that: “As it resulted from the technical expertise and from the accounting one that have been carried out on the occasion of the trial of the cause in the first instance court, real investments have been made at the privatized company, investments that consisted in construction and installation works, as well as in the acquisition of fixed assets, investments whose total value amounted to 1,400,000 USD, and the Annex contains the estimations of the works to be done and the list with the invoices that have been checked by the accounting expert, invoices that certify the achievement of the investment.

*As concerns the nominal share capital increase, at the Trade Register, there has been written down the notification related to it that was subsequent to the ruling no. 6962 /20.12.2000 that has been rendered by the mandatory judge from the Court of Law from Bucharest at O.R.C.T.B. Given the above mentioned, it is considered that there have been observed and fulfilled the conditions from Art. 8.10.12 from the privatization contract, that there have been observed and fulfilled the registration conditions at the Trade Register, as capital increase, of the investment made by [Continent SA].*

*The decision of the Shareholders’ Extraordinary General Meeting (AGEA) no. 6 / 2000 reflects the reality as concerns the effective increase of the nominal share capital by the amount of 1,400,000 USD; (...).*

*(...), as concerns the investment financing sources, these ones comply with the issues stipulated in the Shares Sale – Purchase Contract, and in the own sources / attracted sources contract, respectively, on the name of [Continent SRL].*

*(...), the own sources to achieve the investments were transformed into re-investing the profit obtained by [Continent SA] during the years of 1998, 1999 and 2000. The re-investing of the profit was possible as a consequence of the decision, reached to this purpose, by [Continent SRL], the controlling shareholder, who has, thus, given up the idea of cashing dividends for the respective years, his target being to make investments into the privatized company.*

*At the same time, there have also been amounts that have been attracted on the name of [Continent SRL]. The above refers to the acquisition of some fixed assets and to the carrying out of construction works for [Continent SA] by S.C. CONTINENT MARINE CONSTRUCTION S.R.L. and by S.C. CONTINENT MARINE TRADING S.R.L. These companies have assigned, subsequently to having made the investments, their debts amounting to 9,250,087,000 LEI (ROL) and 3,985,471,852 LEI (ROL), respectively, in favor of the assignee [Continent SRL] by means of transfer of debts contracts signed and concluded on the 15-th of June 2001 and on the 30-th of June 2001.*

*At the same time, Roussalis Spyridon, who is the representative of [Continent SRL], has credited, on his own name [Continent SA] with the amount of 3,237,146,146 LEI (ROL) in view of purchasing fixed assets. After this acquisition, a contract called “novation contract” was signed and concluded on the 30-th of June 2001, which stands for a*

*perfect deputation. This way, Roussalis Spyridon, the creditor, has agreed to the replacement of the initial debtor, [Continent SA] by the new debtor, [Continent SRL]. As previously indicated by the accounting expert, both the transfer of debts contracts, and the novation contract have been registered in accounting (...).*

*Based on the analysis made to the previously presented facts in the accounting expertise minutes, there results that the financing sources of the investment are either own sources, or sources attracted on the name of the controlling shareholder [Continent SRL] (...).*

*The irregularities that have been found by the Financial Guard's representatives (...) cannot annul the reality of the achieved investments, reality that has been noticed by the technical experts who have concretely valued these investments, and, more than that, they can represent only civil penalties with reference to the way in which the accounting registration are made, as, the Financial Guard has stipulated, as a matter of fact.*

*Given the above stipulated, it is contended the reality of the effective achievement, out of own or attracted sources, on the name of [Continent SRL], of the investments brought as contribution to the nominal share capital of the privatized company, and, therefore, the achievement, by the plaintiff in appeal – defendant, of the liability assumed at Art. 8.10.1 and at Art. 8.10.2 from the Shares Sale – Purchase Contract. As the investment that represents a contribution to the share nominal capital of [Continent SA] has been integrally achieved at the end of 2000, and as Art. 8.10.3 from the Shares Sale – Purchase Contract stipulates that “the shares that represent a collateral shall be withdrawn from the collateral within 30 days since the date of the integral achievement of the capital investment /contribution by the Purchaser, under the conditions stipulated at Art. 8.10.1 and Art. 8.10.2 from the present Contract” (sic., Claimant's Reply Exhibit n°3).*

**B. Despite Claimant's fulfilment of his contractual obligations, AVAS filed judicial proceedings for the enforcement of the pledge**

91. Claimant submits that despite the fulfilment of Continent SRL's contractual obligations, on April 23, 2001, AVAS filed a breach of contract claim in the Bucharest Commercial Court (Claimant's Exhibit n°7). AVAS also sought to enforce its rights under Article 8.10 of the Privatization Agreement with respect to the share pledge as security for the investment obligation. It requested the *registration* of the pledge, as well as the payment of “comminatory damages” (*i.e. per diem* delay penalties) if the execution of the court's decision was delayed.
92. On June 22, 2001, AVAS amended the claim to seek *enforcement* of the share pledge and requested to have the property of the pledged asset, i.e. the 372,532 shares, returned to the State.
93. AVAS contended during the proceedings that Continent SRL had not fulfilled its obligations arising out of Article 8 of the Privatization Agreement and had not made the investments under the contract to the value of 1.4 million USD. It mainly based its allegation on the fact that:

- the documentation submitted by Continent SRL contained estimates of the investments that were based on works managed and executed by Continent SA and on invoices pertaining to fixed assets purchased by Continent SA; that
- accordingly, the financing sources of the investments were not the buyer's (Continent SRL) or "attracted on its behalf."

94. The first instance court and the appeal court ruled in favor of Continent SRL and rejected AVAS's requests as groundless (See Claimant's Exhibits n° 9 to 11). According to Claimant, the civil judge's decision n°7886/19.10.2001 in favor of Continent SRL became therefore irrevocable.

**C. Despite the existence of an irrevocable judgment, AVAS requested that the General Prosecutor take steps to seek supervisory review by the Supreme Court and an order vacating the judgment**

95. Notwithstanding the above, AVAS requested that the General Prosecutor take steps to seek supervisory review by the Romanian Supreme Court (the "Supreme Court") and an order vacating the judgment. On November 21, 2002, AVAS requested the General Prosecutor to file a motion to vacate the judgments rendered by the lower courts.

96. On March 11, 2002, the Public Ministry, through the General Prosecutor, filed a motion to vacate the lower court judgments (Claimant's Exhibit n°12). On July 9, 2003, the Supreme Court accepted the motion, cancelled the two judgments and remanded the case to the Bucharest Commercial Court for a full re-trial (Judgment n°3397/09.07.2003, Claimant's Exhibit n°13).

97. Claimant submits that this procedure of submitting motions to vacate irrevocable judgments is a reminiscence of the communist procedural system, which was subsequently abrogated. Indeed, such procedure does not compare to regular "annulment" proceedings since the right to file a motion to vacate a final judgment is left to the discretion of the General Prosecutor, an instrument of the State. According to Claimant, it infringes the principle of legal certainty.

98. The Supreme Court's decision reads as follows: "[r]egarding the criticism brought by the General Prosecutor to the mode how the debt concession contracts were signed and also the novation contract, they will be examined by the main instance after it would be established if the material contribution was real or fictive, in the conditions presented above and after checking the operations performed between the companies belonging to the same group" (*sic.*, Claimant's Exhibit n°13). The Supreme Court remanded the case to the trial court for further proceedings without any substantiated reasons. The decision led to an unreasonable new delay in the final settlement of the case. Indeed, it ordered a full retrial more than four years after the execution of the SPA.

#### **D. Subsequent Decisions**

99. On remand, the 6<sup>th</sup> Commercial Department within the Bucharest Court ruled on 5 May 2006 in favor of Continent SRL, deciding that it had fulfilled its investment obligations (Claimant's Exhibit n°14).
100. AVAS, once again, filed an appeal against the judgment. Following a further full trial, the Court of Appeal ruled in favour of Continent SRL on August 10, 2007 (Judgment no. 430/08.10.2007, Claimant's Exhibit n°3, C. Reply).
101. AVAS appealed the Court of Appeal's decision. On June 30, 2009, the Supreme Court ruled in favour of Continent SRL (Judgment no. 2090, Claimant's Exhibit n°1, C. Rejoinder).
102. It results from the above that for nearly ten years, the ownership of the shares has been challenged by the State on grounds which were ultimately found to be without merit.

#### **II. AVAS'S JUDICIAL PROCEEDINGS FOR THE ANNULMENT OF THE SHAREHOLDERS' RESOLUTION DATED DECEMBER 15, 2000**

103. Claimant asserts that notwithstanding the Supreme Court's decision, AVAS resorted to a new subterfuge lacking any legal ground. On August 17, 2007, it filed a request for:
  - the annulment of the shareholders' resolution dated December 15, 2000 approving the share capital increase (Claimant's Exhibits n°15 and 16), and
  - the registration of the annulment decision with the Trade Registry and thereby the deletion of the registration of Continent SA's share capital increase.
104. AVAS's aim was to establish that Continent SRL had not fulfilled its investment obligations.
105. Claimant argues that AVAS was not entitled to a set aside ruling declaring the Continent SA shareholders' resolution null. Indeed, the "absolute nullity sanction" was introduced in Romanian law in 2005, *i.e.* after the extraordinary general shareholders' meeting took place. Therefore it was not in force when the general meeting approved the capital increase.
106. Prior to 2005, the "absolute nullity sanction" was a remedy provided exclusively to shareholders who had not attended the meeting or who voted against the resolution. The shareholders had the right to contest the general meeting resolution within 15 days following the decision's publication in the Romanian Official Gazette.
107. In any case, the legal grounds that Respondent invoked to justify the filing of its "absolute nullity" claim were spurious. *First*, Article 966 of the Civil Code, invoked by Respondent, which provides that "[a]n obligation without cause or grounded on a false or illicit cause, cannot have any [legally-enforceable] effect", only applies to contracts, not to shareholder resolutions. Therefore it cannot be called upon to justify the filing of

the nullity claim. *Second*, there was no violation of mandatory provisions of the Company Law concerning decisions made with the vote of directors. Indeed, Claimant asserts that he participated in the meeting as the sole shareholder and representative of the controlling shareholder, not as Continent SA's director. The report shows that the directors participated only as guests in the extraordinary general meeting.

108. According to Claimant, Respondent's actions amount to a "*permanent juridical procedural harassment creating a state of juridical insecurity over the ownership (the investment)*." It led to deprive the investor of the exercise of its right of ownership over the investment (Claimant's Memorial, ¶48).
109. The Commercial Court ruled against AVAS and refused to nullify the shareholders' resolution (Claimant's Exhibit n°2, C. Rejoinder). The Court declared that the meeting had been convened and conducted with due process of law and without any conflict because of Roussalis's status as majority shareholder/owner and director of Continent SA.

### III. CONFIRMATION BY DOMESTIC COURTS OF THE PROPER PERFORMANCE OF THE PRIVATIZATION AGREEMENT

110. In light of the foregoing, it is clear that the Romanian courts, where AVAS was adequately represented, have always ruled in favour of Claimant concerning the proper performance of the SPA. Their rulings are binding upon both Continent SA and Continent SRL. They confirm that the post purchase investment was duly made and that the SPA was duly and lawfully performed.

## § 2. THE LAW

### I. VIOLATION OF ARTICLE 4, PARAGRAPH 1 OF THE TREATY AND OF ARTICLE 1 OF THE FIRST ADDITIONAL PROTOCOL TO THE EUROPEAN CONVENTION ON HUMAN RIGHTS

#### A. Introduction

111. Claimant submits that the facts summarized above demonstrate that:
  - he made the initially required investment, and subsequently performed the SPA in accordance with Romanian law.
  - Romania, from 2001 to date, attempted to reclaim the privatized company's shares via lengthy and unjustified court proceedings.
112. It is Claimant's position that AVAS has acted in a manner that is inconsistent with its international obligations, without due regard to its own legal process and in breach of the BIT and the First Additional Protocol to the European Convention on Human Rights (the "European Convention").
113. This persistent refusal to recognize the valid performance of the investment obligations has, *inter alia*, caused Roussalis to be deprived of his right to sell and/or dispose of the

assets forming part of its investment and forced him to manage the investment in a *sub optimum* way. Indeed, even where a potential buyer agreed to a price and/or the fair market value of the assets, as occurred at a point during this arbitration, it would not go ahead with the deal upon completion of its due diligence, in light of Romania's extant claims.

114. Claimant notes the irrelevance of Respondent's observation that Roussalis withdrew funds from Continent SA over the years. He points out that: (i) Continent SA consisted predominantly of tangible assets when it was privatized, the cash that was allegedly made available later would therefore necessarily have come about due to Continent SA's activities or Claimant's investment in Continent SA through Continent SRL; (ii) Continent SA's income could be diverted by its owner in any direction, including reinvestments back into the company; (iii) the domestic courts admitted that such reinvestment of funds took place (Judgment no. 2090, para. 2, page 4, Claimant's Exhibit n°1, C. Rejoinder). Moreover, in light of his near 100% ownership of Continent SA, the manner in which Roussalis withdrew funds was within his business discretion.

**B. AVAS's attempt to enforce the share pledge is a measure equivalent to expropriation**

115. Claimant contends that AVAS's attempt to enforce the share pledge through the Romanian courts is groundless and illegal and amounts to a seizure of Continent SRL's shares in Continent and, together with the other lawsuit filed by AVAS, is tantamount to an expropriation in violation of Article 4(1) of the Treaty and Article 1 of the First Additional Protocol to the European Convention.
116. Article 4(1) of the Treaty provides that :

*“Investments by investors of either Contracting Party in the territory of the other Contracting Party shall not be expropriated, nationalized or subjected to any other measure the effects of which would be tantamount to expropriation or nationalization (hereinafter referred to as “ expropriation”), except under the following conditions:*

*a) the measures are taken in the public interest and under due process of law;*

*b) the measures are clear and on a non discriminatory basis;*

*c) the measures are taken against payment of prompt, adequate and effective compensation. Such compensation shall amount to the market value of the investment affected immediately before the measures referred to above in this paragraph were taken or became public knowledge, whichever is the earlier, it shall include interest from the date of expropriation until the date of payment at a normal commercial rate and shall be freely transferable, without delay, in a freely convertible currency. The amount of the compensation shall be subject to review by due process of law, within the framework of the legislation of the Contracting Party, in the territory of which the investment has been made,”*

117. In this regard, Article 10 of the Treaty provides that “[i]f the provisions of law of either Contracting Party or obligations under international law existing at present or

*established hereafter between the Contracting Parties in addition to this Agreement, contain a regulation, whether general or specific, entitling investments by investors of the other Contracting Party to a treatment more favourable than is provided for by this Agreement, such regulation shall to the extent that it is more favourable, prevail over this Agreement.”* Since Article 1 of the First Additional Protocol to the European Convention creates far better treatment than Article 4 of the Treaty, Article 1 of the First Additional Protocol comes within the jurisdiction of the Tribunal.

118. Article 1 of the First Additional Protocol to the European Convention provides that “[e]very natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law.”

1. The lawsuit filed by AVAS is groundless since Claimant had fulfilled his contractual obligations

119. According to Article 8.10.2 of the Privatization Agreement, in order for the capital investment to be “*deemed to be performed*,” Continent SRL had to carry out Continent SA’s capital increase and such capital increase had to be registered at the Trade Registry. Claimant submits that it took all the necessary steps to register the capital increase. It obtained the Trade Registry approval and the Trade Registry judge’s decision became irrevocable.
120. Moreover, all of the numerous other experts who submitted reports in connection with the AVAS litigation confirmed that Continent SRL had fulfilled its contractual obligations and invested the amount it had undertaken to invest.
121. Within the commercial litigation, during the proceedings initiated on remand before the 6<sup>th</sup> Commercial Department of the Bucharest Court, Popescu Silvia drafted a technical expertise report (Claimant’s Exhibit n°18). The report stated that the technical expertise and the assessment report drafted by Expert Proiect were correct and valid. Beside the technical expertise report, a judiciary accounting expertise report was drafted by Nicolae Gheorghe (Claimant’s Exhibit n°21). This latter report also confirms the financial description of the investment contained in the Expert Proiect report.
122. In addition to the commercial litigation initiated by AVAS for the enforcement of the pledge on the 372,523 shares, the Financial Guard, Romania’s fiscal control agency, allegedly discovered illegalities which resulted in the filing of a criminal case against Roussalis. During the criminal investigation, technical expertise was also carried out. The expert report drafted by Isuf Eliade and by Mihăilă Dumitru (Claimant’s Exhibit n°19) stated that an investment had been made by December 31<sup>st</sup> 2000, amounting to USD 1,454,443. This report therefore also confirmed the fulfillment of the investor’s obligation.
123. As a supplement to the aforementioned technical expertise, Velicu Viorel also drafted a judiciary technical expert report (Claimant’s Exhibit n°20). This report establishes that the value of the investment performed by December 31<sup>st</sup> 2000 amounted to USD



2,062,143. It further states that, together with the additional investments performed by October 3, 2002, the total value of the investment amounted to USD 2,338,928.

124. Claimant submits that, since the reality of the post-purchase investment and the fact that it exceeds USD 1,400,000 have been established by numerous expertise reports, the only issue that remains concerns the financial means used for the performance of Continent SRL's contractual obligation.
125. In this respect, the Privatization Agreement stipulated the obligation for the seller to perform the investment, using "*private or attracted financial means*" (Claimant's Memorial, para. 67). Both the Nicolae Gheorghe judiciary accounting expertise and the Glăvan Maria report (prepared to assist Claimant in defending criminal charges brought against him and Ms. Doanta (Claimant's Exhibit n°22) confirm that the investment was made through the personal financial resources of Roussalis. In particular, the Gheorghe expert report concludes that the re-valuation methods were accurate and that the three assignment agreements were confirmed as financing sources.

2. The lawsuit filed by AVAS is illegal because the Trade Registry decision has *res judicata* effect

126. Claimant submits that the decision rendered by the Trade Registry judge, who approved the resolution passed at the December 15, 2000 extraordinary general meeting of the shareholders of Continent SA, has, according to Romanian law, the nature of a court decision ascertaining the fulfillment of the obligation. Accordingly, since this court decision was not challenged within the 15 days time limit (see above, ¶85), it became irrevocable in January 2001. It is *res judicata*.
127. Accordingly, the lawsuit filed by AVAS to enforce the Privatization Agreement is "illegal" under Romanian Law. The Trade Registry decision barred AVAS from bringing the action.

**C. The "absolute nullity" claim filed by AVAS in August 2007 to annul the increase in share capital is groundless and illegal, and has effects equivalent to an expropriation**

128. Claimant submits that the purpose of the "absolute nullity" claim filed by AVAS in August 2007 was the cancellation of the effective investment realized by the company, and implicitly, the denial of the investor's right of ownership over such investment as a result of the cancellation of the issued 1,418,648 shares. AVAS filed this claim to create new "arguments", *inter alia*, to support the proceedings regarding the enforcement of the share pledge.
129. Moreover, Claimant points out that the present proceedings initially referred only to the 372,521 shares initially purchased. Through the subsequent filing of the internal "absolute nullity" procedure, Romania ensured that the 1,418,648 shares held by Continent SA, be cancelled, without any kind of compensation. This action is obviously an abusive interference with the investor's right of ownership over such investment.

130. Such course of action amounts to expropriation as established in *Metalclad v. United Mexican States* (ICSID Case No. ARB AF/97/1): “Expropriation can take various forms. Direct expropriation involves the seizure of the investor's property. But expropriation may also be indirect, as where, without the taking of property, the measures of which complaint is made substantially deprive the investment of economic value. Moreover, it is not necessary to show a single act or group of acts committed at one time. As stated earlier, there may be "creeping" expropriation involving a series of acts over a period of time none of which is itself of sufficient gravity to constitute an expropriatory act but all of which taken together produce the effects of expropriation”.

**D. The proceedings initiated by Romania, through the intervention of the General Prosecutor and the Decision of the Supreme Court, have effects equivalent to an expropriation**

131. Claimant rather submits that the proceedings initiated by Respondent's institutions, namely through the intervention of the General Prosecutor and the decision of the Supreme Court to quash the previous courts' decisions in favor of AVAS are also a violation of Article 4(1)(a) of the Treaty which provides that no investor may be deprived of his property unless the measures are taken in the public interest and in accordance with due process of law.
132. Claimant alleges in the first place that the General Prosecutor's intervention, the Supreme Court's acceptance of the motion to vacate the lower courts judgments and the remanding of the case to the Commercial Court represent “an unwarranted interference with the right of ownership of [Continent] S.R.L., the decision having the same value as the depriving of the investor company of its good” (Claimant's Memorial, ¶78).
133. Claimant further submits that the proceedings initiated by Respondent have deprived the investor of the use of his ownership by creating juridical insecurity through a breach of the principle of legal certainty. The principle of legal certainty means, *inter alia*, that a final judgment delivered by a court may not be put on trial again.
134. Indeed, the European Court of Human Rights (“ECHR”) decided on December 1, 2005, in the *Maşinexportimport Industrial Group S.A. v. Romania* case (Case n°22.687/ 03-ECHR) that: “32. (...). En vertu de ce principe [de sécurité des rapports juridiques], aucune partie n'est habilitée à solliciter la supervision d'un jugement définitif et exécutoire à la seule fin d'obtenir un réexamen de l'affaire et une nouvelle décision à son sujet. Les juridictions supérieures ne doivent utiliser leur pouvoir de supervision que pour corriger les erreurs de fait ou de droit et les erreurs judiciaires et non pour procéder à un nouvel examen. La supervision ne doit pas devenir un appel déguisé et le simple fait qu'il puisse exister deux points de vue sur le sujet n'est pas un motif suffisant pour rejeter une affaire<sup>3</sup>.”

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<sup>3</sup> Free translation: “By virtue of this principle, no party shall be entitled to request the supervision of a final and enforceable decision, with the sole purpose of obtaining a re-examination of the case and a new decision. The Supreme Courts should only use their power to review errors of fact or law and miscarriages of justices, and they should not use it to re-examine the entire case. The supervision should not be treated

135. In the *Riabykh v. Russia* case (n°52854/99, § 52, CEDH 2003-IX, §52), the ECHR also decided that “[l]egal certainty presupposes respect of the principle of *res judicata* (...), that is the principle of finality of judgments. This principle insists that no party is entitled to seek a review of a final and binding judgment merely for the purpose of a rehearing and a fresh decision of the case. Higher courts' power of review should be exercised for correction of judicial mistakes, miscarriages of justice, and not to substitute a review. The review cannot be treated as an appeal in disguise, and the mere possibility of two views on the subject is not a ground for re-examination.”
136. The principle of legal certainty has therefore been clearly breached. The “error of law,” invoked by the Supreme Court in order to justify its decision to hinder Continent SRL’s right to ownership, is not sufficient to legitimately deprive Claimant of his legally acquired property.
137. And even if it could be proven that the above actions were taken in the public interest, Claimant asserts that, by vacating the lower court judgment, the Supreme Court’s decision interfered with Claimant’s rights of ownership. Such interference was not justified as being disproportionate.

## **II. VIOLATION OF ARTICLE 2, PARAGRAPH 2 OF THE TREATY: FAIR AND EQUITABLE TREATMENT**

138. Claimant also alleges that through its conduct, Respondent has violated the fair and equitable treatment provision embodied in Article 2(2) of the Treaty.
139. Article 2(2) provides that “[i]nvestments by investors of a Contracting Party shall, at all times, be accorded fair and equitable treatment and shall enjoy full protection and security in the territory of the other Contracting Party. Each Contracting Party shall ensure that the management, maintenance, use, enjoyment or disposal, in its territory, of investments by investors of the other Contracting Party, is not in any ways impaired by unjustifiable or discriminatory measures”.
140. When the Supreme Court rendered its decision vacating the judgment and remanding the case to the Bucharest Commercial Court, Claimant sought protection of his investment by referring the case to an ICSID Tribunal.
141. He first contacted Romania in order to try to reach an amicable settlement (Claimant’s Exhibit n°3). However, Respondent did not respond.
142. According to Claimant, by ignoring his offer to negotiate an amicable settlement, Respondent has violated the Fair and Equitable Treatment Clause of Article 2(2).
143. Moreover, the Romanian institutions were uncooperative:

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*as an appeal in disguise, and the mere possibility of there being two views on the subject does not justify the review of the entire case.”*

- AVAS (Claimant’s Exhibit n°23) and the Ministry of Public Finances (Claimant’s Exhibit n°24) both stated that the disputes at stake were civil commercial litigation matters, which concerned the breach of a commercial agreement and did not implicate a breach of the Treaty. Both institutions refused to dismiss or stay AVAS’s litigation to enforce the share pledge. The General Secretariat of the Romanian Government acknowledged AVAS and the Ministry of Public Finances’ positions and adopted the same view in its letter of April 26, 2004 (Claimant’s Exhibit n°25).
  - After these arbitral proceedings were instituted, on August 17, 2007, Respondent filed a new request before a domestic court (Claimant’s Exhibit n°15: absolute nullity of the resolution n°6 of the ordinary general meeting of shareholders of Continent SA). According to Claimant, Respondent knew that the nullification of resolution n°6 dated December 15, 2000 would have allowed AVAS to have the Trade Registry delete the registration of the share capital increase (Clause 8.10.2 of the SPA; *see* Transcript, Day 1, page 164, lines 11-25).
144. Claimant submits that, even if Respondent later asked for the stay of certain proceedings that were pending before domestic courts, a mere stay of proceedings would not have fulfilled the requirements of Article 26 of the ICSID Convention, which provides that *“consent of the parties to arbitration under this Convention shall, unless otherwise stated, be deemed consent to such arbitration to the exclusion of any other remedy.”* Respondent should have dropped the domestic litigation. It did not. It ostensibly wished to maintain a backup option in the event of an unfavorable arbitral award.
145. Romania has constantly failed both to recognize the rights of the investor and to protect its legitimate expectations, as granted by and crystallized in the SPA. The numerous court proceedings and challenges brought by AVAS were not in the public interest, but were instead aimed at harassing Claimant and regaining Continent SA’s shares and assets. The two sets of proceedings were highly disruptive, their ultimate aim being the return of the Claimant’s property to the State.
146. Respondent’s repeated refutation of its own courts’ rulings must be seen by the Tribunal as an unjustifiable measure, having the effect of depriving the foreign investor of its right to sell Continent SA’s assets and causing a loss in value of those assets. It violates Claimant’s Treaty right to fair and equitable treatment in the administration of his investment.

### **III. VIOLATION OF ARTICLE 2, PARAGRAPH 2 OF THE TREATY: FULL PROTECTION AND SECURITY**

147. Article 2(2) of the Treaty also provides that *“[i]nvestments by investors, of a Contracting Party shall, at all times ... enjoy full protection and security in the territory of the other Contracting Party”*.
148. Article 6 of the European Convention, ratified by Romanian Law n°30/1994, further provides that: *“[i]n the determination of his civil rights and obligations or of any criminal*

*charge against him, everyone is entitled to a fair and public hearing within a reasonable time by an independent and impartial tribunal established by law. (...)*”

149. Claimant invokes a violation by Respondent of the Full Protection and Security Clause of Article 2(2) and of Article 6 of the European Convention. It alleges that Romania’s General Prosecutor violated the principles of legal certainty and *res judicata* when he intervened, at AVAS’ request, in the AVAS share pledge enforcement litigation and asked the Supreme Court to set aside a lower court decision which was in favor of Continent SRL.
150. It further alleges that the Supreme Court also violated the principle of legal certainty when it vacated the judgment and sent the case back to the court of first instance for further consideration of the facts.
151. Moreover, Claimant submits that the Supreme Court lacked independence and impartiality in contravention of Article 6(1) of the European Convention.
152. More specifically, Claimant points out that he had opposed a defense of inadmissibility before the Bucharest Commercial Court to which the case was remanded in 2001. Indeed, whereas the Privatization Agreement had been concluded on October 22, 1998, AVAS founded its request before the Commercial Court on a law which had been modified by Law n°99/1999, which only came into force on July 24, 1999. This new law cancelled the provisions from the Commercial Code regarding the pledge on which AVAS had grounded its request.
153. Claimant alleges that, subsequently, in order to be able to vacate and remand the case, the Supreme Court modified, on its own initiative, the legal grounds on which AVAS had founded its action, by including a new legal basis as ground for AVAS’ request, namely Law n°99/1999. According to Claimant, the Supreme Court thus showed a lack of independence and impartiality.
154. In light of the foregoing, Claimant submits that the Supreme Court exceeded the boundaries of objectivity and decided to subscribe to the abusive position of the Romanian State.
155. Claimant states that this malicious attitude of the Supreme Court is not an isolated case in Romania. Indeed, the ECHR has heard dozens of cases against the Romanian State and has frequently identified serious and essential violations of ownership rights, by the Romanian courts.
156. For example, in the *Brumarescu vs. Romania* case (n°28342/95, ECHR 1999-VII, §§61 *et seq.*), the ECHR decided that: “*the right to a fair hearing before a tribunal as guaranteed by Article 6 § 1 of the Convention must be interpreted in the light of the Preamble to the Convention, which declares, among other things, the rule of law to be part of the common heritage of the Contracting States. One of the fundamental aspects of the rule of law is the principle of legal certainty, which requires inter alia that where the courts have finally determined an issue, their ruling should not be called into question. In the present case the Court notes that at the material time the Procurator-General of*

*Romania – who was not a party to the proceedings – had a power under Article 330 of the Code of Civil Procedure to apply for a final judgment to be quashed. The Court notes that the exercise of that power by the Procurator-General was not subject to any time-limit, so that judgments were liable to challenge indefinitely. The Court observes that, by allowing the application lodged under that power, the Supreme Court of Justice set at naught an entire judicial process which had ended in – to use the Supreme Court of Justice’s words – a judicial decision that was “irreversible” and thus res judicata – and which had, moreover, been executed. In applying the provisions of Article 330 in that manner, the Supreme Court of Justice infringed the principle of legal certainty. On the facts of the present case, that action breached the applicant’s right to a fair hearing under Article 6 § 1 of the Convention. There has thus been a violation of that Article.”*

157. Claimant contends that in the *Brumarescu* case the ECHR “*established as a principle, that the annulment appeal in the hands of the general prosecutor as official representative was a breach of the principle of the security of legal relationships*” (Claimant’s Reply, ¶252).

### **§3. DAMAGES**

158. Claimant submits that where a government has taken action which is contrary to and damages the economic interests of a foreign investor, the investor is entitled to full reparation of the harm suffered.
159. Roussalis further contends that the permanent non-recognition by AVAS of his investment and the related rights deprived him from selling Continent SA’s assets at fair market value.
160. In *Chorzow Factory* [1927 PCIJ series A no. 17, p.47] the tribunal decided that “*reparation must as far as possible, wipe out all the consequences of the illegal act and reestablish the situation which would, in all probability, have existed if that act had not been committed. Restitution in kind, or, if this is not possible, payment of a sum corresponding to the value which a restitution in kind would bear; the award if need be, of damages for loss sustained which would not be covered by restitution in kind or payment in place of it - such are the principles which should serve to determine the amount of compensation due for an act contrary to international law.*”
161. Claimant submits that “*the gravity of the facts*” has to be “*acknowledged pro-rata with the values they affected and with their negative consequences, either caused or potential, with the used means, with the author of the fact and last, but not least, with its subjective attitude, with the purpose for which it had committed the fact*” (Claimant’s Memorial, §99). Claimant refers in this respect to the fact that the Respondent’s actions prevented the functioning of the trade company. They denied or restrained the investor’s rights, or had similar effects.
162. Claimant determines the amount of his damages by reference to the official exchange rate on July 3, 2007, of lei/USD 2.3920, or of lei/EUR 3.2627, the EUR/USD exchange rate being 1.3640.

163. Continent SA held share capital amounting to ROL 13,304,400,000, divided into 532,176 shares of face value ROL 25,000 per share, out of which 464,199 shares (representing 87.227%) belonged to Continent SRL, and 67,977 shares (representing 12.773%) belonged to other shareholders.
164. When the post-purchase investment was performed, the share capital increased by 1,418,648 nominative shares, of face value ROL 25,000 per share, the new value of the share capital rising to ROL 48,770,600,000.
165. Claimant points out that Continent SA's assets included real estate located in Bucharest, 82, Timișoara Boulevard, 6<sup>th</sup> District, comprising land of surface area 36,003.75 sq. m. and a construction with a total built surface of 29,260 sq. m. (Claimant's exhibit n°30). The constructions were functional, being used as ice plants, refrigerating warehouses, food outlets, warehouses for non-commercial goods, and sections for riping bananas. They were equipped with all necessary machinery. According to market prices, the total current value of the real estate amounts to EUR 65,263,750.
166. In light of the above, Claimant requests that the Tribunal order the cessation of the two Romanian legal proceedings to enforce the share pledge and nullify the share capital increase. It further seeks USD 25 million in moral damages for the violation of his Treaty rights.
167. Claimant also asserts a contingent claim: if, at the time of the Tribunal's decision, Continent SRL has lost its majority ownership in Continent SA as a result of adverse rulings by the Romanian courts, Claimant requests USD 85,252,032.34 as compensatory damages for the expropriation of his *pro rata* ownership interest based on his original share purchase, the additional shares he acquired as a result of the share capital increase and those shares that he acquired from minority shareholders. In this case, Claimant also seeks USD 25 million in moral damages for the violation of his Treaty rights.
168. Claimant refutes Respondent's argument that Roussalis has not proved his loss because no expert report was submitted. According to Claimant, no expert report is needed since: (i) at the Hearing, Respondent repeatedly asserted that the property was very valuable (see: Transcript, Day 1, page 90, lines 56); (ii) Respondent never contested the amount put forward by Claimant and equally never produced any expert report(s) to rebut such amount; (iii) Respondent relied on the amount of EUR 65 million or USD 89 million as the fair market value of Continent SA's assets in its application to stop the sale of the assets (see: page 6 of Respondent's Reply to Claimant's Observations on Respondent's Request for Provisional Measures dated 23 June 2008); (iv) Respondent made an interim application to prevent the sale of the assets for EUR 40 million, which it agreed in its application before the Tribunal was an undervaluation.
169. On the basis of the above, Claimant formulates the following request (Claimant's Memorial ¶¶107-108):

“Mainly

1. *The cease of the judiciary actions [sic] carried out by AVAS, Romanian State institution, actions having as object the execution of the pledge formed by the 372,523 shares and the cancellation of the decision made by the Extraordinary General Shareholders' Meeting on 15.12.2000, of increasing the investment by another 1,418,648 shares.*

*and*

2. *To oblige the Respondent - Romanian State to pay 25,000,000 USD as moral damages.*

*In subsidiary,*

1. *We hereby request to oblige the Romanian State to pay compensations [sic] amounting to USD 81,168,212.60, for a number of 1,791,171 shares and a compensation amounting to USD 4,083,819.74, corresponding to the balance for a number of 91.586 shares.*

*The amount of compensations was calculated corresponding to a patrimony amounting to USD 89,019,755.*

*Compensations are requested if, upon the termination of the arbitration litigation [sic], the judicial actions performed by AVAS, representing unjustified measures whose effects are the equivalent of an expropriation, which took place despite the existence of the arbitration litigation [sic], had been completed and the investor had been dispossessed of the 1,791,171 shares and the balance of 91,586 shares has a decreased value by the transformation from a majority shareholder, to a minority shareholder.*

*and*

2. *To oblige the Romanian State to pay 25,000,000. USD as moral damages.*

**SUB-SECTION II. RESPONDENT'S POSITION ON THE INVESTMENT CLAIM**

**§ 1. THE FACTS**

**A. The Privatization Agreement**

170. On October 23, 1998, Claimant entered into a Privatization Agreement with AVAS to purchase, through Continent SRL, the AVAS 70 percent interest in S.C. Malimp SA for ROL 12,140,897,000.
171. Article 8.10.1 of the Privatization Agreement provided that Continent SRL also agreed "*to contribute to [Continent SA] from its own sources or sources gained over its name, over a period of 2 years, starting with the date 1.01.1999, an investment/capital contribution for the total amount of 1.4 million (USD), according to Annex no. 4*" (emphasis added).
172. Annex 4 specified that USD 1.1 million of the capital contribution was to be provided in 1999, with the remainder (USD 300,000) to be provided in 2000. Article 8.10.2 of the



Privatization Agreement confirmed that the capital contribution “*is deemed to be performed on the date of the registration at the Trade Registry of the increase of [Malimp SA’s] capital by the subscribed contribution and fully paid by [Continent SRL]*”. Claimant asserts that it is clear from the inclusion of the words “*and fully paid by [Continent SRL]*” that, in order for the capital investment to be “*deemed to be performed*”, Continent SRL had to demonstrate not only that Continent SA’s capital increase had been registered at the Trade Registry, but also that the capital investment (a) had in fact been fully paid at the date of the registration of the capital increase at the Trade Registry and (b) had been contributed by Continent SRL (as specified in Article 8.10.1).

173. As security for the performance of the post-privatization capital contribution obligation, Continent SRL agreed at Article 8.10.3 of the Privatization Agreement (a) to grant and register a pledge of the 372,523 shares purchased under the Privatization Agreement and (b) that, “*in case [Continent SRL] does not fulfill its obligations stipulated at Article 8.10.1 and 8.10.2, then [AVAS] will execute the pledge over the shares*” (emphasis added).

## **B. Continent SRL failed to perform its capital contribution obligation**

### 1. Claimant’s fraudulent scheme

174. Respondent submits that Continent SRL did not fulfill its obligation to make capital contributions of USD 1.4 million to Continent SA. Respondent asserts that: (a) the value of the claimed investment was fraudulently inflated; and (b) the claimed investment was not made by Continent SRL’s “own sources”, as required under the terms of the Privatization Agreement.
175. Angela Doanta gave a written statement to the police in April 2001 during a criminal investigation against her and Claimant for fraud. Claimant asserts that Ms. Doanta’s testimony is accurate and informative. Her statements are corroborated by the statements of Mr. Herisanu, the former General Manager of Continent Marine Construction SRL, of Ms. Tencu, Assistant Manager of Continent Marine Construction SRL (Respondent’s Exhibit n°28-30), and of Ms. Mina Cornaciu’s expert report. According to Respondent, the Tribunal should consider Ms. Doanta’s Statement in light of the evidentiary record as a whole and decide what weight to give it.
176. According to Ms. Doanta’s statement, on September 30, 2000 – three months prior to the deadline for completing the USD 1.4 million capital contribution – she told Claimant that only ROL 14 billion (approx. USD 553,000) had been invested in Continent SA. However, this “investment” related primarily to converting some of Continent SA’s premises into a personal residence for Roussalis, a swimming pool, and private apartments for sale to third parties. Moreover, the source of this investment was Continent SA (A. Doanta’s statement of 19 April 2001 given to the criminal investigative authorities, Respondent’s Exhibit n°4).

177. After Ms. Doanta informed Claimant of the insufficient investment, Claimant hired Expert Proiect, a company whose office was in the same building as Continent SRL, to value the in-kind investment allegedly made in Continent SA. Expert Proiect conducted a preliminary review of the capital investments and informed Claimant, in October 2000, of its preliminary finding that the value of the works performed at Continent SA was substantially less than USD 1.4 million (Doanta's Statement, Respondent's Exhibit n°4).
178. Claimant then presented false invoices to Expert Proiect. Without conducting an independent review of Continent SA's records or any review of Continent SRL's accounting books, Expert Proiect issued a report dated "December 2000" in which it concluded that an investment of USD 1,404,162 had been accomplished – not by Continent SRL but by Continent SA (Respondent's Exhibit n°5).
179. Claimant published a notice in the Official Gazette on November 29, 2000, *i.e.* before Expert Proiect had even completed the valuation report, announcing that a shareholders' meeting would be convened to approve the Expert Proiect report and to pass a resolution increasing Continent SA's share capital by USD 1,404,162.
180. On December 15, 2000, the shareholders' meeting gathered at Continent SA and a resolution was passed, approving the Expert Proiect report and the capital increase (Respondent's Exhibit n°8).
181. Respondent contends that the shareholders' resolution was invalid as a matter of Romanian law, and, therefore, the share capital increase was a nullity.
182. First, Claimant participated in the shareholder's meeting both as a shareholder (*i.e.*, representing Continent SRL) and as a member of Continent SA's Board of Directors. However, Article 124(5) of the Company Law provides that the directors and officers of the company may not represent shareholders in shareholders' meetings and that any resolution passed in violation of this prohibition will be null and void if, without their votes, the requisite majority would not have been attained. According to Respondent, it is irrelevant that Claimant is mentioned in the Minutes as a director with no right to vote. Indeed, directors are prohibited not only from voting, but also from attending meetings as representatives of other shareholders, in order to avoid the fraudulent formation of a quorum (St. D. Carpenaru et al., *Legea societatilor comerciale - Comentariu pe articole*, 3rd Edition, C.H.Beck Publisher, 2006, 379). Claimant's lack of impartiality, overlapping capacities, and decisive influence on the deliberations of the meeting are revealed in the official Minutes of the shareholders' meeting (Respondent's Exhibit n°3) and render the resolution invalid as a matter of law.
183. Second, none of the minority shareholders attended the meeting or consented to the resolution. There is no list of shareholders in attendance attached to the minutes of the shareholders' meeting as required by Article 130(2) of the Company Law n°31/19903 and the resolution is signed only by Continent SA's Board of Directors. Respondent alleges that Claimant created an invalid paper record of a share capital increase to give a veneer of legitimacy to an investment that Continent SRL in fact never made.

184. Subsequently, on December 15, 2000, Claimant presented to a judge at the Trade Registry a submission consisting of the invalid shareholders' resolution together with the deficient report from Expert Proiect. Solely on the basis of this fraudulent evidence, Claimant obtained approval for the increase in Continent SA's share capital. The process before the Trade Registry judge was *ex parte* and AVAS had no opportunity to bring these obvious shortcomings to the judge's attention before judgment was handed down.
185. Claimant reported to AVAS on December 19, 2000 that Continent SRL had fulfilled its investment obligation. This was contradicted by a letter to AVAS, dated May 10, 2001, in which Continent SA admitted that "*a part of the investment has been made by Continent SA and not by Continent SRL*" (Respondent's Exhibit n°12, see below ¶211).
186. Respondent puts forward that Continent SA's accounts were manipulated to make Continent SA's capital expenditures appear as if they should be credited to Continent SRL as qualifying investments (*see* Judicial Accounting Expert's Report by Floarea Patrusca, Respondent's Exhibit n°13).
187. In June 2001, Claimant used two other companies that he owned, SC Continent Marine Trading SRL and SC Continent Construction SRL, to enter into bogus assignment agreements:
- SC Continent Marine Trading SRL, as assignor, and Continent SRL as assignee, entered into an assignment agreement concerning a receivable of ROL 3.98 Billion (approx. USD 157,000) purportedly owed by Continent SA for refrigeration equipment, a refrigeration chamber, a vacuum packaging machine, and meat chamber refurbishment (Respondent's Exhibit n°15);
  - SC Continent Construction SRL, as assignor, and Continent SRL as assignee, entered into an assignment agreement concerning a receivable of ROL 9.25 billion ROL (approx. USD 365,000) purportedly owed by Continent SA for aluminum kiosks, the refurbishment of aluminum furniture, the refurbishment of Berth 8 in Constanta Harbor, the PVC production line, and the refurbishment of the administrative offices (Respondent's Exhibit n°16); and
  - Continent SA as original debtor, Continent SRL as new debtor, and Claimant, as creditor, entered into a novation agreement concerning receivables amounting to ROL 3.2 Billion (approx. USD 126,000), purportedly for goods acquired by Continent SA and for works performed as part of the investment supposedly financed by Claimant. (Respondent's Exhibit n°17).
188. These agreements created the false impression that expenditures made by Continent SA were investments made by Continent SRL. However, the accounting documentation for these assignment agreements "*is not supported by documents evidencing that those payments would have been effectively made. Therefore, the assignment agreements ... in amount of ROL 13,235,504,852 do not have a real basis*" (Vladimir Popovici's Accounting Expert Report, January 29, 2002, Respondent's Exhibit n°18). Moreover, the

invoice Continent SA issued to Continent SRL, presumably to create the appearance of a reimbursement by Continent SRL, was never paid and was cancelled at the end of 2001.

2. The Expert Project Report does not establish that the investment was made in compliance with the Privatization Agreement

**a) The valuation is baseless and not reliable according to Romanian law**

189. Respondent asserts that almost half of the purported USD 1,404,162 investment reported by Expert Project is based on false invoices. In particular, Expert Project included in its calculation of the value of the capital investment: (i) invoices for goods and services allegedly supplied by companies that do not exist; (ii) invoices issued by a Claimant-owned company that falsely claimed to be the manufacturer of the invoiced goods but, in fact, had no legitimate role in the purchase or sale of the goods; (iii) invoices for services that were never performed and assets that were never acquired by Continent SRL; (iv) invoices recorded as having been paid personally by Claimant but for which there is no legitimate evidence of payment; and (v) invoices for goods and services, the value of which was fraudulently inflated based on illegitimate and unauthorized adjustments (see Accounting Expertise Report by Mina Cornaciu and Lidia Balanescu, Respondent's Exhibit n°24; technical expertise report by Isuf and Mihaila Respondent's Exhibit n°33; A. Doanta Statement, Respondent's Exhibit n°4; Statements of Continent Marine Construction's executive manager, Bogdan Herisanu, Respondent's Exhibits n°28 and 29; Statement of Continent Marine Construction assistant manager, Raluca Tencu, Respondent's Exhibit n°30).
190. Moreover, Expert Project further inflated the value of the alleged capital investment by adjusting the resulting values for inflation. Respondent alleges that such an adjustment contradicts the clear intention of the parties that Continent SRL should contribute USD 1.1 million in 1999 and USD 300,000 in 2000 (Articles 8.10.1 and Annex 4 of the Privatization Agreement). Adjusting such investments *a posteriori* for inflation would eviscerate this obligation by enabling Continent SRL to invest a few hundred thousand dollars in early 1999 and then rely on inflation to argue that the value of that sum has increased to USD 1.4 million as at the end of 2000.
191. Respondent points out that the reliability of the Expert Project report was first challenged on February 13, 2001 by the findings of the Financial Guard, which concluded that certain invoices relied on were false. The subsequent criminal proceedings against Claimant likewise confirmed that "*the conclusions of the technical accounting expert show that by the registration in the accounting of primary accounting documents that were not based upon real operations [...] the income and the expenses of SC Continent Marine Enterprise SA were distorted which provoked a prejudice to the state budget of RON 1,410,997 profit tax and RON 1,828,190 VAT*" (Respondent's Exhibit n°42).

**b) The required capital contribution was not made by Continent SRL**

192. Expert Project proceeded to value a contribution that they concluded was made by Continent SA (Respondent's Exhibit n°5, p.7). Respondent points out in this regard that

Expert Proiect failed to review any of Continent SRL's accounting documentation to verify that any of the alleged capital contributions were made by Continent SRL.

193. Moreover, the valuation of Continent SA's expenditure is inflated. The Expert Proiect report cites, as part of Continent SA's investment, ROL 5.29 billion (approximately USD 209,000) in respect of labor costs (and related social security obligations) arising out of various construction and plumbing works. Ms. Doanta explains in her statement given to the criminal investigative authorities that none of these labor works were performed and that no related social security obligations were ever paid.

### 3. Claimant's criminal conviction for tax evasion

194. The false invoices were uncovered during an inspection carried out in January 2001 by the Financial Guard. Subsequently, on May 18, 2001, the police initiated a prosecution against Claimant for fraud, tax evasion, use of false documents, and instigation to commit forgery. On May 14, 2003, the Public Prosecutor filed an indictment against Claimant.
195. Respondent points out that in the ensuing criminal proceedings, Claimant did not deny that he had committed the offense of tax evasion, choosing instead to rely exclusively on a statute of limitations defense (see Continent SA's written submission to the District Court of Sector 6 in Bucharest, dated April 23, 2007, which was "*formulate[d]*" by "[t]he undersigned attorney, Doru Costea, representative of defendant Spyridon Roussalis ..", Respondent's Exhibit n°46).
196. The expert evidence before the criminal court demonstrated that "*the financing was not raised and paid integrally by [Continent SRL]. Therefore, the agreement cannot be deemed as fulfilled*" and "*the investment was not made and supported by financing from [Continent SRL] (only in proportion of approximately 5 percent)*" (Respondent's Exhibit n°48).
197. Claimant refused to appear for trial on the criminal charges, avoiding service of process for more than three years, although he was summoned nine times in Romania and nine times in Greece. Eventually, service of process was made, and Claimant was tried *in absentia*. On May 28, 2007, he was sentenced to a two-year prison term for tax evasion based on forgery and the use of false documents. Respondent points out that the court found that: "*the purpose of these registrations [i.e. the registration of the fake invoices in Continent SA's accounts] being that of reporting the performance of [falsely] reporting the investment stipulated in the [Privatization Agreement]*" (Respondent's Exhibit n° 42).
198. Respondent points out that although Claimant correctly notes that his criminal conviction was subsequently overturned on appeal and remanded for re-trial, the decision was based on purely procedural grounds regarding summoning. None of the conclusions of the first instance court on the merits were contradicted by the findings of the Bucharest Tribunal.

#### 4. Claimant's misuse of Continent SA's funds

199. On July 15, 1998, Continent SRL concluded a Services Agreement with Continent SA (Respondent's Exhibit n°47). Under that agreement, Continent SA agreed to provide food handling and storage services to Continent SRL in consideration for a monthly rent.
200. After execution of the Privatization Agreement, Continent SRL and Continent SA amended the Services Agreement by executing an *Addendum* purportedly dated November 19, 1998 (Respondent's Exhibit n°49). Continent SA agreed to provide food handling and cold storage services to Continent SRL free of charge until the end of 1999.
201. Respondent submits that both Continent SRL and Expert Project failed to take this net outflow of resources from Continent SA into account when calculating the value of Continent SRL's purported capital investment in Continent SA.
202. The 6th District Tax Administration estimated that Continent SA lost income of over USD 900,000 during the period from November 1998 through December 1999.
203. According to Respondent, this should be considered as having increased Continent SRL's investment obligation by the amount of the rent abatement. Therefore, even if the Expert Project report had documented a USD 1.4 million post-privatization investment by Continent SRL, approximately USD 900,000 of that investment was financed using funds that Continent SRL was legally obliged to pay to Continent SA.

#### **C. AVAS reasonably investigated Continent SRL's failure to fulfill its investment obligation and thereafter sought enforcement of the pledge**

204. As mentioned above (see ¶173), Continent SRL was required to register a pledge in favor of AVAS over the shares purchased pursuant to the Privatization Agreement as security for its obligation to make a post-purchase investment.
205. By letters dated July 6, 1999, December 10, 1999, March 6, 2000, and June 9, 2000 (Respondent's Exhibit n°2), AVAS sought confirmation from Continent SRL that the share pledge had been registered. Continent SRL did not answer. Respondent points out that Claimant never presented any evidence to show that Continent SRL ever registered the share pledge or that it should be released from the pledge.
206. In light of Continent SRL's failure to confirm its compliance with the obligations stipulated in the Privatization Agreement and its repeated failures even to respond to requests for information, AVAS issued a Notice of Default on September 20, 2000 recording (i) Continent SRL's failure to make the USD 1.1 million capital contribution by December 31, 1999; (ii) Continent SRL's failure to register the pledge; and (iii) AVAS's intention to commence legal proceedings if Continent SRL did not provide documents proving compliance with its contractual obligations.
207. On December 19, 2000, Claimant responded in a letter attaching the Expert Project report and falsely stating that Continent SRL had fulfilled its USD 1.4 million investment obligation (Claimant's Exhibit n°6).

208. After reviewing the Expert Project report, AVAS ascertained that Continent SRL had failed to prove the company's compliance with its investment obligations. Moreover, on February 13, 2001, AVAS received a letter from the Financial Guard highlighting various accounting and financial irregularities in the documentation on which the Expert Project report was based.
209. AVAS wrote several times to Continent SRL to request additional documents that might enable AVAS to independently assess the facts surrounding the irregularities reported by the Financial Guard. Continent SRL repeatedly delayed its answer and never fully complied with the request.
210. Respondent submits that, in light of the many concerns that had come to light, AVAS commenced legal action against Continent SRL on April 23, 2001 (Claimant's Exhibit n°7). AVAS requested the court to order Continent SRL to register the share pledge as required by Article 8.10.3(a) of the Privatization Agreement and pay *per diem* delay penalties until the pledge was registered.
211. On May 10, 2001, the General Manager of both Continent SRL and Continent SA, together with Continent SA's Economic Director, sent a letter to AVAS, on behalf of Continent SA, admitting that 90 percent of the investment constituted routine expenditures and "*has been made by Continent SA and not by Continent SRL*" (Respondent's Exhibit n°12). He promised that "*Continent SRL will transfer to the account of Continent SA the owed amounts*". Respondent sets forth that the letter constitutes an admission that the previous claim that Continent SRL had fulfilled the capital investment obligation – on the basis of which it had obtained the Trade Registry judge's approval for the share capital increase – was false. AVAS received no further correspondence stating that the promised "transfer" ever took place.
212. Consequently, on June 22, 2001, AVAS amended its share pledge claim in the pending court proceedings to request enforcement of the share pledge (Claimant's Exhibit n°8).

**D. The General Prosecutor's intervention and the Supreme Court's Decision quashing previous court decisions were necessary**

213. As regard the AVAS share pledge claim, the first instance court and the appeal court ruled in favor of Continent SRL, but solely on the basis of a narrow and flawed interpretation of the requirements in Article 8.10.2 of the Privatization Agreement. The first instance and appeal courts held that the mere fact of the registration at the Trade Registry of the alleged capital increase was sufficient to show that the investment obligation had been fulfilled.
214. Respondent points out that the courts failed to establish that the capital contribution had, in fact, been "fully paid" and that the source of the capital contribution was Continent SRL. In addition, no attempt was made by either court to examine the numerous shortcomings of the Expert Project report or the serious allegations of fraud for which Claimant was being investigated.

215. In light of the above, on November 21, 2002, AVAS requested the General Prosecutor to submit a motion to vacate the judgments rendered by the lower courts, because the lower courts had (a) misconstrued the terms of the Privatization Agreement, (b) denied the request of AVAS to commission a judicial accounting expert report, and (c) ignored evidence showing Continent SRL's breach of the investment obligation through perpetration of a fraud (Respondent's Exhibit n°55).
216. At the time, the General Prosecutor was permitted under Article 330 of the Romanian Code of Civil Procedure to challenge final and irrevocable judgments within one year of their date of entry. The purpose of such a motion was to avoid a miscarriage of justice arising either from a fundamental error of law that prevented a valid finding on the merits, or from a judgment that was manifestly groundless.
217. On March 11, 2002, after considering the request by AVAS, the General Prosecutor filed a motion to vacate the lower court judgments (Claimant's Exhibit n°12). On July 9, 2003, the Supreme Court accepted the motion and remanded the case to the Bucharest Commercial Court with instructions to (a) investigate the challenged transactions, (b) commission a judicial expert report to determine whether the investment complied with the terms of the Privatization Agreement, and (c) consider the criminal charges that had been brought against Claimant and Ms. Doanta (Respondent's Exhibit n°43). The Supreme Court ordered that a new technical and evaluation report be completed to determine the source and value of the investment made by Continent SRL.
218. Respondent points out that the motion to vacate is heard by the Supreme Court in an adversarial hearing. In this case, Claimant's counsel was present when the Supreme Court heard AVAS's motion to vacate.
219. Inexplicably, on remand, the first instance court ignored these instructions of the Supreme Court and, among other things, failed to verify the source of the investment alleged to have been made by Continent SRL. There was no investigation into the accounting and financial documentation of Continent SRL to determine the source of the investment. Moreover, the court failed to appoint a valuation expert to determine the value of the alleged investment. The first instance court neglected to investigate the deficiencies of the Expert Project report and failed to take account of the findings of the Financial Guard. Furthermore, like the prior vacated court rulings, the first instance court held that Continent SRL had complied with the procedure for obtaining approval from the Trade Registry judge for a share capital increase and deemed that to be sufficient to prove Continent SRL's fulfillment of the investment obligation (Claimant's Exhibit n°14).
220. In the subsequent appeal initiated by AVAS, the court-appointed accounting expert reported that she "*ha[d] not found documents which would show the payment of [the capital contribution] by [Continent SRL]*" (Respondent's Exhibit n°13). According to the expert, the use by Continent SA of retained earnings to purchase goods and services did not constitute an 'in-kind' contribution that could justify the capital increase reported to AVAS. On October 8, 2007, a divided Court of Appeal nevertheless affirmed the decision of the lower court.



221. Respondent points out that the chair of the court issued a vigorous dissenting opinion. The chair concluded that the secured investment obligation had not been performed and that AVAS was therefore entitled to enforce its lien over the shares.
222. AVAS appealed the decision but the Supreme Court affirmed the Bucharest Tribunal's decision (Respondent's Exhibit n°193).

**E. AVAS's proceedings to annul the shareholders' resolution dated December 15, 2000 seek to redress serious improprieties committed by Claimant**

223. On August 17, 2007, AVAS filed an action against Continent SA asking the court (i) to rule that the resolution passed by Continent SA's shareholders on December 15, 2000, approving the capital increase, was null and void, and (ii) to register its decision with the Trade Registry and thereby delete the registration of Continent SA's share capital increase.
224. In addition to raising the fraud established at Claimant's criminal trial, AVAS contends that the shareholders' resolution should be declared null and void because it was only passed because Claimant voted in its favor despite being ineligible to do so, and because there is no indication that any of the minority shareholders of Continent SA participated in the vote (see above, ¶180).
225. AVAS submits that it is entitled to having the Continent SA shareholders' resolution set aside as being an absolute nullity. According to Article 2 of Decree 167/1958, in such cases, the exercise of the right to challenge the resolution is not subject to any statute of limitations.

**F. Claimant continues to be the majority owner and continues to exercise control over Continent SA**

226. Claimant, through his wholly owned company Continent SRL, is currently the registered owner of 1,882,847 shares in Continent SA representing 96.52 percent of the company's total share capital. This includes the 372,523 shares purchased from AVAS pursuant to the Privatization Agreement, 91,676 additional shares acquired by Continent SRL from minority shareholders, and the 1,418,648 shares issued to Continent SRL as a result of the fraudulent share capital increase. Claimant is and has been the sole shareholder of Continent SRL since April 13, 1998.
227. For most of the past ten years, Continent SA's principal assets have included real estate consisting of the properties at 82 Timisoara Blvd, Bucharest and at 1 Razoare Street, Bucharest. On May 15, 2006, Continent SA sold the latter property to SC Spavin Invest SRL for EUR 1,000,000 (Respondent's Exhibit n°60). In addition, Claimant has agreed to sell a plot of 350 sq. m. at Continent SA's warehouse facility at 82 Timisoara Blvd. to a company called SC Stefran International SRL pursuant to a Sale-Purchase Pre-Contract, dated October 10, 2007 (Respondent's Exhibit n°64).
228. Respondent asserts that Continent SA has continued to own and manage its assets without any interference from Respondent. Aside from Continent SA's ability to dispose

of its real estate, Continent SA has enjoyed significant earnings from the exploitation of its commercial assets. The annual turnover of Continent SA increased significantly over the decade of Claimant's ownership (Net Financial Results at Continent SA for years 1998-2007, Respondent's Exhibit n°62). Recently, Claimant arranged with his son Stavros Roussalis to sell Continent SA's commercial assets for EUR 40million. The listing for the property (Respondent's Exhibit n°63) states that Continent SA is earning EUR 120,000 – 150,000 per month through the operation of its refrigerated foods warehouse. In this regard, Respondent points out that it was after Roussalis's claims and Romania's counterclaim were submitted to the exclusive jurisdiction of the Tribunal that Claimant attempted to enlarge the dispute by selling Continent SA surreptitiously. That led to the Tribunal's first decision on provisional measures to halt Claimant's actions.

### **G. Conclusion**

229. Respondent submits that, in light of the facts stated above, Continent SRL did not make the required post-purchase investment in accordance with Article 8.10.1.
230. Respondent contests Claimant's allegation that other experts than Expert Proiect submitted reports in connection with the AVAS litigation, and that all of them confirmed that Continent SRL made the required investment.
231. The Popescu Report: Popescu, like Expert Proiect, accepted the documentation provided by Continent SA without verifying the validity of the invoices that had been challenged. Ms. Popescu undertook no investigation into the "physical reality" or value of the construction and installation works that allegedly constituted the investment. Moreover, her report (Respondent's Exhibit n°66) does not say a word about the source of any investment; indeed, the scope of the assignment was limited to verifying the "actualized value" calculations made by Expert Proiect for construction and installation projects.
232. The Isuf and Mihaila Report (Claimant's Exhibit n°19), for the period from January through December 1999, identifies a total "investment" of USD 285,995, a small fraction of the USD 1,100,000 called for under the Privatization Agreement. For the period from January through December 2000, the authors report an "investment" of USD 649,614. These amounts do not confirm compliance with a USD 1.4 million investment obligation. Moreover, the Isuf and Mihaila Report criticizes the Expert Proiect report for overvaluing the claimed investments and says nothing about the source of the funds for the expenditures they tallied.
233. The Viorel Velicu Report (Claimant's Exhibit n°20) does not address the source of any investments and gives no opinion regarding the amount, if any, contributed, by Continent SRL. Velicu's task was to conduct a technical review of the Expert Proiect and the Isuf/Mihaila reports. Moreover, that report is tainted by an artificial increase in the value of the installations and construction works, and by the inclusion of assets whose value was also artificially inflated or could not be verified.
234. The Nicolae Report (Claimant's Exhibit n°21) was prepared at the request of the court in connection with the determination on remand of whether Continent SRL made the

required investment. Nicolae failed to carry out an important part of his assignment to determine whether the investments were “real or fictional.” Instead, he concluded that the “reality of the investment” was confirmed by “the registration of the joint stock increase” at the Trade Registry and the approval by the Trade Registry Judge. Nicolae repeated the conclusion reached in the first court decision, which was criticized and vacated by the Supreme Court. Nicolae merely relied on the Expert Proiect and Popescu reports, without independent verification. His summary conclusion – that the investment “*comes from [Continent SRL’s] own source or attracted sources*” is unexplained and undocumented.

235. The Maria Glavan Report (Claimant’s Exhibit n°22) was prepared to assist Claimant in defending criminal charges brought against him and Ms. Doanta. Ms. Glavan concludes that “[Continent SRL] ... *performed a capital contribution in value of USD \$1,400,000 for [Continent SA] from [its] own sources or attracted sources, investments which was [sic] registered at the Trading Registry as ... the basis of the increase of the joint stock of [Continent SA].*” According to Respondent, no discussion, no analysis, and no data are presented in support of this summary assertion.
236. The Vladimir Popovici Report was prepared as part of the criminal investigation and was the first to scrutinize the source of the claimed investment. It presents a harsh critique of the evidence presented by Roussalis to support the alleged investment. Among other things, Popovici demonstrates that, of the total claimed expenditures identified by Expert Proiect, only about 5 percent could be traced to Continent SRL and the “*financing was not raised and paid integrally by [Continent SRL].*” It goes on to state that “[t]herefore, the privatization agreement can not be deemed as fulfilled” (Respondent’s Exhibit n°18). Furthermore, Popovici reported that financing supposedly provided by Roussalis himself (or other Roussalis-controlled companies) was “*not supported by documents proving that he had actually made these payments.*” As a result, the financing from the supposed assignment agreements, in particular, “*have no real basis.*”
237. Respondent submits that there is no documentary proof in any of the foregoing reports to show that Continent SRL, “from its own sources” or sources it procured, invested USD 1.4 million in Continent SA. However, Claimant bears the burden of proof to establish his claim. Claimant has not met that burden.
238. In light of the foregoing, Respondent submits that Claimant has no basis to complain about AVAS’s efforts to enforce its rights under the Privatization Agreement.

## **§ 2. THE LAW**

### **A. On the facts, there is no basis for claiming that Claimant’s shareholding interest was expropriated, either directly or indirectly**

239. Respondent contests Claimant’s allegation that the acts by Romania, taken alone or together, are tantamount to expropriation of his investment under the above-cited provisions.
240. Even under Claimant’s incorrect version of the facts, his claims of expropriation must fail for two essential reasons. *First*, Respondent’s actions have not deprived Claimant of any

fundamental property rights as he retains full ownership rights in Continent SA: (a) he is still a director of Continent SA; (b) his wholly-owned firm, Continent SRL, remains the controlling shareholder of Continent SA; (c) Continent SA remains a going concern; and (d) there has been no interference with Claimant's management or control of the company's day-to-day operations. *Second*, Claimant's expropriation claims are inconsistent with accepted definitions of expropriation.

1. The law on indirect or creeping expropriation does not support the claim

241. Respondent contends that allegations of indirect expropriation require a “*high level of analytical rigor and precision*” (*Generation Ukraine, Inc. v. Ukraine*, ICSID Case No. ARB/00/9). To prove “creeping expropriation,” the plea must state with particularity which acts, attributable to the state, have already eroded the investor's rights to the investment to the extent that an expropriation in violation of international norms has clearly occurred. According to Respondent, Claimant's vague statements alleging expropriation as a result of his right to dispose of his shares in Continent SA being “likely” to be affected, or AVAS “attempting” to execute its lien on the original shares, do not provide sufficient factual support to meet the applicable standard for indirect expropriation under the Treaty and international law.

2. The alleged interference with Claimant's management and control of his investment cannot amount to an expropriation

242. Respondent submits that the most commonly used test of indirect or regulatory expropriation is the following: “*even though a State may not purport to interfere with rights to property, it may, by its actions, render those rights so useless that it will be deemed to have expropriated them*” (G.C. Christie, *What Constitutes a Taking of Property Under International Law?*, 38 Brit. Y.B. Int'l L. 311). Respondent alleges that Claimant's rights in Continent SA have not been rendered useless.
243. For example, in *Starrett Housing v. Islamic Republic of Iran* (No. 32-24-1, Award of December 19, 1983, Iran-U.S. C.T.R. 122, 1983), Iran appointed its own “temporary manager” of an Iranian firm in which the claimant owned a majority interest. The tribunal found that this interfered with the investor's ability to manage the company, thus rendering the claimant's rights “useless” and constituting indirect expropriation. According to Respondent, Claimant's allegations in this case, however, would not – even if proven – establish that Respondent has interfered with his property rights to such an extent.
244. In *Marvin Feldman v. Mexico* (ICSID Case No. ARB(AF)/99/1), Feldman, a U.S. citizen, operated an export business in Mexico. When he started exporting cigarettes from Mexico in 1990, Mexico rebated production and sales taxes to cigarette resellers upon export. Two years later, Mexico changed the law to permit export rebates only for cigarette producers. The ICSID panel found no expropriation because Mexico had not interfered with the management or control of Feldman's business.

245. In *Waste Management v. United Mexican States* (ICSID Case No. ARB(AF)/00/3), the tribunal rejected Waste Management’s claim that its investment rights under the concession agreement were taken by “creeping expropriation.” Because the claimant at all times retained the control and use of its property – when the company ceased the business, assets were sold off in an orderly way – the tribunal concluded that, although Mexican authorities may have breached the concession contract, “*absent arbitrary intervention by the State amounting to a virtual taking or sterilising of the enterprise,*” this did not amount to an expropriation.
246. Following the tribunals’ reasoning in these cases, Claimant’s allegations of expropriation must be rejected. Claimant retains control of more than 96 percent of Continent SA through his 100 percent ownership of Continent SRL and remains a director of Continent SA. No government entity has interfered in the management of the company. In sum, even if Claimant’s ability to sell his shares has been allegedly diminished through the ongoing litigation, those shares have not been rendered “useless.”
247. Respondent points out that Claimant’s reliance on the *Metalclad* decision is unavailing (see above, ¶130). The ICSID tribunal in that case held that a measure needs to “*substantially deprive the investment of economic value*” to constitute indirect expropriation. However, as explained above, Roussalis has not been deprived of the economic value of his investment as a result of the Romanian government’s actions.

### 3. There is no permanent and irreversible interference with Claimant’s property rights

248. Respondent submits that a measure needs to be permanent and irreversible, as opposed to temporary, to constitute a compensable taking under international law (see *International Technical Products Corporation*, No. 196-302-3, Award of October 28, 1985, 9 Iran-U.S. C.T.R. 206 at 240-41). Similarly, under European Convention case law, it is clear that if the investor’s rights have not been extinguished, but have only been substantially reduced, and the situation is not “irreversible,” there is no “deprivation” – and hence no expropriation – for the purposes of the second sentence of Article 1 of Protocol 1 of the European Convention (see *e.g., Handyside v. United Kingdom*, 24 Eur. Ct. H.R. (ser A) at 29, 1976).
249. In light of the above, there is no basis for Claimant’s claim that the mere attempt by AVAS to nullify the shareholders’ resolution and execute the share pledge amounts to expropriation. Indeed, Claimant’s concern about his right to dispose of shares has not become permanent or irreversible.

### 4. Claimant’s allegations demonstrate that the complained-of actions by AVAS and the Supreme Court have not ripened into an expropriation

250. Claimant states that the measures ordered on behalf of the Romanian State by its public authorities are *likely to affect* the investor’s right to use the investment (Claimant’s Memorial, ¶160). Respondent submits that this argument cannot support a claim of expropriation. A classic example of a case where the arbitrators found state actions had not ripened into an expropriation by the tribunal’s jurisdictional cutoff date is *Foremost*

*Tehran, Inc. v. Iran* (No. 220-37/231-1, Award of April 11, 1986, 10 Iran-U.S. C.T.R. 228). Here, Foremost claimed that the Iranian Government had expropriated its minority share in Pak Dairy through a number of actions. Despite these actions, the tribunal ruled that, at the cutoff date for the Iran-U.S. Claims Tribunal's jurisdiction, Iran had not expropriated Foremost's investment in Pak Dairy. As of the cutoff date, Foremost retained incidents of ownership (shares, two directors on the board, and limited shareholder rights). Despite the significant deprivation of property rights, the key factor in the decision was that the deprivation was not irreversible because Foremost retained its minority ownership. As noted above, Claimant still retains all incidents of ownership in Continent SA, including all of the shares owned through Continent SRL.

5. There is no basis for bringing this claim under Article 4(1) of the Treaty

251. In *International Systems & Controls v. Iran* (No. 256-439-2, Award of September 26, 1986, 10 Iran-U.S. C.T.R. 223), the tribunal rejected the claim for indirect expropriation, reasoning as follows: *"it is to be noted that the owner must at least be deprived of some fundamental rights of ownership and that the deprivation must be not merely ephemeral. The claim for destruction of a business must go beyond a showing of a classical breach of contract... The Respondents' failure to renew a contract or their failure to pay a debt cannot be said to amount to expropriation as in any event the Respondents have rights under the contracts to terminate them for cause or without cause upon making stipulated payments."*
252. Respondent considers that, similarly, AVAS had the right under the Privatization Agreement to enforce the pledge based on Continent SRL's failure to make the USD 1.4 million investment. Accordingly, AVAS's refusal to accept Continent SRL's unsupported contention that it met this obligation, and AVAS's ensuing litigation to enforce its contractual lien on the shares pledged by Continent SRL, cannot be said to amount to expropriation.

**B. The failure to negotiate and the denial of a stay of litigation do not support claims under Article 2(2) of the Treaty**

253. Respondent refutes Claimant's allegation that Respondent's failure to negotiate with him, and the Romanian court's denial of his request to stay proceedings in the AVAS enforcement action, violated the "fair and equitable treatment" clause under Article 2(2) of the Treaty.
254. The Treaty neither imposes a legal duty on the state nor creates a legal right for the investor to negotiate a settlement. The so-called "cooling-off" provision of the Treaty, Article 9(2), provides that: *"[i]f such disputes cannot be settled within six months after the date either party requested amicable settlement, the investor concerned may submit the dispute to [the host state courts] or to international arbitration."* This clause merely sets aside a period during which settlement discussions may be conducted but does not obligate either party to conduct such discussions.

255. Claimant's complaint that the Romanian courts rejected his argument under Article 26 of the ICSID Convention and refused to decline jurisdiction over the AVAS litigation is now moot. Indeed, Respondent has agreed to a suspension of the pending litigation in the Romanian courts, and Claimant has refused to join in applying for a suspension. Further, Respondent submits that it is fanciful for Claimant to demand USD 25 million on the ground that the courts did not stay the AVAS litigation - especially given that Claimant objects to the Counterclaim.
256. More generally, Claimant's contention that AVAS's maintaining of the Romanian court proceedings evidences a failure by Respondent to accept the exclusive jurisdiction of the Tribunal over the Investment Claim is untrue.
257. First, AVAS initiated the share pledge litigation in Romanian courts before the ICSID case was initiated. Claimant refused to seek a postponement. The Supreme Court conducted a hearing and handed down a final and irrevocable decision on the same day, dismissing AVAS's appeal (see above, ¶222).
258. Second, AVAS commenced the proceedings aiming at annulling the share issuance in August 2007, more than one year before Respondent filed its Counterclaim in this arbitration. AVAS initiated the case after its share pledge enforcement claim was dismissed by the first instance Romanian court on the basis that the shareholders' resolution of December 15, 2000 was valid and had not been challenged. AVAS reasonably concluded that the commencement of the suit to annul the share issuance was the best approach to ensure that it would not be foreclosed from arguing that the shareholders' resolution must not be treated as final for the purposes of deciding AVAS's share pledge claim. AVAS's commencement of the share nullification case was the best way to preserve its right to pursue its long-standing share pledge enforcement claim in the event that the Tribunal later decided that it lacked jurisdiction over the Counterclaim. Shortly after the case was filed, AVAS requested Claimant's voluntary cooperation in seeking a stay of both domestic court cases. Claimant did not agree to seek a stay in either case. AVAS attempted to obtain a stay on its own motion but was unsuccessful. It was at that point that Respondent filed its request for provisional measures in these proceedings.

### **C. There is no basis under the Treaty for the "Full Protection and Safety" claims**

#### **1. The Supreme Court's decision to vacate the AVAS judgment was appropriate under Romanian law and international law**

##### **a) The General Prosecutor's motion to vacate was a settled procedure under Romanian law at the time it was filed and granted in this case**

259. Article 330 of the Romanian Civil Procedure Code authorized the Supreme Court to vacate final and irrevocable judgments in certain circumstances (see above, ¶216). That article was in force for decades before the Privatization Agreement was executed, subsequently amended over the years, and eventually repealed in 2003 after the Supreme Court rendered its decision in the litigation between AVAS and Claimant's companies.

260. Respondent points out that the Article 330 procedure was the subject of challenges in Romania's Constitutional Court, and was upheld as an important "*protection of the human rights and freedoms against any abuse, including those having the origin in a judicial ruling*" (Decision of June 4, 1996, Official Gazette n°255 of October 22, 1996).
261. Accordingly, given that, at the time the proceedings were commenced, all final and enforceable judgments in Romania remained subject to the set-aside provisions for one year after entry of the judgment, it is clear that the principle of legal certainty was not violated under the circumstances of this case since the parties to the judgment were fully aware that Article 330 could be invoked during that one-year period.

**b) No violation of the principle of legal certainty arises from the Supreme Court's decision**

262. Respondent denies that the Supreme Court's decision to vacate the judgment violates the "full protection and safety" clause of Article 2(2) because it infringes the principle of legal certainty.
263. Respondent argues that the principle of legal certainty does not absolutely prohibit reopening final judgments. Judicial systems generally provide grounds upon which a final judgment may be vacated, such as in cases where a final judgment was procured on the basis of a fraud committed upon the court. Statutes of limitations are often established to protect against misuse of such procedures.
264. In the United States, for example, federal court judgments may be set aside for the following reasons: (i) mistake, inadvertence, surprise, or excusable neglect; (ii) newly discovered evidence that, with reasonable diligence, could not have been discovered; and (iii) fraud, misrepresentation, or misconduct by an opposing party. This procedural remedy is available within one year of judgment, even after the judgment has become final and all direct appeals are exhausted (Fed. R. Civ. P. 60(b), 2008).
265. In this case, the procedure was in accordance with Article 330 of the Romanian Civil Procedure Code (see above, ¶¶216 and 259-261) when it was invoked by AVAS. It was used in this case because the lower court denied AVAS's request for the commissioning of a judicial expert report and failed to examine serious allegations of fraud regarding Continent SRL's claims that investments were performed and that invoices for goods and services were authentic. The lower court declined even to consider AVAS's allegations because the court incorrectly determined that the Trade Registry approval was binding on AVAS. However, that ruling was in conflict with a 1995 decision of the Romanian Supreme Court, in which the court held that the 15-day period commences upon publication in the Official Gazette, not when the decision was rendered (Supreme Court Decision n°701 of October 19, 1995, Respondent's Exhibit n°74). Under that decision, the 15-day rule would not be applicable to AVAS because the Trade Registry decision was not published in the Official Gazette. Thus, Respondent submits that the Trade Registry's approval did not preclude a full evaluation of the merits of the AVAS claims, which had not been examined by any judge.



**c) The reasons stated for the Supreme Court’s decision are reasonable, justify the relief granted, and do not interfere with Claimant’s right of ownership**

266. In this case, as explained in the Supreme Court’s decision (Claimant’s Exhibit n°13), the General Prosecutor moved to vacate the judgment against AVAS under Article 330 on, *inter alia*, the following grounds: (a) the documents on which the share increase was based reveal that “*the defendant [Continent SRL] did not achieve the investments from its own sources or from others gained over its name*”; (b) there were multiple transactions involving Claimant’s group of companies, causing concern that “*there is no certainty for the reality of the prices*” charged; (c) there were highly suspicious irregularities in the documentation supporting the investment; and (d) there was an “*obvious conflict of interests between the privatized company [Continent SA] and the buyer of the shares [Continent SRL]*”.
267. The Court agreed that the Expert Project report failed to show how the capital increase was made and thus did not resolve the objections raised by AVAS in the lower court. It instructed the lower court on remand to appoint a new expert that would put this issue to rest. The Supreme Court also found that third parties were not bound by the increase in share capital because the decision approving it was not published in the Official Gazette. The Court also recognized the pendency of criminal charges against Claimant and instructed the lower court on remand to take into consideration the proceedings in the criminal case. Finally, the court acknowledged that the General Prosecutor had found defects in various contracts cited by Claimant as support for the claimed investments that involved transactions between companies controlled by Claimant. The court directed the lower court to address those defects (see above, ¶217).
268. Based on the ruling of the Supreme Court, the lower court judgment was vacated. The Supreme Court set aside the judgment so that serious challenges to the integrity of the vacated judgment could be examined for the first time by the lower court. This is an entirely proper and reasonable rationale under the circumstances.
269. Respondent submits that Claimant’s reliance on decisions of the European Court asserting violation of legal certainty is misplaced.
270. Indeed, in *Brumarescu v. Romania*, the claimant had obtained a final judgment in 1993 from a Romanian court, awarding him title to his parents’ home, which had been taken in an unlawful nationalization in 1950. The judgment was later set aside by the Supreme Court in 1995, under Article 330 of the Civil Procedure Code. The court reasoned that the 1950 nationalization was carried out pursuant to a legislative act that precluded judicial review. The ECHR held that a law barring judicial review (the basis of the set-aside order) was itself a violation of the right to a fair hearing guaranteed by the Convention. The ECHR also found fault with the challenged decision because, at the time, Article 330 of the Civil Procedure Code had no temporal restriction, a defect later corrected by the Romanian legislature. The ECHR eventually noted that no justification, such as “public interest”, was given for the Supreme Court’s ruling.

271. None of the *Brumarescu* circumstances are present here. Claimant continues to own all of his shares without interruption, he controls Continent SA, and the Supreme Court's decision was amply justified and in the public interest given the unresolved allegations of fraud. Significantly, in *Brumarescu*, there was no allegation that the initial judgment was tainted by fraud. Moreover, in Claimant's case, the Supreme Court merely remanded for a full and fair consideration of the relevant facts, which is not at all comparable to what occurred in *Brumarescu*. As a result, *Brumarescu* has no application under the facts and circumstances of this case.
272. Similarly in *Ryabykh v. Russia*, a lower court judgment that was favorable to the applicant was quashed as a result of a "supervisory review." The ECHR drew a comparison to *Brumarescu* and observed that the exercise of the "supervisory review" in that case was not subject to any time limit. As in *Brumarescu*, there was no allegation of fraud or criminal misconduct on the part of the complainant or any suggestion that the lower court had failed to inquire into the merits of complainant's case.
273. In *SC Maşinexportimport Industrial Group SA c. Roumanie*, the applicant obtained a favorable decision from the Bucharest Tribunal in a dispute with AVAS, which entitled the applicant to receive ROL 22.28 billion. After the decision became final and no longer subject to appeal, AVAS paid the sum in question. Subsequently, the Supreme Court quashed the Bucharest Tribunal's decision. The applicant was ordered to return the monies he had received. He claimed before the ECHR that the General Prosecutor's intervention at the Supreme Court was a violation of article 6(1) and Article 1 of Protocol 1 of the European Convention. The case is similar to *Brumarescu* in that the original decision had conferred title to a certain sum of money and the complainant was deprived of his property as a consequence of the Supreme Court's exercise of supervisory review.
274. It is notable that, in *Maşinexportimport*, the court partially based its finding that Romania was in breach of the European Convention upon the fact that AVAS had failed to appeal the original court decision through the normal judicial channels and had invoked the supervisory jurisdiction of the Supreme Court in an attempt to escape the consequences of that failure. In the present case, by contrast, AVAS exercised its rights of appeal within good time and invoked the supervisory jurisdiction of the Supreme Court for *bona fide* reasons, namely to avoid a miscarriage of justice arising from alleged fraud.
275. Finally, Respondent submits that ICSID's jurisdiction is limited by the ICSID Convention to deciding investment disputes. Claimant's "legal certainty" claim is not an investment dispute. Whether Romania's Supreme Court applied Romanian civil procedure law in a manner consistent with the European Convention is not an issue that Romania agreed to arbitrate under the Treaty.

**d) The principle of proportionality is not violated by the Supreme Court's order vacating the judgment**

276. Respondent refutes Claimant's allegation that, by vacating the lower court judgment, the Supreme Court's decision interferes with Claimant's rights of ownership and that such interference is not justified because it fails to pass the test of proportionality.

277. According to Respondent, the question of proportionality does not even come into play based on the Supreme Court’s decision, because the admission of the motion to vacate did not amount to an interference with Claimant’s ownership rights. The Supreme Court made no determination as to whether the investment was made or whether AVAS is entitled to execute the pledge and repossess the shares. Those issues remained open for decision by the lower court.
278. On remand, the court of first instance ruled in favor of Continent SRL. On appeal, a divided court ruled for Continental SRL. That judgment was appealed and is pending before the Supreme Court, subject to a request to suspend proceedings. Now the matter is before the Tribunal on the counterclaim of Respondent against Continental SRL and Claimant.

2. Claimant’s other arguments under Romanian law are equally unavailing

**a) Claimant’s argument – that the Trade Registry decision has *res judicata* effect – is contrary to Romanian law**

279. Respondent refutes Claimant’s allegation that the AVAS lawsuit to enforce its rights under the Privatization Agreement, with respect to the pledge of shares as security for the investment obligation, is “illegal” under Romanian Law because approval by the Trade Registry judge had become irrevocable in January 2001, given that no one appealed that decision within 15 days. Respondent denies Claimant’s argument that the Trade Registry decision is *res judicata* and bars AVAS from bringing an enforcement action in 2001.
280. Indeed, the Trade Registry judge’s issuance of a decision to approve or deny an increase in share capital is not an adversarial proceeding. As such, it does not enjoy *res judicata* effect under Romanian law. Articles 331 and 337 of the Civil Procedure Code provide as follows: “Article 331. The applications in respect of which the intervention of the court is necessary, but without pursuing the determination of an adversarial right towards another person, such as those regarding the granting of judicial authorizations, or the granting of legal supervision, safeguards or conservatory measures, are subject to the procedural provisions set out below. [...]”; “Article 337. The decisions do not have the power of *res judicata*.” Respondent sets forth that approval of resolutions by a Trade Registry judge to authorize a company’s share capital increase is a “judicial authorization” under Article 331 and, pursuant to Article 337, is not *res judicata*.
281. Furthermore, according to Article 1201 of the Romanian Civil Code: “[t]here exists *res judicata* when the second claim before the court has the same subject-matter, is grounded as the same cause and is between the same parties initiated by them and against them in the same capacity.” Respondent submits that these requirements are not met. Indeed, neither AVAS nor Continent SRL – the two parties to the AVAS enforcement litigation – was a party before the Trade Registry judge. Nor is the subject-matter and cause the same. The AVAS litigation seeks to enforce the Privatization Agreement against Continent SRL and to obtain relief specified in that contract, because Continent SRL failed to make the required investment. The matter before the Trade Registry was a resolution by the shareholders of Continent SA approving an increase in share capital

based on purported investments made in Continent SA. The Privatization Agreement expressly stipulated that the investment would only be “*deemed to be performed*” once it had been “*fully paid by* [Continent SRL].” The Trade Registry judge made no finding as to whether Continent SRL complied with the investment requirements of the Privatization Agreement and is not competent to make such a finding.

**b) Claimant’s argument that AVAS had 15 days to challenge the Trade Registry ruling is incorrect**

282. Respondent denies Claimant’s assertion that AVAS had 15 days from the date of the Trade Registry decision to lodge an appeal and, because it failed to do so, the April 2001 enforcement action is untimely.
283. Indeed, the relevant legal provision at the material time was Article 60 of the Company Law, which provided that: “*the final appeal term is 15 days and commences upon the rendering of the decision.*” However, based on Decision 701/1995 of the Supreme Court (Respondent’s Exhibit n°74), for third parties the 15-day period begins to run from the date of publication of the Trade Registry decision (or of the amended articles of association) in the Official Gazette (that procedure has since been incorporated into an amendment to Article 60 of the Company Law). Respondent points out in this regard that the decision of the Trade Registry was never published in the Official Gazette.
284. Furthermore, AVAS’s enforcement action is not an appeal of a decision made by the Trade Registry judge concerning the registration of the capital increase. It is a separate action for an alleged breach of the Privatization Agreement by Continent SRL. As such, it is subject to the general prescription period of three years under Romanian law.
285. Respondent notes that Claimant cites Article 6 of Law 26/1990 for the proposition that AVAS had 15 days to dispute the Trade Registry decision. However, the 15-day rule in Article 6 of that law was not even enacted until 2003 (Law 161/2003), three years after AVAS filed its action to enforce the share pledge. Moreover, even under the current version of Article 6, the 15-day period for third parties such as AVAS to challenge a corporate act starts only upon publication of the act in the Official Gazette. Accordingly, a challenge by a third party of an *unpublished* decision would be dismissed as premature.

**c) Romanian law authorized AVAS to file an “absolute nullity” claim against Continent SA to set aside the shareholders’ resolution**

286. Article 131 of the Romanian Company Law provides an express right for any interested party to challenge a shareholders’ resolution as an “absolute nullity.” Although Article 131 of the Company Law was included in the 2003 amendments, interested third parties have for many years enjoyed the right to challenge shareholders’ resolutions on “absolute nullity” grounds under other provisions (St. D. Carpenaru, S. David, C. Predoiu, Gh. Piperea, *The Law of Commercial Companies, Commentary on Articles 400-01*, 3d ed. 2006). Such generally applicable provisions of law include Article 966 of the Romanian Civil Code, which provides that “[a]n obligation without cause or grounded on a false or illicit cause, cannot have any [legally-enforceable] effect.” The right to nullify a legal act,

based on the fundamental principle *fraus omnia corrumpit*, is drawn from Article 5 of the Civil Code: “*It is not allowed to derogate by agreement or unilateral act from laws that concern public order or good morals,*” and Article 968 of the Civil Code, which provides that an “*illicit cause is one that is prohibited by law or is contrary to good morals and public order*”.. Respondent submits that the actions of Continent SA, in submitting to its shareholders for a vote, and to the Trade Registry for approval, a resolution premised on investments that never were made by Continent SRL provide valid grounds for a claim of absolute nullity under Article 966 of the Civil Code.

287. Respondent denies Claimant’s allegation that Article 966 of the Romanian Civil Code does not apply to shareholder resolutions because they are non-contractual acts. Indeed, the shareholders’ resolution which records the common intention of the shareholders to approve a share capital increase, and thereby amends Continent SA’s articles of incorporation, is contractual in nature.
288. Contrary to Claimant’s assertion, any interested party in Romania has the right to bring an “absolute nullity” claim; it is not a right exclusive to shareholders. Further, a transaction based on fraudulent conduct can be nullified at any time. There is no prescription period for “absolute nullity” claims under Romanian law. The 2007 claim by AVAS was, therefore, timely.
289. In addition, the violation of various mandatory provisions of the Company Law is sanctionable by absolute nullity, *e.g.* decisions made with the vote of directors where such vote was prohibited by the Company Law (see Article 125(5) and Article 145 of the Company Law). In this regard, Claimant’s approval of the share capital increase in his fiduciary capacity as a director of Continent SA was in conflict with his personal interest as the sole shareholder, director, and representative of Continent SRL. These interests conflict for obvious reasons: Claimant and his wholly-owned company Continent SRL arranged for approval of the share capital increase because it created the appearance that Continent SRL had fulfilled the investment obligation of the Privatization Agreement. Continent SA and its minority shareholders, on the other hand, would not want to approve the share capital increase if they knew the investment had not been made by Continental SRL.

### **§3. DAMAGES**

290. If the AVAS litigation causes him to lose any shares, Claimant demands the full value of his entire shareholding interest in Continent SA, *i.e.* over USD 85 million, in addition to USD 25 million for moral damages. If the Romanian litigation is suspended, Claimant demands USD 25 million for moral damages. However, Respondent sought suspension of the AVAS claims in local courts and is bringing its counterclaims before the Tribunal so that the factual disputes surrounding the performance of the investment obligation can be decided before this Tribunal. As a result, Respondent submits that Claimant’s secondary claim is moot.

1. There is no basis for the award of Claimant's primary demand for moral damages

291. The first issue regarding the primary relief sought in this claim is whether the evidence establishes that Continent SRL invested the USD 1.4 million from its own resources. If the Tribunal finds that Continent SRL failed to meet its burden of proof, then it must deny this claim. Indeed, Claimant is not entitled to recover damages if AVAS acted reasonably in pursuing its contractual rights under the Privatization Agreement.
292. The next issue is whether AVAS had legitimate reasons for challenging the validity of the Expert Project report in Romanian courts, in light of the serious issues raised. If the Tribunal finds that it was appropriate for AVAS to raise these issues, then it must deny this claim.
293. If the Tribunal concludes that the USD 1.4 million investment was made by Continent SRL, *and* that the court challenges brought by AVAS were unwarranted, then the Tribunal has reasons to consider the question of damages. In that scenario, there is no basis whatsoever for the USD 25 million moral damages award demanded by Claimant.
294. Claimant cannot request moral damages for himself in his individual capacity because the Tribunal can award damages only for the investment. Indeed, Article 2(2) of the Treaty, the provision under which this claim is asserted, protects "Investments by investors of a Contracting Party."
295. Previous decisions of ICSID tribunals can offer valuable guidance to the Tribunal (*Saipem S.p.A v. The People's Republic of Bangladesh*, ICSID Case No. ARB/05/07, Decision on Jurisdiction). According to Respondent, only two ICSID tribunals have awarded moral damages for serious impairment of an investment, and the circumstances of those cases are not comparable to those present here.
296. In *S.A.R.L. Benvenuti and Bonfant v. People's Republic of Congo* (ICSID Case No. ARB/77/2), an ICSID tribunal awarded moral damages to an Italian corporation for the loss of commercial opportunities in its home country under extreme conditions involving harm to its employees and credit sources. The Congolese military occupied the Claimant's property, its employees were forced to leave Congo, and it lost the opportunity to do business in Italy because its banks and suppliers refused to provide credit. Claimant was unable to prove material damages, but the tribunal awarded a token amount equivalent to approximately USD 15,000. Respondent contends that even such a minimal amount would not have been awarded but for the circumstance that the parties jointly authorized the tribunal to decide the moral damages claim *ex aequo et bono*, pursuant to Article 42(3) of the ICSID Convention. Moreover, because such an award is not rendered on the basis of applicable law, it cannot serve as precedent in this case.
297. The only other case in which moral damages were awarded to a claimant by an ICSID tribunal was *Desert Line Projects LLC v. The Republic of Yemen*, ICSID Case No. ARB/05/17. The tribunal explained that "*investment treaties primarily aim at protecting property and economic values,*" but "*they do not exclude, as such, that a party may, in exceptional circumstances, ask for compensation for moral damages.*" The tribunal

emphasized that “a legal person (as opposed to a natural one) may be awarded moral damages, including loss of reputation, in specific circumstances only.” In that case, the claimant’s corporate executives were threatened and detained by the respondent and intimidated in connection with the contracts representing the investment. The claimant’s request for payment for completed works was answered with armed forces. Furthermore, the tribunal explained that it awarded moral damages based on evidence that “*the physical duress exerted on executives of the Claimant was malicious and because “it affected the physical health of the Claimant’s executives”* as well as Desert Line’s credit and reputation. Respondent submits that there are no similarities between the extraordinary circumstances of that case and the allegations and claims asserted by Claimant in this case.

298. Claimant’s claim for moral damages also fails under Romanian law. Pursuant to Articles 998 and 999 of the Civil Code, the following prerequisites must be met to admit a civil liability claim: (a) an unlawful deed; (b) certain and unrepaired damage; (c) a causal link between the unlawful deed and the claimed damage; and (d) culpability of the party accused of committing the unlawful act.
299. Respondent sets forth that Claimant’s damages claim falls short of proving any unlawful character of AVAS’s deeds. Respondent submits that AVAS acted in accordance with its contractual and legal rights and statutory duties in attempting to enforce the share pledge against Continent SRL and exercised its constitutional right of free access to justice when it filed the action for the annulment of the shareholders’ resolution approving the capital increase.
300. Respondent further submits that, where the injury alleged is an uncompensated expropriation, the appropriate measure of damages is the value of the expropriated company (Article 4 of the Treaty).
301. Respondent points out that even if the Tribunal were to find that Claimant was entitled to an award of moral damages, such damages would need to be compensatory in nature, and commensurate with any discernible loss or harm that Claimant has established. However, Claimant has failed to prove any discernible loss or harm in this case.
302. Finally, Claimant’s demand for USD 25 million, without regard for the purported value of Continent SA, runs afoul of the oft-cited standard for damages under international law: “[t]he fundamental concept of “damages” is . . . reparation for a loss suffered, a judicially ascertained compensation for wrong. The remedy should be commensurate with the loss, so that the injured party may be made whole” (*The Lusitania Cases*, US-Germany Mixed Claims Commission, VII R.I.A.A., 32, 1923, at 39, emphasis in original). However, Claimant has failed to show that the USD 25 million moral damages he seeks for this claim represents compensation for any discernible loss. Respondent alleges that it is a completely arbitrary and fanciful figure unsupported by law or fact.
303. For clarity’s sake, Respondent sets forth that its submissions responding to Claimant’s moral damages claims apply to all such claims.

2. Claimant has a heavy burden of proof, which he has failed to meet

304. According to Respondent, Claimant bears the burden to establish the alleged injury, its extent, and its cause. However, Claimant has failed to make out a claim for indirect expropriation given that he continues to own the shares he acquired and enjoys full decision-making authority over his investment. With regard to the claimed damages in particular, Claimant has not proved any specific harm to the business of Continent SA nor quantified his damages on the basis of any accepted valuation principles or methods.
305. Respondent refutes Claimant's assertion that the value of Continent SA was established by Respondent's own evidence. Indeed, Claimant misinterpreted Respondent's arguments from the Interim Measures application dated May 28, 2008. Respondent merely argued that the EUR 40,000,000 listed sale price was "*substantially below the EUR 65,263,750 market value asserted by Claimant in this arbitration. Cl. Mem. ¶ 104.*" (Respondent's Request for provisional measures dated May 28, 2008, page 3, para. 2.) Respondent never contended that the EUR 65,263,750 or EUR 40,000,000 numbers were the correct market value of the property; it just noted that the advertised sale price was below the alleged market value claimed by the Claimant. Also, there is no evidence in the record that the EUR 40,000,000 asking price was ever offered by a buyer or that the self-made evaluation of EUR 65,263,750 was ever documented under any applicable evaluation standard.

SUB-SECTION III. DECISION OF THE ARBITRAL TRIBUNAL

§1. THE LEGAL FRAMEWORK APPLICABLE TO THE MERITS

**I. The Applicable Law**

306. At the first session of the Arbitral Tribunal held on May 4, 2007, the Parties agreed that Romanian law would govern the substantive merits of the dispute and that the BIT would be treated as part of Romanian law (see Minutes First Session, ¶19).
307. Article 9(4) of the BIT provides that:
- "The arbitral tribunal shall decide the dispute in accordance with the provisions of this Agreement and the applicable rules and principles of international law (...)."*
308. The Parties agree that Claimant's investment is protected by the BIT, more specifically its articles 2(2) and 4(1).
309. According to Claimant, in view of Article 10 of the BIT, the international obligations that Respondent has assumed in Article 6 of the European Convention on Human Rights and Article 1 of the First Additional Protocol to the European Convention are also to be taken into consideration in the instant case. This is disputed by Respondent.
310. Article 10 of the BIT provides that:



“[i]f the provisions of law of either Contracting Party or obligations under international law existing at present or established hereafter between the Contracting Parties in addition to this Agreement, contain a regulation, whether general or specific, entitling investments by investors of the other Contracting Party to a treatment more favourable than is provided for by this Agreement, such regulation shall to the extent that it is more favourable, prevail over this Agreement”.

311. In accordance with the interpretation rules of Article 31 of the Vienna Convention<sup>4</sup>, the Tribunal considers that the references made in the text of that Article 10 to “*either Contracting Party*,” “*between the Contracting Parties*,” and “*investors of the other Contracting Party*” refer to the Contracting Parties of the Romania-Greece BIT. The reference to international obligations established between the parties therefore only encompasses international obligations between these two countries.
312. The Tribunal does not exclude the possibility that the international obligations of the Contracting States mentioned at Article 10 of the BIT could include obligations deriving from multilateral instruments to which those states are parties, including, possibly, the European Convention of Human Rights and its Additional Protocol No.1. But the issue is moot in the present case and does not require decision by the Tribunal, given the higher and more specific level of protection offered by the BIT to the investors compared to the more general protections offered to them by the human rights instruments referred above. Consequently Article 10 of the BIT cannot, in its own terms and in the instant case, serve as a useful instrument for enlarging the protections available to the Claimant from the Romanian State under the BIT.

## **II. The Fair and Equitable Treatment Standard**

313. Article 2(2) provides in its relevant part that: “*Investments by investors of a Contracting Party shall, at all times, be accorded fair and equitable treatment (...)*”
314. The Tribunal considers that the Fair and Equitable Treatment standard encompasses *inter alia* the following concrete principles (*Rumeli and Telsim v. Republic of Kazakhstan*, ICSID Case No. ARB/05/16, ¶605) :
- *“the State must act in a transparent manner;*
  - *the State is obliged to act in good faith;*
  - *the State’s conduct cannot be arbitrary, grossly unfair, unjust, idiosyncratic, discriminatory, or lacking in due process;*
  - *the State must respect procedural propriety and due process.”*
315. Denial of justice - that is, a failure of due process - constitutes a violation of the Fair and Equitable Treatment standard. On the other hand, an “erroneous judgment” by a court would not violate the treaty in the absence of a denial of justice, that is, a violation of the due process principle (*Parkerings-Compagniet AS v. Lithuania*, ICSID Case No.

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<sup>4</sup> Vienna Convention on the Law of Treaties (adopted 23 May 1969, entered into force 27 January 1980) 1155 UNTS 331, Art. 31 (the “Vienna Convention”).

ARB/05/8, Award, September 11, 2007, ¶317). According to the ICSID tribunal in *Azinian v. United Mexican States*, “denial of justice could be pleaded if the relevant courts refuse to entertain a suit, if they subject it to undue delay, or if they administer justice in a seriously inadequate way. . . . There is a fourth type of denial of justice, namely, the clear and malicious application of the law.” (ICSID Case No. ARB(AF)/97/2, Award, November 1, 1999, 39 I.L.M., ¶¶102-103).

316. The case law also confirms that to comply with the FET standard, the State must respect the investor’s reasonable and legitimate expectations. This view, reflected in the *Tecmed* decision, has been adopted by a succession of tribunals:

“The Arbitral Tribunal considers that this provision of the [BIT], in light of the good faith principle established by international law, requires the Contracting Parties to provide to international investments treatment that does not affect the basic expectations that were taken into account by the foreign investor to make the investment. The foreign investor expects the host State to act in a consistent manner, free from ambiguity and totally transparently in its relations with the foreign investor, so that it may know beforehand any and all rules and regulations that will govern its investments, as well as the goals of the relevant policies and administrative practices or directives, to be able to plan its investment and comply with such regulations.” (*Técnicas Medioambientales Tecmed S.A. v. The United Mexican States*, ICSID Case No. ARB(AF)/00/02, Award, May 29, 2003, ¶154; cited in e.g., *LG&E Energy Corp., LG&E Capital Corp. and LG&E International Inc. v. Argentine Republic*, ICSID Case No. ARB/02/1, Decision on Liability, October 3, 2006, ¶127; *CMS Gas Transmission Company v. Argentine Republic*, ICSID Case No. ARB/01/8 Award, May 12, 2005, ¶279; *Occidental Exploration and Production Company v. The Republic of Ecuador*, LCIA Case No. UN 3467 Final Award, July 1, 2004, ¶185; *MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Republic of Chile*, ICSID Case No. ARB/01/7 Award, May 25, 2004, ¶114).

317. On the other hand, the Arbitral Tribunal in *Saluka* has pointed out that “no investor may reasonably expect that the circumstances prevailing at the time the investment is made remain totally unchanged. In order to determine whether frustration of the foreign investor’s expectations was justified and reasonable, the host State’s legitimate right subsequently to regulate domestic matters in the public interest must be taken into consideration as well. As the *S.D. Myers* tribunal has stated, the determination of a breach of the obligation of “fair and equitable treatment” by the host State must be made in the light of the high measure of deference that international law generally extends to the right of domestic authorities to regulate matters within their own borders” (*Saluka Investments BV v. The Czech Republic*, UNCITRAL, Partial Award, ¶305, relying on *S.D. Myers, Inc.*, 40 ILM 1408, ¶263).

318. Beyond these general principles, the scope of the standard is not precisely defined. “It offers a general point of departure in formulating an argument that the foreign investor has not been well treated by reason of discriminatory or other unfair measures being taken against its interest. It is therefore a concept that depends on the interpretation of specific facts for its content” (P. Muchlinski, *Multinational enterprises and the law*, 1995, 625). The precise scope of the standard is therefore left to the determination of the

Tribunal which “will have to decide whether in all the circumstances the conduct in issue is fair and equitable or unfair and inequitable” (F.A. Mann, “British Treaties for the Promotion and Protection of Investments”, 52 *British Y.B. Int’l L.* 1981, 241-244).

### **III. The Full Protection and Security Standard**

319. Article 2(2) provides in its relevant part that: “Investments by investors, (...) shall enjoy full protection and security in the territory of the other Contracting Party (...)”
320. As to the scope of the measure, the Tribunal in *Saluka* decided that “the “full security and protection” clause is not meant to cover just any kind of impairment of an investor’s investment, but to protect more specifically the physical integrity of an investment against interference by use of force” (*Saluka Investments BV v. The Czech Republic*, UNCITRAL, Partial Award, ¶305, relying on *S.D. Myers, Inc.*, 40 ILM 1408, ¶483). This seems to see the prevailing approach (see also for example *Rumeli v. Kazakhstan*, *supra*, *Eastern Sugar v. Czech Republic*, Partial Award, March 27, 2007, ¶203; *Wena Hotels v. Egypt*, Award, December 8, 2000 (2002) 41 ILM 896; *AAPL v. Sri Lanka*, Award, June 21, 1990, 4 ICSID Rep. 246).
321. There is also authority indicating that the principle of full protection and security reaches beyond safeguard from physical violence and requires legal protection for the investor. For example, the tribunal in *Biwater* held that when the terms “protection and security” are qualified by “full”, the content of the standard may extend to matters other than physical security. It implies a State’s guarantee of stability in a secure environment, both physical, commercial and legal (*Biwater Gauff Ltd. v. United Republic of Tanzania*, ICSID Case No. ARB/05/22, ¶729; see also for example *Azurix v. Argentina*, Award, July 14, 2006; *Siemens v. Argentina*, Award, February 6, 2007; *Vivendi v. Argentina*, Award, August 20, 2007, ¶7.4.14). But to this extent, the standard is also covered by Fair and Equitable Treatment.
322. As to the standard of liability, it is generally accepted that the obligation to provide protection and security does not create absolute liability (*Elettronica Sicula Spa (ELSI)* (1989) ICJ Rep 15; *AAPL v. Sri Lanka*, *supra*; *Tecmed v. Mexico*, *supra*; *Noble Ventures v. Romania*, Award, 12 October 2005). The tribunal in *Rumeli* considered that “[i]t obliges the State to provide a certain level of protection and security to foreign investment from physical damage.” (*Rumeli v. Republic of Kazakhstan*, *supra*, ¶663). In *AMT v. Zaire*, the tribunal has confirmed that in international law, the full protection and security obligation is one of “due diligence” and no more (*American Manufacturing & Trading v. Republic of Zaire*, ICSID Case No. ARB/93/1, Award of February 21, 1997, 36 ILM 1534).

### **IV. The Non-Impairment Standard: Unjustifiable or Discriminatory Measures**

323. Article 2(2) provides in its relevant part that: “(...) Each Contracting Party shall ensure that the management, maintenance, use, enjoyment or disposal, in its territory, of investments by investors of the other Contracting Party, is not in any ways impaired by unjustifiable or discriminatory measures.”

324. In the case law, the standard is closely associated with “Fair and Equitable Treatment.” In order for the State’s conduct to be justifiable or reasonable, it requires that the conduct “*bears a reasonable relationship to some rational policy, whereas the standard of “non-discrimination” requires a rational justification of any differential treatment of a foreign investor*” (see *Saluka*, ¶460, *Rumeli*, ¶674).
325. Similarly, the Arbitral Tribunal in *CMS* stated that the standard of protection against discrimination “*is related to that of fair and equitable treatment. Any measure that might involve ... discrimination is in itself contrary to fair and equitable treatment. The standard is next related to impairment*” (¶290). A measure is discriminatory when it provides “*the foreign investment with a treatment less favorable than domestic investment*” (*Biwater*, ¶695).

## **V. The Expropriation Standard**

326. Article 4(1) of the Treaty provides that:

*“Investments by investors of either Contracting Party in the territory of the other Contracting Party shall not be expropriated, nationalized or subjected to any other measure the effects of which would be tantamount to expropriation or nationalization (hereinafter referred to as “ expropriation”), except under the following conditions:*

- a) the measures are taken in the public interest and under due process of law;*
- b) the measures are clear and on a non discriminatory basis;*
- c) the measures are taken against payment of prompt, adequate and effective compensation (...)*”

327. Expropriation can be direct, that is, resulting from a deliberate formal act of taking, or indirect. Indirect expropriation may occur when measures “*result in the effective loss of management, use or control, or a significant depreciation of the value, of the assets of a foreign investor*” (UNCTAD Series on issues in international investment agreements, Taking of Property, 2000, p.2).
328. On the other hand, in order to determine whether an indirect expropriation has taken place, the determination of the effect of the measure is the key question. Acts that create impediments to business do not by themselves constitute expropriation. In order to qualify as indirect expropriation, the measure must constitute a deprivation of the economic use and enjoyment, as if the rights related thereto, such as the income or benefits, had ceased to exist (*Tecmed v. Mexico*, Award, May 29, 2003, 43 ILM (2004) 133, para. 115). In *Telenor*, the Tribunal decided that: “[t]he conduct complained of must be such as to have a major adverse impact on the economic value of the investment,” as “*substantially to deprive the investor of the economic value, use or enjoyment of its investment*” (*Telenor Mobile Communications A.S. v. Republic of Hungary*, ICSID Case No. ARB/04/15, Award, September 13, 2006, ¶¶64-65).
329. Expropriation may occur in the absence of a single decisive act that implies a taking of property. It could result from a series of acts and/or omissions that, in sum, result in a

deprivation of property rights. This is frequently characterized as a “creeping” or “constructive” expropriation. In the *Biloune* case the arbitration panel found that a series of governmental acts and omissions which “*effectively prevented*” an investor from pursuing his investment project constituted a “*constructive expropriation.*” Each of these actions, viewed in isolation, may not have constituted expropriation. But the sum of them caused an “*irreparable cessation of work on the project*” (*Biloune and Marine Drive Complex Ltd. v. Ghana Investments Centre and the Government of Ghana*, UNCITRAL ad hoc Tribunal, Award on Jurisdiction and Liability of October 27, 1989, 95 ILR 183, 209).

330. The intention or purpose of the State is relevant but is not decisive of the question whether there has been an expropriation. In *Phillips Petroleum Co Iran v The Islamic Republic of Iran* (CLA 61, ¶97), the arbitral tribunal decided that “[t]he intent of the government is less important than the effects of the measures on the owner, and the form of the measures of control or interference is less important than the reality of their impact... Therefore, the Tribunal need not determine the intent of the Government of Iran...”

## §2. APPLICATION OF THE STANDARDS TO THE FACTS OF THIS CASE

### I. Claimant’s allegations

331. In his “Investment Claim,” Claimant alleges that:
- Romania’s refusal to amicably settle the dispute breaches the fair and equitable clause included in Article 2(2) of the BIT;
  - AVAS’ attempt to execute the Share Pledge Agreement against his shares in Continent SA amounts to an expropriation in violation of Article 4(1) of the BIT and Article 1 of the First Additional Protocol to the European Convention and also breaches Article 2(2) of the BIT;
  - The Prosecutor General’s application to the Supreme Court requesting that it reverse and remand for further development of the facts the Appellate Court decision in the Share Pledge enforcement litigation, the motion by AVAS to set aside the decision of the Court of Appeal in that case and the Supreme Court decision amount to a violation of Article 2(2) of the BIT (fair and equitable treatment and full protection and security), Article 4(1) of the BIT and Article 6 of the European Convention;
  - The absolute nullity claim filed by AVAS to annul the increase in share capital has effects equivalent to an abusive expropriation and also violates Article 2(2) of the BIT (fair and equitable treatment).
332. The Tribunal will examine each of these allegations separately.

## **II. Refusal to negotiate an amicable settlement**

333. The Tribunal notes that Claimant does not elaborate on the reasons why the Respondent's absence of answer to Claimant's letter requesting a negotiation to reach an amicable settlement of the case would amount to an unfair and inequitable treatment.
334. Article 9 of the BIT regulates the "settlement of disputes between an Investor and a Contracting Party" in the following terms:
- 1. Disputes between an investor of a Contracting Party and the other Contracting Party concerning an obligation of the latter under this Agreement, in relation to an investment of the former, shall, if possible, be settled by the disputing parties in an amicable way.*
  - 2. If such disputes cannot be settled within six months from the date either party requested amicable settlement, the investor concerned may submit the dispute either to the competent courts of the Contracting Party in the territory of which the investment has been made or to international arbitration.*
335. The Tribunal agrees with Respondent that, in accordance with the interpretation rules of Article 31 of the Vienna Convention, the Treaty neither imposes a legal duty nor creates a legal right for the Parties to negotiate a settlement. Article 9 does not refer to "negotiations." It only refers to an amicable settlement "*if possible.*"
336. The Tribunal considers that in view of the numerous procedures which had taken place or were still ongoing before the courts of Romania, Respondent may have believed reasonably and in good faith that an amicable settlement was not "*possible*" and that it should not engage in negotiations.
337. The Tribunal therefore decides that Romania's conduct was reasonable and adequate and did not breach the Fair and Equitable Treatment requirement.

## **III. AVAS's attempt to execute the Share Pledge Agreement, the proceedings initiated by the General Prosecutor and the subsequent Supreme Court decision**

338. The Arbitral Tribunal considers, on the basis of the evidence, that Respondent's conduct was reasonable, appropriate and justified.
339. According to the Privatization Agreement, Continent SRL had to make an additional post-purchase investment of USD 1.4 million over a period of two years from January 1, 1999 to December 31, 2000. This investment had to be carried out by the buyer "*from personal sources or sources attracted on its behalf.*" USD 1.1 million had to be provided in 1999, with the remainder (USD 300,000) to be provided in 2000.
340. The evidence confirms that when AVAS decided to start proceedings against Claimant, there were objective reasons to suspect that Claimant had not fulfilled its post-purchase investment. AVAS acted in accordance with its contractual and legal rights and statutory duties.

341. Mrs. Mariana Pedescu, Director of the Post-Privatization Monitoring Department at AVAS, who managed the verification of Continent SRL's compliance with its post-investment obligations, explained at the hearing the reasons why she took steps to recommend enforcement of the Share Pledge to AVAS's Board of Directors.
342. Documents provided by the investor himself to prove compliance with its obligations showed that contrary to what he had told AVAS, the alleged investment did not come from the investor, but from Continent SA's own funds. This included the report from the expert appointed by Claimant – Expert Proiect – according to which the alleged in-kind investment consisted of various expenditures by Continent SA from its own funds. Mrs. Pedescu's doubts were also confirmed by the report submitted in May 2001 by Continent SA management admitting that 90% of the alleged investment consisted of routine operating expenses and capital expenditures made by Continent SA from its own funds and that Continent SRL “*was obliged to transfer the due sum to Continent SA.*”
343. Mrs. Pedescu further testified that AVAS made repeated requests to Continent SRL for additional documents to clear up the inconsistencies in the information provided by Claimant and his company but they were never provided. She concluded that AVAS was never provided with evidence proving that the additional investment had been made by Continent SRL.
344. AVAS's decision to start proceedings for the enforcement of the pledge may therefore be considered justified and reasonable. Contrary to Claimant's allegation, the trade registry decision was not *res judicata*. It could be challenged in subsequent court proceedings.
345. The Tribunal also finds that there were reasons for AVAS not to be satisfied with the first instance and the appellate court decisions. While these decisions were indeed based on the fact that the share capital increase had been registered, the trade registry decision was a non-adversarial procedure and the full facts were not before the judge. The Trade Registry judge did not make an independent assessment of the reality of the investment. He simply relied on the Expert Proiect report without taking into consideration the fact that the report stated that the investment was made by Continent SA and not Continent SRL.
346. Furthermore, in the appellate procedure, the President of the Court expressed a dissenting opinion in which she concluded that “*the modifications operated in the accounting, subsequent to the invalidation by the Financial Guard of the expert report by which the contribution in kind was evaluated .... cannot be validated by the Court*”.
347. It must further be noted that in his expert report dated January 29, 2002, Mr. Popivici, an expert appointed in the criminal investigation concluded that the alleged repayment by SRL of the 90% of the additional investment made by Continent SA on its own funds by way of a so-called restatement of accounts that would have transferred a USD 1.294 million debt from Continent SA to Continent SRL, by way of two agreements for the assignment of receivables, was in fact a sham. In addition, the accounting expert Popescu Elena, in her report of October 2002, established that about 50% of the value of restatement of accounts was cancelled by the end of 2001.

348. AVAS had therefore good reasons to suspect that the Court's decisions were incorrect. They relied exclusively on a narrow interpretation of Article 8.10.2 of the Privatization Agreement that established the date when the post-privatization investment obligation was considered to be fulfilled: the date of the registration of the share capital increase with the Trade Registry. The Court did not analyse the contradictions of the Expert Project report or the serious allegations of fraud for which Claimant was investigated criminally. Therefore, the decision of AVAS to resort to the last available legal option, *i.e.*, the recourse to the General Prosecutor to submit a motion to vacate the judgements of the lower court, may be considered justified and reasonable.
349. At the relevant time, the General Prosecutor was permitted under the Romanian Code of Civil Procedure to challenge final and irrevocable judgments within one year of their date of entry in order to avoid a miscarriage of justice and he often used such prerogative. The General Prosecutor indeed filed such a motion to vacate the judgment on the share pledge issue.
350. The General Prosecutor's motion was motivated. It indicated among others that on the basis of the available documents, it appeared that Continent SRL did not achieve the investments from its own sources or from others gained over its name, that there were highly suspicious irregularities in the documentation supporting the investments, that there were multiple transactions involving Claimant's group of companies, causing concern that there was no certainty for the reality of the prices charged. Moreover, Continent SA received notice of the intended application and had an opportunity to challenge it before an impartial tribunal. The motion to vacate was heard before the Supreme Court in an adversarial hearing where Claimant was represented and could present its defense.
351. There is no evidence before us that the Supreme Court did not act in an impartial way. Its decision vacating the Appellate Court decision and remanding the case was duly motivated. It noted in particular that the Expert Project did not show how the capital increase was made and therefore did not answer the objections raised by AVAS in the lower court; that third parties were not bound by the increase in share capital since the decision approving it was not published in the Official Gazette; that criminal charges were pending against Claimant; that the Prosecutor had found defects in the Debt Assignment Agreement entered into between various companies of the Claimant's group and that therefore it was necessary to determine whether these agreements were real or fictitious.
352. The fact that the decision which was later rendered on remand was again in favour of Continent SA does not mean that the Supreme Court decision was arbitrary.
353. In conclusion, the Arbitral Tribunal considers that AVAS had reasonable suspicions and good reasons to start proceedings for the enforcement of the Share Pledge. At all levels, Claimant was duly summoned, was represented and could present its defence. Given the limited ground on which the Court of First Instance and the Court of Appeal based their decision, and the contradictory evidence in the possession of AVAS, it was reasonable for the latter to use all possible available legal means to try to prevail in accordance with



its deep conviction that the additional investment had not been made. The Arbitral Tribunal does not see anything reprehensible in AVAS's decision to pursue its claim until the end and not to drop the proceedings, in the General Prosecutor's decision to challenge the judgements or in the Supreme Court's decision to remand the case for a new trial. Respondent's conduct did not amount to a breach of the fair and equitable treatment standard.

354. Respondent's conduct also does not amount to an expropriation. The evidence does not demonstrate that Respondent interfered with Claimant's management and control of his investment. Claimant continues to be the sole director of Continent SRL and Continent SA. Between 2004 and 2008, Continent SA transferred assets in excess of USD 2.8 million to Claimant personally. Continent SA transferred to Claimant's company, Ozias, USD 1.5 million for alleged consultancy services and USD 1.37 million for the purchase of equipment (that was never delivered) and Continent SA sold in 2006 a valuable real estate property for EUR 1 million, although it was subject to a sequestration order.
355. Respondent's behaviour did not deprive the investor from its right to use or enjoy its investment. The companies still function and Claimant continues to profit from their operations. Claimant's Counsel recognised in their oral pleadings that: "[the investment at the moment] *is still functioning, it is still a going concern*" (transcript, day 2, p. 112, line 16 at seq.); "[Continent SA] *is operating, and it is still filing accounts, there is still an accountant. The Claimant has been taking management fees continuously out of the business, there is no dispute about that (...)*" (transcript, day 2, p. 113, line 18 at seq.).
356. Claimant has also acknowledged that the value of the investment's asset base, and more specifically of the land, has exponentially increased in Romania since the date it purchased SC Malimp SA.
357. The additional burden that Claimant may have had to assume in consideration of the legal proceedings instituted against him may not be considered equivalent to expropriation.
358. In light of the evidence as restated above, the Arbitral Tribunal also considers that the management, maintenance, use, enjoyment or disposal of the investment by Claimant was not in any way impaired by unjustifiable or discriminatory measures and that Respondent's conduct did not infringe the principles of legal certainty and proportionality in violation of the full protection and safety clause contained in Article 2(2) of the BIT.
359. In particular, the Tribunal considers that the procedure permitting the General Prosecutor to challenge a final and irrevocable judgement does not breach the principle of legal certainty. During the relevant time, all final and enforceable judgements in Romania remained subject to the set aside provisions for one year (and no longer indefinitely) after entry of the judgement and the parties to the procedure were fully aware that such provision could be invoked during that one year period. The procedure was initiated without delay, was fully transparent and legitimate and cannot be considered to amount to a violation of the principle of *res judicata*. Moreover, we are not in a situation like in the *Bumarescu* case (above, n°156) where the procedure was initiated after the enforcement of the judgement had taken place.

#### **IV. Filing of the request to annul the increase in share capital**

360. Faced with contradictory evidence as to the issue whether Claimant has fulfilled his obligation to make the additional investment, AVAS started the share nullification litigation in August 2007. AVAS's request was reasonable and fully motivated. Continent SA received notice of the intended application and had an opportunity to dispute it before an impartial tribunal. And indeed, the Commercial Court ruled against AVAS and refused to nullify the shareholders' resolution.
361. The Arbitral Tribunal therefore considers that Continent SA was granted due process. It accepts Respondent's justification that AVAS filed the suit to preserve its right to pursue its share pledge enforceable claim in the event that this tribunal would later decide that it lacked jurisdiction over the counterclaims.
362. The Tribunal therefore considers that Respondent's decision to file and pursue the share nullification litigation was legitimate, did not violate the fair and equitable treatment standard, the full protection and security requirements and did not constitute an unjustifiable or discriminatory measure. It certainly did not amount to expropriation for the reasons enunciated above.

#### **V. The cumulative effect of the various court proceedings**

363. Claimant has not been able to prove how the various court proceedings referred to above, taken collectively, could amount to a violation of Article 2(2) or 4(1) of the Treaty when it was unable to show that, individually, these actions were wrongful.
364. Finally, the Arbitral Tribunal also refers to paragraph 312 above in which it has decided that the application to the present case of Article 6 of the European Convention and of Article 1 of the First Additional Protocol to the latter is denied.

### **SECTION II. THE FISCAL CLAIM**

#### **SUB-SECTION I. CLAIMANT'S POSITION ON THE FISCAL CLAIM**

##### **§ 1. THE FACTS**

#### **I. The Financial Guard Minutes n°11238 and the DGFPMB Minutes n°191624**

365. Continent SA's Board of Directors, during its meeting of November 12, 1998, decided to provide a storage space to Continent SRL, free of charge, as set-off against the investment of USD 1.4 million to be made by Continent SRL (Claimant's Exhibit n°33). As a consequence of this decision, an *Addendum* to a Services Agreement n°1854/15.07.1998 was concluded on November 19, 1998 between Continent SA and Continent SRL. The *Addendum* confirmed Continent SA's Board of Directors' decision (Claimant's Exhibit n°34). The Board of Directors' decision and the *Addendum* were validated by Continent SA's General Shareholders' Meeting on April 8, 1999 (Claimant's Exhibit n°35).

366. On the occasion of an audit performed by the Financial Guard<sup>5</sup>, tax inspectors alleged that Continent SA had to register in its books of account the rent that Continent SRL should have been paying for the use of the storage space. The conclusions of this audit were issued in minute n°11238 dated September 2, 1999 (Claimant's Exhibit n° 36).
367. Claimant alleges that the Financial Guard decided to substitute its own decision for that of Continent SA. The Financial Guard forced Continent SA to claim rent for the storage spaces to continent SRL, according to certain imposed tariffs.
368. Based on such tariffs, the Financial Guard calculated certain alleged unrealized incomes, a VAT for such incomes, together with the corresponding delay penalties. Accordingly, Continent SA owed the following to the Romanian State:
- lei 2,318,028,182 representing uncalculated, unrecorded and non-transferred profit tax as of 30 June 1999;
  - lei 662,640,884 representing delay penalties related to the profit tax;
  - lei 2,428,028,705 representing uncalculated and non-transferred VAT for November 1998 to July 1999;
  - lei 109,261,292 representing delay penalties for the VAT.
369. Claimant formulated objections against the Financial Guard minutes. However, the Bucharest Financial Guard rejected these objections in Decision n°86/24.09.1999.
370. Continent SA then challenged the Decision n°86/24.09.1999 before the DGFPMB<sup>6</sup>. The DGFPMB accepted the challenge and cancelled the Decision n°86/24.09.1999 and the minutes n°11238/02.09.1999 (Disposition n°78/14.04.2000, Claimant's Exhibit n°37).
371. Pursuant to this decision, a new audit was conducted by the tax authorities of the 6th District Financial Administration of Bucharest in December 2000. The 6<sup>th</sup> District Financial Administration carried out the control and ignored the DGFPMB Disposition. On December 22, 2000, new control minutes n°191624 were issued by the 6<sup>th</sup> District Financial Administration.
372. On January 17, 2001, Continent SA filed a challenge against the control minutes n°191624 before the 5<sup>th</sup> Civil and Administrative Petitions Department within the Bucharest Court. The Court accepted the challenge and cancelled the minutes on October 18, 2001 (Claimant's Exhibit n°39). This decision became irrevocable.

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<sup>5</sup> The Financial Guard is a government agency tasked with preventing, discovering and combating tax evasion. It is part of the Ministry of Economy and Finance and overseen by the National Authority for Tax Administration (the "ANAF") which is a government agency, part of the Ministry of Economy and Finance.

<sup>6</sup> The Bucharest General Department of Public Finance is a department within ANAF responsible for conducting tax inspections and audits with jurisdiction over the municipality of Bucharest.

373. Claimant points out that an “accounting expertise” was carried out during these proceedings by the expert Virgiliu State (Claimant’s Exhibit n°40). This expertise stated that the control authority made a mistake by recalculating the company’s fiscal obligations, and that Continent SA had not made any fiscal evasion.
374. Notwithstanding the above, the Financial Guard minutes n°11238, together with two ascertaining notes, constituted the bases for certain charges brought against Claimant in a criminal file n°4/PA/2000.
375. Moreover, although the payment obligations established in minutes n°191624 were cancelled by the irrevocable judgment of October 18, 2001, the amounts that were fixed in these minutes were stipulated as certain and due debts in the DGFPMB control minutes dated December 17, 2003 (Claimant’s Exhibit n°42).
376. Finally, Claimant submits that final and irrevocable decisions were rendered concerning the dispute relating to the warehouse, Respondent should not be permitted to bring the issue again within the scope of this arbitration.

## **II. The Financial Guard - Bucharest Department Minutes n°11275/297/13.02.2001**

377. The Bucharest Financial Guard conducted another audit at Continent SRL for the period between January and December 2000. It established additional tax liabilities (Profit Taxes and VAT) and delay penalties for failure to pay these taxes on time. The results of the audit were included in minutes n°11275/297/13.02.2001.
378. Continent SRL challenged the determination of the tax liability in proceedings before the Administrative Petition Department of the Bucharest Court of Appeal.
379. An accounting expertise report was drafted in this context by Ionescu Dumitru (Claimant’s Exhibit n°43). The expertise report mentions that the fiscal obligations at stake were based on inadequate accounting records kept by Doanta Angela. Ms. Doanta distorted the records in order to hide the money stolen by her, for which she was criminally convicted. Therefore, the accounting records could not be relied upon before being corrected (the correction process was ongoing when the expertise report was being prepared). Consequently, the documents mentioned in the appendices to the control minutes were not documents by which the company’s fiscal obligations could be established. However, Continent SRL’s challenge was rejected as lacking legal basis.
380. Continent SRL challenged this decision before the Administrative Petitions Department within the Supreme Court of Justice. Continent SRL submitted, in support of its appeal, that the fiscal obligations of the company could not be established on the basis of inadequate accounting.
381. In light of a pending criminal investigation of Roussalis, Continent SRL’s appeal against Decision n°48/17.01.2002 was suspended.

### **III. The DGFPMB Minutes of December 17, 2003**

382. On December 19, 2003, Continent SA received the minutes dated December 17, 2003, prepared by the DGFPMB inspectors, covering the period from November 1998 to June 2003 (Claimant's Exhibit n°42).
383. The control was carried out pursuant to the General Juridical Directorate of the Ministry of Public Finance ("MFP")'s request n°101511/25.04.2003. The request was issued after the civil judgment n°351/08.03.2003 had rejected AVAS's appeal to obtain the enforcement of the share pledge and after the General Prosecutor had filed a motion to vacate the lower court judgments (see above, ¶¶95 *et seq.*).
384. Claimant points out that the minutes were intentionally finalized and communicated before the Christmas and New Year holidays in order to prevent Continent SA from presenting an elaborate defense within the 15 days time limit provided by the law to challenge the minutes.
385. The control determined 11 taxes and duties owed to the state budget and to the social state insurances budget: tax on salaries; a 2% fund for supporting state education; a risk, accidents and solidarity with handicapped persons fund; additional contribution to the solidarity with handicapped persons fund; value added tax; profit tax; withholding tax; state social insurance contributions; a fund for labor accidents and professional diseases; contribution to unemployment insurances; and contribution to the social health insurance fund.
386. The minutes identify unpaid tax liabilities and related penalties amounting to ROL 75.7 billion.
387. Claimant points out that these control minutes started by establishing, as an existing current debt, the fiscal obligations established by the DGFPMB minutes n°191624/22.12.2000. However, these minutes had been cancelled by the judgment n°343/F/18.10.2001, delivered by the Bucharest Court in file n°17/CA/2001, which is final and irrevocable.
388. On January 8, 2004, Continent SA challenged the 2003 tax audit before the Bucharest Court.
389. At the court hearing of March 1, 2004, the court approved Continent SA's application for cancellation of the 2003 tax audit. Moreover, the court considered the application for the suspension of the execution of the audit and stated that "[w]ithholding, on one hand, the fact that the creditor of the amounts in litigation has taken guaranteeing measures necessary for their future achievement, being no risk of its prejudice by evading the goods from the forced execution by the debtor, and having in view, on the other hand, the considerable value of the debt for execution and, at the same time, contested by the petitioner, the risk of bringing the company in incapacity of payment and of current activity unrolling, the Court appreciates that in the case there have been proved the circumstances referred to in art.9 from law 29/1990. As a consequence, the Court shall approve the petitioner's application and shall dispose the annulment of the attacked

*administrative document, namely the report from 17.12.2003 until the settlement of the present cause” (sic., Claimant’s Exhibit n°46).*

390. During these Proceedings, Continent SA requested that the court appoint a judicial accounting expert to review the tax liabilities set out in the tax audit. Mr. Iuliu Anchescu was accordingly appointed. The Anchescu expert report (Claimant’s Exhibit n°48) stated that the tax liabilities set out in the tax audit were illegal.
391. Since the DGFPMB representatives considered that the expertise and the Continent SA’s arguments were not favorable to them, they invoked the pending criminal proceedings against Roussalis and requested the suspension of the trial. Continent SA’s challenge to the tax audit was consequently suspended by the court on September 12, 2005.
392. Claimant further submits that, although the court ordered the suspension of the execution of the 2003 tax audit, DGFPMB started the enforcement of the payment obligations contained in the December 17, 2003 minutes. Accordingly, the Tax Agency sought to obtain tax liens to sequester assets, including Continent SA’s movable goods and bank account, to recover the alleged tax liabilities identified in the audit report.
393. In the indictment dated March 17, 2003 (Claimant’s Exhibit n°51), the Prosecutor stated that “[d]uring the prosecution, according to the ordinances enclosed at [sic] the case file, there have been taken insuring measures [sic] upon movables and non-movables of defendant SPYRIDON ROUSSALIS and of the person civilly responsible [Continent SA], in order to cover the damage caused to the state budget” (sic., Claimant’s Exhibit n°51). Claimant considers that such measures are obviously disproportionate since the value of the assets referred to in the statement is out of proportion with Continent SA’s alleged liability. Claimant argues that this “*emphasizes the aggressiveness and the permanent character of the administrative-financial harassments to which the company was subjected*” (Claimant’s Memorial, ¶136).
394. Moreover, whereas Respondent alleged that Roussalis was able to withdraw at least 5 million dollars from Continent SA, it does not explain why instead of freezing only the cash equivalent to the claimed tax amount, Romania chose, through its fiscal authorities, to sequester all Continent SA’s assets, all Continent SRL’s assets and bank accounts, and all of Roussalis’s assets located in Romania. This decision impaired Claimant’s right to dispose of its investment and was taken in breach of the principles of due process, proportionality and reasonableness.
395. Finally, the sequestration of Claimant’s assets, against the background of a continuous an exponential increase of the due amounts of tax because of penalties, led to a further deprivation of the foreign investor’s rights and legitimate expectations as to the sale and disposal of Continent SA’s assets. According to Claimant, the sequestration is ongoing.
396. In light of the above, Claimant considers that the measures taken by Romania were in breach of both its international obligations and the Treaty.

#### **IV. The Ministry of Public Finances' civil action within criminal proceedings: claim for a prejudice not related to the criminal litigation**

397. By the indictment dated March 17, 2003, the Prosecutor instituted criminal proceedings against Roussalis. The latter was sued together with Ms. Doanta. The indictment designates Continent SA as “*party civilly responsible*” (Claimant’s Exhibit n°51).
398. The Prosecutor’s charges refer to prejudice allegedly caused to the state budget by Continent SRL amounting to lei 2,326,101,317 (lei 898,125,354 as VAT and lei 1,427,975,963 as profit tax).
399. The Ministry of Finance elected to intervene in the criminal proceedings as civil party on September 25, 2003. It claimed civil damages for the principal amount of the tax liabilities set out in the December 17, 2003 audit (DGFPMB minutes n°35143), i.e. RON<sup>7</sup> 7,167,136,408.
400. According to Claimant, the December 17, 2003 tax audit did not constitute a relevant basis to claim damages in the criminal proceedings since there is no “*link of causality between the alleged criminal facts and the amounts mentioned in the respective minutes*” (Claimant’s Memorial, ¶141). A criminal prejudice may only be established in relation to facts of which the appropriate criminal investigatory bodies have been notified, and which have been effectively investigated.
401. Moreover, the fact that the tax liabilities set out in the December 2003 tax audit became part of the criminal case entail as a consequence the denial of the suspension of the tax audit decided by the Bucharest Court on March 1, 2004. Since civil courts are bound by criminal judgments, any decision of the criminal court would have as a “*consequence the automate [sic] rejection of the challenge in the fiscal administrative court, with the consequence of affecting the patrimony.*” This amounts, according to Claimant, to an unjustified measure that is equivalent to expropriation (Claimant’s Reply, ¶27).
402. Claimant also points out to further irregularities that occurred during the criminal proceedings: the 6<sup>th</sup> District Criminal Court changed the trial date without legally summoning the parties. Roussalis was summoned to appear at the 6<sup>th</sup> District “City Hall” and the civilly liable party, Continent SA, was summoned to appear on June 25, 2007 (i.e. after the judgment had already been delivered on May 28, 2007).
403. The criminal court eventually awarded the Romanian State ROL 3.2 million, plus penalties and interest.

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<sup>7</sup> RON is the currency abbreviation for the New Romanian lei, as of July 1, 2005, pursuant to Law no. 348/2004 regarding the denomination of the national currency. ROL is converted to RON by cutting four units: e.g. 10,000 ROL = 1 RON.

## § 2. THE LAW

404. Claimant does not dispute the right of the Romanian authorities to carry out control actions and to set tax liabilities as long they offer the opportunity to challenge such tax liabilities. Claimant has challenged the authorities control actions and decisions in Romania. Claimant does not ask the Arbitral Tribunal to solve the tax litigations on the merits. However, he submits that he has been prevented from having the tax litigation solved, since his challenge was suspended. This prevention was worsened by the modification of the nature of his tax liabilities when they were included in the criminal case. These measures affected the investment and represent a serious breach of the Treaty, of Article 6 of the European Convention and of Article 1 of the First Additional Protocol.
405. Claimant submits in the first place that Respondent violated Article 4(1) of the Treaty and Article 1 of the First Additional Protocol to the European Convention. He alleges that the tax liabilities set forth in the December 17, 2003 tax audit are illegal and unfounded and that this is supported by the accounting expertise report carried out by Anchescu Iuliu (Claimant's Exhibit n°48). Claimant further notes that such tax liabilities were never subject to criminal investigation. Therefore, the MFP's abusive election to join the criminal proceedings as a civil party and the subsequent procedure before the Bucharest criminal Court amount to violations of both Article 1 of the First Additional Protocol to the European Convention and of Article 4(1) of the Treaty. According to Claimant, the MFP's actions and their validation by the Romanian courts, specifically by the criminal judgment n°447/28.05.2007, constitute an unjustified measure equivalent to an expropriation.
406. Claimant points out that he is directly affected by the damage suffered by Continent SA, in which he owns 96.51% of the shares.
407. Claimant submits in the second place that Respondent has violated Article 6 of the European Convention (see above, ¶148). He argues that, according to Romanian law, a civil court is bound by a criminal judgement. In this regard, administrative and fiscal bodies are considered civil courts. Therefore, the above mechanism by which pure tax liabilities were awarded in a criminal court's decision without investigation deprived Roussalis, as majority investor, of his rights under Article 6 of the European Convention. Continent SA was deprived of its right to challenge the tax obligations assessed against it in the December 17, 2003 tax audit and, therefore, was denied an equitable and public judgment of its cause under Article 6 of the European Convention. Such an infringement of his right to a fair trial also violates the investor's right to protect its investment.
408. The foregoing is all the more true since the criminal judgment n°447/28 of May 28, 2007 was quashed by the September 22, 2008 decision of the Bucharest Tribunal because Respondent was deprived of a chance to present its defense in the criminal lawsuit (Claimant's Reply Exhibit n°2).
409. Claimant also submits that Respondent violated Article 2(2) of the Treaty.



410. Claimant further objects to the sequestration of Continent SRL's interest in Continent SA as security for the purported tax liabilities identified in the December 17, 2003 tax audit, contending that sequestration was disproportionate and violated the unjustifiable measures clause of Article 2(2) of the Treaty. Claimant alleges that the sequestration is unjustifiable because it interferes with Claimant's right to dispose of, to valorize and use the assets.

### **§ 3. DAMAGES**

411. Claimant seeks USD 5,622,911.34 in compensatory damages, representing the civil damages claimed in the criminal prosecution, USD 1,354,175.16, plus accrued interest and delay penalties (pursuant to the Fiscal Procedure Code) until December 31, 2010, Claimant's estimated completion date of this arbitration.
412. Claimant formulates the following request (Claimant's Memorial, ¶161): *“that the Respondent Romanian State be obliged to pay the amount of USD 5,622,911.34, amount which includes the main debits and interests and delay penalties calculated until 31.12.2010 (ANNEX 53), date on which we estimate that the arbitration litigation is over, this being the influence over the patrimony of the company where I own the shares.”*

## **SUB-SECTION II. RESPONDENT'S POSITION ON THE FISCAL CLAIM**

### **§ 1. THE FACTS**

#### **I. Continent SA was subject to a Tax Audit during 2003**

413. In 2001, the Department of the Economic-Financial Police, part of the 6<sup>th</sup> District Police in Bucharest, started a criminal investigation against Claimant and Ms. Doanta. It addressed issues of tax evasion, fraud, forgery, and the use of false documents at Continent SA, Continent SRL, Continent Marine Trading SRL, and Continent Marine Construction SRL (Respondent's Exhibit n°78). The accounting expert reports produced for the purposes of the criminal investigation revealed that the State had lost tax revenues as a result of the alleged criminal activity.
414. On October 23, 2002, the police notified the Ministry of Finance of the existence of the criminal investigation and asked the Ministry of Finance to confirm whether it intended to join the criminal proceedings as a civil party (Respondent's Exhibit n°79).
415. Following these developments, the Financial Guard (a unit subordinate to the Ministry of Finance) advised the police to ask the Tax Agency for a determination of the appropriate civil damages figure to be claimed (Respondent's Exhibit n°80). Accordingly, the Tax Agency began a tax audit of Continent SA in May 2003 (Declaration of Ana Chivu, hereinafter “Chivu Decl.”, ¶5.2.2, Respondent's Exhibit n°81).
416. On December 17, 2003, the Tax Agency issued minutes n°35143, identifying unpaid tax liabilities and related penalties in the sum of ROL 75.7 billion.

417. Respondent points out that during the period from December 15, 2003 to December 31, 2003, the Tax Agency finalized thirty other tax audits in Bucharest District 6, where Continent SA is located (Chivu Decl., ¶5.3.1.). Contrary to Claimant's allegations, the timing for completion of the audit and notification thereof was the result of normal case scheduling within the Tax Agency.
418. On January 8, 2004, Continent SA registered a challenge to the tax audit before the Bucharest Court (Respondent's Exhibit n°82). The court appointed a judicial accounting expert, Iuliu Anchescu. Although Anchescu criticized the tax liabilities set out in the tax audit, it did not dispute all the tax liabilities assessed by the Tax Agency (Respondent's Exhibit n°83). No court adopted the report's findings. Furthermore, Respondent questions Anchescu's impartiality in light of the fact that Continent SRL retained him in 2005 as its expert in a litigation concerning the pledge enforcement proceedings initiated by AVAS, and he was serving Continent SRL in that capacity at the time he prepared his judicial accounting report for the court (Respondent's Exhibit n°69).
419. Continent SA's challenge to the tax audit was suspended by the court on September 12, 2005, pending resolution of the criminal proceedings against Claimant and Ms. Doanta.

## **II. Rights and obligations of taxpayers and Tax Authorities during a Tax Audit**

420. At all relevant times, tax audits were regulated by Government Ordinance n°70/1997. To protect their interests and to promote clear communication of relevant information to the authorities, taxpayers subject to an audit are entitled to (i) prior notice of the intended audit; (ii) an opportunity to provide information clarifying their activities; (iii) assistance by professionals during the audit; (iv) fair and equitable treatment by the fiscal authorities including respect for confidentiality; and (v) the right to challenge the findings of the fiscal authorities. Continent SA enjoyed all of the above-mentioned rights during the 2003 tax audit (Chivu Decl., ¶5.1) and throughout the administrative and judicial challenges to the tax audit it never claimed otherwise. Indeed, Continent SA has challenged only the amount of the tax liabilities assessed by the tax authorities. (Respondent's Exhibits n° 82 and 84).
421. Continent SA litigated its challenge to the 2003 tax audit in Romanian courts and it lost before the court of appeals (Respondent's Exhibits n°211, 209). Claimant did not assert any error in the final judgment. It is furthermore undisputed that those liabilities remain unpaid.

## **III. Continent SA failed to cooperate with the Tax Authorities during the 2003 Audit**

422. From the outset of the tax audit in May 2003, Continent SA failed to provide the tax authorities with requested accounting documents. The progress of the tax audit was interrupted several times when the tax authorities formally requested (on June 13 and September 18, 2003) essential accounting documents which Continent SA had failed to produce (Respondent's Exhibit n°85; Chivu Decl., ¶5.3.3). In those requests for documents, as well as prior requests dated June 6, 2003, June 12, 2003, and July 8, 2003,

the tax authorities asked Continent SA to submit the following tax documentation: (i) documents evidencing the works performed by its employees in the period from 1999 to 2003 (with work schedules, technical estimates, and construction authorizations); (ii) the calculation note for the amortization of fixed assets; (iii) documents justifying the accounting registrations of payments to and from Claimant or Continent SRL; and (iv) the services agreements and estimates justifying the invoices issued to Continent SA by suppliers (Respondent's Exhibit n°85, p.32; Chivu Decl., ¶5.3.3).

#### **IV. The tax liabilities covered numerous Tax Code violations**

423. The December 17, 2003 tax audit report established additional tax liabilities owed by Continent SA: collectable VAT, deductible VAT, profit tax, salary tax, education fund, risk and accident fund, solidarity fund, nonresident income tax, social security, accident and occupational disease fund, employer-owned unemployment fund, employee-owned unemployment fund and employer/employee health fund (Respondent's Exhibit n°85).

#### **V. The Tax Audit report reassessed penalties for unpaid taxes owed by Continent SA for free storage provided to Continent SRL**

424. In September 1999, the Financial Guard had conducted a tax audit of Continent SA and concluded that the rent forgiveness granted by Continent SA to Continent SRL after the conclusion of the Privatization Agreement constituted an evasion of Continent SA's income tax and VAT obligations (Minute n°11238 dated September 2, 1999, Claimant's Exhibit n°36). The liabilities were subsequently cancelled on procedural grounds in Decision n°78, dated April 14, 2000. Pursuant to this decision, a new audit addressing the merits of additional liabilities was conducted by the tax authorities of the 6th District of Bucharest in December 2000 (Claimant's Exhibit n°37). This is contrary to Claimant's allegation that the December 2000 audit was required by the decision.
425. In the December 2000 audit results, the auditor again concluded that Continent SA owed tax arising out of its provision of free storage services to Continent SRL and re-computed the amount owed (Minutes n°191624, Respondent's Exhibit n°51).
426. Continent SA filed an *administrative* challenge to the new assessment before the Ministry of Finance. These proceedings were suspended on July 6, 2001, pending resolution of the criminal proceedings against Claimant and Ms. Doanta (Respondent's Exhibit n°85).
427. Unbeknownst to the tax auditors, Continent SA had commenced a *court* challenge of minute n°191624 on January 17, 2001, which resulted in cancellation of the minute on October 18, 2001 (Respondent's Exhibit n°88.)
428. In accordance with Article 6(n) of Government Ordinance n°70/1997, the tax auditors who performed the December 2003 tax audit reviewed Continent SA's compliance with previous tax audits. Therefore, unaware that the liabilities established in minute n°191624 had been cancelled, the tax auditors again included them in the December 17, 2003 audit report, plus additional penalties, in the sum of ROL 12.6 billion.

**VI. The Tax Authorities ordered sequestration of certain assets of Continent SA as security for the additional tax liabilities, but enforcement of the tax audit report was suspended (The Tax Agency's 2004 sequestration order)**

429. Continent SA failed to pay the tax liabilities included in the December 17, 2003 tax audit within the time period required (Government Ordinance n°61/2002, Art. 10 (1): "... *if the date of the communication is between 16-31 of the month, the payment term is by the 20th of the following month*"). Upon the expiration of the relevant period, the tax audit minute n°35143 became automatically enforceable (Article 130(2) of the Romanian Code of fiscal procedure). On February 6, 2004, the tax authorities took steps to enforce the liabilities identified in the audit by issuing enforcement titles in accordance with Article 126 of the Romanian code of fiscal procedure (Claimant's Exhibit n°52).
430. On February 16, 2004, the tax authorities issued a sequestration report (Claimant's Exhibit n°49), that (a) required Continent SA to pay assessed taxes within 15 days to avoid any restrictions on the sale of the sequestered assets, and (b) prevented Continent SA from selling the sequestered assets until it paid its taxes. This sequestration report covered Continent SA's improved real estate located at 82 Timisoara Boulevard and 1 Razoare Street, as well as a car.
431. According to Continent SA's balance sheet for 2003, the value of the real estate properties that were the subject of the sequestration report amounted to approximately half of the value of the tax liabilities established by the December 17, 2003 tax audit (ROL 38.9 Billion compared to ROL 75.7 billion, *see* Balance Sheet, Respondent's Exhibit n°91). The value of the assets that were subject to sequestration were therefore not disproportionate.
432. On March 1, 2004, the Bucharest Tribunal suspended enforcement of the tax audit report pending resolution of the challenge to the December 17, 2003 audit (Claimant's Exhibit n° 46).
433. Respondent refutes Claimant's argument that Respondent was responsible for delaying resolution of the challenge to the December 2003 tax audit, causing a denial of justice. The facts are otherwise. Proceedings were suspended in 2005, pending the resolution of the criminal file. Claimant evaded service in the criminal case until the statute of limitations on the enforcement of criminal sanctions had expired. Only then, in November 2009, did Claimant request the reopening of his tax challenge (Respondent Exhibit n°209). The record shows that the Claimant's request was granted promptly and the dispute was resolved expeditiously in 2010. Thus, the delay in resolution of the court challenge of the audit was due to Claimant's own legal strategy.

**VII. The criminal authorities issued proper orders restraining Claimant and Continent SA from disposing of their assets**

434. Based on evidence collected by the Financial Guard (Respondent's Exhibit n°86), the police investigated Claimant and Continent SA for alleged tax fraud. Pending resolution of the criminal investigation, on June 12, 2000, the police issued their sequestration order

directing the company not to sell its real estate pending resolution of the criminal proceedings (Respondent's Exhibit n°93). It was a standard procedure pursuant to the Romanian Criminal Procedure Code. Claimant has neither alleged nor proved that the 2000 order was discriminatory, disproportionate or otherwise improper under the applicable Romanian law. In addition, Claimant never took advantage of the opportunities provided by Romanian law to challenge the sequestration order.

435. In his sworn declaration to the police dated August 8, 2001 (Claimant Rebuttal Exhibit n°27), Claimant admitted that he owed taxes and penalties totaling ROL 23.32 billion (approximately USD 780,000). He agreed to pay that amount. To secure that admitted tax debt, the police ordered Roussalis to maintain Continent SRL's share capital at the minimum level of USD 360,000 until the payment obligation was met (Respondent's Exhibits n°95 and n°115.) Claimant never disputed the fact that he never paid any of the USD 780,000 in admitted tax liabilities. Further, Claimant failed to establish that the sequestration was unlawful or unjustified.
436. There is also no evidence that the police sequestration had any actual effect on Claimant's investment. The November 13, 2001 police minute merely records Claimant's declaration that the subscribed capital was deposited at Alpha Bank. The best evidence of funds on deposit - copies of Claimant's bank records from Alpha Bank - was uniquely in Claimant's control. Claimant presented no such evidence. This gives rise to a negative inference that no funds were actually sequestered at Alpha Bank. The 2001 sequestration was just a paper order without any adverse consequence for Continent SRL.
437. The Public Finances Department of the 6th District Municipality of Bucharest also issued an order prohibiting Continent SA from selling its assets (Respondent's Exhibit n°96). Finally, in criminal decision n°447/28.05.2007, the 6th District Criminal Court granted a conservatory sequestration order over the movable and immovable assets of Claimant, Ms. Doanta and Continent SA up to the amount of the civil damages ordered by the court, *i.e.*, RON 3.2 billion (Respondent's Exhibit n°42).
438. All of the above orders were issued as standard procedure pursuant to Article 163 of the Romanian Code of Criminal Procedure. Despite these orders, Continent SA sold its real estate property at 1 Razoare Street on May 15, 2006 (Respondent's Exhibit n°60). In addition, Claimant recently tried to sell the entirety of the improved real property owned by Continent SA at 82 Timisoara Blvd. Indeed, it appears that Claimant has already entered into a Sale-Purchase Pre-Contract dated October 10, 2007 to sell part of said property (Respondent's Exhibit n°64).

## **VIII. ANAF claimed civil damages in the criminal prosecution**

### **A. Victims of criminal offenses may join their civil damages claim to the criminal prosecution of the indicted persons**

439. Article 15 of the Romanian Criminal Procedure Code provides that a victim may claim civil damages during a criminal investigation or criminal prosecution as long as such claim is lodged prior to the reading of the indictment before the criminal court. The

Ministry of Finance elected to join the criminal proceedings as civil party on September 25, 2003.

B. ANAF claimed civil damages liabilities identified in the December 17, 2003 tax audit

440. Through ANAF, the Ministry stated the quantum of its civil damages claim on April 26, 2004, and subsequently amended the amount on January 12, 2007 (Letter from Valeria Nistor, General Director, General Legal Department, ANAF, dated May 27, 2008, (“Nistor Letter”), ¶2.6 & Att. M).
441. In essence, ANAF claimed civil damages for the principal amount of the tax liabilities set out in the December 17, 2003 tax audit (minute n°35143, *i.e.*, RON 3.4 million, plus related penalties and interest). Therefore, those tax liabilities became part of the case to be decided by the criminal court.
442. Respondent denies that the 2003 tax audit came before the criminal court without any *“link of causality between the alleged criminal facts and the amounts mentioned in the respective minutes”* (Claimant’s Memorial, ¶141). Respondent submits that ANAF has an unrestricted right to assess the full amount of outstanding tax deficiencies as damages, and the criminal court has the duty to determine whether the amounts claimed should be awarded as damages. According to Article 346(1) of the Romanian Criminal Procedure Code, *“[i]n the event of a conviction, acquittal or closure of the criminal proceedings, the court will give judgment on the civil claim in the same decision”*.
443. The criminal court, after reviewing the case, awarded the Romanian State RON 3.2 million, plus penalties and interest (Ex. 42).

C. Claimant did not deny committing tax evasion, and Continent SA had the opportunity to challenge the damages claimed

444. Continent SA participated as civil party in the criminal prosecution of Claimant and Ms. Doanta from the date of the registration of the criminal case. During the four-year duration of the criminal proceedings, not once did Continent SA contest the Ministry’s right to participate as a civil party. Nor did Continent SA ever present a defense to the civil damages claimed by ANAF (Nistor Letter, ¶¶2.5-2.7 and 3.1).
445. On April 20, 2007, Claimant and Continent SA jointly submitted written closing arguments in the criminal prosecution. Claimant did not deny tax evasion (see above, ¶195). In addition, despite having had numerous previous opportunities, Claimant and Continent SA disputed *for the first time* the civil damages claimed by ANAF (Respondent’s Exhibit n°46). The 6th District Court rejected the arguments raised by Claimant and Continent SA, sentenced Claimant to prison for two years and ordered Claimant, Continent SA, and Ms. Doanta jointly to pay the profit tax and VAT liabilities identified in the December 2003 tax audit (Nistor Letter, ¶2.11). However, the conviction was overturned on appeal, the civil damages award was vacated, and the case was remanded for a new trial. The criminal prosecutor offered to drop the case in 2009, once the statute of limitations on criminal penalties had run. But Roussalis requested that the case proceed.

D. The Financial Guard imposed additional tax liabilities and penalties against Continent SRL based on a February 13, 2001 audit for the year 2000

446. During January and February 2001, the Bucharest Financial Guard conducted an audit at Continent SRL and established (i) additional tax liabilities due to the registration in the books of Continent SRL of forged invoices; (ii) delay penalties for failure to pay its taxes on time; and (iii) unpaid tax liabilities. The results of the audit were included in the minute n°11275/297/13.02.2001 (Respondent's Exhibit n°103). Continent SRL challenged the tax liabilities in proceedings before the Bucharest Court of Appeal.
447. In Decision 48/17.01.2002, the Bucharest Court of Appeal rejected Continent SRL's challenge, holding that "*the examination minutes and the decision issued by the Ministry of Public Finances are legal and, consequently the legal action brought by the plaintiff [...] shall be rejected as having no legal grounds*" (Claimant's Exhibit n°44). In light of the pending criminal investigation of Claimant, the final appeal taken by Continent SRL against Decision n°48/17.01.2002 was suspended.
448. Given that Continent SA was designated as the party civilly liable in the criminal proceedings, ANAF did not include Continent SRL's outstanding liabilities in the civil damages requested on January 12, 2007. Respondent denies Claimant's allegation to the contrary.

IX. The taxes and penalties were assessed against Continent SA and included in the criminal judgment.

449. In judgment n°447/28.05.2007 (Respondent's Exhibit n°42), the 6th District Court of Bucharest found Claimant guilty of tax evasion and ordered him, together with Continent SA and Ms. Doanta, to pay RON 1.8 million (representing VAT) and RON 1.4 million (representing profit tax plus additional delay penalties).

X. The criminal court's judgment requiring Continent SA to pay damages has not been enforced

450. On June 6, 2007, Continent SA and Claimant appealed the decision of the 6th District Court, requesting the Bucharest Tribunal to vacate decision n°447/28.05.2007 (Respondent's Exhibits n°105 and 106). Pursuant to Article 370 of the Romanian Code of Criminal Procedure, the filing of this appeal suspended the enforcement of both the civil and criminal elements of the first decision. Eventually, the Criminal Court's decision was vacated on procedural grounds, and the retrial on these issues remains pending. Accordingly there is no obligation to pay the judgment at this time. The damages award is not yet final and has not been paid.
451. Claimant failed to appear at six consecutive hearings, causing further delay in the criminal proceedings (Public Hearing Minutes, Respondent's Exhibits n°109 to 114). However, Claimant was represented by counsel at five of the hearings.
452. If Claimant had come before the Romanian criminal court to defend against the charges of criminal tax fraud, the entire case – including ANAF's civil damages claim – could

have been resolved long ago. There is no merit to Claimant's argument that Romania is pursuing a double recovery through ANAF of tax liabilities from Continent SA. Indeed, the 2010 final judgment in the litigation over the December 2003 tax audit (Respondent's Exhibit n°211) allows the Tax Agency to enforce against Continent SA the established tax liabilities. If ANAF were to prevail on its civil damages claim, it would have the right to recover from Claimant and/or Continent SA any amount still to be owed at that time. As long as the 2010 judgment remains unsatisfied, it may be included in the civil damages claim of ANAF. If the 2010 judgment is paid by Continent SA, ANAF's claim would be reduced accordingly. That is not double recovery.

#### **XI. The criminal case was not a pretense**

453. Respondent contends that, even on the assumption that the Court did fail to comply with the strict summoning procedures, it would lack all credibility for Claimant to suggest that he was not in fact aware of the criminal proceedings. Therefore, if Claimant wanted to present evidence directly to the Criminal Court during the first instance criminal proceedings, he could have done so. He should not now be allowed to invoke his failure to participate in the proceedings as a reason for impugning the legitimacy of the proceedings.
454. Second, Claimant adduces no evidence in support of the suggestion that Respondent corrupted the first instance judge in the criminal proceedings in order to change the date of the final hearing.
455. Third, Respondent denies that Respondent exerted administrative pressure over the first instance judge, in order to obtain a "decision that could be used in the arbitration". Indeed, Respondent's first written submission in the arbitration proceedings was not at that time due until March 5, 2008 so it is clear that Respondent gained no material advantage as a result of the change in the final hearing date in the criminal proceedings from June 26, 2007 to May 28, 2007.
456. Finally, the Bucharest Tribunal did *not* find that Claimant is innocent of the charges of tax evasion brought against him. The Bucharest Tribunal overturned the decision of the first instance court on purely procedural grounds.

### **§ 2. THE LAW**

#### **I. ICSID tribunals have no jurisdiction to resolve tax disputes**

457. Respondent submits that the Tribunal does not have jurisdiction over the tax disputes between Continent SA and the Romanian Tax Agency. Indeed, it is a "*universally accepted rule that public law cannot be extraterritorially enforced*" (F.A. Mann, "Conflict of Laws and Public Law", 132, *Recueil des Cours*, 1971). Nothing in the Treaty suggests that tax disputes come within the jurisdictional scope intended by the Contracting Parties, particularly where, as here, Claimant has not alleged that the tax laws applicable to Continent SA were somehow different from those applicable to similarly-situated companies or that the State took discriminatory measures of any kind against Continent SA.



458. The principle that tax laws are enforceable only in the place where they are imposed has led tribunals to decline jurisdiction over tax-related disputes.
459. In *Computer Sciences Corp. v. The Islamic Republic of Iran* (N°221-65-1, Award of April 16, 1986, 10 Iran-U.S. C.T.R. 269), the Iran-U.S. Claims Tribunal concluded that the tax claim fell beyond its jurisdiction because tax laws were not enforceable except by organs of the taxing State: “*Tax laws are manifestations of the jus imperii which may be exercised only within the borders of a state. In addition, revenue laws are typically enormously complex, so much so that their enforcement is frequently assigned to specialized courts or administrative agencies. For these reasons, actions to enforce tax laws are universally limited to their domestic forum*”.
460. The Iran-U.S. Claims Tribunal went on to hold that, any exception to the above customary rule must “*presuppose the clearest possible expression*” of the parties’ intentions, which was nowhere to be found in the Claims Settlement Declaration on which its jurisdiction was premised. Here, because the Treaty likewise provides no such clear expression, the same conclusion is warranted.
461. The ICSID tribunal in *AMCO Asia v. Indonesia* (*op.cit.*) was faced with a counterclaim for alleged tax fraud on the part of the claimant. The claimant argued that tax fraud was not “*a legal dispute arising directly out of an investment,*” as required by Article 25(1) of the ICSID Convention, but was “*related only in the most indirect way to the investment.*” The tribunal denied the tax claim on jurisdictional grounds, stating its reasons as follows: “*126. The obligation not to engage in tax fraud is clearly a general obligation of law in Indonesia. It was not specially contracted for in the investment agreement and does not arise directly out of the investment.*” The rationale of *AMCO* is applicable here because, as in that case, no claim is actionable within the scope of the ICSID Convention unless it arises “*directly out of an investment.*”
462. Respondent denies that these jurisdictional defects can be overcome with the allegation that the fiscal measures claim also arises under Article 1 of the First Additional Protocol to the European Convention.
463. First, Respondent submits that this article is not applicable to “investments” and, even assuming it is, the European Convention does not provide a jurisdictional platform for the work of the Tribunal. According to Respondent, the right to no deprivation of property granted under Article 1 of the First Additional Protocol is coextensive with the same rights accorded under Article 4(1) of the Treaty. Consequently, Article 1 of the First Additional Protocol does not create any additional obligations and therefore does not come within the jurisdiction of the Tribunal under Articles 2(6) or 10 of the Treaty, which commit the Contracting Parties to honor certain obligations they have made beyond the Treaty. In addition, the European Court of Human Rights was established to enforce Convention rights, and thus the Contracting Parties to the Treaty did not intend for ICSID tribunals to exercise jurisdiction over such claims.
464. Furthermore, Article 1 of the First Additional Protocol seems to indicate that it does not apply under the circumstances alleged here: “[P]rovisions do not impair the right of

*States to adopt the laws they consider necessary ... in order to ensure the payment of taxes and other contributions, or of fines”.*

465. Finally, even if the Tribunal finds that it has subject matter jurisdiction to adjudge European Convention issues, previous decisions of the European Convention suggest that companies’ shareholders do not have standing to bring claims as an indirect victim of losses sustained by the company as a result of alleged violations of Article 1 of the First Additional Protocol (*Agrotexim and Others v. Greece*, n°14807/89, 24 October 1995).
466. According to Respondent, Claimant’s reliance on Article 6 of the European Convention is equally misplaced. That article protects persons with respect to judicial determinations regarding their civil rights and criminal charges brought against them. Continent SA’s civil rights were not implicated by this tax claim, nor was Continent SA charged with criminal wrongdoing. Roussalis was criminally charged, but, as noted above, he did not deny that he was guilty of tax evasion. In any event, Claimant’s personal rights do not arise “directly out of an investment” within the meaning of Article 25(1) of the ICSID Convention and fall outside the provisions of the Treaty, which protect “investments” not “investors.”
467. For the foregoing reasons, Respondent submits that the Tribunal does not have jurisdiction over this tax claim.

## **II. Claimant failed to establish that the Fiscal Claim has merit**

### **A. The expropriation claim has not been proved**

468. Respondent refers to its previous developments to the effect that, Claimant has established no right of expropriation. Further, Continent SA has not paid any of the tax liabilities assessed against it and is challenging them in the Romanian courts. No international wrong can be made out against Respondent while the tax liabilities remain subject to review and have not been reduced to a final and irrevocable judgment. Indeed, “[i]t would be absurd if measures later quashed by higher authority or a superior court could, for that reason, be said to have been arbitrary in the sense of international law” (*United States of America v. Italy*, Judgment of 20 July 1989, 1989 ICJ LEXIS 3, ¶124, “ELSI”).
469. Moreover, Claimant presented no evidence that any of the fiscal measures had any adverse impact on Claimant’s or Continent SA’s ability to freely use the assets and manage the business. The record shows that the sequestration orders did not, in fact, prevent Claimant from transferring ownership or divesting assets from Continent SA. The sequestration order was breached in 2006 by the sale for EURO 1 million of real estate owned by Continent SA (Claimant’s Exhibit n°60). Further, Claimant continued to transfer millions of dollars of assets from Continent SA to his other companies. Since April 2006, all receivables of Continent SA were collected by Continent Frise Delicatesen, a company controlled by Claimant (Claimant’s Exhibits n°215, 218). According to Respondent, millions of additional dollars were paid by Continent SA to Claimant’s company Ozias, and to Claimant directly (*See* Claimant’s Exhibit n°169).

B. Continent SA has not been deprived of any right to an equitable judgment by an independent and fair court

470. The award of civil damages against Continent SA as a civil party liable for taxes in the course of the criminal case against Claimant for tax evasion is a routine procedure under Romanian law. No violation of Continent SA's rights under international law or Romanian law arises from the use of this procedure.
471. According to *Mondev International Ltd. v. United States of America*, the applicable standard for a denial of justice is whether there was a "willful disregard of due process of law ... which shocks, or at least surprises, a sense of judicial propriety" (ICSID Case No. ARB, AF/99/2). Respondent asserts that no such defects can be ascribed to the Romanian court proceedings in this case. Indeed, Continent SA has prevailed in several tax disputes and has been accorded every right granted to taxpayers under Romanian law. Furthermore, the judgment is on appeal, tax liabilities are at issue in the appeal, and neither Claimant nor Continent SA has complained about improprieties in the appellate proceedings.
472. What is more, even assuming that Claimant had established such improprieties: "[I]nternational law attaches state responsibility for juridical action only if it is shown that there was no reasonably available mechanism to correct the challenged action... States are held to an obligation to provide a fair and efficient system of justice, not to an undertaking that there will never be an instance of judicial misconduct" (J. Paulsson, Denial of Justice in International Law, 2005, 100).

C. No "unjustifiable measures" result from the sequestration orders

473. Respondent denies Claimant's allegation that the Tax Agency's imposition of tax liens and initiation of enforcement proceedings were disproportionate and likely to affect his interest in Continent SA. Respondent submits that these assertions do not make out a claim under Article 2(2) of the Treaty.
474. Article 2(2) does not protect against potential *future* injury of the kind alleged by Claimant here. Rather, that article ensures that an investment "is not in any way *impaired* by unjustifiable . . . measures". The mere possibility that an act could "likely affect" the disposal of property at some indefinite time in the future is not sufficient.
475. By way of Ordinance 01123/18.10.2001 (Respondent's Exhibit n°115), the criminal investigatory body instituted a conservatory measure over Claimant's movable and immovable assets up to the value of ROL 24 Billion (approximately USD 780,000). This Ordinance was implemented by attaching the share capital of Continent SRL subscribed and paid by the Claimant in the amount of USD 360,000 (Respondent's Exhibit n°95). A comparison between the value stated to be guaranteed under the conservatory measure (USD 780,000) and the stated value of the share capital (USD 360,000) reveals that the measure was not disproportionate.
476. Respondent further denies Claimant's argument that the enforcement measures instituted by the tax authorities were disproportionate in relation to the value of the attached goods.

The accounting value of the sequestered assets amounted to ROL 38.9 billion (Respondent's Exhibit n°91), while the additional tax liabilities amounted to ROL 75.7 billion.

477. Furthermore, Claimant has, in fact, disposed of valuable assets of Continent SA, notwithstanding the conservatory measures (see above, ¶438).
478. Finally, Claimant admits that execution proceedings were suspended. Moreover, no bank accounts were seized and no other assets of Continent SA were taken.

D. Respondent did not prevent Continent SA from either challenging the Tax Assessment or from enjoying or disposing of his investment

479. Respondent denies Claimant's allegation that the Tax Court's decision to stay its tax enforcement case against Continent SA pending resolution of the criminal case – coupled with ANAF's inclusion of the assessed taxes in its claim for civil damages in the criminal prosecution – prevented Continent SA from challenging the tax liabilities before the *fiscal* courts for an undetermined period of time and thereby prevented Claimant from enjoying or disposing of his investment.
480. Respondent submits that, even after the suspension of the tax proceedings, Romanian law permitted Continent SA to challenge its tax liabilities before the Tax Court by appealing the suspension order and thereby reopening the Tax Court proceedings (Article 244 of the Romanian Civil Procedure Code). Continent SA chose not to do that. That was Claimant's decision and does not engage Romania's responsibilities under the Treaty or Article 6 of the European Convention.
481. Furthermore, Claimant has failed to provide any proof to support his claim that the alleged denial of Continent SA's right to challenge the tax liabilities before the Tax Court prevented him from enjoying or disposing of his investment in breach of Article 4 of the Treaty and Article 1 of Protocol 1 of the European Convention. In fact, Claimant's right to enjoy and dispose of his investment continues to be respected by Respondent. Claimant's has ongoing control of Continent SA and his ability to dispose of its assets at will. The tax liabilities in question are not the subject of any final judgment. Claimant has never been ordered to pay the taxes assessed against Continent SA. His Fiscal Claim is entirely speculative.

**§3. DAMAGES**

482. Respondent submits that Claimant's quantification of the damages evidences the baseless nature of this claim. First, he assumes that the Tax Agency will ultimately prevail and that Continent SA will have to pay the full amount of the tax liabilities assessed in the December 17, 2003 tax audit. Then, he assumes payment of the tax liability will be made on December 31, 2010. Next, he adds interest and penalties that will accumulate to December 31, 2010, assuming interest at .06 percent daily and penalties of .5 percent monthly, until paid. Finally, although he assumes he will prevail before the Tribunal on this claim (otherwise he would not be entitled to any damages), he also assumes that

Continent SA will pay the accrued tax bill on that date, which purportedly will correspond with the amount awarded to Claimant (Claimant's Exhibit n°53).

483. Respondent submits that such calculation is speculative. Speculative damages of this kind are not compensable in international arbitration: "*One of the best settled rules of the law of international responsibility of states is that no reparation for speculative damages or uncertain damages can be awarded*" (*Amoco International Finance Corporation v. The Government of the Islamic Republic of Iran*, Award No. 310-56-3, July 14, 1987, 15 Iran-U.S. C.T.R. 189, 1989). Any relief granted by the Tribunal for this claim should be awarded solely to reimburse tax payments actually made by Continent SA.
484. In any event, even if the claimed damages were recoverable, it is evident that any resulting loss would in reality be suffered by Continent SA. There is no legal basis upon which Claimant could legitimately seek to recover for a tax loss allegedly suffered by a nonparty to the arbitration proceedings.
485. Accordingly, no damages should be awarded for this claim in the unlikely event the Tribunal decides in favor of Claimant.

### **SUB-SECTION III. DECISION OF THE ARBITRAL TRIBUNAL**

#### **§1. JURISDICTION OVER THE FISCAL CLAIM**

486. According to Respondent, ICSID tribunals have no jurisdiction to resolve tax disputes between Continent SA and the Romanian Tax Agency. These disputes do not come within the jurisdictional scope of the BIT, particularly where Claimant has not alleged that the tax laws applicable to Continent SA were discriminatory measures. The Fiscal Measure Claim is not actionable within the scope of the ICSID Convention because it does not arise "*directly out of an investment.*"
487. The Claimant's Counsel declared during the hearings that: "*we agree with the Respondent in that some issues are non-arbitrable before this Tribunal. Though (...), there are current debates as to the arbitrability [sic.] of tax before International Tribunals. (...) We are not asking this Tribunal to adjudicate the tax matters, to provide remedies to, to delve into the sovereign right to -- in terms of tax. Similarly, for the other alleged breaches of the Investment Treaty. We have to be clear, I think, at this stage, before the Tribunal; we are not expecting a remedy such as, "We agree that X tax was available on the principles of fiscal law". (...) There is jurisdiction under Article 25 of the ICSID Convention.*" (Transcript, Day 1, p.81, line 12 *et seq.*). And further: "*there are measures taken by the Romanian State by measures of its public institutions which affect the investment and the Investor. These are measures that in our opinion are violations, as many violations of the Bilateral Agreement. (...) The allegation of a violation of the Bilateral Agreement is prerequisite of the jurisdiction of the Arbitral Tribunal, and the claims that are formulated by the Claimant fulfil, or comply with this request. Because in relation to all the claims there are violations of the agreement by way of the administrative measures taken by the Romanian authority, our opinion is that the Tribunal is -- has got jurisdiction (...)*" (Transcript, Day 3, p.62, line 8 *et seq.*).

488. Claimant alleges that the controls carried out and the decisions taken by the Romanian Tax authorities were *inter alia* unfounded, illegal, abusive and tendentious; that the measures taken to enforce these decisions were disproportionate; that the inclusion of the tax issues in a criminal proceeding were abusive; and that he has been prevented from having his tax issues properly resolved. Claimant further submits that the sequestration of his assets against the background of an abusive taxation interfered with his right to dispose and reap the benefits of his investment. Accordingly, Claimant submits that the action of the tax authorities resulted in breaches of Articles 2(2) and 4(1) BIT.
489. Article 25(1) of the ICSID Convention requires a dispute to arise “*directly out of an investment*” to fall under ICSID jurisdiction. It follows that general measures of tax or economic policy not directly related to the investment, as opposed to measures specifically addressed to the operations of the business concerned, will normally fall outside the jurisdiction of the Centre.
490. On the other hand, previous arbitral awards have considered that: “[i]t may well be, however, that in the context of the commitments assumed by the host State, “general” measures have a ‘specific’ effect in that they violate specific commitments. The expression “a dispute arising directly out of an investment” (Article 25 (1) of the ICSID Convention) cannot, therefore, be interpreted as meaning that the dispute can only result from a measure “directed to” the investment. The adverb “directly” is not related to the link between the measure and the investment but to that between the dispute and the investment” (*El Paso Energy International Company v. Argentine Republic*, ICSID Case No. ARB/03/15, Decision on Jurisdiction, §97, *see also*, *GAMI v. Mexico*, UNCITRAL arbitration. ILM, Vol. 44, 2005, p. 545).
491. In the same vein, in its Decision on Objections to Jurisdiction of 17 July 2003 in *CMS Gas Transmission Co. v. Argentina* (ICSID case No. ARB/01/8, ILM, Vol. 42, 2003, §33), the arbitral tribunal found that it was competent “*to examine whether specific measures affecting the Claimant’s investment or general measures of economic policy having a direct bearing on such investment have been adopted in violation of legally binding commitments made to the investor.*”
492. In this context, the nature of tax laws as public law that cannot be extraterritorially enforced is not relevant to determine if Claimant’s Fiscal Measure Claim comes within the jurisdictional scope of the Tribunal. Indeed, in light of the claims presented by Claimant, the Tribunal will not have to make decisions applying general tax policies. The Tribunal will confine itself to establish in connection with the merits of the case whether the controls carried out and the decisions taken by the Romanian Tax Authorities violate the rights accorded to foreign investors under treaties.
493. In light of the above, the Tribunal considers that, among the matters falling within the scope of its jurisdiction are general measures taken by the host State in the exercise of its public powers, including decisions taken by tax authorities and courts, and actions taken by the State’s authorities to enforce such decisions, which allegedly affect the investment in violation of the BIT.

494. The Tribunal therefore decides that it has jurisdiction to rule on the Claimant's Fiscal Claim.
495. The Arbitral Tribunal refers to paragraph 312 above in which it has decided that the application to the present case of Article 6 of the European Convention and of Article 1 of the First Additional Protocol to the latter is denied.

## §2. MERITS

### **I. WAS THERE A BREACH OF THE FAIR AND EQUITABLE TREATMENT REQUIREMENT?**

496. In its "Fiscal Claim," Claimant contends that Romania has violated the "Fair and Equitable Treatment" standard in Article 2(2) of the Treaty in a number of ways. The Claimant principally contends that:

- The control actions carried out by the tax authorities and the tax liabilities that were assessed by these tax authorities were harassing and deprived Claimant of its legitimate expectations as to the sale and disposal of Continent SA;
- He was prevented from having the tax litigation resolved because his challenge was suspended in light of the pending criminal investigation and because they were wrongfully integrated into criminal proceedings;
- He faced disproportionate sequestration orders.

497. The Tribunal will examine each of these claims separately.

#### 1. The control actions carried out by the Tax Authorities and the tax liabilities

498. At the hearing, Mrs. Luciana Chivu, the senior auditor who handled the Tax Agency's 2003 audit of Continent SA, testified in relation to the procedure she followed and the basis for the conclusion in her report that the company owed USD 2.3 million in taxes and penalties. She confirmed that the audit was conducted in consultation with representatives of the company who were informed of her findings as she proceeded. Questions arose during the audit about undocumented tax deductions and the company was asked to provide supporting evidence. It failed to do so. In the course of the cross-examination, Claimant's Counsel failed to establish any procedural or substantive error in Mrs. Chivu's tax audit.
499. Claimant's Counsel also admitted at the hearing that the fiscal measures taken by Romania were lawful. He submitted that "*the facts that are measures of the Ministry are 3 such concrete facts, or deeds, but we are not going to analyze them, or we do not claim, we do not emit claims as to the fiscal obligations that derive from them. Some of them have been settled by the courts, by the law courts. For us, they are out of the question from the fiscal point of view*" (transcript, day 3, p. 65, lines 12-18).

500. Furthermore, Claimant did not dispute at the hearing the fact that the USD 780,000 tax liability he admitted in 2001 his company owed (Claimant's Rebuttal, Exhibit 27) remains unpaid.
501. Finally, the Tribunal notes that Continent SA litigated its challenge to the 2003 tax audit in Romanian courts and it lost at the Court of Appeals. Claimant did not assert any error in the final judgment at the hearing. It is also undisputed that those liabilities remain unpaid.
502. On the basis of the evidence, the Arbitral Tribunal is of the view that the controls and decisions of the Tax Authorities were consistent with common tax accounting principles, and consequently that none of them was arbitrary.
503. Each of the tax authorities' decisions was motivated. The tax authorities had legitimate concerns about the fulfillment of Claimant's tax obligations. Claimant did not present any convincing evidence that the control actions and the subsequent decisions of the tax authorities were aimed at harassing Claimant.
504. Romania's tax treatment appears to have been consistent with existing law. The tax authorities' decisions were taken in the proper exercise of the tax authorities' responsibilities. Claimant received notice of the decisions and had the opportunity to challenge the findings of the tax authorities before administrative bodies and eventually before impartial judicial courts.
505. The Tribunal considers that the State authorities acted in transparency and in a manner that cannot be considered arbitrary, unfair, unjust, discriminatory or lacking due process.
506. The Tribunal also considers that, under the circumstances, Claimant's argument that the tax authorities' behavior in conducting too numerous tax controls and assessing too severe and too many tax liabilities would amount to a failure to protect his legitimate expectations, is not justified. The tax regulations which led to the incriminated decisions existed and were enforceable by law at the time of the investment. Each of the controls and decisions was based on Romanian legal provisions. Moreover, Claimant could not reasonably have expected that the Romanian authorities would refrain from resolving reasonable concerns they might have concerning Claimant's fulfillment of its tax obligations.
507. The Tribunal therefore decides that the tax authorities' conduct was reasonable and adequate and did not breach the Fair and Equitable Treatment standard.

## 2. Prevention from having the tax litigation resolved because of the criminal proceedings

508. The Romanian Code of Criminal Procedure provides that a victim may claim civil damages during a criminal investigation or criminal prosecution. Therefore, the Ministry, through ANAF, elected to join the criminal proceedings in accordance with Romanian law.



509. In the Tribunal's view, Claimant has not submitted any convincing argument to support his claim that ANAF did not have the right to claim the full amount of the outstanding tax deficiencies as damages. The Romanian Procedural Code provides that the criminal court should render a judgment on the civil claim in the same decision as the one deciding on the criminal deeds. Claimant does not demonstrate that a decision of the criminal court granting ANAF's damage claim would lead to double recovery. Respondent has stated in this regard that if the judgment is paid by Continent SA, ANAF's claim would be reduced accordingly.
510. Moreover, Continent SA received notice of the indictment and had an opportunity to challenge it before the criminal court. The civil damages claim remains unresolved because Claimant abused the summons procedure and caused the delay of the criminal case in order to evade criminal jurisdiction. If he had come before the Romanian criminal court to defend against the charges of criminal tax fraud, the entire case, including ANAF's civil damages claim, could have been resolved long ago.
511. At the hearing, Ms. Scrobota, the former Deputy Legal Director of ANAF, appeared as a witness to answer questions about the May 2008 letter that she helped draft for ANAF's former Legal Director. As Ms. Scrobota comprehensively explained, this was a normal part of Romanian criminal procedure to recover unpaid taxes and penalties. Ms. Scrobota reported that Continent SA and Mr. Roussalis did not object to ANAF's claims and did not submit evidence or present a defense on the merits. She explained that Mr. Roussalis was convicted and sentenced to prison, and he and Continent SA were ordered to pay civil damages to ANAF. But the conviction was overturned on appeal, the civil damages award was vacated, and the case was remanded for a new trial. The criminal prosecutor offered to drop the case in 2009, once the statute of limitations on criminal penalties had run. But Mr. Roussalis requested that the case proceed (Transcripts, Day 3, p.148 *et seq.*).
512. Claimant's allegation that Respondent corrupted the first instance judge or exerted administrative pressure has been disputed by Respondent and is not supported by the record.
513. In conclusion, the Tribunal notes that Romanian courts and administrative procedures have been open to Claimant at all relevant times, Claimant has been successful in his efforts to have the first decision overturned and he had the opportunity to have the case heard on remand. Consequently, there appears to have been no denial of due process or denial of justice that would rise to the level of a violation of international law.
514. In light of the foregoing, the Tribunal decides that AVAS's decisions to join the criminal proceedings and the consequent effect of having the tax litigation becoming part of the latter did not breach the Fair and Equitable Treatment standard.

### 3. The allegedly disproportionate sequestration orders

515. On June 12, 2000, the police issued a sequestration order ordering "*the institution of sequestration of real goods/some goods up to the concurrence ...*" belonging to Continent SA concerning the fixed charges related to the company following an investigation for

tax fraud (Annex 6, Respondent's Rebuttal Documents). The company was ordered not to sell its real estate pending resolution of the criminal proceedings. It was standard procedure pursuant to the Romanian Code of Criminal Procedure. Claimant has not proved that this sequestration order was discriminatory, disproportionate or otherwise improper under Romanian law. In addition, Claimant never challenged the order as he could have done under Romanian law.

516. In a sworn declaration to the police dated August 8, 2001 (Claimant's Rebuttal, Exhibit n°27), Claimant admitted that he owed taxes and penalties totaling RON 23.32 billion (about USD 780,000). He agreed to pay that amount. In order to secure that tax debt, the police ordered Roussalis to maintain Continent SRL's share capital at the minimum level of USD 360,000 until the payment obligation was met (Respondent's Exhibit n°95 and 115). At the hearing, Claimant did not dispute the fact that he never paid any of the above amounts. He also failed to establish that the sequestration was unlawful or unjustified. Moreover, contrary to what Claimant alleged at the hearing, the record contains no evidence whatsoever of any order of seizure of Claimant's shares in SRL or his personal assets or any other property of Claimant's investment.
517. There is also no evidence that the above sequestration order had any effect on Claimant's investment. The November 30, 2001 police minutes record Claimant's declaration that the subscribed capital was deposited at Alpha Bank. Claimant presented no evidence that the USD 360,000 of share capital was on deposit when the sequestration order was issued. It would be justified to believe that as any other business, once Continent SRL's registered share capital was subscribed, it would have been transformed into working capital and used for the activities of the company, with the consequence that the 2001 sequestration did not have any adverse consequence on Continent SRL.
518. Finally, Claimant identified no defect in the 2003 tax audit by which the tax agency established that Continent SA owed additional taxes and penalties of about RON 7.5 million (over USD 2.3 million). The tax agency issued an order in 2004 to sequester certain real estate owned by Continent SA until those tax liabilities were paid (Respondent's Exh. 90). The value of the property sequestered was one half of the tax liability. Continent SA did not challenge the sequestration order. It only challenged the merits of the December 2003 tax audit.
519. Having reviewed the evidence and reasons which the Romanian authorities invoked in support of their sequestration orders, the Tribunal is of the view that these decisions were standard procedures pursuant to Article 163 of the Romanian Code of Criminal Procedure.
520. The sequestration orders were legitimate and not disproportionate. The Tribunal finds no breach of the Fair and Equitable Treatment requirement in Respondent's treatment of the investment in this regard.

## **II. WAS THERE A BREACH OF THE NON-IMPAIRMENT REQUIREMENT?**

521. The Arbitral Tribunal considers that the controls carried out and the decisions taken by Respondent, including the sequestration orders, were not in any way discriminatory, for the reasons invoked above, and consequently did not violate the non-impairment standard of Article 2(2) of the BIT.

## **III. WAS THERE AN EXPROPRIATION OR A MEASURE THE EFFECTS OF WHICH WOULD BE TANTAMOUNT TO EXPROPRIATION?**

522. Claimant articulates its expropriation claim as one of indirect expropriation. He argues that the illegal tax decision, the subsequent judicial proceedings and the enforcement procedures constitute an indirect expropriation of the investments because it deprived Claimant of his right to sell and/or dispose of the assets forming part of its investment. Claimant also suggests that these actions deprived the investment of its economic value.
523. The Tribunal has already dealt with this question above and came to the conclusion that Claimant was not deprived of the ownership of its investment, nor from its right to manage, control, use or enjoy its investment. Reference is therefore made to the Tribunal's decision at ¶354 and following.
524. In relation to the Fiscal Claim, it is undisputed that Continent SA has not paid the tax liabilities assessed against him. He is challenging the tax liabilities in the Romanian courts; they remain subject to review and have not been reduced to a final and irrevocable judgment yet. Therefore, Claimant has not proven an actual impairment of the economic value of his investment or that he would have been deprived of its enjoyment.
525. Moreover, the sequestration orders were all conservatory measures. No bank accounts were seized and no other assets of Continent SA were actually taken.
526. In light of the foregoing, the Tribunal decides that the State's actions invoked by Claimant under the "Fiscal Claim" - taken separately or altogether - did not breach Article 4(1) of the Treaty.

## **SECTION III. THE INTERDICTION CLAIM**

### **SUB-SECTION I. CLAIMANT'S POSITION ON THE INTERDICTION CLAIM**

#### **§ 1. THE FACTS**

##### **A. The criminal proceedings**

527. On May 18, 2001, the police initiated criminal proceedings against Spyridon Roussalis, the director of Continent SRL, and against Angela Doanta, for fraud, tax evasion, use of false documents, and instigation to commit forgery.

528. Claimant disputes Respondent’s allegation that the criminal case was delayed because Claimant, having indicated a wrong address in Greece, could not be summoned. Indeed, Claimant was summoned at the same address for the criminal appeal.
529. As far as the findings in the criminal proceedings are concerned, Claimant points out that the criminal judgment n°447/28 of May 28, 2007 was quashed by the September 22, 2008 decision of the Bucharest Tribunal. Consequently, all the allegations and references made by Respondent on the basis of this judgment are groundless. The Bucharest Tribunal overturned the decision of the first instance court and sent the case back to the first instance court for retrial. The case is still pending. Claimant submits that it is unreasonable that a criminal case that started in 1999 and concerns the compliance of nine invoices should still be pending today. Claimant also refutes Respondent’s allegation that Roussalis did not deny having committed tax evasion:
- First, a defendant is not obliged, under Romanian law, to confess or deny the charges brought against him in criminal proceedings, and even if a defendant confesses such charges, this should not be taken into account by the court.
  - Second, Respondent’s allegation is based on the written notes submitted by Continent SA. Claimant submits that Continent SA could not admit that the offenses had been perpetrated by another person, *i.e.* Roussalis.
  - Third, Claimant did not choose to “merely” rely on a statute of limitations without also expressly denying the charges. Instead, Claimant alleged that the summons procedure was not properly complied with. According to Claimant, the procedure was conducted in violation of fundamental principles of Romanian Law such as the adversarial principle, the right to be heard and the non-mediation principle (see Article 289 of the Criminal Procedure Code). The breach of the above principles renders the decision an “absolute nullity”.
530. Claimant further asserts that “*the entire criminal ... case was a pretense trial*” (Claimant’s Reply Memorial, ¶298).
531. First, the evidence was presented indirectly through lawyers rather than directly by Claimant.
532. Second, Respondent exerted “administrative pressure” over the first instance judge handling the criminal case. The Bucharest Tribunal which quashed the first decision expressly stated that “*By examining the appealed sentence, the Court finds it to be null due to breach of the legal provisions regarding the summoning of the parties, (...), although the defendant Spyridon Roussalis has mentioned his residence address in Greece, the court did not summon him at this address for each hearing term, delivering the evidences alone – the hearing of five witnesses – at a hearing term when there was a lack of procedure with the defendant (...), there were breached the principles of verbal proceedings, nonmediation and contradictory principle, as well as the provisions regarding the hearing of the defendant (...). By all these breaches of norms of criminal procedures there were breached the right to a fair trial as mentioned also in art. 6 of the*

*European Convention of Human Rights (...)*” (sic., Claimant’s Reply Exhibit n°2). According to Claimant, “*Roussalis was subjected to legal and administrative harassment (...) which had as a result the fact that the normal usage of the attributes of the ownership rights over the investment cannot be enforced*” (sic., Claimant’s Reply Memorial, ¶299).

533. Third, Respondent’s motive in exerting such administrative pressure over the first instance judge was to obtain a decision that could be used by Respondent in the arbitration. Claimant points out that the court issued its decision on May 28, 2007, immediately after the Arbitral Tribunal held its first hearing on May 4, 2007.
534. Finally, no expert reports were presented during these proceedings. The only expert report that was taken into consideration by the court was the one which was submitted by the Prosecutor, without being discussed at the hearing or checked by the court.

### **B. The prohibition on leaving the country**

535. On July 31, 2001, the 6<sup>th</sup> District Police Department in Bucharest - Economic Financial Police Service requested the General Customs Police Inspectorate (both institutions being subordinate at that time to the Ministry of Internal Affairs) to order that the Border Police prohibit Claimant from leaving Romania until the criminal investigation was complete (Claimant’s Exhibit n°54).
536. Claimant filed an objection to the 6th District Police Department’s interdiction order with the Prosecutor’s Office at the 6th District Court, under whose jurisdiction the criminal investigation was being conducted. The 6th District Prosecutor’s Office granted Claimant’s challenge and declared the order illegal.
537. On August 9, 2001, responsibility for the criminal investigation was transferred to the General Department of the Bucharest Police (“Bucharest Police”) under the direction of the Prosecutor’s Office at the Bucharest Court of Appeal (Claimant’s Exhibit n° 56). According to Claimant, the administrative re-location of the file triggered the impossibility of enforcing the 6th District Prosecutor’s Office ordinance which declared the administrative measure unlawful.
538. The Prosecutor’s Office at the Bucharest Court of Appeal issued a new order prohibiting Roussalis from leaving the locality of Bucharest during the 30-day period from September 21, 2001 to October 20, 2001 (Claimant’s Exhibit n° 57). This was done without the Prosecutor’s approval.
539. On October 4, 2001, the Bucharest Police rejected Claimant’s subsequent request that the interdiction order preventing him from leaving Romania be lifted on the ground that the September 21, 2001 order forbidding Claimant from leaving Bucharest until October 20, 2001 was still in place (Claimant’s Exhibit n° 58).
540. Article 29(1) of Law 123/2001 provides that an alien may be forbidden from leaving the *country* only if it is established that the alien both has been accused of criminal wrongdoing and is subject to an order preventing him from leaving the *locality*.

541. On October 17, 2001, the Bucharest Police requested that the interdiction order remain in force, after October 20, 2001, until the completion of the criminal investigation.
542. On April 23, 2002, Claimant requested that the Ministry of Internal Affairs lift the interdiction order (Claimant's Exhibit n°59).
543. On April 30, 2002, Claimant argued that the interdiction order was illegal; he directed these arguments to the Administrative Court attached to the Court of Appeal in Bucharest (Claimant's Exhibit n° 60). On June 24, 2002, the Administrative Court cancelled the interdiction order preventing Claimant from leaving Romania (Claimant's Exhibit n°61).
544. Following that ruling, the Ministry of Internal Affairs informed Claimant that it would appeal this decision to the Supreme Court and that the interdiction order would remain in effect until the Supreme Court issued a final, irrevocable decision on the matter (Claimant's Exhibit n° 62). The Ministry of Internal Affairs thus challenged the decision before the Supreme Court. On February 11, 2003, the Supreme Court upheld the lower court's ruling that the interdiction order was illegal. The interdiction order was lifted, and Claimant was free to leave Romania as from February 12, 2003.
545. Claimant submits that the interdiction order, deemed unlawful by both the Court of Appeal in Bucharest and by the Supreme Court of Justice, violated Law 123/2001, the Romanian Constitution and Article 2(2) of Protocol 4 to the European Convention.
546. Claimant disputes Respondent's allegation that forbidden measures, declared illegal by the Romanian courts, may be justified by the fact that the police bodies acted on the basis of a routine. According to the Claimant, such an argument is contrary to the rule of law.

## **§ 2. THE LAW**

547. In light of the foregoing, Claimant submits that Respondent has violated Article 2(2) of the Treaty.
548. According to Claimant, Continent SRL is a trade company established in Romania since 1997. Its main income is derived from import activities. However, since the State unlawfully barred Roussalis from leaving Romania for a period of almost two years, the import activity was blocked, affecting Claimant's right to administer his investment. Indeed, it prevented Continent SRL from obtaining income, the sole shareholder and managing director being Roussalis.
549. Claimant further submits that the Romanian authorities did act in breach of due process. The severity of the interdiction measures, the unnecessary length of the criminal proceedings and their obvious link to the SPA can only be understood as an attempt to regain Continent SA's assets and shares.

### **§ 3. DAMAGES**

550. Claimant claims moral damages. He formulates the following request (Claimant's Memorial, ¶181): "*The requested compensation amounts as material and moral damages to be payed [sic] by the Respondent – the Romanian State is 25,000,000. USD*".

## **SUB-SECTION II. RESPONDENT'S POSITION ON THE INTERDICTION CLAIM**

### **§ 1. THE FACTS**

551. On May 18, 2001, when criminal proceedings were formally commenced against Claimant, the 6th District Police reported that the Financial Guard had observed fraudulent conduct in Continent SA's accounting practices, *inter alia* in relation to the post-purchase investment, and the fraudulent avoidance of fiscal duties (Respondent's Exhibit n°78).
552. Law 123/2001 was adopted in April 2001 and became effective on May 3, 2001. Article 29(1) of Law 123/2001 provides that an "*alien shall not be permitted to leave the country*" under certain circumstances. Under part (b) of that article, for example, such an order may be issued if it can be established that the alien both has been accused of criminal wrongdoing and is subject to an order (issued by a magistrate) preventing him from leaving the locality.
553. On July 31, 2001, with the criminal investigation under way, the 6<sup>th</sup> District Police asked the Border Police to prevent Claimant from leaving Romania until the end of the criminal investigation (Claimant's Exhibit n°54).
554. Claimant filed an objection to the interdiction order with the Prosecutor's Office at the 6th District Court. Claimant complained that no order restricting him from leaving the locality had been issued, as Article 29(1)(b) required. On August 6, 2001, the Prosecutor's Office granted Claimant's challenge and informed both the Border Police and Claimant accordingly.
555. On August 9, 2001, responsibility for the criminal investigation was transferred to the General Department of the Bucharest Police ("Bucharest Police"). Claimant was notified of the transfer and, on August 21, 2001, he renewed his prior objection to the July 31, 2001 interdiction order with the Prosecutor's Office at the Bucharest Court of Appeal, informing the latter that the Prosecutor's Office at the 6th District Court had quashed the July 31, 2001 interdiction order (Respondent's Exhibit n°122).
556. On September 21, 2001, the Bucharest Police requested that the Prosecutor's Office prevent Claimant from leaving Bucharest in order to ensure the proper conduct of the criminal investigation (Respondent's Exhibit n°123).
557. The Prosecutor's Office at the Court of Appeal issued an order prohibiting Claimant from leaving the locality during the 30-day period from September 21, 2001 to October 20,

- 2001 (Claimant's Exhibit n°57). That office was authorized to issue such an order pursuant to Article 136(2) of the Criminal Procedure Code.
558. Claimant again requested that the July 31, 2001 interdiction order preventing him from leaving Romania be lifted, and, on October 4, 2001, the Bucharest Police rejected that request on the ground that the September 21, 2001 order forbidding Claimant from leaving Bucharest was still in place (Claimant's Exhibit n°58).
559. On October 17, 2001, the Bucharest Police requested that the interdiction order remain in force until the completion of the criminal investigation (Respondent's Exhibit n°126). The Border Police and the Prosecutor's Office at the Court of Appeal concluded that the interdiction order met the requirements of Law 123/2001 and could remain in effect until the conclusion of the criminal case (Respondent's Exhibits n°127 and 128).
560. Between February 2002 and April 2002, the Bucharest Police responded to three requests by Claimant to revoke the interdiction order. Each time, the Bucharest Police determined, after a review of the evidence obtained in the criminal investigation, that the interdiction order would remain in place until the conclusion of the criminal proceedings, in accordance with Law 123/2001 (Respondent's Exhibits n°129, 130, 131). In its February 6, 2002 response, the Bucharest Police advised Claimant to address further objections to the supervising case prosecutor or to the competent court (Respondent's Exhibit n°129).
561. On April 23, 2002, Claimant requested that the Ministry of Internal Affairs lift the interdiction order, claiming that it was excessive and unconstitutional, and had caused Claimant serious moral and material damage (Claimant's Exhibit n°59). One week later, Claimant argued that the interdiction order violated: (i) the Romanian Constitution; (ii) his right to free movement under Article 2 of Protocol 4 to the European Convention; and (iii) his right to perform contractual obligations under Article 1 of Protocol 4 to the European Convention. Claimant directed these arguments to the Administrative Court attached to the Court of Appeal in Bucharest (Claimant's Exhibit n°60, pp. 3-4).
562. On June 24, 2002, the Administrative Court cancelled the interdiction order preventing Claimant from leaving Romania on the ground that it did not satisfy the procedural requirements of Article 29(1)(b) of Law 123/2001 (Claimant's Exhibit n°61). Following that ruling, the Ministry of Internal Affairs appealed the decision. On February 11, 2003, the Supreme Court upheld the lower court's ruling that the interdiction order did not meet the requirements of Article 29(1)(b) of Law 123/2001. The interdiction order was lifted. Roussalis left the country around a month later, on March 9, 2003.
563. On May 14, 2003, Claimant was indicted for instigation to commit forgery, use of false documents in fraudulently substantiating Continent SRL's post-privatization obligation in Continent SA, and tax evasion (Claimant's Exhibit n°51). The criminal trial was delayed repeatedly because Claimant gave an erroneous address for his residence in Greece, as a result of which he could not be served with process in Greece. The criminal trial eventually started on November 20, 2006 (Nistor Letter at Att. K).



564. Claimant never appeared in person. On May 28, 2007, Claimant was convicted *in absentia* for tax evasion committed in conjunction with the fraudulent substantiation of Continent SRL's post-privatization investment obligation. The Criminal Court noted that Claimant "*eluded the legal search, tried to mislead the legal bodies [...] during the criminal prosecution [by saying] that he did not know about the [...] accounting records, [and caused] a high quantum of [...] damage [which] he did not try to remedy [...] [instead,] he left Romania.*" Accordingly, the court imposed a sentence of two years in prison because it considered Claimant to be dangerous (Respondent's Exhibit n°42). Claimant appealed the conviction and the appellate court overturned the decision on procedural grounds.

## **§ 2. THE LAW**

### **I. The Treaty does not confer subject matter jurisdiction for this claim**

565. The Treaty provision on which Claimant relies only applies to "*investments by investors,*" not to the investors themselves (Treaty, Article 2(2)).

566. Moreover, Respondent submits that there is no jurisdiction under the Treaty if a dispute is not "*in relation to an investment*" and not somehow tangentially connected to the investment (Treaty, Article 9(1)). This requirement is reinforced by Article 25(1) of the ICSID Convention, which further limits the jurisdiction of the Tribunal to disputes that arise "*directly out of an investment.*" Because this claim does not satisfy these jurisdictional requirements, it should be dismissed for lack of subject matter jurisdiction.

567. The linkage between the subject matter of the alleged fraud and the investment is not sufficient to establish jurisdiction for the Interdiction Claim. The ICSID Convention requires that disputes within the jurisdiction of the Centre must arise *directly* out of an investment. The facts that the underlying crimes of tax fraud and forgery for which Claimant initially was convicted were committed at the premises of Continent SA, and relate to his operation of the business, are not sufficient to meet that test. The interdiction order and Claimant's "interdiction claim" arise directly out of the application of Romanian criminal procedure law to him as an accused criminal; they do not arise directly out of his investment.

568. Respondent notes that the State imposed no restrictions on Claimant's activities in Romania and did not confine Claimant to the custody of the State. Rather, Claimant was free to do as he wished – on the sole exception that he could not leave the country and, for one month could not leave the locality of Bucharest, without permission. He was otherwise free to travel within Romania, conduct his business, and pursue personal interests.

569. In *Biloune v. Ghana Investments Centre* (Award of 27 October 1989 and 30 June 1990, XIX Yearbook Commercial Arbitration 11, 1994), the claimant, after being arrested and deported from Ghana, made a demand for arbitration, alleging that these actions interfered with his investment (a Ghanaian corporation in which the claimant was the principal shareholder). The claimant contended that because the deprivation of his human

rights, by detention and deportation, interfered with his investment, the dispute fell within the tribunal's jurisdiction. Rejecting this argument, the tribunal made clear that more is required than an act that merely touches the investment in some indirect way and decided that it "lack[ed] jurisdiction to address, as an independent cause of action, a claim of violation of human rights." This reasoning applies with equal force here.

570. According to Respondent, the interdiction claim arises out of domestic law and is not arbitrable before an ICSID tribunal. Indeed, in *Loewen v. United States of America*, ICSID Case No. ARB, AF/98/3, the ICSID tribunal dealt with a claimed denial of justice by a United States court. It distinguished between a right of action brought into existence by domestic law and enforceable through a domestic tribunal and a NAFTA treaty claim, which stems from public international law. The tribunal emphasized that "[t]here is no warrant for transferring rules derived from private law into a field of international law where claimants are permitted for convenience to enforce what [are] in origin the rights of Party states". Similarly, in this case there is nothing in Claimant's allegations that would justify the enforcement of his domestic law claim through ICSID.

## **II. The alleged wrongful conduct does not violate the "unjustifiable measures" clause**

### **A. The burden of proof**

571. Respondent submits that Claimant has the burden of demonstrating that his claim states a legally cognizable violation of the Treaty, and that claimant has failed to meet his burden.
572. Respondent points out that the standard of arbitrariness in the Romania-United States BIT was defined by another ICSID tribunal as "something opposed to the rule of law ... [and] a willful disregard of due process of law, an act which shocks, or at least surprises, a sense of juridical propriety." (*Noble Ventures v. Romania*, ICSID Case No. ARB/01/11).
573. The standard also must accord with general principles of customary international law giving rise to state responsibility. Under those principles, mere violations of domestic law, without more, do not trigger state responsibility, as the United Nations codification of international law on this subject makes clear: "Conduct, attributable to a state and causing injury to an alien, that violates the law of the state does not depart from the international standard of justice specified in section 165 merely by reason of such violation. Such conduct departs from the international standard only if it would depart therefrom in the absence of the state law" (R. Ago, First Report on State Responsibility, *Yearbook of the Int.l Law Comm'n*, 1971, Vol. 2, 193-194).

### **B. The interdiction order does not constitute an "unjustifiable measure"**

#### **1. Preventing flight to avoid criminal prosecution promotes a rational public policy**

574. Respondent submits that Claimant was under investigation for serious crimes. Because he was a citizen of Greece, there was a legitimate risk that Claimant might flee Romania and seek to avoid prosecution for these crimes. The interdiction order was issued to minimize that risk. Indeed, the concern that Claimant would avoid the criminal proceedings proved

to be well founded. After the interdiction order was lifted, Claimant left Romania and refused to participate further in the criminal proceedings.

575. Procedures for restricting persons suspected of serious crimes from fleeing the jurisdiction promote the public interest by helping to ensure that the criminal laws are enforced and that those accused of crimes remain subject to the jurisdiction of the courts so they can stand trial and, if convicted, serve their sentences.

576. Against this backdrop, the measure used in this case is not particularly intrusive and allowed Claimant to conduct his business and personal affairs, provided that he remained in the country. The interdiction order represented a reasonable balance between Claimant's risk of flight, on the one hand, and avoiding undue interference in his life, on the other.

2. The measure does not shock the conscience; it is defensible and can be justified in view of the unsettled and confusing state of the law at the time it was issued

577. Claimant complained that no order restricting him from leaving the *locality* had been issued, which in his view was required by Article 29(1)(b) of Law 123/2001 (see above, ¶554). The authorities later obtained such an order, and it remained in effect for 30 days (until October 20, 2001). Claimant then argued that the interdiction order against leaving the *country* also expired on October 20, 2001.

578. Romanian authorities objected that such a reading conflicted with the express terms of Article 30(b) of Law 123/2001, which permit aliens under an interdiction order to leave Romania only if they eventually are not charged with criminal wrongdoing, are acquitted, or the criminal investigation or trial is otherwise discontinued. Accordingly, the requirement of a pre-existing interdiction order restraining the individual from leaving the locality was a pre-condition only to the issuance of an interdiction order to leave the country. Respondent submits that this position was a reasonable attempt to harmonize the various ambiguous legal provisions involved.

579. In the end, the latter interpretation was not adopted by the Supreme Court. The Supreme Court held that the interdiction order was effective only when a valid order restricting Claimant's travel outside the locality was in force (Claimant's Exhibit n°61, p. 5). The Court thus interpreted the new law as having the effect of revoking the authority of magistrates to issue indefinite interdiction orders during the pendency of criminal investigations, a practice that was followed before the enactment of Law 123/2001.

580. Under these circumstances, the actions of the Romanian authorities cannot be said to "shock the conscience" on the ground that they are "indefensible or "incapable of being justified." It does not follow that the authorities acted unjustifiably merely because the courts reached a contrary decision. The issues raised by Claimant were unsettled under a statutory scheme that was new and susceptible to different reasonable interpretations.

3. There is no violation of any international standards of justice that would trigger state responsibility

581. A violation of domestic law does not trigger state responsibility unless the international standard of justice is violated as well. Respondent submits that Claimant identifies no principles of international law entitling him to relief for the alleged violation of Romanian law at issue.
582. Respondent further asserts that the interdiction order does not violate the international standard of justice. When the order was issued, Claimant had complete access to the Romanian courts, the order was quashed, and Claimant was allowed to leave the country. There can be no state responsibility under these circumstances. Indeed, “*it would be absurd if measures later quashed by higher authority or a superior court could ... be said to have been arbitrary in the sense of international law*” (*ELSI, op.cit*, at 133).

**§ 3. DAMAGES**

**I. Claimant has failed to prove both the existence and quantum of material damages**

583. Respondent contests Claimant’s argument that having fulfilled the USD 1.4 million investment obligations, Continent SRL would have resumed its import operations and thereby recouped the cost of its investment in Continent SA. Respondent further denies that the interdiction order prevented Continent SRL (of which he is the sole shareholder and director) from conducting income-earning activities.
584. Claimant presents no evidence to support the above assertions. Therefore, Respondent alleges that such plan to resume allegedly profitable import is fabricated by Claimant to drive up his damage demand. Respondent submits that the Tribunal may not award damages based on an undocumented, speculative, and unproven business venture.
585. Claimant similarly fails to establish that the supposed impairment to Continent SRL’s business ventures was caused by the restriction on Claimant’s travel outside Romania. Claimant neither identifies any negative impact, nor explains why it could not be mitigated or avoided altogether by Claimant conducting business from Romania or by using agents to conduct business outside Romania.
586. Respondent points out that the consensus of European legal systems is that proof of certain loss and causation is required before an award of damages will be made. However, the amount of material damages claimed has not been proven and Claimant has cited no accepted method of determining the quantum of damages.

**II. Moral damages are not appropriate for this claim**

587. Claimant also demands an unspecified amount of moral damages for this claim. Respondent submits that such a demand reveals the true purpose of this claim: to reward the investor for the personal deprivation Claimant attributes to the restriction on his travel, rather than to compensate for any damages allegedly sustained by the investment.

588. Because Claimant is not entitled to recover for any personal deprivation under the Treaty, he claims that Continent SRL was impaired so that he can recover moral damages on behalf of his investment. However, a corporation is not entitled to recover moral damages for business opportunities it supposedly lost as a consequence of restrictions imposed by the State. According to Respondent, the fact that Claimant seeks moral damages is a tacit admission that the business income allegedly lost by Continent SRL is purely speculative and cannot be quantified as compensable material damages, such as lost profits or lost business opportunities.
589. Respondent submits that the Tribunal should dismiss Claimant's speculative moral damages.
590. In any case, should the Tribunal conclude that Claimant is entitled to damages in his personal capacity for the restrictions imposed by the interdiction order, Respondent points out that moral damages are reserved for cases of extreme infliction of distress, often involving severe physical abuse of some kind. However, no such instances of physical violation of the investment or of its personnel and assets are implicated in this case. As explained above, Claimant was not held in custody.
591. Finally, under Romanian law, damages against the State arising out of errors such as those alleged by Claimant are governed by Article 504 of the Code of Criminal Procedure which provides as follows: “*Any person who was finally convicted is entitled to obtain compensation from the state, if after the case’s retrial, the final decision provides that the action was not perpetrated by that person or the action does not exist.*” Accordingly, under Article 504 of the Criminal Procedure Code, as in force at the time, damages were available only if defendant was acquitted or the criminal investigation was closed without charges being brought. Claimant, of course, was charged and ultimately convicted. In this regard, Respondent points out that Claimant’s first instance conviction for tax evasion provides *prima facie* evidence that the measures impugned by Claimant in his Fiscal Claim were in fact fully justified. On September 22, 2008, the Bucharest Tribunal quashed Claimant’s and Continent SA’s criminal convictions on purely procedural grounds without directly challenging any of the conclusions reached by the first instance court. Accordingly, Claimant is not entitled to damages under Article 504 of the Criminal Code for the Border Police’s enforcement of the interdiction order.
592. In light of the foregoing, Claimant’s claim based on the interdiction order should be denied.

### **SUB-SECTION III. DECISION OF THE TRIBUNAL**

#### **§1. JURISDICTION OVER THE INTERDICTION CLAIM**

593. According to Respondent, the tribunal has no jurisdiction over the Interdiction Claim because the Treaty violation on which Claimant relies only applies to “*investments by investors,*” not to the investors themselves (Treaty, Article 2(2)).
594. The Interdiction Claim is actually based on a violation by the State of its Treaty obligations who arguably harmed its investment. The Tribunal considers that it is

therefore irrelevant that the conduct which allegedly harmed the investment in violation of the Treaty was directed against the director of the business, which is also the investor.

595. Respondent further submits that there is no jurisdiction under the Treaty if a dispute is not “*in relation to an investment*” (Treaty, Article 9(1)) and does not arise “*directly out of an investment*” (Article 25(1) of the ICSID Convention). Respondent argues that the measures alleged by Claimant are not specifically related to his investment. They are measures arising out of the application of the Romanian procedure law generally applicable to those who are convicted of tax fraud or forgery crimes.
596. According to Claimant, on the other hand, the illegal interdiction orders forbid Roussalis, who was running the business, to leave the country and travel for about two years, preventing the investment to be properly managed. This allegedly adversely impacted on the investment in violation of Article 2(2) of the Treaty.
597. The Tribunal considers, in light of the foregoing, that what is at stake in Roussalis’ Interdiction Claim is the specific negative impact of the measure on the investment, in violation of the BIT.
598. Respondent also submits that Claimant, in his Interdiction Claim, is asking for the enforcement of a domestic law claim through ICSID. However, a claim arising out of domestic law is not arbitrable before an ICSID tribunal.
599. In this regard, the Tribunal agrees with the ICSID tribunal’s finding in *Continental Casualty Company v. Argentine Republic*, ICSID Case No. ARB/03/9, Decision on Jurisdiction, February 22, 2006, ¶68): “*alleged violation of domestic laws [by the host State] would not give rise per se to an international claim cognizable by the present ICSID Tribunal in the absence of an allegation that the BIT has been thereby breached [by the host State]. It will be of course for the merits to determine whether such breaches have indeed taken place to the prejudice of the protection to which the Claimant, as a U.S. investor, is entitled under the treaty. In the Tribunal’s view, these indications set forth in detail by the Claimant allow the Tribunal to conclude that the Claimant has made legal claims against [the host State], so that the Tribunal is presented with a legal dispute within its jurisdiction.*”
600. Claimant is indeed alleging that Respondent’s illegal decisions to prohibit Roussalis from leaving the municipality or country have breached the BIT. Therefore, the Tribunal considers that the Claimant has made legal claims against the host State, so that the Tribunal is presented with a legal dispute within its jurisdiction.
601. In light of the foregoing, the Tribunal decides that it has jurisdiction to rule on the Claimant’s Interdiction Claim.

## §2. MERITS

### **I. Length of the criminal proceedings**

602. The criminal proceedings lasted for more than ten years. The Tribunal acknowledges that undue delay to rule on a dispute may amount to a denial of justice. Ten years is a significant period, but a long delay does not automatically result in a breach of due process. The Tribunal must also consider evidence regarding the reasons for the delay to determine whether it was undue.
603. In light of the evidence, the Tribunal notes that:
- The whole situation, and the criminal case in particular, were rather complex;
  - The significance of the interests at stake in the case was large,
  - The criminal court noted that Claimant was not cooperative, he “*eluded the legal search, tried to mislead the legal bodies [...] during the criminal prosecution [by saying] that he did not know about the [...] accounting records, [and caused] a high quantum of [...] damage [which] he did not try to remedy [...] [instead,] he left Romania* (Respondent’s Exhibit n°42, p. 6).
  - The ten years proceedings include the court’s first judgment which was rendered in April 2007, the decision vacating the civil damages award on appeal, and the conduct of a new trial on remand. The criminal prosecutor offered to drop the case in 2009, once the statute of limitations on criminal penalties had run. But Claimant requested that the case proceed.
604. In light of all such circumstances, the Tribunal comes to the conclusion that the delay in issuing a final ruling did not exceed the threshold of reasonableness.
605. The Tribunal is further convinced that the criminal proceedings were not a “pretense trial.” The record shows that they concerned alleged fraudulent conduct in Continent SA’s accounting practices, *inter alia* in relation to the post-purchase investment and the fraudulent avoidance of fiscal duties.

### **II. Severity of the interdiction measures**

606. Regarding the underlying policy permitting the issuance of the interdiction orders, the Tribunal notes that such policies are commonplace in many countries and promote the rational public policy of preventing the accused of fleeing the country in avoidance of criminal prosecution.
607. The interdiction orders were motivated. The record shows that the orders were communicated to Claimant and he had an opportunity to contest them. Indeed, the orders were challenged and were ultimately lifted. And Claimant finally left the country.

608. The Tribunal considers that the fact that the interdiction order was lifted does not mean that the orders were arbitrary or not reasonable. In any case, an “erroneous judgment” by a court would not violate the Treaty in the absence of a denial of justice, that is, a violation of due process.
609. In light of the above, the tribunal considers that the temporary restriction order did not amount to a denial of due process or to unfair, inequitable, unjustifiable or discriminatory treatment in violation of Article 2(2) of the Treaty; or to a breach of the full protection and security standard, as there has been no allegation that the temporary interdiction order compromised the physical integrity of Claimant’s investment against interference by use of force.
610. In light of the foregoing, the Tribunal decides that the State’s behavior actions invoked by Claimant under the “Interdiction Claim” did not breach Article 2(2) of the Treaty.

#### **SECTION IV. THE FOOD AND SAFETY CLAIM**

##### **SUB-SECTION I. CLAIMANT’S POSITION ON THE FOOD AND SAFETY CLAIM**

###### **§ 1. THE FACTS**

###### **I. The FSD Order regarding the interdiction to carry out the activities, n°57/06.05.2005**

611. According to Claimant, Romania became obliged to implement Regulation n°852/2004/CE, concerning foodstuff hygiene, only after having joined the European Union in 2007. Accordingly, contrary to Respondent’s submission, food and safety regulations were not introduced in Romania in order to transpose EU Directives for public health purposes. Rather, such regulations were introduced in order to impose tariffs and levy taxes.
612. Continent SA is the owner of food outlets and a refrigerated food warehouse in Bucharest, which it rents to retail and wholesale sellers of food products.
613. On December 10, 2003, Continent SA obtained a permit (A.S.V n°71832/10.12.2003) from the FSD<sup>8</sup>, to operate its refrigerated food warehouse.
614. On May 6, 2005, FSD issued Order n°57/06.05.2005 prohibiting Continent SA from operating its refrigerated warehouse until Continent SA obtained a new operating permit. Continent SA was prohibited from carrying out its reception, storage and delivery activities in relation to frozen and refrigerated products (Claimant’s Exhibit n°63).
615. Continent SA objected to the suspension of its permit and filed an administrative challenge seeking cancellation of the FSD order. FSD answered that: “*Ordinance no.*

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<sup>8</sup> “FSD” (or “DSVSAB”) is the Sanitary-Veterinary and Food Safety Directorate of Bucharest – Food Safety Department sub-unit with jurisdiction over the city of Bucharest. Its tasks include inspections of commercial operators in the food industry and sanitary-veterinary and food safety assistance.



*57/06.05.2005 on forbidding carrying the activities of taking-over, warehousing and delivery of frozen and refrigerated products does not refer as an administrative deed in terms of administrative contentious”* (Claimant’s Exhibit n°64).

616. In parallel with the above challenge, Claimant sought a re-authorization and obtained a new operating permit from FSD (A.S.V. n°103/29.06.2005).
617. On February 1, 2006, the Bucharest Court cancelled the FSD’s May 6, 2005 order n°57/06.05.2005. Claimant submits that the court, by cancelling the Order, confirmed the fact that it was abusive and that Continent SA had fulfilled the sanitary and veterinary conditions to carry out its activity.
618. Claimant contends that the measure ordered by FSD in its order n°57/06.05.2005 was meant to deliberately block the economic activity of the company. Indeed, CSVSA<sup>9</sup> issued an “informative note” n°4042/17.06.2005 to this effect (Claimant’s Exhibit n°66). This notified economic agents about the measure and forbid them to accept products of animal origin coming from Continent SA and 34 other trade companies.
619. Claimant asserts that the impact of this informative note was huge. It “*gave a direct blow to the commercial relationships, by an administrative, abusive and tendentious measure, (Ordinance 57/2005), which was cancelled by a court order (judgment 572/01.02.2006)*” (Claimant’s Memorial, ¶187). Indeed, more than 95% of income realized by Continent SA came from activities carried out at the refrigerating warehouses and food outlets.

## **II. The FSD Order regarding the provisional cancellation of activity n°45/06.03.2006**

620. Claimant submits that the MAPDR<sup>10</sup> and the ANSVSA<sup>11</sup> are competent to issue normative acts in relation to the organization of the sanitary veterinary activity and to the food safety activity. However, there is no regulation establishing the technical conditions for the functioning of refrigerating warehouses. Therefore, there is no objective criterion for the assessment of an authorization.
621. On its own initiative, Continent SA decided to restructure, re-arrange and modernize the space dedicated to the wholesale and retail trade of animal food products, before December 2006. This program was approved by the FSD.
622. In good faith, Continent SA notified its intention to terminate the works in December 2007. Continent SA explained that the delay was due to a shortage of funds preventing

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<sup>9</sup> CSVSA is the Local Food Safety Department office, with jurisdiction over a particular administrative area of Bucharest.

<sup>10</sup> The MAPDR is the Ministry of Agriculture, Forests and Rural Development: the central public authority having competences in the sanitary veterinary domain and in the food safety domain.

<sup>11</sup> The ANSVSA is the National Sanitary-Veterinary and Food Safety Authority (“Food Safety Department”), a government agency, part of the Ministry of Agriculture. Its tasks include promulgation of sanitary-veterinary and food safety regulations.

the investments being made, as well as adverse climatic conditions preventing the performance of construction works (Claimant's Exhibit n°67).

623. Following the notification, the FSD conducted an inspection on March 3, 2006. The inspectors confirmed Continent SA's failure to execute the modernization works in accordance with the initial schedule (minutes n°745/03.03.2006, Claimant's Exhibit n°68). Consequently, for the second time, the FSD suspended Continent SA's operating permit pending completion of the modernization works stipulated in the modernization program. FSD issued order n°45/06.03.2006 regarding the "provisional cancellation of activity." All the reception, storage and delivery activities involving frozen and/or refrigerated products were provisionally prohibited.
624. Continent SA challenged the suspension of its permit by filing an administrative action before the Bucharest Court of Law on June 5, 2006. The court did not issue a decision on the merits but ruled against Continent SA on procedural grounds (Claimant's Exhibit n°70). Continent SA appealed that decision.
625. Claimant contends that, whereas Continent SA was not in breach of any special regulation, it was severely sanctioned for its partial failure to make an investment. The provisional cancellation pending fulfillment of the investment schedule was an unjustified measure, aimed at prejudicing the company by depriving it of its primary income. Indeed, such measure deprived Claimant of its right to use its investment.
626. Claimant further points out that a number of privately owned enterprises were allowed to operate in the same building as Continent SA, while Continent SA's permit was suspended. The witness evidence confirms that Continent SA received discriminatory treatment in relation to other traders on the same premises (Transcript, Day 4, pp. 116-117).
627. The witnesses at the hearing confirmed that Continent SA had not been trading illegally without a license:

*"Mr. Bajan: In the numerous Inspections that were performed ever since 2006, by verification of the traders, of the trade companies which operate by verifying the origin and the quality of products that are sold within the precinct have you ever found commodities, or goods, belonging to Continent SA that Continent SA should have been trading in their own name?"*

*Mrs Dulgheria [head of the veterinary service for hygiene and public health for Bucharest]: No."* (Transcript, Day 4, pp. 116-117).

628. Claimant disputes the testimony given by representatives of the food safety department to the effect that they did not encounter any company except Continent SA that did not comply with the alleged regulations (Transcript, Day 4, page 107). According to Claimant, this is due to the fact that Romania's agents specifically targeted Roussalis's investment in order to eventually force him to abandon it.

### **III. Continent SA did not require a permit in order to operate its refrigerated warehouse facility after the abrogation of Order 139/2004**

629. Claimant asserts that Continent SA did not require a permit to operate its cold storage warehouse after the abrogation of Order 139/2004. Therefore, Continent SA legally operated its refrigerated food warehouse without a valid operating permit.
630. Indeed, Orders 276/2006 and 301/2006 – which replaced the abrogated Order 139/2004 beginning December 29, 2006 – only required *producers* of foodstuffs of animal origin to obtain a permit. Since Continent SA is not a foodstuff producer, the FSD measures were illegal, unjustified and impaired Claimant’s right to use his investment.

### **§ 2. THE LAW**

631. Claimant submits that Respondent violated Article 2(2) of the Treaty. According to Claimant, the series of measures and orders taken by FSD, including banning activities in the premises and the refrigeration warehouses, triggered the closure of the warehouses and consequently blocked the company’s economic activity. Such unjustified measures affected the functioning of Continent SA and impaired the Claimant’s right to use the investment. The removal of the license to perform the trade activity also deprived Claimant of its rights and legitimate expectations as to the sale and disposal of Continent SA’s assets.
632. Moreover, permits and licenses held by foreign investors are considered protected investments. Therefore, measures taken against such investments such as Government controls, indirect seizure of licenses or cessation of permits or licenses, whether or not of direct benefit to the State, is a matter for referral to an international tribunal in case there is evidence that the removal was somehow unjustifiable and/or discriminatory.

### **§3. DAMAGES**

633. Claimant submits that *“for the investor, sources of the moral prejudice are the elements affecting the company’s reputation, bringing uncertainty upon the planning of its decisions, producing anomalies in the company’s administration, producing a state of distress and unpleasant situations to the company’s administrators”* (Claimant’s Memorial, §197).
634. The uncertain status of Continent SA’s investments led to anomalies in the planning of its decisions regarding its economic activities, and “unpleasant situations” in relation to other companies. Claimant also alleges that the reputation of Continent SA was affected.
635. Claimant formulates the following request: *“Moral damage is quantified as amounting to USD 5,000,000 and we request to be payed [sic] by the Respondent – Romanian State”* (Claimant’s Memorial, ¶198).

## SUB-SECTION II. RESPONDENT'S POSITION ON THE FOOD SAFETY CLAIM

### §1. THE FACTS

#### I. Prior to Romania's accession to the EU (January 1, 2007), Romania's Food Safety Regulations were updated to conform to EU standards

636. Romanian law requires that all businesses connected to the food industry in Romania (including operators of refrigerated food warehouses, such as Continent SA) comply with the food safety regulations, including those promulgated by the National Sanitary Veterinary and Food Safety Authority ("NSVFSA"), the public authority entitled to transpose into national legislation EU Directives on food safety. This legislation is intended to protect public health (Declaration of Alexandrina Stoica, "Stoica Decl.", ¶3.2, Respondent's Exhibit n°139).
637. On December 10, 2003, Continent SA obtained a permit (n°71832) from the FSD, a subsection of the NSVFSA, to operate its refrigerated food warehouse in compliance with the food safety regulations in force at that time.
638. With Romania's impending accession to the European Union, Romania's food safety regulations were updated to comply with EU standards (*see* EU Accession Partnership with Romania that required Romania to bring its regulations, including those dealing with Food Safety, in line with EU standards before accession, Council Decision 98/261/EC of March 30, 1998, Official Journal of the European Communities, L 121 of April 23, 1998; this Accession Partnership was subsequently amended in December 1999, January 2002 and May 2003).
639. In their 2003 Regular Report, the EU Commission stated that: "*[a]s regards food safety and foodstuffs legislation the majority of the transposed vertical foodstuff directives entered into force in September 2002 ... In the area of food safety, Romania has transposed legislation setting the general principles for official control of foodstuffs, foodstuff hygiene, including the introduction of HACCP (hazard analysis and critical control points), and good laboratory practices.*" Accordingly, Claimant's contention that that neither EU law nor Romanian law established technical standards regarding the building and functioning of refrigerated warehouse facilities, and that conformity of such facilities was determined at the whim of the NSVFSA, does not stand.
640. In 2004, the NSVFSA issued Order n°139/2004 providing that, by June 30, 2006, it would inspect all permit holders and re-authorize only those that were in compliance with the new regulations. A noncompliant operator could, however, avoid having its permit revoked if it had obtained – prior to the inspection – the approval of the local subsection of the NSVFSA for a modernization plan that ensured full compliance with the regulations by December 31, 2006.
641. Article 7, paragraph 5 of Order n°139/2004 required permit holders to comply with certain general hygiene requirements even if they were in the process of implementing a modernization plan. Failure to so comply was sufficient reason to shut down an operator.

Operators of refrigerated food warehouses that did not bring their facilities into full compliance with the new regulations were shut down.

**II. Continent SA did not comply with Romania's updated food safety standards and its permit to operate a refrigerated warehouse was revoked**

642. The FSD inspected Continent SA's facilities on March 29, 2005. The inspectors found that Continent SA's refrigerated warehouse was not in compliance with the food safety regulations. Continent SA's General Director, Mr. Horia Cornaciu, signed and stamped the report adding the handwritten words "*with objections*" and "*immediate action shall be taken to remedy the deficiencies*" (Minutes n°1325/29.03.2005, Respondent's Exhibit n°142; see also, Declaration of Maria Dulgheriu, "Dulgheriu Decl.," Respondent's Exhibit n°140). The inspection report details approximately eighteen specific deficiencies in Continent SA's facility including: no hot water; broken taps; missing temperature control devices; moldy walls; cracked and dirty floors; meat deposited on rotten wooden pallets; frozen meat displayed out of its packaging; and no locker rooms for specialized personnel.
643. On March 30, 2005, as a result of the inspectors' findings, the FSD temporary suspended Continent SA's permit (Ordinance n°36).
644. On March 30, 2005, one day after the first inspection, Continent SA requested that the FSD re-inspect its facilities (Respondent's Exhibit n°143). On April 5, 2005, FSD inspectors conducted the re-inspection and found that the refrigerated warehouse still was not in compliance with the regulations (Respondent's Exhibit n°139). The inspectors recorded the remaining deficiencies in their re-inspection report, which was signed by Continent SA's General Director, who added a handwritten note agreeing that Continent SA would "*ensure [that] compliance with the hygiene rules shall be continued and finalized*" (Respondent's Exhibits n°139 and 141).
645. On April 18, 2005, upon receiving from Continent SA another re-inspection request, FSD inspectors re-inspected Continent SA. They found that Continent SA still was not in compliance with regulations regarding the handling of products of animal origin or regulations concerning storage temperature restrictions. The inspection report n°2651, dated April 18, 2005, was again signed and stamped by Mr. Cornaciu (Respondent's Exhibit n°139). The FSD decided to maintain the temporary suspension in place, but Continent SA was given another opportunity to cure the deficiencies.
646. After receiving a further re-inspection request from Continent SA on April, 20 2005, FSD inspectors performed a re-inspection on May 6, 2005. They concluded that Continent SA's refrigerated facilities again failed to meet regulatory standards (Minutes n°2062, Respondent's Exhibit n°140). The company inexplicably refused to participate in the inspection or sign the report.
647. Based on Continent SA's repeated failure to bring its facilities into compliance with the food safety regulations, the FSD issued Order n°57/06.05.2005 on May 6, 2005,

prohibiting Continent SA from operating its refrigerated warehouse effective May 11, 2005, until Continent SA obtained a new operating permit (Respondent's Exhibit n°140).

648. On June 22, 2005, Continent SA objected to the suspension of its permit. It filed an administrative challenge seeking cancellation of the order (petition n°164/2005, Respondent's Exhibit n°144). Under the requirements of the NSVFSA Order n°139/2004, noncompliant permit holders, such as Continent SA, were not entitled to continue their operations until June 30, 2006 without an FSD approved modernization and restructuring program in place.
649. On June 13, 2005, Continent SA submitted a petition to the FSD seeking renewal of its operating permit based on the submission of modernization plan n°19997/13.06.2005. Continent SA's modernization plan recognized the existence of the deficiencies identified by the FSD and detailed how Continent SA would bring its refrigerated warehouse into compliance by December 31, 2006 (Dulgheriu Decl., Att. G). The modernization plan set out certain key items for each deficiency previously reported by the FSD. Respondent points out that the modernization plan included references to the legal source of each technical requirement. This contradicts Claimant's unsupported and baseless assertions that: (i) the regulations failed to make clear the technical requirements to be met by operators of refrigerated food warehouses; and (ii) no objective criteria clearly established how FSD would assess the conditions at Continent SA.
650. The modernization plan was approved by a commission of four inspectors, including Ms. Dulgheriu and Ms. Stoica, on June 27, 2005 (Dulgheriu Decl. ¶4.2 and Att. G; Stoica Decl. §5.2). The FSD's approval official report covered all of the elements of the modernization plan, including FSD's expectation that the interim deadlines (to cure the deficiencies) in the modernization plan would be met.
651. Following approval of the modernization plan, the FSD issued a new operating permit to Continent SA (A.S.V. n°103/29.06.2005), which was subject to the same requirements as the modernization plan approved several days earlier (Dulgheriu Decl. §4.3).
652. On February 1, 2006, eight months after Continent SA had obtained a new operating permit based on the modernization plan, the Bucharest Court of Law cancelled the FSD's order of May 6, 2005 (which had not been in force since June 29, 2005 when a new permit was issued to Continent SA). The court did not find that Continent SA was in compliance with the regulations. It held that the approval of the modernization plan in June 2005 constituted a change in circumstances after the revocation of the May 6, 2005 permit, entitling Continent SA to continue its operations (Respondent's Exhibit n°145).
653. On February 2, 2006, one day after the court cancelled the superseded order, Continent SA wrote to the FSD seeking relief from the interim deadlines in the modernization plan asking that all the interim deadlines be extended to the final completion date of December 31, 2006. Continent SA based its request on alleged financial constraints, which were neither explained nor substantiated, and on "*winter weather*" (Respondent's Exhibit n°148). Respondent submits that this explanation for failure to timely perform its obligations is at odds with the minutes of Continent SA shareholders' meeting April 29,

2005 (Respondent's Exhibit n°149). The minutes stress the urgency of implementing the plan, and the approved estimated budgets denote the availability of funds for completion of the modernization plan in advance of the plan's submission. Moreover, the alleged financial constraints are also at odds with two management reports (Respondent's Exhibits n°150 and 151) indicating that RON 1.3 million, in 2005, and RON 1.7 million, in 2006, was available for the company's modernization plan.

654. In the light of the interim deadline of February 28, 2006 set out in Continent SA's modernization plan, FSD inspectors conducted a follow-up inspection. This revealed that none of the planned improvements scheduled for completion prior to that date had been implemented (Dulgheriu Decl. §5.1). Mr. Horia Cornaciu signed a copy of the inspection report (Dulgheriu Decl., Att. I).
655. On March 6, 2006, the FSD suspended Continent SA's operating permit A.S.V. n° 103/20.06.2005 for failure to meet the implementation milestones set out in the approved modernization plan. The suspension order provided that Continent SA's permit could be restored if and when the improvements required under the modernization plan were completed.
656. Respondent points out that Continent SA has continued to operate its refrigerated food warehouse despite the FSD's suspension order. Moreover, Continent SA defied the FSD order by renting out space at its refrigerated warehouse to other commercial entities in the period after the suspension of its permit (Dulgheriu Decl., Att. J).
657. Although Claimant filed this arbitration with ICSID in January 2006, Continent SA challenged the March 6, 2006 suspension of its permit by filing an administrative action in the Bucharest Court of Law on June 5, 2006. The court ruled against Continent SA on procedural grounds. Continent SA appealed the decision. On January 31, 2008, the appellate court granted Continent SA's request to remand the case for a trial on the merits. On January 23, 2009, the Bucharest Tribunal dismissed Continent SA's challenge to the order dated March 6, 2006 on the following grounds: (1) Continent SA admitted that it had not complied with the interim deadlines or with its other obligations under the modernization plan; (2) Continent SA's permit to operate the refrigerated warehouse was subject to the observance and completion of the modernization plan; (3) Continent SA failed to comply with the modernization plan despite numerous inspections and written notices from FSD; (4) the alleged financial constraints invoked by Continent SA have not been proven, and the winter weather could not possibly have prevented Continent SA from executing the works because the modernization plan required mainly indoor works; (5) Continent SA's purported good faith has not been proven, since it has done nothing at any stage to remedy the deficiencies identified in the modernization plan.
658. Indeed, inspections performed by the FSD on February 7, 2008 and April 25, 2008 confirmed that Continent SA had still not completed the work required under the modernization plan, and food safety conditions in the warehouse had deteriorated (Respondent's Exhibits n°154-159). Further, Continent SA continued to operate its refrigerated warehouse illegally, without a permit, and it failed even to apply for a new permit by the deadline established by FSD in an updated food safety regulation, Order n°

276/2006. In this regard, Respondent denies Claimant's assertion that Continent SA did not require a permit after the abrogation of Order 139/2004. Claimant's position is based on the incorrect assumption that Order 276/2006 – which replaced the abrogated Order 139/2004 beginning December 29, 2006 – only required *producers* of foodstuffs of animal origin to obtain a permit. It is clear from the order itself that it required businesses such as Continent SA, operating refrigerated food warehouses, to carry out their activities only after obtaining a permit. Indeed, Article 3(1) of Order 276/2006 provides that: "*Business units shall carry out the activities specified in Annex 1 only after obtaining the authorization issued by the competent sanitary-veterinary authority*". Annex 1 A(1) of Order 276/2006 lists: "*Refrigerated warehouse: unit having adequate premises and low temperature installations for the reception, storage and delivery activities of deep-frozen and/or refrigerated animal origin products*".

659. Respondent emphasizes in its Post Hearing Brief that, when Mrs. Dulgheriu and Mrs. Stoica were shown short segments from the video survey of the premises and operations of Continent SA during the Hearing, the witnesses pointed out numerous health and safety violations (Transcript, Day 3, pages 101-105): a decrepit building, moldy walls, improper ceilings, meat stored out of packaging and without refrigeration which allows bacteria to breed, floor in disrepair allowing bacteria to breed, dogs roaming on the access ramp where food is loaded, unsanitary garbage removal. Mrs. Dulgheriu testified that the images in the video were consistent with what she had seen during her regulatory inspections at Continent SA, but in some instances what she found during the inspections was "*even worse than you can see in the images.*" Therefore, Respondent submits that Claimant obviously operated his company with total disdain for the health and safety rules applicable to the type of business he purchased.

## **§2. THE LAW**

### **I. The Tribunal lacks subject matter jurisdiction to decide this claim, as matters of purely domestic law fall outside ICSID's jurisdiction**

660. Claimant's Food Safety Claim arises from matters of general domestic law in Romania. Continent SA's obligation not to violate the food safety regulations applicable to its refrigerated foods warehouse was not specifically contracted for in the Privatization Agreement and does not arise directly out of Claimant's investment. Accordingly, this claim does not fall within Article 25(1) of the Convention. Rather, it is to be decided under Romanian law by the Bucharest Court of Law, before which Claimant filed an administrative action on June 5, 2006 challenging the FSD's March 2006 order.
661. Respondent submits that Claimant provides no justification for transforming these issues of purely domestic law into matters involving State responsibility for alleged violations of international norms, or for asking the Tribunal to sit as an appellate body in review of domestic administrative decisions. The Tribunal should thus decline to exercise jurisdiction over this claim.



## **II. The claim does not assert any Treaty violation**

### **A. Romania did not take any “unjustifiable or discriminatory measures” against Claimant**

662. Respondent points out that Claimant presents no evidence to support its assertion that the revocation of the operating permit for Continent SA’s refrigerated food facilities was unjustifiable or discriminatory.
663. Claimant does not allege that the FSD’s regulatory measures somehow discriminated against Continent SA. Indeed, in practice, all operators of refrigerated facilities (domestic and foreign) were under identical obligations. In this regard, it is a principle of customary international law that compensation is not required where economic injury results from a *bona fide*, non-discriminatory regulation that falls within the police power of the State (R. Ago, *First Report on State Responsibility, op.cit.* at 197). Respondent asserts that the FSD measures taken against Continent SA are not discriminatory and they constitute an appropriate exercise of the police power of the Romanian State, especially given Continent SA’s admission that it was not in compliance with food safety regulations.
664. Given the absence of any discriminatory conduct, Claimant’s sole basis for this claim is the contention that the orders suspending Continent SA’s operations were unjustifiable. The FSD’s regulatory measures, however, were justified by an important public safety purpose, namely, serious public health and safety considerations.
665. Respondent notes that Claimant does not allege that Continent SA’s refrigerated warehouse facilities complied with the food safety regulations applicable when its operating permit was suspended and eventually revoked. On the contrary, on March 29, 2005, Continent SA’s General Manager promised the FSD inspectors, in writing, that “*immediate action shall be taken to remedy the deficiencies.*” Moreover, Continent SA admitted in its modernization plan that it was not in compliance with a number of requirements. Therefore, in light of the acknowledged deficiencies and the company’s repeated failure to remedy those deficiencies, the FSD’s actions were not only justified, but also necessary.
666. Faced with Continent SA’s inspection record, its disregard of its Managing Director’s commitment to take “immediate action” to correct the deficiencies, and its lack of meaningful progress toward the commitments made in the modernization plan, it is not surprising that the FSD gave short shrift to the company’s 2006 proposal to relax the deadlines under the modernization plan. By failing to comply with food safety regulations for at least a year, Continent SA destroyed any credibility it may have had. Therefore, suspension of Continent SA’s permit was justified under the circumstances.
667. The inspections were not excessive in frequency or scope and were carried out with a team of inspectors whose number was appropriate for a facility of this size. Claimant, over a period of years, failed to come into compliance with sanitary and veterinary regulations governing the operation of a refrigerated food warehouse. Nevertheless, Continent SA has continued unlawfully to operate an unsanitary and substandard facility,

even after its operating permit was suspended and eventually revoked (*See Dulgheriu Testimony, Transcripts, Day 3, pp. 95, 96, 100, 101*).

**B. The Bucharest Court's decision does not establish that the FSD's actions violate the Treaty**

668. The Bucharest Court of Law issued a decision on February 1, 2006, cancelling the May 6, 2005 order. Respondent denies Claimant's allegation that the decision confirmed that the May 2005 order was "abusive" and that Continent SA was in compliance with the food safety regulations. Rather, the court observed that, since Continent SA had submitted a modernization report and the FSD had accepted that plan and issued a new operating permit, the FSD could have imposed a less severe sanction than suspension of the permit to achieve the purposes of Order n°139/2004.
669. The court stated that some unspecified, less burdensome sanction might have been imposed. However, Respondent submits that the mere availability of less onerous remedies fails to establish that the May 2005 order was "abusive." The May 2005 order was appropriate in view of Continent SA's failed inspections from March to May 2005 and its failure to submit a modernization plan to the FSD at that time.

**§ 3. DAMAGES**

670. Respondent submits that Claimant bears the burden to establish his claim but has put forth no evidence to support any of his contentions.

**I. Claimant has demonstrated no compensable damages incurred by Continent SA as a result of the May 2005 order**

671. Respondent denies Claimant's allegation that the "informative note" issued to a company named S.C. Teonel Impex SRL in June 2005 had a huge impact (see above, ¶¶618-619).
672. There is no evidence that this notice caused Continent SA to experience any compensable loss under the Treaty. The notice lists Continent SA and three dozen other companies whose refrigerated food warehouse operations were suspended (presumably due to violations of food safety regulations), and notifies Teonel Impex that "*the receipt of animal origin products from this company is hereby forbidden*" (Claimant's Exhibit n°66). This notice demonstrates that numerous other companies were subjected to measures similar to those applied to Continent SA and that Continent SA was not singled out for disparate treatment.
673. Such notes are common practice and serve to inform retailers about the suspension or revocation of an operator's permit for noncompliance with food safety regulations. The purpose of such notes is to protect public health. Moreover, given that the notice purportedly was issued on June 17, 2005 and Continent SA's operating permit was restored twelve days later, on June 29, 2005, any adverse impact would have been minimal. Claimant offers no evidence that Continent SA was harmed as a consequence of either the informative note or the enforcement actions of the FSD.

## **II. Claimant's allegations of damages caused by the March 2006 order are unproven**

674. Respondent denies Claimant's assertions that the May 2005 permit revocation had a "huge" impact on Continent SA, that the latter's reputation was affected, that there were uncertainties and unspecified "anomalies" in administering the company, and that unnamed company directors have experienced "distress and unpleasant situations." (Claimant's Memorial, ¶197). The complete failure of proof of these vague assertions requires that the claim be denied.
675. Furthermore, Respondent submits that Continent SA failed to mitigate any damage it may have suffered after the order suspending its operating permit in March 2006. Continent SA would have been able to resume operations under a restored permit if it had completed the improvements called for under its own modernization plan.

## **III. The alleged damages fall short of what is required for compensable moral damages**

676. Respondent reiterates that moral damages are not available for alleged investment treaty violations except in the most extreme circumstances, which are not present here (see above, ¶¶294 *et seq.*, in particular ¶¶296-297). Claimant's allegation of reputational harm caused to Continent SA by the FSD's regulatory actions does not meet this standard.
677. Respondent points out that Claimant caused his company, Continent SA, to continue to operate its refrigerated foods warehouse in violation of the FSD shut down order and in contravention of Romania's food safety regulations.
678. In light of the foregoing, Respondent submits that the claim for damages is unsupported by any evidence, baseless and should be dismissed.

## **SUB-SECTION III. DECISION OF THE TRIBUNAL**

### **§1. JURISDICTION OVER THE FOOD SAFETY CLAIM**

679. Respondent submits that because Claimant's Food Safety Claim arises from matters of general domestic law in Romania, the Tribunal should decline to exercise jurisdiction over this claim.
680. The Claimant objects submitting *inter alia* that the orders banning activities in the premises and the refrigerating warehouse, blocked Continent SA's activity, thus impairing the investment. Claimant further submits that those measures which have been taken by FSD, a State authority, have affected its legal rights stemming from the BIT.
681. The Tribunal agrees with the arbitral tribunal's finding in *Continental Casualty Company v. Argentine Republic* referred to in ¶599 above (ICSID Case No. ARB/03/9, Decision on Jurisdiction, February 22, 2006, ¶68).
682. Here, Claimant alleges that Respondent's *illegal* decisions to suspend or prohibit the operation permits of its investments have breached the BIT. The Claimant is therefore

making legal claims against the host State, with the consequence that the Tribunal is presented with a legal dispute within its jurisdiction.

683. Consequently, the Tribunal decides that it has jurisdiction to rule on the Claimant's Food Safety Claim.

## §2. MERITS

684. In its Food Safety Claim, Claimant argues that Romania has violated Article 2(2) of the Treaty. Claimant principally contends that the measures taken were unjustifiable, disproportionate, discriminatory, and deprived Claimant of its rights and legitimate expectations.

685. Having reviewed the evidence and the reasons which the State authorities have invoked in support of their several control minutes and decisions, the Tribunal is of the view that these decisions were not "unjustifiable measures."

686. Indeed, food and safety policies are commonplace in many countries and promote an important public safety purpose, namely public health. Each of the State authorities' decisions was motivated in regard to these food and safety regulations. The Tribunal is therefore not convinced at all that the control actions and the subsequent decisions of the tax authorities were aimed at blocking the activity of the company.

687. Moreover, suspending or revoking operating permits may be regarded as a reasonable and appropriate measure to penalize serious irregularities to the food and safety regulations.

688. The record shows that the State authorities had legitimate concerns about the fulfillment of Claimant's obligations in regard to the food and safety regulations. Moreover, as Mrs. Maria Dulgheria and Mrs. Alexandrina Stoica – veterinary doctors specialising in food hygiene and employed by Romania's Food Safety Department – pointed out in their testimony, the inspections were carried out in accordance with Romania's National Strategic Plan, developed in consultation with the European Union. Their frequency was not excessive, based on objective criteria, such as the level of risk, and they were carried out with a team of inspectors whose number was appropriate for a facility of that size. The witnesses explained their observations and their determinations that the company, over a period of years, failed to come into compliance with sanitary and veterinary regulations governing the operation of a refrigerated fueled warehouse; and that, nevertheless, Continent SA has continued unlawfully to operate the facility, even after its operating permit was suspended and eventually revoked. They also pointed to Claimant's persistent refusal to address the deficiencies that were identified in the inspections. During the cross-examination Claimant did not establish any procedural or substantive irregularities in the inspections conducted by the Food Safety department.

689. The Tribunal does not agree with Claimant's allegation that on the basis of the evidence, Continent SA received discriminatory treatment in relation to other traders on the same premises. Indeed, Ms Dulgheria stated in this regard: "*There was just one licence for Continent SA and all the tenants operate on the basis of such a licence*" (Transcript, Day

4, p.114, line 14). In the Tribunal's view, this is consistent with Respondent's explanation that, according to the lease agreements between Continent SA and the tenants who operated food sales concessions at Continent SA's premises, compliance with the food safety regulations was Continent SA's responsibility; that is why the "other traders on the same premises" were not directly subject to the regulations. Accordingly, Claimant has not proven that the measures targeted Claimant's investment specifically.

690. The Tribunal therefore considers that Claimant did not prove that the measures of which he here complains were unjustifiable, disproportionate and discriminatory.
691. Moreover, Claimant's argument that the State authorities' behavior in conducting too many inspections and imposing too severe penalties, namely suspensions or revocations of operating permits, would amount to a failure to protect its legitimate expectations is not justified. The regulations which lead to the incriminated decisions were taken by FSD in the course of exercising its obligations to implement the food and safety regulations. Such regulations by a state reflect a clear and legitimate public purpose. In the Tribunal's view, Claimant may not have expected that the State would refrain from adopting regulations in the public interest, nor may Claimant have expected that the Romanian authorities would refrain from implementing those regulations.
692. In light of the foregoing, the Tribunal decides that the State's actions invoked by Claimant under the "Food and Safety Claim" did not breach Article 2(2) of the Treaty.

## SECTION V. THE OZIAS TAX CLAIM

### SUB-SECTION I. CLAIMANT'S POSITION ON THE OZIAS TAX CLAIM

#### § 1. THE FACTS

693. In 2001, Continent SA and Ozias Marine Company ("Ozias") entered into consulting contracts pursuant to which Ozias was to provide Continent SA with management and technical consulting services to help Continent SA improve its performance, satisfy its existing customers, and attract new customers (Claimant's Exhibit n°71). On October 26, 2001, Continent SA declared and registered the contracts with the 6<sup>th</sup> District Administration of Public Finance in Bucharest.
694. Claimant submits that Continent SA's income increased during the period when the consulting contracts were in force (Claimant's Exhibits n°42 and 72). Such a spectacular and continuous rise in income evidences the effectiveness of the consulting services. Claimant denies Respondent's allegation that Ozias was dissolved in February 2005. In any case, Claimant points out that the relevant time for considering Ozias's work is 2002-2003, as mentioned in the December 17, 2003 tax audit report at issue.
695. Indeed, the Tax Agency audited Continent SA and, in its December 17, 2003 tax audit report, refused tax deductions for the Ozias consulting fees and held Continent SA liable for unpaid profit tax, VAT, interest and penalties.

696. Whereas the Tax Agency did not recognize the consulting services as having been rendered, the Tax Agency also held Continent SA liable for VAT on the cost of Ozias's fees. Because Continent SA did not pay the required VAT, the Tax Agency assessed additional VAT liabilities, interest, and penalties.

## **§ 2. THE LAW**

697. Claimant contends that the measures taken by the Tax Agency impaired the company's management and discouraged good management. According to Claimant, the Romanian institutions abusively sanctioned Claimant and prevented him from optimizing his business relating to the investment.

698. Claimant submits that the denial of deductions and the imposition of additional taxes were unjustified, and therefore in violation of Article 2(2) of the Treaty, for the following three reasons.

699. First, Claimant asserts that the higher profit tax liability was an unjustified measure since the increase in Continent SA's income proved the efficiency of the consulting services. Indeed, the Tax Agency, when auditing Continent SA's accounts and evaluating the services rendered by Ozias under the consultancy contracts, adopted a formalistic approach and ignored substantive evidence, such as the fiscal results obtained by Continent SA which proved the provision of consultancy services by Ozias.

700. Second, the Romanian State, through its Tax Agency, had a contradictory attitude:

- on the one hand, the effects of the consulting contracts were not acknowledged, resulting in the recalculation of the profit tax and VAT;
- on the other hand, the consulting contracts were invoked in order to claim VAT.

701. Third, the law regarding taxable profits, in force on the date of the tax audit (*i.e.*, December 17, 2003), did not entitle the Tax Agency to deny profit tax deductions on the basis of the economic purpose of a commercial operation. The Tax Agency only became entitled to deny profit tax deductions on the above ground after the enactment of Law 571/2003 (in particular, Article 11), which entered into force on January 1, 2004.

## **§ 3. DAMAGES**

702. Claimant alleges "moral prejudice" and bases his claim for moral damages on the grounds that the denial of tax deductions and imposition of additional taxes affected Continent SA's reputation, brought uncertainty to the company's business planning, and caused distress among Continent SA's directors.

703. In this regard, Claimant formulates the following request: "*Moral damage is quantified as amounting to USD 1.000.000 and we request to be payed [sic] by the Respondent-Romanian State*" (Claimant's Memorial, ¶198).

## **SUB-SECTION II. RESPONDENT’S POSITION ON THE OZIAS TAX CLAIM**

### **§ 1. THE FACTS**

#### **I. Continent SA allegedly contracted with Ozias for Consulting Services**

704. On July 1, 2001, Continent SA and Ozias entered into three contracts for consulting services to be provided to Continent SA (Respondent’s Exhibits n°161, 162 and 163).
705. The first two contracts purport to provide Continent SA with the services of “Commercial Managers.” These required Ozias to provide advice to Continent SA on the following issues: (1) the development of Continent SA’s business; (2) the identification of potential clients in Greece; and (3) any other commercial issues Continent SA might face. The third contract made available the services of a “Technical Manager.” The latter’s role was to provide technical assistance to develop Continent SA’s business. He was required to help with the modernization, reparation and exploitation of the refrigerated warehouse. The contract also required him to identify potential clients in Greece and provide Continent SA with useful information related to business strategy.
706. Each contract: (i) had an indefinite term; (ii) called for a monthly consulting fee of USD 3,500 to be paid to Ozias; and (iii) required Continent SA to pay any additional expenses incurred by the individual consultants for transportation, accommodation, or meals when traveling to Romania. On July 5, 2002, after the contracts had been in force for one year, each contract was amended to increase the monthly consulting fee to USD 5,500, beginning with the July 2002 payment (Respondent’s Exhibits n°164, 165, and 166). In November 2005, the monthly consulting fee apparently increased to USD 7,500 per contract (*See, e.g.*, Ozias’s Invoice N°147 for services performed under all three Consultancy Agreements, Respondent’s Exhibit n°167). The monthly consulting fee increased again to EUR 12,000 per contract for the period from May to November of 2006. (*See, e.g.*, Ozias’s Invoice N°48 for services performed under all three Consultancy Agreements, Respondent’s Exhibit n°168). In total, Ozias billed Continent SA for consulting fees from July 2001 through November 2006 (*See* Respondent’s Exhibit n°169).

#### **II. Ozias was formed to be a shipping company**

707. Respondent points out that Ozias’s corporate records show that Ozias was formed in Greece in 1995 to operate as a shipping company. According to its articles of incorporation, “*the company’s exclusive object of activities [was] to own, operate and manage Greek merchant and fishing ships*” (Respondent’s Exhibit n°170). Claimant was the majority shareholder of Ozias with 70 percent ownership; his son, Stavros Roussalis, owned the remaining 30 percent of the company’s shares.
708. On February 9, 2005, at a general meeting, the Ozias’s shareholders decided to dissolve the company (Respondent’s Exhibit n°171). The fact that Ozias was dissolved in February 2005 is further confirmed by a letter dated November 21, 2006 from the Greek Ministry of Commercial Shipping (Respondent’s Exhibit n°201). Claimant was responsible for liquidating the assets and winding up the business affairs of the company.

However, in February 2005, Ozias continued to send monthly invoices to Continent SA and raised its fee rates under the contracts until at least November 2006.

### **III. Continent SA has not substantiated Ozias's work product**

709. According to Respondent, there is no evidence that Ozias actually provided any services to Continent SA. The invoices sent by Ozias to Continent SA contain no description of the services supposedly provided.
710. Respondent refutes Claimant's assertion that Continent SA's increased revenue during the period in which the Ozias contracts were in force is sufficient to prove that Ozias rendered the services as claimed.

### **IV. Claimant took tax deductions on payments made to Ozias**

#### **A. The Tax Agency disallowed Continent SA's profit tax deductions for the Ozias fees**

711. Law 414/2002 sets forth the supporting documentation that Continent SA was required to provide in order to obtain a tax deduction for the consulting fees paid to Ozias. Article 9(7) of Law 414/2002 requires both a written contract and proof that services were rendered with a view to generating income for the company. The Tax Agency informed Continent SA that its documentation was inadequate because Ozias's invoices did not "*detail [...] the service performed*" and failed to show "*the number of consultancy hours*" (Respondent's Exhibit n°85, p. 16). Because Continent SA's expenses, supposedly for consulting fees, were not properly documented in accordance with the Romanian tax legislation, the Tax Agency denied Continent SA tax deductions for payments made to Ozias and assessed additional profit taxes (Chivu Decl., ¶5.4.2).
712. The Tax Agency's decision in December 2003 to deny profit tax deductions was taken absent any documentary proof of Ozias having provided any services whatsoever to Continent SA. Indeed, Article 27(1) of Law n°414/2002 enables the Tax Agency to verify and recalculate the taxable profit of a company, stating that "*the expenses related to management services, consultancy, assistance or the supply of services are not considered deductible expenses if written agreements are not concluded and if the beneficiary cannot evidence the supply of such services.*"

#### **B. The Tax Agency also assessed VAT liabilities that Continent SA had failed to pay**

713. The Tax Agency also held Continent SA liable for VAT on the cost of Ozias's fees. Romanian tax law in effect before June 2002 required Continent SA to pay the VAT for Ozias's services within seven days after Continent SA received an invoice from Ozias, and immediately upon receipt of the invoice after June 2002 (Respondent's Exhibit n°85, p. 6). Because Continent SA did not pay the required VAT, the Tax Agency assessed additional VAT liabilities, interest, and penalties.



### **C. Continent SA objected to the profit tax and VAT assessments**

714. Continent SA objected to the assessment of additional profit taxes and VAT in the Tax Agency's December 17, 2003 tax audit by filing an administrative challenge on January 5, 2004 (Respondent's Exhibit n°84). Continent SA argued that its revenue growth during the period when Ozias allegedly provided services was sufficient to prove that Ozias had provided services to Continent SA. Continent SA also contested that it owed VAT, arguing that consulting services provided by foreign entities did not incur VAT liability.
715. Continent SA registered a formal challenge to the Tax Agency's tax audit before the Bucharest Court of Law. Continent SA's dispute with the Tax Agency is pending and the company has not paid the Ozias-related tax liabilities assessed by the Tax Agency.

## **§ 2. THE LAW**

### **I. The Tribunal lacks subject matter jurisdiction over the Ozias Tax Claim**

716. Respondent points out that Claimant does not allege that Continent SA was somehow treated differently from other similarly-situated corporate taxpayers with respect to the application of the relevant tax laws. Nor does Claimant allege that the Tax Agency took any discriminatory action against Continent SA with respect to the application of the taxes in this claim.
717. Respondent further submits that the Treaty does not extend its jurisdiction to garden-variety tax disputes of the kind Claimant raises here. The Tribunal should thus decline to exercise jurisdiction over Claimant's claim alleging unjustified tax assessments for the same reasons set out regarding the Fiscal Claim (see above, ¶¶457 *et seq.*).

### **II. Claimant has neither alleged nor proved a Treaty violation**

#### **A. Claimant was not subjected to any "unjustifiable or discriminatory measures"**

718. Respondent points out that Claimant does not allege that the Tax Agency's assessment of additional taxes discriminated against Continent SA. Absent any allegedly discriminatory conduct, Claimant's sole basis for this claim is the contention that the additional tax liabilities relating to the Ozias payments were not justified.
719. State responsibility is not triggered, and thus no compensation is required, where economic injury results from a *bona fide* non-discriminatory regulation that falls within the police power of the State (see above, ¶663). Thus, Romania is not responsible for loss of property or for other economic disadvantage resulting from *bona fide* general taxation.
720. Moreover, Respondent denies Claimant's allegation that this tax dispute "*impair[ed] the company's management, by discouraging the use of good management*" and prevented him from trying "*to optimize the course of [the company's] business related to the investment*" (Claimant's Memorial, ¶202). Indeed, Claimant bears the burden to establish the alleged injury, its extent, and its cause. He has failed to do so.

721. Indeed, Respondent submits that the premise of Claimant's argument is seriously flawed as a matter of basic logic. An increase in the income of Continent SA during 2002 and 2003 could have resulted from any number of factors having nothing to do with any services allegedly provided by Ozias.

**B. There are reasonable grounds to question the legitimacy of the claimed consulting fees**

722. Respondent points out that the Tax Agency specifically requested documentation that Ozias did, in fact, render services to Continent SA, and the company provided none. That failure raises a reasonable doubt as to whether such work was ever performed. Claimant similarly provides no such documentation in support of his claim here.

1. The absence of an arm's-length agreement raises reasonable doubts as to whether any services were ever provided

723. Respondent points out that Claimant used his control as majority owner of both Continent SA and Ozias to commit one Roussalis company to pay another Roussalis company substantial sums for alleged consulting services under circumstances where neither entity has provided any evidence that such services were, in fact, rendered. Respondent submits that the contracts were a scam designed to repatriate a portion of Continent SA's profits as purported consulting fees, whilst claiming a bogus tax deduction for doing so.

2. The contracts raise serious questions that have not been answered

724. First, Ozias's articles of incorporation state that its "*exclusive object*" was to "*own, operate and manage Greek merchant and fishing ships.*" This raises a reasonable question about Ozias's qualifications to render consulting services.

725. Second, Ozias is a company in dissolution, which raises questions as to the *bona fide* purpose of the Ozias contracts and the tax deductibility of payments made under them.

726. Finally, Respondent notes the dubious potential benefit of management consultancy services to Continent SA's *refrigerated warehouse*. Whilst the contracts contemplated that the consultants would travel to Romania at Continent SA's expense, in order "to provide information" and "facilitate new agreements," Ozias never invoiced Continent SA for a single trip. These anomalies give rise to reasonable doubts as to whether the services were rendered.

727. Similarly, the fact that the FSD suspended Continent SA's permit for operating a refrigerated warehouse for failing to implement the modernization plan submitted by the company raises reasonable doubts over whether Ozias ever provided services under the contract for technical services. From May 2006 to November 2006, Continent SA paid Ozias EUR 36,000 per month, a total of EUR 216,000 (Respondent's Exhibit n°169). During that same period, it failed to complete a single improvement required by the modernization plan.

728. To prevail on this claim, Claimant has the burden of producing sufficient evidence for the Tribunal to find that the Tax Agency's denial of Continent SA's tax deduction for lack of documentation is impossible to excuse or justify under any circumstances. Claimant has come nowhere close to meeting this burden.
729. Respondent submits that there were several grounds for questioning the propriety of the tax deductions (see above, ¶¶723 to 727). Moreover, the failure to produce any documentation evidencing that services were rendered by Ozias would itself justify denial of the tax deduction under the documentation requirement of Article 9(7) of Law 414/2002. Indeed, the Romanian Supreme Court gave a definitive ruling on the documentation required to obtain a profit tax deduction for consulting services. In a decision denying profit tax deductions for consulting services, the Supreme Court required proof that consulting services were actually rendered (Decision 248/2006).

**C. Claimant's complaint about the Tax Agency's inconsistent positions is baseless**

730. The profit tax and VAT are governed by different provisions of Romanian tax legislation.
731. VAT is incurred by a company headquartered in Romania that engages consulting services from companies headquartered outside Romania (Chivu Decl. ¶5.4.3.). The applicable law required Continent SA to pay the VAT on those fees within seven days of receiving the invoice from Ozias for the period up until June 2002, and immediately upon receipt of the invoice for the period beginning June 2002. Because the company failed to pay the required VAT, the Tax Agency thus assessed liability for the unpaid VAT and related interest and penalties.
732. Respondent points out that the deductibility of the consulting fees for profit tax depends upon the required documentation. A failure to document the expenses merely disqualifies the taxpayer from claiming a profit tax deduction.
733. Accordingly, contrary to Claimant's allegations, there is no inconsistency in the Tax Agency's position. Continent SA had every opportunity to present documentation that consulting services were rendered by Ozias. Moreover, by receiving Ozias invoices, Continent SA itself showed that it was liable for the VAT. The position of the Tax Agency is grounded in the relevant provisions of the tax legislation and is entirely reasonable.

**§ 3. DAMAGES**

734. Claimant bears the burden of establishing the alleged injury, its extent, and its cause. It has failed to meet this burden.

**A. Continent SA has not paid the assessed tax liability and there is no evidence to prove that this issue affected Continent SA’s reputation, business planning, management, or employee morale**

735. Respondent denies Claimant’s allegation that it should be awarded moral damages because the reputation of Continent SA was affected and because there was uncertainty and unspecified “anomalies” in administering the company (Claimant’s Memorial, ¶207).
736. Claimant boasts that Continent SA enjoyed a “spectacular increase in income” during the very period when this dispute arose (Claimant’s Memorial ¶204). Moreover, as of this date, Continent SA has not paid any part of the tax liability for Continent SA’s payments to Ozias. Until Continent SA is required to pay the assessed tax liability, it has not suffered any injury. Furthermore, Continent SA and Claimant have appealed the ruling of the Criminal Court which held Continent SA liable for the tax liabilities related to the Ozias contracts. The appeal remains pending. It is thus premature to put these issues before the Tribunal.

**B. The USD 1 million sought by Claimant does not qualify as compensable moral damages**

Respondent reiterates that moral damages are not available for alleged investment treaty violations except in the most extreme circumstances, which are not present here (see above, ¶¶294 *et seq.*). Claimant’s allegation of reputational harm certainly does not rise to such a level. Moreover, Claimant failed to offer any proof in support of the amount of moral damages he claims. Indeed, the moral damages claim is duplicative of Claimant’s Fiscal Claim, in which he seeks damages based on the amount of the tax liabilities assessed, including the liabilities related to the Ozias payments.

**SUB-SECTION III. DECISION OF THE TRIBUNAL**

**§1. JURISDICTION OVER THE OZIAS TAX CLAIM**

737. Respondent argues that ICSID tribunals have no jurisdiction to resolve tax disputes between Continent SA and the Romanian Tax Agency. It submits that tax disputes do not come within the jurisdictional scope of the BIT, particularly where Claimant has not alleged that Continent SA was somehow treated discriminatorily or differently from other similarly-situated corporate taxpayers with respect to the application of the relevant tax laws.
738. On the other hand, Claimant submits that the Tax Agency’s decisions were abusive and unjustified and prevented a good management of Continent SA, therefore arguably having an adverse impact on the investment in violation of Article 2(2) of the Treaty.
739. In line with the reasoning set out above regarding the Fiscal Measures Claim (see above, ¶¶489 to 492), the Tribunal considers that, among the matters falling within the scope of its jurisdiction are general measures taken by the host State in the exercise of its public powers, including decisions taken by tax authorities which allegedly affected the investment in violation of the BIT.

740. On the basis of the foregoing reasoning, the Tribunal decides that it has jurisdiction to rule on Claimant's Ozias Tax Claim.

## §2. MERITS

741. In its Ozias Tax Claim, Claimant contends that Romania has violated Article 2(2) of the Treaty, by taking unjustified measures.

742. Having reviewed the evidence and reasons that the Tax Agency invoked in support of its decision regarding the Ozias issue in its December 17, 2003 tax audit report, the Tribunal is of the view that the Tax Agency had legitimate concerns about the fulfillment of Claimant's tax obligations. The initiation and the conduct of the audit were plainly justified and consistent with the existing law.

743. Claimant did not rebut Respondent's submissions that Continent SA advanced to Ozias approximately USD 1.37 million for the purchase of various refrigeration and construction products which were never delivered to Continent SA or proved to be purchased, that Continent SA made payment to Ozias in excess of USD 1.5 million for alleged consultancy services, that Continent SA never substantiated that any consulting services were provided by Ozias, that Ozias exclusive function was to operate merchant and fishing ships, not to provide management consulting services and finally that Ozias was dissolved in 2005, as proven by the certificate presented during the hearing.

744. Claimant did not prove its allegations that "*the Greek family employed Greek people pursuant to those management consultants to perform management services up until the time that the Claimant was forced to leave the country*" (Transcript, day 3, p. 79, lines 11-16), that the contracts were concluded because "*the foreign workers that are all named in there wanted to be paid in their own country*" (idem, p. 87, lines 23-25) and that under these contracts, "*the foreign workers were installing the marble and the flooring*" (idem, p. 86, lines 16-17). Respondent has also rightly observed that if the Ozias' "consultants" were merely foreign workers who were paid in Greece for installing marble at Continent SA, that would support the Tax Agency's denial of tax deductions for alleged management consulting services and although the record shows that Claimant left Romania of his own initiative on March 9, 2003, the transfer of money from Continent SA to Ozias for alleged consulting services continued for many years after Claimant left Romania.

745. In light of the foregoing, the Tribunal decides that the State's actions invoked by Claimant under the Ozias Tax Claim did not breach Article 2(2) of the Treaty.

## OVERALL CONCLUSION

746. After its analysis of each individual claim made by Claimant, the Arbitral Tribunal has reached the conclusion that they were unfounded. The Tribunal further considers that even taken collectively, the actions of Respondent do not amount to violations of Articles 4(1) and 2(2) of the BIT. Claimant's claims are therefore dismissed.

## CHAPTER V. THE RESPONDENT'S COUNTERCLAIM

### SECTION I. RESPONDENT'S POSITION ON ITS COUNTERCLAIM

#### I. THE COUNTERCLAIM

747. Respondent, on behalf of AVAS, asserts counterclaims against Claimant and his companies, Continent SRL and Continent SA, arising out of the failure of Claimant and Continent SRL to make the USD 1.4 million investment on which Claimant bases his Investment Claim.

#### A. Counterclaim against Claimant

748. Claimant controls Continent SRL directly, as its sole shareholder and director, and Continent SA indirectly, through Continent SRL's majority shareholding interest in Continent SA. The claims made by Roussalis, who purportedly seeks compensation for damages sustained by these two corporations, thus stem from his controlling shareholding interest in both companies. By asserting claims as investor for these companies, Claimant implicitly admits that he is the *alter ego* of Continent SRL and Continent SA.

749. Accordingly, Respondent seeks an order directing him, as *alter ego* and controlling shareholder, to take such steps as may be necessary for Continent SRL to transfer the shares of Continent SA to AVAS pursuant to the contractual pledge of those shares. The counterclaim also seeks to hold Roussalis jointly and severally liable with Continent SRL for any damages awarded to Respondent by the Tribunal for his looting of funds from Continent SA.

750. In this regard, Respondent contests Claimant's arguments that he was not himself a party to the Privatization Agreement and therefore cannot be held accountable for the breach of that agreement by Continent SRL. Indeed, Claimant's complete control over the day-to-day operations of Continent SA and Continent SRL warrant treating Claimant and his two companies as one and the same for the purposes of Respondent's counterclaims. Respondent points out that Claimant is the sole shareholder and director of Continent SRL, the majority shareholder (96.52 percent) of Continent SA. He signed the Privatization Agreement on behalf of Continent SRL and is the ultimate beneficiary of the privatization transaction. He is also the sole authorized signatory for the companies. Roussalis also abused the corporate form, and used more than USD 5 million of the company's assets as his own personal assets. Accordingly, those companies are his *alter ego*.

751. Claimant's control over Continent SRL and Continent SA is extensive enough to permit Romanian courts to pierce the corporate veil and hold Claimant accountable for the misappropriation of their assets. According to Romanian legal doctrine, a director or shareholder is deemed the *alter ego* of his company when "*there is confusion between the patrimonies of the company and its owner ... resulting from the use of the company's assets for the owner's personal benefit*" (Florentin Tuca, *Revista de Drept Comercial*, Volume 6, No. 10, 112, 1996, at 115).

## **B. Counterclaim against Continent SRL**

752. The counterclaim against Continent SRL seeks to enforce the contractual pledge over the 372,523 shares acquired by Continent SRL pursuant to the Privatization Agreement. In its Rejoinder, Respondent amended its counterclaims to assert alternative claims for monetary damages in lieu of obtaining the original shares sold by AVAS to Continent SRL, and in connection with the additional shares issued by Continent SA to Continent SRL.
753. The central factual issue related to this counterclaim is whether Continent SRL failed to invest USD 1.4 million in Continent SA.
754. In addition, Respondent seeks an order from the Tribunal requiring Continent SRL to pay damages in a sum representing the value of all funds and assets of Continent SA that were misappropriated by Continent SRL and/or Claimant after privatization. Respondent seeks to hold Continent SRL jointly and severally liable for such damages with Claimant.

## **C. Counterclaim against Continent SA**

755. Respondent's next counterclaim seeks to obtain a declaration that the resolution to increase the share capital that was approved by Continent SA's shareholders in December 2000 was groundless.
756. AVAS filed an "absolute nullity" claim in the Romanian courts in August 2007 to annul the increase in share capital. The share capital increase was based on the purported investment of over USD 1.4 million by Continent SRL in Continent SA. However, that investment was not made and the December 2000 resolution to increase share capital by the shareholders of Continent SA was based on unreliable and intentionally misleading information. AVAS's pending claim against Continent SA in the Romanian courts is premised in significant part on this factual contention.
757. Given that its annulment claim is inextricably intertwined with Claimant's Investment Claim, AVAS has agreed to seek a suspension of proceedings before the Romanian court. This counterclaim is intended to avoid inconsistent rulings on common issues of fact raised by Claimant and by AVAS in these parallel proceedings.

## **II. JURISDICTION**

### **A. The Tribunal has jurisdiction to decide Respondent's Counterclaim**

#### **1. In General**

758. Article 46 of the ICSID Convention states: "[e]xcept as the parties otherwise agree, the Tribunal **shall, if requested by a party, determine any ... counter-claims arising directly out of the subject-matter of the dispute provided that they are within the scope of the consent of the parties and are otherwise within the jurisdiction of the Centre**" (emphasis added). According to Respondent, the Convention thus guarantees Romania's right to arbitrate a closely related counterclaim. Indeed, once an investment dispute is submitted

to ICSID, Article 9(4) of the BIT requires that all aspects of the dispute be decided in accordance “*with the provisions of this Agreement [BIT] and the applicable rules and principles of international law.*” The applicable rules and principles of international law necessarily include the Convention in its entirety, including Article 46, which governs relations between Romania and Greece and their respective nationals with respect to BIT arbitrations.

759. Under Rule 40(1) of the ICSID Arbitration Rules, “*a party may present... [a] counter-claim arising directly out of the subject matter of the dispute, provided [it] is within the scope of the consent of the parties and is otherwise within the jurisdiction of the Centre.*” Because there is no explicit exclusion of counterclaims in the Treaty, Claimant has failed to establish that Respondent is precluded from asserting a counterclaim. Indeed, contrary to Claimant’s argument, there is no ICSID precedent requiring an explicit *authorization* in the BIT as a precondition for asserting a counterclaim.
760. The Tribunal has *subject matter jurisdiction* over Respondent’s counterclaims. Indeed, each counterclaim is a dispute that centers on whether Claimant, as investor acting through Continent SRL, made a USD 1.4 million investment in Continent SA in accordance with the Privatization Agreement. Because that investment was not made, the counterclaims are presented here to protect and enforce the State’s rights under the Privatization Agreement to enforce its lien and recover the shares pledged by Continent SRL to secure performance of its investment obligation. Moreover, presenting these counterclaims here advances the goals of economy and efficiency in international dispute resolution because they will resolve disputes that need not be relitigated in the Romanian courts.
761. Under Article 25(1) of the ICSID Convention, the Tribunal has jurisdiction over “*any legal dispute arising directly out of an investment*” between an investor and a signatory State. These counterclaims satisfy this jurisdictional prerequisite. Indeed, the claims and counterclaims turn on the same factual question and arise out of the investment obligation of the privatization contract.
762. Furthermore, the counterclaims are arbitrable under Article 9(1) of the Treaty, which authorizes arbitration of disputes “*in relation to an investment.*” The factual dispute concerning the investment obligation is the focal point of Claimant’s Investment Claim and Romania’s counterclaims. Indeed, the term “investment” is defined expressly in the Treaty as including, among other things, “*shares in and stock and debentures of a company and any other form of participation in a company*” (Treaty, Art. 1(b)). That definition covers the shares acquired by Claimant through Continent SRL in the Privatization Agreement and the additional shares created as a result of the shareholders’ resolution approved on December 15, 2000.
763. Under Rule 40(2) of the ICSID Arbitration Rules, counterclaims are timely if they are filed no later than the filing of the counter-memorial. Respondent duly filed its counterclaims as part of its Counter-Memorial.



764. The Tribunal also has jurisdiction *ratione personae* under the Treaty to adjudicate counterclaims against Continent SRL and Continent SA.
765. Respondent submits that Article 9 of the Treaty encompasses disputes “*in relation to an investment*” which includes Claimant’s locally incorporated companies. For that reason, and regardless of the Romanian nationality of Continent SRL and Continent SA, claims against these entities fall within the scope of disputes contemplated in Article 9 of the Treaty and are therefore subject to the Tribunal’s jurisdiction.
766. Indeed, first, these two companies together comprise the “investment” Claimant has made and his claims seek compensation for alleged damages to his investment. In that sense, the corporate entities are interested parties in this case because the actions Claimant complains about were, with the exception of the Interdiction Claim, allegedly taken against these companies alone. Under these circumstances, it is entirely reasonable to expect that Continent SRL and Continent SA should answer for any unlawful actions they took with respect to the investment obligation. Respondent contends that the companies took such action at the direction of Roussalis.
767. Second, there would neither be any added burden on the Tribunal nor any inequity to the parties for the Tribunal to render an award enforcing the share pledge and declaring the shareholders resolution to be ungrounded if it were to conclude that the required investment was not made by Continent SRL.
768. If the companies are not impleaded, an award in favor of Respondent on counterclaims brought against Roussalis alone, as *alter ego*, could prove extremely difficult, if not impossible, to enforce. He could interfere with enforcement of any award against him alone by using his control over Continent SRL and Continent SA to ignore or refuse to carry out any directives issued by the Tribunal. It would force Respondent to bring enforcement proceedings against Roussalis in Greece or wherever he may be found.
769. Furthermore, such enforcement would be far more complicated and more costly than executing a money award. Impleading these corporations will greatly simplify enforcement of the Tribunal’s award, as they are Romanian companies subject to the jurisdiction of the Romanian courts.
770. Respondent points out that, in *Klöckner v. Republic of Cameroon*, ICSID Case No. ARB/81/2, an ICSID tribunal was faced with a similar request to implead a corporation through which the investor made an investment. Noting that Cameroon had negotiated the investment agreement with the foreign investor, but had formally signed the agreement only with the local subsidiary, the tribunal concluded that the case presented “*an indivisible whole*” and thus that it had jurisdiction *ratione personae* to rule on the counterclaim against both the investor and its local subsidiary.
771. In sum, Respondent’s counterclaims against Continent SRL and Continent SA are within the Tribunal’s jurisdiction. Claimant used Continent SRL and Continent SA as local investment vehicles. His dominant share ownership and actual control of those companies

constitute investment under Article 1(1) of the Treaty. These investments thus fall within the dispute resolution provisions of the Treaty and the Tribunal's jurisdiction.

772. In addition, the fact that Continent SRL and Continent SA are Claimant's *alter egos* provides an additional basis for asserting jurisdiction over the counterclaims against the companies. Since the Tribunal clearly has jurisdiction over the counterclaims asserted against Mr. Roussalis, it also has jurisdiction over the counterclaims against his corporate *alter egos*.

2. The Counterclaim's contractual basis does not negate the Tribunal's jurisdiction to decide this closely related counterclaim

773. Romania's counterclaim arises directly out of the subject matter of the dispute addressed in Claimant's claim. This condition means that "*the factual connection between the original and ancillary claim is so close as to require the adjudication of the latter in order to achieve the final settlement of the dispute, the object being to dispose of all grounds of dispute arising out of the same subject matter*" (Note B(a) to ICSID Rule 40, 1 ICSID Reports 100).
774. As the tribunal held in *Klöckner v. Cameroon (op.cit.)*, this jurisdictional requirement is met, and a counterclaim is admissible, where it forms "*an indivisible whole*" with the primary claim asserted by the claimant, invoking substantive obligations undertaken for "*the accomplishment of a single goal, [so as to be] interdependent.*" That is the case here. Claimant's Investment Claim and Romania's counterclaim both arise out of Claimant's post-privatization obligations under the Share Purchase Agreement. Both require the Tribunal to answer the same questions: did AVAS properly conclude that Claimant failed to make the post-privatization investment? Is Romania entitled to enforce the share pledge against Claimant and Continent SRL? That close factual connection gives rise to a presumption of admissibility of Romania's counterclaim.

**B. Claimant consented to arbitrate Respondent's Counterclaim**

775. Contrary to Claimant's contention, he has consented to the arbitration of Romania's counterclaims in this case. When Claimant resorted to ICSID arbitration for the settlement of his claims, he agreed to settle *all disputes* relating to Claimant's investment, including Respondent's counterclaims. Indeed, by submitting his claim to ICSID he accepted Romania's offer to arbitrate contained in the BIT in accordance with the ICSID Convention and Rules, which carries with it the possibility that he would be required to arbitrate the closely related counterclaims.
776. Claimant's written consent to arbitrate the share pledge claim initially was manifested in the "cooling off" letter he sent to Romania on December 9, 2003 as a predicate to commencing this arbitration. The letter states: "*Furthermore, the assertion of a counterclaim pursuant to Article 46 is fully consistent with Romania's BIT obligations. APAPS' [AVAS's] actions for the execution of the security [...] motivated by the nonaccomplishment by the undersigned's assumed obligations as a foreign investor [...] represented a dispute in relation to the investment, as it is stipulated by the [...] [BIT].*"

*The undersigned, taking into consideration the provisions of the Agreement, I don't understand to submit the dispute towards settlement to the Romanian legal courts and [...] I consider that the provisions of art. 9(1) from the Agreement have not been observed by APAPS" (sic., Claimant's Exhibit n°3). Shortly before ICSID registered his Request for Arbitration, Claimant represented to the Romanian court in the share pledge litigation that Article 9 of the Treaty required AVAS's share pledge enforcement action to be decided at ICSID (Claimant's Exhibit n°26). These submissions should be deemed as Claimant's consent to arbitrate Respondent's counterclaims.*

777. Similarly, Claimant's Request for Arbitration states: "*The dispute between the undersigned, as the sole associate of SC Continent Marine Enterprise Import Export SRL and the Romanian State, having as scope APAPS [AVAS]'s action to execute the security formed by those 372,523 shares, owned by SC Continent Marine Enterprise SA [...] belongs to the settlement competence, by arbitration, to the International Centre for Settlement of Investments Disputes" (Claimant's request, p. 8).*
778. According to Respondent, Claimant's assertions to the Romanian courts that they should dismiss the State's share pledge enforcement action in favor of resolving that claim before ICSID constitute unambiguous consent to arbitrate the State's claim for relief in this arbitration. Indeed, in 2004, Claimant submitted to the Romanian court in which the share pledge enforcement action was pending a statement contesting the court's jurisdiction on the ground that the dispute must be resolved in arbitration at ICSID (Respondent's Exhibit n°207).
779. Moreover, after urging that Respondent terminate the two cases pending before the Romanian court and rely instead on ICSID to resolve the share pledge and nullification disputes, Claimant cannot dispute that he has consented to arbitration of the disputes in question.
780. As the tribunal in *SGS v. Pakistan (op.cit.)* concluded: "[i]t would be inequitable if, by reason of the invocation of ICSID jurisdiction, the Claimant could on the one hand elevate its side of the dispute to international adjudication and, on the other, preclude the Respondent from pursuing its own claim for damages by obtaining a stay of those proceedings for the pendency of international proceedings, if such international proceedings could not encompass the Respondent's claim."

**C. The Tribunal has jurisdiction over Respondent's Counterclaim by virtue of the umbrella clause in Article 2(6) of the Treaty**

781. Applying the umbrella clause in Article 2(6) of the Treaty, the Tribunal has jurisdiction over Claimant's Investment Claim, as well as Respondent's counterclaims, without regard for the dispute resolution clause in the Privatization Agreement. Article 2(6) of the Treaty provides that "[e]ach Contracting Party shall observe any other obligation it may have entered into with regard to investments of investors of the Contracting Party". Thus, the contractual obligations under the Privatization Agreement become arbitrable before ICSID by operation of the umbrella clause.

782. In *Noble Ventures, Inc. v. Romania* (*op.cit*), the tribunal interpreted a virtually identical umbrella clause in the U.S.-Romania BIT. The issue was whether the tribunal had jurisdiction over a dispute arising under a very similar Privatization Agreement. The tribunal decided that the claimant's breach of contract claim "*constitutes a [claim of] breach of the BIT.*" Similarly, the tribunal in *Eureko v. Poland (Ad Hoc Partial Award*, August 19, 2005) interpreted the Netherlands-Poland BIT with an almost identical umbrella clause, and extended its jurisdiction over a contractual claim.

**D. Romania is under no obligation to exhaust local remedies before submitting its Counterclaim**

783. Article 26 clearly states that "[a] *Contracting State may* require the exhaustion of local administrative or judicial remedies as a condition of its consent to arbitration under this Convention" (emphasis added). The fact is that under Article 26 Romania *may* require exhaustion of local remedies. A Contracting State must actually include in its BIT an explicit provision requiring exhaustion of local remedies in order for exhaustion to become a condition precedent to the exercise of ICSID jurisdiction over investor-state claims. Romania has not done so.
784. Respondent further contends that, since Article 26(2) does not require Roussalis to exhaust local remedies, he has no basis for insisting that Romania exhaust its local remedies before asserting its counterclaims.

**E. Romania's claim for losses incurred in the period from November 1998 to December 1999 is not time-barred**

785. During the period from November 1998 to December 1999, Continent SRL used warehouse space rent-free, which resulted in an estimated USD 900,000 in lost revenues for Continent SA. Respondent's damages claim includes that USD 900,000.
786. Respondent denies Claimant's allegation that Romanian Decree n°167/1958 bars Romania's claim for the above losses incurred in the period from November 1998 to December 1999. According to Respondent, the Tribunal is not constrained by municipal statutes of limitations.
787. In *Wena Hotels Limited v. Arab Republic of Egypt* (ICSID Case No. ARB/94/4), the ICSID tribunal held that: "*municipal statutes of limitation do not necessarily bind a claim for a violation of an international treaty before an international tribunal.*" Indeed, international tribunals may consider equitable principles of prescription. Applying equitable principles of prescription to the facts of the *Wena* case, the tribunal concluded that there was no reason to deny a claim on limitations grounds where Egypt had ample notice of Wena's claims and where neither party appeared to be substantially harmed in its ability to bring its case at ICSID.
788. According to Respondent, equitable principles militate in favor of rejecting Claimant's statute of limitations defense. By invoking the Tribunal's jurisdiction to evaluate the relevant facts from the period 1999-2001 for his Investment Claim, Claimant cannot fairly rely on a domestic statute of limitations to avoid the adjudication of a counterclaim

based on the same or related facts from the same time period. Claimant has had ample opportunity to respond to the counterclaims and has pointed to no prejudice he has suffered as a result of the counterclaims being asserted against him. Moreover, Claimant has been litigating with AVAS over the same issues in the share pledge litigation since AVAS commenced suit in 2001. By commencing this arbitration, Claimant accepted the Tribunal's authority to resolve all claims and counterclaims involving the same underlying facts, whether or not they would be time-barred in a Romanian court.

789. Moreover, Article 41(2) of the Romanian Criminal Code provides that “*an offence is continuing when a person commits such offence at different times, but on the basis of the same resolution, acts or omissions, each of them presenting the content of the same criminal offence.*” Accordingly, even if the 3-years statute of limitations were applicable, Claimant's misappropriation of funds from Continent SA is a continuing act that began in 1998 and continues to the present day. Therefore, the three-year statute of limitations has not even started to run.

#### **F. Romania was not required to annul the Ozias contracts before filing its Counterclaim**

790. Finally, Respondent refutes Claimant's contention that Romania's counterclaim for damages arising out of the consulting contracts concluded between Continent SA and Ozias Marine is inadmissible because Romania failed to seek the prior annulment of those contracts.
791. Romania's counterclaim for damages is a tort claim. There is no requirement under the ICSID Convention or Romanian law that would require Romania to nullify the consultancy contracts (to which Romania is not even a party) as a precondition to advancing a tort claim flowing from the sham nature of those consultancy contracts.

### **III. BASIS OF COUNTERCLAIMS**

#### **A. Enforcement of Share pledge against Continent SRL and damages for misappropriated funds**

792. As demonstrated above (see ¶¶174-203), Continent SRL failed to invest USD 1.4 million in Continent SA during the period from January 1, 1999 to December 31, 2000.
793. Under Article 8.10.3 of the Privatization Agreement, Continent SRL agreed (a) to grant and register a pledge of the 372,523 shares acquired by Continent SRL, and (b) that “*in case [Continent SRL] does not fulfill its obligations stipulated at Article 8.10.1 and 8.10.2, then [AVAS] will execute the pledge over the shares*” (emphasis added). Therefore, if the Tribunal finds that the required investment was not made by Continent SRL in accordance with the Privatization Agreement, it should enforce the share pledge and order Claimant and Continent SRL to cause the 372,523 shares obtained pursuant to the contract to be pledged and transferred to AVAS, as contemplated by Article 8.10.3(e).
794. This counterclaim also seeks damages against Continent SRL for funds misappropriated from Continent SA after privatization:

- Continent SRL exerted control over Continent SA by allowing Continent SRL to use a space rent-free, costing Continent SA an estimated USD 900,000 in lost revenues from November 1998 through December 1999 (see above, ¶¶199 *et seq.*).
- Continent SRL caused Continent SA to expend considerable resources to convert buildings located at 1 Razoare Street into a personal residence for Roussalis (see above, ¶174). Roussalis did not reimburse Continent SA for these personal expenses.
- Roussalis, through his group of companies, inflated the cost of various capital items allegedly purchased as part of the investment obligation by directing his companies to issue invoices to Continent SA for the items with a substantial mark-up in price (see above, ¶¶189 *et seq.*).
- Payments of USD 696,000 and EUR 216,000 were made by Continent SA to a Roussalis-owned company (Ozias), for purported consulting services that were, in fact, never rendered. This represents a significant drain of resources from Continent SA directly to Roussalis and his son, the co-owners of Ozias (see above, ¶704 *et seq.*).

795. In this regard, Respondent requested that the Tribunal bifurcate proceedings on this claim, so that the quantum of damages can be determined in separate proceedings to be conducted after liability for misappropriation of funds has been established.

796. Respondent's counterclaim for damages owed as a result of the misappropriated funds is grounded in Articles 998-999 of the Romanian Civil Code, which lay down the principle of civil tort liability:

- Art. 998: *"Any deed of a person, which causes to another person a loss, obliges the person due to whose fault the loss was occasioned to repair such loss"*.
- Art. 999: *"The person is liable not only for the loss caused by his own deed, but also for the loss caused by his negligence or imprudence" ..*

797. Respondent asserts that Romania has standing to submit its Counterclaim under Articles 998 and 999 because the Romanian state has been harmed by Roussalis's failure to honor his obligations under the Privatization Agreement. If the Tribunal holds that it has jurisdiction to decide the Counterclaim, and that Roussalis, and his two companies, are liable, then the Tribunal should award an appropriate remedy to Romania, which may be entitled to receive an award of monetary damages.

798. Moreover, Article 272 of Romania's Law 31/1990 on commercial companies provides that: *"[i]t is punished with imprisonment from one to three years the shareholder, director, officer or legal representative of the company who: [...] 2. uses, with bad faith, the assets or the credit standing of the company for a purpose contrary to the company's interests or to its own benefit or to favor another company in which he holds directly or indirectly a stake."*

799. Finally, pursuant to Article 1003 of the Romanian Civil Code, “*when the civil delict [...] is imputable to more than one person, such persons are jointly and severally liable for damages*”. Consequently, Claimant and Continent SRL must be held jointly and severally liable for the damages incurred by AVAS, acting on behalf of Romania, due to the misappropriation of the corporate funds following the privatization of Continent SA.
800. Under the relevant provisions of Romanian law, AVAS has a duty to conduct privatization processes in accordance with sound commercial principles and to take reasonable steps to enhance the value of companies being privatized. This duty is central to the mission of AVAS to make former state enterprises attractive to private investors and thus achieve the highest market prices for privatized companies, in accordance with Article 43 of the Government Ordinance 88/1997 regarding the privatization of commercial companies. Respondent submits that the market value for Continent SA has been adversely affected by misappropriation and self-dealing on the part of Claimant and Continent SRL. Therefore Romania is entitled to recover as damages all amounts they improperly took from Continent SA following the privatization sale.

#### **B. Declaration that the shareholders’ resolution is not properly grounded**

801. Respondent submits that the Expert Project report is unreliable and failed to establish that Continent SRL made the investment required under the Privatization Agreement. Therefore, Respondent asks the Tribunal to declare, as part of the Award, that the shareholders’ resolution was groundless.

#### **C. Counterclaim against Claimant for each of these foregoing claims**

802. The claims against Roussalis are the same as set forth above against Continent SRL for damages and enforcement of the share pledge, and against Continent SA for a declaration concerning the ungrounded resolution of the shareholders in approving the share capital increase. Respondent requests that the Tribunal direct Claimant to pay any damages that may be awarded and to cause Continent SRL to transfer the shares acquired pursuant to the Privatization Agreement to AVAS, thereby enforcing the share pledge, as the contract contemplates, for the breach of the investment obligation.
803. If the Tribunal grants any relief sought in the counterclaims against Continent SRL and Continent SA, the same relief should be granted, jointly and severally, against Roussalis. According to Respondent, he was the mastermind of the unlawful schemes and should therefore be held accountable by the Tribunal.

#### **D. Amendment of Respondent’s Counterclaim**

804. In its Rejoinder, Respondent amended its Counterclaim. The amendment is based on the same facts as those alleged in support of the Counterclaim as originally filed. The amendment revises the Request For Relief to include, as additional and/or alternative relief, a request (1) that the Tribunal hold Roussalis and Continent SRL jointly and severally liable to pay money damages for the value of the 372,523 shares in Continent SA, originally sold by AVAS to Roussalis in 1999; and (2) that the Tribunal hold Roussalis and Continent SRL jointly and severally liable to pay money damages to the

value of the additional 1,414,648 shares issued to Continent SRL resulting from the share capital increase, but provide that the award of such damages will be deemed satisfied by cancellation of the registration of those shares with the Trade Registry immediately following the Tribunal's final Award; and (3) that the Tribunal hold that Respondent is entitled to an award of compound interest on all the damages awarded to Romania, to be calculated in accordance with applicable ICSID precedent, which will be addressed by the parties during the damages phase of the case.

805. Respondent submits that the amendment to the Counterclaim was not untimely and should be allowed because Claimant had sufficient opportunity to respond to the proposed amendment in his Rejoinder, and will again have it again during the damages phase of the proceedings. In *Atlantic Triton v. Guinea* (Award of April 21, 1986, 3 ICSID Rep. 18), Guinea added additional elements to its counterclaims in its rejoinder. Since Guinea's Rejoinder was the last scheduled submission in the written procedure, the ICSID tribunal in that case permitted Atlantic Triton to file its own rejoinder on the counterclaims to address Guinea's added points.

#### **IV. Request for Relief**

806. In its Counter-Memorial, Respondent requested that the Tribunal:
- (1) *declare that Continent SRL failed to fulfill its investment obligation and is therefore in breach of the Privatization Agreement;*
  - (2) *order Continent SRL to transfer, and Claimant to cause Continent SRL to transfer, to AVAS the shares in Continent SA purchased under the Privatization Agreement (372,523 shares numbered from 1 to 372,523);*
  - (3) *order Claimant and Continent SRL, jointly and severally, to pay damages, to be assessed after liability is determined, in a sum representing the value of all funds misappropriated from Continent SA after privatization; and*
  - (4) *declare that the resolution of the Continent SA shareholders on December 15, 2000 to increase the share capital was ungrounded.*
807. In its Rejoinder, Respondent has requested that the Tribunal:
- (1) *declare that Claimant Roussalis and/or Continent SRL failed to fulfill the postprivatization obligation to invest USD \$1.4 million in Continent SA and that they are therefore in breach of the Privatization Agreement;*
  - (2) *order Claimant Roussalis and Continent SRL, jointly and severally, to pay money damages to Romania equal to the value of the 372,523 shares in Continent SA numbered from 1 to 372,523 as of a date determined by the Tribunal in accordance with evidence to be presented during the damages phase of the proceedings on the Counter-Claim; PROVIDED HOWEVER that said award of money damages will be deemed fully satisfied if Claimant Roussalis, immediately upon issuance of the Tribunal's final Award, delivers to Respondent the 372,523 shares in Continent SA numbered from 1 to 372,523 and causes the cancellation of the registration with the*



*Trade Registry of the additional 1,414,648 shares in Continent SA issued to Continent SRL in relation to the shareholders' resolution approving a share capital increase;*

- (3) order Claimant Roussalis and Continent SRL, jointly and severally, to pay damages equal to the amount of all funds determined during the damages phase of the Counter-Claim proceedings to have been misappropriated from Continent SA after the date of Privatization Agreement by Claimant Roussalis and/or Continent SRL and/or other companies owned and controlled by Claimant Roussalis;*
- (4) declare that the resolution of the Continent SA shareholders on December 15, 2000 to increase its share capital was ungrounded and shall be deemed to have no legal effect;*
- (5) order Claimant Roussalis and Continent SRL, jointly and severally, to pay additional money damages to Romania equal to the value of the additional 1,414,648 shares issued to Continent SRL pursuant to the resolution of the Continent SA shareholders on December 15, 2000; PROVIDED HOWEVER that said award of money damages will be deemed fully satisfied if Claimant Roussalis delivers to Romania all of the aforementioned additional shares in Continent SA immediately upon issuance of the Tribunal's final Award;*
- (6) order Claimant Roussalis and Continent SRL, jointly and severally, to pay damages to Respondent Romania for the diminution in the value of the 372,523 shares that are the subject of item 2, above, as a result of misappropriation of assets of Continent SA, or as a result of the dilution of Continent SA's shares by issuing 1,414,648 additional shares to Continent SRL based on fraudulent or insufficient evidence of a corresponding capital contribution;*
- (7) order Claimant Roussalis and Continent SRL, jointly and severally, to pay compound interest on the amounts awarded to Respondent Romania as provided in subparagraphs 2 and 5, above, to be calculated in accordance with recent ICSID decisions.*

808. In its Post Hearing Brief, Respondent formulates its prayer for relief as follows:

*Romania asks that the Tribunal enter an interim award that includes the following elements:*

*From Spyridon Roussalis and Continent SRL:*

- A declaration that Claimant and/or Continent SRL failed to fulfill the obligation to invest USD \$1.4 million in Continent SA and that they are therefore in breach of the Privatization Agreement. Resp. Rej. para. 230(1).*
- An order that Claimant and Continent SRL tender to Romania the privatized shares or pay damages to Romania equal to the value of the originally privatized shares, Resp. Rej. para. 230(2).*
- An order that Claimant and Continent SRL tender the shares issued in connection with the fraudulent share capital increase or pay damages to Romania equal to the value of those shares plus any uncompensated diminution in value to the privatized shares. Resp. Rej. para. 230(5).*

- *An order that Claimant and Continent SRL pay damages to Romania equal to the value of the funds misappropriated by him or on his behalf from Continent SA since the date of the Privatization Agreement. Resp. Rej. para. 230(3).*
- *Pre- and post-award compound interest on the above money damages in accordance with recent ICSID decisions. Resp. Rej. para. 230(7).*

*From Continent SA:*

- *declare that the resolution of the Continent SA shareholders on December 15, 2000 to increase its share capital was ungrounded and shall be deemed to have no legal effect.*

809. Finally, Respondent submits that the Tribunal has discretion pursuant to Article 61(2) of the ICSID Convention to direct the losing party to reimburse the prevailing party for its attorneys' fees and costs. Claimant's institution of this arbitral proceeding has required Romania to incur significant fees and costs to defend claims that are wholly without merit and exceed the jurisdiction of the Tribunal. In particular, Claimant's contention that Continent SRL met its post-privatization investment obligation is not only incorrect, but Claimant also knew it to be incorrect at the time he submitted his claims to ICSID. Further, Claimant knew or should have known at the time he submitted his claims to ICSID that his Food Safety, Interdiction, Fiscal and Ozias claims do not arise out of his investments in Continent SRL and Continent SA and are clearly not within the Tribunal's jurisdiction. Further, he surely knew or should have known, that those claims were utterly without merit.
810. Respondent alleges that Claimant's conduct in this proceeding has exemplified bad faith. Claimant's misconduct has necessitated two requests for provisional measures – both of which were granted by the Tribunal – to stop the sale of Continent SA's assets during the pendency of these proceedings, and to require Respondent to take appropriate steps to obtain a suspension of the parallel proceedings in Romanian courts. In addition, Claimant failed to comply with Respondent's reasonable discovery requests by the agreed deadline.
811. Accordingly, the Tribunal should follow the principle that "costs follow the event," making the losing party bear the costs of the proceeding and reimburse Respondent for its attorneys' fees and expenses related to this case.
812. In conclusion, Respondent requests that *"the Tribunal deny Claimant's claims, rule that it has jurisdiction over Respondent's counter-claims, and hold Claimant, together with its two companies, liable for the counter-claims."*

## SECTION II. CLAIMANT'S POSITION ON RESPONDENT'S COUNTERCLAIM

### I. THE INADMISSIBILITY OF THE COUNTERCLAIM ON JURISDICTIONAL AND PROCEDURAL GROUNDS

#### A. In general

813. Claimant points out that, in order to assert the Tribunal's jurisdiction over the counterclaims, Respondent employed a subterfuge and redefined the investment by breaking it down into two different investments. Respondent admitted that the first one, the purchase of Continent SA's shares, was made but alleged, at the hearing, that the second one, the post purchase investment, was not performed in accordance with the SPA (Transcript, Day 4, pages 124 *et seq.*).
814. According to Claimant, on the one hand, if Respondent chose to contest the investment through the non-performance of the SPA, it should have challenged the overall jurisdiction of the Tribunal and would not therefore have been able to bring a counterclaim. In this regard, the absence of a challenge on jurisdiction by Respondent in this context is an implicit admission that the SPA was duly performed.
815. On the other hand, if Respondent chose to contest only the post purchase investment and not the purchase of Continent SA's shares, then, if Respondent were successful, the Tribunal would only have had jurisdiction over the investment that was not contested. Therefore Respondent's counterclaims should be dismissed. Accordingly, the Tribunal does not have jurisdiction over Respondent's Counterclaim, in any of the above schemes.
816. Claimant refutes Respondent's allegations that its Counterclaim has the same object as the issues raised in Claimant's Request. Indeed, Claimant has brought his case before the Tribunal to address Respondent's breach of Article 4(1) of the Treaty, Article 2(2) part 1 of the Treaty, Article 2(2) part 2 of the Treaty, Article 1 of the First Additional Protocol to the European Convention, and Article 6 of the European Convention. Each of Claimant's subsequent submissions was confined to the analysis of these breaches and the facts that represent these breaches.
817. Claimant submits that ICSID tribunals only have jurisdiction over disputes concerning breaches of bilateral investment treaties. Therefore, Respondent's Counterclaim is made up of claims that must be brought before national courts since they do not relate to Treaty breaches. According to Claimant, Respondent should wait until the Arbitral Tribunal issues an award on Claimant's requests, and subsequently, if Romania is awarded a favorable decision, turn to the national courts.
818. Moreover, Claimant denies that application of the umbrella clause in Article 2(6) of the Treaty defeats Claimant's argument that since the Counterclaim is contractual and arise under the Privatization Agreement, they can only be submitted to national courts. Article 2(6) of the Treaty provides that "[e]ach Contracting Party shall observe any other **obligation** it may have entered into **with regard to investments of investors of the Contracting Party**" (emphasis added). Claimant points out that Article 2(6) "*refers to the liabilities the contracting parties have in relationship with the investors, and it does NOT*

*refer to the rights the contracting parties have in relationship with the investors [sic]*". Accordingly, the umbrella clause can only apply to Claimant's obligations, not to Respondent's rights.

819. *Noble Ventures, Inc. v. Romania*, ICSID Case N°ARB/01/11, involved interpretation of a similar umbrella clause in the U.S.-Romania BIT. The tribunal considered Claimant's contractual obligations and admitted that their breach may constitute a breach of the BIT. Similarly, the tribunal in *Eureko v. Poland (Ad Hoc Partial Award*, August 19, 2005) interpreted the umbrella clause in the Netherlands-Poland BIT, and asserted jurisdiction over a contractual claim, although not over a counterclaim.

### **B. Lack of Claimant's consent**

820. Article 46 of the ICSID Convention provides that: "[e]xcept as the parties otherwise agree, the Tribunal shall, if requested by a party, determine any incidental or additional claims or counterclaims arising directly out of the subject-matter of the dispute provided that they are within the scope of the consent of the parties and are otherwise within the jurisdiction of the Centre". Similarly, Rule 40 of the ICSID Arbitration Rules provides: "[e]xcept as the parties otherwise agree, a party may present an incidental or additional claim or counter-claim arising directly out of the subject-matter of the dispute, provided that such ancillary claim is within the scope of the consent of the parties and is otherwise within the jurisdiction of the Centre."
821. In light of the above, Claimant submits that the respondent in an investment dispute is permitted to submit counterclaims only with the claimant's agreement. However, Claimant did not consent to the arbitration of Romania's Counterclaim in this case, having expressly objected thereto in his Counter-Memorial (*see* Claimant's Counter-Memorial, ¶11).
822. Moreover, Claimant's representation to the Romanian court in the share pledge litigation that AVAS's share pledge enforcement action should be decided at ICSID cannot be construed as an agreement that Respondent may submit counterclaims. Claimant has consistently requested the termination of the domestic litigation, since this dispute, under its investment aspects, was indeed to be settled by the Arbitral Tribunal.
823. In the same vein, Claimant's argumentation developed in its Submission on the Request for Provisional Measures should not be read as an agreement that Respondent submit counterclaims. According to Claimant, Respondent's request that Claimant agree to stay the domestic litigation amounted to a request to forego the application of Article 26 of the ICSID Convention. Indeed, the registration of the ICSID case should have resulted in the termination of the internal procedures and the withdrawal of Respondent's requests before the national courts.
824. In this regard, Respondent cannot rely on the findings of the tribunal in *SGS Société Générale de Surveillance S.A. v. Islamic Republic of Pakistan*, ICSID Case No. ARB/01/13, which states that it is equitable that a respondent be allowed to submit

counterclaims. Indeed, in *SGS v. Pakistan*, the disputed counterclaim could be settled on the basis of the provisions of the relevant bilateral investment treaty.

825. Claimant denies Respondent's allegation that the Tribunal should decide on the counterclaims because it would not make sense to have half of the dispute decided before the Tribunal and half of the dispute decided before the Romanian courts (Transcript, Day 4, p.134 *et seq.*). According to Claimant, there is no general principle of international law that allows a State to appeal against its own courts' rulings under the protection of an investment treaty. The Tribunal lacks the competence to do so under the operation of Article 9 of the Treaty.
826. Moreover, Article 41 of the ICSID Convention compels the Tribunal to determine the extent of its own competence. The determinations of Romanian law that are the object of the counterclaims do not fall within the subject matter jurisdiction of the Tribunal. The Tribunal is not competent to allow a further appeal against the Romanian courts' findings on behalf of the State.

### **C. The Tribunal has no jurisdiction to decide counterclaims against Roussalis**

827. Claimant points out that the Treaty concerns the protection of investments. The Treaty provides obligations owed by its Contracting States to investors and not vice versa. Indeed, the Treaty restricts the possibility of the State to file counterclaims.
828. Under Article 9(1), the jurisdiction of an ICSID tribunal is strictly limited to disputes "*between an investor of a contracting party and **the other** contracting party **concerning an obligation of the latter** under this agreement...*" (emphasis added). Accordingly, the jurisdiction of ICSID tribunals is limited to disputes concerning obligations owed to the investor by the State party.
829. Claimant contends that Romania is not permitted to assert claims against Roussalis because Article 9(2) of the Treaty provides that "*the investor concerned may submit the dispute (...) to international arbitration.*" Accordingly, investment disputes can only be heard by an ICSID tribunal when it is the investor, not the State, who has submitted the dispute. Article 9(3) further provides that only the investor has the power to submit disputes and "*may submit*" them to either an *ad hoc* tribunal established pursuant to the UNCITRAL Rules or to a tribunal established under the auspices of ICSID.
830. Claimant points out that the meaning of "*the dispute*" for the purposes of Article 9 is related to the issue of compliance with the Treaty.
831. According to Claimant, the purpose of the Treaty was clear. Both in the text and the preamble, the aim of the Treaty obligations entered into by the State was set out as to promote and protect in accordance with its terms, the investment of the foreign investor.
832. According to the above provisions, Respondent *can only be sued* before arbitral tribunals for breaches of the obligations it assumes under the Treaty. It *cannot be a claimant* for this kind of claim; otherwise it would "*deny its own sovereignty*" (Claimant's Rejoinder, p.14).

833. Moreover, Claimant submits that Romania is not permitted to assert claims against Roussalis based on actions of Continent SA and Continent SRL. Indeed, Respondent's Counterclaim is related to obligations contained in the Privatization Agreement. However, Claimant is not a party to that contract, only Continent SRL is a party to it.
834. According to Claimant, since Respondent's Counterclaim relates to breaches of Continent SRL's obligations under the Privatization Agreement, they should be resolved before the Romanian courts.

**D. The Tribunal has no jurisdiction to decide counterclaims against Continent SRL and Continent SA**

835. Article 25 of the ICSID Convention provides that : “(1) *The jurisdiction of the Centre shall extend to any legal dispute arising directly out of an investment, between a Contracting State (or any constituent subdivision or agency of a Contracting State designated to the Centre by that State) and a national of another Contracting State, (...)* (2) “*National of another Contracting State*” means: (a) *any natural person who had the nationality of a Contracting State other than the State party to the dispute*” (emphasis added).
836. Accordingly, the Tribunal has no jurisdiction over Continent SRL and Continent SA, as locally incorporated entities. As Romanian companies, they cannot become parties to this arbitration.
837. In this regard, Claimant denies Respondent's contention that jurisdiction over Continent SA and Continent SRL is triggered by the fact that Roussalis must be considered an *alter ego* of the two companies. Indeed, according to Article 1(3) and 1(4) of the Treaty (see above, ¶¶44-45), in this case, the investor must be a Greek person.
838. In addition, Claimant submits that the *Klöckner v. Republic of Cameroon*, ICSID Case No. ARB/81/2, where the tribunal decided that it had jurisdiction to rule on the counterclaim against both the investor and its local subsidiary, cannot presently be invoked since it runs counter the provisions of the Treaty.
839. Moreover, Continent SRL and Continent SA are not claimants in this arbitration. Therefore, counterclaims cannot be submitted against them.

**E. Romania failed to exhaust local remedies before submitting its Counterclaim**

840. Article 26 of the ICSID Convention provides as follows: “*Consent of the parties to arbitration under this Convention shall, unless otherwise stated, be deemed consent to such arbitration to the exclusion of any other remedy. A Contracting State may require the exhaustion of local administrative or judicial remedies as a condition of its consent to arbitration under this Convention.*”
841. Accordingly, Claimant contends that Romania was obliged to exhaust local remedies before submitting its Counterclaim to ICSID arbitration, which it did not do.

842. Claimant refutes Respondent's theory that a Contracting State must include in its BIT an explicit provision requiring exhaustion of local remedies in order for this to be a precondition to ICSID jurisdiction. Claimant's contention is based on the ICSID Convention, ratified by Romania prior to conclusion of the Treaty, without reservation to Article 26.
843. Moreover, Romania's contention that, since Article 26(2) does not require Claimant to exhaust his local remedies as a precondition to ICSID arbitration, he has no basis for insisting that Romania exhaust its local remedies before asserting its Counterclaim, is misconceived. This arbitration was filed because of the unjustified local measures taken by AVAS, not by Claimant. Furthermore, Claimant is not a party and therefore not subject to the ICSID Convention.

#### **F. The Counterclaim is time barred under the Romanian statute of limitations**

844. During the period from November 1998 to December 1999, Continent SRL used warehouse space rent-free, resulting in an estimated USD 900,000 in lost revenues for Continent SA, which Respondent claims as damages.
845. Romanian Decree n°167/1958 provides for a 3-year general prescription for material claims. Accordingly, Claimant contends that Romania's claim for losses incurred in the period from November 1998 to December 1999 is time-barred.
846. Claimant denies that Respondent can rely on Claimant's alleged misappropriation being continuous and ongoing as ground that the limitation period has not started running. Indeed, the Counterclaim at stake is of a civil nature, the criminal argument invoked by Respondent has therefore no relevance. Moreover, Roussalis is not subjected to any criminal investigation in relation to this Counterclaim.

#### **G. Romania lacks standing to bring a Counterclaim for damages**

847. Claimant challenges Respondent's standing to assert its Counterclaim under Articles 998 and 999 of the Romanian Civil Code regarding civil tort liability. Articles 998 and 999 enable one who has sustained a loss to recover that loss from the person who caused it. Claimant argues that Respondent does not have standing to assert counterclaims based on these statutes because Respondent did not sustain a *direct* loss as a result of Continent SRL's non-fulfillment of the required investment. Claimant alleges that the loss was sustained by Continent SA and that Respondent would have needed to be a majority shareholder of Continent SA at the time in order to recover under these provisions.
848. Claimant further submits that Respondent lacks standing to assert its Counterclaim against Claimant and Continent SRL based on Article 272 of Romania's Law 31/1990 on commercial companies. This article is not applicable between legal entities.

**H. The Counterclaim for damages arising out of the Ozias contracts is inadmissible because Romania must seek the annulment of those contracts as a condition precedent to bringing a damages claim**

849. Claimant states that the Arbitral Tribunal “*has not been requested to sentence the annulment of these contracts, with the sentence it will pronounce, which is inadmissible*” (Claimant’s Reply, ¶92).

**II. THE AMENDMENT OF THE COUNTERCLAIM IS INADMISSIBLE**

850. Claimant further submits that Article 40(2) of the ICSID Arbitration Rules sets the deadline for the filing of a Counterclaim. It provides that “*An incidental or additional claim shall be presented not later than in the reply and a counter-claim no later than in the countermemorial...*” Accordingly, Respondent may not, as it has sought, present a Counterclaim in its Rejoinder.

**III. THE COUNTERCLAIM IS MERITLESS**

851. As established above, Claimant has fulfilled its post-purchase investment obligations. Respondent’s claim relating to this issue should therefore be dismissed.
852. As regards the AVAS share pledge dispute, the Supreme Court affirmed the lower courts’ decisions and ruled in favor of Continent SRL. The June 30, 2009 decision of the Romanian Supreme Court held that the investment obligation had been fulfilled (Claimant’s Rejoinder Exhibit n°1). This decision is final and irrevocable. Therefore, AVAS’s lien execution request related to the 372,523 shares should be denied.
853. As far as the “absolute nullity” issue is concerned, Claimant contends that the Commercial Court decision of July 8, 2009 dismissed Respondent’s claims as groundless (Claimant’s Rejoinder Exhibit n°2). Therefore, Respondent’s arguments that are derived from the purported nullity of the shareholders’ resolutions should be rejected.
854. In particular, in light of the irrevocable determination that Claimant’s investment obligations were properly fulfilled, Respondent’s claims requesting delivery to Respondent, cancellation of the Continent SA shares, or payment of money damages for the value of the shares, should be dismissed.
855. In any case, since the Romanian courts determined that no funds were misappropriated by Continent SA after the date of the Privatization Agreement, Respondent’s claim in this respect should be dismissed.
856. The Romanian authorities’ decisions imposing tax, VAT and penalties have been declared illegal by Romanian courts. Accordingly, Respondent should not be permitted to bring the issue again within the scope of this arbitration and claims related to this issue should be dismissed.
857. Respondent’s claim concerning the Ozias dispute is meritless.



858. Finally, Respondent's claim concerning the arbitration expenses should be dismissed. Indeed, Claimant's claim is mainly based on Respondent's abusive measures, the main request being that Respondent put an end to such abusive remedies. In this regard, the Romanian courts have rendered judgments by means of which AVAS's proceedings have been rejected. Consequently, Respondent's Counterclaim is without merit. Claimant submits that since Respondent incurred significant fees and costs to submit counterclaims that are wholly without merit, *"the Respondent shall integrally bear the payment of these expenses, and no compensation right shall be granted"* (Claimant's Rejoinder, p. 25).

### **SECTION III. DECISION OF THE TRIBUNAL**

859. Respondent presents several counterclaims which have been outlined above.

860. Being the party asserting that the Tribunal has jurisdiction to hear and determine the counterclaims which it seeks to bring before the Tribunal, the Respondent carries the burden of establishing that jurisdiction exists.

861. Article 46 of the ICSID Convention provides that:

*"Except as the parties otherwise agree, the Tribunal shall, if requested by a party, determine any incidental or additional claims or counterclaims arising directly out of the subject-matter of the dispute provided that they are within the scope of the consent of the parties and are otherwise within the jurisdiction of the Centre."*

862. Similarly, Rule 40 of the ICSID Arbitration Rules provides:

*"Except as the parties otherwise agree, a party may present an incidental or additional claim or counter-claim arising directly out of the subject-matter of the dispute, provided that such ancillary claim is within the scope of the consent of the parties and is otherwise within the jurisdiction of the Centre."*

863. Under these rules, the Tribunal shall determine any counterclaims arising directly out of the subject-matter of the dispute provided that they are within the scope of the consent of the Parties and are otherwise within the jurisdiction of the Centre.

864. Therefore, the first issue which the Tribunal has to determine is whether – and irrespective of the particular counterclaims advanced in these proceedings by the Respondent – the Parties *consented* to have the State's counterclaims arbitrated.

865. Under the system created by the ICSID Convention, consent by both parties is an indispensable condition for the exercise of the Centre's jurisdiction. The Convention only requires that consent be in writing, leaving the parties otherwise free to choose the manner in which to express their consent.

866. It is not disputed that Respondent expressed its consent to arbitration in the BIT and that Claimant accepted Romania's offer to arbitrate. Contrary to Claimant however, Respondent considers that such consent included consent to arbitrate counterclaims.

Whether it is so must be determined in the first place by reference to the dispute resolution clause contained in the BIT. The investor's consent to the BIT's arbitration clause can only exist in relation to counterclaims if such counterclaims come within the consent of the host State as expressed in the BIT.

867. In determining how to interpret agreements to arbitrate under the ICSID Convention, the Tribunal is guided by an ICSID decision which held that:

*"[A] convention to arbitrate is not to be construed restrictively, nor, as a matter of fact, broadly or liberally. It is to be construed in a way which leads to find out and to respect the common will of the parties.... Moreover, ...any convention, including conventions to arbitrate, should be construed in good faith, that is to say by taking into account the consequences of the commitments the parties may be considered as having reasonably and legitimately envisaged"* (*Amco Asia et al. v. Indonesia*, Decision on Jurisdiction of September 25, 1983, 23 I.L.M. 359 (1984).

868. In this respect, Article 9 of the BIT provides in its relevant parts that:

***"Disputes between an investor of a Contracting Party and the other Contracting Party concerning an obligation of the latter under this Agreement, in relation to an investment of the former, shall, if possible, be settled by the disputing parties in an amicable way..."***

*If such disputes cannot be settled within six months from the date either party requested amicable settlement, the investor concerned **may submit** the dispute either to the competent courts of the Contracting Party in the territory of which the investment has been made or to international arbitration"*(emphasis added).

869. Pursuant to the interpretation rules of Article 31 of the Vienna Convention and the above quoted ICSID decision, the Tribunal in its majority considers that the references made in the text of Article 9(1) of the BIT to "*disputes ... concerning an obligation of the latter*" undoubtedly limit jurisdiction to claims brought by investors about obligations of the host State. Accordingly, the BIT does not provide for counterclaims to be introduced by the host state in relation to obligations of the investor. The meaning of the "dispute" is the issue of compliance by the State with the BIT.

870. Article 9(4) of the BIT further provides, in respect of the applicable law, that:

*"The arbitral tribunal shall decide the dispute in accordance with the provisions of this Agreement [the BIT] and the applicable rules and principles of international law..."*

871. As mentioned above, the BIT imposes no obligations on investors, only on contracting States. Therefore, where the BIT does specify that the applicable law is the BIT itself, counterclaims fall outside the tribunal's jurisdiction. Indeed, in order to extend the competence of a tribunal to a State counterclaim, "*the arbitration agreement should refer to disputes that can also be brought under domestic law for counterclaims to be within the tribunal's jurisdiction*" (P. Lalive and L. Halonen, "On the availability of

Counterclaims in Investment treaty Arbitration,” *Czech yearbook of international law*, 2011, p.141, n°7.19).

872. In light of the foregoing, the Tribunal considers that the Parties did not consent to have Respondent’s Counterclaim arbitrated.
873. Contrary to the Respondent’s position, this absence of consent to have the State’s counterclaim arbitrated cannot be overcome by the application of the umbrella clause in Article 2(6) of the Treaty.
874. Article 2(6) of the BIT provides that:
- “Each Contracting Party shall observe any other obligation it may have entered into with regard to investments of investors of the Contracting Party”* (emphasis added).
875. Pursuant to the interpretation rules of Article 31 of the Vienna Convention, the reference in the text of Article 2(6) of the BIT to *“any other obligation ... with regard to investments of investors”* confirms that the host State commits itself to comply with obligations it has entered into with regard to investments of investors. It does not permit that claims be brought about obligations of the investor.
876. For all these reasons, by a majority opinion, the Tribunal finds that the Counterclaim is beyond its jurisdiction in the present proceedings.
877. The Tribunal therefore declares the proceeding closed and issues the present award.

## **CHAPTER VI. COSTS**

878. Article 61 of the ICSID Convention addresses three types of costs which are to be assessed and allocated by the Arbitral Tribunal, namely (a) the expenses incurred by the Parties in connection with the proceedings; (b) the fees and expenses of the members of the Tribunal, and (c) the fees and expenses of ICSID itself.
879. Items (b) and (c) above are referred to collectively below as the “costs of the arbitration.”
880. Each party in this case has claimed the costs it has incurred in relation to these proceedings, and detailed submissions have been made in this regard. The Parties do not dispute that the Tribunal has the discretion to allocate costs.
881. In the Arbitral Tribunal’s view, the following matters are of key significance in relation to the allocation of costs in this case:
- (a) Roussalis has not demonstrated that Romania acted in violation of the BIT, all his claims were rejected, and to this extent Romania has been successful;
  - (b) On the other hand, Romania has submitted a lengthy Counterclaim and failed to demonstrate that the Tribunal had jurisdiction over the Counterclaim.

882. Therefore, although Romania has prevailed on the substance of the dispute, it has failed on its allegations regarding the Counterclaim. On this basis, using its discretion, the Tribunal considers fair that Claimant be ordered to pay 60% of the costs of the arbitration and of Respondent's legal costs and fees as detailed in Romania's submission in support of its claim for an award of costs of June 7, 2011 (with appendices under tab 1 to 5). Accordingly, the Tribunal orders Claimant to pay to the Respondent the sum of USD 217,290, representing 60% of the estimated expended portion of the Respondent's advance on the costs of the arbitration (USD 362,150),<sup>12</sup> as well as EUR 6,053,443.78, representing 60% of the Respondent's legal fees and expenses (EUR 10,089,072.98).

### **AWARD**

For the foregoing reasons, the Arbitral Tribunal decides and declares as follows:

- (a) That the Arbitral Tribunal has jurisdiction over this dispute, in so far as it concerns alleged claims of violations of the BIT put forward by Claimant; but that it has no jurisdiction over the Respondent's Counterclaim;
- (b) That Claimant's claims are unfounded and are therefore dismissed;
- (c) That Claimant shall pay to the Respondent USD 217,290 in reimbursement of 60% of the expended portion of the Respondent's advance on the costs of the arbitration and EUR 6,053,443.78 representing 60% of the Respondent's legal fees and expenses;
- (d) This award puts an end to the provisional measures adopted by the Arbitral Tribunal on July 22, 2008 and July 2, 2009.

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<sup>12</sup> The ICSID Secretariat will in due course provide the Parties with a financial statement of the case account and the Parties will be reimbursed the remaining balance proportionally to the amount which was paid by each Party.



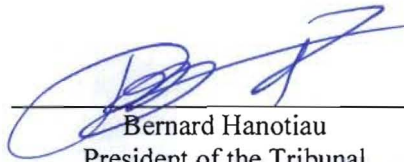
Andrea Giardina  
Arbitrator

Date: 23 November 2011



W. Michael Reisman  
Arbitrator

Date: 28/11/2011



Bernard Hanotiau  
President of the Tribunal

Date: 24 November 2011

**LEGAL AUTHORITY CA-97**

**International Centre for Settlement of Investment Disputes**

**IOAN MICULA,  
VIOREL MICULA,  
S.C. EUROPEAN FOOD S.A.,  
S.C. STARMILL S.R.L.  
AND  
S.C. MULTIPACK S.R.L.**

CLAIMANTS

**v.**

**ROMANIA**

RESPONDENT

**ICSID Case No. ARB/05/20**

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**AWARD**

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Rendered by an Arbitral Tribunal composed of:

Dr. Laurent Lévy, President  
Dr. Stanimir A. Alexandrov, Arbitrator  
Prof. Georges Abi-Saab, Arbitrator

Secretary of the Tribunal  
Ms. Martina Polasek

Assistant to the Tribunal  
Ms. Sabina Sacco

*Date of Dispatch to the Parties: 11 December 2013*

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## ABBREVIATIONS

Arbitration Rules	ICSID Rules of Procedure for Arbitration Proceedings effective 1 January 2003
BIT	Agreement between the Government of the Kingdom of Sweden and the Government of Romania on the Promotion and Reciprocal Protection of Investments dated April 1, 2003
Claimant 1	Mr. Ioan Micula
Claimant 2	Mr. Viorel Micula
Claimant 3	European Food S.A
Claimant 4	Starmill S.R.L.
Claimant 5	Multipack S.R.L.
Commission	European Commission
C-PHB	Claimants' Post-Hearing Submission dated May 13, 2011
C-Reply	Claimants' Reply dated December 22, 2009
C-SoC	Claimants' Statement of Claim dated March 9, 2007
EC	European Community
EC Treaty	Treaty Establishing the European Community
ECHR	European Court of Human Rights
ECJ	European Court of Justice
Commission's Written Submission	European Commission's Written Submission dated July 20, 2009
EFDG or EFDC	European Food and Drinks Group (or European Food and Drinks Companies)
EGO	Emergency Government Ordinance
ER	Expert Report
Exh. C	Claimants' Exhibits
Exh. EC	European Commission's Exhibits
Exh. HEC	Exhibits referred to at the Hearing on the merits and quantum
Exh. R	Respondent's Exhibits
Exh. RB	Exhibits filed with the Legal Opinion of F. Baias dated June 11, 2010
Exh. RJ	Exhibits filed with Expert Opinion of F. Jacobs dated June 11, 2010
EU	European Union
GD	Government Decision
GO	Government Ordinance
ICSID Convention	Convention on the Settlement of Investment Disputes Between States and Nationals of Other States dated March 18, 1965
ICSID or the Centre	International Centre for the Settlement of Investment Disputes
ILC Articles	The ILC Articles on State Responsibility
PIC	Permanent Investor Certificate
R-CM	Respondent's Counter-Memorial dated April 6, 2009
RFA	Request for Arbitration dated July 28, 2005
RL or RLA	Respondent's Legal Authorities
R-PHB	Respondent's Post-Hearing Submission dated May 13, 2011

R-SPHB	Respondent's Supplementary Post-Hearing Submission dated May 27, 2011
R-Rejoinder	Respondent's Rejoinder dated June 11, 2010
TIC	Temporary investment certificate
TGIE	Transilvania General Import Export S.R.L.
Tr.	Transcripts of the Hearing on the merits and quantum
Tr. Jur.	Transcripts of the Hearing on jurisdiction
VCLT	Vienna Convention on the Law of Treaties of 1969

## I. INTRODUCTION

### A. OVERVIEW OF THE DISPUTE

1. The present dispute arises from Romania's introduction and subsequent revocation of certain economic incentives, contained in Emergency Government Ordinance 24/1998 ("EGO 24"), for the development of certain disfavored regions of Romania. The Claimants claim that, in reliance on those incentives, and in reliance on the expectation that these incentives would be maintained during a 10-year period, they made substantial investments in the Ștei-Nucet-Drăgănești disfavored region located in Bihor County in northwestern Romania. The Claimants further claim that Romania's premature revocation of these incentives was in breach of its obligations under the Agreement Between the Government of the Kingdom of Sweden and the Government of Romania on the Promotion and Reciprocal Protection of Investments (the "BIT" or the "Treaty"), which entered into force on 1 April 2003 (Exh. C-1), and caused damages to the Claimants, as described further below.

### B. THE PARTIES

#### 1. The Claimants

2. There are five claimants in this case: two individual persons (the "Individual Claimants" or "Messrs. Micula") and three companies (the "Corporate Claimants") owned directly or indirectly by the Individual Claimants.

3. The Individual Claimants are:

- a. **Mr. Ioan Micula**, who is domiciled at Teatrului Street no. 1-2, Oradea, Bihor County, Romania (hereinafter referred to as "Claimant 1"). Mr. Ioan Micula was born in Romania on 8 April 1957. He moved to Sweden in 1987 where he obtained Swedish nationality in 1992 after having renounced his Romanian nationality.
- b. **Mr. Viorel Micula**, who is domiciled at Colinelor Street no. 48, Oradea, Bihor County, Romania (hereinafter referred to as "Claimant 2"). Mr. Viorel Micula is Ioan Micula's twin brother. He left Romania for Sweden in 1989. He obtained Swedish nationality in 1995 after having renounced his Romanian nationality.

4. The Corporate Claimants are:

- a. **European Food S.A.**, with its registered office at 13 Septembrie Street, Ștei, Bihor County, Romania, registered with the trade register under no. J5/892/1999, registration number 12457015 (hereinafter referred to as "Claimant 3" or "European Food"). Claimant 3 specializes in industrial manufacturing of food products.

- b. **Starmill S.R.L.**, with its registered office at 41 Drăgănești, Pantasesti Village, Bihor County, Romania, registered with the trade register under no. J5/177/2002, registration number 14467201 (hereinafter referred to as “Claimant 4” or “Starmill”). Claimant 4 specializes in the manufacturing of milling products.
  - c. **Multipack S.R.L.**, with its registered office at 41, Drăgănești, Pantasesti Village, Bihor County, Romania, registered with the trade register under no. J5/178/2002, registration number 14467210 (hereinafter referred to as “Claimant 5” or “Multipack”). Claimant 5 specializes in the manufacturing of plastic packaging.
- 5. In its Decision on Jurisdiction and Admissibility of 24 September 2008 (the “Decision on Jurisdiction and Admissibility”), the Tribunal found that the Individual Claimants and the Corporate Claimants (collectively, the “Claimants”) are Swedish nationals for the purposes of this arbitration.
  - 6. Mr. Ioan Micula and the Corporate Claimants are represented in this arbitration by Messrs. Kenneth R. Fleuriet, Reginald R. Smith and Craig S. Miles and Ms. Amy Roebuck Frey of the law firm of King & Spalding, London, Houston and Paris. They were previously represented by Mr. Eric A. Schwartz of the law firm of King & Spalding, as well as by Mr. Gerold Zeiler of the law firm of Schönherr Rechtsanwälte OEG, Vienna, in cooperation with Prof. Christoph Schreuer as Of Counsel, of the University of Vienna.
  - 7. Mr. Viorel Micula is represented in this arbitration by Prof. Emmanuel Gaillard, Dr. Yas Banifatemi and Ms. Veronika Korom of the law firm of Shearman & Sterling LLP, Paris. He was previously represented by Messrs. David Reed and Alex Bevan of Shearman & Sterling LLP, London, Messrs. Eric A. Schwartz and Alain Farhad of the law firm of Dewey & LeBoeuf, Paris, and Messrs. Gheorghe Mușat and Gelu Titus Maravela and Mrs. Luminita Popa of the law firm Mușat & Asociații, Bucharest.

## **2. The Respondent**

- 8. The Respondent is Romania (the “Respondent” or “Romania”).
- 9. The Respondent is represented in this arbitration by H.E. Daniel Chitoiu, Minister of Public Finances and Messrs. Cipriam Badea and Mr. Bogdan Mirghiș, Legal Department of the Ministry of Public Finances; Messrs. D. Brian King, Georgios Petrochilos and Boris Kasolowsky of the law firm of Freshfields Bruckhaus Deringer, New York, Paris and Frankfurt, and Mmes. Adriana I. Gaspar, Ana Diculescu-Sova and Manuela M. Nestor of the law firm of Nestor Nestor Diculescu Kingston Petersen in Bucharest.



## II. PROCEDURAL HISTORY

### A. INITIAL PHASE

10. On 2 August 2005, the Claimants filed a Request for Arbitration dated 28 July 2005 (the "Request" or "RFA") with the International Centre for Settlement of Investment Disputes ("ICSID" or the "Centre"), accompanied by 14 exhibits (Exh. C-1 to C-14).
11. On 3 August 2005, the Centre, in accordance with Rule 5 of the ICSID Rules of Procedure for the Institution of Conciliation and Arbitration Proceedings (the "Institution Rules"), acknowledged receipt and transmitted a copy of the Request to Romania.
12. On 21 September 2005, the Request was supplemented by a statement concerning the entry into force of the BIT with accompanying exhibits C-15 to C-19.
13. On 13 October 2005, the Acting Secretary-General of the Centre registered the Request as supplemented, pursuant to Article 36(3) of the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (the "ICSID Convention"). On the same date, in accordance with Institution Rule 7, the Acting Secretary-General notified the Parties of the registration of the Request as supplemented and invited them to proceed, as soon as possible, to constitute an Arbitral Tribunal.
14. On 10 January 2006, in the absence of an agreement between the Parties, the Claimants elected to submit the arbitration to a Tribunal constituted of three arbitrators, as provided in Article 37(2)(b) of the ICSID Convention. On the same day they appointed Prof. Dr. Stanimir A. Alexandrov, a national of Bulgaria. On 7 February 2006, Romania appointed Dr. Claus-Dieter Ehlermann, a national of Germany. The Parties agreed to appoint Dr. Laurent Lévy, a national of Switzerland and Brazil, as the President of the Tribunal.
15. On 12 September 2006, the Acting Secretary-General of ICSID, in accordance with Rule 6(1) of the ICSID Rules of Procedure for Arbitration Proceedings (the "Arbitration Rules"), notified the Parties that all three arbitrators had accepted their appointments and that the Tribunal was therefore deemed to be constituted and the proceedings to have begun on that date. The Parties were also informed that Mrs. Martina Polasek, ICSID Counsel, would serve as Secretary to the Tribunal.
16. On 10 November 2006, the Tribunal held the first session of the Tribunal in Paris, France. At the outset of the session, the Parties expressed agreement that the Tribunal had been duly constituted (Arbitration Rule 6) and stated that they had no objections in this respect. It was agreed that the applicable ICSID Arbitration Rules were the ones that entered into force on 1 January 2003. The remainder of the procedural issues set forth in the agenda of the session were discussed and agreed upon. In particular, the Tribunal and the Parties agreed upon a timetable for the submissions on the merits and reserved provisional hearing dates. It was agreed that

if Respondent decided to raise any objections to jurisdiction or admissibility before the filing of its Counter-Memorial, the schedule would be revisited. It was also decided that the language of the proceedings would be English, and that the place of arbitration would be Paris, France. The audio recording of the session was later distributed to the Parties. Minutes of the first session were drafted and signed by the President and the Secretary of the Tribunal, and sent to the Parties on 20 December 2006.

## **B. THE JURISDICTIONAL PHASE**

17. The proceedings in respect of the jurisdictional phase are described in detail in the Decision on Jurisdiction and Admissibility, which was notified to the Parties on 25 September 2008 and makes integral part of this Award.
18. The Tribunal dismissed the Respondent's objections on jurisdiction and admissibility and concluded that it had jurisdiction over the claims asserted by the Claimants for breaches of the BIT. Specifically, the dispositive part of the Decision on Jurisdiction and Admissibility stated:

For the reasons set forth above,

- The objections of Respondent are dismissed.
- The Tribunal has jurisdiction over the dispute submitted to it in this arbitration and rejects any objections as to the admissibility of the claims.
- The decision on costs is deferred to the second phase of the arbitration on the merits.

(Decision on Jurisdiction and Admissibility, ¶ 170).

## **C. THE MERITS PHASE**

### **1. Initial procedural steps**

19. By letter of 26 September 2008, the Tribunal invited the Parties to confer and revert to the Tribunal within six weeks from the date of notification of the Decision on Jurisdiction and Admissibility with joint or separate proposals concerning the timetable and other motions and suggestions for the proceedings on the merits.
20. On 29 September 2008, Messrs. Zeiler and Schreuer resigned as counsel for Mr. Ioan Micula and the Corporate Claimants effective 26 September 2008. On 30 September 2008, the Tribunal was advised that Mr. Ioan Micula and the Corporate Claimants would be henceforth represented by Messrs. Kenneth R. Fleuriet, Reginald R. Smith and Craig S. Miles of the law firm of King & Spalding, London and Houston.
21. By letters of 7 November 2008 (Claimants) and 13 November 2008 (Respondent), the Parties presented their proposals for the timetable on the merits. On the basis of the Parties' agreements and after considering their positions on the points in dispute, on

18 November 2008 the Tribunal fixed the procedural schedule for the merits phase. After further correspondence from the Parties, by letter of 2 December 2008 the Secretary confirmed the procedural schedule for the merits phase.

22. By letter of 25 March 2009, the Respondent advised the Tribunal that the Parties had agreed on certain time extensions to the time limits set in the Secretary's letter of 2 December 2008. By letter of the Secretary of 27 March 2009, the Tribunal confirmed the time extensions agreed by the Parties and set out the amended procedural schedule as follows:

Respondent's Counter-Memorial	6 April 2009
Claimants' Reply (including full case on quantum and any accompanying expert reports)	20 August 2009
Respondent's Rejoinder (including any expert reports)	27 November 2009
Pre-hearing Conference	4 January 2010;
Claimants' Rebuttal Expert Reports on Quantum	26 January 2010;
Respondent's Rebuttal Expert Reports on Quantum	5 March 2010;
Hearing	3-7 May 2010;
Hearing reserve days	10-11 May 2010.

23. On 2 April 2009, the European Community ("EC") requested that it be allowed to file a written submission as a non-disputing party in this arbitration. On 7 April 2009, the Tribunal invited the Parties to file their observations on the EC's request by 7 May 2009.

## **2. The written phase on the merits**

24. In accordance with the procedural schedule agreed by the Parties and confirmed in the Secretary's letter of 27 March 2009, the Respondent filed its Counter-Memorial on the merits ("R-CM") on 6 April 2009. The Counter-Memorial was accompanied by:
- a. Expert Report of Professor Rudolf Streinz ("First ER of R. Streinz")
  - b. Exhibits R-59 through R-132
  - c. Legal authorities RL-177 through RL-273.
25. On 7 May 2009, the Parties submitted their observations on the EC's request to file a written submission as a non-disputing party. The Claimants opposed that request. The Respondent submitted that the EC's request was one that could not be reasonably opposed, but in the event that the Claimants opposed that request, it requested the opportunity to provide a fuller response.

26. Also on 7 May 2009, Mr. Viorel Micula advised that the law firm of Dewey & LeBoeuf would no longer be representing him, although the firm of Muşat & Asociații remained as his counsel.
27. By letter of the Secretary of 15 May 2009, having considered the Parties' positions and the applicable procedural rules, the Tribunal decided that it would allow the participation of the EC as a non-disputing party in the present case. The Tribunal noted that:

In doing so, the Tribunal is particularly sensitive to the fact that the European Community may bring a factual or legal perspective that could assist the Tribunal in the adjudication of the Parties' rights. In granting leave to the European Community to participate as a non-disputing party, the Arbitral Tribunal is mindful of the need to preserve due process and the good order of the proceeding. In particular, the European Community shall act as *amicus curiae* and not as *amicus actoris vel rei*. In other words, the non-disputing party shall remain a friend of the court and not a friend of either Party.
28. In light of this, the Tribunal invited the Parties to confer and agree on a procedure for the participation of the EC as a non-disputing party on or before 22 May 2009, and provided certain guidelines for that procedure. It also requested the Parties' comments on a draft letter to the EC by the same date.
29. On 18 May 2009, Mr. Ioan Micula and the Corporate Claimants submitted a request for a site visit pursuant to Article 43(b) of the ICSID Convention and Rule 37 of the 2003 ICSID Arbitration Rules.
30. On 22 May 2009, all Parties submitted their observations on the Tribunal's draft letter to the EC concerning its *amicus* participation and the proposed procedure for such participation. Mr. Ioan Micula and the Corporate Claimants also expressed a concern at certain communications that had taken place between the Respondent and the EC, and requested an instruction from the Tribunal that Romania, its counsel and its expert refrain from any further communications with the EC about this case until after the hearing and the closure of the proceedings.
31. On 25 May 2009, the Respondent opposed Mr. Ioan Micula's and the Corporate Claimants' request for a site visit. It also argued that this request was being used to present an entirely new case on damages, which was impermissible at that stage of the proceedings.
32. Also on 25 May 2009, Dr. Claus-Dieter Ehlermann submitted his resignation as an arbitrator to the other members of the Tribunal and to the Acting Secretary-General of ICSID and indicated his grounds of personal nature for such resignation. On 26 May 2009, pursuant to Arbitration Rule 8(2), the Tribunal consented to Dr. Ehlermann's resignation and on that day notified the Acting Secretary-General of its decision. On that same day, pursuant to Arbitration Rule 10(1) and (2) and on behalf of the Acting Secretary-General, the Secretary notified the Parties of Dr. Ehlermann's resignation and the Tribunal's consent thereto, and of the resulting vacancy on the Tribunal. In accordance with Arbitration Rule 11(1), the Respondent was invited to promptly

appoint an arbitrator to fill that vacancy. Pursuant to Arbitration Rule 10(2), the arbitration proceedings were suspended until the vacancy created by Dr. Ehlermann's resignation had been filled. The Parties were also invited to inform the Tribunal, as soon as the vacancy had been filled, whether they would agree to maintain the existing procedural timetable.

33. On 4 June 2009, the Respondent advised the Tribunal that it was in the process of identifying a new arbitrator and that it was committed to attempting to preserve the current procedural schedule. Given that the question of the modalities of the EC's participation as an *amicus curiae* was still pending before the Tribunal and would likely impact the procedural schedule, the Respondent invited the Claimants to agree, and the Tribunal to approve, that
  - (a) the stay on the proceedings be lifted insofar as the Tribunal's decision on the modalities of the European Community's participation as *amicus curiae* is concerned;
  - (b) the Tribunal render that decision in its present, provisionally truncated formation, by consent of the parties.
34. At the invitation of the Tribunal, on 16 June 2009 Mr. Ioan Micula and the Corporate Claimants agreed with the Respondent's proposal that the Tribunal should proceed to rule on the modality of the EC's participation as an *amicus curiae*, notwithstanding the stay of the proceedings. The Claimants noted that they were not in a position to communicate their views as to the impact of the stay on the procedural timetable, but would do so once the Tribunal's vacancy was filled.
35. On 19 June 2009, Mr. Viorel Micula advised that he had retained as new counsel Messrs. David Reed, Alex Bevan and Emmanuel Gaillard of the law firm of Shearman & Sterling LLP, London and Paris, and accepted the Respondent's request for a partial lift of the stay of the proceedings.
36. By letter of the Secretary of 25 June 2009, the Tribunal approved the Parties' agreement to partially lift the stay of the proceedings concerning the modalities of the EC's *amicus curiae* participation and issued its decision on those modalities, as set forth below. On that same day, the Tribunal informed the EC that it would be allowed to participate as a non-disputing party in this arbitration, specifying that the purpose of such participation would be to assist the Tribunal in its adjudicatory work. The Tribunal set forth the following procedure for the EC's participation:
  1. The European Community shall file a written submission on or before July 20, 2009. It shall send an electronic copy of the submission by e-mail to the Secretary of the Tribunal at [mpolasek@worldbank.org](mailto:mpolasek@worldbank.org) and 15 (fifteen) hard copies of the submission by courier to the Secretary at ICSID, for transmission to the Tribunal and the Parties.
  2. The European Community's written submission shall not respond or comment upon the Parties' prayers for relief, but shall be focused on assisting the Tribunal in the determination of factual or legal issues at stake in the present dispute. It is expected that the scope of the Community's input will be limited to facts within its own knowledge and to European law rather than to any other facts or legal matters at

issue in this arbitration. The Community may within this scope decide which facts and laws are relevant to the dispute.

3. The European Community's written submission shall be limited in length (40 pages) and written in English.
  4. The European Community may file any relevant exhibits with its written submission within the scope described under paragraph 2 above. Any exhibit for which the original language is not English shall be submitted in the original language accompanied by a translation into English. If the document is lengthy and relevant only in part, it is sufficient if only the relevant parts, which must be precisely specified, are translated.
  5. The Tribunal may request the European Community to produce any document or evidentiary material that the Tribunal deems useful for the resolution of this dispute, or which has been requested by either Party.
  6. The European Community shall have access to the Parties' pleadings in their entirety as existing at this juncture, except for materials that have been designated as commercially confidential or legally privileged. Should a disagreement arise as to whether such materials have been so designated, the Tribunal will resolve such disagreement. The Secretary of the Tribunal will transmit electronic copies of the materials to the European Community at the latest by July 6, 2009.
  7. Any person who has participated in the elaboration of the European Community's written submission may be called to provide clarifications on that submission at the hearing, as may be required by the Tribunal of its own initiative or at the request of the Parties. Such clarifications will be given in the form directed by the Tribunal and under its control.
  8. The European Community will bear its own costs incurred in connection with its participation in the proceeding, including any costs relating to any appearance by the Community's representative(s) for examination at the hearing.
  9. The European Community shall indicate whether it had any direct contact with either Party to this arbitration concerning the subject matter of this arbitration and should as far as possible avoid any future contact in this respect.
37. In its letter to the Parties of 25 June 2009, the Tribunal also invited the Parties to comment on the Commission's Written Submission within two months from the date of receipt of that submission.
  38. On 7 July 2009, the Secretary sent the EC two CD-ROMs containing the Parties' pleadings on the merits, including supporting documents, filed as of that date.
  39. On 16 July 2009, in accordance with Articles 56(1) and 37(2)(b) of the ICSID Convention and Arbitration Rule 11(1) and (3), the Respondent appointed as its arbitrator Professor Georges Abi-Saab, a national of the Arab Republic of Egypt. The Respondent also agreed to maintain the current procedural timetable.

40. On 20 July 2009, the EC submitted its written submission as a non-disputing party, including 10 exhibits.
41. On 22 July 2009, the Secretary informed the Parties that the Tribunal had been reconstituted and the proceedings resumed. On 24 July 2009, the Tribunal proposed to the Parties that, subject to their reasoned objection by 7 August 2009, the acts accomplished by the Tribunal regarding the modalities of the EC's participation as a non-disputing party while the suspension of the proceeding was partially lifted were validated. In that same letter, the Tribunal also invited the Parties to state their views on the procedural timetable in consideration of the suspension of the proceedings.
42. By letters of 30 and 31 July 2009, all Claimants agreed to the validation of the acts taken by the Tribunal during the suspension of the proceedings with respect to the EC's *amicus curiae* submission and submitted their views on the procedural timetable. Specifically, the Claimants stated that they would require an extension of the time limits set out in the procedural timetable as a result of the suspension of the proceedings. On 7 August 2009, the Respondent submitted its comments on the new procedural timetable suggested by the Claimants.
43. On 7 September 2009 the Respondent informed the Tribunal that the Parties had reached an agreement on the procedural timetable. By letter of 14 September 2009, the Tribunal confirmed the procedural timetable agreed by the Parties, as follows:

Parties' responses to EC amicus brief	16 November 2009
Claimants' Reply	14 December 2009
Respondent's Rejoinder	12 April 2010
Claimants' Rebuttal Expert Reports on Quantum	10 June 2010
Respondent's Rebuttal Expert Reports on Quantum	19 July 2010

44. After consultation between the Parties and the Tribunal, on 19 October 2009 the Tribunal confirmed that the hearing on the merits would take place between 8 and 19 November 2010, excluding the weekend.
45. On 16 November 2009, the Parties submitted their comments to the EC's *amicus curiae* submission. In addition, the Claimants expressed their concern that there may have been improper contact between the EC and the Respondent or its counsel, in violation of the Tribunal's instructions of 25 June 2009, and requested the Tribunal to order the Respondent to produce copies of all records of communications between the Respondent or any of the Respondent's legal counsel and the EC since 1 January 2009 related to the subject matter of this arbitration.
46. On 23 November 2009, the Tribunal invited the Respondent to provide its comments to the Claimants' request for production of documents by 11 December 2009. This deadline was subsequently extended by agreement of the Parties to 16 December 2009.

47. On 4 December 2009, counsel for Mr. Ioan Micula and the Corporate Claimants informed the Tribunal that all Parties had agreed to extend the deadlines for their upcoming briefs. On 14 December 2009, the Secretary confirmed the amended procedural timetable as follows:

Respondent's Reply to the Claimants' request for production of documents	16 December 2009
Claimants' Reply	22 December 2009
Respondent's Rejoinder	28 April 2010
Claimants' Rebuttal Expert Reports on Quantum	25 June 2010
Respondent's Rebuttal Expert Reports on Quantum	4 August 2010
Hearing on the Merits	8-19 November 2010

48. On 16 December 2009, the Respondent submitted its objections to the Claimants' request for the production of communications between the EC and the Respondent or its counsel.

49. On 22 December 2009, the Claimants submitted their Reply on the Merits ("C-Reply"), which was accompanied by the following evidence:

- a. Third Witness Statement of Mr. Ioan Micula ("Third WS of I. Micula")
- b. Third Witness Statement of Mr. Viorel Micula ("Third WS of V. Micula")
- c. Witness Statement of Mr. Sorin Baciu ("First WS of S. Baciu")
- d. Witness Statement of Mr. Moisa Ban ("First WS of M. Ban")
- e. Witness Statement of Mr. Mircea Halbac ("First WS of M. Halbac")
- f. Witness Statement of Mr. Christian Balog ("First WS of C. Balog")
- g. Witness Statement of Mr. Neculai-Liviu Marcu ("WS of N. Marcu")
- h. Witness Statement of Mr. Nicolae Staiculescu ("WS of N. Staiculescu")
- i. Expert Report of Professor Donald L. Lessard ("First ER of D. Lessard")
- j. Expert Report of Professor Alan Dashwood ("First ER of A. Dashwood")
- k. Expert Report of Professor David Caron ("ER of D. Caron")
- l. Expert Report of Professor Lucian Mihai ("ER of L. Mihai")
- m. Expert Report of Professor Jan-Benedict Steenkamp ("First ER of J. Steenkamp")



- n. Expert Report of Mr. Chris Osborne (FTI) (“First ER of C. Osborne”)
  - o. Expert Report of Dr. James Fry (LMC) (“First ER of J. Fry”)
  - p. Boston Consulting Group Report, originally filed as Exh. C-655 (“First ER of BCG”)
  - q. Claimants' Exhibits and Legal Authorities 271 to 675
50. By means of Procedural Order dated 8 January 2010, the Tribunal rejected the Claimants’ request for the production of correspondence between the EC and the Respondent or its counsel. Specifically, the Tribunal found:
- 6. That after deliberating on the arguments advanced by the Parties, the Tribunal is not persuaded that the documents requested by the Claimants are necessary or useful for the determination of the outcome of the dispute in this arbitration;
  - 7. That even if, for the sake of argument, the Tribunal were to accept the Claimants' allegations and find that the European Community cooperated with the Respondent in preparing its Submission, which the Respondent denies, such finding would not affect the Tribunal's conclusion that the requested documents lack relevance;
  - 8. That to the extent that the requested documents might be relevant for the purposes of establishing the objectivity of the arguments advanced by the non-disputing party in its Submission and the weight to be given to them by the Tribunal, this matter has already been adequately addressed in the Tribunal's letter of 25 June 2009, which, if necessary, provides the Claimants with the opportunity to examine at the hearing any person who has participated in the preparation of the Submission.
51. On 14 January 2010, the Claimants advised that they had found inadvertent errors and omissions in their Reply submission, and submitted corrected versions of their Reply Memorial, three witness statements and 29 exhibits, together with an errata sheet.
52. By letter of 5 February 2010, the Respondent notified the Tribunal that, in accordance with its obligations under the Treaty of Lisbon, it proposed to make available to the EC the Claimants' Reply and its annexes. The Respondent alleged that the Claimants' Reply represented a fundamentally new case, and that, as an EU Member State, it is obliged under the Treaty of Lisbon to notify the EU of any pending international litigation threatening to jeopardize a state's EU law obligations. By letters of 9 February 2010, the Claimants objected to the proposed disclosure, alleging, *inter alia*, that the *amicus curiae* phase of the arbitration had been concluded, that the Reply did not present a fundamentally new case, that such disclosure would violate the Tribunal's order of 25 June 2009, and that the Reply contained material that was commercially confidential to the Claimants.
53. Considering that the Respondent's proposed disclosure could raise issues of confidentiality and privilege, on 10 February 2011 the Tribunal invited the Parties to

make brief submissions addressing (i) the content and scope of Respondent's legal obligation under the Treaty of Lisbon to notify the EU of any pending international litigation threatening to jeopardize a state's EU law obligations; (ii) whether the disclosure would possibly aggravate the dispute and/or adversely affect the conduct of the proceedings, and (iii) whether the disclosure would violate the Claimants' rights to confidentiality and/or privilege. The Parties filed their submissions on 19 February 2010. An additional submission was made by Mr. Viorel Micula on 22 February 2010.

54. By means of a Procedural Order issued on 3 March 2010 and pursuant to Article 47 of the ICSID Convention and Arbitration Rule 39, the Tribunal recommended that the Respondent refrain from providing the EC with the full text of the Claimants' Reply and its exhibits, inviting it instead to provide the EC with the text of the Claimants' amended request for relief, as set forth in the Reply. In making its decision, the Tribunal took into consideration the role of the EC as an *amicus curiae*, the fact that the Claimants had withdrawn a claim and amended their prayers for relief, and issues of confidentiality, privilege, and possible aggravation of the dispute.
55. On 8 April 2010, following the Tribunal's recommendation, the Respondent notified the EC that the Claimants had withdrawn their request for restitution of the legal framework in force at the time of approval of EGO 24/1998.
56. On 19 March 2010, the Respondent requested an extension of its time limit to file its Rejoinder on the merits, alleging, inter alia, that the Claimants' Reply was incomplete. On 25 March 2010, the Claimants objected to that request. After further correspondence among the Parties and a proposal from the Tribunal, the Parties and the Tribunal finally agreed on the following procedural calendar, as confirmed by the Secretary's letter of 12 April 2010:
- |   |                    |
|---|--------------------|
| Respondent's Rejoinder                          | 11 June 2010       |
| Claimants' Rebuttal Expert Reports on Quantum   | 30 July 2010       |
| Respondent's Rebuttal Expert Reports on Quantum | 10 September 2010  |
| Hearing on the Merits and Quantum               | 8-19 November 2010 |
57. On 9 April 2010, the Respondent made an application for production of documents. The Claimants objected to that request by letters of 19 and 26 April 2010. After further comments from the Parties (Respondent's letter of 27 April 2010 and Claimants' submissions of 29 April and 10 May 2010), on 27 May 2010 the Tribunal issued a Procedural Order ruling on the Respondent's request. The Parties further agreed on the timing for the Parties' comments on the documents produced (Respondent's letter of 3 June 2010). The Tribunal approved the Parties' agreement by letter of 7 June 2010 and invited the Parties to report on the production progress (which they did through the Claimants' letter of 10 June 2010).
58. On 13 April 2010, Ioan Micula and the Corporate Claimants renewed their request for a site visit. The Respondent objected to that request on 22 April 2010, and the Claimants submitted further comments on 26 and 28 April 2010. On 5 May 2010,

having considered the Parties' submissions, the Tribunal concluded that a site visit would not enlighten the Tribunal at that stage in the proceedings, as any information gleaned from such visit would be either irrelevant for the resolution of the dispute or unnecessary given that the record supplied sufficient evidence, at least at that juncture. However, the Tribunal invited the Parties to renew the application for a site visit after the hearing on the merits if they continued to wish for one.

59. On 28 May 2010, Mr. Viorel Micula advised that Muşat & Asociații no longer represented him as counsel.
60. On 11 June 2010, the Respondent submitted its Rejoinder ("R-Rejoinder"), which was accompanied by the following evidence:
  - a. Expert Report of Professor Flavius Baias ("ER of F. Baias")
  - b. Expert Report of Sir Francis Jacobs ("ER of F. Jacobs")
  - c. Expert Report of Mr. Asger Petersen ("ER of A. Petersen")
  - d. Rebuttal Expert Report of Professor Dr. Rudolf Streinz ("Second ER of R. Streinz")
  - e. Expert Report of Agra CEAS Consulting, Mr. Conrad Caspari, in conjunction with F.O. Licht ("ER of C. Caspari")
  - f. Expert Report of KPMG, Mr. John Ellison ("First ER of J. Ellison")<sup>1</sup>
  - g. Expert Report of Dr. Bill Robinson ("First ER of B. Robinson")
  - h. Witness Statements of Mr. Leonard Orban ("WS of L. Orban")
  - i. Witness Statement of Professor Mihai Berinde ("WS of M. Berinde")
  - j. Documentary evidence (Exhibits R-134 through R-203)
  - k. Legal authorities (Exhibits RL-284 through RL-336).
61. On 22 July 2010, the Respondent submitted its comments on the documents produced by the Claimants in response to the Procedural Order of 27 May 2010. The Claimants submitted their comments on 3 September 2010. In the interim, the Parties further corresponded on the production of specific documents.
62. On 21 July 2011, Ioan Micula and the Corporate Claimants requested permission to submit four additional witness statements that would be relied upon by the Claimants' damages experts in their rebuttal expert reports due on 30 July 2010. On 22 July 2010, the Respondent objected to that request. The Parties submitted further comments (Claimants' letters of 23 and 26 July 2010 and Respondent's letter of 26

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<sup>1</sup> Mr. Ellison also submitted an expert report during the jurisdictional phase that is not referred to in this Award.

July 2010). After considering the Parties' submissions and in the exercise of the discretion granted to it under paragraphs 14(II)(c) and (e) of the Minutes of the First Session, by letter of 28 July 2010 the Tribunal granted the Claimants permission to submit, by 30 July 2010, new witness statements from the following persons: Messrs. Juan Gamecho, Mircea Halbac, Sorin Baciuc and Cristian Balog. The Tribunal specified that these witness statements should be strictly limited to factual allegations that will be relied upon by the Claimants' damages experts in their rebuttal expert reports, and that the Claimants should make these witnesses available for cross-examination at the hearing.

63. On 30 July 2010 (by separate letters sent by counsel to Mr. Ioan Micula and the Corporate Claimants, on one hand, and counsel to Mr. Viorel Micula, on the other), the Claimants submitted the following rebuttal expert reports on quantum and additional witness statements:
  - a. Expert Reply Report of Professor Donald R. Lessard ("Second ER of D. Lessard")
  - b. Expert Reply Report of Professor Jean-Benedict Steenkamp ("Second ER of J. Steenkamp")
  - c. Expert Opinion of Professor Georghe Piperea ("ER of G. Piperea")
  - d. Rebuttal Expert Report of Dr. James Fry of LMC International ("Second ER of J. Fry")
  - e. Expert Report of Mr. Richard Boulton of LECG ("ER of R. Boulton")
  - f. Rebuttal Expert Report of BCG ("Second ER of BCG")
  - g. Witness Statement of Mr. Juan Gamecho ("WS of J. Gamecho")
  - h. Second Witness Statement of Mr. Mircea Halbac ("Second WS of M. Halbac")
  - i. Second Witness Statement of Mr. Sorin Baciuc ("Second WS of S. Baciuc")
  - j. Second Witness Statement of Mr. Cristian Balog ("Second WS of C. Balog")
  - k. Exhibits and Legal Authorities C-680 to C-1034
64. On 2 August 2010, the Claimants submitted the rebuttal expert report of Mr. Chris Osborne of FTI Consulting.
65. In their letter of 30 July 2010, Mr. Ioan Micula and the Corporate Claimants also noted that the Claimants continued to suffer from acts of the Romanian state, including the initiation of forced execution proceedings against companies of the EFDG, that directly threatened their ability to continue their business activities and reserved their right to request interim relief from the Tribunal. The Claimants also objected to Section VI.G of the Respondent's Rejoinder, entitled "Any Compensation Must Be

Reduced by the Value of Benefits Received as a Result of Romania's EU Accession." The Claimants argued that this defense constituted a new legal theory that had been raised in the Respondent's Counter-Memorial and was thus untimely. In the event that the Tribunal was minded to accept it, the Claimants alleged that it should be rejected on the substantive grounds described in their letter.

66. By letter of 10 August 2010, the Respondent requested the Tribunal to (i) strike certain new evidence (specifically, certain expert reports or relevant parts of them, and new factual exhibits) filed by the Claimants with their rebuttal expert reports submitted on 30 July 2010 and 2 August 2010, as well as certain new legal submissions and allegations made by the Claimants in their letters accompanying such reports; (ii) grant it a four week extension to submit its rebuttal expert reports on quantum; and (iii) grant it the opportunity to comment on the Claimants' new evidence and allegations, to the extent that they are not stricken and, if necessary, to adduce responsive evidence. At the Tribunal's invitation, all Claimants commented on these requests by letters of 19 August 2010. The Respondent submitted further comments on 24 August 2010.
67. By means of a Procedural Order issued on 24 August 2010 and in accordance with ICSID Arbitration Rule 34, the Tribunal declined to strike any evidence filed by the Parties at this stage of the proceeding, stating that it would decide in due time what weight to give to any such evidence. The Tribunal also granted the Respondent a two-week extension (until 24 September 2010) to submit rebuttal expert reports on quantum, and invited the Respondent to produce in advance of the new time limit whatever written evidence they were able to produce without disruption of their work. The Tribunal also ruled that, if the Respondent wished to present new witness statements, it should file a formal application pursuant to Paragraph 14(II)(c) and (e) of the Minutes of the First Session. The scope of any such witness statements would in any event be strictly limited to the factual allegations relied upon by the Respondent's damages experts in their rebuttal expert reports. Finally, the Tribunal ruled that the Respondent should respond to the new documents submitted by the Claimants together with its rebuttal expert reports on damages.
68. By letter of 14 September 2010, the Tribunal asked the Parties if they would be agreeable to the appointment of Ms. Sabina Sacco of the law firm of Lévy Kaufmann-Kohler as Assistant to the Tribunal, which the Parties accepted.
69. On 24 September 2010, the Respondent submitted its Observations on Claimants' Additional Evidence, together with the following evidence and rebuttal expert reports:
  - a. Factual Exhibits R-210 through R-229
  - b. Legal Authorities RLA-337 through 346
  - c. Reply Expert Report of Mr. Conrad Caspari ("Second ER of C. Caspari")
  - d. Reply Expert Report of Mr. John Ellison ("Second ER of J. Ellison")

e. Reply Expert Report of Dr. Bill Robinson (“Second ER of B. Robinson”)

### 3. Procedural steps predating the hearing on the merits

70. On 30 September 2010, the President of the Tribunal and the Parties held a pre-hearing telephone conference to discuss all outstanding matters with respect to the organization of the hearing on the merits and quantum. During that telephone conference, the Parties reached an agreement with respect to certain issues, but maintained disagreement on others (in particular the sequestration of the Messrs. Micula and the modality for the examination of certain witnesses and experts). In addition, the Respondent requested clarification from the Claimants with respect to their quantum case.
71. On 8 October 2011, all Parties identified the witnesses and experts they would call for cross-examination at the hearing and provided further comments on outstanding issues with respect to the hearing. After further correspondence from the Parties, the Tribunal ruled on these issues by means of a Procedural Order of 13 October 2010.
72. By letters of 15 October 2010, the Parties submitted proposed hearing schedules and discussed the need for oral closing submissions. The Claimants also requested that the Tribunal, of its own initiative, call Professor David Caron, Claimants’ international law expert, to appear at the hearing for examination despite the fact that the Respondent did not call him for cross-examination. The Respondent provided further comments on 20 October 2010. The Tribunal ruled on these issues by letter of 22 October 2010. By letter of 28 October 2010, the Respondent expressed concerns with respect to the time allocation during the hearing and reserved its rights. On 1 November 2010, the Tribunal clarified that the ruling of 22 October 2010 contained a clerical error, and issued a corrected time allocation.
73. On 5 October 2010, the Secretary invited the representatives of the EC who had drafted the EC’s *amicus* brief to provide clarifications on that submission at the hearing. On 13 October 2010, the relevant EC representatives confirmed they would attend the hearing. On 15 October 2010, the Tribunal informed the Parties of the EC representatives’ attendance and invited the Parties to confer in view of reaching an agreement with respect to the timing, scope and form of the EC’s testimony. The Parties provided their comments on 22 and 25 October 2010. On 27 October 2010 the Tribunal issued directions with respect to the EC’s participation at the hearing, which were communicated to the EC on 28 October 2010. On 3 November 2010, the Claimants [Viorel Micula] advised the Tribunal that due process required that the EC be treated as a hostile witness vis-à-vis the Claimants, and required more time for their cross-examination. After hearing the Respondent’s position, the Tribunal ruled on this matter during the hearing.
74. By letter of 1 November 2010, the Claimants alleged that Romanian tax enforcement officials had seized significant assets of the EFDG necessary for the continuation of the Claimants’ business (in particular, production equipment and machinery) and were threatening to commence the forced sale of these assets as early as 8

November 2010. The Claimants advised that they would shortly file an application for provisional measures and for a temporary “standstill” order, and requested that their applications be heard during the first day of the hearing. After an invitation from the Tribunal, on 3 November 2010 the Respondent submitted preliminary comments on the Claimants’ letter, to which the Claimants responded on the same date.

75. On 3 November 2010, the Claimants submitted an Application for Provisional Measures (“Claimants’ Application for Provisional Measures”) pursuant to Article 47 of the ICSID Convention and Arbitration Rule 39, together with a request for an emergency temporary order.
76. On 5 November 2010, at the invitation of the Tribunal, the Respondent submitted its comments on the Claimants’ request for an emergency temporary order, requesting that it should be dismissed for the reasons stated in that submission. In that same letter, the Respondent proposed that the Claimants’ Application for Provisional Measures be addressed following, rather than during, the evidentiary hearing, preferably in December 2010, noting that there was no need to disrupt the hearing due to the Claimants’ Application for Provisional Measures.
77. On 5 November 2010, the Tribunal issued a Procedural Order in which it (i) denied the Claimants’ request for an emergency temporary order, without prejudice to the Tribunal’s authority to issue a different determination at a later stage in the proceedings if the circumstances should change; (ii) determined that it would address the Claimants’ Application for Provisional Measures after the hearing on the merits; and (iii) gave instructions with respect to briefing by the Parties.

#### **4. The hearing on the merits and quantum**

78. From 8 to 19 November 2010, the Tribunal and the Parties held a hearing on the merits and quantum in Paris, France. During the course of the hearing, the Parties made oral arguments regarding their merits and quantum cases, had the opportunity to examine the witnesses and experts that had been called to testify, and addressed several evidentiary and procedural issues. The EC representatives invited by the Tribunal provided clarifications to their written submission and answered the Parties’ questions. The Tribunal was addressed by Messrs. Eric A. Schwartz, Reginald R. Smith and Kenneth R. Fleuriet and Ms. Amy R. Frey on behalf of Mr. Ioan Micula and the Corporate Claimants; by Messrs. Emmanuel Galliard and David Reed on behalf of Mr. Viorel Micula, and by Messrs. D. Brian King, Georgios Petrochilos, Noah Rubins, Boris Kasalowsky and Ben Juratowitch on behalf of the Respondent.
79. The following persons participated in the hearing:

On behalf of Mr. Ioan Micula and the Corporate Claimants:

Mr. Ioan Micula  
Mr. Eric Schwartz, King & Spalding  
Mr. Reggie Smith, King & Spalding  
Mr. Ken Fleuriet, King & Spalding

Mr. Ric Toher, King & Spalding  
Mrs. Amy R. Frey, King & Spalding  
Ms. Jamie Miller, King & Spalding  
Ms. Catalina Constantina, King & Spalding  
Mrs. Eva Micula  
Ms. Natalie Micula  
Ms. Olivia Micula  
Mrs. Oana Popa  
Mrs. Diana Radu  
Mr. Vasile Popa-Bota  
Mr. Traian Bulzan

On behalf of Mr. Viorel Micula:

Mr. Viorel Micula  
Mr. Emmanuel Gaillard, Shearman & Sterling  
Mr. David Reed, Shearman & Sterling  
Mr. Robert Williams, Shearman & Sterling  
Ms. Veronika Korum, Shearman & Sterling  
Mr. Henry Ovens, Shearman & Sterling  
Ms. Valerie Ollivier, Shearman & Sterling  
Ms. Ioana Aron Blahuta  
Ms. Medora Purle  
Mr. Cristian Flora  
Mr. Calin Vidican  
Ms. Eva Fogarassy  
Mr. Adrian Rotar  
Ms. Alexandra Gheorghe-Duca  
Mr. Mihai Clepce

On behalf of the Respondent:

HE Minister Gheorghe Ialomițianu, Ministry of Public Finance  
Ms. Manuela Nestor, Nestor Nestor Diculescu Kingston Petersen  
Ms. Georgeta Harapcea, Nestor Nestor Diculescu Kingston Petersen  
Mr. D. Brian King, Freshfields Bruckhaus Deringer LLP  
Mr. Georgios Petrochilos, Freshfields Bruckhaus Deringer LLP  
Mr. Noah Rubins, Freshfields Bruckhaus Deringer LLP  
Mr. Boris Kasolowsky, Freshfields Bruckhaus Deringer LLP  
Mr. Jonathan J Gass, Freshfields Bruckhaus Deringer LLP  
Mr. Ben Juratowitch, Freshfields Bruckhaus Deringer LLP  
Mr. Sami Tannous, Freshfields Bruckhaus Deringer LLP  
Ms. Evgeniya Rubinina, Freshfields Bruckhaus Deringer LLP  
Mr. Moritz Keller, Freshfields Bruckhaus Deringer LLP  
Mr. Marcus Benzing, Freshfields Bruckhaus Deringer LLP  
Mr. Ignacio Stratta, Freshfields Bruckhaus Deringer LLP



Ms. Victoria Bokelmann, Freshfields Bruckhaus Deringer LLP  
Ms. Rebecca Smith, Freshfields Bruckhaus Deringer LLP  
Ms. Lauren Henschke, Freshfields Bruckhaus Deringer LLP  
Ms. Smaranda Miron, Freshfields Bruckhaus Deringer LLP  
Ms. Eleonore Gleitz, Freshfields Bruckhaus Deringer LLP

80. The Tribunal heard oral testimony from the following persons:

Claimants' witnesses and experts

Mr. Ioan Micula	Claimant
Mr. Viorel Micula	Claimant
Professor Lucian Mihai	Expert Witness, University of Bucharest
Professor Alan Dashwood QC	Expert Witness, Henderson Chambers
Professor David Caron	Expert Witness, University of California at Berkeley
Mr. Liviu Marcu	Witness
Mr. Nicolae Staiculescu	Witness
Mr. Mircea Halbac	Witness
Mr. Moisa Ban	Witness
Mr. Sorin Baci	Witness
Mr. Jaun Gamecho	Witness
Professor Don Lessard	Expert Witness, MIT, The Brattle Group
Mr. Alexis Maniatis	Expert Witness, The Brattle Group
Ms. Natasha Dupont	Expert Witness, The Brattle Group
Mr. Chris Osborne	Expert Witness, FTI Consulting
Mr. Richard Edwards	Expert Witness, FTI Consulting
Mr. Richard Boulton	Expert Witness, LECG
Mr. Ian Clemmence	Expert Witness, LECG
Dr. James Fry	Expert Witness, LMC
Mr. Laszlo Juhasz	Expert Witness, BCG

Respondent's witnesses

Mr. Leonard Orban	Fact Witness, Office of the President of Romania
Professor Mihai Berinde	Witness
Sir Francis Jacobs QC	Expert Witness, Fountain Court Chambers
Mr. Alexander Milner	Expert Witness, Fountain Court Chambers
Professor Flavius Baias	Expert Witness, Bucharest Public University
Professor Dr. Rudolf Streinz	Expert Witness, University of Munich
Professor Dr. Christoph Herrmann	Expert Witness, University of Passau
Mr. John Ellison	Expert Witness, KPMG
Dr. Bill Robinson	Expert Witness, KPMG
Mr. Nishad Morjaria	Expert Witness, KPMG
Mr. Dan Aylward	Expert Witness, KPMG
Mr. Conrad Caspari	Expert Witness, Agra CEAS

Mr. Asger Petersen

Expert Witness, Cleary Gottlieb Steen &  
Hamilton

Non-disputing Parties (EC)

Mr. Bernd Martenczuk, Legal Representative, European Commission

Mr. Frank Hoffmeister, Legal Representative, European Commission

Mr. Ion Rogalski, Legal Representative, European Commission

81. A transcript of the hearing was distributed among the Parties. An audio recording was made in English and Romanian and also distributed among the Parties.

**5. Procedural matters following the hearing**

82. By the end of the hearing, the following evidentiary and procedural issues remained outstanding: (i) the Claimants requested that Mr. Mihai Berinde, who had to leave the hearing early, be made available for cross-examination at a later date, whether in person or via videoconference; (ii) the Claimants confirmed that their (or rather Mr. Ioan Micula's) application for a site visit was still in place; (iii) the form and time of the Parties' closing arguments remained outstanding, and (iv) the Respondent requested that the Claimants reformulate their request for relief in such a way that it identified each breach alleged and the specific relief requested on the basis of such breaches.

83. On 25 November 2010, the Tribunal issued a Procedural Order ruling on the evidentiary and procedural matters that remained outstanding. Specifically, the Tribunal (i) decided that Mr. Berinde would not be called for oral examination, but specified that this would not prevent the Parties or the Tribunal from relying on Mr. Berinde's written testimony (and that the same would apply to the other called witnesses/experts that the Parties did not cross-examine at the hearing); (ii) gave instructions on further briefing with respect to the Claimants' application for a site visit; (iii) determined that the Parties should present oral closing arguments and gave instructions for a future hearing in that respect, but also invited the Parties to submit voluntary post-hearing briefs; and (iv) gave directions to the Claimants with respect to the submission of their amended request for relief. The Tribunal also gave further instructions to the Parties with respect to the review of the hearing transcript and audio tapes, and with respect to the Parties' briefs on provisional measures.

84. The Tribunal will address the more relevant procedural matters separately below.

**a. The Claimants' Applications for Provisional Measures and the Respondent's Application for Revocation of Provisional Measures**

85. As noted in para. 75 above, on 3 November 2010 the Claimants submitted an Application for Provisional Measures, as well as a request for an emergency temporary order. Specifically, the Claimants requested (Claimants' Application for Provisional Measures, ¶ 43):

- a. “an Order preserving the *status quo ante* by instructing Respondent to withdraw or otherwise cease and desist from enforcing the above-described seizure orders, or from implementing any new such orders against any of the EFDG companies, prior to the Tribunal’s issuance of its final award (and that the award itself deal with the matter as appropriate at that time, such as by maintaining the Order in place until Romania has satisfied the terms of the award in full); and
  - b. an Order that Respondent refrain from taking any other measure against any of the EFDG companies that would aggravate or extend the existing dispute prior to the Tribunal’s issuance of its final award.”
86. By Procedural Orders of 5 and 25 November 2010, the Tribunal gave instructions with respect to briefing by the Parties. In accordance with these instructions, on 30 November 2010, the Respondent submitted its observations on the Claimants’ Application for Provisional Measures. After further correspondence from the Parties and leave from the Tribunal, on 20 December 2010 the Claimants submitted a reply in support of their Application for Provisional Measures, and the Respondent submitted a rejoinder on 17 January 2011. At the invitation of the Tribunal, the Parties submitted further comments on 9 February 2011.
87. On 2 March 2011, the Tribunal issued a Decision on the Claimants’ Application for Provisional Measures (the “Decision on Provisional Measures”). In that Decision, the Tribunal recommended that the Respondent “inform the Claimants, with a copy to the Tribunal, if it intends to proceed with the seal or forced sale of the seized assets or take any other tax collection measure that could have a similar effect, two months prior to the date in which it intends to implement such seal, sale or other measure, until this arbitration is completed or until reconsideration of this Decision.” The Tribunal denied at that stage the remaining requests for provisional measures brought by the Claimants, and invited either Party to apply to the Tribunal for a reconsideration of the Decision if it should consider that the circumstances under which the Decision was made had changed (Decision on Provisional Measures, ¶ 98).
88. On 4 March 2011, the Claimants informed the Tribunal that the Romanian government had garnished Starmill’s bank accounts to satisfy the payment of overdue taxes and associated penalties, in violation of “the spirit, if not the letter, of the Tribunal’s Decision [on Provisional Measures]” (Claimants’ letter of 4 March 2011, p. 1, or “Claimants’ Second Application for Provisional Measures”). The Claimants requested the Tribunal to order the Respondent to (i) lift the current garnishment of Starmill’s accounts; (ii) replenish those accounts with any funds that have been transferred to the Government’s accounts; (iii) refrain from garnishing the bank accounts of any of Claimants’ companies in relation to the taxes and penalties covered by the Decision on Provisional Measures unless it provides the two months’ advance notice required by the Decision, and (iv) clarify its position on the impending sale of Starmill’s (and the other companies’) seized physical assets (Second Application, pp. 3-4). By letter of 7 March 2011, the Tribunal stated that it understood

this letter to be a new request for provisional measures, and invited the Respondent to comment.

89. By letter of 11 March 2011, the Respondent submitted its comments to the Claimants' letter of 4 March 2011, noting that it also considered the letter to be a new application for provisional measures and requesting that Claimants' request be denied with a full award of costs. The Claimants replied by letter of 17 March 2011, reiterating their first three requests for relief but denying that the 4 March letter constituted a new request for provisional measures. The Parties exchanged further correspondence setting out their positions (Respondent's letters of 23 and 31 March 2011, and Claimants' letters of 28 March and 13 and 22 April 2011).
90. On 27 May 2011, the Tribunal issued a Supplemental Decision on Provisional Measures (the "Supplemental Decision on Provisional Measures") in which it confirmed its Decision on Provisional Measures, with certain amendments. Specifically, the Tribunal recommended that the Respondent inform the Claimants, with a copy to the Tribunal, if it intended to proceed with the seal or forced sale of the seized assets or take any other tax collection measure (including garnishments of bank accounts) that could have a similar effect, two months prior to the date in which it intends to implement such seal, sale or other measure, until this arbitration is completed or until reconsideration of the Supplemental Decision. The Tribunal also recommended that the Parties seek to reach an agreement on a mutually acceptable security or assurance to be provided by the Claimants and that, conditioned upon that agreement, the Respondent should lift the current garnishments over Starmill's accounts. The Tribunal denied the Claimants' request that the garnished accounts be replenished. Once again, the Tribunal invited either Party to apply to the Tribunal for a reconsideration of this Decision if it should consider that the circumstances under which this Decision was made changed (Supplemental Decision on Provisional Measures, ¶ 80).
91. On 5 July 2011, the Claimants informed the Tribunal of further enforcement actions taken by the Respondent with respect to the Claimants' assets, and requested the Tribunal to confirm that the Supplemental Decision on Provisional Measures covered all assets of the EFDG companies seized by the Respondent at any time until the completion of the arbitration. In a letter of 12 July 2011, the Respondent agreed with the Claimants' interpretation. By letter of 22 July 2011, the Tribunal confirmed that the parties' interpretation concerning the scope of the Supplemental Decision was correct.
92. On 13 September 2011, the Respondent notified the Tribunal and the Claimants that it intended to take enforcement measures with respect to three EFDG companies: European Food, European Drinks S.A. ("European Drinks") and Transilvania General Import Export SRL ("TGIE"). The enforcement measures consisted of the seizure of further movable and immovable property of the three companies and the garnishment of their bank accounts for approximately EUR 55 million. The Respondent advised that the seized property would remain in the companies' control, to be used in their

business. The Respondent attached the notices in respect of the enforcement measures to each of the three EFDG companies ("Garnishment Notices").

93. On 12 October 2011, the Respondent notified the Tribunal and the Claimants that, pursuant to Romanian tax law, two EFDG companies had been denied renewal of certain authorisations which enabled the companies to postpone the payment of customs and excise duties for goods imported into or manufactured in the EU if the goods were stored in "fiscal warehouses". The Respondent did not consider that the decisions to repeal and deny renewal of the authorisations were within the scope of the provisional measures recommended by the Tribunal, but advised that it would voluntarily refrain from giving effect to the decisions until two months from the date of their communication.
94. On 14 October 2011, the Claimants submitted an Emergency Supplement to their Application for Provisional Measures ("Claimants' Third Application"), seeking the following emergency interim relief:
  - a. "preventing the Respondent from proceeding with the garnishments of the bank accounts of European Food, European Drinks and TGIE as set out in the [Garnishment] Notices;
  - b. ordering the Respondent to refrain from garnishing the accounts of any other EFDC company until the Tribunal issues its Final Award (collectively, the 'Garnishment Application'); and
  - c. ordering the Respondent to refrain from repealing the fiscal warehouse authorizations of European Food and Scandic Distilleries until the Parties have fully briefed that issue and the Tribunal issues a decision with respect to it ('Fiscal Warehouse Application').
  - d. Insofar as any further briefing may be required on any of these issues or the Tribunal is not able to take up this application immediately, the Claimants further request that the Tribunal issue a temporary emergency order instructing the Respondent to refrain from the acts cited in the preceding paragraph until such time as the Tribunal is able rule upon this application."
95. The Claimants clarified that they "do not in this application request an order preventing the seizure orders as announced in the [Garnishment] Notices over additional assets up to an aggregate value of €55 million, provided that Romania continues to abide by the existing orders of the Tribunal regarding the seal and forced sale of those assets" (Claimants' Third Application, ¶ 25). The Claimants' Third Application was divided into two applications with separate briefing schedules: the Garnishment Application and the Fiscal Warehouse Application.
96. On 1 November 2011, the Claimants supplemented their Fiscal Warehouse Application, requesting the Tribunal to order the Respondent to refrain from repealing the fiscal warehouse authorizations until the final award.

97. The Parties and the Tribunal exchanged correspondence with respect to the briefing schedule and the timing of the enforcement measures. At the invitation of the Tribunal, the Respondent represented that the garnishments would not take effect before 25 November 2011, and that the decision regarding fiscal warehouse authorizations would not take effect before 12 December 2011 (Respondent's letter of 20 October 2011).
98. On 11 November 2011, in accordance with the agreed briefing schedule, the Respondent submitted its observations on the Claimants' Garnishment Application. On 16 November 2011, the Claimants wrote to rebut certain allegations made by the Respondent with respect to the Garnishment Application, and offered to produce the documentation supporting these allegations at the Tribunal's request. On 18 November 2011, the Tribunal requested the Claimants to produce such supporting documentation and also invited the Respondent to submit any documentation it deemed relevant. The Claimants produced the requested documentation to the Tribunal on 21 November 2011.
99. On 22 November 2011, the Respondent submitted its comments on the Claimants' letter of 16 November 2011, requesting the Tribunal to dismiss the Claimants' Garnishment Application.
100. On 23 November 2011, the Tribunal issued the following temporary order concerning the Claimants' Garnishment Application (the "Temporary Order on Garnishment"):
- 5.1. The Claimants' request for a temporary emergency order is granted, until the Tribunal is able to issue its final recommendation with respect to the Claimants' Third Application in its entirety. Specifically, until the Tribunal is able to hand down its final recommendation,
- (i) the Respondent shall refrain from proceeding with the garnishments of the bank accounts of European Food, European Drinks and TGIE;
- (ii) the Respondent shall refrain from garnishing the accounts of any other EFDC company.
101. Following a further exchange of correspondence (Respondent's letters of 29 and 30 November and 8 December 2011, and Claimants' letter of 5 December 2011) on the Garnishment and Fiscal Warehouse Applications, on 16 December 2011 the Tribunal issued a Third Decision on Provisional Measures ("Third Decision"). The Tribunal made the following recommendations (Third Decision, ¶ 109):
- a. "The Respondent shall refrain from proceeding with the garnishments of the bank accounts of European Food, European Drinks and TGIE as set out in the [Garnishment] Notices.
- b. The Respondent shall refrain from repealing the fiscal warehouse authorizations of European Food and Scandic Distilleries until the Tribunal issues its Final Award.

- c. The Tribunal otherwise confirms its (First) Decision on Provisional Measures of 2 March 2011. Accordingly, the Respondent shall inform the Claimants, with a copy to the Tribunal, if it intends to proceed with the seal or forced sale of the seized assets or take any other tax collection measure (including garnishments of bank accounts) that could have a similar effect, two months prior to the date in which it intends to implement such seal, sale or other measure, until this arbitration is completed or this Decision is reconsidered.
  - d. The Parties shall continue to seek to reach an agreement on a mutually acceptable security or assurance to be provided by the Claimants.
  - e. If either Party considers that the circumstances under which this Decision is made have changed, either Party may apply to the Tribunal for reconsideration of this Decision.
  - f. The other prayers are dismissed.
  - g. Costs are reserved for a later decision or award.”
102. The Tribunal noted in its Third Decision that no additional security had been provided by the Claimants in respect of the lifting of the garnishment on Starmill’s accounts, a condition that was imposed by the Tribunal in its Supplemental Decision. It did, however, note that the Micula brothers made a good faith offer of certain properties to satisfy their debts, and requested that the Claimants submit a formal valuation of these properties as soon as it was finalized. Although the Tribunal granted the Claimants’ Garnishment Application, it repeated that it expected the Claimants to supply some form of security and recommended that the Parties continue to seek to reach an agreement on a mutually acceptable security or assurance.
103. On 14 March 2012, the Respondent asked the Claimants to produce the valuation report pursuant to the Tribunal’s instructions in the Third Decision. On 30 March 2012, the Respondent repeated its request. Following further exchanges of correspondence (Claimants’ letters of 17 April, 7 June and 11 July 2012 and Respondent’s letters of 18 May, 21 June, 19 and 20 July 2012), the parties failed to reach a mutual agreement on security to be provided by the Claimants.
104. On 1 August 2012, the Respondent filed an Application to Revoke Provisional Measures (“Respondent’s Revocation Application”) seeking the revocation of the provisional measures recommended by the Tribunal, or, in the alternative, the suspension of the provisional measures until the Claimants had posted security adequate to protect the Respondent’s right to collect taxes owed by the eleven EFDG companies. The Respondent also requested that the Tribunal’s Award provide that any amount awarded to any of the Claimants (whether as damages or costs) be subject to set-off against the EFDG companies’ tax debts, including lawful interest and penalties. At the Tribunal’s invitation, the Parties consulted and agreed on a briefing schedule to submit their comments on the Respondent’s Revocation Application. The Parties informed the Tribunal of this briefing schedule on 17 August 2012.

105. On 28 September 2012, the Claimants submitted their observations on Respondent's Revocation Application. The Claimants opposed the Respondent's Application in its entirety and requested that the provisional measures remain in force until the date of the Award. In addition, the Claimants made three requests of their own: (i) that the Award provide that the Respondent be enjoined from any further tax collection measures until full payment of any damages awarded to the Claimants by the Tribunal, (ii) that the Tribunal declare that the Respondent cannot set-off tax debts as requested, and (iii) that the Respondent is ordered to pay all the Claimants' costs in relation to Respondent's Application.
106. On 8 October 2012, the Respondent submitted a request for production of the valuation reports in regard to the properties which the Claimants had offered to the Respondent as payment in kind to extinguish their existing tax debts. On 18 October 2012, the Claimants opposed production of the valuation reports, stating that the arbitral proceedings were not the appropriate forum to negotiate the details of a proposed payment in kind and that they were prepared to make the reports available to the Romanian authorities in direct meetings.
107. On 30 October 2012, the Tribunal issued a Procedural Order in which it ordered the production of the valuation reports, if the Claimants confirmed that the relevant properties were offered as security for their tax debts owed to the Respondent, rather than as payment in kind. The Tribunal found that the reports were relevant and material to its assessment of the Claimants' good faith efforts to provide additional security to meet the requirement of proportionality, so that they were thus necessary for the determination of the Respondent's Revocation Application. On 9 November 2012, the Claimants confirmed that the properties were offered as payment in kind and not as security, but produced the valuation reports nonetheless. They also mentioned additional assets as potential security. Valuation reports concerning these additional assets were submitted on 23 November 2012.
108. On 21 December 2012, the Respondent filed its reply concerning its Revocation Application and, on 15 February 2013, the Claimants filed their rejoinder.
109. On 5 March 2013, the Claimants submitted their Fourth Application for Provisional Measures ("Claimants' Fourth Application"). The Claimants informed the Tribunal that, on 5 March 2013, Romania had seized brewery-related assets belonging to European Food and requested that the Tribunal order provisional relief to stop the seizure and forced execution of assets. The Claimants argued that the seizure violated the existing provisional measures because Romania had given no notice of the measures and planned a forced sale if the Claimants' tax debt was not paid within 15 days.
110. At the invitation of the Tribunal, the Respondent submitted its response to the Claimants' Fourth Application on 8 March 2013. It argued that the seizure of assets belonging to European Food did not constitute a violation of the provisional measures in place because no notice requirement applied to the seizure of assets and Romania did not intend to proceed with a forced sale of the assets. The Respondent



contended that the seizure was justified because of time limitations on debt collection efforts under Romanian law. The Parties filed further comments by letters of 14 March 2013 (Claimants) and 21 March 2013 (Respondent).

111. On 27 March 2013, the Tribunal issued its Fourth Decision on Provisional Measures (“Fourth Decision”) concerning the Respondent’s Revocation Application. The Tribunal concluded that the Claimants had made good faith attempts to reach an agreement with the Respondent regarding a mutually acceptable security and that the provisional measures preventing garnishment of the bank accounts of European Food, European Drinks and TGIE remained proportional. It further considered that the circumstances surrounding the fiscal warehouse authorizations had not changed to such an extent as to warrant the revocation, suspension or modification of the provisional measures in question. The Tribunal thus confirmed the existing provisional measures and dismissed Romania’s request for revocation or suspension of those measures (Fourth Decision, ¶ 119). It further ruled that the Claimants’ request for post-award injunctive relief concerning Romania’s tax debt collection measures, as well as the Parties’ requests with respect to the set-off of tax debts against a pecuniary award in favor of the Claimants, would be deferred for determination in the Award.<sup>2</sup>
112. On 5 April 2013, the Tribunal issued its Fifth Decision on Provisional Measures (“Fifth Decision”) concerning Claimants’ Fourth Application. The Tribunal found that the mere seizure of assets without providing any notice that did not prevent the Claimants from continuing to use those assets did not, in and of itself, violate the provisional measures recommended by the Tribunal. The Tribunal thus dismissed Claimants’ Fourth Application and all other prayers for relief (Fifth Decision, ¶ 39). The Tribunal also urged the parties to continue seeking a mutually acceptable agreement on security, as previously recommended (Fifth Decision, ¶ 38).

**b. The Claimants’ Renewed Application for a Site Visit**

113. On 9 December 2010, the Claimants submitted a renewed application for a site visit, specifying which allegations a site visit would help prove or disprove and commenting on the Tribunal’s authority to order it. On 17 December 2010, the Respondent objected to Claimants’ application, stating that a site visit was unnecessary and would be procedurally unfair.
114. After careful consideration of each Party’s position and a review of the evidence in the record, the Tribunal concluded that a site visit was neither necessary nor useful for the resolution of the dispute. Accordingly, by Procedural Order of 20 January 2011 the Tribunal denied the Claimants’ application for a site visit. In that same Procedural Order, the Tribunal gave further directions to the Parties with respect to oral closing arguments.

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<sup>2</sup> These matters are addressed in Section IX below.

### **c. The Claimants' Revised Request for Relief**

115. On 20 December 2010, the Claimants submitted a revised request for relief (the "Revised Request for Relief").<sup>3</sup> On 10 January 2011, the Respondent objected to the procedural propriety and content of the Revised Request for Relief and requested that the Tribunal reject specific evidence. The Parties exchanged further submissions on this matter (Claimants' letters of 31 January 2011 and 9 February 2011, and the Respondent's letter of 2 February 2011).
116. The Tribunal ruled on this matter by means of a Procedural Order issued on 6 April 2011. With respect to the procedural propriety of the Revised Request for Relief, the Tribunal declined to reject any evidence submitted by the Claimants, but found that the Claimants' reliance on certain quantum experts was new, and thus invited the Respondent to rebut these testimonies in writing or by further examination of those experts.
117. The Tribunal also found that there had been no prejudice to the Respondent as a result of the reformulation of the Claimants' expropriation case or of their claim for interest. However, it found that the Claimants' request that any damages be awarded to the Individual Claimants on a 50/50 basis, and in the alternative that any damages be awarded to all five Claimants, was a reformulation of the Claimants' case that raised several issues of procedure and merits. The Tribunal also requested the Parties to address the merits of the Claimants' damages case in their post-hearing briefs and gave further directions with respect to briefing. The Tribunal also noted that the Claimants' reformulation of their damages case could affect the procedural schedule for closing arguments. It thus invited the Claimants to confirm if they wished to maintain their request for an award of damages to be distributed to the Individual Claimants on a 50/50 basis. The Claimants provided this confirmation on 15 April 2011.

### **d. Post-hearing briefs and oral closing arguments**

118. The Tribunal's Procedural Order of 25 November 2010 provided that the Parties would present oral closing arguments, setting as a tentative date 1-2 March 2011. It also provided that the Parties could submit voluntary post-hearing briefs.
119. On 25 January 2011, the Respondent informed the Tribunal that its Romanian counsel would not be available for a hearing on 1-2 March 2011. After consulting with the Parties, on 3 February 2011 the Tribunal determined that the hearing for the Parties' closing arguments would take place on 6 and 7 June 2011.
120. As mentioned in paragraph 116 above, on 6 April 2011 the Tribunal issued a Procedural Order that ruled on the Claimants' Revised Request for Relief and gave directions to the Parties with respect to further briefing. Following the Claimants' confirmation that they wished to maintain their reformulated damages case, at the

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<sup>3</sup> The Claimants' Revised Request for Relief is addressed in more detail in Sections IV.A and VII.A.1 below.

Tribunal's invitation the Parties consulted on the next procedural steps. On 4 May 2011 they informed the Tribunal that they had reached an agreement with respect to post-hearing briefs, additional submissions on damages, the hearing schedule and cross-examination of experts.

121. On 12 April 2011, the Respondent requested leave to submit three new fact exhibits. After hearing both Parties' positions, on 29 April 2011 the Tribunal determined that the record was sufficiently complete on the subject matters of those documents insofar as such matters were relevant to the outcome of the dispute, and denied the Respondent's request.
122. On 6 May 2011, in accordance with its Procedural Order of 25 November 2010, the Tribunal submitted to the Parties a list of questions to be addressed in their closing arguments.
123. On 13 May 2011, the Parties submitted their written post-hearing briefs. On 27 May 2011, the Respondent submitted an additional submission with respect to the Claimants' Revised Request for Relief in accordance with the Tribunal's Procedural Order of 6 April 2011.
124. On 6 and 7 June 2011, the Parties and the Tribunal held a hearing in Paris. During the course of the hearing, the Parties presented their oral closing arguments and responded to questions from the Tribunal. The Tribunal was addressed by Messrs. Fleuriet, Gaillard, Reed and Schwartz, on behalf of the Claimants, and by Messrs. King, Petrochilos and Rubins, on behalf of the Respondent.
125. The following persons participated in the hearing:

On behalf of Mr. Ioan Micula and the Corporate Claimants:

Mr. Eric Schwartz	King & Spalding
Mr. Ken Fleuriet	King & Spalding
Mr. Ric Toher	King & Spalding
Ms. Amy R. Frey	King & Spalding
Mr. Ioan Micula	Claimant
Ms. Nathalie Micula	Representative for Ioan Micula, European Food, Starmill, and Multipack
Ms. Olivia Micula	Representative for Ioan Micula, European Food, Starmill, and Multipack
Ms. Dorin Floruta	Representative for Ioan Micula, European Food, Starmill, and Multipack
Mr. Vasile Popa-Bota	Representative for Ioan Micula, European Food, Starmill, and Multipack
Mr. Mircea Halbac	Representative for Ioan Micula, European Food, Starmill, and Multipack
Mrs. Oana Popa	Representative for Ioan Micula, European Food, Starmill, and Multipack

Mr. Ciprian Popa Representative for Ioan Micula, European Food, Starmill, and Multipack

On behalf of Mr. Viorel Micula:

Prof. Emmanuel Gaillard	Shearman & Sterling
Mr. David Reed	Shearman & Sterling
Mr. Robert Williams	Shearman & Sterling
Ms. Veronika Korom	Shearman & Sterling
Mr. Richard Kiveal	Shearman & Sterling
Ms. Gresa Matoshi	Shearman & Sterling
Mr. Viorel Micula	Claimant
Ms. Doina Micula	Representing Mr Viorel Micula
Mr. Victor Micula	Representing Mr Viorel Micula
Ms. Ioana Aron Blahuta	Representing Mr Viorel Micula
Ms. Medora Purle	Representing Mr Viorel Micula
Mr. Calin Vidican	Representing Mr Viorel Micula
Mr. Cristian Flora	Representing Mr Viorel Micula
Ms. Eva Fogarassy	Representing Mr Viorel Micula

On behalf of the Respondent:

Ms. Georgeta Harapcea	Nestor Nestor Diculescu Kingston Petersen
Mr. D. Brian King	Freshfields Bruckhaus Deringer LLP
Mr. Georgios Petrochilos	Freshfields Bruckhaus Deringer LLP
Mr. Boris Kasolowsky	Freshfields Bruckhaus Deringer LLP
Mr. Noah Rubins	Freshfields Bruckhaus Deringer LLP
Mr. Jonathan J. Gass	Freshfields Bruckhaus Deringer LLP
Mr. Ben Juratowitch	Freshfields Bruckhaus Deringer LLP
Mr. Sami Tannous	Freshfields Bruckhaus Deringer LLP
Ms. Evgeniya Rubinina	Freshfields Bruckhaus Deringer LLP
Mr. Moritz Keller	Freshfields Bruckhaus Deringer LLP
Ms. Smaranda Miron	Freshfields Bruckhaus Deringer LLP
Mr. Tunde Oyewole	Freshfields Bruckhaus Deringer LLP
Mr. Ignacio Stratta	Freshfields Bruckhaus Deringer LLP
Ms. Kate Bousfield	Freshfields Bruckhaus Deringer LLP
Mr. Nishad Morjaria	KPMG

126. A transcript of the hearing was distributed among the Parties.

**e. Closure of the Proceeding and Submissions on Costs**

127. On 14 June 2013, in accordance with ICSID Arbitration Rule 28(2), the Tribunal invited the Parties to file statements of costs by 12 July 2013, and their comments on the other Parties' statements of costs by 2 August 2013. The Parties were given the opportunity to inform the Tribunal if they saw a need for submissions on costs, rather than statements. By the same letter, the Tribunal declared the proceeding closed

pursuant to Rule 38(1) of the ICSID Arbitration Rules. The Parties subsequently agreed that they would file submissions on costs, but that they would not file any reply submissions.

128. On 19 July 2013, the Parties submitted their respective submission of costs, each requesting an award requiring the other party to bear the entirety of the expenses incurred by the parties, the fees and expenses of the members of the Tribunal, and the charges for the use of ICSID's facilities. The Claimants also requested compound interest on a costs award. The Claimants' submission was accompanied by an Annex and Exhibits C-1035 to C-1044. The Respondent's submission was accompanied by two declarations of co-counsel Nestor Nestor Diculescu Kingston Petersen and Freshfields Bruckhaus Deringer LLP, Exhibits R-245 to R-268 and Legal Authorities RL-375 and RL-376.
129. On 7 October 2013, the period of 120 days for the rendering of the award was extended pursuant to Rule 46 of the Arbitration Rules.

### III. FACTUAL BACKGROUND

#### A. OVERVIEW

130. The present dispute arises from Romania's introduction of certain economic incentives for the development of disfavored regions of Romania, and their subsequent revocation in the context of Romania's accession to the European Union ("EU").
131. Specifically, in 1998, Romania enacted Emergency Government Ordinance 24/1998 ("EGO 24/1998" or "EGO 24"), which made available certain tax incentives, including customs duties exemptions (called alternatively by the Parties the "Incentives" or the "Facilities"), to investors in certain disfavored regions who met the requirements set out in EGO 24/1998 and its implementing legislation. The Claimants claim that, in reliance on those incentives, and in reliance on the expectation that they would be maintained for a 10-year period, they made substantial investments in the Ștei-Nucet-Drăgănești disfavored region located in Bihor County, northwestern Romania. The Claimants further claim that Romania's revocation of these incentives (effective 22 February 2005) was in breach of its obligations under the BIT and caused damages to the Claimants, as described further below.
132. Romania does not dispute that in 1998 it passed EGO 24, which offered tax incentives to investors investing in disfavored regions, nor does it dispute that, effective 22 February 2005, it repealed most of the tax incentives offered under EGO 24, with the exception of a profit tax incentive. However, it denies that this revocation breached any of its obligations under the BIT. In addition, it argues that this revocation was necessary to comply with EU state aid obligations, which in turn was necessary for Romania to complete its accession to the EU.
133. The Claimants began to invest in Romania in 1991, and continued investing throughout the next two decades. During this time, Romania was undergoing its economic transition from communism to a market economy. As stated by the Respondent, during this time "the factual record [...] portrays a government trying to pursue two policies that came into increasing conflict" (R-Rejoinder, ¶ 103): one directed to the development of its disfavored regions, and another directed to obtaining accession to the EU.
134. There are, therefore, three main areas of factual inquiry for the Tribunal: the evolution of Romania's policy for the development of disfavored areas, the history of the Claimants' investments, and Romania's EU accession process.
135. The Tribunal will first describe the evolution of Romania's policy for the development of disfavored areas, in particular the EGO 24 framework, up to the point at which the Claimants allege that they began investing in reliance on it (Section B). The Tribunal will then describe the Claimants' investments (Section C). It will then describe the main facts surrounding Romania's accession process, together with related events affecting the EGO 24 framework as that process developed (Section D).

136. Sections B, C and D are meant to give a general overview of the facts of the present dispute. They do not include all factual aspects which may be of relevance, particularly as they emerged from the extensive testimony of witnesses and experts at the hearing. The latter, as far as is relevant, will be discussed in the context of the Tribunal's analysis of the disputed issues.

## **B. LEGAL FRAMEWORK FOR THE DISFAVORED REGIONS**

### **1. Romania's efforts to attract investment in the early 1990s**

137. As noted by the European Commission in a 1997 report, "[a]fter the overthrow of the Ceausescu regime in December 1989, Romania found itself in a deep economic and social crisis" (Exh. C-317). This was followed by several years of reforms directed at transforming Romania into a market economy with the ultimate objective of obtaining EU accession.
138. In this context, Romania undertook serious efforts to attract investment, both foreign and domestic. On 14 March 1990, Romania issued Decree Law 96/1990, entitled "on certain measures for the attraction of foreign capital investment in Romania" (Exh. R-134), which contained provisions regulating foreign investment in Romania and granted foreign investors certain tax benefits.
139. This Decree Law was replaced a year later by Law 35/1991 on foreign investment ("Law 35", enacted on 3 April 1991 and effective 10 April 1991, Exh. C-275). To "induce foreign investment in Romania", this law offered the following incentives for new investments made by foreign investors [later amended to include domestic investors] (Arts. 12-15):
- a. An exemption from customs duties related to certain types of imported machinery, equipment and means of transportation;
  - b. A two-year exemption from customs duties on imported raw materials;
  - c. A profit-tax exemption ranging from 2 to 5 years, depending on the type of investment; and
  - d. A profit-tax reduction for certain investments following the expiration of the profit-tax exemption.
140. On 5 August 1996, Romania passed Government Ordinance No. 27/1996 ("GO 27/1996", Exh. C-276), which offered certain benefits to individuals domiciled or working in some localities from the Apuseni Mountains and the Biosphere Reserve (also known as "the Danube Delta"). These benefits included a corporate profit tax incentive for investors ranging from 5 to 10 years, depending on the location of the investment.
141. In the following years, Romania began serious efforts to promote regional development, which was identified as "one of the essential elements of the general

strategy reform of Romania” in Romania’s Government Program for 1998-2000. One of the objectives of this regional development was “[s]trengthening the ability of Romania to undertake responsibilities as a future member of the European Union.” The program also stated that the Government defined a minimum set of priorities, “achievement of which is in full compliance with the criteria and objectives of the National Program on the Accession of Romania to the European Union.” (Annex 2 to Government Decision 6 issued 15 April 1998, Exh. C-567).

142. In this context, on 16 July 1998, Romania passed Law 151/1998 on Regional Development (the “Regional Development Law”, Exh. C-392). Among its objectives was the “diminution of existing regional imbalances by stimulation of a balanced development, by accelerated recovery of delays in the development of deprived zones as a result of some historical, geographic, economic, social, and political conditions, and prevention of the production of new imbalances.” (Art. 1(a)). The methodological norms issued for Law 151 (Exh. C-392) stated that the objective of regional development was the improvement of the economic performance of certain development regions, and that such objective had the support of the Government and the EU (Art. 1).
143. The Regional Development Law divided the country into 8 development regions. The area in which the Claimants invested (the Ștei-Nucet-Drăgănești region in Bihor County) is located in the North West Regional Development Area, and was managed by the NW-Regional Development Agency (NW-RDA). A key objective of the NW-RDA was to “increase[e] the living standard and long-lasting social-economic development of the region within a European context”, by *inter alia* increasing the attractiveness of the region, establishing a business environment and promoting long-lasting development (Exh. C-393, Section III.2).
144. At the time of these reforms, unemployment levels in Bihor County were high. In its effort to restructure the mining industry, between 1997 and 2005 the Romanian government closed down over 500 uneconomic mines. By the end of 1998, approximately 100,000 miners were out of work. Unemployment was felt strongly in Bihor County, which had been dependent on mining for many years (Exh. C-319, C-320, C-321, C-325, C-566).

## **2. EGO 24/1998**

145. It was in this context that on 30 September 1998 (effective 2 October 1998), Romania adopted Emergency Government Ordinance No. 24/1998 (“EGO 24/1998” or “EGO 24”, Exh. R-5 or C-38). EGO 24/1998 established the legislative framework for the granting of certain incentives to investors investing in certain “disfavored” regions.
146. EGO 24/1998 was subsequently approved and amended by Law No. 20/1999 of 15 January 1999 (effective 19 January 1999) (Exh. C-39), and a renumbered version containing the amendments made by Law 20 was republished on 8 November 1999 (Exh. R-68). It is on this republished version that the Claimants claim they relied. As



a result, for the sake of simplicity, henceforth all references to EGO 24/1998 will refer to its reformulated version republished on 8 November 1999 (Exh. R-68).

147. EGO 24/1998 provided that the Government could declare the creation of certain “disadvantaged areas”, in response to proposals of the National Council for Regional Development (Art. 3). This declaration would be done by means of a “government decision”, which would also approve (a) the period for which a geographical area would be declared a disadvantaged region, (b) the fields of interest for investments, and (c) “the required financing and advantages provided by law, and granted to the investors” (Art. 4). Article 5 provided that “[a] geographical area may be declared a disadvantaged area for a period of at least 3 years, but for not more than 10 years, with possibility for extension, under the conditions of this Emergency Ordinance.”
148. Article 6(1) went on to say that investors meeting certain requirements “will be granted the following advantages for their new investments in these regions”, and proceeded to list the incentives:

Art. 6. - (1) Privately held companies, Romanian legal entities, as well as small or family businesses, authorized pursuant to the Decree-Law no. 54/1990 concerning the organization and operation of free initiative-based economic activities that are headquartered and conduct business within the disadvantaged region, will be granted the following advantages for their new investments in these regions:

(a) exemptions from payment of:

- customs duties and value added tax on machinery, tools, installations, equipment, means of transportation, other goods subject to depreciation which are imported for the purpose of making investments in that region;
- value added tax on machinery, tools, installations, equipment, means of transportation, other goods subject to depreciation manufactured domestically with the purpose of making investments in that region;

[the “**Machinery Incentive**” or “**Machinery Facility**”]

- (b) refunds of customs duties on raw materials, spare parts and/or components necessary for achieving the investor's own production in that region. The refunds will be made based on the approval by the regional development agencies of the companies' production sales documents. The funds necessary for the refund of the customs duties will be provided to the Agency for Regional Development from the Regional Development Fund. In case [of] unprivileged regions belonging to two or more administrative-territorial units, the funds necessary for the refund of the customs duties will be provided by the National Agency for Regional Development from the National Development Fund [the “**Raw Materials Incentive**” or “**Raw Materials Facility**”];
- (c) exemptions from payment of the profit tax during the existence of the disadvantaged region [the “**Profit Tax Incentive**” or “**Profit Tax Facility**”];

- (d) exemptions from payment of the taxes collected for the changes of the destination of the land or for the removal from the agricultural use of some plots of land that had been earmarked for the fulfillment of the investment [the “**Agricultural Land Incentive**” or “**Agricultural Land Facility**”];:]
- (e) preferred payments from the Special Development Fund of the Romanian Government, which was established pursuant to the Emergency Government Ordinance no. 59/1997 concerning the purpose of the funds collected by the State Property Fund during the privatization process of the companies where the State is a shareholder, with the purpose of:
  - encouraging the exports of the final products and/or for the industrial services, as the case may be;
  - guaranteeing external credits, within the annual limit set by the Ministry of Finance;
  - financing special programs, approved by Government Decision;
  - financing investment projects for companies through the state's participation in the share capital.

[the “**Subsidies**”]

2) The advantages and the financing stipulated in paragraph (1) letter e) is established through a Government Decision.

149. Article 8 provided the requirements for investors to qualify for the incentives: “[t]he advantages stipulated in the present Emergency Ordinance are granted to businesses, privately held Romanian legal entities, as well as to small and family businesses, authorized according to Decree-Law No. 54/1990, who have their headquarters and conduct business in this area, if the investment made yields new jobs for the unemployed or for their family members who live in the disadvantaged area.”

150. Articles 7 and 9 set out investors’ obligation to stay in the disadvantaged area for twice the period they received the incentives, as follows:

Art. 7. - If an investment which is benefiting from the provisions of the present Emergency Ordinance is **voluntarily liquidated in a period of time shorter than twice the period of time in which they enjoyed the advantages** granted through the Government Decision to create the underprivileged area, **the liquidator(s) is/are obligated first to pay the funds related to the advantages** granted in accordance with the provisions of the present Emergency Ordinance, to the State Budget, the State Social Insurance Budget and the Special Funds Budgets from the funds resulting from the liquidation procedure.

[...]

Art. 9. - Businesses established in a disadvantaged area **may voluntarily cease to operate in the respective area**, and those opening subsidiaries as legal entities in such an area may **close them or move the location of their headquarters out of the disadvantaged area in a period shorter than the one provided in Art. 7 only if they pay the funds they owe** to

the State Budget, the State Social Insurance Budget and the Special Funds Budgets **related to the advantages granted** in accordance with the provisions of the present Emergency Ordinance.

151. Finally, Article 15 provided that “the Government will approve, through a decision, the methodological standards to be used for the implementation of this Emergency Ordinance.”

### 3. Government Decision 194/1999 and the 1999 Methodological Norms

152. By means of Government Decision 194/1999, dated 25 March 1999 (Exh. C-31, also C-280), Romania designated the Ştei-Nucet region as a disfavoured region for a period of ten years, starting on 1 April 1999. The Ştei-Nucet region is located in Bihor County in the northwestern part of Romania, and its primary industry at the time was the mining and oil industry. GD 194/1999 also stipulated that all six incentives offered under EGO 24/1998 would be available to investors in the Ştei-Nucet region while that region was designated disfavoured, and set out the types of investments that could benefit from the incentives. Specifically, GD 194/1999 provided:

Art. 1. - The mining area of Ştei-Nucet, Bihor county, is established as a disfavoured region.

Art. 2. - The geographical boundaries of the mining area of Ştei-Nucet, Bihor county are represented by Ştei and Nucet, as administrative-territorial units having a surface of 4,678 ha, according to annex no. 1.

Art. 3. - The mining area referred to in art. 1 will be established as a disfavoured region for a period of 10 years.

Art. 4. - During the existence of the disfavoured region, established according to this decision, the facilities under annex no. 2\*) **will be granted**. [“se acordă” in the Romanian original]

153. In turn, Annex 2 of GD 194/1999 listed all of the incentives provided under Article 6(1) of EGO 24, with slightly amended language. Specifically, it stated:

Companies the majority of the share capital of which is privately owned, Romanian legal entities, as well as the private investors or family associations authorized pursuant to the "Decree-Law no. 54/1990 on the organization and operation of economic activities based on free initiative" that were set up after the date of establishment of the disfavoured region and have their registered seat and operate in the disfavoured region, will be granted the following facilities for new investments in these regions:

- (a) an exemption from payment of:
- custom duties and value added tax on machinery, tools, installations, equipment, means of transportation, other goods subject to depreciation which are imported with a view to performing and conducting investments in that region;
  - value added tax on machinery, tools, installations, equipment, means of transportation, other goods subject to depreciation manufactured in the country with a view to performing and conducting investments in that region;

- (b) refund of custom duties on raw materials, spare parts and/or components necessary for achieving the investor's own production in that region;
- (c) an exemption from payment of profit tax during the existence of the disfavoured region;
- (d) an exemption from payment of taxes collected for changes in the nature of land or for conversion of agricultural plots of land into industrial land for the implementation of the investment;
- (e) preferred payment of amounts available from the Special Development Fund at the disposal of the Romanian Government that was established pursuant to the "Emergency Government Ordinance no. 59/1997 on the amounts collected by the State Property Fund during the privatization process of the companies in which the State is shareholder" to - encourage the export activities for the final products and/or for the industrial services, as the case may be;
  - guarantee the external credits within the annual limit set by the Ministry of Finance;
  - finance special programs approved by Government Decision;
  - finance investment projects for companies through the state's participation in the share capital.

154. On 29 June 1999, Romania issued Government Decision No. 525/1999, which set out the methodological norms for the application of EGO 24/1998 (the "1999 Methodological Norms", Exh. R-6). (The 1999 Methodological Norms repealed a previous version issued in December 1998 which has not been relied upon in this arbitration).

155. With respect to the requirements for granting the incentives, Article 5 of the 1999 Methodological Norms provided:

- (1) The incentives provided by the law **shall be granted** [in Romanian, "se acorda"] pursuant to the certificate of investor in a disfavored area, which is issued, upon the business entity's request, by the Regional Development Agency under the jurisdiction of which the head office of such business entity is located.

[...]

- (3) Business entities requesting the issuance of the certificate of investor in a disfavored area shall prove they meet the requirements set forth by the [EGO].
- (4) Emerging business entities, unable to produce evidence regarding the investment, the commissioning of the operations and the creation of new jobs, may request the issuance of a temporary certificate of investor in a disfavored area, for a maximum of 3 months. In case they do not bring, during this period, evidence of having met the requirements set forth by the [EGO], they shall be compelled to pay and return, respectively the equivalent value of all the incentives they have benefited of.

- (5) The temporary certificate shall be issued pursuant to the business entity's commitment regarding the investment and the creation of new jobs.

[...]

### **C. THE CLAIMANTS' INVESTMENTS**

156. The Individual Claimants claim to be the majority shareholders of a group of companies (the European Food and Drinks Group or "EFDG") engaged in food and beverage production in the disfavored region of Ștei-Nucet-Drăgănești, Bihor County. The Corporate Claimants (European Food, Starmill and Multipack) are part of the EFDG, and are thus owned directly or indirectly by the Individual Claimants.
157. The evolution of the Claimants' investments can be separated in two phases: their initial investments (principally in the beverage production business), allegedly made in reliance on the incentive programs that predated EGO 24, and their investments (in the food and beverage production business), allegedly made in reliance on the EGO 24 incentives.

#### **1. The Claimants' initial investments in reliance on previous incentive regimes**

158. The Individual Claimants allege that their beverage business was initially developed in reliance on the incentive programs established by Law 35 and GO 27, predecessors to EGO 24. (C-Reply, ¶¶ 62-124; Third WS of I. Micula ¶¶ 10-27). Law 35 (C-275) was enacted in 1991 to attract foreign investors to Romania by offering the incentives for new investments, including customs duties and profit tax exemptions (see ¶ 139 above). GO 27/1996 (Exh. C-276) was enacted in 1996 to attract investments in Bihor County and other disadvantaged regions, and provided a corporate profit tax incentive ranging from 5 to 10 years, depending on the location of the investment (see ¶ 140 above).
159. The Claimants claim that these incentives allowed them to produce a wide variety of beverages at a low cost. Law 35's encouragement of additional production activities and the Claimants' knowledge of advanced technologies enabled them to sell their beverages in a variety of different packages, including TetraPak and PET packaging. Capitalizing on this expertise, they began to produce intermediate products related to packaging (C-Reply, ¶¶ 81-96, Third WS of I. Micula, ¶¶ 10-24).
160. After the success of their initial investments, Messrs. Micula expanded their beverage production business, building what would become an integrated system of production companies. All of the core companies, with the exception of the Corporate Claimants and Scandic Distilleries, were established under Law 35 (C-Reply, ¶¶ 77, 81-96; Third WS of I. Micula, ¶ 29).<sup>4</sup>

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<sup>4</sup> The record shows the following with respect to the Claimants' incorporation or participation in companies during this period (1991-1997):

161. The Claimants claim that their business model was premised on the existence and specific form of the incentives. Because an investor could benefit from Law 35 incentives each time he created a new company, the Law 35 incentives encouraged the establishment of an expanding group of companies. New companies, and thus the expansion of Claimants' production business, were planned and created to coincide with the expiration of the incentives for older companies. The new companies and investments were integrated into the existing companies and investments, so that all companies functioned cooperatively to create, manufacture, package, and distribute products efficiently (C-Reply, ¶¶ 77-80; Third WS of I. Micula, ¶¶ 26-27; WS of M. Ban, ¶ 27).
162. The Claimants allege that this integration allowed them to realize an increased level of profit. They also state that profits were consistently re-invested to support the expansion of the business and to take advantage of the tax profit exemption under Law 35. Moreover, the raw materials customs duty exemption in Law 35 encouraged production activities, because it only applied to raw materials used to produce new end-products. It thus encouraged a proliferation of businesses that worked together to produce a variety of products, and provided a competitive advantage because the incentives allowed the companies to keep product prices low (C-Reply, ¶¶ 80-81, Third WS of I. Micula, ¶ 25).
163. The Claimants claim that they were able to successfully expand their production activities by using savings from the incentives programs and their profits, which they consistently reinvested in the business. The Claimants claim that they followed this approach throughout the years: using the realized savings during the time in which the incentives were offered to reinvest and build facilities that were functional and profit-producing by the time the incentives expired. (C-Reply, ¶ 96).

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- a. On 19 October 1990, Messrs. Micula allegedly incorporated the Romanian company Transilvania General Import Export S.R.L ("TGIE") (Claimants' "Correct Timeline of Messrs. Micula's Investments", C-Reply at page 25). The Claimants allege that this company was set up to benefit from Law 35/1991, as it was originally set up for the five years for which Law 35 granted corporate profit tax exemptions (C-Reply, Note 102). The Tribunal notes however that Law 35 was enacted after TGIE's stated date of incorporation, so it understands the Claimants to be saying that TGIE was established to benefit from the earlier Decree Law 96/1990, which was later replaced by Law 35. That being said, the Tribunal also notes that, according to the information provided by the Bihor Trade Register Office (Exh. R-60) and TGIE's 1993 Fiscal Report (Exh. C-356), TGIE was assigned its trade register reference number in May 1991. TGIE's date of incorporation is therefore not established with certainty.
- b. From June 1993 to April 1995, Messrs. Micula incorporated or acquired an interest in ten Romanian companies, including European Drinks S.A. and Rieni Drinks S.A. (Claimants' "Correct Timeline of Messrs. Micula's Investments", C-Reply at page 25; R-CM, Figure 1, p. 7; Exh. R-60 and R-61).
- c. From November 1996 to July 1998, the Claimants incorporated or acquired an interest in three additional Romanian companies (Claimants' "Correct Timeline of Messrs. Micula's Investments", C-Reply at page 25; R-CM, Figure 1, p. 7; Exh. R-60 and R-61.)
- d. On 8 July 1997, the Claimants, through their company Edri Trading SRL purchased shares in SC Iplic Bucuresti S.A., a previously state-owned company which owned 88,000 square meters of land in Bucharest (Third WS of I. Micula, ¶¶ 31-36; Tr., Day 2, 211, Day 3, 133,141,145-150 (I.Micula); Exh. C-346; C-439).

164. In turn, the GO 27 incentives motivated the Claimants to relocate certain projects to Drăgănești (in the Apuseni region of Bihor County, which was expressly covered by GO 27). In particular, the Miculas relocated the distillery for what would eventually become Scandic Distilleries from the Madaras region to Drăgănești (C-Reply, ¶¶ 105-110). Other companies developed new projects in Bihor County to realize GO 27 benefits (C-Reply, ¶¶ 111-118).
165. The Claimants claim that their beverage business was very successful. By 2001, they state that European Drinks held an estimated 55% of the total carbonated drink market in Romania and a 51% share of the bottled mineral water market (C-Reply, ¶ 87).

## **2. The Claimants' investments in reliance on the EGO 24 incentives**

166. After Romania's introduction of the EGO 24 incentives, the Claimants allege that they built a large, highly integrated food production platform in reliance on these incentives, in particular the Raw Materials Incentive. The Respondent disputes this reliance, the Claimants' description of their business plan and the Claimants' intention to build certain parts of the platform.
167. Specifically, the Claimants allege that, starting in 1998, they expanded their business under a ten-year plan to capitalize on the EGO 24 incentives with the objective of building an integrated food platform, incorporating several companies in the process.<sup>5</sup> In 1999 they incorporated European Food (Claimant 3), which as explained below was the first Corporate Claimant to benefit from the EGO 24 program (see paragraph 174 below). The Claimants state that they imported the majority of their raw material products through European Food, which brought them customs duties savings and allowed them to pursue a two-phase expansion plan (C-Reply, ¶¶ 161-170).
168. The first phase consisted in production of fast-moving consumer products new to the Romanian market, which had significant market potential and would generate quick

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<sup>5</sup> The record shows the following with respect to the Claimants' incorporation or participation in companies during this period (1998-2007):

- a. From June 1998 to December 1999, Messrs. Micula incorporated or acquired an interest in 23 Romanian companies, including S.C. European Food S.A., which was established as a Romanian joint stock company in Ștei, Bihor county on 30 November 1999 (Exh. HEC-1).
- b. During 2000, Messrs. Micula incorporated or acquired an interest in five other Romanian companies ("Correct Timeline of Messrs. Micula's Investments", C-Reply at page 25), including Scandic Distilleries S.A., which was incorporated on 20 January 2000 (Exh. R-60).
- c. During 2001, Messrs. Micula incorporated or acquired an interest in 3 Romanian companies ("Correct Timeline of Messrs. Micula's Investments", C-Reply at page 25; Exh. R-60).
- d. During 2002, Messrs. Micula incorporated or acquired an interest in five Romanian companies, including S.C. Multipack S.R.L. and S.C. Starmill S.R.L., which were incorporated on 21 February 2002 ("Correct Timeline of Messrs. Micula's Investments", C-Reply at page 25; Exh. R-60).
- e. During 2003 and 2004, Messrs. Micula incorporated or acquired an interest in four Romanian companies ("Correct Timeline of Messrs. Micula's Investments", C-Reply at page 25; Exh. R-60).
- f. Between July 2005 and January 2007, Messrs. Micula incorporated or acquired an interest in three Romanian companies ("Correct Timeline of Messrs. Micula's Investments", C-Reply at page 25; Exh. R-60).

cash flow. Together with the incentive savings, this approach would allow the companies to integrate vertically and achieve economies of scale. The companies could thereby save on operational costs and minimize waste and energy consumption.

169. In this context, in February 2002 the Claimants incorporated Starmill and Multipack (Claimants 4 and 5):<sup>6</sup>
- a. Starmill was incorporated to establish integrated in-house grain milling facilities. It was designed to provide the milling capacity necessary for the planned brewery, but started as a corn mill which provided raw materials for the distillery. It was also responsible for the production of flour for several food products. According to the Claimants, through the use of the Raw Materials Incentive, Starmill would create cost efficiencies to help carry the businesses forward after the incentives expired. The Claimants claim that they made substantial investments for Starmill, including the purchase of land and construction (C-Reply, ¶¶ 197-200).
  - b. Multipack was incorporated to carry out the packaging and labeling for nearly all of the companies' products. The Claimants also allege that it relied heavily on the Raw Materials Incentive, and required substantial investments and created over 200 new jobs (C-Reply, ¶¶ 201-204).
170. The second phase of the Claimants' alleged expansion plan was to build a brewery, the core capital expenditure for which would be funded by the profits from the other investments. According to the Claimants, the construction and integration of the brewery consisted of 4 components:
- a. A state-of-the-art brewery with an initial capacity for 2M hectoliters/year, expandable to 6M.
  - b. A malt plant, which would reduce the cost of malt by in-house manufacture;
  - c. A canning plant, which would reduce packaging costs;
  - d. A co-generation plant, which would use the biomass by-products of the brewery and other food and beverage production, and would save costs and produce revenue through sales back to the state of excess electricity.
171. The Claimants allege that in 2001 they started construction of the brewery (component (a) of paragraph 170 above), which was integrated into the other facilities of the companies. The first phase of construction was completed in 2003 and the second in 2006. (C-Reply, ¶¶ 205-207).
172. The Claimants claim that they had plans to build the components identified in letters (b) through (d) of paragraph 170 above, but their completion was thwarted by cash-

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<sup>6</sup> Starmill and Multipack were incorporated on 21 February 2002 ("Correct Timeline of Messrs. Micula's Investments", C-Reply at page 25; Exh. R-60).



constraints caused by the revocation of the incentives. The Claimants further claim that the construction of these components began prior to the revocation of the incentives, but that none of these components was ever completed. The Respondent disputes all of these assertions (See Section VII below on Damages).

### 3. Permanent Investor Certificates

173. In order to benefit from EGO 24, the Claimants allege that the three Corporate Claimants were required to obtain Permanent Investor Certificates (“PICs”), all of which were issued by the North-West Regional Development Agency. Prior to their issuance, the Claimants state that the Corporate Claimants could operate on the basis of a Temporary Investor Certificate (“TIC”) for a period of 3 months (C-Reply, ¶¶ 156-160; WS of M. Ban, ¶¶ 41-46).

174. European Food (Claimant 3) obtained its Temporary Investor Certificate on 9 December 1999 (Exh. C-442). It was then issued PIC No. 524 on 1 June 2000 (Exh. C-42, Exh. C-638), which stated that European Food

is the beneficiary of the facilities under Government Decision no. 194/1999, in accordance with the provisions of Emergency Government Ordinance no. 24/1998, republished and subsequently amended, and in accordance with the provisions of Government Decision no. 728/2001 on the approval of the methodological norms for the application of Emergency Government Ordinance no. 24/1998 on the disfavoured regions regime.

The present certificate is valid until 01.04.2009.<sup>7</sup>

175. Starmill (Claimant 4) was issued PIC No. 1664 on 17 May 2002 (Exh. C-43), which stated that Starmill

is the beneficiary of the facilities under Government Decision no. 194/1999, in accordance with the provisions of Emergency Government Ordinance no. 24/1998, approved and amended by Law no. 20/1999 and in accordance with the provisions of Government Decision no. 525/1999 on the approval of the methodological norms for application of Emergency Government Ordinance no. 24/1998 on the disfavoured regions regime.

The present certificate is valid until 4/1/09

176. Multipack (Claimant 5) holds PIC No. 1663 issued on 17 May 2002 (Exh. C-44), which stated that Multipack

is the beneficiary of the facilities under Government Decision no. 194/1999, in accordance with the provisions of Emergency Government Ordinance no. 24/1998, republished and subsequently amended, and in accordance with the provisions of Government Decision no. 728/2001 on the approval

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<sup>7</sup> The Tribunal observes that this cannot have been the original PIC, because it includes a reference to the 2001 Methodological Norms, which had not been issued at the time. The original PIC appears to be at page 1 of Exh. C-638, which has not been translated. This version also appears to state that European Food is the beneficiary of the facilities under GD 194/1999, in accordance with the provisions of EGO 24. However, it does not say “republished and subsequently amended”, but rather appears to say “approved and amended by Law 20/1999”, and adds a reference to the 1999 Methodological Norms (GD 525/1999).

of the methodological norms for application of Emergency Government Ordinance no. 24/1998 on the disfavoured regions regime.

The present certificate is valid until 01.04.2009.

177. The legal nature and relevance of the PICs are disputed by the Parties.

#### **D. ROMANIA'S ACCESSION PROCESS**

178. In this section, the Tribunal will set out the chronology of events leading up to Romania's accession to the EU. One of the key areas of tension between Romania and the EU during this process was the alignment of Romania's competition policy and state aid laws with the *acquis communautaire* (hereinafter the "*acquis*"), namely the European body of law as it existed at a given time and resulting from, without limitation, legal acts, court decisions or Commission's ordinances. In this process, the incentives granted under the EGO 24 framework became increasingly relevant, and were finally repealed. As a result, the Tribunal will include in this chronology the developments relating to this framework.

##### **1. Early steps: the Europe Agreement and Romania's application for EU membership**

179. On 1 February 1993, Romania signed the Europe Agreement with the predecessor of the EU (the "European Community"<sup>8</sup>) and its Member States (Exh. R-10, C-565). The Europe Agreement, which was to enter into force on 1 February 1995, established an association between the European Community, its existing Member States and Romania and provided the legal framework for the accession process. Among its objectives was the promotion of Romania's economic development and its gradual integration into the European Community, in exchange for which Romania would have to work towards fulfilling certain conditions (Europe Agreement, Article 1).

180. The Europe Agreement covered many different areas of governance, including competition. With respect to state aid, Article 64 of the Europe Agreement provided:

##### Article 64

1. The following are incompatible with the proper functioning of this Agreement, in so far as they may affect trade between the Community and Romania: [...] (iii) any public aid which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods.
2. Any practices contrary to this Article shall be assessed on the basis of criteria arising from the application of the rules of Articles 85, 86, and 92<sup>9</sup> of the Treaty establishing the European Economic Community.

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<sup>8</sup> The Tribunal will use the term "European Community" to refer to the predecessor of the EU that signed the Europe Agreement, formed by the European Economic Community, the European Atomic Energy Community and the European Coal and Steel Community.

<sup>9</sup> Article 92 of the Treaty establishing the European Economic Community became Article 87 of the EC Treaty (Exh. RS-9; C-583), which provided:

3. The Association Council shall, within three years of the entry into force of the Agreement, adopt the necessary rules for the implementation of paragraphs 1 and 2.
4. (a) For the purposes of applying the provisions of paragraph 1, point (iii), the Parties recognize that during the first five years after the entry into force of the Agreement, any public aid granted by Romania shall be assessed taking into account the fact that Romania shall be regarded as an area identical to those areas of the Community described in Article 92(3)(a) of the Treaty establishing the European Economic Community. The Association Council shall, taking into account the economic situation of Romania, decide whether that period should be extended by further periods of five years. [...]

181. In turn, Article 87(3)(a) of the EC Treaty (which replaced Article 92(3)(a) of the Treaty establishing the European Economic Community) (Exh. RL-177; C-583) provided:

The following may be considered to be compatible with the common market: (a) aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment; [...]

182. Another of the aims of the Europe Agreement was to promote economic cooperation between Romania and the EC Member States. In this context, Article 74 of the Europe Agreement on investment promotion and protection provided:

Article 74 - Investment promotion and protection

1. Cooperation shall aim to establish a favourable climate for private investment, both domestic and foreign, which is essential to the economic and industrial reconstruction of Romania.
2. The particular aims of the cooperation shall be:
  - for Romania to establish and improve a legal framework which favours and protects investment;
  - the conclusion by the Member States and Romania of Agreements for the promotion and protection of investment [...]

183. In addition to establishing principles and rules of governance, the Europe Agreement provided that Romania would have to harmonize its existing and future legislation with that of the Community:

Article 69 - The Parties recognize that an important condition for Romania's economic integration into the Community is the approximation of

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1. Save as otherwise provided in this Treaty, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market.
  2. The following shall be compatible with the common market:  
[...]
  3. The following may be considered to be compatible with the common market:
    - (a) aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment; [...]

Romania's existing and future legislation to that of the Community. Romania shall endeavour to ensure that its legislation will be gradually made compatible with that of the Community.

Article 70 - The approximation of laws shall extend to the following areas in particular: [...] rules on competition [...].

184. On 21-22 June 1993, the European Council concluded at its meeting in Copenhagen that countries from Central and Eastern Europe which wished to become members of the European Union would have to satisfy the economic and political conditions required for membership (known as the "Copenhagen criteria"), including "the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union." The European Council also "underlined the importance of approximation of laws in the associated countries to those applicable in the Community, in the first instance with regard to distortion of competition [...]" (Exh. R-62).
185. On 1 February 1995, the Europe Agreement entered into force.
186. On 22 June 1995, Romania presented its application for EU membership. On 17 July 1995, Romania's application was submitted to the Commission, which pursuant to [the EC Treaty] was required to give a favorable opinion for accession negotiations to begin (Exh. C-317).
187. In its December 1995 meeting in Madrid, the European Council referred to the need, in the context of the pre-accession strategy, "to create the conditions for the gradual, harmonious integration of the applicant countries, particularly through: the development of the market economy, the adjustment of their administrative structure, [and] the creation of a stable economic and monetary environment" (Exh. C-317).
188. The European Commission, in an opinion dated 15 July 1997 (Exh. C-317), summarized the state of Romania's economy in 1995 as follows:

Romania, with a population of 22.6 million, had in 1995 a gross domestic product (GDP) of ECU 93 billion (expressed in purchasing power parity); its population was about 6.5% of the Union's, while its economy was only about 1.5%. Per capita GDP is about 24% of the Union average.
189. On 10 April 1996 (effective 30 April 1996), Romania passed Law No. 21/1996 on competition (Exh. R-73). The purpose of this law was to "protect, sustain and stimulate competition and a normal competitive environment in order to promote the interests of consumers." This law created the Competition Office and the Competition Council, which were tasked with overseeing the implementation of the law.
190. On 15 July 1997, the European Commission issued its Opinion on Romania's Application for Membership of the European Union (Exh. C-317). That Opinion concluded that, despite its post-communist reforms, Romania did not meet the Copenhagen criteria and thus was not yet ready to initiate accession talks. Specifically, the European Commission concluded that:

- Romania has made considerable progress in the creation of a market economy, but it would still face serious difficulties to cope with competitive pressure and market forces within the Union in the medium term;

- despite the progress that has been made, Romania has neither transposed nor taken on the essential elements of the acquis, particularly as regards the internal market. It is therefore uncertain whether Romania will be in a position to assume the obligations of membership in the medium term. [...]

191. The European Commission described Romania's economic situation in the pre-accession context as follows (Section 2.2):

Romania has made enormous progress since the beginning of the transition, although it cannot be considered, as yet, to be a functioning market economy. [...]

Policy-making on economic issues has not always been coherent. As a result, progress towards macroeconomic stability has not been steady: recent years have been characterised by widely fluctuating performances in terms of growth, inflation and unemployment. Economic agents do not necessarily perceive the macroeconomic environment to be stable enough to promote the necessary level of savings and investment (both domestic and foreign).

If fully implemented, the comprehensive programme of macroeconomic stabilisation and structural reforms announced by the authorities in early 1997 should radically transform Romania's economy and lay the foundations for healthy growth in the years ahead. But the implementation of the basic features of the programme, especially with regard to restructuring, will take many years. It is yet too early to assess whether the programme will be implemented fully and successfully. [...]

In order to complete its transformation process successfully and prepare for EU membership, the country still needs to implement many, detailed and complex measures. [...]

In the past, foreign investors have singled out the unpredictable evolution of the legal system and the different interpretation of double taxation treaties as obstacles to doing business in Romania. [...]

[T]he ability to withstand competitive pressure depends not only on the current structure of the economy, but also on the way in which it will develop in the near to medium-term future. In this respect, Romania offers a contrasted situation: the existing economic structure points to very important structural weaknesses, while the reforms that have been announced at the beginning of 1997 could have a very positive impact in a relatively short period of time, especially if rapid privatisation is achieved and foreign direct investment is forthcoming. However, in order to withstand competition within the Union both the industrial and agricultural sectors would need to undergo major structural transformation.

[...]

The current production base in industry relies to a large extent, although not exclusively, on sectors with very high energy intensity, or which are strongly dependent on imported raw materials, or have been the object of exercises of capacity reduction within the Union. [...] The current structural reforms should aim at the restructuring of the very large state-owned

*combinats*, which, in their present condition, would face strong competitive pressures from their western competitors.

A diversification of the industrial base towards lighter industries, entailing the creation of a large number of new, small and medium-sized enterprises, and increased participation of foreign capital and know-how, will help Romania adjust to the restructuring of the large enterprises. Light industry is already well-developed in some sectors (wood products, leather, textiles) and has achieved good performances on exports markets.

Although agriculture has been neglected in the last decades, it represents a potentially important source of comparative advantage for Romania [...]. But the process of modernisation of the agricultural sector has just begun and will require a policy aiming at stimulating investments both in the farming sector and in the food industry.

Foreign direct investment has been low for a country the size of Romania: at the end of 1996 cumulative FDI per capita stood at ECU 50. With a few notable exceptions, FDI has not made a significant contribution to the modernisation of either industry or agriculture. This means that production in many sectors still relies on old and obsolete technologies. Increasing the chances that Romanian producers will be able to withstand competition of high-quality, high-standards EU goods, and improving the level of skills in the economy calls for much bigger inflows of FDI.

[...]

Romania possesses a number of key advantages: its geographical location at the cross-roads of many trade routes and in particular as the sea-gate for accessing central European markets; the size of its population which will attract industries with economies of scale; the relatively young population which points to vast needs for durable goods; and its low level of labour costs. All these factors could make Romania a strong export base for accessing markets of smaller neighbours, especially for consumer goods.

[...]

The relative success which Romania achieved in macroeconomic stabilisation during 1995 and 1996 rested on very fragile foundations. In fact, given the very slow progress in structural reforms, the high growth rates of this period were not sustainable, and not compatible with the aim of integrating Romania in the European and world economy. This diagnosis was at the heart of the economic and social programme of the new government elected in November 1996.

The programme of macroeconomic stabilisation and structural reforms announced in February 1997 represents a very ambitious attempt to radically transform, in a relatively short period of time, the old economic structures and lay the foundations for a fully-functioning market economy. However, this is only a first step in the right direction and much remains to be done.

A stable and predictable macroeconomic framework is the first key condition for laying the foundations of sustainable growth and modernisation of the microeconomic side of the economy. [...]

The new Romanian authorities have already recognised the crucial role that foreign investors and international financial institutions will play in the success of their reform efforts. Restoring confidence among international

investors and lenders and securing their medium-term investment in Romania calls for a stable macroeconomic framework, a sustained and credible commitment to structural reforms, a clear and broad political consensus over a medium-term strategy and the continuing legitimacy of reforms among the population. These conditions are indispensable to reduce political and economic uncertainty and so lay the foundations for successful investment planning.

192. The Commission concluded with respect to the economic conditions for accession (Section 2.3):

Romania has made considerable progress in the creation of a market economy. The reorientation of economic policy since the recent change of government marks a change for the better, but much still needs to be done. While prices have been almost fully liberalised, property rights are not yet fully assured for land, the legal system is still fragile and policy-making on economic issues has not always been coherent. Further efforts to consolidate the legal and administrative framework, and to address persistent macroeconomic imbalances, are required to ensure a stable environment.

Romania would face serious difficulties coping with competitive pressure and market forces within the Union in the medium term. It has recently made progress towards improving the competitive capacity of its economy, notably by addressing major distortions such as low energy prices, accelerating privatisation and beginning to wind up large loss-making state-owned firms. However, much of Romania's industry is obsolete, and agriculture needs to be modernised. The low levels of research and development, and of skills among the workforce also suggest that the economy needs a number of years of sustained structural reform.

## 2. Romania's initial efforts to align its state aid laws

193. On 10 March 1998, the European Commission issued its Guidelines on Regional Aid, a set of criteria for assessing whether to allow regional aid under Article 87(3) of the EC Treaty (previously Article 92(3) of the Treaty establishing the ECC) (Exh. RJ-9). These Guidelines stated:

### 1. Introduction

[...]

Regional aid is designed to develop the less-favoured regions by supporting investment and job creation in a sustainable context. It promotes the expansion, modernisation and diversification of the activities of establishments located in those regions and encourages new firms to settle there. In order to foster this development and reduce the potential negative effects of any relocation, it is necessary to make the granting of such aid conditional on the maintenance of the investment and the jobs created during a minimum period in the less favoured region.

In exceptional cases, such aid may not be enough to trigger a process of regional development, if the structural handicaps of the region concerned are too great. ***Only in such cases may regional aid be supplemented by operating aid.***

[...]

## 2. Scope

A derogation from the incompatibility principle established by Article 92(1) of the Treaty may be granted in respect of regional aid only if the equilibrium between the resulting distortions of competition and the advantages of the aid in terms of the development of a less-favoured region (6) can be guaranteed. The weight given to the advantages of the aid is likely to vary according to the derogation applied, having a more adverse effect on competition in the situations described in Article 92(3)(a) than in those described in Article 92(3)(c) (7).

## 3. Demarcation of regions

[...]

The derogation in Article 92(3)(a)

3.5. Article 92(3)(a) provides that aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment may be considered compatible with the common market. As the Court of Justice of the European Communities has held, 'the use of the words "abnormally" and "serious" in the exemption contained in Article 92(3)(a) shows that it concerns only areas where the economic situation is extremely unfavourable in relation to the Community as a whole` (12).

The Commission accordingly considers, following a tried and tested approach, that the conditions laid down are fulfilled if the region, being a NUTS (13) level II geographical unit, has a per capita gross domestic product (GDP), measured in purchasing power standards (PPS), of less than 75,0 % of the Community average (14). The GDP/PPS of each region and the Community average to be used in the analysis must relate to the average of the last three years for which statistics are available. These amounts are calculated on the basis of data furnished by the Statistical Office for the European Communities.

[...]

## 4. Object, form and level of aid

4.1. The object of regional aid is to secure either productive investment (initial investment) or job creation which is linked to investment. Thus this method favours neither the capital factor nor the labour factor.

4.2. To ensure that the productive investment aided is viable and sound, the recipient's contribution (20) to its financing must be at least 25 %.

The form of the aid is variable: grant, low-interest loan or interest rebate, government guarantee or purchase of a State shareholding on favourable terms, **tax exemption**, reduction in social security contributions, supply of goods and services at a concessionary price, etc.

In addition, aid schemes must lay down that an application for aid must be submitted before work is started on the projects.

[...]

Operating aid



4.15. Regional aid aimed at reducing a firm's current expenses (operating aid) is normally prohibited. Exceptionally, however, such aid may be granted in regions eligible under the derogation in Article 92(3)(a) provided that (i) it is justified in terms of its contribution to regional development and its nature and (ii) its level is proportional to the handicaps it seeks to alleviate (36). It is for the Member State to demonstrate the existence of any handicaps and gauge their importance.

4.16. In the outermost regions qualifying for exemption under Article 92(3)(a) and (c), and in the regions of low population density qualifying either for exemption under Article 92(3)(a) or under 92(3)(c) on the basis of the population density test referred to at point 3.10.4, aid intended partly to offset additional transport costs (37) may be authorised under special conditions (38). It is up to the Member State to prove that such additional costs exist and to determine their amount.

4.17. With the exception of the cases mentioned in point 4.16, operating aid must be both limited in time and progressively reduced. In addition, operating aid intended to promote exports (39) between Member States is ruled out.

(Emphasis added).

194. In its Annual Report of 1998 regarding PHARE Program<sup>10</sup> (Exh. C-391), the European Commission concluded:

Romania meets the Copenhagen political criteria. Much remains to be done in rooting out corruption, improving the working of the courts and protecting individual liberties and the rights of the Roma. Priority should also be given to reform of the public administration.

Romania has made very little progress in the creation of a market economy and its capacity to cope with competitive pressure and market forces has worsened.

Despite progress made in transposition of key parts of the *acquis*, Romania has a long way to go in terms of additional legislative transposition, implementation and enforcement before the country will be able to assume the obligations of membership. (p. 61).

195. The EC's 1998 Annual Report also highlighted the importance of regional development in Romania (p. 63):

Case study: regional development in Romania

Through a series of projects beginning in 1994, Phare is contributing to the creation of the institutional and legal framework for the development of

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<sup>10</sup> The Programme of Community aid to the countries of Central and Eastern Europe (Phare) is the main financial instrument of the pre-accession strategy for the Central and Eastern European countries (CEECs) which have applied for membership of the European Union. Since 1994, Phare's tasks have been adapted to the priorities and needs of each CEEC. The revamped Phare programme, with a budget of over EUR 10 billion for the period 2000-2006 (about 1.5 billion per year), has two main priorities, namely institutional and capacity-building and investment financing. Although the Phare programme was originally reserved for the countries of Central and Eastern Europe, it is set to be extended to the applicant countries of the western Balkans (See [http://europa.eu/legislation\\_summaries/enlargement/2004\\_and\\_2007\\_enlargement/e50004\\_en.htm](http://europa.eu/legislation_summaries/enlargement/2004_and_2007_enlargement/e50004_en.htm)).

regional policy in Romania, and to preparations for programmes to be implemented along the lines of the EU structural funds.

Under a 1994 Phare budget, EU and Romanian experts prepared an analysis of regional disparities in Romania, and drew up proposals for a legal and institutional framework for the development of regional policy.

In 1997, the conclusions of a Phare-financed study were published as a Green Paper on Regional Development, which proposed the establishment of a number of macro regions as planning units, based on associations of elected county councils. The Green Paper also defined a national framework for the development of regional policy and the financing of programmes.

The government adopted the main points of the Green Paper as its policy on regional development; consequently, a 1997 Phare budget was approved, providing support for institution building at national and regional level.

In 1998 a Law on Regional Development was passed, creating an appropriate institutional framework and establishing a National Agency for Regional Development and a National Fund for Regional Development.

A 1998 Phare budget was approved, providing preliminary financial support for projects which would be proposed by the regions and financed out of the National Fund for Regional Development. Linked to this is technical assistance under the Special Preparatory Programme for Structural Funds, which provides further support and training to relevant institutions at regional and national level.

196. It is in this context that Romania adopted EGO 24/1998, which established the legislative framework for the incentives at issue in this arbitration. As noted in paragraph 145 above, the original version of EGO 24/1998 was passed on 30 September 1998 and entered into force on 2 October 1998.
197. On 22 March 1999, the Council of the EU issued Council Regulation (EC) No. 659/1999, which set out detailed rules for the application of Article 93 of the EC Treaty with respect to the implementation of state aid measures and recovery of unlawful and incompatible state aid (Exh. R-128).<sup>11</sup> Article 1 of this Regulation provided the following definitions:

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<sup>11</sup> Articles 88 and 89 of the EC Treaty (previously Articles 93 and 94 of the Treaty establishing the EEC) provided:

*Article 88 [previously Article 93]*

1. The Commission shall, in cooperation with Member States, keep under constant review all systems of aid existing in those States. It shall propose to the latter any appropriate measures required by the progressive development or by the functioning of the common market.

2. If, after giving notice to the parties concerned to submit their comments, the Commission finds that aid granted by a State or through State resources is not compatible with the common market having regard to Article 87, or that such aid is being misused, it shall decide that the State concerned shall abolish or alter such aid within a period of time to be determined by the Commission.

If the State concerned does not comply with this decision within the prescribed time, the Commission or any other interested State may, in derogation from the provisions of Articles 226 and 227, refer the matter to the Court of Justice direct.

(b) "existing aid" shall mean: (i) all aid which existed prior to the entry into force of the Treaty in the respective Member States, that is to say, aid schemes and individual aid which were put into effect before, and are still applicable after, the entry into force of the Treaty; [...]

(c) 'new aid' shall mean all aid, that is to say, aid schemes and individual aid, which is not existing aid, including alterations to existing aid; [...]

(f) 'unlawful aid' shall mean new aid put into effect in contravention of Article 93(3) of the Treaty;

198. Under the Regulation, if the Commission considered that an existing aid scheme was not, or was no longer, compatible with the common market, it would consult with the Member State and issue a recommendation, which could consist in a substantive amendment of the aid scheme, the introduction of procedural requirements, or the abolition of the aid scheme. If the Member State did not accept the proposed measures, the Commission could initiate a formal investigation procedure (Articles 17-19, 4(4), 6-9 of the Regulation).
199. On 27 July 1999, Romania passed Law No. 142/1999 on state aid (the "State Aid Law", Exh. R-75), which granted the Competition Council a wide range of powers to regulate state aid in Romania, including the power to authorize or forbid the granting of state aid.
200. In its composite paper "Reports on Progress towards Accession by each of the Candidate Countries" dated 13 October 1999 (Exh. R-76), the EC noted that Romania had made "some progress" in aligning state aid laws.
201. For context, the Tribunal recalls that, during 1999, the following events relating to the EGO 24 framework and the Claimants' investments took place:

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On application by a Member State, the Council may, acting unanimously, decide that aid which that State is granting or intends to grant shall be considered to be compatible with the common market, in derogation from the provisions of Article 87 or from the regulations provided for in Article 89, if such a decision is justified by exceptional circumstances. If, as regards the aid in question, the Commission has already initiated the procedure provided for in the first subparagraph of this paragraph, the fact that the State concerned has made its application to the Council shall have the effect of suspending that procedure until the Council has made its attitude known.

If, however, the Council has not made its attitude known within three months of the said application being made, the Commission shall give its decision on the case.

3. The Commission shall be informed, in sufficient time to enable it to submit its comments, of any plans to grant or alter aid. If it considers that any such plan is not compatible with the common market having regard to Article 87, it shall without delay initiate the procedure provided for in paragraph 2.

The Member State concerned shall not put its proposed measures into effect until this procedure has resulted in a final decision.

*Article 89 [previously Article 94]*

The Council, acting by a qualified majority on a proposal from the Commission and after consulting the European Parliament, may make any appropriate regulations for the application of Articles 87 and 88 and may in particular determine the conditions in which Article 88(3) shall apply and the categories of aid exempted from this procedure.

- a. On 25 March 1999, by means of Government Decision No. 194/1999 (“GD 194/1999”, Exh. C-31), Romania designated the Ştei-Nucet region as a disfavored region for a period of ten years, starting on 1 April 1999, and stipulated that all six incentives offered under EGO 24/1998 would be available to investors in the Ştei-Nucet region while that region was designated disfavored.
- b. As noted in paragraph 146 above, on 8 November 1999, Romania republished a renumbered version of EGO 24/1998 (Exh. R-68).
- c. On 9 December 1999, European Food obtained its Temporary Investor Certificate (Exh. C-442).

### **3. Romania and the EU begin formal accession negotiations**

202. On 10 and 11 December 1999, the European Council met in Helsinki to take a series of decisions related to the EU’s enlargement process. As reflected in the Presidency’s Conclusions (Exh. R-11, C-318), the European Council decided to convene bilateral intergovernmental conferences in February 2000 to begin accession negotiations with Romania and other countries.
203. In February 2000, Romania began its formal accession negotiations with the EU. Chapter 6 was dedicated to competition policy.
204. The Respondent’s expert Prof. Streinz notes that in July 2000, “[i]n accordance with its mandate under Article 106 of the Europe Agreement, the Association Council determined [...] to extend retroactively the application of Art. 87(3)(a) of the EC Treaty to Romania for an additional period of five years.” (First ER of R. Streinz, p. 7, note 22). According to Prof. Dashwood, this was done in Decision 4/2000 published in April 2001 (Exh. R-65; C-579).

### **4. The Decision of the Romanian Competition Council and amendments to the EGO 24 regime**

205. On 15 May 2000, the Romanian Competition Council, in the context of reviewing proposed amendments to EGO 24/1998, issued Decision No. 244/2000 (Exh. R-78), in which it determined, *inter alia*, that certain facilities provided under EGO 24/1998 distorted competition (specifically, the Raw Materials Incentive and the Components Incentive) and had to be eliminated. It stated:

Whereas:

3. Exemption from customs duties· on raw materials are deemed State aid for operating purposes and goes beyond the purpose of Emergency Government Ordinance No 24/1998 on Less-Favoured Areas, leading to distortion of competition. The granting of such facilities, subject to the conditions set forth in the Ordinance, solely to economic operators who make and register new investments puts the economic operators already in the market at a disadvantage, as was alleged before the Competition Council by both the Milling and Baking Industry Employers’ Association and the Romanian Meat Association. Exemption from paying customs duties effectively stimulates imports to the detriment of domestic

producers. Largescale importing of live pigs from Hungary and the mere slaughtering of these animals in Less Favoured Areas have occurred, with the meat being sold in the form of carcasses and no significant degree of processing occurring. The cost of these products, which were subsidised in their country of origin and also benefited from the facilities provided by Emergency Government Ordinance No 24/1998, is lower and they are penetrating neighbouring markets, with the result that they are in competition with products produced outside Less Favoured Areas.

The Competition Council takes the view that the granting of these facilities is distorting competition within the market, and has also expressed this opinion in other similar cases.

[...]

On the basis of Article 12(2) [unclear letter - possibly "c" or "e"], the Competition Council hereby takes the following.

#### DECISION

Article 1. The aid scheme set forth in Article 6 of Emergency Government Ordinance No 24/1998 is authorised subject to the following conditions:

- a) the provisions of Article 6(1)(b) of Emergency Government Ordinance No 24/1998 republished, concerning the reimbursement of customs duties on imported raw materials, spare parts and/or components necessary for own production purposes within an area, and consequently, the proposed amendment concerning exemption from customs duties on raw materials shall be deleted;

[...]

- d) the methodological standards for the application of Emergency Government Ordinance No 24/1998 on Less Favoured Areas are to be submitted to the Competition Council for approval, in accordance with the provisions of Article 27(j) of Law No 21/1996.

Article 2. Pursuant to Article 13(2) of Law No 143/1999, the Competition Council may decide to suspend the State aid scheme if the aid provider fails to take the steps referred to in Article 1 of this Decision.

[...]

206. It was in this context that, on 1 June 2000, European Food was issued its PIC (see paragraph 174 above).
207. On 16 June 2000 (effective 1 July 2000), Romania passed Emergency Government Ordinance No. 75/2000 ("EGO 75/2000", Exh. C-45, R-81), which amended EGO 24/1998 in the following ways: (a) it provided for an exemption (rather than the refund originally contemplated) on customs duties on imported raw materials; (b) it excluded spare parts and components from the customs duty exemption, and (c) it amended the provisions regarding the award of funds under the Special Development Fund. It did not eliminate the Raw Materials Incentive and the Components Incentive, as recommended by the Competition Council.

## 5. Romania's progress towards accession in the period 2000-2001

208. On 1 August 2000, the Romanian government presented a Position Paper on Chapter 6 (Competition Policy) (Exh. EC-1), in which Romania "accepts the entire *acquis communautaire* in force on 31 December 1999, does not request transition periods or derogations and declares that it will be able to entirely implement it upon accession." However, Romania added that:

Regarding the state aid rules and agreeing to the principles provided for in Art. 87 and 88 of the Treaty establishing the European Community, it is necessary to grant state aids to the sensitive sectors of economy and the deprived areas due to the difficulties confronting the Romanian economy during the transition to a market economy.

It is also obvious that, after accession, Romania's development level will not exceed the EU average, and, consequently, the whole territory of Romania will comply with the conditions laid down in Art. 87(3) of the Treaty establishing the European Community.

209. In this Position Paper, Romania gave a detailed description of EGO 24/1998, as amended by EGO 75/2000:

Regional development. Deprived areas

Based on the Romanian legislation, namely the Law on Regional Development no. 151/1998, eight development regions were established. Those regions correspond to the NUTS II level of the European classification. At that level, the programs and projects of regional development are funded through the National Fund for Regional Development that was established according to the Law no. 151/1998. The funds for these programmes are yearly allocated through the state budget as distinct item [sic] for the policy on regional development and also from other domestic and foreign resources. The National Agency for Regional Development administers, as provided for in the law, the National Fund for Regional Development by annual allocations of funds to the eight Funds for Regional Developments that were established in accordance to same law and are managed by eight Agencies for Regional Development. The funds allocated in this manner are granted to the recipients on competitive basis, such as tendering for regional development projects.

The Government Emergency Ordinance no. 24/1998 on the deprived areas (D areas) ensures a framework for granting state aid for the NUTS IV (villages) to NUTS III (counties) areas. Since July 1999 the majority of facilities granted to the investors within those areas became applicable after the Methodological Rules which were authorised by Government Decision no. 525/1999, came into effect.

On 16 June 2000, the Government Emergency Ordinance no. 75 amending the Government Emergency Ordinance no. 24/1998 was adopted, the main facilities granted to the investors acting within the D areas being the following:

- customs duty and VAT exemptions for machinery, equipment, motor-vehicles, other capital assets which are imported for making investments within the area;

- VAT exemption for the domestic machinery, equipment, motor-vehicles, other capital assets which are used for making investments within the area;
- customs duty exemption for the raw materials imported for producing within the area; profit tax exemption during the existence of the 0 area;
- fee exemption for the alteration of destination or driving out from agricultural use of lands necessary for the investment.

In accordance to the legislation in force, the terms under which the investors are deemed to benefit of the mentioned facilities are the following:

- the facilities are granted only to the companies where the majority is owned by private shareholders, Romanian legal persons; to private undertakings or family associations which are licensed in accordance to the Law no. 54/1990;
- the companies must have their headquarters and act within the D area;
- the new investment to be made and registered within the financial records of the undertaking, after the qualification of [sic] as a D area;
- the investment to be made within the interest fields which are covered by the Government Decision qualifying the area as D area;
- through investment new jobs must be created for the unemployed people which live within the D area;
- the goods for which facilities, such as fee exemption, must be used for investments/production within the D area;
- the investment within the D area must be in function for a period twice as long as the period when the facilities were granted, otherwise, the investor is held to reimburse the amounts granted as facilities.

210. On 31 October 2000, at an Accession Conference with Romania, fifteen EU Member States and Romania adopted the first European Union Common Position on Competition Policy ("EU Common Position 2000", Exh. EC-2). In this Common Position, the EU stated:

The EU underlines the particular importance of the "acquis" under chapter 6 for the proper functioning of the internal market, including the creation of a level playing field for investment. The significance of the "acquis" is such that Romania has undertaken, under the Europe Agreement, to comply with the Community rules on competition. Thus, while welcoming Romania's statement that it accepts the "acquis" and will apply it as from the accession, the EU underlines that the "acquis" under chapter 6, in accordance with the Europe Agreement, has to be applied by Romania already now. In this context, the EU also underlines the importance of reinforcing the administrative capacity for effective implementation and enforcement of the "acquis". Therefore, the EU will conduct a general assessment of whether Romania has set up effective structures to enforce and apply the relevant substantive rules of the "acquis". Moreover, the full and immediate application of the "acquis" is also necessary in order to adapt companies well before the date of accession to be able to withstand

the competitive pressures of the internal market resulting from the full and direct application of the competition "acquis" upon accession. It is inconceivable that the Romanian economy would be able to support the switching from one day to the next to the full and correct application of the "acquis".

211. With respect to the timely implementation of the Europe Agreement and the fulfillment of accession criteria in the state aid field, the EU invited Romania, *inter alia*, to

- provide details regarding existing aid measures (i.e. those programs on the basis of which aid continues to be granted and which existed already before the entry into force of the present state aid law). In particular, Romania should explain which measures are envisaged for bringing such aid into line with the EU "acquis";
- provide a more detailed analysis of the aid facilities in the so-called D areas of the country. In particular, Romania should explain what action, in light of the Community Guidelines on Regional Aid, the Competition Council has taken with regard to the Government Ordinances providing for these aid facilities.

212. In its Regular Report on Romania's progress towards accession dated 8 November 2000, the EC noted that:

Romania has made further progress in the transposition in the *acquis* in this chapter.

Further alignment with the EC competition legislation and the improvement of the administrative capacity in this field is a short-term priority in the Accession Partnership.

Romania's anti-trust legislation is largely in line with the *acquis*. During the period under consideration the legislative framework for anti-trust has been developed further by the adoption of secondary legislation. The anti-trust enforcement authorities have dealt with an increasing number of cases. The main challenge is now to ensure that the application and enforcement of the anti-trust rules is effective and that priority is given to such cases that concern the most serious distortions of competition. In order to achieve this, the administrative capacity of the Romanian Competition Council and Competition Office will need to be reinforced.

As concerns state aid the entry into force of the new state aid law on 1 January 2000 and the subsequent adoption of secondary legislation is an important step forward. However, the major challenge is to ensure that the legislation will be properly implemented and enforced. The recent adoption of the law on 'industrial parks' is a major concern.

State aid reports have still to be submitted for the years 1998 and 1999. The latest report broadly follows the methodology and the presentation of the Community's Survey on State Aid. Additional work is needed in order to finalise a comprehensive state aid inventory covering all aid measures in operation in Romania.

In order to ensure a differentiation of maximum aid intensities in assisted areas, Romania still has to prepare a regional aid map in consultation with the Commission.



213. On 28 February 2001, Romania issued its Complementary Position Paper on Chapter 6 (Competition Policy) (Exh. EC-3). In this Complementary Position Paper, Romania explained the EGO 24/1998 incentive regime as follows:

Through the Emergency Ordinance no. 75/2000 modifying the Emergency Ordinance no. 24/1998 on the deprived areas, the following facilities may be granted to the investors within D areas:

- customs duty and VAT exemptions for machinery, equipment, installations, motor-vehicles, other capital assets which are imported for making investments within the area;
- VAT exemption for the domestic machinery, equipment, installations, motor vehicles, other capital assets, which are used for making investments within the area;
- customs duty exemption for the raw materials imported for the own production within the area;
- profit tax exemption during the existence of D area;
- fee exemption for the alteration of destination or driving out from agricultural use of lands necessary for the investment.

Facilities provided for by Government Emergency Ordinance (GEO) no. 24/1998, amended by GEO no. 75/2000, are granted to undertakings operating within deprived areas, mention being made that in the deprived area co financing is approved only for projects selected by the National Agency for Regional Development (NARD) through public tender, nationwide, and within "Special Programs", as approved by decision of the Government, programs which have been notified to the Competition Council.

[The] Competition Council analyzed the existing state aid scheme provided in GEO no. 24/1998; it found out that it seriously distorts competition, and thus issued Decision no. 244/15.05.2000 whereby it authorized with conditions the state aid scheme as contained in art. 6 of the GEO no. 24/1998. Providing for the elimination of art. 6 (l)(b) referring to refunding of customs duties for imported raw materials, spare parts and/or components dedicated to the own production in the deprived area, and for modification of art. 6 (l)(c), mainly, the exemption from profit tax payment during the existence of the deprived area shall be done only for plowed-back profit. The modification of the existing state aid scheme contained in 311.6 of the GED no. 24/1998, referring to exemption from customs duty payment for imported raw materials, notified by NARD, has not been authorized by the Competition Council.

GEO no. 75/2000 amending GED no. 24/1998 overlooked the conditions set by the Competition Council through Decision no. 244/15.05.2000, and maintained the facilities in art. 6 (l)(b) and (c) of GEO no. 24/1998. Although the Competition Council did not authorize the modification of the state aid scheme, GEO no. 75/2000 provides for exemption from payment of custom duties for imported raw materials for the own production in the deprived area.

In December 2000, the Competition Council has brought action at the Court of Appeals alleging failure to comply with Competition Council's Decision no. 244/15.05.2000 by the Government, which authorized, with

conditions, the modification of the state aid scheme within GEO no. 24/1998, modification made through GEO 00.75/2000.

The request was made in front of the Court of Appeals to cancel GED no. 75/2000 and to recover the state aid.

The Government will made [sic] a study in order to assess the effects of enforcing this Ordinance, and further takes necessary measures.

214. On 10 April 2001, the EU-Romania Association Council adopted Decision 4/2000 (the “Implementing Rules”, Exh. R-65), which prescribed the manner in which Article 64 of the Europe Agreement would be implemented by Romania.
215. In its Regular Report on Romania’s progress towards accession dated 13 November 2001 (Exh. R-141), the EC provided the following assessment of Romania’s competition policy:

Romania has made considerable progress in creating a legal framework in this area that is broadly aligned with the Community *acquis*. However, additional efforts are necessary to complete the legal framework and ensure its adequate enforcement.

As regards anti-trust, Romania’s legislation is largely in line with, and covers most of, the *acquis* provisions. However, further secondary legislation still needs to be adopted, to take account of the Commission’s new vertical restraints policy and its policy on horizontal cooperation agreements. The Competition Council has broad powers to enforce competition rules but will need further reinforcements- especially in the form of training and IT equipment, in order to fulfil the tasks assigned to it. It is essential that the Competition Council could focus its resources more effectively on cases with most serious distortions to competition. A more deterrent sanctioning policy will also be required. Finally, general transparency, including an improved access of the public to relevant documents should be increased.

As regards state aids, the existing legislation covers the basic principles of state aid control. However, the field of application of this law is not comprehensive and numerous state aid measures are not notified to the competition authorities. Romania should rapidly adopt the required secondary legislation on state aids, which is currently being prepared. This is a precondition to any effective enforcement activities. A significant number of unaligned aid schemes remains such as the profit tax rate 5% on export earnings and the law on direct investment promotion. Moreover, implementation of state aid policy in sensitive sectors is still at an early stage. There are continuous problems with the monitoring of frequent waivers by public bodies of the accumulated debt.

Romania has now formally adopted state aid reports for the period 1996 – 1999 but has yet to finalise the state aid inventory. In addition, Romania’s recent proposal for the regional aid map would allow aid intensities for regional investment aid of up to 50% net grant equivalent. In the area of state aids, both the Competition Office and the Competition Council require further strengthening in terms of human resources and training.

In addition to strengthening administrative capacity within the competition authorities, particular attention should also be given to intensifying the training of the judiciary in the specific fields of anti-trust and state aid. There is also a need to raise awareness amongst all market participants,

and especially amongst administrations granting state aids, of the policy and legislative provisions in this area.

216. The EU Common Position issued on 21 November 2001 (the “2001 EU Common Position”, Exh. EC-5) once again stressed “the particular importance of the *acquis* under chapter 6 for the proper functioning of the internal market, including the creation of a level playing field for investment”, and reminded Romania that “the *acquis* under chapter 6, in accordance with the Europe Agreement, has to be applied by Romania already now.” The EU Common Position also stated:

The EU further notes that there are a number of existing as well as new incompatible aid schemes which have not been brought into line with the *acquis*. The EU notes that such schemes include in particular the new draft law on industrial parks, the fiscal facilities offered in the free areas which are set up under Law No. 84/1992, the reduced rate of corporate income tax of 5% for income from exports, and facilities provided under Emergency Ordinances no. 24/1998 and 75/2000 in the so-called “D-areas”. The EU urges Romania to align the existing incompatible aid schemes without delay. (2001 EU Common Position, p. 4)

217. However, the 2001 EU Common Position also stated:

With regard to aid which Romania wishes to operate beyond the date of accession, the EU invites Romania to draw up a list of those existing aid measures which the Competition Council considers as compatible with the *acquis*. The EU invites Romania to transmit this list to the Commission; Romania may continue to operate any aid which is included in the list and against which the Commission has not objected for the period for which the aid was approved by the Competition Council. A reference to the existing aid list and to the procedure for its establishment will be included in the Accession Treaty. (2001 EU Common Position, p. 4)

## **6. Further amendments to the EGO 24 Regime (2000-2001)**

218. On 29 November 2000, by means of Government Decision No. 1199/2000 (Exh. C-32) Romania extended the boundaries of the Ștei-Nucet disfavored region to include Drăgănești, and specified that the entire region would remain disfavored until 31 March 2009.
219. On 26 January 2001, by means of Civil Decision No. 26 (Exh. C-582, R-140), the Bucharest Court of Appeals dismissed the Competition Council’s application for the partial annulment of EGO 75/2000.
220. On 26 April 2001, Government Decision No. 728/2001 repealed the earlier methodological norms [for the implementation of] EGO 24/1998 and provided new methodological norms (the “2001 Methodological Norms”, Exh. R-69, R-35).
221. In August 2001, Prime Minister Nastase announced a new policy in relation to the establishment of new disfavored regions and the time periods for which the zones would be declared disfavored. As reported by the press, he stated that “for the existing zones, the current law shall be maintained”, although “the economic and social status of the area shall be considered when allotting budgetary funds, with a view to balance facilities through the level of budgetary allotments” (Exh. C-630).

222. On 7 November 2001, Romania passed Law No. 621/2001 (Exh. R-33, R-129), which amended EGO 75/2000 by, among others, reinstating the customs duties exemption on imported components.

## 7. Parallel developments in the EU and EGO 24 fronts (2002)

223. In its Regular Report on Romania's progress towards accession dated 9 October 2002, the EC noted that "there are still a large number of incompatible fiscal aid schemes which need to be aligned" (Exh. R-109).

224. On 19 February 2002, the High Court of Cassation of Justice of Romania rejected, on admissibility grounds, the lawsuit brought by the Competition Council for the partial annulment of EGO 75/2000 (Exh. C-643).

225. On 17 May 2002, Multipack and Starmill were issued their PICs (see paragraphs 175-176 above). Both PICs stated that they would be valid until 1 April 2009.

226. On 29 May 2002, Romania and Sweden signed the Bilateral Investment Treaty under which this arbitration is brought (Exh. C-1). Romania ratified the BIT through Law No. 651/2002 (Exh. C-15) enacted on 7 December 2002. The BIT entered into force on 1 April 2003.

227. On 1 June 2002, Romania passed Law No. 345/2002 (Exh. R-90), which abolished two of the incentives contemplated under EGO 24/1998, the Machinery Incentive and the VAT Incentive.

228. In June 2002, the Romanian Government issued a "Report on the progress in preparing for the accession to the European Union September 2001-May 2002", dated June 2002 (Exh. HEC-6), which stated that:

All existing State aid measures will be assessed, establishing their compatibility with the *acquis* in order to suggest measures eliminating or transforming the incompatible ones in compatibles [sic] aids, taking into account the legal and economic implication of the modification of any incompatible schemes on the already granted specific allocations.

This approach will be made according to the European Commission recommendation and will take into consideration [sic] following three steps: (i) closing the incompatibles [sic] schemes in order to stop potential future allocations; (ii) the modification of these scheme to reach the compatibility with the *acquis*; (iii) the identification of the solutions for the economic agents that received the State aid under the present schemes (e.g. Free areas, deprived areas etc). [...] (p. 132)

229. More specifically with respect to EGO 24, it stated that:

Regarding the "D areas", the State aid granted in the present **must [] be converted into a compatible State aid**. The Ministry of Development and Prognosis started the technical debates with the beneficiary associations in order to identify solutions and to make, in 2 months, proposals for alteration of the present system of facilities. (p. 133)

230. At the same time, Romania's "National Programme for Accession of Romania to the European Union" dated June 2002 (Exh. HEC-7) stated that "[t]he provisions of the normative acts on facilities granted for 'D areas' will be maintained till the moment of Romania's accession to the European Union" (p. 148).
231. On 1 July 2002, Romania passed Law No. 414/2002 (Exh. C-48), which repealed the Profit Tax Incentive but grandfathered it for investors who held a PIC prior to the date in which this law entered into force. The Profit Tax Incentive was later reintroduced on 1 January 2004 by Law No. 507/2004 (Exh. C-52).
232. On 7 November 2002, Romania provided the EC with Additional Information on Chapter 6 – Competition Policy (Exh. EC-6). With respect to EGO 24, Romania merely informed the Commission that state aid for the D-areas was regulated by Law 621/2001, which approved EGO 75/2000, and informed the Commission of the amendment to the VAT and the repeal of the profit tax incentive (noting that it had been grandfathered for PIC holders).

"D area" granted facilities

Presently in Romania D areas are regulated by Law no. 621/2001 on the approval of Government Emergency Ordinance (GEO) no. 75/2000 for the alteration of Government Emergency Ordinance no. 24/1998, republished, on deprived area (OG no. 737 of 19<sup>th</sup> November 2001), GEO no. 75/2000 for the alteration of GEO no. 24/1998, republished and GEO no. 24/1998 on deprived areas, approved and modified by Law no. 20/1999.

The regime of the facilities granted in "D" areas was changed by the recent entering into force of the law on VAT and of the law on profit tax.

The Law 345/2002 on VAT entered into force on 01.06.2002 and abrogated the facility of exempting from VAT payment granted for machines, outfits, installations, equipments, means of transport, other depreciable goods imported or produced in the country that were necessary for the investments in a D area. This facility was stipulated in Art. 6(1) of the GEO no. 24/1998 regarding the regime of the deprived areas.

The Law no. 414/2002 (OG no. 456/27.06.2002) on profit tax abrogated the facility of exempting undertakings acting in "D" areas from the payment of the profit tax. This facility was stipulated in Art. 6(1), let. c) of the GEO no. 24/1998 regarding the regime of the deprived areas.

For ensuring the legislative continuity, the legal persons that had obtained the permanent certificate of investor in "D" area before the Law no. 414/2002 entered into force, will further benefit from the profit tax exemption on the whole duration of existence of the deprived area, according to Art. 35, par. 3.

233. On 19 November 2002, Romania passed Law No. 678/2002 (Exh. C-49) which amended the Raw Materials Incentive by excluding from the customs duties exemption raw materials for the production, processing and preservation of meat.

## 8. Events leading up to the revocation of EGO 24

234. On 7 April 2003, the Mission of Romania to the EU sent a communication to the Romanian Minister for European Integration and other state officials, including Mr. Orban and Mr. Berinde (Communication No. 1480, Exh. R-93). It stated:

Community officials stated clearly that the **negotiations on this chapter may be closed if, and only if, the following conditions** (relating primarily to State aid, which was found to have the highest potential to distort the Internal Market) **are met**: new aid must comply strictly with the acquis, **existing aid must be aligned or in the process of being aligned** (including in terms of duration; the granting of transition periods may be considered depending on the outcomes of discussions between the competent institutions in Romania and the relevant operators), and ALL cases of non-notified State aid must be analysed and resolved.

[...]

The Commission stated that it had asked all of the candidate countries to bring their tax breaks into line with the acquis communautaire, including those granted in Free Zones or **Less Favoured Areas**, which entails either their withdrawal or their conversion into compatible aid. In the latter case, **negotiations with a view to converting them into compatible schemes must be pursued directly by the Competition Council with the economic operators concerned**. Only once this has occurred can the companies for which transition periods may be negotiated with the EU be identified.

(Emphasis added)

235. In its Common Position dated 28 May 2003 (Exh. EC-8), the EU invited Romania to provide information on benefits granted in disfavored regions and urged Romania to close “incompatible aid schemes for new entrants with immediate effect.” More specifically:

The EU recalls that all fiscal aid provisions, (for example those included in the VAT Law; the **Law on customs duties exemptions** - including benefits for transactions undertaken by firms located in industrial parks, free zones and **disadvantaged areas** [...]) **should be subject to the approval by the Competition Council. In cases where the Competition Council assesses the respective measures to be incompatible with the State aid rules, the EU invites Romania to either end the measures or to align them with the acquis.**

The EU invites Romania to bring all incompatible aid measures in line with the acquis without delay and to continue to provide information on the progress made towards this goal. [...]

The EU moreover invites Romania to provide information on individual benefits granted in the free zones and the disadvantaged areas and on any other individual tax benefits that have already been granted and which provide for tax benefits beyond Romania's target date for accession. **The EU urges Romania to close incompatible aid schemes for new entrants with immediate effect.**

In this context Romania is further invited to present a **plan outlining how it intends to convert the benefits that are incompatible with the acquis**

and to hold further technical consultations with the Commission to explore the possibilities for this conversion.

[...]

With regard to aid which Romania wishes to operate beyond the date of accession, the EU recalls its invitation to Romania to draw up a list of those existing aid measures which the Competition Council considers as compatible with the *acquis* and to transmit this list to the Commission. The EU recalls that Romania may continue to operate any aid which is included in the list and against which the Commission has not objected for the period for which the aid was approved by the Competition Council. A reference to the existing aid list and to the procedure for its establishment will be included in the Accession Treaty.

The EU recalls that the ***existing aid measures*** are subject in accordance with Article 88(1) of the EC Treaty to the ***appropriate measures procedure***, under which the Commission can, in cooperation with the (future) Member State, propose changes to an aid measure for the future. To the extent that Romania wishes to benefit from this mechanism, the EU invites Romania to present the following to the Commission, every six months as from 1 January 2002, and up until the date of accession:

(a) a list of all existing aid measures (both schemes and ad hoc aid) (i) which have been assessed by the Competition Council and (ii) which it found to be compatible with the *acquis*; (b) any other information which is essential for the assessment of the compatibility of the aid measures referred to under (a).

Details on the precise format for this reporting have been provided by the Commission.

The EU underlines that all aid measures in Romania which are considered State aid according to the *acquis* and which are not included in this list shall be considered as new aid upon Romania's accession. After that date, application of such an aid measure will be conditional upon Romania's notification of it pursuant to Article 88 of the EC Treaty, and a decision of the Commission that the aid measure in question is compatible with the Common Market. As regards individual aid, no measures which continue to have effects after accession and which are incompatible will be acceptable.

(Emphasis added)

236. On 23 December 2003, Law No. 571/2003 on the Fiscal Code (Exh. R-37) revoked Law 345/2002, thus reinstating the Machinery Incentive and the VAT Incentive.
237. In an interview on national TV conducted on 12 January 2004, Prime Minister Nastase indicated that the incentives regime provided by EGO 24/1998 could be terminated due to EU requirements. However, he also stated that the Government was examining whether some of the incentives would remain in place until 2007, noting that the Government had negotiated some transition periods with the EU and that they were trying to find "elegant solutions" (Exh. C-651). When asked to confirm if certain investors could benefit from the program until 2007, Minister Nastase stated that they would try to negotiate an extension that would allow the incentives to remain in place until that time. When asked what would happen to investors who had

invested large amounts of money, the Minister stated that the Government was negotiating with each investor.

238. On 24 March 2004, Romania issued its Complementary Position Paper III on Chapter 6 – Competition Policy (Exh. EC-9). With respect to EGO 24/1998, Romania noted:

The Ministry of Administration and Interior elaborated a draft law for completing the Government Emergency Ordinance no. 24/1998 on the regime of deprived areas. The draft provides that the facilities the undertakings that have an investor certificate and operate in deprived areas benefit from, will be granted below the maximum admitted intensity foreseen in the Regulation on regional aid. At present, the draft normative act is under inter-ministerial endorsement procedure.

By entering into force of the Fiscal Code, the fiscal facilities have been significantly diminished. In fact, ***the undertakings with investor certificate in the deprived areas will benefit from*** the exemption from the payment of the taxes perceived for changing the destination or removing from the agrarian circuit of certain fields designated to achieving the investment as well as ***the exemption from the custom duties payment for raw materials and imported components, excepting the import of the raw material for meat production, processing and preserving***. Also the undertakings that obtained before 1 July 2003 the permanent certificate of investor in the deprived area, will benefit from exemption from the profit tax payment related to the new investment, during the whole existing duration of the deprived area.

(Emphasis added).

239. In May 2004, in an interview in Oradea, Bihor County (Exh. C-652), Prime Minister Nastase indicated that “[s]ubsequent to 2007, when we want to be accepted in the European Union, these disfavored areas will no longer exist in Romania.” When asked about compensation to investors in those areas, the Prime Minister answered that Romania would discuss these matters during its negotiations with the European Union and they would see if Romania was “able to obtain some transition periods for them.” The Prime Minister specified that “there will be no fiscal incentives, there will be some compensation packages, established during direct negotiations.” The Prime Minister also stated that the government would talk to the investors, and “based on the conclusions of the negotiations of the Competition Chapter, we will negotiate with those who initially obtained these fiscal incentives” (Exh. C-652, pp. 7-9 of translation).
240. On 7 June 2004, Romania passed Law No. 239/2004 to supplement EGO 24/1998 (Exh. R-147). This law subjected all state aid to a maximum intensity requirement.<sup>12</sup> In other words, it provided that the EGO 24/1998 facilities could not exceed the thresholds of permissible state aid approved by the Competition Council. If investors exceeded the maximum permitted intensity, the facilities would cease to be granted.

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<sup>12</sup> In June 2004, Romania passed Law 239/2004, which made all State aid subject to a maximum-intensity requirement. According to a definition provided by the Respondent, “[v]alid intensity is measured as the amount of aid in relation to the costs of production or the costs of investment of the company or project that receives the aid.” P. Nicolaidis, M. Kekelekis, P. Buyskes, State Aid Policy in the European Community (2nd edn 2005) (Exh. RL-179), p. 38.



241. On 31 August 2004, by means of Government Ordinance No. 94/2004 (“GO 94/2004”, Exh. R-94), Romania repealed Article 6(1)b)d) and e) of EGO 24/1998, thus repealing/revoking the incentives provided under EGO 24/1998, including the Raw Materials Incentive, with the exception of the Tax Profit Incentive. The repeal was originally to become effective 90 days from the date of entry into force of GO 94/2004 (that is, on 3 December 2004). However, the date of repeal was subsequently extended to 22 February 2005 by means of Law No. 507/2004 of 22 November 2004 (Exh. C-52), which approved and amended GO 94/2004 to that effect. The substantiation report accompanying GO 94/2004 stated:

In order to meet the criteria in the Community rules on state aid, and also to complete the negotiations under Chapter No. 6 – Policy it is necessary to eliminate all forms of State aid in national legislation incompatible with the *acquis communautaire* in this area and, in this respect, it is proposed to repeal [...] the provisions of Article 6 paragraph (1), letter (b), letter (d) and letter (e) of the Emergency Government Ordinance no. 24/1998 on the disadvantaged areas [...]

(Substantiation Report accompanying EGO 94/2004, 26 August 2004, Exh. R-95, pp. 12-13).

242. On 13 September 2004, the Claimants requested Romania to restore the tax incentive regime (Exh. C-8, ER of G. Piperea, ¶ 5.3).

243. On 8 December 2004, the EU issued a Common Position (“2004 EU Common Position”, Exh. EC-10), in which it welcomed the amendments to the regimes related to Free Trade Areas and Deprived Areas. In this context, the EU noted that Romania had requested two transitional periods, one with respect to the Profit Tax Incentive under EGO 24/1998 and another with respect to a royalty exemption under Law No. 84/1992. The EU accepted both transitional arrangements proposed by Romania. With respect to the Deprived Areas, this meant that investors holding a PIC granted prior to 1 July 2003 could continue to benefit from the Profit Tax Incentive for as long as the Deprived Areas continued to exist, under certain conditions (limited to 2008, 2009 or 2010, depending on the deprived area; net intensity of aid granted must remain below certain specified aid ceilings and the eligible costs must be defined in accordance with the Regional Aid Guidelines).

244. On 22 February 2005, the revocation of the EGO 24/1998 incentives (with the exception of the Profit Tax Incentive) became effective.

245. Also on 22 February 2005, the EC issued its Opinion on Romania’s EU application (Exh. R-50) where it stated:

(7) In joining the European Union, the Republic of Bulgaria and Romania accept, without reserve, the Treaty establishing a Constitution for Europe, and until its entry into force, the Treaty on European Union and the Treaties establishing the European Communities including all their objectives and all decisions taken since their entry into force, and the options taken in respect of the development and strengthening of those Communities and of the Union.

(8) It is an essential feature of the legal order introduced by the Treaties establishing the European Communities and, at its entry into force, the Treaty establishing a Constitution for Europe that certain of their provisions and certain acts adopted by the institutions are directly applicable, that the law of the Union takes precedence over any national provisions which might conflict with it, and that procedures exist for ensuring the uniform interpretation of the law of the Union; accession to the European Union implies recognition of the binding nature of these rules, observance of which is indispensable to guarantee the effectiveness and unity of the law of the Union.

## **9. Subsequent events**

246. On 25 April 2005, the Member States of the EU signed the Accession Treaty with Romania and Bulgaria (the “Accession Treaty”, Exh. R-27). The Treaty was to enter into force on 1 January 2007 [i.e., this would be the date of accession]. However, pursuant to Article 4(3), the institutions of the EU could adopt before accession certain measures specified in the Protocol annexed to the Accession Treaty, which set out the conditions and arrangements for admission. Annex VII to the Accession Protocol (Exh. R-52, R-98), Section 4 on Competition Policy, subsection A on Fiscal Aid, set out the transitional period with respect to the Profit Tax Incentive referred to in the 2004 EU Common Position. With respect to the Ştei-Nucet disfavored regions, it stated that Romania could continue granting the Profit Tax Exemption until 31 December 2009, subject to certain state aid intensity requirements and other conditions.

247. On 28 July 2005, the Claimants filed their Request for Arbitration.

248. On 4 March 2006, the EC issued the Guidelines on National Regional Aid for 2007-2013 (Exh. C-298), which set out the principles according to which EU Member States could grant regional aid to disadvantaged areas. With respect to operating aid, the Guidelines provided:

Regional aid aimed at reducing a firm's current expenses (operating aid) is normally prohibited. Exceptionally, however, such aid may be granted in regions eligible under the derogation in Article 87(3)(a) provided that (i) it is justified in terms of its contribution to regional development and its nature and (ii) its level is proportional to the handicaps it seeks to alleviate (69). It is for the Member State to demonstrate the existence and importance of any handicaps (70). In addition, certain specific forms of operating aid can be accepted in the low population density regions and the least populated areas.

249. On 1 January 2007, the Accession Treaty entered into force and Romania became a Member State of the EU.

#### **IV. SUMMARY OF THE PARTIES' POSITIONS**

250. The purpose of this section is to provide an overview of the Parties' positions. The Parties' detailed positions with respect to each claim are described in Section VI below (Analysis of the Claimants' Treaty Claims).

##### **A. THE CLAIMANTS' POSITION**

251. The Claimants' case has evolved over time. Although its core elements remain unchanged, the focus of the Claimants' arguments has shifted, as has the structure of these arguments.

252. The Claimants contend that "[i]n the course of enacting, promoting and implementing the EGO 24 regime, the Respondent made unambiguous and binding commitments to foreign investors, the Micula brothers, that they would be granted a number of incentives for a 10 year period in return for making certain large investments in one of the poorest and least developed regions of Romania" (C-PHB, ¶ 1). The Claimants claim that, in specific reliance on these commitments, and in particular in reliance on the expectation that the incentives would last through the entire 10 year period, the Claimants invested massively in the Ștei-Nucet-Drăgănești area, one of Romania's most remote and disfavored regions.

253. In the latest formulation of their case, the Claimants argue that Romania entered into these binding commitments through EGO 24; its implementing legislation, in particular GD 194/1999; and the issuance of Permanent Investor Certificates (PICs) to the three Corporate Claimants. The Claimants submit that these PICs certified that the Claimants had the right to receive the incentives until 1 April 2009, which was also the date in which Ștei-Nucet-Drăgănești would cease to be considered a disfavored region.

254. The Claimants argue that Romania's binding commitment to provide the incentives to the Claimants until 1 April 2009 gave rise to a right to receive those incentives until that date, or at least generated a legitimate expectation that they would benefit from those incentives until that date. The Claimants contend that Romania's revocation of these incentives effective 22 February 2005 (approximately 4 years before they were set to expire) breached that commitment or undermined that legitimate expectation.

255. The Claimants contend that Romania's premature revocation of the incentives was unfair and unlawful. While Romania argues that it was forced to revoke the incentives to comply with EU requirements, the Claimants assert that the incentives were in fact compatible with EU law, and no competent authority had issued a decision requiring Romania to terminate the incentives. The Claimants also complain that Romania did not attempt to negotiate with either the EU or the Claimants to find a solution that would mitigate the adverse effects on their business of the premature revocation of the incentives. The Claimants argue that, most egregiously, Romania revoked only the provisions of EGO 24 that established the incentives, while retaining those that

set out the Claimants' obligations to remain invested in the Ștei-Nucet-Drăgănești region for twice the time they received the incentives.

256. In view of the above, the Claimants argue that Romania has breached the Claimants' rights under the Sweden-Romania BIT and under international law. Specifically, they contend that the premature revocation of the EGO 24 incentives:
- a. Breached a clear commitment undertaken by Romania vis-à-vis the Claimants, and therefore breached the BIT's umbrella clause contained in Article 2(4) of the BIT;
  - b. Undermined the Claimants' legitimate expectations, upset the stability of the regulatory regime, lacked transparency and consistency, and was taken in bad faith, and therefore breached Romania's obligation under Article 2(3) of the BIT to afford the Claimants fair and equitable treatment;
  - c. Impaired by unreasonable measures the management, maintenance, use, enjoyment and disposal of the Claimants' investments, and therefore breached Article 2(3) of the BIT; and
  - d. Expropriated without compensation the Claimants' right to receive the incentives and substantially deprived their entire investment of value, and therefore breached Article 4(1) of the BIT.
257. The Claimants claim that, because the early revocation of these incentives violated an obligation entered into by Romania vis-à-vis the investors (and thus breached the BIT's umbrella clause), the revocation also undermined the Claimants' legitimate expectations (and consequently breached the BIT's fair and equitable treatment standard). However, in the Claimants' view, even if the premature revocation of the incentives does not breach the umbrella clause (e.g., because the promise allegedly made by the Respondent does not rise to the level of an obligation protected by the umbrella clause), the Tribunal could still find a violation of the fair and equitable treatment standard because the revocation upset the Claimants' legitimate expectations (Tr., Day 12, 126:22-128:6 (Reed)).
258. The Claimants deny that the termination of the incentives was required under EU law. The Claimants allege that, to the contrary, the incentives were one of the factors that allowed Romania to accede to the EU in the first place. Indeed, the Claimants argue that Romania desperately needed economic development, particularly in certain distressed regions, to be able to join the EU. In their view, incentive programs such as EGO 24 greatly contributed to this development.
259. The Claimants argue that Romania has failed to show how the EGO 24 incentives conflicted with EU law and that Romania has not provided evidence that the EU required the termination of the incentives in order to obtain accession.
260. The Claimants specific arguments with respect to the alleged treaty breaches are discussed in Section VI below (Analysis of the Claimants' Treaty Claims).

261. The Claimants argue that these breaches caused substantial damage to the Claimants, as set out in Section VII below (Damages).

262. On the basis of the foregoing, the Claimants request the following relief:

The Claimants request an award be made granting the relief set out in paragraphs 1 to 6 below.

Any damages payable, including interest and costs, should be awarded to the individual Claimants, Ioan Micula and Viorel Micula, to be divided between them on a 50:50 basis.

In the alternative, any damages payable, including interest and costs, should be awarded to all five Claimants.

1. A declaration that Romania has violated the Sweden-Romania Bilateral Investment Treaty ("Treaty") and customary international law by:

1.1 failing to ensure fair and equitable treatment of the Claimants' investments (Article 2(3) of the Treaty) by treating the Claimants' investments in a manner that was inconsistent, ambiguous, and not transparent;

1.2 failing to ensure fair and equitable treatment of the Claimants' investments (Article 2(3) of the Treaty) by violating the Claimants' legitimate expectations regarding their investments;

1.3 impairing the Claimants' investments through unreasonable and discriminatory measures (Article 2(3) of the Treaty);

1.4 failing to observe obligations entered into with the Claimants with regard to their investments (Article 2(4) of the Treaty); and

1.5 expropriating the Claimants' investments without the payment of prompt, adequate, and effective compensation (Article 4(1) of the Treaty).

2. Damages for the following losses suffered by the Claimants:

**A. Expectation losses**

2.1 Losses suffered as a result of the increased cost of raw materials following revocation of the incentives provided by Emergency Government Ordinance 24/1998 ("Incentives") and the lost opportunity to build a sugar stockpile in 2009, comprising:

(a) increased costs of sugar in the amount of RON 85.1 million;

(b) increased costs of PET in the amount of RON 6.3 million;

(c) increased costs of raw materials other than sugar and PET in the amount of RON 17.5 million; and

(d) lost opportunity to stockpile sugar in 2009 in the amount of RON 62.5 million.

- 2.2 Financial penalties incurred but not yet paid as a result of the Claimants being financially constrained due to the losses incurred as a result of the revocation of the Incentives in the amount of RON 63.65 million as 30 September 2010 unless these financial penalties are waived by the Respondent and a declaration that the Respondent shall waive or reimburse all additional financial penalties imposed or assessed until the date of Romania's full and final satisfaction of the award.
- 2.2A Financial penalties paid by the Micula brothers' companies in the period 1 April 2005 to 30 September 2010 in the amount of RON 40 million.
- 2.3 Lost profits on sales of finished goods following revocation of the Incentives of no less than RON 427 million.
- 2.4 Lost profits on sales of Sugar Containing Products ("SCPs") following revocation of the Incentives in the amount of RON 492.3 million.
- 2.5 Lost profits incurred as a result of the Claimants' inability to complete their incremental investments following revocation of the Incentives comprising:
  - (a) a malt plant in the amount of RON 28 million;
  - (b) a cogeneration [p]lant in the amount of RON 712.6 million; and
  - (c) a canning [p]lant and subsequent sales of private label beer in the amount of RON 720.4 million.
- 2.6 In the alternative to paragraphs 2.3, 2.4 and 2.5 above, lost profits on sales of finished goods following revocation of the Incentives in the amount of RON 2423.2 million.

**B. Reliance losses**

- 2.7 In the alternative to the losses described in paragraphs 2.1, 2.2A, and 2.3 to 2.6 above, but not 2.2, the amounts lost by the Claimants as a result of investing in reliance on the Incentives in the amount of RON 811 million.
3. An award of interest on the damages payable pursuant to paragraph 2 above calculated in the following manner:
  - 3.1 For losses as described in paragraphs 2.1(a) to (c) above, interest compounded on a quarterly basis at a rate of 3 month ROBOR (Romanian Interbank Offer Rate) plus 5% from 1 March 2007 until the date of Romania's full and final satisfaction of the award.
  - 3.2 For losses as described in paragraph 2.1(d) above, interest compounded on a quarterly basis at a rate of 3 month ROBOR plus 5% from 1 July 2010 until the date of Romania's full and final satisfaction of the award.
  - 3.3 For penalties as described in paragraph 2.2A above, interest compounded on a quarterly basis at a rate of 3 month ROBOR

plus 5% from 1 July 2007 until the date of Romania's full and final satisfaction of the award.

- 3.4 For losses as described in paragraph 2.3 above, interest compounded on a quarterly basis at a rate of 3 month ROBOR plus 5% from 1 May 2008 until the date of Romania's full and final satisfaction of the award.
  - 3.5 For losses as described in paragraph 2.4 above, interest compounded on a quarterly basis at a rate of 3 month ROBOR plus 5% from 1 March 2007 until the date of Romania's full and final satisfaction of the award.
  - 3.6 For losses as described in paragraph 2.5 above, interest compounded on a quarterly basis at a rate of 3 month ROBOR plus 5% from 30 September 2009 until the date of Romania's full and final satisfaction of the award.
  - 3.7 For losses as described in paragraph 2.6 above, interest compounded on a quarterly basis at a rate of 3 month ROBOR plus 5% from 15 August 2007 until the date of Romania's full and final satisfaction of the award.
  - 3.8 For the amounts lost by the Claimants as a result of investing in reliance on the Incentives as described in paragraph 2.7 above, interest to be applied compounded on a quarterly basis at a rate of 3 month ROBOR plus 5% from 1 January 2002 until the date of Romania's full and final satisfaction of the award.
  - 3.9 The ROBOR rate to be applied in relation to paragraphs 3.1 to 3.8 above is to be the average annual rate for each year or part thereof.
4. The total amount of damages payable by the Respondent comprising the amounts set out in paragraphs 2, 3 and 5 to be received net of any tax obligations imposed by Romania on the proceeds.
  5. All costs incurred by the Claimants in relation to these proceedings, including but not limited to the Claimants' lawyers' fees and expenses, experts' fees and expenses, and all costs of ICSID and the Tribunal.
  6. Any further relief that the Tribunal may deem fit and proper.

(Claimants' Revised Request for Relief, footnotes omitted)

263. In addition, the Claimants request that the Tribunal:<sup>13</sup>

[...]

- b. provide in the Award that Romania is enjoined from any further tax collection measures of any kind in respect of the Claimants and the EFDC until such a time as the damages awarded by the Tribunal have been paid in full, and include a pecuniary alternative in case of non-performance;

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<sup>13</sup> These additional requests were made in the context of the Respondent's application to revoke the provisional measures recommended by the Tribunal. As noted in paragraph 111 above, the determination of these matters was deferred to the final Award.

- c. issue a declaration that Romania is not entitled to set-off tax debts of the EFDC against an Award in favor of Claimants;
- d. order Romania to pay all of Claimants' costs in responding to this Application, including reasonable lawyers' fees and other costs; and
- e. grant any other relief that the Tribunal may deem fit and proper in these proceedings.

(Claimants' Rejoinder on the Respondent's Revocation Application, ¶ 75).

## **B. THE RESPONDENT'S POSITION**

264. The Respondent rejects each of the Claimants' claims under the BIT.
265. The Respondent argues that the key question in this case is "who bore the risk of regulatory change: the state or the investors who benefitted from the existing regulatory regime" (R-Rejoinder, ¶ 9).
266. The Respondent contends that the BIT does not require the Contracting States to tailor their laws and regulations to the preference of foreign investors, nor does it establish liability for every regulatory change that has a negative impact on the foreign investors' businesses. To the contrary, investment protection treaties accord host states considerable deference in relation to regulatory policy. As a result, the Respondent argues that where a state has exercised its sovereign powers to regulate in a general, non-discriminatory way to advance public welfare (including by legislative changes), such conduct is not an "expropriation", "unfair and inequitable treatment", or otherwise in breach of the provisions of an investment protection treaty. Absent a clear commitment from the state to stabilize a regulatory framework, states are usually free to change their laws.
267. Indeed, the Respondent argues that businessmen know this, and factor regulatory risk into their business plans. According to the Respondent, the Claimants did not do so because they thought they had a special status that protected them from any regulatory changes.
268. In the present case, the Respondent notes that it is undisputed that the modification of the facilities that had been granted pursuant to EGO 24/1998 was a generally applicable act. The Respondent also argues that it was compelled to curtail the facilities as an essential precondition to accession to the EU. Accordingly, the Tribunal should give deference to Romania's action when applying the substantive provisions of the BIT (R-CM, ¶ 92).
269. Building on this fundamental premise, the Respondent makes four main arguments.
270. The Respondent's first line of argument is that three (and possibly four) of the Claimants' claims fail because the Claimants have not proven that Romania made a binding promise to the Claimants that the facilities under EGO 24, either in their totality or the Raw Materials Facility individually, would remain unchanged until 2009. The Respondent argues that the Claimants' ability to establish the existence, terms



and duration of this promise is an essential condition for the following three claims (although it is not a sufficient condition for the success of any of them) (Tr., Day 13, 60:2-65-7; 73:3-83-25 (Petrochilos)):

- a. First, the existence of such a promise is the basis for the Claimants' assertions regarding their legitimate expectations, including their expectation of legal stability, and is therefore necessary for proving this aspect of the Claimants' fair and equitable treatment claim.
  - b. Second, the existence of such a promise is necessary to establish the existence and scope of an obligation under Romanian law, the breach of which could result in the breach of the umbrella clause.
  - c. Third, the existence of such a promise is allegedly what gave rise to the Claimants' right to the facilities, which Claimants assert has been expropriated.
271. In addition, the Respondent contends that the Claimants' claims relating to an asserted lack of transparency and consistency in the regulatory regime are based on the notion that the Claimants were entitled to receive some kind of an advance notice or warning from Romania that the Raw Materials Incentive would change, because Romania had allegedly promised that the incentive would remain in place until 2009.
272. The Respondent argues that the Claimants must prove two distinct components of this promise: (i) that the EGO 24 facilities would remain unchanged until 2009, and (ii) that the promise was contained in an instrument which either conferred individual rights on them, or was otherwise one on which they could legitimately rely as securing some form of entitlement that was specific to them and that would remain in place even in the case of a general legislative or regulatory change.
273. The Respondent further contends that, to establish any of these claims, the Claimants must prove that Romania's promise was binding under Romanian law:
- a. With respect to the fair and equitable treatment claim, the Respondent argues that the Claimants must show that, after exercising due diligence, they legitimately and reasonably relied on an instrument which a reasonable investor, properly advised by Romanian lawyers, would have understood as an assurance of the immutability of the EGO 24 facilities.
  - b. With respect to the umbrella clause and expropriation claims, the Respondent argues that the Claimants must show that they had an actionable vested right existing under Romanian law which was breached or expropriated.
274. According to the Respondent, the Claimants' claims fail because they have failed to establish the existence of a binding promise under Romanian law.
275. The Respondent's second line of argument is that, regardless of the existence of a promise, either the Claimants did not rely on the existence of that promise to make their investments, or any such reliance was unreasonable. The Respondent argues

that, given the lack of reliance, the Claimants' fair and equitable treatment claim fails, even if a promise existed. In this respect (and as noted below), the Respondent argues that the Claimants' case hinges on the credibility of their witnesses, and their testimony is neither credible nor reliable (Tr., Day 13:19-43 (King)).

276. The Respondent's third line of argument is that the remaining claims (namely, the Claimants' other fair and equitable treatment claims and their claims that Romania impaired the Claimants' investments through unreasonable measures) fail because Romania's actions were reasonably related to a rational policy, which was EU accession. The Respondent also argues that the actions giving rise to the Claimants' assertions of lack of transparency and inconsistency in the regulatory regime were, in fact, reasonable and consistent with the BIT.
277. The Respondent advances further arguments with respect to each of the Claimants' claims, which will be addressed in the specific analysis of each of the Claimants' claims in Chapter VI.
278. Finally, as discussed in Section VII below, the Respondent challenges the Claimants' case on quantum.
279. In addition to these four main arguments, the Respondent challenges the credibility and reliability of the Claimants' witnesses. The Respondent argues that this lack of credibility and reliability was exposed during the November 2010 hearing on the merits, and that this is the reason why the Claimants shifted the focus of their case. Specifically, the Respondent argues that while the Claimants originally focused on their legitimate expectations claim (which requires proof of the Claimants' subjective reliance on their alleged expectations and of the reasonableness of that reliance), after the hearing on the merits the Claimants shifted their focus to their claims related to the umbrella clause, expropriation and transparency. According to the Respondent, these are "claims that have nothing to do with the Claimants in particular", and the Claimants shifted their focus to them because they believe that "these are claims that might survive without the need to rely on the doubtful words of the Miculas and their employee witnesses" (Tr., Day 13, 30:21-31:2 (King)).
280. The Respondent has stated that its challenge to the credibility and reliability of the Claimants' witnesses extends to "all aspects that the Claimants have asserted" (Tr., Day 13, 62:6-8). However, given that the Respondent acknowledges that the umbrella clause, expropriation and transparency claims are premised on objective rather than subjective factors, it seems that the Respondent's challenge to the credibility and reliability of the Claimants' witnesses is directed principally to the Claimants' legitimate expectations claim and their damages case.
281. The Respondent also argues that, despite the Claimants' shift in focus, this is not and has never been a case about transparency; it has only become so because the hearing undermined the Claimants' previous case theory (Tr., Day 13, 19-43 (King)).
282. For the foregoing reasons, the Respondent requests the Tribunal to:

- “(a) DISMISS the Claimants’ claims in their entirety; and
- (b) ORDER the Claimants to pay in their entirety the costs of this arbitration, including the fees and expenses of the Tribunal and the Centre and the reasonable fees and expenses incurred by Romania in defending against the Claimants’ claims.”

(Respondent’s Post-Hearing Brief, ¶ 354).

283. In addition, the Respondent requests the Tribunal to:<sup>14</sup>

“[...]

- c. if any amount is awarded to any of the Claimants, whether as damages, arbitration costs, or otherwise, explicitly provide in the award that the amount awarded is subject to set-off against the tax debts of all eleven EFDG companies, including lawful interest and penalties;
- d. grant any other relief the Tribunal considers just and proper.”

(Respondent’s Reply regarding its Revocation Application, ¶ 41)

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<sup>14</sup> These additional requests were made in the context of the Respondent’s application to revoke the provisional measures recommended by the Tribunal. As noted in paragraph 111 above, the determination of these matters was deferred to the final Award.

## V. PRELIMINARY MATTERS

### A. THE TRIBUNAL'S JURISDICTION

284. The Tribunal's jurisdiction over this dispute was addressed in the Decision on Jurisdiction and Admissibility, which makes integral part of this Award. In that Decision, the Tribunal found that it had jurisdiction over the dispute submitted to it in this arbitration and rejected any objections as to the admissibility of the claims (Decision on Jurisdiction and Admissibility, ¶ 170).
285. Specifically, in the Decision on Jurisdiction and Admissibility the Tribunal found that:
- a. The Tribunal's jurisdiction is determined by Article 25 of the ICSID Convention and Article 7 of the BIT.
  - b. Regarding jurisdiction *ratione personae*, the Tribunal rejected Romania's argument that the Individual Claimants' Swedish nationality could not be opposed to Romania because of purported tenuous links with Sweden. Accordingly, the Tribunal concluded that Messrs. Micula are and have been Swedish nationals at all times relevant to the Tribunal's jurisdiction. As for the three Corporate Claimants, the Tribunal resolved that they were held by nationals of another Contracting State at the time of consent to arbitration, in accordance with the requirements of Article 25(2)(b) of the ICSID Convention and Article 7(3) of the BIT.
  - c. Regarding jurisdiction *ratione materiae*, the Tribunal found that the investments made by the Corporate Claimants qualified as such for the purposes of the ICSID Convention. In the same vein, the Tribunal was satisfied that the shareholding of Messrs. Micula qualified as an investment under the ICSID Convention. The Tribunal also held that there was an investment for the purposes of the BIT. Further, the Tribunal expressed no doubt that the dispute was of a legal nature, arising directly out of an investment, for the purposes of Article 25 of the ICSID Convention. Moreover, the Tribunal understood that the dispute was not merely hypothetical and that the Claimants had made a *prima facie* case of entitlement.
  - d. Regarding jurisdiction *ratione temporis*, the Tribunal found that the dispute arose after the entry into force of the BIT and therefore fell within the scope of application of the BIT *ratione temporis*.
  - e. The Tribunal also rejected the Respondent's objection related to the remedy of restitution sought by the Claimants, ruling that the Tribunal had powers to order restitution both under the ICSID Convention and the BIT.

## B. APPLICABLE LAW

286. Article 42(1) of the ICSID Convention provides that:

The Tribunal shall decide a dispute in accordance with such rules of law as may be agreed by the parties. In the absence of such agreement, the Tribunal shall apply the law of the Contracting State party to the dispute (including its rules on the conflict of laws) and such rules of international law as may be applicable.

287. The Parties note that the BIT does not contain a choice of law clause (C-SoC, ¶ 170; R-CM, ¶ 72; R-Rejoinder, ¶ 230). Accordingly, Article 42(1) of the ICSID Convention directs the Tribunal to apply the host state's law (here, Romanian law) and "such rules of international law as may be applicable." The Parties agree that, in the case of conflict between Romanian law and international law, international law should take precedence (C-SoC, ¶¶ 172; R-CM, ¶ 72).<sup>15</sup>

288. The Claimants submit that "where the basis of jurisdiction is a BIT and the claims put forward are based on the BIT, it is established practice to accept the BIT's substantive rules as the applicable law" (C-SoC, ¶ 170). The Respondent appears to agree, noting that "the interpretation of the BIT must be guided by relevant principles of international law", and adding that "[i]ts actual text is of course the starting point" (R-CM, ¶ 73;). Indeed, the Respondent contends that the rule of international law of primary significance to the Claimants' case is Article 2(3) of the BIT (R-Rejoinder, ¶ 230).

289. The Parties disagree however on the role of other rules of international law in this dispute. The Claimants contend that no international law principle displaces the terms of the BIT or otherwise excuses Romania's treaty breaches. In turn, the Respondent argues that the BIT must be interpreted in light of the context in which it was concluded, and should be consistent with Romania's and Sweden's other relevant international law obligations, including in particular Romania's obligations under the Europe Agreement and the EC Treaty. Romania argues that, in any event, the Parties intended EU law to prevail.

290. The Tribunal addresses the Parties' positions below, as well as comments made by the European Commission in its capacity as *amicus curiae*.

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<sup>15</sup> See, e.g., *Compañía de Desarrollo de Santa Elena SA v Republic of Costa Rica* (ICSID Case No ARB/96/1), Award, 17 February 2000 (hereinafter "*Santa Elena v. Costa Rica*"), ¶¶ 64-65; *LG&E Energy Corp, LG&E Corp, LG&E International Inc. v Argentine Republic* (ICSID Case No ARB/02/1), Decision on Liability, 3 October 2006 (hereinafter "*LG&E v. Argentina*" or "*LG&E*"), ¶ 94; *Amco Asia Corporation and others v. Republic of Indonesia* (ICSID Case No. ARB/81/1), Resubmission Proceeding, Award, 5 June 1990, ¶ 40.

## 1. The Claimants' position

291. The Claimants contend that EU law does not displace the terms of the BIT (C-Reply, ¶¶ 515-555; ER of D. Caron; C-PHB, ¶¶ 86-95). The Claimants argue that there is no conflict of treaties that could make EU law prevail over the BIT, but even if there were, the BIT should prevail (Section (a) below). The Claimants further contend that the Respondent's attempts to interpret the BIT in accordance with EU law should be rejected (Section (b) below). In any event, the Claimants contend that EU law requirements would not justify or excuse breaches of the BIT (Section (c) below).

### a. There is no conflict of treaties, and even if there were, the BIT should prevail

292. The Claimants submit that there is no conflict of treaties in this case because the Accession Treaty and the EC Treaty were not in force vis-à-vis Romania at the time it entered into the BIT, or at the time when the breaches of the BIT occurred. Thus, the Claimants assert that:

Everything here in this case is crystallised prior to the accession of Romania to the EU. The BIT was entered in force before, the breach predates the accession and hence the right to be compensated predates accession. [...] [T]he only element which postdates accession is the payment: the payment of a sum of money which represents the consequences of the breach which predates accession (Tr., Day 12, 141 (Gaillard)).

293. The Claimants also note that the Commission expressly concludes that the BIT has been neither superseded nor terminated by Romania's accession to the EU pursuant to Article 59 of the Vienna Convention.

294. In the Claimants' view, the only treaty with which the BIT could be deemed to be in conflict is the Europe Agreement. The Claimants deny that such a conflict exists, but if such a conflict were deemed to exist, they submit that the BIT should prevail:

- a. First, under the preservation of rights provision in Article 9(2) of the BIT, the BIT prevails over external provisions, except to the extent that the latter would be more favorable to the investor than the provisions of the BIT.
- b. Second, the BIT prevails as *lex posterior* pursuant to Article 30(3) of the Vienna Convention on the Law of Treaties of 1969 (the "VCLT")<sup>16</sup> because none of the requirements for Article 30(3) to apply is met (in particular, the Europe Agreement and the BIT were not entered into between the same parties, nor do they have the same subject matter).
- c. Third, the BIT prevails as *lex specialis*, because it is the treaty with a more precisely delimited scope of application. In addition, the Claimants argue that

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<sup>16</sup> Article 30(3) of the VCLT provides: "When all the parties to the earlier treaty are parties also to the later treaty but the earlier treaty is not terminated or suspended in operation under article 59, the earlier treaty applies only to the extent that its provisions are compatible with those of the later treaty."

there is no evidence of Romania's and Sweden's common intention to give precedence to EU law and subordinate the BIT to it. Indeed, the Claimants note that, in the few instances where Romania has intended to give precedence over a BIT to a particular source of law, it has done so expressly.

**b. Romania's interpretation of the provisions of the BIT is flawed**

295. The Claimants further argue that Romania misapplies Article 31(3)(c) of the VCLT in an attempt to supplant the BIT with EU law. Article 31(3)(c) of the VCLT provides: "There shall be taken into account, together with the context: [...] (c) any relevant rules of international law applicable in the relations between the parties." According to the Claimants, Romania's attempt to "interpret" the BIT by taking into account EU law as part of the "relevant rules of international law applicable in the relations between the parties" is an improper attempt to displace the BIT and apply EU law instead. Relying on Prof. Caron's expert opinion, the Claimants argue that:

- a. An "interpretation" cannot be construed to abrogate express language in the BIT;
- b. The meaning of the terms "shall be taken into account" should be understood to mean that an interpreter of the treaty has the discretion to consider relevant rules of international law, not that such rules must be incorporated into the treaty, and
- c. The "relevant rules of international law" are only those that are in place at the time of the violation.

296. As a result, the Claimants argue that, for purposes of Article 31(3)(c) of the VCLT, the Tribunal could "take into account" the Europe Agreement, which existed at the time the BIT entered into force and at the time Romania breached the BIT's provisions (subject to the additional requirement of the Europe Agreement being "between the parties", which the Claimants deny). However, the Tribunal cannot take into account the Accession Agreement or the EC Treaty, as Romania had not entered into either at the time it concluded the BIT. Therefore, in the view of the Claimants, if the Tribunal seeks to determine the relevant state aid requirements that applied to Romania, the Tribunal should refer to the regime existing under the Europe Agreement, rather than the post-accession regime.

**c. EU law requirements would not justify or excuse breaches of the BIT or international law**

297. The Claimants submit that even if Romania was required by EU law to repeal the EGO 24 incentives prior to their planned expiration in 2009, this would not justify or excuse breaches of the BIT and international law.

298. The Claimants note that, according to Art. 12 of the ILC Articles on State Responsibility (the "ILC Articles"),<sup>17</sup> "[t]here is a breach of an international obligation

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<sup>17</sup> Articles on Responsibility of States for Internationally Wrongful Acts adopted by the International Law Commission (ILC) in 2001. The Tribunal notes that the Claimants have included a complete version of the ILC Articles, with commentaries, at Exh. C-592 (ILC Articles on State Responsibility,

by a State when an act of that State is not in conformity with what is required of it by that obligation, regardless of its origin or character.” In the Claimants’ submission, the relevant international obligations here are those contained in the BIT. Romania would breach those obligations even if its actions were required by EU law. Pursuant to Article 31(1) of the ILC Articles, “[t]he responsible State is under an obligation to make full reparation for the injury caused by the internationally wrongful act.”

299. The Claimants submit that, for all of their claims except their fair and equitable treatment claim, the obligation to compensate arises irrespective of the rationale for the adoption of the internationally wrongful act. In their view, Romania’s reasons for adopting the measure could only be relevant if Romania were trying to avail itself of one of the circumstances precluding wrongfulness described in Chapter V of the ILC Articles, i.e., force majeure (Article 23), duress (Article 24), or necessity (Article 25). Thus, for their expropriation and umbrella clause claims, the Claimants argue that Romania’s “EU law defense” should be assessed after the Tribunal has decided whether there is liability under the BIT, to determine if the reasons for Romania’s actions qualify as a circumstance precluding wrongfulness.
300. The Claimants note that Romania has not expressly invoked Articles 23-25 of the ILC Articles, but in any event the Claimants submit that none of them applies. In particular, Romania has not proven the “necessity” of its alleged compliance with its EU law obligations in the terms of Article 25.
301. Even if the doctrine of “necessity” applied, the Claimants contend that Romania would still be required to compensate them. Article 25 only provides an excuse for an act by a state; it does not affect a state’s obligation to pay compensation for damages caused by that act (even if excused). Indeed, according to the Claimants ILC Article 27(b) leaves open whether a state relying on a circumstance precluding wrongfulness should nonetheless be expected to make good any material loss suffered.
302. In contrast, the Claimants submit that Romania’s EU law defense is relevant to the determination of whether Romania has breached the fair and equitable treatment standard. As explained in further detail below, the Claimants argue that EU law is part of the factual matrix against which the Tribunal must determine whether the Claimants’ expectations were legitimate and, specifically, whether they were reasonable (Tr., Day 1, 159-164, 170-177 (Gaillard)). Thus, the Tribunal must assess Romania’s EU law defense during the Tribunal’s analysis of whether Romania has breached the fair and equitable treatment standard.

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Report of the International Law Commission on the Work of Its Fifty-third Session, UN GAOR, 56th Sess., Supp. No. 10, at 43, UN Doc. A/56/10 (2001), and that the Respondent has done the same at Exh. RL-8 (International Law Commission, “Draft Articles on Responsibility of States for Internationally Wrongful Acts with commentaries”, [2001-II(2)] Yearbook of the International Law Commission 59). The Tribunal understands that all of these versions are identical and will use them indistinctly. The Tribunal further notes that, by Resolution 53/83 of 12 December 2001, the UN General Assembly took note of the ILC Articles and “commend[ed] them to the attention of Governments without prejudice to the question of their future adoption or other appropriate action.” All references to the ILC Articles themselves in this Award are to the version to which the UN General Assembly referred in Resolution 53/83. All references to the commentary to the Articles are to the version adopted by the ILC.



## 2. The Respondent's position

303. The Respondent argues that the BIT must be interpreted in light of the context in which it was concluded, and should be consistent with Romania's and Sweden's other relevant international law obligations, including in particular Romania's obligations under the Europe Agreement and the EC Treaty. Romania argues that, in any event, the Parties intended EU law to prevail (R-CM, ¶¶ 72-84; R-Rejoinder, ¶¶ 226-258; Tr. Day 13, 50:18-51:24 (King)).

### a. The BIT must be interpreted consistently with EU law

304. As noted above, the Respondent does not dispute that the substantive rules of international law applicable to this dispute are those contained in the BIT. However, it argues that the BIT cannot be interpreted in a vacuum. Citing *AAPL v. Sri Lanka*, the Respondent argues that an investment protection treaty "is not a self-contained closed legal system limited to provide for substantive material rules of direct applicability, but it has to be envisaged within a wider juridical context [...]."<sup>18</sup> In this respect, the Respondent argues that the BIT must be interpreted in light of the context in which it was negotiated and concluded between Romania and Sweden. In Romania's submission, this context should take into account the purpose for which it was concluded (Article 31(1) of the VLCT), as well as the circumstances of its conclusion (Article 32 of the VCLT). Romania argues that the conclusion of the BIT was a direct consequence of the Europe Agreement, in the context of Romania's accession to the EU and adoption of the *acquis*.
305. The Respondent also argues that, pursuant to Article 31(3)(c) of the VCLT, when interpreting a treaty, the "relevant rules of international law applicable in the relations between the parties" must also be taken into account. According to Romania, this includes the rules of international law existing at the time the BIT is being interpreted (that is, today). Thus, in Romania's submission, the Europe Agreement and the EC Treaty fall under the category of relevant rules of international law that should be considered when construing the BIT. In this respect, Romania notes that the ILC has stated that "[i]t is a generally accepted principle that when several norms bear on a single issue they should, to the extent possible, be interpreted so as to give rise to a single set of compatible obligations."<sup>19</sup>
306. Specifically, Romania claims that "the BIT should be interpreted as part of a harmonious set of treaty obligations that Romania and Sweden have entered into, starting with the 1993 Europe Agreement and continuing, all pursuant to that same initial instrument with the BIT and the accession treaty [...] [T]he Europe Agreement indeed called on Romania to negotiate BITs with EU countries" (Tr., Day 13, 51 (King)). The Respondent submits that, if the BIT is construed in that light, no conflict between the various instruments arises.

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<sup>18</sup> *Asian Agricultural Products Limited v. Republic of Sri Lanka* (ICSID Case No. ARB/87/3), Award, 27 June 1990 (hereinafter "*AAPL v. Sri Lanka*"), ¶ 21.

<sup>19</sup> International Law Commission, "Report of the International Law Commission on the Work of its 58th Session", UN Doc A/61/10 (2006), Exh. RL-187, p 408.

307. Romania contends that, in the present case, such a “systemic” interpretation of the BIT is of special importance. It submits that the treatment of foreign investors that Sweden and Romania intended to mandate through the BIT cannot be divorced from Romania’s obligations under the Europe Agreement and the EC Treaty. The Respondent argues that Sweden, together with the other EU Member States, expected Romania to take all reasonable measures to comply with the EU treaties, and in particular expected Romania to abolish EGO 24.

308. In view of the above, the Respondent contends that all substantive obligations contained in the BIT must be interpreted in a manner consistent with EU law. This includes in particular Article 64 of the Europe Agreement and Article 87 of the EC Treaty.

**b. In any event, the Contracting Parties to the BIT intended European law to prevail**

309. The Respondent further submits that, in the unlikely event that the Tribunal should find Romania’s obligations under EU law and the BIT impossible to reconcile, any conflict ought to be resolved in favor of EU law.

310. In this respect, the Respondent argues that where conflicts arise between competing rules of international law which cannot be resolved by systemic interpretation, the intention of the relevant States determines which of the competing rules takes precedence. According to the Respondent, in the present case the common intention of Romania and Sweden is clear: they intended the BIT to be subordinated to EU law. As EU law contains more specific rules on state aid, EU law should prevail by application of the principle *lex specialis derogat generali*.

311. In addition, the Respondent argues that it concluded the BIT with Sweden precisely in furtherance of its obligations to the EU and the EU Member States. It would thus be irrational to suppose that Sweden and Romania intended the BIT to circumvent or otherwise weaken EU law. Indeed, for Sweden this would mean breaching the EC Treaty.

312. Finally, the Respondent notes that the European Court of Justice ("ECJ") has ruled that EU law takes precedence over all pre-accession bilateral treaties concluded between Member States (Exh. RL-197 to RL-200).

**c. EU law is relevant to the determination of wrongfulness**

313. The Respondent asserts that, contrary to the Claimants' contentions, EU law is relevant to the determination of whether it breached the BIT.
314. Specifically, Romania argues that the rights and obligations of Romania and Sweden under the Europe Agreement and, eventually, the Accession Treaty, are not only rules of international law that the Tribunal should take into account when interpreting the BIT, but are relevant in at least three ways: (i) as the factual motivation for the change in Romanian law that is the basis of the Claimants' allegations; (ii) as binding rules of Romanian law, having been incorporated into Romanian law, and (iii) as factual circumstances to take into account as part of the consideration of what would have constituted fair and equitable treatment (R-Rejoinder, ¶ 227).
315. The Respondent further submits that it was indeed "necessary" for Romania to repeal EGO 98 in order to either comply with EU law or accede to the EU. However, the Respondent submits that "necessity" is not the test; the question is whether Romania's course of action was reasonable (R-Rejoinder, ¶ 99). The Tribunal understands Romania's position to be that the requirements of EU law play a role in determining whether Romania breached the standards of the BIT that require the state to act reasonably, in particular, the fair and equitable treatment obligation and the obligation not to impair the Claimants' investments by unreasonable or discriminatory measures. The Tribunal also understands that Romania is not invoking Articles 23, 24 or 25 of the ILC Articles to plead that there are circumstances precluding wrongfulness that would excuse any liability under the BIT.

**3. The Commission's position**

316. In its capacity as *amicus curiae*, the European Commission submitted comments on the law applicable to this dispute.
317. The Commission's position in this respect is similar to that of the Respondent. The Commission submits that the interpretation of the BIT should take into account the BIT's European context and origin. It notes that the ECJ has recommended interpreting intra-EU BITs in the light of EU law (ECJ Case 26/62, *Van Gend en Loos* [1963], ECR 3). The Commission also submits that the parties to the Europe Agreement intended that any future BIT should subscribe to the same logic regarding state aid law. Therefore, the Tribunal should take into account the EU's state aid rules when interpreting specific BIT provisions. The Commission further contends that Article 30(3) of the VCLT directs the Tribunal to apply the EU's state aid law rather than provisions of the BIT that would prove incompatible with the EC Treaty.

**4. The Tribunal's analysis**

318. There is no dispute among the Parties that the primary source of law for this Tribunal is the BIT itself. The disagreements lie in the role of other rules of international law, in particular rules arising from treaties established under EU law to which Romania and Sweden are parties.

319. As a first step, the Tribunal notes that there is no real conflict of treaties. In the time period relevant to this dispute, the relevant rules of international law applicable to Romania and Sweden were the Europe Agreement (which entered into force on 1 February 1995) and the BIT (which entered into force on 1 April 2003). The Accession Treaty was not signed until 25 April 2005, and entered into force on 1 January 2007 (date on which the EC Treaty also entered into force with respect to Romania) (ER of F. Jacobs, ¶ 12). Thus, from 1 February 1995 to 1 January 2007, Romania was in a negotiating phase during which it declared that it accepted the *acquis* but it was not properly subject to EU law, with the exception of its international obligations under the Europe Agreement itself. As a result, EU law was not directly applicable to Romania.
320. The relevant question then becomes whether EU law plays a role in the interpretation of the BIT. To answer that question, the Tribunal needs to address three points.
321. First, the Tribunal notes that the BIT does not contain any reference to EU accession or to the EU. Further, the Accession Treaty did not contain any references to the BIT, let alone seek to modify any of the BIT's provisions. To recall, the Europe Agreement entered into force on 1 February 1995, the BIT entered into force on 1 April 2003, and the Accession Treaty was signed on 25 April 2005, and entered into force on 1 January 2007 (on which date the EC Treaty also entered into force with respect to Romania). The Tribunal cannot therefore assume that by virtue of entering into the Accession Treaty or by virtue of Romania's accession to the EU, either Romania, or Sweden, or the EU sought to amend, modify or otherwise detract from the application of the BIT.
322. Second, Article 31(1) of the VCLT provides that "[a] treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose." Article 31(2) expressly notes that such context comprises, *inter alia*, the text of the treaty, including its preamble and annexes. The Preamble of the BIT states that the Contracting Parties have agreed on the terms of the BIT:
- desiring* to intensify economic cooperation to the mutual benefit of both States and to maintain fair and equitable conditions for investments by investors of one Contracting Party in the territory of the other Contracting Party,
- recognizing* that the promotion and protection of such investments favour the expansion of the economic relations between the two Contracting Parties and stimulate investment initiatives [...]
323. The Tribunal must interpret the BIT in light of these overarching goals, which the Parties do not dispute.
324. Likewise, it is undisputed that one of the goals of the Europe Agreement, which predated the BIT, was to promote economic cooperation between Romania and the EC Member States. In this context, Article 74 of the Europe Agreement on investment promotion and protection provided:

Article 74 - Investment promotion and protection

1. Cooperation shall aim to establish a favourable climate for private investment, both domestic and foreign, which is essential to the economic and industrial reconstruction of Romania.
2. The particular aims of the cooperation shall be:
  - for Romania to establish and improve a legal framework which favours and protects investment;
  - the conclusion by the Member States and Romania of Agreements for the promotion and protection of investment [...]

325. This suggests that the BIT was part of Romania's strategy to develop economically in order to obtain accession.
326. That being said (and this is the third point), the Tribunal will interpret each of the various applicable treaties having due regard to the other applicable treaties, assuming that the parties entered into each of those treaties in full awareness of their legal obligations under all of them. In other words, there is no reason to assume that Sweden and Romania had any intent to defeat their obligations under any of the applicable treaties when they entered into each of them and the Tribunal must interpret each treaty – in particular, the BIT – according to that intent of the parties.
327. The Tribunal finds that, factually, the general context of EU accession must be taken into account when interpreting the BIT. In particular, the overall circumstances of EU accession may play a role in determining whether the Respondent has breached some of its obligations under the BIT.
328. The Tribunal notes in this regard that the Parties appear to agree that EU law forms part of the “factual matrix” of the case. In particular, the Parties agree that the question of EU law may be relevant to determining whether Romania acted fairly and equitably with respect to the Claimants' investments in accordance with Article 2(3) of the BIT. The Tribunal concurs. The overall context of EU accession in general and the pertinent provisions of EU law in particular may be relevant to the determination of whether, *inter alia*, Romania's actions were reasonable in light of all the circumstances, or whether Claimants' expectations were legitimate.
329. The Tribunal also sees merit in the Claimants' suggestion that, in theory, EU law could also possibly come into play as a circumstance precluding wrongfulness under ILC Articles 23, 24 or 25. However, as noted above, the Respondent has not put forth a case of force majeure, duress or necessity. Accordingly, the Tribunal does not address the relevance of EU law in this context.

**C. THE ENFORCEMENT OF THE ARBITRAL AWARD AND EU LAW**

330. The Respondent and the Commission contend that any payment of compensation arising out of this Award would constitute illegal state aid under EU law and render the Award unenforceable within the EU. Prior to determining whether it is useful for

the Tribunal to decide this question (Section 4 below), the Tribunal will set out the Parties' positions. As this point was first raised by the Respondent and second by the Commission, the Tribunal will address the Respondent's position first (Section 1 below), then the Commission's position (Section 2 below), and finally the Claimants' position (Section 3 below).

## **1. The Respondent's position**

331. The Respondent contends that an award of damages in the present case would constitute impermissible state aid (R-CM, ¶ 78 (note 142); First ER of R. Streinz, ¶¶ 29-34; Second ER of R. Streinz, ¶¶ 21-24; ER of F. Jacobs, ¶¶ 45-49; 50(4) and (5); Respondent's observations on Commission's Submission, ¶ 3).
332. Relying on Professor Streinz's expert opinion, the Respondent argues that an award of damages for the abolition of the EGO 24 regime would amount to the granting of new state aid by Romania to the Claimants. For such new state aid to be granted, Romania must first seek and obtain prior approval from the Commission, which in the opinion of the expert would most likely be denied.
333. Professor Jacobs, another of the Respondent's experts, confirms that the payment of compensation in lieu of aid must be regarded as equivalent to a payment of the relevant aid itself. Such a payment in this case would amount to a payment of new state aid and could not be made without the European Commission being informed pursuant to Article 88(3) of the EC Treaty. Prof. Jacobs also states that, as a matter of EU law, an award of compensation in lieu of aid in respect of the period 2007-2009, and possibly in respect of earlier years as well, may be denied enforcement in the EU on grounds of public policy.

## **2. The European Commission's position**

334. The Commission submits that "[i]f the Tribunal rendered an award that is contrary to obligations binding on Romania as an EU Member State, such award could not be implemented in Romania by virtue of the supremacy of EC law, and in particular State aid rules" (Commission's Written Submission, ¶ 125(4)).
335. In particular, the Commission submits that "any award requiring Romania to reestablish investment schemes which have been found incompatible with the internal market during accession negotiations, is subject to EU State aid rules", and "[t]he execution of such award can thus not take place if it would contradict the rules of EU State aid policy." The Commission notes that in the *Eco Swiss* case,<sup>20</sup> the ECJ held that the competition rules of the EC Treaty are part of the public order which national courts must take into account when they review the legality of arbitral awards under the public policy exception recognized by the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (Commission's Written Submission, ¶ 121).

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<sup>20</sup> ECJ, Case C-126/97 *Eco Swiss v. Benetton* ECR [1999] 1-3055, ¶¶ 35-41.

336. The Commission acknowledges that Article 54(1) of the ICSID Convention provides that each Contracting State shall automatically recognize and enforce an ICSID award within its territory as if it were a final judgment of a court in that State. However, it contends that if a national court in the EU were asked to enforce an ICSID award that is contrary to EU law and EU state aid policy rules, the proceedings would have to be stayed under the conditions of Article 234 of the EC Treaty so that the ECJ may decide on the applicability of Article 54 of the ICSID Convention, as transposed into the national law of the referring judge. The Commission notes that “the ICSID Convention is not binding on the EC under Article 300(7) EC, as the terms of the Convention do not allow the EC to become a Contracting Party to it” and concludes that, “[a]ccordingly, the ICSID Convention does not form part of the EC legal order.” However, the Commission adds that it “sincerely believes that such a conflict between the BIT, the ICSID Convention, and EC law can be avoided through a contextual interpretation of the BIT or the application of Article 30(3) of the Vienna Convention, as the case may be” (Commission’s Written Submission, ¶¶ 122-124).

### **3. The Claimants' position**

337. The Claimants argue that issues regarding enforcement of an award are irrelevant to the Tribunal's decision on the substance of the Claimants' claims. In particular, the Claimants deny that considerations relating to the enforcement of the Award should affect the interpretation of the BIT or the Tribunal's decision as to whether Romania has breached certain provisions of the BIT (Claimants' comments on the Commission’s submission, ¶¶ 167-170; C-PHB, ¶¶ 270-278; ER of A. Dashwood, ¶¶ 92-100).

338. In any event, the Claimants submit that, contrary to the Respondent's and the Commission’s contention, an award of damages in the present arbitration could not be characterized as a grant of state aid, since the payment of damages would result from the Tribunal's determination that Romania breached the BIT. The Claimants rely on the opinion of Prof. Dashwood, who asserts that an award of damages cannot be equated with the granting of state aid and consequently would not involve any conflict between Romania’s obligations under the BIT and its present obligations as a Member State of the EU.

339. The Claimants further contend that Romania was not bound by EU state aid laws when it breached the BIT. The purpose of any award of damages would be to compensate the Claimants for the harm resulting from the Respondent’s unlawful conduct, which occurred before Romania joined the EU and became bound by EU law. According to the Claimants, a payment for a breach that predates Romania's EU accession cannot violate EU law.

### **4. The Tribunal's analysis**

340. The Tribunal finds that it is not desirable to embark on predictions as to the possible conduct of various persons and authorities after the Award has been rendered, especially but not exclusively when it comes to enforcement matters. It is thus

inappropriate for the Tribunal to base its decisions in this case on matters of EU law that may come to apply after the Award has been rendered. It will thus not address the Parties' and the Commission's arguments on enforceability of the Award.

341. That being said, the Tribunal notes that Articles 53 and 54 of the ICSID Convention, which are reproduced below, apply in any event to the Award:

Article 53

- (1) The award shall be binding on the parties and shall not be subject to any appeal or to any other remedy except those provided for in this Convention. Each party shall abide by and comply with the terms of the award except to the extent that enforcement shall have been stayed pursuant to the relevant provisions of this Convention.
- (2) For the purposes of this Section, "award" shall include any decision interpreting, revising or annulling such award pursuant to Articles 50, 51 or 52.

Article 54

- (1) Each Contracting State shall recognize an award rendered pursuant to this Convention as binding and enforce the pecuniary obligations imposed by that award within its territories as if it were a final judgment of a court in that State. A Contracting State with a federal constitution may enforce such an award in or through its federal courts and may provide that such courts shall treat the award as if it were a final judgment of the courts of a constituent state.
- (2) A party seeking recognition or enforcement in the territories of a Contracting State shall furnish to a competent court or other authority which such State shall have designated for this purpose a copy of the award certified by the Secretary-General. Each Contracting State shall notify the Secretary-General of the designation of the competent court or other authority for this purpose and of any subsequent change in such designation.
- (3) Execution of the award shall be governed by the laws concerning the execution of judgments in force in the State in whose territories such execution is sought.



## **VI. ANALYSIS OF THE CLAIMANTS' TREATY CLAIMS**

342. In the latest presentation of their argument, the Claimants contend in the first place that, by revoking the EGO 24 incentives before they were due to expire, Romania violated an obligation entered into by Romania vis-à-vis the Claimants and thus breached the BIT's umbrella clause. However, even if the premature revocation of the incentives does not breach the umbrella clause (e.g., because the promise allegedly made by the Respondent does not rise to the level of an obligation protected by the umbrella clause), the Claimants argue that the Tribunal could still find a violation of the fair and equitable treatment standard because the revocation undermined the Claimants' legitimate expectations (Tr., Day 12, 126:22-128:6 (Reed)). In view of this alternative argument, the Tribunal will first address the Claimants' umbrella clause claim. If necessary, it will then move on to the Claimants' remaining claims.

### **A. UMBRELLA CLAUSE**

343. Article 2(4) of the BIT provides in relevant part:

Each Contracting Party shall observe any obligation it has entered into with an investor of the other Contracting Party with regard to his or her investment.

#### **1. The Claimants' position**

344. The Claimants contend that through the EGO 24 framework and the related PICs, Romania entered into an obligation with the Claimants with regard to their investment. As a result, they argue that, by revoking the Raw Materials Incentive before it was due to expire, the Respondent breached the BIT's umbrella clause, contained in Article 2(4) of the BIT.

345. Section (a) below addresses the Claimants' position with respect to the nature and scope of the BIT's umbrella clause. Section (b) sets out the Claimants' position with respect to the existence of a specific obligation vis-à-vis the Claimants. Section (c) sets out the Claimants' arguments with respect to the Respondent's alleged breach of that umbrella clause.

##### **a. Nature and scope of the BIT's umbrella clause**

346. The Claimants submit that the purpose of umbrella clauses (such as Article 2(4) of the BIT, also called "undertakings clauses") is to put the host state's compliance with commitments assumed vis-à-vis investors under the protective "umbrella" of the relevant treaty. This protection is extended to the state's commitments vis-à-vis the investor independently of whether a violation of the other provisions of the treaty has occurred, with the result that any violation of an assurance given by the host state becomes a violation of the treaty. As a result, claims raised under an umbrella clause are additional to and independent of claims based on unfair and inequitable

treatment, unreasonable or discriminatory measures, treatment less favorable than required by international law and expropriation (C-SoC, ¶ 286).

347. The Claimants submit that, unless a treaty expressly provides otherwise, an umbrella clause is not limited to contractual obligations or undertakings, but may cover unilateral undertakings by the host state, including obligations arising from legislation and regulations (C-SoC, ¶¶ 289-299; C-Reply, ¶¶ 461-468; C-PHB, ¶¶ 6-14).
348. In support of this contention, the Claimants argue that there is no justification to interpret Art. 2(4) of the BIT narrowly. First, pursuant to Article 31(1) of the VCLT, treaty provisions are to be interpreted in accordance to their ordinary meaning. Relying on *SGS v. Philippines*<sup>21</sup>, *Eureko v. Poland*<sup>22</sup>, *CMS v. Argentina*<sup>23</sup>, *LG&E v. Argentina* and *Enron v. Argentina*<sup>24</sup>, the Claimants contend that the ordinary meaning of the relevant terms supports the binding nature of the clause, as well as its comprehensive scope. The Claimants rely in particular on *Eureko v. Poland*, where the language of the umbrella clause at issue was very similar to the umbrella clause in the Sweden-Romania BIT (“Each Contracting Party shall observe any obligation it may have entered into with regard to investments of investors of the other Contracting Party”). In that case, the tribunal held that:

The plain meaning—the “ordinary meaning”—of a provision prescribing that a State “shall observe any obligations it may have entered into” with regard to certain foreign investments is not obscure. The phrase “shall observe” is imperative and categorical. “Any” obligations is capacious; it means not only obligations of a certain type, but “any”—that is to say, all—obligations entered into with regard to investments of investors of the other Contracting Party.<sup>25</sup>

349. In addition, the Claimants note that the tribunal in *Enron v. Argentina* held that “[u]nder its ordinary meaning the phrase ‘any obligation’ refers to obligations regardless of their nature”, noting that “[t]ribunals interpreting this expression have found it to cover both contractual obligations such as payment as well as obligations assumed through law or regulation.”<sup>26</sup>
350. The Claimants argue that this is all the more so when the legislation or regulations are specifically designed to induce investors to invest in reliance on those assurances. The Claimants point out that the tribunal in *LG&E v. Argentina* found

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<sup>21</sup> *Société Générale de Surveillance S.A. v. Republic of the Philippines* (ICSID Case No. ARB/02/6), Decision of the Tribunal on Objections to Jurisdiction, 29 January 2004 (hereinafter “*SGS v. Philippines*”).

<sup>22</sup> *Eureko B.V. v. Republic of Poland*, Partial Award, 19 August 2005 (hereinafter “*Eureko v. Poland*”).

<sup>23</sup> *CMS Gas Transmission Company v Argentine Republic* (ICSID Case No. ARB/01/8), Award, 12 May 2005 (hereinafter “*CMS v. Argentina*”).

<sup>24</sup> *Enron Creditors Recovery Corporation (formerly Enron Corporation) and Ponderosa Assets, L.P.* (ICSID Case No. ARB/01/3), Award, 22 May 2007 (hereinafter “*Enron v. Argentina*”).

<sup>25</sup> *Eureko v. Poland*, ¶ 246.

<sup>26</sup> *Enron v. Argentina*, ¶ 274, (citing *Fedax N.V. v. Republic of Venezuela* (ICSID Case No. ARB/96/3), Award, 9 March 1998, ¶ 29; *SGS v. Philippines*, ¶¶ 127-128; *Société Générale de Surveillance S.A. v. Islamic Republic of Pakistan* (ICSID Case No. ARB/01/13), Decision of the Tribunal on Objections to Jurisdiction, 6 August 2003, ¶ 166; *LG&E v. Argentina*, ¶ 175).

that laws and regulations that targeted foreign investors and applied specifically to their investments gave rise to “obligations” under the meaning of the relevant treaty’s umbrella clause.<sup>27</sup>

351. In addition, the Claimants contend that the Contracting States could have chosen to draft the BIT’s umbrella clause more restrictively (for example, limiting it to contractual obligations), and chose not to do so.
352. The Claimants deny that the wording of Article 2(4) makes it a particularly narrow umbrella clause, to the extent that it requires that an obligation be “entered into with an investor of the other Contracting Party”. In the Claimants’ view, this language does not set it apart from other umbrella clauses, as all umbrella clauses require that there be a party to whom the obligation is owed (i.e., the investor). Similarly, the Claimants argue that there is no real distinction between the term “obligations” and “undertakings” for these purposes: when someone undertakes to do something, he or she becomes obliged to do that thing.
353. Second, the Claimants argue that the umbrella clause must be interpreted in a manner that gives it substantive meaning. Relying on *Eureko v. Poland*, they contend that

It is a cardinal rule of the interpretation of treaties that each and every operative clause of a treaty is to be interpreted as meaningful rather than meaningless. It is equally well established in the jurisprudence of international law, particularly that of the Permanent Court of International Justice and the International Court of Justice, that treaties, and hence their clauses, are to be interpreted so as to render them effective rather than ineffective.

It follows that the effect of Article 3.5 [the umbrella clause] in this proceeding cannot be overlooked, or equated with the Treaty’s provisions for fair and equitable treatment, national treatment, most-favored-nation treatment, deprivation of investments, and full protection and security. On the contrary, Article 3.5 must be interpreted to mean something in itself.<sup>28</sup>

354. Third, the Claimants also argue that the binding force of obligations unilaterally assumed by the host State is supported by the binding nature of the consent to international arbitration granted by host states through their national legislation, and is in accordance with the treatment of unilateral undertakings in customary international law (citing the *Nuclear Tests Cases*<sup>29</sup>).
355. Finally, the Claimants argue that there is no way in which EU law can limit the breadth of this umbrella clause. EU law is only part of the factual matrix of the case, and thus the only role it could play in relation to an umbrella clause claim is when any factors precluding wrongfulness come to be examined.

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<sup>27</sup> *LG&E v. Argentina*, ¶ 175.

<sup>28</sup> *Eureko v. Poland*, ¶¶ 248-249.

<sup>29</sup> *Nuclear Tests Cases (Australia/New Zealand v. France)*, Judgment, 20 December 1974, ICJ Reports 1974 (hereinafter “*The Nuclear Tests Cases*”).

356. In response to the Respondent's arguments, the Claimants acknowledge that there is no dispute that umbrella clauses only protect specific obligations. However, as explained below, the Claimants submit that Romania entered into a specific obligation with the Claimants.

**b. The EGO 24 regime gave rise to a specific obligation vis-à-vis the Claimants**

357. The Claimants contend that, through the EGO 24 regime, Romania entered into a specific obligation vis-à-vis the Claimants, which consisted of Romania's undertaking with respect to the Claimants to maintain the incentives in the Ștei-Nucet disfavored region for the full 10-year period provided by GD 194/1999, which the Claimants argue was stabilized for 10 years (C-SoC, ¶ 300; C-Reply, ¶¶ 467-468; C-PHB, ¶¶ 6-24; Tr., Day 12, 70-91 (Reed), 163-164 (Gaillard)).

358. Although the Claimants acknowledge that, taken on its own, EGO 24 is a general and non-specific piece of legislation, they argue that "the regime as a whole and its specific application to the Claimants gives rise to a specific obligation" (C-PHB, ¶ 15).<sup>30</sup>

359. In the Claimants' view, this specific obligation arises primarily from the content of EGO 24 and its implementing legislation. The Claimants claim that, properly construed, EGO 24, read in conjunction with the implementing measures (in particular, GD 194/1999, the Methodological Norms and the PICs), contained a clear and unequivocal undertaking to provide PIC holders such as the Corporate Claimants with the Raw Materials Incentive until 1 April 2009. According to the Claimants, this undertaking arises from the following features of the EGO 24 regime:

- a. EGO 24 was specifically targeted to persons who invested and conducted business within specific disfavored regions. To benefit from the incentives offered by EGO 24, investors had to be headquartered and conduct business in the disfavored area and had to create new jobs there for the unemployed (EGO 24, Articles 6 and 8).
- b. These disfavored regions were created by government decisions (such as GD 194/1999 and GD 1199/2000), which set out a specific geographic scope and a specific period for which that region would be considered disfavored, as well as the incentives that would be made available in that area and the types of investments that could benefit from them (EGO 24, Articles 3 and 4).

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<sup>30</sup> The Claimants had initially argued that Romania had entered into obligations towards foreign investors, including the Claimants, when it granted the incentives on the basis of EGO 24, GD 194 and GD 1199, and that these were the obligations protected under the umbrella clause (C-SoC, ¶ 300). The Claimants have since clarified that the obligations allegedly breached by the Respondent do not arise solely from provisions of a general legislative framework; they arise also from specific commitments and obligations undertaken by Romania in the form of the PICs granted to each of the Corporate Claimants (C-Reply, ¶ 466).

- c. To take advantage of the incentives, investors were required to make a specific application for an investor certificate (either temporary or permanent), which required them to submit a detailed investment plan. If they wished to undertake new investments or activities, they needed to submit a new investment plan.
  - d. Investors were awarded a PIC that set out the period for which it was valid and the fields of activity for which it was valid. PICs were required for investors to obtain the incentives, and had to be presented to the Romanian authorities every single time that investors wished to take advantage of the incentives.
  - e. Investors assumed obligations in exchange for the incentives. In particular, they were required to employ persons living in the disfavored area (EGO 24, Article 8); they were required to undertake investments prior to obtaining the PIC and, after receiving the PIC, they had to maintain their investments in the disfavored region for twice the period of time they enjoyed the incentives (EGO 24, Articles 7 and 9).
360. In addition, the Claimants argue that the existence of Romania's specific obligation was evidenced by Romania's conduct, in particular its promotion of the EGO 24 regime and the extensive monitoring that PIC holders were subjected to throughout the period during which they received the incentives.
361. In view of the above, the Claimants contend that "the entire EGO 24 regime was far more than a general legislative scheme. Instead it was a specific scheme targeted to specific investors in specific regions for specific periods of time. Further the rights granted were given in exchange for investors undertaking specific obligations, carrying out investments specified in investment plans and receiving specific PICs by which the investors' rights were granted (and conversely from which the Respondent's obligations arose)" (C-PHB, ¶ 16). Relying on the testimony of Mr. Neculai Liviu Marcu, the Claimants add that "[t]he specific purpose of that regime was to entice investors to invest in the least developed areas of Romania; areas in which they would not otherwise invest" (*Id.* See also WS of N. Marcu, ¶¶ 31-32; Tr., Day 7, 51-53).
362. The Claimants argue that the fact that Romania's undertaking is not contained in one particular document is irrelevant. It is plain from EGO 24 itself that it did not stand alone; it required and expressly provided for implementing measures to be taken by the Romanian Government. Articles 3 and 4 of EGO 24 required government decisions to declare and delineate disfavored areas, determine the period of time for which each disfavored zone is to be declared, and determine the eligible investments and the incentives which would be granted to investors. In addition, Article 15 required methodological norms to be established by government decision.
363. Nonetheless, the Claimants contend that the basic scheme of the incentives program was set out in EGO 24 (Exh. R-68). Disfavored areas had to satisfy the conditions set out in Article 1. They could be declared for a period of between 3 and 10 years at the discretion of the government authorities. The incentives that could be granted

were set out in Article 6, but it was the government decision for each disfavored area that would determine which incentives were available in that area. In turn, Article 8 provided that, to benefit from the incentives, companies had to be headquartered and conduct business in the disfavored area and had to create new jobs there for the unemployed. Articles 7 and 9 provided that investors would have to refund the incentives if the investments were not maintained in the disfavored area for twice the period during which they had been eligible to receive the incentives.

364. Although the Claimants concede that EGO 24 did not spell out that the incentives available within the disfavored area would be maintained for the entire period for which the disfavored area had been declared disfavored, this is, in the Claimants' submission, the only sensible interpretation of EGO 24. Indeed, they argue that it is also the way it was interpreted by the Romanian Government, as evidenced by the government decisions that implemented EGO 24.
365. The Claimants rely in particular on GD 194/1999 (Exh. C-280, also C-31), which is the government decision that declared Ștei-Nucet a deprived zone (Article 1). Article 3 provides that the period for which Ștei-Nucet shall be declared a deprived zone is 10 years. Article 4 then states that "[d]uring the period of existence of the deprived zone [...] there shall be granted the facilities provided in Annex No. 2." In turn, Annex No. 2, which forms part of GD 194/1999, sets out that investors shall benefit from all of the facilities provided for in Article 6 of EGO 24. As a result, the Claimants argue that Article 4 of GD 194/1999 explicitly ties the period during which the incentives are granted to the period of existence of the deprived zone.
366. The Claimants find additional support in the fact that the language of Article 4 in 37 of the 38 government decisions which declared disfavored areas between 1998 and 2003 is either identical or virtually the same as the language of Article 4 of GD 194/1999 (Table contained at Tab 5 of Vol. 1 of the Claimants' documents for the closing hearing (Shearman & Sterling)). They note that 20 of these 37 government decisions, including GD 194/1999, were signed by Mr. Nicolae Staiculescu, who testified that the incentives were to be offered for the entire period during which the area was a disfavored region (WS of N. Staiculescu, ¶¶ 21-22).
367. The Claimants also note that Mr. Marcu, who was the president of the National Agency for Regional Development, submitted similar testimony:
- We interpreted Article 4 as a firm pledge, commitment on behalf of the government to maintain the zone for a ten-year period in order to persuade investors that we were meaning what we were saying and to give them incentives to invest bigger sums of money in those areas to fulfil the needs of those regions, for example. This created employment, provided social protection through income and also social protection for the families of the miners. (Tr., Day 7, 15:2-9 (Marcu))
368. The Claimants argue that neither Mr. Staiculescu nor Mr. Marcu's testimony was challenged at the hearing on that point.

369. The Claimants find further support in the Methodological Norms issued through GD 728/2001 (Exh. R-35, R-69), which define the period in which companies are deemed to have benefitted from the incentives for purposes of the obligation to repay the incentives if they are voluntarily liquidated or cease operations under Articles 7 and 9 of EGO 24, as “the period between the moment when the certificate of investor in the disfavored area was obtained and the moment when the disfavored area ceases to exist” (Article 1(f) of GD 728/2001, as translated in Exh. R-69). In the case of temporary investor certificates, “followed by the procurement of the certificate of investor in disfavored area, the period is calculated from the moment the provisional certificate of investor is obtained until the disfavored area ceases to exist” (*Id.*). Further, Article 5 of GD 728/2001 (as translated in Exh. R-35) confirms this when it states that “[t]he business entities which obtained the certificate of investor in the disfavored area and which perform activities from fields of interest other than those provided under annex no. 1 shall continue to benefit from facilities under the law, until the expiry of the period for which the disfavored area was declared.”
370. According to the Claimants, it is thus clear from EGO 24, read in conjunction with the methodological norms, that the incentives were to be granted for the entire period between the date of the granting of the investment certificate (temporary or permanent), and the expiry of the disfavored area, which in the case of Ștei-Nucet was 1 April 2009. This was further evidenced by the PICs issued to the Corporate Claimants, which expressly stated that the certificate holder benefitted from the incentives under GD 194/1999 and that the certificate was valid until 1 April 2009.
371. The Claimants also submit that this interpretation is the only one that makes sense from a teleological standpoint. According to the Claimants, if the incentives could have been revoked at any time, they would have been ineffective in incentivizing investment, because investors would have lacked the certainty that they would have needed to commit funds.
372. Contrary to the Respondent’s contentions, the Claimants submit that the implementing measures (such as GD 194/1999 and the PICs) did not go beyond what was authorized in the primary legislation (EGO 24). They argue that the only sensible interpretation of EGO 24 is that it authorized the grant by government decision of a predetermined list of incentives for a period between 3 and 10 years. The Claimants contend that this was confirmed by Prof. Baias, the Respondent’s expert on Romanian law, who testified that when GD 194/1999 was adopted, it was not in conflict with EGO 24. Rather, his position was that it became in conflict with the modified version of EGO 24 when the incentives were revoked, because GD 194/1999 was not modified accordingly (Tr., Day 5, 264:5-266-2 (Reed/Baias)).
373. According to the Claimants, Prof. Baias’s testimony confirms that, at the time when GD 194/1999 was enacted, it provided that the incentives set out in Annex 2 were being granted for the full period until 1 April 2009, and that it neither contradicted nor added to EGO 24. This proves that, at the time that the investments were made, the Claimants had a clear and unambiguous commitment from the Romanian State that the incentives would be granted for 10 years. There was nothing unlawful or

improper in that commitment, and any contradiction only arose when the incentives were repealed prematurely.

374. The Claimants also deny that the various amendments made to the EGO 24 regime demonstrate the absence of such a commitment by the Romanian State. Even if significant amendments were made to the EGO 24 regime to the investors' detriment, they were done in a way to protect existing investors' rights, or in order to address specific problems in relation to specific industries or in relation to Romania's tax regime.
375. The Claimants also argue that the absence of a stabilization clause did not mean that Romania could renege on its commitment. Contrary to the Respondent's contention, the *Parkerings v. Lithuania*<sup>31</sup> case does not require a stabilization clause to prevent a state from amending its legislation. In the Claimants' view, the *Parkerings* tribunal cites a stabilization clause as one (but not the only) type of measure pursuant to which a state can promise to freeze or stabilize an existing regulatory framework. The Claimants submit that an express promise enshrined in the legislation to keep a particular regulatory framework in place for a defined period of time also constitutes such an undertaking. In other words, the Claimants submit that, in agreeing to provide certain incentives for ten years, the state in effect agrees not to change the law before then. According to the Claimants, an additional promise that the state will not renege on its earlier promise would be superfluous.
376. Finally, the Claimants contend that the Respondent's reliance on Decision 130/2003 of the Constitutional Court of Romania (Exh. RL-214) is misplaced, because it deals with incentives granted under Law 35 and not the incentives granted under EGO 24. It is thus a matter of pure speculation what the Constitutional Court would have found if it had been dealing with EGO 24.
377. In particular, the Claimants reject Prof. Baias' opinion that it is possible to extrapolate from Decision 130/2003 what the Constitutional Court would have decided in a case dealing with EGO 24. The Claimants argue that Prof. Baias based his opinion on the premise that Law 35 and EGO 24 were "more or less identical" (Tr., Day 6, 27:9-10), when in fact there are key differences between Law 35 and EGO 24 which according to the Claimants go to the root of the Constitutional Court's reasoning in Decision 130/2003. The Claimants contend that Law 35 provided positive discrimination in the form of incentives for foreign investors investing anywhere in Romania, without requiring the investor to fulfill any requirements. Unlike EGO 24, Law 35 did not require the investor to invest in a disfavored area, nor did it require it to create any particular number of new jobs or employ the unemployed. It was not even necessary to obtain an investor certificate; all that was required was proof that the investor was foreign. The Claimants argue that the Constitutional Court decided that the repeal of Law 35 incentives did not breach the rule of law because it merely did away with

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<sup>31</sup> *Parkerings-Compagniet AS v. Republic of Lithuania* (ICSID Case No. ARB/05/8), Award, 11 September 2007 (hereinafter "*Parkerings v. Lithuania*" or "*Parkerings*"),



positive discrimination and put foreign investors on a level playing field with domestic competition.

378. To the contrary, the Claimants argue that, to qualify for the incentives under EGO 24, the investor was required to show that it had met its side of the bargain. This included fulfilling all the obligations mentioned above, in addition to submitting an investment plan, undergoing an on-site inspection and various monitoring procedures during the lifetime of the investments. Thus, in the Claimants' submission, Decision 130/2000 is of no assistance and of no relevance to an analysis of EGO 24.

**c. Romania breached the BIT's umbrella clause**

379. In view of the above, the Claimants contend that, by revoking the Raw Materials Incentive effective 22 February 2005, Romania breached a specific obligation it had entered into with respect to the Claimants' investments, and as such violated the BIT's umbrella clause.

**2. The Respondent's position**

380. The Respondent denies that it has breached the BIT's umbrella clause. It contends that the Claimants' umbrella clause claim does not comport with the plain text of Article 2(4) of the BIT, and is inconsistent with established jurisprudence on the application of umbrella clauses. In particular, the Respondent argues that the regulatory acts upon which the Claimants rely created no "obligation" enforceable through Article 2(4). Thus, the necessary predicate of Article 2(4) – an enforceable obligation under Romanian law – is absent. The Respondent argues that Romania never "entered into" any obligation specifically with the Claimants, and nothing in the relevant Romanian legal texts suggests that Romania undertook to freeze its regulatory regime for ten years (R-CM, ¶¶ 175-188; R-Rejoinder, ¶¶ 37-38, R-PHB, ¶¶ 104-120, 203-206; Tr., Day 13, 75-134 (Petrochilos)).

381. Section (a) below addresses the Respondent's comments with respect to the nature and scope of the BIT's umbrella clause. Section (b) sets out its comments on the existence of an obligation covered by the umbrella clause. Section (c) addresses its arguments on the absence of a breach of the umbrella clause.

**a. Nature and scope of the BIT's umbrella clause**

382. The Respondent contends that the umbrella clause contained in Article 2(4) of the BIT is one of the narrowest used in investment treaties. According to the Respondent, its formulation limits the scope of the provision in the following ways:
- a. It is limited to "obligations", and does not cover "undertakings".
  - b. The obligations must have been "entered into with an investor". It is not open to obligations or undertakings "related to an investment", as do the majority of umbrella clauses.

- c. The obligations must be specific (i.e., entered into with a specific investor), and thus it does not cover general obligations.
383. The Respondent notes that there is debate on whether umbrella clauses elevate municipal law rights to the international law realm, or simply provide an international remedy to enforce rights that remain in their essence and scope creations of national law. However, it argues that the Claimants' case fails under either proposition. This is because, according to the Respondent, generally-applicable regulatory and legislative acts, standing alone, do not give rise to the kind of obligations covered by umbrella clauses (even under those more broadly formulated). In the Respondent's view, umbrella clauses only protect contractual or quasi-contractual obligations.
384. The Respondent relies on the writings of Dr. F.A. Mann, Dr. Shihata, Prof. Dolzer and Ms. Stevens, Prof. Gaillard and Prof. Schreuer, noting that in their view umbrella clauses mainly or exclusively protect contractual commitments. The Respondent also relies on *Continental Casualty v. Argentina*, where the tribunal, faced with an umbrella clause broader than the present one (applying to obligations "with regard to investments"), found that
- It should be clear that this umbrella clause does not come into play when the breach complained of concerns general obligations arising from the law of the host State. ... Therefore, the provisions of the [disputed legislation] cannot be a source of obligations that Argentina has assumed specifically with regard to the Claimant's investment company and which are protected under the BIT's umbrella clause.<sup>32</sup>
385. To the contrary, the Respondent contends that there is no authority for the Claimants' position that legislative or regulatory acts, standing alone, can constitute "obligations" enforceable through an umbrella clause. They note that most decisions applying umbrella clauses have involved contractual obligations entered into by the state, and in the few cases where tribunals have found a breach of provisions due to a legislative change (such as *LG&E v. Argentina*), the state had provided separate and specific commitments to investors in which it guaranteed that a particular legislative regime would not change. Specifically, it argues that, in *LG&E v. Argentina*, the tribunal's determination that the dismantling of the regulatory regime in the gas-transmission sector resulted in the breach of the (broadly-worded) umbrella clause turned upon specific assurances that Argentina had given investors that the regulatory environment would remain stable.
386. The Respondent further contends that the Claimants' reliance on *CMS v. Argentina* is misplaced, noting that the part of that award dealing with umbrella clauses was subsequently annulled by an ICSID *ad hoc* committee. The Respondent argues that the *CMS v. Argentina* annulment committee reversed the tribunal's findings with respect to whether umbrella clauses can, as a matter of principle, extend to general legislative acts, in the following terms:

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<sup>32</sup> *Continental Casualty Company v Argentine Republic* (ICSID Case No ARB/03/9), Award, 5 September 2008 (hereinafter "*Continental Casualty v. Argentina*"), ¶¶ 300 and 302.

[I]t seems clear that Article II(2)(c) is concerned with consensual obligations arising independently of the BIT itself (i.e. under the law of the host State or possibly under international law). Further they must be specific obligations concerning investment. They do not cover general requirements imposed by the law of the host State.<sup>33</sup>

387. According to the Respondent, the drafting of the umbrella clause applicable in this case reinforces the inadmissibility of a claim based upon regulatory acts. It argues that, by limiting the scope of the provision to obligations “entered into with” qualifying investors, the drafters of the BIT intended it to apply exclusively to contractual or quasi-contractual obligations (e.g., those arising from an individual license granted by the state), which are created and enforceable under domestic law. Unilateral instruments such as laws and regulations, which are per se liable to change, cannot be understood to have been “entered into” with anyone.

**b. Romania did not enter into a specific obligation with the Claimants**

388. Further, the Respondent argues that, whatever the scope of the BIT’s umbrella clause, the claim fails because there is no “obligation” that may trigger the application of the clause. The Respondent contends that, in order to be elevated to the protection of the umbrella clause, this obligation must have given the Claimants an actionable vested right under Romanian law.

389. Relying on *SGS v. Philippines* and *Eureko v. Poland*, the Respondent submits that the obligation that is protected under the umbrella clause has a proper law (usually domestic law), and its nature does not change by being enforced under the treaty. Therefore, to be actionable under the treaty, the obligation must have been actionable under domestic law. For this, the alleged obligation must have constituted a vested right under domestic law, which the Respondent argues was the case in *Enron v. Argentina* and *LG&E v. Argentina*. However, it argues that it is not the case here.

390. Contrary to the Claimants’ contentions, the Respondent argues that under Romanian law the Romanian State was under no obligation to make all of the facilities available to the Claimants for 10 years. The Claimants have identified no contractual or quasi-contractual obligations of any kind that might have been entered into and owed to them in relation to the facilities, nor have the Claimants alleged any assurances or other unilateral undertakings by Romania directed to them specifically. As a result, the Claimants had no vested right to the facilities.

391. The Respondent argues that the Claimants’ case as to the source of that alleged obligation (and corresponding right) has changed over time, but all of those theories fail. The Respondent also contends that if Romania had decided to bind itself to regulatory stasis for ten years, it would have done so in one clear instrument, through an appropriate organ, and that instrument would contain clear terms with respect to the promise of stability and its duration. This obligation cannot be implied from a patchwork of documents and a selection of surrounding circumstances.

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<sup>33</sup> *CMS v. Argentina*, Decision on Annulment, 25 September 2007, ¶ 95a.

392. More specifically, the Respondent contends that none of the regulatory acts invoked by the Claimants (EGO 24/1998, GD 194/1999 and GD 1199/2000), whether alone or in conjunction with the PICs, created obligations “entered into” with the Claimants.
393. First, the source of the obligation could not have been EGO 24. The Respondent concedes that “there is no doubt that EGO 24 set forth a generalized entitlement that could be claimed by qualifying investors” (Tr., Day 13, 85:7-10 (Petrochilos)). Article 4(c) of EGO 24 stated that a government decision would determine the facilities “provided by law” that would be granted to investors (which confirms that the source of the entitlement is EGO 24). But it contained no promise as to the length of time the facilities would remain available, nor any stabilization language (unlike its predecessor, Law 35, which did contain express stabilization language). The Respondent further argues that, under Romanian law, general laws such as EGO 24 do not confer individual vested rights (as was confirmed by the Romanian Constitutional Court in Decision 130/2003).
394. Second, the Respondent notes that the Claimants’ latest theory seems to be that GD 194/1999, read together with the PICs, creates an obligation for the State. However, according to the Respondent this is impossible as a matter of Romanian law. Relying on the expert opinion of Prof. Baias, it argues that these were subsidiary normative or administrative instruments issued to implement and administer EGO 24 and Law 20/1999, which could not modify or contradict the authority of a government ordinance or a law, and as such could not have granted an entitlement beyond what EGO 24 authorized. In particular, they could not have imposed significant, long-term obligations on the State that the authorizing statute did not impose. As a result of the hierarchy of Romanian laws, the Government, implementing the law through the government decision, could not have bound the legislature not to change the law. And once EGO 24 was modified, GD 194/1999 could not have had a broader field of application than the modified EGO 24. Thus, no prudent investor in Romania could have understood Annex 2 of GD 194/1999 as freezing the facilities there listed. For the same reason, because EGO 24 created no vested right but only a general entitlement, neither could GD 194/1999 or the PICs create such a vested right.
395. In any event, the Respondent argues that the Claimants’ theory has no support from their Romanian law expert, Prof. Mihai. Considering that the nature of GD 194/1999 and the PICs has become the cornerstone of their expropriation, umbrella clause and fair and equitable treatment cases, the Respondent considers it notable that Prof. Mihai made no mention of either instrument in his expert report.
396. The Respondent also denies that the PICs could have been the source of an investor’s right to the EGO 24 incentives. For the Respondent, the correct interpretation is that the PICs were merely administrative tools that certified the holders’ eligibility to obtain the facilities; the source of the right was EGO 24. Specifically, the Respondent argues that Article 5 of the GD 525/1999 published on 8 July 1999 (Exh. R-6),<sup>34</sup> which approved the 1999 Methodological Norms for the

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<sup>34</sup> The Respondent notes that GD 525/1999 replaced an earlier version of the methodological norms, contained in GD 907 of 1998, published on 22 December 1998.

application of EGO 24, stated that the “incentives provided by the law shall be granted pursuant to the certificate of the investor in a disadvantaged region”. Such a certificate was to be issued by the relevant Regional Development Agency, upon an investor’s request. According to the Respondent, the language of Article 5 makes it explicit that the PICs merely certified eligibility to “incentives provided by the law”. That law was EGO 24, as approved by Law 20, neither of which contained any provision concerning their duration nor any restriction on the government’s ability to amend or repeal them.

397. According to the Respondent, this conclusion was reaffirmed by a subsequent version of the Methodological Norms, adopted by GD 728/2001 (Exh. R-35). Article 4(1) of these Methodological Norms stated: “The *facilities provided by the law* are granted based on the certificate of the investor in the disfavored area” (emphasis added by the Respondent). According to the Respondent, this demonstrates that the content of the facilities was established by law (i.e., EGO 24) and that PICs were an administrative tool attesting to eligibility to access facilities available under EGO 24.
398. The Respondent contends that the language of the PICs themselves does not change this conclusion. All the PICs stated was that the titleholder was the beneficiary of the facilities granted under GD 194/1999, in accordance with the provisions of EGO 24 approved and amended by Law 20, and in accordance with the government decision approving the methodological norms. Accordingly, all the PICs did was certify that the titleholder was the beneficiary of the facilities granted by the law, whatever the law determined that those facilities were at any point in time.
399. The Respondent further argues that the PICs did not list any individual facilities, let alone purport to stabilize them for any particular period. The PICs only stated that they were valid until a given date. That only meant that they certified eligibility to whatever facilities were available under the law until that date.
400. The Respondent rejects the Claimants’ argument that the PICs were the source of the right to the facilities because they had to present them every time that they wanted to benefit from them. The PICs were needed so that administrators did not have to evaluate eligibility on each occasion that a business applied for an exemption. This conclusion is also supported by the fact that it was not necessary to obtain a new PIC each time EGO 24 was amended; the PIC continued to certify eligibility to the remaining facilities in EGO 24, as amended. This was confirmed by the Claimants’ expert, Prof. Mihai (Tr., Day 5, 215).
401. The Respondent also denies that the administrative process to qualify for a PIC was equivalent to a contractual negotiation, or that the PICs were tantamount to contracts. In the legal order in which that process occurred, the issuance of a PIC did not create a contract. Nor did the obligation to submit an investment plan amount to a bilateral deal; the investment plan was merely a requirement for the government to establish that investors met the qualifying criteria.

402. Similarly, the requirements to employ a certain number of unemployed persons and to have made certain investments were part of the criteria for eligibility; they did not establish the existence of a promise that the facilities would be available for a certain duration. The Respondent adds that it is misleading to suggest that these requirements show that EGO 24 was intended to foster capital intensive industries, because there was no threshold of magnitude for a qualifying investment, the employment requirement was met by employing ten persons, five of which had to be unemployed, and the eligible sectors covered a wide range of activities.
403. The Respondent also denies that EGO 24 created an obligation for investors to maintain their investments for twice as long as the investor is a recipient of the incentives. The Respondent alleges that it “has repeatedly stated that the obligation does not exist and that (therefore) it has no intention of enforcing it” (R-Rejoinder, ¶ 118). In any event, it argues that the alleged obligation is of only theoretical interest, because the Claimants have no desire to move the operations from Bihor county, and thus the state has never had the occasion to enforce the alleged obligation. However, it notes that Prof. Mihai did not address this matter in his expert opinion, and the Claimants have not cited any instances in which any investor has been subjected to the supposed obligation, or any Romanian court or agency has interpreted it in that fashion.
404. The Respondent further contends that neither the monitoring process to which the Claimants were submitted, nor the alleged promotion of the EGO 24 regime by government officials, could have given rise to a promise that the facilities would remain unchanged for any period of time.
405. Finally, the Respondent contends that the Romanian Constitutional Court disagrees with the Claimants’ theory: when the profit tax exemption available under Law 35 of 1991 was repealed, the Constitutional Court found that the repeal of that exemption could not be construed as the termination of a contract, nor as an infringement of the right to property or of the investor’s right to recover debt (Decision 130/2003). The Respondent notes that Prof. Mihai called this decision *ultra vires* at the hearing but did not discuss it in his expert report, while Prof. Baias confirmed the decision’s relevance for this case. Thus, Romania submits that the Tribunal should afford this decision great weight and conclude that GD 194/1999, alone or together with the PICs, did not constitute a contractual or other obligation under Romanian law.

**c. Even if the umbrella clause were applicable, Romania did not breach it**

406. Even assuming that the regulatory acts relied upon by the Claimants could have created “obligations entered into” with the Claimants, the Respondent argues that it could not have failed to observe such obligations simply by modifying the facilities. If the underlying obligation (properly construed under its governing law) has not been breached, then there cannot be a breach of the umbrella clause.
407. Specifically, the Respondent argues that nothing in EGO 24 could be construed as a guarantee to preserve EGO 24 unchanged for ten years. The only reference to

duration is found in Article 5, which provides that “[a] geographical area can be declared a disfavoured zone at least for three years but not for more than ten”. Romania did not breach or amend this provision: both Ștei-Nucet and Drăgănești retained their status of “disfavoured regions” until April 2009, as provided in GD 94/1999<sup>35</sup> and GD 1199/2000.

408. As to the availability of the facilities, the Respondent argues that there was nothing in EGO 24 that prevented the Respondent from eliminating some of them (the Respondent notes that the Profit Tax Incentive was maintained). Relying on *Parkerings v. Lithuania*,<sup>36</sup> the Respondent contends that the mere existence of a law or regulation in no way implies that the government will not amend its terms. EGO 24/1998 contained no “stabilization” element that could ensure that the facilities listed therein would remain unchanged for ten years. Thus, Romania could not have assumed any obligation to freeze the content of the facilities regime simply by promulgating EGO 24/1998. To the contrary, the Respondent argues that by the time the facilities were first extended under EGO 24/1998, Romanian law on state aid (Exh. R-75) specifically provided that such measures were subject to possible repeal at any time. In particular, Article 13 of the State Aid Law provided:

(1) The Competition Council and the Competition Office will supervise on a permanent basis all the existent aids. If it is determined that an existent aid distorts relevantly the normal competitive environment and affects the proper enforcement of the international agreements in which Romania is a party, the Competition Council will request the aid provider to adopt proper measures in order to remove its incompatibility with this law. Such measures may include a recommendation for cancellation or amendment of the existent aid. Such recommendations will be submitted also to the Competition Office achievement monitoring of the imposed measures.

(2) If the measures are not adopted by the aid provider, within the time frame indicated in the request, the Competition Council may decide to stop the granting of the existent aid or may impose conditions and obligations which may insure the compatibility of the aid with this law's dispositions. The decision will not have a retroactive effect and must allow the aid provider a reasonable time period in order to comply with such decision.

409. Accordingly, the Respondent argues that as Romania was under no obligation to make all of the facilities available to the Claimants for 10 years, failure to do so cannot constitute a breach of the umbrella clause.

### **3. The Tribunal’s analysis**

#### **a. Interpretation of the BIT’s umbrella clause**

410. Article 2(4) of the BIT provides that “[e]ach Contracting Party shall observe any obligation it has entered into with an investor of the other Contracting Party with regard to his or her investment.”

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<sup>35</sup> The Tribunal understands that the Respondent refers to GD 194/1999.

<sup>36</sup> *Parkerings v. Lithuania*, ¶ 332.

411. The Parties agree that, for the umbrella clause to apply, Romania must have entered into an obligation with the Claimants with regard to their investment. The Parties further agree that this obligation must be specific. The Parties dispute whether the EGO 24 framework and the PICs did in fact give rise to such an obligation. The Parties also dispute whether the repeal of the Raw Materials Facility constituted a breach of any such obligation, to the extent it arose.
412. The first step in the Tribunal’s analysis is thus to determine whether the EGO 24 framework gave rise to an “obligation” in the meaning of Article 2(4) of the BIT. Pursuant to Article 31(1) of the VCLT, “[a] treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.” The Tribunal sees no reason to deviate from this rule.<sup>37</sup> Accordingly, the Tribunal must first turn to the ordinary meaning of the term “obligation”.
413. Relying on *Enron v. Argentina*, the Claimants argue that “[u]nder its ordinary meaning the phrase ‘any obligation’ refers to obligations regardless of their nature”, noting that “[t]ribunals interpreting this expression have found it to cover both contractual obligations such as payment as well as obligations assumed through law or regulation.”<sup>38</sup>
414. The Respondent denies this. It argues that generally-applicable regulatory and legislative acts, standing alone, do not give rise to the kind of obligations covered by umbrella clauses (even under those more broadly formulated). In the Respondent’s view, umbrella clauses only protect contractual or quasi-contractual obligations.
415. The Tribunal agrees with the tribunal in *Eureko v. Poland* that the term “[a]ny’ obligations is capacious; it means not only obligations of a certain type, but ‘any’ – that is to say, all – obligations entered into with regard to investments of investors of the other Contracting Party.”<sup>39</sup> In addition, the BIT specifies that these obligations must also be “entered into with an investor [...] with regard to his or her investment”. This language suggests that the state must have committed with respect to a particular investor with regard to his or her investments.<sup>40</sup> Indeed, both sides agree

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<sup>37</sup> In doing so, the Tribunal adopts the line followed by the tribunals in *SGS v. Philippines*, ¶¶ 114- 128 (although it partially based its decision on considerations extrinsic from the text); *Eureko v. Poland*, ¶¶ 244-260; *Enron v. Argentina*, ¶¶ 273-277; *SGS Société Générale de Surveillance S.A. v. Republic of Paraguay* (ICSID Case No. ARB/07/29), Decision on Jurisdiction, 12 February 2010, ¶¶ 167-168; *Burlington Resources, Inc. v. Republic of Ecuador* (ICSID Case No. ARB/08/5), Decision on Liability, 14 December 2012 (hereinafter “*Burlington v. Ecuador*”), ¶ 212.

<sup>38</sup> *Enron v. Argentina*, ¶ 274.

<sup>39</sup> *Eureko v. Poland*, ¶ 246.

<sup>40</sup> See, e.g., F.A. Mann, “British Treaties for the Promotion and Protection of Investments,” 52 *British Yearbook of International Law* (1981), Exhibit RL-257, p 246 (explaining that an umbrella clause “only covers an obligation arising from a particular commitment either of the Contracting Parties may have entered into. [...] What is assumed is that the State has entered into a particular commitment which imposes obligations. Such obligations may arise from contract with the State or from the terms of the licence granted by it. It may be express or implied, it may be in writing or oral. But it must be clearly ascertainable as an obligation of the State itself arising from its own commitments. No difficulty occurs where the contract is made with the State itself – and the term may fairly be said to comprise its instrumentalities, even if they are separate legal entities, as well as companies of which it is the sole



that the obligation must be specific. Thus, the umbrella clause in this BIT covers obligations of any nature, regardless of their source, provided that they are indeed “obligations” entered into with a particular investor with regard to his or her investment.

416. Having said this, for the umbrella clause to be triggered, there must be an obligation in the first place. The BIT does not define “obligation”, nor have the Parties attempted to do so. The Claimants simply state that the term obligation is equivalent to an “undertaking”, because when someone undertakes to do something, they become obliged to do that thing. The Respondent, however, submits (and the Claimants do not seem to dispute) that the determination of whether an obligation exists must be done in accordance to domestic law. Specifically, the Respondent has argued that in order to be elevated to the protection of the umbrella clause, the obligation must have given the Claimants an actionable vested right under Romanian law.
417. In the Tribunal’s view, establishing whether an obligation exists is a question that cannot be answered by turning solely to the interpretation of the meaning of this term as stated in the BIT. The purpose of the umbrella clause is to cover or “elevate” to the protection of the BIT an obligation of the state that is separate from, and additional to, the treaty obligations that it has assumed under the BIT. As noted by the *Burlington v. Ecuador* tribunal, this separate and additional obligation does not exist in a vacuum; it is subject to its own proper law.<sup>41</sup> In the words of the tribunal in *SGS v. Philippines*, an umbrella clause

... does not convert non-binding domestic blandishments into binding international obligations. It does not convert questions of contract law into questions of treaty law. In particular it does not change the proper law of the [relevant agreement] from the law of the Philippines to international law.<sup>42</sup>

418. This Tribunal concurs with this view. Thus, whether an obligation has arisen depends on the law governing that obligation, and so the interpretation of the term “obligation” for purposes of the umbrella clause would rely primarily on that law rather than on international law. In other words, to be afforded the protection of the BIT, the obligation must qualify as such under its governing law. In this case, the governing law cannot be other than Romanian law and the Parties did not point to any other possibly applicable law. The obligation to which the Claimants wish to extend the protection of the BIT purportedly arose under EGO 24, its implementing legislation and/or the granting of the PICs. Thus, the existence and content of that purported obligation depends on Romanian law.

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shareholder. But where the contract is made with a private person, then the provision only applies if and in so far as an obligation of the State arising from its own particular commitment (as opposed to existing general legislation) may be discerned. Thus if the law of the land provides that the State is liable for the torts of its servants this is not an ‘obligation arising from a particular commitment’ the State may have entered into and may be changed, though in certain circumstances this may become subject to the provisions about expropriation.”).

<sup>41</sup> *Burlington v. Ecuador*, ¶ 214.

<sup>42</sup> *SGS v. Philippines*, ¶ 126.

419. Accordingly, whether Romania was bound by an “obligation” to provide the incentives to the Claimants until 31 March 2009 is a question to be determined by Romanian law. The Tribunal will now address whether such an obligation arose.

**b. Did Romania enter into a specific obligation with the Claimants?**

420. The Claimants argue that, through the EGO 24 framework, Romania entered into a specific obligation with the Claimants with regard to their investment, which consisted of Romania’s undertaking with respect to the Claimants to maintain the EGO 24 incentives in the Ștei-Nucet disfavored region for the full 10-year period provided by GD 194/1999. The Respondent concedes that EGO 24 created a generalized entitlement that could be claimed by qualifying investors, but denies that it promised that the incentives would remain in place or unchanged for any specific period. It also denies that this entitlement gives rise to an obligation on the part of Romania under Romanian law.

421. The Tribunal will first address the content of the entitlement created by EGO 24 (Section (i)). It will then address whether it gives rise to a specific obligation for Romania under Romanian law that may trigger the application of the umbrella clause (Section (ii)).

**i. Content of the Claimants’ entitlement**

422. Having reviewed the evidence before it, the Tribunal’s conclusion is that EGO 24 created a general scheme of incentives available to investors who fulfilled certain requirements, which were later “granted” to qualifying investors through a specific administrative act (the PIC). In other words, the legislation created a generalized entitlement that could be claimed by qualifying investors, but this general entitlement later crystallized with respect to qualifying investors through the granting of the PICs, becoming from that moment on a specific entitlement with respect to specific investors. Therefore, the Tribunal does not need to decide whether a general entitlement, in a law or regulation, could give rise to an obligation subject to the umbrella clause; here the general obligation was converted into a specific commitment.

423. In particular, EGO 24, as republished on 8 November 1999 (Exh. R-68) provided that the Government could declare the creation of certain “disadvantaged areas”, at the proposal of the National Council for Regional Development (Article 3). This declaration would be made by means of a “government decision”, which would also approve (a) the period for which a geographical area was declared a disadvantaged region, (b) the fields of investments, and (c) “the required financing and advantages provided by law, and granted to the investors” (Article 4). Article 5 provided that “[a] geographical area may be declared a disadvantaged area for a period of at least 3 years, but for not more than 10 years, with possibility for extension, under the conditions of this Emergency Ordinance.” Article 6(1) went on to say that investors meeting certain requirements “will be granted the following advantages for their new

investments in these regions”, and then listed those advantages (that is, the incentives or facilities) (see paragraph 148 above).

424. It is thus clear that EGO 24 did not stand alone: by its own terms it required an important part of its implementation to be carried out by way of a government decision (including the determination of the disfavored area and of the incentives or facilities that would be available for investors in that area). For the case of Ștei-Nucet, this government decision was GD 194/1999 (Exh. C-31, C-280), later extended to Drăgănești by GD 1190/2000. The boundaries of the disfavored region were extended to include Drăgănești by means of GD 1190/2000 on 29 November 2000 (Exh. C-32).
425. The Respondent argues that, even if EGO 24 delegated certain aspects to a government decision, because of the hierarchy of norms under Romanian law it was legally impossible for GD 194/1999 or GD 1190/2000 to grant anything that EGO 24 did not authorize. This may be so, but based on the relevant laws and regulations and the testimony of the Respondent’s expert, Prof. Baias, the Tribunal concludes that GD 194/1999 and GD 1190/2000 did exactly what was authorized by EGO 24:
- a. GD 194/1999 determined that Ștei-Nucet would be a disfavored region (Articles 1 and 2), established the time period for that (i.e., 10 years, Article 3), and provided that, “during the existence of the disfavored region, established according to this decision, the facilities under annex no. 2\*) will be granted” (Article 4 of GD 194/1999). In turn, Annex 2 of GD 194/1999 listed all of the incentives provided under Article 6(1) of EGO 24 (see paragraph 153 above). Article 5 of GD 194/1999 also provided that “[t]he domains of interest for the achievement of investments in the zone shall be those provided for in Annex No. 3.” In turn, Annex 3 provided that these domains of interest were agriculture and “zootechny”, production (except the manufacture of distilled alcoholic drinks and manufacture of ethyl alcohol by fermentation), services (except public alimentation not included in an investment in tourism), trade (except marketing of products not made in activities performed in the zone) and environmental protection and rehabilitation of natural sites. Article 6 of GD 194/1999 provided that Annexes 1-3 would “be an integral part of the present decision.”
  - b. Similarly, GD 1190/2000 extended the boundaries of the disfavored region to include Drăgănești (Article I), confirmed that “the period for which the Ștei-Nucet region is established as a disfavored region shall end on 31 March 2009”, and added that “[f]or the commune of Drăgănești, the facilities related to the disfavored region shall be granted commencing with the date this decision is published in the Official Gazette of Romania, Part I.” (Article II)
426. Prof. Baias confirmed that GD 194/1999 was *intra vires* at the time it was issued and until the time when EGO 24 was amended in 2004 by GO 94/2004 to revoke the facilities, because, in Prof. Baias’s view, the subsidiary norm is automatically restricted to the scope of the amended primary norm.<sup>43</sup> However, at the time of its

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<sup>43</sup> Specifically, Prof. Baias testified:

issuance in 1999 and up until the facilities were revoked in November 2004 (or February 2005, if we take the effective date), GD 194/1999 validly provided that qualifying investors investing in the Ștei-Nucet area (later expanded to include Drăgănești) would be granted the incentives listed in Annex 2 until the date in which the region ceased to be disfavored (i.e., 1 April 2009). The same conclusion should apply to GD 1190/2000.

427. Thus, EGO 24, GD 194/1999 and GD 1190/2000 by themselves do nothing more than establish a general entitlement to qualifying investors in the Ștei-Nucet disfavored region. Standing alone, they do not give rise to a specific entitlement to a specific investor. The rules for the actual granting of the incentives to investors were established by the Methodological Norms (GD 525/1999, the “1999 Methodological Norms”, and later by GD 728/2001, the “2001 Methodological Norms”). Pursuant to these Methodological Norms, qualifying investors (only) became entitled to the incentives once they received their PIC (or TIC, on a temporary basis).

428. Specifically, Article 5 of the 1999 Methodological Norms provided:

“(1) The incentives provided by the law **shall be granted** [in Romanian, “*se acorda*”] pursuant to the certificate of investor in a disfavored area, which is issued, upon the business entity's request, by the Regional Development Agency under the jurisdiction of which the head office of such business entity is located.

[...]

(3) Business entities requesting the issuance of the certificate of investor in a disfavored area shall prove they meet the requirements set forth by the [EGO].

(4) Emerging business entities, unable to produce evidence regarding the investment, the commissioning of the operations and the creation of new jobs, may request the issuance of a temporary certificate of investor in a disfavored area, for a maximum of 3 months. In case they do not bring, during this period, evidence of having met the requirements set forth by the [EGO], they shall be compelled to pay and return, respectively the equivalent value of all the incentives they have benefited of.

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Q. So are we agreed, then, that when the government decision was issued, the way in which it should be interpreted is that in Ștei-Nucet, the incentives granted, or indicated in Annex 2, would be granted for the full duration of the time when Ștei-Nucet was declared a disfavoured zone; that was the position at that time?

A. At the very moment of the adoption of this government decision, I agree.

Q. That was in conformity with EGO 24 at that time?

A. At that moment.

Q. So your position is that because EGO 24 was subsequently changed, this government decision became in contradiction with -- not EGO 24 as it was, but the subsequent legislative position?

A. Yes. With the subsequent form of the EGO 24 as it was modified.

(Tr., Day 5, 265:11-266-2 (Reed/Baias)).

- (5) The temporary certificate shall be issued pursuant to the business entity's commitment regarding the investment and the creation of new jobs.

[...]"

(Emphasis added).

429. The substance of these requirements was repeated in Articles 4 and 5 of the 2001 version, which added two specifications:
  - a. Investors applying for a certificate of investor had to prove that they had "at least 10 employees with individual employment contracts for an indefinite term out of which at least 5 should be employed from the unoccupied work" (Article 4(4)).
  - b. "The business entities which obtained the certificate of investor in the disfavoured area and which perform activities from fields of interest other than those provided under annex no. 1 shall continue to benefit from facilities under the law, until the expiry of the period for which the disfavoured area was declared" (Article 5(3)).
430. Prof. Mihai testified in cross-examination that the correct translation of Article 5(1) of GD 525/1999 should be "[t]he facilities provided by the law shall be granted on the basis of the certificate of investor" (Tr., Day 5, 214:14-215:1). Although the Respondent argues that the key words here are "provided by the law", in the Tribunal's view the key words are rather that such facilities "shall be granted." The applicable regulation (EGO 24) "provided" or created certain incentives or facilities; GD 194/1999 and GD 1190/2000 (by express delegation of the law) determined which of these incentives would be available to investors in a particular disfavored area and for what time period, and the Methodological Norms established the rules under which these incentives would be granted to specific investors. But the actual "granting", "awarding" or "vesting" of the entitlement to the incentives occurred at the moment of the issuance of the PICs. It is in this moment when the general entitlement becomes a specific entitlement with respect to a particular investor.
431. In other words, the specific entitlement of a particular investor to the incentives provided under the EGO 24 framework arises from an administrative act of specific scope (i.e., directed to specific investors with respect to specific investments). This administrative act is evidenced by the issuance of the PICs. In the Tribunal's view, it is irrelevant for purposes of determining the existence of a specific entitlement whether the PIC merely certified eligibility to the incentives under generally applicable legislation. The fact is that, without having been granted a PIC, an investor could not benefit from the incentives offered by EGO 24, GD 194/1999 and GD 1190/2000. In other words, the granting of the PIC was the moment in which a particular relationship between the Government and the investor was "perfected": an investor could benefit from the privileges offered by the legislative framework only after having applied for a PIC, proved it fulfilled the requirements and received a favorable decision from the government in the form of a PIC. Only thereafter did the investor have the actual entitlement to the incentives, and only after that moment did it have the obligations established under EGO 24.

432. The question that follows is: did the regulatory framework provide that this specific entitlement would last until 1 April 2009? The Tribunal finds that it did.
433. EGO 24 itself did not say anything with respect to the timing of the entitlement, but by its own terms it delegated this determination to a government decision. For Ștei-Nucet, this government decision was GD 194/1999. Article 4 of GD 194/1999 provided that the facilities listed in Annex 2 “shall be granted” (“*se acorda*” in Romanian) during the existence of the disfavored region. In turn, Article 3 provides that Ștei-Nucet is designated a disfavored region for a period of 10 years, starting on 1 April 1999. This was confirmed by GD 1199/2000 when the boundaries of the region were extended to include Drăgănești, which stated that the designation of the region as disfavored would end on 31 March 2009.
434. This was further confirmed by Article 5(3) of the 2001 version of the Methodological Norms (GD 728/2001, Exh. R-35), which provided that:
- The business entities which obtained the certificate of investor in the disfavoured area and which perform activities from fields of interest other than those provided under annex no. 1 ***shall continue to benefit from facilities under the law, until the expiry of the period for which the disfavoured area was declared.*** (Emphasis added)
435. In addition, Article 1(f) of the 2001 Methodological Norms defined the period during which it would be understood that an investor had benefitted from the incentives for purposes of Article 7 and 9 of EGO 24 as the period “comprised between obtaining the certificate of investor in [the] disfavored area and disappearance of the disfavored area; in case of a temporary investor certificate, followed by obtaining an investor certificate in the disfavored area, the period shall be calculated as of obtaining a temporary investor certificate until the disfavored area ceases to exist.”
436. It is true that these provisions were added in the 2001 Methodological Norms, and not in the 1999 version. However, they confirm an interpretation that was already reasonable in light of the interplay of the legal provisions.
437. In addition, all three of the Corporate Claimants’ PICs provided that the certificate (which certified that they were the beneficiaries of the facilities granted under EGO 24 and GD 194/1999) would be valid until 1 April 2009. Indeed, Romania concedes that the PICs certified eligibility to the incentives until 1 April 2009, arguing however that the PICs only entitled the Claimants to whatever incentives were available under the general scheme from time to time.
438. Thus, the Tribunal concludes that the PICs, in the context of the EGO 24 regulatory framework, provided (or, to use Respondent’s words, entitled) that PIC holders would be entitled to the incentives offered under EGO 24 until 1 April 2009.
439. The third question that arises is: did the legislative framework provide that the Claimants would be entitled to the same incentives, or at least substantially the same incentives, that were originally provided under GD 194/1999? The PICs merely state that the investor is the “beneficiary” of the facilities provided under the general

scheme, as republished and amended. This seemingly supports Romania's contention that they merely certified eligibility to whatever incentives were available under the general scheme from time to time.

440. However, Article 4 of GD 194/1999 provides that the facilities listed in Annex 2 "shall be granted" during the existence of the disfavored region, and that annex was attached to GD 194/1999 and was deemed to form an "integral part" of that decision (see paragraph 425.a). It could thus be argued that the facilities listed in that annex are incorporated into the Government Decision and thus "stabilized" in some form by the reference to a specific time period. It would be a difficult question to determine whether the Government would thus unduly exceed its authority under Romanian law and what the legal consequences would be under such law, but it is unnecessary to make that determination.
441. In fact, the incentives underwent several amendments during the life of EGO 24, which included the revocation of some of the facilities. Specifically:
- a. On 16 June 2000 (effective 1 July 2000), Romania passed Emergency Government Ordinance No. 75/2000 ("EGO 75/2000", Exh. C-45, R-81). Although the Competition Council had issued Decision 244/2000 a month before, EGO 75/2000 ignored the Competition Council's recommendation to eliminate the Raw Materials Incentive. Instead, it amended EGO 24 in the following ways:
    - i. It amended the Raw Materials Incentive by providing for an exemption (rather than the refund) on customs duties, and excluded spare parts and components from the customs duty exemption. Article 6(1)(b) of EGO 24 was replaced with the following text:

b) the exemption from the payment of customs duties for imported raw material necessary for the own production in the area.
    - ii. It amended the provisions regarding the award of funds under the Special Development Fund.
  - b. On 7 November 2001, Romania passed Law No. 621/2001 (Exh. R-33, R-129), which amended EGO 75/2000 by, among others, reinstating the customs duties exemption on imported components. Article 6(1)(b) of EGO 24 was replaced with the following text:

b) the exemption of customs duties for imported raw materials and components required to perform the area's own production.
  - c. On 1 June 2002, Romania passed Law No. 345/2002 (Exh. R-90), which abolished the Machinery Incentive provided under Article 6(1)(a) of EGO 24 (both with respect to customs duties and VAT).

- d. On 1 July 2002, Romania passed Law No. 414/2002 (Exh. C-48, R-34), which repealed the Profit Tax Incentive but grandfathered it for investors who held a PIC prior to the date on which this law entered into force (Articles 36(1)(d), 35(3)).
  - e. On 19 November 2002, Romania passed Law No. 678/2002 (Exh. C-49) which amended the Raw Materials Incentive by excluding from the customs duties exemption raw materials for the production, processing and preservation of meat.
  - f. In June 2004, Law 239/2004 (Exh. C-50) subjected the remaining facilities to a requirement that they not exceed a threshold of maximum intensity of state aid.
  - g. On 31 August 2004, Romania passed EGO 94/2004 (Exh. R-94), which abolished all the remaining incentives with the exception of the grandfathered Profit Tax Incentive. EGO 94/2004 also provided that “[i]n calculating the intensity of state aid, eligible costs related to investments made before 15 September 2004 shall be taken into account.”
442. Thus, from its enactment in 1998 and until its final revocation in 2004, EGO 24 was amended several times, either to the benefit or to the detriment of PIC holders. The Machinery Incentive was eliminated completely in 2002. The Profit Tax Incentive was repealed in 2002, but grandfathered for PIC holders. The Raw Materials Incentive survived, in some ways enhanced (it was transformed into an exemption instead of a refund in 2000), but its scope of application was modified (it was eliminated for components in 2000 and then reinstated in 2001, and later eliminated for meat products in 2002). Only the Profit Tax Incentive was grandfathered for PIC holders.
443. This seems to confirm the Respondent’s argument that the legislative framework only provided that PIC holders would be entitled to whatever incentives were available under the regime from time to time. However, the Claimants argue that these amendments (at least until 2002) did not indicate in any way that the entire regime would be brought to a premature conclusion. They argue that EGO 75/2000 strengthened the regime, even against the Competition Council’s recommendation, noting that the Raw Materials Incentive was made into an exemption rather than a refund, and that the components part of it was reinstated the following year. They also argue that the amendments to the Machinery Incentive and the Profit Tax Incentive were made in the context of other reforms (VAT laws, profit tax laws) and did not target EGO 24 in the context of state aid. Finally, they argue that the elimination of the Raw Materials Incentive with respect to raw materials for the production, processing and preservation of meat was made to address problems specific to the Romanian meat industry.
444. In the Tribunal’s view, Romania’s conduct cannot change the content of the entitlement. That Romania did as a matter of fact amend or eliminate certain incentives without grandfathering them does not mean that it was entitled to do so, at least not if that amendment or elimination, in itself or in conjunction with other amendments or eliminations, would amount to a repeal of the entitlement altogether, more precisely of the entitlement based on PICs (or TICs). This does not contradict



the principle *lex posterior derogat legi priori*: it is undisputed that Romania may validly amend its laws, and presumably GD 194/1999 could be validly amended by subsequent legislation, but this is not the question.

445. The question is whether such an amendment could affect rights or entitlement created by previous laws with respect to private parties. In this case, the question is whether PIC holders continued to have the entitlement to the same incentives specified in Annex 2 of GD 194/1999 despite the later amendments to the EGO 24 regime. This question is addressed in the following section.

**ii. Does Romania's undertaking qualify as an "obligation" under Romanian law? If yes, did Romania breach it?**

446. The Tribunal has found that the EGO 24 framework, once specified with respect to the Claimants through the granting of the PICs, created for the Claimants a specific entitlement to the EGO 24 incentives until 1 April 2009. Thus, under the EGO 24 framework Romania committed to provide the EGO 24 incentives until 1 April 2009.
447. However, for purposes of the umbrella clause, the Tribunal will determine whether this commitment (or undertaking) amounts to an "obligation" under Romanian law. In addition, the Tribunal must answer the question raised in the preceding section: whether that undertaking, commitment or obligation consisted of providing the Claimants the *same* incentives that were listed in Annex 2 of GD 194/1999 until 1 April 2009. Both questions are relevant. If there is no obligation under Romanian law, the umbrella clause is not triggered. If an obligation under Romanian law exists but its scope is limited to providing the Claimants with whatever incentives are available under the regime from time to time, Romania discharges that obligation by providing whatever incentives were in force in a particular time. If, on the other hand, there is an obligation under Romanian law to maintain the same incentives through 1 April 2009 with respect to the Claimants, then Romania would be in violation of the BIT's umbrella clause.
448. The Tribunal considers two alternative approaches potentially relevant to that analysis. Under the first approach, the answer to the questions above depends on whether the EGO 24 framework provided the Claimants with a vested right to the incentives listed in Annex 2 of GD 194/1999 until 1 April 2009. In other words, under that approach, the Tribunal would need to decide whether the Claimants' entitlement qualifies as a "vested right" under Romanian law, and whether Romania's corresponding undertaking qualifies as an "obligation" under Romanian law. In many legal systems, the existence of a debtor's obligation is inseparable from the existence of the creditor's vested right to performance of the obligation and is a mirror view of that right from the debtor's perspective. Thus, presumably, under this approach, in order for Romania to be legally obligated to provide the Claimants with the incentives listed in Annex 2 of GD 194/1999 until 1 April 2009 (or legally obligated to compensate the Claimants if those incentives were eliminated or amended), the EGO 24 framework would have had to provide the Claimants with a vested right to receive those very same incentives.

449. These are matters of Romanian law that the Tribunal cannot answer in the abstract or with reference to comparative law. It is the Claimants' burden to prove that Romania's undertaking amounts to an obligation under Romanian law, and that the content of that obligation is such that Romania's actions have breached it. The Claimants have not addressed these issues convincingly. The Claimants' legal expert on Romanian law, Prof. Mihai, did not address whether the regulatory framework created an obligation under Romanian law. In particular, he did not address the nature of GD 194/1999 or of the PICs in his expert report, and only briefly in his oral examination. Nor was this matter addressed by Romania's expert, Prof. Baias. His report only referred to whether EGO 24, GD 194/1999 or the PICs created contractual relations between the Claimants and the state (his answer was no) (ER of F. Baias, ¶¶ 5.1-5.2).
450. Similarly, the Claimants have not addressed to the Tribunal's satisfaction whether their alleged right to the incentives might be lawfully withdrawn without compensation under Romanian law. The Tribunal has paid particular attention to Decision 130/2003 of the Constitutional Court. The Respondent argues that this decision (which applied to the incentives provided by Law 35 on Foreign Investment) proves that the EGO 24 framework did not give PIC holders a vested right to the incentives, and their withdrawal did not give PIC holders a right to compensation. Decision 130/2003 specifically stated:
- The Court finds that no contract was concluded between the Romanian State and the potential investors by the adoption of this law, as the entity raising the objection of unconstitutionality groundlessly claims, and no ownership right or right to recover debt was created in their favor, but a legal framework was created that could offer to the foreign investors an attractive business climate, taking into account the requirements of the transition from a State centralized economy to the market economy. Therefore, the fact that the contested provisions provide for the cessation of the applicability of such facilitations may not be construed as the termination of a contract and the least as infringement of the ownership right or of the investors; rights to recover debt, but the amendment of the legal framework in connection with the business background. The measure is not meant to harm foreign investors, as they must still carry out their activity under the usual conditions of a market economy, without the facilities that represented positive discriminations by comparison to the other participants to the business circuit. (Exh. RL-214, p.4).
451. The Claimants contend that the findings of this decision cannot be extrapolated to EGO 24 because the regimes created by Law 35 and EGO 24 were significantly different (in particular, because Law 35 provided all foreign investors in Romania with benefits, while EGO 24 only benefited investors who met certain specific criteria who invested in disfavored regions and fulfilled other obligations), adding that the testimony of the Respondent's expert, Prof. Baias, was based on the mistaken premise that both regimes were substantially similar. During cross-examination it became evident that Prof. Baias did not know the details of either incentive regime (Tr., Day 6, 26-31), while the Claimants' expert, Prof. Mihai, testified that there were important differences between EGO 24 and Law 35 (Tr., Day 5, 252 (Mihai)). Prof. Mihai (a former president of the Constitutional Court) also characterized Decision 130/2003 as "extremely infelicitous" and "ultra vires", stating that the reasoning of the

Constitutional Court was “inappropriate” and “not in line with the reality“ because “by the repeal of [EGO] 24, damages were brought to the foreign investors, because that repeal created [...] a worse legal and economic situation than before the repeal.” (Tr., Day 5, 231, 252 (Mihai)). In the circumstances, the Tribunal is far from certain that it should revisit as such the validity of the Constitutional Court's decision, as opposed to the extent of its possible application by way of extrapolation to EGO 24, but finds that Decision 130/2003 is in any circumstance not decisive when interpreting the nature of the EGO 24 incentives.

452. However, the fact that Decision 130/2003 may not be applicable to the EGO 24 incentives does not prove that the EGO 24 incentives gave rise to vested rights or a right to compensation if they were withdrawn, and Prof. Mihai's testimony was insufficient to establish this. Prof. Mihai testified that the constitutional principle of the rule of law set out in Article 1(3) of the Romanian Constitution<sup>44</sup> “required the Romanian state to maintain unchanged all facilities granted under prior regulations in favour of holders of investment certificates, issued before [GO 94/2004] was enforced”, or required GO 94/2004 to contain grandfathering provisions (ER of L. Mihai, ¶¶ 12.6-12.7). He also stated that, by failing to do so, GO 94/2004 was issued in breach of the ECHR's jurisprudence on legitimate expectations and legal foreseeability, as well as the Romanian principles of vested/acquired rights (ER of L. Mihai, ¶¶ 13.1-13.3) and non-retroactivity (Tr., Day 5, 207-208, 247 (Mihai)). But Prof. Mihai refrained from going as far as stating that the EGO 24 framework gave rise to vested rights. He did say, with respect to the Machinery Facility repealed in 2000, that “those who had already acquired this right on the basis of some laws which were in effect at the moment when these rights had been acquired [...] could continue to claim these tax exemptions” (Tr., Day 5, 210 (Mihai)). However, he accepted that most of the changes made to EGO 24 during its life did not contain grandfathering provisions (e.g., the revocation of the meat facility and the machinery facility), although he did characterize these regulations as unconstitutional (Tr., Day 5, 212, 234-238 (Mihai)). In the Tribunal's view, this is not sufficient to establish the existence of a vested right to the incentives for the Claimants (and a corresponding obligation for Romania), or a right to compensation if the incentives were withdrawn.
453. The Tribunal concurs with the Claimants in that the entitlement created by the EGO 24 framework and the PICs creates an appearance, perhaps even a distinct appearance, of a vested right giving rise to the corresponding obligation. In particular, as discussed in paragraph 457 below, the relationship between the Claimants and the Romanian State included a certain *quid pro quo*. However, the Claimants have not proved that Romanian law would characterize such an appearance, even in the presence of such *quid pro quo*, as a vested right or obligation, or afford it the same protection.

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<sup>44</sup> Article 1 paragraph (3) of the Romanian Constitution provides: "Romania is a democratic and social state governed by the rule of law, in which human dignity, the citizens' rights and freedoms, the free development of human personality, justice and political pluralism represent supreme values, in the spirit of the Romanian people's democratic traditions and the ideals embodied by the December 1989 Revolution, and shall be guaranteed."

454. Under this approach, therefore, the Tribunal lacks sufficient evidence on the content of Romanian law to be able to ascertain whether the EGO 24 framework, including after "crystallizing" through the issuance of a PIC, gave the Claimants a vested right under Romanian law to the incentives listed in Annex 2 of GD 194/1999 until 1 April 2009. For the same reason, it cannot ascertain that the EGO 24 framework created the corresponding obligation for Romania to provide those very incentives during that period.<sup>45</sup>
455. Under the second approach, it is not necessary that the obligation be "vested" or "actionable" in order to be considered an obligation covered by the umbrella clause. Although the Respondent has argued that granting a "vested" or "actionable" right is a prerequisite for an obligation to arise and to have binding legal effect under Romanian law, its experts have not established that this is the case. Thus, to find an obligation it would be sufficient to find that (i) Romania undertook a firm commitment vis-à-vis the Claimants, and (ii) that the scope of that commitment was to provide substantially the same incentives during a specific period of time.
456. The first question is whether Romania undertook a firm commitment vis-à-vis the Claimants under Romanian law. Through its regulatory framework, which was intended to promote investments and job creation in certain disadvantaged regions, Romania made an offer to investors who would consider establishing their business in those regions. The offer included granting the incentives and maintaining them through 1 April 2009. The offer was however, conditional. Investors who accepted the offer would only qualify if they met certain requirements and remained in compliance with those requirements for a period twice as long as the period of the incentives. Therefore, Romania's offer and the Claimants' acceptance of that offer established a relationship of mutual rights and duties: Romania accepted to grant the incentives and maintain them through 1 April 2009 and the Claimants committed to comply with the requirements of the offer for the requisite period. To state it differently, Romania had the right to insist that the Claimants carry out their business activities in compliance with the requirements while the Claimants had the right to receive the incentives. The investors were taking a firm commitment and the regulatory framework required a firm commitment on the side of Romania. This relationship was certified by the PICs, the wording of which confirms that analysis of the regulatory framework. The offer and the acceptance thus included a *quid pro quo* and, therefore, can be considered a relationship of mutual rights and obligations. If such is the nature of the relationship, Romania must have undertaken an obligation to maintain the incentives through 1 April 2009 and the Claimants must have the corresponding right to the incentives during that period. Romania's obligation, and the Claimants' corresponding rights, are by definition obligations and rights under Romanian law because they were established through the regulatory framework that created the incentives.
457. The second inquiry relates to the scope of Romania's undertaking. Romania has argued that, even if an obligation existed (which it denies), the scope of the obligation

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<sup>45</sup> Arbitrators Lévy and Abi-Saab favor this approach.

was only to grant whatever incentives might be available under the EGO 24 framework from time to time. The question is thus whether Romania's commitment to provide the incentives contained an element of stabilization in the event of an amendment of the laws governing the EGO 24 framework. The commitment to maintain the incentives for a certain specific time period induced investors to take advantage of the offer. Therefore, Romania cannot in good faith ignore the fact that such a commitment would necessarily be understood as including a promise of stabilization; that is, that the incentives would be maintained for the specified period. Stated differently, because Romania promised certified investors that it would maintain the incentives through a certain date, that promise could not be understood otherwise than as including the undertaking that the incentives would not be withdrawn earlier. Thus, while Romania did not make a commitment not to amend its laws as a general matter, certified investors understood that they would benefit from the incentives through 1 April 2009. For example, if Romania promised to waive customs duties on the imports of certain raw materials for a certain period of time with respect to a certified investor, that promise would be understood as remaining valid regardless of whether Romania amends its general legal framework to impose higher or lower duties on the same raw materials during the specified period. Therefore, the certified investors were offered (and accepted as part of the *quid pro quo*) a guarantee of some stability of the legal regime within the scope of the incentives, as described in the PICs, for a specific time period.

458. Under both aspects of the second approach, therefore, the Tribunal would find that a legal obligation by Romania with respect to the Claimants exists. The mirror image of that legal obligation would be the Claimants' right to the incentives through 1 April 2009.<sup>46</sup>
459. The Tribunal has considered carefully both approaches and is conscious of the fact that their application would lead to different conclusions. The majority follows the first approach and concludes that the burden of proof lies with the Claimants and that the Claimants have not met that burden. The majority does not find that the Claimants have provided sufficient evidence and legal arguments on the content of Romanian law for the Tribunal to find the existence of an obligation protected by the umbrella clause. The majority accordingly dismisses the Claimants' umbrella clause claim, and the Tribunal will now address the Claimants' arguments in the context of their fair and equitable treatment claim, which spans the same injuries alleged by the Claimants under the umbrella clause.

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<sup>46</sup> Arbitrator Alexandrov favors this approach.

## **B. FAIR AND EQUITABLE TREATMENT**

460. Article 2(3) of the BIT provides:

Each Contracting Party shall at all times ensure fair and equitable treatment of the investments by investors of the other Contracting Party and shall not impair the management, maintenance, use, enjoyment or disposal thereof, as well as the acquisition of goods and services or the sale of their production, through unreasonable or discriminatory measures.

461. This section addresses the Claimants' allegation that the Respondent has breached its obligations under this provision by failing to afford to their investments fair and equitable treatment.

462. To facilitate the discussion of the Parties' arguments with respect to the Claimants' fair and equitable treatment claim, the Tribunal will first set out a summary of the Parties' general positions (Section 1 below). It will then address the nature, interpretation and content of the fair and equitable treatment standard (Section 2 below). Finally, it will address the Parties' specific arguments with respect to each alleged breach of the standard (Sections 3 to 6 below).

### **1. Summary of the Parties' positions**

#### **a. The Claimants' position**

463. The Claimants argue that the fair and equitable treatment standard, which is contained in Article 2(3) of the BIT, is an autonomous standard that is additional to general international law, and is thus not restricted by the international minimum standard contained in customary international law (C-SoC, ¶¶ 183-192, citing scholarly opinion, an UNCTAD study and the practice of international tribunals, in particular, *Tecmed v. Mexico*<sup>47</sup>, *Azurix v. Argentina*<sup>48</sup>). The Claimants also contend that the fair and equitable treatment standard has a specific meaning, which is not to be confused with a decision *ex aequo et bono* (citing *ADF Group Inc. v. United States*<sup>49</sup>, ¶ 184).

464. According to the Claimants, the interpretation of the treaty provision containing the fair and equitable treatment standard should start from the normal canons of treaty interpretation as contained in Articles 31 and 32 of the VCLT, which include the ordinary meaning of the treaty's terms, their context, and the object and purpose of

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<sup>47</sup> *Técnicas Medioambientales Tecmed, S.A. v. United Mexican States* (ICSID Case No. ARB(AF)/00/2), Award, 29 May 2003 (hereinafter "*Tecmed v. Mexico*" or "*Tecmed*").

<sup>48</sup> *Azurix Corp. v. Argentine Republic* (ICSID Case No. ARB/01/12), Award, 14 July 2006 (hereinafter "*Azurix v. Argentina*").

<sup>49</sup> *ADF Group Inc. v. United States of America* (ICSID Case No. ARB(AF)/00/1), Award, 8 January 2003 (hereinafter "*ADF Group Inc. United States*" or "*ADF Group*").

the treaty, the preamble being of particular importance (C-SoC, ¶¶ 194-200, citing *Tecmed v. Mexico*, *MTD v. Chile*<sup>50</sup>, *Azurix v. Argentina*, *Siemens v. Argentina*<sup>51</sup>).

465. Starting with the text of the provision, the Claimants note that the Oxford Dictionary defines “fair” as “free from bias, fraud or injustice; equitably legitimate”; the word “equitable” as “characterized by equity or fairness”; and the word “equity” as “the quality of being equal or fair; impartiality; even-handed dealing [...] that which is fair and right” (C-SoC, ¶ 200, Exh. C-83).
466. With respect to the context of the provision, the Claimants argue that a comparison of the fair and equitable treatment standard with other standards of the BIT shows that, as opposed to standards that are relative (such as the national treatment or most-favored nation treatment standards), the fair and equitable treatment standard is an absolute standard that provides a fixed reference point. As a result, it is not a valid defense for Romania to argue that investors of Romanian nationality or investors from third countries were also adversely affected by the revocation of tax exemptions or other incentives (C-SoC, ¶¶ 201-203).
467. In addition, the Claimants submit that the fair and equitable treatment standard should be interpreted in the light of the object and purpose of the BIT as reflected in its Preamble.<sup>52</sup> As a result, any interpretation of the fair and equitable treatment standard should be generally favorable to the intensification of economic cooperation between the two countries, help promote and protect investments, be conducive to expanding the economic relations between the two countries and stimulate investment initiatives. In this regard, the Claimants argue that attracting investors through tax exemptions and other incentives that are promised for a certain period of time, and withdrawing these incentives unilaterally, is not conducive to the intensification of economic cooperation nor the stimulation of investment initiatives (C-SoC, ¶¶ 205-206).
468. As discussed in Section V(B) on Applicable Law, the Claimants deny that the interpretation of the BIT must take into consideration EU law (see 291 above *et seq.*).
469. The Claimants endorse the definitions of the fair and equitable treatment standard made by several international tribunals (including, among others, *Waste Management v. Mexico II*<sup>53</sup>, *MTD v. Chile*, and *Saluka v. Czech Republic*<sup>54</sup>). Relying in particular

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<sup>50</sup> *MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Republic of Chile* (ICSID Case No. 01/7), Award, 25 May 2004 (hereinafter “*MTD v. Chile*”).

<sup>51</sup> *Siemens A.G. v. Argentine Republic* (ICSID Case No. ARB/02/8), Award, 6 February 2007 (hereinafter “*Siemens v. Argentina*” or “*Siemens*”).

<sup>52</sup> The Claimants note that the Preamble expresses the Parties’ desire “to intensify economic cooperation to the mutual benefit of both States and to maintain fair and equitable conditions for investments by investors of one Contracting Party in the territory of the other Contracting Party” and recognizes “that the promotion and protection of such investments favour the expansion of the economic relations between the two Contracting Parties and stimulate investment initiatives...” (BIT, Preamble).

<sup>53</sup> *Waste Management Inc. v. United Mexican States* (ICSID Case No. ARB(AF)/00/3), Award, 30 April 2004 (hereinafter “*Waste Management v. Mexico II*” or “*Waste Management II*”).

on *Saluka v. Czech Republic*, the Claimants submit that the fair and equitable treatment standard “prohibits at least six different types of host state misconduct [...], including: (1) a government’s violation of an investor’s legitimate expectations; (2) inconsistent treatment of an investment by different organs or officials of the same government; (3) a lack of transparency that hampers the ability of an investor to operate its investment or understand what is required by the government in order for an investment to succeed; (4) failure by a government to provide adequate advance notice of measures that will negatively impact an investment; (5) governmental treatment of an investment that is in bad faith; and (6) discriminatory conduct” (C-Reply, ¶¶ 367; 374). In later submissions the Claimants group categories (2), (3) and (4) into one single category covering lack of transparency (C-PHB, ¶¶ 51-62). The Claimants also seem to suggest that the fair and equitable treatment standard requires the state to ensure a stable and predictable legal and business environment beyond the protection of an investor’s legitimate expectations (C-SoC, ¶ 211, C-Reply, ¶¶ 424-430).

470. The Claimants contend that Romania’s treatment of the Claimants’ investments fell below the standard of treatment required by the fair and equitable treatment obligation of the BIT. Specifically, the Claimants submit that Romania (i) failed to provide a stable and predictable legal framework and violated the Claimants’ legitimate expectations, (ii) failed to act transparently with respect to the Claimants’ investments, and (iii) acted in bad faith with respect to those investments.
471. First, the Claimants contend that Romania breached the fair and equitable treatment standard by failing to provide a stable and predictable legal and business environment for the investment, and in particular by violating the Claimants’ legitimate expectations with respect to that regulatory framework.
472. The Claimants submit that the core element of the fair and equitable obligation is to ensure a consistent and stable legal environment (C-SoC, ¶¶ 211-225; C-Reply, ¶¶ 424-430; C-PHB, ¶¶ 40-41). Numerous tribunals concur with this interpretation of the obligation (*Metalclad v. Mexico*<sup>55</sup>, *Tecmed v. Mexico*, *CMS v. Argentina*, *Eureko v. Poland*, *Bayindir v. Pakistan*<sup>56</sup>, *LG&E v. Argentina*, *Duke Energy v. Ecuador*<sup>57</sup>, *PSEG v. Turkey*<sup>58</sup>, *Enron v. Argentina*). The fair and equitable treatment standard extends to regulation in matters of taxation (*Occidental v. Ecuador*<sup>59</sup>). For this obligation to be

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<sup>54</sup> *Saluka Investments BV (the Netherlands) v. Czech Republic*, UNCITRAL, Partial Award, 17 March 2006 (hereinafter “*Saluka v. Czech Republic*” or “*Saluka*”).

<sup>55</sup> *Metalclad Corporation v. United Mexican States* (ICSID Case No. ARB(AF)/97/1), Award, 30 August 2000 (hereinafter “*Metalclad v. Mexico*” or “*Metalclad*”).

<sup>56</sup> *Bayindir Insaat Turizm Ticaret Ve Sanayi A.S. v. Islamic Republic of Pakistan* (ICSID Case No. ARB/03/29), Decision on Jurisdiction, 14 November 2005 (hereinafter “*Bayindir v. Pakistan*”).

<sup>57</sup> *Duke Energy Electroquil Partners and Electroquil S.A. v. Republic of Ecuador*, ICSID Case No. ARB/04/19, Award, 18 August 2008 (hereinafter “*Duke Energy v. Ecuador*”).

<sup>58</sup> *PSEG Global Inc. and Konya Ilgin Elektrik Üretim ve Ticaret Limited Şirketi v. Republic of Turkey* (ICSID Case No. ARB/02/5), Award, 19 January 2007 (hereinafter “*PSEG v. Turkey*”).

<sup>59</sup> *Occidental Exploration and Production Company v. The Republic of Ecuador*, LCIA Case No. UN3467, Final Award, 1 July 2004 (hereinafter “*Occidental v. Ecuador*”).



breached, investors do not need to have a contract with the state containing a stabilization clause.

473. In particular, the Claimants argue that the fair and equitable treatment standard requires the state to protect the investor's legitimate expectations based on the legal framework at the time of the investment and on any undertakings and representations made explicitly or implicitly by the host state. The legal framework on which the investor is entitled to rely consists of legislation and treaties, and assurances contained in decrees, licenses and similar executive assurances, as well as in contractual undertakings. Relying on a number of investment cases, the Claimants argue that a state will violate the fair and equitable treatment standard if it reverses assurances that have resulted in the investor's legitimate expectations (C-SoC, ¶¶ 211-228, citing *Metalclad v. Mexico*, *Tecmed v. Mexico*, *CMS v. Argentina*, *Eureko v. Poland*, *Bayindir v. Pakistan*, *LG&E v. Argentina*, *PSEG v. Turkey*, and *Occidental v. Ecuador*).
474. The Claimants contend that Romania failed to provide a stable and predictable legal and business environment for their investment, and undermined their legitimate expectations with respect to the regulatory framework. Specifically, they argue that Romania created a special regulatory regime for disfavored regions that consisted of certain tax exemptions and other incentives promised for a 10 year period. This special regime instilled in the Claimants the legitimate expectation that the EGO 24 incentives would remain in place during the 10 year period that Ștei-Nucet was designated a disfavored region. The Claimants assert that this legitimate expectation was an essential basis for their investment, and without it the Claimants would not have invested in the manner that they did. Having enticed the Claimants to make substantial investments in reliance on these incentives, in February 2005 Romania changed its legislation and withdrew most of the EGO 24 incentives, four years before they were scheduled to expire. The Claimants argue that, by prematurely revoking the EGO 24 incentives, Romania failed to provide a predictable and stable legal framework for the Claimants to plan their investments, and in particular violated their legitimate expectation that these incentives would be in place for the promised 10-year period.
475. The Claimants clarify that the obligation to accord fair and equitable treatment does not mean that a state must completely freeze its regulatory regime (and the Claimants acknowledge that a stabilization clause would be needed to obtain that result). However, it does mean that, by entering into the BIT, Romania accepted limitations on its power to fundamentally alter the regulatory framework of the investment, particularly in ways that would be unfair, unreasonable and inequitable, including by undermining an investor's legitimate expectations (C-PHB, ¶ 40). As a result, Romania could not, consistent with the BIT, simply dispense with the legal framework it had put in place, but instead was required to meet its commitments with respect to investors. Specifically, the Claimants concede that Romania was entitled to revoke the incentives it had put in place if it grandfathered them for existing PIC holders (as it did with the Profit Tax Incentive).

476. Second, the Claimants contend that Romania breached its obligation to accord them fair and equitable treatment by acting in a manner that was not transparent.
477. The Claimants submit that the obligation to accord fair and equitable treatment requires that the state's conduct toward investors and its legal environment must be transparent (i.e., free from ambiguity and uncertainty). The Claimants rely on *Metalclad v. Mexico*, *Tecmed v. Mexico*, *Waste Management v. Mexico II*, *Saluka v. Czech Republic*, *Bayindir v. Pakistan*, *Occidental v. Ecuador*, *CMS v. Argentina*, *LG&E v. Argentina*, *PSEG v. Turkey*, and an UNCTAD study.<sup>60</sup> In particular, the *Tecmed* tribunal held that a foreign investor "expects the host state to act in a consistent manner, free from ambiguity and totally transparently in its relations with the foreign investor, so that it may know beforehand any and all rules and regulations that will govern its investments, as well as the goals of the relevant policies and administrative practices or directives, to be able to plan its investment and comply with such regulations." (*Tecmed*, ¶ 154). Similarly, the late Prof. Thomas Wälde noted that transparency requires "that government administration has to make clear what it wants from the investor and cannot hide behind ambiguity if it has created such ambiguity and contradiction itself."<sup>61</sup>
478. The Claimants contend that Romania acted in a manner that was not transparent. Specifically, they argue that Romania actively pursued two conflicting policies: on the one hand, it promoted the EGO 24 incentives, and at the same time it negotiated their revocation behind closed doors. In addition, they argue that Romania's conduct with respect to the validity of the EGO 24 incentives was contradictory and the manner in which they were revoked created uncertainty.
479. Third, the Claimants argue that Romania acted in bad faith with respect to the Claimants' investments. The Claimants contend that the fair and equitable treatment standard is breached if the host state acts in bad faith (C-SoC, ¶ 243, C-Reply ¶¶ 443-449). Although bad faith is not required for a violation of the standard to occur (*Tecmed v. Mexico*, *Mondev v. United States*<sup>62</sup>, *Loewen v. United States*<sup>63</sup>, *CMS v. Argentina*), the Claimants argue that host state measures taken in bad faith against an investor violate the fair and equitable treatment standard (*Waste Management v. Mexico II*, *Tecmed v. Mexico*, *Bayindir v. Pakistan*, *Saluka v. Czech Republic*).
480. Finally, the Claimants contend that Romania's responsibility for violation of the fair and equitable treatment standard arises regardless of its motives, and irrespective of any showing of bad faith (although, as explained above the Claimants do argue that Romania acted in bad faith). Consequently, the Claimants do not need to show that

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<sup>60</sup> UNCTAD Series on issues in international investment agreements, Fair and Equitable Treatment, p. 51 (1999) (Exh. C-74).

<sup>61</sup> T.W. Wälde, Energy Charter Treaty-based Investment Arbitration, 5 *The Journal of World Investment* 387 (2004), (Exh. C-94).

<sup>62</sup> *Mondev International Ltd. v. United States of America* (ICSID Case No. ARB(AF)/99/2), Award, 11 October 2002 (hereinafter "*Mondev v. United States*" or "*Mondev*").

<sup>63</sup> *The Loewen Group, Inc. and Raymond L. Loewen v. United States of America* (ICSID Case No. ARB(AF)/98/3), Award, 26 June 2003 (hereinafter "*Loewen v. United States*").

Romania acted with an improper motive in order to establish violation of the fair and equitable treatment standard. Conversely, a showing of good faith or legitimate cause on Romania's part does not excuse a violation of the fair and equitable treatment standard (C-SoC, ¶¶ 242-252, citing, *inter alia*, *Mondev v. United States*; *Tecmed v. Mexico*, *Loewen v. United States*, *Occidental v. Ecuador*, and *PSEG v. Turkey*).

481. Accordingly, the Claimants submit that, no matter how laudable or justifiable Romania's motives might have been, they do not excuse the fact that Romania breached the fair and equitable treatment standard. Whether Romania withdrew the incentives for fiscal reasons, for reasons of international economic policy or for other reasons of public interest, is irrelevant (C-SoC, ¶ 252). In particular, as discussed in Section V(B) above on Applicable Law, the Claimants contend that Romania's "EU law" defense does not immunize Romania from liability.

**b. The Respondent's position**

482. With respect to the content of the fair and equitable treatment standard, the Respondent does not dispute that many of the decisions cited by the Claimants can provide useful guidance to the Tribunal, subject to the general interpretative principles applicable to this dispute as explained in Section V(B) above on Applicable Law. Indeed, the Respondent concedes that "[m]ost of the general principles governing the interpretation of the fair and equitable treatment standard form common ground between the Parties" (R-CM, ¶ 101). In particular, the Respondent does not dispute that Article 2(3) of the BIT must be interpreted in accordance with Articles 31 and 32 of the VCLT, according to which the Tribunal must first look to the plain meaning or the language of the provision, and in the event of ambiguity construe the relevant provision in its context and in the light of the objective and purpose of the BIT (*Id.*). However, the Respondent disputes Claimants' actual interpretation of these terms.
483. With respect to the plain meaning of the provision, the Respondent accepts for present purposes the Claimants' definition of "fair and equitable" as "free from bias, fraud or injustice" and "even-handed dealing." The Respondent also concurs with the Claimants' reliance on *Waste Management v. Mexico II*, where the Tribunal concluded that:
- ... fair and equitable treatment is infringed by conduct attributable to the State and harmful to the claimant if the conduct is arbitrary, grossly unfair, unjust or idiosyncratic, is discriminatory and exposes the claimant to sectional or racial prejudice, or involves a lack of due process leading to an outcome which offends judicial propriety ...
484. The Respondent agrees that the preamble of the BIT reflects the signatories' goal of intensifying economic cooperation between Romania and Sweden. However, the BIT's preamble does not in itself indicate what interpretation of "fair and equitable treatment" is appropriate to achieve this goal. The proper approach depends upon the state parties' intentions with respect to the intensification of economic relations. The Respondent submits that this intention was to intensify economic relations in the context of Romania's integration into the EU (R-CM, ¶ 108).

485. In this regard, the Respondent argues that the BIT was signed pursuant to Article 74 of the Europe Agreement (to which both Sweden and Romania were parties), which calls for Romania to enter into investment protection agreements with EU Member States. The goal of the Europe Agreement was to establish close and lasting economic political integration between Romania and the EU, with the ultimate goal of EU accession. For this, Romania undertook to harmonize Romanian law with EU law (Articles 69 and 70 of the Europe Agreement). Accordingly, the Respondent submits that “the fair and equitable treatment standard contained in the [BIT] must therefore be interpreted consistently with any requirements for Romania’s integration into the EU, including the elimination of impermissible State aid [...]”(R-CM, ¶ 109).
486. The Respondent further contends that, under the Europe Agreement, the Accession Agreement and the EC Treaty, Romania owed an obligation to Sweden to eliminate all state aid that did not conform to EU law and that distorted competition in the common market. As a result, Romania and Sweden could not have intended that Romania’s obligation to afford fair and equitable treatment to Swedish investors would require the preservation of non-conforming State aid. In other words, “the object and purpose of the [BIT], and the context in which it was concluded as an integral part of Romania’s integration into the EU, indicate that the [BIT] cannot be construed to sanction as ‘unfair and inequitable’ the adjustment of the Facilities in accordance with the requirements of the Europe Agreement and the *acquis communautaire*” (R-CM, ¶¶ 109-110).
487. Referring to the Claimants’ division of the fair and equitable treatment standard into different “strands”, the Respondent contends that the fair and equitable treatment clause of the BIT is not a laundry list, and there is no claim under the BIT for violating any particular “strand.” Citing *Mondev v. United States*, the Respondent submits that whether a host state has treated an investment fairly and equitably must be assessed in view of all of the facts and circumstances. However, for analytical organization, the Respondent accepts that the Claimants’ allegations may be grouped into three categories, corresponding to types of conduct where other international tribunals have found breaches of the fair and equitable treatment standard (R-PHB, ¶¶ 15-16):
- a. Cases in which the state’s action is alleged to have been substantively improper (for example because it was unreasonable, arbitrary, or discriminatory);
  - b. Cases in which the state’s action is claimed to have violated a promise the state made to the investor, thus upsetting the investor’s “legitimate expectations”, and
  - c. Cases in which a state’s action may be attacked as having been procedurally unfair, as in cases of denial of justice or lack of due process, retroactive or secret regulation, or inconsistent and non-transparent administration (although there are very few awards finding a violation of fair and equitable treatment solely on the basis of this class of allegations).
488. The Respondent denies having engaged in any of these types of conduct. It contends that, given the factual circumstances surrounding the investment, the

Claimants could have had no reasonable expectation that the incentives (facilities) would remain in force unchanged for ten years. The modification of the incentives was wholly predictable and equitable, and Romania conducted itself as consistently and transparently as possible given the historical context of economic transition and EU accession (R-CM, ¶ 100).

489. First, the Respondent denies having engaged in substantively improper conduct. The Respondent contends that, where an investor challenges general legislation that modifies existing general legislation, the question for an international tribunal is whether that legislation is grounded in reason (rather than being arbitrary) and enacted in pursuit of legitimate objectives (rather than for illicit purposes, such as discrimination). Relying on *Saluka v. Czech Republic*, the Respondent argues that for a state's conduct to be reasonable it must "bear a reasonable relationship to some rational policy" (*Saluka*, ¶¶ 309 and 460). This requirement was further developed in *AES v. Hungary*,<sup>64</sup> where the Tribunal found that "two elements" must be analyzed in judging whether a state acted reasonably: "the existence of a rational policy; and the reasonableness of the act of the state in relation to the policy" (*AES v. Hungary*, ¶ 10.3.7). According to that Tribunal, a policy is rational when the state adopts it "following a logical (good sense) explanation and with the aim of addressing a public interest matter" (*Id.*, ¶ 10.3.8), and an action is reasonable when there is "an appropriate correlation between the state's public policy objective and the measure adopted to achieve it" (*Id.*, ¶ 10.3.9).
490. In addition, for there to be a breach of the fair and equitable treatment standard, the state's conduct must be manifestly unreasonable. A state does not breach the standard merely by failing to adopt the optimal course of action. Citing *Glamis Gold v. United States*,<sup>65</sup> the Respondent contends that it is Claimants' burden to prove a manifest lack of reasons for the legislation.<sup>66</sup> (R-PHB, ¶ 33, fn. 50).
491. However, as explained further below, the Respondent argues that the Claimants do not allege that Romania engaged in any fraud, bias or discrimination, or that they were denied justice with respect to the Facilities. Nor do the facts show "grossly unfair, unjust or idiosyncratic" treatment (R-CM, ¶¶ 102-103). To the contrary, Romania argues that its conduct was fair and equitable under the circumstances.
492. Second, the Respondent denies having failed to provide regulatory stability or having violated the Claimants' legitimate expectations. The Respondent contends that the BIT does not require the Contracting States to tailor their laws and regulations to the preference of foreign investors, nor does it create liability for every regulatory change that has a negative impact on the foreign investors' businesses. To the contrary, investment protection treaties accord host States considerable deference in relation

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<sup>64</sup> *AES Summit Generation Limited and AES-Tisza Erömu Kft. v. Hungary* (ICSID Case No. ARB/07/22), Award, 23 September, 2010 (hereinafter "*AES v. Hungary*" or "*AES*").

<sup>65</sup> *Glamis Gold, Ltd. v. The United States of America*, UNCITRAL, Award, 8 June 2009 (hereinafter "*Glamis Gold v. United States*").

<sup>66</sup> *Id.*, ¶ 803.

to regulatory policy (*El Paso v. Argentina*;<sup>67</sup> *S.D. Myers v. Canada*;<sup>68</sup> *Saluka v. Czech Republic*;<sup>69</sup> *Waste Management v. Mexico II*;<sup>70</sup> *Parkerings v. Lithuania*;<sup>71</sup> *Genin v. Estonia*<sup>72</sup>; *Methanex v. United States*<sup>73</sup>). This is a reflection of the fundamental rule of international law that a state's regulatory sovereignty can only be subject to the specific limitations that flow from the international legal obligations that it has voluntarily assumed (relying on *The Case of the S.S. Lotus (France v. Turkey)*<sup>74</sup>) (R-CM, ¶¶ 85-90).

493. As a result, the Respondent argues that where a state has exercised its sovereign powers to regulate in a general, non-discriminatory way to advance public welfare (including by legislative changes), international law will not characterize such conduct as “expropriation”, “unfair and inequitable treatment”, or otherwise in breach of the provisions of an investment protection treaty. International law (and the BIT) does not call for a regulatory standstill, and there is no warrant that a legal regime will remain unaltered. Laws are inherently liable to change, even when the original legislative intent was to create a permanent regime or a regime for a given period (*Continental Casualty v. Argentina*, ¶ 258). The Respondent concedes that international law will require observance of specific commitments about the stability of legislation, but contends that such commitments will not be lightly inferred, and are never to be found in general legislative texts. Rather, they may be found in stabilization terms specially bargained for with specific investors (R-CM, ¶ 91).
494. In the present case, it is undisputed that the modification of the Facilities that had been granted pursuant to EGO 24/1998 was a generally applicable act. Moreover, Romania was compelled to curtail the Facilities as an essential precondition for accession to the EU. Accordingly, in considering Romania's compliance with the substantive provisions of the BIT, Romania is entitled to the deference under international law (R-CM, ¶ 92). The modification of the Facilities was fair under the circumstances. In light of the plain meaning of Article 2(3), Romania argues that an examination of the Claimants' supposed expectations is unnecessary. In any event, Romania contends that the Claimants had no legitimate expectations that were undermined by the modification of the Facilities.
495. The Respondent agrees that the doctrine of legitimate expectations is part of the general duty to afford fair and equitable treatment. However, under this doctrine a

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<sup>67</sup> *El Paso Energy International Company v. Argentine Republic* (ICSID Case No. ARB/03/15), Decision on Jurisdiction, 27 April 2006 (hereinafter “*El Paso v. Argentina*”), ¶ 70.

<sup>68</sup> *S.D. Myers, Inc. v. Government of Canada*, UNCITRAL, Partial Award, 13 November 2000 (hereinafter “*S.D. Myers v. Canada*”), ¶ 263.

<sup>69</sup> *Saluka v. Czech Republic*, ¶ 305.

<sup>70</sup> *Waste Management v. Mexico II*, ¶ 94.

<sup>71</sup> *Parkerings v. Lithuania*, ¶ 332.

<sup>72</sup> *Alex Genin and others v. Republic of Estonia* (ICSID Case No. ARB/99/2), Award, 25 June 2001 (hereinafter “*Genin v. Estonia*”), ¶ 370.

<sup>73</sup> *Methanex Corporation v. United States of America*, UNCITRAL, Final Award, 3 August 2005 (hereinafter “*Methanex v. United States*”), Part IV, Ch D, p 4, ¶ 7.

<sup>74</sup> *The Case of the S.S. “Lotus” (France v Turkey)*, PCIJ Series A No 10 (1927).

state would only violate this duty if it exercised its regulatory sovereignty in such a way as to create a legitimate expectation in an investor that the state will or will not act in a certain way in the future. In this way, the state itself derogates from its right and duty to change its regulations. Thus, the Respondent argues that an expectation of regulatory stability must be based on some sort of promise or at the very least, a proper representation made to the investor, on the part of the state. However, “if the state has not committed itself to freeze a particular area of regulation, or to shield an investor from regulatory change, the most an investor can legitimately expect is regulatory rationality and absence of arbitrariness” (R-Rejoinder, ¶ 169). The Respondent relies on *EDF v. Romania*<sup>75</sup> and *Parkerings v. Lithuania*. The Respondent’s detailed position with respect to the standard of legitimate expectations is addressed in Section 3(b) below.

496. Third, the Respondent asserts it acted transparently and consistently. The Respondent appears to agree that transparency and consistency are a part of the fair and equitable treatment standard. For the Respondent, this “strand” refers to whether Romania complied with due process and fair administration. The Respondent notes that the UNCTAD report cited by the Claimants states the following:

If laws, administrative decisions and other binding decisions are to be imposed upon a foreign investor by a host State, then fairness requires that the investor is informed about such decisions before they are imposed.<sup>76</sup>

497. According to the Respondent, this means that investors should be able to find out what the rules are and how to comply with them, and the rules should be administered in an even-handed and reasonably consistent fashion (R-PHB, ¶ 160).
498. In the present case, the Respondent argues, the Claimants do not contend that Romania was unclear about the rules and procedures they had to follow, or that the rules were applied inconsistently. Rather, the Claimants contend that they were not given enough information about ongoing diplomatic negotiations. The Respondent argues that there is no authority suggesting that international investment law requires a state to disclose its assessment of the likely outcome of such negotiations. As a result, the Respondent argues that “the Claimants’ contentions are not only irrelevant as a matter of law but illogical as a matter of fact: if, as the Claimants seemed to suggest at the hearing, Romania should have publicly announced at the earliest possible date that it did not expect to obtain the EU’s agreement to continue the EGO Facilities in force, the only possible difference is that the Claimants would have lost the benefit of the Facilities sooner” (R-Rejoinder, ¶ 161). Likewise, the Respondent argues that there is no need to warn investors of legislative changes, in particular in legal and political environments that are unpredictable and evolving (*Parkerings*, ¶¶ 341-342, 345).

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<sup>75</sup> *EDF (Services) Limited v. Romania* (ICSID Case No. ARB/05/13), Award, 8 October 2009 (hereinafter “*EDF v. Romania*”).

<sup>76</sup> “Fair and Equitable Treatment”, UNCTAD Series on Issues in International Investment Agreements (1999) 3 UNCTAD/ITE/IIT/11, Exh. C–527, quoted at ¶ 433 of the Claimants’ Reply.

499. In view of the above, the Respondent submits that there are four propositions that the Claimants must prove in order for their fair and equitable treatment claim to succeed, and they have failed to prove them. These propositions are (Tr., Day 13, 45:1-20 (King)):
- (i) First, the Claimants must prove that Romania's actions, and in particular the 31 August 2004 amendment of EGO 24, were manifestly unreasonable.
  - (ii) Second, the Claimants must prove that Romania promised them ten years of stabilization of the EGO 24 facilities.
  - (iii) Third, the Claimants must prove that they made investments in reasonable reliance on the legitimate expectation that the EGO 24 facilities would not change until 2009.
  - (iv) Fourth, the Claimants must prove that Romania acted in such a non-transparent and inconsistent way as to violate the fair and equitable treatment clause.
500. The Respondent has clarified that these propositions are not cumulative except (ii) and (iii). In other words, the Respondent's position is that the Tribunal could find a breach if the Claimant can prove that either proposition (i), propositions (ii) and (iii) jointly, or proposition (iv) are true (Tr., Day 13, 58:5-60:7).
501. In addition, as noted in paragraph 279 above, the Respondent argues as a general matter that the Claimants' case on fair and equitable treatment hinges on the testimony of their witnesses, which the Respondent contends is neither credible nor reliable. It also argues that, despite the Claimants' shift in focus, this is not and has never been a case about whether Romania acted transparently; it has only become so because the hearing undermined the Claimants' previous legal theories (Tr., Day 13, 19-43 (King)).

## **2. Nature, interpretation and content of the fair and equitable treatment standard**

502. The Tribunal will now address the nature, interpretation and content of the fair and equitable treatment standard.

### **a. Interpretation and general contours of the standard**

503. The Parties seem to agree on the basics of the fair and equitable treatment standard, with certain nuances. The Respondent does not contest the Claimants' portrayal of the standard as an autonomous one, different from the international minimum standard. Nor does it contest that the standard has specific meaning. Likewise, both Parties agree that the interpretation of Article 2(3) of the BIT should start from the normal canons of treaty interpretation as contained in Articles 31 and 32 of the VCLT. Romania is not a party to the VCLT, but it is common ground that the VCLT reflects



customary international law<sup>77</sup> and Romania relies on it as the appropriate method to interpret the BIT.<sup>78</sup>

504. To establish the content of the standard, the Tribunal must first turn to the plain meaning of the terms “fair and equitable.” The plain meaning of these terms, however, does not provide much assistance. As noted by the tribunal in *MTD v. Chile*, “[i]n their ordinary meaning, the terms ‘fair’ and ‘equitable’ [...] mean ‘just’, ‘even-handed’, ‘unbiased’, ‘legitimate’.”<sup>79</sup> Similarly, the tribunal in *S.D. Myers v. Canada* stated that unfair and inequitable treatment meant “treatment in such an unjust or arbitrary manner that the treatment rises to the level that is unacceptable from the international perspective.”<sup>80</sup> This Tribunal agrees with the *Saluka* tribunal in that “[t]his is probably as far as one can get by looking at the ‘ordinary meaning’ of the terms of Article 3.1 of the Treaty.”<sup>81</sup>

505. The question is rather how those concepts should be applied to the facts. It is undisputed that an analysis of whether a state’s conduct has been fair and equitable requires an assessment of all the facts, context and circumstances of a particular case. As stated in *Mondev v. United States*:

When a tribunal is faced with the claim by a foreign investor that the investment has been unfairly or inequitably treated or not accorded full protection and security, it is bound to pass upon that claim on the facts and by application of any governing treaty provisions. A judgment of what is fair and equitable cannot be reached in the abstract; it must depend on the facts of the particular case.<sup>82</sup>

506. Similarly, the tribunal in *Waste Management II* said that “the standard is to some extent a flexible one which must be adapted to the circumstances of each case.”<sup>83</sup> This has been echoed by several tribunals, including in *Lauder v. Czech Republic*<sup>84</sup>, *CMS v. Argentina*, *Noble Ventures v. Romania*<sup>85</sup>, *Saluka v. Czech Republic*.

507. That being said, as the Claimants point out and the Respondent does not contest, the content of the fair and equitable treatment standard does not depend on a tribunal’s

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<sup>77</sup> See, e.g., *Case Concerning the Territorial Dispute (Libyan Arab Jamahiriya v Chad)*, [1994] ICJ Reports 6, ¶ 41 (“The Court would recall that, in accordance with customary international law, reflected in Article 31 of the 1969 Vienna Convention on the Law of Treaties, a treaty must be interpreted in good faith in accordance with the ordinary meaning to be given to its terms in their context and in the light of its object and purpose. Interpretation must be based above all upon the text of the treaty. As a supplementary measure recourse may be had to means of interpretation such as the preparatory work of the treaty and the circumstances of its conclusion.”)

<sup>78</sup> See, e.g., R-CM, ¶¶ 73-75.

<sup>79</sup> *MTD v. Chile*, ¶ 113.

<sup>80</sup> *S.D. Myers v. Canada*, ¶ 263.

<sup>81</sup> *Saluka v. Czech Republic*, ¶ 297.

<sup>82</sup> *Mondev v. United States*, ¶ 118. See also *M.C.I. Power Group L.C. and New Turbine, Inc. v. Republic of Ecuador* (ICSID Case No. ARB/03/6), Award, 31 July 2007, ¶ 370.

<sup>83</sup> *Waste Management v. Mexico II*, ¶ 99.

<sup>84</sup> *Ronald S. Lauder v. The Czech Republic*, UNCITRAL, Final Award, 3 September 2001 (hereinafter, “*Lauder v. Czech Republic*”).

<sup>85</sup> *Noble Ventures, Inc. v. Romania* (ICSID Case No. ARB/01/11), Award, 12 October 2005.

idiosyncratic interpretation of the standard but “must be disciplined by being based upon state practice and judicial or arbitral case law or other sources of customary or general international law” (C-SoC, ¶ 193, citing *ADF Group*, ¶ 184). The tribunal in *Saluka* held:

This does not imply, however, that such standards as laid down in Article 3 of the Treaty would invite the Tribunal to decide the dispute in a way that resembles a decision *ex aequo et bono*. This Tribunal is bound by Article 6 of the Treaty to decide the dispute on the basis of the law, including the provisions of the Treaty. Even though Article 3 obviously leaves room for judgment and appreciation by the Tribunal, it does not set out totally subjective standards which would allow the Tribunal to substitute, with regard to the Czech Republic’s conduct to be assessed in the present case, its judgment on the choice of solutions for the Czech Republic’s. As the tribunal in *S.D. Myers* has said, the “fair and equitable treatment” standard does not create an “open-ended mandate to second-guess government decision-making”. The standards formulated in Article 3 of the Treaty, vague as they may be, are susceptible of specification through judicial practice and do in fact have sufficient legal content to allow the case to be decided on the basis of law. Over the last few years, a number of awards have dealt with such standards yielding a fair amount of practice that sheds light on their legal meaning.<sup>86</sup>

508. In any event, it is established that the state’s conduct does not need to be egregious to violate the standard (*Mondev, ADF Group, Waste Management II* – see paragraph 524 below).
509. Further, both Parties agree that the fair and equitable treatment standard should be interpreted in the light of the object and purpose of the BIT as reflected in its Preamble. This was also the approach taken by the *Saluka* tribunal, which noted that “[t]he preamble thus links the ‘fair and equitable treatment’ standard directly to the stimulation of foreign investments and to the economic development of both Contracting Parties.”<sup>87</sup> The Respondent further argues that the standard should be interpreted in the broader context of EU accession.
510. The Preamble of the BIT states that the Contracting Parties have agreed on the terms of the BIT:

*desiring* to intensify economic cooperation to the mutual benefit of both States and to maintain fair and equitable conditions for investments by investors of one Contracting Party in the territory of the other Contracting Party,

*recognizing* that the promotion and protection of such investments favour the expansion of the economic relations between the two Contracting Parties and stimulate investment initiatives, [...]

511. The Parties agree that the Preamble reflects the BIT signatories’ goal of intensifying economic cooperation between Romania and Sweden, but disagree on what interpretation of “fair and equitable treatment” is appropriate to achieve this goal. The

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<sup>86</sup> *Saluka v. Czech Republic*, ¶ 284.

<sup>87</sup> *Id.*, ¶ 298.

Claimants do not suggest a specific interpretation of the fair and equitable treatment standard in this context, other than to argue that attracting investors through tax exemptions and other incentives that are promised for a certain period of time, and then withdrawing those incentives unilaterally, is not conducive to the intensification of economic cooperation or to the stimulation of investment initiatives.

512. The Respondent for its part contends that the Contracting Parties' intention was to intensify economic relations in the context of Romania's accession to the EU. The Respondent argues that the BIT was signed pursuant to Article 74 of the Europe Agreement, which prompted Romania to sign investment protection treaties with EU member states. As the goal of the Europe Agreement was to integrate Romania and the EU at a political level, which carried with it the obligation to harmonize Romanian law to EU law, the goal of the BIT between Romania and Sweden must be interpreted in this context. Therefore, Romania's obligation to afford fair and equitable treatment to Swedish investors must be interpreted in such a way that it is consistent with EU law.
513. It is undisputed that the Europe Agreement predated the BIT and, indeed, promoted the conclusion of BITs such as the Sweden-Romania BIT. Despite the lack of express reference in the BIT to EU accession or the EU, the Tribunal has also found that the general context of EU accession must be taken into account when interpreting the BIT.
514. That being said, the Tribunal cannot conclude in the abstract (as Romania seems to suggest) that the revocation of the incentives is fair and equitable solely because it was undertaken pursuant to Romania's obligation under the Europe Agreement to harmonize its law with EU law. As previously stated, whether the state's conduct is unfair and inequitable must be assessed in view of all the facts and surrounding circumstances.
515. The Tribunal must bear in mind that the goal of the BIT is the "intensification of] economic cooperation to the mutual benefit of both States" and, in this context, "to maintain fair and equitable conditions for investments by investors of one Contracting Party in the territory of the other Contracting Party", and that when the Contracting States set this goal they recognized "that the promotion and protection of such investments favour the expansion of the economic relations between the two Contracting Parties and stimulate investment initiatives." In this respect, the Claimants argue that the objective of the BIT was to help Romania raise its level of economic development so it could join the EU (Tr., Day 1, 181-184 (Gaillard)).
516. In view of these considerations, the Tribunal favors a balanced view of the goals of the BIT similar to that adopted by the *Saluka* tribunal:

This is a more subtle and balanced statement of the Treaty's aims than is sometimes appreciated. The protection of foreign investments is not the sole aim of the Treaty, but rather a necessary element alongside the overall aim of encouraging foreign investment and extending and intensifying the parties' economic relations. That in turn calls for a balanced approach to the interpretation of the Treaty's substantive provisions for the

protection of investments, since an interpretation which exaggerates the protection to be accorded to foreign investments may serve to dissuade host States from admitting foreign investments and so undermine the overall aim of extending and intensifying the parties' mutual economic relations.

Seen in this light, the "fair and equitable treatment" standard prescribed in the Treaty should therefore be understood to be treatment which, if not proactively stimulating the inflow of foreign investment capital, does at least not deter foreign capital by providing disincentives to foreign investors. An investor's decision to make an investment is based on an assessment of the state of the law and the totality of the business environment at the time of the investment as well as on the investor's expectation that the conduct of the host State subsequent to the investment will be fair and equitable.<sup>88</sup>

517. Finally, the Tribunal agrees with the Respondent that the fair and equitable treatment standard is not a laundry list of potential acts of misconduct. Whether a state has treated an investor's investments unfairly and inequitably defies abstract analysis or definitions, and can only be assessed when looking at the totality of the state's conduct. As noted by the tribunal in *Total S.A. v. Argentina*,<sup>89</sup> "[s]ince this standard is inherently flexible, it is difficult, if not impossible, 'to anticipate in the abstract the range of possible types of infringements upon the investor's legal position'."<sup>90</sup>
518. Nonetheless, as noted by Professors Dolzer and Schreuer, one way to "gauge the meaning of an elusive concept such as FET" is "to identify typical factual situations to which this principle has been applied. An examination of the practice of tribunals demonstrates that several principles can be identified, which are embraced by the standard of fair and equitable treatment."<sup>91</sup> As noted by the *Total* tribunal, "[o]n the premise that a 'judgement of what is fair and equitable cannot be reached in the abstract; it must depend on the fact[s] of the particular case' and that 'the standard is to some extent a flexible one which must be adapted to the circumstances of each case', tribunals have endeavoured to pinpoint some typical obligations that may be included in the standard, as well as types of conduct that would breach the standard, in order to be guided in their analysis of the issue before them."<sup>92</sup>
519. According to Dolzer and Schreuer, tribunal practice shows that the concepts of transparency, stability and the protection of the investor's legitimate expectations play a central role in defining the FET standard, and so does compliance with contractual obligations, procedural propriety and due process, action in good faith and freedom

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<sup>88</sup> *Saluka v. Czech Republic*, ¶¶ 304-309.

<sup>89</sup> *Total S.A. v. Argentine Republic* (ICSID Case No. ARB/04/01), Decision on Liability, 27 December 2010 (hereinafter "*Total S.A. v. Argentina*" or "*Total*").

<sup>90</sup> *Total S.A. v. Argentina*, ¶ 107.

<sup>91</sup> R. Dolzer and C. Schreuer, *Principles of International Investment Law*, 2008, p. 133.

<sup>92</sup> *Total S.A. v. Argentina*, ¶ 109.

from coercion and harassment.<sup>93</sup> Cases reflecting these conclusions include *Bayindir v. Pakistan*<sup>94</sup> and *Total S.A. v. Argentina*.<sup>95</sup>

520. In this context, the Parties appear to agree that there are certain types of conduct that are usually deemed to violate the fair and equitable treatment standard, bearing in mind the facts of the particular case. For analytical purposes, the Tribunal will use the Respondent's distinction between (i) conduct that is substantively improper (because it is arbitrary, unreasonable, discriminatory or in bad faith), (ii) conduct that violates legitimate expectations relied upon by the investor (including here the Claimants' stability "strand"), and (iii) conduct that is procedurally improper. That being said, the Tribunal is not persuaded that the Claimants' claim that Romania acted non-transparently and inconsistently is based on an assertion that the violation is "procedural," so the Tribunal will not use the Respondent's terminology for that claim.
521. The Tribunal addresses the standard for substantively proper conduct in Section (b) below, the standard for determining when a legitimate expectation has arisen in Section (c) below, and the standard for transparency in Section (d) below.

**b. Conduct that is substantively improper**

522. There is no dispute that conduct that is substantively improper, whether because it is arbitrary, manifestly unreasonable, discriminatory or in bad faith, will violate the fair and equitable treatment standard. As stated by the *Waste Management II* tribunal:

"[T]he minimum standard of treatment of fair and equitable treatment is infringed by conduct attributable to the State and harmful to the claimant if the conduct is arbitrary, grossly unfair, unjust or idiosyncratic, is discriminatory and exposes the claimant to sectional or racial prejudice, or involves a lack of due process leading to an outcome which offends judicial propriety—as might be the case with a manifest failure of natural justice in

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<sup>93</sup> *Id.*

<sup>94</sup> *Bayindir v. Pakistan*, Award, 27 August 2009, ¶ 178 ("The Tribunal agrees with Bayindir when it identifies the different factors which emerge from decisions of investment tribunals as forming part of the FET standard. These comprise the obligation to act transparently and grant due process [*Metalclad v. Mexico*], to refrain from taking arbitrary or discriminatory measures [*Waste Management v. Mexico II*, *Lauder v. Czech Republic*], from exercising coercion [*Saluka v. Czech Republic*] or from frustrating the investor's reasonable expectations with respect to the legal framework affecting the investment [*Duke Energy v. Ecuador*].")

<sup>95</sup> *Total S.A. v. Argentina*, ¶¶ 109 ("A breach of the fair and equitable treatment standard has been found in respect of conduct characterized by 'arbitrariness' [*ELSI* case] and of 'acts showing a wilful neglect of duty, an insufficiency of action falling far below international standards, or even subjective bad faith' [*Genin v. Estonia*]. It has been also held that the standard requires 'treatment in an even-handed and just manner, conducive to fostering the promotion of foreign investment' [*MTD v. Chile*], thereby condemning conduct that is arbitrary, grossly unfair, unjust or idiosyncratic or that 'involves a lack of due process leading to an outcome which offends judicial propriety – as might be the case with a manifest failure of natural justice in judicial proceedings or a complete lack of transparency and candour in administrative process' [*Waste Management v. Mexico II*]. Awards have found a breach in cases of discrimination against foreigners and 'improper and discreditable' or 'unreasonable' conduct. [*Saluka v. Czech Republic*] This does not mean that bad faith is necessarily required in order to find a breach: 'A State may treat foreign investment unfairly and inequitably without necessarily acting in bad faith.' [*Mondev v. U.S.*]").

judicial proceedings or a complete lack of transparency and candour in an administrative process. In applying this standard it is relevant that the treatment is in breach of representations made by the host State which were reasonably relied on by the claimant.”<sup>96</sup>

523. On this subject, the *Saluka* tribunal stated:

A foreign investor protected by the Treaty may in any case properly expect that the Czech Republic implements its policies bona fide by conduct that is, as far as it affects the investors' investment, reasonably justifiable by public policies and that such conduct does not manifestly violate the requirements of consistency, transparency, even-handedness and nondiscrimination. In particular, any differential treatment of a foreign investor must not be based on unreasonable distinctions and demands, and must be justified by showing that it bears a reasonable relationship to rational policies not motivated by a preference for other investments over the foreign-owned investment.<sup>97</sup>

524. That being said, it is well established that the state's conduct need not be outrageous to breach the fair and equitable treatment standard. In *Mondev v. United States*, the tribunal held that “[t]o the modern eye, what is unfair or inequitable need not equate with the outrageous or the egregious. In particular, a state may treat foreign investment unfairly and inequitably without necessarily acting in bad faith.”<sup>98</sup> This finding was echoed by the tribunal in *Waste Management v. Mexico II*:

Both the *Mondev* and *ADF* tribunals rejected any suggestion that the standard of treatment of a foreign investment set by NAFTA is confined to the kind of outrageous treatment referred to in the *Neer* case, i.e. to treatment amounting to an “outrage, to bad faith, to wilful neglect of duty, or to an insufficiency of governmental action so far short of international standards that every reasonable and impartial man would readily recognize its insufficiency.”<sup>99</sup>

525. With respect to the meaning of the term “unreasonable”, both Parties appear to agree that “unreasonable” means lacking in justification or not grounded in reason (i.e., arbitrary), or not enacted in pursuit of legitimate objectives (C-Reply, ¶ 454; R-PHB, ¶ 33). The Respondent also proposes the formulation used by the *Saluka* tribunal: for a state's conduct to be reasonable, it must “bear a reasonable relationship to rational policies [...]”<sup>100</sup> Although the definition is rather circular, the Tribunal finds it appropriate, with the specification made by the *AES* tribunal, namely that the determination of whether the state's conduct is reasonable requires the analysis of two elements: “the existence of a rational policy; and the reasonableness of the act of

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<sup>96</sup> *Waste Management v. Mexico II*, ¶ 98. The Tribunal notes that, strictly speaking, this case refers to the minimum standard of treatment contained in NAFTA Article 1105. However, both Parties have relied on this definition in their submissions in this case, so the Tribunal understands that they accept that it is relevant for the fair and equitable treatment standard under the BIT.

<sup>97</sup> *Saluka v. Czech Republic*, ¶ 307.

<sup>98</sup> *Mondev v. U.S.*, ¶ 116.

<sup>99</sup> *Waste Management v. Mexico II*, ¶ 93. This paragraph has been cited by many different tribunals, including *Chemtura Corporation v. Government of Canada*, UNCITRAL, Award, 2 August 2010 (hereinafter, “*Chemtura v. Canada*”), ¶ 215. See Dolzer & Schreuer p. 129.

<sup>100</sup> *Saluka v. Czech Republic*, ¶¶ 309 and 460.

the state in relation to the policy” (*AES v. Hungary*, ¶ 10.3.7). As noted by the AES tribunal, a policy is rational when the state adopts it “following a logical (good sense) explanation and with the aim of addressing a public interest matter” (*Id.*, ¶ 10.3.8), and an action is reasonable when there is “an appropriate correlation between the state’s public policy objective and the measure adopted to achieve it” (*Id.*, ¶ 10.3.9). In other words, for a state’s conduct to be reasonable, it is not sufficient that it be related to a rational policy; it is also necessary that, in the implementation of that policy, the state’s acts have been appropriately tailored to the pursuit of that rational policy with due regard for the consequences imposed on investors.

526. That is not to say that any conduct that is “reasonable” under this definition will be “fair and equitable”. As stated above, the determination of what is fair and equitable cannot be made in the abstract: it requires the assessment of all the factual and legal circumstances surrounding both the state’s conduct and an investor’s investments. There are conceivably cases in which reasonable action by a state in pursuit of a rational policy may nonetheless be unfair with respect to certain investors.

### **c. Regulatory stability and legitimate expectations**

527. The Claimants argue that Romania’s obligation to afford them fair and equitable treatment means that Romania must ensure a stable and predictable legal and business environment, and must protect the Claimants’ legitimate expectations. In turn, the Respondent submits that “[t]he default position in international law is that a state is free to adopt, change, and repeal regulations as it sees fit – so long as its actions are reasonably related to a legitimate public interest and are not discriminatory” (R-Rejoinder, ¶ 9). However, the Respondent concedes that its regulatory sovereignty is limited by the legitimate expectations the state has validly created in investors, provided that these expectations arise from specific assurances entered into by the state, are reasonable, and were the predicate of the Claimants’ investments (R-CM, ¶¶ 111-135; R-Rejoinder, ¶¶ 169-172, 191).
528. The tribunal in *LG&E v. Argentina* stated that “the stability of the legal and business framework in the state party is an essential element in the standard of what is fair and equitable treatment”, and found that it “was an emerging standard of fair and equitable treatment in international law.”<sup>101</sup> This Tribunal agrees as a general matter.
529. However, the fair and equitable treatment obligation is not an unqualified guarantee that regulations will never change. Investors must expect that the legislation will change from time to time, absent a stabilization clause or other specific assurances giving rise to a legitimate expectation of stabilization. The BIT’s protection of the stability of the legal and business environment cannot be interpreted as the equivalent of a stabilization clause. In the Tribunal’s view, the correct position is that the state may always change its legislation, being aware and thus taking into consideration that: (i) an investor’s legitimate expectations must be protected; (ii) the state’s conduct must be substantively proper (e.g., not arbitrary or discriminatory);

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<sup>101</sup> *LG&E v. Argentina*, ¶ 125.

and (iii) the state's conduct must be procedurally proper (e.g., in compliance with due process and fair administration). If a change in legislation fails to meet these requirements, while the legislation may be validly amended as a matter of domestic law, the state may incur international liability.

**d. Transparency / Consistency**

530. Professors Dolzer and Schreuer submit that “[t]ransparency means that the legal framework for the investor’s operations is readily apparent and that any decisions affecting the investor can be traced to that legal framework.”<sup>102</sup> They also state that by now the requirement of transparency is “firmly rooted in arbitral practice.”<sup>103</sup>

531. This was also the view adopted by the tribunal in *Metalclad v. Mexico*, which stated as follows:

The Tribunal understands [transparency] to include the idea that all relevant legal requirements for the purpose of initiating, completing and successfully operating investments made, or intended to be made, under the Agreement should be capable of being readily known to all affected investors of another Party. There should be no room for doubt or uncertainty on such matters. Once the authorities of the central government of any Party (whose international responsibility in such matters has been identified in the preceding section) become aware of any scope for misunderstanding or confusion in this connection, it is their duty to ensure that the correct position is promptly determined and clearly stated so that investors can proceed with all appropriate expedition in the confident belief that they are acting in accordance with all relevant laws.<sup>104</sup>

532. The Tribunal is also mindful that, when defining fair and equitable treatment, the *Tecmed* tribunal stated that:

The foreign investor expects the host State to act in a consistent manner, free from ambiguity and totally transparently in its relations with the foreign investor, so that it may know beforehand any and all rules and regulations that will govern its investments, as well as the goals of the relevant policies and administrative practices or directives, to be able to plan its investment and comply with such regulations. Any and all State actions conforming to such criteria should relate not only to the guidelines, directives or requirements issued, or the resolutions approved thereunder, but also to the goals underlying such regulations.<sup>105</sup>

533. The Tribunal agrees with the general thrust of these statements. However, as noted by the *Saluka* tribunal, such propositions must be considered in the proper context; “taken too literally, they would impose upon host States obligations which would be inappropriate and unrealistic.”<sup>106</sup> Whether a state has been unfair and inequitable by failing to be transparent with respect to its laws and regulations, or being ambiguous

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<sup>102</sup> Dolzer & Schreuer, pp. 133-134 (citing the UNCTAD Series on Issues in International Investment Agreements, Fair and Equitable Treatment (1991) p. 51).

<sup>103</sup> *Id.*

<sup>104</sup> *Metalclad v. Mexico*, ¶ 76.

<sup>105</sup> *Tecmed v. Mexico*, ¶ 154.

<sup>106</sup> *Saluka v. Czech Republic*, ¶ 304.



and inconsistent in their application, must be assessed in light of all of the factual circumstances surrounding such conduct. For example, it would be unrealistic to require Romania to be totally transparent with the general public in the context of diplomatic negotiations. The question before the Tribunal is thus not whether Romania has failed to make full disclosure of or grant full access to sensitive information; it is whether, in the event that Romania failed to do so, Romania acted unfairly and inequitably with respect to the Claimants. The same applies to consistency: the question is not merely whether Romania has acted inconsistently; it is whether, in acting inconsistently, it has been unfair and inequitable with respect to the Claimants. This is a question that cannot be answered in a vacuum; it is highly dependent on the factual circumstances.

534. Whether a state acted in an ambiguous or inconsistent manner is also assessed taking into consideration that state's past conduct which is part of the context. As stated by the *Tecmed* tribunal, "[t]he foreign investor also expects the host State to act consistently, i.e. without arbitrarily revoking any preexisting decisions or permits issued by the State that were relied upon by the investor to assume its commitments as well as to plan and launch its commercial and business activities [...]."<sup>107</sup> It also found that "the Claimant was entitled to expect that the government's actions would be free from any ambiguity that might affect the early assessment made by the foreign investor of its real legal situation or the situation affecting its investment and the actions the investor should take to act accordingly."<sup>108</sup> Consequently, the tribunal found that the investor's legitimate expectations were frustrated by the contradiction and uncertainty in Mexico's conduct, "which [were] prejudicial to the investor in terms of its advance assessment of the legal situation surrounding its investment and the planning of its business activity and its adjustment to preserve its rights."<sup>109</sup>
535. Following this reasoning, the Tribunal will thus now assess the Claimants' claims that Romania acted unfairly and inequitably.

**3. Did Romania fail to provide a predictable and stable legal framework for the Claimants' investments? In particular, did it violate the Claimants' legitimate expectations of regulatory stability?**

**a. The Claimants' position**

536. The Claimants contend that, by prematurely revoking the EGO 24 incentives, Romania failed to provide a predictable and stable legal framework for the Claimants to plan their investments. In particular, they argue that Romania violated their legitimate expectation that these incentives would be in place for the promised 10-year period (C-SoC, ¶¶ 211-228; C-Reply, ¶¶ 359-430; C-PHB, ¶¶ 36-50).
537. The Claimants address the stability and legitimate expectations "strands" of their fair and equitable treatment claim together in their Statement of Claim and Post-Hearing

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<sup>107</sup> *Tecmed v. Mexico*, ¶ 154 (Emphasis added).

<sup>108</sup> *Id.*, ¶ 167.

<sup>109</sup> *Id.*, ¶¶ 172-173.

Brief, but treated the individual claims separately in their Reply. As discussed above, the Tribunal finds that the Claimants' arguments with respect to these two "strands" are closely interlinked, and will thus address them jointly. Indeed, as noted by the tribunal in *Duke v. Ecuador*, "[t]he stability of the legal and business environment is directly linked to the investor's justified expectations."<sup>110</sup>

**i. The standard for determining whether there has been a breach of legitimate expectations**

538. The Claimants argue that the threshold legal question is how a Tribunal should determine whether it was reasonable for an investor to rely on a particular expectation in a particular context. The Claimants rely on *Parkerings v. Lithuania* (at ¶ 331), where the Tribunal held that an investor's expectation is legitimate if:
- a. The investor received an explicit promise or guarantee as to particular legal or regulatory provisions;
  - b. The investor received implicit promises or guarantees to that effect that it then took into account in making its investment; or
  - c. Absent such assurances or representations, the circumstances surrounding the investment were such as to give rise to a legitimate expectation.
539. Contrary to the Respondent's allegations, the Claimants contend that explicit assurances or specific representations from the host state are not required to generate legitimate expectations (C-PHB, ¶ 38). The Claimants' argue this was the position adopted by the tribunals in *Saluka v. Czech Republic*, *Occidental v. Ecuador*, *MTD v. Chile*, and *PSEG v. Turkey*).
540. According to the Claimants, in determining whether an expectation was legitimate, the Tribunal must also consider whether the Claimants conducted due diligence and whether the expectations were reasonable in light of the circumstances (*Parkerings*, ¶ 333). Furthermore, according to the Claimants, whether an expectation was legitimate must be examined at the time the investment was made (*EDF v. Romania*, ¶ 41).
541. The Claimants submit that an investor's expectation must be legitimate at the time when the promise or assurance was made, and when the investors relied on that promise or assurance (Tr., Day 1, 176:3-8 (Gaillard)).
542. In this case, the Claimants argue that Romania made a promise or assurance to them that gave rise to a legitimate expectation (Section (ii) below); the Claimants relied on that assurance (Section (iii) below), and the Claimants' expectation was reasonable (Section (iv) below). They also argue that Romania breached that legitimate expectation when it revoked the EGO 24 incentives (Section (v) below).

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<sup>110</sup> *Duke Energy v. Ecuador*, ¶ 340.

**ii. Romania made a promise or assurance to the Claimants that gave rise to a legitimate expectation**

543. The Claimants submit that Romania made a promise or assurance to the Claimants (i.e., that the EGO 24 incentives would remain in place during the 10 year period that Ștei-Nucet was a disfavored region) that gave rise to a legitimate expectation (C-Reply, ¶¶ 411-423; C-PHB, ¶ 42). As explained in Section A above with respect to the umbrella clause, the Claimants argue that EGO 24 and its implementing legislation (in particular GD 194/1999) gave investors benefiting from that regime through the issuance of a PIC, a right to receive all of the incentives created by EGO 24 until 1 April 2009. Furthermore, the Claimants argue, Romania had a corresponding obligation to grant all of those incentives, substantially unchanged, during that time period. In the event that the Tribunal finds that the legislation did not give rise to an obligation *stricto sensu*, the Claimants argue that the legislation at least constituted a representation or promise that gave rise to a legitimate expectation that those incentives would remain in place until 1 April 2009.
544. The Claimants assert that their legitimate expectation arose “upon the granting to them of their PIC, or in the case of European Food possibly at the time of the granting of its temporary certificate” (Tr., Day 12, 91 (Reed)). In other words, it arose for European Food at the earliest on 9 December 1999, and for Starmill and Multipack on 17 May 2002.
545. According to the Claimants, the promise or assurance that gives rise to their legitimate expectation satisfies the *Parkerings* criteria.
546. First, as explained in Section A above, the Claimants contend that, through the enactment of EGO 24 and its implementing legislation, and through the issuance of investor-specific PICs, Romania explicitly committed to make the incentives available to the Claimants in the Ștei-Nucet disfavored region until 1 April 2009 (C-SoC, ¶ 300; C-Reply, ¶¶ 467-468; C-PHB, ¶¶ 6-24; Tr., Day 12, 70-91 (Reed), 163-164 (Gaillard)).<sup>111</sup> This assurance was made to investors generally through EGO 24 and its implementing legislation, and to the Claimants in particular by means of the issuance of investor-specific PICs to each of the Corporate Claimants that explicitly granted these particular Claimants the benefits of the EGO 24 incentives regime for a period of 10 years. The Claimants argue that this assurance from the Respondent was evident from the language of the relevant regulations and the PICs, and was reinforced by Romania’s conduct. The Claimants stress that these PICs constitute a specific assurance that gives rise to a legitimate expectation, regardless of whether the Tribunal finds that Romania did or did not enter into an obligation with the Corporate Claimants.
547. Second, even absent the express language in EGO 24 and the investor-specific commitments made in the PICs, the Claimants submit that Romania implicitly committed to maintain the incentives for ten years. By offering, reaffirming and

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<sup>111</sup> This argument is also the core of the Claimants’ umbrella clause claim.

maintaining for their designated durations various incentives to invest in disadvantaged regions during the 1990s, Romania demonstrated the reasonableness of relying on the stability of the EGO 24 incentives and the rights embodied in the PICs. In addition, the fact that Romania offered the Raw Materials Incentive in 1998 – three years after it subjected itself to EU state aid requirements – reflected Romania’s own belief that the incentive was permissible under those requirements and its intent to maintain the incentives regime despite the ongoing EU accession negotiations. Moreover, when the Romanian Competition Council issued its findings in 2000 questioning the legality of the Raw Materials Incentive, the Government disagreed with and opposed those findings, which were ultimately dismissed by Romanian courts.

548. Third, the Claimants submit that the circumstances surrounding their investments demonstrate Romania’s commitment to maintain the incentives for ten years. The Claimants argue that “this is not a case of an investor taking advantage of a legal regime that just happened to be in place at the time of investment, and then complaining when the host state legislated a new regime. Rather, the regime was specifically designed to attract investors like Claimants, so that they would spend money and create jobs in Romania’s disadvantaged regions” (C-Reply, ¶ 421).
549. As a result, the Claimants submit that this interpretation is the only one that makes sense from a teleological standpoint. According to the Claimants, if the incentives could have been revoked at any time, they would have been ineffective in incentivizing investment, because investors would have lacked the certainty that they would have needed to commit funds.
550. The Claimants argue that Romania was successful in attracting investors, but revoked the incentives before the Claimants could achieve the benefits that had been used to attract them. In this context, Romania violated the Claimants’ legitimate expectation of basic regulatory stability with respect to the incentives regime.

### **iii. The Claimants relied upon that promise or assurance**

551. The Claimants argue that they relied upon Romania’s promise or assurance when deciding to invest on the scale and at the speed they did in the Ștei-Nucet disfavored region. In particular, they allege that they had a ten-year plan for European Food to capitalize on the EGO 24 benefits. Although the Claimants acknowledge that Messrs. Micula’s initial investments in Bihor County were made in reliance on previous incentive regimes (specifically, Law 35 and GD 27) (C-Reply, ¶¶ 62-124), they claim that they would not have invested in the manner, scale and speed that they did if they had not reasonably relied on the expectation that the EGO 24 incentives regime would remain in place for the full 10-year period (C-Reply, ¶¶ 161-170; C-PHB, ¶ 43; Third WS of I. Micula, ¶¶ 44-64; WS of M. Ban, ¶ 38).
552. The Claimants allege that their investments in Bihor County only made economic sense if they could count on the benefits of the Raw Materials’ Incentive for the 10-year period. Absent that incentive, the Claimants would not have invested in the way

they did, and Romania would not have achieved the socioeconomic benefits in its disadvantaged regions that it sought (C-Reply, ¶ 422).

553. The Claimants contend that Romania is incorrect and misleading when it states that EGO 24 was neither the predicate for the Miculas' initial investment decision, nor the cause of any apparent change in their investment strategy (C-Reply, ¶¶ 62-68). The Miculas allege that they did not invest in Bihor County because of legislative "fluctuations" happening at the time (implying instability); rather, they relied on legislative changes that promoted investment. Prior to the implementation of EGO 24, the Miculas relied on two predecessor state aid regimes, Law 35 and GO 27, which illustrates the reasonableness of the Claimants' reliance on other incentive programs such as EGO 24. In any event, the Miculas did not create the fully integrated and complex facilities that include today's food production business until after 1998, in reliance on EGO 24.<sup>112</sup>
554. The Claimants argue that their reliance on the EGO 24 incentives is proven by the following facts (C-Reply, ¶¶ 165-170, 197-204; C-PHB, ¶ 43):
- a. *The Claimants' decision to invest in Ștei-Nucet instead of Bucharest.* In 1997, the Miculas had planned to relocate from Bihor county to Bucharest, which would have meant considerable cost savings (given its location within Romania's largest market and proximity to the port of Constanța). They had already purchased two companies and land in Bucharest in 1997 and had entered into a contract for bottling lines to be installed in Bucharest in January 1998. However, after learning of the EGO 24 incentives, the Miculas changed their mind and remained in Bihor County. On the understanding that the incentives would last for the full 10 years, they determined that the incentives outweighed the costs of investing in such a remote region (Third WS of I. Micula, ¶¶ 31-36; Third WS of V. Micula, ¶¶ 28-29; Tr., Day 2:211, Day 3:133,141,145-150, Day 4:72-73 (I. Micula); WS of M. Ban, ¶ 38; Exh. C-439; C-346; C-679; C-676-678).
  - b. *The Corporate Claimants were created specifically to benefit from the incentives.* The Articles of Incorporation of European Food state that the company was created "in accordance with the provisions of Law 20/15.01.1999 regarding the approval of EGO 24/1998..." (Exh. HEC-1). The Miculas used European Food to import the majority of the raw materials used by the business to take advantage of customs duties exemptions. Starmill was incorporated to establish integrated in-house grain milling facilities, which would also take advantage of the Raw Materials Incentive and create cost efficiencies. Multipack was incorporated to establish the packaging and labeling for nearly all of the companies' products, and also relied heavily on the Raw Materials Incentive. (Third WS of I. Micula, ¶¶ 47, 55, 59-67; WS of M. Halbac, ¶¶ 17-19; Exh. C-385).

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<sup>112</sup> The Claimants note that Romania's timeline of the Claimants' investments in Romania (R-CM, Figure 1, page 7) shows the dates in which the relevant companies were incorporated, rather than the dates in which Messrs. Micula acquired the shares in the preexisting companies created by others. The Claimants include a "correct timeline" at C-Reply, page 25.

- c. *The scale of the investments, the integration of the Claimants' business model and the Claimants' expansion into new markets such as food and beer, only made economic sense if the incentives were to last for the full 10-year period.* The Claimants allege that their business strategy depended on taking advantage of the incentives to achieve long-term profitability through the vertical integration of their facilities and the construction of cost-saving and revenue-generating capital projects. This would allow them to achieve economies of scale and reduce costs, which would allow them to maintain successful businesses after the expiration of the incentives. However, for this strategy to be successful, they needed sufficient time (and the cash savings provided by the incentives) to integrate their existing operations and construct these additional capital projects, as well as time to penetrate domestic and foreign markets. As explained in Section III.C.2 above, this business strategy contemplated two phases, each of which depended on the availability of the Raw Materials Incentive. The first phase consisted in penetrating the Romanian market with fast-moving consumer products. This would generate quick cash flows, which together with the incentive savings, would allow the companies to integrate vertically and achieve economies of scale, allowing them to save on operational costs and minimize waste and energy consumption. The second phase was to build a brewery and the so-called "Incremental Investments" (malt plant, canning plant and co-generation plant). The Claimants thus planned to use the EGO 24 incentives to expand their production facilities so that they would no longer be dependent on the incentives after their expiration on 2009 (Third WS of I. Micula, ¶¶ 44-46; ¶¶ 59-64, 83-84; Third WS of V. Micula, ¶ 33, 51-52).
- d. *The fact that the obligations were to last for twice the period that the investors benefitted from the incentives.* As the obligations imposed by EGO 24 would last for twice the period that the Claimants benefitted from the incentives, the Claimants argue that they had to invest up-front so as to take advantage of the incentives to develop an integrated business that would be competitive and successful in the long term (Third WS of I. Micula, ¶¶ 59-64; Third WS of V. Micula, ¶¶ 33, 51-52).
- e. *The availability of funding.* Due to the higher debt/equity ratio that would have existed but for the incentives, the Claimants argue that, without the promise that the incentives would last 10 years, it is unlikely that sufficient funding would have been available for the Claimants to invest the way they did (Second ER of C. Osborne, ¶¶ 7.18-7.21).
555. The Claimants argue that the lack of written business plans reflecting their reliance on Romania's assurances is irrelevant. They contend that family businesses such as the Miculas' do not generally prepare all the types of written documents that the Respondent claims should exist. Instead, the Tribunal must consider the actual evidence before it, which shows that the Miculas carefully considered the impact of the incentives, how they could take advantage of those incentives, and how the incentives could be weighed against the disadvantages of investing in a disfavored

region that lacked basic infrastructure and skilled workers, which ultimately led to their decision to invest (C-PHB, ¶¶ 44-45).

556. The Claimants contend that it is likewise irrelevant that the Claimants may have adapted their plans over time to respond to changes in the market; what matters is that the Miculas made specific investment decisions in reliance on the expectation that the incentives would remain in place for 10 years (C-PHB, ¶¶ 46).

**iv. The Claimants' reliance was reasonable**

557. The Claimants' argue that their reliance on the expectation that the EGO 24 incentives would last for the entire 10-year period was reasonable. According to the Claimants, the reasonableness of this expectation is proven by (a) the content of EGO 24 and of its enacting legislation; (b) the content of the PICs; (c) Romania's intimate involvement in the granting and monitoring of the EGO 24 incentives program; (d) Romania's promotion and support of the EGO 24 regime and previous incentive regimes, and (e) Romania's interaction with the Competition Council. In addition, the Claimants argue that, contrary to Romania's contentions, the Claimants' reliance was reasonable in light of Romania's impending accession to the EU.

*(a) The purpose and content of EGO 24 and its enacting legislation*

558. The Claimants submit that the very purpose and content of EGO 24 – and of its enacting legislation – gave rise to a legitimate expectation that the facilities would remain in place until 31 March 2009 (C-Reply, ¶¶ 211-221).
559. First, the Claimants argue that the language of EGO 24 and its implementing legislation were clear, and it was legitimate for the Claimants to rely on that language. In particular, Article 3 of GD 194/1999 declared Ștei-Nucet a disfavored region for a period of 10 years, while Article 4 stated that the incentives were available to investors during the existence of that disfavored region. GD 1199/2000, which amended GD 194/1999, increased the size of the disfavored region to include Drăgănești, confirmed that the region would be declared disfavored for 10 years, and did not amend Article 4 of GD 194/1999. GD 728/2001, which established the Methodological Norms for EGO 24, also stated that investors who had obtained a PIC would continue to benefit from the incentives until the lapse of the period during which the region was declared disfavored (Art. 5(3) of GD 728). Law 20, which enacted EGO 24, allowed this period to be extended (Art. I(5) of Law 20). In the light of these provisions, it was reasonable for the Claimants to believe that the incentives would be granted for the full 10 year period.
560. The Claimants further argue that EGO 24 was designed to induce long-term investments. To this end, Article 9 of EGO 24 required investors to continue to operate in the disfavored regions for twice the period for which they received the incentives, or they would have to repay the amounts they had received and/or saved. This meant that the Claimants had to ensure that their investments lasted for twenty years. Thus, the reciprocal nature of the obligations demonstrated the existence of a

*quid pro quo* between the investors and the state and instilled in the Claimants the reasonable expectation that both parties would comply with their obligations.

561. In addition, because the benefits applied only to new investments, any investor wishing to take advantage of them would either need to make a greenfield investment or reform an outdated facility. The Claimants also had to build their own utility support, which was nonexistent in the region. All of this necessitated significant commitments of capital which only made economic sense if the promised benefits were to last their full, 10-year term.
562. The Claimants further argue that the amendments made to the EGO 24 regime in the following years were made for a variety of reasons and did not give rise to an expectation that the regime would come to an end in early 2005 (C-Reply, ¶¶ 230-238). For example, EGO 75/2000 solved certain practical problems in the application of the incentives and even made some of them more readily available to investors. Although EGO 75/2000 repealed the “Components Facility”, Law 625/2001 reinstated it. GD 1199/2000 extended the disfavored region to include Drăgănești. Law 345/2002 repealed the exemption from customs duties and VAT provided in Art. 6(1) of EGO 24, but did so in the context of a general taxation reform, not for the purpose of regulating state aid. Law 414/2002 repealed the profit tax exemption, but that exemption remained in place for investors (such as the Claimants) who had received PICs prior to 1 July 2002. Although another set of amendments passed in 2002 targeted the Raw Materials Incentive, it was clear from parliamentary debates and other contemporaneous sources that their purpose was to address problems in the meat industry, not the harmonization of Romania’s law with EU law.

*(b) The issuance and content of the PICs*

563. The Claimants argue that the issuance and content of the PICs further enhanced their legitimate expectations that the facilities would remain in place for the entire period (C-Reply, ¶¶ 239-245). All of the Corporate Claimants’ PICs expressly stated that they would be valid until 1 April 2009. The granting of the PICs and the fact that the Government allowed the Claimants to use them repeatedly to receive the benefits confirmed this belief. Further, the PICs confirmed all of the activities for which the Claimants could receive incentives (C-Reply, ¶¶ 156, 159).<sup>113</sup> Thus, the PICs explicitly and implicitly confirmed that the Claimants were entitled to benefit from the incentives until 1 April 2009.
564. According to the Claimants, Romania’s attempts to minimize the importance of investor-specific PICs based on the language granting the incentives “in accordance with the provisions of EGO 24/1998” are unconvincing. That language merely reflects that EGO 24 had been amended prior to the date the PIC was granted. In any event, Multipack’s PIC does not contain that language. Further, the PICs do not contain any language contemplating potential revocation of the incentives.

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<sup>113</sup> The reference seems to be to Exh. C-638, which contains various versions of the PICs and a list of investment activities, but it is unclear to the Tribunal if this list was attached to the original PICs.



(c) *Romania's intimate involvement in the granting of the EGO 24 incentives*

565. The Claimants further submit that the reasonableness of their expectations was reinforced by the state's intimate involvement in the EGO 24 regime and close monitoring of the Claimants' receipt of the EGO 24 benefits (C-Reply, ¶¶ 171-196; 260-272).
566. In this regard, the Claimants allege that they underwent lengthy and detailed approval processes with different government agencies, which kept the Government fully apprised of the Claimants' investment plans and actual investments. Specifically, to obtain their Temporary Investment Certificates they needed to file and secure approval of their investment plan with the NW-RDA (e.g., European Food's investment plan of December 1999 is found at Exh. C-385). Each time they planned a new investment, they had to file updated versions of the investment plans for approval and obtain new, modified PICs that reflected the newly-approved investments. Similarly, to obtain their PICs, the Claimants had to undergo another approval process, including an on-site visit from the NW-RDA to verify that the companies qualified for EGO 24 benefits. In addition, to actually benefit from the incentives, the Corporate Claimants had to obtain approval from different regulatory bodies to verify that they met their EGO 24 requirements. Indeed, each time European Food wanted to import equipment or raw materials it had to submit very specific information regarding the machinery or raw materials it wished to import, as well as the investment purpose.
567. In addition to monitoring and regulating Claimants' activities via the PICs, the NW-RDA and the Oradea Customs Department closely supervised and controlled the Claimants' activities on a day-to-day basis via the continuous approvals processes in relation to the importation of equipment and raw materials. The Claimants' investments were also reviewed outside the approvals process, e.g., through audits, biannual reviews, information obligations, and other monitoring activities.
568. The Claimants thus argue that, through the key role the Romanian authorities played at all levels of the EGO 24 incentives regime, these authorities provided explicit as well as implicit assurances to Claimants that the EGO 24 incentives would be available for their full term. These approval processes allowed the Government to track the amount and type of incentives the Claimants received under the EGO 24 program and ensured that the Claimants received incentives only for those business purposes for which they had obtained approval under their Temporary or Permanent Investor Certificates. Each approval by the Government agencies solidified the Claimants' expectation that the Government had every intention of complying with its obligations under EGO 24, which in turn encouraged the Claimants to continue with their investments.

(d) *Romania's promotion and support of the EGO 24 regime and previous incentive regimes*

569. The Claimants argue that the legitimacy of their expectations and the reasonableness of their reliance was further enhanced by Romania's contemporaneous statements and conduct with respect to the EGO 24 regime and previous incentive regimes.
570. The Claimants first allege that the Government actively promoted the EGO 24 incentives regime in order to induce investments in disfavored areas, and gave assurances as to its 10 year duration (C-Reply, ¶¶ 222-229). The Claimants cite, *inter alia*:
- a. Presentations by Mr. Neculai Liviu Marcu, then President of the NARD, in which he explained the EGO 24 regime and its benefits for investors. In his witness statement submitted in this arbitration, Mr. Marcu states that "[o]n all of the occasions where I presented in disfavoured regions that had been declared as such for a 10 year period I explained that the benefits of the regime would last for the full 10 years" (WS of N. Marcu, ¶ 32);
  - b. Meetings with potential investors run by the NW-RDA and local government representatives (WS of M. Ban, ¶¶ 32-37);
  - c. The NW-RDA's annual reports (Exh. C-393, C-458);
  - d. The preparation of a CD-ROM for international promotion ("Romania – Your Business Partner 1999/2000" (Exh. C-563)).
  - e. Media reports of government initiatives (Exh. C-568 and C-630). In particular, the Claimants allege that the Government's June 2003 press release<sup>114</sup> noted the success of the EGO 24 program and, according to the Claimants, assured that the EGO 24 incentives would continue to be in place at least until Romania joined the EU (Exh. C-489).
  - f. Romania's National Program for Joining the EU, where the Claimants allege that the Government stated that the laws in force at the time would continue to be in place.<sup>115</sup>
571. Further, the Claimants contend that the success of the EGO 24 program – and Romania's public acknowledgement of this fact – reinforced the Claimants' legitimate expectation that the regime would remain in place for the stated term (C-Reply, ¶¶ 273-278). The EGO 24 program was enacted as part of Romania's attempts to address significant economic problems related to regional development and to further Romania's accession aspirations. The Claimants allege that the program was extremely successful in attracting investors to areas in need of capital, and this

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<sup>114</sup> The Claimants refer to June 2002, but the date on Exh. C-489 is 18 June 2003.

<sup>115</sup> The Claimants mistakenly cite Exh. C-489. The correct reference appears to be Exh. HEC-7, which states at page 147 that "[t]he provisions of the normative acts on facilities granted for "D areas" will be maintained till the moment of Romania's accession to the European Union."

success was recognized and hailed by the Government. Romania continued to reaffirm the need for investment and reduction of unemployment in the disfavored regions, and continued to issue PICs and promote the EGO 24 scheme. In this context, it was reasonable for the Claimants to believe that Romania would remain committed to the EGO 24 program.

572. The Claimants also argue that it was reasonable for them to rely on the EGO 24 incentive program and its stated duration because Romania had previously offered and maintained other incentive regimes similar to the EGO 24 regime, including Law 35 and GO 27 (both of which had been implemented in the context of the Europe Agreement and were never challenged by the European Commission or the Government). The Government never revoked the incentives granted under these programs, and when Law 35 ended the incentives were “grandfathered” so that existing investors were able to benefit from them until their original expiration date. The Claimants thus argue that Romania’s consistent pattern of conduct and the Miculas’ successful experience with these previous incentive programs created a course of dealing between Romania and the Claimants that made it reasonable for the Claimants to expect that Romania would maintain the EGO 24 incentive program for its full stated term or at least grandfather its benefits.
573. In addition, the Claimants contend that, under Romanian law, the government was not allowed to revoke the incentives without grandfathering the provisions or compensating the investors. Relying on the testimony of Prof. Mihai, the Claimants argue that new legislation cannot affect acquired rights (Tr., Day 5:207-208, 210, 247 (Mihai)).
574. Finally, the Claimants contend that Romania never suggested to investors that reliance on the EGO 24 regime was inappropriate (C-Reply, ¶¶ 279-280). Romania argues that the Claimants should have somehow known that the EGO 24 regime would come to a premature end. However, until its revocation, the Claimants aver that the Government never suggested to, let alone informed, investors that the regime would not remain in place for the full ten-year period (Tr., Day 9, 21-23 (Juratowitch/Ban)). Instead, the Government continued to promote, apply and support the EGO 24 regime. When Romania finally started to indicate that the incentives could be terminated, Romania did not clearly state the timing and effects of that termination. In fact, Romania suggested that investors that relied on that regime would be protected or compensated.

*(e) Romania’s interaction with the Competition Council*

575. The Claimants further argue that their expectation that the EGO 24 incentives would remain in place for the entire 10 year period was solidified by Romania’s reaction to Decision 244 of the Competition Council (C-Reply, ¶¶ 246-259). In Decision 244 of 15 May 2000 (Exh. R-78), the Competition Council recommended alterations to EGO 24 (including the Raw Materials Incentive and the Machinery Incentive) after finding that the incentives distorted competition. However, the Government ignored Decision 244 and instead adopted EGO 75/2000, which did not implement the

recommendations of Decision 244. The Claimants argue that this suggests that the Government disagreed with Decision 244. Indeed, the Claimants submit that Romania's comments to the Commission's Written Submission in this arbitration suggest that Romania still considered the EGO 24 incentives to be compatible with state aid at that time (C-Reply, ¶ 60, citing Romania's letter of 16 November 2009).

576. The Claimants argue that the Government was right to disagree with Decision 244 for a number of reasons, in particular because it was flawed and was not based on EU competition law considerations. As explained by Prof. Dashwood, its findings were not supported by evidence and were not based on facts relating to the Claimants or their business. The Decision made no reference to the EU or the requirement for Romania to harmonize its laws with those of the EU, nor did it state that EGO 24 was incompatible with EU law. Decision 244 was also silent on whether EGO 24 fell under Article 87(3) of the EU Treaty, which exempts certain forms of state aid, especially aid designed to alleviate under-developed regions, from a general prohibition of aid that distorts competition (ER of A. Dashwood).
577. This disagreement generated a public debate between the Government and the Competition Council, which later led to a lawsuit brought by the Competition Council against the Government. The Government prevailed both in the first instance before the Bucharest Court of Appeal and on appeal before the High Court of Cassation and Justice (Exh. C-528 and C-643; ER of L. Mihai). In both instances the courts held that the Competition Council did not have the authority to challenge emergency government ordinances such as EGO 24, which are legislative acts.
578. According to the Claimants, the Romanian courts' decisions highlighted the Competition Council's lack of authority regarding EGO 24. The Claimants argue that under Law 143/1999 (Exh. R-18) the Competition Council was not authorized to scrutinize all state aid or order government agencies to stop granting aid. With respect to existing state aid (such as the EGO 24 incentives), the Competition Council was only authorized to request the aid provider to remove the incompatibility of the measures with the law, including through a recommendation for cancellation or amendment. But as shown by the Court decisions, the Government was not required to comply, and the Competition Council had no ability to challenge the legislation in court. Indeed, the Government did not comply with the Council's recommendation. This strengthened the Claimants' reasonable belief that the Government was committed to the EGO 24 program. This belief was confirmed by the fact that European Food was granted its PIC on 1 June 2000, only a few weeks after Decision 244 was rendered, and Starmill and Multipack were granted their PICs soon after the Supreme Court Decision was granted.
579. The Claimants further submit that the Government's support of the EGO 24 regime in the face of the opposition of the Competition Council was a strong indicator that the Government considered the EGO 24 regime to be lawful, and made the Claimants' reliance on that regime all the more reasonable. They argue that investors are entitled to assume that the government is acting lawfully, and if the government was acting as if EGO 24 was lawful, the Claimants were entitled to rely on that.

580. In addition, the Claimants conducted sufficient due diligence prior to investing. According to the Claimants, investors cannot be required to conduct a higher standard of due diligence than the government itself: it would be unreasonable to require the investors to know whether Romania would accede to the EU and what effect that would have on EGO 24, if Romania itself did not know that.

(f) *The Claimants' expectations were reasonable in light of Romania's impending accession to the EU*

581. As discussed in Section V.B on Applicable Law, in the Claimants' view EU law plays a different role with respect to the analysis of the Claimants' fair and equitable treatment claim than with respect to its expropriation and umbrella clause claims. With respect to these latter two claims, the Claimants argue that Romania's EU law defense can only be analyzed as a circumstance precluding wrongfulness, and thus should be assessed after the Tribunal has decided whether there is liability under the BIT. In contrast, the Claimants submit that with respect to the fair and equitable treatment claim, Romania's EU law defense is relevant to the determination of the wrongfulness itself; in other words, it is relevant to determining whether Romania has breached the fair and equitable treatment standard. Thus, Romania's EU law defense must be assessed during the Tribunal's analysis of whether the fair and equitable treatment standard has been breached (Tr., Day 1, 159-164, 170-174 (Gaillard)).

582. Specifically, the Claimants argue that EU law is part of the factual matrix against which the Tribunal must determine whether the Claimants' expectations were legitimate and, specifically, whether they were reasonable (Tr., Day 1, 176-177 (Gaillard)). The Claimants deny that, as argued by the Respondent, Romania's impending accession to the EU made their reliance unreasonable. To the contrary, the Claimants contend that their expectation that the Raw Materials Incentive would be afforded to them for 10 years was reasonable despite Romania's accession process. The Claimants stress that this analysis must consider the state of EU law and Romania's relationship with the EU at the time that the expectation arose and at the time the Claimants made their investments in reliance on this expectation (Tr., Day 1, 167 (Gaillard)).

583. First, the Claimants argue that, from a substantive standpoint, the incentives were compatible with EU law. At the very least, it would have been reasonable (from the time in which EGO 24 was enacted and until the incentives were revoked) for an investor to believe that the incentives were compatible with EU law. With the support of their expert in EU law, Prof. Dashwood, the Claimants assert that the incentives could have fallen within the scope of a valid exception to the EC Treaty's prohibition on state aid as provided in Article 87(3)(a) of the EC Treaty (formerly Article 92 of the Treaty establishing the European Economic Community, and incorporated into the Europe Agreement regime by Article 64 of the Europe Agreement), and could have validly constituted regional operating aid under the EU Guidelines on Regional Aid (ER of A. Dashwood, ¶¶ 43-55).

584. The “Implementing Rules” for the application of Article 64 of the Europe Agreement were adopted on 10 April 2001 through Decision 4/2000 of the EU-Romania Association Council (Exh. R-65; C-579).<sup>116</sup> Article 2(1) of the Implementing Rules provided that “[t]he assessment of compatibility of individual aid awards and programmes with the Europe Agreement, as provided for in Article 1 of these Rules, shall be made on the basis of the criteria arising from the application of the rules of Article 87 of the Treaty establishing the European Community [...].”
585. According to Prof. Dashwood, “the criteria applicable in respect of regional aid granted by the Romanian authorities under the regime of the [Europe Agreement] were those of the 1998 Guidelines [on Regional Aid] relating to areas covered by the Article 83(3)(a) derogation” (ER of A. Dashwood, ¶ 22). Prof. Dashwood explained that the Guidelines on Regional Aid distinguished between various types of state aid, and described the circumstances under which certain state aid could be granted. These circumstances included cases where the economic situation was extremely unfavorable in relation to the European Community as a whole, and the Guidelines specified the types of aid that could be granted as tax exemptions. In addition, although Prof. Dashwood acknowledges that while “operating aid aimed at reducing a firm’s current expenditure is normally prohibited, the Guidelines recognise that, exceptionally, such aid may be granted in regions eligible under the derogation in Article 87(3)(a), subject to certain conditions” (ER of A. Dashwood, ¶ 11). Relying on Prof. Dashwood’s expert opinion, the Claimants argue that EGO 24 incentives met all of the criteria for state aid permitted by Art. 87(3)(a). Accordingly, the Claimants argue that the EGO 24 incentives could have qualified under the Art. 87(3)(a) exemption.
586. Indeed, the Claimants argue that Romania itself appears to have believed that, at the time EGO 24 was enacted, the incentives were compatible with EU state aid requirements, noting that Romania itself has acknowledged this point in its submissions in this arbitration (see R-CM, ¶ 29; Respondent’s Comments to the Commission’s Written Submission, 16 Nov. 2009, ¶ 1(b)). Thus, the Claimants argue that any reasonable investor would have relied on Romania’s own position that EGO 24 was compatible with EU law, and would have had no reason to expect the incentives to be prematurely revoked.
587. The Claimants reject Romania’s suggestion that the Implementing Rules effective 2001 (Exh. R-65; C-579) explain why it viewed the incentives compatible with EU law in 1998, but incompatible in 2004 (R-CM, ¶ 20). According to the Claimants, there is nothing in the Implementing Rules to suggest this. Instead, the Implementing Rules clarified that “the procedural rules to ensure effective application of the criteria

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<sup>116</sup> Article 4(1) of the Implementing Rules also extended the time period in which Romania would be considered an underdeveloped area pursuant to Article 64(4)(a) of the Europe Agreement:

In accordance with and within the limits of Article 64(4)(a) of the Europe Agreement, Romania shall be regarded as an area identical to those areas of the Community referred to in Article 87(3)(a) of the Treaty establishing the European Community. (Article 4(1) of Decision 4/2000).

governing the compatibility of aid granted in Romania with the proper functioning of the [Europe] Agreement were left to be determined exclusively as a matter of Romanian law.” (ER of A. Dashwood, ¶ 25). Given that Romania had entered into the Europe Agreement in 1993, it was well aware by 1998 which kinds of state aid it could provide. It is thus inappropriate for Romania to rely on the issuance of the 2001 Implementing Rules to try to argue that in 1998 there was little specific guidance as to whether particular incentive regimes would be permissible under EC state aid rules.

588. According to the Claimants, nothing after the issuance of EGO 24 affects this conclusion. The EC never requested that Romania repeal the EGO 24 incentives, and there was never a determination (by the EC) that the incentives did not qualify for an exemption of Art. 87(3)(a). The only body that examined whether the incentives in EGO 24 were compatible with EU law was the Romanian Competition Council through Decision 244 in 2001. In any event, the Competition Council’s complaint against the Government for failure to apply Decision 244 was dismissed by Romanian courts.

589. Indeed, the Claimants contend that, as late as 2003, the EU was giving signals that it would accept existing aid schemes and would only require that the rules be changed for new entrants. In its Common Position of May 2003, the EU invited Romania to:

[...] provide information on individual benefits granted in the free zones and the disadvantaged areas and on any other individual tax benefits that have already been granted and which provide for tax benefits beyond Romania’s target date for accession. The EU urges Romania to close incompatible aid schemes for new entrants with immediate effect. (EU Common Position, May 2003, Exh. EC-8, p. 5).

590. According to the Claimants, this document shows that, even at that late point in time, the EU was only requiring Romania to change the rules for new entrants, but it had no problem with grandfathering vested rights of existing investors (Tr., Day 1, 180:13-25 (Gaillard)).

So even at that late point in time, the EU is saying: hey, change the rules for the new entrants. Frankly, I take issue with what I call the Commission’s brief in this matter, because they fail to quote that. They quote the rest of the document but they forget conveniently this reference to the new entrants. So it was pretty clear, even at that late point in time, that the EU had no problem with granting -- grandfathering vested rights to existing entrants, existing investors, and that they would maybe insist that the rules are changed going forwards for the new entrants, as they should, because, frankly, the rule of law should mean something, even in Europe. (Tr., Day 1, 180:13-25 (Gaillard))

591. Second, the Claimants contend that, from a procedural standpoint, only Romania (and not the European Commission) had the competence to determine which forms of state aid qualified as permissible state aid. This is because during the relevant time Romania was a pre-accession regime, where the only applicable law was Romanian law. As opposed to a post-accession regime, where there is a duality of functions between the State’s legal order and the European Commission, in pre-accession

Romania the European Commission and EU law played no role (Tr., Day 1, 178-179 (Gaillard); ER of A. Dashwood, ¶ 25).

592. Specifically, Prof. Dashwood states that the Europe Agreement said nothing about the procedural aspects of disciplining state aid. The Implementing Rules merely established rules for cooperation, consultation and problem solving between the European Commission and the Romanian monitoring authority (which was the Romanian Competition Office and Competition Council). Thus, Prof. Dashwood concludes that “[w]hat emerges clearly is that in the State aid regime of the [Europe Agreement] the procedural rules to ensure effective application of the criteria governing the compatibility of aid granted in Romania with the proper functioning of the Agreement were to be left to be determined exclusively as a matter of Romanian law” (ER of A. Dashwood, ¶ 25).
593. Prof. Dashwood further asserts that the substantive rules regarding State aid (in particular, Article 87 of the EC Treaty) cannot apply independently of the procedural rules in Articles 88 and 89 of the EC Treaty: “There has to be a concrete finding, by way of an individual Commission decision or legislation, that a particular aid, or aid of a certain type, is or is not compatible with the common market. It follows that the granting of the disputed aid could only be rendered unlawful under the [Europe Agreement] regime by a ruling compliant with the procedural requirements of that regime, finding that the aid satisfied all four of the criteria in Article 87 (1) [of the EC Treaty], while not qualifying as an exemption under Article 87(3)(a)” (ER of A. Dashwood, ¶¶ 32-33).]
594. Fourth, the Claimants contend that Romania contradicts itself when it asserts that the Miculas should have known that the incentives would disappear with Romania’s accession to the EU. Indeed, Romania’s acknowledged that it enacted the incentives legislation in order to advance its accession prospects. According to the Claimants, Romania admits (at R-CM, ¶ 29<sup>117</sup>) that EGO 24 was not incompatible with the Europe Agreement’s provisions and Romania’s accession obligations, and was, in fact, necessary for accession (C-Reply, ¶ 210).
595. The Claimants argue that there is a similar “element of schizophrenia” in the Commission’s position. On the one hand, the EU urged Romania to take the measures necessary to improve Romania’s economic and legal status, including negotiating BITs, so that it would be in a position to join the EU. Romania’s economic situation at the conclusion of the Europe Agreement was so dire that the EU expressly stated that the whole of Romania should be considered an underdeveloped area for purposes of State aid (Art. 64(4)(a) of the Europe Agreement). Accordingly,

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<sup>117</sup> “Especially given Romania’s status as an ‘underdeveloped area’ within the meaning of Article 87(3)(a) of the EC Treaty, the government could reasonably conclude at the time that the EGO 24/1998 regime was not incompatible with the Europe Agreement’s provisions. Furthermore, given the economic dislocation that existed at the time, measures to ameliorate conditions in the disfavoured regions were necessary. Romania was not alone among EU candidate States in making the policy choice to implement new economic-assistance measures based upon such an assessment of the legal position. For example, Poland passed similar legislation authorizing State aid for underdeveloped regions in 1994, while it was a candidate for EU admission” (R-CM, ¶ 29).



to “establish and improve a legal framework which favours and protects investment” and with the higher aim of achieving EU accession, the EU promoted the conclusion of bilateral investment treaties between Romania and EU member states (Art. 74(2) of the Europe Agreement), including the BIT that is the basis of the Tribunal’s jurisdiction. However, under the EC’s argument, once Romania had achieved the necessary economic development for accession, and once the Claimants had made their investments under the BIT, Romania then had to renege on its BIT obligations because revocation of the incentives was allegedly needed to obtain EU accession. As stated by the Claimants:

Now, the last thing I will say about the European attitude is that if you were to believe them at face value and take at face value what they say regarding the alleged EU requirements which would oblige countries to renege on their commitments when they join the EU, even if you were to take that at face value, and I don't think you should because, frankly, it's an argument for the purposes of litigation, it's nothing which remotely resembles the true goals of the EU, and that's fortunate -- but even if you were to take that at face value, you would notice a certain element of schizophrenia in the EU position.

Because, and this is the last thing I would like you to look at in my table, back on page 1 and page 2, and you will see that an element of the Europe agreement of February, which came into force in February 1995; an element is what? Look at page 2 of my chart, Article 74(2). You see that in plain words the EU is promoting what? Promoting the conclusion of bilateral investment treaties.

They say, in plain words, the particular aims of the cooperation will be: "... for Romania ..." That's entered into with Romania, it's specific to Romania: "... for Romania to establish and improve a legal framework which favours and protects investment, the conclusion by the Member States and Romania of agreements for the promotion and protection of investment."

So the very BIT which is the basis of your jurisdiction has been blessed, promoted by Europe itself. They told Romania: you are a very disfavoured region; the whole of Romania would qualify in terms of state aids for an exemption, the whole thing, because you are so way behind because of the history you suffered, you are so behind that you qualify all together. Please enter into BITs because that will help you catch up.

Now, that is exactly what Romania has done. They entered into the BIT, which does protect the investment. So I am saying that if you were to give any credence to the current litigation argument of the Commission, which is: well, they shouldn't be liable because they had to give up all this after the fact; that would be in direct contradiction with what the EU at the time was requesting Romania to do. ***So if you were to follow that type of argument, I would say -- frankly, it's an argument which is pretty shocking because it means: well, thank you for having invested, thank you for having helped Romania to catch up and to be able to join in the first place the EU, but now that it has joined, we don't need you any more, so we can dump you, and the state should renege and should renege without compensation on its promises. There is no problem whatsoever.***

(Tr., Day 1, 181:1-183:6 (Gaillard)) (Emphasis added)

596. The Claimants argue that the Commission’s position is wrong on four counts:

It's wrong from a timing standpoint, because EU law has nothing to say before the accession; all these representations on the right side of the paper are compatible with our case.

It's wrong from an EC law standpoint, because EC law is not that bad.

It's wrong from a policy standpoint, because if that were true, no one could ever carry [sic] any policy, because if you were to listen to the EU litigation paper, you would have to say that investors, if they are in their right mind when representations are made to them, when they are given certificates, when they are given incentives, they shouldn't believe that that's valid; they should ignore that and invest elsewhere, in countries where they respect the rule of law I guess, and they should not invest in the places they are told to invest in, because EU law would somehow permit states to change their mind without carrying any consequence of that change.

So that's wrong under EU law, but I would say for you the only thing which matters is that it's wrong from an international law standpoint: look at Articles 25 and 27 of the ILC Articles; and I would add just for the sake of the record that I find it wrong morally as well.

(Tr., Day 1, 183:8-184:6 (Gaillard)).

597. In sum, the Claimants argue that:

At the very least, it was reasonable for Claimants to expect, based on Romania's promulgation of the incentives regime in 1998 and its awarding the Corporate Claimants PICs in 2000 and 2002, that even assuming Romania entered the EU before April 1, 2009 (which was highly uncertain at the time), the Government would (1) wait for an official EC decision demanding the revocation of the Raw Materials Incentive before revoking it; (2) attempt to negotiate with the EC a disadvantaged-regions exception for the Raw Materials Incentive under Article 87(3) of the Europe Treaty; or (3) compensate Claimants or otherwise help to mitigate their damages as a result of revocation of the Raw Materials Incentive, perhaps by promulgating a new regulatory regime designed to meet EU requirements. But Romania did none of these things. Instead, having achieved the desired economic benefits from Claimants' investments in the country's disadvantaged regions and of EU membership, it unilaterally shifted all of the risks associated with EU accession to investors like Claimants. (C-Reply ¶ 419)

**v. Romania violated this legitimate expectation**

598. The Claimants argue that all the factors described above instilled in them the legitimate expectation that the EGO 24 incentives would remain in place for 10 years. The Claimants allege that, by prematurely revoking these incentives 5 years before they were due to expire, Romania violated that legitimate expectation, and consequently breached its obligation under the treaty to afford the Claimants fair and equitable treatment.

599. The Claimants acknowledge that not all incentives were revoked – indeed, the Profit Tax Incentive remained in place for the Claimants until the expiration of their PICs in April 2009. Nonetheless, they argue that the revocation of the Raw Materials Incentive was sufficient to constitute a breach of the BIT (C-PHB, ¶ 49). The Claimants also argue that leaving the Profit Tax Exemption in place until 2009

enabled Romania to keep the Claimants' obligations to maintain their investments in the disfavored region of eight years longer than if they had simply revoked all of the incentives (Tr., Day 12, 41-43 (Fleuriet)).

600. The Claimants contend that Romania's revocation of the incentives was unfair and inequitable, because:

- a. Romania failed to provide alternatives or otherwise mitigate the effects of the revocation on investors through transitional periods or grandfathering the incentives for existing PIC holders. Nor did Romania provide any evidence that it attempted to negotiate any alternatives or transitional periods with the EU.
- b. Romania failed to show how the incentives conflicted with EU law.
- c. The Claimants' obligations under EGO 24 remain in place.
- d. Romania failed to grandfather the incentives, in breach of Romanian Law. According to the Claimants, under Romanian law, grandfathering provisions are mandatory in all cases where an enactment of a new law affects legal relations established under an earlier statute and these relations are still in operation at the time the new law is enacted. (ER of L. Mihai, ¶ 6.1).

601. The Claimants summarize their legitimate expectations claim as follows:

At its core, Claimants' story is a simple one: Romania attracted substantial investments from them on the basis of a Raw Materials Incentive granted to them through domestic legislation (EGO 24 and GD 194) and individual PICs until 2009; did so after subjecting itself to EU requirements, thereby representing to investors that the incentive was consistent with those requirements; successfully opposed its own Competition Council's determination to the contrary; achieved the desired benefits accruing from both Claimants' investments and EU accession; and then revoked the Raw Materials Incentive without waiting for an official demand from the EC, without attempting to negotiate an exception or transition period, and after it was too late for Claimants to modify their incentive-based business strategy pursuant to which they had invested hundreds of millions of dollars in the disadvantaged regions of northwestern Romania. As a result, Claimants have suffered significant damages that Romania has made no attempt to mitigate. When compared to leading BIT cases like *MTD* (in which the Tribunal found that the investor had failed to conduct proper due diligence) and *Saluka* (in which the Czech Government specifically refused to assure the investor of State aid), this case presents a classic instance of the violation of investors' legitimate expectations of minimal regulatory stability. (C-Reply, ¶ 423).

**b. The Respondent's position**

602. The Respondent denies that it has breached any legitimate expectation of the Claimants. It contends that the Claimants have not met any of the requirements necessary for the doctrine of legitimate expectations to apply. First, the Claimants received no assurance that could have created a legitimate expectation that the Facilities would remain in place for 10 years. Second, the Claimants did not invest in

reliance on that expectation. Finally, even if that had been the case, any such reliance would not have been objectively reasonable.

**i. The standard for determining if a measure has undermined legitimate expectations**

603. The Respondent agrees with the Claimants that the appropriate standard to evaluate whether a measure has undermined legitimate expectations is that set out in *Parkerings v. Lithuania* (R-PHB, ¶ 101). On the basis of this and other awards, the Respondent contends that for a legitimate expectation of regulatory stability to be protected, the following requirements must be met (R-CM, ¶¶ 111-135; R-Rejoinder, ¶¶ 170-173; R-PHB, ¶¶ 99-159):

- i. There must be a contract, or at least a promise or specific representation that the law will remain unchanged, that created a subjective expectation.
- ii. The expectation (or the reliance on that expectation) must have been objectively reasonable.<sup>118</sup> In particular, the investor must anticipate that the law may change, especially if the general legislative climate is in a state of flux (*Glamis Gold v. United States*, ¶ 767).
- iii. The investor must have relied on that subjective expectation when it made its investment.

604. With respect to the first requirement, the Respondent submits that any claim based on the frustration of legitimate expectations requires the claimant to prove that the state created or reinforced the expectations through its own affirmative acts.<sup>119</sup> The practice of international tribunals shows that legitimate expectations may only be frustrated where the state has made “specific commitments” that particular laws or regulations would remain in place.<sup>120</sup> These specific commitments or assurances cannot be generated by inaction or generally applicable regulation. In addition, these specific commitments must be valid under domestic law.

605. Further, the Respondent contends that it is well established that a regulatory regime does not carry with it any promise that the law will remain unchanged indefinitely. Citing *Parkerings v. Lithuania*, the Respondent argues that “[a] State has the right to enact, modify or cancel a law at its own discretion”, and “save for the existence of an agreement in the form of a stabilisation clause or otherwise, there is nothing

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<sup>118</sup> In some briefs, the Respondent focuses on the reasonableness of the expectation, whilst in others on the reasonableness of the reliance. The Tribunal considers this to be the same argument, which goes to the legitimacy of the expectation.

<sup>119</sup> *Gami Investments, Inc. v. The Government of the United Mexican States*, UNCITRAL, Final Award, 15 November 2004 (hereinafter, “*GAMI v. Mexico*”), ¶¶ 90-110; *International Thunderbird Gaming Corporation v. The United Mexican States*, UNCITRAL, Arbitral Award, 26 January 2006 (hereinafter, “*International Thunderbird v. Mexico*”), ¶ 196; *CMS v. Argentina*, ¶¶ 78-82; *CME Czech Republic B.V. v. The Czech Republic*, UNCITRAL, Partial Award, 13 September 2001 (hereinafter “*CME v. Czech Republic*”), ¶¶ 610-611; *MTD v. Chile*, ¶ 167; *Tecmed v. Mexico*, ¶ 154.

<sup>120</sup> *CMS v. Argentina* (Award), ¶¶ 127-166; *Tecmed v. Mexico*, ¶ 154; *Metalclad v. Mexico*, ¶ 87; *Marvin Roy Feldman Karpa v. United Mexican States* (ICSID Case No. ARB(AF)/99/1), Award, 16 December 2012 (hereinafter “*Feldman v. Mexico*”), ¶ 111.

objectionable about the amendment brought to the regulatory framework existing at the time an investor made its investment” (*Parkerings v. Lithuania*, ¶ 332).<sup>121</sup>

606. Similarly, the Respondent notes that in *AES v. Hungary* the tribunal found that, absent a specific representation to the investor, such as a stabilization clause, an investor cannot have a legitimate expectation of legislative stasis, and any general entitlement to regulatory stability does not preclude legislative changes that are significant and even surprising (*AES v. Hungary*, ¶¶ 9.3.17-9.3.34). In the *AES* case, the investor did have a contract with the state. Although in that case the tribunal found that the state did not have a rational policy in modifying or eliminating its own contractual obligations, “this does not mean that the state cannot exercise it[s] governmental powers, including its legislative function, with the consequence that private interests – such as the investor’s contractual rights – are affected. But that effect would have to be a consequence of a measure based on public policy that was not aimed only at those contractual rights” (*AES v. Hungary*, ¶ 10.3.13). Romania concludes that, *a fortiori*, where the investor has no contract with the state, it can have no legitimate expectation that generally applicable legislation will not affect it.
607. Second, the Respondent submits that, for an expectation to be legitimate and therefore protected under international law, it must be reasonable and justified in the circumstances.<sup>122</sup> According to the Respondent, it is well established that foreign investors must accept the conditions of the host state as they find them (*The Oscar Chinn Case*<sup>123</sup>). An investor cannot complain if its business suffers economically from laws or practices that were in place at the time of the investment (*MTD v. Chile*, ¶ 204). The investor must conduct its business in a reasonable manner, which includes undertaking due diligence with respect to the regulatory environment in which it operates and the likelihood that it may change and evolve (*Parkerings v. Lithuania*, ¶ 333). Indeed, investors are required to seek relevant professional advice in assessing the risks inherent in a particular host state (*Feldman v. Mexico*, ¶¶ 114, 132). An investor who fails to conduct such due diligence cannot invoke any legitimate expectations (ECJ jurisprudence). Citing *Maffezini v. Spain*<sup>124</sup>, the Respondent submits that BITs “are not insurance policies against bad business judgments (*Maffezini v. Spain*, ¶ 64).
608. The Respondent adds that regulatory change must be anticipated all the more in regulatory environments where there is public and continuous scrutiny of the actions

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<sup>121</sup> The Respondent cites, inter alia, *PSEG v. Turkey*, ¶ 241 (“Legitimate expectations by definition require a promise of the administration ...”); *Metalpar S.A. and Buen Aire S.A. v. Argentine Republic* (ICSID Case No ARB/03/5), Award, 6 June 2008 (hereinafter “*Metalpar v. Argentina*”), ¶ 186 (“There was no bid, license, permit or contract of any kind between Argentina and Claimants”); *Plama Consortium Ltd v Republic of Bulgaria* (ICSID Case No ARB/03/24), Award, 27 August 2008 (hereinafter, “*Plama v. Bulgaria*”), ¶ 219 (“It does not appear that Bulgaria made any promises or other representations to freeze its legislation on environmental law to the Claimant or at all”).

<sup>122</sup> *Parkerings*, ¶ 333; *Saluka v. Czech Republic*, ¶¶ 304 and 309; *Mondev v. U.S.*, ¶ 118; *Waste Management v. Mexico II*, ¶¶ 98-99; *Lauder v. Czech Republic*, ¶ 292.

<sup>123</sup> *The Oscar Chinn Case*, PCIJ Series A/B No 63 (1934), p. 25.

<sup>124</sup> *Emilio Agustín Maffezini v. The Kingdom of Spain* (ICSID Case No. ARB/97/7), Award, 13 November 2000 (hereinafter, “*Maffezini v. Spain*”).

of the state (e.g., *Methanex v. United States*, Part IV D, ¶ 10, *Glamis Gold v. United States*, *Chemtura v. Canada*), and in transition or otherwise unstable economies (*Olguín v. Paraguay*, ¶ 65(b),<sup>125</sup> *Generation Ukraine v. Ukraine*, ¶ 20.37,<sup>126</sup> *Parkerings v. Lithuania*, ¶¶ 335-338).

609. The Respondent asserts that, even if an expectation is reasonable, it will not be protected absent specific assurances to the investor. As stated by the tribunal in *Glamis Gold v. United States*, the inquiry is not whether the expectations were reasonable, but whether the State has made specific assurances to the investor in order to induce the investor's investment (*Glamis Gold v. United States*, ¶¶ 810-811).
610. Third, the Respondent argues that for a breach of legitimate expectations to violate the fair and equitable treatment standard, the investor must have relied on that expectation when it made the investment. The Respondent submits that "a legitimate expectation is protected only if, and to the extent that, it was the predicate upon which an investment was made. If an expectation, however legitimate, was not the predicate of an investment, there is nothing inequitable in the state's acting against it" (R-Rejoinder, ¶ 191). Specifically, "[w]here an investor claims that it was induced by a particular regulatory measure, it must demonstrate that the existing regulatory framework was the crucial factor in determining whether or not to invest in the host state and that, absent that measure, the investor would not have made the investment" (*Id.*, relying on *CMS v. Argentina*, ¶ 275).
611. In this case, the Respondent contends that it did not make a promise or assurance that could have created a subjective expectation that the Facilities would not change for 10 years (Section (ii) below); any expectation of regulatory stability would have been unreasonable (Section (iii) below), and the Claimants have not proven that they relied on a subjective expectation (Section (iv) below).

**ii. Romania did not make a promise or assurance that could have created a subjective expectation**

612. The Respondent contends that the Claimants have not proven that Romania made a promise or assurance that could have created a subjective expectation that the EGO 24 Facilities would remain unchanged for ten years. Romania never represented to the Claimants, or to anyone else, that the Facilities would be available to them for the entire 10 year period indicated in the PICs (R-CM, ¶¶ 113-117; R-Rejoinder, ¶¶ 169-189; R-PHB, ¶¶ 104-120).
613. As discussed in Section A above (umbrella clause), the Respondent denies that the EGO 24 framework gave rise to an actionable vested right to the Facilities for any particular period.<sup>127</sup> The Respondent also denies that it made a promise or assurance

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<sup>125</sup> *Eudoro Armando Olguín v. Republic of Paraguay*, (ICSID Case No. ARB/98/5), Award, 26 July 2001 (hereinafter "*Olguín v. Paraguay*").

<sup>126</sup> *Generation Ukraine, Inc. v. Ukraine* (ICSID Case No. ARB/00/9), Award, 16 September 2003 (hereinafter "*Generation Ukraine v. Ukraine*").

<sup>127</sup> The Respondent focused on this argument in the context of the Claimants' umbrella clause claim, but it is also relevant to its defense to the Claimants' legitimate expectations case.

that could constitute the basis for a legitimate expectation, through the EGO 24 framework or elsewhere.

614. First, the Respondent argues that the Claimants have not proven that the State made a promise specifically to them. There is no evidence that any state organ made such a promise or representation to the Claimants. Nor do the Claimants or their witnesses claim to have received such an assurance from a State official. Mr. Ban's testimony (Tr., Day 9, 22–23 (Juratowitch/Ban)) only serves to highlight this: rather than admit that no one ever told him that the Facilities would be stabilized for 10 years, he stated that no one had explicitly warned him that the Facilities might not last that long. However, relying on *Parkerings v. Lithuania*, the Respondent argues that a state has no duty to warn investors that the law might change.<sup>128</sup> Even when a legislative change is sudden and radical, an investor has no claim for a lack of transparency or predictability unless there has been an "active inducement of a quasi-contractual expectation" (*Glamis Gold v. United States*, ¶ 799).
615. Similarly, the Respondent notes that Mr. Marcu never said he or anyone else ever spoke to any of the Claimants about EGO 24. In fact, his testimony about the NARD's general efforts to promote investment in disfavored areas showed that those efforts began after the Claimants' supposed decision to invest in the Ștei-Nucet region, rather than in Bucharest (Tr., Day 7, 49 (Marcu)). The two promotional activities he mentioned in 2000 were not attended by the Claimants, so anything Mr. Marcu may have said there is irrelevant. In any event, Mr. Marcu admitted that EGO 24 had been amended a number of times and that by the time of his presentations the Competition Council had already issued Decision 244. On this basis, the Respondent argues that it is difficult to see how Mr. Marcu could have said in his presentations that every EGO 24 Facility was locked in for 10 years.
616. Second, the Respondent contends that the Claimants have not proven that, through the EGO 24 framework or the issuance of the PICs, the State made a promise to investors in general. As discussed above, the Respondent argues that general regulation cannot generate a specific commitment of the kind needed to create a legitimate expectation. The Respondent argues:

The Claimants contend that their legitimate expectation arose from unilateral acts taken by Romania which were general in scope, rather than specific assurances to the Claimants. Also, the Claimants' case relies extremely heavily on the PICs that the Corporate Claimants received in 2000 and 2002 – but they acknowledge that these were not individually negotiated documents. They were standard administrative certifications of eligibility that were received by thousands of beneficiaries of the EGO 24/1998 state aid scheme. The Claimants depend on the same government actions that any of those beneficiaries could cite, such as the terms of executive instruments implementing EGO 24/1998, which as we have seen (Chapter II) were necessarily subject to amendments to EGO 24/1998 itself. Overwhelmingly consistent authority suggests that it must be an extremely rare case when such general legislative acts, and

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<sup>128</sup> *Parkerings v. Lithuania*, ¶ 345 ("The acts and omissions of the Municipality of Vilnius, in particular any failure to advise or warn the claimant of likely or possible changes to Lithuanian law, may be breaches of the Agreement but that does not mean they are inconsistent with the Treaty").

implementing regulations, can generate legitimate expectations that those acts will not be amended in future. (Rejoinder, ¶ 170).

617. In any event, as explained in Section A with respect to the umbrella clause, the Respondent argues that the relevant regulations did not promise that the Facilities would remain unchanged for a period of 10 years.
618. The Respondent also contends that, if Romania had decided to bind itself to regulatory stasis for 10 years, it would have done so in one clear instrument, through an appropriate organ, and that instrument would contain clear terms with respect to the promise of stability and its duration. However, the Claimants have not identified which regulation would embody this promise. It cannot be EGO 24, because that regulation lays out a general scheme and makes no reference to a 10 year time period. The Respondent concedes that “there is no doubt that EGO 24 set forth a generalized entitlement that could be claimed by qualifying investors” (Tr., Day 13, 85:7-10 (Petrochilos)). Article 4(c) of EGO 24 stated that a government decision would determine the facilities “provided by law” that would be granted to investors (which confirms that the source of the entitlement is EGO 24). But it contained no promise as to the length of time the facilities would remain available, nor any stabilization language (unlike its predecessor, Law 35, which did contain express stabilization language). The Respondent further argues that, under Romanian law, general laws such as EGO 24 do not confer individual vested rights (as was confirmed by the Romanian Constitutional Court in Decision 130/2003).
619. The Respondent notes that the Claimants appear to rely on GD 194/1999 and the PICs, which are lower ranking documents issued to implement and administer EGO 24 and Law 20/1999.<sup>129</sup> However, relying on the expert opinion of Prof. Baias, it argues that these were subsidiary normative or administrative instruments issued to implement and administer EGO 24 and Law 20/1999, which could not modify or contradict the authority of a government ordinance or a law, and as such could not have granted an entitlement beyond what EGO 24 authorized. In particular, they could not have imposed significant, long-term obligations on the state that the authorizing statute did not impose. As a result of the hierarchy of Romanian laws, the Government, implementing the law through the government decision, could not have bound the legislature not to change the law. And once EGO 24 was modified, GD 194/1999 could not have had a broader field of application than the modified EGO 24. Thus, no prudent investor in Romania could have understood that Annex 2 of GD 194/1999 as freezing the facilities there listed. For the same reason, because EGO 24 created no vested right but only a general entitlement, neither could GD 194/1999 or the PICs create such a vested right.
620. The Respondent also denies that the PICs could have been the source of an investor’s right to the EGO 24 incentives. The Respondent argues that the PICs were

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<sup>129</sup> The Respondent finds it notable that, considering that the nature of GD 194/1999 and the PICs has become the cornerstone of their expropriation, umbrella clause and fair and equitable treatment cases, Prof. Mihai (the Claimants’ own expert in Romanian law) made no mention of either instrument in his expert report. Thus, the Respondent argues that the Claimants are left with no evidence to support an allegation that, under Romanian law, they had a right to the Raw Materials Facility until 2009.



merely administrative tools that certified the holders' eligibility to obtain the Facilities; the source of the right was EGO 24. Specifically, the Respondent argues that Article 5 of the GD 525/1999 published on 8 July 1999 (Exh. R-6),<sup>130</sup> which approved the 1999 Methodological Norms for the application of EGO 24, provided that the "incentives *provided by the law* shall be granted pursuant to the certificate of the investor in a disadvantaged region" (emphasis added). Such a certificate was to be issued by the relevant Regional Development Agency, upon an investor's request. According to the Respondent, the language of Article 5 makes it explicit that the PICs merely certified eligibility to "incentives provided by the law." That law was EGO 24, as approved by Law 20, neither of which contained any provision concerning their duration nor any restriction on the government's ability to amend or repeal them.

621. The Respondent contends that this conclusion was reaffirmed by a subsequent version of the Methodological Norms, adopted by GD 728/2001 (Exh. R-9). Article 4(1) of these Methodological Norms stated: "The *facilities provided by the law* are granted based on the certificate of the investor in the disfavoured area" (emphasis added). According to the Respondent, this demonstrates that the content of the facilities was established by law (i.e., EGO 24) and that PICs were an administrative tool attesting to eligibility to access facilities available under EGO 24.
622. In the Respondent's view, the language of the PICs themselves does not change this conclusion. All the PICs stated was that the titleholder was the beneficiary of the facilities granted under GD 194/1999, in accordance with the provisions of EGO 24 approved and amended by Law 20, and in accordance with the government decision approving the methodological norms. Accordingly, all the PICs did was certify that the titleholder was the beneficiary of the facilities granted by the law, whatever the law determined that those facilities were at any point in time.
623. The Respondent further argues that the PICs did not list any individual facilities, let alone purport to stabilize them for any particular period. The PICs only stated that they were valid until a given date. That only meant that they certified eligibility to whatever facilities were available under the law until that date.
624. The Respondent rejects the Claimants' argument that the PICs were the source of the right to the facilities because they had to present them every time that they wanted to benefit from them. The PICs were needed so that administrators did not have to evaluate eligibility on each occasion that a business applied for an exemption. This conclusion is also supported by the fact that it was not necessary to obtain a new PIC each time EGO 24 was amended; the PIC continued to certify eligibility to the remaining facilities in EGO 24, as amended. This was confirmed by the Claimants' expert, Prof. Mihai (Tr., Day 5, 215).
625. The Respondent also denies that the administrative process to qualify for a PIC was equivalent to a contractual negotiation, or that the PICs were tantamount to contracts. In the legal order in which that process occurred, the issuance of a PIC did not create

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<sup>130</sup> The Respondent notes that GD 525/1999 replaced an earlier version of the Methodological Norms, contained in GD 907 of 1998, published on 22 December 1998.

a contract. Nor did the obligation to submit an investment plan amount to a bilateral deal; the investment plan was merely a requirement for the government to establish that investors met the qualifying criteria.

626. Similarly, the requirement to employ a certain number of unemployed persons and to have made certain investments were part of the criteria for eligibility; they do not establish the existence of a promise that the facilities would be available for a certain duration. The Respondent adds that it is misleading to suggest that these requirements show that EGO 24 was intended to foster capital intensive industries, because there was no threshold of magnitude for a qualifying investment, the employment requirement was met by employing ten persons, five of which had to be unemployed, and the eligible sectors covered a wide range of activities.
627. The Respondent also denies that EGO 24 created an obligation for investors to maintain their investments for twice as long as the investor is a recipient of the incentives. The Respondent alleges that it “has repeatedly stated that the obligation does not exist and that (therefore) it has no intention of enforcing it” (R-Rejoinder, ¶ 118). In any event, it argues that the alleged obligation is of only theoretical interest, because the Claimants have no desire to move the operations from Bihor county, and thus the State has never had the occasion to enforce the alleged obligation. However, it notes that Prof. Mihai did not address this matter in his expert opinion, and the Claimants have not cited any instances in which any investor has been subjected to the supposed obligation, or any Romanian court or agency has interpreted it in that fashion.
628. The Respondent further contends that neither the monitoring process to which the Claimants were submitted, nor the alleged promotion of the EGO 24 regime by government officials, could have given rise to a promise that the facilities would remain unchanged for any period of time.
629. Finally, the Respondent contends that the Romanian Constitutional Court disagrees with the Claimants’ theory: when the profit tax exemption available under Law 35 of 1991 was repealed, the Constitutional Court found that the repeal of that exemption could not be construed as the termination of a contract, nor as an infringement of the right to property or of the investor’s right to recover debt (Decision 130/2003). The Respondent notes that Prof. Mihai called this decision *ultra vires* at the hearing but did not discuss it in his expert report, while Prof. Baias confirmed the decision’s relevance for this case. Thus, Romania submits that the Tribunal should afford this decision great weight and conclude that GD 194/1999, alone or together with the PICs, did not constitute a contractual or other obligation under Romanian law.
630. Finally, the Respondent argues that not only did Romania not make any specific commitments or representations that the Facilities would remain unchanged during the 10 year period indicated in the PICs, but:

[T]he only indications that Romania offered were to the contrary. Six months before EGO 24/1998 was adopted, Romania publicly committed to harmonize its national law with the *acquis*, including competition law. This

was consistent with the binding provisions of the Europe Agreement, to which Romania had been a party since 1995. Before any PICs were ever issued to the Corporate Claimants, Romania adopted Law 143/1999 on State aid, which expressly indicated that incentives like the Facilities (defined as “Existing Aid”) could be subject to nullification or modification at any time. Within months after Law 143/1999 came into force, the responsible regulatory authority, the Competition Council, challenged the Facilities’ validity in a public decision and, later, in the Romanian courts. Again, this public challenge was underway and reported in the Romanian media before European Drinks received a PIC in June 2000. The Claimants concede that by July 2000, the government had already begun restricting the Facilities, which in itself put all beneficiaries on notice that further modifications could be forthcoming. When Starmill and Multipack were established and obtained PICs in 2002, the European Commission was actively pursuing calls for the abolition of Romania’s State aid programs, including specifically the EGO 24/1998 regime, and the dismantling of the Facilities was continuing apace. The PICs clearly reflected the evolution that was underway, and the lack of any undertaking by Romania to stop it: the benefits to be granted under the Facilities expressly depended in part upon the terms of EGO 24/1998 as amended. (R-CM, ¶ 116).

631. In any event, Romania’s actions did not create a legitimate expectation that EGO 24 would not be amended, even substantially amended, before 2009 (Rejoinder, ¶¶ 173-188). According to the Respondent:

173. The doctrine of legitimate expectations is objective: the question is whether, in all the circumstances, the investor’s claimed expectation is reasonable. To answer this, however, one first must know what the supposed subjective expectation was. In their Reply, the Claimants say they expected that “the Raw Materials Incentive would remain in place until 2009”. However, in their Statement of Claim, the Claimants had asserted that it was the entire suite of EGO 24/1998 state aid that they legitimately expected would remain in force until 2009.

174. Indeed, that is what they must show: there is no logical or evidentiary basis for a supposed expectation that while all other Facilities were subject to change or repeal, the one Facility that the Claimants say they actually cared about had a special reason to remain unchanged. If the Claimants expected one EGO 24/1998 facility to last until 2009, there is no reason why they, and every other beneficiary, could not have expected all of the existing EGO 24/1998 facilities to have remained unchanged. There is no distinction between the Raw Materials Facility and the other Facilities, in terms of the state’s conduct or statements with respect to each Facility, that would create a different regime of legitimate expectations.

175. In sum, the position is this. The Claimants are challenging a general legislative programme; if they are right, the repeal of any EGO 24/1998 facility was unfair and inequitable to every actual or prospective beneficiary. The Claimants must show, therefore, that there was a commitment or representation by Romania, binding on future Parliaments, that EGO 24/1998 would not be amended at all.

(R-Rejoinder, ¶¶ 173-175)

**iii. Any expectation of regulatory stability would have been unreasonable**

632. In the Respondent's view, even if the Claimants had actually believed that the Facilities would remain unchanged for ten years (which the Respondent argues has not been proved), such an expectation would have been unreasonable, and thus irrelevant to the assessment of the fairness of Romania's conduct (R-CM, ¶¶ 118-126; R-Rejoinder, ¶¶ 176-189; R-PHB, ¶¶ 136-159).
633. As a preliminary matter, the Respondent contends that there is no reliable evidence of Messrs. Micula's reasoning. There are no documents, contemporaneous or otherwise, explaining the Claimants' reasoning at the time. The only evidence is the testimony of Messrs. Micula, which is unreliable. In any event, this testimony does not evidence reasonable reliance, but rather unreasonable expectations with no legitimate basis and reckless business conduct.
634. The Respondent's main argument is that any expectation that the Facilities would remain unchanged for ten years would have been unreasonable taking into consideration the regulatory framework in which the Facilities were granted, both from a Romanian law and an EU law perspective.
635. The Respondent argues that, as a general matter, the Miculas' alleged trust in the stability of Romanian law was misplaced. Ordinarily, an investor must take into account that the legislation will change. There were no representations or assurances that made this case an exception. Nor do the circumstances and context invoked by the Claimants change this basic principle.
636. In the context of EU accession, the Respondent argues that this alleged trust in the stability of Romanian law was even more misplaced. By 2000, it was public knowledge that the target date for EU accession was 1 January 2007 (as evidenced in Romania's first Position Paper on competition policy of August 2000, Exh. EC-1). As noted above, the Respondent submits that regulatory change must be anticipated all the more in regulatory environments where there is public and continuous scrutiny of the actions of the state, and in transition or otherwise unstable economies. In this case, the Claimants chose to invest in a transitional economy, and were fully aware of the risks associated with such a choice. Indeed, Mr. Ioan Micula testified that he and his brother were drawn to invest in Romania precisely because they sought to benefit from the rapid changes taking place in the local economy and regulatory system (Second WS of I. Micula, ¶ 7; Tr. Jur., Day 2, 53-54; 183). Messrs. Micula began to invest in Romania in 1991, and were fully aware of the risks of doing business in Romania during the transition period.
637. The Respondent rejects the Claimants' portrayal of themselves as *ingénues* who were oblivious to what was happening around them. Businessmen with substantial activity in Romania like the Miculas can have no excuse for their purported ignorance. It was public knowledge that Romania was undergoing significant regulatory changes to align itself with the *acquis*. Three reports shown during the hearing (Exh. HEC-6, HEC-7 and HER-1) show that over 100 draft laws were initiated (R-PHB, ¶ 144 and

Annex A). The Respondent contends that “[t]he fact that EU-accession changes would likely include Romania’s state aid schemes was a fact readily knowable by anyone who cared to conduct even the most cursory research” (R-Rejoinder, ¶ 178).

638. With respect to the Facilities in particular, the Respondent contends that it would have been impossible for a rational investor not to perceive the risk that they could change or be withdrawn. Not only had they been changing since they were first enacted, but their continuing viability was seriously in doubt. Even the most optimistic business person would have known that the Facilities’ continued existence was the subject of fierce political battle. Indeed, the Respondent submits that “[g]iven the political and economic environment in 2000 and 2002, when the Claimants obtained their PICs, it would have been impossible for a reasonable investor to expect any particular form of state aid to remain in place and unchanged. The only way one could entertain such an expectation is if the Competition Council or the European Commission had specifically approved EGO 24/1998. Both institutions, however, expressed views that were squarely contrary to any expectation of preservation of the Raw Materials Facility” (R-Rejoinder, ¶ 179).
639. In particular, the Respondent argues that Decision 244/2000 of the RCC was a clear warning signal that the Facilities were incompatible with Romania’s current obligations under the Europe Agreement and future obligations under the EC Treaty. Although the Claimants try to characterize this decision as referring only to the pig farming industry, the Respondent asserts that it refers to the same Raw Materials Incentive and declared the entire aid scheme illegal.
640. The Respondent argues that, if the Claimants had conducted any legal due diligence, any competent lawyer would have advised them that EU accession would likely affect the Facilities. However, it notes that although the Claimants have alleged that they had a legal department of over 30 persons that was allegedly monitoring legislative changes (Third WS of I. Micula, ¶ 37), they have been unable to produce any evidence of contemporaneous due diligence on the subject.
641. The Respondent contends that, instead, the Miculas recklessly ignored obvious signs that the Facilities could change or be withdrawn. They paid no heed to the 2000 PWC Business Plan section on “Political Risk”, which highlighted the possibility of legislative or regulatory change, or to all the PWC plans’ note that Romania was “clamping down on incentives” even as early as 2000. Their attention and belief in the press was selective: when the reports were unfavorable, they simply did not believe them.
642. The Respondent also rejects the Claimants’ suggestions that a particular statement in a government report, standing alone, could have led them to believe that the Facilities would be maintained until or after accession. First, as the Claimants profess ignorance of anything written or published about the future of the Facilities, any such statement is irrelevant, because they did not rely on it. But even if the Claimants had reviewed it, the Respondent contends that a diligent and prudent investor would not have been misled by that statement, because a diligent investor would have known

that each country had an independent monitoring authority (R-PHB, ¶ 156; Tr., Day 6, 127–8 (Petersen/Smith)). Even in the absence of EU requirements, under Romanian law it would have been unreasonable to expect that the Facilities would remain unchanged for any particular period of time. Contrary to the Claimants' allegations, the content and nature of EGO 24 did not make the Claimants' expectation of regulatory stability reasonable. Nor does the content of the PICs or the manner in which they were issued support that alleged expectation. As noted above, the Respondent argues that the PICs were administrative tools certifying eligibility to access facilities available under EGO 24. The source of the facilities was thus EGO 24, not the PICs. The PICs could not reasonably be read as anything more than confirmation that their holder was eligible for the EGO 24 Facilities, whatever those Facilities might happen to be at any particular time. EGO 24 had no stabilization clause or other clause of similar effect (unlike Law 35 which, as amended by Law 57/1993, promised that the changes would only affect investors if they were more favorable). The Claimants argue that there was no possibility of bargaining for a stabilization clause, suggesting that they were not at fault for failing to obtain one, but this cannot mean that the State is therefore impeded from amending its regulations.

643. In any event, the Respondent argues that the Claimants repeatedly contradict themselves as to the nature and significance of the PICs. At some points the Claimants assert that the PICs are the allegedly expropriated investment; at other times they state that the PICs “enhance” an expectation that has already arisen, while at others they are the instrument creating the expectation. The Claimants also state that the PICs are administrative documents not subject to a bargain and whose terms were unilaterally imposed, while at other times describing them as akin to contracts. The Respondent submits that “[i]t is a claimant’s burden to set out a coherent claim and then to prove it” (R-Rejoinder, ¶ 183).
644. The Respondent rejects the Claimants’ remaining arguments with respect to the reasonableness of their expectation.
645. First, the Respondent argues that the Claimants’ trust in the stability of the regulatory framework, based on the alleged stability of previous incentive schemes, was misplaced. Previous incentive regimes had been anything but stable. Indeed, the Claimants’ trust seems to stem from the fact that they were not bothered by amendments to previous legislation. However, the Respondent argues that international law does not enshrine an investor’s supposed faith that new legislation will always benefit him because he has had good fortune in the past.
646. Second, it was unreasonable for the Claimants to believe that if the Facilities were repealed they would get special treatment from the government in the form of grandfathering of benefits.
647. Third, the Respondent contends that the contemporaneous statements and actions by the Government or its officials are not sufficient to make their alleged expectation reasonable. In particular, the Respondent avers that:

- a. The Government's Development Plan for 1998-2000 (Exh. C-567) does not mention tax customs or customs duty exemptions; it merely places Romania's regional development strategy within the country's general economic reform (the major objective of which was EU accession).
- b. Although Mr. Marcu, then President of the body charged with administering EGO 24/1998, would have presumably been knowledgeable about EGO 24/1998, he had no authority to commit Parliament not to amend the law, and thus his statements would not have made the Claimants' alleged expectation reasonable. In addition, his remarks were so informal that there is no contemporaneous evidence of them. In the context of the public debates over the future of the Facilities, no reasonable investor could have taken Mr. Marcu's alleged oral statements as authority committing the state to leave the Facilities in place.
- c. Although Mr. Ban alleges that he attended meetings hosted by government officials, he did not testify that those officials said specifically that all of the EGO 24/1998 facilities would remain unchanged, nor did he testify that he held any bilateral discussions with government officials in this regard or received particular assurances. In addition, there is no contemporaneous record of what any official purportedly did say in Mr. Ban's presence, whether at a meeting or otherwise.
- d. The generic investment promotion materials cited by the Claimants (e.g. CD-ROM prepared by ANEIR, a non-governmental trade organization, Exh. C-563) do not highlight EGO 24/1998, nor do they make any representations as to its legislative future.
- e. The two media reports (Exh. C-568 and C-630) cited by the Claimants are not attributable to the government, and it is not clear whether the reporters' words are direct quotations or narrative reporting.
- f. The June 2002 government press release (Exh. C-489) was issued well after the Claimants' legitimate expectations are said to have arisen, their PICs obtained, and their supposed 10-year plan put into motion. In any event, the press release says the opposite of what the Claimants say it does:

With view to joining the European Union, we are concerned with making the legislation of the disfavoured areas compatible as concerns the state aid ... . The project for a norm to modify the Emergency Ordinance of the Government No. 24/1998 regarding the system of the disfavoured areas [...].

- g. The positive assessments of the incentive regime and their businesses by Government officials were not assurances that the Facilities would stay in place. The fact that the withdrawal of the Facilities could have negative social consequences for the region is not a reason to believe they would not be withdrawn. If there were policy reasons for adopting and maintaining the Facilities, a reasonable investor would also have considered that there may be other equally legitimate policies militating against them (e.g., pro-competition policies).

648. In any event, relying on *Saluka v. Czech Republic*, the Respondent contends that undocumented and informal remarks by government officials cannot generate legitimate expectations. Nor can road shows or general pronouncements create legitimate expectations on their own: citing *CMS v. Argentina*, the Respondent argues that, at best, such statements are confirmatory evidence of a legitimate expectation created by other, authoritative state actions.
649. Finally, the Respondent submits that the reasonableness of the Claimants' strategy (making decisions based on how to best run ahead of competitors with respect to customs duties) as the basis of a 20-year business plan is questionable.
650. In sum, considering all the circumstances, the Respondent argues that it would have been unreasonable for the Claimants to believe that they were guaranteed anti-competitive advantages until 2009. "In a legal system where everything was changing, sometimes dramatically, they adopted a fragile business model that depended on the stability of a customs policy and on state aid whose legality was publicly challenged and reported to be the subject of a fierce political battle. That things did not turn out as the Claimants would have wished does not give them a claim under the [BIT]" (R-PHB, ¶159).

**iv. The Claimants have not proven that they relied on a subjective expectation that the facilities would not change for 10 years**

651. Citing *CMS v. Argentina*, the Respondent argues that "[w]here a foreign investor claims that it was induced by a particular regulatory measure, it must normally demonstrate that the existing regulatory framework was the crucial factor in determining whether or not to invest in the host state and that, absent that measure, the investor would not have made the investment." It adds that "a legitimate expectation is protected only if, and to the extent that, it was the predicate upon which an investment was made. If an expectation, however legitimate, was not the predicate of an investment, there is nothing inequitable in the state's acting against it" (R-Rejoinder, ¶ 191).
652. The Respondent points out that the Claimants are not arguing that, had they known that EGO 24 would change over time, they would not have invested in Romania. Rather, they argue that they would have invested elsewhere in Romania, or in different sectors (R-Rejoinder, ¶ 192).
653. Nonetheless, the premise of the Claimants' case is that when they made the relevant investments, they expected the facilities to remain unchanged at least until 2009. Thus, the Respondent argues that they must prove that they had this subjective expectation at the time of the investments. It is insufficient to establish that they "relied on" the facilities that existed at the moment of any particular investment, in the sense that they took advantage of the tax and duty exemptions that were then available.
654. The Respondent contends that there is no evidence of that reliance. To the contrary, the evidence available suggests that the Claimants' business decisions had nothing



to do with the facilities or their duration. Indeed, the Respondent alleges that there is no contemporaneous record of the Claimants' supposed subjective belief that the EGO 24 facilities would remain in place and unchanged (R-CM, ¶¶ 128-135; R-Rejoinder, ¶¶ 177, 190-217; R-PHB, ¶¶ 121-135).

655. First, had the Claimants acted in reliance on any legitimate expectation, there would have been abundant contemporaneous evidence of such reliance in the form of business plans, possible press statements, legal advice about duration of the facilities, and decisions of the Corporate Claimants' Boards of Directors. Messrs. Micula's unsubstantiated and self-serving witness statements are not sufficient to prove reliance.
656. In particular, there is not a single contemporaneous record of the alleged "10-year business plan" to capitalize on the EGO 24 incentives. This is telling given that the Claimants' claim to have had many discussions with their management team and the shareholders and several analyses of market demand and the customs implications of different raw materials. The lack of contemporaneous evidence is also striking given the level of detail of the Claimants' alleged 10-year plan (supposedly consisting of two phases, beginning with food production and moving to "core capital expenditures", including a brewery, a malt plant, a canning plant and a co-generation plant).
657. The only "business plans" submitted by the Claimants do not prove reliance. None of the "feasibility studies" for the financing of the proposed investments mentions EGO 24. The 3 PWC business plans for 2000, 2002 and 2003 do not say that the incentives were stabilized for 10 years. To the contrary, they all noted that the government was "clamping down... on tax incentives" (Exh. R-215; R-204; R-214). The Miculas' explanation for these plans (that they were valuations prepared for a potential sale of all or part of EFDG) does not make sense: on one hand, it undermines the claim of a 10-year business plan, and on the other, if they truly were prepared for potential sale, the valuations would have included the existence of a 10-year guarantee of the facilities.
658. Indeed, according to the Respondent, the record suggests that the Miculas made decisions on an *ad hoc* basis, identifying good opportunities for short-term profit (Tr., Day 3, 37; Day 4, 161-163, 174; Day 5, 10 (I. Micula); Day 4, 214 (V. Micula)). Taking immediate advantage of whatever incentives happen to be available does not constitute reliance on a guarantee that those incentives will remain in place and unchanged for 10 years.
659. Significantly, the Respondent notes that Viorel Micula confirmed at the hearing that it was not true that the EFDG made sense only if they could count on the benefits of the Raw Materials Incentive for 10 years (Tr., Day 6, 279 (Petrochilos/V. Micula)).
660. Second, the Claimants' decision to base their businesses in Romania was motivated by their familiarity with their home country and their desire to profit from the rapid evolution of Romania's economic and regulatory system, not by the facilities (Tr. Jur.,

Day 2, 23, 32-33, 53-55). Indeed, Messrs. Micula began to develop their food and drinks business in Bihor County in 1991, long before EGO 24 was introduced, long before any of the Corporate Claimants were established, and long before any of the Corporate Claimants had obtained a PIC. When the Claimants invested in the 1990s, they did not even rely on the then-available incentives. Even considering that under Law 35/1991 they could have invested anywhere in Romania, from 1991 to 1998 they chose Bihor County for other reasons.

661. In fact, had the Claimants really wanted to establish businesses in Bucharest, as they claim they did, they could have taken advantage of the EGO 24 facilities there as well: there were a half-dozen disfavored areas far closer to Bucharest and the port of Constanța.<sup>131</sup> Whatever led the Miculas to install new lines in the same place where they had always located their businesses, it was not EGO 24. If the cost savings of moving closer to their consumers were so significant, the Miculas could have gone to any of three disfavored areas within 90 km of Bucharest and enjoyed both those cost savings and the facilities.
662. Third, the timing of the investments confirms that these investments were not made in reliance of the facilities. The Claimants' investments made prior to the enactment of EGO 24 and the issuance of the PICs could not have been made in reliance on any expectation allegedly generated by the PICs. Starmill and Multipack were only incorporated in 2002, after Romania had begun to limit the facilities (a fact that the Claimants acknowledge, see SoC, ¶¶ 104-109). In addition, all three Corporate Claimants increased their investment activity after 2003, by which time Romania had already restricted or eliminated the Components Facility, the Machinery Facility, the Meat-Related Facility, and the Subsidies. More significantly, the Claimants continued to make substantial investments in Bihor County even after the revocation of the Raw Materials Facility; indeed, the Claimants invested a total of €182 million after the Raw Materials Facility was repealed (Second ER of D. Lessard, ¶ 128; Tr. Day 8, 69 (Lessard)). Each of the Corporate Claimants allegedly invested millions of Euro in 2005, and continued to invest more in 2007, allegedly pursuing the regional expansion of the EFDG. According to the Respondent, the Claimants continue to expand their economic activity today, boasting of increased turnover in 2006, 2007 and 2008.
663. Finally, there is no evidence that the Claimants relied on the specific document that they now claim incorporates a 10-year stabilization clause: GD 194. Indeed, the Miculas themselves always refer to EGO 24, which does not specify a period (R-PHB, ¶ 134).

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<sup>131</sup> The Respondent argues that the Miculas could have invested in the following regions that were closer to Bucharest and Constanta than Bihor and had been granted disfavored region status for ten years: Comănești, Bacău County (Exh. C-412); Baraolt, Covasna County (see Exh. C-414); Filipești, Prahova County (Exh. C-410); Ceptura, Prahova County (Exh. C-411); Altân Tepe, Tulcea County (Exh. C-415); and Motru-Rovinari, Gorj County (Exh. C-399); Zimnicea, Teleorman County (Exh. C-416) (R-Rejoinder, fn. 345).

664. According to the Respondent, “[a]ll of this belies any suggestion that Messrs Micula made investment decisions relying upon a belief that the facilities would remain unchanged until 2009. Indeed, the investment expansions in 2005 and thereafter cannot possibly assist the Claimants’ legitimate expectations arguments: they espoused, rather than avoided, Romania’s regulatory framework” (R-CM, ¶ 131).

**c. The Tribunal’s analysis**

**i. The standard to determine whether a legitimate expectation has been breached**

665. As the Respondent puts it, the key issue before the Tribunal is “who bore the risk of regulatory change: the state or the investors who benefitted from the existing regulatory regime” (R-Rejoinder, ¶ 9).

666. In the Tribunal’s view, the fair and equitable treatment standard does not give a right to regulatory stability *per se*. The state has a right to regulate, and investors must expect that the legislation will change, absent a stabilization clause or other specific assurance giving rise to a legitimate expectation of stability. Thus, the Claimants’ “regulatory stability” argument must be analyzed in the context of the protection of an investor’s legitimate expectations.

667. Cases supporting the doctrine of legitimate expectations are numerous. As noted by Dolzer and Schreuer, the protection of legitimate expectations is by now “firmly rooted in arbitral practice.”<sup>132</sup> Although the question of whether these legitimate expectations were breached is a factual one, an overwhelming majority of cases supports the contention that, where the investor has acquired rights, or where the state has acted in such a way so as to generate a legitimate expectation in the investor and that investor has relied on that expectation to make its investment, action by the state that reverses or destroys those legitimate expectations will be in breach of the fair and equitable treatment standard and thus give rise to compensation.<sup>133</sup>

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<sup>132</sup> Dolzer & Schreuer, p. 134.

<sup>133</sup> See, e.g., *Saluka v. Czech Republic*, ¶¶ 302 (The standard of “fair and equitable treatment” is therefore closely tied to the notion of legitimate expectations which is the dominant element of that standard. By virtue of the “fair and equitable treatment” standard included in Article 3.1 the Czech Republic must therefore be regarded as having assumed an obligation to treat foreign investors so as to avoid the frustration of investors’ legitimate and reasonable expectations”); *Tecmed v. Mexico*, ¶ 154 (where the tribunal found that the obligation to provide “fair and equitable treatment” meant “to provide to international investments treatment that does not affect the basic expectations that were taken into account by the foreign investor to make the investment”); *CME v. Czech Republic*, ¶ 611 (where the tribunal concluded that the Czech authority “breached its obligation of fair and equitable treatment by evisceration of the arrangements in reliance upon with the foreign investor was induced to invest”); *Waste Management v. Mexico II*, ¶ 98 (“In applying [the ‘fair and equitable treatment’] standard it is relevant that the treatment is in breach of representations made by the host State which were reasonably relied on by the claimant.”); *International Thunderbird v. Mexico*, ¶ 147 (“[t]he concept of ‘legitimate expectations’ relates, within the context of the NAFTA framework, to a situation where a Contracting Party’s conduct creates reasonable and justifiable expectations on the part of an investor (or investment) to act in reliance on said conduct, such that a failure by the NAFTA Party to honour those expectations could cause the investor (or investment) to suffer damages”)

668. The Parties agree that, in order to establish a breach of the fair and equitable treatment obligation based on an allegation that Romania undermined the Claimants' legitimate expectations, the Claimants must establish that (a) Romania made a promise or assurance, (b) the Claimants relied on that promise or assurance as a matter of fact, and (c) such reliance (and expectation) was reasonable.<sup>134</sup> This test is consistent with the elements considered by other international tribunals.<sup>135</sup>
669. In the Tribunal's view, elements (a) and (c) are related. There must be a promise, assurance or representation attributable to a competent organ or representative of the state, which may be explicit or implicit. The crucial point is whether the state, through statements or conduct, has contributed to the creation of a reasonable expectation, in this case, a representation of regulatory stability. It is irrelevant whether the state in fact wished to commit itself; it is sufficient that it acted in a manner that would reasonably be understood to create such an appearance. The element of reasonableness cannot be separated from the promise, assurance or representation, in particular if the promise is not contained in a contract or is otherwise stated explicitly. Whether a state has created a legitimate expectation in an investor is thus a factual assessment which must be undertaken in consideration of all the surrounding circumstances.
670. In this regard, the Tribunal subscribes to the view of the tribunal in *Duke Energy v. Ecuador* (quoted in *Bayindir v. Pakistan*, ¶ 179):

The stability of the legal and business environment is directly linked to the investor's justified expectations. The Tribunal acknowledges that such expectations are an important element of fair and equitable treatment. At the same time, it is mindful of their limitations. To be protected, the investor's expectations must be legitimate and reasonable at the time when the investor makes the investment [*Tecmed*, ¶ 154; *Occidental*, ¶ 185; *LG&E*, ¶ 127]. The assessment of the reasonableness or legitimacy must take into account all circumstances, including not only the facts surrounding the investment, but also the political, socioeconomic, cultural and historical conditions prevailing in the host State. In addition, such expectations must arise from the conditions that the State offered the investor and the latter must have relied upon them when deciding to invest [*SPP v. Egypt*<sup>136</sup>, ¶ 82; *LG&E*, ¶¶ 127-130; *Tecmed*, ¶ 154].<sup>137</sup>

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<sup>134</sup> In their final briefs, both Parties refer to the reasonableness of the reliance, although Romania at first had focused on the reasonableness of the expectation. In the Tribunal's view, both must be reasonable, but in particular the expectation itself.

<sup>135</sup> For example, the late Prof. Thomas Wälde explained that a claim of legitimate expectations required "an expectation of the investor to be caused by and attributed to the government, backed-up by investment relying on such expectation, requiring the legitimacy of the expectation in terms of the competency of the officials responsible for it and the procedure for issuing it and the reasonableness of the investor in relying on the expectation" (*International Thunderbird v. Mexico*, Separate Opinion of Thomas Wälde, 1 December 2005, ¶ 1). It must be noted that Prof. Wälde did not dissent on the standard, but rather on the application of that to the facts of the case).

<sup>136</sup> *Southern Pacific Properties (Middle East) Limited v. Arab Republic of Egypt* (ICSID Case No. ARB/84/3), Award, 20 May 1992 (hereinafter "*SPP v. Egypt*").

<sup>137</sup> *Duke Energy v. Ecuador*, ¶ 340. See also *Generation Ukraine v. Ukraine*, ¶ 20.37 ("it is relevant to consider the vicissitudes of the economy of the state that is host to the investment in determining the investor's legitimate expectations").

671. This promise, assurance or representation may have been issued generally or specifically, but it must have created a specific and reasonable expectation in the investor. That is not to say that a subjective expectation will suffice; that subjective expectation must also have been objectively reasonable. As stated by the *Saluka* tribunal, “the scope of the Treaty’s protection of foreign investment against unfair and inequitable treatment cannot exclusively be determined by foreign investors’ subjective motivations and considerations. Their expectations, in order for them to be protected, must rise to the level of legitimacy and reasonableness in light of the circumstances.”<sup>138</sup>
672. The Claimants must also have relied on that expectation when they made their investments. However, it is not necessary for the entire investment to have been predicated solely on such expectation. Businessmen do not invest on the basis of one single consideration, no matter how important. In the Tribunal’s view, that expectation must be a determining factor in an investor’s decision to invest, or in the manner or magnitude of its investments.
673. When the alleged legitimate expectation is one of regulatory stability, the reasonableness of the expectation must take into account the underlying presumption that, absent an assurance to the contrary, a state cannot be expected to freeze its laws and regulations. As noted by the *Saluka* tribunal, “[n]o investor may reasonably expect that the circumstances prevailing at the time the investment is made remain totally unchanged. In order to determine whether frustration of the foreign investor’s expectations was justified and reasonable, the host state’s legitimate right subsequently to regulate domestic matters in the public interest must be taken into consideration as well.”<sup>139</sup> Accordingly, for a state to violate the fair and equitable treatment standard by changing the regulatory framework, the investor must have received a legitimate assurance that the relevant laws and regulations would not be changed in his or her respect. By legitimate assurance, the Tribunal refers to the considerations identified in paragraph 669 above.

**ii. Did Romania make a promise or assurance that gave rise to a legitimate expectation?**

674. In Section A on the umbrella clause, the Tribunal found that the EGO 24 framework, in conjunction with the PICs, created a specific entitlement for the Claimants, according to which they were entitled to receive the incentives until 1 April 2009. To recall, the Tribunal found that EGO 24 created a general scheme of incentives available to investors who fulfilled certain requirements, which were later “granted” to qualifying investors through a specific administrative act (the PIC). In other words, the legislation created a generalized entitlement that could be claimed by qualifying investors, but this general entitlement was later crystallized with respect to qualifying investors through the granting of the PICs, becoming from that moment on a specified entitlement with respect to specified investors.

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<sup>138</sup> *Saluka v. Czech Republic*, ¶ 304.

<sup>139</sup> *Id.*, ¶ 305.

675. Although the majority of the Tribunal found that it had insufficient evidence as to whether that entitlement gave rise to a legal obligation for purposes of the umbrella clause, it stated that the same set of facts could give rise to a breach of the fair and equitable treatment standard, if it found that the EGO 24 framework, in conjunction with the PICs, provided the Claimants with the legitimate expectation that they would be entitled to receive the incentives until 1 April 2009.
676. Another question remained open in the majority's analysis of the umbrella clause: whether there was an element of stabilization in the EGO 24 framework (in other words, whether PIC holders (including the Claimants) were entitled to receive the incentives in the same form (or substantially the same form) as when they were first given their PICs during the entire period, regardless of changes in the Romanian legislation). Although the majority of the Tribunal was not able to answer that question as a matter of Romanian law, it will do so now as a matter of fair and equitable treatment.
677. After a review of all of the facts and circumstances surrounding the Claimants' investment and Romania's enactment of EGO 24 and related legislation, the Tribunal (again by majority<sup>140</sup>) answers both questions in the affirmative. For the reasons set out below, it finds that, even from an objective standpoint the legislative framework in Romania between the years 1998-2002 (taking into consideration EU law, as it applied to Romania at the time), together with the PICs, instilled in the Claimants a legitimate expectation that they would be entitled to the EGO 24 incentives, in substantially the same form as when they received their PICs, until 1 April 2009. Specifically, the Tribunal finds that, through an interplay of the purpose behind the EGO 24 regime, the legal norms, the PICs, and Romania's conduct, Romania made a representation that created a legitimate expectation that the EGO 24 incentives would be available substantially in the same form as they were initially offered.
678. First, the purpose behind the EGO 24 regime was to attract investment in the disadvantaged areas, preferably long-term investment that created employment. In the context in which this legislation was passed, it is evident that Romania was eager to attract investment in order to boost its economy and work towards EU accession. If Romania had spelled out that it retained the right to eliminate the incentives at its discretion, despite the stated duration term for the incentives, Romania likely would not have achieved its objective of attracting investment. Investors require legal certainty, and Romania knew this full well, otherwise it would not have specified in several different documents that the incentives would be available during the period in which Ştei-Nucet was declared a disadvantaged area. Indeed, it is evident from Romania's conduct that it intended for the regime to remain in place until 1 April 2009 and, absent the EU's intervention, this is what would have happened, as discussed further below.

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<sup>140</sup> Arbitrator Abi-Saab does not concur with this view, as expressed in his separate opinion.

679. Second, the regime required a certain *quid pro quo* from the investors. As specified in EGO 24 itself and in the Methodological Norms, investors had to fulfill certain requirements to obtain their PIC, and undertook certain obligations:

- a. Investors were required to create employment. The 2001 Methodological Norms required 10 employees, 5 of which must have been previously unemployed (Article 4(4) of the 2001 Methodological Norms).
- b. Investors were required to create new investments. In this regard, Article 6(1) of EGO 24 provided that the facilities would be granted to qualifying investors “for their new investments in [the disfavoured] regions.” Only three of the Claimants’ companies benefitted from the EGO 24 incentives, but the Claimants have argued (and Romania has not disputed) that for each new investment they had to submit an investment plan and amend their PIC.
- c. PIC holders had to undergo substantial monitoring to continue receiving the incentives under their PICs (Articles 14 and 16 of the 1999 Methodological Norms, Articles 6, 8, 14 and 15 of the 2001 Methodological Norms). Indeed, the Claimants’ witnesses have described audits and monitoring procedures that seem to go beyond what is provided in the Methodological Norms, but it is not surprising that actual administrative procedures were more detailed than the relevant norms set out. The Respondent has not challenged these descriptions.
- d. Investors were required to maintain their investments in the disadvantaged area for at least twice the time they benefitted from the incentives (Articles 7 and 9 of EGO 24).

680. This last obligation was set out in Articles 7 and 9 of EGO 24, as follows:

Art. 7. - If an investment which is benefiting from the provisions of the present Emergency Ordinance is ***voluntarily liquidated in a period of time shorter than twice the period of time in which they enjoyed the advantages*** granted through the Government Decision to create the underprivileged area, ***the liquidator(s) is/are obligated first to pay the funds related to the advantages*** granted in accordance with the provisions of the present Emergency Ordinance, to the State Budget, the State Social Insurance Budget and the Special Funds Budgets from the funds resulting from the liquidation procedure.

Art. 9. - Businesses established in a disadvantaged area ***may voluntarily cease to operate in the respective area***, and those opening subsidiaries as legal entities in such an area may ***close them or move the location of their headquarters out of the disadvantaged area in a period shorter than the one provided in Art. 7 only if they pay the funds they owe*** to the State Budget, the State Social Insurance Budget and the Special Funds Budgets ***related to the advantages granted*** in accordance with the provisions of the present Emergency Ordinance. (Emphasis added)

681. Thus, Articles 7 and 9 of EGO 24 put investors on notice that, if they planned to benefit from the incentives for the full period they were offered, they had to be prepared to make long-term commitments and investments in the region, and make

sure that their investments would continue to be profitable without the incentives when the incentives were no longer available.

682. Third, the Respondent did not merely “trim down” the incentives, as the Respondent contends. It is true that the incentives were amended several times, and that by 2002 the Machinery Incentive had been eliminated and the Raw Materials Incentive could not apply to raw materials for the production, processing and preservation of meat. (The Profit Tax Incentive had also been eliminated but grandfathered for existing PIC holders). However, three of the original six incentives remained (four counting the grandfathered Profit Tax Incentive). These three remaining incentives (other than the Profit Tax Incentive) were eliminated by EGO 94/2004. Therefore, the incentives were virtually eliminated rather than simply modified or amended.

683. Specifically, Chapter II, Section 3, Article VI(2) of EGO 94/2004 provided (Exh. R-94):

Art. VI. - Emergency Government Ordinance no. 24/1998 on Less-Favoured Areas, republished in the Official Gazette of Romania, Part I, Issue 545 of 8 November 1999, as subsequently amended and supplemented, shall be amended and supplemented as follows:

1. After paragraph (1) of Article 14<sup>1</sup> insert a new paragraph, paragraph (1<sup>1</sup>) with the following content:

"(1<sup>1</sup>) In calculating the intensity of State aid, eligible costs related to investments made before 15 September 2004 shall be taken into account."

2. Article 6(1)b)d) and e) shall be repealed within 90 days from the date of entry into force of this Ordinance."

684. As can be seen from the text of EGO 94/2004, the amendment eliminated the incentives and added rules for the calculation of the intensity of state aid. In turn, it left in place all remaining provisions of the regime, including its obligations, which is however disputed. In turn, this stripped EGO 24 of most of its practical content and reduced almost to nothing its advantages given that the purpose of the regime for disadvantaged areas was to attract investment in exchange for certain tax benefits. After EGO 94/2004, the only tax benefit that remained was the Profit Tax Incentive, and only for existing PIC holders. This is not a “trimming down” of the incentives. It was an outright termination.

685. The Tribunal thus finds that Romania’s representation that the EGO 24 incentives would be available to PIC holders until 1 April 2009 meant that the Claimants would continue to benefit from substantially the same incentives that were available when the Claimants obtained their PIC.

686. As stated above, the Tribunal considers that, in determining whether the Claimants had a legitimate expectation, it must take account of the accepted principle that Romania is free to amend its laws and regulations absent an assurance to the contrary. However, in this case the Tribunal finds that Romania’s conduct had included an element of inducement that required Romania to stand by its statements and its conduct. Romania launched a program directed to attract investors to the



disfavored regions. To obtain that investment, it offered certain tax benefits for a certain amount of time. In other words, Romania created the appearance of a ten-year tax holiday for investors who decided to invest in the disadvantaged area (and this appearance conformed to what Romania did in fact wish to enact). The Tribunal has noted in particular that the former president of the NARD, Mr. Neculai Liviu Marcu, testified that the incentives were to be understood to be granted for the full duration of the disadvantaged area (WS of Mr. N. Marcu, ¶¶ 28, 32; Tr., Day 7, 15:2-9 (Marcu)). In the Tribunal's view, Romania thereby made a representation that gave rise to the PIC holders' legitimate expectation that during this tax holiday they would receive substantially the same benefits they were offered when they committed their investments.

687. What is at stake is not Romania's regulatory sovereignty, which is not to be questioned. However, it cannot be fair and equitable for a state to offer advantages to investors with the purpose of attracting investment in an otherwise unattractive region, require these investors to maintain their investments in that region for twice the period they receive the investments, and then maintain the formal shell of the regime but eviscerate it of all (or substantially all) content.
688. The record shows that Romania itself shared that belief. It did all it could to preserve the incentives regime through its accession negotiations (see Section 4 below). Whether or not it felt committed to existing PIC holders, it certainly wished to maintain the regime for as long as possible and publicly stated so. Romania thereby created the legitimate expectation that the regime would not be repealed or fundamentally altered during the duration of each PIC.
689. Romanian officials also stated that investors would be compensated if the regime were repealed or fundamentally altered. In particular, in his interview in May 2004 (Exh. C-652), Prime Minister Nastase indicated that during its negotiations with the European Union, Romania would see if it was "able to obtain some transition periods" for PIC holders, as well as "some compensation packages, established during direct negotiations." The Prime Minister also stated that the government would talk to the investors, and "based on the conclusions of the negotiations of the Competition Chapter, we will negotiate with those who initially obtained these fiscal incentives" (Exh. C-652, pp. 7-9 of translation). These statements confirm that Romania itself understood that the EGO 24 regime was to last for 10 years, and that in repealing it prematurely Romania was undermining PIC holders' legitimate expectations and causing them to suffer damages.

### **iii. Was this expectation reasonable?**

690. In broad terms, the Tribunal will analyze the reasonableness of the Claimants' expectation from two perspectives: (i) the legitimacy of the expectation in the context of Romania's accession to the EU, and (ii) the legitimacy of the expectation under Romanian law.

(a) *Reasonableness in the context of Romania's Accession to the EU*

691. After a careful review of the record, the Tribunal has come to the conclusion that between 1998 and late 2003 it was reasonable for the Claimants to believe that the EGO 24 incentives were compatible with EU law. The Tribunal agrees with Prof. Dashwood's conclusion that "a strong case can be made that the Romanian authorities were justified in treating the disputed aid as a valid regional operating aid, up until the moment when they abolished it" (ER of A. Dashwood ¶ 55).
692. There seems to be no dispute that, throughout the period during which the Claimants received the EGO 24 incentives (that is, from receipt of European Food's TIC in 1999 until the incentives were abolished in February 2005), the EGO 24 scheme was subject to the state aid regime of the Europe Agreement (which was the operative pre-accession treaty; ER of A. Dashwood, ¶ 31). As explained by Prof. Dashwood (with no convincing rebuttal by Romania's experts), under the Europe Agreement regime, the substantive rules to assess the compatibility of the EGO 24 incentives with the common market were the substantive rules of the EU state aid regime contained in Article 87 of the EC Treaty (through the operation of Article 64(2) of the Europe Agreement), as amplified by case law and Commission practice, and as subsequently clarified by the Implementing Rules that were annexed to Decision 4/2000 of the Romania-EU Association Committee (Exh. R-65; C-579).
693. Article 64 of the Europe Agreement provides in relevant part:
1. The following are incompatible with the proper functioning of this Agreement, in so far as they may affect trade between the Community and Romania: [...] (iii) any public aid which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods.
  2. Any practices contrary to this Article shall be assessed on the basis of criteria arising from the application of the rules of Articles 85, 86, and 92 of the Treaty establishing the European Economic Community.
  3. The Association Council shall, within three years of the entry into force of the Agreement, adopt the necessary rules for the implementation of paragraphs 1 and 2.
  4. (a) For the purposes of applying the provisions of paragraph 1, point (iii), the Parties recognize that during the first five years after the entry into force of the Agreement, any public aid granted by Romania shall be assessed taking into account the fact that Romania shall be regarded as an area identical to those areas of the Community described in Article 92(3)(a) of the Treaty establishing the European Economic Community. The Association Council shall, taking into account the economic situation of Romania, decide whether that period should be extended by further periods of five years. [...]
694. Article 64 of the Europe Agreement incorporated Article 87 of the EC Treaty, which is the primary source of the EU's substantive rules on state aid. Article 87(1) of the EC Treaty contains the general principle that "any aid granted by a Member State or through state resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall,

in so far as it affects trade between Member States, be incompatible with the common market.” However, Article 87(3)(a) (which replaced Article 92(3)(a) of the Treaty establishing the European Economic Community) expressly permitted “aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment.”

695. In turn, Art. 64(4)(a) of the Europe Agreement expressly stated that all of Romania would be considered an underdeveloped area for purposes of Article 87(3)(a) of the EC Treaty for the first five years after the entry into force of the Europe Agreement:

For the purposes of applying the provisions of paragraph 1, point (iii), the Parties recognize that during the first five years after the entry into force of the Agreement, any public aid granted by Romania shall be assessed taking into account the fact that Romania shall be regarded as an area identical to those areas of the Community described in Article 92(3)(a) of the Treaty establishing the European Economic Community. The Association Council shall, taking into account the economic situation of Romania, decide whether that period should be extended by further periods of five years. [...] (Art. 64(4)(a) of the Europe Agreement).

696. Article 64(3) of the Europe Agreement provided that “[t]he Association Council shall, within three years of the entry into force of the Agreement, adopt the necessary rules for the implementation of paragraphs 1 and 2.” With some delay, on 10 April 2001, the EU-Romania Association Council adopted Decision 4/2000 which contained these “Implementing Rules”, Exh. R-65; C-579), which prescribed the manner in which Article 64 of the Europe Agreement would be implemented by Romania.<sup>141</sup>
697. Article 2(1) of the Implementing Rules provided that “[t]he assessment of compatibility of individual aid awards and programmes with the Europe Agreement, as provided for in Article 1 of these Rules, shall be made on the basis of the criteria arising from the application of the rules of Article 87 of the Treaty establishing the European Community, including the present and future secondary legislation, frameworks, guidelines and other relevant administrative acts in force in the Community, as well as the case law of the Court of First Instance and the Court of Justice of the European Communities and any decision taken by the Association Council pursuant to Article 4(3).”
698. The criteria applied by the European Commission when examining the Article 87(3)(a) exception were set down in the 1998 Guidelines on Regional Aid (first published in 1998 (Exh. RJ-9) and since replaced by a revised version for the years 2007-2013) (Exh. C-298).

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<sup>141</sup> Article 4(1) of the Implementing Rules also extended the time period in which Romania would be considered an underdeveloped area pursuant to Article 64(4)(a) of the Europe Agreement:

In accordance with and within the limits of Article 64(4)(a) of the Europe Agreement, Romania shall be regarded as an area identical to those areas of the Community referred to in Article 87(3)(a) of the Treaty establishing the European Community. (Article 4(1) of Decision 4/2000).

699. The Guidelines on Regional Aid distinguished between various types of state aid, and described the circumstances under which certain state aid could be granted, including where the economic situation was extremely unfavorable in relation to the Community as a whole. In such cases, the aid could be granted as tax exemptions. In addition, although operating aid aimed at reducing a firm's current expenses is normally prohibited, the Guidelines recognize that, exceptionally, such aid may be granted in regions eligible under the derogation in Article 87(3)(a), subject to certain conditions. Specifically, the 1998 EU Guidelines on Regional Aid (RJ-9) provided:

Operating aid

4.15. Regional aid aimed at reducing a firm's current expenses (operating aid) is normally prohibited. Exceptionally, however, such aid may be granted in regions eligible under the derogation in Article 92(3)(a) provided that (i) it is justified in terms of its contribution to regional development and its nature and (ii) its level is proportional to the handicaps it seeks to alleviate (36). It is for the Member State to demonstrate the existence of any handicaps and gauge their importance.

4.16. In the outermost regions qualifying for exemption under Article 92(3)(a) and (c), and in the regions of low population density qualifying either for exemption under Article 92(3)(a) or under 92(3)(c) on the basis of the population density test referred to at point 3.10.4, aid intended partly to offset additional transport costs (37) may be authorised under special conditions (38). It is up to the Member State to prove that such additional costs exist and to determine their amount.

4.17. With the exception of the cases mentioned in point 4.16, operating aid must be both limited in time and progressively reduced. In addition, operating aid intended to promote exports (39) between Member States is ruled out.

700. The Tribunal agrees with Prof. Dashwood that the EGO 24 incentives appeared to meet most of the criteria for regional operating aid set forth in the 1998 Guidelines (ER of A. Dashwood, ¶¶ 52-53). Specifically:

- a. EGO 24/1998 was created to contribute to regional development, and there is evidence that it did in fact contribute to such development.
- b. The level of disputed aid appears to have been proportional to the handicaps of the disadvantaged areas that the aid was designed to alleviate, and the Romanian government could have been able to demonstrate this.

701. The only unsatisfied criterion would be its "non-degressive character" (i.e., the fact that the EGO 24 incentives were not meant to be progressive, as mandated by Article 4.17 of the 1998 Guidelines). However, given the level of unemployment in the Ștei-Nucet-Drăgănești area Prof. Dashwood did not consider it a determinative factor (ER of A. Dashwood, ¶ 54).

702. Neither the Respondent nor its experts contested Prof. Dashwood's conclusions persuasively, and the Tribunal finds Prof. Dashwood's assessment reasonable.

703. As a result, the Tribunal concludes that the EGO 24 incentives could have reasonably been thought (both by the Romanian government and the Claimants) to be valid regional operating aid under EU law. Indeed, Romania itself appears to have believed that, at the time EGO 24 was enacted, the incentives were compatible with EU state aid requirements. In its Counter-Memorial, Romania stated:

Especially given Romania's status as an 'underdeveloped area' within the meaning of Article 87(3)(a) of the EC Treaty, the government could reasonably conclude at the time that the EGO 24/1998 regime was not incompatible with the Europe Agreement's provisions. Furthermore, given the economic dislocation that existed at the time, measures to ameliorate conditions in the disfavoured regions were necessary. Romania was not alone among EU candidate States in making the policy choice to implement new economic-assistance measures based upon such an assessment of the legal position. For example, Poland passed similar legislation authorizing State aid for underdeveloped regions in 1994, while it was a candidate for EU admission (R-CM, ¶ 29).

704. Similarly, in its comments to the Commission's Written Submission, Romania acknowledged that:

The facilities in EGO 24/1998 appeared to be regional aid for economically disadvantaged areas. Thus, EGO 24/1998 was reasonably considered as falling within the exceptions in Article 87(3)(a) and 87(3)(c) EC Treaty. (Respondent's Comments to the Commission's Written Submission, 16 Nov. 2009, ¶ 2).

705. Romania's expert, Prof. Rudolf Streinz confirms the reasonableness of that position:

In my opinion, in 1998 and particularly in the absence of effective State aid control and support from the European Commission, Romania could, in the exercise of its discretion, reasonably have considered that the EGO 24/1998 regime fell under one of the State aid exceptions of the EC Treaty [...]. For example, Romania, having been designated in its entirety in Article 64(4) of the Europe Agreement as underdeveloped within the meaning of Article 87(3)(a) of the EC Treaty, could have considered itself permitted to enact EGO 24/1998. EGO 24/1998 provided for State aid to foster economic development of areas – i.e. the whole of Romania – where the standard of living was abnormally low or where there was serious underemployment. Alternatively, Romania might have considered that the State aid granted pursuant to EGO 24/1998 was exempt under Article 87(3)(c), because the regime amounted to assistance of regions which are disadvantaged compared to the national average, based on national criteria (First ER of R. Streinz, ¶ 19).

706. As expressly acknowledged by Romania, many government officials maintained this "sincere belief" until after the Competition Council issued Decision 244 in 2000, and the Respondent's expert Mr. Petersen acknowledged that "Romanian politicians and officials who thought that EGO 24 was legal were incorrect, but they were not unreasonable, and they acted in good faith" (R-PHB, ¶ 174, Tr., Day 6, 111, 178). The Tribunal does not believe that investors should be held to a higher standard than the government. Investors are entitled to believe that the government is acting legally.

707. The question is when should the Claimants have realized that the incentives were (or became) vulnerable because they contravened EU law and, as a consequence, at what time they might be phased out. As late as June 2002, Romania's "National Programme for Accession of Romania to the European Union" (Exh. HEC-7) stated that "[t]he provisions of the normative acts on facilities granted for 'D areas' will be maintained till the moment of Romania's accession to the European Union" (p. 148). Mr. Orban testified that this was Romania's intention, and that it "battled a lot with the Commission to get this" (Tr., Day 8, 219-220 (Orban)). Indeed, when asked when it should have been clear to the public that the facilities would not survive, Mr. Orban testified that it could have been as late as April/May 2004 (Tr., Day 8, 12-14 (Orban)).

(b) *Reasonableness under Romanian law*

708. Determining whether the Claimants' expectations were reasonable under Romanian law is less straightforward. On the one hand, the Claimants argue that the purpose of EGO 24 and its enacting legislation, as well as the issuance and content of the PICs, made their expectations reasonable. Romania argues that, to the contrary, nothing in the regulation and the PICs themselves assured the Claimants that the incentives would remain in place for 10 years. However, the Tribunal has already found that the content of the legislation and the PICs themselves gave rise to a legitimate expectation that the incentives would last until 1 April 2009.

709. On the other hand, Romania argues that the regulatory framework as it existed at the time of the Claimants' alleged investment in reliance on Romania's assurances (from 2000 to 2004, if the issuance of European Food's PIC is taken as starting point) contemplated the possibility that the incentives could be subject to repeal. Romania argues that the incentives could have been revoked as a matter of general administrative law, or because in 1999, prior to the issuance of the PICs, Romania passed the Competition Law, which allowed the Competition Council to determine whether any existing aid was compatible with the Europe Agreement and, if it was not compatible, to recommend cancellation of such aid and request its repayment (Articles 12-13 of the Competition Law). In Romania's submission, the fact that Romanian legislation allowed the Competition Council to recommend the revocation of the incentives undermines the reasonableness of any expectation that these incentives would remain unchanged for 10 years. Indeed, Romania argues that this is exactly what the Competition Council did with Decision 244/2000.

710. In the Tribunal's view, two distinct but related issues must be analyzed: (i) the possibility that the incentives would be found incompatible with Romanian law, and (ii) Romania's interaction with the Competition Council with respect to Decision 244/2000.

711. With respect to the first point, the Respondent argues that, under the existing regulatory framework, the incentives were inherently subject to the Competition Council's review and possible cancellation. Thus, the fact that the fate of all existing legal aid could depend on a decision by the Competition Council weakens any reasonable belief that any incentives would remain unchanged for any particular

period of time. In other words, the Claimants should have known, when they obtained the PICs, that the incentives could be at any time declared by the Competition Council to be incompatible with Romanian law.

712. This proposition cannot be sustained. Any piece of legislation must comply with higher ranking norms. That does not change the fact that enacted rules are supposed to be valid and enforceable for so long as they have not been repealed or annulled. Law-abiding actors may not violate enacted laws or regulations because they question their validity or legality: they may know that such validity or legality is debatable, and seek appropriate relief in court or otherwise, but, in the meantime, they must obey the law. Romania has not argued that the incentives were illegal or that there were any doubts as to their legality. In other words, the possibility of cancellation of the incentives by order of the Competition Council is in itself not a valid argument.
713. With respect to the second point, on 15 May 2000, the Competition Council issued Decision 244/2000, which recommended that the Raw Materials Incentive be abolished. However, the Romanian Government (with the approval of the judiciary) overruled this decision, and thus confirmed the incentives' legality under Romanian law.
714. The Claimants' expectation that the incentives were compatible with Romanian law was particularly reasonable given the sequence of events with respect to the process surrounding Decision 244 and the granting of the Claimants' PICs. Decision 244 was rendered on 15 May 2000, European Food's PIC was issued on 1 June 2000, and EGO 75/2000 (which amended EGO 24 but maintained the Raw Materials Incentive) was enacted on 16 June 2000. The Competition Council brought a law suit against the Government, which the High Court of Cassation dismissed on admissibility grounds on 19 February 2002. Multipack and Starmill's PICs were issued on 17 May 2002.
715. In the Tribunal's view, given that the Government, in this case through Parliament, did not follow the Competition Council's recommendation to abolish the incentives, and decided instead to confirm them via new legislation (EGO 75/2000), and immediately afterwards issued the Claimants PICs confirming their eligibility for the questioned incentives, it was reasonable for the Claimants to believe that the Government considered that such incentives were legitimate and intended to maintain them for the stated period. The fact that the Competition Council sought to enforce Decision 244 in Romanian courts and that its action was dismissed by the original and appellate courts, further enhances the notion that the Government (at its legislative and judicial level) endorsed the legitimacy of the incentives. In other words, the Government implicitly confirmed the incentives' legality under Romanian law.
716. The fact that the court action was dismissed on admissibility grounds does not change this conclusion. Indeed, by determining that the Competition Council did not have the power to challenge legislative acts, the courts merely confirmed that, as a matter of Romanian law, the existence and legitimacy of the incentives depended on

Parliament, not on the Competition Council. And as a matter of Romanian law, the Claimants were entitled to rely on the assumption that the incentives were legal. The fact that Starmill and Multipack received their PICs after the challenge was dismissed further confirms that it was reasonable for the Claimants to believe that the incentives were legitimate.

717. In conclusion, the Tribunal finds that it was reasonable for the Claimants to believe that the incentives were legal under Romanian law and would be maintained for the full 10 year period.

**iv. Did the Claimants in fact rely on that expectation?**

718. There is no dispute that the Claimants invested in Bihor County, and that they made use of the incentives. However, it is also evident from the record that their initial investments were not made in reliance on the EGO 24 incentives, because they began to invest in the early 90s, before these incentives were created. Indeed, the Claimants concede that their initial investments were made in reliance on previous incentive regimes (R-Reply, ¶¶ 62-124). The Claimants have also stated that their expectation that the Raw Materials Incentive would be available for 10 years arose when the PICs (or TIC, in the case of European Food) were granted (Tr., Day 12, 91 (Reed)). In the Tribunal's view, a legitimate expectation could only have been crystallized at the time when the Corporate Claimants were granted their permanent investor certificates, not temporary certificates. A temporary certificate is, by its own nature, granted only for a limited time and does not necessarily guarantee that a permanent certificate will be issued. A TIC can give rise to an expectation that its beneficiary is temporarily entitled to some benefits but not that the permanent certificate will actually be issued as the beneficiary will have to prove that, in the meantime, it has satisfied some conditions. Thus, the only investments that could have been made in reliance on that expectation are those made after European Food obtained its PIC in June 2000, and after Starmill and Multipack obtained theirs in May 2002. Whether the Claimants relied on previous incentive programs neither proves their reliance on the EGO 24 incentives nor strengthens their reliance argument.

719. In addition, there is evidence that, further to the EGO 24 incentives, there were other reasons why the Miculas invested in Bihor County. The Tribunal recalls that, according to Mr. Viorel Micula's cross-examination, there were other reasons for the Claimants' investment in Bihor apart from the availability of the Raw Materials Facility for the planned 10 year period until 2009. Mr. Viorel Micula testified as follows:

Q. Mr Micula, let's not beat around the bush. I will read out a proposition to you and you tell me if you agree. Your investment in Bihor in the European Food and Drinks Group only made economic sense if you could count on the benefits of the raw materials facility for the planned ten-year period until 2009, is that correct? Is it true to say that your investment makes economic sense only if you have the raw materials facility?

A. It is wrong, Mr Petrochilos. I think no one, either myself or my brother who knew about this leverage had made such a mistake. That would have been a big mistake. Maybe you made that mistake.



(Tr., Day 6, 279 (Petrochilos/V. Micula)).

720. In addition, the Micula brothers were born in Bihor County and Ioan Micula conceded that there was “a very emotional drive” behind their business initiative (Tr. Jur., Day 2, 23). However, he also stated that “it was not just a question of us being born there, it was also a question of long-standing facilities and exemptions that have been there for a very long time and many of them are still there” (Tr. Jur., Day 2, 54).
721. Taking all of this into consideration, it is clear that (i) not all of the Claimants’ investments were predicated on the EGO 24 incentives; and (ii) even when the Claimants’ took the EGO 24 incentives into account in making investment decisions, other factors also influenced the Claimants’ decisions. However, the Tribunal is satisfied that a significant part of the Claimants’ investments (from 2000 to 2004) were made in reliance on the incentives. In particular, the Tribunal is satisfied that the existence of the incentives was one of the reasons for the scale and manner of those investments. It is evident from the record that the Claimants built a large and complex platform for the production of food and drink products, and that its profits depended largely on the reduction of their operating costs resulting from the Raw Materials Incentive (Third WS of I. Micula, ¶¶ 44-67, 83-84; Third WS of V. Micula, ¶ 33, 51-52; WS of M. Ban ¶ 38; WS of M. Halbac, ¶¶ 12-61; First ER of D. Lessard, ¶¶ 32-42; ER of R. Boulton, Sections 4 and 5; ER of C. Osborne, ¶¶ 1.11-1.15; Section 4; Exh. C-385, C-987). Accordingly, the Tribunal is satisfied that the Claimants in fact relied on the incentives to build and develop their investment in the manner in which it stood at the date of the revocation of those incentives.
722. It goes without saying that the BIT only protects investments made in reliance on legitimate expectations (see paragraphs 667 to 673 above). It does not protect investments made after such an expectation has been destroyed. The Tribunal has found that the Claimants’ expectations arose in June 2000, with the granting of European Food’s PIC. This expectation was shattered once it became clear that Romania would revoke the incentives without compensation, which, as discussed further below, occurred on 31 August 2004, with the issuance of GO 94/2004. Although Prime Minister Nastase publicly announced the termination of the regime for the first time in January 2004, it was still uncertain at that time whether PIC holders would be compensated (see Section 4 below). Accordingly, the BIT can only protect the Claimants’ investments made between 1 June 2000 and 31 August 2004.
723. The Tribunal does not ignore the fact that the Respondent has challenged the credibility and reliability of the Claimants’ witnesses, in particular with respect to the question of whether, in making their investment decisions, the Claimants’ relied on an expectation that the incentives would remain in place for 10 years, and with respect to their damages case.
724. The Tribunal will address the Respondent’s arguments with respect to damages in due course. With respect to Claimants’ legitimate expectations, however, the Tribunal is not persuaded that the testimony of the Claimants and their witnesses is unreliable. The key issue before the Tribunal is whether and to what extent the

Claimants relied on the EGO 24 incentives to make and develop their investments, and if that reliance was reasonable. It is evident from the documentary record that the Claimants did in fact rely on the EGO 24 regime to expand their business (see paragraph 721 above). The Tribunal has also found that the Claimants' expectation that the EGO 24 regime would be in place for 10 years was objectively reasonable. It was also reasonable to rely, at least until 31 August 2004, on the survival of that regime.

\* \* \*

725. For the reasons set out above, the majority of the Tribunal finds that Romania violated the Claimants' legitimate expectations with respect to the availability of the EGO 24 incentives.

726. Although the majority of the Tribunal has found a breach of legitimate expectations, in order to provide a complete ruling on Romania's compliance with its obligation to provide fair and equitable treatment, the Tribunal will address the Parties' remaining arguments with respect to this standard. The Tribunal will next address Romania's defense that it acted reasonably (Section 4 below). It will then address whether Romania acted in bad faith (Section 5 below). Finally, it will address the Claimants' argument that Romania failed to act transparently and consistently (Section 6 below).

#### **4. Did Romania act unreasonably?**

727. The Respondent's main defense with respect to the Claimants' fair and equitable treatment and unreasonableness claims is that it acted reasonably when it terminated the EGO 24 incentives regime. It thus argues that it did not engage in what it has called "substantively improper conduct", and it should not be made to compensate for reasonable general regulation. Although the Respondent has acknowledged that the Tribunal may find a breach of the BIT if it finds that Romania promised that the incentives would remain unchanged for ten years and the Claimants reasonably relied on that expectation (see paragraph 500 above, Tr., Day 13, 19-43 (King)), the Respondent devoted considerable time and effort to establishing that it acted reasonably.

728. The Claimants have not addressed this defense directly in the context of their fair and equitable treatment claim, other than to argue that Romania's subjective motivation is irrelevant to determine if it has breached the fair and equitable treatment standard. However, in the context of their claim for "impairment by unreasonable or discriminatory measures" under the second section of Article 2(3) of the BIT (the "impairment clause"), the Claimants also argue that Romania acted unreasonably when it repealed the EGO 24 incentives. When discussing unreasonableness in the context of fair and equitable treatment, the Tribunal will thus refer to the arguments made by the Claimants on that issue in the context of the impairment clause.

##### **a. The Claimants' position**

729. The Claimants argue that Romania acted unreasonably by:

- a. Actively promoting and extending the EGO 24 regime and encouraging investors to participate in that scheme (at least until 2003), despite the fact that behind closed doors it was negotiating for the scheme's early termination.
  - b. Revoking the incentives regime prematurely without being required to do so by any competent legal authority, without attempting to negotiate with the EU or the Claimants to mitigate the damages caused by the revocation, and in contradiction of its repeated statements over the years that the regime was legal and satisfied EU requirements.
  - c. Revoking the benefits of the incentives regime while maintaining the investors' obligations under that regime (in particular the obligation to maintain the investments for 20 years). In the Claimants' view, "a government's decision unilaterally to continue to reap the full benefits of a deal with investors while denying those investors the originally-promised benefits is a textbook example of unreasonableness" (C-Reply, ¶¶ 459-460; C-PHB, ¶¶ 65-66).
730. In terms of the relevant case authority, the Claimants argue that Romania deprived the Claimants of their legitimate rights under circumstances that are contrary to the rule of law (relying on the ICJ's decision in *ELSI*<sup>142</sup>). They further contend that there was no factual justification for the withdrawal of the tax exemptions and incentives (*Lauder v. Czech Republic*). In addition, they argue that the reversal of Romania's position upon which the Claimants had relied was not merely surprising but outrageous (*Pope & Talbot*<sup>143</sup>). Finally, they argue that the measures affecting the Claimants' position were not based on rational decision-making or any consideration of the effects on foreign investments, and did not balance the interests of the state with the burden imposed on Claimants' investments (*LG&E*).

**b. The Respondent's position**

731. The Respondent submits that the central question in this case is whether Romania acted reasonably in amending EGO 24 in August 2004. The Respondent argues that where an investor challenges general legislation that modifies existing general legislation, the question for an international tribunal is whether that legislation is grounded in reason (rather than being arbitrary) and enacted in pursuit of legitimate objectives (rather than for illicit purposes, such as discrimination). The Claimants have not argued that Romania acted in a discriminatory fashion; the question is thus whether Romania acted unreasonably. The Respondent contends that, to show that Romania acted unreasonably, the test is to determine whether, in light of all of the surrounding circumstances, what Romania did was reasonably connected to a rational policy (R-CM, ¶¶ 167-174; R-Rejoinder, ¶¶ 108-117; R-PHB, ¶¶ 33-98; Tr., Day 13, 45-50 (King)).

<sup>142</sup> *Case Concerning Elettronica Sicula SpA (ELSI) (United States of America v Italy)*, 20 July 1989 (hereinafter "*ELSI*"), [1989] ICJ Reports 15.

<sup>143</sup> *Pope & Talbot Inc v. The Government of Canada*, UNCITRAL, Award in Respect of Damaques, 31 May 2002, 41 ILM 1347 (2002), ¶ 64.

732. The Respondent argues that it is the Claimants' burden to prove that Romania's action in withdrawing the facilities was manifestly unreasonable (as stated in *AES v. Hungary*). The Respondent submits that the Claimants have not met that burden. Rather, the Claimants speculate about possible transitional measures or possibly delaying the withdrawal of the facilities, and other things Romania might have done. In the Respondent's view, such speculation is not sufficient to prove that Romania's actions were manifestly unreasonable. The Respondent submits that the Claimants' burden is to prove, not merely that Romania could have made better decisions, but rather that the decisions that it did make were so poor and so arbitrary, that they lacked any reasonable relationship to a rational policy goal.
733. In any event, according to the Respondent the record shows that Romania, over a 4 year period of negotiations with the EU, did endeavor to salvage what it could of the EGO 24 facilities. However, the Member States were adamant about the need to eliminate nonconforming state aid, not just by the date of accession but before the negotiations on Chapter 6 (the competition policy chapter of the EU accession negotiations) could be closed and the accession treaty signed. This was especially true of operating aid, and aid that would have been inconsistent with the rules of the customs union, which is what the raw materials exemption would have been.
734. More specifically, the Respondent argues that (i) its motivation in amending EGO 24 was to comply with EU accession; (ii) it acted reasonably in pursuit of conflicting policies, and (ii) none of the Claimants' contentions about what Romania could or should have done differently proves that Romania acted unreasonably.

**i. The Respondent's motivation in amending EGO 24 was to comply with EU accession**

735. The Respondent argues that its subjective motivation in amending EGO 24 was to address the EC's concerns over state aid. Romania alleges that it gradually repealed the facilities, not irrationally or unreasonably, but in response to increasing pressure from the Commission and the Member States, and in pursuit of the universally accepted national policy priority of joining the EU. According to the Respondent, the facts "indicate that the measures were based upon a rational decision-making process, related directly to the dual (and competing) policy goals of support for disadvantaged regions and admission to the EU" (R-CM, ¶ 173).
736. Specifically, the Respondent alleges that in 2000, Romania announced that the target for EU accession was 2007, and that was public knowledge. During the next three years, Romania, the Commission and the Member States talked with each other about state aid. The Respondent argues that there was a particular focus on EGO 24, especially once the EU was informed that in May 2000 Romania's Competition Council had found certain facilities to be incompatible with the *acquis* on state aid.
737. The Respondent contends that, as a result, Romania began to "chip away" at the customs duty exemptions. In 2002, it eliminated the Machinery Facility, and then the meat-related Raw Materials Facility. Also in 2002, it repealed the Profit Tax

Exemption but grandfathered it for existing PIC holders. Ultimately Romania managed to persuade the EU to accept the grandfathering of the Profit Tax Exemption.

738. The Respondent argues that, by 2004, time was running out if it was to meet its longstanding 1 January 2007 target date for accession. For that to happen, negotiations had to be closed in 2004 and the Accession Treaty had to be signed in 2005. So in June 2004 Romania placed maximum intensity caps on the EGO 24 facilities, but that was not enough for the EU. Finally, in August 2004 the Romanian Parliament passed GO 94/2004, withdrawing the remaining facilities. Romania communicated this fact to the EU in November 2004, and the very next month Chapter 6 was provisionally closed. The revocation of the EGO 24 facilities took effect on 22 February 2005, and two months later Romania and Bulgaria signed the Accession Treaty with the existing member states. Even then, the Accession Treaty imposed on Romania a probationary period regarding state aid, which it did not impose on Bulgaria.
739. The Respondent contends that the EU's position was clear: the EGO 24 incentives had to be terminated and, as confirmed by the Commission representatives during the hearing, the Commission and the Member States were inflexible on this point. According to the Respondent, the documentary record demonstrates that the EU insisted on the revocation of the Raw Materials Incentive and other types of illegal state aid. It argues that the Claimants' attempt to read the EU documents as leaving room for Romania to maintain the EGO 24 facilities ignores the structure of the accession negotiations. The Respondent points out that in its first Position Paper on competition policy of August 2000, Romania confirmed that it accepted the competition *acquis* in full. In light of Decision 244/2000 of the Competition Council in May 2000, this could not have been reasonably interpreted to mean that Romania believed that EGO 24 complied with the *acquis*. Nor does the fact that the EU did not expressly object to EGO 24 at that time mean that the EU accepted the regime; it merely meant that the EU did not yet know all the details of EGO 24.
740. In particular, the Respondent argues that in its Common Position of 2003 (Exh. EC-8) the EU invited Romania to "bring all incompatible aid measures in line with the *acquis* without delay and to continue to provide information on the progress made towards this goal." The Respondent argues that, despite the "diplomatic language" used by the EU, the message was strong: Romania must repeal the facilities as promptly as possible. Likewise, the EU's request that Romania "close incompatible aid schemes for new entrants with immediate effect" cannot negate other statements that made clear that such schemes must be removed for all beneficiaries. The Commission representatives confirmed at the hearing that EGO 24 had to be terminated immediately both for existing and new entrants.
741. In this respect, the Respondent argues that EU law is particularly hostile to operating aid in the form of customs duty exemptions. This is because operating aid reduces the recipient's operating costs, creating an artificial (even if temporary) ability to undersell competitors as long as the aid continues to flow. Romania asserts that this was confirmed by the Commission at the hearing (Tr., Day 5, 157-157 (Commission)).

742. In addition, the Respondent argues that the Raw Materials Facility is, by its very nature, contrary to the Customs Union, as it would create a hole in the metaphorical wall around the EU created by the Common Customs Tariff. This is illustrated by the Claimants' business model: taking advantage of the Raw Materials Facility enabled the Claimants to purchase their raw materials for a price substantially lower than their competitors outside the disfavored regions. This did not simply lower the cost of operations in the disadvantaged region; it gave the Claimants a chance to become sugar dealers (at least if the Claimants' quantum case is to be believed) by importing far more duty-free sugar than needed for their own operations, minimally processing it, and then selling it outside the disfavored region. According to the Respondent, this is exactly the type of situation that the EU's policies against operating aid are trying to prevent.

**ii. Romania reasonably balanced conflicting policies**

743. The Respondent contends that it reasonably balanced conflicting policies when negotiating the state aid aspects of Chapter 6. Romania states that "[t]he government, including a majority of Parliament, favoured the policy underlying subsidies for disadvantaged areas. But EU accession was also a crucial policy supported across the government (and among the Romanian people). As the conflict between those two policies became increasingly apparent, Romania had to balance conflicting policy objectives, as must any democratic state in which diverse constituencies pursue divergent interests" (R-PHB, ¶ 40). This balancing was made difficult by the differing and sometimes opposing views of various state organs and officials, as exemplified by the differing positions of Mr. Marcu (who was president of the NARD) and Mr. Orban (who was negotiating EU accession).

744. Even once the legal and political difficulties surrounding EGO 24 had become evident, Romania contends that it actively sought to maintain the facilities. Indeed, it argues that many of its actions during the accession negotiations can be explained by its intention to prolong the facilities as long as possible. According to Mr. Orban, this is why Romania was sometimes slow in providing information to the EU about the EGO 24 regime (Tr., Day 8, 205 (Orban)). This is also why Parliament refused to comply with the Competition Council's decision and why it gradually repealed the facilities in response to new demands by the EU.

745. The Respondent argues that whether Romania accurately assessed the EU's position is irrelevant. As Mr. Orban confirmed, Romania acted on the basis of its good-faith understanding of the EU's demands.

746. The Respondent further argues that it could not bargain with the EU from a position of strength. It contends that in EU accession negotiations, candidate countries had very little bargaining power, and that this was particularly true of competition policy.

747. Nonetheless, Romania notes that it obtained substantial concessions from the EU to the benefit of investors in the disfavored areas. Specifically, Romania was able to obtain (i) the grandfathering of the Profit Tax Exemption (for a maximum period of

three years after accession); (ii) a delay of the repeal of the Raw Materials Facility until February 2005; and (iii) a favorable formula to calculate the maximum state aid intensity that investors could receive, which excluded from the cap aid received prior to 1 January 2001. The Respondent asserts that all of these concessions were very real and useful solutions for many companies.

**iii. None of the Claimants' contentions about what Romania could or should have done differently prove that Romania acted unreasonably**

748. The Respondent denies that Romania could have obtained concessions from the Commission and EU Member States that would have allowed the incentives to remain in place. According to the Respondent, the Claimants must prove that Romania's actions were not reasonably related to its rational policy objectives; it is irrelevant whether Romania got the best possible deal. In the Respondent's view, none of the Claimants' contentions about what Romania could or should have done differently prove that Romania acted unreasonably.
749. First, the Respondent contends that the Claimants have not proven that Romania could have maintained the Raw Materials Facility after EU accession. Indeed, the Claimants have not proven that the Raw Materials Facility was legal under Article 87(3) of the EC Treaty. Nor is there any plausible basis to believe that the EU would have granted derogation, and the Claimants have not cited a single comparable instance in which this has happened.
750. Second, the Respondent argues that none of the alternatives to maintaining the Raw Materials Facility suggested by the Claimants (i.e., a delay in the repeal of the Raw Materials Facility, the grandfathering of the Raw Materials Facility, or the payment of compensation to PIC holders) were feasible. The Respondent contends that Romania kept the Raw Materials Facility in place for as long as possible without delaying accession. Mr. Orban testified that the Commission was very displeased when Parliament delayed the repeal of the Raw Materials Facility to February 2005.
751. Similarly, the Respondent argues that Romania could not have persuaded the EU to agree to grandfather the Raw Materials Facility or agree to other transitional arrangements. Because the Raw Materials Facility constituted incompatible state aid, Romania could not have included it in the list of aid it wished to continue after accession. The Respondent concedes that in its 2001 Common Position the EU invited Romania to submit "a list of those existing aid measures which the Competition Council considers as compatible with the *acquis*", stating that "Romania may continue to operate any aid which is included in the list and against which the Commission has not objected for the period for which the aid was approved by the Competition Council." However, Romania argues that by definition it could only include measures that the Competition Council considered compatible, which was not the case for the Raw Materials Facility.
752. The Commission confirmed at the hearing that to operate incompatible state aid beyond accession, Romania would have needed a special provision in the Accession

Treaty (Tr., Day 5, 90-91 (Gaillard/Commission)). Because the Raw Materials Facility involved an exemption from certain customs duties, grandfathering would have created a hole in the “wall” around the Customs Union. Relying on the Commission’s testimony, the Respondent contends that, because of the characteristics of the EGO 24 scheme, grandfathering any facility other than the Profit Tax Exemption “would not have been agreed in the context of accession negotiations” (Tr., Day 5, 174 (Commission)). An exception was made for the Profit Tax Exemption because it constituted investment aid rather than operating aid.

753. Finally, the Respondent contends that the Claimants have not proven that Romania could (let alone, should) have paid compensation to all PIC holders. As Mr. Orban and the Commission testified, any compensation paid to the beneficiaries of the incentives would have been seen as incompatible state aid, and the Commission would have requested reimbursement (Tr., Day 5, 45-46 (Commission); Day 8, 216-217 (Orban)). Thus, the Commission and Member States would not have agreed to the payment of compensation to PIC holders.

754. Even if the Claimants could prove that Romania could have implemented these alternatives, the Respondent contends that that would not establish a breach of the BIT. For a breach to be established, the Respondent argues that the Claimants must show that the judgments made by Romania were not reasonably related to a legitimate policy, i.e., that Romania’s judgment of how to balance the policies and interests at stake in the accession process was not merely incorrect, but unreasonable. The Respondent denies that the Claimants have proven this.

### **c. The Tribunal’s analysis**

755. Before addressing the Parties’ arguments, the Tribunal will first summarize the relevant facts to establish whether Romania did indeed act in pursuit of a rational policy, as it asserts (Section (i) below). It will then turn to the question of whether Romania acted reasonably in pursuit of that policy and will review the Claimants’ specific allegations of unreasonable conduct (Section (ii) below).

#### **i. Did Romania act in pursuit of a rational policy?**

756. As discussed in paragraphs 691 to 707 above, the Tribunal has found that, given Romania’s status as an “underdeveloped area” within the meaning of Article 87(3)(a) of the EC Treaty, it was reasonable for Romania to believe that the EGO 24 incentives could qualify under the operating aid exception contemplated in the 1998 Community Guidelines on Regional Aid.

757. Romania’s conduct suggests that, during the first years of the accession negotiations, this was indeed the belief of a significant part of the Romanian Government. The evolution of the government views on the compatibility of EGO 24 with EU law is described by Romania as follows:

In August 2000, when Romania submitted its first position paper on competition issues to the EU, most officials (outside the Competition



Council) apparently still believed that EGO 24 was legal. When Romania received the Member States' response in October 2000, more Romanian officials began to realise that EGO 24 might be incompatible with EU state aid rules. Even then, there was considerable support for the EGO 24 Facilities outside the Competition Council and the negotiating team. For example, after the Court of Appeal rejected the Competition Council's litigation against EGO 75/2000, Parliament reinstated the one Facility that EGO 75/2000 had eliminated. (R-PHB, ¶ 175).

758. The exchange of position papers between Romania and the EU suggests that there may have been an initial miscommunication as to the nature of the EGO 24 regime.
759. In its first Position Paper 6 (Competition Policy) dated August 2000 (Exh. EC-1), Romania stated that it "accepts the entire *acquis communautaire* in force on 31 December 1999, does not request transition periods or derogations and declares that it will be able to entirely implement it upon accession." However, it also stated that:

Regarding the state aid rules and agreeing to the principles provided for in Art. 87 and 88 of the Treaty establishing the European Community, ***it is necessary to grant state aids to the sensitive sectors of economy and the deprived areas*** due to the difficulties confronting the Romanian economy during the transition to a market economy.

It is also obvious that, after accession, Romania's development level will not exceed the EU average, and, consequently, ***the whole territory of Romania will comply with the conditions laid down in Art. 87(3) of the Treaty*** establishing the European Community.

(Emphasis added).

760. In that same Position Paper, Romania provided a description of EGO 24, as amended by EGO 75/2000. However, it did not mention Decision 244/2000 of the Competition Council, which had recommended the revocation of the Raw Materials Incentive.
761. This suggests that in 2000 Romania believed that the EGO 24 regime was compatible with the *acquis*, or at least that Romania hoped to be able to negotiate to maintain the EGO 24 aid after accession. It may very well be that the "full acceptance" of the *acquis* was a classic formula, as Mr. Orban testified (Tr., Day 8, 188-189 (Orban)), but Romania still appears to have been stating that it nonetheless required state aid for deprived areas to continue its economic development, and that it understood that Romania was considered underdeveloped for this purpose. In other words, Romania appeared to have been saying that it believed it fell into the Article 87(3)(a) exception. This conclusion was confirmed by Mr. Orban, who testified that, at the time Romania submitted its first position paper, the Government believed that the EGO 24 facilities were permissible state aid consistent with Romania's obligations under the *acquis*, and thus believed no derogations from the *acquis* would be needed (Tr., Day 8, 188-189; 196-197 (Orban)).
762. Romania argues that, because of the Competition Council's decision in 2000, Romania's acceptance of the *acquis* cannot be reasonably interpreted to mean that Romania believed that the EGO 24 regime complied with the *acquis*. The Tribunal disagrees. First, Romania expressly acknowledges that many government officials

maintained the “sincere belief” that the EGO 24 regime complied with *acquis* even after the Competition Council issued Decision 244 in 2000 (R-PHB, ¶ 174). Second, Mr. Orban testified that the Government believed that the EGO 24 regime complied with the *acquis*. Thus, if that belief was unreasonable, then Romania was being unreasonable. Third, the fact that the legislature refused to follow the Competition Council’s recommendation and instead confirmed the EGO 24 incentives via new legislation (EGO 75/2000) suggests that the Government (at least as a body even if some of its members possibly disagreed) verily believed that these incentives were compatible with the *acquis*.

763. Moreover, Romania omitted any mention of the Competition Council’s decision in its first Position Paper. This suggests, as one alternative, that Romania did not see the link between the Competition Council decision and EU state aid law (indeed, the decision made no mention of EU state aid rules). Another possible reason was that Romania did not believe it needed to inform the EU of this decision, perhaps because it considered that under domestic law Parliament had overruled that decision. The omission of any mention of the Competition Council’s decision could also suggest that Romania preferred not to raise thorny issues with the EU, because it wanted to maintain the incentives. Any of these interpretations suggests that Romania believed that the EGO 24 incentives were compatible with the *acquis*, or at least that it might be able to negotiate to maintain them.
764. The EU did not immediately ask Romania to revoke the EGO 24 regime. In its first Common Position (“EU Common Position 2000”, Exh. EC-2), it underlined that “the ‘acquis’ under chapter 6, in accordance with the Europe Agreement, has to be applied by Romania already now.” However, it also invited Romania to “provide details regarding existing aid measures”, and “provide a more detailed analysis of the aid facilities in the so-called D-areas”, in particular “what action, in light of the Community Guidelines on Regional Aid, the Competition Council has taken with regard to the Government Ordinances providing for these aid facilities.”
765. In February 2001, Romania issued a Complementary Position Paper on Chapter 6 (Competition Policy) (Exh. EC-3). In this position paper, Romania provided further information with respect to EGO 24, but, as confirmed by Mr. Orban, not the detailed analysis that the EU had requested (according to Mr. Orban, this detailed analysis was not made until 2004 (Tr., Day 8, 203-204)). Romania also provided a brief summary with respect to the Competition Council’s decision of 244/2000 of 8 May 2000, noting that it had been “overlooked” by EGO 75/2000, but did not explain whether the Competition Council had assessed EGO 24 in light of the Community Guidelines on Regional Aid. It appears that no such study was ever undertaken (there is none in the record).
766. In its next common position (the “2001 EU Common Position”, Exh. EC-5), the EU’s language became stronger:

The EU further notes that there are a number of existing as well as new incompatible aid schemes which have not been brought into line with the *acquis*. The EU notes that such schemes include in particular [...] facilities

provided under Emergency Ordinances no. 24/1998 and 75/2000 in the so-called "D-areas". The EU urges Romania to align the existing incompatible aid schemes without delay. (2001 EU Common Position, p. 4)

767. The Claimants argue that this request to "align" EGO 24 did not imply that EGO 24 necessarily had to be terminated. They further note that the 2001 EU Common Position also invited Romania to draw up a list of existing aid measures that it wished to operate beyond accession. Specifically, the EU stated that:

With regard to aid which Romania wishes to operate beyond the date of accession, the EU invites Romania to draw up a list of those existing aid measures which the Competition Council considers as compatible with the *acquis*. The EU invites Romania to transmit this list to the Commission; Romania may continue to operate any aid which is included in the list and against which the Commission has not objected for the period for which the aid was approved by the Competition Council. A reference to the existing aid list and to the procedure for its establishment will be included in the Accession Treaty. (2001 EU Common Position, p. 4)

768. In view of these statements, it is not evident to the Tribunal that the EU was requesting the revocation of the EGO 24 incentives, and the record shows that it was not evident to Romania either. Mr. Orban testified that it was not necessary for the EU to expressly say that EGO 24 had to be eliminated, because in his opinion "the first position paper of the Union was very clear: every scheme incompatible with the *acquis* has to be eliminated immediately", but "it was the duty of the national authority in the competition policy to exactly define" what schemes were compatible with the *acquis* and which were not (Tr., Day 8, 212 (Orban)). However, he also confirmed that the Romanian Government continued to enact legislation and regulations that maintained the EGO 24 regime, because the Government still believed it to be a compatible scheme (Tr., Day 8, 213 (Orban)). Mr. Orban also testified that "it was a gradual process of learning" for the Romanian Government, that "a significant number of members of the government were not aware about the requirements of the [accession] process", that there was a "lack of expertise" within the Government, but also "a certain confidence that Romania would be able to get [...] a lot from the accession process, which finally proved to be wishful thinking" (Tr., Day 8, 208-209 (Orban)).

769. By June 2002, however, Romania apparently understood that the EGO 24 regime constituted incompatible aid, but believed that it could "align" it with the *acquis* by converting it into compatible aid. The Romanian Government's "Report on the progress in preparing for the accession to the European Union September 2001-May 2002", dated June 2002 (Exh. HEC-6) stated that:

All existing State aid measures will be assessed, establishing their compatibility with the *acquis* in order to suggest measures eliminating or transforming the incompatible ones in compatibles aids, taking into account the legal and economic implication of the modification of any incompatible schemes on the already granted specific allocations.

This approach will be made according to the European Commission recommendation and will take into consideration following three steps: (i) closing the incompatibles schemes in order to stop potential future

allocations; (ii) the modification of these scheme[s] to reach the compatibility with the acquis; (iii) the identification of the solutions for the economic agents that received the State aid under the present schemes (e.g. Free areas, deprived areas etc). [...] (p. 132)

770. More specifically with respect to EGO 24, it stated that:

Regarding the “D areas”, the State aid granted in the present ***must to [sic] be converted into a compatible State aid***. The Ministry of Development and Prognosis started the technical debates with the beneficiary associations in order to identify solutions and to make, in 2 months, proposals for alteration of the present system of facilities. (p. 133. Emphasis added).

771. At the same time, Romania’s “National Programme for Accession of Romania to the European Union” dated June 2002 (Exh. HEC-7) stated that “[t]he provisions of the normative acts on facilities granted for ‘D areas’ will be maintained till the moment of Romania’s accession to the European Union” (p. 148). Mr. Orban testified that this was Romania’s intention, and that it “battled a lot with the Commission to get this” (Tr., Day 8, 219-220 (Orban)).

772. In November 2002, Romania provided the Commission with Additional Information on Chapter 6 – Competition Policy (Exh. EC-6). With respect to EGO 24, Romania merely informed the Commission that state aid for the D-areas was regulated by Law 621/2001, which approved EGO 75/2000, and explained the amendment to the VAT and the repeal of the profit tax incentive (noting that it had been grandfathered for PIC holders) (see paragraph 232 above).

773. On 7 April 2003, the Mission of Romania to the EU sent a communication to the Romanian Minister for European Integration and other state officials, including Mr. Orban and Mr. Berinde (Communication No. 1480, Exh. R-93). It stated:

Community officials stated clearly that the ***negotiations on this chapter may be closed if, and only if, the following conditions*** (relating primarily to State aid, which was found to have the highest potential to distort the Internal Market) ***are met***: new aid must comply strictly with the acquis, ***existing aid must be aligned or in the process of being aligned*** (including in terms of duration; the granting of transition periods may be considered depending on the outcomes of discussions between the competent institutions in Romania and the relevant operators), and ALL cases of non-notified State aid must be analysed and resolved.

[...]

The Commission stated that it had asked all of the candidate countries to bring their tax breaks into line with the *acquis communautaire*, including those granted in Free Zones or ***Less Favoured Areas***, which entails either their withdrawal or their conversion into compatible aid. In the latter case, ***negotiations with a view to converting them into compatible schemes must be pursued directly by the Competition Council with the economic operators concerned***. Only once this has occurred can the companies for which transition periods may be negotiated with the EU be identified.

(Emphasis added)

774. In its Common Position dated 28 May 2003 (EC-8), the EU's language also became stronger:

The EU recalls that all fiscal aid provisions, (for example those included in the VAT Law; the **Law on customs duties exemptions** - including benefits for transactions undertaken by firms located in industrial parks, free zones and **disadvantaged areas** [...]) **should be subject to the approval by the Competition Council. In cases where the Competition Council assesses the respective measures to be incompatible with the State aid rules, the EU invites Romania to either end the measures or to align them with the acquis.**

The EU invites Romania to bring all incompatible aid measures in line with the acquis without delay and to continue to provide information on the progress made towards this goal. [...]

The EU moreover invites Romania to provide information on individual benefits granted in the free zones and the disadvantaged areas and on any other individual tax benefits that have already been granted and which provide for tax benefits beyond Romania's target date for accession. **The EU urges Romania to close incompatible aid schemes for new entrants with immediate effect.**

In this context Romania is further invited to present a **plan outlining how it intends to convert the benefits that are incompatible with the acquis** and to hold further technical consultations with the Commission to explore the possibilities for this conversion.

[...]

With regard to aid which Romania wishes to operate beyond the date of accession, the EU recalls its invitation to Romania to draw up a list of those existing aid measures which the Competition Council considers as compatible with the acquis and to transmit this list to the Commission. The EU recalls that Romania may continue to operate any aid which is included in the list and against which the Commission has not objected for the period for which the aid was approved by the Competition Council. A reference to the existing aid list and to the procedure for its establishment will be included in the Accession Treaty.

The EU recalls that the **existing aid measures** are subject in accordance with Article 88(1) of the EC Treaty to the **appropriate measures procedure**, under which the Commission can, in cooperation with the (future) Member State, propose changes to an aid measure for the future. To the extent that Romania wishes to benefit from this mechanism, the EU invites Romania to present the following to the Commission, every six months as from 1 January 2002, and up until the date of accession:

(a) a list of all existing aid measures (both schemes and ad hoc aid) (i) which have been assessed by the Competition Council and (ii) which it found to be compatible with the *acquis*; (b) any other information which is essential for the assessment of the compatibility of the aid measures referred to under (a).

Details on the precise format for this reporting have been provided by the Commission.

The EU underlines that all aid measures in Romania which are considered State aid according to the acquis and which are not included in this list

shall be considered as new aid upon Romania's accession. After that date, application of such an aid measure will be conditional upon Romania's notification of it pursuant to Article 88 of the EC Treaty, and a decision of the Commission that the aid measure in question is compatible with the Common Market. As regards individual aid, no measures which continue to have effects after accession and which are incompatible will be acceptable.

(Emphasis added)

775. The Claimants argue that at this point the EU was still inviting Romania to “align” incompatible aid schemes, and the request for immediate termination was only for new entrants. They also argue that Romania could have included the EGO 24 scheme in the list of aid it wished to operate beyond accession.
776. The Respondent rejects these interpretations, arguing that, despite the “diplomatic language” used by the EU, the message was strong: Romania had to repeal the facilities as promptly as possible. Likewise, the EU’s request that Romania “close incompatible aid schemes for new entrants with immediate effect” cannot negate other statements that made clear that such schemes had to be removed for all beneficiaries.
777. Although the EU had not expressly ordered, in so many words, that the EGO 24 scheme had to be terminated, at that point the message was clear for Romania. It appears that Romania interpreted that message to be diplomatic in language and adamant in substance. Mr. Orban testified that, from the technical consultations in 2003 “it was absolutely obvious [...] that for Custom duties exemptions there will be no, not at all, any chance to get, not only a transition period, but we were obliged to stop as soon as possible”, and that “it was absolutely clear that for such kind of facilities, there is no room for manoeuvre” (Tr., Day 8, 229-230 (Orban)).
778. Nor could the revocation have been delayed until accession. Asked whether it would have been possible to keep the Raw Materials Facility until the entry into force of the Accession Treaty, Mr. Orban replied “[m]y clear answer is no. It was a very clear condition formulated by the Commission to stop, to repeal these facilities, the Customs duties exemptions, before the conclusion of the accession negotiation process” (Tr., Day 8, 232:6-9 (Orban)).
779. The Commission representatives confirmed during the hearing that the Commission’s message was that the EGO 24 incentives had to be terminated:
- During the accession negotiations with Romania, the EU [...] made clear through a number of common positions and other documents which we have submitted to this Tribunal that ***Ordinance No. 24/1998 involved illegal state aid and therefore would have to be revoked prior to accession.*** In its reaction to this unambiguous position of the EU, Romania proceeded with the successive abolition of the incentives foreseen in the ordinance. (Tr., Day 5, 45 (Commission); Emphasis added)
780. Indeed, despite the difference in language in the EU’s 2003 Common Position, the Commission representatives confirmed at the hearing that EGO 24 had to be terminated immediately both for existing and new entrants:

So the EU does two things. It says, first of all: end your incompatible aid schemes, and that of course mean[s] also for existing entrants; but then the EU also says: stop them with immediate effect for new entrants, because of course allowing new entrants then creates further problems, deepens further the distortions of competition which arise from the scheme.

So there are, in fact, several exhortations here. Now, this may all not seem very structured or logical; it's a diplomatic document which set out a number of desiderata that the Union had to formulate at the time towards Romania in the context of the accession negotiation. But I think the overall thrust is quite clear: the EU wanted that the aid scheme for disadvantaged areas be terminated. (Tr., Day 5, 156-157 (Commission))

781. Notwithstanding Mr. Orban's testimony, the record suggests that in early 2004 Romania was still attempting to prolong the incentives until the date of accession or negotiate transitional periods. In particular, in an interview on national television on 12 January 2004 (Exh. C-651), Prime Minister Nastase announced that the EGO 24 regime would be terminated due to EU requirements. However, he also stated that the Government was examining whether some of the incentives would remain in place until 2007, noting that the Government had negotiated some transition periods with the EU and that they were trying to find "elegant solutions." When asked to confirm if certain investors could benefit from the program until 2007, Minister Nastase stated that they would try to negotiate an agreement on that point. When asked what would happen to investors who had invested significant sums, the Minister stated that the Government was negotiating with each investor.
782. Notably, in its Complementary Position Paper III on Chapter 6 – Competition Policy dated 24 March 2004 (Exh. EC-9), Romania did not state that the EGO 24 regime would be terminated. Instead, it stated that PIC holders would be subject to maximum permitted intensity thresholds. Romania also highlighted that the EGO 24 incentives had been "significantly diminished" by the elimination of the Raw Materials Facility for the production, processing and preservation of meat. It also stated that investors who had obtained a PIC prior to 1 July 2003 would benefit from the Profit Tax Incentive, which would be grandfathered for the entire duration of the deprived area.<sup>144</sup> This suggests a final attempt by Romania to convince the EU that the EGO

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<sup>144</sup> Specifically, Romania's Complementary Position Paper III on Chapter 6 – Competition Policy dated 24 March 2004 (Exh. EC-9) stated: "The Ministry of Administration and Interior elaborated a draft law for completing the Government Emergency Ordinance no. 24/1998 on the regime of deprived areas. The draft provides that the facilities the undertakings that have an investor certificate and operate in deprived areas benefit from, will be granted below the maximum admitted intensity foreseen in the Regulation on regional aid. At present, the draft normative act is under inter-ministerial endorsement procedure.

By entering into force of the Fiscal Code, the fiscal facilities have been significantly diminished. In fact, the undertakings with investor certificate in the deprived areas will benefit from the exemption from the payment of the taxes perceived for changing the destination or removing from the agrarian circuit of certain fields designated to achieving the investment as well as the exemption from the custom duties payment for raw materials and imported components, excepting the import of the raw material for meat production, processing and preserving. Also the undertakings that obtained before 1 July 2003 the permanent certificate of investor in the deprived area, will benefit from exemption from the profit tax payment related to the new investment, during the whole existing duration of the deprived area" (Emphasis added).

24 incentives could be aligned with the *acquis* without outright termination, or at least that the incentives could be prolonged until the date of accession.

783. Prime Minister Nastase confirmed this view in public statements. In an interview in Oradea, Bihor County in May 2004 (Exh. C-652), Prime Minister Nastase indicated that “[s]ubsequent to 2007, when we want to be accepted in the European Union, these disfavored areas will no longer exist in Romania” (emphasis added). When asked about compensation to investors in those areas, the Prime Minister answered that Romania would discuss these matters during its negotiations with the European Union and they would see if Romania was “able to obtain some transition periods for them.” The Prime Minister specified that “there will be no fiscal incentives, there will be some compensation packages, established during direct negotiations.” The Prime Minister also stated that the Government would talk to the investors, and “based on the conclusions of the negotiations of the Competition Chapter, we will negotiate with those who initially obtained these fiscal incentives” (Exh. C-652, pp. 7-9 of translation).
784. However, by August 2004 Romania must have understood that no transitional periods or compensation packages were possible. On 31 August 2004, through GO 94/2004 (Exh. R-94), Romania repealed Article 6(1)(b)(d) and (e) of EGO 24/1998, thus revoking the incentives provided under EGO 24/1998, including the Raw Materials Incentive, with the exception of the Profit Tax Exemption. The repeal was originally to become effective 90 days from the date of entry into force of GO 94/2004 (that is, on 3 December 2004). However, the date of repeal was subsequently extended to 22 February 2005 by means of Law No. 507/2004 of 22 November 2004 (Exh. C-52), which approved and amended GO 94/2004.
785. Despite this strict position, Romania obtained certain concessions from the EU to the benefit of investors in the D-areas. Specifically, as previously mentioned, Romania was able to obtain (i) the grandfathering of the Profit Tax Exemption (for a maximum period of three years after accession), (ii) a delay of the repeal of the Raw Materials Facility until February 2005, and (iii) a favourable formula to calculate the maximum state aid intensity that investors could receive, which excluded from the cap aid received prior to 1 January 2001.
786. From the documentary and oral evidence described above, the Tribunal draws two broad conclusions. First, at the beginning of the accession negotiations Romania believed that the EGO 24 incentives were compatible state aid. This belief must have ended at least by 2002, when the Romanian government acknowledged in its report on the progress for accession that the EGO 24 regime constituted incompatible state aid and had to be converted into compatible state aid. However, only in mid-2003 did it become clear to Romania that the incentives must be revoked (see paragraph 777 above). That being said, it appears that by as late as May 2004 Romania still believed that it could negotiate transitional periods or compensation packages.



787. As acknowledged by Romania's expert in EU competition law, Mr. Petersen, Romania's belief that the EGO 24 regime constituted compatible state aid was incorrect, but it was not unreasonable:

Q. [D]o you have any opinion on whether Romania thought as of 1999 that EGO 24 was fully compliant with its obligations under the Europe agreement?

A. I have no knowledge about it. But I could understand that they have a certain good faith, I'm not doubting the good faith, because they were pursuing an objective which was definitely in line with the European Community's cohesion objective.

Q. Do you think that view of the Romanian Government as of that time would have been reasonable?

A. As to that policy, yes [...].

(Tr., Day 6, 111 (Smith/Petersen)).

788. Second, it is plain that Romania revoked the incentives in order to comply with EU competition regulations and, in particular, to obtain EU accession. Romania would not have been able to sign the Accession Treaty in 2005 if it had not brought the incentives into compliance with EU competition law. Although it is true that there does not appear to have been an official determination from the European Commission that the incentives constituted incompatible state aid, by mid-2003 it should have been quite clear to the Romanian government that the EGO 24 incentives were impermissible state aid under EU standards.

789. The EU did not explicitly order the revocation of the incentives in the Common Positions; rather, it requested the *alignment* of incompatible state aid regimes (such as EGO 24). However, Mr. Orban testified that in 2003 it became absolutely clear that this was the EU's position, and this was confirmed by the Commission. Indeed, the Commission confirmed during the hearing that, in its view, EGO 24 constituted incompatible state aid:

Emergency Ordinance 24/1998 involved state aid which was not compatible with EU rules on regional aid. In particular, the various measures did not respect the basic EU rules on eligible costs, which exclude in particular that mere operating costs may not be compensated. Moreover, the limits on maximum aid intensities were not respected either. (Tr., Day 5, 45:10-16 (Commission)).

790. The Commission representatives also explained at the hearing that, because the Raw Materials Incentive constituted operating rather than investment aid, it could not have been transformed into compatible aid without substantially changing their nature. In response to questions from the Tribunal, the Commission testified as follows:

THE PRESIDENT: [...] Is there any way to read EGO 24/1998 specifically with respect to the raw material duty, Customs duty exemption which would make it compatible with EU law now?

A. (By PROFESSOR MARTENCZUK) I find that somewhat difficult to see. There are, of course, various grounds in EU law which allow state aid to be

declared compatible. These grounds are contained in Articles -- today they are Article 107, paragraphs 2 and 3, of the Treaty on the Function of the European Union; at the material time, they were paragraphs 2 and 3 of 87 of the EC treaty.

Essentially you need to have a legitimate objective. Such a legitimate objective could, of course, be, for instance, to further regional development. The EU has rules under which member states can grant aid to help the regional development of certain defined particularly disadvantaged regions. And presumably many of the regions in Romania that are at issue here qualify as such areas; that's not contested.

However, in general the EU, as a matter of competition policy, has formulated limits to that. One of these limits is, for instance, that regional aid should always be granted in the form of investment aid. The reason for that is that it is felt that aid towards investment creates a more durable effect in the development of the underdeveloped region than aid which purely goes towards operating cost. It alleviates an undertaking which otherwise may already be there, and operating maybe inefficiently, of its normal running costs.

It would seem to me that one of the problems precisely with the exemptions that were at issue here is that they essentially are operating aid: they alleviate the undertaking from operating costs. And therefore I think it would have been very difficult to find a ground on which to find these aids compatible, and that is -- and that also doesn't seem to have been, in the end, pursued in the accession negotiations.

THE PRESIDENT: I just want to make clear. You said it would have been very difficult, and I will come back to that question, but much later.

My question right now is: right now, would it be possible, if the Romanian State just for any reason was to enact right now EGO 24/1998, which would be called EGO something/2010, would there be any way to read it which would make it compatible with the EU law now?

A. (By PROFESSOR MARTENCZUK) Unfortunately I am not here in the company of our competition law experts from DG Competition who might be able to provide more direct expertise on that. But my tentative response would be: probably not.

(Tr., Day 5, 158-160 (Tribunal/Commission)).

791. In response to further questions, the Commission added:

THE PRESIDENT: [...] Taking Professor Alexandrov's question [on the possibility of redress for investors], what would have been your answer if -- if it had been possible to consider that the goal of the investment was compatible? That is the contrary, I think he said incompatible, and really what I was also interested in is knowing: what if it had been compatible?

A. (By PROFESSOR MARTENCZUK) Well, if the aid scheme by its nature had been such that it was compatible with -- or capable of being compatible with EU law, then the correct approach for Romania would have been to include it in the list of compatible existing aid schemes which were adopted at the time of the accession treaty, and which in fact constitutes, if you like, the list of grandfathered existing aid schemes which the Commission sometimes under a number of conditions allows, and which may continue to be applied by Romania without requiring any further -- a new approval by the Commission which would otherwise be necessary.

Now, however, because of the characteristics of the aid scheme, and with the exception of the profit tax exemption, Romania made no -- as far as I am aware, at least, made no such request, and that's why -- and probably if it had made such a request, given the characteristics of the scheme, it would not have been agreed in the context of the accession negotiations.

And that's why, if you like, these aid schemes did not find themselves on the positive list unless [*recte*: unlike] other schemes.

THE PRESIDENT: Such kind of incentive as the Customs duties exemption on the import of raw material, is it totally incompatible with European law, even if it's for disfavoured areas and for a limited duration?

A. (By PROFESSOR MARTENCZUK) I would believe that it would be, I'm at least not aware of any examples of such types of aid. There may be -- there may be specific rules, but I would -- that is something I would have to verify for -- there are some more specific regimes for what is called the ultra-peripheral regions of the European Union. This is for instance the DOM-TOM français, and so forth. For ultra-peripheral regions --

THE PRESIDENT: Angola?

A. (By PROFESSOR MARTENCZUK) For those regions, there are in fact possibilities to grant under more lenient conditions operating aid. I have a suspicion that you might find things there. But that's really just for those specific regions, and the regions that we are talking about here in Romania don't fall under any specific category.

(Tr., Day 5, 173-175 (Tribunal/Commission)).

792. Other than these last comments, neither in its submission nor at the hearing did the Commission explain why the EGO 24 incentives could not have been covered by an exception to operating aid requirements under the 1998 Community Guidelines on Regional Aid (Exh. RJ-9). As noted above, both sides' experts agree that, as an underdeveloped region in meaning of Article 87(3)(a) of the EC Treaty, Romania could have been exceptionally allowed to grant operating aid.
793. The Tribunal cannot speculate as to why the Commission refused to consider the EGO 24 regime as permissible operating aid under the 1998 Community Guidelines on Regional Aid. The fact is that the EU (in particular, the Commission) wanted the EGO 24 regime terminated, and this termination was made a pre-condition for accession.
794. It also seems clear that Romania could not have included the EGO 24 incentives in the list of aid it wished to operate beyond accession. In its 2001 Common Position the EU invited Romania to submit "a list of those existing aid measures which the Competition Council considers as compatible with the *acquis*", stating that "Romania may continue to operate any aid which is included in the list and against which the Commission has not objected for the period for which the aid was approved by the Competition Council." It then reiterated this invitation in its 2003 Common Position. However, as is evident from the language of that invitation, for any state aid to be included in this list, it had to be approved by the Competition Council, and such approval was not given for the Raw Materials Incentive. The Commission confirmed

that this was probably the reason why Romania had not made this request (Tr., Day 5, 174 (Commission)).

795. Finally, the Tribunal notes that the Substantiation Note accompanying the repeal of the EGO 24 incentives stated that

In order to meet the criteria in the Community rules on state aid, and also to complete the negotiations under Chapter No. 6 – Policy it is necessary to eliminate all forms of State aid in national legislation incompatible with the *acquis communautaire* in this area and, in this respect, it is proposed to repeal [...] the provisions of Article 6 paragraph (1), letter (b), letter (d) and letter (e) of the Emergency Government Ordinance no. 24/1998 on the disadvantaged areas [...]

(Substantiation Report accompanying EGO 94/2004, 26 August 2004, Exh. R-95, pp. 12-13).

796. Under those circumstances, it is clear that Romania was under considerable pressure from the EU to terminate the EGO 24 regime. Thus, there is no doubt in the Tribunal's mind that Romania's repeal of the EGO 24 incentives was motivated by the EU's demands.

#### **ii. The Claimants' specific allegations of unreasonable conduct**

797. The Tribunal will now turn to the question of whether, in pursuit of its objective to join the EU, Romania acted reasonably and, in that context, will address the Claimants' specific allegations of unreasonable conduct.

*(a) The Claimants' allegation that Romania actively promoted and extended the EGO 24 regime, while at the same time negotiating for the scheme's early termination*

798. The Claimants first argue that Romania acted unreasonably by actively promoting and extending the EGO 24 regime, and (at least until 2003) encouraging investors to participate in that scheme, while at the same time it was negotiating for the scheme's early termination.
799. The Tribunal rejects this argument. As discussed above the record shows that, until mid-2003, Romania believed that the incentives were compatible with EU law and believed they could be maintained after accession. The record suggests that, after realizing that the incentives were incompatible aid, Romania tried to maintain the incentives for as long as possible, but there is no evidence to suggest that during that period after mid-2003 it actively promoted the regime. Romania has not been able to establish clearly when or how it began to inform stakeholders that the incentives would be terminated, but Mr. Orban confirmed that the public should have known at least by May 2004. This is consistent with the fact that Prime Minister Nastase announced the termination of the scheme in January and May 2004.
800. Accordingly, the record shows that Romania did not at the same time promote the EGO 24 regime and seek its early termination. During the time it promoted the regime, it sought to maintain the incentives. After it became clear that this would not

be acceptable to the EU, it announced that the incentives would be revoked. Thus, the factual basis for the Claimants' allegation is incorrect.

(b) *The Claimants' allegation that Romania revoked the incentives regime prematurely, without being required to do so by any competent legal authority and without attempting to mitigate damages*

801. The Claimants also argue that it was unreasonable for Romania to revoke the incentives regime prematurely without being required to do so by any competent legal authority, without attempting to negotiate with the EU or the Claimants to mitigate the damages caused by the revocation, and in contradiction of its repeated statements over the years that the regime was legal and satisfied EU requirements.
802. The Tribunal rejects this argument. Applying the standard enunciated in paragraph 525 above, the Tribunal does not find that Romania acted unreasonably. Romania did not act arbitrarily; to the contrary: it is evident that Romania's repeal of the EGO 24 incentives was done in response to conditions imposed by the EU for accession. It is true that the EU did not explicitly order the revocation of the incentives; rather, it requested the alignment of incompatible state aid regimes (such as EGO 24) with the *acquis*. However, as discussed above, the EU's demand must be interpreted as a request for termination of the incentives as a pre-condition for accession, and Romania understood that sometime in 2003. Thus, the repeal of the EGO 24 incentives was reasonably related to a rational public policy objective (i.e., EU accession), and there was an appropriate correlation between that objective and the measure adopted to achieve it (i.e., the repeal of the EGO 24 incentives). However, as will be seen, it does not follow of necessity that such repeal was fair and equitable to the Claimants.
803. As to the Claimants' argument that this termination was not ordered by a "competent legal authority", the demands were issued by the Commission on the behalf of the EU itself during accession negotiations. Given Romania's goal of accession, it was not unreasonable for Romania to comply with the EU's demands, even if such demands were not formally issued by a "competent legal authority" if that should have been the case. Even if the Claimants were correct as a matter of law that the termination was not ordered by a competent legal authority, it is not for this Tribunal to decide whether Romania properly understood the point at the time or whether it would have been opportune for Romania to raise the point in its negotiations with the EU.
804. Indeed, the "competent legal authority" appears to have been the Romanian Competition Council, which did in fact recommend the revocation of the Raw Materials Incentive in Decision 244/2000. The Claimants (relying on Prof. Dashwood) have argued that, from a procedural standpoint, during the pre-accession regime only Romania (and not the European Commission) had the competence to determine which forms of state aid qualified as permissible state aid (Tr., Day 1, 178-179 (Gaillard); ER of A. Dashwood, ¶ 25). This appears also to have been the position of the EU, which in its Common Positions repeatedly stated that the determination of whether aid was compatible with the *acquis* depended on the local Competition

Council. It is unclear whether Decision 244/2000 was premised on EGO 24's incompatibility with EU law (indeed, the decision makes no mention of EU law at all). However, to the extent that the Claimants argue that Romania eliminated the Raw Materials Incentive without a finding by a "competent legal authority", they may be technically incorrect.

805. What matters, however, is that, both at the EU and Romanian levels, there was some exhortation to end the EGO 24 scheme because of its capacity to distort competition. This, in addition to the fact that revocation of the Raw Materials Incentive was a pre-condition for accession, shows that Romania's decision to repeal the EGO 24 incentives was not irrational, arbitrary, or based on preference. It was a decision logically related to, narrowly tailored, and necessary for, the pursuit of a legitimate and rational policy.
806. The Claimants also contend that it was unreasonable for Romania to revoke the incentives without attempting to negotiate with the EU or the Claimants to mitigate the damages caused by the revocation. It is true that there is no convincing evidence that Romania tried to negotiate alternative solutions with the EU, such as a delay in the revocation date, a transition period, or payment of compensation. However, as became abundantly clear at the hearing, it would have been extremely difficult (perhaps even impossible) to obtain agreement from the EU on any of these alternative solutions.
807. First, the EU would not have allowed the revocation to be delayed until the date of accession. The Commission representatives testified that the Commission's unambiguous message was that "Ordinance No. 24/1998 involved illegal state aid and therefore would have to be revoked *prior* to accession" (Tr., Day 5, 45 (Commission), emphasis added). As mentioned above, when he was asked whether it would have been possible to keep the Raw Materials Facility in place until the entry into force of the Accession Treaty, Mr. Orban replied "[m]y clear answer is no. It was a very clear condition formulated by the Commission to stop, to repeal these facilities, the Customs duties exemptions, before the conclusion of the accession negotiation process" (Tr., Day 8, 232 (Orban)). He also testified that the Commission was very displeased when Parliament delayed the repeal of the Raw Materials Facility to February 2005 (*Id.*).
808. Second, the EU would not have accepted a transitional period or grandfathering for the Raw Materials Incentive. The Commission confirmed at the hearing that to operate incompatible state aid beyond accession, Romania would have required a special provision in the Accession Treaty itself (Tr., Day 5, 90-91 (Gaillard/Commission)). The Commission also confirmed that, because of the characteristics of the EGO 24 scheme, grandfathering any facility other than the Profit Tax Exemption "would not have been agreed in the context of accession negotiations" (Tr., Day 5, 174 (Commission)). As noted above, Mr. Orban testified that, from the technical consultations in 2003 "it was absolutely obvious [...] that for Custom duties exemptions there will be no, not at all, any chance to get, not only a transition period, but we were obliged to stop as soon as possible", and that "it was absolutely clear

that for such kind of facilities, there is no room for manoeuvre” (Tr., Day 8, 229-230 (Orban)).

809. There is some logic to the Commission’s inflexibility, at least with respect to transition periods beyond accession. The Respondent is right in that, because of the very nature of the Raw Materials Facility, grandfathering it would have created a “hole in the wall” around the Customs Union. This would only have been the case after accession, not before. However, the Tribunal is not assessing whether the Commission was being reasonable when it imposed these conditions; the Tribunal’s mandate is to determine whether Romania acted reasonably in the factual context in which it found itself.
810. Third, Mr. Orban and the Commission confirmed very clearly that any compensation paid to PIC holders would have been seen as incompatible state aid, and the Commission would have requested its reimbursement (Tr., Day 5, 45-46 (Commission); Day 8, 216-217 (Orban)). Thus, the Commission and Member States would not have agreed to the payment of compensation to PIC holders.
811. Given Romania’s uncertain chances to obtain any of these alternative arrangements, its lack or, at least, weakness of bargaining power before the Commission, and the Commission’s inflexible stance, the Tribunal does not find that it was unreasonable for Romania to revoke the incentives without making more efforts to maintain them. In addition, a negotiation involves many considerations and trade-offs. It is not for a Tribunal subsequently to second-guess decisions which are within the realm of diplomatic bargaining if there are no objective circumstances allowing and requiring such an evaluation.
812. Finally, the Tribunal finds that any contradiction in Romania’s statements as to the legitimacy of the EGO 24 regime or its compatibility with EU state aid regulations in the earlier years of the accession process was based on a good faith lack of knowledge and an overly optimistic initial assessment of its bargaining power vis-à-vis the EU.

(c) *The Claimants’ allegation that Romania revoked the benefits of the incentives regime for investors, while maintaining the investors’ obligations under that regime*

813. The Claimants argue that it was unreasonable for Romania to revoke the benefits of the incentives regime for investors like the Claimants, while preserving the investors’ obligations under that regime, in particular the obligation to maintain the investments for twenty years.
814. There is some dispute among the parties as to the content and length of this obligation. The Claimants argue that under Articles 7 and 9 of EGO 24 (republished version of November 1999, Exh. R-68) investors were required to maintain their investments for twice the period during which they benefitted from the incentives provided under EGO 24. However, relying on Article 1(f) of the 2001 Methodological Norms (GD 728/2001, Exh. R-69), the Claimants argue that the period in which an

investor is deemed to have benefitted from the incentives, for purposes of Articles 7 and 9 of EGO 24, is calculated as “the period between the moment when the certificate of investor in the disfavoured area was obtained and the moment when the disfavoured area ceases to exist.”

815. Because Articles 7 and 9 of EGO 24 have not been repealed, and because the revocation did not affect the Profit Tax Exemption, the Claimants argue that European Food must maintain its investments until 2018. They argue that this was confirmed by both Prof. Baias and Prof. Mihai. In this respect, the Claimants argue that “Romania has acted like it did [the Claimants] a big favour by leaving the profit tax exemption in place until 2009, but in reality that was what enabled Romania to keep the obligations on [the Claimants] in place for eight years longer than they would have been otherwise if Romania had simply revoked all the incentives in early 2005.” As a result, the Claimants “are effectively hostage in the [Ștei-Nucet-Drăgănești] region and they will be until 2018 or until they go bankrupt” (Tr., Day 12, 41-43 (Fleuriet)).
816. The Claimants further allege that Romania is still monitoring their compliance with EGO 24 to this day, and “still carrying out audits and inspections to make sure that Romania gets its benefit from its side of the bargain in terms of employment” (Tr., Day 12, 43 (Fleuriet)). In any event, the Claimants argue that, due to the nature of their investments, they cannot simply move them to another area of Romania (Tr., Day 12, 40-44).
817. In its Post-Hearing Brief, Romania argued that it “has repeatedly stated that the obligation does not exist and that (therefore) it has no intention of enforcing it.” As the alleged 20-year obligation is non-existent, Romania argues that there is no merit to the Claimants’ assertion of unfairness (R-PHB, ¶ 120).
818. However, Romania took a different position in its closing argument. First, it argued that the Claimants are not hostages in the Ștei-Nucet-Drăgănești region; they can leave whenever they wish. It explained that “the obligation is to repay the value of exemptions that have been received if a decision is made by an investor voluntarily to leave the deprived area”, and that “[t]he state is not empowered to force a business to stay in the deprived area, nor does it wish to do so.” Thus, “[t]his is a business decision to be made by an individual investor”; “[i]t is just a money decision” (Tr., Day 13, 128-129 (Petrochilos)).
819. Second, relying on Prof. Baias, Romania argued the period for which the investments must be maintained is twice the period in which the investor actually enjoyed the facility, not twice the period between the issuance of the investment certificate and the termination of the designation of the region as disfavoured. In this respect, the Respondent noted that the Claimants have conceded that they stopped receiving the Profit Tax Exemption in 2006 (ref. to Tr., Day 12, 42 (Fleuriet)). In any event, the Respondent argued that Claimants’ arguments are irrelevant, because the Claimants have never sought to leave Bihor county (as confirmed by Mr. Ban, Tr., Day 9, 13), and thus they have never been threatened by an obligation to repay the benefits they have received (Tr., Day 13, 131-2 (Petrochilos)).



820. The Parties agree that the obligations set forth in Articles 7 and 9 of EGO 24 have not been repealed. Despite Romania's initial allegation that the obligation does not exist, Prof. Baias confirmed at the hearing that some form of obligation to maintain investments did indeed exist. His position was that the period for which investors were obliged to stay in the disfavored area was twice the period during which they had actually benefitted from the program (Tr., Day 5, 267-273).

821. Articles 7 and 9 of EGO 24 provide:

ART. 7

In the situation in which ***an investment*** that benefits [sic] from the provisions under the present expeditious ordinance ***is voluntarily liquidated in a period smaller than double the period in which it had enjoyed the facilities*** granted by the Government decision for the setting up of the deprived zone, ***the liquidator/liquidators shall compulsorily pay***, with priority, to the state budget, to the state social insurance budget and to the special funds budgets ***the amounts of money relating to the facilities*** granted in accordance with the provisions under the present expeditious ordinance, from the amounts of money resulting from the liquidation.

ART. 9

The trading companies set up in a deprived zone ***may voluntarily cease their activity in the respective zone***, and those that open branches with legal personality in such a zone may liquidate them or change their head-office from the deprived zone, ***in a shorter period than the one provided under Art. 7, only under the sanction of paying the debts*** to the state budget, state social insurance budget and special funds budgets, ***relating to the facilities*** granted in accordance with the provisions of the present expeditious ordinance.

(Emphasis added)

822. In turn, Article 1(f) of the 2001 Methodological Norms (GD 728/2001, Exh. R-69) defines:

f) the period in which it benefited from the facilitations granted by the Government Decision designating the area as disfavored, as specified under Art. 7 and 9 of the ordinance - the period between the moment when the certificate of investor in the disfavored area was obtained and the moment when the disfavored area ceases to exist; in the case of the provisional certificate of investor, followed by the procurement of the certificate of investor in disfavored area, the period is calculated from the moment the provisional certificate of investor is obtained until the disfavored area ceases to exist;

823. Prof. Baias insisted that Article 1(f) of the 2001 Methodological Norms contradicted the higher norm, which was Article 7 of EGO 24, and thus in his opinion the 2001 Methodological Norms should be ignored on this point.

824. The Tribunal does not find that the duration of the Claimants' obligation makes in itself a difference for purposes of assessing the reasonableness of Romania's conduct. The point is that Romania repealed the Raw Materials Incentive while at the

same time maintaining all of the Claimants' obligations under the scheme, including the obligation to maintain their investments for twice the period they received the incentives, or twice the period between the issuance of the certificate and the end of period in which the region is designated as disfavored, depending on the interpretation. The Tribunal finds that either scenario is unreasonable. The obligation to maintain investments had no rational justification after the incentives were terminated. The survival of the Profit Tax Exemption is not sufficient justification for the maintenance of investments made in reliance on the legitimate expectation that customs duties exemptions such as the Raw Materials Incentive would be available, just as the Profit Tax Exemption would not have been sufficiently attractive on its own to encourage investment in the disfavored region. Indeed, the maintenance of the Profit Tax Exemption ensured that, despite the absence of the Raw Materials Incentive, the Claimants would continue to be tied to the EGO 24 regime for as long as they made a profit. And, as the Claimants argue, the Profit Tax Exemption would have been useless for companies not making a profit, which could easily have been the case for businesses premised on the existence of operating aid such as the Raw Materials Incentive.

### **iii. Conclusion**

825. For the reasons stated above, the Tribunal finds that, with one exception, Romania did not act unreasonably. Romania's decision to revoke the incentives was reasonably tailored to the pursuit of a rational policy (specifically, EU accession), and there was an appropriate correlation between that objective and the measure adopted to achieve it (i.e., the repeal of the EGO 24 incentives). The question is whether Romania could have negotiated a transition period for the incentives or their conversion into compatible aid. However, even if it could have done more, but failed to do so, objectively speaking the Tribunal does not find that it acted unreasonably. Even if Romania could have done more to maintain the incentives, its failure to negotiate transitional periods or compensation was not arbitrary, but appears justified under the specific circumstances of the accession negotiations.
826. The exception to this conclusion was Romania's decision to maintain the investors' obligations despite the repeal of the incentives. It is not for this Tribunal to say what would have been the right decision (i.e., possibly shortening the period or diminishing in other ways the obligations imposed upon the investors), but it was not reasonable for Romania to maintain as a whole the investors' obligations while at the same time eliminating virtually all of their benefits.
827. In other words, with the exception noted in the preceding paragraph, Romania's repeal of the incentives was a reasonable action in pursuit of a rational policy. That being said, this conclusion does not detract from the Tribunal's holding in Section 3(c) above that Romania undermined the Claimants' legitimate expectations with respect to the continued availability of the incentives until 1 April 2009. As a result, Romania's actions, although for the most part appropriately and narrowly tailored in pursuit of a rational policy, were unfair or inequitable vis-à-vis the Claimants. In

addition, the Tribunal finds that Romania could have been more transparent with PIC holders, as discussed in Section 6 below.

## 5. Did Romania act in bad faith?

828. The Tribunal now turns to the Claimants' arguments on bad faith.

### a. The Parties' positions

829. The Claimants argue that Romania breached its fair and equitable treatment obligation by acting in bad faith when it repealed the EGO 24 incentives. Specifically, the Claimants argue that "Romania acted in bad faith by (1) reneging on its oft-repeated defense of the legality of the incentives regime within the EU accession framework by ultimately revoking the incentives prematurely without a decision from any competent legal authority requiring it to do so; (2) neglecting to negotiate with the EU in order to secure an exception to any potentially-violated State aid rules; (3) failing to negotiate with Claimants in order to protect them from premature revocation of the incentives regime via measures that would be acceptable to the EU; and (4) reaping the benefits from Claimants' investments in the Stei-Nucet-Drăgănești disadvantaged region, and in particular accepting fulfillment of Claimants' various obligations under the incentives program as described above, before revoking the incentives four years before the promised date, refusing to compensate Claimants, and thereby failing to fulfill its own obligations under the program" (C-Reply, ¶ 449).

830. The Respondent does not directly address the Claimants' arguments on bad faith. However, the Tribunal presumes that the Respondent's arguments as to the reasonableness of its actions (as discussed in Section 4 above) are applicable.

### b. The Tribunal's analysis

831. Good faith is a standard that is flexible. A requirement of good faith is prevalent in all fields of the law and will arise in various matters, such as the interpretation of treaties (Article 31 of the VLCT), the prohibition to abuse rights, and the protection of legitimate expectations. As such, it eludes any strict definition. However, as a minimum, good faith would require that any party would not consciously conduct itself in such a way that should contradict the implications of that party's earlier behavior, a concept akin to the prohibition of estoppel.

832. The concept of bad faith is likewise difficult to define with precision. Black's Law Dictionary defines bad faith as "dishonesty of belief or purpose."<sup>145</sup> The commentary to Section 205 of the American Law Institute's *Restatement (Second) of Contracts* (1981) states with respect to good faith in the performance of an obligation:

*d. Good faith performance.* Subterfuges and evasions violate the obligation of good faith in performance even though the actor believes his conduct to be justified. But the obligation goes further: bad faith may be overt or may consist of inaction, and fair dealing may require more than honesty. A

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<sup>145</sup> Black's Law Dictionary, Ninth Edition (2009), p. 159.

complete catalogue of types of bad faith is impossible, but the following types are among those which have been recognized in judicial decisions: evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance.<sup>146</sup>

833. In the treaty context, Bin Cheng notes that “[t]he principle that treaty obligations should be fulfilled in good faith and not merely in accordance with the letter of the treaty has long been recognised by international tribunals and is reaffirmed by the United Nations as an ‘act of faith.’”<sup>147</sup> Similarly, citing a string of investment arbitration cases, the *Europe Cement* tribunal noted that “it is well accepted in investment arbitrations that the principle of good faith is a principle of international law applicable to the interpretation and application of obligations under international investment agreements.”<sup>148</sup>
834. According to Bin Cheng, “[p]erformance of a treaty obligation in good faith means carrying out the substance of this mutual understanding honestly and loyally.”<sup>149</sup> International investment tribunals confirm this interpretation. For instance, in *Canfor and Terminal Forest v. USA*, the tribunal stated that “a fundamental principle of international law that States Party to a treaty must perform treaty obligations in good faith and, therefore, would not intentionally take steps that would undermine performance of those obligations.”<sup>150</sup> Similarly, the *Waste Management II* tribunal held that “[a] basic obligation of the State under Article 1105(1) [which sets out NAFTA’s minimum standard of treatment] is to act in good faith and form, and not deliberately to set out to destroy or frustrate the investment by improper means.”<sup>151</sup>
835. The Tribunal notes that the Claimants’ allegations of bad faith are virtually identical to their arguments with respect to Romania’s allegedly unreasonable conduct. The Tribunal understands that the difference between both sets of allegations is that the Claimants are arguing here that not only was Romania’s conduct unreasonable (i.e., not justified by the reasonably tailored pursuit of a rational objective), but that it was intentional or at least conscious in its unreasonableness.
836. The Tribunal has already found that Romania’s conduct was, with one exception, a reasonable action in pursuit of a rational policy. But even with respect to that one

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<sup>146</sup> Restatement (Second) of Contracts § 205 cmt. d (1981).

<sup>147</sup> Bin Cheng, *General Principles of Law as Applied by International Courts Tribunals* (1953, 2006), p. 114.

<sup>148</sup> *Europe Cement Investment & Trade S.A. v. Republic of Turkey* (ICSID Case No. ARB(AF)/07/2), Award, 13 August 2009 (hereinafter “*Europe Cement v. Turkey*” or “*Europe Cement*”), ¶ 171, citing *Amco Asia Corporation and others v. Republic of Indonesia* (ICSID Case No. ARB/81/1), Award, 20 November 1984; *Plama v. Bulgaria*; *Inceysa Vallisoletana S.L. v. Republic of El Salvador* (ICSID Case No. ARB/03/26), Award, 2 August 2006; *Phoenix Action Ltd v. Czech Republic* (ICSID Case No. ARB/06/5), Award, 15 April 2009.

<sup>149</sup> Bin Cheng, p. 115.

<sup>150</sup> *Canfor Corporation v. United States of America, Tembec Inc. et. al. v. United States of America and Terminal Forest Products Ltd. v. United States of America*, UNCITRAL, Decision of on Preliminary Question, 6 June 2006.

<sup>151</sup> *Waste Management v. Mexico II*, ¶ 138.

exception (maintaining investors' obligations after terminating the incentives), the record does not include any indication that Romania acted in bad faith. Accordingly, the Tribunal rejects this argument.

## **6. Did Romania fail to act transparently or consistently?**

837. The Tribunal now turns to the Claimants' allegation that Romania failed to act transparently or consistently.

### **a. The Claimants' position**

838. In addition to failing to provide stability of the legal framework and violating their legitimate expectations, the Claimants argue that Romania breached its obligation to accord fair and equitable treatment by acting in a manner that was not transparent or consistent (C-SoC, ¶¶ 229-241; C-Reply, ¶¶ 440-442; C-PHB, ¶¶ 51-62). The Claimants argue that this was acknowledged by Romania's own witness, Mr. Orban (Tr., Day 8, 208-209, 221 (Orban)).

839. Specifically, the Claimants contend that Romania acted in a manner that was not transparent by actively pursuing two conflicting policies: on one hand, it promoted the EGO 24 incentives, and at the same time it negotiated their revocation behind closed doors. The Claimants allege that, at least until 2003, Romania actively promoted and supported the EGO 24 regime (as evidenced by the Government and Parliament's disagreement with the Competition Council on Decision 244 and the adoption of the Methodological Norms). However, at the same time Romania was secretly negotiating the revocation of these incentives. The Claimants also assert that there is no evidence that the government met with the Claimants to inform them that the incentives were likely to be prematurely revoked.

840. The Claimants further submit that Romania acted inconsistently when it repeatedly proclaimed that the incentives were compatible with the requirements of the *acquis*, but ultimately decided to revoke them prematurely based on their alleged incompatibility with those same requirements. The Claimants also allege that officials within the Romanian government took inconsistent positions with respect to the compatibility of EGO 24 with EU law. According to the Claimants, as explained above the evidence suggests that until 2004 Romania thought that EGO 24 was permissible state aid under EU law.

841. In addition, the Claimants argue that the manner in which Romania revoked the incentives created uncertainty. The Claimants state that the incentives were subject to a string of contradictory measures that repealed some of the incentives, partially reintroduced some of them, and then repealed them again. In particular, the Claimants note that Romania repealed the incentives from EGO 24, but it did not amend GD 194/1999, which states that investors in the Ștei-Nucet-Drăgănești region will benefit from the incentives for ten years. The Claimants argue that this led to insecurity and confusion, and as a result the investors could not plan their business in a rational way.

842. In any event, the Claimants contend that Romania did not align its measures with the various goals and policies behind EGO 24 and similar incentives programs granted to investors over the years (which pursued the goals of attracting capital, reducing unemployment, etc). In that context, the Claimants invoke *Tecmed*, as quoted in paragraph 534 above.

**b. The Respondent's position**

843. The Respondent denies that Romania treated the Claimants' investments in an inconsistent and non-transparent manner (R-PHB, ¶¶ 160-184).

844. As noted above, the Respondent understands that the transparency and consistency "strand" of the fair and equitable treatment standard requires Romania to comply with due process and fair administration. In particular, it means that Romania should conduct itself in such a way that investors are able to find out what the rules are and how to comply with them, and the rules should be administered in an even handed and reasonably consistent fashion.

845. However, the Respondent argues that the situation here is different. The Claimants do not contend that Romania was unclear about the rules and procedures they had to follow, or that the rules were applied inconsistently. Rather, the Claimants contend that they were not given enough information about ongoing diplomatic negotiations. According to the Respondent, international investment law does not require a state to disclose its assessment of the likely outcome of such negotiations. As a result, the Respondent argues that "the Claimants' contentions are not only irrelevant as a matter of law but illogical as a matter of fact: if, as the Claimants seemed to suggest at the hearing, Romania should have publicly announced at the earliest possible date that it did not expect to obtain the EU's agreement to continue the EGO Facilities in force, the only possible difference is that the Claimants would have lost the benefit of the Facilities sooner" (R-Rejoinder, ¶ 161). Likewise, the Respondent argues that there is no need to warn investors of legislative changes (*Parkerings*, ¶ 345).

846. The Respondent also contends that the Claimants' consistency and transparency allegations fail on the evidence. It asserts that Romania's conduct "was entirely fair and reasonable, particularly in a context in which its negotiating partners insisted on a degree of confidentiality and there were—legitimately and unsurprisingly—differing views among different government officials and constituencies as to the best approaches and the most likely outcomes" (R-PHB, ¶ 162). In any case, the Respondent argues that the Claimants knew or should have known (given their duty to conduct due diligence, and given their alleged strong political connections) that the future of the facilities was uncertain. The Respondent also denies that the Claimants were in fact misled by any of the supposedly inconsistent or non-transparent Government statements or omissions.

847. More specifically, Romania argues that (i) its balancing of confidentiality and openness was reasonable, (ii) it complied with any standard of consistency or transparency that could reasonably be imposed in the context of complex or politically

sensitive legislation and negotiation, and (iii) it was common knowledge that the facilities were vulnerable.

**i. Romania's balancing of confidentiality and openness was reasonable**

848. Romania asserts that some measure of confidentiality and discretion was necessary during the accession negotiations. Romania alleges that this discretion was important "if Romania was to have any hope of obtaining transitional provisions or delayed repeal of the Facilities", but also to comply with confidentiality conditions imposed by the EU. In this regard, Mr. Orban testified that

We tried to inform as much as possible, but in a discreet way, because we were bound by the clear conditions of conducting accession negotiation process not to express publicly some of the conclusions which were already derived at that time from the negotiations with the Union (Tr., Day 8, 233 (Orban)).

849. Despite the confidentiality constraints imposed by the EU and the need to protect its bargaining position, Romania argues that it pursued a policy of openness. It asserts that the government disseminated information about its progress through governmental websites, the Official Gazette and national media, including detailed reports on the country's progress towards accession. Although the Claimants may criticize the way Romania made information available, Romania contends that the legislative process need not be perfect nor perfectly transparent (*AES v. Hungary*, ¶ 9.3.73).

850. Relying on Mr. Orban's testimony, the Respondent argues that "from the technical consultations in 2003, it was absolutely clear that for such kind of facilities [customs duty exemptions] there is no room for manoeuvre" (Tr., Day 8, 229-230 (Orban)). This conclusion was announced gradually rather than immediately to different stakeholders (mainly through non-public discussions) because Romania was "not in a position to make a public statement" (Tr., Day 8, 230 (Orban)). Romania argues that, as the EU's opposition to the facilities became increasingly apparent, Romania "sought to convey this information to stakeholders in a way that would not undermine its negotiating position with the Commission and Member States" (Tr., Day 8, 223-224 (Orban)).

851. In particular, the Respondent asserts that the Competition Council organized extensive discussions with stakeholders and provided them with copies of state aid documents, such as the EU guidelines on regional aid. With respect to the Claimants' suggestion that the Miculas had not been included in these discussions, Romania argues that it is implausible that businessmen with the Miculas' level of political access and experience could have been deprived of information made available to smaller stakeholders, or that they would not have insisted on being privy to that information. The Respondent notes that the Miculas have boasted about their political connections, and argues that the Romanian government has been responsive to the Miculas' concerns in the past (citing as an example the Parmalat affair, where it alleges that the Miculas were able to use their political influence to overturn a court judgment that was against their interests). Indeed, given the

Claimants own testimony about frequent contacts with government officials, Romania argues that the Claimants cannot prove that they were excluded from the consultative process. In any event, Romania argues that this information was public.

**ii. Romania complied with any standard of consistency or transparency that could reasonably be imposed in the context of complex or politically sensitive legislation and negotiation**

852. The Respondent contends that it complied with any standard of consistency or transparency that could reasonably be imposed in the context of complex or politically sensitive legislation and negotiation.
853. The Respondent asserts that “various agencies and individuals connected to the Government held differing views about the Facilities’ future”, which it argues “is normal for any state, and it certainly is to be expected of a state undergoing massive changes in its legal and political culture” (R-PHB, ¶ 173). The Respondent first highlights Romanian officials’ lack of expertise in the enactment of EGO 24, noting that Mr. Orban described the EGO 24 program as a “non-professional” attempt by Romania to achieve its objective of regional development, passed “with an incredible lack of expertise in terms of how the regional policy is developed at the European Union level” (Tr., Day 8, 178-180 (Orban)).
854. In addition, the Respondent acknowledges that, at the time of EGO 24’s enactment and even after the Competition Council issued Decision 244, a significant part of the government believed that the EGO 24 facilities were legal. Citing Mr. Marcu’s testimony at the hearing, the Respondent alleges that “it was this sincere belief that motivated Romania to enact EGO 75/2000, which only partially implemented the Competition Council’s decision” (R-PHB, ¶ 175, citing Tr., Day 7; 20-21(Marcu)). Relying on Mr. Petersen’s testimony, the Respondent argues that “Romanian politicians and officials who thought that EGO 24 was legal were incorrect, but they were not unreasonable, and they acted in good faith” (R-PHB, ¶ 174, Tr., Day 6, 111, 178).
855. The Respondent argues that it was in this environment that Romania promulgated the 2001 Methodological Norms (GD 728/2001). This was the document on which Mr. Orban was being cross-examined when he admitted that Romania was not being particularly transparent to investors and was also acting inconsistently in terms of the availability of EGO 24 (Tr., Day 8, 208-209 (Smith/Orban)). However, the Respondent contends that when this document was promulgated, “the Government was publicly at odds with the Competition Council regarding the legality of several of the EGO 24 Facilities”, and “[a]s Mr. Orban explained, any inconsistency in the position taken by different agencies resulted from different levels of knowledge and sophistication and different assessments (or even ‘wishful thinking’) of what might be obtained”, which “is natural and unavoidable in any state” (R-PHB, ¶ 177).
856. In any event, the Respondent argues that the 2001 Methodological Norms did not say that any particular Facility would stay in place for any period of time. Rather, Article 5



of GD 728/2001 provided that PIC holders “shall continue to benefit from facilities under the law, until the expiry of the period for which the disfavored area was declared.” The Respondent points out that the Claimants and other PIC holders did indeed continue to benefit from the facilities under EGO 24 [as amended] until 2009.

857. Similarly, any ambiguity in reports to the public regarding Romania’s progress towards accession (Exh. HEC-6 and HEC-7) “can be explained by the quandary in which Romania found itself.” (R-PHB, ¶ 178). Relying on Mr. Orban’s testimony, Romania argues that single statements in the reports (such as statements saying that the provisions on the facilities granted in the D-areas would be maintained until the moment of Romania’s accession) should not be taken at face value, but rather interpreted in context with other sections stating that the issue of state aid was a sensible subject in the negotiating process. For instance, the Respondent cites to the following testimony by Mr. Orban:

Q. And in this public document in June 2002, anyone who took the time to read this would have been told by the government that the provisions on the facilities granted in the D-areas would be maintained until the moment of Romania’s accession; correct?

A. Yes, this was the intention, and this is why we battled a lot with the Commission to get this.

Q. So any investor reading this report in June 2002 would be led to believe that these facilities under EGO 24 would be in place for -- the shortest period of time would be 2007; correct?

A. No. Because -- once again, I don’t want to repeat my previous answer, but at that time it was clear that this is a subject, a delicate subject in the accession negotiation process with not a very clear ending.

Q. What’s unclear about “will be maintained until the moment of accession”?

A. No, you have to read all the documents, not only this sentence. Because it was clear, you mentioned the previous document, the report, where it is mentioned clearly at page -- so it’s 9, okay, it’s the negotiation on state aid control on Romania focused, pages 132, on the following sensible topics concerning the assessment of the fiscal aid.

So it was clearly mentioned that this is a sensible subject in the accession negotiation process.

(Tr., Day 8, 219:21-220:21 (Smith/Orban)).

858. The Respondent also contends that the June 2002 programme (Exh. HEC-7) was equivocal about the facilities’ future, as confirmed by Mr. Orban:

Q. [...] You were looking at page 148. You were directed to go to the second highlighted passage at the beginning. It says:

“The provisions of the normative acts on facilities granted for ‘D areas’ will be maintained till the moment of Romania’s accession to the European Union.”

You were asked about this, you were asked about the import of this statement and what one would make of it. I think in fairness I want you to read the next two sentences, where it is said:

"In conformity with the commitment assumed within the Complementary Position Paper of Chapter 6 'Competition Policy', the Ministry of Development and Prognosis worked out a study analysing the activities carried out in D-areas since July 1999 till June 2001. This study showed that the facilities within deprived areas might be maintained."

I wanted to read out this passage and direct your attention to it, so that I can elicit your comment.

- A. So, as I told you, I haven't seen this study. So it clearly shows that the study was made by the Ministry of Development and Prognosis. But here the formulation is not -- how to say? -- has presented some doubts about the possibility of preserving these facilities until the end of the -- until before the accession to the European Union.

(Tr., Day 8, 240:13-241:13 (Petrochilos/Orban)).]

859. The Respondent also denies the Claimants' accusation of deliberate adoption of contradictory positions, arguing that it is unsupported by the evidence. The Respondent contends that "[t]he state may be a unitary entity for purposes of international law, but in judging allegations of bad faith and intentional action, reality must prevail." The Respondent argues that "[d]ifferent officials—in any state—have different roles, different expertise, different levels of legal sophistication, and different opinions", and that "[i]n a period of transition, the diversity of knowledge and views is inevitably greater" (R-PHB, ¶ 179). Citing authors Newcombe and Paradell, the Respondent submits that "[i]n the case of a large investment that involves the jurisdiction of several government ministries and agencies and multiple levels of government, a host state cannot be held to a standard of strict or absolute liability whereby any degree of inconsistency, ambiguity or lack of transparency breaches fair and equitable treatment."<sup>152</sup>
860. According to the Respondent, the only conclusion that can be reached from the record is that the Romanian Government was unsure what would happen with the facilities. It submits that, "[o]n the totality of the record, no reasonable investor could have concluded that the Government was certain that the facilities would remain intact until accession, let alone until 2009. There was doubt, and there is nothing illegal about that, particularly in the context of a state making the transition to EU membership. Investors may choose to invest in conditions of greater uncertainty, in search of greater returns—but also taking on, knowingly, the greater risk that comes with it" (R-PHB, ¶ 180).

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<sup>152</sup> A. Newcombe, L. Paradell, *Law and Practice of Investment Treaties: Standards of Treatment* (2009), Exh. RL-365, p 294.

### iii. It was common knowledge that the facilities were vulnerable

861. As explained in detail in Section 3 above, the Respondent argues that it was common knowledge that the facilities would be scaled back or withdrawn, and the Miculas knew or should have known of that risk. The Respondent contends that the fair and equitable treatment standard does not require more than that. Relying on *Parkerings v. Lithuania*,<sup>153</sup> the Respondent argues that it was not required to advise the Claimants of future modifications of the law. Referring to the four points addressed by the *Parkerings* tribunal, the Respondent contends that (R-PHB, ¶ 182):

- a. The record does not show that Romania “deliberately neglected to advise the Claimant[s] of the possible amendment of the law”. There was a diversity of views among Romanian officials at different times about what was likely to happen and what was desirable. Particularly at the time when the Claimants say that they committed themselves to a 10- or 20-year investment program (circa 1988-2000) it would be highly unrealistic to say that the Romanian state “knew” that the facilities would be withdrawn before 2009. There is no evidence that this information was intentionally withheld from the Claimants; to the contrary, the evidence is that the Claimants were in frequent contact with many different officials, including the chief negotiator in the accession negotiations.
- b. Moreover, “the political environment was changing at the time... and the Claimant[s] should have known that the legal framework was unpredictable and could evolve.”
- c. The fact that Romanian officials knew that the facilities might have to be changed or withdrawn does not mean that they knew exactly what was going to happen or when, particularly at the times relevant to the Claimants’ case.
- d. The Claimants and their legal advisors were entirely capable of perceiving that the facilities were “in play” and there was a significant chance of amendment or repeal before 2009.

862. In addition, the *Parkerings* tribunal held that, while the municipality of Vilnius might well have breached a contractual obligation of disclosure, that would not amount to a

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<sup>153</sup> *Parkerings v. Lithuania*, ¶¶ 341-342: “[T]he City of Vilnius was in possession of information, prior to the conclusion of the Agreement, concerning possible modifications of the Law on Self-Government and omitted to advise the Claimant ...

However, first, the record does not show that the Respondent deliberately neglected to advise the Claimant of the possible amendment of the law. Second, as described above, the political environment was changing at the time of the negotiation of the Agreement and the Claimant should have known that the legal framework was unpredictable and could evolve. Third, the fact that the City of Vilnius knew the intention of the legislator to modify certain laws, does not mean that the City of Vilnius knew the substance of the modification. Indeed, the record does not show that the City of Vilnius was in possession of any specific information which indicated that the Agreement would be affected by a modification of the law. Fourth, the Claimant failed to demonstrate that any investor or at least a qualified law firm was unable to get the information about the amendment process. Therefore, the Tribunal sees no reason why, in the circumstances, the alleged contractual obligation of the Municipality to inform BP of the future modification of the law is constitutive of a legitimate expectation for the Claimant.”

breach of the relevant BIT. The Respondent notes that here there is no question of a contractual or other municipal law obligation requiring the Government to disclose to the Claimants the details of the accession negotiations or warn them that the law might change.

863. In view of the above, the Respondent argues that “[t]he Claimants’ allegations about transparency and consistency are red herrings. The plain fact is that, no matter what calumnies the Claimants wish to direct at Romania’s conduct, the Claimants could not reasonably have believed that the facilities were guaranteed to remain in place and unchanged until 2009. There is no evidence that they were in fact duped or misled by anything the Government said (or failed to say)—because they were not” (R-PHB, ¶ 184).

**c. The Tribunal’s analysis**

864. It is evident from the record that, as the Respondent itself puts it, Romania was in a quandary whilst trying to balance two conflicting policies, *i.e.*, first, the continuation of the facilities regime and the protection of the interests of PIC holders in the disfavored regions, and, second, EU accession. The Tribunal has already found that Romania’s actions, including its choice to terminate the EGO 24 regime in order to obtain EU accession, were not undertaken in bad faith. However, it finds that the manner in which Romania carried out that termination was not sufficiently transparent to meet the fair and equitable treatment standard.
865. The Tribunal cannot fail to note that the Respondent’s own witness, Mr. Orban, who was Romania’s Deputy Chief Negotiator for EU accession from 2001 to 2004, conceded that Romania acted inconsistently, non-transparently and ambiguously in terms of the availability of the EGO 24 program and the information given to PIC holders as late as 2002 (Tr., Day 8, 208-209, 221 (Orban)). For example, Romania’s official reports regarding its progress towards EU accession were ambiguous (and perhaps even misleading, even if unintentionally) with respect to the duration of the EGO 24 regime. Specifically, Romania’s “National Programme for Accession of Romania to the European Union” (Exh. HEC-7) stated that “[t]he provisions of the normative acts on facilities granted for ‘D areas’ will be maintained till the moment of Romania’s accession to the European Union” (Exh. HEC-7, p. 148). Mr. Orban’s protests that this document should not be interpreted literally (Tr., Day 8, 219:21-220:21 (Smith/Orban), cited above at paragraph 857) are unpersuasive: an ordinary reader would not have understood that, because the assessment of fiscal aid was a “delicate subject” in the accession negotiations, these statements should not be taken literally.
866. The Tribunal has already found that, until sometime in 2003, any inconsistencies in Romania’s statements as to the compatibility of the EGO 24 regime with EU state aid regulations were based on a good faith lack of knowledge and an overly optimistic initial assessment of its bargaining power vis-à-vis the EU (see Section 4 above). In addition, although for purposes of attribution the state is one single entity, when it comes to assessing transparency one cannot ignore the reality that the state is made

of different departments which may hold conflicting views as to how to implement a particular policy. However, once it became clear to Romania that the incentives would have to be abolished (sometime in 2003, according to Mr. Orban), Romania should have made PIC holders aware of this fact. This was the position taken by the tribunal in *Metalclad*:

The Tribunal understands [transparency] to include the idea that all relevant legal requirements for the purpose of initiating, completing and successfully operating investments made, or intended to be made, under the Agreement should be capable of being readily known to all affected investors of another Party. There should be no room for doubt or uncertainty on such matters. **Once the authorities of the central government of any Party** (whose international responsibility in such matters has been identified in the preceding section) **become aware of any scope for misunderstanding or confusion in this connection, it is their duty to ensure that the correct position is promptly determined and clearly stated so that investors can proceed with all appropriate expedition in the confident belief that they are acting in accordance with all relevant laws.**<sup>154</sup> (Emphasis added)

867. Romania argues that it was bound by confidentiality obligations imposed by the EU. However, there is no evidence of such requirements, other than Mr. Orban's testimony. While the Tribunal does not discount this testimony (and finds Mr. Orban generally to be a credible witness), it seems unlikely that the EU would object to Romania informing affected parties of steps taken by Romania in order to align incompatible aid with the *acquis*, when such alignment was exactly what the EU was requesting Romania to do since the conclusion of the Europe Agreement. Even if confidentiality was required, or Romania preferred to keep the negotiations with the EU confidential for other reasons, Romania then had to make a choice and accept the consequences of maintaining such confidentiality.
868. Moreover, the Tribunal finds Romania's argument that it had to keep the negotiations confidential to maintain its "bargaining position" with the EU unconvincing. If, according to Mr. Orban, "from the technical consultations in 2003, it was absolutely clear that for such kind of facilities [customs duty exemptions] there is no room for manoeuvre" (Tr., Day 8, 229-230 (Orban)), then Romania had no bargaining position to speak of. Romania could be referring to negotiations to obtain transitional periods on the EGO 24 incentives, but there is no evidence whatsoever that Romania even attempted to negotiate transitional periods for the customs duty exemptions.
869. Thus, the Tribunal finds that Romania should have alerted PIC holders reasonably soon after it became clear that the EGO 24 incentives would be abolished. The statements made by Prime Minister Nastase on national television in January and May of 2004 were of a general nature (as befitting their context), and thus insufficient. Given the importance of the EGO 24 program and how intensely it was discussed in the context of Romania's EU accession, it was reasonable to expect that the Government would have given to the participants a formal advance notice of the program's anticipated termination. Prime Minister Nastase had also stated that the

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<sup>154</sup> *Metalclad v. Mexico*, ¶ 76 (Emphasis added).

incentives would be in place until the date of accession,<sup>155</sup> and that the government would try to negotiate transitional periods or that there would be compensation packages for PIC holders (see paragraph 689 above), so the actual situation was unclear to PIC holders. Nor has the Respondent pointed to any evidence of discussions with stakeholders organized by the Competition Council or other government agencies.

870. As a result, the Tribunal finds that the Respondent breached the fair and equitable treatment obligation by failing to inform PIC holders in a timely manner that the EGO 24 regime would be ended prior to its stated date of expiry (1 April 2009).
871. The Tribunal finds the Claimants' remaining claims on lack of transparency or inconsistency unsubstantiated. Although perhaps the manner in which Romania offered, amended and then finally revoked the incentives could give rise to some confusion, it did not rise to the level of a breach of the fair and equitable treatment obligation. The fact that the Government repealed the incentives from EGO 24 but made no amendment to GD 194/1999 (which states that investors in the Ștei-Nucet-Drăgănești region will benefit from the incentives for ten years) likewise could not have created the level of uncertainty that could rise to the level of a breach of the fair and equitable treatment standard.

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872. The Tribunal concludes that, by repealing the EGO 24 incentives prior to 1 April 2009, Romania did not act unreasonably or in bad faith (except that the Respondent acted unreasonably by maintaining investors' obligations after terminating the incentives). The Tribunal, however, concludes by majority that Romania violated the Claimants' legitimate expectations that those incentives would be available, in substantially the same form, until 1 April 2009. Romania also failed to act transparently by failing to inform the Claimants in a timely manner that the regime would be terminated prior to its stated date of expiration. As a result, the Tribunal finds that Romania failed to "ensure fair and equitable treatment of the investments" of the Claimants in the meaning of Article 2(3) of the BIT.

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<sup>155</sup> In an interview in Oradea, Bihor County in May 2004 (Exh. C-652), Prime Minister Nastase indicated that "[s]ubsequent to 2007, when we want to be accepted in the European Union, these disfavored areas will no longer exist in Romania" (Emphasis added).

### **C. THE CLAIMANTS' REMAINING CLAIMS**

873. In addition to their claims under the umbrella clause and their fair and equitable treatment claims, the Claimants assert that the Respondent has breached the second part of Article 2(3) of the BIT by impairing the management, maintenance, use, enjoyment and disposal of their investments through unreasonable or discriminatory measures; and Article 4(1) of the BIT by expropriating their right to receive the incentives (as well as their entire investment) without compensation.
874. In light of the Tribunal's conclusion that, by prematurely revoking the EGO 24 incentives in the manner that it did, the Respondent breached its obligation to treat the Claimants' investments fairly and equitably, the Tribunal does not need to address the Claimants' remaining claims. Indeed, each of those claims arises from the same facts as the fair and equitable treatment claim, and the Claimants claim the same compensation in each instance (see Section VII below). Thus, even if the Tribunal were to find in favor of the Claimants with respect to these claims, this would not impact the Tribunal's calculation of damages. As a result, any legal findings on these matters are unnecessary.

## **VII. DAMAGES**

875. Having found a breach of the BIT, the Tribunal now turns to the Claimants' requests for reparation.
876. During the hearing on the merits, the Respondent argued that the Claimants had amended their case on damages. As a result, the Tribunal directed the Claimants to clarify their final request for relief, which they did on 20 December 2013 with their Revised Request for Relief and later confirmed in their Post-Hearing Brief and closing arguments. The Respondent had several opportunities to comment on this Revised Request for Relief, and submitted its own prayers for relief in response. The Tribunal has focused exclusively on the Parties' formal prayers for relief, namely the Claimants' prayers for relief as set out in their Revised Request for Relief,<sup>156</sup> and the Respondent's response in its Post-Hearing Brief.<sup>157</sup> The Tribunal has also considered that the Parties' additional requests for relief made in the context of their submissions on provisional measures fall under the category of formal prayers for relief. All arguments have been considered, but the Tribunal sees no need to decide on some of the arguments the Parties have made during the course of the proceedings where they are not necessary to the Tribunal's decisions on the actual requests themselves.
877. The Tribunal will first provide an overview of the Claimants' damages case and the Respondent's position in this respect (Section A below). It will then address certain preliminary matters (Section B below), before analyzing the Claimants' specific claims for damages (Section C below). The Tribunal will turn next to the Respondent's defense that EU accession benefitted the Claimants (Section D below), followed by the Claimants' request that damages be awarded net of taxes (Section E below). Finally, the Tribunal will address the question of who should be the beneficiaries of the Award (Section F below).

### **A. OVERVIEW**

#### **1. Overview of the Claimants' damages case**

878. The Claimants' damages case has evolved over time, as described below.

##### **a. The Claimants' original damages case**

879. In their Statement of Claim, relying on ILC Articles 34 to 36, the Claimants articulated their damages case as follows:

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<sup>156</sup> At the end of their Post-Hearing Brief, the Claimants "request an award granting them the relief set out in the Revised Request" (C-PHB, ¶ 279).

<sup>157</sup> At the end of its Post-Hearing Brief, the Respondent requests that the Tribunal "(a) DISMISS the Claimants' claim in their entirety; and (b) ORDER the Claimants to pay in their entirety the costs of this arbitration [...] (R-PHB, ¶ 354). Although the Respondent submitted a Supplementary Post-Hearing Brief commenting on the Claimants' Revised Request for Relief, it did not articulate a formal prayer for relief in that submission.



“378. [...] Claimants are entitled to restitution of the legal framework that would have prevailed had Romania not withdrawn the tax exemptions and other incentives. In addition, Claimants are entitled to consequential damages arising as a consequence of Romania's illegal acts.

379. In the alternative, if the Tribunal finds that restitution is impossible or constitutes a disproportionate burden, the Claimants are entitled to full damages for the loss suffered as a consequence of Romania's illegal acts. This includes damages for the direct loss suffered as a consequence of the impermissible withdrawal of the tax exemptions and other incentives. It also includes consequential damages for the loss suffered as a consequence of the loss of the cash flow and loss of opportunity.”

(C-SoC, ¶¶ 378-379)

880. On this basis, the Claimants requested the following:

- a. “[R]estitution of the legal framework as in force at the time of the approval of the EGO 24/1998, alternatively adequate compensation for the losses suffered up to the amount of EUR 450,000,000; plus lost profits and any further losses suffered by Claimants as a consequence of Respondent's actions described above. The exact amount will be specified at an appropriate point during the proceedings” (C-SoC, ¶ 381).
- b. “[R]eimbursement of their costs and expenses including the costs of the present proceedings” (C-SoC, ¶ 382), and
- c. “[I]nterest compounded quarterly on all monetary claims with the precise rate of interest to be specified at an appropriate time during the proceedings” (C-SoC, ¶ 383).

**b. The Claimants’ damages case in their Reply**

881. In their Reply, the Claimants abandoned their request for restitution (C-Reply, ¶¶ 583, 666, fn. 960). From this point forward, their case focused on compensation.

882. The Claimants submit that, to determine the compensation owed by Romania for its breaches of the BIT, the Tribunal should apply, in the first instance, any *lex specialis* in the BIT. In the absence of any *lex specialis*, the Tribunal must apply the rules of customary international law. The Claimants note that the only *lex specialis* found in the BIT with respect to compensation is in Article 4, which sets out the standard of compensation for a “lawful” expropriation (i.e., an expropriation that meets the requirements of Article 4). However, the BIT is silent with respect to the standard of compensation for “unlawful” expropriations and other breaches of the BIT’s substantive protections, such as those alleged by the Claimants in this arbitration. In these cases, the Claimants contend that the appropriate standard for compensation under customary international law is the principle of “full compensation”, as articulated by the Permanent Court of International Justice (PCIJ) in the *Factory at Chorzów*

case.<sup>158</sup> According to the Claimants, this principle is supported by the ILC Articles and by an overwhelming majority of cases and authorities. The Claimants add that the generally accepted view is that they are entitled to be fully compensated irrespective of the breach or breaches of the BIT that the Tribunal may find (C-Reply, ¶¶ 575-588).

883. The Claimants argue that they can only be fully compensated by being placed in the position in which they would have been had Romania not breached the BIT. This includes in particular the lost profits that the Claimants would have made had the Raw Materials Incentive not been repealed. The Claimants further submit that the Tribunal has wide discretion in calculating damages (C-Reply, ¶¶ 589-609).

884. In their Reply, the Claimants requested an award of compensation for the damages described in Professor Lessard's First Expert Report, in the amount of €613.7 million for the following categories of damages (R-Reply, ¶¶ 611-655):

- a. Increased costs for imported raw materials;
- b. Lost sales of products containing sugar free of customs tax;
- c. Financial penalties incurred to the state for delays in tax payments and that could have been avoided with cash available from the incentives and the lost product sales;
- d. Lost opportunities to complete or initiate incremental investments (malt, can and cogeneration plants) that would have created cost savings and incentive payments for green energy; and
- e. Lost incremental sales of private-label beer that would have been profitable with completion of the cost-saving investments.

885. The damages sought were broken down as follows (C-Reply, ¶ 653):

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<sup>158</sup> *Case Concerning Factory at Chorzów (Germany v. Poland)*, Judgment 13, Permanent Court of International Justice, 13 Sept. 1928 (hereinafter "*Factory at Chorzów*" or "*Chorzów Factory*") (1928 PCIJ, Series A. No. 17).

**Summary of Damages Including Incremental Sales**  
(Present Value at September 30, 2009 in Millions of RON unless Otherwise Noted)

	Damage (Million RON)	<u>Grossed-Up For Tax on Award</u>	
		(Million RON)	(Million EUR)
Increased Costs on Raw Materials	139.8	166.4	39.6
Lost Sales of SCPs to Industrial Users	524.4	624.3	148.7
Incremental Margin from Lost Sales of Finished Goods	98.5	117.3	27.9
Penalties Avoided	46.9	55.8	13.3
Malt Plant	28.0	33.3	7.9
Cogeneration Plant	591.8	704.5	167.8
Can Plant	734.9	874.8	208.4
Total	2,164.3	2,576.5	613.7

886. The Claimants added that, in any event, their injury could not be found to be inferior to the amount that they invested in reliance upon Romania’s undertaking to provide the incentives for a period of 10 years. The Claimants provided an “evaluation of that amount” in the expert reports of Chris Osborne of (FTI) (C-Reply, ¶ 655). Specifically, Mr. Osborne calculated this amount to be RON 811 million.<sup>159</sup>

887. In addition to the damages sought, the Claimants requested post-award compound interest (C-Reply, ¶¶ 657-665), and costs and expenses associated with this arbitration proceeding, including attorneys’ fees (C-Reply, ¶¶ 656).

**c. The Claimants’ revised request for relief**

888. On 20 December 2010, the Claimants submitted a revised request for relief (“Claimants’ Revised Request for Relief”). In their Post-Hearing Brief submitted on 13 May 2011, the Claimants explained this Revised Request in detail, and set out three alternative methods (Methods A through C) according to which the Tribunal could calculate the damages sought. They stressed however that “it is not their contention that the three methods listed below, or the itemized injuries that comprise the elements of the three methods, must be strictly adhered to in the ultimate calculation of an award” (C-PHB, ¶ 96).

889. The Claimants explain that Methods A and B are “alternative expectation scenarios that are offered to demonstrate the value of the integrated and flexible factory platform that the Claimants could have expected to derive had the Incentives not been revoked” (C-PHB, ¶ 97).

<sup>159</sup> In his second expert Report, Mr. Osborne places the value of the Claimants’ pre-EGO 24 business in “a valuation range of approximately Euro 340 million to Euro 450 million” (¶ 7.60), settling for a final estimation of Euro 400 million (¶ 1.38); see also C-PHB, ¶ 228. However, Mr. Osborne then deducts €100 million to take into account factors other than revocation that may have affected the Claimants’ financial situation, arriving to a final estimation of €300 million (at the time, RON 811 million) (Second ER of C. Osborne, ¶ 1.43).

890. According to the Claimants, **Method A** “represents the expected returns from continuation of the ten year plan that Claimants undertook in reliance on the Incentives, a plan intended to both capitalize on the Incentives themselves during their duration, and to complete a platform that would have performed profitably after the Incentives statutorily expired” (C-PHB, ¶ 97).
891. Specifically, in Method A the Claimants request an award of **RON 2,655.35 million** (before interest) (at the date of this Award, approximately **€597 million**) representing the total of each of the following itemized injuries:<sup>160</sup>

<b>No.</b>	<b>Claim</b>	<b>Amount claimed before interest (RON)</b>	<b>Approximate equivalent in Euro</b>	<b>Interest applies from</b>
1.	Increased cost of sugar	RON 85.1 million	€ 19.1 million	1 March 2007
2.	Increased cost of PET	RON 6.3 million	€ 1.4 million	1 March 2007
3.	Increased cost of raw materials other than sugar and PET	RON 17.5 million	€ 3.9 million	1 March 2007
4.	Lost opportunity to stockpile sugar in 2009	RON 62.5 million	€ 14 million	1 July 2010
	<b>Subtotal</b>	<b>RON 171.4 M</b>	<b>€38.5 M</b>	
5.	Financial penalties incurred but not yet paid	RON 63.65 million (unless waived by Respondent)	€ 14.3 million	N/A
6.	Financial penalties paid between 1 April 2005 and 30 September 2010	RON 40 million	€ 9 million	1 July 2007
7.	Lost profits on sales of finished goods	No less than ROM 427 million	€ 96 million <sup>161</sup>	1 May 2008
8.	Lost profits on sales of SCPs	RON 492.3 million	€ 110.7 million	1 July 2007 <sup>162</sup>
9.	Lost profits from inability to complete a malt plant	RON 28 million	€ 6.3 million	30 Sept. 2009
10.	Lost profits from inability to complete a canning plant	RON 720.4 million	€ 161.9 million	30 Sept. 2009
11.	Lost profits from inability to complete a co-generation plant	RON 712.6 million	€ 160.2 million	30 Sept. 2009
	<b>TOTAL</b>	<b>RON 2,655.35 M</b>	<b>€597 M</b>	

<sup>160</sup> Claimants’ Revised Request for Relief, ¶¶ 2.1 to 2.5. The tables set out in this section are based on the tables included in pages 42-43 of the Claimants’ Post-Hearing Brief. As the Parties have done in some of their respective submissions, the Tribunal has added, for indicative purposes only, the Euro equivalent of the amounts claimed rounded up to the nearest hundred thousand at the exchange rate of 9 December 2013 of 4.4482 RON/EUR, source: European Central Bank.

<sup>161</sup> Mr. Boulton’s valuation was originally made in Euro, for an amount of “in excess of €100 million” (ER of R. Boulton, ¶ 5.99).

<sup>162</sup> In his expert reports, Mr. Osborne had proposed that interest be computed as of 1 March 2007. However, during the hearing on closing arguments, the Claimants circulated a letter from Mr. Osborne dated 7 June 2011 in which he made an adjustment to the calculation of this claim in order to take into account working capital needs (Tr., Day 13, 6-7, 293 (Schwartz)). This adjustment involved a delay of 120 days for computing interest, which meant that interest should be computed from 1 July 2007 (Letter from Mr. Osborne dated 7 June 2011).

892. As an alternative to Method A, the Claimants propose **Method B**, which they argue “represents the expected returns from the platform that the Claimants actually constructed, had the Claimants been able to maintain their respective market shares in their existing and proven product lines.” The Claimants argue that they “have a proven track record of constructing flexible, cost-efficient, and integrated factories, and of successfully and profitably penetrating markets and building market share.” They further contend that “[g]iven this track record, and the Claimants’ known reliance on state investment incentives in building this track record, it was reasonably foreseeable to the Respondent that revocation of the Incentives at issue here would result in the losses reflected by either Methods A or B” (C-PHB, ¶ 97).
893. Specifically, in Method B the Claimants request an award of **RON 2,698.25 million** (before interest) (at the date of this Award, approximately **€606.5 million**) representing the total of each of the following itemized injuries:<sup>163</sup>

No.	Claim	Amount claimed before interest (RON)	Approximate equivalent in Euro <sup>164</sup>	Interest applies from
1.	The subtotal of items 1 through 6 of Method A	RON 275.05 million	€ 61.8 million	N/A
2.	Lost profits on sales of finished goods as calculated by BCG	RON 2,423.20 million <sup>165</sup>	€ 544.7 million	15 Aug. 2007
	<b>TOTAL</b>	<b>RON 2,698.25 M</b>	<b>€606.5 M</b>	

894. In the alternative to the expectation losses set out in Methods A and B, the Claimants have proposed **Method C**, a reliance damages calculation. According to the Claimants, Method C “is a means by which the Tribunal can measure the consequences of the Respondent’s unlawful act by calculating the value of the investment actually made by the Claimants in reliance on the promised, ten-year duration of the Incentives, and which has been lost” (C-PHB, ¶ 98).
895. Specifically, in Method C the Claimants request an award of **RON 874.65 million** (before interest) (at the date of this Award, approximately **€196.6 million**), representing each of the following itemized injuries:<sup>166</sup>

<sup>163</sup> Claimants’ Revised Request for Relief, ¶ 2.6.

<sup>164</sup> At the exchange rate of 9 December 2013 of 4.4482 RON/EUR, source: European Central Bank.

<sup>165</sup> Although the Claimants’ final prayer for relief is made in RON, the Parties have also expressed this claim in different Euro amounts. These differences appear to stem from the fact that BCG’s calculations were done in Euros, while the Claimants have expressed their claims in RON, and the fluctuations in the exchange rate since the submission of the BCG report have affected the Euro amount at which the Parties have referred to this claim. Specifically, BCG’s second report calculates the lost profits at €722 million (Second ER of BCG, p. 17), while in its Supplementary Post-Hearing Brief the Respondent values this claim at €590 million (R-SPHB, p. 15).

<sup>166</sup> Claimants’ Revised Request for Relief, ¶ 2.7.

<b>No.</b>	<b>Claim</b>	<b>Amount claimed (before interest)</b>	<b>Equivalent in Euro<sup>167</sup></b>	<b>Interest applies from</b>
1.	Financial penalties incurred but not yet paid	RON 63.65 million (unless waived by Respondent)	€ 14.3 million	N/A
2.	Loss of value incurred in investing in reliance on the Incentives	RON 811 million <sup>168</sup>	€ 182.3 million	1 Jan. 2002
	<b>TOTAL</b>	<b>RON 874.65 M</b>	<b>€196.6 M</b>	

896. The Claimants further request interest and costs (Revised Request for Relief, ¶¶ 3 and 5), as described in Sections VIII and X below. The Claimants also request that “[t]he total amount of damages payable by the Respondent comprising the amounts set out in paragraphs 2, 3 and 5 [that is, all damages, interest and costs requested] to be received net of any tax obligations imposed by Romania on the proceeds” (Claimants’ Revised Request for Relief, ¶ 4).
897. In addition, the Claimants have requested that “[a]ny damages payable, including interest and costs, should be awarded to the individual Claimants, Ioan Micula and Viorel Micula, to be divided between them on a 50:50 basis. In the alternative, any damages payable, including interest and costs, should be awarded to all five Claimants” (Revised Request for Relief, p. 1). This request was later confirmed in the Claimants’ prayer for relief included at the end of their Post-Hearing Brief: “the Claimants request an award granting them the relief set out in the Revised Request” (C-PHB, ¶ 279).
898. Finally, in the context of their applications for provisional measures, the Claimants have also requested post-award injunctive relief, as described in Section IX.B below, as well as a declaration that the Respondent is not allowed to set off any damages awarded to the Claimants against the EFDG’s tax debts (as described in Section IX.A below).

## **2. Overview of the Respondent’s position**

899. The Respondent argues that the Claimants’ damages case is speculative and unsupported (R-Rejoinder, ¶¶ 259-288, R-PHB ¶¶ 207-210; R-SPHB, ¶¶ 1-6; Tr., Day 1, 191; Day 2, 137-138).
900. The Respondent contends that the Claimants’ quantum case has changed substantially over the course of the proceedings. It notes that this claim began as an

<sup>167</sup> At the exchange rate of 9 December 2013 of 4.4482 RON/EUR, source: European Central Bank.

<sup>168</sup> Mr. Osborne’s final valuation for the reliance claim was €300 million (at the time, RON 811 million) (Second ER of C. Osborne, ¶ 1.43). In line with this final valuation, in their Revised Request for Relief and in their Post-Hearing Brief, the Claimants requested RON 811 million for this claim (Revised Request for Relief, ¶ 2.7; C-PHB, ¶¶ 228-231). Although in their Closing Statements the Claimants stated that they disagree with this discount and therefore the claim remained within the range between €350-400 million (Tr., Day 12, 123-125 (Reed)), the Tribunal will disregard this latest argument. It is far from certain that the Claimants could purport to amend their sought relief at this late juncture and actually did.

unparticularized claim for €450 million “plus lost profits and any further losses”, but was transformed substantially when the Claimants submitted their Reply. From that point forward, the Claimants’ case has centered on direct losses for approximately €33 million, which they have “snowballed” into indirect losses for approximately €600 million. Specifically, the Claimants allege that the loss of the Raw Materials Incentive caused them to lose cash flows totaling approximately €33 million (mostly related to the higher cost of purchasing sugar), which have allegedly prevented the Claimants from pursuing a purported “10-year plan”, causing the Claimants to forgo hundreds of million Euro in hypothetical lost profits (most of them relating to investments they never made or businesses they never developed). The Respondent also notes that the Claimants blame this “cash crunch” and their subsequent inability to expand for having prevented them from paying Romanian taxes in a timely manner, resulting in interest and penalties which they now claim as losses.

901. The Respondent also complains that the Claimants have instructed an army of experts, made conflicting damages calculations and constantly changed positions. For example, until the hearing their damages claims were mostly supported by Prof. Lessard’s expert reports; however, in their Post-Hearing Brief the Claimants rely on Mr. Osborne’s calculations. The Claimants have also advanced an alternative reliance losses claim on the basis of Mr. Osborne’s expert reports. The Respondent also complains that the Claimants submitted expert reports from Mr. Juhász of BCG and Mr. Boulton of LECG, and that the status and relevance of these reports remained unclear to Respondent even after the hearing. However, the Claimants rely on both of these reports in their Revised Request for Relief.
902. The Respondent further argues that the Claimants’ damages case is fundamentally flawed, and should be dismissed, for the following reasons.
903. First, the Respondent argues that all of the claimed categories of damages are barred by legal standards. The Respondent does not dispute the general applicability of the *Chorzów Factory* standard of compensation under international law, upon which the Claimants rely. However, it argues that “the ‘full compensation’ principle does not create an entitlement to collect a windfall based on damages not suffered, not proven, and not causally connected with a violation of a treaty obligation”, which in the Respondent’s view is what the Claimants seek here (R-Rejoinder, ¶ 277).
904. More specifically, the Respondent argues that the Claimants (i) have not met their burden of proof, in particular with respect to claims of lost profits, and (ii) have failed to prove causation.
905. With respect to **burden of proof**, the Respondent argues that the Claimants bear the burden of proving every element of their claim, and have failed to do so. Even with respect to heads of damages where there is some evidence, the Respondent submits that it is incomplete and insufficient. The Respondent thus argues that the Tribunal should dismiss the Claimants’ claims on this basis (R-PHB, ¶ 216).<sup>169</sup> In addition, the

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<sup>169</sup> The Respondent’s specific comments as to the lack of evidence of each head of claim are provided in Section C below.

Respondent contends that the Claimants must also meet the specific legal standard with respect to lost profits (discussed in Section VII.C.3 below), which it argues they have not done (R-PHB, ¶¶ 217-221, R-Rejoinder, ¶¶ 297-300).

906. With respect to **causation**, the Respondent submits that a state's actions must be the direct and proximate cause of the damages suffered (R-Rejoinder, ¶¶ 316-321). The Claimants must prove that breaches of the BIT by Romania were the "underlying" or "dominant" cause of each head of damage claimed. The causal connection must not be too remote, and there can be no intervening causes breaking the chain of causation.
907. In the Respondent's view, this rule disposes of the Claimants' entire damages claim, leaving only the claim for alleged direct losses for payments of customs duties. The Respondent argues that all but the direct losses claim are premised on the theory that the Claimants had insufficient funds (or cash flows) to undertake other activities because of the repeal of the Raw Materials Facility. If the Tribunal were to consider that this "cash crunch" had other causes, or that the Claimants might have obtained alternative funds from other sources, then the chain of causation has been broken. As explained further below, Romania argues that the hearing exposed the Claimants' rapidly deteriorating financial position before repeal of the Raw Materials Facility and their own business decisions as the real causes of the Claimants' alleged losses, severing the causal link between repeal of the Raw Materials Facility and the claimed damages. The Respondent adds that, if the Claimants really had been able to convert €30 million of cash flow into more than €600 million, there would have been no shortage of lenders and equity investors ready to provide the funding.
908. In addition, the Respondent contends that the Claimants must also establish the causal link between each alleged breach of the BIT and the specific damages caused by such breach. The Respondent notes that the Claimants have consistently refused to do so, including in the Revised Request for Relief. As a result, the Respondent contends that no assumptions can or should be made about which damages flow from each alleged treaty breach. It would be wrong to expect the Tribunal to simply assume that all of the heads of damages claimed flow directly from all of the alleged treaty breaches. In particular, the Respondent argues that it would be wrong to assume that the same damages would flow from an expropriation than from a breach of other treaty standards. In this respect, the Respondent argues that the Claimants have not even purported to identify the fair market value of the assets expropriated (their alleged vested right to enjoy the Raw Materials Facility).
909. Second, the Respondent argues that every category of the Claimants' quantum case (with the exception of the direct losses claim) is based on two assumptions for which there is no evidentiary support:<sup>170</sup>
- a. That the Claimants had a "10-year plan" that they would have implemented but for the withdrawal of the Raw Materials Facility, and

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<sup>170</sup> The Respondent's arguments on the assumptions identified above (including arguments on evidence) are addressed in the analysis of each of the Claimants' claims in Section C below.



- b. That, but for that withdrawal, the Claimants would have started selling SCPs to industrial customers (at about the time of revocation) and would have cornered the Romanian sugar market, thereby generating the cash flows necessary to undertake the Incremental Investments.
910. In addition, the Respondent argues that no award of damages can be made in respect to losses incurred by non-Claimant companies, nor for the diminution in value of the Individual Claimants' direct or indirect shareholdings in such companies, because they fall outside the jurisdiction of this Tribunal. In this regard, it argues that the Tribunal accepted jurisdiction over the Claimants' shareholdings only over the Corporate Claimants (R-PHB, ¶ 314).
911. Further, the Respondent opposes the Claimants' request that all damages be awarded to the Individual Claimants.
912. In view of the above, at the end of its Post-Hearing Brief the Respondent requests the Tribunal to award the following relief:<sup>171</sup>
- “(a) DISMISS the Claimants' claim in their entirety; and
- (b) ORDER the Claimants to pay in their entirety the costs of this arbitration [...] (R-PHB, ¶ 354).
913. Finally, in the context of its application for the revocation of provisional measures, the Respondent requested the Tribunal to “explicitly provide in the Award that any amount awarded to any of the Claimants, whether as damages, arbitration costs, or otherwise, is subject to set-off by Romania against the tax debts of all eleven EFDG companies, including lawful interest and penalties” (Respondent's Revocation Application, ¶ 87(c)).

## **B. PRELIMINARY MATTERS**

914. Before turning to the Claimants' specific claims for damages, the Tribunal will address certain preliminary matters, in particular legal standards (Section 1 below), and the Respondent's claim that certain of the Claimants' claims fall outside of the jurisdiction of this Tribunal (Section 2 below).
- ### **1. Legal Standards**
915. A substantial part of the Respondent's arguments on quantum relates to the legal standards applicable to an award of damages. Accordingly, before addressing the quantification of the Claimants' claims, the Tribunal will address these standards.
916. The basis for the Claimants' expectations damages claims is the principle of full reparation enshrined in Article 31 of the ILC Articles,<sup>172</sup> which provides:

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<sup>171</sup> Although the Respondent submitted a Supplementary Post-Hearing Brief commenting on the Claimants' Revised Request for Relief, it did not articulate a prayer for relief in that submission.

## Article 31. Reparation

1. The responsible State is under an obligation to make full reparation for the injury caused by the internationally wrongful act.

2. Injury includes any damage, whether material or moral, caused by the internationally wrongful act of a State.

917. As articulated by the PCIJ in the *Factory at Chorzów* case, “reparation must, as far as possible, wipe out all the consequences of the illegal act and reestablish the situation which would, in all probability, have existed if that act had not been committed.”<sup>173</sup> This principle has been generally understood to mean that the claimant must be placed back in the position it would have been “in all probability” but for the international wrong. In most cases, this involves the payment of compensation (ILC Articles 34 and 36).<sup>174</sup>
918. The Respondent does not dispute the principle of full reparation. Rather, it contends that the Claimants have not met their burden of proof with respect to the damage suffered, and have failed to prove that the damages alleged were caused by Romania’s breaches of the BIT.
919. The Respondent also argues that the Claimants must prove both the existence of the damage for which they request compensation, as well as the existence of a causal link between the breaches of the BIT found by the Tribunal and the damage alleged.
920. Article 36(2) of the ILC Articles provides that “compensation shall cover any financially assessable damage including loss of profits ***insofar as it is established.***” The Parties do not dispute the general principles on burden and standard of proof, except when they relate to lost profits. The Tribunal addresses the standard for an award of lost profits together with the analysis of the Claimants’ specific claims for lost profits in Section C.3 below.

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<sup>172</sup> The Tribunal is aware that Part Two of the ILC Articles, which sets out the legal consequences of internationally wrongful acts, may not apply, at least directly, to cases involving persons or entities other than States, such as in investment disputes as is the case here. In particular, it is aware that Comment (3) to Article 28 states that “[...] while Part One applies to all the cases in which an internationally wrongful act may be committed by a State, Part Two has a more limited scope. It does not apply to obligations of reparation to the extent that these arise towards or are invoked by a person or entity other than a State. In other words, the provisions of Part Two are without prejudice to any right, arising from the international responsibility of a State, which may accrue directly to any person or entity other than a State, and article 33 makes this clear.” That being said, the ILC Articles reflect customary international law in the matter of state responsibility, and to the extent that a matter is not ruled by the treaties applicable to this case and that there are no circumstances commanding otherwise, the Tribunal will turn to the ILC Articles for guidance. The Tribunal further notes that the Claimants have cited to the ILC Articles and the Respondent has not objected.

<sup>173</sup> *Factory at Chorzów*, p. 47.

<sup>174</sup> Article 34 of the ILC Articles (forms of reparation) provides that “[f]ull reparation for the injury caused by the internationally wrongful act shall take the form of restitution, compensation and satisfaction, either singly or in combination, in accordance with the provisions of this chapter.”

Article 36 of the ILC Articles (compensation) provides: “1. The State responsible for an internationally wrongful act is under an obligation to compensate for the damage caused thereby, insofar as such damage is not made good by restitution. 2. The compensation shall cover any financially assessable damage including loss of profits insofar as it is established.”

921. With respect to causation, the Respondent argues that the Claimants must not only prove causality in fact (which has been defined by the *Biwater v. Tanzania* tribunal as “the sufficient link between the wrongful act and the damages in question”<sup>175</sup>), but must establish that causation is proximate (i.e., not too remote or inconsequential). According to the Respondent, to prove proximate causation, it would not be enough for the Claimants to demonstrate that the repeal of the Raw Materials Facility had a detrimental impact on their business activities; they must also prove that the breaches of the Treaty were the “underlying” or “dominant” cause of each element of compensation that they seek. The Respondent relies (among others) on the *ELSI* case, where the International Court of Justice found that, despite the fact that there were several causes that led to the ELSI disaster, “the underlying cause was ELSI’s headlong course towards insolvency,”<sup>176</sup> and on *GAMI v. Mexico*, where the tribunal found that the damages suffered by the claimant had been largely the result of market forces<sup>177</sup> (R-Rejoinder, ¶¶ 317-320). In addition, the Respondent contends that the Claimants must show a direct causal link between each violation of the BIT and the specific damages caused (see paragraph 908 above). Finally, relying on *Lauder v. Czech Republic*,<sup>178</sup> the Respondent argues that there must be no intervening cause for the damage (R-Rejoinder, ¶ 319).
922. The Claimants do not dispute the principles on causation described by the Respondent. Citing *Biwater v. Tanzania*,<sup>179</sup> the Claimants simply assert that “for each item of damage claimed, there is a ‘sufficient link between the wrongful act and the damage in question’”, and that “the Respondent’s actions were the ‘underlying’ or ‘dominant’ cause of the Claimants’ losses” (C-PHB, ¶ 100). The Claimants provide further details on these alleged causal links in the description of each claim.
923. The ILC Articles emphasize the need for a causal link between the internationally wrongful act and the injury for which compensation is due. Article 31(1) provides that “[t]he responsible State is under an obligation to make full reparation for the injury **caused** by the internationally wrongful act.” Article 31(2) goes on to say that “[i]njury includes any damage, whether material or moral, **caused** by the internationally wrongful act of a State.” Commentary (9) to Article 31 explains that
- “It is only ‘[i]njury ... caused by the internationally wrongful act of a State’ for which full reparation must be made. This phrase is used to make clear that the subject matter of reparation is, globally, the injury resulting from and ascribable to the wrongful act, rather than any and all consequences flowing from an internationally wrongful act.”
924. Commentary (10) adds that “[t]he allocation of injury or loss to a wrongful act is, in principle, a legal and not only a historical or causal process”, and that “causality in fact is a necessary but not a sufficient condition for reparation. There is a further

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<sup>175</sup> *Biwater Gauff (Tanzania) Limited v. United Republic of Tanzania* (ICSID Case No ARB/05/22), Award, 24 July 2008 (hereinafter “*Biwater v. Tanzania*”), ¶ 785.

<sup>176</sup> *ELSI*, ¶¶ 100 and 101.

<sup>177</sup> *GAMI v. Mexico*, ¶ 85.

<sup>178</sup> *Lauder v. Czech Republic*, ¶¶ 234-235.

<sup>179</sup> *Biwater v. Tanzania*, ¶ 785.

element, associated with the exclusion of injury that is too 'remote' or 'consequential' to be the subject of reparation." The commentary explains that "in international as in national law, the question of remoteness of damage 'is not a part of the law which can be satisfactorily solved by search for a single verbal formula'", but notes that international tribunals have used the criteria of directness, foreseeability or proximity to establish this, and that other factors may also be relevant.

925. With respect to the concept of directness, the Tribunal notes that under the ILC Articles not every event subsequent to the wrongful act and antecedent to the occurrence of the injury will necessarily break the chain of causation and qualify as an intervening cause. Indeed, the commentary to the ILC Articles explains that, in cases where "the injury in question was effectively caused by a combination of factors, only one of which is to be ascribed to the responsible State, international practice and the decisions of international tribunals do not support the reduction or attenuation of reparation for concurrent causes, except in cases of contributory fault" (Comment 12 to Article 31 of the ILC Articles). The only other exception seems to be cases "where an identifiable element of injury can properly be allocated to one of several concurrently operating causes alone", "[b]ut unless some part of the injury can be shown to be severable in causal terms from that attributed to the responsible State, the latter is held responsible for all the consequences, **not being too remote**, of its wrongful conduct" (Commentary 13 to Article 31 of the ILC Articles. Emphasis added).
926. Thus, an intervening event will only release the State from liability when that intervening event is (i) the cause of a specific, severable part of the damage, or (ii) makes the original wrongful conduct of the State become too remote. Unless they fall under either of these categories, cases of contributory fault by the injured party appear to warrant solely a reduction in the amount of compensation.<sup>180</sup>
927. Therefore, the question seems to be whether the intervening event is so compelling that it interrupts the causal link, thus making the initial event too remote. Accordingly, when assessing the impact of an intervening cause, the Tribunal will first focus on whether the damage can be properly attributed to the cause cited by the Claimants, or rather to the intervening cause.
928. Finally, the Respondent has argued that the Claimants must show a direct causal link between each violation of the BIT and the specific damages caused. In this particular case, however, all of the violations of the BIT alleged by the Claimants arise from the same fact: the premature revocation of the incentives or in direct connection with that premature revocation. Even if the Respondent's argument were correct, the damages claimed by the Claimants arise from one and the same set of facts, irrespective of the specific treaty breach alleged.

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<sup>180</sup> Article 39 of the ILC Articles provides that "in the determination of reparation, account shall be taken of the contribution to the injury by willful or negligent action or omission" of the injured party. Commentary 5 to Article 39 explains that the phrase "account shall be taken" "indicates that the article deals with factors that are capable of affecting the form or reducing the amount of reparation in the appropriate case".

**2. Does the Tribunal have jurisdiction over claims for damages relating to the non-claimant companies of the EFDG?**

929. During the course of this arbitration, it has become evident that all of the damages calculations provided by the Claimants (be it under Methods A, B or C) refer to the damages suffered by the entire EFDG.<sup>181</sup> In the Claimants' view, the Individual Claimants are entitled to all of the damages suffered by all of the companies in the EFDG because they assert that "all of the main companies [in the EFDG] are 100% owned, or virtually 100% owned, by the Micula brothers" (Tr., Day 11, 105 (Reed)).
930. The Respondent argues that no award of damages can be made with respect to losses incurred by non-Claimant companies, nor for the diminution in value of the Individual Claimants' direct or indirect shareholdings in such companies, because they fall outside the jurisdiction of this Tribunal. In this regard, they argue that the Tribunal accepted jurisdiction over the Claimants' shareholdings only over the Corporate Claimants (R-PHB, ¶ 314).
931. The Tribunal makes two observations in that regard. First, in its Decision on Jurisdiction and Admissibility, the Tribunal found that it had jurisdiction "over the dispute submitted to it in this arbitration" (Decision on Jurisdiction and Admissibility, ¶ 170), after having found that it had jurisdiction *ratione personae*, *ratione materiae*, and *ratione temporis* over the Claimants' claims.<sup>182</sup> The Tribunal did not state that it accepted jurisdiction only with respect to the Individual Claimants' shareholdings over the three Corporate Claimants. The Tribunal noted that, at that juncture, "it need only determine whether there is an investment for the purpose of Article 25 of the ICSID Convention and Article 7 of the BIT" (Decision on Jurisdiction and Admissibility, ¶ 123). The Tribunal was satisfied that the investments made by the Corporate Claimants, as well as the shareholding of Messrs. Micula in the Corporate Claimants, qualified as investments (Decision on Jurisdiction and Admissibility, ¶ 125.) However, the Tribunal did not exhaustively determine what the Claimants' investments were nor hold that those were the only investments out of which the dispute arose. For example, the Tribunal concluded that it did "not need to establish at this stage whether the incentives as such are considered investments capable of expropriation" (Decision on Jurisdiction and Admissibility, ¶ 128).
932. Further, in their Statement of Claim, the Claimants stated that this dispute arose "out of investments made by Claimants in the Romanian areas Stei-Nucet and Drăgănești village", adding that "[t]hese investments comprise various facilities for the production of food and related services" (SoC, ¶¶ 32-33). The Claimants did not specify that all of those facilities were owned directly by the Individual Claimants or the Corporate Claimants, although they did suggest in a fashion (see SoC, ¶¶ 45-168). During the

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<sup>181</sup> See, e.g., First ER of D. Lessard, ¶¶ 72-73; Tr., Day 8, 118-121 (Lessard); First ER of C. Osborne, fn. 1 and Appendix 2 (definition of "Companies"); ER of R. Boulton, p. i (definition of "Companies"); Second ER of BCG, p. 2; Tr., Day 10, 88-89 (Osborne).

<sup>182</sup> In particular, the Tribunal found that the Corporate Claimants' physical assets and the Individual Claimants' shares in the Corporate Claimants qualified as investments for purposes of the ICSID Convention and for purposes of the BIT (Decision on Jurisdiction and Admissibility, ¶¶ 124-128).

course of the arbitration, the Claimants have explained that their food production facilities are owned and operated through a group of Romanian companies, the EFDG, which they allege is ultimately owned by the Individual Claimants. The fact that part of the Claimants' business is channeled through Romanian companies that may be owned by the Individual Claimants, which was not brought to the Tribunal's (or the Respondent's) attention during the jurisdictional phase, does not negate the Parties' consent to ICSID arbitration, nor the Tribunal's competence and the Centre's jurisdiction over the dispute. Finally, it is not disputed that the claims related to the investments in non-claimant companies of the EFDG, which are within the competence of the Tribunal, were made in a timely fashion as they were raised at the latest in the Claimants' Reply.

933. Second, in the Tribunal's view, the question whether an award of damages can be made in respect to losses incurred by non-Claimant companies owned by the Individual Claimants is not a question of jurisdiction, that is, whether the Parties have consented to this Tribunal and to ICSID as the appropriate forum to adjudicate the dispute. The question is rather whether it is permissible for the Individual Claimants to seek remedy for losses suffered by companies owned by them but that are not claimants in this arbitration. Thus, the issue is whether the Individual Claimants are entitled to a remedy if neither of them personally suffered the prejudice directly suffered by corporations in which they are shareholders but which are not claimants in this arbitration.
934. In their Statement of Claim, the Claimants requested "adequate compensation for the losses suffered up to the amount of EUR 450,000,000; plus lost profits and any further losses suffered by Claimants as a consequence of Respondent's actions", the exact amount to be specified at an appropriate point during the proceedings (SoC, ¶ 381). The Claimants did not at that stage specify that the Individual Claimants' losses stemmed exclusively from their investment in the Corporate Claimants. The Respondent does not dispute that the Individual Claimants have standing to bring claims related to their investments in shares of corporations.<sup>183</sup>
935. Thus, to the extent that the Individual Claimants can prove their ownership of the other (Romanian) companies in the EFDG and can prove that they have been affected in this regard by the Respondent's breaches of the BIT, the Tribunal finds that claims for losses suffered by the Individual Claimants through those other companies are within the scope of permissible damages claims.
936. Although the Claimants provided surprisingly little documentary evidence of the Individual Claimants' ownership of the non-claimant companies of the EFDG, the evidence in the record (most of it provided by the Respondent) confirms that the

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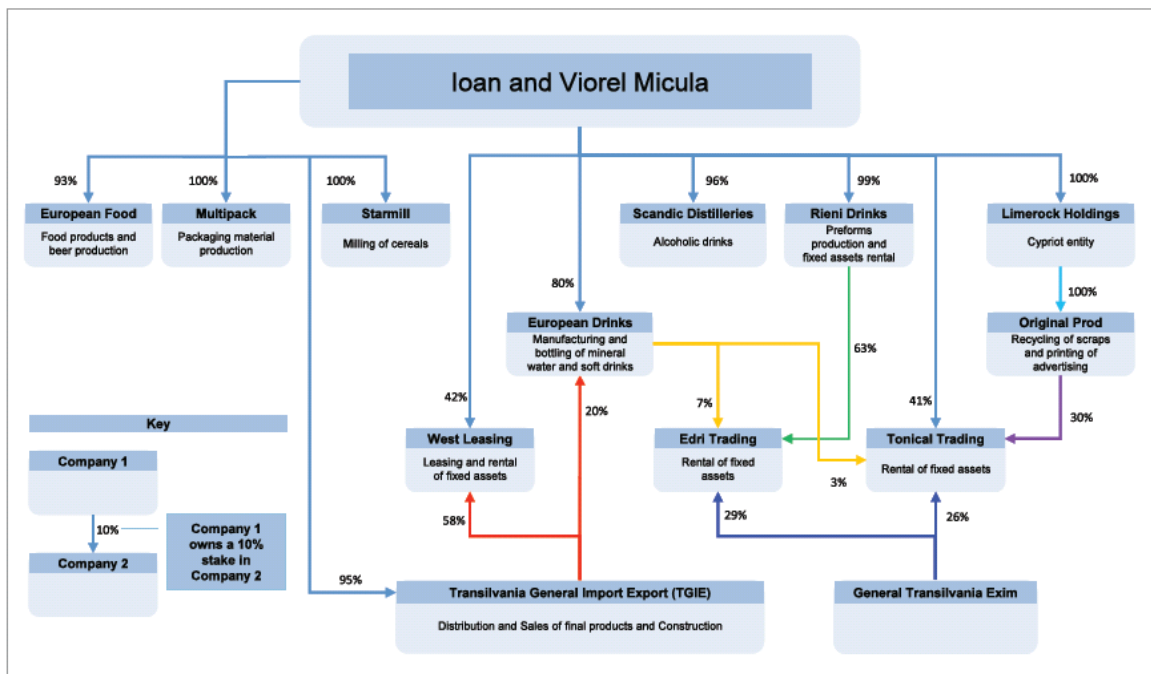
<sup>183</sup> Indeed, the Respondent does not dispute that the Individual Claimants could have chosen to bring a case by themselves, without joining the Corporate Claimants. That being said, the Respondent contends that, had the Individual Claimants done so, "they would have been entitled (assuming liability) only to damages they had suffered" (R-PHB, ¶ 338). This is a different issue which the Tribunal addresses in Section VII.F below.

Individual Claimants are jointly the owners of at least 99.96% of the companies in the EFDG that have allegedly suffered the losses claimed in this arbitration.

937. Mr. Osborne identified the following companies as part of the EFDG (Second ER of C. Osborne, ¶ 10.3, Figure 64): the Corporate Claimants (European Food, Multipack and Starmill), European Drinks S.A. (“European Drinks”), EDRI Trading S.R.L. (“EDRI Trading”), Original Prod S.R.L. (“Original Prod”), Rieni Drinks S.A. (“Rieni Drinks”), Scandic Distilleries S.A. (“Scandic Distilleries”), Transilvania General Import-Export S.R.L. (“TGIE”), Tonical Trading S.R.L. (“Tonical Trading”), West Leasing S.R.L. (“West Leasing”). Mr. Osborne also provided a diagram of the ownership structure of these companies with an indication at Figure 3 of his First Expert Report (p. 57). However, he did not cite the source of the information shown. Figure 3 is reproduced below, together with Mr. Osborne’s explanations:

The Miculas are majority shareholders in most of the Companies, and the remainder are controlled by companies that are in turn owned by the Miculas. The diagram below shows the ownership structure of the 11 companies plus Limerock holdings, a Cypriot entity that owns Original Prod, and General Transilvania Exim. Some minor shareholdings have been omitted from the diagram for the sake of clarity, but shareholders not included are primarily other family members including Mrs Eeva Micula and Mrs Doina Micula.

**Figure 3: The Companies’ Major Shareholdings**



938. As recorded in the Decision on Jurisdiction and Admissibility, during the jurisdictional phase the Claimants provided evidence of their shareholdings in the Corporate Claimants in 2008, as follows:

- a. "Claimant 3 [European Food] is a Romanian joint stock company established on 30 November 1989. Respondent does not dispute that Claimant 3 was held on 1 February 2007 (Exh. C-25) at more than 93% by Messrs. Micula. The rest of the shares were held by Rieni Drinks SA, a Romanian company (6.5%). The excerpt from the Register of the Ministry of Justice dated 27 May 2005 (Exh. C-7) shows that the Miculas each held 46.7289% and Rieni Drinks 6.5415%" (Decision on Jurisdiction and Admissibility, ¶ 112).
  - b. "Claimants 4 [Starmill] and 5 [Multipack] were established as Romanian limited liability companies on 21 February 2002. Claimants 1 and 2 each hold 50% of the shares (Exh. C-7, dated 27 May 2005)" (*Id.*, ¶ 113).
  - c. "On 31 July 2008 Counsel for Mr. Ioan Micula and the Corporate Claimants submitted, for each of the three Corporate Claimants, excerpts from the Romanian commercial registry showing the status of each of these three companies as of 25 June 2008, as well as their corporate biographies from 1 July 2005 on. These documents confirm the above conclusions" (*Id.*, ¶ 113).
939. The Claimants did not provide updated information of the Individual Claimants' shareholdings in the Corporate Claimants during the merits phase. However, the Respondent has not disputed these shareholdings or suggested that there has been any change in them. In addition, an excerpt from the Bihor Trade Registry dated 9 December 2008 provided by the Respondent (Exh. R-60) shows that Ioan Micula holds 50.65% of Rieni Drinks, while Viorel Micula holds 49.34%, which would put their joint shareholding at 99.99%. Mr. Osborne confirmed this in Figure 3 of his First Expert Report, which showed Rieni Drinks as 99% owned by the Individual Claimants (although he did not cite the source for this affirmation). Accordingly, the Tribunal deems that all three Corporate Claimants are virtually 100% owned by the Individual Claimants, whether directly or indirectly.
940. By contrast, the Claimants have provided no documentary evidence of their shareholding in the remaining companies of the EFDG. They simply assert that most of the companies in the EFDG are "directly or indirectly wholly owned by the Micula brothers", with the exception of Original Prod, Tonical Trading, and EDRI Trading. However, with respect to those three companies, they also state that "[n]one of these companies has any real claim to any of the damages claimed in this case" (Tr., Day 1, 146 (Reed)). Accordingly, the Tribunal will disregard the three companies named above for purposes of its damages analysis. However, this statement also suggests that, in addition to the Corporate Claimants, there are five other companies within the EFDG (namely, European Drinks, Rieni Drinks, Scandic Distilleries, TGIE and West Leasing) that have suffered part of the damages claimed in this case. As a result, the Tribunal must determine whether they are indeed owned by the Individual Claimants.
941. The Tribunal shares the Respondent's frustration at the lack of evidence submitted by the Claimants. As noted by Mr. Ellison, it is difficult to understand why the Individual Claimants did not, of their own initiative, provide evidence of their shareholdings in the EFDG. It is the Individual Claimants' burden to prove that they are the owners of



the companies they assert they own and that have suffered the damages they now claim. It is not fair to impose upon the Respondent (or, for that matter, the Tribunal) the burden of searching through the Romanian Registry of Commerce in order to assess whether the Claimants' assertions are true. Like Mr. Ellison, the Tribunal cannot help but to find the Claimants' approach to this matter "bizarre" (Tr., Day 11, 100-105 (Reed/Ellison)).

942. That being said, the evidence submitted by the Respondent (in particular, an excerpt from the Bihor Trade Registry dated 9 December 2008 (Exh. R-60) and from the Orbis Commercial Database (Exh. R-61, date unclear), indicates that, at the date the information was collected, the shareholding of the remaining EFDG companies was as follows:<sup>184</sup>
- a. **Rieni Drinks:** Ioan Micula with 50.65%, Viorel Micula with 49.34%, European Drinks with 0.001%, and Intermark S.R.L. with 0.00002%. In other words, Rieni Drinks is 99.99% owned directly by the Individual Claimants.
  - b. **TGIE:** Ioan Micula with 47.50%, Viorel Micula with 47.50%, and Rieni Drinks 5%. Considering that Rieni Drinks is 99.99% owned directly by the Micula brothers, the Tribunal deems this company owned 99.99% by the Individual Claimants.
  - c. **European Drinks:** Ioan Micula with 39.94%, Viorel Micula with 39.94%, and TGIE with 20.05%, Rieni Drinks with 0.05% and Edri Trading with 0.02%. Considering that, with the exception of Edri Trading, all the companies that have shareholdings are 99.99% owned directly by the Micula brothers, the Tribunal deems that European Drinks is 99.98% owned by the Individual Claimants.
  - d. **Scandic Distilleries:** Ioan Micula with 48.12%, Viorel Micula with 48.12%, Rieni Drinks with 0.05%, Intermark S.R.L. with 0.05%, European Drinks with 0.05%, and World Brands Production S.A. with 3.61%. Considering that, with the exception of Intermark and World Brand Productions S.A., all the companies that have shareholdings are at least 99.98% owned by the Micula brothers, the Tribunal deems that European Drinks is 99.96% owned by the Individual Claimants.
  - e. **West Leasing:** Ioan Micula with 21.25%, Viorel Micula with 21.25%, and TGIE with 57.50%. Considering that TGIE is 99.99% owned by the Micula brothers, the Tribunal deems this company owned 99.99% by the Individual Claimants.
943. These shareholdings are roughly consistent with the shareholdings shown by Mr. Osborne in Figure 3 of his First Report. Accordingly, although the evidence reviewed by the Tribunal is from December 2008, the Tribunal accepts Mr. Osborne's assertions and deems that the companies in the EFDG identified above are at least 99.96% owned by the Individual Claimants. Accordingly, the Individual Claimants can claim for damages that they have suffered by virtue of the harm to those companies as well as the harm to the Corporate Claimants.

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<sup>184</sup> Numbers have been rounded up to the nearest hundredth.

## C. ANALYSIS OF THE CLAIMANTS' DAMAGES CLAIMS

### 1. General comments

944. As discussed above, the Claimants have advanced two expectation damages computations (Methods A and B) and one reliance damages computation (Method C). Method A quantifies the increased costs and lost profits that the Claimants would have made had they been allowed to develop their business the way they allege they had planned to do, in particular by implementing the Incremental Investments and the sale of SCPs to third parties. Method B quantifies the increased costs and lost profits that the Claimants would have made had they continued operating their existing platform. Method C presents a reliance damages scenario, which quantifies the value of the losses incurred by the Claimants in investing in reliance on their expectation that the incentives would remain in place for ten years. The Claimants have emphasized that the Tribunal need not adhere strictly to either of these three methods or the injuries itemized therein in order to make an award (C-PHB, ¶ 96).<sup>185</sup>
945. For the reasons set out below, the Tribunal will focus its attention on Method A.
946. First, Method A is the Claimants' primary expectation damages scenario. The Claimants have devoted most of their efforts to Method A and have identified Methods B and C as "alternative" damages scenarios. In their Reply, the Claimants focused almost exclusively on the damages listed in Method A, as calculated by Prof. Lessard (and partly on the reports of Dr. Fry and Prof. Steenkamp). In their Revised Request for Relief, the Claimants continue to rely heavily on Method A, although some of the claims are now calculated by Mr. Osborne and Mr. Boulton.
947. Second, the Tribunal rejects Method B, for the following principal reasons:
- a. Compared to Method A, the BCG Report (which quantifies the main head of claim under Method B) was subject to much less rigorous scrutiny in the proceedings. The Respondent repeatedly requested clarification as to the role of that report in the Claimants' quantum case, but this was only made clear with the Claimants' Revised Request for Relief. Although the Respondent had an opportunity to comment on that Revised Request (the Tribunal allowed it to submit a Supplementary Post-Hearing Brief), the Tribunal finds that it has a less complete and less well tested record as to Method B than Method A.
  - b. The Tribunal has serious concerns regarding the methodology used by BCG. The flaws in BCG's First Report seem to have caused concern to the Claimants themselves, who requested Mr. Boulton to assist BCG and supervise the preparation of BCG's Second Report. However, as the Respondent pointed out, despite the changes in methodology and assumptions, the quantification of the

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<sup>185</sup> The Claimants stated expressly: "Claimants' Revised Request for Relief submitted on 20 December 2010 is summarized below. Claimants wish to stress, however, that it is not their contention that the three methods listed below, or the itemized injuries that comprise the elements of the three methods, must be strictly adhered to in the ultimate calculation of an award" (C-PHB, ¶ 96).

Claimants' losses proposed by BCG's Second Report (€722 million present value of EBITDA, Second ER of BCG, p. 17) does not differ greatly from that proposed in its First Report (between €757-796 million present value of EBITDA, First ER of BCG, p. 14).

- c. The BCG Report purports to quantify lost profits for sales of finished goods that the Claimants would have allegedly earned but for the revocation on the basis of the Claimants' existing production platform at the time of the revocation. But despite the fact that Claimants' platform at that time did not have the benefit of the Incremental Investments, BCG's calculations yield a higher result for only the sales of finished goods (quantified by the Claimants as RON 2,423 million) than all of the lost profits claims included in Method A combined (i.e., lost profits deriving from sales of finished goods calculated by Mr. Boulton, lost profits deriving from the sale of SCPs and lost profits deriving from the Incremental Investments, which combined amount to RON 2,380 million). In stark contrast to BCG's calculations, Mr. Boulton (on whose report the Claimants rely under Method A) quantified lost sales of finished goods at €100 million. Although part of the difference in their results can be attributed to the fact that Mr. Boulton excluded export markets in his calculations, the Tribunal finds that this further calls into question the credibility of the assumptions and methodology used by BCG. Accordingly, as explained in Section 3(b) below, the Tribunal relies on Mr. Boulton's analysis of lost profits on sales of finished goods rather than the analysis of BCG.
  - d. Although the Claimants specify that certain amounts calculated by Mr. Osborne in relation with Claims 1-4 of Method A (specifically, section 4 of Mr. Osborne's First Report and in section 3 of Mr. Osborne's Second Report) must be subtracted from the amount calculated by BCG (C-PHB, ¶¶ 204), the Claimants do not provide a final calculation that takes into account this subtraction. Indeed, the RON number claimed by the Claimants does not appear to consider any deductions at all, since BCG's valuation of the losses at € 722 million has simply been claimed in RON (see C-PHB, ¶ 206, note 305, where the Claimants simply state that "RON 2,423.2 million is the [sic] RON €722 million").
  - e. Finally, the Tribunal notes that the Claimants devote a mere three paragraphs to the BCG Report in their Post-Hearing Brief (C-PHB, ¶¶ 204-206). The least that can be said is thus that the Claimants did not build the core of their arguments and claims on the BCG Report.
948. Third, the Tribunal rejects Method C. Method C provides an alternative reliance approach to the calculation of the Claimants' losses, in which Mr. Osborne attempts to "value the business absent the investments made in reliance on the Incentives" (C-PHB, ¶ 332; Tr., Day 10, 36-37 (Osborne)). The Tribunal does not see any reason to deviate from the Claimants' primary expectation damages approach which, in the Claimants' own submission, should place them in the position that they would have been but for Romania's breach of the BIT, and is thus consistent with the full compensation principle articulated in the *Chorzow Factory* case.

949. The Claimants' claims under Method A are summarized in paragraph 891 above. For purposes of the analysis, the Tribunal will divide them into three main groups: the Claimants' claims for actual / realized losses (*damnum emergens*) as a result of the increased cost of raw materials (addressed in Section 2 below), the Claimants' claims for lost profits (addressed in Section 3 below), and the Claimants' claims for tax penalties (addressed in Section 4 below).

## **2. Increased cost of raw materials**

950. The Claimants had previously presented this claim as a single claim, but in their Post-Hearing Brief they divided it up into claims for increased costs of sugar, PET, other raw materials and sugar stockpile. Each sub-claim is addressed below.

### **a. Increased cost of sugar**

951. The Claimants claim losses for the increased cost of sugar in the amount of RON 81.5 million, based on:

- a. The calculations contained in section 4 of Mr. Osborne's first report, and paragraphs 4.9 to 4.16 and 4.23 to 4.24 in particular;
- b. The calculations contained in section 3 of Mr. Osborne's second report, and paragraphs 3.1 to 3.28 in particular; and
- c. The evidence referred to in those sections, including exhibits CO-1.18, CO-1.19, CO-2.1 and CO-9.1 (C-PHB, ¶¶ 101-110).

952. Although in their Post-Hearing Brief the Claimants rely on Mr. Osborne's figures, they submit that the differences with the calculations made by Prof. Lessard (on whose report they relied on for this same claim prior to the hearing) are minimal. In particular, they argue that working capital does not impact the calculation of these damages. Mr. Osborne explains that the reason for the nominal differences between both calculations is the different approaches to estimating the volume weighted actual transport premium (Second ER of C. Osborne, ¶ 3.21).

953. For the reasons set out below, the Tribunal accepts this claim. Both the existence of the damage and the causal link between the revocation of the incentives and the damage suffered have been adequately proved. There is no dispute that, as a result of the revocation of the Raw Materials Incentive, the Claimants were required to pay an increased amount for the sugar they purchased after February 2005. The Respondent's expert, Mr. Ellison, accepts that this is the case, subject to certain criticisms and exclusions (First ER of J. Ellison, ¶ 6.2.24), as discussed further below.

954. The Tribunal is also satisfied with the quantification of this claim, which is based on reliable documentary evidence. In his second report, Mr. Osborne reconciled the sugar purchase data used by him and Prof. Lessard, and reconciled his work with the raw material audit work carried out by BDO. Mr. Ellison recognized and accepted these reconciliations, noting that "the reconciliation now appears valid" (Second ER of

J. Ellison, ¶ 2.2.16). Mr. Ellison also confirmed that BDO checked all 2,586 sugar invoices in the process of conducting their audit (Tr., Day 11, 96-97 (Ellison/Reed)).

955. Mr. Ellison contends that these damages should exclude sugar purchases by non-Claimant EFDG companies after revocation of the incentives (RON 64.7 million, approximately €14.9 million, about 75% of the losses claimed) (First ER of J. Ellison, ¶¶ 6.2.9-6.2.12; Second ER of J. Ellison, ¶¶ 5.1.4, 5.3.1-5.3.5). Mr. Ellison notes that, before revocation, European Food was making substantially all the sugar imports for the entire group and selling it to its affiliates; however, after revocation, each EFDG company started importing its own needs for sugar. The Claimants and their experts argue that this exclusion is perverse: after the revocation, there was no incentive for the sugar purchases to be channeled through the Claimant companies, because they no longer had a right to the customs duty exemption and thus there was no cost advantage for them or their affiliates that are not parties in this arbitration. Had the incentives remained in place, the Claimants would have continued to purchase sugar through European Food (Second ER of C. Osborne, ¶¶ 1.3, 3.13-3.17; Second ER of D. Lessard, ¶ 138). The Respondent argues that this is irrelevant, because there is no legal basis upon which the Corporate Claimants could be compensated for an outlay from someone else's pocket (R-PHB, ¶ 313).
956. The Tribunal has difficulty with the Respondent's argument. European Food lost the opportunity to buy cheaper sugar, and as a result the Claimants were forced to buy more expensive sugar, incurring an additional cost. That this more expensive sugar was bought by a different company of the group does not eliminate the loss to the Individual Claimants, who the Tribunal has confirmed are the ultimate shareholders of the entire group.
957. As previously noted, the Respondent also argues that no award of damages can be made with respect to losses incurred by non-Claimant companies, nor for the diminution in value of the Individual Claimants' direct or indirect shareholdings in such companies, because they fall outside the jurisdiction of this Tribunal. As discussed in Section B.2 above, the Tribunal rejects this argument: this argument does not turn on jurisdiction, but rather whether it is permissible for the Individual Claimants to seek remedy for losses suffered by companies 99.96% owned by them that are not claimants in this arbitration. As set out in paragraph 943 above, the Tribunal has found that claims for losses suffered by the Individual Claimants through those other companies are within the scope of permissible damages claims.
958. Mr. Ellison also excludes the loss of the benefit to European Food of the arm's-length transactions by which it sold intermediate sugar products to European Drinks and Rieni Drinks. The documentary evidence appears to confirm (and Mr. Ellison conceded at the hearing) that the transactions were indeed at arm's length (Tr., Day 11, 59-63 (Ellison/Schwartz)). The Tribunal understands the Claimants to be saying that, prior to the revocation, European Food bought the sugar duty-free and then sold the intermediate products to other EFDG companies at the same price it would have sold them to third party companies. The Claimants' argument seems to be that

European Food lost that “business” as a result of the revocation. The Tribunal sees no reason to exclude this loss from the calculation.

959. Finally, the Respondent argues that, because the Claimants cannot establish that they would have been entitled to import sugar duty free after 1 January 2007, no damages should be awarded for that period. Mr. Caspari, the Respondent’s sugar expert, testified that the Claimants could not possibly have imported duty free sugar into the EU after accession (even absent the repeal), as such activity would have fundamentally undermined the EU sugar regime and threatened the stability of the EU sugar market (ER of C. Caspari, ¶ 26; Tr., Day 11, 261 (Caspari)). According to the Respondent, this warrants a reduction of RON 18.1 million (or 19.4 million, if adjusted to account for Mr. Osborne’s approach) (R-PHB, ¶ 320, fn. 703).
960. The Claimants’ sugar expert, Dr. Fry, seemed to recognize this problem but assumed that Romania would have negotiated with the European Commission a specific derogation allowing the Claimants to import duty free sugar into the EU. However, he conceded that he had no evidentiary basis for this assumption, and that such a derogation would have been unprecedented in EU history (Tr., Day 11, 234-236 (Fry)).
961. The Tribunal agrees with the Respondent that it is uncertain whether the Claimants could have imported sugar duty free after Romania’s accession to the EU, even if the facilities had remained in place. However, the Respondent has not established that the Claimants could not have done so. The Claimants argue that the EU could have granted exemptions if Romania had negotiated such exemptions, and there is no evidence that Romania even tried to negotiate such exemptions. The Tribunal has found that Romania breached the Claimants’ legitimate expectation to benefit from the Raw Materials Incentive until 31 March 2009. In these circumstances, the Tribunal considers that the Claimants are entitled to all losses regarding increased cost of sugar until that date.
962. For the foregoing reasons, the Tribunal accepts the Claimants’ claim for increased cost of sugar, for a total amount of RON 85.1 million.

**b. Increased cost of PET**

963. The Claimants claim losses caused by the increased cost of PET in the amount of RON 6.3 million, based on:
- a. The calculations contained in section 4 of Mr. Osborne’s first report, and paragraphs 4.17 to 4.24 in particular;
  - b. The calculations contained in section 3 of Mr. Osborne’s second report, and paragraphs 3.29 to 3.35 in particular; and
  - c. The evidence referred to in those sections, including the witness statement of Mr. Halbac dated 22 December 2009 and exhibits CO-1.18, CO-1.19, CO-2.1 and CO-9.1 (C-PHB, ¶¶ 111-115).

964. The Tribunal rejects this claim. It is undisputed that the Claimants never benefitted from the Raw Materials Facility in respect of PET imports because their PET equipment was not located in the Stei-Nucet region (R-PHB, ¶ 318; C-PHB, ¶ 112; First WS of M. Halbac, ¶ 42; First ER of D. Lessard, ¶ 83, Exh. C-681, C-686). Although Mr. Halbac testified that the Claimants did have PET equipment in Drăgănești as far back as 2002, it is unclear whether they benefitted from the incentives. The Claimants do not expressly say so, and Mr. Ellison testified that he found invoices for PET in 2002 that had duty on them (See C-PHB, ¶¶ 112-115; Second WS of M. Halbac, fn. 53; C-680; Tr., Day 10, 195 (Ellison)).
965. In fact, the Claimants' claim for PET is based on their alleged intention to relocate their PET equipment in late 2004 or early 2005 to the disfavored region precisely for the purpose of taking advantage of the incentives. As the Respondent states, "[i]n effect, this claim is for a hypothetical future lost opportunity to save money on the purchase of raw materials, rather than any claim for actual losses" (R-PHB, ¶ 318). The claim is thus not for actual losses, but for future losses. The Tribunal agrees with the Respondent: the Claimants have not met their burden to prove the existence of a lost opportunity; therefore, they cannot claim a loss for increased cost of PET if the repeal of the Raw Materials Facility did not in fact cause them to incur greater costs in purchasing PET.
966. In addition, the Claimants have not proven that they would have indeed relocated their PET equipment to the disfavored region. This claim appears to rely entirely on Mr. Halbac's oral testimony, which the Tribunal did not find convincing in this respect. Although he cites some contemporaneous documents (Exh. C-681, C-686), Mr. Osborne appears not to have considered them in his report (Tr., Day 11, 147-148). In any event, these documents are not sufficient to prove that alleged intention:
- a. Exh. C-681 is an invoice dated 1 September 2004 cited as evidence for moving Husky PET Equipment from Rieni to Drăgănești. However, the document merely appears to list "Works of wiring within Drăgănești Complex, Hall 11, Plugs Machine - HUSKY, as per the work status due to May 2004" with respect to an "AGREEMENT 748/15th of July 2002". This does not clearly evidence a purported move of that equipment. In addition, the agreement that appears to serve as basis for those works was signed in July 2002, but it is undisputed that the equipment had not been moved by the time the incentives were repealed in February 2005. This raises questions with respect to the intent to move that equipment and the timing of that alleged move, as discussed further below.
  - b. Exh. C-686 is a drawing of a layout of the Multipack facilities showing where PET equipment would allegedly be installed. However, the Tribunal has no way of knowing when this drawing was made, how concrete of a project it embodied and what its intended use would have been.
967. In addition, the modest scale of the cost and effort allegedly required to move the equipment undermines the credibility of the claim. Mr. Halbac stated that the move would have cost only 250,000 RON (approx. €50,000) and taken approximately only 2

months to complete (see First WS of M. Halbac, ¶ 42). In these circumstances, and considering that Exh. C-681 cites an agreement dated July 2002, it is unclear why the Claimants had not moved that equipment before the date of the revocation of the incentives.

968. For all these reasons, the Tribunal rejects the Claimants' claim for increased cost of PET.

**c. Increased cost of other raw materials**

969. The Claimants claim losses caused by the increased cost of raw materials other than sugar or PET in the amount of RON 17.5 million, based on:

- a. The calculations contained in section 4 of Mr. Osborne's first report, and paragraphs 4.17 to 4.24 in particular; and
- b. The evidence referred to in that section, including exhibits CO-1.18, CO-1.19 and CO-2.1 (C-PHB, ¶¶ 116-120).

970. The Claimants base their claim on Mr. Osborne's calculations, but note that the differences with Prof. Lessard's results are nominal (Prof. Lessard calculates RON 17.37 million). They thus state that the Tribunal may choose either calculation.

971. The Tribunal accepts this claim, as calculated by Mr. Osborne. As in the case of sugar, it is undisputed that following the revocation of the incentives, the Claimants were required to pay more for the other raw materials they purchased, including tomato paste, juice concentrates, wheat and corn flour, vegetable fats, and potato flakes and granules. The Respondent's expert, Mr. Ellison concedes that losses from these higher costs were incurred by the Claimants, and does not dispute the prices used by their experts (which the Claimants argue are conservative and understated, because they switched to cheaper products, and because the experts were unable to find benchmark prices to estimate but for prices).

972. That being said, Mr. Ellison argues that the total loss should be discounted to RON 14.5 million (or RON 11.2 million if one counts only damages suffered until the date of accession) for two reasons: first, that only 20% of the amount claimed is supported by documentary evidence, and second, that much of these increased costs were paid by non-Claimant companies within the EFDG (First ER of J. Ellison, ¶¶ 6.3.1-6.3.5; Appendix JMHE-4C).

973. The Tribunal dismisses Mr. Ellison's second argument for the reasons set out in paragraphs 956 to 958 above. With respect to Mr. Ellison's first argument, the Tribunal understands that the documentary evidence cited by the Claimants (Exh. C-166, C-167, C-218, C-220 and C-222, which contain between them 43 customs declaration forms with customs duties amounting to RON 3.6 million) is a sample. Given the nature of the Claimants' business, the Tribunal does not expect the Claimants to provide an invoice for every item they ever imported, and thus accepts that a sample of customs declaration forms is an appropriate evidentiary means. In



addition, the Respondent has given no compelling reasons why that sample is not representative of the total. As a result, the Tribunal rejects Mr. Ellison's first argument.

974. For the reasons stated above, the Tribunal accepts this claim for a total of RON 17.5 million.

**d. Lost opportunity to stockpile sugar**

975. The Claimants claim losses for the lost opportunity to stockpile sugar in the amount of RON 62.5 million, based on:

- a. The calculations contained in section 4 of Mr. Osborne's first report, and paragraphs 4.13 to 4.16 in particular;
- b. The calculations contained in section 4 of Mr. Osborne's second report;
- c. The calculations contained in the expert reports of Dr. Fry of December 2009 and July 2010; and
- d. The evidence referred to in the abovementioned sections, including the witness statements of Mr. Balog dated 22 December 2009 and 30 July 2010 (C-PHB, ¶¶ 121-130).

976. The Claimants argue that, because the incentives were going to end in 2009, they planned to buy large quantities of sugar ahead of that and thus avoid paying higher sugar prices for some months. The stockpile would thus help them to maintain the effects of the incentives for a longer period of time. The Claimants assert that, in late 2004/early 2005, after they heard that the incentives would be revoked, they stockpiled what they could, but not as much as they would have liked to do.

977. Mr. Osborne includes this claim in his calculation of increased cost of raw materials, as follows:

- “4.1 The early termination of the EGO 24/1998 incentives has had a clearly detrimental effect on the Claimants. That effect comes in part from an impact on their costs – and therefore on their ability to earn a satisfactory return on the investments that they have made. [...]
- 4.2 The first impact on the Claimants arises because of the increase in the effective cost of raw materials purchased for their own use – including sugar, fruit and tomato concentrates, and potato products. This applies both in respect of purchases that the Companies have made and **purchases that the Companies would have made in creating a stockpile of sugar in 2009 to extend the period in which it could benefit from reduced sugar costs.**
- 4.3 In the latter case, the reason for including the effect of stockpiling in 2009 is that the Companies would, had the EGO 24/1998 incentives continued, have undoubtedly sought to create a stockpile of sugar in 2009 – in essentially the same way as was actually done in 2004/2005. On that basis it seems reasonable also to assume that equivalent amounts would or should have been negotiated by way of

compensation in the alternative scenario in which the EGO 24/1998 incentives continued only to the point of EU accession. To ensure symmetry, the calculations treat the beneficial effects of the stockpile actually created in 2005 as reducing the losses suffered by the Claimants.” (First ER of C. Osborne, ¶¶ 4.1-4.3, emphasis added).

978. In preparing his calculations, Mr. Osborne assumed that, if the Claimants had time to properly organize and prepare for the termination of the incentives, they would have built an optimal stockpile, based on, among other things, sugar price forecasts, storage costs, the cost of capital and the EFDG companies’ sugar consumption (First ER of C. Osborne, ¶ 4.10). According to Mr. Osborne, this optimal stockpile would have been around 75,000 tonnes. The Claimants argue that they were prevented from amassing this optimal stockpile because (i) they did not have enough time to properly plan for the optimal stockpile, and (ii) in 2004/2005 they had not put funds aside for this purpose. Instead, they amassed around 30,000 tonnes. Mr. Osborne calculates damages based on the optimal stockpile, not the actual stockpile amassed by the Claimants.
979. The Respondent argues that including any stockpiling in the direct damages claim is impermissibly speculative, transforming this part of the case into yet another “lost opportunity” claim. The Respondent contends that there is no way of knowing what the Claimants would have done in 2009 had the Raw Materials Facility remained in place. In particular, would they have had the funds to purchase and store vast quantities of sugar? Would it have been permissible to stockpile at that time? The Respondent also notes that Prof. Lessard did not incorporate a stockpile in his original calculations (R-PHB, ¶¶ 315-316).
980. That being said, Mr. Ellison appears to accept this claim from an economic perspective, subject to proof that (i) the large quantities purchased in late 2004 and early 2005 were indeed a stockpile, and not, e.g., a period of intensified production or a seasonal issue, and (ii) that this stockpiling activity was a direct response in anticipation of revocation (and in this respect differed from the increased purchasing in 2003) and not, e.g., EFDG taking advantage of a particularly good price (beyond the discount provided by the incentives) and/or the replenishment of previously run-down stock levels and/or seasonal issues (Second ER of J. Ellison, ¶¶ 6.2.22-6.2.21).
981. The Tribunal concludes that it is established that the Claimants did in fact stockpile 30,000 tonnes in 2004/2005. Mr. Balog testified and Mr. Gamecho confirmed that the Claimants had purchased enough duty-free sugar to delay the economic effect of the repeal until the second half of 2006 (First WS of C. Balog, ¶ 7; Tr., Day 4, 28 (Gamecho)). Mr. Ellison accepts that large quantities of sugar were purchased in late 2004 and early 2005, although as described above he questions whether these purchases were meant to create a stockpile.
982. In contrast, evidence of the Claimants’ intention to stockpile in the future is limited:
- a. The Claimants contend that “Mr Balog has given clear and unchallenged evidence that upon hearing about the revocation of the Raw Materials Incentive in 2004, the Claimants set about building as large a sugar stockpile as possible

[WS of C. Balog dated 30 July 2010, ¶ 12]. It is safe then to assume that had the incentives lasted for the promised 10 year period, at the end of that period the Claimants would have built a sugar stockpile, and in fact, Mr. Ellison has accepted that a sugar stockpile would have been made at that time [Tr., Day 10, 196]. The real issue in dispute is therefore over the size of the stockpile that would have been built” (C-PHB, ¶ 123). However, the Respondent points out that Mr. Balog’s testimony purports to describe what the Claimants did in response to the announcement of the repeal of the Raw Materials Facility, and that it does not directly support the suggestion that the Claimants ever intended to (or could have) stockpiled vast amounts of sugar in 2009 (R-SPHB, ¶¶ 12-13).

- b. Mr. Osborne also relies on Mr. Viorel Micula’s assertion that “we had planned to purchase and stock-pile a large amount of sugar on a customs duty free basis prior to the incentives coming to an end” (Third WS of V. Micula, ¶ 68; First ER of C. Osborne, ¶ 4.10, third bullet point).

983. Despite the absence of hard evidence on the Claimants’ future intentions, the Tribunal considers that the Claimants’ established past practice of stockpiling provides sufficient certainty that, but for the revocation, the Claimants would have stockpiled sugar in early 2008 in anticipation of the expiry of the incentives. In 2004, the stockpiling was organized as a reaction to the allegedly unforeseen occurrence of the early termination of the incentives. Indeed, the stockpiling was to be planned and organized closer to the scheduled expiry of the incentives and in preparation for such expiry, so there was no need for such stockpiling before the latter became looming. Other than Mr. Viorel Micula’s testimony, the record does not show that the Claimants had planned for either event. However, this is understandable as the need for the actual stockpiling appears to have caught the Claimants off guard, and the scheduled expiry of the incentives was to occur almost 4 years after the revocation. In view of these considerations, the Tribunal finds that it is sufficiently certain that the Claimants would have acted in 2008/2009 as they actually did in 2004/2005. Indeed, Mr. Ellison conceded that, “on the basis that in early 2008, the claimants would probably have started preparing a stockpile, knowing that [...] expiry was coming along” (Tr., Day 10, 196).

984. The Tribunal is also satisfied that there is a sufficient causal link between the damage asserted and the revocation of the incentives. The Respondent has not provided a plausible alternative explanation as to why the Claimants would have stockpiled sugar in late 2004/2005 if it was not in anticipation of the revocation of the incentives. Having accepted the causal link in 2004/2005, the Tribunal is satisfied that the same causal link would apply in 2008/2009 with respect to the scheduled expiry of the incentives.

985. However, the Tribunal agrees with Mr. Ellison that this loss should be circumscribed to the volumes actually stockpiled in 2004/2005. The “optimal stockpile” calculated by Mr. Osborne must be rejected because the size of such an optimal stockpile is too speculative. As Mr. Ellison points out, “the way [Mr. Osborne’s] formula works is that he has used 2009 prices and forecasts to work out what would have been the best

stockpile to create in 2008. And the way commodities work, of course, you don't normally have that advantage of being able to look a year ahead and see actual prices" (Tr., Day 10, 197 (Ellison)).

986. Instead, it is more reasonable to use as counterfactual data the 30,000 tonnes that were actually stockpiled in 2004/2005 (Tr., Day 10, 196 (Ellison)). Using these volumes, Mr. Ellison recalculates the loss at RON 18,133,229 (approximately €4.3 million at the exchange rate of 30 September 2009 used by Mr. Ellison),<sup>186</sup> as follows:

“6.2.20 I have recalculated the potential loss resulting from a higher price for white sugar. I have assumed a stockpile of 30,000 tonnes would have been assembled over the period 1 April 2008 to 31 March 2009, in line with the stockpiled volume possibly amassed in 2004 and 2005 (see paragraph 6.2.17 above). (Although whether there was any stockpiling in 2004/2005 is not entirely clear). In the absence of any contemporaneous documentation establishing the decision process undertaken by EFDG in 2004 and 2005 (or, indeed, any contemporaneous evidence that the volumes purchased were in fact a stockpile), this is a more reasonable approach than to pick an optimal stockpile with the benefit of hindsight.

6.2.21 I therefore calculate the impact of allowing for a delay in the (assumed) stockpiling patterns until 2008/2009, but at the volumes asserted to have been stockpiled in 2004/2005. My calculation of the loss for the Sub-Head of Claim relating to sugar therefore increases by approximately €4.3 million.”

(Second ER of J. Ellison, ¶¶ 6.2.20-6.2.21)

987. The Tribunal agrees with Mr. Ellison's methodology and calculations. As a result, the Tribunal accepts the Claimants' claim with Mr. Ellison's reductions (i.e., for RON 18,133,229).
988. By contrast, the Tribunal rejects Mr. Ellison's alternative calculation on the basis of the assumption that the incentives would only have been available until the date of accession, for the reasons set out in paragraph 961 above.

### **3. The Claimants' claims for lost profits**

989. The Claimants advance five claims for lost profits under Method A. The Tribunal has grouped them into three categories: the Claimants' claim for lost profits on the sale of finished goods (Section (b) below); the Claimants' claim for lost profits on the sale of sugar-containing products (SCPs) (Section (c) below), and the Claimants' claim for lost profits due to the inability to complete the Incremental Investments (Section (d) below). Before addressing each of these claims, the Tribunal will address the standard for an award of lost profits (Section (a) below).

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<sup>186</sup> Appendix JMHE-4C.

### a. Standard for an award of lost profits

990. As noted above, Article 36(2) of the ILC Articles provides that “compensation shall cover any financially assessable damage including loss of profits insofar as it is established.” The Respondent argues that the standard of proof for an award of lost profits is more restrictive than for an award of other losses, and the Claimant has responded to these arguments. As a result, the Tribunal will first address the Respondent’s position, and will then turn to the Claimants’ comments.

#### i. The Respondent’s position

991. The Respondent contends that, for their claims for lost profits to succeed, the Claimants must meet a specific legal standard with respect to lost profits (R-PHB, ¶¶ 217-221, R-Rejoinder, ¶¶ 297-300).<sup>187</sup>

992. Specifically, the Respondent argues that international law requires a claimant to demonstrate lost profits with “reasonable” or “sufficient” certainty. The Respondent contends that a claimant must adduce probative evidence that lost profits are “probable” and not “merely possible”.<sup>188</sup> If there is no proof that the alleged profit-making activity would have been undertaken at all, the standard has not been met. According to the Respondent, this disposes of the Claimants’ claim in respect of the Incremental Investments and the alleged SCP opportunity, which together amount to more than €450 million.

993. Indeed, the Respondent argues that most of the Claimants’ alleged lost profits claims (in particular the claims related to the Incremental Investments and sale of SCPs) constitute claims of lost opportunities, rather than lost profits. As none of these activities were ever undertaken in fact, the Claimants seek compensation for the loss of a hypothetical chance to profit, not for the loss of profit itself. According to the Respondent, in these circumstances international law does not recognize an entitlement to compensation for mere opportunities. The only circumstances in which international tribunals have accepted claims for lost opportunities are situations in which the lost opportunities had intrinsic value, which the Respondent argues is not the case here (R-Rejoinder, ¶¶ 278-288, citing *S.D. Myers v. Canada*, *Merrill & Ring v. Canada*<sup>189</sup>, *Sapphire v. NIOC*<sup>190</sup>).

994. But even where there is no doubt that an investment would have been undertaken, the Respondent submits that the reasonable certainty standard cannot be satisfied in the absence of a going concern and a proven record of profitability. Citing a string of cases including *Aucon v. Venezuela*<sup>191</sup>, *PSEG v. Turkey*, *Metalclad v. Mexico* and

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<sup>187</sup> This is in addition to a causal link between the international wrong and the profits allegedly lost. The Respondent’s position on causation is addressed in the context of each specific claim.

<sup>188</sup> M.M. Whiteman, *Damages in International Law*, Vol. 3 (1937), Exh. RL–313, p. 1837.

<sup>189</sup> *Merrill & Ring Forestry L.P. v. The Government of Canada*, UNCITRAL, Award, 31 March 2010.

<sup>190</sup> *Sapphire International Petroleum Ltd v National Iranian Oil Company*, Award, 15 March 1963 (hereinafter “*Sapphire v. NIOC*”).

<sup>191</sup> *Autopista Concesionada de Venezuela, CA v. Bolivarian Republic of Venezuela* (ICSID Case No ARB/00/5), Award, 23 September 2003 (hereinafter “*Aucon v. Venezuela*”).

*AAPL v. Sri Lanka*, the Respondent contends that arbitral tribunals have consistently rejected lost profits claims where such a record of profitability could not be proven, noting that any compensation awarded in such circumstances has generally been limited to proven investment expenditures.

995. In this respect, the Respondent argues that international law precludes any award of prospective damages for projects that have not commenced. The Respondent submits that “no tribunal adjudicating an investment treaty dispute has ever awarded lost profits where, as here, the claiming party had not made the investment that allegedly would have generated the profits” (R-Rejoinder, ¶ 290). The Respondent cites *Aucoven v Venezuela*, where the Tribunal refused to award lost profits for the operation of a bridge that was never built or put into operation, despite the fact that it was undisputed that the bridge would have been built and would have been a profitable venture.<sup>192</sup> This tribunal also noted that “ICSID tribunals are reluctant to award lost profits for a beginning industry and unperformed work”, adding that this reluctance is confirmed by the practice of the Iran-U.S. Claims Tribunal.<sup>193</sup> Romania also cites *Himpurnia California Energy Ltd. v. PLN*, where the tribunal held that “it would be intolerable ... to uphold claims for lost profits from investment not yet incurred”.<sup>194</sup>
996. Similarly, the Respondent argues that mere projections of future profits made by investors or draft contracts that were never finalized are insufficient to prove lost profits. In particular, the tribunal in *PSEG v. Turkey* held that “[r]elying on cash flow tables that were a part of proposals that did not materialize does not offer a solid basis for calculating future profits.”<sup>195</sup>
997. In addition, the Respondent argues that “even claims for the lost future profits of existing investments have been disallowed where the investment had no track record of profit generation. An award to the contrary would be inherently speculative, and therefore contrary to the dictates of international law” (R-Rejoinder, ¶ 290). The Respondent cites a string of cases where tribunals have rejected such claims, notably:
- a. *AAPL v. Sri Lanka*, where the tribunal found, in connection with a newly formed company that had no record of profits and was undercapitalized, that neither the “goodwill” of the company nor its “‘future profitability’ [...] could be reasonably established with a sufficient degree of certainty”.<sup>196</sup>
  - b. *Metalclad v. Mexico*, where the tribunal held that “where the enterprise has not operated for a sufficiently long time to establish a performance record or where it

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<sup>192</sup> *Id.*, ¶ 357, cited with approval in *PSEG v. Turkey*, ¶ 310.

<sup>193</sup> *Id.*, ¶ 360.

<sup>194</sup> *Himpurnia California Energy Ltd v PLN*, UNCITRAL, Final Award, 4 May 1999, ¶ 330.

<sup>195</sup> *PSEG v. Turkey*, ¶ 313.

<sup>196</sup> *AAPL v. Sri Lanka*, ¶ 106.

has failed to make a profit, future profits cannot be used to determine going concern or fair market value.”<sup>197</sup>

c. *PSEG v. Turkey*, where the tribunal found that compensation for lost profits “is normally reserved for the compensation of investments that have been substantially made and have a record of profits, and refused when such profits offer no certainty.”<sup>198</sup>

d. Several decisions of the Iran–US Claims Tribunal (see R-Rejoinder, fn. 446).

998. The Respondent argues that in such circumstances, international tribunals have “repeatedly held that damages should be limited to proven, net out-of-pocket expenditures (or “sunk costs”) that the claimant has incurred in advancing the project” (R-Rejoinder, ¶ 291). For example, in *Biloune v. Ghana*, the tribunal concluded that “[g]iven the nature of the project, and its early interruption by the respondents (...), the most appropriate method for valuing the damages to be paid [for expropriation] will be to return to Mr. Biloune the amounts he invested”.<sup>199</sup>

999. The Respondent argues that, in the Claimants’ case, there was no going concern with respect to the Incremental Investments or the sale of SCPs to third parties, and thus no proven record of profitability. As a result, the Respondent submits that the Tribunal need not even consider the evidence submitted with respect to the alleged lost opportunities. Even if the Tribunal were convinced of the Claimants’ intention to “complete” the Incremental Investments and to engage in the sale of SCPs to third party industrial customers, it is undisputed that none of these ventures was ever launched, let alone earned profit (See, e.g, Tr., Day 8,33–38 and 45–46 (Lessard); Tr., Day 8, 10:66–67 (Osborne)). Thus, the Respondent argues that no award of damages for the Incremental Investments or the sale of SCPs to third parties can be contemplated in the present case as a matter of law. The Respondent’s specific comments on the evidence submitted with respect to the sale of SCPs and the Incremental Investments is set out in Sections (c) and (d) below.

## ii. The Claimants’ position

1000. The Claimants do not contest the standard offered by the Respondent for an award of lost profits (that is, that the claim must have “sufficient certainty”) (C-PHB, ¶ 145).<sup>200</sup> However, they offer a different interpretation of how this “sufficient certainty” must be established (C-PHB, ¶¶ 145-150; C-Reply, ¶¶ 604-609).

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<sup>197</sup> *Metalclad v. Mexico*, ¶ 120.

<sup>198</sup> *PSEG v. Turkey*, ¶ 310.

<sup>199</sup> *Biloune & Marine Drive Complex Ltd v Government of Ghana*, UNCITRAL, Award, 30 June 1990 (hereinafter “*Biloune v. Ghana*”), pp. 228 and 229.

<sup>200</sup> Indeed, the Claimants concede that tribunals have traditionally been less willing to award compensation for lost profits than for other losses due to the inherently speculative nature of a lost profits claim. However, relying on the ILC Articles and an article by Prof. John Gotanda, they contend that such damages should be awarded where the claim for them has sufficient certainty. (See ILC Articles, Art. 36, and John Y Gotanda, *Recovering Lost Profits in International Disputes*, 36 *Georgetown Journal of International Law* 61, 111 (2004), Exh. C-603).

1001. Citing *Gemplus and Talsud v. Mexico*, the Claimants contend that the concept of certainty is both “relative and reasonable in its application”. The Claimants argue that, in that case, the tribunal rejected the argument that the claimants had failed to prove their lost profits claims because their quantification was uncertain or difficult. The tribunal also emphasized that the assessment of a claim of lost profits was not an exercise in certainty but in “sufficient certainty”, noting that “[i]t is not always possible for a claimant to prove that a future event could or could not happen with certainty; and a tribunal can only evaluate the chances of such a future event happening.”<sup>201</sup> The *Gemplus and Talsud* tribunal was also more lenient with respect to the claimants’ burden of proof, having concluded first that “the Claimant’s evidential difficulties in proving their claim for loss of future profits [were] directly caused by the breaches of the BITs by the Respondent responsible for such loss.”<sup>202</sup> The Claimants also rely on *Sapphire v. NIOC*,<sup>203</sup> *SPP v. Egypt*,<sup>204</sup> and *Lemire v. Ukraine*<sup>205</sup> for the proposition that the uncertainty in the amount of damages should not be an obstacle to an award of lost profits.
1002. The Claimants argue that, in the present case, the fact of injury from revocation of the incentives is not disputed; only the amount of the injury is in dispute. The Claimants also contend that the legal wrong giving rise to those injuries has been established beyond question. Relying on the cases cited above, the Claimants argue that the Respondent is therefore not entitled to invoke an unattainable burden of proof as to the amount of compensation for the Claimants’ losses that would compound the Respondent’s wrongs and unfairly defeat the Claimants’ claim for compensation.
1003. With respect to the Respondent’s arguments regarding the need for a proven record of profitability, citing *Sapphire v. NIOC*, *SPP v. Egypt* and *Lemire v. Ukraine*, the Claimants argue that tribunals have awarded damages to un-established businesses or businesses still in their infancy (C-PHB, ¶ 149). The Claimants note that in these cases the tribunals awarded damages despite the fact that the claimant was unable to

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<sup>201</sup> *Gemplus S.A., SLP S.A. and Gemplus Industrial S.A. de C.V. v. United Mexican States and Talsud, S.A. v. United Mexican States* (Conjoined ICSID Cases Nos. ARB (AF)/04/3 and ARB(AF)/04/4), Award, 16 June 2010 (hereinafter “*Gemplus and Talsud v. Mexico*” or “*Gemplus and Talsud*”), ¶ 13-91.

<sup>202</sup> *Id.*, ¶ 13-92.

<sup>203</sup> *Sapphire v. NIOC*, pp. 187-188, (“It is not necessary to prove the exact damage suffered in order to award damages. On the contrary, when such proof is impossible, particularly as a result of the behaviour of the author of the damage, it is enough for the judge to be able to admit with sufficient probability the existence and extent of the damage.”).

<sup>204</sup> *SPP v. Egypt*, ¶ 215 (where the tribunal held that the inability to assess damages with certainty is not alone a reason not to award them when a loss has been suffered).

<sup>205</sup> *Joseph C. Lemire v. Ukraine* (ICSID Case No. ARB/06/18), Award, 28 March 2011 (hereinafter “*Lemire v. Ukraine*”), ¶ 246 (“The Tribunal agrees that it is a commonly accepted standard for awarding forward looking compensation that damages must not be speculative or uncertain, but proved with reasonable certainty; the level of certainty is unlikely, however, to be the same with respect to the conclusion that damages have been caused, and the precise quantification of such damages. Once causation has been established, and it has been proven that the *in bonis* party has indeed suffered a loss, less certainty is required in proof of the actual amount of damages; for this latter determination Claimant only needs to provide a basis upon which the Tribunal can, with reasonable confidence, estimate the extent of the loss.”).



prove the exact amount of damage suffered. However, these cases do not specifically address the situation where the claimant has not made the investment that would have allegedly generated the profits.

1004. In any event, the Claimants contend that the successes enjoyed by the Miculas' businesses from the early 1990s until the time of revocation of the incentives should satisfy the Tribunal to the requisite degree of certainty that, had the incentives remained in place, those successes would have continued. The Claimants emphasize that their business was not in its infancy; to the contrary, it was a very successful drinks and food business with large market shares at the time the incentives were revoked (C-PHB, ¶ 149).
1005. Accordingly, the Claimants argue that the Tribunal should have no hesitation in accepting the Claimants' claims for lost profits, and awarding them full compensation so as to put them in the position they would have been in had Romania not breached the BIT by prematurely terminating the incentives.

### iii. The Tribunal's analysis

1006. Article 36(2) of the ILC Articles provides that "compensation shall cover any financially assessable damage including loss of profits ***insofar as it is established.***" As discussed above, the Respondent submits that lost profits must be proved with "sufficient certainty". The Respondent argues that this means that they must at least be "probable", and "not merely possible."
1007. The Claimants do not dispute that lost profits must be established with sufficient certainty, but rather argue that the Tribunal must be more lenient in determining whether that standard has been met. In particular, the Claimants submit that once the fact of damage has been established, a claimant should not be required to prove its exact quantification. They argue that this is especially true where the conduct of the author of the damage has made that proof difficult or impossible.
1008. The Tribunal understands that any future damage is difficult to prove and is willing to take that into account. There remains nevertheless a requirement to show sufficient certainty as speculation is not the same as prediction. Indeed, the cases cited by the Claimants call for leniency in the assessment of the *amount* of damage, not of its existence. The Tribunal agrees with the tribunal in *Lemire v. Ukraine* when it states that "[o]nce causation has been established, and it has been proven that the *in bonis* party has indeed suffered a loss, less certainty is required in proof of the actual amount of damages; for this latter determination Claimant only needs to provide a basis upon which the Tribunal can, with reasonable confidence, estimate the extent of the loss."<sup>206</sup>
1009. The Tribunal also notes that the commentary to the ILC Articles limits compensation to "damage actually suffered as a result of the internationally wrongful act, and excludes damage which is indirect or too remote" (Comment 5 to Article 34 of the ILC

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<sup>206</sup> *Lemire v. Ukraine*, ¶ 246.

Articles). In the case of lost profits, this can only mean that the claimant must have been deprived of profits that would have actually been earned but for the internationally wrongful act. Accordingly, before they are entitled to request a more lenient application of the standard of proof, the Claimants must first prove that they would have actually suffered lost profits, i.e., that they have been deprived of profits that would have actually been earned. In the Tribunal's view, this requires proving (i) that the Claimants were engaged in a profit-making activity (or, at the very least, that there is sufficient certainty that they had engaged or would have engaged in a profit-making activity but for the revocation of the incentives), and (ii) that that activity would have indeed been profitable (at the very least, that such profitability was probable).

1010. In the Tribunal's view, the sufficient certainty standard is usually quite difficult to meet in the absence of a going concern and a proven record of profitability. But it places the emphasis on the word "usually." Depending on the circumstances of the case, there may be instances where a claimant can prove with sufficient certainty that it would have made future profits but for the international wrong. This might be the case, for example, where the claimant benefitted from a long-term contract or concession that guaranteed a certain level of profits or where, as here, there is a track record of similar sales. This must be assessed on a case by case basis, in light of all the factual circumstances of the case. That is what the Tribunal will now do with respect to the Claimants' specific claims for lost profits.

**b. Lost profits on sales of finished goods**

1011. The Claimants claim no less than RON 427 million (originally calculated by Mr. Boulton as an amount "in excess of €100 million", ER of R. Boulton, ¶ 5.99) for lost profits on sales of finished goods, based on:

- a. The calculations contained in section 5 of Mr. Boulton's report dated 30 July 2010 and paragraphs 5.24 to 5.70 and 5.95 to 5.99 in particular; and
- b. The evidence referred to in the abovementioned section, including exhibits RB-2 and RB-4 (C-PHB, ¶¶ 151-161).

1012. Mr. Boulton carries out a very specific lost profits analysis: he focuses on the impact of the increased cost of raw materials on sales of the EFDG companies' branded goods, and that consequent impact on profits.<sup>207</sup> Mr. Boulton's analysis starts from the premise that the revocation of the incentives caused an increase in the cost of the Claimants' products, which in turn caused the Claimants to raise their prices. That price increase in turn caused the Claimants to lose market share, preventing them from making sales they otherwise would have made. This in turn caused a loss in profits.

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<sup>207</sup> In his Expert Report, Mr. Boulton also makes comments on the expert reports submitted by the Respondent's experts Dr. Robinson (on the effect of Romania's accession to the EU on the Claimants) and Mr. Ellison (on quantum in general). He also comments on the First Expert Report submitted by BCG on behalf of the Claimants and provides his own calculation of the impact of price increases on the Claimants' sales of branded products in Romania. It is on this latter analysis that the Claimants rely for this claim.

1013. Mr. Boulton’s empirical analysis focuses on the relationship between increased prices and loss of market share. Mr. Boulton does not carry out an empirical analysis of the first two causal links (that revocation caused an increase in costs, and that this increase in costs caused the Claimants to raise their prices), but rather appears to accept them through a combination of reliance on evidence rendered by the Claimants (including Mr. V. Micula’s Witness Statement) and of conclusions based on his experience (i.e., his expert opinion) as explained in more detail below.

1014. Mr. Boulton’s calculation overlaps with:

- a. Prof. Lessard’s quantification of lost profits for the EFDG’s incremental sales at RON 97.3 million, which on 30 September 2009 was approximately €28 million when grossed up for taxes (Prof. Lessard’s Updated Summary of Damages distributed at the merits hearing), and
- b. BCG’s quantification of the EFDG’s lost profits on sales of finished goods at RON 2,423.20 million, which at the date of BCG’s Reply Report (30 July 2010) was approximately €722 million (Second ER of BCG , p. 17).

1015. Mr. Boulton’s methodology and conclusions can be summarized as follows:

- a. Mr. Boulton focused on the relationship between price and market share (ER of R. Boulton, ¶¶ 5.25-5.70; Appendix 5.1). He first identified eleven factors that may have an impact on market share.<sup>208</sup> Out of these, he identified six that could have been affected by revocation (including cost structure and price decisions). Mr. Boulton stated that the factor with “most obvious” impact on market share was cost structure,<sup>209</sup> but testified that he had only quantified the effect of price decisions, because it was the only one for which he had sufficient empirical data:

“[A]t a high level, what I did was say: is there a relationship between price and market share? And the answer to that is statistically "yes". I then cross-checked that statistics to make sure it made sense with what third-party research shows, which it does. I then sought to identify what price rises were made in response to revocation. And having done that, I quantified: what was the impact of those price rises on sales? And then [...] having identified the lost sales, you identify how much margin was lost and what profits have been lost.” (Tr., Day 9, 159 (Boulton))

- b. Mr. Boulton’s empirical analysis only focused on lost sales for the Claimants’ “own branded soft drinks products”. Mr. Boulton identified five products within this larger “soft drinks” category: carbonated sugar drinks (CSDs), mineral water,

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<sup>208</sup> These eleven factors were: macroeconomic factors, market structure, barriers to entry, competitive behavior, price decisions, cost structure, existing knowledge of the market, an established distribution network, market share of other products, marketing and availability of working capital (ER of R. Boulton, ¶ 5.24).

<sup>209</sup> With respect to cost structure, Mr. Boulton explained: “Of course, if the price of sugar goes up, then that changes the cost structure of the claimants’ businesses for CSDs. That in turn is likely to affect price decisions and/or the ability to respond to competitive behaviour. It’s much harder to maintain a price positioning below most of your competitors if you’ve lost your cost advantage.” (Tr., Day 9, 157-158 (Boulton)).

still drinks,<sup>210</sup> nectars and juices. Of these five products, he then narrowed the analysis down to three: CSDs, nectars and juices. According to his testimony, these were the only products for which he was able to obtain sufficiently reliable and detailed price and market share data (relying on AC Nielsen data which the expert found trustworthy). In particular, Mr. Boulton excluded from his calculations losses related to mineral water where, in his submission, there is an element of government control that impacts price, as well as losses related to still drinks (i.e., soft drinks other than those identified above, for which he had insufficient historical price data)<sup>211</sup> (ER of R. Boulton, ¶¶ 5.36-5.70; Tr., Day 9, 167-168).

- c. Mr. Boulton calculated that, over the period 2004-2009, lost profits for loss of market share for CSDs, juices and nectars amounted to €88 million. After netting out the effect of the higher margin obtained from raising prices, Mr. Boulton concluded that the net effect on the Claimants was a loss of €28 million (RON 119.3 million at the time of his report) (ER of R. Boulton, ¶¶ 5.36-5.70, Tr. Day 9, 168).<sup>212</sup>
- d. To do this, Mr. Boulton calculated a “but for” market share: as he explained it, he used “the results of [his] regression analysis to say: if the price increases hadn't been made, what sales would have been achieved -- they would have been higher -- and then putting that back in as what would they then have been as a proportion of the total market.” His conclusion was that “the claimants’ market share would have declined more slowly over the period, converging when the sugar stockpile ran out in 2011. So I have assumed that there is no benefit after 2011.” For this calculation, he assumed that the Claimants would have had the advantage of a sugar stockpile that would have allowed the Claimants to continue without increasing their prices (about 18 months) (Tr., Day 9, 169-171 (Boulton)).
- e. Mr. Boulton then extrapolated the profits lost with respect to the Claimants’ soft drinks business (€28 million) to all the EFDG companies’ products, using a ratio based on what percentage soft drinks sales had in the total group’s sales (in Mr. Boulton’s submission, soft drinks accounted for 42% of the total value of sales made by the EFDG<sup>213</sup>). The exact result of this extrapolation would have been €66 million, but he rounded it down to €60 million (RON 255.7 million), because not all the products have the same sugar inputs (he stated that he did not have the data to make an exact calculation). This number is based solely on sales of

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<sup>210</sup> In some places, Mr. Boulton refers to still drinks simply as “soft drinks”, which may lead to confusion (see, e.g., Mr. Boulton’s Presentation at the Merits Hearing, Slide 19). In this section the Tribunal refers to them as “still drinks”, which was the terminology used by Mr. Boulton in his expert report.

<sup>211</sup> For these last two categories, Mr. Boulton stated that “price rises may still have been made in response to the Revocation, but I have not included any losses as a result in my calculations” (Mr. Boulton’s Presentation at the Merits Hearing, Slide 19). See also Tr., Day 9, 218-219, where Mr. Boulton repeats that he has quantified no loss for mineral water.

<sup>212</sup> This reflects the corrected figures submitted by Mr. Boulton on 17 August 2010 (Letter from the Claimants to the Tribunal of 18 August 2010 and attachments).

<sup>213</sup> Mr. Boulton refers to Appendix 5-1 of his report.

the Claimants' products within Romania, and based only on the effect of price increases (ER of R. Boulton, ¶ 5.70; Appendix 5.1; Tr., Day 9, 177 (Boulton)).

- f. After arriving at this €60 million number, Mr. Boulton's overall conclusion (which he acknowledged was his subjective "expert opinion") was that the Claimants suffered a loss "in excess of €100 million" (ER of R. Boulton, ¶ 5.99; Tr., Day 9, 177 (Boulton)). He justified this increase because in the original calculation:
    - i. He did not take into account the impact of revocation on other factors that could affect market share, such as marketing, market share of other products, and the availability of working capital.
    - ii. He used data from AC Nielsen, a well known global marketing company, which "almost certainly understates the size of the whole market", making his calculations "very conservative".
    - iii. He ignored export markets, which were included in the much higher BCG calculation (Tr., Day 9, 178 (Boulton)).
  - g. The €100 million refers to losses over the period running from January 2005 through mid-2011. Mr. Boulton explained that "[i]t's certainly a convergence period post when the incentives would have ended, but on the assumption that there would have been a significant stockpile of sugar and prices would have come down and converged. But the vast majority of those losses are 2005-2009" (Tr., Day 9, 221-222).
1016. As a general matter, the Tribunal agrees with Mr. Boulton's analysis, if not with his full calculation. It seems difficult to dispute that the increased cost of raw materials caused by the revocation of the incentives would have an impact on the prices of the Claimants' products, thereby probably leading to a decrease in market share and lost sales, and consequently lost profits. As explained below, on the facts, the Tribunal finds that this has indeed been the case.
1017. First, this claim focuses on profits deriving from a business that the Claimants were actually engaged in, and is calculated on the basis of profits actually made in the past. The Claimants had a proven record of profitability regarding the sale of their own branded goods.
1018. The Respondent's main criticism has rather to do with causation. Romania argues that Mr. Boulton's report is premised on the assumption that the repeal of the Raw Materials Facility caused the Claimants to raise the prices of their finished goods, which in turn caused them to lose market share. But this, according to Romania, is false.
- a. First, Romania argues that the prices of EFDG products were rising as early as January 2004, long before revocation (which took place in February 2005), so there could be no causal link with revocation (R-PHB, ¶ 300). Mr. Boulton accepts that the rise in prices predated revocation (starting in 2004), but states

that his “understanding is the price decisions made in 2004 were a response to first of all the rumours and then the announcement of revocation” (Tr., Day 9, 200). Romania argues that Mr. Boulton admitted that this assumption was based entirely on the Claimants’ witness evidence, which Romania argues is unreliable, but this is not entirely accurate. Mr. Boulton did not state that he relied exclusively on the Claimants’ witness evidence; he also drew a conclusion (or an inference) from the evidential pattern and timing of the price increase. In addition, he noted that the loss of market share was not due only to an increase in prices in 2004, but to an inability to reverse them after revocation (Tr., Day 9, 200, 210-212 (Rubins/Boulton)).

- b. Second, Romania argues that price increases in 2004 could not have been a response to rumors or announcements of revocation, because the Miculas testified that in January 2004 they still did not believe that the incentives would be revoked. In fact, Ioan Micula testified that he first became concerned with the revocation at the beginning of 2004 after Prime Minister Nastase’s interview on TV in January 2004, so the timing of the price increase is not inconsistent with his testimony (Tr., Day 2, 220 (I. Micula)). It is true however that Viorel Micula testified that he was not certain that the incentives would be withdrawn until the fall of 2004 (Tr., Day 4, 199 (V. Micula)).
- c. Third, Romania argues that the price increases in 2004 could not have been a response to rumors or announcements of revocation because Mr. Balog testified and Mr. Gamecho confirmed that the Claimants had purchased enough duty-free sugar to delay the economic effect of the repeal until the second half of 2006 (see First WS of C. Balog, ¶ 7, Tr., Day 4, 28 (Gamecho)). Romania is correct: the witnesses did say that, and Mr. Boulton accepted that, if that was correct it “must follow” that the actual cost of sugar to the claimants wouldn’t have risen until the end of 2006 (Tr., Day 9, 195-196).

1019. The Tribunal has considered Romania’s arguments on causation. But absent another, more plausible explanation for this increase in prices, the Tribunal has difficulty rejecting the causation sequence used by Mr. Boulton. It is undisputed that the revocation of the incentives had an impact on the Claimants’ costs. It cannot be seriously disputed that this cost increase eventually would have had an impact on their prices. The increase in the Claimants’ prices started in January 2004, which coincides with Prime Minister Nastase’s announcement of the revocation. Even if the Claimants had a stockpile that lasted them through 2006, they may have increased their prices to anticipate future losses or smooth out the rise of their prices. In any event, as Mr. Boulton testified, the issue is not just the increase in prices in 2004, but the Claimants’ inability to lower them in the future. In any event, while this is a different question, Mr. Boulton only quantified damages after revocation (to be accurate, from January 2005) (Tr., Day 9, 196-197 (Rubins/ Boulton)).

1020. As a result, the Tribunal finds that, with respect to this particular claim, the Claimants have proved with sufficient certainty that, as a result of the revocation of the

incentives, they were deprived of profits that they would otherwise have earned. The question that remains is: what is the value of this loss?

1021. The Tribunal accepts Mr. Boulton's first step in the quantification of this claim, that is, his quantification of lost profits related to lost sales of soft drinks for €28 million. It finds Mr. Boulton's methodology and conclusions reliable and conservative to this point. In particular:

a. Mr. Boulton did not conclude that, but for revocation, the Claimants would have maintained their entire market share. Mr. Boulton conceded that there has been a significant fall in market share over the last five years.<sup>214</sup> As a result he concluded that "about half of that is referable to revocation, and about half of it is referable to all of the other competitive forces in the market and would have happened anyway" (Tr., Day 9, 155 (Boulton)).

b. Although he looked at prices that increased in 2004, he did not quantify damages prior to 1 January 2005. Indeed, he rejected the suggestion that he should have calculated damages since 2004 (when revocation was almost certain), stating:

"Yes, I think my clients would fairly put to me that I am being overly cautious. They would believe that a greater magnitude of the price increases were their response to revocation. I am seeking always to try to maintain, where things are uncertain, as much caution in my figures as I can." (Tr., Day 9, 167)

c. Mr. Boulton used AC Nielsen data, which was lower than the Claimants' figures and the Euromonitor figures relied upon by BCG, and which may have understated the size of the market. This was because, in his view, AC Nielsen was the only data provider that gave him a full data set of the Claimants' sales and prices and their competitors, and to be rigorous he had to use this data consistently. However, he stated that this had a significant impact on his calculations: according to Mr. Boulton, if he had used Euromonitor, his calculation would have been more than €10 million higher every year (Tr., Day 9, 175-176 (Boulton)).

d. Mr. Boulton ignored export markets in preparing his calculations, which the Tribunal finds appropriate considering that it is difficult to predict how the Claimants' products would have fared in export markets after EU accession.

1022. The Tribunal also finds Romania's additional criticisms of Mr. Boulton's report, to the extent that they refer to the first step of his analysis, unfounded. In particular, Romania argues that "even if there had been an anti-temporal causal link between repeal in 2005 and increased prices in 2004, Mr Boulton's analysis would still be deeply flawed", because he assumed that EFDG's entire loss of market share resulted from rising prices, and ignored the other 10 factors he identified that could

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<sup>214</sup> Mr. Boulton testified that the fall in market share started in 2004, not in 2002 (Tr., Day 9, 164 (Boulton)). The Tribunal thus understands that, when Mr. Boulton states that market share has fallen "over the last five years", he is referring to the period 2004-2009.

affect market share” (R-PHB, ¶ 303). Mr. Boulton admitted that he has only quantified the effect of price increases, but denied that he has ignored the other factors or that this makes his quantification inaccurate. Specifically, Mr. Boulton explained: “What I have done is calculate by how much the fall in market share was attributable to the relative price increases, and that is the pink line. Therefore, I am not ignoring, as has been suggested, all of the other factors that affect market share, because they are all in that line. They are all in the actual line and they are also all in my adjusted actual. All I have done is adjust for the effect of price increases” (Tr., Day 9, 169, referring to slide 15 of his presentation). The Tribunal is satisfied with Mr. Boulton’s response.

1023. The second and third steps of Mr. Boulton’s analysis are however less straightforward.

1024. To recall, Mr. Boulton’s second step in the analysis was to extrapolate the profits lost with respect to the Claimants’ soft drinks business (€28 million) to all the EFDG companies’ products, using a ratio based on what percentage soft drinks sales had in the total group’s sales (42%). The exact result of this extrapolation would have been €66 million, but Mr. Boulton rounded it down to €60 million (RON 255.7 million), because not all the products have the same sugar inputs (he stated that he did not have the data to make an exact calculation) (Tr., Day 9, 177 (Boulton)).

1025. After arriving at this number, Mr. Boulton went a step further, and concluded that the Claimants actually suffered a loss of at least €100 million. Mr. Boulton justified this increase in the original calculation (which he acknowledged was his subjective “expert opinion”) because in the original calculation:

- a. He did not take into account the impact of revocation on other factors that could affect market share, such as marketing, market share of other products, and the availability of working capital.
- b. He used AC Nielsen data, which “almost certainly understates the size of the whole market”, making his calculations “very conservative”.
- c. He ignored export markets, which were included in the much higher BCG calculation (Tr., Day 9, 178 (Boulton)).

1026. The Respondent criticizes both of these steps. First, Romania argues that Mr. Boulton extrapolated his estimate of €28 million for soft drinks across the EFDG’s entire business, arriving at €60 million, but in so doing he included products (such as beer) which use no sugar. Mr. Boulton defended his position as follows:

“Q. Given that discussion we’ve just had, isn’t it fair to say that €60 million extrapolated by a direct ratio, even rounded down, is bound to be an overstatement within the bounds of this calculation?

A. Well, I think that’s a fair question to put, because it’s something I have worried about in thinking about how to get to those numbers.



The reason that I was comfortable with the conclusion I came to is partly because my five products include some for which I found nil effect. So if you like, if you look at my slide 18, the bottom-left quadrant includes big categories like alcohol and beer where the incentives would not have a big effect. But my top-left box from which I am extrapolating includes mineral water. So I haven't just chosen the products that are affected, like CSDs and extrapolated to all products; I have chosen a mix of products, including mineral water, for which I've quantified no loss, and extrapolated that across all products.

So it's not, I think, as open to criticism as you are suggesting. It is uncertain; I tried to say that. It's why I round it down.

The other factor is, of course, the price increases may have been put through on other products, even where there wasn't the direct raw material cost impact coming through. Essentially pricing decisions were made in response to revocation, even where there wasn't that raw material impact.

So could I argue that 60 million was definitely a better number than 50 million? No. Am I comfortable that I considered the relevant factors in coming to my conclusion? Yes.

Q. When you say "comfortable", you think it's probable that that's the right number, that is the amount, €60 million?

A. That would be my best estimate of what the loss was across these 14 categories, before taking into account the other factors that I look at about total size of the market and other impacts of revocation on market share."

(Tr., Day 9, 218-219)

1027. Romania also argues that Mr. Boulton "inflated" his €60 million figure to a level in excess of €100 million "without any support or explanation" (R-PHB, ¶ 304), adding that this €100 million figure is a "guess, based on no calculations whatsoever" (R-PHB, ¶ 214).

1028. The Tribunal has duly noted Romania's objections. However, it is evident to the Tribunal that the Claimants' losses under this claim are not limited to €28 million lost in relation to soft drinks. It is undisputed that the Claimants sold other products that did contain sugar, whose prices would have been affected by the increased cost of sugar. As noted in paragraph 1008 above, once the fact of damage has been established, the Tribunal has wide discretion to establish its exact amount, provided that the Claimants have provided a basis for that calculation.

1029. In the absence of exact data related to other sugar-containing products, the Tribunal accepts that an extrapolation may be appropriate. However, Mr. Boulton's analysis is premised on the assumption that an increased cost of sugar caused an increase in prices of certain products. It is thus not reasonable to extrapolate the profits lost on soft drinks containing sugar to products that do not contain sugar. The Tribunal is not fully satisfied with Mr. Boulton's explanation, cited above, as to why that extrapolation was reasonable. For the same reason, the Tribunal cannot agree with Mr. Boulton's

conclusion that €28 million accurately reflects the losses related to an increased cost of sugar for 42% of the Claimants' total sales, because that 42% includes mineral water, which does not contain sugar.<sup>215</sup> According to the table provided on page 5 of Appendix 5-1 to Mr. Boulton's report, sugar-containing soft drinks (that is, CSDs, other soft drinks and juices/nectars) account for 32.76% of the Claimants' total sales over the period 2004-2008).<sup>216</sup> The Tribunal therefore rejects the specific calculations in the extrapolation carried out by Mr. Boulton.

1030. Instead, and in the exercise of its discretion in the calculation of damages, the Tribunal will extrapolate the Claimants' losses in sugar-containing soft drinks to the Claimants' other sugar-containing products. In the absence of an exact breakdown of what products contain sugar, the Tribunal has assumed that the following categories of products identified in Table A5-1.1 of Appendix 5-1 of Mr. Boulton's report contain sugar in some measure: soft drinks, juices and nectars, alcoholic drinks, biscuits, tomato sauce/ketchup, co-extruded products, breakfast cereals, and sticks. Based on the information provided in Table A5-1.1 of Mr. Boulton's report, the Tribunal has concluded that sugar-containing soft drinks account for approximately 54% of the EFDG's total sales in sugar-containing products (which amount to approximately 850 million over a period between 2004 and 2008). If the losses calculated by Mr. Boulton for sugar-containing soft drinks (i.e., €28 million) are then extrapolated to the remaining sugar-containing product line, the result is €51.6 million.<sup>217</sup>

1031. The Tribunal now turns to Mr. Boulton's third step, in which he concludes that the Claimants actually suffered a loss of at least €100 million. Mr. Boulton conceded that he was unable to quantify this step, which is testimony to his professional integrity; however, the Tribunal is not prepared to accept an increase of €40 million (equivalent to 67% of the amount he arrives to for the entire product line) solely on the basis of Mr. Boulton's "subjective expert opinion" (Tr., Day 9, 177 (Boulton)). In addition, the Tribunal finds that the arguments advanced by Mr. Boulton in order to reach this number are not satisfactory for the following reasons:

- a. The fact that Mr. Boulton used conservative data, such as AC Nielsen data, should not be used as a reason to inflate the results by 67%. If the use of conservative figures is deemed warranted and justified, this approach should not be reversed subsequently, especially on the basis of assumptions, even where – as in this case – the assumptions are based on the expert's professional experience.

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<sup>215</sup> The Tribunal understands that Claimants' entire soft drinks business (including the five categories identified by Mr. Boulton in para. 1018(b) above) account for 42% of the Claimants' total sales. See Table A5-1.1 in Appendix 5-1 of Mr. Boulton's report, p. 5.

<sup>216</sup> The Tribunal notes that this table does not distinguish between CSDs and still drinks, so it assumes they both categories fall under the label "soft drinks".

<sup>217</sup> The Tribunal will not set out in detail its calculations. It suffices to say that the results of the Tribunal's calculations are confirmed by the fact that 54% (i.e., the percentage of sugar-containing soft drinks in the EFDG's total sales of sugar containing products) of €51.6 million (the Tribunal's calculation of overall losses in sugar-containing products) is €28 million (Mr. Boulton's calculation of losses in sugar-containing soft-drinks).

- b. Similarly, Mr. Boulton himself stated that he was unable to quantify exactly the impact of the revocation on other factors that could affect market share, such as marketing, market share of other products, and the availability of working capital. In these circumstances, there is no sufficient factual basis for Mr. Boulton's final number, and an increase of 67% appears unjustified.
- c. Given the uncertainties that the Claimants' business would have faced after Romania entered the EU, the Tribunal does not believe that it would be appropriate to consider export markets in its calculation of damages.

1032. That being said, although Mr. Boulton has failed to prove that the Claimants have suffered a loss of €100 million, the factors outlined in the preceding paragraph suffice to convince the Tribunal that the Claimants have lost profits in excess of €51.6 million as a result of lost sales of finished goods. In particular, the Tribunal is satisfied that the revocation of the incentives must have had an impact on other factors that could affect market share, such as marketing, market share of other products and the availability of working capital, an impact which Mr. Boulton was unable to quantify. The Tribunal is not well-positioned to quantify the economic impact of factors that the expert himself was unable to quantify, however, it is satisfied that an additional damage was indeed suffered. Having reached that conclusion, and in the exercise of its discretion to quantify damages, the Tribunal is prepared to return to the initial figure proposed by Mr. Boulton in his second step, that is, €60 million.

1033. For these reasons, the Tribunal values the lost profits suffered by the Claimants for lost sales of finished goods at €60 million. In his report, Mr. Boulton calculates this to be equivalent to RON 255.7 million at the exchange rate of the date of his report (ER of R. Boulton, ¶ 5.70).<sup>218</sup> The Claimants have made their claims in RON; as a result, the Tribunal finds that it would be improper to use a different exchange rate and will in particular derive the consequences from this finding when it comes to compute the interest on the claims. Thus, the Tribunal values the lost profits suffered by the Claimants for lost sales of finished goods in RON, namely at RON 255.7 million.

**c. Lost profits on sales of sugar containing products (SCPs)**

1034. In addition to their claim for lost profits on sales of finished goods, the Claimants claim lost profits on sales of sugar containing products ("SCPs") following the revocation of the incentives, in the amount of RON 492.3 million (C-PHB, ¶¶ 162-170). This claim is cumulatively based on:

- a. The calculations contained in section 4 of Mr. Osborne's first report and paragraphs 4.25 and 4.31 in particular;

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<sup>218</sup> Indeed, although Mr. Boulton quantifies the claim in Euro, his model was principally denominated in RON. Mr. Boulton explains that "[w]ith the exception of transportation and distribution costs, my model is denominated in RON. I have converted the RON values into Euros on a monthly basis in my model. However, for illustrative purposes here, I have used the 30 July 2010 €RON exchange rate [equivalent to 1:4.26179, as noted in ¶ 5.69] to convert my Euro denominated calculations back into RON" (ER of R. Boulton, fn. 125, p. 54).

- b. The calculations contained in section 5 of Mr. Osborne's second report;
  - c. The calculations contained in Dr. Fry's reports of December 2009 and July 2010; and
  - d. The evidence referred to in the abovementioned sections and reports, including paragraph 69 of Mr. Viorel Micula's witness statement dated 22 December 2009, paragraphs 82 and 124 of Mr. Halbac's witness statement dated 22 December 2009, paragraph 17 of Mr. Halbac's witness statement dated 30 July 2010, and exhibits CO-1.19 and CO-13.1.
1035. This claim can be summarized as follows. Relying on the evidence cited above, the Claimants assert that, from 2005, they planned on manufacturing SCPs and selling those SCPs to industrial third parties. They further assert that, as a result of the revocation of the incentives, they were unable to do so. As a result, they now claim for the lost profits they would have allegedly made had they been able to sell SCPs to third parties.
1036. For the quantification of this claim, the Claimants rely on the expert reports prepared by Dr. Fry (of LMC International) and Mr. Osborne (of FTI). In fact, the quantification analysis is carried out by Dr. Fry; Mr. Osborne has adopted his estimates, added interest and grossed-up for taxes (First ER of C. Osborne, ¶ 4.31; Second ER of C. Osborne, ¶ 5.3, 1.19).
1037. Specifically, Dr. Fry asserts that the SCP opportunity would have been worth €131 million to the Claimants had they been able to take advantage of it (Second ER of J. Fry, p. 5). Dr. Fry's quantification is based on the following main assumptions (some of which are the result of his own expert opinion):
- a. That, with the price advantage the Raw Materials Incentive would have given the Claimants, they would have been able to capture 90% of the Romanian SCP market (excluding sales of SCPs from domestic sugar beet production, with about half of the market captured in 2005). The Claimants argue that Dr. Fry has successfully responded to all criticisms leveled at this conclusion (see C-PHB, ¶ 164).
  - b. That the Claimants, in taking advantage of the SCP opportunity, would not have undermined or come into conflict with the EU's sugar regime. This is because the EU's sugar regime defends a reference price and in so doing provides the Commission with mechanisms to deal with all kinds of events (see C-PHB, ¶ 165).
1038. In addition, the Claimants assert that "[a]t no stage of the proceedings has the Respondent ever alleged that sales of SCPs to industrial third parties would have been unlawful under Romanian law or outside what was permitted pursuant to the EGO 24 regime" (C-PHB, ¶ 168).

1039. Finally, the Claimants argue that “the additional capacity to enable the Claimants to engage in sales of SCPs would have attracted a premium in the valuation of the European Food and Drinks Companies prior to Revocation. This capacity gave the Claimants an option to generate incremental cash from a structural cost advantage relative to other sugar suppliers in the market and as such, would definitely have had a value” (C-PHB, ¶ 170). However, they do not attempt to give a value to this premium.
1040. The Respondent criticizes this claim for the following reasons (R-PHB, ¶¶ 244-254; R-SPHB, ¶¶ 19-23):
- a. First, the Respondent argues that there is no evidentiary support for this claim. It notes that, in the five years during which the Claimants had access to the Raw Materials Incentive, no SCPs were ever marketed or sold to an industrial third party. Likewise, the Respondent notes that there is no contemporaneous evidence in the record reflecting the alleged intention to pursue the SCP opportunity. The Respondent argues that this claim is premised solely on Mr. Viorel Micula’s and Mr. Halbac’s testimony, which it characterizes as unreliable.
  - b. Second, for this same reason, the Respondent argues that there is no evidence of the scale upon which the SCP opportunity would have allegedly been pursued.
  - c. Third, the Respondent argues that the assumptions that underlie Dr. Fry’s calculations are unreasonable. In particular, the Respondent contends that it is unreasonable to assume that the EFDG would have captured 90% of the Romanian market, on the further assumption that the EFDG’s competitors (including Coca-Cola) would have been willing to purchase SCPs from EFDG and that all sugar producers capable of producing SCPs would have allowed their businesses to be wiped out (with the exception of sugar beet producers, who would have been able to survive on break-even margins). The Respondent also argues that it is unreasonable to assume that this strategy would have been legal as a matter of Romanian and EU law, or that Romania would have been able to maintain the customs duty exemption until March 2009 (R-PHB, ¶ 247).
1041. After analyzing the evidence before it, the Tribunal rejects this claim. In particular, it finds that the Claimants have not proved with sufficient certainty that, but for the revocation, they would have earned profits as a result of sales of SCPs to industrial third parties. First, it is undisputed that the Claimants never sold SCPs to industrial third parties (Section (i) below). Second, the Claimants have not proven that they would have in fact engaged in the business of selling SCPs to industrial third parties (Section (ii) below). The Tribunal therefore does not need to address the quantum of the alleged lost profits.
- i. The Claimants never sold SCPs to industrial third parties**
1042. It is uncontested that the Claimants never sold SCPs to industrial third parties. Mr. Osborne stated in his first report and confirmed at the hearing that “[t]he opportunity to sell sugar-based products is not one that was ever pursued. The objective of the

Micula brothers had rather been to build higher value-added businesses including manufacturing finished goods” (First ER of C. Osborne, ¶ 4.26; Tr., Day 10, 66-67 (Osborne)).

1043. In this respect, Mr. Halbac and Mr. Osborne both acknowledged that European Food only sold SCPs to other members of the EFDG. Specifically:
- a. Mr. Osborne states that “[p]rior to revocation, European Food was processing sugar and selling intermediate sugar products to industrial users, in the way posited by LMC, although primarily to European Drinks” (Second ER of C. Osborne ¶ 5.5). Mr. Osborne cites Exh. CO-19.1, but this exhibit only reflects sales of SCPs from European Food to other EFDG companies (specifically, European Drinks and Original Prod SRL).
  - b. Mr. Halbac states that “European Food has been selling intermediate sugar products to industrial users since 2000, when it first began selling sugar syrup” (Second WS of M. Halbac, ¶ 3), but then he clarifies that “[w]hile many of European Food’s customer’s [sic] were EFDG related companies, this does not change the fact that European Food was well versed in selling intermediate products. Further, European Food had been selling these products to unrelated third party customers for some time before revocation, contrary to Romania’s position” (*Id.*, note 3). But Mr. Halbac does not say that European Food sold SCPs to industrial third party customers.
  - c. Indeed, Mr. Halbac was not able to cite to a single invoice clearly reflecting sales of SCPs to industrial third party customers. All invoices cited refer either to sales of SCPs to other EFDG companies, or sales of other intermediate products (not SCPs) to third parties. Specifically:
    - i. Exh. C-840, C-841, C-842 and C-839 contain invoices for sugar syrup sales from European Food to European Drinks from 2002 to 2005.
    - ii. Exh. C-954 to C-958 are all bulk sales invoices for wafers, cocoa, and other sugar products from European Food to TGIE (another member of the EFDG) from 2002 to 2005.
    - iii. Mr. Halbac cites one invoice that could refer to sales to third parties, but the names are illegible and no translation was provided (Exh. C-959). In any event, most of the products may not be SCPs (e.g., tomato paste, ketchup, mustard, cereals), although there appears to be some reference to products containing cocoa, which presumably could involve SCPs. Importantly, there appears to be no mention of sugar syrup. The Tribunal cannot confirm, especially as the document is in Romanian.
1044. Given that no sales of SCPs to industrial third parties were proven to have been made, it also was not proven that the Claimants ever earned profits as a result of this activity. Thus, there is no proven record of profitability to support the Claimants’ lost profits claim. As stated at paragraph 1010 above, the absence of a proven record of

profitability need not necessarily be fatal to a lost profits claim. However, in this particular case the Claimants have not met their burden of proving that they would have in fact engaged in the business of selling SCPs to industrial third parties, as discussed below.

**ii. The Claimants have not proven that they would have in fact engaged in the business of selling SCPs to industrial third parties**

1045. The evidence in the record does not support, with the requisite degree of certainty, a finding that the Claimants would have in fact pursued the SCP opportunity. None of the Claimants' experts could identify any contemporaneous evidence of an intention to pursue the SCP opportunity (Tr., Day 8, 46 (Lessard); Tr., Day 10, 66–70 (Osborne); Tr., Day 11, 224–225 (Fry)). The Claimants rely heavily on witness evidence, in particular by Mr. Viorel Micula and Mr. Halbac, but the Tribunal finds this evidence unconvincing.
1046. Mr. Viorel Micula simply asserts that “[f]rom 2005, we had planned on manufacturing from raw sugar, sugar-based products such as sugar syrup, and then selling these sugar-based products to industrial third-parties” (Third WS of V. Micula, ¶ 69). Mr. Viorel Micula does not cite any documentary evidence.
1047. In his second witness Statement, Mr. Halbac testifies that the Claimants intended to sell SCPs to third party industrial consumers (Second WS of M. Halbac, ¶¶ 23-24). In that statement, he links the expansion of the chocolate cream line, done in December 2004 (although according to him it was planned since 2002) to an increased capacity to process sugar and produce SCPs, thus allegedly allowing for sales of SCPs. He also suggests that EFDG was already selling SCPs to industrial consumers (Second WS of M. Halbac, ¶¶ 3-7), but as stated above, this only referred to customers within the EFDG. Mr. Halbac also testifies that EFDG had the capacity to produce, sell and distribute SCPs to third parties (Second WS of M. Halbac, ¶¶ 25-55).
1048. The Tribunal has several comments on Mr. Halbac's statements. First, it is puzzling that Mr. Halbac did not mention sales of SCPs to third parties in his First Witness Statement. There Mr. Halbac referred only to the internal use of SCPs by EFDG companies (First WS of M. Halbac, ¶¶ 14-17; 81-120). Mr. Halbac did make one statement at paragraph 118 of his First Witness Statement that could potentially have referred to sales of SCPs (specifically, chocolate cream) to third parties, but this is unclear.<sup>219</sup> In any event, in his First Witness Statement he makes no mention of sugar syrup, which is a crucial aspect of the Claimants' SCP claim.
1049. Second, Mr. Halbac's statements do not prove that the Claimants had the capacity to sell SCPs to third parties at the scale assumed by Dr. Fry, Prof. Lessard and Mr. Osborne. Indeed, although Mr. Halbac's statements could support the assertion that

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<sup>219</sup> Specifically, Mr. Halbac stated that “[w]hen we extended the chocolate cream line, we were planning for future developments such as the chocolate tablet line, the cream filled biscuit line, and the bulk delivery of chocolate cream for patisseries or other food producers. However, these projects were never realized due to the fact that we lost the EGO raw materials incentive” (First WS of M. Halbac, ¶ 118).

the December 2004 expansion of the chocolate cream line was sufficient to sell chocolate cream to industrial third parties, it does not support the conclusion that this expansion gave the Claimants sufficient capacity to sell powdered sugar or sugar syrup to industrial customers.

- a. With respect to sugar syrup, Mr. Halbac states that “[b]efore the December 2004 expansion, we did not have the capacity to sell powdered sugar to industrial consumers. To prepare for these sales, we expanded our handling system with additional Reimelt and Wiener equipment. This equipment is identified in the attached diagram” (Second WS of M. Halbac, ¶ 23). However, the “attached diagram” (Exh. C-848) is an unsigned diagram in English, dated 09.04.03, that does not prove that the equipment was actually bought and installed.
- b. Similarly, neither Mr. Halbac’s statements nor the evidence cited prove that the Claimants had the capacity to sell sugar syrup to third party industrial customers. Mr. Halbac merely states that “[i]n addition to powdered sugar products and chocolate cream, EFDG planned to extend its sale of sugar syrup to third party industrial consumers. As previously stated, European Food was already selling significant amounts of sugar syrup to European Drinks for the soft drink production. These sales were processed just as they would be if European Food sold sugar syrup to a completely unrelated company, and each sale was invoiced.” (Second WS of M. Halbac, ¶ 24). There is no reference to how the 2004 expansion of the chocolate cream line could have impacted the production of sugar syrup. Perhaps the implication is that the Claimants already had that capacity. However, as stated above, European Food never did sell sugar syrup to industrial third parties. If this was such a profitable venture and the Claimants already had the capacity to do so, it is difficult to understand why they did not pursue this opportunity before. There is no credible contemporaneous evidence that the Claimants contemplated or made any preparatory work for the sale of sugar syrup or significant quantities of SCPs to third-party industrial users, be it in or outside Romania. One would for instance have expected some internal correspondence or exchanges of memos as to the abandonment or alteration of such plans in relation to the repeal of the incentives.

1050. In turn, Mr. Osborne’s position seems to be that the SCP opportunity was possible and valuable for the Claimants, and given their financial constraints he concludes that they would have “undoubtedly” pursued it. Specifically, Mr. Osborne makes the following statements:

- a. “With the EGO 24/1998 raw materials incentive in place, the Claimant Companies **could have made** additional sales of sugar-based products to industrial users of sugar outside of the Companies controlled by the individual Claimants, in the same way that it does to Companies that are controlled by the Claimants. Post revocation of the raw materials incentive however, its cost advantage in the purchase of sugar for processing into such products had been removed.” (First ER of C. Osborne, ¶ 4.25, emphasis added)



- b. “The opportunity to sell sugar-based products is not one that was ever pursued. The objective of the Micula brothers had rather been to build higher value-added businesses including manufacturing finished goods. Given the financial constraints that the Companies are now under, however, the opportunity **would have been valuable**, and **would undoubtedly have been exploited**’ (First ER of C. Osborne, ¶ 4.26; emphasis added).
  - c. “Selling intermediate sugar products to industrial customers that were not under common ownership was not the brothers’ primary strategy from the outset of the EGO 24/1998 investment programme. However, it was an **obvious potential source of significant incremental cash flow** should the risks they were taking in investing in new businesses and new facilities crystallise on the downside, as they did” (First ER of C. Osborne, ¶ 5.1, emphasis added).
  - d. “During 2004 when the EBITDA contribution of European Food and soft drinks declined, and the import duty on refined sugar was doubled to 90%, the brothers were preparing to process and sell intermediate sugar products in large quantities to third parties. **The brothers believed that this would allow them to avoid financial constraints** within the corporate Claimants, and any negative effects on the other companies they owned” (Second ER of C. Osborne, ¶ 5.2. Mr. Osborne relies here on the Third WS of V. Micula, ¶ 69, emphasis added).
  - e. “Given the value of the opportunity, as set out by LMC, it appears to me that **the natural assumption is that the opportunity would have been pursued**, at least at the point at which it became important to the financial well-being of the Companies” (Second ER of C. Osborne, ¶ 5.6).
  - f. “The EGO 24/1998 incentives allowed the corporate Claimants to sell intermediate sugar products to industrial customers. In fact sales of such products were only ever made to companies under common ownership, but **there was scope to sell to third parties had the need arisen**. This could have been highly cash generative, especially towards the end of the original incentives period after Romania’s accession to the EU” (Second ER of C. Osborne, ¶ 7.28).
1051. The Tribunal cannot accept Mr. Halbac’s or Mr. Osborne’s statements as proof with sufficient certainty that the Claimants would have in fact sold SCPs to third parties. Even if the Claimants had the capacity to do so, capacity alone does not provide sufficient certainty that an opportunity would have been pursued and that it would have been profitable. Nor can Mr. Osborne’s assertions as to the reasonableness of this plan establish with sufficient certainty that the Claimants would have in fact pursued the SCP opportunity. Reasonable and viable as it may have been, Mr. Osborne is only speculating. In the Tribunal’s view, this does not meet the standard of sufficient certainty. Excellent prospects of profitability may contribute to prove that an opportunity would have existed, especially from the vantage point of retrospective view rather than actual prediction, but this is still a far cry from demonstrating that this opportunity could and would have been availed of.

1052. The Tribunal is likewise not persuaded by the Claimants' explanations for the lack of documentary evidence. Relying on Mr. Boulton, the Claimants argue that it is "completely unrealistic" to treat the EFDG companies as though they are quoted public companies with documents prepared for every single decision, plan and aspect of the business. Although this may be true, this does not dispense with the requirement of proving their lost profits case with sufficient certainty. The Claimants also quote Prof. Lessard, who stated that "as an economic matter, the fact that Claimants invested to develop this capacity and the related product standards and permits is stronger evidence of their intent than would be internal memoranda, corporate resolutions, or other formalities" (Second ER of D. Lessard, ¶ 57). The Tribunal also accepts that in theory this could be true. However, it has found no convincing evidence that the Claimants indeed invested specifically with the purpose of developing this capacity. Although there is evidence that they invested to expand the chocolate cream line, it is unclear whether this gave them the capacity to sell SCPs (especially sugar syrup and powdered sugar) to industrial third parties at the scale that they allege. And even if they had this capacity, this is not in itself proof that they intended to produce different types of SCPs in large quantities to sell to industrial third parties.
1053. The Tribunal is also troubled by the fact the timing of the alleged SCP opportunity. In particular, if this opportunity was so attractive, why did the Claimants not pursue it earlier?
1054. The Claimants argue that there are "proper explanations as to why the SCP opportunity was not pursued prior to the unlawful premature revocation of the Incentives" (C-PHB, ¶ 167). According to the Claimants:
- a. The evidence shows, and both Professor Lessard and Mr. Osborne explained during the course of the hearing, that the reason why the SCP opportunity became attractive at the start of 2005 is that the customs duties on sugar doubled at about that time (Exh. C-805; Tr., Day 8, 22 (Lessard); Tr., Day 10, 67 (Osborne); Second ER of D. Lessard, Exhibit A).
  - b. As explained by Mr. Osborne, the SCP opportunity, being reliant on the Raw Materials Incentive, was not a long-term business proposition but instead was helpful for cash generation. The suggestion seems to be that it was not necessary to pursue it before the Claimants became cash constrained (Tr., Day 10, 67-68 (Osborne)).
  - c. Mr Osborne also explained that as the financial ratios of the European Food and Drinks Companies were starting to decline by 2005 (though they were not poor), the SCP opportunity and its ability to be highly cash generative became more attractive (Second ER of C. Osborne, ¶ 5.2).
  - d. Additionally, it was only after the expansion of the Claimants' sugar production facilities was completed in December 2004 that the Claimants had sufficient

capacity to produce and sell SCPs to industrial third parties in addition to selling their private label goods (Second WS of M. Halbac, ¶ 23).

1055. The Tribunal has the following comments:

- a. First, if the SCP opportunity only became attractive in 2005 because of an increase in customs duties, it can hardly have been part of the Claimants' original plan. Thus, there was no ongoing investment plan that was frustrated by revocation.
- b. Second, by 2005 revocation had already been announced. Thus, the SCP opportunity cannot be said to have properly existed pre-revocation.
- c. Third, the expansion of the chocolate cream line (which purports to serve as intention of pursuing this opportunity) was made in December 2004. If the SPC opportunity only became attractive in 2005 because of an increase in customs duties in 2005, the purpose of the chocolate cream line expansion must have been other than pursuing the SCP opportunity. Indeed, Mr. Halbac asserts that this had been planned as early as 2002 (see Second WS of M. Halbac, fn. 8 at ¶ 19).

1056. In view of the above, there does not appear to be in the record sufficient evidence of existing and concrete plans rather than, in the most favorable hypothesis for the Claimants, some general speculations that the Claimants might have gone into such sales if certain events would have materialized. In addition, at best, this opportunity appears to have been thought of when the revocation became imminent, as a life saver of sorts to help the Claimants out of financial distress, a mitigating measure to obtain cash flows in times of financial constraint. Indeed, Mr. Osborne's comments cited at paragraph 1050 above seem to suggest this. This is also confirmed by the following statements by Mr. Osborne:

"1.13 My own view remains that the Claimants had the ***motive, the means and the opportunity*** to generate significant profits from expanding the sales of intermediate sugar products. As I have said, the existence of the opportunity does not appear to me to be contested; and Professor Lessard has dealt with the question of whether the Claimants had the means to take advantage of that opportunity.

1.14 The fact that the Claimants had not done so, prior to revocation, goes in my view to the question of *motive*. Mr Ellison suggests that it is odd that the "quasi-arbitrage opportunity" was not pursued, prior to revocation, given the high profits apparently available and the low associated risk.

1.15 I do not find it odd: nothing in the history of the Claimants' operations in Romania suggests to me that the Claimants were motivated to maximise either short-term profitability or personal gain; and all of the interactions that I have had during the course of multiple site visits have suggested the reverse – that they were motivated primarily to build a long term, sustainable business.

- 1.16 For much of the period up to revocation, ***that motivation would not have been compatible with the exploitation of the opportunity to expand sales of intermediate sugar products.*** Once the Claimants started to become financially constrained, however, the motivations would have been precisely aligned, since the survival of the underlying and potentially sustainable business would have been at stake.
- 1.17 To repeat a point that I have made before, it appears to me that ***the natural assumption is that the Claimants would have taken advantage of the opportunity, as soon as it became expedient or necessary to do so.*** As I demonstrate in Section 6 of this report, ***it did indeed become necessary, for reasons connected with the scale of the investments undertaken by the Claimants.***"

(Second ER of C. Osborne, ¶¶ 1.13-1.17).

1057. The Tribunal cannot accept Mr. Osborne's conclusions as sufficient evidence of intent to pursue the SCP opportunity. Even if the Claimants had the motive, the means and the opportunity to generate profits from expanding the sales of SCPs to third parties, this does not provide sufficient certainty that, but for the revocation, the Claimants would in fact have engaged in the sale of SCPs to third parties. Absent other convincing evidence in this respect, the Tribunal dismisses this claim.

**d. Lost profits incurred as a result of the Claimants' inability to complete the Incremental Investments**

**i. Overview of the Parties' positions**

1058. The Claimants' primary expectation damages case (Method A) is premised on the existence of an alleged ten-year plan to capitalize on the incentives and to complete an expanded manufacturing platform that would have performed profitably after the incentives expired (C-PHB, ¶ 97). This platform allegedly included a malt manufacturing plant, a can manufacturing plant, and a co-generation plant (which the Claimants collectively call the "Incremental Investments"). As part of Method A, the Claimants claim the profits that these Incremental Investments would have generated but for the revocation.

1059. There is no dispute that the Claimants never implemented the Incremental Investments. The Claimants are requesting, in their own words, "damages for lost cash flows that Claimants expected to receive from certain projects that they intended to implement as part of their business plan, and would have implemented, but for the premature revocation of the incentives" (C-Reply, ¶ 595, emphasis in original). Specifically, the Claimants claim:

- a. RON 28 million in lost profits from the inability to complete a **malt manufacturing plant**. They base this claim on Prof. Lessard's first and second reports (First ER of D. Lessard, ¶¶ 97-99, Fig. 22, Table 7; Second ER of D. Lessard, ¶¶ 99-103, 113-122, Fig. 16), the evidence cited in those reports, including Mr. Halbac's two witness statements, and the figures contained in Updated Summary of Damages Separating Interest (in RON), Tab 2 of Mr. Schwartz's Opening Presentation;

- b. RON 720.4 million in lost profits from inability to complete a **can manufacturing plant**. The Claimants base this claim on Prof. Lessard's first and second reports (First ER of D. Lessard, ¶¶ 105-110, Fig. 23, Table 9 and 10; Second ER of D. Lessard, ¶¶ 104-107, 113-122); Prof. Steenkamp's Expert Report, including Table 15; the evidence cited in those reports, including Mr. Halbac's two witness statements, and the figures contained in Updated Summary of Damages Separating Interest (in RON), Tab 2 of Mr. Schwartz's Opening Presentation.
  - c. RON 712.6 million from the inability to complete a **co-generation plant**. They base this claim on Prof. Lessard's first and second expert reports (First ER of D. Lessard, ¶¶ 100-104 Table 4; Second ER of D. Lessard, ¶¶ 108-111); the evidence cited in those reports, including Mr. Baciú's witness statement, and figures contained in Updated Summary of Damages Separating Interest (in RON), Tab 2 of Mr. Schwartz's Opening Presentation.
1060. The Claimants assert that they had planned to implement the Incremental Investments, and had in fact taken steps towards their implementation, but the revocation of the incentives deprived them of both the cash and financing leverage necessary to "complete" these Incremental Investments. Relying on the principle of full reparation enshrined in Article 31 of the ILC Articles, as articulated by the PCIJ in the *Factory at Chorzów* case, the Claimants' argument is that, but for the revocation, they would have implemented the Incremental Investments; consequently, to put them back in the position they would have been but for the revocation, the Tribunal should award them the future net cash flows that these plants would have generated.
1061. The Respondent contends that the Claimants have failed to prove with reasonable or sufficient certainty their claims for lost profits related to the Incremental Investments.
1062. First, the Respondent argues that there is no proof that the Incremental Investments would have been undertaken at all. The Respondent notes that Prof. Lessard, despite multiple site visits, meetings with the Claimants' employees, and having relied on much of the information provided by the Claimants, testified that he considered the Incremental Investments to be merely "plausible" (by which he appeared to mean that they would have made "economic sense"), but was unwilling to characterize them as "probable" (Tr., Day 8, 40-2), which the Respondent argues is the minimal standard under international law. Contrary to the Claimants' suggestion, the Respondent denies that all that remained was to "complete" the Incremental Investments. The Respondent argues that to make this assertion the Claimants have mischaracterized the documentary evidence and manipulated witness testimony.
1063. Second, even if there was no doubt that the Incremental Investments would have been undertaken, the Respondent submits that the Claimants cannot meet the sufficient certainty standard to establish that they would have been profitable, or what would have been the level of such projected profits, because the Incremental Investments were not going concerns and had no proven record of profitability. As noted above, the Respondent submits that international law precludes any award of prospective damages for projects that have not commenced, and that the reasonable

certainty standard cannot be satisfied in the absence of a going concern and a proven record of profitability.

1064. In addition, the Respondent argues that the Claimants have failed to prove that the revocation of the incentives was the dominant or proximate cause of their failure to implement the Incremental Investments. The Respondent argues that the financial distress that allegedly prevented the Claimants from implementing the Incremental Investments is attributable to causes other than the revocation of the incentives.

**ii. The Tribunal's analysis**

1065. For the reasons set out below, the Tribunal rejects the Claimants' claims for lost profits allegedly incurred as a result of their inability to complete the Incremental Investments. It is undisputed that none of the facilities that would have allegedly generated the lost profits claimed (i.e., the malt plant, the canning plant and the co-generation plant) existed in their complete, revenue-generating form at the time of revocation. Instead, the Claimants claim that they intended to build these facilities, and that these facilities were at various stages of completion. The Claimants also argue that the Incremental Investments were consistent with their integrated business model, and submit this as further proof of their intention to complete these facilities. However, after an analysis of the record, the Tribunal finds that the Claimants have failed to prove with sufficient certainty that they would have indeed implemented the Incremental Investments that serve as the basis for this lost profits claim.
1066. In the following sections, the Tribunal addresses the evidence and arguments submitted by the Claimants with respect to each of the Incremental Investments, as well as their general arguments with respect to their integrated business model and advance planning for the Incremental Investments.

*(a) The Claimants' integrated business model – Advance planning for the Incremental Investments*

1067. In support of their intention to implement the Incremental Investments, the Claimants contend that the Incremental Investments were necessary to the success of the Claimants' overall business model, which they argue was designed to take advantage of the incentives' ten-year duration to build out a manufacturing platform that would be sustainable upon the expiry of the incentives in 2009. The Claimants argue that the Incremental Investments were tied to the brewery, which they claim was also an integral part of their plan for retaining profitability beyond the expiry of the incentives in 2009, because beer was not as dependent on the incentives as their soft drinks or food business. Specifically, they argue that:
- a. The malt manufacturing plant would have improved the cost effectiveness of the brewery, improving the Claimants' competitiveness in the beer market;
  - b. The can manufacturing plant would have permitted the Claimants to competitively expand their beer sales into the private label market; and

- c. The co-generation plant would have capitalized on the brewery's waste products to reduce the Claimants' overall energy costs and improve the Claimants' cost and price competitiveness. It would have also provided revenue from the sale of energy and green certificates to third parties.

(C-PHB, ¶ 171; Second ER of D. Lessard, ¶¶ 7-8; First and Second WS of S. Baciú).

1068. The Claimants contend that their model was driven by both the ten-year term of the incentives and the 20-year obligation to continue operations in the disfavored region imposed by EGO 24 (C-PHB, ¶¶ 172-173). This assertion is supported mainly by:
  - a. Mr. Ioan Micula's oral testimony, where he states that their strategy after 1999 was "to use the temporary facilities for ten years to turn them into permanent advantages. [...] By way of these temporary facilities, we tried in fact to turn them into permanent standing facilities by building up those components of the equipment that could be used after termination of the facilities" (Tr., Day 3, 33-35 (I. Micula)).
  - b. Prof. Lessard's description of the Claimants' business model, which he explains "involved a high degree of commitment [...] because the Claimants had to build factories and produce successful products well within the ten-year period that the Incentives were available in order to create a base that would sustain their activities for the ten years they were obligated to remain in business after the Incentives expired" (First ER of D. Lessard, ¶ 39).
1069. The Claimants argue that these facilities made economic sense in the context of their integrated platform and would have been easy to "plug in" to that platform. Through the witness testimony of Mr. Halbac (and to a lesser extent, Mr. Baciú), the Claimants claim that their infrastructure was engineered in such a way that new production facilities could be easily connected to it.
1070. Mr. Halbac explained (and the Respondent did not dispute) that the region in which the Claimants invested did not have the infrastructure in place to support large production facilities. As a result, it was necessary to invest heavily in basic utilities such as reliable electricity, gas, and water supply to support each of the production sites (First WS of M. Halbac, ¶ 45). Mr. Halbac asserted that the basic utilities were built on a larger scale than the companies needed at that time due to the obligation under the EGO 24 to maintain the investment for 20 years, and because the Claimants wanted to make use of the networks for future projects. As a result, the infrastructure was engineered in such a way that it could be easily connected to new production facilities (First WS of M. Halbac, ¶ 46).
1071. In his First Witness Statement, Mr. Halbac included diagrams showing the integration of the different facilities. He stated that the dashed lines in the diagrams "represent investments that EFDG has not completed, but that could have been easily integrated into EFDG's existing utility connections, had early revocation of the EGO 24 incentives not constrained our cash" (First WS of M. Halbac, ¶ 50). He also testified that "[t]he ability of EFDG to engineer and construct utility networks was absolutely

critical, since the State did not provide these utilities for us. We planned ahead and built these networks so that they could support additional production capacities, and as a result, we have been able to expand our facilities fairly easily. This also means that the projects we have been unable to complete could be easily added to our existing network. Thus, EFDG's initial planning for the shared infrastructure has saved considerable amounts of money, because the infrastructure does not have to be duplicated at each site. These cost savings have been invested in the expansion and integration of the business" (First WS of M. Halbac, ¶¶ 60-61).

1072. On the basis of Mr. Halbac's testimony and other evidence in the record, the Tribunal has no reason to doubt that the Claimants built a highly integrated platform that allowed them to save costs if they decided to insert new product lines or plants. However, this does not provide sufficient certainty that the Claimants would have in fact built a malt plant, a can manufacturing plant and/or a co-generation plant. This finding is in line with the general pattern of conduct evinced by the Individual Claimants and the EFDG: they built up and expanded their businesses with foresight, with the intent always to preserve as many options as possible and keep flexible in order to be able to seize those opportunities which would actually materialize at the right time depending on market conditions and financial possibilities, among other considerations. This speaks for the fact that the two Individual Claimants are savvy and experienced business people, which their very success also establishes, but it does not prove that they would actually have embarked on all of the options that they had envisaged at one point or another.
1073. Indeed, there is virtually no contemporaneous evidence of advance planning for any of the Incremental investments. There are no specific feasibility plans for any of the plants, nor is there any record of them in the 2000, 2002 or 2003 PWC business plans (Exh. R-204, R-214 and R-215). Other than a few quotes and invoices, the Claimants have not been able to point to any internal documents, such as budget, memos or correspondence evidencing their intention to build these plants. This is particularly surprising considering that Mr. Halbac testified that EFDG had a "development department" specifically created to reduce costs associated with future investments (First WS of M. Halbac, ¶¶ 20-34). According to Mr. Halbac, this development department consisted of a group of engineers that "cover virtually every aspect of any investment, including mechanical engineers, architectural engineers, electric engineers, civil engineers, structural engineers, and even engineers who focus solely on plumbing" (First WS of M. Halbac, ¶ 21). Mr. Halbac also testified that for each new project, this department organized a team of project managers responsible for the optimum realization of the investments, starting from the initial contracts. Mr. Halbac even included a diagram titled "EFG Plant Building" (First WS of M. Halbac, p. 13) illustrating "EFDG's planning and implementation process for new investments". However, despite the existence of this team of engineers and highly organized and structured process, there is not a single internal plan, memo or email documenting the Claimants' intention to pursue the Incremental Investments.
1074. As discussed in detail in the sections that follow, the documentary evidence in the record refers mainly to correspondence with and quotations from third parties for



equipment necessary to develop these projects. Although it does evidence an interest in these projects as potential investments, it does not prove that the Claimants would have in fact invested in them.

1075. Despite this lack of evidence of advance planning, the Claimants contend that they in fact took steps to materialize the Incremental Investments, which in their view shows that they intended to pursue them (indeed, they argue that only final steps were needed to complete them). The Claimants argue that they were a family-run business that took decisions verbally and did not usually operate on the basis of written plans. They submit that the development of the brewery is evidence of this, because it was built despite the absence of written plans and despite the fact that it was not mentioned in the 2000 or 2003 PWC business plans. Indeed, they point out that according to the 2003 PWC business plan, no major capital investment was planned or needed over the period 2003 to 2007, and despite that statement, the Claimants' heaviest capital investments occurred from 2003 to 2007 (including the expansion of the brewery) (C-PHB, ¶ 179). The Tribunal has duly considered this argument. However, as discussed below, it finds that the steps identified by the Claimants as evidence of their intention to implement the Incremental Investments do not show with sufficient certainty that these investments would in fact have been undertaken.

*(b) The malt manufacturing plant*

1076. Mr. Halbac testified that, because malt is one of the main ingredients used in beer production, "we had been exploring options for building a malt plant ever since we considered building the brewery. This is because we knew that we could realize significant cost savings if we produced our own malt instead of importing or buying it on the domestic market" (First WS of M. Halbac, ¶ 145).
1077. However, in his Second Witness Statement Mr. Halbac clarified that the plans to construct or complete the malt plan were not immediate. Although he stated that the Claimants always considered the malt plant as a portion of their brewery, he clarified that they "would complete [it] at a critical point in time to increase the brewery's overall efficiency" (Second WS of M. Halbac, ¶ 57). He also stated that at the time that the Claimants constructed the initial stages of the brewery (and later its expansion), it was "unnecessary for [the Claimants] to construct a complete malt plant." This was because they were still benefitting from EGO 24 and could import malt without paying customs duties. However, he added that "we knew that these Incentives would not last forever, and that it would be important for us to make preparations for the malt plant so that we could eventually control our malt production and not rely on outside sources for the main ingredient to one of our most successful products – beer" (Second WS of M. Halbac, ¶ 60). This suggests that the Claimants may have been considering the construction of a malt plant from early on, but they did not specifically plan to build one at any particular time until the expiry of the incentives was near.

1078. The documentary evidence suggests that the possibility of building a malt plant was indeed considered by the Claimants from at least 2002. There is evidence of correspondence with Buhler and Schmidt-Seeger for the construction of a malt plant during 2002,<sup>220</sup> including quotations for malt plants of various capacities (Exh. C-335; C-659; C-628; C-658; C-336<sup>221</sup>). However, the Claimants do not appear to have acted upon these quotations.
1079. Mr. Halbac testified that, at the time of the revocation, the Claimants already had many of the necessary components for a malt plant, including equipment for barley reception, silos for barley, transport, conveying, and cleaning systems for barley, utilities including steam supply, water, water treatment, compressed air, electrical, and cooling systems, malt transport, cleaning, and silos for storing malt (First WS of M. Halbac, ¶¶ 146-151, Second WS of M. Halbac, ¶¶ 57-65; Tr., Day 7, 141-144). According to Mr. Halbac, this accounted for 60% of the malt plant (Second WS of M. Halbac, ¶ 61). Mr. Halbac testified that the only missing elements were the germination equipment, construction of the actual building and final connection of utilities to finish the integration into the brewery (Second WS of M. Halbac, ¶¶ 61-65; Tr., Day 7, 143-144). He also testified that Claimants had taken steps to acquire these missing elements, including the finalization of a contract to purchase the germination machine and negotiations with the EBRD for the necessary financing.
1080. The Respondent denies that the malt manufacturing plant was nearly finished, as the Claimants claim. It notes that the Claimants never bought a germination machine, which was the central component of the malt plant (R-PHB, ¶ 259). The Respondent also argues that the Claimants have sought to pass off infrastructure and equipment used for other manufacturing processes as specifically meant for the malt plant. In particular, the Respondent argues that the empty silo that Mr. Halbac testified was reserved for barley was in fact constructed before EGO 24 (Mr. Halbac testified it was built before 2000) and could have been used for other purposes than storing grains for a malt plant (R-PHB, ¶ 260 and Tr., Day 7, 169 (Halbac)). The Respondent also asserts that Mr. Halbac<sup>222</sup> admitted that the transportation system for malt was in fact used for malt purchased from third parties (R-PHB, ¶ 260 and Tr., Day 7, 148 (Halbac)).
1081. The Tribunal's review of the documentary evidence confirms that, at the time of the revocation of the incentives, the Claimants did indeed have the components identified by Mr. Halbac. However, the Claimants have not established that any of those

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<sup>220</sup> Although Mr. Halbac testified that their "first offer for equipment came from Seeger in 1997", that offer was not submitted.

<sup>221</sup> Exh. C-335 is a quotation dated 19 March 2002 from Schmidt-Seeger for a malt plant with a capacity of 23,000 tons; Exh. C-659 is an email from Buhler dated 19 March 2002 with an attached quotation for a malt plant with a capacity of 35,000 tons; Exh. C-628 is an email from Buhler dated 22 April 2002 mentioning the layout (sent by a previous email) for a malt plant with a capacity of 35,000 tons; Exh. C-658 is an email from Buhler dated 2 August 2002 attaching a revised quotation for a capacity of 22,960 tons worth over €3,9 million but with the possibility of extension to 34,440 tons; and Exh. C-336 is a quotation from Schmidt-Seeger dated 4 November 2002 for the establishment components of a malt plant with a capacity of 37,000 – 50,000 tons.

<sup>222</sup> The Respondent refers to Mr. Baciu, but the citation is to Mr. Halbac's testimony.

components were purchased exclusively for a malt plant. Indeed, many of them appear to have been for the brewery's normal operation. In particular:

- a. The Claimants appear to have bought malt handling equipment, including silos and conveyor systems in 2004 (Exh. C-970 contains invoices dated November 2002 from Schmidt-Seeger), and invoices dated November 2004 from Privé and Denis (Exh. C-967-968).<sup>223</sup> However, it is unclear whether this equipment was bought in connection with a malt *manufacturing* plant, rather than malt *handling* related to a brewery. As the Respondent notes, Mr. Halbac testified at the hearing that the silos and conveying systems were also used for other grains, although the silo reserved for barley was empty (Tr., Day 7, 145-148). Mr. Halbac also stated that the transportation system could be used for both malt and barley, but he also testified that the transportation system "was conceived to fit the malt plant", and in the absence of the malt plant to process the barley it was being used to transport malt only (Tr., Day 7, 146-148 (Halbac)).
- b. With respect to utilities, Mr. Halbac testified that when the Claimants built the brewery they constructed a steam pipeline with sufficient capacity to supply both the brewery in its expanded form (which would account for 50% of the pipeline's capacity), and the malt and can manufacturing plants (which would account for the remaining 50% of the pipeline's capacity) (Tr., Day 7, 149-153 (Halbac); Exh. C-647, a certificate of completion of the steam pipe).

1082. Even if this equipment had been intended exclusively for the malt plant (which the Tribunal finds has not been established), it is undisputed that the Claimants were missing key elements for a malt plant, in particular the germination machine and the building. Although there is evidence in the record to support the Claimants' assertion that they intended to buy a germination machine and construct the building to house the malt plant, most of this evidence post-dates the revocation of the incentives. In particular:

- a. Mr. Halbac testified that the Claimants had purchased land in 2000-2001 with an estimated value of €1 million, which they set aside for the malt plant (Second WS of M. Halbac, ¶ 62), and that the Claimants had "gained approval from the State to construct the building" (Second WS of M. Halbac, ¶ 62). Indeed, the Claimants submitted an Urban Planning Certificate that certifies that the land it refers to may be used to build a malt plant (Exh. C-976), but this certificate was issued on 5 Dec. 2005 (i.e., post-revocation). The certificate also states that it is not in lieu of the relevant building permit.
- b. Mr. Halbac referred to a geotechnical study conducted by the Claimants for the malt plant (Second WS of M. Halbac, ¶ 62). This study is indeed in the record (Exh. C-978), but it is dated "2005", which means it was carried out after the announcement of the revocation in November 2004.

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<sup>223</sup> Exh. C-970 contains invoices dated November 2002 from Schmidt-Seeger), and Exh. C-967-968 contain invoices dated November 2004 from Privé and Denis.

- c. Mr. Halbac also testified that the Claimants had ordered the structural building design to the Romanian company IPROLAN (Second WS of M. Halbac, ¶ 63). However, the engineering design contract with IPROLAN (Exh. C-704) is dated 19 June 2006, more than a year after the revocation.
- d. Mr. Halbac also testified that the Claimants had a contract in place with Lausmann GmbH for the germination machine (Tr., Day 7, 149 (Halbac); Exh. C-478). At the hearing, the Claimants stated that the document only concerned a germination machine (Tr., Day 7, 172 (Fleuriet)). However, this contract appears to involve more than just a germination machine, as Article 1.1 of the contract mentions a “complete malt producing plant, spare parts, wear parts and accessories as described in the Appendix 1”, which in turn includes, among others, steeping, cleaning, kilning and transport equipment. In addition, the contract post-dates the revocation (Exh. C-478).<sup>224</sup>
- e. Finally, the record confirms that in the Claimants’ negotiations with the EBRD for a potential loan referred to financing for the “potential acquisition, installation and operation of a malt processing plant with a capacity of 30,000 tons” (Exh. C-744, C-745, C-746).<sup>225</sup> However, these documents are from 2006, and therefore post-date the revocation.

1083. The Tribunal’s conclusion from the available evidence is that the Claimants contemplated the possibility of building a malt plant from at least 2002, and invested in certain cost efficiencies that they added to the brewery. They also planned ahead with respect to utilities, making sure that the steam pipe could service the brewery as well as future plants. However, they did not plan to build a complete malt manufacturing plant (i.e., a plant that could process barley into malt rather than handle ready-made malt) until close to the expiry of the incentives, presumably because prior to that it was cheaper for them to import duty-free malt. This would explain why their more serious efforts to set up this plant (financing with the EBRD, geotechnical study, contract for germination and other equipment) came in 2005 and 2006, after the early revocation of the incentives.

1084. In the Tribunal’s view, this means that, although there is evidence of the Claimants’ intention to build a malt manufacturing plant sometime in the future, the Claimants have not proven with sufficient certainty that they planned to build it prior to expiry of the incentives (whether by their early revocation in 2005 or their scheduled expiry in 2009). Nor is it accurate to say that at the date of the revocation the Claimants had built 60% of a malt manufacturing plant. At the date of the revocation, the Claimants could only boast certain minor equipment and cost efficiencies that would have made it relatively easy and less expensive to construct and operate a malt manufacturing plant. What they had was a highly integrated platform to which a malt plant could

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<sup>224</sup> On its front page, the contract is dated 6 July 2005, but the final price appears to have been negotiated in December 2006 (the date “19.12.2006” is handwritten in Appendix 1 next to the final negotiated price (€ 4.425 million))

<sup>225</sup> Although the Claimants argue that negotiations with EBRD involved financing of a “germination machine”, the EBRD documents refer to a full “malt processing plant”.

easily have been added. This would prove again that the Claimants are savvy business people. This does not provide sufficient certainty that, but for the revocation of the incentives, they would have built a malt manufacturing plant.

(c) *The can manufacturing plant*

1085. With respect to their intention to build a can manufacturing plant, the Claimants again rely heavily on Mr. Halbac's testimony.
1086. Mr. Halbac testified that it is very expensive to buy and transport aluminum cans, while it is much cheaper to transport the raw materials needed to produce the cans. He further testified that EFDG had always understood that they would save money by importing raw materials to make their own cans. "Thus, ever since we started considering a brewery, we planned to construct a nearby can making facility." (First WS of M. Halbac, ¶¶ 156-157).
1087. Mr. Halbac also testified that "[t]here is a significant canned beer market in both the Romanian and export markets", and that while the Claimants were building the brewery, they "became even more interested in the prospect of having [their] own can plant" (First WS of M. Halbac, ¶ 162). In addition, Mr. Halbac stated that by reducing the can costs, they could reduce the price for which they sold their canned beer to about the same price as their PET bottled-beer, which would have made them more competitive in both the domestic and export beer markets by increasing their shelf space, which would have in turn increased sales to consumers (First WS of M. Halbac, ¶ 168). Mr. Halbac also testified that canned beer has a better shelf life than PET bottled beer and is cheaper to transport, which is why it was their preferred method of bottling for their export beer (First WS of M. Halbac, ¶ 169).
1088. The evidence in the record suggests that the Claimants did begin to consider building a can plant as early as 1998. Specifically, Mr. Halbac testified that in 1997/1998, the Claimants contacted various American companies to investigate the relevant technologies and visited a trade show in Denver and production facilities (First WS of M. Halbac, ¶ 158). The correspondence submitted as Exh. C-844-846 refers to meetings with Mr. Halbac in 1998 at the vendors' respective booths at "Cannex '98" in Denver, Colorado. Mr. Halbac testified that the Claimants "continued to receive and study vendor proposals" (First WS of M. Halbac, ¶ 162), and indeed, the record includes correspondence and quotations related to, inter alia, a turn-key canning plant and can manufacturing equipment and accessories (Exh. C-337, C-844, C-845, C-856, C-847).<sup>226</sup>

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<sup>226</sup> Exh. C-337 contains a proposal from Pac International to Rien Drinks, dated 20 May 1998. The detailed quotation concerns a turn-key canning plant offered for a price of over \$2.6 million. Exh. C-844 is a letter of 18 May 1998 from Cambridge Applied Systems, Inc. (US), to Mr. Halbac concerning requested information on viscometers. Exh. C-845 is a letter 5 June 1998 from Kerry (UK) to Mr. Halbac with an offer for a "Kerry Seam Plus Station". Exh. C-846 is a letter of 30 June 1998 from Chemetall (Sweden) to Mr. Halbac concerning, i.a., can washer treatments. Exh. C-847 is a letter of 9 July 1998 from Omnitech International, Inc. (US), to Mr. Halbac with an offer for can manufacturing equipment and accessories offered at a price of \$19.2 million.

1089. Efforts to find suppliers appear to have continued in the following years. Mr. Halbac testified that “[t]o determine whether the can plant was a viable option, our engineers attended a variety of symposiums and expositions. For instance, in 2002, we visited the Metpak exhibition in Essen, Germany to find possible suppliers for the can plant. After this exhibition, we decided we would construct the can plant after the brewery was complete.” (First WS of M. Halbac, ¶ 162).
1090. The Claimants also refer to Exh. C-388, C-339 and C-343, which are quotations from 2006-2008 in relation to a can manufacturing plant. In particular, the Claimants appear to have engaged in negotiations with TG Can which included the possibility of financing of supply credit (Exh. C-339; Tr., Day 7, 168 (Halbac)).
1091. In addition to the documents cited above, the Claimants argue that their intention to build a can manufacturing plant is supported by the fact that they took certain steps and made investments in preparation for this plant. At the hearing, Mr. Halbac testified that about 50% of the can manufacturing plant had been either built or purchased (Tr., Day 7, 166). Using as an example an offer from PAC International for a turnkey can manufacturing facility (Exh. C-337), Mr. Halbac testified that the Claimants had already completed the following elements of the plant: support systems equipment area, warehousing, utility and steam supply systems, demineralization system, cooling and hot water systems, compressed air system, waste water treatment, electrical shop and quality control lab equipment, chemical storage, machine shop, and specialized can printing and labeling equipment (Tr., Day 7, 156-159 (Halbac)). According to the Claimants, the only missing elements to complete the can plant were the building (Tr., Day 7, 157 (Halbac)), and the can manufacturing machines for producing the aluminum cans (Tr., Day 7, 165 (Halbac)).
1092. As with the malt plant, the Respondent denies that any of these alleged steps or investments support the Claimants’ intention to build a can plant. The Respondent argues that the Claimants have sought to pass equipment used for other manufacturing processes as evidence of a nearly completed can plant, although the most basic components of the plant were missing (R-PHB, ¶¶ 262-264).
1093. In the Tribunal’s view, although there is evidence suggesting that the Claimants indeed contemplated the possibility of building a can manufacturing plant, the evidence of concrete plans or specific steps taken to materialize this project is weak. The documentation cited above shows that the Claimants had an interest in purchasing elements for a can manufacturing plant, but it does not prove that they seriously planned to purchase them, in particular considering that this interest did not materialize within an almost 10-year span.
1094. Similarly, while there is evidence to support Mr. Halbac’s assertions that the Claimants already had many components necessary for building a can plant, most of these components appear to refer to shared utilities, land or facilities. Specifically:
- a. As mentioned above for the malt plant, Mr. Halbac testified that the steam pipe was built with an expanded capacity, so that 50% was reserved for the can and

malt facilities (C-PHB, ¶ 196 and Tr., Day 7, 152-153 (Halbac); Exh. C-649). In other words, it was not built specifically for the can plant.

- b. Mr. Halbac also testified that, in late 1999, the Claimants set aside approximately 50,000 square meters of land for a can factory (Second WS of M. Halbac, ¶ 80). There is little evidence in the record of this land other than a photograph that was shown during the 2010 hearing. It is also unclear whether this land was purchased especially for the can plant. In his first witness statement Mr. Halbac had testified that the Claimants had available land located next to the brewery in Drăgănești West, which made sense because it would have allowed the canning plant to utilize EDFG's existing infrastructure and become integrated with the rest of the plants, and they would use a significant number of the cans to bottle beer from the brewery (First WS of M. Halbac, ¶ 164). The timing of this step and the absence of purchase documentation suggests that reserve land was indeed available but not that specific investments were made to acquire the land in connection with the can plant.

1095. That being said, some equipment appears to have been bought with the can plant in mind, although again it is unclear if the equipment could also be used in other manufacturing processes. Specifically:

- a. Mr. Halbac testified that the grinding machine at the repair shop was purchased in 2002 especially for the can manufacturing plant (Tr., Day 7, 161-163). However, it is unclear why this machine was bought in 2002 if no can plant existed at the time. It is also unclear whether it was also used in other manufacturing processes.
- b. Mr. Halbac testified that "one of the most difficult processes in can making is the design and production of the printing plates – which they have been able to do since 2000." (Second WS of M. Halbac, ¶ 90). For this purpose, the Claimants argue that they invested heavily in can printing plates and production equipment as well as film printing machines for the labeling of cans (C-PHB, ¶ 196). The Claimants submitted invoices to support this (Exh. C-951, C-946, C-942). Some of these invoices are from 1998 and pre-date the construction of the brewery, so it seems unlikely that the equipment related to beer cans. The Respondent also argues that machinery used to manufacture and wash printing plates could be used to print on cans, but was acquired and used in the Claimants' business to produce other types of packages (R-PHB, ¶ 262). However, Mr. Halbac testified that "[o]ne of the machines is equipped so as to be able to produce special plates for cans....So we bought that type of machinery instead of the cylindrical one in order to be able to manufacture plates for the cans as well" (Tr., Day 7, 171 (Halbac)). Mr. Halbac also testified that no one sold unprinted cans, so they could not have used the plates to print on purchased cans as suggested by the Respondent (Tr. Day 7, 171-172 (Halbac)).
- c. Mr. Halbac also testified that in 2003, allegedly anticipating a can making line being constructed in Drăgănești, EDFG invested €128,000 in the relocation of its

can filling line to Drăgănești. An offer from Krones for new can conveyor equipment offered at a price of €120,000 was apparently accepted in this regard (Exh. C-644).

1096. Despite the purchase of this equipment, the Tribunal is not persuaded that the can plant project was 50% complete, as the Claimants assert, or that it was seriously planned by the Claimants. Even if this equipment was purchased with a possible can plant in mind, the Claimants were also using it for other purposes. In addition, the relocation of the can *filling* line does not necessarily imply that a can *making* line will be subsequently built. More importantly, it is undisputed that the Claimants never purchased the can manufacturing machines for producing the aluminum cans. As a result, the Tribunal finds that the Claimants have not proved with sufficient certainty that but for the revocation they would have built the can manufacturing plant.

(d) *The co-generation plant*

1097. Mr. Baciú and Mr. Halbac testified that from early on EFDG intended to build a co-generation plant to reduce internal operational costs. The co-generation plant would accomplish this by reducing EFDG's dependence on outside fuel, reducing energy costs, and using waste from the company's production processes (First WS of S. Baciú, ¶ 18; First WS of M. Halbac, ¶¶ 56-59). Mr. Baciú also testified that after Romania passed renewable energy laws in 2004, EFDG's intention was to produce energy to sell electricity to the wholesale market, as well as green certificates (First WS of S. Baciú, ¶¶ 15, 24-29). As a result, the profits that the co-generation plant would have allegedly made rested on both savings on operational costs and the sale of electricity/green certificates to third parties. The Respondent alleges, and Prof. Lessard confirmed at the hearing, that the green certificates accounted for 72% of the value that Prof. Lessard attributed to the project (Tr., Day 7, 109; Tr., Day 8, 95-96).
1098. According to Mr. Baciú, EFDG planned to construct a 20 MW electricity co-generation plant. The estimated cost to build the plant was €20 million (including equipment and connection) (First WS of S. Baciú, ¶¶ 16, 30-32).
1099. After reviewing the evidence, the Tribunal finds that the Claimants have failed to prove with sufficient certainty that they would have built a co-generation plant. Although there is some evidence that the Claimants considered the option of building a co-generation plant in the future, the evidence of advance planning or specific steps in the implementation of such a plant is inconclusive at best.
1100. According to Mr. Baciú, the co-generation plant was part of EFDG's plans from its early days. He testified that the Claimants began contemplating co-generation in the late 1990s, when they considered establishing beverage production lines in Bucharest, and continued with this plan when they established their food business in Bihor after the passage of GD 194/1999.
1101. The record confirms that the Claimants had an interest in building a co-generation plant as early as 1998, and contacted several manufacturers for this purpose. The record includes several offers or quotations for a co-generation plant between 1998



and 1999 (Exh. C-821, C-822, C-823).<sup>227</sup> The Claimants appear to have started to consider co-generation more seriously in 2002:

- a. In 2002, the Claimants contracted with ABB to implement switch-gear technology in the substation, which would allow them to reverse the flow of electricity from a future co-generation source into the national distribution network (Exh. C-480).
- b. Also in 2002, the Claimants contracted with Biothane International (Biothane) for the construction of their waste water treatment plant. Mr. Baciú explains that they also discussed the possibility of using the by-products of this facility as possible renewable energy sources. These discussions evolved into discussions for the construction of a co-generation plant (First WS of S. Baciú, ¶¶ 19-22).<sup>228</sup> However, there seems to have been no follow-up to this correspondence, and the Biothane co-generation project did not materialize. Indeed, in 2003 the Claimants initiated correspondence with Schmidt for biomass testing (Exh. C-712), and made inquiries with General Electric for turbines (Exh. C-708<sup>229</sup>) (Second WS of S. Baciú, ¶ 44).

1102. The Claimants' interest in a co-generation plant seems to have grown when Romania passed renewable energy laws. Although the laws were not passed until 2004, Mr. Baciú testified that around 2002 they already anticipated that these laws would be passed (First WS of S. Baciú, ¶ 23). According to Mr. Baciú, "[t]his probability of co-generation as a revenue generator gave us another reason to seriously consider construction of our own co-generation facility. Thus, we knew that we could produce energy for our facilities at a lower cost than what we were currently paying in electricity from the State's distribution network, and we knew that any additional energy we produced had the potential to be sold" (*Id.*). When Romania did pass the renewable energy laws in 2004, their attractiveness was enhanced by the possibility of trading green certificates. However, as a result of the revocation of the incentives,

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<sup>227</sup> Exh. C-821 is an offer/quotation from ABB dated 4 February 1999; Exh. C-822 is a preliminary proposal from Hyundai dated 3 November 1998, and Exh. C-823 is a quotation from Mannesman dated 19 February 1999.

<sup>228</sup> The record includes:

- Meeting Minutes from 16 April 2002 (Exh. C-483) between European Food and Biothane anticipating potential construction of a co-generation plant, where equipment and next steps were discussed;
- An email from Biothane to European Drinks, 2 May 2002 (Exh. C-484), documenting European Food Group's May 2002 delivery of a sample dried material (DDGS) to determine composition and biodegradability for fuel component testing.
- An email from Christian Flora of EFDG to Biothane dated 27 May 2002 (Exh. C-484, second page), referring to various "problems" related to the "project". Among other matters, Mr. Flora requested the final lay-out drawings, asked about the correct foundation they should build for tanks, requested an offer for tanks and engineering for the boiler, and a time schedule. However, given that the subject line contains the initials "wwtp", this appears to refer to the waste water treatment plant rather than the co-generation plant.
- An email from Biothane to European Drinks, 20 August 2002 (Exh. C-482), referencing a quotation for the construction of a co-generation plant.

<sup>229</sup> Exh. C-708 is an undated presentation from General Electric regarding turbines suitable for co-generation

Mr. Baciú states that “we were unable to continue with our planned expansion and integration (First WS of S. Baciú, ¶ 25). Mr. Baciú explains that this came at a great detriment to their company, because subsequent changes in Romania’s renewable energy laws would have enabled them to earn more green certificates than under the original law (specifically, three instead of one per MWh produced), and they would have been entitled to sell these green certificates at a higher value (First WS of S. Baciú, ¶ 26).

1103. The Claimants continued to receive quotations for a co-generation plant after revocation. The Claimants submitted two offers from Siemens dated November 2005 and July 2006 for a turbine and generator and other equipment (Exh. C-687, C-708). Mr. Baciú also testified that in 2009 they received a quotation for a 20 MW co-generation plant from Bio-Energieanlagen, which estimated the project at less than €20 million (First WS of S. Baciú, ¶ 43).
1104. The Claimants’ continued interest in a co-generation plant is also evidenced by the EBRD loan negotiation documents. As discussed above, during 2005 and 2006 the Claimants carried out negotiations with the EBRD regarding possible development financing. In addition to the malt plant, the early documents related to those negotiations mentioned the construction of a co-generation plant. Specifically, the co-generation plant was mentioned in the EBRD Environmental Questionnaire dated 12 March 2005 (Exh. C-743) and the first draft Loan Agreement dated 16 June 2006 (Exh. C-745). However, it is not mentioned in either the Term Sheet dated 4 March 2006 (Exh. C-744) or the last draft Loan Agreement dated 2 November 2006 (Exh. C-746). Thus, it would appear that the project either was dropped entirely or at least that by 2 November 2006 (over 20 months after the revocation) it had not yet reached a level of concrete planning.
1105. However, despite the evidence of the Claimants’ continuing interest in building a co-generation plant (which spans several years), other than Mr. Baciú’s testimony, there is no documentary evidence of concrete internal planning of such a project:
  - a. Mr. Baciú asserts that when the Claimants developed the lay-out of their factories, they “kept in mind” where an optimal place for the co-generation plant would be, and bought 20 hectares of land for this purpose (Second WS of S. Baciú, ¶¶ 3-5). However, there is no record of this advance planning in internal plans for the factories, nor documentary evidence of the purchase of land.
  - b. There is no feasibility study or other preliminary study. The Respondent pointed out during the cross-examination of Mr. Baciú that the Claimants had carried out a feasibility study for a corn mill valued at €4.8 million, and found it surprising that the Claimants had not carried out a similar feasibility study for a co-generation plant that would cost approximately €20 million. Mr. Baciú admitted that in the case of the co-generation plant, “no feasibility study was made; only some calculations, engineering calculations” (Tr., Day 7, 120 (Baciú)). However, Mr. Baciú was not able to point to any documentary evidence of these alleged calculations. He stated that they “just calculated internally” for themselves, and

“never kept the figures”. He added that these were not financial calculations, only simple calculations involving “the rough cost of the raw materials involved” and “the availability of [these] raw materials”, that these calculations were “very easy to do” and that this was “not the kind of document that you save and keep” (Tr., Day 7, 120 (Baciu)).

- c. Mr. Baciu submitted for the purposes of this arbitration a diagram showing an overview of the co-generation project at page 5 of his second witness statement showing how the different components fit in, but no such diagram or plan is found among the Claimants’ contemporaneous evidence.

1106. Irrespective of the available documentation, the Claimants argue that their intention to build a co-generation plant is evidenced by the steps they took to complete it. Indeed, Mr. Baciu testified that at the date of the revocation of the incentives they had acquired or constructed most of the components of a co-generation plant, as discussed in sub-paragraphs (a) through (g) below. However, although the existence of these components appears to be undisputed, the Tribunal is not persuaded that these components were acquired or constructed specifically with the co-generation plant in mind, or that at the date of the revocation of the incentives the co-generation plant was as near completion as the Claimants suggest. Specifically:

- a. Mr. Baciu testified that the Claimants had set aside 20 hectares of land, which would be used for the plant itself and for biomass storage (First WS of S. Baciu, ¶¶ 16, 38, 43; Second WS of S. Baciu, ¶ 5 and related photographs). However, there is insufficient evidence showing when this land was acquired or with what purpose.
- b. Mr. Baciu testified that the Claimants had the biomass needed for co-generation, which came from by-products or waste from the products used for food production (Second WS of S. Baciu, ¶¶ 11-12; 18-23). According to Mr. Baciu, this was “the most important component” of a co-generation facility (Tr., Day 7, 95, 99 (Baciu)). However, Mr. Baciu acknowledged that for the size of plant they were considering (20 MW), they would need to purchase additional biomass (Tr., Day 7; 126 (Baciu)). Specifically, a 20 MW electricity co-generation plant would need 160,000 metric tons of biomass, of which 90,000 to 110,000 metric tons would come from internal sources. The remainder would have to be purchased from third parties, but Mr. Baciu testified that the Claimants were well-positioned to buy them at competitive rates and had a transportation system in place (First WS of S. Baciu, ¶¶ 33-38).
- c. Mr. Baciu testified that the Claimants had acquired the equipment for the preparation, conditioning, storing and handling of the biomass sources. Mr. Baciu testified that the Claimants had “already built and already mastered the process of collecting, storing, handling, and drying these types of biomass” (Second WS of S. Baciu, ¶¶ 11; 24; Mr. Baciu also included several photographs of existing biomass conditioning installations and storage areas, and explained the process (Second WS of S. Baciu, pp. 6-21). With respect to conditioning, Mr.

Baciu testified that the Claimants had mincers for solid biomass, centrifuges for humid biomass, and dryers (Tr., Day 7, 96-97 (Baciu)). With respect to storage and handling, Mr. Baciu testified that the Claimants had silos, platforms, transportation equipment and loading equipment (Tr., Day 7, 97 (Baciu)). This appears to be undisputed, although it is unclear how much of this equipment was purchased for the cogeneration plant.

- d. Mr. Baciu also testified that the Claimants had biogas, produced at the Claimants' wastewater treatment plant. The biogas would serve as catalyst in burning the biomass to produce steam and electricity (Second WS of S. Baciu, ¶ 21-22).
- e. Mr. Baciu further testified that the Claimants had built an electrical substation precisely designed with plat space and additional electrical control capacity for constructing and handling co-generation, including step-up transformation capability and an installed switchgear that permits re-direction of co-generated power directly into the State's transmission lines (C-PHB, ¶ 202; Second WS of S. Baciu, ¶¶ 33-45). However, it is undisputed that the substation was not built exclusively for the co-generation plant, but to provide electricity to the group's production facilities (First WS of S. Baciu, ¶ 3). The Tribunal does not doubt that the substation was built with the capacity to eventually "plug in" a co-generation plant: (i) both Mr. Baciu and Mr. Halbac testified that when they built the substation, they also planned for the construction of a co-generation plant (First WS of S. Baciu, ¶¶ 4, 18; First WS of M. Halbac, ¶ 56), and that "[m]any of the features on the substation were placed there only because we had already planned the construction of a co-generation plant" (First WS of M. Halbac, ¶ 56); (ii) as noted above, Mr. Baciu testified that, with the co-generation plant in mind, in 2002 the Claimants contracted with ABB to implement switch-gear technology in the substation, which would allow them to reverse the flow of electricity into the national distribution network,<sup>230</sup> and (iii) the power plant appears to have been found suitable for co-generation.<sup>231</sup> However, this only proves that the Claimants designed their substation in a way that would allow them to easily plug in a co-generation plant; it does not prove that they would have actually built such a plant.
- f. Mr. Baciu also testified that the Claimants built an electrical conversion plant to raise the current from 20 kv to 110 kv power (Tr., Day 7, 99 (Baciu)). However, it is unclear whether this was part of the electrical substation or was purchased specifically for the co-generation plant.

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<sup>230</sup> The record includes a contract dated 2001-2002 with ABB for electric switchgear (Exh. C-480), but from the English translation it is impossible to determine if the equipment was bought with co-generation as the purpose.

<sup>231</sup> Mr. Baciu testified that a state-owned electric company subordinated to the Ministry of Economy acknowledged in 2010 that the "110/20kV power station European Drinks Sudrigiu has been such designed and made to allow the beneficiary S.C. European Drinks to deliver in SEN its own electricity (BIOMASS COGENERATION), by cell no. 3 and cell no. 20." (Second WS of S. Baciu, ¶ 45; Exh. C-820).

- g. Finally, Mr. Baciu testified that the Claimants had a connection to the national power grid, which allowed them to take power from the grid or supply power (Tr., Day 7, 99 (Baciu)). Mr. Baciu also qualified this as one of the most important components for a co-generation plant, together with the biomass source (*Id.*). Once again, for what that connection was specifically built beyond the Claimants' ongoing operations remains unclear.
1107. According to Mr. Baciu, the only missing components to complete a co-generation plant were:
- a. The turbine, which the Claimants would have to purchase, and for which they received several quotations from suppliers (Tr., Day 7, 98 (Baciu); Second WS of S. Baciu, ¶ 35). Presumably Mr. Baciu refers to the quotations cited in paragraphs 1101 and 1103 above.
  - b. A dedicated boiler for steam generation to run the turbine, which would have been designed and largely manufactured in-house.
  - c. The building to house the plant.
1108. The Respondent emphasizes that the most important (and missing) parts of the co-generation plant were the boiler and turbine and not the biomass and connection to the power grid as claimed by Mr. Baciu (R-PHB, ¶ 256). The Tribunal must agree. Mr. Baciu testified (both in his WS and in cross-examination) that although most of the biomass would come from internal sources, they would need to purchase part of it from third parties (First WS of S. Baciu, ¶ 36; Tr., Day 7, 126 (Rubins/Baciu)). As the Respondent points out, this shows that having one's own source of biomass is not essential to the operation of a co-generation plant, although it would of course mean a cost advantage. With respect to the connection to the power grid, Mr. Baciu clarified that by "important", he meant "difficult to obtain." In particular, the connection to the national power grid was a huge advantage for them because it was very difficult for other investors to obtain (Tr., Day 7, 102-104 (President Lévy/Baciu)). However, it cannot be disputed that the boiler and the turbine are crucial elements of a co-generation plant, without which no energy can be produced.
1109. Mr. Baciu also testified that the Claimants had "all the necessary authorizations" to operate a co-generation facility, but in cross-examination he was obliged to retract in part. Mr. Baciu confirmed that they would have needed an authorization from the water management authorities for the boiler, an environmental authorization, an electricity generation license, and an electric supply license, none of which the Claimants had yet obtained. However, with respect to generation he stressed that the company had an authorization as a distributor and eligible consumer, and "most likely would have obtained" the generation license and electric supply license as well. (Tr., Day 7, 123-126 (Rubins/Baciu)). The Respondent argues that Mr. Baciu testified falsely on this point. However, while notable, Mr. Baciu's contradictory statements could have been the result of a misunderstanding during his oral examination: indeed, Mr. Baciu clarified that when he responded to Mr. Fleuriet's question in direct

examination, he “understood that his question referred to the 110 plant and the connection to the national system” (Tr., Day 7, 123-124 (Rubins/Baciu)).<sup>232</sup>

1110. Finally, Mr. Baciu testified that the Claimants had “mastered the technological process for turning prepared biomass and biogas into steam and electricity”, as well as considerable engineering expertise and experience designing boilers. In this respect, Mr. Baciu testified that after revocation (around 2010) the Claimants built three biomass boilers which are currently in operation (Second WS of S. Baciu, ¶¶ 25-31). Indeed, from Mr. Baciu’s testimony it appears that the Claimants are already using biomass to produce energy. Specifically, Mr. Baciu states that “[i]n these existing boilers, we burn our existing biomass and biogas, capture the steam produced, and use it to run our factories. This reduces our heavy fuel oil costs and the emission of carbon dioxide that results from burning heavy fuel oil” (Second WS of S. Baciu, ¶ 26). Mr. Baciu also testified that the operation of these boilers was similar to that needed for the co-generation process, but they operated at lower capacities and pressures (Tr., Day 7, 97 (Baciu)). Mr. Baciu also clarified that these boilers started operating in May 2010 (Second WS of S. Baciu, ¶ 31). Although this shows the Claimants’ capacity to use biomass to produce energy, steam to be precise, for their own consumption, it also shows that, without the turbine, they could not claim to have a co-generation plant. In particular, without the turbine they could not sell energy to third parties through green certificates, which is the main source of the profits they claim.

1111. The Tribunal’s conclusion from the evidence discussed above is that the Claimants have not shown with sufficient certainty that they would have implemented a co-generation plant. The record does suggest that, despite the absence of evidence with respect to internal planning, the Claimants considered implementing ways to turn biomass and biogas into steam and electricity. However, that does not show that they would have built an actual co-generation plant. The Claimants requested quotations as early as 1998, and continued to show interest in 2002 and 2003, but it took them seven years from then to go into and to master the process of using their own biomass and biogas for fuel, which they only started doing in 2010 (after the revocation). In addition, the lack of a building, boiler and a turbine, along with the lack of licenses and authorizations, indicates that at the time of the revocation of the incentives the co-generation project was not as close to completion as the Claimants contend.

(e) *Conclusions*

1112. On the basis of the evidence analyzed above, the Tribunal finds that the Claimants have not proven with sufficient certainty that, but for the revocation, they would have implemented the Incremental Investments.

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<sup>232</sup> The Respondent also contends that Mr. Baciu was unable to specify which company (or companies) was/were meant to make the investments required to build the co-generation plant (Tr., Day 7, 105-106 (Baciu)). However, this does not show much. Mr. Baciu was an engineer; it is not likely that he was privy to the Claimants’ strategic corporate decisions with respect to the channeling of investments.

1113. With respect to their alleged intention to build these facilities, the Claimants rely heavily on witness testimony. In fact, other than offers and quotes provided by third party suppliers, there is surprisingly little contemporaneous evidence of advance planning predating the revocation. There is not a single business plan, feasibility study, internal memo or budget documenting the Claimants' intention to build these facilities. The construction of these plants thus seems to have been a desirable possibility for the Claimants, which they investigated with third party suppliers, but which never materialized into concrete plans.
1114. The Tribunal does not doubt that the Incremental Investments were consistent with the Claimants' integration model, and would have complemented it very well. Mr. Halbac and Mr. Baciu describe very persuasively the cost-efficiencies that the Claimants could have achieved. As Prof. Lessard testified on cross-examination, the investments were "plausible" (by which he seems to have meant that they made economic sense). However, this does not prove with sufficient certainty that the Claimants would have actually implemented those investments. After the fact, it is always possible to say that one would have engaged into an activity which turns out to have been potentially fruitful: this does not suffice, as it is necessary to prove with sufficient certainty that an intention to do so would have materialized but for the wrongful act. Contemporaneous evidence is not indispensable but, in this instance, its absence does not help the Claimants.
1115. The Tribunal has also given due consideration to the Claimants' argument that, as a family business, they did not make plans on paper, and that the best evidence of their intentions are the steps they took to materialize these investments. However, although there is some evidence of steps taken to further these investments, the record shows that the Claimants had built or acquired almost exclusively equipment that could be used with their existing platform (i.e., utilities, electric connections, transportation, storage and handling systems). Some of this equipment created cost efficiencies that would have made it easy to "plug in" the Incremental Investments, but for each of the Incremental Investments the Claimants still had to purchase the key equipment that would in fact allow them to operate these Incremental Investments as separate profit-making activities. For instance, for the malt plant, they still needed to purchase the germination machine; for the can manufacturing plant, they still needed to purchase the can manufacturing machines, and for the co-generation plant, they still needed to purchase the turbine and manufacture the boiler. As a result, the steps taken by the Claimants do not show with sufficient certainty that the Incremental Investments were projects at an advanced stage of completion, nor that the Claimants clearly intended to carry them out in the near future. They have proved that they had an option to build these Incremental Investments and that they were contemplating them as a possibility, but not more.
1116. The Tribunal does not believe that these conclusions would have been altered by conducting a site visit as proposed by the Claimants. After a full review of the record, the Tribunal confirms the views it expressed in its Procedural Order dated 20 January 2011. In particular, the Tribunal confirms that a site visit was not necessary nor useful for the resolution of the dispute, as it would not have supplied further evidence

of the Claimants' intention to pursue the Incremental Investments than that already in the record. Due to the characteristics of a site visit, it could not have provided further useful, certainly not documentary, evidence of advance planning of these investments; rather, it would have allowed the Tribunal to see the size and characteristics of the Claimants' integrated platform and their ability to easily implement the Incremental Investments, which is sufficiently confirmed by evidence in the record (including the 17-minute video of the site and the Incremental Investments attached as Exhibit C-987, as well as the witness statements of Mr. Halbac and Mr. Baciu, which contain numerous color photographs and diagrams that explain the characteristics and distribution of the site, their oral testimonies and the documentary evidence they cite in their witness statements). However, the fact that the Tribunal has found that Claimants' platform was highly integrated and that they had made certain investments that would have made it easy to add the Incremental Investments does not provide sufficient certainty that, but for the revocation of the incentives, the Claimants would have implemented these projects.

1117. For the reasons stated above, the Tribunal finds that the Claimants have not proven with sufficient certainty that they would have in fact engaged in the activity that they claim would have earned the profits they were allegedly deprived of. In particular, the Claimants have not established that the lost profits that they claim in relation to the Incremental Investments "were *reasonably* anticipated; and that the profits anticipated were probable and not merely possible."<sup>233</sup>
1118. For all these reasons, the Tribunal rejects all lost profits claims related to the Incremental Investments.

#### **4. Financial penalties for failure to pay taxes**

##### **a. Overview**

1119. It is undisputed that, following the revocation of the incentives, the Claimants have failed to pay certain tax debts to Romania. The Claimants do not question these debts, which they acknowledge are owed.
1120. However, the Claimants argue that their failure to pay these tax debts has caused them to incur substantial financial penalties, which are attributable to the Respondent's conduct and thus require compensation. Indeed, the Claimants contend that the tax penalties that they incurred post-revocation (from 2006 onwards), were "a direct result of the financial constraints caused by Revocation". Specifically, the Claimants argue that if they had been able to benefit from the Raw Materials Incentive until 2009, they would have been able to pay their tax debts to Romania and, as a result, would not have incurred the substantial tax penalties that have accrued since the revocation. Thus, to place them back in the position they would have been but for the revocation, the Tribunal should award them these penalties (C-PHB, ¶¶ 132, 142).

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<sup>233</sup> Marjorie M. Whiteman, *Damages in International Law*, vol. II (1937), p. 1837 (emphasis in original); *AAPL v. Sri Lanka*, ¶ 104.



1121. The Claimants claim damages for two sets of financial penalties (C-PHB, ¶¶ 140, 144):
- a. Financial penalties incurred but not yet paid as a result of the Claimants being financially constrained due to the losses incurred as a result of the revocation, in the amount of RON 63.65 million. The Claimants bring this claim unless Romania waives such tax penalties and declares that it shall waive or reimburse all additional financial penalties imposed or assessed until the date of Romania's full and final satisfaction of the award.
  - b. Financial penalties incurred and paid by the EFDG companies in the period 1 April 2005 to 30 September 2010, in the amount of RON 40 million.
1122. The Claimants argue that, because the Respondent's conduct caused the financial penalties to accrue, the unpaid portion of those penalties should be awarded to the Claimants (if not waived by Romania), and the portion of those penalties that the Claimants have already paid should be awarded back to the Claimants (C-PHB, ¶ 143).
1123. Both claims are cumulatively based on the following evidence (C-PHB, ¶¶ 131 and 141):
- a. The calculations contained in paragraphs 85 and 86 and Table 4 of Professor Lessard's first report, dated 22 December 2009;
  - b. The calculations contained in paragraphs 132 to 135 of Professor Lessard's second report, dated 30 July 2010;
  - c. The calculations contained in paragraph 3.25 and table 4 of Mr. Osborne's first report and the calculations contained in section 8 of Mr. Osborne's second report;
  - d. Updated Summary of Damages from Penalties Avoided, Tab 51 from Mr. Schwartz's Opening Presentation;
  - e. Professor Lessard's corrected tables handed out by counsel at the hearing on 16 November 2010, table 4, page 2;
  - f. The evidence referred to in the abovementioned sections, paragraphs and tables, including Exh. CO-1.19 ("Workings for December 2009 report") (submitted as an exhibit to Mr. Osborne's second report).
1124. The two claims concern tax penalties incurred not only by the Corporate Claimants, but also by other companies of the group which are not parties to this arbitration (specifically, European Drinks, Edri Trading, Original Products, Rieni Drinks, Scandic Distilleries, TGIE, Tonical Trading, and West Leasing).
1125. The Respondent does not contest the calculations performed by Mr. Osborne or Prof. Lessard. Rather, it contests the existence of a causal link between the revocation and the accrual of the tax penalties, and criticizes the Claimants' experts for simply

assuming that such a causal link existed. The Respondent argues that the Claimants' experts did not conduct their own analysis of the evidence but simply assumed (or "understood" or "believed") it to be true and simply added up the figures. (R-SPHB, ¶ 16). The Respondent points to:

- a. Professor Lessard's assertion in his first report that "with revocation of the incentives, EFDG entered a sustained cash crunch";
- b. Mr. Osborne's assertion that "since the Companies became financially constrained (2006) significant penalties have accrued on debts to the state";
- c. Professor Lessard's "understand[ing] that penalties in earlier periods were in some cases caused by unanticipated changes in Romanian tax or excise regulations" and his "understand[ing]" that the terms of EFDG's credit lines did not permit the Claimants to pay down existing state debts (there being no evidence supporting either "understanding"); and
- d. Mr. Osborne's "belief" that penalties "are likely to have arisen only because of the financial constraints the Companies have been under since 2006".

1126. The Respondent argues that these assumptions are in turn based solely on Mr. Ioan Micula's assertion that "we suffered delays in making required tax payments to the State because of the cash constraints caused by the State's termination of the incentives" (Third WS of I. Micula, ¶ 95). The Respondent argues that this is not evidence and stresses that "the Claimants must *prove* that they *could not* pay their taxes *because of* repeal of the Facilities" (R-SPHB, ¶ 17, emphasis in original). The Respondent denies that the Claimants have proved this. To the contrary, it argues that the evidence in the record in fact demonstrates that there is no causal link between the revocation of the incentives and the incurred tax penalties.

1127. In particular, the Respondent contends that the Claimants have not proven that they could not pay their taxes, nor have they proved that this alleged inability to do so was caused by the revocation of the incentives (R-SPHB, ¶ 17). In particular, the Respondent argues that:

- a. The Claimants did indeed have access to funds, but chose to spend them elsewhere. The Respondent notes that it is undisputed that the Claimants spent €182 million on other projects and developments after the repeal of the Raw Materials Facility, at the same time that the EFDG companies were not paying their taxes and consequently incurring penalties.
- b. The Claimants had access to financing at competitive interest rates after repeal, and thus could have borrowed to cover their tax debts.
- c. While the Claimants assert that they could not pay the taxes they owed because of financial difficulties, Mr. Osborne accepted that those financial difficulties would have occurred in any event, even without repeal of the Raw Materials Facility. (Tr., Day 10, 137 (Osborne, acknowledging that "absent sales of SCPs, and

assuming all else equal, they would have been in trouble, if I can put it that way.”)).

- d. EFDG’s financial statements show that the Claimants were in arrears on taxes and incurred penalties in every year before the revocation of the incentives.<sup>234</sup> According to the Respondent, there is not a single year, at any time in the Corporate Claimants’ history, in which the Corporate Claimants did not incur fresh penalties for non-payment of taxes. That includes the period in 2004-05 in which the Claimants say they paid down their tax debts. The Respondent argues that there is therefore no basis to infer that the Claimants would have paid their taxes in and after 2006 if they had been able to, and hence no basis to infer that their failure to do so proves that they could not (R-Rejoinder, ¶ 340; First ER of J. Ellison, Section 9; Second ER of J. Ellison, Section 8).
  - e. EFDG entered into various tax-rescheduling agreements with Romania in 2001, 2002 and 2003, through which Romania forgave millions of Euro in tax penalties due from the Claimants. The Respondent argues that “it thus appears that the Claimants chose not to pay their taxes as part of a long-standing business strategy, hoping to negotiate advantageous restructuring of their tax debts and to use the funds that otherwise would have been paid to the state for other purposes. That this gamble ultimately did not pay off is a far cry from a causal link between the repeal of the facilities and the Claimants’ inability to pay taxes. Indeed, it reveals the entire tax-penalty claim to be an unseemly perpetuation of improper practices against Romania, which the Claimants ask this Tribunal to endorse and continue” (R-Rejoinder, ¶ 341; Second ER of J. Ellison, Section 8). The Respondent further notes (and the Claimants acknowledge) that these rescheduling agreements (and forgiveness of debts granted by Romania) are the main reason why the Claimants reduced their tax debts by 2005 (R-SPHB, fn. 27; see ¶ 1132 below).
1128. Finally, the Respondent stresses that the Claimants have failed to produce evidence (other than witness testimony and experts relying on these witnesses) in support of their claim (R-SPHB, ¶ 18). Specifically, according to the Respondent:
- a. There is no contemporaneous correspondence with the Romanian tax authorities or internal documents explaining why they were not paying taxes;
  - b. There is no correspondence with banks refusing to grant loans due to financial constraints;
  - c. There is no evidence of the “business necessities” on which they spent the €182 million that they acknowledge was spent after the revocation of the incentives to

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<sup>234</sup> The Respondent criticizes the Claimants’ experts for failing to mention this state of affairs. In particular, the Respondent notes that the table of penalties paid to the State presented in Mr. Osborne’s First Report (Table 4, p. 22) covers only 2006-2009, while his working papers include payments as far back as 2002 (R-Rejoinder, ¶ 340).

other ends. The only documentary evidence that Mr. Halbac could point out to was for €5 million in relation to the brewery (Exh. C-306). (R-PHB, ¶ 627).

1129. The Respondent also points out that “the vast majority” of the taxes (and resulting penalties) owed to Romania by the EFDG companies relates to VAT payments and employee social security contributions.<sup>235</sup> The Respondent thus argues that the Claimants have improperly retained money that belongs to their customers and employees. In other words, the Claimants have improperly used “other people’s money” to finance their operations. The Respondent argues that this seriously undermines their claim, in particular with respect to VAT, because the Claimants had the cash on hand to remit the required amount of VAT, but failed to do so. This failure cannot be attributed to reduced cash flows (R-PHB, ¶ 295; Exh. A to F to the Claimants’ Application for Provisional Measures; Respondent’s Rejoinder on Provisional Measures, ¶ 18; Respondent’s Opposition to Provisional Measures, fn. 9).
1130. With respect to the availability of cash and post-revocation investments, the Claimants acknowledge that they invested approximately €182 million post-revocation, but contend that these investments were for business necessities in order to continue the operation of the companies, comply with legal requirements and meet contractual obligations (Second ER of D. Lessard, ¶ 128; Tr., Day 8, 69 (Lessard); Second WS of M. Halbac, ¶¶ 145-167).
1131. The Claimants deny that the Respondent’s additional arguments undermine their claim for damages for tax penalties incurred after the revocation of the incentives (C-PHB, ¶¶ 132-139). First, the Claimants deny that the mere existence of penalties prior to the revocation negates the causal link between the revocation and penalties post-revocation. As Prof. Lessard explains: “If the penalties post Revocation could have been avoided absent Revocation and not otherwise, then the fact of earlier penalties does not change the impact on damages” (Second ER of D. Lessard, ¶ 134).
1132. Second, the Claimants reject the Respondent’s contention that they had a “strategy” of not paying taxes:
- a. The Claimants contend that the tax arrears and penalties that they incurred in the years prior to the revocation were not due to any such business strategy, but were caused by hyperinflation, regulatory changes and widespread economic difficulties throughout Romania during that period. Romania has suggested that this does not explain the Claimants’ situation because they could not have been the only taxpayers affected by this (Second ER of J. Ellison, ¶ 8.2.3). The Claimants agree but contend that Romania misses the point: the fact is that the period of hyperinflation in Romania was widespread and recognized by the government. Indeed, through the enactment of EGO 163/2000 and EGO 40/2002 (Exh. J and K to Claimants’ Application for Provisional Measures),

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<sup>235</sup> In its Application to Revoke Provisional Measures, the Respondent alleges that VAT comprised approximately 43% of the tax liabilities incurred by EFDG from January 2010 to February 2012 (R-Application to Revoke PM, fn. 85; EFDG tax payment tables, RA-17).

Romania acknowledged “the great number of taxpayers recorded with outstanding budget debts” as “the outcome of the economic environment”. These two normative acts offered extensions to taxpayers in arrears and reductions or eliminations of penalties under strict conditions, which the Claimants took advantage of. The Claimants made the additional investments required by Romania for the rescheduling of the debts, and the Claimants paid off outstanding debts in advance of the deadline imposed by Romania under the agreements. The Claimants note that the Respondent has not disputed those facts (C-PHB, ¶ 137).

- b. The Claimants argue that they had fully paid off their tax arrears at the time of Revocation, a fact that the Respondent does not dispute (C-PHB, ¶ 138).
- c. The Claimants deny that they are tax evaders, as they made partial payments on their outstanding state debts after the revocation when they were financially able to do so. For instance, the outstanding balance on state debts decreased from the third quarter to the fourth quarter of 2007, as well as from the second quarter to the third quarter of 2009. Thus, the Claimants reject any contention that they have deliberately avoided paying taxes or have acted in any way other than in good faith regarding their taxes (C-PHB, ¶ 139).
- d. The Claimants argue that their claim for penalties already paid to Romania is further evidence that the Claimants have not altogether avoided paying their outstanding tax debts (C-PHB, ¶ 143).

1133. The Claimants do not deny that the unpaid taxes for which they are being charged penalties include VAT. However, they dispute the Respondent’s calculations of EFDG’s tax payments submitted as Exh. RA-17, including VAT calculations (Claimants’ Response to Romania’s Application to Revoke PM, ¶ 68). Specifically, the Claimants argue that:

- a. The Respondent has erroneously duplicated European Food’s VAT liability and payments and the figures in the section dealing with persons with disabilities, and
- b. The Respondent has erroneously included interest and penalties on unpaid VAT for European Food and Rieni Drinks.

1134. At Exh. CA-23 of their Response, the Claimants provide a “full analysis” of the Respondent’s Exh. RA-17. However, the Claimants do not explain what is the impact of these recalculations on the amount and percentage of VAT owed.

**b. The Tribunal’s analysis**

1135. It is undisputed that the Claimants did not pay some of their taxes, and that, as a result, they accrued significant financial penalties.

1136. The key question to determine whether this damages claim has merit is whether the Claimants have been able to establish a sufficient causal link between the repeal of

the EGO 24 incentives and their failure to pay their taxes. In essence, the Claimants are arguing that, but for the revocation of the incentives, they would have paid their taxes, but because of the revocation, they suffered financial constraints that prevented them from doing so. Thus, the argument goes, to place them back in the position in which they would have been but for the revocation, the Tribunal must award them the penalties they have already paid and those which they will be forced to pay (unless the Respondent waives the latter).

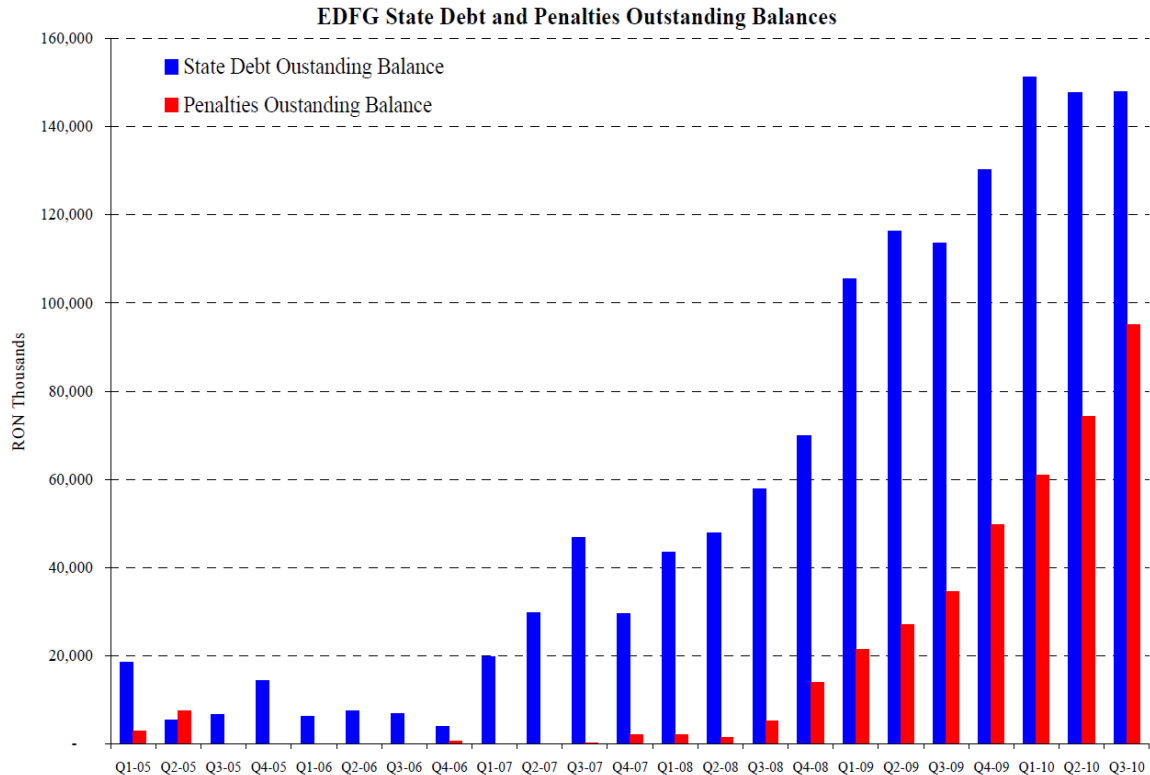
1137. In the Tribunal's view, to determine whether such a sufficient causal link exists between the Respondent's breach of the BIT and the losses alleged, the Claimants must prove:

- a. First, that after the revocation of the incentives, the Claimants could not pay their taxes. In other words, that they did not, as a matter of fact, have sufficient funds to pay their taxes.
- b. Second, that the dominant cause for this lack of sufficient funds (or the financial constraints that prevented them from borrowing them) was the revocation of the incentives.
- c. Third, that but for that lack of sufficient funds, they would have paid their taxes.

1138. The Tribunal has found it unnecessary to address points (b) and (c) because it has come to the conclusion that the Claimants have not proved that, as a matter of fact, they had insufficient funds to pay their taxes. In the view of the Tribunal, the relevant question is whether the Claimants had sufficient funds to pay their taxes and to meet the needs of their business, giving due deference to the business judgment of the owners and managers of the business.

1139. The Tribunal has first tried to establish from the information in the record what was the amount of the EFDG companies' principal tax debts, which they allegedly could not pay after revocation. This information turned out to be difficult to locate in the Claimants' submissions on the merits, but additional information was provided in the context of the Claimants' various requests for provisional measures on which Romania commented. The Tribunal has found in particular two useful sources: (i) the table provided at paragraph 140 of the Claimants' Post-Hearing Brief, and (ii) footnote 5 of the Claimants' letter of 9 November 2012.

1140. The table provided by the Claimants at paragraph 140 of the Claimants' Post-Hearing Brief shows the outstanding balance of the Claimants' principal tax debt and penalties from 1 January 2005 up to 30 September 2010, as follows:



Source: Data from EFDG Overdue State Debt and Penalties Expense.xls produced as backup to December 22, 2009 Lessard Report, with updated data through September 30, 2010.

1141. The Claimants provide the amounts in RON and on a quarterly basis. It would appear from this table that, at the end of 2005, the outstanding balance of the Claimants' principal tax debt was approximately RON 18 million (today approximately €4 million<sup>236</sup>), and that by the end of 2006 this outstanding balance was less than RON 5 million (today approximately €1.1 million), with minimal penalties. However, by the end of 2007 the outstanding balance for the principal tax debt had risen to approximately RON 30 million (today approximately €6.7 million). Even then, their tax penalties were relatively minor. Since then there has been a steady rise, with its highest point at the end of 2009, where the outstanding principal tax debt appears to have been approximately RON 150 million (today approximately €33.7 million).
1142. These figures are roughly consistent with the Claimants' assertion in footnote 5 of their letter of 9 November 2012, where they stated that "[i]n March 2006, the EFDC companies had virtually no outstanding tax debt [...]. By the end of 2006, as a result of the premature revocation of the EGO 24 incentives, the EFDC companies accumulated tax debts in the amount of €4.8 million. By 20 September 2012, as a result of draconian interest and penalties imposed, the EFDC companies' total outstanding tax debt had increased to €104.1 million." Indeed, the first quarter of 2007 shows a principal tax debt of approximately RON 20 million (today approximately €4.5 million) and no accrued penalties.

<sup>236</sup> All Euro amounts in this section reflect the exchange rate of 9 December 2013 of 4.4482 RON/EUR. Source: European Central Bank.

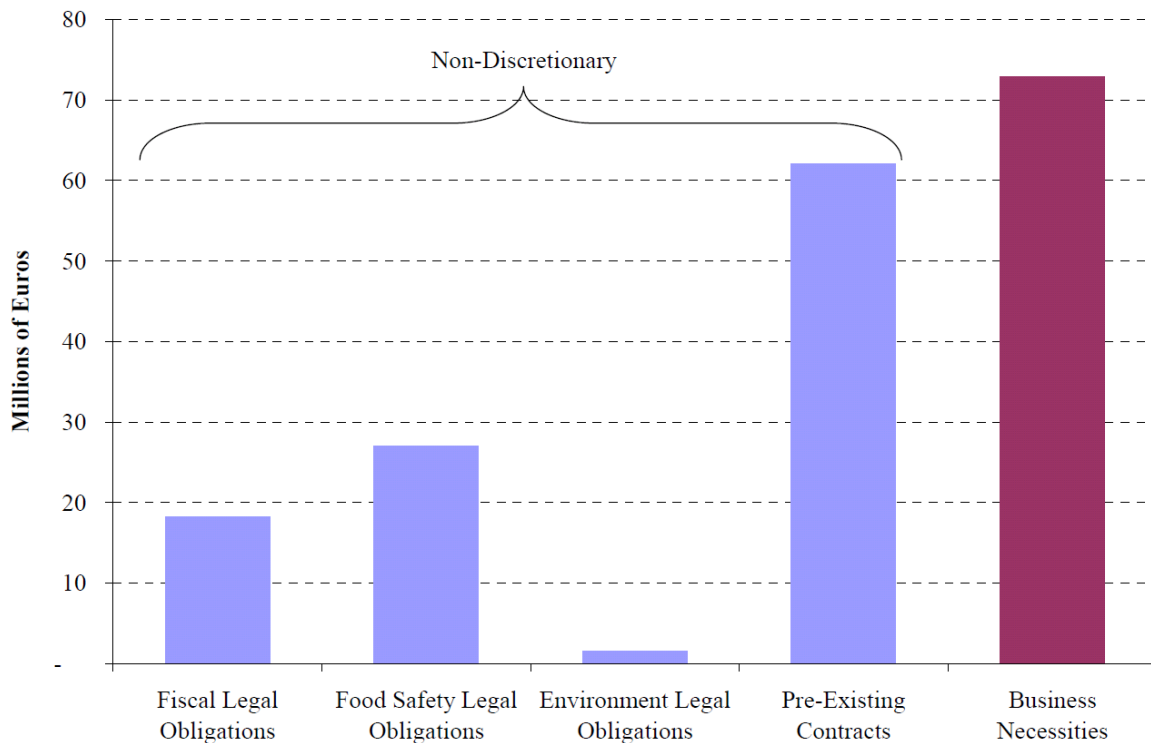
1143. From these numbers, the Tribunal concludes that, in 2007, the Claimants would have needed approximately €5 million to completely pay off their tax debt.
1144. The Tribunal now turns to the Parties' arguments on the availability of cash or financing for the payment of tax debts. The Respondent argues that the Claimants (i) did indeed have cash on hand, but chose to spend it elsewhere, and (ii) had access to financing from the EBRD and other banks, but chose not to use it.
1145. With respect to the first point, it is undisputed that the Claimants spent €182 million on other projects and developments after repeal of the Raw Materials Facility (Tr., Day 8, 69 (Lessard); Second ER of D. Lessard, ¶ 128). The Respondent argues that these funds would have been sufficient to satisfy the Claimants' tax debts (and to fund the Incremental Investments).
1146. The Claimants defend their decision to spend money on other operations and expenditures after the revocation of the incentives. Mr. Halbac testified that "[i]t was determined that we would make investments in our business necessities, as a way of remaining competitive with the business adventures that we did have, and conforming to legal requirements imposed on food and beverage manufacturers" (Second WS of M. Halbac, ¶ 147). In particular, he testified that these expenditures were made to maintain their existing manufacturing platform, preserve their existing market positions, and comply with health and safety laws. According to Mr. Halbac, the Claimants spent approximately €140 million in investments they considered to be business necessities, and an additional €27 million in normal maintenance costs. Although Mr. Halbac described these expenditures in some detail (including a breakdown of the various costs), with one exception<sup>237</sup> he submitted no documentary evidence in support of his assertions (Second WS of M. Halbac, ¶¶ 145-167).
1147. In turn, Prof. Lessard stated that "total investment by EFDG since 2005 has been €182 million", noting that "[t]he majority of these investments were non-discretionary" (Second ER of D. Lessard, ¶¶ 127-128). According to Prof. Lessard, the Claimants had identified five categories of investments: fiscal legal obligations, food safety obligations, environmental legal obligations, investments to fulfill contracts signed before the revocation of the incentives, and "business necessities", as reflected in Figure 17 of his Second Expert Report, copied below:

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<sup>237</sup> That exception is a contract with Kronen dated 10 May 2004 (Exh. 306) for € 5.2 million related to the expansion of the brewery. [Mr. Halbac mistakenly refers to Exh. 305, and also mistakenly notes the date as 10 May 2003.]



**Figure 17— Damages from Revocation**



1148. Of these five categories, Prof. Lessard stated that only the first four categories were effectively “non-discretionary investments”, which he defined as “amounts that EFDG was required to spend to comply with legal or contractual obligations.” He stated that these non-discretionary projects accounted for 60% of the investments made since 2005. The remaining 40% was invested in projects that the EFDG considered to be “business necessities” (as shown in the table, these amounted to approximately €70 million). As examples of these “business necessities”, Prof. Lessard referred to capital expenditures required to maintain the EFDG’s existing productive capacity, to the purchase of beer dispensers and new coolers that allowed distribution of beer in draft form, or to the installation of equipment that allowed the EFDG to produce 2.5 liter bottles for mineral water and soft drinks (Second ER of D. Lessard, ¶¶ 129-130).

1149. The Respondent contests the sufficiency of the evidence provided by Mr. Halbac and Prof. Lessard. The Claimants argue that the Respondent had ample opportunity to cross-examine Mr. Halbac about these expenditures and their necessity, but chose not to do so (C-PHB, ¶ 189). The Respondent in turn argues that there was no need to cross-examine him, because (with the aforementioned exception) Mr. Halbac’s assertions were unsupported by documentary evidence (R-PHB, ¶ 627). In addition, the Respondent points out that Prof. Lessard acknowledged that his understanding with respect to the non-discretionary nature of the Claimants’ expenditures post-revocation came from discussions with the Claimants and their personnel (in particular Mr. Halbac), and could cite no documentary evidence in support of his assertion (indeed, in cross-examination Prof. Lessard acknowledged he had not seen

any invoices justifying such “non-discretionary investments” or “business necessities”) (Tr., Day 8, 70-71 (Lessard)).

1150. In view of the available evidence, the Tribunal cannot accept the Claimants’ assertion that they did not have enough cash to pay their tax debts and, at the same time, meet the needs of their business. The Tribunal reaches that conclusion taking into account the need for the Claimants to be able to continue with their business operations and to exercise managerial discretion in doing so. As noted above, the Claimants could have paid off their outstanding tax debts in full by devoting a mere €5 million in 2007 for that purpose. But instead of paying these tax debts, the Claimants chose to spend over €70 million in “business necessities”<sup>238</sup>, despite the fact that the payment of taxes to the State qualifies as a non-discretionary expenditure required to comply with fiscal legal obligations (indeed, Prof. Lessard includes fiscal legal obligations in his description of non-discretionary expenditures). This evidences that the Claimants had made a decision selectively to allocate their available funds among the five categories of “investments” they have identified. Expressed otherwise, they had a policy that they would pay taxes if that payment appeared to be sensible in view of the circumstances. In fact, the Claimants do have an earlier history of not paying their taxes, which corroborates that inference.
1151. The Tribunal does not doubt that the Claimants’ investments in these “business necessities” were made with the underlying objective to maintain the competitive nature of their business. However, paying taxes is a legal obligation, and not paying them has legal and financial consequences attached to it. The fact of the matter is that, assuming that Prof. Lessard is correct in saying that 60% of the Claimants’ expenditures since 2005 were non-discretionary, the Claimants still had approximately €70 million that they chose to use in other investments or activities. In other words, the Claimants made a conscious choice not to pay €5 million to extinguish their tax debt in 2007, in favor of making other investments.
1152. This may have been a business decision, based on the hope that, by investing in other business activities, the Claimants would have generated more cash than what they would eventually have to pay in taxes and accrued penalties. Prof. Lessard confirmed this at the hearing when, asked why the Claimants had chosen to invest in business necessities instead of in the Incremental Investments, he stated that “the only inference I can make is that the economics of those expenditures [the alleged business necessities] were even better than the economics of these projects [the Incremental Investments]” (Tr., Day 8, 71 (Lessard)). Prof. Lessard also stated that the investments in business necessities “heavily leveraged Claimants’ existing assets, and it is reasonable for Claimants to have assumed that they would provide high incremental returns. Thus, Mr. Ellison’s suggestion that EFDG could or should have diverted investment from these actual uses to alternative uses is incorrect” (Second ER of D. Lessard, ¶ 130).

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<sup>238</sup> As shown in Figure 17 of Second ER of D. Lessard, cited above.

1153. What Prof. Lessard seems to be implying is that, economically, it made more sense to spend the available funds on the business necessities because it would have been more profitable than paying taxes (or building the Incremental Investments). In the case of tax payment (which is by definition not a profitable activity), the implication is that the Claimants believed that the profits they would generate from these business necessities would be higher than the penalties they would accrue by failing to pay their tax debts. Indeed, Prof. Lessard accepted as much in cross-examination:

Q: [...] The claimants had €182 million to invest after revocation; correct?

A. They spent that amount on various projects, yes.

Q. They chose not to spend any of that amount to pay down the remaining tax debts; correct?

A. Which tells one that they had at least a 36% internal rate of return on the projects they invested in, because that's the cost of the penalties.

Q. Okay. But they chose not to spend this amount to pay down their tax debts; correct?

A. That's correct.

(Tr., Day 8, 85 (Rubins/Lessard)).

1154. In other words, the Claimants' decision not to pay their tax debts was a strategic choice, which eventually proved to be the wrong one. The Claimants apparently exercised their business judgment, analyzed the pros and cons, and decided to invest in other projects rather than pay their taxes. But this does not mean that they did not have sufficient funds to pay them and still carry on with their business. It is evident from the record that they did have sufficient funds to pay their taxes, at least at a given juncture, namely in 2007. In the Tribunal's view, this fatally severs the chain of causation. Romania cannot be held liable for the Claimants' bad business decisions, especially if such decisions may have implied failure to comply with certain legal obligations, namely the payment of taxes.

1155. As a result, the Tribunal does not need to address the remaining elements of proof identified in paragraph 1137 above. Accordingly, the Tribunal dismisses this claim.

#### **D. THE RESPONDENT'S DEFENSE THAT ACCESSION TO THE EU BENEFITED THE CLAIMANTS**

1156. In addition to its specific defenses on each of the Claimants' damages claims, the Respondent argues that, even if the Claimants had to pay more for certain raw materials as a result of the repeal of the incentives, this does not necessarily mean that they were harmed overall. To the contrary, the Respondent contends that the Claimants received economic benefits from EU accession that must be taken into account when assessing what compensation is due (R-Rejoinder, ¶¶ 415-421; R-PHB, ¶¶ 329-331).

1157. Relying on two expert reports by Dr. Bill Robinson of KPMG Forensic, the Respondent contends that the EU accession process brought “price stability, increased trade, FDI, reduced risk premia, strong institutions and a marked acceleration in economic growth” (R-Rejoinder, ¶ 417, First ER of B. Robinson, sections 5.3 and 5.4). Specifically, the Respondent alleges that the Claimants benefited from “increased domestic sales due to increased local expenditure on food and beverages (over 42% between 2001 and 2008), an increase of sales abroad due to an expanded export market (between 13% and 30% higher in each year between 2002 and 2008), and access to duty-free imports through the EU customs union” (R-Rejoinder, ¶ 418; First ER of B. Robinson, sections 6.2 and 6.3).

1158. Using a macroeconomic approach, Dr. Robinson evaluated the tangible benefits of EU accession on 1 January 2007 to the Claimants’ business. To quantify these benefits, Dr. Robinson calculated the impact on the Claimants’ business of three counterfactual situations (Romania joins the EU in 2009, Romania joins the EU in 2011, or Romania never joins the EU at all), using the following methodology:

For every percentage point reduction in Romanian GDP growth, the evidence suggests a 0.77 percentage point reduction in growth of expenditure of food and drink and hence (assuming a constant share of Accession-driven growth) in EFDG’s sales. By applying actual and counterfactual rates of growth to variable costs and revenues shown in EFDG’s financial statements, I calculate the net present value of the effect on EFDG’s profits of Romania’s Accession in 2007 compared with three counterfactual scenarios [...]. (First ER of B. Robinson, ¶ 8.1.8)

1159. As explained by Dr. Robinson, he tried to assess the effect of a scenario in which the Claimants had access to the incentives but did not have access to the other benefits provided by the EU:

[...] in that world, where they can still have the import exemptions, I am taking it as instructed that they would not have been in the EU, or that accession would have been delayed for a couple of years, and in that world, although they would have had these nice cheap sugar imports, they wouldn’t have sold so much soft drink. And my calculation tries to show, as it were, [...] that net effect (Tr., Day 11, 184 (Robinson)).

1160. Dr. Robinson concluded that:

- a. Had EU accession been delayed by two years, the Claimants would have lost €18.9 million in profits;
- b. Had EU accession been delayed by an additional two years (*i.e.* four years in total), the Claimants would have lost €34.4 million in profits, and
- c. Had EU accession not happened at all, the Claimants would have lost €235 million (First ER of B. Robinson, ¶ 8.1.8).

1161. Dr. Robinson confirmed his conclusions in his second report, which responded to Mr. Boulton’s criticisms. In particular, he noted that Mr. Boulton had not disputed

Romania's growth in prosperity over the last decade, which in his opinion was largely due to EU membership (Second ER of B. Robinson, ¶ 3.6.1).

1162. As a result, the Respondent argues that "Romania's EU accession resulted in tangible financial benefits for the Claimants that offset any short-term disadvantages from repeal of the Facilities" (which in the Respondent's view are limited to the Claimants' direct losses claims), and that "[o]nce this adjustment has been made, the Claimants' direct losses are reduced to nil" (R-Rejoinder, ¶ 421).
1163. Relying on *Metalpar v. Argentina*<sup>239</sup> and *GAMI v. Mexico*,<sup>240</sup> the Respondent contends that in situations where state measures both harmed and benefited a claimant's business activities, tribunals have taken the positive impact into account in assessing what compensation is due. In its Rejoinder, the Respondent stated that "[s]ince the advantages of EU membership would have been lost or at least delayed had Romania maintained state aid (including the EGO 24/1998 facilities), these advantages must be considered to be a benefit accruing to the Claimants as a result of the repeal, to be deducted from any compensation assessed as a result of Romania's alleged breaches" (R-Rejoinder, ¶ 416). However, in its Post-Hearing Brief the Respondent clarified that it "is not making a counterclaim or seeking a set-off against an award of damages"; it "simply asks the Tribunal to take into account the important benefits to the Claimants arising out of EU accession in determining the extent to which the Claimants were harmed as a result of Romania's actions" (R-PHB, ¶ 331; see also R-Rejoinder, ¶¶ 415, and Tr., Day 2, 198-200 (Rubins)).
1164. In turn, the Claimants argue that Dr. Robinson's analysis should be disregarded, both with respect to expectation damages as well as reliance damages, as it is "entirely unsupported by authority" (C-PHB, ¶ 230).
1165. More specific comments are provided by the Claimants' expert, Mr. Boulton. Mr. Boulton criticizes Dr. Robinson's report as "deeply flawed" (ER of R. Boulton, ¶ 2.2), because:
- a. "Dr Robinson applies a macroeconomic approach to what is essentially a microeconomic question. In other words, Dr Robinson takes a top down approach to estimating the effect of the EU accession on Romania as a whole, and then simply assumes that the Claimants have benefitted pro rata to the national economy" (*Id.*), and
  - b. "Dr Robinson does not consider whether there is any evidence that the Claimants have in fact benefitted from EU accession and ignores those factors that might have had a negative impact" (*Id.*).
1166. In particular, Mr. Boulton criticizes Dr. Robinson for failing to perform an analysis of the Claimants' financial statements to confirm that they have in fact benefitted from EU accession (*Id.*, ¶ 3.10), for failing to take into account the impact of EU accession

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<sup>239</sup> *Metalpar v. Argentina*, ¶¶ 218–233.

<sup>240</sup> *GAMI v. Mexico*, ¶¶ 83–87.

on the level of competition faced by the Claimants (*Id.*, ¶¶ 3.17-3.22), and for ignoring the potential effect of EU accession on the Claimants' fixed costs, in particular with respect to EU health and safety legislation (*Id.*, ¶¶ 3.26-3.28). As a result, in Mr. Boulton's opinion, Dr. Robinson fails to establish that the Claimants have in fact benefitted at all from EU accession (*Id.*, ¶ 2.3).

1167. The Tribunal cannot accept the Respondent's defense. As a legal matter, it is unclear whether EU accession, an act of general application in Romania which produced effects on every single person, should be accepted as an act having specific effect with respect to specific persons, such as the mitigation of a specific damage. Even if that were possible (a question that the Tribunal does not need to answer), the Tribunal rejects the Respondent's defense on its merits. The issue is what effect EU accession had on the damages suffered by the Claimants. The Respondent contends that EU accession had a mitigating effect on the Claimants' damages, because accession would have had the effect of increasing their sales and therefore their profits. However, the Respondent has not provided a convincing quantification of this effect: the Tribunal does not find that Dr. Robinson's macroeconomic analysis proves the extent, if any, of the benefits of EU accession to the Claimants in particular.
1168. First, the Tribunal is not persuaded by Dr. Robinson's methodology. It is theoretically possible to attempt to quantify the benefits that accession brought the Claimants by assessing the Claimants' situation in a counterfactual world where accession was delayed or did not happen at all; however, this evaluation must be made with a view to the specific circumstances of the case and a global assessment is relevant only if it is a means to ascertain the effects of accession in the specific case. As Mr. Boulton states, it seems overly simplistic to extrapolate the macroeconomic impact of EU accession on the Romanian economy as a whole to the microeconomic impact on the Claimants (ER of R. Boulton, ¶ 3.15). Although EU accession may have benefitted the Romanian economy as a whole, the extent of the benefits (and the costs) of EU accession will have varied greatly across different industries and companies. Indeed, Dr. Robinson accepted in cross-examination that EU accession could have had varying impacts on existing businesses in Romania (helping some and hurting others, even in the same sector). He also accepted that the costs of EU accession could be widely different for Romanian businesses in the same sector (Tr., Day 11, 184-185 (Fleuriet/Robinson)).
1169. However, Dr. Robinson appears to have focused only on the benefits of EU accession, but ignored the costs. For instance, he did not take into consideration in his calculations that the EFDG's labor costs could rise as a result of accession. Although he stated that his underlying model considered increases in labor costs, he "took the view that they would not change as a result of accession" (*Id.*, 188 (Robinson)). Nor did he consider that the increased sales that he estimated as a result of accession would have required an increase in the Claimants' labor costs: "I did not increase wage costs because I thought that additional volumes could be sold with the same labour force, and my evidence for that is that volumes at the time were lower than they had been, and I don't imagine the factory had shrunk" (Tr., Day 11, 203 (Robinson)).

1170. Similarly, Dr. Robinson did not consider that EU accession could have the effect of decreasing the Claimants' sales as a result of the increased costs and prices due to the revocation of the incentives (a loss of a competitive edge):

Q. Now, you did not account for any lost sales that the claimants may have experienced as a result of paying increased Customs taxes, or as a result of them paying more domestically to avoid such taxes; correct?

A. Correct.

Q. You have simply assumed -- just so we're clear, you have simply assumed that EU accession only had the positive impact of increased sales?

A. Yes, because Mr Ellison did the negatives.

(Tr., Day 11, 189 (Fleuriet/Robinson)).

1171. Further, Dr. Robinson did not take into consideration the fixed costs and regulatory burdens imposed by EU accession (e.g., in matters of health, safety or environment), because in his opinion they had not changed (*Id.*, 196-197). He acknowledged at the hearing that such costs could have affected the Claimants' performance, but decided that they ultimately did not affect his conclusions. Specifically, when counsel for the Claimants represented that the Claimants had incurred significant costs to comply with EU requirements on wooden pallets, Dr. Robinson made the following comments:

Q. [...] this is an example of one of the fixed costs that would have increased as a result of EU accession that you don't consider in your opinion; correct?

A. Yes.

Q. It's a pretty big omission, is it not, in your opinion, not to have considered increases in fixed costs that were required by -- required of our clients by virtue of the fact that Romania was acceding to the European Union?

A. I don't think those are a very large sum in the general scheme of things. I mean, I worried about it, obviously, because I can see there is a case. I didn't worry about it too much, I mean, partly because, as I say, it's a level playing field; the competitors have those increases as well, so it doesn't mean they lose market share.

I sort of comforted myself with the thought that many other judgments I had taken were really quite deliberately cautious. So the EU effect, you know, is 1.5 to 2, and I used 1.5. The food and drink is 1.1.

Now, you might actually argue that the class of food and drink that EFDG are in are rather more towards the luxury end, with the soft drinks and so forth, so actually that would be a bigger number. But I went with the smaller number, which includes the potatoes and all those other very unelastic items.

So, yes, I haven't specifically allowed for these factors; I admit that. But I don't think it affects my conclusion.

(Tr., Day 11, 198-199 (Fleuriet/Robinson)).

1172. The Tribunal is aware that in re-direct examination Dr. Robinson clarified that, in the two scenarios involving delayed accession, all of those additional fixed costs would have happened to the Claimants anyway, it was just a question of when (Tr., Day 11, 209-210). However, that does not detract from the fact that EU accession brought a “mixed bag of goods” to Romanian companies, which included varying costs and benefits, all of which need to be assessed to understand the total impact of EU accession on the Claimants.
1173. The Tribunal thus finds that the Respondent has failed to prove the extent, if any, of the benefits of EU accession to the Claimants. This does not mean that the Tribunal is oblivious to the fact that EU accession may have had an effect (whether positive or negative) on the Claimants’ investments. This raises a procedural question, namely which party must bear the consequences of this uncertainty. It is the Claimants’ burden to prove their damage and the Tribunal has found to what extent such damage has been proved. The Respondent has argued that the Claimants’ experts have failed to take into consideration the effects of EU accession, and has endeavored to quantify such effects, but – in the Tribunal’s view – unsuccessfully. First, the effects of EU accession appear to be mixed, both potentially increasing or decreasing the value of the investment. Second, it is legally difficult to see why an alleged advantage, from which the Claimants should have benefitted in any circumstances and which is available to their competitors, including those who are not located in the distressed zones, should be taken into consideration to their detriment.
1174. For these reasons, the Tribunal dismisses the Respondent’s defense to the extent that it requests a diminution of the damages awarded to the Claimants.

#### **E. THE CLAIMANTS’ REQUEST THAT DAMAGES BE AWARDED NET OF TAXES**

1175. In their Reply, the Claimants had requested that any damages and interest payable be grossed up for taxes, as follows: “Claimants’ Permanent Investor Certificates, valid until April 1, 2009, contained profit tax exemption provisions. Therefore, Romania would not have taxed the additional profit arising from lower costs on raw materials from the customs tax exemption. But-for cash flows after April 1, 2009, reflect the 16% profit tax. However, Professor Lessard assumes that an award in this proceeding would be taxable. Therefore, in order for the Claimants to receive the full amount of direct damages from the loss of the customs tax exemption, the damages and interest through April 1, 2009, must be grossed up to reflect the tax payable on the award” (C-Reply, ¶ 652).
1176. The Respondent had contended that there is no merit to the Claimants’ gross-up claim (R-Rejoinder, ¶¶ 431-436). Citing Romanian law provisions, it had argued that “[t]he Corporate Claimants might also be able to set off tax losses against any future taxable profits (including a damages award). Moreover, to the extent that an award is



paid to the Micula brothers, Romanian law provides that damages awards are non-taxable” (R-Rejoinder, ¶ 434).<sup>241</sup>

1177. However, in their Revised Request for Relief the Claimants did not include their request for gross-up, and instead requested, presumably for the same reasons, “[t]he total amount of damages payable by the Respondent comprising the amounts set out in paragraphs 2, 3 and 5 to be received net of any tax obligations imposed by Romania on the proceeds” (Revised Request for Relief, ¶ 4).
1178. In their Post-hearing Brief, the Claimants confirmed their primary position that the total amount of damages awarded should be “received by the Claimants net of any tax obligations imposed by the Respondent on the proceeds” (C-PHB, ¶ 268). In their view, the position under Romanian law in relation to both the Individual Claimants and the Corporate Claimants is unclear, but it would be possible for an award to be taxable in both instances. That said, the Claimants asserted that they would maintain their gross-up claim if the Respondent stated that in its view taxes would be payable on an award. Otherwise, the Claimants stated that “[s]hould the Respondent state in sufficiently clear terms that it will not tax any damages award in favour of the Claimants, the Claimants will not seek that that award be grossed-up for taxes” (C-PHB, ¶ 269).
1179. The Respondent opposed the Claimants’ request that the award be paid net of any taxes, and requested the Tribunal not to add any language to that effect. Given the EFDG companies’ outstanding tax debts, the Respondent argued that such request “could well lead to unknown and unintended consequences”. The Respondent urged the Tribunal to “be cautious about phrasing any award in terms that the EFDG Companies might use in other proceedings”, adding that the language of the award with respect to taxes that the Claimants request is not commonly used in investment arbitration awards (R-PHB, ¶ 322).
1180. The Tribunal sees no justification for providing that the amounts awarded be received net of taxes. First, part of the damages awarded, for instance the damages for increased cost of raw materials, are not profits at all, but a reimbursement of increased costs, even if they may have effect on the profits.
1181. Second, with respect to the part of the damages that does refer to lost profits, Mr. Boulton (on whose calculations the Tribunal has relied) has used gross profit margins for his calculations (ER of R. Boulton, ¶ 5.63). The Tribunal understands from this that the profits calculated by Mr. Boulton are before tax, and thus absent the Profit Tax Exemption would have been subject to tax. The Respondent does not contest that, under EGO 24, until 1 April 2009 the Corporate Claimants were entitled to the Profit Tax Exemption. However, the Tribunal understands that this exemption would apply only to profits made by the Corporate Claimants, and the Claimants have not shown which company within the EFDG would have made the profits that are being awarded.

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<sup>241</sup> Romania relies on the Romanian Fiscal Code (Exh. R-200), Article 42(b), and the KPMG Damages Report, ¶ 13.3.2.

1182. Finally, the Tribunal is indeed aware of the tax dispute between the Claimants and the Respondent. Given this delicate situation which raises many questions of Romanian law and in view of all circumstances, the Tribunal does not consider it appropriate to use in the Award the language requested by the Claimants.
1183. For the foregoing reasons, the Claimants' request that any damages be awarded net of taxes is dismissed.

## **F. TO WHOM SHOULD THE AWARD BE MADE?**

### **1. The Claimants' request for a different allocation of damages**

1184. Up until the hearing on the merits, the Claimants did not specify to whom an award should be made.
1185. In their Reply, the Claimants requested "an award granting them the following relief", *inter alia*, "compensation to Claimants for all damages they have suffered, as set forth herein and as may be further developed and quantified in the course of this proceeding" (C-Reply, ¶ 666, second bullet point).
1186. During the hearing on the merits, however, the Claimants stated that "as a matter of investment treaty law, the Micula brothers are the foreign shareholders while the [C]orporate [C]laimants are the vehicles for some of their investments. For this reason, it's appropriate that any award granted by the Tribunal should be made only to the foreign shareholders protected by the Sweden-Romania BIT, Viorel and Ioan Micula, and [...] they are agreed that as between themselves, the damages should be awarded on a 50/50 basis." Citing *Suez v. Argentina* and *PSEG v. Turkey*, the Claimants argued that this approach would be consistent with the approach taken in other treaty cases (Tr., Day 1, 143-145 (Reed)).
1187. The Claimants confirmed this position in their Revised Request for Relief submitted on 20 December 2010, where they requested that "[a]ny damages payable, including interest and costs, should be awarded to the [I]ndividual Claimants, Ioan Micula and Viorel Micula, to be divided between them on a 50:50 basis. In the alternative, any damages payable, including interest and costs, should be awarded to all five Claimants" (Revised Request for Relief, p. 1).
1188. This request was later confirmed in the Claimants' prayer for relief included at the end of their Post-Hearing Brief, in which "the Claimants request an award granting them the relief set out in the Revised Request" (C-PHB, ¶ 279).<sup>242</sup> This was further

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<sup>242</sup> The Tribunal is aware that in the body of their Post-Hearing Brief, the Claimants argued that "[s]hould the Tribunal not award damages to the Individual Claimants alone, the Claimants' secondary position is that any 'reliance' damages, or damages calculated on the basis of the fair market value immediately before the alleged breach, awarded should be awarded to the Individual Claimants and any other damages should be awarded to all of the Claimants", and that "[t]heir tertiary position was that "any award be made to each of the five Claimants" (C-PHB, ¶¶ 258-259). However, these arguments were not formulated as formal requests for relief and, as noted in paragraph 876 above, the Tribunal has focused on the Parties' formal requests for relief.

confirmed by the Claimants in their closing arguments during the hearing of June 2011.<sup>243</sup> As a result, the Claimants have formally prayed for two alternatives:

- a. That “[a]ny damages payable, including interest and costs, should be awarded to the [I]ndividual Claimants, Ioan Micula and Viorel Micula, to be divided between them on a 50:50 basis” (Revised Request for Relief, p. 1).
- b. “In the alternative, any damages payable, including interest and costs, should be awarded to all five Claimants” (*Id.*).

1189. In its Procedural Order of 6 April 2011, which addressed the Respondent’s objections to the Claimants’ Revised Request for Relief, the Tribunal found that “in requesting that any damages be awarded to Mr. Ioan Micula and Mr. Viorel Micula (the “Individual Claimants”) on a 50/50 basis (second sentence of the Revised Request), and in the alternative that any damages be awarded to all five Claimants (third sentence of the Revised Request), the Claimants have reformulated their damages case.” The Tribunal also found that “this raises several issues of procedure and of the merits” (P.O. of 6 April 2011, Section 3.3), and issued certain directions in this regard. Specifically, at Section 4.5 of that same Procedural Order, the Tribunal requested the Claimants to confirm that they wished to maintain their request (Section 4.5(a)). The Tribunal then directed the Parties to address the following matters in their post-hearing briefs (Section 4.5(b)):

- (i) Is it possible, as a matter of procedure and of the merits, for the claims of the Individual Claimants to be designated as either sole or principal claimants (as opposed to the Corporate Claimants, who would become subsidiary claimants) at this stage of the proceedings? In particular, would the Corporate Claimants need to waive their claims in favor of the Individual Claimants, and would this waiver be possible under Romanian and international law?
- (ii) What are the consequences of this new distribution of damages (if any) on the damages sought by the Claimants as pleaded to this date, both with respect to the factual and legal basis for the sought damages and their quantification?

1190. In addition, by letter of 6 May 2011, the Tribunal formulated certain questions to be addressed by the Parties with respect to the Claimants’ damages case. In particular, the Tribunal requested the Claimants to address the following points in relation to their new request for allocation of damages:

1.1 [...]

- a. Please address the Tribunal’s questions under Section 4.5 of the P.O. of 6 April 2011. In this context, please clarify what is the exact status of the Corporate Claimants’ claims. Are they subsidiary? Are they withdrawn? What are the consequences of either alternative?

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<sup>243</sup> In particular, the Claimants did not contradict the President when he stated that he understood that the first two paragraphs at the beginning of page 1 of the Revised Request attached to the Claimants’ letter of 20 December 2010 to be a prayer for relief (Tr., Day 12, 134-135 (President Lévy)).

- b. Please explain what is the legal basis on which the Tribunal should decline to award damages to the three Claimant Corporations and award damages only to the Individual Claimants? Is there a waiver of some kind by the Corporate Claimants?
- c. Please address the exact evidence in the record of the harm allegedly suffered by the Individual Claimants.

(Tribunal's letter of 6 May 2011, Section III.A.1.1).

1191. The Parties' responses to these questions are set out in Section 2 below.

## **2. The Parties' positions**

### **a. The Individual Claimants' right to claim damages in their capacity as shareholders**

1192. Citing a string of cases, the Claimants submit that, as a matter of investment treaty law, the Individual Claimants have the right to claim damages in their capacity as shareholders (C-PHB, ¶¶ 232-238). According to the Claimants, it is well-established that shareholders have standing to bring claims under investment treaties and may submit claims independently from the corporate entities in which they hold shares without the participation of those corporate entities. This is particularly so in this case, where the BIT defines "investment" very broadly as "any kind of asset owned or controlled invested directly or indirectly by an investor". In the Claimants' view, this means that the BIT directly protects all the Individual Claimants' rights in the entire investment, including tangible assets and the PICs, rather than merely the individuals' shares. Given that during the jurisdictional phase the Tribunal found that the Individual Claimants were foreign investors covered by the BIT, it follows that they could have brought the claims independently and without the participation of the Corporate Claimants in relation to the entire investment. In the Claimants' view, the Tribunal's Decision on Jurisdiction and Admissibility did not limit the scope of the Individual Claimants' claims to those of the Corporate Claimants; to the contrary, the Tribunal declined to determine every element of property over which it had jurisdiction.

1193. With respect to the damages that shareholders may claim as a result of an investment treaty violation, the Claimants contend that shareholders do not need to prove that they suffered harm directly and separately or independently from that suffered by the entity in which they hold shares. According to the Claimants, there is nothing in the BIT, the ICSID Convention or investment treaty law that would limit the rights of shareholders in this respect. For example:

- a. In *Goetz v Burundi*, the tribunal observed that "[...] prior ICSID case-law does not restrict the capacity to act to only those legal persons that are directly affected by

the alleged breaching measures; it extends that capacity to cover the shareholders in such legal persons, who are the actual investors.”<sup>244</sup>

- b. In *Bogdanov v. Moldova*, the tribunal stated that “[i]n the practice of investment arbitration it is generally accepted that the shareholders may be awarded indirect damages (SCHREUER. C. “Shareholder Protection in International Investment Law”, cit, pp.18f.). The remedy that may be claimed by the Foreign Investor, therefore, is not limited to the damage directly affecting his rights as shareholder in the Local Investment Company, but extends to any losses affecting the assets of the Local Investment Company, including also any reduction in value of the assets due to any alleged breach of contract by the Respondent. The indirect damage suffered by the Foreign Investor, therefore, corresponds to the loss of the Local Investment Company [...]”<sup>245</sup>

1194. The Claimants also assert that, in cases where claims have been brought by both shareholders and the companies in which they hold shares, ICSID tribunals have awarded damages directly to the shareholders alone and without the need for those shareholders to quantify their losses separately from those of the companies. The Claimants rely on the following cases, among others:

- a. *PSEG v. Turkey*, where the Tribunal, after noting that the project company was wholly owned by PSEG Global, decided to award all compensation to PSEG Global.<sup>246</sup>
- b. *Eastern Sugar v. Czech Republic*, where the tribunal awarded full damages to the parent company for losses suffered by its subsidiary following the subsidiary’s loss of its quota.<sup>247</sup>
- c. *Vivendi v. Argentina II*, where claims were brought by both the parent shareholder (Vivendi) and its subsidiary, and the tribunal, after concluding that Argentina had breached its treaty obligations to both Vivendi and its subsidiary,

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<sup>244</sup> *Antoine Goetz and others v Republic of Burundi* (ICSID Case No. ARB/95/3), Award Embodying the Parties’ Settlement Agreement, 10 February 1999, ¶ 89, as translated in S.A. Alexandrov, “The ‘Baby Boom’ of Treaty-Based Arbitrations and the Jurisdiction of ICSID Tribunals – Shareholders as ‘Investors’ under Investment Treaties”, *Journal of World Investment & Trade*, vol. 6, issue 3, June 2005, pages 393-398 (Exh. C-234).

<sup>245</sup> *Bogdanov v. Moldova* (BIT Arbitration under the Rules of the Arbitration Institute of the Stockholm Chamber of Commerce), Award, 22 September 2005, pp. 18-19.

<sup>246</sup> *PSEG v. Turkey*, ¶ 340.

<sup>247</sup> *Eastern Sugar B.V.(Netherlands) v. Czech Republic*, SCC Case No. 088/2004, Partial Award, 27 March 2007 (hereinafter “*Eastern Sugar v. Czech Republic*”), ¶ 367. (“The Arbitral Tribunal is aware that the loss of quota was suffered primarily by Eastern Sugar Ceska Republika a.s. However, this is a practically wholly-owned subsidiary of the Claimant Eastern Sugar B.V and the value of the subsidiary is in the present circumstances in practical terms determined by the value of the quota allocated to it. The Arbitral Tribunal deems it correct to award to the Claimant full damages for Eastern Sugar Ceska Republika a.s.’ loss of quota attributable to the Third Sugar Decree.”)

stated that “[a]s its 94.4% de facto shareholder, Vivendi is entitled to a 94.4% share of [the subsidiary’s] damages”.<sup>248</sup>

1195. The Respondent argues that “[t]he Claimants have confounded two issues: the Miculas’ standing to bring a claim and the quantum of damages to which they may be entitled” (R-PHB, ¶ 340, R-SPHB, ¶ 53). The Respondent submits that, “[w]hile the Miculas’ *jus standi* is a matter of jurisdiction, the amount of damages they can be awarded is a separate substantive legal issue.” The Respondent clarifies that it does not contest the Individual Claimants’ standing to bring a claim in respect of their identified investment (their shareholdings), and notes that the Tribunal accepted jurisdiction over claims arising from that investment. However, the Respondent emphasizes that that does not mean they are entitled to the same damages as the Corporate Claimants (R-PHB, ¶ 340).
1196. The Respondent contends that the cases cited by the Claimants do not support the proposition that a shareholder can be compensated for the quantum of harm suffered directly from the corporation (R-PHB, ¶¶ 343-345; R-SPHB, ¶¶ 54-55). For instance, in *PSEG v. Turkey*, a parent company was compensated for sunk costs that it had itself invested. In *AAPL v. Sri Lanka*, the tribunal declined to award the claimant damages for harm to the local company’s assets, and instead held that “[t]he scope of the international law protection granted to the foreign investor in the present case is limited to a single item: the value of his share-holding in the joint-venture entity [...]”.<sup>249</sup> In *Eastern Sugar v. Czech Republic*, the Respondent did not contest the payment of damages to the parent company rather than to the subsidiary, and the claimant had presented a report calculating the loss of share value.<sup>250</sup> In *Vivendi v. Argentina II*, the tribunal awarded the investment value of the concession, measured by the sunk costs that Vivendi had put into its local subsidiary.<sup>251</sup> In other cases cited by the Claimants, tribunals have awarded damages to compensate shareholders for the loss of value in their equity participation, measured differently from the damages incurred by their subsidiaries (as was the case in *Enron v. Argentina* and *CMS v. Argentina*), or lost dividends (as was the case in *LG&E v. Argentina*). As a result, the Respondent contends that “[s]hareholder damages are limited to losses suffered by the shareholder himself, such as any losses in the value of his shares or lost dividends” (R-PHB, ¶¶ 343-345).
1197. Citing *Nykomb v. Latvia*<sup>252</sup> and *Gemplus and Talsud v. Mexico*,<sup>253</sup> the Respondent argues that “[u]nder principles of company law common to virtually all jurisdictions, it

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<sup>248</sup> *Compañía de Aguas del Aconquija S.A. and Vivendi Universal S.A. v Argentine Republic*, (ICSID Case No. ARB/97/3, Award, 20 August 2007 (hereinafter “*Vivendi v. Argentina II*” or “*Vivendi II*”), ¶ 8.3.20).

<sup>249</sup> *AAPL v. Sri Lanka*, ¶ 95.

<sup>250</sup> *Eastern Sugar v. Czech Republic*, ¶ 358.

<sup>251</sup> *Vivendi v. Argentina II*, ¶¶ 8.3.12-8.3.19.

<sup>252</sup> *Nykomb Synergetics Technology Holding AB v. The Republic of Latvia*, SCC Case No 118/2001, Award, 16 December 2003 (hereinafter “*Nykomb v. Latvia*” or “*Nykomb*”), p 39. (“The Respondent has argued, and the Arbitral Tribunal must agree, that the reduced flow of income into Windau obviously does not cause an identical loss for Nykomb as an investor. [...] [I]t is clear that the higher payments for electric power would not have flowed fully and directly through to Nykomb. The money would have

cannot be assumed that the harm suffered by even a 100% shareholder equates to the harm suffered by a corporation” (R-PHB, ¶¶ 343-348; R-SPHB, ¶¶ 57-58). The Respondent submits in this respect that “[t]his approach is clearly correct. As noted by the *Nykomb* tribunal, a number of deductions may be made to a company’s income before it can be distributed to shareholders as dividends. To ignore this is to be blind to the legal and economic reality of equity ownership” (R-PHB, ¶ 346).

1198. In response to the Respondent’s arguments, the Claimants submit, relying on scholarly writings by Ripinsky and Williams, that “two factors appear to be determinative of whether a shareholder can claim directly the losses of the underlying business or whether a shareholder is restricted to its flow-through damages [...] first the provisions of the relevant BIT; and second, whether the shareholders hold a majority or a minority interest” (Tr., Day 12, 95 (Reed)). With respect to the first factor, a BIT’s definition of investment will determine whether the protection to a shareholder extends only to its direct investments or also to its indirect investments. The Claimants argue that, if the definition of investment extends to a shareholder’s indirect investments (as is the case here), then shareholders would be entitled to claim for harm to the assets of the underlying company. With respect to the second factor, the Claimants contend that it would be all the more appropriate to treat the underlying business unit as the protected investment when the shareholder owns a majority interest in the underlying company. In this regard, citing Ripinsky and Williams, they submit that “[i]f the business unit in its entirety is considered to be the claimant’s protected investment, then all of the damages caused to the business must be assumed to flow to the shareholder as the owner of the business, or part thereof, directly without distortion” (Tr., Day 12, 102 (Reed)).<sup>254</sup>
1199. The Claimants argue that both of these factors were present in the cases cited by the Claimants where tribunals awarded the parent company the damages suffered by the subsidiary (*Azurix v. Argentina*, *Vivendi II*, *Eastern Sugar v. Czech Republic*). By contrast, in all of the cases cited by the Respondent except one, at least one of the factors was missing. Specifically, in *AAPL v. Sri Lanka*, the relevant BIT did not

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been subject to Latvian taxes etc., would have been used to cover Windau’s costs and down payments on Windau’s loans etc., and disbursements to the shareholder would be subject to restrictions in Latvian company law on payment of dividends. An assessment of the Claimant’s loss on or damage to its investment based directly on the reduced income flow into Windau is unfounded and must be rejected.”)

<sup>253</sup> *Gemplus and Talsud v. Mexico*, ¶ 12-50 (“The Claimants’ claims for compensation derive only from their status as investors with investments in the form of their respective minority shareholdings in the Concessionaire, as distinct from any claim by the Concessionaire itself. Perhaps inevitably, the Parties’ submissions occasionally elided this important distinction, effectively treating the valuation of the Concessionaire’s future profits (if any) as the relevant exercise for the assessment of compensation due to the Claimants. The exercise required of this Tribunal is, in contrast, the valuation of the Claimants’ lost investments in the form of their shares in the Concessionaire and not, as such, the lost profits incurred by the Concessionaire under the Concession Agreement. The latter are not, of course, irrelevant; but they are not directly relevant as if the Claimants’ claims were made by the Concessionaire itself.”)

<sup>254</sup> The Claimants do not provide a citation for this, but the Tribunal notes that the text roughly corresponds to S. Ripinsky & K. Williams, *Damages in International Investment Law* (2008), pp. 149-150.

protect indirect investments of shareholders and the claimant was a minority shareholder, while in *Gemplus and Talsud* the claimants were minority shareholders (Tr., Day 12, 99-103 (Reed)).

1200. The Claimants concede that *Nykomb v. Latvia*, cited by the Respondent, does not conform to Ripinsky's and Williams' theory. However, they submit that there is a third factor that should be considered, namely "whether the company in which the shareholder holds the shares was specifically set up for the purposes of carrying out the investment, and that is therefore whether the local entity is simply a vehicle for the investment, an investment vehicle" (Tr., Day 12, 105 (Reed)). The Claimants point out that Nykomb had not incorporated the local entity, but had acquired the shares at a subsequent point in time, when the dispute had already arisen, and submit that these circumstances could have been a factor that led the tribunal to limit Nykomb's recovery to the value of its shares.
1201. In view of the foregoing, the Claimants submit that all of the cases cited by the Parties "can be reconciled with the following proposition: that where a foreign investors [sic] incorporates an entity in the host state for the purposes of making an investment in the host state, and where the investor owns 100% interest or at least a majority interest in the entity thus created and controls it, and where the investment treaty protects both the investor's indirect and direct interests, the local entity can properly be viewed as a conduit or investment vehicle and the investor's protected interest is in the underlying business and assets carried out through the investment vehicle, such that the investor is entitled to claim the local entity's losses as its own" (Tr., Day 12, 107-108 (Reed)). The Tribunal understands that the Claimants' position is that this is the case here: (i) Article 1(1) of the BIT does not limit its protection to the Individual Claimants' direct investments (their shares), but extends to their indirect interest in the underlying EFDG companies; (ii) the Individual Claimants own virtually 100% of the shares of the EFDG, and (iii) the Corporate Claimants were created as investment vehicles.
1202. Despite these arguments, the Respondent contends that most of the cases cited by the Claimants do not support the right of shareholders to compensation for the profits lost by the underlying business of their company. For example, in *Siemens* the Tribunal refused to award damages to the shareholder for its subsidiary's lost profits; it only awarded Siemens the book value of the subsidiary itself. Similarly, it argues that claims for lost profits were rejected in *Vivendi II* and *Azurix v. Argentina* (Tr., Day 13, 249 (Rubins))
1203. The Respondent further contends that, "as the present case shows, it would be fundamentally unjust to ignore the fact that shareholders are last in line for corporate assets. Those assets cannot go to shareholders if that means creditors cannot be paid in full" (R-PHB, ¶ 346). More specifically, the Respondent argues:
  - a. "This is part of the basic bargain investors make when they choose to conduct business through corporations rather than in their own names. [...] The Individual Claimants [...] chose to run their food and drinks business through a complex



network of corporations because it was advantageous to do so. They cannot now ignore the facts that the Corporate Claimants have separate legal personality; that the Individual Claimants do not own the corporations' assets; or that the corporations' creditors—including the state, through its undisputed entitlement to overdue tax payments—have the first claim on those assets, if (as the Claimants contend) the Corporate Claimants are incapable of paying their debts" (R-PHB, ¶ 347).

- b. "[O]ne of the most obvious scenarios in which harm to a corporation causes no compensable harm to shareholders is when the corporation cannot pay its debts, so that the shares have no value in any event. This highlights an important reason for not diverting to the Individual Claimants damages actually suffered by the Corporate Claimants: the risk of a fraudulent conveyance" (R-PHB, ¶ 348). Indeed, the Respondent argues the Claimants "acknowledge that the very reason they have suddenly requested that all damages go to the Individual Claimants is to avoid paying the Corporate Claimants' tax obligations" (*Id.*).<sup>255</sup>

1204. In response to questions from the Tribunal regarding the protection of the Corporate Claimants' creditors (including Romania) in the case of an award to the Individual Claimants,<sup>256</sup> the Claimants stated in their oral closing arguments:

[T]hose points are kind of answered in allowing shareholders to bring these kind of claims. And the reason for that in investment law is they are the real parties in interest in these matters, and creditors, including state creditors, cannot think that they have a claim to these kinds of losses because they know that shareholders have their own rights in international law. So a creditor or the taxman has no expectation that they can recover these taxes or whatever on the basis of amounts to be awarded in an ICSID arbitration.

[...]

With respect to the position of the [C]orporate [C]laimants and their creditors and employees if the Tribunal were to make an award to the shareholders, [...] in our view strictly as a legal matter, the answer is that the BIT protects foreign investors and breaches of the foreign investors' rights entitled them to compensation, and the foreign investors are the real parties in interest, as has been decided in a number of cases. The fate of the investment vehicle doesn't come into the balance, strictly legally speaking, in our submission.

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<sup>255</sup> The Respondent cites a letter from King and Spalding dated 15 April 2011 (Exh. R-242), in which the Corporate Claimants state that they "certainly have no intention of avoiding their liabilities to commercial creditors, in respect of whom they are not in default." The Respondent concludes that "they apparently do intend to avoid their liability for taxes that they admit are overdue" (R-PHB, ¶ 348).

<sup>256</sup> Specifically, Dr. Alexandrov asked counsel for Claimants: "If the Tribunal decides to follow your suggestion and order payment to the two individual claimants, wouldn't the Tribunal expose respondent to a situation where respondent would not be able to collect principal due that is not disputed? [...] [A]ssuming we agree with your legal proposition that the two individual claimants are entitled to the damages of the group, and that the damages should be paid to them, if there are any damages of course, the question then is [...] if the Tribunal wants to protect Romania and make sure that Romania collects the debt that is owed by the corporate claimants, how do we reconcile that with the legal proposition that you are advancing that the shareholders are entitled to be paid the amount of damages?" (Tr., Day 12, 132-134).

As a more pragmatic matter it seems to us that if you were to make the award that we urge, then my client -- Johnny Micula would have an award, and an award is not money. There would be a negotiation with the state and with the banks. Probably the banks would have to take a bit of a haircut because these are basically more or less sound businesses but crippled by debt. If the debt were relieved, things might be better. The state might have to do something as well.

We see it more as an issue that arises after an award rather than in arriving at the award, as a strict matter. I suppose if the parties can't agree, it is of course plausible that the companies will go into bankruptcy. That doesn't actually mean that people will lose jobs because the businesses will presumably be sold, new investors will be found, they won't have to carry those debts; they will remain with the bankrupt entities. The banks will presumably lose money if the assets aren't sufficient to cover all the debts. We think that's the proper view.

With that said, it does follow from some of the points that Professor Alexandrov made that you may be in a position to make a distinction between damages owed to the individual shareholders in their own right, and notably in relation to the investments of the companies that are not the corporate claimants, you may be able to take a view on the damages owed to the corporate claimants. So whilst we think that is possible, we don't actually think that is the right approach.

(Tr., Day 12, 133-140 (Reed))

1205. In its closing statement, the Respondent strongly objected to the Claimants' comments in this respect. According to the Respondent, the Claimants' comments suggest that "international law gives equity holders a right to take for themselves what may be their company's largest asset, a claim against the state, and creditors be damned", which is a result that would be "contrary to basic corporate law" and could not be expected either by the Corporate Claimants' creditors or their employees (Tr., Day 13, 253 (Rubins)). Instead, the Respondent reiterates that "the assets of a company, which includes all receivables, do not belong to the shareholders. The [C]orporate [C]laimants have obligations to third parties that rank higher in priority than dividends payments to shareholders: they need to pay corporate creditors, they need to pay their employees' salaries and they need to pay Romania for the undisputed taxes they owe. These are all ahead of them in line." (Tr., Day 13, 252 (Rubins)).
1206. The Respondent further criticized the Claimants' suggestion that an award of damages would be followed by a negotiation with the Romanian State and other creditors, arguing that the Claimants' position appeared to be that "international law gives shareholders a stick with which to beat their creditors" and that it allows them to "empty the company of its assets under the guise of a BIT and then strike a deal the banks and the state can't refuse because they are holding all the cards" (Tr., Day 13, 254 (Rubins)).

**b. Is it possible for the Individual Claimants to be designated as the sole or principal claimants at this stage of the proceedings?**

1207. The Claimants submit that “[i]t is possible as a matter of both procedure and the merits for the Individual Claimants to be designated as the sole or principal claimants at this stage of the proceedings” (C-PHB, ¶¶ 239-243).
1208. The Claimants first argue that, as “the Individual Claimants could have brought their claims independently without the participation of the Corporate Claimants in the first instance [...] there is no legal basis why the Individual Claimants cannot become the sole or principal claimants at this stage” (C-PHB, ¶ 241). The Claimants rely on *Suez v. Argentina*, where the tribunal allowed the proceedings brought by the local company to be discontinued at the jurisdictional stage, noting that this discontinuance “[...] does not affect the rights of the Shareholder Claimants to bring a claim in ICSID arbitration under the two BITs in question. The Claimant Shareholders would have had a right to bring such claims independently without the participation of the [local company] in first instance.”<sup>257</sup> Although the Claimants acknowledge that in this case no discontinuance is being sought, and the Claimants’ request for damages to be awarded to the Individual Claimants was made at the merits stage rather than at the jurisdictional stage, they argue that the tribunal’s reasoning in *Suez v. Argentina* is equally applicable to the present case.
1209. In addition, the Claimants assert that “the claims for monetary damages in this case have always related to the financial losses suffered by the individual shareholders. The Corporate Claimants were primarily included as Claimants five years ago as a result of the original alternative claim for restitution of the EGO 24 regime. Unlike monetary damages, which have consistently been awarded to shareholder claimants in BIT practice, restitution of a legal framework – essentially an order for specific performance – could only be awarded to the Corporate Claimants. Regardless, that claim for restitution was dropped at the beginning of the merits phase of this case. There has never been any question that this case involved claims for monetary damages, that the Micula brothers owned nearly 100% of the companies comprising the European Food and Drinks Companies, or that the brothers, as shareholders, were the Claimants who ultimately suffered the losses at issue in this dispute” (C-PHB, ¶ 242).
1210. In light of the case law cited in the preceding section, the Claimants contend that awarding damages to the Individual Claimants is lawful under international law:
- a. The Claimants emphasize that the investment vehicle in *Suez v. Argentina* was entitled to lawfully withdraw its claim, leaving only the shareholders as claimants. Similarly, the Claimants argue that “as a matter of principle, it must be that in every case where both the shareholders and the local investment vehicle could have brought proceedings but only the shareholders did, the local investment

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<sup>257</sup> *Suez, Sociedad General de Aguas de Barcelona S.A. and Interagua Servicios Integrales de Agua S.A. v. Argentine Republic* (ICSID Case No. ARB/03/17), Decision on Jurisdiction, 16 May 2006 (hereinafter “*Suez v. Argentina*”), ¶ 51.

vehicle ‘waived’ its rights to an award.” In addition, they contend that “had the Individual Claimants commenced these proceedings alone, this issue would likely never have arisen. Consequently, this is a non-issue about which the Tribunal need not concern itself further” (C-PHB, ¶¶ 244-245).

- b. The Claimants further submit that “[t]he approach in international investment law is to award damages to the foreign investor, not to the investment vehicle incorporated in the host state.” According to the Claimants, “[t]here are sound policy reasons for this approach”, as the contrary “would entirely undermine the protections afforded by investment treaties if states could breach their obligations to foreign investors, impose draconian penalties on the local investment vehicle and then demand that tribunals make payments only to the local investment vehicle on the basis that otherwise the investment vehicle will get away with not paying taxes and penalties (that it should never have incurred)” (C-PHB, ¶ 246).

1211. The Claimants further submit that awarding damages to the Individual Claimants is lawful under Romanian law (although they clarify that, in their view, Romanian law is irrelevant to this issue and the Tribunal should award damages in accordance with international law). Specifically, the Claimants argue that:

- a. Pursuant to the “principle of availability”, Romanian law recognizes the right of legal persons to exercise their civil rights as they see fit. According to the Claimants, this principle allows legal persons to determine whether or not they wish to commence legal proceedings, what claims or defenses to make in such proceedings, whether to discontinue or settle such proceedings, and whether to appeal or enforce any decision. The Claimants further submit that this principle gives to legal persons the right to agree that any damages award to which they are entitled be granted to other co-claimants with the same entitlement to such an award. Thus, pursuant to this principle the Corporate Claimants would be entitled to “waive” any rights they have to the award (C-PHB, ¶ 249). In support of this contention, the Claimants cite article 129(6) of the Romanian Procedural Civil Code, which provides that “[i]n all cases, the judges shall decide only regarding the request’s object in dispute.” According to the Claimants, “[a]s it is applied, that provision supports the Claimants’ contention that they can decide amongst themselves how the Tribunal is to award their damages. There is no requirement that the Corporate Claimants formally waive their claims in order to apply that principle” (C-PHB, fn. 364).
- b. In addition, the Claimants submit that nothing in the Romanian Commercial Code or laws regulating companies, including Law 31/1990, would prevent the Corporate Claimants from assigning their rights to the award to the Individual Claimants (C-PHB, ¶ 250).

1212. By contrast, the Respondent submits that the Individual Claimants cannot be designated as sole or principal claimants at this stage without Romania’s consent or without complying with certain legal requirements (R-PHB, ¶¶ 335-338, R-SPHB, ¶¶ 59-64).

1213. The Respondent contends that, if the Individual Claimants were designated as sole Claimants at this late stage with the consent of the Corporate Claimants, that would constitute an abandonment of the Corporate Claimants' claims that would amount to a partial discontinuance of the proceeding. In that case, the Respondent argues that it would be entitled to an award with *res judicata* effect against the Corporate Claimants. The Respondent explains that the Corporate Claimants cannot discontinue the proceeding without Romania's consent under Rule 44 of the ICSID Arbitration Rules, and that Romania will not consent to any resolution that would permit the Corporate Claimants later to revive claims or requested relief that they have pursued (or could have pursued) in this proceeding, or without compensation for wasted costs.
1214. Romania further contends that the Claimants' reliance on *Suez v. Argentina* is inapposite, because in that case the local company's claims were withdrawn without objection by the Respondent. Here Romania has objected expressly: "apart from the substantive unfairness to the Corporate Claimants' creditors, including Romania, of the proposed waiver, a respondent that has been made to defend proceedings for five years has a legitimate interest in both an award with *res judicata* effect and reimbursement of its wasted costs as conditions of a discontinuance" (R-SPHB, ¶ 61).
1215. According to Romania, Romanian substantive and procedural law lead to the same conclusion. Citing Romanian case law, the Respondent submits that "[a] court need not accept a claimant's withdrawal of claims over the respondent's objection; but if the court does accept the withdrawal, it must render a judgment extinguishing the underlying right and determining the costs consequences of the claimant's waiver"<sup>258</sup> (R-SPHB, ¶ 61).
1216. The Respondent adds that, in any event, Romanian civil and company laws prohibit any action, including renunciation of claims, that could violate the rights of third parties, including removing assets from a company's patrimony to the detriment of creditors.<sup>259</sup> Given the value of the Corporate Claimants' damages claims and the Claimants' assertion that the Corporate Claimants have zero equity value and cannot pay their overdue debts, the Respondent argues that relinquishing those claims would prejudice the rights of creditors. The Respondent notes that Romanian law permits an interested party, such as a creditor, to move to nullify the waiver.<sup>260</sup> Romania, which is a substantial creditor, opposes the waiver, but notes that the other creditors of the Corporate Claimants may have no knowledge of a proposed waiver (R-SPHB, ¶ 62).
1217. Even if the Corporate Claimants were to waive their own damages claims, the Respondent argues that that would not be equivalent to assigning those claims to the Individual Claimants (R-PHB, ¶ 336). Only by assignment, and not by waiver, could

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<sup>258</sup> The Respondent cites Civil Decision 28/30 January 2008, Constanta Court of Appeal, Civil Section; High Court of Justice and Appeal of Romania Decision 3519/26 November, 2008; Romanian Civil Procedure Code, Article 247(1).

<sup>259</sup> The Respondent cites Law 31/1990, Article 237(3), Article 237(4), and Article 272 (1)(2).

<sup>260</sup> The Respondent cites the Romanian Civil Code, Title III, Chapter III, Section II, Article 975.

the Individual Claimants receive compensation for harm to the Corporate Claimants. However, the Respondent argues that “Romanian law does not permit a debtor to give away an asset, receiving no payment in return, if that may frustrate creditors’ ability to recover what they are owed. When the debtor is a corporation or limited liability company, the conditions are stricter, as such entities can only rarely make gratuitous transfers (particularly to their own shareholders). To effect an assignment, the Corporate Claimants and Individual Claimants would need to enter into an assignment agreement, on an arm’s length basis – in other words, in which the Individual Claimants paid market value for the assignment. Procedurally, the assignment would have to be validly approved by a general meeting of shareholders, and it would have to be publicised in a manner set out by Romanian law if it were to have any effect against third parties – including, again, the Corporate Claimants’ creditors who are not represented here” (R-SPHB, ¶ 63).<sup>261</sup> Here, the Respondent points out that the Corporate Claimants have not assigned their claims to the Individual Claimants, and it is highly unlikely that such an assignment could be made without violating Romanian civil and criminal law (R-SPHB, ¶¶ 63-64).

1218. Without an assignment of the Corporate Claimants’ claims, the Respondent contends that the Individual Claimants cannot receive compensation that they have not proven to be their own. As explained in the previous section, the Respondent submits that, if liability is proven, each Claimant would be entitled to compensation for harm to his or its own investment, and damage to the Corporate Claimants’ assets cannot be equated with damage to the Individual Claimants’ shares in the Corporate Claimants. As a result, the Claimants cannot properly ask the Tribunal to award to the Individual Claimants damages that would have been awarded to the Corporate Claimants had they not stepped aside. Thus, the request for “all damages” to be paid to the Individual Claimants cannot entitle them to anything more than compensation for losses they have suffered (R-PHB, ¶¶ 336-337).

1219. The Respondent contends that, “[f]or the same reason, it is irrelevant that the Individual Claimants could have chosen to bring a case by themselves, without joining the Corporate Claimants. Had they done so, they would have been entitled (assuming liability) only to damages they had suffered. [...] Whether the Corporate Claimants withdraw now, had never been in the case, or continue to pursue their own damages claims, the Individual Claimants would not be entitled to receive compensation that they have not proven to be their own” (R-PHB, ¶ 338).

**c. The impact of the Claimants’ requested allocation on the factual or legal bases for the claimed damages or their quantification**

1220. The Claimants contend that “[a]warding damages to the Individual Claimants alone does not have any consequences with respect to the factual or legal basis for the claimed damages or the quantification of those damages” (C-PHB, ¶¶ 251-254). The Claimants assert that the Individual Claimants own (directly or indirectly) virtually all of the shares in each of the companies of the EFDG. As a result, had the Individual

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<sup>261</sup> The Respondent cites Law 99/1999, Title VI, Chapter 1, Article 2(a) and Chapter 3, Article 29, as well as Articles 1391 *et seq.* of the Romanian Civil Code.

Claimants commenced these proceedings on their own, as the Claimants argue that they were entitled to do, they could have claimed and been entitled to all of the damages being sought in these proceedings.

1221. By contrast, the Respondent argues that the Individual Claimants are not entitled to any damages, because they have not proven the quantum of any loss. Indeed, the Respondent contends that there is no factual basis for any award of damages to the Individual Claimants, whether or not the Corporate Claimants stay in the case, because the Claimants have not assessed the damages incurred by the Individual Claimants, whether as shareholders of the Corporate Claimants or in any other capacity. The Respondent also argues that the Claimants have not justified their request for a different damages allocation, and that this request at such a late stage constitutes a change of position that should be taken into consideration when determining costs (R-PHB, ¶¶ 332-350, R-SPHB, ¶¶ 53-65).
1222. The Respondent contends that, because they have not proved damages that they themselves have suffered (*i.e.*, the diminution in value of their shares), the Individual Claimants should receive nothing. The Respondent adds that “[t]his is the Individual Claimants’ burden of proof, and they have not even attempted to quantify the loss in value of their shareholdings in the Corporate Claimants. The Claimants have consistently declined to instruct one of their many quantum experts to carry out such a valuation. It would be fundamentally improper, and improper to Romania, to excuse this willful failure of proof and guess at a damages figure for the Individual Claimants, which is the only basis on which any damages could be awarded to them” (R-SPHB, ¶ 65).
1223. Contrary to the Respondent’s contentions, the Claimants argue that there is significant evidence in the record showing that the Individual Claimants have suffered harm as a result of the Respondent’s unlawful actions (C-PHB, ¶¶ 255-257):
- a. According to Mr. Osborne’s calculations, in 2001 the EFDG had retained earnings of €152 million. The Claimants argue that this means that the EFDG companies could have paid to their shareholders (the Individual Claimants) €152 million at that time. The Claimants further assert that today the EFDG’s retained earnings are gone and as such, the Micula brothers, as shareholders, have lost at least that €152 million (less the €17 million worth of dividends paid in the interim period) (First ER of C. Osborne, ¶¶ 3.27-3.30).
  - b. In his reliance damages analysis, Mr. Osborne valued the Claimants’ pre-EGO 24 businesses at €400 million.<sup>262</sup> According to the Claimants, had the Individual Claimants sold their businesses at that time for that price, the Individual Claimants, in their capacity as shareholders, would likely have received the vast majority of this sale. Also relying on Mr. Osborne, the Claimants contend that, if

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<sup>262</sup> As noted in paragraph 886 above, the Tribunal understands that the Claimants’ final prayer on the basis of Mr. Osborne’s reliance damages analysis is RON 811 million, not €400 million. That being said, as the Tribunal is not awarding any damages for this head of claim it is unnecessary to determine whether the Claimants could have augmented this claim.

the Miculas were to sell their businesses today, they would likely recover not a single lei. The Claimants argue that Mr. Ellison agreed that the value of the shares prior to the revocation could have been as high as €350 million and that the current value of the shares is likely to be nil or virtually nil (Tr., Day 12, 109-110 (Reed); Tr., Day 10, 36-37 (Osborne)).

- c. The Individual Claimants have suffered losses even from an expectation damages perspective. The Claimants argue that, “[h]ad the Claimants been able to make additional sales, due to the advantages of the Raw Materials Incentive (including an ability to sell their products at lower relative prices than their competitors to take advantage of the SCP opportunity) and by being able to complete the Incremental Investments (again by being able to take advantage of the incentives), the Claimants’ businesses would have been more profitable, which would likely have led to increased dividends to the shareholders and/or the Individual Claimants being able to sell the businesses for a considerable profit.

1224. With respect to the impact of their requested allocation on the quantum of damages, in their closing statements the Claimants made the following comments (Tr., Day 12, 108-112 (Reed)):

- a. “If the Tribunal considers that the Micula brothers’ protected investments in Romania include the underlying business assets, then no separate damages calculation is required: all the damages should be awarded to the brothers as 50/50 shareholders. There’s no need for the [C]orporate [C]laimants to withdraw from the case or to waive any claim, and the award would be binding upon them.” (Tr., Day 12, 108-109 (Reed)).
- b. In the Claimants’ submission, the question of flow-through damages only arises if the Tribunal takes the view that only the Individual Claimants’ shares constitute protected investments. In this case, their damages would be limited to the impact on the shares themselves, in particular to the loss of value of those shares. The Claimants argue that this loss of share value has been calculated by Mr. Osborne in his reliance damages analysis.<sup>263</sup> As explained in the paragraph 1223.b above, the Claimants submit that, based on this analysis, the loss of value of the Individual Claimants’ shares is €400 million.
- c. If, as in *Nykomb*, the Tribunal were inclined to take a stricter approach, and was inclined to limit the damages to the shareholders to amounts that would have been available to distribute as dividends, the Claimants submit that the Tribunal would still be able to establish quantum in this case. The Claimants argue that the Individual Claimants would have been entitled to take as dividends all of the retained earnings built up in the EFDG companies over the preceding years. The Claimants assert that the retained earnings of the EFDG companies over the years 1999-2004 amount to €173 million, a number that is not controversial as it

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<sup>263</sup> The Claimants refute the Respondent’s suggestion that they did not instruct any of their experts to carry out an evaluation of the loss of value of the shares of the Individual Claimants in the EFDG: they argue that this evaluation was carried out by Mr. Osborne in his reliance damages analysis.



is taken directly from the accounts and does not require computation. The Claimants argue that, because these amounts were earnings available for distribution as dividends, they take into account all of the creditors (Tr., Day 12, 110-111 (Reed)). The Claimants further contend that, under the *Nykomb* approach, the Individual Claimants would have been entitled to a proportion of the EFDG companies' future income (*i.e.* the Claimants' claims for expectation losses). The *Nykomb* tribunal assessed that the shareholders were entitled to one-third of the underlying company's losses, but the Claimants submit that under normal circumstances a higher proportion would be appropriate (Tr., Day 12, 110-112 (Reed)).

1225. In turn, the Respondent denies that the Individual Claimants' loss of shareholder value can be quantified on the basis of Mr. Osborne's reliance losses analysis:

- a. The Respondent acknowledges that Mr. Osborne attempted to quantify the EFDG shareholder equity prior to the revocation by comparing EFDG to other publicly traded companies in the same line of business. However, the Respondent contends that the valuation date chosen by Mr. Osborne (2001) is not a proper valuation date because it is neither the date of the breach nor the date of the award. Rather, the Respondent argues that Mr. Osborne chose 2001 because it is the date of EFDG's financial peak, the "year just before the straight-line drop" in the financials, "so it's helpful to come up with a big number" (Tr., Day 13, 250 (Rubins)).
- b. The Respondent also denies that Mr. Ellison confirmed a nil value for the EFDG today. The Respondent asserts that Mr. Ellison said that the value could be nil, but as he had not seen any audited financial statements for the EFDG since 2006, "he could say nothing about the state of EFDG's business today, and [the Tribunal] can't know because of the absence of documentation" (Tr., Day 13, 250 (Rubins)). Indeed, the Respondent asserts that, in their closing statements, the Claimants stated that the EFDG's business had been improving in 2009<sup>264</sup> and that this was also confirmed by a better EBITDA in the financials (Tr., Day 13, 250-251 (Rubins)).
- c. The Respondent also notes that, according to Mr. Ellison, there was substantial shareholder equity in the business according to the 2009 draft financial statements, which suggests substantial remaining value for the Micula brothers. Specifically, the Respondent states that "[a]ccording to the draft 2009 accounts, shareholder equity was RON 461.7 million; [...] €109 million roughly. So by assuming a zero value today, which is what Mr. Osborne does, he was asking you to ignore that €109 million are there, and the claimants would be likely to access that money on liquidation" (Tr., Day 13, 252 (Rubins)).

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<sup>264</sup> The Respondent notes that, in their closing statements, the Claimants admitted that "on operating profits the company has actually performed better in 2009 than in 2008, although not well enough to meet their debt repayment obligations" (Tr., Day 12, 119 (Reed)), and that "[t]hese are basically more or less sound businesses but crippled by debt. If the debt were relieved, things might be better" (Tr., Day 12, 139 (Reed)).

1226. Instead, the Respondent argues that the proper way to value the Individual Claimants' losses would have been "to perform a DCF valuation of the claimants' business as it was just before repeal and as it would have been with the €8 million per year in facilities through 2009", because this would have allowed the Tribunal to isolate the effect of the revocation. The Respondent "infer[s] that the result of such conventional modelling would have revealed the limited direct impact on equity value" (Tr., Day 13, 251-252 (Rubins)).
1227. The Respondent concludes that, "[o]n this record, the only damages that have been quantified are damages allegedly incurred by EFDG companies, not all of which are claimants. The Tribunal should ensure that only damages proven to have been incurred by each Corporate Claimant are awarded to the specific Corporate Claimant that incurred them. [...] [D]amages allegedly incurred by other entities cannot be recovered by any of the Claimants" (R-PHB, ¶ 350).
1228. In response to questions from the Tribunal, the Claimants clarified that, if the Tribunal were inclined to award damages to all five Claimants, the damages suffered by the Individual Claimants may not be coextensive with those suffered by the Corporate Claimants:
- a. With respect to the reliance losses claim, the Corporate Claimants could not make the same claim as the Individual Claimants, because the reliance loss is calculated on the loss of value to all companies of the EFDG (Tr., Day 12, 129 (Reed)), not all of which are claimants here. Possibly somewhat contradictorily, the Claimants have also argued that, should the Tribunal award reliance damages, it would be inappropriate to award these damages to the Corporate Claimants. This is because the reliance damages approach looks at the value lost from the pre-EGO 24 businesses as a result of investing in reliance on the incentives. As the Corporate Claimants were specifically created in order to receive the incentives, had the Individual Claimants not invested in reliance on the incentives, it is likely that the Corporate Claimants would have never been created and thus would have never incurred a reliance loss (C-PHB, ¶ 253).
  - b. For similar reasons, should the Tribunal award damages by looking at the fair market value of the investment immediately before the breach, the Claimants contend that such an award ought to be made to the Individual Claimants to compensate them for the loss in value of their business (C-PHB, ¶ 254).
  - c. With respect to expectation losses, counsel for the Claimants first stated that "they would not be coextensive if much of the loss was suffered outside of the three [C]orporate [C]laimants", but then clarified that "they may be more or less the same", depending on which company had suffered most of the damages, adding that in his understanding "most of the expectation damages would have been suffered by European Food" (Tr., Day 12, 129-130 (Reed)).

### 3. The Tribunal's analysis with respect to the requested allocation of damages

#### a. The Claimants' request that all damages be awarded to the Individual Claimants

1229. The Tribunal rejects, for procedural reasons, the Claimants' request that all damages be awarded to the Individual Claimants.
1230. Relying on *Suez v. Argentina*, the Claimants contend that, as "the Individual Claimants could have brought their claims independently without the participation of the Corporate Claimants in the first instance [...] there is no legal basis why the Individual Claimants cannot become the sole or principal claimants at this stage" (C-PHB, ¶ 241).
1231. That the Individual Claimants could have brought claims on a stand-alone basis is not in dispute. However, the Tribunal disagrees with the consequences that the Claimants purport to derive from that observation. It is true that in *Suez v. Argentina* the tribunal, applying Rule 44 of the ICSID Arbitration Rules,<sup>265</sup> allowed the local company to withdraw its claim leaving only the shareholders as claimants.<sup>266</sup> However, the local company in that case elected to pursue a very different route than that followed by the Corporate Claimants in this case. First, the investment vehicle expressly withdrew its claim and sought a discontinuance of the proceeding. Second, upon Argentina's request, the local company supplied the minutes of their shareholders meeting authorizing that discontinuance. Third, having received those assurances, Argentina consented to the discontinuance.
1232. Here the situation is quite different. The Corporate Claimants have not requested the discontinuance of the proceedings with respect to their claims. Quite to the contrary, the Corporate Claimants are still seeking alternative relief in case the Tribunal decides not to grant all damages to the Individual Claimants. As a result, Rule 44 is simply not applicable to the situation at hand.
1233. Even if the Claimants' request could be interpreted as an implied request for a discontinuance with respect to the Corporate Claimants (*quod non*, because they have expressly stated that they are not seeking a discontinuance), the conditions set out by Rule 44 would not be satisfied because Romania has objected to such a discontinuance. Indeed, Romania has expressly stated that it will not consent to any resolution that would permit the Corporate Claimants to revive at a later date the claims or the relief that they have pursued (or could have pursued) in this proceeding, or without compensation for wasted costs.

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<sup>265</sup> ICSID Arbitration Rule 44 provides: "If a party requests the discontinuance of the proceeding, the Tribunal, or the Secretary-General if the Tribunal has not yet been constituted, shall in an order fix a time limit within which the other party may state whether it opposes the discontinuance. If no objection is made in writing within the time limit, the other party shall be deemed to have acquiesced in the discontinuance and the Tribunal, or if appropriate the Secretary-General, shall in an order take note of the discontinuance of the proceeding. If objection is made, the proceeding shall continue."

<sup>266</sup> *Suez v. Argentina*, ¶ 51.

1234. Rule 44 provides that if an objection is made, the “proceeding shall continue”, regardless of the nature of the objection, or whether it is justified or not. In this case, moreover, Romania’s objections are more than reasonable.
1235. As the Corporate Claimants have not discontinued their claims, it follows that they are not waiving their claims against Romania and, in fact, definitely maintain them in the event that the Tribunal should not make the award fully payable to the Individual Claimants. Moreover, there is nothing in the Claimants’ submissions that could amount to a conditional waiver (that is, a waiver conditioned upon the Individual Claimants obtaining the requested relief). Even if the Corporate Claimants had indicated that they waived their claims against Romania, there is no evidence in the record establishing that such waiver would be valid, in particular under Romanian law (for instance, there are no shareholders’ minutes or board resolutions from the Corporate Claimants or their shareholders authorizing such a waiver). In these circumstances, the Tribunal agrees with Romania that it is entitled to an award with *res judicata* effect against the Corporate Claimants.
1236. In the Tribunal’s view, whether the Individual Claimants could have been entitled to bring this case independently, without the participation of the Corporate Claimants, is irrelevant. They did not choose to do so. The fact is that this arbitration was commenced and pursued by five Claimants, all of whom have requested relief to this Tribunal. The Corporate Claimants have sought the same relief as the Individual Claimants and have not withdrawn their claims. The Tribunal must thus decide the claims raised by the five Claimants and not only the claims raised by two of them.
1237. All five Claimants have requested monetary relief. The Tribunal having found liability, the Claimants’ request to have all damages awarded to the Individual Claimants would thus deprive the Corporate Claimants of a right (credit or account payable) to the relief requested. This would amount to the Corporate Claimants suffering a loss in the amounts owed in favor of their shareholders, which is particularly serious considering that the Claimants allege that the Corporate Claimants are unable to pay their debts. The Corporate Claimants would have to give their valid consent to such a conveyance, for instance, through an assignment of their claims to the Individual Claimants, an assignment that would have to comply with the relevant provisions of Romanian law. There is no evidence in the record that they have done so. Thus, as things stand, the Tribunal cannot disregard the Corporate Claimants’ requests for relief.
1238. For the reasons set out above, the Tribunal rejects the Claimants’ request for all damages to be awarded to the Individual Claimants.

**b. Allocation of damages to all five Claimants**

1239. As previously explained, in calculating the total damages, the Tribunal has decided to follow the Claimants’ primary damages methodology, which quantified expectation damages for the entire EFDG. The Tribunal has found that the Claimants have proven two groups of damages: (i) increased costs of raw materials (sugar, other raw materials other than PET, and the sugar stockpile) for a total of RON 120,733,229

(Section VII.C.2), and (ii) lost profits of RON 255,700,000 on the sale of finished goods (Section VII.C.3 above).

1240. The Tribunal still must consider whether, and how, the damages should be allocated among the five Claimants. The Tribunal has carefully considered the arguments of both sides. As discussed above, the Tribunal has concluded that (i) it cannot award the entirety of the damages to the Individual Claimants. For the reasons set out below, the Tribunal has also concluded that it cannot (ii) award the entirety of the damages to the Corporate Claimants; (iii) allocate the damages to each of the five Claimants; or (iv) without double counting, compensate the Corporate Claimants for the direct harm they suffered and compensate the Individual Claimants for the indirect harm they suffered. As a result, the Tribunal shall not allocate the damages but shall award the entirety of the damages to the five Claimants collectively.
1241. First, for the reasons set out in Section (a) above, the Tribunal cannot award the entirety of the damages to the Individual Claimants.
1242. Second, the Tribunal cannot award the entirety of the damages to the Corporate Claimants, for the simple reason that a portion of the damages are associated with *other* companies that the Individual Claimants own. The Corporate Claimants are not entitled to compensation for such damages.
1243. Third, in Method A, the Claimants' principal expectation damages scenario (which the Tribunal has chosen to follow for the reasons set out in Section VII.C.1 above), the Claimants have made no attempt to allocate the damages among the five Claimants other than to request that the total damages be split evenly between the Individual Claimants.<sup>267</sup> In addition, it is evident from the reports prepared by the Claimants' experts and from their oral testimony that, for each head of claim, they have quantified the losses for the entire EFDG, including damages suffered by the non-claimant companies.<sup>268</sup> While counsel for the Claimants asserted at the hearing on

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<sup>267</sup> The Tribunal is aware that, at paragraph 258 of their Post-Hearing Brief, the Claimants stated that their secondary position was that "any 'reliance' damages, or damages calculated on the basis of the fair market value immediately before the alleged breach, awarded should be awarded to the Individual Claimants and any other damages should be awarded to all of the Claimants" (C-PHB, ¶ 258). However, the Claimants have not made a formal prayer for this relief. Even if this statement could be construed to be a prayer for relief, the Tribunal rejects it on the merits. First, the Tribunal has not awarded any reliance damages nor damages based on the fair market value of the Claimants' investments immediately before the breach. In addition to favoring the Claimants' expectations damages case (as discussed in Section VII.C.1 above), the Tribunal does not find that the record contains a reliable quantification of the fair market value of the Claimants' investments immediately before the breach. The Tribunal understands that Mr. Osborne's analysis of reliance losses does not attempt to quantify the fair market value of the Claimants' business before the breach, but rather the value of the Claimants' pre-EGO 24 business, that is, money they could have invested elsewhere if they had not invested in reliance on the incentives. Even if Mr. Osborne's quantification could be understood to be a proxy for the fair market value of the business before the breach, the Tribunal cannot accept it, as the valuation date chosen by Mr. Osborne (2001) predates the revocation by over three years. In any event, the Claimants have not demonstrated how these reliance damages would be compatible with other damages, nor provided sufficient support for the allocation requested.

<sup>268</sup> See, e.g., First ER of D. Lessard, ¶¶ 72-73; Tr., Day 8, 118-121 (Lessard); First ER of C. Osborne, fn. 1 and Appendix 2 (definition of "Companies"); ER of R. Boulton, p. i (definition of "Companies"); Second ER of BCG, p. 2; Tr., Day 10, 88-89 (Osborne).

closing arguments that “most of the expectation damages would have been suffered by European Food” (Tr., Day 12, 130 (Reed)) and Prof. Lessard testified along the same lines during the merits hearing (Tr., Day 8, 118-121), neither the Claimants nor their experts have provided a figure for the damages suffered by each Claimant, or stated in what proportion these damages should be distributed. Nor does the record contain clear elements that would allow the Tribunal to carry out such an allocation. There is, therefore, no evidentiary basis for allocating the damages.

1244. The Respondent argues that the Claimants’ failure to quantify damages for each Claimant is reason to deny the payment of some or all of the damages. According to the Respondent, “the only damages that have been quantified are damages allegedly incurred by EFDG companies, not all of which are claimants. The Tribunal should ensure that only damages proven to have been incurred by each Corporate Claimant are awarded to the specific Corporate Claimant that incurred them. [...] [D]amages allegedly incurred by other entities cannot be recovered by any of the Claimants” (R-PHB, ¶ 350). The Respondent further argues that the Individual Claimants cannot be awarded damages suffered by the EFDG companies, because “damage to the Corporate Claimants’ assets cannot be equated with damage to the Individual Claimants’ shares in the Corporate Claimants” (R-PHB, ¶ 336). Instead, the Respondent submits that “[s]hareholder damages are limited to losses suffered by the shareholder himself, such as any losses in the value of his shares or lost dividends” (R-PHB, ¶ 344).
1245. The Tribunal has found that the Claimants have quantified the damage suffered by the entire EFDG, of which the Corporate Claimants are a part and of which the Individual Claimants own at least 99.96%. In the circumstances of this case, the Tribunal does not find that the Claimants’ failure to specify and prove the exact quantum of damages suffered by each one of the five Claimants is sufficient reason to deny the payment of the damages that have been quantified. The Tribunal is satisfied that some or most of the damage was directly suffered by the Corporate Claimants, and that virtually all of the damage was indirectly suffered by the Individual Claimants. There is nothing inconsistent between those two conclusions. Indeed, while the Tribunal will not enter into the discussion of whether shareholder damages are equivalent to the damages suffered by the underlying company,<sup>269</sup> the Tribunal is satisfied that, given the size of the Individual Claimants’ shareholding in the EFDG companies, the Individual Claimants indirectly suffered at least a large part, if not virtually all, of the damage suffered directly by the Corporate Claimants. Furthermore, the Tribunal has already found that, provided that the Individual Claimants can prove their ownership of the other companies in the EFDG and can prove that they have been affected in this regard by the Respondent’s breaches of the BIT, they can claim for losses they have suffered indirectly through those companies (see Section VII.B.2 *supra*). The Tribunal has further found that the Individual Claimants have met that burden and are, therefore, entitled to damages suffered by the non-claimant EFDG entities as well. Having established that both the Corporate and Individual Claimants were harmed, the Tribunal is not comfortable with

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<sup>269</sup> If the Tribunal had to address this matter, it would not do so unanimously.

declining to award damages to one group or the other simply because it lacks the information needed to allocate the damages among them.

1246. Fourth, on the current record, the Tribunal cannot separately award damages to the Corporate Claimants for their direct damages, and damages to the Individual Claimants for their indirect damages. In Method A, the Claimants have only quantified the direct damages suffered by the entire EFDG. The Tribunal has no basis to distinguish which part of those damages has been suffered directly by the Corporate Claimants, and which part has been suffered indirectly by the Individual Claimants as a result of their shareholdings in non-claimant companies of the EFDG. Nor can the Tribunal award the Corporate Claimants all of the direct damages quantified in Method A, and in addition award the Individual Claimants the reliance damages quantified in Method C.<sup>270</sup> To do so would result in double recovery.
1247. Given these constraints, the Tribunal concludes that the appropriate way forward is, as the Claimants suggest, to award any damages, interest and costs to all five Claimants collectively, without allocating the damages among them. The Tribunal believes that this conclusion is particularly appropriate given that neither party has actually prayed for a particular allocation of damages among the five Claimants. The Claimants have requested that all damages be awarded to the Individual Claimants or, alternatively, to all five Claimants. They have not proffered adequate evidence or legal arguments to support a particular allocation. The Respondent also has not sought any particular allocation, other than to oppose Claimants' request that damages be awarded to the Individual Claimants. This Award thus disposes of the total amount that Romania has to pay fully to discharge its obligations and does not deal with the specific entitlement of each Claimant individually.
1248. A tribunal should not pass judgment on what has not been claimed. In particular, if two or more claimants fail to request a specific allocation of damages and rather claim for common entitlement, there is no reason for a tribunal to determine which claimant is entitled to what, subject of course to counterclaims or defenses made by the respondent in this regard.

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<sup>270</sup> In addition, the Tribunal has rejected Method C, for the reasons set out in Section C.1 and fn. 267 above.

## VIII. INTEREST

### A. INTRODUCTION

1249. Up until their Reply, the Claimants requested “post-award interest (until the date Romania pays in full) at the highest possible lawful rate” (C-Reply, ¶ 657). The Claimants further requested that this interest be compounded, arguing that compound interest is the generally accepted standard in international investment arbitrations (C-Reply, ¶¶ 657-658).
1250. However, in their Revised Request for Relief the Claimants requested “[a]n award of interest on the damages payable pursuant to paragraph 2 above calculated in the following manner:
- 3.1 For losses as described in paragraphs 2.1(a) to (c) above [i.e., increased cost of raw materials], interest compounded on a quarterly basis at a rate of 3 month ROBOR (Romanian Interbank Offer Rate) plus 5% from 1 March 2007 until the date of Romania’s full and final satisfaction of the award.
  - 3.2 For losses as described in paragraph 2.1(d) above [i.e., lost opportunity to stockpile sugar], interest compounded on a quarterly basis at a rate of 3 month ROBOR plus 5% from 1 July 2010 until the date of Romania’s full and final satisfaction of the award.
  - 3.3 For penalties as described in paragraph 2.2A above [i.e., tax penalties already paid by the Claimants], interest compounded on a quarterly basis at a rate of 3 month ROBOR plus 5% from 1 July 2007 until the date of Romania’s full and final satisfaction of the award.
  - 3.4 For losses as described in paragraph 2.3 above [i.e., lost profits on sales of finished goods], interest compounded on a quarterly basis at a rate of 3 month ROBOR plus 5% from 1 May 2008 until the date of Romania’s full and final satisfaction of the award.
  - 3.5 For losses as described in paragraph 2.4 above [i.e., lost sales of SCPs to third parties], interest compounded on a quarterly basis at a rate of 3 month ROBOR plus 5% from 1 March 2007 until the date of Romania’s full and final satisfaction of the award.
  - 3.6 For losses as described in paragraph 2.5 above [i.e., lost profits incurred due to the Claimants’ inability to complete the Incremental Investments], interest compounded on a quarterly basis at a rate of 3 month ROBOR plus 5% from 30 September 2009 until the date of Romania’s full and final satisfaction of the award.
  - 3.7 For losses as described in paragraph 2.6 above [i.e., the Claimants’ alternative claim for lost sales on finished goods as calculated by BCG], interest compounded on a quarterly basis at a rate of 3 month ROBOR plus 5% from 15 August 2007 until the date of Romania’s full and final satisfaction of the award.
  - 3.8 For the amounts lost by the Claimants as a result of investing in reliance on the Incentives as described in paragraph 2.7 above [i.e., the Claimants’ alternative claim for reliance losses], interest to be



applied compounded on a quarterly basis at a rate of 3 month ROBOR plus 5% from 1 January 2002 until the date of Romania's full and final satisfaction of the award.

- 3.9 The ROBOR rate to be applied in relation to paragraphs 3.1 to 3.8 above is to be the average annual rate for each year or part thereof.

1251. The Respondent objected to the Claimants' specified interest claim, but in its Procedural Order of 6 April 2011, the Tribunal found that there had been "no detrimental reformulation of the Claimants' claim for interest" (P.O. of 6 April 2011, ¶ 3.2). The Tribunal does not see any good cause to change its view and, accordingly, will address the Claimants' request for interest as it was formulated in their Revised Request for Relief, to the extent that it refers to the heads of claim for which the Tribunal has decided to award damages.

## **B. THE CLAIMANTS' POSITION**

1252. The Claimants request pre- and post-award interest at 3-month ROBOR plus 5%, compounded on a quarterly basis (Revised Request for Relief, ¶ 3; R-PHB, ¶ 261). The Claimants submit that this interest should be calculated from different starting dates depending on the head of claim, and run until the date of Romania's full and final satisfaction of the award (Revised Request for Relief, ¶ 3).

1253. With respect to their request that interest be compounded, the Claimants argue that compound interest is the generally accepted standard in international investment arbitrations. In this respect, the Claimants note that since 2000, 16 out of 17 BIT tribunals ruling on BIT cases have awarded compound interest<sup>271</sup> (C-Reply, ¶¶ 657-658).

1254. The Claimants submit that there are three reasons for awarding compound interest. First, the payment of compound interest "furthers the principle of full compensation because it aids in restoring the claimant to the position where it would have been had the respondent not committed the breach" (C-Reply, ¶ 662). They add that "[t]he role of interest is to compensate a claimant fully for the delay between the date of harm suffered and the award of damages. [...] [I]nterest awarded on a compound basis more accurately reflects what the claimant would have been able to earn on the sums owed if they had been paid in a timely manner" (C-Reply, ¶ 663). Second, the Claimants argue that an award of compound interest "prevents unjust enrichment of the respondent by requiring it to pay compensation for the benefits received from using the money it wrongfully withheld" (*Id.*) Third, the Claimants argue that awarding

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<sup>271</sup> The Claimants cite, inter alia, *Santa Elena v. Costa Rica*, ¶ 104; *Wena Hotels Limited v. Arab Republic of Egypt* (ICSID Case No. ARB/98/4), Award, 8 December 2000 (hereinafter "*Wena Hotels v. Egypt*" or "*Wena*"), *Vivendi v. Argentina II*, ¶ 9.2.6; *LG&E v. Argentina*, Award, 25 July 2007, ¶ 103; *Middle East Cement Shipping and Handling Co. S.A. v. Arab Republic of Egypt* (ICSID Case No. ARB/99/6), Award, 12 April 2002, ¶ 174; *ADC Affiliate Limited and ADC & ADMC Management Limited v. Republic of Hungary* (ICSID Case No. ARB/03/16), Award, 2 October 2006, ¶ 522; *Azurix v. Argentina*, ¶ 440, *PSEG v. Turkey*, ¶ 354; *Enron v. Argentina*, ¶¶ 451-52; *CMS v. Argentina*, ¶ 471; *Waguilh Elie George Siag and Clorinda Vecchi v. Arab Republic of Egypt* (ICSID Case No. ARB/05/15), Award, 1 June 2009, ¶ 598.

simple interest generally fails to compensate claimants fully, because the claimant is in essence making interest-free loans to the respondent. This in turn creates an incentive for respondents to delay the proceedings because they are able to profit from the use of the claimant's money during the pendency of the arbitration (or enforcement proceedings) (C-Reply, ¶¶ 663-664).<sup>272</sup>

1255. With respect to the requested rate (ROBOR + 5%), the Claimants argue that this is the approximate rate at which they borrowed money during the relevant period. The Claimants acknowledge that the 5% above ROBOR is higher than that at which interest has been awarded in several other ICSID cases (which has tended to be 2% above LIBOR). However, the Claimants argue that in those cases the claimants were large, multinational companies, with greater access to funding, at lower rates, than the Claimants, who are not international companies and cannot borrow at only 2 points above the interbank offer rate. Thus, the Claimants argue that a higher rate is required in order to reflect the Claimants' higher actual borrowing costs and ensure that they are adequately compensated for the Respondent's breaches (C-PHB, ¶ 262).
1256. In the Claimants' view, the Respondent's objections to an interest rate based on ROBOR are unsustainable. They argue that "ROBOR is the rate at which banks lend to each other, that is set by the market and which accurately reflects Romania's underlying economic conditions. Therefore at times of high inflation, which occurred in Romania in the period relevant to this dispute, it is logical that ROBOR rose accordingly, including to 30% at one point. However, due to the manner in which ROBOR is calculated and applied, it cannot sensibly be contended that it is not an appropriate rate for the calculation of interest when a claimant borrows from Romanian banks and/or borrows in RON" (C-PHB, ¶ 263). The Claimants add that "in the period 2005 to date (which is the period relevant to the Claimants' expectation damages claim), the average (mean) 3 month ROBOR rate was only approximately 8.9%, which is considerably below the 30% rate which the Respondent would have the Tribunal believe was the norm. In fact, for extended periods since 2005 the 3 month ROBOR rate has been below 5%. Tellingly, as at 10 January 2011 (the date of Freshfields' letter objecting to the Detailed Request), the 3 month ROBOR rate was only 5.16%" (C-PHB, ¶ 264). Finally, the Claimants note that Romania has charged the Claimants a penalty interest on unpaid taxes "at a consistent annual rate of 36.5% (with an effective rate in excess of 40%)", arguing that "[i]f anything, the Claimants' use of ROBOR rates as the basis for their calculations is conservative when juxtaposed to the punitive, draconian interest rates imposed on the Claimants by the Respondent" (*Id.*).
1257. With respect to the date from which interest must be calculated on the damages awarded by the Tribunal, the Claimants argue that "each date is the approximate midpoint between the time the relevant loss or damage began to be incurred and the

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<sup>272</sup> The Claimants cite Jeffrey Colón and Michael Knoll, Prejudgment Interest In International Arbitration, Vol. 4, Issue 6, TRANSNATIONAL DISPUTE MANAGEMENT 10 (Nov. 2007), and John Y. Gotanda, A Study of Interest, Villanova University School of Law Working Paper Series, Paper 83, at 4 (2007).

time when that loss or damage would have ceased to have been suffered” (C-Reply, ¶ 265). Specifically:

- a. With respect to the claims for increased cost of sugar, PET and other raw materials, the Claimants claim interest calculated from 1 March 2007. This date is “approximately the midpoint between the time at which the Incentives were prematurely revoked (22 February 2005) and the time when the Incentives were due to come to an end (31 March 2009)” (C-Reply, ¶ 265(a)).
  - b. With respect to the claim for the lost opportunity to stockpile sugar in 2009, the Claimants request an award of interest calculated from 1 July 2010. According to the Claimants, this is “the approximate midpoint between the time when the sugar stockpile would have started being used (31 March 2009) and the time, based on Mr Osborne’s calculations, when it would have all been used (31 August 2011)” (C-Reply, ¶ 265(b)).
  - c. With respect to their claim for lost profits on sales of finished goods, the Claimants claim interest from 1 May 2008, which is the approximate midpoint of the period for which Mr Boulton has calculated losses (1 January 2005 to 31 August 2011)” (C-Reply, ¶ 265(d)).
1258. According to the Claimants, “[t]he midpoint provides a sensible and practical date from which the Tribunal may make its calculations” (C-Reply, ¶ 266). It notes that this approach has been adopted by other tribunals, such as the tribunals in *PSEG v. Turkey* (where the tribunal chose the mean date of the seven year period during which the relevant expenses were incurred<sup>273</sup>), and *Nykomb v. Latvia* (where the tribunal awarded interest “from the mid point of the respective periods up to the time of the award”<sup>274</sup>).

### C. THE RESPONDENT’S POSITION

1259. The Respondent argues that the Claimants’ interest claim should be rejected with respect to the interest rate, compounding and date of calculation (R-PHB, ¶¶ 325-328).
1260. With respect to the interest rate, the Respondent contends that the rate requested by the Claimants (ROBOR + 5%) is far higher than that awarded by other investment arbitration tribunals, and could end up yielding a rate as high as 30%. The Respondent argues that this rate is at odds with the rates used by their own experts, noting that Mr. Osborne used EFDG’s RON cost of debt for pre-award interest (about 11% according to Mr. Osborne, First Osborne Report, ¶ 4.10), whereas Professor Lessard applied ROBOR without any premium (First ER of D. Lessard, ¶ 111). The Respondent further argues that “the proposed rate is based on speculation as to what the Claimants’ borrowing costs could be, rather than on their actual borrowing costs”

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<sup>273</sup> *PSEG v. Turkey*, ¶¶ 349-351.

<sup>274</sup> *Nykomb v. Latvia*, p. 43.

(R-PHB, ¶ 326). According to the Respondent, the record on the EFDG's borrowing costs "reveals a rate of 5.88% for foreign currency and 10.75% for borrowings in RON" (EFDG combined financial statements for the year 2006, 31 December 2006, Exh. JMHE-8, p 27), which is consistent with Mr. Gamecho's testimony that the Claimants had access to financing at rates of less than 5.5% (Tr., Day 4, 54 (Gamecho)). The Respondent further contends that there is no justification for the 5% premium.

1261. The Respondent also objects to a rate based on ROBOR. It argues that the fact the Claimants' claims are made in RON does not mean that the Tribunal must use a RON-based interest rate for pre-award interest. The Respondent argues that the Claimants had substantial loans in Euros and purchased many of their imports in Euros. The Respondent contends that "the Claimants are subject to the inherent currency risks of their business", and thus "[i]t is not for Romania to subsidise that risk through payment of a higher interest rate. Therefore, only a pre-award interest rate that takes into account the fact that the Claimants can borrow in Euro would be appropriate" (R-PHB, ¶ 327).

1262. Further, the Respondent argues that any award of interest should be on a simple rather than compound basis. The Respondent relies on the Commentary to ILC Article 38, which states that "[t]he general view of courts and tribunals has been against the award of compound interest, and this is true even of those tribunals which hold claimants to be normally entitled to compensatory interest. [...] [G]iven the present state of international law it cannot be said that an injured [party] has any entitlement to compound interest, in the absence of special circumstances which justify some element of compounding as an aspect of full reparation."<sup>275</sup> The Respondent also relies on *ADM v. Mexico*,<sup>276</sup> *Feldman v. Mexico*,<sup>277</sup> *Biloune v. Ghana*,<sup>278</sup> and *Occidental v. Ecuador*<sup>279</sup> (R-Rejoinder, ¶ 351, fn. 560).

1263. In view of the above, the Respondent submits that "the interest rate the Tribunal should apply for pre-award interest (the purpose of which is compensatory) is 3-month EURIBOR without any premium and on a simple basis" (R-PHB, ¶ 327). The Respondent further submits that "any post-award interest should be set a 3-month ROBOR, without any premium, and on a simple basis." The Respondent does not make entirely clear the reasons for the difference in approach between pre- and post-award interest, nor does it explain further or in more detail why it should be awarded on a simple basis.

1264. The Respondent further contends that the Claimants have manipulated the starting dates for the calculation of interest in order to maximize their claim. It argues that "[t]he selection of a mid-point date inflates the claim in this case in circumstances

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<sup>275</sup> Commentary to ILC Article 38, ¶¶ 8-9.

<sup>276</sup> *Archer Daniels Midland Company and Tate & Lyle v United Mexican States* (ICSID Case No. ARB(AF)/04/05), Award, 21 November 2007, ¶¶ 294-297.

<sup>277</sup> *Feldman v. Mexico*, ¶¶ 205, 206 and 211.

<sup>278</sup> *Biloune v. Ghana*, pp 230 and 231.

<sup>279</sup> *Occidental v. Ecuador*, ¶ 211.

where the largest of the Claimants' alleged losses occurred after this arbitrary point in time. For example, selecting a mid-point start date in respect of sugar purchases ignores the fact that most sugar purchases were actually made in later years" (R-PHB, ¶ 328). The Respondent adds that "it would not have been difficult for the Claimants to present interest calculations starting from the dates when losses were allegedly suffered", as Prof. Lessard did in his calculations (*Id.*).

#### **D. THE TRIBUNAL'S ANALYSIS**

1265. Having found a breach of the BIT, the Tribunal must ensure that the Claimants are restored to the position they would have been had the breach not occurred. This includes awarding interest on the sums that the Claimants would have had if the breach had not occurred in order to compensate for the cost of money until the full payment of the Award. The Respondent does not dispute the principle that interest must be awarded; rather, it objects to the rate, compounding and date of calculation proposed by the Claimants.

##### **1. Simple versus compound interest**

1266. The overwhelming trend among investment tribunals is to award compound rather than simple interest. The reason is that an award of damages (including interest) must place the claimant in the position it would have been had it never been injured. As noted by the *Wena* tribunal, "almost all financing and investment vehicles involve compound interest. [...] If the claimant could have received compound interest merely by placing its money in a readily available and commonly used investment vehicle, it is neither logical nor equitable to award the claimant only simple interest."<sup>280</sup> The Commentary to ILC Article 38, on which the Respondent relies to object to compound interest, does not reflect the recent tribunal practice, with which the Tribunal agrees.

1267. The Tribunal will thus award compound interest, at the rate determined below.

##### **2. Rate**

1268. The Claimants request the same treatment for both pre- and post-award interest (3-month ROBOR plus 5%, compounded on a quarterly basis), starting from different dates depending on the claim. The Respondent requests that (i) pre-award interest be granted at a rate of 3-month EURIBOR without any premium and on a simple basis, while (ii) post-award interest should be set at 3-month ROBOR, without any premium, also on a simple basis.

1269. As a preliminary matter, the Tribunal does not see why the cost of the deprivation of money (which interest compensates) should be different before and after the Award, and neither Party has convinced it otherwise. Both are awarded to compensate a party for the deprivation of the use of its funds. The Tribunal will thus award pre- and post-award interest at the same rate.

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<sup>280</sup> *Wena Hotels v. Egypt*, ¶ 129 (citing John Y. Gotanda, Awarding Interest in International Arbitration, 90 *Amer. J. Int'l L.*, 40, 61 (1996)).

1270. The Tribunal agrees with the Claimants that the appropriate rate is that which would compensate them for their cost of borrowing money during the relevant period. In the Tribunal's view, the Corporate Claimants' cost of debt should be assessed on the basis of operations in RON: the Claimants are Romanian nationals with their principal place of business in Romania, and the fact that they could borrow in Euro does not detract that the currency in the place where they operate was and remains RON.
1271. The Respondent objects to using a ROBOR-based rate, arguing that at times it has risen as high as 30% (R-PHB, ¶ 325). It has not provided any sufficient evidence for this allegation, but the Claimants appear to accept that this in fact occurred at one point in time (C-PHB, ¶ 263). In turn, the Claimants argue that in the period 2005 to the date of their Post-Hearing Brief, the average (mean) 3-month ROBOR rate was approximately 8.9%. This allegation is similarly insufficiently supported. This lack of evidence on the actual ROBOR rates is, however, irrelevant: as the Claimants note, the ROBOR rate is the rate at which Romanian banks lend to each other, and commercial borrowing rates will usually thus be ROBOR plus a premium. It is thus highly likely that any borrowing by the Claimants in Romania between 2005 and the date of payment of the award would have been and will be subject to a ROBOR-based interest rate plus a premium. In any event, the rates reflected in the record (10.75% for RON-based operations for 2006, 13.8% for those operations in 2005, according to the Corporate Claimants' 2006 financials (Exh. JMHE-8, p. 27) and 11% according to Mr. Osborne (First ER of C. Osborne, ¶ 4.10)), are closer to the Claimants' allegation that the mean 3-month ROBOR rate during the relevant period was 8.9%, than to the 30% rate alleged by the Respondent. Accordingly, the Tribunal finds that a 3-month ROBOR plus a reasonable premium, compounded on a quarterly basis, is reasonable, 3-month ROBOR being computed at an average annual rate to be applied for each period of one year or part of a year.
1272. The question that remains is what premium is reasonable. The Claimants request 5% above the ROBOR rate. They argue that, because they are not international companies, they cannot borrow at only 2 points above the interbank offer rate (which is the premium that has been awarded by other investment tribunals). The Tribunal finds this argument persuasive: the Claimants probably would not have obtained better conditions. The Tribunal will thus award interest at 3-month ROBOR plus 5%, compounded on a quarterly basis.

### **3. Date of calculation**

1273. Interest must be calculated from the date on which the loss was suffered. This is usually the day on which the breach occurs. This cannot be the case or, at least, is not easily practicable when the damage is suffered progressively after the date of the breach, as has happened here. After the revocation of the incentives became effective on 22 February 2005, the Claimants incurred their damages progressively: they progressively purchased raw materials at a higher price, thus progressively incurring higher costs, and they progressively lost profits that they could have earned on the sales of their own finished goods. With respect to the lost opportunity to

stockpile sugar in 2009, because they were unable to stockpile sugar at that time, they progressively bought sugar at a higher price.

1274. Under the circumstances, the Tribunal finds that the midpoint approach proposed by the Claimants is appropriate. Despite the Respondent's arguments, it would have been difficult and next to impossible for the Claimants to point out to the exact date on which this damage was suffered, while at the same time, damage has definitely been proved to exist during that period. Indeed, a part of the damage may have been suffered every day since the revocation. The Tribunal also notes that this midpoint approach has been used by other investment tribunals.<sup>281</sup> And it does not seem that there exist circumstances in this arbitration that should detract as a matter of principle from this approach: for instance, the record does not point to a use of the stockpile that should not have been evenly spread over the months concerned (in which case the "midpoint approach" could lead to distortions).
1275. Finally, with respect to lost profits, the Tribunal is aware that, according to the Commentary to ILC Article 38, "[w]here a sum for loss of profits is included as part of the compensation for the injury caused by a wrongful act, an award of interest will be inappropriate if the injured State would thereby obtain double recovery", because "[a] capital sum cannot be earning interest and notionally employed in earning profits at one and the same time" (Commentary to ILC Article 38, ¶ 11). However, the Commentary goes on to say that "interest may be due on the profits which would have been earned but which have been withheld from the original owner." The Tribunal understands that, by awarding interest on lost profits on sales of finished goods as of the midpoint in which the total quantified would have been earned, interest is only applied to amounts that would have been earned but were withheld from the Claimants.
1276. Accordingly, the Tribunal awards interest, at 3-month ROBOR, the ROBOR being computed at an average annual rate to be applied for each period of one year or part of a year, plus 5%, compounded on a quarterly basis, calculated from the following dates until full payment of the award:
- a. With respect to the claims for increased cost of sugar and other raw materials, interest shall be calculated from 1 March 2007, which is the approximate midpoint between the time at which the EGO 24 incentives were revoked (22 February 2005) and the time when the incentives were due to expire (31 March 2009).
  - b. With respect to the claim for the lost opportunity to stockpile sugar in 2009, interest shall be calculated from 1 November 2009, which is the approximate midpoint between the time when the sugar stockpile would have started being used (31 March 2009) and the time, when it would have all been used (1 July 2010). The Tribunal is aware that, according to Mr. Osborne's calculations, the Claimants' optimal stockpile of 75,000 tonnes would have been used by 31 August 2011 (First ER of C. Osborne, ¶4.10). However, the Tribunal has

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<sup>281</sup> See, e.g., *PSEG v Turkey*, ¶¶ 349-351; *Nykomb v. Latvia*, p. 43.

awarded this claim on the basis of Mr. Ellison's calculations, which account for a smaller stockpile of 30,000 tonnes. The Tribunal has thus adjusted Mr. Osborne's timing forecast to this smaller amount.

- c. With respect to the claim for lost profits on sales of finished goods, the interest shall be calculated from 1 May 2008, which is the approximate midpoint of the period for which Mr Boulton calculated losses (1 January 2005 to 31 August 2011) (C-Reply, ¶ 265(d)).



## **IX. THE PARTIES' OTHER REQUESTS FOR RELIEF**

1277. In the context of the Respondent's Application to Revoke Provisional Measures, both sides requested other specific relief that was deferred for determination to the final Award (see paragraph 111 above). These requests for relief concern (A) set-off of the amounts awarded to the Claimants against the EFDG's tax debts with Romania, and (B) post-award injunctive relief, as explained below.<sup>282</sup>

### **A. THE PARTIES' REQUESTS CONCERNING SET-OFF OF THE AMOUNTS AWARDED AGAINST THE EFDG'S TAX DEBTS**

#### **1. The Respondent's position**

1278. The Respondent argues that, because of the EFDG's opaque intra-group finances and the prejudice to Romania's tax enforcement rights resulting from the Claimants' manipulation of provisional measures, if there were to be any monetary award in favor of any Claimant, the amount should be explicitly subject to set-off against all of the EFDG companies' tax debts (Respondent's Revocation Application, ¶ 8(b)).

1279. In support of this request, the Respondent argues that, in its Supplemental Decision on Provisional Measures, the Tribunal made a "straightforward recommendation" that the Individual Claimants should allow any award to them to be set off against the Corporate Claimants' tax debts — a recommendation that has been ignored by the Claimants (Respondent's Revocation Application, ¶ 60(c)).

1280. On this basis, the Respondent requests the Tribunal to "explicitly provide in the Award that any amount awarded to any of the Claimants, whether as damages, arbitration costs, or otherwise, is subject to set-off by Romania against the tax debts of all eleven EFDG companies, including lawful interest and penalties" (Respondent's Revocation Application, ¶ 87(c)).

1281. The Respondent maintained this request in its Reply on its Revocation Application (¶¶ 2 and 41(c)), but did not provide further arguments or respond to the Claimants' comments set out below.

#### **2. The Claimants' position**

1282. The Claimants argue that the Tribunal lacks jurisdiction to grant the Respondent's set-off request, for three main reasons (Claimants' Response, ¶¶ 113- 116):

- a. First, because it is procedurally improper: The Claimants contend that the Respondent has not established, or even argued beyond a cursory request, that it is entitled to a set-off. Such a new claim would have to be briefed and it is far too late in the arbitral process for that. In any event, the Claimants assert that such a set-off would be unnecessary because the Respondent has retained all of

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<sup>282</sup> All briefs cited in this section relate to the Respondent's Application to Revoke Provisional Measures.

its rights to collect outstanding taxes from the EFDG (Claimants' Response, ¶ 114).

- b. Second, because the parties against whom the set-off would be ordered (that is, the Claimants) are not identical to the parties who owe the debts: The Claimants argue that the Tribunal would thus lack the necessary jurisdiction. Relying on Article 8.1 of the UNIDROIT Principles of International Commercial Contracts, the Claimants add that "[e]ligibility for set-off requires that the obligations be between the same parties", which is an argument going to the merits (Claimants' Response, ¶ 115 and fn. 113).
- c. Third, the Claimants argue that the Tribunal has no jurisdiction *rationae materiae* because the Respondent's set-off request is not "a legal dispute arising directly out of an investment" within the meaning of Article 25(1) of the ICSID Convention, as it was not especially contracted for in an investment agreement and does not arise directly out of an investment (Claimants' Response, ¶ 116).

1283. In addition, the Claimants argue that, apart from any legal defense to the Respondent's set-off request, it would be fundamentally unfair to provide for a set-off, or for the Award (or at least a significant portion thereof, reflecting at least the value of the retained earnings at the time the incentives were withdrawn) to be made out to anyone but the Individual Claimants "on a 50/50 basis" (Claimants' Response, ¶ 117). The Claimants contend that they are entitled to full compensation for their significant losses over the years due to the revocation of the EGO 24 incentives, and that allowing set-off would be unfair in the light of these losses (Claimants' Rejoinder, ¶¶ 67-72).

1284. The Claimants add that a set-off would imply that the Individual Claimants should take personal responsibility for the EFDG companies' tax debts. In their view, this would not only be unfair to the Individual Claimants, but would also imply that the Individual Claimants, by paying further amounts to the ongoing business operations in Romania or paying debts relating to those investments, would be making additional investments, which are not reflected in the current damages claim and for which compensation would be owed (Claimants' Rejoinder, ¶¶ 63-66).

1285. The Claimants acknowledge that if the Award is made out to the Individual Claimants alone, unless the Award is of a certain size, some creditors may not be paid in full, including the Respondent. In that case, they note that the EFDG companies may no longer be viable as going concerns. They argue that these are factors to consider in determining how the Award should be drafted, but they should not be at the forefront of the Tribunal's considerations, as the ICSID Convention was put in place to protect investors, not creditors (Claimants' Response, ¶ 118). The Claimants further note that the Respondent did not respond substantively to their arguments, but merely referenced the Tribunal's recommendation. The Claimants argue that the Tribunal recommended that the Parties were free to agree to a set-off, and the Parties did not agree.

1286. For the reasons set out above, the Claimants request the Tribunal to “issue a declaration that Romania is not entitled to set-off tax debts of the companies against an Award in favor of Claimants” (Claimants’ Response, ¶ 127(c)).

### **3. The Tribunal’s analysis**

1287. The Tribunal has carefully considered both sides’ prayers for relief with respect to set-off, and dismisses them both.

1288. First, both prayers have been made too late in the arbitral proceedings. To the extent that both requests are for declaratory relief to be given in the Award, the requests must be seen as ancillary claims covered by Article 46 of the ICSID Convention<sup>283</sup> and Rule 40 of the ICSID Arbitration Rules. In particular, the Respondent has not raised the issue of set-off as a defense to the Claimants’ claims: it has not requested an acknowledgment of set-off, nor for set-off to be ordered; it is seeking a declaration that any amounts awarded to any of the Claimants are subject to set-off by Romania against the tax debts of the EFDG companies. The Claimants request a declaration in the opposite sense. In this context, the Parties do not argue whether the legal conditions for set-off are satisfied, but discuss rather whether set-off should be allowed or not as a "modus" (qualification) added to any amount awarded. Such requests for declaratory relief must be treated as ancillary claims subject to the time limits set out in Rule 40 of the ICSID Arbitration Rules.

1289. Pursuant to Rule 40 of the ICSID Arbitration Rules:

- (1) Except as the parties otherwise agree, a party may present an incidental or additional claim or counter-claim arising directly out of the subject-matter of the dispute, provided that such ancillary claim is within the scope of the consent of the parties and is otherwise within the jurisdiction of the Centre.
- (2) An incidental or additional claim shall be presented not later than in the reply and a counter-claim no later than in the counter-memorial, unless the Tribunal, upon justification by the party presenting the ancillary claim and upon considering any objection of the other party, authorizes the presentation of the claim at a later stage in the proceeding.
- (3) The Tribunal shall fix a time limit within which the party against which an ancillary claim is presented may file its observations thereon.

1290. Both Parties’ requests regarding set-off have been made considerably past the time limits set out in Rule 40. The Respondent’s request was made in its Application to Revoke Provisional Measures submitted on 1 August 2012, more than three years after the submission of its Counter-Memorial. Similarly, the Claimants’ request was made in their Response to the Respondent’s Application to Revoke Provisional

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<sup>283</sup> Article 46 of the ICSID Convention provides: “Except as the parties otherwise agree, the Tribunal shall, if requested by a party, determine any incidental or additional claims or counterclaims arising directly out of the subject-matter of the dispute provided that they are within the scope of the consent of the parties and are otherwise within the jurisdiction of the Centre.”

Measures, submitted on 28 September 2012, almost two years after the submission of their Reply. The record does not evidence any good causes for such delay.

1291. If the Tribunal had not dismissed these requests on procedural grounds, it would have done so on the merits. Indeed, whether the Respondent has a right to set off the Award against the EFDG's tax debts would be (primarily at least) a matter of Romanian law and of enforcement of this Award. Romanian law establishes the conditions under which a set-off may be carried out and nothing the Tribunal says will affect that. In certain jurisdictions, set-off may even operate as a matter of law (*ipso iure*) when strict conditions are met. Thus, as a matter of principle, the Tribunal is not in a position to declare that Romania has a right to set-off the amounts awarded in this arbitration against the EFDG's tax debts. Whether Romania has a right to set-off the amounts awarded against the Claimants or other companies of the EFDG will depend on whether the conditions set out in Romanian law are fulfilled.
1292. Even if the Tribunal were to state that, in principle, Romania has a right to set-off, it would not be able to decide whether in this particular case such set-off is warranted. The Respondent has not explained why the (Romanian law) conditions for set-off are fulfilled in this case, what are the amounts to be set off, or which are the specific parties involved. The only apposite mention of legal principles applicable to set-off seems to be the Claimants' reference to the UNIDROIT Principles (see paragraph 1282 above) rather than applicable Romanian law. In addition, for the reasons set out in Section VII.F above, the Tribunal has declined to allocate the damages among the Claimants, and is instead awarding the totality of the damages to all five Claimants. Under the circumstances of the case itself, the Tribunal is simply not in a position to declare whether Romania is or is not entitled to set off an award in favor of the Claimants against the EFDG companies' tax debts.
1293. For these reasons, the Tribunal dismisses the Respondent's request that the Award explicitly provide that any amount awarded to any of the Claimants is subject to set-off by Romania against the tax debts of the EFDG companies, without prejudice to the application of Romanian law, especially but not exclusively its dispositions for the satisfaction of tax debts.
1294. For the same reasons, the Tribunal dismisses the Claimants' request for a declaration that Romania is not entitled to set off tax debts of the EFDG companies against the Award, again without prejudice to the application of Romanian law, including for the satisfaction of tax debts.

## B. THE CLAIMANTS' REQUEST FOR POST-AWARD INJUNCTIVE RELIEF

### 1. The Claimants' position

1295. Again in the context of the Respondent's Application to Revoke Provisional Measures, the Claimants request the Tribunal to provide in the Award that the Respondent "is enjoined from any further tax collection measures of any kind in respect of the Claimants and the EFDC until such a time as the damages awarded by the Tribunal have been paid in full, and include a pecuniary alternative in case of non-performance" (Claimants' Rejoinder, ¶ 75(b); see also Claimants' Response, ¶ 127(b)).
1296. According to the Claimants, it is obvious that Romania intends to collect on the taxes owed to it as soon as it can, by whatever means it can (Claimants' Response, ¶ 108). The Claimants understand that the provisional measures recommended by the Tribunal will come to an end upon issuance of the Award. They thus argue that for any award in their favor to have any meaning, equivalent relief to that granted under the provisional measures must be put in place in the Award until the Claimants are compensated in full (Claimants' Response, ¶ 119; Claimants' Rejoinder, ¶ 58).
1297. The Claimants argue that the Tribunal has the jurisdiction to order permanent injunctive relief. They rely on *Enron v. Argentina*,<sup>284</sup> where the tribunal allegedly asserted that it had such power (Claimants' Response, ¶ 122). The Claimants also rely on writings by Prof. Schreuer, as well as the Decision on Jurisdiction rendered by this very Tribunal (Claimants' Rejoinder, ¶¶ 54-55).
1298. The Claimants note that already in their First Application for Provisional Measures, they requested
- an Order preserving the status quo ante by instructing Respondent to withdraw or otherwise cease and desist from enforcing the above-described seizure orders, or from implementing any new such orders against any of the EFDC prior to the Tribunal's issuance of its final award **(and that the award itself deal with the matter as appropriate at that time, such as by maintaining the Order in place until Romania has satisfied the terms of the award in full)** [...] (Claimants' First Application for Provisional Measures, ¶ 43, emphasis added).
1299. The Claimants recognize however that this relief has not been expressly requested, but submit that the Tribunal is empowered to make such an order under paragraph 6 of Claimants' Revised Request for Relief,<sup>285</sup> which seeks "[a]ny further relief that the Tribunal may deem fit and proper" (Claimants' Response, ¶¶ 120-121; Claimants' Rejoinder, ¶ 59).
1300. In the alternative, if the Tribunal concludes that it cannot order relief on the basis of the Revised Request for Relief as drafted, the Claimants request that the Tribunal

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<sup>284</sup> *Enron v. Argentina (Decision on Jurisdiction)*, ¶¶ 77-79.

<sup>285</sup> The Claimants refer to their "Detailed Request for Relief", which the Tribunal refers to throughout this document as their "Revised Request for Relief".

permit the Claimants to add a specific request for injunctive relief to their Request for Relief pursuant to Rule 40 of the ICSID Rules (Claimants' Response, ¶ 123). The Claimants argue that the Respondent has already had notice of the Claimants' intentions and will suffer no prejudice as a result of the requested amendment to the Request for Relief. Specifically, the Claimants assert that the cover letter enclosing their Revised Request for Relief put Romania on notice that Claimants might seek to amend the requested relief "[i]n the event that financial or operational circumstances materially change to Claimants' detriment prior to the Tribunal's issuance of its award" (Claimants' Response, ¶¶ 124-125).

1301. Even if the Tribunal were to conclude that Romania will suffer prejudice as a result of the requested amendment of the Request for Relief, the Claimants contend that such prejudice should be balanced against the greater harm that the Claimants would suffer if the request is not granted. According to the Claimants, "it would be a fundamental denial of justice to Claimants and an absurd result if Romania could bankrupt the companies on the day after the Award was issued, prior to making payment, the timing of which is solely within its control" (Claimants' Response, ¶ 125).

## **2. The Respondent's position**

1302. The Respondent argues that the Claimants' request must fail for the following reasons.
1303. First, the Respondent submits that Provisional Measures are temporary in nature and cannot be upheld beyond the point where the proceedings come to an end. Relying on writings by Prof. Schreuer, the Respondent contends that the Tribunal's authority to grant interim relief pursuant to Article 47 of the ICSID Convention and Rule 39 of the ICSID Arbitration Rules only extends throughout the arbitration and any provisional measure lapses automatically when a final award is rendered. According to the Respondent, this cannot be circumvented by including the provisional measures in the Award (Respondent's Reply, ¶ 36).
1304. Second, the Respondent argues that it is irrelevant whether the Tribunal has the power to grant injunctive relief, because the legitimacy of the collection of taxes has never been subject matter of the proceedings leading to the Award. By contrast, in *Enron v. Argentina* the request for permanent injunctive relief was linked to taxes that were the basis for Enron's expropriation claim (Respondent's Reply, ¶ 37).
1305. Third, the Respondent contends that the Claimants' new attempt to amend their Request for Relief is in fact a new claim submitted out of time. The Respondent notes that, pursuant to Article 46 of the ICSID Convention and Rule 40(2) of the ICSID Arbitration Rules, any incidental or additional claim must be presented no later than in the reply. The Respondent adds that such a new claim would require further written and oral proceedings, and the Claimants have failed to provide a justification for it (Respondent's Reply, ¶ 38).
1306. Fourth, the Respondent argues that the Claimants' request to amend their Request for Relief involves relief in favor of eight EFDG companies that are not parties to the

present arbitration, but Article 46 of the ICSID Convention does not permit extension of the dispute *ratione personae*. The fact that the Claimants purported to reserve their right to amend their Request for Relief is thus irrelevant, as the issues at stake in the provisional measures are not part of the dispute which forms the subject matter of the arbitration proceedings (Respondent's Reply, ¶ 39).

### 3. The Tribunal's analysis

1307. There is no dispute that the provisional measures recommended by the Tribunal in its five decisions on Provisional Measures will lapse upon the issuance of the Award. The Tribunal concurs with Prof. Schreuer when he states that

The provisional nature of interim measures implies that they are recommended only for the duration of the proceedings. [...] Provisional measures will lapse automatically upon the rendering of the tribunal's award. They will also lapse upon the discontinuance of the proceedings in accordance with Arbitration Rules 43-45. Although neither Art. 47 nor Arbitration Rule 39 say so explicitly, this is a consequence of their provisional nature.<sup>286</sup>

1308. However, the Claimants are neither requesting the extension of these provisional measures beyond the Award, nor the recommendation of new provisional measures. The Claimants frame their request as one for "permanent injunctive relief". Thus, the threshold question is whether the Tribunal has the authority to issue permanent (or rather, definitive) injunctive relief in the Award, even if it is only temporary.

1309. In its Decision on Jurisdiction and Admissibility the Tribunal recognized its power to grant non-pecuniary relief (Decision on Jurisdiction and Admissibility, ¶ 166).<sup>287</sup> An ICSID tribunal's powers derive from the nature and purpose of its mandate, which in turn is defined by the parties' consent. In this case, such consent is reflected in the ICSID Convention, the BIT and the Claimants' request for arbitration. From these instruments it emerges that the Tribunal's task is to resolve the legal disputes between the Claimants and the Respondent arising directly out of the Claimants' investments in the territory of the Respondent which have their origin in the Respondent's breaches of the BIT. As none of the aforementioned instruments *expressis verbis* defines the powers granted to a tribunal nor limits the remedies available to the Claimants in the event of an internationally wrongful act,<sup>288</sup> this

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<sup>286</sup> C. Schreuer, *The ICSID Convention: A Commentary*, 2<sup>nd</sup> edition (2009), pp. 774-775.

<sup>287</sup> At paragraph 166 of its Decision on Jurisdiction and Admissibility, the Tribunal stated: "Under the ICSID Convention, a tribunal has the power to order pecuniary or non-pecuniary remedies, including restitution, i.e., re-establishing the situation which existed before a wrongful act was committed. As Respondent itself admits, restitution is, in theory, a remedy that is available under the ICSID Convention (Tr. p. 56). That admission essentially disposes of the objection as an objection to jurisdiction and admissibility. The fact that restitution is a rarely ordered remedy is not relevant at this stage of the proceedings. Similarly, and contrary to Respondent's argument, the fact that such a remedy might not be enforceable pursuant to Article 54 of the ICSID Convention should not preclude a tribunal from ordering it. Remedies and enforcement are two distinct concepts."

<sup>288</sup> The only remedy specified by the BIT is compensation in cases of expropriation (Article 4 of the BIT). However, the BIT does not specify what remedies are available in cases of breaches of other standards of protection.

Tribunal must conclude that its powers include all of those required to provide effective remedy in order to redress the injuries suffered by the Claimants as a result of such internationally wrongful acts, within the limits of the parties' requests for relief and provided that such relief is admissible under international law. In the Tribunal's view, such relief includes pecuniary and non-pecuniary relief.

1310. The Tribunal is aware that, although Article 54(1) of the ICSID Convention provides that a state shall recognize an award as binding, it then proceeds to limit a state's obligation to enforce an award to the pecuniary obligations imposed by that award.<sup>289</sup> However, this should not be interpreted as limiting ICSID tribunals to awarding pecuniary relief. As the Tribunal already stated, awarding remedies and enforcement are two distinct concepts.<sup>290</sup> Moreover, the *travaux préparatoires* of the ICSID Convention confirm that "the restriction in Article 54 to pecuniary obligations was based on doubts concerning the feasibility of an enforcement of non-pecuniary obligations and not on a desire to prohibit tribunals from imposing such obligations."<sup>291</sup> Indeed, the fact that Article 54 found it necessary to specify that only pecuniary obligations could be enforced confirms that a tribunal has the power to order non-pecuniary relief.<sup>292</sup>

1311. In the Tribunal's view, such non-pecuniary relief may take many forms, such as restitution or specific performance.<sup>293</sup> It may also take the form of definitive (i.e., not provisional) injunctive relief, if the Tribunal finds that such relief is necessary to ensure that the breach will be redressed. To quote Prof. Schreuer:

There is a wide range of possibilities for non-pecuniary obligations that awards might impose. [...] Possible obligations imposed upon the host State would include the restitution of seized property [...] or desistance from imposing unreasonable taxes. In the cases so far published, ICSID tribunals have framed the obligations imposed by their awards in pecuniary terms. This is not due to a belief that they lack the power to proceed otherwise. Rather, the cases involved situations in which the investment relationship had broken down and the claimants had defined their demands in pecuniary terms. [...] It is likely that in the future more cases will arise,

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<sup>289</sup> Article 54(1) of the ICSID Convention provides in relevant part: "Each Contracting State shall recognize an award rendered pursuant to this Convention as binding and enforce the pecuniary obligations imposed by that award within its territories as if it were a final judgment of a court in that State. [...]"

<sup>290</sup> See Decision on Jurisdiction and Admissibility, ¶ 166.

<sup>291</sup> C. Schreuer, *Non-Pecuniary Remedies in ICSID Arbitration*, *Arbitration International*, Vol. 20, No. 4 (2004), pp. 325-326.

<sup>292</sup> Indeed, Article 53(1) of the ICSID Convention, which deals with the binding nature of the award rather than enforcement, provides that "[t]he award shall be binding on the parties" and that "[e]ach party shall abide by and comply with the terms of the award except to the extent that enforcement shall have been stayed pursuant to the relevant provisions of this Convention", without limiting such binding nature to the non-pecuniary obligations imposed by the award.

<sup>293</sup> In the state-to-state sphere, the ILC Articles expressly recognize a tribunal's power to grant non-pecuniary relief. Article 31 of the ILC Articles provides that "[t]he responsible State is under an obligation to make full reparation for the injury caused by the internationally wrongful act." In turn, Article 34 provides that "[f]ull reparation for the injury caused by the internationally wrongful act shall take the form of restitution, compensation and satisfaction, either singly or in combination, in accordance with the provisions of this chapter."



involving disputes stemming from ongoing relationships, in which awards providing for specific performance or injunctions will become relevant.<sup>294</sup>

1312. Finally, the power to award injunctive relief has been affirmed by ICSID tribunals. For instance, in *Enron v. Argentina* the tribunal expressly concluded that “in addition to declaratory powers, it has the power to order measures involving performance or injunction of certain acts.”<sup>295</sup>
1313. The Tribunal concludes that it has the power to grant injunctive relief in a final award. This relief, however, must be definitive (i.e., not provisional, not meant to “preserve the respective rights of either party” until final resolution of the dispute, which is the objective of provisional measures pursuant to Article 47 of the ICSID Convention). The Tribunal prefers the term “definitive” to “permanent”, as the relief granted may be temporary (i.e., granted only until a certain date or until a certain condition is met). However, as the Tribunal will become *functus officio* upon the rendering of the Award (subject to a party filing a claim for rectification, supplementary decision, interpretation or revision of the Award pursuant to Articles 49, 50 or 51 of the ICSID Convention), the injunctive relief granted cannot be later reconsidered or lifted by the Tribunal, as would be the case with provisional relief: such definitive injunctive relief would have *res judicata* effect.
1314. The Tribunal turns now to the Claimants’ specific request for post-award injunctive relief.
1315. The first question that arises is whether this request for relief is timely. As a request for definitive relief in the Award, the request must be treated as an ancillary claim, and thus the conditions set out in Rule 40 of the ICSID Arbitration Rules (cited at paragraph 1289 above) apply.
1316. The Claimants formally articulated their request for post-award injunctive relief in their Response to the Respondent’s Application to Revoke Provisional Measures, submitted on 28 September 2012, which is considerably past the submission of their Reply (submitted in December 2009). Although the Claimants had included a similar request in their First Application for Provisional Measures, submitted on 3 November 2010 on the eve of the hearing on the merits (see paragraph 1298 above), that request was also submitted after their Reply. In any event, as the Claimants themselves acknowledge, this request was made in the context of a request for provisional measures and was not formulated as a substantive request for relief in the award.
1317. The Claimants contend that their request is timely because the Tribunal is empowered to award post-award injunctive relief as a result of their request for “[a]ny

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<sup>294</sup> C. Schreuer, *The ICSID Convention: A Commentary*, 2nd ed. (2009), pp. 1137-1138. Prof. Schreuer adds that “[t]ribunals imposing such non pecuniary obligations should keep the impossibility to enforce them in mind. Such awards should [...] provide for a pecuniary alternative in case of non-performance such as liquidated damages, penalties or another obligation to pay a certain amount of money.” (*Id.*)

<sup>295</sup> *Enron v. Argentina (Decision on Jurisdiction)*, ¶ 81.

further relief that the Tribunal may deem fit and proper” (Revised Request for Relief, ¶ 6). A first question is whether, as a result of such a generic request, the Tribunal has the power to order relief that has not been expressly requested. Assuming that the Tribunal has the power and the discretion to make such an order (a matter that the Tribunal does not need to address), in the particular circumstances of this case, the Tribunal would not wish to exercise any such discretion to order definitive injunctive relief such as the relief sought by the Claimants without having been expressly requested to do so. In particular, the Tribunal would be loath to do so because that would defeat one of the *rationes legis* of Article 40, namely afford the Responding State the possibility fully to put its case in defense to a given relief before the evidentiary hearing and take advantage of that hearing to bring forth the correlative necessary evidence. The Respondent was not in a position at the time to predict that Claimants would subsequently come up with the disputed prayers or that the Tribunal would exercise its discretion, if it exists, in the way the Claimants are suggesting now.

1318. The Claimants’ request for definitive injunctive relief is thus untimely, and it falls to the Tribunal to determine, upon justification by the Claimants and after considering the Respondent’s objections, whether it authorizes the presentation of the claim at a later stage in the proceedings. After considering both Parties’ arguments, the Tribunal finds that there is not a sufficient justification to authorize the presentation of this claim at this stage of the proceedings. Nor was there sufficient justification to authorize the presentation of this claim in September 2012, when the Claimants first formulated their request for definitive injunctive relief. The Claimants submitted their first application for provisional measures in November 2010. They thus had ample time since the occurrence of the facts that gave rise to their alleged need for injunctive relief to properly file for an ancillary claim for definitive relief in accordance with Rule 40. The Claimants have not justified why such a claim could not have been brought before September 2012. Accordingly, the Tribunal dismisses the Claimants’ request for definitive injunctive relief.
1319. Had it not dismissed the claim on procedural grounds, the Tribunal would have done so on the merits. The Tribunal has dismissed the Claimants’ argument that the Respondent’s wrongful act (the breach of the BIT) caused them to incur the tax debts and penalties that are the basis for the Respondent’s tax enforcement actions (see Section VII.C.4 above). Thus, while during the pendency of these proceedings the legitimacy of the tax penalties imposed upon the Claimants could be deemed to be part of the subject matter of the dispute, the Claimants’ claims in that respect have been dismissed on the merits. Similarly, now that the proceedings are finalized, the Claimants have no independent right to the maintenance of a status quo or to a non-aggravation of the dispute that could require preservation. There is thus no justification for providing the requested additional and definitive injunctive relief in the Award.
1320. Finally, although the Tribunal has the power to grant additional definitive injunctive relief in the Award, any such relief should be granted with the utmost caution. Once the Award is issued and subject to potential requests for rectification, supplementary

decision, interpretation or revision, the Tribunal will become *functus officio*. It will not be able to reconsider the injunctive relief granted, which would have *res judicata* effect.

1321. Under the circumstances, the Tribunal is not convinced that such additional relief is warranted. In its decisions on provisional measures, the Tribunal repeatedly stated that Romania must be allowed to collect the taxes due to it. While these proceedings were pending and for their duration, the Tribunal afforded protection to the Claimants in order, among other reasons, to maintain the status quo and prevent the aggravation of the dispute. The Tribunal recognized the benefits of preventing the Claimants' bankruptcy and allowing the Claimants' business to survive as a going concern. However, the Tribunal cannot do so indefinitely. It trusts that the Parties will find a way to pay their respective debts in a way that allows the Claimants' investment to continue contributing to the prosperity of Bihor County.
1322. For these reasons, the Claimants' request for post-award injunctive relief is dismissed. Accordingly, all provisional measures recommended by the Tribunal will cease to have effect as of the date of dispatch of this Award.

## **X. COSTS**

1323. Both sides request an award of costs in respect of the legal fees and expenses and the costs of arbitration incurred in connection with this proceeding and have filed submissions quantifying their fees and costs (Claimants' Request for Costs, ¶¶ 58-59; Respondent's Submission on Costs, ¶ 49).
1324. The Claimants' legal fees and expenses amount to EUR 18,409,213 or RON 86,478,476. They have advanced USD 1,510,000 on account of the fees and expenses of the Members of the Tribunal and the ICSID administrative fees and expenses, including the lodging fee of USD 25,000. The Claimants seek an award of the entirety of these costs and compound interest at a rate of 3-month ROBOR plus 5% until the date of payment.
1325. The Respondent's legal fees and expenses amount to EUR 11,499,347.97. It has advanced USD 1,485,000 to ICSID.
1326. The Parties agree that the Tribunal has broad discretion to allocate all costs of the arbitration, including legal fees and expenses, between the Parties as it deems appropriate, pursuant to Article 61 of the ICSID Convention. Both sides argue that a costs award is warranted because they should prevail in the arbitration and because the other party has conducted the arbitration in a manner which has led to delay and increased costs.
1327. The Tribunal has considered all the circumstances of this case: the procedure (including the jurisdictional phase, the Parties' requests for production of documents, the Claimants' requests for provisional measures, the Respondent's request for revocation of provisional measures, the Claimants' request for a site visit, the merits phase of the proceeding, the Claimants' revised request for relief, and multiple hearings) as well as the Parties' substantive arguments on jurisdiction, admissibility and the merits. As evidenced by Section II above, there were numerous procedural issues and difficult legal questions involved in the jurisdictional and merits phases. Many of these issues were far from clear-cut and involved meritorious arguments by both Parties. The Claimants have prevailed on jurisdiction and have established a breach of the fair and equitable standard under the BIT. They have, however, only been partially successful in regard to their claims for damages, which evolved during the proceedings.
1328. In light of these factors, the Tribunal has concluded that it is fair overall that both sides (that is, the five Claimants on one side and the Respondent on the other) bear the costs of the arbitration (the fees and expenses of the Members of the Tribunal and the charges for the use of the facilities of the Centre) in equal shares, and that each side bears its own legal and other costs incurred in connection with this case.<sup>296</sup>

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<sup>296</sup> The Parties will receive a statement of the account from the ICSID Secretariat. Any remaining balance will be reimbursed to the Parties.

## **XI. DECISION**

1329. For the reasons stated in the body of this Award, the Tribunal makes the following decision:

- a. The Claimants' claim that the Respondent has violated Article 2(4) of the BIT by failing to observe obligations entered into with the Claimants with regard to their investments is dismissed by majority.
- b. The Claimants' claim that the Respondent has violated Article 2(3) of the BIT by failing to ensure fair and equitable treatment of the Claimants' investments is upheld by majority. In view of this decision, the Tribunal does not need to determine whether the Respondent has breached the BIT by impairing the Claimants' investments through unreasonable or discriminatory measures (Article 2(3) of the BIT, second part) or by expropriating the Claimants' investments without the payment of prompt, adequate, and effective compensation (Article 4(1) of the BIT).
- c. As a result of the Respondent's breach of the BIT, the Claimants are awarded and the Respondent is ordered to pay RON 376,433,229 as damages, broken down as follows:
  - i. RON 85,100,000 for increased costs of sugar;
  - ii. RON 17,500,000 for increased costs of raw materials other than sugar or PET;
  - iii. RON 18,133,229 for the lost opportunity to stockpile sugar; and
  - iv. RON 255,700,000 for lost profits on sales of finished goods.
- d. The Respondent is ordered to pay interest on the amount specified in subparagraph (c) above, at 3-month ROBOR plus 5%, compounded on a quarterly basis, calculated from the following dates until full payment of the Award:
  - i. With respect to the claims for increased cost of sugar and other raw materials, interest shall be calculated from 1 March 2007.
  - ii. With respect to the claim for the lost opportunity to stockpile sugar, interest shall be calculated from 1 November 2009.
  - iii. With respect to the claim for lost profits on sales of finished goods, interest shall be calculated from 1 May 2008.
- e. The Claimants on one side and the Respondent on the other shall bear the costs of the arbitration in equal shares, and each Party shall bear its own legal and other costs incurred in connection with this case.

- f. All provisional measures recommended by the Tribunal will cease to have effect as of the date of dispatch of this Award.
- g. All other claims or prayers for relief are dismissed.

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Dr. Stanimir A. Alexandrov  
Arbitrator

Date: 9 December 2013

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Prof. Georges Abi-Saab  
Arbitrator

Date: 5 December 2013

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Dr. Laurent Lévy  
President of the Tribunal

Date: 5 December 2013

## **LEGAL AUTHORITY CA-98**





**Arbitration CAS 2004/A/725 United States Olympic Committee (USOC) v. International Olympic Committee (IOC) & International Association of Athletics Federation (IAAF), award of 20 July 2005**

Panel: Mr. Kaj Hobér (Sweden), President; Mr. L. Yves Fortier QC (Canada); Mr. David A.R. Williams QC (New Zealand)

*Athletics*

*Disqualification of a relay team further to the suspension of an individual member of the team  
Interpretation of the IAAF Rules*

- 1. Rule 59.4 of the IAAF Rules in force at the time of the Sydney Games concerns the disqualification, ineligibility and annulment of performance results of *individual* athletes, in cases where an athlete has been found guilty of a doping offence; it does not concern teams or team results. One should not take a rule that plainly concerns individual ineligibility and the annulment of individual results, and then stretch and complement and construe it in order that it may be said to govern the results achieved by teams.**
- 2. Clarity and predictability of the rules are required so that the entire sport community are informed of the normative system in which they live, work and compete, which requires at the very least that they be able to understand the meaning of rules and the circumstances in which those rules apply.**

This case, in its essence, concerns the interpretation of relevant IAAF Rules and their application to five members of the gold medal-winning U.S.A. team (the “U.S.A. team”) in the men's 4 x 400m relay event at the 2000 Sydney Olympic Games (the “relay event”). It is a most peculiar case, arising in most unusual circumstances.

As explained more fully in this Award, the results of the relay event and the fate of the medals awarded to the U.S.A. team at the 2000 Sydney Games have, five years later, been called into question as a result of two occurrences.

First, on 28 June 2004, a Panel of the Court of Arbitration for Sport (CAS) found that a Doping Appeals Board of USA Track & Field (USATF), the national federation that governs the sport of athletics in the United States of America, had misdirected itself and reached an erroneous conclusion when, on 10 July 2000, it exonerated Mr. Jerome Young (a sixth member of the U.S.A. team, who is not one of the Appellants in this arbitration) of having committed a doping offence on 26 June 1999, just prior to the Sydney Games. The CAS Panel found that Mr. Young had

committed a doping offence, that the resulting period of ineligibility extended through the Sydney Games, and that Mr. Young should therefore not have participated in those Games (CAS 2004/A/628, award of 28 June 2004).

Second, on 18 July 2004, the IAAF Council determined that “as a consequence of Jerome Young’s ineligibility to have competed at the Sydney Olympic Games in 2000 [by virtue of having committed a doping offence on 26 June 1999], the result of the USA Men’s 4 x 400m relay event is annulled and the final placings are revised accordingly”.

It is the subject matter of the second of these decisions – that is, whether under IAAF Rules in force at the time of the Sydney Games, the results of the relay event should be annulled and the final placings revised accordingly – that is the primary issue in the present appeal.

First Appellant, USOC, is the body to which all US Olympic sports federations are affiliated and is responsible, among other duties, for the selection and registration of athletes in the Olympic Games. USOC has its seat in Colorado Springs, Colorado, U.S.A.

Second, third, fourth, fifth and sixth Appellants, Messrs. Michael Johnson, Antonio Pettigrew, Angelo Taylor, Alvin Harrison and Calvin Harrison (the “Athletes”) are five of the six athletes who were members of the U.S.A. team awarded gold medals in the 4 x 400 men’s relay event at the 2000 Sydney Olympic Games. The sixth member of that team, Mr. Jerome Young, is not a party in these proceedings.

First Respondent, the International Olympic Committee (IOC) is the governing body of the Olympic Movement. One of its missions is to ensure the regular celebration of the Olympic Games. The IOC has its seat in Lausanne, Switzerland.

Second Respondent, the International Association of Athletics Federations (IAAF) is the international federation that governs the sport of athletics throughout the world. The IAAF has its seat in the Principality of Monaco. On 18 July 2004, the IAAF Council made the decision (the “IAAF decision”) that is the subject of the present appeal.

IAAF Rule 59.4 is in the following terms:

If an athlete is found to have committed a doping offence and this is confirmed after a hearing or the athlete waives his right to a hearing, he shall be declared ineligible. In addition, where testing was conducted in a competition, the athlete shall be disqualified from that competition and the result amended accordingly. His ineligibility shall begin from the date of suspension. Performances achieved from the date on which the sample was provided shall be annulled.

(emphasis added)

Bye-law 1.2 to Rule 57 of the Olympic Charter provides:

1. Technical provisions relating to IFs at the Olympic Games:  
The IFs have the following rights and responsibilities:

[...]

1.2 To establish the final results and ranking of Olympic competitions.

In addition, it is relevant to note articles 6.11 (d) and (e) of the IAAF Constitution in force as from 1 November 2003 (the version of the IAAF Constitution that is relevant here), which provide:

The Council's powers shall include the following:

[...]

- (d) to make decisions in urgent matters relating to all Rules. Any such decisions may be notified to the members by the IAAF Office and shall be reported to the next Congress.
- (e) to make decisions regarding the interpretation of the Rules. Any such decisions may be notified to the members by the IAAF Office and shall be reported to the next Congress.

(emphasis added)

Although this case concerns essentially a pure question of law, an appreciation of its lengthy and complicated history is relevant to an understanding both of the context in which the present appeal arises and of the issues addressed in this Award. That history has been thoroughly traversed by the parties in their written and oral submissions, and is summarized here.

On 26 June 1999, Mr. Young provided a urine sample while competing at the United States National Outdoor Championships in Eugene, Oregon. The IOC-accredited laboratory in Indianapolis, Indiana reported that the sample was positive for nandrolone metabolites.

On 11 March 2000, a USATF Doping Hearing Panel found Mr. Young guilty of a doping offence. That decision was reversed on 10 July 2000 by a USATF Doping Appeals Board, thus exonerating Mr. Young and rendering him eligible to enter and compete in the Sydney Games. The USATF, IAAF and IOC accordingly allowed Mr. Young to compete in the Sydney Games as a member of the U.S.A. team, which eventually won the gold medal.

During the Sydney Games, Mr. Young competed in the semi-final heat for the relay event, on 29 September 2000. He did not compete in the final race on 30 September 2000, which four members of the U.S.A. team (Michael Johnson, Antonio Pettigrew, Alvin Harrison and Calvin Harrison) won.

There is no evidence and there has been no suggestion that any member of the U.S.A. team (including Mr. Young) used or ingested any prohibited substance or committed any doping offence during the Sydney Games. Nor is there any evidence, and there has been no suggestion, that any member of the U.S.A. team even knew of Mr. Young's case at the time.

The reason for this lay in USATF's rules (since amended) concerning athletes' privacy and the confidentiality of information pertaining to doping cases in which athletes were ultimately exonerated. In July 2002, the IAAF submitted its concerns about the USATF's confidentiality policy to arbitration before a CAS Panel. On 10 January 2003, that Panel held that although IAAF Rules

did obligate the USATF to disclose information regarding its drug tests to the IAAF, and that information should have been disclosed, given the passage of time and the equities, including the IAAF's familiarity with the USATF rules in question, the USATF should not in the circumstances be required to disclose the identity, or any information about the drug tests, of athletes who had been exonerated<sup>1</sup>.

In August 2003 – three years after the Sydney Games – the United States media (*Los Angeles Times*) reported Mr. Young's June 1999 doping offense and subsequent exoneration by the USATF Doping Appeals Board.

On 30 September 2003, the IOC Executive Board formed a Disciplinary Commission to investigate the circumstances surrounding Mr. Young's entry and participation in the Sydney Games.

In early February 2004, USATF released the unredacted decision of its Appeals Board that had exonerated Mr. Young and sent it to the USOC. The USOC forwarded the decision to the IOC and IAAF.

On 18 February 2004, the IAAF referred the matter to arbitration before the CAS, requesting that the decision exonerating Mr. Young be overturned.

On 29 June 2004, a CAS Panel ruled, *inter alia*, that (1) the USATF Doping Appeals Board had acted erroneously in overturning the 11 March 2000 decision finding Mr. Young guilty of a doping offence; (2) Mr. Young should have been ineligible to compete in international competition for the 2-year period from 26 June 1999 (the date of his urine sample) to 25 June 2001; and (3) Mr. Young therefore should not have been allowed to compete in the Sydney Games.

On 5 July 2004, the IAAF convened an Extraordinary Council Meeting for 18 July 2004, to consider the action which it should take in the light of the decision in the Jerome Young case and further to the correspondence received from the IOC Disciplinary Commission.

By letter dated 17 July 2004, USATF sent the IAAF a written submission in the matter, stating, *inter alia*, that fairness demanded that Jerome Young alone, and not his innocent teammates, should forfeit the gold medal won by the U.S.A. team.

Two days prior to the Extraordinary Council Meeting, a "Briefing Note to Council" was prepared for the assistance and use of the Council members at their 18 July 2004 meeting (the "IAAF briefing note"). The IAAF briefing note set out the history of the Jerome Young case, the action required of the IAAF Council, the relevant IAAF Rules, and how relevant previous cases had been dealt with.

On 18 July 2004, the Extraordinary Council Meeting was held in Grosseto, Italy.

The IAAF Legal Counsel stated:

[...]

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<sup>1</sup> See CAS 2002/O/401, in: REEB M. (ed.), *Digest of CAS Awards III 2001-2003*, The Hague 2004, p. 36 ff.

(x) (...) all the IAAF Council was required to do was to interpret the relevant IAAF Rules in 1999 as regards the consequences of Jerome Young's ineligibility on the USA Relay Team. The IAAF Council was not being asked to reach a decision on the withdrawal of the gold medals of the USA Relay Team Members. This was a matter exclusively for the IOC.

There then ensued a general discussion among Council members. As stated at paragraph 9 of the General Secretary's note:

The broad views of the council were:

(i) That the spirit and intent of the relevant IAAF Rules was to annul all Jerome Young's results in the 2-year period of his ineligibility, including the USA 4x400m Relay Team result at the Sydney Olympic Games.

(ii) That the natural consequence under the relevant IAAF Rules of the annulment of an individual's results was the annulment of any relay result in which the athlete had competed. Every member of a winning relay team is awarded a gold medal whether they participate only in the preliminary rounds or in the final. This shows that a relay is one event composed of the preliminary rounds and a final. If an athlete is ineligible to compete as part of the team in a preliminary round, the team's performance in the overall event must be affected.

[...]

(v) Jerome Young's appearance in the Sydney Games was caused by the fault of USATF; USATF had, [despite reminders from the IAAF Council,] failed to comply with IAAF Rules in notifying the IAAF of its doping decisions; had they done so, Jerome Young would never had been allowed by the IAAF to compete in Sydney.

The IAAF President then summed up the discussion and called for a vote to be taken as to whether the results of the USA team should be modified. In a secret ballot, the meeting voted 16 - 1 in favour of annulling the result (with one abstention). The motion was therefore passed.

On 18 July 2004, the IAAF President wrote to the Secretary of the IOC Disciplinary Commission. His letter reads:

[...]

Further to the request of the IOC Disciplinary Commission by letter dated 2 July 2004, the IAAF Council has interpreted the relevant IAAF Rules that were in force at the time that Mr. Young committed a doping offence on 26 June 1999. Its interpretation is that, as a consequence of Jerome Young's ineligibility to have competed at the Sydney Olympic Games in 2000, the result of the USA Men's 4x400m Relay Team is annulled and the final placings are revised accordingly.

[...]

The present arbitration was commenced by the filing of Appellants' Statement of Appeal with the CAS on 27 September 2004.

The hearing of the appeal took place in London, on 10 May 2005.

## LAW

1. As stated by Appellants in their Statement of Appeal, this appeal is brought pursuant to both IAAF Rule 21 (IAAF Handbook 2002-2003) and more particularly, because the matter concerns the Olympic Games, Article 61 of the Olympic Charter, which provides:

*Any dispute arising on the occasion of, or in connection with, the Olympic Games, shall be submitted exclusively to the Court of Arbitration for Sport, in accordance with the Code of Sports-Related Arbitration.*

2. For its part, the IAAF acknowledges that the Athletes, who are the subject of the IAAF decision, have standing to appeal that decision to the CAS in virtue of IAAF Rule 60.13 (IAAF Handbook 2004-2005)<sup>2</sup>. However, the IAAF contends that USOC enjoys no such standing and should be removed as a party to these proceedings. For the reasons set forth below, and in view of the Panel's findings in respect of the substantive issues in this appeal, the IAAF's request that USOC be struck as a party to these proceedings need not be determined; and the Panel thus refrains from doing so.
3. The question to be answered is whether, under IAAF Rules in force at the time of the 2000 Sydney Olympic Games, the results obtained by the U.S.A. team in the relay event should be annulled. It is the unanimous opinion of the Panel that they should not be annulled.
4. IAAF Rule 59.4, which the IAAF puts before the Panel as the principal governing rule in the circumstances, is set out in full above. For ease of reference, it is reproduced here:

*If an athlete is found to have committed a doping offence and this is confirmed after a hearing or the athlete waives his right to a hearing, he shall be declared ineligible. In addition, where testing was conducted in a competition, the athlete shall be disqualified from that competition and the result amended accordingly. His ineligibility shall begin from the date of suspension. Performances achieved from the date on which the sample was provided shall be annulled.*

---

<sup>2</sup> IAAF Rule 60.13 (IAAF Handbook 2004-2005) reads as follows:

***Parties entitled to appeal decisions***

In any case involving International-Level athletes (or their athlete support personnel) or arising from an International Competition, the following parties shall have the right to appeal a decision to CAS:

- a. the athlete or other person who is the subject of the decision being appealed;
- b. the other party to the case in which the decision was rendered;
- c. the IAAF;
- d. the IOC (where the decision may have an effect on eligibility in relation to the Olympic Games; and
- e. WADA (in doping-related matters only).

5. It was urged upon the Panel with great conviction and eloquence by the IAAF's counsel that IAAF Rule 59.4 provides a clear statement of a rule providing for the annulment of the results of the U.S.A. team in the circumstances of this case – that is, a rule to the effect that *where an athlete tests positive in an earlier competition and is subsequently declared ineligible, and his results from the date of the provision of his sample through to the imposition of his ineligibility are annulled* (as in the case of Mr. Young), *the result of any relay team in which he has competed during such period* (e.g., the results of the U.S.A. team at the Sydney Olympic Games) *shall also be annulled*.
6. The IAAF argues that the express provisions of IAAF Rule 59.4 must be “complemented” by anything which is necessarily to be implied in them, and that they must be construed “purposively”. It maintains that Rule 59.4 is to be complemented, for example, by provisions such as those contained in IAAF Rules 170 (17) and (18), which govern the composition of a relay team and the nature and timing of permitted substitutions to a team. It contends that the annulment of the U.S.A. team's winning results “follows inexorably” from the last sentence of Rule 59.4, which states that “[p]erformances achieved from date the sample was provided shall be annulled,” in that:

There is no distinction drawn between performance in individual or in relay results. Young’s performance in the first round and semi-final stage of the 4 x 400 men’s relay (which occurred ... during his period of ineligibility) are annulled. It follows inexorably that (i) the other results of the squad in which he [Mr. Young] ran (the qualification round squads) are annulled, since the squad had to compete 4 not 3 legs (in qualification) (ii) the results of the squad in which he did not run (the final squad) are also annulled, since that squad's right to participate and participation in other final depended upon the results of the earlier squad being valid.

Alternatively since the word “performances” is not limited to the athlete's own performances it should be construed as applying to the performances of a team in which the athlete participated.
7. More broadly, the IAAF contends that the applicability of the relevant rules in the circumstances of the present case, and the consequent annulment of the results obtained by the U.S.A. team in the relay event is implicit in order to give efficiency to the Olympic Movement Anti-doping Code and related rules. In the submission of the IAAF, “it would be perverse and undermine the force of the Anti-doping Code if results achieved through reliance on an ineligible athlete, whether [results] of the athlete or of his team, should stand”.
8. In sum, the IAAF takes the position that both a purposive and even a literal interpretation of IAAF Rules require that the results of the gold medal-winning U.S.A. team be annulled. The proposition, it says, is straightforward: Jerome Young was ineligible to compete at the Sydney Olympic Games; his results are annulled; therefore the results of the four-some in which he ran must also be annulled; and the results achieved by the four U.S.A. team members who ran in the final race of the relay event must similarly be annulled, since they only made it to the finals due to the results achieved by the U.S.A. team in earlier heats, in which Mr. Young ran. “In team sports,” the IAAF submits (with reference to the CAS award OG 1998/004-005, published in the Digest of CAS Awards I 1986-1998, p. 435ss.), “the chain is no stronger than its weakest link”.

9. As stated above, the argument is not without force or logic. However, in the view of the Panel, even when articulated in its most simple and compelling fashion, its shortcomings are apparent.
10. On its face, Rule 59.4 concerns the disqualification, ineligibility and annulment of performance results of *individual* athletes, in cases where that athlete has been found guilty of a doping offence; it does not concern teams or team results (in fact, as explained below, the IAAF Rules did not contain any express provisions covering the sort of situation at issue in this case until they were amended in 2004-2005.)
11. IAAF Rule 59.4 plainly deals with, and is plainly intended to deal *only* with, the situation of “an athlete” who is found to have committed a doping offence. It speaks to “the athlete” being disqualified and to the period of “his” ineligibility as well as to the annulment of his performances achieved as from the date on which his positive sample was provided.
12. To take a rule that plainly concerns individual ineligibility and the annulment of individual results, and then to stretch and complement and construe it in order that it may be said to govern the results achieved by teams, is the sort of legal abracadabra that lawyers and partisans in the fight against doping in sport can love, but in which athletes should not be required to engage in order to understand the meaning of the rules to which they are subject.
13. In seeking a proper interpretation of relevant IAAF Rules and their application in the circumstances of this case, one returns inevitably to the observations contained in the IAAF briefing note prepared for IAAF Council members in advance of their 18 July 2004 deliberations and decision. Whereas the alleged clarity of the relevant IAAF Rules is much to be doubted, this much *is* crystal clear and is stated, correctly, in the IAAF briefing note: “In the 2000 Rules, there was ... no specific provision for what should happen when a competitor who had been a member of a team (either of a relay team or otherwise) was found guilty of doping”.
14. As explained in the IAAF briefing note, it is not until their amendment in 2004-2005 that IAAF Rules provide expressly for what happens when an athlete who is a member of a relay team is found guilty of doping. According to the briefing note, Rule 39.4 of the 2004-2005 IAAF Rules makes it clear “*for the first time*” that:  
  
*[I]f an athlete tests positive in an earlier competition or admits doping (and is subsequently declared ineligible) and his results from the date of the provision of his sample through to the imposition of his suspension or ineligibility are annulled, the result of any relay team in which he has competed during such period shall also be annulled.*
15. It is immediately apparent that this is in essence the very rule which the IAAF contends existed, whether literally or by implication, at the time of the 2000 Sydney Olympic Games. This is the rule which it attempts to tease out of IAAF Rule 59.4.



16. In fact, IAAF Rule 39.4 says more than even the IAAF briefing note suggests. While it is true that the 2004-2005 IAAF Rules are the “the first time” that the implication for teams whose members may have committed doping offences is spelled out, Rule 39.4 also introduces the concept of *fairness* as a consideration. It reads as follows:

*[W]here an athlete has been declared ineligible under R40 below, all competitive results obtained from the date the positive sample was provided (whether in competition or out of competition) or other anti-doping rule violation occurred, through to the commencement of the period of provisional suspension shall, unless fairness dictates otherwise, be annulled, with all resulting consequences for the athlete (and, where applicable, any team in which the athlete has competed) including the forfeiture of all titles, awards, medals, points and prize and appearance money.*

(emphasis added)

17. The relevant IAAF Rules in force at the time of the Sydney Games contained no such “fairness consideration”. And of course, to construe those Rules, in particular Rule 59.4, in the manner contended for by the IAAF in this arbitration would entail an automatic disqualification or annulment of the results of the entire USA team, without any consideration of fairness to the members of that team. In the view of the Panel, the absence of a “fairness consideration” in Rule 59.4 makes it even less likely that it was intended to apply, by implication, to teams as well as to individuals.
18. The IAAF contends that “this is not a Q.<sup>3</sup> case”. In a sense, however, this is very much “a Q. case”. Firstly, the clarity of the relevant anti-doping rules related to team results in force at the time of the Sydney Olympic Games is manifestly in doubt. This explains why the main issue before this Panel is, as the IAAF recognises, the merits of the IAAF decision interpreting those rules.
19. Secondly, the principles underlying the approach adopted by the CAS in CAS 94/129 and similar cases cannot be ignored, as the IAAF suggests they should be, on the basis that, because the Athletes were entirely ignorant of their teammate's doping offence (given that he had been exonerated at the time, and that exoneration was not overturned until many years later), their behaviour was in no way affected by those rules or their understanding of them.
20. The rationale for requiring clarity of rules extends beyond enabling athletes in given cases to determine their conduct in such cases by reference to understandable rules. As argued by the Appellants at the hearing, clarity and predictability are required so that the entire sport community are informed of the normative system in which they live, work and compete, which requires at the very least that they be able to understand the meaning of rules and the circumstances in which those rules apply.
21. There was simply no express rule in force at the time of the Sydney Games which provided for the annulment of results obtained by a team, one of whose members later was found to have been ineligible to compete at the time. As became apparent in these proceedings, such a

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<sup>3</sup> CAS 94/129, published in the Digest of CAS Awards I 1986-1998, p. 187ss.

rule could only be said to have been produced by what the Panel in the CAS 94/129 case referred to as “an obscure process of accretion” – here, as the IAAF would have it, a process of complementation and inference. The Panel consider that the following oft-cited passage from the CAS 94/129 decision is apposite:

The fight against doping is arduous, and it may require strict rule. But the rule-makers and the rule-appliers must begin by being strict with themselves. Regulations that may affect the careers of dedicated athletes must be predictable. They must emanate from duly authorised bodies. They must be adopted in constitutionally proper ways. They should not be the product of an obscure process of accretion. Athletes and officials should not be confronted with a thicket of mutually qualifying or even contradictory rules that can be understood only on the basis of the de facto practice over the course of many years of a small group of insiders.

(emphasis added)

22. In *A.C. v. FINA*,<sup>4</sup> in which, as in this case, the International Federation in question argued for a “purposive construction” of the relevant rules, the CAS nonetheless granted the Appellant’s appeal in part (as to the sanction). In doing so it cited with approval the approach taken in CAS 94/129 and further stated that the federation in question bore the responsibility:

[T]o take every step to ensure that competitors under their jurisdiction were familiar with all rules, regulations, guidelines and requirements in such a sensitive area as doping control.

[...]

It is important that the fight against doping in sport, national and international, be waged unremittingly. The reasons are well known ... It is equally important that athletes in any sport ... know clearly where they stand. It is unfair if they are to be found guilty of offences in circumstances where they neither knew nor reasonably could have known that what they were doing was wrong (to avoid any doubt we are not to be taken as saying that doping offences should not be offences as a strict liability, but rather that the nature of the offence [as one of strict liability] should be known and understood).

For this purpose, it is incumbent both upon the international and the national federation to keep those within their jurisdiction aware of the precepts of the relevant codes.

(emphasis added)

23. IAAF Rule 59.4 applies plainly to Mr. Young. The same simply cannot be said with respect to the Athletes who are Appellants in this case.
24. For these reasons, the Panel is unanimously of the opinion that the decision taken by the IAAF Council on 18 July 2004 interpreting its rules is incorrect, and should be overturned.

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<sup>4</sup> CAS 96/149, published in the Digest of CAS Awards I 1986-1998, p. 251 at 261-262.

The Panel reaches this conclusion with all due respect to the IAAF Council and its role under the IAAF Constitution as the primary decision-maker regarding the interpretation of its Rules.

25. On the basis of IAAF rules applicable at the time of the 2000 Sydney Olympic Games, the results obtained by the Athletes in the men's 4 x 400m relay event at the Sydney Games shall not be amended. Those results therefore stand. Furthermore, it is the understanding of the Panel that only Jerome Young in the US relay team should be stripped of his gold medal pursuant to the CAS award 2004/A/628 of 28 June 2004.
26. Having so found, the Panel considers it unnecessary for it to consider the other issues raised by the parties in these proceedings. In particular, the Panel considers that there is no need for it to determine, and it refrains from determining:
  - Whether the IAAF has the jurisdiction, power or authority to annul the results of the relay event (the Panel having determined that, even assuming (without deciding) that the IAAF has such jurisdiction, its decision in this case was incorrect);
  - Whether the IAAF decision should be overturned on grounds unrelated to the merits of that decision (for example, whether modification of the results of the relay event is time-barred, or whether the IAAF decision is vitiated by a lack of due process);
  - Whether or not USOC, as distinct from the Athletes, has standing to appeal the IAAF decision.
27. The Panel also refrains from determining, because it need not in the circumstances determine, the IOC's Request for a Stay of the proceedings as against it.

#### **The Court of Arbitration for Sport rules:**

1. The appeal filed by Michael Johnson, Antonio Pettigrew, Angelo Taylor, Alvin Harrison and Calvin Harrison on 27 September 2004 is upheld.
2. The IAAF Council decision of 18 July 2004 is hereby overturned.
3. On the basis of IAAF Rules in force and applicable at the time of the 2000 Sydney Olympic Games, the results of the men's 4 x 400m relay event at those Games shall not be amended; those results stand.

(...)

## **LEGAL AUTHORITY CA-99**

**International Centre for Settlement of Investment Disputes**

**TECNICAS MEDIOAMBIENTALES TECMED S.A.**

**v.**

**THE UNITED MEXICAN STATES**

**CASE No. ARB (AF)/00/2**

**AWARD**

**President: Dr. Horacio A. GRIGERA NAON**

**Co-arbitrators: Prof. José Carlos FERNANDEZ ROZAS  
Mr. Carlos BERNAL VERA**

**Secretary to the Tribunal: Ms. Gabriela ALVAREZ AVILA**

**Date of dispatch to the parties: May 29, 2003**

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## THE TRIBUNAL

Constituted as indicated above,

Having conducted its deliberations,

Issues the following award:

### **A. Introduction**

1. The Claimant, Técnicas Medioambientales, TECMED S.A., is a commercial company organized under Spanish law, domiciled in Madrid, Spain. It is represented in this arbitration proceeding by:

Mr. Juan Carlos Calvo Corbella  
Técnicas Medioambientales TECMED S.A.  
Albasanz 16 – 1a planta  
28037 Madrid, Spain

Ms. Mercedes Fernández  
Mr. Juan Ignacio Tena García  
Jones, Day, Reavis & Pogue abogados  
Velázquez 51 – 4a planta  
28001 Madrid, Spain

2. The Respondent is the Government of the United Mexican States, represented in this arbitration proceeding by:

Mr. Hugo Perezcano Díaz  
Consultor Jurídico  
Dirección General de Consultoría Jurídica  
de Negociaciones Comerciales  
Subsecretaría de Negociaciones Comerciales Internacionales  
Secretaría de Economía  
Alfonso Reyes No. 30, piso 17  
Colonia Condesa  
Mexico, D.F., C.P. 06179, Mexico

3. This Award decides on the merits of the dispute between the parties in accordance with Article 53 of the Arbitration Additional Facility Rules (Arbitration Rules) of the International Centre for Settlement of Investment Disputes.

## **B. Procedural History**

4. On July 28, 2000, the Claimant filed with the Secretariat of the International Centre for Settlement of Investment Disputes (“ICSID”) an application for approval of access to the Additional Facility and a request for arbitration against the Respondent in accordance with the Additional Facility Rules for the Administration of Proceedings by the Secretariat of the International Centre for Settlement of Investment Disputes (hereinafter referred to as the “Rules”) and under the provisions of the Agreement on the Reciprocal Promotion and Protection of Investments signed by the Kingdom of Spain and the United Mexican States (hereinafter referred to as the “Agreement”). The Agreement entered into force for both countries on December 18, 1996. The Claimant is the parent company in Spain of TECMED, TECNICAS MEDIOAMBIENTALES DE MEXICO, S.A. de C.V. (“Tecmed”), a company incorporated under Mexican law, and holds over 99% of the shares of such company. Additionally, Tecmed holds over 99% of the shares of CYTRAR, S.A. DE C.V. (“Cytrar”), a company incorporated under Mexican law through which the investment giving rise to the disputes leading to these arbitration proceedings was made.

5. On August 28, 2000, the Acting Secretary-General of ICSID, pursuant to Article 4 of the Rules, notified the Claimant that access to the Additional Facility Rules had been approved with respect to this case and that the notice of institution of arbitration proceedings had been registered; he then sent the certificate of registration to the parties and forwarded copies of the notice of institution of arbitration proceedings to the Respondent.

6. On October 2, 2000, the Claimant notified the Centre of the appointment of Professor José Carlos Fernández Rosas as arbitrator and of its consent for the Parties to appoint as arbitrator a person of the same nationality of the Party making the proposal.

7. On November 7, 2000, the Respondent notified the Centre of the appointment of Mr. Guillermo Aguilar Alvarez as arbitrator and nominated Mr. Albert Jan van den Berg as President of the Arbitral Tribunal.

8. On November 29, 2000, the Claimant objected to the nomination of Mr. van den Berg and proposed instead that the Parties request their designated arbitrators to appoint the President of the Arbitral Tribunal, which was accepted by the Respondent.

9. On January 30, 2001, the ICSID Secretariat informed that Mr. Fernández Rosas and Mr. Aguilar Alvarez had appointed Dr. Horacio A. Grigera Naón as President of the Arbitral Tribunal. On February 2, 2001, the Claimant confirmed its agreement to this appointment and, in its communication dated February 22, 2001, the Respondent notified the Centre of its agreement to the President’s appointment.

10. On March 13, 2001, the Centre’s Acting Secretary-General informed the parties that, as from that date, the Arbitral Tribunal was deemed to have been constituted and the proceedings to have begun.

11. The first session of the Arbitral Tribunal with the parties was held in Paris, France on May 7, 2001. During the course of the session, procedural rules applicable to these



proceedings were established and the schedule for the submission of memorials by the Parties was fixed, among other things.

12. On September 4, 2001, the Claimant filed its memorial.

13. On November 16, 2001, the Respondent made certain observations regarding opinions alleged to have been given by Mr. Aguilar Alvarez in another arbitration proceeding which, in the Respondent's view, also involved legal matters to be debated in this arbitration proceeding.

14. On November 16, 2001, Lic. Aguilar Alvarez submitted his resignation as arbitrator in these proceedings, upon which, in a letter of the same date, the ICSID Secretariat served notice of the suspension of the proceedings until the vacancy created by Mr. Aguilar Alvarez's resignation was filled.

15. On November 20, 2001, the Arbitral Tribunal accepted the resignation of Mr. Aguilar Alvarez.

16. On December 14, 2001, the Respondent served notice of the appointment of Mr. Carlos Bernal Vereá in replacement of Mr. Guillermo Aguilar Alvarez.

17. On December 17, 2001, the ICSID Secretariat informed that Mr. Carlos Bernal Vereá had accepted his appointment by the Respondent to serve as arbitrator in these proceedings and as from such date deemed the Arbitral Tribunal to have been reconstituted and the arbitration proceedings to have resumed.

18. On January 22, 2002, the Arbitral Tribunal issued a procedural order deciding certain procedural matters raised by the Parties and extended the deadline for the submission of the Respondent's counter-memorial until February 4, 2002.

19. Following a new request by the Respondent in its written communication of January 31, 2002, on February 1, 2002, the Arbitral Tribunal extended the deadline for the submission of the Respondent's counter-memorial until February 11, 2002.

20. The Respondent's counter-memorial was received on February 11, 2002. On February 19, 2002, the Respondent enclosed a list of the facts alleged in the memorial that were recognized by the Respondent in its counter-memorial and those that were not.

21. On March 7, 2002, the Arbitral Tribunal issued Procedural Order No. 1, fixing the week of May 20, 2002 for the Evidentiary Hearing to be held in Washington, D.C., USA, dispensing with the submission of a reply and rejoinder by the Parties, establishing guidelines for holding the hearing and setting June 28, 2002 as the deadline for the Parties to submit their closing statements after the hearing.

22. Following new requests and exchanges between the Parties in the notes of the Respondent and Claimant dated March 13 and 21, 2002, respectively, the Arbitral Tribunal issued its Procedural Order No. 2, which—in addition to specifying certain additional

matters in relation to the hearing scheduled for the week of May 20 – provided that, at the end of the hearing on May 24, 2003, the Parties could address the Arbitral Tribunal orally, and extended the deadline for the submission of closing statements until July 15, 2002.

23. On April 29, 2002, the Secretariat of ICSID notified the Parties of the agenda issued by the Arbitral Tribunal for the conduct of the hearing.

24. The hearing was held in Washington, D.C., at the seat of ICSID. It began in the morning of May 20, 2002, and ended on May 24, 2002, after the Parties addressed the Arbitral Tribunal orally.

25. A stenographic transcript of the hearing was made, which lists the following persons as having been present at the hearing:

**Members of the Arbitral Tribunal**

1. Dr. Horacio A. Grigera Naón, President
2. Prof. José Carlos Fernández Rozas
3. Mr. Carlos Bernal Vereza

**Secretary of the Arbitral Tribunal**

4. Ms. Gabriela Alvarez Avila

**Técnicas Medioambientales TECMED S.A.**

5. Mr. Juan Carlos Calvo Corbella
6. Ms. Mercedes Fernández
7. Mr. José Daniel Fernández

**The United Mexican States**

8. Mr. Hugo Perezcano Díaz
9. Mr. Luis Alberto González García
10. Ms. Alejandra Treviño Solís
11. Mr. Sergio Ampudia
12. Mr. Carlos García
13. Mr. Rolando García

14. Cameron Mowatt, Esq.
15. Stephen Becker, Esq.
16. Sanjay Mullick, Esq.
17. Ms. Jacqueline Paniagua
18. Lars Christianson, Engineer
- 19 Ms. Ruth Benkley
20. Francisco Maytorena Fontes, Engineer
21. Christopher Thomas, Esq.

26. The hearing was held in accordance with the agenda fixed by the Arbitral Tribunal and within the time limit set for the Parties in Procedural Order No. 2 for the examination of witnesses and experts.

27. The following witnesses and experts were heard at the hearing after the opening statements made by the Claimant and the Respondent, respectively.

Offered by the Claimant

José Luis Calderón Bartheneuf

Javier Polanco Gómez Lavin

Enrique Diez Canedo Ruiz

José María Zapatero Vaquero

Jesús M. Pérez de Vega

Luis R. Vera Morales

José Visoso Lomelín

Offered by the Respondent

Alfonso Camacho Gómez

Cristina Cortinas de Nava

Jorge Sánchez Gómez

Lars Christianson

28. During the course of the hearing, the Arbitral Tribunal decided to agree to the inclusion of documents introduced by either the Respondent or the Claimant during the hearing. It further decided —after dismissing the Respondent’s objections in this regard— to agree to the inclusion of certain documents submitted in support of the statement made by Mr. Jesús M. Pérez de Vega as an expert proposed by the Claimant; nevertheless, it gave the Respondent an opportunity to examine such documents and exercise its right to question the expert once the inclusion of such documents had been decided. However, the Respondent declined to exercise such right.

29. At the end of the hearing, the Arbitral Tribunal heard the oral presentations made by the Parties, each of which was allowed 90 minutes.

30. On August 1, 2002, the Claimant and the Respondent submitted their respective closing statements.

31. In a note dated July 31, 2002, the Respondent had explained the reasons why it was annexing to its closing statement a “Declaration of Lars Christianson, Engineer”, accompanied by exhibits.

32. In a note dated August 2, 2002, the Claimant objected to the inclusion of such declaration and exhibits.

33. In its procedural order of August 12, 2002, the Arbitral Tribunal decided to agree to the inclusion of such statement and exhibits, not as part of the evidence offered and produced, but as part of the Respondent’s closing statement.

34. By note dated April 9, 2003, the Secretariat of ICSID notified the Parties that the Arbitral Tribunal had declared the proceedings closed in accordance with Article 45 of the Rules.

### **C. Summary of Facts and Allegations presented by the Parties**

35. The Claimant's claims are related to an investment in land, buildings and other assets in connection with a public auction called by Promotora Inmobiliaria del Ayuntamiento de Hermosillo (hereinafter referred to as "Promotora"), a decentralized municipal agency of the Municipality of Hermosillo, located in the State of Sonora, Mexico. The purpose of the auction was the sale of real property, buildings and facilities and other assets relating to "Cytrar", a controlled landfill of hazardous industrial waste. Tecmed was the awardee, pursuant to a decision adopted by the Management Board of Promotora on February 16, 1996. Later on, the holder of Tecmed's rights and obligations under the tender came to be Cytrar, a company organized by Tecmed for such purpose and to run the landfill operations.

36. The landfill was built in 1988 on land purchased by the Government of the State of Sonora, in the locality of Las Víboras, within the jurisdiction of the Municipality of Hermosillo, State of Sonora. The landfill had a renewable license to operate for a five-year term as from December 7, 1988, issued by the Ministry of Urban Development and Ecology (SEDUE) of the Federal Government of Mexico to Parques Industriales de Sonora, a decentralized agency of the Government of the State of Sonora. During this period, the landfill operator was not this agency but another entity, Parque Industrial de Hermosillo, another public agency of the State of Sonora. Ownership of the landfill was then transferred to a decentralized agency of the Municipality of Hermosillo, Confinamiento Controlado Parque Industrial de Hermosillo O.P.D.; in this new phase, it had a new authorization to operate for an indefinite period of time. Such authorization had been granted on May 4, 1994, by the Hazardous Materials, Waste and Activities Division of the National Ecology Institute of Mexico (hereinafter referred to as INE), an agency of the Federal Government of the United Mexican States within the Ministry of the Environment, Natural Resources and Fisheries (SEMARNAP), which cancelled the previous authorization, granted on December 7, 1988. INE—both within the framework of SEDUE as well as of its successor SEMARNAP—is in charge of Mexico's national policy on ecology and environmental protection, and is also the regulatory body on environmental issues.

37. Upon the liquidation and dissolution of the above-mentioned decentralized agency, ordered by the Governor of the State of Sonora on July 6, 1995, in mid-1995, the assets of the landfill became the property of the Government of the State of Sonora. Subsequently, on November 27, 1995, through a donation agreement entered into between that Government and the Municipality of Hermosillo, the property was transferred to Promotora.

38. In a letter dated April 16, 1996, confirmed by letters of June 5, August 26 and September 5, 1996, Tecmed made a request to INE for the operating license of the landfill—then in the name of Confinamiento Controlado Parque Industrial de Hermosillo O.P.D.—to be issued in the name of Cytrar. The Municipality of Hermosillo supported this request in its note to INE dated March 28, 1996, requesting INE to provide all possible assistance in connection with the name change procedure in the operating license in favor of Tecmed or of the company organized by it. In an official letter of September 24, 1996, INE notified

Cytrar, in connection with the application to change the name of the entity from Promotora to Cytrar, that Cytrar had been registered with INE. The official letter was then returned by Cytrar to INE as requested by INE after having been issued, and replaced by another one of the same date to which the authorization relating to the landfill was attached, dated November 11, 1996, stating the new name of the entity. Such authorization could be extended every year at the applicant's request 30 days prior to expiration. It was so extended for an additional year, until November 19, 1998.

39. The arbitration claim seeks damages, including compensation for damage to reputation, and interests in connection with damage alleged to have accrued as of November 25, 1998, on which date INE rejected the application for renewal of the authorization to operate the landfill, expiring on November 19, 1998, pursuant to an INE resolution on the same date, whereby INE further requested Cytrar to submit a program for the closure of the landfill. Subsidiarily, the Claimant has requested restitution in kind through the granting of permits to the Claimant enabling it to operate the Las Víboras landfill until the end of its useful life, in addition to compensation for damages.

40. The Claimant further argues that the successive permits granted by INE to Cytrar in connection with the operation of the landfill constitute a violation of the conditions on which the Claimant made its investment because (i) such permits, both as regards their duration as well as the conditions to which they were subject, were different from the permit given for operation of the landfill at the time the investment was made; and (ii) the price paid by Cytrar included the acquisition of intangible assets which involved the transfer to Cytrar of existing permits to operate the landfill and under which such landfill was being operated at the time of making the investment, and not the ones ultimately granted to it. The Claimant argues that such a violation of conditions also involves a violation of, among other provisions, Articles 2 and 3(1) of the Agreement and a violation of Mexican law. However, the Claimant states that it is not seeking in these arbitration proceedings a pronouncement or declaration regarding the lawfulness or unlawfulness, legality or illegality of acts or omissions attributable to the Respondent in connection with permits or authorizations relating to the operation of the Las Víboras landfill prior to the INE resolution of November 19, 1998, which terminated Cytrar's authorization to operate the landfill, considered in isolation, although it highlights the significance of such acts or omissions as preparatory acts for subsequent conduct attributable to the Respondent which, according to the Claimant, is in violation of the Agreement or facilitated such conduct.

41. The Claimant argues that the refusal to renew the landfill's operating permit, contained in the INE resolution of November 25, 1998, constitutes an expropriation of its investment, without any compensation or justification thereof, and further constitutes a violation of Articles 3(1), 3(2), 4(1), 4(5), 5(1), 5(2) and 5(3) of the Agreement, as well as a violation of Mexican law. According to the Claimant, such refusal would frustrate its justified expectation of the continuity and duration of the investment made and would impair recovery of the invested amounts and the expected rate of return.

42. The Claimant alleges that the conditions of the tender and the invitation to tender, the award or sale of the landfill or of the assets relating thereto and the investment made by the Claimant were substantially modified after the investment was made for reasons

attributable to acts or omissions of Mexican municipal, state and federal authorities. The Claimant claims that such modifications, with detrimental effects for its investment and which allegedly led to the denial by the Federal Government of an extension to operate the landfill, are, to a large extent, due to political circumstances essentially associated to the change of administration in the Municipality of Hermosillo, in which the landfill is physically situated, rather than to legal considerations. Specifically, the Claimant attributes such changes to the result of the election held in Mexico in July 1997, one of the consequences of which was the taking of office of a new Mayor of the Municipality of Hermosillo and similar changes in other municipal governments in the State of Sonora. According to the Claimant's allegations, the new authorities of Hermosillo encouraged a movement of citizens against the landfill, which sought the withdrawal or non-renewal of the landfill's operating permit and its closedown, and which also led to confrontation with the community, even leading to blocking access to the landfill. The authorities of the State of Sonora, where the Municipality of Hermosillo is located, are alleged to have expressly supported the position adopted by the Municipality.

43. The Claimant argues that the Federal Government yielded to the combined pressure of the municipal authorities of Hermosillo and of the State of Sonora along with the community movement opposed to the landfill, which, according to the Claimant, led to the INE Resolution of November 25, 1998, referred to above. This Resolution denied Cytrar authorization to operate the landfill and ordered its closedown. The Claimant argues that INE's refusal to extend the authorization to operate the landfill is an arbitrary act which violates the Agreement, international law and Mexican law. It further denies any misconduct or violation on its part of the terms under which the landfill permit was granted and which could justify a refusal to extend the authorization. The Claimant alleges that certain breaches of the conditions of the permit that expired on November 19, 1998, which was subsequently not extended by INE, did not warrant such an extreme decision. The Claimant points out that such breaches had been the subject matter of an investigation conducted by the Federal Environmental Protection Attorney's Office ("PROFEPA"), which, like INE, is an agency within the purview of SEMARNAP, but with powers, among other things, to monitor compliance with federal environmental rules and to impose sanctions, which may include a revocation of the operating license. It also stresses that PROFEPA had not found violations of such an extent that they might endanger the environment or the health of the population or which justified more stringent sanctions than the fines eventually imposed on Cytrar by PROFEPA as a result of its investigations.

44. The Claimant stresses the commitment of Cytrar, with the support of Tecmed, as from July 3, 1998, to relocate the hazardous waste landfill operation to another site on the basis of agreements reached with federal, state and municipal authorities as of such date, and denies the allegation that the fact that such relocation had not yet taken place at the time the extension of Cytrar's permit was refused could be validly argued among the grounds referred to by INE in its resolution of November 1998 denying the extension. The Claimant points out that Cytrar, with the support of Tecmed, subsequently added to its commitment to relocate the landfill another commitment to pay the costs and economic consequences involved in such relocation, and further denies that the delay or failure to relocate was attributable to it. The Claimant insists that the only condition to which Cytrar subjected its relocation commitment was that, pending such relocation, operation by Cytrar of the Las

Viboras landfill and the relevant operating permit should continue, and that such condition is a part of the relocation agreement entered into with the federal, state and municipal authorities of the Respondent. At any rate, the Respondent argues that Cytrar unsuccessfully applied to INE for a limited extension of its permit to operate the Las Viboras landfill (five months as from November 19, 1998), in order to come to an agreement, within such term, on the identification of the site to which the landfill operation would be relocated and to carry out the relocation.

45. According to the Claimant, the expropriation act and other violations of the Agreement which it deems to have suffered, have caused the Claimant to sustain a complete loss of the profits and income from the economic and commercial operation of the Las Viboras landfill as an on going business. Therefore the damage sustained includes the impossibility of recovering the cost incurred in the acquisition of assets for the landfill, its adaptation and preparation and, more generally, the investments relating to or required for this kind of industrial activity, including, but not limited to, constructions relating to the landfill; lost profits and business opportunities; the impossibility of performing contracts entered into with entities producing industrial waste, thus leading to termination of such contracts and to possible claims relating thereto; and the injury caused to the Claimant and to its subsidiaries in Mexico due to the adverse effect on its image in that country, with the consequent negative impact on the Claimant's capacity to expand and develop its activities in Mexico.

46. The Respondent, after pointing out that it does not consider that the powers of INE to deny the landfill's operating permit are regulated but discretionary, denies that such denial was a result of an arbitrary exercise of such discretionary powers. The Respondent claims that denial of the permit is a control measure in a highly regulated sector and which is very closely linked to public interests. Accordingly, the Respondent holds that such denial seeks to discourage certain types of conduct, but is not intended to penalize. The Respondent stresses that the matters debated in these arbitration proceedings are to be solved in a manner consistent with the provisions of the Agreement and of international law.

47. The Respondent denies that the subject matter of the tender and subsequent award to Tecmed was a landfill, understood as a group or pool of tangible and intangible assets including licenses or permits to operate a controlled landfill of hazardous waste. The Respondent argues that the assets tendered and sold by Promotora solely include certain facilities, land, infrastructure and equipment, but no permits, authorizations or licenses. With regard to the documents signed by Promotora, Tecmed and Cytrar in connection with the public auction of the assets relating to the landfill, the Respondent further argues that (i) the obligation or responsibility to obtain permits, licenses or authorizations to operate the landfill was vested in Cytrar; (ii) Promotora did not attempt to obtain or provide such permits, licenses and authorizations for the benefit of or in the name of Cytrar, of the Claimant or of Tecmed, nor did it guarantee that they would be obtained; (iii) Promotora's only commitment in this regard was to ensure that Cytrar could operate the landfill under the existing permits, authorizations or licenses, which remained vested in Confinamiento Parque Industrial de Hermosillo O.P.D. until Cytrar obtained its own permits, authorizations or licenses; (iv) it was always clear to Cytrar that it would require its own licenses, authorizations or permits in order to operate the landfill; and (v) neither Cytrar nor



Tecmed contacted the competent federal authorities for information regarding the possibility of transferring existing authorizations or permits. The Respondent denies the claim that the amount of \$ 24,047,988.26 (Mexican Pesos) was paid as price for the permits or authorizations to operate the landfill, or that Promotora's related invoice reflects the reality of the tender and of the subsequent sales transaction.

48. The Respondent challenges the Arbitral Tribunal's jurisdiction to decide in connection with conduct attributable or attributed to the Respondent which occurred before the entry into force of the Agreement, or that any interpretation thereof—particularly Article 2(2), which extends the application of the Agreement to investments made prior to its entry into force— could lead to a different conclusion. Likewise, based on Title II.5 of the Appendix to the Agreement, the Respondent rejects the Arbitral Tribunal's jurisdiction over acts or omissions attributed or attributable to the Respondent which were or could have been known to the Claimant, together with the resulting damages, prior to a fixed 3-year period, calculated as from the commencement date of this arbitration pursuant to the Agreement. The Respondent further denies that the conduct allegedly in violation of the Agreement attributed to the Respondent caused any damage to the Claimant, so the Claimant's claims would not fulfill the requirements of Title II.4 of the Appendix to the Agreement.

49. The Respondent claims that the granting and conditions of the license of November 11, 1996, were within the statutory powers of INE, and that such conditions were similar to the ones governing other permits granted by INE at the time. The Respondent stresses the negative attitude of the community towards the landfill due to its location and to the negative and highly critical view taken by the community with regard to the way Cytrar performed its task of transporting and confining the hazardous toxic waste originating in the former lead recycling and recovery plant of Alco Pacífico de México, S.A. de C.V. (hereinafter referred to as "Alco Pacífico"), located in Tijuana, Baja California, which would highlight the importance of demanding strict compliance with the new operating permit granted by INE to Cytrar on November 19, 1997.

50. The Respondent alleges that the municipal, state and federal authorities, as well as the security forces and courts of law addressed by Cytrar, acted diligently and in a manner consistent with the Respondent's obligations under the Agreement to offer protection to Cytrar, to its personnel and to the Claimant's investment relating to the landfill, in view of the different forms of social pressure exercised by groups or individuals opposed to the landfill, as well as to finding solutions to the problems resulting from such social pressure. The Respondent further denies that any acts or omissions on the part of such groups or individuals or any liability arising out of such acts or omissions are attributable to the Respondent under the Agreement or under international law. The Respondent underscores the distinct duties performed by PROFEPA and INE, and points out that only INE is competent to decide whether or not to renew an expired permit, based on an assessment of different elements and circumstances exclusively pertaining to INE. The Respondent therefore argues that it is irrelevant that PROFEPA did not revoke Cytrar's permit relating to the Landfill or that it did not close it down due to considerations taken into account by INE in order to decide not to extend the authorization, or that PROFEPA did not find that such matters were significant enough to justify more serious sanctions other than a fine.

However, the Respondent highlights the growing number of violations committed by PROFEPA in Cytrar's operation of the landfill.

51. The Respondent ultimately concludes that there is no conduct on the part of municipal, state or federal authorities of the United Mexican States in connection with Cytrar, Tecmed, the Claimant, the landfill or the Claimant's investments which constitutes a violation of the Agreement pursuant to its provisions or to the provisions of Mexican or international law. It specifically denies that refusing to give a new permit to Cytrar to operate the landfill is in the nature of an expropriation or that there has been a violation of Article 5 of the Agreement. The Respondent also denies that the Claimant suffered discrimination or that it was denied national treatment in violation of Article 4 of the Agreement. The Respondent denies having violated Article 2(1) of the Agreement regarding promotion or admission of investments or having committed any violation of Article 3 of the Agreement. Finally, the Respondent challenges the calculation basis for the compensation sought by the Claimant, which it considers absolutely inappropriate and inordinate.

#### **D. Preliminary Matters**

52. The Arbitral Tribunal will first examine the issues which, due to their nature or connection with its jurisdiction to decide this case or due to their close connection with other matters relating to the decisions that the Tribunal must make on the merits of the disputes between the Parties, need to be decided previously. Such matters are (i) the Respondent's challenges to the Arbitral Tribunal's jurisdiction; (ii) the Respondent's challenges to the timely submission by the Claimant of some of its claims; and (iii) the price and scope of the acquisition by Cytrar and Tecmed of assets relating to the Las Viboras landfill.

##### I. Jurisdiction of the Arbitral Tribunal

53. The Claimant argues,<sup>1</sup> based on Article 2(2) of the Agreement, that the Agreement applies retroactively to the Respondent's conduct prior to the effective date of the Agreement. Such provision stipulates that the Agreement "...shall also apply to investments made prior to its entry into force by the investors of a Contracting Party". According to the Claimant, under this provision, the Agreement covers all conduct or events relating to the investment giving rise to the disputes of this arbitration which took place before December 18, 1996, the entry into force of the Agreement pursuant to Article 12 thereof. Article 12 provides that the Agreement will enter into force on the date of mutual notification between the Contracting Parties of compliance with constitutional requirements for the entry into force of international agreements. Title X of the Appendix to the Agreement shows that this took place on December 18, 1996. The Claimant also alleges, based on Article 18 of the United Nations Vienna Convention of 1969 on the Law of Treaties (hereinafter referred to as the "Vienna Convention"),<sup>2</sup> that the Respondent was

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<sup>1</sup> Memorial, p. 84, note 109.

<sup>2</sup> United Nations Conference on the Law of Treaties, First and Second Sessions, Official Records-Documents of the Conference, A/CONF.39/11/Add.2, or 1155 U.N.T.S. 331.

bound, even before entry into force of the Agreement, to “...refrain from acts which would defeat the object matter and purpose...” of the Agreement.<sup>3</sup>

54. The Respondent, in turn,<sup>4</sup> contends that this Arbitral Tribunal has no jurisdiction *ratione temporis* to consider the application of the Agreement to the Respondent’s conduct prior to December 18, 1996. The Respondent alleges that any other interpretation would be inconsistent with the principle of non-retroactive application of treaties embodied in Article 28 of the Vienna Convention and with a basic rule of international law. In other words, the Respondent does not recognize the Arbitral Tribunal’s jurisdiction to decide in connection with matters or conduct taking place prior to such date.<sup>5</sup>

55. The Arbitral Tribunal does not deem it appropriate to establish the meaning, in abstract or general terms, of “retroactive application” of a legal provision, an expression that does not appear to meet generally accepted criteria.<sup>6</sup> Therefore, in this regard, in addition to following the claims of the Parties as indicated below, the Tribunal will follow the text of the Agreement itself and the rules governing the interpretation of treaties.<sup>7</sup>

56. Based on the standards that have just been defined, consideration of whether the Agreement is to be applied retroactively must first be determined in light of the claims of the Parties. The mandate of an arbitration tribunal is subject to limitations, among them those arising out of disputed issues specifically referred to it by the Parties in their claims. An arbitral tribunal cannot decide more or less than is necessary to settle the disputes referred to it. There is no doubt that the Parties have opposing views as to whether the Agreement applies retroactively or not, and they have extensively argued this point<sup>8</sup> —all the more reason to examine this matter in light of the express requests and arguments of the Parties.

57. The Respondent’s conduct prior to December 18, 1996, complained about by the Claimant, essentially consisted of (a) failure to transfer to Cytrar the permit already existing for the operation of the landfill or failure to grant to Cytrar a permit equal or equivalent to such permit, particularly as regards its indefinite duration,<sup>9</sup> and (b) INE’s alleged

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<sup>3</sup> In 109, p. 85 of its memorial, the Claimant misquotes Article 28 of the Vienna Convention, when in fact the correct reference, based on the text and content of such note, should have been to Article 18 of the Convention.

<sup>4</sup> Counter-memorial, pp. 116-120; 414 *et seq.*

<sup>5</sup> The text and case quoted on page 117, 418 of the counter-memorial and note 327, clearly evidence that the Respondent challenges the jurisdiction of the Arbitral Tribunal to the extent stated above.

<sup>6</sup> See Decision on Jurisdiction in *Tradex Hellas S.A. v. Republic of Albania*, December 24, 1996, ICSID case No. Arb/94/2, [http://www.worldbank.org/icsid/cases/tradex\\_decision.pdf](http://www.worldbank.org/icsid/cases/tradex_decision.pdf), p. 186, “there does not seem to be a common terminology as to what is “retroactive” application, and also the solutions found in substantive and procedural national and international law in this regard seem to make it very difficult, if at all possible, to agree on a common denominator as to where “retroactive” application is permissible and where not”.

<sup>7</sup> Award in *Mondev International Ltd. v. United States of America*, October 11, 2002, ICSID case No. ARB(AF)/99/2, p. 14, 43: [www.nafta.law.org](http://www.nafta.law.org).

<sup>8</sup> Counter-memorial, pp. 116-120, 414 *et seq.* Claimant’s closing statement, pp. 93-97. Respondent’s closing statement, pp. 4-6; 13 *et seq.*

<sup>9</sup> These events took place as follows: the first one on September 24, 1996 (note from INE to Cytrar informing that “it had been duly registered”), document A42, and the second one some time later, upon INE replacing the note by a new one on even date and with a substantially identical text, except that the new note evidences

ambiguous conduct, in that it first included Cytrar in an INE register in terms that could be deemed to be a transfer to Cytrar of the existing unlimited permit, subsequently revoking it by replacing it with another one, limited in its initial duration (a year) and the subsequent renewal of which was subject to approval by INE.<sup>10</sup>

58. In its memorial, the Claimant states as follows with regard to the conduct of INE with respect to the exchange or replacement of operating permits for the landfill:

However, this fact, although serious when we know what happened subsequently, did not cause immediate prejudice to the claimant which, after all, was still entitled to operate the Landfill acquired.<sup>11</sup>

Nevertheless, the Claimant highlights the following in this regard:

...the unwarranted change in the conditions of operation and as a result of a new and different permit being issued, unrelated to the plans and guarantees existing as of the time of the investment, is truly a discriminatory measure without any legal foundation, expressly prohibited by Article III of the ARPPI (Agreement on the Reciprocal Promotion and Protection of Investments).<sup>12</sup>

And a little later:

It should not be understood that the conversion of an authorization for an unlimited period of time into a temporary one legitimized or enabled the subsequent resolution contrary to renewal. That resolution of INE, challenged in this arbitration, is illegal and unlawful just like a revocation of the license on the same grounds. It is, however, beyond doubt that the precariousness (due to the short duration) and provisional nature of an authorization for such a limited time are greater than in the case of an authorization for an unlimited period of time.<sup>13</sup>

In connection with the same point, the Claimant explains the following:

However, CYTRAR, S.A. de C.V. and TECMED had an authorization covering the operation of the landfill and were not in a position to make complaints that could “displease” the competent officials. Still, in spite of undeniable differences between an authorization for an unlimited duration and a temporary one, the one granted in 1996 was a legitimate and sufficient title, operation of the landfill continued uninterrupted and relations between the personnel of the companies and the representatives of the Administration were cordial and fluid. Everyone’s intent was that the landfill should operate and be managed appropriately and that it should last. At the time, at least for the Claimant, it was unthinkable that it would be unlawfully deprived of its lawfully obtained authorization only two years later.<sup>14</sup>

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the granting of a new permit and notifies it to Cytrar (this permit, for a year and renewable, was dated November 11, 1996) as an annex, documents A43 and A44, Memorial, pp. 40-45; 107-109. Claimant’s closing statement, pp. 30-38.

<sup>10</sup> Claimant’s closing statement, pp. 110-115.

<sup>11</sup> Memorial, p. 42.

<sup>12</sup> Memorial, p. 108.

<sup>13</sup> Memorial, p. 109.

<sup>14</sup> Memorial, pp. 44-45. This was later reaffirmed by the Claimant when referring to the authorization granted by INE for the operation of the landfill by Cytrar, of November 19, 1997: “At any rate, we shall reiterate what has already been stated regarding the sufficiency of both authorizations to make operation of the landfill lawful and the practical considerations that caused CYTRAR S.A. de C.V. and TECMED to refrain from expressly protesting such changes in the conditions. The landfill continued to be operational; its duration potential, which depended on its useful life, had not been altered; and the competent authorities had expressed

Referring to INE's refusal to renew the authorization granted on November 19, 1997, the Claimant states that:

This is precisely the violation challenged in this arbitration —an Official Letter of the National Ecology Institute which deprived Cytrar, S.A. de C.V. of the asset that was the basis of its exclusive activity. A definitive and fundamental act accompanied by a number of proximate, previous and subsequent acts which completed the multiple violation of the ARPPI and which are claimed against in this arbitration.<sup>15</sup>

The Claimant further states:

However, the necessary accuracy with which the facts have been dealt in this memorial shows how the respondent's breach did not materialize in a single act, but was gradually prepared, implemented and strengthened until it was finally consummated in the act of refusing renewal.

It was certainly the refusal that caused damage and definitively prevented this company from obtaining a legitimate return on its investment. The preceding acts, particularly the ones leading to adverse modifications of the terms of the authorization, are in the nature of acts prior to that decisive breach which caused the damage for which compensation is requested. But the truth is that, although there is a difference between the operation of a landfill under a temporary authorization and under a license for an unlimited duration, in both cases there exists a title to undertake and lawfully continue operations, and the day-to-day activities are not curtailed by such time limitations.<sup>16</sup>

In connection with the refusal to renew the authorization of November 19, 1997, the Claimant further points out the following:

Therein lies the respondent's essential breach, which has caused the damage for which compensation is requested in this arbitration.<sup>17</sup>

Referring to the fair and equitable treatment under international law guaranteed by Article 4(1) of the Agreement, the Claimant claims that it encompasses the duty to act transparently and respecting the legitimate trust generated in the investor. In this regard, the Claimant states the following:

In sum, the legitimate trust generated in TECMED inducing it to make the investment was violated and seriously trampled upon. First, as a result of the change in the landfill's operating conditions and, subsequently and definitively, through the measure that led to its immediate standstill.

If Mexican law were to protect and permit the conversion of unlimited permits into annual ones, which we deny, the least that could be said is that such legislation is completely lacking in transparency, since none of its provisions specifies that licenses are limited in duration.<sup>18</sup>

The Claimant also argues that the replacement of the existing unlimited duration license, which in the past was given to state investors (municipal investors or investors from the

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no reservations with regard to the landfill or operation thereof, nor had they expressed any intention that might affect the extent or duration of such operation": Memorial, pp. 47-48.

<sup>15</sup> Memorial, p. 53.

<sup>16</sup> Memorial, p. 103-104.

<sup>17</sup> Memorial, p. 112.

<sup>18</sup> Memorial, p. 122.

State of Sonora) by a limited duration license when it was granted to Cytrar constituted a violation of the fair and equitable treatment guarantee set forth in Article 4(5) of the Agreement.<sup>19</sup>

Finally, the Claimant summarizes its claims as follows:

A declaration is sought from the Arbitral Tribunal regarding the breach committed by the United Mexican States as a result of the actions and decisions stated in this memorial, both as regards the breach itself and in connection with acts in preparation of such breach...<sup>20</sup>

After listing the main breaches of the Agreement alleged by the Claimant against the Respondent, which include “the substantial change in the conditions governing the operation of the landfill...” as a result of the replacement of the authorization existing at the time of making the investment and “...particularly due to the conversion of an unlimited duration permit into an annual or annually renewable one”,<sup>21</sup> the Claimant summarizes its claims as follows:

Such acts prepare and constitute an express, serious and blatant breach of the duty to protect foreign investments, declared in Article II of the ARPPI and of the duty to offer fair and equitable treatment to foreign investors, pursuant to Article IV of the Agreement; non-renewal is a measure having equivalent effects to the type of expropriation provided for in Article V of the ARPPI, carried out for political reasons and interests contrary to the public interest and without appropriate compensation.<sup>22</sup>

59. In its closing statement, the Claimant gives additional details of its requests and claims. Regarding the replacement of the unlimited duration license to operate the Landfill by a one-year license, and in view of the Respondent’s statement that the Claimant’s claims also seek to hold the Respondent liable for such replacement, the Claimant states as follows:

This is absolutely false. Suffice it to look at the request for relief in the claim, which contains the Claimant’s claims, to understand that the only declaration of breach sought from the Arbitral Tribunal relates to the refusal to renew the license for the operation of the CYTRAR Landfill.

Certainly, the Claimant has provided an account, and informed the Tribunal, of other facts occurring prior to November 25, 1998, because they are relevant and clearly illustrate the attitude and conduct of the Mexican authorities, but the Claimant has not requested a declaration of breach or liability in respect of only one of them.<sup>23</sup>

The Claimant then adds:

In sum, we hold that the act in connection with which an award is requested in this arbitration is the refusal to renew the permit with respect to the Landfill of Cytrar, aside from the fact that the Tribunal needs to know and assess the meaning of previous acts and measures of the Mexican authorities.

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<sup>19</sup> Memorial, p. 127.

<sup>20</sup> Memorial, p. 139.

<sup>21</sup> Memorial, p. 139.

<sup>22</sup> Memorial, pp. 139-140.

<sup>23</sup> Claimant’s closing statement, p. 93.

This claim is fully and expressly supported by the provisions on retroactivity contained in the ARPPI between Spain and Mexico, and does not need to rely on any other conventions.<sup>24</sup>

The Claimant further states that:

We stress that the only violation of the ARPPI requested to be penalized by the Tribunal is the decision not to renew the license, which caused the damage sustained by TECMED [...] However, this does not prevent, but rather determines, that the Arbitral Tribunal should examine and assess the preceding and even subsequent acts of the Mexican authorities.<sup>25</sup>

60. The Arbitral Tribunal sees a certain fluctuation in the Claimant's position as to whether the Respondent's conduct prior to December 18, 1996, can be taken into account in order to determine whether the Respondent has violated the Agreement. In any case, the Arbitral Tribunal concludes that the Claimant does not include in its claims submitted to this Tribunal acts or omissions of the Respondent prior to such date which, considered *in isolation*, could be deemed to be in violation of the Agreement prior to such date.

61. A more difficult issue is whether such acts or omissions, combined with acts or conduct of the Respondent after December 18, 1996, constitute a violation of the Agreement after that date.

62. The Claimant's considerations, particularly detailed in its memorial and transcribed in paragraph 58 above, show that the Claimant, in order to determine whether there has been a violation of the Agreement, holds that the investment and the Respondent's conduct are to be considered as a process and not as an unrelated sequence of isolated events. This position of the Claimant would have two consequences. The first one is that the Respondent, prior to December 18, 1996, and through the conduct of different agencies or entities in the state structure, gradually but increasingly appears to have weakened the rights and legal position of the Claimant as an investor. Such conduct would appear to have continued after the entry into force of the Agreement, and would have resulted in the refusal to extend the authorization on November 25, 1998, which would have caused the concrete damage suffered by the Claimant as a result of such conduct. The common thread weaving together each act or omission into a single conduct attributable to the Respondent is not a subjective element or intent, but a converging action towards the same result, i.e. depriving the investor of its investment, thereby violating the Agreement. The second consequence is that, before getting to know the final result of such conduct, this conduct could not be fully recognized as a violation or detriment for the purpose of a claim under the Agreement,<sup>26</sup> all the more so if, at the time a substantial part of such conduct occurred, the provisions of the Agreement could not be relied upon before an international arbitration tribunal because the Agreement was not yet in force.

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<sup>24</sup> Claimant's closing statement, p. 97.

<sup>25</sup> Claimant's closing statement, p. 98.

<sup>26</sup> Whether it be conduct that continues in time, or a complex act whose constituting elements are in a time period with different durations, it is only by observation as a whole or as a unit that it is possible to see to what extent a violation of a treaty or of international law rises or to what extent damage is caused: J. Crawford, *The International Law Commission's Articles on State Responsibility* (Cambridge University Press, 2002), pp. 136-137; 143.

63. Clearly, the basic principle in international law is that unless there is a different interpretation of the treaty or unless otherwise established in its provisions, such provisions are not binding in connection with an act or event which took place or a situation that ceased to exist before the date of its entry into force.<sup>27</sup> The burden of proving the existence of any exception to the principle of non-retroactive application established therein naturally lies with the party making the claim.

64. Although the Agreement applies to investments existing as of the date of its entry into force—which suggests as a logical conclusion that the situations surrounding investments existing at the time do not escape its provisions—the way the provisions on which the Claimant relies are drafted suggests that application thereof is forward-looking. Thus, for example,<sup>28</sup> Article 3(1) of the Agreement:

Each Contracting Party *shall offer* full protection and security...[...] and *shall not hinder*<sup>29</sup> [...] the management, maintenance, development, use, enjoyment, expansion, sale or, as the case may be, the liquidation of such investments.

The same can be said about Article 3(2) of the Agreement:

Each Contracting Party, within the framework of its own legislation, *shall grant*<sup>30</sup> any authorizations needed in connection with the investments...

Or about Article 4(1) and (2) with regard to fair and equitable treatment:

Each Contracting Party *shall guarantee*<sup>31</sup> fair and equitable treatment in its territory pursuant to international law for investments made by investors from another Contracting Party [...]. Such treatment *shall not be* less favorable than that afforded in similar circumstances by each Contracting Party to investments made in its territory by investors from a third party state.

The same is found in Article 4(5) in connection with national treatment:

...each Contracting party *shall offer*<sup>32</sup> to investors from the other Contracting Party treatment no less favorable than that afforded to its own investors.

Or in Article 5(1) in connection with nationalization or expropriation:

Nationalization, expropriation or any other measure of similar effects [...] *which may be adopted*<sup>33</sup> by the authorities of a Contracting Party against investments in its territory made by investors from the other Contracting Party...

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<sup>27</sup> Vienna Convention, Article 28. Award in *Mondev International Ltd. v. United States of America* (ICSID Case No. ARB(AF)/99/2), 68, p. 22, [www.naftalaw.org](http://www.naftalaw.org). I. Sinclair, *The Vienna Convention on the Law of Treaties*, 2<sup>nd</sup> Edition (Manchester University Press, 1984), p. 85.

<sup>28</sup> Italics in the quotations transcribed in paragraph 64 inserted by the Arbitral Tribunal.

<sup>29</sup> Emphasis added by the Arbitral Tribunal.

<sup>30</sup> Emphasis added by the Arbitral Tribunal.

<sup>31</sup> Emphasis added by the Arbitral Tribunal.

<sup>32</sup> Emphasis added by the Arbitral Tribunal.

<sup>33</sup> Emphasis added by the Arbitral Tribunal.



65. The continuous use of the future tense, which connotes the undertaking of an obligation linked to a time period, rules out any interpretation to the effect that the provisions of the Agreement, even in relation to investments existing as of the time of its entry into force, apply retroactively.<sup>34</sup>

66. However, it should not necessarily follow from this that events or conduct prior to the entry into force of the Agreement are not relevant for the purpose of determining whether the Respondent violated the Agreement through conduct which took place or reached its consummation point *after* its entry into force. For this purpose, it will still be necessary to identify conduct —acts or omissions— of the Respondent after the entry into force of the Agreement constituting a violation thereof.

...events or conduct prior to the entry into force of an obligation for the respondent State may be relevant in determining whether the State has subsequently committed a breach of the obligation. But it must still be possible to point to conduct of the State after that date which is itself a breach.<sup>35</sup>

In broader terms, Article 28 of the Vienna Convention reads as follows on this matter:

If, however, an act or fact or situation which took place or arose prior to the entry into force of a treaty continues to occur or exist after the treaty has come into force, it will be caught by the provisions of the treaty.(United Nations Conference on The Law of Treaties, First and Second Sessions, Official Records (Documents of the Conference, Draft Articles on the Law of Treaties with Commentaries, as adopted by the International Law Commission at its Eighteenth Session), pag. 32, (3) (United Nations publication, Sales No.:E.70V.5, A/CONF.39/11/Add.2))

67. In view of the above precedents and of the Claimant's specific requests, the Arbitral Tribunal will not consider any possible violations of the Agreement prior to its entry into force on December 18, 1996, as a result of isolated acts or omissions that took place previously or of conduct by the Respondent considered in whole as an isolated unit and that went by before such date. In order to reach such conclusion, a relevant fact is that Cytrar, Tecmed and the Claimant did not choose to make any claim in connection with conduct occurring prior to December 18, 1996, not even through a note addressed to the relevant Mexican authorities stating their objections to the measures or resolutions adopted,<sup>36</sup> although they were not under any violence or pressure at the time preventing them from doing so.

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<sup>34</sup> Decision on Jurisdiction in *Tradex Hellas S.A. v. Republic of Albania*, December 24, 1996, ICSID case No.Arb/94/2, p. 191, [http://www.worldbank.org/icsid/cases/tradex\\_decision.pdf](http://www.worldbank.org/icsid/cases/tradex_decision.pdf).

<sup>35</sup> Award in *Mondev International Ltd. v. United States of America* (ICSID Case No. ARB(AF)/99/2), 70, p. 23, [www.naftalaw.org](http://www.naftalaw.org).

<sup>36</sup> For instance, the Claimant chose not to make any claim in connection with the replacement of its operating permits in order not to damage its relationship with the Mexican authorities: see transcript of the Claimant's statements in paragraph 58. As pointed out by the arbitral tribunal in the case *Kuwait and the American Independent Oil Company (Aminoil)*, 21 I.L.M. p. 976 et seq. (1982), 44, p. 1008: "In truth, the Company made a choice; disagreeable as certain demands might be, it considered that it was better to accede to them because it was still possible to live with them. The whole conduct of the Company shows that the pressure it was under was not of a kind to inhibit its freedom of choice. The absence of protest during the years following [...], confirms the non-existence, or else the abandonment, of this ground of complaint." See also I. Brownlie, *Principles of International Law* (5<sup>th</sup> Ed., Oxford University Press, 1998), p. 642-644.

68. On the other hand, conduct, acts or omissions of the Respondent which, though they happened before the entry into force, may be considered a constituting part, concurrent factor or aggravating or mitigating element of conduct or acts or omissions of the Respondent which took place after such date do fall within the scope of this Arbitral Tribunal's jurisdiction. This is so, provided such conduct or acts, upon consummation or completion of their consummation after the entry into force of the Agreement constitute a breach of the Agreement, and particularly if the conduct, acts or omissions prior to December 18, 1996, could not reasonably have been fully assessed by the Claimant in their significance and effects when they took place, either because as the Agreement was not in force they could not be considered within the framework of a possible claim under its provisions or because it was not possible to assess them within the general context of conduct attributable to the Respondent in connection with the investment, the key point of which led to violations of the Agreement following its entry into force.

69. The Arbitral Tribunal is aware that the Claimant, relying on the decision in the case *Emilio Agustín Maffezini v. Kingdom of Spain*,<sup>37</sup> refers in its closing statement to the most favored nation treatment provided for in Article 8(1) of the Agreement in order to enable retroactive application in view of the more favorable treatment in connection with that matter which would be afforded to an Austrian investor under the bilateral treaty on investment protection between the United Mexican States and Austria of June 29, 1998. The Arbitral Tribunal will not examine the provisions of such Treaty in detail in light of such principle, because it deems that matters relating to the application over time of the Agreement, which involve more the time dimension of application of its substantive provisions rather than matters of procedure or jurisdiction, due to their significance and importance, go to the core of matters that must be deemed to be specifically negotiated by the Contracting Parties. These are determining factors for their acceptance of the Agreement, as they are directly linked to the identification of the substantive protection regime applicable to the foreign investor and, particularly, to the general (national or international) legal context within which such regime operates, as well as to the access of the foreign investor to the substantive provisions of such regime. Their application cannot therefore be impaired by the principle contained in the most favored nation clause.<sup>38</sup>

70. In assessing the Respondent's conduct, for the purpose of and with the scope provided for in paragraph 68 above, the Arbitral Tribunal shall take into account the principle of good faith, both as the general expression of a principle of international law embodied in Article 26 of the Vienna Convention and in its particular manifestation embodied in Article 18 of such Convention<sup>39</sup> with respect to the Respondent's conduct between June 23, 1995

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<sup>37</sup> ICSID Case No. ARB/97/7, decision on jurisdiction of January 25, 1999, <http://www.worldbank.org/icsid/cases/awards.htm>.

<sup>38</sup> *Ibid.*, *Maffezini case*, Decision on jurisdiction, p. 25-26, 62-63.

<sup>39</sup> Regarding the importance of the principle of good faith within the framework of the law of treaties, including the period between signing and ratification, see R. Kolb, *La bonne foi en droit international public*, Presses Universitaires de France, 179-207 (2000). Article 18 of the Vienna Convention arises out of a general rule of international law based on good faith, which it expresses; it is therefore independent, and does not constitute an exception to the principle of non-retroactive application of treaties: I. Sinclair, *The Vienna Convention on the Law of Treaties*, p. 99, Manchester University Press (2<sup>nd</sup> Edition, 1984).

—the date on which the Agreement was signed by the Contracting Parties— and the date of its entry into force mentioned above,<sup>40</sup> in that such Article provides that:

A State shall refrain from acts that defeat<sup>41</sup> the object and purpose of a treaty when:

a) it has signed the treaty or has exchanged instruments constituting the treaty subject to ratification, acceptance or approval, until it shall have made its intention clear not to become a party to the treaty...

71. Writings of publicists point out that Article 18 of the Vienna Convention does not only refer to the intentional acts of States but also to conduct which falls within its provisions,<sup>42</sup> which need not be intentional or manifestly damaging or fraudulent to go against the principle of good faith, but merely negligent or in disregard of the provisions of a treaty or of its underlying principles, or contradictory or unreasonable in light of such provisions or principles. It should be noted that the principle inspiring such article has been applied in order to settle, through international arbitration, disputes between States and individuals which, in order to be decided, required a pronouncement on obligations of the former vis-à-vis the latter based on the law of treaties. The Mixed Greek-Turkish Arbitral Tribunal, in the case *A.A. Megalidis v. Turkey*,<sup>43</sup> stated:

qu'il est de principe que déjà avec la signature d'un Traité et avant sa mise en vigueur, il existe pour les parties contractantes une obligation de ne rien faire qui puisse nuire au Traité en diminuant la portée de ses clauses.

Qu'il est intéressant de faire observer que ce principe —lequel en somme n'est qu'une manifestation de la bonne foi qui est la base de toute loi et de toute convention— a reçu un certain nombre d'applications...<sup>44</sup>

## II. Timely submission by the Claimant of its Claims against the Respondent

72. In Chapter III of its counter-memorial, in a general section entitled “C. Objections regarding Jurisdiction”, the Respondent introduces defenses based on the Claimant’s claims allegedly not satisfying the requirements of Title II(4) and Title II(5) of the Appendix to the Agreement, for which reason this Arbitral Tribunal would be prevented from dealing with such claims.

Title II(4) of the Appendix to the Agreement provides the following:

An investor from a Contracting Party may, either on its own behalf or representing a company owned by it or under its direct or indirect control, refer to arbitration a claim on the grounds that the other Contracting Party

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<sup>40</sup> See comment at the International Law Commission (United Nations Conference on the Law of Treaties, Official Records, Documents of the Conference, United Nations Publication A/CONF.39/11/Add.2), p. 22.

<sup>41</sup> It should be noted that the English version of this provision uses the expression “*defeat the object*”, which is not strictly equivalent to the notion of “frustrate” in English or “frustrar” in Spanish.

<sup>42</sup> A. Remiro Brotons, *Derecho Internacional Público. 2 Derecho de los Tratados* (Tecnos, Madrid, 1987), p. 246.

<sup>43</sup> Annual Digest of Public International Law Cases (1927-1928) [A. Mc Nair & H. Lauterpacht Editors], Vol. 4 (1931), 272, p. 395.

<sup>44</sup> Lord McNair, *The Law of Treaties* (Clarendon Press, Oxford, 1961), p. 202.

has violated an obligation under this Agreement, as long as the investor or its investment have suffered a loss or damage by reason or as a consequence of the breach.

Title II(5) of the Appendix to the Agreement provides the following:

The investor may not submit a claim under this Agreement if more than three years have elapsed since the date on which the investor had or should have had notice of the alleged violation, as well as of the loss or damage sustained.

73. In the opinion of the Arbitral Tribunal, the defenses filed by the Respondent, relying on Title II(4) and (5) of the Appendix to the Agreement, do not relate to the jurisdiction of the Arbitral Tribunal but rather to (non)compliance with certain requirements of the Agreement governing the admissibility of the foreign investor's claims. The Arbitral Tribunal notes that to the extent such defenses have been filed with respect to claims referring to conduct or acts or omissions of the Respondent which are excluded from the Arbitral Tribunal's jurisdiction or from the substantive scope of application of the Agreement pursuant to the decision contained in paragraphs 67 and 68 of this award, any determination as to whether such claims fulfill the requirements of Title II(4) and (5) of the Appendix to the Agreement would be superfluous.

74. When it comes to the Claimant's claims falling within the scope of this arbitration and of the provisions of the Agreement, the Arbitral Tribunal will decide if the admissibility requirements set forth in Title II(4) and (5) of the Appendix to the Agreement have been complied with or not with respect to the acts on which such claims are based, together with the remaining considerations or matters to be taken into account by the Arbitral Tribunal in deciding on the merits of the allegations of the Parties in this award. If the acts under review are deemed by the Arbitral Tribunal to be a part of more general, and not merely isolated conduct, the Arbitral Tribunal reserves the power to consider that the time when it will assess whether such acts have caused losses or damage for the purposes of Title II(4) of the Appendix to the Agreement, or whether they were deemed by the Claimant to be a breach of the Agreement or damaging within the three-year term provided for in Title II(5), will not be earlier than the point of consummation of the conduct encompassing and giving an overarching sense to such acts. In any case, and within the general framework of considerations already made when deciding whether the provisions of the Agreement are to be applied retroactively or not, the Arbitral Tribunal is of the view that Title II(4) and (5) of the Appendix to the Agreement contains requirements relating to the substantive admissibility of claims by the foreign investor, i.e. its access to the substantive protection regime contemplated under the Agreement. Consequently, such requirements are necessarily a part of the essential core of negotiations of the Contracting Parties; it should therefore be presumed that they would not have entered into the Agreement in the absence of such provisions. Such provisions, in the opinion of the Arbitral Tribunal, therefore fall outside the scope of the most favored nation clause contained in Article 8(1) of the Agreement.

### III. The Scope of the Purchase Transaction

75. The Claimant alleges, mainly on the basis of documents signed with Promotora in the process of award and transfer of the assets under which it operated the landfill of hazardous waste physically located in Las Víboras, Municipality of Hermosillo, State of Sonora, that what the Claimant acquired through that process was actually a pool of personal and real property and intangibles, the latter consisting of permits issued by municipal and federal authorities of the Respondent which enabled and empowered the Claimant to operate the Las Víboras site as a hazardous waste landfill. According to the Claimant, out of the total price of \$34,047,988.26 (Mexican Pesos) paid to Promotora for the acquisition of the assets relating to the landfill, the most substantial part, \$24,047,988.26 (Mexican Pesos), was paid by the Claimant in kind —by closing down an existing landfill for urban waste and constructing and advising in respect of the operation of a new landfill for the same purpose— in exchange for the permits and authorizations to operate the Las Víboras site as a landfill for hazardous waste.<sup>45</sup> Both the landfill that was closed down as well as the new one currently in operation are located in land owned by the Municipality of Hermosillo, under the jurisdiction of that Municipality and this location is other than the site for landfill of hazardous waste at Las Víboras, acquired by the Claimant as a result of the public bidding.<sup>46</sup>

76. The Respondent, on the other hand, argues that Promotora only tendered and sold to the Claimant a pool of personal and real property “relating to the Industrial Park” of the city of Hermosillo, which did not include permits or licenses to operate the landfill.<sup>47</sup> According to the Respondent, the public bidding and award of assets relating to the landfill at the Las Víboras site to Tecmed and Cytrar also included acquisition by another company of the Tecmed group of a concession for a landfill —a municipal dump also situated in the Municipality of Hermosillo—, for which Cytrar allegedly paid the above-mentioned amount of \$ 24,047,988.26 (Mexican Pesos). The Respondent specifically argues the following:

Tecmed (Mexico) acquired two things in the tender of February 1996. A pool of personal and real property relating to the landfill of hazardous waste, which consisted of a piece of land, existing constructions and machinery and equipment clearly described in the supporting documents of the transaction. It paid 10 million pesos in cash for them, as reflected in the financial statements submitted in these proceedings.

Secondly, it acquired the concession of a landfill, the municipal dump, for which it offered 24 million pesos, a concession which it still holds and continues to operate. What Dr. Calvo Corbella said a moment ago is true, not in respect of Cytrar but in respect of the company [sic], as confirmed by engineer Polanco, who attended the Tecmed (Mexico) tender. This was also confirmed by engineer Diez-Canedo, in reply to a question I expressly made when I asked him if, in addition to the amount of ten million pesos, he had offered a non-monetary contribution consisting of the construction and comprising the general facilities and the first phase of operations. Engineer Díaz Canedo answered that that was true.<sup>48</sup>

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<sup>45</sup> Memorial, pp. 20-40. Claimant’s closing statement, pp. 10-30.

<sup>46</sup> Declaration of Javier Polanco Gómez Lavin, Hearing of May 20-24, 2002; transcription of May 20, 2002, pp. 31 overleaf/33.

<sup>47</sup> Counter-memorial, pp. 24-31; N° 90 *et seq.*

<sup>48</sup> Oral statement by the Claimant at the Hearing of May 20, 2002, transcript of May 24, 2002, pp. 27-28.

In sum, the Respondent not only holds that that amount, or contribution in kind valued at such amount, was not paid or made in exchange for intangible assets (the permits, authorizations or licenses to which Claimant refers), but also that it was not even a part of the price paid for assets relating to the landfill in Las Víboras. According to the Respondent, such amount or contribution was paid or made in exchange for the concession to operate the urban waste landfill of Hermosillo.

77. Based on the allegations of the Parties and of the facts presented before this Arbitral Tribunal, it is to be concluded that the award, the public bidding and sales transaction of assets relating to the Las Víboras landfill and the rights and obligations for each of the parties to such transaction and resulting therefrom were embodied in different instruments requiring joint consideration in order to determine the scope of the operation and its effects.

78. The award by Promotora of assets relating to the Las Víboras landfill to Tecmed as a result of the tender of such assets by Promotora was followed by the signing of a “promise to sell” contract dated February 20, 1996, entered into between Promotora and Tecmed, the fourth clause of which provides that at the time of executing the notarial deed of conveyance, the assets conveyed would include copies of permits, licenses and authorizations relating to the assets specified in the agreement.<sup>49</sup> In item or representation No. III of such instrument, it is stated that the Board of Directors of Promotora unanimously approved the following proposal:

Price offer for the purchase of Cytrar, alternative number two, consisting of 10 million pesos plus a non-monetary contribution to the Municipality of Hermosillo in the form of a project for the construction of and advice in connection with the operation of the new landfill in accordance with the attached project which comprises the general facilities and their first phase of operation, including the closedown of the current landfill, services valued at \$ 24,155,185.00 (Mexican Pesos). Total offer: \$34,155,185 (Mexican Pesos).

The second clause of the document stipulates that part of the price - \$ 10,000,000 (Mexican Pesos)- would be paid in cash, part upon signing the promise to sell and part upon signing the notarized deed of conveyance of the tendered real property, with the balance, amounting to \$24,155,185.00 (Mexican Pesos), to be paid in kind, by providing the service of closing down the existing landfill and constructing and providing advice in connection with the operation of a new one as mentioned above and referred to in item or representation number III of the “promise to sell” contract. As regards payment in kind of that part of the price, the second clause of the promise to sell expressly states as follows:

The difference relates to the cost of constructing a new landfill and closing down the existing one, in accordance with the approved proposal, which would be at the time of completing the construction of the new landfill to the satisfaction of Promotora Inmobiliaria of the Municipality of Hermosillo based on the construction project submitted by the buyer, upon which time the reservation of ownership would end; in the case of sale of the personal property located in the “landfill”, it will be billed by seller to buyer upon formalization of the final transaction, such formalities being the responsibility of Promotora Inmobiliaria of the Municipality of Hermosillo.

In turn, the fifth clause of the “promise to sell” contract provides the following:

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<sup>49</sup> Document A23.

The parties specify that as from now the use to be given to the hazardous waste landfill shall be precisely that, failing which the property will revert back to the seller, in which case the buyer shall automatically forfeit any advances or payments made, unless the buyer “Tecmed, Técnicas Medioambientales de México S.A. de C.V.” fails to obtain the government permits and licenses required for lawful operation, in which case it may change the mode of operation by using the existing original license for operation of the landfill by “Tecmed, Técnicas Medioambientales de México S.A. de C.V.”.

79. In addition to the above, on the same date, Promotora, Tecmed and Cytrar entered into an agreement “to determine the method and terms of payment of the consideration arising out of the ‘promise to sell’ contract with reservation of ownership, dated February 20, 1996”.<sup>50</sup> Under such agreement, the total price to be paid by Cytrar amounted to \$ 24,047,988.26 (Mexican Pesos), broken down as follows: \$6,277,409.50 (Mexican Pesos) for land and constructions; \$237,034.00 (Mexican Pesos) for machinery and equipment; \$24,047,988.26 (Mexican Pesos) for intangibles. The agreement sets forth that Promotora shall issue an invoice covering the intangibles and that Cytrar shall issue invoices for the part of the price payable through the construction of the new landfill and closedown of the Hermosillo municipal dump, such invoices to be issued upon completion of the works. Clauses three and four of the agreement specifically provide the following:

Third: Promotora Inmobiliaria of the Municipality of Hermosillo OPD further undertakes to issue an invoice for the intangibles upon full compliance by Cytrar S.A. de C.V. of the obligation set forth in clause two of the above-mentioned agreement of February 20, 1996. The invoice value will be \$24,047,988.26 (Mexican Pesos) plus \$ 3,607,198.24 (Mexican Pesos) VAT, totaling \$ 27,655,186.50 (Mexican Pesos).

Fourth: Cytrar S.A. de C.V. agrees to the terms of the preceding clauses and in turn undertakes to issue invoices for the part it will pay with the construction and delivery of the new landfill of the Municipality of Hermosillo and the closedown of the current municipal dump. Such invoices will be issued upon formal delivery of the works.

80. Finally, pursuant to the award conditions, through a notarial deed of March 27, 1996,<sup>51</sup> Cytrar acquired from Promotora the real property, constructions and personal property relating to the landfill. Item or representation number 1 of the deed specifies that the seller (Promotora). “..tendered various assets held by it, in particular the ‘hazardous waste landfill situated at the Las Víboras’ site in the Hermosillo Industrial Park.” In item or representation II of such deed, reference is made to the meeting of the Board of Directors of Promotora, which unanimously approved the proposal submitted by Tecmed on the following terms:

“Price Offer for Acquisition of Cytrar”, alternative number two, consisting of \$10,000,000 (ten million pesos), plus a non-monetary contribution to the Municipality of Hermosillo, approval recorded in minutes, stating that it was unanimous, and including the closedown of the current landfill, the project and the construction of the first phase of the new landfill, pursuant to the resolutions approving performance, issued by the Board of Directors...”

The requirements for approval by the Board of Directors of Promotora include, as point c) of item or representation II the following:

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<sup>50</sup> Document A24.

<sup>51</sup> Document A25.

Identifying the responsibility of each party and the timing for obtaining operating licenses.

The second clause of the deed states a cash amount of \$ 10,000,000 (Mexican Pesos) as the price, which is broken down into different amounts paid for the constructions already existing, personal property and land. Such clause also provides that:

... regardless of the price fixed, the PURCHASER undertakes to perform non-monetary obligations consisting of the project and construction of the first phase of the new landfill and closedown of the existing one, to the satisfaction of “Promotora Inmobiliaria of the Municipality of Hermosillo”, in accordance with the approved proposal.

The fourth clause of the deed provides that the reservation of ownership subject to which the sale is made will be lifted

... upon completion of the construction works for the new landfill and the closing down of the existing one, to the entire satisfaction of “Promotora Inmobiliaria of the Municipality of Hermosillo”, in accordance with the approved proposal.

Clause 5a) of the deed provides that the transferee (Cytrar) must undertake to perform its obligations under the public bidding in full, including the following obligations:

Specification that the acquired assets will be used solely as a landfill for hazardous waste, failing which they shall revert back to Promotora Inmobiliaria of the Municipality of Hermosillo, and any payments made will be forfeited, if the buyer “Cytrar” S.A. de C.V. should fail to obtain the government permits and licenses required for lawful operation; in such case, the mode of operation may be changed by using the existing original license for operation of the landfill by “Cytrar” S.A. de C.V.

Clause 5d) also provides that:

The steps required to be taken in order to obtain the government permits and licenses necessary for operation of the hazardous waste landfill shall be the sole responsibility of the transferee, Promotora Inmobiliaria of the Municipality of Hermosillo hereby being released from any liability with regard to the official authorizations required to be requested from the Municipality of Hermosillo. Promotora Inmobiliaria will lend its support to secure approval.

81. In a rectifying notarial deed of December 16, 1996,<sup>52</sup> Promotora and Cytrar corrected the amount of the part of the price relating to the acquisition of the real property as described in the original deed of conveyance of March 27, 1996, which was thus rectified and fixed at \$ 6,132,530 (Mexican Pesos), but the prices for the other items were not rectified. The deed also specified that real property and intangibles would be invoiced separately as follows:

As specified in the agreement signed between the parties on March 20, 1996, which fixes the terms and conditions under which the transaction will be settled, an involuntary error led to a mistaken and insufficient breakdown of values and calculation of Value Added Tax, AS THE TECHNICAL DESCRIPTION<sup>53</sup> of such assets WAS NOT TAKEN INTO ACCOUNT, i.e. the necessary topographic survey and description of

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<sup>52</sup> Document A26.

<sup>53</sup> Emphasis in the original.



constructions and intangibles, since it was agreed that personal property and intangibles would be invoiced separately.

82. In a service contract of March 28, 1996,<sup>54</sup> between Promotora and Cytrar, in consideration of Cytrar's provision of "environmental advice services to the Municipality of Hermosillo" (clause 6), Promotora undertook, among other things (clause 2 d), to:

Keep in force any federal, state and municipal licenses and other permits required for operation of the landfill.

83. After the contribution in kind provided for as part of the purchase price of the assets relating to the landfill having been made, and apparently pursuant to the procedure set forth in the second clause of the "promise to buy" contract of February 20, 1996, the third and fourth clauses of the agreement regarding the method and terms of payment on the same date and the rectifying notarially-recorded deed of December 16, 1996, Promotora issued on July 24, 1997, Invoice No. 304 to Cytrar<sup>55</sup> for the amount of \$24,047,988.26 (Mexican Pesos) plus the applicable value added tax (VAT). The invoice comprises:

An authorization granted by the National Ecology Institute for the operation of a controlled landfill, through the collection, transport, treatment, temporary storage, and disposal of hazardous waste; the authorization also includes an authorization for soil use on the part of the Municipality of Hermosillo.

84. The different provisions laid down above and included in several documents signed by Promotora and Tecmed or Cytrar to record their mutual rights and obligations in connection with the sale and operation of the Las Víboras landfill show that performance of the works and services that were the responsibility of Cytrar relating to the landfill of urban waste, valued at \$ 24,047,988.26 (Mexican Pesos), was a payment in kind that was part of the consideration to be furnished by Cytrar for the award and sale to it of different assets for Cytrar to operate the hazardous waste landfill at Las Víboras; in other words, it was part of the price for which the assets of the Las Víboras landfill were awarded and sold to Tecmed and ultimately to Cytrar. So much so that the reservation of ownership to which such sale was subject would only terminate when such consideration had been furnished in full.<sup>56</sup> The audited financial statements of Cytrar as of December 31, 1997 enclosed with the expert witness report of American Appraisal<sup>57</sup> offered by the Claimant, particularly note 6, leads to the same conclusion; no evidence to the contrary has been provided based on the accounting books of Promotora or on statements of its management that took part in the sale of assets relating to the hazardous waste landfill of Las Víboras, nor evidence of any judicial challenges, for fiscal or any other reasons, with respect to the part of the sales price paid in kind, or the value or amount thereof, or the public tender offer proposed by Tecmed on the basis of such price, or its division into a cash component and a component in kind, nor denying that such payment in kind is all part of the price payable for assets relating to the Las Víboras landfill. The expert witness proposed by the Respondent does not state otherwise in his reports, when he says that "The urban waste landfill was an operation arising out of the payment in kind to be made by Tecmed for the acquisition of Cytrar".<sup>58</sup>

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<sup>54</sup> Document A33.

<sup>55</sup> Document A31

<sup>56</sup> Deed of purchase and sale of March 27, 1996, fourth clause (Document A25).

<sup>57</sup> Document A117.

<sup>58</sup> Report by Fausto García y Asociados, p. 26.

85. It is the view of the Arbitral Tribunal that the minutes of the board meeting of Promotora of March 15, 1996,<sup>59</sup> which reflect Promotora's decision to approve the offer made by Tecmed, clearly establish, in accordance with alternative 2 of the Tecmed acquisition offer,<sup>60</sup> that the contribution in kind, valued at \$ 24,155,185.00 (Mexican Pesos), which was to take place through the performance of different works and services relating to the municipal dump of Hermosillo for urban waste, was part of the price paid for the assets of the Las Víboras landfill, concerned with hazardous waste, as can be read on the second page of the minutes:

In item two, RODOLFO SALAZAR PLATT (an engineer) reads out the resolution adopted at the preceding meeting which reads (verbatim): After these reviews, the Board declares the following proposal to be unanimously approved: "Price offer for the acquisition of CYTRAR, alternative 2 (two), consisting of \$10,000,000.00 (TEN MILLION MEXICAN PESOS) and a non-monetary contribution to the Municipality of Hermosillo in the form of a construction project and provision of advice to the operation of the new landfill in accordance with the enclosed project, which comprises the general installations and the first phase of operation. It includes the closing of the current landfill, work valued at \$24,155,185.00 (Mexican Pesos) [...] Total value of offer is \$34,155,185.00 (Mexican Pesos) [...], the opinion of the full Board being that it is the most convenient offer from the economic and technical point of view and that it is beneficial for all the community of Hermosillo.

86. There is no doubt that payment of the sales price was to be made by the purchaser of the tendered assets,<sup>61</sup> regardless of the individual or corporation holding or being the beneficiary of the concession for the operation of the Hermosillo urban waste landfill, and that such obligation was vested in Cytrar.<sup>62</sup> The approval of the tender by Promotora's management board already contemplated the acquisition by Cytrar of the Las Víboras landfill assets awarded to Tecmed, and further that Cytrar should become "...a joint and several obligee with respect to the rights and obligations acquired by the successful awardee..."<sup>63</sup> without excluding from such obligations the ones relating to the furnishing of the consideration in kind, referred to above. The declaration of Mr. Javier Polanco Gómez Lavín—which has not been challenged or refuted in this regard by any other evidence produced in this arbitration— confirms the above.<sup>64</sup>

87. Having been concluded that the consideration in kind to be furnished by the purchaser of the assets relating to the hazardous waste landfill of Las Víboras in connection with the urban waste landfill of the Municipality of Hermosillo is part of the purchase price of such assets, it remains to be determined to what extent all or part of such consideration is allocable to the acquisition of the intangible assets referred to by the Claimant.

88. A rational and logical interpretation of the documentation presented by the Parties shows that what Promotora, on the one hand, and Tecmed and Cytrar, on the other, had in

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<sup>59</sup> Document A21.

<sup>60</sup> Document A17

<sup>61</sup> Page 5, notarial deed of conveyance, document A25.

<sup>62</sup> Second clause of the "promise-to-buy" contract (document A23); third clause of the Agreement (document A24).

<sup>63</sup> Document A21, p. 4

<sup>64</sup> Declaration of Javier Polanco Gómez Lavín, transcript of the Hearing for the Production of Evidence of May 20-24, 2002, section on May 20, 2002, pp. 31-33.

mind when entering into the agreement (from the standpoint of the latter, also when contemplating an investment in Mexico and in the Las Víboras landfill), was not simply the transfer of certain personal and real property but also to create the means for Cytrar to be able to operate the Las Víboras site as a hazardous waste landfill —i.e. to accomplish a public use purpose fully consistent with the activity that this landfill had been serving since its beginning in 1988— and to continue the same activity. Such were necessarily the legitimate expectations of Cytrar and of the Claimant, not only because the site and facilities being acquired as well as the commitments in terms of use and operation undertaken upon doing so, were to serve the normal purpose of operations of Tecmed and Cytrar, but also because the documentation of the tender whereby Tecmed was awarded the landfill assets, and the subsequent documentation signed with Promotora, highlighted that this was the only possible use for the assets being acquired, to such an extent that they would revert to Promotora if Cytrar failed to use them for the exclusive public use purpose for which such assets had been earmarked long before. This was, certainly, the expectation of Promotora and of the Municipality of Hermosillo, which controlled it, as they were both certainly interested in ensuring that the assets of the Las Víboras landfill continued being allocated to the hazardous waste landfill in view of their having been set aside for the protection of the environment and public health, as evidenced by the conditions of the tender of the assets of the landfill<sup>65</sup> and the terms and conditions of the documents whereby the sale was executed.<sup>66</sup> For example, paragraph eleven of the tender specifications required (and this requirement was fulfilled) that the notarial deed of conveyance include a clause whereby the purchaser agreed to include as an advisor, appointed by the Municipality of Hermosillo, with a voice but no vote, on an “indefinite and irrevocable” basis, in addition to ensuring that the landfill would be operated in accordance with the highest national and international standards. The Respondent points out<sup>67</sup> that this clause evidences

the interest and powers of the Municipality, as a government agency formed by representatives elected by the people, by and for the purpose of supervising the proper operation of the landfill in accordance with the highest applicable national and international standards.

The appointment of the advisor was thus directly linked to the Municipality’s interest in ensuring that the assets purchased should be treated as a unit for landfill of hazardous waste pursuant to the legal provisions, which was obviously not possible without the permits authorizing the operation.

89. Promotora could not, in good faith, impose such a drastic requirement or such a harsh sanction on Cytrar as the reversion to Promotora of the assets relating to the Las Víboras landfill if Cytrar was not authorized to use them in accordance with the agreed use, without assuming that access to the permits and licenses for the operation of the Las Víboras landfill in a manner consistent with their historical use was a fundamental part of the operation and of the expectations of Cytrar, Tecmed and, ultimately, the Claimant, and without assuming certain commitments to vest Cytrar with minimum rights that would prevent an outcome as adverse to such expectations and interests as the reversion of assets

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<sup>65</sup> Document A16, paragraph 6.

<sup>66</sup> Document A25, notarial deed of March 27, 1996, fifth clause.

<sup>67</sup> Counter-memorial, pp. 24-25, 95.

and at the same time the loss of amounts paid in cash or consideration furnished until then as payment of the price. Neither could INE ignore that the real property and tangible personal property relating to the Las Víboras landfill—and the investment relating to the Las Víboras landfill— would be devoid of economic value if Cytrar did not obtain the permits, licenses or authorizations required for operation. The note of the Municipality of Hermosillo addressed to INE on March 28, 1996,<sup>68</sup> whereby the Municipality “most respectfully” requests the Institute

to provide to TECMED Técnicas Medioambientales de México, S.A. de C.V., or to the company organized by it to operate the landfill, all necessary assistance to comply with the formalities for changing the name appearing in the operating license, which is currently Confinamiento Controlado Parque Industrial de Hermosillo<sup>69</sup>

not only confirms the above, but also evidences that no doubts were being cast as to the fact that the change of the license holder’s name was considered to be the lawful, normal and logical procedure in order to ensure that Cytrar could operate the Las Víboras site in accordance with the purpose mandated to it under the tender, sale and transfer documents.

90. However, Promotora did not guarantee to Cytrar or to Tecmed that Cytrar would obtain from INE the outcome certainly desired by Cytrar and apparently –at least at that time- by Promotora and by the Municipality of Hermosillo, i.e. that Cytrar would secure an authorization to operate a hazardous waste landfill at Las Víboras, or, if granted, that such authorization would conform to certain expected requirements such as its duration. Promotora did not guarantee to Cytrar either that the transfer to the latter’s name of the license given to Confinamiento Controlado Parque Industrial de Hermosillo O.P.D. would definitely take place. This does not, however, mean that Promotora was not willing to maintain the existing permits and licenses and their potential use by Cytrar in the event that that authorization or transfer did not materialize, as evidenced in clause 5 (a) of the contract of sale of March 27, 1996, between Promotora and Cytrar, mentioned above. Nor does it mean that Cytrar, through the transaction entered into with Promotora, only acquired real property and tangible personal property considered as such in isolation, i.e. unrelated to their historical and structural use and to the functional and economic dimension intimately associated to such use. As stated by Tecmed in its offer when it made it conditional to obtaining the authorizations for the use of such assets as a hazardous waste landfill,<sup>70</sup> neither Tecmed nor Cytrar would have acquired the assets without access to the authorizations and permits that would enable them to use them for a hazardous waste landfill. Accordingly, pursuant to clause five of the promise to sell contract signed with Tecmed on February 20, 1996, and clause 5 a) of the notarially recorded deed executed by Promotora, Tecmed and Cytrar on March 27, 1996 (transcribed above), Promotora consented to the potential use, in the case of the first document, by Tecmed, and in the second case, by Cytrar, of the existing licenses, authorizations or permits (mainly the authorization granted by INE on May 4, 1994, to Confinamiento Controlado Parque Industrial de Hermosillo O.P.D.) in the event of the failure of – as applicable – Cytrar or Tecmed to obtain the permits, licenses or authorizations required for the operation of the

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<sup>68</sup> Document A41.

<sup>69</sup> Emphasis in the original.

<sup>70</sup> Document A17.

landfill. Under clause 2 d) of the service contract of March 28, 1996, Promotora also undertook to keep current the existing licenses and authorizations, including the federal ones, for the operation of the Las Víboras landfill until Cytrar could do so on its own. These provisions show beyond any doubt that access by Cytrar to the licenses, authorizations or permits enabling it to operate the landfill was a central part of the tender and acquisition of assets relating to the Las Víboras landfill and of the expectations of Tecmed and Cytrar when the decision was made to invest in the landfill.

91. The documentation produced evidences that such licenses, authorizations and permits, and the right to use them for the operation of the Las Víboras landfill were vested in Promotora as a result of the winding-up of Confinamiento Controlado.<sup>71</sup> Accordingly, and also in view of the precedent of such landfill having already been operated by an entity other than that authorized,<sup>72</sup> it is also inferred that Promotora could allow the operation of the Las Víboras landfill by third parties under such authorizations, licenses or permits (to the extent such third parties adapted their operation to the framework allowed thereunder), as well as the transfer to third parties of the real property and tangible personal property of the Las Víboras landfill. This is a logical conclusion not only from a functional point of view, because the personal and real property of such landfill cannot be put to use for the benefit of the public or to the advantage of the community in accordance with or pursuant to the function on the basis and in furtherance of which they are technically structured and organized as an autonomous unit, without the required authorizations, licenses or permits, but also from an economic or business point of view, as the value of the real property and tangible personal property of the landfill—which, in practical terms, have been invalidated for any use other than the landfill of hazardous waste— depends on the existence or subsistence of such authorizations, licenses and permits. Consequently, from the perspective of Promotora, the price of those assets is, at the time of sale, enhanced by the possibility of use under such authorizations or permits. It should therefore be concluded that the consideration in kind valued at \$ 24,155,185.00 (Mexican Pesos) was paid as a lump sum in consideration of, on the one hand, Promotora’s undertakings relating to the maintenance of the licenses, permits and authorizations and of their being made available to Cytrar for the operation, as a hazardous waste landfill, of the Las Víboras site and other assets allocated to it in the event of Cytrar not obtaining new authorizations or licenses,<sup>73</sup> or the transfer to Cytrar of existing ones; and on the other hand, in recognition of the higher value of the real property and tangible personal property acquired in anticipation of the expectation to use them under such authorizations, permits and licenses and, consequently, as part of the purchase price of such personal and real property, as such value was not just

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<sup>71</sup> Administrative record of the winding-up of Confinamiento Controlado Parque Industrial de Hermosillo O.P.D. of August 31, 1995, Point IV, Annex No. 15 (Document A13); donation contract between the Government of the State of Sonora and Promotora, evidencing transfer to Promotora of the personal property listed in the record, which in Point IV, Annex 15, includes a list of permits for operation of the Las Víboras landfill, including the authorization granted by INE on May 4, 1994 (Document A14, introductory paragraphs III and IV; third clause).

<sup>72</sup> See paragraph 36 of this award.

<sup>73</sup> Regardless of the way in which this commitment on the part of Promotora should be complied with, even if compliance was as suggested by the Respondent: Cytrar being hired by Promotora –the latter, as holder of the authorizations, licenses and permits for the operation of the Las Víboras landfill- for Cytrar to operate it under them (“Admissions and Denials”, pleading filed by the Respondent, p. 25).

their inherent value but also the value resulting from the possibility of being functionally applied to the storage and management of hazardous waste within the framework of a legally authorized landfill operation. From this perspective, payment of a higher price is justified by the expectation of Tecmed and Cytrar —highlighted by the expert witness appointed by the Respondent— at the time of the tender and sale of the assets relating to the Las Víboras landfill and of their acquisition by such companies, to use it “with an “unlimited duration” license”.<sup>74</sup> It has also been established that the part in kind of the purchase price for the landfill was fully paid by its purchaser, Cytrar.

92. Upon replacement of the first official letter of INE dated September 24, 1996, by a subsequent new letter of the same date, but accompanied by an INE authorization, different not only in terms of its duration and in other respects, but which also revoked the existing authorization that had been issued to Confinamiento Controlado Parque Industrial de Hermosillo OPD under which the landfill had operated since May 4, 1994, an important change in the existing situation took place, because Promotora could no longer make such authorization available to Cytrar, nor would Cytrar probably be able to hold Promotora responsible because presumably, under both the “promise-to-buy” contract of February 20, 1996 and the notarial deed of March 27, 1996, Cytrar could only demand the performance of Promotora’s obligation to make the 1994 license available if Cytrar had failed to obtain a license “required for the lawful operation of the landfill”. Although of limited duration, the license of November 11, 1996, obtained by Cytrar from INE enabled the legal operation of the landfill and therefore did not give Cytrar rights against Promotora under the deed. In any event, this Arbitral Tribunal is not called to decide on these issues.

### **E. The Merits of the Dispute**

93. The Claimant alleges that the Respondent’s conduct violates the following provisions of the Agreement:

- 1) Article 2(1) on the promotion and admission of investments;
- 2) Article 3 on protection of investments;
- 3) Article 4(1) on fair and equitable treatment;
- 4) Article 4(2) on the most favorable treatment;
- 5) Article 4(5) on national treatment; and
- 6) Article 5 on nationalization and expropriation.

94. The Arbitral Tribunal deems it appropriate to consider and resolve upon the issues referred to above in the following order:

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<sup>74</sup> Report of Fausto García y Asociados, p. 48.

- 1) The obligation to refrain from expropriating or nationalizing in violation of the Agreement;
- 2) The obligation to assure fair and equitable treatment in accordance with international law; and
- 3) The obligation to grant full security and protection to investments under international law, and the other violations to the Agreement alleged by the Claimant.

#### I. Expropriation

95. The Claimant alleges that, when the INE did not renew the permit to operate the Las Viboras Landfill (the «Landfill») through its resolution dated November 25, 1998 (hereinafter the «Resolution»), it expropriated the Claimant's investment and that such expropriation has caused damage to the Claimant. The Claimant relates the expropriation—which according to the Claimant is the exclusive cause of the damage—to the prior actions of a number of organizations and entities at the federal, state and municipal levels, and also states that those actions are attributable to the Respondent and that they are adverse to the Claimant's rights under the Agreement and to the protection awarded to its investment thereunder. The Claimant further alleges that those actions objectively facilitated or prepared the subsequent expropriatory action carried out by INE.

96. The Claimant alleges that the Agreement protects foreign investors and their investments from direct and indirect expropriation; i.e. not only expropriation aimed at real or tangible personal property whereby the owner thereof is deprived of interests over such property, but also actions consisting of measures tantamount to an expropriation with respect to such property and also to intangible property. The Claimant states that, as the resolution deprived Cytrar of its rights to use and enjoy the real and personal property forming the Landfill in accordance with its sole intended purpose, the Resolution put an end to the operation of the Landfill as an on going business exclusively engaged in the landfill of hazardous waste, an activity that is only feasible under a permit, the renewal of which was denied. Therefore, Cytrar alleges that it was deprived of the benefits and economic use of its investment. The Claimant highlights that without such permit the personal and real property had no individual or aggregate market value and that the existence of the Landfill as an on going business, as well as its value as such, were completely destroyed due to such Resolution which, in addition, ordered the closing of the Landfill.<sup>75</sup>

97. The Respondent alleges that INE had the discretionary powers required to grant and deny permits, and that such issues, except in special cases, are exclusively governed by domestic and not international law. On the other hand, the Respondent states that there was no progressive taking of the rights related to the permit to operate the Las Viboras landfill by means of a legislative change that could have destroyed the *status quo*, and that the Resolution was neither arbitrary nor discriminatory. It also states that the Resolution was a regulatory measure issued in compliance with the State's police power within the highly regulated and extremely sensitive framework of environmental protection and public

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<sup>75</sup> Memorial, p. 53.

health. In those circumstances, the Respondent alleges that the Resolution is a legitimate action of the State that does not amount to an expropriation under international law.<sup>76</sup>

98. The Claimant affirms that the Resolution is arbitrary because the reasons invoked therein to deny the renewal of the permit that had been granted on November 19, 1997 (the «Permit»), under which the Claimant had operated the Landfill over the last year, are not proportional to the decision not to renew the Permit.

99. The Resolution<sup>77</sup> refuses renewal of the Permit on the following grounds: (i) the Landfill was only authorized to receive waste from agrochemicals or pesticides or containers and materials contaminated with such elements; (ii) PROFEPA's delegates in Sonora had informed, in the official communication dated November 11, 1998,<sup>78</sup> that the waste confined far exceeded the landfill limits established for one of the Landfill's active cells, cell No. 2; (iii) the Landfill temporarily stored hazardous waste destined for a place outside the Landfill, acting as a «transfer center», an activity for which the Landfill did not have the required authorization; Cytrar was requested on October 16, 1997 to file reports in connection with this activity, but to date the relevant authorization had not been issued; and (iv) liquid and biological-infectious waste was received at the Landfill, an activity that was prohibited and that amounted to a breach of the obligation to notify in advance any change or modification in the scope of the Permit, and to unauthorized storage at the Landfill of liquid and biological-infectious waste. The Resolution also textually provides as follows:

Furthermore, CYTRAR S.A. de C.V. agreed with the different levels of the Federal, State and Municipal Government and communicated to the public the relocation of the landfill.

100. The Claimant challenges those statements because, among other things, the excess of the authorized landfill levels of cell no. 2 was the subject matter of an investigation and an audit by PROFEPA, as a result of which a fine was imposed on Cytrar by means of an official communication dated December 16, 1999.<sup>79</sup> That fine was a minor penalty, substantially smaller than the maximum fine established by law. The Claimant also highlights that the official communication issued by PROFEPA to impose the fine stated that the infringement did not have a «significant effect on public health or generate an ecological imbalance».<sup>80</sup> The Claimant also stated that in another similar official communication issued by PROFEPA,<sup>81</sup> in which a fine was imposed on Cytrar for a number of infringements—including acting as a temporary storage of hazardous waste to be sent to other companies and operating as a transfer center, circumstances that were invoked by INE in the Resolution that denied the renewal of the Permit—<sup>82</sup>, PROFEPA expressly stated that

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<sup>76</sup> Counter-memorial, pp.160-162, 550 *et seq.* Respondent's closing statement, pp. 24-25, 56 *et seq.*

<sup>77</sup> Document A59.

<sup>78</sup> Document A62.

<sup>79</sup> Official communication No. PFPA-DS-UJ-2625/99 issued by Profepa, December 16, 1999; document A61.

<sup>80</sup> PROFEPA's official communication already cited, document A61, p. 16.

<sup>81</sup> Official communication No. PFPA-DS-UJ-1105/99 dated May 25, 1999. Document A63.

<sup>82</sup> PROFEPA's official communication already cited, page 55, paragraph (ah). Document A63.



... the infringements committed by the company involved are not sufficient to immediately cancel, suspend or revoke the permit for carrying out hazardous material and/or waste management activities, nor do they have an impact on public health or generate an ecological imbalance.<sup>83</sup>

101. The Claimant also states that, through the notes dated June 25<sup>84</sup> and July 15<sup>85</sup> 1998, Cytrar had already requested from INE the permit to expand cell No. 2 of the Landfill and build another cell. INE replied to this request on October 23, 1998,<sup>86</sup> stating, among other things, that the expansion request would be resolved together with the decision on renewal of the Permit. The Claimant claims that this decision adversely affected it because INE partly used the same reasons for which it already knew that the authorization to expand cell No. 2 would be denied (the same reasons used by PROFEPA to impose a fine on Cytrar by means of an official communication dated December 16, 1999, mentioned above), but deferred its decision to be able to use those reasons as the grounds for the Resolution under which INE refused to renew the Permit.<sup>87</sup>

102. The Claimant also states that in the letter dated September 5, 1996,<sup>88</sup> upon requesting «the change of name», Tecmed had reported to INE, among other things, that the processes carried out at the Landfill included the collection of waste in a specialized means of transportation, the preparation, packaging and labelling of waste for its subsequent transportation and the «temporary storage of waste (oil and solvents)» and that INE made no objection or reservation. Tecmed also reported that the operation of the transfer center and temporary storage of biological-infectious waste at the Landfill was not carried out by Cytrar, but by an affiliate, Técnicas Medioambientales Winco S.A. de CV,<sup>89</sup> which was authorized to engage in those activities at that site under a permit granted by INE for that purpose,<sup>90</sup> circumstances that could not be ignored by INE upon issuing the Resolution.

103. The Respondent highlights that Cytrar had not met the requirements to allow INE to evaluate an authorization to expand cell No. 2, since Cytrar had not submitted the related plans. The Respondent also states that as Cytrar had not submitted these plans and, regardless of such a breach, had commenced the cell's expansion activities, Cytrar had not complied with one of the Permit's conditions. The Respondent states that on October 23, 1998, INE requested additional information from Cytrar to decide on the expansion of cell No. 2 and on the construction of cell No. 3, and requested that Cytrar present the engineering project and the related drawings.<sup>91</sup> The Claimant complied with such requirement on November 4, 1998.<sup>92</sup>

104. The Respondent also refers to a number of circumstances related to the Landfill and its operation. The Claimant also refers to such circumstances, and substantial evidence has

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<sup>83</sup> PROFEPA's official communication already cited, paragraph A, page 50. Document A63.

<sup>84</sup> Document A49

<sup>85</sup> Document A50

<sup>86</sup> Official Communication No. D00.800/005262, document A51.

<sup>87</sup> Memorial, pp.58-59.

<sup>88</sup> Document A39.

<sup>89</sup> Claimant's closing statement, p. 65 *et seq.*

<sup>90</sup> Memorial, p. 62.

<sup>91</sup> Counter-memorial, p. 78, 282; document D142.

<sup>92</sup> Counter-memorial, p. 79, 287; document D146.

been produced in that regard. Such circumstances underlie the Resolution or had a significant effect thereon, although not all such circumstances have been mentioned in the text of the Resolution.

105. According to the Respondent, those circumstances are:<sup>93</sup>

1) the site of the Landfill did not comply with applicable Mexican regulations in terms of its location and characteristics;

2) in 1998, Cytrar had committed a number of irregularities while operating the Landfill, mainly related to the transportation of waste from Alco Pacífico, and such irregularities triggered strong community pressure against the Landfill;

3) Mexican authorities, mainly from the Municipality of Hermosillo, expressed their doubts as to the Landfill's operations;

4) there was the risk that community pressure might increase if operation of the Landfill continued; and

5) Since 1997 Cytrar had reportedly been aware that community pressure suggested that the operation of the Landfill was not feasible due to its location, and that is why it agreed to relocate it at its own cost.

106. The opposing community groups claimed that the Landfill was only 8 km from the urban center of Hermosillo, and that such proximity breached the regulations that required a distance of at least 25 km from any settlement of more than 10,000 residents. Legally, however, such circumstance could not be invoked against Cytrar because the Landfill had been located and authorized to operate at such site before the adoption of such regulations, which are not retroactive. Reportedly, in deciding to refuse to renew the Permit, INE took into account the fact that the location of the site did not comply with the regulations as well as the resulting community pressure.<sup>94</sup>

107. The Parties agree that community opposition to the Landfill was due not to the manner in which Cytrar operated it, but to the transportation to the Landfill of contaminated and abandoned soil from the Alco Pacífico plant located in the state of Baja California, Mexico. Owing to a series of events that are not relevant at this point, Cytrar was in charge of the collection, transportation and landfill of Alco Pacífico's hazardous waste and contaminated soil pursuant to an agreement dated November 19, 1996, executed between PROFEPA, Los Angeles County, USA, Fomento de Ingeniería S.A. de C.V. (Fomín) and Cytrar.<sup>95</sup> Fomín was entrusted with the supervision of the transportation and discharge services that Cytrar had to provide under such agreement, in compliance with the contract and the applicable legal provisions, and had to report its findings to PROFEPA. The shipments of toxic materials and soil destined for the Landfill began under an initial transport permit

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<sup>93</sup> Counter-memorial, pp. 88-89, 315.

<sup>94</sup> Memorial, pp. 72-74; Counter-memorial, p. 89, 315-316.

<sup>95</sup> Document D64

issued by INE<sup>96</sup> in early 1997.<sup>97</sup> In view of the claims of the community, PROFEPA conducted inspections of the trucks in October 1997, which essentially determined that there were open hazardous material packaging bags. PROFEPA therefore adopted urgent measures for Cytrar to rectify the situation, which were complied with by Cytrar. There were similar situations in November 1997, and, at the time, in addition to adopting urgent measures affecting Cytrar, PROFEPA applied a fine to Cytrar.<sup>98</sup> In April 1998, PROFEPA found some irregularities in the discharge of Alco Pacifico's waste and levied a fine on Cytrar, stating that «there are circumstances that pose or may pose a risk to the environment or to health». A similar situation was found in May 1998 in connection with the transportation and discharge of waste from the company Siderúrgica de California, which also gave rise to the issuance of urgent measures by PROFEPA, which were also complied with by Cytrar.<sup>99</sup>

108. The community's opposition to the Landfill, in its public manifestations, was widespread and aggressive, as evidenced by several events at different times. In November 1997, the association *Alianza Cívica de Hermosillo* (Hermosillo's Alliance for Civic Affairs) publicly denounced Cytrar's "actions and omissions" particularly in connection with waste transportation from Alco Pacifico, and requested that Cytrar's permit to operate the Landfill be cancelled and the extension thereof be denied.<sup>100</sup> Also in November<sup>101</sup> "...around 200 people organized a demonstration, marching to the landfill and closing it down symbolically... ", and then, a meeting was held with federal, state, and municipal public officials including the President of INE, the Deputy Director of the PROFEPA Environmental Audit Bureau, the Minister of SEMARNAP and representatives of the community organizations. In December 1997, the association *Academia Sonorense de Derechos Humanos* (Sonora Human Rights Academy) filed a criminal complaint against Cytrar for the commission of acts that could be defined as "environmental crimes".<sup>102</sup> In January 1998, the same association " ...filed a challenge... " against the Municipality of Hermosillo for the permit granted by that Municipality in 1994 to operate the Landfill.<sup>103</sup> In late January 1998 "...members of the community and of the different community organizations ...." organized a blockade of the Landfill which lasted until March 7, 1998, when the police intervened under orders of the Attorney's General Office. After the police intervention, the community organizations that questioned such measures organized a sit-in at Hermosillo's Town Hall<sup>104</sup> that lasted 192 days. By late March 1998, the same opposition groups issued a communication condemning the actions of the authorities that had put an end to the blockade of the Landfill.<sup>105</sup> In April 1998, a group of demonstrators attempted to block access to the Landfill but the police thwarted this action.<sup>106</sup> In

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<sup>96</sup> Official Communication D00-800/000269 dated January 23, 1997; document D65.

<sup>97</sup> Counter-memorial, pp. 43-44, 161 *et. seq.*; particularly 166.

<sup>98</sup> Counter-memorial, pp. 48-52, 180 *et. seq.*

<sup>99</sup> Counter-memorial, pp. 67-70, 240 *et. seq.*

<sup>100</sup> Counter-memorial, pp. 51-52, 191 *et. seq.*

<sup>101</sup> Article published in Hermosillo newspaper *El Imparcial* on November 23, 1997. Document D88.

<sup>102</sup> Counter-memorial, p. 55, 203

<sup>103</sup> Counter-memorial, p. 56, 207

<sup>104</sup> Counter-memorial, pp. 57-59, 210 *et. seq.*

<sup>105</sup> Counter-memorial, p. 63, 232

<sup>106</sup> Counter-memorial, p. 66, 237

September 1998, a certain *Asociación de Organismos No Gubernamentales en Lucha contra el CYTRAR* (Association of NGOs Against CYTRAR) filed a claim before the State Commission of Human Rights against the authorities of the State of Sonora and the Municipality of Hermosillo for having intervened to put an end to the 192-day sit-in organized at the Town Hall<sup>107</sup>. In October 1998, a “family demonstration for the defense of health and dignity” and against “the landfill and the authorities’ position in that regard” was organized and a public communication contrary to the Landfill was issued.<sup>108</sup> According to the news media, about 400 people participated in the demonstration.<sup>109</sup> In November 1998, community organizations submitted a petition to the local office of SEMARNAP so that expressions of such associations and individual citizens be considered upon evaluating the renewal of the Permit. During that period —as evidenced by the “Press Dossier (I)” included in the documents offered by the Claimant—<sup>110</sup> these developments were covered by the local press and Hermosillo’s radio and television.

109. The authorities of the Municipality of Hermosillo were the direct target of “community pressure”. The Municipality was one of INE’s interlocutors at the time of consideration of the Permit’s renewal. In view of the pressure that questioned the Municipality’s grant of the permit to use the land where the Landfill was operated, the Municipality rendered an opinion on March 31, 1998, which explained that at the time of granting such permit the current legal provisions were not applicable and that those provisions came into force subsequently, establishing a minimum distance between landfills and urban centers which the Landfill did not comply with. However, the Municipality expressed its agreement with the community about the need to relocate Cytrar’s hazardous waste landfill operation to a different site and its support to conduct an audit of operations to determine whether the Landfill’s operation entailed any risks. That same day, the Health Commission of the Municipality rendered an opinion confirming that, although Cytrar’s operation at the Las Víboras site met the legal requirements for functioning and there were no “legal, ethical or logical arguments” to seek the closing of the Landfill, all necessary efforts should be made to relocate Cytrar’s operations. After this, several other decisions to the same effect were issued by the Municipality, additionally highlighting that only the federal Mexican authorities were competent in “...events relating to toxic waste”.<sup>111</sup> INE also consulted with the Municipality on November 18, 1998 about Cytrar’s requests to, among other things, expand cell No. 2 and build another one. The Municipality did not agree to the construction of a third cell, but accepted expansion subject to:<sup>112</sup>

....a detailed and legal relocation commitment agreed upon between the three levels of Government and the company

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<sup>107</sup> Counter-memorial, pp. 74-75, 265 *et. seq.*

<sup>108</sup> Counter-memorial, p. 79, 285

<sup>109</sup> Article published in Hermosillo newspaper *El Imparcial* on October 26, 1998. Press dossier (I), annex A70.

<sup>110</sup> Under annex A70

<sup>111</sup> Counter-memorial, pp. 63-65, 233 *et. seq.*

<sup>112</sup> Counter-memorial, pp. 86-97, 311 *et. seq.*; note of the Mayor of the Municipality of Hermosillo to INE’s President dated November 18, 1998, document D157.

and provided that:

...a commission with representatives from each party be formed; and that, prior to that, an audit of operations be conducted and the final close down of the landfill be carried out; and that it would have to be made clear that that would be the last authorization for the current site.

The consultation with the Municipality and with the authorities of the State of Sonora and its results have been summarized as follows in the declaration of Dra. Cristina Cortinas de Nava,<sup>113</sup> who was at the time INE's General Director for Hazardous Materials, Waste and Activities and issued the Resolution, during the Hearing held from May 20 to May 24, 2002:

.... the gentleman is right to point out that I consulted with the municipal authority and with the state authority before making my decision about the company's application for an authorization to expand its capacity while relocation was pending[...]. Let me inform you that the reply that I obtained from the authorities was "let them fill in the cell, that's all right. But don't let them build anything else because we have waited too long for their relocation to allow them to have more space at the site they are at".

110. The relocation of Cytrar's operations as a response to community pressure was therefore also one of the factors taken into account by INE, and mentioned incidentally in the Resolution, upon deciding whether to renew the Permit. By late 1997, owing to the community pressure against the Landfill, Cytrar and the Municipality of Hermosillo started negotiations about the relocation, which, indeed, entailed the final close down of the hazardous waste landfill operation at the Las Viboras site, and that was undoubtedly the aim pursued by the community groups and the authorities of the Municipality. The relocation and the final close down of the Landfill, as it has been seen, were also the express claims of the Municipality of Hermosillo, apparently in response to the complaints about the Landfill and Cytrar's operation described above. The Claimant underscores that, as from the commencement of the negotiations, it did not object to the relocation but accepted it on the condition that a new site be identified before closing the operation at Las Viboras, and that the continuity of the operation at the new site and premises be guaranteed with the necessary permits.<sup>114</sup> On March 16, 1998, in a notice published by the local press, Cytrar ratified, among other things, its agreement to relocate its operation.<sup>115</sup> On July 3, 1998, at a meeting called by the Governor of the State of Sonora and attended by the Minister of SEMARNAP, Ms. Julia Carabias Lillo and the authorities of the Municipality of Hermosillo, Cytrar was informed of a joint declaration issued by the federal, state and municipal authorities stating that although the inspections conducted did not provide "...evidence of any risk to health and the ecosystems..." arising out of the Landfill, the relocation was necessary to "secure environmental safety in view of the rapid urban growth of Hermosillo, provide a response to the concerns that had been expressed and guarantee, in the long term, the environmental infrastructure to handle and dispose of industrial waste".<sup>116</sup>

The declaration also states that:

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<sup>113</sup> Hearing held from May 20 to May 24, 2002, transcript of the session of May 21, 2002, p. 82 overleaf.

<sup>114</sup> Memorial, pp. 77-78

<sup>115</sup> Counter-memorial, p. 61, 228; document D111

<sup>116</sup> Document A92; Memorial, pp. 78-79

...As a consequence, the present landfill operated by CYTRAR shall cease to operate as soon as the new premises are ready to start operations...

111. Later, IMADES (Sonora's Environmental and Sustainable Development Institute), a government entity, focused on the search for a new site in the State of Sonora on the basis of a broader and more ambitious landfill proposal as to the scope, activities and functions related to the landfill of hazardous waste, or CIMARI (integral center for the management of industrial waste).<sup>117</sup> By October 1998, IMADES had "... shortlisted three possible areas...". After visiting the sites, together with Cytrar, INE considered that, with the approval of Cytrar, "carrying out the applicable studies" in a site located in the Municipality of Benjamín Hill<sup>118</sup> would be feasible.

112. When INE considered the renewal of the Permit, the relocation had not taken place and, reportedly, the final relocation site had not been identified, i.e. a site which had tested positive to all feasibility studies for the purpose for which it would be used, and a site qualified to be authorized as hazardous waste landfill. On November 9, 1998, a few days before issuance of the Resolution, Cytrar sent a note to the Governor of the State of Sonora—following the procedure stated by INE through the official communication of October 23, 1998, sent by Dr. Cristina Cortinas Nava—<sup>119</sup> ratifying its relocation commitment, stating also that it would relocate to any site indicated to it. In this note Cytrar also expressed that it would assume all costs related to the acquisition of the land, constructions and transfer of the landfill's waste to the new site, all the above without resigning to its position that the Permit should remain in full force and effect until the relocation had effectively taken place.<sup>120</sup> Similar commitments were reaffirmed by Tecmed in the notes dated November 12, 1998, to Julia Carabias Lillo, head of SEMARNAP,<sup>121</sup> and November 17, 1998, to Dr. Cristina Cortinas Nava, INE's General Director of Hazardous Materials, Waste and Activities.<sup>122</sup> This last note was also sent by Cytrar to Sonora's governor and to the mayor of the Municipality of Hermosillo by means of communications where Cytrar highlighted its relocation commitment included in point 7 of the original note.<sup>123</sup> After issuance of the Resolution that denied the renewal of the Permit, there were a number of discussions and actions, which involved Tecmed, intended to carry out the relocation. These discussions and actions extended to January 2000 but have currently ceased.<sup>124</sup>

113. The Agreement does not define the term "expropriation", nor does it establish the measures, actions or behaviors that would be equivalent to an expropriation or that would

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<sup>117</sup> Counter-memorial, p. 67, 239.

<sup>118</sup> Counter-memorial, p. 75, 270

<sup>119</sup> Document A51. This official communication makes reference to the relocation agreement and makes a proposal to Cytrar so that it "...contact the authorities of the State and Municipal Government to define the steps to be followed as to the landfill relocation."

<sup>120</sup> Document A89. Counter-memorial, pp. 84-85, 303 *et seq.* Memorial, pp. 80-81.

<sup>121</sup> Document A 90.

<sup>122</sup> Document A55.

<sup>123</sup> Document A 54.

<sup>124</sup> Counter-memorial, p. 96, 337.

have similar characteristics. Although formally an expropriation means a forcible taking by the Government of tangible or intangible property owned by private persons by means of administrative or legislative action to that effect, the term also covers a number of situations defined as *de facto* expropriation, where such actions or laws transfer assets to third parties different from the expropriating State or where such laws or actions deprive persons of their ownership over such assets, without allocating such assets to third parties or to the Government.<sup>125</sup>

114. Generally, it is understood that the term “...equivalent to expropriation...” or “tantamount to expropriation” included in the Agreement and in other international treaties related to the protection of foreign investors refers to the so-called “indirect expropriation” or “creeping expropriation”, as well as to the above-mentioned *de facto* expropriation.<sup>126</sup> Although these forms of expropriation do not have a clear or unequivocal definition, it is generally understood that they materialize through actions or conduct, which do not explicitly express the purpose of depriving one of rights or assets, but actually have that effect. This type of expropriation does not necessarily take place gradually or stealthily — the term “creeping” refers only to a type of indirect expropriation—and may be carried out through a single action, through a series of actions in a short period of time or through simultaneous actions. Therefore, a difference should be made between creeping expropriation and *de facto* expropriation,<sup>127</sup> although they are usually included within the broader concept of “indirect expropriation” and although both expropriation methods may take place by means of a broad number of actions that have to be examined on a case-by-case basis to conclude if one of such expropriation methods has taken place.<sup>128</sup>

115. To establish whether the Resolution is a measure equivalent to an expropriation under the terms of section 5(1) of the Agreement, it must be first determined if the Claimant, due to the Resolution, was radically deprived of the economical use and enjoyment of its investments, as if the rights related thereto —such as the income or benefits related to the Landfill or to its exploitation— had ceased to exist. In other words, if due to the actions of the Respondent, the assets involved have lost their value or economic use for their holder and the extent of the loss.<sup>129</sup> This determination is important because it is one of the main elements to distinguish, from the point of view of an international tribunal, between a regulatory measure, which is an ordinary expression of the exercise of the state’s police power that entails a decrease in assets or rights, and a *de facto* expropriation that deprives

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<sup>125</sup> Award dated August 30, 2000, in ICSID case No. ARB(AF)/97/1 *Metalclad v. United Mexican States*, 16 Mealey’s International Arbitration Report (2000), pp. A-1 *et seq.*; p. A-13 (p. 33 of the award, 103): «Thus, expropriation [...] includes not only open, deliberate and acknowledged takings of property, such as outright seizure or formal or obligatory transfer of title in favor of the host State, but also covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use or reasonably-to-be expected economic benefit of property even if not necessarily to the obvious benefit of the host State. »

<sup>126</sup> G. Sacerdoti, *Bilateral Treaties and Multilateral Instruments on Investment Protection*, 269 *Recueil des cours*, Académie de droit international de La Haye, 255, 385-386 (1997).

<sup>127</sup> *Ibid.* p. 383.

<sup>128</sup> R. Dolzer & M. Stevens, *Bilateral Investment Treaties*, pp. 99-100 (1995).

<sup>129</sup> Partial award in the case *Pope Talbot Inc v. Government of Canada*, 102-104, pp. 36-38, [www.naftalaw.org](http://www.naftalaw.org); and II Restatement of the Law (Third) Restatement of the Foreign Relations Law of the United States, § 712, pp. 200-201; notes 6-7, pp. 211-212 (1987).

those assets and rights of any real substance. Upon determining the degree to which the investor is deprived of its goods or rights, whether such deprivation should be compensated and whether it amounts or not to a *de facto* expropriation is also determined. Thus, the effects of the actions or behavior under analysis are not irrelevant to determine whether the action or behavior is an expropriation. Section 5(1) of the Agreement confirms the above, as it covers expropriations, nationalizations or

...any other measure with similar characteristics or *effects*...<sup>130</sup>

The following has been stated in that respect:

In determining whether a taking constitutes an «indirect expropriation», it is particularly important to examine the effect that such taking may have had on the investor's rights. Where the effect is similar to what might have occurred under an outright expropriation, the investor could in all likelihood be covered under most BIT provisions.<sup>131</sup>

116. In addition to the provisions of the Agreement, the Arbitral Tribunal has to resolve any dispute submitted to it by applying international law provisions (Title VI.1 of the Appendix to the Agreement), for which purpose the Arbitral Tribunal understands that disputes are to be resolved by resorting to the sources described in Article 38 of the Statute of the International Court of Justice<sup>132</sup> considered, also in the case of customary international law, not as frozen in time, but in their evolution.<sup>133</sup> Therefore, it is understood that the measures adopted by a State, whether regulatory or not, are an indirect *de facto* expropriation if they are irreversible and permanent and if the assets or rights subject to such measure have been affected in such a way that "...any form of exploitation thereof..." has disappeared; i.e. the economic value of the use, enjoyment or disposition of the assets or rights affected by the administrative action or decision have been neutralized or destroyed.<sup>134</sup> Under international law, the owner is also deprived of property where the use or enjoyment of benefits related thereto is exacted or interfered with to a similar extent, even where legal ownership over the assets in question is not affected, and so long as the deprivation is not temporary. The government's intention is less important than the effects of the measures on the owner of the assets or on the benefits arising from such assets affected by the measures; and the form of the deprivation measure is less important than its actual effects.<sup>135</sup> To determine whether such an expropriation has taken place, the Arbitral Tribunal should not

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<sup>130</sup> Emphasis added by the Arbitral Tribunal.

<sup>131</sup> R. Dolzer & M. Stevens, *Bilateral Investment Treaties*, p. 100 (1995).

<sup>132</sup> I. Brownlie, *Principles of International Law* (5<sup>th</sup> Edition, 1998) p.3: «These provisions [...] represent the previous practice of arbitral tribunals, and Article 38 is generally regarded as a complete statement of the sources of international law ».

<sup>133</sup> *Mondev International Ltd v. United States of America* award, October 11, 2002, ICSID case No. ARB(AF)/99/2, p. 40, 116

<sup>134</sup> European Court of Human Rights, *In the case of Matos e Silva, Lda., and Others v. Portugal*, judgment of September 16, 1996, 85, p. 18, <http://hudoc.echr.coe.int>

<sup>135</sup> See Iran-USA Claims Tribunal, *Tippetts, Abbet, McCarthy, Stratton v. TAMS/Affa Consulting Engineers of Iran et al.*, decision of June 29, 1984; 6 Iran-United States Rep., p. 219 *et seq.*; p. 225 (1984-II); of the same Tribunal, *Phelps Dodge Corp. et al. v. Iran*, 10 Iran-U.S.Cl. Trib. Rep. p. 121 *et seq.*; esp. 22, p.130 (1986-I).



.... restrict itself to evaluating whether a formal dispossession or expropriation took place, but should look beyond mere appearances and establish the real situation behind the situation that was denounced.<sup>136</sup>

117. The Resolution meets the characteristics mentioned above: undoubtedly it has provided for the non-renewal of the Permit and the closing of the Landfill permanently and irrevocably, not only due to the imperative, affirmative and irrevocable terms under which the INE's decision included in the Resolution is formulated, which constitutes an action — and not a mere omission— attributable to the Respondent, with negative effects on the Claimant's investment and its rights to obtain the benefits arising therefrom, but also because after the non-renewal of the Permit, the Mexican regulations issued by INE become fully applicable. Such regulations prevent the use of the site where the Landfill is located to confine hazardous waste due to the proximity to the urban center of Hermosillo. Since it has been proved in this case that one of the essential causes for which the renewal of the Permit was denied was its proximity and the community pressure related thereto, there is no doubt that in the future the Landfill may not be used for the activity for which it has been used in the past and that Cytrar's economic and commercial operations in the Landfill after such denial have been fully and irrevocably destroyed, just as the benefits and profits expected or projected by the Claimant as a result of the operation of the Landfill. Moreover, the Landfill could not be used for a different purpose since hazardous waste has accumulated and been confined there for ten years. Undoubtedly, this reason would rule out any possible sale of the premises in the real estate market. Finally, the destruction of the economic value of the site should be assessed from the investor's point of view at the time it made such an investment. In consideration of the activities carried out, of its corporate purpose and of the terms and conditions under which assets related to the Landfill were acquired from Promotora, the Claimant, through Tecmed and Cytrar, invested in such assets only to engage in hazardous waste landfill activities and to profit from such activities. When the Resolution put an end to such operations and activities at the Las Viboras site, the economic or commercial value directly or indirectly associated with those operations and activities and with the assets earmarked for such operations and activities was irremediably destroyed. The above conclusions are not jeopardized by the fact that the Resolution has not prevented Cytrar from continuing operating the Landfill until completion of the authorized installed capacity existing as of the Resolution's date. Such limited, temporary and partial continuation of operation of the Landfill does not modify the definitive and detrimental effects of the Resolution with respect to the long-term investment made in the Landfill. As far as the effects of such Resolution are concerned, the decision can be treated as an expropriation under Article 5(1) of the Agreement.

118. However, the Arbitral Tribunal deems it appropriate to examine, in light of Article 5(1) of the Agreement, whether the Resolution, due to its characteristics and considering not only its effects, is an expropriatory decision.

119. The principle that the State's exercise of its sovereign powers within the framework of its police power may cause economic damage to those subject to its powers as administrator without entitling them to any compensation whatsoever is undisputable. Another undisputed issue is that within the framework or from the viewpoint of the

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<sup>136</sup> Interamerican Court of Human Rights, *Ivcher Bronstein Case (Baruch Ivcher Bronstein vs. Peru)*, judgment of February 6, 2001, 124, p. 56; [www.corteidh.or.cr](http://www.corteidh.or.cr).

domestic laws of the State, it is only in accordance with domestic laws and before the courts of the State that the determination of whether the exercise of such power is legitimate may take place. And such determination includes that of the limits which, if infringed, would give rise to the obligation to compensate an owner for the violation of its property rights.

120. However, the perspective of this Arbitral Tribunal is different. Its function is to examine whether the Resolution violates the Agreement in light of its provisions and of international law. The Arbitral Tribunal will not review the grounds or motives of the Resolution in order to determine whether it could be or was legally issued. However, it must consider such matters to determine if the Agreement was violated. That the actions of the Respondent are legitimate or lawful or in compliance with the law from the standpoint of the Respondent's domestic laws does not mean that they conform to the Agreement or to international law.<sup>137</sup>

An Act of State must be characterized as internationally wrongful if it constitutes a breach of an international obligation, even if the act does not contravene the State's internal law – even if under that law, the State was actually bound to act that way.<sup>138</sup>

121. After reading Article 5(1) of the Agreement and interpreting its terms according to the ordinary meaning to be given to them (Article 31(1) of the Vienna Convention), we find no principle stating that regulatory administrative actions are *per se* excluded from the scope of the Agreement, even if they are beneficial to society as a whole —such as environmental protection—, particularly if the negative economic impact of such actions on the financial position of the investor is sufficient to neutralize in full the value, or economic or commercial use of its investment without receiving any compensation whatsoever. It has been stated that:

Expropriatory environmental measures – no matter how laudable and beneficial to society as a whole – are, in this respect, similar to any other expropriatory measures that a state may take in order to implement its policies: where property is expropriated, even for environmental purposes, whether domestic or international, the state's obligation to pay compensation remains.<sup>139</sup>

122. After establishing that regulatory actions and measures will not be initially excluded from the definition of expropriatory acts, in addition to the negative financial impact of such actions or measures, the Arbitral Tribunal will consider, in order to determine if they are to be characterized as expropriatory, whether such actions or measures are proportional to the public interest presumably protected thereby and to the protection legally granted to investments, taking into account that the significance of such impact has a key role upon deciding the proportionality.<sup>140</sup> Although the analysis starts at the due deference owing to

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<sup>137</sup> International Court of Justice, *Elettronica Sicula s.p.a. (ELSI) (United States v. Italy)* case, judgment dated July 20, 1989, ICJ Reports, 1989, 73. ICSID Case No. ARB(AF)/99/1, *Marvin Feldman v. Mexico*, award of December 16, 2002, p.26, 78, [www.naftalaw.org](http://www.naftalaw.org).

<sup>138</sup> J. Crawford, *The International Law Commission's Articles on State Responsibility*, p. 84 (Cambridge University Press, 2002).

<sup>139</sup> Award: *Compañía del Desarrollo de Santa Elena, S.A. v. Republic of Costa Rica*, ICSID case No. ARB/96/1, 15 ICSID Review-Foreign Investment Law Journal, 72, p.192 (2000).

<sup>140</sup> European Court of Human Rights, *In the case of Matos e Silva, Lda., and Others v. Portugal*, judgment of September 16, 1996, 92, p. 19, <http://hudoc.echr.coe.int>.

the State when defining the issues that affect its public policy or the interests of society as a whole, as well as the actions that will be implemented to protect such values, such situation does not prevent the Arbitral Tribunal, without thereby questioning such due deference, from examining the actions of the State in light of Article 5(1) of the Agreement to determine whether such measures are reasonable with respect to their goals, the deprivation of economic rights and the legitimate expectations of who suffered such deprivation. There must be a reasonable relationship of proportionality between the charge or weight imposed to the foreign investor and the aim sought to be realized by any expropriatory measure.<sup>141</sup> To value such charge or weight, it is very important to measure the size of the ownership deprivation caused by the actions of the state and whether such deprivation was compensated or not.<sup>142</sup> On the basis of a number of legal and practical factors, it should be also considered that the foreign investor has a reduced or nil participation in the taking of the decisions that affect it, partly because the investors are not entitled to exercise political rights reserved to the nationals of the State, such as voting for the authorities that will issue the decisions that affect such investors.

The European Court of Human Rights has defined such circumstances as follows:

Not only must a measure depriving a person of his property pursue, on the facts as well as in principle, a legitimate aim « in the public interest », but there must also be a reasonable relationship of proportionality between the means employed and the aim sought to be realised...[...]. The requisite balance will not be found if the person concerned has had to bear “an individual and excessive burden” [...] The Court considers that a measure must be both appropriate for achieving its aim and not disproportionate thereto.<sup>143</sup>

...non-nationals are more vulnerable to domestic legislation: unlike nationals, they will generally have played no part in the election or designation of its authors nor have been consulted on its adoption. Secondly, although a taking of property must always be effected in the public interest, different considerations may apply to nationals and non-nationals and there may well be legitimate reason for requiring nationals to bear a greater burden in the public interest than non-nationals.<sup>144</sup>

The Arbitral Tribunal understands that such statements of the Strasburg Court apply to the actions of the State in its capacity as administrator, not only to its capacity as law-making body.

123. During its operation of the Landfill, Cytrar breached a number of the conditions under which the Permit was issued, which have been referred to above. Such breaches were verified by PROFEPA. In the opinion of the Arbitral Tribunal, these are the breaches to the Permit that triggered the issuance of the Resolution, since those are the breaches on which the Resolution is based and to which it refers. This is the conclusion to be reached under

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<sup>141</sup> European Court of Human Rights, *In the case of Mellacher and Others v. Austria*, judgment of December 19, 1989, 48, p.24; In the case of *Pressos Compañía Naviera and Others v. Belgium*, judgment of November 20, 1995, 38, p. 19, <http://hudoc.echr.coe.int>

<sup>142</sup> It has been stated that: “...on the whole [...] notwithstanding compliance with the public interest requirement, the failure to pay fair compensation would render the deprivation of property inconsistent with the condition of proportionality”, Y. Dinstein, *Deprivation of Property of Foreigners under International Law*, 2 Liber Amicorum Judge Shigeru Oda, p. 849 *et seq.*; esp. p. 868 (2002).

<sup>143</sup> European Court of Human Rights, *In the case of James and Others*, judgment of February 21, 1986, 50, pp.19-20, <http://hudoc.echr.coe.int>

<sup>144</sup> *ibid.*, 63, pp. 24.

Mexican law, according to which administrative decisions must be duly grounded in order to have, among other things, the transparency required so that persons that disagree with such decisions may challenge them through all the available legal remedies.<sup>145</sup> The Resolution has not referred to the events related to the transportation and discharge of the hazardous waste of Alco Pacífico, as they took place under the terms of the permits and authorizations granted by the Mexican authorities, including INE, other than the Permit, and the violations committed by Cytrar in the performance of such activities have not been proved or penalized as infringements to the Permit. Therefore, without prejudice to the possibility of taking into account later on the effects of such events on the political and social considerations taken into account by INE upon issuing the Resolution—such considerations are generally referred to in the Resolution and in INE’s correspondence addressed to Cytrar immediately before such Resolution—the Arbitral Tribunal considers that such infringements, that did not trigger the revocation or termination of the permits under which such transportation and discharge took place and that are not defined in the Permit’s conditions, are not determinants of the Resolution. On the other hand, PROFEPA and SEMARNAP also stated that the violations in the transportation and discharge of the hazardous waste of Alco Pacífico should not be taken into account to determine if the Landfill’s permit should be revoked upon answering a claim to that effect filed by a social group adverse to the Landfill.<sup>146</sup>

124. This Arbitral Tribunal considers that the violations to the Permit mentioned in the Resolution, to the extent they have been verified by PROFEPA or INE under the applicable Mexican law, are issues that the Tribunal does not need to review. However, the Arbitral Tribunal points out that such Resolution does not suggest that the violations compromise public health, impair ecological balance or protection of the environment, or that they may be the reason for a genuine social crisis. Additionally, when PROFEPA verified the existence of such violations in 1999, it applied the pertinent sanctions in the proportion it deemed appropriate to the importance of the violation. The sanction applied was in the form of a fine imposed after evaluating whether a greater or more serious sanction would have been applicable, such as the revocation of the Permit, and underscoring the fact that such violations did not compromise the condition of the environment, the ecological balance or the health of the population. With that, PROFEPA confirmed its statements in the note dated February 11, 1998, sent to Cytrar.<sup>147</sup>

The inspections conducted by this Office to the landfill referred to several times, have not shown [sic in the Spanish original] any indication that risks for the population’s health or the environment might exist.

On various occasions, the Municipality of Hermosillo<sup>148</sup> and the Minister of SEMARNAP, Ms. Julia Carabías Lillo,<sup>149</sup> have insisted that Cytrar’s Landfill operation complies with the

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<sup>145</sup> Declaration of expert witness Alfonso Camacho Gómez, Hearing held from May 20 to May 24, 2002, transcript of May 22, 2002, pp. 36-36 overleaf.

<sup>146</sup> Note signed by PROFEPA and SEMARNAP of December 18, 1997, 44, p. 21; document D93.

<sup>147</sup> Document D101, p. 2.

<sup>148</sup> Communication issued by the Municipality of Hermosillo dated March 26, 1998, document D114; Declaration 300398 issued by the Commission of Public Health of the Municipality of Hermosillo dated April 1998, document D116, Communication Forms of the Municipality of Hermosillo, document D117.

<sup>149</sup> Stenographic transcript of the declaration given by Julia Carabías Lillo in her appearance before the House of Representatives of the Federal Congress on September 10, 1999; pp. 10-11; document A69.

Mexican legal provisions on environmental protection and public health preservation or meets the requirements necessary not to impair the environment or public health. More specifically, in a document dated September 3, 1998,<sup>150</sup> SEMARNAP—which comprises both INE and PROFEPA as autonomous divisions—, on the basis of the statements made by PROFEPA, stated as follows:

...CYTRAR's handles hazardous waste in strict compliance with the law, that the last stage of the landfill has the maximum safety conditions required, which provide the necessary grounds to authorize the relevant operations.

125. In addition to the reference made to the infractions to conditions for the Permit and a brief statement about Cytrar's commitment to relocate, the Resolution does not specify any reasons of public interest, public use or public emergency that may justify it. According to the Respondent's allegations, such reasons would basically be the following:

1. The protection of the environment and public health, and
2. The need to provide a response to the community pressure resulting from the location of the Landfill and Cytrar's violations during the operation, which some groups interpreted as harmful to the environment or the public health and the social unease in Hermosillo originated in these circumstances.

126. One of the factors that undoubtedly underlies such reasons is the location of the Landfill with respect to Hermosillo's urban center. As the Respondent's counsel stated in its oral allegation:

I have stated several times and insisted that the problem was not a problem with a company or with an investor, but with a specific site.<sup>151</sup>

Such declaration does not differ from the statements made by Dr. Cristina Cortinas Nava, INE's General Director of Hazardous Materials, Waste and Activities in this regard:

I insist once again that, for us, the position was: let's come to a close with this site; it is the reason for the conflict. People keep coming to the place to see how it's being operated; they won't even let it operate with all that community pressure. Let's start from scratch in some other place, in the right manner and with all the mechanisms that we think might ensure that this operation could be acceptable for society.<sup>152</sup>

127. Actually, according to the evidence submitted in this arbitration proceeding, it is irrefutable that there were factors other than compliance or non-compliance by Cytrar with the Permit's conditions or the Mexican environmental protection laws and that such factors had a decisive effect in the decision to deny the Permit's renewal. These factors included

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<sup>150</sup> Document A92.

<sup>151</sup> Oral allegation by the Respondent's counsel. Hearing held from May 20 to May 24, 2002. Transcript of the session of May 24, 2002, p. 37 overleaf.

<sup>152</sup> Hearing held from May 20 to May 24, 2002. Transcript of the session of May 21, 2002, p. 78.

“political circumstances”. As stated by Dr. Cristina Cortinas Nava in the official communication sent to Cytrar on October 23, 1998,<sup>153</sup>

It is publicly known that your company has assumed a relocation commitment as to the landfill you operate and that, as you have stated in point seven of the brief dated July, 15, 1998, there are political issues that have to be taken into account to render a resolution as to the renewal of the operation permit and an increase in the landfill capacity. Therefore, we suggest that you contact the authorities of the State and of the Municipality to define the steps to be followed to relocate the landfill.

In its note dated July 15, 1998, addressed to INE, Cytrar requests that INE issue its decision on Cytrar’s application for an increase in the landfill capacity according to the alternatives that Cytrar had presented to INE while

....the actions to be taken are defined on the basis of the political events affecting Cytrar (relocation)...<sup>154</sup>

128. Therefore the Arbitral Tribunal has to evaluate, pursuant to Article 5(1) of the Agreement and from the perspective of international law, the extent to which such political circumstances —that in the opinion of the Arbitral Tribunal, on the basis of the evidence submitted, do not seem to go beyond the circumstances arising from community pressure— are the basis of the Resolution, in order to assess whether the Resolution is proportional to such circumstances and to other circumstances, and to the neutralization of the economic and commercial value of the Claimant’s investment caused by the Resolution.

129. These socio-political circumstances are the reason why INE has considered the renewal of the Permit as an “exceptional case”. As a consequence, INE, instead of deciding by itself —as it was empowered by law— as to the Permit’s renewal on the basis of considerations exclusively related to INE’s specific function linked to the protection of the environment, ecological balance and public health, it consulted with the mayor of the Municipality of Hermosillo and the Governor of the State of Sonora as to Cytrar’s requests related to the expansion of cell N° 2 and the construction of cell N° 3 in the Landfill.<sup>155</sup> The only conclusion possible is that such consultation or inquiries were driven by INE’s socio-political concerns, since it is not in dispute that INE and PROFEPA were the only entities legally authorized and technically competent to have a role in issues in which public health and the protection of the environment in connection with the Landfill were involved. None of the parties to which INE makes the inquiry expresses concerns as to the danger that the Landfill may pose to public health, ecological balance or the environment. To the contrary, their concerns are to ensure the relocation of the Landfill to a different site far away from Hermosillo, the immediate closing of the Landfill and, after depleting its authorized and installed capacity, the prohibition to grant new permits to confine hazardous waste at the Las Víboras site;<sup>156</sup> i.e. to put an end to the political problems —defined as “community

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<sup>153</sup> Document A51.

<sup>154</sup> Document A50.

<sup>155</sup> Hearing held from May 20 to May 24, 2002. Declaration of Dr. Cristina Cortinas Nava, transcript of the session of May 21, 2002, pp. 70 overleaf /71.

<sup>156</sup> Note of November 18, 1998, of the Mayor of the Municipality of Hermosillo to INE’s President, document D157.

pressure”— caused by the Landfill to the federal, state and municipal authorities, by permanently closing the Landfill.

130. The INE’s General Director of Hazardous Materials, Waste and Activities, Dr. Cristina Cortinas Nava, sustains the political or social factor “...was one of the factors involved but not the main factor...”,<sup>157</sup> and to the question of whether the influence on the Resolution of the unauthorized expansion of cell no. 2 was “strong, small, insignificant, decisive”, the answer was “I would say it was important”.<sup>158</sup> However, in fact, the absence of any statement in the Resolution and in the opinions rendered by the municipal and state officers consulted by INE prior to issuing the Resolution about these or the other infringements committed by Cytrar and mentioned in the Resolution being infringements seriously or imminently affecting public health, ecological balance or the environment, together with the confirmation by PROFEPA that such infringements did not pose such dangers, reveal that the Resolution was mainly driven by socio-political factors. Even the significance awarded by INE to the technical infringements committed during the operation of the Landfill, on which the Resolution is based, and therefore the relative relevance awarded by INE to such factors upon issuing the Resolution, were actually strongly influenced by the community pressure and the political consequences faced by INE since municipal and state authorities and opposing community associations interpreted the expansion of the Landfill and any other action intended to expand the Landfill capacity as a signal that such facility would not be relocated and that the Las Víboras site, close to Hermosillo’s urban center, would continue to be a hazardous waste landfill site in violation of existing rules and regulations.<sup>159</sup> Indeed, Dr. Cristina Cortinas Nava considered that continuation by Cytrar of the expansion of cell no. 2 did not create current or future hazards for the protection of the environment or public health; she considered that such expansion increased INE’s difficulties to manage community pressure and the related political consequences adverse to the Landfill:

..... as I had issued no written resolution authorizing the expansion of the cell, the fact that [Cytrar] commenced to expand the cell was a concern to me and I took it as evidence that the company was doing things before obtaining the permit it had applied for [...] I took that into account as one of the elements, but I insist: the circumstance that the company had not helped me create trust among local authorities as it expanded the cells without any authorization, whether issued by me or local authorities, was included among such elements...<sup>160</sup>

131. This item has been confirmed by the importance attributed to the relocation of Cytrar’s operations to a site different from the Landfill. Such importance was actually motivated by the community’s opposition to the Landfill’s existing site and was not related to the fact that Cytrar’s operations in the site or the site’s appropriateness<sup>161</sup> or the way in which the Landfill was operated—as the municipal and state authorities and PROFEPA themselves

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<sup>157</sup> Hearing held from May 20 to May 24, 2002. Declaration of Dr. Cristina Cortinas Nava, transcript of the session of May 21, 2002, pp. 71, overleaf.

<sup>158</sup> *Ibid.*, p. 80.

<sup>159</sup> *Ibid.*, p.82 overleaf.

<sup>160</sup> *Ibid.*, p.82 overleaf.

<sup>161</sup> *Ibid.*, p.90 overleaf. “Because our interest was to recover the infrastructure that had already been created, and, as I have always held and still believe today, those premises were necessary for this State, they were located at the right site and, with an environmentally safe handling of hazardous waste; it was a good option”.

admitted— entailed a risk for the environment or for the public health. The Landfill's still unresolved relocation, which, according to Dr. Cristina Cortinas Nava, was one of the motivations for the Resolution in that denying the renewal of the Permit —thus preventing Cytrar from operating the Landfill— was a strategy to put pressure on Cytrar to relocate, was then one of the factors that were closely related to the social and political tense circumstances surrounding the Landfill and its operation. INE thought it would placate such tensions by denying the renewal of the Permit instead of keeping the preservation of public health, ecological balance or the environment in mind.<sup>162</sup>

132. To sum up, the reasons that prevailed in INE's decision to deny the renewal of the Permit were reasons related to the social or political circumstances and the pressure exerted on municipal and state authorities and even on INE itself created by such circumstances. It will be necessary, then, for the purpose of establishing whether the Respondent breached Article 5(1) of the Agreement, to evaluate such reasons as a whole to determine whether the Resolution is proportional to the deprivation of rights sustained by Cytrar and with the negative economic impact on the Claimant arising from such deprivation.

133. There is no doubt as to the existence of community or political pressure —as both Parties have acknowledged and as made public by the local mass media and shown by the evidence submitted in these arbitral proceedings— against the Landfill. However, a substantial portion of the community opposition is based on objective situations that are beyond Cytrar or Tecmed's control or even beyond the Claimant's control. On the other hand, the Arbitral Tribunal should consider whether community pressure and its consequences, which presumably gave rise to the government action qualified as expropriatory by the Claimant, were so great as to lead to a serious emergency situation, social crisis or public unrest, in addition to the economic impact of such a government action, which in this case deprived the foreign investor of its investment with no compensation whatsoever. These factors must be weighed when trying to assess the proportionality of the action adopted with respect to the purpose pursued by such measure.

134. As highlighted before, the events related to the transportation and discharge of hazardous waste from Alco Pacífico belong to an operation safeguarded by legal instruments, licenses and permits that are different from the ones governing the Landfill. Therefore, any infringement or sanction imposed in connection with operations covered by such instruments, licenses and permits may not be regarded as infringements committed or sanctions imposed under the Permit or the legal provisions applicable to the activities specifically contemplated by such Permit. For that very same reason, any violation to such transport operation could not be part of the Resolution's grounds as the Resolution is based exclusively on violations to the legal provisions applicable to the activities covered by the Permit. However —as both Parties have admitted— the negative attitude that some social groups had with respect to the Landfill was taken as a result of the events related to the waste transportation from Alco Pacífico. Consequently, upon an overall examination of the impact of socio-political factors on the Resolution, such adverse attitude should be considered together with the real weight it had.

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<sup>162</sup> Hearing held from May 20 to May 24, 2002. Declaration of Dr. Cristina Cortinas Nava, transcript of the session of May 21, 2002, pp. 72 overleaf-73, 75 oveleaf-76.



135. Actually, the negative reactions to the transportation of waste from Alco Pacífico to Hermosillo became apparent even before PROFEPA verified that Cytrar had committed certain violations when carrying out this operation. In the Respondent's words:

The landfill of Alco Pacífico's waste in Sonora generated reactions almost immediately. On January 14, 1997, a local newspaper published an article stating that Cytrar would confine imported hazardous waste that had been abandoned in Alco Pacífico's premises [...]. On March 7, 1997, another article was published about the landfill of Alco Pacífico's hazardous waste in Sonora. On March 9, 1997, Manuel Llano Ortega, an engineer and a resident of Hermosillo, requested that the State Governor provide a response to the community's concerns about the landfill of Alco Pacífico's waste [...]. On May 2, 1997, Sonora's Human Rights Academy filed a complaint against SEMARNAP, PROFEPA, the State Legislature and the State Governor. It held that the authorities had violated the State's sovereignty by authorizing the deposit of toxic waste from Baja California without the relevant permit by the competent local authorities. On May 15, 1997, the same association filed a complaint before the National Commission of Human Rights.<sup>163</sup>

136. Thus, community opposition to Cytrar's activities of transportation and discharge of Alco Pacífico's waste must be analyzed in light of the initial opposition shown by some citizens or associations to the decision of PROFEPA—which hired the transportation to Hermosillo of such waste with Cytrar—and INE—which granted the relevant permits for Cytrar to undertake such transportation activities—<sup>164</sup> as to whether such waste could be confined in Hermosillo. Undoubtedly, the Mexican authorities opted to choose or accept Hermosillo, Sonora, as the appropriate site for the landfill of Alco Pacífico's waste and they were responsible for that decision. The criticism by groups from Sonora on Cytrar's management of Alco Pacífico's waste transportation cannot be separated from such groups' repudiation of the authorities' decision to transport the waste from Alco Pacífico to Hermosillo, Sonora, to have it confined there, and at the same time such criticism was the evident expression of such repudiation. And it is not possible to state that it was Cytrar's management of such transportation activities, and not the previous decision of the authorities to have Alco Pacífico's waste confined in Hermosillo, the determinant of community opposition.

137. The truth is that PROFEPA did not choose the early termination of the agreement entered into with Cytrar because of community opposition; and under no circumstance did INE cancel or otherwise remove Cytrar's permit for the transportation or discharge of Alco Pacífico's waste. The infringements or irregularities found by PROFEPA in connection with these operations triggered the imposition of fines on Cytrar or brought about orders to amend its manner of operation, but apparently they did not originate any recommendation or action by PROFEPA for the cancellation of the permit or the termination of the agreement under which Cytrar operated. Neither Cytrar's shortcomings as to Alco Pacífico's waste transportation nor the community opposition that such transportation brought about seem to have originated emergency situations, genuine social crisis or public unrest or urgency, which, due to their severity, could have led the competent authorities to terminate the contractual relationship governing the transport operation or to revoke or

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<sup>163</sup> Counter-memorial, pp. 44-45; 164 *et. seq.*

<sup>164</sup> INE's permit of January 23, 1997 for the transportation and discharge of waste from Alco Pacífico. Clause 11 (p. 3), (document D65) of this permit also allowed for the termination of the permit in the event of justified complaints or risk to the environment or to human life.

deny the renewal of the licenses or permits under which such transport operation was carried out. Upon the termination of Alco Pacífico's waste transportation agreement with Cytrar, PROFEPA did not make note of any breach or obligation under such agreement. Although in one of the provisions of the minutes evidencing the cessation of Cytrar's services under the agreement PROFEPA reserved its right to subsequently hold Cytrar liable "... for any hidden defects or non-performance and non-fulfillment of its obligations...",<sup>165</sup> no evidence has been brought forth to indicate that PROFEPA has enforced that right against Cytrar. There is no evidence that during the effective term of the agreement any actions against Cytrar were filed by the other parties to the contract for breach, whether seeking to terminate the contract on sufficient grounds as authorized by its clause 6,<sup>166</sup> to interrupt payments owed under the contract or to seek any other type of redress or compensation for breach of contract. There is no evidence either that Fomín, the company that under clause 5-D (p. 5) of such agreement was responsible for the supervision of Cytrar's services provided under the agreement, made any reservations, negative remarks or warnings about Cytrar's performance of its contractual obligations during the effective term of the agreement.

138. Therefore, if the level of opposition generated by the transportation and discharge by Cytrar of Alco Pacífico's waste did not trigger any decisive action by the competent federal authorities, including PROFEPA —such as revocation of the relevant permits or authorizations, the commencement of legal actions or the early termination of the agreement— to put an end to such activities and if such opposition is not of the essence in the Resolution, it is not appropriate to attribute any considerable significance to it upon taking into account and weighing factors to determine if the Resolution *per se* amounts to a violation of the Agreement.

139. Those events —not related to the transportation and discharge of Alco Pacifico's waste by Cytrar— which constitute material evidence of the opposition put up by community entities and associations to the Landfill or its operation by Cytrar, do not give rise, in the opinion of the Arbitral Tribunal, to a serious urgent situation, crisis, need or social emergency that, weighed against the deprivation or neutralization of the economic or commercial value of the Claimant's investment, permits reaching the conclusion that the Resolution did not amount to an expropriation under the Agreement and international law.

140. First of all, such opposition was mainly based —as recognized by the Respondent itself— on the site's proximity to Hermosillo's urban center and on the circumstance, not attributable to Cytrar, that the site's location violated the applicable Mexican regulations —i.e. NOM-055-ECOL-1993 issued by INE—,<sup>167</sup> a circumstance that was certainly known by Promotora upon selling the Landfill's assets to Cytrar and also by INE upon granting the different permits to operate the Landfill. As expressed by the Respondent, the Landfill's proximity to Hermosillo's urban center, and not concrete evidence that the Landfill's operation is harmful for the environment or public health, is the issue that concentrates the opposition of the groups that are against the Landfill. Therefore, since such groups could not obtain the Permit's revocation due to the lack of such evidence —as explained to them

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<sup>165</sup> Document A76: Minutes executed by PROFEPA, Cytrar and Fomin on July 6, 1999. Provision 11.

<sup>166</sup> Agreement dated November 19, 1996, p. 6, document D64.

<sup>167</sup> Counter-memorial, 33, p. 9

by INE and the municipal authorities— their ultimate goal was to close down the Landfill and make Cytrar relocate its operations. SEMARNAP, INE, and the authorities of the Municipality and of the State of Sonora finally agreed with these objectives.

141. Tecmed and Cytrar were certainly aware of the existence of those regulations, but it is clear that those regulations did not apply to the Landfill, since when the Landfill was designed and built and specific technical procedures governing the Landfill's operation were established, such regulations were not effective and their application could not be retroactive, as confirmed by a note from PROFEPA to Cytrar.<sup>168</sup> Therefore, at the time the investment was made, Cytrar and Tecmed had no reason to doubt the lawfulness of the Landfill's location, regardless of the social and political pressure that appeared subsequently. These companies were not negligent upon analyzing the legal issues related to the Landfill's location.

142. As a result of the community pressure it ran into, Cytrar also agreed that the relocation—actively sought by the municipal and state authorities and by SEMARNAP— should take place. However, Cytrar conditioned the relocation, as was obviously to be expected from any operator of an on going business, to being able to transfer its activities to a new site. The minimum requirements for the relocation were the identification of the site, the completion of the studies to prove the site's adequacy for the landfill of hazardous waste, the acquisition of the site and the granting of the relevant authorizations and permits required to operate a hazardous waste landfill prior to closing down the Las Víboras site. As time went by, due to the growing pressure arising from the above-mentioned events and from the Mexican federal, state and municipal authorities, Cytrar or Tecmed agreed to assume a substantial portion of the cost of the acquisition and start-up of the new site as a hazardous waste landfill and of the cost of transferring the waste confined at the Las Víboras site to the new landfill site. The Mexican authorities were to find the site and issue the relevant permits, and they focused the search on the state of Sonora. An institution from Sonora, IMADES (Sonora's Environmental and Sustainable Development Institute) was in charge to look for the site. The evidence submitted has not proved that Cytrar breached, or had the intention to breach, any of its relocation commitments. In addition, there is not proof, and no evidence has been submitted, that the federal or state authorities or IMADES sent any notice to Cytrar or Tecmed demanding compliance with their relocation commitment to a concrete site identified by such authorities with or without the consent of Cytrar. Evidence is only available as to a number of sites identified by the state and federal authorities in the Municipality of Benjamín Hill which, in principle, were fit for the relocation of the Landfill, subject to the related studies. Cytrar agreed that the sites identified in such place were fit for the Landfill<sup>169</sup>. However, for reasons that, based on the evidence available, cannot be attributed to Cytrar, the relocation did not take place at such time or subsequently within that Municipality. Reportedly, such reasons were the community pressures that Mexican authorities did not deem advisable to contradict.<sup>170</sup>

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<sup>168</sup> Note dated February 11, 1998. document D101.

<sup>169</sup> Counter-memorial, 270, p. 75.

<sup>170</sup> Opposition to the Landfill's relocation to Benjamín Hill, reportedly coming from the same groups that also opposed to the Las Víboras Landfill, continued even after the Resolution was issued, as shown by the journalistic evidence submitted: readers' opinions and articles published in Hermosillo newspaper *El Imparcial*, dated March 30, April 23, and May 4, 1999; letter from an environmental activist, Francisco

143. The evidence submitted does not lead to concluding that Cytrar's petitions to expand cell N° 2 of the Landfill were actually a surreptitious way to postpone the relocation in order to continue operating the Landfill for the longest time possible, rather than a way to pursue an alternative solution to operating needs until the relocation was effective. In Cytrar's note to INE dated July 15, 1998,<sup>171</sup> in which Cytrar states the need to increase the Landfill's volume capacity by expanding cell N° 2, Cytrar expressly relates such increase to the time required to continue operating the Landfill for a year, which was necessary for the relocation. That was precisely the minimum term estimated for that purpose by the Municipality of Hermosillo. INE never denied that that was the appropriate term to relocate nor did it state that the proposed additional landfill capacity was excessive compared to the Landfill's proposed additional term for operation by Cytrar until relocation or that it may have had the purpose of prolonging the Landfill's exploitation for a period longer than necessary –or indefinitely– to achieve such relocation. If the construction of cell N° 3 — the authorization of which was also requested by Cytrar to INE “only in the event relocation was not completed after expanded cell N° 2 was full”<sup>172</sup>— meant giving Cytrar landfill capacity at the Las Víboras site for a term longer than necessary to relocate, it would have been enough for INE to refuse to grant such authorization in order to dissuade Cytrar from delaying the relocation and it would not have been necessary for that purpose to dismiss the application for renewal of the Permit. INE, by itself or in association with IMADES, the Government of Sonora or the Municipality of Hermosillo, did not respond to the proposal included in the note dated July 15, 1998, with any other counter-offer. Until a few days before the Resolution, both Cytrar and Tecmed reaffirmed, through communications dated November 9, 12 and 17, 1998, their commitment to relocate the Landfill to any of the areas identified by the Mexican authorities and to bear the most significant costs associated with the relocation, including any costs related to the

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Pavlovich, published in *El Imparcial* on April 16, 1999, (Press Dossier (I) exhibit A70). The same happened in connection with other places or sites located in Sonora according to the press information submitted by IMADES: note published in *El Imparcial* on March 25, 1999, about the towns of Carbó and Guaymas; notes published in *El Imparcial* on March 4 and April 15, 1999, about the town of Carbó, article published in *El Imparcial* on November 6, 1998 about the Agua Blanca site located in Benjamín Hill) (Press Dossier (I) exhibit A70). The approval by the Municipality of Benjamín Hill and the Mayor of this Municipality to commence the studies related to the identification of the site and the preliminary contract of sale of «El Pinito», a plot located in this Municipality, occurred in April 1999, i.e. quite a long time after the date of the Resolution. Such actions continue to be preparatory acts that have apparently not been implemented through concrete decisions or relocation proposals made by the authorities: Counter-memorial, 337, p. 96. On the other hand, according to the article published in *El Imparcial* on May 4, 1999, mentioned above, as well as to the article published in such newspaper on April 15, 1999, related to the construction of a landfill in “El Pinito”, despite the resolutions of the authorities of Benjamín Hill, the community opposition to the relocation of the Landfill to that town continues and the issue does not seem to be definitively resolved. It is striking that as of February 22, 2000, almost a year later, the identification studies to determine whether that site would be definitely chosen by the authorities as a place fit for the relocation of the Landfill (letter of the Government of Sonora to Dra. Cristina Cortinas de Nava dated February 22, 2000, document D165) are still pending. In April 1999, IMADES had referred to another site located in Benjamín Hill, called “El Tilico”. IMADES had reportedly obtained the permit of the authorities of such Municipality to construct the landfill (article published in *El Imparcial* on April 16, 1999, Press Dossier (I), exhibit A70). However, it seems that the authorities never carried this out.

<sup>171</sup> Document A50, 7.

<sup>172</sup> Cytrar's note to INE dated November 16, 1998, 5, p. 2, document A54.

construction of the new premises in the new site and the payment of part of the purchase price of the land.<sup>173</sup> INE and the Mexican authorities involved in the relocation arrangements did not indicate, in view of this statement and before the Resolution was issued, any site for such commitment, nor did they challenge Cytrar's technical, economic or operational capacity to fulfill its relocation commitment and operate in the new site under conditions that would guarantee the protection of the environment and the preservation of public health. The fact that such capacities were not controversial is confirmed by the fact that Cytrar and Tecmed continued negotiating to relocate the Landfill even after the Permit's renewal had been denied, at least during January 2000.<sup>174</sup>

144. Finally, the Respondent has not presented any evidence that community opposition to the Landfill —however intense, aggressive and sustained— was in any way massive or went any further than the positions assumed by some individuals or the members of some groups that were opposed to the Landfill. Even after having gained substantial momentum, community opposition, although it had been sustained by its advocates through an insistent, active and continuous public campaign in the mass media, could gather on two occasions a crowd of only two hundred people the first time and of four hundred people, the second time out of a community with a population of almost one million inhabitants, "... which makes it the city with the highest population in the state of Sonora".<sup>175</sup> Additionally, the "blockage" of the Landfill was carried out by small groups of no more than forty people.<sup>176</sup> The absence of any evidence that the operation of the Landfill was a real or potential threat to the environment or to the public health, coupled with the absence of massive opposition, limits "community pressure" to a series of events, which, although they amount to significant pressure on the Mexican authorities, do not constitute a real crisis or disaster of great proportions, triggered by acts or omissions committed by the foreign investor or its affiliates.

145. The fact that the real problem was the site of the Landfill and not the manner in which the Landfill was operated by Cytrar is confirmed by the fact that the Mexican federal, state and municipal authorities, including INE, did not hesitate to entrust Cytrar with the construction and operation of a new hazardous waste landfill located outside Hermosillo, with characteristics, activities and a scope apparently wider and more ambitious than the operation in Las Víboras. If these authorities had considered that Cytrar was not a suitable company to operate the Landfill in a prudent and responsible manner, and under technical conditions that ensured the protection of the environment, ecological balance and the health of the population, these authorities could not have agreed to —or even proposed— Cytrar's relocation, in good faith and without committing a breach of their obligations. That would entail the possible and almost certain risk that Cytrar's unscrupulous and careless

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<sup>173</sup> Counter-memorial, pp. 85, 304. Cytrar's note to the President of INE, dated November 9, 1998, document D94; Tecmed's notes dated November 12, 1998 sent to the Governor of Sonora, document D149 and to the Minister of SEMARNAP, Ms. Julia Carabias Lillo, document D150; Tecmed's note dated November 17, 1998 sent to the Director of INE, Ms. Cristina Cortinas Nava, document D154.

<sup>174</sup> Counter-memorial, p. 96, 337.

<sup>175</sup> Counter-memorial, p. 15, 54.

<sup>176</sup> Hearing held from May 20 to May 24, 2002. Transcript of the session of May 20, 2002. Declaration of Javier Polanco Lavín, pp 33 overleaf, 35, 42-43; transcript of the session of May 21, 2002, declaration of José María Zapatero Vaquero, p. 57 overleaf.

action, allegedly lacking meticulousness in public relations management or in the relationship with the people, would lead to new expressions of condemnation in addition to the predictable damage to the environment and public health. This confirms that it was political pressure mainly revolving around the physical location of the site rather than a condemnation of major consequences expressed by the community or a situation originating a serious social emergency due to Cytrar's behavior that motivated the refusal to renew the Permit.

146. The situation described above is not comparable to the situation that led to the case *Elettronica Sicula S.p.A.(Elsi)*, invoked by the Respondent.<sup>177</sup> First, the decision of the Mayor of Palermo, which brought about the US claim against Italy filed before the International Court of Justice<sup>178</sup> upon ordering that the foreign investor's plant be requisitioned, is expressly based on —and the preambular clauses thereof refer to— a serious emergency and social crisis related to the closing of the plant located in Palermo, Italy (the closing down of an important job source —the second one in significance of the district— with the consequent dismissal of around one thousand workers and negative consequences on the same number of families and the Palermo community in general, which added to the suffering caused by the earthquakes that had occurred in the area a few months before).<sup>179</sup> This emergency was also recognized by the Palermo courts in terms of significant public hardship related to the plant's closing and of the unexpected urgent need to adopt measures to alleviate the crisis.<sup>180</sup> Second, the closing and mass firing of workers were directly attributable to the decision of the controlling shareholders of the company that owned the plant —i.e. the foreign investors— not to make new capital contributions or to execute the necessary bonds as security to obtain financial resources that would allow the company to stay in business.<sup>181</sup>

147. In this case, there are no similar or comparable circumstances of emergency, no serious social situation, nor any urgency related to such situations, in addition to the fact that the Mexican courts have not identified any crisis. The actions undertaken by the authorities to face these socio-political difficulties, where these difficulties do not have serious emergency or public hardship connotations, or wide-ranging and serious consequences, may not be considered from the standpoint of the Agreement or international law to be sufficient justification to deprive the foreign investor of its investment with no compensation, particularly if it has not been proved that Cytrar or Tecmed's behavior has been the determinant of the political pressure or the demonstrations that led to such deprivation, which underlie the Resolution and conclusively conditioned it. On the contrary, the commitment by such companies to relocate the Las Víboras operation to a different site, although immediately motivated in the deeply reasonable —though non-altruistic— concern of being able to continue with the commercial exploitation they were engaged in makes it clear that, objectively, such commitment was intended to make a positive contribution to mitigate the socio-political pressure and to continue providing

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<sup>177</sup> E.g., see p. 127, 452, Counter-memorial.

<sup>178</sup> Case *Elettronica Sicula S.p.A (ELSI) (United States of America v. Italy)*, July 20, 1989, ICJ Reports, 1989.

<sup>179</sup> *Ibid.* 30, pp. 21-22

<sup>180</sup> *Ibid.* 75, pp. 40-41

<sup>181</sup> *Ibid.* 17, p. 14

Mexico with hazardous waste landfill services from a new site. It should be underscored that, as argued in these arbitration proceedings, Mexico urgently needs these services due to a serious lack thereof.

148. Another factor should be added: Cytrar's operation of the Landfill never compromised the ecological balance, the protection of the environment or the health of the people, and all the infringements committed were either remediable or remediated or subject to minor penalties. The Resolution not only terminates the Permit, but also resolves to permanently close down the site at Las Víboras, and such circumstance irrefutably confirms that the problem concerned the location of the Landfill rather than Cytrar's operation of it. This is so, as such closing means that the Landfill may not be operated by Cytrar or by anyone else, even if it complied with INE's requirements as to the expansion of cell N° 2, the prohibition to act as a transfer center or the requirements as to the type of waste to be confined or the temporary storage of such hazardous waste or any other action on which the Resolution was based. Such an extreme measure, the effects of which will have a permanent impact on the future, in view of the fact that the violations did not give rise to irreparable deficiencies in the operation of the Landfill, shows that INE concluded that the Permit granted to Cytrar should not be renewed and also that from then on nobody should be authorized to operate a hazardous waste landfill at the Las Víboras site, even if it was an operator whose behavior was so flawless that it could not give rise even to minor faults. Such conclusion was consistent with the requests of the Municipality of Hermosillo and the authorities of the state of Sonora with whom INE consulted.

149. While the Resolution is based on some of these violations to deny the renewal of the Permit, apparently through a literal and strict interpretation of the conditions under which the Permit was granted,<sup>182</sup> it would be excessively formalistic, in light of the above considerations, the Agreement and international law, to understand that the Resolution is proportional to such violations when such infringements do not pose a present or imminent risk to the ecological balance or to people's health, and the Resolution, without providing for the payment of compensation as required by Article 5 of the Agreement, leads to the neutralization of the investment's economic and business value and the Claimant's return on investment and profitability expectations upon making the investment. The Arbitral Tribunal does not agree with the Respondent's position denying that upon making its investment, the Claimant had legitimate reasons to believe that the operation of the Landfill would extend over the long term.<sup>183</sup> The political and social circumstances referred to above, which conclusively conditioned the issuance of the Resolution, were shown with all their magnitude after a substantial part of the investment had been made and could not have reasonably been foreseen by the Claimant with the scope, effects and consequences that those circumstances had. There is no doubt that, even if Cytrar did not have an indefinite permit but a permit renewable every year, the Claimant's expectation was that of a long-term investment relying on the recovery of its investment and the estimated return through the operation of the Landfill during its entire useful life.

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<sup>182</sup> Counter-memorial, 314 *et. seq.*, pp. 87-93; 489, p.143

<sup>183</sup> Closing statement of the Respondent's counsel, 124-126, pp. 65-66

150. Such circumstances are also included in the bid offer submitted by Tecmed under the bidding auction of the assets related to the Landfill, where it states that the investment will be applied for the benefit of the “...industries of the state of Sonora in the short, medium and long terms, and that to that effect no policies that might deplete the full capacity of the Landfill in the short term will be adopted...”, and that “...Cytrar will increase its role as a regional plant, self-limiting its annual volume of waste acceptance from extra-regional sources to the level required to maintain a minimum profitability level ...”.<sup>184</sup> In view of the above, it is clear the Cytrar would not have an operation level to reach a break-even point and obtain the expected rate of return in a short time. INE could not be unaware of this and of the need to act in line with such expectations to avoid rendering unfeasible any private investment of the scale required to confine hazardous waste in the United Mexican States under acceptable technical operating conditions. Both the authorization to operate as a landfill, dated May 1994, and the subsequent permits granted by INE, including the Permit, were based on the Environmental Impact Declaration of 1994, which projected a useful life of ten years for the Landfill.<sup>185</sup> This shows that even before the Claimant made its investment, it was widely known that the investor expected its investments in the Landfill to last for a long term and that it took this into account to estimate the time and business required to recover such investment and obtain the expected return upon making its tender offer for the acquisition of the assets related to the Landfill. To evaluate if the actions attributable to the Respondent —as well as the Resolution— violate the Agreement, such expectations should be considered legitimate and should be evaluated in light of the Agreement and of international law.

151. Based on the above; and furthermore considering that INE’s actions (an entity of the United Mexican States “...in charge of designing Mexican ecological and environmental policy and of concentrating the issuance of all environmental regulations and standards”)<sup>186</sup> are attributable to the Respondent under international law<sup>187</sup> and have caused damage to the Claimant, and the fact that the claim related to the violation of Article 5(1) of the Agreement attributable to the Respondent is admissible under Title II(5) of its Appendix because the date of the damage and the date on which the Claimant should have become aware of the alleged violation of Article 5(1) of the Agreement is the date of the expropriatory act —i.e. the Resolution— subsequent to the entry into force of the Agreement but always within three years before the date the request for arbitration was filed,<sup>188</sup> the Arbitral Tribunal finds and resolves that the Resolution and its effects amount to an expropriation in violation of Article 5 of the Agreement and international law.

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<sup>184</sup> Tecmed’s tender offer, Sections 1.1.1; 1.1.2, document A17.

<sup>185</sup> Document D21, 51, p. 33. Counter-memorial, 43, p. 13.

<sup>186</sup> Counter-memorial, p. 2, 11.

<sup>187</sup> J. Crawford, *The International Law Commission’s Articles on State Responsibility*, 94-99 (Cambridge University Press, 2002).

<sup>188</sup> According to the certificate of registration issued on August 28, 2002, by the ICSID Interim Secretary-General, the Claimant’s notice to commence this arbitration was received by the ICSID Secretariat on August 7, 2000. The three-year term established in Title II(5) of the Appendix to the Agreement, within which the Claimant became aware or should have become aware of the alleged violations of the Agreement on which its claims are based and of the related damage, is the period commencing on August 7 1997, and ending on August 7, 2000.



## II. Fair and Equitable Treatment

### 152. According to Article 4(1) of the Agreement:

Each Contracting Party will guarantee in its territory fair and equitable treatment, according to International Law, for the investments made by investors of the other Contracting Party.

153. The Arbitral Tribunal finds that the commitment of fair and equitable treatment included in Article 4(1) of the Agreement is an expression and part of the *bona fide* principle recognized in international law,<sup>189</sup> although bad faith from the State is not required for its violation:

To the modern eye, what is unfair or inequitable need not equate with the outrageous or the egregious. In particular, a State may treat foreign investment unfairly and inequitably without necessarily acting in bad faith.<sup>190</sup>

154. The Arbitral Tribunal considers that this provision of the Agreement, in light of the good faith principle established by international law, requires the Contracting Parties to provide to international investments treatment that does not affect the basic expectations that were taken into account by the foreign investor to make the investment. The foreign investor expects the host State to act in a consistent manner, free from ambiguity and totally transparently in its relations with the foreign investor, so that it may know beforehand any and all rules and regulations that will govern its investments, as well as the goals of the relevant policies and administrative practices or directives, to be able to plan its investment and comply with such regulations. Any and all State actions conforming to such criteria should relate not only to the guidelines, directives or requirements issued, or the resolutions approved thereunder, but also to the goals underlying such regulations. The foreign investor also expects the host State to act consistently, i.e. without arbitrarily revoking any preexisting decisions or permits issued by the State that were relied upon by the investor to assume its commitments as well as to plan and launch its commercial and business activities. The investor also expects the State to use the legal instruments that govern the actions of the investor or the investment in conformity with the function usually assigned to such instruments, and not to deprive the investor of its investment without the required compensation. In fact, failure by the host State to comply with such pattern of conduct with respect to the foreign investor or its investments affects the investor's ability to measure the treatment and protection awarded by the host State and to determine whether the actions of the host State conform to the fair and equitable treatment principle. Therefore, compliance by the host State with such pattern of conduct is closely related to the above-mentioned principle, to the actual chances of enforcing such principle, and to excluding the possibility that state action be characterized as arbitrary; i.e. as presenting insufficiencies that would

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<sup>189</sup> I. Brownlie, *Principles of Public International Law*, Oxford, 5<sup>th</sup>. Edition (1989), p. 19. It is understood that the fair and equitable treatment principle included in international agreements for the protection of foreign investments expresses "...the international law requirements of due process, economic rights, obligations of good faith and natural justice": arbitration case *S.D. Myers, Inc.v. Government of Canada*, partial award of November 13, 2000; 134, p. 29 ; [www.naftalaw.org](http://www.naftalaw.org).

<sup>190</sup> ICSID Arbitration no. ARB(AF)/99/2, *Mondev International Ltd v United States of America*, p.40, 116, October 11, 2002, [www.naftalaw.org](http://www.naftalaw.org).

be recognized “...by any reasonable and impartial man,”<sup>191</sup> or, although not in violation of specific regulations, as being contrary to the law because:

...(it) shocks, or at least surprises, a sense of juridical propriety.<sup>192</sup>

155. The Arbitral Tribunal understands that the scope of the undertaking of fair and equitable treatment under Article 4(1) of the Agreement described above is that resulting from an autonomous interpretation, taking into account the text of Article 4(1) of the Agreement according to its ordinary meaning (Article 31(1) of the Vienna Convention), or from international law and the good faith principle, on the basis of which the scope of the obligation assumed under the Agreement and the actions related to compliance therewith are to be assessed.

156. If the above were not its intended scope, Article 4(1) of the Agreement would be deprived of any semantic content or practical utility of its own, which would surely be against the intention of the Contracting Parties upon executing and ratifying the Agreement since, by including this provision in the Agreement, the parties intended to strengthen and increase the security and trust of foreign investors that invest in the member States, thus maximizing the use of the economic resources of each Contracting Party by facilitating the economic contributions of their economic operators. This is the goal of such undertaking in light of the Agreement’s preambular paragraphs which express the will and intention of the member States to “...intensify economic cooperation for the benefit of both countries...” and the resolve of the member States, within such framework, “....to create favorable conditions for investments made by each of the Contracting Parties in the territory of the other ...”.

157. Upon making its investment, the fair expectations of the Claimant were that the Mexican laws applicable to such investment, as well as the supervision, control, prevention and punitive powers granted to the authorities in charge of managing such system, would be used for the purpose of assuring compliance with environmental protection, human health and ecological balance goals underlying such laws.

158. The evidence submitted reveals that when the authorities of the Municipality of Hermosillo, in the state of Sonora, of SEMARNAP and INE, perceived that the political problems mentioned above, closely related to the community opposition already described, made it necessary to relocate Cytrar’s activities in the Landfill to a place outside Hermosillo, Cytrar, with Tecmed’s support, agreed that its publicly known relocation proposal would become a commitment of Cytrar and of the Mexican federal, state and municipal authorities. Such evidence also shows that although Cytrar accepted or agreed to such relocation, it made it conditional upon having a new site to carry out its technical and business activities and that it expressed this condition before the Mexican authorities on several occasions. In its note dated June 25, 1998, to the President of INE, Cytrar defines the distribution of duties and obligations related to the relocation as follows:

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<sup>191</sup> *Neer v. México* case, (1926) R.I.A.A. iv. 60.

<sup>192</sup> International Court of Justice Case: *Elettronica Sicula S.p.A. (ELSI) (United States of America v. Italy)*, 128, p. 65, July 20, 1989, ICJ, General List No. 76.

...[Cytrar] will accept its relocation and, to that end, the municipal and state authorities will be in charge of finding, acquiring and delivering a new site, and they will also be in charge of carrying out any and all pertinent studies and of granting the related permits and licenses.<sup>193</sup>

159. There is no proof that INE or the state and municipal authorities challenged the distribution of the relocation obligations. Such allocation was only changed to the extent that Cytrar offered to assume a significant portion of the financial cost of the relocation. At no time, from the time the authorities communicated to the public the relocation of the Landfill to the date of the Resolution, did such authorities or IMADES express any disagreement as to conditioning the operation of the Landfill by Cytrar to the relocation of such operations to a different place, nor did they deny that the relocation was the result of an agreement with Cytrar on the basis of conditions agreed upon between Cytrar and such authorities. Dr. Cristina Cortinas Nava, INE's General Director of Hazardous Materials, Waste and Activities recognized this as follows:

.....I recognize that the company stated that the relocation would take place after finding a new site. Therefore, the company expected to continue operating the Landfill at its current site until then. [...] I recognize that, and if you ask me why, then, at the time I made the decision that implied an interruption of the continuity sought by the company, why did I do it? [...] my answer is that it was because the circumstances in November were such that I am sure that if I had renewed the permit I would not have been able to guarantee to the company the continuity of its operations there. Because there were many objections to the continuity of the company's operations there.<sup>194</sup>

160. Cytrar may have understood in good faith that its operations at Las Víboras under the Permit would continue for a reasonable time until effective relocation. Although it is true that the relocation agreement has not been memorialized in an instrument signed by all the parties involved, the evidence submitted leads to the conclusion that there was such an agreement, as evidenced by the joint declaration of SEMARNAP, the Government of the state of Sonora and the Honorable Municipality of Hermosillo to that effect. Section 4 of such declaration states that "...the current landfill operated by CYTRAR shall be closed as soon as the new facilities are ready to operate".<sup>195</sup> On the other hand, the Resolution<sup>196</sup> itself stated that:

Furthermore, CYTRAR S.A. de C.V. agreed with the different levels of the federal, state and municipal government that the landfill would be relocated and made this agreement public.

There is no doubt that the agreement commenced to be performed, as evidenced by the joint visits of Cytrar and IMADES to sites that were possible locations for the relocated landfill. There is no evidence stating or suggesting that the parties to such agreement agreed that external factors stemming from community pressure—which the Mexican authorities were fully aware of upon reaching the agreement— would cause the closing of Cytrar's business

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<sup>193</sup> Document A49. The relocation commitment project between the Mexican authorities and Cytrar referred to by the Respondent in the Counter-memorial, n. 324-329, pp. 93-94, which reportedly gives rise to a change in the allocation of obligations described above, has never been executed and was still subject to comments as of January 13, 1999. Therefore, such commitment cannot be taken into account to measure the allocation of the relocation obligations assumed by the parties in the stage prior to the issuance of the Resolution.

<sup>194</sup> Hearing held from May 20 to May 24, 2002; transcript of the session of May 21, 2002, pp. 77-77 overleaf.

<sup>195</sup> Document A88.

<sup>196</sup> Document A59.

at the Landfill without complying with the prior relocation of this business to another place. The incidental statements as to the Landfill's relocation in the correspondence exchanged between INE and Cytrar or Tecmed, and that constitute the immediate precedents of the Resolution, cannot be considered to be a clear and unequivocal expression of the will of the Mexican authorities to change their position as to the extension of the Permit so long as Cytrar's business was not relocated, nor can it be considered an explicit, transparent and clear warning addressed to Cytrar from the Mexican authorities that rejected conditioning the revocation of the Permit to the relocation of Cytrar's operations at the Landfill to another place, a rejection that should not have been expressed only by INE, but also by the other authorities responsible for deciding on the Landfill's relocation; i.e. the Municipality of Hermosillo, the Government of Sonora and SEMARNAP. The conclusion is that Cytrar may have reasonably trusted, on the basis of existing agreements and of the good faith principle, that the Permit would continue in full force and effect until the effective relocation date.

161. As stated above, on July 15, 1998, in a letter sent to the General Director of Hazardous Materials, Waste and Activities of INE, Dr. Cristina Cortinas Nava, Cytrar presented a number of proposals related to the expansion of cell N° 2 and the construction of cell N° 3 to address the company's commitments while the process to relocate its operations to a different site was carried out.<sup>197</sup> In spite of the urgency of the case and of the letter that Cytrar had sent to INE's President on June 25, 1998, reporting the need to increase the Landfill's capacity for those very reasons,<sup>198</sup> and reiterating Cytrar's commitment to relocate subject to the conditions expressed therein, INE took about three months to issue its reply to Cytrar. In its response, included in an official communication sent to Cytrar on October 23, 1998,<sup>199</sup> i.e. scarcely more than one month before the expiration of the Permit's term and when Cytrar had already requested the Permit's renewal in a letter sent to INE on October 19, 1998,<sup>200</sup> INE did not express the existence of any irregularity committed by Cytrar in the Landfill's operation or of any default by Cytrar of the conditions under which the Permit was granted that, in the opinion of INE, might jeopardize the Permit's renewal or its limited extension for a reasonable time so as to permit the relocation as proposed by Cytrar. INE could not have been unaware at the time of the existence of irregularities or infringements related to the expansion of cell N° 2. The expansions seemed to be the biggest concern of the sectors that opposed the Landfill, as their interpretation was that the expansions, which had been communicated by PROFEPA to INE by means of an official communication received by INE on September 14, 1998,<sup>201</sup> were *sine die* the cause for the delay in closing the Landfill. As INE only stated that it would evaluate the request for the expansion of cell N° 2 and construction of cell N° 3 upon considering renewal of the Permit, without warning Cytrar of any breach or irregularity in the expansion of the Landfill's capacity that, in the opinion of INE, jeopardized the renewal of the Permit, INE significantly affected Cytrar's ability to cure such defaults or irregularities in due time and prevent the denial of the Permit's renewal upon its expiration. Although INE, in its official

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<sup>197</sup> Letter sent to Dr. Cristina Cortinas Nava, document A50.

<sup>198</sup> Letter sent to Enrique Provencio, document A49.

<sup>199</sup> Official communication no. DOO-800/005262 of October 23, 1998, document A51.

<sup>200</sup> Cytrar's letter to Dr. Cristina Cortinas Nava, document A52.

<sup>201</sup> Document D133.

communication addressed to Cytrar on November 13, 1998,<sup>202</sup> in reply to the note sent by Cytrar on October 19, 1998, whereby it requested the renewal of the Permit, refers to these and other infringements, only six days before expiration of the Permit, it seems evident that, at that time, any meaningful effort to cure such infringement and prevent a denial of the permit's renewal was not feasible.

162. INE did not report, in clear and express terms, to Cytrar or Tecmed, before issuing the Resolution, its position as to the effect of these infringements on the renewal of the Permit. As a consequence, it prevented Cytrar from being able to express its position as to such issue and to agree with INE about the measures required to cure the defaults that INE considered significant when it denied the renewal without allowing a reasonable time to relocate Cytrar to another site. Providing an opportunity to Cytrar was reasonable and equitable, since at all times the parties considered that Cytrar would relocate the Landfill to another place, and such relocation and the necessity for the Landfill to continue operating at Las Víboras until the effective relocation, was the purpose of the recent correspondence exchanged between the parties. There was no disagreement that relocation could not be immediate and that it would require continued efforts, probably for many months, even for more than a year. There are clear inconsistencies or contradictions in the attitude of INE, which, on the one hand, did not challenge the technical capacity and operating qualifications of Cytrar upon entrusting it with the operation of a hazardous waste landfill that would be relocated to another site and that would operate under the more ambitious conditions—and surely with more responsibilities for the operator—of a Comprehensive Center for the Management of Industrial Waste, or CIMARI, and that, on the other hand, did not warn Cytrar about the curable defaults in its operations at Las Víboras sufficiently in advance so as to avoid the denial of the Permit's renewal. As shown, such defaults have not endangered public health, ecological balance or the environment. It should be noted that, although the official communication sent by INE to Cytrar on November 13, 1998, refers to an alleged violation by Cytrar of the specific condition 1.12 of the Permit, under which “...the presentation of repeated and justified complaints against the company or the occurrence of events due to problems in the Landfill's operation that may endanger public health...” (without going any deeper into this subject or expressly mentioning such events) are sufficient events to «cancel» the Permit (not to *deny its renewal*), such condition was not invoked among the grounds of the Resolution. After analyzing such inconsistencies, it may be concluded that the contradictions and lack of transparency in INE's attitudes vis-à-vis Cytrar, and the absence of clear signs from INE, did not permit Cytrar to adopt a behavior to prevent the non-renewal of the Permit, or that might at least guarantee the continuity of the permit for the period required to relocate the Landfill to a new site.

163. If INE's position was that relocation was to take place within a given period—which, as stated above, according to the Mexican authorities, should be about twelve months—<sup>203</sup> after the expiration of which the Permit would not be renewed, it would be reasonable to expect such situation to be reported to or agreed upon by Cytrar. Certainly, it is surprising that INE did not unequivocally and clearly specify the deadlines, terms and conditions that would apply to the relocation, as requested by the authorities of the Municipality of

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<sup>202</sup> Document A53.

<sup>203</sup> Communication of the Mayor of the Municipality of Hermosillo, document D113.

Hermosillo a day before the Permit's expiration,<sup>204</sup> even when Cytrar and Tecmed had agreed to relocate Cytrar's business to any site selected by the Mexican authorities and regardless of the note sent by Tecmed to INE on November 17, 1998, in which Tecmed clearly requests the execution of an agreement with INE and the Mexican federal, state and municipal authorities containing a certain and specific relocation schedule.<sup>205</sup> There are also express inconsistencies between, on the one hand, the absence of such specifications and a notice to Cytrar warning it to agree to or abide by such conditions and, on the other hand, the use of the denial to renew the Permit as a factor to pressure Cytrar to relocate, as declared by INE's General Director of Hazardous Materials, Waste and Activities, who authored the Resolution:

.....for them [the local authorities] if I continued renewing the Permit, that would [sic] extend ... For as long as the company could continue receiving waste, it would not assume a full commitment to perform the studies required to relocate the site ...<sup>206</sup>

This statement reveals the two goals pursued by INE upon issuing the Resolution. On the one hand it denies the renewal of Cytrar's Permit without any compensation whatsoever for the loss of the financial and commercial value of the investment. On the other hand, this denial is described as a means to pressure Cytrar and force it to assume a similar operation in another site, bearing the costs and risks of a new business, mainly because by adopting such course of action, INE expected to overcome the social and political difficulties directly related to the Landfill's relocation. Under such circumstances, such pressure involves forms of coercion that may be considered inconsistent with the fair and equitable treatment to be given to international investments under Article 4(1) of the Agreement and objectionable from the perspective of international law.<sup>207</sup>

164. If, on the other hand, INE's position was —as has actually been established— to close the Landfill inevitably, with or without relocation, INE should have expressed such position clearly. Regardless of the hypothesis contemplated, the decisive factor —for which Cytrar was not responsible— was the Landfill's location at the Las Víboras site and its proximity to Hermosillo's urban center, which was in violation of Mexican regulations and a source of community opposition and political unrest, but which was not —as confirmed by Mexican authorities— against the legitimacy of the Landfill's operation under Mexican law. If the inevitable consequence of this situation, evaluated by the Mexican authorities, was the refusal to renew the Permit and the closing of the site, such determination, from the Agreement's standpoint, should have been accompanied, as has already been decided, by the payment of the appropriate compensation. The lack of transparency in INE's behavior and intention throughout the process that led to the Resolution, which does not reflect in full the reasons that led to the non-renewal of the Permit, cover up the final and real

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<sup>204</sup> Communication sent to INE's President by the Mayor of the Municipality of Hermosillo on November 18, 1998, in which the Mayor requests "the execution of a landfill relocation agreement between the Federation, the State, the Municipality and the company. A detailed, signed, legal agreement containing a schedule and fixed dates." Document D157.

<sup>205</sup> Document A 91.

<sup>206</sup> Hearing held from May 20 to May 24, 2002; transcript of the session held on May 21, 2002, p. 72.

<sup>207</sup> D.F.Vagts, *Coercion and Foreign Investment Rearrangements*, 72. *The American Journal of International Law*, pp. 17 *et seq.*, specially p. 28 (1978) : "...the threat of cancellation of the right to do business might well be considered coercion."

consequence of such actions and of the Resolution: the definitive closing of the activities at the Las Víboras landfill without any compensation whatsoever, whether Cytrar agreed or not, in spite of the expectations created, and without considering ways enabling it to neutralize or mitigate the negative economic effect of such closing by continuing with its economic and business activities at a different place. Within the general context of the circumstances mentioned above, the ambiguity of INE's actions was even greater when it resorted to the non-renewal of the Permit to overcome obstacles not related to the preservation of health and the environment although, according to the evidence submitted, the protection of public health and the environment is where INE's preventive function should be focused. To the question about the factors or parameters that INE should take into account to decide on the renewal of authorizations such as the Permit, witness Dr. Cristina Cortina Navas answered:

Provisions can have two different purposes: to evaluate environmental performance and to assess the management of companies. Thus, you will distinguish, among the conditions established, such conditions that allowed for the evaluation of the former and the conditions that allowed for the assessment of the latter. As regards management, there were a series of instruments, reports, records and issues that the company had to take care of. In turn, performance involved providing sufficient security that there would not be escapes, leaks or accidents during hazardous waste management, including transportation and storage. Any of these issues could be verified, and, in fact, before issuing any resolution we tried to gather all the elements necessary to be able to pass judgment on whether or not such purposes had been fulfilled.<sup>208</sup>

The refusal to renew the Permit in this case was actually used to permanently close down a site whose operation had become a nuisance due to political reasons relating to the community's opposition expressed in a variety of forms, regardless of the company in charge of the operation and regardless of whether or not it was being properly operated.

165. The Arbitral Tribunal considers that INE's behavior described above with respect to Cytrar, which had a material adverse effect on Cytrar's ability to get to know clearly the real circumstances on which the maintenance or validity of the Permit depended—it must be recalled that Cytrar could not operate without this Permit—is not an unprecedented action. INE's denial to renew the Permit belongs to the wider framework of the general conduct taken by INE towards Cytrar, Tecmed and, ultimately, the Claimant's investment.

166. The Arbitral Tribunal finds that INE's behavior, as analyzed in paragraphs 153-164 above and because of the "deficiencies" explained therein, conflicts with what a reasonable and unbiased observer would consider fair and equitable, and that this amounts to a violation of Article 4(1) of the Agreement. The Arbitral Tribunal also finds that such a behavior can be related, in terms of its prejudicial consequences, to the consequences of the Resolution; and that only after the Resolution was issued could the Claimant fully realize the breach of the Agreement incurred by such behavior and the resulting damage. Consequently, the Claimant's claims in connection with such behavior satisfy the requirements for admissibility contemplated in Title II(4) and (5) of the Appendix to the Agreement.

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<sup>208</sup> *Ibidem*, pp. 68-68 overleaf

167. Notwithstanding the above, the Arbitral Tribunal considers it equally appropriate to place this behavior within the context of INE's prior conduct on the basis of the abundant arguments and evidence presented by the Parties in connection with such prior conduct and in view of the undeniable fact that the legal relationship between INE and Cytrar or Tecmed associated with the Landfill is one and only one, starting with the initial procedures in connection with the authorization to operate the Landfill and finishing with the Resolution—the immediate cause for the damage sustained by the Claimant. This conduct should also be analyzed in light of the fact that throughout a relationship of such nature, necessarily prolonged in time, the Claimant was entitled to expect that the government's actions would be free from any ambiguity that might affect the early assessment made by the foreign investor of its real legal situation or the situation affecting its investment and the actions the investor should take to act accordingly.

168. As a result of the judicial sale of the Landfill's assets, Tecmed and the Municipality of Hermosillo request from INE the "change of name" or the facilitation of such change, which, according to the administrative practice up to date, at least in connection with the Landfill, entailed the replacement of the holder of the permits necessary for the operation of the landfill at Las Viboras by such holder's successors. There is no evidence that INE has responded to such communications stating that Cytrar had actually to request a new permit, which may differ from the existing one, instead of requesting the replacement of the old holder with a new one; and no convincing evidence has been offered to support the Respondent's allegations as to the fact that, from the beginning, INE's officers instructed Cytrar to obtain a new "operating license" because, for example, as stated by the Respondent, the nature of the operation undertaken by Cytrar and the consequent expansion of the Landfill's installed capacity would so require it.<sup>209</sup> Among others, in the note dated June 5, 1996, sent to INE by Tecmed together with the MRP Form, containing information that INE should evaluate in connection with the individual or entity that was to be in charge of a hazardous waste landfill operation, Tecmed specifically requested from INE "...the change of the name appearing in the permit granted by INE to the new company for such purpose, CYTRAR S.A. de C.V.". Attached as Annex "A" to such presentation and Form, are the Establishment License granted on December 7, 1988, and the permit to operate the already existing Controlled Landfill, dated May 4, 1994, together with its expansion of August 25, 1994.<sup>210</sup>

169. Thus, there was no possible margin for error with respect to the request made by Tecmed and Cytrar with the support of the Municipality of Hermosillo in connection with the existing licenses or permits by virtue of which the Landfill had operated and was still operating. Considering such very clear requests, there is no evidence that INE had warned Cytrar that such requests could only be interpreted as petitions to be included in INE's listing of companies that would qualify for the operation of CIMARIS or Comprehensive Centers for Industrial Waste Management—to which the witness Jorge Sánchez Gómez, the INE's General Director of Hazardous Materials, Waste and Activities at that time<sup>211</sup> had made reference—or evidence of practices, resolutions or administrative regulations or legal

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<sup>209</sup> Counter-memorial, 127, pp. 34-35

<sup>210</sup> Document D46

<sup>211</sup> Hearing held from May 20 to May 24, 2002. Transcript of the session of May 23, 2002, p. 57.



provisions leading to such sole and exclusive interpretation. On September 24, 1996, INE sent Cytrar an official communication signed by Jorge Sánchez Gómez, whereby Cytrar was informed that “In view of the request filed by the company Promotora e Inmobiliaria del Municipio de Hermosillo, OPD to change its name to Cytrar S.A. de C.V.,” and considering that according to the recommendations of INE’s “...Legal Affairs Department ...” Cytrar had furnished “...the documents required by this General Office and had fulfilled all legal requirements that, in such Department’s understanding, are essential *for carrying out the necessary procedure*,”<sup>212</sup> Cytrar “... for all legal and administrative purposes...” had been “duly registered in this General Office under my charge”.<sup>213</sup> It is not surprising that from this communication, Cytrar interpreted that INE had changed the corporate name appearing on the permits to operate the Landfill, as requested by Cytrar, Tecmed and the Municipality of Hermosillo.

170. Subsequently, it is no wonder to see Cytrar surprised when after Cytrar had been operating the Landfill under the existing permit dated May 4, 1994, in its capacity as new company authorized under the permit pursuant to INE’s official communication dated September 24, 1996, as Cytrar was entitled to believe in good faith, INE demanded Cytrar to return such communication to be replaced by another, with the same date and an almost identical text, except for an annex whereby Cytrar was granted a permit to operate the Las Víboras landfill, dated November 11, 1996.<sup>214</sup> Such permit, in addition to terminating the prior permit dated May 4, 1994, in which Cytrar had requested the change of name, differed from the last one in some material respects. The most outstanding difference, which would only be appreciated upon refusal to renew the Permit in 1998, was that the permit of May 1994 had an indefinite duration and the permit of November 1996 had a term of one year that could be extended. As highlighted by the witness Jorge Sánchez Gómez, the purpose behind the annual renewal of permits was to facilitate INE’s actions to put an end to the operations carried out by companies that, in INE’s understanding, did not adjust their actions to the applicable legal provisions; the INE could refuse the extension or refuse to renew such permits at the end of each year. According to the witness, this allowed INE to dispense with the more cumbersome procedure —of uncertain success— of obtaining the revocation of the permit by PROFEPA, which required that a case be opened and that the party subject to sanctions be given the opportunity to express its argumentations and defenses:

....apparently, there is an alternative: that the agency that had to enforce the law; in this case, PROFEPA, carried out the execution. However, it was very difficult to have a company’s registration withdrawn if there were no elements that would clearly allow verification of a breach. Revocation of permits is a very complicated procedure.....<sup>215</sup>

To emphasize INE’s discretionary powers as to the continuation of Cytrar’s operation of the Landfill and in accordance with INE’s policy of facilitating the possibility of putting an end to such operation without having to start the proceeding to withdraw the permit, when

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<sup>212</sup> Emphasis added by the Arbitral Tribunal

<sup>213</sup> Document A42

<sup>214</sup> Documents A43 and A44

<sup>215</sup> Hearing held from May 20 to May 24, 2002. Declaration of Jorge Sánchez Gómez, transcript for the session of May 23, 2002, p. 53 overleaf.

the Permit was granted —on November 19, 1997— it was determined that this Permit, instead of being “subject to extension” (as the previous permit stated), was subject to “renewal” upon request of the interested party. That is to say, it required a new permit at the end of each year, instead of extending its validity at the end of such period. In the words of the witness Jorge Sánchez Gómez:

...the notion of renewal is much easier to handle for the purpose of refusing a permit to a company that is not complying with the requirements.<sup>216</sup>

171. If the indefinite-duration permit dated May 4, 1994 had been transferred to Cytrar as requested to INE by Cytrar, Tecmed and the Municipality of Hermosillo, INE would not have been able to put an end to Cytrar’s operation of the Landfill by means of the Resolution and the only remedy available for that purpose would have been the revocation of the Permit by PROFEPA. But such revocation would probably have not been successful on the basis of the infringements of the Permit used to justify the Resolution, which were not even considered by PROFEPA as deserving any sanction other than a fine. To sum up, INE unilaterally transformed a previous administrative act, which, as such, was presumed to be legitimate, had immediate effects and could only be interpreted in good faith as having accepted Cytrar’s petition to be the transferee of the existing permits for the operation of the Landfill. The objective consequence of such transformation was to grant Cytrar a permit to operate the Landfill, which reduced Cytrar’s entitlement to question actions that deprived it of the Permit or that had such effect. Subsequently, INE —also unilaterally— classified the petition as a request to be registered in a listing that Cytrar was not aware of, and regarding which, in any case, Cytrar had shown no interest. The same objective consequence is to be attributed to the transformation as from November 19, 1997, of Cytrar’s permit to operate the Landfill, from a permit that was subject to extension to a permit that was subject to renewal.

172. The contradiction and uncertainty inherent in INE’s actions as to Cytrar and Tecmed is evidenced, then, both in the initial stage of the processing of the necessary permits to operate the Landfill and when INE decided to put an end to such operation by means of the Resolution. Such actions belong to one and the same course of conduct characterized by its ambiguity and uncertainty which are prejudicial to the investor in terms of its advance assessment of the legal situation surrounding its investment and the planning of its business activity and its adjustment to preserve its rights. Such ambiguity and uncertainty are also present in the last stage of the relationship, analyzed under paragraphs 153-164 above, which led to the Resolution, and added their harmful effects to the damage resulting from the denial to grant the Permit. Although INE’s initial behavior was before the effective date of the Agreement and the Arbitral Tribunal will not pass judgment on whether at that stage such conduct, considered in isolation, amounted to a breach of the provisions thereof before its entry into force, it cannot be ignored, in light of the good faith principle (Articles 18 and 26 of the Vienna Convention), that the conduct of the Respondent between the date of execution of the Agreement (in view of the Respondent’s determination to ratify it subsequently) and the effective date thereof, is incompatible with the imperative rules deriving from Article 4(1) of the Agreement as to fair and equitable treatment. This is

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<sup>216</sup> Transcript of the session of May 23, 2002, p. 59 overleaf.

particularly so since, according to Article 2(2) of the Agreement, it is applicable to investments made before its entry into force, a circumstance to be certainly considered when analyzing the conduct attributable to the Respondent that took place before that time but after the Respondent having executed the Agreement. INE's contradictory and ambiguous conduct at the beginning of the relationship between INE, Cytrar and Tecmed before the entry into force of the Agreement has the same deficiencies as those encountered in such conduct during the last stage of the relationship, immediately preceding the Resolution. Thus, INE's conduct during such time is added to the prejudicial effects of its conduct during the last stage, which breached Article 4(1) of the Agreement.

173. Briefly, INE's described behavior frustrated Cytrar's fair expectations upon which Cytrar's actions were based and upon the basis of which the Claimant's investment was made, or negatively affected the generation of clear guidelines that would allow the Claimant or Cytrar to direct its actions or behavior to prevent the non-renewal of the Permit, or weakened its position to enforce rights or explore ways to maintain the Permit. During the term immediately preceding the Resolution, INE did not enter into any form of dialogue through which Cytrar or Tecmed would become aware of INE's position with regard to the possible non-renewal of the Permit and the deficiencies attributed to Cytrar's behavior—including those attributed in the process of relocation of operations—which would be the grounds for such a drastic measure and, thus, Cytrar or Tecmed did not have the opportunity, prior to the Resolution, to inform of, in turn, their position or provide an explanation with respect to such deficiencies, or the way to solve such deficiencies to avoid the denial of renewal and, ultimately, the deprivation of the Claimant's investment. Despite Cytrar's good faith expectation that the Permit's total or partial renewal would be granted to maintain Cytrar's operation of the Landfill effective until the relocation to a new site had been completed, INE did not consider Cytrar's proposals in that regard and not only did it deny the renewal of the Permit although the relocation had not yet taken place, but it also did so in the understanding that this would lead Cytrar to relocate.

174. Such behavior on the part of INE, which is attributable to the Respondent, results in losses and damage<sup>217</sup> for the investor and the investment pursuant to Title II(4) of the Appendix to the Agreement coinciding both as to essence and time with those derived from the Resolution, whether such behavior is considered generically or only as to the stages mentioned and analyzed by the Arbitral Tribunal in paragraphs 153-164 above. The Respondent's behavior in such stages amounts, in itself, to a violation of the duty to accord fair and equitable treatment to the Claimant's investment as set forth in Article 4(1) of the Agreement and such behavior constitutes sufficient basis for the Claimant's claims founded on such violation to be admissible, given the time at which the damage occurred and the time when the damage and the violation of the Agreement were necessarily perceived by the Claimant (on the date of issuance of the Resolution), pursuant to Title II(4) and (5) of the Appendix to the Agreement.

### III. Full Protection and Security and Other Guarantees under the Agreement

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<sup>217</sup> "Damage" is not limited to the economic loss or detriment and shall be interpreted in a broad sense (J. Crawford, *The International Law Commission's Articles on State Responsibility*, 29-31 (Cambridge University Press, 2002)).

175. The Claimant alleges that Mexican municipal and state authorities encouraged the community's adverse movements against the Landfill and its operation by Tecmed or Cytrar, as well as the transport by Cytrar of Alco Pacifico's waste. Further, the Claimant alleges that Mexican authorities, including the police and the judicial authorities, did not act as quickly, efficiently and thoroughly as they should have to avoid, prevent or put an end to the adverse social demonstrations expressed through disturbances in the operation of the Landfill or access thereto, or the personal security or freedom to move about of the members of Cytrar's staff related to the Landfill. It is the opinion of the Claimant that such behavior of the Mexican authorities, attributable to the Respondent, amounts to a violation of Article 3(1) of the Agreement, which provides that:

Each Contracting Party shall accord full protection and security to the investments made by the other Contracting Party's investors, in accordance with International Law and shall not, through legally groundless actions or discriminatory measures, hinder the management, maintenance, development, usage, enjoyment, expansion, sale, or, where applicable, disposition of such investments.

176. The Arbitral Tribunal considers that the Claimant has not furnished evidence to prove that the Mexican authorities, regardless of their level, have encouraged, fostered, or contributed their support to the people or groups that conducted the community and political movements against the Landfill, or that such authorities have participated in such movement. Also, there is not sufficient evidence to attribute the activity or behavior of such people or groups to the Respondent pursuant to international law.

177. The Arbitral Tribunal agrees with the Respondent, and with the case law quoted by it, in that the guarantee of full protection and security is not absolute and does not impose strict liability upon the State that grants it. At any rate, the Arbitral Tribunal holds that there is not sufficient evidence supporting the allegation that the Mexican authorities, whether municipal, state, or federal, have not reacted reasonably, in accordance with the parameters inherent in a democratic state, to the direct action movements conducted by those who were against the Landfill. This conclusion is also applicable to the judicial system, in relation to the efforts made to take action against the community's opposing demonstrations or to the attempt to reverse administrative measures which were deemed inconsistent with the legal rules applicable to the Landfill, such as the withdrawal by the Hermosillo's Municipal authorities of the license to use the Landfill's site.

178. Promotora's behavior, or INE's behavior attributable to the Respondent, regarding the sale of the assets related to the Landfill, the commitments undertaken in connection with such sale or the grant of the Permit to operate of November 11, 1996, and preceding events, all took place prior to the entry into force of the Agreement. With respect to Promotora, such behavior has not been considered by the Arbitral Tribunal due to the reasons described in paragraph 92 of this award, and will not be analyzed, even if it were hypothetically attributable to the Respondent, to determine whether there has been a violation of Article 3(1) of the Agreement or not.

179. With regard to INE's behavior prior to the entry into force of the Agreement, described above, and the subsequent stages following such date, the Arbitral Tribunal does

not consider, even at the time of its consummation and turning point —the refusal to renew the Permit— that such behavior has no legal grounds under Mexican law or that such behavior is discriminatory, as required by Article 3(1) of the Agreement in order to constitute a violation. The Arbitral Tribunal has not found that INE’s denial to renew the Permit violated any Mexican laws or was issued beyond the Mexican legal framework. As provided below, the Arbitral Tribunal has not verified, either, the existence of discriminatory treatment detrimental to the Claimant in violation of the national and foreign treatment guarantees also set forth in the Agreement. Therefore, the Arbitral Tribunal considers that neither the Resolution nor the Respondent’s behavior leading to such Resolution amount to a violation of Article 3(1) of the Agreement.

180. According to Article 4(2) of the Agreement, each Contracting Party guarantees the foreign investor a treatment that should not be less favorable... “than that accorded under similar circumstances [...] to investments made in its territory by investors from a third State”. Pursuant to Article 4(5) of the Agreement, each Contracting Party, “In accordance with the restrictions and methods provided by the local laws [...] shall accord to the investments made by the other Contracting Party’s investors a treatment that should not be less favorable than the treatment afforded to its own investors...”. The Arbitral Tribunal observes, however, in its post-hearing brief, when referring to the alleged breach of the Agreement, that the Claimant omits any statement regarding the violation of the guarantees of non-discriminatory treatment (national or accorded to investors from a third State) provided in Articles 4(2) and (5) of the Agreement, which are not even mentioned, though the Claimant does sustain its allegations relative to the breach attributable to the Respondent of Articles 3 and 5 of the Agreement as alleged by the Claimant in the request for arbitration.<sup>218</sup>

181. In any case, the Arbitral Tribunal does not consider that the behavior attributable to the Respondent, to the extent such behavior commenced prior to the entry into force of the Agreement and was accomplished after such date, or occurred following the entry into force, such as, for instance in the latter case, the issuance of the Resolution, amounts to violations to the guarantee of national or foreign treatment set forth by the provisions of the Agreement referred to above. The Claimant has failed to furnish convincing or sufficient evidence to prove, at least *prima facie*, that the Claimant’s investment received, under similar circumstances, less favorable treatment than that afforded to nationals of the State receiving the investment or of a third State, or that said investment was subject to discriminatory treatment upon the basis of considerations relative to nationality or origin of the investment or the investor. The Arbitral Tribunal further considers that the alleged discriminatory treatment attributed by the Claimant to the Respondent on the grounds of the unlimited duration of operation permits or licenses granted to Residuos Industriales Multiquim S.A. de C.V. (RIMSA), which would be owned by a foreign investor,<sup>219</sup> or to prior operators or owners of the landfill, all of which were government entities of the state of Sonora,<sup>220</sup> occurred and were entirely isolated events taking place prior to the

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<sup>218</sup> Claimant’s post-hearing brief, pp. 104-126.

<sup>219</sup> Memorial, p. 124.

<sup>220</sup> Memorial, p. 26

Agreement's entry into force, and will not be considered by this Arbitral Tribunal as stated in paragraph 67 of this arbitration award.

182. With regard to other forms of discrimination apparently originated in the allegedly different treatment accorded by INE to RIMSA's and Claimant's investments, the Arbitral Tribunal holds that the Respondent has furnished satisfactory evidence —not rebutted by the Claimant on this point— of the fact that the circumstances under which RIMSA's investment was made and concerning such investment materially differed from the investment in the Landfill. Thus, it is not possible to establish standards which allow a comparison of the treatment accorded to the investment in RIMSA's landfill and the investment in the Landfill. Further, it is the opinion of this Arbitral Tribunal that the Respondent has not breached Article 2(1) of the Agreement with respect to the promotion and admission of foreign investments, and that no evidence of such violation has been submitted; it being also relevant to point out that the Claimant itself has stated that if such violation existed, it should be the subject matter of a direct claim between the Contracting Parties<sup>221</sup> of the Agreement. The Arbitral Tribunal also holds that the denial of the Permit's renewal does not amount to a violation of Article 3(2) of the Agreement, pursuant to which each Contracting Party "within the local legal framework" shall grant the necessary permits with regard to the investments from the other Party, as the Arbitral Tribunal considers that there is no evidence proving the fact that INE's denial of the Permit is contrary to Mexican laws.

#### **F. Compensation. Restitution in kind.**

183. The Claimant's claim for compensation or restitution in kind is based upon the provisions of Title VII(1) of the Appendix to the Agreement, which contemplates those two options. The Claimant requests restitution in kind —which the Claimant considers "absolutely impossible"— only secondarily, as the Claimant primarily seeks monetary damages.<sup>222</sup> The Arbitral Tribunal considers that monetary damages paid to the Claimant as compensation for the loss of the investment constitutes an adequate satisfaction of the Claimant's claim under the Agreement. Therefore, and taking into account that the Claimant primarily seeks monetary damages, the Arbitral Tribunal will not consider the admissibility or inadmissibility of the restitution in kind in this case.

184. The Claimant calculates the amount to be paid as monetary damages under the discounted cash flow calculation method by which the Claimant intends to determine the Landfill's market value. Upon the basis of the report issued by the expert witness appointed by the Claimant, the amount to be paid as damages as of the date of the expropriation —November 25, 1998—totals US\$ 52,000,000, plus interest. The Claimant further claims compensation for the damage allegedly caused to the Claimant's reputation, with arbitration costs to be borne by the Respondent.

185. The Respondent objects to the application of a discounted cash flow analysis, as the Respondent considers such calculation method to be highly speculative given the short term

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<sup>221</sup> Memorial, p. 93.

<sup>222</sup> Memorial, pp. 142 – 144.

during which the Landfill operated as an on going business (about two years and a half), thus preventing the application of sufficient historical data to prepare the reliable estimates required by such calculation methodology. The Respondent has proposed the calculation of damages based on the investment made, upon which the investment's market value would be determined. In any case, the Respondent's expert witness challenges the discounted cash flow calculation methodology—as applied by the Claimant's expert witness—with regard to various aspects, including the price, costs, and market condition estimates, the failure to compute certain costs, such as remediation and maintenance of closed cells, and the discount rate applied by the Claimant's expert witness. Also, the Respondent's expert witness offers its own analysis under the discounted cash flow methodology, which in an “optimistic” version as such expert witness puts it, would be calculated in the amount of US\$ 2,100,000 for the investment, and according to a “conservative” version such amount would total US\$ 1,800,000.

186. The Arbitral Tribunal has noted both the remarkable disparity between the estimates of the two expert witnesses upheld throughout the examination directed by the parties and the Arbitral Tribunal at the hearing held on May, 20-24, 2002, and also the considerable difference in the amount paid under the tender offer for the assets related to the Landfill—US\$ 4,028,788—<sup>223</sup> and the relief sought by the Claimant, amounting to US\$ 52,000,000, likely to be inconsistent with the legitimate and genuine estimates on return on the Claimant's investment at the time of making the investment. The non-relevance of the brief history of operation of the Landfill by Cytrar—a little more than two years—and the difficulties in obtaining objective data allowing for application of the discounted cash flow method on the basis of estimates for a protracted future, not less than 15 years, together with the fact that such future cash flow also depends upon investments to be made—building of seven additional cells—in the long term, lead the Arbitral Tribunal to disregard such methodology to determine the relief to be awarded to the Claimant.<sup>224</sup>

187. In Article 5.2, the Agreement provides that, in the event of expropriation, or any other similar measure or with similar effects:

Compensation shall be equivalent to the fair market value of the expropriated investment immediately before the time when the expropriation took place, was decided, announced or made known to the public (...) valuation criteria shall be determined pursuant to the laws in force applicable in the territory of the Contracting Party receiving the investment.

Also, Article 10 of the Mexican Federal Law on Expropriation provides that the applicable compensation shall indemnify for the commercial value of the expropriated property, which in the case of real property shall not be less than the tax value. There has been no evidence or allegations as to the interpretation of this rule in light of Mexican laws.

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<sup>223</sup> Report by Fausto García y Asociados, p. 22

<sup>224</sup> Award of ICSID case No. ARB (AF)/97/1 *Metalclad Corporation v. United Mexican States*, 16 Mealey's International Arbitration Report, p. A-1 *et. seq.*; pp. A-14/A-15, 119-122 (2000). Award in case *Phelps Dodge Corp. and Overseas Private Investment Corp. v. The Islamic Republic of Iran*, 10 Iran-U.S. Claims Tribunal Reps., p. 121 *et. seq.*; 30, pp. 132-133 (1986-1); award of ICSID case No. ARB/98/4, *Wena Hotels v. Arab Republic of Egypt*, 41 I.L.M. 896 (2002), 122-125, pp. 918-919, award of December 8, 2000.

188. The Arbitral Tribunal considers that compensation to be awarded pursuant to such parameters—that is, the market value of the Landfill— shall be the total compensation for all the violations to the Agreement proved in this award, which, in relation to the Claimant, have the damaging effect of depriving the Claimant of its investment.

189. It is not in dispute that the assets forming the Landfill are owned by the “Tecmed Group”, which belongs to the Actividades, Construcciones y Servicios group and thus has the Claimant as its parent corporation, into which, under Spanish accounting standards, the accounts of Tecmed and Cytrar are consolidated.<sup>225</sup> According to Articles 1(1)(b) and (2)(e) of the Agreement, the Claimant—the foreign investor—is the owner of the foreign investment in Mexico through the Claimant’s subsidiaries. The Respondent has recognized that:

The TECMED group, through the Mexican company TECMED, TECNICAS MEDIOAMBIENTALES DE MEXICO, S.A. de C.V., presently has the following environmental facilities in Mexico (in addition to the landfill, CYTRAR and its administrative offices).....<sup>226</sup>

It is also undisputed, at least after Cytrar obtained the permit from INE to operate the Las Viboras Landfill, that the related assets indirectly held by the Claimant constitute a hazardous waste landfill,<sup>227</sup> i.e. an integrated unit comprising tangible and intangible assets, including the Permit and other permits or licenses to operate as a hazardous waste landfill. Such unit must be valued by this Arbitral Tribunal upon rendering its award. Therefore, the Arbitral Tribunal concludes that the deprivation of the financial and business use of the Landfill’s operation arising from the Respondent’s actions and in violation of the Agreement has caused damage to the Claimant and its investment in the Landfill. Therefore, the Claimant is entitled to receive compensation in accordance with the provisions of the Agreement and on the basis of the market value of the assets the Claimant has been deprived of.

190. The Arbitral Tribunal also considers that, although the Arbitral Tribunal may consider general equitable principles when setting the compensation owed to the Claimant, without thereby assuming the role of an arbitrator *ex aequo et bono*,<sup>228</sup> the burden to prove the investment’s market value alleged by the Claimant is on the Claimant. Such burden is transferred to the Respondent if the Claimant submits evidence that *prima facie* supports its allegation, and any difficulty in determining the compensation does not prevent the assessment of such compensation where the existence of damage is certain.<sup>229</sup>

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<sup>225</sup> “2000 Annual Report of Actividades de Construcción y Servicios”, document A7, Annex 8.1 “Consolidated Information”, pp. 131-132 ; 133.

<sup>226</sup> Respondent’s brief “Admissions and denials”, p. 4.

<sup>227</sup> Respondent’s brief “Admissions and denials”, p. 32.

<sup>228</sup> Award in the case *Kuwait and the American Independent Oil Company (Aminoil)*, 21 I.L.M., p. 976 *et seq.* (1982), 77-78 p.1016 ; specially No.78 : “It is well known that any estimate in purely monetary terms of amounts intended to express the value of an asset, of an undertaking, of a contract, or of services rendered, must take equitable principles into account”. To the same effect, award in the case *Himpurna California Energy Ltd. (Bermuda) v. PT (Persero) Perusahaan Listrik Negara (Indonesia)*, 14 Mealey’s International Arbitration Report, A-1 *et seq.* 441, p. 129 [A-44] (1999).

<sup>229</sup> ICSID case ARB/84/3, *Southern Pacific Properties (Middle East) Limited v Arab Republic of Egypt*, 8 ICSID Law Review-Foreign Investment Law Journal, p. 389, 215 (1993).



191. The Parties have not raised any dispute as to the fact that this market value is defined as the fair value of the transaction on an arms' length basis, where both parties to the transaction have knowledge of the applicable circumstances.<sup>230</sup> The Respondent acknowledges that the price obtained in a public tender "...is an efficient manner to determine the price of the assets sold..."<sup>231</sup> The Claimant has not challenged this allegation. The Arbitral Tribunal finds that upon the 1996 sale the Landfill's market value was US\$ 4,028,788, and will take that figure as the starting point for a subsequent analysis. The Arbitral Tribunal also finds, on the basis of the evidence submitted, that the existence of a market supported by a sufficient number of similar transactions that may be used as a guide to determine the Landfill's market value as of November 25, 1998, has not been established.

192. In the task of establishing the market value as of such date —the moment when the expropriatory act occurred—, the Arbitral Tribunal will also take into account other factors in accordance with the practice of international arbitral tribunals in similar cases.

193. For such purposes and on the basis of Article 5(2) of the Agreement, although the Arbitral Tribunal will consider the existence of community pressure against the location of the Landfill at its current place and that such pressures and the location would have jeopardized the operations of the Landfill in the long run, the Arbitral Tribunal will not necessarily take into account the actions or determinations of the Mexican authorities that, echoing the community sentiment, in turn exerted pressure on Cytrar for it to relocate or that are part of the Respondent's actions considered to be in violation of the Agreement in this award or that contributed to the damage resulting from such violations,<sup>232</sup> and that may have an adverse effect on valuation of the compensation. Upon weighing such community pressure, the Arbitral Tribunal cannot ignore the relocation commitment assumed by Cytrar, supported by Tecmed, the performance of which would have mitigated or eliminated such pressure, and whose non-performance is not attributable to Cytrar or Tecmed, nor the responsibilities of the Municipality of Hermosillo and of INE, as the case may be, that were involved in the sale of the site to Cytrar or that authorized Cytrar to operate the site under the premise that its location was legitimate despite the fact that it did not comply with Mexican laws. Such legitimacy was terminated by the Resolution which, in practice, ignored such legitimacy in order to address social and political factors against such location.

194. The Arbitral Tribunal will also take into account the additional investments made as from the Landfill's acquisition until the date of the Resolution and will consider that Cytrar has contributed management and client development elements that caused, among other things, a 39% increase in the Landfill's operation by 1997, excluding the activities related

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<sup>230</sup> American Appraisal report, p.2.

<sup>231</sup> Respondent's closing statement, 167, p. 76. Declaration of expert witness Christianson, hearing held from May 20 to May 24, 2002; transcript for the session of May 22, p. 50. Expert witness report of Fausto García y Asociados, p. 23.

<sup>232</sup> *Philips Petroleum Co. Iran v Iran*, 21 Iran-U.S. Claims Tribunal Reports, p. 79 *et seq.*, specially 135, p. 133 (1989-1).

to Alco Pacifico,<sup>233</sup> and that also produced net income in the second year of operations, i.e. during a stage of entry into and consolidation in the market at the beginning of its operations. It cannot be denied that the investment in the Landfill was productive and added value to the former Landfill's operations as well as goodwill, nor can it be denied that the Claimant was deprived of its investment's profits, and value added and goodwill, or that the Claimant's losses also include lost profits. As acknowledged by the Respondent itself, this operation almost did not exist for a long time before Cytrar's acquisition of the Landfill and, in the short periods in which it did exist, such activities were reduced in scope from a financial and business standpoint.<sup>234</sup> It is logical to understand that, as activities increased due to Cytrar's operations, this increase must have required additional investments. Although upon assessing the Landfill's market value two of the nine cells of the Landfill were full, thus reducing the original landfill capacity from nine to seven cells, it must also be taken into account that the increased productivity of the Landfill was evidenced after Cytrar took over the Landfill's operation. Such increased productivity is necessarily based on Cytrar's managerial and organizational skills and on gaining new clients, to the extent that the Respondent is willing to acknowledge at least net income for one additional year for an amount of US\$ 314,545.<sup>235</sup> On the basis of these considerations, it is legitimate to conclude that the Landfill's market value as of November 25, 1998, could not be lower than the acquisition price paid by Cytrar.

195. On the basis of its own valuation, taking into account the Landfill's market value of US\$ 4,028,788 upon its acquisition and adding the investments made thereafter according to Cytrar's financial statements for 1996, 1997 and 1998, and the profits for two years of operation following the Resolution date, the Arbitral Tribunal finds that such market value as of November 25, 1998, was US\$ 5,553,017.12.<sup>236</sup> Although the Claimant's expert witness assessed the value of such additional investments at US\$ 1,951,473,<sup>237</sup> no documentary evidence has been filed to support such amount, and such evidence has not been alleged by the Claimant in its closing statement. The Respondent challenges such amount in its closing statement on the basis of accounting data by comparing the fiscal years mentioned above, and estimates such amount to be US\$ 439,000.<sup>238</sup> This amount has been accepted by the Arbitral Tribunal. Regarding the profits for the two additional years of operation, the Arbitral Tribunal has calculated such profits at the amount of US\$ 1,085,229.12. For this, the Arbitral Tribunal has considered that an informed buyer of the Landfill would have assumed that it had to be relocated due to the community pressure and that such relocation might take about two years. In such calculation, the Arbitral Tribunal has further considered that the projections clearly stated that Cytrar was increasing its

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<sup>233</sup> Report of Fausto García y Asociados, p. 26.

<sup>234</sup> Respondent's brief "Admissions and Denials", p. 12.

<sup>235</sup> Counter-memorial, 598, p. 171.

<sup>236</sup> The Arbitral Tribunal finds that the Claimant has made its compensation claim in US dollars (memorial, p. 146), and that such claim has not been challenged by the Respondent, who also uses such currency in its allegations to denominate the amounts to which it resorts to challenge the Claimant's claims. The expert witnesses for both parties also translate into such currency the figures they use for their analyses. Therefore, the Arbitral Tribunal makes its determination in US dollars.

<sup>237</sup> Hearing held from May 20 to May 24, 2003; transcript for the session of May 23, pp. 7 overleaf / 8.

<sup>238</sup> Respondent's closing statement added by expert witness Lars Christianson, taken into account by the Arbitral Tribunal as a part of such closing statement according to the Arbitral Tribunal's decision of August 12, 2002, p. 8.

revenues, the value of its clientele and goodwill as an on going business related to the Landfill exploitation, and the other considerations included in this Chapter F, particularly the circumstances explained in paragraphs 189-190 and 193-194, which, in the opinion of the Arbitral Tribunal, cannot be ignored upon establishing the economic compensation owed to the Claimant for the loss of the market value of its investment. The Arbitral Tribunal finds that it is not appropriate to deduct from such amount, which also reflects the principle that compensation of such loss must amount to an integral compensation for the damage suffered, including lost profits,<sup>239</sup> the cost of closing down the Landfill due to a decision attributable to the Respondent that the Arbitral Tribunal has found to be in violation of the Agreement.

196. The Claimant requests that any compensation awarded to it accrue compound interest at a rate of 6%.<sup>240</sup> The Arbitral Tribunal has not found any specific allegation by the Respondent regarding this point. The application of compound interest has been accepted in a number of awards, and it has been stated that:

...compound (as opposed to simple) interest is at present deemed appropriate as the standard of international law in [...] expropriation cases.<sup>241</sup>

In connection with this case, in the opinion of the Arbitral Tribunal, application of compound interest is justified as part of the integral compensation owed to the Claimant as a result of the loss of its investment.

197. Therefore, the amount of US\$ 5,533,017.12 will accrue interest at an annual rate of 6%, compounded annually, commencing on November 25, 1998, until the effective and full payment by the Respondent of all amounts payable by the Respondent to the Claimant under this award.<sup>242</sup>

198. The Arbitral Tribunal finds no reason to award compensation for moral damage, as requested by the Claimant,<sup>243</sup> due to the absence of evidence proving that the actions attributable to the Respondent that the Arbitral Tribunal has found to be in violation of the Agreement have also affected the Claimant's reputation and therefore caused the loss of business opportunities for the Claimant. In addition, the Arbitral Tribunal has not found that the adverse press coverage for Tecmed or Cytrar of the events regarding the Landfill,

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<sup>239</sup> P.C.I.J., *Chorzów Factory* case, (1938) P.C.I.J., Ser. A, 17, p. 29, 47.

<sup>240</sup> Memorial, p. 146.

<sup>241</sup> Award in ICSID case ARB/99/6 *Middle East Cement Shipping and Handling Co.S.A v Arab Republic of Egypt*, April 12, 2002, 174 , p. 42, <http://www.worldbank.org/icsid/cases/awards.htm>. See also: award of December 8, 2000, in ICSID case ARB/98/4, *Wena Hotels Ltd. v Arab Republic of Egypt*, 41 I.L.M. 896 (2002), specially 128-129, p. 919; award in ICSID case No. ARB/96/1 *Compañía del Desarrollo de Santa Elena S.A. v Republic of Costa Rica*, 15 ICSID Law Review-Foreign Investment Law Journal, p. 167; specially 96-106, p. 200-202 (2000); award in ICSID case no. ARB(AF)/97/1 *Metalclad Corporation v United Mexican States*, 16 Mealey's International Arbitration Report, A-1; specially 128, pp. 41-42 (A-16) (2000).

<sup>242</sup> Award in ICSID case No. ARB/84 /3 *Southern Pacific Properties (Middle East) Limited v Arab Republic of Egypt*, 8 Foreign Investment Law Journal-ICSID Law Review, p 328, specially 234-235, p. 393 (1993).

<sup>243</sup> Memorial, pp. 141-142.

was fostered by the Respondent or that it was the result of actions attributable to the Respondent.

199. Promptly after effective payment to the Claimant of all sums payable to it by the Respondent under this award, the Claimant shall take all the necessary steps to transfer, or cause to be transferred, to the Respondent, or to a nominee designated by the Respondent, the assets forming the Landfill.

200. Taking into account that the Claimant has been successful only with respect to some of its claims and that the challenges or defenses filed by the Respondent were also admitted partially, each Party will bear its own costs, expenses and legal counsel fees. The costs incurred by the Arbitral Tribunal and ICSID will be shared equally between the Claimant and the Respondent.

### **G. Decision**

201. Therefore, the Arbitral Tribunal finds as follows:

1. The Respondent has breached its obligations under the Agreement set forth in Articles 4(1) and 5(1).

2. The Respondent will pay the Claimant the amount of US\$ 5,533,017.12, plus a compound interest on such amount at an annual rate of 6%, commencing on November 25, 1998, until the effective and full payment by the Respondent of all amounts payable by the Respondent to the Claimant under this award.

3. Promptly after effective and full payment to the Claimant of all sums payable to it by the Respondent under this award, the Claimant shall take all the necessary steps to transfer, or cause to be transferred, to the Respondent, or to a nominee designated by the Respondent, the assets forming the Landfill.

4. Each Party will bear its own costs, expenses and legal counsel fees. The costs incurred by the Arbitral Tribunal and ICSID will be shared equally between the Claimant and the Respondent.

5. Any claim or petition filed in this arbitration and not admitted herein will be considered rejected.

Rendered in Washington, D.C.

Mr. Carlos Bernal Verea  
Arbitrator  
Date and place of  
execution:

Prof. José Carlos Fernández-  
Rozas  
Arbitrator  
Date and place of execution:

Dr. Horacio A. Grigera Naón  
Chairman of the Arbitral  
Tribunal  
Date and place of execution

# **LEGAL AUTHORITY CA-100**

**WORLD TRADE  
ORGANIZATION**

**WT/DS152/R**  
22 December 1999

(99-5454)

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Original: English

**UNITED STATES – SECTIONS 301-310 OF THE TRADE ACT  
OF 1974**

*Report of the Panel*

The report of the Panel on United States – Sections 301-310 of the Trade Act of 1974 is being circulated to all Members, pursuant to the DSU. The report is being circulated as an unrestricted document from 22 December 1999 pursuant to the Procedures for the Circulation and Derestriction of WTO Documents (WT/L/160/Rev.1). Members are reminded that in accordance with the DSU only parties to the dispute may appeal a panel report. An appeal shall be limited to issues of law covered in the Panel report and legal interpretations developed by the Panel. There shall be no *ex parte* communications with the Panel or Appellate Body concerning matters under consideration by the Panel or Appellate Body.

Note by the Secretariat: This Panel Report shall be adopted by the Dispute Settlement Body (DSB) within 60 days after the date of its circulation unless a party to the dispute decides to appeal or the DSB decides by consensus not to adopt the report. If the Panel Report is appealed to the Appellate Body, it shall not be considered for adoption by the DSB until after the completion of the appeal. Information on the current status of the Panel Report is available from the WTO Secretariat.





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## I. PROCEDURAL BACKGROUND

1.1 This proceeding has been initiated by a complaining party, the European Communities.

1.2 On 25 November 1998, the European Communities requested consultations with the United States under Article XXII:1 of the General Agreement on Tariffs and Trade 1994 ("GATT 1994") and Article 4 of the Understanding on Rules and Procedures Governing the Settlement of Dispute ("DSU") with regard to Title III, chapter 1 (Sections 301-310) of the United States Trade Act of 1974, as amended (19 U.S.C., paragraphs 2411-2420)(WT/DS152/1). The United States agreed to the request. Dominican Republic, Panama, Guatemala, Mexico, Jamaica, Honduras, Japan, and Ecuador requested, in communications dated 7 December 1998 (WT/DS152/2), 4 December 1998 (WT/DS152/3), 9 December 1998 (WT/DS152/4, WT/DS152/5 and WT/DS152/6), 7 December 1998 (WT/DS152/7), and 10 December 1998 (WT/DS152/8 and WT/DS152/10) respectively, to be joined in those consultations, pursuant to Article 4.11 of the DSU. Consultations between the European Communities and the United States were held on 17 December 1998, but the parties were unable to settle the dispute.

1.3 On 26 January 1999, the European Communities requested the establishment of a panel pursuant to Article 6 of the DSU (WT/DS152/11).

1.4 In its panel request, the European Communities claims that:

"By imposing specific, strict time limits within which unilateral determinations must be made and trade sanctions must be taken, Sections 306 and 305 of the Trade Act of 1974 do not allow the United States to comply with the rules of the DSU in situations where a prior multilateral ruling under the DSU on the conformity of implementing measures has not yet been adopted by the DSB. Where measures have been taken to implement DSB recommendations, the DSU rules require either agreement between the parties to the dispute or a multilateral finding on non-conformity under Article 21.5 DSU before any determination of non-conformity can be made, let alone any measures of retaliation can be announced or implemented. The DSU procedure resulting in a multilateral finding, even if initiated immediately at the end of the reasonable period of time for implementation, cannot be finalised, nor can the subsequent DSU procedure for seeking compensation or suspension of concessions be complied with, within the time limits of Sections 306 and 305.

The European Communities considers that Title III, chapter 1 (Sections 301 - 310) of the Trade Act of 1974, as amended, and in particular Sections 306 and 305 of that Act, are inconsistent with, in particular, but not necessarily exclusively, the following WTO provisions:

- (a) Articles 3, 21, 22 and 23 of the DSU;
- (b) Articles XVI:4 of the Marrakesh Agreement Establishing the World Trade Organization; and
- (c) Articles I, II, III, VIII and XI of GATT 1994.

Through these violations of WTO rules, this legislation nullifies or impairs benefits accruing, directly or indirectly, to the European Communities under

GATT 1994. This legislation also impedes important objectives of the GATT 1994 and of the WTO.

1.5 The Dispute Settlement Body ("DSB") agreed to this request for a panel at its meeting of 2 March 1999, establishing a panel pursuant to Article 6 of the DSU. In accordance with Article 7.1 of the DSU, the terms of reference of the Panel were:

"To examine, in the light of the relevant provisions of the covered agreements cited by the European Communities in document WT/DS152/11, the matter referred to the DSB by the European Communities in that document and to make such findings as will assist the DSB in making the recommendations or in giving the rulings provided for in those agreements".

1.6 Brazil, Cameroon, Canada, Columbia, Costa Rica, Cuba, Dominica, Dominican Republic, Ecuador, Hong Kong (China), India, Israel, Jamaica, Japan, Korea, St. Lucia, and Thailand, reserved their rights to participate in the Panel proceedings as third parties. Cameroon later withdrew its reservations as a third party.

1.7 On 24 March 1999, the European Communities requested the Director-General, pursuant to Article 8.7 of the DSU, to determine the composition of the Panel. On 31 March 1999, the Director-General announced the composition of the Panel as follows:

Chairman: Mr. David Hawes  
Member: Mr. Terje Johannessen  
Mr. Joseph Weiler

1.8 The Panel had substantive meetings with the parties on 29 and 30 June 1999, and 28 July 1999.

## **II. FACTUAL ASPECTS**

### **A. BASIC STRUCTURE OF MEASURES AT ISSUE<sup>1</sup>**

#### **1. Section 301(a)**

2.1 Section 301(a) applies to any case in which "the United States Trade Representative determines under section 304(a)(1) that (A) the rights of the United States under any trade agreement are being denied" or "(B) an act, policy or practice of a foreign country – (i) violates, or is inconsistent with, the provisions of, or otherwise denies benefits to the United States under, any trade agreement, or (ii) is unjustifiable and burdens or restricts United States commerce".<sup>2</sup>

2.2 According to Section 304(a)(1),

"On the basis of the investigation initiated under section 302 and the consultations (and the proceedings, if applicable) under section 303, the [United States] Trade Representative shall ... determine whether ... the rights to which

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<sup>1</sup> The original text of the Sections 301-310 is attached hereto as Annex I.

<sup>2</sup> Section 301(a)(1), 19 U.S.C. §2411(a)(1).

the United States is entitled under any trade agreement are being denied, or any act, policy, or practice described in sub-section (a)(1)(B) or (b)(1) of section 301 exists".<sup>3</sup>

2.3 Section 301(a) also provides that if the USTR determines that one of these situations has occurred, "the Trade Representative shall take action authorized in [Section 301](c), subject to the specific direction, if any, of the President regarding any such action ... to enforce such rights or to obtain the elimination of such act, policy, or practice".<sup>4</sup>

2.4 According to Section 301(a)(2)(A), action is not required under Section 301(a) if the DSB adopts a report finding that United States rights under a WTO Agreement have not been denied or that the act, policy or practice at issue "(I) is not a violation of, or inconsistent with, the rights of the United States, or (II) does not deny, nullify, or impair benefits to the United States under any trade agreement".<sup>5</sup>

2.5 Section 301(a)(2)(B)(i) also provides that the USTR is not required to take action if "the Trade Representative finds that the foreign country is taking satisfactory measures to grant the rights of the United States under a trade agreement". The commitment of a WTO Member to implement DSB recommendations favourable to the United States within the period foreseen in Article 21 of the DSB has, for example, been determined by the USTR to be a "satisfactory measure" justifying a termination of the investigation without taking any action under Section 301.<sup>6</sup>

2.6 According to Section 301(a)(2)(B)(ii) and (iii), the USTR is not required to take action if the foreign country agrees to "eliminate or phase out the act, policy or practice"<sup>7</sup> at issue or if it agrees to "an imminent solution to the burden or restriction on United States commerce",<sup>8</sup> or "provide to the United States compensatory trade benefits that are satisfactory to the Trade Representative", when "it is impossible for the foreign country to achieve the results described in clause (i) or (ii)".<sup>9</sup>

2.7 Further, according to Section 301(a)(2)(B)(iv) and (v), the USTR is not required to take action when she finds that:

"(iv) in extraordinary cases, where the taking of action ... would have an adverse impact on the United States economy substantially out of proportion to the benefits of such action, taking into account the impact of not taking such action on the credibility of the provisions of this chapter";<sup>10</sup> or

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<sup>3</sup> Section 304(a)(1), 19 U.S.C. §2414(a)(1).

<sup>4</sup> Section 301(a), 19 U.S.C. §2411(a).

<sup>5</sup> Section 301(a)(2)(A), 19 U.S.C. §2411(a)(2)(A).

<sup>6</sup> The European Communities notes that the USTR terminated on this basis the original Section 301 investigation concerning the EC banana regime. (See Federal Register, Vol. 63, No. 204, October 22 1998, page 56688).

<sup>7</sup> Section 301(a)(2)(B)(ii)(I), 19 U.S.C. §2411(a)(1)(B)(ii)(I).

<sup>8</sup> Section 301(a)(2)(B)(ii)(II), 19 U.S.C. §2411(a)(1)(B)(ii)(II).

<sup>9</sup> Section 301(a)(2)(B)(iii), 19 U.S.C. §2411(a)(1)(B)(iii).

<sup>10</sup> Section 301(a)(2)(B)(iv), 19 U.S.C. §2411(a)(1)(B)(iv).

"(v) the taking of action under this subsection would cause serious harm to the national security of the United States".<sup>11</sup>

2.8 Section 301(a)(3) provides:

"(3) Any action taken under paragraph (1) to eliminate an act, policy, or practice shall be devised so as to affect goods or services of the foreign country in an amount that is equivalent in value to the burden or restriction being imposed by that country on United States commerce".<sup>12</sup>

## 2. Section 301(b)

2.9 Section 301(b) applies to an act, policy or practice which, while not denying rights or benefits of the United States under a trade agreement, is nevertheless "unreasonable or discriminatory and burdens or restricts United States commerce".<sup>13</sup>

2.10 Section 301(d)(3)(B) provides examples of unreasonable acts, among them the denial of opportunities for the establishment of an enterprise, failure to protect intellectual property rights, export targeting, toleration of anti-competitive practices by private firms and denial of worker rights.<sup>14</sup> "Discriminatory" acts, policies and practices are defined in Section 301(d)(5) as including those that deny "national or most-favoured-nation treatment to United States goods, services, or investment".<sup>15</sup> If the USTR determines that an act, policy or practice is actionable under Section 301(b) and determines that "action by the United States is appropriate" the USTR shall take retaliatory action "subject to the specific direction, if any, of the President regarding such action".<sup>16</sup>

## B. SCOPE OF AUTHORITY TO TAKE ACTION

2.11 Section 301(c) authorizes the USTR to "suspend, withdraw, or prevent the application of, benefits of trade agreement concessions", or "impose duties or other import restrictions on the goods of, and ... fees or restrictions on the services of, such foreign country for such time as the Trade Representative determines appropriate".<sup>17</sup> If the act, policy or practice of the foreign country fails to meet the eligibility criteria for duty-free treatment under the United States' Generalised System of Preferences, the Caribbean Basin Economic Recovery Act or the Andean Trade Preference Act, the USTR is also authorized to withdraw, limit or suspend such treatment. In addition, the USTR may enter into binding agreements with the country in question.

## C. PROCEDURES

2.12 Sections 301-310 of the Trade Act of 1974 provide a means by which U.S. citizens may petition the United States government to investigate and act against potential violations of international trade agreements.<sup>18</sup> These provisions also authorize the USTR to initiate such

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<sup>11</sup> Section 301(a)(2)(B)(v), 19 U.S.C. §2411(a)(1)(B)(v).

<sup>12</sup> Section 301(a)(3), 19 U.S.C. §2411(a)(3).

<sup>13</sup> Section 301(b), 19 U.S.C. §2411(b).

<sup>14</sup> Section 301(d)(3)(B), 19 U.S.C. §2411(d)(3)(B).

<sup>15</sup> Section 301(d)(5), 19 U.S.C. §2411(d)(5).

<sup>16</sup> Section 301(b), 19 U.S.C. §2411(b).

<sup>17</sup> Section 301(c), 19 U.S.C. §2411(c).

<sup>18</sup> Section 302(a)(2), 19 U.S.C. § 2412(a)(2).



investigations at her own initiative.<sup>19</sup> The USTR is a cabinet level official serving at the pleasure of the President, and her office is located within the Executive Office of the President.<sup>20</sup> The USTR operates under the direction of the President and advises and assists the President in various Presidential functions.<sup>21</sup>

2.13 According to Section 302, investigations may be initiated either upon citizen petition or at the initiative of the USTR. After a petition is filed, the USTR decides within 45 days whether or not to initiate an investigation.<sup>22</sup> If the investigation is initiated, the USTR must, according to Section 303, request consultations with the country concerned, normally on the date of initiation but in any case not later than 90 days thereafter.<sup>23</sup>

2.14 Section 303(a)(2) provides that, if the investigation involves a trade agreement and a mutually acceptable resolution is not reached "before the earlier of A) the close of the consultation period, if any, specified in the trade agreement, or B) the 150<sup>th</sup> day after the day on which consultation commenced", the USTR must request proceedings under the formal dispute settlement procedures of the trade agreement.<sup>24</sup>

2.15 Section 304(a) provides that on or before the earlier of "(i) the date that is 30 days after the date on which the dispute settlement procedure is concluded, or (ii) the date that is 18 months after the date on which the investigation is initiated",<sup>25</sup> "[o]n the basis of the investigation initiated under section 302 and the consultations (and the proceedings, if applicable) under section 303, the Trade Representative shall ... determine whether" US rights are being denied.<sup>26</sup> If the determination is affirmative, USTR shall at the same time determine what action it will take under section 301.<sup>27</sup>

2.16 If the DSB adopts rulings favourable to the United States on a measure investigated under Section 301, and the WTO Member concerned agrees to implement that ruling within the reasonable period foreseen in Article 21 of the DSU, the USTR can determine that the rights of the United States are being denied but that "satisfactory measures" are being taken that justify the termination of the Section 301 investigation.

2.17 Section 306(a) requires the USTR to "monitor" the implementation of measures undertaken by, or agreements entered into with, a foreign government to provide a satisfactory resolution of a matter subject to dispute settlement to enforce the rights of the United States under a trade agreement.<sup>28</sup>

2.18 Section 306(b) provides:

"(1) **IN GENERAL.**—If, on the basis of the monitoring carried out under subsection (a), the Trade Representative considers that a foreign country is not

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<sup>19</sup> Section 302(b), 19 U.S.C. § 2412(b).

<sup>20</sup> See 19 U.S.C. § 2171(a), (b)(1) (1998).

<sup>21</sup> See 19 U.S.C. § 2171(c)(1) (1998); Reorg. Plan No. 3 of 1979, 44 Fed. Reg. 69273 (1979); 19 C.F.R. § 2001.3(a) (1998).

<sup>22</sup> Section 302(a)(2), 19 U.S.C. §2412(a)(2).

<sup>23</sup> Section 303(a)(1), 19 U.S.C. §2413(a)(1)

<sup>24</sup> Section 303(a)(2), 19 U.S.C. §2413(a)(2).

<sup>25</sup> Section 304(a)(2), 19 U.S.C. §2414(a)(2).

<sup>26</sup> Section 304(a)(1)(A), 19 U.S.C. §2414(a)(1)(A).

<sup>27</sup> Section 304(a)(1)(B), 19 U.S.C. §2414(a)(1)(B).

<sup>28</sup> Section 306(a), 19 U.S.C. §2416(a).

satisfactorily implementing a measure or agreement referred to in subsection (a), the Trade Representative shall determine what further action the Trade Representative shall take under section 301(a). For purposes of section 301, any such determination shall be treated as a determination made under section 304(a)(1).

(2) **WTO DISPUTE SETTLEMENT RECOMMENDATIONS.**—If the measure or agreement referred to in subsection (a) concerns the implementation of a recommendation made pursuant to dispute settlement proceedings under the World Trade Organization, and the Trade Representative considers that the foreign country has failed to implement it, the Trade Representative shall make the determination in paragraph (1) no later than 30 days after the expiration of the reasonable period of time provided for such implementation under paragraph 21 of the Understanding on Rules and Procedures Governing the Settlement of Disputes ...".<sup>29</sup>

2.19 Section 305(a)(1) provides that, "Except as provided in paragraph (2), the Trade Representative shall implement the action the Trade Representative determines under section 304(a)(1)(B), subject to the specific direction, if any, of the President regarding such action" "by no later than ... 30 days after the date on which such determination is made".<sup>30</sup>

2.20 According to Section 305(a)(2)(A), however, "the [USTR] may delay, by not more than 180 days, the implementation" of any action under Section 301 in response to a request by the petitioner or the industry that would benefit from the Section 301 action or if the USTR determines "that substantial progress is being made, or that a delay is necessary or desirable to obtain United States rights or satisfactory solution with respect to the acts, policies, or practices that are the subject of the action".<sup>31</sup>

### III. CLAIMS OF PARTIES

3.1 In the light of the considerations set out above and of the general principles laid down in Article 3.7 of the DSU, **the European Communities requests** the Panel

to find that:

- (a) inconsistently with Article 23.2(a) of the DSU:
- Section 304(a)(2)(A) of Trade Act of 1974 requires the USTR to determine whether another Member denies US rights or benefits under a WTO agreement irrespective of whether the DSB adopted a panel or Appellate Body finding on the matter; and
  - Section 306(b) requires the USTR to determine whether a recommendation of the DSB has been implemented irrespective of whether proceedings on this issue under Article 21.5 of the DSU have been completed;

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<sup>29</sup> Section 306(b), 19 U.S.C. § 2416(b).

<sup>30</sup> Section 305(a)(1), 19 U.S.C. §2415(a)(1).

<sup>31</sup> Section 305(a)(2)(A), 19 U.S.C. §2415(a)(2)(A).

- (b) inconsistently with Article 23.2(c) of the DSU:
- Section 306(b) requires the USTR to determine what further action to take under Section 301 in the case of a failure to implement DSB recommendations; and
  - Section 305(a) requires the USTR to implement that action,
- and this in both instances, irrespective of whether the procedures set forth in Articles 21.5 and 22 of the DSU have been completed; and
- (c) Section 306(b) is inconsistent with Articles I, II, III, VIII and XI of the GATT 1994 because, in the case of disputes involving trade in goods, it requires the USTR to impose duties, fees or restrictions that violate one or more of these provisions; and

to rule on these grounds, that the United States, by failing to bring the Trade Act of 1974 into conformity with the requirements of Article 23 of the DSU and of Articles I, II, III, VIII and XI of the GATT 1994, acted inconsistently with its obligations under those provisions and under Article XVI.4 of the WTO Agreement and thereby nullifies or impairs benefits accruing to the European Communities under the DSU, the GATT 1994 and the WTO Agreement; and

to recommend that the DSB request the United States to bring its Trade Act of 1974 into conformity with its obligations under the DSU, the GATT 1994 and the WTO Agreement.

3.2 **The United States requests** that the Panel reject the EC's claims in their entirety, and find that:

- (a) Section 304(a)(2)(A) is not inconsistent with Article 23 of the DSU because the EC has failed to demonstrate that it requires the Trade Representative to determine that U.S. agreement rights have been denied in the absence of DSB rulings;
- (b) Section 306(b) is not inconsistent with Article 23 of the DSU because the EC has failed to demonstrate that it requires the Trade Representative to determine that U.S. agreement rights have been denied;
- (c) Sections 306(b) and 305(a)(1) are not inconsistent with Article 23 of the DSU because the EC has failed to demonstrate that these provisions require the Trade Representative to suspend concessions without DSB authorization;
- (d) Section 306(b) is not inconsistent with Articles I, II, III, VIII and XI of the GATT 1994 because the EC has failed to demonstrate that this provision requires the suspension of concessions in a manner inconsistent with DSB authorization; and
- (e) Sections 301-310 are not inconsistent with Article XVI:4 because they do not mandate action in violation of any provision of the DSU or GATT 1994, nor do they preclude action consistent with those obligations.

#### IV. ARGUMENTS OF THE PARTIES

##### A. OVERVIEW

4.1 **The European Communities** argues that Article 23 of the DSU prohibits unilateralism in the framework of the WTO dispute settlement procedures. Members must await the adoption of a panel or Appellate Body report by the DSB, or the rendering of an arbitration decision under Article 22 of the DSU, before determining whether rights or benefits accruing to them under a WTO agreement are being denied and whether rulings or recommendations by the DSB or an arbitrator have been implemented.

4.2 The European Communities indicates that Article 23 also requires Members to follow the procedures of the DSU on the suspension of concessions and to await an authorization by the DSB before responding to a failure to comply with such rulings or recommendations.<sup>32</sup>

4.3 The European Communities states that while Sections 301-310 require the United States administration to resort to the DSU in respect of WTO matters, they explicitly mandate the United States administration to proceed unilaterally on the basis of determinations reached independently of the DSB, and without its authorization, once specified time periods have lapsed. A law that requires resort to the DSU procedures but expressly stipulates unilateral determinations and actions before the end of these procedures makes a mockery of the WTO dispute settlement system.

4.4 The European Communities therefore believes that Sections 301-310 must be amended to make clear that the United States administration is required to act in accordance with the United States' obligations under the WTO agreements in all circumstances and at all times.

4.5 The European Communities indicates that the obligation set out in Article 23 of the DSU is one of the key elements in the negotiated balance of rights and obligations of the Uruguay Round.

4.6 The European Communities states that the European Communities itself as well as many other countries, consistently took the position in the Uruguay Round that a strengthened dispute settlement system must include an explicit ban on any government taking unilateral action to redress what that government judges to be the trade wrongs of others.

4.7 The European Communities argues that the creation of automatic dispute settlement procedures leave no excuse for any government to take the law into its own hands. Article 23 of the DSU and Article XVI:4 of the WTO Agreement are the principal reflections of the outcome of the negotiation in the Uruguay Round on these issues.

4.8 The European Communities indicates that its Regulation on the enforcement of WTO rights adopted after the Uruguay Round meets both the letter and the spirit of Article 23 of the DSU. This Regulation, generally referred to as the "Trade Barriers Regulation", enables Member States and Community enterprises to request the European Commission to examine

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<sup>32</sup> The European Communities notes that an alternative route with the agreement of the parties to the dispute would be to follow the procedures under Article 25 of the DSU before an authorization to suspend concessions is sought.

obstacles to trade and to initiate international dispute settlement procedures on such obstacles.<sup>33</sup> However, all actions under the Regulation are "subject to compliance with existing international obligations and procedures".<sup>34</sup> Specifically, the Regulation provides that "where the Community's international obligations require the prior discharge of an international procedure for consultation or for the settlement of disputes" any response to the obstacle "shall only be decided after that procedure has been terminated".<sup>35</sup> The European Communities has faithfully implemented its obligations under Article 23 of the DSU and Article XVI:4 of the WTO Agreement and expects all the other Members of the WTO, including the United States, to do the same.

4.9 According to the European Communities, although the present complaint was ultimately prompted by the experience of the Communities with the measures the United States took under Sections 301-310 in the dispute on the European banana regime, this complaint does not concern those measures. The European Communities indicates that these measures are presently the subject matter of a different dispute (WT/DS165/1).

4.10 The European Communities further argues that this experience did however reveal the seriousness of the inconsistencies between the requirements under which the USTR is mandated to act under the domestic law of the United States and the requirements for the completion of dispute settlement procedures under WTO law. It also confirmed that the United States has implemented *ob torto collo* the results of the Uruguay Round into its legislation, keeping open for itself the possibility of resorting to unilateral measures, in clear contradiction with its obligations under the DSU.

4.11 The European Communities notes that in the statement of administrative action submitted by the President to the Congress on 27 September 1994 and approved by the Congress together with the Uruguay Round Agreements Act of 1994<sup>36</sup>, the United States announced that

"[t]he administration intends to use section 301 to pursue vigorously foreign unfair barriers that violate U.S. rights or deny benefits to the United States under the Uruguay Round agreements".<sup>37</sup>

"... There is no basis for concern that the Uruguay Round agreements in general, or the DSU in particular, will make future Administrations more reluctant to apply Section 301 sanctions that may be inconsistent with U.S. trade obligations because such sanctions could engender DSU-authorized counter-retaliation. Although in specific cases the United States has expressed its intention to address an unfair foreign practice by taking action under Section 301 that has not been authorized by the GATT, the United States has done so infrequently. In certain cases the United States has taken such action

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<sup>33</sup> Council Regulation (EC) No. 3286/94 of 22 December 1994, which, according to the European Communities, lays down Community procedures in the field of the common commercial policy in order to ensure the exercise of the Community's rights under international trade rules, in particular those established under the auspices of the World Trade Organization.

<sup>34</sup> *Ibid.*, Article 1.

<sup>35</sup> *Ibid.*, Article 12.2.

<sup>36</sup> Section 101(a) (1).

<sup>37</sup> Statement of Administrative Action, *reprinted in* H.R. Doc. No. 103-316, at 1029 (US Exhibit 11), Chapter B, subchapter 2, littera b (enforcement of US rights), p. 364.

because the foreign government has blocked adoption of a GATT panel report against it.

Just as the United States may now choose to take Section 301 actions that are not GATT-authorized, governments that are the subject of such actions may choose to respond in kind. That situation will not change under the Uruguay Round agreements".<sup>38</sup>

4.12 According to the European Communities, this way of implementing the results of the Uruguay Round multilateral trade negotiations is simply incompatible with the international obligations of the United States resulting from the basic deal that was struck in Marrakech in 1994.

4.13 The European Communities argues that it is in exchange for a US commitment not to resort to unilateral determination of the consistency of foreign trade measures with WTO trade rules and to section 301-type trade restrictions without multilateral authorization that the European Communities and other Uruguay Round participants agreed to accept a dispute settlement system that would allow binding adjudication of all trade disputes coming under the purview of the WTO and a credible enforcement procedure.

4.14 In the view of the European Communities, this deal responded to US criticism of the perceived imperfections of the GATT dispute settlement system which had been discussed at a special session of the GATT Council on unilateralism in 1989,<sup>39</sup> i.e. the possibility to block the adoption of adverse panel reports. That possibility has now been removed. Thus, it is only fair for the European Communities to require the United States to carry out the agreed counterpart of the deal by refraining from mandating recourse to unilateral section 301-type trade restrictions. This is the deal for which the European Communities bargained in the Uruguay Round.

4.15 The European Communities argues that it therefore resorted to the present dispute settlement procedures in order to ensure that the United States brings Sections 301-310, as such, into conformity with Article 23 of the DSU, as required by Article XVI:4 of the WTO Agreement. It follows from these considerations that the present complaint is not intended in any way to either foreclose or prejudge the resort of the European Communities to the DSU with respect to the discriminatory specific measures that the United States has applied or might apply in the future to European exports under Sections 301-310 of the Trade Act of 1974.

4.16 Also, the European Communities explains the legislative history of Sections 301-310 as follows: Under the Trade Expansion Act of 1962, the United States Congress granted the President the power to take actions against imports under certain conditions.<sup>40</sup> This statute was replaced and expanded by Title III of the Trade Act of 1974, which granted similar powers to the President in its Section 301. The Act also established procedures enabling U.S. citizens to petition the government for action against measures by foreign governments. This part of the Trade Act of 1974 was amended several times, most recently by the Uruguay Round

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<sup>38</sup> Statement of Administrative Action, op. cit., Chapter B, subchapter 2, littera b (enforcement of US rights), p. 366 (emphasis added).

<sup>39</sup> GATT doc. C/163 of 16 March 1989 (The European Communities referred to the arguments for example, contained in paras. 4.75-4.81, and 4.374-4.378 of this Report for a more detailed discussion of the negotiating history concerning Article 23 DSU).

<sup>40</sup> Trade Expansion Act of 1962, § 252, Pub.L. No. 87-794, 75 Stat. 879.

Agreements Act of 1994.<sup>41</sup> Title III of the Trade Act of 1974, as amended, entitled "Relief from unfair trade practices", comprises Sections 301-310 which set out in detail how the administration is to enforce the United States rights under trade agreements and respond to certain foreign trade practices.

4.17 The European Communities adds that most of the amendments enacted between 1974 and 1994 were designed to reduce the President's discretion under Section 301. The prevailing view in Congress was that the President had not made sufficient use of the powers under Section 301 because he had given priority to foreign policy concerns over trade interests. In the hearings preceding the 1988 amendments, Senator George J. Mitchell stated:

"The history of Section 301 is a history of administration after administration of both parties refusing to implement the law. Instead, this president and his predecessors have used the wide discretion provided in the law to deny or to delay taking action sometimes for close to a decade... The administration will claim that [the proposed Section 301] reforms limit their discretion. But it is this very discretion which had led to the disastrous record of enforcement under Section 301".<sup>42</sup>

The Chairman of the Senate Finance Committee, Senator Lloyd Bentsen, took a similar position:

"We need a trade policy that our trade partners can predict, and I maintain that requires limits on the President's discretion not to act. He needs plenty of discretion on what action to take, but limits have to be placed on his discretion to take no action".<sup>43</sup>

4.18 The European Communities further states that prior to the 1988 amendments of Section 301, it was the President who was authorized to determine whether the foreign government practices were actionable and whether the United States should respond to them with trade measures. In 1985, the Congress discussed whether the President's power should be transferred to the United States Trade Representative ("USTR"). Those in favour argued that it "will ensure that when decisions are made under Section 301 authority, these decisions will be made primarily for reasons of trade policy" and that it would "enhance USTR's position as the lead trade agency and ... make it less likely that trade retaliation would be waived because of foreign policy, defence, or other considerations".<sup>44</sup> The administration strongly opposed such a transfer of authority, arguing that the President required discretion to defend the United States interests effectively, and that the USTR in any case served at the President's pleasure and could therefore not be expected to act contrary to the President's views. Moreover, the President was in a better position to weigh the national and industry-specific interests at stake in a Section 301 investigation. Ambassador Yeutter, the former USTR, wrote to the Chairman of the Committee on Ways and Means that

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<sup>41</sup> See the description of the legislative history of Section 301 in Jackson-Davey-Sykes, *Legal Problems of International Economic Relations*, Third Edition (West Publishing Co., 1995), page 818.

<sup>42</sup> Quoted from Judith Hippler Bello and Alan F. Holmer, *The Heart of the 1988 Trade Act. A Legislative History of the Amendments to Section 301*, in Jagdish Bhagwati and Hugh T. Patrick, Editors, *Aggressive Unilateralism. America's 301 Trade Policy and the World Trading System* (Harvester Wheatsheaf, 1990), page 58.

<sup>43</sup> *Ibid.*, page 59.

<sup>44</sup> Quoted from Bello and Holmer, *op. cit.*, page 51.

"Section 301 is the H-bomb of trade policy; and in my judgement, H-bombs ought to be dropped by the President of the United States and not by anyone else".<sup>45</sup>

4.19 **The United States responds** that in its request for the establishment of this Panel, the European Communities defined its legal challenge to Sections 301-310 of the Trade Act of 1974 as follows:

"By imposing specific, strict time limits within which unilateral determinations must be made that other WTO Members have failed to comply with their WTO obligations and trade sanctions must be taken against such WTO Members, this legislation does not allow the United States to comply with the rules of the DSU and the obligations of GATT 1994 in situations where the Dispute Settlement Body has, by the end of those time limits, not made a prior determination...".<sup>46</sup>

4.20 The United States argues that the European Communities thus from the outset has acknowledged its burden in this case: since it is challenging a law as such, and no specific action taken pursuant to the law, it must demonstrate that Sections 301-310 themselves do not allow the US government to act in accordance with its WTO obligations. As panel reports cited by the European Communities make clear, a law is not in itself inconsistent with a WTO Member's obligations unless that law mandates action which violates those obligations, even if the law does not preclude such action. The question before this Panel is therefore straightforward: do Sections 304(a)(2)(A), 306(b) and 305(a) of the Trade Act of 1974 mandate actions that are inconsistent with US obligations under the Understanding on Rules and Procedures Governing the Settlement of Disputes ("DSU") and the General Agreement on Tariffs and Trade 1994 ("GATT 1994")?

4.21 According to the United States, the European Communities falls woefully short of demonstrating that they do. The European Communities ignores key provisions of the statute and engages in tortured readings of others in an unsuccessful attempt to find even the narrowest of WTO violations – that if WTO dispute proceedings were to require the maximum time authorized under the DSU, Sections 304(a)(2)(A), 306(b) and 305(a) would require US government determinations and actions shortly before formal – and inevitable – adoption of panel, Appellate Body and arbitral findings which have already been issued. However, not even this claim is true. Sections 301 - 310 of the Trade Act of 1974 on their face ensure that the US government may make its determinations and take actions in a manner which is fully consistent with DSU Article 23 and GATT 1994 Articles I, II, III, VIII and XI. The statute does not require the USTR to make a unilateral determination that US agreement rights have been denied, nor does it impose time limits which preclude prior action by the Dispute Settlement Body either to support US determinations or to authorize actions responding to another Member's failure to comply with DSB recommendations.

4.22 The United States maintains that the USTR need not and may not, under Section 304(a)(1), determine that US agreement rights have been denied if there are not adopted panel or Appellate Body findings to that effect. The requirement to make a determination within 18 months is not frustrated by the need to comply with the additional statutory requirement that a determination that agreement rights have been denied must be based on the results of dispute settlement proceedings. The USTR is required under Section 304(a)(1) to

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<sup>45</sup> Quoted from Bello and Holmer, op. cit., page 52.

<sup>46</sup> Circulated on 2 February 1999 as document WT/DS152/11 (emphasis added).



base a determination of whether agreement rights have been denied on the results of WTO dispute settlement proceedings. Thus, in the event that a dispute settlement panel were to fail to complete its proceedings within the time frames provided for in the DSU and Section 304(a)(2)(A), the USTR would not be able to make a determination that US agreement rights have been denied. On this basis, she could determine that dispute settlement proceedings had not yet finished, and that a determination concerning US agreement rights would be made following completion of these proceedings. She could also, for example, terminate the Section 304 investigation on the basis of the fact that information necessary to make her Section 304(a)(1) determination is not available, then reinitiate another case. The USTR has terminated and reinitiated Section 302 investigations before, including in the *Bananas* dispute,<sup>47</sup> and has terminated investigations without making a determination on numerous occasions.<sup>48</sup>

4.23 The United States adds with respect to Section 306(b) that the European Communities is simply wrong in asserting that there are "explicit requirements to make a determination within a specified time frame whether ... failure to implement DSB recommendations has occurred". When the USTR considers non-implementation to have occurred, this is not a determination. Moreover, there are no "specified time frames" for such a "consideration". Inasmuch as a consideration is no more than a belief, the USTR may, at any time – before, during or after the reasonable period of time – consider that another Member has not implemented DSB rulings and recommendations, just as a Member may consider, may believe, that another Member has violated its WTO obligations before, during and after the deadline for submitting a request to establish a panel at a given DSB meeting. Section 306 provides only that if, during the 30 days following the reasonable period, the USTR considers that non-implementation has occurred, she shall determine whether to avail herself of Article 22 procedures. Indeed, as Article 22 is currently drafted, she must avail herself of these procedures within this time frame if the United States is to preserve its WTO rights. However, nothing prevents her from not considering during that 30-day period that non-implementation has occurred.

4.24 The United States argues that nothing in Sections 301-310 requires the US government to act in violation of its WTO obligations. To the contrary, Section 303(a) of the Act requires the USTR to undertake WTO dispute settlement proceedings when a WTO agreement is involved,<sup>49</sup> and Section 304(a)(1)(A) provides that the USTR will rely on the results of those proceedings when determining whether US agreement rights have been denied.<sup>50</sup> Likewise, Section 301(a)(2)(A) explicitly indicates that the USTR need not take action when the DSB has adopted a report finding no denial of US WTO rights.<sup>51</sup> The European Communities acknowledges that these provisions, the core provisions establishing the relationship between Sections 301-310 and the WTO dispute settlement process, are "in conformity with the principles set out in Article 23".

4.25 The United States argues that as the complaining party to this proceeding, the European Communities bears the burden of presenting evidence and arguments sufficient to establish a presumption that Sections 301-310 of the Trade Act of 1974 are inconsistent with the DSU and

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<sup>47</sup> The United States refers to Termination of Investigation; Initiation of New Investigation and Request for Public Comments: European Union Banana Regime, 60 Fed. Reg. 52026 (1995) (US Exhibit 18).

<sup>48</sup> The United States provides a list as US Exhibit 13.

<sup>49</sup> Section 303(a), 19 U.S.C. § 2413(a)(2).

<sup>50</sup> Section 304(a)(1)(A), 19 U.S.C. § 2414(a)(2)(A).

<sup>51</sup> The United States notes that all of these provisions predate the conclusion of the Uruguay Round.

GATT 1994.<sup>52</sup> In this case, the evidence is the language of Sections 301-310 and how this language is interpreted and applied under United States law.<sup>53</sup> Under well-established GATT and WTO jurisprudence and practice which the European Communities appears to accept, a law may be found inconsistent with a Member's WTO obligations only if it precludes a Member from acting consistently with those obligations. The European Communities must therefore demonstrate that Sections 301-310 do not permit the United States government to take action consistent with US WTO obligations – that this legislation in fact mandates WTO-inconsistent action. The European Communities has failed to meet this burden. Its analysis of the language of Sections 301-310 ignores pertinent statutory language and relies on constructions not permitted under US law. Sections 301-310 of the Trade Act of 1974 are fully consistent with US WTO rights and obligations.

4.26 **The European Communities argues** that it has basically submitted to the panel's examination a single, fundamental claim, which is supported by a number of arguments: by adopting, maintaining on its statute book and applying Sections 301-310 (as they are presently worded) after the entry into force of the Uruguay Round Agreements (i.e. after 1 January 1995) the United States has breached the historical deal that was struck in Marrakech between the United States on the one hand, and the other Uruguay Round participants, among them its major trading partners like the European Communities and the developing countries, on the other hand.

4.27 The European Communities indicates that that deal, which it has proposed to call the "Marrakech Deal", has found its expression in the legal texts of the WTO Agreements, *inter alia* in Articles 3, 21, 22 and, most importantly, 23 of the DSU and Article XVI:4 of the Marrakech Agreement. It is the trade-off between the practical certainty of adoption by the DSB of panel and Appellate Body reports and the authorizations for Members to suspend concessions (an explicit US request<sup>54</sup>) and the complete and definitive abandoning by the United States of its long-standing policy of unilateral action. The second leg of the deal, which is the core of the present panel procedure, has been enshrined in the following WTO provisions:

- (a) Strengthening of the multilateral system (Article 23 of the DSU and the related provisions under Articles 21 and 22)
- (b) Security and predictability of the multilateral trading system (Article 3 of the DSU)
- (c) Ensuring the conformity of domestic law (Article XVI:4 of the Marrakech Agreement)

4.28 The European Communities states that Article 23 of the DSU prohibits unilateralism in the framework of the WTO dispute settlement procedures. Members must await the adoption of

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<sup>52</sup> Appellate Body Report on *United States – Measures Affecting Imports of Woven Wool Shirts and Blouses from India* ("US – Shirts and Blouses"), adopted 23 May 1997, WT/DS33/AB/R, p. 14.

<sup>53</sup> Appellate Body Report on *India – Patent Protection for Pharmaceutical and Agricultural Chemical Products* ("India – Patents (US)"), adopted 16 January 1998, WT/DS50/AB/R, para. 65.

<sup>54</sup> According to the European Communities, the United States confirmed indirectly the EC views in the following phrase: "... the United States infrequently expressed its intention to take retaliatory action, and such action was often a response to a trading partner's decision to obstruct dispute settlement proceedings". The European Communities does not warrant, of course, the statement of the United States defining the retaliatory actions also in the past as "infrequent". The reality, as all the third parties have shown, is quite different.

a panel or Appellate Body report by the DSB before determining that rights or benefits accruing to them under a WTO agreement are being denied and that rulings or recommendations by the DSB have not been implemented.

4.29 In the view of the European Communities, Article 23 also requires WTO Members to follow the procedures of the DSU, including the procedure under Article 21.5, before determining a failure to comply with such rulings or recommendations and to await an authorization by the DSB before resorting to the suspension of concessions or other obligations, where applicable on the basis of the level of such suspension determined by an arbitration decision under Article 22 of the DSU.

4.30 The European Communities further argues that Article 3 of the DSU describes the dispute settlement system of the DSU as "a central element in providing security and predictability to the multilateral trading system". As the Appellate Body has indicated in the *EC – Computer Equipment* report,<sup>55</sup> the objective of the "security and predictability of the multilateral trading system" is also an object and purpose of the WTO Agreements themselves. It is the reflection of the general principle of public international law "*pacta sunt servanda*" (Article 26 of the Vienna Convention of the Law of Treaties), which requires that international agreements be performed in good faith. According to the Appellate Body report in *India – Patent Protection for Pharmaceutical and Agricultural Chemical Products*<sup>56</sup>, this means in practice not merely the possibility for the Members' executive authorities to act consistently with WTO law, but requires WTO Members to provide "a sound legal basis" in domestic law for the measures required to implement their WTO obligations. The Appellate Body ruling was adopted at the request of the United States and should therefore be easily accepted by the United States as applicable also in the present case.

4.31 The European Communities further states that Article XVI:4 of the Marrakech Agreement is a fundamental, additional principle of the WTO legal system governing the relationship between domestic laws, regulations and administrative procedures (i.e. the entire domestic law of each WTO Member) and WTO law that applies over and above the obligation under general public international law enshrined in Articles 26 and 27 of the Vienna Convention on the Law of Treaties. In fact, Article 27 of the Vienna Convention on the Law of Treaties spells out a negative obligation to refrain from invoking the domestic law in order to justify any departure from the international obligation undertaken by a State.

4.32 According to the European Communities, Article XVI:4 of the Marrakech Agreement establishes a positive obligation to ensure the conformity of such domestic law with their WTO obligations. Therefore, in cases where pre-existing domestic law was inconsistent with the new WTO obligations, including those under Article 23 of the DSU, Members were required to amend their domestic laws, regulations or administrative procedures.

4.33 For the European Communities, this also constitutes a fundamental difference from the pre-existing rules under the Protocol of Provisional Application (PPA) of GATT 1947 and the protocols of accession that permitted the maintenance of mandatory legislation inconsistent with the GATT 1947. Article XVI:4 not only confirms the abrogation of the PPA in the Introduction to the General Agreement on Tariffs and Trade 1994, but requires WTO Members to be pro-

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<sup>55</sup> Appellate Body Report on *European Communities/United Kingdom/Ireland – Customs Classification of Certain Computer Equipment* ("EC – Computer Equipment"), adopted 26 June 1998, WT/DS62/AB/R - WT/DS67/AB/R - WT/DS68/AB/R.

<sup>56</sup> Appellate Body Report on *India – Patents (US)*, op. cit.

active in ensuring, on their own initiative, the conformity of all of their internal law with WTO law. This task had to be accomplished by the United States no later than 1 January 1995.

4.34 The European Communities argues that the violation by the United States of its obligations enshrined in the above WTO provisions inevitably entails also a violation of Articles I, II, III, VIII and XI of the GATT 1994.

4.35 The European Communities maintains that Sections 301-310 breach the above-mentioned provisions and fundamentally undermine the Marrakech deal. The EC's main legal grounds supporting this basic claim, which will be examined in turn in more detail below, are threefold:

- (a) Sections 301-310, on their face, mandate unilateral action by the US authorities in breach of Article 23 of the DSU (and consequently of Articles I, II, III, VIII and XI of the GATT 1994). This is true both under the former GATT 1947 standards concerning mandatory versus discretionary legislation and the present standards under the GATT 1994 and the Marrakech Agreement, which the European Communities considers the relevant sources of law applicable after the entry into force of the WTO Agreements. The European Communities recalls that the issue of the standards applicable to determine whether legislation is genuinely discretionary was examined at length, as shown below.
- (b) In addition, Sections 301-310, even if they could be interpreted to permit the USTR to avoid WTO-inconsistent determinations and actions, could not be regarded as a sound legal basis for the implementation of the US obligations under the WTO. The lack of this "sound legal basis" produces a situation of threat and legal uncertainty against other WTO Members and their economic operators that fundamentally undermines the "security and predictability" of the multilateral trading system.
- (c) Furthermore, Sections 301-310 are not in conformity with the United States' WTO obligations since they are an expression of a deliberate policy creating a pattern of executive action which is biased against WTO-conformity. Even if Sections 301-310 could be interpreted to provide the USTR with a legal basis for the implementation of the United States' obligations under the WTO, they could not be considered to be in conformity with WTO law within the meaning of Article XVI:4 of the Marrakech Agreement.

4.36 In the view of the European Communities, the arguments presented by the United States are entirely unconvincing. In particular, it defies common sense when the United States asserts

- (a) that the verb "shall" in Sections 301-310 should be read to mean "may";
- (b) that definite deadlines like those in Section 306 could be considered an "invitation" to the executive authorities, without showing a legal basis for such a reading of the text;
- (c) that the legislation always authorizes USTR to determine that rights of the United States have not been denied and no failure to implement DSB recommendations has occurred, while the text of Section 304(a)(1) requires the USTR to base her determinations on the results of the investigation initiated under Section 302;

- (d) that a chapter heading called "Mandatory action" containing a mandatory list of retaliatory measures or, in the alternative, the possibility of entering into a bilateral agreement whose main conditions are set by the law, shows that the executive has broad discretion what action to take;
- (e) that the power of the President to give specific directions to the USTR in individual cases covers also the right to bar the USTR from implementing actions required by the text of Sections 301-310 and which are qualified as "mandatory" by the US Congress; and
- (f) that the existence of a limited exception left in the hands of the President, which has never been used so far, conveys to the law the character of discretionary legislation.

4.37 The European Communities further argues that this is of course by no means a theoretical debate only. Sections 301-310 were drafted by the United States in the present convoluted way in order to correspond to a very precise, albeit illegitimate, goal.

4.38 According to the European Communities, eminent scholars have expressed their view on this particular aspect. For instance, Professor Robert E. Hudec wrote:

"Section 301 is an intricate maze of mandatory commands in one place and extremely wide loopholes in the other. One needs a wiring diagram to trace whether mandatory commands given in one part will actually reach their final target without passing through at least one discretionary exit point. Even with the aid of such a diagram, one cannot predict actual outcomes".<sup>57</sup>

4.39 The European Communities also indicates that Professor John H. Jackson testified before the Senate Foreign Relations Committee as follows:

"Although there are plausible ways to interpret the statutory provisions of regular Section 301 so as to give the President discretion to act consistently with the Uruguay Round dispute settlement rules, in a few cases, particularly in Section 301(a) (mandatory provision) the interpretations to do this are a bit strained. It would clearly therefore be better if the statute were amended to give the President and the Trade Representative in all cases under the statute the discretion to act in a way consistently with U.S. international obligations".<sup>58</sup>

4.40 According to the European Communities, these comments were prompted also by the consideration that the uncertainty about the possible use by the United States of unilateral measures "inconsistent with the Uruguay Round dispute settlement rules" defeats the purpose pursued by the Uruguay Round participants when they agreed to adopt the DSU: namely to provide security and predictability to the multilateral trading system (Article 3.2 of the DSU). This objective was subsequently confirmed by the Appellate Body in *EC – Computer Equipment* case (WT/DS62/AB/R, WT/DS67/AB/R, WT/DS68/AB/R) where it affirmed that

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<sup>57</sup> Robert E. Hudec, Thinking About the New Section 301: Beyond Good and Evil, in: Jagdish Bhagwati and Hugh T. Patrick, Editors, *Aggressive Unilateralism. America's 301 Trade Policy and the World Trading System* (Harvester Wheatsheaf 1990), page 122.

<sup>58</sup> Senate Committee on Foreign Relations, Hearing on the World Trade Organisation, June 14, 1994 (testimony of Professor John H. Jackson).

security and predictability are "an object and purpose of the *WTO Agreement*, generally, as well as of the GATT 1994".

4.41 In the view of the European Communities, despite these comments and well-advised suggestions of eminent lawyers well versed in international trade law, the statute was adopted without amendment.

4.42 The European Communities notes that this comes as no surprise when considering the legislative history of the 1988 Trade Act which is at the origin in particular of the present draft of Section 301 (Mandatory action). During the hearings before the Senate Committee on Finance, 100<sup>th</sup> Congress, 1<sup>st</sup> session, Robert Strauss, former Special Trade Representative is quoted in an exchange with Senator Bob Packwood, Chairman of that Committee, as follows:

Sen. Packwood: "Do you think any trade [bill] that we have should require mandatory retaliation?"

Mr. Strauss: "Well, I am a little hesitant to require mandatory retaliation ... I hate to make [Section 301] mandatory. I think somewhere in between...[M]ore mandatory is a bum choice of words".

Sen. Packwood: "But not compulsory".<sup>59</sup>

The advice to "make retaliation mandatory but not compulsory" was frequently referred to throughout the debate in the Senate on mandatory retaliation.

4.43 The European Communities thus concludes that everything indicates that the apparent confusion in Sections 301-310 is nothing else than a deliberate policy. In fact, the European Communities is convinced that the United States, by maintaining a legislation on the statute book which on its face and by its intent mandates unilateral determinations and actions in breach of US obligations under the DSU and the GATT, implements a deliberate policy pursuing a double objective, which could be called the "Damocles sword effect".

4.44 The European Communities further states that on the one hand, the very existence of Sections 301-310, with their mixture of clear-cut mandatory provisions inconsistent with the DSU patched together with convoluted exceptions, creates a climate of legal uncertainty that entails by itself immediate and very concrete trade effects.

4.45 The European Communities maintains that in particular, the constant threat of imposition of unilateral measures has an influence on the behaviour and the decisions of the economic operators. In practice, the fact of the filing of a petition or the simple publication of a notice in the Federal Register announcing the initiation of an investigation, within the concrete context of the provisions contained in Sections 301-310 and the publicly known interpretation given by the US administration and the Congress, creates "chilling" trade effects that may range from the slowing down of importation of products to the more radical stoppage of any bilateral trade with the United States in those products. The recent events in the banana dispute, where retaliatory measures stopping the trade of some specific non-banana related products were adopted while the procedure for authorization to suspend concessions within the WTO had not yet been concluded, demonstrate what could happen to practically any trade operator once the unilaterally set deadlines in Sections 301-310 have expired in a given dispute.

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<sup>59</sup> Senate Committee on Finance, 100<sup>th</sup> Congress, 1<sup>st</sup> session, pt.1, 44-45.

4.46 For the European Communities, on the other hand, the present text and intent of Sections 301-310 are used by the United States as a "bargaining" tool in order to extract trade concessions from their trading partners, which they are not bound to make under WTO law, by threatening the violation of commitments the United States has assumed under WTO law. Whatever one may think about the legitimacy of this type of action outside the WTO, this is no longer acceptable in the WTO system, which was established on the basis of multilateralism, equality and law.

4.47 The European Communities argues that the Damocles sword effect is thus very real. The European Communities would refer the Panel not only to its own experience, but also to the cases described in the third party submissions filed by practically all of the most important trading partners of the United States.

4.48 The European Communities contends that Canada, Korea, Hong Kong China, India, Japan and Brazil, all insist on the Damocles sword effects - which they experienced themselves even after the conclusion of the Uruguay Round - and they all concur with the European Communities in indicating to the panel the unacceptable effects of this legislation with regard to the security and predictability of international trade.

4.49 **In response, the United States claims** that the European Communities, confronted with the need to find a legal basis to justify what is in essence a political case, has been forced to rely on false assumptions, speculation and miscalculations. Such an approach would be fatal to any complaining party seeking to meet its burden of proof, and this case is no exception.

4.50 In the view of the United States, the European Communities claims that Sections 301-310 of the Trade Act of 1974 on their face mandate a violation of US WTO obligations. The European Communities challenges no particular application of this legislation. Rather, it argues that the legislation by its terms "does not allow the United States to comply with the rules of the DSU and the obligations of GATT 1994" because of time frames in the statute.

4.51 The United States maintains that the terms of Sections 301-310 are readily available and may easily be compared to the requirements of DSU Article 23. Sections 301-310 do not prevent the United States from following to the letter the requirements of the DSU. This legislation provides ample discretion to the United States Trade Representative to pursue and comply with multilateral dispute settlement procedures in every instance. The United States notes that the European Communities cites with approval the conclusion of Professor Hudec that Section 301 includes "extremely wide loopholes", which further reinforces the fact that Section 301 provides for very broad discretion. The European Communities may not assume that the USTR will exercise this discretion in a WTO-inconsistent manner, nor may the European Communities assume away discretionary elements of the statute in order to make its case. The European Communities has taken on the task of demonstrating that Sections 301-310 mandate a WTO violation, and it has failed.

4.52 The United States explains that as the European Communities made clear, this case does not call for the Panel to examine whether the actions of either party in connection with the *Bananas* case were consistent with their WTO obligations. Nevertheless, the reason this case has been filed is because the European Communities found itself in the position of having failed to comply with DSB rulings and recommendations in that matter. The EC's reaction to that situation was: to bring this case. EC officials publicly and loudly attempted to cast the issue in *Bananas* as one of US unilateralism, and declared a case against Section 301 the appropriate response. In other words, the European Communities decided to bring a political case to distract attention from itself.

4.53 The United States argues that notwithstanding its political origins, this case must not be about politics, but about law. The issue before the Panel is not whether Sections 301-310 of the Trade Act of 1974 are popular or desirable; rather, it is whether the European Communities has demonstrated that this legislation "does not allow" the United States to comply with DSU rules, as the European Communities asserts in its panel request.

4.54 In the view of the United States, the European Communities has brought a political case that is in search of a legal argument. It is apparent that this search continues. Having unsuccessfully argued that Sections 301-310 mandate violations of DSU Article 23 based on a comparison of statutory and DSU time frames, the European Communities now argues that DSU time frames are irrelevant. Indeed, the European Communities appears to argue that the textual obligations set forth in the DSU and WTO Agreement are irrelevant. In their stead, the European Communities posits a "new legal environment", in which certain discretionary legislation may be treated as mandatory, and may be found to violate an unspecified and non-existent obligation to avoid "uncertainty". The EC's approach to this case is driven by its desire for a specific result at the expense of sound legal reasoning. This approach reinforces the fact that its goal is political, and its legal approaches without merit.

4.55 The United States argues that the EC's main objective in, and approach to, this proceeding is illustrated by two statements in the EC's answers to the Panel's questions:

"It is true that Article 23.2(a) of the DSU was drafted with Sections 301-310 of the Trade Act of 1974 in mind. But this means, of course, that the Uruguay Round participants had also in mind the threat to the security and predictability of the international trade relations created by the text of the Trade Act as it was drafted in the 1988 version. They had therefore in mind the need to insert in the covered agreements language that would constitute the second leg of what the EC has proposed in its oral statement of 29 June to call the 'Marrakesh deal'.

A law that requires a determination in all cases *whether* a violation of WTO law has occurred therefore comprises the requirement to determine in certain cases *that* a violation of WTO law has occurred. Such a law therefore mandates determinations that are inconsistent with Article 23".

4.56 According to the United States, the first quotation illustrates the EC's view of the purpose of DSU Article 23: as a tool to attack Sections 301-310. However, the EC's intention to use DSU Article 23 against Sections 301-310 has been hamstrung by the fact that this legislation does not mandate any violation of DSU Article 23 or any other WTO obligation. The European Communities itself quotes the conclusions of Professors Jackson and Hudec that, "there are plausible ways to interpret the statutory provisions of regular Section 301 as to give the President discretion to act consistently with the Uruguay Round dispute settlement rules", and that Section 301 includes "extremely wide loopholes". Under the well-established principle that discretionary legislation is not WTO-inconsistent if it permits WTO-consistent action, Sections 301-310 cannot be found inconsistent with DSU Article 23. This is because Sections 301-310 provide adequate discretion for the United States to comply with DSU rules and procedures in each and every case.

4.57 The United States is of the view that the EC's response to this situation has been to develop novel and untenable definitions of the term "mandatory", as illustrated by the second quotation, and to create out of whole cloth new WTO obligations centering on "security and predictability" where the text of the WTO Agreement, including the DSU, cannot be stretched to achieve the EC's political objectives. Apparently unwilling to go so far as Hong Kong and



dispense with the distinction between mandatory and discretionary legislation altogether, the European Communities now argues that the Panel should disregard the clear and consistent delineation between discretionary and mandatory measures set forth in each and every GATT and WTO panel report that has dealt with the issue, and instead redefine "mandatory" to include a law which *might* "in certain cases" be exercised in violation of DSU Article 23. The European Communities further asks the Panel to find that avoiding "uncertainty" and ensuring "security and predictability" are not only objectives of the WTO and DSU, but are obligations, or else require the Panel to adopt interpretations of DSU Article 23 and WTO Agreement Article XVI:4 that are at odds with the actual text of those provisions.

4.58 The United States states the Panel must reject these requests. The European Communities has failed to meet its burden in this dispute on either the law or the facts. The continued applicability of the rule distinguishing mandatory and discretionary legislation is clear, as is the ordinary meaning of the text of DSU Article 23 and WTO Article XVI:4. It is also clear that Sections 301-310 provide more than adequate discretion to the USTR to comply with DSU Article 23 and other WTO obligations in every case. Section 304 permits the USTR to base her determinations on adopted panel and Appellate Body findings in every case. And Section 306 permits, in every case, the USTR to request and receive DSB authorization to suspend concessions in accordance with DSU Article 22. As Japan correctly notes, "laws are not inconsistent with WTO rules when ... discretion [to comply with WTO obligations] is given to administrators under the laws". Sections 301-310 are thus consistent with DSU Article 23, WTO Agreement Article XVI:4, and GATT 1994 Articles I, II, III, VIII and XI.

4.59 The United States argues that with respect to WTO Agreement Article XVI:4, it is important to recognise that a measure must first violate some other WTO commitment in order to violate Article XVI:4. The ordinary meaning of the text of this provision makes this clear: "Each Member shall ensure the conformity of its laws, regulations and administrative procedures with its obligations as provided in the annexed Agreements". If those laws, regulations and administrative procedures conform with the obligations in the annexed agreements, including the DSU, there is no violation of Article XVI:4. The European Communities may not assume that Sections 301-310 violate the DSU for the purpose of finding a violation of Article XVI:4.

4.60 The United States asserts that in the end, the legal analysis of whether Sections 301-310 are consistent with US WTO obligations must focus on the text of the provisions setting forth those obligations. It must focus on the language of the Agreement. Not on objectives, and not on alleged deals so recently invented that their names have to be "proposed". The rights and obligations of the Members of the World Trade Organization are found in the text of the agreements they negotiated. The text reflects, better than any paraphrasing by any Member, the objectives and purposes of all Members when they negotiated those agreements. The Panel's analysis must begin, and end with text.

4.61 The United States argues that the question in this dispute, and the only question, is whether Sections 301-310 command the United States to violate specific WTO obligations found in the text of DSU Article 23, WTO Agreement Article XVI:4 and GATT 1994 Articles I, II, III, VIII and XI. The answer to this question is no, and the only way the European Communities can achieve its desired political result is to assume bad faith on the part of another WTO Member. This it may not do.

4.62 The United States further states that if ever there were a case which emphasised the importance of the rule of law, this is that case. The law is the protector of both the weak and the strong, equally. It protects the small and the large, equally. It protects the popular and the

unpopular, equally. While there are cases where the small and weak are grateful for the restraints it places on the powerful, there are others in which the law provides a shelter to the unpopular, whatever its size, when it has done no wrong. The United States knows that Sections 301-310 are not popular. But the WTO and the DSU are not a club to be used in a popularity contest against any one Member. If they are credibly to protect the weak, they must also protect the strong against attacks not on what they have done, but on who they are. And a statute does no wrong unless it commands authorities to violate their WTO obligations.

4.63 According to the United States, here at the WTO, the law, the substantive provisions of the WTO Agreement and its annexes, enforced through the provisions of the dispute settlement system, provides security and predictability to all WTO Members. That security and predictability rests firmly on a mode of legal analysis which focuses first and foremost on the text of the Agreement, because that is what the Members have agreed to. It is the text which they signed; it is the text which they submitted to their legislatures for approval by the representatives of their people. The Members brought to the negotiation of the text a number of objectives and purposes, some of which are explicitly listed in the text, and some of which are not. In either case, however, those objectives and purposes are reflected in the agreement text itself. There can be no security and predictability in the multilateral trading system if the explicit rules Members have agreed to may be ignored in favour of a mode of analysis driven by a desire to achieve a specific result. The law must apply equally to all, and in all cases.

4.64 The United States notes that by its terms of reference, this dispute is not about something the United States has done. Because of this, it is not proper to speculate about what the United States might do, any more than it would be proper for the United States to bring a case based on speculation that another Member will not act in accordance with its obligations. The only way that a panel may rule on something that a Member might do in the future is if that Member's law commands it to do it. It may not be assumed that they will not fulfill their solemn international obligations if they are in a position to do so. Only when a Member has crossed the line, by enacting a law which does not permit compliance with its international obligations, has it created a situation in which other Members have a legitimate and non-speculative basis for assuming that another Member will not abide by its international obligations. Only then will those Members find the security and predictability of their trade threatened in a manner distinguishable from the ever-present uncertainty as to whether other Members will fulfill their obligations.

4.65 The United States contends that as has been clear from the outset of this case, Sections 301-310 allow the USTR to comply fully with US obligations under the WTO Agreement and its annexes. This law does not command the USTR to violate the WTO obligations of the United States. This law by its mere existence violates none of these obligations. The EC's transparent efforts to turn this proceeding into a forum for making political attacks on US trade policy only highlight the absolute void at the center of its legal case. It has none. This Panel must find that the European Communities has failed to meet its burden of establishing that Sections 301-310 of the Trade Act of 1974 are inconsistent with DSU Article 23, WTO Agreement Article XVI:4 and GATT 1994 Articles I, II, III, VIII and XI, and that Sections 301-310 are therefore not inconsistent with these obligations.

#### B. WTO PROVISIONS AT ISSUE - DSU ARTICLE 23.2(A) AND (C)

4.66 **The European Communities points out** that the parts of Article 23 of the DSU relevant in this proceeding are:

"1. When Members seek the redress of a violation of obligations or other nullification or impairment of benefits under the covered agreements or an impediment to the attainment of any objective of the covered agreements, they shall have recourse to, and abide by, the rules and procedures of this Understanding

2. In such cases, Members shall:

(a) not make a determination to the effect that a violation has occurred, that benefits have been nullified or impaired or that the attainment of any objective of the covered agreements has been impeded, except through recourse to dispute settlement in accordance with the rules and procedures of this Understanding, and shall make any such determination consistent with the findings contained in the panel or Appellate Body report adopted by the DSB or an arbitration award rendered under this Understanding;

...

(c) follow the procedures set forth in Article 22 to determine the level of suspension of concessions or other obligations and obtain DSB authorization in accordance with those procedures before suspending concessions or other obligations under the covered agreements in response to the failure of the Member concerned to implement the recommendations and rulings within that reasonable period of time".

4.67 The European Communities claims that these provisions clearly oblige the United States to refrain from unilaterally determining whether another Member has denied rights or benefits under a WTO agreement to the United States and whether DSB rulings and recommendations have been implemented. They also leave no doubt that obligations under the GATT and the GATS may be suspended in response to a failure to comply with DSB rulings and recommendations only upon the grant of an authorization by the DSB.

4.68 **The United States notes** that Article 23.2(a) provides that Members shall:

"not make a determination to the effect that a violation has occurred, that benefits have been nullified or impaired or that the attainment of any objective of the covered agreements has been impeded, except through recourse to dispute settlement in accordance with the rules and procedures of this Understanding, and shall make any such determination consistent with the findings contained in the panel or Appellate Body report adopted by the DSB or an arbitration award rendered under this Understanding".

4.69 The United States argues that thus, for there to be a violation of Article 23.2(a): (1) there must be a determination that a WTO agreement violation has occurred; and (2) that determination is not consistent with panel or Appellate Body report findings adopted by the DSB or an arbitration award rendered under the DSU. Because the European Communities has not, as part of this case, alleged that a specific US determination violates Article 23.2(a), the European Communities must show that, under Sections 301-310, the USTR is required to make a violation determination, and to do so in a manner inconsistent with panel or Appellate Body findings adopted by the DSB.

4.70 The United States states that Article 23.2(c) requires Members to "follow the procedures set forth in Article 22 to determine the level of suspension of concessions or other obligations and obtain DSB authorization in accordance with those procedures before suspending concessions or other obligations" when a Member has failed to implement DSB rulings and recommendations. Again, no actual case involving the suspension of concessions is before this Panel. It is thus not possible to determine whether the United States in such a concrete case actually complied with the requirements of Article 22. The only question, then, is whether Section 306(b) commands the USTR not to follow Article 22 procedures or to suspend concessions without DSB authorization. The United States indicates that it manifestly does not. Nothing in Section 306(b) or in Section 305(a) prevents the USTR from complying to the letter with Article 22 procedures, including DSB authorization.

4.71 **The European Communities adds** that international customary law recognises that a party to a treaty breached by another party may reciprocally suspend proportional obligations under the treaty.<sup>60</sup> However, it is also recognised that this right may only be exercised in accordance with any provision in the treaty applicable in the event of a breach.<sup>61</sup>

4.72 The European Communities maintains that Articles XXII and XXIII of the GATT 1947 were such provisions. Clair Wilcox, a drafter of the Havana Charter for an International Trade Organisation (ITO), from which these provisions derived, explained their rationale as follows:

"We have introduced a new principle in international economic relations. We have asked the nations of the world to confer upon an international organisation the right to limit their power to retaliate. We have sought to tame retaliation, to discipline it, to keep it within bounds. By subjecting it to the restraints of international control, we have endeavoured to check its spread and growth, to convert it from a weapon of economic warfare to an instrument of international order".<sup>62</sup>

4.73 The European Communities states that this idea was forcefully expressed in Article 92 of the Havana Charter:

"Reliance on the Procedures of the Charter

1. The Members undertake that they will not have recourse, in relation to other Members and to the Organisation, to any procedure other than the procedures envisaged in this Charter for complaints and the settlement of differences arising out of its operation.

2. The Members also undertake, without prejudice to any other international agreement, that they will not have recourse to unilateral economic measures of any kind contrary to the provisions of this Charter".

4.74 According to the European Communities, international customary law also recognises that a fundamental change of circumstances not foreseen by the parties to a treaty may, under certain conditions, be invoked as a ground for terminating or withdrawing from the treaty.<sup>63</sup>

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<sup>60</sup> Vienna Convention on the Law of Treaties, Article 60.1.

<sup>61</sup> Ibid., Article 60.4.

<sup>62</sup> UN document E/PC/T/A/PV6, page 4.

<sup>63</sup> Vienna Convention on the Law of Treaties, Article 62.

However, the right of a party to such action may in principle be exercised only with respect to the treaty as a whole.<sup>64</sup> International customary law does not entitle a party to a treaty to perform its obligations selectively on the ground that the balance of interest under the treaty has shifted to its disadvantage.

4.75 The European Communities argues that in respect of the GATT 1947, the United States did not consider itself prevented from taking unilateral restrictive trade actions.<sup>65</sup> In its view, unilateral measures were justified because the dispute settlement procedures of Article XXIII were based on consensus and the approval of the suspension of obligations in response to another contracting party's failure to observe obligations could therefore be blocked by the defendant party.

4.76 In the view of the European Communities, the United States also did not consider itself bound by the unconditional most-favoured-nation principle of the GATT 1947 because it enabled contracting parties to obtain the benefit of negotiated market access commitments or new rules even if they had not contributed to the liberalisation efforts or accepted the new rules.

4.77 According to the European Communities, the United States believed that these features of the GATT 1947 justified resorting to unilateral trade measures inconsistent with the GATT whenever the GATT mechanisms did not produce results meeting its expectations. In 1989, during a special session of the GATT Council of Representatives on unilateral measures, the United States explained:

"Wherever it could, the United States would challenge unfair practices under the dispute settlement provisions of the General Agreement or the Tokyo Round Codes, but where other contracting parties prevented or impeded that process or blocked efforts to ensure that their practices were covered by multilateral disciplines, the United States would act to protect its interests. If such action was considered unilateral, it should be nevertheless recognised as perfectly justifiable, responsive action necessitated by the failure of bilateral or multilateral efforts to address a problem. The way to minimise or avoid unilateralism was to create a credible multilateral system - by strengthening the existing system".<sup>66</sup>

4.78 The European Communities further argues that the Uruguay Round ended with a considerably strengthened multilateral system:

- (a) the possibility of blocking the dispute settlement procedures was eliminated;
- (b) the Uruguay Round results were adopted as a "single undertaking" replacing the GATT 1947. This ensured that, notwithstanding the most-favoured-nation provisions of the GATT 1947, only those countries that accepted the additional obligations were accorded the corresponding rights;
- (c) as a result, all WTO Members are now bound by agreements similar to the Tokyo Round Codes and the main areas the United States had found missing in

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<sup>64</sup> Ibid., Article 44.

<sup>65</sup> Cf. Statement of Administrative Action, *op. cit.*

<sup>66</sup> GATT document C/163 of 16 March 1989, page 4.

the GATT 1947 - protection of intellectual property rights and trade in services  
- were made subject to enforceable rules.

4.79 The European Communities contends that as a counterpart, the United States accepted the obligations in Article 23 of the DSU, the introductory clause of which reads:

"When Members seek the redress of a violation of obligations or other nullification or impairment of benefits under the covered agreements or an impediment to the attainment of any objective of the covered agreements, they shall have recourse to, and abide by, the rules and procedures of this Understanding".

4.80 The European Communities considers this provision to be one of the cornerstones of the multilateral trading system. Security and predictability in international trade relations is inconceivable unless each and every WTO Member scrupulously submits all trade disputes to the DSU procedures.

4.81 According to the European Communities, if Members take the law into their own hands and unilaterally impose their own views on their rights under the WTO by threatening or taking measures violating their obligations, they risk provoking spirals of retaliatory actions that would jeopardise the results of half a century of trade negotiations.

C. EVIDENTIARY AND OTHER MATTERS

**1. Burden of Proof and Fact-finding concerning Domestic Law**

4.82 **The European Communities** argues that according to the Appellate Body's decision in *United States - Measure Affecting Imports of Woven Wool Shirts and Blouses from India*,

"The foundation of dispute settlement under Article XXIII of the GATT 1994 is the assurance to Members of the benefits accruing directly or indirectly to them under the GATT 1994. This was true as well of dispute settlement under the GATT 1947. If any Member should consider that its benefits are nullified or impaired as the result of circumstances set out in Article XXIII, then dispute settlement is available. With respect to complaints of violation of obligations pursuant to Article XXIII:1(a) of the GATT 1994, Article 3.8 of the *DSU* codifies previous GATT 1947 practice:

'In cases where there is an infringement of the obligations assumed under a covered agreement, the action is considered *prima facie* to constitute a case of nullification or impairment. This means that there is normally a presumption that a breach of the rules has an adverse impact on other Members parties to that covered agreement, and in such cases, it shall be up to the Member against whom the complaint has been brought to rebut the charge'.

Article 3.8 of the *DSU* provides that in cases where there is an infringement of the obligations assumed under a covered agreement – that is, in cases where a violation is established – there is a presumption of nullification or impairment. Article 3.8 then goes on to explain that "the Member against whom the complaint has been brought" must rebut this presumption. However, the issue

in this case is not what happens after a violation is established; the issue in this case is which party must first show that there is, or is not, a violation. ...

In addressing this issue, we find it difficult, indeed, to see how any system of judicial settlement could work if it incorporated the proposition that the mere assertion of a claim might amount to proof. It is, thus, hardly surprising that various international tribunals, including the International Court of Justice, have generally and consistently accepted and applied the rule that the party who asserts a fact, whether the claimant or the respondent, is responsible for providing proof thereof. Also, it is a generally-accepted canon of evidence in civil law, common law and, in fact, most jurisdictions, that the burden of proof rests upon the party, whether complaining or defending, who asserts the affirmative of a particular claim or defence. If that party adduces evidence sufficient to raise a presumption that what is claimed is true, the burden then shifts to the other party, who will fail unless it adduces sufficient evidence to rebut the presumption".<sup>67</sup>

4.83 The European Communities considers that in the *India - Patents (US)* case, the Appellate Body refined its above-mentioned milestone decision by addressing the specific issue of the authority of Panels and the Appellate Body when interpreting India's municipal law (i.e. a domestic law of a Member) as follows:

"In public international law, an international tribunal may treat municipal law in several ways. Municipal law may serve as evidence of facts and may provide evidence of state practice. However, municipal law may also constitute evidence of compliance or non-compliance with international obligations. For example, in *Certain German Interests in Polish Upper Silesia*, the Permanent Court of International Justice observed:

It might be asked whether a difficulty does not arise from the fact that the Court would have to deal with the Polish law of July 14th, 1920. This, however, does not appear to be the case. From the standpoint of International Law and of the Court which is its organ, municipal laws are merely facts which express the will and constitute the activities of States, in the same manner as do legal decisions and administrative measures. *The Court is certainly not called upon to interpret the Polish law as such; but there is nothing to prevent the Court's giving judgment on the question whether or not, in applying that law, Poland is acting in conformity with its obligations towards Germany under the Geneva Convention.* (original emphasis)

In this case, the Panel was simply performing its task in determining whether India's 'administrative instructions' for receiving mailbox applications were in conformity with India's obligations under Article 70.8(a) of the *TRIPS Agreement*. It is clear that an examination of the relevant aspects of Indian municipal law and, in particular, the relevant provisions of the Patents Act as they relate to the 'administrative instructions,' is essential to determining

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<sup>67</sup> WT/DS33/AB/R, chapter IV, page 12 and following.

whether India has complied with its obligations under Article 70.8(a). There was simply no way for the Panel to make this determination without engaging in an examination of Indian law. But, as in the case cited above before the Permanent Court of International Justice, in this case, the Panel was not interpreting Indian law 'as such'; rather, the Panel was examining Indian law solely for the purpose of determining whether India had met its obligations under the *TRIPS Agreement*. To say that the Panel should have done otherwise would be to say that only India can assess whether Indian law is consistent with India's obligations under the *WTO Agreement*. This, clearly, cannot be so".

4.84 In the view of the European Communities, more specifically on the issue of which of the parties bore the burden of determining the interpretation of India's domestic law in order to assess its conformity with the TRIPs Agreement, the Appellate Body then added the following:

"The Panel states:

'As the Appellate Body report on *Shirts and Blouses* points out, 'a party claiming a violation of a provision of the WTO Agreement by another Member must assert and prove its claim'. In this case, it is the United States that claims a violation by India of Article 70.8 of the TRIPS Agreement. Therefore, it is up to the United States to put forward evidence and legal arguments sufficient to demonstrate that action by India is inconsistent with the obligations assumed by India under Article 70.8. In our view, the United States has successfully put forward such evidence and arguments. Then, ... the onus shifts to India to bring forward evidence and arguments to disprove the claim. We are not convinced that India has been able to do so (footnotes omitted)'.

This statement of the Panel is a legally correct characterization of the approach to burden of proof that we set out in *United States - Shirts and Blouses*. However, it is not sufficient for a Panel to enunciate the correct approach to burden of proof; a Panel must also apply the burden of proof correctly. A careful reading of paragraphs 7.35 and 7.37 of the Panel Report reveals that the Panel has done so in this case. These paragraphs show that the United States put forward evidence and arguments that India's 'administrative instructions' pertaining to mailbox applications were legally insufficient to prevail over the application of certain mandatory provisions of the Patents Act. India put forward rebuttal evidence and arguments. India misinterprets what the Panel said about "reasonable doubts". The Panel did not require the United States merely to raise "reasonable doubts" before the burden shifted to India. Rather, after properly requiring the United States to establish a *prima facie* case and after hearing India's rebuttal evidence and arguments, the Panel concluded that *it* had 'reasonable doubts' that the 'administrative instructions' would prevail over the mandatory provisions of the Patents Act if a challenge were brought in an Indian court".

4.85 The European Communities finally points out that in the context of the *Argentina – Textiles and Apparel (US)* panel procedure, the United States submitted its views on how the burden of proof should be shared between the parties to the dispute when considering the interpretation of a Member's domestic law:



"The United States contended that, by any standard, the evidence submitted by the United States was sufficient to establish a presumption of a violation of Article II. In fact, the Panel needed look no further than the face of the Argentine resolutions and decrees imposing the specific duties that were the subject of this dispute. ... Previous GATT jurisprudence had made clear that this potential, in and of itself, was a sufficient basis for the Panel to find that Argentina had violated Article II.

The United States also argued that a Panel could condemn Argentina's mandatory minimum specific import duties even if they were not yet being applied".<sup>68</sup>

4.86 The European Communities further argues that the panel in the *Argentina – Textiles and Apparel (US)* case assessed the legal situation as follows:

"We consider that when the Appellate Body refers to the obligation of the complainant party to provide sufficient evidence to establish a "presumption", it refers to two aspects: the procedural aspect, i.e. the obligation for the complainant to present the evidence first, but also to the nature of evidence needed. In the present case, we consider that it was for the United States to raise a presumption that Argentina did violate the provisions of Article II of GATT. Then, it is for Argentina to provide sufficient evidence to rebut the said presumption. When, however, Argentina is claiming a specific affirmative defense, such that its national challenge procedure can be used to correct any alleged violation of GATT rules, it is for Argentina to raise first a presumption that such system operates in a way that there is, in effect, no infringement of GATT/WTO rules".<sup>69</sup>

4.87 In the view of the European Communities, it appears from the above mentioned quotations from earlier Panel and Appellate Body reports that, in the specific case at hand, the European Communities is subject to the burden of proving the existence of the attacked US domestic legislation (i.e. Sections 301-310). Moreover, the European Communities bears the burden to establish the existence of a *prima facie* violation of the provisions of the covered agreements invoked in its request for establishment of this Panel.

4.88 The European Communities contends that the Appellate Body therefore concluded that, while panels cannot interpret domestic law as such, they can examine it to determine whether the WTO Member has met its obligations. Otherwise, so the Appellate Body ruled, only the defendant itself would be able to assess whether its law is consistent with its obligations. This could clearly not be so. The Appellate Body noted that GATT/WTO panels had conducted a detailed examination of domestic law to determine its conformity with GATT/WTO obligations. The Appellate Body cited,<sup>70</sup> as an example, the GATT panel on *United States - Section 337 of the Tariff Act of 1930*<sup>71</sup> which conducted a detailed examination of the relevant United States'

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<sup>68</sup> Panel Report on *Argentina – Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items* ("*Argentina – Textiles and Apparel (US)*"), adopted 22 April 1998, WT/DS56/R, paras. 3.199-3.200.

<sup>69</sup> *Ibid.*, para. 6.37.

<sup>70</sup> Appellate Body Report on *India – Patents (US)*, *op. cit.*, para. 67.

<sup>71</sup> Panel Report on *United States - Section 337 of the Tariff Act of 1930* ("*US – Section 337*"), adopted on 7 November 1989, BISD 36S/345.

legislation and practice to determine whether Section 337 was consistent with Article III.4 of the GATT 1947.

4.89 The European Communities states that it may therefore be concluded that the United States could not validly claim that only it can interpret its own laws and that the Panel would consequently have to rely on the United States' interpretation of Sections 301-310 to determine whether they are in conformity with WTO law.

4.90 The European Communities maintains that with all these elements in mind, it appears that the interpretation of the burden of proof suggested by the United States itself in the *Argentina – Textiles and Apparel (US)* case constitutes an appropriate way forward in the context of this particular dispute.

4.91 The European Communities argues that it is thus required

- (a) to submit the text of the relevant provisions of Sections 301-310 and
- (b) to indicate how, on their face, their wording is in contradiction with the US WTO obligations.

4.92 According to the European Communities, in particular, it has shown and will further show that the text of Sections 301-310 mandates determinations and actions in violation of Articles 3, 21, 22 and 23 of the DSU and, consequently, of Articles I, II, VIII and XI of the GATT 1994; it has shown and will further show that Sections 301-310 do not provide a sound legal basis for the executive actions necessary to implement US WTO obligations, thus violating the good faith implementation principle under the Vienna Convention on the Law of Treaties and Article 3.2 of the DSU; finally, it has shown and will further show that the text, structure, design and architecture of Sections 301-310 create a pattern of executive practice that undermines the substantial objectives of the WTO thus also violating Article XVI:4 of the Marrakech Agreement. This already meets the burden of proof of the European Communities and therefore shifts the burden upon the United States as the respondent.

4.93 The European Communities then maintains that in any case, *ad abundantiam*, it submitted and will submit as further evidence additional contextual documentation and information concerning the official interpretation by the US executive authorities and the Congress. Finally, the European Communities also provided, and will continue to provide, additional proof by submitting contextual evidence concerning the practice followed by the United States in the practical implementation of Sections 301-310.

4.94 In the EC's view, at the end of this procedure, given the particular context of this case and having considered the specific obligations of positive action enshrined in Article XVI:4 of the Marrakech Agreement, a legal uncertainty that might persist with respect to the interpretation of Sections 301-310 should play to the detriment of the respondent, in its capacity of WTO Member on which legally lies the obligation to ensure the compatibility of its internal legislation with WTO obligations as from 1 January 1995.

4.95 **The United States responds** that as the complaining party, it is the European Communities, not the United States, that bears the burden of proof in this case.<sup>72</sup> As a result,

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<sup>72</sup> The United States cites Appellate Body Report on *US – Shirts and Blouses*, op. cit., p. 14 as stating that "it is a generally-accepted canon of evidence in civil law, common law and, in fact, most

the European Communities is obligated to establish a *prima facie* case with respect to each of the elements necessary to demonstrate the violations alleged. Establishing a *prima facie* case requires presenting both sufficient legal arguments and, where factual issues are in dispute, adequate supporting evidence. The Appellate Body has made this clear, stating that a panel should begin "its analysis of each legal provision by examining whether the [complaining party] has presented evidence and legal arguments sufficient to demonstrate that the ... measures were inconsistent with the obligations assumed by the [responding party] under each article of the [applicable] agreement addressed by the Panel".<sup>73</sup>

4.96 The United States further argues that to establish a *prima facie* case, the European Communities must provide evidence and arguments sufficient to establish a presumption that Sections 301-310 violate a provision of a WTO agreement.<sup>74</sup> In this regard, the Appellate Body has stated, "we find it difficult, indeed, to see how any system of judicial settlement could work if it incorporated the proposition that the mere assertion of a claim might amount to proof . . . [T]he party who asserts a fact ... is responsible for providing proof thereof".<sup>75</sup>

4.97 The United States asserts that absent such a showing, the United States, as the responding party, need not rebut the allegations. The Appellate Body has explained that "[o]nly after such a *prima facie* determination has been made by the Panel may the onus be shifted to the [responding party] to bring forward evidence and arguments to disprove the complaining party's claim".<sup>76</sup> The United States notes that, despite this fact, it has nevertheless rebutted each EC claim.

4.98 According to the United States, the EC's statements in this case with respect to whether Sections 301-310 mandate determinations and actions violating DSU Article 23 have consisted of mere assertions, a fact exemplified by the statement of the European Communities that it had met its burden simply by providing a copy of the text of Sections 301-310. The United States reiterates that the EC's case rests on numerous unsupported, erroneous assumptions. To meet its burden, the European Communities must in fact prove why, under US law, each and every one of the EC assumptions identified by the United States is correct, and why, under US law, the interpretations of Sections 301-310 put forward by the United States are incorrect.

4.99 The United States points out that in meeting its burden in this dispute, the European Communities may not rely on "mere assertions".<sup>77</sup> The European Communities claims that it

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jurisdictions, that the burden of proof rests upon the party, whether complaining or defending, who asserts the affirmative of a particular claim or defence".

<sup>73</sup> Appellate Body Report on *EC – Measures Affecting Meat and Meat Products (Hormones)* ("*EC - Hormones*"), adopted 16 January 1998, WT/DS26/AB/R, WT/DS48/AB/R, para. 109; see also, Appellate Body Report on *US - Shirts and Blouses*, op. cit., p. 16 ("a party claiming a violation of a provision of the WTO Agreement by another Member must assert and prove its claim"); and Appellate Body Report on *India – Patents (US)*, op. cit., para. 74 (noting that the Panel had "properly requir[ed] the [complaining party] to establish a *prima facie* case" before proceeding to the next step of its evaluation of the claim at issue).

<sup>74</sup> Appellate Body Report on *US - Shirts and Blouses*, op. cit., p. 13.

<sup>75</sup> *Ibid.*, p. 14.

<sup>76</sup> Appellate Body Report on *EC - Hormones*, op. cit., para. 109; see also, Appellate Body Report on *US - Shirts and Blouses*, op. cit., p. 14.

<sup>77</sup> The United States cites Appellate Body Report on *US – Shirts and Blouses*, op. cit., p. 14 as stating that "we find it difficult, indeed, to see how any system of judicial settlement could work if it

may meet its burden merely by submitting the text of Sections 301-310, because the statute on its face mandates a violation. It cites *Argentina – Textiles and Apparel (US)* for this proposition. However, in *Argentina – Textiles and Apparel (US)*, the issue was whether Argentina's law provided for a tariff in excess of bound rates, and the United States demonstrated that the law did, in fact, provide for such a tariff. Moreover, contrary to the impression the European Communities attempts to leave, the United States made its case not only through an analysis of the law, but also through submission of data and charts relating to average prices and specific transactions. As a result, the burden shifted to Argentina.<sup>78</sup>

## **2. Relevance of the US Statements before the Panel and Statement of Administrative Action**

4.100 **The European Communities indicates** the International Court of Justice has, in a limited number of cases, considered unilateral declarations made by high State representatives as internationally binding on that State. Moreover, some GATT 1947 panels have attached legal value to declarations made by a party to a panel procedure concerning the future exercise of the discretionary power conferred to it domestically by a legislative act.

4.101 In the view of the European Communities, in the *East Greenland case*,<sup>79</sup> the declaration at issue was made by the Minister of Foreign Affairs of Norway in a bilateral meeting with a representative of Denmark. The declaration had to do with a dispute over the territorial sovereignty with regard to certain parts of Eastern Greenland.

4.102 According to the European Communities, it is clear that this situation is not comparable with the present situation, because while the Permanent Court of International Justice considered that such a declaration was binding on Norway, this declaration had a recipient and was made in a context similar to that of the conclusion of an international agreement.

4.103 The European Communities considers this case irrelevant for present purposes, because in the *East Greenland case* the issue of the application and correct interpretation of a piece of domestic legislation was not at stake. This could never have been achieved by a declaration made in private during a bilateral contact between governments. The situation described in the judgement does not in fact resemble a unilateral declaration of the executive branch of the Norwegian government, but was made in bilateral contacts aimed at settling a dispute over territorial sovereignty.

4.104 The European Communities argues that in the *Nuclear Tests case*,<sup>80</sup> the International Court of Justice dealt with unilateral public declarations of high representatives of France, including the President of the French Republic concerning the termination of atmospheric nuclear tests. In this context, the ICJ states the following:

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incorporated the proposition that the mere assertion of a claim might amount to proof . . . [T]he party who asserts a fact . . . is responsible for providing proof thereof".

<sup>78</sup> See Panel Report on *Argentina – Textiles and Apparel (US)*, op. cit., paras. 6.41-6.65.

<sup>79</sup> Judgement of the Permanent Court of International Justice of 5 April 1933 on the *Legal Status of Eastern Greenland*, PCIJ Reports 1933, p. 21 (cf. specifically p. 71 referring to the reply by the Minister of Foreign Affairs of Norway to a request by the representative of Denmark).

<sup>80</sup> Judgement of the International Court of Justice of 20 December 1974 in the *Nuclear Tests Case*, ICJ Reports 1974, 253 (cf. specifically para. 43).

"When it is the intention of the State making the declaration that it should become bound according to its terms, that intention confers on the declaration the character of a legal undertaking, the State being thenceforth legally required to follow a course of conduct consistent with the declaration. An undertaking of this kind, if given publicly, and with an intent to be bound, even though not made within the context of international negotiations, is binding".

It appears from the judgement that the ICJ considered the intent of being bound, the public character of the declaration and the rank of the representatives of France decisive for its finding that the declaration created international obligations for France.

4.105 The European Communities asserts that in the circumstances of the present case, the situation is quite different, because the European Communities is confronted with the issue of the application and correct interpretation of a piece of domestic US law, i.e. Sections 301-310 of the US Trade Act of 1974.

4.106 According to the European Communities, even if it were demonstrated (*quod non*) that the executive branch of the US government has broad discretion on how to apply Sections 301-310 in individual cases, it must be recalled that, as a matter of fact, the United States has already made an official and public declaration by its President concerning the way in which it intends to apply Sections 301-310 in cases of disputes under the procedures instituted by the WTO in form of the Statement of Administrative Action.

4.107 The European Communities states that the Statement of Administrative Action was approved by the US Congress together with the Uruguay Round Agreements and is thus domestically binding on the executive branch of the US government. As the United States has explained itself, the Statement of Administrative Action is "an authoritative expression by the Administration concerning its views regarding the interpretation and application of the Uruguay Round agreements, both for purposes of U.S. international obligations and domestic law".<sup>81</sup>

4.108 The European Communities points out that as the Panel is aware, the Statement of Administrative Action contains the following portion:

"There is no basis for concern that the Uruguay Round agreements in general, or the DSU in particular, will make future Administrations more reluctant to apply section 301 sanctions that may be inconsistent with U.S. trade obligations because such sanctions could engender DSU-authorized counter-retaliation. Although in specific cases the United States has expressed its intention to address an unfair foreign practice by taking action under section 301 that has not been authorized by the GATT, the United States has done so infrequently. In certain cases, the United States has taken such action because a foreign government has blocked adoption of a GATT panel report against it.

Just as the United States may now choose to take section 301 actions that are not GATT authorized, governments that are the subject of such actions may choose to respond in kind. That situation will not change under the Uruguay

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<sup>81</sup> The European Communities points out that, according to Section 101(a) of the Uruguay Round Agreements Act of 1994, the US Congress approves (1) the trade agreements resulting from the Uruguay Round of multilateral trade negotiations and (2) the statement of administrative action that was submitted to Congress on 27 September 1994.

Round agreements. The risk of counter-retaliation under the GATT has not prevented the United States from taking action in connection with such matters as semiconductors, pharmaceuticals, beer, and hormone-treated beef".<sup>82</sup>

4.109 The European Communities further contends that it is obvious that this portion of the Statement of Administrative Action provides for an authoritative interpretation of the Uruguay Round Agreements Act that undermines the security and predictability of international trade relations. Moreover it announces in very clear terms a policy: the United States will not feel impeded by its international obligations to have recourse to retaliatory action.

4.110 The European Communities maintains that in the presence of these explicit indications on the political intentions and the legal texts as they stand, the explanation given by the United States<sup>83</sup> is by no means reassuring.

4.111 In this context, the European Communities recalls that, after the entry into force of the Uruguay Round agreements, the United States has as a matter of fact resorted to retaliatory action without having recourse to WTO dispute settlement procedures or without awaiting the result of the relevant WTO dispute settlement procedure in at least two well-documented cases (*Japan - Autos* and *EC - Bananas III*).<sup>84</sup> The assertions made by the United States therefore give rise to the additional concern that the US administration apparently considers itself to be judge and jury also with regard to the applicability of the WTO dispute settlement procedures *ratione materiae*.<sup>85</sup>

4.112 The European Communities goes on to state that it appears thus obvious that the statements made so far by the US representatives in the present procedure are of a completely different nature from the declaration considered binding by the ICJ in the *Nuclear Tests* case.

4.113 The European Communities further argues that this legal assessment would not change even if those statements were incorporated into the Panel report. In fact, the statements made in the present case by the US representatives were not made with the intent to create an international obligation by a person empowered to undertake a substantial legal commitment on

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<sup>82</sup> Statement of Administrative Action, op. cit., p. 366 *et seq.*

<sup>83</sup> The European Communities quotes the US following argument: "The last paragraph on page 366 of the Statement of Administrative Action does not relate to a situation in which the United States is seeking redress for the denial of US WTO rights, and thus is not covered by DSU Article 23, nor is it otherwise within the terms of reference of this dispute". The European Communities would also underline that it does not agree with the United States that the terms of reference of this panel include in any way a limitation of the examination of Sections 301-310. With respect to the EC claims of violation of WTO provisions listed in doc. WT/DS152/11, Sections 301-310 are under the scrutiny of this panel in their entirety. The same is also valid for the US comments on a statement from Korea.

<sup>84</sup> The European Communities claims that these cases are documented by Japan.

<sup>85</sup> According to the European Communities, this concern is corroborated by the following paragraph from the Statement of Administrative Action (at the top of p. 366):

"Neither section 301 nor the DSU will require the Trade Representative to invoke DSU dispute settlement procedures if the Trade Representative does not consider that a matter involves a Uruguay Round agreement. Section 301 will remain fully available to address unfair practices that do not violate U.S. rights or deny U.S. benefits under the Uruguay Round agreements and, as in the past, such investigations will not involve recourse to multilateral dispute settlement procedures".

behalf of the United States.<sup>86</sup> It is thus obvious that none of the conditions on which the judgement of the ICJ in that case was based is fulfilled in the present case.

4.114 According to the European Communities, in any event, the problem of the present case is not the absence of a clearly defined international commitment, because that already exists in the form of Article 23 of the DSU which clearly was accepted by the United States as part of the Uruguay Round agreements. Rather, it is the subsequent implementation of that international obligation into the US legislation by the United States legislature, compounded by the Statement of Administrative Action, that runs counter to the United States obligation to respect its international commitments.

4.115 The European Communities further notes that at the same time, US executive determinations and actions add to the uncertainty as to the willingness of the United States to respect its international obligations in future.

4.116 The European Communities claims that given the importance of the United States in the multilateral trade relations and within the institutional framework of the WTO, this situation is the source of uncertainty and unpredictability, which is unacceptably detrimental to the multilateral trading system.

4.117 The European Communities further states that, looking at the panel findings in the *Superfund* case,<sup>87</sup> it must be recalled that in that case the panel accepted the statement of the United States only because it considered that the United States had discretion to act in accordance with its statement. In addition, that decision was adopted in a legal situation where the strict interpretation of mandatory legislation under the PPA had a decisive influence on the examination of domestic legislation.

4.118 According to the European Communities, the only possible way for a panel to "marry" the limitation of the "existing legislation" clause of the PPA with the need to control the implementation of the broadly-defined discretionary legislation was, in cases such as the "*Superfund*", to obtain promises or commitments concerning the exercise of the discretionary power in the future.

4.119 In the EC's opinion, there is no reason for a WTO panel to follow the legal path of the *US - Superfund* panel under the new WTO rules. In fact, in the present case, given the new legal environment after the entry into force of the WTO Agreements and in particular of Article XVI:4 of the Marrakech Agreement, and given also the public policy statement contained in the Statement of Administrative Action made by the highest representative of the executive branch of the US government and approved by its legislative branch, a simple statement to the Panel in a meeting behind closed doors without revoking the Statement of Administrative Action in this regard would clearly be insufficient to lift the uncertainty created by the Statement of Administrative Action.

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<sup>86</sup> In the EC's view, this power is generally vested in the Head of State, the Head of Government and the Minister of Foreign Affairs. Any other representative of the State would either have to be specifically accredited or need full powers to be able to make a substantial commitment under public international law (cf. Art. 7 VCLT).

<sup>87</sup> Panel Report on *United States – Taxes on Petroleum and Certain Imported Substances* ("*US – Superfund*"), adopted 17 June 1987, BISD 34S/136, in particular, para. 5.2.9 *in fine*.

4.120 **In the view of the United States**, Section 304(a)(1) requires that determinations under that section be made "on the basis of the investigation initiated under Section 302 and the consultations (and the proceedings, if applicable, under section 303)". The "proceedings" under Section 303 are dispute settlement proceedings.<sup>88</sup> Moreover, such proceedings would be "applicable" in any case involving a trade agreement, since Section 303 requires that dispute settlement procedures under a trade agreement be invoked in any case involving a trade agreement, if no mutually acceptable resolution has been achieved.<sup>89</sup>

4.121 The United States indicates that its Administration has, in the Statement of Administrative Action approved by Congress, provided its "authoritative expression ... concerning its views regarding the interpretation and application of the Uruguay Round agreements, ... for purposes of domestic law".<sup>90</sup> The Statement of Administrative Action must, by law, be treated as the authoritative expression concerning the interpretation of the statute in any judicial proceeding.<sup>91</sup> The Statement of Administrative Action at page 365-366 provides that the USTR will:

- invoke DSU dispute settlement procedures, as required under current law;
- base any section 301 determination that there has been a violation or denial of U.S. rights under the relevant agreement on the panel or Appellate Body findings adopted by the DSB;
- following adoption of a favorable panel or Appellate Body report, allow the defending party a reasonable period of time to implement the report's recommendations; and
- if the matter cannot be resolved during that period, seek authority from the DSB to retaliate.<sup>92</sup>

4.122 The United States explains that it is an established principle of US statutory construction that the administering agency's interpretation of a statute is entitled to deference if the statute is "silent or ambiguous with respect to [a] specific issue". *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-43. In such circumstances, the court must uphold the agency's interpretation as long as it is based upon a "permissible construction" of the statute. *Ibid.* The agency's interpretation need not be the "only possible construction", *Sullivan v. Everhart*, 494 U.S. 83, 89 (1990), nor must it be the construction the court would have selected in the first instance. *Chevron*, 467 U.S. at 844. A court errs by substituting "its own construction of a statutory provision for a reasonable interpretation made by [the agency]". *Ibid.* The court's duty is not to weigh the wisdom of the agency's legitimate

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<sup>88</sup> The United States notes that Section 303(a)(2) provides that if dispute settlement consultations under a trade agreement have not resulted in a mutually acceptable resolution, the Trade Representative shall request "proceedings" under the "formal dispute settlement procedures provided under such agreement".

<sup>89</sup> *Ibid.*

<sup>90</sup> Statement of Administrative Action, *op. cit.*, p. 1.

<sup>91</sup> The United States refers to 19 U.S.C. § 3512(d) as stating that "[t]he statement of administrative action approved by Congress under section 3511(a) of this title shall be regarded as an authoritative expression by the United States concerning the interpretation and application of the Uruguay Round Agreements and this Act in any judicial proceeding in which a question arises concerning such interpretation or application".

<sup>92</sup> Statement of Administrative Action, *op. cit.*, pp. 365-366 (emphasis added).



policy choices. *Suramerica de Aleaciones Laminadas, C.A. v. United States*, 966 F.2d 660, 665 (Fed. Cir., 1992). Thus, under US law, the USTR's interpretations of its authority to undertake multiple determinations, determinations other than violation/non-violation determinations, or termination of investigations would receive such deference in a US court – to the extent such determinations would be subject to judicial review at all.<sup>93</sup> Likewise, the USTR's interpretation of Section 304(a)(1) as requiring her to rely on DSB-adopted findings in determining that US WTO agreement rights have been denied would be accorded such deference.

4.123 The United States indicates that it is not merely offering assertions of its legal authority. Rather, these interpretations are reflected in longstanding practice, in investigations predating this case and predating the WTO. Under US law, these interpretations would be entitled to deference, and, in examining whether the statute commands WTO-inconsistent action, the Panel is required to examine the meaning of the statute as it would be interpreted under US law.<sup>94</sup>

4.124 The United States further argues that another legal basis for US interpretations of statutory provisions is the US principle of statutory construction known as legislative ratification. As the US Supreme Court has stated, this principle provides that Congress is presumed to be aware of an administrative or judicial interpretation of a statute and to adopt that interpretation when it re-enacts a statute without change. *Lindahl v. Office of Personnel Management*, 470 U.S. 768, 783, citing *Albemarle paper Co. v. Moody*, 422 U.S. 405, 414 n.8 (1975).

4.125 The United States also states that the multiple determinations in *Oilseeds* predated the WTO, and the fact that Congress did not amend the statute to prevent such determinations when other amendments were made in 1994 supports the view that the Administration's interpretation is permitted. Similarly, the USTR's practice of applying Sections 301-310 to make determinations other than simple "yes/no" determinations on whether agreement rights have been denied, and to terminate Section 302 investigations before making a determination, predates 1994. Exhibit 13 describes examples of this long-standing practice since 1988, though it predates 1988 as well. And, although Congress amended section 301 in 1994, it did not amend it to undermine the USTR's interpretation or application of Sections 301-310, even though it was fully aware of how it was being applied.

4.126 **The European Communities disagrees** with the US introduction of an entirely new defence at this late stage. The European Communities stresses the fact that the new US arguments are very similar to those submitted by India in the *India - Patents (US)* case. They were rejected by the panel and the Appellate Body at the request of the US as a complainant in that case.<sup>95</sup>

4.127 The European Communities further states that the quotation of the AB report in *India - Patents (US)*, paragraph 65 [in fact 66], is incorrect. The Appellate Body did not state that "the Panel is required to examine the meaning of the statute as it would be interpreted under US law". Rather, the correct quotation, which has an entirely different meaning, is the following:

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<sup>93</sup> The United States points out that if, in fact, these determinations were not reviewable, the USTR's interpretations would be definitive.

<sup>94</sup> The United States refers to Appellate Body Report on *India – Patents (US)*, op. cit., para. 65.

<sup>95</sup> *Ibid.*, para. 69, "... like the Panel, we are not persuaded that India's "administrative instructions" would prevail over the contradictory mandatory provisions of the Patents Act".

"... as in the case cited above before the Permanent Court of International Justice, in this case, the Panel was not interpreting Indian law "as such"; rather, the Panel was examining Indian law solely for the purpose of determining whether India had met its obligations under the *TRIPS Agreement*".

4.128 **The United States rebuts** the EC argument that the US response raises a new defense, and that allegedly similar arguments were rejected in *India – Patents (US)*. Both of the EC's contentions are incorrect. First, the United States has not raised a new defense. The US discussion of judicial deference under U.S. law was directly responsive to the Panel's request for the textual or other legal basis which permits the USTR to make multiple determinations – a factual issue in this dispute. While the textual basis for the USTR's interpretation is sufficiently clear, the doctrine of judicial deference would serve as an additional basis under US law were a US court to consider the statutory language ambiguous.

4.129 The United States also contends that the EC's references to *India – Patents (US)* fail to support its position. The Appellate Body, in paragraphs 65-66 of its report in *India – Patents (US)*, emphasizes that it was necessary in that case to examine Indian law to determine its compliance with India's international obligations. Domestic law consists not only of statutory provisions, but of domestic legal rules concerning the interpretation of those provisions or, in the case of *India – Patents (US)*, domestic rules concerning conflicts between laws. In *India – Patents (US)*, the Appellate Body examined "the relevant provisions of the Patents Act as they relate to the 'administrative instructions'" at issue in that case<sup>96</sup>; in other words, the Appellate Body examined whether there was any support under Indian law for India's assertion that unpublished, unwritten administrative instructions would prevail over a conflicting statute explicitly mandating a WTO violation. India in that case failed to provide sufficient evidence that, under Indian law, the instructions would prevail.

4.130 In the US view, the doctrine of judicial deference to an agency's interpretation of its statute is part of U.S. law, though it would only become relevant in this dispute were the panel to conclude that there was some ambiguity as to whether a particular provision of Sections 301-310 commanded specific actions violating a WTO obligation. In fact, as the U.S. has explained throughout this proceeding, the statute contains no such ambiguity. On its face, the U.S. statute does not command violation determinations in the absence of DSB-adopted findings, and in fact requires that any such determinations be based on the results of WTO proceedings.<sup>97</sup>

4.131 According to the United States, however, should the Panel find the statute ambiguous, the US Executive Branch interpretation of the statute is of great importance under US law. First, many Executive Branch determinations are not subject to judicial review. As already noted, if this were the case with respect to Section 301 determinations, the USTR interpretation would be definitive under US law. Second, even if a US court were to review such determinations, and even if that court were to conclude that the statutory language is ambiguous, it would be required under US law to interpret that language in light of the *Chevron* standard of judicial deference.

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<sup>96</sup> Appellate Body Report on *India – Patents (US)*, op. cit., para. 66.

<sup>97</sup> The United States again states that this US legal requirement goes beyond what the EC asserts are a Member's WTO obligations: "[I]t would be inappropriate to interpret Article XVI:4 of the WTO Agreement so extensively as to require WTO Members to include specific language in their domestic law precluding WTO-inconsistent action".

4.132 The United States recalls again that the burden in this dispute lies with the European Communities. As already discussed, the European Communities failed to establish that US law commands the USTR to take actions which violate Article 23, failed to establish that US rules of statutory interpretation permit the European Communities and this Panel to interpret "whether" to mean "that", and failed to establish that it is permissible to disregard entire sections of the statute providing the USTR with discretion to delay or not take action. Likewise, in its latest submission, the European Communities failed to establish that the *Chevron* deference standard may, under US law, be disregarded.

4.133 The United States points out that the last paragraph on page 366 of the Statement of Administrative Action does not relate to a situation in which the United States is seeking redress for the denial of US WTO rights, and thus is not covered by DSU Article 23, nor is it otherwise within the terms of reference of this dispute. As described in the preceding paragraphs on page 366, there will often be cases not involving WTO rights, or involving a mixture of actions only some of which are covered by WTO rules. Moreover, this paragraph describes the fact that, even before establishment of the WTO and its strengthened dispute settlement procedures, the United States infrequently expressed its intention to take retaliatory action, and such action was often a response to a trading partner's decision to obstruct dispute settlement proceedings. The statement that the Administration will not be "more reluctant" to impose sanctions given the DSU should be read in that context.

4.134 In response to the Panel's question as to the US statement that "[t]he last paragraph on page 366 of the Statement of Administrative Action does not relate to a situation in which the United States is seeking redress for the denial of U.S. WTO rights", the United States maintains that it is clear from their context that neither the last paragraph on page 366 nor the first full paragraph on page 367 relate to situations in which the United States is seeking redress for denial of US WTO rights. The Statement of Administrative Action at pages 365-67 addresses three situations in which Section 301 may be invoked: (1) cases involving a WTO Member and its denial of US WTO rights; (2) cases involving a WTO Member and non-WTO rights; and, (3) cases involving non-WTO Members or WTO Members to which the United States does not apply the Uruguay Round Agreements pursuant to Article XIII of the WTO Agreement.

4.135 The United States also explains that the last paragraph on page 365 deals with the first type of case, that is, situations involving the denial of US rights under the WTO Agreement. The following paragraph, the first full paragraph on page 366, introduces the discussion of the second type of case, those involving WTO Members but not US WTO rights. Each of the first four paragraphs on page 366 explicitly clarifies the types of situations in which a case may involve a WTO Member, but not a US WTO right. The next two paragraphs (those addressed in the question, the last on 366 and the first on 367) follow directly on that discussion and are part of the section of the Statement of Administrative Action discussion relating to situations not involving a US WTO right. Finally, the last paragraph of this section of the Statement of Administrative Action, the second full paragraph on page 367, addresses the third type of case, that is, cases not involving WTO Members or cases involving WTO Members as to which the United States does not apply the Uruguay Round Agreements. The organization of the discussion in the Statement of Administrative Action thus follows precisely the three types of cases for which Section 301 may be applicable.

4.136 In the view of the United States, the statement in the first paragraph on page 367 may be reconciled with the earlier bullet points on pages 365-366 of the Statement of Administrative Action, and are logical, only if understood as referring to two different types of cases, those involving US WTO rights and those which do not. The paragraph on page 367 should not be read so as to produce an illogical result.

4.137 With respect to the substance of these paragraphs, the United States reiterates again that the last paragraph on page 366 emphasises the infrequency with which the United States took action under the GATT 1947 which had not been authorized, as well as the fact that such situations often involved efforts by a losing party (generally the European Communities) to obstruct multilateral dispute settlement proceedings.

4.138 According to the United States, with respect to the first paragraph on page 367, the statement only provides that the prospect of counter-retaliation by a trading partner would not enter into the consideration of whether to take action against that partner in a case not involving the denial of US WTO rights by that partner. The listed cases are provided only as illustrations of this point. None of this says anything about the factors which would be taken into consideration in deciding whether and how to take action when a US WTO Agreement right is not involved, factors such as the US desire to comply with its international obligations. Again, the paragraphs indicate that even under the GATT 1947, the instances in which action was taken were infrequent.

4.139 The United States states that because these paragraphs do not relate to situations involving US rights under the WTO Agreement, on that basis alone they are irrelevant to an examination of whether Sections 301-310 are inconsistent with DSU Article 23. Article 23 deals only with situations in which Members "seek the redress of a violation of obligations or other nullification or impairment of benefits under the covered agreements".<sup>98</sup> However, even were the statements in the paragraphs on pages 366-367 somehow relevant to Article 23, they would not be relevant to the analysis of whether the European Communities has demonstrated that the law itself, Sections 301-310, command the USTR to violate specific US WTO obligations. The mere existence of the statements is no substitute for the analysis the European Communities has consistently failed to provide on precisely how specific requirements in Sections 301-310 mandate actions inconsistent with specific textual obligations in the WTO provisions set forth in the terms of reference.

4.140 The United States finally notes that the statements speak to no more than the possibility of WTO-inconsistent action, a possibility which other WTO Members have repeatedly made a reality through not only their initial decisions to create and implement WTO-inconsistent measures, but in their decisions to disregard DSB rulings and recommendations with respect to these measures. Neither the United States nor any other WTO Member is entitled to bring a successful WTO challenge against another Member because of the mere possibility that it may, in the future, breach its WTO obligations. There must be a measure which does in fact, currently breach a specific WTO obligation, or at the least legislation which commands such a breach in the future.

4.141 **The European Communities criticises** the United States for introducing a new argument by asserting that the Statement of Administrative Action, at pages 365-367 "addresses three situations ...". The European Communities recalls its argument: irrespective of the allegations made by the US concerning its views on the interpretation of the Statement of Administrative Action (and this latest attempt has no more support in the text of the Statement of Administrative Action than the previous ones), the examples provided at page 367 of the Statement of Administrative Action are clearly within the scope of the WTO Agreements and thus defeat also the latest US argument in this respect.

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<sup>98</sup> DSU, Article 23.1.

4.142 **The United States reiterates** that the only logical reading of the statements at pages 366-67 is that they apply only to cases not involving a US WTO right, that this conclusion also follows from the organization of the Statement of Administrative Action, and that the statements refer to no more than hypothetical possibilities, as it already argued.

4.143 The United States contends that the European Communities has brought an essentially political case. The European Communities and several third parties have attempted to leave the impression that the United States is an implacable foe of the Dispute Settlement Understanding and of multilateral determinations of WTO Agreement rights. They hope through these accusations to raise doubts among the panel about how the Trade Representative could be expected to exercise her discretion under Sections 301-310. However, beyond the lack of relevance of these accusations to the legal question of whether Sections 301-310 mandate a WTO violation, they are quite simply untrue. The United States was an early and strong supporter of the creation of the Dispute Settlement Understanding and of the fundamental improvements in dispute settlement procedures which have established the credibility of the new system: the negative consensus rule, strict deadlines and virtually automatic panel establishment, adoption of reports, and authorization to suspend concessions upon non-implementation.

4.144 The United States points out that it has brought 49 disputes to the WTO under its multilateral procedures and has defended itself in 28 others. In five cases, a US measure was found inconsistent with US obligations. The United States not only committed to bring its measure into compliance with DSB rulings and recommendations in each of these cases, it did in fact bring its measure into compliance in three cases, and the reasonable period of time has yet to expire in the remaining two. The US commitment to multilateral dispute settlement procedures is thus evident in the US role in developing those procedures, in the active US use of those procedures, and in US compliance with multilateral decisions when those decisions have been adverse.

4.145 In the view of the United States, when stripped of political arguments, it is clear that the European Communities is attempting in this case to challenge a statute based on statutory provisions which do not exist. The European Communities cannot meet its burden in this case by assuming such provisions into existence. The United States therefore respectfully requests that this Panel reject the EC's speculative arguments in their entirety.<sup>99</sup>

4.146 **The European Communities**, in response to the Panel's question whether Sections 301-310 would be rendered consistent with US obligations under the WTO, assuming that the panel were to find that Sections 301-310 leave sufficient discretion to the USTR to allow it to meet its WTO obligations, **claims** that this question is of a highly hypothetical nature, and – as the Panel is aware – the European Communities disagrees with the hypothesis that is underlying the question.

4.147 According to the European Communities, its complaint concerns Sections 301-310 as such. The European Communities recalls in this context that both parties agree that the question of how the USTR enforces Sections 301-310 is irrelevant in this proceeding.

4.148 In the view of the European Communities, in order to address the EC's complaint, the Panel needs to answer the question of whether Sections 301-310, by their terms or expressed

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<sup>99</sup> With regard to Statement of Administrative Action, see further the US arguments shown below (in particular, in paras. 4.534-4.536) and the corresponding EC arguments.

intent, mandate WTO-inconsistent determinations or actions, whether they provide the USTR with a sound legal basis for the implementation of the United States' WTO obligations and whether they make certain ("ensure") the conformity with WTO obligations within the meaning of Article XVI:4 of the WTO Agreement.

4.149 The European Communities contends that any (hypothetical) reassuring statement by the United States' executive authorities could not change the terms and expressed intent of Sections 301-310 nor could it create a sound legal basis for WTO-consistent actions in US law nor could it bring Sections 301-310, as such, into conformity with WTO law. Such a statement could only relate to the intentions of the current administration on the enforcement of Sections 301-310.<sup>100</sup>

4.150 In the present case, the European Communities considers that the statute compels the executive branch of the US government to act in contradiction with the US WTO obligations or, in any case, creates a legal situation which is biased against compatibility with those obligations. As the European Communities has explained, this legal situation, created by Sections 301-310 as such, is highly detrimental to the multilateral trading system.

4.151 It is the EC's understanding of the US internal legal order that no statement of the executive authorities of the United States, however it would be formulated and by whomever it would be made, could do away with the constraints under which the executive branch of the US government finds itself under the US Constitution which imposes on the executive authorities to act in accordance with statutory requirements enacted by the US Congress. In addition, under US law these statutory requirements take precedence over any international obligation contracted by the United States under the Uruguay Round agreements pursuant to Section 102(a) of the Uruguay Round Agreements Act of 1994.

4.152 The European Communities recalls once more that the US representative, during the first substantive meeting with the Panel, could not exclude the possibility of a legal challenge before the US domestic courts concerning the implementation of Sections 301-310.

4.153 The European Communities reiterates that the situation of the present case is not comparable to the situation that was addressed by the ICJ in the *Nuclear Tests Case* where the French President and certain highly ranked French representatives made public statements on behalf of the French Republic that were not in contradiction with any piece of domestic legislation.

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<sup>100</sup> The European Communities recalls in this context the rulings of the panel on *India - Protection for Pharmaceutical and Agricultural Products*, and states that the assurances that the Indian government had given to the United States regarding its interpretation and application of the Indian Patent Act, the fact that no mail box application had been rejected by the Indian authorities and that the Indian government had informed the Parliament that it would treat the mailbox applications in a WTO-consistent manner were not considered to be relevant to the panel's finding that the Indian mailbox system lacked a sound legal basis in the domestic law of India. The European Communities refers to Panel Report on *India - Protection for Pharmaceutical and Agricultural Products* ("*India - Patents (US)*"), adopted 2 September 1998, WT/DS50/R, paras. 4.5 and 4.6.

In the EC's view, the United States sought in that case an amendment of the Patents Act to achieve greater legal security for its intellectual property right holders notwithstanding the assurances by the executive authorities. It would be very surprising for the WTO's membership if one standard were applied to domestic law when the United States is a complainant and another when it is a defendant.

4.154 **In rebuttal, the United States points out** that the European Communities attempts to make much of the fact that, in US courts, US law would prevail in the event of a conflict with the Uruguay Round Agreements. For example, the European Communities cites Professor D.W. Leebron for this proposition. However, the European Communities fails to quote Professor Leebron's conclusion on page 232 of the very same work cited in footnote 27 that, "Nothing, however, in those provisions [that is, the provisions of Section 301] requires the President or the USTR to act in violation of the Uruguay Round Agreements". In other words, because there is no conflict between Sections 301-310 and the WTO Agreement, it does not matter which would prevail in the event of a conflict. In fact, were there actually a conflict, that is, if a US law mandated a violation of the WTO Agreement, there would be a WTO violation regardless of whether a US court would apply US law. The EC's discussion of US law on when actual conflicts are present is thus completely irrelevant to the Panel's analysis.

D. ANALYSIS OF WTO-CONSISTENCY OF MEASURES AT ISSUE

**1. Reach of WTO obligations with respect to law authorizing WTO-inconsistent action, not specific applications**

**(a) General Arguments**

*(i) Relevance of GATT/WTO Precedents*

4.155 **The European Communities first contends** that previous GATT panels recognised that a law requiring the executive authorities to impose a measure inconsistent with a provision of the GATT can be challenged under the dispute settlement procedure whether or not it had been applied to the trade of the complaining party. The 1987 panel on *United States - Taxes on Petroleum and Certain Imported Substances* reasoned as follows:

"...The general prohibition of quantitative restrictions under Article XI ... and the national treatment obligation of Article III ... have essentially the same rationale, namely to protect expectations of the contracting parties as to the competitive relationship between their products and those of the other contracting parties. Both articles are not only to protect current trade but also to create the predictability needed to plan future trade. That objective could not be attained if contracting parties could not challenge existing legislation mandating actions at variance with the General Agreement until the administrative acts implementing it had actually been applied to their trade. Just as the very existence of a regulation providing for a quota, without it restricting particular imports, has been recognised to constitute a violation of Article XI.1, the very existence of mandatory legislation providing for an internal tax, without it being applied to a particular imported product, should be regarded as falling within the scope of Article III.2, first sentence. The Panel noted that the tax on certain imported substances had been enacted, that the legislation was mandatory and that the tax authorities had to apply it after the end of next year and hence within a time frame within which the trade and investment decisions that could be influenced by the tax are taken. The Panel therefore concluded that Canada and the EEC were entitled to an investigation of their claim that this tax did not meet the criteria of Article III.2, first sentence".<sup>101</sup>

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<sup>101</sup> Panel Report on *US – Superfund*, op. cit., para. 5.2.2.

4.156 The European Communities further argues that it follows that a WTO obligation proscribing a particular behaviour is violated by the adoption of a domestic law mandating such behaviour. Such a law also violates Article XVI:4 of the WTO Agreement. The European Communities is therefore entitled to findings and rulings by the Panel on the question of whether the United States has brought the provisions of the Trade Act of 1974, as such, into conformity with its WTO obligations under Article 23 of the DSU.

4.157 According to the European Communities, the 1992 panel on *United States - Measures Affecting Alcoholic and Malt Beverages* examined legislation which, by its terms, mandatorily required the authorities to impose GATT-inconsistent measures, but which was not actually applied. The United States argued that such legislation did not constitute a measure in respect of which Article XXIII of the GATT could be invoked. The panel ruled as follows:

"The Panel then proceeded to consider the United States argument that the provisions in the state of Illinois permitting manufacturers to sell directly to retailers were not given effect. In this regard, the Panel recalled the decisions of the CONTRACTING PARTIES on the relevance of the non-application of laws in dispute. Recent panels addressing the issue of mandatory versus discretionary legislation in the context of both Articles III.2 and III.4 concluded that legislation mandatorily requiring the executive authority to take action inconsistent with the General Agreement would be inconsistent with Article III, whether or not the legislation were being applied, whereas legislation merely giving the executive authority the possibility to act inconsistently with Article III would not, by itself, constitute a violation of that Article. The Panel agreed with the above reasoning and concluded that because the Illinois legislation in issue allows a holder of a manufacturer's license to sell beer to retailers, without allowing imported beer to be sold directly to retailers, the legislation mandates governmental action inconsistent with Article III.4".<sup>102</sup>

4.158 The European Communities notes that with respect to a law in the state of Mississippi, the panel similarly found:

"The Panel then proceeded to consider the United States argument that the Mississippi law was not being applied. In this regard, the Panel recalled its previous discussion of this issue. ... The Panel noted that the option law in Mississippi provides discretion only for the reinstatement of prohibition, but not for the discriminatory treatment of imported wines. The Panel concluded, therefore, that because the Mississippi legislation in issue, which permits native wines to be sold in areas of the state which otherwise prohibit the sale of alcoholic beverages, including imported wine, mandates governmental action inconsistent with Article III.4, it is inconsistent with that provision whether or not the political subdivisions are currently making use of their power to reinstate prohibition".<sup>103</sup>

4.159 The European Communities then argues that the panel explained the rationale behind these rulings when presenting its findings on the maximum price laws in Massachusetts and Rhode Island:

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<sup>102</sup> Panel Report on *United States - Measures Affecting Alcoholic and Malt Beverages* ("US – Malt Beverages"), adopted on 19 June 1992, BISD 39S/206, pp. 281-282.

<sup>103</sup> *Ibid.*, p. 289.



"In respect of the United States contention that the Massachusetts measure was not being enforced and that the Rhode Island measure was only nominally enforced, the Panel recalled its discussion of mandatory versus discretionary laws in the previous section. The Panel noted that the price affirmation measures in both Massachusetts and Rhode Island are mandatory legislation. Even if Massachusetts may not currently be using its police powers to enforce this mandatory legislation, the measure continues to be mandatory legislation which may influence the decisions of economic operators. Hence, a non-enforcement of a mandatory law in respect of imported products does not ensure that imported beer and wine are not treated less favourably than like domestic products to which the law does not apply. Similarly, the contention that Rhode Island only 'nominally' enforces its mandatory legislation a fortiori does not immunise this measure from Article III.4. The mandatory laws in these two states by their terms treat imported beer and wine less favourably than the like domestic products. Accordingly, the Panel found that the mandatory price affirmation laws in Massachusetts and Rhode Island are inconsistent with Article III.4, irrespective of the extent to which they are being enforced".<sup>104</sup>

4.160 The European Communities explains that in the proceedings of the WTO panel on *India - Patent Protection for Pharmaceutical and Agricultural Chemical Products*, the United States claimed that the "mailbox system" for patent applications which India had established by administrative action did not meet the requirements of Article 70.8 of the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS Agreement), because mandatory provisions of the India Patents Act required the rejection of the mailbox applications within a specified delay.

4.161 In the view of the European Communities, India cited provisions of its Constitution on the distribution of authority between the legislative and the executive branch and court rulings on the non-binding nature of statutes requiring administrative actions by a specified date, to argue that a mail box system could be established by administrative action notwithstanding the mandatory provisions of the Patents Act.

4.162 The European Communities points out that the United States responds to the European Communities claiming that the GATT 1947 jurisprudence on mandatory legislation made clear that India was obliged to eliminate the legal uncertainty created by the fact that its administrative practices were inconsistent with mandatory provisions of the Patents Act. India was consequently required to amend its Patents Act. Referring to the GATT<sup>105</sup> and on *United States - Measures Affecting Alcoholic and Malt Beverages (Beer II)*, the United States argued:

"The mailbox system ... had a rationale common to many other WTO obligations, "namely to protect expectations of the contracting parties as the competitive relationship between their products and those of other contracting parties". The *Superfund* report had established clearly the importance of "creat[ing] the predictability needed to plan future trade". (...) Despite India's claim that it had decided for the moment not to enforce the mandatory provisions of (...) its Patent Act ... that "measure continues to be mandatory legislation which may influence the decisions of economic operators". The

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<sup>104</sup> Ibid., p. 290.

<sup>105</sup> Ibid.

economic operators in the present case - potential patent applicants - had no confidence that a valid mailbox system had been established ... To paraphrase the *Beer II* panel, a non-enforcement of a mandatory law that violated a WTO obligation did not ensure that the obligation was not being broken".<sup>106</sup>

4.163 The European Communities notes that the United States thus argued that the domestic law of a Member must not only be such as to enable it to act consistently with its WTO obligations; the domestic law must also not create legal uncertainty by prescribing WTO-inconsistent measures.

4.164 For the European Communities, the panel accepted the United States' argumentation. It examined the provisions of India's Patent Act and then ruled:

"In the light of these provisions, the current administrative practice creates a certain degree of legal insecurity in that it requires India officials to ignore certain mandatory provisions of the Patents Act. We recall that the Malt Beverages panel dealt with a similar issue. There the respondent offered as a defence that certain GATT-inconsistent legislation was not currently enforced. The panel rejected this defence by stating as follows:

'Even if Massachusetts may not currently be using its policy powers to enforce this mandatory legislation, the measure continues to be mandatory legislation which may influence the decisions of economic operators. Hence, a non-enforcement of a mandatory law in respect of imported products does not ensure that imported beer and wine are not treated less favourably than like domestic products to which the law does not apply'.

We find great force in this line of reasoning. There is no denying that economic operators - in this case the patent applicants - are influenced by the legal insecurity created by the continued existence of mandatory legislation that requires the rejection of product patent applications in respect of pharmaceutical and agricultural chemical products".<sup>107</sup>

4.165 The European Communities argues that these findings imply that a law that, by its terms, mandates behaviour inconsistent with a provision of a WTO agreement, violates that provision, irrespective of whether and how the law is or could possibly be applied.

4.166 According to the European Communities, this principle is a reflection of the fact that a law with such terms creates uncertainty adversely affecting the competitive opportunities for the goods or services of other Members.

4.167 The European Communities points out that one of the basic objectives of the WTO agreements, however, is to ensure that goods or services of domestic and foreign origin are accorded equal competitive opportunities. In the framework of a treaty designed to ensure stable and predictable conditions of competition, a party does not act in good faith if it accepts an obligation stipulating one behaviour, but adopts a law explicitly stipulating another. The fact

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<sup>106</sup> Panel Report on *India – Patents (US)*, op. cit., para. 4.4 (footnotes omitted, emphasis added).

<sup>107</sup> *Ibid.*, para. 7.35.

that it might exceptionally apply that law in a way that is not inconsistent with its WTO obligations does not affect the above conclusion, particularly where there is no legal entitlement to obtain such an exceptional "act of grace". This manner of implementing WTO obligations is simply incompatible with the fundamental requirement of security and predictability in international trade relations, which is at the basis of the WTO.<sup>108</sup>

4.168 In the view of the European Communities, the consistent line followed by GATT panels is therefore essentially an application of the general principle of international law that a treaty must be interpreted and performed in good faith.<sup>109</sup>

4.169 The European Communities goes on to state that Article XVI:4 of the WTO Agreement turns this principle into a specific legal obligation that can be separately invoked. This provision and the related panel findings quoted above have important implications for the scope of the Panel's examination.

4.170 The European Communities maintains that it is sufficient for the Panel to examine whether Sections 301-310 mandate determinations and actions by the USTR that are inconsistent with the United States' obligations under Article 23 of the DSU.

4.171 The European Communities further argues that there is no need to examine whether the USTR has actually implemented Sections 301-310 as mandated, whether Sections 301-310 are mandatory in the sense that their application could be enforced by domestic courts, or whether the President would be entitled to instruct the USTR to refrain from taking the actions prescribed by Sections 301-310.

4.172 The European Communities concludes that it follows from the above that, if the Panel were to find that certain provisions of Sections 301-310, on their face, mandate determinations or actions that are inconsistent with Article 23 of the DSU, it would have to rule that these provisions must be amended.

4.173 **The United States responds** that GATT and WTO panels have uniformly found that legislation may be challenged as such only if it mandates action inconsistent with WTO or GATT obligations. Most recently, the panel in *Canada – Measures Affecting the Export of Civilian Aircraft* stated:

"We recall the distinction that GATT/WTO panels have consistently drawn between discretionary legislation and mandatory legislation. For example, in *United States – Tobacco*, the panel "recalled that panels had consistently ruled that legislation which mandated action inconsistent with the General Agreement could be challenged as such, whereas legislation which merely gave the discretion to the executive authority ... to act inconsistently with the General Agreement could not be challenged as such; only the actual application of such legislation inconsistent with the General Agreement could be subject to challenge". (citation omitted)<sup>110</sup>

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<sup>108</sup> Cf. DSU, Article 3.2, first sentence.

<sup>109</sup> Vienna Convention on the Law of Treaties, Articles 26 and 31.

<sup>110</sup> Panel Report on *Canada – Measures Affecting the Export of Civilian Aircraft* ("*Canada – Aircraft*"), circulated 14 April 1999, WT/DS70/R, para. 9.124, appeal pending on other grounds, citing

4.174 The United States notes that the European Communities was the beneficiary of the settled distinction between mandatory and discretionary legislation in *EEC – Regulation on Imports of Parts and Components*.<sup>111</sup> In that case, the panel found that "the mere existence" of the anticircumvention provision of the EC's antidumping legislation was not inconsistent with the EC's GATT obligations, even though the European Communities had taken GATT-inconsistent measures under that provision.<sup>112</sup> The panel based its finding on its conclusion that the anticircumvention provision "does not mandate the imposition of duties or other measures by the EEC Commission and Council; it merely authorizes the Commission and the Council to take certain actions".<sup>113</sup>

4.175 The United States further contends that in this dispute, the European Communities is challenging no specific measures taken under Sections 301-310.<sup>114</sup> It is challenging the mere existence of Sections 301-310. Thus, for that challenge to succeed, the European Communities must demonstrate not only that Sections 301-310 authorize WTO-inconsistent action, but that they mandate such action. As the European Communities acknowledges, it must show that this legislation "does not allow" the US government to follow DSU procedures.<sup>115</sup>

4.176 The United States further indicates that in applying the discretionary-mandatory distinction, panels have found that legislation explicitly directing action inconsistent with GATT principles does not mandate inconsistent action so long as it provides the possibility for authorities to avoid such action. For example, in *United States – Taxes on Petroleum and Certain Imported Substances*,<sup>116</sup> the Superfund Act required importers to supply sufficient information regarding the chemical inputs of taxable substances to enable the tax authorities to determine the amount of tax to be imposed; otherwise, a penalty tax would be imposed in the amount of five percent *ad valorem* or a different rate to be prescribed in regulations by the Secretary of the Treasury by a different methodology. The regulations in question had not yet been issued. Nevertheless, the panel concluded:

"[W]hether [the regulations] will eliminate the need to impose the penalty tax and whether they will establish complete equivalence between domestic and imported products, as required by Article III:2, first sentence, remain open questions. From the perspective of the overall objectives of the General Agreement it is regrettable that the Superfund Act explicitly directs the United States tax authorities to impose a tax inconsistent with the national treatment principle but, since the Superfund Act also gives them the possibility to avoid the need to impose that tax by issuing regulations, the existence of the penalty

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Panel Report on *United States – Measures Affecting the Importation, Internal Sale and Use of Tobacco* ("US – Tobacco"), adopted 4 October 1994, BISD 41S/131, para 118.

<sup>111</sup> Panel Report on *EEC – Regulation on Imports of Parts and Components* ("EEC – Parts and Components"), adopted 16 May 1990, BISD 37S/132.

<sup>112</sup> *Ibid.*, paras. 5.9, 5.21, 5.25-5.26.

<sup>113</sup> *Ibid.*, para. 5.25.

<sup>114</sup> According to the United States, to the contrary, the European Communities has explicitly acknowledged that its complaint does not address the US measures taken in the context of the EC's failure to comply with DSB recommendations in the *Bananas* case. The European Communities has initiated separate dispute proceedings relating to the *Bananas* case, and the United States intends in that proceeding to rebut EC claims specific to that dispute.

<sup>115</sup> See WT/DS152/11.

<sup>116</sup> Panel Report on *US – Superfund*, *op. cit.*

rate provisions as such does not constitute a violation of the United States obligations under the General Agreement".<sup>117</sup>

4.177 The United States adds that similarly, in *Thailand – Restrictions on Importation of and Internal Taxes on Cigarettes*,<sup>118</sup> the panel examined Thailand's Tobacco Act, which established a higher ceiling tax rate for imported cigarettes than for domestic cigarettes. While the Act explicitly gave Thai officials the authority to implement discriminatory tax rates, this did not render the statute mandatory. The panel concluded that "the possibility that the Tobacco Act might be applied contrary to Article III:2 was, by itself, not sufficient to make it inconsistent with the General Agreement".<sup>119</sup>

4.178 The United States finally points out that in *United States – Measures Affecting the Importation, Internal Sale and Use of Tobacco*,<sup>120</sup> the panel found that a law did not mandate GATT-inconsistent action where the language of that law was susceptible of a range of meanings, including ones permitting GATT-consistent action. The panel examined the question of whether a statute requiring that "comparable" inspection fees be assessed for imported and domestic tobacco mandated that these fees had to be identical for each, without respect to differences in inspection costs. If so, the statute would be inconsistent with GATT 1947 Article VIII:1(a), which prohibits the imposition of fees in excess of services rendered.<sup>121</sup> The United States argued that the term "comparable" need not be interpreted to mean "identical", and that the law did not preclude a fee structure commensurate with the cost of services rendered.<sup>122</sup> The panel agreed with the United States:

"[T]he Panel noted that there was no clear interpretation on the meaning of the term "comparable" as used in the 1993 legislative amendment. It appeared to the Panel that the term "comparable", including the ordinary meaning thereof, was susceptible of a range of meanings. The Panel considered that this range of meanings could encompass the interpretation advanced by the United States in this proceeding, an interpretation which could potentially enable USDA to comply with the obligation of Article VIII:1(a) not to impose fees in excess of the cost of services rendered, while at the same time meeting the comparability requirement of [the US law]".<sup>123</sup>

4.179 In the view of the United States, the Panel therefore found that the complaining party had "not demonstrated that [the US law] *could not* be applied in a manner ensuring that fees charged for inspecting tobacco were not in excess of the cost of services rendered".<sup>124</sup>

4.180 In conclusion, the United States states that there is thus a strict burden on a complaining party seeking to establish that a Member's legislation mandates a WTO agreement violation: the complaining party must demonstrate that the legislation, as interpreted in accordance with the

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<sup>117</sup> Ibid., para. 5.2.9.

<sup>118</sup> Panel Report on *Thailand – Restrictions on Importation of and Internal Taxes on Cigarettes* ("*Thai – Cigarettes*"), adopted 7 November 1990, BISD 37S/200.

<sup>119</sup> Ibid., para. 86. The United States notes that the panel found that the actual implementation of the tax rates through regulations was also consistent with Thai obligations, since these rates were non-discriminatory. Ibid., para. 88.

<sup>120</sup> Panel Report on *US – Tobacco*, op. cit., footnote 47.

<sup>121</sup> Ibid., para. 118.

<sup>122</sup> Ibid., para. 122.

<sup>123</sup> Ibid., para. 123.

<sup>124</sup> Ibid.

domestic law of the Member, precludes any possibility of action consistent with the Member's WTO obligations. Moreover, where legislation is susceptible of multiple interpretations, the complaining party must demonstrate that none of these interpretations permits WTO-consistent action. As described in the following section, the European Communities has failed to meet that burden in this case.

4.181 The United States adds that the distinction between mandatory and discretionary action in GATT/WTO jurisprudence was a basic element of the practice of the GATT 1947 Contracting Parties in interpreting the GATT 1947, and remains a basic element of the practice of WTO Members in interpreting the WTO Agreement. The alternative to this distinction would be to require Members to write into their domestic laws specific limitations on the exercise of discretion in order to avoid even the possibility of WTO-inconsistent action. Each Member would be required to make the WTO Agreement pre-eminent in its legal order – a step which the European Communities expressly rejected for itself in 1994.<sup>125</sup> No such obligation now exists in the WTO agreements, and the European Communities has conceded as much in the current review of the Dispute Settlement Understanding. There, the European Communities has submitted a proposal which "would remove the *current distinction* between discretionary and mandatory measures"<sup>126</sup> and make it possible to establish the WTO-incompatibility of discretionary measures.<sup>127</sup>

4.182 The United States argues that when addressing specific provisions of Sections 301-310, the European Communities generally appears to accept that it must demonstrate that the US statute actually mandates (and not merely permits) WTO-inconsistent behaviour. Indeed, the EC's fundamental claim in its request for a panel is that the Section 301 legislation "does not allow" the United States to comply with its WTO obligations.<sup>128</sup>

4.183 In the view of the United States, in its introductory remarks, however, and in statements scattered throughout its submission, the European Communities suggests that it believes that WTO Members are under an affirmative obligation to include in their domestic law explicit limits on discretionary authority. For example, the European Communities states,

"The European Communities ... believes that Sections 301-310 must be amended to make clear that the United States administration is required to act in accordance with the United States' obligations under the WTO agreements in all circumstances and at all times". (emphasis added)

4.184 The United States contends that likewise, the European Communities laments remaining discretion within Sections 301-310 and decries the alleged fact that the United States is "keeping open for itself the possibility" of resorting to unilateral measures.<sup>129</sup>

4.185 The United States argues that these formulations of WTO obligations are diametrically opposed to the principle set forth in each and every panel report which has addressed the issue –

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<sup>125</sup> The United States refers to Council Decision 94/800, 1994 O.J. (L 336) 1 as stating that "by its nature, the Agreement establishing the World Trade Organization, including the Annexes thereto, is not susceptible to being directly invoked in Community or Member State courts".

<sup>126</sup> The United States refers to *Review of the Dispute Settlement Understanding*, Non-Paper by the European Communities (Oct. 1998) (emphasis added); and also *Review of the DSU*, Note by the Secretariat, Compilation of Comments Submitted by Members – Rev. 3 (12 December 1998).

<sup>127</sup> Ibid.

<sup>128</sup> WT/DS152/11.

<sup>129</sup> Ibid., para. 9.

that legislation must require, and not merely leave open the possibility, of GATT or WTO-inconsistent action.<sup>130</sup> Likewise, they are also inconsistent with the approach taken in other GATT contexts, for example, working parties examining the legislation of a contracting party or acceding country to determine whether that legislation mandates GATT-inconsistent results, and not whether it could deliver such results.<sup>131</sup>

4.186 In the US view, surely the European Communities understands this. Wholly apart from the fact that the European Communities in its submissions generally acknowledges this principle in its analysis, the European Communities has, in the context of the on-going DSU Review, submitted a proposal which "would remove the current distinction between discretionary and mandatory measures"<sup>132</sup> and make it possible to establish the WTO-incompatibility of discretionary measures.<sup>133</sup> The European Communities now appears to be asking this Panel to legislate that very change.

4.187 In the US view, the implications of the EC DSU proposal and of its request to this panel to establish a rule that all municipal legislation must "make clear" that authorities must act consistently with their WTO obligations "in all circumstances and at all times" are profound. The proposed rule would touch on the sovereignty of Members in a manner they have not, to date, agreed to. One has to ask whether the European Communities has thoroughly considered the implications of its argument. Would, for example, the European Communities be required to amend the legislative and Treaty of Amsterdam authority under which it has been implementing its banana regime in order to include the specific requirement that this regime must comply with the EC's WTO obligations?

4.188 The United States argues that in fact, under the EC's proposal, the European Communities would have to amend virtually every piece of European Communities and Member State legislation to require that it be administered in WTO-consistent fashion, since the EC's WTO commitments are at present not directly enforceable under EC law.<sup>134</sup> The EC Council of Ministers stated this clearly at the time it ratified the WTO agreements: "[B]y its nature, the Agreement establishing the World Trade Organization, including the Annexes thereto, is not susceptible to being directly invoked in Community or Member State courts".<sup>135</sup> Thus, the European Communities does not differ from the United States in this regard, contrary to the impression the European Communities attempts to leave.

4.189 The United States further notes that it appears that the European Communities would have to amend its "Trade Barriers Regulation" to remove discretionary elements, which, in the

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<sup>130</sup> The United States refers to Panel Report on *Canada – Aircraft*, op. cit., para 9.124; Panel Report on *US – Superfund*, op. cit., para. 5.2.9; Panel Report on *Thai – Cigarettes*, op. cit., para. 86; Panel Report on *EEC – Parts and Components*, op. cit., paras. 5.25-5.26; Panel Report on *US – Tobacco*, op. cit., para. 118; Panel Report on *US – Malt Beverages*, op. cit., para. 5.39; Panel Report on *India – Patents (US)*, op. cit., para. 7.35; GATT *Analytical Index/Guide to GATT Law and Practice* (6<sup>th</sup> ed. 1995), 133-36, 645-49.

<sup>131</sup> The United States refers to Report on *The European Economic Community*, L/778, adopted on 29 November 1957, 6S/70, 80, para. 10.

<sup>132</sup> The United States refers to *Review of the Dispute Settlement Understanding*, Non-Paper by the European Communities (Oct. 1998); and also *Review of the DSU*, Note by the Secretariat, Compilation of Comments Submitted by Members – Rev. 3 (12 December 1998).

<sup>133</sup> Ibid.

<sup>134</sup> The United States refers to Case C-280/94, *Germany v. Council*, 1994 ECJ CELEX LEXIS 2609 (5 Oct. 1994).

<sup>135</sup> Council Decision 94/800, 1994 O.J. (L 336) 1.

EC's words, "keep[] open for itself the possibility" of WTO-inconsistent action. The "General Provisions" in Article 15 of the Regulation provide in part:

"[This Regulation] shall be without prejudice to other measures which may be taken pursuant to Article 113 of the Treaty, as well as to Community procedures for dealing with matters concerning obstacles to trade raised by Member States in the committee established by Article 113 of the Treaty".<sup>136</sup>

4.190 The United States maintains that under Article 133 of the Treaty of Amsterdam (formerly, Article 113 of the Treaty of Rome), the European Communities appears to have complete discretion to take any action, for any reason, at any time, in the commercial policy field without regard to WTO rules or DSB authorization. In fact, despite the implication left by the European Communities that its Trade Barriers Regulation is the sole mechanism by which it brings disputes at the WTO, the European Communities has brought only six of 45 WTO disputes through that regulation.<sup>137</sup> The remainder have been brought through the unpublished, non-transparent procedures of the Article 133 Committee (if, indeed, any such procedures exist).<sup>138</sup> The United States is not aware of any EC legislation or treaty provision which would make "retaliatory action of the [European Communities under its Article 133 procedures] dependent on the authorization of the DSB", nor is the United States aware of any such provision which creates any "legal entitlement to obtain such an exceptional 'act of grace'". Presumably, under the EC's requested rule, it would be required to amend the Treaty of Amsterdam to provide the clarity and further assurances it seeks from the United States.

4.191 In the view of the United States, while the European Communities appears to have lost its appreciation for the importance of distinguishing between discretionary and mandatory measures in the context of this dispute, it understood this distinction well in 1957. The 1957 Report on "The European Economic Community" states,

"Following an exchange of views on the provisions of the Rome Treaty in the field of quantitative restrictions, the Sub-Group noted that these provisions were not mandatory and imposed on the Members of the Community no obligation to take action which would be inconsistent with the General

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<sup>136</sup> Art. 15, Council Reg. 3286/94, 1994 O.J. (L 349) 71.

<sup>137</sup> The United States notes that the WTO cases brought through the TBR are: *United States – Measures Affecting Textiles and Apparel Products* (DS85); *United States – Antidumping Act of 1916* (DS136); *Japan – Tariff Quotas and Subsidies Affecting Leather* (DS147); *United States – Measures Affecting Textiles and Apparel Products (II)* (DS151); *Argentina – Measures Affecting the Export of Bovine Hides and the Import of Finished Leather* (DS155); and *United States – Section 110(5) of the U.S. Copyright Act* (DS160).

<sup>138</sup> The United States argues that a former Chairman at the Deputies level of the Article 133 Committee has written that its proceedings are formally confidential (though, in practice, strict confidentiality is not maintained), and that the Committee does not issue public statements. Michael Johnson, *European Community Trade Policy and the Article 113 Committee*, 35 (Royal Institute of Int'l Affairs 1998). With respect to the operation of the Committee, the author concludes,

"The Committee's development over a period of forty years – erratic and largely unplanned – reflects that of the Community itself. On the basis of ... political compromises ... it has found practical ways of responding to the escalating demands of international trade relations .... By consent of all concerned it has grown to exercise an authority well beyond the apparent legal limits set by its vague remit in Article 113 of the Treaty of Rome. The result is a highly pragmatic body in which most of the time individuals who recognize each other as experts can settle trade issues in a familiar setting". *Ibid.* p. 37.



Agreement. On the other hand because of the very general scope and competence conferred on the institutions of the Community, it could be within their powers to take measures which could be inconsistent with the GATT whatever the interpretation given to the provisions of Article XXIV. The Six pointed out that many contracting parties had permissive domestic legislation of a general character which, if implemented in full, would enable them to impose restrictions in a manner contrary to Article XI. These countries were not, however, required to consult with the CONTRACTING PARTIES about their possible intentions as regards the implementation of such legislation. The six could not accept that any contracting party by virtue of its adherence to the Rome Treaty should be subjected to additional requirements or obligations as to the consultations about the use of quantitative restrictions".<sup>139</sup>

4.192 The United States argues that however much the European Communities may now wish to amend WTO treaty terms to authorize panels to find discretionary legislation inconsistent with WTO rules, no such term now exists. The European Communities refers to Article XVI:4 of the WTO Agreement, which requires each Member to "ensure the conformity of its laws, regulations and administrative procedures with its obligations as provided in the annexed Agreements".<sup>140</sup> However, inasmuch as Sections 301-310 neither mandate action in violation of any provision of the DSU or GATT 1994 nor preclude action consistent with those obligations, Sections 301-310 are in conformity with those obligations and with Article XVI:4 as well. Likewise, because Sections 301-310 do not preclude the USTR from having recourse to, and abiding by, the rules and procedures of the DSU, Sections 301-310 are not inconsistent with DSU Article 23.1.

4.193 The United States emphasises the applicable legal standard, which the European Communities appears to recognise. That is the proposition that, where a law itself is challenged under WTO rules, that law must mandate action which is inconsistent with a Member's obligations. A law which provides discretion which may be exercised in a manner either consistent or inconsistent with the Member's obligations does not in itself violate those obligations. The EC panel request recognises this standard when it asserts that the Section 301 legislation "does not allow" the USTR to adhere to DSU procedures as a result of time frames in the statute. In addition, the EC proposal in the DSU review to "remove the current distinction between discretionary and mandatory measures" also reinforces the fact that the European Communities appreciates that WTO Members have never, to date, consented to limitations on their right to adopt discretionary legislation.

4.194 The United States argues that in the *US – Tobacco* case, the panel not only affirmed this rule, it clarified that where statutory language is ambiguous and is susceptible of multiple readings, the complaining party must demonstrate that none of those readings permits action consistent with the defending party's obligations. This approach follows logically from the applicable burden of proof in dispute settlement proceedings, since a complaining party is responsible for proving that the statute does not permit the defending party to comply with its international obligations. One may not assume that a party will not act in good faith to comply with its obligations. Only in cases where the party adopts legislation which does not allow its authorities to comply with its WTO obligations may that legislation be found inconsistent with those obligations.

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<sup>139</sup> The United States cites Report on *The European Economic Community*, L/778, adopted on 29 November 1957, BISD 6S/70, para. 10 (emphasis added).

<sup>140</sup> Marrakesh Agreement Establishing the World Trade Organization, Art. XVI:4.

4.195 In the view of the United States, no panel under the GATT or the WTO has diverged from this rule. Contrary to the claims of some that only GATT panels have applied this rule, the WTO panels in the *Canada – Aircraft* and *Turkey – Clothing and Textile* cases have also applied it. Moreover, as just noted, the European Communities has, in the context of the DSU review, recognised the rule's continued applicability. There is nothing in the WTO Agreement or its annexes which alters this practice.

(ii) *Relevance of Protocol of Provisional Application*

4.196 **In response, the European Communities argues** that the distinction between mandatory and discretionary legislation in GATT 1947 practice was a reflection of the fact that the contracting parties to GATT 1947, under the existing legislation clause in the Protocol of Provisional Application (PPA) and the protocols of accession, were bound by their obligations under the GATT 1947 only to the extent that their domestic legislation permitted the executive authorities to perform those obligations.

4.197 The European Communities points out that according to paragraph 1(b) of the PPA,

"The Governments of ... undertake ... to apply provisionally on and after January 1, 1948 ... Part II of that Agreement to the fullest extent not inconsistent with existing legislation" (emphasis added)

4.198 In the view of the European Communities, this clause allowed the government of the United States and other governments to accept the GATT 1947 without submitting it for ratification by their legislature. Under the GATT 1947 there was thus an assumption and the clear expectation that pre-existing legislation stipulating measures contrary to the provisions of the GATT 1947 could continue.

4.199 The European Communities contends that the notion of mandatory legislation under the GATT 1947 was adopted in this particular context of a conflict between an existing legislation and a new GATT-Part II obligation: the existing legislation clause required each contracting party to resolve such a conflict in favour of the former and to the detriment of the latter.

4.200 In the EC's view, already in its deliberations in 1947, i.e. before the provisional application of the GATT 1947, the Tariff Agreement Committee stated the following:

"the intent is that it should be what the executive authority can do - in other words, the administration would be required to give effect to the general provisions to the extent that it could do so without either (1) changing the existing legislation or (2) violating existing legislation. If a particular administrative regulation is necessary to carry out the law... that regulation would, of course, have to stand; but to the extent that the administration had the authority within the framework of existing laws to carry out these provisions, it would be required to do so".<sup>141</sup> (emphasis added)

4.201 The European Communities points out that after the GATT 1947 was provisionally applied by means of the PPA, a 1949 GATT Working party, examining, in the course of its work, measures that could be permitted to be exempted under the "existing legislation" clause of the PPA, confirmed this view:

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<sup>141</sup> EPCT/TAC/PV.5 page 20

"The working party agreed that a measure is so permitted, provided that the legislation on which it is based is by its terms or expressed intent of a mandatory character - that is, it imposes on the executive authority requirements which cannot be modified by executive action"<sup>142</sup> (emphasis added).

4.202 The European Communities notes that the contracting parties therefore had no right to expect that the legal uncertainty arising from the existence of such legislation would be eliminated. All they could expect was that the executive authorities would use the discretion available to them under the legislation in a GATT-consistent manner.

4.203 The European Communities argues that this explains the need of a restrictive interpretation of mandatory legislation with the aim to allow a rapid entry into force of the GATT 1947. The intention was in fact to limit the scope of the "existing legislation" clause of the PPA thus allowing an effective application of GATT 1947. A more open reading of the PPA clause would have *de facto* reduced considerably the achievement of the objectives of the GATT.

4.204 The European Communities further maintains that the GATT panels had no option but to apply the same standard to all domestic legislation, whether it was adopted before or after the entry into force of the GATT. The working parties and Panels under GATT 1947<sup>143</sup> therefore faced a dilemma: adopting a narrow definition of "mandatory" legislation furthered the objectives of the GATT with respect to existing legislation<sup>144</sup> but had exactly the opposite effect when applied to new legislation. The findings of the 1987 *United States - Taxes on Petroleum and Certain Imported Substances* show that this Panel was aware of this dilemma<sup>145</sup>:

"... These regulations have not yet been adopted. Thus, whether they will eliminate the need to impose the penalty tax and whether they will establish complete equivalence between domestic and imported products, ... remain open questions. From the perspective of the overall objectives of the General Agreement it is regrettable that the Superfund Act explicitly directs the United States tax authorities to impose tax inconsistent with the national treatment with respect to that case ... The Panel noted with satisfaction the statement of the

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<sup>142</sup> BISD Vol. II/49, para. 99

<sup>143</sup> Panel Report on *Belgium - Family allowances*, adopted on 7 November 1952, BISD 1S/59, para. 6; Reports of the Working Parties on *Organizational and Functional Questions*, adopted on 28 February, 5 and 7 March 1955, BISD 3S/231, para. 58; and Report of the Working Parties on *Import Restrictions of the Federal Republic of Germany*, adopted on 30 November 1957, BISD 6S/55, para. 12; Panel Report on *Norway - Restrictions on Imports of Apples and Pears* ("*Norway - Restrictions on Apples and Pears*"), adopted on 22 June 1989, BISD 36S/306, para. 5.6; Panel Report on *Thai - Cigarettes*, op. cit., para. 83; Panel Report on *Canada - Import, Distribution and Sale of Certain Alcoholic Drinks by Provincial Marketing Agencies*, adopted on 18 February 1992, DS17/R, para. 5.9; and Panel Report on *US - Malt Beverages*, op. cit., para. 5.44.

<sup>144</sup> The European Communities notes that in the "Belgian Family Allowances" case, paragraph 6, a Panel explicitly stated what follows: "the Panel noted, however, that, in another case ["Brazilian Internal Taxes" case], the Contracting Parties agreed that the Protocol of Provisional Application had to be construed so as to limit the operation of the provisions of paragraph 1 (b) of the Protocol to those cases where "the legislation on which [the measure] is based is, by its tenor or expressed intent, of a mandatory character - that is, it imposes on the executive authorities requirements which cannot be modified by executive action"

<sup>145</sup> Panel Report on *US - Superfund*, op. cit., para. 5.2.9

United States that, given the tax authorities' regulatory authority under the Act, 'in all probability the 5 per cent penalty rate would never be applied'" (emphasis added)".

4.205 In the EC's view, along the same lines, the 1990 *EEC - Parts and Components* panel report stated that

"...the mere existence of the anti-circumvention provision in the EEC's anti-dumping Regulation is not inconsistent with the EEC's obligations under the General Agreement. Although it would, from the perspective of the overall objectives of the General Agreement, be desirable if the EEC were to withdraw the anti-circumvention provision, the EEC would meet its obligations under the General Agreement if it were to cease to apply the provision in respect to contracting parties".<sup>146</sup>

4.206 The European Communities adds that more explicitly referring to the PPA, the 1989 *Norway - Restrictions of Imports of Apples and Pears* panel report reaffirmed the 1947 understanding that a legislation should be considered to

"be mandatory in character by its terms or expressed intent".

4.207 The European Communities further argues that the 1990 panel report's findings on *Thailand - Restrictions on Importation of and Internal Taxes on Cigarettes* were expressly based on the two earlier precedents, i.e. the 1989 *Norway - Apples and Pears* panel report and the 1949 *Working party on 'Notifications of existing measures and procedural questions'*. The European Communities draws the attention of the Panel to the fact that, consistently with the *Norway - Apples and Pears* panel report and the 1949 - *Working party* report, the *Thai - Cigarettes* panel report dealt with the issue of mandatory *versus* discretionary legislation exclusively in the context of the interpretation of a clause in Thailand's Protocol of accession identical to paragraph 1(b) of the PPA.

4.208 The European Communities maintains that the 1992 *United States - Measures Affecting Alcoholic and Malt Beverages*, the panel again had to assess as a matter of priority the scope of application of the PPA with respect to state legislation in the United States. In that context, it came to the conclusion that

"the record does not support the conclusion that the inconsistent state liquor legislation at issue in this proceeding is 'mandatory existing legislation' in terms of the PPA".

4.209 The European Communities recalls the 1992 *United States - Denial of Most-Favoured-Nation Treatment as to Non-Rubber Footwear from Brazil* panel report. The context was again provided by the PPA:

"2.6 This legislation, in effect at the time the United States acceded to the GATT in 1947, was inconsistent with Article VI:6(a), which proscribes the levy of countervailing duties without a determination of injury. However, Section 303 was covered by the "existing legislation" clause of paragraph 1(b) of the Protocol of Provisional Application of the General Agreement (the "PPA").

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<sup>146</sup> Panel Report on *EEC - Parts and Components*, op. cit., para. 5.26

Paragraph 1(b) of the PPA states that GATT contracting parties shall apply Part II of the General Agreement (which includes Article VI) "to the fullest extent not inconsistent with existing legislation". Section 303 remains in effect today and applies to dutiable imports from all countries that are not signatories to the Subsidies Agreement.

2.7 It was under Section 303 that the countervailing duty order on non-rubber footwear from Brazil was imposed in 1974, without the benefit of an injury test.

2.8 In 1974, the United States enacted Section 331 of the Trade Act of 1974,<sup>147</sup> amending its countervailing duty law to apply also to imports of duty-free products. The United States acknowledged that this provision was not in existence in 1947 and, therefore, was not sheltered by the PPA. Accordingly, the United States law provided that, with respect to imports of duty-free products from a GATT contracting party, the United States would provide an injury test before the imposition of countervailing duties". (emphasis added)

4.210 The European Communities contends that the only legislation that was therefore under the scrutiny of the Panel was Section 331 of the Trade Act of 1974. This provision, which is part of the Trade Act of 1974 that includes also Sections 301-310 that are the subject-matter of the present dispute settlement procedure, was drafted, in relevant part, as follows:

"(a)(2) In the case of any imported article or merchandise which is free of duty, duties may be imposed under this section only if there is an affirmative determination by the Commission under subsection (b)(1) ...

(b) Injury Determination With Respect to Duty-Free Merchandise; Suspension of Liquidation.—(1) Whenever the Secretary makes a final determination under subsection (a) that a bounty or grant is being paid or bestowed with respect to any article or merchandise which is free of duty and a determination by the Commission is required under subsection (a)(2), he shall—

(A) so advise the Commission, and the Commission shall determine within three months thereafter, and after such investigation as it deems necessary, whether an industry in the United States is being or is likely to be injured, or is prevented from being established, by reason of the importation of such article or merchandise into the United States; and the Commission shall notify the Secretary of its determination; ...

(c) Application of Affirmative Determination.--An affirmative determination by the Secretary under subsection (a) with respect to any imported article or merchandise shall apply with respect to articles entered ... on or after the date of the publication in the Federal Register of such determination. In the case of any imported article or merchandise which is free of duty, so long as a finding of injury is required by the international obligations of the United States, the preceding sentence shall apply only if the Commission makes an affirmative determination of injury under subsection (b)(1)".

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<sup>147</sup>(Original footnote ) 19 U.S.C. Section 1303(a)(2)

4.211 The European Communities underlines the very similar wording used by Section 331 and Sections 301-310 of the same Trade Act. With respect to the above mentioned provisions in Section 331, the 1992 "*Non-Rubber Footwear*" Panel found that

"6.13 Having found that Section 331 of the 1974 Act and Section 104(b) of the 1979 Act are applicable to like products, the Panel examined whether this legislation as such is consistent with Article I:1. The Panel noted that the CONTRACTING PARTIES had decided in previous cases that legislation mandatorily requiring the executive authority to impose a measure inconsistent with the General Agreement was inconsistent with that Agreement as such, whether or not an occasion for the actual application of the legislation had arisen. The Panel recalled that the backdating provisions of the two Acts are mandatory legislation, that is they impose on the executive authority requirements which cannot be modified by executive action, and it therefore found that these provisions as such, not merely their application in concrete cases, have to be consistent with Article I:1". (footnote omitted)

4.212 The European Communities notes that, under the United States' countervailing duty law, the administration has discretion whether or not to apply a countervailing duty on subsidised products. The requirement that the Administration not apply the injury criterion *if* it decides to apply a countervailing duty was nevertheless regarded to be "mandatory".

4.213 In the view of the European Communities, in the case of the 1994 *United States - Measures Affecting the Importation, Internal Sale and Use of Tobacco* panel report,<sup>148</sup> its findings were based, on the one hand, on the "*Superfund*" and the *Thai - Cigarettes* panel reports (thus confirming the past GATT 1947 practice). On the other hand, the panel explicitly indicated that the discriminatory measures in Section 1106(c) of the 1993 US Budget Act had not been followed by the promulgation of the implementing rules required by the Act.

4.214 The European Communities contends that further "useful guidance"<sup>149</sup> for this Panel could also be found in the unadopted panel report on *EEC - Member States' Import Regimes for Bananas*<sup>150</sup>, paragraphs 342 to 349.

4.215 **The United States responds by recalling** that the European Communities argues that GATT 1947 panels implicitly relied on a "restrictive interpretation of mandatory legislation" because such an interpretation was necessary in light of the Protocol of Provisional Application. According to the European Communities, because the Protocol exempted from GATT 1947 coverage existing legislation, "effective application of GATT 1947" required that this exemption have a limited scope. The European Communities states, "[t]he contracting parties therefore had no right to expect that the legal uncertainty arising from the existence of such [mandatory] legislation would be eliminated". According to the European Communities, GATT panels in fact either implicitly or explicitly relied on the existence of the Protocol in those cases finding discretionary legislation non-actionable.

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<sup>148</sup> Panel Report on *US - Tobacco*, op. cit., in particular, para. 118.

<sup>149</sup> Appellate Body Report on *Japan - Taxes on Alcoholic Beverages* ("*Japan - Alcoholic Beverages*"), adopted 1 November 1996, WT/DS8/AB/R, WT/DS10/AB/R, and WT/DS11/AB/R, page 15.

<sup>150</sup> Panel Report on *EEC - Member States' Import Regimes for Bananas*, adopted 3 June 1993, DS32/R.

4.216 The United States then contends that the EC's logic is flawed and hard to follow, and it is not clear what "legal uncertainty" arose from "the existence of" pre-existing mandatory legislation. The European Communities apparently is attempting to claim that "uncertainties" existed and had to be tolerated under the GATT 1947 in order to support its argument that they may no longer be tolerated under the WTO Agreement. The United States will address the EC's arguments regarding "uncertainty" in more detail shortly. For now it is sufficient to note that the distinction between the consistency of discretionary and mandatory legislation arose for reasons having nothing to do with the Protocol of Provisional Application or any "uncertainties" the Protocol created.

4.217 The United States notes that the European Communities claimed that the panel reports which developed this doctrine either cited the Protocol or cases citing the Protocol, but it fails to establish this in its analysis of these panel reports. To the contrary, these cases never once reference the Protocol or cases citing the Protocol when dealing with the issue of whether the mere existence of discretionary legislation is actionable. The analysis of these cases confirms this. It also confirms that there has been no change in the application of this doctrine in WTO jurisprudence, nor any reference in that jurisprudence to the fact that the Protocol was eliminated. The EC's assertions concerning the relationship between the development of this doctrine and the Protocol are completely without foundation.

4.218 The United States notes that the European Communities purports to demonstrate how the doctrine of the non-actionability of discretionary legislation arose in connection with the Protocol of Provisional Application. The European Communities stated that the panels which developed this doctrine either cited the Protocol or cases citing the protocol. The following analysis of these cases reveals that this is not true, and that the EC's discussion of these cases is highly distorted, inaccurate and misleading.

4.219 The United States argues that the first panel to find that the mere existence of discretionary legislation is not actionable was the 1987 *US - Superfund* panel.<sup>151</sup> In its analysis of this case, the European Communities makes the bald assertion that this panel "was aware of" the dilemma allegedly created by the Protocol. It offers absolutely no support for this assertion. The EC offers no evidence that the *Superfund* case so much as references the Protocol, because there is no such reference. The *Superfund* panel referred neither to prior panel reports, nor to the Protocol, in making its finding regarding discretionary legislation.<sup>152</sup>

4.220 The United States argues that after referencing *US - Superfund*, the European Communities next introduces, with the phrase "[a]long the same lines", a quotation from the 1990 panel report on *EEC - Parts and Components* applying the mandatory/discretionary distinction, as if the leap it made with respect to the *Superfund* panel may be transferred to yet another case. However, the *EEC - Parts and Components* case makes no reference to the

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<sup>151</sup> Panel Report on *US - Superfund*, op. cit., para. 5.2.9.

<sup>152</sup> See Panel Report on *US - Superfund*, op. cit., para. 5.29. The United States notes that elsewhere in the *Superfund* report, the panel cited *Japan Leather* in support of its finding that mandatory legislation is actionable even if not yet in effect. *Ibid.*, para. 5.22. The *Japan Leather* panel made no reference to the Protocol or to any cases citing the protocol. Rather, the panel found that a quantitative restriction was actionable even if an exporting country had not filled its quota. Panel Report on *Japanese Measures on Imports of Leather*, adopted 15/16 May 1984, BISD 31S/94, para. 55.

Protocol, or to cases citing the Protocol. Instead, it refers to the *Superfund* panel report which, as we have seen, makes no reference to the Protocol or to cases citing the Protocol.<sup>153</sup>

4.221 In the view of the United States, the European Communities next juxtaposes a reference to the 1989 panel on *Norway -- Restrictions on Imports of Apples and Pears*, a case which does, indeed, refer to the Protocol and the question of whether certain mandatory legislation was, by virtue of the Protocol, exempt from GATT coverage. This case did not, however, involve the question of whether the mere existence of discretionary legislation is actionable.<sup>154</sup>

4.222 According to the United States, the European Communities identifies a case which discusses both the Protocol and the question of whether the mere existence of discretionary legislation is actionable: *Thai - Cigarettes*. However, the European Communities incorrectly states that the *Thai - Cigarettes* panel report "dealt with the issue of mandatory *versus* discretionary legislation exclusively in the context of the interpretation of a clause in Thailand's Protocol of accession identical to paragraph 1(b) of the PPA".

4.223 The United States contends that in fact, the issue of mandatory versus discretionary legislation arises three times in *Thai - Cigarettes*. The first is in the context of addressing whether Thailand's Protocol exempted a provision of the Tobacco Act (Section 27) from the application of Article XI:1 of the GATT 1947.<sup>155</sup> The Panel's discussion of this point references *Norway Apples*, but makes no reference to *US - Superfund* or to *EEC - Parts and Components*.<sup>156</sup> The next reference to a discretionary/mandatory distinction comes in the context of determining whether the mere existence of excise tax provisions allowing for the possibility of a violation of GATT 1947 Article III:2 could be said to violate that provision.<sup>157</sup> The panel found it did not, relying on the *US - Superfund* and *EEC - Parts and Components* panel reports.<sup>158</sup> Despite the fact that the Panel had one paragraph earlier applied the discretionary/mandatory distinction in the context of the PPA, the panel did not refer to this finding or to the Protocol.<sup>159</sup> Likewise, when the panel for a third time addressed a mandatory/discretionary distinction, this time to determine whether the existence of a provision "enabling the executive authorities to levy [a] discriminatory [business and municipal tax]" violated Article III, the panel concluded that it did not.<sup>160</sup> In making this finding, the panel referenced its finding with respect to excise taxes (which referenced the *US - Superfund* and *EEC - Parts and Components* reports), but made no reference to its earlier findings with respect to the Protocol.<sup>161</sup> The panel thus drew no connection between the non-actionability of discretionary legislation and the exemption of pre-existing mandatory legislation under the Protocol, despite the opportunity presented by the fact that the dispute dealt with both issues.

4.224 The United States notes that the EC citation to *US - Malt Beverages* is equally without support. The European Communities notes that this panel report addressed the question of whether legislation was exempt from the GATT 1947 because it was covered by the Protocol (the panel found it was not), but neglects to point out that the Protocol is not so much as mentioned in the separate discussion in that report of whether the non-enforcement of

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<sup>153</sup> See *EEC - Parts and Components*, op. cit., paras. 5.25-5.26.

<sup>154</sup> Panel Report on *Norway - Restrictions on Apples and Pears*, op. cit., paras. 5.6-5.13.

<sup>155</sup> Panel Report on *Thai - Cigarettes*, op. cit., paras. 82-83.

<sup>156</sup> Ibid.

<sup>157</sup> Ibid., para. 84.

<sup>158</sup> Ibid.

<sup>159</sup> See *ibid.*

<sup>160</sup> Ibid., paras. 85-86.

<sup>161</sup> See *ibid.*



mandatory legislation rendered legislation non-actionable.<sup>162</sup> That discussion again references *Thai - Cigarettes*, *EEC Parts and Components* and *US - Superfund*, but not the Protocol or cases citing the Protocol.<sup>163</sup> The Protocol issue cited by the European Communities is clearly unrelated to the issues presented here.

4.225 The United States notes that the European Communities next discusses the 1992 panel report on *United States - Non-Rubber Footwear*. The European Communities asserts that "the context was again provided by the PPA", an assertion which is at best misleading. While issues relating to the PPA were responsible for the fact that the United States was applying multiple countervailing duty regimes to countries in different circumstances, the exemption of various of these regimes under the PPA was not at issue.<sup>164</sup> Rather, the issue related to the comparative treatment different countries received under each of these regimes, which the panel found to violate GATT 1947 Article I:1.<sup>165</sup> The panel found that the specific provisions of these regimes granting more or less favorable treatment were mandatory because they could not be modified through executive discretion, and were therefore actionable as such.<sup>166</sup> In a footnote to this finding omitted by the European Communities, the panel cited *US - Superfund* and *EEC - Parts and Components*.<sup>167</sup> There is no reference to the Protocol or to cases citing the Protocol.

4.226 The United States points out that the European Communities also draws false comparisons between Sections 301-310 and the laws at issue in *Non-Rubber Footwear*. First, the EC focuses on only one of the laws under examination in that case, an amendment to a 1930s law included in the Trade Act of 1974. That amendment, like the other laws at issue dating to the 1930s and 1979, related to countervailing duties and had nothing to do with Sections 301-310. Second, the EC quotes with emphasis references in the 1974 amendment to "determinations" and the word "shall", and states, "the EC cannot help but underline the very similar wording used by Section 331 and Sections 301-310 of the same Trade Act".

4.227 The United States argues that the European Communities ignores the fact that the "determinations" on which it focuses had absolutely nothing to do with the finding in the case. The issue in *Non-Rubber Footwear* was the timing and procedures under each of the laws for lifting existing countervailing duty orders. Existing countervailing duty orders on products of countries newly granted GSP benefits were automatically given an injury review. If that review was negative, the order was revoked, "backdated" to the date these countries were granted GSP benefits. On the other hand, countervailing duty orders on dutiable products from countries acceding to the Subsidies Code were given an injury review only upon application within three years of accession, and the revocations were "backdated" only to the date of the application. The differential treatment was the basis for the panel's Article I:1 finding; that finding had nothing to do with the language highlighted in the EC description.

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<sup>162</sup> The United States refers to Panel Report on *US - Malt Beverages*, op. cit., paras. 5.39, 5.57, 5.60.

<sup>163</sup> See *ibid.*, para. 5.39 and note.

<sup>164</sup> The United States refers to Panel Report on *Denial of Most-favoured Treatment as to Non-Rubber Footwear from Brazil* ("*Brazilian Non-Rubber Footwear*"), adopted 19 June 1992, BISD 39S/128, paras. 2.6, 2.8 (explaining that the United States did not contest the fact that while a countervailing duty law dating to the 1930s was exempt under the PPA, a 1974 amendment to that law was not).

<sup>165</sup> *Ibid.*, paras. 6.14, 6.17.

<sup>166</sup> *Ibid.*, para. 6.13.

<sup>167</sup> Panel Report on *Brazilian Non-Rubber Footwear*, op. cit., paras. 6.4, 6.5, 6.14, 6.17.

4.228 In the US's view, the European Communities further attempts to draw false parallels between the 1974 countervailing duty law amendment and Sections 301-310 by stating that, under the countervailing duty law,

"the administration has discretion whether or not to apply a countervailing duty on subsidized products. The requirement that the Administration not apply the injury criterion *if* it decides to apply a countervailing duty was nevertheless regarded to be mandatory".

4.229 According to the United States, the only problem with the EC's analysis is that it bears no relationship to that of the panel. "The requirement that the Administration not apply the injury criterion" was (1) not at issue in the case, if for no other reason than (2) no such requirement is in the law. Again, the issue in the case was the timing and procedures for injury reviews and for revocation of existing countervailing duty orders. Because the case dealt with existing orders, the Administration had already in each of these cases determined that a countervailable subsidy existed, years before the issue of revocation, and the application of different revocation regimes, ever arose. Thus, even were it accurate to describe such determinations as discretionary (the procedures and methodologies for making the determination are detailed in statutory and regulatory provisions, and allow for limited discretion), these determinations were never at issue in the case, and were completely irrelevant to the "backdating provisions" which the panel considered mandatory and therefore actionable as such.

4.230 The United States points out that the European Communities fails to include any discussion of how this practice allegedly changed under the WTO because the Protocol was no longer in effect. The non-actionability of discretionary legislation (or the actionability of mandatory legislation) was again at issue in *Canada – Civil Aircraft*, *Turkey - Textiles* and *Argentina – Textiles and Apparel (US)*, but the European Communities addresses only the last of these. In its discussion of that case the European Communities provides no demonstration that the panel applied a new definition of "mandatory", or that the panel referred to the Protocol of Provisional Application. Instead, the panel found that Argentina's specific duties were mandatory measures, relying on the consistent line of GATT and WTO cases establishing the mandatory/discretionary distinction.<sup>168</sup> The panel stated, "GATT/WTO case law is clear in that a mandatory measure can be brought before a Panel, even if such an adopted measure is not yet in effect".<sup>169</sup> In a footnote omitted from the EC's discussion, the panel cited *US - Superfund*. The panel also noted that the *U.S. Tobacco* report confirmed this interpretation.<sup>170</sup>

4.231 According to the United States, had the EC bothered to address the *Canada – Aircraft* and *Turkey - Textile* cases, it would have found that neither of these cases did anything other than apply the GATT distinction on discretionary/mandatory legislation. For example, in *Canada – Aircraft*, the panel stated:

"We recall the distinction that GATT/WTO panels have consistently drawn between discretionary legislation and mandatory legislation. For example, in *United States Tobacco*, the panel 'recalled that panels had consistently ruled that legislation which mandated action inconsistent with the General Agreement could be challenged as such, whereas legislation which merely gave the discretion to the executive authority ... to act

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<sup>168</sup> Panel Report on *Argentina – Textiles and Apparel(US)*, op. cit., para. 6.45.

<sup>169</sup> Ibid.

<sup>170</sup> Ibid.

inconsistently with the General Agreement could not be challenged as such; only the actual application of such legislation inconsistent with the General Agreement could be subject to challenge".<sup>171</sup> (citation omitted)

4.232 The United States considers that neither *Canada - Aircraft* nor *Turkey - Textiles* redefined the meaning of "mandatory" or refer to the Protocol of Provisional Application to do so.<sup>172</sup> The EC's claim that the definition of mandatory has changed because of the elimination of the Protocol of Provisional Application is thus pure fantasy. Neither the GATT cases establishing the actionability of mandatory legislation nor the WTO cases which have continued to apply this rule relied on the existence, expiration, or anything else regarding, the Protocol of Provisional Application.<sup>173</sup>

(iii) *Marrakech Agreement*

4.233 **The European Communities also argues** that Article XVI:4 of the Marrakech Agreement provides for a more far-reaching and novel obligation upon WTO Members when compared to Articles 26 and 27 of the Vienna Convention on the Law of Treaties or to the legal situation existing under the GATT 1947,

"each Member shall ensure the conformity of its laws, regulations and administrative procedures with its obligations [under the WTO agreements]".

4.234 The European Communities points out that in particular, the provision requires a positive action by the WTO Member ensuring the conformity of its domestic law, which includes not only legislation but also regulations and administrative procedures.

4.235 The European Communities further indicates that through Article 3.2 of the DSU, the Uruguay Round participants when they agreed to adopt the DSU explicitly pursued the objective of providing security and predictability to the multilateral trading system. This objective has been subsequently confirmed by the Appellate Body in *EC – Computer Equipment* case<sup>174</sup> as

"an object and purpose of the *WTO Agreement*, generally, as well as of the GATT 1994".

4.236 The European Communities finally contends that the existing legislation clauses in the PPA and the protocols of accession have been explicitly excluded from the definition of the General Agreement on Tariffs and Trade 1994.

4.237 In the view of the European Communities, four sets of important consequences derive from the above-mentioned new legal environment:

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<sup>171</sup> Panel Report on *Canada – Aircraft*, op. cit., para. 9.124, citing Panel Report on *US – Tobacco*, op. cit., para. 118.

<sup>172</sup> See *Canada – Aircraft*, op. cit., para. 9.124; Panel Report on *Turkey – Restrictions on Imports of Textile and Clothing Products*, circulated 31 May 1999, WT/DS/34/R, para. 9.37.

<sup>173</sup> The United States adds that even if the distinction between mandatory and discretionary measures had originated in the distinction drawn in the Protocol of Provisional Application, it is difficult to understand how the definition of "mandatory" could change. Either legislation "mandates" – commands or obliges – a violation, or it does not.

<sup>174</sup> Appellate Body Report on *EC – Computer Equipment*, op. cit.

- (a) Unlike under the GATT 1947, a conflict between a pre-existing incompatible legislation and any obligation under the covered agreements must be resolved in favour of the latter and to the detriment of the former. As the Appellate Body has decided in the *India - Patents (US)* case<sup>175</sup>, this new rule is applicable with no exceptions as from 1 January 1995;
- (b) The obligations under Article XVI:4 encompass not only legislation but also regulations and administrative procedures and thus include the type of law that is normally adopted and amended by actions of executive authorities. The distinction between law that binds the executive authorities and law that can be modified by them is thus no longer relevant.
- (c) As was recalled in the EC's oral statement of 29 June 1999, the terms "ensure" and "conformity" in Article XVI:4, taken together in their context, indicate that that provision obliges all WTO Members not merely to grant their executive authorities formally the right to act consistently with WTO law but to structure their law in a manner that "makes certain" that the objectives of the covered agreements will be achieved.<sup>176</sup>
- (d) Article 3.2 of the DSU and the principle of "good faith" implementation of international obligations under Article 26 of the Vienna Convention on the Law of Treaties no longer allow the existence of legal situations, under domestic legislation, regulations, administrative procedures or under any combination of them, which could seriously impair the security and predictability of the international trading system. A domestic law, regulation or administrative procedure whose structure and architecture is specifically designed to create uncertainty for the trade with other Members could therefore never be deemed to ensure conformity with WTO law.

4.238 The European Communities further argues that in this new legal environment it is then no longer justified to apply as such the standards developed under the GATT 1947 to domestic legislation. According to Articles XVI:4 of the WTO and 3.2 of the DSU together with the principle of "good faith" implementation under Article 26 of the Vienna Convention on the Law of Treaties Members' domestic law cannot be considered to be WTO-consistent merely because it does not formally preclude WTO-consistent actions. WTO Members must now go further and ensure that their domestic law is not designed to frustrate the implementation of their WTO obligations.

4.239 The European Communities argues that the Panel practice after the entry into force of the WTO is either inconclusive (and therefore does not stand in the way of the above-described interpretation) or supports the EC's views.

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<sup>175</sup> Appellate Body Report on *India - Patents (US)*, op. cit., para. 81

<sup>176</sup> The European Communities notes that it is interesting to note that in a different factual context, the Human Rights Committee - established by Article 28 of the International Covenant on Civil and Political Rights - followed a logic that, *mutatis mutandis*, is comparable to the logic suggested by the European Communities in this case. In the "Mauritian Women" case, it held with respect to the possibility of a direct violation of a right by a law that "it must in any event be applicable in such a way that the alleged victim's risk of being affected is more than a theoretical possibility" (emphasis added). (35/1978, paragraph 9.2)

4.240 The European Communities points out that the 1998 Report of the Panel *Japan – Measures Affecting Agricultural Products* dealt in particular with the interpretation of paragraph 1 of Annex A to the SPS Agreement. That provision reads as follows:

"phytosanitary measures include all relevant laws, decrees, regulations, requirements and procedures".

4.241 In the view of the European Communities, this provision has a function similar to that of Article XVI:4 of the Marrakech Agreement. It defines the domestic law related to phytosanitary measures, not merely actions taken under such law, as a phytosanitary measure. This means that each Member must ensure that its domestic law related to phytosanitary measures is in conformity with its obligations under the SPS Agreement. Japan essentially argued that its domestic law is in conformity with the SPS Agreement because it does not mandate actions inconsistent with the SPS Agreement. The Panel rejected this argument on the following grounds:

"8.111 Even though the varietal testing requirement is not mandatory – in that exporting countries can demonstrate quarantine efficiency by other means – in our view, it does constitute a "phytosanitary regulation" subject to the publication requirement in Annex B. The footnote to paragraph 1 of Annex B refers in general terms to "phytosanitary measures such as laws, decrees or ordinances".<sup>177</sup> Nowhere does the wording of this paragraph require such measures to be mandatory or legally enforceable. Moreover, Paragraph 1 of Annex A to the SPS Agreement makes clear that "phytosanitary measures include all relevant laws, decrees, regulations, requirements and procedures". It does not, in turn, require that such measures be mandatory or legally enforceable. The interpretation that measures need not be mandatory to be subject to WTO disciplines is confirmed by the context of the relevant SPS provisions, a context which includes provisions of other WTO agreements and the way these provisions define "measure", "requirement" or "restriction"<sup>178</sup>, as interpreted in GATT and WTO jurisprudence.<sup>179</sup> This context indicates that a

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<sup>177</sup> [original footnote] In accordance with Article 3.2 of the DSU and established WTO jurisprudence, we shall interpret these terms in paragraph 1 of Annex A in accordance with the interpretative rules of the 1969 Vienna Convention on the Law of Treaties ("Vienna Convention"), in particular Article 31 thereof which provides in relevant part as follows: "1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose".

<sup>178</sup> [original footnote] For example, the Illustrative List of Trade-Related Investment Measures ("TRIMs") contained in the Annex to the Agreement on TRIMs indicates that TRIMs inconsistent with Articles III:4 and XI:1 of the GATT include those which are "mandatory or enforceable under domestic law or under administrative rulings, or compliance with which is necessary to obtain an advantage" (emphasis added).

<sup>179</sup> [original footnote] Recently, for example, the Panel on *Japan – Measures Affecting Consumer Photographic Film and Paper* (adopted on 22 April 1998, WT/DS44/R), addressing a claim of non-violation nullification and impairment under Article XXIII:1(b) of the GATT, stated the following (at paragraph 10.49):

a government policy or action need not necessarily have a substantially binding or compulsory nature for it to entail a likelihood of compliance by private actors in a way so as to nullify or impair legitimately expected benefits within the purview of Article XXIII:1(b). Indeed, it is clear that non-binding actions, which include sufficient

non-mandatory government measure is also subject to WTO provisions in the event compliance with this measure is necessary to obtain an advantage from the government or, in other words, if sufficient incentives or disincentives exist for that measure to be abided by". (emphasis added)

4.242 The European Communities considers that the above reasoning can be transposed to Article XVI:4 of the WTO Agreement because the rationale of that provision is similar to that of paragraph 1 of Annex A to the SPS Agreement: what is relevant are the trade effects of the law at issue and the incentives or disincentives it creates, not merely whether it is mandatory.

4.243 The European Communities further notes that in its 1997 report on *Argentina - Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items*,<sup>180</sup> a panel found what follows:

"6.45 In respect of the Argentine argument that the US claim should not be considered because it addresses only a potential violation - in support of which it refers to the *Tobacco* Panel report - we note that the Argentine measures, the specific duties, are mandatory measures. Argentina admits that its customs officials are obligated to collect the specific duties on all imports. GATT/WTO case law is clear in that a mandatory measure can be brought before a Panel, even if such an adopted measure is not yet in effect, and independently of the absence of trade effect of such measure for the complaining party:

'[T]he very existence of mandatory legislation providing for an internal tax, without it being applied to a particular imported product, should be regarded as falling within the scope of Article III:2, first sentence'.

We are also of the view that the *Tobacco* Panel report merely confirms this principle.

6.46 Moreover, in *Bananas III*, the Appellate Body confirmed that the principles developed in *Superfund* were still applicable to WTO disputes and that any measure, which changes the competitive relationship of Members, nullifies any such Members' benefits under the WTO Agreement.

'Article III:2, first sentence, cannot be interpreted to protect expectations on export volumes; it protects expectations on the

incentives or disincentives for private parties to act in a particular manner, can potentially have adverse effects on competitive conditions of market access.

See also the Panel Report on *Japan - Trade in Semi-Conductors* ("*Japan - Semiconductors*"), adopted on 4 May 1988, BISD 35S/116, where the Panel found (at paragraph 109) that although measures are not mandatory, they could be considered as "restrictions" subject to Article XI:1 of the GATT in the event "sufficient incentives or disincentives existed for non-mandatory measures to take effect". Similarly, the Panel on *EEC - Regulation on Imports of Parts and Components* (adopted on 16 May 1990, BISD 37S/132) considered (at paragraph 5.21) that the term "laws, regulations or requirements" contained in Article III:4 of the GATT included requirements "which an enterprise voluntarily accepts in order to obtain an advantage from the government".

<sup>180</sup> Panel Report on *Argentina - Textiles and Apparel (US)*, op. cit.

competitive relationship between imported and domestic products. A change in the competitive relationship contrary to that provision must consequently be regarded *ipso facto* as a nullification or impairment of benefits accruing under the General Agreement'.

We consider that this principle is also appropriate when dealing with the application of the obligations contained in Article II of GATT which requires a 'treatment no less favourable than that" provided in a Member's Schedule. In the present dispute we consider that the competitive relationship of the parties was changed unilaterally by Argentina because its mandatory measure clearly has the potential to violate its bindings, thus undermining the security and the predictability of the WTO system". (emphasis added).

4.244 In the view of the European Communities, the panel's decision fully supports the EC's approach as well.

4.245 **The United States contends** that the European Communities claims that panel practice after entry into force of the WTO "is either inconclusive (and therefore does not stand in the way of the [the EC's "new legal environment" theory]) or supports the EC's views". In support of this statement, the European Communities cites *Japan – Measures Affecting Agricultural Products*<sup>181</sup> and *Argentina – Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items*. However, the *Argentina – Textiles and Apparel (US)* panel does no more than reaffirm that mandatory legislation is actionable, without redefining the term "mandatory" as the European Communities seeks to do here.

4.246 The United States points out that as for *Japan – Agricultural Products*, the European Communities refers to a panel discussion involving the publication requirement in paragraph 1 of Annex B of the Agreement on Sanitary and Phytosanitary Measures. This discussion did not involve the question of whether discretionary measures are actionable, nor did the issue arise at any point in *Japan – Agricultural Products*. Japan did not, as the European Communities would have it, "essentially argue[] that its domestic law is in conformity with the SPS Agreement because it does not mandate actions inconsistent with the SPS Agreement".<sup>182</sup> Rather, Japan argued that its varietal testing requirement did not come within the specific terms of the definition of "sanitary and phytosanitary regulations" provided in Annex B of the SPS Agreement.<sup>183</sup> The panel rejected Japan's argument, finding that the definition in the Annex was not limited as proposed by Japan.

4.247 The United States notes that according to the European Communities, the *Japan – Agricultural Products* panel's reasoning "can be transposed to" WTO Agreement Article XVI:4 "because the rationale of that provision is similar to that of paragraph 1 of Annex A to the SPS Agreement". This conclusion is absurd. The rationale of paragraph 1 of Annex B – publication of SPS measures – cannot be equated with that of WTO Agreement Article XVI:4 – to ensure that domestic laws permit compliance with international obligations. Moreover, a panel's

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<sup>181</sup> Panel Report on *Japan – Measures Affecting Agricultural Products* ("*Japan – Agricultural Products*"), adopted 19 March 1999, WT/DS76/R.

<sup>182</sup> Ibid. page 10.

<sup>183</sup> Footnote 5 to Annex B provided that the annex covered "phytosanitary measures such as laws, decrees or ordinances". See Agreement on the Application of Sanitary and Phytosanitary Measures, Annex B, footnote 5.

examination of an explicit definition of "measures" cannot be equated to the question of whether the mere existence of non-mandatory legislation can result in a finding of WTO inconsistency.

4.248 The United States further argues that the European Communities also claims that the *Japan – Agricultural Products* panel's reliance on a line of GATT cases which pre-date the WTO<sup>184</sup> somehow supports the EC's claim that the advent of the WTO changed the definition of "mandatory". Beyond the issue of timing, the European Communities is confusing two separate lines of GATT cases which stand for very different propositions: (1) the *Superfund* line of cases, which stand for the mere existence of legislation which grants governmental authorities the discretion to comply or not comply with their GATT/WTO obligations is not grounds for a finding of inconsistency; and (2) the *Italian Machinery/FIRA* line of cases, which stand for the proposition that a measure which nominally does not mandate compliance by private actors may nevertheless be considered a government "requirement" or "restriction" subject to the requirements of GATT 1947 Article III or XI if it creates sufficient incentives or disincentives for those private actors to comply.<sup>185</sup>

4.249 The United States claims that the EC's confusion recalls that of the panel in *India - Patents (US)*, which "merge[d], and thereby confuse[d], two different concepts from previous GATT practice".<sup>186</sup> In similar fashion, the European Communities posits a theory of "not genuinely discretionary" measures it has pieced together from assumptions, inferences and misreadings of unrelated panel findings, the Protocol of Provisional Application and miscellaneous DSU and WTO objectives. Like the theories at issue in *India - Patents (US)* and *US - Shrimp*, the EC's theory has no textual basis and must be rejected. The analysis of whether Sections 301-310 are consistent with DSU Article 23 and WTO Agreement Article XVI:4 must be based on the text of those provisions.

4.250 In response to the Panel's question as to what standards should be used in order to determine whether a Member has ensured the conformity of its laws, regulations and administrative procedures with its WTO obligations, **the European Communities contends** that as demonstrated above, it is no longer correct to rely on the distinction between mandatory and discretionary legislation along the legal path followed by the GATT 1947 practice. However, this does not mean that all domestic law that does not preclude WTO-inconsistent measures and thus provides for the possibility of actions deviating from WTO law (a "potential deviation") is WTO-inconsistent. It is now necessary to distinguish between

- (a) domestic law that is merely meant to transfer decision-making authority from one constitutional body (most often the Parliament) to another constitutional body (most often the executive authorities) within specified parameters, and

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<sup>184</sup> These cases include Panel Report on *Japan – Semiconductors*, op. cit., para. 109 and Panel Report on *EEC – Parts and Components*, op. cit., para. 5.21.

<sup>185</sup> See Panel Report on *Italian Discrimination Against Imported Agricultural Machinery* ("*Italian Machinery*"), adopted 23 October 1958, BISD 7S/60; Panel Report on *Canada – Administration of the Foreign Investment Review Act* ("*Canada - FIRA*"), adopted 7 February 1984, BISD 30S/140, para. 5.4; *EEC – Parts and Components*, para. 5.21; Panel Report on *Japan – Semiconductors*, op. cit., para. 109.

<sup>186</sup> Appellate Body Report on *India - Patents (US)*, op. cit., para. 36. According to the United States, the *India - Patents (US)* panel confused the concept of protecting expectations of parties as to the competitive relationship between their products and those of other parties with the concept of protecting reasonable expectations of parties relating to market access concessions, all in the service of developing a theory of "protection of legitimate expectations" not found in the text of the TRIPs Agreement. Ibid.



- (b) domestic law that does not preclude the executive authorities from acting consistently with WTO law but that is - by its design, structure and architecture - manifestly intended to encourage violations of WTO law or is otherwise biased against WTO-consistent action.

4.251 In the view of the European Communities, the first type of domestic law is genuinely discretionary. It is simply a consequence of the legislator's decision to delegate decision-making power to the administration. WTO Members are free to decide how to distribute decision-making authority on trade policy matters between the legislature and executive authorities. Article XVI:4 positively requires WTO Members to ensure that their domestic law is in conformity with their obligations under the covered agreements and therefore does not frustrate the objectives of the WTO. However, nothing in Article XVI:4 requires Members to transfer all decision making to the legislator. For these reasons, it would be inappropriate to interpret Article XVI:4 of the WTO Agreement so extensively as to require WTO Members to include explicit language in their domestic law precluding WTO-inconsistent actions.

4.252 The European Communities goes on to state that the second type of legislation is not genuinely discretionary. It is not intended to transfer decision-making authority within specified parameters from one branch of the government to another but to frustrate the implementation of specific WTO obligations. It creates, for no legitimate reason, legal uncertainty and unpredictability for the trade with other Members. A Member that maintains such law has not ensured the conformity of its law with its WTO obligations even if the law does not preclude the theoretical possibility of WTO-consistent actions.

4.253 The European Communities recalls its argument that in order to determine whether legislation that does not preclude WTO-consistent actions is genuinely discretionary, Panels should concentrate their examination as a matter of priority on the text of the domestic law or regulation.

4.254 In the view of the European Communities, this analysis on the text should focus firstly on verifying whether that domestic legislation leaves a large degree of liberty of action to the administration to develop a policy within certain predetermined parameters<sup>187</sup> or whether it

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<sup>187</sup> The European Communities notes that the United States quoted the still unadopted Panel Report on *Canada – Aircraft*, op. cit., as an evidence of the continuing application of the GATT 1947 practice concerning the definition of mandatory and discretionary legislation after the Uruguay Round. The European Communities disagrees. The European Communities is of the view that this recent Panel report supports fully the EC's suggested approach. When considering the legal nature of Canada's Export Development Act (EDA), Section 10, the Panel reached the correct conclusion that "a mandate to support and develop Canada's export trade does not amount to a mandate to grant subsidies, since support and development could be provided in a broad variety of ways" (para. 9.127, *in fine*). The reading of the relevant provision of Canada's EDA confirms it as a clear example of a genuine discretionary legislation within the criteria suggested here by the European Communities:

"Purposes and Powers

10. (1) The Corporation is established for the purposes of supporting and developing, directly or indirectly, Canada's export trade and Canadian capacity to engage in that trade and to respond to international business opportunities.

Powers.

(1.1) Subject to any regulations that may be made under subsection (6), in carrying out its purposes under subsection (1), the Corporation may

(a) acquire and dispose of any interest in any property by any means;

(b) enter into any arrangement that has the effect of providing, to any person, any insurance, reinsurance,

induces the executive to act systematically in conflict with the Member's WTO obligations and that it is at the very least sufficiently constraining and well-defined. In the latter situation, the measure should not be considered genuinely discretionary.

4.255 In the view of the European Communities, in addition, Panels should consider the design, structure and architecture of the domestic legislation under examination. Any domestic legislation or regulation whose structure, design or architecture is biased against compatibility with the Member's WTO obligations, or that is designed to create uncertainty and unpredictability in the trade relations among WTO Members, or that is structured so as to render difficult, unlikely or practically impossible for the executive to pursue a WTO compatible implementation could not be considered genuinely discretionary.

4.256 The European Communities points out in this respect that, as the very recent Panel Report on *Chile - Taxes on Alcoholic Beverages*<sup>188</sup> rightly indicates at paragraph 7.119

"Statements by a government against WTO interests (e.g. indicating a protective purpose or design) are most probative. Correspondingly, it is less likely that self-serving comments by a government attempting to justify its measure would be particularly probative".

4.257 The European Communities further explains that finally, an additional guiding principle to be used in order to determine whether a domestic law or regulation corresponds to a genuinely discretionary measure is the definition by Dailler and Pellet of the public international law principle of "good faith" implementation: "[L]'exécution de bonne foi, exige positivement fidélité et loyauté aux engagements pris" and should therefore exclude "toute tentative de 'fraude à la loi', toute ruse".<sup>189</sup>

4.258 In response to the Panel's question as to whether the standards applicable under WTO law in general and Article XVI:4 of the WTO Agreement in particular are met by legislation that mandates discriminatory tax but at the same time allows for "some limited exceptions in special circumstances subject to discretionary powers", the European Communities argues that this specific issue raised by the Panel can be resolved by applying the criteria suggested by the European Communities above.

indemnity or guarantee;

(c) enter into any arrangement that has the effect of extending credit to any person or providing an undertaking to pay money to any person;

(d) take any security interest in any property;

(e) prepare, compile, publish and distribute information and provide consulting services;

(f) procure the incorporation, dissolution or amalgamation of subsidiaries;

(g) acquire and dispose of any interest in any entity by any means;

(h) make any investment and enter into any transaction necessary or desirable for the financial management of the Corporation;

(i) act as agent for any person or authorize any person to act as agent for the Corporation;

(j) take such steps and do all such things as to it appear necessary or desirable to protect the interests of the Corporation; and

(k) generally, do all such other things as are incidental or conducive to the exercise of its powers, the performance of its functions and the conduct of its business.

<sup>188</sup> Panel Report on *Chile - Taxes on Alcoholic Beverages*, circulated 15 June 1999, WT/DS87/R - WT/DS110/R.

<sup>189</sup> Droit International public, (1994), paragraph 143.

4.259 The European Communities points out that according to the Oxford English Reference Dictionary, a rule is "a principle to which an action conforms or is required to conform". An exception is "an instance that does not follow the rule". In practice, the existence of exceptions is considered to be the confirmation of the existence of the rule.

4.260 The European Communities argues that in the example submitted by the Panel to the parties, the fact that the administration is granted, in some limited circumstances, with the power to act by exception to the rule should therefore be interpreted in the following way:

- (a) The administration is required to follow as a matter of principle the (WTO-inconsistent) rule;
- (b) The use of the exception is limited to specific and limited cases;
- (c) The existence of the exception confirms the existence of the (WTO-inconsistent) rule in the first place.
- (d) Consequently, the exceptions could not be implemented in such a way as to systematically replace the rule without amending the law itself and, in any case, without defeating its overall (WTO-inconsistent) purpose that the legislative body intended to achieve.

4.261 In the EC's view, therefore, a Member's legislation providing for a (number of) rule(s) that are inconsistent with one or more of the obligations under a WTO Agreement should be deemed to violate as such that Member's WTO obligations irrespective of whether the legislation was actually implemented and also independently from the existence of some "limited exceptions in special circumstances subject to discretionary powers".

4.262 The European Communities then contends that the design, structure and architecture of such legislation (i.e. its objectively expressed "intent") would be dominated by the (WTO-inconsistent) rule. It would be a legislation purposefully biased against WTO compatibility and thus could not be mended by the existence of some "limited exceptions" to the (WTO-inconsistent) rule. Moreover, the mere existence of such a legislation imposing (WTO-inconsistent) rules would inevitably create a pattern of uncertainty, insecurity and unpredictability in the trade relations among the Members and could by no means constitute a "good faith" implementation of the Member's WTO obligations under Article 26 of the Vienna Convention on the Law of Treaties or (even less so) under the more demanding standard set out in Article XVI:4 of the Marrakech Agreement.

4.263 The European Communities further argues that this is, if at all possible, even more relevant in instances where only a remote possibility to obtain an "act of grace" in a specific case, a kind of waiver, to be granted by the highest political authorities of the WTO Member concerned<sup>190</sup> and where such an "act of grace" is subject to a number of objective criteria that may, in practice, require the targeted WTO Member to give in to WTO-inconsistent pressure.

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<sup>190</sup> The European Communities notes that in a different factual context, the European Court of Human Rights followed a logic that, *mutatis mutandis*, is comparable to the logic suggested by the European Communities in this case. In the "*Soering*" case (1/1989/161/217), the ECHR stated the following:

"In the independent exercise of his discretion the Commonwealth's attorney has himself decided to seek and to persist in seeking the death penalty because the evidence, in his determination

4.264 **The United States points out** that the European Communities suggested that WTO Agreement Article XVI:4, read together with DSU Article 3.2 and the elimination of the Protocol of Provisional Application, have created a "new legal environment". According to the European Communities, "In this new legal environment it is then no longer justified to apply as such the standards developed under the GATT 1947 to domestic legislation". Rather, "WTO Members must now go further and ensure that their domestic law is not designed to frustrate the implementation of their WTO obligations". Panels must therefore apply new standards in distinguishing among discretionary legislation to determine which are "not genuinely discretionary". According to the European Communities, a law is not genuinely discretionary if it "does not preclude the executive authorities from acting consistently with WTO law but that is - by design, structure and architecture - manifestly intended to encourage violations of WTO law or is otherwise biased against WTO-consistent action". Such a law "creates, for no legitimate reason, legal uncertainty and unpredictability for the trade with other Members".

4.265 According to the United States, the European Communities claims to derive this test from "Article 3.2 of the DSU and the principle of 'good faith' implementation of international obligations under Article 26 of the Vienna Convention on the Law of Treaties", which "no longer allows" legal situations "which could seriously impair the security and predictability of the international trading system". Leaving aside the fact that the language of Article 3.2 dates to the 1989 Montreal Rules, and thus predates the EC's "new legal environment", the European Communities is seeking to create from a WTO provision relating to the objectives of the Dispute Settlement Understanding, and its own notions of "good faith" and "uncertainty", an entirely new obligation not found in any provision of the WTO Agreement or its annexes.

4.266 The United States puts forth that the Appellate Body has confronted such a situation before. The European Communities even alludes to one such situation in its oral statement, when it refers to the US endorsement in *India - Patents (US)* of panel findings that the "protection of legitimate expectations of WTO Members regarding conditions of competition is as central to trade relating to intellectual property as it is to trade in goods that do not relate to intellectual property". What the European Communities fails to mention is that the Appellate Body squarely reversed the panel on this point.

4.267 The United States points out that the *India - Patents (US)* panel found that "the legitimate expectations of WTO Members" must be taken into account, and that the "protection of legitimate expectations of Members regarding the conditions of competition is a well established GATT principle" derived in part from GATT 1994 Article XXIII, the basic dispute settlement provisions of the GATT and WTO, and GATT 1947 panel reports relating to GATT 1947 Article III.<sup>191</sup> Further, based on Article 31 of the Vienna Convention, which provides for "good faith" interpretation of treaty terms in accordance with their ordinary meaning in their context and in light of their object and purpose, the Panel stated,

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supports such action. (...) The Court's conclusion is therefore that the likelihood of the feared exposure of the applicant to the "death row phenomenon" has been shown to be such as to bring Article 3 into play".

<sup>191</sup> Panel Report on *India - Patents (US)*, op. cit., paras. 7.20, 7.22. The panel reports which the panel cited included Panel Report on *Italian Machinery*, op. cit., paras. 12-13; Panel Report on *US - Superfund*, op. cit., para. 5.22, and Panel Report on *US - Section 337*, op. cit., para. 5.13.

"In our view, good faith interpretation requires the protection of legitimate expectations derived from the protection of intellectual property rights provided for in the Agreement".<sup>192</sup>

4.268 The United States further notes that the Appellate Body rejected this approach, noting that the panel had "merge[d], and thereby confuse[d], two different concepts from previous GATT practice,<sup>193</sup> and had misapplied VCLT Article 31:

"The Panel misunderstands the concept of legitimate expectations in the context of the customary rules of interpretation of public international law. The legitimate expectations of the parties to a treaty are reflected in the language of the treaty itself. The duty of a treaty interpreter is to examine the words of the treaty to determine the intentions of the parties. This should be done in accordance with the principles of treaty interpretation set out in Article 31 of the Vienna Convention. But these principles neither require nor condone the imputation into a treaty of words that are not there or the importation into a treaty of concepts that were not intended".<sup>194</sup>

4.269 The United States indicates that the Appellate Body went on to refer to DSU Article 3.2, which provides, "Recommendations and rulings of the DSB cannot add to or diminish the rights and obligations provided in the covered agreements", and DSU Article 19.2, which provides, "In accordance with paragraph 2 of Article 3, in their findings and recommendations, the panel and Appellate Body cannot add to or diminish the rights and obligations provided in the covered agreements".<sup>195</sup> The Appellate Body stated, "These provisions speak for themselves. Unquestionably, both panels and the Appellate Body are bound by them".<sup>196</sup>

4.270 According to the United States, the European Communities in this case is attempting to engage in even more dramatic fashion in the "imputation into a treaty of words that are not there or the importation into a treaty of concepts that were not intended",<sup>197</sup> the approach which the Appellate Body rejected in *India - Patents (US)*. Nowhere is the EC's "not genuinely discretionary" test found in WTO Agreement Article XVI:4, DSU Article 3.2, or any other provision of a covered agreement. Indeed, the European Communities does not claim that it does. Its test is based on extrapolation from the concept of "security and predictability" in Article 3.2 – an objective, not an obligation – and from a vague explanation of the "good faith" obligation in the VCLT – not a covered agreement.

4.271 The United States notes that Article 3.2 opens with the statement, "The dispute settlement system of the WTO is a central element in providing security and predictability to the multilateral trading system".<sup>198</sup> This enunciation of the purpose of the DSU contains within it the understanding that it is the DSU itself which achieves this purpose. In other words, the substantive obligations in the text of the WTO Agreement and its annexes, enforced through the DSU, provide security and predictability. "The legitimate expectations of the parties to a treaty

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<sup>192</sup> Panel Report on *India - Patents (US)*, op. cit., para. 7.18.

<sup>193</sup> Appellate Body Report on *India - Patents (US)*, op. cit., para. 36.

<sup>194</sup> Ibid., para. 45. (emphasis added)

<sup>195</sup> Ibid., para. 47, citing DSU Arts. 3.2 and 19.2.

<sup>196</sup> Ibid.

<sup>197</sup> Ibid., para. 45. (emphasis added)

<sup>198</sup> The United States notes that this language is derived from the 1989 Montreal Rules.

are reflected in the language of the treaty itself".<sup>199</sup> As the Appellate Body underlined in *India - Patents (US)*, interpretations which go beyond the text to make up obligations out of thin air and aspirations can threaten the legitimacy of the dispute settlement system. Article 3.2 draws a line between dispute settlement and legislation, and directs that panels abstain from the latter.

4.272 The United States further contends that similarly, in *United States – Import Prohibition of Certain Shrimp and Shrimp Products*, the Appellate Body stated, "A treaty interpreter must begin with, and focus upon, the text of the particular provision to be interpreted. It is in the words constituting that provision, read in their context, that the object and purpose of the states parties to the treaty must first be sought".<sup>200</sup> In *US – Shrimp*, the Appellate Body rejected a panel's interpretation of the chapeau of Article XX that focused not on the ordinary meaning of the words of the chapeau and its immediate object and purpose, but instead on the general object and purpose of the GATT and WTO Agreement. Just as the European Communities now seeks to derive new obligations from the general notion of security and predictability, the *US – Shrimp* panel concluded that the chapeau included a general obligation "not to undermine the WTO multilateral trading system". According to the panel,

"we must determine not only whether the measure *on its own* undermines the WTO multilateral trading system, but also whether *such type of measure*, if it were to be adopted by other Members, would threaten the security and predictability of the multilateral trading system".<sup>201</sup>

4.273 The United States emphasises that the Appellate Body rejected this approach. The Appellate Body explained that, rather than examining the consistency of the measure in question with the chapeau of Article XX, the panel focused repeatedly on *'the design of the measure itself'*.<sup>202</sup> The Appellate Body referred to this as:

"a standard or a test that finds no basis either in the text of the chapeau or in that of either of the two specific exceptions claimed by the United States. The panel, in effect, constructed an *a priori* test that purports to define a category of measures which, *ratione materiae*, fall outside the justifying protection of Article XX".<sup>203</sup>

4.274 In the view of the United States, the Appellate Body therefore reversed the panel's analysis and the findings based on that analysis.<sup>204</sup> It described the panel's analysis as "abhorrent to the principles of interpretation we are bound to apply".<sup>205</sup>

4.275 The United States argues that the European Communities is proposing a mode of analysis strikingly similar to one already rejected by the Appellate Body in *US - Shrimp*. Based on the same generalized notion of "security and predictability", the European Communities is proposing a test not found in DSU Article 23 or WTO Agreement Article XVI:4, a test focusing

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<sup>199</sup> Appellate Body Report on *India - Patents (US)*, op. cit., para. 45.

<sup>200</sup> Appellate Body Report on *United States – Import Prohibition of Certain Shrimp and Shrimp Products* ("*US - Shrimp*"), adopted 6 November 1998, WT/DS58/AB/R, para. 114. (emphasis added)

<sup>201</sup> Panel Report on *United States – Import Prohibition of Certain Shrimp and Shrimp Products*, adopted 6 November 1998, WT/DS58/R, para. 7.44 (underlining added), quoted in Appellate Body Report on *US - Shrimp*, op. cit., para. 112.

<sup>202</sup> Appellate Body Report on *US - Shrimp*, op. cit., para 115. (emphasis in original)

<sup>203</sup> *Ibid.*, para. 121.

<sup>204</sup> *Ibid.*, para. 122.

<sup>205</sup> *Ibid.*, para. 121.

on "the design of the measure itself": whether a discretionary domestic law's "design, structure and architecture" is "manifestly intended to encourage violations of WTO law or is otherwise biased against WTO-consistent action". The Panel must reject this test. The analysis of whether Sections 301-310 are consistent with DSU Article 23 and WTO Agreement Article XVI:4 "must begin with, and focus upon, the text of"<sup>206</sup> these provisions.

4.276 In this respect, further, the United States responds to the Panel's request for comments on the following statement in the third-party submission by Hong Kong, China:

"The question is consequently raised as to how international obligations can be implemented in good faith if the possibility of deviation exists in a domestic legislation? Are there expectations that the international obligations will be observed and not impaired when the possibility of deviation is *expressis verbis* provided for in a domestic legislation? Is the predictability, necessary to plan future trade as the *Superfund* panel acknowledged, not affected when trading partners know *ex ante* that their partners have enacted legislation which allows them to disregard their international obligations?"

4.277 The United States answers that the question Hong Kong raises in the first sentence quoted above is a *non sequitur*. Parties to an international agreement have, by becoming parties, committed to implement their agreement obligations in good faith. It is this very fact that leads to the conclusion that one cannot assume that authorities will exercise discretion under domestic legislation so as to violate international obligations.

4.278 In the view of the United States, if authorities exercise their discretion such that they actually deviate from their international obligations, they may then be found to have violated those obligations. Until that point, however, it may not be assumed that they will exercise their discretion in this manner. It may not be assumed that parties will act in bad faith. Certainly the European Communities should accept this: in the Article 21.5 proceedings in the *Bananas* dispute and again in its recent proposal to amend Article 21, the European Communities has taken the position that there is a presumption of compliance in all WTO proceedings, even in Article 21.5 proceedings to determine whether a Member has brought into compliance a measure already found to be WTO-inconsistent.<sup>207</sup>

4.279 The United States adds that with respect to the relevance of whether legislation provides *expressis verbis* for the "possibility of deviation" from international obligations, the United States notes that any legislation which does not explicitly limit the exercise of discretion provides for such a possibility, and the United States doubts that Hong Kong authorities lack

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<sup>206</sup> Appellate Body Report on *US - Shrimp*, op. cit., para. 114.

<sup>207</sup> See Panel Report on *European Communities – Regime for the Importation, Sale and Distribution of Bananas – Recourse to Article 21.5 by the European Communities*, WT/DS27/RW/EEC, paras. 2.19, 4.13 (12 April 1999) (The United States points out that according to the European Communities, implementing measures "must be presumed to conform to WTO rules unless their conformity has been duly challenged under appropriate DSU procedures" (para. 4.13); also according to the European Communities, a trading system based on a presumption of inconsistency would not be based on security and predictability of international trade relations and thus would be the opposite of the multilateral trading system envisaged by the Marrakesh Agreement (para. 2.19)); DSU Review, Discussion Paper from the European Communities dated 30 June 1999, Document No. 3864, para. 5, circulated on 1 July 1999 ("In the multilateral procedure to determine the conformity of implementing measures, the task of bringing a challenge and the burden of proof are on the party arguing non-conformity".) (US Exhibit 12).

such discretion.<sup>208</sup> This does not change the fact that WTO Members with discretionary legislation, whatever the form, have made a binding legal commitment to comply with their WTO obligations – in other words, to exercise their discretion in a WTO-consistent manner. As discussed further in response to the following question, there is no greater assurance that a Member will act in accordance with its WTO obligations if it exercises broad, undefined discretionary authority than if it must exercise discretion not to undertake WTO-inconsistent action explicitly provided for in legislation.

4.280 In the view of the United States, Hong Kong's reference to the *Superfund*<sup>209</sup> panel's discussion of "predictability" ignores the facts and findings of that case, which contradict Hong Kong's position. There, the legislation in question specifically did, *expressis verbis*, provide for action which, if delegated discretion were not exercised in a particular manner, would have been inconsistent with US obligations under the GATT 1947. The 1986 Superfund Act required importers to supply sufficient information regarding the chemical inputs of taxable substances to enable the tax authorities to determine the amount of tax to be imposed; otherwise, a penalty tax would be imposed in the amount of five percent ad valorem or a different rate to be prescribed in regulations by the Secretary of the Treasury by a different methodology.<sup>210</sup> The five per cent penalty tax, which was to go into effect on January 1, 1989 if regulations to the contrary were not issued, would have been inconsistent with GATT 1947 Article III:2.<sup>211</sup> At the time of the panel proceedings in 1987, the regulations in question had not yet been issued. Nevertheless, the panel concluded:

"[W]hether [the regulations] will eliminate the need to impose the penalty tax and whether they will establish complete equivalence between domestic and imported products, as required by Article III:2, first sentence, remain open questions. From the perspective of the overall objectives of the General Agreement it is regrettable that the Superfund Act explicitly directs the United States tax authorities to impose a tax inconsistent with the national treatment principle but, since the Superfund Act also gives them the possibility to avoid the need to impose that tax by issuing regulations, the existence of the penalty rate provisions as such does not constitute a violation of the United States obligations under the General Agreement".<sup>212</sup>

4.281 According to the United States, it is worth emphasising the *US – Superfund* panel's reliance on the fact that there were "open questions" regarding the *Superfund* regulations which would have to be answered before a panel could determine the GATT-inconsistency of the penalty tax provision. On the one hand, this illustrates the fact that the panel would not assume that the United States would ultimately exercise its discretion in bad faith. However, it also illustrates the fact that, even where a statute is discretionary, the actual exercise of that discretion remains open to challenge. In *Superfund*, the regulations in that case – once issued – would have been subject to challenge if they violated GATT rules. Likewise, it remains open to WTO Members, including the European Communities, to challenge the US exercise of discretion under Sections 301-310 in particular cases if they believe it to be inconsistent with

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<sup>208</sup> The United States moreover notes that even were specific limits on discretion included in a country's domestic laws, this would not eliminate the possibility that authorities might exercise their power in violation of both these limits and their international obligations.

<sup>209</sup> Panel Report on *US – Superfund*, op. cit.

<sup>210</sup> *Ibid.*, para. 5.2.9.

<sup>211</sup> *Ibid.*

<sup>212</sup> *Ibid.* (emphasis added)



US WTO obligations.<sup>213</sup> Thus, for this Panel to confirm the consistent findings of every GATT and WTO panel to date regarding the mandatory/discretionary distinction would in no way deny the European Communities or other Members the ability to challenge US actions taken under Sections 301-310.<sup>214</sup>

4.282 The United States further contends that the *Superfund* panel's discussion of "predictability" came in the context of explaining why mandatory legislation may be challenged even if it will not go into effect until a fixed time in the future.<sup>215</sup> As described above, the Superfund Act was enacted in 1986 but the penalty tax provision would not become effective until 1989. According to the panel, the fact that legislation is not yet in effect would not excuse any GATT-inconsistent acts which the legislation mandates.<sup>216</sup> However, the panel went on to conclude that the penalty tax provisions of the legislation were not mandatory because they also included discretion to implement regulations consistent with US GATT obligations.<sup>217</sup> As the panel indicated, the legislation gave US authorities "the possibility" to avoid GATT-inconsistent action.<sup>218</sup> Thus, as the United States has emphasized, it is the possibility of compliance, and not the possibility of deviation, which is the proper question for panels examining whether the mere existence of legislation as such is consistent with a Member's obligations. This has uniformly been the analysis which GATT and WTO panels have applied to date.

4.283 The United States claims that Hong Kong's attempt to subject to WTO findings of inconsistency discretionary legislation which "allows WTO-inconsistent action to be taken" also ignores the fact that domestic legislation may be applicable not only to WTO Members in connection with rights under covered agreements, but also to countries which are not WTO Members, and to WTO Members with respect to matters not subject to a covered agreement. The WTO Agreement and its annexes by definition are not applicable to such cases. Thus, even if discretionary legislation were to "leave open the possibility" of determinations which would violate DSU Article 23 if applied to a WTO Member regarding rights under a covered agreement, DSU Article 23 may not be read so as to circumscribe the exercise of a Member's rights with respect to non-WTO Members and non-WTO matters.

4.284 The United States indicates that to put another way, international agreements are made between contracting parties. The actions of those parties towards one another may or may not violate the obligations they have undertaken vis-à-vis one another. However, the actions taken towards non-parties are not relevant to this analysis. It is one thing to conclude that a contracting party may challenge legislation mandating action towards all if that action violates an obligation with respect to contracting parties. However, if legislation permitting such action

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<sup>213</sup> The United States notes that likewise, if it believes the European Communities is exercising its broad discretion under Article 133 of the Treaty of Amsterdam to regulate or restrict international commerce in a manner inconsistent with the EC's WTO obligations, or its broad discretion under the Treaty of Amsterdam to create WTO-inconsistent banana import regimes, it may challenge the European Communities in dispute settlement proceedings. However, the United States, like the European Communities, must wait until such discretion is actually exercised in a given case, and may then only challenge that specific exercise of discretion.

<sup>214</sup> The United States emphasises again that no such specific action, of the recent or more distant past, is within the terms of reference of this Panel. Unlike the situation in *EEC – Parts and Components*, op. cit., this case does not include a challenge both to the exercise of statutory discretion in a given case and to the "mere existence" of the statute. See *ibid.*, paras. 5.25-5.26. It only includes the latter.

<sup>215</sup> Panel Report on *US – Superfund*, op. cit., paras. 5.2.1-5.2.2.

<sup>216</sup> *Ibid.*

<sup>217</sup> *Ibid.*, para. 5.2.9.

<sup>218</sup> *Ibid.*

could also be challenged, contracting parties would effectively be precluded from exercising sovereign powers with regard to non-parties, except by establishing parallel sets of laws applicable to parties and non-parties, or by explicitly providing for limits in their domestic laws as to how discretion may be exercised towards parties. There is absolutely no indication in the WTO Agreement or its annexes that Members agreed to this degree of interference with the exercise of national sovereignty.

4.285 In response to a question posed by the Panel, the United States further argues that no distinction can or should be made between different types of discretionary legislation for purposes of determining whether the mere existence of that legislation violates a Member's WTO obligations. In either case, authorities may exercise their discretion in a manner consistent or inconsistent with their international obligations. One may not assume that authorities will fail to implement their international obligations in good faith.

4.286 The United States contends that leaving aside the fact that it may not be assumed that a Member will fail to act in good faith to comply with its obligations, it would be impossible to distinguish "good" and "bad" discretionary legislation. The Panel's question implies that it may be possible to distinguish based on whether the legislation provides for general, non-specific discretion to achieve certain goals, rather than discretion not to undertake a specified course of action which would violate a country's international obligations. However, if this were the test, it could lead to the odd result that legislation providing for broad discretion could not be reviewed as such even if authorities repeatedly exercise their discretion in a WTO-inconsistent manner, while legislation providing for discretion not to take WTO-inconsistent action could be found inconsistent even if authorities always exercise that discretion so as to be consistent with their WTO obligations.

4.287 The United States further points out that on the other hand, if the means of distinguishing discretionary legislation were based on whether there were a pattern of exercising that discretion in a WTO-inconsistent manner, as the European Communities suggests, this would present other problems. For example, the first requirement of any such test would be that a particular incident could not be included in the pattern unless there were panel or Appellate Body findings of a violation with respect to that incident. Complaining parties could not merely assert that violations had taken place in the past, and panels could not merely accept these assertions. However, if no such findings exist, the panel could itself make these findings only if the subject matter of each incident were within the panel's terms of reference, and involved a violation of a covered agreement.<sup>219</sup> Moreover, incidents occurring prior to entry into force of the covered agreements – before 1995 – could not be considered as part of the "pattern".

4.288 The United States adds that such a "pattern of conduct" test would imply a presumption that a Member will not comply with its WTO obligations. If experience under the WTO Agreement has established any pattern, it is that the European Communities has persistently failed to comply with its obligations with respect to its banana import regime, and any presumption of non-compliance could be expected to apply in this case. Yet, as noted above, in the Article 21.5 proceedings in the *Bananas* dispute and again in its recent proposal to amend DSU Articles 21, 22 and 23, the European Communities has taken the position that there is a presumption of compliance in all WTO proceedings, even in Article 21.5 proceedings. Article 21.5 proceedings will only take place if there is a disagreement on the existence or consistency of measures taken to implement DSB rulings or recommendations, in other words if, after the DSB has at least once already adopted findings that a Member has violated its WTO

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<sup>219</sup> See DSU, Article 7.

obligations, there remain doubts as to whether the Member has fulfilled its commitment pursuant to Article 21.3 to bring its measure into compliance. Nevertheless, even under these circumstances (and in the *Bananas* dispute, the DSB rulings had been preceded by adverse rulings by two GATT panels), the European Communities insists that there remains a presumption that a Member is complying with its obligations. It is difficult to square this position with one suggesting that, after a pattern of violations has been demonstrated, one may assume that a Member will violate its obligation to implement in good faith.

4.289 The United States goes on to state that in addition, in order to find a pattern of conduct, it would be necessary to define a "pattern". How many actions inconsistent with WTO rules would establish such a pattern? Moreover, if such a pattern were established and a violation found, how could a Member bring itself into compliance? For example, if the EC's pattern of violating its international obligations in connection with its banana import regime were sufficient to establish that the Treaty of Amsterdam authority for this regime is WTO-inconsistent, would the European Communities have to amend its Treaty authority to preclude any further WTO violations?

4.290 In the view of the United States, all of this illustrates the complexity of this issue. It is a proper subject of debate in the DSU Review, since any change from current practice would require an amendment under Article X of the WTO Agreement or interpretation under Article IX of the WTO Agreement. In that connection, the United States again notes that the European Communities has in those discussions conceded that there currently is a distinction between mandatory and discretionary legislation in GATT/WTO jurisprudence and practice, by offering a proposal to "remove the *current distinction* between discretionary and mandatory measures",<sup>220</sup> thereby making it possible to establish the WTO-incompatibility of discretionary measures.<sup>221</sup>

4.291 **In rebuttal, the European Communities argues** that according to consistent GATT 1947 practice, a law that mandates a measure inconsistent with an obligation under the GATT is deemed to be inconsistent with that obligation even if it has not yet been applied. The GATT 1947 panels were of the view that the objective of predictability could not be achieved if a GATT 1947 contracting party adopted domestic legislation stipulating actions at variance with its obligations.

4.292 The European Communities asserts that even in applying the standard developed by the GATT 1947 panels, the obligations of the United States set out in Article 23 of the DSU and Articles I, II, III, VIII and XI of the GATT 1994 are violated by Sections 301-310 because they mandate the executive authorities of the United States to act inconsistently with these DSU and GATT provisions.

4.293 In the view of the European Communities, the United States recognises that Sections 301-310 must meet the standard developed under GATT 1947 practice. Its principal argument is that Sections 301-310 do not require the USTR to determine that a WTO Member is denying the United States' rights under a WTO agreement or is failing to implement DSB recommendations. In its view, Sections 301-310 therefore do not "preclude" WTO-consistent action and are consequently not mandatory within the meaning of the GATT 1947 practice.

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<sup>220</sup> *Review of the Dispute Settlement Understanding*, Non-Paper by the European Communities (Oct. 1998) (US Exhibit 12)(emphasis added); see also, *Review of the DSU*, Note by the Secretariat, Compilation of Comments Submitted by Members – Rev. 3 (12 December 1998) (US Exhibit 12).

<sup>221</sup> *Ibid.*

4.294 According to the European Communities, the United States further claims that the USTR is not required to determine that United States' rights under a WTO agreement are being denied and that a failure to implement DSB recommendations occurred and that, consequently, Sections 301-310 do not mandate determinations inconsistent with Article 23 of the DSU. However, these determinations must be based on the investigation initiated by the USTR under Section 302 or the monitoring conducted by the USTR under Section 306(a).

**(b) Arguments specific to distinction between mandatory law and discretionary law**

4.295 **The European Communities is of the view** that the US arguments are based on a misinterpretation of the legal standard developed by GATT 1947 panels.

4.296 In the view of the European Communities, under the GATT 1947, the United States maintained provisions of its countervailing duty law, pre-dating the provisional application of the GATT 1947, that required its executive authorities to impose countervailing duties without an injury criterion, which was inconsistent with Article VI of the GATT. The United States consistently claimed that these provisions constitute mandatory legislation, even though the executive authorities of the United States could theoretically have acted consistently with Article VI by not making the affirmative determinations required for the imposition of countervailing duties. The GATT Panel on *United States - Denial of Most-Favoured-Nation Treatment as to Non-Rubber Footwear from Brazil* endorsed the US claim and considered on this basis that part of the relevant US legislation, i.e. Section 303 of the Tariff Act of 1930, was covered by the "existing legislation" clause of the GATT Protocol of Provisional Application.<sup>222</sup>

4.297 The European Communities points out that the United States countervailing duty law that was at issue in that case is comparable to Sections 301-310 to the extent that it also required the executive to make a negative or affirmative determination on the basis of specified factual criteria and mandated a GATT-inconsistent action if the determination was affirmative.

4.298 The European Communities further notes that the fact that the countervailing duty legislation did not preclude GATT-consistent action because there was the possibility for the USTR to determine that there was no basis to impose countervailing duties did not, in the view of United States and the GATT 1947 panel, turn this legislation into discretionary legislation.

4.299 The European Communities is thus of the view that this conclusion was compelled by the fact that there was no basis under the US countervailing duty law to exercise the discretion available under it for the purpose of avoiding inconsistencies with the provisions of Article VI of the GATT 1947 on injury findings. In addition, such an exercise of the discretion would have frustrated the objectives pursued by the US law.

4.300 The European Communities argues that as for the US countervailing duty law, the mere fact that Sections 301-310 provide for the possibility to determine that rights of the United States have not been denied and no failure to implement DSB recommendations has occurred and that these provisions therefore do not "preclude" WTO-consistency does not turn them into discretionary legislation: the discretion in making determinations was not given to the USTR to ensure the WTO-consistency but only to the limited effect to take into account the results of her investigations under Section 302 or the monitoring of implementation under Section 306(b), which constitute the compelling basis of her decisions.

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<sup>222</sup> Panel Report on *Brazilian Non-Rubber Footwear*, op. cit., para. 2.3.

4.301 **In rebuttal, the United States points out** that the European Communities appears to be unwilling to go so far as Hong Kong in discarding the distinction between mandatory and discretionary legislation. Further, the European Communities opposes the notion that discretionary legislation must include explicit language limiting that discretion so as to "preclud[e] WTO inconsistent actions".<sup>223</sup> The European Communities thus rejects Hong Kong's argument that legislation which allows for "a potential deviation" from WTO obligations is WTO-inconsistent.<sup>224</sup> Indeed, the European Communities would have significant difficulty complying with such an obligation to avoid "potential deviations". Having recognised the danger to the WTO system of embarking upon such an interpretation, the European Communities nonetheless seeks a case-specific, results-driven approach to the definition of "mandatory" to ensure that Sections 301-310 be found mandatory. The EC's approach denies the meaning of GATT/WTO jurisprudence based on the spurious claim that these cases relied on the now inapplicable Protocol of Provisional Application, and argues that the term "mandatory" – and the language of Sections 301-310 – must be interpreted by reference to a new-found obligation to avoid uncertainty and to ensure "security and predictability".

4.302 The United States argues that the European Communities clearly and correctly sets forth the distinction between discretionary and mandatory legislation in its panel request: legislation is mandatory, and actionable, if it "does not allow" a Member's authorities to comply with its WTO obligations.<sup>225</sup> Having offered this clear formulation and using it as the basis for its analysis, the European Communities now appears to realize that Sections 301-310 do, indeed, allow the United States to comply with DSU rules and procedures in every case. The European Communities therefore attempts to walk away from its earlier formulation, arguing that the United States overstates the conclusion of GATT and WTO panel reports when it points out that laws are not inconsistent with WTO obligations when those laws do not preclude compliance, or may reasonably be interpreted to permit compliance .

4.303 In the view of the United States, to say that a law "does not allow" WTO-consistent action is no different than saying that the law "precludes" such action. A law allows authorities to comply with their WTO obligations if, under domestic law, there is an interpretation of that law which permits WTO-consistent action. The US formulation follows directly from that set forth by the European Communities. Moreover, it is solidly grounded in GATT/WTO jurisprudence and applicable international practice in construing national and international law.

4.304 The United States argues that several statements from the panel reports it cited demonstrate the clear line drawn between mandatory and discretionary legislation. In *US – Tobacco*, the panel found against the complaining party because it had "not demonstrated that [the US law at issue] could not be applied in a [GATT-consistent] manner".<sup>226</sup> In other words, the complaining party had not demonstrated that the law precluded authorities from complying with their GATT obligations. Moreover, the *Tobacco* panel's finding turned on the fact that the term "comparable" in the US legislation was "susceptible of a range of meanings", including

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<sup>223</sup> The United States quotes the EC following argument: "[I]t would be inappropriate to interpret Article XVI:4 of the WTO Agreement so extensively as to require WTO Members to include specific language in their domestic law precluding WTO-inconsistent action".

<sup>224</sup> The United States points out, according to the European Communities, "[T]his does not mean that all domestic law that does not preclude WTO inconsistent measures and thus provides for the possibility of actions deviating from WTO law (a "potential deviation") is WTO inconsistent".

<sup>225</sup> See EC Panel Request, Circulated on 2 February 1999 as document WT/DS152/11.

<sup>226</sup> Panel Report on *US – Tobacco*, op. cit., para. 123. (emphasis added)

one which permitted GATT-consistent action.<sup>227</sup> The *US – Tobacco* panel report thus rests squarely on a finding that the burden is on the complaining party to demonstrate that domestic law does not allow an interpretation permitting a party to comply with its international obligations.

4.305 The United States further contends that likewise, in *US – Superfund*, the panel found, "since the Superfund Act also gives [US authorities] the possibility to avoid the need to impose [a GATT-inconsistent penalty] tax by issuing regulations [not yet issued or drafted], the existence of the penalty rate provisions as such does not constitute a violation of the United States obligations under the General Agreement".<sup>228</sup> It is difficult to conceive of any reading of this finding other than that drawn by the United States, namely, that a law which provides for the possibility of GATT-consistent action provides authorities with adequate discretion to comply with their GATT/WTO obligations. Again – unlike Sections 301-310 – the Superfund Act explicitly provided for a GATT-inconsistent tax; yet the panel found it sufficient that the statute also provided for the possibility that authorities might take action in the future that would be GATT-consistent. The panel did not assume that they would not.

4.306 The United States also points out that similarly, in *Thai – Cigarettes*, the panel was unfazed by a provision in the statute explicitly authorizing a tax which would, if implemented, have constituted a violation of Thailand's GATT obligations. The panel concluded that "the possibility that the Tobacco Act might be applied contrary to Article III:2 was, by itself, not sufficient to make it inconsistent with the General Agreement".<sup>229</sup> Again, the possibility of deviation from a party's international obligations does not render mean that law is WTO inconsistent. To the contrary, the very fact that there is a possibility of compliance is *dispositive* of whether the law is discretionary, and its mere existence is not a WTO violation. If the law permits a party to comply with its international obligations, it must be assumed that it will.

4.307 The United States is of the view that all of these GATT findings are consistent with the ordinary meaning of "mandatory", which is "obligatory in consequence of a command, compulsory".<sup>230</sup> If a law does not make it compulsory for authorities to act so as to violate their international obligations, that law may not be said to command such action. This can be illustrated through a simple example. A law which provides, "the Trade Representative shall take a walk in the park on Tuesdays, unless she chooses not to" does not oblige the USTR to walk in the park on Tuesdays. She has complete discretion not to take a walk in the park on Tuesdays; the law in no way obliges or commands her to do so. This remains true despite the use of the word "shall" in that law.

4.308 The United States maintains that the clear distinction in GATT/WTO jurisprudence between discretionary and mandatory legislation is also consistent with general international practice in interpreting domestic legislation in light of international law, and of US practice in particular. Under the principles set forth in *India – Patents (US)*, the relevant facts of this case are to be found in US municipal law, which includes not only the language of Sections 301-310, but also how those provisions would be interpreted under US law.<sup>231</sup> It is both general international practice and that of the United States that statutory language is to be interpreted so

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<sup>227</sup> Ibid.

<sup>228</sup> Panel Report on *US – Superfund*, op. cit., para. 5.2.9. (emphasis added)

<sup>229</sup> Panel Report on *Thai – Cigarettes*, op. cit., para. 86.

<sup>230</sup> The New Shorter Oxford English Dictionary, at 1683 (1993).

<sup>231</sup> Appellate Body Report on *India – Patents (US)*, op. cit., para. 65.

as to avoid conflicts with international obligations. There is thus a presumption against a conflict between international and national law. In general,

"[A]lthough national courts must apply national laws even if they conflict with international law, there is a presumption against the existence of such a conflict. As international law is based upon the common consent of the different states, it is improbable that a state would intentionally enact a rule conflicting with international law. A rule of national law which ostensibly seems to conflict with international law must, therefore, if possible always be so interpreted as to avoid such conflict".<sup>232</sup>

4.309 The United States further notes that in US law, it is an elementary principle of statutory construction that "an act of Congress ought never to be construed to violate the law of nations if any other possible construction remains". *Murray v. Schooner Charming Betsy*, 6 U.S. (2 Cranch) 64, 118 (1804). While international obligations cannot override inconsistent requirements of domestic law, "ambiguous statutory provisions . . . [should] be construed, where possible, to be consistent with international obligations of the United States". *Footwear Distributors and Retailers of America v. United States*, 852 F. Supp. 1078, 1088 (CIT), appeal dismissed, 43 F.3d 1486 (Table) (Fed. Cir. 1994), citing *DeBartolo Corp. v. Florida Gulf Coast Building and Trades Council*, 485 U.S. 568 (1988).

4.310 In the view of the United States, GATT jurisprudence distinguishing between mandatory and discretionary legislation does no more than apply the general practice of nations, including the United States, that there is a presumption against conflicts between national and international law. If a law provides discretion not to violate international obligations, there is a presumption that domestic authorities will interpret that law so as to avoid a conflict with those obligations. Likewise, this presumption may be seen as underlying the *US – Tobacco* panel's finding that a domestic law susceptible of multiple interpretations would not violate a party's international obligations so long as one possible interpretation permits action consistent with those obligations.<sup>233</sup>

4.311 The United States explains that the mandatory/discretionary distinction in GATT/WTO jurisprudence is clear and unequivocal: a law which allows WTO-consistent action is not WTO-inconsistent. The EC's attempt to qualify this principle to satisfy its political objectives would have the Panel presume bad faith on the part of the United States in its observance of its international obligations. Such a presumption would clearly be contrary to this jurisprudence and to the international practice underlying it.

4.312 In support of its argument, the United States refers to the text of DSU Article 23.2(a). That Article deals with "determinations to the effect that a violation has occurred". It prohibits Members from making these determinations without following DSU rules and procedures, and these determinations must be consistent with findings in panel and Appellate Body reports adopted by the DSB.

4.313 In the view of the United States, there is no "determination to the effect that a violation has occurred" before the Panel in this case. The European Communities does not challenge a determination which has actually been made. It is therefore not possible to analyze whether such a determination meets the requirements of Article 23.2(a). One cannot say whether, in

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<sup>232</sup> *Oppenheim's International Law*, 9th ed., at 81-82 (footnote omitted).

<sup>233</sup> Panel Report on *US – Tobacco*, op. cit., para. 123.

making such a determination, the United States followed DSU rules and procedures, nor whether the United States made a determination consistent with DSB-adopted findings. Neither the findings nor the determination exist.

4.314 The United States asks how the Panel can perform its analysis under these circumstances. In the absence of a concrete determination, how is it possible to know whether a Member has breached its obligations under Article 23.2(a)? It is not permissible to speculate about how the Member will make its determination in the future. It is not permissible to look at determinations made in the past which are not within the terms of reference. It is not permissible to assume that certain Members are not to be trusted. It is not permissible to assume that they will act in bad faith. Under these circumstances, must the conclusion be that without a concrete determination, there can be no violation of Article 23.2(a)?

4.315 The United States points out that over 10 years ago, in 1987, a GATT panel wrestled with this type of question. It looked at a statute which would not go into effect for another three years and asked, may a panel determine whether this law is inconsistent with a party's GATT obligations when it is possible that the party may change the law before it goes into effect? The panel's conclusion was that it could, but it was very careful in how it drew this conclusion. The panel found that only if a statute commands a party's authorities to violate a specific GATT obligation could that statute be found inconsistent with that obligation. In enacting such legislation, the party crossed a line. It left itself with no choice but to violate its obligations, even if only at some point in the future. Conversely, the panel found, if a statute does not command the party's authorities to violate a specific GATT obligation, it is not possible to conclude that the statute violates that obligation. The party may exercise its discretion so as to comply with its international obligations. Any other conclusion would be speculation as to whether the party will act in bad faith, speculation with no more foundation than if the statute did not exist at all.

4.316 The United States again states that the reasoning of the *Superfund* panel made very good sense. It was so good that at least five GATT panels adopted it as their own. At least three WTO panels have also adopted it. And none of those panels in any way revised the core question asked by the *Superfund* panel: does the statute command, does it mandate, a violation of a specific agreement obligation?

4.317 The United States further argues that the *Superfund* analysis is not an analysis of character. It is not necessary to examine whether the character of the Member enacting the legislation is bad, whether that party had a WTO-inconsistent motive. Nor is it necessary to examine whether the "character" of the legislation is bad, whether the legislation reflects an intent to breach WTO-obligations. All that matters is whether the law commands an action which violates a specific textual obligation. Absent such a command, the Panel is left with the fundamental problem – there is nothing that can be said to violate a specific textual obligation. Legislation which leaves open the possibility of a violation cannot be considered a violation, any more than may a constitutional system which provides broad authority to act. However, by including a specific command in legislation to violate a specific obligation, the legislation itself becomes that violation.



(c) **Arguments specific to "Security and Predictability"**

4.318 **The European Communities claims** that the second legal standard that Sections 301-310 must meet has been developed by two panels<sup>234</sup> and the Appellate Body in the *India – Patents (US)* case. In this case, the Appellate Body interpreted Article 70:8(a) of the TRIPS Agreement to require Members "to provide a legal mechanism for the filing of mailbox applications that provides a sound legal basis to preserve both the novelty of the inventions and the priority of the applications as of the relevant filing and priority dates".<sup>235</sup>

4.319 The European Communities contends that there was in this case no dispute that India had a "mailbox" system based on administrative instructions in place. The dispute was on the question whether this system rested on a legal basis in Indian law sufficiently sound to ensure that the patent applications could not be invalidated by Indian courts.

4.320 In the view of the European Communities, one of the issues before the panel was whether a provision in India's Patent Act requiring the rejection of certain patent applications permitted the Patent Office to act consistently with the TRIPS Agreement by simply not acting on the patent application.

4.321 According to the European Communities, another issue was whether, under Indian law, the competitors of a patent applicant had the right to challenge a patent application in the courts or whether they had to wait until the patent was actually granted.

4.322 The European Communities contends that the panel ruled against India because, based on the evidence submitted by the parties, "it had reasonable doubts that the administrative instructions would prevail over the mandatory provisions of the Patents Act if a challenge were brought in an Indian court".<sup>236</sup> As the United States correctly stated before the Appellate Body in this case:

"Protection of legitimate expectations of WTO Members regarding conditions of competition is as central to trade relating to intellectual property as it is to trade in goods that do not relate to intellectual property".<sup>237</sup>

4.323 The European Communities argues that there must consequently be a sound legal basis in domestic law for the executive actions required to implement WTO obligations also in the area of trade in goods.

4.324 The European Communities further points out that the *India – Patents (US)* Appellate Body report sets an important precedent that should guide the resolution of the present case if the Panel were to conclude that Sections 301-310 do not mandate WTO-inconsistent determinations or actions.

4.325 According to the European Communities, in this case, the question would arise whether Sections 301-310 provide the USTR with a sufficiently sound legal basis for the implementation of the US obligations under the DSU and the GATT 1994. The European Communities submits

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<sup>234</sup> Panel Report on *India – Patents (US)*, op. cit. and Panel Report on *India – Patent Protection for Pharmaceutical and Agricultural Chemical Products ("India – Patents (EC)")*, adopted 2 September 1998, WT/DS79/R.

<sup>235</sup> Appellate Body Report on *India – Patents (US)*, op. cit., para. 58.

<sup>236</sup> Ibid., para. 74.

<sup>237</sup> Ibid., para. 15.

that, to the extent that there is uncertainty on the mandatory nature of Sections 301-310, this legislation does not provide a sound legal basis for the implementation of the US obligations under the DSU and the GATT 1994 by the USTR.

4.326 The European Communities cites Professor Robert E. Hudec as writing:

"Section 301 is an intricate maze of mandatory commands in one place and extremely wide loopholes in the other. One needs a wiring diagram to trace whether mandatory commands given in one part will actually reach their final target without passing through at least one discretionary exit point. Even with the aid of such a diagram, one cannot predict actual outcomes".<sup>238</sup>

4.327 The European Communities also points out that Professor John H. Jackson testified before the Senate Foreign Relations Committee as follows:

"Although there are plausible ways to interpret the statutory provisions of regular Section 301 so as to give the President discretion to act consistently with the Uruguay Round dispute settlement rules, in a few cases, particularly in Section 301(a) (mandatory provision) the interpretations to do this are a bit strained ...".<sup>239</sup>

4.328 According to the European Communities, if the United States' two foremost scholars on international trade law are unable to identify a sound legal avenue in Sections 301-310 permitting the USTR to act consistently with the DSU and the GATT 1994, nobody else can do it.

4.329 The European Communities maintains that the legislative history of the 1988 Omnibus Trade and Competitiveness Act, which is at the origin in particular of the present version of Sections 301-310, demonstrates that the lack of a sound legal avenue was deliberate.

4.330 In the view of the European Communities, the United States now attempts to benefit from the creation of this legal "maze" by claiming that it is for the European Communities to prove that it is not possible to interpret Sections 301-310 as permitting WTO-consistent implementation.

4.331 The European Communities contends that the fundamental objective of the WTO - namely to create security and predictability in international trade relations - could not be achieved if WTO Members were permitted to maintain domestic legislation that fails to provide the executive authorities with a sound legal basis for the measures required to implement their WTO obligations.

4.332 The European Communities is therefore of the view that, in a panel's examination of whether domestic legislation stipulates WTO-inconsistent determinations or action, the defendant should not be able to hide behind legal uncertainties arising from its own law, in particular if these uncertainties have been deliberately created. In accordance with the approach

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<sup>238</sup> Robert E. Hudec, Thinking About the New Section 301: Beyond Good and Evil, in: Jagdish Bhagwati and Hugh T. Patrick, Editors, *Aggressive Unilateralism. America's 301 Trade Policy and the World Trading System* (Harvester Wheatsheaf 1990), p. 122.

<sup>239</sup> Senate Committee on Foreign Relations, Hearing on the World Trade Organization, June 14, 1994 (testimony of Professor John H. Jackson).

endorsed by the Appellate Body in *India - Patents (US)*, a panel should rule against the defendant if it concludes, on the basis of the evidence before it, that there is an objective (and thus reasonable) uncertainty on whether the domestic law permits WTO-consistent determinations or actions.

4.333 The European Communities argues that if the panel has reasonable doubts, so will economic operators planning their future trade. No legitimate interest would be protected if Members were entitled to retain law lacking such a basis. In fact, as the case before the Panel demonstrates, this would be an invitation to Members to restrict trade by exposing it deliberately to legal uncertainties.

4.334 The European Communities further contends that each Member is required to perform its WTO obligations in good faith. No additional policy constraint is therefore imposed on Members by requiring them to create a sound legal basis in their domestic law for the performance of their WTO obligations. If it is the intention of the United States to perform its WTO obligations in the framework of the Section 301-310 procedures, why does it object to the EC's demand to create a sound legal basis for the performance of these obligations? If the legal uncertainties under Sections 301-310 are an expression of the contrary intention, why should they nevertheless be considered to be a sound legal basis for a good faith performance of the United States' WTO obligations?

4.335 In the view of the European Communities, the legal standard applicable to domestic law that the United States defended so vigorously when Indian patent law was at issue is equally applicable to United States trade law.

4.336 The European Communities indicates that it would be extremely regrettable if the unjustifiably low standard for the evaluation of the WTO-consistency of domestic law that the United States opportunistically defends in the present proceedings were to be endorsed as the generally applicable standard. United States law should be adapted to WTO law, not *vice versa*. Otherwise, the considerable legal progress of the WTO legal system endorsed by the Appellate Body in *India - Patents (US)* would be lost.

4.337 **The United States argues** that the Statement of Administrative Action and accompanying legislation are the definitive congressional materials with respect to the WTO-consistency of Sections 301-310 before the adoption of the Uruguay Round Agreements Act by the Congress. Page 360 of the Statement of Administrative Action (US Exhibits 3 and 11) outlines the changes considered necessary to ensure compliance. In addition, the United States directs the Panel's attention to the testimony on this topic of Professor John Jackson when he appeared before the Senate Finance Committee.<sup>240</sup>

4.338 The United States points out that Professor Jackson concluded that, "There may need to be some alterations to some time limits, or transition measures, but the basic structure of 301 is not necessarily inconsistent with the Uruguay Round results". He also concluded that even when Section 301 is considered "in its current statutory form" (i.e. before the 1994 amendments), "the Executive appears to have the discretion to apply actions under Section 301 in a manner consistent with the proposed new rules of the Uruguay Round dispute settlement

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<sup>240</sup> *Results of the Uruguay Round Trade Negotiations: Hearings Before the Senate Committee on Finance*, 103d Cong. 195 (1994) (statement of Professor John Jackson) (US Exhibit 24). The European Communities excerpts this testimony.

understanding".<sup>241</sup> Professor Jackson thus considered that with only minor changes, Section 301 would be clearly consistent with the WTO obligations of the United States. Moreover, his emphasis on the fact that the Executive had adequate discretion to apply Section 301 in a WTO-consistent manner reflects the fact that he took for granted that the reasoning applied in the *Superfund* line of cases would continue to apply under the WTO.

4.339 The United States notes that Professor Jackson believed that sufficient clarity could be provided to the interpretation of the statute through the inclusion of language in the Statement of Administrative Action.<sup>242</sup>

4.340 The United States further points out that the *India - Patents (US)* discussion of a "sound legal basis" comes in the context of an analysis of the specific textual obligation at issue in that case, TRIPs Article 70.8(a). This provision affirmatively requires Members to provide in their domestic legal systems a mechanism for the filing of applications for patents which protects their novelty and priority. India instead had on its books a law explicitly prohibiting such applications, that is, specifically mandating a violation of India's TRIPs obligations. India claimed that unwritten, unpublished "administrative instructions" never produced for the panel took priority over the mandatory law, but the panel and Appellate Body found nothing to support this claim. It was in this context, the context of TRIPs Article 70.8(a)'s requirement for a domestic legal mechanism accomplishing specific ends, that the panel and Appellate Body concluded that the "administrative instructions" failed to provide a sound legal basis. The concept was not analyzed in the abstract as somehow derived independently of Article 70.8(a) and, as noted, the Appellate Body reversed panel findings relating to "legitimate expectations" generally and removal of "reasonable doubts" because these findings were not textually based.

4.341 In response to the Panel's request for clarification on the US reference to "security and predictability" as an objective, not an obligation, the United States notes that Article 31(1) of the Vienna Convention on the Law of Treaties provides:

"1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose".

4.342 The United States also notes that the Appellate Body explained the proper role of an examination of an agreement's object and purpose in *US - Shrimp* as follows:

"A treaty interpreter must begin with, and focus upon, the text of the particular provision to be interpreted. It is in the words constituting that provision, read in their context, that the object and purpose of the states parties to the treaty must first be sought. Where the meaning imparted by the text itself is equivocal or inconclusive, or where confirmation of the correctness of the reading of the text itself is desired, light from the object and purpose of the treaty as a whole may usefully be sought".<sup>243</sup>

4.343 The United States then concludes that while the terms of an agreement are to be examined in light of the object and purpose of the agreement, it is the ordinary meaning of those terms which must first be analyzed in interpreting an agreement provision, and relied upon in

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<sup>241</sup> Ibid. at 200.

<sup>242</sup> Ibid.

<sup>243</sup> Appellate Body Report on *US - Shrimp*, op. cit., para. 114. (emphasis added)

applying that provision to a given set of facts. The object and purpose cannot change the ordinary meaning of the agreement terms. Where the terms are ambiguous, and their meaning is not clear on their face or in their context, a consideration of the object and purpose of the agreement can be productive. However, a consideration of the object and purpose of an agreement is secondary to, and cannot serve as substitute for, an analysis of the ordinary meaning. Nor can an examination of the object and purpose of an agreement be made to the exclusion of an analysis of the ordinary meaning of the agreement text.

4.344 The United States further states that in *US - Shrimp* the Appellate Body chastised the panel in that case for not examining the ordinary meaning of the words of the chapeau of GATT 1994 Article XX, the chapeau's context within Article XX, or the chapeau's object and purpose, and for instead focusing on the "object and purpose of the *whole of the GATT 1994 and the WTO Agreement*".<sup>244</sup> Just as the European Communities asks the Panel to focus on "security and predictability", the *US - Shrimp* panel focused on the very same concept of security and predictability in the context of its discussion of an overall goal of the WTO Agreement to avoid "undermin[ing] the multilateral trading system". According to the *US - Shrimp* panel, "we must determine . . . whether [the type of measure in *US - Shrimp*] would threaten the security and predictability of the multilateral trading system".<sup>245</sup>

4.345 The United States further notes that in response, the Appellate Body drew the clear distinction between objectives and obligations that the United States is asking the Panel to recognise again in this dispute. According to the Appellate Body:

"Maintaining, rather than undermining, the multilateral trading system is necessarily a fundamental and pervasive premise underlying *WTO Agreement*; but it is not a right or obligation, nor is it an interpretive rule which can be employed in the appraisal of a given measure under the chapeau of Article XX".<sup>246</sup>

4.346 According to the United States, just as maintaining the multilateral system is a premise – an objective – underlying the WTO Agreement as a whole, "security and predictability" are explicitly set forth in Article 3.2 as a *premise*, an objective, underlying the DSU: "The dispute settlement system of the WTO *is* a central element *in providing* security and predictability to the multilateral trading system".<sup>247</sup> Security and predictability are thus the objective which the DSU itself *helps to achieve*.

4.347 In the view of the United States, to put this in its most fundamental terms, Article 3.2 does *not* state "Members shall provide security and predictability to the multilateral trading system". This would impose an obligation. Rather, Article 3.2 states, the DSU is a central element in providing security and predictability to the multilateral system. In other words, the DSU is premised on the need for security and predictability, and itself helps to provide it.

4.348 The United States points out that the European Communities does not claim that Sections 301-310 are inconsistent with Article 3.2 precisely in recognition of the fact that it does

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<sup>244</sup> Ibid., para. 116 (emphasis in original).

<sup>245</sup> Panel Report on *US - Shrimp*, op. cit., para. 7.44 (underlining added), quoted in Appellate Body Report on *US - Shrimp*, op. cit., para. 112.

<sup>246</sup> Appellate Body Report on *US - Shrimp*, op. cit., para. 116 (underlining added).

<sup>247</sup> DSU Article 3.2 (emphasis added).

not impose an obligation to provide security and predictability. However, neither does DSU Article 23 impose such an obligation.

4.349 **The European Communities stresses** that the US comparison of this case with the *US - Shrimp* case is incorrect. The legal error which the panel committed in that case was that it formulated a broad standard or an *a priori* test which found no basis in the text<sup>248</sup> of the Treaty. By contrast, in the present case, the Panel's task is to provide an interpretation of the text of several provisions of the WTO agreements (i.e. Article 3.2 of the DSU, Article XVI:4 of the Marrakech Agreement, Article 23 of the DSU).

4.350 **The United States challenges** the EC claim that while *US - Shrimp* involved a panel formulating a new, broad test which found "no basis in the text of the Treaty", the EC proposal in this case for a new, broad test involves "an interpretation of the text of several provisions". However, as explained earlier, there is no basis in the text of any of these provisions to conclude that Article 23 imposes an obligation to provide "security and predictability". The situation is thus precisely analogous to that in *US - Shrimp*, and the EC's proposal to create new obligations must be rejected for the same reasons.

4.351 In response to the Panel's further question whether providing "security and predictability" to other Members in respect of avoiding determinations and actions prohibited under Article 23 of the DSU – read in light of Article 3.2 of the DSU and Article XVI:4 of the WTO Agreement – is part of the legal obligation imposed in Article 23, the United States indicates that providing security and predictability to other Members is not part of the obligation set forth in DSU Article 23. Rather, the obligation set forth in DSU Article 23 itself helps to provide that security and predictability. Any reading of Article 23 which creates an obligation to provide security and predictability would repeat the error of the panel in *US - Shrimp*.

4.352 In the view of the United States, the consideration of the object and purpose of an agreement cannot serve as a substitute for an analysis of the ordinary meaning. Even worse would be the consideration of the object and purpose of an agreement to the apparent exclusion of an analysis of the ordinary meaning of the text of an agreement provision. Yet that is what the European Communities asks the Panel to do. Without regard to the ordinary meaning to be ascribed to the term "determination to the effect that a violation has occurred", read in the context of requirements in Article 23.2(a) applicable to that specific type of determination, the European Communities instead asks this Panel to find an obligation "to provide security and predictability", and to analyze whether the very act of making a determination would breach this new-found obligation.

4.353 The United States notes that DSU Article 23.2(a) does not state, "Members *shall* provide security and predictability". Nor does this provision even state, "Members *should* provide security and predictability". Nor does Article 23.2(a) state, "Members shall/should make determinations so as to provide security and predictability", or "so as to avoid insecurity and unpredictability". The WTO Members agreed to none of these formulations. They agreed that they "shall not make determinations to the effect that a violation has occurred" unless specified conditions have been met. That is all they agreed to. Nowhere does the term "security and predictability" appear in Article 23, nor is Article 3.2 cross-referenced. Like the rest of the substantive obligations of the WTO Agreement, the provisions of DSU Article 23 itself, enforced through the dispute settlement system, help to provide security and predictability.

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<sup>248</sup> Appellate Body Report on *US - Shrimp*, op. cit., para. 121.

4.354 The United States claims that the ordinary meaning of the words of Article 23.2(a) are that it relates only to certain determinations, that is, "determinations to the effect that a violation has occurred". As Brazil and Canada have noted, it does not apply to determinations that a violation has not occurred, or even to determinations that a violation of a non-WTO agreement has occurred. Nothing in the ordinary meaning of "determination to the effect that a violation has occurred" would permit a panel to examine such other determinations against the requirements of Article 23.2(a), or to examine the very act of making determinations generally.

4.355 In the view of the United States, likewise, nothing in the ordinary meaning of Article 23.2(a)'s requirements permits an analysis of whether the very act of making determinations harms "security and predictability". Article 23.2(a) imposes the requirement that a determination to the effect that a violation has occurred not be made without recourse to dispute settlement "in accordance with the rules and procedures" of the DSU, and the requirement that any such determination be consistent with DSB-adopted findings. Nothing in the ordinary meaning of the language setting forth these requirements imposes an additional, independent requirement to provide "security and predictability". There is no "rule" of the DSU which requires that security and predictability be provided. Again, Article 3.2 states that the rules themselves help to provide security and predictability.

4.356 The United States further considers that an examination of Article 23.2(a)'s context supports the conclusion to be drawn from an examination of the ordinary meaning of its language. The immediate context of Article 23.2(a) is provided by paragraphs (b) and (c) and by Article 23.1. Like paragraph (a), paragraphs (b) and (c) impose requirements to follow DSU procedures when undertaking dispute settlement proceedings or when taking action. The references in these provisions are to specific DSU requirements which must be met, just as paragraph (a) refers to following DSU rules and procedures and to DSB adopted panel and appellate body findings. Similarly, Article 23.1 requires recourse to DSU rules and procedures, none of which impose a separate obligation to provide security and predictability. There is thus nothing in the context of Article 23.2(a) which supports the notion that there is an independent obligation to provide security and predictability in making determinations generally.

4.357 The United States argues that given the fact that nothing in "the meaning imparted by the text itself[, read in its context,] is equivocal or inconclusive",<sup>249</sup> there is no need to examine the object and purpose of Article 23.2(a). However, such an examination confirms the meaning yielded by the ordinary meaning of the language of that provision. To avoid the mistake of *US - Shrimp*,<sup>250</sup> it is necessary to look to the object and purpose of Article 23, which is "strengthening the multilateral system". It does nothing to strengthen the multilateral system to restrict determinations that a violation has not occurred, or to restrict determinations not relating to WTO agreement rights and obligations. Looking to the broader purpose of providing "security and predictability" to the multilateral trading system, security and predictability is affirmatively harmed when the text of agreement provisions may be disregarded and new obligations created out of thin air.

4.358 The United States further maintains that the obligations set forth in DSU Article 23, enforced through the dispute settlement system, thus themselves help to provide the security and predictability referred to in Article 3.2. The ordinary meaning of the language of Article 23,

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<sup>249</sup> Appellate Body Report on *US - Shrimp*, op. cit., para. 114.

<sup>250</sup> See *ibid.*, para. 116 (criticizing the panel for examining the objectives of the WTO Agreement as a whole (maintaining the multilateral trading system) rather than the object and purpose of the chapeau to Article XX).

read in its context, is unambiguous that there is no separate obligation imposed by that article to provide security and predictability.

4.359 **The European Communities states** the US argument based on the assertion that nowhere do the terms "security and predictability" appear in Article 23, nor is Article 3.2 cross-referenced", is both new and incorrect. All the provisions of the DSU, including of course Article 23, must be read in the light of Article 3.2 of the DSU which informs the interpretation of the obligations of the WTO Members contained in the more detailed provisions. In fact, Article 3.2 of the DSU is part of the "General Provisions" contained in Article 3 and thus is applicable throughout the whole dispute settlement understanding without the need for cross-references in each and every Article.

4.360 **The United States rebuts** the EC claim that Article 3.2 is a general provision, applicable throughout the whole dispute settlement proceeding. However, as noted earlier, Article 3.2 does not set forth an obligation to provide security and predictability. Instead, Article 3.2 explains that the dispute settlement system *itself* provides security and predictability. The general applicability of this explanation does not create an obligation under Article 23.2(a) to provide security and predictability. However, Article 3.2 does, in fact, impose a generally applicable obligation – on panels: not to add to or diminish the rights and obligations under the covered agreements. This provision mandates that the Panel reject the EC's proposal to add a new obligation not found in the text of the WTO Agreement.

**(d) Arguments specific to WTO Agreement Article XVI:4**

4.361 **The European Communities also argues** that the third legal standard that domestic law must meet is set out in Article XVI:4 of the Marrakech Agreement according to which "each Member shall ensure the conformity of its laws, regulations and administrative procedures with its obligations [under the WTO agreements]".

4.362 The European Communities contends that by creating a new type of obligation that goes beyond the commitments under the GATT 1947, this specific provision governing domestic law sets without any doubt a standard more demanding than the standards that Members' domestic law must meet under the WTO practice in order to ensure a good faith implementation of their substantive obligations in accordance with principles codified in Articles 26 and 27 of the Vienna Convention on the Law of Treaties.

4.363 The European Communities then concludes that this third legal standard would therefore need to be considered by the Panel only if, and to the extent that, it were to conclude that Sections 301-310 do not mandate WTO-inconsistent determinations or actions and provide a sound legal basis for the implementation of the United States' WTO obligations.

4.364 The European Communities argues that the United States claims, without any supporting arguments, that "Sections 301-310 are not inconsistent with Article XVI:4 because they do not mandate action in violation of any provisions of the DSU or GATT 1994, nor do they preclude action consistent with those provisions".

4.365 The European Communities recalls that Article XVI:4 of the Marrakech Agreement requires a positive action by the WTO Member ensuring the conformity of its entire domestic law. The distinction between legislative and executive actions is not made in this provision. It covers also regulations and administrative procedures, which can typically be adopted and modified by the executive branch of the government. The question of whether the domestic law



mandates the executive authorities to take WTO-inconsistent measures is therefore irrelevant under Article XVI:4.

4.366 The European Communities further maintains that moreover, if Article XVI:4 were interpreted to merely impose the requirements that arise already under the Vienna Convention on the Law of Treaties, it would be redundant. As the Appellate Body recognised in the *US-Gasoline* case,<sup>251</sup> interpretations rendering whole clauses of a treaty redundant are however not permitted under the principles of interpretations set out in the Vienna Convention on the Law of Treaties (Articles 31 and 32).

4.367 The European Communities alleges that the United States' reading of Article XVI:4 of the Marrakech Agreement is therefore clearly incompatible with the ordinary meaning to be given to its terms in their context and in the light of the object and purpose of the WTO Agreement to ensure security and predictability in international trade relations.

4.368 In the view of the European Communities, one of the important tasks before this Panel is to give meaning to the terms "ensure" and "conformity" in Article XVI:4. The principles of interpretation set out in the Vienna Convention require the Panel to interpret these terms in good faith in accordance with the ordinary meaning to be given to them in their context and in the light of the object and purpose of the WTO Agreement.

4.369 The European Communities points out that the ordinary meaning of the term "ensure" is to "make certain". The ordinary meaning of the term "conformity" is, firstly, "action or behaviour in accordance with established practice; compliance" and, secondly, "correspondence in form or manner, likeness, agreement" (Oxford).

4.370 The European Communities repeats its argument that Article XVI:4 must be interpreted to impose requirements with respect to domestic law additional to the requirements that arise already from the substantive WTO obligations themselves. This is achieved if Article XVI:4 is interpreted to stipulate a "correspondence, likeness or agreement" between domestic law and the relevant WTO obligations.

4.371 In the view of the European Communities, the terms "ensure" and "conformity", taken together in their context, therefore indicate that Article XVI:4 obliges Members not merely to give their executive authorities formally the right to act consistently with WTO law, but to structure their law in a manner that "makes certain" that the objectives of the covered agreements will be achieved.

4.372 The European Communities notes that one basic objective of WTO law is to strengthen the multilateral system. Another basic objective is to obtain greater legal certainty in multilateral trade relations.

4.373 The European Communities claims that a domestic law, regulation or administrative procedure whose structure, design and architecture is specifically framed to create uncertainty for the trade with other WTO Members could therefore never be deemed to ensure conformity with WTO law.

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<sup>251</sup> Appellate Body Report on *United States – Standards for Reformulated and Conventional Gasoline* ("*US - Gasoline*"), adopted 20 March 1996, WT/DS2/AB/R.

4.374 The European Communities further argues that the participants in the Uruguay Round expected the United States not only to commit itself to refrain from unilateral action but also to bring its domestic law into conformity with that commitment. One of the earliest texts on dispute settlement submitted on 19 October 1990 by Mr. Julio Lacarte-Muró, Chairman of the Negotiating Group on Dispute Settlement, contained the following provision:

"The contracting parties shall:

- (i) abide by GATT dispute settlement rules and procedures;
- (ii) abide by the recommendations, rulings and decisions of the CONTRACTING PARTIES;
- (iii) not resort to unilateral action inconsistent with GATT rules and procedures; and
- (iv) for the purpose of (iii), undertake to adapt their domestic trade legislation and enforcement procedures in a manner ensuring the conformity of all measures with GATT dispute settlement procedures".

4.375 The European Communities goes on to state that subsequent drafts of the DSU no longer contained a provision on the adaptation of domestic legislation. However, a provision to that effect was included in the proposed draft Agreement Establishing the Multilateral Trade Organisation. Article XVI:4 of this draft Agreement stated:

"The Members shall endeavour to take all necessary steps, where changes to domestic laws will be required to implement the provisions of the agreements annexed hereto, to ensure the conformity of their laws with these agreements".<sup>252</sup>

4.376 The European Communities points out that in an informal note to the Legal Drafting Group, the Secretariat noted:

"Under general international law, a party to a treaty may not invoke the provisions of its internal law as justification for its failure to perform a treaty and according to several GATT panels, laws mandating action inconsistent with the General Agreement constitute themselves violations of the General Agreement, whether or not such action has been taken. This paragraph would therefore provide for a lesser level of obligation under the Multilateral Trade Agreements than that provided for under the current GATT".<sup>253</sup>

4.377 The European Communities further notes that the final version of Article XVI:4 was therefore drafted not as a "best-endeavours" clause, applicable only to cases where changes to domestic laws are required, but as an unqualified obligation:

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<sup>252</sup> Informal note by the Secretariat "Draft Agreement Establishing the Multilateral Trade Organisation" (No. 462, dated 12 March 1992), page 26.

<sup>253</sup> Ibid.

"Each Member shall ensure the conformity of its laws, regulations and administrative procedures with its obligations as provided in the annexed Agreements".

4.378 The European Communities explains that the Tokyo Round agreements on government procurement, subsidies, licensing procedures, civil aircraft and anti-dumping each contained provisions similar to Article XVI:4.<sup>254</sup> These provisions were taken over into the final provisions of the corresponding WTO agreements, but not however into the GATT 1994, the GATS or the DSU.<sup>255</sup> The effect of Article XVI:4 is to extend the explicit requirement of the WTO-conformity of domestic law to all agreements and legal instruments in Annexes 1, 2 and 3 of the WTO Agreement, including the DSU.<sup>256</sup>

4.379 **The United States points out** that the EC's claims with respect to the GATT 1994 and WTO Agreement Article XVI:4 each rely on the assumption that the EC's claims with respect to DSU violations are correct. For example, there can be no violation of GATT 1994 if the United States takes no action and, for the reasons already discussed, one cannot assume that Sections 301-310 require such action. Moreover, it cannot be assumed that any action taken pursuant to Sections 301-310 would not be preceded by DSB authorization.

4.380 The United States argues that with respect to WTO Agreement Article XVI:4, it is important to recognise that a measure must first violate some other WTO commitment in order to violate Article XVI:4. The ordinary meaning of the text of this provision makes this clear: "Each Member shall ensure the conformity of its laws, regulations and administrative procedures with its obligations as provided in the annexed Agreements". If those laws, regulations and administrative procedures conform with the obligations in the annexed agreements, including the DSU, there is no violation of Article XVI:4. The European Communities may not assume that Sections 301-310 violate the DSU for the purpose of finding a violation of Article XVI:4.

4.381 The United States points out that Article XVI:4 of the WTO Agreement provides:

"Each Member shall ensure the conformity of its laws, regulations and administrative procedures with its obligations as provided in the annexed Agreements".

4.382 The United States argues that nothing in this provision suggests, let alone dictates, the redefinition of the concept of mandatory legislation as proposed by the European Communities. The meaning of the text of Article XVI:4 is straightforward: if a Member's law, regulation, or administrative procedure does not conform with its obligations as provided in the annexed Agreements, that Member has an affirmative obligation to bring it into conformity. Conversely,

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<sup>254</sup> The European Communities refers to Article IX.4(a) of the Agreement on Government Procurement, Article 19.5(a) of the Agreement on Interpretation and Application of Article VI, XVI and XXIII, Article 5.4 (a) of the Agreement on Import Licensing Procedures, Article 9.4.1 of the Agreement on Trade in Civil Aircraft, and Article 16.6(a) of the Agreement on Implementation of Article VI.

<sup>255</sup> The European Communities refers to Article XXIV.5(a) of the Agreement on Government Procurement, Article 32.5 of the Agreement on Subsidies and Countervailing Measures, Article 8.2(a) of the Agreement on Import Licensing Procedures, Article 9.4.1 of the Agreement on Civil Aircraft, and Article 18.4 of the Agreement on the Implementation of Article VI of the General Agreement on Tariffs and Trade 1994.

<sup>256</sup> The European Communities refers to Article II.1 of the WTO Agreement.

however, if those laws, regulations and administrative procedures conform with its obligations, it need undertake no further action.

4.383 The United States claims that Article XVI:4 does not in any way provide that the definition of "mandatory legislation" may now include "certain discretionary legislation". Nor does Article XVI:4 create a "new legal environment" which would permit substantive obligations to be created out of whole cloth.

4.384 The United States notes that the European Communities suggests that Article XVI:4's inclusion of regulations and administrative procedures as well as laws is part of this "new legal environment". According to the European Communities, "[t]he distinction between law that binds the executive authorities and law that can be modified by them is thus no longer relevant". This EC distinction is baseless. Regulations and administrative procedures have always been subject to the rules of the GATT 1947,<sup>257</sup> and there is absolutely nothing extraordinary about their inclusion in Article XVI:4. The obligation with respect to regulations and administrative procedures is the same as that for laws: if they are not in conformity with the Member's WTO obligations under the covered Agreements, they must be brought into conformity. However, if they are in conformity, they need not be changed.

4.385 The United States goes on to state that the European Communities also claims that the inclusion of the word "ensure" in Article XVI:4 means that laws must be structured in a manner that "makes certain" that "the objectives of the covered agreements will be achieved". As discussed above, the objectives of the covered agreements are reflected in their text, and in any event "objectives" are not themselves "obligations". One may not depart from the text on the basis of fanciful, results-driven constructions of agreement objectives. A Member may "ensure" that its laws, regulations and administrative procedures are in compliance with its obligations through any number of means:

"From the standpoint of international law states are generally free as to the manner in which, domestically, they put themselves in the position to meet their international obligations; the choice between the direct reception and application of international law, or its transformation into national law by way of statute, is a matter of indifference, as is the choice between the various forms of legislation, common law, or administrative action as the means for giving effect to international obligations. These are matters for each state to determine for itself according to its own constitutional practices".<sup>258</sup>

4.386 The United States indicates that one of those means by which a Member may ensure conformity with its obligations is to ensure that the Member's authorities have adequate discretion to comply with the Member's obligations. This notion lies at the heart of the doctrine of the non-actionability of discretionary legislation reflected in the consistent, unmodified GATT and WTO practice in this area. As Japan noted in responses to the Panel's questions, "laws are not inconsistent with WTO rules when ... discretion [to comply with WTO obligations] is given to administrators under the laws".

4.387 The United States argues that there is no basis for distinguishing among different forms of discretionary legislation, or for recharacterising some discretionary legislation as "mandatory". If legislation provides adequate discretion for a Member's authorities to comply

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<sup>257</sup> E.g. GATT 1947 Article III:4 covers "laws, regulations and requirements".

<sup>258</sup> Oppenheim's International Law, 9th ed., at 82-83 (footnote omitted).

with their obligations, it may not be assumed that the Member will not exercise that discretion in good faith so as to comply with its obligations. The good faith principle of which the European Communities speaks is the very reason it may not be assumed that a Member's authorities will violate its international obligations.

4.388 In the view of the United States, even if there were some conceivable construction of the text of Article XVI:4 which would permit the redefinition of "mandatory legislation" so as to include legislation which does not require a Member to violate its international obligations, it would not be permissible to adopt that construction in interpreting Article XVI:4. The Appellate Body explained in *EC – Hormones* that the customary principle of interpretation of international law known as *in dubio mitius* is applicable in WTO disputes as a supplementary means of interpretation. That principle applies

"in interpreting treaties, in deference to the sovereignty of states. If the meaning of a term is ambiguous, that meaning is to be preferred which is less onerous to the party assuming an obligation, or which interferes less with the territorial and personal supremacy of a party, or involves less general restrictions upon the parties".<sup>259</sup>

4.389 The United States argues that the EC's proposed construction of Article XVI:4, even if it had so much as an ambiguous textual basis, would run afoul of the *in dubio mitius* principle, since that construction would interfere with a Member's sovereign right to choose the form by which it implements its obligations in domestic law, and require each and every Member to re-examine and potentially revise the form of various pieces of legislation they quite correctly assumed in 1995 to be consistent with their WTO obligations based on the consistent application of the doctrine of the non-actionability of discretionary legislation.

4.390 The United States points out that the European Communities claims that the *India - Patents (US)* case and DSU Article 3.2's reference to "security and predictability" support its claim that Article XVI:4 includes a prohibition against "uncertainty". As discussed above, the reference to "security and predictability" in DSU Article 3.2 is made in the context of explaining that the dispute settlement system provides such security and predictability, and it does so through the substantive obligations in the text of the WTO Agreement and its annexes, enforced through the DSU. Article 3.2 also provides that DSB rulings and recommendations "cannot add to or diminish the rights and obligations provided in the covered agreements".

4.391 In view of the United States, neither the facts nor findings of *India - Patents (US)* support the EC position. As described above, that case stands strongly for the proposition that obligations may not be divined from vague and free-standing notions such as "uncertainty" divorced from the agreement's text.<sup>260</sup> Nor in its specifics does *India - Patents (US)* support the EC's position that such an "uncertainty" principle may be found in the text of Article XVI:4. The *India - Patents (US)* Appellate Body report refers to Article XVI:4 only in the context of reinforcing the fact that India's WTO obligations dated from 1 January 1995, and could not be delayed.<sup>261</sup> There is no reference in the report to an obligation in Article XVI:4 to avoid "uncertainty". Rather, the obligation in Article XVI:4 is to comply with the obligations of the annexed Agreements.

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<sup>259</sup> Appellate Body Report on *EC – Hormones*, op. cit., para. 165 and footnote 154, citing *Oppenheim's International Law*, 9<sup>th</sup> ed., at 1278.

<sup>260</sup> The United States refers to Appellate Body Report on *India - Patents (US)*, op. cit., para. 45.

<sup>261</sup> The United States refers to id., paras. 78-84.

4.392 The United States argues that the *India – Patents (US)* discussion of mandatory/discretionary legislation in no way modifies that doctrine. That case, like the *Malt Beverages* case before it, stands for the proposition that the non-application of mandatory legislation does not render that mandatory legislation non-actionable.<sup>262</sup> The issue in *India - Patents (US)* was whether India's unpublished, unwritten "administrative instructions" prevailed over mandatory legislation which prohibited India from complying with its TRIPs obligations.<sup>263</sup> The Appellate Body found that because of this conflict, the administrative instructions did not create a sound legal basis to preserve the novelty and priority of patent applications.<sup>264</sup> Even then, however, the Appellate Body emphatically rejected the position that a Member is required to remove any reasonable doubts regarding whether a patent application could be rejected.<sup>265</sup>

4.393 The United States explains that the *India - Patents (US)* case thus offers no support for the EC position that Article XVI:4 provides for a new definition of mandatory legislation to be determined based on the legislation's "design, structure and architecture". In fact, *India - Patents (US)* undermines the EC's position. The analysis of whether Sections 301-310 is consistent with WTO Agreement Article XVI:4 must be based on the text of that provision. The ordinary meaning of Article XVI:4 is that a law, regulation or administrative procedure is not inconsistent with Article XVI:4 unless it is also inconsistent with a separate obligation of a covered agreement. Sections 301-310 are not inconsistent with any such provision, and are therefore consistent with Article XVI:4.

4.394 **In response, the European Communities argues** that as the Appellate Body has indicated in the *Japan - Alcoholic Beverages* case following its earlier decision in the *US - Gasoline* case, the principle of effectiveness (*ut res magis valeat quam pereat*) is a

"fundamental tenet of treaty interpretation flowing from the general rule of interpretation set out in Article 31".

4.395 The European Communities contends that with this rule in mind, the correct interpretation of Article XVI:4 of the Marrakech Agreement could not be such as to read this provision just as a useless *replica* of the obligations under the covered agreements. Such an interpretation would reach the non-permissible effect of rendering "whole clauses of a treaty redundant".

4.396 Thus, in the view of the European Communities, the US following assertion cannot be correct:

"[T]he ordinary meaning of Article XVI:4 is that a law, regulation or administrative procedure is not inconsistent with Article XVI:4 unless it is also inconsistent with a separate obligation of a covered agreement".

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<sup>262</sup> The United States refers to Panel Report on *India - Patents (US)*, op. cit., para. 7.35.

<sup>263</sup> The United States refers to Appellate Body Report on *India - Patents (US)*, op. cit., paras. 60-62.

<sup>264</sup> *Ibid.*, paras. 69-70.

<sup>265</sup> *Ibid.*, para. 58. The United States notes that the Appellate Body stated, "[W]e do *not* agree with the Panel that Article 70.8(a) requires a Member to establish a means 'so as to eliminate any reasonable doubts regarding whether mailbox applications and eventual patents based on them could be rejected or invalidated .... In our view, India is obliged, by Article 70.8(a), to provide a legal mechanism for the filing of mailbox applications that provides a sound legal basis to preserve ... novelty ... and priority of the applications .... No more". (Emphasis in original)

4.397 The European Communities argues that "discretionary" legislation is not as such defined under any of the WTO agreements. There is thus no textual basis in any of the WTO agreements to distinguish between "discretionary" and other legislation of a WTO Member.

4.398 The European Communities goes on to state that the relevance in the WTO legal system of a definition of discretionary legislation lies in the fact that WTO Members frequently adopt open-ended legislation, which delegates powers to the executive branch of government. This legal phenomenon should not, in our view, be sidelined or underestimated.

4.399 According to the European Communities, in addressing this issue, a balance must be struck between two basic sets of principles of WTO law and of public international law: on the one hand, the obligation to ensure the protection of "the security and predictability of the multilateral trading system" (Article 3.2 of the DSU) by "ensuring the conformity of [domestic] laws, regulations and administrative procedures" (Article XVI:4 of the Marrakech Agreement) through a "sound [domestic] legal basis" (Appellate Body Report on *India - Patents (US)*).

4.400 The European Communities maintains that on the other hand, the (rebuttable) presumption of compliance according to which one may not assume that WTO-Members' authorities will fail to implement their WTO obligations in good faith.

4.401 The European Communities argues that in this legal perspective, it is impossible to accept the US approach which would require WTO panels to mechanically continue past panel practice based on a legal situation which is no longer in force. The European Communities cannot, on the other extreme of the *spectrum*, go as far as Hong Kong, China has done in suggesting that any "potential deviation" is in breach of Article 3.2 of the DSU, Article XVI:4 of the Marrakech Agreement and the principles developed by the Appellate Body in the *India - Patents (US)* case. This will practically deny any distinction between "discretionary" and other legislation. *In medio stat virtus* (The truth lies in the middle ground).

4.402 In the view of the European Communities, there are a number of practical criteria that would assist panels in discerning the dividing line between a "genuinely discretionary" legislation and all the other legislation.

4.403 The European Communities recalls that the presumption of compliance would be overturned by a legislation which, by its terms, design, architecture and revealing structure, is biased against compatibility or otherwise creates a conflict with the Member's WTO obligations.

4.404 The European Communities maintains that on the other hand, the fewer criteria such legislation contains and the more freedom it leaves to the executive authorities with regard to the decision-making process, in principle the less problematic such legislation is from a WTO standpoint.

4.405 According to the European Communities, an additional argument in this issue was submitted by the United States. In the US's view, all legislation that is not "mandatory" in the sense of the definition adopted by the 1949 GATT Working Party decision with respect to the "existing legislation" clause of the PPA must thus be "discretionary" and, by way of consequence, cannot be construed to be in violation of the relevant WTO obligations. This US view is obviously incorrect on several counts.

4.406 The European Communities firstly argues that as the Appellate Body has found in the *India - Patents (US)* case, the implementation of WTO obligations must take place on a "sound legal basis". This would not be the case if a given piece of legislation creates a situation biased

against WTO compatibility, because the situation created by such a piece of legislation undermines the security and predictability of the multilateral trade relations. It could also not be considered in line with the presumption of compliance, given that its text would already defeat such a presumption.

4.407 The European Communities further contends that the bias against WTO compatibility will be discernible in particular where WTO-inconsistent measures are required by the law as a rule and WTO-consistent action is permitted only as an exception under limited circumstances. In this way, the competitive opportunities, which the WTO Agreements intend to foster, cannot be achieved.

4.408 The European Communities secondly supposes that the legislation of a WTO Member provides that in a given factual situation, described in some detail in the piece of law, the executive authorities have the choice between several actions, each of them being WTO-inconsistent. While such a law may be described as "discretionary", because it allows several different types of action, such a law must nevertheless be considered WTO-incompatible, simply because it does not allow for an action of the executive authorities that is WTO-compatible.

4.409 The European Communities goes on to state that even under the GATT 1947, domestic legislation which gave the executive branch of government only a choice between several measures which all were inconsistent with the GATT 1947 would not have qualified as genuinely "discretionary" legislation. In the view of the European Communities, this is the situation that characterises the present case. This, of course, does not mean that the panel practice under the GATT 1947 still holds good under the WTO to the extent that it was based on the much narrower interpretation of "mandatory legislation".

4.410 The European Communities thirdly contends that, to come even closer to the legal situation underlying this case, it may happen that the law requires the executive authorities to take action on the basis of the results of an investigation. Suppose the fiscal authorities are required to take WTO-inconsistent action each time they find on the basis of an investigation that an act of tax fraud has been committed. Of course, the tax authorities are not "free" to abstain from finding a case of fraud and in this way avoid WTO-inconsistent action. Any other reading of such a piece of legislation would defy its intent, as expressed in the law. It should be noted in this context that it was clearly understood under the GATT 1947 that legislation could be mandatory not only by its terms but also by its expressed intent.<sup>266</sup>

4.411 Fourthly, the European Communities disagrees with the US allegation that a domestic legislation such as Section 301(a) contains sufficient discretionary powers for the executive authorities to take WTO consistent action because the highest political authorities of the WTO Member concerned, *in casu* the US President, may give directions to the administration. It would defy the purpose and the spirit of the law to consider this legislation discretionary rather than mandatory.

4.412 The European Communities recalls that Sections 301-310 provide as a rule strict time limitations on the actions of the USTR. This is in fact one of the most characteristic features of this piece of legislation. At the end of these firmly set time frames, the USTR is required to take

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<sup>266</sup> "Guide to GATT Law and Practice" (Analytical Index), 1995 edition, page 1075, penultimate paragraph.



action based on the result of the investigation initiated under section 302. Such action shall be taken "subject to the specific direction, if any, of the President regarding any such action".

4.413 In the view of the European Communities, it is simply not credible that such a clause should be understood as providing the President with the discretionary power to grant waivers on a regular basis. This would obviously run counter to the express will of the legislator, *in casu* the US Congress, by reversing the relationship between rules and exceptions. As a matter of fact, the President has never granted such a waiver.

4.414 Moreover, the European Communities notes that the vague formulations contained in Section 301(a) do not mean that the President would be entitled to direct the USTR against what she is required to do by the law itself. This provision, unlike other US legislation providing for explicit powers of the President to waive requirements of the law, states that any direction from the President concerns "any other appropriate and feasible action within the power of the President". The President does not have the power to ignore a law providing that an action must be taken within a mandatory time limit.

4.415 The European Communities claims that if on this basis Sections 301-310 were considered to be entirely discretionary and thus not capable of being challenged as such under WTO dispute settlement procedures, this would mean that an exception that was never applied in practice would be considered, from the standpoint of WTO law, as governing the entire legislation that is under scrutiny, in clear conflict with the design, architecture and revealing structure of this piece of legislation.

4.416 The European Communities submits that this cannot be correct under WTO law as a result of its enhanced requirement to "ensure the conformity" of domestic legislation under Article XVI:4 of the WTO Agreement and the requirement of a "sound legal basis" for administrative action developed from the provision contained in Article 3.2 of the DSU. These legal standards, which the United States itself has taken great pains to develop before the panel and the Appellate Body in the *India - Patents (US)* case, are of course applicable in other contexts as well.

4.417 The European Communities then concludes that under WTO law, an ill-defined exception that is not applied in practice and that goes against the main purpose of a piece of domestic legislation cannot possibly be the basis of the analysis of that piece of domestic legislation.

4.418 **The United States rebuts** the EC claim that Sections 301-310 are inconsistent with WTO Agreement Article XVI:4. The United States recalls that the European Communities asks the Panel "to rule":

"that the United States, by failing to bring the Trade Act of 1974 into compliance with the requirements of Article 23 of the DSU and of Articles I, II, III, VIII and XI of the GATT 1994, acted inconsistently with its obligations under those provisions and under Article XVI:4 of the WTO Agreement ... ".  
(emphasis added)

4.419 The United States notes that the European Communities thus acknowledges that there must be a violation of another WTO provision before there can be a violation of Article XVI:4. Unfortunately, elsewhere the European Communities argues that Article XVI:4 forms the basis of a new set of obligations not derived from the text of that provision.

4.420 In the view of the United States, WTO Agreement Article XVI:4 provides that each Member "shall ensure the conformity of its laws, regulations and administrative procedures with its obligations as provided in the annexed Agreements". By its terms, this provision does not state that there is now a "new legal environment". Nor does Article XVI:4 by its terms "creat[e] . . . an obligation to provide certainty and predictability in multilateral trade relations", as the European Communities asserts. It should be added that Article XVI:4 does not, by its terms, provide that legal findings of WTO-inconsistency may be based on transparently political attacks. The EC's contorted formulations cannot change the ordinary meaning of the text of Article XVI:4.

4.421 According to the United States, that text makes clear that the only obligation set forth in Article XVI:4 which is independent of the obligations in the annexed Agreements is that a Member "ensure the conformity" of its laws, regulations and administrative procedures with those obligations. The European Communities has explained that the definition of "ensure" is "make certain". According to the Oxford English Dictionary, it also means "make sure". Members were thus required, as of January 1, 1995, to review and make certain, to make sure, that existing laws, regulations and procedures conformed with the substantive obligations in the annexed Agreements, and where they did not, to bring them into conformity.

4.422 The United States claims that this is precisely the meaning ascribed to Article XVI:4 by the Appellate Body in *India - Patents (US)*. The United States reiterates that the Appellate Body in *India - Patents (US)* referenced Article XVI:4 in order to reinforce its finding that India's obligation to bring itself into conformity with its TRIPs obligations dated from 1 January 1995, and could not be delayed. The European Communities is thus incorrect that the US and Appellate Body interpretation of this provision renders it redundant. In reinforcing the date by which Members had an affirmative obligation to bring measures into conformity, Article XVI:4 makes crystal clear that existing laws and regulations not in conformity had to be changed, that no such measures would be "grandfathered".

4.423 The United States maintains that the European Communities takes two contradictory positions on Article XVI:4. On the one hand, the European Communities takes the position that Article XVI:4 obliges Members to structure their law in a manner that "makes certain" that Agreement violations will not occur. However, the European Communities at the same time opposes the notion that discretionary legislation must include explicit language limiting discretion so as to preclude WTO-inconsistent actions. This contradiction highlights how the EC's arguments are directed towards achieving a particular political result in this dispute, without regard to generally applicable legal reasoning or principles. The European Communities apparently wants a panel finding that Sections 301-310 must be amended to remove "uncertainty", but is unwilling to accept panel intervention requiring the European Communities to limit its unfettered authority to implement WTO-inconsistent banana regimes or hormone bans, or to stop trade at any time, for any reason, without regard to DSU requirements, pursuant to Article 133 of the Treaty of Amsterdam.

4.424 The United States notes that the European Communities claims that Article XVI:4 requires an examination of a statute's structure, design and architecture. The United States explained the Appellate Body's clear rejection of attempts to create obligations and modes of analysis based on "the design of the measure" where there is no textual basis for either. The same reasoning would apply to the EC's attempt to create a generalized obligation to provide a "sound legal basis" for the implementation of US WTO obligations. The *India - Patents (US)* and *US - Shrimp* Appellate Body reports are clear that new obligations may not be created out of thin air. The objectives of agreements are reflected in the specific obligations set forth in those agreements.

4.425 The United States then claims that the EC's analysis under Article XVI:4 ultimately degenerates into random accusations concerning past US actions not within the terms of reference of this Panel, and for which no GATT or WTO panel has made findings. The EC's discussion strips bare the utter lack of legal foundation for the EC's arguments, and reinforces the fact that its goal in this case is to obtain a political declaration by this Panel that the United States is a "bad actor", a declaration it hopes will counter the impression left by the EC's consistent pattern of disregarding its obligations in connection with its banana import regime. The European Communities particularly hopes to obtain a political declaration that the United States does not respect the multilateral dispute settlement system, to counter the impression left in the context of the *Bananas* dispute by the EC's unilateral disregard of several multilateral dispute settlement panel findings, its unilateral decision to disregard its pledge to bring its measure into compliance with these multilateral findings, and its unilateral efforts to block the operation of multilateral provisions of Article 22 through the unprecedented and extraordinary action of attempting to block the agenda of a DSB meeting. The United States regrets having been forced to raise these matters, but the EC's attacks in its Second Submission have left us no choice. The United States does not claim that these points are relevant to the Panel's legal analysis. However, neither is the EC's discussion of such matters. The question in this dispute, and the only question, is whether Sections 301-310 command the United States to violate specific WTO obligations found in the text of DSU Article 23, WTO Agreement Article XVI:4 and GATT 1994 Articles I, II, III, VIII and XI.

4.426 **The European Communities stresses** a fundamental inconsistency in the US approach. A quote from the US arguments is particularly revealing:

"Nowhere is the EC's "not genuinely discretionary" test found in WTO Agreement Article XVI:4, DSU Article 3.2, or any other provision of a covered agreement. Indeed, the EC does not claim that it does. Its test is based on extrapolation from the concept of "security and predictability" in Article 3.2 – an objective, not an obligation – and from a vague explanation of the "good faith" obligation in the VCLT – not a covered agreement".

4.427 According to the European Communities, however, the United States is incapable of showing that a distinction between mandatory versus discretionary legislation which constitutes the basis of its defence, can – to use the United States' own terms – be "found in WTO Agreement Article XVI:4, DSU Article 3.2, or any other provision of a covered agreement".

4.428 The European Communities claims that the United States is incapable of quoting any legal basis in WTO law in support of its defence simply because this legal basis does not exist. This becomes even clearer when the United States argued that:

"[T]he *Superfund* panel referred neither to prior panel reports, nor to the Protocol, in making its finding regarding discretionary legislation".

4.429 The European Communities maintains that logically, there is no legal basis under the WTO which allows the United States to insist that GATT 1947 precedents like the *Superfund* case are applicable *sic et simpliciter* to this case.

4.430 The European Communities accepts that, in general, the reasoning followed by panels when interpreting provisions of the GATT and, after the entry into force of the Marrakech Agreement, of the WTO agreements may constitute an extremely valuable source of inspiration for subsequent panels dealing with identical or similar issues of law. However, this cannot be

mistaken with an implicit obligation of panels, of this Panel, to mechanically apply panel practice developed under the GATT 1947 that has lost its basis under WTO law.

4.431 The European Communities recalls that the Appellate Body has entirely dismissed the existence of the principle *stare decisis* within the WTO legal system in the *Japan - Alcoholic Beverages* report (quoted selectively by the United States):

"a decision to adopt a panel report did not under GATT 1947 constitute agreement by the CONTRACTING PARTIES on the legal reasoning in that panel report. The generally-accepted view under GATT 1947 was that the conclusions and recommendations in an adopted panel report bound the parties to the dispute in that particular case, but subsequent panels did not feel legally bound by the details and reasoning of a previous panel report.

We do not believe that the CONTRACTING PARTIES, in deciding to adopt a panel report, intended that their decision would constitute a definitive interpretation of the relevant provisions of GATT 1947. Nor do we believe that this is contemplated under GATT 1994".

4.432 The European Communities goes on to state that in contrast to the legal situation in WTO law, under the GATT 1947 a legal basis providing for a distinction between mandatory and discretionary legislation existed. It was the Protocol of Provisional Application and, in particular, its "existing legislation" clause as interpreted already in 1949 by a working party report adopted by the GATT CONTRACTING PARTIES:

"The working party agreed that a measure is so permitted, provided that the legislation on which it is based is by its terms or expressed intent of a mandatory character - that is, it imposes on the executive authority requirements which cannot be modified by executive action".

4.433 The European Communities then concludes that the "mandatory legislation" requirement evolved under the GATT 1947 as an interpretation of the "existing legislation" clause of the PPA. The GATT 1947 panel practice was therefore a development based on that fundamental initial decision within that specific context.

4.434 The European Communities argues that GATT 1947 standards to determine whether a legislation was mandatory were

- (a) the "text" and the "expressed intent" of the legislation and
- (b) the further requirement that the obligations imposed upon "the executive authorities" could not "be modified by executive action".

4.435 The European Communities, referring to the US argument that:

"It is not necessary to examine whether the character of the Member enacting the legislation is bad, whether that party had a WTO-inconsistent motive",

argues that this statement contradicts the interpretation of the GATT CONTRACTING PARTIES of mandatory legislation under the strict interpretation pursuant to the "existing legislation" clause of the PPA. It also contradicts the United States' own interpretation as

expressed already 50 years ago during the discussions leading to the 1949 Working Party report on the "existing legislation" clause of the PPA:

"... The United States representative suggested the addition of the words 'without departing from the intent of a measure embodied in the legislation' to the last sentence cited, so as to cover the case of legislation which was mandatory in intent but couched in permissive terms. ... It was agreed that the United States position would be met by the insertion of the wording 'by its terms or expressed intent' ".<sup>267</sup>

4.436 In the view of the European Communities, in the specific legal situation under the PPA, the strict interpretation of mandatory legislation had a decisive influence on the examination of domestic legislation by the GATT 1947 panels.

4.437 The European Communities then claims that the only possible way for a GATT 1947 panel to "marry" the limitation of the "existing legislation" clause of the PPA (aimed at applying the GATT 1947 as broadly as possible) with the need to control the implementation of the consequently broadly-defined discretionary legislation was, in extreme cases such as the *US – Superfund* case or the *EEC Parts and Components* case, to obtain from the defendant political assurances concerning the exercise of the executive power in the future.

4.438 According to the European Communities, for the rest, the United States does not contest the central point made by the European Communities that all the other GATT 1947 panel reports dealing with the issue of mandatory versus discretionary legislation made either direct reference to the PPA (or to the identical provisions in the Protocols of accession) or were based on panel precedents directly referring to the PPA. This is the objective legal context in which all these panels took their decision.

4.439 The European Communities points out that it was simply not necessary for the GATT 1947 panels to base every decision concerning this issue specifically on the "existing legislation" clause of the PPA as soon as they had already accepted, often without any further legal analysis, to apply that distinction based directly or by reference on the interpretation of the "existing legislation" clause of the PPA. When reading all the GATT 1947 panel reports that the European Communities has quoted with this approach in mind, it is clear that the US simply misses the point.

4.440 The European Communities maintains that the legal situation under WTO law is fundamentally different. The PPA and its "existing legislation" clause are no longer in force. Rather, an opposite obligation has been agreed by the Uruguay Round participants according to which the conformity of the domestic (even pre-existing) legislation must be ensured as from 1 January 1995.

4.441 The European Communities further argues that the insertion in the text of Article XVI:4 of the Marrakech Agreement of the terms "regulations and administrative procedures" renders from now on impossible the application of the third standard under the GATT 1947 definition of mandatory legislation, i.e. that the obligations imposed upon " the executive authorities" could not "be modified by executive action". In fact, regulations and administrative procedures are

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<sup>267</sup> "Guide to GATT Law and Practice" (Analytical Index), 1995 edition, page 1075, penultimate paragraph.

acts typically within the full powers of the executive authorities that, by definition, can always modify them "by executive action".

4.442 **The United States disagrees** with the European Communities that the European Communities is asking this Panel to disregard decades of GATT/WTO jurisprudence and practice in the name of "security and predictability". In *Japan – Taxes on Alcoholic Beverages*, the Appellate Body explained,

"Article XVI:1 of the *WTO Agreement* and paragraph 1(b)(iv) of the language of Annex 1A incorporating the GATT 1994 into the *WTO Agreement* bring the legal history and experience under the GATT 1947 into the new realm of the WTO in a way that ensures continuity and consistency in a smooth transition from the GATT 1947 system. This affirms the importance to the Members of the WTO of the experience acquired by the CONTRACTING PARTIES to the GATT 1947 – and acknowledges the continuing relevance of that experience to the new trading system served by the WTO. Adopted panel reports are an important part of the GATT *acquis*. They are often considered by subsequent panels. They create legitimate expectations among WTO Members, and, therefore, should be taken into account where they are relevant to any dispute".<sup>268</sup>

4.443 The United States contends that WTO Members were most certainly aware of the discretionary/mandatory distinction when they signed the Marrakesh Agreement, and panels have continued to apply it. In the DSU review, the European Communities has even asked that WTO Members agree to remove it.<sup>269</sup> However, the European Communities now asks this Panel, five years after the conclusion of the Uruguay Round, to discard a fundamental principle of jurisprudence and create uncertainty as to the WTO-consistency of an indeterminate number of domestic laws heretofore considered discretionary. Even if "security and predictability" were themselves an independent WTO obligation, it would be difficult to conclude that a law which permits WTO-consistent action in every instance would do more harm to "security and predictability" than what the European Communities now proposes. Beyond this, the European Communities simply fails in its attempt to argue that "discretionary means mandatory" because of changes under the WTO Agreement.

4.444 With regard to the textual basis for the mandatory/discretionary distinction, the United States refers to the text of DSU Article 23.2(a). That Article deals with "determinations to the effect that a violation has occurred". It prohibits Members from making these determinations without following DSU rules and procedures, and these determinations must be consistent with findings in panel and Appellate Body reports adopted by the DSB.

4.445 In the view of the United States, there is no "determination to the effect that a violation has occurred" before the Panel in this case. The European Communities does not challenge a determination which has actually been made. It is therefore not possible to analyze whether such a determination meets the requirements of Article 23.2(a). One cannot say whether, in making such a determination, the United States followed DSU rules and procedures, nor

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<sup>268</sup> Appellate Body Report on *Japan – Alcoholic Beverages*, op. cit., p. 14.

<sup>269</sup> See *Review of the Dispute Settlement Understanding*, Non-Paper by the European Communities (Oct. 1998) (emphasis added); see also, *Review of the DSU*, Note by the Secretariat, Compilation of Comments Submitted by Members – Rev. 3 (12 December 1998).

whether the United States made a determination consistent with DSB-adopted findings. Neither the findings nor the determination exist.

4.446 The United States asks how the Panel can perform its analysis under these circumstances. In the absence of a concrete determination, how is it possible to know whether a Member has breached its obligations under Article 23.2(a)? It is not permissible to speculate about how the Member will make its determination in the future. It is not permissible to look at determinations made in the past which are not within the terms of reference. It is not permissible to assume that certain Members are not to be trusted. It is not permissible to assume that they will act in bad faith. Under these circumstance, must the conclusion be that without a concrete determination, there can be no violation of Article 23.2(a)?

4.447 The United States points out that over 10 years ago, in 1987, a GATT panel wrestled with this type of question. It looked at a statute which would not go into effect for another three years and asked, may a panel determine whether this law is inconsistent with a party's GATT obligations when it is possible that the party may change the law before it goes into effect? The panel's conclusion was that it could, but it was very careful in how it drew this conclusion. The panel found that only if a statute commands a party's authorities to violate a specific GATT obligation could that statute be found inconsistent with that obligation. In enacting such legislation, the party crossed a line. It left itself with no choice but to violate its obligations, even if only at some point in the future. Conversely, the panel found, if a statute does not command the party's authorities to violate a specific GATT obligation, it is not possible to conclude that the statute violates that obligation. The party may exercise its discretion so as to comply with its international obligations. Any other conclusion would be speculation as to whether the party will act in bad faith, speculation with no more foundation than if the statute did not exist at all.

4.448 The United States again states that the reasoning of the *Superfund* panel made very good sense. It was so good that at least five GATT panels adopted it as their own. At least three WTO panels have also adopted it. And none of those panels in any way revised the core question asked by the *Superfund* panel: does the statute command, does it mandate, a violation of a specific agreement obligation?

4.449 The United States further argues that the *Superfund* analysis is not an analysis of character. It is not necessary to examine whether the character of the Member enacting the legislation is bad, whether that party had a WTO-inconsistent motive. Nor is it necessary to examine whether the "character" of the legislation is bad, whether the legislation reflects an intent to breach WTO-obligations. All that matters is whether the law commands an action which violates a specific textual obligation. Absent such a command, the Panel is left with the fundamental problem – there is nothing that can be said to violate a specific textual obligation. Legislation which leaves open the possibility of a violation cannot be considered a violation, any more than may a constitutional system which provides broad authority to act. However, by including a specific command in legislation to violate a specific obligation, the legislation itself becomes that violation.

4.450 In response to the Panel's request for any *travaux preparatoires* that may be relevant for an interpretation of Article XVI:4 of the WTO Agreement, the United States first indicates that there was no decision to create any official *travaux preparatoires* for the Marrakesh Agreement Establishing the WTO. The discussions of October and November 1993, when the most contentious and politically sensitive issues in the WTO Agreement text were settled, were conducted orally in small meetings that did not include all delegations. Some issues, including the final wording of Article XVI:4, were resolved in plurilateral working groups that were

smaller still. When the plurilateral subgroups reported to the larger Institutions Group, some delegations objected to having written documents become part of a negotiating history, because if there were to be an official negotiating history, its importance would be such that its contents would have to be negotiated line by line, and this added burden was clearly impossible given the November 15, 1993 deadline for finishing the Institutions Group's work. In any event, absent a complete picture of every note and proposal from every delegation, it would be difficult to obtain an accurate picture of the parties' intentions. For these reasons, the Chairman, Ambassador Julio Lacarte, announced during these discussions that no negotiating history would be issued and all trade-offs had to be made in the text of the agreement itself.

4.451 According to the United States, the informal record of the final negotiations on the "MTO Agreement" (as it was known at the time) therefore is incomplete, and consists only of a series of "room" documents circulated in the room where the Institutions Group met, and the notes of individual negotiators. No official summary of these meetings was prepared, and no documents prepared for negotiating sessions were collected as an official negotiating record.

4.452 The United States then provided the following documents as US Exhibit 23:

- (a) Draft Agreement Establishing the Multilateral Trade Organization, Informal Note by the Secretariat (Third Revised Text of the MTO Agreement (27 May 1992);
- (b) Comparison of the Second and Third Revised Texts of the Draft Agreement Establishing the Multilateral Trade Organization (27 May 1992) (Document 551).
- (c) Draft of Article XVI:4 (11 November 1993).
- (d) Excerpt from Daily Report From US Negotiator on MTO Issues, Including Article XVI:4 (November 11, 1993).
- (e) Draft of Article XVI:4 (12 November 1993).
- (f) Draft Agreement Establishing the Multilateral Trade Organization, Revised Text (14 November 1993).
- (g) Draft Agreement Establishing the Multilateral Trade Organization (24 November 1993).

4.453 The United States explains that the Dunkel Draft Final Act included the text of an Agreement Establishing a Multilateral Trade Organization (MTO), with the caveat that the MTO text required further elaboration "to ensure a proper relation to the other results of the Uruguay Round". Participants in the negotiations generally understood that further negotiation concerning establishment of an organization would be required. Negotiations proceeded from February through December 1992 with additional problems being raised with the draft text. The Secretariat produced a "third revised text" on May 27, 1992 and a comparison document (document 551), which the United States has included in Exhibit 23. When work on the MTO text intensified in September 1993, the May 1992 text was the starting point.

4.454 In the view of the United States, two points relevant to the negotiating history of Article XVI:4 must be noted from the "third draft" document that the Secretariat produced. First, the language states that



"[T]he Members shall endeavor to take all necessary steps, where changes to domestic laws will be required to implement the provisions of the agreements annexed hereto, to ensure the conformity of their laws with these agreements" (emphasis added)

4.455 According to the United States, it was the view of several delegations, including the United States, that this language required a government to take the relevant procedural steps to implement the other agreements negotiated in the Uruguay Round. Moreover, use of the term "endeavor" called into question the obligatory nature of even this limited undertaking.

4.456 Second, the United States claims that while it merely questioned the need for this provision, other delegations actively opposed the provision as indicated in the remarks column of the May 1992 document. The document states that "Further discussions are necessary to determine whether the provision should be retained, deleted, reformulated or moved into the Final Act". This comment is unique in this document.

4.457 The United States points out that while the European Communities correctly notes that the use of the term "endeavor" in the third draft called into question the obligatory nature of this undertaking, it neglects to explain several steps in the negotiating process which followed. As described below, when the term "endeavor" was removed, the trade-off was removal of terms including "taking all necessary steps" and the clarification that only obligations were subject to this provision (through inclusion of the phrase "obligations as provided in the annexed agreements").

4.458 The United States goes on to state that in the fall of 1993, the "Lacarte Group" working on institutional issues held several discussions of Article XVI:4. During these negotiations, the European Communities recognised the weakness of the "endeavor" language and proposed to delete the "endeavor" language and make the provision mandatory.

4.459 The United States further points out that several objections were raised. Brazil and other Latin delegations with legal systems providing for "direct incorporation" of certain international agreements into their law were concerned that the draft language could require them to attempt to enact laws on matters of extreme sensitivity. Second, delegations with federal systems, such as Canada, Brazil and the United States, questioned the interaction between the new language and provisions in Article XXIV:12 of GATT 1994 and GATS Article I:3(a). These provisions related to measures of regional and local governments and require national governments to take "such reasonable steps as may be available to it" to ensure compliance.

4.460 In the view of the United States, direct negotiations between those delegations and the European Communities took place in November 1993. Our negotiators' notes show that as of November 11<sup>th</sup>, the EC's latest proposal – "The Members shall take all necessary steps to ensure the conformity of their laws, regulations and administrative procedures with the provisions of the annexed agreements, in accordance with their individual constitutional or legal systems" – was rejected because it was seen to weaken the duty under international law to implement agreements.<sup>270</sup>

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<sup>270</sup> See Daily Report From U.S. Negotiator on MTO Issues, Including Article XVI:4 (November 11, 1993).

4.461 The United States notes that the European Communities on the following day (November 12) proposed that the language read, "The Members shall ensure the conformity of their laws, regulations and administrative procedures with the provisions of the annexed Agreements". This draft, as well, was opposed by Brazil and others. It was incorporated in brackets into a November 14 draft of the agreement as a whole, along with the note, "For further consideration".

4.462 The United States further explains that the draft Agreement Establishing the Multilateral Trade Organization of 24 November 1993 includes bracketed language on Article XVI:4 that was ultimately agreed upon.<sup>271</sup> This language included the phrase "obligations as provided in the annexed agreements", limiting language making clear that an expansive interpretation of Article XVI:4 was not intended. On the basis of the inclusion of this term, (and the earlier removal of EC language which would have created a weaker obligation than that under VCLT Article 26), the Members agreed to include Article XVI:4 in the WTO Agreement.

4.463 The United States points out that a final point is that, near the end of the negotiations on this provision, Brazil and other delegations asked the EC legal expert who was present how this provision differed from Article 26 of the Vienna Convention. The EC's legal adviser did not identify a difference or distinction.

4.464 The United States further indicates that on the other hand, shortly afterward, this same legal adviser provided the following views on Article XVI:4:

"A provision that has been championed to a large extent by the Community, but which may have serious consequences for the Community itself, and for the Member States too, is Article XVI:4 of the WTO. . . . This may turn out to be a very onerous obligation, requiring full conformity of all Community and national laws . . . with the precise provisions of the WTO's annexes. It may also have hardly any consequences at all, compared to the present situation, if it is interpreted in the light of standing panel case law which determines that a law or regulation is contrary to the GATT only if it is mandatory and as such contrary to GATT terms, but that such is not the case, if the text of the law or regulation permits a GATT conform [sic] application of the text.<sup>272</sup> If conformity to WTO obligations is interpreted in this way - which would not be unreasonable in the light of the succession of the WTO to the «acquis gattien»<sup>273</sup> - it should be clear that the added value of Article XVI:4 is rather limited".<sup>274</sup>

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<sup>271</sup> The United States notes that the only changes were the modifications to number and tense made throughout the WTO Agreement during the legal review in early 1994.

<sup>272</sup> See the Panel Report on *US - Superfund*, op. cit., para. 5.2.9. and the Panel Report on *EEC - Part and Components*, op. cit., para. 5.25-26. (Citation in original. The United States specifically requests the Panel to note that no reference is made to the Protocol of Provisional Application, or to cases citing the Protocol of Provisional Application.)

<sup>273</sup> (citation in original) See Article XVI:1 of the WTO Agreement.

<sup>274</sup> Pieter-Jan Kuyper, *The New WTO Dispute Settlement System: The Impact on the Community, in The Uruguay Round Results, A European Lawyers' Perspective* 87, 110 (Jacques H.J. Bourgeois, Frédérique Berrod & Eric Gippini Fournier eds. 1995) (emphasis added) (US Exhibit 25).

4.465 The United States notes that the EC legal adviser stated in a footnote that the conclusion that the value of Article XVI:4 is "rather limited" "is the view of the author himself".<sup>275</sup> He went on to note that if a more expansive view of Article XVI:4 were adopted, "it must be clear that the European Communities and the Member States have an obligation to maintain their laws and regulations in constant conformity with the terms of the WTO Agreement and its annexes. That is no simple matter".<sup>276</sup>

4.466 According to the United States, this Article provides a nearly contemporaneous record of the understanding of the legal adviser to the EC negotiators, who was the chief GATT lawyer in the EC Legal Service and a former professor of public international law. While he earlier could not explain the difference between Article XVI:4 and VCLT Article 26, he shortly afterward recognised that Article XVI:4 would have a limited impact, and that, were a contrary interpretation adopted, it would be highly disruptive to the sovereignty of WTO Members, including the EC itself. The EC lawyer also expressed his expectation that the *Superfund* reasoning would not be affected by Article XVI:4; indeed, he was relying on this conclusion.

4.467 **The European Communities challenges** the US quote from an article written by Mr. Pieter-Jan Kuyper in his personal capacity<sup>277</sup> in order to contest the EC's interpretation of Article XVI:4 of the WTO Agreement. The United States purposefully omits to indicate that the quotation stems from a chapter of the article dealing with the relations between the European Communities and its member States. It is with this concern in mind that the author refers to the potential burden imposed on the European Communities by Article XVI:4 of the WTO Agreement, and not in the much more general way that the United States would have it now.

4.468 The European Communities also argues that the conclusion drawn by the United States from this article is also quite wrong (and in contradiction with the internal meeting report of 11 November 1993 by the US delegate, Mr. Andy Shoyer, cf. US Exhibit 23). The European Communities never considered the final version of Article XVI:4 of the WTO Agreement to be of limited impact because, as is clear from the developments the European Communities described in this proceeding and the internal meeting report of the United States, the European Communities always strove for and finally achieved substantial strengthening of what is now Article XVI:4 of the WTO Agreement.

4.469 The European Communities adds that when writing his article based on a conference held in Bruges in October 1994, Mr. Kuyper for obvious reasons could not be aware of the legal development that occurred in the *India - Patents (US)* case where the Appellate Body found that WTO Members are required to provide a sound legal basis in their domestic law in order to ensure conformity with the covered agreements.

4.470 **The United States challenges** the EC suggestion that it is somehow significant that Mr. Pieter-Jan Kuyper drew his conclusions concerning Article XVI:4 in the context of a discussion of the relations between the European Communities and its Member States, and that his statements concerning "the potential burden imposed on the European Communities" by the interpretation of Article XVI:4 that the European Communities now posits must be understood

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<sup>275</sup> Ibid. at footnote 46.

<sup>276</sup> Ibid. at 110.

<sup>277</sup> Pieter-Jan Kuyper, *The New WTO Dispute Settlement System: The Impact on the Community*, in: J.H.J. Bourgeois *et al.*, *The Uruguay Round Results, A European Lawyers' Perspective*, p. 87, publishing the papers of a conference held in Bruges in October 1994.

in this context. The European Communities appears to be arguing that Mr. Kuyper's conclusions, and a panel's, should depend on whether the defending party in a particular dispute is the United States or the EC. If the defending party is the EC, then the *Superfund* rule should continue to be applied (as Mr. Kuyper anticipated it would in 1995<sup>278</sup>), and the "burden on the European Communities" (i.e. the *in dubio mitius* principle, as the United States already argued) would be relevant. However, as the United States emphasised, the law must apply equally to all parties, and at all times. The Panel must reject the EC's self-serving, *post hoc* reassessment of its legal position on Article XVI:4 and its attempt to apply a double standard.

4.471 The United States further states that with respect to the EC's argument that it always sought a "strengthened" Article XVI:4, the United States notes that what the European Communities sought is not what it actually got. In fact, as already discussed, in seeking a "strengthened" Article XVI:4, the European Communities on several occasions proposed language which would have unintentionally resulted in an obligation weaker than that found in VCLT Article 26. Moreover, as the United States pointed out, Mr. Kuyper as the legal adviser to the EC negotiators was unable to explain the difference between Article XVI:4 and VCLT Article 26 when Brazil and other delegations requested such an explanation towards the close of negotiations.

4.472 In response to the Panel's question as to what would be different in a legal universe without Article XVI:4, the United States claims that by definition, Article 1(a) and (b) are applicable only to the GATT 1994, and not to other WTO Agreements such as the General Agreement on Trade in Services (GATS) and the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs). Article XVI:4 therefore provides an overarching statement in the WTO Agreement, clearly applicable to all annexed agreements and not just the GATT 1994, that no measures are grandfathered. Article XVI:4 thus serves to remove any doubt which might have existed in its absence that all measures must be brought into conformity as from January 1, 1995.

4.473 The United States recalls its argument that it was precisely in this manner and for this purpose that the Appellate Body cited Article XVI:4 in *India - Patents (US)*. In that case, India attempted to argue that it could delay changing its law as required by TRIPs Article 70.9 because of differences between the language of that provision and that of other TRIPs articles. Specifically, India claimed that while other TRIPs provisions explicitly required changes to domestic laws, Article 70.9 did not.<sup>279</sup>

4.474 The United States notes that the Appellate Body rejected this argument, stating at the outset of its discussion, "India's arguments must be examined in the light of Article XVI:4 of the *WTO Agreement*", and then quoting this provision.<sup>280</sup> Article XVI:4 thus assisted in clarifying that India could not rely on claimed differences in agreement language to delay compliance.

4.475 According to the United States, beyond serving this overarching function of providing context for other agreement provisions, Article XVI:4 imposed an obligation on Members to

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<sup>278</sup> According to the United States, Mr. Kuyper's reliance on the *Superfund* reasoning, like that of Mr. Roessler and Professor Jackson, highlights the importance of the Appellate Body's conclusion that adopted panel reports "create legitimate expectations among WTO Members, and, therefore, should be taken into account where they are relevant to any dispute". Appellate Body Report on *Japan - Alcoholic Beverages*, op. cit., p. 14.

<sup>279</sup> Appellate Body Report on *India - Patents (US)*, op. cit., para. 78.

<sup>280</sup> Ibid., para. 79.

review existing legislation at the time the Agreement was to enter into effect to make sure that existing laws, regulations and administrative procedures did, in fact, conform to the Members' WTO obligations, and where those laws did not, to bring them into conformity.

4.476 In response to the Panel's further question as to what would be the use and meaning of Article XVI:4 if no difference would exist, with or without Article XVI:4, the United States argues that in respect of the application *ratione temporis* of the WTO Agreement nor in respect of "grandfathering" or the removal of mandatory legislation, the United States states that Article XVI:4 does provide additional clarity with respect to the need to bring non-conforming measures into conformity as from January 1, 1995. The Appellate Body in *India - Patents (US)* found this provision useful in clarifying potential ambiguities in other provisions which might be read to permit delayed implementation. The provision also serves the useful function of establishing, under the umbrella of the WTO Agreement, that none of the annexed agreements – and not just the GATT 1994 – are subject to grandfathering.

4.477 The United States adds that through the provisions of Article XVI:4, the principles of Article 26 of the Vienna Convention on the Law of Treaties became legally binding on all Members of the WTO, even though not all Members are parties to the Vienna Convention.<sup>281</sup>

4.478 The United States further argues that beyond this, another function of Article XVI:4 is suggested by comments by Frieder Roessler, formerly the Director of the Legal Affairs Division of the GATT Secretariat, who explained:

"There are similar provisions [to Article XVI:4] in the Tokyo Round Agreements on Anti-dumping and Subsidies<sup>282</sup>, which have generally been interpreted as requiring the parties to these Agreements to adopt laws, regulations and procedures that permit them to act in conformity with their obligations under these Agreements. The main function of these provisions was to permit the committees established under these Agreements to review the law of the parties and not merely the practices followed under that law".<sup>283</sup>

4.479 The United States also asserts that likewise, the inclusion of Article XVI:4 makes clear that the laws of Members, and not just the application of these laws, may be the subject of reviews conducted in various WTO committees.

4.480 The United States further notes that in *EC – Bananas III*, the Appellate Body examined Article 4.1 of the Agreement on Agriculture, which provides:

"Market access concessions contained in Schedules relate to bindings and reductions of tariffs, and to other market access commitments as specified therein".

4.481 The United States notes that the European Communities argued that Article 4.1 is a substantive provision, which, read in context of Article 21.1 of the Agreement on Agriculture

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<sup>281</sup> The United States points out as an example that it is not a party.

<sup>282</sup> (Footnote in original) Article 16(6) of the Anti-Dumping Code and Article 19(5) of the Agreement on Subsidies and Countervailing Duties.

<sup>283</sup> Frieder Roessler, *The Agreement Establishing the World Trade Organization, in The Uruguay Round Results, A European Lawyers' Perspective* 67, 80 (Jacques H.J. Bourgeois, Frédérique Berrod & Eric Gippini Fournier eds. 1995)(emphasis added).

(providing that the provisions of the GATT 1994 "shall apply subject to the provisions of this Agreement"), demonstrates that Schedules of concessions supersede the requirements of GATT 1994 Article XIII.<sup>284</sup> Accordingly, the European Communities contended that the tariff rate quotas provided for in its Schedule would not be subject to Article XIII.<sup>285</sup> The Appellate Body disagreed. It concluded, "Article 4.1 does no more than merely indicate where market access concessions and commitments for agricultural products are to be found".<sup>286</sup> The Appellate Body went on, "If the negotiators intended to permit Members to act inconsistently with Article XIII of the GATT 1994, they would have said so explicitly".<sup>287</sup>

4.482 The United States claims that the Appellate Body's interpretation of Article 4.1 illustrates the fact that sometimes an agreement provision may serve a limited purpose, and that obligations should not be extracted from a provision unless the language explicitly supports that interpretation. Likewise, Article XVI:4 does not by its terms provide that there is an obligation to "provide security and predictability", and such an obligation must not be inferred merely to augment the utility of Article XVI:4.

4.483 The United States refers again to Professor Jackson's testimony at the Senate Finance Committee, in which he concludes, "There may need to be some alterations to some time limits, or transition measures, but the basic structure of 301 is not necessarily inconsistent with the Uruguay Round results", and that even when Section 301 is considered "in its current statutory form" (i.e. before the 1994 amendments), "the Executive appears to have the discretion to apply actions under Section 301 in a manner consistent with the proposed new rules of the Uruguay Round dispute settlement understanding".<sup>288</sup> Professor Jackson thus considered that with only minor changes, Section 301 would be consistent with the WTO obligations of the United States. He clearly did not believe that any provision of the WTO Agreement or its annexes, including Article XVI:4, would require significant changes to the statute.

4.484 In response to the Panel's question as to the situation in which a Member can be found to be in breach of Article XVI:4, the United States argues that in precisely that manner set forth by the European Communities. There it asked the Panel to rule :

"on the basis of these findings [with respect to DSU Article 23 and GATT Articles I, II, III, VIII and XI] that the United States, by failing to bring the Trade Act of 1974 into compliance with the requirements of Article 23 of the DSU and of Articles I, II, III, VIII and XI of the GATT 1994, acted inconsistently with its obligations under those provisions and under Article XVI:4 of the WTO Agreement ...". (emphasis added)

4.485 In the view of the United States, in other words, the fact that a Member has not brought into conformity a measure inconsistent with its obligations in an annexed agreement would constitute a breach of Article XVI:4. For example, the TRIPS Agreement obligates WTO Members to grant a term of protection for patents that runs at least 20 years after the filing date of the underlying protection, and requires each Member to grant this minimum patent term to all

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<sup>284</sup> See Appellate Body Report on *European Communities – Regime for the Importation, Sale and Distribution of Bananas ("EC – Bananas III")*, adopted 25 September 1997, WT/DS27/AB/R, para. 20.

<sup>285</sup> Ibid.

<sup>286</sup> Ibid., para. 156.

<sup>287</sup> Ibid., para. 157.

<sup>288</sup> Jackson Testimony at 200.

patents existing as of the date of application of the Agreement to that Member. Under the Canadian Patent Act, the term granted to patents issued on the basis of applications filed before October 1, 1989 is only 17 years from the date on which the patent is issued. The United States considers that by failing to bring this law into conformity with its obligations under the TRIPs Agreement, Canada has breached Article XVI:4. The same conclusion could be drawn in the case of failure to implement other provisions of the TRIPs Agreement; failure to eliminate notified TRIMs by the end of the period provided in Article 5.2 of the TRIMs Agreement; or failure to fully implement the customs valuation obligations in the Valuation Agreement.

4.486 **The European Communities emphasises** that the US arguments are both new and incorrect, as can be seen already from the internal meeting report of 11 November 1993 by the US delegate contained in US Exhibit 23. This exhibit, in particular, shows that several Uruguay Round participants, including the European Communities, worked for a strengthening of Article XVI:4 of the WTO Agreement beyond the "natural obligation under int'l law" which finds its source in Articles 26 and 27 of the Vienna Convention on the Law of Treaties. This "natural obligation" is already incorporated into the WTO by virtue of Article 3.2, second sentence, of the DSU, which provides that "[t]he Members recognise that [the dispute settlement system] serves to ... clarify the existing provisions of those agreements in accordance with customary rules of interpretation of public international law". The US reply thus appears to be an attempt to go back on the achievements of the Uruguay Round.

4.487 **The United States rebuts** the EC argument that the principles of VCLT Article 26 have already been incorporated into the WTO through DSU Article 3.2, second sentence, and that Article XVI:4 therefore need not serve this purpose. However, DSU Article 3.2 provides for the dispute settlement system to clarify WTO provisions "in accordance with customary rules of interpretation of public international law". Article 26 is not such a customary rule of interpretation. As the Appellate Body explained in *US – Gasoline* and *Japan – Alcoholic Beverages*, these rules of interpretation are reflected in VCLT Articles 31 and 32, which, indeed, are entitled "General rule of interpretation" and "Supplementary means of interpretation", respectively.<sup>289</sup> Inasmuch as Article 26 is not such a rule of interpretation, DSU Article 3.2, second sentence, may not be read to reference it. Thus, the EC argument fails to undermine the United States point that Article XVI:4 made the principles of VCLT Article 26 binding on all WTO Members, even those Members not parties to the Vienna Convention. It is worth noting that, during negotiations from 1991-1993, the United States negotiator explicitly brought to the attention of other delegations that the United States is not a party to the Vienna Convention.

4.488 The United States responds to the Panel's request to provide examples where the United States took steps in accordance with the US argument that Section 304 determinations have to be made within the 18 months time-frame but that their publications can wait completion of WTO procedure, and the Panel's question as to why the United States does not immediately publish a notice, e.g. before the end of WTO procedures, thereby assuring Members that it will await the completion of WTO procedures before making a final determination. The United States states that it cannot offer an example from the handful of Section 302 investigations which have taken place since January 1, 1995. Providing assurances is not an obligation under DSU Article 23; Article 23 itself helps to provide these assurances. In other words, the US commitment to comply with DSU Article 23, combined with the availability of effective dispute settlement procedures should the United States not comply, provides the very assurances to

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<sup>289</sup> The United States cites Appellate Body Report on *US – Gasoline*, op. cit., pp. 16-17; Appellate Body Report on *Japan – Alcoholic Beverages*, op. cit., pp. 10-12.

which the question refers. Further, although not required to by any WTO obligation, the United States has gone beyond its WTO obligations in providing assurances in the form of US legal requirements to resort to dispute settlement procedures and to base determinations that US WTO agreement rights have been denied on DSB-adopted panel and Appellate Body findings. The European Communities has acknowledged that no such obligation to limit the exercise of discretion is provided for in Article XVI:4. Nevertheless, the United States has done so. It is for this reason that Professor Jackson concluded that Section 301 "is a constructive measure for US trade policy, and for world trade policy".<sup>290</sup>

4.489 The United States indicates that any delay in publishing or issuing a determination changes none of this. The United States remains subject to its international obligation to comply with DSU Article 23 (not to actually make proscribed determinations or take action), US law continues to require reliance on DSB-adopted findings, and the dispute settlement system remains available both as a deterrent to WTO-inconsistent action and for redress of any such action. In the end, however, the question is not whether Sections 301-310 provide "adequate assurances", but whether Sections 301-310 command action inconsistent with DSU Article 23. The timing of publication, or even of the determination itself, is not relevant to this question. DSU Article 23 sets forth conditions applicable to "determinations to the effect that a violation has occurred" and to suspension of concessions. No actual determination to the effect that a violation has occurred, and no actual suspension of concessions, is before this Panel. And none is commanded by the statute which is before the Panel. There is no basis in either the text of DSU Article 23 or Sections 301-310 for a finding that this statute violates that, or any other, WTO provision cited by the European Communities.<sup>291</sup>

## 2. Section 304

### (a) Overview

4.490 **The European Communities claims** that the USTR is required to proceed unilaterally when the results of the WTO dispute settlement procedures are not available within the time limits set out in Sections 301-310.<sup>292</sup>

4.491 The European Communities first notes that Section 304(a)(2)(A) provides in relevant part:

"The Trade Representative shall [determine whether the rights to which the United States is entitled under any trade agreement are being denied] [in the case of an investigation involving a trade agreement] on or before . . . the earlier of

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<sup>290</sup> Jackson Testimony, op. cit., at 200.

<sup>291</sup> See also the parties' further arguments contained in Paragraphs 4.759-4.790 below.

<sup>292</sup> The European Communities notes that its complaint does not relate to those provisions of Sections 301-310 that are in conformity with the principles set out in Article 23. This applies in particular to Section 303(a), according to which the USTR must resort to the DSU in cases involving a WTO agreement, as well as Section 304(a)(1)(A), according to which the USTR's determination of denial of United States' rights or benefits under a WTO agreement must be based not only on the investigation and the consultations with the country concerned but also on the WTO dispute settlement proceeding, and Section 301(a)(2)(A), according to which the USTR is not required to take action in a case in which the DSB has adopted a report confirming that the defendant Member does not deny United States' rights or benefits under a WTO agreement.



- (i) the date that is 30 days after the date on which the dispute settlement procedure is concluded, or
- (ii) the date that is 18 months after the date on which the investigation is initiated".

4.492 The European Communities next states that Section 303 prescribes that the decision to initiate the investigation and the request for consultations in accordance with Article 4.3 of the DSU must normally take place on the same day. If there is a delay in the request for consultations, there is a corresponding extension of the 18-month time limitation.

4.493 The European Communities argues that Section 304(a)(2)(A) therefore mandates the USTR to make a determination 18 months after the request for consultations on the United States' denial of rights under a WTO agreement, even if the DSB has not adopted a report with findings on the matter within that time frame.

4.494 The European Communities further asserts that the text and the intent of Section 304 are that after a maximum of 18 months USTR must proceed with a determination of whether the rights of the United States have been denied, whether or not the WTO dispute settlement procedure is concluded at that time.

4.495 The European Communities points out that the text does not say anywhere that the determination must be negative if by the end of the 18 months the WTO procedure has not finished.

4.496 In the view of the European Communities, by providing explicitly that the determination must either be made 30 days after the end of the WTO procedure (in which case the result of that procedure can be taken into account) or by the end of 18 months (meaning that in certain cases the result of the WTO procedure cannot possibly be taken into account), whichever the earlier, the legislator has made clear its intention that in the latter case USTR must go ahead and make a substantive determination even though the "results" from the WTO are not yet available.

4.497 The European Communities then concludes that one must thus assume that, given the language of the law and its design, architecture and revealing structure, if the intent of the legislator were different, as the United States affirms, Congress would have said so explicitly.

4.498 The European Communities further claims that at the very least, the text is so unclear and ambiguous that economic operators and foreign governments perceive it as imposing upon the USTR an obligation to make a unilateral determination that US rights have been denied even in the absence of a WTO ruling. In that sense, the text does not provide a "sound legal basis" (for the implementation of Article 23 of the DSU) as required by the Appellate Body in the *India – Patents (US)* case.

4.499 **The United State points out** the numerous assumptions on which the EC argument rests. US Exhibit 10 is reproduced in part here, summarizes these assumptions. The United States argues that for each EC claim, all of the EC's assumptions must be correct for it to prevail, but none of them is correct

US view on EC assumptions or miscalculations

EC Claim	Relevant WTO Provisions	EC Assumptions or Miscalculations
<p>The 18-month time-frame in Section 304(a)(2)(A) requires the USTR to make a violation determination inconsistent with DSU Article 23.2(a).</p>	<p>DSU Article 23.2(a):</p> <p>(1) violation determination</p> <p>(2) not consistent with adopted panel or Appellate Body finding or arbitral award</p>	<p><b>EC Assumption (1):</b> The USTR's determination under Section 304(a)(1) must be a violation determination, even if the DSB has not yet adopted panel or Appellate Body findings.</p> <p><u>In fact, the USTR is required to base her determination on dispute settlement proceedings, and may make any of a number of determinations – including terminating an investigation – if those proceedings are not complete.</u></p> <p><b>EC Assumption (2):</b> The maximum period for dispute settlement is 19 ½ months, rather than 18.</p> <ul style="list-style-type: none"> <li>- the European Communities assumes that panels may extend proceedings by 3 months rather than 2 months;</li> <li>- the European Communities assumes that DSB meetings will always take place on the final day authorized under the DSU, even though regularly scheduled meetings take place more frequently;</li> <li>- the European Communities assumes that the United States cannot request DSB meetings.</li> </ul> <p><u>In fact, the maximum period is 18 months, and can be less given regularly scheduled DSB meetings and the fact that Members may request meetings.</u></p> <p><b>EC Assumption (3):</b> The USTR cannot initiate WTO dispute proceedings before initiating a Section 301 investigation.</p> <p><u>In fact, the USTR may initiate dispute settlement proceedings before initiating a Section 301 investigation.</u></p>

4.500 In the view of the United States, the first set of EC assumptions relates to its claim that Section 304 mandates a violation of DSU Article 23.2(a). The European Communities argues that Section 304 requires the USTR to make a determination that US trade agreement rights have been violated within 18 months of initiation of a Section 302 investigation, while the DSU provides for a longer period for completion and adoption of panel and Appellate Body proceedings in some instances.

4.501 The United States challenges the EC assumption, its most fundamental assumption, that Section 304 requires the USTR to make an affirmative determination that US agreement rights have been denied even if the DSB has not adopted panel or Appellate Body findings to this effect. It is important to recognise that Article 23.2(a) does not prohibit determinations that a violation has not occurred, nor does it prohibit accurate descriptions of a process which is under way. Article 23.2(a) prohibits determinations that another WTO Member has violated its WTO obligations unless DSU rules and procedures have been followed. In other words, Article 23.2(a) relates only to a finding of a violation.

4.502 The United States notes that the European Communities makes absolutely no attempt to explain how Sections 301-310 mandate such a determination. The European Communities

merely assumes that in determining "whether" US agreement rights have been denied, the USTR must make an affirmative determination. Unless the European Communities can explain why, under US law, this assumption is correct, it has failed to meet its burden with respect to this claim. The United States reiterates that the USTR is completely free to make any of a number of determinations, including a negative determination, if the DSB has not yet adopted panel or Appellate Body findings.

4.503 The United States notes that the European Communities also makes assumptions relating to the time frames in Section 301 and the DSU. However, because Section 304 does not mandate an affirmative determination, these time frames are simply not relevant to the Panel's decision. Nevertheless, even were this not so, the 18-month time frame in the statute would not prevent the USTR from complying to the letter with DSU rules and procedures. The EC's calculation of the time by which a panel may extend its proceedings is incorrect by one month. Moreover, the European Communities ignores the fact that DSB meetings normally are held monthly and instead assumes that DSB meetings would not be held until the final day permitted under the DSU. The European Communities also assumes that the United States would not attempt to affect the schedule of DSB meetings. Finally, the European Communities ignores the fact that Sections 301-310 do not preclude the USTR from initiating dispute settlement proceedings before initiating a Section 301 investigation. Thus, wholly apart from the fact that the European Communities cannot assume that the USTR will always make an affirmative determination, the time frames in the US statute do, in fact, permit the USTR to base her determination on adopted panel and Appellate Body findings. The DSU time frames were negotiated with this 18-month time frame in mind, and the European Communities and others were well aware of this fact during the Uruguay Round.

4.504 The United States further indicates that Section 304(a)(1) of the Trade Act of 1974 does not command the authorities of the United States of America to violate the obligations found in the text of DSU Article 23.2(a). It does not command the United States USTR to determine, within the meaning of Article 23.2(a), that another WTO Member is denying US trade agreement rights absent DSB recommendations and rulings to that effect.

4.505 The United States recalls that the European Communities asked the Panel to find that Section 304(a)(2)(A),

"is inconsistent with Article 23.2(b) [sic] of the DSU because it requires the USTR to determine whether another Member denies rights or benefits under a WTO Agreement irrespective of whether the DSB adopted a panel or Appellate Body finding on this matter". (emphasis added)

4.506 The United States emphasised that the EC's formulation is wrong because it assumes that "whether" means "that". In requiring that she make a determination of whether US trade agreement rights have been denied, the statute does not command the USTR to conclude that such rights have been denied. In the absence of a concrete determination that another Member has violated its WTO obligations, or a command in the statute to make that specific determination, there is quite simply nothing for the Panel to examine against the requirements of Article 23.2(a). The closest the European Communities has come to arguing that Section 304(a)(1) mandates a determination of breach is its statement that the Section 304(a)(1) determination must be based on the results of the Section 302 investigation. But this is no argument at all, for the investigation won't be concluded without the DSB rulings and recommendations the USTR is required to seek under Section 303(a) and is required to rely on under Section 304(a)(1), a point the European Communities was willing to acknowledge.

Section 304(a)(2)(A) is not inconsistent with DSU Article 23.2(a) because Section 304(a)(1) does not mandate a determination that a violation has occurred.

**(b) Discretion not to make a determination of violation**

*(i) Interpretation of Section 304*

4.507 **The European Communities claims** that there is nothing in Sections 301-310 that would permit the USTR to make her determinations on any other basis, for instance on the basis of a delay in the WTO dispute settlement proceedings. The United States in effect makes the astonishing claim that the USTR may determine under Sections 301-310 that no denial of rights and no failure to implement DSB recommendation occurred because the WTO dispute settlement have not been completed.

4.508 The European Communities submits that it would not be logical to interpret Sections 301-310 to authorize determinations on the WTO-consistency of measures on the basis of factors that are entirely outside the plain language of the law and, as such, irrelevant to such a determination.

4.509 The European Communities argues that Sections 301-310 as they appear on the US statute books cannot be described as discretionary legislation.

4.510 The European Communities first claims that the United States has unconvincingly claimed for example that the USTR is somehow "free" not to make a finding that US trade agreement rights have been denied in a situation where the results of an investigation undertaken under Section 302 do not support such a determination. Even less convincing is the US argument that the USTR could postpone making such a determination until after the conclusion of a WTO dispute settlement case or could terminate the investigation without making any determination at all and instead open a new investigation.

4.511 The European Communities adds that there is simply no support for any of these allegations in the relevant provisions of the 1974 Trade Act. It is striking that the United States itself does not point to any provision in the law that would bear out such a reading which goes in fact against the express terms and declared purpose of that law.

4.512 The argument of the European Communities thus is that Sections 301-310 are not genuinely discretionary in that they instruct the USTR to take her decisions in a way that does not allow her to avoid WTO-inconsistent action in situations where the time-frames stipulated in section 304(a)(1) and 306(b) are overstepped.

4.513 In the view of the European Communities, it is of little importance what the USTR has actually done in such situations, since the terms of the law are such that they limit any marginal discretion that the USTR may have in such a way that she cannot avoid to choose between either violating the law or violating the WTO. It is this element of "diabolic choice" that makes a law WTO-inconsistent, whatever the characterisation of the law under the "discretionary versus mandatory" criterion may otherwise be.

4.514 The European Communities secondly points out that in order to rebut the EC interpretation of the text of Sections 301-310, the United States affirmed that:

"... the Trade Representative is required under Section 304(a)(1) to base a determination of whether agreement rights have been denied on the results of

WTO dispute settlement proceedings. The Trade Representative has done so in every GATT and WTO case to date in which the US was a complainant. Thus, in the event that a dispute settlement panel were to fail to complete its proceedings within the time frames provided for in the DSU and Section 304(a)(2)(A), the Trade Representative would not be able to make a determination that US agreement rights have been denied".

4.515 The European Communities considers that the text of Sections 301-310 does not support such a description of the factual and legal situation.

"Section 304 (a) is applicable in two instances:

- (a) in the initial phase after the conclusion of an initial investigation and
- (b) pursuant to Section 306 (b) (2) and, by reference, to Section 306 (b) (1), in the later phase of "monitoring of compliance".

4.516 The European Communities deems it appropriate to quote in extenso the text of the relevant provisions under Section 304 (a) (1):

"(a) In general

(1) On the basis of the investigation initiated under section 2412 [Section 302] of this title and the consultations (and the proceedings, if applicable) under section 2413 [Section 303] of this title, the Trade Representative shall -

(A) determine whether -

(i) the rights to which the United States is entitled under any trade agreement are being denied, ...". (emphasis added)

4.517 The European Communities then notes that Section 304 (a) (2) provides as follows:

"(2) The Trade Representative shall make the determinations required under paragraph (1) on or before -

(A) in the case of an investigation involving a trade agreement, the earlier of -

(i) the date that is 30 days after the date on which the dispute settlement procedure is concluded, or

(ii) the date that is 18 months after the date on which the investigation is initiated ...". (emphasis added)

4.518 The European Communities argues that the chapeau of Section 304 imposes an obligation ("shall") upon the USTR to determine whether the rights of the United States are being denied "on the basis of the investigation initiated under section 302".

4.519 In support of its argument, the European Communities points out that the sentence in the chapeau of Section 304 (a) (1):

"(and the proceedings, if applicable) under section 303", (emphasis added)

explicitly refers to Section 303 ("Consultation upon initiation of investigation"), where, under Section 303 (2), the USTR

"shall promptly request proceedings on the matter under the formal dispute settlement procedures provided under such agreement". (emphasis added)

4.520 The European Communities states that, according to Section 304, the obligatory ("shall") determination by the USTR on whether rights of the United States are being denied is not discretionary but must be based upon the results of the investigation (where the domestic industry interests become therefore decisive) and "if applicable" on the "proceedings" under Section 303. Moreover, according to Section 304(a)(2), it must be made within "the earlier of" certain time frames.

4.521 The European Communities argues that the result of the investigation is obviously not discretionary, as the USTR is not free to determine whether such situation arises or not independently from the facts of the case. Rather, it is the USTR's duty to ascertain the existence of a factual situation: to even suggest that an authority charged with investigative powers as regards factual situations possesses discretion as to the actual results of the investigation would be equivalent to replacing the rule of law with arbitrariness.

4.522 The European Communities adds that the United States has officially stated both in the DSU review process and in front of you that it does not consider that any panel proceedings under the formal dispute settlement procedures are obligatory in the phase of "monitoring of compliance" in order to determine a failure of compliance of a WTO Member with the recommendations and rulings of the DSB. However, in the WTO dispute settlement system, no other procedure to that effect is available at the request of the original complainant. Section 303 referred to in the chapeau of Section 304(a)(1) clearly requires a positive "request" by USTR to make the dispute settlement procedure "applicable" in the context of Section 304.

4.523 **The United States argues**, in connection with the foregoing EC arguments, that the European Communities asserts that Section 304(a)(2)(A) violates DSU Article 23, in particular Article 23.2(a), because it requires the USTR to determine whether another WTO Member has denied rights under a WTO Agreement within 18 months of a request for consultations, even if the DSB has not adopted a report with findings on the matter within that time frame. This assertion is based on numerous miscalculations and unsupported assumptions.

4.524 The United States argues that the EC's formulation on its face fails to state a violation of Article 23, since it claims only that the USTR must determine whether US rights have been denied within the prescribed time frames, and not that the USTR must determine that such rights have been denied. Nothing in Sections 301-310 compels the USTR to find that US rights have been denied in the absence of panel or Appellate Body findings adopted by the DSB. Therefore, regardless of the relationship between the time frames in Section 304(a)(2)(A) to those in the DSU, the European Communities may not conclude that they compel a violation of Article 23.

4.525 The United States recalls that Article 23.2(a) provides that Members shall:

(a) not make a determination to the effect that a violation has occurred, that benefits have been nullified or impaired or that the attainment of any objective of the covered agreements has been impeded, except through recourse to dispute settlement in accordance with the rules and procedures of this

Understanding, and shall make any such determination consistent with the findings contained in the panel or Appellate Body report adopted by the DSB or an arbitration award rendered under this Understanding.

4.526 The United States argues that for there to be a violation of Article 23.2(a): (1) there must be a determination that a WTO agreement violation has occurred; and (2) that determination is not consistent with panel or Appellate Body report findings adopted by the DSB or an arbitration award rendered under the DSU. Because the European Communities has not, as part of this case, alleged that a specific US determination violates Article 23.2(a), the European Communities must show that, under Sections 301-310, the USTR is required to make a violation determination, and to do so in a manner inconsistent with panel or Appellate Body findings adopted by the DSB.

4.527 According to the United States, Section 304(a)(2)(A) establishes time limits for the USTR's determination of whether US trade agreement rights are being denied: the earlier of 30 days following the date on which dispute settlement proceedings are concluded or 18 months from the initiation of a Section 301 investigation.<sup>293</sup> While Section 304(a)(2)(A) sets forth the time limits for this determination, Section 304(a)(1)(A) sets forth the criteria: the USTR's determination is made on the basis of WTO dispute settlement proceedings.<sup>294</sup>

4.528 The United States argues that nothing in the language of Section 304(a)(1)(A) compels a specific determination, and the European Communities has made no attempt to demonstrate that it does. Therefore, even if the 18-month target date in Section 304(a)(2)(A) were to occur before the DSB has adopted panel and Appellate Body findings, nothing in Section 304(a)(1) would compel the USTR to find an agreement violation, let alone one inconsistent with panel or Appellate Body findings.

4.529 In the view of the United States, the USTR has broad discretion to issue any of a number of determinations which would not remotely conflict with Article 23.2(a) – most fundamentally, a determination that no violation has occurred. In order to meet its burden in this case, the European Communities must explain why, under US law, the USTR *could not*<sup>295</sup> make such a negative determination, or could not, for example, determine that no violation has been confirmed by the DSB, that a violation will be confirmed on the date the DSB adopts circulated panel or Appellate Body findings, or that, in order to comply with US international obligations, the USTR must terminate the current Section 302 investigation and reinitiate another.

4.530 According to the United States, the European Communities makes no attempt to address these threshold questions, and instead rests its case with regard to Section 304(a)(2)(A) on pure speculation that the USTR will always make an affirmative determination that US agreement rights have been denied. However, unless the European Communities can demonstrate that such a determination is mandated by law, and that no other determinations are possible, the fact that there is an 18-month time frame in Section 304(a)(2)(A) is irrelevant.

4.531 The United States further challenges the EC assumption, its most fundamental assumption, that Section 304 requires the USTR to make an affirmative determination that US agreement rights have been denied even if the DSB has not adopted panel or Appellate Body

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<sup>293</sup> Section 304(a)(2)(A), 19 U.S.C. § 2414(a)(2)(A).

<sup>294</sup> Section 304(a)(1), 19 U.S.C. § 2414(a)(1).

<sup>295</sup> The United States cites Panel Report on *US – Tobacco*, op. cit., para. 123.

findings to this effect. It is important to recognise that Article 23.2(a) does not prohibit determinations that a violation has not occurred, nor does it prohibit accurate descriptions of a process which is under way. Article 23.2(a) prohibits determinations that another WTO Member has violated its WTO obligations unless DSU rules and procedures have been followed. In other words, Article 23.2(a) relates only to a finding of a violation.

4.532 The United States notes that the European Communities makes absolutely no attempt to explain how Sections 301-310 mandate such a determination. The European Communities merely assumes that in determining "whether" US agreement rights have been denied, the USTR must make an affirmative determination. Unless the European Communities can explain why, under US law, this assumption is correct, it has failed to meet its burden with respect to this claim. The United States reiterates that the USTR is completely free to make any of a number of determinations, including a negative determination, if the DSB has not yet adopted panel or Appellate Body findings.

4.533 In response to the Panels question regarding the precise basis under Section 304, or any other legal basis, for the United States to argue that unless WTO procedures are completed, the USTR is precluded from making a determination of violation, the United States states that Section 304(a)(1) requires that determinations under that Section be made "on the basis of the investigation initiated under Section 302 and the consultations (and the proceedings, if applicable, under section 303)". The "proceedings" under Section 303 are dispute settlement proceedings.<sup>296</sup> Moreover, such proceedings would be "applicable" in any case involving a trade agreement, since Section 303 requires that dispute settlement procedures under a trade agreement be invoked in any case involving a trade agreement, if no mutually acceptable resolution has been achieved.<sup>297</sup>

4.534 The United States considers that the United States Administration has, in the Statement of Administrative Action approved by Congress, provided its "authoritative expression . . . concerning its views regarding the interpretation and application of the Uruguay Round agreements, . . . for purposes of domestic law".<sup>298</sup> The Statement of Administrative Action must, by law, be treated as the authoritative expression concerning the interpretation of the statute in any judicial proceeding.<sup>299</sup> As already noted, the Statement of Administrative Action at page 365 provides that the USTR will:

"base any section 301 determination that there has been a violation or denial of U.S. rights under the relevant agreement on the panel or Appellate Body findings adopted by the DSB".<sup>300</sup>

4.535 The United States notes that this commitment is consistent with the requirements of US case law that in US law, it is an elementary principle of statutory construction that "an act of

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<sup>296</sup> The United States notes that Section 303(a)(2) provides that if dispute settlement consultations under a trade agreement have not resulted in a mutually acceptable resolution, the Trade Representative shall request "proceedings" under the "formal dispute settlement procedures provided under such agreement".

<sup>297</sup> Ibid.

<sup>298</sup> Statement of Administrative Action, op. cit., p. 1.

<sup>299</sup> 19 U.S.C. § 3512(d) ("The statement of administrative action approved by Congress under section 3511(a) of this title shall be regarded as an authoritative expression by the United States concerning the interpretation and application of the Uruguay Round Agreements and this Act in any judicial proceeding in which a question arises concerning such interpretation or application".).

<sup>300</sup> Statement of Administrative Action, op. cit., p. 365 (emphasis added).



Congress ought never to be construed to violate the law of nations if any other possible construction remains". Murray v. Schooner Charming Betsy, 6 U.S. (2 Cranch) 64, 118 (1804). While international obligations cannot override inconsistent requirements of domestic law, "ambiguous statutory provisions . . . [should] be construed, where possible, to be consistent with international obligations of the United States". Footwear Distributors and Retailers of America v. United States, 852 F. Supp. 1078, 1088 (CIT), appeal dismissed, 43 F.3d 1486 (Table) (Fed. Cir. 1994), citing DeBartolo Corp. v. Florida Gulf Coast Building and Trades Council, 485 U.S. 568 (1988).

4.536 Based on these considerations, the United States considers that, under US law, it is required to base an affirmative determination that US WTO agreement rights have been denied on adopted panel and Appellate Body findings. That is to say, US law precludes such an affirmative determination not based on adopted panel or Appellate Body findings. The United States notes that in so doing, United States law goes beyond what the European Communities argues is required by Article XVI:4. The United States recalls that the European Communities states: "[I]t would be inappropriate to interpret Article XVI:4 of the WTO Agreement so extensively as to require WTO Members to include specific language in their domestic law precluding WTO-inconsistent action".

4.537 The United States points out that the European Communities acknowledged the requirement in US law to base determinations that US agreement rights have been denied on adopted DSB findings. There, the European Communities notes that certain provisions of Sections 301-310 "are in conformity with the principles set out in Article 23", such as

"Section 304(a)(1)(A), according to which the USTR's determination of denial of United States rights or benefits under a WTO agreement must be based not only on the investigation and the consultations with the country concerned but also on the WTO dispute settlement proceeding". (emphasis added)

4.538 The United States adds that there have been numerous statements that the United States will resort to WTO dispute settlement procedures in cases involving WTO rights,<sup>301</sup> and these procedures include basing determinations on adopted panel and Appellate Body findings. More importantly, the Statement of Administrative Action is by law an authoritative expression of the proper interpretation of the statute in any judicial proceeding.<sup>302</sup>

4.539 The United States further considers that in this dispute, the law does not provide for a determination inconsistent with Article 23.2(a), and the European Communities has failed to establish that it does. While the European Communities merely assumed that Section 304(a)(1)(A) mandated a determination that US agreement rights have been denied, in its answers to Panel questions it explicitly concedes that Section 304(a)(1)(A) does not mandate such a determination. The European Communities states that the USTR "may make only one of two determinations: United States' WTO rights are being denied or the United States' WTO rights are not being denied". This statement in and of itself admits that the USTR is not

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<sup>301</sup> The United States notes that for example, in an appearance before the Senate Foreign Relations Committee, Deputy US Trade Representative Rufus Yerxa explained that under the GATT, "it is explicitly provided [in the statute] that we take matters covered by GATT rules to the GATT for dispute resolution", and that this would not change under the WTO. Senate Foreign Relations Committee Hearing on the World Trade Organization, Federal News Service, June 14, 1994.

<sup>302</sup> 19 U.S.C. § 3512(d).

mandated to make "a determination to the effect that a violation has occurred", and the EC's case with respect to Section 304(a)(1)(A) must therefore fail.

4.540 The United States notes that the European Communities similarly admits that the USTR need not determine that a violation has occurred when it states, "The EC would like to underline that a determination of the absence of a violation is of course the mirror image of a determination that a violation has occurred. It is not possible to make a determination . . . in one direction without at least the possibility of coming to a different conclusion".<sup>303</sup> In this statement, the European Communities again concedes that it is possible for the USTR not to determine that US agreement rights have been denied.

4.541 The United States notes that the European Communities concluded:

"A law that requires a determination in all cases *whether* a violation of WTO law has occurred therefore comprises the requirement to determine in certain cases *that* a violation of WTO law has occurred. Such a law therefore mandates determinations that are inconsistent with Article 23".

4.542 In the view of the United States, these *non-sequiturs* now comprise the sole basis for the EC's argument that Section 304(a)(1)(A) mandates a determination inconsistent with DSU Article 23.2(a) (and that Section 306(b) mandates violations of DSU Article 23.2(a) and (c)). Only if the Panel agrees that a determination "whether" agreement rights have been denied may be equated with a determination "that" such rights have been denied – that, contrary to the EC's earlier admission, there is no possibility of making a negative determination – will the first requirement for a violation of Article 23.2(a) be met. However, aside from the absence of any logical or legal foundation for the EC's argument, it would have the impermissible consequence of preventing even determinations of consistency, notwithstanding the explicit language of Article 23.2(a), which only addresses certain determinations of inconsistency.

4.543 The United States claims that both Canada and Brazil make this point. Canada states in its response to a Panel question that DSU Article 23.2(a):

"does not prohibit determination of consistency with WTO norms. Any such prohibition would be counterproductive to the objectives of Article 3.7 of the DSU which states that '(a) solution mutually acceptable to the parties to the dispute and consistent with the covered agreements is clearly to be preferred'".

4.544 The United States further notes that likewise, Brazil states:

"WTO Members are, of course, entitled to make unilateral determinations of non-violation and of any interests they may have that are not currently covered by the WTO Agreements".

4.545 The United States challenges the EC's argument because it would have the impermissible consequence of reading out of Article 23.2(a) the exception for violation determinations made in accordance with DSU rules and procedures. Under the EC's reading, the very fact of making a determination would be inconsistent with Article 23.2(a), thereby prohibiting even those violation determinations made in accordance with DSU rules and procedures.

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<sup>303</sup> Ibid. at 25 (emphasis in original).

4.546 The United States claims that the EC admission that Section 304 does not mandate a determination that US agreement rights have been denied is a sufficient basis for this Panel to find that Section 304 is not inconsistent with DSU Article 23.2(a). Nevertheless, even if the Panel were to conclude otherwise, the EC's claim fails because the USTR is not limited under Section 304(a)(1)(A) to making the two determinations the European Communities refers to, and because the time frames in Sections 304(a)(2)(A) do not preclude the USTR from basing her determinations on panel and Appellate Body findings in every case.

4.547 The United States points out that as provided at page 365 of the Statement of Administrative Action,<sup>304</sup> the USTR is required under Section 304(a)(1) to base a determination of whether agreement rights have been denied on the results of WTO dispute settlement proceedings. The USTR has done so in every GATT and WTO case to date in which the United States was a complainant.<sup>305</sup> Thus, in the event that a dispute settlement panel were to fail to complete its proceedings within the time frames provided for in the DSU and Section 304(a)(2)(A), the USTR would not be able to make a determination that US agreement rights have been denied. On this basis, she could, for example, determine that dispute settlement proceedings had not yet finished, and that a determination concerning US agreement rights would be made following completion of these proceedings. There is no limitation in the statute on the definition of "determination" which would prevent such determinations.

4.548 The United States further maintains that even if the European Communities were correct that Section 304(a)(1)(A) permits only two determinations, this would not explain why the USTR does not have a third option: terminating the investigation without making a determination. There is nothing in Sections 301-310 to prevent this, and US Exhibit 13 demonstrates that this option has frequently been exercised in the past. The USTR would then be free to reinitiate a new investigation, as in fact occurred in the *Bananas* dispute.

4.549 The United States considers that because of the requirement in Section 304 to base determinations under that provision on adopted panel and Appellate Body findings and because the USTR may either terminate an investigation or else make multiple determinations under Section 304, Section 304 would not mandate actions inconsistent with Article 23.2(a) even if a panel or the Appellate Body were to exceed the time frames set forth in the DSU.

4.550 **The European Communities also notes** that legal scholars differ on the question of whether Section 301 actions are subject to judicial review under United States law.<sup>306</sup> There is, however, no doubt that, even if such actions were subject to review, no domestic court would declare invalid an action taken under Section 301 on the ground that it is inconsistent with the United States' obligations under a WTO agreement. This follows from Section 102(a)(1) of the Uruguay Round Agreements Act, according to which United States law prevails in the case of a conflict with a WTO provision:

"No provision of any of the Uruguay Round Agreements, nor the application of any such provision to any person or circumstance, that is inconsistent with any law of the United States shall have effect".

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<sup>304</sup> US Exhibit 11

<sup>305</sup> See US Exhibit 13.

<sup>306</sup> On this issue, the European Communities refers to Erwin P. Eichman and Gary N. Horlick, *Political Questions in International Trade . Judicial Review of Section 301?* in Mich. J. Int'l L., Vol. 10 (1989), pages 735-764.

4.551 The European Communities points out that Section 102(a)(1) also provides that nothing in the Uruguay Round Agreements Act shall be construed

"to limit any authority conferred under any law of the United States, including section 301 of the Trade Act of 1974".

Section 102(c) further states:

"No person other than the United States ... may challenge, in any action brought under any provision of law, any action or inaction by any department, agency, or other instrumentality of the United States, any State, or any political subdivision of a State on the ground that such action or inaction is inconsistent with such [a WTO] agreement".

4.552 **In rebuttal, the United States points out** that the European Communities attempts to make much of the fact that, in US courts, US law would prevail in the event of a conflict with the Uruguay Round Agreements. For example, the European Communities cites Professor D.W. Leebron for this proposition. However, the European Communities fails to quote Professor Leebron's conclusion on page 232 of the very same work cited in footnote 27 that, "Nothing, however, in those provisions [that is, the provisions of Section 301] requires the President or the USTR to act in violation of the Uruguay Round Agreements". In other words, because there is no conflict between Sections 301-310 and the WTO Agreement, it does not matter which would prevail in the event of a conflict. In fact, were there actually a conflict, that is, if a US law mandated a violation of the WTO Agreement, there would be a WTO violation regardless of whether a US court would apply US law. The EC's discussion of US law on when actual conflicts are present is thus completely irrelevant to the Panel's analysis.

4.553 The United States further argues that Sections 301-310 provide for the President and the USTR to exercise discretion at various points in the Section 302 investigation. Among the most relevant discretionary decisions for purposes of this proceeding are those relating to the USTR's determination of whether US trade agreement rights have been denied, the determination of action to be taken if those rights have been denied, and the timing of that action.

4.554 The United States notes that the USTR determines whether US agreement rights have been denied pursuant to Section 304(a)(1). That section provides:

"(1) On the basis of the investigation initiated under section 302 and the consultations (and the proceedings, if applicable) under section 303, the Trade Representative shall -

(A) determine whether -

(i) the rights to which the United States is entitled under any trade agreement are being denied, ...".<sup>307</sup>

4.555 The United States contends that in Section 302 investigations where a WTO agreement is involved, the USTR thus makes her determination on the basis of the results of any WTO dispute settlement proceeding.<sup>308</sup> If the DSB has adopted a panel or Appellate Body report, the

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<sup>307</sup> Section 304(a)(1)(A)(i); 19 U.S.C. § 2414(a)(1)(A)(i).

<sup>308</sup> See Section 303(a)(1)-(2), 19 U.S.C. § 2413(a)(1)-(2).

USTR will make her determination on the basis of that adopted report. If, on the other hand, WTO dispute settlement proceedings have not yet concluded, the USTR is not required to determine that US rights have been denied. Nothing in Section 304(a)(1) or any other provision of Sections 301-310 requires the USTR to make a determination that US agreement rights have been denied if the DSB has not ruled to that effect. The USTR is free, for example, to determine that no violation has been confirmed by the DSB, that a violation found in a panel or Appellate Body report will be confirmed on the date of the DSB meeting at which the report will be adopted, or that there is reason to believe that a violation has occurred, but that the DSB has not yet confirmed this. The USTR is also free to make a negative determination, and then reinitiate a second investigation in order to make a definitive determination of an agreement violation upon DSB adoption of panel and Appellate Body findings.<sup>309</sup>

4.556 The United States stresses that the USTR is a cabinet level official serving at the pleasure of the President, whose office is located within the Executive Office of the President.<sup>310</sup> Pursuant to 19 U.S.C. § 2171(c)(1) (1998), Reorg. Plan No. 3 of 1979, Sec. 1(b)(4), 44 Fed. Reg. 69273 (1979) and 19 C.F.R. § 2001.3(a) (1998), the USTR operates under the direction of the President and advises and assists the President in various Presidential functions.<sup>311</sup> The President may through this authority direct the Trade Representative as to the determinations she makes.

4.557 **The European Communities responds** to the US argument that Section 304(a)(1) refers to WTO "proceedings" as a basis for the determination to be made, and until WTO procedures completed the USTR cannot make a determination of violation, by claiming the US argument before the Panel is defeated by two considerations.

4.558 In the view of the European Communities, the first consideration relates to the time frames in section 304(a)(2) which do not allow the USTR to await the outcome of WTO dispute settlement proceedings in all cases, because the USTR must make the determination under Section 304(a)(1) by the earlier of the expiry of two deadlines, of which only one is related to the completion of the procedures under the DSU. If the completion of these procedures takes more than the time frame stipulated under the alternative provision (18 months after the date on which the investigation under section 302 was initiated), the USTR is not allowed to await the outcome of the dispute settlement procedure under the DSU and thus cannot base her determination on the results of that procedure. The European Communities would recall that the chapeau of Section 304(a)(2) refers back to the "determinations [all of them] under paragraph (1)" of Section 304(a).

4.559 The European Communities presents the second consideration which relates to a situation that arises at a later stage of the procedure, which is described under Section 306 as "Monitoring of foreign compliance". In this context, it must be recalled that the reference to "the proceedings" in Section 304(a)(1) is qualified by the words "if applicable" and by a cross-reference to Section 303. Section 303(2) provides in this context that "the Trade Representative shall promptly request proceedings on the matter under the formal dispute settlement procedures provided under such agreement". In other words, the proceedings referred to in Section 303(2) are those which may be requested by the USTR.

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<sup>309</sup> The United States notes that upon a negative determination, the USTR would be free to reinitiate an investigation pursuant to Section 302(b)(1). See Section 302(b)(1), 19 U.S.C. § 2412(b)(1).

<sup>310</sup> See 19 U.S.C. § 2171(a), (b)(1) (1998).

<sup>311</sup> See 19 U.S.C. § 2171(c)(1) (1998); Reorg. Plan No. 3 of 1979, Sec. 1(b)(4), 44 Fed. Reg. 69273 (1979); 19 C.F.R. § 2001.3(a) (1998).

4.560 The European Communities points out that since, in the view of the USTR, in cases of disagreement on the consistency with a covered agreement of measures taken to comply with the recommendations and rulings of the DSB in a prior dispute, the complainant is not required to first resort to the procedure under Article 21.5 of the DSU, but must have immediately recourse to Article 22 in order to comply with the time limits under Article 22.2, the USTR cannot request any proceedings under the formal dispute settlement procedures under the WTO in such situations (under Article 22.6 of the DSU, the procedural right to request arbitration is not available to the original complainant, but only to the original respondent).

4.561 The European Communities then argues that if the US interpretation of Article 21.5 of the DSU were correct (*quod non*), no "proceedings" in the sense of Section 303(2) would be applicable in such situations, and therefore the USTR would be compelled to make determinations under 304(a)(1) of the failure of compliance by another WTO Member without resorting to WTO dispute settlement procedures (and in fact has done so in the *Bananas* case).

4.562 According to the European Communities, in any case, the time frames stipulated in Section 306(b) and Section 304(a)(2) would not allow the conclusion of the multilateral dispute settlement procedures and thus violate Article 23 (and the related provisions under Articles 21 and 22) of the DSU.<sup>312</sup>

4.563 **The United States**, in response to the Panel's question as to how the reference to "proceedings" in Section 304(a)(1) as a basis for determinations under Section 304 is read exclusively to refer to the outcome or result of WTO proceedings and not also include, for example, the conduct and statements of the Member concerned in ongoing WTO procedures, i.e. before the adoption of DSB recommendations, **answered** as follows: The United States is not sure what is meant by "conduct and statements of the Member concerned", or how such statements would be relevant to particular determinations. If this phrase is meant to refer to statements made by a losing party regarding its intentions with respect to implementation, such statements are indeed taken into consideration when determining whether, under Section 301(a)(2)(B)(i), satisfactory measures are being taken to grant US rights. The United States reiterates that the USTR has determined not to take action based only on the "expectation" that another WTO Member would implement DSB rulings and recommendations, without any formal statement from that Member to that effect. A statement by a losing party would thus certainly be considered relevant, and is part of the proceedings. In this connection, the United States notes that the "date on which the dispute settlement procedure is concluded" is the date by which parties state their intention with regard to compliance, i.e. 30 days after DSB adoption (or, in terms of the DSU time frames, 17 months and 20 days after the consultation request).

4.564 The United States goes on to state that on the other hand, if by "conduct and statements" the Panel means an expressed desire to resolve the dispute, the USTR most certainly would take this into account in deciding whether to terminate the Section 302 investigation without a Section 304 determination. Again, as described in US Exhibit 13, the USTR has frequently done this.

4.565 The United States challenges the EC's argument that it reconsidered this position in light of the United States decision not to request Article 21.5 proceedings in the *Bananas* dispute. First, it incorrectly assumes that Article 21.5 proceedings are a prerequisite to

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<sup>312</sup> The European Communities notes that this is obvious when taking into account the duration of a procedure under 21.5 of the DSU, given that the Panel procedure alone will take up to 90 days.

requesting suspension under Article 22. Second, it assumes that Section 306 requires a determination of breach, which it does not, and ignores the fact that the action determination which is provided for in Section 306 is to be based on Article 22 procedures. Third, even if, contrary to the conclusion of the *Bananas* arbitrators, it were concluded that Article 21.5 is a prerequisite to requesting suspension under Article 22, this would not explain why US law would not still require that dispute settlement procedures be relied on to make affirmative determinations of breach. Further, as indicated above, if an agreement were reached in the DSU Review by which parties would resort to an amended Article 21.5 process prior to resorting to Article 22 procedures, nothing in Section 306 would prevent the United States from acting consistently with such an agreement.

4.566 **The European Communities emphasises** that while describing the events in the *Bananas* case, the United States misrepresents the facts, and their sequence, as they occurred in reality. On 9 October 1998, while the "reasonable period of time for implementation" granted to the European Communities in order to take measures to comply with recommendations and rulings in the *Banana III* DS procedure was still running (deadline 31 December 1998) and the European Communities had not yet adopted all these measures, the Chief of Staff of US President W. Clinton, M. Erskine Bowles, wrote a letter to the leaders of both the Republican and Democrat parties in the House and in the Senate (submitted on 8 July 1999 by the Commonwealth of Dominica and Saint Lucia as third party). In the name of the President (the *incipit* of the letter is "the Administration shares your view (...)", Mr. Bowles stated the following:

"To put maximum pressure on the EU, the Administration is pursuing three separate tracks (1) continuing to indicate our willingness to try to resolve the dispute in a mutually acceptable manner consistent with WTO obligations (2) preserving our rights in the WTO process and (3) proceeding under section 301 of the Trade Act of 1974.

(...)

Then, unless the EU has agreed to suspend implementation of its banana regime and to implement a WTO-consistent regime acceptable to us by January 2, 1999, the Administration will publish a second Federal Register notice on November 10. This notice will request comments on a list of specific retaliatory options and indicate that the administration will announce on December 15 retaliatory action pursuant to section 301 to take effect on February 1, 1999, unless the EU's banana regime is in full compliance with WTO rules".

4.567 The European Communities contends that as these examples show, both the threat and the action violate the text, the object and purpose of Article 23 (and the related provisions of Article 21 and 22) of the DSU. In this perspective, the European Communities argues that the statement made by the United States according to which:

"the Trade Representative has never once made a section 304 (a)(1) determination that US GATT or WTO agreement rights have been denied which was not based on the results of GATT and WTO dispute settlement proceedings"

is factually incorrect, since the USTR, at least in the *Banana III* case, took a determination under 304 (a)(1) that US WTO agreements rights had been denied after the end of the reasonable period of time without resorting to any WTO DS procedure on the conformity of the

new EC measures which repealed the legislation that an earlier panel had declared incompatible with the WTO. It is also misleading, since the threat of retaliatory action could force upon the targeted WTO Member a "mutually" agreed solution that makes a determination under Section 304 (a)(1) unnecessary (as in the *Japan – Auto Parts* Section 301 procedure).

4.568 **The United States responds** that the European Communities merely asserts that the US response was inaccurate, without introducing any relevant new arguments. The United States reaffirms the accuracy of its response. Moreover, the arguments referred to by the European Communities do not address the points made here by the United States.

(ii) *Practice*

4.569 **The European Communities further refers** to the resolution of the House of Representatives in the *Japan – Auto Parts* case to which it has referred in its oral statement during the second substantive meeting with the Panel. According to that resolution, the House of Representatives

"strongly supports the decision by the President to impose trade sanctions on Japanese products in accordance with section 301 of the Trade Act of 1974 unless an acceptable accord with Japan is reached in the interim that renders such action unnecessary",<sup>313</sup>

although it was obvious that no dispute settlement procedure under the WTO had been requested in a situation where trade sanctions in the area of trade in goods had been announced by the President. That resolution was taken only a few months after the adoption by the US Congress of the Uruguay Round Agreements Act and is a clear indication of how the US legislator understood Sections 301-310 in that specific context.

4.570 The European Communities draws the attention of the Panel to the fact that the US claims that the USTR has been following constantly a certain pattern of behaviour is contradicted by the *Japan - Auto Parts* procedure which did not follow that pattern.

4.571 **The United States points out** that no determination relating to WTO Agreement rights was made in the *Japan - Auto Parts* case. As the question notes, the determination in that case involved the issue of whether Japan's acts, practices and policies were "unreasonable", not whether US rights under the WTO had been denied. Any claim in connection with the *Auto Parts* case thus would bear no relationship to any of the EC claims relating to Article 23.

4.572 As a general response to Panel questions relating to the practice under Section 304, the United States notes that it is mindful that the application of Section 301 in particular cases is not within the Panel's terms of reference, and that the Panel therefore will not offer findings with respect to specific Section 302 investigations. Likewise, the practical application of Sections 301-310 is only relevant insofar as it sheds light on the only relevant question in this dispute: do Sections 301-310 mandate (and not merely permit) actions which are inconsistent with specific textual obligations found in DSU Article 23, WTO Article XVI:4 and GATT 1994 Articles I, II, III, VIII and XI.

4.573 With respect to the practice under Section 304, the United States also argues that, as noted elsewhere and as provided at page 365 of the Statement of Administrative Action (US

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<sup>313</sup> 104<sup>th</sup> Congress, 1<sup>st</sup> session, H.Res. 141.



Exhibit 11), the USTR is required under Section 304(a)(1) to base a determination of whether agreement rights have been denied on the results of WTO dispute settlement proceedings. Thus, in the event that a dispute settlement panel were to fail to complete its proceedings within the time frames provided for in the DSU and Section 304(a)(2)(A), the USTR would not be able to make a determination that US agreement rights have been denied. On this basis, she could determine that dispute settlement proceedings had not yet finished, and that a determination concerning US agreement rights would be made following completion of these proceedings. She could also, for example, terminate the Section 304 investigation on the basis of the fact that information necessary to make her Section 304(a)(1) determination is not available, then reinitiate another case. The USTR has terminated and reinitiated Section 302 investigations before, including in the *Bananas* dispute,<sup>314</sup> and has terminated investigations without making a determination on numerous occasions.<sup>315</sup>

4.574 The United States explained that it is not possible to provide an exhaustive list of the determinations that can be made under Section 304(a)(2)(A) because there is no definition in the statute that constrains the USTR's discretion in this regard. The USTR's determinations under Section 304(a)(2)(A) are provided below. Also listed below are cases in which the USTR terminated an investigation involving trade agreement rights without making a determination. As indicated below, the USTR has never determined that US rights under the GATT 1947 or the WTO Agreement have been denied in the absence of GATT panel findings or adopted DSB rulings and recommendations.

#### Determinations under Section 304(a)(1)(A)<sup>316</sup>

Section 304(a)(2)(A) refers to determinations under Section 304(a)(1)(A) relating to denial of rights or benefits under a trade agreement. A list of these determination follows. Please note that none of these cases is within the terms of reference of this Panel. Section 304(a)(1)(A) dates to 1988.

WTO Cases:

Canadian Export Subsidies and Market Access for Dairy Products (1999):

At the 18-month anniversary, the USTR determined that it would not be possible to determine whether US agreement rights had been denied until the DSB had adopted panel and Appellate Body findings. US Exhibit 14 includes a letter from the Trade Representative to Congressional officials explaining this. Dispute settlement proceedings are still in progress.

India's Practices Regarding Patent Protection for Pharmaceuticals and Agricultural Chemicals (1998):

Following adoption of panel and Appellate Body reports finding Indian TRIPs Agreement violations, the USTR determined that certain acts, policies and practices of India violate, or otherwise deny benefits to which the United States is entitled under, the TRIPs Agreement.

European Community Banana Import Regime (1998):

Following adoption of panel and Appellate Body reports finding EC violations of the GATT 1994 and the GATS in response to a US complaint, the USTR determined that certain acts, policies and practices of the EC violate, or otherwise deny benefits to which the United States is entitled under, GATT 1994 and the GATS. The USTR had earlier determined on the 18-month anniversary that it would not be possible to determine whether US agreement rights had been

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<sup>314</sup> The United States cites Termination of Investigation; Initiation of New Investigation and Request for Public Comments: European Union Banana Regime, 60 Fed. Reg. 52026 (1995) (U.S. Exhibit 18).

<sup>315</sup> A list is provided at US Exhibit 13.

<sup>316</sup> US Exhibit 13.

denied until the DSB adopted panel and Appellate Body findings. US Exhibit 14 includes a letter from the USTR to Congressional officials explaining this.

Argentine Specific Duties and Non-Tariff Barriers Affecting Apparel, Textiles, Footwear and Other Items (1998):

Following adoption of panel and Appellate Body reports finding Argentine GATT violations, the USTR determined that Argentina's specific duties on textile and apparel imports violate Argentina's obligations under GATT 1994 Article II and its statistical tax on almost all imports violates GATT Article VIII.

Canadian Practices Affecting Periodicals (1997):

Following adoption of panel and Appellate Body finding Canadian GATT violations, the USTR determined that certain acts, policies and practices of Canada violate, or otherwise deny benefits to which the United States is entitled under GATT 1994.

GATT 1947 Cases:

Canada Import Restrictions on Beer (1991):

Following adoption of a GATT panel report finding Canadian GATT violations, the USTR determined that acts, policies, or practices of Canada violate the GATT.

Thailand Cigarettes (1990):

Following adoption of a GATT panel report finding Thai GATT violations, the USTR determined that US rights under the GATT were violated.

Korea Beef (1990):

Based on a GATT panel report finding Korean GATT violations, the USTR determined that US trade agreement rights were being denied.

EC Oilseeds (1990):

Following adoption of a GATT panel report finding EC GATT violations, the USTR determined that US trade agreement rights were being denied. The USTR had earlier determined on the 18-month anniversary that there was reason to believe that rights under a trade agreement were being denied, but did not determine that a violation had occurred because panel proceedings had not yet finished.

In the following cases, the USTR terminated an investigation involving trade agreement rights without making a determination:

Brazilian Practices Regarding Trade and Investment in the Auto Sector (1998):

Following WTO dispute settlement consultations, Brazil committed not to extend its automotive trade-related measures beyond 1999. As a result, the USTR terminated the investigation.

Turkey's Practices Regarding the Imposition of a Discriminatory Tax on Box Office Revenues (1997):

Following WTO dispute settlement consultations, Turkey agreed to equalize any tax imposed in Turkey on box office receipts from the showing of domestic and imported films. As a result, the USTR terminated the investigation.

Pakistan's Practices Regarding Patent Protection for Pharmaceuticals and Agricultural Chemicals (1997):

Following WTO dispute settlement consultations, Pakistan established a mailbox system in accordance with the TRIPs Agreement and the USTR terminated the investigation.

Portugal's Practices Regarding Term of Patent Protection (1996):

Following WTO dispute settlement consultations, Portugal implemented its patent related obligations under the TRIPs Agreement and the USTR terminated the investigation.

EU Enlargement (1996):

After an agreement was reached, the USTR terminated the investigation.

EC Enlargement (1990):

Following notification to the GATT contracting parties of the US intention to suspend tariff concessions in response to actions by the EEC under Article XXIV of the GATT, the United States and the European Communities reached agreement and the USTR terminated the investigation.

Norway Toll Equipment (1990):

Following consultations under the GATT Procurement Code, the United States and Norway reached agreement and the USTR terminated the investigation.

Brazil Import Licensing (1990):

Following GATT dispute settlement consultations, the United States informed Brazil of its intention to request panel proceedings. Brazil withdrew the measure and the USTR terminated the investigation.

EC Copper Scrap (1990):

Following the first GATT panel meeting, the United States and the European Communities settled their dispute. The USTR terminated the investigation and withdrew the US complaint from the GATT dispute settlement panel.

4.575 The United States further explains that similarly, in the 1989 dispute between the United States and the European Communities over oilseeds, the USTR delayed action for 180 days pursuant to Section 305(a)(2)(A)(ii) on the basis that substantial progress was being made in GATT dispute panel proceedings which had not yet finished as of the 18-month target date.<sup>317</sup> Moreover, the USTR specifically waited until after panel proceedings had finished before determining that US agreement rights had been denied under Section 304(a)(1)(A)(i), even though this was well after the 18-month target.<sup>318</sup> Thus, it was consistent US practice, even before the conclusion of the Uruguay Round, to rely on dispute settlement results when determining whether US agreement rights were denied.

4.576 The United States then indicates that the USTR and the President thus have broad discretion under Sections 301-310 to dictate the timing of any action, the conditions under which the action will be given effect, and whether the action will be taken at all. The USTR or the President may, for example, specify that any action taken should not become effective until the United States has received formal DSB approval.

4.577 In response to a Panel question as to whether the USTR has made decisions other than affirmative or negative Section 304 determinations, and the legal basis for such determinations, the United States responds that there is no definition of "determination" in the statute which constrains the USTR's discretion to make determinations other than violation/non-violation. Beyond this, the existence of a legal requirement in Section 304(a)(1) to base determinations on dispute settlement proceedings indicates that the law contemplates a determination that it is not possible without DSB rulings and recommendations to determine that US agreement rights have

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<sup>317</sup> See Determinations Under Section 304 of the Trade Act of 1974, as Amended: European Community Policies and Practices With Respect to, Inter Alia, Production and Processing Subsidies on Oilseeds, 55 Fed. Reg. 4294 (1990) (US Exhibit 6)

<sup>318</sup> See *ibid.* The United States notes that on the 18-month anniversary, the USTR instead concluded that she had reason to believe agreement rights were being denied, and therefore was pursuing such a ruling under GATT dispute settlement procedures.

been denied. Examples of this determination are reflected in the letters in US Exhibit 14. In addition, US Exhibit 6 is a Federal Register notice of the determinations made in *Oilseeds*, including the determination that "there was reason to believe that United States' rights under a trade agreement were being denied".<sup>319</sup>

4.578 The United States adds that other legal bases for making determinations other than violation/non-violation determinations include established US legal principles of statutory construction regarding deference to administering agency interpretations of their statutes and legislative ratification of agency interpretations. US courts may not substitute their interpretations of ambiguous statutory provisions for those of the administering agency. In addition, Congress is presumed to be aware of an administrative or judicial interpretation of a statute and to adopt that interpretation when it re-enacts a statute without change. Having determined that the United States had "reason to believe" agreement rights were being denied in the 1989 *Oilseeds* case, the fact that Congress did not amend the statute to prevent such determinations when other amendments were made in 1994 supports the position that the Administration's interpretation is correct.

4.579 In response to the Panel's question as to the public notice referred to by the European Communities and the 3 March 1999 announcement in respect of the *Bananas* case, the United States contends that the statement does not provide that the United States will act without DSB authorization. For one thing, it specifically states "in the event of an affirmative determination", indicating that the USTR retains discretion to take no action under Section 306, including if DSU proceedings have not yet finished. At most, the notice reflected certain assumptions regarding the progress that DSU proceedings would make by March 3.

4.580 The United States goes on to note that the March 3 announcement was not made pursuant to Section 301. Thus, wholly apart from the fact that no specific application of Section 301 is within the terms of reference of this dispute, the announcement is even further removed from the subject matter of this case. In any event, the announcement is the subject of separate dispute settlement proceedings, and the United States intends to address the EC's specific claims regarding it in that context.

4.581 In response to the Panel's question on the following disputes brought by the United States: *EC – Bananas III*, *EC - Hormones*, *Japan - Film*, *India – Patents (US)*, *EC – Computer Equipment*, *Indonesia - Autos*, *Japan – Agricultural Products*, the United States explains that of the listed cases, only *EC – Bananas III*, *India – Patents (US)*, *Indonesia – Autos* and *Japan – Agricultural Products* involved a situation in which Section 304(a)(2)(A) would have been relevant. The USTR's actions in those cases are explained below. A Section 302 investigation was never initiated in the *EC – Computer Equipment* dispute, highlighting further the ultimate discretion available to the USTR: not to initiate a Section 302 investigation at all. Similarly, in *EC – Hormones*, the USTR's resort to WTO dispute settlement procedures was not taken pursuant to the Section 302 investigation of several years earlier. Thus, no separate determination under Section 304 was required or made as a result of WTO dispute settlement proceedings. Likewise, in *Japan – Film*, the Section 302 investigation was terminated prior to

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<sup>319</sup> This determination was originally reflected in Determination Under Section 304 of the Trade Act of 1974, as Amended: European Community's Policies and Practices With Respect to, Inter Alia, Production and Processing Subsidies on Oilseeds and Determination Under Section 305 to Delay Implementation of Any Action Taken Pursuant to Section 301, 54 Fed. Reg. 29123 (1989).

initiation of dispute settlement proceedings; indeed, those proceedings were the action taken in the case.<sup>320</sup>

4.582 The United States further explains that in the *EC – Bananas III* dispute, the determination was initially made at the 18-month anniversary that it would not be possible to determine whether US agreement rights had been denied until the DSB adopted panel and Appellate Body findings. US Exhibit 14 includes a letter from the USTR to a member of Congress explaining this, along with a similar letter recently provided in the *Canada – Dairy Subsidy* dispute. Following adoption of panel and Appellate Body reports finding EC violations of GATT 1994 and the GATS in response to a US complaint, the USTR determined that certain acts, policies and practices of the European Communities violate, or otherwise deny benefits to which the United States is entitled under, GATT 1994 and the GATS.<sup>321</sup>

4.583 The United States goes on to state that in *India – Patents (US)*, following adoption of panel and Appellate Body reports finding Indian violations of the TRIPS Agreement in response to a US complaint, the USTR determined that certain acts, policies and practices of India violate, or otherwise deny benefits to which the United States is entitled under, the TRIPS Agreement.<sup>322</sup>

4.584 The United States notes that in *Japan - Agricultural Products*, the DSB adopted panel and Appellate Body reports finding Japanese violations of the SPS Agreement in response to a US complaint. Likewise, in *Indonesia – Autos*, the DSB adopted a panel report finding Indonesian violations of the GATT 1994 and the TRIMs Agreement in response to a US complaint. The USTR followed customary WTO practice and agreed to or arbitrated a reasonable period of time for compliance in each case, but has not yet published formal Section 304 determinations.

4.585 In response to a Panel question, the United States states that the Panel might have misunderstood the timing of two of the four WTO cases in question. It is true that WTO dispute settlement proceedings were not complete at the 18-month anniversary in the *Bananas* and *Indonesia Autos* disputes. However, the Section 302 investigation in *Japan – Agricultural Products* was initiated on October 7, 1997.<sup>323</sup> The 18-month anniversary was thus on April 7, 1999. The DSB adopted the *Japan – Agricultural Products* panel and Appellate Body reports on March 19, 1999, before the 18-month anniversary. In *India Patents (US)*, the Section 302

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<sup>320</sup> The United States notes that in *Japan – Film*, the USTR determined pursuant to Section 304(a)(1)(A)(ii) that certain acts, policies, and practices of the Government of Japan were unreasonable and burden or restrict US commerce and that these acts should be addressed by: (1) seeking recourse to WTO dispute settlement procedures to challenge the Japanese measures; (2)(a) requesting consultations with Japan under a WTO provision for consultations on restrictive business practices; (2)(b) requesting the petitioner to submit information to be provided to Japan's Fair Trade Commission; (2)(c) seeking to cooperate with the JFTC in its review; (2)(d) studying the extent to which Japan's market structure distorts competition in US and third markets. Section 304 Determinations: Barriers to Access to the Japanese Market for Consumer Photographic Film and Paper, 61 Fed. Reg. 30929, 30929-30 (1996)

<sup>321</sup> See Determinations Under Section 304 of the Trade Act of 1974: European Communities' Banana Regime, 63 Fed. Reg. 8248, 8248-49 (1998) (US Exhibit 15).

<sup>322</sup> See Determination Under Section 304 of the Trade Act of 1974: Practices of the Government of India Regarding Patent Protection for Pharmaceuticals and Agricultural Chemicals, 63 Fed. Reg. 29053, 29053 (1998) (US Exhibit 16).

<sup>323</sup> See Initiation of Section 302 Investigation and Request for Public Comment: Japan Market Access Barriers to Agricultural Products, 62 Fed. Reg. 53853 (1997) (US Exhibit 8).

investigation was initiated on July 2, 1996.<sup>324</sup> The 18-month anniversary was thus on January 2, 1998. The Appellate Body issued its report on December 19, 1997, and the DSB adopted this report on January 16, 1998. Thus, in *Japan – Agricultural Products*, the DSB adopted findings of WTO violations before the 18-month anniversary, and in *India Patents*, the panel and Appellate Body issued reports finding WTO violations before the 18-month anniversary, findings which were "subject to confirmation" (automatically) by the DSB shortly thereafter.

4.586 The United States explains in response to further Panel questions that in *Japan – Agricultural Products* and *India – Patents (US)*, the United States did not make formal Section 304 determinations by the 18-month anniversary, but should have. However, in neither case did this affect continued US adherence to DSU procedures. In both cases, the USTR decided to pursue and conclude agreements on the reasonable period of time for implementation pursuant to DSU Article 21.3. The United States notes again that no specific application of Sections 301-310 is within the Panel's terms of reference, and the relevance of any such cases is therefore limited to whether they illustrate that the statute does or does not command a violation of DSU Article 23. Moreover, as explained before, if a statute itself is *WTO-consistent*, the fact that a Member does not apply that statute in a specific instance does not make the statute inconsistent with the WTO agreement.

4.587 In response to the Panel's following question regarding *Canada – Dairy Subsidies* and *EC - Bananas III*, where the USTR sent a letter to a member of Congress within the 18 months time-frame, the United States states that the letters reflect determinations by the USTR, just as Federal Register notices of determinations are not themselves the determinations, but reflect them. Federal Register notices are typically signed by the Chairman of the Section 301 Committee and explain that the USTR made a determination on a given date. There usually are no other public documents associated with the USTR's deliberative process.<sup>325</sup> As explained at the hearing, while there is a publication requirement in Section 301(c), there is no deadline for publication provided for in this provision.

4.588 In this connection, the United States disagrees with the following EC statement:

"The explicit requirements to make a determination within a specified time frame whether the United States' WTO rights are being denied or failure to implement DSB recommendations has occurred would be completely frustrated if they were deemed fulfilled by a decision to postpone the determination".

The United States reiterates that the USTR need not and may not, under Section 304(a)(1), determine that US agreement rights have been denied if there are not adopted panel or Appellate Body findings to that effect. The requirement to make a determination within 18 months is not frustrated by the need to comply with the additional statutory requirement that a determination that agreement rights have been denied must be based on the results of dispute settlement proceedings. The USTR, and not the European Communities, is administering Sections 301-310, and it is not for the European Communities to opine on either the objectives of the statute or whether the USTR is meeting them. From the Panel's perspective, the only relevant question

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<sup>324</sup> See Determination Under Section 304 of the Trade Act of 1974: Practices of the Government of India Regarding Patent Protection for Pharmaceuticals and Agricultural Chemicals, 63 Fed. Reg. 29053, 29053 (1998) (US Exhibit 16).

<sup>325</sup> The United States notes the EC's Article 133 Committee appears to operate no differently in this regard.

is whether the statute commands a violation of the DSU Article 23. It is not relevant whether the "objectives" of any US law are being fulfilled.

4.589 In response to the Panel's question, the United States confirmed that the Panel was correct in understanding that in the *Korea - Beef* case – a GATT case but a case conducted also under the same Section 304 provisions as they stand today - the USTR made a determination of violation under Section 304 on 28 September 1989 – i.e. *after* the circulation of the panel report, but *before* its adoption – even though the USTR subsequently, in the same decision delayed implementation of the planned action under Section 301. The *Korea Beef* case illustrates well the circumstances under which Section 301 was applied under the GATT. As described in US Exhibits 4 and 5, a GATT panel found Korea's import restrictions on beef a violation of GATT Article XI:1. However, at successive meetings of the GATT Council following issuance of the report, Korea declined to join a consensus to adopt the report. In other words, Korea unilaterally refused to agree to comply with multilateral panel findings through the flaw in GATT 1947 dispute settlement procedures which permitted losing parties to unilaterally block panel reports. As described in the Statement of Administrative Action on page 367, this is precisely the type of circumstance in which the United States took, or proposed to take, action under the GATT 1947. Following the US determination, Korea agreed to adoption of the panel report and to resolve the dispute in a mutually satisfactory manner, as contemplated in GATT dispute settlement procedures.

4.590 The United States recalls that there was no DSU, let alone a DSU Article 23, in 1989 and 1990, when the *Korea - Beef* case was taking place. The Section 304 determinations made in that case breached no US GATT obligation, nor, if they had, would that be relevant to the Panel's consideration of whether Sections 301-310 command any DSU or WTO Agreement violations. The *Korea Beef* case does, however, illustrate how strengthened multilateral dispute settlement procedures prevent losing parties from blocking the proper functioning of those procedures, removing the need for complaining parties to seek remedies for the denial of WTO rights outside of dispute settlement procedures.

4.591 In response to the Panel's request for clarification on *Korea - Beef*, the United States explains that there was no DSU, and no DSU Article 23, in 1989-90, when the *Korea Beef* case was taking place. In light of the new obligations found in DSU Article 23, the United States has since January 1, 1995 interpreted its international obligation – and its obligation under Section 304(a)(1) – as requiring it to wait until the DSB adopts panel and Appellate Body reports finding WTO violations before determining that US agreement rights have been denied. Inasmuch as no "determinations to the effect that a violation have occurred" were inconsistent with the GATT 1947, the United States could (but, as US Exhibit 13 illustrates, rarely did) determine that US agreement rights had been denied based on dispute settlement proceedings in which a panel had issued a report, but the losing party was blocking adoption of that report.

4.592 **The European Communities criticises** the following US statement:

"As explained in response to the previous question, there was no DSU, and no DSU Article 23, in 1989-90, when the *Korea - Beef* case was taking place. In light of the new obligations found in DSU Article 23, the United States has since January 1, 1995 interpreted its international obligation – and its obligation under Section 304(a)(1) – as requiring it to wait until the DSB adopts panel and Appellate Body reports finding WTO violations before determining that U.S. agreement rights have been denied".

4.593 In the view of the European Communities, this statement is contradicted by the adoption by the USTR, after the conclusion of the Uruguay Round, of determinations in the *Japan - Auto Parts* case and in the *EC – Bananas III* case. Moreover, the US omits to mention the *Argentina – Textiles and Apparel (US)* case where the USTR took her determination before the adoption of the panel report by the DSB in violation of the explicit provision of Article 23.2 (a) of the DSU, as the United States itself admits.

4.594 **The United States responds** that the European Communities makes the puzzling and inaccurate argument that the United States "admits" to making a Section 304 determination of a trade agreement violation in *Argentina – Textiles and Apparel (US)* before the DSB adopted findings to that effect. However, the cited portion of the U.S. submission has nothing to do with *Argentina – Textiles and Apparel (US)*.

4.595 The cited U.S. statement only notes that in *India – Patents (US)*, the 18-month anniversary in the Section 302 investigation fell two weeks before adoption of panel and Appellate Body findings. As previously explained, Section 301 does not mandate WTO-inconsistent action in such cases. The USTR is free, for example, to determine that dispute settlement proceedings have not yet finished, and that a determination concerning U.S. agreement rights will be made following completion of these proceedings. Likewise, she is free to terminate the investigation and reinstate it.<sup>326</sup>

4.596 In response to the Panel's question regarding the textual and legal basis on which in *Japan - Film*, WTO dispute settlement proceedings were the action taken in the case, the United States indicates that the action taken in *Japan – Film* was taken pursuant to Section 301(b). Section 301(b)(2) authorizes the USTR to take all "appropriate and feasible action under Section 301(c)", as well as "all other appropriate and feasible action within the power of the President that the President may direct the USTR to take under this subsection, to obtain the elimination of that act, policy, or practice". The USTR did not consider action under Section 301(c) "appropriate and feasible", and therefore took the appropriate and feasible actions within the power of the President described above. A request for panel proceedings is within the President's foreign affairs powers under Article II of the United States Constitution. Pursuant to 24 U.S.C. § 2411(c), the USTR is responsible for such functions as the President may direct, and is responsible for representing the United States at the WTO.

4.597 In response to a Panel question on *Argentina – Textiles and Apparel (US)* suggesting that a Section 304 determination of violation had been made but a Section 302 investigation had not been initiated in that case, the United States states that a Section 302 investigation on Argentina Footwear was initiated on October 4, 1996.<sup>327</sup> The United States note that the Panel's question highlights the fact that the Panel has only a partial picture of how Sections 301-310 were applied in individual cases. Because no such individual cases are within the terms of reference, the United States submitted information on these cases only for its relevance in illustrating what the statute does or does not require. The United States has illustrated that the USTR has adequate discretion under Sections 301-310 to comply fully with DSU and GATT rules, and has done so when making determinations on the denial of GATT and WTO

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<sup>326</sup> The United States further claims that contrary to the EC assertion, the Trade Representative made no section 304 determination that U.S. agreement rights had been denied in *Auto Parts*, nor did she make any such determination in *Bananas* not based on DSB-adopted findings. Further, her determination in *India Patents (US)* followed DSB adoption of panel and Appellate Body findings.

<sup>327</sup> Initiation of Section 302 Investigation and Request for Public Comment: Argentine Specific Duties and Non-Tariff Barriers Affecting Apparel, Textiles, Footwear, 61 Fed. Reg. 53776 (1996).



agreement rights. The European Communities, on the other hand, has referenced these cases not to illustrate whether the statute commands WTO-inconsistent action, but to improperly characterize past actions as violations, in the hope that the Panel will be distracted from its legal analysis and prejudiced in its decision-making. The Panel must reject this approach.

4.598 In response to the Panel's question on the *EC - Oilseeds* case where the USTR, on 5 July 1989 - i.e. before the circulation and adoption of the panel report – "determined that there was reason to believe that United States' rights under a trade agreement were being denied by ... the EC's production and processing subsidies on oilseeds and animal feed proteins but that the USTR "decided to delay implementation of any action to be taken under section 301 not more than 180 days...", because it "determined ... that substantial progress was being made with respect to the dispute ...", the United States indicates that this does not imply that the USTR made a determination of violation under Section 304 before the adoption of a panel report. The USTR did not make a determination that US agreement rights had been denied until the GATT Council adopted panel findings to this effect.

4.599 In response to the Panel's question as to the textual or other legal basis allowing the USTR to make multiple determinations in the *EC – Oilseeds* case where "[o]n January 31, 1990, ... the USTR determined under section 304 ... that rights of the United States under a trade agreement are being denied" by the same measures of the European Communities, the United States states that there is nothing in the text of Sections 301-310 which prevents the USTR from making two determinations under Section 304 in one and the same case, and the European Communities has not provided any arguments that there is. While the USTR is required to make a determination within the time frames set forth in that section, nothing prevents her from making additional determinations after that time.

4.600 The United States explains that it is an established principle of US statutory construction that the administering agency's interpretation of a statute is entitled to deference if the statute is "silent or ambiguous with respect to [a] specific issue". Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 842-43. In such circumstances, the court must uphold the agency's interpretation as long as it is based upon a "permissible construction" of the statute. Id. The agency's interpretation need not be the "only possible construction", Sullivan v. Everhart, 494 U.S. 83, 89 (1990), nor must it be the construction the court would have selected in the first instance. Chevron, 467 U.S. at 844. A court errs by substituting "its own construction of a statutory provision for a reasonable interpretation made by [the agency]". Id. The court's duty is not to weigh the wisdom of the agency's legitimate policy choices. Suramerica de Aleaciones Laminadas, C.A. v. United States, 966 F.2d 660, 665 (Fed. Cir. 1992). Thus, under US law, the USTR's interpretations of its authority to undertake multiple determinations, determinations other than violation/non-violation determinations, or termination of investigations would receive such deference in a US court – to the extent such determinations would be subject to judicial review at all.<sup>328</sup> Likewise, the USTR's interpretation of Section 304(a)(1) as requiring her to rely on DSB-adopted findings in determining that US WTO agreement rights have been denied would be accorded such deference.

4.601 The United States indicates that it is not merely offering assertions of its legal authority. Rather, these interpretations are reflected in longstanding practice, in investigations predating this case and predating the WTO. Under US law, these interpretations would be entitled to

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<sup>328</sup> The United States points out that if, in fact, these determinations were not reviewable, the USTR's interpretations would be definitive.

deference, and, in examining whether the statute commands WTO-inconsistent action, the Panel is required to examine the meaning of the statute as it would be interpreted under US law.<sup>329</sup>

4.602 The United States further argues that another legal basis for US interpretations of statutory provisions is the US principle of statutory construction known as legislative ratification. As the US Supreme Court has stated, this principle provides that Congress is presumed to be aware of an administrative or judicial interpretation of a statute and to adopt that interpretation when it re-enacts a statute without change. Lindahl v. Office of Personnel Management, 470 U.S. 768, 783, citing Albemarle paper Co. v. Moody, 422 U.S. 405, 414 n.8 (1975).

4.603 The United States also states that the multiple determinations in *Oilseeds* predated the WTO, and the fact that Congress did not amend the statute to prevent such determinations when other amendments were made in 1994 supports the view that the Administration's interpretation is permitted. Similarly, the USTR's practice of applying Sections 301-310 to make determinations other than simple "yes/no" determinations on whether agreement rights have been denied, and to terminate Section 302 investigations before making a determination, predates 1994. Exhibit 13 describes examples of this long-standing practice since 1988, though it predates 1988 as well. And, although Congress amended section 301 in 1994, it did not amend it to undermine the USTR's interpretation or application of Sections 301-310, even though it was fully aware of how it was being applied.

4.604 **The European Communities disagrees** with the US introduction of an entirely new defence at this late stage. The European Communities stresses the fact that the new US arguments are very similar to those submitted by India in the *India - Patents (US)* case. They were rejected by the panel and the Appellate Body at the request of the US as a complainant in that case.<sup>330</sup>

4.605 The European Communities further states that the quotation of the AB report in *India - Patents (US)*, paragraph 65 [in fact 66], is incorrect. The Appellate Body did not state that "the Panel is required to examine the meaning of the statute as it would be interpreted under US law". Rather, the correct quotation, which has an entirely different meaning, is the following:

"... as in the case cited above before the Permanent Court of International Justice, in this case, the Panel was not interpreting Indian law "as such"; rather, the Panel was examining Indian law solely for the purpose of determining whether India had met its obligations under the *TRIPS Agreement*".

4.606 **The United States rebuts** the EC argument that the US response raises a new defense, and that allegedly similar arguments were rejected in *India – Patents (US)*. Both of the EC's contentions are incorrect. First, the United States has not raised a new defense. The US discussion of judicial deference under U.S. law was directly responsive to the Panel's request for the textual or other legal basis which permits the USTR to make multiple determinations – a factual issue in this dispute. While the textual basis for the USTR's interpretation is sufficiently clear, the doctrine of judicial deference would serve as an additional basis under US law were a US court to consider the statutory language ambiguous.

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<sup>329</sup> The United States refers to Appellate Body Report on *India – Patents (US)*, op. cit., para. 65.

<sup>330</sup> Ibid., para. 69, "... like the Panel, we are not persuaded that India's "administrative instructions" would prevail over the contradictory mandatory provisions of the Patents Act".

4.607 The United States also contends that the EC's references to *India – Patents (US)* fail to support its position. The Appellate Body, in paragraphs 65-66 of its report in *India – Patents (US)*, emphasizes that it was necessary in that case to examine Indian law to determine its compliance with India's international obligations. Domestic law consists not only of statutory provisions, but of domestic legal rules concerning the interpretation of those provisions or, in the case of *India – Patents (US)*, domestic rules concerning conflicts between laws. In *India – Patents (US)*, the Appellate Body examined "the relevant provisions of the Patents Act as they relate to the 'administrative instructions'" at issue in that case<sup>331</sup>; in other words, the Appellate Body examined whether there was any support under Indian law for India's assertion that unpublished, unwritten administrative instructions would prevail over a conflicting statute explicitly mandating a WTO violation. India in that case failed to provide sufficient evidence that, under Indian law, the instructions would prevail.

4.608 In the US view, the doctrine of judicial deference to an agency's interpretation of its statute is part of U.S. law, though it would only become relevant in this dispute were the panel to conclude that there was some ambiguity as to whether a particular provision of Sections 301-310 commanded specific actions violating a WTO obligation. In fact, as the U.S. has explained throughout this proceeding, the statute contains no such ambiguity. On its face, the U.S. statute does not command violation determinations in the absence of DSB-adopted findings, and in fact requires that any such determinations be based on the results of WTO proceedings.<sup>332</sup>

4.609 According to the United States, however, should the Panel find the statute ambiguous, the US Executive Branch interpretation of the statute is of great importance under US law. First, many Executive Branch determinations are not subject to judicial review. As already noted, if this were the case with respect to Section 301 determinations, the USTR interpretation would be definitive under US law. Second, even if a US court were to review such determinations, and even if that court were to conclude that the statutory language is ambiguous, it would be required under US law to interpret that language in light of the Chevron standard of judicial deference.

4.610 The United States reiterates that it did not, as the European Communities suggests, raise the doctrine of judicial deference to suggest that the Panel is precluded from examining the WTO-consistency of Sections 301-310. Rather, the United States raised this doctrine because it is part of the U.S. law which the Panel is examining.

4.611 The United States recalls again that the burden in this dispute lies with the European Communities. As already discussed, the European Communities failed to establish that US law commands the USTR to take actions which violate Article 23, failed to establish that US rules of statutory interpretation permit the European Communities and this Panel to interpret "whether" to mean "that", and failed to establish that it is permissible to disregard entire sections of the statute providing the USTR with discretion to delay or not take action. Likewise, in its latest submission, the European Communities failed to establish that the Chevron deference standard may, under US law, be disregarded.

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<sup>331</sup> Appellate Body Report on *India – Patents (US)*, op. cit., para. 66.

<sup>332</sup> The United States again states that this US legal requirement goes beyond what the EC asserts are a Member's WTO obligations: "[I]t would be inappropriate to interpret Article XVI:4 of the WTO Agreement so extensively as to require WTO Members to include specific language in their domestic law precluding WTO-inconsistent action".

4.612 **The European Communities also claims** that when dealing with the issue of the publication by the USTR of notices announcing unilateral retaliatory actions raised by Korea as a third party, the United States reports the EC's position as follows "if suspension is proposed, this necessarily includes publication of a list of products".

4.613 The European Communities recalls that the United States insists on the fact that the European Communities "fails to explain why this so, or if it is so, what the timing must be".

4.614 The European Communities indicates that in the *Bananas III* dispute the USTR itself published two notices in the Federal Register (22 October 1998, page 56689 and 10 November, page 63099). The first one, according to which "Section 306 (c) of the Trade Act provides that the USTR shall allow an opportunity for the presentation of views by interested parties prior to the issuance of a determination pursuant to section 306 (b)"; the second notice was published explicitly "in accordance with section 304 (b)". The European Communities then questions who is right, the USTR when publishing notices on the Federal Register or the USTR when representing the US government in these panel proceedings.

4.615 According to the European Communities, in addition and by definition, the publication must be made before any determination or action is adopted.

4.616 The European Communities claims that in neglecting this fundamental albeit obvious element, the US side-steps the most important point of substance raised by Korea, and supported by the EC: the practical effects for the trade of such publication made before and irrespective of any decision taken in the WTO dispute settlement system is the most effective implementation of the "Damocles sword" policy that engenders severe effects on the economic operators on the market (coupled with substantial protectionist benefits for domestic competing goods and services). As this Panel is aware, sometimes a threat of action can be even more effective than the action itself.

4.617 In the view of the European Communities, in order to illustrate better this concept, it would be appropriate to provide the Panel with some examples. In the *Japan - Auto Parts* Section 301 procedure, no dispute settlement procedure was ever requested by the United States against Japan while an announcement that the United States would have resort to retaliatory measures was made by the USTR on 10 May 1995. According to the European Communities, the US representative confirmed during the panel procedure that WTO Members have a positive obligation of putting their legislation into conformity with the obligations under the covered agreements, including the DSU, as from the 1 January 1995 "and [this] could not be delayed".

4.618 The European Communities points out that the *Auto Parts* procedure was eventually closed after an agreement between the United States and Japan was reached under the threat of retaliatory action. Some factual elements could help the Panel clarify the impact of the threat of the US unilateral action enacted under Sections 301-310.

4.619 The European Communities explains that on 27 September 1994, the US President transmitted to Congress legislation to implement the GATT Uruguay Round of multilateral trade negotiations. In the Statement of Administrative Action accompanying the legislation the US President explicitly indicates that:

"There is no basis for concern that the Uruguay Round agreements in general, or the DSU in particular, will make future Administrations more reluctant to apply section 301 sanctions that may be inconsistent with US trade obligations because such sanctions could engender DSU-authorized counter-retaliation.

Although in specific cases the United States has expressed its intention to address an unfair foreign practice by taking action under section 301 that has not been authorized by the GATT, the United States has done so infrequently".

4.620 According to the European Communities, consistently with this (WTO-inconsistent) line, on 13 October 1994 a Section 301 investigation was opened against Japan which was eventually followed by the 10 May 1995 announcement by the USTR that Japanese car market was closed and that a list of Japanese products to be subject to retaliation was to be published by 28 June 1995.

4.621 The European Communities further notes that that announcement had been preceded on 9 May 1995 by a Resolution of the House of Representatives (104<sup>th</sup> Congress, 1<sup>st</sup> session, H. Res. 141) which states the following:

"Whereas President Clinton, stated, on May 5, 1995, that the United States is 'committed to taking strong action' regarding Japanese imports into the United States if no agreement is reached. Now, therefore, be it

*Resolved*, That it is the sense of the House that

(1) ...

(2) the House therefore strongly supports the decision by the President to impose trade sanctions on Japanese products in accordance with section 301 of the Trade Act of 1974 unless an acceptable accord with Japan is reached in the interim that renders such action unnecessary".

4.622 The European Communities recalls once more that no WTO dispute settlement procedure was ever started by the United States against Japan on this issue.

4.623 The European Communities also explains that three years later, on 9 October 1998, while the "reasonable period of time for implementation" granted to the European Communities in order to take measures to comply with recommendations and rulings in the *Banana III* DS procedure was still running (deadline 31 December 1998) and the European Communities had not yet adopted all these measures, the Chief of Staff of US President W. Clinton, M. Erskine Bowles, wrote a letter to the leaders of both the Republican and Democrat parties in the House and in the Senate (submitted on 8 July 1999 by the Commonwealth of Dominica and Saint Lucia as third party). In the name of the President (the *incipit* of the letter is "the Administration shares your view ..."), Mr. Bowles stated the following:

"To put maximum pressure on the EU, the Administration is pursuing three separate tracks (1) continuing to indicate our willingness to try to resolve the dispute in a mutually acceptable manner consistent with WTO obligations (2) preserving our rights in the WTO process and (3) proceeding under section 301 of the Trade Act of 1974.

...

Then, unless the EU has agreed to suspend implementation of its banana regime and to implement a WTO-consistent regime acceptable to us by January 2, 1999, the Administration will publish a second Federal Register notice on November 10. This notice will request comments on a list of specific retaliatory

options and indicate that the administration will announce on December 15 retaliatory action pursuant to section 301 to take effect on February 1, 1999, unless the EU's banana regime is in full compliance with WTO rules".

4.624 In the view of the European Communities, as these examples show, both the threat and the action violate the text, the object and purpose of Article 23 (and the related provisions of Article 21 and 22) of the DSU. In this perspective, the statement made by the United States according to which

"the USTR has never once made a section 304 (a) (1) determination that US GATT or WTO agreement rights have been denied which was not based on the results of GATT and WTO dispute settlement proceedings"

is factually incorrect, since the USTR, at least in the *Banana III* case, took a determination under 304 (a) (1) that US WTO agreements rights had been denied after the end of the reasonable period of time without resorting to any WTO DS procedure on the conformity of the new EC measures which repealed the legislation that an earlier panel had declared incompatible with the WTO. It is also misleading, since the threat of retaliatory action could force upon the targeted WTO Member a "mutually" agreed solution that makes a determination under Section 304 (a) (1) unnecessary (as in the *Japan - Auto Parts* Section 301 procedure).

4.625 In addition to these contradictory statements, the United States relies on some other arguments that are, in the EC's view, also entirely unconvincing. The European Communities believes it appropriate to briefly elaborate on certain issues raised by the United States.

4.626 In the EC's view, the *Bananas III* case is an example where the USTR has made, in order to take action under Section 301, a determination that "a foreign country [the European Communities] is not satisfactorily implementing a measure or agreement" (cf. Section 306(b)(1)) and in so doing has made a determination that "shall be treated as a determination made under section 304(a)(1)".

4.627 The European Communities argues that it should be noted that this provision in Section 306(b)(1) contains a wholesale reference to Section 304(a)(1). It thus explicitly includes and logically implies that a determination of a denial of US rights under the WTO is required. In fact, it would be quite impossible under the structure of Section 304(a)(1) to proceed immediately to a determination of an action without a prior determination of a denial of US rights.

4.628 The European Communities points out that any other reading would lead to arbitrariness and to an even more serious breach of the provisions of Article 23 of the DSU which, as the European Communities has repeatedly underlined, deals generally with all situations (including the situation described in Article 23.2(a)) where WTO Members "seek redress of a violation of obligations or other nullification or impairment of benefits under the covered agreements or an impediment to the attainment of any objective of the covered agreements". In fact, Article 23 of the DSU deals with all situations described as a "violation" case, a "non-violation" case or "any other situation" under Article XXIII.1 of GATT 1994.

4.629 The European Communities recalls that the fact remains that the EC's complaint is directed against Sections 301-310 as such, and not against the application of these Sections in particular cases. The European Communities then refers once again to the *Japan - Auto Parts* case.

4.630 The European Communities recalls that the United States explained that in that case, no determination of a denial of US rights under the GATT or the WTO was made. If the US statement were to be understood as implying that no determination of denial of US rights was taken by the USTR, on the basis of the 16 May 1995 notice in the US Federal Register, the European Communities would disagree. The public announcements and the decisions taken by the USTR were necessarily based on a substantive determination of denial of US rights.

4.631 In the view of the European Communities, given the subject matter of the *Japan - Auto Parts* case, which clearly is dealing with trade in goods, it is impossible to see how any determination made in that case would not be governed by Article 23 of the DSU.<sup>333</sup> In the view of the European Communities, the United States is under no circumstances entitled to take trade sanctions in the area of trade in goods against another WTO Member without following the requirements of Article 23 of the DSU.

4.632 The European Communities notes that, whatever the precise terms of the determination in the *Japan - Auto Parts* case, there can be no serious doubt that this determination was made in total disregard of the requirements of Article 23 of the DSU. It is also clear that the determination must have been made under Section 304(a)(1). It is logically not possible to make a determination of action under Section 304(a)(1)(B) without a prior determination under Section 304(a)(1)(A).

4.633 In rebutting the EC argument that Section 301 has the "illegitimate goal" of serving as a sword of Damocles, **the United States observes** that the European Communities assumes that Section 301 is being used for an illegitimate purpose. In fact, it has the legitimate purpose to enforce WTO rights, in accordance with WTO procedures. The sword of Damocles is WTO-authorized retaliation under Article 22 when a Member has failed to comply with DSB rulings and recommendations. Section 301 implements this under U.S. law.

4.634 In a question to the parties, the Panel noted its understanding that in *Auto Parts* case, the US determination and action was taken based upon an investigation into the question of whether Japan's act, policy or practice in this respect is "unreasonable or discriminatory and burdens or restricts United States commerce" (referred to in Section 301(b)), not on whether US rights under the WTO are being denied. In response to the Panel's question as to whether the European Communities makes an additional claim that another aspect of Sections 301-310 – authorizing the USTR to make determinations as to whether or not a matter falls outside the scope of the WTO Agreement – violates DSU Article 23, and if so, whether and how this claim is included in the terms of reference of this Panel, as provided in document WT/DS152/11, in particular para. 2 thereof, as a preliminary observation, **the European Communities states** that all the claims it has made before this Panel are exclusively related to the WTO-inconsistency of Sections 301-310 of the Trade Act of 1974 as such. Reference to individual cases in which these provisions were applied is only made as supporting evidence for the way in which these provisions are interpreted by the US authorities, thereby constituting a counter-argument to some US assertions and not a separate claim.

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<sup>333</sup> The European Communities is not aware of, and the United States has not shown, any application of Sections 301-310 to situations not covered *ratione materiae* by one of the WTO Agreements. Even if such a case existed, it would still not be permissible to take retaliatory action in the areas covered by the WTO Agreements against another WTO Member. In addition, Section 304 (a)(1)(A)(ii) no doubt applies to situations covered by the WTO Agreements: the fact that in theory it could also be used for determinations in situations that are not covered by the WTO Agreements does not affect its inconsistency with Article 23 of the DSU as already discussed.

4.635 In this context, the European Communities draws the Panel's attention to the distinction made between claims and supporting arguments in earlier cases. Most recently, the Appellate Body report in the case on *Guatemala – Anti-dumping duties on imports of grey Portland cement from Mexico* stated the following<sup>334</sup>:

"The *matter*' referred to the DSB, therefore, consists of two elements: the specific *measures* at issue and the *legal basis of the complaint* (or the *claims*)".

4.636 The European Communities further points out that in the *EC – Bananas III* case, the Appellate Body made the following additional statement:

"Article 6.2 of the DSU requires that the *claims*, but not the *arguments*, must all be specified sufficiently in the request for the establishment of a panel in order to allow the defending party and any third parties to know the legal basis of the complaint. If a *claim* is not specified in the request for the establishment of a panel, then a faulty request cannot be subsequently 'cured' by a complaining party's argumentation in its first written submission to the panel or in any other submission or statement made later in the panel proceeding".<sup>335</sup>

4.637 The European Communities goes on to state that a supporting argument, particularly when made as a reaction to a contestation by the other party to the dispute, cannot on its own be excluded as not being covered by the terms of reference of the Panel which only deals with claims.

4.638 The European Communities recalls that according to the terms of reference of this Panel as described in WTO document WT/DS152/11 of 2 February 1999, the matter referred to the DSB by the European Communities includes the violation of Articles 3, 21, 22, 23 of the DSU, Article XVI:4 of the Marrakech Agreement and Articles I, II, III, VIII and XI of GATT 1994 by Sections 301-310 of the US Trade Act of 1974.

4.639 The European Communities also draws the Panel's attention to the fact that the Panel itself appeared to consider the *Japan – Auto Parts* case to be relevant when it requested Japan, in the questions asked to the third parties, to submit available documentation on this case. Moreover, the European Communities has relied on this case as a reaction to the US reply to a question of the Panel. The European Communities has moreover already rebutted a US allegation that the situation that was at the basis of the *Japan – Auto Parts* case is not covered by the terms of reference of this Panel.

4.640 The European Communities further indicates that it is important to recall the events in the *Japan – Auto Parts* case. In that case, the United States announced on 16 May 1995<sup>336</sup> that it would withhold the liquidation of customs duties on a number of Japanese luxury cars as of 20 May 1995 and that it would impose prohibitive 100 per cent *ad valorem* duties on these cars by a determination to be taken on 28 June 1995, effective as of 20 May 1995, unless the

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<sup>334</sup> Appellate Body Report on *Guatemala – Anti-dumping duties on imports of grey Portland cement from Mexico* ("*Guatemala – Cement*"), 25 November 1998, WT/DS60/AB/R, para. 72 *in fine*.

<sup>335</sup> Appellate Body Report on *EC – Bananas III*, *op. cit.*, para. 143.

<sup>336</sup> The European Communities notes that the announcement was preceded by public statements by the US President and the USTR to the press. Moreover, as the European Communities indicated in its second oral submission, the US House of Representatives adopted a Resolution on the same subject supporting unilateral action announced by the US President.



governments of the United States and Japan could agree on a solution of their dispute that satisfied the US car industry.<sup>337</sup> As a consequence of the withholding of customs liquidation, all imports in the targeted products were immediately stopped as of 20 May 1995. The United States had not requested a dispute settlement procedure prior to these steps.<sup>338</sup>

4.641 The European Communities notes that the United States announced measures entering into effect on a date certain<sup>339</sup> that a WTO Member may only take vis-à-vis another WTO Member upon completion of a DS procedure pursuant to Article 3.7, last sentence, in conjunction with Article 22 and 23 of the DSU, on the basis of an authorization by the DSB under Article 22.2 or 22.7 of the DSU.

4.642 The European Communities points out that these measures were based on a determination explicitly and specifically taken under Sections 301-310 in flagrant violation of the WTO rules on dispute settlement, so much so that the United States itself felt compelled to make a "pre-filing notification" announcing the "intention to invoke the dispute settlement mechanism of the WTO".<sup>340</sup>

4.643 The European Communities further points out that unless there is an authorization granted by the DSB in accordance with Articles 3.7, last sentence, and 22 of the DSU, which in turn must be based on an earlier multilateral determination by a Panel to the effect that a measure nullifies or impairs the benefits accruing to a WTO Member under a covered agreement, discriminatory trade restrictions of the kind provided for under Sections 301-310 and applied by the United States in the *Japan – Auto Parts* case cannot possibly be considered compatible with WTO rules.

4.644 The European Communities also notes that the United States could have been authorized to apply its domestic legislation as it did in the *Japan – Auto Parts* case only by following the prescripts of Article 23 of the DSU. However, as already mentioned before, the United States stopped short of invoking the dispute settlement procedures of the WTO.

4.645 The European Communities then argues that on the basis of the above and since the European Communities has clearly referred in its request for the establishment of a Panel to all the above-mentioned provisions of the DSU, the European Communities does not see how it could be argued that the Panel would be acting outside its terms of reference by taking legal notice of the way in which Sections 301-310 were applied by the USTR in the context of the *Japan – Auto Parts* case, in flagrant violation of precisely these provisions of the DSU.

4.646 The European Communities indicates that the aforesaid Panel's question seems to have as its starting point the consideration that, in the specific case at hand, a distinction could be made between a determination of whether "Japan's act, policy or practice" in this respect is "unreasonable or discriminatory and burdens or restricts United States commerce" and a determination on "whether US rights under the WTO are being denied".

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<sup>337</sup> Cf. Section 301 (c) (4).

<sup>338</sup> The European Communities notes that the so-called "pre-filing" of the intention to invoke the DS mechanism of the WTO which the United States communicated on 10 May 1995 to the Director-General of the WTO does not meet the requirements under the DSU allowing it to be considered a request for starting such a procedure.

<sup>339</sup> Cf. the press statement of the USTR of 16 May 1995 submitted by Japan as Japan Exhibit 6 ("The final determination will be made on June 28, 1995").

<sup>340</sup> Cf. doc. WT/INF/1 of 17 May 1995, submitted by Japan (in its original form) as Japan Exhibit 4.

4.647 The European Communities first notes that the United States, as any WTO Member, is under no circumstances entitled to take trade sanctions against another WTO Member, in particular in the area of trade in goods, without following the requirements under Article 23 of the DSU, and this irrespective of the reasons that could be invoked as a basis for such unilateral measure. The European Communities would like to draw the Panel's attention to the fact that asserting, as the United States seems to do, that it is possible to interpret Sections 301-310 as allowing the United States to impose unilateral retaliatory measures with respect to products, services or other rights under the covered agreements without pursuing a DS procedure as required by Article 23 (and the related provisions under Articles 21 and 22) of the DSU would amount to transform the unqualified and unconditional obligation under Article 23 of the DSU into no more than a "best endeavours" clause. The Panel should reject such unacceptable consequence of the approach suggested by the United States.

4.648 The European Communities secondly draws the attention of the Panel to a possible misunderstanding of the facts surrounding the *Japan - Auto Parts* case, on the one hand, and to the contents of the notice published on 16 May 1995 in the US Federal Register, on the other hand.

4.649 The European Communities recalls that in accordance with the chapeau of Section 304(a)(1), a determination thereunder "shall" be taken "[O]n the basis of the investigation initiated under section 302".

4.650 The European Communities points out that according to the notice published in the US Federal Register on 13 October 1994,<sup>341</sup> the initiation of the investigation was aimed at "certain acts, policies and practices of the Government of Japan that restrict or deny US auto parts suppliers' access to the auto parts replacement and accessories market ("after-market") in Japan". The issue thus was, in the USTR's own language, a restriction or denial of "US auto parts suppliers' access" to the "after-market". A denial or restriction of market access of products corresponds to the typical violation of obligations under the GATT 1947 and 1994.

4.651 The European Communities contends that this view is confirmed by the USTR itself. Prior to the publication of the 16 May notice, in its 10 May 1995 "pre-filing notification" to the Director-General of the WTO,<sup>342</sup> the USTR wrote: "I am writing you today to give pre-filing notification of the intention of the United States to invoke the dispute settlement mechanism of the WTO to challenge the discrimination against the United States and other competitive foreign products in the market for automobiles and automotive parts in Japan".

4.652 In the view of the European Communities, it would thus simply be beyond reason to claim that that issue could be something separate from matters concerning the violation of GATT/WTO obligations, or, in the Section 304 language, "that rights to which the United States is entitled under any trade agreement are being denied".

4.653 The European Communities further notes that the notice published on 16 May 1995,<sup>343</sup> which is apparently the source of the quotation in the chapeau of this question, should not be taken as the exclusive source for a correct understanding of the legal situation in the *Japan - Auto Parts* case. In the attempt to justify its actions in the WTO context, given the strong

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<sup>341</sup> Japan Exhibit 1. The notice was explicitly based on Section 302.

<sup>342</sup> The European Communities notes that this letter was distributed as WTO document WT/INF/1 on 17.5.1995 to all WTO Members.

<sup>343</sup> Japan Exhibit 7.

criticism to which it was subject as a result of its decision,<sup>344</sup> the United States clearly tried to hide the impact of the violation of the WTO rules, in particular of Article 23 of the DSU.<sup>345</sup> In the 16 May notice, even though reference is made to the investigation under section 302 as it appeared in the 13 October notice, the conclusion is not "based on" that investigation that, as the European Communities just recalled, would have required a determination of denial of rights "to which the United States is entitled under any trade agreement".

4.654 The European Communities argues that the attempt to hide the true nature of the "determination" must fail also on the basis of the text of Section 301 itself, in particular under the definitions contained in Section 301(d).<sup>346</sup> These definitions correspond precisely to what is described as a "violation" case, a "non-violation" case or "any other situation" under Article XXIII.1, (a) to (c), of the GATT 1994 and the consistent practice of the GATT 1947 and the WTO panels. These definitions describe without any doubt also a situation that is objectively covered by Article 23, paragraphs 1 and 2 of the DSU, according to which

- "(1) when Members seek redress
- of a violation of obligations or
  - other nullification or impairment or
  - an impediment to the attainment of any objective of the covered agreements
- (2) 'In such cases, Members shall' follow the prescripts of Article 23.2 (a) to (c)".

4.655 The European Communities considers that the United States itself has confirmed the above-mentioned interpretation when it affirmed that:

"[I]n *Japan - Film*, the USTR determined pursuant to Section 304(a)(1)(A)(ii) that certain acts, policies, and practices of the Government of Japan were unreasonable and burden or restrict US commerce and that these acts should be addressed by (1) seeking recourse to WTO dispute settlement procedures to challenge the Japanese measures ...".

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<sup>344</sup> The European Communities notes that Japan requested consultations under Article XXII of the GATT which included the issue of the compatibility of Sections 301-310 with Article 23 of the DSU (see WTO doc. WT/DS6/5 of 27 June 1995). In an earlier statement, supported by other WTO Members, Japan made clear that "If the USG faithfully follows the WTO dispute settlement procedures, there is no need to announce unilateral measures under Section 301 without recourse to the WTO process. Indeed, the Section 301 statutory deadlines will force action even before the WTO procedures have been genuinely concluded" (WTO document WT/INF/2 of 22 May 1995).

<sup>345</sup> The European Communities notes that the so-called "pre-filing of intention" to consult under the WTO dispute settlement procedures provides already sufficient evidence of this US attitude.

<sup>346</sup> Section 301 (d) provides for definitions of what is "discriminatory" or "unreasonable" practice by a foreign country. Section 301(d)(5) provides that "Acts, policies, and practices that are discriminatory include, when appropriate, any act, policy, and practice which denies national or most-favoured-nation treatment to United States goods, services, or investment". Section 301(d)(3)(A) provides that "an act, policy or practice, is unreasonable if the act, or policy, or practice, while not necessarily in violation of, or inconsistent with, the international legal rights of the United States is otherwise unfair and inequitable".

4.656 The European Communities points out that the Panel is aware, the United States decided (correctly in that case) to pursue a DS procedure against Japan based on Article XXIII.1 (b) of GATT 1994 ("non-violation" case).<sup>347</sup> The European Communities does not understand how the United States could claim now that the same Section 304(a)(1)(A)(ii) would allow it to act unilaterally outside the obligatory WTO procedures thus disregarding its unqualified and unconditional obligations pursuant to Article 23 of the DSU.

4.657 The European Communities then concludes that whatever the precise terms of the determination in the *Japan – Auto Parts* case, there can be no serious doubt that this determination was made in total disregard of the requirements of Article 23 of the DSU.

4.658 In the light of the above, the European Communities repeats that it does not make an additional claim in relation to the *Japan - Auto Parts* case, other than those already mentioned. Under these circumstances, there is no need for the European Communities to respond in detail to sub-questions (b) and (c).

4.659 In response to the same Panel's question (whether the European Communities, in referring to the "unreasonableness" determination under Section 301(b) in *Japan – Auto Parts*, was making an additional claim within the terms of reference), **the United States considers** that it is for the European Communities to say whether it is making this claim. If, indeed, its response is that the European Communities is making such a claim, the United States would need an opportunity to respond. However, as question (b) recognises, this claim, if asserted, would raise an issue not within the Panel's terms of reference. Any such claim would, in fact, be additional to those raised by the European Communities in this dispute.

4.660 The United States contends that there the European Communities requests findings concerning alleged violations of DSU Article 23.2(a) and (c) based on arguments that Sections 304(a)(2)(A) and 306(b) require the USTR to make determinations and to implement action regarding and in connection with WTO Agreement rights without DSB-adopted findings or DSB authorization. In paragraph 77, the European Communities also requests a finding that Section 306(b) is inconsistent with "one or more" GATT 1994 provisions for unspecified reasons, and a ruling to be made "on the basis of these findings" that the US has acted inconsistently with WTO Agreement Article XVI:4 "by failing to bring the Trade Act of 1974 into conformity with" DSU Article 23 and the GATT 1994.

4.661 The United States claims that Article 23.2 sets forth requirements on how a Member may make determinations and suspend concessions when that Member is seeking the redress of a "violation of obligations or other nullification or impairment of benefits under the covered agreements".<sup>348</sup> Moreover, Article 23.2(a) by its terms deals only with determinations "to the effect that a violation has occurred". It does not deal with determinations that a violation has not occurred or has not been confirmed, or with determinations unrelated to WTO Agreement rights.

4.662 The United States points out that no determination relating to WTO Agreement rights was made in the *Japan - Auto Parts* case. As the question notes, the determination in that case involved the issue of whether Japan's acts, practices and policies were "unreasonable", not whether US rights under the WTO had been denied. Any claim in connection with the *Auto*

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<sup>347</sup> *Japan - Measures Affecting Consumer Photographic Film and Paper*, WT/DS44.

<sup>348</sup> DSU, Article 23.1. The United States notes that Article 23.2 is prefaced with the phrase, "In such cases".

*Parts* case thus would bear no relationship to any of the EC claims relating to Article 23. In addition, the EC's claim relating to *Auto Parts* does not relate to the EC's claim concerning alleged violations of GATT 1994 by Section 306. The *Auto Parts* case did not involve Section 306 in any way.

4.663 The United States goes on to state that this claim would not be within the Panel's terms of reference, which relate only to the Section 301-310 legislation as such, and not any particular application of that legislation.<sup>349</sup> If the European Communities does take the position that it is asserting this claim, the United States requests a preliminary ruling from the Panel that it is not within the terms of reference. The United States requests that the Panel render such a ruling before addressing the merits of the claim.

4.664 The United States further notes that the EC's panel request provides that, "this legislation does not allow the United States to comply with the rules of the DSU and the obligations of GATT 1994", that "this legislation" is inconsistent with various WTO provisions, and that "this legislation" nullifies and impairs benefits accruing to the European Communities.<sup>350</sup> The European Communities has emphasized over the course of these proceedings that it is the legislation, and not any particular application of that legislation, which is in the terms of reference of this case.<sup>351</sup> As a result, the panel may not examine the *Auto Parts* case or the EC's claim that a decision in the context of that case not to bring a WTO case is somehow WTO-inconsistent.

4.665 In the view of the United States, the Autos 302 investigation is also outside the panel's terms of reference because it does not relate to the aspects of Sections 301-310 which the European Communities describes in its panel request. There it states,

"By imposing specific, strict time limits within which unilateral determinations must be made that other WTO Members have failed to comply with their WTO obligations and trade sanctions must be taken against such WTO Members, this legislation does not allow the United States to comply with the rules of the DSU and the obligations of GATT 1994 in situations where the Dispute Settlement Body (DSB) has, by the end of those time limits, not made a prior determination that the WTO Member concerned has failed to comply with its WTO obligations and has not authorized the suspension of concessions or other obligations on that basis".<sup>352</sup>

4.666 The United States contends that thus, the aspects of Sections 301-310 within the terms of reference of this dispute are provisions relating to deadlines and how these deadlines allegedly mandate determinations and actions inconsistent with the DSU and GATT 1994 because they are not based on DSB-adopted findings or DSB authorization. Indeed, that is precisely the focus of the European Communities. The EC's *Auto Parts* claim is completely unrelated to the EC's claim that Section 301 deadlines allegedly do not allow determinations and

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<sup>349</sup> The United States notes that indeed, no specific Section 302 investigation is within the Panel's terms of reference.

<sup>350</sup> WT/DS152/11.

<sup>351</sup> The United States points out that the European Communities argues that it is of little importance what the USTR has actually done in [individual cases]". The European Communities makes this point to suggest that even the Trade Representative's exercise of any discretion under the statute is unacceptable, but it more accurately supports the point that how the Trade Representative exercises her discretion in a given case is not conclusive as to what is commanded by the statute).

<sup>352</sup> WT/DS152/11 (emphasis added).

actions to be made with DSB approval, and relates to determinations under Section 301(b), which do not relate to WTO rights and obligations. The mere existence of such determinations in Sections 301-310 is nowhere addressed in the terms of reference.

4.667 The United States further indicates that the introduction of a new claim at the second panel meeting raises serious due process concerns which should, on that basis alone, lead the Panel to reject consideration of the EC's *Auto Parts* claim. The United States notes that not only was the EC's claim raised for the first time at the Second Meeting of the Panel, but it was raised extemporaneously. The opportunity to respond effectively was thus further limited. These due process concerns require that the United State be given an opportunity to respond to this claim, if asserted by the European Communities and if the Panel concludes it is within the terms of reference.

4.668 In the view of the United States, the European Communities has attempted to expand the nature of its arguments beyond the straightforward textual analysis contemplated in its panel request and advanced later. That analysis involved the question of whether the time frames in Sections 301-310 "do not allow" the USTR to make determinations and to take action in accordance with DSU rules. The EC's argument has since expanded to include the notion that the statute's mere existence threatens "security and predictability" and discussions of specific applications of Sections 301-310 not within the terms of reference for the sole purpose of distracting the Panel from its legal analysis. Nevertheless, even these arguments could be addressed to the extent included in submissions prior to the Second Meeting of the Panel. To raise a new issue at the Second Meeting for the first time denies a defending party any effective opportunity to rebut or consider the argument. This is particularly a problem with respect to the EC's new claim, since it is so vague and poorly defined.

4.669 In addition, the United States notes that the evidence submitted in connection with the EC's extemporaneous introduction of its claim must be excluded from the record on the basis of Rule 12 of the Panel's Working Procedures. The panel must abide by the procedures it laid down at the outset of this proceeding. That rule states that, "Parties shall submit all factual evidence to the Panel no later than the first substantive meeting, except with respect to evidence necessary for purposes of rebuttal submissions, answers to questions or comments on answers provided by others".<sup>353</sup> The evidence submitted by the European Communities in connection with the EC's new claim is not necessary for rebuttal, for answers to questions or for comments on those questions. It is particularly inappropriate for the European Communities to have introduced this claim and supporting evidence at the second substantive meeting because this information was equally available at the outset of this case and relates to an incident a number of years in the past.

**(c) Discretion with respect to the timing of determination and other issues relating to time frames**

4.670 **The European Communities considers** that the DSU does not provide Members with the assurance that the DSB will adopt findings on their complaints within that time frame. The DSU allots to each stage in the dispute settlement proceeding a minimum or maximum period of time.<sup>354</sup>

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<sup>353</sup> Working Procedures for the Panel, Rule 12 (19 April 1999).

<sup>354</sup> These time limits are summarised for the convenience of the Panel as EC Exhibit II.

4.671 The European Communities claims that according to Article 5.4 of the DSU, "the complaining party must allow a period of 60 days after the date of receipt of the request for consultations before requesting the establishment of a panel". The request for the establishment of the panel must be submitted at least 10 days before the meeting of the DSB.<sup>355</sup> Since the DSB normally meets at monthly intervals, the first meeting at which the request for the establishment of the panel can be considered will thus take place between 10 days and one month after the end of the consultation period.

4.672 The European Communities states that Article 6.1 of the DSU provides that, upon request, "a panel shall be established at the latest at the DSB meeting following that at which the request first appears as an item on the DSB's agenda ..." and that "a meeting for this purpose shall be convened for this purpose within 15 days of the request ...".

4.673 Further, the European Communities argues that according to Article 20 of the DSU, the maximum period between the establishment of the panel and the adoption of the Appellate Body report is normally 12 months. However, this maximum period is extended by up to three months if the panel makes use of its right under Article 12.9 of the DSU to delay the circulation of its report and by a further period of up to 30 days if the Appellate Body extends its proceedings in accordance with Article 17.5 of the DSU. The total period thus is 15 months plus 30 days, or about 16 months.

Phase	Months	Days
Consultations		60
From end of consultation period to establishment of a panel	1	15
From establishment of the panel to the adoption of the Appellate Body report	15	30
TOTAL	16	105

4.674 The European Communities then considers that even on the assumption that all the Dispute Settlement organs of the WTO act within the period of time allotted to them under the DSU, a period of 19 ½ months is at the disposal for the normal operation of a given dispute settlement procedure. This is without prejudice to the possibility for the parties, and in particular for the complainant, to extend, at their discretion, these deadlines beyond the 19 1/2 months period allocated to the dispute settlements organs.

4.675 The European Communities then concludes that the USTR is therefore mandated by Section 304(a)(2)(A) to make a determination on the United States' denial of rights under a WTO agreement within a time frame that is shorter than the time frame within which it can reasonably expect DSB findings on that matter.

4.676 The European Communities, however, stresses that this is the most important issue in this respect, a possible delay in the dispute settlement proceedings does not give the United States the right to revert to unilateralism. As a result of the Uruguay Round, the United States

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<sup>355</sup> The European Communities refers to Rules 2 and 4 of the rules of procedure of the General Council which are applicable to the DSB pursuant to Rule 1 of the rules of procedure of the Dispute Settlement Body.

has undertaken an unqualified and unconditional international obligation not to revert to unilateral determinations and actions. As was already mentioned in para. 10 above, the deal was struck on the basis of a concession by the European Communities and other Uruguay Round participants allowing for binding dispute settlement against a commitment by the United States to refrain from unilateral determinations and section 301-type trade restrictions without multilateral authorization. By imposing an obligation upon USTR to determine in all cases within 18 months of the request for consultations whether the United States' WTO rights are being denied without awaiting the conclusion of the relevant DS procedures, the United States is clearly in breach of this unconditional obligation, and in particular of Article 23.2(a) of the DSU.

4.677 **The United States responds** that even if the European Communities were permitted to assume that the USTR's determination under Section 304(a)(1) will always be affirmative, its analysis of the time frames under Section 304(a)(2)(A) and whether they conflict with those in the DSU is incorrect. The United States specifically considered DSU time frames when Sections 301 - 310 were amended in 1994, and these time frames are compatible with those in Section 304(a)(2)(A).<sup>356</sup>

4.678 The United States goes on to argue that the European Communities focuses on whether the USTR's determination must, because of the 18-month time frame in Section 304(a)(2), occur before DSB adoption of panel and dispute settlement findings in those instances in which dispute settlement proceedings require the maximum period provided for in the DSU. According to the European Communities, because Section 303 requires that the USTR request consultations on the date a Section 302 investigation is initiated, and because a determination must be made no later than 18 months after the investigation is initiated, the USTR must necessarily make its determination before DSB adoption in some cases.

4.679 In the view of the United States, the EC's claim is based on its conclusion that, under the DSU, the maximum period from a request for consultations until DSB adoption of panel and Appellate Body findings is 19 ½ months. The European Communities assumes not only that the panel and Appellate Body require the maximum time authorized under the DSU for their deliberations and report preparations, but that DSB meetings are held on the final day allowed under the DSU to establish the panel, to adopt the panel report (and thereby establish the deadline for an appeal), and to adopt the Appellate Body report.

4.680 The United States argues that the European Communities has however simply miscalculated the deadlines under the DSU. First, the European Communities has erroneously assumed that the normal period for panel proceedings may be extended by three months pursuant to DSU Article 12.9, rather than the actual figure of two months or less.<sup>357</sup> Thus, even

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<sup>356</sup> The United States refers to Statement of Administrative Action, op. cit., p. 360 (US Exhibit 11), as describing amendments to "section 304 ... and section 305 ... to ensure that the timetables for investigations and determinations under the enforcement provisions of U.S. trade laws allow DSU dispute settlement proceedings to be completed before trade sanctions may be imposed".

<sup>357</sup> In the US view, the European Communities appears to have incorrectly assumed that the six month figure referred to in the first sentence of Article 12.9 was measured on the same basis as the nine month figure in the second sentence. In fact, the six-month figure in the first sentence is, as indicated in Article 12.8, measured from panel *composition* to issuance of the report *to the parties*, while the nine month figure is measured from *establishment* of the panel to circulation of the report *to the Members*. Since panel composition may require a month (DSU Article 8.7), and, under DSU Appendix 3 guidelines (para. 12(k)), the period between issuance of the report to the parties and circulation to the Members is two to three weeks, the actual extension provided for under Article 12.9 is at most two months (assuming



if the EC's other assumptions were correct, the maximum period for dispute settlement proceedings under Article 20 would be between 17 months and three weeks and 18 ½ months, and not 19 ½ months.<sup>358</sup>

4.681 The United States further claims that even this 18 ½ month time frame is longer than that provided for in the DSU. This is because the European Communities assumes a longer period than it may (1) between the completion of consultations and the DSB meeting at which the panel request first appears on the agenda, and (2) between circulation of the panel report and the DSB meeting at which the report is scheduled for adoption (which establishes the deadline for an appeal). With respect to the DSB meeting at which the panel request first appears on the agenda, the European Communities ignores footnote 5 to DSU Article 6.1, which requires a DSB meeting to be convened to consider panel establishment within 15 days of a request.<sup>359</sup> Thus, the European Communities may not assume that the first DSB meeting after the consultation period will take place 30 days after the conclusion of the consultation period, or that the period for establishment of the panel will require one and a half months, rather than one month.

4.682 The United States considers that likewise, the European Communities ignores the fact that a Member may, at any time, request that a DSB meeting be held.<sup>360</sup> Both for this reason and because DSB meetings generally take place on a monthly basis, the European Communities may not assume that the DSB meeting at which the panel report is scheduled for adoption will take place 60 days after circulation.

4.683 The United States points out that while it is not unreasonable for the European Communities to assume that certain aspects of the dispute settlement schedule are beyond the control of the United States (consultation period under Article 4.7, panel deadline under Article 12.9, Appellate Body deadline under Article 17.5), the European Communities may not assume that the United States would not act to expedite the dispute settlement schedule were this necessary to ensure that US determinations under Section 304 are fully consistent with US DSU obligations.<sup>361</sup> Thus, for purposes of comparing Section 301 time frames with the maximum period provided for dispute settlement proceedings under the DSU, the relevant period is 16 months and 20 days.<sup>362</sup>

4.684 The United States further argues that even if it were assumed that the United States could not expedite the DSB meeting schedule, and that the maximum period under the DSU for dispute settlement proceedings were more than 18 months, the European Communities would still be incorrect in concluding that Section 304(a)(2)(A) precludes the USTR from issuing her determination after DSB adoption of Appellate Body findings. This is because the United

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no time between issuance to the parties and circulation to Members), and arguably 1 month and one week (assuming a three week period before the panel report is circulated to Members).

<sup>358</sup> The United States refers to the above footnote.

<sup>359</sup> DSU Article 6.1 and footnote 5.

<sup>360</sup> The United States claims that Rules 1 and 2 of the rules of procedure of the General Council, which are applicable to the DSB pursuant to Rule 1 of the rules of procedure of the Dispute Settlement Body.

<sup>361</sup> Again, the United States claims that it is not in fact necessary for it to request DSB meetings prior to those normally scheduled because the Trade Representative is not required under Section 304(a)(1) determine that US agreement rights have been denied.

<sup>362</sup> US Exhibit 2.

States may, under US law, request WTO dispute consultations prior to initiating a Section 302 investigation. Nothing in Sections 301-310 prevents this, and the USTR has in fact done so.<sup>363</sup>

4.685 The United States then states that Section 302(a)(2) provides the USTR 45 days from the filing of a petition to determine whether she will initiate an investigation, during which period the USTR is free to request dispute settlement consultations.<sup>364</sup> Moreover, under Section 302(b), the USTR is free to self-initiate an investigation at any time; in such a case, there is nothing preventing the USTR from first requesting dispute settlement consultations.<sup>365</sup>

4.686 The United States emphasises that to meet its burden with respect to Section 304(a)(2)(A), the European Communities must demonstrate that it would not be possible<sup>366</sup> under the 18-month time frame in that section for the USTR to issue a WTO-consistent determination. In addition to the reasons set forth above with respect to the determination itself and the EC's miscalculation of DSU deadlines, the European Communities has failed to meet its burden because it has not established why the USTR could not initiate a Section 301 investigation several weeks after a US request for WTO dispute settlement consultations, thereby allowing for DSB adoption of panel and Appellate Body findings within the 18-month period provided for under Section 304(a)(2)(A).

4.687 The United States further claims that even if it were assumed that Sections 301-310 preclude the USTR from requesting consultations prior to initiating a Section 302 investigation, that the USTR could not expedite the DSB meeting schedule, and that the maximum period for dispute settlement were 18 ½ months, this would still mean that the USTR would always have the benefit of circulated Appellate Body findings when she makes her determination.<sup>367</sup> Moreover, in light of the negative-consensus rule of DSU Article 17.14, the USTR would also know that the DSB would adopt the reports of the panel and/or Appellate Body when it meets, and would also know the date of that meeting.<sup>368</sup>

4.688 In the view of the United States, the goal of Article 23.1 is to ensure that WTO Members resort to multilateral dispute settlement procedures, and it is difficult to understand

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<sup>363</sup> The United States, as an example, Initiation of Section 302 Investigation and Request for Public Comment: Japan Market Access Barriers to Agricultural Products, 62 Fed. Reg. 53853 (1997) (US Exhibit 8) (consultations under DSU requested April 7, 1997, investigation initiated on October 7, 1997); Korea's Restrictions on Imports of High Quality Beef; Notice of Initiation, 53 Fed. Reg. 10995 (1988) (US Exhibit 9) (GATT 1947 Article XXIII:1 consultations held February 19-20, 1988 and March 21, 1988, investigation initiated on March 28, 1988).

<sup>364</sup> Section 302(a)(2), 19 U.S.C. § 2412(a)(2).

<sup>365</sup> Section 302(b)(1)(A), 19 U.S.C. § 2412(b)(1)(A). The United States points out that just as the European Communities has authority under its Article 133 procedures to undertake dispute settlement proceedings without resorting to the procedures set forth in its Trade Barrier Regulation, see Section IV.D below, the Trade Representative and her office have independent authority to act for the United States at the WTO, including activities relating to dispute settlement proceedings such as requesting and holding consultations. See 19 U.S.C. § 2171(c)(1) (1998); Reorg. Plan No. 3 of 1979, 44 Fed. Reg. 69273 (1979); 19 C.F.R. § 2001.3(a) (1998).

<sup>366</sup> The United States cites Panel Report on *US – Superfund*, op. cit., para. 5.2.9; Panel Report on *Thai – Cigarettes*, op. cit., para. 86.

<sup>367</sup> In the US view, assuming a maximum of 18 ½ months from the consultation request to DSB adoption, the Appellate Body report would be issued no later than 17 ½ months after the request for consultations. See DSU Article 17.14.

<sup>368</sup> According to the United States, if a regularly scheduled DSB meeting were not scheduled to take place within 30 days following circulation of the Appellate Body report to Members, such a meeting would be scheduled. DSB Article 17.14 and footnote 8.

how this goal would be frustrated if the United States were to follow such procedures through to their conclusion and state what every WTO Member would already know – that US WTO rights had been denied, and that the DSB would shortly adopt that conclusion. Thus, even if (as is not the case) the USTR were required under US law to make an unqualified affirmative determination under Section 304(a)(1) based on favorable, but unadopted, panel and Appellate Body findings, such a determination would not be inconsistent with the goal of Article 23 – multilateral determinations of violations.

4.689 The United States further stresses that nothing in Sections 301-310 compels the USTR to make a determination that US agreement rights have been denied in the absence of adopted Appellate Body or panel findings, nor do Sections 301-310 compel the USTR to wait until the initiation of a Section 302 investigation to request dispute settlement consultations. Moreover, the European Communities is incorrect in claiming that the time frames for dispute settlement under the DSU are longer than 18 months. The European Communities has therefore not demonstrated that Section 304(a)(2)(A) precludes the USTR from fully complying with the letter and spirit of DSU Article 23.

4.690 In response to the Panel's question on the precise basis under Section 304, or any other legal basis, for the United States to argue that unless WTO procedures are completed, the USTR is precluded from making a determination of violation, the United States argues that Section 304(a)(1) requires that determinations under that section be made "on the basis of the investigation initiated under Section 302 and the consultations (and the proceedings, if applicable, under section 303)". The "proceedings" under Section 303 are dispute settlement proceedings.<sup>369</sup> Moreover, such proceedings would be "applicable" in any case involving a trade agreement, since Section 303 requires that dispute settlement procedures under a trade agreement be invoked in any case involving a trade agreement, if no mutually acceptable resolution has been achieved.<sup>370</sup>

4.691 The United States notes that Section 304(a)(2) specifies the timing of the USTR's determinations under Section 304(a)(1). Under this provision, the USTR must make her determination under Section 304(a)(1) by the earlier of 30 days after the conclusion of dispute settlement proceedings or 18 months after initiation of an investigation. The 18-month time frame permits the USTR to base her determination on adopted panel and Appellate Body findings in all cases.<sup>371</sup> The United States specifically considered DSU time frames when amending Section 304 in 1994 to ensure the compatibility of Section 304 time frames with those in the DSU.<sup>372</sup>

4.692 The United States examines the numerous assumptions on which the EC argument rests. US Exhibit 10 summarizes these assumptions. The United States argues that for each EC claim, all of the EC's assumptions must be correct for it to prevail, but none of them is correct.

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<sup>369</sup> The United States claims that Section 303(a)(2) provides that if dispute settlement consultations under a trade agreement have not resulted in a mutually acceptable resolution, the USTR shall request "proceedings" under the "formal dispute settlement procedures provided under such agreement".

<sup>370</sup> Ibid.

<sup>371</sup> The United States refers to US Exhibit 2. As explained there, the European Communities has, in paragraph 77 of its First Submission, miscalculated the time frames provided for under the DSU.

<sup>372</sup> Statement of Administrative Action at 360, *reprinted in* H.R. Doc. No. 103-316, at 1029 (US Exhibit 3) (describing amendments to "section 304 . . . and section 305 . . . to ensure that the timetables for investigations and determinations under the enforcement provisions of U.S. trade laws allow DSU dispute settlement proceedings to be completed before trade sanctions may be imposed".).

4.693 In the view of the United States, the first set of EC assumptions relates to its claim that Section 304 mandates a violation of DSU Article 23.2(a). The European Communities argues that Section 304 requires the USTR to make a determination that US trade agreement rights have been violated within 18 months of initiation of a Section 302 investigation, while the DSU provides for a longer period for completion and adoption of panel and Appellate Body proceedings in some instances.

4.694 The United States notes that these EC assumptions relate to the time frames in Section 301 and the DSU. However, because Section 304 does not mandate an affirmative determination, these time frames are simply not relevant to the Panel's decision. Nevertheless, even were this not so, the 18-month time frame in the statute would not prevent the USTR from complying to the letter with DSU rules and procedures. The EC's calculation of the time by which a panel may extend its proceedings is incorrect by one month. Moreover, the European Communities ignores the fact that DSB meetings normally are held monthly and instead assumes that DSB meetings would not be held until the final day permitted under the DSU. The European Communities also assumes that the United States would not attempt to affect the schedule of DSB meetings. Finally, the European Communities ignores the fact that Sections 301-310 do not preclude the USTR from initiating dispute settlement proceedings before initiating a Section 301 investigation. Thus, wholly apart from the fact that the European Communities cannot assume that the USTR will always make an affirmative determination, the time frames in the US statute do, in fact, permit the USTR to base her determination on adopted panel and Appellate Body findings. The DSU time frames were negotiated with this 18-month time frame in mind, and the European Communities and others were well aware of this fact during the Uruguay Round.

4.695 **The European Communities notes** that the European Communities and the United States differ on certain timeframes under the DSU.

4.696 The European Communities notes that as to this time frame, the United States claims that the total length is 18 months while the European Communities claims that the total length is 19 ½ months. This difference arises from different assumptions on the length of time it takes to establish and compose Panels.

4.697 The European Communities rebuts the US assumption that all the panels that it requests the DSB to establish are composed as a result of two special meetings of the DSB convened in accordance with Article 6.1 of the DSU. This provision provides that, upon request,

"a Panel shall be established at the latest at the DSB meeting following that at which the request first appears as an item on the DSB's agenda ...". and that "a meeting for this purpose shall be convened for this purpose within 15 days of the request ...".

4.698 The European Communities indicates that it interprets the terms "for this purpose" to refer to the second meeting of the DSB at which the panel must be established. This is in conformity with the consistent practice of the WTO Members and of the DSB. The complainant can thus not request two special DSB meetings benefiting from the compulsory reduced time of convocation, as the United States assumes, but only one. Since the DSB normally meets once a month (but not necessarily every month, as during August and at the end of the year DSB meetings are rarely held), the complainant can for these reasons not expect the establishment of the Panel until one month + 15 days have lapsed.

4.699 The European Communities notes that the United States claims that it can at any time request a special meeting of the DSB. However, the United States has a right to a special meeting (i.e. benefiting from the compulsory reduced time of convocation) only in the circumstances foreseen in the DSU and can therefore not count on two special DSB meetings.

4.700 Moreover, the European Communities points out that the United States makes the assumption that it will in all cases request two special meetings in anticipation of later delays. The US assumption is based on a logical *non-sequitur*. The anticipation of the delays would be put in practice without knowing whether any delay at all would appear in the course of the procedure. The panelists in the *EC – Hormones (US)* case, for example, could not have anticipated the duration of the procedure before they actually started it and recognised the need to request expert advice on extremely sensitive and complicated scientific issues brought to their attention. Consequently, the US assumption could only be credible if it could show that it pursued a systematic policy of shortening the procedural deadlines by anticipation. However, the United States has not shown (and cannot show) it pursued such a systematic practice.

4.701 The European Communities further notes that the second source of discrepancy can be found in the different assumptions regarding the length of the extension period under Article 12.9 of the DSU.

4.702 The European Communities recalls that the United States assumes that the composition of the Panel takes one month and that the actual extension provided for under Article 12.9 is therefore only two months.

4.703 The European Communities argues that here it assumed that the Panel is composed shortly after it has been established (for instance, there was no disagreement on the composition between the parties). Under the EC's assumption, the two starting dates for calculating the six-month and the nine-month periods referred to in Article 12.9 are close to one another so that the period of extension available to the Panel effectively remains three months.

4.704 The European Communities is further of the view that the United States' claims are based on a misrepresentation of the discretion available to the United States under the legislation at issue. Under Sections 301-310, the USTR must determine within specified time frames whether United States' rights under a WTO agreement are being denied and whether a failure to implement DSB recommendations has occurred.<sup>373</sup>

4.705 The European Communities challenges the US claim that the USTR has the right not to make any determination at all or to decide to postpone the determination so as to await the completion of WTO proceedings. There is nothing in the text of Sections 301-310 to support this claim. The explicit requirements to make a determination within a specified time frame whether the United States' WTO rights are being denied or a failure to implement DSB recommendations has occurred would be completely frustrated if they were deemed fulfilled by a decision to postpone the determination.

4.706 The European Communities maintains that it is irrelevant whether the USTR has decided in a few individual cases to postpone her determination beyond the deadlines foreseen in Sections 301-310. Both parties agree that the issue in this dispute is the legislation of the United States, not its actual application. The European Communities would like to recall in this

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<sup>373</sup> In particular Sections 304(a)(1) and 306 (b).

context the following ruling of the GATT panel on *United States - Measures Affecting Alcoholic and Malt Beverages (Beer II)*

"Even if Massachusetts may not currently be using its police powers to enforce this mandatory legislation, the measure continues to be mandatory legislation which may influence the decisions of economic operators. Hence, a non-enforcement of a mandatory law in respect of imported products does not ensure that imported beer and wine are not treated less favourably than like domestic products to which the law does not apply".<sup>374</sup>

4.707 The European Communities recalls the arguments that the United States presented to the WTO panel on *India - Patents (US)*:

"The mailbox system ... had a rationale common to many other WTO obligations, 'namely to protect expectations of the contracting parties as the competitive relationship between their products and those of other contracting parties'. The *Superfund* report had established clearly the importance of 'creat[ing] the predictability needed to plan future trade.' ... Despite India's claim that it had decided for the moment not to enforce the mandatory provisions of ... its Patent Act ... that 'measure continues to be mandatory legislation, which may influence the decisions of economic operators.' The economic operators in the present case - potential patent applicants - had no confidence that a valid mailbox system had been established ... To paraphrase the *Beer II* panel, a non-enforcement of a mandatory law that violated a WTO obligations did not ensure that the obligation was not being broken".<sup>375</sup>

4.708 The European Communities then argues that the provisions of Sections 301-310 stipulating WTO-inconsistent action would thus remain WTO-inconsistent even if the USTR did not enforce them at all.<sup>376</sup>

4.709 The European Communities agrees that the time limits set out in the DSU are not "legally binding" in the sense that they affect neither the obligations under Article 23 of the DSU nor the validity of the act of the judicial organs subject to the time limits. On this issue, the European Communities would like to draw the Panel's attention to the following.

4.710 The European Communities points out that the arbitrators' decision on the EC banana regime was submitted on 9 April 1999. According to Article 22.6 of the DSU, their work should have been completed on 3 March 1999, that is 60 days after 1 January 1999, the date on which the implementation period accorded to the European Communities expired. The arbitrators explained in their decision that this delay did not have any impact on the validity of that decision:

"On the face of it, the 60-day period specified in Article 22.6 does not limit the jurisdiction of the Arbitrators *ratione temporis*. It imposes a *procedural*

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<sup>374</sup> Panel Report on *US - Malt Beverages*, op. cit., p. 290 at BISD 39S.

<sup>375</sup> Panel Report on *India - Patents (US)*, op. cit., para. 4.4 (footnotes omitted, underlining added).

<sup>376</sup> In the EC's view, this is the way in which the law was applied in a number of cases (e.g. *Japan - Autos and Auto Parts* and *EC - Bananas*). Their non-application in a few other cases, in contradiction with the plain language of the law, cannot demonstrate their WTO-consistency.

obligation on the Arbitrators in respect of the conduct of their work, not a *substantive* obligation in respect of the validity. In our view, if the time-period of Article 17.5 and Article 22.6 of the DSU were to cause the lapse of the authority of the Appellate Body or the Arbitrators, the DSU would have explicitly provided so. Such a lapse of jurisdiction is explicitly foreseen, e.g. in Article 12.12 of the DSU which provides that "if the work of the Panel has been suspended for more than 12 months, the authority for establishment of the Panel shall lapse".<sup>377</sup>

4.711 The European Communities notes that the Arbitrators thus considered that the DSU provisions imposing time limits relate exclusively to their work and not to the substantive validity of its result. They expected the DSB to authorize the suspension of concessions and other obligations on the basis of their decision even though it had been made available after the time limits foreseen in Article 22.6. The DSB authorized the suspension on 19 April 1999, thereby indicating that its jurisdiction to grant such an authorization is not time-bound.

4.712 The European Communities further argues that in domestic law, a "provision in a statute, rule of procedure, or the like, which is a mere direction or instruction ... involving no invalidating consequences for its disregard ... as in the case of a statute requiring an officer to prepare and deliver a document ... before a certain day" is considered to be a "directory" provision.<sup>378</sup> The case of the arbitration decision on the EC banana regime demonstrates, that the arbitrators, and the DSB perceived the time limits set out in Article 22.6 of the DSU to be of a "directory" nature whose disregard does not change the substantive rights and obligations of Members.

4.713 In the view of the European Communities, the directory nature of the time limits is reflected in the practice under the DSU. The median time period that lapsed between the establishment of the Panels and the adoption of the reports has been 13 months and 28 days, which is well within the target set out in Article 20 of the DSU and the time frame foreseen in Sections 301-310. However, this median covers periods from 11 months and 6 days to 21 months and 5 days.<sup>379</sup> It would be wrong to attribute the delays referred to in the question to inefficiencies in the conduct of the proceedings. In some cases, the issues involved in the proceedings were simply too complex to be resolved within the standard time limits; in other cases, the Panels required more time to obtain expert advice. The delays were thus necessary to ensure due process for the parties to the proceedings.

4.714 **The United States rejects** the EC argument that the non-application of statutory time-frames would render them WTO-consistent because that is not a relevant issue in this dispute. The European Communities has failed first to establish that Sections 301-310 mandate WTO-inconsistent actions, so it is irrelevant whether they are not applied in a given case. The USTR has more than adequate statutory discretion to comply with WTO rules without ignoring the statute.

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<sup>377</sup> Footnote 7 of the Arbitrators' award.

<sup>378</sup> Black's Law Dictionary (Sixth Edition).

<sup>379</sup> The United States refers to the table entitled "WTO Dispute Settlement Timeframes - Panels Established and Composed - 1 January 1995 and 30 April 1999" in the informal Secretariat Note circulated as Job No. 2330 on 22 April 1999.

4.715 The United States further adds that Article 21.4 of the DSU supports the US view that the European Communities has erroneously claimed that panels may extend their proceedings by three, rather than two, months. Article 21.4 provides:

"Except where the panel or the Appellate Body has extended, pursuant to paragraph 9 of Article 12 or paragraph 5 of Article 17, the time of providing its report, the period from the date of establishment of the panel by the DSB until the date of determination of the reasonable period of time *shall not exceed 15 months* unless the parties to the dispute agree otherwise. Where either the panel or Appellate Body has acted to extend the time of providing its report, the additional time taken shall be added to the 15-month period, provided that unless the parties to the dispute agree that there are exceptional circumstances, the total time *shall not exceed 18 months*".<sup>380</sup>

4.716 The United States points out that Article 21.4 sets forth the maximum period from panel establishment to determination of the reasonable period of time, a period 90 days longer than the period from panel establishment to adoption of the panel and Appellate Body reports.<sup>381</sup> Subtracting 90 days from each of the time frames in Article 21.4 yields a maximum period from panel establishment to adoption of the panel and Appellate Body reports as 12 months if the panel and Appellate Body have not extended the time for issuing their reports and 15 months if they have. Since Article 17.5 clearly provides 30 days for the Appellate Body to extend the time for issuing its report, this leaves at most two months for the panel to extend the time to circulate its report (assuming no time between issuance and circulation).

4.717 The United States also notes that, with the exception of also erroneously assuming that panels may extend their proceedings by three months, the time frames set forth by Thailand in its oral statement match those described by the United States regarding the maximum period permitted under the DSU. Based on its error, Thailand stated that the period was 19 months, rather than 18 months. However, even this is longer than may be assumed for purposes of this dispute, since regularly held DSB meetings generally occur monthly and since the United States could, if necessary, request DSB meetings to ensure that time frames are met.

4.718 In response to the Panel's question as to the relevance, to the parties' discussion on DSU timeframes, of the following arguments: (1) most DSU timeframes do not seem to be legally binding and are determined case by case not by the claiming party but by the panel, Appellate Body or even the defendant; (2) of the 22 cases where a panel and/or Appellate Body report has been adopted, 12 cases required more than 18 months for reports to get adopted, the United States notes that the time frames in Article 21.4 do appear to be legally binding, since they provide that the time frames "shall not exceed 18 months". The consequences of any failure to meet these time frames is less clear.

4.719 The United States argues that in any event, for purposes of deciding this dispute, the time frames in the DSU are, in the end, not relevant, nor is the fact that these time frames have been exceeded in many cases. Because the USTR is free, under Section 304, not to make a determination that a violation has occurred, she is not required to make a determination inconsistent with Article 23.2(a). Sections 301-310 do not mandate any DSU violations.

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<sup>380</sup> DSU Art. 21.4 (emphasis added).

<sup>381</sup> DSU Art. 21.3 (the period for determining the reasonable period of time through arbitration is 90 days from the adoption of the panel and Appellate Body reports).



4.720 The United States further claims that on the other hand, were it incorrectly assumed that Section 304 actually does mandate a determination that a violation has occurred, the time frames in the DSU would remain relevant, though the actual performance of panels in complying with these time frames would not. This is because this dispute involves an examination of whether the mere existence of Sections 301-310 violates WTO rules. In determining whether the legislation mandates a violation of DSU Article 23, certain assumptions must be made because no specific case applying Sections 301-310 is within the terms of reference of this Panel. For example, the timing of the Section 304(a)(1) determination would be relevant if – contrary to the ordinary meaning of Section 304(a)(1) and the requirement in that provision and the commitment on Statement of Administrative Action page 365 to base the determination on adopted panel and Appellate Body findings – it were assumed that Section 304 actually does mandate a determination that a violation has occurred. The question then would be whether such a determination must be made before panel and Appellate Body findings can be adopted. The European Communities assumed for purposes of this analysis that panels and the Appellate Body will extend their proceedings as authorized under the DSU, and that DSB meetings will be held on the last possible day authorized under the DSU. The United States pointed out that while it is reasonable to assume that panels will extend their proceedings as authorized under the DSU, it is not reasonable to assume that the United States would not take steps to request DSB meetings at earlier times. Moreover, the United States explained above that the EC's calculations of DSU time frames were in error.

4.721 According to the United States, in other words, both the United States and the European Communities assume that panel would comply with DSU time frames. This is a proper assumption for purposes of this dispute. Despite the actual record of panel compliance with DSU time limits, it cannot, for purposes of this dispute, be assumed that these panels will fail to comply with their obligations. It is remarkable enough that the European Communities believes it may establish its *prima facie* case based on adverse assumptions concerning the choices the USTR will actually make in a given case. It should not be permitted to assume that panels as well will disregard their obligations under the DSU.

4.722 The United States claims that nevertheless, the DSU time frames remain relevant to the Panel's analysis. This dispute does not involve the application of Sections 301-310 in the context of a specific WTO dispute. There are therefore no established facts as to when and how the USTR made specific determinations, nor are there established facts as to when and how a panel and Appellate Body issued their reports. Assumptions must be made. It is not appropriate to assume that panels and the Appellate Body will not comply with DSU time frames, any more than it is appropriate to make any other assumption adverse to the United States in this case.

4.723 The United States points out that the European Communities argues at pages 31-32 of its answers to Panel questions that DSU time frames are irrelevant because they are merely "directory" in nature. The European Communities states:

"In domestic law, a 'provision in a statute, rule of procedure, or the like, which is a mere direction or instruction ... involving no invalidating consequences for its disregard ... as in the case of a statute requiring an officer to prepare and deliver a document ... before a certain day' is considered a 'directory'

provision.<sup>382</sup> . . . [The disregard of time limits] of a 'directory' nature . . . does not change the substantive rights and obligations of Members".

4.724 The United States goes on to state that the European Communities raises this point with respect to DSU time frames, arguing that because they are directory, they are irrelevant to the Panel's analysis in this case. While the United States disagrees that DSU time frames are irrelevant to this dispute, it notes that if the EC's argument were accepted, that argument would apply equally to the time frames in Section 301. The "domestic law" referred to in the EC quotation is US law,<sup>383</sup> and the principle would apply equally to Section 301 time frames. There are no "invalidating consequences" provided for in Sections 301-310 if the USTR misses her deadlines. Nevertheless, like panels, the USTR takes her deadlines seriously. However, if the panel accepts the EC's arguments that DSU time frames are irrelevant, that same conclusion must be applied to those in Section 301. In that case, the EC complaint fails because even if it were incorrectly assumed that Section 304(a)(1)(A) mandates a determination that US agreement rights have been denied, it would not be possible to conclude that the law mandates that such a determination be made prior to DSB adoption of panel and Appellate Body findings to that effect.

4.725 The United States contends that assuming that the Panel chooses to analyze the time frames in Sections 301-310 against those in the DSU (and has not already concluded that Section 304 neither mandates a determination that US agreement rights have been denied, nor precludes any such determination after the DSB has adopted panel and Appellate Body findings), that analysis reveals that Section 301 time frames do not require a determination before the time established in the DSU for adoption of panel or Appellate Body findings. The United States already explained in response to Panel question 9 that Article 21.4 provides further support for the US position that the maximum period from panel establishment to adoption of panel and Appellate Body findings is 15 months. That provision establishes a firm deadline of 18 months from panel establishment to determination of the reasonable period of time, a period which includes 90 days for the determination of the reasonable period.<sup>384</sup>

4.726 The United States argues that the EC's explanation that it "assumed that the Panel is composed shortly after it has been established" ignores the fact that the time limit in DSU Article 12.9 is nine months from panel establishment to circulation to Members. Combining this with the maximum period of 60 days for appeal or adoption of the panel report (DSU Article 16.4), the maximum 90 day period for Appellate Body proceedings (DSU Article 17.5), and the maximum period for DSB adoption of 30 days (DSU Article 17.14), yields a maximum period from panel establishment to adoption of panel and Appellate Body findings of 15 months, as the United States has argued.

4.727 The United States notes that the European Communities disputes the fact that a panel may be established within one month. The United States disagrees with the EC's interpretation of the footnote to Article 6.1 as being limited to the second meeting at which a panel meets to consider establishment, and further notes that Thailand concurs in the US conclusion that a panel may be established within a month of completion of the 60 day consultation period.

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<sup>382</sup> Black's Law Dictionary (Sixth Edition) (citation in original).

<sup>383</sup> Black's Law Dictionary is a US publication, and citations provided in the definition of "directory" are to US court opinions. See Black's Law Dictionary, 5<sup>th</sup> ed., at 414.

<sup>384</sup> See DSU Art. 21.4.

4.728 In the view of the United States, when the one month period for establishing a panel is added to the 60 day consultation period (DSU Article 4.7) and the maximum fifteen month period from panel establishment to DSB adoption of panel and Appellate Body findings, the total is 18 months, allowing the USTR to make a determination on the date provided for in Section 304(a)(2)(A) based on adopted panel and Appellate Body findings in all cases.

4.729 However, the United States has observed that, even this overstates the amount of time for panel and Appellate Body proceedings that may be assumed for purposes of this dispute. This is because DSB meetings generally occur on a monthly basis, so it may not be assumed that it will take all of 60 or 30 days for an appeal to be filed or an Appellate Body report to be adopted, and because the US may request meetings at earlier times. In response, the European Communities asserts that the Panel may not take into account the fact that the United States may request DSB meetings at a time earlier than those established by time limits, unless the United States can show that the USTR pursues a "systematic policy" of shortening procedural time frames through such requests.

4.730 The United States argues that the European Communities does not explain why it may disregard the "systematic policy" of monthly DSB meetings which can be expected to shorten the time frames from 18 months.<sup>385</sup> Leaving that aside, the European Communities forgets that to meet its burden in this case, it must show that Sections 301-310 "do not allow" the USTR to comply with DSU procedures, that is, that it would not, in a given case, be possible for the USTR to take steps to ensure compliance with the DSU. The European Communities thus may not assume that the USTR will not act to shorten time frames. Further, to establish that it would not be possible for the United States to comply with DSU rules, the European Communities would have to explain why, under US law, it would not be possible for the USTR to request consultations prior to initiating a Section 302 investigation, as she has, in fact, done in the past. The European Communities may not base its claim on adverse assumptions about the choices that the USTR, the panel, the Appellate Body and the WTO Secretariat (in scheduling DSB meetings) will make in a concrete case.

4.731 The United States argues that the time frames in Sections 301-310 are entirely compatible with those in the DSU. Even if the Panel were to ignore the EC's concession that the USTR need not determine that US trade agreement rights have been denied, the USTR may – indeed, must – base her determination on adopted panel and Appellate Body findings in each and every WTO case.

4.732 **The European Communities contends** that in order to hide this fundamental inconsistency in its defence, the United States has engaged in an attempt to play down the importance of this case, even though, in its view, it is more than likely to constitute a turning point in the history of the World Trade Organization. The United States seems rather more interested in distracting the Panel's attention from the central legal issues of this case by alleging unsupported political links with other entirely separate dispute settlement procedures. This attitude is not in line with the explicit prohibition under Article 3.10, last sentence, of the DSU according to which "complaints and counter-complaints should not be linked".

4.733 The European Communities repeats once more that any reference in this case to previous dispute settlement procedures is made only within the limited (but procedurally

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<sup>385</sup> Nor does the European Communities explain why it may disregard the Trade Representative's "systematic policy" of basing Section 304 determinations on WTO proceedings. See Statement of Administrative Action at 365-66, *reprinted in* H.R. Doc. No. 103-316, at 1034-35 (US Exhibit 11)

important) purpose of providing evidence in support of the EC's main claim in this case, i.e. that Sections 301-310 are as such in breach of numerous substantive obligations under the WTO Agreements.

4.734 The European Communities further indicates that likewise and in the same spirit, it would continue to abstain from what it perceives as slightly too energetic comments from our US counterparts as, for example, that the logic of the EC's case is "hard to follow" or that interpretations proposed by the European Communities "make up obligations out of thin air and aspirations" or that a given interpretation is based on "fanciful, results driven constructions" or that an assertion is "bold" or that a given claim is "pure fantasy".

4.735 The European Communities rather draws the attention of the Panel to the presentation by the United States of the legal situation of this case, in general, and of its domestic legislation, in particular. The European Communities indicates that it has the impression that, as this Panel procedure advances, the description by the United States of the legal issues under scrutiny of this Panel add up to the "intricate maze" of Sections 301-310 (as Professor Hudec defined them) with the aim of rendering the contours of these issues less and less discernible.

4.736 In order to illustrate this assertion, the European Communities refers to some telling examples from the US arguments:

"In paragraph 35, when addressing the issue of the relevance of the WTO panel report on *Japan - Varietals* the US states that '[t]he rationale of paragraph 1 of Annex B – publication of SPS measures – cannot be equated with that of WTO Agreement Article XVI:4 – to ensure that domestic laws permit compliance with international obligations'. However, the language of paragraph 1 of Annex A of the SPS Agreement, when combined with the language of the provisions governing SPS measures, is parallel and comparable to the language of Article XVI:4 of the Marrakech Agreement that plainly states that '[e]ach Member shall ensure the conformity of its laws, regulations or administrative procedures ...'".

The confusion operated by the United States between the terms "ensure the conformity", one of the fundamental issues of this case, and the terms "ensure that domestic laws permit compliance" seems by no means accidental.

4.737 The European Communities also cites the US assertion that

"[N]evertheless, the DSU time frames remain relevant to the Panel's analysis. This dispute does not involve the application of Sections 301-310 in the context of a specific WTO dispute. There are therefore no established facts as to when and how the Trade Representative made specific determinations, nor are there established facts as to when and how a panel and Appellate Body issued their reports. Assumptions must be made ...".

4.738 The European Communities points out that in answering only 20 days ago to a question from the Panel, the United States expressed an opposite view:

"In any event, for purposes of deciding this dispute, the time frames in the DSU are, in the end, not relevant, nor is the fact that these time frames have been exceeded in many cases".

4.739 The European Communities points out that the contradiction is further revealed where the United States added:

"... It is remarkable enough that the EC believes it may establish its *prima facie* case based on adverse assumptions concerning the choices the USTR will actually make in a given case".

4.740 The European Communities argues that the issue here is that, according to the text of Sections 301-310, when the United States seeks redress of a violation of WTO obligations, its determinations and subsequent actions must be made and implemented even when the WTO proceedings on which such a determination or action could be based have not been completed. The mandatory deadlines in Sections 301-310 thus clearly violate Article 23 (and the related Articles 21 and 22) of the DSU.

4.741 The European Communities further recalls the US argument that

"[T]here are no 'invalidating consequences' provided for in Sections 301-310 if the Trade Representative misses her deadlines. Nevertheless, like panels, the USTR takes her deadlines seriously".

4.742 In the view of the European Communities, while it does not discuss the seriousness of the USTR in this or other matters, this statement needs nevertheless to be compared with the apparently irreconcilable statement made by the United States to the effect that the could not exclude a judiciary control over the way the USTR implements Sections 301-310 in concrete cases.

4.743 The European Communities points out that the text of Sections 301-310, on its face, is clear in the sense that it imposes not only "serious" deadlines, but mandatory deadlines. In practice, the European Communities is still in the dark on what is the official and definitive interpretation of the US government of the text of Sections 301-310 dealing with deadlines, in particular Section 306 (b) (2) and 304 (a) (2).

4.744 The European Communities reiterates that a text of law that imposes WTO-inconsistent behaviours upon the executive by the use of express terms like "shall" and "Mandatory Action" within certain express time-limits defined as "the earlier of" or "no later than" falls within the description of mandatory legislation developed by the GATT 1947 panel practice.

4.745 **The United States responds** that the issue in this dispute is not whether certain actions under Sections 301-310 may be characterized as "mandatory". It is whether the law mandates violations of WTO rules. A law may mandate walks in the park, but unless walks in the park are WTO-inconsistent, this fact would not be relevant in a WTO dispute. The European Communities has the burden of adducing evidence and arguments that Sections 301-310 do, in fact, mandate a violation of WTO rules. The European Communities has claimed that Sections 301-310 mandate violations by requiring determinations that a violation has occurred prior to completion of dispute settlement proceedings and action without DSB authorization. The United States has rebutted those claims. If the European Communities believes that the mere use of the word "mandatory" and "discretionary" in Sections 301-310 violates WTO rules, it should explain why this is so. The United States could then respond.

**(d) "Security and Predictability"**

4.746 **The European Communities points out** that Professor Robert E. Hudec wrote:

"Section 301 is an intricate maze of mandatory commands in one place and extremely wide loopholes in the other. One needs a wiring diagram to trace whether mandatory commands given in one part will actually reach their final target without passing through at least one discretionary exit point. Even with the aid of such a diagram, one cannot predict actual outcomes".<sup>386</sup>

4.747 The European Communities also points out that Professor John H. Jackson testified before the Senate Foreign Relations Committee as follows:

"Although there are plausible ways to interpret the statutory provisions of regular Section 301 so as to give the President discretion to act consistently with the Uruguay Round dispute settlement rules, in a few cases, particularly in Section 301(a) (mandatory provision) the interpretations to do this are a bit strained ...".<sup>387</sup>

4.748 In the EC's view, if the United States' two foremost scholars on international trade law are unable to identify a sound legal avenue in Sections 301-310 permitting the USTR to act consistently with the DSU and the GATT 1994, nobody else can.

4.749 The European Communities notes that the legislative history of the 1988 Omnibus Trade and Competitiveness Act, which is at the origin in particular of the present version of Sections 301-310, demonstrates that the lack of a sound legal avenue was deliberate.

4.750 The European Communities states that the United States now attempts to benefit from the creation of this legal "maze" by claiming that it is for the European Communities to prove that it is not possible to interpret Sections 301-310 as permitting WTO-consistent implementation.

4.751 According to the European Communities, the fundamental objective of the WTO - namely to create security and predictability in international trade relations - could not be achieved if WTO Members were permitted to maintain domestic legislation that fails to provide the executive authorities with a sound legal basis for the measures required to implement their WTO obligations.

4.752 The European Communities is therefore of the view that, in a panel's examination of whether domestic legislation stipulates WTO-inconsistent determinations or action, the defendant should not be able to hide behind legal uncertainties arising from its own law, in particular if these uncertainties have been deliberately created. In accordance with the approach endorsed by the Appellate Body in *India - Patents (US)*, a panel should rule against the defendant if it concludes, on the basis of the evidence before it, that there is an objective (and thus reasonable) uncertainty on whether the domestic law permits WTO-consistent determinations or actions.

4.753 The European Communities considers that if the panel has reasonable doubts, so will economic operators planning their future trade. No legitimate interest would be protected if Members were entitled to retain law lacking such a basis. In fact, as the case before the Panel

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<sup>386</sup> Robert E. Hudec, Thinking About the New Section 301: Beyond Good and Evil, in: Jagdish Bhagwati and Hugh T. Patrick, Editors, *Aggressive Unilateralism. America's 301 Trade Policy and the World Trading System* (Harvester Wheatsheaf 1990), page 122.

<sup>387</sup> Jackson Testimony, op. cit.

demonstrates, this would be an invitation to Members to restrict trade by exposing it deliberately to legal uncertainties.

4.754 **The United States argues** that the Statement of Administrative Action and accompanying legislation are the definitive congressional materials with respect to the WTO-consistency of Sections 301-310 before the adoption of the Uruguay Round Agreements Act by the Congress. Page 360 of the Statement of Administrative Action (US Exhibits 3 and 11) outlines the changes considered necessary to ensure compliance. In addition, the United States directs the Panel's attention to the testimony on this topic of Professor John Jackson when he appeared before the Senate Finance Committee.<sup>388</sup>

4.755 The United States points out that Professor Jackson concluded that, "There may need to be some alterations to some time limits, or transition measures, but the basic structure of 301 is not necessarily inconsistent with the Uruguay Round results". He also concluded that even when Section 301 is considered "in its current statutory form" (i.e. before the 1994 amendments), "the Executive appears to have the discretion to apply actions under Section 301 in a manner consistent with the proposed new rules of the Uruguay Round dispute settlement understanding".<sup>389</sup> Professor Jackson thus considered that with only minor changes, Section 301 would be clearly consistent with the WTO obligations of the United States. Moreover, his emphasis on the fact that the Executive had adequate discretion to apply Section 301 in a WTO-consistent manner reflects the fact that he took for granted that the reasoning applied in the *Superfund* line of cases would continue to apply under the WTO.

4.756 The United States notes that Professor Jackson believed that sufficient clarity could be provided to the interpretation of the statute through the inclusion of language in the Statement of Administrative Action.<sup>390,391</sup>

4.757 **The European Communities emphasises** that the US arguments are both new and incorrect, as can be seen already from the internal meeting report of 11 November 1993 by the US delegate contained in US Exhibit 23. This exhibit, in particular, shows that several Uruguay Round participants, including the European Communities, worked for a strengthening of Article XVI:4 of the WTO Agreement beyond the "natural obligation under int'l law" which finds its source in Articles 26 and 27 of the Vienna Convention on the Law of Treaties. This "natural obligation" is already incorporated into the WTO by virtue of Article 3.2, second sentence, of the DSU, which provides that "[t]he Members recognise that [the dispute settlement system] serves to ... clarify the existing provisions of those agreements in accordance with customary rules of interpretation of public international law". The US reply thus appears to be an attempt to go back on the achievements of the Uruguay Round.

4.758 **The United States rebuts** the EC argument that the principles of VCLT Article 26 have already been incorporated into the WTO through DSU Article 3.2, second sentence, and that Article XVI:4 therefore need not serve this purpose. However, DSU Article 3.2 provides for the dispute settlement system to clarify WTO provisions "in accordance with customary rules of interpretation of public international law". Article 26 is not such a customary rule of

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<sup>388</sup> *Results of the Uruguay Round Trade Negotiations: Hearings Before the Senate Committee on Finance*, 103d Cong. 195 (1994) (statement of Professor John Jackson) (US Exhibit 24). The EC excerpts this testimony.

<sup>389</sup> *Ibid.* at 200.

<sup>390</sup> *Ibid.*

<sup>391</sup> See the parties' further arguments contained in Paragraphs 4.340-4.360 above.

interpretation. As the Appellate Body explained in *US – Gasoline* and *Japan – Alcoholic Beverages*, these rules of interpretation are reflected in VCLT Articles 31 and 32, which, indeed, are entitled "General rule of interpretation" and "Supplementary means of interpretation", respectively.<sup>392</sup> Inasmuch as Article 26 is not such a rule of interpretation, DSU Article 3.2, second sentence, may not be read to reference it. Thus, the EC argument fails to undermine the United States point that Article XVI:4 made the principles of VCLT Article 26 binding on all WTO Members, even those Members not parties to the Vienna Convention. It is worth noting that, during negotiations from 1991-1993, the United States negotiator explicitly brought to the attention of other delegations that the United States is not a party to the Vienna Convention.

**(e) Article XVI:4 of WTO Agreement**

4.759 In the case of Sections 301-310, **the European Communities is of the view** that these provisions are biased against the conformity with the requirements of Article 23 (and the related provisions under Articles 21 and 22) of the DSU and thus in breach of Article XVI:4 of the Marrakech Agreement. This view is supported by the fact that the United States has always given precedence to an Act of Congress in the event of a conflict with an international obligation that the United States had accepted, at least in situations where the acceptance of the international agreement was prior to the adoption of the Act of Congress.

4.760 In this regard, the European Communities refers to an official statement made by the US Attorney-General in a letter of 21 March 1988<sup>393</sup> to the PLO Permanent Observer accredited to the United Nations quoted in the Advisory Opinion of the International Court of Justice on the Headquarters Agreement of the United Nations:

"I am aware of your position that requiring closure of the Palestine Liberation Organisation ('PLO') Observer Mission violates our obligations under the United Nations ('UN') Headquarters Agreement and, thus, international law. However, among a number of grounds in support of our action, the United States Supreme Court has held for more than a century that Congress has the authority to override treaties and, thus, international law for the purpose of domestic law. Here Congress has chosen, irrespective of international law, to ban the presence of all PLO offices in this country, including the presence of the PLO Observer Mission to the United Nations. In discharging my obligation to enforce the law, the only responsible course of action available to me is to respect and follow that decision".<sup>394</sup>

4.761 The European Communities indicates that its concerns in the present case are based on this description of the legal situation with regard to the relationship between US domestic law and the international obligations of the United States.<sup>395</sup>

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<sup>392</sup> The United States cites Appellate Body Report on *US – Gasoline*, op. cit., pp. 16-17; Appellate Body Report on *Japan – Alcoholic Beverages*, op. cit., pp. 10-12.

<sup>393</sup> The European Communities recalls that this is the same year in which the US Trade Act of 1974 was substantially amended by the Omnibus Trade and Competitiveness Act of 1988.

<sup>394</sup> International Court of Justice, Advisory Opinion of 26 April 1988 on the *Applicability of the Obligation to Arbitrate under Section 21 of the United Nations Headquarters Agreement*, ICJ-Reports 1988, p. 12, para. 27.

<sup>395</sup> The European Communities claims that this is the main reason why the European Communities is not reassured by the ruling of the US Supreme Court in *Missouri v. Holland*, 252 U.S.



4.762 The European Communities further states that the Uruguay Round Agreements Act 1994, which is the Act by which the United States Congress approved the Marrakech Agreement Establishing the World Trade Organisation, contains the following provisions in Section 102(a):

"(1) UNITED STATES LAW TO PREVAIL IN CONFLICT. - No provision in any of the Uruguay Round Agreements, nor the application of any such provision to any person or circumstance, that is inconsistent with any law of the United States shall have effect.

(2) CONSTRUCTION. - Nothing in this Act shall be construed - ...

(B) to limit any authority conferred under any law of the United States, including section 301 of the Trade Act of 1974,

unless specifically provided for in this Act".

4.763 In the view of the European Communities, it clearly follows from these provisions of the Uruguay Round Agreements Act 1994 that none of the provisions contained in any of the Uruguay Round Agreements can override any Act of the US Congress or affect any authority conferred under such an Act, whether adopted before or after the approval of the Uruguay Round Agreements by the US Congress, including in particular Section 301.<sup>396</sup>

4.764 The European Communities claims that on this basis, it is apparent that the approval of the Uruguay Round Agreements by the US Congress in 1994 is not sufficient to bring US domestic legislation, to the extent that it is inconsistent with US obligations under the covered agreements, into conformity with these agreements.

4.765 The European Communities maintains that rather, it is necessary that the United States amend the existing inconsistent legislation in order to fulfil the obligation placed on all WTO Members by the very explicit terms of Article XVI:4 of the WTO Agreement.

4.766 The European Communities points out that the very purpose of Article XVI:4 of the Marrakech Agreement resides in the creation of an obligation to provide certainty and

416 (1920) in which Mr. Justice HOLMES, in delivering the opinion of the Court, made the following statement: "[B]y Article 6 [of the Tenth Amendment] treaties made under the authority of the United States, along with the Constitution and laws of the United States made in pursuance thereof, are declared the supreme law of the land. If the treaty is valid there can be no dispute about the validity of the statute under Article 1, Section 8, as a necessary and proper means to execute the powers of the Government. The language of the Constitution as to the supremacy of treaties being general, the question before us is narrowed to an inquiry into the ground upon which the present supposed exception is placed". The apparent discrepancy between this statement and the statement of the Attorney-General quoted in this paragraph can be explained by the consideration that, under US constitutional law, international treaties concluded in the forms foreseen by the Constitution generally take precedence only on earlier domestic legislation, but not on subsequent Acts of the US Congress. However, because of the specific provisions contained in Section 102 of the Uruguay Round Agreements Act 1994, this general rule does not apply in the case of the Marrakech Agreement Establishing the World Trade Organisation, as we explain in paragraph 52 of our present submission.

<sup>396</sup> Cf. D.W. Leebron, Implementation of the Uruguay Round Results in the United States, in: J.H. Jackson/A. Sykes, Implementing the Uruguay Round, Oxford 1997, p. 175 (at 213); L. Henkin, Foreign Affairs and the US Constitution, 2<sup>nd</sup> ed., Oxford 1996, p. 209.

predictability in multilateral trade relations by bringing domestic laws into conformity with the requirements under the relevant covered agreement. It is thus not sufficient just to abstain (or to promise to do so) from applying a piece of legislation that is inconsistent with the obligations under the relevant covered agreements since the mere existence of such a piece of legislation creates uncertainty. While not dealing explicitly with the requirements of Article XVI:4 of the Marrakech Agreement, the panels and the Appellate Body in the *India - Patents (US)* case have clearly indicated the need to create a sound and predictable basis for WTO-consistent behaviour of the administration in domestic law and to avoid a situation where domestic legislation destabilises the solidity of WTO rights and obligations.

4.767 **The United States responds** that an analysis of whether Sections 304(a)(1)(A) and 304(a)(2)(A) mandate a violation of DSU Article 23.2(a) must begin with an analysis of the text of DSU Article 23.2(a). Article 23.2(a) provides that Members shall:

"not make a determination to the effect that a violation has occurred, that benefits have been nullified or impaired or that the attainment of any objective of the covered agreements has been impeded, except through recourse to dispute settlement in accordance with the rules and procedures of this Understanding, and shall make any such determination consistent with the findings contained in the panel or Appellate Body report adopted by the DSB or an arbitration award rendered under this Understanding".

4.768 The United States claims that there can be no violation of Article 23.2(a) unless: (1) there is a determination to the effect that a violation has occurred; and (2) that determination has not been made through recourse to DSU rules and procedures, or is not consistent with adopted panel or Appellate Body findings or an arbitral award. In the absence of a specific determination, the mere existence of legislation may be found inconsistent with Article 23.2(a) only if that legislation mandates a determination which does not meet the requirements of Article 23.2(a).<sup>397</sup> If that legislation may reasonably be read to provide authorities with discretion to comply with DSU Article 23.2(a), then that legislation does not mandate a determination inconsistent with Article 23.2(a).<sup>398</sup> On the other hand, nothing in the language of Article 23.2(a) or its context supports the EC's claim that the "design, structure and architecture" of legislation must be examined to determine whether it is "manifestly intended to encourage violations of WTO law or is otherwise biased against WTO-consistent action".

4.769 **The European Communities recalls** the US claim that the fact that the European Communities in a separate panel procedure<sup>399</sup> affirmed that "implementing measures must be presumed to conform to WTO rules unless their conformity has been duly challenged under the appropriate DSU procedures" should be in some ways inconsistent with the EC's stance in this case aimed at finding that Sections 301-310 structure, design and architecture by mandating actions of the US executive authorities that are incompatible with the US WTO obligations, are biased against compliance with US' WTO obligations.

4.770 The European Communities considers that the core of the US argument is that "[o]ne may not assume that authorities will fail to implement their international obligations in good faith"

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<sup>397</sup> Panel Report on *US – Superfund*, op. cit., para. 5.2.9.

<sup>398</sup> Panel Report on *US – Tobacco*, op. cit., para. 123.

<sup>399</sup> *European Communities - Regime for Importation, Sale and Distribution of Bananas, Recourse to Article 21.5 by the European Communities*, WT/DS27/RW/EC.

4.771 The European Communities points out that while this last US statement is certainly correct, and it agrees with it, it is however not logically linked with the previous US affirmation (the European Communities is inconsistent) and, more importantly, it does not refer to the factual situation before this Panel.

4.772 The European Communities claims that in the specific case of Sections 301-310, the presumption of compliance is not applicable for the simple reason that their text, design structure and architecture are, on their face, clearly biased against compliance.

4.773 In the view of the European Communities, it would therefore be extraordinary to claim, as the United States seems to imply, that a presumption (*iuris tantum*, i.e. rebuttable) of compliance would shield a domestic legislation which on its face defeats such a presumption. Legally, this would mean transforming a presumption *iuris tantum* in a presumption *iuris et de jure* (i.e. non-rebuttable), which is however not foreseen under the WTO Agreements.

4.774 The European Communities then argues that the burden of demonstrating that the text, design, structure and architecture of Sections 301-310 are not what they appear to be from the text published in the US statute books still rests with the United States. Until such evidence is submitted, the onus remains on the United States.

4.775 In response to the Panel's question as to how the United States has dealt with the obligation under Article XVI:4 to review existing legislation and bring it into conformity with the WTO Agreement, if necessary, in respect of Sections 301-310, **the United States responds** that as explained in greater detail in US Exhibits 3 and 11, it dealt with this obligation with respect to Sections 301-310 by adjusting time frames for disputes involving subsidies, the TRIPs Agreement and government procurement to conform with the standard time frames in the DSU.

4.776 The United States also refers to US Exhibit 24, which includes the 1994 testimony of Professor John Jackson cited by the European Communities. In the paragraph immediately prior to that which the European Communities quoted, Professor Jackson states:

"My basic judgment is that very few statutory changes will be needed to U.S. Section 301, at least the 'regular 301' (compared to Special 301 and other similar statutory provisions, such as those on telecommunications.) *There may need to be some alterations to some time limits, or transition measures, but the basic structure of 301 is not necessarily inconsistent with the Uruguay Round results.* Indeed, I continue to have the opinion that Section 301 appropriately used in its *current* statutory form, is a constructive measure for U.S. trade policy, and for world trade policy. Section 301 calls for cases presented under the 301 procedural framework to be taken to the international dispute settlement process. *Thus the Executive appears to have the discretion to apply actions under Section 301 in a manner consistent with the proposed new rules of the Uruguay Round dispute settlement understanding*".<sup>400</sup>

4.777 The United States explains that with respect to how the Administration more generally applied Article XVI:4 by reviewing existing legislation and bringing it into conformity, the United States notes that precisely such a review was necessary to prepare the Statement of Administrative Action. As described on page 1 of that document (Exhibit 11),

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<sup>400</sup> Jackson Testimony, op. cit., at 200.

"This Statement describes significant administrative actions proposed to implement the Uruguay Round agreements. In addition, incorporated into this Statement are two other statements required under section 1103: (1) an explanation of how the implementing bill and proposed administrative action will change or affect existing law; and (2) a statement setting forth the reasons why the implementing bill and proposed administrative action are necessary or appropriate to carry out the Uruguay Round agreements". (emphasis added.)

4.778 In response to the Panel's question as to whether considering "security and predictability" from a factual dimension, a public announcement in legislation mandating the making of a determination even if WTO proceedings have not yet been completed – albeit not necessarily a determination of violation – does not affect the assurance given to other Members that no determinations of violation can be made before the completion of WTO procedures? Does the very discretion explicitly provided for and publicly announced - allowing the Member to decide either way - not constitute a threat to security and predictability, the United States comments that there is no independent obligation to provide "security and predictability" apart from that provided by compliance with substantive WTO obligations and DSU rules and procedures. A finding that such an obligation exists would run counter to the entire line of reasoning underlying the mandatory/discretionary distinction under which the trading system now operates. However, even if there were such an obligation, from a factual standpoint the circumstances posited in the question most certainly do not threaten "security and predictability".

4.779 In the view of the United States, there is nothing inherently threatening to "security and predictability" in the making of determinations – even determinations that a violation has occurred – or in suspending concessions. If there were, then the only conclusion to be drawn would be that the DSU itself threatens security and predictability, since it provides for findings of violations and for the suspension of concessions. Each and every WTO Member knows that it is possible that another Member may obtain a DSB ruling that a WTO violation has occurred, may make a determination consistent with that ruling, and may suspend concessions in response – and each such Member has agreed to accept this possibility by virtue of its having become a WTO Member. It should therefore come as no surprise when a Member provides in its laws for the possibility of making determinations or suspending concessions. This possibility cannot be considered a threat to security and predictability.

4.780 The United States points out that Members were willing to accept this possibility because they also accepted an obligation to make such determinations of violations and to suspend concessions in accordance with DSU rules and procedures. That binding international obligation is no different in nature than that assumed by the Members with respect to any other WTO obligation. The willingness of WTO Members to enter into these obligations provides the only assurance that any WTO Member has that its fellow Members will not deny their WTO rights. Every WTO Member has the power, and most of their governments have the domestic legal authority, to violate their international obligations. However, the fact that these Members have accepted WTO obligations – and the fact that effective dispute settlement procedures exist – provides assurances that they will respect other Members' rights. The dispute settlement system itself helps to provide security and predictability, as DSU Article 3.2 states.

4.781 The United States notes that these are the only assurances. In fact, the European Communities concedes that there is no independent WTO obligation to limit discretion in

domestic law so as to preclude the possibility of WTO-inconsistent action.<sup>401</sup> According to the European Communities, such an obligation is not found in Article XVI:4.<sup>402</sup> It is an error to assume that the "public warning" that authorities may decide either way on the issue of whether agreement rights have been denied creates any special threat or insecurity beyond that present when authorities have broad, undefined authority to violate their obligations. To the extent a law provides for a determination by a given date – a date consistent with DSU guidelines – but does *not* require the *only* determination proscribed by the DSU (that a violation has occurred), the possibility that the determination will breach that Member's obligations under Article 23.2(a) is no greater than if the law did not exist at all. In either case, WTO Members must rely on the good faith of the Member in question to exercise its discretion in accordance with its binding, international obligations. Good faith, and the security and predictability provided by a dispute settlement system that rules on the basis of law, and which may not be undermined by a losing party, provide all the assurances WTO Members have, and all that they agreed they would have.

4.782 The United States claims that nevertheless, it has provided additional assurances in US law, in the form of the Section 304(a)(1) requirement that determinations that agreement rights have been denied must be based on the results of dispute settlement proceedings, as interpreted in light of the authoritative interpretation of the statute provided in the Statement of Administrative Action at pages 365-66.

4.783 The United States notes that if it were appropriate to examine whether "assurances" have been undermined by a Member because of the possibility of future breaches, it would be impossible to escape the conclusion that a broad, non-specific discretionary authority which has been repeatedly exercised to violate another Member's rights creates a greater possibility of further violations than a statute which explicitly provides discretionary authority to make determinations only one of which might violate another Member's rights,<sup>403</sup> but which has never been used to make that determination in violation of DSU or GATT rules. However, it is not appropriate to examine the likelihood of future breach. It may not be assumed that in the future, the Member in question will act in bad faith. If it may be assumed that a Member will exercise its discretion in bad faith, then, indeed, there would be a threat to the security and predictability of the multilateral trading system, because the rules set forth in the DSU and the other covered agreements will have been reduced to a popularity contest on the question of who can be trusted.

4.784 The United States further argues that because it is the dispute settlement system which provides security and predictability, it is no exaggeration to conclude that a true threat to security and predictability would come from a legal analysis which departs from the text agreed to by the Members in favor of creation of new obligations not found in the text, or which abandons a consistent, logical analysis applied for years before the WTO Agreement entered into affect, and which Members assumed would remain in effect. On this point – the continued applicability of the *Superfund* reasoning – and on the issue of whether Article XVI:4 changed this, the United States wishes to quote the views expressed by Pieter-Jan Kuyper, the legal adviser to the EC's Uruguay Round negotiators, and by Frieder Roessler, the Director of the

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<sup>401</sup> The United States notes the EC statement that "it would be inappropriate to interpret Article XVI:4 of the WTO Agreement so extensively as to require WTO Members to include specific language in their domestic law precluding WTO-inconsistent action".

<sup>402</sup> Ibid.

<sup>403</sup> The United States also notes that then only if the timing of the proceedings does not conform with DSU time frames and if the Member makes specific choices.

Legal Affairs Division of the GATT Secretariat, in a volume reproducing papers from a conference held in October 1994 on the WTO Agreement and dispute settlement. Mr. Roessler stated:

"The wording of [Article XVI:4] could be interpreted to mean either that domestic law must prescribe that the executive authority act in conformity with WTO law or that domestic law must permit that authority to act in conformity with WTO law. There are similar provisions in the Tokyo Round Agreements on Anti-dumping and Subsidies<sup>404</sup>, which have generally been interpreted as requiring the parties to these Agreements to adopt laws, regulations and procedures *that permit* them to act in conformity with their obligations under these Agreements. The main function of these provisions was to permit the committees established under these Agreements to review the law of the parties and not merely the practices followed under that law. Several GATT 1947 panels concluded that legislation mandatorily requiring the executive authority of a contracting party to act inconsistently with the GATT may be found to be inconsistent with that contracting party's obligations under the GATT, whether or not an occasion for its actual application has yet arisen, but that legislation merely giving the executive authorities the power to act inconsistently with the GATT is not, by itself, inconsistent with the GATT.<sup>405</sup> Given this background, *one can expect that the WTO Agreement provision stipulating consistency between domestic law and WTO law will be interpreted to establish the obligation for each WTO Member to ensure that the domestic law is such as to permit the executive authority to act in conformity with the obligations under the WTO Agreement*".<sup>406</sup>

4.785 The United States points out that likewise, Mr. Kuyper in his paper stated that Article XVI:4

"may turn out to be a very onerous obligation, requiring full conformity of all Community and national laws . . . with the precise provisions of the WTO's annexes. *It may also have hardly any consequences at all, compared to the present situation, if it is interpreted in the light of standing panel case law which determines that a law or regulation is contrary to the GATT only if it is mandatory and as such contrary to GATT terms, but that such is not the case, if the text of the law or regulation permits a GATT conform [sic] application of the text.*<sup>407</sup> If conformity to WTO obligations is interpreted in this way - which would not be unreasonable in the light of the succession of the WTO to the

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<sup>404</sup> (footnote in original) Article 16(6) of the Anti-Dumping Code and Article 19(5) of the Agreement on Subsidies and Countervailing Duties.

<sup>405</sup> (footnote in original) See BISD, 39th Suppl., p.197.

<sup>406</sup> Frieder Roessler, *The Agreement Establishing the World Trade Organization, in The Uruguay Round Results, A European Lawyers' Perspective* 67, 80 (Jacques H.J. Bourgeois, Frédérique Berrod & Eric Gippini Fournier eds. 1995) (emphasis added).

<sup>407</sup> (citation in original) See *US - Taxes on Petroleum («Superfund»*), BISD 34S/134, para. 5.2.9. and *EEC - Regulation on imports of parts and components*, BISD 37S/132, para. 5.25-26. The United States notes that no reference is made to the Protocol of Provisional Application, or to cases citing the Protocol of Provisional Application.

«acquis gattien»<sup>408</sup> – it should be clear that the added value of Article XVI:4 is rather limited".<sup>409</sup>

4.786 The United States further notes that Mr. Kuyper stated in a footnote that the conclusion that the value of Article XVI:4 is "rather limited" is his own view.<sup>410</sup> Mr. Kuyper went on to note that if a more expansive view of Article XVI:4 were adopted, "it must be clear that the European Communities and the Member States have an obligation to maintain their laws and regulations in constant conformity with the terms of the WTO Agreement and its annexes. That is no simple matter".<sup>411</sup> He explained that, in order to prevent WTO panel condemnation, the Commission would frequently be required to aggressively step in and quickly enforce WTO rules domestically through the procedures of Article 169 of the Treaty of Rome, which had been little used with a view to enforcing international treaties.<sup>412</sup> This would mean a fundamental change in the balance between the Community and the Member States.

4.787 The United States then argues that the EC's own legal adviser, writing shortly after the conclusion of the negotiations, took a position contradicting that presented by the European Communities in the context of this dispute, and expressed his view that Article XVI:4 did not in any way change the operation of the principle that laws are WTO-consistent if they provide for discretion to act in a WTO-consistent manner. To the contrary, he, like the United States here, emphasized the great disruption to security and predictability were a different interpretation adopted. He, like the United States, fully expected that the principle in *Superfund* would continue to be applied.

4.788 The United States further points out that Professor Jackson's testimony to Congress makes clear that he also took for granted the continued relevance and applicability of the principle that legislation would not be WTO inconsistent if it provided adequate discretion to act in a WTO-consistent manner. Thus, he emphasized, "the Executive appears to have the discretion to apply actions under Section 301 in a manner consistent with the proposed new rules of the Uruguay Round dispute settlement understanding".<sup>413</sup>

4.789 The United States goes on to state that Professor Jackson's testimony also highlights the fact that, whatever the statute may provide regarding determinations and their timing, additional assurances are provided in US law to counter any insecurities other Members may feel. Referring to the statute before it was amended, he stated:

"I continue to have the opinion that Section 301 appropriately used in its *current* statutory form, is a constructive measure for U.S. trade policy, and for world trade policy. Section 301 calls for cases presented under the 301 procedural framework to be taken to the international dispute settlement process".<sup>414</sup>

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<sup>408</sup> (citation in original) See Article XVI:1 of the WTO Agreement.

<sup>409</sup> Pieter-Jan Kuyper, *The New WTO Dispute Settlement System: The Impact on the Community*, in *The Uruguay Round Results, A European Lawyers' Perspective* 87, 110 (Jacques H.J. Bourgeois, Frédérique Berrod & Eric Gippini Fournier eds. 1995)(emphasis added).

<sup>410</sup> *Ibid.* at footnote 46.

<sup>411</sup> *Ibid.*, at 110.

<sup>412</sup> *Ibid.*, at 110-11.

<sup>413</sup> Jackson Testimony, *op. cit.*, at 200.

<sup>414</sup> *Ibid.* (emphasis added)

4.790 The United States adds that US law also includes assurances in the form of the Section 304(a)(1) requirement that determinations that agreement rights have been denied be based on DSB-adopted panel and Appellate Body findings. Thus, even though the WTO Agreement requires Members to provide no assurances beyond the fact of their good faith and the certainty of effective dispute settlement procedures, the United States has, in fact, included in its laws further legal assurances. The notion that the European Communities or any other Member nevertheless feels "threatened" in the face of these assurances is absurd, and testifies only to a desire to attack a statute not for what it is or commands, but for specific instances of how discretion was exercised in the past – instances not within the Panel's terms of reference, and all of which involved the parallel use of multilateral dispute settlement rules when a US right under a multilateral agreement was at stake.

### 3. Section 306

#### (a) Overview

4.791 **The European Communities claims** that Section 306(a) requires the USTR to monitor the compliance of WTO Members with the recommendations of the DSB. Section 306(b)(2) regulates within which time limits the USTR must determine whether there has been compliance:

"If ... the Trade Representative considers that the foreign country has failed to implement it [a recommendation made pursuant to dispute settlement proceedings under the World Trade Organisation], the Trade Representative shall [determine what further action to take under Section 301(a)] ... no later than 30 days after the expiration of the reasonable period of time provided for such implementation under paragraph [sic] 21 of the Understanding on Rules and Procedures Governing the Settlement of Disputes ...".

4.792 The European Communities considers that the determination of the USTR that the DSB recommendations were not implemented implies a determination that the WTO Member concerned violates its obligations under a WTO agreement or that it nullifies or impairs benefits accruing to the United States under such an agreement. If there is a dispute on the question of implementation, the United States must therefore take recourse to the DSU to settle the issue, as stipulated in Article 23.1 and 2(a). Article 21.5 establishes a specific obligatory procedure for disputes on the implementation of DSB ruling and recommendations:

"Where there is a disagreement as to the existence or consistency with a covered agreement of measures taken to comply with the recommendations and rulings such disputes shall be decided through recourse to these procedures, including wherever possible resort to the original panel. The Panel shall circulate its report within 90 days after the date of the referral of the matter to it".

4.793 The European Communities further argues that the 30-day limit set out in Section 306(b)(2) makes it impossible for the United States to await the results of such a proceeding before making the determination that the Member concerned has failed to comply with DSB rulings or recommendations.

4.794 The European Communities reiterates that as a result of the Uruguay Round, the United States has undertaken an unqualified and unconditional international obligation not to revert to unilateral determinations and actions. By imposing an obligation upon USTR to determine in



all cases within 30 days from the end of the reasonable period of time that the Member concerned has failed to comply with DSB rulings or recommendations without awaiting the conclusion of the relevant DS procedures, the United States is forced by its own law to act inconsistently with Article 23 of the DSU.

4.795 **In response, the United States points out** that the European Communities argues that Section 306(b) also violates Article 23 because the language of Section 306(b) "implies a determination that the WTO Member concerned violates its obligations under a WTO agreement". The EC's use of the term "implies" highlights the fact that it cannot credibly claim that Section 306(b) mandates such a determination. In its brief discussion of this issue, the European Communities ignores the language and purpose of Section 306(b), as well as the findings of the Article 22.6 arbitrators in the *Bananas* dispute rejecting similar EC claims.

4.796 The United States also stresses that Section 306 provides a procedure in US law by which the United States invokes its right to take action in accordance with DSU Article 22, that is, to take action when a US trading partner fails to implement DSB recommendations. Here again, the time frames in the statute conform with those of the DSU.

4.797 The United States further challenges the EC assumption that the USTR must always conclude that another Member has failed to implement DSB rulings and recommendations. Again, Article 23.2(a) only prohibits certain violation determinations. It does not, for example, preclude a determination that there has been no violation, or a determination consisting of a description of a case's procedural status. Thus, even if the European Communities were justified in "implying" a determination in Section 306(b), the European Communities would have to prove that Section 306 requires the USTR to determine that a violation has occurred. However, the European Communities simply skips over this step in its argument. The European Communities does not even attempt to meet its burden on this point, and, indeed, there is no point in its trying. Nothing in Section 306(b) prevents the USTR from considering that another Member has fully implemented DSB rulings and recommendations and from taking no action at all. This in and of itself undermines the EC's argument that Section 306 mandates a violation determination not meeting Article 23.2(a) requirements.

4.798 The United States contends that Section 306(b) does not command the authorities of the United States of America to violate DSU Article 23.2(a). The European Communities has asked the Panel to find that Section 306(b)

"is inconsistent with Article 23.2(b) [sic] of the DSU because it requires the USTR to determine *whether* a recommendation of the DSB has been implemented irrespective of whether any proceedings on this issue under Article 21.5 of the DSU have been completed". (emphasis added)

Again, the EC's very use of the word "whether" demonstrates that the European Communities has asked the wrong question. Section 306(b) must first command a determination of breach before the other requirements of Article 23.2(a) become relevant. It does not.

**(b) What constitutes "determination" – Relationship between DSU Articles 21.5 and 22**

4.799 The United States explains that following DSB adoption of panel or Appellate Body findings that US agreement rights have been denied, the USTR makes her determination of this result pursuant to Section 304(a)(1). Under DSB rules, the defending party must state its intentions with respect to implementation of DSB recommendations and rulings at a DSB

meeting held within 30 days of adoption. If that party states its intention to implement the DSB's recommendations and rulings, the USTR treats this statement as a "satisfactory measure" pursuant to Section 301(a)(2)(B)(i),<sup>415</sup> justifying termination of the Section 302 investigation.<sup>416</sup>

4.800 The United States goes on to state that during the reasonable period of time for implementation provided for in DSU Article 21.3, the USTR monitors implementation pursuant to Section 306(a). Section 306(b) provides for situations in which the USTR believes implementation has not occurred by the conclusion of the reasonable period of time. It states:

"(1) IN GENERAL.–If, on the basis of the monitoring carried out under subsection (a), the Trade Representative considers that a foreign country is not satisfactorily implementing a measure or agreement referred to in subsection (a), the Trade Representative shall determine what further action the Trade Representative shall take under section 301(a). For purposes of section 301, any such determination shall be treated as a determination made under section 304(a)(1).

(2) WTO DISPUTE SETTLEMENT RECOMMENDATIONS.–If the measure or agreement referred to in subsection (a) concerns the implementation of a recommendation made pursuant to dispute settlement proceedings under the World Trade Organization, and the Trade Representative considers that the foreign country has failed to implement it, the Trade Representative shall make the determination in paragraph (1) no later than 30 days after the expiration of the reasonable period of time provided for such implementation under paragraph 21 of the Understanding on Rules and Procedures Governing the Settlement of Disputes ...".<sup>417</sup>

4.801 The United States maintains that contrary to the EC's claims, the language of Section 306(b) does not "imply" – let alone state – that the USTR is required to make a determination in violation of Article 23. Section 306(b) sets forth steps the USTR should take to assert US rights under DSU Article 22 when she considers that there has not been full implementation by another WTO Member. The USTR must make this judgment – which is not a "determination" – because the deadlines provided for in DSU Article 22 require that she must.<sup>418</sup>

4.802 The United States notes that under the procedures set forth in DSU Articles 22.2, 22.6 and 22.7, a complaining party wishing to avail itself of the negative-consensus rule must propose to the DSB how it intends to suspend concessions within 30 days of the expiration of the reasonable period of time. Section 306(b) provides the US analogue for this process, requiring the USTR to determine what action she proposes to take within that 30-day period.

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<sup>415</sup> Section 301(a)(2)(B)(ii), 19 U.S.C. § 2411(a)(2)(B)(ii).

<sup>416</sup> The United States cites, for example, Determinations Under Section 304 of the Trade Act of 1974 With Respect to Certain Canadian Practices Affecting Periodicals, 62 Fed. Reg. 50651 (1997) (US Exhibit 7).

<sup>417</sup> Section 306(b), 19 U.S.C. § 2416(b).

<sup>418</sup> The United States points out that Section 306(b) does not call for the Trade Representative to make a definitive or formal determination that the trading partner has, in fact, failed to implement DSB recommendations, nor does it prevent the Trade Representative from either making such a determination, or implementing such action, contingent upon DSB authorization under either Article 22.2, 22.6 or 22.7. Again, the European Communities merely assumes, without demonstrating, that statutory language reflecting broad discretion in fact mandates WTO-inconsistent action.

4.803 The United States considers that DSU Article 22.2 provides that if a Member fails to comply with DSB recommendations by the conclusion of the reasonable period of time determined pursuant to Article 21.3, the Member shall, if requested, enter into compensation negotiations with the complaining party. Where an agreement on compensation has not been reached within 20 days after the end of the reasonable period of time, the complaining party may request DSB authorization to suspend the application of concessions or other obligations to the Member concerned.<sup>419</sup> Under DSU Article 22.6, the DSB is obligated to grant this request in the absence of a negative consensus within 30 days of expiration of the reasonable period of time, unless the Member concerned requests arbitration with respect to the level or nature of suspension proposed. In that case, the matter is referred to arbitration for a decision which must be completed within 60 days of the expiration of the reasonable period of time.<sup>420</sup> If the complaining party then requests authorization to suspend concessions in accordance with the arbitrator's decision, the DSB is, under Article 22.7, obligated to grant this request in the absence of a negative consensus.<sup>421</sup>

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<sup>419</sup> DSU Article 22.2 provides:

"If the Member concerned fails to bring the measure found to be inconsistent with a covered agreement into compliance therewith or otherwise comply with the recommendations and rulings within the reasonable period of time determined pursuant to paragraph 3 of Article 21, such Member shall, if so requested, and no later than the expiry of the reasonable period of time, enter into negotiations with any party having invoked the dispute settlement procedures, with a view to developing mutually acceptable compensation. If no satisfactory compensation has been agreed within 20 days after the date of expiry of the reasonable period of time, any party having invoked the dispute settlement procedures may request authorization from the DSB to suspend the application to the Member concerned of concessions or other obligations under the covered agreements".

<sup>420</sup> DSU Article 22.6 provides:

"When the situation described in paragraph 2 occurs, the DSB, upon request, shall grant authorization to suspend concessions or other obligations within 30 days of the expiry of the reasonable period of time unless the DSB decides by consensus to reject the request. However, if the Member concerned objects to the level of suspension proposed, or claims that the principles and procedures set forth in paragraph 3 have not been followed where a complaining party has requested authorization to suspend concessions or other obligations pursuant to paragraph 3(b) or (c), the matter shall be referred to arbitration. Such arbitration shall be carried out by the original panel, if members are available, or by an arbitrator appointed by the Director-General and shall be completed within 60 days after the date of expiry of the reasonable period of time. Concessions or other obligations shall not be suspended during the course of the arbitration.

<sup>421</sup> DSU Article 22.7 provides:

"The arbitrator [footnote omitted] acting pursuant to paragraph 6 shall not examine the nature of the concessions or other obligations to be suspended but shall determine whether the level of such suspension is equivalent to the level of nullification or impairment. The arbitrator may also determine if the proposed suspension of concessions or other obligations is allowed under the covered agreement. However, if the matter referred to arbitration includes a claim that the principles and procedures set forth in paragraph 3 have not been followed, the arbitrator shall examine that claim. In the event the arbitrator determines that those principles and procedures have not been followed, the complaining party shall apply them consistent with paragraph 3. The parties shall accept the arbitrator's decision as final and the parties concerned shall not seek

4.804 The United States then argues that Articles 22.2 and 22.6 presuppose that, by the thirtieth day following the expiration of the reasonable period of time, a complaining party wishing to suspend concessions will already have indicated how it intends to do so. Failing this, the DSB would not be in a position to authorize the action by day 30, nor would the Member concerned be in a position to evaluate the proposal to enable it to challenge the level or nature of proposed suspension. Were the complaining party to wait until after day 30 to propose suspension of concessions, it would lose the benefit of automatic DSB authorization for the suspension (subject to the negative-consensus rule) provided for in Articles 22.6 and 22.7.

4.805 The United States concludes that a determination of proposed action under Section 306(b) is not only permitted under the dispute settlement framework contemplated in the DSU, it is affirmatively required by that framework in cases where a Member wishes to exercise its right to suspend concessions.

4.806 With respect to the EC claim that such a determination "implies" that the USTR is also determining that another Member has violated US agreement rights, the United States first notes that there is no such implication in Section 306(b); nor, if there were, could an implication alone serve as the basis for finding that Section 306(b) violates DSU Article 23.2(a). The European Communities has the burden of demonstrating that Section 306(b) mandates a determination in violation of Article 23.2(a), and that the language of Section 306(b) cannot be interpreted in a manner which does not "imply" such a determination.<sup>422</sup> Section 306(b) only requires a determination of proposed action and, as the United States has seen, this is entirely consistent with the framework set forth in DSU Articles 22.2, 22.6 and 22.7.

4.807 The United States points out that WTO Members wishing to exercise their WTO rights must come to some judgment as to whether other Members are acting consistently with their obligations. If, for purposes of Article 23.2(a), "determinations" of agreement violations may be "implied" from other actions or determinations, the United States must conclude that the EC's decision to bring this case "implies" that the European Communities has, contrary to Article 23.2(a), made a determination that the United States has violated the DSU and the GATT 1994. Likewise, when the European Communities decries "illegal" US actions in the press,<sup>423</sup> may the United States then "imply" that the European Communities has made such a determination? Presumably not, but how then would one distinguish among various "determinations" which may be "implied" from various governmental statements and actions, including actions taken in connection with multilateral dispute settlement proceedings?

4.808 The United States considers that Article 23 is intended to ensure that Members use multilateral dispute settlement rules when they consider that their agreement rights have been violated. The broad interpretation of "determination" which the European Communities proposes is both unnecessary to, and potentially at odds with, the object and purpose of

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a second arbitration. The DSB shall be informed promptly of the decision of the arbitrator and shall upon request, grant authorization to suspend concessions or other obligations where the request is consistent with the decision of the arbitrator, unless the DSB decides by consensus to reject the request".

<sup>422</sup> Panel Report on *US – Tobacco*, op. cit., para. 123.

<sup>423</sup> The United States cites, e.g. "U.S. threatens tariffs on European luxury items", *The Associated Press*, 22 December 1998, PM cycle (in which Sir Leon Brittan states, with respect to section 301: "It is time to take action against the pernicious and *unlawful* effect of this wholly unilateral legislation". (emphasis added)).

Article 23. Obviously, Members will only undertake multilateral dispute settlement proceedings – including a request for suspension of concessions – if they consider that another Member is not meeting its obligations. Section 306(b) says no more than this. If the USTR "considers" that another Member has failed to implement DSB recommendations, the USTR must determine a course of action, as indeed she must in order to have the benefit of the negative-consensus rule. To read into this a "determination" of violation for purposes of Article 23.2(a) would be to preclude, not encourage, resort to multilateral dispute settlement rules.

4.809 The United States alleges that the EC's assumptions with respect to Section 306(b) are, if possible, even more extreme than those relating to Section 304. The European Communities assumes that it may "imply" from the language of Section 306 a violation determination not meeting the requirements of DSU Article 23.2(a). The EC's use of the word "implies" speaks volumes about its inability to meet its burden of establishing that Section 306 mandates such a determination. Section 306 neither mandates, nor may it be said to "imply", a determination that another WTO Member has violated its WTO obligations, and the European Communities may not simply assume that it does.

4.810 The United States explains that under Section 306, the USTR proposes what action she will take when she "considers" that another WTO Member has failed to implement DSB rulings and recommendations. The USTR must propose this action within 30 days of the expiration of the reasonable period of time in order to allow the United States to request and obtain authorization to suspend concessions pursuant to DSU Articles 22.2 and 22.6.

4.811 The United States argues that the US statute's use of the term "considers" makes clear that no formal determination is involved. Indeed, the term "considers" is used in various provisions of the DSU itself, such as Articles 3.3, 4.1, 4.7, 5.4 and 10.4. As in Section 306, these provisions lay out the steps a party may take to assert its WTO rights when it believes these rights have been denied. It is axiomatic that Members invoking dispute settlement procedures are doing so based on a belief that their rights have been denied. The DSU, like Section 306, reflects this concept through use of the term "considers". For example, Article 3.3 provides that "prompt settlement of situations in which a Member considers that any benefits accruing to it . . . are being impaired by measures taken by another Member is essential to the effective functioning of the WTO and the maintenance of a proper balance between the rights and obligations of Members". Likewise, Article 10.4 provides that a third party to a dispute may have recourse to normal dispute settlement procedures if it considers that a measure already the subject of a panel proceeding nullifies or impairs benefits accruing to it under any covered agreement".

4.812 The United States considers that it is difficult to see the logic in concluding that a Member has disregarded DSU rules and procedures based on the very fact that the Member believes it is necessary to invoke those rules and procedures. Yet that is the EC's conclusion. It flies in the face of the very purpose of Article 23.2(a), which is to encourage multilateral determinations. The Panel should therefore reject the EC's claim that the USTR is making an "implied" violation determination when she considers that another Member has not complied with DSB rulings and recommendations.

4.813 The United States reiterates that, in order to meet its burden, the European Communities must demonstrate that Section 306(b) precludes the possibility of US action consistent with its WTO obligations, and that the language of Section 306(b) cannot be read to permit such WTO-consistent action. However, even if one were to accept the EC argument that the USTR makes an "implied" determination for purposes of Article 23.2(a) when she considers that another

Member has failed to implement DSB recommendations and determines a course of action, nothing in Section 306(b) mandates that the USTR must actually "consider" non-implementation to have occurred. Section 306(b) establishes no criteria requiring the Trade Representative to "consider" that non-implementation has occurred for a given set of circumstances. As with her determination under Section 304(a)(1), the USTR has broad discretion in making this decision, and the fact that she may choose not to implement any action in and of itself establishes that Section 306 does not mandate WTO-inconsistent action.

4.814 In the view of the United States, based on its invalid assumptions that Section 306(b) both "implies" a determination for Article 23.2(a) purposes and also requires that the determination always be affirmative, the European Communities then argues that the 30-day time frame in Section 306(b) for this alleged determination precludes the USTR from basing that determination on Article 21.5 panel findings, since Article 21.5 proceedings may require up to 90 days.<sup>424</sup> The European Communities claims that WTO Members are required to pursue a panel under Article 21.5 whenever implementation is at issue. This claim is not correct, as is abundantly clear from the discussions in the ongoing DSU Review, where members are currently struggling with proposals to amend the DSU on this very point.<sup>425</sup> However, even if, for the sake of argument, one were to accept the EC's claim, the 30-day time frame in Section 306(b) would not preclude consideration of Article 21.5 panel findings and making a determination on that basis.

4.815 The United States points out that the European Communities argues that Article 21.5 proceedings are obligatory before a complaining party may request, or the DSB may authorize, suspension of concessions. However, in authorizing US retaliation in the *Bananas* dispute based only on the decision of Article 22.6 arbitrators, the DSB implicitly rejected this argument. Moreover, the Article 22.6 arbitrators themselves explicitly refused to accept the EC position.<sup>426</sup>

4.816 The United States argues that the arbitrators noted the US view that were it not possible to request suspension of concessions within 30 days of expiration of the reasonable period of time, the complaining party would lose the benefit of the negative-consensus rule.<sup>427</sup> Moreover, to the extent a Member believed that it had complied with DSB recommendations, it could request arbitration pursuant to Article 22.6. The arbitrators would address the issue of compliance in determining the extent of nullification or impairment, a prerequisite to fulfilling their mandate under Article 22.7 to determine whether the level of suspension is equivalent to the level of nullification or impairment.<sup>428</sup> The arbitrators also noted that they could address the

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<sup>424</sup> Article 21.5 provides:

"Where there is disagreement as to the existence or consistency with a covered agreement of measures taken to comply with the recommendations and rulings such dispute shall be decided through recourse to these dispute settlement procedures, including wherever possible resort to the original panel. The panel shall circulate its report within 90 days after the date of referral of the matter to it. When the panel considers that it cannot provide its report within this time frame, it shall inform the DSB in writing of the reasons for the delay together with an estimate of the period within which it will submit its report".

<sup>425</sup> See Review of the DSU, Note by the Secretariat, Compilation of Comments Submitted by Members – Rev. 3 (12 December 1998).

<sup>426</sup> Arbitration under Article 22.6 of the DSU in *European Communities – Regime for the Importation, Sale and Distribution of Bananas*, WT/DS27/ARB, para. 4.11 (9 April 1999).

<sup>427</sup> Ibid.

<sup>428</sup> Ibid.

issue of nullification and impairment for this purpose even without making a formal determination of nullification or impairment, and emphasized that, "the goal of DSU Article 23 – multilateral determination – is achieved if the issue of nullification and impairment is considered in an arbitration before the original panel".<sup>429</sup>

4.817 The United States claims that the EC's claim that Section 306(b) violates DSU Article 23.2(a) rests on a series of unsupported assumptions – that Section 306(b) "implies" a determination of a violation within the meaning of Article 23.2(a), that the implied Section 306(b) determination would always be affirmative and that WTO Members must always resort to Article 21.5 proceedings before requesting authorization to suspend concessions. These assumptions in no way meet the EC's burden of demonstrating that Section 306(b) mandates action inconsistent with DSU Article 23.2(a).

4.818 The United States challenges that EC assumption that a Member wishing to suspend concessions under DSU Article 22 must first seek a determination under DSU Article 21.5. According to the European Communities, because the USTR must make her "implied" violation determination under Section 306(b) within 30 days of the expiration of the reasonable period of time, it is possible this might precede the conclusion of the 90-day period provided for in Article 21.5. Therefore, the European Communities contends that the USTR's determination would not be authorized under multilateral procedures.

4.819 The United States argues that in light of the other flawed assumptions which the European Communities makes with respect to "implied" violation determinations and whether they must, under Section 306, be affirmative, the Panel need not and should not reach the issue of whether a Member must first invoke Article 21.5 procedures before seeking authorization to suspend concessions under Article 22. The absence of such a requirement is precisely what has prompted intensified negotiations in the DSB during the past five months. While that issue is a proper subject for negotiations to change the DSU, for that reason it is not capable of resolution by a panel. Nevertheless, the United States notes that the arbitrators in the *Bananas* dispute did not accept the EC's arguments. Indeed, Article 22 includes no reference whatsoever to Article 21.5, nor does Article 23.2(c). The time frames in Article 22 for seeking authorization to suspend concessions are measured exclusively against the expiration of the reasonable period of time.

4.820 The United States points out that Article 22.6 explicitly requires the DSB to grant a request to authorize the suspension of concessions within 30 days of the expiration of the reasonable period of time unless there is a consensus to the contrary or a challenge to the level of suspension proposed. The 30 day time frame in Section 306 is thus not only consistent with Article 22, it is required by it. If the United States or another Member were forced to wait until after day 30 to propose and seek authorization to retaliate, it would lose the benefit of the negative consensus rule. One of the principal tools in the DSU to ensure compliance with DSB rulings would be undermined.

4.821 **The European Communities notes** that the European Communities and the United States differ on the interpretation of Articles 21.5 and 22 of the DSU.

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<sup>429</sup> Ibid., paras. 4.12, 4.14. The United States notes that these conclusions shed further light on the proper interpretation of "determination" for purposes of Article 23.2(a), since they emphasise that, in pursuing a multilateral determination of one's agreement rights, it is necessary to make decisions regarding these rights.

4.822 As to this timeframe, the European Communities notes that, according to Article 22.6 of the DSU, the arbitration on the level or nature of the suspension of concession or obligations

"shall be completed within 60 days after the date of the expiry of the reasonable period of time".

4.823 The European Communities considers that a request to suspend concessions must be consistent with the decision of the arbitrator and must be submitted at least ten days before the meeting of the DSB. Thus, even if the arbitrator's decision is made within the 60-day period, 70 days can elapse between the expiry of the implementation period and the DSB authorization.<sup>430</sup> USTR is nevertheless required under Section 305 to determine unilaterally the level and the nature of the suspension of concessions or other obligations within 60 days. The European Communities notes that the United States has not argued that the EC's assumptions in respect of the 70-day period are incorrect.

4.824 The European Communities points out that the United States contests the EC's claim that WTO Members are required to request the establishment of a Panel under Article 21.5 whenever implementation is at issue. The United States affirms that:

"This claim is not correct, as is abundantly clear from the discussions in the ongoing DSU Review, where members are currently struggling with proposals to amend the DSU on this very point. ... [I]n authorizing US retaliation in the *Bananas* dispute based only on the decision of Article 22.6 arbitrators, the DSB implicitly rejected this argument. Moreover, the Article 22.6 arbitrators themselves explicitly refused to accept the EC position ...".

4.825 The European Communities addresses this issue in the framework of the answer to this question since it is related to the issue of the duration of the dispute settlement procedures and the failure of Sections 301-310 to conform to US WTO obligations under the DSU.

4.826 The European Communities firstly contends that it is incorrect to state that the DSB implicitly rejected the EC argument while authorizing the suspension of concessions in the "Banana III" procedure. The DSB authorized by reversed consensus the decision of the Arbitrators concerning the level of suspension in equivalence with the level of nullification or impairment. That was the task of the DSB under Article 22.7 of the DSU, which constitutes the mirror image of the terms of reference of the arbitrator Panel under the same provision. The DSB never adopted the arbitrator's decision,<sup>431</sup> nor explicitly or implicitly warranted its content, with the exception of the authorization of the level of suspension of concessions. In fact, most Members participating in the DSB meeting on 19 April 1999 considered that, when addressing substantive arguments concerning the consistency of the measures adopted by the European Communities to comply with the recommendations and rulings of the DSB, the arbitrator Panel went clearly *ultra vires*. The European Communities considers therefore that part of its decision as taken outside its terms of reference and thus legally non-existent.

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<sup>430</sup> The European Communities understood Japan's third party oral statement read on 30 June, at paragraph 7, as confirming this (straightforward) interpretation of the existing obligatory rules of procedure for meetings of the DSB.

<sup>431</sup> Arbitration under Article 22.6 of the DSU in European Communities – Regime for the Importation, Sale and Distribution of Bananas, WT/DS27/ARB, 9 April 1999



4.827 The European Communities secondly argues that as was recalled also by Brazil, "the logical way forward adopted in the banana arbitration is not a precedent for the interpretation of the sequence between Articles 21.5 and 22 of the DSU".<sup>432</sup> The statement by the United States according to which the DSB "implicitly rejected" the views of the majority of members of the WTO concerning Article 21.5 misrepresents the reality. As Brazil pointed out, "it would suffice to read the long records of minutes related to the banana dispute to confirm that there never was any implicit rejection of the obligatory sequence".<sup>433</sup>

4.828 Thirdly, the European Communities notes that Article 21.5 of the DSU provides that

"where there is a disagreement as to the existence or consistency with a covered agreement of measures taken to comply with the recommendations and rulings such dispute shall be decided through recourse to these dispute settlement procedures, including whenever possible resort to the original Panel. The Panel shall circulate its report within 90 days after the date of referral of the matter to it"

4.829 In the view of the European Communities, this provision, and in particular the terms "shall", "Panel" and "these dispute settlement procedures" must be interpreted in accordance with the principles of the Vienna Convention on the Law of Treaties, i.e. it must be interpreted

"in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose" (Article 31.1).

4.830 The European Communities states that it is the EC view, supported by the vast majority of WTO Members, that the ordinary meaning of the term "shall" is "expressing a command or duty" (Oxford English Reference Dictionary). In the WTO context, the term "Panel" is defined in Articles 6, 7 and 8 of the DSU. The terms "these dispute settlement procedures" interpreted in "good faith" in the context of Article 21.5 mean nothing else than a dispute settlement procedure under the DSU, which includes a Panel as defined in Articles, 6, 7 and 8 (and thus not an arbitration procedure).

4.831 The European Communities points out that as the Appellate Body stated in the *India - Patents (US)* case, paragraph 45:

"The duty of a treaty interpreter is to examine the words of the treaty to determine the intentions of the parties. This should be done in accordance with the principles of treaty interpretation set out in Article 31 of the *Vienna Convention*. But these principles of interpretation neither require nor condone the imputation into a treaty of words that are not there or the importation into a treaty of concepts that were not intended".

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<sup>432</sup> The European Communities recalls the statement by Ambassador K. Morjane, Chairman of the DSB, at the meeting held on 29 January 1999: "The solution to the banana matter *would be totally without prejudice* to future cases and to the question of how to resolve the systemic issue of the relationship between Articles 21.5 and 22 of the DSU" (WT/DSB/M/54, page 30 - original emphasis).

<sup>433</sup> See also the Minutes of the General Council meeting held on 15/16 February 1999 in the WTO doc. WT/GC/M/35.

4.832 The European Communities then argues that "where there is a disagreement as to the existence or consistency with a covered agreement of measures taken to comply with the recommendations and rulings" there is an obligation (unless the complainant decides not to proceed as it is allowed under Article 3.7, first sentence, of the DSU) to pursue a Panel procedure whose duration is determined by the DSU itself to be at least 90 days. Sections 301-310, and in particular Section 306, unilaterally set time limits and mandate compulsory determinations and actions that are clearly incompatible with this provision. Consequently, they also breach Article 23 of the DSU.

4.833 The European Communities considers that the term "determination" in Article 23.2(a) of the DSU must be interpreted in accordance with the principles of the Vienna Convention on the Law of Treaties, i.e. it must be interpreted:

"in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose" (Article 31.1).

4.834 The European Communities contends that the ordinary meaning of "determination" is "the process of deciding, determining or calculating"; (in a legal context) "the conclusion of a dispute by the decision of an arbitrator"; "the decision reached"; "a judicial decision or sentence"; in the figurative sense: "firmness of purpose, resoluteness". The verb "determine" means "to find out or establish precisely"; "to decide or settle"; "make or cause a person to make a decision", (in a legal context) "bring or come to an end" (Oxford English Reference Dictionary). These explanations of the term "determination" are unequivocally turning around the idea of a formal and definitive decision with legal consequences made in the framework of a formal proceeding.

4.835 The European Communities further argues that the immediate context of this provision is Article 23.1 of the DSU that describes the object and purpose of the more detailed rules in paragraph 2 of the same Article.<sup>434</sup>

4.836 The European Communities points out that Article 23.1 of the DSU starts with the temporal conjunction "when" and establishes a link with a situation in which a Member seeks the

"redress of a violation of obligations or other nullification or impairments of benefits under the covered agreements or an impediment to the attainment of any objective of the covered agreements".

4.837 The European Communities then claims that a public statement or a report made outside the context of seeking redress of an alleged violation or other nullification or impairment of benefits or any impediment to the attainment of any objective of the covered agreements would not be relevant in the context of Article 23.1 or 23.2 of the DSU.

4.838 According to the European Communities, the context makes also clear that decisions taken to exercise the rights under the DSU are not determinations covered by Article 23 because the very purpose of this provision is to ensure that Members make use of the DSU. Article 3.7

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<sup>434</sup> The European Communities notes that Article 23.2 of the DSU starts with the words "[i]n such cases, Members shall". This indicates that Article 23.2 is governed by the more general provision contained in Article 23.1 of the DSU.

first sentence of the DSU is also part of the context of Article 23.2 (a). This provision indicates that

"[b]efore bringing a case, a Member shall exercise its judgement as to whether action under these procedures would be fruitful".

4.839 In the view of the European Communities, this provision is complemented by provisions in other covered agreements concerning the initial steps to be taken in case of a dispute.<sup>435</sup>

4.840 The European Communities argues that in these provisions, reference is made to a Member considering that another Member has failed to carry out its obligations under the relevant covered agreement. This type of "consideration" is clearly permissible under WTO law as a prerequisite to starting a dispute settlement procedure under the relevant procedural rules; indeed it is necessary to "play by the rules". It is thus obvious that a distinction must be drawn under WTO law<sup>436</sup> between the terms "determination" and "consideration".

4.841 The European Communities then concludes that a consideration is no more than an allegation, a view expressed by a WTO Member. A mere consideration does not by itself entail any legal consequences, because it forms at best the basis for a further procedural step that must still be taken (by submitting a complaint to an outside adjudicatory body, the so-called "third-party adjudication"). In this sense, it is an expression of an opinion subject to confirmation by the exclusively competent WTO bodies.

4.842 The European Communities notes that a determination by contrast is a formal and final decision with clearly defined legal consequences. It is not subject to confirmation and is meant to have a direct legal consequence under domestic law, e.g. as a step in the process leading to retaliatory action. Since it has legal consequences, it is self-sufficient and is capable of becoming the subject matter of a dispute, both domestically and internationally.

4.843 The European Communities underlines that a determination of the absence of a violation is of course the mirror image of a determination that a violation has occurred. It is not possible to make a determination (in the above-mentioned WTO legal meaning) in one direction without at least the possibility of coming to a different conclusion. A law that requires a determination in all cases *whether* a violation of WTO law has occurred therefore comprises the requirement to determine in certain cases that a violation of WTO law has occurred. Such a law therefore mandates determinations that are inconsistent with Article 23.

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<sup>435</sup> The European Communities refers to Article XXIII:1 GATT: "If any contracting party should consider that any benefit accruing to it directly or indirectly under this Agreement is being nullified or impaired or that the attainment of any objective of the Agreement is being impeded as the result of (a) the failure of another contracting party to carry out its obligations under this Agreement, or (b) the application by another contracting party of any measure, whether or not it conflicts with the provisions of this Agreement, or (c) the existence of any other situation ..."; Article XXIII:1 GATS: "If any Member should consider that any other Member fails to carry out its obligations or specific commitments under this Agreement ..."; Article 17.3 of the Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994: "If any Member considers that any benefit accruing to it, directly or indirectly, under this Agreement is being nullified or impaired, or that the achievement of any objective under this Agreement is being impeded, by another Member or Members ...".

<sup>436</sup> The European Communities notes that this does not necessarily mean that the corresponding terms in a piece of domestic legislation of a WTO Member must be read as operating a similar distinction

4.844 The European Communities indicates that it firmly believes that the final word concerning either the presence or the absence of a violation must lie in the hands of the multilateral dispute settlement system. The prohibition contained in Article 23.2(a) of the DSU must be read to outlaw any formal and legally binding decision by a WTO Member regarding the WTO-consistency or otherwise of measures taken by another WTO-Member. The United States effectively argues that, because Members need to take position on the WTO-consistency of a measure adopted by another Member in order to assert their rights under the DSU, they may also adopt determinations for the purpose of deciding whether or not to impose unilateral sanctions. This reasoning turns the requirements of Article 23 on their head.

4.845 According to the European Communities, what a WTO Member can and must legitimately decide upon is whether or not it will submit an alleged WTO-inconsistency to the multilateral dispute settlement system. But this is a matter covered by a different DSU provision, i.e. Article 3.7, first sentence.

4.846 The European Communities considers that it is true that Article 23.2(a) of the DSU was drafted with Sections 301-310 of the 1974 US Trade Act in mind. But this means, of course, that the Uruguay Round participants had also in mind the threat to the security and predictability of the international trade relations created by the text of the Trade Act as it was drafted in the 1988 version. They had therefore in mind the need to insert in the covered agreements language that would constitute the second leg of what the European Communities has proposed in its oral statement of 29 June to call the "Marrakech deal".

4.847 The European Communities then maintains that the terminology used in Sections 301-310 cannot be decisive for the categorisation of the different provisions under WTO law. Quite to the opposite, the amendment of the Trade Act adopted by the US Congress in 1994 should have adjusted the US legislation to the new WTO rules. It is well known that the US Congress failed to do so. Any suggestion that Article 23 of the DSU must be read in the light of section 306 of the 1974 Trade Act as amended in 1994, after the conclusion of the Uruguay Round, would of course amount to an absurdity.

4.848 In the view of the European Communities, the objective of Article 23 of the DSU is ensuring multilateral dispute resolution, as the title of Article 23 of the DSU suggests ("Strengthening of the Multilateral System"). The mere fact that Section 306(b)(2) uses the verb "considers" does not mean that this corresponds to a "consideration" in the sense of WTO law.<sup>437</sup> The distinguishing feature under WTO law is whether the WTO Member takes a formal and final position with regard to the WTO-consistency of another Member's measures, on which substantive legal consequences (e.g. trade action) can be based domestically, without awaiting the final result of the WTO dispute settlement system.

4.849 The European Communities claims that the word "considers" in Section 306(b)(2) falls in this latter category, because of the existence of a "determination" of further action under

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<sup>437</sup> The European Communities notes that the publication in the Federal Register of October 22, 1998, states (in the summary) that "The United States Trade Representative is seeking written comments on (1) the measures that the European Communities has undertaken to apply as of January 1, 1999 to implement the WTO recommendations concerning the EC banana regime; and (2) the USTR's proposed affirmative determination under section 306(b) of the Trade Act of 1974, as amended, (Trade Act) (19 U.S.C § 2416), that the measures fail to implement the WTO recommendations. The USTR must make the determination under section 306(b) no later than January 31, 1999" (emphasis added). This quotation confirms that the "consideration" in section 306(b) is in reality a determination in the sense of Article 23 of the DSU.

Section 306(b)(1). In the text of Section 306, this "consideration" leads to further actions (listed under Section 301) within pre-determined time limits irrespective of the conclusion of the dispute settlement procedures under the WTO. This situation occurred, as an example, in the final phase of the "bananas" dispute and led to retaliatory trade action (withholding of customs liquidation and increase of bonds for imports of a large number of items from the EC) before the conclusion of the arbitration procedure under Article 22.6 of the DSU.

4.850 The European Communities claims that the choice of the wording in the US legislation is misleading and should not constitute the standard to interpret Article 23 of the DSU. Rather, the opposite is the correct interpretative approach, which the Panel should follow.

4.851 The European Communities recalls in this context that it drew the Panel's attention to the following discrepancy in the following statements of the USTR. The United States asserts that:

"Contrary to the EC's claims, the language of Section 306(b) does not 'imply' - let alone state - that the Trade Representative is required to make a determination in violation of Article 23. Section 306 (b) sets forth steps the Trade Representative should take to assert US rights under DSU Article 22 when she considers that there has not been full implementation by another WTO Member ... this judgement ... is not a 'determination' ..."

4.852 The European Communities point out that the public notice requesting comments on the planned 3 March 1999 action contains the following sentence:

"Given that the reasonable period of time for the EC's implementation of the WTO recommendations concerning the EC banana regime expires on January 1, 1999, the USTR must make the determination required by section 306(b) no later than January 31, 1999, and, in the event of an affirmative determination, must implement further action no later than 30 days thereafter". (emphasis added)

4.853 The European Communities considers that it is thus clear from the above that the USTR describes herself the consideration she must make under Section 306(b) as a determination and the action to be taken as a result of this determination as mandatory.

4.854 **In rebuttal, the United States notes** that the determination referred to in the notice is the determination indicated in Section 306(b) – to propose action to be taken if the USTR considers non-implementation to have occurred. It is not a determination that US agreement rights have been denied. While, under Section 306(b), the USTR must make the determination of proposed action if she considers that another Member has not implemented DSB rulings and recommendations, the USTR has complete discretion on the question of whether she considers non-implementation to have occurred.

4.855 In response to the Panel's question as to the definition of "determination" in the context of Article 23.2(c), the United States contends that it may be difficult to distinguish such determinations on their face.<sup>438</sup> The ordinary meaning of "determination" is: "The settlement of

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<sup>438</sup> The United States notes that the European Communities has, for example, stated that: "The decision not to take into account the complete conversion of a territory from a non-market economy into a market economy and the full privatization of the exporting enterprises *is a violation* of the United States'

a suit or controversy by the authoritative decision of a judge or arbiter; a settlement or decision so made, an authoritative opinion"; "The settlement of a question by reasoning or argument"; "The action of coming to a decision; the result of this; a fixed intention"; "The action of definitely locating, identifying, or establishing the nature of something; exact ascertainment (of); a fact established, a conclusion or solution reached".<sup>439</sup>

4.856 The United States claims that this ordinary meaning must be read within the context of this term in Article 23 and the DSU and in light of the object and purpose of Article 23.2(a). Article 23 is captioned "Strengthening the Multilateral System", and Article 23.1 emphasises that Members seeking redress of violations shall have recourse to, and abide by, the (multilateral) rules and procedures of the DSU. Read in this light, for purposes of Article 23.2(a), the term "determinations" must not be read so broadly as to frustrate, rather than promote, the goal of multilateral dispute settlement. The Panel's question recognises that Members pursuing multilateral dispute settlement will frequently need to take positions in order to conduct dispute settlement. It would be absurd and at odds with the object and purpose of Article 23 to include the taking of positions necessary to the pursuit of dispute settlement within the definition of "determinations" for purposes of Article 23.2(a).

4.857 In the US view, for this reason, the term "determination" in Article 23.2(a) can not include decisions reflecting a Member's belief that another Member has failed to comply with its obligations, since Members will frequently undertake dispute settlement procedures based on such a belief.

4.858 The United States goes on to explain that notwithstanding the above explanation, for purposes of this dispute, it is not necessary to delineate the precise boundaries of the term "determination". The European Communities has characterized two actions in Sections 301-310 as "determinations": when the USTR issues her "determination" under Section 304, and when the USTR "considers" under Section 306 whether implementation has occurred in order to decide whether to pursue DSB authorization pursuant to Article 22. Even if Section 304 involves a "determination", the European Communities has failed to prove it is a determination in violation of Article 23.2(a) since, among other reasons, it need not be a determination that a violation has occurred. However, Section 306 does not involve a determination for purposes of Article 23.2(a). The United States argues that the use of the term "considers" in Section 306 parallels that in the DSU, and is used in both places to indicate the belief that recourse to multilateral dispute settlement procedures is necessary. In the view of the United States, Article 22 requires that a Member seeking DSB authorization to suspend concessions must propose how it intends to do so no later than 30 days following the expiration of the reasonable period of time, and Section 306 reflects this fact in US law.

4.859 In response to a Panel question concerning statements in annual reports, and whether such statements can be "determinations", the United States considers that the question highlights the fact that only a limited sub-set of statements will constitute "determinations" under Article 23. As discussed earlier, this sub-set cannot include statements merely indicating a belief regarding another Member's practices.

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obligation under Article 11 of the Agreement". (*United States - Anti-Dumping Measures on Imports of Solid Urea from the Former German Democratic Republic*, WT/DS63/1, emphasis added.)

<sup>439</sup> The New Shorter Oxford English Dictionary, at 651 (1993).

4.860 In the view of the United States, it is difficult in the abstract to answer the question of whether statements in annual reports or public statements would rise to the level of determinations without knowledge of the specific context and statements made. Ultimately, a decision on whether a given statement constitutes a "determination" would have to be addressed on a case-by-case basis.

4.861 **In rebuttal, the European Communities notes** that the United States claims that the "consideration" of the USTR under Section 306(b) is not a determination within the meaning of Article 23 of the DSU but a logical pre-condition for the exercise of the rights under Article 22 of the DSU. This would be correct if the only consequence of the "consideration" of the USTR was an invocation of Article 22.

4.862 The European Communities points out that the plain language of the law however shows that this is clearly not the case. If the USTR makes an affirmative determination under Section 306(b), she shall simultaneously determine what further action she will take.

4.863 The European Communities considers that the USTR shall treat the determination on further actions as a determination made under Section 304(a)(1), which is subject to the provisions of Section 305 governing the implementation of sanctions.

4.864 The European Communities then concludes that the "consideration" is thus a formal determination in the framework of a domestic procedure through which the United States seeks redress of a violation of WTO obligations, and that determination must be made and implemented even when the WTO proceedings on which such a determination or action could be based have not been completed.

4.865 The European Communities argues that a mere requirement that the USTR monitors the implementation of DSB recommendations and decides to invoke Article 22 if appropriate would, of course, not be inconsistent with Article 23. However, the "consideration" and the simultaneous determination of further action the USTR is obliged to make under Section 306(b) are inconsistent with Article 23 because they constitute the first step in a domestic proceeding under which sanctions must be imposed even in the absence of a DSB authorization to this effect.

4.866 **The United States further responds** that as with its claim regarding Section 304, it can meet its burden with respect to its Section 306(b) claim only by establishing that Section 306(b) mandates: (1) a determination to the effect that a violation has occurred; (2) which has not been made through recourse to DSU rules and procedures, or is not consistent with adopted panel or Appellate Body findings or an arbitral award.

4.867 The United States argues that the EC's concession that Section 304 allows the USTR to make a determination of consistency must be considered to include an acknowledgement that the USTR is free under Section 306(b) to "consider" that another Member has implemented its commitment to comply with DSB rulings and recommendations. The European Communities reasoned that the language of Section 304(a)(1) provided for an "either/or" determination, including the option of determining that US agreement rights had not been denied. While the United States rejects the EC's conclusion that only two determinations are possible under Section 304, at least these two must be considered possible under Section 306(b). Section 306(b) provides "if the USTR considers [non-implementation to have occurred]", with no constraint whatsoever on what might lead her to consider otherwise, or how she may characterize that belief. This is a purely discretionary decision, and Section 306(b) cannot be read to mandate in any way what the USTR will "consider", let alone a "determination" that a

violation has occurred. The EC's claim regarding Section 306(b) must fail for this reason. Without a determination that a violation has occurred, or a law mandating such a determination, there can be no violation of DSU Article 23.2(a).

4.868 The United States considers that the EC's claim must also fail because what the USTR may "consider" is not a determination. The term "considers" is used throughout the DSU in precisely the same manner as it is used in Section 306(b): to indicate a belief concerning another Member's actions calling for the invocation of multilateral dispute settlement proceedings. To characterise such a belief as a "determination" for purposes of DSU Article 23.2(a) would undermine the objective of multilateral determinations underlying Article 23.

4.869 The United States recalls that the European Communities argues that "the terminology used in Sections 301-310 cannot be decisive for the categorization of the different provisions under WTO law". According to the European Communities, despite the use of these different terms in the DSU, "this does not necessarily mean that the corresponding terms in a piece of domestic legislation of a WTO Member must be read as operating in a similar fashion". This may well be so, but this does not explain why Sections 301-310 themselves include the distinction between "determination" and situations in which the USTR "considers" that DSU procedures must be invoked. US rules of statutory construction differ little, if at all, from those of treaty interpretation. If different terms are used in the statute, there must be a reason that they differ.

4.870 The United States claims that the EC's argument that the use of different terms in the statute "cannot be decisive for the categorization of the different provisions under WTO law" must also be read in light of its argument one paragraph earlier that, "It is true that Article 23.2(a) of the DSU was drafted with Sections 301-310 of the 1974 US Trade Act in mind". Assuming this is true, then the drafters of the DSU were certainly aware of the pre-existing distinction between determinations and situations in which the USTR might "consider" in Sections 301-310, and intended to make the same distinction when these terms were adopted into the DSU. At a minimum, if the drafters of the DSU had Sections 301-310 "in mind" – if it had been their intention to subject mere beliefs to potential discipline under Article 23.2(a) – then they would have included "considerations" in DSU Article 23.2(a). They did not, however, do so, and there is no basis now for subjecting such beliefs to scrutiny as "determinations".

4.871 The United States further states that the European Communities attempts to claim that "determinations" are associated with "clearly defined legal consequences", for example, "as a step in the process leading to retaliatory action". The European Communities offers no textual basis for this claim, and the text and context of Article 23.2(a) in fact contradict it. The text of Article 23.2(a) refers to determinations that a violation has occurred, with no discussion whatsoever of the consequences of those determinations. It is a straightforward obligation of conduct, not an obligation of result.<sup>440</sup> Moreover, Article 23.2(c) deals specifically with suspension of concessions or other obligations, the "retaliatory action" of which the European Communities speaks. That provision makes no reference to violation determinations. If "legal

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<sup>440</sup> The United States refers to International Law Commission, *Draft Articles on State Responsibility*, Arts. 20-21, 37 I.L.M. 440, 448 (1998), as stating that: "There is a breach by a State of an international obligation requiring it to adopt a particular course of conduct when the conduct of that State is not in conformity with that required of it by that obligation". (Art. 20) "There is a breach by a State of an international obligation requiring it to achieve, by means of its own choice, a specified result if, by the conduct adopted, the State does not achieve the result required of it by that obligation". (Art. 21.1)).



consequences" such as suspension of concessions were a prerequisite for a "determination" under Article 23.2(a), what would be the need for a separate Article 23.2(c)? The determination of violation would have the legal consequence of mandating suspension of concessions and would encompass the situations provided for in both paragraphs (a) and (c). The EC approach would thus collapse two separate DSU provisions into one.

4.872 The United States argues that if the European Communities were to respond that Article 23.2(c) provides for action actually taken, while Article 23.2(a) just provides for first steps that might not actually result in action, then this suggests that the action need not be taken as a result of the determination, that is, that action remains discretionary. Under this formulation, even a decision to initiate an investigation, which might ultimately have "the legal consequence" of action taken, could be drawn into the definition of "determination". Moreover, a Member could avoid liability under Article 23.2(a) simply by explicitly decoupling the violation determination from the action taken, even if the Member retains complete discretion to suspend concessions at any time for any reason.

4.873 The United States further contends that it is also questionable whether the European Communities or other WTO Members would be willing to accept the consequences of the EC's approach. Assume, for example, that a Member has a statute mandating that authorities, without first resorting to WTO dispute settlement proceedings, make definitive, official, published determinations that another Member has violated its WTO obligations. The statute would not otherwise provide for any "legal consequences". Such a clear "determination" would certainly appear to be precisely within the terms of Article 23.2(a), yet under the EC's approach it would be excluded.

4.874 In the view of the United States, the EC's definition of "determination" based on "legal consequences" is not sustainable. The USTR's belief as to whether Article 22 proceedings need be invoked, expressed through the term "considers", is not actionable under DSU Article 23.2(a).

4.875 The United States further maintains that another aspect of the EC's proposed definitions of "considerations" and "determinations" worthy of comment is the fact that it would appear to lead to the conclusion that all Section 304(a)(1) determinations are in fact "considerations". The European Communities states, "the terminology used in Sections 301-310 cannot be decisive for the categorization of the different provisions under WTO law". The European Communities thus allows for the possibility that a "determination" under domestic law may in fact be a "consideration" for WTO purposes. The European Communities explains that a "consideration"

"does not by itself entail any legal consequences, because it forms at best the basis for the further procedural step that must still be taken (by submitting a complaint to an outside adjudicatory body . . .). In this sense, it is an expression of an opinion subject to confirmation by the exclusively competent WTO bodies".

4.876 The United States considers that because Section 303(a)(1) and (2) require the USTR to initiate WTO dispute settlement proceedings in investigations involving a WTO agreement, the views expressed by the USTR pursuant to Sections 301-310 would, in the EC's definition, be opinions "subject to confirmation by the exclusively competent WTO bodies". Thus, but for the fact that Section 304(a)(1) requires the USTR to base her determinations on adopted panel and Appellate Body findings, the USTR could determine under Section 304(a)(1) that US agreement rights are being denied, and the European Communities would treat this as a "consideration" not subject to Article 23.2(a) because it is an opinion during on-going dispute settlement

procedures. To the EC's likely response that Section 304(a)(1) determinations have legal consequences, the United States notes again that Section 301(a)(2) provides for exceptions to action which include Section 301(a)(2)(B)(i), which covers situations in which the foreign country is taking satisfactory measures to grant US rights under a trade agreement. This exception would be applicable if dispute settlement proceedings were on-going, since, by its participation in those proceedings, the foreign country would be taking satisfactory measures. The determination would thus be no more a step in the chain of events towards suspension of concessions than would initiation of an investigation (which also, under the EC's definition, might be characterized in domestic law as a determination without implicating Article 23.2(a)).

4.877 The United States states that it must, under Section 304(a)(1), base its determinations on the results of WTO dispute settlement and could not, therefore, make the above determination. On the other hand, the USTR could make any of a number of determinations, and this could include a determination that US agreement rights were being denied, "subject to confirmation by the DSB". Presumably this, too, would meet the EC's definition of "consideration". In substance, such a "consideration" would certainly be less definitive than a statement in the press by a trade minister that another Member is violating its WTO obligations.

4.878 The United States recalls that the European Communities also addresses whether Article 21.5 proceedings must first precede Article 22 proceedings. The United States notes at the outset that this Panel need not, and should not, reach this issue. The EC claim would appear to draw the Panel into the heart of a disagreement that is recognised by the WTO Members and is the subject of a separate negotiation in an attempt to resolve it. This is therefore not an area ripe for a Panel. The United States furthermore notes that this issue would only be relevant in this dispute if (1) what the USTR "considers" is deemed an "implied determination", and (2) the law mandates that she always consider that another Member has not complied with its obligations. Again, the EC's burden is to prove that Sections 301-310 do not allow, that is, that they preclude, WTO-consistent action by the USTR. To the extent that she need not make a "determination" that a violation has occurred, the mere existence of a law not precluding that possibility would not violate Article 23.2(a). It is worth recalling that the European Communities now takes the position that Members need not "include explicit language in their domestic law precluding WTO-inconsistent action".

4.879 In rebuttal, the United States claims that assuming that a "consideration" is a "determination", and that it must always be affirmative, the European Communities remains incorrect regarding the relationship between Articles 21.5 and Article 22. The United States first notes that the EC's dismissal of US references to DSU review documents misses the point for which the United States raises them.<sup>441</sup> The United States first noted that the European Communities explicitly acknowledged in a DSU review document the current distinction between mandatory and discretionary legislation. Inasmuch as the European Communities appears to accept the mandatory/discretionary distinction (albeit with a liberally reinterpreted definition of "mandatory"), this reference is no longer necessary. The remaining references were intended to point out that the relationship between Articles 21.5 and 22 is anything but clear and that this fact is generally recognised.

4.880 The United States argues that Article 22 does not by its terms, context or purpose require that a Member first resort to Article 21.5 proceedings. All time frames in Article 22 are measured against the end of the reasonable period of time, and Article 21.5 is not even mentioned once. Likewise, Article 21.5 is not mentioned once in Article 23.2(c), which only

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<sup>441</sup> See *ibid.* at 33.

requires that Article 22 proceedings be pursued before suspension of concessions may be undertaken. Article 22 represents a central element in the credibility and effectiveness of WTO dispute settlement, since it provides that losing Members may no longer block suspension of concessions against them. However, the EC's claim that Article 21.5 proceedings must first be completed would result in the loss of this right to suspend concessions, since Article 22 only applies the negative consensus rule to requests to suspend concessions if such requests are made within 30 days of the conclusion of the reasonable period. Members whose rights have already been found to have been violated, and who have already lived with these violations through the year-and-a-half panel process and additional year of implementation, would find themselves, as they were under the GATT 1947, again at the mercy of the very party that had denied their rights and impaired their trade.

4.881 The United States further contends that in response to the concern that there must first be a multilateral determination of violation, it notes that when Article 22 procedures are invoked, there is already such a determination – in the original, adopted panel and/or Appellate Body reports. Further, as the Article 22 arbitrators found, Article 22 proceedings cannot result in suspension of concessions where a Member has in fact brought its measure into compliance, because the level of nullification and impairment in that case would be zero.<sup>442</sup>

4.882 In the view of the United States, Article 22 thus does not require recourse to Article 21.5 proceedings, and a statutory provision such as Section 306(b) which merely provides a domestic means for resorting to Article 22 proceedings cannot be said to violate Article 23.2(a) through an "implied determination".

4.883 The United States adds that even if the European Communities were correct that Article 21.5 proceedings must precede Article 22 proceedings, this would not mean that Section 306(b) mandates a violation of Article 23.2(a). The USTR has complete discretion in her assessment, her "consideration" under Section 306(b), of whether another country's implementation status requires that dispute settlement procedures be invoked. If DSU rules actually provided that a Member first undertake Article 21.5 procedures before requesting suspension under Article 22, there would be nothing in Section 306 to prevent the USTR from complying with this requirement. She could for example consider that she needs to pursue Article 21.5 proceedings to ascertain whether there has been full implementation.

4.884 **The European Communities further responds** that Article 23.2 (a), read in the immediate context of Article 23.1 and in the broader context of Article 3.7 of the DSU, is an obligation of conduct and of result: the redress of a violation or other nullification or impairment of benefits must be achieved in substance through the multilateral dispute settlement system or through a mutually agreed solution only.

4.885 In the view of the European Communities, there is no third way. Of course any Member can freely accept to tolerate the consequences of the conduct of another Member in violation of

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<sup>442</sup> See Arbitration under Article 22.6 of the DSU in *European Communities – Regime for the Importation, Sale and Distribution of Bananas*, WT/DS27/ARB, para. 4.11 (9 April 1999).

The United States points out that the European Communities adopts the Brazilian argument that the *Bananas* arbitration represents a "logical step forward" relevant only to that dispute. The "logical step forward" adopted by the *Bananas* arbitrators – simultaneous Article 21.5 and 22 proceedings conducted by the original panel – remains, for the present, the only logical step forward in those cases when an implementing Member uses the full implementation period. This of course could easily change as a result of the efforts now underway in the DSU review.

its WTO obligations. However, abstaining from action, also a hypothesis foreseen in the DSU - Article 3.7 - is outside the realm of Article 23, paragraphs 1 and 2 ("When Members seek redress ... In such cases, Members shall ...").

4.886 In this legal perspective, the European Communities recalls the US argument that Article 23.2(a) of the DSU "... is a straightforward obligation of conduct, not an obligation of result".

4.887 The European Communities indicates that if this statement were to be understood as meaning that WTO Members do not have a positive obligation to insert in their domestic law a clause expressly obliging the executive authorities to observe Article 23 in all cases, it would not disagree with such an argument.

4.888 The European Communities contends that if, however, the US argument were to imply that Article 23.2(a) is a mere obligation of conduct, it would disagree. If the US approach were followed, a Member would find itself at the conclusion of the process of verification of consistency to discover that a negative result entails that it had not followed the obligation of conduct under Article 23.2(a). One should in fact bear in mind that the outcome of a process of "verification of consistency" cannot be predetermined in advance and, thus, a determination of consistency or inconsistency is achieved at the end of a process of verification.

4.889 The European Communities argues that this unavoidable consideration shows better than anything else that it is not true that the EC's interpretation of Section 304(a)(1)(A) "would have the impermissible consequence of preventing even determinations of consistency, notwithstanding the explicit language of Article 23.2(a), which only addresses certain determinations of inconsistency". Rather, it is the US suggestion of an "obligation of conduct" merely consisting of a formality of a procedure and not of the substance of a multilateral decision within the WTO DS system that gets to the "impermissible consequence of preventing a determination of consistency".

4.890 The European Communities also recalls that the United States has again erroneously denied the obligatory prior application of the "formal dispute settlement proceeding" under Article 21.5 of the DSU where there is disagreement on the conformity of the measures taken to comply with recommendations and rulings of the DSB. The European Communities notes in passing that the United States does not contest the interpretation of the ordinary meaning of the terms of Article 21.5 in their context and in the light of its object and purpose advanced by the European Communities.

4.891 The European Communities further points out that the procedures under Article 22 cannot be defined as "formal dispute settlement proceedings" and are in any case at the request of the defending party and not of the complainant (contrary to the provision of Section 303 (2)). According to the US' own interpretation, when the United States is a complainant, Article 22 procedures are not covered by the "proceedings" within the scope of Section 304 (a)(1).

4.892 According to the European Communities, thus, it is clear from the text of Section 304 that whatever the interpretation of Article 21.5 and Article 22 of the DSU, at least during the phase of "monitoring of compliance", the USTR shall determine whether the rights to which the United States is entitled under any trade agreement are being denied" exclusively "on the basis of the investigation initiated under section 302".

4.893 The European Communities further maintains that this means in practice that the text of Section 304 does not provide for any real discretion since if the factual findings of the

investigation are negative, pursuant to Section 306 (b) (2) the USTR must ("shall") make the determination no later than 30 days after the expiration of the reasonable period of time. This must be done irrespective of any decision of the DSB.

4.894 The European Communities points out that according to Section 306 (b) (1), the content of USTR's determination is "what further action the USTR shall take under section 301(a)".

4.895 The European Communities notes that Section 301(a) - entitled "Mandatory Action" - provides that:

"if the USTR determines under section 304 (a) (1) that (A) the rights of the United States under any trade agreement are being denied or (B) an act, policy or practice of a foreign country (i) violates, or is inconsistent with the provisions of or otherwise denies benefits to the United States under any trade agreement or (ii) is unjustifiable and burdens or restricts United States commerce, the Trade representative shall take action authorized in sub-section c)".

4.896 The European Communities further notes that according to Section 301 (d) (4) (A),

"an act, policy, or practice is unjustifiable if the act, policy or practice is in violation of, or inconsistent with, the international legal rights of the United States".

4.897 The European Communities considers that not only the USTR does not have any discretion in discharging her obligation of making a determination of action, but the law also strictly defines what is "unjustifiable" without any respect whatsoever of the need of going through the dispute settlement procedures under the DSU before such a determination is taken.

4.898 The European Communities notes that Section 301, sub-section (c), spells out in detail "what" action the USTR is authorized to take. The closed list requires either to withdraw concessions or other benefits or to enter into a binding agreement (whose content is pre-determined). The targeted WTO Member then has only two options: it must either bear the consequences of retaliation or sign an agreement acceptable to the United States (as in the "*Japan -Auto Parts*" case). The second option open to the USTR constitutes the only escape for the targeted WTO Member in order to avoid the (explicitly threatened) retaliation.

4.899 **The United States responds** that in contrast to other provisions of the DSU, Article 23.2(a) by its terms deals with "determinations", not beliefs as reflected in what an individual or Member may "consider". Section 306(b) does not command the USTR to make a determination that another Member has violated its WTO obligations. It merely provides for the steps to be taken if she believes, if she considers, that full implementation has not occurred. This belief, the prerequisite to invoking multilateral agreement rules on the suspension of concessions, is not a determination. Nor, if it were, would it by statutory command be limited to a determination that another Member has violated its WTO obligations. Section 306(b) does not command the USTR to consider that another Member has failed to fully implement its commitment to comply with DSB rulings and recommendations.

4.900 The United States recalls that the European Communities has suggested that the very act of determining whether US agreement rights have been denied, or considering whether implementation has occurred, "mandates" a determination that a WTO violation has occurred. There is no rule of grammar or US rule of statutory construction which permits such a reading.

To the contrary, even were the US statutory language considered ambiguous, US and international practice would be to interpret that language so as to avoid a conflict with US international obligations. This practice is reflected in GATT/WTO jurisprudence in the *Tobacco* panel report, which asks whether any reading of a statute permits authorities to comply with their international obligations. The EC's argument ignores this practice and precedent. Moreover, in arguing that it is WTO inconsistent to determine "whether" agreement rights have been denied because such a determination inherently "must" sometimes be affirmative, the European Communities would render any determination a violation of DSU Article 23.2(a), even a determination that no agreement rights have been denied or confirmed, and even those determinations not involving a WTO agreement. No reading of DSU Article 23.2(a) supports this result.

4.901 In response to the Panel's question regarding the relationship between Article 21.5 and Article 22 of the DSU, **the European Communities first underlines** that it has not requested this Panel to "make a decision on the relationship between Article 21.5 and 22" of the DSU. Rather, the European Communities has requested the DSB and obtained the establishment of this Panel in order to make "such findings as will assist the DSB in making the recommendations or giving the rulings provided for in" the provisions of the agreements cited in the WTO document WT/DS152/11 of 2 February 1999.

4.902 The European Communities warns that the Panel, therefore, should not be distracted by the US attempt to curtail or diminish the Panel's terms of reference by creating the (erroneous) impression that this procedure is in some ways overlapping with a parallel procedure in other WTO *fora*. This characterisation of the situation is erroneous and the Panel should resist and reject these US procedural tactics. In the EC's view, this panel procedure should concentrate on its terms of reference: the WTO consistency of Sections 301-310 must be assessed against all the provisions quoted in the Panel's terms of reference, including Article 21.5 of the DSU on its own.

4.903 The European Communities also contends that as the Appellate Body indicated already in its early reports and constantly repeated afterwards, in application of Article 31 of the Vienna Convention on the Law of Treaties, the Panel should concentrate first on the ordinary meaning of the terms of Article 21.5 of the DSU, in their context, and in the light of the object and purpose of the DSU and of the WTO agreements. The interpretation of Article 22 of the DSU is logically and legally a distinct issue to be addressed by the Panel separately, if necessary.

4.904 Pursuant to Article 11 of the DSU, the European Communities expects that the Panel will follow this line of interpretation in order to reach its conclusions aimed at assisting the DSB to make the appropriate recommendations and rulings. The European Communities believes that the notion that a Member of the WTO can somehow curtail another Member's rights under the DSU by introducing a proposal to amend the covered agreement at issue is inconsistent with Article 3.2 of the DSU according to which the DSB rulings cannot diminish the rights of Members under the covered agreements.

4.905 The European Communities is of the view that the mandate of the Panel is to "make an objective assessment of the matter before it" (Article 11, second sentence, of the DSU). Such an objective assessment must be based on the covered agreements as they stand and cannot be based on possible future amendments of these agreements. Of course, panels should give the parties adequate opportunity to develop a mutually satisfactory solution (Article 11, last sentence of the DSU). However, as is stipulated in Article 12.7 of the DSU, "[w]here the parties to the dispute have failed to develop a mutually satisfactory solution, the panel shall submit its findings in the form of a written report to the DSB".

4.906 The European Communities further argues that it is thus clearly stated that the Panel is required to go ahead with the procedure as long as the parties to the dispute have failed to develop a mutually satisfactory solution. As the debate before the Panel has demonstrated, the views of the European Communities and the United States on the relationship between Article 21.5 and 22 of the DSU are as far apart as ever and there does not appear any immediate perspective of a mutually satisfactory solution on this issue at the present time. If the political negotiations on the relationship between Articles 21.5 and 22 of the DSU end with the a solution favourable to the United States, the United States would therefore benefit from that solution irrespective of the rulings of the Panel.

4.907 The European Communities would not wish to speculate on what a negotiated solution on the relationship between Article 21.5 and 22 of the DSU might look like and whether it would put this aspect of the present dispute to rest. In this context, it may be of interest that the DSB has not been in a position to date to come to an agreed conclusion on any of the informal proposals for the review of the DSU.

4.908 However, the European Communities draws the attention of the Panel to the recent developments in the dispute on *Australia – Salmon*,<sup>443</sup> as shown by the sequence of events as follows:

- (a) on 15 July 1999, Canada requested authorization for suspension of concessions under Article 22.2 of the DSU<sup>444</sup> based on a unilateral determination of failure to comply by Australia. Canada appeared at that time to follow the (illegal) US approach to this matter;
- (b) on 27 July 1999, Australia, while indicating that "[T]he DSB meeting on 27 July (now 28 July) will be the first opportunity for Australia to contest Canada's right to seek authorization on the basis of WT/DS18/12", it requested arbitration "with an abundance of legal caution in regard to safeguarding its WTO right to arbitration accorded by Article 22.6" of the DSU<sup>445</sup>;
- (c) on 28 July 1999, as a result of the discussions in the DSB on this issue on the same day, Canada requested that the determination of consistency of the implementation measures by Australia be referred to the original panel "pursuant to article 21.5 of the DSU".<sup>446</sup>

4.909 In the view of the European Communities, these events demonstrate that the US position on this essential issue is not only unjustifiable under WTO law but that the United States is also more and more isolated in the DSB in this regard.

4.910 In addition, the European Communities maintains that the time frames provided for under Section 306(b)(2) of the Trade Act 1974 are in any case entirely insufficient to carry out a dispute settlement procedure on the failure of compliance of another WTO Member that would respect the requirements of due process.

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<sup>443</sup> WT/DS18.

<sup>444</sup> WT/DS18/12 of 15 July 1999.

<sup>445</sup> WT/DS18/13 of 3 August 1999.

<sup>446</sup> WT/DS18/14 of 3 August 1999.

4.911 **The United States considers** that the Panel should not decide on the relationship between Article 21.5 and 22. First, it is unnecessary for the Panel to reach the issue of the relationship between Articles 21.5 and 22. This issue is ultimately irrelevant to the Panel's decision because the European Communities has failed to prove several other points necessary to establish its claims with respect to Articles 23.2(a) and 23.2(c).

4.912 In the view of the United States, with respect to its claim regarding Article 23.2(a), the European Communities has failed to meet its burden of demonstrating: (1) that Section 306 involves a "determination" on whether another Member has violated its WTO obligations; and (2) that Section 306 commands that such a determination always be a violation determination. Without a determination to the effect that a violation has occurred, it is not relevant for the Panel to determine whether the other requirements of Article 23.2(a) have been met.

4.913 The United States also considers that with respect to its claim regarding Article 23.2(c), the European Communities has failed to meet its burden of demonstrating: (1) that Section 306 commands the USTR to always consider that non-implementation has occurred; (2) that the USTR must take action involving the suspension of concessions, rather than other alternatives; (3) that the USTR cannot avail herself of the exceptions set forth in Section 301(a)(2)(B); (4) that the President may not condition action or direct that it not be taken; (5) that the USTR cannot delay action until 240 days – eight months – after the reasonable period of time pursuant to Section 305(a)(2), well beyond either or both of the 60 and 90 day periods provided for in Articles 21.5 and 22.

4.914 The United States adds that the Panel should not reach this issue because doing so would preempt the ongoing negotiations and encroach upon the rights of all WTO Members (not just parties to a single dispute) to negotiate the balance of rights and obligations under the WTO Agreement. Only the Members may amend or adopt interpretations of the DSU (WTO Agreement Arts. IX:2 and X), and Panels cannot add to or diminish the rights and obligations provided in the covered agreements (DSU Arts. 3.2 and 19.2). The discussions in the DSU review are likely to lead to amendment or agreement on the relationship of Article 21.5 and 22.

4.915 The United States also claims that as with the analysis of other agreement provisions, the analysis of the relationship between Articles 21.5 and 22 must be based on the text. As already explained in more detail, the text of Article 22 nowhere references Article 21.5 for any purpose. Moreover, by its terms Article 23.2(c) only requires that Article 22 procedures be followed; it makes no reference to Article 21.5. For these reasons and others set forth earlier and in the Article 22 Arbitration report in *Bananas*, the DSU does not presently require that a Member resort to Article 21.5 proceedings before requesting authorization to suspend concessions pursuant to Article 22.

4.916 In response to the Panel's question as to whether the issue would be moot if an agreement were reached on this relationship before the completion of this Panel's proceedings, the United States answers in the affirmative. More importantly, however, if an agreement were reached by which parties would resort to an amended Article 21.5 process prior to resorting to Article 22 procedures, nothing in Sections 301-310 would preclude the United States from acting consistently with such an agreement.

**(c) Discretion not to consider that non-implementation has occurred/Discretion with respect to timing of consideration**

4.917 **The European Communities argues** that when the USTR "shall" determine "what" action she "shall" take, she is constrained by the closed list under section 301(c). That list



requires either to withdraw concessions or other benefits (and therefore the publication of a "retaliation list") or to enter into a binding agreement (whose content is pre-determined). This second leg of the alternative open for the USTR constitutes the only escape for the targeted WTO Member in order to avoid the (explicitly threatened) retaliation.

4.918 The European Communities notes that in the *Bananas III* case, the USTR published a notice on the Federal Register<sup>447</sup> where, *inter alia*, it explicitly indicated the following

"Section 306 (c) of the Trade Act provides that the USTR shall allow an opportunity for the presentation of views by interested parties prior to the issuance of a determination pursuant to section 306 (b)" (emphasis added)

4.919 The European Communities also recalls that on 10 November 1998, USTR published a second notice on the Federal Register<sup>448</sup> concerning a proposed "determination of action" with an attached list of selected EC products on which the imposition of prohibitive (100 per cent ad valorem) duties was envisaged. The notice in question was published "in accordance with section 304 (b) of the Trade Act".

4.920 The European Communities considers that there can be no doubt that the Korean statement is correct as it is the immediate consequence of the text, design, structure and architecture of Sections 301-310 in their present form. Moreover, the implementation and the public statements by the USTR concerning the interpretation of Sections 304 and 306 come as further confirmation of the EC's claims, which are supported by Korea and several other WTO Members.

4.921 The European Communities then argues that the mechanics of the mandatory determinations and actions that the US executive authorities are mandated to implement together with the ensuing explicit threat against the other WTO Members resulting from this legal situation is more than sufficient<sup>449</sup> evidence to prove the full disregard that Sections 301-310 have for the US obligations under the WTO Agreements, in particular under Article XVI:4 of the Marrakech Agreement, Article 23 of the DSU and Article 26 of the Vienna Convention on the Law of Treaties.

4.922 **The United States points out** that nothing in Section 306(b) obligates the USTR to conclude that another Member has failed to implement DSB recommendations. This is a purely discretionary decision, and the European Communities has failed to meet its burden of demonstrating why it would not be possible for the USTR to conclude that no action need be taken because implementation has been satisfactory, because adequate progress is being made, or because further dispute settlement proceedings are necessary to achieve satisfactory implementation.

4.923 **In rebuttal, the European Communities recalls** that the United States further claims that the USTR is not required to determine that United States' rights under a WTO agreement are being denied and that a failure to implement DSB recommendations occurred and that,

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<sup>447</sup> Vol. 63, No 204, 22 October 1998, page 56689

<sup>448</sup> Vol. 63, No 217, page 63099

<sup>449</sup> According to G. Schwarzenberger, *International Law*, 3<sup>rd</sup> Edition, page 614, "[s]ufficient relevant dicta of the World Court exist to permit the conclusion that the mere existence of such legislation may constitute a sufficiently proximate threat of illegality to establish a claimant's legal interest in proceedings for at least a declaratory judgement".

consequently, Sections 301-310 do not mandate determinations inconsistent with Article 23 of the DSU. However, these determinations must be based on the investigation initiated by the USTR under Section 302 or the monitoring conducted by the USTR under Section 306(a).

4.924 In the view of the European Communities, there is nothing in Sections 301-310 that would permit the USTR to make her determinations on any other basis, for instance on the basis of a delay in the WTO dispute settlement proceedings. The United States in effect makes the astonishing claim that the USTR may determine under Sections 301-310 that no denial of rights and no failure to implement DSB recommendation occurred because the WTO dispute settlement have not been completed.

4.925 The European Communities submits that it would not be logical to interpret Sections 301-310 to authorize determinations on the WTO-consistency of measures on the basis of factors that are entirely outside the plain language of the law and, as such, irrelevant to such a determination.

4.926 **The United States argues** that there are no "specified time frames" for "considerations". Inasmuch as a consideration is no more than a belief, the USTR may, at any time – before, during or after the reasonable period of time – consider that another Member has not implemented DSB rulings and recommendations, just as a Member may consider, may believe, that another Member has violated its WTO obligations before, during and after the deadline for submitting a request to establish a panel at a given DSB meeting. Section 306 provides only that if, during the 30 days following the reasonable period, the USTR considers that non-implementation has occurred, she shall determine whether to avail herself of Article 22 procedures. Indeed, as Article 22 is currently drafted, she must avail herself of these procedures within this time frame if the United States is to preserve its WTO rights. However, nothing prevents her from not considering during that 30-day period that non-implementation has occurred.

**(d) Practice**

4.927 In response to a Panel question, **the United States explains** that to date, the USTR has considered that an agreement was not being satisfactorily implemented in two cases involving the GATT or a WTO agreement. In January 1999, the USTR considered that it would be necessary to pursue Article 22 proceedings in the *Bananas* dispute, and proposed suspension of concessions on certain products. On April 19, 1999 the DSB authorized suspension in accordance with an arbitrator's report. In May 1999, the USTR considered that it would be necessary to pursue Article 22 proceedings in the *EC – Hormones* dispute. Those Article 22 proceedings are now in progress.

4.928 The United States explains that in January 1999, the USTR considered that it would be necessary to pursue Article 22 proceedings in the *Bananas* dispute, and proposed suspension of concessions on certain products. On April 19, 1999 the DSB authorized suspension in accordance with an arbitrator's report. There is no copy of the USTR's decision to pursue Article 22 procedures because it was not a determination. In May 1999, the USTR considered that it would be necessary to pursue Article 22 proceedings in the *EC – Hormones* dispute. Article 22 proceedings are now in progress. There is no copy of the decision to pursue Article 22 procedures because it was not a determination. However, attached please find a notice issued on March 25, 1999 requesting comments on implementation of WTO recommendations in *Hormones* (US Exhibit 17). That notice stated that it likely would be necessary to pursue Article 22 procedures in light of the EC's having indicated at the March

DSB meeting that it did not expect to be in compliance by the end of the reasonable period of time in May.

4.929 In response to the Panel's question as to the *EC – Banana III*, the United States states that it is difficult to respond to the question of when a "consideration" is "actually taken" because it reflects no more than a belief on the part of the USTR. As such it is not "taken". At any given point in time, she may believe that implementation has occurred, that it has not occurred as of that time, or that it may occur if certain steps are taken or commitments made. The first formal written record that the USTR considered that the European Communities had not implemented DSB rulings and recommendations by the end of the reasonable period of time is the January 14, 1999 request of the United States for authorization to suspend concessions.<sup>450</sup>

4.930 The United States explains that the initial determination of what action to take, made on January 14, 1999, was that the United States should, in accordance with Article 22, suspend concessions if authorized at the DSB meeting of January 29, 1999 or, if the European Communities requested arbitration pursuant to Article 22.6 regarding the level of suspension, then to suspend concessions thereafter in accordance with the arbitrators' decision, and upon DSB authorization pursuant to Article 22.7. This determination is reflected in the Federal Register notice of April 19, 1999 announcing DSB authorization to suspend concessions.<sup>451</sup> The domestic legal basis for this determination was: (1) Section 301(c)(1)(A), which provides for suspension of concessions; (2) Section 301(a)(3), which provides that action affecting goods or services will be in an amount equivalent in value to the burden or restriction on US commerce (requiring that the USTR not suspend concessions in an amount in excess of the level of nullification and impairment found by the arbitrators and authorized by the DSB); (3) Section 304(a)(1), requiring that determinations be based on dispute settlement proceedings; (4) Section 301(a)(2)(A)(ii)(II), specifying that the USTR need not take action if dispute settlement proceedings indicate no nullification or impairment; (5) Section 302(a)(2)(B)(i), specifying that the USTR need not take action if the foreign country has taken satisfactory measures, which participation in and compliance with DSU proceedings and rules would constitute.<sup>452</sup>

4.931 The United States argues that the consideration was not a determination, and was not published. The Section 304 determination of action taken under Section 301 is reflected in the Federal Register notice of April 19, 1999. As discussed at the second substantive meeting, the publication requirement in Section 304(c) is not time limited. The United States explained that the determination of action was made within the 30-day time frame.

4.932 In response to the Panel's question on *EC – Hormones*, the United States further explains that the first formal written record that the USTR considered that the European Communities had not implemented DSB rulings and recommendations by the end of the reasonable period of time is the May 18, 1999 request of the United States for DSB authorization to suspend concessions.<sup>453</sup>

4.933 The United States further indicates that the initial determination of what action to take, made on May 18, 1999, was that the United States should, in accordance with Article 22, suspend concessions if authorized at the DSB meeting of January 29, 1999 or, if the European

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<sup>450</sup> WT/DS27/43 (14 January 1999).

<sup>451</sup> Implementation of WTO Recommendations Concerning the European Communities' Regime for the Importation, Sale and Distribution of Bananas, 64 Fed. Reg. 19209 (1999).

<sup>452</sup> See response to Question 33.

<sup>453</sup> WT/DS26/19 (18 May 1999).

Communities requested arbitration pursuant to Article 22.6 regarding the level of suspension, then to suspend concessions thereafter in accordance with the arbitrators' decision, upon DSB authorization pursuant to Article 22.7. This determination is reflected in the Federal Register notice of July 27, 1999 announcing DSB authorization to suspend concessions.<sup>454</sup> The consideration was not a determination, and was not published. The determination is reflected in the Federal Register notice of July 27, 1999. The determination of action was made within the 30-day time frame.

#### **4. Sections 306 and 305**

##### **(a) Overview**

4.934 **The European Communities claims** that Section 306(b) provides that the USTR shall determine what further action to take under Section 301(a) no later than 30 days after the expiration of the reasonable period of time if in its view the compliance is not satisfactory. The use of the terms "*determine what further action* [will be taken]" (rather than "whether" or "when" further action will be taken) and the reference to the part of Section 301 dealing with "mandatory actions" implies that the USTR is required to announce at this stage which of the retaliatory trade measures that the USTR is authorized to take under Section 301(c) will be applied in response to what the United States unilaterally considers to be unsatisfactory compliance.

4.935 The European Communities argues that Section 305 regulates when the announced action must be implemented. Here again the USTR must observe strict time limits. According to Section 305(a)(1) the action must be implemented in principle "no later than the date that is 30 days after the date on which such determination is made". If the USTR considers that the compliance is unsatisfactory, the USTR must thus determine, at the latest 60 days after the expiration of the reasonable period of time, the level of suspension of concessions or other obligations and the sector to which the suspension shall apply, and impose discriminatory duties, fees or restrictions on the trade of the Member concerned.

4.936 The European Communities further states that in cases where disagreement exists between the parties as to the existence or the conformity of the implementing measures, the procedure of Article 21.5 DSU must be applied before any suspension of concessions can be authorized by the DSB. In such cases, the 60-day time frame of section 306(b) will not normally be sufficient to carry out the dispute settlement procedure, since the procedure of Article 21.5 foresees 90 days for the panel ruling alone. But even where there is no disagreement between the parties to the dispute as to the existence or the conformity of the implementing measures, the 60-day time limit will still be insufficient for the following reasons.

4.937 In the view of the European Communities, Article 23.2(c) of the DSU obliges the United States to follow "the procedures set forth in Article 22 to determine the level of suspension of concessions or other obligations and obtain DSB authorization in accordance with those procedures before suspending concessions or other obligations". According to those procedures, both the level of suspension and the sector chosen may be challenged and referred to arbitration.

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<sup>454</sup> Implementation of WTO Recommendations Concerning EC-Measures Concerning Meat and Meat Products (Hormones), 64 Fed. Reg. 40638 (1999).

4.938 The European Communities considers that under Article 22.6 of the DSU, "concessions or other obligations shall not be suspended during the course of the arbitration".

4.939 The European Communities asserts that Article 22.7 stipulates that the "DSB shall ... upon request grant authorization to suspend concessions or obligations where the request is consistent with the decision of the arbitrator", which implies that the DSB must await the completion of the arbitration proceeding before authorizing a suspension of concessions or obligations.

4.940 The European Communities notes that according to Article 22.6 of the DSU, the arbitration on the level or nature of the suspension of concessions or obligations "shall be completed within 60 days after the date of the expiry of the reasonable period of time".

4.941 The European Communities explains that when an arbitration decision is issued, the request to suspend concessions is subject to two compulsory conditions:

- (a) it must be consistent with the decision of the arbitrator; and
- (b) pursuant to Rule 1 of the rules of procedure governing the meetings of the DSB referring to the rules of procedure governing the meetings of the General Council, and in particular Rules 2 and 4, it must be submitted at least ten days before the meeting of the DSB.

4.942 The European Communities then considers that after the end of the reasonable period of time, a period of at least 70 days is foreseen to carry out the several actions (i.e. *inter alia*, request for compensation, request for authorization, arbitration on the level of the requested suspension) which must precede the authorization of suspension of concession by the DSB. This period of 70 days is not at the disposal of the party wishing to be authorized to suspend concessions.

4.943 The European Communities argues that the USTR is nevertheless required under Section 305 to determine unilaterally the level and the nature of the suspension of concessions or other obligations within 60 days. This statutory requirement is inconsistent with United States' obligations under Article 23:2(c) of the DSU and Article XVI:4 of the WTO Agreement.

4.944 In the view of the European Communities, the operation of Section 306 can be illustrated by the USTR's determinations and actions in the case of the dispute between the United States and the European Communities on the banana regime.

4.945 The European Communities further maintains that on the basis of a unilateral determination that the European Communities had failed to implement the DSB's recommendations on this regime, the USTR announced on 3 March 1999 that the US Customs Service would begin as of that date withholding liquidation and reviewing the sufficiency of bonds on imports of selected European products covering trade in an amount of \$520 million. The arbitration on the level and nature of the announced suspension requested by the European Communities under Article 22.6 of the DSU should have been completed on 2 March 1999, that is 60 days after 1 January 1999 when the period of implementation accorded to the Communities had expired. However, because of the novelty and complexity of the issues involved, the arbitrators' decision was submitted only on 9 April 1999 and the DSB could therefore act on the United States' request for an authorization of sanctions only on 19 April 1999. This authorization covered trade in an amount of US \$191.4 million.

4.946 The European Communities considers that the decision to withhold customs liquidation on 3 March 1999 exposed importers of selected European products to a contingent duty liability of 100 percent, while importers of like products of other origins were only exposed to a duty liability corresponding to the normal customs tariff. The bonds on imports from Europe corresponded to that higher contingent duty liability.

4.947 In the EC's view, these discriminatory rules and formalities in connection with the importation of European products are inconsistent with Article I of the GATT 1994. Moreover, the requirement to submit bonds entailed additional costs for importers that constitute "other charges" imposed in connection with importation that are prohibited by Articles II.2(a) and VIII.1 of the GATT 1994. Finally and most importantly, the real purpose and effect of the measure was to deter imports altogether, as importers would logically be very reluctant to accept a risk of having to pay 100% duties retroactively. As the USTR indicated at a press conference held on 3 March, "we retaliated by effectively stopping trade as of March 3 in response to the harm caused by the EC's WTO-inconsistent banana regime".<sup>455</sup>

4.948 The European Communities then concludes that this measure therefore created a *de facto* import prohibition or restriction within the meaning of Article XI of GATT. There can for these reasons be no doubt that the United States suspended on 3 March 1999 its obligations under, *inter alia*, Articles I, II, VIII and XI of the GATT 1994 towards the European Communities without prior authorization by the DSB.

4.949 The European Communities notes that the USTR made clear in a public notice requesting comments on the planned 3 March 1999 action that it was required under Sections 301-310 to implement that action on that date:

"Given that the reasonable period of time for the EC's implementation of the WTO recommendations concerning the EC banana regime expires on January 1, 1999, the USTR must make the determination required by section 306(b) no later than January 31, 1999, and, in the event of an affirmative determination, must implement further action no later than 30 days thereafter".<sup>456</sup>

4.950 According to the European Communities, the USTR thus considers itself bound to take retaliatory action 60 days after the expiry of the implementation period in response to a perceived failure to implement rulings or recommendations of the DSB. The USTR added "these time frames permit the USTR to seek recourse to the procedures for compensation and suspension of concessions provided in Article 22 of the DSU".<sup>457</sup>

4.951 The European Communities nevertheless argues that when it turned out that the Article 22 procedures were not completed on 3 March 1999 and that the United States could therefore not obtain the necessary DSB authorization at the time required by its domestic legislation, the USTR nevertheless imposed trade sanctions "effectively stopping trade". This course of events confirms what the text of Section 306(b) indicates, namely that the USTR must implement the further action decided upon irrespective of whether that action conforms to the requirements of Article 22 of the DSU.

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<sup>455</sup> Quoted from notes prepared for the press by the staff of the Office of the USTR entitled "March 3 Action on Bananas".

<sup>456</sup> Federal Register, Vol.63, No.204, Thursday, October 22, 1998, pages 56688 and 56689.

<sup>457</sup> *Ibid.*, page 56689.

4.952 In the view of the European Communities, the United States has accepted an unqualified obligation to impose trade sanctions only with DSB approval but has maintained domestic legislation that explicitly requires the unilateral imposition of such sanctions. It is sufficient for the Panel to note these facts and to rule that Sections 306(b) and 305 do not constitute a good faith performance of the obligations under Articles 21.5 and 22 of the DSU and therefore of Article 23 DSU and Article XVI:4 of the WTO Agreement.

4.953 **The United States responds** that Sections 301-310 of the Trade Act provide the USTR and the President with broad discretion both with respect to determinations under those provisions and the timing of any action taken in accordance with those determinations. Nothing in these provisions mandates action inconsistent with US WTO obligations.

4.954 The United States recalls that the European Communities asks the Panel to find that Section 306(b) is inconsistent with Article 23.2(c),

"because it requires the USTR to determine what further action to take under Section 301 in the case of a failure to implement DSB recommendations and to implement that action, irrespective of whether the procedures set forth in Article 22 of the DSU have been completed and the DSB authorized such action".

4.955 In the US view, the EC case rests entirely on inaccurate and unsupported assumptions regarding whether action need be taken, the nature of the action, and the timing of such action. Section 306(b) commands no action, let alone action inconsistent with Article 23.2(c).

4.956 The United States considers that turning again to the text, Article 23.2(c) requires Members to "follow the procedures set forth in Article 22 to determine the level of suspension of concessions or other obligations and obtain DSB authorization in accordance with those procedures before suspending concessions or other obligations" when a Member has failed to implement DSB rulings and recommendations. Again, no actual case involving the suspension of concessions is before this Panel. It is thus not possible to determine whether the United States in such a concrete case actually complied with the requirements of Article 22. The only question, then, is whether Section 306(b) commands the USTR not to follow Article 22 procedures or to suspend concessions without DSB authorization.

4.957 The United States indicates that it manifestly does not. Nothing in Section 306(b) or in Section 305(a) prevents the USTR from complying to the letter with Article 22 procedures, including DSB authorization. As the United States has noted before, the EC's arguments rest on a series of unsupported assumptions and unfounded speculation. If the USTR considers that another Member has not implemented DSB rulings and recommendations, and if she disregards Article 22 procedures, and if she decides to take action, and if that action involves the suspension of concessions, and if she or the President choose not to exercise the discretion available to them not to take action, or to await the outcome of Article 22 proceedings, then, the European Communities asserts, there would be a violation of DSU Article 23.2(c). However, Section 306(b) commands none of this, and the European Communities is not entitled to establish its *prima facie* case based on speculation and an assumption of bad faith regarding how the USTR will exercise discretion.

4.958 The United States considers that it has explained the numerous unsupported assumption underlying the EC's Article 23.2(c) claim. The European Communities has failed to rebut these explanations, or otherwise meet its burden in this dispute. Its claim under Article 23.2(c) therefore also fails.

4.959 The United States recalls that the European Communities argues that Sections 306(b) and 305(a) violate DSU Article 23.2(c), which requires that a Member follow the procedures set forth in Article 22 before suspending concessions or other WTO obligations when another Member has failed to implement DSB recommendations.<sup>458</sup> According to the European Communities, the language of Section 306(b) "implies" that the USTR must announce that she will take mandatory retaliatory action when she considers that another Member has not implemented DSB recommendations. The European Communities further contends that the time frames in Sections 306(b) and 305(a) require the USTR to suspend concessions no later than 60 days following the reasonable period of time, while the soonest that the DSB could authorize the suspension of concessions would be 70 days.

4.960 In the view of the United States, the EC argument flagrantly disregards the broad discretion provided for in Sections 306(b), 301(a) and 305(a) both with regard to the nature of any action taken under those provisions and the timing of that action.

4.961 The United States first points out that nothing in Section 306(b) obligates the USTR to conclude that another Member has failed to implement DSB recommendations. This is a purely discretionary decision, and the European Communities has failed to meet its burden of demonstrating why it would not be possible for the USTR to conclude that no action need be taken because implementation has been satisfactory, because adequate progress is being made, or because further dispute settlement proceedings are necessary to achieve satisfactory implementation.

4.962 The United States also notes that even if the USTR were required under Section 306(b) to conclude in all cases that another Member has not complied with DSB recommendations, and to take action in response, the 210-day time frame set forth in Section 305(a) is more than sufficient to allow any such action to reflect the results of completed Article 22 proceedings, and to be implemented after DSB authorization. The European Communities claims that under Section 305(a)(1), the USTR must take action no later than 30 days after its determination under Section 306(b), which itself will follow the expiration of the reasonable period by no more than 30 days.

4.963 According to the United States, this EC argument completely disregards the fact that the 30-day period in Section 305(a)(1) is applicable "[e]xcept as provided in paragraph (2)".<sup>459</sup> Paragraph 2 of Section 305 provides that the 30-day period set forth in paragraph (1) may be extended for an *additional 180 days*:

"(2) (A) Except as otherwise provided in this paragraph, the Trade Representative may delay, by not more than 180 days, the implementation of any action that is to be taken under section 301 –

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<sup>458</sup> Article 23.2(c) provides that Members seeking redress of violations must:

"follow the procedures set forth in Article 22 to determine the level of suspension of concessions or other obligations and obtain DSB authorization in accordance with those procedures before suspending concessions or other obligations under the covered agreements in response to the failure of the Member concerned to implement the recommendations and rulings within that reasonable period of time".

<sup>459</sup> Section 305(a)(1), 19 U.S.C. § 2415(a)(1).



(ii) if the Trade Representative determines that substantial progress is being made, or that a delay is necessary or desirable, to obtain United States rights or a satisfactory solution with respect to the acts, policies, or practices that are the subject of the action".<sup>460</sup>

4.964 The United States further explains that Section 305(a)(2)(A)(ii) explicitly authorizes the USTR to delay action by an additional 180 days, among other reasons, in order "to obtain U.S. rights". Thus, the USTR may delay any action pursuant to Section 306(b) until the United States has obtained the right to suspend concessions based upon completion of Article 22 proceedings and receipt of DSB authorization.

4.965 The United States indicates that the USTR has, in fact, exercised her discretion under Section 305(a)(2)(A)(ii) to delay action by 180 days for the specific purpose of obtaining GATT rights. On May 24, 1989, a GATT panel issued a report finding that Korea's import restrictions on beef were inconsistent with Article XI:1 of the GATT 1947.<sup>461</sup> However, at meetings of the GATT Council on June 21 and July 19, 1989, Korea declined to agree to adoption of the panel report. USTR's target date for action pursuant to Section 305(a)(1) was October 28, 1989. Nevertheless, citing Section 305(a)(2), the USTR determined that "a delay in implementation of such action is necessary and desirable to obtain US rights under the General Agreement on Tariffs and Trade".<sup>462</sup> The USTR further explained that the delay in action beyond October 28, 1989 was desirable "to allow additional time for proceedings in the GATT".<sup>463</sup> Korea allowed the panel report to be adopted on November 8, 1989, and the United States and Korea initialed an agreement on implementation on March 21, 1990.<sup>464</sup>

4.966 The United States further explains that when the 180 days is added to the 60 days provided for in Sections 306(b) and 305(a)(1), it is clear that, in all cases, the USTR has more than enough time to await DSB authorization to suspend concessions consistent with an Article 22 arbitrator's award, regardless of whether this would require 60 or 70 days. Moreover, the 240-day time frame for implementation would even allow the USTR to first complete Article 21.5 proceedings (a 90-day process), were this necessary to obtain the US right to suspend concessions. However, the DSU as currently drafted neither requires nor permits<sup>465</sup>

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<sup>460</sup> Section 305(a)(2)(A), 19 U.S.C. § 2415(a)(2)(A).

<sup>461</sup> Panel Report on *Republic of Korea – Restrictions on Imports of Beef ("Korea - Beef")*, adopted 7 November 1989, BISD 36S/268.

<sup>462</sup> Determinations Under Section 304 of the Trade Act of 1974, as Amended, Regarding the Republic of Korea's restrictions on Imports of Beef, 54 Fed. Reg. 40769 (1989) (US Exhibit 4).

<sup>463</sup> *Ibid.*

<sup>464</sup> See Termination of Section 302 Investigation Regarding the Republic of Korea's Restrictions on Imports of Beef, 55 Fed. Reg. 20376 (1990) (US Exhibit 5). The United States notes that similarly, in the 1989 dispute between the United States and the European Communities over oilseeds, the Trade Representative delayed action for 180 days pursuant to Section 305(a)(2)(A)(ii) on the basis that substantial progress was being made in GATT dispute panel proceedings which had not yet finished as of the 18-month target date. Moreover, the Trade Representative made a determination that US agreement rights had been denied under Section 304(a)(1)(A)(i) only after the *Oilseeds* panel report had been adopted, even though this was well after the 18-month target date. See Determinations Under Section 304 of the Trade Act of 1974, as Amended: European Community Policies and Practices With Respect to, Inter Alia, Production and Processing Subsidies on Oilseeds, 55 Fed. Reg. 4294 (1990) (US Exhibit 6).

<sup>465</sup> If a complaining party wishes to have the benefit of the negative consensus rule in Articles 22.6 and 22.7.

completion of the Article 21.5 panel process before seeking and receiving authorization to suspend concessions under Article 22.

**(b) USTR's discretion not to take action**

4.967 **The United States recalls** that under Section 301(a)(1), upon a determination that US rights under a trade agreement have been denied,

"the Trade Representative shall take action authorized in subsection (c) of this section, subject to the specific direction, if any, of the President regarding any such action, and shall take all other appropriate and feasible action within the power of the President that the President may direct the Trade Representative to take under this subsection, to enforce such rights or to obtain the elimination of such act, policy, or practice.

Actions may be taken that are within the power of the President with respect to trade in any goods or services, or with respect to any other area of pertinent relations with the foreign country".<sup>466</sup>

4.968 The United States explains that Section 301(c) authorizes the USTR to act against goods or services or to enter into agreements to eliminate the violation of US agreement rights or to receive compensation for those violations.<sup>467</sup> It does not mandate any particular form of action.

4.969 The United States further states that with respect to action taken under Section 301, the USTR has substantial discretion, including discretion to take no action at all. The USTR is explicitly not required to take action: (1) when the DSB has adopted report findings that US rights have not been violated<sup>468</sup>; (2) when the foreign country "is taking satisfactory measures to grant the rights of the United States under a trade agreement",<sup>469</sup> has agreed to eliminate or phase out the practice which violated US rights,<sup>470</sup> or has agreed to provide compensation<sup>471</sup>; (3) when action would have "an adverse impact on the United States economy substantially out of proportion to the benefits of such action;"<sup>472</sup> (4) or when action would cause "serious harm to [US] national security".<sup>473</sup> The European Communities has acknowledged that when WTO Members commit to implement DSB recommendations within the time period foreseen in DSB Article 21, the United States has considered this a "satisfactory measure" justifying termination of an investigation without further action.

4.970 In response to the Panel's question, the United States explains that Section 301(a)(2)(B)(i) allows the USTR to take no action if the foreign country is taking "satisfactory measures to grant the rights of the United States under a trade agreement". In all of the scenarios presented in the question – DSB recommendations not yet adopted, suspension of concessions not yet authorized, the Member concerned has not expressed an intention to comply and has decided not to do anything before the expiration of the reasonable period of

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<sup>466</sup> Section 301(a)(1), 19 U.S.C. § 2411(a)(1) (emphasis added).

<sup>467</sup> Section 301(c), 19 U.S.C. § 2411(c).

<sup>468</sup> Section 301(a)(2)(A), 19 U.S.C. § 2411(a)(2)(A).

<sup>469</sup> Section 301(a)(2)(B)(i), 19 U.S.C. § 2411(a)(2)(B)(i).

<sup>470</sup> Section 301(a)(2)(B)(ii), 19 U.S.C. § 2411(a)(2)(B)(ii).

<sup>471</sup> Section 301(a)(2)(B)(iii), 19 U.S.C. § 2411(a)(2)(B)(iii).

<sup>472</sup> Section 301(a)(2)(B)(iv), 19 U.S.C. § 2411(a)(2)(B)(iv).

<sup>473</sup> Section 301(a)(2)(B)(v), 19 U.S.C. § 2411(a)(2)(B)(v).

time – the continued participation of the Member concerned in dispute settlement proceedings would constitute satisfactory measures to grant US agreement rights. It is important to recognise that the rights in question would not necessarily be the substantive rights the Member had been denying through its challenged measure, but, rather, US WTO rights under DSU Articles 21 - 23. For example, if the Member concerned had failed to express its intention to implement DSB recommendations, or was choosing not to use the reasonable period of time to implement, this would ultimately result in the United States obtaining the right to compensation or to suspend concessions pursuant to DSU Article 22.2. The United States could on this basis determine not to take action pursuant to Section 301(a)(2)(B)(i).

4.971 In the view of the United States, the European Communities disregards entirely provisions of Section 301(a)(2) which provide the USTR and the President with discretion to limit any action to that authorized by the DSB, or to take no action at all. These include explicit authority not to take action when the DSB adopts findings that US agreement rights are not being denied or that US trade agreement benefits are not being nullified or impaired. In other words, the USTR may limit or take no action depending on the outcome of Article 22 proceedings. In addition, the USTR may choose not to take action for reasons of national security, if the action has an adverse economic impact or if the USTR is satisfied that satisfactory measures are being taken to grant US agreement rights. Finally, actions taken under Section 301(a) are subject to "the specific direction, if any, of the President". The President may also place conditions on any action taken or direct that action not be taken.

4.972 In response to the Panel's question as to whether the sole fact that DSB recommendations have not yet been adopted or that the DSB has not yet authorized the suspension of concessions can mean that USTR action in these circumstances would "have an adverse impact on the United States economy substantially out of proportion to the benefits of such action" or "cause serious harm to the national security of the United States", the United States indicates that given the broad discretion she has under Section 301(a)(2)(B)(i), the USTR might not consider it necessary to rely on these two provisions, though they could be available depending on the particular circumstances of a given case.

4.973 The United States further argues that a third reason the EC's argument fails is that any action the USTR may consider under Section 306(b) is taken pursuant to Section 301(a)(1), and is therefore subject to the exceptions to action set forth in Section 301(a)(2). The most important of these from the perspective of the current proceeding is Section 301(a)(2)(A), which provides that the USTR need not take action in any case in which the DSB has adopted a report or ruling finding that US agreement rights are not being denied or that US trade agreement benefits are not being nullified or impaired.<sup>474</sup> The USTR is therefore free to take no action if an Article 22 arbitrator concludes that there is no nullification or impairment of US agreement benefits (i.e. that the other Member has complied with DSB recommendations), or to reduce the proposed level of suspension if the arbitrator concludes that the proposal exceeds the actual level of nullification or impairment. Other exceptions under Section 302(a)(2) which would ensure a WTO-consistent outcome (since no action would be taken) include exceptions when the USTR finds that action would have an adverse impact on the United States economy or would cause serious harm to national security.<sup>475</sup>

4.974 The United States claims that again, the European Communities case rests on an extensive string of unsupported assumptions. The EC assumption is that the USTR will always

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<sup>474</sup> Section 301(a)(2)(A), 19 U.S.C. § 2411(a)(2)(A).

<sup>475</sup> Section 301(a)(2)(B)(iv), (v), 19 U.S.C. § 2411(a)(2)(B)(iv), (v).

conclude that another Member has failed to implement DSB recommendations and rulings and that the United States must therefore take action. There is absolutely no basis in Section 306 for this conclusion. The USTR enjoys more than adequate discretion under Section 306 not to take action either because she considers that there has been full implementation, or because she considers that further dispute settlement proceedings are necessary to achieve such implementation. Section 306(b) therefore does not mandate that action be taken. In the absence of such action, there can be no violation of Article 23.2(c). The time frames in Section 305 never become relevant.

4.975 The United States argues that Section 305(a)(2)(A)(ii) and Section 301(a)(2)(B)(i), (iv) and (v) provide the USTR with broad discretion to delay or not take action, a fact explained in the Statement of Administrative Action on page 360.<sup>476</sup> There it is explained that, "section 301 does not automatically require the imposition of sanctions where the United States wins a dispute settlement case under a trade agreement". The USTR may delay action under Section 305(a)(2)(A)(ii) if she has determined that "substantial progress is being made" or if the delay is necessary to obtain US rights or a satisfactory solution. Likewise, Sections 301(a)(2)(B)(i), (iv) and (v) permit no action to be taken if a foreign country is taking satisfactory measures to grant US agreement rights, if there would be an adverse economic impact, or for reasons of national security. The provisions of Section 305(a)(2)(A)(ii) and Section 302(a)(2)(B)(i) are particularly broad, since they are available based on the USTR's judgment that progress is being made, or that delay is necessary to achieve such progress.

4.976 The United States notes that Section 305(a)(2)(A)(ii) has been used on at least 3 occasions relating to GATT and WTO dispute settlement proceedings. Two of these, involving *Korean – Beef* and *EC – Oilseeds*. In addition, the USTR used Section 305(a)(2)(A)(ii) in December 1991, to delay implementation of action in an investigation involving Canadian import restrictions on beer. Based on an adopted GATT panel report finding Canadian violations, the USTR determined on December 27, 1991 that Canada had denied US rights under a trade agreement, and proposed increased duties on Canadian beer. However, the USTR determined, pursuant to Section 305(a)(2), that "it was desirable to delay implementation of action ... in order to provide Canada with a full opportunity to comply with the recommendations of the GATT panel".<sup>477</sup>

4.977 The United States further points out that Section 301(a)(2)(B)(i) has also been used on several occasions. These include situations in which a WTO Member has stated its intention to comply with DSB rulings and recommendations (*EC – Bananas III*, *Canada – Periodicals*, *India – Patents (US)*, *Argentina – Textiles and Apparel (US)*), situations in which a country has committed to implement GATT panel proceedings (*EC Canned Fruit*, *EC – Oilseeds*), and situations in which a country has confirmed that it would take measures to implement an earlier agreement (*China Intellectual Property Rights*).

**(c) Discretion with respect to timing of action**

4.978 **The United States considers** that the European Communities has failed to meet its burden of establishing that Sections 306(b) and 305(a) mandate any violation of DSU Article 23.2(c). The European Communities may not establish its claim that Section 306(b) mandates suspension of concessions without DSB authorization based on unsupported

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<sup>476</sup> US Exhibits 3 and 11

<sup>477</sup> The United States cites Notice of Determinations Under Section 304 of the Trade Act of 1974: Canadian Provincial Practices Affecting Imports of Beer, 57 Fed. Reg. 308, 309 (1992).

assumptions concerning how, and when, she will make decisions in a particular case. The European Communities may not meet its burden by assuming or asserting that the USTR must consider non-implementation to have occurred, or that it is permissible under US law to disregard entire statutory provisions which give the USTR and the President broad discretion to delay action, or to take no action at all. Section 306(b) permits the USTR to follow Article 22 procedures in every case.

4.979 The United States argues that there have now been two situations in which the European Communities has failed to implement DSB rulings and recommendations, and the United States as well as other WTO Members are gaining experience in this regard. The United States refers the Panel to US Exhibit 17, a *Federal Register* notice issued in connection with the *Hormones* dispute which describes in detail the manner in which the United States follows Article 22 procedures when exercising its authority under Section 306.

4.980 The United States further argues that even in those cases in which the USTR and President have determined that action will be taken, the time frames provided for in Sections 301-310 ensure that such action may await DSB authorization. Section 305(a)(1) provides,

(1) Except as provided in paragraph (2), the Trade Representative shall implement the action the Trade Representative determines under section 304(a)(1)(B) to take under section 301, subject to the specific direction, if any, of the President regarding any such action, by no later than the date that is 30 days after the date on which such determination is made.<sup>478</sup>

4.981 In the view of the United States, Paragraph 2 of Section 305 provides that the 30-day period set forth in paragraph (1) may be extended for an additional 180 days:

(2) (A) Except as otherwise provided in this paragraph, the Trade Representative may delay, by not more than 180 days, the implementation of any action that is to be taken under section 301 -

. . .

(ii) if the Trade Representative determines that substantial progress is being made, or that a delay is necessary or desirable, to obtain United States rights or a satisfactory solution with respect to the acts, policies, or practices that are the subject of the action.<sup>479</sup>

4.982 The United States then concludes that Section 305(a)(2)(A)(ii) thus explicitly authorizes the USTR to delay action beyond the 30 days provided for in Section 305(a)(1) in order "to obtain U.S. rights", among other reasons. This would include rights under international agreements such as the GATT or other WTO agreements. The USTR has, in fact, exercised her discretion under Section 305(a)(2)(A) to delay action for just this purpose. On May 24, 1989, a GATT panel issued a report finding that Korea's import restrictions on beef were inconsistent with Article XI:1 of the GATT 1947.<sup>480</sup> However, at meetings of the GATT Council on June 21

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<sup>478</sup> Section 305(a)(1), 19 U.S.C. § 2415(a)(1).

<sup>479</sup> Section 305(a)(2)(A), 19 U.S.C. § 2415(a)(2)(A).

<sup>480</sup> Panel Report on *Korea – Beef*, op. cit.

and July 19, 1989, Korea declined to agree to adoption of the panel report. USTR's time frame for action pursuant to Section 305(a)(1) was October 28, 1989. Nevertheless, citing Section 305(a)(2), the USTR determined that "a delay in implementation of such action is necessary and desirable to obtain U.S. rights under the General Agreement on Tariffs and Trade".<sup>481</sup> The USTR further explained that the delay in action beyond October 28, 1989 was desirable "to allow additional time for proceedings in the GATT".<sup>482</sup> Korea allowed the panel report to be adopted on November 8, 1989, and the United States and Korea initialed an agreement on implementation on March 21, 1990.<sup>483</sup>

4.983 The United States further explains that similarly, in the 1989 dispute between the United States and the European Communities over oilseeds, the USTR delayed action for 180 days pursuant to Section 305(a)(2)(A)(ii) on the basis that substantial progress was being made in GATT dispute panel proceedings which had not yet finished as of the 18-month target date.<sup>484</sup> Moreover, the USTR specifically waited until after panel proceedings had finished before determining that US agreement rights had been denied under Section 304(a)(1)(A)(i), even though this was well after the 18-month target.<sup>485</sup> Thus, it was consistent US practice, even before the conclusion of the Uruguay Round, to rely on dispute settlement results when determining whether US agreement rights were denied.

4.984 The United States then indicates that the USTR and the President thus have broad discretion under Sections 301-310 to dictate the timing of any action, the conditions under which the action will be given effect, and whether the action will be taken at all. The USTR or the President may, for example, specify that any action taken should not become effective until the United States has received formal DSB approval.

4.985 The United States argues that when a WTO Member has indicated, pursuant to DSU Article 21.3, that it intends to implement the recommendations and rulings of the DSB in a case involving violations of US WTO rights, the USTR has considered this a "satisfactory measure" pursuant to Section 301(a)(2)(B) justifying termination of a Section 302 investigation.<sup>486</sup> In such cases, the USTR continues to monitor the Member's implementation of the DSB rulings and recommendations pursuant to Section 306(a).<sup>487</sup>

4.986 The United States notes that in those cases in which the USTR considers that a WTO Member has not implemented DSB rulings and recommendations by the conclusion of the reasonable period of time provided for in Article 21.3, the USTR determines what further action she will take pursuant to Section 301(a).<sup>488</sup> Contrary to the representation of the European

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<sup>481</sup> Determinations Under Section 304 of the Trade Act of 1974, as Amended, Regarding the Republic of Korea's Restrictions on Imports of Beef, 54 Fed. Reg. 40769 (1989) (US Exhibit 4).

<sup>482</sup> Ibid.

<sup>483</sup> See Termination of Section 302 Investigation Regarding the Republic of Korea's Restrictions on Imports of Beef, 55 Fed. Reg. 20376 (1990) (US Exhibit 5).

<sup>484</sup> See Determinations Under Section 304 of the Trade Act of 1974, as Amended: European Community Policies and Practices With Respect to, Inter Alia, Production and Processing Subsidies on Oilseeds, 55 Fed. Reg. 4294 (1990) (US Exhibit 6)

<sup>485</sup> See *ibid.* The United States notes that on the 18-month anniversary, the USTR instead concluded that she had reason to believe agreement rights were being denied, and therefore was pursuing such a ruling under GATT dispute settlement procedures.

<sup>486</sup> E.g. Determinations Under Section 304 of the Trade Act of 1974 With Respect to Certain Canadian Practices Affecting Periodicals, 62 Fed. Reg. 50651 (1997) (US Exhibit 7).

<sup>487</sup> Section 306(a), 19 U.S.C. § 2416(a).

<sup>488</sup> Section 306(b), 19 U.S.C. § 2416(b).

Communities, the further action the USTR will take is subject to the specific direction of the President, since that action is taken pursuant to Section 301(a).<sup>489</sup> Moreover, because the action is taken under Section 301(a), it is subject to the exceptions set forth in Section 301(a)(2) relating to, among other things, conformity with DSB-adopted reports, the adverse impact of such action on the US economy or its harm to US national security.<sup>490</sup>

4.987 The United States further argues that just as importantly, because the determination regarding the action to be taken is considered a determination under Section 304(a)(1),<sup>491</sup> the time frames for implementing the action are those set forth in Section 305. As described above, under Section 305, the action must be implemented within 30 days of the determination to take action, unless the USTR,

"determines that substantial progress is being made, *or that a delay is necessary or desirable to obtain United States rights or satisfactory solution...*".<sup>492</sup>

4.988 The United States maintains that in such cases, the USTR may delay action by a further 180 days. This permits the USTR to delay any action until well beyond the time frames required for DSB authorization for the right to suspend concessions pursuant to DSU Articles 22.6 or 22.7.

4.989 The United States challenges the EC assumption that, under US law, it is permissible to ignore entire statutory provisions. Specifically, in claiming that Section 305(a) requires action to be taken within 60 days of the expiration of the reasonable period of time, the European Communities completely disregards explicit statutory language authorizing the USTR to delay action by 180 days. Section 305(a)(2) authorizes the USTR to implement such a delay to obtain US rights or a satisfactory solution to the dispute. The United States used this provision to delay action until it was able to obtain rights under GATT 1947 dispute settlement procedures, and the European Communities has offered no explanation of why, under US law, the United States would not again be able to use this provision to delay action in order to first obtain DSB authorization.

4.990 The United States recalls that the European Communities has at times argued that the time frames in the DSU and Sections 301-310 are relevant to the above issues, and at other times that they are not. The United States indicates that the time frames in Sections 301-310 comport with those in the DSU, but even if they did not, it would not matter. For example, even if panel proceedings were to exceed 18 months, the USTR would not be obligated to make the one determination that is an absolute prerequisite before any other requirements under Article 23.2(a) become relevant. The USTR is not obligated to determine that US agreement rights have been denied. The record shows that the USTR has never once made a Section 304(a)(1) determination that US GATT or WTO agreement rights have been denied which was not based on the results of GATT and WTO dispute settlement proceedings. Not once.

4.991 The United States recalls that the European Communities now claims that the United States violates "Article 23" by virtue of the "retaliation list" Korea asserts the USTR must publish. The EC's response to this question repeats many of its previous false assumptions, and

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<sup>489</sup> Section 306(b)(1), 19 U.S.C. § 2416(b)(1).

<sup>490</sup> Section 301(a)(2), 19 U.S.C. § 2411(a)(2).

<sup>491</sup> Section 306(b)(1), 19 U.S.C. § 2416(b)(1).

<sup>492</sup> Section 305(a)(2)(ii), 19 U.S.C. § 2415(a)(2)(ii).

adds to them the erroneous assumption that in providing for a determination of "action", Section 304(a)(1) requires publication of a list of products for which the United States is requesting suspension.

4.992 The United States points out that the USTR is not required to publish a "retaliation list" under Sections 301-310, and only Sections 301-310 are within the Panel's term's of reference. In the event of an affirmative determination that US agreement rights have been denied, she is required, pursuant to Section 304(a)(1)(B), to determine what action to take. This need not include publication of a proposed list of products subject to suspension of concessions. The European Communities may not assume that it does.

4.993 The United States considers that public notice concerning which products might be the subject of a suspension of concessions is both good public policy and important to the effective exercise of WTO rights. It is good public policy because importers and the public generally need to understand the actions the US government is proposing so they can comment, and because the government needs to receive public input in order to evaluate whether action is appropriate, if the action is to be taken under Section 301(b), or whether an exception under Section 301(a)(2) is applicable, if the action is to be taken under Section 301(a). The government also needs this information to apply the principles and procedures in DSU Article 22.3. For example, the United States must evaluate whether suspension of concessions within the same sector would be "practicable or effective" for purposes of undertaking the analysis called for in DSU Article 22.3. Public input is required to ensure that officials have the information necessary to make this judgment.

4.994 The United States notes that Canada, as well, publishes lists of products which might be the subject of a suspension of concessions in connection with Article 22 proceedings. US Exhibit 19 includes Canadian press releases describing and reproducing the proposed list of products Canada has published in the *EC Hormones* and *Australia Salmon* disputes. This reinforces the fact that such lists are an integral part of domestic implementation of Article 22. Until its answer to a Panel question, the European Communities had not claimed that such lists are inconsistent with the DSU. In fact, in the DSU Review, it now appears that the European Communities is insisting that such lists be offered at the time suspension is proposed.<sup>493</sup>

4.995 In the view of the United States, the European Communities merely asserts that Section 304 requires publication of a list of products, despite the absence of any textual basis for that assertion. It states that the USTR must either propose suspension of concessions or reach an agreement with the foreign country. According to the European Communities, if suspension is proposed, this necessarily includes publication of a list of products, but it fails to explain why this so, or if it is so, what the timing must be.<sup>494</sup>

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<sup>493</sup> See DSU Review, Discussion Paper from the European Communities dated 30 June 1999, Document No. 3864, para. 16, circulated on 1 July 1999 (US Exhibit 12).

<sup>494</sup> The United States claims that if, in fact, the European Communities and Korea were entitled to assume, on the basis of a statutory requirement to allow the "presentation of views" on proposed determinations, that this necessarily entails publication of a list of products proposed for suspension, then they would have to conclude that Korea's laws include precisely the same requirement. Article 4 of Korea's Foreign Trade Act (the "Act") authorizes the Ministry of Trade, Industry and Resources to "take special measures concerning restrictions on or prohibition of the export and import of goods" if, among other reasons, the trading partner has denied Korean rights under an international convention, or if that partner imposes any "unreasonable burden or restriction" on Korean trade. See Foreign Trade Act, <http://www.oomph.net/law/html/15-13.htm> (US Exhibit 20). Article 4 of the Enforcement Decree for the



4.996 The United States considers that leaving aside whether a list must be issued when suspension of concessions is proposed, the EC's description of the options available to the USTR (suspension or agreement) itself makes clear that suspension is not the only choice available. It therefore may not be concluded that suspension is mandated. Moreover, the USTR is not obliged to take any action at all. The European Communities again assumes it may ignore Section 301(a)(2), which allows the USTR to take no action if, among other reasons, she believes the foreign country is taking satisfactory measures to grant US trade rights, or if WTO dispute settlement proceedings result in a finding that US agreement rights have not been denied or benefits under a trade agreement have not been impaired. As a result, the USTR is never obligated to take action at odds with the results of WTO dispute settlement panels or arbitrators.

4.997 The United States claims that the USTR considers dispute settlement proceedings to conclude up to 30 days after adoption of the panel and Appellate Body reports, a date which allows defending parties to state their intentions with regard to implementation. Thus, the USTR has typically issued her determination regarding denial of US trade agreement rights together with the determination that the foreign country is taking satisfactory measures.<sup>495</sup> In fact, the USTR has even determined that a foreign country is taking satisfactory measures solely on the basis that she "expected" that country would implement DSB rulings and recommendations – without regard to whether it had actually informed the DSB of its intentions.<sup>496</sup> Thus, the other half of the premise underlying Korea's argument is also incorrect, namely, that the time frames in Section 301 and 304, combined with the alleged requirement to publish a list, means that the list must be published before a losing party has had an opportunity to state its intentions with respect to implementation.

4.998 The United States argues that even were the European Communities permitted to assume that Section 304(a)(1) mandates the publication of a list of products for which the US is proposing suspension, it has failed to explain exactly how this violates Article 23. The European Communities does not even specify which paragraph of Article 23 publication of a list would violate. Instead, it merely characterizes publication as a "unilateral determination" which one must assume violates Article 23. This exemplifies the EC's flight from the text of the DSU in favor of its generalized approach of divining obligations from slogans.

4.999 In the US view, while it is difficult to respond to the EC's vague claims that the publication of a list of products proposed for suspension would violate Article 23, the mere fact that such lists are not mandated under Sections 301-310 (or even mentioned therein) precludes any finding of WTO inconsistency. The EC's arguments in response to Panel question 20

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Act requires the Minister of Trade and Industry to "notify publicly the contents of the measure" taken under Article 4 of the Act if the Minister "desires to take a special measure", as well when the measure is actually taken. See Enforcement Decree of the Foreign Trade Act, <http://www.oomph.net/law/html/15-9.htm> (US Exhibit 21). If anything, the Korean law is very clear in requiring publication of the specifics of its proposed measures. No such requirement is found in Sections 301-310.

<sup>495</sup> See e.g. Determinations Under Section 304 of the Trade Act of 1974 With Respect to Certain Canadian Practices Affecting Periodicals, 62 Fed. Reg. 50651 (1997) (US Exhibit 7); Determinations Under Section 304 of the Trade Act of 1974: European Communities' Banana Regime, 63 Fed. Reg. 8248 (1998) (US Exhibit 15); Determination Under Section 304 of the Trade Act of 1974: Practices of the Government of India Regarding Patent Protection for Pharmaceuticals and Agricultural Chemicals, 63 Fed. Reg. 29053 (1998)(US Exhibit 16).

<sup>496</sup> Determinations Under Section 304 of the Trade Act of 1974: Argentine Specific Duties and Non-tariff Barriers Affecting Textiles, Apparel, Footwear and Other Items, 63 Fed. Reg. 25539, 25540 (1998) (US Exhibit 22)

provide yet another example of how the European Communities is asking this Panel to make adverse assumptions concerning how the United States will exercise discretion under Sections 301-310. If the European Communities believes that publication of a list of products proposed for suspension would violate US WTO obligations, the European Communities should wait until the United States actually publishes such a list in a concrete case. Then, it would be in a position to argue from facts, not assumptions.

**(d) President's discretion**

4.1000 **The European Communities notes** that the President has never given the USTR any general direction to impose trade sanctions only in accordance with the United States' obligations under international law nor has he ever instructed the USTR in specific cases to do so.

4.1001 **The United States recalls** that the European Communities notes that 1988 amendments to Section 301 transferred from the President to the USTR the authority to determine whether agreement violations have occurred and what US action to take in response. However, the European Communities ignores the discretion retained by the USTR in making these determinations, as well as the continued discretion of the President to intervene under the terms of the statute. Indeed, the authors of the very article which the European Communities cites for Section 301's legislative history concluded that the transfer of authority was an "important symbolic statement" but that

"the change is unlikely to be particularly significant. The Trade Representative still serves at the pleasure of the President, and therefore is unlikely to take actions of which the President disapproves".<sup>497</sup>

4.1002 The United States argues that a fourth reason Section 306(b) does not violate Section 23.2(c) relates to the EC's disregard for the discretion granted the President under Section 301(a)(1) to condition – or cancel – any decision to take action. Section 301(a)(1) states that action taken pursuant to that provision is "subject to the specific direction, if any, of the President regarding any such action".<sup>498</sup> The President may thus dictate the timing of the action, the conditions under which the action will be given effect, or whether the action will be taken at all. Thus, the President may, like the USTR herself, specify that action be conditioned upon DSB approval, or not be taken at all. The United States notes that there is no limitation in the language of Sections 301-310 on how the President may exercise this discretion.

4.1003 The United States recalls that in its discussion of Section 306(b), the European Communities refers to this Presidential discretion, where it states that the President has never given the USTR "any general direction to impose trade sanctions only in accordance with the United States' obligations under international law, nor has he ever instructed the USTR in specific cases to do so". Aside from the fact that this statement assumes that the President would have found it necessary to offer such direction to the USTR, this statement does not

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<sup>497</sup> Judith Hippler Bello and Alan F. Holmer, *The Heart of the 1988 Trade Act: A Legislative History of the Amendments to Section 301*, 25 Stanford J. Int'l Law 1, 9-10 (1988). The authors were the USTR General Counsel and Deputy USTR at the time the article was written, and had been deeply involved in the development of the provisions.

<sup>498</sup> Section 301(a)(1), 19 U.S.C. § 2411(a)(1). Section 305(a)(1) also refers to the fact that action under Section 301 is "subject to the specific direction, if any, of the President regarding any such action". Section 305(a)(1), 19 U.S.C. § 2415(a)(1).

change the fact that the President is completely free to provide such direction. Again, to meet its burden, the European Communities must demonstrate that the President *could not* exercise the discretion provided for in the statute to direct a WTO-consistent result; it is not sufficient to assert that the President has not felt the need to do so in the past.<sup>499</sup>

4.1004 The United States considers that the European Communities attempts to dismiss Presidential discretion under Section 301 by claiming that such an interpretation is permitted under the principle set forth in two panel proceedings, *United States – Measures Affecting Alcoholic and Malt Beverages*<sup>500</sup> and *India – Patent Protection for Pharmaceutical and Agricultural Chemical Products*.<sup>501</sup> However, as is clear from the excerpts quoted by the European Communities, the principle which these cases emphasize is that the non-application or non-enforcement of mandatory legislation which otherwise violates trade agreement rules does not excuse that violation.<sup>502</sup> Non-application or non-enforcement is not at issue in this case. Before one reaches the question of whether mandatory legislation is not being applied or enforced, one must first determine that the legislation is mandatory. The European Communities has failed to do, notwithstanding its bald assertions that Sections 301-310 "explicitly stipulat[e]" or "mandate" WTO-inconsistent determinations and actions.

4.1005 In the US view, the European Communities in particular focuses on the *India - Patents (US)* panel report in support of its claim that the "legal uncertainty" at issue in that case is somehow present here. However, that case involved a question whether, under Indian law, an administrative practice could legally take precedence over a law which on its face mandated actions in violation of WTO obligations.<sup>503</sup> That is quite a different matter from the question of whether discretionary language in the statute itself renders it non-mandatory.

4.1006 According to the United States, the European Communities can point to no principle of US domestic law which would permit the European Communities to excise language from a statute to suit its convenience, or to examine a statute's meaning based only on selected clauses. The discretion accorded both the USTR and the President under Sections 301-310 ensures that the United States government may fully comply with its WTO obligations under all circumstances. The European Communities has therefore failed to meet its burden of demonstrating that Sections 306 (b) and 305(a) "do not allow" the European Communities to meet these obligations.

4.1007 Finally, with regard to the "illustration" of the operation of Sections 306(b) and 305(a) which the European Communities purports to provide, the United States reiterates that the EC challenge to Sections 301-310 is to the statute itself, and not to the application of those provisions in any particular case.<sup>504</sup> The European Communities explicitly acknowledges that

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<sup>499</sup> Panel Report on *US – Tobacco*, op. cit., para. 123.

<sup>500</sup> Panel Report on *US – Malt Beverages*, op. cit.

<sup>501</sup> Panel Report on *India – Patents (US)*, as modified by Appellate Body Report on *India – Patents (US)*, op. cit.

<sup>502</sup> In Panel Report on *US – Malt Beverages*, op. cit., for example, the panel explained, "Even if Massachusetts may not currently be using its police powers to enforce this mandatory legislation, the measure continues to be mandatory legislation which may influence the decisions of economic operators. Hence, a *non-enforcement of a mandatory law* in respect of imported products does not ensure that imported beer and wine are not treated less favourably than like domestic products to which the law does not apply".

*Ibid.*, para. 5.60. (emphasis added)

<sup>503</sup> See *India - Patents (US)*, op. cit., paras. 7.35-7.37.

<sup>504</sup> See WT/DS152/11.

its complaint does not address the US measures taken in the context of the EC's failure to comply with DSB recommendations in the *Bananas* case, and that those measures are the subject of a separate dispute. The United States fully intends in the context of that dispute to rebut any EC claims that the United States did not act in accordance with its WTO obligations.<sup>505</sup>

4.1008 The United States also confirms that the US President can exercise the discretion granted under Section 301(a)(1) not to take action and under Section 305(a)(1) to direct the USTR not to implement action taken under Section 301, based upon the fact DSB recommendations have not yet been adopted or that the DSB has not yet authorized the suspension of concession.

4.1009 In response to the Panel's question as to whether any "specific directions" have been given so far by the US President under Sections 301 (a)(1) or 305 (a)(1), the United States states that no such specific directions have to date been given, but the specific directions may include a direction to the USTR not to take action.

## 5. GATT claim

4.1010 **The European Communities claims** that Section 301(c)(1)(b) allows the USTR to target either goods or services when determining the actions to be taken in response to a unilaterally determined failure to implement DSB recommendations. However, according to Article 22.3 of the DSU, the United States must suspend concessions or other obligations with respect to goods, in disputes involving trade in goods, except when this is not practical or effective. This implies that, in disputes involving trade in goods, Sections 306(b) and 305(a) require the USTR to unilaterally impose measures as a consequence of a unilaterally determined failure to implement DSB recommendations that violate basic provisions of the GATT 1994, among them Articles I, II, III, VIII and XI.

4.1011 The European Communities explains that Section 301(c) authorizes the USTR to "suspend, withdraw, or prevent the application of, benefits of trade agreement concessions", and "impose duties or other import restrictions on the goods of, and ... services of such foreign country for such time as the Trade Representative determines appropriate".<sup>506</sup> To the knowledge of the Communities, the USTR has not yet made use of the possibility to impose duties or restrictions on services. If the act, policy or practice of the foreign country violates the criteria for duty-free treatment under the United States' Generalised System of Preferences, the Caribbean Basin Economic Recovery Act or the Andean Trade Preference Act, the USTR is also authorized to withdraw, limit or suspend such treatment.

4.1012 The European Communities argues that in the case of WTO Members, other than the beneficiaries of these preference schemes, the imposition of duties or restrictions on the goods or services under Section 301(c) is bound to be inconsistent with the United States obligations under the GATT and the General Agreement on Trade in Services (GATS), in particular the

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<sup>505</sup> Having said this, the United States comments on the quotation from a USTR notice of October 22, 1998, quoted by the European Communities. That quotation includes the statement "in the event of an affirmative determination", indicating that the Trade Representative continued to have discretion not to determine to propose any action. Further, while the statement included a description of the 30-day deadline in Section 305(a)(1), the language of that provision – and of Section 305(a)(2) – is the best evidence of its contents.

<sup>506</sup> Section 301(c), 19 U.S.C. §2411(c).

most-favoured-nation provisions of these agreements. Only an authorization by the DSB in accordance with Article 22 of the DSU could possibly justify such measures. However, there is no provision in the Trade Act of 1974 that makes the retaliatory action of the USTR dependent on the authorization of the DSB.

4.1013 The European Communities maintains that given that Sections 304(a)(2)(A) and 306(b), as amended, require the United States to resort to retaliatory trade action within certain time limits irrespective of the result of WTO dispute settlement procedures, the actions taken in the area of trade in goods and not authorized pursuant to Article 3.7 and 22 of the DSU will necessarily be in violation of US obligations under one or more of the following GATT obligations: the Most-Favoured Nation clause (Article I, GATT 1994), the tariff bindings undertaken by the United States (Article II, GATT 1994), the National Treatment clause (Article III, GATT 1994), the obligation not to collect excessive charges (Article VIII, GATT 1994) and the prohibition of quantitative restrictions (Article XI, GATT 1994).

4.1014 **The United States responds** that as in its other claims in this dispute, the European Communities cites discretionary language in Sections 301-310 and then claims it "implies" mandatory action inconsistent with US obligations. In this case, the European Communities states in perfunctory fashion that Section 301(c)(1)(b) "allows the USTR to target either goods or services" and then assumes that this means that USTR must suspend concessions in a manner inconsistent with Article 22.3. The European Communities asserts that this discretion "implies that" Sections 306(b) and 305(a) "require" the USTR to violate GATT Articles I, II, III, VIII and XI.

4.1015 In the view of the United States, for the reasons described in the preceding sections, the USTR and the President have the discretion not to take any action under Section 306(b) or to take only those actions authorized in accordance with adopted panel findings or arbitral awards. The EC's claims with respect to the USTR's discretionary authority in the selection of retaliation targets in no way suggests that any provision of Sections 301-310 requires the USTR to suspend concessions, or to suspend concessions in a manner inconsistent with any WTO obligation.

4.1016 The United States further argues that having looked at the text of Article 23.2(a) and (c), the United States would logically look at the text of GATT Articles I, II, III, VIII and XI. However, the European Communities itself never even refers to the text of these provisions, and there is thus little for the United States to rebut. The European Communities never does more than assert that Sections 304(a)(2)(A) and 306(b) "necessarily" violate these provisions. The EC's only reasoning is that "certain time limits" create this result. Even if the European Communities were entitled to make the incorrect assumption that the statute commands "retaliatory trade action" and that Section 305 is not available to delay such action until receipt of DSB authorization, the European Communities has failed to offer any legal argumentation as to how Sections 304(a)(2)(A) and 306(b) are inconsistent with any of these provisions. Indeed, the European Communities only states that Section 306(b) violates "one or more of these [GATT 1994] provisions". The European Communities thus cannot even say which of these provisions has been violated, let alone how. The European Communities may not establish its *prima facie* case on the basis of mere assertions such as these. With regard to Article 23.1, as well, the European Communities has failed to attempt to make its case, let alone to establish it. Nothing in Sections 301-310 commands that the USTR not abide by the rules and procedures of the DSU in seeking redress of WTO violations.

4.1017 The United States further points out that any actions taken pursuant to Section 301(c)(1)(B) on an MFN basis involving a service sector not subject to a GATS commitment would not be WTO-inconsistent. Likewise, an MFN-based increase in an unbound

tariff, or an applied tariff that is under the bound rate, would not violate GATT 1994. Moreover, action taken pursuant to Section 301(c)(1)(D) would not be WTO-inconsistent. This provision provides for mutually satisfactory agreements and compensation agreements, which are clearly contemplated in DSU Articles 3.7 and 22.2. Finally, the United States refers to the fact that neither Section 305 nor any other provision of Sections 301-310 requires the USTR to suspend concessions without receiving DSB approval. Thus, one cannot conclude that the actions set forth in Section 301(c) are inherently inconsistent with US WTO obligations.

## **V. THIRD PARTY ARGUMENTS**

### **A. BRAZIL**

#### **1. Introduction**

5.1 **Brazil welcomes** the opportunity to present its views to the panel requested by the EUROPEAN COMMUNITIES to examine Chapter 1 of Title III (Sections 301-310) of the US Trade Act of 1974, as amended.

5.2 Brazil indicates that its interest in this case derives from the possible effects of this legislation on its rights and obligations as a Member of the WTO, as well as from its wider interest in the integrity of the multilateral trading system itself.

5.3 In Brazil's view, the European Communities makes exception to the operation of Section 306 in the dispute on the implementation of recommended changes to the EC's banana regime. The European Communities, however, has made it clear that it did not request this panel to rule on the measures taken in connection with that specific dispute, but rather on the compatibility of US law as such with US obligations under the WTO Agreements.

5.4 Brazil also takes the view that a law that is inconsistent with the obligations of a Member under the WTO Agreements can be challenged under the dispute settlement procedures. The issue before the panel is not the application of Sections 301-310 in a particular instance, but rather the need to bring the law into conformity with relevant WTO provisions, as provided in Article XVI:4 of the WTO Agreement.

5.5 Brazil recalls that the European Communities bases its claims on three premises:

- (a) WTO agreements cannot provide security and predictability unless Members settle all their trade disputes in accordance with the procedures of the DSU;
- (b) WTO agreements cannot provide security and predictability unless Members bring their law into conformity with their obligations under those agreements; and
- (c) The United States failed to bring Sections 301-310 into conformity with its obligations under the WTO agreements.

5.6 According to Brazil, to these grounds of action, the European Communities applies relevant provisions of the WTO Agreements, supplemented by the legal history and experience under the GATT 1947.<sup>507</sup>

5.7 Brazil also notes that the European Communities concludes that Sections 302(a)(2)(A), 305(a) and 306(b) are inconsistent with Article 23 of the DSU because they require the USTR to make unilateral determinations to the effect that a violation has occurred and to act upon such determination, without regard to the rules and procedures of the DSU. It further concludes that Section 306(b) of the Trade Act of 1974 is inconsistent with Articles I, II, III, VIII and XI of the GATT 1994 because, in the case of disputes involving trade in goods, it requires the USTR to impose duties, fees or restrictions that violate one or more of these provisions. Finally, the European Communities considers that, by failing to bring the Trade Act of 1974 into conformity with those provisions of the WTO Agreements, the US acted inconsistently with Article XVI:4 of the WTO Agreement.

## 2. Legal Arguments

### (a) Article XVI:4 of the WTO Agreement

5.8 Brazil recalls that the European Communities draws a distinction between mandatory and discretionary actions under Sections 301-310. The European Communities then proceeds to claim that those sections which require actions that are in themselves contrary to WTO provisions – unilateral determinations to the effect that a violation has occurred and that benefits have been nullified or impaired, or that measures taken to comply with findings adopted by the DSB are not satisfactory – as well as those actions which the USTR will be required to perform under certain circumstances – "further actions" in cases where a unilateral determination of non-compliance is made – amount to violations of various provisions of the WTO Agreement and thereby nullify or impair benefits accruing to the European Communities under the DSU, the GATT 1994 and the WTO Agreement.

5.9 In Brazil's view, the European Communities has placed undue emphasis on previous GATT practices and decisions, such as the 1987 panel on *United States – Taxes on Petroleum and Certain Imported Substances*,<sup>508</sup> the 1989 panel on *United States – Section 337 of the Tariff Act of 1930*,<sup>509</sup> and the 1992 panel on *United States – Measures Affecting Alcoholic and Malt Beverages*.<sup>510</sup> Under GATT 1947 – and no doubt under the influence of the Protocol of Provisional Application – only mandatory legislation was found liable to a judgement of inconsistency by a panel. It should be noted, however, that even then, a mandatory law that was not enforced was found to constitute a violation of GATT obligations.

5.10 Brazil argues that it would be wrong to assume that this part of GATT 1947 practice was carried into the WTO unchanged. Article XVI:1 of the WTO Agreement, which is the foundation for incorporating the legal history and experience under the GATT 1947 into the WTO,<sup>511</sup> contains a proviso:

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<sup>507</sup> Brazil refers to the GATT *acquis*, as defined by the Appellate Body in *Japan – Alcoholic Beverages II*, op. cit., p. 14

<sup>508</sup> Panel Report on *US – Superfund*, op. cit.

<sup>509</sup> Panel Report on *US – Section 337*, op. cit.

<sup>510</sup> Brazil also refers to the Panel Report on *India – Patents (US)*, op. cit.

<sup>511</sup> Brazil refers to the Appellate Body Report on *Japan – Alcoholic Beverages*, op. cit., p. 14.

"Except as otherwise provided under this Agreement or the Multilateral Trade Agreements, the WTO shall be guided by the decisions, procedures and customary practices followed by the GATT CONTRACTING PARTIES and the bodies established in the framework of GATT 1947". (emphasis added)

5.11 Brazil contends that the adoption of Article XVI:4 should lead to a review of previous practice. It states unequivocally that:

"Each Member shall ensure the conformity of its laws, regulations and administrative procedures with its obligations as provided in the annexed Agreements".

5.12 Brazil points out that GATT 1947 had no equivalent provision. To interpret Article XVI:4 in the old spirit would be to deprive it of meaning.

5.13 In Brazil's view, whilst the European Communities may have restrained its claims, it would be clearly out of order to deduct from such restraint new terms of reference for the Panel, as the United States would have it. The task before the Panel still is "to examine, in the light of the relevant provisions of the covered agreements cited by the European Communities in document WT/DS152/11, the matter referred to the DSB in that document and to make such findings and recommendations as will assist the DSB in making the recommendations or in giving the rulings provided for in those agreements". The matter referred by the European Communities is whether Sections 301-310 of the US Trade Act of 1974 is inconsistent with various provisions of the DSU, the WTO Agreement and GATT 1994. This is the burden of proof incumbent upon the European Communities. The European Communities did not request a ruling on the consistency of Sections 301-310 with previous GATT practice, let alone with the US interpretation of what such previous practice meant.

5.14 Brazil recalls that the United States bases its rebuttal solely on GATT 1947 practice. According to the United States, previous panels had come to the conclusion that (1) only mandatory legislation may be found inconsistent with WTO obligations and (2) legislation must not only be mandatory, it must preclude a Member from acting consistently with those obligations. The United States then proceeds to claim that in effect the whole of Sections 301-310 is either discretionary or mandates action that may, at times, be WTO consistent.

5.15 Brazil disagrees with the notion that GATT practice was carried unchanged into the WTO. Brazil disapproves even more of the proposition that no law may be found inconsistent unless "it does not allow" a government to act in accordance with its WTO obligations, in particular if "does not allow" is understood as "never allows". If such had been the practice in the past, the argument to the effect that Article XVI:4 of the WTO Agreement has abrogated jurisprudence in this respect becomes even more compelling than it already is. There is no possible interpretation of Article XVI:4, in light of the criteria laid down in Article 31 of the Vienna Convention on the Law of Treaties, that would warrant such an extravagant reading.<sup>512</sup>

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<sup>512</sup> Article 31 of the Vienna Convention on the Law of Treaties establishes that "a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose". It is extremely hard to conceive that the "ordinary" meaning of "ensure the conformity of its laws, regulations and administrative procedures with its obligations as provided in the annexed Agreements" could be construed as merely not precluding a Member from acting in conformity with its obligations at all times, as the United States argues, or as



5.16 Brazil argues that it is worth noting that the US First Submission did not reply to the EC's claim of violation of Article XVI:4. The United States invoked "past practice", and claimed that the European Communities has not proven that Sections 301-310 are mandatory in a way that precludes WTO-consistency at all times and "deducts" that Sections 301-310 are therefore consistent with Article XVI:4. Thus, at a stroke, almost extempore, past practice developed in the absence of any provision similar to Article XVI:4 is used to interpret Article XVI:4 of the WTO Agreement, in a way which would render it meaningless. In addition to the questionable validity of the premises, this is a good example of the logical fallacy known as *ignoratio elenchi*: arguing for one thing as if it proved another thing.

5.17 Brazil notes that the European Communities recognizes that "[Article XVI:4] is not a 'best endeavors' clause, applicable only to cases where changes to domestic laws are required, but an unqualified obligation". Article XVI:4 requires that internal law be brought into conformity with obligations under the WTO Agreements.

5.18 Brazil recalls that Article 22 of the Agreement on Implementation of Article VII of the GATT 1994 contains a similar provision:

"Each Member shall ensure, not later than the date of application of the provisions of this Agreement for it, the conformity of its laws, regulations and administrative procedures with the provisions of this Agreement".

5.19 Brazil contends that if a WTO Member country were to include in its legislation on customs valuation a section "authorizing", but not requiring, Customs "to make a determination, based on an investigation initiated at the request of a private party, determining that the importation of goods below a certain price would be unreasonable and burden or restrict" that Member's commerce, such a provision would be consistent with Article 22 of the Agreement on Customs Valuation and with Article XVI:4 of the WTO Agreement. Or the uncertainty that would ensue from such an "authorization" would not be deemed unacceptable. Yet, the Agreement on Implementation of Article VII of the GATT 1994 is not "a central element providing security and predictability to the multilateral trading system". The DSU, however, is.<sup>513</sup>

5.20 Brazil notes that its argument is far from stating that any law authorizing actions that might result in violations of the WTO Agreements would, in themselves, be inconsistent with obligations under those Agreements. The dichotomy suggested by the United States is a *non sequitur*. What is necessary, is lawful. For example, in the Agreement on the Application of Sanitary and Phytosanitary Measures, one of the basic obligations is that "Members shall ensure that any sanitary or phytosanitary measure is applied only to the extent necessary to protect human, animal or plant life or health, is based on scientific principles and is not maintained without scientific evidence, except as provided".<sup>514</sup> No internal law could, however, be drafted in a manner that would *a priori* ensure conformity with WTO obligations without impinging upon "the right to take sanitary and phytosanitary measures necessary for the protection of

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providing the possibility for authorities to avoid WTO-inconsistent actions, as the United States also argues.

<sup>513</sup> DSU, Article 3.2.

<sup>514</sup> SPS Agreement, Article 2.2.

human, animal or plant life or health".<sup>515</sup> In such cases, conformity must necessarily be assessed in relation to specific measures, on a case by case basis.

5.21 Brazil argues that the distinguishing feature of Section 301(b) is that if any action is ever undertaken under its authority, it will necessarily lead to violations of GATT and GATS, including, *inter alia*, the most-favored-nation provisions of those agreements. In addition to that, there are no legitimate "reserved domain" considerations that might justify it. Legislation whose only possible application is the threat of illegal WTO action can hardly be deemed to be compatible with Article 23 of the DSU and with Article XVI:4 of the WTO Agreement.

5.22 Brazil points out that as regards Section 301(a), the question is not whether it precludes at all times WTO-consistent actions, but rather whether it mandates actions which will eventually result in WTO violations.

5.23 According to Brazil, it has been noted that "arising from the nature of treaty obligations and from customary law, there is a general duty to bring internal law into conformity with obligations under international law ... however, in general a failure to bring about such conformity is not in itself a direct breach of international law, and a breach arises only when the state concerned fails to observe its obligations on a specific occasion. ... In some circumstances legislation could of itself constitute a breach of a treaty provision and a tribunal might be requested to make a declaration to that effect".<sup>516</sup> Article XVI:4 requires that legislation be brought into conformity, and failure to do so is in itself a breach of the WTO Agreement. There is no need to look at any specific cases, or to the mandatory or discretionary nature of the legislation.

5.24 Brazil further argues that in any event, the *bona fide* argument with regard to the non-violation status of a discretionary law rests solely on its non-utilization.<sup>517</sup> This is not, however, the intention of the United States. To invoke the "discretionary" label as its defense, whilst pronouncing its intention to utilize the law, can hardly be deemed as an act in good faith.

5.25 In Brazil's view, lest there be any doubt, the Statement of Administrative Action which accompanies the Uruguay Round Agreements Act,<sup>518</sup> and which represents "an authoritative expression by the Administration concerning its views regarding the interpretation and application of the Uruguay Round Agreements, both for purposes of US international obligations and domestic laws",<sup>519</sup> gives notice of the "Administration's intent to expand the focus of possible action under Section 301 to areas that are not within the scope of US obligations under the Uruguay Round Agreements".<sup>520</sup>

5.26 Brazil notes that this "expansion of focus" is explained in further detail:

"The Administration intends to use section 301 to pursue vigorously foreign unfair trade barriers that violate US rights or deny benefits to the United States

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<sup>515</sup> Ibid. Article 2.1.

<sup>516</sup> Brownlie, Ian, "Principles of Public International Law", 5<sup>th</sup> ed. (Oxford University Press, 1998), pp. 35-36.

<sup>517</sup> Brazil points out that this was the argument invoked by the United States in *US – Superfund* panel (Panel Report on *US – Superfund*, op. cit., para. 3.2.13) and in the *US – Tobacco* panel (Panel Report on *US – Tobacco*, op. cit., para. 45).

<sup>518</sup> Section 101(a)(2)

<sup>519</sup> Statement of Administrative Action, op. cit., Introduction, third paragraph.

<sup>520</sup> Statement of Administrative Action, op. cit., page 358 (Authority under Section 301)

under the Uruguay Round Agreements. The Administration equally intends to use section 301 to pursue foreign unfair trade barriers that are not covered by those agreements".<sup>521</sup>

"Neither section 301 nor the DSU will require the Trade Representative to invoke DSU dispute settlement procedures if the Trade Representative does not consider that a matter involves a Uruguay Round Agreement. Section 301 will remain fully available to address unfair practices that do not violate US rights or deny US benefits under the Uruguay Round Agreements and, as in the past, such investigations will not involve recourse to multilateral dispute settlement procedures.... For example, with minor exceptions, the Uruguay Round Agreements do not address government measures that encourage or tolerate private, anticompetitive practices..... Section 301 will also remain available to address persistent patterns of conduct by foreign governments that deny basic worker rights and burden or restrict US commerce.... Moreover, the mere fact that the Uruguay Round agreements treat a particular subject matter – such as intellectual property rights – does not mean that the Trade Representative must initiate DSU proceedings in every section 301 investigation involving that subject matter. In the event that the actions of the foreign government in question fall outside the disciplines of those agreements, the section 301 investigation would proceed without recourse to DSU procedures".<sup>522</sup>

5.27 Brazil then recalls the scope of authority available to the US Administration to proceed without recourse to DSU procedures in Section 301(c):

"For purposes of carrying out the provisions of subsections (a) or (b), the Trade Representative is authorized to –

(A) suspend, withdraw, or prevent the application of, benefits of trade agreement concessions to carry out a trade agreement with the foreign country referred to in such subsection;

(B) impose duties or other import restrictions on the goods of, and, notwithstanding any other provision of law, fees or restrictions on the services of, such foreign country for such time as the Trade Representative determines appropriate...".

5.28 Brazil contends that in other words, to pursue the removal of practices that do not violate US rights, the US threatens to violate the rights of WTO Members.

5.29 Brazil argues that it would have been positively anomalous to include a provision in the DSU stating that WTO Members would have to make recourse to a panel and to the DSB to make a determination of non-violation. Yet, the United States seems to use this as a pretext for unilateral action. WTO Members are, of course, entitled to make unilateral determinations of non-violation and of any interests they may have that are not currently covered by the WTO

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<sup>521</sup> Statement of Administrative Action, op. cit., page 364 (Enforcement of US Rights) (emphasis added).

<sup>522</sup> Statement of Administrative Action, op. cit., page 366 (Enforcement of US Rights)(emphasis added).

Agreements. What they may not do in such instances is to take unilateral action equivalent to that foreseen under Article 22 of the DSU.

5.30 Brazil stresses that WTO Members are entitled, in accordance with Article 23 of the DSU, not to be subject to suspension of concessions unless "the Member concerned fails to bring the measure found to be inconsistent with a covered agreement into compliance therewith or otherwise comply with the recommendations and rulings within the reasonable period of time".<sup>523</sup> *A fortiori*, they are entitled not to be subject to suspension of rights and concessions in the absence of a determination of violation by the DSB.

5.31 Brazil further asserts that along the same lines, it is a well recognized general principle of law that a prohibition to do less encompasses a prohibition to do more. The United States would turn the principle upside down: where the United States has a right, arising from denial of benefits under the WTO Agreements, the Statement of Administrative Action acknowledges the limits for action imposed by the DSU. Yet, it unaccountably comes to the conclusion that in cases where it has no rights, it faces no limits under the DSU.

5.32 According to Brazil, the fact that the USTR is not required to take action in such circumstances at all times should not shield it from a judgement of non-compliance with its WTO obligations. As stated by the European Communities, "a party does not act in good faith if it accepts an obligation stipulating one behavior, but adopts a law explicitly stipulating another. The fact that it might exceptionally apply that law in a way that is not inconsistent with its WTO obligations does not affect the above conclusion, particularly where there is no legal entitlement to obtain such an exceptional 'act of grace'".

5.33 Brazil recalls that in 1988 the United States threatened and then imposed sanctions, in the guise of 100 per cent duties against imports of more than 20 products from Brazil under Section 301, in a determination of "unreasonable measures" related to patent protection for pharmaceuticals. The sanctions remained in place for two years, and were only lifted after Brazil undertook to grant patent protection to pharmaceutical products.

5.34 Brazil emphasizes that the issue before this Panel is not the application of Section 301, but its inherent inconsistency with the WTO obligations of the United States. This example is given as background, which the panel may wish to consider in connection with the US assertion that "it was consistent US practice, even before the conclusion of the Uruguay Round, to rely on dispute settlement results when determining whether US agreement rights were denied". In the case involving Brazil, no US rights under any agreement had been denied. This may have given the USTR a sense of unbounded freedom to act as it did in violation of Brazil's rights under the GATT 1947.

5.35 According to Brazil, the freedom to threaten to negate unilaterally the benefits of WTO Agreements may be effective,<sup>524</sup> but it is not compatible with a rule-based multilateral trading system. The system cannot survive if its most powerful Members wish to enjoy its benefits, but

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<sup>523</sup> DSU, Article 22.2.

<sup>524</sup> According to Brazil, a lawyer is quoted by Jackson as finding the procedure useful: "In practice, a petition filed under Section 301 by a private party carries an effective threat of potential retaliation, combined with the threat of adverse publicity and a general souring of trade relations. These potential ramifications alone may bring the offending government to the bargaining table". John H. Jackson, "The World Trading System", 2<sup>nd</sup> edition (MIT Press, 1997), p.131.

reject its responsibilities: *qui habet comoda, ferre debet onera*.<sup>525</sup> Brazil recalls the following dictum of the Permanent Court of Justice in *Certain German Interest in Polish Upper Silesia* :

"The Court is certainly not called upon to interpret the Polish law as such; but there is nothing to prevent the Court's giving judgement on the question whether or not, in applying that law, Poland is acting in conformity with its obligations towards Germany under the Geneva Convention".<sup>526</sup>

5.36 Brazil contends that in those cases under the GATT 1947 when a law was found to be inconsistent with GATT obligations, a prospective judgement on the application of the law was made, in contrast with the retrospective judgement made with regard to specific measures. There is nothing to prevent the same prospective judgement of the discretionary sections of a law, specially when the application of that law will necessarily lead to violation of the WTO Agreements.

**(b) Distinction between mandatory law and discretionary law**

5.37 Brazil further contends that even if the panel were to find incorrectly that the distinction established by previous GATT panels regarding mandatory versus discretionary legislation remains valid, it should flatly reject the US interpretation of such past practice. The United States alleges that "legislation explicitly directing action inconsistent with GATT principles does not mandate inconsistent action so long as it provides the possibility for authorities to avoid such action" and cites, as the basis for this extraordinary conclusion, excerpts of the panel reports on *United States – Taxes on Petroleum and Certain Imported Substances*,<sup>527</sup> *Thailand – Restrictions on importation of and Internal Taxes on Cigarettes*<sup>528</sup> and *United States – Measures Affecting the Importation, Internal Sale and Use of Tobacco*.<sup>529</sup>

5.38 Brazil argues that none of the panels cited came to the conclusion espoused by the United States. The *US – Superfund* panel gave US authorities the benefit of doubt, pending the completion of the applicable legislation. It did not say that the US tax authorities could retain forever the discretion to deny the equivalence prescribed in Article III:2 of GATT. In fact, the panel recommended that the CONTRACTING PARTIES "take note of the statement by the United States that the penalty rate would in all probability never be applied".<sup>530</sup> WTO Members might take some solace if the United States were to argue, in these panel proceedings, that the WTO-inconsistent provisions of Sections 301-310 would in all probability never be applied. In that case, however, the assertion would have to be pondered against the evidence of the views presented in the Statement of Administrative Action.

5.39 Brazil further alleges that the panel on *United States – Measures Affecting the Importation, Internal Sale and Use of Tobacco* came to a similar finding. Given that the United States had as yet neither changed the fee structure nor promulgated rules implementing Section 1106(c), it gave the United States the benefit of doubt, in light of its declared intention to promulgate regulations that would be GATT-consistent:

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<sup>525</sup> In Brazil's view, one who has the advantages must also bear the burdens.

<sup>526</sup> PCIJ Rep., Series A, N° 7, p. 19

<sup>527</sup> Panel Report on *US – Superfund*, op. cit.

<sup>528</sup> Panel Report on *Thai – Cigarettes*, op. cit.

<sup>529</sup> Panel Report on *US – Tobacco*, op. cit.

<sup>530</sup> Panel Report on *US - Superfund*, op. cit., para. 5.2.10.

"The United States had indicated that it was the intention of the U.S. Government and the requirement of U.S. law that any new inspection fees promulgated by USDA would be commensurate with the cost of services rendered. The United States had further indicated that the amendment requiring the fees for inspecting imported tobacco to be *comparable* to those imposed on domestic tobacco did not require the fees to be identical and did not preclude a fee structure under which the fees for inspection of imports were less than those imposed on domestic products and at the same time commensurate with the cost of services rendered".<sup>531</sup>

5.40 In the view of Brazil, the example of the panel on *Thailand – Restrictions on importation of and Internal Taxes on Cigarettes*<sup>532</sup> is even less appropriate. In this case, regulations had already been issued stipulating that an excise tax would be applied to domestic and imported cigarettes at a single rate of 55 per cent.<sup>533</sup> Thus, in reading the conclusion cited by the United States, it must be borne in mind that whilst the Thai Tobacco Act continued to enable the executive authorities to levy discriminatory taxes, regulations already issued prevented such discrimination.

5.41 According to Brazil, no GATT panel has ever come to the conclusions alleged by the United States. Under GATT 1947, panels made a distinction regarding mandatory and discretionary legislation, but mandatory was never understood as "precluding all possibility of consistency" at all times.

5.42 In Brazil's view, the US arguments therefore attempt to introduce a confusion with regard to the seemingly clear meaning of "mandatory". In addition to that, it also attempts to confuse the meaning of "discretionary". Thus, the United States argues that "the Trade Representative has substantial discretion, including discretion to take no action at all. The Trade Representative is explicitly not required to take action: (1) when the DSB has adopted report findings that US rights have not been violated; (2) when the foreign country "is taking satisfactory measures to grant the rights of the United States under a trade agreement", has agreed to eliminate or phase out the practice which violated US rights, or has agreed to provide compensation; (3) when action would have "an adverse impact on the United States economy substantially out of proportion to the benefits of such action;" (4) or when action would cause "serious harm to [US] national security".

5.43 Brazil further argues that apart from noting that the heading under which these provisions are listed is entitled "Mandatory action", one must also recall that, to the extent that past practice is invoked as relevant to discern the content of treaty obligations, its concepts must also be interpreted in good faith, in accordance with the ordinary meaning of the terms.

5.44 Brazil points out that according to Black's Law Dictionary,<sup>534</sup> "when applied to public functionaries, discretion means a power or right conferred upon them by law of acting officially in certain circumstances, according to the dictates of their own conscience uncontrolled by the judgement or conscience of others". If a condition must be fulfilled before the effect can follow, the preceding definition is not applicable. If the lack of action is made contingent upon a WTO

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<sup>531</sup> Panel Report on *US - Tobacco*, op. cit., para. 122.

<sup>532</sup> Panel Report on *Thai – Cigarettes*, op. cit.

<sup>533</sup> Ibid. para. 43.

<sup>534</sup> Black's Law Dictionary, Revised 4<sup>th</sup> edition (West Publishing Co., 1968).

Member, for instance, "agreeing to an imminent solution to the burden or restriction on United States commerce",<sup>535</sup> the "discretion" takes on a very special meaning.

5.45 Brazil concludes that *ex re sed non ex nomine* is a principle of good faith. This principle precludes, *inter alia*, a party from using the form of the law to cover the commission of what in effect is an unlawful act.

**(c) Other arguments**

5.46 Brazil further argues that there are other elements to be noted. The first is that the "logical way forward" adopted in the bananas III arbitration is not a precedent for the interpretation of the sequence between Articles 21.5 and 22 of the DSU. Brazil also strongly disagrees with the US assertion that the DSB "implicitly rejected" the views of the majority of Members of the WTO concerning Article 21.5. The principle of automaticity prevented the DSB from doing otherwise. It would suffice, nevertheless, to read the long records of minutes related to the bananas III dispute to confirm that there never was any implicit rejection of the obligatory sequence.

5.47 Brazil also notes the concept put forward by Hong Kong, China, concerning third party or multilateral adjudication. This is exactly what Brazil expected from the DSU and why, as Korea, Brazil believed that the single undertaking of the Uruguay Round was a beneficial package for a developing country like Brazil. Brazil did not sign on to the WTO Agreement to be the object of unilateral determinations of non-compliance.

5.48 Brazil points out that the third is related to the impact of the US legislation and the US concern that the Panel is being asked to emit a political declaration.

5.49 Brazil emphasizes that when it discusses this case, although it is not dealing with a specific application of the legislation, it addresses the question of retaliation, and the impact of potential retaliation, and Korea has illustrated this point very clearly. In other words, the US legislation under examination is a unilateral instrument for exerting political and economic pressure. While Brazil agrees that the Panel should not engage in a debate about the popularity of the US law, the Panel should not disregard the impact of Sections 301 to 310 of the Trade Act of 1974 on WTO rights and obligations because of its political connotations.

5.50 Brazil summarises its view as follows: There is an irreconcilable conflict between those provisions of Sections 301-310 of the Trade Act of 1974 which mandate or authorize actions that are illegal under the WTO and Article 23 of the DSU and Article XVI:4 of the WTO Agreement. Brazil believes, therefore, that the panel should affirm that Members have an unqualified obligation to bring their legislation into conformity with WTO provisions.

**3. Conclusion**

5.51 Brazil recalls that the United States may claim a large part of the merit for the improved dispute settlement procedures of the WTO. In the course of the negotiations, it overcame many objections, included those which were initially held by Brazil. Brazil's reluctance was based on fear that the major trading partners would require compliance by smaller countries, whilst refusing themselves to be bound by the stricter dispute settlement rules.

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<sup>535</sup> Section 301 (a)(2)(B)(ii)(II).

5.52 Brazil also notes that the WTO dispute settlement system may still yield benefits approaching those of a fully binding procedure, without unduly encroaching upon the sovereignty of Members. It would be ironic if the dispute settlement system which the United States fought so hard to establish were to be discredited by the refusal of the United States to apply its provisions in good faith.

5.53 In Brazil's view, there are parts of Sections 301-310 which serve a useful purpose, as a delegation of competence from the United States Congress to the Executive branch and as a procedure for the initiation of citizens' complaints.

5.54 Brazil also considers, however, that there is an irreconcilable conflict between those provisions which mandate or authorize actions that are illegal under the WTO and Article 23 of the DSU and Article XVI:4 of the WTO Agreement. It therefore believes that the Panel should not limit its findings to a restatement of traditional GATT practice, but should affirm that Members have an unqualified obligation to bring their legislation into conformity with WTO provisions.

## B. CANADA

### 1. Introduction

5.55 **Canada welcomes** the opportunity to participate in this Panel established pursuant to the European Commission's request for the establishment of a panel under the Dispute Settlement Body of the World Trade Organization regarding Sections 301-310 of the US Trade Act of 1974. In this context, Canada wishes to highlight its specific concerns with respect to Sections 301-310 of the Trade Act of 1974 (collectively referred to as "301 legislation") in the form of a "third party" submission pursuant to Article 10 of the Understanding on Rules and Procedures Governing the Settlement of Disputes.

5.56 Canada firmly believes that disputes arising between Members concerning WTO obligations should be addressed within the parameters established by the DSU. In Canada's view, the application of 301 legislation that results in unilateral imposition of retaliatory measures in response to WTO violations, whether alleged or established, without obtaining the requisite authorization for such retaliatory measures from the WTO Dispute Settlement Body violates the DSU specifically and multilateralism in general. This threatened and actual use of unilateral sanctions is fundamentally incompatible with the multilateral trading system and threatens the overall stability and viability of the WTO dispute settlement regime.

5.57 As a preliminary matter, Canada would note that it appreciates that 301 legislation may be applied to situations arising under trade agreements other than the WTO, to countries that are not WTO Members or to situations that are not subject to WTO obligations. Canada appreciates that those situations are not subject to WTO dispute settlement proceedings unless they somehow violate obligations owed to WTO Members. Accordingly, Canada's present submissions are not directed to those situations.



## 2. Measures at Issue

5.58 Canada explains that Section 301(a)(1) of the Trade Act of 1974 requires the USTR to determine<sup>536</sup> whether an act, policy or practice of a foreign country violates or denies the benefits or rights of the United States under any trade agreement or places an "unjustifiable" burden or restriction on US commerce.

5.59 In Canada's view, the Section 301 legislation combines mandatory and discretionary elements. Actions leading to the imposition of trade sanctions pursuant to section 301 can begin either as the result of a petition filed by an interested person<sup>537</sup> or as a result of an investigation initiated by USTR.<sup>538</sup> USTR is not obliged to initiate an investigation requested by a petitioner but if a decision is made not to do so, USTR must publish a notice in the *Federal Register* that contains a summary of the reasons for not initiating an investigation.<sup>539</sup>

5.60 Canada points out that there are essentially two types of matters that are actionable under section 301(a). The first type is a denial of benefits under, or a violation of a trade agreement,<sup>540</sup> including the WTO Agreements. The other type of matter which is actionable under section 301 is whether an act, policy or practice of a foreign country is unjustifiable and burdens or restricts United States commerce.<sup>541</sup>

5.61 Canada stresses that 301 legislation sets out specific and definitive time frames within which certain actions must occur. Examples of this include the following:

- (a) Where an alleged violation of a trade agreement is the subject matter of the investigation and a mutually acceptable resolution cannot be reached within the

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<sup>536</sup> Canada points out that Sections 301 to 310 of the Trade Act of 1974, as amended, calls for the making of numerous "determinations". These represent more than mere statements of policy or negotiating positions. The outcome of these determinations are formal acts of the United States Government and result in the legal consequences set out in the legislation.

<sup>537</sup> Section 302(a)(1) of the Trade Act of 1974, as amended.

<sup>538</sup> Section 302(b)(1)(A) of the Trade Act of 1974, as amended.

<sup>539</sup> Section 302(a)(3) of the Trade Act of 1974, as amended.

<sup>540</sup> Section 301(a)(1)(A) and 301(a)(1)(B)(i) of the Trade Act of 1974, as amended.

<sup>541</sup> Section 301(a)(1)(B)(ii) of the Trade Act of 1974, as amended. Canada notes that, pursuant to Section 301(d)(2), an act, policy or practice that burdens or restricts United States commerce is defined as including acts, policies or practices defined as "unreasonable" under section 301(d)(3)(B) notwithstanding that such matters may not be inconsistent with the international legal rights of the United States. Section 301(d)(3)(B) is not an exclusive definition so it is not possible to determine from it what other actions might subject a country to US trade sanctions notwithstanding that the country is not in violation of international law. Canada further notes that the second type of actionable matters (i.e. acts, policies or practices considered to be unjustifiable and which burdens or restricts United States commerce) includes matters which the United States consider to deny fair and equitable provision of adequate and effective intellectual property rights "notwithstanding the fact that the foreign country may be in compliance with the specific obligations of the Agreement on Trade-Related Aspects of Intellectual Property Rights ..." negotiated pursuant to the Uruguay Round. Accordingly, 301 legislation exposes foreign countries to US trade sanctions for perceived intellectual property wrongs even though that country is living up to the commitments that WTO Members agreed to in the negotiations leading to the Agreement on Trade-Related Aspects of Intellectual Property Rights.

time frames noted in the legislation,<sup>542</sup> USTR is obligated by the statute to promptly initiate dispute settlement procedures under the trade agreement.

- (b) In the case of an investigation subject to dispute settlement procedures under a trade agreement, USTR must make a determination as to whether the matter in issue is "actionable" under section 301 within specific time frames.<sup>543</sup>
- (c) Where USTR determines that a matter is actionable under section 301 retaliatory action must normally be implemented no more than 30 days after making that determination.<sup>544</sup>

5.62 Canada explains that in the case of implementation of WTO dispute settlement recommendations, where USTR considers that a WTO Member has failed to implement a recommendation made pursuant to a WTO dispute settlement proceeding, USTR is required within 30 days of the expiration of the reasonable period of time established pursuant to Article 21 of the DSU to determine what further action USTR shall take under section 301(a).<sup>545</sup>

5.63 Canada notes that the provisions in question use the mandatory verb "shall". The burden of demonstrating that any action referred to in these provisions is not mandatory in US law falls upon the United States.

5.64 Canada specifically argues that Section 304(a)(2) of the Trade Act of 1974 requires that the USTR determination of whether US rights are being denied must be made by the earlier of thirty days after the conclusion of formal dispute settlement procedures or eighteen months after the date of the initiation of the Section 301 investigation.

5.65 According to Canada, while it is certainly possible for WTO dispute settlement procedures to be completed within 18 months, WTO practice demonstrates that factors such as delays in panel selection, extension of time frames by panels or the Appellate Body and delays in translation and other logistical matters can and do result in disputes not being determined within a 18 month time frame.

5.66 Canada further points out that an affirmative determination pursuant to section 304(a)(2) requires USTR to impose sanctions set out in section 301(c) which must normally be implemented no later than thirty days after making that determination.<sup>546</sup> Once again Canada notes that the legislation uses the word "shall".

5.67 Canada notes that USTR retaliatory authority under section 301 to (i) suspend, withdraw or prevent the application of benefits of trade agreement concessions; (ii) impose duties or other import restrictions on the goods of the foreign country for such time as USTR

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<sup>542</sup> Canada notes that it is the earlier of (i) the close of any consultation period specified in the trade agreement; and (ii) 150 days after the day on which consultations was commenced. See Section 303(a)(2) of the Trade Act of 1974, as amended.

<sup>543</sup> Canada notes that it is the earlier of (i) thirty days after the conclusion of formal dispute settlement procedures; and (ii) eighteen months after the date of the initiation of the Section 301 investigation. See 304(a)(2) of the trade Act of 1974, as amended.

<sup>544</sup> Canada notes that this can be delayed by a maximum of 180 days where the specific circumstances cited in section 305(2)(A) occurs.

<sup>545</sup> Section 306(b)(2) of the Trade Act of 1974, as amended. Canada notes that it is noteworthy that section 301(a) is entitled "Mandatory Action".

<sup>546</sup> Sections 301(a)(1) and 305(a)(1) of the Trade Act of 1974, as amended. See also footnote 9.

determines appropriate; or (iii) enter into agreements with the foreign country to eliminate the act, policy or practice that is the subject of the determination or provide the United States with compensatory trade benefits<sup>547</sup> is subject to the direction, if any, of the President. While this provision of section 301(a)(1) concerning the direction of the President may create an ability for the President to formally direct the type of sanction applied, it does not remove the legislative requirement for the US executive branch to act. Section 301(b) clearly does remove the requirement to act in the circumstances set out in that section. If the provision that allows the President to make a specific direction concerning the action to be taken was intended to include an ability to override the requirement otherwise imposed by the US Congress that intention would have been expressly stated as was done in section 301(b).

### 3. Legal Arguments

5.68 Canada contends that the requirement that retaliatory measures be implemented where an affirmative determination is made by the USTR pursuant to section 304 is not contingent in any way on the approval for such action by the WTO's Dispute Settlement Body ("DSB"). Where the statutory deadlines contained in section 304(a)(2) expire prior to authorization by the DSB for retaliation pursuant to Article 22 of the DSU, the USTR is nonetheless required to determine the appropriate retaliatory action to take against the offending Member. While the DSU notes that the "prompt" settlement of disputes between Members is essential to the effective functioning of the WTO and the maintenance of a proper balance between the rights and obligations of Members, the resolution of a dispute may not be achieved within the deadlines contained in section 304(a)(2).

5.69 According to Canada, where an affirmative determination has been made pursuant to section 304(a)(2), then section 305(a)(1) becomes operative. Under that provision, the action determined to be appropriate under section 304(a)(1) becomes mandatory. That action must occur on or before 30 days of the section 304(a)(1) determination.

5.70 Canada further argues that similarly, the implementation of retaliatory measures directed against a WTO member by means of section 306(b) and 301(a) in the absence of the approval of such measures by the DSB would clearly be in contravention of DSU Article 23. This determination by USTR leads to the implementation of retaliatory measures directed against the foreign country within thirty days regardless of whether or not the other Member has been found under WTO procedures to not be in compliance with the recommendations and rulings adopted by the DSB. The result would be that retaliation that has not been authorized by the DSB.

5.71 In Canada's view, the plain language of Article 23 contains an obligation by WTO Members to refrain from unilateral action. Article 23(1), entitled *Strengthening the Multilateral System*, states:

"When Members seek the redress of a violation of obligations or other nullification or impairment of benefits under the covered agreements or an impediment to the attainment of any objective of the covered agreements, they *shall* have recourse to, and abide by, the rules and procedures of this Understanding". (emphasis added)

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<sup>547</sup> Section 301(c) of the trade Act of 1974, as amended.

5.72 Canada further alleges that Article 23 of the DSU obligates Members to employ the procedures contained in the DSU to remedy alleged or established WTO obligations. Retaliatory action taken pursuant to Section 301 legislation prior to the approval of the DSB violates DSU Article 23(2)(a) which states that WTO Members "shall not make a determination to the effect that a violation has occurred ... except through recourse to dispute settlement in accordance with the rules and procedures of this Understanding". A Member that makes a determination unilaterally that a measure of another Member is inconsistent with WTO obligations is in clear violation of DSU Article 23. A Member that makes a determination unilaterally that another Member has failed to bring a measure found to be inconsistent with a covered agreement into compliance with that agreement also violates Article 23 in that the DSU establishes a procedure for determining the consistency of the measure. Such a unilateral determination of non-compliance without recourse to the DSU procedures amounts to a determination that a violation has occurred other than through recourse to DSB dispute settlement procedures.

5.73 Canada notes that it too has legislative authority to suspend concessions in response to measures of other countries. Section 13(1) of the World Trade Organization Agreement Implementation Act<sup>548</sup> provides the Government of Canada with the legislative authority to take retaliatory measures under federal law to suspend rights or privileges granted by Canada to a WTO Member. However, unlike Section 301, the Canadian government is expressly authorized to do so for the purpose of suspending in accordance with the WTO Agreement the application to a WTO Member of concessions or obligations of equivalent effect pursuant to Article 22 of the DSU. Accordingly, Canadian law requires that the exercise of this authority must occur in accordance with Canada's WTO obligations. In particular, the authority permits action to suspend concessions pursuant to Article 22 of the DSU. As there is a presumption in Canadian law that a statute does not operate retrospectively so as to affect rights unless an intention to do so is clearly expressed or arises by necessary implication,<sup>549</sup> suspension of concessions can only apply subsequent to the DSB authorizing a suspension of concessions or other obligations pursuant to Article 22.

5.74 Canada would distinguish 301 legislation from the type of matter at issue in *Thailand – Restrictions on Importation of and Internal Taxes on Cigarettes*.<sup>550</sup> In that case, the panel was concerned with an enabling provision which allowed executive authorities to impose discriminatory taxes. The panel concluded that the possibility that the Act in question could be applied in a manner contrary to the GATT, was not sufficient to make the Act inconsistent with

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<sup>548</sup> S.C. 1994, c. 47. Subsection 13 (1) reads as follows:

"13 (1) The Governor in Council may, for the purpose of suspending in accordance with the Agreement the application to a WTO Member of concessions or obligations of equivalent effect pursuant to Article 22 of the Understanding on Rules and Procedures Governing the Settlement of Disputes set out in Annex 2 to the Agreement, by order, do any one or more of the following:

- (a) suspend rights or privileges granted by Canada to that Member or to goods, service providers, suppliers, investors or investments of that Member under the Agreement or any federal law;
- (b) modify or suspend the application of any federal law with respect to that Member or to goods, service providers, suppliers, investors or investments of that Member;
- (c) extend the application of any federal law to that Member or to goods, service providers, suppliers, investors or investments of that Member; and
- (d) take any other measure that the Governor in Council considers necessary".

<sup>549</sup> E.A. Dreidger, "The Composition of Legislation" (Second Edition); Department Of Justice: Ottawa, Ontario; 1976.

<sup>550</sup> Panel Report on *Thai – Cigarettes*, op. cit.

the General Agreement. In this case the legislation requires a determination regarding the consistency of a country's measures to be made in a thirty day time frame following the conclusion of dispute settlement procedures. The United States' publication "The Uruguay Round Agreements Act: Statement of Administrative Action" appears to indicate that the United States regards the conclusion of Uruguay Round dispute settlement procedures to be the conclusion of the reasonable time to implement the panel or Appellate Body's report.<sup>551</sup> Canada would be interested to know whether the United States has a different interpretation of when WTO dispute settlement procedures conclude. Unlike Thailand's excise tax regime on cigarettes which was totally discretionary until such time as the Thai authorities imposed the tax, 301 legislation has mandatory elements which can require the United States to make an unilateral determination of the WTO consistency of another country's measures and impose trade sanctions in response. The Thai Cigarette panel recognized that legislation mandatorily requiring the executive to act inconsistent GATT obligations was a violation "...whether or not an occasion for its actual application had yet arisen;...".<sup>552</sup>

5.75 In response to the US inquiry, Canada states that as a preliminary matter prior to responding to the questions of the United States, it would note that the measures in question are those of the United States and not those of any other Member. Accordingly, the practices of any other Member and their consistency with WTO obligations are not germane to the issues before the Panel. Nonetheless, and without prejudice, Canada would provide the following responses in the interests of being helpful in resolving the broad systemic matters before the Panel.

5.76 Canada emphasizes that its legislative authority to suspend concessions in response to measures of other countries is found at subsection 13(1) of *the World Trade Organization Agreement Implementation Act*, Statutes of Canada, 1994, c.47. Although subsection 13(2) of the Act is not relevant to WTO Members, Canada reproduces below section 13 in its entirety.

#### "Orders

##### 13(1) Orders re suspension of concessions

13. (1) The Governor in Council may, for the purpose of suspending in accordance with the Agreement the application to a WTO Member of concessions or obligations of equivalent effect pursuant to Article 22 of the Understanding on Rules and Procedures Governing the Settlement of Disputes set out in Annex 2 to the Agreement, by order, do any one or more of the following:

- (a) suspend rights or privileges granted by Canada to that Member or to goods, service providers, suppliers, investors or investments of that Member under the Agreement or any federal law;
- (b) modify or suspend the application of any federal law with respect to that Member or to goods, service providers, suppliers, investors or investments of that Member;
- (c) extend the application of any federal law to that Member or to goods, service providers, suppliers, investors or investments of that Member; and

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<sup>551</sup> Statement of Administrative Action, op. cit., pp. 365-366.

<sup>552</sup> Panel Report on *Thai – Cigarettes*, op. cit., para. 84.

(d) take any other measure that the Governor in Council considers necessary.

13(2) Suspension of concessions to non-WTO Members

(2) The Governor in Council may, with respect to a country that is not a WTO Member, by order, do any one or more of the following:

(a) suspend rights or privileges granted by Canada to that country or to goods, service providers, suppliers, investors or investments of that country under any federal law;

(b) modify or suspend the application of any federal law with respect to that country or to goods, service providers, suppliers, investors or investments of that country;

(c) extend the application of any federal law to that country or to goods, service providers, suppliers, investors or investments of that country; and

(d) take any other measure that the Governor in Council considers necessary.

13(3) Period of order

(3) Unless repealed, an order made under subsection (1) or (2) shall have effect for such period as is specified in the order.

13(4) Definition of 'country'

(4) In this section, "country" includes any state or separate customs territory that may, under the Agreement, become a WTO Member".

5.77 Canada explains that pursuant to section 10 of the *Department of Foreign Affairs and International Trade Act*, Revised Statutes of Canada, 1985, as amended, chapter E-22, the powers, duties and functions of the Minister of Foreign Affairs extend to and include all matters over which Parliament has jurisdiction, not by law assigned to any other department, board or agency of the Government of Canada, relating to the conduct of the external affairs of Canada, including international trade and commerce and international development. The Minister for International Trade is appointed pursuant section 3 of the *Department of Foreign Affairs and International Trade Act* to assist the Minister of Foreign Affairs in carrying out his responsibilities relating to international trade. Canada has signed the WTO Agreement and the Agreement was approved by the Parliament of Canada by means of section 8 of the *World Trade Organization Agreement Implementation Act* (see previous paragraph for citation). These authorities give Canada its authority to exercise its rights pursuant to the WTO Agreement.

5.78 Canada further points out that prior to requesting consultation or a panel pursuant to the DSU, Canada will have concluded that a dispute exists between itself and another WTO Member with respect to one of the WTO covered agreements or a Plurilateral Trade Agreement to which both Canada and the other WTO Member are party. Prior to proceeding with such

action, Canada will have satisfied itself that it has a legitimate claim and that the matter is justiciable under the DSU.

5.79 Canada argues that Article 23(a) expressly notes that recourse to dispute settlement in accordance with the DSU is permitted. Canada, in requesting consultations or panels under the DSU is acting in accordance with the DSU and therefore in conformity with Article 23(a). Canada notes that it is interesting that the drafters of the DSU specifically chose the word "determination" in drafting Article 23 as that happens to be the exact language used in the Trade Act of 1974.

5.80 Canada states that its measures are fully consistent with its international obligations and in particular its obligations under the *WTO Agreement*. If any measures are determined pursuant to the DSU to be inconsistent with Canada's obligations, Canada will take the appropriate actions to eliminate the inconsistency or remedy the nullification and impairment of benefits determined to accrue to other Members.

5.81 In the view of Canada, past GATT practice<sup>553</sup> has clearly established that to the extent that legislation is mandatory it is no defence to claim that it has not been applied or enforced in a manner contrary to the WTO Agreements. The very existence of mandatory legislation influences decisions of economic operators and, as such, has a "chilling" economic effect.

5.82 In response to the Panel's question as to whether DSU Article 23.2 prohibits any determination on WTO consistency or any determination to the effect that a violation has occurred, Canada states that Article 23(a) of the DSU prohibits determinations of non-consistency with WTO obligations or the existence of nullification or impairment or any impediment of the objectives of WTO covered agreement except through recourse to DSU procedures. The Article does not prohibit determination of consistency with WTO norms. Any such prohibition would be counterproductive to the objectives of Article 3.7 of the DSU which states that "(a) solution mutually acceptable to the parties to the dispute and consistent with the covered agreements is clearly to be preferred".

5.83 Canada further argues that the answer to this question must necessarily be speculative, as the question does not set forth the basis of the reasoning that would apply to the finding of inconsistency. The DSU is applicable to measures of WTO Members that impair any benefits accruing to other WTO Members under any covered agreement. Depending upon the reasoning underlying a finding that Sections 301 to 310 are WTO inconsistent, a measure of the United States, enforceable pursuant to DSU procedures, that those sections could only be applied in a manner consistent with the DSU would remove the WTO inconsistency and provide a remedy for non-compliance.

#### **4. Conclusion**

5.84 Canada claims that the mandatory nature of section 301 legislation is clear even if there are a number of instances where a determination could occur which would terminate the application of the legislation. Canada emphasises its recognition that 301 legislation combines mandatory and discretionary elements. Those opportunities for self-control do not alter the fact that section 301 legislation can culminate in a situation where retaliatory actions are mandated notwithstanding the status of such matters pursuant to the DSU.

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<sup>553</sup> Panel Report on *US – Malt Beverages*, op. cit.

5.85 Canada further argues that the facts surrounding the timing of the arbitrators' decision in the arbitration under article 22.6 of the DSU between the European Communities and the United States concerning the validity of the EC's implementation of the DSB's recommendations concerning the EC's banana import regime are well known. Canada does not intend to add to the EC's narrative on this point. Those facts demonstrate that DSB dispute settlement procedures do not necessarily coincide with the time frames set out in US 301 legislation in which the United States took the actions noted by the European Communities. This panel should clearly indicate to WTO Members that such an application of domestic legislation to suspend WTO benefits and concessions without DSB authorization results in a violation of a Members obligations under the DSU.

5.86 Canada submits that the Panel should find that where the statutory language contained in Sections 301-310 of the US Trade Act of 1974 results in an unilateral determination that a WTO violation by another Member has occurred or in the implementation of retaliatory measures against another Member without DSB authorization, such actions and mandatory provisions requiring such actions are inconsistent with the United States' obligations under the Dispute Settlement Understanding.

## C. CUBA

### 1. Introduction

5.87 **Cuba indicates** that it has a substantial systemic interest in this dispute, which is important for the entire system of trading relations among Members of the Organization. The principle of multilateral decision-making which is the cornerstone of the WTO and on which its functioning is based is the crux of this case.

### 2. Legal Arguments

5.88 Cuba recalls that all WTO Members have freely accepted to belong to a multilateral system based on rules which must be respected. To that end, they are obliged to ensure that their domestic legislation is adapted to and meets those rules. Without the security that all Members will abide by the rules, there can be no certainty of a genuine multilateral system meeting the interests of all.

5.89 Cuba considers that the conflicts stemming from the actions of Members in their mutual relations must be resolved multilaterally and in accordance with the provisions of the Understanding on Rules and Procedures Governing the Settlement of Disputes. Any unilateral action taken by a country is harmful to the predictability and stability of, and confidence in, the dispute settlement mechanism, as well as being a blatant violation of the WTO principles, objectives and rules and of the commitments entered into in the multilateral negotiating framework. Various ministerial declarations adopted in this forum bear this out. Recourse to unilateral measures encourages unilateral responses, which heightens and extends conflicts rather than helping to resolve them.

5.90 Cuba notes that the DSU is the applicable set of rules for making determinations as to whether a Member's law, policy or practice is incompatible with the covered WTO Agreements. It also establishes provisions governing the application of sanctions against Members that infringe the multilateral rules.

5.91 Cuba argues that Sections 301-310 of the United States Foreign Trade Act of 1974 establish a unilateral procedure for applying sanctions against other States, including WTO



Members, where the United States considers that its trade interests are affected. The time-limits provided for carrying out this procedure are different from, and incompatible with, those laid down in the DSU. The measures in question are adopted on the basis of unilateral determinations, outside the Dispute Settlement Body, and without its prior authorization. Their duration is also a matter for unilateral decision by the United States. The latter thus becomes both judge and party in international trade conflicts.

5.92 Cuba further claims that the WTO system of rules is based on the principles of public international law, of which it is a specialized sub-system. In this connection, the above-mentioned provisions of the Foreign Trade Act of 1974 violate the principle of sovereign equality of States, one of the central pillars of public international law, according to which in the full exercise of their sovereignty all States enjoy equal rights and at the same time are equally obliged to respect the rules governing their mutual relations. They also infringe the "*pacta sunt servanda*" principle governing the implementation of treaties, whereby the signatories to an international agreement must fulfill the agreed provisions.

5.93 Cuba also points out that in the dispute with which Cuba is concerned, another important factor is the particularity of the United States legal system in which national law has primacy over international law in cases where there is a conflict of provisions, regardless of the time at which one was adopted in comparison with the other. By making domestic law prevail over multilateral law, the United States limits the complete fulfilment of the obligations entered into under international agreements, thereby reducing confidence in its undertakings.

5.94 Cuba further contends that as far as this Organization is concerned, pursuant to Article XVI:4 of the Agreement Establishing the WTO, Members have the responsibility to ensure the conformity of their domestic laws and administrative procedures with their obligations under the covered agreements. The Foreign Trade Act of 1974 is a violation of this provision.

5.95 In the view of Cuba, the above-mentioned Act ignores the procedures provided for in the DSU, to which all of Members entrust the guardianship of their rights and obligations. It disregards the undertaking to comply with the principles set out in Article 3, as well as the provisions on surveillance of implementation of recommendations and rulings of the Dispute Settlement Body and compensation or suspension of concessions contained in Articles 21 and 22 of the DSU.

5.96 Cuba argues that by adopting these unilateral measures, the United States weakens the multilateral trading system and disregards Article 23 of the DSU, which provides that Members shall not make a determination as to the existence of a violation or nullification or impairment of benefits, or the attainment of the objectives of the covered agreements, except through recourse to dispute settlement in accordance with the procedures of the DSU. The above-mentioned legislation also encourages recourse to practices that lie outside the international trade rules, and creates a situation of uncertainty and disrespect for the multilaterally agreed provisions.

5.97 Cuba further alleges that this is a question not only of the existence of the violation caused by the above-mentioned legislation, but also of the ensuing nullification or impairment of legitimate benefits accruing to Members directly or indirectly from the GATT 1994 and membership of the WTO, within the meaning of Article XXIII of the GATT 1994.

5.98 In the opinion of the Republic of Cuba, Sections 301-310 of the Foreign Trade Act of 1974 contribute to establishing a power-based policy in international economic relations, creating an atmosphere of insecurity and unpredictability.

5.99 Cuba notes that in practice, it has seen how far the friction among Members as a result of the application of this Act can lead, and the danger it represents for the stability of the Organization at a time when it is essential to preserve balance and security in order to achieve the objectives that Members have agreed upon multilaterally.

5.100 Cuba then urges the Panel to find that Sections 301-310 of the Foreign Trade Act of 1974 are inconsistent with the WTO rules and at the same time to recommend that the United States Government bring its legislation into line with the obligations imposed upon it as a Member of the Organization.

#### D. DOMINICA AND ST. LUCIA

##### 1. Introduction

5.101 **Dominica and St. Lucia jointly indicate** that the interest of the Commonwealth of Dominica and St Lucia in this case derives from the indirect impact of Section 301 procedures on their rights, and the attainment of the legitimate objectives of the WTO Agreements. It also stems from the important systemic issues raised in the case which threaten the multilateral system on which those without the power either to threaten unilateral measures or to defend themselves against them must depend.

##### 2. Legal Arguments

5.102 Dominica and St. Lucia claim that the actions taken by the United States in the *Bananas case* are not the subject of the present proceedings. Their interventions on the clear violation of WTO rules with respect to US actions in that regard will be made before another panel. The initial EC complaint, on which this panel is expected to rule, is limited to the compatibility of US law as such with the obligations imposed on the United States by the WTO Agreements. The recent actions of the USTR in the *Bananas* dispute, however, are instructive in so far as they highlight US administrative practice and show that the strict timetables imposed by Section 301 procedures are in fact mandatory and can lead to conflict with US obligations in the WTO.

5.103 Dominica and St. Lucia argue that the "discretion" given to the USTR to delay action in certain limited circumstances and the never used Presidential discretion are in fact a legal nicety with no bearing on reality. The expectations of economic actors in the market place are not built upon the technical distinction between "compulsory" and "mandatory" in US domestic law.

5.104 Dominica and St. Lucia note that the USTR announcement on March 3rd, of the immediate withholding of customs liquidation and possible retroactive imposition of 100% duties on targeted EC imports, in spite of the "Initial Decision" of the Arbitration Panel that it required further time to make a determination in the case, is clear evidence of the USTR's interpretation of the legislation that precedence must be accorded to US domestic timetables over international rules of due process.

5.105 Dominica and St. Lucia claim that the trade measures taken by the United States in the *Bananas* dispute have clearly shown that US domestic law will not be constrained by WTO timetables.

5.106 Dominica and St. Lucia contend that the pressures imposed on WTO dispute settlement procedures and the complexities of particular cases have led the Dispute Settlement Body to adopt a flexible approach to time limitations specified in the DSU. Section 301 procedures, however, do not provide sufficient flexibility for upholding the multilateral system. They do not allow the United States to comply with the rules of the DSU and other WTO obligations in situations where the DSB has, by the end of those time limits, not made a prior determination that the WTO Member concerned has failed to comply with its WTO obligations and has not authorized the suspension of concessions or other obligations on that basis.

5.107 In the view of Dominica and St. Lucia, the strengthened multilateral system and judicialisation of the dispute settlement process were designed to promote the 'international rule of law'. The rule of international law requires that governments act under that law.

5.108 For Dominica and St. Lucia, Article XVI:4 of the Marrakesh Agreement requires each Member to "ensure the conformity of its laws, regulations and administrative procedures with its obligations as provided in the annexed [WTO] agreements". The US domestic implementing legislation, the Uruguay Round Agreements Act of 1994 (URAA), explicitly states (in section 102(a)) that the Act shall not be construed to limit Section 301 authority. Section 301 procedures were not designed to promote the security and predictability of the multilateral trading system. Given the economic and political power of the United States, Section 301 procedures are in effect a sword of Damocles hanging over us all.

5.109 Dominica and St. Lucia recall that the basic notion behind the multilateral approach to retaliation was espoused half a century ago by the drafters of the Havana Charter. It was designed to "tame retaliation, to discipline it, to keep it within bounds ..., to convert it from a weapon of economic warfare to an instrument of international order". (UN Doc. E/PC/T/A/PV6, page 4) In the *Bananas dispute* at every step of the way there was the veiled threat of US unilateral action.

5.110 In support of this argument, Dominica and St. Lucia contend that the use of Section 301 procedures is widely associated with the threat of WTO-illegal action.<sup>554</sup> Dominica and St. Lucia note that "veiled threats" are, by very definition, usually not documented. In light of this, Dominica and St. Lucia provided two letters as primary evidence of their assertion and further supplemental background materials on the *Bananas* crisis and the threat posed to the multilateral system by USTR rigid adherence to Section 301 timetables.<sup>555</sup>

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<sup>554</sup> Dominica and St. Lucia cite, e.g. David Palmeter, "A Few - Very Few - Kind Words for Section 301", in Philip Ruttley, Ian Mac Vay & Carol George, eds., *The WTO and International Trade Regulation* (London: Cameron May, 1998) 123, indicating at 124: "Section 301 was, and to many, still is, notorious. It is the vehicle by which the United States is perceived, with an extremely high degree of accuracy, to pursue whatever threat advantage it possessed. Section 301, it is safe to say, embodies few principles of justice, Rawlsian or otherwise".

<sup>555</sup> Dominica and St. Lucia submitted WT/DSB/M/54, p. 4; WT/GC/M/37, pp. 3-4; WT/DSB/M/53; WT/DSB/M/59; Guy de Jonquieres, "Bananas and beef take trade conflict to the brink", *Financial Times*, 22/10/98, p.8; Frances Williams, "US steps up banana battle with EU", *Financial Times*, 22/10/98, p.8; Guy de Jonquieres, "Nerves are taut as leaders hint at an EU-US trade war", *Financial Times*, 9/11/98, p.3; Guy de Jonquieres, "Trade war edges closer as US plans action against EU exports", *Financial Times*, 9/11/98, p.22; "The US and EU go Bananas", *Financial Times*, 11/11/98, p.19; Neil Buckley, "Brussels rejects US banana peace offer", *Financial Times*, 20/11/98, p.5.

5.111 In the view of Dominica and St. Lucia, Article 22.6 of the DSU clearly states that "[c]oncessions or other obligations shall not be suspended during the course of the arbitration". A deadline for retaliation which precedes the completion of arbitration proceedings is evidence of 'aggressive unilateralism'.

5.112 In response to the Panel's question regarding the relevance of a specific case under Section 301, Dominica and St. Lucia state that a panel has a duty to review all relevant evidence. As such, this Panel must take legal notice of US actions leading to the suspension of concessions in the *Bananas* case to the extent that it is evidence germane to the 'matter' referred to it by the DSB.

5.113 Dominica and St. Lucia recall that the "matter" referred to the Panel consists of two elements: "the specific *measures* at issue and the *legal basis of the complaint* (or the *claims*)".<sup>556</sup> Taken together these elements constitute the dispute which is properly before the panel as defined in its terms of reference: "A panel's terms of reference are important for two reasons. First, terms of reference fulfil an important due process objective -- they give the parties and third parties sufficient information concerning the claims at issue in the dispute in order to allow them an opportunity to respond to the complainant's case. Second, they establish the jurisdiction of the panel by defining the precise claims at issue in the dispute".<sup>557</sup>

5.114 Dominica and St. Lucia point out that although measures not explicitly mentioned in a complaint may nevertheless be covered by a panel's terms of reference, "it seems clear that a 'measure' not explicitly described in a panel request must have a clear relationship to a 'measure' that is specifically described therein, so that it can be said to be 'included' in the specified 'measure'".<sup>558</sup> Similarly, claims which a panel is entitled to consider should also be stated in the panel request. A distinction is made, however, between "actions", on the one hand, and "measures" and "claims", on the other.<sup>559</sup>

5.115 According to Dominica and St. Lucia, it is one thing to submit to a panel the examination of a particular measure claiming that that measure does not conform to the WTO obligations of a Member. It is another, completely different thing to submit to a panel the existence of a specific action of a Member as evidence supporting the claims with respect to the "matter" which is properly before the panel. The first hypothesis is the case of the "Import Measures" panel. The second, is the "Section 301" panel procedure.

5.116 Dominica and St. Lucia argue that there should be no question of confusion, or overlap or even divergence. This Panel may take legal notice of the US actions leading to the suspension of concessions in the *Bananas* case as pertinent evidence for the interpretation of Sections 301-310 as such. Whether US actions in this regard are themselves in conformity with US

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<sup>556</sup> *Guatemala - Anti-dumping Investigation Regarding Portland Cement from Mexico*, adopted on 25 November 1998, WT/DS60/AB/R, para. 72. See also DSU, Article 6.2.

<sup>557</sup> Appellate Body Report on *Brazil - Measures Affecting Dessicated Coconut*, adopted on 20 March 1997, WT/DS22/AB/R, p. 21.

<sup>558</sup> Panel Report on *Japan - Measures Affecting Consumer Photographic Film and Paper*, adopted on 22 April 1998, WT/DS/44/R, para. 10.8. Dominica and St. Lucia also cite, e.g. Appellate Body Report on *EC - Bananas III*, op. cit., para. 142; Appellate Body Report on *Australia - Measures Affecting the Importation of Salmon* ("*Australia - Salmon*"), adopted 6 November 1998, WT/DS18/AB/R, op. cit., paras. 90-105; Panel Report on *Argentina - Safeguard Measures on Imports of Footwear*, circulated 25 June 1999, WT/DS121/R, paras. 8.23-8.46.

<sup>559</sup> Dominica and St. Lucia cite e.g. Appellate Body Report on *Guatemala - Cement*, op. cit., paras. 69-73, 84-86.

obligations under the WTO Agreements will be addressed by another panel and it is not required that this Panel rule on that issue.

5.117 Dominica and St. Lucia argue that the terms of reference of this Panel call for an examination of the specific claims stated by the complainant in WT/DS152/11. The EC complaint is limited to the compatibility of US law as such with the obligations imposed on the United States by the WTO Agreements. Where municipal law is examined as evidence of compliance or non-compliance with international obligations, it is within the competence of an international tribunal to review evidence on whether or not, in applying that law, the Executive is acting in conformity with its obligations under international law.<sup>560</sup> In such a case, legislation cannot be assessed in abstract.

5.118 Dominica and St. Lucia note that the European Communities refers to US actions leading to the suspension of concessions in the *Bananas* case as confirming "what the text of Section 306(b) indicates, namely that the USTR must implement the further action decided upon irrespective of whether that action conforms to the requirements of Article 22 of the DSU". Dominica and St. Lucia assert that US actions in the *Bananas* dispute highlight US administrative practice and show that the strict timetables imposed by Section 301 procedures are in fact mandatory and can lead to conflict with US obligations in the WTO. The mere fact that certain of these actions are now subject to review by another panel does not preclude this Panel from taking legal notice of all relevant evidence.

5.119 In response to the US inquiry, Dominica and St. Lucia state that a series of reports to Congress on 'Section 301' developments as required by section 309(a)(3) of the Trade Act of 1974 chronicle the implementation of Section 301 mandates in the *Bananas* case. The term "Section 301" is generally used as shorthand for Chapter 1 of Title III of the Trade Act of 1974, as amended, which covers Sections 301-310, the subject of the EC complaint.

5.120 Dominica and St. Lucia point out that with regard to the March 3<sup>d</sup> announcement, the USTR made clear in a public notice requesting comments on anticipated US action as required under Sections 301-310 that:

"Given that the reasonable period of time for the EC's implementation of the WTO recommendations concerning the EC banana regime expires on January 1, 1999, the USTR must make the determination required by section 306(b) no later than January 31, 1999, and, in the event of an affirmative determination, must implement further action no later than 30 days thereafter".<sup>561</sup>

5.121 Dominica and St. Lucia argue that although the March 3<sup>d</sup> announcement does not explicitly refer to Section 301 authority, this does not infer that the March 3<sup>d</sup> announcement "did not involve Section 301".

5.122 Dominica and St. Lucia note that a number of GATT/WTO panels have examined complaints by different contracting parties involving the same or similar measures of a responding party. To the extent that there is overlap in the scope of review panels have taken into account the reasoning in previous panel and Appellate Body reports. Additionally, the

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<sup>560</sup> Dominica and St. Lucia refer to Appellate Body Report on *India – Patents (US)*, op. cit., paras. 65-66, citing *Certain German Interests in Polish Upper Silesia* [1926], PCIJ Rep., Series A, No.7, p.19.

<sup>561</sup> Federal Register, Vol. 63, No.204, Thursday, 22 October 1998, pp. 56688 and 56689.

Appellate Body has been mindful of its role in providing security and predictability to the multilateral system through ensuring consistency and coherence in WTO jurisprudence.

5.123 Dominica and St. Lucia claim that the task of this Panel is to make an objective assessment of the matter before it, including an objective assessment of the facts of the case.<sup>562</sup> Even where there are multiple complaints related to the same matter the DSU does not circumscribe the jurisdiction of any panel(s) established to examine the complaints. Article 9 of the DSU on 'Procedures for Multiple Complainants' is "a code of conduct for the DSB because its provisions pertain to the establishment of a panel, the authority for which is exclusively reserved for the DSB".<sup>563</sup> Neither Article 9 nor any other provision of the DSU authorizes a panel to retroactively redefine the scope of its review simply because another panel has been established to examine related issues. The jurisdiction of a panel is defined at the moment at which it becomes seised of a 'matter'. Events occurring subsequent to this should not be presumed to exclude from a panel's consideration evidence which would otherwise be deemed relevant.<sup>564</sup>

5.124 Dominica and St. Lucia then conclude that the establishment of a panel to review certain US actions leading to the suspension of concessions in the *Bananas* case involves procedural considerations which do not diminish the responsibility of this Panel to make an objective assessment of the matter before it, including an objective assessment of all relevant evidence adduced in the case.

5.125 Dominica and St. Lucia further contend that WTO/GATT jurisprudence suggests that the GATT and the GATS covers both *de jure* and *de facto* breaches; *viz.* the issue is not whether regulations on the face of it comply with WTO rules but whether as administered they in fact do.

5.126 Dominica and St. Lucia note that when one's livelihood and survival depends on something, it is impossible to ignore the frightening ramifications of a situation in which what a powerful country "considers" to be WTO-compatible or incompatible may be even more important than what the multilateral system determines.

5.127 Dominica and St. Lucia then respectfully request the Panel to find that the challenged Section 301 procedures are inconsistent with US obligations under the WTO Agreements and recommend that the DSB request the United States to bring its Trade Act of 1974 into conformity with its WTO obligations.

5.128 In response to the Panel's question as to whether DSU Article 23.2 prohibits any determination on WTO consistency or any determination to the effect that a violation has occurred, Dominica and St. Lucia state that Article 23.2(a) of the DSU prohibits WTO Members from making "a determination to the effect that a violation has occurred, that benefits have been nullified or impaired or that the attainment of any objective of the covered agreements has been impeded, except through recourse to dispute settlement in accordance with the rules and procedures of this Understanding". The preambular words of Article 23.2 refer to "such cases"

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<sup>562</sup> See DSU, Article 11.

<sup>563</sup> Panel Report on *India – Patents (EC)*, *op. cit.*, para. 7.14.

<sup>564</sup> Dominica and St. Lucia note that GATT/WTO jurisprudence affirms the legitimacy of using updated information concerning the same measures to inform an assessment of the substantive complaint before a panel, *e.g.* Panel Reports on *Korea – Beef*, all adopted on 7 November 1989 (BISD 36S/202, 234 and 268), paras. 99-101, 115-117, 121-123).

as addressed in Article 23.1. Article 23.1 concerns actions taken to redress measures which violate WTO rules or otherwise impede the attainment of any objective of the WTO agreements.

5.129 Dominica and St. Lucia further argue that Article 23, read in its context,<sup>565</sup> suggests that the strengthened multilateral system proscribes any unilateral determination on WTO consistency which has consequences for other WTO Members without respect for due process.

5.130 In the view of Dominica and St. Lucia, a multilateral determination on WTO consistency is a necessary and central element in providing security and predictability in the implementation of WTO rules. The Appellate Body Report on the *EC – Bananas III* case emphasizes that "with the increased interdependence of the global economy, which means that actions taken in one country are likely to have significant effects on trade and foreign direct investment flows in others, Members have a greater stake in enforcing WTO rules than in the past since any deviation from the negotiated balance of rights and obligations is more likely than ever to affect them, directly or indirectly".<sup>566</sup> If every Member has a stake in enforcing WTO rules then no unilateral determination on WTO consistency which in any way prejudices the rights of other Members is permissible, except through recourse to the rules and procedures of the DSU.<sup>567</sup>

5.131 Dominica and St. Lucia contend that Article 3.7 of the DSU exhorts a Member before bringing a case to exercise its judgement as to whether action under dispute settlement procedures would be fruitful. This is likely to entail an assessment of the WTO-consistency of measures taken by another Member. Such a preliminary determination *per se* would not be a "determination" on WTO consistency in violation of Article 23 as it should not preclude other Members from challenging the legitimacy of the measures in question.

5.132 Dominica and St. Lucia are of the view that legislation merely facilitating such a "determination", however, must be distinguished from legislation which triggers retaliatory action where one "considers" non-implementation to have occurred. The "threat advantage" of WTO-illegality undermines the fundamental objectives of Article 23 of the DSU. The very fact that a determination must be made whether or not WTO rules are being infringed holds other WTO Members to ransom.

5.133 Dominica and St. Lucia then argue that the strengthened multilateral system requires that Members have recourse to, and abide by, the rules and procedures of the DSU. The

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<sup>565</sup> Dominica and St. Lucia point out that for example, Article 3 of the DSU also underscores the precedence of the multilateral system over the positions adopted by individual Members. Article 3.6, for example, provides that where the parties to a dispute achieve a mutually agreed solution to matters formally raised under the consultation and dispute settlement provisions of the covered agreements, this shall be notified to the DSB and the relevant Councils and Committees, where any Member may raise any point relating thereto. As such, even where there is a mutually agreed solution between parties to a dispute this is subject to multilateral review.

<sup>566</sup> Appellate Body Report on *EC – Bananas III*, op. cit., para. 7.50.

<sup>567</sup> Dominica and St. Lucia note that the Uruguay Round Agreements essentially deny a right of auto-interpretation in the multilateral trading system. Article IX:2 of the Marrakesh Agreement complements Article 23 of the DSU; see also DSU, Article 3.9. The strengthened multilateral system empowers the collective will to make "determinations" not individual Members. Significantly, the Appellate Body report on *Japan - Alcoholic Beverages*, op. cit., Section E states: "The fact that such an 'exclusive authority' in interpreting the treaty has been established so specifically in the WTO Agreement is reason enough to conclude that such authority does not exist by implication or by inadvertence elsewhere".

principle of 'automaticity' ensures that the strengthened multilateral system will function. The wheels of justice may, at times, turn slowly but the multilateral determination on WTO consistency should be, at all times, all important. If the unilateral determinations of a WTO Member are viewed as of greater significance, then the multilateral system is threatened.

5.134 In the view of Dominica and St. Lucia, Article 23.2(a) of the DSU effectively prohibits Members to take any determination on WTO consistency with consequences for the multilateral system without recourse to dispute settlement in accordance with the rules and procedures of the DSU.

5.135 Dominica and St. Lucia, in response to the Panel's question as to whether an official US statement binding in international law that the US government will not exercise its discretion in a way contrary to WTO rule remove the WTO inconsistency of Sections 301-10 on the assumptions that the USTR and the President have the discretion to avoid determinations and actions contrary to WTO rules in all circumstances, and that, nevertheless, Sections 301-310 were found inconsistent with WTO rules, state that such an official US statement, whether or not binding in international law, would not remove the WTO inconsistency. The binding nature of unilateral declarations is a matter of wide jurisprudential debate. Article 38 of the Statute of the International Court of Justice (ICJ) refers to international conventions, whether general or particular; international custom, as evidence of a general practice accepted as law; general principles of law; and other subsidiary means for the determination of rules of law. It does not mention unilateral declarations.

5.136 Dominica and St. Lucia explain that Article 38 of the ICJ Statute, arguably, is not an exhaustive statement of the sources of international law. The *Nuclear Test cases*<sup>568</sup> and *Frontier Dispute case*<sup>569</sup> suggest that in certain limited circumstances an official statement, if given publicly, with the clear intent of binding a State to a particular course of conduct will be upheld by an international tribunal. Appellate Body reports increasingly refer to general international law principles as applied in the case law of the ICJ. This 'cooperation among international courts' and 'cross-fertilization' of legal systems enhances the legitimacy, consistency and political acceptability of WTO dispute settlement rulings.<sup>570</sup> The *Nuclear Test cases* and *Frontier Dispute case*, however, stand as the exception rather than the rule. It is widely believed that, "States don't mean what they say, and don't say what they mean". It therefore seems questionable whether the existing degree of legal insecurity surrounding Section 301 procedures would be removed by an official US statement.<sup>571</sup>

5.137 Dominica and St. Lucia recall that Article 3.7 of the DSU suggests that "[t]he aim of dispute settlement mechanism is to secure a positive solution to a dispute". A positive solution is one which promotes the security and predictability of the multilateral trading system. An official statement that the US government will not exercise its discretion in a way contrary to WTO rules seems hardly adequate in light of the clear pressure which may be applied on the Executive in individual cases. The "threat advantage" of WTO-illegality is further bolstered by

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<sup>568</sup> (*Australia v. France; New Zealand v. France*) ICJ Rep. 1974, pp.253, 457, esp. paras. 43-45; but see Sir Garfield Barwick J., diss. op. See also *Legal Status of Eastern Greenland (Denmark v. Norway)* (1933) PCIJ Rep., Series A/B, No. 53, Anzilotti J., diss. op.

<sup>569</sup> ICJ Rep. 1986, p.554 at p.573.

<sup>570</sup> Dominica and St. Lucia cite Ernst-Ulrich Petersmann, "Dispute Settlement in International Economic Law - Lessons for Strengthening International Dispute Settlement in Non-Economic Areas" (1999) 2 J.I.E.L. 189 at 209.

<sup>571</sup> Dominica and St. Lucia also cite Panel Report on *India – Patents (US)*, op. cit., paras. 63-71 on the need to provide a sound legal basis for implementing WTO obligations.



section 102(a) of the Uruguay Round Agreements Act of 1994 (URRA), which explicitly provides that the Act shall not be construed to limit Section 301 authority. The debates on the legislation which evidence Congressional intent further reinforce this view. Statements of the USTR at the time show the Executive's clear concurrence:

"Just as the United States may now choose to take Section 301 actions that are not GATT-authorized, governments that are the subject of such actions may choose to respond in kind. That situation will not change under the Uruguay Round Agreements. The risk of counter-retaliation under the GATT has not prevented the United States from taking actions in connection with such matters as semiconductors, pharmaceuticals, beer, and hormone-treated beef".<sup>572</sup>

5.138 Dominica and St. Lucia then argue that a positive solution is one which removes the "threat advantage" in the administration of Section 301 procedures. It is one which provides the secure basis on which those without the power either to threaten unilateral measures or to defend themselves against them must depend.

5.139 Dominica and St. Lucia state that the suggestion that an official statement may be sufficient to comply with the mandates imposed in Article XVI:4 of the Marrakesh Agreement that "[e]ach Member shall ensure the conformity of its laws, regulations and administrative procedures with its obligations as provided in the annexed Agreements", indeed, could create an even more fundamental problem than the one this Panel is now addressing.

5.140 Dominica and St Lucia add that both of them are parliamentary democracies with dualist legal systems. No legislation has been passed specifically directing Executive action on making determinations regarding WTO rights and obligations before panel and Appellate Body reports have been adopted. Additionally, the Commonwealth of Dominica and St Lucia have not been a complainant or respondent in WTO dispute settlement proceedings, nor initiated consultations under the DSU. Where the Commonwealth of Dominica and St Lucia have requested to be joined in consultations they have sought to protect their interests through recourse to the rules and procedures of the DSU.

## E. DOMINICAN REPUBLIC

### 1. Introduction

5.141 **The Dominican Republic welcomes** this opportunity to participate as Third Party in these proceedings in order to add its voice in support for a single multilateral procedure for the settlement of trade disputes.

### 2. Legal Arguments

5.142 Like Brazil, the Dominican Republic is of the view that "a law that is inconsistent with the obligations of a Member under the WTO Agreements can be challenged under the dispute settlement procedures. The issue before the Panel is ... the need to bring the law into conformity with relevant WTO provisions, as provided in Article XVI:4 of the WTO Agreement".

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<sup>572</sup> SSA, 367, 1994 USCCAN at 4321.

5.143 Like the European Communities, the Dominican Republic is of the view that "WTO Agreements cannot provide security and predictability unless Members settle all their trade disputes in accordance with the procedures of the Dispute Settlement Understanding (DSU)".

5.144 Like Japan, the Dominican Republic is of the view that "WTO Members are prohibited from unilaterally suspending concessions or other obligations under the WTO Agreement".

5.145 Like Brazil, the Dominican Republic is of the view that, given "the scope of authority available to the US Administration to proceed without recourse to DSU procedures in Section 301 (c)", the United States seeks "to pursue the removal of practices that do not violate US rights" by threatening "to violate the rights of WTO Members". This clearly contradicts Article 23 of the DSU.

5.146 Like India, the Dominican Republic agrees with the relevance of US views expressed in other Panel proceedings, where it stated that "the domestic law of a Member must not only be such as to enable it to act consistently with its WTO obligations but the domestic law must also not create legal uncertainty by prescribing WTO-inconsistent measures".

5.147 Like Hong Kong, China, the Dominican Republic is of the view that "good faith implementation of international obligations should not be accidental, nor merely the outcome of exercise of discretion by a Member government".

5.148 Like the Republic of Korea, the Dominican Republic believes firmly that the publication of retaliation lists "clearly affect the competitive relationship between the targeted products and similar products from all other countries".

5.149 The Dominican Republic then requests respectfully to the Panel to rule along the lines proposed by the European Communities and by Brazil, Japan, Hong Kong, China, India and Korea, and that it also give due consideration to two additional concerns:

- (a) Section 301(c)(1)(C) establishes a number of eligibility criteria for the continued market access under preferential trading conditions. In addition, Section 301(d)(3)(B) defines:

"(B) Acts, policies, and practices that are unreasonable include, but are not limited to, any act, policy or practice, or any combination of acts, policies or practices, which—

(i) denies fair and equitable—

(I) opportunities for the establishment of an enterprise,

(II) provision of adequate and effective protection of intellectual property rights notwithstanding the fact that the foreign country may be in compliance with the specific obligations of the Agreement of Trade-Related Aspects of Intellectual Property Rights referred to in section 101(d)(15) of the Uruguay Round Agreements Act.

(III) nondiscriminatory market access opportunities for United States persons that rely upon intellectual property protection, or

(IV) market opportunities, including the toleration by a foreign government of systematic anticompetitive activities by enterprises or among enterprises in the foreign country that have the effect of restricting, on a basis that is inconsistent with commercial considerations, access of United States goods or services to a foreign market",

- (b) In none of the cases listed it is required that the US person that is deemed to be affected by the "unreasonable" conditions subject the act, policy or practice in question to a judicial review. Rather, "watch", "priority watch" and other types of country lists are elaborated based solely on petitions (section 302(a)) or requests of petitions in the Federal Register (section 302(b)) with a disproportionate effect on the viability of the activities concerned, whether or not these are beneficiaries of preferential trading conditions.

5.150 The Dominican Republic requests the Panel that it consider:

- (a) examining the consistency of these criteria with the provisions on non-discrimination in the "Habilitation Clause" (adopted by the CONTRACTING PARTIES on 28 November 1979) and the Generalized System of Preferences (as described in the Decision of the CONTRACTING PARTIES of 25 June 1971, relating to the establishment of 'generalized non-reciprocal and non-discriminatory preferences beneficial to the developing countries');
- (b) as suggested by Brazil, examining whether it is WTO-consistent to deny any WTO Member its rights because of non-violation of the rights of the United States under the WTO agreements. Specifically, section 301 (d)(B)(3)(B)(i)(I) refers to the right of establishment for an enterprise, which is not covered automatically by any WTO agreement, except in the form of a specific commitment under the General Agreement of Trade in Services (GATS); section 301 (d)(B)(3)(B)(i)(II) refers to non-violation of the provisions of the TRIPS Agreement, but the relevant article of this agreement (66.2) has yet to enter into force because a significant number of developed and developing country WTO Members have requested additional time to study the implications of carrying to the intellectual property area the provisions on non-violation devised for trade in goods; and section 301 (d)(B)(3)(B)(i)(III) refers to the toleration of anticompetitive activities, but these have yet to be disciplined by the WTO; and
- (c) examining the standard of review utilized to enforce these WTO-unrelated criteria.

5.151 In response to the Panel's question as to the relevance of "two additional concerns" in light of the terms of reference of the Panel, the Dominican Republic states that Article 7.1 of the DSU states that the Panel has to work on the basis of terms of reference. The matter at issue is "to analyze if the Sections 301-310 of the Trade Act of 1974 of the United States are inconsistent with the US international obligations under the WTO Agreements". If in the course of the process additional elements are found that can help to clarify the matter at issue, then these elements should be taken into account.

5.152 The Dominican Republic further states that the two "additional concerns" of the Dominican Republic are clear examples of how specific provisions in Section 301 of the Trade

Act of 1974 are inconsistent with the US international obligations under the WTO Agreements. They provide further evidence to the statement by Brazil that "the scope of authority available to the US Administration to proceed without recourse to DSU procedures in Section 301(c)", the United States seeks "to pursue the removal of practices that do not violate US rights" by threatening "to violate the rights of WTO Members".

5.153 The Dominican Republic emphasizes that this clearly contradicts Article 23 of the DSU.

5.154 The Dominican Republic considers that it is its right as a beneficiary of trade preferences that these be awarded in compliance with the "Habilitation Clause", that is, on a non-discriminatory basis. By conditioning trade preferences to compliance with other criteria such as the ones listed in Section 301(d)(3)(B) (criteria that are unrelated to any nation's multilateral rights), the United States threatens to violate the rights of Dominican exporters.

5.155 Further, by constantly reviewing compliance with such criteria without subjecting "interested party petitions" to established procedures of judicial review, the United States places Dominican exporters in a situation of continued juridical risk, which is what WTO Members sought to avoid by adopting a single, multilateral procedure for the settlement of trade disputes after the Uruguay Round.

5.156 Therefore, the Dominican Republic respectfully reiterates to the Panel that it should analyze also the issues of its "two additional concerns".

F. HONG KONG, CHINA

## 1. Overview

5.157 **Hong Kong, China indicates** that it decided to participate in the current proceedings as third party in view of the systemic importance of the dispute. It is our firm belief that the cornerstone of the WTO legal regime – the principle of multilateral determination of the WTO consistency of measures – shall not be undermined by domestic legislation that mandates unilateral action. We consider that Members' compliance with this principle is essential in order to ensure the security and predictability of the multilateral trading system, and to preserve Members' rights and obligations under the WTO Agreements.

5.158 Hong Kong, China does not question the right of WTO Members to enact domestic legislation to protect their legitimate trade interests, but such legislation must not detract from their obligations under the WTO. By virtue of their WTO membership, Members have subscribed to the WTO Agreements including the Dispute Settlement Understanding (DSU), and agreed to settle their trade disputes in accordance with the rules and procedures provided therein. In other words, they have agreed to refrain from adopting any unilateral measures against alleged inconsistencies of their trading partners. In this perspective, Hong Kong, China submits that Sections 304(a)(2)(A), 305(a) and 306(b) of the US Trade Act of 1974, to the extent that they oblige the United States Trade Representative (USTR) to have recourse to unilateral actions without respecting the multilateral framework for resolution of disputes as laid down in the DSU, violate the WTO obligations of the United States under the DSU.

5.159 Hong Kong, China summarises its arguments as follows: First, Hong Kong, China places the DSU in the realm of public international law. Hong Kong, China demonstrates that, through the enactment of the DSU, WTO Members have agreed to refrain from taking unilateral actions and to resort to the WTO exclusively to determine the consistency or otherwise of measures with WTO Agreements. In other words, the WTO is the exclusive forum for

determination of the WTO consistency of trade measures. Second, Hong Kong, China discusses the US legislation in question relating to adjudication of trade disputes. Adopted GATT panel reports suggest that only mandatory legislation can be found to be in violation of WTO law. We argue that the legislation being challenged in the present dispute is mandatory in nature. Third, Hong Kong, China advances some arguments, inspired by public international law, as to whether the distinction between mandatory and discretionary legislation in GATT jurisprudence is justified. Hong Kong, China essentially submits that even potential deviation from an international obligation (where a competent national authority has discretion allowing it to disrespect its international obligations) amounts to a violation of WTO rules and obligations.

## 2. Legal Arguments

### (a) Nature of the Dispute Settlement Mechanism under the GATT 1947 and the WTO

5.160 Hong Kong, China argues that by becoming a party to an international agreement, a country voluntarily assumes obligations which impose disciplines on its behaviour, in exchange for the other parties agreeing to abide by the same disciplines. In other words, rights and obligations must go together as a party's rights are derived from the obligations of the other parties. The GATT 1947, the WTO and their provisions for dispute settlement are meaningful only when appreciated in this context.

5.161 In the view of Hong Kong, China, to ensure the security of rights in a multilateral agreement, third party adjudication is a necessary feature. The injured party would tend to see wrong when it may not exist; and where it exists, there could be pressure to exaggerate the extent of the wrong. Conversely, the offending party may perceive its actions in an entirely different light. It would tend to regard its action as permissible under the agreement; or where it concedes violation, would have every incentive to downplay the degree of injury that others suffer as a result. For an agreement where rights and concessions are multilateralised, it is unthinkable to regard the offending or injured party as being competent to adjudicate on its own the legality of a measure, to determine on its own the extent of the wrong when illegality is found, or to authorize counter-measures on its own. Were such allowed in the agreement, an escalation of counter-measures would likely result, as every time counter-measures are taken, the affected party might conclude that they are disproportionate and consequently retaliate to some extent (which might in turn be regarded as disproportionate by the affected party which will retaliate further).

5.162 Hong Kong, China contends that problems relating to the proportionality of retaliatory and countermeasures can be avoided if the privilege to qualify a measure as unlawful under public international law is removed from the injured party. This is precisely why states have through conventional means always sought to give effect to the maxim *nemo in re sua (in sua propria causa) judex esse potest* (nobody should be the judge of his/her own cause). The Statute of the International Court of Justice (ICJ) also provides for compulsory third party adjudication - Article 59 St. ICJ provides the possibility for states to grant *ante hoc* consent to see all disputes against them adjudicated by the ICJ.

5.163 Hong Kong, China further argues that in the post-World War II era, states were eager to agree to the principle of third party adjudication in a functional manner for settlement of their investment-related or trade-related disputes. The Special Rapporteur of the International Law Commission (ILC) concluded in his report on "State Responsibility" that for illegal acts *de lege lata* (the law as it is) and not *de lege ferenda* (the law as it should be), there is world-wide recognition of the principle of third party adjudication and that consequently recourse to unilateral countermeasures should be lawful only in cases where the state authorizing the illegal

act refuses an invitation by the injured state to negotiate. The ILC report, which has been heralded by expert commentators, provides an authoritative indication that in the general field of public international law, the world community is moving towards compulsory third party adjudication.

5.164 Hong Kong, China notes that third-party adjudication had also been a feature of the GATT. After the GATT 1947 came into being, GATT Contracting Parties resorted to procedures laid down in Articles XXII and XXIII of GATT to resolve their trade disputes. Building on Article 92 of the Havana Charter, the two GATT Articles provided a basis for multilateral adjudication of disputes, whereby Contracting Parties undertook to refer their disputes to the GATT which would investigate the matter and make appropriate recommendations/rulings. The system served to prevent recourse to unilateral measures against alleged inconsistencies of trade measures. However, the dispute settlement procedures under the GATT were constrained by a number of factors, e.g. the parties to the dispute were allowed to block consensus on the establishment of panels and the adoption of panel reports. Notwithstanding the deficiencies of the system however, GATT Contracting Parties resorted to resolving their disputes through Articles XXII and XXIII of the GATT, rather than by resorting to unilateral adjudication and actions.

5.165 According to Hong Kong, China, the deficiencies of the GATT dispute settlement system have to a large extent been rectified under the WTO Dispute Settlement Mechanism (DSM). The DSU provides for the automatic establishment of panels upon request and the automatic adoption of panel reports, unless the Dispute Settlement Body (DSB) decides by consensus against such establishment or adoption. With this new rule of "negative consensus", the possibility of one Member blocking the establishment of panels or the adoption of panel reports no longer exists. The improvements made to the dispute settlement mechanism convey two messages. These are: parties to the GATT reaffirmed third-party adjudication as a means to resolve disputes between them, and their collective intention to make dispute resolution more effective in the WTO.

5.166 Hong Kong, China argues that the improvements secured in the Uruguay Round have indeed made the DSU a more effective-mechanism than the GATT system in resolving disputes concerning WTO agreements. In the recent DSU review, the general view has been that the DSM has been working satisfactorily and that only fine-tuning in certain respects is required. Further efforts to make the DSU work better are a reaffirmation of Members' recognition of multilateral adjudication as the way to resolve disputes between them.

5.167 Hong Kong, China states that the conclusion to be drawn is that the DSU is the exclusive forum for adjudication of trade-related disputes among WTO Members. Article 23 of the DSU further strengthens the multilateral adjudication system by obliging Members to have recourse to, and abide by, the rules and procedures of the DSU to resolve their trade disputes. All WTO Members, including the United States, have accepted this obligation.

5.168 Hong Kong, China further argues that the legal and logical consequence of the preceding analysis is that WTO Members must always seek redress of their complaints under the WTO DSU.

5.169 Hong Kong, China goes on to state that WTO law intervenes and performs its multilateral adjudication role when a WTO Member decides to complain formally about the trade policies and practices maintained by another Member. From this point onward, the WTO Member is under the obligation to have recourse exclusively to the WTO dispute settlement procedures (Article 23.2 of the DSU). It must consult with the Member concerned and, if

within the time-limits laid down in the DSU no amicable solution has been reached, may request the establishment of a dispute settlement panel. Following panel (and eventually Appellate Body) proceedings, and provided no action has been taken by the losing party to implement the DSB rulings within the reasonable period of time laid down in Article 21.3 of the DSU, the Member can request DSB's authorization to adopt counter-measures, and the DSB has to grant such authorization unless rejected by consensus.

5.170 Hong Kong, China concludes that in a nutshell, with the entry into force of the DSU, recourse to unilateral counter-measures by WTO Members is forbidden under the WTO. It is up to the WTO adjudicating bodies to pronounce the legality of measures maintained by a WTO Member and to authorize, upon request, the adoption of counter-measures. From the moment that a WTO Member has decided to complain about the trade policies and practices of another Member, it must follow the substantive and procedural obligations laid down in the DSU. To do otherwise will violate its obligations under the WTO.

5.171 In response to the Panel's question as to whether DSU Article 23.2 prohibits any determination on WTO consistency or any determination to the effect that a violation has occurred, Hong Kong, China states that the answer is in Article 23.2(a) of the DSU itself. Article 23.2(a) specifically prohibits determinations "to the effect that a violation has occurred, that benefits have been nullified or impaired or that the attainment of any objective of the covered agreements has been implemented".

5.172 In the view of Hong Kong, China, the object and purpose of the DSU are also relevant. The DSM is the exclusive forum for adjudication of trade disputes among WTO Members. Even if bilateral consultations reach a result, the result has to be WTO consistent (Article 3.5 of DSU) and it has to be notified to the DSU where multilateral control will ensure its consistency with the applicable WTO rules (Article 3.6 of DSU).

5.173 Hong Kong, China further argues that the negotiating history of the DSU, and Article 23 more specifically, confirm this interpretation: it was negotiated with a view to ensure that recourse to unilateralism would not be an option for WTO Members.

#### **(b) Application**

5.174 Hong Kong, China argues that Section 303 of the Trade Act of 1974 prescribes that on the date on which an investigation under Section 302 is initiated, the USTR shall request consultations with its trading partner in accordance with Article 4.3 of the DSU. Section 304(a)(2)(A) requires the USTR to determine whether the rights of the United States are being denied on or before the earlier of (i) 30 days after the date on which the dispute settlement procedure is concluded, or (ii) the date that is 18 months after the date on which the investigation is initiated. According to Section 306(b), if the USTR considers that its trading partner has failed to implement the DSB rulings, he/she shall make a determination, no later than 30 days after the expiry of the reasonable period of time provided for in Article 21.3 of the DSU, what further (retaliatory) action must be taken under Section 301(a). Finally, according to Section 305(a), the USTR shall implement the (retaliatory) action no later than 30 days after he/she made the determination. In this connection, Hong Kong, China notes that Section 305(a)(2)(A) provides that implementation of the (retaliatory) action may be delayed by no more than 180 days if the USTR considers, *inter alia*, that substantial progress is being made, or that a delay is necessary or desirable to obtain US rights or a satisfactory solution. However, it should be noted that in exercising his/her discretion to delay implementation, the USTR is not obliged to observe the rules and procedures stipulated in the DSU.

5.175 Hong Kong, China considers that as the European Communities mentioned, the timeframe stipulated by the cited sub-sections of the US Trade Act is shorter than that within which one can reasonably expect DSB findings on that matter. In such a case though, Section 304(a)(2)(A) mandates the USTR to make a determination of whether the US rights have been denied, independently of the still missing multilateral determination on the same issue.

5.176 Hong Kong, China points out that the USTR of course has discretion as regards the determination that he/she will make. This does not at all annihilate the mandatory character of the US legislation in question. What counts is not the eventual content of the USTR's determination. What counts is the very fact that the USTR is mandated to make such a determination, notwithstanding the clear and unambiguous provision of DSU Article 23.2(a) that Members shall not make a determination to the effect that a violation has occurred or that benefits have been nullified or impaired, except through recourse to dispute settlement in accordance with the rules and procedures of the DSU.

5.177 Hong Kong, China further states that the same is true with respect to the determination made under Section 306(b). In case the USTR determines that the US rights have been denied, he/she must make a determination on the (retaliatory) action that needs to be taken within 30 days following the expiration of the reasonable period of time for implementation of the DSB rulings. The very fact that such a determination has to be taken is incompatible with the timeframe stipulated in Article 21.5 of the DSU and amounts to a substitution of the procedures laid down therein.

5.178 Hong Kong, China asserts that Article 21.5 of the DSU provides that, in case there is disagreement between the parties on the compliance of implementing measures, the dispute should be decided through recourse to the dispute settlement procedures, including resort to the original panel where possible. The panel shall circulate its report within 90 days. As the USTR has to make a determination on the compliance question long before the Article 21.5 panel has issued its report, Section 306(b) makes Article 21.5 redundant and violates Article 23 of the DSU. The provision is also incompatible with the principle of "effective treaty interpretation" as laid down in Article 31 of the Vienna Convention on the Law of Treaties (VCLT), which requires that interpretation must give meaning to each and every provision of the treaty in its context and in the light of its object and purpose. Here the United States, in interpreting its obligations under the DSU, opted for an interpretation which effectively disregards Article 21.5 of the DSU.

5.179 Hong Kong, China further explains that Section 305(a) ensures the timely implementation of the retaliatory actions pursuant to the USTR's determinations under Section 306(a) and (b). This amounts to unilateral retaliation which bypasses Members' obligations prescribed in Article 22 of the DSU to request DSB's authorization for imposing counter-measures. Being a unilateral retaliatory measure, Section 305(a) also violates Article 23.2 of the DSU.

5.180 Hong Kong, China then concludes that, by obliging the USTR to determine whether the US rights have been denied and to ensure that retaliatory action(s) is taken in accordance with his/her unilateral determination, the US legislation in question violates DSU Article 23. Furthermore, the requirements to make the determination and implement the action within a specified period of time are incompatible with the timeframes stipulated in Articles 21.5 and 22 of the DSU and hence render the provisions redundant.



5.181 In the view of Hong Kong, China, the United States has insisted that for there to be a violation of Article 23.2(a) of the DSU, the European Communities must show that (a) a determination that a WTO agreement violation has occurred, and (b) such determination is inconsistent with the panel or Appellate Body rulings or an arbitration award. This cannot be the standard of proof adopted for Article 23.2(a). In Hong Kong, China's view, the mere possibility of having a unilateral determination of WTO agreement violation is inconsistent with Article 23.2(a), which stipulates that determination of violation of obligations should not be made except through recourse to the rules and procedures of the DSU. The US's interpretation is tantamount to arguing that a Member can demonstrate that a violation of Article 23.2(a) has occurred only in cases where a Member (a) makes a (unilateral) determination before the WTO adjudicating body has pronounced on the issue; or (b) makes such a determination after the adjudicating body has pronounced on the issue but reaches a conclusion inconsistent with the WTO body's findings. In doing so, the United States is trying to avoid interpreting the crucial Article 23.2(a) in good faith.

5.182 Hong Kong, China further notes that the question remains in a case where a unilateral determination as described above has been made but no action is taken to implement the determination. Hong Kong, China considers that this would constitute a violation of Article 23.2. This is because Article 23.2(a) outlaws all unilateral determinations to the effect that a violation occurred regardless of whether it is accompanied by subsequent implementing action.

5.183 Hong Kong, China answered in the negative in response to the Panel's question as to whether an official US statement binding in international law that the US government will not exercise its discretion in a way contrary to WTO rule removes the WTO inconsistency of Sections 301-310 on the assumption that the USTR and the President have the direction to avoid determinations and actions contrary to WTO rules in all circumstances, and that, nevertheless, Sections 301-310 were found to be inconsistent with WTO rules. Its answer is dictated by the ambiguity in public international law surrounding the legal value of unilateral declarations. Although the International Court of Justice had on two occasions pronounced in favour of the binding character of unilateral declarations (*Ihlen*, 1933; *Nuclear Tests*, 1974), both findings were very narrowly constructed and were taken in a particular context. Moreover, the ICJ's decisions on both occasions pay particular attention to the circumstances surrounding the declarations and it is not clear whether *mutatis mutandis* such circumstances can find application in the present dispute.

5.184 Hong Kong, China moreover argues that attempts in literature to extrapolate these decisions in other spheres of international activity (like for example, the UN resolutions) often met with scepticism. Hence, even though it may be possible to advance good arguments in favour of the under specific circumstances binding nature of unilateral declarations, the situation in public international law is unclear in this respect.

5.185 In the view of Hong Kong, China, in an area like dispute settlement, one should always aim for maximum clarity and precision. There is no room for ambiguity. A modification of the contentious aspects of the relevant provisions of the US legislation along the lines suggested in our answers to the Panel's questions and in our submission eliminates ambiguities. A unilateral declaration does not.

(c) **Distinction between mandatory legislation and discretionary legislation**

5.186 Hong Kong, China recalls that in the *US – Superfund*<sup>573</sup> case, the panel report stated that mandatory, as opposed to discretionary, national legislation can form the subject matter of a claim brought before the GATT independently of its application in a particular case. In particular, the panel stated that:

"Both articles (Articles XI and III of GATT 1947) are not only to protect current trade but also to create the predictability needed to plan future trade. That objective could not be attained if contracting parties could not challenge existing legislation mandating actions at variance with the General Agreement until the administrative acts implementing it had actually been applied to their trade".<sup>574</sup>

5.187 Hong Kong, China argues that the language of the cited sub-Sections of the Trade Act of 1974 makes it plain that the legislation in question is mandatory. Consequently, following the *Superfund* ruling, the sub-Sections can be proclaimed illegal as such, independently of any practice or enforcement of the legislation.

5.188 Hong Kong, China points out that the United States argued that nothing in its legislation mandates actions inconsistent with its WTO obligations. Hong Kong, China submits that even when legislation is not mandatory and simply allows WTO-inconsistent action to be taken, it should still be found to be WTO-inconsistent. Our argument is based on, in our view, an appropriate interpretation of the "good faith" principle enshrined in the VCLT.

5.189 Hong Kong, China notes that Article 26 of the VCLT states that :"(E)very treaty in force is binding upon the parties to it and must be performed by them in good faith". This means that, where domestic legislation is needed in accordance with domestic constitutional procedures in order to implement international obligations, such domestic legislation must be a good faith implementation of the international obligations assumed by the signatory.

5.190 Hong Kong, China argues that in the WTO regime, Article XVI:4 of the WTO Agreement requires Members to "ensure the conformity of its laws, regulations and administrative procedures with its obligations as provided in the annexed Agreements". Parties to an international regime should always honour their obligations as long as they remain parties to the said regime. This obligation stems unequivocally from Article 70 of VCLT. The question is consequently raised as to how international obligations can be implemented in good faith if the possibility of deviation exists in a domestic legislation. In the view of Hong Kong, China, there is no expectation that the international obligations will be observed and not impaired when the possibility of deviation is *expressis verbis* provided for in a domestic legislation. The predictability, necessary to plan future trade as the *Superfund* panel acknowledged, is affected when trading partners know *ex ante* that their partners have enacted legislation which allows them to disregard their international obligations.

5.191 Hong Kong, China is of the view that good faith implementation of international obligations should not be accidental, nor merely the outcome of exercise of discretion by a member government. Good faith implementation of international obligations suggests that parties to an international treaty should always honour their obligations as long as they remain

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<sup>573</sup> Panel Report on *US – Superfund*, op. cit., p.160

<sup>574</sup> Ibid.

parties to the said treaty. Thus, a Member maintaining discretionary legislation which allows deviation from international obligations (independently of the eventual application of such legislation) falls foul of the good faith principle.

5.192 Hong Kong, China notes that the United States claims that in the present case the European Communities has to demonstrate that the US legislation in question "precludes any possibility of action consistent with the Member's WTO obligations" and that none of the interpretations of the legislation permits WTO-consistent action. Hong Kong, China does not agree with these arguments. The mere existence of legislation that mandates or allows WTO-inconsistent action to be taken by a WTO Member already poses a serious threat to the good faith principle and to the certainty and predictability of the WTO regime.

5.193 Hong Kong, China also notes that the United States has pointed out that eventually any action undertaken in the context of Section 301 depends on the discretion of the President. Hong Kong, China further notes that while Presidential discretion is provided for in Section 301(a) and 305(a) of the US legislation, the legislation makes it plain that the USTR shall take specific action as a result of a determination to the effect that the US' rights have been denied. Indeed, according to Section 301(a), the USTR does not have to revert to presidential discretion in order to make such determinations. Such determinations have to be made by the USTR within the time limits specified in the legislation in question.

5.194 Hong Kong, China acknowledges that it is true that the President has discretion as to whether specific action should be taken. It is also true that in case discretion is exercised and a WTO Member thinks the outcome of such discretion amounts to a WTO violation, this Member can attack the specific measure but not the legislation giving rise to the specific measure. This is because GATT jurisprudence has held that Members may only attack legislation if such legislation is mandatory. But this is not good law. Such a distinction between mandatory and discretionary legislation, leaving the possibility to WTO Members to attack only the former but not the latter, is clearly inconsistent with public international law for the reasons explained above.

5.195 Hong Kong, China adds that its basic point is that a national legislation which implements an international obligation must do so in good faith (*bona fides*). This is essentially what Article 26 of the VCLT is all about (*pacta sunt servanda*).

5.196 Hong Kong, China argues that the good faith obligation actually kicks in before the entry into force of an international agreement: Article 18 of VCLT imposes on signatories an obligation to respect the spirit of the agreement they signed until the point in time when they definitively decide to either become part of it or not. In the former case (and provided that the agreement at hand enters into force) they are bound by Article 26 of VCLT as of the moment of the entry into force of the agreement; in the latter, they do not have to respect Article 18 of VCLT anymore and they will never have to respect Article 26 of VCLT either.

5.197 Hong Kong, China goes on to state that on the other hand, the obligation to implement and perform in good faith the agreement is active for the time-period during which a state is part of an international agreement. Article 70 of VCLT makes this point plain. From the moment it decides to abandon such an agreement, a state is no longer bound by Article 26 of VCLT (provided of course, that the agreement at hand does not codify rules of *jus cogens*). It remains liable though, for any violation of the agreement that it committed during the time-period when it was part of it.

5.198 Hong Kong, China considers that the good faith obligation is severely damaged if an implementing legislation leaves the door open to violations. The very notion that a state by its implementing legislation allows for behaviour which is inconsistent with international law Oruns afoul the principle of good faith which requires performance of the agreement at all times.

5.199 Hong Kong, China further alleges that compensation (in the wide sense of the term) for failure to perform should not be accepted as (and indeed is not) equivalent to performance. This stems clearly from a careful examination of the primary and secondary obligations of states when entering into international commitments:

- (a) the primary obligation to perform treaty (Article 26 of VCLT);
- (b) the secondary obligations, which come into play if an internationally wrongful act is committed, comprise an obligation to stop the illegal act (cessation of the illegal act) and an obligation of reparation for any damage caused as a result of the commission of the internationally wrongful act.<sup>575</sup>

5.200 In the view of Hong Kong, China, state authors of an illegal act are under an unambiguous obligation to stop the illegal act (even in cases where no such request has been made by the affected party, as the wording of Article 41 of the Draft on State Responsibility and the constant jurisprudence of the ICJ in this respect – *Chorzow Factories* – make it plain). By definition, they have to perform in good faith. This in turn means that reparation for an illegal act and performance of international obligations should not be understood to be two equivalent forms of behaviour in the sense that a state can alternatively have recourse to either and be deemed to be consistent with its international obligations. Rather, our analysis above supports the view that good faith performance of the treaty in all times is what is requested from states when they adhere to an international regime.

5.201 Hong Kong, China contends that a domestic instrument which allows for deviations severely undermines this basic international obligation, since deviation from the obligation to always perform the international obligations adhered to becomes an option available to the state alongside the option to perform the treaty. As stated above though, the two options are of no equivalent value.

5.202 The overall conclusion of Hong Kong, China therefore is that, in the event parties to an international agreement have to implement their obligations in a domestic instrument in order to fulfil domestic constitutional requirements, they should ensure that their implementing legislation allows no deviations. In any other case, states have failed to perform in good faith their international obligations.

5.203 Hong Kong, China is of the view that the US legislation under challenge fails to guarantee a good faith performance of the US international obligations at all times.

### **3. Conclusion**

5.204 Hong Kong, China contends that it attaches much importance to the current proceedings. Trade disputes will inevitably occur in the future as they have in the past. The

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<sup>575</sup> Hong Kong, China notes that there is, however, some disagreement in literature as to the nature of cessation. Some authors do accept that cessation is a primary obligation in the sense that it goes hand in hand with the obligations to perform the treaty.

DSU has been the cornerstone of the WTO and an important achievement of the Uruguay Round. The multilateral dispute settlement system, as opposed to unilateralism, must be preserved and strengthened.

5.205 In the view of Hong Kong, China, the cited sub-sections of the US Section 301-310 of the US Trade Act of 1974 constitute a violation of the obligations imposed by Article 23 of the DSU that all WTO Members should resort to WTO adjudication bodies to resolve disputes arising from the operation of the WTO agreements. Hong Kong, China requests the Panel to recommend that the United States bring, in this very important respect, its legislation into compliance with its WTO obligations.

## G. INDIA

### 1. Introduction

5.206 **India recalls** that in its meeting on 2 March, 1999, the Dispute Settlement Body established the Panel on United States-Sections 301-310 of the Trade Act of 1974. India had signalled its substantial interest as third party in the matter before this Panel. The following is the written submission of India in accordance with paragraph 2 of Article 10 of the Understanding on Rules and Procedures Governing the Settlement of Disputes.

5.207 India considers that the essential matter at issue before the Panel relates to Sections 301-310 of the Trade Act of 1974. The European Communities has contended that Sections 301-310 explicitly mandate the US administration to proceed unilaterally on the basis of determinations reached independently of the DSB and without its authorization especially once specified time periods have lapsed. The European Communities therefore believes that Sections 301-310 must be amended to make it clear that the US administration is required to act in accordance with the US' obligations under the WTO agreements in all circumstances and at all times.

### 2. Measures at issue

5.208 India explains that Section 301(a) describes situations where the rights of the United States under any trade agreement are being denied or an act, policy or practice of a foreign country that denies benefits to the United States and is unjustifiable and burdens or restricts US commerce. If the USTR determines (and such determination is unilateral) that one of the above situations has occurred, then the USTR "shall take" retaliatory action. Section 301(a)(2) (A) and (B) do talk of exceptions where action is not required to be taken by USTR and these relate to situations where there is a DSB report which states that the action is not a violation of or inconsistent with the rights of the United States or does not deny, nullify or impair benefits to the United States, or where the foreign country is taking satisfactory measures to grant the rights of the United States under a trade agreement or where the national security of the United States is at stake.

5.209 India goes on to state that Section 301(b) applies to an act, policy or practice which while not denying rights or benefits of the United States under a trade agreement is nevertheless "unreasonable or discriminatory and burdens or restricts US commerce". It goes on to provide examples of unreasonable acts, such as failure to protect intellectual property rights, toleration of anti-competitive practices by private firms or denial of worker rights. If the USTR determines that an act, policy or practice is actionable under this Section and determines that action by United States is appropriate then the USTR shall take retaliatory action subject to the specific direction, if any, of the President regarding such action.

5.210 India adds that the scope of retaliatory action is set out in Section 301(c) which authorizes the USTR to suspend, withdraw or prevent the application of benefits of trade agreement concessions and impose duties or other import restrictions on the goods and services of such foreign country for such time as the USTR determines appropriate.

5.211 India points out that in the United States itself, no domestic court could pronounce Section 301 inconsistent with WTO because Section 102 (a)(1) provides that "no provision of any of the Uruguay Round Agreements nor the application of any such provision to any person or circumstance that is inconsistent with any law of the United States shall have any effect". Also, the same section provides that nothing in the Uruguay Round Agreements Act shall be construed to limit any authority conferred under any law of the United States including Section 301 of the Trade Act of 1974.

5.212 India further explains that Sections 302 to 310 deal with questions such as who can initiate investigations under Section 301, the various time limits for action, monitoring of measures taken by foreign country etc.

5.213 In the view of India, the central feature of the US legislation, it will be observed therefore, is that the USTR can make a unilateral determination concerning a foreign country's act, policy or practice vis-à-vis the rights and benefits of United States and its effects on US commerce and then decide on trade retaliatory measures for as long as it (USTR) deems fit.

5.214 India contends that Sections 301-310 of the Trade Act of 1974 is both legally indefensible and morally unacceptable. From a legal point of view, it is clear that inasmuch as it embodies unilateralism, Sections 301-310 violate all canons of International Law. From a moral point of view, it is unacceptable because it implies that might is right and that the strong can prevail over the weak.

5.215 India points out that it has had a long history of being subjected to Sections 301-310 of the Trade Act on grounds of alleged unfair trade practices. These Sections put pressure on countries like India to conform to what the United States believes is "fair trading practices". As will be shown below, the determination of what constitutes "unfair trading practices" or "unreasonable acts" is done solely by United States and hence is unilateral; besides, there are no objective criteria to determine those unfair practices making the whole process therefore completely arbitrary.

5.216 India notes that in sum, Sections 301-310 of the Trade Act of 1974 is an instrument of unilateralism used by the United States to force its trading partners to offer market access for American goods and services beyond the scope of commitments undertaken in multilateral trade negotiations. Consequently, these Sections undermine the multilateral trading system.

### **3. Legal Arguments**

#### **(a) Drafting History of WTO Agreement**

5.217 India considers that any scrutiny of the drafting history of the Uruguay Round Agreements in general and the DSU in particular, would reveal that a number of countries, chiefly developing ones, accepted the strengthening of the dispute settlement mechanism including the controversial provision of cross retaliation because they were given to understand that in return they need no longer fear the threat of unilateralism. Indeed, many developing countries such as India accepted the dispute settlement system with its provisions relating to

automaticity and cross retaliation in the expectation that under the new system there would be no scope for unilateral action by trading entities.

5.218 India argues that the fact that this has not happened and statutes such as Section 301 have still remained on the statute books of the United States is a matter of profound regret for those who believe in a rule-based multilateral trading system.

**(b) Article XVI:4 of the WTO Agreement**

5.219 India contends that the WTO Agreement in paragraph 4 of Article XVI clearly states that each Member shall ensure the conformity of its laws, regulations and administrative procedures with its obligations as provided in the annexed Agreements.

5.220 India explains that in the discussions of the Legal Drafting Group during the Uruguay Round, this provision was objected to by the United States and with good reason. It was believed, correctly, by US negotiators that acceptance of this provision would pose a serious problem for Section 301. Hence, the US negotiators tried to water down this provision but with little success. Finally, the language was couched in strong terms so as to make it a binding obligation on Members.

5.221 India also notes that GATT jurisprudence has a long history of cases where a law requiring the executive to impose a measure inconsistent with a provision of the GATT can be challenged under the dispute settlement procedure whether or not it had been applied to the trade of the complaining party. Thus, the 1987 Panel on *United States – Taxes on Petroleum and Certain Imported Substances* said that the very existence of mandatory legislation providing for an internal tax without it being applied to a particular imported product should be regarded as falling within the scope of Article III. Similarly, the famous 1992 Panel on *United States -- Measures Affecting Alcoholic and Malt Beverages* examined legislation in the state of Illinois which the United States argued that it was not giving effect. Again, the Panel ruled that the Mississippi legislation was inconsistent with Article III whether or not it was given effect to. More recently, in the proceedings of the WTO Panel on *India – Patent Protection for Pharmaceutical and Agricultural Chemical Products*, the United States claimed that the "mailbox system" for patent applications which India had established by administrative action did not meet the requirements of Article 70.8 of the TRIPs Agreement because mandatory provisions of the India Patents Act prohibited grant of product patents in pharmaceutical and agricultural chemical products.. India cited provisions of its Constitution on the distribution of authority between its legislative and executive branch and court rulings on the non-binding nature of the statutes requiring administrative actions by a specified date to argue that a mailbox system could be established by administrative action notwithstanding the mandatory provisions of the Patents Act. In response, the United States argued that GATT jurisprudence on mandatory legislation made clear that India was obliged to eliminate what it called legal uncertainty created by the fact that its administrative practices were inconsistent with mandatory provisions of the Patents Act. In effect, the United States argued that the domestic law of a Member must not only be such as to enable it to act consistently with its WTO obligations but the domestic law must also not create legal uncertainty by prescribing WTO-inconsistent measures. The Panel accepted this argument of the United States and ruled that the current administrative practice creates a certain degree of legal insecurity in that it requires Indian officials to ignore certain mandatory provisions of the Patents Act.

5.222 In India's view, the verdict is therefore clear: a law that, by its terms, mandates behaviour inconsistent with a provision of a WTO Agreement violates that provision irrespective of whether and how the law is or could be applied. This principle is a reflection of

the fact that a law with such terms creates uncertainty adversely affecting the competitive opportunities for the goods or services of other Members.

5.223 India states that Article XVI:4 turns this principle into a specific and binding legal obligation. In the light of the above, it is sufficient for the Panel to examine whether Sections 301-310 mandate determinations and actions by the USTR that are inconsistent with the US' obligations under the WTO Agreement.

**(c) Article 23 of the DSU**

5.224 India contends that Article 23 clearly states that all WTO Members shall have recourse to and abide by the rules and procedures of the DSU to seek the redress of a violation of obligations or other nullification or impairment of benefits under the covered agreements. Specifically, it is stated that Members shall not make a unilateral determination about nullification and impairment of benefits except through recourse to DSU. And yet, Sections 301-310 seek to do precisely that. Sections 301-310 do not follow the procedures or the rules of DSU; indeed, they seek to do just the opposite by threatening the foreign country that is allegedly causing impairment and nullification for the United States. As amply demonstrated by the European Communities, the USTR is required to proceed unilaterally when the results of the WTO dispute settlement procedures are not available within the time limits set out in Sections 301-310. For example, the USTR is mandated by Section 304(a) (2) (A) to make a determination within a time frame that is shorter than the time frame within which it can reasonably expect DSB findings on that matter. In effect, Section 304 mandates the USTR to make a determination 18 months after the request for consultations on the United States denial of rights under a WTO Agreement even if the DSB has not adopted a report with findings on the matter within that time frame.

5.225 India concludes that for this reason, the US Sections 301-310 are inconsistent with the time limits given in the DSU and in particular violate Article 23 of the DSU.

**(d) Articles I, II, III, VIII and XI of GATT 1994**

5.226 India contends that again, Section 306 (b)(2) sets out a 30-day limit from the end of the reasonable period of time at which the USTR has to determine that the Member concerned has failed to comply with the DSB recommendations without waiting for the conclusion of the relevant DSU procedures. The operation of Section 306 can best be illustrated by the USTR's determinations and actions in the Banana dispute. On the basis of a unilateral determination that the European Communities had failed to implement the DSB's recommendations, the USTR announced on 3 March 1999 that the US Customs Service would begin as of that date withholding liquidation and reviewing the sufficiency of bonds on imports of selected European products amounting to \$520 million. The arbitrators decision came only on 9 April 1999 and US request for retaliation was granted only on 19 April 1999. And the amount granted was \$191.4 million. It is clear that the United States had on 3 March 1999 suspended its obligations under, inter alia, Articles I, II, III, VIII and XI of GATT 1994 towards the European Communities without prior authorization by the DSB. In retrospect, it is obvious that the USTR was obliged to take action on 3 March 1999 because of Section 306 regardless of whether or not there was DSB authorization under Article 22 of the DSU.

**4. Conclusion**

5.227 India concludes as follows: Firstly, it is clear that Sections 301-310 are a case of United States renegeing on its commitments undertaken in the Uruguay Round. Secondly, regardless of



whether or not it is applied in practice, GATT/WTO jurisprudence is that a law, which, by its terms mandates behaviour that is inconsistent with a WTO provision, does violate that provision. Thirdly, Sections 301-310 fall foul of Article 23 of the DSU; specifically, they also contravene the time limits and other procedures of the DSU. Fourthly, Sections 301-310 violate Articles I, II, III, VIII and XI of GATT 1994 as evidenced in the *Bananas* dispute.

5.228 For the above reasons, India requests the Panel to find that Sections 301-310 are violative of the DSU, GATT 1994 and the WTO Agreement and to recommend that the DSB request the United States to bring its Trade Act of 1974 into conformity with its obligations under the WTO Agreements.

H. JAMAICA

## 1. Introduction

5.229 **Jamaica first states** that its Government has taken the decision to seek the third party status in this case because, as a small developing country, it places great emphasis on the rule of international law and the honouring of international treaty obligations in accordance with the principle of "*pacta sunt servanda*".

## 2. Legal Arguments

5.230 It is Jamaica's contention that by maintaining recourse to unilateral action, under Sections 301-310 of the Trade Act of 1974, the United States is acting in breach of its obligations under the WTO Dispute Settlement Understanding, which unequivocally commits Members not to resort to such actions.

5.231 Jamaica further argues that underpinning this contention is the fact that the WTO DSU is fully consistent with agreed rules on the principle of the peaceful settlement of Disputes between States enshrined in Article 1(1) of the United Nations Charter and various resolutions and declarations of the United Nations General Assembly.

5.232 Jamaica contends that the WTO Dispute Settlement mechanism is linked to the historical effort to prevent resort to unilateral action which undermines the credibility of the multilateral trading system. As was observed by the Panel in *United States – Import Prohibition of Certain Shrimp and Shrimp Products*, the adoption of unilateral measures by Members could "threaten the security and predictability of the multilateral trading system".

5.233 Jamaica points out that it is generally accepted that the WTO Dispute Settlement System is the central pillar of the multilateral trading system and the WTO's most individual contribution to the stability of the global economy. However, the confidence behind this derives from the Organization's ability to ensure that Members will comply with the rules. The integrity of the WTO would suffer a great deal if Members were able to adopt unilateral actions in defiance of their obligations under the WTO Agreement.

5.234 Jamaica also notes that it is accepted that the fundamental principle of treaty law is "*pacta sunt servanda*" whether based on customary law or the Vienna Convention on the Law of Treaties, Article 26.

5.235 In the view of Jamaica, this fundamental concept has been given effect in Articles 3.1, 21.5, 23.1, 23.2 of the WTO Dispute Settlement Understanding in requiring Members to subject themselves to the rules agreed thereto.

5.236 Jamaica also contends that Article XVI:4 of the Agreement Establishing the WTO clearly requires domestic action to incorporate the entirety of WTO obligations:

"Each Member shall ensure the conformity of its laws, regulations and administrative procedures with its obligations as provided in the Annexed Agreements". (emphasis added).

5.237 Jamaica further argues that the Dispute Settlement Understanding is an integral part of the WTO Agreement, and Article III:3 of the latter confers authority on the WTO to administer the DSU.

5.238 Jamaica points out that the United States actively participated in the negotiation of the WTO Agreements and made a substantial contribution in the drafting of the dispute settlement rules. Further, the United States was party to the Marrakesh Declaration of 15 April 1994, in which the Ministers welcomed, *inter alia* :

"the stronger and clearer legal framework they have adopted for the conduct of international trade, including a more effective and reliable dispute settlement mechanism".

5.239 Jamaica concludes that as signatory to the Uruguay Round Agreements, the United States and other Members of the WTO therefore undertook to resolve disputes in accordance with the agreed multilateral rules enshrined in the DSU.

5.240 Jamaica also considers that by virtue of Sections 102(a)(1) and 102(c) of its Uruguay Round Agreements Act, the United States has decreed that no provision in the WTO Agreement should prevail over any law of the United States to the extent of inconsistency. There is nothing in the Uruguay Round Agreements Act of the United States which should be construed as limiting "any authority conferred under any law of the United States, including section 301".

5.241 Jamaica points out that the effect of these Sections is that provisions in the WTO Agreement which run contrary to the law of the United States are declared to be void and to have no effect, *ab initio*.

5.242 Jamaica states that it does not dispute a Member's right to seek redress for breaches of contractual obligations under the WTO Agreement. However, while actions under Section 301(a) are subject to the final authority of the DSB, there resides a discretionary right to take action under Section 301(b) the process of which is outside the scrutiny of an external and impartial judicial authority. The result of Section 301(b), therefore, is to provide the United States with an alternate procedure through which to achieve a result favourable to its own interests, which it feels that it could not probably get from the DSB

5.243 Jamaica argues that while the retention of a competing system for dispute settlement may not *per se* be contrary to international law, the subsequent reliance on that rival process as a substitute for an agreed multilateral mechanism for the settlement of disputes could constitute a violation of treaty obligations. Indeed, as was stated by the panel in *United States – Taxes on Petroleum and Certain Imported Substances*,<sup>576</sup> a Member would be in violation of its WTO obligations, if it has enacted a law which mandates it to take certain measures in the future

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<sup>576</sup> Panel Report on *US – Superfund*, op. cit.

which are not justified under the WTO Agreement, even if those measures are not specifically applied. The possibility of having an alternative mechanism for seeking redress under Sections 301(a) and (b) undermines the integrity of the WTO dispute settlement mechanism.

5.244 Jamaica further argues that it is also a breach of good faith by the United States towards the other Members who have brought their domestic legislation in line with commitments undertaken in the WTO.

5.245 Jamaica points out that the single undertaking approach which was adopted by Members during the Uruguay Round means that it is no longer possible for Members to pick and chose which agreements they want to adhere to. As the DSU is an integral part of the WTO Agreement, the United States is obliged to respect all its provisions including Article 23 which commits Members to refrain from making unilateral determinations as to whether or not a Member has violated its obligations under the WTO Agreement.

5.246 According to Jamaica, the integrity of the WTO is as strong as its membership's demonstrated commitment to its principles. The Members provide their own checks and balances against the actions of other Members who deviate from the agreed rules and obligations.

5.247 In the view of Jamaica, given the importance of the dispute settlement system of the WTO as a central element in providing security and predictability of market access conditions in the multilateral trading system, the WTO cannot, through a recommendation nor a finding of this Panel, condone the adoption of unilateral action by a Member State on the basis of its domestic legislation. Should this occur, Members themselves would be party to the undermining of the authority of the dispute settlement mechanism. If Members are thereby encouraged to act unilaterally in the settlement of trade disputes, there would be no incentive for continued adherence to the agreed processes of the DSU.

5.248 Jamaica argues that the United States has on many occasions reiterated its commitment to building and maintaining confidence in the WTO. The United States Trade Representative to the WTO in a recent statement in March 1999 reaffirmed that an open trading system which is essential to global prosperity cannot be maintained unless there is adherence to the rules. This will be difficult to achieve if Members of the WTO are constantly confronted with domestic legislation of a Member which authorizes it to impose unilateral sanctions in defiance of agreed multilateral rules.

5.249 Jamaica then requests the Panel to find that unilateral actions taken by the USTR in pursuance of Sections 301- 310 of the 1974 Trade Act are contrary to the obligations of the United States under the WTO Agreement.

5.250 Jamaica also requests the Panel to recommend that the United States bring its Trade Act of 1974 in conformity with its obligations under the WTO Agreement.

5.251 In response to the Panel's question as to whether DSU Article 23.2 prohibits any determination on WTO consistency or any determination to the effect that a violation has occurred, Jamaica states that in order to answer this question on how Article 23(2)(a) is to be interpreted, one has examine the context in which Article 23 (2)(a) applies.

5.252 Jamaica points out that the primary rule for interpretation of treaty provisions, codified in the Vienna Convention on the Law of Treaties, Article 31, requires that,

"a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose".

5.253 Jamaica argues that Article 23.2(a) should therefore be read in conjunction with paragraph (1) of the same Article which puts the entire Article in context. The title of Article 23 is "Strengthening the Multilateral System" and Article 1 sets the overall focus of the Article by stating that,

"when Members seek the redress of a violation of obligations or other nullification or impairment of benefits under the covered agreement or an impediment to the attainment of any objective of the covered agreements, they shall have recourse to, and abide by, the rules and procedures of this Understanding". (emphasis added)

5.254 Jamaica goes on to state that the obligation on Members to utilise the DSU provisions is emphasised in the sub-sections of paragraphs 2(a), (b) and (c) which spell out the steps to be undertaken by Members "in such cases", that is, in cases where Members seek redress for breaches of obligations.

5.255 In the view of Jamaica, Article 23(2)(a) states that Members shall "not make a determination ... except through recourse to dispute settlement in accordance with the rules and procedures of this Understanding..." and the determinations relate not only to the occurrence of violations, but also to benefits which have been nullified or impaired or impediments to the attainment of any objective of the covered agreements.

5.256 Jamaica is of the view that Article 23 does not prohibit the making of a determination *per se* that a violation has occurred, or benefits have been nullified etc., as certainly, a Member which has brought a dispute to the DSB must have made a "determination" of some degree that another Member's practices/policies are WTO inconsistent, hence seeking the DSB's opinion of this preliminary "determination".

5.257 Jamaica contends that the prohibition which is the focus of Article 23(2)(a) , and in effect the entire Article 23, however, relates to determinations executed in the context of seeking redress for breached obligations. Such a "determination" by a Member would be akin to a finding or recommendation by the DSB, on the WTO consistency of a matter, as this "determination" would, of necessity, give rise to redress by the affected party. This exercise would amount to usurping the rights of the DSB to make such decisions. Only the DSB has the right to make determinations affecting the rights and obligations of Members.

5.258 Jamaica further argues that paragraph (a) of Article 23(a) supplements its prohibition on determinations outside of the DSB by concluding that,

"[any] such determinations shall be made consistent with the findings contained in the panel or Appellate Body reports adopted by the DSB ...".

5.259 Jamaica, in response to the Panel's question as to whether an official US statement binding in international law that the US government will not exercise its discretion in a way contrary to WTO rule remove the WTO inconsistency of Sections 301-10 on the assumption that the USTR and the President have the discretion to avoid determinations and actions contrary to WTO rules in all circumstances, and that, nevertheless, Sections 301-310 were found inconsistent with WTO rules, states that the United States is a signatory to the Final Act

embodying the results of the Uruguay Round of Multilateral Trade negotiations, which includes the Marrakesh Agreement and the Understanding on Rules and Procedures governing the Settlement of Disputes.

5.260 Jamaica draws the Panel's attention to the text of Article XVI:4 of the Marrakesh Agreement and Article 23 of the DSU.

5.261 Jamaica contends that having signed onto this legally binding multilateral instrument, the United States thereby solemnly undertook to abide by its rules including, the rules and procedures of the DSU. However, this legally binding undertaking did not prevent the United States from acting contrary to its obligations, which has infringed the rights of other Members.

5.262 Jamaica is of the view that a statement made by a government which contradicts legislation is not a sound basis on which to conduct international treaty relations. The US statement does not therefore constitute an effective restraint on its discretionary action contrary to the obligation which should be enshrined in law.

5.263 Jamaica is of the view that the discretionary latitude given to the US President and the USTR, under Sections 301 and 302, whether exercised or not, leaves the way open for the exercise of that discretion.

5.264 Jamaica states that it can find no justifiable grounds on which the United States holds itself to be exempt from complying with the rules of the WTO. In fact, should the United States be permitted to retain inconsistent domestic legislation, this will pave the way for the "exception to become the rule" as more WTO Members may be inclined to retain non-conforming legislation while conveniently making unilateral undertakings of compliance.

5.265 Jamaica recalls the decision of the panel in *United States - Taxes on Petroleum and Certain Imported Substances*,<sup>577</sup> where it was held that a Member would be in violation of its WTO obligations, if it has enacted a law which obliges it to take certain measures in the future which are not justified under the WTO Agreement, even if those measures are not specifically applied. Thus, the very fact that the United States legislation requires the President to take certain actions upon the fulfilment of certain requirements, it could be said by way of analogy, that this law violates the letter and spirit of the WTO Agreement.

5.266 Accordingly, Jamaica urges the Panel to insist on full compliance with the established rules of the WTO, and thus to rule that, Sections 301-310 be amended accordingly to bring the United States into compliance with the undertaking it made in 1994. Jamaica is confident that the full Membership will accept no less than a complete revision of the offending domestic law of the United States which is the subject of this dispute..

## I. JAPAN

### 1. Introduction

5.267 **Japan points out** that as this case presents the extremely important issue of unilateral determination within the scope of the WTO dispute settlement, it has some substantial systemic interest in the matter. The findings of the Panel will be of acute importance, and it sincerely hopes that the Panel will thoughtfully consider the matter at hand.

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<sup>577</sup> Panel Report on *US – Superfund*, op. cit.

## 2. Legal Arguments

5.268 Japan is of the view that the renunciation of unilateral trade measures in the WTO Dispute Settlement is one of the most important rules of the WTO. WTO Members are prohibited from unilaterally suspending concessions or other obligations under the WTO Agreement. Moreover, Article 23 of the Understanding on Rules and Procedures Governing the Settlement of Disputes clearly requires WTO Members to follow the rules and procedures under the DSU and stipulates that they shall not make a determination such that measures taken by another Member violate the provisions of the WTO Agreement, except through recourse to the dispute settlement in accordance with the rules and procedures of the DSU.

5.269 Japan notes that at the entry into force of the WTO Agreement, the United States announced that it had amended its Trade Act of 1974 in order to respect the procedures in accordance with the enhanced Dispute Settlement system. The amendment, however, has proved to be insufficient. The United States claims that the Trade Act of 1974 can be implemented in compliance with the WTO Agreement by utilising the discretion provided for therein through the USTR when determining whether or not there is violation of WTO Agreement by another Member and what further actions are to be taken and when implementing the determined actions, as well as through the specific direction of the President. Nonetheless, it is doubtful whether the Trade Act of 1974 is truly discretionary. For instance, despite the United States describing that the USTR is free to make a negative determination and then to reinitiate a second investigation in order to make a definitive determination of a violation to the WTO Agreement upon DSB adoption of panel and Appellate Body findings, such discretion does not appear to be explicit from the provisions of the Trade Act of 1974. On the contrary, the Trade Act of 1974 is considered to oblige the United States to determine whether another Member denies the rights or benefits of the United States under the WTO Agreement without following the necessary procedures under the Dispute Settlement Mechanism and, in that case, is inconsistent with Article 23 of the DSU.

5.270 Japan contends that even assuming that the United States can implement the Trade Act of 1974 in compliance with the WTO Agreement with broad discretion, it is very unlikely that such discretion is exercised consistently with the WTO Agreement.

5.271 Japan considers that the facts indeed show that the United States has repeatedly made determinations that actions, policies or practices of another WTO Member were inconsistent with the WTO Agreement, or unreasonable, and has determined further actions, including a suspension of concessions or other obligations under the WTO Agreement, without abiding by the Dispute Settlement procedures.

5.272 In Japan's view, the following cases demonstrate that the United States has used to its advantage unilateral measures under the Trade Act of 1974 as an instrument for settling trade disputes against Japan.

5.273 Japan explains that in October 1994, the United States initiated an investigation on Japan's market regarding the replacement auto parts and automotive accessories under the Trade Act of 1974. In May 1995, it determined that the acts, policies and practices of the Government of Japan were unreasonable and burdensome and that they restricted commerce in the United States. Subsequently, it announced the implementation of sanctions under which the imports of Japanese luxury cars would be subject to duties of 100% *ad valorem*. Following this announcement, the US Customs Service withheld the liquidation of the entry of vehicles on the sanction list, and the exports of those vehicles from Japan was actually halted. Japan requested consultations under Article XXII of the GATT against such unilateral action taken by the United

States. This matter was finally settled through political means conducted independently from the Dispute Settlement process. However, this incidence was a clear example that the United States acted in violation of its obligations under the DSU in favour of the procedures under the Trade Act of 1974.

5.274 Japan emphasizes that it does not claim that the initiation of investigation under Section 302 constitutes a violation of the WTO Agreement. Japan, however, considers that the announcement of affirmative "determination" and the announcement of a list of products that could be subject to increased tariffs, which were made on May 16, 1995, are inconsistent with the obligations of the Government of the United States under Article 23 of the DSU.

5.275 Japan argues that based on the past experience, despite the US claim that the Trade Act of 1974 can be implemented consistently with the WTO Agreement through the broad discretion given to the USTR and the specific instruction of the President, the Trade Act of 1974 has the following major problems in relation to the WTO Agreement.

5.276 Japan further contends that the language of Section 304(a)(2) of the Trade Act of 1974 mandatorily requires the USTR to determine whether the rights of the United States under the WTO are being denied or whether any act, policy or practice of another WTO Member violates or is inconsistent with the WTO, or is unjustifiable, within 18 months after initiation of the investigation of a case. In accordance with the DSU, the Dispute Settlement process normally requires a period of 18.5 months and, as a matter of fact, there have been several cases that have taken longer. This clearly demonstrates that, at least in cases in which the necessary procedures are not completed within the 18 months provided for, the USTR is obligated to act under Section 304(a) 2 in conflict with the DSU. It must also be noted that the discretion mentioned therein is not explicit enough with regard to the given provisions of the Trade Act of 1974. Section 304(a)(2) can, therefore, be considered as obliging the USTR to determine, prior to the adoption of the panel or Appellate Body report, whether another Member denies rights or benefits under the WTO Agreement and, thereby, is inconsistent with Article 23 of the DSU. Even assuming that the United States can implement the Trade Act of 1974 in compliance with the WTO Agreement with broad discretion, there is no guarantee that such discretion is exercised consistently with the WTO Agreement.

5.277 Japan also alleges that Section 306(b)(2) of the Trade Act of 1974 requires the USTR to determine what further action to take within 30 days after completion of the reasonable period of time, if the USTR determines that a recommendation of the Dispute Settlement Body has not been implemented. According to the DSU, where there is disagreement as to the existence or consistency of the measures taken to comply with the recommendations and rulings, such dispute shall be settled through the dispute settlement procedures under Article 21.5 of the DSU. Japan is of the view that if it is assumed that the drafter of the DSU supposed the dispute settlement procedures under Article 21.5 of the DSU to be completed before the date of expiry of the reasonable period of time, the relationship between Article 21 and Article 22 of the DSU would be well explained. It could also ensure the WTO consistency of Section 306(b). However, there is no consensus on such interpretation on Article 21.5 and it is generally understood that the dispute over the existence of implementation of the recommendation shall be referred to the procedure under Article 21.5 after the expiry date of reasonable period of time. Article 21 provides that the panel shall circulate its report within 90 days after the date of referral of the matter to it. Therefore, it is normally difficult to complete the necessary procedures under Article 21.5. Under Section 306(b)(2), the USTR is more than likely to determine that a recommendation of the DSB has not been implemented, as well as to determine further action, including a suspension of concessions or another obligation, to be taken prior to

the completion of the necessary procedures under Article 21.5 and such determination is inconsistent with Article 23 of the DSU.

5.278 Japan adds that when the dispute over the existence or consistency with a covered agreement is referred to the procedure under Article 21.5 after the expiry date of the reasonable period of time, the panel shall circulate its report within 90 days after the date of referral of the matter to it.

5.279 In Japan's view, notwithstanding such a period of 90 days defined in this Article, Section 306(b)(2) requires the determination to be made only within 30 days after the expiration of the reasonable period of time. When the panel determination under Article 21.5 is made on a date beyond the deadline which Section 306(b)(2) requires, the USTR is more than likely to make a determination that a recommendation of the DSB has not been implemented, as well as make a determination on further actions including suspension of concessions pursuant to Section 306(b)(2), prior to the completion of the procedures under Article 21.5 of the DSU.

5.280 Japan notes that in the *EC - Banana III* case, it was not until 19 April 1999, the date on which the DSB authorized the suspension of the concession based on the decision of the arbitrators, that the multilateral determination was made as to the consistency/ inconsistency of the measures taken by the European Communities in response to the recommendations and rulings of the panel and the Appellate Body. In defiance of the WTO rules for determination of compliance, the United States made a decision on 3 March 1999, to the effect of taking customs actions in the form of withholding of liquidation as well as imposition of a contingent liability for 100% duties. In its press release, it was stated that "we must conclude that it is time for the European Communities to bear some of the consequences for its complete disregard for its GATT and WTO obligations". The said press release is attached herewith.

5.281 Japan further argues that Sections 306(b) and 305(a) of the Trade Act of 1974 require the USTR to implement further action within 30 days of the date of determination of such further action (i.e. within 60 days after the expiry date of the reasonable period of time). Even if it is assumed that the procedures under Article 21.5 of the DSU are supposed to be completed before the expiry of the reasonable period of time, and if the suspension of concessions or other obligation is referred to arbitration according to Article 22.6 of the DSU and if the arbitration requires the maximum period of 60 days, it will not be possible to meet the deadline stipulated under the relevant Sections of the Trade Act of 1974, unless a DSB meeting is requested 10 days before the arbitration is awarded. This will be against the current practice, which has also been accepted by the United States. Thus, it is normally difficult to complete the necessary procedures until obtaining authorization from the DSB. When Sections 306(b) and 305(a) require the USTR to implement a suspension of concessions and other obligations as further action prior to the DSB authorization, such suspension is inconsistent with the basic provisions of the GATT (Articles I, II, III, VIII and XI) and GATS (Articles II, XVI, XVII, XVIII), depending on respective measures.

5.282 Japan also asserts that Sections 304(a) and 305(a) require the USTR to determine whether an act, policy or practice of a foreign country is unreasonable even when it does not deny the US rights on the WTO Agreement or is not inconsistent with the WTO Agreement. They also require the USTR to determine what further actions to be taken and then to implement them without following the dispute settlement procedure under the WTO Agreement. Even in such cases where the USTR determines that the act, policy or practice of a foreign country does not deny the US rights under the WTO Agreement but that it is unreasonable, simply implementing further actions which are not consistent with the WTO Agreement including suspensions of concessions or other obligations is inconsistent with the basic provisions of the



GATT (Articles I, II, III, VIII and XI) and the GATS (Articles II, XVI, XVII and XVIII), depending on the respective measures.

5.283 Japan concludes that in the above considerations, the Trade Act of 1974 is considered to oblige the United States to act inconsistently with its obligations under the WTO Agreement. Even assuming that the United States can implement the Trade Act of 1974 in compliance with the WTO Agreement with broad discretion, it is very unlikely that such discretion is exercised in consistence with the WTO Agreement. It also seriously damages the Dispute Settlement Mechanism within the framework of the WTO. Therefore, the United States should amend its Trade Act of 1974 to ensure that it fully complies with its obligations under the DSU.

5.284 Japan also states that on the basis of the above points, whereby the United States unilaterally applies its own rules and regulations by way of the Trade Act of 1974, such action can seriously damage the Dispute Settlement Mechanism within the framework of the WTO. Although the United States claims that the Trade Act of 1974 can be implemented in compliance with the WTO Agreement by utilising discretion, the degree of such discretion contained in the provisions of the Trade Act of 1974 is far from being explicit. Any such ambiguity is also against the spirit of GATT Article X. In conclusion, Japan strongly requests the Panel to request the United States to amend its Trade Act of 1974 in order to ensure its full compliance with its obligations under the DSU.

5.285 Lastly, Japan expresses its concern on the US reinstatement of the Super 301 from March of this year. Under the Super 301, the United States regularly identifies foreign actions, policies and practices as a priority foreign country practice, which would lead the United States to initiate a Section 301 investigation, thus promoting the mechanism under Section 301 of the Trade Act of 1974, thereby leading to unilateral measures. This indicates that the United States has not changed its attitude towards its trading partners, including Japan, to conduct trade disputes to its advantage through the threat of using unilateral trade measures. Japan is greatly concerned that such US policy will seriously damage the WTO framework.

5.286 In response to the Panel's question as to whether DSU Article 23.2 prohibits any determination on WTO consistency or any determination to the effect that a violation has occurred, Japan states that Article 23.2(a) of the DSU should be interpreted in good faith in accordance with the ordinary meaning to be given to the terms that it prohibits Members to determine to the effect that a violation has occurred.

5.287 Japan, in response to the Panel's question as to whether an official US statement binding in international law that the US government will not exercise its discretion in a way contrary to WTO rule removes the WTO inconsistency of Sections 301-10 on the assumption that the USTR and the President have the discretion to avoid determinations and actions contrary to WTO rules in all circumstances, and that, nevertheless, Sections 301-310 were found inconsistent with WTO rules, states that the assumption provided in this question entails a contradiction. That is, generally speaking, laws are not inconsistent with WTO rules when such discretion as is described above is given to administrators under the laws. Moreover, it is not clear how an official statement could be "binding in international law". An "official statement" alone cannot remove the WTO inconsistency from the WTO inconsistent law. In order to remove the inconsistency in law, such removal must be enacted with a legal instrument which is binding in law. Furthermore, it is highly unlikely that a government would announce that it will not exercise its discretion under the WTO inconsistent law in accordance with WTO rules, which would mean that the government would always deviate from the law.

5.288 In response to the US question as to the consistency of the third parties' domestic legal system to proceed with the dispute settlement under the WTO Agreement, Japan explains that Article 98.2 of the Constitution of Japan stipulates that the treaties concluded by Japan and established laws of nations shall be faithfully observed. When requesting for consultations or establishment of panels, the Government of Japan presents its view that another Member's measure concerned is inconsistent with its WTO obligations. Such a view, however, does not constitute a determination in the specific sense under Article 23 of the DSU, and the Government of Japan strictly follows the dispute settlement procedures under the DSU and does not unilaterally make a determination and take actions without observing the rules of the DSU.

## J. KOREA

### 1. Introduction

5.289 **Korea recalls** that on March 2, 1999, pursuant to the request made by the European Communities, the Dispute Settlement Body established a panel to consider whether Sections 301-310 of the United States' Trade Act of 1974 comply with the United States' GATT/WTO obligations. In accordance with Article 10 of the Understanding on Rules and Procedures Governing the Settlement of Disputes, the Republic of Korea reserved its rights as a third party to the dispute by notification to the DSB.<sup>578</sup>

5.290 Korea goes on to state that as a frequent target of United States threats and actions under Sections 301-310, Korea has a substantial interest in the challenge brought by the European Communities to this aspect of US trade law. Although Korea was only the United States' ninth largest trading partner in mid-1998,<sup>579</sup> Korea has been the third most frequent target of Section 301 actions, behind the European Union and Japan.<sup>580</sup> In total, as of June 4, 1998, at least ten Section 301 cases had been initiated against Korea.<sup>581</sup>

5.291 In response to the Panel's request, Korea provided the following table showing the cases where the United States took actions against Korea under Section 301.

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<sup>578</sup> Korea refers to *United States – Sections 301-310 of the Trade Act of 1974*, Note by the Secretariat, Constitution of the Panel Established at the Request of the European Communities, 6 April 1999, WT/DS152/12, para. 5 (noting countries that have reserved rights as third parties).

<sup>579</sup> Central News Agency (Taiwan), *US Deficit with Tigers Grow in Leaps and Bounds*, June 19, 1998.

<sup>580</sup> Thomas O. Bayard & Kimberly Ann Elliott, *Reciprocity and Retaliation in U.S. Trade Policy* 57-58 (1994), cited in Raj Bhala, *International Trade Law: Cases and Materials* 1096 (1996).

<sup>581</sup> United States Trade Representative, *Section 301 Table of Cases* (as of 4 June 1998) <http://www.ustr.gov/reports/301report/act301.htm>

CASES OF US UNILATERAL SECTION 301 MEASURES ON KOREA

A. US Unilateral Section 301 Measures under the GATT system (1980- )

#	NAME OF THE CASES	SECTION 301 MEASURES AND THE BILATERAL NEGOTIATIONS	AGREEMENT
1	<b>Insurance</b>	According to the petition filed by the US industry on Nov. 5, 1979, USTR initiated an investigation on Dec. 19, 1979. On Nov. 26, 1980, USTR invited public comments on, inter alia, proposals for retaliation. Beginning in June 1980, several rounds of consultations were held.	Korea committed to promote more open competition in the Korean insurance market. The industry withdrew the petition on Dec. 19, and the USTR terminated the investigation on Dec. 29, 1980.
2	<b>Insurance</b>	On Sept. 16, 1985, the USTR self-initiated an investigation of Korea's insurance services. This was one of the first cases USTR self-initiated the investigation. Five consultations were held - in Nov. and Dec. 1985 and Feb., March and July 1986 – concerning the opening of the Korean insurance market.	On July 21, 1986, Korea agreed to increase US firms' access to the Korean insurance market by enabling them to underwrite both life and non-life insurance. (Exchange of Letter on Insurance) The US thus terminated the investigation on Aug. 14.
	<b>Amendment</b>		The 1986 Agreement was amended on Sept 10, 1987, setting forth more detailed requirements regarding insurance operations through joint ventures. (Exchange of Letters on Insurance) In January, 1988, the US and ROK further clarified the Sept. 10 amendment to specify the terms under which some Korean firms could participate in joint ventures. (Exchange of Letters on Life Insurance Joint Venture)
3	<b>Non-Rubber Footwear Import Restrictions</b>	Petition was filed by the Footwear Industries of America, Inc. et al. on Oct. 25, 1982, alleging import restrictions on non-rubber footwear by the EC and other countries, including Korea.	Korea consulted with the US on Feb. 5, 1983. In August, Korea reduced tariffs on footwear items and removed leather items from the import surveillance list.
4	<b>Intellectual Property Rights</b>	On Nov. 4, 1985, USTR self-initiated an investigation over Korea's intellectual property rights protection system. Korea held bilateral consultation with the US in November and December 1985 and throughout February-July 1986. The US requested Korea to protect not only patents, copyrights, and trademarks, but also demanded to consider protection of compiled data bases.	On July 21, 1986, Korea agreed to improve protection of intellectual property rights in Korea, and the agreements were signed on Aug. 28, 1986. (Record of Understanding on Intellectual Property Rights, Exchange of letters on Process Patents, and Explanatory Letter on Administrative Guidance) - Korea agreed to lengthen the patent protection and protect US pipeline products, patented in the US after Jan. 1980 for 10 years from 1987-1997. - Korea agreed to increase period of copyrights protection from 30 to 50 years. - Korea enacted a computer software protection law. The US terminated the investigation on Aug. 14, 1986. Korea agreed on the retroactive protection of copyrights even when it was not a contracting party to the Berne Convention.

5	<b>Cigarettes</b>	Pursuant to petition by the US industry on Jan. 22, 1988, the USTR initiated an investigation and requested consultations with the Korean Government on Feb. 16, 1988 over market access for foreign cigarettes.	Korea agreed on May 27, 1988, to allow "full" national treatment and 0% tariff. (ROU on Market Access for Cigarettes) The investigation was terminated on May 31, 1988.
6	<b>Beef</b>	<p>Petition by related industry was filed on Feb. 16, 1988. The petition alleged that Korea maintains a restrictive licensing system on imports of all bovine meat, in violation of GATT Article XI.</p> <p>Korea and US held GATT consultations on Feb. 19-20 and March 21.</p> <p>While the GATT dispute settlement process was ongoing, USTR initiated an investigation on March 28.</p> <p>On May 4, 1988, GATT Council established a panel under Art. XXIII:2. The first panel meeting was November 28, 1988; the second meeting was January 20, 1989. The panel issued a report favorable to the US on May 27.</p> <p>Korea twice rejected to adopt the panel report at GATT Council meetings in June and July 1989.</p> <p>The USTR announced on Sept. 27 that it will delay its retaliatory action for up to 180 days, but will publish a retaliation list by mid-November if "substantial movement toward resolution of the issue in the GATT has not occurred by that time". After bilateral consultations in Aug. and Nov, Korea adopted the GATT panel report on Nov. 7.</p>	<p>Following several rounds of negotiations, Korea concluded an agreement with US on March 21, and exchanged letters on April 26-27, 1990.</p> <p>On April 26, 1990, the section 302 investigation was terminated.</p> <p>However, Korea remains subject of monitoring of its implementation of the commitments.</p>
7	<b>Wine</b>	<p>On April 27, 1988, the US industry filed a petition complaining of policies and practices of the Korean Government on the Korean wine market.</p> <p>On June 11, 1988, USTR initiated an investigation and requested consultations with the Korean Government.</p> <p>Consultations were held October 11-12 in Washington and October 25 in Seoul.</p>	Further consultations finally resulted in an agreement, reached on January 18, 1989, in which Korea agreed to provide foreign manufacturers of wine and wine products non-discriminatory and equitable access to the Korean market.(Exchange of Letters on Imported Wine and Wine Products) Korea also agreed to lower the tariff to 50%. The investigation was terminated on January 18,1989.

B. US Unilateral special 301 measures

#	NAME OF THE CASES	SPECIAL 301 MEASURES AND THE BILATERAL NEGOTIATIONS	AGREEMENT
1	<b>Intellectual Property Rights under Special 301</b>	On June 13, 1988, the USTR formed an interagency task force to examine Korean patent system. In May 1989, USTR included Korea in the Priority Watch List (PWL). The US still monitors implementation of the agreement through annual consultation, and leaves Korea subject of "Special 301 procedure" to this date.	The ROU provided consultative mechanism, which was used to review Korea's implementation of the agreement. Under the threat of Special 301, Korea exchanged letters on the protection of pipeline products which specified products subject to pipeline protection and procedures to follow. (Exchange of Letters on the Protection of Pipeline Products)
2	<b>Telecommunications under Telecommunications Trade Act of 1988</b>	On Feb. 1989, USTR designated Korea as Priority Foreign Countries (PFC) under Section 1374 of the 1988 Trade Act, requested liberalization of Korea's telecommunications market. From Sept. 1989-Jan. 1992, nine consultations were held.  According to 1992 ROU, US requested annual consultations bet. 1993-1995 to review implementations of the agreement, and to yield further concession by threatening to designate Korea again as PFC. Early 1996, USTR requested amendment of 1992ROU, and pronounced that it will designate Korea as PFC by Jul. 1 if talks on market access of telecom fails. USTR threatened to take Super 301 retaliation measures within 1 months if Korea does not amend 92ROU and further open Korea telecom market. Series of consultations held bet. May-July failed, and on July 26, 96, USTR again designated Korea as PFC. Meetings were held in Sept. Oct. Dec. 96, Feb. Mar. and June 97.	On Feb. 24, 1992, Korea agreed to provide national treatment to US firms and joint ventures, and to implement liberalization of telecom market. USTR withdrew its designation of Korea as a PFC on March.  On June 17-18, 97, Korea and US finally ended the trade conflicts. Korea refused to amend/conclude a new agreement, but instead agreed to put on the official gazette "information and communications policy statement". USTR withdrew its designation of Korea as a PFC on July 23, 1997.

## C. US Unilateral 301 measures under the WTO Regime

#	NAME OF THE CASES	SECTION 301 MEASURES AND THE BILATERAL NEGOTIATIONS	AGREEMENT
1	<b>Agricultural Market Access Restrictions</b>	On Nov. 18, 1994, the US Industry filed a petition with respect to Korean practices regarding the importation of certain US agricultural products. On Nov. 22, 1994, USTR initiated an investigation and invited public comment. Korea offered concessions at the April trade sub-group meeting, that it will introduce voluntary-based shelf-life system beginning 1998. The US requested earlier implementation, however. On May 3, 1995, the US requested consultations with Korea under the WTO dispute settlement procedure. The first consultation was held on June 5-6, 1995.	Korea and US reached a solution on July 20, 1995, which was notified to the WTO the following day. The USTR terminated investigation following the agreement. USTR still monitors Korea's implementation of the agreement pursuant to section 306 of the Trade Act.
2	<b>Barriers to Auto Imports</b>	On Oct. 1, 1997, the USTR determined to designate Korea as Priority Foreign Country Practices, according to the Super 301 measure, and initiated on October 20, 1997, an investigation on Korean auto market. On October 28, 1997, the USTR invited public comment. Series of consultations were held. On Sept 7, 1998, US sent a letter to President of Korea reminding of the Oct 19 deadline for Super 301 investigation, requesting "real market opening concessions to resolve the Super 301 investigation".	On Oct. 20, 1998, Korea concluded MOU to improve market access of US and other foreign motor vehicles to the Korea market, and the USTR accordingly terminated the investigation. The MOU established conditions for market operation in Korean motor vehicle sector, touching on Korea's tax regime, public perception, mortgage system, and type-approval procedure.

## 2. Overview

### (a) The Importance of the DSU

5.292 Korea argues that under the 1947 General Agreement on Trade and Tariffs ("GATT 1947"), binding dispute settlement was almost impossible to achieve. In the first place, dispute settlement proceedings were quite lengthy and easily delayed. Even more problematic, however, was the fact that the dispute settlement procedures of GATT 1947 Article XXIII required consensus, such that a "defendant" Contracting Party could effectively block retaliatory suspension of GATT obligations or concessions by the "complainant" Contracting Party.

5.293 Korea also notes that the shortcomings of the dispute settlement system under GATT 1947 occasionally led to unilateral retaliation and counter-retaliation as states exercised their self-determined rights under customary international law to suspend GATT concessions as a response to perceived GATT violations by other states. These costly rounds of unregulated suspensions of trade concessions were destabilizing to the international economic system, particularly as they often devolved into downward-spiralling trade wars. For example, the so-called "chicken war" that took place in the early 1960s between the United States and the European Economic Community ("EEC") grew from a dispute over application of the EEC's Common Agricultural Policy to broiler chickens to a trade war involving threats by the United

States to retaliate against products ranging from wine and Roquefort cheese to scissors and electric shavers.<sup>582</sup> The GATT 1947 system proved largely incapable of checking or preventing such trade wars, and indeed the failure of the system was used by some states as a justification for initiating unilateral action. The United States, in particular, frequently resorted to unilateral trade measures inconsistent with GATT 1947 when dispute settlement under the existing procedures was ineffective, explaining that: "If such action was considered unilateral, it should be nevertheless recognised as perfectly justifiable, responsive action necessitated by the failure of bilateral or multilateral efforts to address a problem. The way to minimise or avoid unilateralism was to create a credible multilateral system – by strengthening the existing system".<sup>583</sup>

5.294 In the view of Korea, the DSU was designed to be just such "a credible multilateral system". The DSU remedied the chief weaknesses of the GATT 1947 dispute settlement system by establishing a predictable timetable for resolving trade disputes and, where appropriate, imposing trade sanctions, and also by eliminating the paralysing requirement that the country targeted by those sanctions agree to them.

5.295 Korea further contends that the DSU's unambiguous prohibition against acts of unilateralism was a critical component of the multilateral bargain represented by the agreements negotiated in the Uruguay Round. These agreements dramatically expanded the mutual obligations of WTO Members to reduce or remove trade barriers. The Uruguay Round led not only to further reductions in barriers to trade in goods but also to new disciplines in areas such as trade in services and protection of intellectual property rights. This expanded substantive scope of the GATT/WTO system—one of the United States' chief objectives in the Uruguay Round negotiations—was achieved partly in exchange for a new commitment in the DSU to effective multilateral, rather than unilateral, resolution of disputes arising under the GATT and associated agreements. The parties to the Uruguay Round instruments would never have agreed to this expansion of their trade-related commitments had they believed that they would remain subject to unilateral suspensions of commitments by other parties.

5.296 According to Korea, reducing unilateralism was a particular concern of smaller countries such as Korea. Smaller countries are far more susceptible to unilateral denials of trade benefits than are larger countries because the impact of the unilateral action on the small country and the impact of any possible retaliation against the large country are disproportionate.<sup>584</sup> For example, in 1997, Korea's Gross Domestic Product ("GDP") was approximately \$631.2 billion,<sup>585</sup> the United States' GDP, at \$8,110.9 billion,<sup>586</sup> was nearly 13 times larger. As a result, equivalent trade sanctions have an impact on Korea's economy that is 13 times greater than their impact on the United States' economy.<sup>587</sup>

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<sup>582</sup> Korea cites, for a fuller discussion of the "chicken war", Abram Chayes *et al.*, "International Legal Process: Materials for an Introductory Course", (1968), 249-306.

<sup>583</sup> GATT document C/163, 16 March 1989, page 4.

<sup>584</sup> Korea cites O. Thomas Johnson, Jr., *Alternative Dispute Resolution in the International Context: The North American Free Trade Agreement*, 46 SMU L. Rev. 2175, 2176-78 (1993) (analyzing phenomenon among NAFTA parties).

<sup>585</sup> Matt Rosenberg, *South Korea* (last visited 8 June 1999) <<http://geography.about.com/library/cia/blcsouthkorea.htm?COB=home&terms=south+korea+gdp>>.

<sup>586</sup> Economic Report of the President Transmitted to the Congress February 1999, Table B-1, Gross Domestic Product, at 326.

<sup>587</sup> In the view of Korea, for example, a Section 301 action concerning \$10 billion in trade would threaten trade sanctions affecting Korean products worth almost two percent of Korea's GNP. Equivalent

5.297 Korea notes that the DSU of course does not do away with nations' rights to suspend GATT concessions or to take other retaliatory trade measures. But by regulating when and in what manner such measures may be used, the DSU benefits smaller countries like Korea by ensuring that trade sanctions are not imposed suddenly or arbitrarily, but only when they are found to be warranted pursuant to an orderly multilateral process and after the nation affected has had a reasonable opportunity to bring its practices into conformity with its GATT undertakings.

5.298 Korea states that it is nevertheless unfortunate that the United States still maintains the statute that allows the USTR to exercise its self-determined right to take retaliatory measures in response to perceived violations by other states. The history and effect of Sections 301-310 are clearly and comprehensively spelled out in the submission of the European Communities. Therefore, Korea will not repeat them here today. Korea would only like to mention one important aspect of Sections 301-310 that is overlooked by the European Communities: the USTR's publication of a retaliation list.

5.299 Korea argues that the USTR is required by Section 304(c) to publish in the Federal Register "any determination made under subsection (a)(1)", which includes the mandatory determination of what action the USTR proposes to take in retaliation against a denial of United States rights under a trade agreement. Publication of this "determination" provides the United States with great negotiating power because of the real-world impact that publication of a retaliation list has on trade flows. In the vast majority of Section 301 cases, the threat of sanctions alone led to a bilateral negotiated solution. The threat posed by Section 301 sanctions is thus aptly described as an effective tool to "extract unilateral concessions from weaker trading partners".

5.300 In Korea's view, this impact is magnified where the US government moves to "suspend liquidation" of customs entries for merchandise on the retaliation list. "Liquidation" is the final computation of the duties accruing on a customs entry. When liquidation is "suspended", the importer's legal liability with respect to the payment of the duties and other fees associated with the entry remains open. In other words, the importer may be required to pay additional customs duties if the retaliation list takes effect at a later date. This open-ended liability adds a level of uncertainty that can dramatically affect trade flows.

**(b) Measures at issue**

5.301 Korea states that the history and effect of Sections 301-310 are clearly and comprehensively spelled out by the European Communities and will not be repeated here, except to emphasize that:

- (a) Under Section 304(a)(2), the USTR "shall", in the event of a determination that a trade agreement has been violated, "determine what action, if any, the Trade Representative should take" in retaliation for that violation "on or before ... the earlier of — (i) the date that is 30 days after the date on which the [WTO]

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retaliatory action by Korea would affect US products representing little more than one tenth of one percent of the United States' GDP.



dispute settlement procedure is concluded, or (ii) the date that is 18 months after the date on which the [Section 301] investigation is initiated";<sup>588</sup> and

- (b) Under Section 306 (b)(2), the USTR must determine whether a WTO Member has failed to implement a recommendation of a dispute settlement panel or the Appellate Body within 30 days of the expiration of the reasonable period of time provided for such implementation under Article 21.3 of the DSU. The USTR also must determine within this 30-day period what further action to take against the supposedly noncompliant WTO Member, again irrespective of the status of any related WTO dispute-resolution procedure.<sup>589</sup>

5.302 Korea states that one aspect of Sections 301-310 that is overlooked by the European Communities bears mentioning: the USTR's publication of a retaliation list. The USTR is required by Section 304(c) to publish in the Federal Register "any determination made under subsection (a)(1)", which includes the mandatory determination of what action the USTR proposes to take in retaliation against a denial of United States rights under a trade agreement. Publication of this "determination" provides the United States with great negotiating power because of the real-world impact that publication of a retaliation list has on trade flows. Between 1974 and 1994 the United States initiated nearly 100 investigations under Section 301.<sup>590</sup> Unilateral retaliatory measures were actually imposed in only eight of those cases, although they were announced in many more. In the vast majority of 301 cases, the threat of sanctions alone led to a bilateral negotiated solution. The threat posed by Section 301 sanctions is thus aptly described as an effective tool to "extract unilateral concessions from weaker trading partners".<sup>591</sup>

5.303 In the view of Korea, as previously discussed, the mere publication of a retaliation list in the Federal Register can materially affect trade. This impact is magnified where the US government moves to "suspend liquidation" of customs entries for merchandise on the retaliation list.<sup>592</sup> "Liquidation" is the final computation of the duties accruing on a customs entry.<sup>593</sup> When liquidation is "suspended", the importer's legal liability with respect to the payment of the duties and other fees associated with the entry remains open. In other words, the importer may be required to pay additional customs duties if the retaliation list takes effect at a later date. This open-ended liability adds a level of uncertainty that can dramatically affect trade flows.

### 3. Legal Arguments

5.304 Korea states that it generally concurs with the arguments made by the European Communities. Nevertheless, and without prejudice to any additional available arguments that Sections 301-310 are inconsistent with GATT 1994, the DSU, and/or other Uruguay Round

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<sup>588</sup> 19 U.S.C. § 2414(a)(2).

<sup>589</sup> See *ibid.* § 2416(b)(2).

<sup>590</sup> United States Trade Representative, 1995 Trade Policy Agenda and 1994 Annual Report 96 (1994), *cited in* Bhala, *op. cit.* note 2, at 1096 and footnote 1.

<sup>591</sup> Jagdish Bhagwati, *The World Trading System at Risk* 53 (1991).

<sup>592</sup> See e.g. *Regime for the Importation, Sale and Distribution of Bananas*: Notice of United States Suspension of Tariff Concessions, 64 Fed. Reg. 19,209 (1999) (liquidation suspended with respect to entries of selected European products as of March 2, 1999, even though arbitrators' final decision on damages not adopted by DSB until April 19, 1999).

<sup>593</sup> See 19 Code of Federal Regulations § 159.1 (1999).

instruments, in this independent submission Korea only emphasizes two particularly troubling aspects of Sections 301-310.

5.305 Korea first emphasises that threats of retaliation manifested by publication of a retaliation list and suspension of liquidation under Sections 301-310 themselves violate Articles I and XIII of GATT 1994. The publication of a retaliation list by USTR—whether the list calls for increased tariffs or quantitative restrictions—clearly affects the competitive relationship between the targeted products and similar products from all other countries.

5.306 Korea argues that it has long been recognized that GATT/WTO disciplines serve to protect the expectations of the parties as to the competitive relationship between their products and those of the other parties; "[t]he protection of legitimate expectations of Members regarding the conditions of competition is a well-established GATT principle".<sup>594</sup> Accordingly, several provisions of GATT 1994 guard against measures by one WTO Member that have a detrimental effect on the competitiveness of imported products.

5.307 Korea points out that among these provisions pertinent to the present dispute is Article I of GATT 1994, which provides that:

"With respect to customs duties and charges of any kind imposed on or in connection with importation or exportation or imposed on the international transfer of payments for imports and exports, ... any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties".

This most-favoured-nation requirement has been read to invalidate measures that upset the expectations of WTO Members concerning the competitiveness of their products vis-à-vis the products of other Members. It was on this basis that the panel considering measures by Ontario, Canada affecting the sale of gold coins determined that those measures denied coins imported from South Africa both national treatment (Article III) and most-favoured-nation treatment.<sup>595</sup>

5.308 Korea further notes that in a similar vein, Article XIII of GATT 1994 provides, with respect to quantitative restrictions, that: "No prohibition or restriction shall be applied by any contracting party on the importation of any product of the territory of any other contracting party ..., unless the importation of the like product of all third countries ... is similarly prohibited or restricted". Like the requirement of most-favoured-nation treatment, this provision aims to prevent measures that competitively disadvantage the products of one WTO Member vis-à-vis other Members where quantitative restrictions are involved.<sup>596</sup>

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<sup>594</sup> Panel Report on *India—Patent (US)*, op. cit., para. 7.20. See also Ernst-Ulrich Petersmann, *The Dispute Settlement System of the World Trade Organization and the Evolution of the GATT Dispute Settlement System since 1948*, 31 *Common Market L. Rev.* \_\_\_\_, 1178-79 (1994). Cf. Panel Report on *US – Superfund*, op. cit., para. 5.2.2 (applying principle in connection with Article III national treatment obligation).

<sup>595</sup> Panel Report on *Canada – Measures Affecting the Sale of Gold Coins*, L/5863, 17 September 1985, para. 70.

<sup>596</sup> Korea refers to Panel Report on *India – Patents (US)*, op. cit., para. 7.20; Panel Report on *US – Superfund*, op. cit., para. 5.2.2; Panel Report on *US – Section 337*, op. cit., para. 5.13.

5.309 Korea argues that the publication of a retaliation list by USTR — whether the list calls for increased tariffs or quantitative restrictions — clearly affects the competitive relationship between the targeted products and similar products from all other countries. Targeting particular imported products for retaliation can have several effects on trade in those products. Faced with the risk of higher duties or restricted supplies, importers will often choose to shift their orders to producers in other countries immediately, thus eliminating the possibility that they will have to pay an exorbitant duty when the ordered goods actually arrive. On the other hand, in cases where ordered goods may be imported promptly, importers actually might increase their purchases of targeted goods in an effort to increase inventories before the threatened retaliation goes into effect, thus harming imports from non-target countries. (For this reason, products with short lead-times between order and importation are probably not good candidates for USTR retaliation lists.) A third possibility is that importers will immediately increase prices in anticipation of future cost increases or shortages caused by implementation of the retaliation list. In any of these cases, the mere publication of a retaliation list changes the competitive relationship between the targeted products from the target country and all competing products. Accordingly, publication of a retaliation list violates Article I of GATT 1994, and, when the proposed retaliatory measures include quantitative restrictions, Article XIII of GATT 1994. Moreover, as is explained below, the USTR is required to publish a retaliation list within 30 days of the adoption of the panel or Appellate Body report or within 18 months from the date on which the USTR's investigation was initiated, whichever is earlier. USTR is also required to publish retaliation lists within 30 days of the expiration of the reasonable period of time for implementation provided under the DSU.

5.310 No matter where in the process they come, the effect of these measures on smaller countries like Korea is magnified by the overwhelming size of the United States' economy and by the relative insignificance to the United States of trade with any one small economy. This pervasive inequality of bargaining power is one thing that the GATT/WTO dispute settlement system was designed to ameliorate. However, in addition to disrupting the worldwide balance of trade for all WTO Members, threats of retaliatory action outside the GATT/WTO framework further magnify this disproportion to the special disadvantage of smaller countries.

5.311 Korea secondly stresses that Sections 301-310 mandate measures that violate Articles 21 and 23 of the DSU. It should be noted, as the European Communities convincingly establish in their first submission, that legislation requiring governmental action inconsistent with a WTO Member's obligations under the Uruguay Round instruments constitutes a measure that can be brought to a WTO dispute-resolution body even if the authority granted under that legislation has not yet been exercised in a manner inconsistent with GATT 1994 or any related agreement.<sup>597</sup> Sections 301-310 mandate action by the USTR that cannot be reconciled with the United States' obligations under Articles 21 and 23 of the DSU, thus Sections 301-310 themselves violate the DSU. It is no defense to the present challenge to the US law that the USTR might comply with DSU procedures by ignoring the requirements of Sections 301-310.<sup>598</sup>

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<sup>597</sup> Korea refers to Panel Report on *US - Superfund*, op. cit., para. 5.2.2; Panel Report on *US - Malt Beverages*, op. cit., pages 281-282 and 289-90; and Panel Report on *India - Patents (US)*, para. 7.35.

<sup>598</sup> Korea cites Panel Report on *US - Malt Beverages*, op. cit., as recognising at 290 that "[e]ven if Massachusetts may not currently be using its police powers to enforce this mandatory legislation, the measure continues to be mandatory legislation which may influence the decisions of economic operators" Also, Korea cites Panel Report on *India - Patents (US)*, at para. 7.35.

5.312 Korea argues that Sections 301-310 not only authorize the GATT-inconsistent measure of publishing a retaliation list, the statute mandates that the USTR take these actions unilaterally within 30 days of a panel or Appellate Body report being adopted. Specifically, Section 304(a)(2)(A)(i) requires the USTR not only to determine unilaterally whether another country is violating the WTO rights of the United States<sup>599</sup> but also, if such a violation is found, to determine what she proposes to do about it by "30 days after the date on which the dispute settlement procedure is concluded". According to Section 304(c), this determination must be published in the Federal Register. And even before she makes this determination, the USTR must generally "provide an opportunity (after giving not less than 30 days notice thereof) for the presentation of views by interested persons, including a public hearing if requested by any interested person".<sup>600</sup> Thus, the USTR must formulate and publicize a threat of retaliation at the very latest within 30 days of the date of adoption of a panel or Appellate Body report. In formulating her threat, the USTR may choose among retaliatory measures, including the decision to:

"(A) suspend, withdraw, or prevent the application of, benefits of trade agreement concessions ...; [or] (B) impose duties or other import restrictions on the goods of, and, notwithstanding any other provision of law, fees or restrictions on the services of, such foreign country for such time as the Trade Representative determines appropriate".<sup>601</sup>

5.313 Korea contends that under the timetable in Section 304(a)(2), this mandatory announcement of retaliatory measures comes, at the latest, on the last day for a Member adjudged by a panel or the Appellate Body not to be in compliance with its GATT/WTO obligations to "inform the DSB of its intentions in respect of implementation of the recommendations and rulings of the DSB".<sup>602</sup> If the USTR is satisfied with the opposing Member's stated "intentions in respect of implementation", she will of course not need to announce any retaliation, but if she is not so satisfied, she must, under Section 304(a)(2)(A)(i), announce retaliatory measures. This requirement forces the USTR to act contrary to Article 21.5, which requires resort to the dispute settlement procedures of the DSU whenever there is a disagreement as to "the consistency with a covered agreement of measures taken to comply with recommendations and rulings" of a panel or the Appellate Body. Inasmuch as Article 21.5 allows 90 days (or possibly longer) for such a proceeding, the USTR finds herself in the position of being required by a provision of United States law to *effectively* retaliate against the noncompliant Member three months (or more) before a DSU panel has had a chance to rule on whether the remedial measures proposed by the noncompliant Member are or are not satisfactory. To be sure, implementation of the threatened measures can then be held in abeyance for up to 180 days,<sup>603</sup> but the threat has already been made, and, as elaborated above, much damage has already been done.

5.314 Korea further argues that Article 21.5 proceedings may also arise at the conclusion of the agreed reasonable period for a noncompliant Member to implement the recommendations of a panel or Appellate Body report. The USTR may have been satisfied with the proposed

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<sup>599</sup> Korea cites the EC argument that the provisions of DSU Article 23 "oblige the United States to refrain from unilaterally determining whether another Member has denied rights or benefits under a WTO agreement to the United States".

<sup>600</sup> Section 304(b)(1)(A), *codified at* 19 U.S.C. § 2414(b)(1)(A).

<sup>601</sup> Section 301(c), *codified at* 19 U.S.C. § 2411(c).

<sup>602</sup> DSU, Article 21.3.

<sup>603</sup> Section 305(a)(2)(A), *codified at* 19 U.S.C. § 2415(a)(2)(A).

implementation in the period immediately following the adoption of the panel or Appellate Body report, but it may become clear by the end of the implementation period that the implementing Member has not lived up to its promises. In such a case, under the DSU, arbitration under Article 21.5 is the next step. But Sections 301-310 do not allow the USTR to wait for Article 21.5 proceedings to conclude before determining and announcing retaliatory action. Section 306(b)(2) requires that:

"If the measure or agreement referred to in subsection (a) concerns the implementation of a recommendation made pursuant to dispute settlement proceedings under the World Trade Organization, and the Trade Representative considers that the foreign country has failed to implement it, the Trade Representative shall make the determination in paragraph (1) [respecting further retaliatory action] no later than 30 days after the expiration of the reasonable period of time provided for such implementation under paragraph 21 of the Understanding on Rules and Procedures Governing the Settlement of Disputes ...".<sup>604</sup>

As with the determination of a violation, governed by the schedule in Section 304(a)(2), the determination of unsatisfactory implementation contemplated by Section 306(b)(2) must be published in the Federal Register,<sup>605</sup> and the USTR must provide public notice and an opportunity for comment thereon.<sup>606</sup> These provisions ensure that the scope and content of any retaliation list will be well known long before the list is formally implemented.

5.315 Korea alleges that the timing requirements of Sections 304 and 306 thus squarely conflict with Article 21.5 of the DSU, which sets forth a detailed procedure for handling disputes relating to implementation. Sections 304 and 306 require unilateral threats of retaliation at times when Article 21.5 provides for a multilateral arbitration process:

"Where there is disagreement as to the existence or consistency with a covered agreement of measures taken to comply with the recommendations and rulings such dispute shall be decided through recourse to these dispute settlement procedures, including wherever possible resort to the original panel. The panel shall circulate its report within 90 days after the date of referral of the matter to it. When the panel considers that it cannot provide its report within this time frame, it shall inform the DSB in writing of the reasons for the delay together with an estimate of the period within which it will submit its report".

Thus, if the United States objects to the manner in which another WTO Member is proposing to implement the recommendations contained in a panel or Appellate Body report, the DSU requires that the United States have recourse to 90 days (or more) of arbitration before taking any further action, including specific threats of retaliation.

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<sup>604</sup> 19 U.S.C. § 2416(b)(2). Korea notes that Section 305(a) requires that the actions described in this determination be implemented within 30 days unless "the Trade Representative determines that substantial progress is being made, or that delay is necessary or desirable to obtain United States rights or satisfactory solution with respect to the acts, policies, or practices that are the subject of the action". 19 U.S.C. § 2415(a).

<sup>605</sup> Section 304(c), *codified at* 19 U.S.C. 2414(c).

<sup>606</sup> Section 304(b), *codified at* 19 U.S.C. § 2414(b).

5.316 Korea argues that the United States unaccountably takes issue with this obvious interpretation of Article 21.5, denying "that WTO Members are required to pursue a panel under Article 21.5 whenever implementation is at issue". Indeed, the United States argues that "the DSB implicitly rejected this argument" by authorizing US retaliation in the *Bananas* dispute based only on the decision of Article 22.6 arbitrators.

5.317 In the view of Korea, this argument suffers from several serious flaws. In the first place, it is inconsistent with the United States' own prior interpretation of Article 21.5 as the vehicle for resolving implementation disputes. In the Statement of Administrative Action accompanying transmission of the Uruguay Round agreements to the United States Congress for approval, President Clinton indicated that:

"Current GATT procedures do not provide a method for resolving disagreements over implementation of the report's recommendations. Paragraph 5 of Article 21 addresses this problem by providing that such disputes will be decided under DSU procedures. Wherever possible, the panel convened to consider the disagreement will be the one that reviewed the original complaint. Panels normally must issue decisions in these cases within 90 days of referral".<sup>607</sup>

5.318 Korea moreover states that the document cited by the United States, a Compilation of Comments on the DSU by WTO Members,<sup>608</sup> discloses no dissent from this fundamental understanding of Article 21.5; although several Members make suggestions about how to strengthen or improve Article 21.5, there seems to be no dispute that Article 21.5 prescribes the process for handling disputes about implementation.

5.319 Korea also points out that the US argument runs against the statement made by the Chairman of the DSB at the January 29, 1999 meeting. The DSB chairman stated that "the solution to the banana matter would be totally without prejudice to future cases and to the question of how to resolve the systemic issue of the relationship between Article 21.5 and 22 of the DSU".<sup>609</sup> Similarly, the panel in the *Bananas* case did not hold that recourse to Article 21.5 procedures was optional any time a Member viewed measures proposed by a noncompliant party as inconsistent with a covered agreement. The decision in *Bananas* concerning Article 21.5 was quite explicitly limited to the unique situation presented in that case.

"*In the special circumstances of this case . . . it is necessary to find a logical way forward that ensures a multilateral decision, subject to DSB scrutiny, of the level of suspension of concessions*".<sup>610</sup>

The special circumstances of the *EC – Bananas III* case were that the United States did not object to the EC's compliance measures until the "reasonable period" had expired, thus making

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<sup>607</sup> Message from The President of the United States transmitting The Uruguay Round Trade Agreements, Texts of Agreements Implementing Bill, Statement of Administrative Action and Required Supporting Statements, September 27, 1994, at 1016.

<sup>608</sup> Review of the DSU, Note by the Secretariat, Compilation of Comments Submitted by Members—Rev. 3 of 12 December 1998, cited by the United States.

<sup>609</sup> Minutes of DSB Meeting of 25, 28 and 29 January and 1 February 1999, WT/DSB/M/54, p. 31.

<sup>610</sup> Arbitration under Article 22.6 of the DSU in *European Communities - Regime for the Importation, Sale and Distribution of Bananas*, dated 19 April 1999 (WT/DS27/ARB), para. 4.15. (emphasis added).

it impossible for the United States to comply with Article 21.5 while at the same time completing its Article 22 proceeding concerning suspension of concessions within the time specified in Article 22.6. These circumstances will not be present in all cases and cannot be present in cases, such as those described above, in which effective retaliation must occur long before the expiration of the "reasonable period".

5.320 Korea also stresses that finally, and most importantly, the interpretation now advocated by the United States would have the impermissible effect of reading Article 21.5 out of the DSU altogether. If this Article does not govern "[w]here there is disagreement as to the existence or consistency with a covered agreement of measures taken to comply with the recommendations and rulings" of a panel or Appellate Body report, what possible effect could it have? If, as the United States contends, the panel in the *Bananas* dispute intimated that Article 21.5 need not serve this function, the panel was simply wrong and need not be followed by this Panel.<sup>611</sup> Such an interpretation of the DSU cannot be reconciled with the most fundamental principles of treaty interpretation as codified in the Vienna Convention on the Law of Treaties. Article 31 of that treaty teaches that "A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose". The ordinary meaning of 21.5 is that it prescribes 90 days of arbitration in the event of a dispute over implementation. An interpretation that denies this plain meaning—and in the process renders the entire clause superfluous and meaningless—as does the position the United States advocates, cannot be called a "good faith" interpretation.

5.321 In the view of Korea, rather, in the DSU, WTO Members have agreed upon a mechanism for resolving disputes about implementation of panel or Appellate Body recommendations. Article 21.5 is that mechanism. Sections 301-310, and in particular Sections 304 and 306, outline timetables that mandate the USTR to announce retaliatory measures in the event of an implementation dispute before the procedures contemplated by Article 21.5 can possibly be completed. Thus, Sections 301-310 deny to the United States' trading partners, including Korea and the European Communities, the benefits of DSU Article 21.5.

5.322 Korea further goes on to state that Article 23.1 of the Dispute Settlement Understanding obligates the United States to "have recourse to, and abide by, the rules and procedures of this Understanding" in "seek[ing] the redress of a violation of obligations or other nullification or impairment of benefits under the covered agreements or an impediment to the attainment of any objective of the covered agreements". As elaborated above, Sections 301-310 require the USTR to act inconsistently with DSU procedures. By requiring the USTR to decide upon and publicize unilateral retaliatory action before there has been time to conclude the arbitration contemplated in DSU Article 21.5, the aggressive timetable set forth in Sections 301-310, and in particular Sections 304 and 306, prevents the USTR from living up to the United States' promise. This aspect of Sections 301-310 is clearly inconsistent with Article 23.1 of the DSU, and the United States should be required to amend its law accordingly.

#### **4. Conclusion**

5.323 Korea concludes that for the foregoing reasons, it respectfully requests this Panel to determine that unilateral threats of retaliation under Sections 301-310 of the United States Trade

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<sup>611</sup> Panel Report on *India – Patents (US)*, op. cit., para. 7.30 ("[P]anels are not bound by previous decisions of panels or the Appellate Body even if the subject matter is the same".).

Act of 1974 deny Korea and other WTO Members the benefits of Articles I and XIII of GATT 1994 and Article 21 of the DSU, and violate Article 23 of the DSU.

K. THAILAND

1. Introduction

5.324 **Thailand states** that as Member of the World Trade Organization and trade partner of the United States, it has substantial systemic interest in the present case.

5.325 In Thailand's view, the crux of the systemic issue here is multilateralism as basis of international trade, a principle all Members of this Organization adhered to. This principle is embodied in the preamble of the Agreement Establishing the World Trade Organization (WTO Agreement), defining its very object and purpose, which is to "develop an integrated, more viable and durable multilateral trading system".<sup>612</sup>

5.326 Thailand goes on to state that in addition to this serious systemic concern, it has been in the past target of decisions and determinations made under Sections 301-310 of the Trade Act of 1974. In 1989, Thailand was placed by the US Government on the "Priority Watch List" (PWL), and in 1991 was named "Priority Foreign Country" (PFC) pursuant to the "Special 301" procedure. In 1994, after some intense negotiations and changes in Thai domestic laws and regulations, Thailand was moved back to the PWL. Thailand was subject in 1990 to a GATT litigation<sup>613</sup> brought pursuant to a petition filed under Section 301 procedure. Also, In December 1991 and in March 1992, the USTR determined under Sections 301-310 that Thailand's acts, policies and practice related to copyright and patent protection were "unreasonable" and "a burden on US commerce". The matters were dropped by the United States only after Thailand agreed to carry out changes to the relevant Thai legislation.

5.327 In response to the Panel's question, Thailand states that its experience serves to illustrate Thailand's interest in the case at hand. The fact that these events took place in the context of the GATT does not affect Thailand's legal arguments in the present case, which is valid for both the GATT and the WTO contexts.

5.328 Thailand underlines the situation where the United States made determinations and/or took actions under the Trade Act of 1974 independently from the GATT dispute settlement procedure. This pattern of US unilateral acts can still happen under the WTO system, since the provisions of the Trade Act 1974 mandating the US Government to do so are still in force after the United States became Party to the WTO Agreement.

5.329 Thailand argues that the US Government has moreover indicated, upon becoming WTO Member, its intention to use its authority under the Trade Act of 1974 to enforce US rights vis-à-vis the other WTO Members out of the WTO, if it unilaterally considers that the matter at hand does not "involve a Uruguay Round Agreement".<sup>614</sup> This has been confirmed in 1999 by

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<sup>612</sup> Preamble of the WTO Agreement, para. 5.

<sup>613</sup> Panel Report on *Thai – Cigarettes*, op. cit.

<sup>614</sup> Statement of Administrative Action, op. cit., 2(b) Enforcement of US rights, pp. 364-367.

Thailand notes that this Statement represents the US Administration's views regarding the interpretation and application of the WTO Agreement both for the purpose of international law and the US domestic laws.



the US President's Executive Order re-instituting the "Super 301 authority" and "Title VII authority".<sup>615</sup>

5.330 Thailand reiterates that these cases of US unilateral acts establish a pattern of violation of the US obligations under the WTO Agreement, and should be taken into account by the Panel in its deliberation.

5.331 Thailand strongly believes that, in a true multilateral trading system, no WTO Member can be judge and jury in its own dispute. The Dispute Settlement Body (DSB) must be the exclusive forum for settling disputes between WTO Members relating to their WTO rights and obligations, and the DSU must provide the exclusive rules and procedures for such settlement.

## 2. Legal Arguments

5.332 Thailand submits, on the basis of the following, that the United States has acted inconsistently with Article XVI:4 of the WTO Agreement, by failing to ensure the conformity of its Trade Act of 1974 with its obligations as provided in Articles 1, 3, 22 and 23 of the Understanding on Rules and Procedures Governing the Settlement of Disputes (DSU); and that consequently the panel should recommend that the DSB request the United States to bring its Trade Act of 1974 into conformity with its obligations under the WTO Agreement.

5.333 Thailand reserves its rights with regard to any other points at issue which are not discussed herein.

5.334 Thailand argues that under Section 304(a)(2)(A), in the case of investigation involving a trade agreement, the USTR is required to determine whether the rights to which the United States is entitled under the trade agreement are being denied on or before *the earlier* of (i) the date that is 30 days after the date on which the dispute settlement procedure is concluded, or (ii) the date that is 18 months after the date on which the investigation is initiated. Under Section 303(a)(1), the USTR is required to request consultations with the foreign country concerned on the date on which an investigation is initiated under Section 302. The combined effect of these two provisions is that the USTR is required to make the determination at the latest 18 months after the request for consultations made by the United States.

5.335 In the view of Thailand, under the DSU, WTO dispute settlement proceedings can take under normal circumstances as long as 19 months (9 months and 300 days) from the beginning of the consultation process to be concluded. This breaks down as follows:

Consultations	60 days	(DSU Article 4.7)
Establishment of panel (From date of request to date of establishment)	30 days	(DSU Article 6.1)
Determination of panel composition	30 days	(DSU Article 8.7)
Panel proceedings	9 months	(DSU Article 12.9)

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<sup>615</sup> USTR Press Release of 26 January 1999, (Thai Ex. 2).

(from establishment to circulation of report)

Adoption of panel report/Notice of appeal 60 days (DSU Article 16)

Appellate Review 90 days (DSU Article 17.5)

(From notification of appeal to AB report circulation)

Adoption of AB report by DSB 30 days (DSU Article 17.14)

Note: In this scenario, the period from the date of establishment of the panel to the date of the adoption of the AB report is 9 months and 210 days, and does not exceed the maximum time frame as provided in DSU Article 20.

5.336 Thailand contends that both Sections 304(a)(2) and 303(a)(1) use the term "shall". They mandate the USTR to determine whether the US WTO rights are being denied before the conclusion of the normal WTO dispute settlement proceedings. The USTR is thus required to act inconsistently with DSU Article 23.2(a).

5.337 Thailand challenges the US allegation that the USTR may request WTO dispute consultations prior to initiating a Section 302 investigation, "thereby allowing for the DSB adoption of panel and Appellate Body findings within the 18-month period provided for under Section 304(a)(2)(A)". This argument, however, must be rejected. The term used by Section 303(a)(1) leave no room for any other understanding or interpretation: WTO consultations must ("shall") be requested by the USTR on the same date as that on which the relevant investigation is initiated under Section 302.<sup>616</sup> The USTR simply cannot violate this US domestic law provision.<sup>617</sup>

5.338 Thailand also rebuts the US further allegation that the USTR has "broad discretion to issue any of a number of determinations which would not remotely conflict with article 23.2(a)". Thailand submits, on the contrary, that the content of the determination is secondary. What counts is the possibility, on the domestic legal plane, for the USTR to determine the WTO inconsistency of another Member. This possibility is in itself a violation of DSU Article 23.2(a). Such determination, moreover, is mandatory for the USTR. Sections 304(a)(2)(A) and 303(a)(1), consequently, are inconsistent with DSU Article 23.2(a).

5.339 Thailand further argues that where an Arbitration under DSU Article 22.6 determines that there is no nullification or impairment of US benefits under the WTO Agreement or that the US-proposed retaliation measure exceeds the actual level of nullification or impairment, Sections 306(b) and 305(a) still mandate the USTR to take action inconsistent with DSU Articles 22.7 and 23.2 (c).

5.340 Thailand contends that Section 306(b)(2) mandates the USTR to determine, within 30 days after the expiration of the reasonable period of time under the DSU, what retaliatory action "the US shall take under Section 301(a)" against a Member implementing a recommendation

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<sup>616</sup> Thailand notes that the 60 day consultation period under DSU Article 4.7 begins on the date of receipt of such request. In practice, this means that a further delay may be added to the normal 19 month period of proceedings.

<sup>617</sup> Thailand notes that the United States indicated that the USTR "has in fact done so" in many cases.

made pursuant to the DSU. Section 305(a)(1) requires the USTR to implement such action within 30 days after the determination is made.

5.341 Thailand further alleges that Section 306(b)(2) and Section 305(a)(1) remain mandatory<sup>618</sup> for the USTR even in the case that an arbitration is appointed under DSU Article 22.6 to consider the level of suspension of concessions or other obligations proposed, and that such arbitration determines that there is no nullification or impairment of US benefits under the WTO Agreement, or that the US-proposed retaliation measure exceeds the actual level of nullification and impairment. In this case, the USTR is required by Section 305(a)(1) to implement the action already determined under Section 306(b)(2), notwithstanding the content of the arbitrator's decision.<sup>619</sup>

5.342 Thailand adds that it has supplied the Panel with the rationale supporting its legal opinion. Thailand, however, is not in a position, nor is it entitled, to give the Panel the rationale or the motive behind the USTR's reduction of the level of retaliation into conformance to the Arbitrators' decision in *Banana III* case..

5.343 Thailand contends that the legality of the said USTR's act, vis-à-vis the US Trade Act of 1974, depends on the meaning of the relevant provisions of the legislation, which under the US constitutional system can only be ascertained through an authoritative, judicial, interpretation of those provisions.

5.344 In the view of Thailand, if, in accordance with an authoritative interpretation under the US legal system, the USTR's act mentioned above is found to be inconsistent with the Trade Act of 1974, then it is the Act itself that is in violation of the WTO Agreement.

5.345 According to Thailand, since it is the United States that invokes the exceptions under Section 301(a)(2) to justify its claim, the onus of proof rests with the United States.

5.346 Thailand further argues that Section 306(b)(2) and Section 305(a)(1) therefore violate DSU Article 22.7 which provides that suspension of concessions and other obligations must be "consistent with the decision of the arbitrator". They also violate DSU Article 23.2(c) which requires the retaliating party to "follow the procedures set forth in Article 22 to determine the level of suspensions of concessions or other obligations".

5.347 Thailand recalls the US allegation that the exceptions set forth in Section 301(a)(2) allow the USTR to act consistently with an Article 22.6 Arbitrators' decision. Section 301(a)(2)(A) provides that the USTR is not required to take action in any case in which "the Dispute Settlement Body ... has adopted a report ..." (emphasis added) that the rights of the United States under a trade agreement are not being denied or that US trade agreement benefits are not being denied, nullified or impaired.

5.348 In the view of Thailand, Section 301(a)(2)(A), however, is not applicable to the case at hand. The decision of an arbitrator appointed under DSU Article 22.6 is not, and cannot be considered as, a "report" in the sense of Section 301(a)(2)(A); and the DSU does not require such arbitrator's decision to be "adopted" by the Dispute Settlement Body. This has been confirmed by the recent WTO practice in the *EC – Bananas III* case, where the DSB agreed to

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<sup>618</sup> Thailand notes that both provisions use the term "shall".

<sup>619</sup> Thailand points out that in the *EC – Bananas III* case, the USTR nevertheless reduced the level of retaliation in order to conform to the Arbitrators' decision. See WT/DS27/49, dated 9 April 1999.

grant, pursuant to the US request, authorization to suspend concessions and related obligations under GATT 1994, consistent with the decision of the Arbitrators, without adopting the said decision.<sup>620</sup>

5.349 Thailand recalls that the United States also invokes other exceptions under Section 301(a)(2) to justify its claim that the USTR may act consistently with an Article 22.6 Arbitrators' decision reducing the level of US-proposed retaliation or denying the US the right to retaliate. These are exceptions when the USTR finds that action would have an adverse impact on the US economy or would cause serious harm to national security.<sup>621</sup> The United States, however, fails to establish that, according to the authoritative (judicial) interpretation of these provisions under the US legal system, these exceptions are applicable to the case (of a decision by an Article 22.6 arbitrator reducing the level of US-proposed retaliation or denying the United States the right to retaliate). The US claim is merely based on an interpretation by the US Government of Section 301. In the US domestic legal system, as in any known legal system, the Judiciary is by no means bound by the Executive Branch interpretations of legal provisions. The applicability of these provisions is all the more questionable here because of their imprecise terms. Section 301(a)(2)(B)(iv), in particular, is limited to "extraordinary cases" only.

5.350 Thailand adds that ascertaining the meaning of the Trade Act of 1974 provisions, in accordance with the authoritative interpretation under the US legal system,<sup>622</sup> is not only within the mandate of the Panel, but also fundamental for carrying out this mandate, which is to determine the conformity, or non-conformity, of this legislation with the US obligations under the WTO Agreement.

5.351 Thailand further argues that the Trade Act of 1974 is a legislation that empowers and mandates the US Government to act in a certain manner within the limits and scope provided therein. Because its terms are vague as to the extent of the power given the US Executive, one must be all the more cautious about its interpretation. In particular, the panel should not base its deliberation on the US Executive's own interpretation of this legislation, at least to the extent involving judgment of the legality of US Government's acts vis-à-vis the legislation itself. In any State of law, a power conferred to State officials is not without limit or purpose. It is impossible to prevent *Abus de pouvoir* or *exces de pouvoir* if one is judge of one's own acts. *Nemo jus sibi dicere potest* - No one can declare the law for himself/herself.

5.352 In the view of Thailand, in the absence of authoritative interpretation, i.e. if the United States fails to establish what it claims, there is a doubt as to whether the Trade Act of 1974 is consistent with the WTO Agreement. In view of the vagueness of this Legislation's terms, doubts deprive the other Members from predictability and security, the very objective of the DSU,<sup>623</sup> and cannot be permitted under the WTO system.

5.353 Thailand further states that the same argument is valid for rejecting the US claim regarding the discretion granted the US President under Section 301(a)(1) to "direct" the USTR action. Again, the United States fails to establish that, according to an authoritative

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<sup>620</sup> Dispute Settlement Body, Minutes of the Meeting held on 19 April 1999, WT/DSB/M/59, 3 June 1999, p.11

<sup>621</sup> Thailand points out that these exceptions are provided for in Section 301(a)(2)(B)(iv) and (v).

<sup>622</sup> Thailand alternatively points out "to use the US wording, 'as interpreted in accordance with the domestic law of the Member'."

<sup>623</sup> DSU Article 3.2

interpretation of this provision under the US law, the discretion granted the US President allows him or the USTR to act inconsistently with Section 306(b)(2) and 305(a)(1).

5.354 Thailand also contends that it would be insufficient for the United States to invoke in this respect Section 305(a)(2) regarding the possibility for the USTR to delay, in certain cases, the implementation of action by up to 180 days. What is violating the US obligations here is not the timing of such implementation, but the action to be implemented itself.

5.355 Thailand further contends that the Trade Act of 1974 provides for determinations to be made and actions to be taken against a WTO Member without recourse by the United States to the DSU rules and procedures. This is the case when the US Government unilaterally considers that the matter at issue falls outside the scope or the disciplines of the WTO Agreement.<sup>624</sup>

5.356 In the view of Thailand, the WTO dispute settlement system is a "central element in providing security and predictability to the multilateral system", and "serves to preserve the rights and obligations of Members" under the WTO Agreement.<sup>625</sup> The rules and procedures of the DSU "shall apply to consultations and the settlement of disputes between Members concerning their rights and obligations" under the WTO Agreement.<sup>626</sup> Members seeking "the redress of a violation of obligations or other nullification or impairment of benefits" under the WTO Agreement "shall have recourse to, and abide by, the rules and procedures" of the DSU.<sup>627</sup> The ordinary meaning of these provisions in their context is clear: the DSU provides the *exclusive* rules and procedures for settling all disputes concerning the rights and obligations of WTO Members.

5.357 Thailand notes that in accordance with the above provisions, any dispute between WTO Members regarding a determination whether a matter concerns the rights and obligations of a WTO Member falls under the scope of the DSU, and must be settled in accordance with the DSU rules and procedures. Sections 301, 304 and 305, however, mandate<sup>628</sup> the USTR to determine unilaterally that a matter does not involve WTO rights and obligations, and mandate action to be taken by the USTR on that basis irrespective of the rules and procedures of the DSU.

5.358 Thailand argues that Sections 301, 304 and 305 consequently deprive the WTO Members of any security or predictability they might legitimately expect from a rules-based multilateral trading system. This leads to a paradoxical situation: for a unilaterally alleged non-violation of WTO obligations, a Member may see their WTO rights violated by the most powerful Member of the WTO on the basis of a domestic legislation of the latter, without the protection of the DSU rules and procedures. A protection that would have been available had the concerned Member been in violation of their WTO obligations. In this case, the Member will have no alternative but to challenge the US sanction measure before the DSB. The process is, however, time-consuming, and in any case much damage will have already been done.

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<sup>624</sup> Thailand cites Statement of Administrative Action, Uruguay Round Agreements Act: Enforcement of US Rights.

<sup>625</sup> DSU, Article 3.2.

<sup>626</sup> DSU, Article 1.1.

<sup>627</sup> DSU, Article 23.1.

<sup>628</sup> Thailand points out that Sections 304(a)(1), 305 (a)(1) and 301(a)(1) all use the term "shall".

5.359 Thailand concludes that the Trade Act of 1974 is thus not only inconsistent with DSU Articles 1.1, 3.2 and 23.1, but also at variance with the very object and purpose of the WTO Agreement

5.360 Thailand emphasizes that the types of action prescribed by Section 301(c) constitute violations of the WTO rights of the target country. In the case of disputes involving trade in goods, in particular, the USTR is mandated by Sections 301, 304 and 305 to impose duties, fees or restrictions that violate the GATT 1994 provisions, including Articles I, II, III, VIII and XI thereof. As already demonstrated above, where the United States unilaterally determines that the matter falls outside the scope or the disciplines of the WTO Agreement, Sections 301, 304 and 305 mandate the USTR to implement these WTO-inconsistent actions irrespective of the DSU proceedings, and in the absence of an authorization by the DSB. Sections 301, 304 and 305 are therefore inconsistent with Articles 22.6, 22.7 and 23.2(c) of the DSU.

5.361 Thailand, in response to the Panel's question as to whether an official US statement binding in international law that the US government will not exercise its discretion in a way contrary to WTO rule remove the WTO inconsistency of Sections 301-10 on the assumption that the USTR and the President have the direction to avoid determinations and actions contrary to WTO rules in all circumstances, and that, nevertheless, Sections 301-310 were found inconsistent with WTO rules, states that in this scenario, Sections 301-310 are "found to be inconsistent with WTO rules". Since these provisions are of legislative nature, an official US Government statement will not remove the inconsistency. As Member of the WTO, the US must, under international law, bring Sections 301-310 into conformity with the WTO Agreement by either amending them or abolishing them.

## VI. INTERIM REVIEW

6.1 Our interim report was sent to the parties on 12 October 1999. On 26 October 1999 both the European Communities ("EC") and the United States ("US") requested us to review, in accordance with Article 15.2 of the DSU, precise aspects of the interim report. Neither the EC nor the US requested a further meeting.

6.2 What follows is a discussion of the arguments made at the interim review stage as required by Article 15.3 of the DSU.

6.3 The EC made two comments. First, it submitted that the findings part of the interim report did not contain a clear description of the legal claims and arguments of the EC that were before the Panel. The EC referred to a summary of the main legal grounds supporting its claims that was incorporated in the EC rebuttal submission. The EC believed that it is necessary for the clarity and the better understanding of the Panel Report that these main legal arguments be inserted at the appropriate place in the findings part of our Report. We did so by adding what are now paragraphs 7.4-7.6 of our Report.

6.4 Second, in respect of what is now footnote 707 of our Report, the EC pointed out that while it is correct that it did not request the Panel to make a decision on the relationship between Articles 21.5 and 22 of the DSU, the EC has clarified in the second paragraph of its response to Panel Question 23 that

"the WTO consistency of Sections 301-310 must be assessed against all the provisions quoted in the Panel's terms of reference, including Article 21.5 of the DSU on its own".

The EC submitted that the Panel's terms of reference included, together with Article 23, also *inter alia* Article 21 of the DSU and that the EC claim of violation by Section 306 of Article 21.5 is inextricably related to the issue of compliance with Article 23.2(c), which in turn is, as the Panel itself has recognised in what is now paragraph 7.44 of the Report, "specifically linked to, and has to be read together with and subject to, Article 23.1". The EC further referred to the fact that it also stated in its response to Panel Question 23 that

"[t]he interpretation of Article 22 of the DSU is logically and legally a distinct issue to be addressed by the Panel separately, if necessary".

6.5 On these grounds, the EC pointed out that the earlier version of what is now footnote 707 of our Report does not fully reflect the EC's position before the Panel and that as a matter of fact, the EC has clearly requested the Panel to rule on the compatibility of the deadlines contained in Section 306 with Article 21.5 of the DSU.

6.6 We added the elements referred to by the EC in footnote 707 and also addressed them there. We slightly redrafted paragraph 7.169 of our Report. On the deadlines in Section 306 and Articles 21.5 and 22, we recall that we addressed those in paragraphs 7.145, 7.180 and footnote 720 of our Report. They fall within our mandate as elements relevant for an assessment of the EC claims under Article 23.

6.7 The US expressed the view that the Panel's ultimate finding on the WTO-consistency of Sections 301-310 is correct and also generally agreed with the Panel's factual findings and its reasoning.

6.8 The US had concerns, however, with certain aspects of the Panel's legal reasoning, in particular with respect to the Panel's treatment of the mandatory/discretionary distinction in GATT/WTO jurisprudence. The US requested that the Panel reconsider and modify its legal reasoning on the fundamental question of whether there may be a violation of Article 23 by a measure which does not preclude WTO-inconsistent action, but which does not actually command a WTO violation. The US reiterated its view that there is no credible and coherent means of drawing legal distinctions among measures which do not preclude a WTO violation, and that it could create substantial unpredictability in the interpretation of a Member's WTO obligations if there is a blurring of the heretofore firm line drawn in the jurisprudence that only legislation mandating a violation of a WTO obligation actually violates that obligation. On that ground, the US asked the Panel to find that the statutory language of Sections 304 and 306, when considered in isolation, does not create a *prima facie* violation of Article 23.2(a) because that language does not preclude a determination of inconsistency.

6.9 As a result of this US comment, we added the last four sentences of what is now paragraph 7.54 of our Report and slightly reworded paragraph 7.93. We also added two new footnotes: footnote 658 and footnote 675. We stress once again that our Report does not overturn the classical test in the pre-existing jurisprudence that only legislation mandating a WTO inconsistency or precluding WTO consistency, can, as such, violate WTO provisions. On the contrary, we have followed this traditional distinction and found that the statutory language of Section 304 precludes consistency with Article 23.2(a), the way we read it. The resulting *prima facie* violation of legislation that "merely" reserves the right for WTO inconsistent action in a given dispute is specific, first, to Member obligations under Article 23 -- and its pivotal role in the DSU as an element strengthening the wider multilateral trading system -- and, second, the many case-specific circumstances we referred to in our Report, peculiar to Section 304 and the US more generally.

6.10 The US also asked us to reconsider our finding, in what is now paragraph 7.146, that Section 306 "considerations" are "determinations" for purposes of Article 23.2(a). The US did so on the ground that Article 22 of the DSU affirmatively requires Members to request suspension of concessions within 30 days of the expiry of the reasonable period of time, and that the USTR must therefore make a judgment – must "consider" – whether implementation has taken place as a prerequisite to exercising its rights under Article 22. The US submits that the Section 306 "consideration" represents no more than a belief necessary to the pursuit of dispute settlement procedures. For these reasons, the US requested the Panel to find that Section 306 does not violate Article 23.2(a) because it does not provide for a "determination" within the meaning of Article 23.2(a).

6.11 In response to this US comment, we revised the part of footnote 657 dealing with the requirement that there be a "determination" of WTO inconsistency. We also expanded the reasoning in paragraph 7.146.

6.12 Finally, in reply to a US comment that the US-Australia agreement in the *Australia – Leather* case was made with reference to footnote 6 of Article 4 of the SCM Agreement, we added such reference in footnote 709.

## VII. FINDINGS

### A. CLAIMS OF THE PARTIES

7.1 The claims of the parties may be summarised as follows.

7.2 The EC claims that by adopting, maintaining on its statute book and applying Sections 301-310 of the 1974 Trade Act after the entry into force of the Uruguay Round Agreements, the US has breached the historical deal that was struck in Marrakech between the US and the other Uruguay Round participants. According to the EC, this deal consists of a trade-off between, on the one hand, the practical certainty of adoption by the Dispute Settlement Body ("DSB") of panel and Appellate Body reports and of authorization for Members to suspend concessions – in the EC's view, an explicit US request – and, on the other hand, the complete and definitive abandoning by the US of its long-standing policy of unilateral action. The EC submits that the second leg of this deal, which is, in its view, the core of the present Panel procedure, has been enshrined in the following WTO provisions: Articles 3, 21, 22 and, most importantly, 23 of the DSU and Article XVI:4 of the WTO Agreement.

7.3 The EC claims, more particularly, that

- (a) inconsistently with Article 23.2(a) of the DSU:
  - Section 304 (a)(2)(A) requires the US Trade Representative ("USTR") to determine whether another Member denies US rights or benefits under a WTO agreement irrespective of whether the DSB adopted a panel or Appellate Body finding on the matter; and
  - Section 306 (b) requires the USTR to determine whether a recommendation of the DSB has been implemented irrespective of whether proceedings on this issue under Article 21.5 of the DSU have been completed;



- (b) inconsistently with Article 23.2(c) of the DSU:
- Section 306 (b) requires the USTR to determine what further action to take under Section 301 in case of a failure to implement DSB recommendations; and
  - Section 305 (a) requires the USTR to implement that action,
- and this in both instances, irrespective of whether the procedures set forth in Articles 21.5 and 22 of the DSU have been completed; and
- (c) Section 306 (b) is inconsistent with Articles I, II, III, VIII and XI of GATT 1994 because, in the case of disputes involving trade in goods, it requires the USTR to impose duties, fees or restrictions that violate one or more of these provisions.

7.4 The EC submits that Sections 301-310, on their face, mandate unilateral action by the US authorities in breach of Article 23 of the DSU and consequently of Articles I, II, III, VIII and XI of the GATT 1994. According to the EC, this is true both under the former GATT 1947 standards concerning mandatory versus discretionary legislation and the present standards under the GATT 1994 and the WTO Agreement which the EC considers the relevant sources of law applicable after the entry into force of the WTO agreements. The EC arguments on the issue of the standards applicable to determine whether legislation is genuinely discretionary are contained in the descriptive part of this Report.<sup>629</sup>

7.5 In addition, the EC argues that Sections 301-310 -- even if they could be interpreted to permit the USTR to avoid WTO-inconsistent determinations and actions -- cannot be regarded as a sound legal basis for the implementation of the US obligations under the WTO. For the EC, the lack of this "sound legal basis" produces a situation of threat and legal uncertainty against other WTO Members and their economic operators that fundamentally undermines the "security and predictability" of the multilateral trading system.

7.6 The EC submits, furthermore, that Sections 301-310 are not in conformity with US obligations under the WTO since they are an expression of a deliberate policy creating a pattern of executive action which is biased against WTO-conformity. According to the EC, even if Sections 301-310 could be interpreted to provide the USTR with a legal basis for the implementation of US obligations under the WTO, they could not be considered to be in conformity with WTO law within the meaning of Article XVI.4 of the WTO Agreement.

7.7 On these grounds, the EC requests us to rule that the US, by failing to bring the Trade Act of 1974 into conformity with the requirements of Article 23 of the DSU and Articles I, II, III, VIII and XI of the GATT 1994, acted inconsistently with its obligations under those provisions and under Article XVI:4 of the WTO Agreement and thereby nullifies or impairs benefits accruing to the EC under the DSU, GATT 1994 and the WTO Agreement.

7.8 The EC, finally, asks us to recommend that the DSB request the US to bring its Trade Act of 1974 into conformity with its obligations under the DSU, GATT 1994 and the WTO Agreement.

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<sup>629</sup> See paras. 4.196-4.214, 4.233-4.244, 4.250-4.263 and 4.295-4.299 of this Report.

7.9 The US responds that the EC has brought a political case that is in search of a legal argument. It submits that the EC is not entitled to prevail in this dispute on the basis of a series of assumptions adverse to the US, assumptions both with respect to the decisions the USTR can make under Sections 301-310 and with respect to panel, Appellate Body and DSB meeting schedules. According to the US, Sections 301-310 permit the US to comply with DSU rules and procedures in every case: Section 304 permits the USTR to base his or her determinations on adopted panel and Appellate Body findings in every case; and Sections 305 and 306 permit the USTR, in every case, to request and receive DSB authorization to suspend concessions in accordance with Article 22 of the DSU. The US concludes that it fully meets its WTO obligations in this respect.

## B. PRELIMINARIES

### 1. Relevant Provisions of the WTO and of Sections 301-310 of the US trade Act

7.10 In Annex I of this Report we reproduce for the convenience of the reader the provisions of Sections 301-310 as they were submitted to us in Exhibit 1 to the US submissions, as well as those provisions of the WTO to which frequent reference is made in this Report.

### 2. The Panel's Mandate

7.11 The political sensitivity of this case is self-evident. In its submissions, the US itself volunteered that Sections 301-310 are an unpopular piece of legislation. In addition to the EC, twelve of the sixteen third parties expressed highly critical views of this legislation.<sup>630</sup>

7.12 Our function in this case is judicial. In accordance with Article 11 of the DSU, it is our duty to "make an objective assessment of the facts of the case and the applicability of and conformity with the relevant covered agreements, and make such other findings as will assist the DSB in making the recommendations or in giving the rulings provided for in the covered agreements".<sup>631</sup>

7.13 The mandate we have been given in this dispute is limited to the specific EC claims set out in Section VII.A above. We are not asked to make an overall assessment of the compatibility of Sections 301-310 with the WTO agreements. It is not our task to examine any aspects of Sections 301-310 outside the EC claims. We are, in particular, not called upon to examine the WTO compatibility of US actions taken in individual cases in which Sections 301-310 have been applied. Likewise, we have not been asked to address the WTO consistency of those provisions in Section 301-310 relating to determinations and actions taken by the USTR that do not concern the enforcement of US rights under the WTO Agreement, including the provisions authorizing the USTR to make a determination as to whether or not a matter falls outside the scope of the WTO agreements.<sup>632</sup>

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<sup>630</sup> See Section V of this Report. Four third parties expressed no opinion in respect of this dispute.

<sup>631</sup> Hereafter we refer to the "covered agreements" as those WTO agreements at issue in this dispute.

<sup>632</sup> Answering Panel Question 43, the EC explicitly confirmed these limitations on the claims before us. See para. 4.634 of this Report.

### **3. Fact Finding: Rules on Burden of Proof and Interpretation of Domestic Legislation**

#### **(a) Burden of Proof – General**

7.14 Part of our task in accordance with Article 11 of the DSU is to make factual findings. We are guided in this matter, as well as others, by the jurisprudence of the Appellate Body. In accordance with this jurisprudence, both parties agreed that it is for the EC, as the complaining party, to present arguments and evidence sufficient to establish a *prima facie* case in respect of the various elements of its claims regarding the inconsistency of Sections 301-310 with US obligations under the WTO. Once the EC has done so, it is for the US to rebut that *prima facie* case. Since, in this case, both parties have submitted extensive facts and arguments in respect of the EC claims, our task will essentially be to balance all evidence on record and decide whether the EC, as party bearing the original burden of proof, has convinced us of the validity of its claims. In case of uncertainty, i.e. in case all the evidence and arguments remain in equipoise, we have to give the benefit of the doubt to the US as defending party.

7.15 We note, in addition, that the party that alleges a specific fact – be it the EC or the US – has the burden to prove it. In other words, it has to establish a *prima facie* case that the fact exists. Following the principles set out in the previous paragraph, this *prima facie* case will stand unless sufficiently rebutted by the other party.

7.16 The factual findings in this Report were reached applying these principles. Of course, when it comes to deciding on the correct interpretation of the covered agreements a panel will be aided by the arguments of the parties but not bound by them; its decisions on such matters must be in accord with the rules of treaty interpretation applicable to the WTO.

#### **(b) Examination of Domestic Legislation**

7.17 In respect of the examination of domestic law by WTO panels, both parties referred to the *India – Patents (US)* case. There the Appellate Body stated that "[i]t is clear that an examination of the relevant aspects of Indian municipal law ... is essential to determining whether India has complied with its obligations under Article 70.8(a) [of the TRIPS Agreement]. There was simply no way for the Panel to make this determination without engaging in an examination of Indian law".<sup>633</sup>

7.18 In this case, too, we have to examine aspects of municipal law, namely Sections 301-310 of the US Trade Act of 1974. Our mandate is to examine Sections 301-310 solely for the purpose of determining whether the US meets its WTO obligations. In doing so, we do not, as noted by the Appellate Body in *India – Patents (US)*<sup>634</sup>, interpret US law "as such", the way we would, say, interpret provisions of the covered agreements. We are, instead, called upon to establish the meaning of Sections 301-310 as factual elements and to check whether these

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<sup>633</sup> Appellate Body Report on *India – Patent Protection for Pharmaceutical and Agricultural Chemical Products ("India – Patents (US)")*, WT/DS50/AB/R (complaint by US), adopted 16 January 1998, para. 66.

<sup>634</sup> *Ibid.*

factual elements constitute conduct by the US contrary to its WTO obligations. The rules on burden of proof for the establishment of facts referred to above also apply in this respect.<sup>635</sup>

7.19 It follows that in making factual findings concerning the meaning of Sections 301-310 we are not bound to accept the interpretation presented by the US. That said, any Member can reasonably expect that considerable deference be given to its views on the meaning of its own law.

7.20 We note, finally, that terms used both in Sections 301-310 and in WTO provisions, do not necessarily have the same meaning. For example, the word "determination" need not always have the same meaning in Sections 304 and 306 as it has in Article 23.2(a) of the DSU. Thus, conduct not meeting, say, the threshold of a "determination" under Sections 304 and 306, is not by this fact alone precluded from meeting the threshold of a "determination" under Article 23.2(a) of the DSU. By contrast, the fact that a certain act is characterized as a "determination" under domestic legislation, does not necessarily mean that it must be construed as a determination under the covered agreements.<sup>636</sup>

#### 4. Rules of Treaty Interpretation

7.21 Evaluating the conformity of Sections 301-310 with US obligations under the WTO requires interpretation of several provisions of the covered agreements. Article 3.2 of the DSU directs panels to clarify WTO provisions "in accordance with customary rules of interpretation of public international law". Articles 31 and 32 of the Vienna Convention on the Law of Treaties ("Vienna Convention") have attained the status of rules of customary international law. In recent years, the jurisprudence of the Appellate Body and WTO panels has become one of the richest sources from which to receive guidance on their application. The principal provision of the Vienna Convention in this respect provides as follows:

"A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose".<sup>637</sup>

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<sup>635</sup> In this respect, the International Court of Justice ("ICJ"), referring to an earlier judgment by the Permanent Court of International Justice ("PCIJ") noted the following: "Where the determination of a question of municipal law is essential to the Court's decision in a case, the Court will have to weigh the jurisprudence of the municipal courts, and 'If this is uncertain or divided, it will rest with the Court to select the interpretation which it considers most in conformity with the law' *Brazilian Loans*, PCIJ, Series A, Nos. 20/21, p. 124)" (*Elettronica Sicula S.p.A. (ELSI)*, Judgment, ICJ Reports 1989, p. 47, para. 62).

<sup>636</sup> See footnote 657 and para. 7.146 below.

<sup>637</sup> Articles 31 and 32 of the Vienna Convention read as follows:

"Article 31  
*General rule of interpretation*

1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.
2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:

7.22 Text, context and object-and-purpose correspond to well established textual, systemic and teleological methodologies of treaty interpretation, all of which typically come into play when interpreting complex provisions in multilateral treaties. For pragmatic reasons the normal usage, and we will follow this usage, is to start the interpretation from the ordinary meaning of the "raw" text of the relevant treaty provisions and then seek to construe it in its context and in the light of the treaty's object and purpose. However, the elements referred to in Article 31 – text, context and object-and-purpose as well as good faith – are to be viewed as one holistic rule of interpretation rather than a sequence of separate tests to be applied in a hierarchical order. Context and object-and-purpose may often appear simply to confirm an interpretation seemingly derived from the "raw" text. In reality it is always some context, even if unstated, that determines which meaning is to be taken as "ordinary" and frequently it is impossible to give meaning, even "ordinary meaning", without looking also at object-and-purpose.<sup>638</sup> As noted by

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- (a) any agreement relating to the treaty which was made between all the parties in connexion with the conclusion of the treaty;
  - (b) any instrument which was made by one or more parties in connexion with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.
3. There shall be taken into account together with the context:
- (a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
  - (b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;
  - (c) any relevant rules of international law applicable in the relations between the parties.
4. A special meaning shall be given to a term if it is established that the parties so intended.

Article 32  
*Supplementary means of interpretation*

Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31:

- (a) leaves the meaning ambiguous or obscure; or
- (b) leads to a result which is manifestly absurd or unreasonable".

<sup>638</sup> As noted by the International Law Commission (ILC) – the original drafter of Article 31 of the Vienna Convention – in its commentary to that provision:

"The Commission, by heading the article 'General Rule of Interpretation' in the singular and by underlining the connexion between paragraphs 1 and 2 and again between paragraph 3 and the two previous paragraphs, intended to indicate that the application of the means of interpretation in the article would be a single combined operation. All

the Appellate Body: "Article 31 of the *Vienna Convention* provides that the words of the treaty form the foundation for the interpretive process: 'interpretation must be based above all upon the text of the treaty'. It adds, however, that "[t]he provisions of the treaty are to be given their ordinary meaning in their context. The object and purpose of the treaty are also to be taken into account in determining the meaning of its provisions".<sup>639</sup>

## 5. General Description of the Operation of Sections 301-310

7.23 It is difficult to appreciate the claims and counterclaims of the parties without a general understanding of the operation of Sections 301-310. Consequently, in Annex II we provide a brief overview as an aid to the readers of this Report. This overview is of a non-binding nature and does not have the status of a factual finding by this Panel. It was prepared following consultations with the parties as part of the descriptive part of this Report.

## 6. The Measure in Question and the Panel's General Methodology

7.24 Our mandate in this case is to evaluate the conformity of Sections 301-310 with the relevant WTO provisions as outlined in the terms of reference. When evaluating the conformity of national law with WTO obligations in accordance with Article XVI:4 of the WTO Agreement<sup>640</sup> account must be taken of the wide-ranging diversity in the legal systems of the Members. Conformity can be ensured in different ways in different legal systems. It is the end result that counts, not the manner in which it is achieved. Only by understanding and respecting the specificities of each Member's legal system, can a correct evaluation of conformity be established.

7.25 Sections 301-310 display some features, common in several jurisdictions, that are typical of much modern complex economic and regulatory legislation. Frequently the Legislator itself does not seek to control, through statute, all covered conduct. Instead it delegates to pre-existing or specially created administrative agencies or other public authorities, regulatory and supervisory tasks which are to be administered according to certain criteria and

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the various elements, as they were present in any given case, would be thrown into the crucible and their interaction would give the legally relevant interpretation. Thus [Article 31] is entitled 'General *rule* of interpretation' in the singular, not 'General *rules*' in the plural, because the Commission desired to emphasize that the process of interpretation is a unity and that the provisions of the article form a single, closely integrated rule" (Yearbook of the ILC, 1966, Vol. II, pp. 219-220).

See also, Sinclair, I., *The Vienna Convention on the Law of Treaties*, 2<sup>nd</sup> Edition, Manchester University Press, 1984, p. 116:

"Every text, however clear on its face, requires to be scrutinised in its context and in the light of the object and purpose which it is designed to serve. The conclusion which may be reached after such a scrutiny is, in most instances, that the clear meaning which originally presented itself is the correct one, but this should not be used to disguise the fact that what is involved is a process of interpretation".

<sup>639</sup> Appellate Body report on *Japan – Taxes on Alcoholic Beverages* ("Japan – Alcoholic Beverages"), WT/DS8/AB/R, adopted 1 November 1996, pp. 11-12.

<sup>640</sup> Article XVI:4 provides as follows: "Each Member shall ensure the conformity of its laws, regulations and administrative procedures with its obligations as provided in the annexed Agreements".

within discretionary limits set out by the Legislator. The discretion can be wide or narrow according to the will of the Legislator. Sections 301-310 are part of such a legislative scheme.

7.26 In evaluating the conformity of Sections 301-310 with the relevant WTO provisions we must, thus, be cognizant of this multi-layered character of the national law under consideration which includes statutory language as well as other institutional and administrative elements.<sup>641</sup> For convenience we will hereafter refer to Sections 301-310 comprising all of these elements as "the Measure in question".

7.27 The elements of this type of national law are, as is the case here, often inseparable and should not be read independently from each other when evaluating the overall conformity of the law with WTO obligations. For example, even though the statutory language granting specific powers to a government agency may be *prima facie* consistent with WTO rules, the agency responsible, within the discretion given to it, may adopt internal criteria or administrative procedures inconsistent with WTO obligations which would, as a result, render the overall law in violation.<sup>642</sup> The opposite may be equally true: though the statutory language as such may be *prima facie* inconsistent, such inconsistency may be lawfully removed upon examination of other administrative or institutional elements of the same law.

7.28 Accordingly, in examining the relevant provisions of Sections 301-310 we first look at the statutory language itself, severed from all other elements of the law. We then look at the other elements of Sections 301-310 which, in our view, constitute an integral part of the Measure in question and make our final evaluation based on all elements taken together.

C. THE EC CLAIM THAT SECTION 304 IS INCONSISTENT WITH ARTICLE 23.2(A) OF THE DSU

## 1. Claims and Arguments of the Parties

7.29 The EC claims that Section 304 mandates the USTR to make a "unilateral" determination on whether another WTO Member has violated US rights under the WTO. The EC submits that this determination by the USTR has to be made within 18 months after the initiation of an investigation under Section 302, a date that normally coincides with the request for consultations under the DSU. According to the EC, DSU procedures can, however, be assumed to take 19 ½ months. The EC submits that, as a result of the 18 months deadline, the

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<sup>641</sup> The meaning of the term "laws" in Article XVI:4 of the WTO Agreement must accommodate the very broad diversity of legal systems of WTO Members. For present purposes, we are of the view that the term "laws" is wide enough to encapsulate as one single measure the multi-layered Sections 301-310. In the alternative – i.e. in case the term "laws" should be said to cover statutory language only – we would consider the non-statutory elements of Sections 301-310 that are of an institutional or administrative nature to fall under the terms "regulations and administrative procedures" also referred to in Article XVI:4. Under this alternative approach as well, we would view it necessary – given the special nature of the national law in question – to examine all elements under Sections 301-310 as one measure in order to correctly assess its overall conformity with WTO rules.

<sup>642</sup> Similarly, the Appellate Body in *US – Import Prohibition of Certain Shrimp and Shrimp Products* ("US – Shrimp", WT/DS58/AB/R, adopted 6 November 1998, at paras. 160 and 186) first examined the US measure itself and found that it was provisionally justified under Article XX(g) of GATT 1994. However, it then found that the *application* of that very same measure, pursuant to administrative guidelines and practice, constituted an abuse or misuse of the provisional justification made available by Article XX(g) in the light of the *chapeau* of Article XX. On these grounds it concluded that the US measure read in this sense was in violation of GATT 1994.

determination under Section 304 is required even if the DSB has not yet adopted a report with findings on the matter, contrary to Article 23.2(a) of the DSU.

7.30 The US responds that nothing in Section 304 compels the USTR to make a specific determination that US rights have been denied in the absence of panel or Appellate Body findings, adopted by the DSB. In its second submission, the US goes even further and submits that since Section 304 determinations have to be made on the basis of WTO dispute settlement proceedings pursuant to Section 304 (a)(1), a determination that US rights have been denied before the adoption of DSB findings is *precluded*. According to the US, Section 304 only requires the USTR to "determine *whether*" – not to determine *that* – US rights have been denied. In the US view, the USTR has the discretion to determine that no violation has occurred, that no violation has been confirmed by the DSB, that a violation will be confirmed on the date the DSB adopts panel or Appellate Body findings or that the ongoing investigation must terminate. The US also argues that the relevant period for DSU procedures to be completed – from the request for consultations to the adoption of reports by the DSB – is not 19 ½ months, as claimed by the EC, but 16 months and 20 days.

## 2. Preliminary Panel Findings in respect of the Statutory Language of Section 304

7.31 As regards the statutory language of Section 304, we consider it sufficient to make the following findings based upon examination of the text itself, the evidence and arguments submitted to us in this respect as well as interpretation, where applicable, of the relevant provisions of the WTO.

- (a) First, as a matter of fact, we find that under the statutory language of Section 304 (a)(2), the USTR is mandated, i.e. obligated in law, to make a determination on whether US rights are being denied within 18 months after the request for consultations.<sup>643</sup> This is a mandatory feature of Section 304 in which the Legislature left no discretion to the Executive Branch.<sup>644</sup>
- (b) Second, as a matter of law, since most of the time-limits in the DSU are either minimum time-limits without ceilings<sup>645</sup> or maximum time-limits that are, nonetheless, indicative only,<sup>646</sup> DSU proceedings – from the request for

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<sup>643</sup> For purposes of this dispute, we assume that the 18 months time-limit is the earlier of the two time-limits mentioned in Section 304, i.e. falls before the lapse of "30 days after the date on which the dispute settlement procedure is concluded".

<sup>644</sup> The US agrees that it cannot postpone the making of this determination. In respect of *Japan – Measures Affecting Agricultural Products* ("*Japan – Agricultural Products*"), adopted 19 March 1999, WT/DS76/AB/R and *India – Patents (US)*, for example, the US – answering Panel Question 24 a) (as reflected in para. 4.586 of this Report) – stated that "the United States did not make formal Section 304 determinations by the 18-month anniversary, *but should have*" (emphasis added).

<sup>645</sup> Article 4.7 of the DSU, for example, provides for a minimum period of 60 days for consultations, unless there is agreement to the contrary or urgency in accordance with Article 4.8.

<sup>646</sup> Article 12.8 refers to six months "as a general rule" for the timeframe between panel composition and issuance of the final report to the parties. Article 12.9 provides that "[i]n no case *should* the period from the establishment of the panel to the circulation of the report to the Members exceed nine months" (emphasis added). Article 17.5 states that "[a]s a general rule, the proceedings [of the Appellate Body] shall not exceed 60 days". It adds, however, that "[i]n no case shall the proceedings exceed 90 days". However, even this seemingly compulsory deadline has been passed in three cases so far (*United States – Restrictions on Imports of Cotton and Man-Made Fibre Underwear*, WT/DS24/AB/R, 91 days; *European Communities – Measures Concerning Meat and Meat Products (Hormones)* ("*EC –*



consultations to the adoption of findings by the DSB<sup>647</sup> – may take longer than 18 months and have in practice often led to time-frames beyond 18 months.<sup>648</sup> As a result, the USTR could be obligated in certain cases brought by the US – and indeed in certain cases has already been so obligated – to make a unilateral determination as to whether US rights are being denied before the completion of multilateral DSU proceedings.

- (c) Third, as a matter of fact, we find that even though the USTR is obligated to make a determination within the 18 months time-frame, under the broad discretion allowed under Section 304 there are no circumstances which would compel him or her to make a determination to the effect that US rights under the WTO Agreement have been denied – hereafter referred to as a "determination of inconsistency" – before the exhaustion of DSU proceedings.

Section 304 (a) requires the USTR to determine *whether* US rights are being denied within 18 months. It does not require the USTR to determine *that* US rights are being denied at the 18 months deadline. The criteria referred to in Section 304 (a) on which the USTR has to base its determination – "the investigation initiated under section 302 ... and the consultations (and the proceedings, if applicable) under section 303" – allow the USTR to exercise wide discretion in all cases concerning the actual content of the determination he or she has to make.

As will be seen below, however, this discretion does not necessarily absolve Section 304 from a breach of the DSU.

- (d) Fourth, as a matter of fact, we find that even though the USTR is not *obligated*, under any circumstance, to make a Section 304 determination of inconsistency

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*Hormones*"), WT/DS26/AB/R and DS48/AB/R, 114 days; and *US – Shrimp*, op. cit., 91 days). Finally, Article 20 refers to 9 months – 12 months in case of an appeal – "as a general rule" for the period between panel establishment and adoption of report(s) by the DSB.

<sup>647</sup> When we refer hereafter to the exhaustion of DSU proceedings, we mean the date of adoption by the DSB of panel and, as the case may be, Appellate Body reports on the matter.

<sup>648</sup> In 17 cases out of the 26 cases which so far led to DSB recommendations, more than 18 months lapsed between the request for consultations and the adoption of reports. Eleven of these 17 cases were brought by the US either as the sole complainant or a co-complainant: *European Communities – Regime for the Importation, Sale and Distribution of Bananas* ("EC - Bananas III", WT/DS27), *EC – Hormones* (op. cit.), *Japan – Measures Affecting Consumer Photographic Film and Paper* (WT/DS44), *India – Patents (US)* (op. cit.), *European Communities/United Kingdom/Ireland – Customs Classification of Certain Computer Equipment* (WT/DS62, 67 and 68), *Indonesia – Certain Measures Affecting the Automobile Industry* (WT/DS54, 55, 59 and 64), *Japan – Agricultural Products* (op. cit.), *Korea – Taxes on Alcoholic Beverages* (WT/DS75 and 84), *Australia – Subsidies Provided to Producers and Exporters of Automobile Leather* (WT/DS106), *India – Quantitative Restrictions on Imports of Agricultural, Textile and Industrial Products* (WT/DS90) and *Canada – Measures Affecting the Importation of Milk and the Exportation of Dairy Products* (WT/DS103, US complaint and WT/DS113, complaint by New Zealand). The six other cases were: *US – Shrimp* (op. cit.), *Australia – Measures Affecting the Importation of Salmon* (WT/DS18), *Guatemala – Anti-Dumping Investigation Regarding Portland Cement from Mexico* (WT/DS60), *US – Anti-Dumping Duty on Dynamic Random Access Memory Semiconductors (DRAMs) of one Megabit or above from Korea* (WT/DS99), *Brazil- Export Financing Programme for Aircraft* (WT/DS46) and *Canada- Measures Affecting the Export of Civilian Aircraft* ("Canada – Aircraft", WT/DS70).

prior to exhaustion of DSU proceedings, it is not *precluded* by the statutory language of Section 304 itself from making such a determination.<sup>649</sup> We find that the broad discretion given to the USTR allows him or her to do exactly what the statutory language suggests: to determine *whether* US rights have been denied, i.e. to determine that they have *not* been denied but also to determine that they *have* been denied.<sup>650</sup>

7.32 In conclusion, the statutory language of Section 304 *mandates* the USTR in certain cases to make a unilateral determination on whether US rights have been denied even *before* the adoption by the DSB of its findings on the matter. However, the statutory language of Section 304 neither *mandates* the USTR to make a determination of inconsistency nor *precludes* him or her from making such a determination.

7.33 Critically, the statutory language of Section 304 reserves to the USTR when exercising his or her mandatory duty after 18 months, the right to make a unilateral determination of inconsistency even prior to exhaustion of DSU proceedings.

### **3. The Statutory Language of Section 304 and Member Obligations under Article 23 of the DSU**

7.34 The statutory language of Section 304 reserves, then, to the USTR when exercising his or her mandatory duty after 18 months, the right to make a unilateral determination of inconsistency even prior to exhaustion of DSU proceedings. As noted, it does not impose on the USTR the duty to make such a determination. What is at issue, then, is whether – given, on the one hand, the duty in some cases to make a unilateral determination prior to exhaustion of multilateral proceedings and, on the other hand, the full discretion as to the content of that determination – Section 304 violates, in and of itself rather than with reference to any particular instance of its application, the obligations assumed by Members under Article 23.2(a) of the DSU. We must, thus, turn to the interpretation of Article 23 of the DSU.

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<sup>649</sup> The US argued in its second submission that the USTR is precluded from making such a determination of inconsistency. To the extent this US argument is based on the statutory language of Section 304 alone, we reject the argument for the reasons given in this Report.

<sup>650</sup> Section 304 (a) refers to WTO "proceedings, if applicable" as a basis of the determination to be made. This statutory language is not sufficiently precise to construe it as curtailing the USTR's discretion to make a determination of inconsistency before the adoption of findings by the DSB. The reference to "proceedings" as a basis for the determination allows WTO proceedings to be taken into account but does not, in our view, preclude a determination of inconsistency before the final outcome of WTO proceedings, i.e. before the adoption of DSB recommendations. We note that whereas the first time-limit under Section 304 (a)(2) explicitly refers to the conclusion of dispute settlement procedures ("30 days after the date on which the dispute settlement procedure is concluded"), the second time-limit does not refer to any proceedings, let alone to the completion of WTO proceedings ("18 months after the date on which the investigation is initiated"). Section 304 (a)(2) mandates the making of a determination "the earlier of" these two time-limits. We note, finally, that the US itself had first argued that Section 304 does not "compel" the making of a determination of inconsistency which seems to imply that although not compelled, the USTR is permitted to make such a determination. Only in its second submission did the US argue that the USTR is actually "precluded" from making such determination.

**(a) The dual nature of obligations under Article 23 of the DSU**

7.35 Article 23 of the DSU deals, as its title indicates, with the "Strengthening of the Multilateral System". Its overall design is to prevent WTO Members from unilaterally resolving their disputes in respect of WTO rights and obligations. It does so by obligating Members to follow the multilateral rules and procedures of the DSU.

7.36 Article 23.1 provides as follows:

*"Strengthening of the Multilateral System*

When Members seek the redress of a violation of obligations or other nullification or impairment of benefits under the covered agreements or an impediment to the attainment of any objective of the covered agreements, *they shall have recourse to, and abide by*, the rules and procedures of this Understanding" (emphasis added).

7.37 Article 23.2 specifies three elements that need to be respected as part of the multilateral DSU dispute settlement process. It provides as follows:

"In such cases [referred to in Article 23.1, i.e. when Members seek the redress of WTO inconsistencies], Members shall:

- (a) not make a determination to the effect that a violation has occurred, that benefits have been nullified or impaired or that the attainment of any objective of the covered agreements has been impeded, except through recourse to dispute settlement in accordance with the rules and procedures of this Understanding, and shall make any such determination consistent with the findings contained in the panel or Appellate Body report adopted by the DSB or an arbitration award rendered under this Understanding;
- (b) follow the procedures set forth in Article 21 to determine the reasonable period of time for the Member concerned to implement the recommendations and rulings; and
- (c) follow the procedures set forth in Article 22 to determine the level of suspension of concessions or other obligations and obtain DSB authorization in accordance with those procedures before suspending concessions or other obligations under the covered agreements in response to the failure of the Member concerned to implement the recommendations and rulings within that reasonable period of time".

7.38 On this basis, we conclude as follows:

- (a) It is for the WTO through the DSU process – not for an individual WTO Member – to determine that a WTO inconsistency has occurred (Article 23.2(a)).

- (b) It is for the WTO or both of the disputing parties, through the procedures set forth in Article 21 – not for an individual WTO Member – to determine the reasonable period of time for the Member concerned to implement DSB recommendations and rulings (Article 23.2(b)).
- (c) It is for the WTO through the procedures set forth in Article 22 – not for an individual WTO Member – to determine, in the event of disagreement, the level of suspension of concessions or other obligations that can be imposed as a result of a WTO inconsistency, as well as to grant authorization for the actual implementation of these suspensions.

7.39 Article 23.2 clearly, thus, prohibits specific instances of unilateral conduct by WTO Members when they seek redress for WTO inconsistencies in any given dispute. This is, in our view, the first type of obligations covered under Article 23.

7.40 It is not, however, our task in these proceedings to assess the WTO conformity of specific determinations made under Section 304 in a given dispute but to determine, instead, whether Section 304 as such violates Article 23 of the DSU. This leads us to the second type of obligations covered under Article 23.

7.41 As a general proposition, GATT *acquis*, confirmed in Article XVI:4 of the WTO Agreement and recent WTO panel reports, make abundantly clear that legislation as such, independently from its application in specific cases, may breach GATT/WTO obligations:

- (a) In GATT jurisprudence, to give one example, legislation providing for tax discrimination against imported products was found to be GATT inconsistent even before it had actually been applied to specific products and thus before any given product had actually been discriminated against.<sup>651</sup>
- (b) Article XVI:4 of the WTO Agreement explicitly confirms that legislation as such falls within the scope of possible WTO violations. It provides as follows:

"Each Member shall ensure the conformity of its *laws, regulations and administrative procedures* with its obligations as provided in the annexed Agreements" (emphasis added).

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<sup>651</sup> See, for example, Panel Reports on *United States – Taxes on Petroleum and Certain Imported Substances* ("US – Superfund"), adopted 17 June 1987, BISD 34S/136, para. 5.2.2 (where the legislation imposing the tax discrimination only had to be applied by the tax authorities at the end of the year after the panel examined the matter) and *United States – Measures Affecting Alcoholic and Malt Beverages* ("US – Malt Beverages"), adopted 19 June 1992, BISD 39S/206, paras. 5.39, 5.57, 5.60 and 5.66 (where the legislation imposing the discrimination was, for example, not being enforced by the authorities). See also Panel Reports on *EEC – Regulation on Imports of Parts and Components* ("EEC – Parts and Components"), adopted 16 May 1990, BISD 37S/132, paras. 5.25-5.26, *Thailand – Restrictions on Importation of and Internal Taxes on Cigarettes* ("Thai – Cigarettes"), adopted 7 November 1990, BISD 37S/200, para. 84 and *United States – Measures Affecting the Importation, Internal Sale and Use of Tobacco* ("US – Tobacco"), adopted 4 October 1994, BISD 41S/131, para. 118.

The three types of measures explicitly made subject to the obligations imposed in the WTO agreements – "laws, regulations and administrative procedures" – are measures that are applicable generally; not measures taken necessarily in a specific case or dispute. Article XVI:4, though not expanding the material obligations under WTO agreements, expands the type of measures made subject to these obligations.<sup>652</sup>

- (c) Recent WTO panel reports confirm, too, that legislation as such, independently from its application in a specific case, can be inconsistent with WTO rules.<sup>653</sup>

7.42 Legislation may thus breach WTO obligations. This must be true, too, in respect of Article 23 of the DSU. This is so, in our view, not only because of the above-mentioned case law and Article XVI:4, but also because of the very nature of obligations under Article 23.

7.43 Article 23.1 is not concerned only with specific instances of violation. It prescribes a general duty of a dual nature. First, it imposes on all Members to "have recourse to" the multilateral process set out in the DSU when they seek the redress of a WTO inconsistency. In these circumstances, Members have to have recourse to the DSU dispute settlement system to the exclusion of any other system, in particular a system of unilateral enforcement of WTO rights and obligations. This, what one could call "exclusive dispute resolution clause", is an important new element of Members' rights and obligations under the DSU. Second, Article 23.1 also prescribes that Members, when they have recourse to the dispute settlement system in the DSU, have to "abide by" the rules and procedures set out in the DSU. This second obligation under Article 23.1 is of a confirmatory nature: when having recourse to the DSU Members must abide by all DSU rules and procedures.

7.44 Turning to the second paragraph under Article 23, Article 23.2 – which, on its face, addresses conduct in specific disputes – starts with the words "[i]n such cases". It is, thus, explicitly linked to, and has to be read together with and subject to, Article 23.1.

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<sup>652</sup> Article XVI:4 goes a step further than Article 27 of the Vienna Convention. Article 27 of the Vienna Convention provides that "[a] party may not invoke the provisions of its internal law as justification for its failure to perform a treaty". Article XVI:4, in contrast, not only precludes pleading conflicting internal law as a justification for WTO inconsistencies, but requires WTO Members actually to ensure the conformity of internal law with its WTO obligations.

<sup>653</sup> Panel Reports on *Argentina – Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items* ("Argentina – Textiles and Apparel (US)"), WT/DS56/R (complaint by US), adopted 22 April 1998, paras. 6.45-47 (see also Appellate Body Report, WT/DS56/AB/R, paras. 48-55); *Canada – Aircraft*, op. cit., paras. 9.124 and 9.208, *Turkey – Restrictions on Imports of Textile and Clothing Products*, WT/DS34/R, circulated to Members on 31 May 1999 (appealed on other grounds), para. 9.37.

7.45 Indeed, two of the three prohibitions mentioned in Article 23.2 – Article 23.2(b) and (c) – are but egregious examples of conduct that contradicts the rules and procedures of the DSU which, under the obligation in Article 23.1 to "abide by the rules and procedures" of the DSU, Members are obligated to follow.<sup>654</sup> These rules and procedures clearly cover much more than the ones specifically mentioned in Article 23.2.<sup>655</sup> There is a great deal more State conduct which can violate the general obligation in Article 23.1 to have recourse to, and abide by, the rules and procedures of the DSU than the instances especially singled out in Article 23.2.<sup>656</sup>

7.46 Article 23 interdicts, thus, more than action in specific disputes, it also provides discipline for the general process WTO Members must follow when seeking redress of WTO inconsistencies. A violation of the explicit provisions of Article 23 can, therefore, be of two different kinds. It can be caused

- (a) by an *ad hoc*, specific action in a given dispute, or
- (b) by measures of general applicability, e.g. legislation or regulations, providing for a certain process to be followed which does not, say, include recourse to the DSU dispute settlement system or abide by the rules and procedures of the DSU.

**(b) Legislation which violates Article 23 of the DSU**

7.47 What kind of legislation would constitute a violation of Article 23?

7.48 Surely, to give an extreme example, legislation mandating the making of a determination of inconsistency as soon as a WTO panel has issued its report – without awaiting the result of a possible appeal and the adoption of DSB recommendations – would violate Article 23.2(a).

7.49 How, then, should we evaluate Section 304 the statutory language of which mandates in some cases the making of a determination prior to exhaustion of DSU proceedings and which reserves to the USTR the right when exercising this mandatory duty to make a unilateral determination of inconsistency?

7.50 We first find that if the USTR were to exercise, *in a specific dispute*, the right thus reserved for him or her in the statutory language of Section 304 and make a determination of

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<sup>654</sup> Article 23.2(a), in contrast, prohibiting Members from making certain determinations, is not covered elsewhere in the DSU.

<sup>655</sup> One could refer, for example, to the requirement to request consultations pursuant to Article 4 of the DSU before requesting a panel under Article 6.

<sup>656</sup> Not notifying mutually agreed solutions to the DSB as required in Article 3.6 of the DSU or not abiding by the requirements for a request for consultations or a panel as elaborated in Articles 4 and 6 are some other examples of conduct that would be contrary to DSU rules and procedures but is not mentioned specifically in Article 23.2.

inconsistency, the US conduct would meet the different elements required for an individual breach under Article 23.2(a).<sup>657</sup> However, Section 304 does not mandate the USTR to make a

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<sup>657</sup> We consider that if the USTR were to exercise, in a specific dispute, the right reserved to him or her under the statutory language of Section 304 to make a determination of inconsistency before exhaustion of DSU procedures, the US conduct would meet the different elements required for a breach of Article 23.2(a) in a specific instance. This conclusion is of crucial importance since it shows that the statutory language of Section 304 reserves the right to the USTR to breach at least the first type of obligations in Article 23.2(a) in a specific instance. Four elements must be satisfied for a specific act in a particular dispute to breach Article 23.2(a):

- (a) the act is taken "in such cases" (*chapeau* of Article 23.2), i.e. in a situation where a Member "seek[s] the redress of a violation of obligations or other nullification or impairment of benefits under the covered agreements or an impediment to the attainment of any objective of the covered agreements", as referred to in Article 23.1;
- (b) the act constitutes a "determination";
- (c) the "determination" is one "to the effect that a violation has occurred, that benefits have been nullified or impaired or that the attainment of any objective of the covered agreements has been impeded";
- (d) the "determination" is either *not* made "through recourse to dispute settlement in accordance with the rules and procedures of [the DSU]" or *not* made "consistent with the findings contained in the panel or Appellate Body report adopted by the DSB or an arbitration award rendered under [the DSU]". The two elements of this requirement are cumulative in nature. Determinations are only allowed when made through recourse to the DSU *and* consistent with findings adopted by the DSB or an arbitration award under the DSU.

Applying these four elements to the specific determination allowed under the statutory language of Section 304, namely a determination of inconsistency before exhaustion of DSU procedures we note, first, the parties' agreement that all Section 304 determinations are made in cases where the US is seeking the redress of WTO inconsistencies, in the sense of the first element outlined above. We agree. Obviously, when pursuing a matter of US rights under the WTO through Section 302 investigations, WTO consultations and procedures, and making a decision on whether US rights under the WTO are being denied under Section 304, the US is seeking redress of what it considers to be WTO inconsistencies.

Both parties also agree that determinations under Section 304 meet the second of the four elements, a determination in the sense of Article 23.2(a). We agree. Some of the relevant dictionary meanings of the word "determination" in the context of Article 23.2(a) are: "the settlement of a suit or controversy by the authoritative decision of a judge or arbiter; a settlement or decision so made, an authoritative opinion ... the action of coming to a decision; the result of this; a fixed intention" (*The New Shorter Oxford English Dictionary*, Ed. Brown, L., Clarendon Press, Oxford, Vol. 1, p. 651). Without there being a need precisely to define what a "determination" in the sense of Article 23.2(a) is, we consider that – given its ordinary meaning – a "determination" implies a high degree of firmness or immutability, i.e. a more or less final decision by a Member in respect of the WTO consistency of a measure taken by another Member.

Given that Article 23.2(a) only deals with "determinations" in case a Member is seeking redress of WTO inconsistencies, we are of the view that a "determination" can only occur *subsequent* to a Member having decided that, in its preliminary view, there may be a WTO inconsistency, i.e. only once that Member has decided to seek redress of such inconsistency. Mere opinions or views expressed before that stage is reached, are not intended to be covered by Article 23.2(a). However, once a Member does

determination of inconsistency in violation of Article 23 in each and every specific dispute; it merely sets out in the statutory language itself that the USTR has the power and right to do so. The question here is whether this constitutes a breach of the second type of obligations under Article 23, namely a breach by measures of general applicability such as a general law.

7.51 The parties focused much of their arguments on the kind of legislation which could be found to be inconsistent with WTO obligations. The US submitted forcefully that only legislation *mandating* a WTO inconsistency or *precluding* WTO consistency, can, as such, violate WTO provisions. This was at the very heart of the US defence. On this US reading it followed that since Section 304 never mandates a specific determination of inconsistency prior to exhaustion of DSU proceeding nor, in the US view, precludes the US from acting consistently with its WTO obligations in all circumstances, the legislation, in and of itself could not be in violation of Article 23.2(a) of the DSU.

7.52 The EC submitted with equal force that also certain types of legislation under which a WTO inconsistent conduct is not *mandated* but is *allowed*, could violate WTO obligations. The EC considered that Section 304 is of such a nature.

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bring a case under the DSU, in particular once it requests the establishment of a panel, one can assume that this preliminary stage has been passed and the threshold of a "determination" met. Such reading of the term "determination" is confirmed by the exception provided for "determinations" made "through recourse to dispute settlement in accordance with" the DSU, an exception that explicitly allows for the "determination" implicit in pursuing a case before a panel. In any event, what is decisive under Article 23.2(a) is not so much whether an act constitutes a "determination" – in our view, a more or less formal requirement that needs broad reading -- but whether it is consistent with DSU rules and procedures, the fourth element discussed below.

On that basis, we find that USTR determinations under Section 304 – made *subsequent* to internal investigations, WTO consultations and proceedings, if applicable; and, in the case of determinations of inconsistency, automatically and as a *conditio sine qua non* leading to a decision on action under Section 301 – meet the threshold of firmness and immutability required for a "determination" under Article 23.2(a).

The third element under Article 23.2(a) as applied to the specific determination under examination is also satisfied. We recall that this determination would be one finding that US rights under the WTO have been denied, i.e. a determination "to the effect that a violation has occurred, that benefits have been nullified or impaired or that the attainment of any objective of the covered agreements has been impeded", thus meeting the third element under Article 23.2(a).

The fourth element under Article 23.2(a) is likewise satisfied. We recall that the specific determination under examination here would be one made *before* DSB findings on the matter have been adopted. It would thus *not* be made "through recourse to dispute settlement in accordance with the rules and procedures of [the DSU]" *nor* made "consistent with the findings contained in the panel or Appellate Body report adopted by the DSB". Indeed, such determination made *before* exhaustion of DSU procedures, would not be required, referred to or relevant for any of the steps or procedures in the DSU. On the contrary, it would be a determination that, at face value, prejudices and could even contradict the outcome of DSU procedures. Moreover, any such determination could not be consistent with DSB findings, since no such findings would, as yet, be adopted.

In conclusion, if the USTR were to exercise, in a specific dispute, the right reserved for it in Section 304 to make a determination of inconsistency before exhaustion of DSU procedures, the US conduct would meet all four elements required for a breach of Article 23.2(a).



7.53 Despite the centrality of this issue in the submissions of both parties, we believe that resolving the dispute as to which type of legislation, *in abstract*, is capable of violating WTO obligations is not germane to the resolution of the type of claims before us. In our view the appropriate method in cases such as this is to examine with care the nature of the WTO obligation at issue and to evaluate the Measure in question in the light of such examination. The question is then whether, on the correct interpretation of the specific WTO obligation at issue, only mandatory or also discretionary national laws are prohibited. We do not accept the legal logic that there has to be one fast and hard rule covering all domestic legislation. After all, is it so implausible that the framers of the WTO Agreement, in their wisdom, would have crafted some obligations which would render illegal even discretionary legislation and crafted other obligations prohibiting only mandatory legislation?<sup>658</sup> Whether or not Section 304 violates Article 23 depends, thus, first and foremost on the precise obligations contained in Article 23.

7.54 We can express this view in a different way:

- (a) Even if we were to operate on the legal assumption that, as argued by the US, only legislation *mandating* a WTO inconsistency or *precluding* WTO consistency, can violate WTO provisions; and
- (b) confirm our earlier factual finding in paragraph 7.31(c) that the USTR enjoys full discretion to decide on the content of the determination,

we would still disagree with the US that the combination of (a) and (b) *necessarily* renders Section 304 compatible with Article 23, since Article 23 may prohibit legislation with certain discretionary elements and therefore the very fact of having in the legislation such discretion could, in effect, preclude WTO consistency. In other words, rejecting, as we have, the presumption implicit in the US argument that no WTO provision ever prohibits discretionary legislation does not imply a reversal of the classical test in the pre-existing jurisprudence that only legislation mandating a WTO inconsistency or precluding WTO consistency, could, as such, violate WTO provisions.<sup>659</sup> Indeed that is the very test we shall apply in our analysis. It simply does not follow from this test, as sometimes has been argued, that legislation with discretion could never violate the WTO. If, for example, it is found that the specific obligations in Article 23 prohibit a certain type of legislative discretion, the existence of such discretion in the statutory language of Section 304 would presumptively preclude WTO consistency.

7.55 What, then, does such an examination of Article 23 yield?

7.56 We have already found that under the statutory provisions of Section 304 each time the USTR exercises the mandatory duty to make a determination, the statutory language gives him or her discretion and reserves to him or her the right to make a determination of inconsistency even in cases where DSU proceedings have not been exhausted.

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<sup>658</sup> Imagine, for example, legislation providing that all imports, including those from WTO Members, would be subjected to a customs inspection and that the administration would enjoy the right, at its discretion, to impose on all such goods tariffs in excess of those allowed under the schedule of tariff concessions of the Member concerned. Would the fact that under such legislation the national administration would not be mandated to impose tariffs in excess of the WTO obligation, in and of itself exonerate the legislation in question? Would such a conclusion not depend on a careful examination of the obligations contained in specific WTO provisions, say, Article II of GATT and specific schedule of concessions?

<sup>659</sup> See paras. 4.173 ff. and 7.51 of this Report.

7.57 In our view, the ordinary meaning of the provisions of Article 23, even when read in abstract, supports the position that this aspect of Section 304 constitutes a *prima facie* violation of DSU rules and procedures. This interpretation of Article 23 is amply confirmed when we consider, as is our duty under the Vienna Convention, the good faith provision in the general rule of interpretation in Article 31 of that Convention, and when we evaluate the terms of Article 23 not in abstract, but in their context and in the light of the DSU's and the WTO's object and purpose.

#### **4. Article 23.2(a) of the DSU interpreted in accordance with the Vienna Convention Rules on Treaty Interpretation**

**(a) "A treaty shall be interpreted ... in accordance with the ordinary meaning to be given to the terms of the treaty ..."**

7.58 First, then, the raw text of Article 23.

7.59 The text of Article 23.1 is simple enough: Members are obligated generally to (a) have recourse to and (b) abide by DSU rules and procedures. These rules and procedures include most specifically in Article 23.2(a) a prohibition on making a unilateral determination of inconsistency prior to exhaustion of DSU proceedings. As a plain textual matter, therefore, could it not be said that statutory language of a Member specifically authorizing a determination of inconsistency prior to exhaustion of DSU procedures violates the ordinary meaning of Members' obligations under Article 23?

7.60 Put differently, cannot the raw text of Articles 23.2(a) and 23.1 be read as constituting a mutual promise among WTO members giving each other a guarantee enshrined in an international legal obligation, that certain specific conduct will not take place? Does not the text of Article 23.1 in particular suggest that this promise has been breached and the guarantee compromised when a Member puts in place legislation which explicitly allows it to do that which it promised not to do?

7.61 On this reading, the very discretion granted under Section 304, which under the US argument absolves the legislation, is what, in our eyes, creates the presumptive violation. The statutory language which gives the USTR this discretion on its face precludes the US from abiding by its obligations under the WTO. In each and every case when a determination is made whilst DSU proceedings are not yet exhausted, Members locked in a dispute with the US will be subject to a mandatory determination by the USTR under a statute which explicitly puts them in that very danger which Article 23 was intended to remove.<sup>660</sup>

7.62 It could be said that this is a danger which can never be entirely removed. After all, even those Members which do not have any internal "trade legislation" can any day of the week decide to violate their WTO obligations including the obligations under Article 23.

7.63 In our view, when a WTO Member has *not* enacted specific legislation providing for procedures to enforce WTO rights, normally only the first type of violation of Article 23 can

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<sup>660</sup> We reject the notion that this danger is removed by virtue of the international obligation alone. Even in the EC where EC norms may produce direct effect and thus give far greater assurance, an EC Member State is not absolved by this fact from its duty to bring national legislation into compliance with its transnational obligations under, say, an EC directive (*Commission v. Belgium*, Case 102/79, [1980] European Court Reports 1473 at para. 12 of the judgment).

occur, i.e. a breach of the promise not to make determinations of inconsistency before the adoption of DSB findings in *specific* disputes. Certain WTO Members, however, including the US and the EC, *have* enacted legislation for seeking redress of WTO inconsistencies. There can be very good reasons related to norms of transparency, democracy and the rule of law which explain why Members may wish to have such legislation. However, when a Member adopts any legislation it has to be mindful that it does not violate its WTO obligations. Trade legislation, important or positive as it may be, which statutorily reserves the right for the Member concerned to do something which it has promised *not* to do under Article 23.2(a), goes, in our view, against the ordinary meaning of Article 23.2(a) read together with Article 23.1.

**(b) "A treaty shall be interpreted in good faith ..."**

7.64 It is notoriously difficult, or at least delicate, to construe the requirement of the Vienna Convention that a treaty shall be interpreted in good faith in third party dispute resolution, not least because of the possible imputation of bad faith to one of the parties. We prefer, thus, to consider which interpretation suggests "better faith" and to deal only briefly with this element of interpretation. Applying the good faith requirement to Article 23 may not lead to a conclusive result but impels us in the direction suggested by our examination of the ordinary meaning of the raw text.

7.65 Imagine two farmers with adjacent land and a history of many disputes concerning real and alleged mutual trespassing. In the past, self help through force and threats of force has been used in their altercations. Naturally, exploitation of the lands close to the boundaries suffers since it is viewed as dangerous terrain. They now sign an agreement under which they undertake that henceforth in any case of alleged trespassing they will abjure self help and always and exclusively make recourse to the police and the courts of law. They specifically undertake never to use force when dealing with alleged trespass. After the entry into force of their agreement one of the farmers erects a large sign on the contested boundary: "No Trespassing. Trespassers may be shot on sight".

7.66 One could, of course, argue that since the sign does not say that trespassers *will* be shot, the obligations undertaken have not been violated. But would that be the "better faith" interpretation of what was promised? Did they not after all promise *always and exclusively* to make recourse to the police and the courts of law?

7.67 Likewise, is it a good faith interpretation to construe the obligations in Article 23 to allow a Member that promised its WTO partners – under Articles 23.1 and 23.2(a) – that it will generally, including in its legislation, have recourse to and abide by the rules and procedures of the DSU which specifically contain an undertaking not to make a determination of inconsistency prior to exhaustion of DSU proceedings, to put in place legislation the language of which explicitly, *urbi et orbi*, reserves to its Executive Branch the right to make a determination of inconsistency – that which it promised it would not do? This Panel thinks otherwise.

7.68 The good faith requirement in the Vienna Convention suggests, thus, that a promise to have recourse to and abide by the rules and procedures of the DSU, also in one's legislation, includes the undertaking to refrain from adopting national laws which threaten prohibited conduct.

7.69 We do not wish to argue that this reading of Article 23 based on the raw text and the good faith consideration referred to in Article 31 of the Vienna Convention, but not yet read in the light of the DSU's and the WTO's object and purpose, is necessarily compelling. It is,

however, in our view a perfectly plausible reading. Whilst we reject the US argument which would construe the interdiction in Article 23.2(a) to refer exclusively to actual determinations of inconsistency or legislation mandating such determinations, we do not think that it, too, based on the raw text alone, is implausible.

7.70 Any doubts one might have, however, between these two possible interpretations are dispelled when we consider the other interpretative elements found in Article 31 of the Vienna Convention. For presentational and narrative reasons we will deal with object-and-purpose before we deal with context.

**(c) "... the ordinary meaning ... in the light of [the treaty's] object and purpose"**

7.71 What are the objects and purposes of the DSU, and the WTO more generally, that are relevant to a construction of Article 23? The most relevant in our view are those which relate to the creation of market conditions conducive to individual economic activity in national and global markets and to the provision of a secure and predictable multilateral trading system.

7.72 Under the doctrine of direct effect, which has been found to exist most notably in the legal order of the EC but also in certain free trade area agreements, obligations addressed to States are construed as creating legally enforceable rights and obligations for individuals. Neither the GATT nor the WTO has so far been interpreted by GATT/WTO institutions as a legal order producing direct effect.<sup>661</sup> Following this approach, the GATT/WTO did *not* create a new legal order the subjects of which comprise both contracting parties or Members and their nationals.

7.73 However, it would be entirely wrong to consider that the position of individuals is of no relevance to the GATT/WTO legal matrix. Many of the benefits to Members which are meant to flow as a result of the acceptance of various disciplines under the GATT/WTO depend on the activity of individual economic operators in the national and global market places. The purpose of many of these disciplines, indeed one of the primary objects of the GATT/WTO as a whole, is to produce certain market conditions which would allow this individual activity to flourish.

7.74 The very first Preamble to the WTO Agreement states that Members recognise

"that their relations in the field of trade and economic endeavour should be conducted with a view to raising standards of living, ensuring full employment and

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<sup>661</sup> We make this statement as a matter of fact, without implying any judgment on the issue. We note that whether there are circumstances where obligations in any of the WTO agreements addressed to Members would create rights for individuals which national courts must protect, remains an open question, in particular in respect of obligations following the exhaustion of DSU procedures in a specific dispute (see Eeckhout, P., *The Domestic Legal Status of the WTO Agreement: Interconnecting Legal Systems*, Common Market Law Review, 1997, p. 11; Berkey, J., *The European Court of Justice and Direct Effect for the GATT: A Question Worth Revisiting*, European Journal of International Law, 1998, p. 626). The fact that WTO institutions have not to date construed any obligations as producing direct effect does not necessarily preclude that in the legal system of any given Member, following internal constitutional principles, some obligations will be found to give rights to individuals. Our statement of fact does not prejudice any decisions by national courts on this issue.

a large and steadily growing volume of real income and effective demand, and expanding the production of and trade in goods and services".<sup>662</sup>

7.75 Providing security and predictability to the multilateral trading system is another central object and purpose of the system which could be instrumental to achieving the broad objectives of the Preamble. Of all WTO disciplines, the DSU is one of the most important instruments to protect the security and predictability of the multilateral trading system and through it that of the market-place and its different operators. DSU provisions must, thus, be interpreted in the light of this object and purpose and in a manner which would most effectively enhance it. In this respect we are referring not only to preambular language but also to positive law provisions in the DSU itself. Article 3.2 of the DSU provides:

"The dispute settlement system of the WTO is a central element in providing security and predictability to the multilateral trading system. The Members recognize that it serves to preserve the rights and obligations of Members under the covered agreements ...".<sup>663</sup>

7.76 The security and predictability in question are of "the multilateral trading system". The multilateral trading system is, per force, composed not only of States but also, indeed mostly, of individual economic operators. The lack of security and predictability affects mostly these individual operators.

7.77 Trade is conducted most often and increasingly by private operators. It is through improved conditions for these private operators that Members benefit from WTO disciplines. The denial of benefits to a Member which flows from a breach is often indirect and results from the impact of the breach on the market place and the activities of individuals within it. Sections 301-310 themselves recognize this nexus. One of the principal triggers for US action to vindicate US rights under covered agreements is the impact alleged breaches have had on, and the complaint emanating from, individual economic operators.

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<sup>662</sup> See also similar language in the second preambles to GATT 1947 and GATS. The TRIPS Agreement addresses even more explicitly the interests of individual operators, obligating WTO Members to protect the intellectual property rights of nationals of all other WTO Members. Creating market conditions so that the activity of economic operators can flourish is also reflected in the object of many WTO agreements, for example, in the non-discrimination principles in GATT, GATS and TRIPS and the market access provisions in both GATT and GATS.

<sup>663</sup> The importance of security and predictability as an object and purpose of the WTO has been recognized as well in many panel and Appellate Body reports. See the Appellate Body report on *Japan – Alcoholic Beverages*, op. cit., p. 31 ("WTO rules are reliable, comprehensible and enforceable. WTO rules are not so rigid or so inflexible as not to leave room for reasoned judgements in confronting the endless and ever-changing ebb and flow of real facts in real cases in the real world. They will serve the multilateral trading system best if they are interpreted with that in mind. In that way, we will achieve the 'security and predictability' sought for the multilateral trading system by the Members of the WTO through the establishment of the dispute settlement system"). It has also been referred to under the TRIPS Agreement. In the Appellate Body Report on *India – Patents (US)*, op. cit., it was found, at para. 58, that "India is obliged, by Article 70.8(a), to provide a legal mechanism for the filing of mailbox applications that provides a sound legal basis to preserve both the novelty of the inventions and the priority of the applications as of the relevant filing and priority dates" (italics added). See also the WTO Panel Report on *Argentina – Textiles and Apparel (US)*, op. cit., para. 6.29 and the GATT Panel Reports on *United States Manufacturing Clause*, adopted 15/16 May 1984, BISD 31S/74, para. 39; *Japan – Measures on Imports of Leather* ("Japan – Leather"), adopted 15/16 May 1984, BISD 31S/94, para. 55; *EEC – Imports of Newsprint*, adopted November 20 1984, BISD 31S/114, para. 52; *Norway – Restrictions on Imports of Apples and Pears*, adopted 22 June 1989, BISD 36S/306, para. 5.6.

7.78 It may, thus, be convenient in the GATT/WTO legal order to speak not of the principle of direct effect but of the principle of indirect effect.

7.79 Apart from this name-of-convenience, there is nothing novel or radical in our analysis. We have already seen that it is rooted in the language of the WTO itself. It also represents a GATT/WTO orthodoxy confirmed in a variety of ways over the years including panel and Appellate Body reports as well as the practice of Members.

7.80 Consider, first, the overall obligation of Members concerning their internal legislation. Under traditional public international law a State cannot rely on its domestic law as a justification for non-performance.<sup>664</sup> Equally, however, under traditional public international law, legislation under which an eventual violation could, or even would, subsequently take place, does not normally in and of itself engage State responsibility. If, say, a State undertakes not to expropriate property of foreign nationals without appropriate compensation, its State responsibility would normally be engaged only at the moment foreign property had actually been expropriated in a given instance. And yet, even in the GATT, prior to the enactment of Article XVI:4 of the WTO Agreement explicitly referring to measures of a general nature, legislation as such independent from its application in specific instances was considered to constitute a violation. This is confirmed by numerous adopted GATT panel reports and is also agreed upon by both parties to this dispute. Why is it, then, that legislation as such was found to be inconsistent with GATT rules? If no specific application is at issue – if, for example, no specific discrimination has yet been made – what is it that constitutes the violation?

7.81 Indirect impact on individuals is, surely, one of the principal reasons. In treaties which concern only the relations between States, State responsibility is incurred only when an actual violation takes place. By contrast, in a treaty the benefits of which depend in part on the activity of individual operators the legislation itself may be construed as a breach, since the mere existence of legislation could have an appreciable "chilling effect" on the economic activities of individuals.

7.82 Thus, Article III:2 of GATT 1947, for example, would not, on its face, seem to prohibit legislation independently from its application to specific products. However, in light of the object and purpose of the GATT, it was read in GATT jurisprudence as a promise by contracting parties not only that they would abstain from actually imposing discriminatory taxes, but also that they would not enact legislation with that effect.

7.83 It is commonplace that domestic law in force imposing discriminatory taxation on imported products would, in and of itself, violate Article III irrespective of proof of actual discrimination in a specific case.<sup>665</sup> Furthermore, a domestic law which exposed imported products to future discrimination was recognized by some GATT panels to constitute, by itself, a violation of Article III, even before the law came into force.<sup>666</sup> Finally, and most tellingly, even where there was no certainty but only a risk under the domestic law that the tax would be

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<sup>664</sup> See Article 27 of the Vienna Convention.

<sup>665</sup> A change in the relative competitive opportunities caused by a measure of general application as such, to the detriment of imported products and in favour of domestically produced products, is the decisive criterion.

<sup>666</sup> In the Panel Report on *US – Superfund* (op. cit., paras. 5.2.1 and 5.2.2) tax legislation as such was found to violate GATT obligations even though the legislation had not yet entered into effect. See also the Panel Report on *US - Malt Beverages* (op. cit., paras. 5.39, 5.57, 5.60 and 5.69) where the legislation imposing the tax discrimination was, for example, not being enforced by the authorities.

discriminatory, certain GATT panels found that the law violated the obligation in Article III.<sup>667</sup> A similar approach was followed in respect of Article II of GATT 1994 by the WTO panel on *Argentina – Textiles and Apparel (US)* when it found that the very change in system from *ad valorem* to specific duties was a breach of Argentina's *ad valorem* tariff binding even though such change only brought about the potential of the tariff binding being exceeded depending on the price of the imported product.<sup>668</sup>

7.84 The rationale in all types of cases has always been the negative effect on economic operators created by such domestic laws. An individual would simply shift his or her trading patterns – buy domestic products, for example, instead of imports – so as to avoid the would-be taxes announced in the legislation or even the mere risk of discriminatory taxation. Such risk or

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<sup>667</sup> See Panel Report on *US – Tobacco*, op. cit., para. 96:

"The Panel noted that an internal regulation which merely exposed imported products to a risk of discrimination had previously been recognized by a GATT panel to constitute, by itself, a form of discrimination, and therefore less favourable treatment within the meaning of Article III. The Panel agreed with this analysis of risk of discrimination as enunciated by this earlier panel".

A footnote to this paragraph refers to the Panel Report on *EEC – Payments and Subsidies Paid to Processors and Producers of Oilseeds and Related Animal Feed Protein*, adopted 25 January 1990, BISD 37S/86, para. 141, which reads as follows:

"Having made this finding the Panel examined whether a purchase regulation which does not necessarily discriminate against imported products but is capable of doing so is consistent with Article III:4. The Panel noted that the exposure of a particular imported product to a *risk* of discrimination constitutes, by itself, a form of discrimination. The Panel therefore concluded that purchase regulations creating such a risk must be considered to be according less favourable treatment within the meaning of Article III:4. The Panel found for these reasons that the payments to processors of Community oilseeds are inconsistent with Article III:4".

<sup>668</sup> Op. cit., paras. 6.45-6.47, in particular para. 6.46: "In the present dispute we consider that the competitive relationship of the parties was changed unilaterally by Argentina because its mandatory measure clearly has *the potential to violate its bindings, thus undermining the security and the predictability of the WTO system*" (emphasis added). This was confirmed by the Appellate Body (op. cit., para. 53):

"In the light of this analysis, we may generalize that under the Argentine system, whether the amount of the DIEM [a regime of Minimum Specific Import Duties] is determined by applying 35 per cent, or a rate less than 35 per cent, to the representative international price, there will remain the possibility of a price that is sufficiently low to produce an *ad valorem* equivalent of the DIEM that is greater than 35 per cent. In other words, the structure and design of the Argentine system is such that for any DIEM, no matter what *ad valorem* rate is used as the multiplier of the representative international price, the possibility remains that there is a "break-even" price below which the *ad valorem* equivalent of the customs duty collected is in excess of the bound *ad valorem* rate of 35 per cent".

On that basis, the Appellate Body found that the application of a type of duty different from the type provided for in a Member's Schedule is inconsistent with Article II:1(b), first sentence, of the GATT 1994. In this respect, see also the Panel Report on *United States – Standards for Reformulated and Conventional Gasoline*, adopted 20 May 1996, WT/DS2/R, para. 6.10.

threat, when real, was found to affect the relative competitive opportunities between imported and domestic products because it could, in and of itself, bring about a shift in consumption from imported to domestic products: This shift would be caused by, for example, an increase in the cost of imported products and a negative impact on economic planning and investment to the detriment of those products. This rationale was paraphrased in the *Superfund* case as follows:

"to protect expectations of the contracting parties as to the competitive relationship between their products and those of the other contracting parties. Both articles [GATT Articles III and XI] are not only to protect current trade but also to create the predictability needed to plan future trade".<sup>669</sup>

Doing so, the panel in *Superfund* referred to the reasoning in the *Japanese Measures on Imports of Leather* case. There the panel found that an import quota constituted a violation of Article XI of GATT even though the quota had not been filled. It did so on the following grounds:

"the existence of a quantitative restriction should be presumed to cause nullification or impairment not only because of any effect it had had on the volume of trade but also for other reasons e.g. it would lead to increased transaction costs and would create uncertainties which could affect investment plans".<sup>670</sup>

7.85 In this sense, Article III:2 is not only a promise not to discriminate in a specific case, but is also designed to give certain guarantees to the market place and the operators within it that discriminatory taxes will not be imposed. For the reasons given above, any ambivalence in GATT panel jurisprudence as to whether a risk of discrimination can constitute a violation should, in our view, be resolved in favour of our reading.<sup>671</sup>

7.86 Similarly, Article 23 too has to be interpreted in the light of these principles which encapsulate such a central object and purpose of the WTO. It may have been plausible if one considered a strict Member-Member matrix to insist that the obligations in Article 23 do not

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<sup>669</sup> Op. cit., para. 5.2.2.

<sup>670</sup> Panel Report on *Japan – Leather*, op. cit., para. 55. In this respect, see also Panel Report on *US – Malt Beverages* (op. cit., para. 5.60), where legislation was found to constitute a GATT violation even though it was not being enforced, for the following reason:

"Even if Massachusetts may not currently be using its police powers to enforce this mandatory legislation, *the measure continues to be mandatory legislation which may influence the decisions of economic operators*. Hence, a non-enforcement of a mandatory law in respect of imported products does not ensure that imported beer and wine are not treated less favourably than like domestic products to which the law does not apply" (emphasis added).

<sup>671</sup> As a result, we do not consider that the general statements made in certain GATT panels are correct in respect of all WTO obligations and in all circumstances, for example, the statement in Panel Report on *EEC – Parts and Components* (op. cit., para. 5.25) that "[u]nder the provisions of the [GATT] which Japan claims have been violated by the EEC contracting parties are to avoid certain measures; but these provisions do not establish the obligation to avoid legislation under which the executive authorities may possibly impose such measures" and in Panel Report on *Thai – Cigarettes* (op. cit., para. 84), the statement that "legislation merely giving the executive the possibility to act inconsistently with Article III:2 [of GATT] could not, by itself, constitute a violation of that provision". In respect of this ambivalence in GATT jurisprudence, see Chua, A., *Precedent and Principles of WTO Panel Jurisprudence*, Berkeley Journal of International Law, 1998, p. 171, in particular at p. 193.



apply to legislation that threatens unilateral determinations but does not actually mandate them. It is not, however, plausible to construe Article 23 in this way if one interprets it in the light of the indirect effect such legislation has on individuals and the market-place, the protection of which is one of the principal objects and purposes of the WTO.

7.87 To be sure, in the cases referred to above, whether the risk materialised or not depended on certain market factors such as fluctuating reference prices on which the taxation of the imported product was based by virtue of the domestic legislation. In this case, whether the risk materializes depends on a decision of a government agency. From the perspective of the individual economic operator, however, this makes little difference. Indeed, it may be more difficult to predict the outcome of discretionary government action than to predict market conditions, thereby exacerbating the negative economic impact of the type of domestic law under examination here.

7.88 When a Member imposes unilateral measures in violation of Article 23 in a specific dispute, serious damage is created both to other Members and the market-place. However, in our view, the creation of damage is not confined to actual conduct in specific cases. A law reserving the right for unilateral measures to be taken contrary to DSU rules and procedures, may – as is the case here – constitute an ongoing threat and produce a "chilling effect" causing serious damage in a variety of ways.

7.89 First, there is the damage caused directly to another Member. Members faced with a threat of unilateral action, especially when it emanates from an economically powerful Member, may in effect be forced to give in to the demands imposed by the Member exerting the threat, even before DSU procedures have been activated. To put it differently, merely carrying a big stick is, in many cases, as effective a means to having one's way as actually using the stick. The threat alone of conduct prohibited by the WTO would enable the Member concerned to exert undue leverage on other Members. It would disrupt the very stability and equilibrium which multilateral dispute resolution was meant to foster and consequently establish, namely equal protection of both large and small, powerful and less powerful Members through the consistent application of a set of rules and procedures.<sup>672</sup>

7.90 Second, there is the damage caused to the market-place itself. The mere fact of having legislation the statutory language of which permits conduct which is WTO prohibited – namely, the imposition of unilateral measures against other Members with which it is locked in a trade dispute – may in and of itself prompt economic operators to change their commercial behaviour in a way that distorts trade. Economic operators may be afraid, say, to continue ongoing trade with, or investment in, the industries or products threatened by unilateral measures. Existing trade may also be distorted because economic operators may feel a need to take out extra insurance to allow for the illegal possibility that the legislation contemplates, thus reducing the relative competitive opportunity of their products on the market. Other operators may be deterred from trading with such a Member altogether, distorting potential trade. The damage thus caused to the market-place may actually increase when national legislation empowers individual economic operators to trigger unilateral State action, as is the case in the US which allows individual petitioners to request the USTR to initiate an investigation under Sections 301-310. This in itself is not illegal. But the ability conferred upon economic operators to threaten their foreign competitors with the triggering of a State procedure which includes the possibility of illegal unilateral action is another matter. It may affect their competitive economic

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<sup>672</sup> In this respect, see the statements made by third parties to this dispute in Section V of our Report.

relationship and deny certain commercial advantages that foreign competitors would otherwise have. The threat of unilateral action can be as damaging on the market-place as the action itself.

7.91 In conclusion, the risk of discrimination was found in GATT jurisprudence to constitute a violation of Article III of GATT – because of the "chilling effect" it has on economic operators. The risk of a unilateral determination of inconsistency as found in the statutory language of Section 304 itself has an equally apparent "chilling effect" on both Members and the market-place even if it is not quite certain that such a determination would be made. The point is that neither other Members nor, in particular, individuals can be reasonably certain that it will not be made. Whereas States which are part of the international legal system may expect their treaty partners to assume good faith fulfillment of treaty obligations on their behalf, the same assumption cannot be made as regards individuals.

7.92 It is a circumspect use of the teleological method to choose that interpretation of Article 23 of the DSU that provides this certainty and eliminates the undesired "chilling effects" which run against the object and purpose of the WTO Agreement.

**(d) "...in their context..."**

7.93 Construing a WTO obligation as prohibiting a domestic law that "merely" exposes Members and individual operators to risk of WTO inconsistent action should not be done lightly. It depends on the specific WTO obligation at issue, the measure under consideration and the specific circumstances of each case. We are, however, confirmed in our view that Article 23 contains such an obligation not only by textual and teleological considerations but also by systemic ones, namely the context of Article 23 and the DSU in the overall WTO system.<sup>673</sup>

7.94 The more effective and quasi-automatic dispute settlement system under the WTO has often been heralded as one of the fundamental changes and major achievements of the Uruguay Round agreements. Because of that, the relevance of Article 23 obligations for individuals and the market-place is particularly important since they radiate on to all substantive obligations under the WTO. If individual economic operators cannot be confident about the integrity of WTO dispute resolution and may fear unilateral measures outside the guarantees and disciplines which the DSU ensures, their confidence in each and every of the substantive disciplines of the system will be undermined as well. The overall systemic damage and the denial of benefits would be amplified accordingly. The assurances thus given under the DSU may, in our view, be of even greater importance than those provided under substantive WTO provisions. For that reason, the preservation of the specific guarantees provided for in Article 23 is of added importance given the spill-over effect they have on all material WTO rights and obligations.

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<sup>673</sup> We realise that the possibility for a Member to breach its obligations under Article 23.2(a) will always remain. In that sense, guarantees can never be completely assured. However, remote possibilities that obligations may be breached, i.e. normal risks to be accepted in all trade relations, should be distinguished from explicit risks or threats created by statute, i.e. where a Member makes it known to all its trade partners that they may be subjected to an internal procedure under which the right to breach WTO obligations is reserved.

## 5. Preliminary Conclusion after the Panel's Examination of the Statutory Language of Section 304

7.95 Our textual interpretation of Article 23.2(a) is thus confirmed when taking account also of the other elements referred to in Article 31 of the Vienna Convention.<sup>674</sup> Under this reading the duty of Members under Article 23 to have recourse to and abide by the rules and procedures of the DSU and to abstain from unilateral determinations of inconsistency, is meant to guarantee Members as well as the market-place and those who operate in it that no such determinations in respect of WTO rights and obligations will be made.

7.96 Consequently, the statutory language of Section 304 – by mandating a determination *before* the adoption of DSB findings and statutorily reserving the right for this determination to be one of inconsistency – must be considered presumptively to be inconsistent with the obligations in Article 23.2(a). The discretion given to the USTR to make a determination of inconsistency creates a real risk or threat for both Members and individual economic operators that determinations prohibited under Article 23.2(a) will be imposed. The USTR's discretion effectively to make such determinations removes the guarantee which Article 23 is intended to give not only to Members but indirectly also to individuals and the market place. In this sense, the USTR's discretion under Section 304 does not – as the US argued – ensure the consistency of Section 304. On the contrary, it is the core element of the *prima facie* inconsistency of the statutory language of Section 304.

7.97 Therefore, pursuant to our examination of text, context and object-and-purpose of Article 23.2(a) we find, at least *prima facie*, that the statutory language of Section 304 precludes compliance with Article 23.2(a). This is so because of the nature of the obligations under Article 23. Under Article 23 the US promised to have recourse to and abide by the DSU rules and procedures, specifically not to resort to unilateral measures referred to in Article 23.2(a). In Section 304, in contrast, the US statutorily reserves the right to do so. In our view, because of that, the statutory language of Section 304 constitutes a *prima facie* violation of Article 23.2(a).<sup>675</sup>

## 6. The Non-Statutory Elements of Section 304

### (a) Introduction and Summary of the Panel's Analysis

7.98 In the previous analysis we have deliberately referred to the "statutory language" of Section 304 and likewise we have deliberately concluded that the statutory language creates a

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<sup>674</sup> Since an examination of the elements referred to in Article 31 does not leave the meaning of Article 23.2(a) "ambiguous or obscure" nor leads to a result which is "manifestly absurd or unreasonable" in the sense of Article 32 of the Vienna Convention, we do not need to evaluate the supplementary means of interpretation referred to in Article 32.

<sup>675</sup> We would like to emphasize again that this finding does not require the wholesale reversing of earlier GATT and WTO jurisprudence on mandatory and discretionary legislation. The classical test under previous jurisprudence was that only legislation *mandating* a WTO inconsistency or *precluding* WTO consistency, could, as such, violate WTO provisions (see paras. 4.173 ff. and 7.51 of this Report). The methodology we adopted was to examine first and with care the WTO provision in question and the obligation it imposed on Members. It could not be presumed, in our view, that the WTO would never prohibit legislation under which a national administration would enjoy certain discretionary powers. If it were found upon such examination that certain discretionary powers were in fact inconsistent with a WTO obligation, then legislation allowing such discretion would, on its face, fail the classical test: it would preclude WTO consistency.

*prima facie* violation. We did not conclude that a violation has been confirmed. This is so because of the special nature of the Measure in question. The Measure in question includes statutory language as well as other institutional and administrative elements.<sup>676</sup> To evaluate its overall WTO conformity we have to assess all of these elements together.

7.99 Therefore, although we found above that the statutory language of Section 304 creates a *prima facie* violation of Article 23.2(a), this does not, in and of itself, establish a US violation. There is more to Section 304 than statutory language. Consequently, we have to examine the impact of the other elements on the overall conformity of the Measure in question with the relevant WTO provisions.

7.100 To do this, we should recall first the nature of the *prima facie* violation created by the statutory language. The *prima facie* violation was created by the possibility under the statute of the USTR making a determination of inconsistency which negates the assurances that WTO partners of the US and individuals in the market place were entitled to expect under Article 23.

7.101 One can imagine different ways to remove the *prima facie* violation. If, for example, the statutory language itself were modified so that the USTR were not under an obligation to make a determination within the 18 months time-frame, but could, for example, await the making of any determination until such time as DSU procedures were completed the guarantee that Article 23 was intended to create would remain intact and the *prima facie* inconsistency would not exist.<sup>677</sup> Likewise, if, by a change in the statutory language, the USTR's discretion to make a determination of inconsistency prior to exhaustion of DSU proceedings were curtailed, once again the *prima facie* inconsistency would no longer exist.

7.102 Changing the statute is not the only way to remove the *prima facie* inconsistency. If the possibility of the USTR making a determination of inconsistency prior to exhaustion of DSU proceedings were lawfully curtailed in a different manner, the same legal effect would be achieved. The obligation on Members to bring their laws into conformity with WTO obligations is a fundamental feature of the system and, despite the fact that it affects the internal legal system of a State, has to be applied rigorously. At the same time, enforcement of this obligation must be done in the least intrusive way possible. The Member concerned must be allowed the maximum autonomy in ensuring such conformity and, if there is more than one lawful way to achieve this, should have the freedom to choose that way which suits it best.

7.103 Critically, the offending discretionary element has to be *lawfully* curtailed since, as found in WTO case law, conformity with WTO obligations cannot be obtained by an administrative promise to disregard its own binding internal legislation, i.e. by an administrative undertaking to act illegally.<sup>678</sup>

7.104 For the following reasons we find that the *prima facie* violation has in fact in this case been lawfully removed and no longer exists.

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<sup>676</sup> See paras. 7.25-7.28 of this Report.

<sup>677</sup> On this issue, the statutory language is, however, conclusive in that, as we found in para. 7.31(a), the USTR is obligated to make a determination within the 18 months time-frame under Section 304.

<sup>678</sup> Appellate Body Report on *India – Patents (US)*, op. cit., paras. 69-71.

7.105 The Trade Act in general and Sections 301-310 in particular are part of US legislation which covers the broad range of US trade relations including relations with States that are not WTO Members and including relations with Members that are not covered by WTO obligations.

7.106 The statutory language of Section 304 gives the USTR the broad discretion we outlined above as regards the entire scope of US trade relations, only a part of which comes within the orbit of WTO obligations. Within the discretion allowed, the statutory language leaves it to the USTR to apply the provisions of the Trade Act which relate to the entire gamut of US trade relations in a manner which is consistent with US interests and obligations. The interests and obligations can be different from one group of States to another.

7.107 We find, as a matter of fact, that it is within that broad discretion afforded to the US Administration, notably as regards the content of determinations pursuant to Section 304, lawfully to set out different regimes for the application of Section 304 depending on whether or not it concerns WTO covered situations.

7.108 The language of Section 304 allows the existence of multilateral dispute resolution proceedings to be taken into account.<sup>679</sup> It also allows for determinations of inconsistency to be postponed until after the exhaustion of DSU proceedings.<sup>680</sup> This language surely permits the Administration to limit the discretion of the USTR so that no determination of inconsistency would be made before the exhaustion of DSU proceedings. The wide discretion granted as to the content of the determination to be made should be interpreted as including the power of the US Administration to adopt an administrative decision limiting the USTR's discretion in a manner consistent with US international obligations.<sup>681</sup>

7.109 For reasons we explain below, we find that this is precisely the situation in the present case. Briefly, the US Administration has carved out WTO covered situations from the general application of the Trade Act. It did this in a most authoritative way, *inter alia*, through a Statement of Administrative Action ("SAA") submitted by the President to, and approved by, Congress. Under the SAA so approved "... it is the expectation of the Congress that future administrations would observe and apply the [undertakings given in the SAA]". One of these undertakings was to "base any section 301 determination that there has been a violation or

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<sup>679</sup> Section 304 states that the determination is to be based on "the investigation initiated under section 302 ... and the consultations (*and proceedings, if applicable*) under section 303" (emphasis added). See, in this respect, footnote 649 above.

<sup>680</sup> As the US noted in its answer to Panel Question 32(b), "[t]here is nothing in the text of Sections 301-310 which prevents [the USTR from making two determinations in one and the same case] ... While the Trade Representative is required to make a determination within the time frames set forth in that section, nothing prevents her from making additional determinations after that time". See para. 4.599 above.

<sup>681</sup> We reach this conclusion not least because of the US constitutional principle of construing US domestic law, where possible, in a way that is consistent with US obligations under international law. We accept the US submissions that "[i]n U.S. law, it is an elementary principle of statutory construction that 'an act of Congress ought never to be construed to violate the law of nations if any other possible construction remains'. *Murray v. Schooner Charming Betsy*, 6 U.S. (2 Cranch) 64, 118 (1804). While international obligations cannot override inconsistent requirements of domestic law, 'ambiguous statutory provisions . . . [should] be construed, where possible, to be consistent with international obligations of the United States'. *Footwear Distributors and Retailers of America v. United States*, 852 F. Supp. 1078, 1088 (CIT), appeal dismissed, 43 F.3d 1486 (Table) (Fed. Cir. 1994), citing *DeBartolo Corp. v. Florida Gulf Coast Building and Trades Council*, 485 U.S. 568 (1988)".

denial of US rights ... on the panel or Appellate Body findings adopted by the DSB".<sup>682</sup> This limitation of discretion would effectively preclude a determination of inconsistency prior to exhaustion of DSU proceedings.<sup>683</sup> The exercise of discretion under the statutory scheme is in the hands of the Administration and it is the Administration which has given this undertaking. We recognize of course that an undertaking given by one Administration can be repealed by that Administration or by another Administration. But this is no different from the possibility that statutory language under examination by a panel be amended subsequently by the same or another Legislator.<sup>684</sup> The critical question is whether the curtailment of discretion is lawful and effective. This Panel finds that it is.

**(b) The Internal Dimension: US Statement of Administrative Action**

7.110 The limitation on the USTR's discretion under Section 304, outlined above, was contained in the US Statement of Administrative Action ("SAA") that accompanied the US legislation implementing the results of the Uruguay Round submitted by the President to Congress. The SAA provides, in its own terms, as follows:

"This Statement describes significant administrative actions proposed to implement the Uruguay Round agreements....

... this Statement represents an authoritative expression by the Administration concerning its views regarding the interpretation and application of the Uruguay Round agreements, both for purposes of U.S. international obligations and domestic law. Furthermore, the Administration understands that it is the expectation of the Congress that future Administrations will observe and apply the interpretations and commitments set out in this Statement. Moreover, since this Statement will be approved by the Congress at the time it implements the Uruguay Round agreements, the interpretations of those agreements included in this Statement carry particular authority".<sup>685</sup>

7.111 The SAA thus contains the view of the Administration, submitted by the President to Congress and receiving its imprimatur, concerning both interpretation and application and containing commitments, to be followed also by future Administrations, on which domestic as well as international actors can rely.

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<sup>682</sup> The SAA, as is often the case in trade policy and trade law circles, uses "section 301" as a generic term referring to enforcement procedures under Sections 301-310 more generally. Thus, when referring to "section 301 determinations", we understand this to mean any determination made under Sections 301-310.

<sup>683</sup> The US, in its answer to Panel Question 25 (as reflected in paras. 4.121 and 4.534 of this Report), unambiguously confirmed this construction. It noted in particular that "[t]he SAA must, by law, be treated as the authoritative expression concerning the interpretation of the statute in any judicial proceedings" and that with reference to all elements under Section 304 "under U.S. law, it is required to base an affirmative determination that U.S. WTO agreement rights have been denied on adopted panel and Appellate Body findings. That is to say, U.S. law precludes such an affirmative determination not based on adopted panel or Appellate Body findings".

<sup>684</sup> Of course, it is easier to change administrative decisions than it is to change legislation. However, as noted in para. 7.133, in the event the US administration were to repeal its undertaking in respect of US domestic law, it would not only go against express expectations held by Congress set out in the SAA. The US would also expose itself to a finding of inconsistency with its WTO obligations.

<sup>685</sup> SAA, p. 1.

7.112 In the SAA the US Administration indicated its interpretation of Sections 301-310 as well as the manner in which it intends to use its discretion under Sections 301-310, as follows (emphases added):

"Although it will enhance the effectiveness of section 301, the DSU does not require any significant change in section 301 *for investigations that involve an alleged violation of a Uruguay Round agreement or the impairment of U.S. benefits under such an agreement.* In such cases, *the Trade Representative will:*

- invoke DSU dispute settlement procedures, as required under current law;
- base any section 301 determination that there has been a violation or denial of U.S. rights under the relevant agreement on the panel or Appellate Body findings adopted by the DSB;
- following adoption of a favourable panel or Appellate Body report, allow the defending party a reasonable period of time to implement the report's recommendations; and
- if the matter cannot be resolved during that period, seek authority from the DSB to retaliate" (emphasis added).<sup>686</sup>

This official statement in the SAA – in particular, the commitment undertaken in the second bullet point – approved by the US Congress in the expectation that it will be followed by future US Administrations, is a major element in our conclusion that the discretion created by the statutory language permitting a determination of inconsistency prior to exhaustion of DSU proceeding has effectively been curtailed. As we already noted, we find that this decision of the US Administration on the manner in which it plans to exercise its discretion, namely to curtail it in such a way so as never to adopt a determination of inconsistency prior to the adoption of DSB findings, was lawfully made under the statutory language of Section 304.<sup>687</sup>

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<sup>686</sup> SAA, pp. 365-366.

<sup>687</sup> In this respect, the EC refers to Section 102(a) of the US Uruguay Round Agreements Act 1994, the Act by which the US Congress approved the WTO Agreement. Section 102(a) of this Act provides

"(1) UNITED STATES LAW TO PREVAIL IN CONFLICT. - No provision in any of the Uruguay Round Agreements, nor the application of any such provision to any person or circumstance, that is inconsistent with any law of the United States shall have effect.

(2) CONSTRUCTION. - Nothing in this Act shall be construed - ...

(B) to limit any authority conferred under any law of the United States, including section 301 of the Trade Act of 1974 unless specifically provided for in this Act".

We note, however, that even if one were to hold that, pursuant to Section 102(a), the WTO agreements and the Uruguay Round Act itself could not, and did not, curtail the USTR's discretion under Section 304, in our view, the US Administration itself could do so, and did so, *inter alia*, in the SAA. It did so validly by means of exercising discretion granted to it under the statutory language of Section 304.

7.113 The EC refers to subsequent paragraphs in the SAA that allegedly contradict the above quoted statement in the SAA.<sup>688</sup> We are persuaded, however, and so find, that these other paragraphs, read in their context, do not contradict the decision to apply Sections 301-310 in a manner consistent with US obligations under the WTO. Some of the disputed language clearly does not cover the issues considered here, i.e. involving WTO Members and an alleged denial of US rights under the WTO Agreement. Those paragraphs deal rather with cases involving WTO Members but not involving US rights under the WTO Agreement, i.e. where the subject-matter is not covered by the WTO. Admittedly, some of the language in the SAA appears ambivalent. We note however that, following US constitutional law, cases of ambiguity in the construction of legal instruments should, where possible, always be resolved in a manner consistent with US international obligations. We find that it is possible to do so in this case.

**(c) US Statements before this Panel**

7.114 The international elements of the SAA, though clearly present<sup>689</sup> were not at its centre. The SAA was made in a domestic context, before Congress on the occasion of the implementation by the US of the results of the Uruguay Round negotiations. Since the alleged violation at issue is domestic legislation, in principle, internal elements legally relevant to the construction of the legislation should be determinative.

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<sup>688</sup> SAA, pp. 366-367:

"There is no basis for concern that the Uruguay Round agreements in general, or the DSU in particular, will make future Administrations more reluctant to apply section 301 sanctions that may be inconsistent with U.S. trade obligations because such sanctions could engender DSU-authorized counter-retaliation. Although in specific cases the United States has expressed its intention to address an unfair foreign practice by taking action under section 301 that has not been authorized by the GATT, the United States has done so infrequently. In certain cases, the United States has taken such action because a foreign government has blocked adoption of a GATT panel report against it.

Just as the United States may now choose to take section 301 actions that are not GATT authorized, governments that are the subject of such actions may choose to respond in kind. That situation will not change under the Uruguay Round agreements. The risk of counter-retaliation under the GATT has not prevented the United States from taking action in connection with such matters as semiconductors, pharmaceuticals, beer, and hormone-treated beef".

It may be possible to construe these two paragraphs in the SAA as in fact indicating that the conditions which explain an abusive use of Section 301 in the past – in particular, the blocking of adoption of a panel report – no longer prevail under the WTO (see US Answer to Panel Question 38 reflected in paras. 4.134-4.140 of this Report). We decided to put the worst possible construction on these paragraphs in the SAA concluding that there is a tension between these paragraphs and the undertakings in the bullet points. As indicated in the body of the Report, this tension ought to be resolved following US constitutional law principles in favour of a construction which upholds compliance with international legal obligations. We were brought to that solution also when considering, in addition, the solemn undertakings of the US to the Panel confirming the Administration's view set out in the bullet points that in the light of the SAA the USTR is precluded from applying Sections 301-310 in a manner inconsistent with WTO obligations.

<sup>689</sup> As noted earlier, the SAA is explicitly said to represent an authoritative expression "both for purposes of U.S. international obligations and domestic law", see para. 7.110 of this Report.



7.115 The international legal relevance of the US commitments in the SAA were confirmed and amplified also in the context of the very proceedings before this Panel. In response to our very insistent questions, the US explicitly, officially, repeatedly and unconditionally confirmed the commitment expressed in the SAA namely that the USTR would "... base any section 301 determination that there has been a violation or denial of U.S. rights under the relevant agreement on the panel or Appellate Body findings adopted by the DSB".<sup>690</sup>

7.116 The US confirmed this for the record during the first meeting with the parties before the Panel. Subsequently, answering Panel Question 14, the US stated the following:

"With regard to determinations under Section 304, as noted in paragraphs 12 and 41 of the U.S. First Submission, and as provided at page 365 of the Statement of Administrative Action (U.S. Exhibit 11), the Trade Representative is required under Section 304(a)(1) to base a determination of whether agreement rights have been denied on the results of WTO dispute settlement proceedings. Thus, in the event that a dispute settlement panel were to fail to complete its proceedings within the time frames provided for in the DSU and Section 304(a)(2)(A), the Trade Representative would not be able to make a determination that U.S. agreement rights have been denied".<sup>691</sup>

7.117 Whilst we have rejected the view that the statutory language of Section 304 itself precludes a determination of inconsistency, we fully accept the power of the US Administration to determine that it is its duty to exercise the discretion given to it by the statutory language in a way consistent with WTO obligations, to make this duty, through the SAA, official US policy for future Administrations, and, in turn, for the USTR, as part of the US Administration, to perceive it as its legal duty to follow such a policy.

7.118 Attributing international legal significance to unilateral statements made by a State should not be done lightly and should be subject to strict conditions. Although the legal effects we are ascribing to the US statements made to the DSB through this Panel are of a more narrow and limited nature and reach compared to other internationally relevant instances in which legal effect was given to unilateral declarations, we have conditioned even these limited effects on the fulfilment of the most stringent criteria. A sovereign State should normally not find itself legally affected on the international plane by the casual statement of any of the numerous representatives speaking on its behalf in today's highly interactive and inter-dependant world<sup>692</sup>

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<sup>690</sup> SAA, p. 366.

<sup>691</sup> See also footnote 683 above.

<sup>692</sup> In the *Nuclear Test* case (Australia v. France), the ICJ held that France was legally bound by publicly given undertakings, made on behalf of the French Government, to cease the conduct of atmospheric nuclear tests. The criteria of obligation were: the intention of the state making the declaration that it should be bound according to its terms; and that the undertaking be given publicly:

"It is well recognized that declarations made by way of unilateral acts, concerning legal or factual situations, may have the effect of creating legal obligations. Declarations of this kind may be, and often are, very specific. When it is the intention of the State making the declaration that it should become bound according to its terms, that intention confers on the declaration the character of a legal undertaking, the State being henceforth legally required to follow a course of conduct consistent with the declaration. An undertaking of this kind, if given publicly, and with an intent to be bound, even though not made within the context of international negotiations, is binding".

nor by a representation made in the heat of legal argument on a State's behalf. This, however, is very far from the case before us.

7.119 At this juncture, it is also worth recalling that under Article 11 of the DSU it is our duty to "... make an objective assessment of the facts of the case ... *and make such other findings* as will assist the DSB in making the recommendations or in giving the rulings provided for in the covered agreements" (emphasis added).

7.120 As regards these statements we find, thus, as follows:

7.121 The statements made by the US before this Panel were a reflection of official US policy, intended to express US understanding of its international obligations as incorporated in domestic US law.<sup>693</sup> The statements did not represent a new US policy or undertaking but the bringing of a pre-existing US policy and undertaking made in a domestic setting into an international forum.

7.122 The representations and statements by the representatives of the US appearing before us were solemnly made, in a deliberative manner, for the record, repeated in writing and confirmed in the Panel's second hearing. There was nothing casual about these statements nor were they made in the heat of argument. There was ample opportunity to retract. Rather than retract, the US even sought to deepen its legal commitment in this respect.<sup>694</sup>

7.123 We are satisfied that the representatives appearing before us had full powers to make such legal representations and that they were acting within the authority bestowed on them. Panel proceedings are part of the DSB dispute resolution process. It is inconceivable except in extreme circumstances that a panel would reject the power of the legal representatives of a Member to state before a panel, and through the panel to the DSB, the legal position of a Member as regards its domestic law read in the light of its WTO obligations. The panel system would not function if such a power could not be presumed.

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(ICJ Reports (1974), p. 253 at pp. 267-271, quoted above from para. 43; see also *Nuclear Test case* (New Zealand v. France), ICJ Reports (1974), p. 457, at pp. 472-475; *Legal Status of Eastern Greenland case*, PCIJ Reports, Series A/B, No. 53, where a statement was found to have legal effects even though it was not made publicly but in the course of conversations with the Norwegian Foreign Minister; *Nicaragua case* (Merits), ICJ Reports (1986), p. 14, at p. 132; *Case Concerning the Frontier Dispute*, ICJ Reports (1986), p. 554, at pp. 573-574 ).

In this case, the legal effect of the US statements does not go as far as creating a new legal obligation. Nonetheless we have applied to them the same, and perhaps even more, stringent conditions. Subsequent to the *Nuclear test case*, some authors criticised giving legal effect to declarations not directed to a specific State or States but expressed *erga omnes* (see Rubin, A., *The International Legal Effects of Unilateral Declarations*, American Journal of International Law, 1977, p. 1 and Franck, T., *Word Made Law: The Decision of the ICJ in the Nuclear Test Cases*, American Journal of International Law, 1975, p. 612). In this case the US statements had explicit recipients and were made in the context of a specific dispute settlement procedure.

<sup>693</sup> See paras. 7.110 and 7.114 of this Report.

<sup>694</sup> In its first submission the US argued forcefully that Section 304 did not ever require the USTR to make a determination of inconsistency before exhaustion of DSU proceedings (see paras. 4.527-4.530 of this Report). In its second submission the US went further and argued that the correct interpretation of Section 304 is that the USTR is legally precluded from making such determination (see paras. 4.536-4.537 of this Report).

7.124 We are equally satisfied, as a matter of fact, that the statements made to us were intended to be part of the record in the full knowledge and understanding that they could, as any other official submission, be made part of our Report; that they were made with the intention not only that we rely on them but also that the EC and the third parties to the dispute as well as all Members of the DSB – effectively all WTO Members – place such reliance on them.

7.125 Accordingly, we find that these statements by the US express the unambiguous and official position of the US representing, in a manner that can be relied upon by all Members, an undertaking that the discretion of the USTR has been limited so as to prevent a determination of inconsistency before exhaustion of DSU proceedings. Although this representation does not create a new international legal obligation for the US – after all the US was already bound by Article 23 in becoming a WTO Member – it clarifies and gives an undertaking, at an international level, concerning aspects of domestic US law, in particular, the way the US has implemented its obligations under Article 23.2(a) of the DSU.

7.126 The aggregate effect of the SAA and the US statements made to us is to provide the guarantees, both direct to other Members and indirect to the market place, that Article 23 is intended to secure. Through the SAA and the US statements, as we have construed them, it is now clear that under Section 304, taking account of the different elements that compose it, the USTR is precluded from making a determination of inconsistency contrary to Article 23.2(a). As a matter of international law, the effect of the US undertakings is to anticipate, or discharge, any would-be State responsibility that could have arisen had the national law under consideration in this case consisted of nothing more than the statutory language.<sup>695</sup> It of course follows that should the US repudiate or remove in any way these undertakings, the US would incur State responsibility since its law would be rendered inconsistent with the obligations under Article 23.

**(d) USTR Practice under Section 304**

7.127 It is not our task to examine the individual conduct of the US in specific cases. We did, however, examine the practice of the USTR in specific cases as a means of shedding light on the meaning of Sections 301-310. We also considered that the USTR record could be of limited probative value in evaluating the veracity and significance of the SAA and the policy it articulated.

7.128 In support of its position the US made the following submission to the Panel:

"The record shows that the Trade Representative has never once made a Section 304(a)(1) determination that U.S. GATT or WTO agreement rights have been denied which was not based on the results of GATT and WTO dispute settlement proceedings. Not once".<sup>696</sup>

7.129 Given the intense criticism of Sections 301-310 articulated in the submissions of third parties before this Panel, we expressly invited the EC and all third parties to submit to us any evidence of WTO inconsistent conduct by the US corresponding to the complaints of the EC – and, thus, within our terms of reference – that took place since the entry into force of the WTO.

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<sup>695</sup> Below we also canvass another hypothesis, see para. 7.133 of this Report. In that alternative hypothesis the effect of the undertaking is actually to discharge State responsibility that the statutory language may have given rise to.

<sup>696</sup> US oral statement, second meeting, para. 16 (see para. 4.990).

One such alleged case was submitted by one of the third parties (*Japan – Auto Parts*<sup>697</sup>) to which the EC joined two other cases (*EC – Bananas III* and *Argentina – Textiles and Apparel (US)*).

7.130 It is not for us to make a conclusive finding in relation to any of these cases, not least *Bananas III* which is the subject of proceedings before another panel.<sup>698</sup> However, on the face of the record before us, we do not find the evidence submitted to us in this connection sufficient to overturn the US claim of a consistent record of compliance of Section 304 with Article 23.2(a) as invoked by the EC. In any event, we do not consider the evidence before us sufficient to overturn our conclusions regarding Section 304 itself.<sup>699</sup>

## **7. Summary of the Panel's Analysis and Finding in respect of the EC claim under Section 304**

7.131 The overall result of our analysis may be summarized as follows. We found that the statutory language of Section 304 constitutes a serious threat that determinations contrary to Article 23.2(a) may be taken and, in the circumstances of this case, is *prima facie* inconsistent with Article 23.2(a) read in the light of Article 23.1. We then found, however, that this threat had been removed by the aggregate effect of the SAA and the US statements before this Panel in a way that also removes the *prima facie* inconsistency and fulfils the guarantees incumbent on the US under Article 23. In the analogy described in paragraph 7.65, the sign "No

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<sup>697</sup> This dispute is explained in paras. 5.273-274 of this Report. As a result of the US action in this respect, see also *United States – Imposition of Duties on Automobiles from Japan under Section 301 and 304 of the Trade Act of 1974 ("Japan – Auto Parts")*, WT/DS6 (complaint by Japan), settlement notified to the DSB.

<sup>698</sup> See documents under WT/DS165.

<sup>699</sup> In *Japan – Auto Parts* the US was not seeking redress of inconsistencies under the WTO, it was examining, *inter alia*, whether Japanese acts or policies in this respect were "unreasonable" under Section 301 (b). We consider that even if conduct inconsistent with Article 23.2(a) occurred – a matter on which we express no opinion – the kind of inconsistency implicated would be outside our terms of reference since it covers issues not raised in the EC claims before us.

Whether the US violated Article 23 in the *Bananas III* case is one of the claims subject to separate panel proceedings. Even if the US conduct in response to the alleged implementation of DSB findings by the EC was inconsistent with Article 23.2(a), we note that any determinations made by the US in this respect were made under Section 306 – i.e. were determinations on whether implementation of DSB findings took place – not under Section 304 at issue here, i.e. determinations on whether US rights are being denied prior to the issue of implementation arising. The fact that determinations under Section 306 have to be considered, for purposes of, e.g. publication and subsequent action under Section 301, as determinations under Section 304, pursuant to Section 306 (b)(1), does not alter our conclusion. We deal with the EC claim of inconsistency of Section 306 in Section VII.D below.

Finally, in *Argentina – Textiles and Apparel (US)*, the USTR determination was published subsequently to both the lapse of the 18 months time-period referred to in Section 304 and the adoption of DSB findings on the matter. The determination explicitly states that it is based on the findings of the DSB on the matter. We do not consider the fact that the determination was retroactively dated back to 3 April 1998, i.e. the day before the lapse of the 18 months time-period and thereby also a date prior to the adoption of DSB findings on the matter (22 April 1998), to be relevant on the international plane. In our view, when it comes to examining Article 23.2(a), the actual date of the determination and, especially, the basis of the determination's finding are the critical elements. In terms of US obligations to other WTO Members, this case shows that the US waited until the end of DSU procedures before it publicly announced its determination and that the USTR effectively based her findings on the result of the DSU process. The outcome of the DSU process conditioned the content of the USTR determination.

Trespassing. Trespassers may be shot on sight" was construed by us as going against the mutual promise made among the neighbours always and exclusively to have recourse to the police and the courts of law in any case of alleged trespassing. Continuing with that analogy, we would find in this case that the farmer has added to the original sign which was erected for all to read another line stating: "In case of trespass by neighbours, however, immediate recourse to the police and the courts of law will be made". We would hold – as we did in this case – that with this addition the agreement has been respected.

7.132 This conclusion is based on our reading of Section 304 as part of a multi-layered law containing statutory, institutional and administrative elements. We did, however, for prudential reasons, consider Section 304 on an alternative hypothesis which would regard our task as limited to an examination of statutory elements only. Even on this hypothesis, our overall conclusion of conformity would remain intact albeit by virtue of slightly different methodologies.

7.133 First, the SAA could be considered not as an autonomous measure of the Administration determining its policy of implementing Section 304, but as an important interpretative element in the construction of the statutory language of Section 304 itself. Whereas the statutory language read on its own does not preclude a determination of inconsistency, as we found above in paragraph 7.31(d), following this alternative methodology, the statutory language read in the light of the SAA would have that effect.

7.134 Second, assuming that examination of the statutory language of Section 304 led us to conclude that, because of the broad discretion it gives to the USTR, the statute is in violation of Article 23, we would then need to consider an appropriate remedy, i.e. to consider how the US could restore to its WTO partners the guarantees embodied in Article 23. In our view, any lawful means by which the US Administration could curtail the discretionary element would be sufficient to achieve that goal. In the case at hand, we would then find that the SAA and statements of the kind made by the US to the DSB through this Panel effectively provide, for the reasons we explained above, such a remedy. Therefore, any violation we would thus have found on the basis of the statutory language of Section 304, under this second alternative, would have been remedied.

7.135 For the reasons outlined above we find that Section 304 is not inconsistent with US obligations under Article 23.2(a) of the DSU.

7.136 Should the undertakings articulated in the SAA and confirmed and amplified by the US to this Panel be repudiated or in any other way removed by the US Administration or another branch of the US Government<sup>700</sup>, this finding of conformity would no longer be warranted.

D. THE EC CLAIM THAT SECTION 306 IS INCONSISTENT WITH ARTICLE 23.2(A) OF THE DSU

## **1. Claims and Arguments of the Parties**

7.137 Section 306 concerns the follow-up by the USTR to a determination under Section 304 that US rights under the WTO were being denied. When applied to WTO covered situations referred to in the EC claim it presupposes the completion of panel and, as the case may be,

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<sup>700</sup> When we refer to the "US Government" in this Report we mean to include legislature, executive and judiciary.

Appellate Body proceedings and a ruling by the DSB in favour of the US. Section 306 sets out the procedures under the Trade Act for obtaining DSB authorization for the suspension of concessions when, in the view of the US, another Member has failed adequately to implement the original ruling of the DSB.

7.138 The EC claims that Section 306 (b) requires the USTR to "consider" whether a WTO Member has implemented the recommendations of the DSB and, in the event of non-implementation, to determine what further action to take. The EC claims that this "consideration" constitutes a "determination" in the sense of Article 23 by the USTR on whether the Member concerned has violated US rights under the WTO Agreement. According to Article 23, determinations of inconsistency may not be made prior to exhaustion of DSB proceedings. However, the EC contends, according to Section 306 this specific determination has to be made no later than *30 days* after the expiration of the reasonable period of time granted to the losing WTO Member to implement DSB recommendations. In the EC view, any dispute on the question of implementation has to be settled under Article 21.5 of the DSU which provides for referral of the matter to the original panel for a decision within *90 days*. Since such referral can take place at the end or even after the lapse of the reasonable period of time, the EC contends, Section 306 (b) requires a unilateral determination on compliance without awaiting the results of a WTO proceeding under Article 21.5 in violation of Article 23.2(a).

7.139 The US responds that Section 306 does *not* require the USTR to make a "determination" in violation of Article 23.2(a) of the DSU. In the US view, for the USTR to assert US rights under Article 22 of the DSU, the USTR is not only permitted, but is affirmatively required to make a judgment on – i.e. to "consider", the word used in Section 306 (b) itself – whether implementation of DSB recommendations has taken place. According to the US, a Member wanting to suspend concessions under Article 22 has to request authorization from the DSB within 30 days after the lapse of the reasonable period of time. If not, it loses the right to obtain such authorization by negative consensus. Since, therefore, a winning Member has to formulate its request for authorization within 30 days – even if, subsequently, the matter is referred to arbitration and authorization is only granted thereafter – the US argues that Article 22 itself presupposes that the USTR indicate how it intends to suspend concessions within this 30 day deadline. This 30 day deadline has been transposed into Section 306 (b) and is, therefore, in the view of the US, consistent with Article 23.2(a).

7.140 In respect of the possible conflict between the 30 day period in Section 306 (b) and the 90 day time-limit for a ruling on implementation under Article 21.5, the US argues that recourse to and completion of Article 21.5 proceedings is *not* a prerequisite for a *request* for authorization to suspend concessions to be made whenever disagreement arises on implementation.

7.141 Article 21.5 of the DSU provides as follows:

"Where there is disagreement as to the existence or consistency with a covered agreement of measures taken to comply with the recommendations and rulings such dispute shall be decided through recourse to these dispute settlement procedures, including wherever possible resort to the original panel. The panel shall circulate its report within 90 days after the date of referral of the matter to it. When the panel considers that it cannot provide its report within this time frame, it shall inform the DSB in writing of the reasons for the delay together with an estimate of the period within which it will submit its report".

Article 22.6 states:

"When the situation described in paragraph 2 occurs ["if the Member concerned fails to bring the measure found to be inconsistent with a covered agreement into compliance therewith or otherwise comply with the recommendations and rulings within the reasonable period of time determined pursuant to paragraph 3 of Article 21"], the DSB, upon request, shall grant authorization to suspend concessions or other obligations within 30 days of the expiry of the reasonable period of time unless the DSB decides by consensus to reject the request. However, if the Member concerned objects to the level of suspension proposed, or claims that the principles and procedures set forth in paragraph 3 have not been followed where a complaining party has requested authorization to suspend concessions or other obligations pursuant to paragraph 3(b) or (c), the matter shall be referred to arbitration. Such arbitration shall be ... completed within 60 days after the date of expiry of the reasonable period of time. Concessions or other obligations shall not be suspended during the course of the arbitration".

## **2. Preliminary Panel Findings in respect of the Statutory Language of Section 306**

7.142 We propose to adopt here a similar methodology as the one we employed in our examination of Section 304 and examine first the statutory language of Section 306 in the light of US obligations under Article 23.2(a) read in the light of Article 23.1.<sup>701</sup>

7.143 To facilitate the understanding of our subsequent findings, it may be useful to read Section 306 as consisting of two phases. A first phase deals with a "consideration" by the USTR that "a foreign country is not satisfactorily implementing a measure or agreement" (Section 306(b)(1)) or, as repeated in Section 306(b)(2), a "consideration" that "the foreign country has failed to implement". A second phase addresses the "determination" by the USTR on "what further action the Trade Representative shall take under section 301" (Section 306(b)(1)).

7.144 The second phase contains a mandatory element: the determination on the proposed action has to be made, according to Section 306, no later than 30 days after the expiration of the reasonable period of time given to the other WTO Member to implement DSB findings. This second phase can only be activated when the "consideration" in the first phase is made, i.e. when the USTR considers that implementation has failed. *Ipso facto*, the first phase as well has to take place within the 30 day time-frame prescribed for the second phase. We find, therefore, as a matter of fact, that Section 306 mandates the USTR to "consider" whether or not the WTO Member concerned has implemented DSB recommendations within 30 days after the lapse of the reasonable period of time.

7.145 We also find that the EC is correct in claiming that in certain circumstances this "consideration" by the USTR will necessarily take place *before* the completion of Article 21.5 procedures on implementation. The usual deadline for completion of procedures under Article 21.5 is 90 days after referral of the matter to the original panel. Article 21.5 does not further specify when and how such referral has to take place nor does it include a deadline for parties to invoke Article 21.5. On these grounds, it is reasonable to assume that situations can occur where Article 21.5 is invoked later than 60 days before the expiration of the reasonable period of time. As a result, the deadline for completion of the panel's work under Article 21.5 could fall later than the 30<sup>th</sup> day after the lapse of the reasonable period of time, the trigger

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<sup>701</sup> See Section VII.B.6.

referred to in Section 306 (b). In that event, the "consideration" required under Section 306 would thus need to be taken *before* the completion of Article 21.5 procedures.

7.146 We further find that USTR "considerations" under the first phase of Section 306 – made *subsequent* to, and based on, internal monitoring by the USTR pursuant to Section 306 (a); and, in the case of a "consideration" that implementation failed, automatically and as a *conditio sine qua non* leading to a decision on action under Section 301 – meet the threshold of firmness and immutability required for a "determination" under Article 23.2(a).<sup>702</sup> Hereafter we thus refer to these "considerations" as "determinations".<sup>703</sup> The US argument that the first phase of Section 306 is affirmatively required under Article 22 and represents no more than a belief necessary to the pursuit of dispute settlement procedures is, in our view, relevant not so much to the question of whether there is a "determination" but to the question of whether such "determination" is allowed under Article 23.2(a) since made "through recourse to dispute settlement in accordance with the rules and procedures" of the DSU, another element under Article 23.2(a) discussed below. We recall also that the USTR view under Section 306 that implementation failed is not a preliminary one that requires further confirmation by a panel but one referred to the DSB for immediate authorization to suspend concessions (unless an objection is raised against the level of suspension or the principles or procedures followed in considering what concessions to suspend).<sup>704</sup>

7.147 We further find, as a matter of fact, that although the USTR is obligated to make this determination within the 30 day time-frame, it has wide discretion as to the content of this determination. Specifically, we find that there do not exist any circumstances which would compel the USTR under the statutory language of Section 306 to determine that implementation has *failed*, i.e. to make a determination of inconsistency, whilst Article 21.5 procedures are still pending. In other words, it would always be open to the USTR under the Trade Act to determine that implementation has not failed so long as DSB procedures have not been exhausted. However, as in the case of Section 304, within the discretion created by the statutory language the USTR is not precluded by the statute from making such a determination.

7.148 It is important to note, however, that the determination at issue here, in WTO covered situations, is only a preliminary step under Section 306 to seek DSB authorization for the suspension of concessions or other obligations. The result of this determination is not the suspension of concessions without DSB authorization but a request – albeit, according to the EC, a premature one – for authorization from the DSB to impose such suspension.

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<sup>702</sup> In this respect, see para. 7.20 and footnote 657 above.

<sup>703</sup> Recalling the four elements required for there to be a breach of Article 23.2(a) in respect of specific acts taken in a given dispute, outlined above in footnote 657, we thus find that "considerations" under Section 306 are "determinations" in the sense of the second element under Article 23.2(a). We also find that determinations under Section 306 meet the first element under Article 23.2(a). The US is obviously seeking redress of WTO inconsistencies when it monitors the implementation of DSB findings under Section 306. The third element concerns the question as to whether the determination under Section 306 is one "to the effect that a violation has occurred ...". Examining specifically the determination at issue here, the one statutorily reserved in Section 306, i.e. the determination that implementation did *not* take place, in other words, that implementing measures are not consistent with WTO rules even though Article 21.5 procedures have not yet been completed, we hold the view that such determination is one of inconsistency meeting the third element under Article 23.2(a).

<sup>704</sup> See footnote 657 above.



### 3. US obligations under Article 23.2(a) of the DSU as applied to Section 306

7.149 We recall that our mandate is to examine the conformity of Section 306 as such with Article 23.2(a), rather than any specific application of Section 306 in a given dispute.

7.150 In relation to Section 304 it was clear that a determination of inconsistency made in a specific case prior to the completion of panel or Appellate Body proceedings and the adoption of a ruling by the DSB was a violation of Article 23.2(a).<sup>705</sup> It was on this premise that we concluded that statutory language merely reserving the right to make such a determination was also a *prima facie* violation.

7.151 In the case of Section 306 we have already found that here, too, the statutory language reserves the right to the USTR to consider that implementation has failed, i.e. to make a determination of inconsistency prior to termination of Article 21.5 proceedings. However, before we conclude that statutory language which reserves this right amounts to a *prima facie* violation we need to decide whether such a determination in a specific case amounts to a violation. Unlike Section 304, in the case of Section 306 this issue is highly contentious and far from clear. Only if we find, as a matter of law, that Article 23.2(a) is violated when the USTR determines, in a specific case, that implementation has failed in the sense of Section 306 *before* the completion of Article 21.5 proceedings – as a prelude to seeking DSB authorization for the suspension of concessions – will we be able to find that statutory language in and of itself, which reserves the right to make such a determination, is WTO inconsistent.

7.152 Reading Section 306 in the light of US obligations under Article 23.2(a), the question arises, more particularly, whether determinations under Section 306 are made "through recourse to dispute settlement in accordance with the rules and procedures of [the DSU]" and made "consistent with the findings contained in the panel or Appellate Body report adopted by the DSB or an arbitration award rendered under [the DSU]".<sup>706</sup> These two elements referred to in Article 23.2(a) are cumulative in nature. Determinations are only allowed when made through recourse to the DSU *and* consistent with findings adopted by the DSB or an arbitration award under the DSU.

7.153 In our view, this question goes to the core of the EC claim under Section 306. As noted earlier, the US maintains that determining that implementation has failed as a prelude to a request for authorization to suspend concessions even prior to the completion of Article 21.5 proceedings is mandated by Article 22. The EC contests this.

7.154 In accordance with our terms of reference, our mandate is to examine whether Section 306 conforms with Article 23.2(a). If we are able to discharge this mandate without seeking to resolve the altogether separate dispute on the correct interpretation of Articles 21.5 and 22 and the relationship between them, the subject of negotiations in the context of the DSU

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<sup>705</sup> See para. 7.50 and footnote 657.

<sup>706</sup> As outlined in footnote 698, the determination statutorily reserved in Section 306 meets the first three elements for there to be a breach of Article 23.2(a) in a given dispute. The crucial question to be dealt with here remains, however, whether such determination also meets the fourth element under Article 23.2(a). In this respect see footnote 657.

review, we should do so.<sup>707</sup> Thus, this Panel should decide on the correct interpretation of Articles 21.5 and 22 and the relationship between them, only if it is legally indispensable.

7.155 We will, therefore, examine the conformity of Section 306 with Article 23.2(a) on the assumption, first, that the US view on Articles 21.5 and 22 is correct and, then, on the alternative assumption that the EC view in this respect is the correct one.

**(a) Assuming the US view is correct**

7.156 The US maintains that a proposal for suspension of concessions has to be submitted to the DSB within a 30 days time-frame and that, consequently, the US is obligated to determine that implementation has failed within that time-frame. The US view is based on the following reading of Article 22.

7.157 Article 22.6 states that the DSB "*shall grant authorization* to suspend concessions or other obligations *within 30 days* of the expiry of the reasonable period of time unless the DSB decides by consensus to reject the request" (emphasis added) or an objection to such request is raised and referred to arbitration. Article 22 thus provides an explicit time-limit for DSB authorization to be requested and granted, at least by virtue of negative consensus. Article 22 and Article 23 do not explicitly refer to Article 21.5. *A fortiori* nowhere is reference to Article 22 explicitly limited to cases where Article 21.5 has *not* been invoked.

7.158 Under this reading the US would effectively be obligated under Article 22 to make a determination on whether implementation took place within the time-frame prescribed in Section 306 if it is to benefit from the negative consensus rule. If not, the practice of positive consensus being reactivated, DSB authorization would only be obtained in case all Members, including the defending Member, agree.

7.159 Following the US approach, any determination made under Section 306 in the circumstances referred to in the EC claim would be consistent with Article 23.2(a) since it would be made "through recourse to dispute settlement in accordance with the rules and procedures of [the DSU]", in particular Article 22 thereof. The determination would then not be made as a unilateral act in pursuit of redress, but as an act required when seeking multilateral authorization for the suspension of concessions as provided for in the DSU itself.

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<sup>707</sup> As noted in the EC response to Panel question 23, "the EC has not requested this Panel to 'make a decision on the relationship between Article 21.5 and 22' of the DSU. Rather, the EC has requested the DSB and obtained the establishment of this Panel in order to make 'such findings as will assist the DSB in making the recommendations or giving the rulings provided for in' the provisions of the agreements cited in the WTO document WT/DS152/11 of 2 February 1999" (see para. 4.901 of this Report). We note that the EC added to its response that "the WTO consistency of Sections 301-310 must be assessed against all the provisions quoted in the Panel's terms of reference, including Article 21.5 of the DSU on its own" and that "[t]he interpretation of Article 22 of the DSU is logically and legally a distinct issue to be addressed by the Panel separately, if necessary". However, nowhere did the EC substantiate any specific claim of violation of Article 21.5 or Article 22. These provisions are only relevant in this case as elements for an assessment of the EC claims under Article 23. If such assessment does not require a decision on the relationship between Articles 21.5 and 22, we do not consider it necessary – the word referred to by the EC -- nor within our mandate as set out in Section VII.A of this Report, to solve this controversy.

7.160 On this reading, the question then arises whether the determination of non-implementation made through recourse to the DSU is also one "consistent with the findings contained in the panel or Appellate Body report adopted by the DSB or an arbitration award rendered under [the DSU]", in the sense of the second phrase of Article 23.2(a). If we consider this to be a reference to the findings of the panel or Appellate Body in the original dispute, then also this requirement would be met. The USTR determination of non-implementation would, indeed, follow and be based on the original findings of inconsistency with WTO rules as adopted by the DSB in respect of the original complaint.

7.161 Could the findings referred to in Article 23.2(a) be regarded, in the specific circumstances under the EC claim, as the findings of the panel examining implementation in the pending Article 21.5 procedures rather than the findings of the original panel? If this were so, one would have to conclude that – since Article 21.5 procedures would still be pending – no such findings would have been adopted. The determination would then be contrary to Article 23.2(a). In our view this does not constitute a plausible interpretation of Article 23.2(a) if we assume the US reading of Article 22 is correct.

7.162 As noted earlier, the determination would be one *required* under Article 22 in order to maintain the reversed consensus rule. Because of that, it would also be conduct required or at least authorized under Article 23.2(c), obliging Members to "follow the procedures set forth in Article 22 to determine the level of suspension of concessions or other obligations and obtain DSB authorization". There would then be a conflict between Article 23.2(a) and Article 23.2(c). Such conflict could be avoided by adopting the interpretation that the findings referred to in Article 23.2(a) are those of the original panel, not those of the Article 21.5 panel. For these reasons, and assuming the US approach is correct, we do not find that, in the circumstances at hand, the findings referred to in Article 23.2(a) are those of the panel under Article 21.5.

7.163 On these grounds, we find that if the US reading of Article 22 is correct, a determination, in a specific case, that implementation has failed pursuant to Section 306 as a prelude to a request for suspension of concessions in the circumstances referred to in the EC claim, could not be found to be inconsistent with Article 23.2(a) of the DSU. Consequently, the legislation authorizing such a determination would not be in violation either.<sup>708</sup>

**(b) Assuming the EC view is correct**

7.164 The EC view that Article 22 can only be activated once Article 21.5 procedures have been completed is based on the following reading of the relevant provisions. Article 21.5 states that "[w]here there is disagreement as to the existence or consistency with a covered agreement of measures taken to comply" – and in the circumstances referred to under the EC claim there is such disagreement – "such dispute shall be decided through recourse to these dispute settlement procedures". This arguably implies that in case of disagreement on implementation, Article 21.5 must be pursued, not Article 22. Moreover, Article 22.6 only applies "[w]hen the situation described in paragraph 2 occurs", i.e. in the event "the Member concerned fails to bring the measure found to be inconsistent with a covered agreement into compliance". Since, in the circumstances under examination, an Article 21.5 procedure is pending to make a decision on this very issue, it could be argued that as long as that procedure has not been completed, the conditions for a request for suspension of concessions under Article 22.6 are not

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<sup>708</sup> See para. 7.151 of this Report.

fulfilled. Following this line of reasoning, pending Article 21.5, Article 22 cannot be invoked.<sup>709</sup>

7.165 Thus, following the EC approach, a Section 306 determination of non-implementation made, in a specific case, before the completion of Article 21.5 proceedings would be contrary to Article 23.2(a) because it would, in the EC view, not be made 'through recourse to dispute settlement in accordance with the rules and procedures of [the DSU]', more particularly, made inconsistently with Articles 21.5 and 22. However, as we have already found, the statutory language of Section 306 mandates the USTR to make a determination within 30 days even if Article 21.5 procedures have not been completed and reserves for the USTR the discretion to make determinations of non-implementation that are – on EC reading – contrary to Article 23.2(a). As a result we consider that – assuming the EC position is correct and for the reasons explained in our examination of the EC claim under Section 304<sup>710</sup> – the statutory language of Section 306, independently from its application in specific disputes, would *prima facie* violate US obligations under Article 23.2(a).

7.166 As explained earlier, this would be so because of the nature of the US obligations under Article 23. Under Article 23 the US promised not to resort to unilateral measures referred to in Article 23.2(a). However, in Section 306 – assuming that the reading of the EC of Articles 21.5 and 22 is correct – the US statutorily reserved the right to do exactly that.

7.167 However, even if we were to find such *prima facie* violation, it would be removed after consideration of the other elements under Section 306. For the reasons given above<sup>711</sup>, we would then find that the cumulative effect of the US undertakings in the SAA and the statements made by the US to the DSB through this Panel,<sup>712</sup> is effectively and lawfully to curtail the discretion under Section 306 which would be at the source of the *prima facie* violation of Article 23.2(a).<sup>713</sup> These undertakings would, indeed, fulfill the guarantees received by other WTO Members and, through them, economic operators in the market-place under Article 23.

7.168 Whatever the outcome of other pending panel proceedings, on which we have no view, the fact that the USTR did make a determination of non-implementation before the completion of Article 21.5 procedures in *Bananas III*, even if it turns out eventually that this was illegal, is not, in our view, an act of bad faith. It was based on the US interpretation given to Articles 21.5

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<sup>709</sup> In this respect, we note that in another dispute, *Australia - Subsidies Provided to Producers and Exporters of Automotive Leather* ("*Australia - Leather*", WT/DS126/R, adopted 16 June 1999, not appealed), the US invoked Article 21.5 but agreed with the defending party, Australia, to await completion of Article 21.5 proceedings before requesting authorization to suspend concessions. With reference to footnote 6 to Article 4 of the SCM Agreement both parties agreed "that the deadline for DSB action under the first sentence of Article 22.6 of the DSU shall be 60 days after the circulation of the review panel report under Article 21.5 of the DSU, and that the deadline specified in the third sentence of Article 22.6 of the DSU for completion of arbitration shall be 45 days after the matter is referred to arbitration" (WT/DS126/8, p. 2).

<sup>710</sup> See Section VII.C.3 and 4.

<sup>711</sup> See Section VII.C.6.

<sup>712</sup> See para. 7.112, second bullet point, paras. 7.114 ff. as well as footnotes 680 and 681.

<sup>713</sup> In this respect, we recall that we found earlier that the statutory language of Section 306 allows the USTR to await the completion of DSU procedures, including Article 21.5 procedures, before making a determination of inconsistency under Section 306 (see para. 7.146 above). As to the lawfulness of taking account of result of Article 21.5 proceedings, Section 306 determinations have to be made "on the basis of the monitoring carried out" under Section 306 (a). Such monitoring may include reference to Article 21.5 proceedings.

and 22, an interpretation shared by other Members and now subject to negotiation. It seems to this Panel that the US attitude in this respect was due in large measure to the contradictory drafting of Articles 21.5 and 22 and may, as a result, be defensible as an act taken in order to safeguard its right to obtain DSB authorization to suspend concessions by negative consensus.<sup>714</sup> This Panel has no basis on which it could doubt that if as a result of these negotiations or the *Bananas III* dispute resolution procedures, the EC view in relation to Articles 21.5 and 22 turns out to be correct, the US would honour its undertakings to respect DSU procedures also under Section 306. Indeed, once US obligations on this matter would thus be clear and the EC view in this respect be confirmed, the overriding commitment made by the US Administration to follow and await the completion of DSU procedures before making determinations under Section 306 would be activated.

#### 4. The Panel's Finding in respect of the EC claim under Section 306

7.169 Based on the above, irrespective of whether we accept the US or the EC approach to Articles 21.5 and 22, our conclusion on the compatibility of Section 306 with Article 23.2(a) is the same. In these circumstances, since we are able to discharge our mandate without seeking to resolve the altogether separate dispute on the correct interpretation of Articles 21.5 and 22 and the relationship between them, we shall refrain from examining further the Article 21.5 versus Article 22 controversy. To do otherwise would fall outside our mandate as set out in Section VII.A of our Report.<sup>715</sup>

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<sup>714</sup> We note that at least one other WTO Member recently acted in a similar way. In *Australia – Salmon*, Canada as well requested DSB authorization to suspend concessions within the 30 days framework even though there was disagreement as to whether Australia had implemented DSB recommendations and a panel under Article 21.5 is now examining this disagreement. In *Australia – Salmon*, Canada took an approach similar to that of the US in order to preserve its rights under Article 22. At the DSB meeting of 28 July 1999, Canada stated the following:

"in the context of the DSU review, both Australia and Canada had taken the same position on the interpretation of Articles 21.5 and 22: i.e. where there was a disagreement about implementation, a multilateral determination of inconsistency should precede the authorization to suspend concessions. Canada had tabled a detailed proposal to amend the DSU provisions with a view to ensuring such sequence. Since no agreement had yet been reached on this issue, Canada had to pursue its rights in accordance with the existing provisions of the DSU. At this stage, it was not possible for Canada to proceed with the Article 21.5 panel proceedings only, because such proceedings would be concluded after the expiry of the 30-day period provided for in Article 22, within which Canada had the right to request suspension of concessions by negative consensus" (WT/DSB/M/66, pp. 4-5).

On the other hand, see the sequence and procedures agreed upon in *Australia – Leather*, set out in footnote 709.

<sup>715</sup> We realize that as a result it is still unclear whether the USTR is now (1) as the US argues, *required* to make determinations of inconsistency under Section 306 even pending Article 21.5 procedures in order to preserve US rights under Article 22 or (2) as the EC argues, *prohibited* under Article 23.2(a) to make such determinations until the completion of Article 21.5 procedures. We stress, however, that our task was to examine the compatibility of US law as such and not its application in a specific dispute, i.e. not whether in a given dispute the USTR is allowed to make this or that determination. Under either hypothesis – the US or the EC approach – we found that Section 306 is not inconsistent with Article 23.2(a). This is now clearly established. Only the way Section 306 should be applied in a specific dispute – an issue not falling within our mandate – is left open.

7.170 On these grounds, we find that Section 306, in the circumstances referred to in the EC claim, is not inconsistent with Article 23.2(a) of the DSU. The same *caveats* made in our findings as regards Section 304 also apply here.<sup>716</sup>

E. THE EC CLAIM THAT SECTIONS 305 AND 306 ARE INCONSISTENT WITH ARTICLE 23.2(C) OF THE DSU

## 1. Introduction

7.171 The EC claims that Section 306 (b) is inconsistent with Article 23.2(c) of the DSU because it requires the USTR to determine within 30 days after the expiration of the reasonable period of time what further action to take under Section 301 in case of a failure to implement DSB recommendations. The EC also claims that Section 305 (a)(2) is inconsistent with Article 23.2(c) of the DSU because it requires the USTR to implement the action determined earlier under Section 306 within 60 days after the expiration of the reasonable period of time.

7.172 As noted earlier, Article 23.2(c) provides that in cases where WTO Members seek redress of WTO inconsistencies, Members shall

"follow the procedures set forth in Article 22 to determine the level of suspension of concessions or other obligations and obtain DSB authorization in accordance with those procedures before suspending concessions or other obligations under the covered agreements in response to the failure of the Member concerned to implement the recommendations and rulings within that reasonable period of time".

Article 23.2(c) thus includes two cumulative obligations:

- (a) the US has to "follow the procedures set forth in Article 22 to *determine* the level of suspension of concessions or other obligations" (emphasis added); and
- (b) the US has to "obtain DSB authorization in accordance with those procedures before *suspending* concessions or other obligations under the covered agreements in response to the failure of the Member concerned to implement the recommendations and rulings within that reasonable period of time" (emphasis added).

7.173 After considering the submissions of the parties in relation to this claim, detailed exhaustively in the descriptive part of this Report, we reach the following conclusions.

## 2. The EC claim in respect of Determinations on Action under Section 306 (b)

7.174 Whereas the previous EC claim dealt with the "consideration" that implementation had failed under Section 306, this claim concerns the subsequent determination on action following such a determination of non-implementation. At issue here is the second phase of Section 306 as outlined above.<sup>717</sup> We recall that this determination has to be made within 30 days after the expiry of the reasonable period of time and that, in the circumstances referred to by the EC, it may, indeed, be mandated before the completion of Article 21.5 procedures on implementation.

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<sup>716</sup> See paras. 7.131-7.136 above.

<sup>717</sup> See paras. 7.142-7.143 above.

7.175 We find, as a matter of fact, that this determination on what action to take under the second phase of Section 306 is only mandated if the USTR has determined under the first phase that implementation failed.

7.176 As we did in respect of the previous claim, we will examine the conformity of Section 306 with Article 23.2(c) on the assumption, first, that the US view on Articles 21.5 and 22 is correct and, then, on the alternative assumption that the EC view in this respect is the correct one.

7.177 We recall that if one were to accept the US view on the relationship between Articles 21.5 and 22, then the US would effectively be obligated, or at least authorized, under Article 22 – in the event it determines that implementation failed – to make a determination on what action to take within 30 days after the expiry of the reasonable period of time. If not, it would lose the right to obtain DSB authorization by negative consensus. In that event, any determination on action made under Section 306 in the circumstances referred to in the EC claim would "follow the procedures set forth in Article 22 to determine the level of suspension of concessions or other obligations" and thus be consistent with Article 23.2(c).

7.178 Turning now to the EC view on Articles 21.5 and 22, we found in examining the first phase of Section 306 that – if one were to accept the EC view – discretion to make a determination of non-implementation before the completion of Article 21.5 procedures would be *prima facie* inconsistent with Article 23.2(a). If such discretion were maintained, it would spill over to the second phase of Section 306 as well. However, we have already found that – assuming the EC view is correct – the discretion afforded to the USTR to make a determination that implementation has failed prior to the exhaustion of DSU proceedings under Article 21.5 would be effectively curtailed by the undertakings given by the US Administration both internally and internationally. So long as the US undertakings are in place, the trigger for the determination of action under the second phase of Section 306 would thus be disabled and any potential violation also of Article 23.2(c) eliminated.<sup>718</sup> Indeed, in these circumstances, any determination on action under the second phase of Section 306 would – as the determination on consistency under the first phase – take place subsequent to the completion of Article 21.5 procedures in accordance with the EC view on Article 22. Any such determination on action would thus "follow the procedures set forth in Article 22 to determine the level of suspension of concessions or other obligations" and be consistent with Article 23.2(c).

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<sup>718</sup> We note that – in addition to the discretion granted to the USTR under the first phase of Section 306 allowing it to delay a determination of non-implementation – the USTR has also been granted a certain discretion under the second phase of Section 306, as well as under Section 301, allowing it not to determine what action to take until the completion of Article 21.5 procedures. The determination mandated in Section 306 on what action to take refers to "mandatory action" under Section 301 (a). Section 301 (a) itself provides for several exceptions where the USTR is not required to take action. Under this provision, action is not required, *inter alia*, if the DSB has adopted a report or ruling finding that US rights have not been denied; if the Member concerned is taking satisfactory measures to grant the US rights at issue under the WTO Agreement, including an expression of intention to comply with DSB recommendations; or if, in extraordinary cases, action would have a disproportionate adverse impact on the US economy or cause serious harm to the national security of the US. An additional discretionary element – allowing the USTR to determine that no action is to be taken – is that action under Section 301(a) is subject to "the specific direction, if any, of the President regarding any such action". Even if the existence of the discretion under both phases of Section 306 and under Section 301 were to constitute a *prima facie* violation, the undertakings given by the US would remove these.

7.179 For the reasons outlined above, we find that Section 306 – irrespective of whether we accept the US or the EC approach in respect of Articles 21.5 and 22 – is not inconsistent with US obligations under Article 23.2(c). The same *caveats* made in our findings as regards Section 304 also apply here.<sup>719</sup>

### 3. The EC claim in respect of Implementation of Action under Section 305

7.180 Similar reasoning applies to the EC claim in respect of Section 305. Any action the USTR determined to take pursuant to Section 306, constituting the suspension of concessions or other obligations under the WTO, has to be implemented within "30 days after the date on which such determination is made" in accordance with Section 305(a)(1). In other words, if the USTR determines to take action within 30 days after the expiry of the reasonable period of time as referred to in Section 306, it will be obligated to implement such action within 60 days after the expiry of the reasonable period of time. We agree with the EC that Article 21.5 and even Article 22.6 arbitration procedures on the level of suspension may not be over within this 60 days period.<sup>720</sup> As a result, Section 305(a)(1) read in isolation may, in certain circumstances, mandate the implementation of action before receiving DSB authorization to do so.

7.181 However, under Section 305 (a)(2) there is discretion to suspend any implementation of action for up to 180 days beyond the 60 days after the expiration of the reasonable period of time. The USTR may do so if it determines, for example, that a delay is "necessary or desirable to obtain United States rights", for example, DSB authorization to suspend concessions.<sup>721</sup> In addition, implementation of action under Section 305 is also subject to "the specific direction, if any, of the President regarding any such action".<sup>722</sup>

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<sup>719</sup> See paras. 7.131-7.136 above.

<sup>720</sup> In respect of Article 21.5 procedures, see para. 7.145 above. Since Article 21.5 procedures may seemingly start on or about the date of expiry of the reasonable period of time and, as a general rule, take 90 days, it is likely that such procedures would not be completed within the 60 day deadline of Section 305. In respect of Article 22.6 arbitration procedures, we note that Article 22.6 provides that the arbitration has to be completed within 60 days after the expiry of the reasonable period of time, i.e. the time-limit in Section 305. However, even if the arbitration is completed by then, it may take some more time for the DSB to actually authorize the suspension of concessions consistent with the arbitration report. Considering footnote 7 in the *Bananas III* arbitration report (WT/DS27/ARB), even the completion of arbitration procedures within 60 days is not a certainty: "On the face of it, the 60-day period specified in Article 22.6 does not limit or define the jurisdiction of the Arbitrators *ratione temporis*. It imposes a *procedural* obligation on the Arbitrators in respect of the conduct of their work, not a *substantive* obligation in respect of the validity thereof. In our view, if the time-periods of Article 17.5 and Article 22.6 of the DSU were to cause the lapse of the authority of the Appellate Body or the Arbitrators, the DSU would have explicitly provided so. Such lapse of jurisdiction is explicitly foreseen, e.g. in Article 12.12 of the DSU which provides that 'if the work of the panel has been suspended for more than 12 months, the authority for establishment of the panel shall lapse' ".

<sup>721</sup> Thus, even if the US view on the relationship between Articles 21.5 and 22 were correct, the USTR could – after having made determinations on WTO consistency and Section 301 action *before* the completion of Article 21.5 procedures as required, or at least authorized, under its reading of Article 22 – still delay the implementation of any such action it may have determined to take until it has obtained DSB authorization to implement such action consistently with Article 23.2(c).

<sup>722</sup> We note also that activation of Section 305 is dependent on a determination of action under Section 306 (second phase) and that the determination of action under Section 306 (second phase) is dependent on a "consideration" that implementation has not taken place under Section 306 (first phase). Since the initial trigger of determining that implementation has not taken place would – following the EC



7.182 The requirement to implement action within 60 days – unless exceptions are made – even in cases where DSB authorization has not yet been obtained, may constitute a *prima facie* violation of the US obligation under Article 23.2(c) to "obtain DSB authorization in accordance with [Article 22] procedures before suspending concessions or other obligations". The fact that implementation can be delayed does not, in our view, necessarily meet the US guarantee granted under Article 23.2(c) to all WTO Members and, through them, economic operators in the market-place, that determinations contrary to Article 23.2(c) will not be made.

7.183 However, even if the existence of such discretion were to constitute a *prima facie* violation, the undertakings given by the US would remove it and no violation of Article 23.2(c) could be found. We note, in particular, that under the SAA the USTR is obligated to do the following:

"if the matter cannot be resolved during that period [the reasonable period of time], seek authority from the DSB to retaliate".<sup>723</sup>

7.184 As a result, after evaluation of all elements relevant to Section 305, we come to the conclusion that the USTR under US law is precluded from exercising his or her discretion under Section 305 in a way that results in implementation of action before DSB authorization has been obtained.<sup>724</sup> We note that USTR discretion in this respect has been lawfully curtailed. Section 305 (a)(2)(ii), in particular, allows the USTR to delay action when "necessary or desirable to obtain United States rights", in this case, the right to be obtained from the DSB to suspend concessions or other obligations.<sup>725</sup>

7.185 For the reasons set out above, we find that Section 305, in the circumstances referred to in the EC claim, is not inconsistent with US obligations under Article 23.2(c). The same *caveats* made in our findings as regards Section 304 also apply here.<sup>726</sup>

#### F. THE EC CLAIMS UNDER GATT 1994

7.186 The EC submits, finally, that in disputes involving goods, Section 306 requires the USTR "unilaterally" to impose measures as a consequence of a "unilaterally" determined failure to implement DSB recommendations, not authorized under the DSU, that necessarily violate Article I, II, III, VIII or XI of GATT 1994. Therefore, the EC concludes, also Section 306 itself violates the said GATT provisions.

7.187 We note, first, that these GATT claims depend on acceptance of the EC claims under the DSU.<sup>727</sup> If action is explicitly allowed under the DSU, it can arguably not be prohibited

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view on the relationship between Articles 21.5 and 22 – be removed the consequent implementation of action would also be delayed at least until completion of Article 21.5 procedures.

<sup>723</sup> SAA, p. 366, fourth bullet point.

<sup>724</sup> We agree with the US that if the maximum delay were imposed, the total of 240 days subsequent to the lapse of the reasonable period of time – the original 60 day time-frame combined with the 180 days delay – should be sufficient for the USTR to await in all cases the completion of both Article 21.5 and Article 22.6 procedures as well as DSB authorization to suspend concessions.

<sup>725</sup> By so finding, we explicitly leave open the question of how DSB authorization to suspend concessions is to be applied *ratione temporis*, a question that is subject to another panel proceeding.

<sup>726</sup> See paras. 7.131-7.136 above.

under the more general GATT 1994. Since we have found that Section 306 is not inconsistent with Article 23 of the DSU, we can presume also that the dependent claim under GATT should be rejected.<sup>728</sup>

7.188 Moreover, on the substance of its argument, the EC did not further develop this claim.<sup>729</sup> It did not even refer to the text of the GATT provisions invoked.

7.189 On these grounds, we find that the EC has not met its burden of proving that Section 306 as such constitutes a violation of GATT 1994.

## VIII. CONCLUSIONS

8.1 In the light of the statutory and non-statutory elements of Sections 301-310, in particular the US undertakings articulated in the Statement of Administrative Action approved by the US Congress at the time it implemented the Uruguay Round agreements and confirmed and amplified in the statements by the US to this Panel, we conclude that those aspects of Sections 301-310 of the US Trade Act brought before us in this dispute are not inconsistent with US obligations under the WTO. More specifically we conclude that

- (a) Section 304 (a)(2)(A) of the US Trade Act of 1974, is not inconsistent with Article 23.2(a) of the DSU;
- (b) Section 306 (b) of the US Trade Act of 1974, irrespective of whether we accept the US or the EC approach in respect of Articles 21.5 and 22 of the DSU, is not inconsistent with either
  - Article 23.2(a) of the DSU; or
  - Article 23.2(c) of the DSU;
- (c) Section 305 (a) of the US Trade Act of 1974, is not inconsistent with Article 23.2(c) of the DSU;
- (d) Section 306 (b) of the US Trade Act of 1974 is not inconsistent with Articles I, II, III, VIII and XI of GATT 1994, as they have been referred to by the EC.

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<sup>727</sup> The EC seems to agree with this when it states, in para. 11 of its rebuttal submission, that "Section 301-310, on their face, mandate unilateral action by the US authorities in breach of Article 23 of the DSU (*and consequently* of Articles I, II, III, VIII and XI of the GATT 1994)" (emphasised added).

<sup>728</sup> In this respect we note, in addition, that action under Section 301 can also be consistent with GATT provisions even when it is not explicitly allowed under the DSU. This could be the case, for example, when the action consists of a rise in applied tariffs to a level within the bound rate, implemented on an MFN basis.

<sup>729</sup> In its rebuttal submission, at p. 22, the EC only stated the following on this claim: "Given that Sections 304(a)(2)(A) and 306(b), as amended, require the United States to resort to retaliatory trade action within certain time limits irrespective of the result of WTO dispute settlement procedures, the actions taken in the area of trade in goods and not authorised pursuant to Article 3.7 and 22 of the DSU will necessarily be in violation of US obligations under one or more of the following GATT obligations: the Most-Favoured Nation clause (Article I GATT 1994), the tariff bindings undertaken by the United States (Article II GATT 1994), the National Treatment clause (Article III GATT 1994), the obligation not to collect excessive charges (Article VIII GATT 1994) and the prohibition of quantitative restrictions (Article XI GATT 1994)". See para. 4.1013 of this Report.

Significantly, all these conclusions are based in full or in part on the US Administration's undertakings mentioned above. It thus follows that should they be repudiated or in any other way removed by the US Administration or another branch of the US Government, the findings of conformity contained in these conclusions would no longer be warranted.

Signed in the original this 8<sup>th</sup> of November 1999 by:

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David Hawes  
Chairman

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Terje Johannessen  
Member

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Joseph Weiler  
Member

## ANNEX I

### A. SECTIONS 301-310 OF THE TRADE ACT OF 1974

#### **SEC. 301. ACTIONS BY UNITED STATES TRADE REPRESENTATIVE.**

(a) MANDATORY ACTION.—

(1) If the United States Trade Representative determines under section 304(a)(1) that—  
(A) the rights of the United States under any trade agreement are being denied; or  
(B) an act, policy, or practice of a foreign country—  
(i) violates, or is inconsistent with, the provisions of, or otherwise denies benefits to the United States under, any trade agreement, or  
(ii) is unjustifiable and burdens or restricts United States commerce;  
the Trade Representative shall take action authorized in subsection (c), subject to the specific direction, if any, of the President regarding any such action, and shall take all other appropriate and feasible action within the power of the President that the President may direct the Trade Representative to take under this subsection, to enforce such rights or to obtain the elimination of such act, policy, or practice.

Actions may be taken that are within the power of the President with respect to trade in any goods or services, or with respect to any other area of pertinent relations with the foreign country.

(2) The Trade Representative is not required to take action under paragraph (1) in any case in which—  
(A) the Dispute Settlement Body (as defined in section 121(5) of the Uruguay Round Agreements Act) has adopted a report, or a ruling issued under the formal dispute settlement proceeding provided under any other trade agreement finds, that—  
(i) the rights of the United States under a trade agreement are not being denied,  
or  
(ii) the act, policy, or practice—  
(I) is not a violation of, or inconsistent with, the rights of the United States,  
or  
(II) does not deny, nullify, or impair benefits to the United States under any trade agreement; or  
(B) the Trade Representative finds that—  
(i) the foreign country is taking satisfactory measures to grant the rights of the United States under a trade agreement,  
(ii) the foreign country has—  
(I) agreed to eliminate or phase out the act, policy, or practice, or  
(II) agreed to an imminent solution to the burden or restriction on United States commerce that is satisfactory to the Trade Representative,  
(iii) it is impossible for the foreign country to achieve the results described in clause (i) or (ii), as appropriate, but the foreign country agrees to provide to the United States compensatory trade benefits that are satisfactory to the Trade Representative,  
(iv) in extraordinary cases, where the taking of action under this subsection would have an adverse impact on the United States economy substantially out of proportion to the benefits of such action, taking into account the impact of not taking such action on the credibility of the provisions of this chapter, or

(v) the taking of action under this subsection would cause serious harm to the national security of the United States.

(3) Any action taken under paragraph (1) to eliminate an act, policy, or practice shall be devised so as to affect goods or services of the foreign country in an amount that is equivalent in value to the burden or restriction being imposed by that country on United States commerce.

(b) DISCRETIONARY ACTION.—If the Trade Representative determines under section 304(a)(1) that—

(1) an act, policy, or practice of a foreign country is unreasonable or discriminatory and burdens or restricts United States commerce, and

(2) action by the United States is appropriate, the Trade Representative shall take all appropriate and feasible action authorized under subsection (c), subject to the specific direction, if any, of the President regarding any such action, and all other appropriate and feasible action within the power of the President that the President may direct the Trade Representative to take under this subsection, to obtain the elimination of that act, policy, or practice.

Actions may be taken that are within the power of the President with respect to trade in any goods or services, or with respect to any other area of pertinent relations with the foreign country.

(c) SCOPE OF AUTHORITY.—

(1) For purposes of carrying out the provisions of subsection (a) or (b), the Trade Representative is authorized to—

(A) suspend, withdraw, or prevent the application of, benefits of trade agreement concessions to carry out a trade agreement with the foreign country referred to in such subsection;

(B) impose duties or other import restrictions on the goods of, and, notwithstanding any other provision of law, fees or restrictions on the services of, such foreign country for such time as the Trade Representative determines appropriate;

(C) in a case in which the act, policy, or practice also fails to meet the eligibility criteria for receiving duty-free treatment under subsections (b) and (c) of section 502 of this Act, subsections (b) and (c) of section 212 of the Caribbean Basin Economic Recovery Act (19 U.S.C. 2702 (b) and (c)), or subsections (c) and (d) of section 203 of the Andean Trade Preference Act (19 U.S.C. 3202 (c) and (d)), withdraw, limit, or suspend such treatment under such provisions, notwithstanding the provisions of subsection (a)(3) of this section; or

(D) enter into binding agreements with such foreign country that commit such foreign country to—

(i) eliminate, or phase out, the act, policy, or practice that is the subject of the action to be taken under subsection (a) or (b),

(ii) eliminate any burden or restriction on United States commerce resulting from such act, policy, or practice, or

(iii) provide the United States with compensatory trade benefits that—

(I) are satisfactory to the Trade Representative, and

(II) meet the requirements of paragraph (4).

(2)(A) Notwithstanding any other provision of law governing any service sector access authorization, and in addition to the authority conferred in paragraph (1), the Trade Representative may, for purposes of carrying out the provisions of subsection (a) or (b)—

- (i) restrict, in the manner and to the extent the Trade Representative determines appropriate, the terms and conditions of any such authorization, or
- (ii) deny the issuance of any such authorization.

(B) Actions described in subparagraph (A) may only be taken under this section with respect to service sector access authorizations granted, or applications therefor pending, on or after the date on which—

- (i) a petition is filed under section 302(a), or
- (ii) a determination to initiate an investigation is made by the Trade Representative under section 302(b).

(C) Before the Trade Representative takes any action under this section involving the imposition of fees or other restrictions on the services of a foreign country, the Trade Representative shall, if the services involved are subject to regulation by any agency of the Federal Government or of any State, consult, as appropriate, with the head of the agency concerned.

(3) The actions the Trade Representative is authorized to take under subsection (a) or (b) may be taken against any goods or economic sector—

- (A) on a nondiscriminatory basis or solely against the foreign country described in such subsection, and
- (B) without regard to whether or not such goods or economic sector were involved in the act, policy, or practice that is the subject of such action.

(4) Any trade agreement described in paragraph (1)(D)(iii) shall provide compensatory trade benefits that benefit the economic sector which includes the domestic industry that would benefit from the elimination of the act, policy, or practice that is the subject of the action to be taken under subsection (a) or (b), or benefit the economic sector as closely related as possible to such economic sector, unless—

- (A) the provision of such trade benefits is not feasible, or
- (B) trade benefits that benefit any other economic sector would be more satisfactory than such trade benefits.

(5) If the Trade Representative determines that actions to be taken under subsection (a) or (b) are to be in the form of import restrictions, the Trade Representative shall—

- (A) give preference to the imposition of duties over the imposition of other import restrictions, and
- (B) if an import restriction other than a duty is imposed, consider substituting, on an incremental basis, an equivalent duty for such other import restriction.

(6) Any action taken by the Trade Representative under this section with respect to export targeting shall, to the extent possible, reflect the full benefit level of the export targeting to the beneficiary over the period during which the action taken has an effect.

(d) DEFINITIONS AND SPECIAL RULES.—For purposes of this chapter—

- (1) The term "commerce" includes, but is not limited to—
  - (A) services (including transfers of information) associated with international trade, whether or not such services are related to specific goods, and

(B) foreign direct investment by United States persons with implications for trade in goods or services.

(2) An act, policy, or practice of a foreign country that burdens or restricts United States commerce may include the provision, directly or indirectly, by that foreign country of subsidies for the construction of vessels used in the commercial transportation by water of goods between foreign countries and the United States.

(3)(A) An act, policy, or practice is unreasonable if the act, policy, or practice, while not necessarily in violation of, or inconsistent with, the international legal rights of the United States, is otherwise unfair and inequitable.

(B) Acts, policies, and practices that are unreasonable include, but are not limited to, any act, policy, or practice, or any combination of acts, policies, or practices, which—

(i) denies fair and equitable—

(I) opportunities for the establishment of an enterprise,

(II) provision of adequate and effective protection of intellectual property rights notwithstanding the fact that the foreign country may be in compliance with the specific obligations of the Agreement on Trade-Related Aspects of Intellectual Property Rights referred to in section 101(d)(15) of the Uruguay Round Agreements Act,

(III) nondiscriminatory market access opportunities for United States persons that rely upon intellectual property protection, or

(IV) market opportunities, including the toleration by a foreign government of systematic anticompetitive activities by enterprises or among enterprises in the foreign country that have the effect of restricting, on a basis that is inconsistent with commercial considerations, access of United States goods or services to a foreign market,

(ii) constitutes export targeting, or

(iii) constitutes a persistent pattern of conduct that—

(I) denies workers the right of association,

(II) denies workers the right to organize and bargain collectively,

(III) permits any form of forced or compulsory labor,

(IV) fails to provide a minimum age for the employment of children, or

(V) fails to provide standards for minimum wages, hours of work, and occupational safety and health of workers.

(C)(i) Acts, policies, and practices of a foreign country described in subparagraph (B)(iii) shall not be treated as being unreasonable if the Trade Representative determines that—

(I) the foreign country has taken, or is taking, actions that demonstrate a significant and tangible overall advancement in providing throughout the foreign country (including any designated zone within the foreign country) the rights and other standards described in the subclauses of subparagraph (B)(iii), or

(II) such acts, policies, and practices are not inconsistent with the level of economic development of the foreign country.

(ii) The Trade Representative shall publish in the Federal Register any determination made under clause (i), together with a description of the facts on which such determination is based.

(D) For purposes of determining whether any act, policy, or practice is unreasonable, reciprocal opportunities in the United States for foreign nationals and firms shall be taken into account, to the extent appropriate.

(E) The term "export targeting" means any government plan or scheme consisting of a combination of coordinated actions (whether carried out severally or jointly) that are bestowed on a specific enterprise, industry, or group thereof, the effect of which is to assist the enterprise, industry, or group to become more competitive in the export of a class or kind of merchandise.

(F)(i) For the purposes of subparagraph (B)(i)(II), adequate and effective protection of intellectual property rights includes adequate and effective means under the laws of the foreign country for persons who are not citizens or nationals of such country to secure, exercise, and enforce rights and enjoy commercial benefits relating to patents, trademarks, copyrights and related rights, mask works, trade secrets, and plant breeder's rights.

(ii) For purposes of subparagraph (B)(i)(IV), the denial of fair and equitable nondiscriminatory market access opportunities includes restrictions on market access related to the use, exploitation, or enjoyment of commercial benefits derived from exercising intellectual property rights in protected works or fixations or products embodying protected works.

(4)(A) An act, policy, or practice is unjustifiable if the act, policy, or practice is in violation of, or inconsistent with, the international legal rights of the United States.

(B) Acts, policies, and practices that are unjustifiable include, but are not limited to, any act, policy, or practice described in subparagraph (A) which denies national or most-favoured-nation treatment or the right of establishment or protection of intellectual property rights.

(5) Acts, policies, and practices that are discriminatory include, when appropriate, any act, policy, and practice which denies national or most-favoured-nation treatment to United States goods, services, or investment.

(6) The term "service sector access authorization" means any license, permit, order, or other authorization, issued under the authority of Federal law, that permits a foreign supplier of services access to the United States market in a service sector concerned.

(7) The term "foreign country" includes any foreign instrumentality. Any possession or territory of a foreign country that is administered separately for customs purposes shall be treated as a separate foreign country.

(8) The term "Trade Representative" means the United States Trade Representative.

(9) The term "interested persons", only for purposes of sections 302(a)(4)(B), 304(b)(1)(A), 306(c)(2), and 307(a)(2), includes, but is not limited to, domestic firms and workers, representatives of consumer interests, United States product exporters, and any industrial user of any goods or services that may be affected by actions taken under subsection (a) or (b).



**SEC. 302. INITIATION OF INVESTIGATIONS.**

(a) PETITIONS.—

(1) Any interested person may file a petition with the Trade Representative requesting that action be taken under section 301 and setting forth the allegations in support of the request.

(2) The Trade Representative shall review the allegations in any petition filed under paragraph (1) and, not later than 45 days after the date on which the Trade Representative received the petition, shall determine whether to initiate an investigation.

(3) If the Trade Representative determines not to initiate an investigation with respect to a petition, the Trade Representative shall inform the petitioner of the reasons therefor and shall publish notice of the determination, together with a summary of such reasons, in the Federal Register.

(4) If the Trade Representative makes an affirmative determination under paragraph (2) with respect to a petition, the Trade Representative shall initiate an investigation regarding the issues raised in the petition. The Trade Representative shall publish a summary of the petition in the Federal Register and shall, as soon as possible, provide opportunity for the presentation of views concerning the issues, including a public hearing—

(A) within the 30-day period beginning on the date of affirmative determination (or on a date after such period if agreed to by the petitioner) if a public hearing within such period is requested in the petition, or

(B) at such other time if a timely request therefor is made by the petitioner or by any interested person.

(b) INITIATION OF INVESTIGATION BY MEANS OTHER THAN PETITION.—

(1)(A) If the Trade Representative determines that an investigation should be initiated under this chapter with respect to any matter in order to determine whether the matter is actionable under section 301, the Trade Representative shall publish such determination in the Federal Register and shall initiate such investigation.

(B) The Trade Representative shall, before making any determination under subparagraph (A), consult with appropriate committees established pursuant to section 135.

(2)(A) By no later than the date that is 30 days after the date on which a country is identified under section 182(a)(2), the Trade Representative shall initiate an investigation under this chapter with respect to any act, policy, or practice of that country that—

(i) was the basis for such identification, and

(ii) is not at that time the subject of any other investigation or action under this chapter.

(B) The Trade Representative is not required under subparagraph (A) to initiate an investigation under this chapter with respect to any act, policy, or practice of a foreign country if the Trade Representative determines that the initiation of the investigation would be detrimental to United States economic interests.

(C) If the Trade Representative makes a determination under subparagraph (B) not to initiate an investigation, the Trade Representative shall submit to the Congress a written report setting forth, in detail—

(i) the reasons for the determination, and

(ii) the United States economic interests that would be adversely affected by the investigation.

(D) The Trade Representative shall, from time to time, consult with the Register of Copyrights, the Commissioner of Patents and Trademarks, and other appropriate officers of the Federal Government, during any investigation initiated under this chapter by reason of subparagraph (A).

(c) DISCRETION.— In determining whether to initiate an investigation under subsection (a) or (b) of any act, policy, or practice that is enumerated in any provision of section 301(d), the Trade Representative shall have discretion to determine whether action under section 301 would be effective in addressing such act, policy, or practice.

### **SEC. 303. CONSULTATION UPON INITIATION OF INVESTIGATION.**

(a) IN GENERAL.—

(1) On the date on which an investigation is initiated under section 302, the Trade Representative, on behalf of the United States, shall request consultations with the foreign country concerned regarding the issues involved in such investigation.

(2) If the investigation initiated under section 302 involves a trade agreement and a mutually acceptable resolution is not reached before the earlier of—

(A) the close of the consultation period, if any, specified in the trade agreement, or

(B) the 150th day after the day on which consultation was commenced,

the Trade Representative shall promptly request proceedings on the matter under the formal dispute settlement procedures provided under such agreement.

(3) The Trade Representative shall seek information and advice from the petitioner (if any) and the appropriate committees established pursuant to section 135 in preparing United States presentations for consultations and dispute settlement proceedings.

(b) DELAY OF REQUEST FOR CONSULTATIONS.—

(1) Notwithstanding the provisions of subsection (a)—

(A) the United States Trade Representative may, after consulting with the petitioner (if any), delay for up to 90 days any request for consultations under subsection (a) for the purpose of verifying or improving the petition to ensure an adequate basis for consultation, and

(B) if such consultations are delayed by reason of subparagraph (A), each time limitation under section 304 shall be extended for the period of such delay.

(2) The Trade Representative shall—

(A) publish notice of any delay under paragraph (1) in the Federal Register, and

(B) report to Congress on the reasons for such delay in the report required under section 309(a)(3).

### **SEC. 304. DETERMINATIONS BY THE TRADE REPRESENTATIVE.**

(a) IN GENERAL.—

(1) On the basis of the investigation initiated under section 302 and the consultations (and the proceedings, if applicable) under section 303, the Trade Representative shall—

(A) determine whether—

(i) the rights to which the United States is entitled under any trade agreement are being denied, or

(ii) any act, policy, or practice described in subsection (a)(1)(B) or (b)(1) of section 301 exists, and

(B) if the determination made under subparagraph (A) is affirmative, determine what action, if any, the Trade Representative should take under subsection (a) or (b) of section 301.

(2) The Trade Representative shall make the determinations required under paragraph (1) on or before—

(A) in the case of an investigation involving a trade agreement, the earlier of—

(i) the date that is 30 days after the date on which the dispute settlement procedure is concluded, or

(ii) the date that is 18 months after the date on which the investigation is initiated, or

(B) in all cases not described in subparagraph (A) or paragraph (3), the date that is 12 months after the date on which the investigation is initiated.

(3)(A) If an investigation is initiated under this chapter by reason of section 302(b)(2) and the Trade Representative does not consider that a trade agreement, including the Agreement on Trade-Related Aspects of Intellectual Property Rights (referred to in section 101(d)(15) of the Uruguay Round Agreements Act), is involved or does not make a determination described in subparagraph (B) with respect to such investigation, the Trade Representative shall make the determinations required under paragraph (1) with respect to such investigation by no later than the date that is 6 months after the date on which such investigation is initiated.

(B) If the Trade Representative determines with respect to an investigation initiated by reason of section 302(b)(2) (other than an investigation involving a trade agreement) that—

(i) complex or complicated issues are involved in the investigation that require additional time,

(ii) the foreign country involved in the investigation is making substantial progress in drafting or implementing legislative or administrative measures that will provide adequate and effective protection of intellectual property rights, or

(iii) such foreign country is undertaking enforcement measures to provide adequate and effective protection of intellectual property rights,

the Trade Representative shall publish in the Federal Register notice of such determination and shall make the determinations required under paragraph (1) with respect to such investigation by no later than the date that is 9 months after the date on which such investigation is initiated.

(4) In any case in which a dispute is not resolved before the close of the minimum dispute settlement period provided for in a trade agreement, the Trade Representative, within 15 days after the close of such dispute settlement period, shall submit a report to Congress setting forth the reasons why the dispute was not resolved within the minimum dispute settlement period, the status of the case at the close of the period, and the prospects for resolution. For purposes of this paragraph, the minimum dispute settlement period provided for under any such trade agreement is the total period of time that results if all stages of the formal dispute settlement procedures are carried out within the time limitations specified in the agreement, but computed without regard to any extension authorized under the agreement at any stage.

(b) CONSULTATION BEFORE DETERMINATIONS.—

(1) Before making the determinations required under subsection (a)(1), the Trade Representative, unless expeditious action is required—

(A) shall provide an opportunity (after giving not less than 30 days notice thereof) for the presentation of views by interested persons, including a public hearing if requested by any interested person,

(B) shall obtain advice from the appropriate committees established pursuant to section 135, and

(C) may request the views of the United States International Trade Commission regarding the probable impact on the economy of the United States of the taking of action with respect to any goods or service.

(2) If the Trade Representative does not comply with the requirements of subparagraphs (A) and (B) of paragraph (1) because expeditious action is required, the Trade Representative shall, after making the determinations under subsection (a)(1), comply with such subparagraphs.

(c) PUBLICATION.— The Trade Representative shall publish in the Federal Register any determination made under subsection (a)(1), together with a description of the facts on which such determination is based.

**SEC. 305. IMPLEMENTATION OF ACTIONS.**

(a) ACTIONS TO BE TAKEN UNDER SECTION 301.—

(1) Except as provided in paragraph (2), the Trade Representative shall implement the action the Trade Representative determines under section 304(a)(1)(B) to take under section 301, subject to the specific direction, if any, of the President regarding any such action, by no later than the date that is 30 days after the date on which such determination is made.

(2)(A) Except as otherwise provided in this paragraph, the Trade Representative may delay, by not more than 180 days, the implementation of any action that is to be taken under section 301 —

(i) if—

(I) in the case of an investigation initiated under section 302(a), the petitioner requests a delay, or

(II) in the case of an investigation initiated under section 302(b)(1) or to which section 304(a)(3)(B) applies, a delay is requested by a majority of the representatives of the domestic industry that would benefit from the action, or

(ii) if the Trade Representative determines that substantial progress is being made, or that a delay is necessary or desirable to obtain United States rights or satisfactory solution with respect to the acts, policies, or practices that are the subject of the action.

(B) The Trade Representative may not delay under subparagraph (A) the implementation of any action that is to be taken under section 301 with respect to any investigation to which section 304(a)(3)(A) applies.

(C) The Trade Representative may not delay under subparagraph (A) the implementation of any action that is to be taken under section 301 with respect to any investigation to which section 304(a)(3)(B) applies by more than 90 days.

(b) ALTERNATIVE ACTIONS IN CERTAIN CASES OF EXPORT TARGETING.—

(1) If the Trade Representative makes an affirmative determination under section 304(a)(1)(A) involving export targeting by a foreign country and determines to take no action under section 301 with respect to such affirmation determination, the Trade Representative—

(A) shall establish an advisory panel to recommend measures which will promote the competitiveness of the domestic industry affected by the export targeting,

(B) on the basis of the report of such panel submitted under paragraph (2)(B) and subject to the specific direction, if any, of the President, may take any administrative actions authorized under any other provision of law, and, if necessary, propose legislation to implement any other actions, that would restore or improve the international competitiveness of the domestic industry affected by the export targeting, and

(C) shall, by no later than the date that is 30 days after the date on which the report of such panel is submitted under paragraph (2)(B), submit a report to the Congress on the administrative actions taken, and legislative proposals made, under subparagraph (B) with respect to the domestic industry affected by the export targeting.

(2)(A) The advisory panels established under paragraph (1)(A) shall consist of individuals appointed by the Trade Representative who—

(i) earn their livelihood in the private sector of the economy, including individuals who represent management and labor in the domestic industry affected by the export targeting that is the subject of the affirmative determination made under section 304(a)(1)(A), and

(ii) by education or experience, are qualified to serve on the advisory panel.

(B) By no later than the date that is 6 months after the date on which an advisory panel is established under paragraph (1)(A), the advisory panel shall submit to the Trade Representative and to the Congress a report on measures that the advisory panel recommends be taken by the United States to promote the competitiveness of the domestic industry affected by the export targeting that is the subject of the affirmative determination made under section 304(a)(1)(A).

**SEC. 306. MONITORING OF FOREIGN COMPLIANCE.**

(a) IN GENERAL.—The Trade Representative shall monitor the implementation of each measure undertaken, or agreement that is entered into to provide a satisfactory resolution of a matter subject to investigation under this chapter or subject to dispute settlement proceedings to enforce the rights of the United States under a trade agreement providing for such proceedings.

(b) FURTHER ACTION.—

(1) IN GENERAL.—If, on the basis of the monitoring carried out under subsection (a), the Trade Representative considers that a foreign country is not satisfactorily implementing a measure or agreement referred to in subsection (a), the Trade Representative shall determine what further action the Trade Representative shall take under section 301(a). For purposes of section 301, any such determination shall be treated as a determination made under section 304(a)(1).

(2) WTO DISPUTE SETTLEMENT RECOMMENDATIONS.— If the measure or agreement referred to in subsection (a) concerns the implementation of a recommendation made pursuant to dispute settlement proceedings under the World Trade Organization, and the Trade Representative considers that the foreign country has failed to implement it, the Trade

Representative shall make the determination in paragraph (1) no later than 30 days after the expiration of the reasonable period of time provided for such implementation under paragraph 21 of the Understanding on Rules and Procedures Governing the Settlement of Disputes that is referred to in section 101(d)(16) of the Uruguay Round Agreements Act.

(c) CONSULTATIONS.—Before making any determination under subsection (b), the Trade Representative shall—

- (1) consult with the petitioner, if any, involved in the initial investigation under this chapter and with representatives of the domestic industry concerned; and
- (2) provide an opportunity for the presentation of views by interested persons.

#### **SEC. 307. MODIFICATION AND TERMINATION OF ACTIONS.**

(a) IN GENERAL.—

(1) The Trade Representative may modify or terminate any action, subject to the specific direction, if any, of the President with respect to such action, that is being taken under section 301 if—

- (A) any of the conditions described in section 301(a)(2) exist,
- (B) the burden or restriction on United States commerce of the denial rights, or of the acts, policies, and practices, that are the subject of such action has increased or decreased, or
- (C) such action is being taken under section 301(b) and is no longer appropriate.

(2) Before taking any action under paragraph (1) to modify or terminate any action taken under section 301, the Trade Representative shall consult with the petitioner, if any, and with representatives of the domestic industry concerned, and shall provide opportunity for the presentation of views by other interested persons affected by the proposed modification or termination concerning the effects of the modification or termination and whether any modification or termination of the action is appropriate.

(b) NOTICE; REPORT TO CONGRESS.—The Trade Representative shall promptly publish in the Federal Register notice of, and report in writing to the Congress with respect to, any modification or termination of any action taken under section 301 and the reasons therefor.

(c) REVIEW OF NECESSITY.—

(1) If—

- (A) a particular action has been taken under section 301 during any 4-year period, and
- (B) neither the petitioner nor any representative of the domestic industry which benefits from such action has submitted to the Trade Representative during the last 60 days of such 4-year period a written request for the continuation of such action, such action shall terminate at the close of such 4-year period.

(2) The Trade Representative shall notify by mail the petitioner and representatives of the domestic industry described in paragraph (1)(B) of any termination of action by reason of paragraph (1) at least 60 days before the date of such termination.

(3) If a request is submitted to the Trade Representative under paragraph (1)(B) to continue taking a particular action under section 301, the Trade Representative shall conduct a review of—

- (A) the effectiveness in achieving the objectives of section 301 of—
  - (i) such action, and

- (ii) other actions that could be taken (including actions against other products or services), and
- (B) the effects of such actions on the United States economy, including consumers.

**SEC. 308. REQUEST FOR INFORMATION.**

(a) **IN GENERAL.**—Upon receipt of written request therefor from any person, the Trade Representative shall make available to that person information (other than that to which confidentiality applies) concerning—

- (1) the nature and extent of a specific trade policy or practice of a foreign country with respect to particular goods, services, investment, or intellectual property rights, to the extent that such information is available to the Trade Representative or other Federal agencies;
- (2) United States rights under any trade agreement and the remedies which may be available under that agreement and under the laws of the United States; and
- (3) past and present domestic and international proceedings or actions with respect to the policy or practice concerned.

(b) **IF INFORMATION NOT AVAILABLE.**—If information that is requested by a person under subsection (a) is not available to the Trade Representative or other Federal agencies, the Trade Representative shall, within 30 days after receipt of the request—

- (1) request the information from the foreign government; or
- (2) decline to request the information and inform the person in writing of the reasons for refusal.

(c) **CERTAIN BUSINESS INFORMATION NOT MADE AVAILABLE.**—

(1) Except as provided in paragraph (2), and notwithstanding any other provision of law (including section 552 of title 5, United States Code), no information requested and received by the Trade Representative in aid of any investigation under this chapter shall be made available to any person if—

- (A) the person providing such information certifies that—
  - (i) such information is business confidential,
  - (ii) the disclosure of such information would endanger trade secrets or profitability, and
  - (iii) such information is not generally available;
- (B) the Trade Representative determines that such certification is well-founded; and
- (C) to the extent required in regulations prescribed by the Trade Representative, the person providing such information provides an adequate nonconfidential summary of such information.

(2) The Trade Representative may—

- (A) use such information, or make such information available (in his own discretion) to any employee of the Federal Government for use, in any investigation under this chapter, or
- (B) may make such information available to any other person in a form which cannot be associated with, or otherwise identify, the person providing the information.

**SEC. 309. ADMINISTRATION.**

The Trade Representative shall—

- (1) issue regulations concerning the filing of petitions and the conduct of investigations and hearings under this subchapter,

(2) keep the petitioner regularly informed of all determinations and developments regarding the investigation conducted with respect to the petition under this chapter, including the reasons for any undue delays, and

(3) submit a report to the House of Representatives and the Senate semiannually describing—

(A) the petitions filed and the determinations made (and reasons therefor) under section 302,

(B) developments in, and the current status of, each investigation or proceeding under this chapter,

(C) the actions taken, or the reasons for no action, by the Trade Representative under section 301 with respect to investigations conducted under this chapter, and

(D) the commercial effects of actions taken under section 301.

### **SEC. 310. IDENTIFICATION OF TRADE EXPANSION PRIORITIES.**

(a) IDENTIFICATION.—

(1) Within 180 days after the submission in calendar year 1995 of the report required by section 181(b), the Trade Representative shall—

(A) review United States trade expansion priorities,

(B) identify priority foreign country practices, the elimination of which is likely to have the most significant potential to increase United States exports, either directly or through the establishment of a beneficial precedent, and

(C) submit to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives and publish in the Federal Register a report on the priority foreign country practices identified.

(2) In identifying priority foreign country practices under paragraph (1) of this section, the Trade Representative shall take into account all relevant factors, including—

(A) the major barriers and trade distorting practices described in the National Trade Estimate Report required under section 181(b);

(B) the trade agreements to which a foreign country is a party and its compliance with those agreements;

(C) the medium- and long-term implications of foreign government procurement plans; and

(D) the international competitive position and export potential of United States products and services.

(3) The Trade Representative may include in the report, if appropriate—

(A) a description of foreign country practices that may in the future warrant identification as priority foreign country practices; and

(B) a statement about other foreign country practices that were not identified because they are already being addressed by provisions of United States trade law, by existing bilateral trade agreements, or as part of trade negotiations with other countries and progress is being made toward the elimination of such practices.

(b) INITIATION OF INVESTIGATIONS.—By no later than the date which is 21 days after the date on which a report is submitted to the appropriate congressional committees under subsection (a)(1), the Trade Representative shall initiate under section 302(b)(1) investigations under this chapter with respect to all of the priority foreign country practices identified.

(c) AGREEMENTS FOR ELIMINATION OF BARRIERS.—In the consultations with a foreign country that the Trade Representative is required to request under section 303(a) with respect to



an investigation initiated by reason of subsection (b), the Trade Representative shall seek to negotiate an agreement that provides for the elimination of the practices that are the subject of the investigation as quickly as possible or, if elimination of the practices is not feasible, an agreement that provides for compensatory trade benefits.

(d) REPORTS.—The Trade Representative shall include in the semiannual report required by section 309 a report on the status of any investigations initiated pursuant to subsection (b) and, where appropriate, the extent to which such investigations have led to increased opportunities for the export of products of the United States.

B. RELEVANT WTO PROVISIONS

**UNDERSTANDING ON RULES AND PROCEDURES  
GOVERNING THE SETTLEMENT OF DISPUTES**

...

*Article 21*

*Surveillance of Implementation of Recommendations and Rulings*

1. Prompt compliance with recommendations or rulings of the DSB is essential in order to ensure effective resolution of disputes to the benefit of all Members.

...

3. At a DSB meeting held within 30 days<sup>11</sup> after the date of adoption of the panel or Appellate Body report, the Member concerned shall inform the DSB of its intentions in respect of implementation of the recommendations and rulings of the DSB. If it is impracticable to comply immediately with the recommendations and rulings, the Member concerned shall have a reasonable period of time in which to do so. The reasonable period of time shall be ...

4. Except where the panel or the Appellate Body has extended, pursuant to paragraph 9 of Article 12 or paragraph 5 of Article 17, the time of providing its report, the period from the date of establishment of the panel by the DSB until the date of determination of the reasonable period of time shall not exceed 15 months unless the parties to the dispute agree otherwise. Where either the panel or the Appellate Body has acted to extend the time of providing its report, the additional time taken shall be added to the 15-month period; provided that unless the parties to the dispute agree that there are exceptional circumstances, the total time shall not exceed 18 months.

5. Where there is disagreement as to the existence or consistency with a covered agreement of measures taken to comply with the recommendations and rulings such dispute shall be decided through recourse to these dispute settlement procedures, including wherever possible resort to the original panel. The panel shall circulate its report within 90 days after the

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<sup>11</sup> If a meeting of the DSB is not scheduled during this period, such a meeting of the DSB shall be held for this purpose.

date of referral of the matter to it. When the panel considers that it cannot provide its report within this time frame, it shall inform the DSB in writing of the reasons for the delay together with an estimate of the period within which it will submit its report.

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## *Article 22*

### *Compensation and the Suspension of Concessions*

1. Compensation and the suspension of concessions or other obligations are temporary measures available in the event that the recommendations and rulings are not implemented within a reasonable period of time. However, neither compensation nor the suspension of concessions or other obligations is preferred to full implementation of a recommendation to bring a measure into conformity with the covered agreements. Compensation is voluntary and, if granted, shall be consistent with the covered agreements.

2. If the Member concerned fails to bring the measure found to be inconsistent with a covered agreement into compliance therewith or otherwise comply with the recommendations and rulings within the reasonable period of time determined pursuant to paragraph 3 of Article 21, such Member shall, if so requested, and no later than the expiry of the reasonable period of time, enter into negotiations with any party having invoked the dispute settlement procedures, with a view to developing mutually acceptable compensation. If no satisfactory compensation has been agreed within 20 days after the date of expiry of the reasonable period of time, any party having invoked the dispute settlement procedures may request authorization from the DSB to suspend the application to the Member concerned of concessions or other obligations under the covered agreements.

...

6. When the situation described in paragraph 2 occurs, the DSB, upon request, shall grant authorization to suspend concessions or other obligations within 30 days of the expiry of the reasonable period of time unless the DSB decides by consensus to reject the request. However, if the Member concerned objects to the level of suspension proposed, or claims that the principles and procedures set forth in paragraph 3 have not been followed where a complaining party has requested authorization to suspend concessions or other obligations pursuant to paragraph 3(b) or (c), the matter shall be referred to arbitration. Such arbitration shall be carried out by the original panel, if members are available, or by an arbitrator<sup>15</sup> appointed by the Director-General and shall be completed within 60 days after the date of expiry of the reasonable period of time. Concessions or other obligations shall not be suspended during the course of the arbitration.

7. The arbitrator<sup>16</sup> acting pursuant to paragraph 6 shall not examine the nature of the concessions or other obligations to be suspended but shall determine whether the level of such suspension is equivalent to the level of nullification or impairment. The arbitrator may also determine if the proposed suspension of concessions or other obligations is allowed under the

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<sup>15</sup> The expression "arbitrator" shall be interpreted as referring either to an individual or a group.

<sup>16</sup> The expression "arbitrator" shall be interpreted as referring either to an individual or a group or to the members of the original panel when serving in the capacity of arbitrator.

covered agreement. However, if the matter referred to arbitration includes a claim that the principles and procedures set forth in paragraph 3 have not been followed, the arbitrator shall examine that claim. In the event the arbitrator determines that those principles and procedures have not been followed, the complaining party shall apply them consistent with paragraph 3. The parties shall accept the arbitrator's decision as final and the parties concerned shall not seek a second arbitration. The DSB shall be informed promptly of the decision of the arbitrator and shall upon request, grant authorization to suspend concessions or other obligations where the request is consistent with the decision of the arbitrator, unless the DSB decides by consensus to reject the request.

...

### *Article 23*

#### *Strengthening of the Multilateral System*

1. When Members seek the redress of a violation of obligations or other nullification or impairment of benefits under the covered agreements or an impediment to the attainment of any objective of the covered agreements, they shall have recourse to, and abide by, the rules and procedures of this Understanding.

2. In such cases, Members shall:

- (a) not make a determination to the effect that a violation has occurred, that benefits have been nullified or impaired or that the attainment of any objective of the covered agreements has been impeded, except through recourse to dispute settlement in accordance with the rules and procedures of this Understanding, and shall make any such determination consistent with the findings contained in the panel or Appellate Body report adopted by the DSB or an arbitration award rendered under this Understanding;
- (b) follow the procedures set forth in Article 21 to determine the reasonable period of time for the Member concerned to implement the recommendations and rulings; and
- (c) follow the procedures set forth in Article 22 to determine the level of suspension of concessions or other obligations and obtain DSB authorization in accordance with those procedures before suspending concessions or other obligations under the covered agreements in response to the failure of the Member concerned to implement the recommendations and rulings within that reasonable period of time.

...

## ANNEX II

### GENERAL DESCRIPTION OF THE OPERATION OF SECTIONS 301-310<sup>730</sup>

#### A. INVESTIGATION BY THE USTR UNDER SECTIONS 302-303

1. Sections 301-310 provide an important avenue to enforce US rights under the WTO Agreement. The USTR can also start WTO proceedings outside the framework of Sections 301-310, as she did, for example, in the *EC – Hormones* and *EC – LAN* cases. Sections 301-310 are also used in the context of other trade agreements.

2. If Sections 301-310 are used, an investigation needs to be carried out by the USTR under Sections 302-303. Such investigation can be initiated by the USTR either after the filing of a petition by any interested person or at the initiative of the USTR him or herself.

3. If an interested person files a petition to request that action be taken under Section 301, the USTR has to first review the allegations in the petition. Not later than 45 days after receipt of the petition, the USTR has to determine whether to initiate an investigation. If the USTR makes an affirmative determination, he or she must initiate an investigation.

4. On the date an investigation is initiated – or within maximum 90 days thereafter -- the USTR also has to request consultations with the other WTO Member concerned under DSU procedures (Section 303(a)(1)). If no mutually acceptable solution is reached before the 60 day consultation period provided in the DSU, the USTR has to "promptly request proceedings on the matter under the formal dispute settlement procedures provided" in the DSU (Section 303(a)(2)). The US is thus obliged to initiate consultations and, as the case may be, panel proceedings, before concluding its investigation. At the same time, the USTR is free to terminate an investigation at any time, including before the initiation of panel proceedings.

#### B. "DETERMINATION" ON DENIAL OF US RIGHTS UNDER SECTION 304

5. Section 304 then mandates the USTR to "determine whether the rights to which the United States is entitled under [the WTO Agreement] are being denied". The USTR has to do this "[o]n the basis of the investigation initiated under section 302 and the consultations (and the proceedings, if applicable) under section 303".

6. This determination under Section 304 has to be made within the following timeframe: "the earlier of (i) the date that is 30 days after the date on which the dispute settlement procedure is concluded, or (ii) the date that is 18 months after the date on which the investigation is initiated".

7. Section 304 further provides that "if the determination made ... is affirmative, [the Trade Representative shall] determine what action, if any, the Trade Representative should take under subsection (a) or (b) of section 301".

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<sup>730</sup> This overview is of a non-binding nature and does not have the status of a factual finding by this Panel. It was prepared following consultations with the parties as part of the descriptive part of this Report.

8. Section 301(a) – entitled "Mandatory action" and the relevant provision in respect of determinations under the WTO Agreement – provides that "[i]f the United States Trade Representative determines under section 304(a)(1) that ... the rights of the United States under any trade agreement are being denied ... the Trade Representative shall take action authorized in section 301(c), subject to the specific direction, if any, of the President regarding any such action, and shall take all other appropriate and feasible action within the power of the President that the President may direct the Trade Representative to take under this subsection, to enforce such rights".

9. Section 304(c) mandates the USTR to "publish in the Federal Register any determination made under section 304(a)(1), together with a description of the facts on which such determination is based".

C. "CONSIDERATION" ON IMPLEMENTATION UNDER SECTION 306

10. As noted above, following the investigation under Section 302, the related request for WTO consultations and, as the case may be, the completion of panel or Appellate Body proceedings and an affirmative determination under Section 304, Section 304(a)(1) requires the USTR to determine what action, if any, to take under Section 301.

11. Section 301(c) defines the scope of the USTR's authority, i.e. the actions he or she can take, under Section 301. Section 301(a)(2) provides for certain exceptions where the USTR "is not required to take action under section 301(a)(1)". One of these exceptions is provided for cases where the USTR finds that "the foreign country is taking satisfactory measures to grant the rights of the United States under a trade agreement". In practice, the USTR has interpreted this exception to include situations where the WTO Member concerned expresses the intention - within 30 days after the date of adoption of the panel or Appellate Body report, pursuant to Article 21.3 of the DSU -- to comply with the recommendations and rulings of the DSB.

12. Nevertheless, in such cases where no action is taken -- because a measure is undertaken or an agreement is entered into to provide a satisfactory resolution -- the USTR is obliged, under Section 306(a) to

"monitor the implementation of each measure undertaken, or agreement that is entered into, by a foreign country to provide a satisfactory resolution of a matter subject to investigation under this subchapter or subject to dispute settlement proceedings to enforce the rights of the United States under a trade agreement providing for such proceedings".

13. If the measure – including a statement by the WTO Member concerned that it will comply – or agreement concerns the implementation of DSB recommendations *and* the USTR "considers that the foreign country has failed to implement it", the USTR shall determine what further action he or she shall take under Section 301 "no later than 30 days after the expiration of the reasonable period of time provided for such implementation" in Article 21 of the DSU (Section 306 (b)). In other words, the USTR's obligation to monitor a Member's intention to comply with DSB recommendations allows him or her to await the lapse of the reasonable period of time granted to the Member concerned to implement the panel or Appellate Body report.

14. Since Section 306(b)(1) provides that any determination under Section 306(b) is to be treated as a determination made under Section 304(a)(1), the effect of a Section 306 determination is identical to that of Section 304 determinations in terms of the action the USTR

has to take – or is allowed not to take – under Section 301. As a result, the USTR also has to publish any Section 306 determination in the Federal Register, together with a description of the facts on which such determination is based pursuant to Section 304(c).

D. "DETERMINATION" ON ACTION TO TAKE UNDER SECTION 306 AND IMPLEMENTATION OF ACTION UNDER SECTION 305

15. As noted earlier, in case the USTR considers under Section 306(b) that implementation failed, he or she has to determine what further action to take under Section 301(a). He or she has to do so no later than *30 days* after the expiration of the reasonable period of time. Section 301(a)(2) provides for exceptions where the USTR is not required to take action.

16. In case the USTR decides to take action under Section 301, Section 305(a)(1) states:

"Except as provided in paragraph (2), the Trade Representative shall implement the action the Trade Representative determines under section 304(a)(1)(B) to take under section 301, subject to the specific direction, if any, of the President regarding any such action, by no later than the date that is 30 days after the date on which such determination is made".

Unless exceptions apply, a determination of action made within 30 days after the expiry of the reasonable period of time would thus be implemented no later than *60 days* after the expiration of the reasonable period of time.

17. Section 305(a)(2)(A), in turn, provides for certain exceptions to this 60 day rule. The exception most relevant to this case is contained in Section 305(a)(2)(A)(ii):

"the Trade Representative may delay, by not more than 180 days, the implementation of any action that is to be taken under section 301 ... if the Trade Representative determines that substantial progress is being made, or that a delay is necessary or desirable, to obtain United States rights or a satisfactory solution with respect to the acts, policies, or practices that are the subject of the action".

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## **LEGAL AUTHORITY CA-101**



Decision No. 253

Walter Prescott,  
Applicant

v.

International Bank for Reconstruction and Development,  
Respondent

1. The World Bank Administrative Tribunal, composed of Francisco Orrego Vicuña, President, Thio Su Mien and Bola A. Ajibola, Vice Presidents, and A. Kamal Abul-Magd, Robert A. Gorman, Elizabeth Evatt and Jan Paulsson, Judges, has been seized of an application, received on February 25, 2000, by Walter Prescott against the International Bank for Reconstruction and Development. In *Prescott*, Decision No. 234 [2000], the Tribunal denied the Bank's request to declare the application inadmissible for lack of jurisdiction. The parties thereafter submitted their written pleadings on the merits. A request made by the Applicant to hold oral proceedings was granted by the Tribunal. After a postponement at the request of the Applicant, the hearing took place on November 26, 2001. The case was listed on November 27, 2001.

2. This case concerns a claim for pension credits and related benefits during the period the Applicant held a Non-Regular Staff (NRS) Temporary appointment before April 15, 1998. The claim is based on arguments that the Bank pursued policies in violation of the Principles of Staff Employment and the relevant Staff Rules and that it misclassified the Applicant's position.

#### **The Applicant's career in the Bank**

3. The Bank hired the Applicant on December 2, 1985 as a Temporary Messenger to serve in the Administrative Services Department on an initial six-month appointment. The Applicant's Temporary appointment was extended continuously for six-month or one-year periods. Sixteen extensions of his contract were made between 1985 and 1999. Other than a six-month assignment in 1987 as a Telephone Operator, the Applicant performed the same messenger functions through December 1988.

4. In January 1989, the Applicant moved to the Information Technology and Facilities Department (ITF), Internal Documents Unit (ITFIO), as a Records Clerk. ITF later became the Information Solutions Group (ISG). The clerical functions the Applicant performed remained essentially the same and were subject to the changes in priorities and technologies periodically introduced in ITF and later in ISG. Training was provided to enable the Applicant to take on additional duties.

5. In 1999, ISG advertised a two-year Term position for an Information Technician that corresponded to the Applicant's functions. Having applied for this position, the Applicant was selected and appointed to it effective August 1, 1999.

6. When the Applicant joined the Bank, a Temporary appointment was defined as a "full-time appointment to the staff of the World Bank for a specified period of time, less than one year in duration." Although the length of the period specified in the Rule changed over time, it was always short-term. Conversely, a Regular appointment was a "full-time appointment of indefinite duration."

7. The Applicant's initial appointment as a Temporary employee allowed for participation in the Medical Insurance Plan, annual and sick leave and overtime pay, but did not allow for participation in the Staff Retirement Plan (SRP).

#### **The Human Resources Policy Reform**

8. As a result of the Human Resources Policy Reform enacted in 1998, the Applicant, like other NRS, commenced participation in the SRP and the corresponding accrual of service credit toward retirement benefits and retiree medical benefits on April 15, 1998. It is important to note in this respect that notwithstanding specific requests by the Staff Association to the effect that credit should also be received for employment prior to April 15, 1998, the Executive Directors expressly decided that no past service credit would be granted.

9. The Human Resources Policy Reform also led to a new policy concerning the phasing out of long-term NRS appointments by December 31, 2000. Staff holding this kind of appointment would be either selected for a Term or Open-Ended appointment or their appointment would expire by that date. It is in this context that the Applicant was appointed to a Term position in 1999.

10. The Applicant's first argument is that the Bank's management, by means of intentional and improper policy decisions, created incentives for an unjustified differentiation against particular NRS. He further argues that while lower-level management did not intentionally engage in *détournement de procédure* and unjustifiable differentiation, such abuses nevertheless resulted from the policy framework in which management had to operate. He mentions dollar budgeting, different comparators to determine pay rates, power inequalities and considerations based on nationality as particular policies that created incentives for managers to hire NRS instead of Regular staff. He maintains that they led to violations of the Principles of Staff Employment requiring proper process, equal treatment and equitable compensation.



11. The Respondent answers that at all times staff employment followed the applicable Staff Rules and Principles of Staff Employment, and that there was no abuse of power or any form of unjustifiable differentiation.

12. The policy questions involved in the Human Resources Policy Reform were discussed and decided by the Tribunal in *Caryk* (Decision No. 214 [1999]) and *Madhusudan* (Decision No. 215 [1999]). After examining various initiatives and decisions taken by the Bank in order to correct the adverse consequences of dollar budgeting, recruitment practices and, generally, the condition of NRS, the Tribunal then concluded:

These examples of policy initiatives or studies ... show that the Respondent, far from being involved in a *détournement de pouvoir* and *détournement de procédure*, was sensitive to a wide range of different, and occasionally conflicting, factors. The task of the Tribunal cannot possibly be to judge whether the Respondent could have been wiser.

(*Caryk* at para. 40; *Madhusudan* at para. 49.) The Respondent, during the Human Resources Policy Reform, was particularly sensitive to the situation in ISG, which had the highest percentage (50.9 percent) of NRS in the Bank.

13. Consistent with this jurisprudence, the Tribunal concludes that to the extent the issue before it involves a question of general policy pertaining to the ambit of managerial discretion, there is no basis for a finding of *détournement de procédure* or *de pouvoir* on the facts of this case. This does not, of course, obviate an examination of whether the implementation of the Bank's policies in fact resulted in a violation of the Applicant's conditions of employment.

#### **Regularization under the Staff Rules**

14. Regularization of NRS was governed at the time by Staff Rule 4.01. The 1986 version of this Rule allowed for the regularization of staff members in two situations: (i) if the Director of the Personnel Management Department or a designated official, at his or her discretion, authorized such regularization and the staff member met the eligibility criteria for the Regular position (para. 7.01); or (ii) the staff member was selected on a competitive basis against qualified external candidates for a Regular position (para. 7.02). Staff Rule 4.01 was amended in November 1991 and remained in effect until July 1998. Paragraph 7.02(b) of the amended Rule provided:

Staff holding Consultant or Temporary appointments before September 30, 1990 who have remained in continuous service and in the same job for four years or more, may be appointed ... to a Regular or Fixed-Term position if (i) before September 30, 1995, the vice president responsible for the hiring unit has selected the staff member, after determining that the staff member meets the criteria required for the new appointment, that the Bank Group's requirements for the work are likely to continue, and that the expected needs of the Bank Group indicate the staff member's skills should be secured by converting the existing appointment ....

15. The policy embodied in the Rule was first set out by the President of the Bank in an August 1, 1991 memorandum. This document stated that a special effort was to be made to regularize NRS who met similar criteria. The Tribunal referred to this memorandum in *Caryk* and *Madhusudan* when discussing the initiatives undertaken by Bank management to improve the conditions of NRS. (*Caryk* at para. 38; *Madhusudan* at para. 47.)

16. In the present case, the situation of the Applicant was addressed in a memorandum directed to him by the Acting Director of ITF on October 9, 1991, and communicated in exactly the same terms to other staff in ITF. This memorandum explicitly referred to the initiative of the President of the Bank to regularize NRS. It concluded, however, that

[a]s you had less than four years in your current assignment as of September 30, 1991, a final decision on your case cannot be taken at this time. You should be aware, however, that it is unlikely that you will be considered for regularization even if you do accumulate the necessary service. ... Arrangements for contract renewal remain unchanged and will continue to be based on the ongoing need for your services.

17. The Bank has argued that the Applicant, who was well aware of the fact that as a Temporary staff member he was not entitled to pension benefits, cannot plausibly complain now before the Tribunal since he could have brought a grievance many years ago. In particular, so the Bank argues, he could have complained on the occasion of one of the numerous renewals of his contract. Having failed to do so, he should not be allowed to rewrite his employment history by alleging that it had been wrong to maintain his NRS status.

18. In this respect, the Tribunal concludes, however, that the Applicant did ask to have his situation addressed. The Applicant's testimony, which the Tribunal views as credible in the circumstances (and which the Bank did not seek to rebut), is that during his early years of employment he had a number of conversations with his managers about his prospects for regularization, and was consistently told that this would not be possible at the moment because of budget constraints but not to be concerned because "[his] job would still be there." As for the October 1991 memorandum, the Applicant testified that it came as "quite a shock," that he "immediately confronted [his] supervisor," and that he was told "this is probably just temporary.... Everything changes in the Bank.... Be patient." When the Applicant's position was regularized in August 1999, he realized, as the Tribunal accepted in its decision on jurisdiction, that this brought into question the propriety of his NRS status over many years. The Applicant then took action without delay and in a timely manner to challenge his prior NRS condition and his exclusion from participation in the SRP prior to April 15, 1998. It is only because the Applicant has satisfied in a timely manner the indispensable jurisdictional requirements imposed by the Tribunal's Statute that the Tribunal is now in a position to consider his claim on the merits.

19. Although regularization under Staff Rule 4.01, paragraph 7.02(b), was not mandatory, as indicated by the expression "may," there was a clear indication in the Rule and the related policies that the matter should be considered if the terms of the Rule and the policies were met. The application of the Rule was conditioned on various cumulative elements. First, there had to be a continuous service for at least four years. Second, service had to be "in the same job." On this point, the Tribunal accepts the Applicant's argument that the term "same job" does not necessarily mean that the staff member performs precisely the same tasks over the relevant period.

20. Between 1985 and 1988, the Applicant held the Temporary messenger position described above. In 1989, he

undertook a new job in ITF. Even though there may have been some continuity between the two, the fact is that the ITF position was a new job. The Applicant himself speaks of having "undergone training in different functions of a new job."

21. However, from January 1989 the Applicant held one single job, which involved filing reports into archives, duplicating microfiche, making photocopies, coordinating electronic mail, and ordering and stocking office supplies. Over time, some of these functions diminished considerably and new functions were added to this job, such as operating a new imaging system, printing reports, and maintaining the condition and performance of the printers. The Applicant was particularly successful in handling these assignments, as evidenced by the fact that by 1997 manual processing had been largely discontinued and the functions performed formerly by three staff members were now handled by the Applicant alone. This same job is the one currently held by the Applicant as an Information Technician after his regularization.

22. Other requirements of Staff Rule 4.01, paragraph 7.02(b), included that the work envisaged was likely to continue and that the staff member's skills met the expected needs of the Bank. The Bank has explained, particularly at the oral hearing, that it had expected that the Applicant's responsibilities would be either discontinued – through the development of the computer network – or absorbed by different departments. The Bank argues that it had anticipated these plans to begin as early as 1989 and finalized within a decade's time. Because of these plans, the Bank further argues, the Applicant's contract was appropriately extended for only short periods of time. Any long extensions, in the Bank's view, would have given the Applicant an expectation of continued employment and would have committed the Bank on a long-term basis.

23. The Bank's arguments are untenable. There can be no doubt that the work of the Applicant was expected to continue as in fact it did continue and does so presently. It may be true, as the Respondent has argued, that the specific tasks of the Applicant "changed significantly" over time; however, the general nature of his work remained substantially the same. As noted above, the Applicant was particularly successful in handling new assignments, thus evidencing that he also had the skills to meet the expected needs of the Bank. All the elements required under Staff Rule 4.01, paragraph 7.02(b), were thus met. The Respondent's argument that ITF experienced significant changes over time does not alter the fact that the core functions of the Applicant remained the same over time and that he proved to be capable of adapting to new methods.

24. The question then arises as to why, if the Applicant met all the criteria under Staff Rule 4.01, paragraph 7.02(b), and performed competently, he was not regularized between the date when he achieved four years in the job and the last date on which regularization was permitted under the Rule, that is to say September 29, 1995. Not only did he complete four years in the same job as of January 1993, but he also had the skills that met the expected needs of the Bank and his functions were expected to continue.

25. As a general principle, the Bank did not have an obligation to regularize the Applicant. This was a discretionary decision, which was final unless the decision constituted an abuse of discretion, being arbitrary, discriminatory, improperly motivated or carried out in violation of a fair and reasonable procedure. But under the applicable policy and rules, and in the context of contemporaneous communications to staff and managers, the Bank had an obligation to consider his regularization after four years in the light of the unique circumstances of the case. The Bank undertook no such consideration and thus failed to comply with this obligation. Moreover, the Bank at the time offered no valid reason for this failure.

26. Reasons now invoked by the Respondent, such as technological advances mentioned above, or the policy relied upon to regularize only staff having critical technological skills, were only raised by the Respondent for the first time in its pleadings, and most certainly not explained to the Applicant. In fact, the Tribunal, as noted, has been persuaded that there was an ongoing need for the Applicant's services.

27. In light of the above, the Tribunal concludes that the managers responsible for ITF/ISG decisions in this case abused their discretion in not considering and determining the Applicant's regularization before September 30, 1995 despite the clear terms of Staff Rule 4.01, paragraph 7.02(b), and of the President's directive of August 1, 1991. This directive should have weighed heavily in favor of regularization as it mandated the managers to make a "special effort" to regularize NRS who met the established criteria. The directive, in effect, placed the burden on the Respondent to show – when NRS met the criteria, but were not regularized – that there were particular reasons which justified a negative outcome. Here, however, although the Applicant satisfied the criteria, no special effort was made to regularize him and no particular reasons were offered at any material time to justify this failure.

28. This was not the result of a general policy of the Bank, which was leading in the opposite direction, nor of a deceitful purpose aiming at the denial of benefits, but rather of the failure to apply the policy on regularization to the Applicant. If all the legal and policy elements point in one direction and the managers choose to go the opposite way, probably relying on how things had been done in the past, there is an element of arbitrariness amounting to an abuse of discretion. In the light of this finding, the question of misclassification becomes moot.

#### **Interpretation of the SRP**

29. Because of the finding of abuse of discretion, there is likewise no need to address the question of interpretation of the SRP in respect of the definition of "service," "participant," and "days of service" that the Applicant has raised. Nor is it necessary to discuss questions of practice in the Bank and the International Monetary Fund. (See *Yang*, Decision No. 252 [2001], paras. 37 and 38.)

30. The Respondent has argued that under Staff Rule 11.01, paragraph 2.01, a Statute of Limitations would apply were the Applicant to establish an entitlement to past pension and medical service credits. This Rule provides as follows: "[T]he right of a staff member to claim any refund, allowance or payment due but unpaid or any benefit not credited shall lapse three years after the date on which a right to the benefit, allowance or payment claimed arose."

31. The Applicant has argued that this is a jurisdictional provision and not one related to the determination of substantive rights. The Tribunal agrees with this view. (See *Singh*, Decision No. 240 [2001], para. 22; *Thomas*, Decision No. 232 [2000], para. 21; and *Mitra*, Decision No. 230 [2000], para. 14.) The jurisdictional aspect of the

case has already been settled. Moreover, as a right to pension and other credits shall be established only as a consequence of this judgment, the three-year statute of limitations would only apply, if at all, as from the date of the decision establishing the right.

**Date for commencing participation in the SRP and related benefits**

32. The Tribunal must now establish the date from which participation in the SRP and related medical benefits is recognized. The Applicant's first three years of service in the Bank do not qualify under the terms of Staff Rule 4.01, paragraph 7.02(b), because he had a different kind of job that lasted less than four years. The Applicant began his work with ITF in January 1989. After four years in this last job and having met all the other conditions of the Staff Rule and the Bank's stated policy, the Applicant was entitled to be given fair consideration for regularization and participation in the SRP and related benefits as from January 1, 1993. He was not given such consideration, and the Bank's explanations for this failure, as seen above, do not overcome the finding of arbitrariness. This is the date accordingly identified by the Tribunal for commencing SRP participation and entitlement to related medical benefits.

33. Account must be taken of the Applicant's obligation to make contributions to the SRP as from January 1, 1993 and until the date he began his present participation. However, as the Bank has been found at fault in this matter, it should provide the Applicant with an adequate time frame for completing these contributions and grant the appropriate facilities to this effect, as has been done on other occasions regarding the bridging of benefits.

**Decision**

For the above reasons, the Tribunal decides to:

- (i) direct the Respondent to allow the Applicant to participate in the Staff Retirement Plan and to receive related benefits beginning on January 1, 1993; and
- (ii) award costs to the Applicant in the amount of \$15,000.

/S/ Francisco Orrego Vicuña  
Francisco Orrego Vicuña  
President

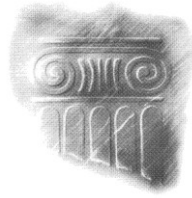
/S/ Nassib G. Ziadé  
Nassib G. Ziadé  
Executive Secretary

At Washington, D.C., December 4, 2001

**The World Bank Administrative Tribunal**

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## **LEGAL AUTHORITY CA-102**



**Arbitration CAS 2000/A/284 Sullivan / The Judo Federation of Australia Inc., the Judo Federation of Australia Inc. Appeal Tribunal and Raguz, award of 14 August 2000\***

Panel: Mr. Malcolm Holmes (Australia), President, Mrs. Tricia Kavanagh (Australia); Mr. David Grace (Australia)

*Judo*  
*Olympic Games*  
*Selection dispute*

**Any power to amend the criteria for selection must be subject to a limitation that it could not be exercised retrospectively once that allocation of points (earned in selection events and relevant for the selection in the 2000 Australian Olympic Team) had been made and once it had been scrutinised and confirmed.**

Ms. Rebecca Sullivan (“The Applicant”) is a competitor in the sport of judo and has made herself available for selection in the 2000 Australian Olympic Team.

The Judo Federation of Australia Inc. (“The First Respondent”) is the governing body of the sport of Judo in Australia.

The First Respondent is responsible for nominating to the Australian Olympic Committee Inc. (“the AOC”) athletes and officials for selection by the AOC as members of the 2000 Australian Olympic Team.

In the lead up to the 2000 Olympic Games the AOC desired to promote awareness and a clear understanding of its selection criteria by all athletes involved in the sport of Judo. For its part the First Respondent desired to have certainty in the selection criteria for athletes in the sport of judo and to ensure that its athletes and officials were aware and had a clear understanding of the manner in which athletes and officials would be nominated to the AOC for selection in the 2000 Australian Olympic Team.

By an Agreement made the 27<sup>th</sup> day of September 1999 (“the Agreement”) the AOC and the First Respondent reflected their respective, but common, intentions as outlined above.

The Agreement purported to be a comprehensive agreement detailing nomination, participation and selection criteria. Annexed to the Agreement were the following:

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\* NB: This award has been challenged before the New South Wales Court of Appeal (Australia) (réf. CA 40650/00); cf. Judgment of 1 September 2000, delivered by the New South Wales Court of Appeal (Australia) in the case *Angela Raguz v Rebecca Sullivan & Ors.*

- *Annexure A* comprising the Participation and Qualification Criteria for athletes for the 2000 Olympic Games determined from time to time by the International Judo Federation (hereinafter referred to as “the IJF”) and the International Olympic Committee (hereinafter referred to as “the IOC”).
- *Annexure B* comprising the 2000 Australian Olympic Team Selection Criteria.
- *Annexure C* comprising the 2000 Australian Olympic Team Nomination Criteria developed by the First Respondent.
- *Annexure D* comprising the 2000 Australian Olympic Team Athlete Nomination Form.
- *Annexure E* comprising the 2000 Australian Olympic Team Officials Nomination Form.
- *Annexure F* (which was not put in evidence) comprising the 2000 Olympic Team Membership Agreement - Athletes.

Clause 5.3 of the Agreement provides that selection of an athlete in the Olympic Team is conditional upon the AOC confirming that the athlete has met all the applicable criteria for nomination and selection including the signing of the Team Membership Agreement (Annexure F).

The First Respondent has accepted that at all material times the Applicant has been eligible for nomination to the AOC for selection in the 2000 Australian Olympic Team.

Clause 7 of the Agreement has the heading “Appeal Process”. Clause 7.1 provides as follows:

*“Subject to clause 7.2, any dispute regarding an Athlete’s nomination or non-nomination of an athlete by the NF to the AOC and whether arising during the term of this Agreement or after its termination will be according to the following procedure:*

- (1) *The appeal process is two tier, with the appeal being first heard by the Judo Federation of Australia’s Appeal Tribunal (“Tribunal”) with any subsequent appeal to be heard by the Court of Arbitration for Sport.*
- (2) *The sole grounds for any appeal are that the Nomination Criteria have not been properly followed and/or implemented.*
- (3) *Any appeal by an athlete against non-nomination to the AOC must be made to the Tribunal. Any appeal must accord with the following procedure:*
  - (a) *The appellant must give written notice of his appeal to the chief executive officer of the NF within 48 hours of the announcement of the decision against which the appeal is made.*
  - (b) *Within 5 working days of submitting his or her written notice of appeal, the appellant must submit to the chief executive officer of the NF the grounds of that appeal accompanied by a non-refundable deposit of \$100 payable to the NF.*
  - (c) *Unless otherwise agreed in writing between the AOC and the NF, the Tribunal will comprise the following persons appointed by the Board of the NF:*
    - (i) *a barrister or solicitor who will act as Chairman;*
    - (ii) *a person with a thorough knowledge of the Sport and who preferably has had recent international competition experience in the Sport; and*
    - (iii) *one other person of experience and skills suitable to the function of the NF Appeal Tribunal.*

*No person is eligible to be appointed to the Tribunal if he or she is a member of Board of the NF or its selection panel or by reason of his or her relationship with the appellant or any member of the Board of the NF or its selection panel would be reasonably considered to be other than impartial.*

- (d) *The Tribunal will convene a hearing as soon as possible after the submission of the grounds of appeal. The hearing may occur in such manner as the Chairman decides, including telephone or video conferencing. The Tribunal is not bound by the rules of evidence but must observe the principles of procedural fairness.*
  - (e) *Prior to the hearing, the selection panel will provide the Tribunal and the appellant with a written statement as to the reasons for the decision against which the appeal is made.*
  - (f) *The Tribunal will give its decision as soon as practicable after the hearing and will provide the chief executive officer of the NF and the appellant with a statement of the reasons for its decision.*
  - (g) *The decision of the Tribunal will be binding on the parties and, subject only to any appeal to the Court of Arbitration for Sport pursuant to clause 7.1(4), it is agreed that neither party will institute or maintain proceedings in any court or tribunal other than the said Tribunal.*
- (4) *Any appeal from a decision of the Tribunal must be solely and exclusively resolved by the Court of Arbitration for Sport according to the Code of Sports-Related Arbitration. The decision of the said Court will be final and binding on the parties and it is agreed that neither party will institute or maintain proceedings in any court or tribunal other than the said Court.*
  - (5) *An athlete wishing to appeal to the Court of Arbitration for Sport must give written notice of that fact to the chief executive officer of the NF within 48 hours of the announcement of the decision against which the appeal is made and must then file his or her statement of appeal with the Court of Arbitration for Sport within 5 working days.*
  - (6) *Failure to observe the above time limits will render any appeal a nullity provided that an athlete may apply to the body to hear the appeal in question for an extension of time in which to commence an appeal. The body to hear the appeal in question may grant such an extension of time only in extenuating circumstances outside the control of the athlete concerned.”*

Both the Applicant and Ms. Angela Raguz (“the Third Party”) were competitors for selection in the Australian Olympic Team in Judo in the 52-kilogram weight division. Under the Agreement the only events in respect of which points were to be awarded and upon which the selection was to be based were the following:

- (a) the 1999 Senior World Championships which were held between 4 and 11 October 1999;
- (b) the 1999 USA Open Championships which were held between 23 and 24 October 1999;
- (c) the Oceania Judo Union Championships which were held between 11 and 12 March 2000.

The Applicant competed in all three selection events and the Third Party participated in the latter two selection events. Their results were as follows:

<b>Event</b>	<b>Sullivan</b>	<b>Raguz</b>
1999 World Championships	9 <sup>th</sup> place	Did not compete
1999 USA Open Championships	7 <sup>th</sup> place	5 <sup>th</sup> place
2000 Oceania Judo Union Championships	2 <sup>nd</sup> place	1 <sup>st</sup> place

After the final selection events, the Applicant said in evidence that the first indication that she received that she had not been nominated was when she was not invited to attend a meeting of the proposed Olympic Team in March 2000.

On or about 17 March 2000 the Applicant wrote to the First Respondent expressing her belief that she would not be nominated by the First Respondent for selection in the 2000 Australian Olympic Team.

On 10 April 2000 the Applicant wrote to the First Respondent requesting urgent advice as to when it was intended that the First Respondent would nominate its team to the AOC and when the Applicant would know whether she had been so nominated. The letter also foreshadowed a request to refer any non-nomination to the Judo Federation of Australia Inc. Appeal Tribunal (“the Second Respondent”).

On 14 May 2000 the First Respondent’s Committee of Management met to discuss, inter alia, its nominations to the AOC for the 2000 Australian Olympic Games Team. The Committee of Management of the Respondent unanimously passed a motion that in the Women’s under 52-kilogram weight division Angela Raguz be the nominated athlete with the Applicant being a reserve athlete in that weight division. The First Respondent’s Committee of Management further resolved that the Applicant be advised that her Appeal should be lodged with the Oceania Judo Union and that the First Respondent’s Committee of Management had nominated this division to the AOC through the Oceania Judo Union selection criteria. On 11 June 2000 the Applicant wrote to the Oceania Judo Union appealing the decision by the First Respondent not to nominate her to the AOC. On 12 June 2000 the Oceania Judo Union wrote to the Applicant advising her that the Oceania Judo Union had no jurisdiction to hear the Applicant’s appeal.

On 19 June 2000 the Oceania Judo Union wrote a further letter to the Applicant confirming that the Applicant’s appeal should be directed to the First Respondent and further confirming that the Oceania Judo Union had no jurisdiction in the matter.

On 22 June 2000 the First Respondent wrote to the Applicant confirming her correspondence to the Second Respondent on 10 April 2000 and further confirming that her appeal must proceed pursuant to Clause 7.1 of the Agreement (set out above). Attached to that letter was a circular letter forwarded to the Applicant from the Section Manager Judo 2000 Olympic Games and dated 23 June 2000 advising the names of those athletes that had been nominated to the AOC by the First Respondent for selection in the 2000 Australian Olympic Games Team. That letter advised the procedures to follow in the case of an appeal and specified that the sole grounds for any appeal were that the Nomination Criteria had not been properly followed and/or implemented.



By letter dated 24 June 2000 the Applicant appealed to the Second Respondent against her non-nomination by the First Respondent to the AOC for selection to the 2000 Australian Olympic Team.

On 30 June 2000 the Applicant wrote to the First Respondent setting out the Applicant's Grounds of Appeal together with a request for clarification, information and documentation. The letter requested advice, amongst other things, as to the date, time and proposed venue for the Appeal Tribunal hearing. The letter also advised the intention to call Ms Sharon Rendle to give evidence at the hearing.

By letter dated 28 June 2000, Mr. Gerry Hay, Solicitor and Barrister of Rockdale NSW, advised the President of the First Respondent, Mr. J Deacon, that he had convened a panel to consider the Applicant's appeal. The other appointed members of the panel were Mrs. Margeurite Wilson and Mrs. Dianne Moffit. He further advised that the relevant documentation had been delivered to the nominated panel members the same day.

By letter dated 5 July 2000 Mr. Hay wrote to the Applicant's Solicitors advising that the Appeal Tribunal was "*now in operation*" and that he anticipated "*that the Tribunal would complete its task within the next week*". In relation to the intention to call Ms Sharon Rendle to give evidence on behalf of the Applicant Mr. Hay stated "*I note your intention to call Ms Sharon Rendle to the Appeal and I must point out that the initial process does not involve examination of the parties concerned but relies on the documentation provided by all the relevant parties. Any subsequent appeal is a matter for the Court of Arbitration for Sport where examination processes are available.*" Mr. Hay then proceeded to answer each of the Grounds of Appeal, in effect rejecting each of the grounds. The letter concluded that "*the initial appeal has commenced and is almost completed*" and that "*the Tribunal had reached a decision to consider the evidence in the first instance, on the documents provided by the parties*".

By letter dated 6 July 2000 the Applicant's Solicitors wrote to Mr. Hay advising that the Applicant had not received the Selection Panel's Written Statement of Reasons as contemplated by Clause 7.1(3)(e) of the Agreement. The letter also requested the documents which had been requested in the 30 June 2000 letter to the First Respondent. The letter also complained that the Second Respondent had not been constituted in accordance with Clause 7.1(3)(c) of the Agreement, that the Tribunal was required to convene a hearing, allow the Applicant to give evidence, provide documents and call witnesses and that generally the Appeal procedure set out in the Agreement had not been followed. A copy of that letter to Mr. Hay was forwarded to the First Respondent on 6 July 2000.

By letter dated 11 July 2000 Mr. Hay wrote to the Applicant's Solicitors enclosing previously requested documentation, clarifying a number of matters that had been raised in previous correspondence and advising that he had "*a wide scope of choice in the format in which*" the Appeal Tribunal operated. He stated that "*sufficient documentation was available to indicate to the Tribunal that the Appellant did not meet the criteria*" and that "*the hearing may occur in such a manner as the Chairman decides, including telephone or video conferencing. My method of conducting this Tribunal was to provide all the relevant*

*information to my colleagues along with permission for them to ring the Appellant if necessary and discuss with her, any query that they may have. I am informed that one of the members of the Tribunal did use this method to gain information for herself. I am now in the process of writing to Rebecca Sullivan and give her the decision of the Tribunal ...”.*

On 13 July 2000 the Applicant’s Solicitors wrote to Mr. Hay acknowledging receipt of his letter dated 11 July 2000 on 13 July 2000 and requesting that any decision of the Tribunal be delayed until the Solicitors had the opportunity to respond to Mr. Hay’s letter. The author further indicated that he would respond in writing by “close of business tomorrow”. By letter dated 12 July 2000 which appears to have been faxed on 13 July 2000 the First Respondent wrote to the Applicant via her Solicitors advising that Mr. Hay had advised “that the Tribunal has met and concluded the investigation and has upheld the selection criteria as applied” by the First Respondent.

By letter dated 14 July 2000 the Applicant’s Solicitors wrote to the First Respondent and gave notice that pursuant to Clause 7.1(4) of the Agreement the Applicant wished to appeal to the Court of Arbitration for Sport.

By letter dated 19 July 2000 the Applicant’s Solicitors wrote to the Court of Arbitration for Sport enclosing an application form together with other relevant documentation.

The application form outlined the relief sought by the Applicant as being “an order nominating Rebecca Sullivan to the AOC for selection in an OJU place at the 27<sup>th</sup> Olympiad in the Women’s Judo under 52 kg weight division.”

Pursuant to the Order of Procedure, a copy of the Applicant’s Appeal Brief was served on the Third Party and she was invited to attend and participate in the proceedings and the hearing on Saturday 12 August 2000.

At the commencement of the hearing, the Applicant indicated to the Court that the sole ground to be relied upon was that the nomination criteria had not been properly followed and/or implemented and that if properly followed then the Applicant would have been the nominated athlete. The other ground which related to discretionary considerations was then abandoned.

Pursuant to the Order of Procedure the First Respondent was required to provide by 12pm on Tuesday 10<sup>th</sup> August 2000 the written statement of reasons of the First Respondent’s selection panel referred to in clause 7.1(3)(e) of the Agreement and the statement of reasons of the First Respondent’s Appeal Tribunal for its decision. Neither of these documents (if indeed they are in existence as appears unlikely) was supplied to the Applicant or the Court.

## LAW

1. At the hearing the sole Ground of Appeal was that on the true construction of the Agreement, the Nomination Criteria had not been properly followed and/or implemented. The Applicant submitted that the Nomination Criteria were inconsistent with the Participation Criteria and pursuant to clause 4.3 of the Agreement the Participation Criteria prevailed over the Nomination Criteria to the extent of the inconsistency.

2. The Applicant submitted that:

*“The inconsistency between the Participation criteria and the Nomination criteria lies in the different points awarded towards an Oceania Judo Union (“OJU”) place in the Olympics for an athlete who places ninth in the 1999 world championship. The participation criteria awarded 8 points to such an athlete; the nomination criteria only awarded 6 points”.*

The Applicant relied upon the fact that Rebecca Sullivan was placed 9<sup>th</sup> in the 1999 World Championships and therefore earned 8 points whilst Angela Raguz did not compete in those championships. Further points relied upon were that the Applicant was placed 7<sup>th</sup> in the 1999 USA Open and thereby earned 3 points; Angela Raguz was placed 5<sup>th</sup> in the 1999 USA Open and thereby earned 6 points. The Applicant was placed second in the 2000 OJU championships and thereby earned 12 points; Angela Raguz was placed first in the 2000 OJU championships and thereby earned 15 points. The Applicant submitted that she has, therefore, accrued 23 points and Angela Raguz has accrued only 21 points. The nomination of Angela Raguz had been based on Rebecca Sullivan only being credited with 6 points as a result of her 9<sup>th</sup> place at the 1999 World Championships.

3. The only issue for determination therefore on the appeal was the proper construction and effect of the Agreement. If the construction and effect contended for by the Applicant was correct then she would have accumulated 23 points and the Third Party 21 points and the Applicant should have been nominated. If the construction and effect contended for by the First Respondent was correct then both parties would have accumulated 21 points and as the Third Party achieved a higher place in the 2000 OJU Championships, the Third Party was correctly nominated.
4. The Court was not asked nor required to consider the respective abilities or performances of both athletes. All parties proceeded on the basis that both were suitable for nomination and no other athletes matched them in their division of the sport. The Court was not asked or required to make any evaluation of the merits or appropriateness of the selection system adopted by the First Respondent. No discretionary matters or subsequent circumstances were relied upon by any of the parties.
5. All parties proceeded on the basis that if the construction and effect of the Agreement contended for by the Applicant was correct then the Applicant should be nominated and if unsuccessful then the Third Party's nomination would stand. No party submitted that if the

appeal should be upheld then the issue of whom should be nominated should be remitted back to the First Respondent or its selection panel for further consideration. The sole issue for determination by the Court was thus the proper construction and effect of the Agreement.

6. It is necessary to consider in detail the terms of the Agreement and the various annexures which were attached to the Agreement when executed on 27 August 1999.
7. There are five Recitals to the Agreement. Recital D provides that:  
*“The AOC wishes to promote awareness and a clear understanding of its Selection Criteria throughout the Sport.”*
8. Recital E provides that:  
*“The NF desires to have certainty in the selection criteria for athletes and to ensure that its athletes and officials are aware and have a clear understanding of the manner by which it will decide to nominate Athletes and Officials to the AOC for selection in the Team.”*
9. Clause 1.1 of the Agreement defines certain terms. Amongst those terms are “Nomination Criteria”, “Participation Criteria” and “Selection Criteria”. The Nomination Criteria were included in Annexure C, the Participation Criteria included in Annexure A and the Selection Criteria included in Annexure B.
10. Clause 1.2(6) provides that:  
*“The Recitals to this Agreement are incorporated into the operative portion of this Agreement as if repeated in full.”*
11. The Agreement critically imposes on the First Respondent in clause 3.1 the obligation to *“abide by the Selection Criteria and this Agreement in nominating Athletes for selection as members of the Team”*. The essence of the case for the Applicant is that she would have been nominated had the First Respondent abided by the Selection Criteria and the Agreement.
12. Clauses 3.1 and 4.3 of the Agreement, collectively, provide that:
  - (a) the Participation Criteria will prevail over both the Selection Criteria and the Nomination Criteria (clauses 3.1 and 4.3); and
  - (b) the Selection Criteria will prevail over the Nomination Criteria (clause 4.3).
13. Clause 4.3 of the Agreement states:  
*“The NF will develop the Nomination Criteria no later than 12 months prior to the NF’s first nomination event for the Games, or as agreed with the AOC. The Nomination Criteria will be at all times subject to:*
  - (1) *the prior approval of the AOC;*
  - (2) *the Participation Criteria; and*
  - (3) *the Selection Criteria.*

*In the event that the Nomination Criteria are inconsistent in any way with the Participation Criteria and the Selection Criteria, the latter will prevail to the extent of that inconsistency.*

*Once the Nomination Criteria are so developed and approved, they will be deemed to be automatically incorporated into this Agreement as Annexure C and the NF will publish them to all persons to whom it has provided a copy of the Agreement”.*

14. Clause 4.4 of the Agreement ensures that the Nomination Criteria must be applied in a way to ensure that “*no Athlete is nominated to the AOC where another Athlete is, or other Athletes, are entitled to be nominated in priority*”.
15. Clause 8.3 and 8.4 of the Nomination Criteria (Annexure C of the Agreement) provide as follows:
  - 8.3 *To qualify for an OJU place, an athlete must comply with the selection criteria set out in Attachment 2. (OJU Olympic Selection System).*
  - 8.4 *Subject to clause 8.2 and 12, the NCC will nominate an athlete who has qualified for an OJU place, provided that athlete meets the preconditions for nomination set out in clause 11.”*

The Applicant submitted that as she qualified for an OJU place the First Respondent was obliged to nominate her and accordingly this court should substitute the Respondent’s decision.

16. The Respondents contended, supported by the Third Party, that as clause 7.1(2) states that the sole ground for an Appeal is that the Nomination Criteria have not been properly followed and/or implemented, the Applicant was restricted to a complaint about a breach of the words found in Annexure C, Nomination Criteria, as being the basis of the Appeal. The difficulty with this submission is that within the Annexure C itself there is an obligation in Clause 6.2.2 that in order to be selected athletes must satisfy the requirements in the Selection Criteria in Annexure B. It is a requirement of Clause 5(1)(a) of the Selection Criteria in Annexure B that the athlete “*must have met the Participation and Qualification Criteria*”. The language used both in the operative provisions of the Agreement and each of the Annexures makes it clear that they are interlinked and should be read together. It is the Court’s view that on the proper construction of the Agreement the ground for an Appeal should not be so restricted and that the Court is able to determine whether there has been a breach of the Nomination Criteria by reading the Agreement as a whole.
17. The first question which arises is whether any rights flow to potential Olympic Athletes pursuant to the Agreement. It is clear from Recital E quoted above that certainty in Selection Criteria for Athletes and the ensuring that Athletes are aware of the manner by which nominations will be decided are the objectives of the parties to the Agreement. As a matter of the ordinary and natural meaning of the language used in the Agreement the parties intended an immediate and clear benefit to accrue to those Athletes. This is reinforced by the fact that clause 2.4 of the Agreement provides that:

*“The NF will provide a copy of this Agreement to each member of the Shadow Team and all other individuals*

*and organisations with a legitimate interest in the selection procedures. The NF will, if requested by the AOC, provide that the AOC written acknowledgement from each such Athlete that the Athlete has read and is aware of this Agreement.”*

18. The Agreement defines the class of persons intended to be benefited by the Agreement. It is also reinforced by the definition of “Athlete” contained in Clause 1.1 of the Agreement which states:

*“means those athletes who participate in the sport and are registered members or recognised athletes of the N.F.”*

Further support is found in clause 11 of Annexure C (Nomination Criteria) which provides, inter alia, that in order for an Athlete to fulfil certain conditions prior to being considered for nomination, the Athlete must be a registered member of his or her State/Territory Judo Association which is a registered financial member of the First Respondent. In the opinion of the Court it is clear from the language used that the Agreement was intended to confer rights and legitimate expectations in relation to the Athletes in relation to whom it is directed from the time of its execution on 27 September 1999. It is clear that the Agreement including the Annexures form a comprehensive code in relation to the nomination and selection of Athletes, as defined, in the sport of Judo for the 2000 Olympic Games. The Agreement became the terms of reference for the Athletes and the Athletes by their participation in the selection events accepted and were entitled to rely upon the Agreement. We conclude that Athletes vying for selection in the 2000 Olympic Games Team in the sport of Judo have and at all times from 27 September 1999 have had a legitimate expectation that the provisions of the Agreement would be complied with.

19. The crucial question which then arises is whether the Respondents were required to apply the points table contained in Annexure A (which provided that 8 points would be provided for ninth place at the 1999 World Championships) or the points table contained in Annexure C (which provided that 6 points would be allocated for ninth placing at the 1999 World Championships). The terms of the Agreement and the Annexures provide a clear answer to this question. Where there is inconsistency then the provisions of Annexure A prevail over Annexure C, e.g. Clause 3.1, Clause 4.3 of the Agreement, Clause 1 and Clause 5(1)(a) of Annexure B and Clause 6.2.2 of Annexure C.
20. The Respondents sought support from evidence extraneous to the agreement notwithstanding that the Agreement contained an “entire agreement” clause in clause 9.1. This clause states that the “*Agreement contains the entire agreement between the parties*”. Any reliance on earlier discussions about a draft proposal is inconsistent with the terms and objects of the Agreement.
21. The evidence from the Respondent’s coaching director, who also held the position of technical director of the OJU, Mr. Peter Hermann, was that at a training camp held in late August 1999, the Applicant, together with other Athletes at the training camp was advised of a draft proposal to change the points table contained in Annexure A and to reduce the points

- allocated for ninth place at the 1999 World Championships from 8 points to 6 points. In order for that draft proposal to become effected, it was necessary for the Executive of the Oceania Judo Union to approve the proposal. The draft proposal and the eventual amendment after all the Selection Events had been completed had a long history.
22. At the Executive Meeting of the OJU on 22 January 1998, its executive adopted a 2000 Olympic Selection System which, inter alia, provided 8 points for ninth place at the 1999 World Championships. By letter dated 11 March 1999, Mr. Hermann in his capacity as Technical Director of the OJU wrote to the Executive and proposed some amendments which included an amendment to the points tables so that the points would be reduced from 8 points to 6 points. On 6 September 1999, the Secretary of the OJU distributed a copy of the proposed amended points system to the Presidents of the member countries although it was not incorporated in the Participation Criteria annexed as Annexure A to the Agreement when executed on 27 September 1999. The Agreement in Annexure A allocated 8 points for ninth place at the 1999 World Championships. Accordingly any prior inconsistent or informal discussion was in the circumstances irrelevant.
  23. Mr. Hermann stated that the Agreement including the Annexures thereto were forwarded to the Athletes, Coaches and Officials shortly after execution by the First Respondent but as the whole Judo Team was overseas at the time with most of the Athletes, Coaches and Officials returning to Australia at the end of October/November 1999, those Athletes, Coaches and Officials would not have received the document until after their return. Some time in late November 1999 Mr. Hermann was advised by the Judo Section Manager that there was an inconsistency between the points table of the Oceania Judo Union and that of the International Judo Federation. The Third Party had queried the inconsistency with him, together with another Athlete. Mr. Hermann wrote a letter dated 6 December 1999 to the Sports Director of the International Judo Federation advising of the inconsistency. The Sports Director of the International Judo Federation was confused and sought clarification in relation to the proposed amendment and by letter dated 17 December 1999 Mr. Hermann wrote to him and provided further information. Some delay then ensued.
  24. It was not until 3 March 2000 that the International Judo Federation sent the proposed changes to the Oceania Judo Union qualification system and sought verification from Mr. Hermann that it was appropriate to seek confirmation with the International Olympic Committee. Mr. Hermann replied on 8 March 2000 confirming that the draft proposal be processed. On 23 March 2000 the IOC wrote to the National Olympic Committees of Oceania and advised them that an amendment had been made to the Oceania Judo Union qualification procedure for the Sydney 2000 Olympic Games. The result was a purported amendment to the qualification system by a change to the points awarded for a ninth placing at the 1999 World Championships from 8 points to 6 points.
  25. By letter dated 14 March 2000, however, Peter Hermann as Technical Director of the OJU, wrote to the General Secretary of the Union setting out the final ranking for the 2000 Olympic Games of the OJU Athletes to be recommended for selection and in so doing

applied the proposed amendment to the points retrospectively system which gave the Third Party 21 points and the Applicant 21 points but ranked the Third Party ahead of the Applicant in accordance with the term of the Agreement which gave priority to that Athlete who achieved a higher place at the 2000 OJU Championships.

26. The Applicant relied upon Clause 5 under the heading "Oceania Judo Union" of Annexure A as emphasising the fact that when the points are gained by Athletes at the various competitions, the allocations occur at that time and not at a later time. Furthermore, if this was permissible it would produce the anomalous result that allocated points could be taken away from the Athlete after all the selection events have been completed. Clause 5 of Annexure A provides that the OJU points system will be the basis used by the Oceania Judo Union to recommend their representatives for the 2000 Olympic Games selection. Subclauses provide, *inter alia*, that points would be allocated for Athletes of all OJU member countries, points gained by Athletes "will be allocated at all selected Olympic selection events" (clause 5.1.3), points allocated at the 2000 Olympic selection will be constantly scrutinised by the OJU Technical Director or his delegate and confirmation of points claimed must be provided to the Technical Director by the President of the member country by supplying copies of the relevant draw sheets pertaining to each Athlete. At all material times the Technical Director was Peter Hermann.
27. The Respondents, supported by the Third Party, relied substantially upon the meaning of the phrase "Participation Criteria" contained in clause 1.1 of the Agreement. That clause defines that phrase as meaning "the Participation and Qualification Criteria for the Games for Athletes determined from time to time by the IF and the IOC and attached as Annexure A". The Respondents contended that the definition makes clear that the Participation Criteria as at the time of entry into the Agreement may change from time to time and that by the time the Nomination Criteria came to be developed and formulated the Participation Criteria had in fact changed by reducing the number of points to be allocated for ninth placing from 8 points to 6 points. This was so, it was contended, because at the time of the decision of the First Respondent to nominate its Athletes to the AOC, namely in May 2000, the points table contained within the Participation Criteria had in fact been amended. Thus the Respondents submitted the change to the number of points to be awarded even though made after all the selection events had been held was merely the result of the exercise of a right or power in the Agreement itself.
28. The Court finds that whatever may have been the subjective intention of the First Respondent in pursuing a change to the relevant points table the proposed change was not effective until after the three selection events had taken place. The language used in the Agreement and in the Annexures required action to be taken in relation to the points accrued at the 1999 World Championships. Any power to amend must be subject to a limitation that it could not be exercised retrospectively once that "allocation" had been made and once it had been scrutinised and confirmed. Furthermore no indication in writing had been given by the First Respondent to any of the potential Olympic nominees for selection that the points table was proposed to be changed prior to the change occurring.



29. The Court finds that in the particular circumstances of this case, all Athletes had a legitimate expectation that the issue of the nomination to the AOC would be governed by the documentation existing on 27 September 1999 which had not been amended prior to the selection decision by the Oceania Judo Union. The documentation as at that date, as it had at all times from 27 September 1999, objectively assured the Athletes that there would be awarded 8 points for a placing of ninth in the 1999 World Championships.
30. The Court concludes that as a matter of the proper construction of the Agreement, the Nomination Criteria were not properly followed and/or implemented in that they required the points table contained in Annexure A which remained in its unamended form until 23 March 2000 to be applied in the nomination by the First Respondent of Athletes to the AOC for selection for the 2000 Olympic Games Australian Judo Team.
31. Accordingly, the Court upholds the Appeal of the Applicant and orders that First Respondent nominate to the AOC the Applicant in substitution for the Third Party.
32. The Panel finds that the Second Respondent conducted a procedurally flawed appeal process. The Applicant was never given a statement of reasons by the selectors, as contemplated by the Agreement, nor any associated documentation or a proper chance to be heard, although she had notified the First Respondent of her concern at the selection processes as far back as 17 March 2000.
33. As a result of a determination of the Respondents not to consider her various complaints at the various stages, the other parties and the Court have been drawn into a full appeal on 12 August 2000. The Third Party has been led to believe from a March 2000 meeting of the proposed members of the Olympic Team that she was to be the nominated Athlete. For some five months she has held a belief that she would represent Australia and compete in the 2000 Olympic Games. This is a matter of grave concern. Responsibility for this is solely due to the actions and inactions of the Respondents.

**The Court of Arbitration for Sport hereby rules :**

1. The appeal is upheld and the decision of the Judo Federation of Australia Inc to nominate Angela Raguz to the Australian Olympic Committee for selection in the Women's Under 52-kilogram Division is set aside.
2. The Judo Federation of Australia Inc is directed to forthwith advise the Australian Olympic Committee that its nomination of Angela Raguz is withdrawn and substituted by the nomination of Rebecca Sullivan.

3. The award setting forth the results of the proceedings shall be made public unless all parties agree.

(...)

## **LEGAL AUTHORITY CA-103**

**UNCITRAL Arbitration Proceedings  
CME Czech Republic B.V. (The Netherlands)**

vs.

**The Czech Republic**

**PARTIAL AWARD**

We hereby certify this  
to be a true copy of the  
original.

Signed *Clifford Chance*

Clifford Chance  
Limited Liability Partnership

200 Aldersgate Street

London

EC1A 4JJ

issued in Stockholm, Sweden, on September 13, 2001 in the UNCITRAL  
Arbitration Proceedings

between

CLAIMANT: CME Czech Republic B.V., Hoogoorddreef 9, 1101 BA Am-  
sterdam Zuid-Oost, The Netherlands (hereinafter referred  
to as "CME") represented by:

Mr. John S. Kiernan and Mr. Michael M. Ostrove, De-  
bevoise & Plimpton, 875 Third Avenue, New York, New  
York 10022, U.S.A.

and

RESPONDENT: The Czech Republic

represented by the Minister of Finance of the Czech Re-  
public Mr. Jiří Rusnoki, Ministry of Finance, Letenzka 15,  
11810 Prague 1, The Czech Republic represented by:  
Mr. Jeremy Carver and Mr. Audley Sheppard, Clifford  
Chance, 200 Aldersgate Street, London EC1A 4JJ and  
Mr. Vladimír Petrus and Mr. Miroslav Dubovský, Clifford  
Chance Pünder, Charles Bridge Center, Křižovnické  
nám. 2, 110 00 Prague 1, Czech Republic

BEFORE: Dr. Wolfgang Kühn, Düsseldorf, Chairman,  
Judge Stephen M. Schwebel, Washington D.C., Arbitrator,  
JUDr. Jaroslav Hándl, Prague, Arbitrator

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A.

**Background of the Dispute**

**(1) The Parties**

1. The Claimant CME Czech Republic B.V. is a corporation organized under the laws of the Netherlands. The Respondent, the Czech Republic, is a sovereign governmental entity, represented in these proceedings by its Ministry of Finance.

**(2) The UNCITRAL Arbitration Proceedings**

2. CME Czech Republic B.V. (CME) initiated these arbitration proceedings on February 22, 2000 by notice of arbitration against the Czech Republic pursuant to Art. 3 of the Arbitration Rules of the United Nations Commission on International Trade Law (UNCITRAL).

**(3) The Netherlands / Czech Republic Bilateral Investment Treaty**

3. CME brought this arbitration as a result of alleged actions and inactions and omissions by the Czech Republic claimed to be in breach of the Agreement on Encouragement and Reciprocal Protection of Investments between the Kingdom of the Netherlands and the Czech and Slovak Federal Republic, executed on April 29, 1991 (hereinafter: "the Treaty"). The Treaty entered into force in the Czech and Slovak Federal Republic on October 1, 1992 and, after the Czech and Slovak Federal Republic ceased to exist on December 31, 1992, the Czech Republic succeeded to the rights and obligations of the Czech and Slovak Federal Republic under the Treaty.

**(4) CME's "investments" under the Treaty**

4. CME holds a 99 % equity interest in Česká Nezávislá Televizní Společnost, spol. s r.o. ("ČNTS"), a Czech television services company. CME maintains that, among other things, CME's ownership interest in ČNTS and its indirect ownership of ČNTS' assets qualify as "investments" pursuant to Art. 1 (a) of the Treaty. CME and these investments, therefore, are thereby entitled to the protection and benefits of the Treaty.



**(5) CME's shareholding**

5. CME acquired its 99 % ownership interest in ČNTS in steps. It acquired 5.8 % shares in 1997 by purchasing the Czech holding company NOVA Consulting, which owned these shares, and by purchasing, in May 1997, 93.2 % from CME's affiliated company, CME Media Enterprises B.V., which, in turn, in 1996 had acquired 22 % of the shares in ČNTS from the Česká Spořitelna a.s. (Czech Savings Bank) and 5.2 % from CET 21 Spol. s r.o. (CET 21).
6. Earlier, in 1994, CME Media Enterprises B.V. had acquired a 66 % shareholding in ČNTS from the Central European Development Corporation GmbH ("CEDC"), a German company under the same ultimate control as CME and CME Media Enterprises B.V. of an American corporation in turn controlled by Mr. Ronald S. Lauder, an American businessman with domicile in the United States of America.
7. CEDC (with a share of 66 %), CET 21 (with a share of 21 %) and the Czech Savings Bank (with a share of 22 %) were co-founders of ČNTS, formed as a joint venture company in 1993 with the object of providing broadcasting services to CET 21.

**(6) The Broadcasting Licence**

8. CME's investments (its ownership interest in ČNTS and its indirect ownership of ČNTS' assets) are related to a Licence for television broadcasting granted by the Czech Media Council, empowered to issue licences by the Czech Republic's Act on the Operation of Radio and Television Broadcasting, adopted on October 30, 1991, Act No. 468/1991 Coll. (hereinafter, the "Media Law"). This Licence was granted to CET 21, acting in conjunction inter alia with CEDC, for the purpose of the acquisition and use of the Licence for broadcasting throughout the Czech Republic. CME's and its predecessors' investments in this joint venture, inter alia between CEDC and CET 21, are the object of the dispute between the parties.
9. In late 1992 and early 1993, CEDC, on the invitation of CET 21, which was owned by five Czech nationals and advised by Dr. Vladimír Železný, a Czech national, participated in negotiations with the Czech Media Council (hereinafter: "the Council") with the goal of the issuance of the Broad-

casting Licence to CET 21 with a participation therein, either directly or indirectly, by CEDC.

10. The Council issued the Licence to CET 21 on February 9, 1993 to operate the first nation-wide private television station in the Czech Republic. The decision granting the Licence acknowledged CEDC's "substantial involvement of foreign capital necessary to begin television station activities" and the conditions attached to the Licence acknowledged CEDC's partnership with the holder of the Licence, CET 21.

#### **(7) The Formation of ČNTS**

11. Instead of CEDC taking a direct share in CET 21 (as initially contemplated), and instead of a license being issued jointly to CET 21 and CEDC (also so contemplated), the partners of CET 21 and Dr. Železný agreed with CEDC and the Media Council to establish CEDC's participation in the form of a joint venture, ČNTS. The Media Council was of the view that such an arrangement would be more acceptable to Czech Parliamentary and public opinion than one that accorded foreign capital a direct ownership or licensee interest.

#### **(8) The ČNTS Memorandum of Association**

12. The Memorandum of Association was made part of the Licence Conditions, defining the co-operation between CET 21 as the licence holder and ČNTS as the operator of the broadcasting station. CET 21 contributed to ČNTS the right to use the Licence "unconditionally, unequivocally and on an exclusive basis" and obtained its 12 % ownership interest in ČNTS in return for this contribution in kind. Dr. Železný served as the general director and chief executive of ČNTS and as a general director of CET 21. ČNTS' Memorandum of Association ("MOA") was approved by the Council on April 20, 1993 and, in February 1994, ČNTS and CET 21 began broadcasting under the Licence through their newly-created medium, the broadcasting station TV NOVA.

#### **(9) ČNTS' Broadcasting Services**

13. ČNTS provided all broadcasting services, including the acquisition and production of programs and the sale of advertising time to CET 21, which acted only as the licence holder. In that capacity, CET 21 maintained liaison with the Media Council. It was CET 21 that appeared before the Me-

dia Council, not CME, though Dr. Železný's dual directorships of CET 21 and ČNTS did not lend themselves to clear lines of authority.

**(10) TV NOVA's success**

14. TV NOVA became the Czech Republic's most popular and successful television station with an audience share of more than 50 % with US \$109 million revenues and US \$ 30 million net income in 1998. CME claims to have invested totally an amount of US \$ 140 million, including the afore-mentioned share purchase transactions for the acquisition of the 99 % shareholding in ČNTS, by 1997. The audience share, the revenues and amount of the investment are disputed by the Respondent.

**(11) The Change of Media Law**

15. As of January 1, 1996, the Media Law was changed. According to the new Media Law, licence holders were entitled to request the waiver of licence conditions (and Media Council regulations imposed in pursuance of those conditions) related to non-programming. Most of the licence holders applied for this waiver, including CET 21, with the consequence that the Media Council lost its strongest tool to monitor and direct the licence holders.

**(12) The Amendment of the Memorandum of Association**

16. As a consequence of certain inter-actions between the Media Council and CET 21, including ČNTS, the shareholders of ČNTS in 1996 agreed to change ČNTS' Memorandum of Association and replaced CET 21 's contribution "Use of the Licence" by „Use of the Know-how of the Licence“. The circumstances, reasons and events related to, and the commercial and legal effects deriving from? this change are in dispute between the parties. In conjunction with the change of the contribution of the use of the Licence, CET 21 and ČNTS entered into a Service Agreement. That Agreement thereafter was the basis for the broadcasting services provided by ČNTS to CET 21 for operating TV NOVA.

**(13) The 1999 Events**

17. In 1999, after communications between the Media Council and Dr. Železný, the character and the legal impact of these communications being in dispute between the parties, CET 21 terminated the Service Agreement on August 5, 1999 for what it maintains was good cause.

18. The reason given for this termination was the non-delivery of the day-log by ČNTS to CET 21 on August 4, 1999 for the following day. CET 21 thereafter replaced ČNTS as service provider and operator of broadcasting services by other service providers, with the consequence that ČNTS' broadcasting services became idle and, according to CME, ČNTS' business was totally destroyed.

**(14) The Prague Civil Court proceedings**

19. ČNTS sued CET 21 for having terminated the Service Agreement without cause. The Prague District Court on May 4, 2000 judged that the termination was void, the Court of Appeal, however, confirmed the validity of the termination, and the Czech Supreme Court decision was still pending when these arbitration proceedings were closed.

**(15) CME's Allegations**

20. CME claims that ČNTS, the most successful Czech private broadcasting station operator with annual net income of roughly US \$ 30 million, has been commercially destroyed by the actions and omissions attributed to the Media Council, an organ of the Czech Republic.
21. CME claims, inter alia, that an already signed Merger and Acquisition Agreement between CME's interim parent company and the Scandinavian broadcaster and investor SBS was vitiated by these actions and omissions of the Media Council. CME accordingly suffered damage in the amount of US \$ 500 million, which was the value allocated by that Agreement and by the joint venture partners to ČNTS in 1999 before the disruption of the legal and commercial status of ČNTS as a consequence of the Media Council's actions and omissions.
22. The Czech Republic strongly disputes this contention and the purported underlying facts, maintaining that, inter alia, the loss of investment (if any) is the consequence of commercial failures and misjudgments of CME and, in any event, that CME's claim is part of a commercial dispute between ČNTS and Dr. Železný, for which the protection of the Treaty is not available.

**(16) Investment Dispute and Breach of Treaty**

23. CME contends that the dispute between the parties is a dispute “between one Contracting Party and an investor of the other Contracting Party concerning an investment of the latter” as defined by Art. 8 (1) of the Treaty. As such, it is the position of CME that the dispute is subject to Arbitration pursuant to Art. 8 (2) through 8 (7) of the Treaty.
24. CME alleges that the Czech Republic has breached each of the following provisions of the Treaty:
- (a) *“Each Contracting Party shall ensure fair and equitable treatment to the investments of investors of the other Contracting Party and shall not impair, by unreasonable or discriminatory measures, the operation, management, maintenance, use, enjoyment or disposal thereof by those investors” (Art. 3 (1));*
  - (b) *“... each Contracting Party shall accord to [the investments of investors of the other Contracting Party] full security and protection which in any case shall not be less than that accorded either to investments of its own investors or to investments of investors of any third State, whichever is more favourable to the investor concerned” (Art. 3 (2)); and*
  - (c) *“Neither Contracting Party shall take any measures depriving, directly or indirectly, investors of the other Contracting Party of their investments unless the following conditions are complied with:*
    - a) the measures are taken in the public interest and under due process of law;*
    - b) the measures are not discriminatory;*
    - c) the measures are accompanied by provision for the payment of just compensation” (Art. 5).*

**B.**

**Relief Sought**

25. In its Notice of Arbitration, CME *“requested the Tribunal to provide a relief necessary to restore ČNTS’ exclusive rights to provide broadcasting services for TV NOVA and thereby restore to CME the economic benefit available under the arrangement initially approved by the Council” (restitutio in integrum)*. During the proceedings, CME changed the Relief Sought and requested the Tribunal to give the following Relief to the Claimant. Both

parties instructed the Tribunal that, if damages are to be awarded, the Tribunal shall not decide on the quantum at this stage of the proceedings.

**(1) Relief Sought by CME Czech Republic B.V.**

26. Claimant seeks an award:

1. Deciding Respondent has violated the following provisions of the Treaty:
  - a) The obligation of fair and equitable treatment (Art. 3 (1));
  - b) The obligation not to impair the operation, management, maintenance, use, enjoyment or disposal of investments by unreasonable or discriminatory measures (Article 3 (1));
  - c) The obligation of full security and protection (Art. 3 (2)); and
  - d) The obligation to treat investments at least in conformity with the rules of international law (Art. 3 (5)); and
  - e) The obligation not to deprive Claimant of its investment by direct or indirect measures (Art. 5); and
2. Declaring that Respondent is obliged to remedy the injury that Claimant suffered as a result of Respondent's violations of the Treaty by payment of the fair market value of Claimant's investment in an amount to be determined at a second phase of this arbitration;
3. Declaring the Respondent is liable for the costs that Claimant has incurred in these proceedings to date, including the costs of legal representation and assistance.

27. Claimant confirms that it has withdrawn its request for the remedy of *restitutio in in tegrum*.

28. The Respondent sought the following Relief:

**(2) Relief Sought by the Czech Republic**

29. The Czech Republic seeks an award that:

- (1) CME's claim be dismissed as an abuse of process.
- (2) And/or CME's claim be dismissed on grounds that the Czech Republic did not violate the following provisions of the Treaty as alleged (or at all):
  - (a) The obligation of fair and equitable treatment of investments (Art. 3 (1)).
  - (b) The obligation not to impair investments by unreasonable or discriminatory measures (Art. 3 (1)).
  - (c) The obligation to accord full security and protection to investments (Art. 3 (2)).
  - (d) The obligation to treat investments in accordance with the standard of international law (Art. 3 (5)).
  - (e) The obligation to not deprive investors directly or indirectly of their investments (Art. 5).
- (3) And/or CME's claim be dismissed and/or CME is not entitled to damages, on grounds that alleged injury to CME's investment was not the direct and foreseeable result of any violation of the Treaty.
- (4) And CME pay the costs of the proceedings and reimburse the reasonable legal and other costs of the Czech Republic.

**C.**

**Procedure**

**(1) Initiation and Conduct of Proceedings**

30. After having initiated the arbitration proceedings, the Claimant appointed Judge Stephen M. Schwebel, Washington, and the Respondent JUDr. Jaroslav Hándl, Prague, as party-appointed arbitrators. Both arbitrators appointed Dr. Wolfgang Kühn, Düsseldorf, as Chairman of the Arbitral Tribunal on July 19, 2000, which appointment was accepted by the Chairman on July 21, 2000.

31. On August 4, 2000 the Tribunal issued a Procedural Order No. 1 setting dates for the parties for the Statement of Claim and the Statement of De-

fence, in accordance with Art. 23 of the UNCITRAL Arbitration Rules. The Tribunal requested the parties to annex to their statements the documents that the parties deemed relevant.

32. In accordance with Art. 17 of the UNCITRAL Rules, the Tribunal determined the language to be used in the proceedings to be English and instructed the parties that any documents annexed to the Statement of Claim or Statement of Defence and any supplementary documents or exhibits submitted in the course of the proceedings, delivered in their original language, shall be accompanied by a translation into English.
33. In accordance with Art. 16 of the UNCITRAL Rules, the place of arbitration was determined to be Stockholm. The Tribunal convened a meeting with counsel of the parties on November 17, 2000 in Stockholm in order to discuss further conduct of the proceedings and the parties were invited to give a short presentation of their case. The Tribunal also made a proposal with respect to the Arbitrators' fees.
34. The Claimant by letter dated August 10, 2000 accepted the Tribunal's proposal in respect to costs and fees, whereas no answer was received from the Respondent within the specified time. The Tribunal therefore informed the parties by letter dated September 5, 2000 that the Tribunal will proceed on the basis that the parties accept the Tribunal's proposal in Order No. 1 dated August 4, 2000. By letter dated September 25, 2000 the Respondent requested that the whole amount of the costs for the arbitration should be borne by the Claimant and therefore declined to pay the advance payment, which was requested by the Tribunal by Order No. 2.
35. On September 22, 2000 the Claimant submitted its Statement of Claim including exhibits, declarations and authorities. The Claimant made the required deposits for costs. By Order No. 3 the Tribunal requested the Claimant to make the required payment not made by the Respondent, which the Claimant did.
36. By Court Order No. 4 dated October 24, 2000 the Tribunal changed the place of the hearing on November 17, 2000, due to accommodation problems in Stockholm, to Dusseldorf. The change of the place for the hearing



did not change the seat of the arbitration, which still was denominated to be Stockholm.

37. On November 9, 2000 the Respondent submitted its Statement of Defence including witness statements, exhibits and authorities. In its Statement of Defence the Respondent raised, inter alia, the defence of jurisdiction stating that the Tribunal lacks jurisdiction, or, in the alternative, CME's claim is inadmissible.
38. On November 14, 2000 the Claimant submitted a Request for Production of Documents describing the requested documents broadly as Media Council's records related to the grant of the Licence to CET 21, the operation of TV NOVA, the administrative proceedings initiated by the Media Council against ČNTS in 1996 and the correspondence between the Media Council and CET 21, Dr. Železný, CME or ČNTS, including internal minutes for 1998, 1999 and 2000.
39. On November 16, 2000 the Respondent requested the Tribunal to refuse the Claimant's Request for Production of Documents as being too broad and unsubstantiated and, therefore, not in compliance with the International Bar Association Rules on Taking Evidence in International Commercial Arbitration adopted on June 1, 1999 ("IBA Rules").

## **(2) The Procedural Hearing**

40. For the hearing of November 17, 2000, the parties jointly submitted an agenda. Under the first topic, CME suggested the co-ordination of these arbitration proceedings with the so-called *Lauder vs. the Czech Republic* arbitration proceedings. In the *Lauder vs. the Czech Republic* proceedings, the ultimate majority shareholder of CME advanced similar claims in a pending UNCITRAL Arbitration brought against the Czech Republic under a bilateral investment treaty between the United States of America and the Czech Republic. The Tribunal did not take a decision on co-ordination because the parties did not agree to co-ordination.
41. The Claimant's proposal to have the two proceedings inter-linked in their timing was not pursued because the parties were in disagreement.

42. In respect to jurisdiction, the Respondent requested that the Tribunal should hold summary threshold proceedings whereas the Claimant's position was that the jurisdictional issues should be considered in conjunction with the hearing of the merits after the Claimant's Reply Memorial, the Respondent's Sur-Reply and the issues (in substance) had been fully presented.
43. In respect to this and other procedural issues the Tribunal, on November 17,2000, issued Order No. 5.
44. The Tribunal decided that at this point of time no hearing on jurisdiction or the admissibility of the claim was to be held.
45. In respect to Procedures for Taking Evidence, the parties proposed to apply the IBA Rules except as follows:
  - (i) In interpreting Article 4 (7 and 8), the Arbitral Tribunal can decide, taking into consideration all circumstances, whether to accept or disregard a witness statement if the witness does not appear. The Arbitral Tribunal additionally can decide whether it wants to hear testimony from all witnesses who have previously submitted a witness statement, or only testimony from certain witnesses.*
  - (ii) The Claimant did not agree to the adoption of Article 3 (2-7) (relating to requests to produce documents) or Article 3 (12) (relating to confidentiality of documents produced by a party). The Respondent, however, invited the Tribunal to adopt these articles.*
  - (iii) The parties jointly agreed that witness statements and testimony provided in the arbitration between Mr. Lauder and the Czech Republic may be referred to in this arbitration."*
46. In accordance with Art. 15.1 of the UNCITRAL Arbitration Rules, the Tribunal decided to conduct the arbitration in the manner it considers appropriate. For this purpose, the Tribunal decided, to the extent appropriate, to apply the IBA Rules.
47. In respect to the production of documents the Tribunal decided that the Claimant's Request for the Production of Documents dated November 14,2000 was not in accordance with the IBA Rules. The Tribunal, by

Order No. 5, instructed the Claimant and the Respondent to submit detailed requests for the production of documents, such documents to be produced in their original language and to be accompanied by an English translation.

- 4%. In respect to the Determination of the Amount of Any Damage Award, the parties jointly informed the Tribunal that they were in agreement that the hearing on the merits should be devoted to resolving issues of liability and the appropriate form of remedy. If the determination of a quantum of monetary damages was necessary - for example, because the Arbitral Tribunal were to order a remedy referred to in § 111 or § 112 of Claimant's Statement of Claim - that quantum should be established in further proceedings, so that the briefs and witness statements will not at this stage deal with the amount of monetary damages.
49. In respect to Confidentiality, the parties informed the Arbitral Tribunal that they were in agreement that these proceedings should not be open to the public; however, the parties indicated that they were in disagreement as to whether they are required to keep the submissions in the proceedings confidential. The Arbitral Tribunal did not comment on this subject.
50. Further, in accordance with the joint proposals of the parties, the Tribunal set dates for further submissions by the parties, for the Claimant for its "Reply" and for the Defendant for its "Sur-Reply", final witness statements to be filed and served by a set date thereafter. Further, the Tribunal set a date for a hearing from April 23, 2001 to May 2, 2001 and reconfirmed the legal seat of the arbitration as Stockholm.
51. The parties complied with the dates set. The Chairman submitted its Reply Memorial on December 22, 2000 and the Respondent its Sur-Reply on February 14, 2001.

### **(3) The Parties' Request for Production of Documents**

52. The Claimant submitted its Request for Production of Documents on December 1, 2000 invoking the Tribunal's procedural Order No. 5 and Art. 3 (3) of the IBA Rules. The Claimant requested the production of documents related to specific Media Council files related to the Licence, comprising 18 specifically described documents. The Claimant further re-

requested the production of six further categories of documents related inter alia to CET 21. These categories of documents were all defined either by dates or by specific file numbers of the Media Council. Further, the Claimant asked for the production of eleven specific documents identified by date and a further description. The Claimant gave reasons in respect to relevance and materiality and also in respect to the possession of the documents.

53. By Order No. 6 dated December 22, 2000, the Tribunal by majority-decision instructed the Respondent to produce the documents requested by the Claimant, however deleting certain documents from the list which were already in the possession of the Claimant, and further deleting a statement of the chief of the legal department of the Media Council dated July 22, 1996, which statement might have a status of privilege or confidentiality.
54. On February 14, 2001 the Tribunal issued Order No. 7 on costs and proceedings. The Tribunal set the date for the hearing beginning on April 23, 2001 in Stockholm and set out a time schedule for the hearings.

#### **(4) The Parties' Request for Interim Remedies or Similar Orders**

55. By submission dated January 30, 2001, the Respondent notified to the Tribunal "that the Respondent has been provided with copies of documents which indicate that Mr. Lauder/CME has been spying on the Media Council, immediately prior to this arbitration being commenced, if not earlier." The Respondent requested the Tribunal to issue an Order that Mr. Lauder/CME disclose immediately all copies of communications related to the Media Council, which have been provided by a source within the Media Council, copies of all communications from a certain investigation agency, copies of CME's instructions to this agency and further to order that Mr. Lauder/CME identify the name of the person(s) who has/have provided any communications referred to herein-above to the investigation agency. By a submission dated February 6, 2001, the Respondent extended the request for an Order and further requested the Tribunal to order that CME shall identify any other person(s) in Czech Government Departments who has/have provided, directly or indirectly, any communications of a similar nature to the investigation agency and/or CME.

56. Further, the Respondent requested permission from the Tribunal to apply for an order securing the attendance before the Tribunal of a certain employee of the investigation agency in order to give oral testimony and to produce documents (pursuant to Section 43 of the English Arbitration Act 1996).
57. By submission dated February 11, 2001, the Respondent extended its previous submissions and requested permission to subpoena the already mentioned employee of the investigation agency under Section 43 of the English Arbitration Act, should the Tribunal decide to hold a hearing in England and repeated the request under Section 26 of the Swedish Arbitration Act and Section 1050 of the German Arbitration Act.
58. By submission dated February 12, 2001, the Respondent requested the Tribunal to issue an Order that the Claimant produce the following documents:
- (1) All pleadings, submissions and evidence submitted by ČNTS in the Czech Court proceedings between ČNTS and CET 21, including both, the Prague Regional Court and Prague Czech Supreme Court (i.e. Appeal Court) proceedings.
  - (2) All pleadings, submissions and evidence submitted by CME Media Enterprises B.V. in the ICC Arbitration proceedings between CME and Dr. Železný. The Respondent stated that the requested documents are relevant to the present Arbitration proceedings.
59. By submission dated February 27, 2001, the Respondent notified to the Tribunal that, after having received from the Czech Civil Court copies of the Court file in the proceedings between ČNTS and CET 21, the request for the production of the respective documents was withdrawn, whereas the Respondent maintained its request for all pleadings, submissions and evidence "submitted by CME Media Enterprises B.V." in the proceedings against Dr. Železný.
60. On the same day, the Respondent reconfirmed that it maintains its position that it should not have to pay for parallel arbitrations brought, in effect, by the same Claimant.

61. By submission dated February 2, 2001 and submissions thereafter, the Claimant rejected the Respondent's request for an Order and accused the Respondent of unlawful use of stolen confidential documents, which allegedly had been taken from CME's offices in London in breach of English law. The Claimant requested the Tribunal to issue an Order that the Respondent be directed to cease its review of stolen CME documents and confidential CME arbitration records that have been improperly provided to it by Dr. Železný or its representatives.
62. Further, the Claimant demanded that Respondent's request for the Orders related to further information be denied and that Respondent's request for permission to subpoena an employee of the investigation agency be rejected.
63. By submission dated February 26, 2001, the Claimant further made the argument that the Respondent's request for disclosure of documents was untimely, as the subject was already substantially discussed between the parties six months prior to the first hearing of these proceedings. The Claimant further took the position that the pleadings and documents of the CME v. Železný ICC proceedings are irrelevant for this Arbitration.

**(5) The Tribunal's Decision on Interim Remedies and Similar Orders**

64. On March 3, 2001 the Arbitral Tribunal decided not to take a decision on Interim Remedies or similar Orders at the present time. The Tribunal issued the following Order No. 8 on Interim Remedies or similar Orders:
  1. *The Tribunal rejects the Respondent's request that the Tribunal order the Claimant*
    - I. *to disclose*
      - (a) *Copies of all communications relating to the Media Council which have been provided by a source within the Media Council, including any reports of the Council's meetings;*
      - (b) *copies of all communications from Kroll to CME, relating to (a) above; and*
      - (c) *a copy of CME's instructions to Kroll.*
    - II. *to identify the name of the person(s) who has/have provided any communications referred to in (a) above to Kroll and the "intermediary" between Kroll and the informant;*

- III. *to identify any other person(s) in Czech government departments who has/have provided, direct/y or indirectly, any communications of a similar nature to Kroll and/or CME.*

*The request by the Respondent for the arbitrators' consent under Section 26 of the Swedish Arbitration Act of 1999 and/or other national laws to have Mr. Morgan-Jones testify before the respective countries' civil courts is rejected.*

*The Claimant's request dated February 8, 2001 that the Respondent to be directed "to cease its review of stolen CME documents and confidential CME arbitration records that have been improperly provided to it by Dr. Železný or its representative" is rejected.*

*The Tribunal is of the opinion that any flow of information between the Media Council and the Claimant and/or its intermediaries and its usage as alleged by the Respondent, and any flow of information from the Claimant to the Respondent and its usage as alleged by the Claimant are not subject of these proceedings and the respective Claimant's and Respondent's requests should be addressed to the appropriate authorities / courts of the countries involved.*

2. *In respect to the Respondent's request regarding the disclosure by the Claimant of all pleadings, submissions and evidence submitted by CME Media Enterprises B.V. in the ICC Arbitration Proceedings between CME Media Enterprises B.V. and Dr. Železný, the Tribunal is not in a position to order the requested discovery, as the Parties of the ICC Arbitration Proceedings are different from the Parties to these proceedings. The Tribunal understands, however, that the ICC Award of the afore-mentioned proceedings was published on the internet on the CME pages. The Arbitral Tribunal, therefore, instructs the Claimant to submit as soon as possible to the Arbitral Tribunal and to the Respondent the ICC Award to the extent available to the public on the internet. The Tribunal assumes that the Respondent's demand for disclosure of the ICC proceeding will be sufficiently met by the disclosure of the ICC Award.*

#### **(6) Further Conduct of Proceedings**

65. The Claimant in accordance with Order No. 8 submitted to the Tribunal the ICC Award CME Media Enterprises B.V. vs. Dr. Železný
66. By submission dated March 14, 2001 and upon receipt of Order No. 8 dated March 6, 2001 the Respondent maintained its position in respect to the Court Order requested and declared:

*“The Czech Republic continues to participate in this Arbitration under protest and reserves all its rights, in particular its rights under Swedish Arbitration Act, Art. V (2) (b) of the New York Convention 1958 and principles of public policy generally.”*

67. On March 19, 2001 the Respondent declared that without prejudice to its position that it should not have to pay for two parallel arbitrations brought in effect, by the same Claimant; and without prejudice to its protest communicated in its fax of March 14, 2001 the Czech Republic is willing to pay the requested down payment for costs of the Stockholm hearing.
68. Thereinafter the Respondent complied with further Tribunal's request for down payments of costs equally with the Claimant.
69. On April 16, 2001 the Claimant as requested by the Chairman submitted a chronological list of the executives of ČNTS, CEDC/CME and CET 21 and a diagram showing the sequence of shareholdings in ČNTS, including the dates of the share transfer and enclosed a similar diagram showing the sequence of shareholdings in CET 21.

#### **(7) The Submission of Witness Statements**

70. In conjunction with their submissions, the parties have submitted to the Tribunal the following witness statements:

#### **(8) Declarations in Support of the Statement of Claim**

1. Declaration of Richard Bacek dated 22 September 2000 (without attachments)
2. Declaration of Laura DeBruce dated 22 September 2000
3. Declaration of Michel Delloye dated 20 September 2000
4. Declaration of Fred T. Klinkhammer dated 20 September 2000
5. Declaration of Martin Radvan dated 22 September 2000
6. Declaration of Jan Vavra dated 20 September 2000
7. Statement of Ing. Jiří Brož dated 5 December 2000
8. Supplemental Declaration of Laura DeBruce dated 15 December 2000
9. Declaration of Leonard M. Fertig dated 7 December 2000
10. Supplementary Declaration of Fred T. Klinkhammer dated 13 December 2000
11. Declaration of PhDr Marina Landová dated 15 December 2000
12. Supplemental Declaration of Martin Radvan dated 15 December 2000
13. Declaration of Nicholas G. Trollope dated 21 December 2000
14. Supplemental Declaration of Jan Vavra dated 15 December 2000
15. Declaration of Ing. Miroslav Pýcha dated 21 December 2000



16. Second Supplemental Declaration of Laura DeBruce dated 27 February 2001

### **(9) Statements in Support of the Statement of Defence**

1. Statement of Doc. Ing. Pavel Mertlík CSc dated 7 November 2000
2. Statement of Josef Josefík dated 6 November 2000
3. Statement of RNDR. Josef Musil, PhDr. dated 6 November 2000
4. Statement of PhDr. Helena Halvíková dated 6 November 2000
5. Second Statement of Josef Josefík dated 28 February 2001
6. Statement of Mgr. Milan Jakobec dated 28 February 2001

### **(10) Documents and Authorities**

71. The parties attached to their submissions copies of some 300 documents comprising several thousand pages. They further attached binders comprising several thousand pages of authorities in support of their respective memorials.

### **(11) The Stockholm Hearing**

72. From Monday, April 23, 2001 to Wednesday, May 2, 2001 the hearing took place in Stockholm. At the beginning of the hearing, the parties' representatives submitted to the Tribunal the verbatim record of the examination of witnesses taken in London at the *Lauder vs. Czech Republic* UNCITRAL proceeding under US / Czech Republic BIT. At the Stockholm hearing the parties presented their case and the following witnesses were examined:

- Claimant's witnesses: Laura DeBruce  
Michel Delloye  
Fred T. Klinkhammer  
Martin Radvan  
Jan Vavra  
Leonard M. Fertig  
Marina Landová
- Respondent's witnesses: Josef Josefík  
Josef Musil  
Helena Havlíková

73. At the end of the hearing, the parties' representatives summarized orally their respective positions. The Tribunal in agreement with the parties declared the hearing closed (Art. 29 UNCITRAL Rules). The Claimant submitted to the Tribunal Claimant's post-hearing brief on May 25, 2001. The Respondent submitted its written Closing Submissions on the same day.

**D.**

**Position of the Claimant**

74. CME's claims arise out of the Czech Republic's treatment of its investments in the first private nation-wide commercial television station in the Czech Republic. CME maintains that the Czech Republic breached its obligations under the Treaty by actions and inactions of the Media Council which destroyed the Claimant's investment in the Czech Republic.

**I. The Claimant's Investment in the Czech Republic**

75. In 1992, the Czech National Council decided to issue a Licence for the first nation-wide commercial television station. The Licence was to be awarded through a tender process administered by the Czech Media Council which the Czech National Council had created in 1992 as a separate State agency, subject exclusively to the sovereignty of the Czech Republic, to be responsible for regulating the broadcasting industry and ensuring compliance with laws relating to radio and television broadcasting.
76. The Media Law required the Media Council to take into consideration the extent of Czech ownership and management when considering a Licence application from a company with foreign equity participation, but no provision in the Media Law expressly barred (or now bars) foreign parties from holding television licences.
77. CEDC, the Claimant's predecessor, pursued an application for the Licence.
78. Initially, CEDC and CET 21 pursued a joint application for a Licence, contemplating that they would act together to administer the Licence. On January 5, 1993, CEDC and the Czech investors in CET 21 executed an agreement providing that upon the award of a Licence to CET 21, CEDC would "provide financing needed . . . to establish[ ] a commercial television station in Prague through an equity investment in CET 21," in return for a 49 % ownership share in CET 21, with the Czech investors in CET 21 holding 14 % and the remaining equity reserved for further investors.

79. CET 21's Project Proposal, submitted to the Media Council as a centerpiece of the application, presented CEDC as a desirable "direct participant in CET 21's application for the Licence" on the basis that CEDC was "a quality foreign partner," which had "investment experience" in Central Europe, knew how to "advantageously combine[] a commercial . . . TV station with a programme of a higher standard, and with the participation of cultural foundations," offered "sensitive respect for local traditions and a well-qualified understanding of the needs of the Central European region," was financially supported by "prominent entrepreneurial personalities and groups (e.g. the Lauder group)," and offered valuable links to sources of programming. The minutes of a January 25, 1993 public hearing on the Licence application reflect the centrality of CEDC's role and the need for long-term foreign investments.
80. The Media Council publicly announced on January 31, 1993, that after public hearings and full deliberation concerning the twenty-six candidates who had submitted applications for a Licence, it had determined to issue the Licence to CET 21, with CEDC as "a direct participant of the Licence application." In its letter to CET 21 announcing its decision, the Media Council similarly noted that CEDC was "a direct party to the application," listing the proposal's "adequate financing with capital about whose origin and reliability there can be no doubt" as one of the main factors in its decision. Likewise, in a public statement on February 1, the Media Council's chairman, Mr. Daniel Korte, repeated this language and stressed that the choice of the successful Licence applicant had taken into account that "the project has proved sufficiently financially backed by the capital whose origin and reliability cannot be doubted."
81. In the face of intense political pressure, though, the Media Council decided that it would not permit foreign ownership of the Licence. This requirement created a significant practical difficulty because foreign capital was plainly needed to fund the development of the station. As CET 21 had explained in the Project Proposal it submitted to the Media Council, "[i]t would be a . . . pretense to say that the financial funds in terms of millions and billions [of Czech crowns] which must be invested in relatively short time [to establish the station] are available in the Czech Republic, and that CET 21 (as any other starting TV station) will do without foreign partners."

82. In close consultation with the Media Council, CEDC and the Czech investors in CET 21 sought to resolve this difficulty through the creation of ČNTS - an entity that would be jointly owned by CEDC (which would contribute the majority of the cash needed to fund the establishment of the station), CET 21 (as the party that would contribute the use of the Licence), and a Czech bank (as a third investor). Each contributor was to obtain an equity interest in ČNTS corresponding to the economic value of its contribution, and ČNTS was to establish and manage the television station. The Media Council participated actively in negotiating this solution that maintained domestic ownership of the Licence while providing for the obtaining of needed foreign capital from a desirable source.
83. The Media Council openly acknowledged, prior to this dispute, that it had played a central role in directing the formation of ČNTS, and that its motivation for doing so had arisen from its determination that the Licence not fall directly into the hands of a non-Czech investor. In a January 31, 1998 report to the Czech Parliament, for example, the Media Council explained its 1993 insistence on the ČNTS structure, and the reasons for that insistence, as follows:

The reason why this model came into existence [was] the Council's fears of a majority share of foreign capital in the licence-holder's Company.

. . .

When granting the Licence to the Company CET 21, for fear that a majority share of foreign capital in the licence-holder's Company might impact the independence of full-format broadcasts, the Council assumed a configuration that separates the investor from the licence-holder himself. That is how an agreement came into existence (upon a series of remarks from the Council) by which the Company ČNTS was established the majority owner of which is CEDC/CME.

84. The Media Council thus approved the arrangements between ČNTS and CET 21. It realized that direct foreign investment in television would be unacceptable. It, therefore, blessed a structure that gave the foreign investment the economic benefits of Licence ownership through carefully considered and negotiated contractual arrangements, in the formulation of which, leading to the approval it gave, it actively participated.

85. CEDC was entitled to rely and did rely on the Media Council's strong official assurances that ČNTS's role and economic position would be closely integrated with that of CET 21 (as the nominal licence-holder) in the formation, management, operation and broadcasting of the new commercial television station.

## II. The Role of ČNTS

86. On February 3 and 5, 1993, after CET 21 and CEDC had been informed of the award of the Licence but before the Licence was actually issued, they entered into a pair of nearly identical agreements describing their relationship and establishing the framework under which ČNTS would operate. Each of these agreements described CEDC as "a direct contractual participant within the terms and conditions of this Licence." The February 3 agreement, entitled "Overall Structure of a New Czech Commercial Television Entity," further stated:

1. CET 21 and CEDC will jointly create a new Czech company which will be *the only Commercial Company to create and run the TV station*. CET 21 and CEDC agree to allow the Commercial Company to have *exclusive use of the Licence* as long as CET 21 and CEDC have such a Licence.
2. CET 21 and CEDC confirm that *neither party has the authority to broadcast commercial television without the other*.

(Emphasis added)

87. The February 3 agreement further provided that "[a]ll operating personnel [of the station] will be employees of the Commercial Company." The agreement stated that within two months following the execution of the conditions to the Licence, CET 21 and CEDC would enter into a more complete agreement respecting the organization of the "Commercial Company" that ultimately became ČNTS. This agreement was submitted to the Media Council which requested changes. It became part of the official file of CET 21's application. The February 5 agreement, entitled "Basic Structure of a New Czech Commercial Television Entity," substantially identical, contained the changes.

88. After receiving the agreements setting out the terms of the ČNTS structure, the Media Council formally issued Broadcasting Licence No. 001/1993 (the "Licence") on February 9, 1993. The Licence documentation included the "Licence Certificate," the "Licence Decision" and the "Licence Conditions."
89. Each of these documents expressly linked CEDC and ČNTS to the Licence grant. The Licence Certificate required CET 21 to "ensure that the broadcasting is in accordance with the information stated in the application on the basis of which this Licence was issued." That "information" included the terms of the arrangements between CET 21 and CEDC that had been described to the Media Council and had been specified in the February 5 agreement submitted to the Media Council before the Licence was issued. That "information" also included the Project Proposal that described CET 21 and CEDC as "partners" in the project.
90. The Licence Decision observed once again the importance of CET 21's "contractual partner, the Company CEDC" to the Licence application process. In listing critical features of the winning applicant, the Media Council explained that the applicant had "demonstrated adequate financing with capital about whose origin and reliability there can be no doubt", and acknowledged with approval "the substantial involvement of foreign capital necessary to begin television station activities".
91. The Licence Conditions which were labelled "Appendix to Licence" and were made a part of the Licence through the Licence Certificate's requirement that the licensee "observe the conditions stated in the appendix to this Licence", provided a more specific presentation of the rules under which the Licence would operate. Condition 17 expressly required that the Licence be used in accordance with the arrangements between CET 21 and CEDC that had been described to the Media Council during the application process and recorded in the February 3 and 5 agreements. In relevant part, it provided:

The licence-holder agrees:

*"17/ that it will submit to the Council for its prior consent any changes in the legal entity that is the licence-holder,*

*capital structure of investors and provisions of the business agreement between the licence-holder and investors. Parties to the business agreement are the licence-holder, CEDC and Česká spořitelna, in the scope and under the conditions set by the business agreement which will be submitted to the Council within 90 days after the decision to issue the Licence takes legal effect; the business agreement will observe the provisions of the "agreement on the business agreement" between the licence-holder and CEDC [i.e. the February 3/5 agreements that had been submitted to the Council] which is an appendix to the Licence conditions. "*

*"18/ that CEDC, as a party to the business agreement specified in the Licence conditions, and other investors specified by the business agreement, will not in any way interfere in the programming of the television station, and, in particular, will not interfere with the editorial independence of newscasting employees. "*

92. With this language, the Media Council not only endorsed, but also made explicitly a part of its Licence grant, the basic contractual agreement between CEDC and CET 21, including the provisions that CET 21 would contribute the "exclusive use of the Licence" into ČNTS, that neither CET 21 nor CEDC would have "the authority to broadcast commercial television without the other," and that all business of the project would be transacted through ČNTS (which would employ all staff). Because the Licence Conditions expressly implicated the rights, obligations and interests of CEDC, and because CEDC was a "direct participant" in the application process, Mark Palmer, the president of CEDC, executed the Licence Conditions for CEDC.

### **III. The Memorandum of Association**

93. Over the next several months, CET 21 and CEDC negotiated a Memorandum of Association and Investment Agreement (the "MOA") to flesh out the February 3/5 agreements that the Media Council had incorporated into the Licence in Condition 17. The Media Council participated actively in this process, providing comments on drafts before the MOA was finalized to ensure that the MOA reflected the Media Council's views about how the ČNTS arrangement was to be structured. For example, on April 9, 1993, the Media Council wrote CET 21 to request (i) that CET 21 provide a final draft of the MOA for its approval by April 19, (ii) that "the final draft of the

contract proposal be in accord with the effective legal status” (making particular reference to “certain comments in the Appendix” containing the Licence Conditions), and (iii) that the parties amend certain provisions of the draft to conform with the requirements of Licence Condition 18. Condition 18 provided that CEDC will not interfere in the programming of the television station with the editorial independence of newscasting employees.

94. CET 21, CEDC and the Czech Savings Bank agreed upon the final terms of an MOA for ČNTS in April 1993 and submitted it to the Media Council for approval. The MOA provided that CEDC would contribute 75 % of ČNTS’s capital and obtain a 66 % ownership interest in return, while the Czech Savings Bank would contribute 25 % of the capital and obtain a 22 % ownership interest. CET 21 contributed no cash, contributing instead “the right to use, benefit from, and maintain the Licence . . . on an unconditional, irrevocable and exclusive basis,” in return for a 12 % ownership interest. *Id.* at art. 1.4.1. Dr. Vladimír Železný, a shareholder of CET 21, who would eventually become its 60 % shareholder and one of its Executives, was appointed to serve as ČNTS’s General Director.
95. Reflecting the parties’ discussions with the Media Council, the MOA recognized that ČNTS would be the operating company for the new television station. Article 3.1 recited that ČNTS’s business would include the “development and operation of a new, independent, private national television broadcasting station.” Paragraph D of the Preamble similarly confirmed that the station would be “managed” by ČNTS.
96. On April 21, 1993, the Media Council released a letter confirming that “in accordance with Article 17 of the Conditions to the Licence,” it had approved “the submitted version of the Business Agreement between” CET 21, CEDC and Czech Savings Bank at its April 20 meeting. CEDC and the other parties executed the MOA shortly afterward, on May 4, 1993. The Media Council confirmed its official approval of the MOA and all its provisions on May 12, 1993, when it issued a decision changing the wording of the Licence to add, among other amendments, a new sentence in Licence Condition 17 expressly stating that the MOA “is an integral part of the Licence terms.”



97. As a result of its actions, the Media Council gave the imprimatur of the State to CME's investment. The Media Council, established by law to "supervise[] the observance of legal regulations governing . . . television broadcasting" (i) approved the ČNTS arrangement, by requiring in the Licence Certificate that the licensee act in accordance with the facts set forth in the application, (ii) required as a Condition to the Licence that CET 21 and CEDC operate in accordance with the February 3/5 agreements, (iii) expressly approved the MOA, including the provision in which CET 21 contributed the exclusive use of the Licence, and (iv) amended the Licence Conditions to make the MOA an "integral part of the Licence."
98. The arrangement between ČNTS and CET 21 was thus known to and approved by the State organ responsible for administering television licences. No organ of the Czech Republic challenged it or asserted that it was illegal. Claimant's entire investment in ČNTS being based on this arrangement, it is legally entitled under the Treaty (and under Czech law) to rely on these approvals and to expect the Czech Republic to adhere to the legal arrangements that the Media Council had itself proposed and had formally and publicly endorsed.
99. The Media Council documents clearly reflect not only substantial Media Council involvement in the negotiation and finalization of the MOA's terms, but also the Media Council's adherence to its original approvals of the ČNTS arrangement until changing political winds prompted a reversal in 1996. In a 1994 opinion responding to a challenge that it had acted improperly in approving the ČNTS arrangement, for example, the Media Council publicly stated:

ČNTS is, by duly registered Memorandum of Association, authorized by the holder of the Licence to perform *all acts related to the development and operation of the NOVA TV television station*. Participation of CET 21 in the company consists of a non-financial contribution, i.e., *the financial valuation of the Licence*. The Licence as such has not been contributed to ČNTS and is separate from all other activities of ČNTS.

This is a standard business procedure which was duly discussed and approved by the licensing body, i.e., by the [Media] Council, and does not violate any effective legal regulations. [*The Media Council*] consulted with a

number of *leading legal experts*, both Czech and foreign [before approving the arrangement].

100. Similarly, in a report to Parliament for the period from February 1-September 30, 1996, the Media Council explained that it was fully aware of and accepted the ČNTS structure:

At the time when [the CET 21-ČNTS] arrangement was made, *there were no doubts about its legitimacy*; in regard to many related steps that were taken, *the Council, as it was then constituted and based on its experience at the time, took a position of consent*.

101. The Media Council's January 1998 Report to Parliament equally acknowledged that it had intended for ČNTS to be a co-participant with CET 21 in all TV NOVA broadcasting:

July 1993: ČNTS . . . gets registered in the Companies register. It[s] general director is V. Železný. As its subject of activity, ČNTS states "full-format television broadcasts." *Two Companies thus appear around one Licence; one that has obtained it, and another that is supposed to co-participate in implementing the broadcasts*. The majority partner of ČNTS is CEDC/CME. This model later appears elsewhere too . . . *and the Council considers it to be legal*, it raised legal doubt only later. . . .

Thus, next to the licence-holder's Company, directly linked to it, a new Company was established which was to co-participate in implementing the broadcasts.

*From the legal viewpoint, this construction did not and does not contradict any law*, but it created a basis for problems . . . .

(Emphasis supplied.)

102. Given the Media Council's discriminatory position as to foreign investment and ownership of the Licence, neither CEDC nor CET 21 intended that ČNTS would hold the actual Licence. All recognized that the Licence would have to be held nominally by a company owned by Czech nation-

als. The parties nevertheless envisioned and sought to structure a symbiotic relationship in which the actual operations of TV NOVA, and all of its economics, would be centered in ČNTS, with the contributing partners enjoying the benefit of the station's success in accordance with their equity interests in ČNTS. The documentary record demonstrates conclusively that the Media Council participated substantively in developing this arrangement, formally endorsed its legality, and gave Claimant every reason to conclude that it could commit funds to the project based on this arrangement without fear that the arrangement would later be forcibly dismantled by Media Council actions.

#### **IV. The Formation of TV NOVA**

103. Following the Media Council's approval of the ČNTS structure, CEDC provided capital to ČNTS for the formation and development of the new television station, TV NOVA. ČNTS registered in the Czech Companies Register in July 1993, indicating that one of its activities was "nation-wide television broadcasting," and in February 1994 ČNTS and CET 21 began broadcasting TV NOVA under the Licence.
104. TV NOVA quickly became the Czech Republic's most successful and profitable private television station, with audience shares consistently above 50 %. In contrast to the experiences of most start-up television operations, TV NOVA became profitable within a year after beginning operations, and grew quickly. By 1995, ČNTS's net income was approximately US \$ 23 million, on revenues of approximately US \$ 98 million. ČNTS's net income climbed to nearly US \$25 million, on revenues of approximately US \$109 million, in 1996, and would ultimately exceed US \$ 30 million on revenues of slightly under US \$ 109 million in the year before ČNTS was shut down and destroyed.
105. As provided by the MOA and contemplated in all of CEDC's dealings with the Media Council, ČNTS from the beginning performed all of the activities associated with operating and broadcasting TV NOVA. ČNTS acquired all programmes, or produced them in its TV NOVA studios and other facilities, and employed all the personnel needed to operate the station. Editorial decisions were made by CET 21 through Dr. Železný,

who became its 60 % shareholder and Executive while also serving as ČNTS's General Director. Pursuant to a June 2, 1994 agreement, ČNTS was authorized by CET 21 to enter into an agreement with Czech Radio-communications (České radiokomunikace) which would perform the technical tasks of transmitting TV NOVA's signal. All other operational, advertising and programming activities took place exclusively within ČNTS. ČNTS also gathered all revenues associated with the television station, using a portion of the revenues to pay all expenses of running TV NOVA and retaining the balance as profit and return on its members' cash and non-cash investments. CET 21, meanwhile, had no separate operations. Its offices consisted of two rooms in a different building, it held no assets other than the Licence, and its only employee was a secretary whose compensation was paid by ČNTS.

106. As ČNTS grew and became a prosperous investment, its Czech investors began seeking to realize the profits from their investments by selling their ownership interests in ČNTS. On July 17, 1996, CME purchased the 22 % interest in ČNTS held by the Czech Savings Bank, at the Bank's request, bringing the bank a profit of well over US \$ 30 million on an investment of slightly more than US \$2 million over the 38 months of its participation in ČNTS, and raising CME's ownership interest in ČNTS to 88 %. In December 1996, CME acceded to a request from CET 21's shareholders that it purchase a 5.2 % interest in ČNTS from CET 21, to accelerate a portion of their return on the investment's success. This transaction raised CME's interest in ČNTS to over 93 %. The shareholders of CET 21 then arranged to pool all but 1% of their remaining interests in ČNTS in a special purpose entity wholly owned by Dr. Železný. At Dr. Železný's insistence, CME purchased this entity (and the 5.8% interest in ČNTS that was its only asset) on August 11, 1997, for US \$28.5 million, thereby increasing its ownership interest in ČNTS to 99 %, while the local Czech investors retained only the remaining 1 %. As a result of these transactions, virtually the entirety of any gain or loss experienced by ČNTS belonged to CME.

## V. The Media Council's Reversal of Position

107. Three years after the Media Council mandated the creation of and gave express approval to the ČNTS structure, it abruptly reversed its position, repudiated the arrangement it had officially approved, and forced ČNTS to surrender the exclusive right to use the Licence that CET 21 had contributed in return for its equity interest. By a letter dated July 23, 1996, but not sent to ČNTS until August 30, 1996, the Media Council commenced administrative proceedings against ČNTS claiming that ČNTS was “operating television broadcasting without authorization.”
108. The Media Council founded its claim of unauthorized broadcasting on assertions that ČNTS had improperly arrogated power to itself by (i) participating in the “agreements” (and, particularly, the MOA) with CET 21, (ii) including “nation-wide television broadcasting” as one of its recited business activities in its Commercial Register entry, and (iii) entering into contracts with an authors’ organization and Czech Radiocommunications in its own name. The Media Council claimed that the Czech Academy Institute of State and Law (the “Academy”) had issued an opinion concluding that ČNTS was carrying out “unauthorized broadcasting” based on these three concerns, but the Media Council refused to provide that asserted opinion to ČNTS. The Media Council also indicated that the Czech police had launched a criminal investigation “for suspicion of committing the crime of ‘unauthorized conduct of business’ and ‘distorting facts in economic and business records,’” that turned on the same determination as was presented in the administrative proceedings.
109. The Media Council offered no reason why the activities of ČNTS that it had approved and had permitted to proceed for several years had suddenly become objectionable. While the Czech Parliament had amended the Media Law as of January 1, 1996, Act No. 301/1995 Coll., the Media Council identified no provision of the new law that could serve as justification for its reversal of position under Czech law.
110. The central motivating concern behind the Media Council’s action appears to have been that ČNTS was simply becoming too prosperous, and that Czech political circles looked with disfavour on permitting a company overwhelmingly owned by foreigners to obtain such substantial

wealth from an investment in such a conspicuous Czech company using a broadcast Licence allocated by the State.

111. ČNTS vigorously defended itself against the Media Council's proceedings, contending that it had been operating as agreed with the Media Council in 1993 and had violated no law. As part of this defence, ČNTS contacted the Academy to inquire about the opinion that the Media Council had indicated was a foundation for its proceedings. ČNTS was told that the Academy had not released an opinion at all, and that the Media Council had merely been inaccurately characterizing as an Academy opinion an expression of views by a single individual, Dr. Jan Bárta. In expressing these views, moreover, Dr. Bárta was responding to a hypothetical question put to him by the Media Council that took no account of the history or specific nature of the CET 21-ČNTS arrangements and was worded in conclusory terms calculated to solicit a response unfavourable to ČNTS.
  
112. On August 13, 1996 the Academy released its only real opinion on the issues presented by the administrative proceeding which concluded that ČNTS's activities did not violate the Media Law. In direct rebuttal to the Media Council's contention that ČNTS's activities constituted unauthorized broadcasting based on the Licence that had been granted to CET 21 rather than ČNTS, the Academy Opinion asserted that the Media Law permitted a "broadcasting operator" as that term is used in the Media Law (such as CET 21) to use another party (such as ČNTS) to carry out broadcasting, stating:

The realization of broadcasting, through third parties is . . . not excluded by the [Media Law] . . . . This means that also somebody else than the operator may ensure broadcasting by conclusion of contracts with third parties . . . .

The relationship of [ČNTS] with the licence-holder is in our opinion just such ensuring of broadcasting through third persons.

113. While the Academy explained that it was not authorized "to assess opinions prepared by [legal] experts" (id. at 2), it made clear that Dr. Bárta's opinion was not an expression of the Academy's views, was directed entirely to the Media Council's irrelevant hypothetical question of what rules

should apply if a licence failed to broadcast and an unlicensed party did broadcast, and unwarrantedly failed to address whether a licensee could arrange to have a third party carry out the operational mechanics of broadcasting so long as the operating company did not interfere with the licensee's editorial functions (as had always been ČNTS's practice). ČNTS submitted the Academy Opinion to the Media Council, but that submission did not alter the Media Council's position or even prompt the Media Council to release the opinion by Dr. Bárta on which it had claimed to rely.

## **VI. The Council Compels ČNTS to Alter the MOA**

114. In opposing the Media Council's proceedings, ČNTS had to weigh the risk that if it failed to dissuade the Media Council, ČNTS could face the fines authorized by Section 20 (5) of the Media Law, plus criminal charges against its statutory representatives and Executives, plus revocation of the Licence. Claimant's representatives recognized that while such actions by the Media Council or other Czech authorities might be subject to court challenges, TV NOVA could be destroyed by any such actions even before any such challenge could be resolved. Moreover, there was the risk, acute in light of the political pressures in the Czech Republic arising from the resentment of ČNTS's profitability, that the Media Council's reversal of position, although violative of the Treaty, might be found by a Czech court to satisfy Czech law.
  
115. In these circumstances, ČNTS had no choice but to make changes to the MOA to obtain the termination of the administrative proceedings. CME and ČNTS capitulated to the Media Council because they quite reasonably believed they could not win if they opposed the Media Council. Thus, its hand forced by the Media Council, CME agreed to amend Article 1.4.1 of the ČNTS MOA, in which CET 21 had contributed the "right to use" the Licence on an exclusive basis, to provide that CET 21 contributed to ČNTS only the "know-how" connected with the Licence, albeit still on an exclusive basis. ČNTS also amended the description of its business activities in the Czech Commercial Register to delete the reference to "nation-wide broadcasting," again yielding to the Media Council's insistence that ČNTS could not be involved in broadcasting because that was the exclusive province of the licensee.

116. As part of the package of contractual changes coerced by the Media Council, on May 21, 1997, ČNTS and CET 21 also entered into a new Agreement on Co-operation in Ensuring Service for Television Broadcasting (the “Co-operation Agreement”, hereinafter also the “Service Agreement”). This agreement expressly identified CET 21 as the licence-holder and the “television broadcasting operator” of TV NOVA. It further provided that ČNTS had the “rights and obligations . . . to ensure, according to this contract, service for the television broadcasting that is conducted on the basis of the Licence issued to CET 21, and that ČNTS is authorized to keep an agreed income from this activity.” An annex identified the “agreed income” as advertising and related revenues, less CZK 100,000 per month paid to CET 21. The Co-operation Agreement further addressed the Media Council’s concerns by stating that ČNTS would enter contracts with the Czech Radiocommunications and authors’ organizations on “behalf of CET 21 as the licence-holder and operator of television broadcasting” while providing that ČNTS would continue to pay all the costs of those contracts. Once again, the Media Council reviewed and approved this agreement which was a direct response to the administrative proceedings.
  
117. The Media Council dismissed the administrative proceeding against ČNTS in September 1997. Its order of dismissal expressly declared that it had obtained the concessions it required from ČNTS. In a September 1999 opinion to the Czech Parliament, the Media Council made clear that the amendment of the MOA had been a primary condition for the Media Council’s termination of the proceedings, stating that through the 1996 proceedings “the Council made the licence-holder to remedy certain legal faults in the Memorandum of Association.” In connection with the resolution of the administrative proceedings, the Media Council cancelled Condition 17 of the Licence.
  
118. The agreements for the creation of ČNTS that the Media Council originally approved had not characterized ČNTS as a mere provider of “services,” but rather as the manager of the station and as a co-participant in broadcasting with exclusive rights to use the Licence. Nonetheless, at the time when ČNTS made the concessions compelled by the Media Council, Claimant’s representatives were hopeful, and expected, that the



resulting amendments to the MOA would not alter ČNTS's position as the exclusive manager of TV NOVA and as the economic and operational center-piece of the enterprise. They did not yet know that the changes that the Media Council had lawlessly extorted would become the basis for the destruction of ČNTS.

## **VII. The Destruction of Claimant's Investment**

119. The consequences to the Claimant of the Media Council's actions in 1996 and 1997 began to become apparent in 1998. At that time, CET 21 and Dr. Železný - having virtually no remaining economic interest in ČNTS - began taking steps to dismantle the exclusive arrangement between ČNTS and CET 21 that had been the foundation for CEDC's original investment in TV NOVA and had been in place since TV NOVA began operations. Those steps were made possible by the Media Council's prior actions, and were carried out with the Media Council's connivance and active assistance.
120. In mid-1998 and continuing thereafter, Dr. Železný began to demand with increasing frequency and intensity that CME agree to fundamental changes in the arrangement between ČNTS and CET 21. While the specific changes Dr. Železný was demanding varied over time, all would have required CME to make substantial economic and contractual concessions to its great financial detriment. Various proposals would have required, for example, that CME agree to delete all references to exclusivity in agreements between CET 21 and ČNTS and permit CET 21 to obtain business from other providers, that CME pay a portion of TV NOVA's revenues to CET 21, and that CME agree to release all obligations from CET 21 to ČNTS at the end of the current Licence period, while surrendering its existing rights to participate in any Licence renewal.
121. The Media Council's actions in 1996, along with the threat of future Media Council action against ČNTS, formed Dr. Železný's primary foundation for these demands. In discussions with Michel Delloye (then CME's President and Chief Executive Officer) and later with Mr. Delloye's successor, Fred Klinkhammer, Dr. Železný repeatedly insisted that the changes he demanded were needed because the Media Council's 1996

administrative proceedings and the resulting amendments to ČNTS's MOA had ended any contractual obligation of exclusivity in the relationship between ČNTS and CET 21. He also contended that the Media Council strongly disfavoured exclusivity, was continuing and would continue to pressure ČNTS to surrender all exclusive arrangements with CET 21, and would take further action if CME refused to make these changes. In late 1998, Dr. Železný caused CET 21, without CME's consent, to begin acquiring programming through sources other than ČNTS.

122. The agreement between the parties that ČNTS would manage TV NOVA and gather all revenues, and the commitment that CET 21 would use its best efforts to obtain the renewal of the Licence in 2005 and to continue the relationship between CET 21 and ČNTS, had been the predicates for CME's investment. Therefore, CME could not let ČNTS be bullied by Dr. Železný into accepting an arrangement according to which CET 21 would elect whether to use ČNTS or some other service provider for each particular line of activity, and pay ČNTS only for the work CET 21 might ask it to perform. Likewise, it could not agree to a termination of the relationship between ČNTS and CET 21 at the end of the current Licence period which Dr. Železný was insisting on. Each of these changes would have had an enormously adverse effect on the value of CME's investment.
123. Over time, Dr. Železný began to threaten that CET 21 would sever all relations with ČNTS if CME did not capitulate to his wishes, relying again on the Media Council's 1996 actions terminating CET 21's contribution to ČNTS of the exclusive "right to use" the Licence and on the continuing pressure assertedly being exerted by the Media Council to alter the relationship. At a February 24, 1999 ČNTS board meeting, for instance, Dr. Železný demanded that CME agree to pay CET 21 4 % of TV NOVA's gross revenues and replace the Co-operation Agreement with a collection of new agreements directed to separate areas of service being provided by ČNTS. These proposed new agreements would have permitted CET 21 to acquire services from sources other than ČNTS and to pay ČNTS only for particular services acquired from ČNTS, would have eliminated ČNTS's right to collect and keep all revenues from advertising, and would have provided that CET 21's relationship with ČNTS would extend only until the end of the current Licence period on Janu-

ary 30, 2005. These changes were needed, Dr. Železný asserted, because the Media Council continued to disapprove of any exclusive arrangement between CET 21 and ČNTS and would shortly issue a statement that the arrangement was “not correct.” Dr. Železný threatened that if CME did not agree to this “ultimatum,” CET 21 would hire another company to sell TV NOVA’s advertising time and shift advertising revenues away from ČNTS - a step that Dr. Železný asserted CET 21 was free to take because the changes to the MOA mandated by the Media Council in 1996 had left CET 21 with no obligation of exclusivity toward ČNTS.

124. The arrangements demanded by Dr. Železný in 1998 and 1999, based on the Media Council’s past actions and threatened future actions, were a far cry from the original arrangement, in which (in the Media Council’s words) “two companies” would “appear around one Licence,” with ČNTS, as a “co-particip[ant] in implementing the broadcasts, “performing“ all acts relat[ing] to the development and operation of the NOVA TV” in an exclusive bond with CET 21 that was to last as long as CET 21 held the Licence.
125. In fulfilment of the threats by Dr. Železný, in early 1999 the Media Council went beyond its 1996 reversal of position leading to the forced amendment of the MOA. Now it provided active assistance to Dr. Železný in his campaign to eliminate ČNTS’S exclusive position respecting CET 21. On March 3, 1999, a few days after threatening CME that the Media Council would issue a letter supporting his position, Dr. Železný surreptitiously wrote the Media Council to solicit a declaration from it that exclusive relations between the licensee and service provider were legally impermissible, particularly as a result of the Media Council’s 1996 action “withdrawing the use of the Licence from a service organization [ČNTS] and taking it back for the licensed holder”. Dr. Železný’s letter asked the Media Council to confirm in writing that:

Relations between the operator of broadcasting and its service organizations must be established on a nonexclusive basis, because exclusive relations between the licence-holder and the service organization may encourage the transfer of some functions and rights that are dependent on the Licence and that are not transferable by law.

126. Dr. Železný further sought confirmation that “CET 21 s.r.o. will act, function, and proceed as an operator, and therefore, it has to carry out relevant managerial, administrative and accounting tasks, and must build up its own company structure” - an express request for a mandate that ČNTS should no longer perform the managerial functions it was created to perform. He additionally sought a declaration that revenues from advertisements “must be revenues of CET 21,” although they had always been collected and, after payment of expenses, retained exclusively by ČNTS.
127. Dr. Železný did not hide his motives for seeking these confirmations in the form of a Media Council declaration. He told the Media Council that “[w]e would like to use this opinion for discussions with our contractual partners, without disclosing other internal matters of our company.” Brazenly, he explained that he wished to use the Media Council’s declaration to restructure the arrangement with ČNTS in critical ways, including not only by “build[ing]-up” CET 21 to perform management functions previously performed by ČNTS and by having CET 21 rather than ČNTS collect all advertising revenues, but also by replacing existing contracts with ČNTS with new short-term contracts that would permit the use of new service providers other than ČNTS and would terminate all obligations to ČNTS upon any Licence renewal.
128. Instead of refusing to make the proclamations Dr. Železný had proposed on the basis that they were flatly at odds with entitlements for ČNTS that the Media Council had expressly approved, the Media Council sent Dr. Železný a letter on March 15, 1999, parroting nearly verbatim from his request the language respecting exclusivity:
- Business relations between the operator of broadcasting and service organizations are built on a nonexclusive basis. Exclusive relations between the operator and the service organization may result in de facto transfer of some functions and rights pertaining to the operator of broadcasting and, in effect, a transfer of the Licence.
129. The Media Council also stated that CET 21 “operates, functions and acts as an operator, *i.e.*, carries out relevant administrative and accounting tasks,” and that all advertising revenues must be treated as revenues of CET 21. In issuing this letter, the Media Council did not disclose that it

was adopting the language and the analysis Dr. Železný had proposed, or that it had received a letter from Dr. Železný asking it to express these views.

130. The Media Council stated in its March 15 letter that the fulfilment of these so-called “requirements” had been the “precondition” for its termination of the 1996 administrative proceedings against ČNTS, and that it believed these requirements had been “confirmed by changes in the Memorandum of Association.” The positions set forth in the letter, like the 1996 administrative proceedings, were wholly at odds with the Media Council’s 1993 approval of the MOA which gave ČNTS the exclusive right to use the Licence and established ČNTS as the manager of TV NOVA, and on the basis of which approval ČNTS had acted for years as the exclusive source of managerial, administrative and other business activity for TV NOVA. The issuance of the letter was also beyond the scope of the Media Council’s authority under the Media Council Act which authorizes the Media Council only to adjudicate rights and obligations in the context of administrative proceedings - not to issue *ex parte* declarations in support of one party to a dispute.
  
131. Dr. Železný used the Media Council’s letter as conclusive proof that the existing exclusive arrangement between ČNTS and CET 21 had to be changed. Based on the letter, over the succeeding weeks he continued to take steps to destroy that exclusive arrangement. On April 19, 1999, CME concluded that given Dr. Železný’s lack of loyalty - indeed, given his outright hostility to CME’s essential interests and those of ČNTS - it had no alternative but to recall Dr. Železný from his position as General Director of ČNTS. Dr. Železný responded by publicly pursuing the development of entities whose mission was to replace ČNTS in the performance of the activities necessary to operate TV NOVA. Finally, on August 5, 1999, three and a half months after his termination, Dr. Železný caused CET 21 to sever its dealings with ČNTS altogether, and to begin broadcasting TV NOVA using the services of new companies under his direction. Since that date, ČNTS has performed no services for CET 21 and has generated no revenues. It has been forced to lay off nearly all of its workforce. It has essentially gone out of business.

132. The pivotal role that the Media Council played in bringing about this State of affairs is apparent from CET 21's August 16, 1999 letter to CME's shareholders. In it, CET 21 again pointed to the Media Council's actions in 1996 and 1999 as the basis for the August 5 termination of its dealings with ČNTS, echoing many of the statements in the Media Council's January 1998 report to the Czech Parliament. CET 21 recited, for instance, that the "partnership structure" that the Media Council approved in 1993 had been "consistently criticized" by "legislati[ve], regulatory and State bodies of the Czech Republic" in succeeding years, on the basis that it provided "excessive powers to foreign investors." These criticisms, CET 21 alleged, combined with the "serious political and social problems" caused by the perception of CME's "extraordinarily high revenues," were the forces that had prompted the Media Council to open the 1996 administrative proceedings against ČNTS and demand that ČNTS amend its MOA. CET 21 also asserted that it was not required to maintain the exclusive relationship with ČNTS, because the "exclusive link" between the two companies had been "terminated" with the 1996 amendment of the MOA. CET 21 additionally referred to the Media Council's March 15, 1999 letter as proof that the Media Council would not tolerate an exclusive arrangement, not only because of the Media Council's view of the Media Law, but also on the ground of CME's focus "on its immediate short-term profit."

### **VIII. The Media Council's Failure to Fulfil its Obligation to Protect Claimant's Investment**

133. As the authority charged with ensuring compliance with the Czech Republic's television broadcasting laws, the Media Council had both the power and the obligation under Czech law to remedy CET 21's unlawful actions to sever its exclusive relationship with ČNTS. The Media Law requires the Media Council to impose an appropriate penalty if it determines that a licence-holder has "violat[ed] the duties specified by this Act or the conditions of the granted Licence." The "duties specified" by the Media Law include an obligation to obtain the Council's advance approval for any "change concerning data stated in an application" for a Licence. *Id.* at §§14(1), 20(4)(g) (requiring a fine for any breach of this obligation). The Media Law further authorizes the Media Council to revoke

a Licence if, among other things, the licence-holder “seriously violates the conditions given by a decision to grant a Licence” or the “duties set by this Act or other legal regulations.” *Id.* at § 15 (2) (a).

134. CET 21’s actions were in direct violation of the Licence which explicitly required CET 21 to broadcast in accordance with the premises described in its Licence application, and were in violation of the undertakings by CET 21 that the Media Council had expressly identified as a basis for issuance of the Licence in Condition 17. The statement of facts submitted with the Licence application included an explanation of the proposed “partnership” with CEDC in the Project Proposal. The same facts as to the arrangement between CET 21 and CEDC were addressed in discussion during oral hearings before the Media Council. The statement in the original version of Condition 17, that the February 3/5, 1993 agreements were attached as an appendix to the original Licence, makes clear that the agreement between CET 21 and CEDC was part of the set of critical “facts” on which the Media Council based its Licence grant. After CET 21 repudiated its exclusive relationship with ČNTS, it was no longer broadcasting through TV NOVA in compliance with the facts set forth in its application for the Licence. The Media Council consequently could and should have acted under the Media Law - even apart from its obligations under the Treaty - and forced CET 21 into compliance with its obligations under the threat of the revocation of the Licence.
  
135. However, the Media Council has repeatedly refused to take such action, and other organs of the Czech Republic have equally refused to intervene, despite the pivotal role that the Media Council played in bringing about the loss of ČNTS’s exclusive right to use the Licence. Since June 1999, ČNTS and CME have repeatedly asked the Media Council and other Czech bodies to redress these breaches of the Licence, the Media Law and the Treaty:
  - In a June 24, 1999 letter to the Media Council, ČNTS identified the Media Council’s approval of the ČNTS arrangement as the basis for the issuance of the Licence, and asked the Media Council to intervene against the unlawful actions by Dr. Železný and CET 21 to repudiate that arrangement. ČNTS followed this request with a letter specifically pointing out that ČNTS’s continued participation in CET 21’s broadcasting was a requirement of the Licence.

- On August 2, 1999, ČNTS and CME wrote to the Permanent Committee of the House of Representatives of the Czech Parliament (“Parliamentary Media Committee”) challenging the Media Council’s policy of passivity in respect to Dr. Železný’s actions and asking that the Media Council (which is answerable to Parliament) be directed to take action. This letter was accompanied by a detailed factual summary with supporting documentation.
  - On August 6, 1999, the day after Dr. Železný caused CET 21 to terminate all dealings between CET 21 and ČNTS, ČNTS asked the Media Council to commence Licence revocation proceedings against CET 21 “due to its . . . material breach of the conditions arising out of the decision granting the Licence, of the obligations stipulated by the [Media Law] and obligations stipulated by other above-stated legal acts.”
  - On August 13, 1999, ČNTS again asked the Media Council to address CET 21’s breaches of the conditions to the Licence and the Media Law, including the failure “to perform the broadcasting in accordance with the facts which it stipulated in the application.”
136. In response to these repeated requests for action, the Media Council publicly characterized the actions of CET 21 and Dr. Železný as mere manoeuvres in a commercial dispute that should be resolved by the private parties, and not by State action. With its July 26, 1999 letter to ČNTS, the Media Council enclosed an excerpt from its most recent report to the Parliamentary Media Committee, in which it stated that the dispute between CME and CET 21 was of a “commercial nature,” in which the Media Council had “no legal reason or right to interfere.” The Media Council has continued to adhere to this position in subsequent public statements. Thus, the Media Council failed to take responsibility for the role it had played in igniting the dispute, ignored its own regulatory obligations to address the resulting violations of the Licence and the law, and has refused to fulfil its obligation, binding on all organs of the Czech Republic, to comply with the Treaty.

## **IX. The Czech Republic’s Additional Continuing Violations of the Treaty**

137. Since this arbitration was filed, the Czech Republic has continued to breach its obligations to provide Claimant’s investment full security and protection, and has continued to take actions (or has refused to act) in ways that, at Claimant’s expense, improperly favour the Czech investors in CET 21. For example, the Media Council has affirmatively assisted



Dr. Železný in evading the effectiveness of orders of an ICC arbitral tribunal. On November 10, 1999, CME obtained an order of interim measures in an ICC arbitration initiated against Dr. Železný, directing him to use his control over CET 21 as its Executive and majority shareholder to restore the partnership between CET 21 and ČNTS to its prior position of economic exclusivity. Dr. Železný refused to comply with this order.

138. ČNTS gave the Media Council a copy of the ICC tribunal's order. Nevertheless, the Media Council approved, on December 21, 1999, a plan by which Dr. Železný, in a sham transaction, transformed his majority shareholding in CET 21 into a minority shareholding, so as to be able to foil the ICC tribunal's order by asserting that he could no longer exercise a 60 % shareholder's power over CET 21. The sham was apparent: Close associates of Dr. Železný agreed to contribute only CZK 4.8 million (less than US \$ 150,000) to the capital of CET 21, paid nothing to Dr. Železný, and were issued large nominal interests in CET 21 designed to dilute Dr. Železný's interest to approximately 12 %. The Media Council had full knowledge of the ICC tribunal's order, and ČNTS explained the sham to the Media Council in a letter dated November 18, 1999. CET 21 was required to obtain the Media Council's approval for the transaction. The Media Council approved this recapitalization. The Media Council's approval brought Dr. Železný the goal he had sought: In an April 17, 2000 ruling, the ICC tribunal amended its order by withdrawing the directive that Dr. Železný use his control over CET 21 to restore ČNTS'S exclusivity, stating that Dr. Železný no longer possessed the majority control over CET 21 that he needed to comply with the order.
139. In addition to helping Dr. Železný avoid his obligations to the foreign investors in ČNTS, the Czech Republic has disregarded criminal wrongdoing by Dr. Železný directed against CME's investment. On October 14, 1999, ČNTS filed a criminal complaint against Dr. Železný with the Prague State Attorney's Office. To date, neither the Czech police nor the City or State Attorney's Office has taken any action with respect to ČNTS's complaint.

## X. Other Legal Actions by CME or ČNTS Apart from this Arbitration

140. Several actions have been brought in Czech court by both ČNTS and CET 21. On May 4, 2000, the Prague Regional Commercial Court held in an action initiated by ČNTS that CET 21 was obligated under the 1997 Co-operation Agreement to procure all services for the operation of TV NOVA exclusively through ČNTS.
141. CET 21 has refused to comply with this decision. Despite a request by ČNTS, the Media Council has refused to take any action based on the Court's decision.
142. CME's ICC arbitration against Dr. Železný alleges that he personally breached the August 11, 1997 Share Purchase Agreement pursuant to which CME acquired a 5.8% interest in ČNTS held by an entity that Dr. Železný owned. On February 9, 2001 the ICC International Court of Arbitration rendered the Award ordering Dr. Železný to pay US \$23.35 million to CME Media against the return of the NOVA Consulting shares.
143. Ronald S. Lauder, the ultimate controlling shareholder of CME, has himself brought an *ad hoc* arbitration against the Czech Republic pursuant to the bilateral investment treaty in force between the United States and the Czech Republic (the "US Treaty"). The factual predicate of the claims in that proceeding are virtually identical to the factual predicate of this action. An award in favour of Mr. Lauder restoring ČNTS to the exclusive position it held before Respondent's breaches and providing him damages for the losses he has suffered as a result of those breaches could be of substantial assistance to CME and reduce the damage suffered by CME as a result of Respondent's breaches. Such an award would not, however, make CME itself whole.
144. Claimant, ČNTS and Mr. Lauder have properly taken multiple measures to seek to protect their interests and recover for the harm they have suffered in this matter. The existence of other claims neither erases Respondent's egregious violations of binding international obligations nor excuses Respondent from its obligation to remedy those breaches and their proximate results.

**E.**

**Claimant's Argument**

**I. CME's Entitlement to Assert a Claim under the Treaty**

145. As a "legal person[] constituted under the law" of The Netherlands, CME is an investor subject to the protections of the Treaty. Exh. CI at art. I(b). CME directly holds a 99 % ownership interest in ČNTS.
146. The Treaty protects "investments" in the Czech Republic that are made by Dutch investors. The Treaty defines "investment" broadly, to include "every kind of asset." Treaty at art. 1(a). Examples of protected investments enumerated in the Treaty include "movable and immovable property . . . rights," "shares . . . and other kinds of interests in companies and joint ventures, as well as rights derived therefrom," "title to . . . assets and to any performance having an economic value" and "intellectual property, also including technical processes, goodwill and know-how." *Id.*
147. CME's ownership interest in ČNTS, and all that CME has directly or indirectly invested to obtain that ownership interest and cause it to grow, plainly constitutes an investment in the Czech Republic within the meaning of the Treaty. The investment assets of CME in the Czech Republic also plainly include ČNTS's tangible and intangible property - including its buildings, studio equipment, and intellectual property rights, such as its rights to air licensed programmes - and CME's and ČNTS's legal interest in maintaining the exclusive business arrangement between ČNTS and CET 21, all of which CME owns either directly or indirectly by virtue of its 99 % ownership interest in ČNTS.

**II. The Czech Republic's Obligations under the Treaty**

148. The Treaty imposes five central obligations on the Czech Republic: (i) not to deprive investors of their investments, directly or indirectly, if such deprivation is unlawful or without compensation; (ii) to treat investments fairly and equitably; (iii) not to impair the enjoyment of investments by unreasonable or discriminatory measures; (iv) to provide investments full security and protection; and (v) to ensure treatment of investments that complies with the standards of international law.

## 1. The Obligation Not to Deprive Investors of Their Investments

149. Article 5 of the Treaty provides that “[n]either Contracting Party shall take any measures depriving, directly or indirectly, investors of the other Contracting Party of their investments,” unless the deprivation is “taken in the public interest and under due process of law,” is carried out non-discriminatorily, and is accompanied by just compensation.
150. The Treaty’s provision regarding “deprivation” tracks the broadest expropriation provisions in bilateral investment treaties, specifically, and in international law, generally. A “deprivation” thus occurs under the Treaty whenever a State takes steps “that effectively neutralize the benefit of the property for the foreign owner.” Such expropriations may be deemed to have occurred regardless of whether the State “takes” or transfers legal title to the investment. It is also immaterial whether the State itself (rather than local investors or other third parties) economically benefits from its actions. These rules arise under the well-established principle that State interference with an investor’s use of property should be deemed an actionable “deprivation” regardless of the form that the interference takes.
151. The Treaty avoids any narrow definition of expropriation in part by avoiding the use of that word altogether. The Treaty focuses on the interference in the investor’s ownership, rather than any transfer of the investment to the State, by prohibiting “deprivations” rather than “takings.” Article 5 further expressly adopts the international rule against unlawful indirect expropriations (measures may not be taken “depriving, directly or indirectly,” investors of their investments).
152. A deprivation effected by coercing an investor’s agreement to changes in its investment’s status violates the Treaty in the same measure as a direct taking. Attempts by State defendants to use “consent” obtained from an investor on pain of administrative sanction to defend State conduct have a long pedigree in expropriation cases. States often “take the circuitous route of expropriation by consent,” either due to a “recognition of the existence of an international [prohibition against expropriation] or out of a practical desire not to advertise their defiance of it.”

153. The Czech Republic's actions in this case - threatening destruction of CME's investment through regulatory proceedings once the foreign investor's profits appeared too large - fall within this recognizable pattern:
154. The "expropriation by consent" that the Czech Republic extorted from ČNTS through its administrative proceedings is no more permissible under international law than the outright appropriation of an investment.

## **2. The Obligation of Fair and Equitable Treatment**

155. The Treaty further provides that investments are to be ensured "fair and equitable treatment." Treaty at art. 3 (I). The Treaty's Preamble underscores the importance of this obligation, acknowledging that "fair and equitable treatment" of investments plays a major role in realizing the Treaty's goal of encouraging foreign investment.
156. The broad concept of fair and equitable treatment imposes obligations beyond customary international requirements of good faith treatment. The Treaty makes this plain by separating the requirement of "fair and equitable treatment" in article 3(1) from the obligation to adhere to "obligations under international law" in article 3(5). The obligation of fair and equitable treatment is a specific provision commonly at the heart of investment treaties that may prohibit actions - including State administrative actions - that would otherwise be legal under both domestic and international law.
157. Whether conduct is fair and equitable depends on the factual context of the State's actions, including factors such as the undertakings made to the investor and the actions the investor took in reliance on those undertakings. This requirement can thus prohibit conduct that might be permissible in some circumstances but appears unfair and inequitable in the context of a particular dispute.

## **3. The Obligation Not to Engage in Unreasonable and Discriminatory Treatment**

158. The Treaty similarly provides that a State shall not "impair, by unreasonable or discriminatory measures, the operation, management, mainte-

nance, use, enjoyment or disposal” of investments. Treaty at art. 3 (1). As with the fair and equitable standard, the determination of reasonableness is in its essence a matter for the arbitrator’s judgment. That judgment must be exercised within the context of asking what the parties to bilateral investment treaties should jointly anticipate, in advance of a challenged action, to be appropriate behaviour in light of the goals of the Treaty.

#### **4. The Obligation of Full Security and Protection**

159. The Treaty further requires that, “[m]ore particularly, each Contracting Party shall accord to such investments full security and protection.” Treaty at art. 3 (2). Under this provision, each State is required to take all steps necessary to protect investments, regardless of whether its domestic law requires or provides mechanisms for it to do so, and regardless of whether the threat to the investment arises from the State’s own actions or from the actions of private individuals or others.
160. The provision imposes an *obligation of vigilance* under which the State must take all measures necessary to ensure the full enjoyment of protection and security of the foreign investment. The State may not invoke its own legislation to detract from any such obligation.
161. The Treaty stresses the primacy of its “full security and protection” standard over domestic limitations by making clear that the more favourable of domestic or most favoured nation protections is a necessary, but not of itself sufficient, component of what must be accorded to investors of the other Contracting Party. Exh. CI at art. 3 (2).

#### **5. The Obligation of Treatment in Accordance with Standards of International Law**

162. The Treaty contains a broad provision requiring the Contracting Parties to treat investments at least as well as required by “obligations under international law existing at present or established hereafter between the Contracting Parties . . . whether general or specific.” Treaty at art. 3 (5). In addition to all obligations under treaties or otherwise, general principles of international law require host States to provide certain minimum protections to international investments.

### **III. The Czech Republic Has Violated Its Treaty Obligations**

#### **1. The Czech Republic Is Responsible for the Media Council's Conduct**

163. The Media Council is an official organ of the Czech Republic established as an administrative body by the Media Council Act. The Czech Republic is responsible under the Treaty for the Media Council's conduct, based on the well-established principle that a State is responsible for the wrongful acts of its instrumentalities or agents.
164. A State bears international responsibility for the actions of its instrumentalities or agents even if the conduct at issue was beyond the agent's authority under domestic law.
165. The Media Council's official endorsement of the MOA and related agreements which led to Claimant's initial investment thus gave Claimant legally enforceable rights under the Treaty irrespective of whether the endorsement was valid under Czech law (as it was) or whether the Media Council's subsequent reversal of position and failure to intervene to protect ČNTS were valid under Czech law (as they were not).

#### **2. The Media Council's Conduct has Violated the Czech Republic's Treaty Obligations**

166. Respondent has violated each of the foregoing Treaty obligations with respect to CME's investment. The 1993 structuring of the investment through ČNTS was the product of the Media Council's own instigation and approval. The Media Council's 1996 reversal of its own 1993 action approving the partnership between ČNTS and CET 21, as spelled out in the February 1993 agreements and the MOA, violated its obligations not to deprive Claimant of its investments, to provide fair and equitable treatment, not to take unreasonable and discriminatory actions, to provide full security and protection for Claimant's investment, and to act in compliance with principles of international law.
167. The Media Council's continued connivance with Dr. Železný to destroy the exclusive relationship between ČNTS and CET 21 constituted a further breach of its Treaty obligations, including particularly its obligations

to provide full security and protection to Claimant's investment. Indifferent to the Czech Republic's affirmative obligation of protection, the Media Council actively assisted Dr. Železný's efforts, most notably by issuing its March 15, 1999 declaration to support Dr. Železný's avowed effort to eliminate the exclusive economic relationship between ČNTS and CET 21 that had been the foundation of CME's investment. The Media Council's willingness to put forward Dr. Železný's views as its own was unambiguously calculated to gut the "partnership" that had been entered between ČNTS and CET 21 in 1993 at the Media Council's instigation and with its full support.

168. Respondent further breached its obligation to provide full security and protection to Claimant's investments when both the Media Council and the Parliament refused all requests for intervention to protect ČNTS, although at the time of such requests ČNTS was being destroyed by the Media Council's reversal of its original approval of the exclusive arrangements it had brought about between ČNTS and CET 21.
169. ČNTS did not lose its entire business and revenues simply as the result of market forces or a private business dispute, as the Media Council has asserted. The ground for Dr. Železný's termination of the relationship between ČNTS and CET 21 was laid by the amendments to the MOA that the Media Council coerced, since CET 21 could not have severed an arrangement in which ČNTS was entitled to the exclusive right to use the Licence. Even after that wrongful severance which the Media Council facilitated, ČNTS would not have been forced to discontinue its business operations if the Media Council had fulfilled its obligations under the Treaty and Czech law by restoring ČNTS to the exclusive position with respect to CET 21 that the Media Council had approved in 1993.
170. The Media Council's course of dealings - including its initial requirement that the Licence be held by Czech nationals, its commencement of the unfounded administrative proceedings against ČNTS, its actions forcing ČNTS to weaken the contractual underpinnings that were the basis of Claimant's investment, its articulation of a policy disfavoring the exclusive economic relationship it had helped to structure and had approved, and its failure to act to protect ČNTS's interests - enabled Dr. Železný to take actions that have destroyed the value of Claimant's investment. The



Media Council's actions and refusals to act have effected a deprivation of Claimant's investment by the Czech Republic that fails to meet the Treaty's requirements of public purpose, due process, non-discrimination and adequate compensation.

#### **IV. The Czech Republic Is Required to Remedy Its Breaches of the Treaty**

171. The Czech Republic has an obligation under international law to remedy its Treaty violations. The Permanent Court of International Justice recognized more than seventy years ago that States must be required to remedy violations of international treaties, noting that "[i]t is a principle of international law that the breach of an engagement involves an obligation to make reparation" in an adequate form.

#### **F.**

##### **Position of the Respondent I. Introduction**

172. The Czech Republic acknowledged its obligations under the Treaty and confirms that it is committed to providing fair and equitable treatment to investment by Dutch nationals and companies. The Czech Republic's position is, however, that it is an abuse of the protection afforded by the Treaty for CME to have brought this arbitration against the Czech Republic.
173. The claims brought by CME relate to a private commercial dispute between the CME group and its former business partner, Dr. Vladimír Železný. The essence of CME's complaint is that Dr. Železný procured the wrongful termination of the contractual relationship between the broadcast licence-holder CET 21 and a provider of broadcast services ČNTS. The Czech Republic is not a party to any contract involving ČNTS. The Treaty is not intended as a means of resolving commercial disputes arising out of private contractual arrangements between two private parties.

174. CME/ČNTS brought legal proceedings against Dr. Železný/CET 21 in the Czech courts alleging wrongful termination of this contractual relationship. In those proceedings, CME/ČNTS alleged that Dr. Železný/CET 21 deprived CME/ ČNTS of their investment in the Czech Republic.
175. On 4 May 2000 the Regional Commercial Court in Prague has held that CET 21 wrongfully terminated the Service Agreement with ČNTS and that ČNTS is to be the exclusive service provider to CET 21. (The judgment was reversed in 2000 by the Court of Appeal). Dr. Železný/CET 21 caused the loss of which CME complains in this arbitration. Those proceedings confirm that there is no substance in CME's argument that it is the Czech Republic that has deprived CME of its investment. Those proceedings raise a *res judicata* and issue estoppel in respect of the issues pleaded and decided therein.
176. The judgment discloses no wrongdoing by the Czech Republic which could give rise to a cause of action under the Treaty.
177. As a further abuse of the Dutch Treaty, Mr. Lauder, who purportedly controls CME, has brought arbitration proceedings under the "US Treaty" in which Mr. Lauder makes identical allegations and seeks identical relief.
178. CME fails to establish that the contractual relationship between ČNTS and CET 21 constitutes an asset of CME invested in the Czech Republic.
179. The Czech Republic requests dismissal of CME's claims on grounds of lack of jurisdiction:
  - (a) CME has not established that it has an asset invested in the Czech Republic as defined in the Treaty;
  - (b) CME's claim is not an investment dispute as defined in the Treaty, but is of a private commercial nature with Dr. Železný/CET 21; and
  - (c) CME may not concurrently pursue the same remedies in different fora;

further and/or alternatively, on grounds of lack of admissibility:

- (a) CME has pursued the same remedies in other fora; and
- (b) CME has failed to plead any loss.

180. The Czech Republic denies that there has been any breach of the Treaty or of Czech law by the State or any of its instrumentalities.

## II. The Treaty

181. The Czech Republic relies on the terms of the Treaty for its full terms and effect and agrees that it is bound by the Treaty as from 1 January 1993.

## III. The Media Law

182. The Media Law of 30 October 1991 provided, amongst other things, for the issuing of a Licence by the Media Council to a “broadcasting operator”.

183. Article 10 set out the “*Conditions for granting a Licence*” and provided, inter alia:

- "(1) *A Licence authorizes its holder to broadcast in the scope and under the conditions set in it.*
- (2) *A Licence is not transferable.*
- ...
- (4) *In evaluating the application (§ 11), the licence-granting bodies give consideration to ensuring the conditions for plurality and balance in the programme services offered, especially local programme services, equal accessibility of cultural values, information and views, as well as ensuring the development of the culture of the nations, nationalities and ethnic groups in the Czech and Slovak Republic, and the extent of the applicant's previous business activities in the area of mass media.*
- (5) *In evaluating the application, the licence-granting bodies see to it that none of the applicants will gain a dominant position in the mass media.*
- (6) *In evaluating applications from companies with foreign equity participation, the licence-granting bodies take into consideration the applicant's contribution to the development of original domestic work, as well as the equity holdings of Czechoslovak natural persons and legal entities, and their representation in the company's bodies. “*

184. Article 11 concerned the “*Licence application*” and provided, inter alia:

„(3) *Only the person or entity who is applying for a Licence is a party to the Licence proceedings.*”

185. Article 12 concerned the “*Decision to grant a Licence*” and provided, inter alia:

“(3) *In addition to conditions stated in paragraph 2, the decision to grant a Licence also includes conditions which the licence-granting body will set for the broadcasting operator.*”

The power to impose conditions was, however, removed in 1996.

186. Article 14 concerned “*Changes in the licence*” and provided, inter alia:

“(7) *A broadcaster is required to notify the body which issued the Licence of all changes relating to the data stated in the application or the fulfilment of the conditions set in the licence and submit documentation of them within 15 days after these changes occur . . .*

(2) *On the basis of the notification under paragraph 1, the licence-granting body, depending on the circumstances of the case, will decide on a change in the granted Licence or will revoke the Licence (§ 15). ”*

187. Article 15 concerned “*Revoking a Licence*” and provided, inter alia:

“(1) *The body which granted the Licence shall revoke it from the licence-holder if:*

(a) *the licence-holder no longer meets the prerequisites for granting a Licence specified in § 10 par. 6 and 7;*

...

(c) *changes have occurred concerning the licence-holder which do not permit fulfilment of the conditions set in the Licence [this provision was removed in 1996]*

...

(2) *The body which granted the Licence may revoke it if*

(a) *the licence-holder violates in a serious manner the conditions set in the Licence, duties specified by this Act or by other generally binding legal regulations;”*

188. Article 20 concerned “*Fines*” and gave the Media Council the power to impose fines if the licence-holder violated its duties set by the Media Law or the Conditions to the licence. In addition, Article 20 (6) provided that a fine will be imposed on anyone who broadcasts without being authorised to do so. The fine could be between CZK 10,000 and CZK 2,000,000.

#### **IV. The Media Council**

189. On 21 February 1992, the Czech Parliament passed an Act (Act No. 103/1992 COLL.) establishing the Media Council or "Council". The function of the Council was to supervise the observance of legal regulations governing radio and television broadcasting, including the observance of the Media Law.
190. The Council has at all times been an autonomous body, independent of the Government and answerable to the Czech Parliament under Article 3 (5) of the Media Law and Article 29 of the Act on Competencies of State Institutions. It has nine members elected by the Czech Parliament. Members of the Council may not be members of Parliament, nor hold offices in political parties or political movements, nor be members of companies that do business in the field of mass media, nor represent business interests that might be in conflict with the performance of their office or that could adversely affect their impartiality and the objectivity of their decision making.

#### **V. Grant of the Licence to CET 21**

191. In 1992, the Council commenced proceedings for the issue of a new Licence for broadcasting commercial television, pursuant to the procedures prescribed in the Media Law. The Council had special regard to the urgency and importance of such task at a time when no competition existed in Czech television broadcasting.
192. The Licence was not to be issued through a tender process (in the sense that it would be awarded to the bidder with the most advantageous financial package to the Government). The Licence was to be issued after a public enquiry which examined the viability and suitability of all submitted bids.

193. The Council invited bidders. Over 20 applications were received, one of which was CET 21, represented by Dr. Železný. In April 1993, Dr. Železný acquired a 17 % interest in CET 21. In August 1996 he increased his interest to 60 %.
194. The Media Law did not bar foreign parties from effectively holding television licences. The Media Law merely stipulated, as many countries do, that a legal entity could only become a licence-holder if it had a registered office on the territory of the Czech Republic and was registered in the Commercial Register. CEDC never applied to the Media Council for a Licence. CME has failed to establish that it assumed the rights and obligations of CEDC as a matter of law.
195. CEDC could have applied for a Licence on its own through a Czech registered company. CEDC chose not to. Neither CEDC (nor later CME) ever raised any formal complaint with the Council or the Government at the time. The Czech Republic has also no knowledge of whether CEDC and CET 21 contemplated pursuing a joint application for a Licence. In any event, only CET 21 submitted an application, dated 27 August 1992.
196. CET 21's application was supported by a document entitled "*Project for an independent Television Station*". It explained that, inter alia, financial backing would be provided by CEDC, the shareholders of which were said to be part of the "Lauder group". CET 21 stated in the Project Proposal, submitted with its application, that CEDC was a "*direct participant in CET 21's application for the Licence*". However, neither the Media Law, nor Czech law in general, recognises any legal term or gives any legal definition to the term "*direct participant*". The Project Proposal itself made clear that it was CET 21, and CET 21 only, that was applying for the Licence. The applicant for the Licence was named as CET 21.

197. In mid January 1993, CET 21 provided the Council with a “business plan” which set out in detail the expected revenues and expenses of CET 21 and ČNTS.
198. The Council received assistance from a Council of Europe expert mission. It evaluated the business plans of the projects. CET 21 and two other companies had the best plans. The Council then had to choose one of the three shortlisted applicants, having regard to the criteria in Article 10 of the Media Law. CET 21 was chosen.
199. The Council, by letter dated 30 January 1993, informed CET 21 that it had been granted a Licence for nation-wide broadcasting. It was clearly understood by Council members such as Dr. Josefík that the applicant for the Licence was CET 21 alone and that CEDC would be a future investor. The letter referred to CEDC being a “*direct participant to the application*”. That reflected the understanding that CEDC would be an investor in the project, and this phrase had no legal significance under the Media Law. In addition to the financial considerations, members of the Council such as Dr. Josefík voted in favour of CET 21 because their broadcasting format appeared most likely to provide competition to the existing public television stations and to provide a plurality of views.
200. Accordingly, as a matter of Czech law, any rights and obligations prescribed by the Media Law and the Licence are only given to and assumed by the party that made the application and is named in the Licence.
201. The Council did not violate the Treaty including in particular by not permitting foreign ownership of the Licence. No political pressure took place. The Media Law does not preclude foreign investment in the broadcasting industry. It only requires that the broadcasting Licence be held by an entity which has a registered office in the Czech Republic and which is registered in the Commercial Register.
202. After the announcement of the decision, CET 21 and CEDC entered into two agreements: the “*Overall Structure of a Czech Commercial Television Entity*” of 3 February 1993 and the “*Basic Structure of a New Czech*

*Commercial Television Entity*” of 5 February 1993. Both agreements provided that CET 21 and CEDC would create a new company to manage the TV station, with investments to be made by CEDC and the Czech Savings Bank. The earlier agreement stated that CET 21 and CEDC agreed to allow the new company to have exclusive use of the Licence but this was omitted from the later agreement. The earlier agreement confirmed *“that neither party has the authority to broadcast commercial television without the other”* but in the later *“CET 21 acknowledges that it is not entitled to carry on broadcasting without the direct participation of CEDC”*.

203. The two agreements were different in certain material respects. Moreover, they were both significantly different from the *“Terms of Agreement”* between CEDC and CET 21 dated 5 January 1993 which provided that CEDC was to be a major shareholder of CET 21.
204. The Council did not participate actively in negotiating a solution which led to the creation of ČNTS. It did not play a central role in directing the formation of ČNTS. It did not discriminate against foreign investors in Czech television. The Council did not bless the arrangements between CET 21 and ČNTS or give its approval to those arrangements or actively participate in their formulation. The Council could not and did not provide any official assurances to CEDC.
205. The Council's Decision and the separate Licence (containing 31 Conditions) were formally issued in writing to CET 21 on 9 February 1993. The Decision stated that the Council *“awards a Licence for nation-wide television broadcasting on the territory of the Czech Republic to the limited liability company CET 21.”*
206. The *“Reasoning”* referred to CET 21's *“contractual partner, the company CEDC”*. The *“Reasoning”* stated that *“the CET 21 proposal best suited the aim to create a project for television broadcasting by a private operator which respects the public interest, contributes to the creation of a democratic society, and reflects a plurality of opinion and will provide objective and balanced information necessary to form opinions free/y.”*



It also noted that the proposal demonstrated adequate financing, but it added that “[d]espite the substantial involvement of foreign capital necessary to begin television station activities, the proposal clearly guarantees the intent to preserve the national character of programming. ”

It concluded:

*"... Through the formulation of Licence conditions and through inspection of their observance, [the Council] intends to ensure that the aims stated in the proposal which convinced the Council that this proposal is the best, will be observed. "*

207. The Licence itself named the “licence-holder” as “CET 27”. It stated:

*“The licence-holder is required to ensure that the broadcasting is in accordance with the information stated in the application on the basis of which this Licence was issued. It also agrees to observe the conditions stated in the appendix to this Licence. ”*

208. The Licence Conditions 17 and 18 (the complete wording already cited above) provided that “any change in the legal entity” of the licence-holder and the investors CEDC and the Czech Savings Bank required the prior approval of the Media Council (Condition 17) and that the investors shall not interfere into “the programming and the editorial independence of the newscasting employees” (Condition 18).

209. The purpose of the Licence Conditions was, to monitor the business arrangements between CET 21 and the investors (CEDC and Czech Savings Bank) and to ensure that the investors actually became parties to the project. At that time (1992/93), many foreign investors promised to fund huge projects in the Czech Republic, but when it came to pay the money they disappeared. Condition 18 also emphasized the requirement of editorial independence (a key attribute of any Licence). Similar conditions were imposed upon other licence-holders. The Czech Republic contends that the wording of Condition 17 has very little legal significance as far as the investors were concerned. It conferred no right on the investors (or ČNTS) vis-à-vis the Czech Republic. The legal effect of the Conditions was exactly according to their terms: they imposed obligations on CET 21. And the Licence and the Conditions were expressly accepted by CET 21, and only by CET 21.

210. The specific reference to the MOA was recognition that the requirement in the original Condition 17 that CET 21 submit the MOA within 90 days had been fulfilled. It also identified the contractual structure which the licence-holder had entered into with its investors and over which the Council intended to exercise regulatory supervision (pursuant to Condition 17). The Council was concerned to ensure that the editorial independence of CET 21 was secured (Condition 18). The Council was responsible for ensuring that this independence remained intact, and it therefore imposed reporting requirements in Condition 17.
211. Thus, the Council envisaged, as reflected in the Licence Conditions, that CEDC and Czech Savings Bank would be “investors” in a company established to manage and operate the television station. The Czech Republic contends that this terminology has no legal significance in the sense contended by CME and does not confer any rights upon CEDC, or the Czech Savings Bank, or ČNTS. Such wording recognised the fact that the licence-holder, CET 21, intended to obtain funding and know-how from CEDC; and that CEDC’s rights vis-à-vis CET 21 were to be contractual. It does not elevate CEDC to the status of co-licence-holder. In the Conditions to the Licence, CEDC is referred to as an “investor”.
212. The Council did not contemplate that CET 21 would transfer the Licence to CEDC or any other entity or person. Indeed, the Media Law forbade it. Neither the Decision nor the Licence required CET 21 to enter into any relationship with CEDC or anyone else whereby it would lose control of broadcasting and programming, nor did the Decision or the Licence approve any such relationship made by CET 21.
213. The Council did not take into account the February agreements when it issued the Licence. The Licence documentation did not link CEDC and ČNTS to the Licence issued to CET 21 in any manner beyond acknowledging that CEDC was to be an investor in the project.

## VI. The Formation of ČNTS

214. CET 21, Czech Savings Bank and CEDC established and became shareholders in ČNTS.
215. Condition 17 of the Licence Conditions required the submission to the Council of a Business Agreement (herein: the "MOA"). A text was submitted to the Council. By letter dated 21 April 1993 the Council notified CET 21 that the Council affirmed in its meeting of April 20, 1993 "in accordance with the Article 17 of the Conditions to the Licence" the submitted version of the MOA between CET 21, CEDC and the Czech Savings Bank.
216. In respect to the formation of ČNTS and its MOA, the Czech Republic's position is that the Council did not participate actively in the negotiation of the MOA. The Council did not have the power or authority to approve the MOA submitted to it. It simply acknowledged that Condition 17 of the Licence had been complied with. The Council did neither approve the arrangements between ČNTS and CET 21, nor proposed them, nor publicly endorsed them. No actions of the Council could release CET 21 and ČNTS from conducting their arrangements in compliance with the Media Law. The Council was not substantially involved in the negotiation and finalization of the terms of the MOA and the adherence to these arrangements until 1996. The Council was not influenced by "changing *political winds*".
217. In 1996, the Council commenced administrative proceedings because there was clear evidence of a violation of the Media Law which ČNTS was unwilling to remedy. The Council was not fully aware of and did not accept the ČNTS structure. The Council never agreed that CET 21 could transfer the Licence to ČNTS. The Council did not take a discriminatory position towards foreign investment and/or ownership of the Licence. The Council did not participate substantively in developing the arrangement between CET 21 and ČNTS, did not formally endorse its legality and did not forcibly dismantle the arrangement.
218. On 4 May 1993 CET 21, Czech Savings Bank and CEDC executed the "*Memorandum of Association*" (the MOA). CET 21 was to have a 12 %

ownership interest in ČNTS; Czech Savings Bank a 22 % ownership interest; and CEDC a 66% (and therefore controlling) ownership interest.

219. The MOA recorded that the subject of ČNTS's business activity was "*the development and management of a new independent private, country-wide television broadcasting station in compliance with the Licence and the conditions attached thereto*". The MOA noted that CET 21 had been "*granted and became the holder of a Licence for nation-wide broadcasting*" and referred to CEDC as an "*investment company*". In addition, the MOA provided (at para. 1.4.1):

*"[CET 21] shall contribute to [ČNTS] unconditionally, unequivocally, and on an exclusive basis the right to use, exploit and maintain the Licence held by [CET 27]."*

The Czech Republic's position is that no specific legal entitlements derive for ČNTS or CME from the MOA and in particular from CET 21's contribution of the use of the Licence to ČNTS. The meaning and effect of the Memorandum of Association is a matter governed by Czech law. CME would have the Tribunal conclude that it allowed ČNTS to broadcast without a Licence. The Czech Republic contends that the wording in the Memorandum of Association did not, and in any event could not, equate to a transfer of the Licence to ČNTS, as that would have been in clear breach of Article 10 (2) of the Czech Media Law. CME may have had a different understanding or expectation: in its Statement of Claim, CME states that "*... the Media Council expressly approved the agreement under which CET 21 assigned the exclusive right to use its Licence to ČNTS*". That premise, namely that ČNTS became assignee of all rights associated with the Licence, is an essential element of CME's case. But that premise is fundamentally wrong both in fact and law.

The Council's understanding of the contribution of the Licence to ČNTS was explained in its Report of May 1994:

*"The Licence as such has not been contributed to ČNTS and is separate from all other activities of ČNTS . . . The Memorandum of Association and the Licence terms specify the relationships between ČNTS and CET 21 and contain a number of mechanisms that prevent the potential non-permissible involvement of ČNTS in the rights and obligations of the licence-holder".*

In the opinion of the Council, and contrary to CME's contention, the Licence Conditions and in particular, Conditions 17 and 18, were in fact intended to prevent ČNTS becoming the broadcaster.

220. ČNTS was to have a Programming Council consisting of seven (7) members of whom three (3) were to be appointed by CET 21, two (2) by Czech Savings Bank, and one (1) by CEDC. The seventh was to be the Programming Director (para 8.1). This implied that CEDC would not control the programming (as required by Condition 18 of the Licence).
221. At paragraph 10.4, CEDC, Czech Savings Bank and CET 21 expressly agreed *"to be bound and to respect all of the conditions of the Licence, mandated by the Council. In particular, CEDC and [Czech Savings Bank] agree to abide by condition No. 18 not to interfere by any means with the programming of Television station and especially not to interfere with journalistic independence of the news department."*
222. The Council did not consider that it had the power to disapprove the wording of the commercial arrangements between the parties, including the words of CET 21's contribution to ČNTS. But the Council was concerned as to how the arrangement between the various parties would be implemented in practice, and how CET 21 would perform its obligations as broadcaster under the Media Law. The Council understood that ČNTS would provide services to CET 21, but the Council did not foresee that the scope of exclusivity between the licence-holder and the service provider would be so great that CET 21, far from being the broadcaster, would become a mere shell company, the entire operation lying in practice in the hands of ČNTS. Even if the Council had been actively involved in drafting the MOA, that cannot be interpreted as approval of unauthorized broadcasting by ČNTS.
223. At the request of CET 21, the Council issued a Decision dated 12 May 1993 changing the wording of the Licence Conditions. The relevant Conditions which were changed were Conditions 17 and 18:

*"The licence-holder obliges itself:*

- ...  
(17) to submit [to] the Council for approval any changes of legal person which has been the licence-holder, or of the capital structure of the investor which result in a change of control over their activities, and of the provisions of partnership*

*agreement between the licence-holder and investors. The partnership agreement is an integral part of the Licence terms. The partners of this partnership agreement are the licence-holder, CEDC and Česká spořitelna, in the scope and under the conditions stipulated by this Memorandum of Association.*

- (18) *to ensure the CEDC specified as the partner to the partnership agreement in the Licence terms and other investors specified therein will in no way interfere in television station programmes, particularly in editorial independence of news service workers. "*

224. ČNTS was registered on 8 July 1993. ČNTS entered in the Commercial Register that the subject of its business activity was "*nation-wide television broadcasting under Licence no, 001/1993*". This was unknown to the Council. Dr. Železný was appointed General Manager. TV NOVA commenced broadcasting in February 1994.

## **VII. The Unlawful Implementation of the Licence**

225. Soon after broadcasting commenced, the Council became concerned about the role of ČNTS. The Council was contacted by an independent producer of programmes who complained that two television broadcasting licence-holders, TV NOVA and Premiéra TV, were only re-broadcasting existing programmes and not developing domestically produced programmes. It was also observed that the broadcaster was not clearly identified at the end of each TV NOVA programme. The Council started to investigate these issues.
226. On 1 February 1995, the Council received a letter from a law firm claiming that their client believed his reputation had been damaged as a result of a programme broadcast on TV NOVA and intended to start defamation proceedings. They wanted to know the identity of the broadcaster. The letter also referred to a judgment of the Regional Commercial Court in Prague dated 13 September 1994 and a decision of the Municipal Court of Prague 1 which stated that ČNTS was the actual operator of the broadcasting.
227. Following this, the Council requested the Commercial Court to clarify the scope of the registered business activities of CET 21 and ČNTS.

228. Further, it came to the attention of the Council that CME had apparently replaced CEDC (in August 1994) as a party to the business agreement but that no approval had been sought from the Council as required by Condition 17 of the Licence.
229. The Media Council also discovered that it was ČNTS, rather than the licence-holder, CET 21, that had entered into agreements with Czech Radiocommunications which was transmitting the signal, and with OSA and Integram which represented authors and producers respectively and protected their copyright. The Media Law required the broadcaster to enter into these agreements.
230. It thus became evident to the Council that CET 21 was just an empty shell company performing none of the obligations of the licence-holder and that ČNTS was in fact acting as licence-holder and receiving all the revenues therefrom. The Council concluded there had been a de facto transfer of the Licence to ČNTS and that ČNTS was broadcasting without a Licence, in breach of the Media Law.
231. The Council sought an independent legal opinion from the Institute of State and Law of the Academy of Sciences (the "Institute") concerning the arrangements between CET 21 and ČNTS. In February 1996, the Institute issued a legal opinion concluding that ČNTS was not authorised to broadcast as the Licence was issued to CET 21 and therefore ČNTS was in breach of the law. The opinion recommended that the Council initiate administrative proceedings against ČNTS for unlicensed broadcasting and that the Council consider the revocation of CET 21's Licence.
232. On 13 March 1996, the Council met CET 21 to discuss the issue of unlicensed broadcasting by ČNTS and the changes to CET 21's shareholders which had not been notified to and approved by the Council. In April 1996, CET 21 provided the Council with two alternative draft agreements between CET 21 and ČNTS regarding the services to be performed by ČNTS for CET 21. The Council again referred the question of lawfulness to the Institute. On 2 May 1996, the Institute issued a further legal opinion commenting on the draft agreements.
233. The Institute concluded that Draft No. 1 "*basically correctly resolves the situation.*" In summary, the Institute found decisive not so much the text of the agreement but the factual fulfilment of two points:

- (a) CET 21 (and not ČNTS) was to become a party to the agreement with Czech Radiocommunications; and
- (b) Advertising revenues were, in terms of “accounting and taxes, to be revenues of CET 21 (and not ČNTS), and CET 21 was to pay fees to ČNTS for its services.

234. In its second opinion, the institute set out at some length the conditions which had to be satisfied for the issue of unlicensed broadcasting to be resolved. On 4 June 1996, the Council wrote to CET 21 requesting CET 21 to amend the description of the business activities of CET 21 and of ČNTS, and commented on the two draft agreements submitted by CET 21 in April 1996, and requested CET 21 to notify properly the changes to its shareholders. On 27 June 1996, the Council was provided by CET 21 with a copy of an agreement between CET 21 and ČNTS (in fact dated 23 May 1996). It was different to the drafts provided in May. The arrangements between CET 21 and ČNTS still did not satisfy the concerns of the Council.

235. The new Media Law entered into force on 1 January 1996. A licence-holder could request the Council to delete those conditions of its Licence which did not concern control of the programming. On 2 January 1996, CET 21 had applied for the removal of most of the conditions to its Licence, including Conditions 17 and 18. If that were done, the Council would no longer be able to request information on the arrangements between CET 21 and ČNTS, and thereby monitor those arrangements.

236. During 1996, the Council had also been investigating Premiéra TV and Rádio Alfa, discovering that the arrangements between the respective licence-holders and their service providers were not as the Council thought they should be.

### **VIII. Administrative Proceedings Against ČNTS**

237. At a meeting on 23 July 1996, the Council decided to commence administrative proceedings against the service providers involved in TV NOVA, Premiéra TV and Rádio Alfa.



238. By letter dated 23 July 1996, the Council advised ČNTS that, as recommended by the Institute in its Opinion, the Council was commencing administrative proceedings against ČNTS seeking the imposition of financial sanctions for unauthorised broadcasting in breach of the Media Law. There were three grounds for such proceedings: (i) the incorrect description of the business activities of ČNTS in the Commercial Register; (ii) that ČNTS rather than CET 21 had entered into contracts with Czech Radiocommunications and OSA; and (iii) the lack of control by CET 21 over the disseminated programmes.
239. Article 20 (5) of the Media Law provides for fines between CZK 10,000 (approximately US \$ 250) to CZK 2,000,000 (approximately US \$ 50,000). It is determined by the Council after a decision on liability is reached. In fact, the Council's intention was not to impose a fine, because that would not solve the problem, but to ensure that the relationship between the licence-holder and the service provider was corrected.
240. It was not relevant to the Council whether the service provider (of TV NOVA, Premiéra TV or Rádio Alfa) was owned or controlled by a foreign entity. It was concerned only with the relationship between the broadcaster and the service provider. Its key concern was that the attributes of the licence-holder were not transferred to the unlicensed service provider. In fact, Premiéra TV a.s. which was a service provider similar to ČNTS, had no foreign ownership (as far as the Council was aware).

### **IX. CME Takes Secret Control of CET 21**

241. About this time in 1996, no doubt aware that the arrangements between CET 21 and ČNTS violated the Media Law and would have to be changed, CME secretly sought to acquire control of CET 21. CME provided a loan to Dr. Železný of US \$4.7 million to enable him to buy an additional 43 % stake in CET 21 (from four of the original five shareholders) thus increasing his holding from 17 % to 60 % which he did. The loan agreement, dated 1 August 1996, provided that Dr. Železný would exercise his voting rights only as directed by CME. The secret control by CME of CET 21 was in clear breach of the requirements of the Media Law and the Licence. The Council was not informed either of Dr. Žel-

ezný's acquisition of a controlling interest in the licence-holder, or of the terms of the loan agreement giving voting control over CET 21 to CME. Condition 17 of the Licence required the Council's prior approval of both arrangements.

242. Upon discovering in late 1996 the Loan Agreement between CME and Dr. Železný, the Council initiated a meeting with CET 21 and Dr. Železný in order to find out more about the loan agreement. Dr. Železný assured the Council that the Agreement was not going to be fulfilled. In fact, as appears from an Amendment to the Loan Agreement, dated 11 March 1997, the Conditions of the original Loan Agreement had been fulfilled and Dr. Železný was released from the obligation to repay the loan.

#### **X. Change of Memorandum of Association of ČNTS and Service Agreement**

243. By letter dated 4 October 1996, ČNTS and CET 21 made a joint proposal to the Council involving a sequence of several steps which it hoped would resolve the Council's concerns over the CET 21/ČNTS relationship. ČNTS and CET 21 asked that the proposal be taken as "*an expression of our goodwill, openness to discussion, and forthcoming attitude.*" CET 21/ČNTS offered, inter alia: to submit to the Council for their information a new business agreement between CET 21 and ČNTS; that ČNTS would conclude in the name of CET 21 agreements with Czech Radiocommunications and agencies representing authors and performing artists (i.e. OSA and Intergram); to change the description of ČNTS's business activities in the commercial register; and to submit for approval by ČNTS's General Assembly a change to Article 1.4.1 of its Memorandum of Association whereby CET 21 contributed the Licence on an exclusive basis. ČNTS and CET 21 also sought the cancellation of Condition 17 of the Licence. These proposals were in principle agreeable to the Council.
244. ČNTS provided the Council with a copy of an agreement between CET 21 and ČNTS, dated 4 October 1996 which was said to govern the relationship between them.

245. In November 1996, the MOA of ČNTS was amended to read that CET 21:

“contributes to [ČNTS] unconditionally, irrevocably and on an exclusive basis, the right to use, make a subject of [ČNTS'S] benefit and maintain, know how related to the Licence, its maintenance and protection”.

246. In December 1996, Condition 17 was removed with legal effect from February 1997.

247. In February 1997, the change of business activities of ČNTS was registered with the Commercial Register. ČNTS deleted “*nation-wide television broadcasting pursuant to Licence no. 001/1993*” from its activities.

248. On 15 May 1997, the investigation by the State Prosecution Office which had commenced in April 1996, was stopped.

249. In May 1997, the 4 October 1996 agreement between CET 21 and ČNTS was superseded by a further agreement dated 21 May 1997 (which was stated to reflect the changes in the Commercial Register). An Addendum to that Agreement was also agreed on the same date. These became known as the “Services Agreement” or “Co-operation Agreement”. This new agreement provided:

*“The parties confirm that the holder of Licence 001/1993 and operator of television broadcasting with the Licence under Act no. 468/1991 Co/l., as amended, is CET 21 and that the Licence is non-transferable. [Art. 1]*

...

*The parties have agreed that from prior agreements ČNTS has authorization to arrange, under this agreement, services for television broadcasting which is operated on the basis of the licence issued to CET 21 and that ČNTS is authorized to keep an agreed profit from this activity. [Art. 2 (1)]*

...

*ČNTS shall conduct the activity stated in para. 1 in accordance with generally binding legal regulations, as well as with the content of the Licence whose holder is CET 21. [Art. 2 (3)]*

...

*If broadcasting on TV NOVA violates obligations to which CET 21, as the licence-holder and broadcasting operator, is bound by law or the Licence, CET 21 is authorized to interfere with program-*

*ming through persons named by the general assembly of CET 21 and whose names CET 21 will announce to the company ČNTS immediate/y after their appointment [Art. 5]"*

250. Also during this period, CET 21 concluded agreements with Czech Radiocommunications, OSA and Intergram.
251. The formal arrangements between CET 21, CME and ČNTS were now considered to comply with the Media Law. Accordingly, the Council stopped the administrative proceedings by its Decision dated 16 September 1997.
252. Premiéra TV and Rádio Alfa eventually made similar changes to their arrangements and the administrative proceedings against their respective service providers stopped on 14 December 1998.

#### **XI. The Media Council did not reverse its Position**

253. The Council did not abruptly reverse its position or repudiate the arrangement it had officially approved or force ČNTS to surrender the exclusive right to the use of the Licence.
254. The Council became concerned that there had been a de facto transfer of the Licence to ČNTS in violation of the Media Law. Such violation could not and was not approved by the Media Council. When it discovered the violation, it first held negotiations with CET 21 and ČNTS in an attempt to persuade them to change their arrangements. When this was unsuccessful, the Council commenced administrative proceedings against ČNTS for unlawful broadcasting. Similar proceedings were commenced against the service providers to Premiéra TV and Rádio Alfa. CET 21 and ČNTS subsequently proposed changes to their arrangements and relationship which appeared to comply with the Media Law.
255. The activities of ČNTS were in violation of the Media Law. They had never been approved by the Council. They did not "*sudden/y become objectionable*". The Council had been concerned for many months that there may have been unlawful broadcasting by ČNTS, and had raised its

concerns with CET 21 and ČNTS. The relevant legislative provisions were those in the original Media Law which forbade a transfer of the Licence. Political factors did not motivate the Council.

256. The Council did receive an Opinion from the Institute, not from Dr. Bárta in his individual capacity. Dr. Jan Bárta was the head of the public law Section at the Institute and thus had to issue legal opinions on Institute letterhead on behalf of the Institute. The Institute's letter dated 13 August 1996 relied on by CME does not support its assertion that the institute disowned the Opinions of Dr. Bárta. The letter addressed to Dr. Železný dated 13 August 1996 was not the Institute's "only *real opinion*".

## **XII. The Media Council did not Compel ČNTS to Alter the MOA**

257. The Council did not "force" ČNTS and CET 21 to amend the Memorandum of Association. ČNTS and CET 21 no doubt "*capitulated*" because they recognised that their implementation of the Licence did, in fact, violate the Media Law. The Council did not insist that ČNTS "could *not be involved in broadcasting*" but rather, the Council insisted that ČNTS could not be the de facto licence-holder.
258. The contractual changes were not "*coerced*" by the Council. This assertion is contradicted by ČNTS's pleadings in the recent Czech Court proceedings against CET 21 in which ČNTS relied on the validity of, inter alia, the amended Memorandum of Association and the Service Agreement dated 21 May 1997.
259. The Czech Republic relies on the "*Reasoning*" which is included in the "*Decision*" of the Council dated 16 September 1997. The Czech Republic is not responsible for the consequences of changes to commercial arrangements required to be made by the parties thereto in order to comply with Czech law.
260. ČNTS could have contested the Council's interpretation of the Media Law through the administrative proceedings or through the Czech courts. Alternatively, it could amend the business arrangements with CET 21 and have the proceedings dropped. It chose voluntarily to amend the business arrangements, and has since relied in the Czech courts upon

those amended agreements as a valid expression of the clear will of ČNTS and CET 21.

### **XIII. March 15,1999 Letter**

261. In response to a request by CET 21, the Council met with Dr. Železný on 2 March 1999 which was in compliance with a licence-holder's right to request a meeting with the Council in order to discuss issues relating to its Licence. They discussed a number of matters relating to CET 21, including its relationship with its service provider.
262. The Council's policy in connection with the arrangements between licence-holders and service providers was discussed. This was a topic of public debate. The Council had expressed its views at meetings of a special Media Panel which had been set up by a number of broadcasters to discuss a new Media Law then being drafted by the Ministry of Culture. Dr. Železný and his lawyer had attended most of those meetings. It was a matter of public record that the Council did not favour exclusive relationships between licence-holders and service providers because that might lead to a de facto transfer of the Licence. That policy was based on its experience with TV NOVA, Premiéra TV and Rádio Alfa.
263. The next day (3 March), Dr. Železný wrote to the Council, setting out his summary of the Council's policy and asking for confirmation. The Council replied by letter dated 15 March 1999. Dr. Železný's summary was generally an accurate summary of the Council's policy, as expressed at the 2 March meeting and elsewhere. The Council wrote a similar letter to at least one other licence-holder.
264. This letter represented the Council's policy and applied to all licence-holders. However, since the Council no longer had the power to impose conditions through which it could monitor the arrangements between the licence-holder and its service provider(s), the Council could not enforce this policy.

#### XIV. The Dispute Between CET 21 and ČNTS

265. In or about October 1998, CET 21 had informed ČNTS that activities performed by ČNTS would in future be performed by a company called AQS a.s. The effect of this on the relations between ČNTS and Dr. Železný is not known, but on 19 April 1999, CME dismissed Dr. Železný from his position as General Manager of ČNTS. Then on 5 August 1999, CET 21 withdrew from the Services Agreement (of 21 May 1997), on the ground that ČNTS's failure to provide daily broadcasting schedules constituted a material breach of contract, and stopped using the services of ČNTS.
266. On 9 August 1999, ČNTS commenced proceedings against CET 21 in the Regional Commercial Court in Prague. The Court decided:
- "[CET 21] is obligated to procure all services for television broadcasting performed on the basis of Licence No. 001/1993 for the operation of a full-coverage television broadcasting station granted to him by the Council exclusively through [ČNTS], and by means of services provided by [ČNTS], in accordance with the terms and conditions of the [Services Contract] concluded between [ČNTS] and [CET 21] on 5/21/1997, ..."*
267. The Court stated that the arrangements between CET 21 and ČNTS had been voluntarily amended.
268. The Services Agreement was not *"part of the package of contractual changes coerced by the Media Council"*. On the contrary, ČNTS relied upon the Services Agreement as the basis of its claim against CET 21. The Regional Commercial Court recorded that ČNTS had submitted that *"[t]he change in the definition of the contribution to the capital stock was not understood by [ČNTS] and [CET 21] as a change altering their legal relationship, but only as a change meeting the requirements of the Council and resulting in staying the administrative proceedings."* The Court noted that, *"[a]ccording to an expert opinion [of ČNTS] valuing this non-monetary contribution [of the Licence know-how], the value of this contribution remain unchanged. "*

The Court stated that CET 21 was not entitled to withdraw from the Services Agreement. The judgment was reversed by the Court of Appeal.

269. The proceedings before the Prague Regional Commercial Court deprive this Tribunal of jurisdiction. CME must be assumed to have elected to pursue ČNTS's commercial rights before the Czech courts. CME cannot refer that same dispute to arbitration under the Treaty. Moreover, the pleadings and judgment in those proceedings confirm that the Czech Republic is not responsible for any harm which CME may have suffered to its alleged investment.

#### **XV. The alleged Destruction of Claimant's Investment**

270. The Council is not responsible for the actions of private parties in their dealings with their contractual partners. The steps taken by Dr. Železný and CET 21 were not taken with the Council's "*connivance and assistance*".
271. The Czech Republic cannot comment on the dealings between Dr. Železný and ČNTS/CME. Any action taken by Dr. Železný in relation to ČNTS/CME is part of their private commercial dispute. It is irrelevant to the Czech Republic's obligations under the Treaty. The Council did not threaten further action. The dispute escalating between Dr. Železný and CME has led to any "investment" by CME being harmed.
272. The Council did not provide "*active assistance to Dr. Železný in his campaign to eliminate ČNTS's exclusive position respecting CET 21*". All actions of the Council, including responding to Dr. Železný's request in his letter of 3 March 1999, were carried out in fulfilment of its role of broadcasting regulator. The Czech Republic cannot comment on Dr. Železný's motivations or intentions in writing to the Council.
273. In the Council's letter of 15 March 1999 to Dr. Železný, the Council reiterated its policy concerning the relationship between licence-holders and service providers. That policy had been expressed publicly in meetings of the Media Panel and in its submissions to the Ministry of Culture on



- the proposed new Media Law. The Council wrote a similar letter to at least one other licence-holder.
274. The Council's policy in early 1999 as reflected in its letter of 15 March 1999 was not in conflict with its previous practice. The Council's policy was consistently not to favour exclusive relationships between licence-holders and service providers because that might lead to a de facto transfer of the Licence. The Council's experience with TV NOVA, Premiéra TV and Rádio Alfa was evidence that this might happen. However, the Council had no power to intervene unless a violation of the Media Law occurred.
275. The 15 March 1999 letter did not go beyond the scope of the Council's authority under the Council Act. The Council, as broadcasting regulator, was not only entitled to, but obliged to, respond to queries from licence-holders. The Council was not issuing an ex parte declaration in support of one party to a dispute.
276. The Council did not play a negative role in the events leading to the estrangement of Dr. Železný/CET 21 and Mr. Lauder/ČNTS/CME. The Council was to monitor and enforce the Media Law, as it was empowered and obliged to do under Czech law.

#### **XVI. The Media Council did not Fail to Protect Claimant's Investment**

277. The Council does not have the power to police and enforce private commercial contracts. Nor can it dictate to a licence-holder whom it should choose as a service provider.
278. The Council and other organs of the Czech Republic did not fail to respond as appropriate to complaints made by ČNTS and CME. The Council, inter alia, reported to the Permanent Commission for Media of the House of Deputies of Parliament concerning the dispute between Dr. Železný and ČNTS, and wrote to ČNTS and CET 21 (letters dated 26 July and 29 July 1999).
279. The actions of CET 21 and Dr. Železný of which ČNTS had complained in its letters in June, July and August 1999 to the Council were part of a

commercial dispute that should be resolved by the parties concerned, with resort to the courts, if necessary.

280. The Council is not responsible in any way for the dispute between CET 21 and ČNTS. It did not ignite the dispute, ignore its own regulatory obligations, or refuse to comply with its obligations under the Treaty.

## **XVII. The Czech Republic's Alleged Additional Continuing Violations of the Treaty**

281. The Czech Republic did not continue to breach its obligations under the Treaty since the instigation of this arbitration. It did not favour the Czech investors in CET 21. The Council has not "*affirmatively assisted Dr. Železný in evading the effectiveness of orders of an ICC arbitral tribunal*". The Czech Republic has enacted legislation relating to the recognition and enforcement of arbitral awards in accordance with its obligations under the New York Convention.
282. The Council considered the request to increase the share capital of CET 21 and to transfer certain shares. The Council concluded that there was no legal obstacle preventing the transactions and therefore gave its approval.
283. The Czech Republic did not disregard criminal wrongdoing by Dr. Železný directed against CME's investment. Respective complaints have been properly investigated by the Czech police authorities.

### **G.**

#### **The Respondent's Argument**

##### **I. The Interpretation of the Treaty and Burden of Proof**

284. The Treaty must be interpreted according to the ordinary rules of treaty interpretation as established by State practice and as codified in Article 31 of the *Vienna Convention on the Law of Treaties (1969)*.
285. In respect to the breach of the Treaty as alleged, the burden of proof is on the Claimant to demonstrate that both the breach and the responsibility of the Czech State is engaged: a "[p]arty having the burden of proof

*must not only bring evidence in support of his allegations, but must also convince the Tribunal of their truth, lest they be disregarded for want, or insufficiency, of proof".*

## **II. The Governing Law**

286. Article 6 of the Treaty provides:

*"The arbitral tribunal shall decide on the basis of the law, taking into account in particular though not exclusively:  
the law in force of the Contracting Party concerned;  
the provisions of this Agreement, and other relevant Agreements between the Contracting Parties;  
the provisions of special agreements relating to the investment;  
the general principles of international law."*

287. The Respondent's view is that Czech law should be given primacy in determining whether or not the Czech Republic has breached its obligations under the Treaty.

## **III. The Tribunal Lacks Jurisdiction**

288. The Tribunal has jurisdiction in respect of *"All disputes between one Contracting Party and an investor of the other Contracting Party concerning an investment of the latter"* (Art. 8).

289. *"Investment"* is defined as *"every kind of asset invested either directly or through an investor of a third State . . ."* (Art. 1 (a)).

290. The Tribunal lacks jurisdiction, on the grounds that:

- (i) CME has failed to establish that it has an asset invested in the Czech Republic;
- (ii) CME's claim is not an investment dispute under the Treaty; and
- (iii) CME may not concurrently pursue the same remedies in different fora.

### **1. CME has Failed to Establish that It has an Asset Invested in the Czech Republic**

291. The Claimant's assertion of a claim under the Treaty is unclear and unparticularized. CME is not entitled to bring a claim under the Treaty.
292. CME fails to identify the "investment" which it alleges gives rise to rights under the Treaty. CME failed to identify, whether CME's "investment" is its alleged shareholding in ČNTS or some contractual right allegedly enjoyed by ČNTS or some right conferred on CEDC.
293. Further, CME fails to establish that it has assumed the rights and obligations of CEDC.

### **2. CME's Claim is Not an Investment Dispute under the Treaty**

294. CME'S claim demonstrates a fundamental misunderstanding of the purpose and ambit of the Treaty (and, indeed, BITs in general). The Czech Republic considers that the attempt to use the dispute settlement provisions of the Treaty in order to settle private disputes in the manner sought by CME distorts the Treaty and if successful would represent a grave threat to the stability of the entire network of BITs.
295. This is a private commercial dispute and not an investor-host State dispute.
296. CME seeks to utilise the Treaty regime as an alternative or additional means for the resolution of a dispute arising from a falling out between two business partners, CME/ ČNTS and Dr. Železný/CET 21. The contractual rights and legal rights referred to are exclusively those made between ČNTS or CME and CET 21 or Dr. Železný. The Czech Republic is a party to none of them.
297. It is the contractual arrangements between CET 21 and ČNTS, and not the Licence, upon which the claimed exclusivity that CME seeks to secure in these proceedings is based. The Council did not impose the claimed exclusivity arrangement, and had no power to do so. The grant of the Licence signified no more than that the Council considered, on the basis of the information then available to it, that CET 21 was a proper re-

ipient of the Licence. The Council attached conditions to the Licence that required CET 21 to advise the Council of the business arrangements it entered into with CEDC and the Czech Savings Bank but the Council did not have the power, nor did it, approve or endorse those arrangements.

298. The dispute between Mr. Lauder (and his companies including CME) and Dr. Železný (and his companies) has already been, and is still being, pursued through various courts and arbitral tribunals. The Czech Republic is not a party to that dispute, and it takes no position on the merits of the arguments advanced on either side in the continuing litigation (save as articulated in judgments of the Czech courts). But it is clear from CME's own Statement of Claim that Mr. Lauder's claim against the Czech Republic relates to the withdrawal by Dr. Železný and his companies from various contractual arrangements to which the State was not a party. The Prague Commercial Court has upheld ČNTS's claim that Dr. Železný/CET 21 wrongly withdrew from those arrangements. It is therefore Dr. Železný / CET 21 that has allegedly injured CME's interests within the Czech Republic. The Czech Republic is not responsible for the actions of private parties.
299. In the relief originally sought, CME asked the Tribunal to restore the exclusivity of the relationship between ČNTS and CET 21. CME dropped this request during the proceedings. The relationship of exclusivity is a contractual one for which the parties must bargain and agree, within the limits of the law, and which they must enforce using the procedures of the law. The courts may uphold and enforce such contractual relationships (and it is to the courts which ČNTS has turned to obtain such relief). But contractual relationships between a licence-holder and service provider(s) cannot be imposed or enforced via the licensing procedures of the Czech Republic.
300. This is not a dispute concerning the treatment by the Czech Republic of an investment: it is a dispute concerning an alleged breach of a commercial contract made by private parties. That dispute should be settled either according to procedures agreed by the parties (such as arbitration), or through courts in the Czech Republic or some other State within the jurisdiction of whose courts the dispute falls. Treaty procedures were not intended to be used in these circumstances. If they were allowed to be so used, every commercial dispute involving a foreign investor could be

elevated to the level of a dispute within the Treaty procedures. That is plainly not the intention of the Treaty.

301. CME's claim must be dismissed on grounds that CME's claim is not an investment dispute within the scope of the Treaty.

### **3. CME May Not Concurrently Pursue the Same Remedies in Different Fora**

302. It is an abuse of the Bilateral Investment Treaty regime for Mr. Lauder, who purportedly controls CME, and, subsequently, CME to bring virtually identical claims under two separate treaties. The Czech Republic does not consider it appropriate that claims brought by different claimants under separate Treaties should be consolidated and the Czech Republic asserts the right that each action be determined independently and promptly.

As recognized by CME in its Statement of Claim, the action commenced by Mr. Lauder *"may not provide the full relief to which CME is entitled because it is brought on behalf of only a single controlling ultimate shareholder of CME . . . Only this Tribunal can declare that the Czech Republic has breached its Treaty obligations to [CME] and can provide full relief to [CME] for those breaches"*. In these circumstances, it is an abuse for Mr. Lauder to pursue his claim under the US Treaty and the Czech Republic is fully entitled to insist that CME make good its claim under the Dutch Treaty in separate proceedings.

303. The dispute between CME/ČNTS and Dr. Železný/CET 21 has been conducted as a private dispute. Several actions, in courts and arbitral tribunals, have according to CME itself, already been instituted, including one ICC arbitration and ten law suits at the Regional Commercial Court in Prague.
304. In particular, ČNTS has sought a ruling from the Czech Court upholding its claim to exclusivity under the Services Agreement made with CET 21. That is essentially the same remedy as is sought in the present proceedings. Thus, CME/ČNTS has already taken the present dispute before a competent court. The Regional Commercial Court has ruled in CME/ČNTS's favour and upheld the claim to exclusivity in relations between ČNTS and CET 21, precisely in terms that *"restore the initial eco-*

*conomic and legal underpinnings of [CME's] investment*", as those underpinnings were set out in the Services Agreement. The Prague Court of Appeal meanwhile reversed the judgment. The lawsuit is pending at the Czech Supreme Court. That Services Agreement was said by ČNTS itself to be *"the expression of a clear will of both contractual parties to determine the mutual relationship on an exclusive basis"* between them. CME/ČNTS is seeking at the Prague Civil Courts the remedy that it seeks from this Tribunal. Seeking the same remedy again is a plain abuse of process; and it conflicts with the spirit, if not with the letter, of the *res judicata* principle.

305. The Regional Commercial Court found that CET 21 had acted in breach of the contract, and whatever losses might have been suffered by ČNTS clearly derive from ČNTS's departure from the exclusivity arrangement. There is no suggestion, in the present claim or elsewhere, that there is any compensable loss that is not attributable to the breakdown of the exclusivity arrangement.
306. If a Claimant chooses to pursue a contractual remedy in the local courts or private arbitral tribunals, he should not be allowed concurrently to pursue a remedy under the Treaty.
307. The claims by investors under a BIT depend upon assertions that the State has treated the investment in a manner incompatible with the treaty. "The State" includes also the State's courts. If an investor takes the complaint of mistreatment before the State's court, it cannot be determined how "the State" has treated the investment until the State's courts have finally disposed of the case initiated by the investor. There can be no complaint that "the State" has mistreated the investment until the litigation has run its course.
308. An investor should not be allowed to switch to a treaty procedure which has the result of depriving the other party to the proceedings in the local court of the opportunity of arguing its case before the treaty tribunal.
309. The Tribunal is faced with the danger of incompatible and ostensibly "final" decisions being made not only in the various Czech court proceedings but also by another tribunal set up under the US Treaty and by the ICC arbitral tribunal ruling between CME and Dr. Železný. This is precisely the prospect of disorder that the principle of *lis alibi pendens* is designed to avert.

310. Therefore, the Tribunal lacks jurisdiction, or in the alternative, CME's claim is inadmissible.

#### **IV. CME Czech Republic B.V. has no claim in substance**

311. CME invested in ČNTS only after the broadcasting of TV NOVA commenced in February 1994. CME must have considered the commercial risk of investing in ČNTS as well as the legal framework in which this investment would be made, when it decided to acquire CEDC's rights and obligations in the Memorandum of Association to CME. This assignment was not notified by the Council as required by Condition 17.

#### **V. The Czech Republic's Obligations under the Treaty**

312. CME's claim should be dismissed on grounds that its Statement of Claim does not disclose a prima facie case that the Czech Republic has breached the Treaty having regard in particular to Czech law.
313. Essentially, CME claims that a Czech public body having granted a licence and had filed with it a contractual scheme which on its face did not infringe the law, may not take action when implementation of the Licence clearly does infringe the law. That proposition is patently incorrect, and must be clearly rejected if the entire balance of international instruments for the protection of foreign investment is to be maintained. The Czech Republic owes duties to investors, foreign and domestic, other than CME and Dr. Železný, and to the Czech people. The Czech Republic, like other States, must have the power to enact laws and regulate industries, such as broadcasting, pursuant to those laws, for the good order of the State and its economy. The Treaty was not intended to remove that power and does not remove that power.
314. The very core of the argument advanced by CME is fundamentally misconceived, because it denies the right of States to regulate their own economies, and to enact and to modify the laws, and to secure the



proper application of the law. It is no exaggeration to say that CME's argument involves a repudiation of the Rule of Law.

315. The facts show that the Council consistently applied the Media Law (in particular Article 10 (2) which proscribes the transfer of a Licence) and took action when the implementation of the Licence by CET 21 and ČNTS infringed the law. It took similar action against Premiéra TV and Rádio Alfa. Its position remains the same today: The transfer of a broadcasting Licence to a service provider is contrary to the Media Law. The Czech Republic has done no more than regulate its economy in a normal and entirely proper way. The impact of that regulation upon private contractual relations between investors is solely a matter for such investors.
316. The Czech Republic accepts its obligations under the Treaty.

### **1. The Obligation Not to Deprive Investors of Their Investments**

317. The Treaty provides at Article 5 that "*[n]either Contracting Party shall take any measures depriving, directly or indirectly, investors of the other Contracting Party of their investments unless the following conditions are complied with:*
- (a) *The measures are taken in the public interest and under due process of law;*
  - (b) *The measures are not discriminatory;*
  - (c) *The measures are accompanied by provision for the payment of just compensation. "*
318. In accordance with customary international law, the Treaty does not provide that the deprivation (or expropriation as it is often referred to) of investments is unlawful *per se*. Such deprivation is unlawful only if certain conditions are not met. It is acknowledged that the Treaty includes both "direct" and "indirect" forms of deprivation: however, no deprivation in either form has taken place in this case. There has been no taking attributable to the State.

319. Deprivation or expropriation clearly involves a “*compulsory transfer of property rights*”. It is said to occur if a State interferes with property rights “*to such an extent that these rights are rendered so useless that they must be deemed to have been expropriated*”.
320. In the legal literature, it is said that, *the essence of the matter is the deprivation by State organs of a right of property either as such, or by permanent transfer of the power of management and control. State measures, prima facie a lawful exercise of powers of government, may affect foreign interests considerably without amounting to expropriation. Bona fide regulation must also be distinguished from expropriation or deprivations of property.*
321. The meaning of *deprivation* may be drawn from the *Convention Establishing the Multilateral Investment Guarantee Agency*. Article 11 (a) (ii) defines that expropriation is not given by
- “non-discriminatory measures of general application which governments normally take for the purpose of regulating economic activity in their territories. ”*
322. The Council’s actions do not fall within the definition of deprivation or expropriation of investments.
323. The Czech Republic’s involvement in this dispute was as follows: (i) the Council issued a Licence to CET 21 in light of the information provided to it; (ii) it reviewed compliance with the Media Law; (iii) the Council commenced administrative proceedings against ČNTS on the basis of unlawful broadcasting in breach of the Media Law; (iv) it withdrew the administrative proceedings in light of the amended arrangement between ČNTS and CET 21; (v) the jurisdiction of Czech courts have been invoked in respect of disputes arising out of the arrangements between ČNTS and CET 21.
324. In addition, a deprivation requires that there has been governmental interference with a property right of CME. It is not enough for CME to say that it is less well off than it thinks that it should be because ČNTS changed its arrangements with CET 21 at the insistence of the Council.

The Respondent refers to the Permanent Court of International Justice stated in the *Oscar Chinn Case*:

*"The Court, though not failing to recognize the change that had come over Mr. Chinn's financial position, a change which is said to have led him to wind up his transport and ship-building businesses, is unable to see in his original position - which was characterised by the possession of customers and the possibility of making a profit - anything in the nature of a genuine vested right. Favourable business conditions and good-will are transient circumstances, subject to inevitable changes. "*

325. CME's complaint is this. CME had an initial arrangement with CET 21 which, it says, gave ČNTS the arrangements of an exclusive supplier to CET 21. That arrangement was amended at the behest of the Council. The amended arrangement, CME fears, does not give ČNTS the rights of an exclusive supplier. But what CME says it has lost is not property, nor even rights under the initial or amended contracts. What CME says it has lost is the measure by which the business advantage to it of the initial agreement exceeds that of the amended agreement. That is not a property right. The law recognises and upholds rights created by contract, but there is no legal concept of a separate property right to the maintenance of a particular balance of commercial power.
326. The Council's actions have been the lawful exercise of the power of Government, carried out as part of the regulation of economic activity in the Czech Republic.
327. The Czech Republic has taken no property of CME, of ČNTS, or of any company owned or controlled by Mr. Lauder. The only property right granted by the Czech Republic, the Licence issued to CET 21, remains in the hands of CET 21 as it has done at all material times.
328. The Czech Republic did not agree, and could not agree, to CET 21 transferring the Licence to ČNTS. The Czech Republic did not create or confirm any rights for ČNTS. ČNTS's rights, and CME's alleged interests, arose solely under contracts made with CET 21. The rights asserted by CME in this case were created and defined by those contracts and were necessarily constrained by Czech law: those rights could not amount to a

transfer of the Licence to ČNTS. ČNTS is correct to look to CET 21, rather than the State, as the source of any remedy for unlawful injury to its rights.

329. The authorities cited by CME do not support the case it has advanced. The Czech Republic denies that it had any intention of injuring CME or its investment.
330. There is no *a priori* limit on the kind of State measure or action that may amount to deprivation or expropriation. CME has, however, entirely failed to explain why it considers that the actions of the Czech Republic do so.
331. Although in some circumstances a coerced capitulation may constitute an expropriation, a review of the authorities indicates that there is no solid or wide consensus on coercion outside of the cases dealing with physical force.
332. Far from maintaining that ČNTS was coerced into the making of a new agreement with CET 21 in 1997, in the proceedings in the Prague Commercial Court, ČNTS stated, "*that the Services Agreement as well as the agreements previously concluded between [ČNTS] and [CET 21] on 6/2/1994, 5/23/1996 and 10/4/1996 determining the rights and obligations relating to operating the television broadcasting facilities, have always been the expression of a clear will of both contractual parties to determine the mutual relationship on an exclusive basis.* "
333. ČNTS makes no suggestion that the Services Agreement, described in CME's Statement of Claim as "*part of the package of contractual changes coerced by the Media Council,*" was coerced or was invalid. On the contrary, it was used as the basis of ČNTS's claim; and the Regional Commercial Court upheld its validity (meanwhile reversed by the Court of Appeal).

CME has failed to establish a *prima facie* case of deprivation or expropriation.

334. The Respondent's position is that expropriation has not occurred due to the fact that
- (1) the Claimant invested in ČNTS after the 1996 changes had been made; therefore, it cannot have lost the 1993 safety net by expropriation;
  - (2) it is a matter of pure speculation, whether the 1996 safety net was materially better or more effective than the 1993 safety net;
  - (3) that, in any event, the 1996 changes were voluntarily, if reluctantly, made by ČNTS; and
  - (4) that the institution of the 1996 administrative proceedings could not, in the absence of proof of abuse of power or mala fides, or some such defect, amount to coercion. In essence, it is not established that anything was taken from the Claimant or that the Respondent forced the Claimant to give anything up.

## **2. The Obligation of Fair and Equitable Treatment**

335. The Treaty provides that investments shall be accorded fair and equitable treatment (Art. 3 (1)). The support given for this principle in its Preamble provides:

*"Recognising that agreement upon the treatment to be accorded to such investments will stimulate the flow of capital and technology and economic development of the Contracting Parties and that fair and equitable treatment is desirable".*

336. There is no precise definition of the requirement contained in Article 3 (1) of the Treaty to provide investments with *"fair and equitable treatment"*. What is fair and equitable is an issue to be interpreted on the facts in each individual case.
337. CME does not point to the facts relied upon in order to support the allegation that this obligation has been breached. No case is made out to which the Czech Republic can respond.

338. It is denied that the Czech Republic treated CME's alleged interests less than fairly and equitably. The Media Law has been applied according to its terms. Unlawful broadcasting by ČNTS has been treated in the same way as that by other service providers, in particular Premiéra TV and Rádio Alfa. Due process has been respected.
339. CME has failed to establish a prima facie case that the Czech Republic breached its obligation of fair and equitable treatment.
340. In particular in respect to the March 15, 1999 letter addressed by the Media Council to Dr. Železný, the Czech republic is of the opinion that there is no unfair or non-equitable treatment. The Council could not ignore Dr. Železný's request for giving guidance and had to consider CET 21's right to be heard. Further, the letter was addressed to TV NOVA, being also represented by Dr. Železný at that time. The letter itself had no legal effect. No proceedings were connected to it. The Media Council explained its general policy.
341. Also, the 1996 administrative proceedings did not breach the obligation on fair and equitable treatment as other broadcasters were treated in the same way. Until 1996, both, CET 21 and ČNTS were joined in a continuing duty to comply with the terms of the Media Law, and that included a duty not to effect a de facto transfer of the Licence. ČNTS appeared to be breaking that obligation. The Media Council simply tried to bring it back into line with the law.

### **3. The Obligation Not to Engage in Unreasonable and Discriminatory Treatment**

342. The Treaty provides that a State party shall not "*impair, by unreasonable or discriminatory measures, the operation, management, maintenance, use, enjoyment or disposal*" of investments (Art. 3 (1)).
343. The term "*unreasonable*" is not defined in the Treaty. It is insufficient to show discrimination; unreasonable conduct must also be demonstrated. In any event, the actions of the Czech Republic have been neither unreasonable nor discriminatory.
344. CME's claim fails at two levels.

345. First, CME does not explain why it considers that the Czech Republic behaved unlawfully. In the view of the Czech Republic, the Council acted at all times in conformity with Czech law. The Czech Republic notes that CME did not seek to raise in the Czech courts at the time of the administrative proceedings, or subsequently, arguments that the Council had violated Czech law. Second, CME does not explain what unreasonableness it finds in the allegedly unlawful conduct of the Council.
346. The term “discriminatory” is not of itself defined in the Treaty.
347. The complete failure to indicate what facts are alleged to amount to discrimination prevents a reasoned response by the Czech Republic. The Czech Republic notes, that it cannot be seriously suggested that administrative proceedings to stop unlicensed broadcasting lacked any legal basis in Czech law or bona fide governmental purpose. It should also be noted that ČNTS and CET 21 were treated in accordance with the Media Law, and in the same manner as Premiéra TV and Rádio Alfa were treated in similar proceedings at the same time.
346. CME’s assertion that the requirement that the licence-holder had to be Czech is a violation of the Treaty’s prohibition against discrimination, is wrong. It is routine in international practice that foreign investors invest in the State through the medium of a locally incorporated company, which is a regulation stipulating how foreign investment is to be organized.
349. CME’s Statement of Claim refrains from any explaining as to why the Council’s reconsideration of the initial arrangement and agreement with ČNTS and CET 21 of the amended arrangement might be thought unreasonable and discriminatory.
350. CME has failed to establish a prima facie case that the Czech Republic breached its obligation not to engage in unreasonable and discriminatory treatment.

#### 4. The Obligation of Full Security and Protection

351. The Treaty provides that “*each Contracting Party shall accord to such investments full security and protection*” (Art. 3 (2)).
352. The phrase “*full security and protection*” has received attention in both arbitral and judicial bodies. The cases indicate that CME must demonstrate both that the standard contained in the phrase “*full security and protection*” has been breached; and that the breach is the result of the actions of the Czech Republic.
353. The requirement to provide constant or full security and protection *cannot be construed as the giving of a warranty that property shall never in any circumstances be occupied or disturbed*. Similarly an obligation to provide the nationals of the other Contracting State to a BIT with “*full protection and security*” is not an absolute obligation *in the sense that any violation thereof creates automatically a ‘strict liability’ on behalf of the host State*. A government is only obliged to provide protection which is reasonable in the circumstances.
354. CME asserts a failure to provide full security and protection for its investment. CME is arguing that it was the responsibility of the Czech authorities to maintain and enforce the contractual arrangements into which ČNTS entered with CET 21. That is absurd. The obligation of “*full security and protection*” is an obligation of due diligence relating to the activities of the State. No Czech authority was a party to the contracts between ČNTS and CET 21. It was for ČNTS to enforce its rights under those contracts, as it is doing through the Czech courts.
355. Also, CME’s argument that the alleged change of position of the Council in 1996 deprived ČNTS of benefits that it had enjoyed by virtue of the alleged previous position of the Council in 1993, is untenable. The Council did not change its position between 1993 and 1996. At all times the Council has taken the view that the Media Law forbids the transfer of licences, and has sought to apply that law. What changed was the nature of the relationship between CET 21 and ČNTS. On the basis of facts



discovered in 1994 - 1996, the Council reacted so as to ensure that CET 21 and ČNTS complied with Czech law.

356. CME contradicts the position that ČNTS has taken in its successful litigation in the Czech courts. It cannot be argued that investors have any right to suppose that positions taken by State authorities and provisions of State law are forever unalterable. Nor can it be argued that every regulatory change made by a State in accordance with its laws must be accompanied by compensatory payments to anyone whose profits are adversely altered by the change. There can be no legitimate expectation that provisions and laws become frozen the minute that they touch the interests of a foreign investor.
357. CME fails to identify any factual circumstances that could support its allegation that the Czech Republic failed to provide full security and protection for its investment, or that the Czech Republic breached the obligations of full security and protection.
358. Further, it should be noted that the Media Council simply had no competence to act outside administrative proceedings. Condition No. 17 of the Licence was to be lifted under the new Media Law as of January 1, 1996; the Media Council had no influence any more on the relationship between CET 21 and ČNTS. There was and is full protection and security for ČNTS's legal rights available under the Czech legal system provided by Czech courts.

## **5. The Obligation of Treatment in Accordance with Standards of International Law**

359. The Treaty provides that if "*obligations under international law . . . entitling investments by investors . . . to a treatment more favourable than is provided for by the present Agreement, such rules shall to the extent that they are more favourable prevail over the present Agreement,*" (Art. 3 (5)).

360. CME has quoted from the decision in the International Court of Justice in the *Barcelona Traction Case* to affirm that "[w]hen a State admits into its territory foreign investments, . . . it is bound to extend to them the protection of the law and assumes obligations concerning the treatment to be afforded them." The judgment in the *Barcelona Traction Case* continues with the sentence, "These obligations, however, are neither absolute or unqualified." The Court's comment was made in the quite different context of a State's right to provide diplomatic protection to shareholders of entities incorporated in a third State. The Court did not set up absolute standards for treatment of foreign investment.
361. No argument is presented to indicate why it is thought that the Czech Republic has violated its obligations to treat CME in accordance with general international law. CME mentions this obligation, but it is not possible to discern what, if any, argument CME seeks to make in relation to it. This obligation has not been breached.

## **VI. The Czech Republic has not Violated its Treaty Obligations**

### **1. The Czech Republic is Responsible for the Media Council's Conduct**

362. The Czech Republic accepts responsibility for the actions of the Council for the purposes of this case. The Czech Republic does not accept the characterisation of the Council activities made by CME, and denies any breach of the Treaty by reason of the Council's actions.

### **2. The Council's Conduct did not Violate the Czech Republic's Treaty Obligations**

363. CME must demonstrate that the State has acted in breach of its Treaty obligations, i.e. unlawfully, so as to harm its "investment". Here, nothing that the State has done, through the Council or the Institute or the courts, can be described as unlawful or otherwise a breach of the Treaty. On the contrary, the Council has sought to uphold the law by ensuring that the implementation of the Licence was in accordance with the Media Law; and that it was the licensee, CET 21, not the unlicensed ČNTS which controlled broadcasting by TV NOVA.

364. The administration of the law or insistence upon compliance with the law cannot be described as “*unreasonable*” or “*discriminatory*” conduct by the Council. Neither can they be characterised as actions “*tantamount to deprivation*” by the Czech Republic.
365. CME knew the Media Law from the start of its involvement in the Czech Republic. CME cannot complain about the consequences of its acting unlawfully. CME’s own case and the facts known to the Council suggest that CME was fully aware of the legal conditions under which television broadcasting was licensed; and sought by various means to ensure its control over the Licence despite the provisions of the Media Law and of the Licence itself.
366. CME abandoned its attempts to circumvent the Media Law in 1997, when ČNTS voluntarily agreed new contractual terms with CET 21. Subsequent events have shown that CME’s loss of control of the Licence and TV NOVA may have harmed its investment in ČNTS. But this cannot be attributed to the Czech Republic.
367. CME now claims that the actions of the Council in addressing the ways in which CET 21 and ČNTS were implementing the Licence, and in bringing administrative proceedings against ČNTS for unlawful broadcasting in 1996, constitutes an unlawful deprivation and otherwise breaches the obligations of the Czech Republic under the Treaty. This ignores the fact that the response of CET 21 and ČNTS was voluntarily to agree between themselves to change their relationship so as to comply with the law. The Media Law, in common with the laws and procedures of many other nations, licences scarce broadcast spectrum on the basis of prudential and public interest considerations; and does not permit unlicensed broadcasting. Under no circumstances can it be held that the conduct of the Council gave rise to any breach by the Czech Republic of the Treaty.
368. The Council in its letter of 15 March 1999 was not supporting Dr. Železný’s effort to eliminate the exclusive economic relationship between ČNTS and CET 21; it did not put forward Dr. Železný’s views as its own. The Council was stating the policy which it had publicly declared in the meetings of the Media Panel and in submissions on the proposed new Media Law, as well as to individual licence-holders.

369. CME does not indicate what specific obligations it considers the Council and Parliament to have in respect of ČNTS's requests. The Czech Republic notes that three of the four requests were made in the fortnight preceding the filing of Mr. Lauder's Notice of Arbitration in mid-August 1999, and the fourth some six weeks before that. Under no circumstances is it reasonable to expect a Parliamentary Committee to take action within two weeks on the basis of "a detailed factual summary with supporting documentation". The requests were intended to establish a record for the purpose of the dispute which had by then broken out between CME and Dr. Železný.
370. The Council did not fail to fulfil its obligations under the Treaty and the Council did not cause ČNTS's business operations to be discontinued. The Council only ever took action to ensure that broadcasting was conducted in accordance with the Media Law.
371. The Council's course of dealings did not enable Dr. Železný to take actions that may have affected CME's investment. The Council was merely fulfilling its obligations under Czech law by requiring that the Licence not be transferred and by commencing the administrative proceedings against unauthorised broadcasting. The Council's actions did not force ČNTS to weaken the contractual arrangements under which CME's investment was made. The Council did not adopt a policy disfavouring the exclusive economic relationship between CET 21 and ČNTS. The Council did not fail to act to protect ČNTS's interests.

## **VII. CME Failed to Plead Any Loss**

372. The Czech Republic has an obligation under international law to remedy any violations under the Treaty for which it is responsible. However, CME failed to plead any loss. CME must demonstrate that it has in fact suffered damage. No plea has been made addressing questions of the nature of the loss, causation, the identity of the specific companies or individuals that are alleged to have suffered loss, the ownership and control of the companies at the material times and of the heads of damages.
373. The remedies which the companies owned or controlled by Mr. Lauder, allegedly including CME which may be obtained in the various fora in

which his dispute with Dr. Železný/CET 21 is being fought out, may compensate for any losses which such entities may be found to have suffered. It may be found that no damage has been suffered by any of the entities involved in this affair, including CME. Thus the failure to plead that CME has suffered damage not only strikes at the heart of the claim, but is an inevitable consequence of the realities of the dispute. If CME has suffered no damage, this claim fails *in limine*. CME must show that it has suffered damage for the claim to be admissible under the Treaty.

### **VIII. Respondent's Conclusion**

374. The Czech Republic requests that CME's claim be dismissed on grounds of lack of jurisdiction; alternatively on grounds of lack of admissibility; alternatively on grounds that CME has failed to establish any breach of the Treaty; alternatively on grounds that CME has failed to plead any loss.

#### **H.**

#### **The Analysis of the Tribunal**

##### **I. Jurisdiction**

##### **(1) The Claimant's Investment**

375. The Tribunal has jurisdiction to decide this dispute under Article 8 of the Treaty. According to Article 8.2 of the Treaty, each Contracting Party consents to submit an investment dispute as defined in Article 8.1 to arbitration. Investment disputes covered by this arbitration clause are disputes between one Contracting Party and an investor of the other Contracting Party concerning an investment of the latter. The Claimant is an investor in accordance with Article 1 (b) of the Treaty, as the Claimant is a legal person constituted under the law of one of the Contracting Parties, the Kingdom of the Netherlands. The dispute concerns an investment of the Claimant within the terms of Article 1 (a) of the Treaty. Article 1 (a) provides that the term investment shall comprise every kind of asset invested either directly or through an investor of a third State. The investment can be (inter alia) shares, other kinds of interests in companies and joint ventures, as well as rights deriving therefrom, title to

money and other assets and to any performance having an economic value.

376. The Claimant is the 99 % shareholder of ČNTS. These shares as well as all rights deriving therefrom qualify as an investment of the Claimant under Article 8.1 and Article 1 (a) (ii) of the Treaty.
377. CME, the Claimant, acquired its 99 % ownership interest in ČNTS in two steps. CME acquired 93.2 % in May 1997 from its parent company, the Czech Media Enterprises B.V. The Claimant further acquired 5.8 % shares in 1997 by purchasing the Czech holding company NOVA Consulting, which held a 5.8 % shareholding in ČNTS.

## **(2) The Claimant's 1997 Share Acquisition**

378. The Respondent, for the first time at the Stockholm hearing, expressed its view that the investment of the Claimant in the Czech Republic within the meaning of the Treaty was (only) made when it purchased in 1997 the ČNTS shares held by CME Media Enterprises B.V. The Respondent, in respect to this investment of the Claimant in the Czech Republic, expressly did not raise the defence of lack of jurisdiction. The Respondent is, however, of the opinion that Claimant's investment in 1997 limits timewise the Claimant's claim in substance which, therefore, will be dealt with hereafter, when dealing with the merits of the Claim.
379. Any possible defence in respect to lack of jurisdiction related to the Claimant's acquisition of the ČNTS shares in 1997, therefore, must be deemed as waived. That also would be consistent with Rule 21.3 of the UNCITRAL Rules, according to which objections in respect to jurisdiction must have been made in the Statement of Defence.
380. The Arbitral Tribunal considered whether (by disregarding the Respondent's waiver of a defence of lack of jurisdiction in respect to the 1997 share acquisition), the Tribunal is obligated ex officio to decide on this subject. The majority of the Tribunal is of the opinion that, disregarding possible Czech national law requirements, the clear provision of the UNCITRAL Rules must supersede national law, if deviating. According to

the UNCITRAL Rules, a defence of jurisdiction is deemed to be waived, if not raised in time. This concept derives from the assumption that defences on jurisdiction can be waived by the Parties, with the consequence that a Tribunal is not able to set aside or disregard a Party's waiver in respect to the defence of lack of jurisdiction.

381. Therefore, the Respondent's argument that the investment of the Claimant in the Czech Republic was not made until May 21, 1997 must be dealt with by the Tribunal in accordance with the Respondent's express pleadings as a substantive defence, not as a defence to jurisdiction.

### **(3) The Claimant's Predecessor's 1994 Share Acquisition**

382. The Respondent in its Statement of Defence dated November 9, 2000 raised the defence of lack of jurisdiction in respect to the Claimant's predecessor's share acquisition. The Respondent claimed inter alia that CME has failed to establish that it has an asset invested in the Czech Republic as defined under the Treaty. The Respondent's position is that the Claimant did not sufficiently identify its investment by leaving open whether CME's investment "is its alleged shareholding in ČNTS or some contractual right allegedly enjoyed by ČNTS or some right conferred on CEDC". According to the Respondent, CME fails to establish that it has assumed the rights and obligations of CEDC as a matter of law. This defence of lack of jurisdiction, even if accepted as sufficiently specified, is not justified. The Claimant's investment is vested in its shareholding in ČNTS which is an investment covered by Article 1 (a) (ii) of the Treaty.
383. As recounted in Section A. 5 of this Award, CME acquired its 99 % ownership interest in ČNTS in 1997, an acquisition which, in respect to jurisdiction is not in dispute between the Parties (as described above). CME's predecessor, its parent company, Czech Media Enterprises B.V., had acquired in 1994 66 % of ČNTS from CEDC, a German company under the same ultimate control as CME of an American corporation, in turn controlled by Mr. Ronald S. Lauder. The transfer document done in Prague on July 28, 1994 between CEDC and CME Media Enterprises B.V. gives sufficient proof that CME Media Enterprises B.V. acquired CEDC's 66 % shareholding in ČNTS. Under this Assignment Agreement and

Declaration on Accession to Memorandum of Association of ČNTS, the Claimant's predecessor CME Media Enterprises B.V. acquired CEDC's shares in ČNTS, comprising all rights and obligations thereto.

384. The acquired shares, including all rights and legal entitlements, are protected under the Treaty. Upon the acquisition, the Claimant's predecessor became owner of the investment in the Czech Republic. The Treaty does not distinguish as to whether the investor made the investment itself or whether the investor acquired a predecessor's investment. In this respect, Article 8 of the Treaty defines an investment dispute as existing, if a dispute concerns an investment of the investor. Article 1 of the Treaty clearly spells out that an investment comprises every kind of asset invested either directly or through an investor of a third State, which makes it clear that the investor need not make the investment himself to be protected under the Treaty.

**(4) The 1994 Share Assignment not notified**

385. The Respondent did not expressly argue in these arbitration proceedings that the assignment of the 66 % ČNTS shares from CEDC to CME Media Enterprises B.V. was void. The Respondent stated, however, that the assignment was not notified to the Media Council which, in the view of the Respondent, was necessary under Condition 17 of the Licence.
386. The non-notification of the assignment did not remove the Claimant's protection under the Treaty. Under Section 12.1 of the MOA, the assignment of shares to an affiliated company was permitted without requesting the Media Council's approval. Under Condition 17 of the Licence as amended as of May 12, 1993, the Media Council stipulated that the partnership agreement (the MOA) is an integral part of the Licence terms. Further, the Media Council prescribed that the partners of the MOA are the licence-holder (CET 21), CEDC and the Czech Savings Bank in the scope and under the conditions stipulated by the MOA.
387. CET 21 was obligated to submit to the Council for approval any changes of the legal person which has been the licence-holder, or of the capital structure of the investor which results in a change of control over the ac-



tivities and of the provisions of the partnership agreement between the licence-holder and investors (the MOA). The change-of-control clause of the MOA (Section 12.1) linked the shareholding in ČNTS to the Licence. Article 12. 1 of the MOA stated that, in accordance with the terms and conditions of the Licence, CEDC, CET 21 and the Czech Savings Bank cannot and shall not assign their shares to any third Party without obtaining in advance the express consent of all partners and the Council, which would be given after a full disclosure of the intended transaction.

388. However, this provision does not apply to any “direct family member or associated persons”. An associated company was defined as an entity controlled by the same last partner of the shareholders. Therefore, the MOA, being an integral part of the Licence, did allow a change of control without having obtained in advance the express consent of the Council.
389. The Council requested by its resolution of April 9, 1993, the submission of the final draft of the MOA for approval and by its resolution of April 9, 1993, requested final changes. At the Council Meeting on April 20, 1993, the Council approved the final wording of the MOA which was implemented accordingly. On May 12, 1993, the Council approved Licence Condition 17 which referred to the amended MOA as approved by the Council. This sequence of events is not in dispute between the Parties, although the Parties interpret these facts differently.
390. In respect to jurisdiction, it is clear that CEDC’s investment in ČNTS could be assigned to CME Media Enterprises B.V. without requesting prior approval from the Council. On the contrary, it is clear that CEDC’s investment in ČNTS included the right to freely transfer this investment to an affiliated company. The assignment by CEDC of its shares in ČNTS to CME Media Enterprises B.V. was made with express reference to the MOA. It is therefore clear that CME Media Enterprises B.V. (as a permitted successor under the MOA, which was approved by the Council), when acquiring CEDC’s investment in the Czech Republic, acquired full protection for this investment under the laws of the Czech Republic which include the bilateral investment treaties the Czech Republic had entered into, including the Treaty.

**(5) The Claimant's Predecessor's 1996 Share Acquisitions**

391. The acquisition of 22 % of the shares in ČNTS by CME Media Enterprises B.V. in 1996 from the Czech Savings Bank also qualifies as an investment under the Treaty. The same applies to the acquisition of 5.2 % shares in ČNTS from CET 21, also in 1996. These further acquisitions were not the subject of any judicial dispute by the Parties in these arbitration proceedings. These shares were part of the same initial investment made by the founding shareholders, CEDC (with a share of 66 %), CET21 (with a share of 21 %) and the Czech Savings Bank (with a share of 22 %) as co-founders who formed the joint venture company ČNTS in 1993.
392. In respect to jurisdiction, CEDC's and CME Media Enterprises B.V.'s acquisition of shares qualify as an investment within the meaning of Article 8 of the Treaty in conjunction with Article 1 (a) (ii) of the Treaty. When initiating these arbitration proceedings, the Claimant was and still is owner of 99 % of these shares in ČNTS. It is true that the shares themselves were not directly affected by the Respondent's alleged breach of the Treaty. The dispute to be defined as an investment dispute under Article 8 of the Treaty does not necessarily relate to the shares themselves, but to the value of the shares, which, the Claimant alleges, have been eviscerated by the Respondent. It is the Claimant's case that the Respondent, in breach of the Treaty, expropriated (inter alia) ČNTS' legal and commercial assets and rights. Such an expropriation of assets and, in particular, legal rights and entitlements of ČNTS, a joint venture of the Claimant with Czech nationals (the Czech Savings Bank and CET 21), could and allegedly did affect the value of CME's shares in the joint venture, such shares clearly being an "investment" in accordance with Article 1 of the Treaty. Therefore, the Arbitral Tribunal will have to examine whether the Czech Republic expropriated the joint venture company ČNTS as alleged by the Claimant (see *Tradex Hellas S.A., Greece vs/ Republic of Albania*, ICSID Arbitration Award, April 29, 1999).

**(6) CME's Predecessor's Original 1993/1994 Contributions qualify as Investment under the Treaty**

393. The original contributions by CEDC, the Czech Savings Bank and CET 21 were made on the basis of the Memorandum of Association and Investment Agreement (the MOA) notarized in front of a Czech notary on/or about May 4, 1993 and submitted for registration on/or about July 8, 1993. The registered capital of ČNTS was 148 million Czech Crowns. CET 21's non-monetary contribution, evaluated at 48 million Czech Crowns, was to contribute to ČNTS "unconditionally, unequivocally and on an exclusive basis the right to use, exploit and maintain the Licence held by CET 21." The Czech Savings Bank contributed 25 million Czech Crowns and CEDC contributed 75 million Czech Crowns. The ownership interests were allocated as follows: CEDC 66 %, Czech Savings Bank 22 %, CET 21, 12 %.
394. According to Sec. 2 of the MOA, CEDC and the Czech Savings Bank agreed to provide additional financing to ČNTS as additional contributions to the registered capital of up to 400 million Czech Crowns. Thereafter, the shareholders agreed to provide additional financing up to 900 million Czech Crowns as needed through bank loans. This obligation to provide additional financing either by share capital or by bank loans was secured under Section 2.5 of the MOA by 20 % interest on the debt sum in respect to which a shareholder was in default. CEDC, therefore, and the Czech Savings Bank obligated themselves to make substantial contributions for the future of ČNTS, dedicated for "the development and management of the Television Station".
395. The Claimant's predecessor's investments, by acquiring in 1994 and thereafter ČNTS' founders' shares and by consummating their obligations under the MOA, qualify as an investment under the Treaty.
396. The Respondent, in this context, raised the defence that the Claimant exercised some kind of (unacceptable) forum shopping. The Respondent characterized the initiation of parallel treaty proceedings by Mr. Lauder and by the Claimant as an abuse. In respect to jurisdiction, this defence is not persuasive. CEDC, when making the investment in ČNTS in 1993/1994, was under the protection of the German-Czech Republic In-

vestment Treaty which, in essence, provides a similar protection as the Treaty. The assignment of the investment in ČNTS from a German corporation to a corporation having its legal seat in the Netherlands does not have, on the face of it, the stigma of an abuse. The Respondent characterized the initiation of parallel treaty proceedings by Mr. Lauder and by the Claimant as an abuse.

397. The Arbitral Tribunal's view is that the contribution made by CEDC and the assignment thereof in compliance with the investment structure approved by the Media Council to CME Media Enterprises B.V., qualifies as an investment under Article 8 of the Treaty. The Respondent's argument in respect to an alleged forum (or treaty) shopping is not sustainable.
398. In this context, the Tribunal refers to the FEDAX Award on jurisdiction dated July 11, 1997, an ICSID arbitration (37 I.L.M. 1378/1998). In that case, the FEDAX tribunal accepted ICSID jurisdiction for a claim under promissory notes which had been transferred and endorsed to subsequent holders and to the claimant outside of the host country of the original investment. The FEDAX tribunal rejected the argument that the foreign owner of the promissory notes did not qualify as an investor, because it has not made an investment in the territory of the host country and accepted that, although the identity of the investor will change with every endorsement, the investment itself will remain constant, while the issuer of the notes will enjoy a continuous credit benefit until the time the notes become due.
399. In the Claimant's case, the situation is even clearer. CEDC made the investment by making its shareholder's contribution at the formation of ČNTS in 1993. ČNTS enjoyed the benefit of the investment during its corporate life-time. TV NOVA started broadcasting in February 1994 by using CEDC's invested funds (together with the funds invested by the Czech Savings Bank). By mid-1994, when the Claimant's predecessor acquired the investment, the investment was at full risk and it was not until one year later that the investment turned out to be a success for the investors.
400. Further, CEDC's investment in ČNTS must be seen in its legal entirety as approved by the Media Council. A company affiliated to the investor,

being an acknowledged (permitted) successor under the investment structure approved by the Media Council, is protected by the investment protection laws of the host country. Article 8 of the Treaty does not set specific requirements related to the circumstances under which an investment can be regarded as belonging to the investor protected by the Treaty. This is in accord with the great majority of modern bilateral investment treaties (see Antonio R. Parra in "Economic development, foreign investment and the law", published by Kluwer 1996, page 35). In respect to jurisdiction, therefore, the Claimant enjoys the full protection of the Treaty, having acquired through its predecessor CEDC's investment 66 % shareholding in ČNTS in 1994. The same applies to the further shareholding in ČNTS acquired thereafter by the Claimant and the Claimant's predecessor.

#### **(7) The Investment Dispute under the Treaty**

401. The dispute between the parties as alleged by the Claimant derives from the destruction of the joint venture's assets and the devaluation of its factual and legal position connected with the use of the broadcasting Licence, contributed by CET 21 to ČNTS as a founding shareholder of ČNTS. This dispute qualifies as an investment dispute within the meaning of Article 8 of the Treaty. In particular, it is not disqualified as an investment dispute because it is not, as alleged by the Respondent, a private commercial dispute but an investor-host State dispute.
402. ČNTS' disputes and legal proceedings with CET 21 and Dr. Železný also do not transform the dispute between the Claimant and the Czech Republic into a commercial dispute unrelated to the Treaty. Commercial disputes and proceedings between private parties, though one party be the investor and/or his joint venture company, do not per se exclude the existence of an investment dispute under the Treaty.
403. The investment dispute under the Treaty and the commercial dispute between the investors' joint venture company in the Czech Republic and its shareholders and/or business partners must be distinguished. The Claimant's position is that the Czech Republic, represented by the Media Council, violated its duties under the Treaty in various ways. The Arbitral

Tribunal has jurisdiction over such an investment dispute, whereas jurisdiction over private commercial disputes between ČNTS and CET 21 / Dr. Železný is vested in the Czech Republic's courts or in arbitration as the case may be.

404. The private commercial disputes in question are different in respect to the parties, certain basic facts and underlying legal rights and obligations. This Tribunal has jurisdiction in respect to the dispute concerning the alleged violation of the Treaty by the Czech Republic. The Tribunal has no jurisdiction related to commercial disputes, regardless of whether the respective civil court proceedings, in particular as initiated by ČNTS vs. CET 21, may provide a remedy to ČNTS (depending on the final judgment of the Czech Supreme Court). These civil court proceedings may effect the quantum of the damage as claimed by CME in these arbitration proceedings. The civil court proceedings, however, have no effect on the jurisdiction of this arbitral Tribunal under the Treaty.
405. Although the contractual arrangements between CET 21 and ČNTS could be decisive for the Claimant's claim under these arbitration proceedings, this does not take away jurisdiction from this Tribunal. The Claimant's claim is based on the Czech Republic's interference and non-protection of the Claimant's and its predecessor's investment which is clearly an investment dispute and not a private commercial dispute. The fact that a contractual arrangement between CET 21 and ČNTS is also the basis for civil law proceedings between these contractual parties does not deprive the Claimant of its claims under the Treaty deriving from the alleged breach of the Treaty committed by the Czech Republic acting through the Media Council.
406. The Czech Republic's position that the grant of the Licence signified no more than the Council considered, on the basis of the information then available to it, that CET 21 was a proper recipient of the Licence, is irrelevant for the qualification of these arbitration proceedings as investment treaty proceedings.
407. Whether the Media Council, as the Czech Republic stated, did not have the power to approve or endorse the business arrangement between

CEDC, the Czech Savings Bank and CET 21 is a question of the substance of the claim and not a question of jurisdiction.

408. Furthermore, the Respondents position, according to which the prejudice to the Claimants and its predecessor's investment was caused not by the Media Council but by Dr. Železný, is a matter of substance and not of jurisdiction. Decisive for the matter of jurisdiction is only the issue of whether the Czech Republic by the Media Council's action breached the Treaty and caused injury to the Claimant's and/or its predecessor's investment. The Arbitral Tribunal is aware that it may well be that a variety of circumstances may have caused the debasement of the Claimant's investment. That will not take away jurisdiction from this Tribunal, which is obliged to investigate and adjudicate the case restricted to the investment treaty dispute, whereas civil law claims might be sorted out between the respective parties in other proceedings.

### **(8) Parallel Proceedings**

409. The Czech Republic's view that Treaty procedures were not intended to be used in these circumstances is not sustainable. Treaty proceedings are barred by civil law proceedings only if the respective investment treaty contains such a provision. Modern bilateral investment treaties usually do not contain judicial limitations like that. Modern investment treaties tend to allow a broad and extended access in the same way as modern treaties avoid any kind of restrictions which may provide uncertainties for the identification of the protected investment (Giorgio Sacerdoti "Bilateral Treaties and Multilateral Instruments on Investment Protection" in *Recueil des Cours* 1997).
410. The Respondent's contention that the Claimant exploited a dispute under a commercial contract to pursue Treaty proceedings must be rejected. The Claimant based its claim on the alleged breach of the Treaty. In parallel the Claimant's subsidiary in the Czech Republic has pursued its civil law claims in front of the Czech Civil Courts. The fact that the object of the two proceedings, compensation for injury to the Claimant's investment, is the same, does not deprive the parties in the Treaty proceedings nor in the civil court proceedings of jurisdiction. An affirmative award

and/or judgment may have impact on the quantum of the damages adjudicated in the proceedings or give the right to the respective defendant to raise legal defences in the respective enforcement proceedings with the argument that the adjudicated damage claim has been already remedied under the award and/or judgment of the respective other proceeding. However, jurisdiction is not affected by this incidence of parallel proceedings.

411. The Respondent's defence that the Claimant may not concurrently pursue the same remedies in different fora is, therefore, rejected. Further, it is understood and agreed between the Parties that the Claimant is not obligated under the Treaty to exhaust local remedies in the Czech Republic.

**(9) No abuse of Treaty Proceedings**

412. There is also no abuse of the Treaty regime by Mr. Lauder in bringing virtually identical claims under two separate Treaties. The Czech Republic views it as inappropriate that claims are brought by different claimants under separate Treaties. The Czech Republic did not agree to consolidate the Treaty proceedings, a request raised by the Claimant (again) during these arbitration proceedings. The Czech Republic asserted the right to have each action determined independently and promptly. This has the consequence that there will be two awards on the same subject which may be consistent with each other or may differ. Should two different Treaties grant remedies to the respective claimants deriving from the same facts and circumstances, this does not deprive one of the claimants of jurisdiction, if jurisdiction is granted under the respective Treaty. A possible abuse by Mr. Lauder in pursuing his claim under the US Treaty as alleged by the Respondent does not affect jurisdiction in these arbitration proceedings.

**(10) Outcome of Civil Court Proceedings have no Effect on Jurisdiction**

413. Moreover, the Respondent's further contention that the outcome of the civil court proceedings between ČNTS and CET 21 will finally determine



whether the Claimants shareholding in ČNTS was prejudiced, is not conclusive. The final judgment by the Czech Supreme Court may reinstate the Czech Regional Commercial Court judgment which ruled that CET 21 did not validly terminate the Service Agreement and that CET 21 is obligated to exclusively have broadcasting services supplied by ČNTS. The outcome of the civil court proceedings was open at the closing of the hearing of these proceedings. The civil law suit was still pending at the Czech Supreme Court. However, even if the Czech Supreme Court were to reinstate the Regional Commercial Court judgment, this would not remedy the harm to the Claimant's investment.

414. On the contrary, the dependence of the Claimants investment on the contradictory Civil Court judgments clearly shows how fragile the Claimant's investment is (the alleged consequence of the Czech Republic's breaches of the Treaty). Even if the regional Commercial Court's judgment is reinstated by the Czech Supreme Court, this will not remedy the Claimant's investment situation. CET 21 may well, at any time, terminate again the Service Agreement for good cause, whether given or not, thereby recurrently jeopardizing the Claimant's investment.
415. The Claimant was, therefore, not obligated to wait for the Czech Supreme Court's decision before instigating Treaty proceedings. The outcome of the civil court proceedings is irrelevant to the decision on the alleged breach of the Treaty by the Media Council acting in concert with the Respondent. It may affect the quantum of a damage claim which, pursuant to agreement between the parties, is not a subject of this Partial Award.

**(11) Respondent's Defence that no Loss Occurred**

416. The Respondents' argument that under the Claimant's pleadings there is no suggestion that there is any compensable loss that is attributable to the breakdown of the exclusivity arrangement should be dealt with on the merits of the claim, not in respect to jurisdiction. The Respondents' position that an investor's complaint of a mistreatment in investment proceedings cannot be determined before the State has treated the investment finally including through judicial process, is a position which is not sustainable. It is generally accepted that claims under investment trea-

ties can be and shall be dealt with separately from the judicial process in local courts, unless otherwise specifically provided for in the respective Treaty. Such a requirement to exhaust local remedies is not found under this Treaty and the initiating of a judicial process in the Czech Republic does not bear upon proceedings under the Treaty. This is the understanding also of the Respondent, as specifically stated by Prof. Lowe, the Respondent's representative at the Stockholm hearing, when he said that there was plainly no requirement under the Treaty for the Claimant to exhaust local remedies.

417. The Respondent's position was, as submitted by Prof. Lowe, a slightly different one. The Respondents' view is that the Claimant cannot prove any loss as long as the Claimant did not exhaust the legal remedies under the Czech Civil Court system. This contention is not acceptable. A purpose of an international investment treaty is to grant arbitral recourse outside the host country's domestic legal system. The clear purpose is to grant independent judicial remedies on the basis of an international, accepted legal standard in order to protect foreign investments. An investment treaty therefore may even grant indemnification in case of expropriation where the domestic law does not (see *Sacerdoti* as cited above at page 289 referring to a decision of the Italian Supreme Court on this subject). As the Treaty is silent on the obligation of exhaustion of local remedies, the Claimant is entitled and in the position to substantiate its loss without being obligated to have its subsidiary ČNTS obtain a final civil law court decision by the Czech Supreme Court.

## **(12) Claimant itself made no Investment**

418. The Respondent's further argument that the Claimant itself never made an investment in the Czech Republic is rejected for the reasons already mentioned above. The Treaty does not require that the assets or funds be imported from abroad or specifically from the Netherlands or have been contributed by the investor itself. (As *Sacerdoti* as cited above observes, this requirement is rarely found in recent bilateral investment treaties. This is in compliance with the above-cited *FEDAX Award* which held that the acquisition of promissory notes by the Dutch claimant was a foreign investment despite the fact that *FEDAX* itself never transferred

funds to Venezuela. FEDAX N.V. vs. Republic of Venezuela ICSID Case no. ARB 96/3, the award on jurisdiction dated July 11, 1997 published in ILM 37 (1998), 1378/1390 and the award in substance of March 9, 1998 published in ILM 37 (1998), 1391/1398.)

## **II. The Substance of the Claimant's Case**

### **1. Admissibility / Timewise Limitation**

#### **(1) Parallel Treaty Proceedings**

419. The same reasons for the Tribunal to acknowledge jurisdiction apply to the admissibility of the Claimant's case. The Respondent's argument that the Claimant's case is not admissible, submitted by the Respondent as an alternative to the defence of non-jurisdiction, is rejected. The inadmissibility argument is predominantly based on the fact that Mr. Lauder in parallel to the Claimant initiated other Treaty proceedings. However, the Claimant is free to initiate the Treaty proceedings, if there is an investment dispute in the meaning of Article 8 of the Treaty. The argument of abusive Treaty shopping is not convincing. A party may seek its legal protection under any scheme provided by the laws of the host country. The Treaty as well as the US Treaty are part of the laws of the Czech Republic and neither of the treaties supersedes the other. Any overlapping of the results of parallel processes must be dealt with on the level of loss and quantum but not on the level of breach of treaty. The Claimants' case is admissible.

#### **(2) No restriction of the Claimant's case timewise**

420. There is no time bar to the Claimant's case. The Respondent's position is that the investment of the Claimant in the Czech Republic was not made until May 21, 1997, when it purchased the shares held by CME Media Enterprises B.V. in ČNTS. This, as the Respondent clarified, is the Respondent's defence on the merits. However, this defence, whether in substance or in respect to admissibility, cannot succeed.

421. The Claimant acquired the shares held by CME Media Enterprises B.V. under the Agreement on Transfer of Participation Interest. The Claimant,

under the MOA, was an authorized transferee and the transfer did not need the consent of the Media Council under Condition 17 of the Licence which referred to the MOA of ČNTS, because the transferor and transferee of the assignment had the same ultimate shareholder, Mr. Ronald S. Lauder. The Claimant acquired the participation interest as it was at the day of transfer. The purchase price was US \$52,723,613 and the acquired participation interest reflected a contribution of 344 million Czech Crowns. The Agreement on Transfer expressly stipulated that the Claimant, being the transferee, declared its consent with the MOA without any reservation. The Claimant, therefore, acquired its parent company's shares in ČNTS without any reservation or limitation. The participation interest transferred the legal status as it was, including all rights and liabilities connected thereto.

422. The Respondent's view that the Claimant, by declaring its consent to the MOA, may only advance claims in respect of violations of the Treaty that occurred after May 21, 1997, is not sustainable. The consent to the MOA which is required by Czech law has effect only between the shareholders. The consent is not a waiver of claims which derive from the Respondent's violations of the Treaty already incurred at the transfer date and the consent did not waive the Claimant's protection under the Treaty, should such protection derive from acts and circumstances that occurred before the transfer of shares took place.
423. The Respondent's view that the transfer of shares deprived the Claimant of the protection under the Treaty, because the investment changed hands from one (Dutch) shareholder to the other is not convincing. The Memorandum of Association was approved by the Media Council in 1993 and thereafter again, when the new MOA was implemented on November 14, 1996 without providing for any change of the change-of-control clause. Therefore, any claims deriving from the Claimant's predecessor's investment (also covered by the Treaty) follow the assigned shares.
424. Article 8 of the Treaty, therefore, does not debar the Claimant's claims on the ground advanced by the Respondent. In accordance with Article 8 of the Treaty, an investment dispute under the Treaty is covered, if the dispute derives from an investment of the investor. As already shown above under the issue of jurisdiction and now, and in respect to the ad-

missibility of the claims, it is the Tribunal's view that the investment need not have been made by the investor himself. This conclusion is supported by Article 1 of the Treaty which defines an investment as "any kind of asset invested either directly or through an investor of a third State". This indicates a broad interpretation of the investment which also allows the (Dutch) parent company's investment to be identified as an investment under the Treaty. If the Treaty allows - as it does - the protection of indirect investments, the more the Treaty must continuously protect the parent company's investment assigned to its daughter company under the same Treaty regime.

### **(3) Admissibility of the Claimant's case in respect to the 1994 Share Acquisition**

425. The Parties did not specifically address under the aspect of admissibility of the Claimant's claim or elsewhere the Claimant's predecessor's acquisition of shares from CEDC in 1994. The reason for not addressing this subject might be that the alleged violations of the Treaty took place thereafter. Therefore, this 1994 transfer need not specifically be dealt with under the aspect of admissibility of the Claimant's case. However, it is obvious that the Claimant's predecessor, when acquiring the ČNTS shares from CEDC (as admitted transferee under the MOA's Change of Control clause), acquired CEDC's full investment, including all ancillary rights and obligations.
426. In respect to this share transaction, the Respondent raised the view that the Claimant's predecessor CME Media Enterprises B.V., when acquiring the shares in 1994, "must have considered the commercial risk of investing in ČNTS as well as the legal frame work, in which this investment would be made, when it decided to acquire CEDC's rights and obligations in the MOA". It is undisputed between the Parties to these arbitration proceedings that CME Media Enterprises B.V. understood the legal framework of CEDC's investment when acquiring the ČNTS shares. This knowledge, however, has no influence on the investment's protection under the Treaty. It is not the case that the Claimant and its predecessors entered willingly into the risk that their investments in ČNTS will be eviscerated by acts of the Media Council. On the contrary, it became

clear from the documents and other written communications submitted by the Parties to these proceedings that the Claimant and its predecessors relied on the protection of their investments by the Czech legal system, including the Czech Republic's obligations under the Treaty. Therefore, the Claimants case is admissible and there is no time bar to CME's claim related to the Claimants and its predecessor's investment in the Czech Republic.

## **2. The Merits of the Claimant's Case under the Treaty**

427. The Claimant's case is justified in substance. The Czech Republic violated the Treaty by actions and inactions of the Media Council which led to the complete collapse of the Claimants and the Claimants predecessor's investment in the Czech Republic.

### **(1) CME's and CME's predecessor's investments in the Czech Republic**

428. The 66 % shareholding in ČNTS which was acquired by CME's predecessor from its affiliated company CEDC in 1994 qualifies, as explained above, as an investment under the Treaty. The same applies to the further 33 % shareholding in ČNTS acquired by the Claimant and the Claimant's predecessor. CEDC made a capital contribution under the MOA for the initial share capital in the amount of 75 million Czech Crowns. A further investment obligation obligated CEDC and the Czech Savings Bank to invest further 1.3 billion Czech Crowns. The purpose of the investments was to develop and manage the television station TV NOVA, for which the broadcasting Licence was granted to CET 21 by the Media Council, acting as the statutory regulator of the Czech Republic. CEDC's investment was made under an investment scheme which was developed in close liaison with and under approval of the Media Council. It was also CEDC which had to provide the know-how for developing the new TV station, as neither the Czech Savings Bank as co-founder of ČNTS, nor CET 21 and its shareholders had relevant experience. The five Czech nationals who were the shareholders of CET 21 which initiated the joint project never worked in the broadcasting indus-

try. The investment structure was developed by CEDC, jointly with its Czech Republic joint venture partner CET 21 in close conjunction with the Media Council. While the broadcasting Licence was granted to CET 21 (having no foreign shareholder), the operation of the TV station was in its totality vested in the joint venture company ČNTS.

429. The documents submitted by the Parties in these proceedings, in particular, the Media Council's own statements to the Czech Parliament leave no doubt that the investment, made by CEDC for the exclusive use of the broadcasting Licence granted to CET 21, was monitored, directed and approved by the Media Council. The basis for the investment structure with the participation of CEDC is the broadcasting Licence as awarded by decision of the Media Council of February 9, 1993 to CET 21. Its reasoning clearly spells out that the substantial involvement of foreign capital and broadcasting know-how was necessary to begin and operate television station activities. The legal tool to safeguard the public interest was to require that the leading positions in the television station were taken by Czech nationals, that the programming was not influenced by the foreign investor and that journalistic independence was safeguarded. These were the Licence conditions designed to ensure the national character of the programming of the new television station.
430. The Media Council further, in its justification for the Licence, stated that the Media Council created sufficient mechanisms through which it could monitor the observance of the schedule for implementation of the new TV station. Through the formulation of Licence conditions and through the inspection of their observance, the Media Council ensured that the aims of the Media Council were realized.
431. The basis for the Media Council's decision to grant the Licence to CET 21 was the "all-over structure" of a new Czech commercial television entity dated February 5, 1993 which was submitted jointly by CET 21 and CEDC to the Media Council. This "all-over structure" clearly described the separation of the broadcasting operation vested in a new legal entity ("the Commercial Company") to be formed by CEDC, the Czech Savings Bank and CET 21, whereas the broadcasting Licence was granted to CET 21 as the holder of the Licence for nation-wide television broadcasting under the legal Act No. 468/1991 Col. The "all-over

structure” clearly spelled out that CET 21 and CEDC (CEDC as “direct participant” in the contract under the conditions of that Licence) agreed on the structure of the new entity which was formed with the purpose to finance and run the commercial, technical, management and other activities of the station. It was further clearly spelled out that the new company would be authorized to carry out these activities as long as CET 21 held the television Licence.

432. Further, it was stated that CET 21 acknowledged that it does not have the authority to perform broadcasting “without the direct participation of CEDC”. The “all-over structure” provided that a Board of Directors shall govern the basic decisions in respect to the economic management of the corporation. The day-to-day management and administration as well as the programming of the station was to be performed by the operating management. All operating personnel must be employees of the joint venture company. 90 % of the employees and the management of the station must be citizens of the Czech Republic. This management was to be complemented by the best foreign experts talented in engineering and technology, marketing and other areas to assist and train the local personnel.
433. The “all-over structure” of February 5, 1993 was made an integral part of the Licence granted by the Media Council to CET 21 by reference in the Licence conditions to an appendix to it. In Licence conditions Nos. 17 and 18, CET 21 as licence-holder agreed

*17/ that is will submit to the Council for its prior consent any changes in the legal entity that is the licence-holder, capital structure of investors and provisions of the business agreement [i.e. the Memorandum of Association] between the licence-holder and investors. Parties to the business agreement are the licence-holder, CEDC and Česká Spořitelna a.s., in the scope and under the conditions set by the business agreement which will be submitted to the Media Council within 90 days after the decision to issue the Licence takes legal effect; the business agreement will observe the provisions of the “agreement on the business agreement” between the licence-holder and CEDC which is an appendix to the licence conditions;*

*18/ that CEDC, as a party to the business agreement specified in the Licence conditions, and other investors specified by the business agreement, will not in any way interfere in the programming*



*of the television station , and, in particular will not interfere with the editorial independence of newscasting employees;”*

434. The reference to the “agreement on the business agreement” was a reference to the “all-over structure” of February 5, 1993, as was confirmed by witnesses at the Stockholm hearing. This is consistent with the minutes of the meeting of the Media Council on February 4 and February 5, 1994, where CET 21 submitted “only one of the requested materials, the agreement on the structure of broadcasting between CET 21 and CEDC”. The witness Mr. Josefík, who was in 1993 member of the Council and later its chairman, confirmed that on February 5, 1993 the Council received “a new organizational structure of the future commercial broadcasting”. The witness confirmed that the appendix to the Licence condition was the February 5 agreement. It is, therefore, clear that the “all-over-structure” of CEDC’s investment was made part of the Licence. Mr. Josefík further confirmed that the Council discussed the future arrangement between CET21 and CEDC. The Council expressed its opinion on proposals made by CET 21 in respect to the structure and, based on the Council’s comments, CET 21 submitted the amended structure dated February 5, 1993 which was made part by reference of Licence condition No. 17.
435. The various witness statements clarified that the “over-all structure” dated February 5, 1993 was a carefully designed scheme to allow the foreign investor CEDC take part in the operation of the TV station without becoming a shareholder of licence-holder CET 21. The scheme was developed in close inter-action between the Media Council and CET 21. It was developed from the an initial proposal submitted by CET 21 to the Council dated February 3, 1993 which was prepared by CEDC’s representative, Mr. Fertig, and submitted to the Council by Dr. Železný. Both papers follow the same idea, having the holder of the broadcasting Licence separated from the operator.
436. The separation of the licence-holder CET 21 and the operator became necessary after the Council’s decision to grant the Licence to CET 21 was published on January 31, 1993. This decision created an uproar in the Czech Parliament and the Czech public. Members of the Parliament in particular criticised the grant of the Licence to CET 21. The Council developed the view that, accordingly, it would not be feasible to transfer

a share in CET 21 as originally contemplated to the foreign investor CEDC.

437. This sequence of events is supported by the underlying documents related to the application for the broadcasting Licence by CET 21, including personal presentations by CEDC's representatives in front of the Media Council before the Council decided to grant the Licence to CET 21.
438. The justifications of the decision to award the Licence of February 9, 1993 expressly stated that the Council's decision is based on the application by CET 21 for the broadcasting Licence, the written documents submitted to the Council and also the facts presented in the public hearing by CET 21 and CEDC. The documents submitted as part of the CET 21 application for the broadcasting Licence comprised inter alia the "project of an independent television station CET 21" which spelled out that CEDC is "a direct participant in CET 21's application for the Licence" and, in the enclosed Letter of Intent, it was made clear that CEDC was going to acquire a 49 % shareholding in CET 21 in exchange for its commitment to fund the broadcast station and provide the seed capital.
439. The agreement between CET 21 and "its foreign partners and experts" was communicated by CET 21 on December 21, 1992 to the Council. At the Council hearing on December 21, 1992, Mr. Palmer and Mr. Fertig represented CEDC and submitted the proposal to the Council according to which an "extensive share [was] reserved for foreign capital" and it was clearly indicated that this would be "a direct capital share, not credit". The financing to be provided by CEDC was an amount of US \$10 million which was confirmed in the Letter of Intent issued by CEDC to CET 21 as an attachment to the application documents.
440. After the grant of the Licence to CET 21 was released to the public in a press conference, followed by the uproar in the Czech Parliament, as described by the witness Mr. Fertig, the Council communicated to CET 21 that direct shareholding of CEDC was "politically impossible". Mr. Fertig stated that the Council requested the replacement of the direct shareholding by a structure which would give an equivalent level of participation from an economic standpoint and an equivalent level of influence from a business standpoint. In accordance with this request,

Mr. Fertig worked out the “over-all structure” dated February 3, 1993 which he typed on his personal computer. A Czech translation was submitted to the Council. Mr. Fertig stated that the “all-over structure” dated February 5, 1993 was developed by incorporating the changes requested by the Council.

441. The purpose of the changes was to have a separation of the Licence on the one hand and the operations on the other hand. As Mr. Fertig stated, the official “Decision to Award a Licence” at the Council meeting on February 9, 1993 was not made before the amended “all-over structure” dated February 5, 1993 was signed by CET 21 and CEDC.
442. This sequence of events as stated by the witness is confirmed by the minutes of the Council meeting dated February 4, 1993 and the “Decision to Award a Licence” dated February 9, 1993 which, in its reasoning, referred to the necessity of the substantial involvement of foreign capital for beginning television station activities and referred to the legal structure set out in the Licence conditions, “which shall fully guarantee the leading positions of domestic persons in the television station and their programming and journalistic independence” and further, by the official Licence document, including the Licence conditions and in particular the Licence conditions Nos. 17 and 18, all dated February 9, 1993.
443. The split structure of the licence-holder CET 21 and the operator ČNTS was developed on the basis of the Media Law of October 30, 1991. The Media Law of 1991 defined broadcasting as “*dissemination of programme services or picture and sound information by transmitters, cable systems, satellites and other means intended to be received by the public*”. A broadcaster under the Media Law 1991 is (inter alia) anyone, who obtained authorization to broadcast on the basis of an Act of the Federal Assembly, an Act of the Czech National Council, etc. or by being granted a Licence under this Act (a licence-holder). The Media Law 1991 did not describe the commercial or technical requirements to be performed by a licence-holder. However, according to Section 12.3 of the Media Law 1991, the Council was entitled to impose conditions on the licence-holder as part of the Licence.

444. Therefore, the Media Council, the regulator of the Czech Republic under the Media Law, decided to monitor the operation of the Licence under the split structure (CET 21 as licence-holder and ČNTS as operator) on the basis of inter alia the Licence conditions Nos. 17 and 18. This scheme was carefully designed legally and, on the face of it, in compliance with the Media Law, as the Media Law did not contain any restrictions or requirements in respect to the operation of the broadcasting system by the licence-holder or another operator. The Council, under condition No. 17, imposed as a part of the broadcasting Licence, the condition on CET 21 to submit the MOA between CET 21 and CEDC within 90 days after the decision to issue the Licence was to take legal effect. The MOA must reflect the provisions of the “agreement on the business agreement” which was the “all-over structure” dated February 5, 1993.
445. At the Council meeting dated April 8, 1993, the Council reviewed the draft MOA as submitted by CET 21. The Council declined to approve the MOA. With reference to the conditions of the Licence, the Council required that CET 21 shall provide the final version of the MOA between CET 21, CEDC and the Czech Savings Bank to the Council for approval by April 19, 1993 with the amendments required by the Council. This request for a change of the MOA was communicated by the Council to CET 21 on April 9, 1993 with reference to the terms of the Licence. Further, the Council approved Dr. Železný becoming a shareholder of CET 21. CEDC did not agree with the proposed amendments and its president and chief executive officer Mark Palmer sent a responsive letter to the Chairman of the Council on April 13, 1992. At the Council meeting on April 20, 1993, the final wording of the MOA was approved in accordance with Article 17 of the Licence conditions which was communicated to CET 21 on the next day.
446. The MOA, with the full title “Memorandum of Association and Investment Agreement”, thereby became the basic document for the Claimant’s predecessor’s investment in the Czech Republic. The clear wording established that the television station shall be managed by the new company and that the object of the new company’s business activity was “the development and operation of the new, independent, private, national television broadcasting station in compliance with the Licence and the

terms and conditions attached to it.” The purpose of the new company was to operate an independent television station and to achieve profits and ensure a high rate of return of equity for the partners, while providing a popular television channel for the Czech public.

447. The business decisions of the new company were vested in the Committee of Representatives which committee in particular had the power for decision-making on the programming principles, the programme structures and the programme plan of the TV station “in consultation with the chairman of the Programming Council”. The Programming Council had certain veto rights in respect to the programming and CET 21, despite its minority shareholding in ČNTS, was entitled to appoint three members to a Programming Council, two of its members to be appointed by the Czech Savings Bank and only one member to be appointed by CEDC, the seventh member being the programming director. The shareholders expressly agreed to be bound by and to respect the terms and conditions of the Licence granted by the Council.
448. Under Article 1.4.1 of the MOA, CET 21 was obligated to contribute to the company “the right to use, benefit from and maintain the Licence of the company on an unconditional, irrevocable and exclusive basis“. The value of the non-monetary contribution was denominated by 48 million Czech Crowns.
449. Further, the partners expressly agreed that they shall not undertake any action that would present a well-founded concern that it will make it more difficult to obtain a prolongation or renewal of the Licence in favour of the company.
450. *“In consideration of the efforts and the contributions to the Company, CET, CEDC and CS herewith commit themselves not to undertake any actions, either by assuming a contractual obligation or by negligence, that would jeopardize the granting of the Licence in general, and especially in accordance with the Act on Television Broadcasting in the Czech Republic (No. 468/1991 Sb.), to assign any right, in part or in full, relating to the aforementioned Licence to any third Party that is not a Party to this Agreement, with the exception of any successor appointed by the Company with the approval of the Council”.*

451. It is the view of the Arbitral Tribunal that this structure, as it appears from the MOA in conjunction with the Licence and its conditions Nos. 17 and 18, is a well-defined legal basis for the Claimant's predecessor's investment in the Czech Republic, granted after intensive consultations with and following requests and advice by the Media Council.
452. It is obvious that the structure of the split of the licence-holder and the operator, as specifically described and set out in this scheme, was the legal basis for the Claimant's predecessor's investment. The purpose of this scheme was to secure the Claimant's predecessor's investment in the Czech Republic in compliance with the Media Law of 1991. The scheme was recognized and developed in conjunction with the Media Council. In scrutinizing this scheme, it is apparent that the Claimant's predecessor's position was substantially more than a financial investor as suggested by the witness Mr. Josefík, who, in the eyes of the Tribunal, showed a rather selective and unpersuasive memory of the facts as the documents show them to be.
453. The Parties to these arbitration proceedings described CET 21's contribution, the right to use the Licence, as a lawful contribution. The Media Council itself in its report of October 1996 to the Czech Parliament reiterated that, *"at the time when the arrangement was made, there were no doubts about its legitimacy; in regard to many related steps that were taken, the Council, as it was then constituted and based on its experience at the time, took a position of consent"*. The Council in its report to the Czech Parliament described the structure which was used by TV NOVA, Premiéra TV and Rádio Alfa as having the following analogous features:
- "Their operation and programming are provided by other companies than the companies that were awarded the Licence, namely, on the basis of a special legal construction which captures, on the basis of a contract, their collaboration and mutual rights and duties. Therefore, there are two companies [related] to one Licence, the one that was awarded the Licence and the one that was established in order to implement it"*.
454. The witnesses confirmed that the CET 21 / ČNTS structure was used for other broadcasting stations. It was in particular used also for Pre-

miéra TV (a minor enterprise) and for Rádio Alfa (also controlled by CME).

455. Also, the report (called "opinion") of the Council to a Parliament Committee of May 1994 qualified the structure as *"standard business procedure which was duly discussed and approved by the licensing body, i.e. by the Council, and does not violate any effective legal regulations, [The Council] consulted with a number of leading legal experts, Czech and foreign "*.

456. Further, the Council stated in its legal opinion to the Parliament that

*"the operation of a television station, it is of a television organization (e.g., for the production of programmes), should be in no case confused with the operation of television broadcasting, i.e. the dissemination of programmes (Article 2 para. 1, letter (a) of Act No. 468/1991 Coll.). The Memorandum of Association and the Licence terms specified the relationship between ČNTS and CET 21 and contain a number of mechanisms that prevent the potential non-permissible involvement of ČNTS in the rights and obligations of the licence-holder. CET 21 is responsible to the Council to the full extent for the operation of television broadcasting. For the reasons stated above, the Council does not share the opinion of the Committee for Science [Parliament Committee]. The Council is convinced about the correctness of the procedure and does not admit any doubts of its legitimacy. "*

457. Therefore, the Council itself viewed the CET 21/ČNTS structure when created and at least until May 1994 as a structure in compliance with the Czech Media Law. The Tribunal accordingly concludes that the Claimant's predecessor's investment was based on a carefully designed legal structure which was developed in conjunction with the Media Council and implemented with its approval. The Tribunal concludes that such structure must be regarded as a legally well-founded basis for the Claimant's predecessor's investment. It was also the legal basis for CME Media when acquiring CEDC's 60 % shareholding in ČNTS in 1994. At that point of time, the investment in TV NOVA was still at a high risk after having started the TV station in spring 1994 with a substantial investment commitment under the MOA as requested and approved by the Council. Any change of the CET 21/ ČNTS investment structure by law or by Council's interference, therefore, must be considered in the light of

whether such changes adversely affected CME's investment in the Czech Republic and whether it could be seen as a breach of the Treaty.

458. It is undisputed between the Parties that TV NOVA within one year after having started broadcasting in February 1994 became the most successful and profitable private television station in the Czech Republic with revenues which increased by 1996 to more than US \$ 100 million per year with a profit of roughly US \$30 million per year (or US \$51 million pre-tax profit). This success is to be attributed to CEDC's operational support which enabled broadcasting to start within a timetable set by the Licence, one year, which was seen as rather ambitious.
459. The witness Mr. Klinkhammer stated that CEDC and CME invested US \$ 140 million in TV NOVA which included the share acquisitions made between 1994 and 1999. In the first purchase of 5,2 % ČNTS shares from the CET 21 shareholders, CME Czech Media Enterprises B.V. had paid US \$5 million. In 1997, in the share transaction with Dr. Železný, CME paid US \$ 27,5 million for 5,8 %, evaluating ČNTS at that time at roughly US \$500 million. Also, the acquisition of 22 % interest in ČNTS held by the Czech Savings Bank for roughly US \$ 30 million on July 17, 1996 indicated that the investment in ČNTS was regarded as sound and prosperous, a success must be, to a large extent, attributed to the foreign investor CEDC and CME because the Czech nationals who initiated the joint venture as shareholders of CET 21, including Dr. Železný, never had practical experience in starting and running a TV station.

**(2) The Media Council in 1996 coerced CME to abandon the legal security for its investment in the Czech Republic**

460. In 1996, the Media Council reversed its position related to the split broadcasting structure between the licence-holder and the operator. The reason for the reversed position is clearly spelled out in the Council's report of October 1996 to the Czech Parliament. In this report, the Council made it clear that the split structure was in compliance with the Media Law as long as it could be controlled by the Council via the Licence conditions. *"... in 1995 there existed a sufficient tie, in the form of Licence terms [Licence conditions] between the licence-holder and the other*



*company, to make it possible for the Council to intervene in the event the existing split became truly problematic. "*

461. *"At the beginning of 1996, however, the amended law on broadcasting that came into effect included the mandatory abolishing Licence terms, and the operators of broadcasting reacted to it by requesting some changes in the Licence. That meant a weakening and/or nullification of the above-mentioned tie as a certain guarantee of the legality of the existing situation".*
462. Indeed, as the Council stated in its report to the Parliament, all three broadcasting companies TV NOVA, Premiéra TV and Rádio Alfa requested that the relevant condition be abolished, which would have had the effect that the Council would have lost control of the operator of the Licence under the split Licence/operator scheme. The Council, in its report to Parliament, identified the problem as follows: *"The focus of the problem is a subtle legal question of who is the operator of broadcasting, which activities [it] may provide itself and which ones it may delegate to other entities without actually transferring the Licence to them. The Law on Broadcasting [Media Law], which stipulates inter alia the basic rules for this very specific business activity, suffers from deficient shortcomings in this respect;"*
463. The Arbitral Tribunal's clear view and understanding is that the Council, in order to avoid loss of control of the operator of the split licence-holder/operator scheme in 1996, decided to put pressure on the participants of the split scheme in order to change it. This transpires from the facts, in particular the Council's own statements in this respect, the documents and the witness statements.
464. As one step of its strategy, the Council did not comply with CET 21 request to delete condition No. 17 of the Licence which is "the tie" in the words of the Council to the Parliament, to safeguard the split structure of licence-holder and operator.
465. On February 12, 1996, the Council instructed Dr. Jan Barta of the State and Law Institute of the Academy of Science of the Czech Republic to render a legal opinion on the split structure. Dr. Barta rendered a legal

opinion submitted under the letterhead of the institute of the State and the Law within one week, on February 19, 1996, which concluded that CET 21 does not operate broadcasting and never did, whereas ČNTS was broadcasting without authority. Dr. Barta stated that the approval of the MOA by the Council has no significance as the Council has not issued any resolution on this subject. In Dr. Barta's view, the MOA expressly stated that the law would be violated (*the Licence-holder pledges not to broadcast, and the company that is being established carries on unauthorized broadcasting*). This was a violation of the law and the Council was not in the position to permit that which is not permitted by the law. Dr. Barta suggested initiating administrative proceedings for unauthorized broadcasting against ČNTS and he suggested as an alternative to withdraw the Licence from CET 21. He further stated "*the given group of investors can be excluded from broadcasting in accordance with the law by these methods*". Further, as an alternative, Dr. Barta suggested to compel CET 21 through penalties to initiate broadcasting at its own expense and to modify contractual relations with the group of investors accordingly. As a further alternative, Dr. Barta suggested to issue a new Licence for ČNTS. "*Until such Licence is legally effective, however, the broadcasting is still unauthorized and the fine has to be levied in such a case as well*".

466. The circumstances of the rendering of Dr. Barta's legal opinion are dubious. It is quite obvious that this legal opinion was rendered in response to the Council's instruction letter of February 12, 1996 with the purpose of laying the ground for the Media Council's reversal of position which was opposite to the Media Council's view that the CET 21/ČNTS split structure was in compliance with the Media Law, when implemented. Dr. Barta's legal opinion had serious deficiencies. Contrary to Dr. Barta's statement under Section 4 of his opinion, the Media Council by resolution of May 11, 1993 topic 2 by unanimous vote approved Licence condition No. 17, which decision was certified under the date of May 12, 1993 in full form. Further, the legal opinion did not deal with the question whether an official State body, when reversing its decision by declaring a legal structure for the use of a broadcasting licence illegal, must pay compensation to the foreign investor who, in reliance on the validity of the split structure, made large investments in the television station. Dr. Barta was of the opinion that the Council at that time (1993) from a

formal point of view, acted incorrectly as administrative body. Dr. Barta's legal conclusion was that the Council is obligated to disregard the MOA and that a decision of the Council shall "simply (be) *based on the determined facts described above.*"

467. This suggestion for the application of administrative law shall not be dissected by the Arbitral Tribunal. Dr. Barta's opinion, however, is unacceptable under the requirements of the Treaty which does not allow reversal and elimination of the legal basis of a foreign investor's investment by just taking the view that an administrative body's formal resolution, the corner-stone for the security of the investment, was simply wrong. The Tribunal is not to decide on the Czech Administrative Law aspect of this question. However, Dr. Barta's legal opinion is not in compliance with the Respondent's obligations under the Treaty.
468. On the face of it, Dr. Barta's opinion was requested by the Media Council simply as a tool to cover up the reversal of the Council's legal position towards CET 21 and the foreign investor CEDC/CME. This view of the Arbitral Tribunal is supported by the sequence of events, ending with CME being forced to change the MOA and to give up the "safety net" (as it was described by the Respondent's representative Prof. Lowe at the Stockholm hearing) by replacing in the MOA the "use of the Licence" as CET 21's contribution in ČNTS by the "use of the know-how of the licence".
469. It is clear that the replacement of the "use of the Licence" (which ČNTS enjoyed under the split structure) by the "use of the know-how of the licence" vitiated the Claimant's protection for its investment in the Czech Republic. The Tribunal need not decide whether the contribution of the "use of the Licence" in 1993 was legally valid under Czech law. The parties to these proceedings are in agreement that (in contrast to Dr. Barta) the contribution of the use of the Licence was legally not questionable. This view of the Respondent is supported by the Media Council's legal opinions and reports to Parliament cited above.
470. However, the Respondent at the Stockholm hearing took the position that the 1993 "safety net" (use of the Licence) was not better than the amended structure (use of know-how of the licence and conclusion of a

Service Agreement). The Respondent's position on this subject is unsustainable. The use of "know-how" of a broadcasting Licence is meaningless and worthless. The obvious purpose for replacing the wording of "use of the licence" by "use of the know-how of the licence" was to buttress a wording in the MOA which could sustain the interpretation that CET 21 did not receive a pay-back of its share capital made by a contribution in kind.

471. The Respondent's position that the waiver of the "use of the Licence" was counterbalanced by the new Section 10.8 of the new 1996 MOA is unsustainable. The wording of Section 10.8 speaks against it:

*"[CET 21] hereby undertakes not to entrust the subject matter of its contribution, or any other right connected with the Licence, or the Licence itself, to the ownership or use of another legal entity or natural person, or to enter into any legal relationship with any legal entity or natural person other than the Company, by which it would give that, or another, person or entity any right to the subject matter of its contribution to the Company or to CET 21 as such which would result in the creation of rights similar to those which the Company has, and undertakes not to even begin any negotiations with another legal entity or natural person about the creation of such a legal relationship."*

472. The "subject matter of its contribution" which, under Section 10.8 is restricted in respect to transfer or even negotiations, is nothing else than the "use of the know-how of the Licence" which, as indicated above, was a rather meaningless and worthless right. Further, CET 21's undertaking not to assign the Licence itself was useless as the assignment of the Licence is not permitted under the Media Law anyway. The only important issue was, whether CET 21 as licence-holder was obligated to contribute the use of the Licence to ČNTS which contribution alone was the "safety net" for ČNTS, ensuring that CET 21 would exclusively use the operational services of ČNTS.

473. Moreover, the Respondent's argument that the waiver of the "use of the Licence" under the 1993 split structure was fully compensated by the Service Agreement entered into between CET 21 and ČNTS 1996/1997, is unsustainable. The contribution of the use of the Licence under the MOA is legally substantially stronger than the Service Agreement, as was demonstrated by the further sequence of events. A Service Agree-

ment could be terminated much more easily for good cause at any time by CET 21 compared with a change or amendment of CET 21's contribution in kind as shareholder of ČNTS under the MOA. Such contribution cannot be recalled by an unilateral act of the shareholder who made the contribution. This may not always apply, e.g. if ČNTS as user of the Licence by its conduct would have jeopardized the Licence, which was never seriously suggested, either by CET 21 or by the Media Council.

474. In 1999, the legal weakness of the 1996 arrangements materialized. On August 5, 1999, CET 21 terminated the Service Agreement for good cause with the effect that the alleged non-delivery of the daily work log for one (!) day (August 4, 1999) gave sufficient reason to terminate the Service Agreement. Thereby, the legal basis for the co-operation between CET 21 and ČNTS was vitiated with the consequence that the Claimant's investments of purportedly US \$ 140 million, evaluated at US \$ 500 million, was put at the risk of civil court decisions which ended up with the first instance Regional Commercial Court decision which decided that the termination was void, which decision was reversed by the Appellate Court with the consequence that the dispute was still pending at the Czech Supreme Court without a final decision having been obtained at the time of the closing of the hearing of these arbitration proceedings, the Claimant's investment meanwhile having been totally destroyed.
475. The Arbitral Tribunal cannot accept the argument that the 1996 "safety net" was a real safety net in comparison with the 1993 safety net. Even if the Czech Supreme Court were to reverse the Appellate Court's decision and re-instate the first instance court decision, this would not change the Tribunal's assessment. Even if ČNTS would be in the position to restore the status of the TV station as it was on August 5, 1999, CET 21 could easily jeopardize the arrangement by repeating the same procedure, terminating the Service Agreement for purported good cause and again dragging ČNTS into Civil Court proceedings.
476. It is not the Tribunal's role to pass a decision upon the legal protection granted to the foreign investor for its investment under the Czech Civil Law and civil court system.

477. Nevertheless, the Tribunal, after having studied the first instance judgment and the Court of Appeal judgment, cannot conceal its opinion that the Court of Appeal inadequately dealt with the facts and circumstances. It permitted a US \$ 500 million value investment to be destroyed by the purported non-delivery of a one-day day-log under a Service Agreement imposed on the investor by the Media Council, which circumstances and facts were set out in detail by the first instance Court judge.
478. The Arbitral Tribunal is charged with assessing whether the amendment of the legal structure of the Claimant's investment in 1996 prejudiced the protection of the Claimant's investment in the Czech Republic and whether this was a breach of the Treaty.
479. The facts in respect to the change of the so called "safety net" themselves are to a large extent undisputed, whereas the Parties' legal and factual interpretation of these facts is controversial. The Respondent's view that the change of the "safety net" in 1996 did not change or prejudice the protection of the Claimant's investment is, as explained, unsustainable.
480. The events in 1996 as documented by the exhibits to the parties' submissions are decisive in sustaining the conclusion that the Media Council in 1996 forced ČNTS and CME to agree to undermine the legal protection of CME's investment. Considering the interpretation of the documents and the witness statements, the Tribunal is of the view that the Council, in order to re-establish its control over the broadcasting operations of CET 21/ČNTS (which operations were disconnected from the licence-holder by the 1993 split structure), "made a very intensive effort" (Mr. Josefík's oral report to the Standing Committee of Parliament on September 30, 1999) to force CET 21 / ČNTS and its shareholders to surrender the 1993 split structure.
481. At the March 13, 1996 Council Meeting, the representatives for CET 21 were confronted in the presence of Dr. Barta with the request to enter into a different contractual relation; Dr. Barta acting in a rather inquisitorial function. He requested that measures be taken so that the physical operator will be CET 21. After the cancellation of Licence condition No. 17, a trade contract between CET 21 and ČNTS was necessary as,

in Dr. Barta's view, "CET 21 does not operate broadcasting". The conclusion to this part of the meeting was:

*"Lawyers of the Council and CET 21 will prepare the first version of a contract on provision of performances and services between CET 21 and ČNTS, so that the first version of this contract will be prepared by CET 21 within 10 days and submitted to the Council for discussion. "*

482. Keeping Dr. Barta in the process, Dr. Barta rendered a further legal opinion dated May 2, 1996 which would have turned the existing 1993 split structure, CET 21 being the licence-holder and ČNTS the operator, upside-down. This legal opinion stipulated, in particular, that all payments for advertising are the income of CET 21 which would deprive ČNTS of its original source of income. The Council asked for a consequent change of the MOA which was discussed at the Council Meeting of May 7, 1996. On May 15, 1996, CME's legal counsel, Laura DeBruce, circulated a letter to the lawyers of CET 21 and ČNTS, expressing CME's concern about the Council's recent proposal that the MOA be amended so that the CET 21 contribution of the "exclusive use" of the Licence would be deleted from the MOA and replaced by a Service Agreement. Laura DeBruce made clear that ČNTS as a consequence of the change requested by the Council would be in rather weak legal position, should CET 21 simply claim that ČNTS was in breach of the Service Agreement and terminate it.
483. The Council at that time involved itself in the draft of the Service Agreement, sending comments to the parties to the agreement with the request to incorporate the comments in the agreement or to comment on them within five business days of receiving the Council's request which dated June 4, 1996.
484. The Council put the issue of CET 21's legal structure on the agenda of the Council Meeting on June 28 and June 29, 1996 and decided at that meeting in respect of ČNTS that a warning of illegality of broadcasting shall be sent to ČNTS, which shall include a time-period for remedy, ending on August 27, 1996. Further, the Council decided to postpone a decision on a cancellation of Condition No. 17 of the Licence, "because of the preliminary question of proceedings before a court and proceedings at the State Prosecutor's Office".

485. On July 23, 1996, the Council initiated administrative proceedings to impose a fine for operating television broadcasting without authorization against ČNTS. In the letter addressed to ČNTS which reached ČNTS in September 1999, the Council set out three reasons.

- The first reason was that the Commercial Register for ČNTS showed it to be operating television broadcasting on the basis of the Licence as its business activity.
- The second reason was that the agreement with the Authors' Protection Union was concluded by ČNTS and not by CET 21.
- The third reason was described as follows:

*"Another basis are the agreements between ČNTS and the company CET 21 spol. s. r. o. which indicate, among other things, that ČNTS is arranging the broadcasting on its own account. There is no control by the broadcasting operator over the disseminated programming; the broadcasting operator's liability is rendered unclear by the Agreement. "*

486. In support, the Council, in its letter to ČNTS, referred to Dr. Barta's legal opinion rendered in the name of the Institute of State and Law of the Academy of Sciences of the Czech Republic.

487. Mr. Josefík, who was Member of the Council and later Chairman of the Council, stated at the Stockholm hearing that *"the agreements between ČNTS and the company CET 21"*, referred to in the Council's letter to ČNTS, were the MOA. This interpretation of Mr. Josefík confirms the wording of the Council's letter, taking into account that no other agreements between CET 21 and ČNTS related to the use of the Licence were in existence at that point of time.

488. The letter of July 23, 1996 and Mr. Josefík's interpretation are in clear contrast to the Respondent's view and position that not the contractual basis of the 1993 split structure but its implementation violated the Media Law. Indeed, Dr. Barta's opinion also did not suggest that the implementation of the 1993 split structure was a violation of the Media Law. Dr. Barta maintained that the 1993 split structure itself was illegal.



489. Therefore, the Media Council reversed its legal position in 1996, taking the view that the 1993 split structure was illegal. The Respondents interpretation of the events as an unlawful implementation of a lawful structure is, in the light of the facts, unsustainable.
490. The purpose of initiating administrative proceedings against ČNTS was solely to put pressure on CET 21 and ČNTS, with the aim of elimination of the 1993 split structure. This assessment, although contested by the Respondent and some of the Respondent's witnesses in these proceedings, is confirmed by the Media Council's own written documents, reports and legal opinions. The legal opinion of the Media Council's legal department dated November 6, 1996 stated in its review of the draft Service Agreement::

*"It may be stated that the said Agreement undoubtedly reacts to the commencement of administrative proceedings against ČNTS for illegal broadcasting with the aim of making it seem that ČNTS has not been committing such illegal acts."*

491. In the report to Parliament of January 31, 1998, the Council repeated its position, stating that the Council halted the proceedings with ČNTS in September 1997 because, in its opinion, once the scenario of actions agreed with ČNTS and CET 21 was fulfilled, the reasons for which the proceedings about unauthorized broadcasting were conducted ceased to exist.
492. In this report, the Council also confirmed the legality of the original 1993 split structure, which the Council considered to be *"legal and which raised legal doubts only later"*.
493. *"The reasons why this model came into existence were the Council's fears of a majority share of foreign capital in the licence-holder's company. The licensing conditions were an insurance of this configuration that the Council considered to be a sufficient tool for regulating the broadcast, even after the softening of them"*.
494. In a sequence of events, the Council initiated administrative proceedings after CET 21 and ČNTS presented a proposal for an amicable solution in

individual legal steps (which did not please the Council). In this respect, the Council reported to the Parliament that, in December 1996, *“after a partial success regarding the legal documents of CET 21 as well as ČNTS, the Council abolished the licensing conditions according to the application. The proceedings concerning unjustified broadcast against ČNTS, however, continue”*. In the period from January till July, 1997, according to the Council’s report to Parliament, CET 21 and ČNTS gradually documented the implementation of the promised steps. On June 3, the Council concluded that the premises for stopping the proceedings were thus fulfilled.

495. On September 15, 1997 (as the Council further stated to the Parliament), having examined the remaining legal issue, the Council stopped the proceedings against ČNTS.

496. The Council, in its report to Parliament of January 31, 1998 reiterates that the original 1993 construction “from the legal view-point did not and does not contradict any law, but it created a basis for problems ...”.

*“When it came into existence, such a construction was just right and had its logic, on top of that, an integral part of this configuration were the licensing conditions set by the Council by means of which inadmissible influences on the broadcasting, emanating from the procurement organization ČNTS, were ruled out.”*

497. The Council (in the response to Parliament’s request) fully disclosed the motivation for the 1993 split structure:

*“When granting the Licence to the company CET 21, for fear that a majority share of foreign capital in the licence-holder’s company might impact the independence of full-format broadcasts, the Council assumed a configuration that separates the investor from the licence-holder himself That is how an agreement came into existence (upon a series of remarks from the Council) by which the company ČNTS was established the majority owner of which is CEDC/CME. Thus, next to the licence-holder’s company, directly linked to it, a new company was established which was to co-participate in implementing the broadcast.*

498. This is clear. The alleged unlawful implementation was not referred to. The Respondent’s view that the structure itself was legal, whereas the

implementation was illegal, is not supported by the Council's own report to Parliament on January 31, 1998.

499. From the witness statements at the Stockholm hearing, it became apparent that CME had to take Council's threat against ČNTS seriously. As an ultimate possibility which was already mentioned in Dr. Barta's legal opinion, the Council could have imposed substantial fines on ČNTS in order to stop ČNTS operating TV NOVA and, furthermore, the Council could have withdrawn CET 21's broadcasting Licence.
500. Dr. Železný, who, at this point of time was in full accord with CME and ČNTS, informed the Representative Committee of ČNTS that the broadcasting Licence will be seriously endangered as a consequence of administrative proceedings and there was a substantial risk for the Licence, should CET 21/ ČNTS not comply with the Media Council's request for change of the legal structure. From the minutes of this meeting, confirmed by the witness statements at the Stockholm hearing, it becomes clear that, at that point of time, Dr. Železný was not acting in conflict with ČNTS and/or CME. On the contrary, he fully supported the joint position of ČNTS and CME towards the Council.
501. By a joint letter of ČNTS and CET 21 dated October 4, 1996, both companies gave in to the pressure of the Council and submitted a proposal to amicably resolve the prolonged differences, "*which arose in addressing the legal situation concerning the arrangement of legal relationship between ČNTS and CET 21, as well as around the cancellation of Licence conditions in connection with Act No. 301/1995 Col.*"
502. The proposal was:
- *"First, to enter into a Service Agreement between CET21 and ČNTS related to television broadcasting services to be provided by ČNTS to CET 21;*
  - *second, to amend ČNTS's entry in the Commercial Register;*
  - *third, to delete radio broadcasting from CET 21's registration and*
  - *fourth, to obligate ČNTS "to submit to the Council a draft amendment to Article 1.4. 1 of the Memorandum of Association of ČNTS*

*which will be submitted to the ČNTS General Assembly for approval.*”

503. By letter dated October 4, 1996, Dr. Železný, acting as “General Manager and Agent” on behalf of TV NOVA, summarized the legal view and situation on behalf of ČNTS. This letter fully explained ČNTS’ position in respect to the legality of the ČNTS/CET 21 structure, supported by a legal opinion of the Institute of State and Law of the Academy of Science which confirmed that the licence-holder, in compliance with the Media Law, may broadcast through other persons.
504. In reference to the proposal submitted by ČNTS by its joint letter with CET 21 of October 4, 1996, in which they proposed steps for a conciliatory settlement to the administrative body, ČNTS requested termination of the administrative proceedings.
505. The shareholders of ČNTS did not give in on a voluntary basis. The amendment of the MOA on November 14, 1996, and the implementation of the Service Agreement was the result of the Council’s threat to discontinue ČNTS’ broadcasting operations. CME decided to disregard its own counsel’s legal advice according to which the replacement of the CET 21 contribution “use of the Licence” by the “right to use, benefit and maintain the know-how concerning the Licence” will be detrimental for ČNTS’ position as exclusive supplier of broadcasting services to CET 21, the basis of ČNTS’ business. CME carefully considered this advice, however it was clear that without the amendment requested by the Council the broadcasting Licence would be endangered. The change lifting CME’s legal “safety net” for its investment was made because of coercion exerted by the Council.
506. This clearly transpires from the submitted documents, in particular the Council’s own report to the Parliament, and this position was supported by Mr. Fertig. The witness, who communicated through Dr. Železný with the Media Council, confirmed that the danger of losing the licence as final consequence of the Media Council’s action was to be taken seriously, if an amicable solution were not reached. The Council demonstrated the seriousness of the threat by initiating administrative proceedings against ČNTS, when ČNTS tried to negotiate and delay the amendment of the MOA.

507. The witness stated that only because of the exercise of coercion was the legal basis for the investment changed. Only the amendment of the MOA to be redrafted along the lines that would satisfy the Media Council could have solved the situation which otherwise would have been destructive for CME's investment.
508. Also, the witness Ms. Landová, who, in the years 1993 to 1997 worked as a senior member of the staff of the office of the Council, supported this position. She clearly stated that the Council initiated administrative proceedings for unauthorized broadcasting against ČNTS in order to put pressure on ČNTS to change the MOA and to make the other changes requested by the Council.
509. The witness Mr. Radvan, a Czech lawyer who represented CEDC, also testified that the Council insisted on deletion of the use of the Licence from the MOA. Dr. Železný's efforts to change the wording without changing the substance had no success. According to Mr. Radvan's witness statement, it was clear that, in respect to the legal protection of ČNTS, it made a huge difference between the use of a licence and the contractual relationship which was introduced in 1996 instead of it, and that it was abundantly clear for everybody involved that the use of the Licence was different from the use of the know-how. By changing the MOA, CET 21's contribution to ČNTS in the eyes of this witness was almost eliminated and the witness stated that the new Article 10.8 did not adequately protect ČNTS.
510. The witness Mr. Musil who was at the relevant time a member of the Media Council, also confirmed to a large extent the sequence of events. His interpretation of the events was that the Media Law of 1991 was unclear in respect to the definition of the "broadcasting operator". He was of the opinion that the administrative proceedings against ČNTS achieved a better status for the Council which was a stricter distinction between the broadcasting operator and the service company. Also, his witness statement made clear that the Council had the clear target of changing the legal structure which was the basis for the Claimant's investment.

511. According to the statement of Mr. Josefík, who later became the Chairman of the Media Council, the administrative proceedings must have been seen in the eyes of ČNTS as a real threat. The witness stated that, on the same basis as the Council initiated administrative proceedings against ČNTS, the Council, in accordance with the legal opinion of Dr. Barta, could initiate proceedings to withdraw the Licence from CET 21.
512. This threat was not a theoretical threat, as the Council in its notification of the initiation of administrative proceedings to ČNTS, referred explicitly to the legal opinion of Dr. Barta which opinion was made known to all respective parties involved and which clearly spelled out the possibility for the Council to initiate proceedings to withdraw the Licence from CET 21.
513. This threat was fundamental because a withdrawal of the Licence in the same way as interference with ČNTS' broadcasting operations would have destroyed the Claimant's investment in the Czech Republic.
514. CME, at this point of time, could not take the risk of entering into long-lasting legal battles, civil law and/or administrative law proceedings, as such proceedings would carry the danger that, if the lawsuits were to be lost, CME's investment would have been irreversibly destroyed.
515. The Claimant decided to give in, which is a normal commercial consequence in any situation of unlawful pressure, when the affected victim of such pressure has to make a careful assessment.
516. Such a decision for a compromise, however, does not make the Council's unlawful acts legal and cannot be deemed as a waiver of CME's rights under the Treaty. This is the considered conclusion of the Arbitral Tribunal.
517. This view is supported by prominent legal authors such as Professor Detlev F. Vagts "Coercion and Foreign Investment Re-Arrangements" 1978, published in the American Journal of International Law. Professor Vagts pointed out that, for example:

*"The threat of cancellation of the right to do business might well be considered coercion . . . Such coercion might be found, even where a "clean" waiver of rights is signed".*

518. The Respondent's contention that CME voluntarily and of its own free will amended the basis for its investment is unsustainable. The (unlawful) situation of coercion is documented by the Media Council's above-cited reports and opinions to Parliament and, furthermore, in the Media Council's letter dated March 15, 1999 to Dr. Železný in his capacity as CEO of TV NOVA and as Executive Director of CET 21. In this letter, which was described by the Respondent as a letter containing the Council's general policy in respect to the relationship between a broadcasting operator and a service organization, the Chairman of the Media Council stated:

*"I confirm the fulfilment of the Council's requirements that were a pre-condition for the termination of the proceedings on unauthorized broadcasting by the ČNTS company. "*

*"The Council terminated the administrative proceedings on unauthorized broadcasting, because most of the above-mentioned material characteristics of the operator were respected and documented, by CET 21. According to the report and documents submitted by CET 21, this cause was also confirmed by changes in the Memorandum of Association and its business contracts. "*

519. The Media Council, also by this letter, gave an authentic interpretation of the reasons for initiating administrative proceedings against ČNTS. The purpose of the proceedings was to force ČNTS to release CET 21 from its contribution, the exclusive use of the broadcasting Licence. The Council's aim was to bring back the right of the use of the Licence to CET 21 which as the licence-holder, was, under the new Media Law in force since 1996, the only legal entity which the Council could control, whereas ČNTS, enjoying the exclusive use of the Licence under the 1993 split structure, could not be monitored and controlled any more by the Council, since Condition No. 17 of the 1993 Licence was to be cancelled under the new Media Law.
520. The Media Council violated the Treaty when dismantling the legal basis of the foreign investor's investments by forcing the foreign investor's joint venture company ČNTS to give up substantial accrued legal rights. The clear alternative available for the Media Council in this situation was to abstain from any pressure on CME/ČNTS and allow the foreign investor

to maintain its investment on the basis of the legal structure which was developed jointly with the Media Council and which was the basis for the foreign investor's investment decision. Any consequences deriving from such coercion against the foreign investor and/or its investment company ČNTS must be remedied. The Respondent's contention that the change of the legal basis of the Claimant's investment was made voluntarily or was the result of a commercial dispute between CME and/or ČNTS and Dr. Železný is unsustainable and must be rejected.

521. It is speculation whether the Media Council would finally have exercised its powers to the full, or whether CME could have gained support through the Czech Republic's administrative and/or civil courts. A threat does not become legal upon the victim's surrender to the threat and the surrender cannot be deemed as a waiver of its legal rights. The possibility that the threatening State Authority would not exercise its powers or that law courts would grant sufficient relief do not qualify the victim's surrender as voluntary.
522. A reasonable investor, having invested financial funds deriving from public placements, such as the CME group, the parent group of which was listed on the New York Stock Exchange, cannot jeopardize the funds raised in the public financial markets by taking unforeseeable risks. The Respondent's suggestion that CME could have sorted out the problem with the Media Council, if any, in the law courts is therefore unacceptable.
523. The Respondent's further contention that the coercion in reality did not take place as the communication between CME and the Media Council was, to a large extent, channelled through Dr. Železný who followed his own target which was, to regain the usage of the licence for CET 21, of which he was majority shareholder, is unsustainable. Not a single document or witness statement proves that in 1996, Dr. Železný exploited the situation of being communicator between CET 21/ČNTS and the Media Council. On the contrary, more than one witness stated that, at that period of time, Dr. Železný acted as an honest representative of both corporations, pursuing the business interest solely of these corporations.
524. The Arbitral Tribunal is aware that coercion claims suffer significant practical difficulties as they may raise the suspicion that the Claimant has



been playing a too clever game, first taking what he could get from the deal with the foreign government and then, coming for a second bite under the Treaty proceedings (see Professor Vagts as cited with similar concern on page 34). The Arbitral Tribunal is of the view that such danger does not exist in these arbitration proceedings.

525. Should the Claimant's joint venture company ČNTS receive a remedy through Czech Republic civil or administrative court proceedings, this may have an impact on the quantum of the damage claim. This issue however, must clearly be distinguished from the question whether the 1996 treatment of ČNTS and CME by the Media Council was a breach of the Treaty. The Arbitral Tribunal's response to this question is affirmative. The danger that the coercion claim under the Treaty in these arbitration proceedings will grant compensation in addition to ČNTS Civil Court claim (if granted), is not present, as the Parties instructed this Tribunal not to deal with the quantum at this stage of the arbitration proceedings.
526. Professor Vagts made the following suggestion for the elements of a code of unfair bargaining practices during investor-government negotiations (page 34 of Professor Vagts' publication as cited above) which, inter alia, prohibits a government from the following acts:

*“Cancellation of the franchise, permit, or authorization to do business in which the investor relies, except in accordance with its terms; and Regulatory Action without bona fide governmental purpose (or without bona fide timing) designed to make the investor's business unprofitable.”*

This seems to be a reasonable threshold which is passed by the Council's actions in this case.

527. The Respondents argument that a breach of the Treaty by coercion did not take place, because ČNTS' business under the amended 1996 MOA and the Service Agreement was even more profitable than before is unsustainable. The effect of the coercion was that CME lost its legal protection for the investment. It is not necessary that the economic disadvantage, as a consequence of the loss of legal protection, occurred immediately after the Media Council's intervention into the contractual relationship between CET 21 and ČNTS took place. Causation arises if the

damage or disadvantage deriving from the deprivation of the legal safety of the investment is foreseeable and occurs in a normal sequence of events. The protection of rights in corporate life does not materialize before a commercial conflict arises. This may occur years later. The mere lapse of time does not diminish the Claimant's rights as a consequence of the Media Council's unlawful interference in ČNTS' basic legal right to operate TV NOVA on the basis of the exclusive use of the Licence. The negative effects of the loss of the legal security of the investment materialized and surfaced in 1999 which is roughly 30 months later. This is not a long time neither in corporate life nor in respect to a long-term investment in a TV station.

528. The Respondent's further contention is that the 1996 change of CME's investment protection is not a breach of the Treaty, as the 1993 investment protection, if construed in any legal action in accordance with Czech law, would not have been enforced by a court as the Media Law prohibited the transfer of the Licence under Article 10.2 of the Media Law. The Respondent's actions therefore, as Professor Lowe at the Stockholm hearing argued, did not violate any legal disposition.
529. This contention is unsustainable. The Media Council jointly with CEDC developed the investment scheme by creating the 1993 split structure which was thereafter also used by other broadcasters. CME and its predecessor as foreign investor could reasonably rely on this structure which was developed in close conjunction with and approved by the Media Council.
530. Whether a Czech National Court would support and defend this structure is not dispositive. The Media Council was obligated to defend and secure this structure, after having attracted foreign investment on the basis of it. This placed the obligation on the Media Council not to interfere with the legal foundation of the Claimant's predecessor's investment.
531. The Respondent's position, also submitted by Professor Lowe at the Stockholm hearing, that CET 21, by law, was always in the position to use and exploit the Licence itself, is in clear contradiction to the MOA, under which CET 21 contributed the exclusive use of the Licence to ČNTS. The legality or non-legality of the 1993 split structure is not at

stake. At stake is the protection of the structure and the Council's obligation not to undermine this structure by pressing the investor to give up basic rights which secured his investment.

532. The Respondent's further contention submitted by Professor Lowe that the efficiency of the 1996 arrangement has never been tested is not convincing. The lack of efficiency of the 1996 arrangement was seriously displayed in civil law court proceedings. The Regional Commercial Court protected the validity of the Service Agreement after it was terminated by CET 21 on questionable grounds. The first instance judgment was however overturned by the Appellate Court by a highly unconvincing judgment, leaving the final decision to the Czech Supreme Court. This unacceptable legal and commercial risk of prolonged legal battles was exactly what CEDC as foreign investor tried to avoid, when making its investment decisions in 1996. Such risk for the investor's investment is unacceptable and demonstrates the inadequacy of the 1996 arrangements (in contrast to Professor Lowe's submissions).
533. The Czech Republic and/or the Media Council are as a matter of principle not debarred from amending or altering the basis for CME's investment, subject to acquired rights and treaty obligations. This is a question of the Czech Republic's national sovereignty. However, any such action should have been done under due process of law, providing just compensation to the deprived investor (Art. 5 of the Treaty). The silent and coerced vitiation of CME's basis for its investment does not fulfil such a requirement and is, therefore, under the standards of the Treaty, and the rules of international law, a breach of treaty obligations.
534. The Respondent's further contention that ČNTS could have avoided the pressure from administrative proceedings: it only had "to stop breaking the law", is unsustainable. The Arbitral Tribunal cannot identify a breach of law by ČNTS, having scrutinized the documents submitted in these proceedings and the witness statements made, as well as the testimony of witnesses.
535. The Respondent's contention that CET 21 / ČNTS improperly implemented the 1993 legal arrangements is not supported either by documents or by witness statements. On the contrary, as shown in detail

above and also later in this Award, administrative proceedings were initiated not to enforce the proper implementation of the 1993 legal arrangements but to undo these arrangements. Otherwise, the Media Council could have requested a change of the implementation without requesting the change of the MOA and without requesting the implementation of the new Service Agreement. This was not the case. The Media Council requested a complete change of the basic legal protection of CME's investment by substituting for "the use of the licence" contributed by CET 21 to ČNTS the (useless) use of know-how of the licence.

536. Therefore, the final argument of the Respondent at the Stockholm hearing, in particular alleging the "hand-over of the reins from CET 21 to ČNTS", is not convincing. The reins were not handed over by CET 21 to ČNTS in the years 1993 to 1996. The legal basis for the investment was not changed before 1996. The implementation of the 1993 legal arrangements conformed to the legal documents of its formation.
537. The legal arrangements between CET 21 and ČNTS were implemented in accordance with the wording and the intentions of the Parties, including the Media Council, which co-designed and approved the structure in 1993.
538. The Media Council, acting on behalf of the Czech Republic, in 1996 breached the Treaty by coercing CME and ČNTS into giving up legal security for CME's investment in the Czech Republic.

### **(3) The Media Council supports the destruction of CME's investment**

539. In 1999, the Media Council actively supported the destruction of CME's investment in ČNTS. This conclusion is based predominantly on the documents submitted to the Arbitral Tribunal and by the statements of the witnesses. According to the minutes of the Council Meeting of March 2, 1999, Dr. Železný, at that time CEO of TV NOVA (ČNTS) and Executive Director of CET 21, visited the Media Council on the so-called "Visitation Day". According to the minutes, the reasons for the visit were "the current relationships with the foreign investor, current internal situa-

tion of the investor". Dr. Železný informed the Council about purported financial difficulties of ČNTS' 99 % shareholder CME (1 % shareholding by CET 21). Dr. Železný informed the Council about the conflict between CET 21 (Dr. Železný having a majority of 60 % shareholding in this company at that time) and ČNTS and that CET 21 had set a deadline for CME for changing the MOA. Otherwise, CET 21 would sell its 1 % share in ČNTS and withdraw the broadcasting Licence from ČNTS, unless ČNTS were prepared to enter in a new set of agreements "on the sale of advertisements, technology operations and technology support". If CME would not accept this solution by March 20, CET 21 will enforce this "clean alternative". Dr. Železný, in his capacity as Executive Director and shareholder of CET 21, requested the support of the Council against ČNTS, in spite of being the CEO of this company as well:

*"CET 21 would like to ask the Council to repeat some statements of the Council (exclusivity, withdrawal of the Licence) in relation to all steps within the logic of the development of the relationships between CET 21 and the Council. If and when harming the interests of ČNTS, Železný will need to be supported by a formal or informal letter. They are interested in a long-term stability, also in connection with a re-granting of the Licence. They ask the Council, whether it would be willing to remind of the principles which it had discussed with NOVA during various administrative proceedings and other negotiations".*

540. Dr. Železný further gave details for the contemplated new legal structure which he was going to impose on ČNTS.

*"It is a shift from a general [Service] Agreement to 5 specific agreements. The only exception - exclusivity in case of re-granting of the Licence. Železný asks for a letter redefining the general principles on the basis of which a package of sufficiently specific agreements could be proposed to the partners. If the Council decides that such letter is not suitable, because it would pre-conceive some formulations of the act, Železný will solve the situation. He would need as one of the documents a relevant document with a new date, the partners consider it more convenient not to reflect to it and not to risk a criminal recourse for not having reported correctly on changes (amendment) . . . "*

541. In the further discussions, the Council suggested to Dr. Železný to put concrete questions to the Council. Further, the minutes say:

*"We have a common interest. It is not a problem for Železný to formulate the questions. The current version of the agreement will be attached. They are willing to hand-over the agreements which have been prepared in order to make the matter more transparent. "*

542. On the next day, on March 3, 1999, Dr. Železný, under the letterhead of CET 21, sent the questionnaire to the Council. The letter spelled out that the communication between the Council and Dr. Železný should not be disclosed:

*"It is extremely important for us to receive the formulated principles in the form of an independent report of the Council as a reply to our request. We would like to use this opinion for discussions with our contractual partners, without disclosing other internal matters of our company . . . "*

*"We consider this type of co-operation with the regulatory body, in the form of a preliminary inquiry and professional consultation, to be very suitable, and we would like to apply it in the future as well . . . "*

543. Further, Dr. Železný offered (as promised) to supply to the Council the new set of contracts to be implemented for the future co-operation with ČNTS. Further, Dr. Železný asked for the confirmation of his principles:

*"These are formulations of general principles, on which we want to base our activities. We ask you to confirm their validity in the form of the Council's opinion:*

*"CET 21 will act, function and proceed as an operator, and, therefore, it has to carry out relevant managerial, administrative, and accounting tasks, and must build up its own company structure to include functions that cannot be transferred to service organizations. Employees responsible for programming and programme composition must be persons appointed or authorized directly by the CET 21 company.*

*Relations between the operator of broadcasting and its service must be established on a non-exclusive basis, because exclusive relations between the licence-holder and the service organization may encourage the transfer of some functions and rights that are dependent on the Licence and that are not transferable by law. In our opinion, CET 21, the operator, should order services from service organizations at regular prices so as to respect rules of equal competition. The selection of services should be decided by the licensed company independently, so that services are in ac-*

*cordance with the profile of the television station stipulated in the Licence and the quality of the services meet the requirements of the licensed company, For the level of provided services to agree with the terms of the Licence and Czech regulatory requirements, the licensed subject must have the ability to select relevant services anytime and anywhere at will which consideration ensues from the responsibility to operate television broadcasting.*

*Because the broadcasting time reserved for advertisements is by law a direct function of the Licence, and broadcasting business activity is registered by the operator only, revenues from advertisements that result from the sale of broadcasting time must be revenues of CET 21, from which proportional profit is reported and properly taxed in accordance with the Commercial Code. The accounting methodology for the company should be adapted to this fact. Of course, the right of the CET 21 company to pay fees for services ordered by CET 21 is not affected by this fact.*

*CET 21 will unequivocally decide on the composition of broadcasting, on programming and allotted time slots and genre, on the ratio of domestically produced and foreign programmes, and on questions of journalistic independence, objectivity, and balance in news reporting. The right to use programme Licences and copyrights in the form of broadcasting is exclusively within the scope of the operator who, for this purpose, must acquire Licences and rights from servicing organizations or directly from the owners of such rights and Licences. "*

544. The Council responded to this letter on March 15, 1999 by a letter signed by the Chairman of the Council, Josef Josefik, on the Council's official letterhead. The Council confirmed the "general principles" by six bullet points which, in essence, repeat (to some extent word by word) the proposal of Dr. Železný, the main difference being that the Council generalized the principles by replacing "CET 21" by "operator" or "licence-holder". In essence, the contents of the bullet points and the "general principles" as proposed by Dr. Železný are identical:

*"In regard to the preparation of the Annual Activity Report of the Council for Radio and Television Broadcasting, the Council also dealt with the current status of private television broadcasting.*

*I refer to your personal visit to the Council during which you informed us about the current situation in broadcasting and I confirm the fulfilment of the Council's requirements that were a precondition for termination of the proceedings on unauthorized broadcasting by the ČNTS company.*

*Because the Council was also asked by the Parliamentary Media Committee to issue an opinion on whether commercial television broadcasting complies with the Act on Broadcasting and valid Li-*

cences, we would like to summarize requirements that, in our opinion, express the contents of television broadcasting:

*An operator operates, functions and acts as an operator, i.e. carries out relevant administrative, and accounting tasks. Employees responsible for programming and composition of programmes are persons employed and appointed (authorized) directly by the licence-holder;*

*Business relations between the operator of broadcasting and service organizations are built on a non-exclusive basis. Exclusive relations between the operator and the service organization may result in de facto transfer of some functions and rights pertaining to the operator of broadcasting and, in effect, a transfer of the licence;*

*The operator is fully responsible for the structure and composition of programme and carries full editorial responsibility. The operator broadcasts programme in its own and on its own account and responsibility. The operator, therefore, must unequivocally decide on the content of broadcasting, its time and genre composition, and the ratio between domestic and foreign programmes;*

- *The operator concludes contracts in its own name with protection organizations for authors and performing artists.*

*The redemption of programme rights and copyright in the form of broadcasting shall be from the exclusively by the operator. For that purpose, the operator is obliged to obtain Licences and rights from commission organizations or directly from their owners;*

- *The operator concludes contracts in its own name with organizations providing technical transmission of television signals;*

*Revenue from advertising is the result of the sale of advertising time which is directly connected to the Licence; therefore, it must be reported and taxed by the entity performing the actual fulfilment [Translator's Note: broadcasting the commercials], i.e., the operator. (Of course, it is permitted with respect to this area of business that the operator concludes a contract with an agency which will purchase the advertisement for the operator).*

*The Council terminated the administrative proceedings on unauthorized broadcasting because most of the above-mentioned material characteristics of the operator were respected and documented, by CET 21 s.r.o. According to the report and documents submitted by CET 21, this course was also confirmed by changes in the Memorandum of Association and its business contracts,*

*We ask you to inform us about the current status of the implementation of the above-mentioned procedures and to document the manner of the actual implementation of the above-mentioned points in the current wording of the Memorandum of Association*



*and related business contracts concluded by the operator of broadcasting, CET 21, s.r.o.*

*The Council inspects the current status of private television broadcasting and monitors whether the broadcasting of commercial television stations complies with the Act on Broadcasting and whether these stations broadcast on basis of valid Licences.*

*Therefore, we ask you to submit the current programme composition and broadcasting schedule, in accordance with the Licence terms.*

*[illegible signature]  
Josef Josefík*

545. The Parties' interpretation of the March 15, 1999 letter differs. While the Claimant is of the opinion that the letter is a Treaty violation, the Respondent's view is that the letter expressed the Council's general policy, not binding in the specific situation of ČNTS. The witness Josef Josefík, at that time Chairman of the Council, interpreted the letter as a recommendation and the witness Musil said that the letter reflected the Council's model, the Council's policy and that this letter was used as a model by the Council.
546. The Arbitral Tribunal's assessment is that the letter cannot be interpreted without taking the circumstances into consideration. The letter was addressed and sent to Dr. Železný in both of his capacities: as CEO of TV NOVA and as Executive Director of CET 21. The letter stated general principles of the current status of private television broadcasting and, in this letter, the Council summarized "requirements that, in our opinion, express the contents of television broadcasting." The principles summarized under six bullet points are, therefore, not recommendations. The Council summarizes "requirements". Specifically addressed to CET 21 and TV NOVA, the Council requested TV NOVA and CET 21 *"to inform the Council about the current status of the implementation of the above-mentioned procedures and to document the manner of the actual implementation of the above-mentioned points in the current wording of the Memorandum of Association and related business contracts concluded by the operator of broadcasting, CET 21."*
547. This letter, therefore, as its clear wording demonstrates, is not just the expression of the Council's general policy. It is directly addressed to ČNTS and CET 21 and deals with their specific contractual situation.

Moreover, the Council stated that *“it terminated the administrative proceedings on unauthorized broadcasting because **most** of the above-mentioned material characteristics of the operator were respected and documented by CET 21. According to the report and documents submitted by CET 21, this course was also confirmed by changes in the Memorandum of Association and its business contracts”*.

548. A neutral reader of this letter must interpret this letter as a clear request by the Council to CET 21 and ČNTS to comply with all of the “requirements” because the 1996/1997 contractual changes had fulfilled most but not all of the “characteristics”. The reference to administrative proceedings was a clear warning by the regulator about possible consequences, should CET 21 and ČNTS not comply with the “characteristics” or “requirements”.
549. The “characteristics” or “requirements” in the six bullet points substantially deviate from the 1993 legal concept (the above so-called 1993 split structure) and further, they also substantially deviate from the 1996/1997 required amendment of the legal structure between CET 21 and ČNTS. The first bullet point stipulates that the licence-holder has to carry out relevant administrative and accounting tasks. The second bullet point stipulates that the business relations between the operator of broadcasting and service organizations are built on a non-exclusive basis (which was in clear contrast to the exclusive Service Agreement between CET 21 and ČNTS) and, the sixth bullet point stipulates that revenues from advertising must be reported and taxed by the entity performing the actual fulfilment, i.e. the operator (in the meaning of the licence-holder).
550. This letter of the broadcasting regulator was a further blow to the already fragile 1996/1997 contractual basis of CME’s investment (the exclusive use of the know-how of the Licence as stipulated in the MOA and the exclusive Service Agreement). It was a clear interference by the Council with the 1996/1997 structure as implemented under the pressure of the Council by ČNTS being forced to enter into the Service Agreement and agree on the amendment of the MOA. It was a serious interference, as it contained the Regulator’s threat to enforce the requested changes, referring to the administrative proceedings for unlawful broadcasting by

ČNTS. The waiver of exclusivity would clearly destroy the legal basis for CME's investment in the Czech Republic.

551. This interference by the Media Council in the economic and legal basis of CME's investment carries the stigma of a Treaty violation. The Media Council was obviously working hand-in-hand with Dr. Železný when supporting Dr. Železný in his attack upon CME's already fragile basis for CME's investment in ČNTS. The March 15, 1999 letter refers to the personal visit of Dr. Železný to the Media Council. It, however, conceals Dr. Železný's letter dated March 3, 1999 which provided the wording for the bullet points. As the witness Mr. Klinkhammer stated, the letter of March 3 was found in Dr. Železný's papers by the company's auditors after Dr. Železný was dismissed later in the year. The March 3, 1999 letter was not seen by Mr. Klinkhammer, CME's representative in the Czech Republic, when it was communicated. The Respondent's witnesses (including Mr. Josefík and Mr. Musil) could offer no explanation for the failure of the Council's letter of March 15 to refer to Dr. Železný's letter of March 3, despite the former letter in fact being a reply to the latter.
552. Dr. Železný, at the meeting with the Media Council on March 2, 1999 openly disclosed to the Council that the purpose of the requested intervention by the Council was "to harm ČNTS". Dr. Železný further openly discussed with the Council his conflict of interest ("*Dr. Železný - I am sitting on two chairs which move off one from the other*"). The Media Council, the Czech Republic's broadcasting regulator, at the Council Meeting on March 2, 1999, when dealing with the topic "the current relationship with the foreign investor", did not abstain from actively supporting Dr. Železný who clearly and openly violated his duties as CEO of ČNTS, the joint venture company, the beneficiary of the foreign investor's investment. This unconcealed violation by Dr. Železný of his duties under corporate and civil law cannot be seen as a harmless commercial difference between the majority shareholder and Executive Director of CET 21 on one side and the service company ČNTS on the other side. It is a massive, clear and intentional breach by Dr. Železný of his director's duties, a breach of law that must be assessed as a serious criminal offence in any functioning judicial system.

553. The minutes of the March 2, 1999 Council Meeting which disclosed the foregoing facts are from the Media Council's files, remitted to the Arbitral Tribunal by its Order at the request of the Claimant. The parties are in agreement on the translation submitted to the Arbitral Tribunal. The parties disagree on the interpretation, but they do not dispute the wording of the minutes. This wording is consistent with the witness statements, according to which written minutes were in conformity with the facts or speeches of what was heard at the Council Meeting.
554. The Arbitral Tribunal's conclusion is that the sole purpose of the March 15, 1999 letter was to support Dr. Železný in putting pressure on the foreign investor CME in order to achieve a re-arrangement of the contractual relations between CET 21 and ČNTS as desired by Dr. Železný, an arrangement that would destroy the legal basis (the safety net) of the foreign investor's investment. There was no other purpose. In particular, there was no serious follow-up to this letter. In response to the specific question by the Tribunal at the Stockholm hearing, Mr. Josefík stated that he could not recall off the top of his head that the Council had received a response to the part of the letter that asked CET 21 to inform the Council about the current status of the implementation of the requirements. On the face of it and quite obviously, the Media Council did not pursue any regulatory purpose with the letter. The only object was to put the letter with the agreed wording into Dr. Železný's hands, the purpose of which was clearly described by Dr. Železný to the Media Council at the Council meeting on March 2, 1999, which was "harming the interest of ČNTS".
555. The March 15, 1999 letter was not a private matter of the Council's Chairman. According to Mr. Josefík, the letter was drafted in a standard procedure, cleared through individual departments and then presented to the Council. The letter referred to Dr. Železný's visit at the Council Meeting on March 2, 1999, but did not reveal that the bullet points were prepared by Dr. Železný in his letter of March 3, 1999. The March 15, 1999 letter, a regulatory letter of the broadcasting regulator, was fabricated in collusion between Dr. Železný and the Media Council behind the back of ČNTS (TV NOVA) to give CET 21 a tool to undermine the legal foundation of CME's investment.

556. The Respondent's view, supported by Mr. Josefík, according to which the Council did not intend to support Dr. Železný in his dispute with CME, is not convincing. The clear facts and circumstances speak against it. In this context, the Arbitral Tribunal is constrained to observe again that Mr. Josefík showed a selective memory. Specifically questioned on his personal contacts with Dr. Železný in 1999, he responded on page 48 of the Stockholm hearing outprint of day 7: *"However, I do not recall that I had any other talk than a courtesy talk"*. When further interrogated as whether he talked to Dr. Železný over the telephone in 1999, he admitted that telephone conversations took place about the relationship between CET 21 and ČNTS, Dr. Železný carrying on a monologue on the subject. *"However, I do not recall any specific topic."* The witness Mr. Josefík was vague in recollecting these communications, whereas in respect to other details of the March 15, 1999 letter, his recollection was precise and clear.
557. The Arbitral Tribunal's impression was that Mr. Josefík's witness statements were coloured voluntarily or involuntarily by his desire not to qualify the Media Council's actions as a breach of the Treaty, taking into account that Mr. Josefík prepared his written witness statements at a time when he was still holding the position of the Chairman of the Council.
558. The Tribunal, therefore, is of the opinion that the Respondent's witness' statements and the Respondent's suggestions for the interpretation of the minutes of March 2, and the March 3 and the March 15, 1999 letters do not overturn the plain wording of these documents which speak for themselves. The Czech Republic, acting through its broadcasting regulator, the Media Council, massively supported Dr. Železný in his efforts to destroy CME's investment in the Czech Republic by eliminating ČNTS as the exclusive service provider for CET 21.

**(4) ČNTS' dismantling as exclusive service provider supported by Council's actions and inactions**

559. With the Media Council' letter of March 15, 1999 in his hands, Dr. Železný fulfilled the threats of his ultimatum which he had given to CME at the meeting of the Board of Representatives of ČNTS on February 24, 1999. At this meeting, Dr. Železný had requested a change of the

Service Agreement by eliminating exclusivity. Otherwise, he threatened, he would change the contractual relation between CET 21 and ČNTS unilaterally. In that case, Dr. Železný announced, CET 21 will hire another advertising agency for the sale of the advertisement time and procure broadcasting services from other providers on the basis that the Service Agreement between CET 21 and ČNTS was not exclusive. This was, de facto, the withdrawal of the use of the Licence, what Dr. Železný later at his visit at the Media Council, according to the minutes of this meeting, described as “the clean alternative”.

560. Dr. Železný, at the Board Meeting, further announced that *"the Council wants to change its original decision and to write a letter with the statement that the present relationship between CET 21 and ČNTS is not correct"*. In particular, due to the announcement of this yet-to-be-written letter of the Media Council, it is obvious that, in contrast to the Council's chairman Mr. Josefík's rather vague and evasive oral witness statement at the Stockholm hearing, Dr. Železný had prepared his ultimatum and the implementation of his threats in communications with the Council, which communications were confirmed by Mr. Josefík (who denied any talk of substance) and which communications are also confirmed by Mr. Klinkhammer's witness statement, according to which Dr. Železný in this critical period, as revealed by company telephone charges, made numbers of telephone calls on the ČNTS mobile phone to the Council.
561. The witness Mr. Klinkhammer, who took over as a Chief Executive of CME on March 23, 1999, stated that CME made substantial efforts to prevent the dismantling of ČNTS by Dr. Železný by making various commercial approaches to bring to him such as merging CET21 and ČNTS in order to retain the use of the licence for the joint venture company. The witness stated that, as part of these efforts, CME and/or its ultimate shareholder Mr. Lauder, offered to pay to Dr. Železný up to US \$ 200 million in order to find a suitable arrangement securing the continued exclusive use of the Licence which was the basis for the investment of CME in the Czech Republic. These efforts failed and it appears obvious that Dr. Železný had gained the Media Council's legal support for CET 21's view that the Service Agreement was not exclusive. This legal position of the Regulator provided the basis for Dr. Železný to

dismantle the Service Agreement relationship and take over TV NOVA without compensating the foreign investor CME.

562. According to Mr. Klinkhammer's witness statement, ČNTS' majority shareholder CME at the shareholder's meeting on April 19, 1999 dismissed Dr. Železný as CEO of ČNTS after having confronted Dr. Železný with documents proving that CET 21 through Dr. Železný's actions already had breached the exclusive Service Agreement with ČNTS, inter alia submitting a letter which Dr. Železný had written announcing that ČNTS had been withdrawn from the business of programme acquisition and that this would now be handled by a company AQS, a clear breach of the Service Agreement.
563. Dr. Železný's breach of contract was strongly supported by the Council's letter dated March 15, 1999. This view is supported by the further sequence of events as derived from the documents and confirmed inter alia by the witness Mr. Klinkhammer. Mr. Klinkhammer, as representative of CME, appeared in front of the Council in April 1999 and gave a two-hour presentation on CME's/ČNTS' factual and legal position as basis for CME's investment. Mr. Klinkhammer explained the events that led to Dr. Železný's dismissal. This presentation, according to Mr. Klinkhammer, made the situation abundantly clear for the Media Council. CME made the clear statements about CME's/ČNTS's conviction and intent to continue to operate within the broadcasting and all other laws of the Czech Republic and all regulations imposed on ČNTS, the MOA and the Service Agreement of 1997. CME, also according to Mr. Klinkhammer, put the Council on notice that CME thought that the Council's action of March 15, 1999 *"had confiscated at least a portion of our investment in the Czech Republic"*.
564. At the latest at this point of time the Media Council, the broadcasting regulator in the Czech Republic, must have clearly understood the consequences of its interference in the legal relations between ČNTS as service provider and CET 21 as licence-holder. The Council, at the latest at this point of time, could have clarified the legal situation and remedied its interference by recalling its letter of March 15, 1999.

565. The Council did not respond to CME's two-hour-presentation which, according to Mr. Klinkhammer, was accompanied by a written communication which was handed over, after the presentation was finished.
566. By letter dated June 24, 1999, signed by both its new executive and general director and its lawyer, ČNTS repeated its position to the Media Council with copies to the Vice-Chairman of the Permanent Media Committee of the House of Representatives of the Parliament of the Czech Republic, to the Vice-Chairwoman of the same Committee and with copies to three Vice-Chairpersons of the Media Council. ČNTS, again, described the legal basis for CME's investment in the Czech Republic in 1993 which was amended in 1996 as approved and adopted by the Council in 1997. ČNTS referred to the exclusivity of the legal arrangement and described Dr. Železný's breaches of CET 21's obligations under the various agreements, in particular under the MOA and the Service Agreement. ČNTS requested the Media Council to explain its legal position in respect of the legal structure of the inter-relation between CET 21 and ČNTS and CME or *"to take measures which would resolve the current dispute between CET 21, ČNTS and CME in connection with the legal structure of these relationships and prevent their violation on the part of CET 21 and Dr. Vladimír Železný"*.
567. The Media Council disregarded CME's and ČNTS' request for clarification of the legal situation and abstained from any action or intervention, thus tolerating CET 21's breach of contract, supported by and based on the Council's March 15, 1999 letter.
568. By letter of July 13, 1999 ČNTS, again, requested the Council's evaluation of the exclusivity of the relationship between CET 21 and ČNTS. ČNTS, in full detail, referred to the history of the contractual relation, the Council's involvement and the inter-relation between the exclusive Service Agreement and the foregoing agreements between the contractual parties, as the basis for the Claimant's investment in the Czech Republic.
569. ČNTS concluded its request as follows:

*"We hope the above specified facts ... will help to evaluate the legal relationship between ČNTS and CET 21 impartially, and thus to conclude that the relationship between ČNTS and CET 21 is an*



*exclusive relationship which was as such established, construed, and, up until the creation of the dispute with Dr. Železný, as such respected by all participated physical and legal entities and by concrete legal acts was being fulfilled”.*

570. The Media Council did not reverse its unlawful interference. On the contrary, the Tribunal increased its pressure on ČNTS. In a response letter dated July 26, 1999, the Council referred to a legal opinion which the Council had prepared at request of the Permanent Commission for Media of the Parliament on the dispute between ČNTS and CET 21 with special regard to disputed matters regarding the exclusivity of agreements between ČNTS and CET 21, and which the Council provided to the Parliament on the same day. The Council attached an excerpt of this opinion to the letter to ČNTS requesting ČNTS *“to stop immediate/y your media campaigns in connection with a trade dispute and to inform the Czech Media Council by August 15, 1999 on new steps that shall minimize the risks mentioned and shall lead to a final settlement of the dispute in compliance with the applicable laws”.*
571. The legal opinion submitted to the Parliament referred to the *“risk of a breach of the Media Law taking the position that as long as the dispute did not deviate from its commercial nature, the Council had no legal reason or right to interfere in it.”* The Media Council neither addressed the issue of the non-exclusivity of the Service Agreement nor did it revoke its letter of March 15, 1999.
572. This non-response and inaction by the Media Council aggravated the deterioration of CME’s legal basis for its investment in the Czech Republic by reiterating and further supporting the elimination of the contractual exclusivity of the Service Agreement, the (already fragile) basis for the protection of CME’s investment in the Czech Republic. In August 1999 and thereafter, the Media Council, although recurrently informed by ČNTS and CET 21 of Dr. Železný’s further acts to dismantle ČNTS’ legal and factual position as exclusive service provider to CET 21 (including the termination of the Service Agreement on August 5, 1999), disregarded ČNTS’ request to protect the legal arrangement which was the basis for CME’s investment in the Czech Republic.

573. The Media Council, after having coerced the 1996/1997 change in the legal basis for CME's investment and after having further jeopardized in conjunction with Dr. Železný the (already) fragile legal arrangements between ČNTS and CET 21 by the Council's letter dated March 15, 1999, was obligated to re-establish and secure the legal protection for CME's investment. As a minimum measure to clarify the legal uncertainty for the Claimant's investment (caused by Council's acts), the Council should have recalled its collusive March 15, 1999 letter by confirming the exclusive service relation between CET 21 and ČNTS. The Council, in its capacity as broadcasting regulator, was bound to have abstained from supporting the dismantling of CME's investment by Dr. Železný.
574. After the Council by its acts had jeopardized the legal basis of CME's investment, it was not sufficient for it to keep silent and abstain from any regulatory clarification of the legal situation when, beginning in July 1999 and thereafter, Dr. Železný and CET 21 exploited the vitiation of the legal protection of CME's investment by eliminating ČNTS as exclusive service provider, which was the basis of CME's investment in the Czech Republic.

#### **(5) Causation of damage by Council's actions and omissions**

575. The collapse of CME's investment was caused by the Media Council's coercion against CME, in requiring in 1996 the amendment of the legal structure as the basis of its investment and by aggravating the Media Council's interference with the legal relationship between CET 21 and ČNTS by issuing an official regulator's letter which eliminated the exclusivity of the Service Agreement, an exclusivity that was the cornerstone of CME's legal protection for its investment. The destruction of CME's investment after the termination of the Service Agreement on August 5, 1999 was the consequence of the Media Council's actions and inactions. The legal disputes, proceedings and actions between CET 21, ČNTS and CME thereafter do not affect the qualification of these actions and omissions as breach of the Treaty.
576. The key question of these arbitration proceedings, whether the Council by coercion forced CME to give up its legal "safety net" in 1996, is to a

large extent answered by the Council's own interpretation of the sequence of events. In contrast to the Respondent's submission in these arbitration proceedings (according to which CME 1996 voluntarily agreed on the change of ČNTS' Memorandum of Association and on the implementation of the Service Agreement), the Media Council's own description of the events is probative. In the Report of the Council for the Czech Parliament of September 1999, the Council made it abundantly clear that the Council was successfully requiring CME to change the MOA by threatening it with administrative proceedings. In respect to the exclusivity of the use of the Licence, which was a cornerstone for the protection of the Claimant's investment in the Czech Republic, the Council reported to the Parliament as follows:

*"Each party has its own version of the heart of the issue based on a different interpretation of concluded agreements. CME insists on exclusivity and claims that CET 21 is obliged to broadcast exclusivity through ČNTS whereas CET 21 denies exclusivity and claims its right to conclude service agreements with any companies it pleases. As in the past, the Council's position in this matter is close to the opinion that an exclusive relationship between the licence-holder and a service company is not desirable as it gives an opportunity to manipulate with the licence. However, in this dispute the Council will not provide interpretation of relevant provisions of agreements concluded between the two parties of the dispute as it is not its authority from the nature of matters. The Council can only state that results of past administrative proceedings, when the Council made the licence-holder to remedy certain legal faults in the Memorandum of Association and to adhere to laws, are currently showing in this matter".*

577. This is a very modest description of the Regulator's pressure put on CME/ČNTS in order to change the legal basis for the co-operation between CET 21 and ČNTS, now describing this as *"the remedy of certain legal fault"* in the MOA which, in 1993, the Council (at that time composed of other Council members) had jointly developed and implemented in order to attract the investment and support of the foreign investor CEDC.
578. Also, the oral report of the Chairman of the Council, Mr. Josefík, at the meeting of the Standing Committee for Mass Media of the Parliament of September 30, 1999, as reported by the minutes of the meeting, explained the background for the Council's reversal of its legal position in

respect to the 1993 split structure, taking the ex-post-view that the 1993 structure was the illegal transfer of the licence to ČNTS:

*“The arrangement between the service organization and the operator was quite unclear from the very beginning, and the Council was criticized for insufficient control of whether, for example, the licence was being transferred from the licensed entity to the ČNTS company. In May 1994 the Council was recalled precisely because, in the opinion of the House of Representatives, it had accepted a situation in which the provisions of the Act on Broadcasting were constantly violated in the case of the operation of nation-wide broadcasting by a subject that was not authorized to perform such activity. Therefore it tolerated the illegal transfer of the licence to ČNTS.*

*Then came a period in which the Council, in its new composition, made a very intensive effort to achieve clear relationships between the service organization and the operating company which would be in compliance with the Act on Broadcasting. After an unsuccessful attempt to delete an activity entered in the Commercial Register for the ČNTS company, the Council initiated an administrative proceeding concerning violation of the Act on Broadcasting by this company’s unauthorized broadcasting. . . . [in the following Mr. Josefík dealt with the new Media Law of 1996.] ...however, it then proceeded with administrative proceedings concerning unauthorized broadcasting and terminated them only when the operator, CET 21, proved that the broadcasts were in compliance with the law. These changes were also reflected in the Memorandum of Association and the modification of relationships between CET and ČNTS”.*

579. The Respondent’s position in these arbitration proceedings, according to which the original 1993 split structure did not violate the Media Law, that (only) its implementation was unlawful and (further) that, in 1996, CME/ČNTS voluntarily agreed to change the MOA is unsustainable, in the light of the Media Council’s and its Chairman’s own reports to the parliament. The Media Council required CME to give up its legal protection for its investment and aggravated its so doing by interfering in conjunction with Dr. Železný into the contractual relationship between CET 21 and ČNTS in 1999. These acts caused the complete destruction of CME’s investment in the Czech Republic, ČNTS holding now idle assets without a business operation after Dr. Železný and his company CET 21 established new service providers for TV NOVA.

580. The Respondent further argued that no harm would have come to CME's investment without the actions of Dr. Železný; hence, the Media Council and the Czech State are absolved of responsibility for the fate of CME's investment. This argument fails under the accepted standards of international law. As the United Nations International Law Commission in its Commentary on State responsibility recognizes, a State may be held responsible for injury to an alien investor where it is not the sole cause of the injury; the State is not absolved because of the participation of other tortfeasors in the infliction of the injury (*Articles on the Responsibility of States for Internationally Wrongful Acts, adopted on second reading by the United Nations International Law Commission, 9 August 2001, Article 31, "Reparation", Commentary, paragraphs 9-10, 12-13*).

581. This approach is consistent with the way in which the liability of joint tortfeasors is generally dealt with in international law and State practice:

*"It is the very general rule that if a tortfeasor's behaviour is held to be a cause of the victim's harm, the tortfeasor is liable to pay for all of the harm so caused, notwithstanding that there was a concurrent cause of that harm and that another is responsible for that cause ... . In other words, the liability of a tortfeasor is not affected vis-à-vis the victim by the consideration that another is concurrently liable"* (J.A. Weir, "Complex Liabilities", in A. Tunc (ed.), *International Encyclopedia of Comparative Law*. (Tubingen, Mohr, 1983), vol. XI., p. 41).

582. The Media Council's actions in 1996 interfered with CME's investment by depriving ČNTS's broadcasting operations of their exclusive use of the broadcasting licence, which was contributed by CET 21 to ČNTS as a corporate contribution. This interference with ČNTS' business and the Media Council's actions and omissions in 1999 must be characterized similar to actions in tort. The Tribunal therefore is of the view that the above described principles apply in this case. CME as aggrieved Claimant may sue the Respondent in this arbitration and it may sue Dr. Železný in separate proceedings, if judicial protection is available under Czech or other national laws. In this arbitration the Claimant's claim is not reduced by the Claimant's and/or ČNTS's possible claims to be pursued against Dr. Železný in other courts or arbitration proceedings, although the Claimant may collect from the Respondent and any other

potential tortfeasor only the full amount of its damage. This question is not dealt with in this Partial Award, It could be decided when deciding on the quantum of the Claimant's claim or by national courts when dealing with the enforcement of an award or judgment, which adjudicates the recovery for the same damage.

583. The U.N. International Law Commission observed that sometimes several factors combine to cause damage. The Commission in its Commentary referred to various cases, in which the injury was effectively caused by a combination of factors, only one of which was to be ascribed to the responsible State. International practice and the decisions of international tribunals do not support the reduction or attenuation of reparation of concurrent causes, except in cases of contributory fault. The U.N. International Law Commission referred in particular to the *Corfu Channel case*, according to which the United Kingdom recovered the full amount of its claim against Albania based on the latter's wrongful failure to warn of mines at the Albanian Coast, even though Albania had not itself laid the mines (see *Corfu Channel, Assessment of the Amount of Compensation*, I.C.J. Reports 1949, p. 244 at p. 350). "*Such a result should follow a fortiori in cases, where the concurrent cause is not the act of another State (which might be held separately responsible) but of private individuals*", (UN International Law Commission as cited). The U.N. International Law Commission further stated:

*"It is true that cases can occur where an identifiable element of injury can properly be allocated to one of several concurrently operating causes alone. But unless some part of the injury can be shown to be severable in causal terms from that attributed to the responsible State, the latter is held responsible for all the consequences, not being too remote, of its wrongful conduct."*

584. Various terms are used for such allocation of injury under international law.

*"The allocation of injury or loss to a wrongful act is, in principle, a legal and not only a historical or causal process. Various terms are used to describe the link which must exist between the wrongful act and the injury in order for the obligation of reparation to arise. For example, reference may be made to losses "attributable [to the wrongful act] as a proximate cause", or to damage which is "too indirect, remote, and uncertain to be appraised."*

*"In some cases, the criterion of "directness" may be used, in others "foreseeability" or "proximity". But other factors may also be relevant: for example, whether State organs deliberately caused the harm in question or whether the harm caused was within the ambit of the rule which was breached, having regard to the purpose of that rule (see U.N. international Law Commission with further extensive citations).*

585. Pursuant to these standards, the allocation of injury or loss suffered by CME to the Media Council's acts and omissions is appropriate. The Media Council, when coercing ČNTS in 1996 to amend its MOA and to implement the Service Agreement must have understood the foreseeable consequences of its actions, depriving CME of the legal "safety net" for its investment in the Czech Republic. Also in 1999 the Media Council must have foreseen the consequences of supporting Dr. Železný, in dismantling the exclusiveness of ČNTS' services for CET 21 by the Council's regulatory letter of May 15, 1999, which supported Dr. Železný's actions "to harm ČNTS."

#### **(6) The Respondent breached the Treaty**

By the Media Council's actions and failures to act, the Respondent has violated its obligations towards the Claimant and its predecessors under the Treaty.

586. The Respondent's violation of the Treaty relates only to the Media Council's actions and omissions, although the Czech Parliament had substantial influence on the Media Council. For example *"In May 1994, the Council was recalled precisely because, in the opinion of the House of Representatives, it had accepted a situation, in which the provisions of the Act on Broadcasting were constantly violated in the case of the operation of nation-wide broadcasting by a subject that was not authorized to perform such activity" (minutes of the 6th meeting of the Standing Committee for Mass Media of September 30, 1999, page 9 of the translation).* Thereafter, the Council "in its new composition" reviewed the situation and took certain steps to reverse the relationship between the service company and the operating company.

587. Further, the Council was obligated to render regular reports to the Permanent Commission for the Media of the Lower House of the Parliament and further, was obligated to give special reports on certain issues such as *“the situation of the television station NOVA”* as requested by the Permanent Commission in its resolution of September 30, 1999.
588. Moreover, the Czech Parliament, by implementing the new Media Law in force as of January 1, 1996, strongly affected broadcasting licences already granted by the Media Council, in particular by allowing the licence-holder to request the waiver of licence conditions. This amendment of the Media Law had substantial influence on the 1993 split structure as developed by the Media Council for CET 21/ČNTS and other broadcasters to secure the proper co-operation of the licence-holder and the service provider. By this amendment of the Media Law, the Media Council lost its tool to monitor and supervise this co-operation. It remained a broadcasting regulator responsible for the fulfilment of the legal requirements and duties under the Media Law, whereas the service provider, providing the broadcasting operation, as a consequence of the new Media Law, escaped the Council’s survey and control.
589. It transpires from the documents submitted to the Arbitral Tribunal in these proceedings that the Media Council clearly understood and deplored this development. However it is also clear that the Czech Parliament has the authority to organize national broadcasting in any way it feels suitable, subject to any relevant international obligations of the Czech State. The acts of the Czech Government, the Czech Parliament or its Commissions are not under scrutiny by the Arbitral Tribunal in these proceedings.
590. The Czech State acted towards the Claimant and its predecessors as investors under the Treaty solely by acts of the regulator, the Media Council. It is not the task of the Arbitral Tribunal to judge whether these acts were in compliance with Czech law and regulations. The only task for this Tribunal is to judge whether the actions and omissions of the Media Council were in compliance with the Treaty. The Tribunal’s considered conclusion is that the actions and failures to act of the Media Council as described above, affecting CME and ČNTS, were in breach of the Treaty.



**(i) The obligation not to deprive the Claimant of its investment  
(Treaty Article 5)**

591. The Claimant's expropriation claim under Article 5 of the Treaty is justified. The Respondent, represented by the Media Council, breached its obligation not to deprive the Claimant of its investment. The Media Council's actions and omissions, as described above, caused the destruction of ČNTS' operations, leaving ČNTS as a company with assets, but without business. The Respondent's view that the Media Council's actions did not deprive the Claimant of its worth, as there has been no physical taking of the property by the State or because the original Licence granted to CET 21 always has been held by the original Licensee and kept untouched, is irrelevant. What was touched and indeed destroyed was the Claimant's and its predecessor's investment as protected by the Treaty. What was destroyed was the commercial value of the investment in ČNTS by reason of coercion exerted by the Media Council against ČNTS in 1996 and its collusion with Dr. Železný in 1999.
592. The reversal of the Media Council's position in respect to CME's investment (after Council members were replaced by the Czech Parliament in response to criticism of the Licence granted to CET 21 in conjunction with the foreign investment in ČNTS) might have been motivated by the new Media Law as of January 1, 1996. However, this does not justify the Council's new interpretation of the legal situation or other regulatory necessities seen by the Council in 1996 and there is no justification for the Council's actions in 1996, enforcing the amendment of 1993 arrangements.
593. The Respondent's defence that this interference in 1996 did not do any harm, as *"the Czech Court determined that, as a matter of law as well as a matter of fact, ČNTS had the exclusive right to provide certain television services to CET 21 before ČNTS took the step that terminated the 1997 Service Agreement and that step, of course, was the withholding of the daily programme log on the 4th August 1999"*, is not convincing. In particular, the Defendant's view: *"That step plainly had nothing whatever to do with the Czech Authorities"*, is unsustainable. The amendment of the MOA by replacing the licence-holder's contribution of the Licence by

the worthless “use of the know-how of the Licence” is nothing else than the destruction of the legal basis (“the safety net”) of the Claimant’s investment. This destruction was clearly caused by the Czech State, acting through the Media Council.

594. The Respondent’s claim that the Media Council has never reversed its attitude to exclusivity, as it accepted exclusivity in 1993, but also accepted exclusivity in the amended provisions in 1996, is not supported by the clear wording of the documents. The contrary is the case, as already explained above. The Respondent’s contention that the Media Council consistently tried to make clear that it was not concerned by the question of exclusivity but by the question of the danger that an exclusive arrangement may lead to an unlawful transfer of the Licence, is not convincing. The clear facts speak against it. The Council, according to its own interpretations in its reports to the Czech Parliament, reversed its assessment of the legal situation in respect to the validity of the 1993 split ‘structure and took the necessary steps to implement this view by coercing the change in the 1993 legal arrangements.
595. The Respondent’s further argument that the Council, in its internal deliberations, never discussed the matter of exclusivity until recently, might well be the case. Indeed, the Council’s interference in 1996, enforcing the amendment of the MOA, was much more far reaching. The Council forced the shareholders of ČNTS to replace CET 21’s contribution of “use of the Licence” by a worthless substitute, carrying a similar name. The amendment was extracted from ČNTS by the institution of administrative proceedings which sprung from the Media Council’s own assessment of the events. As already dealt with above, the Respondent’s argument that the 1993 arrangement was not better than the 1996 amended arrangement is not convincing.
596. The Respondent’s further argument, also already rebutted above, that the 1993 legal arrangements did not prevent CET 21 from obtaining broadcasting services from other providers, goes against the exclusivity of the 1993 arrangement in the MOA.
597. The Respondent’s further argument, according to which the efficacy of the 1993 arrangement has never been tested, is also not convincing.

The Czech Civil Courts tested the arrangements. The Czech Appeal Court's view that ČNTS' refusal to deliver the 4th August daily log gave good cause for CET 21 to terminate the Service Agreement is a clear proof of the fragile character of the (coerced) 1996 amendment. Since 1996, the legal safety net for the investment was based on the fragile structure of a Service Agreement which could be terminated by CET 21 under any given or invented reason, creating by this an intolerable uncertainty for a long-term investment.

598. In this respect, it would be superfluous to say that the contribution of "the use of a Licence" (approved by the regulator) provided substantially more legal safety for ČNTS than the bilateral Service Agreement whose legal uncertainty is demonstrated by the sequence of the following events and the differing court decisions on this subject by the Regional Commercial Court of Prague, the Appellate Court of Prague and the Czech Appeal Court's decision pending when the hearing of these arbitration proceedings were closed.
599. The Respondent's argument that no loss occurred in 1996 and 1997 as a direct consequence of the legal changes in 1996 and that CME was in the position to equally enjoy its investment after the implementation of the 1996 arrangements, is not convincing. Legal protection (and safety nets, as the Respondents representatives said) prove their strength not at the day of implementation but at the day of breach. The enforced or coerced waiver of legal protection was per se a substantial devaluation of the Claimant's investment. The persons involved, including the representatives of the Media Council, CET 21 and ČNTS and also ČNTS' shareholders, clearly understood the character and the impact of the enforced changes on the protection of ČNTS' operations as exclusive service provider for CET 21. The Media Council deprived the Claimant of its investment's security by requiring CME in 1996 to enter into a new MOA and thereby giving up the exclusive right to use the Licence and further, in 1999, by actively supporting the licence-holder CET 21, when it breached the exclusive Service Agreement with ČNTS.
600. The Council, after having issued on March 15, 1999 a regulatory letter to ČNTS and CET 21 requesting the implementation of the non-exclusive service arrangement in support of Dr. Železný's openly disclosed inten-

tion to harm the foreign investor, was obligated to rectify the situation. In the least, the Council should have withdrawn the March 15, 1999 letter and made clear that the 1996 contractual relations were not in breach of the Media Law. However the Media Council, although frequently notified by ČNTS and CME of the consequences of its actions and failures to act, remained silent or disclaimed jurisdiction and so supported the vitiation of the Claimant's investment.

601. The basic breach by the Council of the Respondent's obligation not to deprive the Claimant of its investment was the coerced amendment of the MOA in 1996. The Council's actions and omissions in 1999 compounded and completed the Council's part in the destruction of CME's investment.
602. The Media Council, by its actions and omissions in 1996 and 1999, caused the damage suffered by the Claimant. Causation arises because the Media Council intentionally required ČNTS to give up the right of the exclusive use of the Licence under the MOA. The Media Council's possible motivation for such action -- to obtain regulatory control again over the broadcasting operation of CET 21 after the new Media Law came into force in 1996 -- is irrelevant. A change of the legal environment does not authorize a host State to deprive a foreign investor of its investment, unless proper compensation is granted. This was and is not the case. Furthermore, it must be noted that the change of the 1993 legal arrangement in 1996 as required by the Media Council, for whatever reasons, does not justify the Council's collaboration in the assault on CME's investment by supporting CET 21's breach of the Service Agreement in 1999. The Respondent, therefore, is obligated to remedy the damages which occurred as a consequence of the destruction of Claimant's investment.
603. Of course, deprivation of property and/or rights must be distinguished from ordinary measures of the State and its agencies in proper execution of the law. Regulatory measures are common in all types of legal and economic systems in order to avoid use of private property contrary to the general welfare of the (host) State. The Council's actions and inactions, however, cannot be characterized as normal broadcasting regulator's regulations in compliance with and in execution of the law, in par-

ticular the Media Law. Neither the Council's actions in 1996 nor the Council's interference in 1999 were part of proper administrative proceedings. They must be characterized as actions designed to force the foreign investor to contractually agree to the elimination of basic rights for the protection of its investment (in 1996) and as actions (in 1999) supporting the foreign investor's contractual partner in destroying the legal basis for the foreign investor's business in the Czech Republic. The actions and inactions affected the value of CME's shares in ČNTS, such shares being clearly a "foreign investment" in accordance with the Treaty, as already dealt with above (see also the TRADEX case as cited above).

604. The expropriation claim is sustained despite the fact that the Media Council did not expropriate CME by express measures of expropriation. De facto expropriations or indirect expropriations, i.e. measures that do not involve an overt taking but that effectively neutralize the benefit of the property of the foreign owner, are subject to expropriation claims. This is undisputed under international law (G. Sacerdoti page 382 as cited above, referring to numerous precedents such as the German Interests In Polish Upper Silesia case, 1926, PCIJ, Series A, No. 7, reprinted in M. Hudson, ed., I World Court Reports 475 (1934); see also Southern Pacific Properties (Middle East) Ltd. v. Egypt, ICSID Case No. ARB/84/3 (1992), 32 I.L.M. 993, 1993, dealing also with the expropriation of contractual rights of the operating company).
605. Furthermore, it makes no difference whether the deprivation was caused by actions or by inactions. [See Biloune, et al. v. Ghana Investment Centre, et al. 95 I.L.R. 183, 207-10 (1993); also published in the Yearbook Commercial Arbitration XIX (1994, page 11) and see also the International Technical Products Corp. v. Iran Award No. 196-302-2 (1985), 9 Iran-US CTR Rep. 273, page 239].
606. In the Metalclad Corporation v. United Mexican States case (ICSID Case No. ARB (AF)/97/1 (2000) in respect to NAFTA Article 1110 (expropriation), the ICSID Tribunal stated that an expropriation under this provision included not only open, deliberate and acknowledged takings of property, such as outright seizure or formal or obligatory transfer of title in favour of the host State, but also covert or incidental interference with use

of property which has the effect of depriving the owner, in whole or in significant part, of the use or reasonably to be expected economic benefit of property even if not necessarily to the obvious benefit of the host State. Thus, by permitting or tolerating the conduct of the municipality, which the tribunal had held amounted to an unfair and inequitable treatment that breached Article 1105, and by participating or acquiescing in the denial to the investor of the right to operate, notwithstanding the fact that the project had been fully approved and endorsed by the federal Government, the State Party must in the tribunal's opinion have taken a measure tantamount to expropriation in violation of Article 1110 (1). This view of the ICSID Tribunal is supported by the Biloune award as cited above.

607. Expropriation of CME's investment is found as a consequence of the Media Council's actions and inactions as there is no immediate prospect at hand that ČNTS will be reinstated in a position to enjoy an exclusive use of the licence as had been granted under the 1993 split structure (even if the Czech Supreme Court would re-instate the Regional Commercial Court decision). There is no immediate prospect at hand that ČNTS can resume its broadcasting operations, as they were in 1996 before the legal protection of the use of the licence was eliminated.
608. In this respect, the Iran-United States Claims Tribunal stated:

*“A deprivation or taking of property may occur under international law through interference by a State in the use of that property or with the enjoyment of its benefits, even where legal title to the property is not affected. [Citations omitted.] While assumption of control over property by a government does not automatically and immediately justify a conclusion that the property has been taken by the government, thus requiring compensation under international law, such a conclusion is warranted whenever events demonstrate that the owner was deprived of fundamental rights of ownership and it appears that this deprivation is not merely ephemeral. The intent of the government is less important than the effects of the measures on the owner, and the form of the measures of control or interference is less important than the reality of their impact.”*

(see Tippetts, Abbett, McCarthy, Stratton v. TAMS/Affa Consulting Engineers of Iran et al. of 29.06.1984; 6 Iran-United States CTR, 219 et seq. page 225 as confirmed by Phelps Dodge Corp. et al v. 2. Iran, Award

No. 217-99-2 (1986), reprinted in 10 Iran - U.S. Cl. Trib. Rep. 121 (1987); see also *Sea-Land Service, Inc. v. Iran*, 6 Iran-United States C.T.R. 149 at 166):

*"A finding of expropriation would require, at the very least, that the Tribunal be satisfied that there was deliberate governmental interference with the conduct of Sea-Land's operation, the effect of which was to deprive Sea-Land of the use and benefit of its investment."*

609. In the case before this Tribunal, the situation is even clearer. The object of the Media Council in 1996 was to amend the 1993 split structure by removing the exclusive use of the licence from ČNTS to CET 21, the only company which under the new Media Law in force as of January 1, 1996 was under control of the Council. This deprivation of ČNTS' "exclusive use of the Licence" was compounded by the Media Council's actions and inactions of 1999. This qualifies the Media Council's actions in 1996 and actions and inactions in 1999 as expropriation under the Treaty.

**(ii) The remaining claims**

610. The remaining claims are based on the same facts as the expropriation claim.

**a) The obligation of fair and equitable treatment (Article 3 (1) of the Treaty)**

611. The Media Council's intentional undermining of the Claimant's investment in ČNTS equally is a breach of the obligation of fair and equitable treatment. The Respondent's position that the Media Council also required other broadcasters in the same way to revise the structure of the 1993 split legal arrangements between licence-holder and service provider is irrelevant. The facts and circumstances of the legal arrangements of the other broadcasters were not a subject of these arbitration proceedings. Should the Media Council have interfered with the contractual relations of other broadcasters in the same way as it did between CET 21 and ČNTS, these other actions might also be qualified as a breach of law as the case may be. These other cases, however, to the

extent that they are realistic, do not legitimate the Media Council's actions and inactions versus CME/ČNTS as being fair and equitable. The standard for actions being assessed as fair and equitable are not to be determined by the acting authority in accordance with the standard used for its own nationals. Standards acceptable under international law apply, e.g. the threshold test of Professor Vagts as cited above. The Media Council breached its obligation of fair and equitable treatment by evisceration of the arrangements in reliance upon with the foreign investor was induced to invest.

**b) The obligation not to impair investments by unreasonable or discriminatory measures (Article 3 (1) of the Treaty)**

612. The same considerations set out under the expropriation claim govern the claim for unfair and inequitable treatment as well. On the face of it, the Media Council's actions and inactions in 1996 and 1999 were unreasonable as the clear intention of the 1996 actions was to deprive the foreign investor of the exclusive use of the Licence under the MOA and the clear intention of the 1999 actions and inactions was collude with the foreign investor's Czech business partner to deprive the foreign investor of its investment. The behaviour of the Media Council also smacks of discrimination against the foreign investor.

**c) The obligation of full security and protection (Article 3 (2) of the Treaty)**

613. The Media Council's actions in 1996 and its actions and inactions in 1999 were targeted to remove the security and legal protection of the Claimant's investment in the Czech Republic. The Media Council's (possible) motivation to regain control of the operation of the broadcasting after the Media Law had been amended as of January 1, 1996 is irrelevant. The host State is obligated to ensure that neither by amendment of its laws nor by actions of its administrative bodies is the agreed and approved security and protection of the foreign investor's investment with-



drawn or devalued. This is not the case. The Respondent therefore is in breach of this obligation.

**d) The obligation to treat investments in conformity with principles of international law (Articles 3(5) and 8 of the Treaty)**

614. The Media Council's actions as described above are not compatible with the principles of international law, which the Arbitral Tribunal is charged with applying. On the contrary, the intentional undermining of the Claimant's investment's protection, the expropriation of the value of that investment, its unfair and inequitable treatment, the Media Council's unreasonable actions, the destruction of the Claimant's investment security and protection, are together a violation of the principles of international law assuring the alien and his investment treatment that does not fall below the standards of customary international law.

**(7) The Reparation Claim**

615. The Respondent, as a consequence of the breach of the Treaty, is under an obligation to make full reparation for the injury caused by the Media Council's wrongful acts and omissions as described above. A causal link between the Media Council's wrongful acts and omissions and the injury the Claimant suffered as a result thereof, is established, as already stated above. The Respondent's obligation to remedy the injury the Claimant suffered as a result of Respondent's violations of the Treaty derives from Article 5 of the Treaty and from the rules of international law. According to Article 5 subpara. c of the Treaty, any measures depriving directly or indirectly an investor of its investments must be accompanied *"by a provision for the payment of just compensation. Such compensation shall represent the genuine value of the investments effected."* A fortiori unlawful measures of deprivation must be remedied by just compensation.

616. In respect to the Claimant's remaining claims, this principle derives also from the generally accepted rules of international law. The obligation to

make full reparation is the general obligation of the responsible State consequent upon the commission of an internationally wrongful act (see the Commentary to the Articles on the Responsibility of States for Internationally Wrongful Acts adopted by the U.N. International Law Commission as cited above). The general principle of the consequences of the commission of an internationally wrongful act was stated by the Permanent Court in the Factory at Chorzów case:

*“It is a principle of international law that the breach of an engagement involves an obligation to make reparation in an adequate form. Reparation therefore is the indispensable complement of a failure to apply a convention itself. Differences relating to reparations, which may be due by reason of failure to apply a convention, are consequently differences relating to its application.”* (Factory at Chorzów, Jurisdiction, 1927, P.C.I.J., Series A, No. 9, para. 21).”

617. In a subsequent decision the Permanent Court in the Factory at Chorzów case went on to specify in more detail the content of the obligation of reparation. It said:

*“The essential principle contained in the actual notion of an illegal act - a principle which seems to be established by international practice and in particular by the decisions of arbitral tribunals - is that reparation must, so far as possible, wipe out all the consequences of the illegal act and re-establish the situation which would, in all probability, have existed if that act had not been committed. Restitution in kind, or, if this is not possible, payment of a sum corresponding to the value which a restitution in kind would bear; the award, if need be, of damages for loss sustained which would not be covered by restitution in kind or payment in place of it - such are the principles which should serve to determine the amount of compensation due for an act contrary to international law.”* (Factory at Chorzów, Merits, 1928, P.C.I.J., Series A, No. 17, para. 47).

618. This view has been accepted and applied by numerous arbitral awards (Commentary of the Articles on the Responsibility of States for Internationally Wrongful Acts with further citations). The Respondent is obligated to “wipe out all the consequences” of the Media Council’s unlawful acts and omissions, which caused the destruction of the Claimant’s investment. Restitution in kind is not requested by the Claimant (as restitution in kind is obviously not possible, ČNTS’ broadcasting operations having been shut down for two years). Therefore, the Respondent is obligated

to compensate the Claimant by payment of a sum corresponding to the value which a restitution in kind would bear. This is the fair market value of Claimant's investment as it was before consummation of the Respondent's breach of the Treaty in August 1999. In accordance with the parties joint request, the quantum of the Claimant's claim shall not be determined by this Award. Therefore, on request of the Claimant, the amount of the Claimant's claim is to be determined in a second phase of this arbitration.

### **III. Costs of the proceedings**

619. The parties instructed the Arbitral Tribunal to render an Award, if affirmative in respect to the Claimant's claims, that does not decide on the quantum of the claims. The parties further requested the Arbitral Tribunal to adopt a decision in respect to the costs of the proceedings incurred by the rendering this Partial Award. The Arbitral Tribunal, however, cannot, at this stage, judge to what extent the Claimant will be successful in respect of the quantum of its damage claims although the decision on the quantum would provide a better basis for the allocation of costs. In respect to costs, the Tribunal, therefore, makes an assessment on the basis of the present status of the proceedings without by this assessment pre-judging the quantum of damages, and on the basis as well of Article 40, paragraph 1 of the UNCITRAL Rules, which says that "the arbitral tribunal may apportion each of such costs between the parties, if it determines that apportionment is reasonable, taking into account the circumstances of the case."
620. In assessing what costs of the Claimant to be refunded by the Respondent are acceptable and reasonably incurred, the Tribunal further considered inter alia that the Claimant initiated these arbitration proceedings after having initiated and partly carried through the *Lauder vs/ The Czech Republic* UNCITRAL Arbitration Proceedings which, in essence, deal with the same dispute. The parties used, as the Tribunal was informed, the work product of their advisors and the witness statements of these parallel UNCITRAL Arbitration Proceedings. The Respondent expressly stated in its Statement of Costs that the Respondent was able to use to a large extent the pleadings and witness statements originally

drafted for the use by the Respondent in the Lauder vs. Czech Republic UNCITRAL Arbitration.

621. The Arbitral Tribunal took account of this situation and also the fact that the Claimant and its ultimate shareholder, by initiating two parallel UNCITRAL Treaty Proceedings had, as the Claimant expressed it, "*two bites of the apple*", and thereby enlarged costs and risks. It is, therefore, reasonable to decide that the Respondent, although this Partial Award is wholly unfavourable to it, shall be required to refund to Claimant only a portion of the Claimant's legal fees and disbursements, which portion is determined by the Arbitral Tribunal being US \$ 750,000.
622. For the Tribunal's costs and disbursements the Tribunal charged the parties in the total amount of US \$ 1,096,498.86 for the Tribunal's services and as compensation for the Tribunal's expenses for the period until the rendering of this Partial Award. The Claimant made an advance of costs in the amount of US \$623,249.43 and the Respondent an advance of US \$400,000, all together US \$ 1,023,249.43. By letter dated August 28, 2001, the Respondent informed the Tribunal that the payment of the final advance of costs in the amount of US \$ 73,249.43 to the Tribunal as requested by the Tribunal on August 15, 2001, will be made. The Tribunal, therefore, by letter dated August 30, 2001, withdraw its instruction to the Claimant dated August 30, 2001 to pay this amount. The Tribunal dealt with the respective payment in this Partial Award as if it has been made. The Tribunal may render a further partial award on costs, should such payment fail.
623. In respect to the allocation of these costs to the parties the Arbitral Tribunal took account of the above-mentioned facts and circumstances and allocated these costs as decided below.

**J.**  
**Decision**

624. The Tribunal decides as follows:

1. The Respondent has violated the following provisions of the Treaty:
  - a. The obligation of fair and equitable treatment (Article 3 (1));
  - b. the obligation not to impair investments by unreasonable or discriminatory measures (Article 3 (1));
  - c. the obligation of full security and protection (Article 3 (2));
  - d. the obligation to treat foreign investments in conformity with principles of international law (Article 3 (5) and Article 8 (6), and
  - e. the obligation not to deprive Claimant of its investment (Article 5); and
2. The Respondent is obligated to remedy the injury that Claimant suffered as a result of Respondent's violations of the Treaty by payment of the fair market value of Claimant's investment as it was before consummation of the Respondent's breach of Treaty in 1999 in an amount to be determined at a second phase of this arbitration;
3.
  - (1) The Respondent shall bear its own legal costs.
  - (2) The Respondent shall pay to Claimant as refund of Claimant's legal costs and expenditures US \$750,000.
  - (3) The Claimant shall bear one third and the Respondent two thirds of the Arbitral Tribunal's costs and expenditures. The Respondent, therefore, shall further pay to the Claimant as refund of Claimant's payments of the Tribunal's fees and disbursements US \$257,749.81.

4. This Partial Award is final and binding in respect to the issues decided herein. The legal seat of the proceedings is Stockholm, Sweden.

The Tribunal will continue the arbitration proceedings in order to decide on the quantum of the Claimant's claim upon request of one of the Parties.

**K. Statement in accordance with Article 32 (4) UNCITRAL Arbitration Rules related to Dr. Hándl's failure to sign the Partial Award**

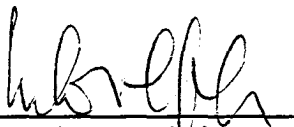
625. By letter dated September 11, 2001, Dr. Hándl requested the Chairman to attach to the Award (whose issuance he delayed) an explanation of his failure to sign the Award, as well as a dissenting opinion. Dr. Hándl refused to sign the Award with the following remark:

*"Partial Award not signed by Dr. Hándl as expression of his protest and dissenting from this Award - dissenting opinion enclosed, date: 11.9.2001, signature Dr. Hándl"*

The Chairman of the Tribunal, on his behalf and that of Judge Schwebel, pointed out to Dr. Hándl that his failure to sign would be in breach of his obligations as arbitrator. In the event, it is also a breach of his repeated recent assurances to the Chairman, in writing, that he "will sign" the Award.

The UNCITRAL Rules that govern this arbitration provide, in Article 32 (4), that: *"An award shall be signed by the arbitrators . . ."* (emphasis supplied). The Tribunal is confirmed in the conclusion that an arbitrator's failure to sign the award is a violation of the arbitrator's professional responsibilities by its examination of the rules and practice of the principal arbitral institutions as well as the papers and proceedings of the Stockholm and Paris Congresses of the International Council on Commercial Arbitration. Dr. Hándl's failure to perform his responsibilities as arbitrator is matched by the intemperance and inaccuracy of his dissent. He makes charges about the conduct of the hearings and the deliberations that are groundless. His position on the merits of the dispute speaks for itself.

Stockholm, 13 September 2001



(Dr. Wolfgang Kühn)  
Chairman of the  
Arbitral Tribunal)



(Judge Stephen M. Schwebel)  
Arbitrator

(JUDr. Jaroslav Hándl)  
Arbitrator

## **LEGAL AUTHORITY CA-104**

388 F.Supp.3d 1133

United States District Court, N.D. California.

ALTERG, INC., Plaintiff,

v.

BOOST TREADMILLS LLC, et al., Defendants.

Case No. 18-cv-07568-EMC

Signed 05/20/2019

**Synopsis**

**Background:** Provider of impact reduction treadmills brought action against three former employees and competing company they founded, asserting patent infringement, breach of contract, trade secret misappropriation, breach of fiduciary duty, interference with contract, interference with prospective economic advantage, false advertisement, trade libel, unfair competition, and conspiracy. Defendants moved to dismiss for failure to state a claim.

**Holdings:** The District Court, [Edward M. Chen, J.](#), held that:

- [1] provider failed to state direct patent infringement claim;
- [2] provider failed to state claim for misappropriation of trade secrets;
- [3] provider failed to state breach of contract claim under California law;
- [4] provider failed to state breach of fiduciary duty claim under California law;
- [5] provider failed to state claim for intentional interference with contractual relations under California law;
- [6] provider failed to state a claim for interference of prospective economic advantage under California law; and
- [7] provider failed to satisfy heightened pleading standards for fraud, in Lanham Act false advertising claim.

Motion granted.

**Procedural Posture(s):** Motion to Dismiss for Failure to State a Claim.

West Headnotes (54)

[1] **Federal Civil Procedure**  **Insufficiency in general**

To survive a motion to dismiss for failure to state a claim, factual allegations must suggest that the claim has at least a plausible chance of success. [Fed. R. Civ. P. 12\(b\)\(6\)](#).

[2] **Federal Civil Procedure**  **Insufficiency in general**


To survive a motion to dismiss for failure to state a claim, the complaint must allege factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged. [Fed. R. Civ. P. 12\(b\)\(6\)](#).

[3] **Federal Civil Procedure**  **Insufficiency in general**

The “plausibility” standard for motion to dismiss for failure to state a claim is not akin to a “probability” requirement, but it asks for more than a sheer possibility that a defendant has acted unlawfully. [Fed. R. Civ. P. 12\(b\)\(6\)](#).

[4] **Federal Civil Procedure**  **Insufficiency in general**

In deciding a motion to dismiss for failure to state a claim, where a complaint pleads facts that are merely consistent with a defendant's liability, it stops short of the line between possibility and plausibility of entitlement to relief. [Fed. R. Civ. P. 12\(b\)\(6\)](#).

[5] **Federal Civil Procedure**  **Matters deemed admitted; acceptance as true of allegations in complaint**

On a motion to dismiss for failure to state a claim, to be entitled to the presumption of truth,



allegations in a complaint or counterclaim may not simply recite the elements of a cause of action, but must contain sufficient allegations of underlying facts to give fair notice and to enable the opposing party to defend itself effectively. Fed. R. Civ. P. 12(b)(6).

[6] **Federal Civil Procedure** ➡ Insufficiency in general

On a motion to dismiss for failure to state a claim, the factual allegations that are taken as true must plausibly suggest an entitlement to relief, such that it is not unfair to require the opposing party to be subjected to the expense of discovery and continued litigation. Fed. R. Civ. P. 12(b)(6).

[7] **Patents** ➡ Complaint or Other Initial Pleading

Pleading requirements for allegations of direct patent infringement are not satisfied by Form 18 of the Appendix of Forms to the Federal Rules of Civil Procedure, governing complaints for patent infringement; rather, sufficiency of claims for direct infringement are assessed under *Twombly* and *Iqbal* pleading standard. Fed. R. Civ. P. App., Form 18.

[8] **Patents** ➡ Infringement and Injury, Loss, or Damage

A direct patent infringement claim does not satisfy the standards of *Twombly* and *Iqbal* where it does not at least contain factual allegations that the accused product practices every element of at least one exemplary claim.

[9] **Patents** ➡ In general; comparison with patent claims

Failure to meet a single limitation is sufficient to negate infringement of a patent claim.

[10] **Patents** ➡ Infringement and Injury, Loss, or Damage

Allegations by provider of impact reduction treadmills that former employees and their business developed a competing machine, without addressing necessary elements of patent claims, failed to state direct infringement claim.

[11] **Patents** ➡ Indirect Infringement

Liability for indirect infringement of a patent requires direct infringement.

[12] **Patents** ➡ Enhanced or punitive damages

A finding of direct infringement of a patent is a prerequisite for willful infringement of kind warranting enhanced damages. 35 U.S.C.A. § 284.

[13] **Antitrust and Trade Regulation** ➡ Elements of misappropriation

To state a claim for trade secret misappropriation under Defend Trade Secrets Act (DTSA), a plaintiff must allege that (1) the plaintiff owned a trade secret; (2) the defendant misappropriated the trade secret; and (3) the defendant's actions damaged the plaintiff. 18 U.S.C.A. § 1839(5).

4 Cases that cite this headnote

[14] **Antitrust and Trade Regulation** ➡ Pleading

A plaintiff need not spell out the details of the trade secret to state a claim for trade secret misappropriation under Defend Trade Secrets Act (DTSA), but must describe the subject matter of the trade secret with sufficient particularity to separate it from matters of general knowledge in the trade or of special persons who are skilled in the trade, and to permit the defendant to ascertain at least the boundaries within which the secret lies. 18 U.S.C.A. § 1839(5).

2 Cases that cite this headnote

[15] **Antitrust and Trade Regulation** ➡ Pleading

Allegations by provider of impact reduction treadmills regarding broad categories of

information, including “positive and negative learnings” and “technology and negative information and learnings,” failed to allege trade secrets with sufficient particularity, as required to state claim against former employees and their competing business for misappropriation of trade secrets under Defend Trade Secrets Act (DTSA). 18 U.S.C.A. § 1839(5).

[1 Cases that cite this headnote](#)

**[16] Antitrust and Trade Regulation** ➡ **Actions**

Continued use of a trade secret after the effective date of Defend Trade Secrets Act (DTSA) is actionable, even if the secret was initially disclosed prior to effective date of DTSA. 18 U.S.C.A. § 1839(5).

[1 Cases that cite this headnote](#)

**[17] Contracts** ➡ **Grounds of action**

The elements of a breach of contract claim under California law are: (1) the existence of a contract, (2) performance or excuse for nonperformance, (3) defendant's breach, and (4) damages.

[2 Cases that cite this headnote](#)

**[18] Contracts** ➡ **Pleading contract or specifications**

Under California law, a complaint for breach of contract must include the contract itself or plead its essential terms.

**[19] Contracts** ➡ **Pleading contract or specifications**

Allegations by provider of impact reduction treadmills regarding broad categories of information covered by confidentiality agreements, without pleading essential terms of relevant contract and the trade secrets they protected, failed to state breach of contract claim under California law against former employees who founded competing business.

**[20] Damages** ➡ **Breach of contract**

Under California law, non-speculative lost sales or profits can constitute contractual damages.

**[21] Damages** ➡ **Loss of profits**

Under California law, allegations of “lost sales or profits” caused by a competitor's contractual breach are sufficient to establish damages at the pleadings stage.

**[22] Fraud** ➡ **Fiduciary or confidential relations**

To state a claim for breach of fiduciary duty under California law, a plaintiff must allege (1) the existence of a fiduciary duty; (2) breach of the fiduciary duty; and (3) damage proximately caused by the breach.

**[23] Corporations and Business Organizations** ➡ **Resignation**

**Corporations and Business Organizations** ➡ **Fiduciary nature of relation**

Under California law, as a general matter, an officer's fiduciary duty to his employer ends upon his resignation.

**[24] Corporations and Business Organizations** ➡ **Fiduciary Duties as to Management of Corporate Affairs in General**

Under California law, officers are charged with a continuing duty to protect privileged and confidential information, which continues even after they leave the company.

**[25] Fraud** ➡ **Allegations of fraud in general**

Allegations by provider of impact reduction treadmills that former employee used its proprietary and confidential information to benefit competing business, without pleading essential terms of confidentiality agreements and the trade secrets they protected, failed to state

breach of fiduciary duty claim under California law against former employee.

**[26]** **Torts** 🔑 **Contracts**

The elements of cause of action for intentional interference with contractual relations under California law are (1) a valid contract between plaintiff and a third party; (2) defendant's knowledge of this contract; (3) defendant's intentional acts designed to induce a breach or disruption of the contractual relationship; (4) actual breach or disruption of the contractual relationship; and (5) resulting damage.

[2 Cases that cite this headnote](#)

**[27]** **Torts** 🔑 **Contracts in general**

Allegations by provider of impact reduction treadmills that former employees and their competing business worked with one of provider's longtime suppliers of treadmills to develop a competing machine failed to state claim for intentional interference with contractual relations under California law based on supplier's confidentiality agreements with provider, absent allegations that former employees and their business induced or caused supplier to disclose provider's confidential information to them.

**[28]** **Torts** 🔑 **Pleading**

Allegations by provider of impact reduction treadmills that former employees and their competing business interfered with contracts between provider and its vendors, suppliers, and customers, without identifying any of those vendors, suppliers, and customers, or providing any details about the contracts and contractual provisions with which former employees and their business allegedly interfered, failed to state claim for intentional interference with contractual relations under California law.

**[29]** **Torts** 🔑 **Pleading**

Allegations by provider of impact reduction treadmills that former employees interfered with each other's confidentiality agreements with provider when they founded competing business and developed another treadmill machine, absent allegations regarding the essential terms of the confidentiality agreements, failed to state claim for intentional interference with contractual relations under California law.

**[30]** **Torts** 🔑 **Prospective advantage, contract or relations; expectancy**

The elements of a claim for intentional interference with prospective economic advantage under California law are (1) an economic relationship between the plaintiff and some third person containing the probability of future economic benefit to the plaintiff; (2) knowledge by the defendant of the existence of the relationship; (3) intentional acts on the part of the defendant designed to disrupt the relationship; (4) actual disruption of the relationship; and (5) damages to the plaintiff proximately caused by the acts of the defendant.

[4 Cases that cite this headnote](#)

**[31]** **Torts** 🔑 **Defense, justification or privilege in general**

Under California law, the chief practical distinction between interference with contract and interference with prospective economic advantage is that a broader range of privilege to interfere is recognized when the relationship or economic advantage interfered with is only prospective.

[2 Cases that cite this headnote](#)

**[32]** **Torts** 🔑 **Existence of valid or identifiable contract, relationship or expectancy**

**Torts** 🔑 **Business relations or economic advantage, in general**

In context of claim for intentional interference with prospective economic advantage, California law precludes recovery for overly speculative expectancies by initially requiring proof that

it is reasonably probable that the prospective economic advantage would have been realized but for defendant's interference.

[2 Cases that cite this headnote](#)

**[33] Torts** 🔑 [Business relations or economic advantage, in general](#)

Allegations by provider of impact reduction treadmills that former employees and their competing business worked with one of provider's longtime suppliers of treadmills to develop a competing machine, absent allegations how former employees' and their business's actions jeopardized the ongoing supplier relationship between supplier and provider, failed to state a claim for interference of prospective economic advantage under California law.

**[34] Torts** 🔑 [Pleading](#)

Allegations by provider of impact reduction treadmills that former employees and their competing business interfered with provider's relationships with its vendors, suppliers, and customers, absent factual allegations of their economic relationship with provider or how such relationships contained the probability of future economic benefit to provider, failed to state a claim for interference of prospective economic advantage under California law.

[1 Cases that cite this headnote](#)

**[35] Antitrust and Trade Regulation** 🔑 [Advertising, Marketing, and Promotion](#)

A false advertising claim under the Lanham Act has five elements: (1) a false statement of fact by the defendant in a commercial advertisement about its own or another's product, (2) the statement actually deceived or has the tendency to deceive a substantial segment of its audience, (3) the deception is material, in that it is likely to influence the purchasing decision, (4) the defendant caused the false statement to enter interstate commerce, and (5) the plaintiff has

been or is likely to be injured as a result of the false statement, either by direct diversion of sales from itself to defendant or by a lessening of the goodwill associated with its products. Lanham Trade-Mark Act § 43, 15 U.S.C.A. § 1125(a).

**[36] Federal Civil Procedure** 🔑 [Fraud, mistake and condition of mind](#)

Lanham Act false advertising claims by provider of impact reduction treadmills, alleging that former employees and their competing business made false and misleading statements in bad faith, willfully, knowingly, and intentionally, sounded in fraud, and thus complaint was required to meet heightened pleading standards under federal rule. Lanham Trade-Mark Act § 43, 15 U.S.C.A. § 1125(a); Fed. R. Civ. P. 9(b).

**[37] Federal Civil Procedure** 🔑 [Fraud, mistake and condition of mind](#)

To satisfy heightened pleading standards for fraud, plaintiff must include the who, what, when, where, and how of the fraud. Fed. R. Civ. P. 9(b).

**[38] Federal Civil Procedure** 🔑 [Fraud, mistake and condition of mind](#)

Provider of impact reduction treadmills failed to satisfy heightened pleading standards for fraud, in Lanham Act false advertising claim alleging former employees and their competing business made false and misleading statements in bad faith, willfully, knowingly, and intentionally, absent specific allegations of “when” and “where” the statements were made, and who made each statement. Lanham Trade-Mark Act § 43, 15 U.S.C.A. § 1125(a); Fed. R. Civ. P. 9(b).

**[39] Federal Civil Procedure** 🔑 [Fraud, mistake and condition of mind](#)

“Everyone did everything” allegations do not satisfy heightened pleading standards for fraud. Fed. R. Civ. P. 9(b).

**[40] Federal Civil Procedure** 🔑 **Fraud, mistake and condition of mind**

In the context of a fraud suit involving multiple defendants, a plaintiff must, at a minimum, identify the role of each defendant in the alleged fraudulent scheme to satisfy the fraud pleading rule. *Fed. R. Civ. P. 9(b)*.

**[41] Libel and Slander** 🔑 **Nature and elements in general**

“Trade libel” is an intentional disparagement of the quality of property, which results in pecuniary damage.

[1 Cases that cite this headnote](#)

**[42] Libel and Slander** 🔑 **Nature and elements in general**

A trade libel claim under California law requires: (1) a publication, (2) which induces others not to deal with plaintiff, and (3) special damages.

**[43] Libel and Slander** 🔑 **Actions**

Plaintiff asserting trade libel claim under California law must allege: (1) who made the statements, (2) to whom the statements were made, (3) the time and place of publication, and (4) the substance of the statements.

**[44] Libel and Slander** 🔑 **Actions**

Allegations by provider of impact reduction treadmills that former employees and their competing business told provider's customers that provider was in poor financial health and going out of business, absent allegations when, where, and particular customers to whom the statements were made, failed to state trade libel claim under California law.

**[45] Libel and Slander** 🔑 **Injury from slander**

To establish the “special damages” element of trade libel claim under California law, a plaintiff may not rely on a general decline in business arising from the alleged falsehood, and must instead identify particular customers and transactions of which it was deprived as a result of the libel.

**[46] Antitrust and Trade Regulation** 🔑 **In general; unfairness****Antitrust and Trade****Regulation** 🔑 **Advertising, marketing, and promotion**

California's Unfair Competition Law (UCL) prohibits unlawful, unfair or fraudulent business act or practice and unfair, deceptive, untrue or misleading advertising. *Cal. Bus. & Prof. Code § 17200*.

[1 Cases that cite this headnote](#)

**[47] Antitrust and Trade Regulation** 🔑 **Source of prohibition or obligation; lawfulness**

California's Unfair Competition Law (UCL) borrows violations of other laws and treats them as unlawful practices that the unfair competition law makes independently actionable. *Cal. Bus. & Prof. Code § 17200*.

[1 Cases that cite this headnote](#)

**[48] Antitrust and Trade Regulation** 🔑 **In general; unfairness**

A business practice is “unfair” within meaning of California's Unfair Competition Law (UCL) if it violates established public policy or if it is immoral, unethical, oppressive, or unscrupulous and causes injury to consumers which outweighs its benefits. *Cal. Bus. & Prof. Code § 17200*.

[1 Cases that cite this headnote](#)

**[49] Antitrust and Trade Regulation** 🔑 **Fraud; deceit; knowledge and intent**

To state a claim under the fraudulent prong of California's Unfair Competition Law (UCL), it

is necessary only to show that members of the public are likely to be deceived. [Cal. Bus. & Prof. Code § 17200](#).

**[50] Antitrust and Trade**

**Regulation** 🔑 Reliance; causation; injury, loss, or damage

Provider of impact reduction treadmills failed to allege its own reliance on alleged misrepresentations made by former employees and their competing business to provider's customers regarding product quality and provider's financial situation, precluding claim under fraudulent prong of California's Unfair Competition Law (UCL). [Cal. Bus. & Prof. Code §§ 17200, 17204](#).

**[51] Antitrust and Trade**

**Regulation** 🔑 Injunction

**Antitrust and Trade**

**Regulation** 🔑 Monetary Relief; Damages

Damages cannot be recovered through a claim under California's Unfair Competition Law (UCL); a plaintiff who prevails on such a claim is limited to injunctive relief and restitution. [Cal. Bus. & Prof. Code § 17200](#).

**[52] Conspiracy** 🔑 Definition and elements of civil conspiracy in general

Under California law, conspiracy is not a cause of action, but a legal doctrine that imposes liability on persons who, although not actually committing a tort themselves, share with the immediate tortfeasors a common plan or design in its perpetration.

**[53] Conspiracy** 🔑 Conspiracy as independent claim; necessity of and relationship to underlying wrong

Under California law, a conspiracy allegation must be activated by the commission of an actual tort.

**[54] Patents** 🔑 In general; utility

US Patent [7,591,795](#), US Patent [8,464,716](#), US Patent [8,840,572](#), US Patent [9,642,764](#), US Patent [10,004,656](#). Cited.

**West Codenotes**

**Recognized as Invalid**

[Fed. R. Civ. P. App., Form 18](#).

**Attorneys and Law Firms**

\***1139** [Carmen Maria Aviles](#), [David James Miclean](#), Miclean Gleason LLP, San Mateo, CA, [Danielle Marie Mihalkanin](#), Manatt, Phelps and Phillips, LLP, Palo Alto, CA, for Plaintiff.

[Rick C. Chang](#), [Duane H. Mathiowetz](#), Morgan Franich Fredkin Siamas & Kays LLP, San Jose, CA, for Defendants.

**ORDER GRANTING DEFENDANTS'  
MOTION TO DISMISS**

Docket No. 15

[EDWARD M. CHEN](#), United States District Judge

Plaintiff AlterG, Inc. (“AlterG”) brings this action against three of its former employees, Sean Whalen, Thomas Allen, and Michael James Bean (the “Individual Defendants”) and the competing company they founded, Boost Treadmills LLC (“Boost”) (collectively, “Defendants”). AlterG alleges that Defendants infringed its patents and misused its trade secret information to create Boost products. AlterG's complaint pleads ten causes of action: (1) patent infringement; (2) breach of contract; (3) trade secret misappropriation; (4) breach of fiduciary duty; (5) interference with contract; (6) interference with prospective economic advantage; (7) false advertisement; (8) trade libel; (9) unfair competition; and (10) conspiracy. Pending before the Court is Defendants' motion to dismiss all counts of the complaint. Docket No. 15 (“Mot.”).

For the reasons stated on the record at the hearing on May 9, 2019 and discussed below, the motion to dismiss is **GRANTED**.



## I. FACTUAL AND PROCEDURAL BACKGROUND

The complaint alleges the following. Plaintiff AlterG is a “medical device company” that is the “leading provider of impact reduction treadmills,” also known as “Anti-Gravity Treadmills,” that are used for “orthopedic rehabilitation and training.” Docket No. 1 (“Compl.”) ¶ 14. “One of the keys [*sic*] drivers of AlterG’s success is its patented Differential Air Pressure (‘DAP’) technology,” which works by “us[ing] a pressurized bag to provide a counterforce to the subject’s body weight, reducing their effective weight on the treadmill surface.” *Id.* ¶ 15. From 2012 to 2015, AlterG devoted substantial resources to develop “a lower cost, bare bones AlterG machine” in response to “potential competitors who wanted to develop anti-gravity training and rehab machines using mechanical unweighting and other options, and at a lower price point than AlterG.” *Id.* ¶ 22. AlterG calls this project the “Low-Cost Platform Project,” or “LCPP.” *Id.* AlterG ultimately decided not to commercialize or sell any products developed as part of the LCPP. *Id.* ¶ 23.

The Individual Defendants are three former employees of AlterG. “Whalen was the founder of AlterG” as well as “the initial \*1140 and primary inventor ... principally involved in developing the technology and products of the company.” *Id.* ¶ 19. He therefore “had intimate access to and knowledge of AlterG products, technology, business plans, intellectual property strategy, marketing strategy, financial data, vendors, suppliers, customers, and confidential research and development.” *Id.* In 2012, Whalen relinquished his former positions at AlterG but continued working for the company as a consultant until he stopped working for AlterG altogether on March 31, 2015. *Id.* ¶¶ 21, 24. During this consultancy period, “Whalen was the principal consultant and engineer” on the LCPP. *Id.* ¶ 22.

Allen joined AlterG in 2007 and has “held numerous jobs at AlterG in sales, business development, and in international sales.” *Id.* ¶ 25. Through those positions, he became “intimately familiar with the products of AlterG and specifically the costing, bill of materials (BOM), sales and financial information, customer acquisition, marketing projections, and business strategy for AlterG products.” *Id.* Like Whalen, Allen worked closely with the LCPP team from 2012 through 2015. *Id.* ¶ 27. Allen was also AlterG’s “principal liaison” to Woodway USA (“Woodway”), a longtime supplier of treadmills for AlterG. *Id.* ¶¶ 25, 28. He resigned from AlterG on April 28, 2015. *Id.* ¶ 29.

Bean joined AlterG in 2008 and worked in various sales roles at the company. *Id.* ¶ 34. He resigned from AlterG in April 2017. *Id.* ¶ 35. “Since Bean’s departure from AlterG in April 2017, AlterG has discovered communications between Bean and Allen about Allen’s work on a competing anti-gravity unit while Bean was still an employee of AlterG.” *Id.*

Each of the Individual Defendants signed various confidentiality and non-disclosure agreements with AlterG during their employment with the company, which provided that they would “not use or disclose AlterG’s proprietary and confidential information in any way contrary to the benefit of AlterG.” *Id.* ¶¶ 20, 25, 34. AlterG and Woodway also “entered into various confidentiality agreements whereby AlterG would provide to Woodway proprietary and confidential information to assist Woodway to build and supply AlterG with anti-gravity units.” *Id.* ¶ 31.

Boost was formed at the end of 2016 and registered in April 2017. *Id.* ¶ 36. Allen and Bean are founders of Boost, and Whalen worked for the company in product development. *Id.* AlterG believes that “Defendants conspired almost immediately [upon leaving AlterG] to create a competing machine incorporating AlterG intellectual property,” and that “Boost was developing an unweighting treadmill well prior to the company’s registration.” *Id.* ¶¶ 36, 39. As part of this process, Whalen and Allen started “secretly” working with Woodway and “utilized confidential, proprietary, and trade secret information from the [LCPP], and other AlterG intellectual property, to shortcut the research and development time to come to market with a lower cost unweighting treadmill.” *Id.* ¶ 33. “At the end of 2017, Boost introduced its first product—the Boost One,” which “infringes AlterG patents” and “incorporates numerous technology features developed by AlterG in connection with the [LCPP].” *Id.* ¶ 38.

AlterG further alleges that Defendants “falsely claim that the problematic Boost One is a superior product over the AlterG DAP systems ‘at a fraction of the cost.’ ” *Id.* ¶ 44. Defendants have also “told customers and prospects false statements to denigrate AlterG and its superior technology, falsely claiming that AlterG was going out of business, is in poor financial health and will not be able to get Woodway treadmills \*1141 anymore.” *Id.* ¶ 45. The upshot of Defendants’ allegedly unlawful practices is that Defendants have been able to “sell over 20 units [of Boost products] to date to customers considering an AlterG unit.” *Id.* ¶ 46.

## II. LEGAL STANDARD

[1] [2] [3] [4] For a plaintiff to survive a Rule 12(b)(6) motion to dismiss after *Ashcroft v. Iqbal*, 556 U.S. 662, 129 S.Ct. 1937, 173 L.Ed.2d 868 (2009) and *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 127 S.Ct. 1955, 167 L.Ed.2d 929 (2007), his factual allegations “must ... suggest that the claim has at least a plausible chance of success.” *Levitt v. Yelp! Inc.*, 765 F.3d 1123, 1134-35 (9th Cir. 2014). In other words, the complaint “must allege ‘factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged.’ ” *Id.* (citations omitted). “The plausibility standard is not akin to a ‘probability requirement,’ but it asks for more than a sheer possibility that a defendant has acted unlawfully.” *Iqbal*, 556 U.S. at 678, 129 S.Ct. 1937. Where a complaint pleads facts that are “merely consistent with” a defendant’s liability, it “stops short of the line between possibility and plausibility ‘of entitlement to relief.’ ” *Id.*

[5] [6] The Ninth Circuit has outlined a two-step process for evaluating pleadings against this standard. “First, to be entitled to the presumption of truth, allegations in a complaint or counterclaim may not simply recite the elements of a cause of action, but must contain sufficient allegations of underlying facts to give fair notice and to enable the opposing party to defend itself effectively. Second, the factual allegations that are taken as true must plausibly suggest an entitlement to relief, such that it is not unfair to require the opposing party to be subjected to the expense of discovery and continued litigation.” *Levitt*, 765 F.3d at 1135 (citations omitted).

## III. DISCUSSION

### A. Patent Infringement

AlterG alleges that Defendants directly, indirectly, and willfully infringed five of AlterG’s patents. The ’795 and ’572 Patents (the “Weight Calibration Patents”) relate to systems that adjust the air pressure inside the treadmill chamber in response to the body weight of the user. *See* Compl. ¶¶ 67–84. The complaint provides the following descriptions of the Weight Calibration Patents:

- [F]eatures of the technology claimed in the ’795 Patent provide a system by applying pressure to a portion of a body of an individual in a chamber having an aperture along a vertical axis for receiving the portion of the body

of the individual. A pressure sensor is coupled to the chamber for measuring a pressure inside the chamber. A negative feedback control system, calibrates, adjusts, and maintains the pressure inside the chamber. Compl. ¶ 67.

- Broadly speaking, the ’572 Patent claims a system by applying pressure to a portion of a body of an individual in a chamber having an aperture along a vertical axis for receiving the portion of the body of the individual. A pressure sensor is coupled to the chamber for measuring a pressure inside the chamber. A negative feedback control system calibrates, adjusts, and maintains the pressure inside the chamber. Compl. ¶ 73.

The ’716, ’764, and ’656 Patents (the “Height Adjustment Patents”) relate to adjustable mechanisms that allow a treadmill to accommodate users of different \*1142 heights. Compl. ¶¶ 49–66. The complaint provides the following descriptions of the Height Adjustment Patents:

- Broadly speaking, the ’716 Patent claims various embodiments of Differential Air Pressure systems and methods of using such systems. Without reference to the particular construction of any claim terms, features of the technology claimed in the ’716 Patent include a Differential Air Pressure system that (1) may comprise a chamber configured to receive a portion of a user’s lower body; (2) the Differential Air Pressure system may further comprise a user seal that seals the pressure chamber to the user’s body; and (3) the height of the user seal may be adjusted to accommodate users with various body heights. Compl. ¶ 49.
- Broadly speaking, the ’656 Patent claims various embodiments of Differential Air Pressure systems and components for Differential Air Pressure systems. Without reference to the particular construction of any claim terms, features of the technology claimed in the ’656 Patent include (1) various methods and related structures for sealing a user into a pressurizable chamber; (2) various methods and related structures for changing the shape and/or height of the chamber; (3) various types and configurations of chambers and support structures for chambers; and (4) various methods and related systems for treating various conditions using the differential air pressure systems, including but not limited to [obesity](#), cardiac disease, [multiple sclerosis](#), [cerebral palsy](#), or [Down Syndrome](#). Compl. ¶ 55.



- Broadly speaking, the '764 Patent claims various embodiments of Differential Air Pressure systems and methods of using such systems. Without reference to the particular construction of any claim terms, features of the technology claimed in the '764 Patent include a Differential Air Pressure system that may comprise (1) a chamber configured to receive a portion of a user's lower body and to create an air pressure differential upon the user's body; (2) the Differential Air Pressure system may further comprise a user seal that seals the pressure chamber to the user's body; and (3) the height of the user seal may be adjusted to accommodate users with various body heights. Compl. ¶ 61.

### 1. Direct Infringement

[7] The parties dispute the pleading standard that applies to claims of direct patent infringement. *See* Mot. at 6–7; Docket No. 19 (“Opp.”) at 4. This dispute arises from a conflict between the general pleading standard set forth in *Twombly* and *Iqbal* and the more lenient standard formerly applied to direct infringement claims pursuant to [Form 18 to the Federal Rules of Civil Procedure](#). Form 18 was abrogated in December 2015. *See Novitaz, Inc. v. inMarket Media, LLC*, No. 16-CV-06795-EJD, 2017 WL 2311407, at \*1 (N.D. Cal. May 26, 2017). Since then, “the majority of district courts”—including this court—“have assessed the sufficiency of claims for direct patent infringement under the standard set forth in *Twombly* and *Iqbal*.” *Id.* at \*2 (collecting cases); *see Software Research, Inc. v. Dynatrace LLC*, 316 F. Supp. 3d 1112, 1116 (N.D. Cal. 2018). The Court will continue to apply the same standard here.

[8] [9] A direct infringement claim “does not satisfy the standards of *Twombly* and *Iqbal* where it does not at least \*1143 contain factual allegations that the accused product practices every element of at least one exemplary claim.” *Novitaz*, 2017 WL 2311407, at \*3. This requirement is animated by the principle that “the failure to meet a single limitation is sufficient to negate infringement of [a] claim.” *Laitram Corp. v. Rexnord, Inc.*, 939 F.2d 1533, 1535 (Fed. Cir. 1991).

[10] AlterG does not allege that Boost products practice every element of at least one exemplary claim. In particular, Defendants point out that the complaint contains no allegations that Boost products practice a key limitation of each of the two types of patents. The Weight Calibration Patents describe a mechanism that calibrates the pressure

inside the treadmill chamber in response to the body weight of the user. *See* Compl., Exh. D ('795 Patent) (Claim 1 claiming a method of “generating a relationship between pressure and actual weight of the individual” and “regulating the pressure in the chamber with respect to the weight of the individual based on the relationship”); Exh. E ('572 Patent) (Claim 1 claiming an “exercise apparatus” that “is configured to receive an input of the individual's weight ..., generate a measured weight and positive pressure relationship for the individual, and ... to regulate the positive pressure in the chamber by referring to only the generated relationship.”). The complaint does not allege that Defendants' products regulate chamber pressure by reference to a measured user weight. In fact, the complaint appears to say the opposite. *See* Compl. ¶ 44 (“[T]he Boost One [does] not calibrate to specific user's actual weight and volume dimensions like the AlterG DAP systems....”).

The Height Adjustment Patents describe adjustable mechanisms that accommodate treadmill users of various heights. *See* Compl., Exh. A ('716 Patent) (Claim 1 claiming “a height adjustment assembly attached to the chamber adjacent to the seal interface”); Exh. B ('656 Patent) (Claim 1 claiming “a height adjustable structure having a plurality of height adjustment slots in a front of the chamber and a plurality of height adjustment slots in a rear of the chamber”); Exh. C ('764 Patent) (Claim 1 claiming “a movable assembly comprising ... a height adjustment bar attached to the seal frame ... configured to provide a vertical position adjustment of the height of the user seal by vertically moving the seal frame”). The complaint does not allege that the Boost One contains any height adjustment mechanism. AlterG's direct infringement claim is therefore inadequately pled. *See Atlas IP LLC v. Pac. Gas & Elec. Co.*, No. 15-CV-05469-EDL, 2016 WL 1719545, at \*4 (N.D. Cal. Mar. 9, 2016) (dismissing a direct infringement claim where “the complaint entirely fails to address [a] necessary element of claim 1”).

### 2. Indirect Infringement

[11] “[L]iability for indirect infringement of a patent requires direct infringement.” *In re Bill of Lading Transmission & Processing Sys. Patent Litig.*, 681 F.3d 1323, 1333 (Fed. Cir. 2012). Because AlterG's direct infringement claims have not been adequately pled, its indirect infringement claims fail as well.

### 3. Willful Infringement

[12] AlterG alleges that Defendants' infringement of its patents is willful and therefore warrants enhanced damages under 35 U.S.C. § 284. However, this willful infringement claim must be dismissed because a finding of direct infringement is a prerequisite for willful infringement. See *Halo Elecs., Inc. v. Pulse Elecs., Inc.*, — U.S. —, 136 S. Ct. 1923, 1930, 195 L.Ed.2d 278 (2016).

\*1144 Defendants' motion to dismiss AlterG's patent infringement claims is **GRANTED** with leave for AlterG to amend its direct infringement claim.

### B. Trade Secret Misappropriation

[13] AlterG's third cause of action is trade secret misappropriation. To state a claim for trade secret misappropriation under the DTSA, a plaintiff must allege that: "(1) the plaintiff owned a trade secret; (2) the defendant misappropriated the trade secret; and (3) the defendant's actions damaged the plaintiff." *Alta Devices, Inc. v. LG Elecs., Inc.*, 343 F. Supp. 3d 868, 877 (N.D. Cal. 2018) (citation omitted); see 18 U.S.C. § 1839(5) (defining "misappropriation" in the context of trade secrets).

#### 1. Alleging Trade Secrets with Sufficient Particularity

Defendants argue that AlterG fails to identify its allegedly misappropriated trade secrets with sufficient particularity to state a claim under the DTSA. Mot. at 13–15. The Court agrees.

[14] "A plaintiff need not spell out the details of the trade secret," but must "describe the subject matter of the trade secret with sufficient particularity to separate it from matters of general knowledge in the trade or of special persons who are skilled in the trade, and to permit the defendant to ascertain at least the boundaries within which the secret lies."<sup>1</sup> *Alta Devices*, 343 F. Supp. 3d at 881 (citations, internal quotation marks and alterations omitted). *Alta Devices* provides helpful guidance as to the degree of particularity that is required. The court there found that the plaintiff, a manufacturer of thin-film solar technology, adequately pleaded its trade secret claim based on a combination of factors. First, the plaintiff identified "the exact technology in question: thin-film GaAs solar technology." *Id.* Second, the plaintiff listed with specificity the types of trade secrets relating to the "thin-film GaAs solar technology": "[m]ethods of [ ] high throughput thin-film deposition; epitaxial lift-off of the thin-film; and GaAs substrate maintenance and re-use," as well as "confidential

cost analysis; proofs and tests of manufacturing concepts and techniques; tool roadmaps; manufacturing process flows; and identification of equipment and equipment vendors; and information related to the foregoing." *Id.* In addition to the fact that the technology was described with specificity, a non-disclosure agreement between the parties described with further particularity the confidential information that was imparted to defendants, for example, "CVD technology and its commercial viability," including the "CVD (Alta 2T) chamber scheme," "growth rate," "thin film quality," "uniformity," "gas utilization efficiency," and "scalability and short cycle time feasibility." *Id.* Because the plaintiff's trade secret claims were based on the confidential information exchanged pursuant to the non-disclosure agreement, the court concluded that the defendant had fair notice of the scope of the trade secrets asserted. *Id.*

1 Plaintiff asserts that the "sufficient particularity" pleading standard applies only to claims under the California Uniform Trade Secrets Act ("CUTSA"), and not the DTSA. See Opp. at 9. Not so. The majority of courts in this district have held that the same standard is applied to both DTSA and CUTSA claims because "[t]he elements of misappropriation under the DTSA are similar to those under the CUTSA." *Alta Devices*, 343 F. Supp. 3d at 877; see *id.* at 880–81 ("Courts have held that the DTSA and the CUTSA share the same pleading requirements for the identification of trade secrets."). But see *Physician's Surrogacy, Inc. v. German*, No. 17CV0718-MMA (WVG), 2017 WL 3622329, at \*9 (S.D. Cal. Aug. 23, 2017).

\*1145 In contrast, the court in *Vendavo, Inc. v. Price f(x) AG*, No. 17-CV-06930-RS, 2018 WL 1456697 (N.D. Cal. Mar. 23, 2018) found that the plaintiff failed to allege its trade secret claim with sufficient particularity. The plaintiff, a provider of business software, claimed that the defendant had misappropriated trade secrets including "source code, customer lists and customer related information, pricing information, vendor lists and related information, marketing plans and strategic business development initiatives, 'negative knowhow' learned through the course of research and development, and other information related to the development of its price-optimization software, including ideas and plans for product enhancements." *Id.* at \*3. The court determined that the plaintiff had "set out its purported trade secrets in broad, categorical terms, more descriptive of the types of information that generally may qualify as protectable trade

secrets than as any kind of listing of particular trade secrets [it] has a basis to believe actually were misappropriated here.” *Id.* at \*4 (emphasis in original).

[15] Here, AlterG alleges that Defendants misappropriated the following trade secrets:

- “[N]umerous learnings from AlterG's Low-Cost Platform Project that explored market alternatives that included positive and negative learnings of low cost mechanical unweighted systems, air pressure systems, and Differential Air Pressure systems under strict confidentiality and non-disclosure agreements. Compl. ¶ 40.
- Trade secrets “related to AlterG's development of anti-gravity rehabilitation products” and “mechanical unweighting mainframes,” including “technology and negative information and learnings.” *Id.* ¶¶ 95–96.
- “[T]rade secret information related to AlterG's design and development of its anti-gravity rehabilitation and training units, including, but not limited to its marketing and product strategy, cost strategies, customer needs, material selection and fabrication techniques, engineering and structural technology, selection and qualification of components, knowledge of vendors with appropriate, specialized skills, and technology innovation.” *Id.* ¶ 102.

These allegations more closely resemble the broad categories of information in *Vendavo* than the specific descriptions provided in *Alta Devices*. The references in paragraphs 40 and 95–96 to “positive and negative learnings” and “technology and negative information and learnings” are vague. The types of information listed in paragraph 102 are somewhat more concrete, but are not tethered to a specific technology; it cannot be discerned which aspects of AlterG's “anti-gravity rehabilitation and training units” the information pertains to. And although AlterG, like the plaintiff in *Alta Devices*, has alleged that the trade secrets at issue are covered by confidentiality agreements between the parties, AlterG only summarizes rather broadly the categories of information protected by the agreements. *See* Compl. at 5 n.2 (defining “Confidential Information” to include “techniques, sketches, drawings, models, inventions, know-how, processes, apparatus, equipment, algorithms, software programs, software source documents, and formulae related to the current, future and proposed products and services of the Company, and includes, without limitation, its respective

information concerning research, experimental work, development, design details, and specifications, engineering, financial information, procurement requirements, purchasing \*1146 manufacturing, customer lists, business forecasts, sales, and merchandising and marketing plans and information”). AlterG has not attached the agreements to the complaint, and its allegations fail to “describe the subject matter of the trade secret with sufficient particularity to separate it from matters of general knowledge in the trade or of special persons who are skilled in the trade.” *Alta Devices*, 343 F. Supp. 3d at 881.

Accordingly, Defendants' motion to dismiss AlterG's trade secret claim is **GRANTED**. AlterG is granted leave to amend its complaint to allege with greater specificity the types of trade secrets that were misappropriated and the exact technology to which they pertain. Such allegations may be enhanced if the confidentiality agreements between the parties detail the protected information that AlterG imparted to Defendants. In amending its trade secret claim, AlterG should also take care to delineate the boundaries between its trade secrets and its information that has been made public through patents and patent applications. *See Aqua-Lung Am., Inc. v. Am. Underwater Prod., Inc.*, 709 F. Supp. 2d 773, 788 (N.D. Cal. 2010) (explaining that “a plaintiff has a viable trade secret claim that would protect his proprietary unpatented technology[ ] only if he reveals implementation details and techniques *beyond* what was disclosed in his patent.”) (emphasis in original) (citation omitted).

## 2. Standing under DTSA

Defendants separately argue that AlterG's DTSA claim must be dismissed because AlterG only alleges acts of misappropriation that took place prior to May 11, 2016, the effective date of the DTSA. Mot. at 15. The DTSA applies to “any misappropriation of a trade secret ... for which any act occurs on or after the date of the enactment of [the] Act.” *Defend Trade Secrets Act of 2016*, Pub. L. No. 114-153, § 2(e), 130 Stat. 376, 381 (2016). The complaint alleges that “Defendants conspired almost immediately [after resigning from AlterG] to create a competing machine incorporating AlterG intellectual property.” Compl. ¶ 39. Defendants seize upon the “almost immediately” language to suggest that the alleged acts of misappropriation must have started as early as April 2015, when Whalen and Allen resigned from AlterG, and before the DTSA was enacted. Mot. at 15.

[16] AlterG counters that, although Defendants may have initially *disclosed* its trade secrets in 2015, they *used* the

secret information in 2017, when they were developing the Boost One. Opp. at 9–10; *see* Compl. ¶ 38. This allegation is sufficient to support liability under the DTSA because “misappropriation” is defined as the “disclosure *or* use of a trade secret.” 18 U.S.C. § 1839(5) (emphasis added). Relying on § 1839(5), courts have generally held that the continued use of a trade secret after the effective date of the DTSA is actionable, even if the secret was initially disclosed prior to May 11, 2016. *See, e.g., Cave Consulting Grp., Inc. v. Truven Health Analytics Inc.*, No. 15-CV-02177-SI, 2017 WL 1436044, at \*4 (N.D. Cal. Apr. 24, 2017); *AllCells, LLC v. Zhai*, No. 16-CV-07323-EMC, 2017 WL 2929380, at \*1 (N.D. Cal. Mar. 27, 2017).<sup>2</sup>

<sup>2</sup> It is true, as Defendants note, that the court in *Avago Techs. U.S. Inc. v. Nanoprecision Prod., Inc.*, No. 16-CV-03737-JCS, 2017 WL 412524 (N.D. Cal. Jan. 31, 2017) ruled the other way. However, *Avago Techs* pre-dates cases like *AllCells* and *Cave Consulting*, and its holding was informed in part by the plaintiff’s inability to “cite[ ] any authority suggesting that the DTSA allows a misappropriation claim to be asserted based on the continued use of information that was disclosed prior to the effective date of the statute.” *Id.* at \*9. Since then, cases have consistently endorsed just that view.

\*1147 The Court therefore finds that AlterG has standing to bring its trade secret claim.

### C. Breach of Contract

[17] AlterG’s second cause of action alleges that each Individual Defendant entered into confidentiality agreements with AlterG and breached those agreements “by integrating and using AlterG’s proprietary and confidential information into the Boost treadmill products.” Compl. ¶ 91. The elements of a breach of contract claim are: (1) the existence of a contract, (2) performance or excuse for nonperformance, (3) defendant’s breach, and (4) damages. *Oasis West Realty, LLC v. Goldman*, 51 Cal. 4th 811, 821, 124 Cal.Rptr.3d 256, 250 P.3d 1115 (2011). Defendants argue that AlterG fails to adequately plead three of these four elements.

#### 1. Existence of a Contract

[18] First, Defendants argue that the complaint does not describe with specificity the terms of the contracts that were allegedly breached. Mot. at 16. A plaintiff can state a claim

for breach of contract by quoting verbatim the terms of the contract or attaching the contract to the complaint, but he is not required to do so. “[A] complaint for breach of contract must include the contract itself or plead its essential terms.” *Gross v. Symantec Corp.*, No. C 12-00154 CRB, 2012 WL 3116158, at \*11 (N.D. Cal. July 31, 2012).

[19] Here, AlterG has not pleaded all of the essential terms of the relevant contracts. While the complaint states clearly that the contracts at issue require Individual Defendants to “keep confidential and not use or disclose AlterG’s proprietary and confidential information in any way contrary to the benefit of AlterG,” Compl. ¶¶ 20, 25–26, 34, it does not allege with sufficient particularity what the “proprietary and confidential information” is. The complaint merely lists broad categories of information covered by the agreements. *See id.* ¶ 34; *id.* at 5 n.2. As explained above, these broad categories are insufficient to put Defendants on notice of the scope of the trade secrets that are the subject of AlterG’s DTSA claim. AlterG’s breach of contract claim is also predicated on Defendants’ alleged disclosure of trade secrets, and AlterG must allege with more specificity the types of information protected by its confidentiality agreements.

Two other arguments Defendants make are easily disposed of. The first is that AlterG references multiple confidentiality agreements but does not specify which particular ones were breached. Mot. at 16. But the complaint indicates that Defendants breached all of the agreements. *See* Compl. ¶ 91; Opp. at 11. The second argument is that the complaint does not explicitly state whether the confidentiality agreements continued to have effect after Defendants’ employment with AlterG terminated. Mot. at 17. The complaint alleges, however, that an agreement signed by Whalen provided that he would not disclose AlterG’s confidential information during his work with AlterG “or at any time thereafter.” Compl. ¶ 21. The allegations with respect to Allen’s and Bean’s agreements are not so explicit, but the complaint states that the agreements required Allen and Bean to “not disclose any of AlterG’s confidential and proprietary information without AlterG’s permission” without mentioning any time limitation. *Id.* ¶ 88. It is therefore reasonable to infer that the duty of confidentiality imposed by Defendants’ agreements extended beyond their periods of employment.

#### \*1148 2. Defendants’ Breach

Next, Defendants argue that AlterG “failed to plead specifically how each individual has breached his respective contract(s)” because AlterG nowhere mentions “what specific



confidential information or trade secrets were in fact integrated into the Boost One.” Mot. at 17–18. The complaint currently alleges that the Boost One utilized “an anti-gravity unit that derived directly from the technology Whalen and other AlterG engineers developed for AlterG in the Low Cost Platform Project”; that Bean, while still employed at AlterG, “disclosed confidential and proprietary information about AlterG technology, marketing strategy, and prospective and actual customers and test sites to his friends at Boost”; and that “Defendants have taken technology and negative information and learnings from the [Low Cost Platform] Project ... and applied them to the Boost One product.” *Id.* ¶¶ 33, 36, 95. Once AlterG amends the complaint to describe the terms of its confidentiality agreements and the substance of its trade secrets with more particularity, it will be able to allege the specific trade secrets incorporated into the Boost One in violation of the confidentiality agreements.

### 3. Damages

[20] [21] Finally, Defendants claim that AlterG has failed to explain how the alleged breaches caused it to suffer damages, given that AlterG admits the LCPP was “not commercialized.” Compl. ¶ 43. Defendants misapprehend AlterG's damages theory. The complaint states that Defendants used AlterG's confidential information to “unfairly compete with AlterG and sell over 20 units to date to customers considering an AlterG unit,” causing “monetary damages” to AlterG. Compl. ¶ 46. It is well-established that non-speculative lost sales or profits can constitute contractual damages. See *Illumina, Inc. v. Ariosa Diagnostics, Inc.*, No. C 14-01921 SI, 2014 WL 3897076, at \*4 (N.D. Cal. Aug. 7, 2014); *Grupe v. Glick*, 26 Cal. 2d 680, 692, 160 P.2d 832 (1945). AlterG may not have brought LCPP-derived products to market, but it has nevertheless alleged that it has lost potential sales of its treadmills as a result of Defendants' exploitation of its confidential information from the LCPP. Allegations of “lost sales or profits” caused by a competitor's contractual breach are sufficient to establish damages at the pleadings stage. *Openwave Messaging, Inc. v. Open-Exchange, Inc.*, No. 16-CV-00253-WHO, 2016 WL 6393503, at \*9 (N.D. Cal. Oct. 28, 2016).

Defendants' motion to dismiss AlterG's breach of contract claim is **GRANTED**. AlterG is granted leave to amend its complaint to either attach the relevant confidentiality agreements or to allege their essential terms.

#### D. Breach of Fiduciary Duty

[22] AlterG's fourth cause of action alleges that Whalen breached the fiduciary duty he owed to AlterG by using AlterG's proprietary and confidential information to benefit Boost. Compl. ¶¶ 115–19. To state a claim for breach of fiduciary duty, a plaintiff must allege: (1) the existence of a fiduciary duty; (2) breach of the fiduciary duty; and (3) damage proximately caused by the breach. *Pierce v. Lyman*, 1 Cal. App. 4th 1093, 1101, 3 Cal.Rptr.2d 236 (1991). Here, Defendants do not dispute that Whalen owed a fiduciary duty to AlterG while he was serving as its director, but contends that the duty ended when he joined Boost, because by that point he was no longer a director of AlterG. Mot. at 18–19.

[23] [24] Defendants are correct that, as a general matter, an officer's fiduciary duty to their employer ends upon their \*1149 resignation. See *GAB Bus. Servs., Inc. v. Lindsey & Newsom Claim Servs., Inc.*, 83 Cal. App. 4th 409, 421, 99 Cal.Rptr.2d 665 (2000), *disapproved of on other grounds by Reeves v. Hanlon*, 33 Cal. 4th 1140, 17 Cal.Rptr.3d 289, 95 P.3d 513 (2004). However, “[c]ourts addressing the issue have rejected an expansive reading of the decision in *GAB Bus. Servs.* and appropriately recognized that officers are also charged with a continuing duty to protect privileged and confidential information, which continues even after they leave the company.” *Sonoma Pharm., Inc. v. Collision Inc.*, No. 17-CV-01459-EDL, 2018 WL 3398940, at \*7 (N.D. Cal. June 1, 2018) (citation and internal quotation marks omitted). Indeed, the Restatement of Agency makes clear that, post termination, an agent continues to have “a duty to the principal not to use or to disclose to third persons ... trade secrets, written lists of names, or other similar confidential matters given to him only for the principal's use.” *Restatement (Second) of Agency* § 396(b). This means that Whalen owed a continuing fiduciary duty to AlterG not to use its confidential information to its detriment, even after he joined Boost. See *Language Line Servs., Inc. v. Language Servs. Assocs., LLC*, No. C 10-02605 JW, 2011 WL 13153247, at \*8 (N.D. Cal. Mar. 17, 2011) (finding breach of fiduciary claim adequately pled where plaintiff alleged that defendant “used his access to Plaintiff's proprietary customer information to further his own anti-competitive agenda during his subsequent employment with [a competitor]”).

[25] However, the breach of fiduciary duty claim arises from the same confidentiality agreements underlying AlterG's breach of contract claim. As explained above, AlterG needs to describe the terms of the confidentiality agreements and the trade secrets they protect with more particularity so that it can be ascertained whether Whalen's disclosures constituted

a breach of his fiduciary duty. Accordingly, Defendants' motion to dismiss AlterG's breach of fiduciary duty claim is **GRANTED**, and AlterG may amend its complaint to either attach the relevant confidentiality agreements or to allege their essential terms.

#### E. Interference with Contract

[26] AlterG's fifth cause of action is interference with contract. Compl. ¶¶ 121–27. “The elements which a plaintiff must plead to state the cause of action for intentional interference with contractual relations are (1) a valid contract between plaintiff and a third party; (2) defendant's knowledge of this contract; (3) defendant's intentional acts designed to induce a breach or disruption of the contractual relationship; (4) actual breach or disruption of the contractual relationship; and (5) resulting damage.” *Pac. Gas & Elec. Co. v. Bear Stearns & Co.*, 50 Cal. 3d 1118, 1126, 270 Cal.Rptr. 1, 791 P.2d 587 (1990). Here, the complaint alleges that Defendants interfered with three sets of contracts: the confidentiality agreements between AlterG and Woodway; contracts between AlterG and its vendors, suppliers, and customers; and the confidentiality agreements between each Individual Defendant and AlterG. Compl. ¶¶ 121–124. Defendants argue that AlterG's allegations are deficient as to all three.

##### 1. Confidentiality Agreements between AlterG and Woodway

[27] Defendants claim that the complaint fails to specify what agreements between AlterG and Woodway were interfered with. Mot. at 20. Defendants also argue that the complaint “presents no facts that support a possible breach of such agreements.” *Id.*

\*1150 The first argument is unpersuasive. The complaint specifies that the contracts at issue are two confidentiality agreements between AlterG and Woodway: “a Master Agreement signed May 30, 2007, and a subsequent agreement signed in 2012.” Compl. ¶ 32. The essential terms of the agreements are also specified: “AlterG would provide to Woodway proprietary and confidential information to assist Woodway to build and supply AlterG with anti-gravity units,” including “all specifications, drawings, files, instructions, and other documents,” and this information was “not to be shared or used with or on behalf of any other person or entity.” *Id.* ¶¶ 30–31.

However, Defendants' second argument has merit. The complaint states that “Whalen and Allen started secretly working with Woodway on developing a low-cost anti-gravity unit,” and “utilized confidential, proprietary, and trade secret information from the [LCPP], and other AlterG intellectual property, to shortcut the research and development time to come to market with a lower cost unweighting treadmill utilizing a Woodway treadmill.” Compl. ¶ 33. This does not mean, however, that Whalen and Allen induced or caused Woodway to disclose AlterG's confidential information to them. In fact, the complaint does not even allege that Woodway in fact disclosed any information; it merely states that Whalen and Allen “utilized” information. It is difficult to imagine that Woodway possessed any confidential information from the LCPP that Whalen and Allen did not already have, given that “Whalen was the principal consultant and engineer” on the LCPP and Allen was also heavily involved in the LCPP. *Id.* ¶¶ 22, 27. If anything, as AlterG's “principal liaison” to Woodway, Allen may have been the one who conveyed AlterG's information to Woodway in the first place. *Id.* ¶¶ 25, 28.

Thus, AlterG has failed to adequately allege that Defendants induced Woodway to breach its contracts with AlterG.

##### 2. Contracts with Vendors, Suppliers, and Customers

[28] AlterG's allegations with respect to its vendors, suppliers, and customers are wholly lacking. The complaint states only that “[c]ontracts existed between AlterG ... and AlterG vendors, suppliers, and customers” and that “Defendants have ... interfered with contracts between AlterG and its vendors, suppliers, and customers.” Compl. ¶¶ 121, 124. AlterG does not identify any of these “vendors, suppliers, and customers,” nor provide any details about the contracts and contractual provisions with which Defendants allegedly interfered. AlterG has therefore failed to state a claim with respect to these contracts. See *AccuImage Diagnostics Corp v. Terarecon, Inc.*, 260 F. Supp. 2d 941, 956 (N.D. Cal. 2003) (dismissing interference with contract claim because plaintiff merely made “conclusory allegations that valid ‘contracts’ exist between itself and an unspecified third party” and provided no “facts surrounding the type or nature of the ‘contracts’ [defendants'] conduct allegedly interfered with”).

##### 3. Confidentiality Agreements between Individual Defendants and AlterG

[29] AlterG alleges that Defendants interfered with each other's confidentiality agreements with AlterG. Compl. ¶ 124.

Defendants counter that “[t]here is not a single statement, allegation, or fact set forth in the complaint regarding Defendant inducing another Defendant to breach” these agreements. Reply at 11. It is true that while the complaint alleges that the Individual Defendants disclosed confidential information to each other, it stops short of explicitly stating that they \*1151 intentionally *induced* each other to disclose this information. *See, e.g.*, Compl. ¶ 36 (“Bean ... disclosed confidential and proprietary information about AlterG technology, marketing strategy, and prospective and actual customers and test sites to his friends at Boost” while he was still working at AlterG.). Nevertheless, a reasonable inference in AlterG’s favor can be drawn that Defendants encouraged each other’s disclosure. The allegation that they “conspired ... to create a competing machine incorporating AlterG’s intellectual property” undercuts the possibility that Whalen, Allen, and Bean each made the independent decision to disclose AlterG’s information to each other without any prompting. Compl. ¶ 39.

However, because AlterG needs to allege with more specificity the essential terms of the confidentiality agreements underlying this contractual interference claim, the Court will dismiss this claim pending AlterG’s amendment.

Accordingly, Defendants’ motion to dismiss the interference with contract claim is **GRANTED with leave to amend**.

#### F. Interference with Prospective Economic Advantage

[30] [31] [32] AlterG’s sixth cause of action alleges that Defendants interfered with its prospective economic advantage with Woodway and with AlterG’s vendors, suppliers, and prospective and current customers. Compl. ¶¶ 129–33. The elements of a claim for intentional interference with prospective economic advantage are: “(1) an economic relationship between the plaintiff and some third person containing the probability of future economic benefit to the plaintiff; (2) knowledge by the defendant of the existence of the relationship; (3) intentional acts on the part of the defendant designed to disrupt the relationship; (4) actual disruption of the relationship; and (5) damages to the plaintiff proximately caused by the acts of the defendant.” *Blank v. Kirwan*, 39 Cal. 3d 311, 330, 216 Cal.Rptr. 718, 703 P.2d 58 (1985). “The chief practical distinction between interference with contract and interference with prospective economic advantage is that a broader range of privilege to interfere is recognized when the relationship or economic advantage interfered with is only prospective.” *Pac. Gas*, 50 Cal. 3d at 1126, 270 Cal.Rptr. 1, 791 P.2d 587. Nevertheless, courts

have made clear that “[t]he law precludes recovery for overly speculative expectancies by initially requiring proof” that it is “reasonably probable that the prospective economic advantage would have been realized but for defendant’s interference.” *Westside Ctr. Assocs. v. Safeway Stores 23, Inc.*, 42 Cal. App. 4th 507, 522, 49 Cal.Rptr.2d 793 (1996) (emphasis in original) (citation and internal quotation marks omitted).

[33] AlterG’s vague allegations are insufficient to state a claim for interference of prospective economic advantage. With respect to Woodway, the complaint explains that Woodway supplies treadmills to AlterG and has long worked with AlterG to build treadmills “using AlterG’s proprietary designs.” Compl. ¶ 30. Thus, it can be reasonably inferred that this established commercial relationship contains the probability of future economic benefit to AlterG as Woodway continues to supply AlterG with treadmills. However, AlterG wholly fails to explain how Defendants’ actions have jeopardized the ongoing supplier relationship between Woodway and AlterG.<sup>3</sup> \*1152 The complaint does not allege that Defendants intentionally acted to disrupt Woodway’s supply of treadmills to AlterG, or that the supply was actually disrupted. Indeed, “[t]o this day, Woodway continues to supply treadmills to AlterG.” Compl. ¶ 30.

3 AlterG alleges Defendants induced Woodway to breach its confidentiality agreements with AlterG, but the complaint does not indicate that any such breach in confidentiality disrupted Woodway’s supply of treadmills to AlterG.

[34] The allegations are even more lacking when it comes to AlterG’s relationship with its “vendors, suppliers, and prospective and current customers.” Compl. ¶¶ 131. Nowhere does the complaint identify these entities or allege any facts to explain their economic relationship with AlterG, much less suggest that such relationships contain[s] the probability of future economic benefit to [AlterG].” *Blank*, 39 Cal. 3d at 330, 216 Cal.Rptr. 718, 703 P.2d 58. Without any facts, it is impossible for the Court to determine whether it is reasonably probable that the prospective economic advantage would have been realized but for Defendants’ interference. *See Buxton v. Eagle Test Sys., Inc.*, No. C-08-04404 RMW, 2010 WL 1240749, at \*2 (N.D. Cal. Mar. 26, 2010) (dismissing interference claim because the complaint did “not contain factual allegations about the existence of any specific economic relationships with identifiable third parties”).

Accordingly, Defendants' motion to dismiss Plaintiff's interference with prospective economic advantage claim is **GRANTED** with leave for AlterG to amend.

#### G. False Advertisement

[35] AlterG's seventh cause of action alleges that Defendants engaged in false advertising in violation of § 43(a) of the Lanham Act, 15 U.S.C. § 1125(a). A false advertising claim under § 43(a) has five elements: "(1) a false statement of fact by the defendant in a commercial advertisement about its own or another's product; (2) the statement actually deceived or has the tendency to deceive a substantial segment of its audience; (3) the deception is material, in that it is likely to influence the purchasing decision; (4) the defendant caused the false statement to enter interstate commerce; and (5) the plaintiff has been or is likely to be injured as a result of the false statement, either by direct diversion of sales from itself to defendant or by a lessening of the goodwill associated with its products." *Skydive Arizona, Inc. v. Quattrocchi*, 673 F.3d 1105, 1110 (9th Cir. 2012) (citing 15 U.S.C. § 1125(a)(1)(B)).

[36] [37] Because AlterG alleges that "Defendants' false and misleading statements were made in bad faith, willfully, knowingly, and intentionally," Compl. ¶ 136, its false advertising claim sounds in fraud and is subject to the heightened pleading requirements of Federal Rule of Civil Procedure 9(b). See *TransFresh Corp. v. Ganzerla & Assoc., Inc.*, 862 F. Supp. 2d 1009, 1017–18 (N.D. Cal. 2012). Accordingly, the complaint must allege " 'the who, what, when, where, and how' of the fraud." *Id.* at 1017 (quoting *Vess v. Ciba-Geigy Corp. USA*, 317 F.3d 1097, 1106 (9th Cir. 2003)).

[38] AlterG's false advertising claim does not meet the Rule 9(b) pleading standard. The complaint adequately alleges "what" the content of the alleged false statements were and "how" they were false:

- (1) [T]he Boost One claims to adjust air pressure to allow specific body weight calibration at any body weight, between full weight and 20% of body weight, and can be adjusted in 1% increments of body weight. In fact, the Boost One, as tested, does not calibrate to a specific user, does not unweight in precise \*1153 1% of body weight increments, and cannot even distinguish an over 50 lb. weight difference between three different users that happen to use the same shorts and same rack height adjustment;

- (2) Boost claims the Boost One is safe and precise. But, not only does the Boost One not calibrate to specific user's actual weight and volume dimensions like the AlterG DAP systems, but the Boost One, as tested, did not record an error or stop when the air pressure dropped during a session when the shorts were unzipped. The Boost One air pressure also oscillates up and down during a session and does not remain stable – though no difference in calibration or pressure was noted on the machine;

- (3) Boost also implies that the Boost One is suitable for use in medical markets or is approved for hospital and clinic use so that it may be "prescribe[d]" for "patients" under the heading "Therapy & Rehabilitation" under product features at woodway.com. On information and belief, the Boost One has not been FDA approved like the AlterG DAP system, and Boost is actively deceiving consumers in their Boost One specification sheet; [and]

- (4) Boost also falsely implies that the Boost One has enjoyed wide market adoption by imputing the Woodway 4Front market to Defendants' Boost One. While the Woodway 4Front is a popular and widely distributed treadmill, on information and belief, the Boost One that incorporates a Woodway 4Front has not enjoyed such widespread acceptance or use by "top athletes" and "Hollywood stars."

Compl. ¶ 44 (line breaks added).

But the complaint does not specify "when" and "where" these statements were made. It merely asserts that "Defendants have disseminated" these statements. *Id.* This is not enough. See *TransFresh Corp. v. Ganzerla & Assoc., Inc.*, 862 F. Supp. 2d 1009, 1020 (N.D. Cal. 2012) (dismissing false advertising claim where plaintiff did not "allege specific facts as to when or where these statements were made").<sup>4</sup> Without information about where and when Defendants made the alleged false statements, the Court cannot determine whether the statements were "disseminated sufficiently to the relevant purchasing public to constitute 'advertising' or 'promotion' " within the meaning of the Lanham Act. *Coastal Abstract Serv., Inc. v. First Am. Title Ins. Co.*, 173 F.3d 725, 734–75 (9th Cir. 1999) (quoting 15 U.S.C. § 1125(a)(1)(B)); see, e.g., *Prager Univ. v. Google LLC*, No. 17-CV-06064-LHK, 2018 WL 1471939, at \*10 (N.D. Cal. Mar. 26, 2018) (dismissing false advertising claim because the complaint lacked enough



detail from which the court could determine whether the challenged representations were sufficiently disseminated).

4 The only specific fact AlterG alleges in this regard is that Defendants' misrepresentation that the "Boost One is suitable for use in medical markets or is approved for hospital and clinic use" is displayed at "woodway.com." Compl. ¶ 44. However, as Defendants point out, AlterG has alleged no facts to suggest that this statement made on *Woodway's* website is attributable to *Defendants*.

[39] [40] The complaint similarly fails to identify the "who." "[W]ithin the realm of Rule 9(b), 'everyone did everything' allegations are not countenanced. *Prime Media Grp. LLC v. Acer Am. Corp.*, No. 5:12-CV-05020 EJD, 2013 WL 621529, at \*3 (N.D. Cal. Feb. 19, 2013) (citing \*1154 *Destfino v. Reiswig*, 630 F.3d 952, 958 (9th Cir. 2011)). But that is exactly what AlterG has alleged here. The complaint's allegations regarding false advertising are completely undifferentiated, merely asserting that "Defendants" are responsible for the statements. See Compl. ¶ 44. Although "there is no absolute requirement that where several defendants are sued in connection with an alleged fraudulent scheme, the complaint must identify *false statements* made by each and every defendant," and, "at a minimum, identif[y] the role of [each] defendant [ ] in the alleged fraudulent scheme." *Swartz v. KPMG LLP*, 476 F.3d 756, 764 (9th Cir. 2007) (emphasis removed). AlterG has failed to do so.

Accordingly, Defendants' motion to dismiss AlterG's false advertisement claim is **GRANTED** with leave for AlterG to amend.

#### H. Trade Libel

[41] [42] [43] AlterG's eighth cause of action is trade libel, based on Defendants' "false, disparaging, and defamatory statements regarding AlterG's business and products to several AlterG customers and potential AlterG customers." Compl. ¶¶ 142–45. "Trade libel is defined as 'an intentional disparagement of the quality of property, which results in pecuniary damage.' " *Aetna Cas. & Sur. Co. v. Centennial Ins. Co.*, 838 F.2d 346, 351 (9th Cir. 1988) (quoting *Erlich v. Etner*, 224 Cal. App. 2d 69, 73, 36 Cal.Rptr. 256 (1964)). A trade libel claim requires: (1) a publication, (2) which induces others not to deal with plaintiff, and (3) special damages." *Id.* (citing *Polygram Records, Inc. v. Superior*

*Court*, 170 Cal. App. 3d 543, 548–49, 216 Cal.Rptr. 252 (1985)). Moreover, "a plaintiff must allege: (1) who made the statements, (2) to whom the statements were made, (3) the time and place of publication, and (4) the substance of the statements." *NPK Indus. v. Hunter*, No. 15-CV-00811-SI, 2015 WL 5461667, at \*4 (N.D. Cal. Sept. 16, 2015) (citations omitted).

[44] Here, AlterG has adequately alleged who made the statements and the substance of the statements. The complaint specifies that "each of" the Individual Defendants told AlterG customers that "AlterG was going out of business, is in poor financial health and will not be able to get Woodway treadmills anymore," and that "AlterG DAP technology is inferior to that of Boost and that Boost is an equal or better system than AlterG DAP technology, but at a lower cost." Compl. ¶¶ 45, 142.

In contrast, AlterG has not adequately alleged when, where, and to whom the statements were made. It only asserts vaguely that the false statements were made to "several AlterG customers and potential AlterG customers," without identifying any of the customers. *Id.* ¶ 142. The trade libel claim is thus insufficiently pled. Compare *NPK Indus.*, 2015 WL 5461667, at \*5 (finding a trade libel claim adequately pled where the complaint specified "that defendants ..., through phone calls, visits and emails, made disparaging statements about [plaintiff] to [plaintiff]'s customers and business partners, several of whom [plaintiff] identifies by name," and that "these activities took place beginning in July 2013 and November 2013").

[45] AlterG has also failed to plead the "special damages" element of its trade libel claim. To establish this element, a plaintiff "may not rely on a general decline in business arising from the [alleged] falsehood, and must instead identify particular customers and transactions of which it was deprived as a result of the libel." *Mann v. Quality Old Time Serv., Inc.*, 120 Cal. App. 4th 90, 109, 15 Cal.Rptr.3d 215 (2004), *disapproved of on other grounds by Baral v. Schnitt*, 1 Cal. 5th 376, 385, 205 Cal.Rptr.3d 475, 376 P.3d 604 (2016). Here, \*1155 AlterG asserts that Defendants have "s[old] over 20 units to date to customers considering an AlterG unit," causing "monetary damages" to AlterG. Compl. ¶ 46. However, AlterG has not identified any particular customers associated with these sales, nor explained whether these customers' decision to purchase Boost products in lieu of AlterG products was attributable to Defendants' trade libel. See *Heartland Payment Sys., Inc. v. Mercury Payment*

*Sys., LLC*, No. C 14-0437 CW, 2016 WL 304764, at \*11 (N.D. Cal. Jan. 26, 2016) (dismissing trade libel claims because “[plaintiff] does not identify any customer who refused to do business with it as a result of [defendant]’s allegedly libelous statements”); *Piping Rock Partners, Inc. v. David Lerner Assocs., Inc.*, 946 F. Supp. 2d 957, 981 (N.D. Cal. 2013) (dismissing trade libel claim where “it is not even clear if this allegation [of lost sales] is connected to counterdefendants’ [libel]”).

Accordingly, Defendants’ motion to dismiss AlterG’s trade libel claim is **GRANTED** with leave for AlterG to amend.

### I. UCL Claim

[46] AlterG’s ninth cause of action is unfair competition, brought under California’s Unfair Competition Law (“UCL”). Compl. ¶¶ 147–53. The UCL prohibits “any unlawful, unfair or fraudulent business act or practice and unfair, deceptive, untrue or misleading advertising.” Cal. Bus. & Prof. Code § 17200.

#### 1. “Unlawful” Prong

[47] Under the “unlawful” prong, “[t]he UCL ‘borrows violations of other laws and treats them as unlawful practices that the unfair competition law makes independently actionable.’ ” *Wilson v. Hewlett-Packard Co.*, 668 F.3d 1136, 1140 (9th Cir. 2012) (quoting *Cel-Tech Commc’ns, Inc. v. L.A. Cellular Tel. Co.*, 20 Cal. 4th 163, 180, 83 Cal.Rptr.2d 548, 973 P.2d 527 (1999)). Although AlterG’s claims are not properly pled at this juncture, it may be able to cure its pleading deficiencies through amendment and establish violations of other laws that serve as a predicate for its “unlawful” claim. Accordingly, AlterG’s claim under the “unlawful” prong of the UCL is **DISMISSED without prejudice**.

#### 2. “Unfair” Prong

[48] The “unfair” prong of the UCL prohibits a business practice that “violates established public policy or if it is immoral, unethical, oppressive or unscrupulous and causes injury to consumers which outweighs its benefits.” *McKell v. Wash. Mut., Inc.*, 142 Cal. App. 4th 1457, 1473, 49 Cal.Rptr.3d 227 (2006). The California Supreme Court has held that “[w]hen a plaintiff who claims to have suffered injury from a direct competitor’s ‘unfair’ act or practice invokes section 17200, the word ‘unfair’ in that section means conduct that threatens an incipient violation of an

antitrust law, or violates the policy or spirit of one of those laws because its effects are comparable to or the same as a violation of the law, or otherwise significantly threatens or harms competition.” *Cel-Tech Commc’ns, Inc. v. Los Angeles Cellular Tel. Co.*, 20 Cal. 4th 163, 186–87, 83 Cal.Rptr.2d 548, 973 P.2d 527 (1999).

Here, AlterG describes Boost as “a direct competitor to AlterG.” Compl. ¶ 117. However, nowhere in its complaint or briefing does AlterG allege or attempt to argue that the misconduct it describes with respect to Defendants threatens an incipient violation of an antitrust law or has effects comparable to a violation of an antitrust law. Indeed, case law suggests that the misconduct of a direct competitor must rise to significantly more serious levels than what has been alleged here to \*1156 sustain a finding of unfairness under the UCL. See, e.g., *In re Acacia Media Techs. Corp.*, No. C 05-01114 JW, 2005 WL 1683660, at \*5 (N.D. Cal. July 19, 2005) (repeated filings of “objectively baseless patent infringement lawsuits” in “bad faith” are covered by antitrust law).

In response, AlterG argues that the false claims made by Defendants have also harmed consumers, Opp. at 18–19, and such harm supports its claim under the unfair prong. For this proposition, Defendants rely on *Luxul Technology Inc. v. Nectarlux, LLC*, 78 F. Supp. 3d 1156 (N.D. Cal. 2015), in which the court determined that the plaintiff had stated a claim under the unfair prong by alleging that the defendant “wrongfully and unfairly represented to third parties that [plaintiff]’s business and/or products are affected by legal issues that do not exist.” *Id.* at 1174. But the parties in *Luxul Technology* were not direct competitors. Rather, the defendant was a sales representative for the plaintiff. *Id.* at 1165. That case is therefore inapposite.

#### 3. “Fraudulent” Prong

[49] To state a claim under the fraudulent prong of the UCL, “it is necessary only to show that members of the public are likely to be deceived” by the business practice or advertising at issue. *In re Tobacco II Cases*, 46 Cal. 4th 298, 312, 93 Cal.Rptr.3d 559, 207 P.3d 20 (2009) (citation and internal quotation marks omitted). Before evaluating the substance of AlterG’s claim under this prong, however, the Court must ensure that AlterG has standing to bring the claim. The UCL limits standing to those individuals who had “suffered injury in fact and has lost money or property as a result of the unfair competition.” Cal. Bus. & Prof. Code § 17204. The California Supreme Court has interpreted this standing

provision as “impos[ing] an actual reliance requirement on plaintiffs prosecuting a private enforcement action under the UCL’s fraud prong.” *In re Tobacco II Cases*, 46 Cal. 4th at 326, 93 Cal.Rptr.3d 559, 207 P.3d 20. Thus, “courts have recognized that UCL fraud plaintiffs must allege their *own* reliance—not the reliance of third parties—to have standing under the UCL.” *O’Connor v. Uber Techs., Inc.*, 58 F. Supp. 3d 989, 1002 (N.D. Cal. 2014) (emphasis in original); see *Kwikset Corp. v. Superior Court*, 51 Cal. 4th 310, 327, 120 Cal.Rptr.3d 741, 246 P.3d 877 (2011) (holding that the “plaintiff must allege he or she was motivated to act or refrain from action based on the truth or falsity of a defendant’s statement”).

[50] AlterG’s fraud claims here are predicated on the allegedly false statements Defendants made “to customers and prospects” about AlterG’s financial situation and product quality. Compl. ¶¶ 45–46. While the complaint explains that AlterG was harmed by Defendants’ fraud because *customers* relied on the misrepresentations and avoided AlterG’s products, there is no allegation that AlterG itself relied on Defendants’ statements. AlterG’s opposition brief does not dispute this. Accordingly, AlterG does not have standing under the UCL to pursue a claim under the fraudulent prong. See *23andMe, Inc. v. Ancestry.com DNA, LLC*, 356 F. Supp. 3d 889, 911 (N.D. Cal. 2018) (dismissing claim under the fraudulent prong of the UCL where plaintiff alleged a competitor’s misrepresentations deceived consumers).

#### 4. Restitution

[51] Damages cannot be recovered through a UCL claim. *Korea Supply Co. v. Lockheed Martin Corp.*, 29 Cal. 4th 1134, 1144, 131 Cal.Rptr.2d 29, 63 P.3d 937 (2003). A plaintiff who prevails on such a claim is limited to injunctive relief and \*1157 restitution. *Id.* Defendants insist that AlterG is not entitled to UCL relief because “restitution under the UCL ... is limited to money or property that defendants took directly from a plaintiff or in which a plaintiff has a vested interest.” *L.A. Taxi Coop., Inc. v. Uber Techs., Inc.*, 114 F. Supp. 3d 852, 867 (N.D. Cal. 2015) (citation and alterations omitted). Defendants’ argument would carry the day if AlterG were seeking to recover money that Defendants made from sales to customers who would otherwise have purchased treadmills from AlterG. In that case, AlterG would not be asking for money that Defendants took directly from AlterG or in which AlterG has a vested interest. *L.A. Taxi Coop.*, 114 F. Supp. 3d at 867. But that is not AlterG’s theory of relief. Rather, AlterG clarifies in its opposition brief that it is seeking to recover the value of the proprietary and

confidential information Defendants misappropriated from AlterG. See Opp. at 19. That information is property in which AlterG “had an ownership interest.” *Korea Supply*, 29 Cal. 4th at 1144–45, 131 Cal.Rptr.2d 29, 63 P.3d 937. AlterG is thus entitled to restitution.

Accordingly, Defendants’ motion to dismiss AlterG’s UCL claim is **GRANTED** as to the unfair and fraudulent prongs. Dismissal of the unfair and fraudulent prong claims is **with prejudice** because AlterG has not demonstrated that Defendants’ alleged conduct threatens an incipient violation of an antitrust law or that AlterG relied on Defendants’ false statements.

#### J. Conspiracy

AlterG’s tenth cause of action alleges that Defendants entered into a conspiracy “to interfere with and damage AlterG’s business and misappropriate AlterG’s intellectual property and confidential information.” Compl. ¶¶ 155–62. Defendants argues this claim must be dismissed because conspiracy cannot be pled as a standalone cause of action.

[52] [53] Defendants are correct that “[c]onspiracy is not a cause of action, but a legal doctrine that imposes liability on persons who, although not actually committing a tort themselves, share with the immediate tortfeasors a common plan or design in its perpetration.” *Applied Equipment Corp. v. Litton Saudi Arabia Ltd.*, 7 Cal. 4th 503, 510–11, 28 Cal.Rptr.2d 475, 869 P.2d 454 (1994). A conspiracy allegation must be “activated by the commission of an actual tort.” *Swipe & Bite, Inc. v. Chow*, 147 F. Supp. 3d 924, 936 (N.D. Cal. 2015) (citing *Applied Equipment*, 7 Cal. 4th at 511, 28 Cal.Rptr.2d 475, 869 P.2d 454). Here, AlterG may be able to state viable tort claims, such as for breach of fiduciary duty and interference with contract, via amendment. Accordingly, Defendants’ motion to dismiss the conspiracy claim as an independent cause of action is **GRANTED**, but AlterG can amend its complaint to state the viable tort claim and to make clear that it is alleging that the Individual Defendants conspired to commit tortious acts and are therefore each liable for those acts under a theory of conspiracy liability.

## IV. CONCLUSION

For the foregoing reasons, the Court **GRANTS** Defendants’ motion to dismiss. The following causes of action are dismissed with prejudice:

- Ninth (UCL claim under the unfair and fraudulent prongs);
- Tenth (conspiracy as an independent cause of action).

The following causes of action are dismissed without prejudice, with leave to amend within 30 days of the date of this Order:

- First (patent infringement);
- \*1158 • Second (breach of contract);
- Third (trade secret misappropriation);
- Fourth (breach of fiduciary duty);
- Fifth (interference with contract);

- Sixth (interference with prospective economic advantage);
- Seventh (false advertisement);
- Eighth (trade libel);
- Ninth (UCL claim under the unlawful prong).

This order disposes of Docket No. 15.

**IT IS SO ORDERED.**

**All Citations**

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## **LEGAL AUTHORITY CA-105**

2020 WL 3833018  
Court of Appeal, Third District, California.

Ronald F. COLEY, Plaintiff and Appellant,  
v.  
ESKATON et al., Defendants and Appellants.

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Filed 6/11/2020  
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Certified for Partial Publication. \*

\* Pursuant to [California Rules of Court, rules 8.1105](#) and [8.1110](#), this opinion is certified for publication with the exception of parts IA, IC, ID, IE, IF, IIB, and IIC of the Discussion.

#### Synopsis

**Background:** Homeowner brought action against homeowners association (HOA), two directors on HOA's board, and housing community operators that employed majority of HOA directors for breach of fiduciary duty and other claims, alleging directors approved actions of HOA for benefit of operators rather than HOA itself and homeowners. Following trial, the Superior Court, Sacramento County, No. 34-2014-00171851-CU-MC-GDS, [David W. Abbott, J.](#), found directors breached fiduciary duty to HOA and its members but declined to find directors liable in their personal capacities and awarded homeowner damages and attorney fees. Operators and directors appealed and homeowner cross-appealed.

**Holdings:** The Court of Appeal, [Raye, J.](#), held that:

[1] directors failed to establish HOA transactions were fair and reasonable;

[2] directors had personal financial interest in transactions they approved that was distinct from interest of HOA members generally; and

[3] directors breached fiduciary duty to HOA members by approving transactions in which they had material financial interest and which were not inherently fair to HOA and its members.

Affirmed in part, reversed in part, and remanded with instructions.

**Procedural Posture(s):** On Appeal; Judgment.

West Headnotes (20)

[1] [Corporations and Business Organizations](#) 🔑

The “business judgment rule” is a policy of deference to a corporate board’s decisionmaking.

[2] [Corporations and Business Organizations](#) 🔑

The common law business judgment rule is similar to the statutory business judgment rule for nonprofit mutual benefit corporations in that it immunizes directors for their corporate decisions that are made in good faith to further the purposes of the corporation, are consistent with the corporation’s governing documents, and comply with public policy. [Cal. Corp. Code § 7231](#).

[3] [Corporations and Business Organizations](#) 🔑

The common law business judgment rule is broader than the statutory business judgment rule for nonprofit mutual benefit corporations in that it insulates from court intervention those management decisions that meet the rule’s requirements. [Cal. Corp. Code § 7231](#).

[4] [Corporations and Business Organizations](#) 🔑

A director cannot obtain the benefit of the business judgment rule when acting under a material conflict of interest.

[5] [Corporations and Business Organizations](#) 🔑



Deference under the business judgment rule is premised on the notion that corporate directors are best able to judge whether a particular transaction will further the company's best interests, but that premise is undermined when directors approve corporate transactions in which they have a material personal interest unrelated to the business's own interest or, particularly, when a majority of directors approve transactions while having a material conflict of interest.

[6] **Corporations and Business Organizations** 🔑

Although the business judgment rule is inapplicable to a director's decision to approve a corporate transaction while having a material conflict of interest, that is not to say that corporate decisions affected by these types of conflicts are improper as a matter of law.

[7] **Corporations and Business Organizations** 🔑

The common law business judgment rule requires interested directors to prove that the business arrangement they approved was fair and reasonable, a rigorous standard that requires them not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein.

[8] **Corporations and Business Organizations** 🔑

Unlike the statutory business judgment rule for nonprofit mutual benefit corporations, the common law business judgment rule is not concerned only with transactions between a corporation and either its directors or a business in which its directors have a material financial interest; rather, recognizing the potential for self-dealing may also exist outside this particular context, the common law business judgment rule requires directors to also satisfy its requirements when they approve other transactions in which

they have a material financial interest distinct from the corporation's own interest. [Cal. Corp. Code § 7233](#).

[9] **Corporations and Business Organizations** 🔑

Under the common law business judgment rule, although a director's conflict of interest with respect to a corporate transaction does not necessarily establish actionable impropriety, it shifts the burden to the director to show the transaction was just and reasonable.

[10] **Corporations and Business Organizations** 🔑

Directors of homeowners association (HOA), a nonprofit mutual benefit corporation, failed to establish that HOA transactions they approved while operating under material conflict of interest were fair and reasonable, as necessary to uphold transactions under common law business judgment rule, where directors made no showing that transactions, namely, assessments against common interest development and individually-owned homes within it, were inherently fair from viewpoint of HOA and those interested therein.

[11] **Corporations and Business Organizations** 🔑

Majority directors who approve a corporate transaction while operating under a material conflict of interest must show the approved transaction was "fair and reasonable," meaning they must not only prove the good faith of the transaction but also show its inherent fairness from the viewpoint of the corporation and those interested therein.

[12] **Corporations and Business Organizations** 🔑

Directors of homeowners association (HOA), a nonprofit mutual benefit corporation, who were employed by housing community operators that were HOA members had a personal financial

interest in HOA's imposition of assessments against homeowners that was distinct from the interest enjoyed by HOA members generally, and, thus, common law business judgment rule did not shield directors' approval of assessments from judicial scrutiny; directors' incomes were tied in part to financial performance of their employers, incentivizing directors to shift costs of operating communities from employers to homeowners.

**[13] Torts** 🔑

The three elements of a cause of action for breach of fiduciary duty are the existence of a fiduciary relationship, a breach of fiduciary duty, and damages.

**[14] Corporations and Business Organizations** 🔑

The directors of a nonprofit mutual benefit corporation are fiduciaries who must act for the benefit of the corporation and its members.

**[15] Common Interest Communities** 🔑

Directors of homeowners association (HOA), a nonprofit mutual benefit corporation, owed fiduciary duty to homeowners who were HOA members.

**[16] Common Interest Communities** 🔑

Directors of homeowners association (HOA), a nonprofit mutual benefit corporation, breached fiduciary duty to HOA members by approving HOA actions in which they had material financial interest, where actions, namely, HOA's assessment of security service fees against homeowners that would have otherwise been paid by housing community operators that employed HOA directors and individual director's disclosure of HOA's privileged communications with its own counsel for director's own benefit, were not inherently fair from viewpoint of HOA and its members.

**[17] Corporations and Business Organizations** 🔑

Although the common law business judgment rule may generally provide a director with immunity for decisions made in good faith, such immunity does not apply when the director is acting under a material conflict of interest.

**[18] Common Interest Communities** 🔑

Homeowner's failure to show that actions by directors of homeowners association (HOA), a nonprofit mutual benefit corporation, were motivated by any specific self-interest or that directors benefited from their breach of fiduciary duty to HOA members, which occurred when directors approved HOA actions that benefited directors' employers while being inherently unfair to HOA and member homeowners, did not preclude homeowner from establishing claim for breach of fiduciary duty; specific self-interest and personal benefit from breach were not elements of cause of action for breach of fiduciary duty.

**[19] Corporations and Business Organizations** 🔑

A corporate director may still be liable for damages resulting from his or her breach of fiduciary duties, even if the director did not personally benefit from that breach; to find otherwise would absolve directors of liability when they abuse their positions to benefit, for example, friends and family, and would inappropriately immunize directors who abuse their positions to benefit themselves but fail to succeed for reasons outside their control.

**[20] Common Interest Communities** 🔑

A director's unlawful failure to abide by a homeowners association's governing documents is mismanagement.



**Witkin Library Reference:** 9 Witkin, *Summary of Cal. Law* (11th ed. 2017) *Corporations*, § 383 [Self-Dealing by Interested Directors.]

APPEAL from a judgment of the Superior Court of Sacramento County, [David W. Abbott](#), Judge. Reversed in part and affirmed in part. (Super. Ct. No. 34-2014-00171851-CU-MC-GDS)

### Attorneys and Law Firms

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### Opinion

[RAYE](#), P. J.

\*1 Eskaton, Eskaton Village-Grass Valley (Eskaton Village), and Eskaton Properties Inc. (collectively, the Eskaton entities) are related corporations that develop and support common interest developments for older adults in Northern California. Ronald F. Coley owns a home in one of their developments, Eskaton Village Grass Valley (the Village). He brought this suit against the Village’s homeowners association, two of the directors on the association’s board, and the directors’ employers (the Eskaton entities), alleging these directors ran the association for the benefit of the Eskaton entities rather than the association and its members.

The trial court agreed with Coley in part, finding these directors breached their fiduciary duty to the homeowners association and its members in several respects. In particular, the court found one director improperly shared with the Eskaton entities the association’s privileged communications with its counsel, and both directors, in violation of the association’s governing documents, approved certain assessments that benefited the Eskaton entities and harmed many of the association’s members. Based on this conduct,

the court found the directors’ employers, the Eskaton entities, were liable for any damages Coley suffered as a result, though it declined to find the directors liable in their personal capacities. It awarded Coley damages of \$2,328.51 and attorney fees of \$654,242.53.

Both parties appealed. The Eskaton entities and the two director defendants (collectively, the defendants) contend the court should have afforded the directors more deference under the business judgment rule—a rule under which courts tend to defer to the decisions of corporate directors. They also claim the court misread the association’s governing documents, miscalculated appropriate damages, and misapplied vicarious-liability principles in finding the Eskaton entities liable for their employees’ conduct even though their employees were not liable themselves. Finally, they assert the court awarded an excessive amount of attorney fees. Coley, in his cross-appeal, raises several additional issues. He contends the court should have found the two directors personally liable for their conduct, and alleges the court wrongly rejected several of his claims against the defendants.

We agree in part with both of the parties. We find, as the defendants contend, that the court miscalculated the damages on certain claims and should, after reducing the damages award on remand, reconsider the awarded attorney fees in light of this reduction. We also agree, as Coley asserts, that the court should have found the two directors personally liable for their actions. In all other respects, we affirm the judgment.

## BACKGROUND

### I. *The Village and the Association*

The Eskaton entities, among other things, develop and support common interest developments for older adults in Northern California. One of those developments is the Village. The Village consists of 130 homes known as the “Patio” homes and 137 rented residences housed in a building known as the “Lodge.” It also consists of several common areas accessible to both Patio and Lodge residents, including walking paths and a maintenance building. Eskaton Village, an Eskaton subsidiary, owns the Lodge and its 137 residences, and various individual homeowners, including Coley, own the 130 Patio homes. Eskaton Properties, another Eskaton subsidiary, is responsible for the Village’s day-to-day management.

\*2 Eskaton Village and the Patio homeowners are members of the Eskaton Village, Grass Valley Homeowners Association (the Association), a nonprofit mutual benefit corporation. A five-member board of directors runs the Association subject to the requirements of the Association's governing document, the "Declaration of Covenants, Conditions and Restrictions for Eskaton Village-Grass Valley Homeowners Association" (or the CC&Rs).

### II. *The Association's Governance Structure*

Since the Association's inception, Eskaton Village has controlled three out of the five seats on the Association's board. Under the CC&Rs, the owners of the 267 housing units (the 137 Lodge residences and 130 Patio homes) are entitled to one vote per housing unit owned. Because Eskaton Village owns a majority of these units (137 of 267), it holds a perpetual voting majority.

Exercising its majority voting power, Eskaton Village has consistently elected three employees of the Eskaton entities to sit on the Association's board. And, at least in recent years, it has appointed directors who are financially incentivized to run the Association for the benefit of Eskaton Village. Two of those employees are defendants here, Todd Murch and Elizabeth L. Donovan. Murch is the chief executive officer and president of all the Eskaton entities. Donovan is the chief operating officer of all the Eskaton entities. Both are paid by Eskaton Properties and receive bonuses and incentive compensation in part based on Eskaton Properties' performance. Eskaton Properties' performance, in turn, is based in part on Eskaton Village's performance. The higher Eskaton Village's operating losses, for example, the lower Eskaton Properties' profits given the latter's subsidizing of Eskaton Village in years of operating losses—which, in fiscal year 2015 alone, amounted in a subsidy of hundreds of thousands of dollars. Given Murch's and Donovan's pay structure, the lower this subsidy (i.e., the better Eskaton Village performs) the higher their potential compensation.

### III. *The Association's Assessments for Security Services*

Under the CC&Rs, the Association is authorized to levy various assessments against Eskaton Village and the Patio owners. Using this authority, the Association has assessed both for, among other things, "Security/Emergency Response" services since its creation in the early 2000s.

For its initial 10 years, the Association allocated the cost of providing these security and emergency response services

equally between Eskaton Village and the Patio owners, with each covering 50 percent of the total cost. But in late 2012, the Association's board, in a three-to-two vote, approved a new budget that increased the Patio owners' relative responsibility for the cost of these services. Under the new budget, the Patio owners would cover 83.3 percent of the total costs of security services and Eskaton Village would cover the remaining 16.7 percent. The Eskaton-affiliated directors, including Murch and Donovan, all voted in favor of the new budget. The two other directors, including Coley, voted against.

### IV. *Coley's Suit and the Trial Court's Judgment*

In November of 2014, Coley and another Patio homeowner, Karen B. Lorini, filed a class action against the Eskaton entities, Murch, Donovan, and, as a nominal defendant, the Association.<sup>1</sup> In their complaint, the two named plaintiffs alleged that Murch and Donovan, acting pursuant to the direction of the Eskaton entities, were managing the Association for the benefit of the Eskaton entities and to the detriment of the Patio owners. In particular, the plaintiffs contended that Murch and Donovan unlawfully voted to require the Patio homeowners to cover 83 percent of the cost associated with security services, allowed Eskaton Village to use the Association's maintenance building rent free, and engaged in various other acts of misconduct to benefit the Eskaton entities. In doing so, the plaintiffs asserted, the defendants breached their fiduciary obligations to the Association and its members and committed elder abuse against Patio owners like Coley who were aged 65 or older.

<sup>1</sup> Coley and Lorini also originally named Mark T. Cullen and Trevor Hammond as additional defendants, but neither were listed in the plaintiffs' final amended complaint.

\*3 Coley and Lorini later amended their complaint to add additional causes of action in light of the defendants' postcomplaint conduct. The first addition concerned the Association's assessment for legal fees. To cover the cost of litigation in this case, the Association initially relied on assessments imposed on both the Patio and Lodge owners. But beginning in late 2015, it began imposing certain fees on the Patio owners alone. Coley and Lorini contended the director defendants violated the Association's CC&Rs in approving this change. The second addition concerned Murch's disclosure of certain records. The Association's attorneys advised the Association on certain matters relating to this litigation. At some point, Murch shared this information with his personal counsel and the Eskaton

entities' counsel. Based on this conduct, Coley and Lorini alleged Murch breached his fiduciary duty to the Association by disclosing the Association's privileged communications.

Before trial, Coley and Lorini moved to certify their action as a class action on behalf of themselves and similarly situated Patio homeowners. But after Coley's individual claims were severed from the proposed class to expedite the resolution of his claims, the parties agreed to stay the hearing on the motion for class certification until after the resolution of Coley's claims.

The trial on Coley's claims began in December of 2015, and in early 2017, the trial court issued its judgment. Before addressing Coley's specific claims, the court first noted a "principle issue in this case guiding the Court's determination of Plaintiff's claims against Defendants is whether a conflict of interest was created when Eskaton retained control of the [Association] Board of Directors by filling three positions with its own employees." The court concluded it was. Although Murch and Donovan, as directors of the Association, were charged with serving the best interest of the Association and all its members, the court found both were financially incentivized to operate the Association for the benefit of one member in particular—Eskaton Village. The court explained that both directors were paid in part based on Eskaton Properties' performance, and that Eskaton Properties' performance in turn was based in part on Eskaton Village's performance. Thus, the court reasoned, "the conclusion is inescapable that the financial success of [Eskaton Village] plays a role in determining [the directors'] compensation and advancement, even if is not the only factor." The court found this pay structure left the directors in an "irreconcilable conflict of interest."

Turning to Coley's specific claims, the trial court agreed in part with six of his 12 causes of action, several of which overlapped. It found Murch and Donovan breached their fiduciary duties and violated the Association's CC&Rs when they voted to raise the Patio owners' share of the security and emergency response costs from 50 percent to 83.3 percent. It found they further breached their fiduciary duties and violated the Association's CC&Rs when they voted to charge certain legal expenses to the Patio owners alone. And it found Murch also breached his fiduciary duty when he disclosed the Association's privileged communications with its counsel to further his own "interest rather than the interest of the [Association]." Because of this conduct, the court found all the defendants—including the corporate defendants—

were liable to pay damages to Coley that resulted from the various breaches of fiduciary duty. The court calculated these damages to be \$2,328.51.

The court, however, clarified in a prejudgment order that only the corporate defendants were in fact liable to pay this amount. Following the court's proposed statement of decision, Coley asked the court to clarify that Murch and Donovan were liable in their personal capacities. But the court declined to find the two directors liable, reasoning that Coley had failed to show they acted in self-interest, benefited from their breach of fiduciary duty, or mismanaged the Association. The court went on to note, however, that Eskaton Properties and Eskaton Village were "vicariously liable" for damages caused by the directors within the scope of their employment.<sup>2</sup>

<sup>2</sup> As the defendants note, the court's reference to Eskaton Properties and Eskaton Village alone, and not also Eskaton, was an apparent oversight.

\*4 Following the court's judgment, Coley moved to obtain attorney fees under [Civil Code section 5975](#), which allows the prevailing party in any action to enforce the CC&Rs of a common interest development to obtain attorney fees and costs. Coley contended the court should find all his attorneys' time compensable, apply a positive multiplier to enhance the fee award, and award total fees in the amount of \$1,140,445.03. The defendants, in opposition, contended the court should instead apply a negative multiplier and award fees only for the time spent on claims that allowed attorney fees. The court struck a middle path. Because it believed the considerations in favor of either a positive or negative multiplier canceled out, it rejected the parties' competing demands for a multiplier and instead declined to apply any multiplier. And because it found "the factual issues between fee-eligible and non-fee eligible claims were inextricably intertwined," it also rejected the defendants' request that Coley be awarded fees only for the time spent on fee-recoverable claims. The court awarded Coley attorney fees in the amount of \$648,058.25 plus accrued interest of \$6,184.28, for a total of \$654,242.53.

Both parties timely appealed the court's judgment.

## DISCUSSION

### I. *The Defendants' Appeal*

A. *The Corporate Defendants' Liability* \*\*

\*\* See footnote \*, *ante*.

B. *Application of the Business Judgment Rule*

[1] The defendants' next claim the court misapplied the business judgment rule. The business judgment rule is a policy of deference to a corporate board's decisionmaking. (*Lamden v. La Jolla Shores Clubdominium Homeowners Assn.* (1999) 21 Cal.4th 249, 257, 87 Cal.Rptr.2d 237, 980 P.2d 940 (*Lamden*)).) But the trial court here found the rule inapplicable because the Eskaton entities' employees who sat on the Association's board had an "irreconcilable conflict of interest" that "preclude[d] the business judgment rule as a defense to liability in this case." According to the defendants, rather than finding this conflict precluded the business judgment rule altogether, the court instead should have afforded the defendants an opportunity to reclaim the benefit of the rule by showing they acted in good faith after reasonably investigating material facts. We view the law differently.

1. *Background law*

\*5 [2] [3] California recognizes two types of business judgment rules: one based on statute and another on the common law. (*Lamden, supra*, 21 Cal.4th at p. 259 & fn. 6, 87 Cal.Rptr.2d 237, 980 P.2d 940.) Corporations Code section 7231 supplies the relevant statutory rule for nonprofit mutual benefit corporations like the Association. Under that statute, a director is not liable for "failure to discharge the person's obligations as a director" if the director acted "in good faith, in a manner such director believes to be in the best interests of the corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances." (Corp. Code, § 7231, subs. (a), (c).) The common law business judgment rule is similar but broader in scope. It is similar in that it immunizes directors for their corporate decisions that are made in "good faith ... to further the purposes of the [corporation], are consistent with the [corporation's] governing documents, and comply with public policy." (*Nahrstedt v. Lakeside Village Condominium Assn.* (1994) 8 Cal.4th 361, 374, 33 Cal.Rptr.2d 63, 878 P.2d 1275; see *Lamden, supra*, 21 Cal.4th at p. 257, 87 Cal.Rptr.2d 237, 980 P.2d 940.) And it is broader in that it also "insulates from court intervention those management decisions" that meet the rule's requirements.

(*Lamden, supra*, 21 Cal.4th at p. 257, 87 Cal.Rptr.2d 237, 980 P.2d 940.)

[4] [5] A director, however, cannot obtain the benefit of the business judgment rule when acting under a material conflict of interest. (*Everest Investors 8 v. McNeil Partners* (2003) 114 Cal.App.4th 411, 430, 8 Cal.Rptr.3d 31 (*Everest Investors*); *Gaillard v. Natomas Co.* (1989) 208 Cal.App.3d 1250, 1263, 256 Cal.Rptr. 702.) Deference under the business judgment rule is premised on the notion that corporate directors are best able to judge whether a particular transaction will further the company's best interests. (*Gaillard, supra*, 208 Cal.App.3d at p. 1263, 256 Cal.Rptr. 702.) But that premise is undermined when directors approve corporate transactions in which they have a material personal interest unrelated to the business's own interest. And it is particularly undermined when a majority of these directors approve transactions while having a material conflict of interest. Under those circumstances, the directors carrying this conflict of interest are precluded from seeking the benefit of the business judgment rule. (See *Everest Investors, supra*, 114 Cal.App.4th at p. 430, 8 Cal.Rptr.3d 31; *Gaillard, supra*, 208 Cal.App.3d at p. 1263, 256 Cal.Rptr. 702.)

[6] [7] [8] But although the business judgment rule is inapplicable under these circumstances, that is not to say that corporate decisions affected by these types of conflicts are improper as a matter of law. As with the business judgment rule generally, statutory and common law requirements are again relevant in this context. Corporations Code section 7233 supplies the relevant statutory rule. It provides, among other things, that an interested director who casts a deciding vote on a transaction must show the "transaction was just and reasonable as to the corporation at the time it was authorized, approved or ratified." (Corp. Code, § 7233, subd. (a)(3).) Section 7233, however, only applies to transactions "between a corporation and one or more of its directors, or between a corporation and any domestic or foreign corporation, firm or association in which one or more of its directors has a material financial interest." (Corp. Code, § 7233, subd. (a).) The common law rule, as before, is similar but broader in scope. It is similar in that it requires interested directors to "prove that the arrangement was fair and reasonable"—a rigorous standard that requires them "not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein." (*Tenzer v. Superscope, Inc.* (1985) 39 Cal.3d 18, 31-32, 216 Cal.Rptr. 130, 702 P.2d 212 (*Tenzer*)).) And it is broader in that, unlike Corporations Code section 7233, it is



not concerned only with transactions between a corporation and either its directors or a business in which its directors have a material financial interest. (See *Corp. Code*, § 7233, subd. (a).) Rather, recognizing the potential for self-dealing may also exist outside this particular context, courts have found directors must also satisfy the common law requirements when they approve other transactions in which they have a material financial interest distinct from the corporation's own interest. (See *Heckmann v. Ahmanson* (1985) 168 Cal.App.3d 119, 127-128, 214 Cal.Rptr. 177 (*Heckmann*) [directors who approved corporate action intended to stave off a company takeover and protect their board positions were required to show “the transaction was entered in good faith” and was “inherent[ly] fair[ ] from the viewpoint of the corporation and those interested therein”]; see also *Remillard Brick Co. v. Remillard-Dandini Co.* (1952) 109 Cal.App.2d 405, 416-421, 241 P.2d 66 [common law requirements of “good faith” and “inherent fairness” exist independent of statutory “‘just and reasonable’” requirements].)

## 2. The trial court's application of the business judgment rule

\*6 [9] Turning to the trial court's decision here, we find the court appropriately summarized the relevant principles governing the business judgment rule. It correctly explained that directors acting under a conflict of interest cannot obtain the benefit of the business judgment rule. (See *Everest Investors, supra*, 114 Cal.App.4th at p. 430, 8 Cal.Rptr.3d 31.) And it rightly added that although “a conflict does not necessarily establish actionable impropriety,” it shifts the burden to the director to show the transaction was “‘just and reasonable.’”<sup>3</sup> (See *Tenzer, supra*, 39 Cal.3d at pp. 31-32, 216 Cal.Rptr. 130, 702 P.2d 212.)

<sup>3</sup> The trial court derived the “just and reasonable” standard from *Corporations Code* section 7233. On the facts here, however, we believe it better to find these principles derive from the common law rather than section 7233. As discussed in Part I.B.1. *ante*, section 7233 only applies to transactions between a corporation and its directors or a business in which its directors have a material financial interest. (*Corp. Code*, § 7233, subd. (a).) And the disputed transactions here do not fit within one of these categories. But even so, we still agree with the court's finding that the director had the burden to show the transaction was just (or

fair) and reasonable. (See *Tenzer, supra*, 39 Cal.3d at pp. 31-32, 216 Cal.Rptr. 130, 702 P.2d 212 [discussing the common law “fair and reasonable” requirements].)

The defendants make no effort to satisfy this “just and reasonable” standard, but instead assert the trial court should have shifted the burden to the Eskaton directors to show they approved the disputed transactions in “good faith” after a “reasonable inquiry.”

In support of this alternative standard, the defendants rely on *Katz v. Chevron Corp.* (1994) 22 Cal.App.4th 1352, 27 Cal.Rptr.2d 681 and *Lee v. Interinsurance Exchange* (1996) 50 Cal.App.4th 694, 57 Cal.Rptr.2d 798. *Katz* concerned a corporate board's defensive actions in response to an attempted corporate takeover—actions that were reviewed under Delaware law. (*Katz, supra*, 22 Cal.App.4th at pp. 1367-1368, 27 Cal.Rptr.2d 681.) Applying Delaware law, the *Katz* court found that because the board directors might have acted to protect their own interests in adopting these defensive measures, the board was not entitled to deference under the business judgment rule unless it first passed the “enhanced” scrutiny test—that is, unless the board showed (1) it had reasonable grounds for believing that “‘a danger to corporate policy and effectiveness existed because of another person's stock ownership’” —which could be established by “‘showing good faith and reasonable investigation’” —and (2) its action was “‘reasonable in relation to the threat posed.’” (*Id.* at p. 1367, 27 Cal.Rptr.2d 681.) The *Lee* court, in turn, relied on *Katz* in discussing California's general background rules on conflicts of interest—even though the *Katz* decision concerned Delaware, not California, law. (*Lee, supra*, 50 Cal.App.4th at p. 715, 57 Cal.Rptr.2d 798.) Never mentioning its principles derived from Delaware law, the *Lee* court suggested that a director is not entitled to the benefit of the business judgment rule in the event of a conflict of interest, unless the director first shows “good faith and reasonable investigation.” (*Ibid.*) But that suggestion was ultimately irrelevant to the case, as the appellants there did not even allege facts establishing a conflict of interest. (*Id.* at pp. 701, 715, 57 Cal.Rptr.2d 798.)

The defendants, in sum, rely on one case that summarized Delaware law, and another case that, in dictum, summarized a case that summarized Delaware law. Belatedly recognizing this heavy reliance on Delaware law after oral argument, the defendants submitted a postargument letter asserting that California courts “may properly rely on corporate law developed in the State of Delaware given that it is identical to

California corporate law for all practical purposes.” (*Oakland Raiders v. National Football League* (2001) 93 Cal.App.4th 572, 586, fn. 5, 113 Cal.Rptr.2d 255.) But even if that were true, it would not favor the defendants’ argument.

\*7 To begin, even under Delaware law, the defendants’ position would fail. Under Delaware law, courts apply “‘enhanced’ ” scrutiny—the type of scrutiny the defendants’ request here—in a narrow set of cases; specifically, “‘whenever the record reflects that a board of directors took defensive measures in response to a perceived threat to corporate policy and effectiveness which touches on issues of control.’ ” (*Gantler v. Stephens* (Del. 2009) 965 A.2d 695, 705.) But they apply “even more exacting scrutiny” when there is evidence of “actual self-interest” that “affects a majority of the directors approving a transaction.” (*Paramount Communications Inc. v. QVC Network Inc.* (Del. 1994) 637 A.2d 34, 42, fn. 9.) And it is the latter scenario, not the former, that describes the facts of our case. Under those circumstances, the directors must prove the “entire fairness” of the transaction—a test requiring directors to “demonstrate both their utmost good faith and the most scrupulous inherent fairness of transactions in which they possess a financial, business or other personal interest which does not devolve upon the corporation or all stockholders generally.” (*Mills Acquisition Co. v. MacMillan, Inc.* (Del. 1989) 559 A.2d 1261, 1280; see *Weinberger v. UOP, Inc.* (Del. 1983) 457 A.2d 701, 710 [“When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain”].)

[10] [11] California law, more importantly, demands the very same of majority directors who approve transactions while operating under a material conflict of interest. Directors faced with such divided loyalties must show the approved transaction was “fair and reasonable”—meaning they must not only “‘prove the good faith of the transaction but also ... show its inherent fairness from the viewpoint of the corporation and those interested therein. [Citation.]’ ” (*Tenzer, supra*, 39 Cal.3d at pp. 31-32, 216 Cal.Rptr. 130, 702 P.2d 212; *Heckmann, supra*, 168 Cal.App.3d at pp. 127-128, 214 Cal.Rptr. 177.) And again, we find the trial court fairly captured this requirement in concluding the Eskaton-affiliated directors, because of their conflict of interest, had the burden to show their approved assessments were “just and reasonable.” The defendants here, however, never made this showing.<sup>4</sup>

4 Although the defendants never contend the directors’ actions were inherently fair, they at least assert the directors acted in good faith. But even there, we question whether their showing could be found sufficient. To demonstrate good faith, the defendants rely principally on two points. First, they contend the California Department of Real Estate’s approval of the creation of the Association (including its management structure) “demonstrates the requisite element of good faith.” But that the department initially approved the creation of the Association does not show the Association’s directors later governed the Association in good faith. Second, the defendants contend the trial court itself found their appointed directors “did nothing worse than make honest mistakes.” But the court only found that Coley failed to show these directors were “motivated by specific self-interest.” It never made an affirmative finding that the directors in fact acted in good faith.

Finally, as an alternative argument, the defendants argue that the Eskaton-affiliated directors had no improper conflict of interest at all, relying on *Lexin v. Superior Court* (2010) 47 Cal.4th 1050, 103 Cal.Rptr.3d 767, 222 P.3d 214 (*Lexin*). But *Lexin* offers them no support. The court in *Lexin* considered whether six city officials who voted on a matter that affected their government pension benefits violated Government Code section 1090—a statute barring public officials from being personally financially interested in the contracts they form in their official capacities. (*Lexin, supra*, 47 Cal.4th at p. 1062, 103 Cal.Rptr.3d 767, 222 P.3d 214.) It ultimately concluded most did not as a matter of law in light of a statutory exception to Government Code section 1090 that applies when the official’s financial interest is the same as the official’s constituency. (*Lexin, supra*, 47 Cal.4th at pp. 1063, 1094, 103 Cal.Rptr.3d 767, 222 P.3d 214.) As the court explained, although the charged officials were financially interested in the matter, their interest was shared by “thousands of their fellow retirement system members.” (*Id.* at p. 1063, 103 Cal.Rptr.3d 767, 222 P.3d 214.)

\*8 [12] But the defendants here can point to no similar statutory exception to absolve them of their conflict. Nor would it matter if they could. The city officials in *Lexin* voted on a matter that affected them and their constituents in similar ways. For that reason, the court found, “the financial interest in question is not personal to an employee or official because it is shared with like members of the public agency’s constituency.” (*Lexin, supra*, 47 Cal.4th at p. 1095, 103

Cal.Rptr.3d 767, 222 P.3d 214.) But the same cannot be said of the Eskaton-controlled directors. Their financial interest was personal and distinct from that enjoyed by the Association members generally. As the trial court explained, the directors' incomes were tied in part to the financial performance of Eskaton Village—incentivizing the directors to shift costs from Eskaton Village to the Patio owners. And that is what they ultimately did, to the benefit of the Eskaton entities and the detriment of the Patio owners.

C.-F. \*\*\*

\*\*\* See footnote \*, *ante*.

## II. Coley's Cross-Appeal

### A. Murch's and Donovan's Liability

Coley, in his cross-appeal, first contends the trial court should have found Murch and Donovan liable in their personal capacities. The trial court declined to do so because it concluded “the evidence failed to establish (1) conduct by the majority directors was motivated by specific self-interest; (2) the individual directors benefited from their breach of fiduciary duty or (3) that the actions of the directors amounted to mismanagement of the HOA.” According to Coley, the court erred in requiring this showing; it was enough, he maintains, that he showed (1) the directors had a fiduciary obligation to him and other Patio owners, (2) they breached this duty by approving transactions—while acting under a material conflict of interest—that were unfair to Coley and other Patio owners, and (3) Coley suffered damages as a result of this breach. We agree.

[13] [14] The trial court correctly set out the three elements of the cause of action at issue: existence of a fiduciary relationship, breach of fiduciary duty, and damages. (*Oasis West Realty, LLC v. Goldman* (2011) 51 Cal.4th 811, 820, 124 Cal.Rptr.3d 256, 250 P.3d 1115 (*Oasis West Realty*)). And as it further explained, the directors of a nonprofit mutual benefit corporation, like the Association here, are fiduciaries who must act for the benefit of the corporation and its members. (*Frances T. v. Village Green Owners Assn.* (1986) 42 Cal.3d 490, 513, 229 Cal.Rptr. 456, 723 P.2d 573 (*Frances T.*) [“Directors of nonprofit corporations ... are fiduciaries who are required to exercise their powers in accordance with the duties imposed by the Corporations Code”]; *Cohen v. S & S Construction Co.* (1983) 151 Cal.App.3d 941, 945, 201 Cal.Rptr. 173 [“This fiduciary duty extends to individual homeowners, not just the homeowners association”].)

The court also correctly applied these principles to the facts. It found the directors Murch and Donovan owed a fiduciary duty to the Association and its members—satisfying the first element for breach of fiduciary duty. It then concluded they breached their fiduciary duties by voting, inconsistent with the CC&Rs, to (1) raise the Patio owners' share of the security services from 50 percent to 83.3 percent, and (2) require the Patio owners alone, and not also the Lodge owners, to cover certain legal fees—satisfying the second element. It found Murch further breached his fiduciary responsibility by disclosing the Association's privileged communications with its counsel. Finally, the court found Coley suffered damages as a result of the directors' breaches of their fiduciary duties—satisfying the third and final element for breach of fiduciary duty.

\*17 [15] [16] Each of these findings were supported by substantial evidence. First, as all parties accept, Murch and Donovan owed a fiduciary duty to Coley and other Patio owners. (See *Frances T.*, *supra*, 42 Cal.3d at p. 514, 229 Cal.Rptr. 456, 723 P.2d 573; *Jones v. H.F. Ahmanson & Co.* (1969) 1 Cal.3d 93, 108-110, 81 Cal.Rptr. 592, 460 P.2d 464.) Second, substantial evidence supports the court's finding that Murch and Donovan breached this duty. As fiduciaries, Murch and Donovan were bound not to approve a transaction in which they had a material financial interest unless that transaction was “fair and reasonable”—meaning the transaction was entered in “ ‘good faith’ ” and was “ ‘inherent[ly] fair[ ] from the viewpoint of the corporation and those interested therein.’ ” (See *Tenzer*, *supra*, 39 Cal.3d at pp. 31-32, 216 Cal.Rptr. 130, 702 P.2d 212; see also *id.* at p. 32, 216 Cal.Rptr. 130, 702 P.2d 212 [discussing “the standards of fairness and good faith required of a fiduciary” in cases involving potential self-dealing]; *Jones*, *supra*, 1 Cal.3d at pp. 110, 112, 81 Cal.Rptr. 592, 460 P.2d 464 [majority shareholders owe a fiduciary duty of “good faith and inherent fairness to the minority in any transaction where control of the corporation is material”]; this “comprehensive rule of ‘inherent fairness’ ” also applies to directors who engage in transactions that conflict with their duty to shareholders]; *Heckmann*, *supra*, 168 Cal.App.3d at pp. 127-128, 214 Cal.Rptr. 177.)

But they failed to meet this standard. Even if the directors required the Patio owners to pay a greater share of the security-services fees and legal fees in good faith—which is debatable (see fn. No. 4, *ante*)—it could not be said that their doing so in violation of the CC&Rs was fair

from the viewpoint of the Patio owners. Nor do we find Murch’s disclosure of the Association’s privileged communications was fair from the Patio owners’ perspective. Finally, substantial evidence supports the court’s finding that Coley and similarly situated Patio owners suffered damages as a result of these breaches—though, as discussed *ante* in Parts I.D. and I.E., some of the awarded damages must be adjusted downward.

Although the trial court found the directors breached their fiduciary duties, it declined to find them personally liable, reasoning in a prejudgment order that something more is required before the directors may be found personally liable for their misconduct. In the court’s view, Coley needed to show, in addition to the directors’ breach of their fiduciary duties, that they acted in self-interest, benefited from their breach of fiduciary duty, and mismanaged the Association.

[17] This was error. Once Coley established the existence of a fiduciary relationship, breach of fiduciary duty, and damages, he was entitled to damages absent some applicable affirmative defense. (See *Meister v. Mensinger* (2014) 230 Cal.App.4th 381, 395-397, 178 Cal.Rptr.3d 604 [“ ‘Where a breach of fiduciary duty occurs, a variety of equitable [and legal] remedies are available’ ”]; see also *Oasis West Realty, supra*, 51 Cal.4th at p. 820, 124 Cal.Rptr.3d 256, 250 P.3d 1115 [“The elements of a cause of action for breach of fiduciary duty are the existence of a fiduciary relationship, breach of fiduciary duty, and damages”]; *Frances T., supra*, 42 Cal.3d at pp. 503-504, 229 Cal.Rptr. 456, 723 P.2d 573 [corporate directors and officers may be liable for corporate wrongs when they “ ‘authorize[ ], direct[ ], or in some meaningful sense actively participate[ ] in the wrongful conduct’ ”].) As we have explained, although the common law business judgment rule may generally provide a director with immunity for decisions made in good faith, such immunity does not apply when, as here, the director is acting under a material conflict of interest.

[18] In demanding more from Coley before awarding damages, the court asked for too much. The court first faulted Coley for failing to show the “conduct by the majority directors was motivated by specific self-interest.” But even if the directors were not “motivated by specific self-interest,” and even if they acted in good faith, that would not be reason enough to avoid liability. Again, considering the directors’ material conflict of interest in the transactions they approved, they were required “ ‘not only to prove the good faith of the transaction but also to show its inherent

fairness from the viewpoint of the corporation and those interested therein.’ [Citation.]” (*Tenzer, supra*, 39 Cal.3d at p. 32, 216 Cal.Rptr. 130, 702 P.2d 212.) And for reasons already discussed, the directors could not show their challenged actions were fair to Coley and other Patio owners.

\*18 [19] The court next took issue with Coley’s failure to show “the individual directors benefitted from their breach of fiduciary duty.” But a director may still be liable for damages resulting from his or her breach of fiduciary duties, even if the director did not personally benefit from that breach. (See *St. James Armenian Church of Los Angeles v. Kurkjian* (1975) 47 Cal.App.3d 547, 553, 121 Cal.Rptr. 214 [“where a fiduciary, in breach of his duty of disclosure, causes secret profits to flow to a third party, the fiduciary may be held liable for those profits even though he did not personally receive any part of them”].) To find otherwise would absolve directors of liability when they abuse their positions to benefit, for example, friends and family. It would also inappropriately immunize directors who abuse their positions to benefit themselves but fail to succeed for reasons outside their control.

[20] Finally, the court faulted Coley for failing to show “that the actions of the directors amounted to mismanagement of the [Association].” But the directors’ failure to comply with the Association’s CC&Rs was mismanagement—at least to the extent of this failure. It may not have been pervasive mismanagement. It may not have been egregious mismanagement. But an unlawful failure to abide by an association’s governing documents is mismanagement to some degree nonetheless.

We find, in sum, the trial court should have found both Murch and Donovan personally liable for any damages resulting from their breaches of their fiduciary duties. We remand to allow the court to determine the amount of these damages consistent with Parts I.D. and I.E. of our opinion. We also remand to allow the court to determine the directors’ liability, if any, for Coley’s attorney fees.

B.-C.†

† See footnote \*, *ante*.

#### DISPOSITION

The judgment is reversed in part and affirmed in part. We direct the trial court to enter a modified judgment finding



Murch and Donovan liable in their personal capacities for their respective breaches of their fiduciary duties. We also remand to allow the court to recalculate the damages award consistent with Parts I.D. and I.E. of our opinion; to consider whether the awarded attorney fees should be reduced in light of the reduced damages; and to determine Murch's and Donovan's liability for damages and their liability, if any, for Coley's attorney fees. In all other respects, the judgment is affirmed. The parties shall bear their own costs on appeal. (Cal. Rules of Court, rule 8.278(a)(5).)

We concur:

[MAURO, J.](#)

[RENNER, J.](#)

**All Citations**

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## **LEGAL AUTHORITY CA-106**

248 Cal.App.4th 268

Court of Appeal, Fourth District, Division 1, California.

PALM SPRINGS VILLAS II  
HOMEOWNERS ASSOCIATION, INC.,  
Cross-complainant and Appellant,

v.

Erna PARTH, Cross-defendant and Respondent.

Do68731

Filed June 21, 2016

As Modified on Denial of Rehearing July 14, 2016

Petition for Review Denied October 12, 2016

**Synopsis**

**Background:** Condominium homeowners association brought action against former president for breach of fiduciary duty and breach of governing documents based on actions she took while president of the association. The Superior Court, Riverside County, No. INC1202588, [John G. Evans, J.](#), sustained former president's demurrer without leave to amend and granted summary judgment for former president, and association appealed.

**Holdings:** The Court of Appeal, [Aaron, J.](#), held that:

[1] genuine issue of material fact as to whether former president breached governing documents, and whether such breach fell outside the business judgment rule, precluded summary judgment under the business judgment rule on breach of fiduciary duty claim;

[2] genuine issue of material fact as to whether former president exercised reasonable diligence in investigating and paying roofers precluded summary judgment under the business judgment rule;

[3] genuine issue of material fact as to whether former president exercised sufficient diligence to inform herself of association's requirements pertaining to two loans secured by association assets precluded summary judgment under the business judgment rule;

[4] genuine issue of material fact as to whether former president acted in good faith precluded summary judgment under the business judgment rule;

[5] genuine issues of material fact as to application of exculpatory clause in conditions, covenants and restrictions precluded summary judgment; and

[6] association's cause of action for breach of governing documents was duplicative of cause of action for breach of fiduciary duty and thus was subject to dismissal by way of demurrer.

Reversed in part, affirmed in part.

**Procedural Posture(s):** On Appeal; Motion for Summary Judgment; Demurrer to Complaint.

West Headnotes (24)

**[1] Appeal and Error**  **Summary Judgment**

A summary judgment is not entitled to a presumption of correctness on appeal.

[1 Cases that cite this headnote](#)

**[2] Corporations and Business Organizations**  **Business judgment rule in general**

The common law business judgment rule refers to a judicial policy of deference to the business judgment of corporate directors in the exercise of their broad discretion in making corporate decisions; under this rule, a director is not liable for a mistake in business judgment which is made in good faith and in what he or she believes to be the best interests of the corporation, where no conflict of interest exists.


[3 Cases that cite this headnote](#)

**[3] Corporations and Business Organizations**  **Business judgment rule in general**

Notwithstanding the deference to a director's business judgment, the business judgment rule

does not immunize a director from liability in the case of his or her abdication of corporate responsibilities. *Cal. Corp. Code § 7231*.


[2 Cases that cite this headnote](#)

- [4] **Corporations and Business Organizations**  Business judgment rule in general


**Corporations and Business**

**Organizations**  Duty to inquire; knowledge or notice

A director cannot close his eyes to what is going on about him in the conduct of the business of the corporation and have it said that he is exercising business judgment. *Cal. Corp. Code § 7231*.

- [5] **Corporations and Business Organizations**  Business judgment rule in general

Whether a director exercised reasonable diligence is one of the factual prerequisites to application of the business judgment rule. *Cal. Corp. Code § 7231*.

- [6] **Corporations and Business Organizations**  Business judgment rule in general

**Corporations and Business**

**Organizations**  Duty to inquire; knowledge or notice

**Corporations and Business**

**Organizations**  Trial and judgment

The business judgment rule raises various issues of fact, including whether a director acted as an ordinarily prudent person under similar circumstances and made a reasonable inquiry as indicated by the circumstances; such questions generally should be left to a trier of fact, but can become questions of law where the evidence establishes there is no controverted material fact. *Cal. Corp. Code § 7231*.

[1 Cases that cite this headnote](#)

- [7] **Corporations and Business Organizations**  Effect of ultra vires acts

“Ultra vires conduct” is conduct that is beyond the power of the corporation, not an individual director.

- [8] **Judgment**  Particular Cases

Genuine issue of material fact as to whether former condominium association president breached governing documents, and whether such breach fell outside the business judgment rule, precluded summary judgment under the business judgment rule in homeowners association's action against former president for breach of fiduciary duty.

[1 Cases that cite this headnote](#)

- [9] **Corporations and Business Organizations**  Business judgment rule in general

Conduct contrary to governing documents may fall outside the business judgment rule. *Cal. Corp. Code § 7231*.

- [10] **Judgment**  Particular Cases

Genuine issue of material fact as to whether former condominium homeowners association president exercised reasonable diligence in investigating and paying roofers precluded summary judgment under the business judgment rule in association's action against former president for breach of fiduciary duty. *Cal. Corp. Code § 7231*.

- [11] **Judgment**  Particular Cases

Genuine issue of material fact as to whether former condominium homeowners association president exercised sufficient diligence to inform herself of association's requirements pertaining to two loans secured by association assets precluded summary judgment under the business judgment rule in association's action against

former president for breach of fiduciary duty. Cal. Corp. Code § 7231.

**[12] Judgment**  Particular Cases

Genuine issue of material fact as to whether former condominium homeowners association president attempted to inform herself as to the extent of her and board's authority to approve multi-year landscaping contract without member approval precluded summary judgment under the business judgment rule in association's action against former president for breach of fiduciary duty. Cal. Corp. Code § 7231.

**[13] Judgment**  Particular Cases

Genuine issue of material fact as to whether former condominium homeowners association president proceeded with reasonable diligence in connection with property management company's termination precluded summary judgment under the business judgment rule in association's action against former president for breach of fiduciary duty. Cal. Corp. Code § 7231.

**[14] Judgment**  Particular Cases

Genuine issue of material fact as to whether former condominium homeowners association president exercised sufficient diligence when executing security contract precluded summary judgment under the business judgment rule in association's action against former president for breach of fiduciary duty. Cal. Corp. Code § 7231.

**[15] Judgment**  Particular Cases

Genuine issue of material fact as to whether former condominium homeowners association president acted in good faith in connection with various acts as president, including entering into contracts and loans, precluded summary judgment under the business judgment rule in association's action against former president for breach of fiduciary duty.

**[16] Appeal and Error**  Particular Cases and Contexts

Court of Appeal would deem forfeited condominium homeowners association's breach of fiduciary duty challenges to former presidents actions which were unsupported by argument and/or specific authority in appellate brief.

**[17] Appeal and Error**  Evidence and Trial

Former condominium homeowners association's president forfeited contention that evidence proffered in opposition to her motion for summary judgment on association's breach of fiduciary duty claims was inadmissible, where former president's appellate brief cited only her own evidentiary objections, rather than any ruling by the trial court, and did not offer any argument regarding the evidence itself other than to state generally that evidence without foundation is inadmissible.

[1 Cases that cite this headnote](#)

**[18] Corporations and Business Organizations**  Business judgment rule in general

**Corporations and Business Organizations**  Degree of care required and negligence

There is no conflict between the business judgment rule and negligence, and application of that rule presupposes that reasonable diligence has in fact been exercised. Cal. Corp. Code § 7231.

**[19] Judgment**  Particular Cases

Genuine issues of material fact as to application of exculpatory clause in condominium homeowners association's conditions, covenants, and restrictions to association's breach of fiduciary claim against former president based on former president's actions, including whether she acted "upon the basis of such information as may be possessed" and whether she performed her duties in "good faith, and without willful

or intentional misconduct” precluded summary judgment in association's action against former president for breach of fiduciary duty.

**[20] Appeal and Error** — Reply briefs

Condominium homeowners association could rely on business judgment rule arguments and evidence for issue of whether exculpatory clause in covenants, conditions and restrictions precluded form association president's liability for breach of fiduciary duty, where, although the association did not address the issue until its reply brief, it took the position that the exculpatory clause was a recitation of the business judgment rule, while president relied on the same undisputed facts to support both issues.

**[21] Fraud** — Time to sue and limitations

Purported four-year statute of limitations could not apply to only portion of condominium homeowners association's breach of fiduciary claim against former president.

**[22] Judgment** — Bar of statute of limitations

Genuine issues of material fact precluded resolution of statute of limitations issues at summary judgment stage in condominium homeowners association's breach of fiduciary duty action against association's former president.

**[23] Pleading** — Particular causes or grounds of action

**Pleading** — Surplusage and irrelevant, immaterial, or redundant matter

Condominium homeowners association's cause of action against former president for breach of governing documents was duplicative of cause of action for breach of fiduciary duty and thus was subject to dismissal by way of demurrer.

[1 Cases that cite this headnote](#)

**[24] Appeal and Error** — Pleadings

Condominium homeowners association failed to offer any argument in appellate brief as to how it could amend its pleading to render breach of governing documents claim sufficient, and thus forfeited argument on appeal that trial court erred in sustaining former president's demurrer without leave to amend on grounds claim duplicated breach of fiduciary duty claim.

*See* 12 Witkin, *Summary of Cal. Law* (10th ed. 2005) *Real Property*, § 104.

[3 Cases that cite this headnote](#)

**\*\*510** APPEAL from a judgment of the Superior Court of Riverside County, [John G. Evans](#), Judge. Reversed in part, affirmed in part. (Super. Ct. No. INC1202588)

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[AARON, J.](#)

**\*271 I**

INTRODUCTION

The Palm Springs Villas II Homeowners Association, Inc. (Association), appeals from a judgment entered in favor of Erna Parth, in connection with actions she took while simultaneously serving as president of the Association and on its board of directors (Board). The court granted Parth's motion for summary judgment as to the Association's claim for breach of fiduciary duty on the basis of the business judgment rule and an exculpatory provision contained in the Association's declaration of covenants, conditions, and restrictions (CC&Rs). The court had previously sustained Parth's demurrer to the Association's claim for breach of

governing documents without leave to amend, finding that the Association failed to allege a cognizable breach.

On appeal, the Association argues that the trial court erred in its application of the business judgment rule and that there remain material issues of fact in dispute regarding whether Parth exercised reasonable **\*\*511** diligence. We agree that the record discloses triable issues of fact that should not have been resolved on summary judgment. We therefore reverse the judgment in favor of Parth. The Association also contends that it stated a claim for breach of the governing documents and that the court erred in sustaining Parth's demurrer. We conclude that the document cause of action is, at best, duplicative of the fiduciary breach cause and affirm the ruling sustaining the demurrer as to that cause of action without leave to amend.

## II

### FACTUAL AND PROCEDURAL BACKGROUND<sup>1</sup>

<sup>1</sup> We rely on the facts that the parties set forth in their separate statements in the trial court and the evidence cited therein, as well as other evidence submitted with the parties' papers below. (*Sandell v. Taylor–Listug, Inc.* (2010) 188 Cal.App.4th 297, 303, fn. 1, 115 Cal.Rptr.3d 453.) However, we do not rely on evidence to which objections were sustained. (*Wall Street Network, Ltd. v. New York Times Co.* (2008) 164 Cal.App.4th 1171, 1176, 80 Cal.Rptr.3d 6.)

#### A. Background on Palm Springs Villas II and its governance

The Association is the governing body for Palm Springs Villas II, a condominium development, and is organized as a nonprofit corporation under California law. The Board, comprised of five homeowners or their agents, governs the Association. The Association's governing documents include the CC&Rs and its bylaws. Each homeowner is an Association member and is required to comply with the terms set forth in these documents.

**\*272** Certain provisions reserve to the Board the authority to take particular actions. Article VI, **section 3, of the CC&Rs** provides that the Board “shall have authority to conduct all business affairs of common interest to all Owners.” Article VI, section 1, of the bylaws describes the Board's

powers, including to “contract ... for maintenance, ... and services” and to “borrow money and incur indebtedness ... provided, however, that no property of the association shall be encumbered as security for any such debt except under the vote of the majority of the members entitled to vote....”

Other provisions limit the Board's power and retain authority for the members. Article VI, section 1, of the bylaws explains that “[n]otwithstanding the foregoing, the Board shall not, except with the vote or written assent of a majority of the unit owners ... [¶] ... [e]nter into a contract with a third person wherein the third person will furnish goods or services for the common area or the association for a term longer than one year....” Article XVI, **section 2, of the CC&Rs** provides that “[n]otwithstanding any other provision of this Declaration or the Bylaws, the prior written approval of at least two-thirds (2/3) of the ... Owners ... shall be required” for actions including “the ... encumbrance, ... whether by act or omission, of the Common Area....”

The CC&Rs also contain an exculpatory provision. Article VI, section 16, provides: “No member of the Board ... shall be personally liable to any Owner, or to any other party, including the Association, for any damage, loss or prejudice of the Association, the Board, the Manager or any other representative or employee of the Association, or any committee, or any officer of the Association, provided that such person has, upon the basis of such information as may be possessed by him, acted in good faith, and without willful or intentional misconduct.”

**\*\*512** During the relevant time, Parth was president of the Association, as well as a Board member.

#### B. Events leading to breach allegations

##### 1. Roofing repairs

In 2006, the Board hired AWS Roofing and Waterproofing Consultants (AWS) in connection with roofing repairs, with the intention that AWS would vet the companies submitting bids and perform other tasks related to the repairs. According to Parth, AWS prepared a budget estimate for the repairs, the Board submitted a request to the members for a special assessment to offset these costs, and the members voted against the request. Parth then found a roofing company on her own, without consulting either the Board or AWS.

**\*273** Parth indicated that she tried to contact the roofing company that had previously worked on the roofs, but it



was no longer in business, and that she could not find another roofer due to the Association's financial condition. She obtained the telephone number for a company called Warren Roofing from a contractor that was working on a unit. The record reflects that the person Parth contacted was Gene Layton. At his deposition, Layton stated that he held a contractor's license for a company called Bonded Roofing and that he had a relationship with Warren Roofing, which held a roofing license. When asked about that relationship, Layton explained that on a large project, he would be the project manager.

At Parth's deposition, Association counsel asked Parth if she had investigated whether Warren Roofing had a valid license. She replied, "[h]e does and did and bonded and insured." Counsel clarified "[t]here's a Bonded Roofing and Warren Roofing. Who did you hire?" Parth responded "One Roofing. That's all one company, I think." Counsel then asked if she had "investigate[d] whether Bonded Roofing was licensed," and Parth answered, "I did not investigate anything."

According to a June 2007 Board resolution, the Board hired Bonded Roofing to work on a time and materials basis. Layton said that he never met with the Board in a formal meeting or submitted a bid for the work before he started work on the roof. The Association had no records of a written contract with Bonded Roofing or any other roofer.

Warren Roofing submitted invoices and was ultimately paid more than \$1.19 million for the work. Many of the checks were signed by Parth. Layton stated that "Bonded Roofing had nothing to do with the money on this job" and that he was paid by Warren Roofing. Boardmember Tom Thomas indicated that no invoices from Warren Roofing were included in the packets provided to the Board members each month, and Boardmember Robert Michael likewise did not recall having seen the invoices. Parth explained that she relied on Board member and treasurer Robert ApRoberts, a retired certified public accountant, to review invoices. Larry Gliko, the Association's contracting expert, opined that the invoices submitted by Warren Roofing were "not at all characteristic" of those typically used in the building industry or submitted to homeowners' associations, included amounts that Gliko viewed as unnecessary, and charged the Association "almost double" what the work should have cost. Gliko also opined that "the work performed by Warren Roofing [was] deficient," "fell far below the standard of care," and "require[d] significant repairs."

#### *\*274 2. Repaving projects and loans*

In April 2007, the Board voted to hire a construction company to repair the walkways. **\*\*513** The Board asked the membership to vote on a special assessment to fund this and other repairs. The membership voted to approve the special assessment.

In July 2007, Parth signed promissory notes for \$900,000 and \$325,000, secured by the Association's assets and property. She stated that at the time the special assessment was approved, the Board was investigating the possibility of obtaining a loan to raise the capital needed to immediately commence work on the walkway project. Thomas indicated that, as an Association member, he was never asked to approve the debt and did not learn about it until this litigation commenced. The Association had no records indicating that the members were ever informed about, or voted on, the debt.

In April 2010, the Board approved a bid from a paving company to perform repaving work. According to Parth, the Board elected to finance this repaving project with a bank loan, the Board reviewed the loan at the April 2010 meeting, and "unanimously approved" that Parth and/or ApRoberts would sign the loan documents. Parth further stated that at a special Board meeting in May 2010, attended by her, ApRoberts, and Boardmember Elvira Kitt-Kellam, the Board "resolved that the Association had the power to borrow and pledge collateral" and authorized her and ApRoberts to execute loan documents. Thomas stated that he never received notice of this meeting. In May 2010, Parth and ApRoberts signed a promissory note for \$550,000, secured by the Association's accounts receivable and assets. Thomas indicated that he was never asked to vote on this debt and, again, there were no Association records indicating that the members were notified about or voted on it.

In construction and business loan agreements in connection with the 2007 and 2010 notes, Parth and ApRoberts represented that the agreements were "duly authorized by all necessary action by [the Association]" and did not conflict with the Association's organizational documents or bylaws. Parth testified at her deposition that she had not reviewed the CC&Rs or bylaws regarding her authority to execute a promissory note and did not know whether she had such authority under the CC&Rs. In her declaration in support of summary judgment, Parth explained that she believed she "had authority to borrow money and execute loan documents on behalf of the Association in [her] capacity as president," and was "unaware that a vote of the majority of the members



was required in order to pledge the Association's assets as security for the loan." She also indicated that "no one advised [her] that she did not have authority to sign the loan documents ... or that a vote of the membership was required."

### \*275 3. *Jesse's Landscaping*

At a December 2010 Board executive meeting attended by Parth, Michael, and Kitt-Kellam, those Board members approved and signed a five-year contract with Jesse's Landscaping. Thomas indicated that he was not given notice of the meeting. At her deposition, in response to a question regarding whether she had the authority to sign a five-year contract, Parth answered, "I don't know." During the same line of questioning, Parth also acknowledged that her "understanding of what [her] authority is under the bylaws" was "[n]one."

### 4. *Termination of Personalized Property Management*

During the relevant time period, the Association's management company was Personalized Property Management (PPM). According to Parth, PPM's owner advised \*\*514 her in or around June or July 2011 that PPM no longer wanted to provide management services for the Association. At a July 9, 2011 Board meeting regarding termination of PPM, the Board tabled any decision to terminate PPM until bids from other companies were obtained and reviewed. Parth proceeded to hire the Lyttleton Company to serve as the Association's new management company. Thomas stated that he never received written notice of a Board meeting to vote on the hiring of Lyttleton. Parth noticed an executive meeting for July 16, 2011, to discuss termination of PPM and retention of a new company, at which time the Board voted three to two to terminate PPM. Thomas stated that he objected to the vote at the time, based on the Board's prior decision to table the matter.

### 5. *Desert Protection Security Services contract*

Gary Drawert, doing business as Desert Protection Security Services (Desert Protection), had provided security services for Palm Springs Villas II since 2004. The Association executed a written contract with Desert Protection in December 2003 for one year of security services. Thomas stated that, after joining the Board, he learned that Desert Protection and other vendors were providing services pursuant to "oral or month-to-month agreements." In July 2010, the Board authorized Thomas to obtain bids from security companies to provide security services for 2011.

In January 2011, Parth signed a one-year contract with Desert Protection. Her understanding was that "any contract that was not renewed in writing would ... be automatically renewed until terminated" and that she was \*276 "merely updating the contract, as instructed by management."<sup>2</sup> She believed that she had the "authority to sign the contract as the Association's president." She further explained that, at the time, the Board had not voted to terminate Desert Protection and discussions regarding a new security company had been tabled.

<sup>2</sup> Although Parth's statement that she *believed* that she had been instructed by management to enter into the contract with Desert Protection is in the record, the trial court sustained an objection to her declaration statement that she was told that the contract "needed to be updated and was ready to be signed."

There were no records indicating that Parth submitted the 2011 Desert Protection agreement to the Board for review or that the Board authorized her to execute it. According to Thomas, Parth did not inform the other Board members that she had signed the agreement. Michael likewise indicated that he had not attended any Board meeting at which the agreement was discussed, and he did not recall the Board having voted on it. Kitt-Kellam stated that the Board never authorized the contract.

In February 2011, the Association's manager sent Parth and others an e-mail recommending that the Board update certain contracts, including the contract with Desert Protection. Thomas presented the security company bids at a March 2011 Board meeting. The Board tabled the discussion at this meeting and at the subsequent April 2011 meeting. At the July 2011 meeting, the Board approved a proposal from Securitas in a three-to-one vote, with Parth abstaining. According to Thomas, Parth did not disclose at any of these meetings that she had signed a one-year contract with Desert Protection in January 2011. Following the July 2011 Board meeting, Desert Protection was sent a 30-day termination letter, based on the Board's understanding that the company was operating on a month-to-month basis.

\*\*515 In August 2011, Gary Drawert, the principal of Desert Protection, left a voicemail message for Thomas regarding the Desert Protection agreement. Thomas indicated that prior to this voicemail, he was not aware of the agreement. At the

September 2011 Board meeting, Parth produced the Desert Protection agreement. The Board did not ratify it.

*C. Desert Protection sues and the Association files a cross-complaint*

Drawert sued the Association for breach of contract. The Association cross-complained against Desert Protection and Parth. Following an initial demurrer, the Association filed the operative first amended cross-complaint. The Association settled with Drawert.

With respect to Parth, the Association asserted causes of action for breach of fiduciary duty and breach of governing documents. The cause of action for \*277 breach of fiduciary duty alleged that Parth had breached her duties to comply with the governing documents and to avoid causing harm to the Association by, among other things, refusing to submit bids or contracts to the Board, “unilaterally terminating” PPM, and signing the contract with Desert Protection. The breach of governing documents cause of action identified CC&R and bylaw provisions and identified actions taken by Parth in breach of these provisions, including the termination of PPM and entering into the Desert Protection contract.

Parth demurred to the first amended cross-complaint. With respect to the governing documents claim, she contended that the claim failed to state a cause of action and was uncertain. The court sustained the demurrer without leave to amend as to this cause of action. We discuss this ruling in more detail, *post*.

Parth moved for summary judgment, contending that the claim of breach of fiduciary duty was barred by the business judgment rule and by the exculpatory provision in the CC&Rs. The trial court granted the motion. In doing so, the court described the business judgment rule (including the requirement that directors “act[ ] on an informed basis”) and observed that courts will not hold directors liable for errors in judgment, as long as the directors were: “(1) disinterested and independent; (2) acting in good faith; and (3) reasonably diligent in informing themselves of the facts.” The court further noted that the plaintiff has the burden of demonstrating, among other things, that “the decision ... was made in bad faith (e.g., fraudulently) or without the requisite degree of care and diligence.”<sup>3</sup>

<sup>3</sup> The trial court also stated that the “business judgment rule standard is one of gross negligence

—i.e., failure to exercise even slight care,” citing *Katz v. Chevron Corp.* (1994) 22 Cal.App.4th 1352, 27 Cal.Rptr.2d 681. The court did not explain how this standard relates to the components of the business judgment rule. The parties likewise cite the concept without such analysis. Given that *Katz* relies on Delaware law for this standard and the issues before us can be resolved according to the standard of reasonable diligence under California law, we will not focus on gross negligence in our analysis. However, the facts that raise a triable issue as to Parth's diligence, discussed *post*, would also raise an issue as to whether she exercised “even slight care.”

The court found that Parth had set forth sufficient evidence that she was “disinterested,” and that she had “acted in good faith and without willful or intentional misconduct,” and “upon the basis of such information as she possessed.” The burden shifted to the Association to establish a triable issue of material fact and the court found that the Association failed to satisfy this burden. As to bad faith, the court found that there was a triable issue as to \*\*516 whether Parth had violated the governing documents, but that such a violation would be insufficient to overcome the business judgment rule or the exculpatory provision of the CC&Rs. With respect to diligence, the court found no \*278 evidence that Parth “did not use reasonable diligence in ascertaining the facts.” According to the court, the “gravamen of the [Association's] claims is ... that Parth repeatedly acted outside the scope of her authority,” and that “[t]he problem with this argument is that Parth believed in her authority to act and the need to act, and the [Association] [fails to] offer any evidence to the contrary, except to say that Parth's actions violated the ... CC&Rs.”

The trial court also ruled on the Association's evidentiary objections; the parties do not indicate whether the court ruled on Parth's objections. The court entered judgment for Parth and the Association timely appealed.

### III

#### DISCUSSION

*A. Motion for summary judgment*

The Association claims that the trial court erred in granting Parth's motion for summary judgment.

### 1. Governing law

A defendant moving for summary judgment “bears the burden of persuasion that there is no triable issue of material fact and that [the defendant] is entitled to judgment as a matter of law.” (*Aguilar v. Atlantic Richfield Co.* (2001) 25 Cal.4th 826, 850, 107 Cal.Rptr.2d 841, 24 P.3d 493 (*Aguilar*)). To meet this burden, the defendant must show that one or more elements of the cause of action cannot be established, or that there is a complete defense to that cause of action. (*Ibid.*) Once the defendant satisfies its burden, “the burden shifts to the plaintiff ... to show that a triable issue of one or more material facts exists as to that cause of action or a defense thereto.” (*Id.* at p. 849, 107 Cal.Rptr.2d 841, 24 P.3d 493.) “Because a summary judgment denies the adversary party a trial, it should be granted with caution.” (*Colores v. Board of Trustees* (2003) 105 Cal.App.4th 1293, 1305, 130 Cal.Rptr.2d 347.)

[1] We review a trial court's grant of summary judgment de novo. (*Buss v. Superior Court* (1997) 16 Cal.4th 35, 60, 65 Cal.Rptr.2d 366, 939 P.2d 766.) “[W]e must assume the role of the trial court and redetermine the merits of the motion. In doing so, we must strictly scrutinize the moving party's papers. [Citation.] The declarations of the party opposing summary judgment, however, are liberally construed to determine the existence of triable issues of fact. All doubts as to whether any material, triable issues of fact \*279 exist are to be resolved in favor of the party opposing summary judgment.” (*Barber v. Marina Sailing, Inc.* (1995) 36 Cal.App.4th 558, 562, 42 Cal.Rptr.2d 697.)<sup>4</sup>

<sup>4</sup> Contrary to Parth's claim, a summary judgment is not “entitled to a presumption of correctness.” The cases on which she relies simply confirm the general principle that an appellant must establish error on appeal. (See, e.g., *Denham v. The Superior Court of Los Angeles County (Marsh & Kidder)* (1970) 2 Cal.3d 557, 564, 86 Cal.Rptr. 65, 468 P.2d 193 [“[E]rror must be affirmatively shown.”]; *Reyes v. Kosha* (1998) 65 Cal.App.4th 451, 466, fn. 6, 76 Cal.Rptr.2d 457 [“Although our review of a summary judgment is de novo, it is limited to issues which have been adequately raised and supported in [appellants'] brief.”].)

### 2. Application

#### a. Principles governing decisionmaking by a director

[2] “The common law ‘business judgment rule’ refers to a judicial policy of \*\*517 deference to the business judgment of corporate directors in the exercise of their broad discretion in making corporate decisions.... Under this rule, a director is not liable for a mistake in business judgment which is made in good faith and in what he or she believes to be the best interests of the corporation, where no conflict of interest exists.” (*Gaillard v. Natomas Co.* (1989) 208 Cal.App.3d 1250, 1263, 256 Cal.Rptr. 702 (*Gaillard*)); see *Ritter & Ritter, Inc. Pension & Profit Plan v. The Churchill Condominium Assn.* (2008) 166 Cal.App.4th 103, 123, 82 Cal.Rptr.3d 389 (*Ritter*) [business judgment rule “sets up a presumption that directors' decisions are based on sound business judgment”].)

In California, there is a statutory business judgment rule. *Corporations Code* section 7231 applies to nonprofit corporations and provides that “[a] director shall perform the duties of a director, ..., in good faith, in a manner such director believes to be in the best interests of the corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.” (§ 7231, subd. (a); see *Ritter, supra*, 166 Cal.App.4th at p. 123, 82 Cal.Rptr.3d 389.) The statute goes on to state that “[a] person who performs the duties of a director in accordance [with the preceding subdivisions] ... shall have no liability based upon any alleged failure to discharge the person's obligations as a director...” (§ 7231, subd. (c); see *Ritter*, at p. 123, 82 Cal.Rptr.3d 389; see also § 7231.5, subd. (a) [limiting liability on the same grounds for volunteer directors and officers].)<sup>5</sup>

<sup>5</sup> All further statutory references are to the *Corporations Code* unless otherwise indicated.

[3] [4] “Notwithstanding the deference to a director's business judgment, the rule does not immunize a director from liability in the case of his or her abdication of corporate responsibilities.” ( \*280 *Gaillard, supra*, 208 Cal.App.3d at p. 1263, 256 Cal.Rptr. 702.) “The question is frequently asked, how does the operation of the so-called ‘business judgment rule’ tie in with the concept of negligence? There is no conflict between the two. When courts say that they will not interfere in matters of business judgment, it is presupposed that judgment—reasonable diligence—has in fact been exercised. A director cannot close his eyes to what is going on about him in the conduct of the business of the corporation and have it said that he is exercising business judgment.” (*Burt v. Irvine Co.* (1965) 237 Cal.App.2d 828,

852–853, 47 Cal.Rptr. 392 (*Burt*); *Gaillard, supra*, at pp. 1263–1264, 256 Cal.Rptr. 702 [accord].)

[5] Put differently, whether a director exercised reasonable diligence is one of the “factual prerequisites” to application of the business judgment rule. (*Affan v. Portofino Cove Homeowners Assn.* (2010) 189 Cal.App.4th 930, 941, 117 Cal.Rptr.3d 481 (*Affan*); *id.* at p. 943, 117 Cal.Rptr.3d 481 [finding a homeowners association “failed to establish the factual prerequisites for applying the rule of judicial deference” at trial, where “there was no evidence the board engaged in ‘reasonable investigation’ (citation) before choosing to continue its ‘piecemeal’ approach to sewage backups”]; see §§ 7231, subd. (a), 7231.5, subd. (a); see also *Lamden v. La Jolla Shores Clubdominium Homeowners Assn.* (1999) 21 Cal.4th 249, 253, 87 Cal.Rptr.2d 237, 980 P.2d 940 (*Lamden*) [requiring “reasonable investigation” for judicial deference]; \*\*518 *Everest Investors 8 v. McNeil Partners* (2003) 114 Cal.App.4th 411, 432, 8 Cal.Rptr.3d 31 (*Everest*) [accord].)

#### b. The business judgment rule on summary judgment

[6] The business judgment rule “raises various issues of fact,” including whether “a director acted as an ordinarily prudent person under similar circumstances” and “made a reasonable inquiry as indicated by the circumstances.” (*Gaillard, supra*, 208 Cal.App.3d at p. 1267, 256 Cal.Rptr. 702.) “Such questions generally should be left to a trier of fact,” but can become questions of law “where the evidence establishes that there is no controverted material fact.” (*Id.* at pp. 1267–1268, 256 Cal.Rptr. 702.) “The function of the trial court in ruling on [a] motion[ ] for summary judgment [is] merely to determine whether such issues of fact exist, and not to decide the merits of the issues themselves. [Citation.] Our function is the same as that of the trial court.” (*Id.* at p. 1268, 256 Cal.Rptr. 702; see *id.* at p. 1271, 256 Cal.Rptr. 702 [identifying a triable issue of fact as to whether it was reasonable for the directors on the compensation committee to rely on outside counsel “with no further inquiry,” and observing that “[a] trier of fact could reasonably find that the circumstances warranted a thorough review of the golden parachute agreements”]; *id.* at pp. 1271–1272, 256 Cal.Rptr. 702 [noting a “triable issue of fact as to whether *some* further inquiry” was warranted by the other directors regarding \*281 the golden parachutes, under the circumstances, notwithstanding that they were entitled to rely on the recommendation of the compensation committee].)<sup>6</sup> (Cf. *Harvey v. The Landing Homeowners Assn.* (2008) 162

Cal.App.4th 809, 822, 76 Cal.Rptr.3d 41 [affirming summary judgment in dispute over attic space use where undisputed evidence showed the board, upon “reasonable investigation” and in good faith “properly exercised its discretion within the scope of the CC&R’s....”].)

6 (See *Everest, supra*, 114 Cal.App.4th at p. 430, 8 Cal.Rptr.3d 31 [finding that triable issues of fact as to the existence of improper motives and a conflict of interest “preclude[d] summary judgment based on the business judgment rule”]; *Will v. Engebretson & Co.* (1989) 213 Cal.App.3d 1033, 1044, 261 Cal.Rptr. 868 [“Will submitted evidence that ... the committee members never reviewed the complaint, the financial records of the corporation, or made any investigation into the matter at all. Company, of course, disputes these allegations. But it is precisely because the issues are disputed that it was error for the trial court to resolve the issues....”].)

#### c. The trial court erred in granting summary judgment

The Association raises two challenges to the summary judgment ruling: that the trial court erred by applying the business judgment rule to Parth's ultra vires acts (or conduct otherwise outside Parth's authority) and that there are triable issues of material fact as to whether Parth exercised reasonable diligence.

##### i. Ultra vires conduct

[7] The Association has not established that Parth's conduct was ultra vires. Ultra vires conduct is conduct that is beyond the power of the corporation, not an individual director. (See *McDermott v. Bear Film Co.* (1963) 219 Cal.App.2d 607, 610–611, 33 Cal.Rptr. 486 [“In its true sense the phrase ultra vires describes action which is beyond the purpose or power of the corporation.”]; *Sammis v. Stafford* (1996) 48 Cal.App.4th 1935, 1942, 56 Cal.Rptr.2d 589 [“If, however, the director's act was within the corporate powers, but was performed without authority or in an unauthorized manner, the act is not ultra vires.”].) The Association does not distinguish \*\*519 these authorities, nor does it identify conduct by Parth that went beyond the power of the Association.

However, the Association does cite cases suggesting that noncompliance with governing documents may fall outside the scope of the business judgment rule, at least in



certain circumstances. (See \*282 *Nahrstedt v. Lakeside Village Condominium Assn.* (1994) 8 Cal.4th 361, 374, 33 Cal.Rptr.2d 63, 878 P.2d 1275 (*Nahrstedt*) [finding “courts will uphold decisions made by the governing board of an owners association,” where among other things, they “are consistent with the development's governing documents”]; *Lamden, supra*, 21 Cal.4th at p. 253, 87 Cal.Rptr.2d 237, 980 P.2d 940 [requiring that association board “exercise[] discretion within the scope of its authority under relevant statutes, covenants and restrictions” in order to merit judicial deference]; *Dolan–King v. Rancho Santa Fe Assn.* (2000) 81 Cal.App.4th 965, 979, 97 Cal.Rptr.2d 280 [accord]; *Scheenstra v. California Dairies, Inc.* (2013) 213 Cal.App.4th 370, 388, 153 Cal.Rptr.3d 21 [finding a “board's decision is not scrutinized under the business judgment rule ... until after the court determines that the action ... falls within the discretionary range of action authorized by the contract”].) See also *Ekstrom v. Marquesa at Monarch Beach Homeowners Assn.* (2008) 168 Cal.App.4th 1111, 1123, 86 Cal.Rptr.3d 145 (“Even if the Board was acting in good faith ..., its policy ... was not in accord with the CC&Rs.... The Board's interpretation of the CC&Rs was inconsistent with the plain meaning of the document and thus not entitled to judicial deference.”).

Parth contends that the business judgment rule protects a director who violates governing documents, as long as the director believes that the actions are in the best interests of the corporation. She relies on *Biren v. Equality Emergency Medical Group, Inc.* (2002) 102 Cal.App.4th 125, 125 Cal.Rptr.2d 325 (*Biren*). *Biren*, which involved a dispute between a company and a former director, held that the “business judgment rule may protect a director who acts in a mistaken but good faith belief on behalf of the corporation without obtaining the requisite shareholder approval.” The *Biren* court determined that the director in question was protected by the rule, even though she violated the shareholder agreement. (*Id.* at pp. 131–132, 125 Cal.Rptr.2d 325.) However, the court did not suggest that such conduct would always be protected. Rather, the court concluded that the violation “did not by itself make the business judgment rule inapplicable,” explaining that the company failed to prove that the director had “intentionally usurped her authority” or that “her actions were anything more than an honest mistake.” (*Id.* at p. 137, 125 Cal.Rptr.2d 325.) The court also noted the trial court's “finding that [the director] ‘reasonably relied’ on information she believed to be correct,” observing that this was “tantamount to a finding she acted in good faith.” (*Id.* at p. 136, 125 Cal.Rptr.2d 325.)

In other words, *Biren* held that the director's violation of the governing documents did not render the business judgment rule inapplicable *under the circumstances*; namely, where the remainder of the business judgment rule requirements were satisfied.

[8] [9] Here, the trial court agreed that there was a triable issue of material fact as to whether Parth breached the governing documents, but concluded that even if she had, this was insufficient to overcome the protection of the business judgment rule. However, the case law is clear that conduct contrary to \*283 governing documents may fall outside the business judgment rule. (See, e.g., \*\*520 *Nahrstedt, supra*, 8 Cal.4th at p. 374, 33 Cal.Rptr.2d 63, 878 P.2d 1275.) Even if *Biren* establishes an exception to this principle where the director has satisfied the remaining elements of the business judgment rule, in this case, triable issues of material fact exist as to other elements of the rule and render *Biren* inapplicable, at least at this stage. The trial court erred in assuming that the business judgment rule would apply to Parth's actions that violated the governing documents.

#### ii. *Material issues of fact*

Although the trial court properly recognized that a director must act on an informed basis, be reasonably diligent, and exercise care in order to rely on the business judgment rule, the court erred in concluding that the Association failed to demonstrate triable issues of fact with respect to these matters. (See *Gaillard, supra*, 208 Cal.App.3d at pp. 1271–1272, 1274, 256 Cal.Rptr. 702 [reversing summary judgment due to material issues of fact as to whether further inquiry was warranted].) We conclude that material issues of fact exist as to whether Parth exercised reasonable diligence in connection with the actions at issue.

[10] First, with respect to the roofing repairs, Parth explained how she found Warren Roofing and testified at her deposition that Warren Roofing was licensed. However, during the same line of questioning, she displayed ignorance of the relationship between Warren Roofing and Bonded Roofing and admitted that she had not “investigate[d] anything” pertaining to whether Bonded Roofing was licensed. The Association also established that Parth found a roofing contractor without any formal bid or contract, that the Board hired Bonded Roofing but paid Warren Roofing, that Warren Roofing may have significantly overcharged the Association for the work performed, and that this work was defective and required repair.<sup>7</sup> This evidence is sufficient to raise an issue

as to Parth's diligence with respect to the investigation and payment of the roofers. (See *Affan, supra*, 189 Cal.App.4th at pp. 941, 943, 117 Cal.Rptr.3d 481 [business judgment rule did not apply where, among other things, there was no evidence of a reasonable investigation into sewage work].)<sup>8</sup> Parth's reliance on ApRoberts to review invoices does not resolve these issues. (See *Gaillard, supra*, 208 Cal.App.3d at p. 1271, 256 Cal.Rptr. 702 [although the directors could rely upon the recommendations of outside counsel and the \*284 compensation committee, triable issues existed as to whether further inquiry was still required under the circumstances].)

7 There also was no evidence of a written warranty for the roofing work. Layton testified at deposition that he provided a warranty, but did not indicate that it was written, and Parth contends only that she obtained a verbal warranty.

8 The Association contends that both Warren Roofing and Bonded Roofing were unlicensed at the time the roofing work was done, while Parth maintains that Warren Roofing was licensed. We need not address this dispute. Although the existence of facts that the exercise of proper diligence might have disclosed (such as license status) may be relevant to whether Parth exhibited reasonable diligence (see *Berg & Berg Enterprises, LLC v. Boyle* (2009) 178 Cal.App.4th 1020, 1046, 100 Cal.Rptr.3d 875), we conclude that her admission that she “did not investigate anything,” in the context of a major repair project, is sufficient to raise a triable issue.

[11] Second, the 2007 and 2010 promissory notes, secured by Association assets, similarly raise issues as to whether Parth proceeded on an informed basis. She relies on her belief that she had the authority to take out the loans, her lack of awareness \*\*521 that a member vote was required to encumber the assets of the Association, and that no one advised her that she lacked the authority or that membership approval was required. She also states in her declaration that she and two other Board members authorized her and ApRoberts to sign the 2010 note. However, as the Association points out, the governing documents require member approval for such debt and there is no record of such approval. Parth's deposition testimony also reflects that she did not know whether she had the authority under the governing documents to sign the loans, and that she made no effort to determine whether she had such authority. Whether Parth exercised sufficient diligence to inform herself of the

Association's requirements pertaining to the loans at issue is a question for the trier of fact. (See *Gaillard, supra*, 208 Cal.App.3d at p. 1267, 256 Cal.Rptr. 702; *id.* at p. 1271, 256 Cal.Rptr. 702 [noting triable issue as to whether the “circumstances warranted a thorough review of the ... agreements”].) Parth “cannot close [her] eyes” to matters as basic as the provisions of the CC&Rs and bylaws of the Association and at the same time claim that she “exercis[ed] business judgment.” (*Id.* at p. 1263–1264, 256 Cal.Rptr. 702.)

[12] Third, as to Jesse's Landscaping, Parth indicated that three Board members, including herself, approved a five-year contract in 2010. However, the Association provided evidence that the governing documents require that a contract with a third party exceeding one year be approved by member vote. In addition, Parth acknowledged at her deposition that she did not know whether she had the authority to sign a five-year contract, and that she had no understanding of what her authority was under the bylaws. This evidence suggests that Parth may not have understood, nor made any effort to understand, whether the Board was permitted to authorize the Jesse's Landscaping contract without member approval. As with the loans, Parth's admitted lack of effort to inform herself of the extent of her authority in this regard is sufficient to establish a triable issue. (See *Gaillard, supra*, 208 Cal.App.3d at pp. 1263, 1267, 1271, 256 Cal.Rptr. 702.)

[13] Fourth, regarding the PPM termination, Parth explained that PPM's owner did not want PPM to be the management company for the Association any \*285 longer and that the Board subsequently voted to terminate PPM on July 16, 2011. However, the Association's evidence reflects that the Board had tabled the issue of the termination of PPM on July 9 and that Parth met with and hired the Lyttleton Company, apparently without calling a Board meeting to vote on the matter. The time line of these events is somewhat unclear, including whether Parth hired Lyttleton before the Board voted to terminate PPM, but we will not attempt to resolve such factual issues on summary judgment. Regardless of the timing, the evidence presented as to the matter raises questions as to whether Parth proceeded with reasonable diligence. (See *Gaillard, supra*, 208 Cal.App.3d at pp. 1271–1272, 256 Cal.Rptr. 702; *Affan, supra*, 189 Cal.App.4th at pp. 941, 943, 117 Cal.Rptr.3d 481.)

[14] Finally, the Desert Security contract similarly calls into question Parth's diligence. Parth offered several explanations for her execution of the contract with Desert Security in January 2011, despite the Board's decision to consider

bids from other companies for security services. Some of her explanations were inconsistent,<sup>9</sup> and the Association's evidence cast \*\*522 doubt on all of them. With respect to Parth's stated belief that she had the authority to sign the contract, the Association provided evidence in other contexts (e.g., the promissory notes) that Parth failed to understand the scope of her authority; this same evidence suggests that she made no effort to ascertain what authority she did possess to conduct the business of the Association. The business judgment rule would not extend to such willful ignorance. (See *Gaillard, supra*, 208 Cal.App.3d at p. 1263, 256 Cal.Rptr. 702.) Parth also indicated that at the time she signed the contract, the Board had tabled the security discussion and had not yet terminated Desert Protection. However, the Association provided evidence that Parth failed to bring the new contract to the attention of the Board or alert the Board to its existence, even after the security discussion had been reopened, thus calling into question Parth's explanations. This conduct raises serious questions as to Parth's diligence, particularly given the timing of the relevant events. (*Id.* at p. 1271, 256 Cal.Rptr. 702 [noting the "nature" and "timing" of the agreements at issue].)

<sup>9</sup> For example, Parth indicated both that she believed nonwritten contracts would be automatically renewed and that she was "merely updating" the contract, without explaining why a new or updated contract would be necessary if the existing contract would automatically be renewed.

Although the trial court declined to address much of the Association's evidence, it did discuss the Desert Protection situation. The court stated that the Association disputed the basis for Parth's belief in her authority to sign the Desert Protection contract by citing the bylaws, and concluded that this evidence did not controvert Parth's professed belief. While the Bylaws may \*286 not undermine Parth's *belief*, together with the Association's other evidence, they do demonstrate the existence of a triable issue of material fact as to whether Parth's proceeding on such belief—without keeping the Board informed—showed reasonable diligence under the circumstances.

In sum, the Association produced evidence establishing the existence of triable issues of material fact as to whether Parth acted on an informed basis and with reasonable diligence, precluding summary judgment based on the business judgment rule. The trial court's erroneous conclusion that "there [was] no evidence that Parth did not use reasonable

diligence" reflects a misapplication of the business judgment rule, summary judgment standards, or both. To the extent that the court viewed the Association's evidence regarding Parth's diligence as irrelevant, in light of her "belief[ ] in her authority to act and the need to act," the court failed to apply the reasonable diligence requirement in any meaningful way. Permitting directors to remain ignorant and to rely on their uninformed beliefs to obtain summary judgment would gut the reasonable diligence element of the rule and, quite possibly, incentivize directors to remain ignorant. To the extent that the trial court did consider the Association's evidence, but found it insufficient to establish a lack of diligence, the court improperly stepped into the role of fact finder and decided the merits of the issue.

[15] [16] In addition, the Association contends that courts treat diligence and good faith as intertwined, citing *Biren's* description of the trial court's finding that the director reasonably relied on information she believed to be correct as "tantamount" to a finding of good faith. (See *Biren, supra*, 102 Cal.App.4th at p. 136, 125 Cal.Rptr.2d 325.) Our own research reveals that other courts similarly have considered diligence as part of the good \*\*523 faith inquiry. (See, e.g., *Affan, supra*, 189 Cal.App.4th at p. 943, 117 Cal.Rptr.3d 481 ["Nor was there evidence the Association acted 'in good faith ...', because no one testified about the board's *decisionmaking process* .... [¶] ... [I]n *Lamden*, ample evidence demonstrated the association board engaged in the sort of reasoned decisionmaking that merits judicial deference. There is no such showing in the case before us."]; see also *Desaigouadar v. Meyercord* (2003) 108 Cal.App.4th 173, 189, 133 Cal.Rptr.2d 408 ["[T]he court must look into the procedures employed and determine whether they were adequate or whether they were so inadequate as to suggest fraud or bad faith. That is, '[p]roof ... that the investigation has been so restricted in scope, so shallow in execution, or otherwise so *pro forma* or halfhearted as to constitute a pretext or sham, consistent with the principles underlying the application of the business judgment doctrine, would raise questions of good faith or conceivably fraud which would never be shielded by that doctrine.'"]) In light of these \*287 authorities, we recognize that there may be a triable issue of material fact as to Parth's good faith, as well.<sup>10</sup>

<sup>10</sup> The Association also appears to challenge several other actions on the part of Parth, but fails to support its challenge with argument and/or specific authority. These actions include Parth's execution of the Board member Code of Conduct, certain

purported violations of the Common Interest Open Meeting Act and Davis–Stirling Common Interest Development Act, and various facts pertaining to bad faith. We deem these matters forfeited. (*People v. Stanley* (1995) 10 Cal.4th 764, 793, 42 Cal.Rptr.2d 543, 897 P.2d 481 (*Stanley*) [it is not the reviewing court's role to “construct a theory” for appellant: “[E]very brief should contain a legal argument with citation of authorities on the points made. If none is furnished on a particular point, the court may treat it as waived....”].) In addition, because we conclude that the Association has established the existence of triable issues of material fact as to both the business judgment rule and the exculpatory provision of the CC & Rs, see discussion *post*, we need not reach its arguments under section 5047.5 and [Civil Code section 5800](#) or its argument that Parth is estopped from claiming ignorance of the governing documents.

### iii. Parth's contentions

[17] As a preliminary matter, Parth contends that “[v]irtually all of the evidence proffered in opposition to the motion for summary judgment was inadmissible,” but cites only her own evidentiary objections, rather than any ruling by the trial court. She also does not offer any argument regarding the evidence itself, other than to state generally that evidence without foundation is inadmissible (and, with one exception not relevant here, does not identify any specific evidence). We conclude that Parth has forfeited these objections. (*Stanley, supra*, 10 Cal.4th at p. 793, 42 Cal.Rptr.2d 543, 897 P.2d 481; *Del Real v. City of Riverside* (2002) 95 Cal.App.4th 761, 768, 115 Cal.Rptr.2d 705 [“[I]t is counsel's duty to point out portions of the record that support the position taken on appeal....”]; *ibid.* [“[A]ny point raised that lacks citation may, in this court's discretion, be deemed waived.”].)

Turning to Parth's substantive arguments, we first address her contention that she displayed no bad faith. She relies on cases characterizing bad faith as intentional misconduct, encompassing fraud, conflicts of interest, and intent to serve an outside purpose. (See, e.g., *Barnes v. State Farm Mut. Auto. Ins. Co.* (1993) 16 Cal.App.4th 365, 379, 20 Cal.Rptr.2d 87.) However, the Association's appeal focuses on Parth's failure to exercise reasonable diligence, so establishing an absence of evidence of intentional misconduct unrelated to diligence does not undermine the Association's arguments.

**\*\*524** [18] Next, Parth suggests that the Association's concerns with respect to her lack of diligence in securing a roofing contractor sound in negligence, contending that “a director's conduct or decisions are not judged according to a negligence standard.” (Boldface omitted.) However, as the authorities **\*288** discussed *ante* make clear, there is “no conflict” between the business judgment rule and negligence, and application of that rule “presuppose[s] that ... reasonable diligence [ ] has in fact been exercised.” (*Gaillard, supra*, 208 Cal.App.3d at pp. 1263–1264, 256 Cal.Rptr. 702, quoting *Burt, supra*, 237 Cal.App.2d at pp. 852–853, 47 Cal.Rptr. 392; *Affan, supra*, 189 Cal.App.4th at p. 941, 117 Cal.Rptr.3d 481.)

[19] [20] Parth's reliance on the exculpatory clause of the Association's CC&Rs is similarly unpersuasive. She contends that even if she exceeded her authority, the “only condition for the stated contractual immunity is that the board members perform their duties in ‘good faith, and without willful or intentional misconduct.’ ” However, she fails to address the immediately preceding clause, which requires that the director act “upon the basis of such information as may be possessed by [her].” This language is arguably analogous to the business judgment rule's reasonable diligence requirement. (*Gaillard, supra*, 208 Cal.App.3d at pp. 1263–1264, 256 Cal.Rptr. 702.) At minimum, even if the exculpatory provision did not obligate Parth to obtain additional information regarding particular undertakings, it surely contemplated that she would familiarize herself with information already in her possession—such as the governing documents of the Association. Further, both the business judgment rule and the exculpatory clause of the CC&Rs require good faith and, as discussed *ante*, an absence of diligence may reflect a lack of good faith. Given this overlap, we conclude that at least some of the triable issues of material fact that bar summary judgment with respect to the business judgment rule similarly preclude it as to the exculpatory clause.<sup>11</sup>

<sup>11</sup> We reject Parth's claim that the Association waived the exculpatory clause issue. Although the Association did not address the issue until its reply brief, it takes the position on reply that the exculpatory clause is “a recitation of the business judgment rule.” Parth, meanwhile, relied on the same undisputed facts to support both issues. Under the circumstances, we see no reason to preclude the Association from relying on its business judgment



rule arguments and evidence for the exculpatory clause issue.

[21] [22] Finally, we address Parth's contention that the Association's claim is time-barred to the extent that it concerns events that occurred prior to May 22, 2008. Parth contends that there is a four-year statute of limitations for a breach of fiduciary duty claim and that admissible evidence is required to support the claim, but does not explain how these principles would permit her to obtain summary judgment as to a portion of a cause of action. We agree with the Association both that Parth's attempt to apply the statute of limitations to obtain judgment on a part of its breach of fiduciary duty claim is improper and that the existence of material questions of fact preclude resolution of statute of limitations issues at this juncture. (See *McCasky v. California State Automobile Assn.* (2010) 189 Cal.App.4th 947, 975, 118 Cal.Rptr.3d 34 [“there can be no summary adjudication of less than an entire cause of action.... If a cause of action is not shown to be barred in its entirety, no order for summary judgment—or adjudication—can be entered.” (citation omitted)]; \*289 *Jolly v. Eli Lilly & Co.* (1988) 44 Cal.3d 1103, 1112, 245 Cal.Rptr. 658, 751 P.2d 923 [“resolution of the statute of limitations issue is normally a question of fact”].)

#### \*\*525 B. Demurrer

The Association contends that the trial court erroneously granted Parth's demurrer to its cause of action for breach of governing documents, without leave to amend.

#### 1. Governing law

We review a ruling sustaining a demurrer de novo, exercising independent judgment as to whether the complaint states a cause of action as a matter of law. (*Desai v. Farmers Ins. Exchange* (1996) 47 Cal.App.4th 1110, 1115, 55 Cal.Rptr.2d 276.) “We affirm the judgment if it is correct on any ground stated in the demurrer, regardless of the trial court's stated reasons.” (*Fremont Indemnity Co. v. Fremont General Corp.* (2007) 148 Cal.App.4th 97, 111, 55 Cal.Rptr.3d 621.) Further, “[i]f another proper ground for sustaining the demurrer exists, this court will still affirm the demurrer[ ]....” (*Jocer Enterprises, Inc. v. Price* (2010) 183 Cal.App.4th 559, 566, 107 Cal.Rptr.3d 539.)

When a demurrer is sustained without leave to amend, “we decide whether there is a reasonable possibility that the defect can be cured by amendment: if it can be, the trial court has abused its discretion and we reverse; if not, there has

been no abuse of discretion and we affirm. [Citations.] The burden of proving such reasonable possibility is squarely on the plaintiff.” (*Blank v. Kirwan* (1985) 39 Cal.3d 311, 318, 216 Cal.Rptr. 718, 703 P.2d 58 (*Blank* ).)

#### 2. Application

With respect to the Association's cause of action for breach of governing documents, the trial court ruled: “The HOA has not alleged that Parth breached any covenant. The only sections of the governing documents referred to in the cross-complaint are bylaws that deal with the Boards [*sic*] transaction of the Associations [*sic*] business affairs 7–11. These sections describe how the Board acts. It ... does not appear that they are covenants between the HOA and individual members that the HOA may sue to enforce.”

First, the Association does not cite only the bylaws; it also cites the CC&R provision reserving authority over the Association's affairs to the Board. In any event, we see no reason why the governing document provisions would be unenforceable as to Parth, an owner and Association member who was \*290 serving as president and was a member of the Board. (See *Civ.Code*, § 5975, subd. (a) [“The covenants and restrictions in the declaration shall be enforceable equitable servitudes ... and bind all owners” and generally “may be enforced by ... the association”], subd. (b) [“A governing document other than the declaration may be enforced by the association against an owner”]; see also, e.g., *Biren, supra*, 102 Cal.App.4th at p. 141, 125 Cal.Rptr.2d 325 [affirming judgment against director for breach of shareholder agreement]; *Briano v. Rubio* (1996) 46 Cal.App.4th 1167, 1172, 1180, 54 Cal.Rptr.2d 408 [affirming judgment against directors for violation of articles of incorporation].)

[23] Regardless, as Parth argues, the cause of action for breach of governing documents appears to be duplicative of the cause of action for breach of fiduciary duty. This court has recognized this as a basis for sustaining a demurrer. (See *Rodriguez v. Campbell Industries* (1978) 87 Cal.App.3d 494, 501, 151 Cal.Rptr. 90 [finding demurrer was properly sustained without leave to amend as to cause of action that contained allegations of other causes and “thus add[ed] nothing to the complaint by way of fact or theory of recovery”]; see also *Award Metals, Inc. v. Superior Court* (1991) 228 Cal.App.3d 1128, 1135, 279 Cal.Rptr. 459 [Second Appellate \*\*526 District, Division Four; demurrer should have been sustained as to duplicative causes of action].)<sup>12</sup> The Association does not address

Parth's argument or explain how its document claim differs from the fiduciary breach claim. We conclude that the trial court properly sustained the demurrer.

IV

DISPOSITION

12 But see *Blickman Turkus, LP v. MF Downtown Sunnyvale, LLC* (2008) 162 Cal.App.4th 858, 890, 76 Cal.Rptr.3d 325 (Sixth Appellate District) (finding that duplication is not grounds for demurrer and that a motion to strike is the proper way to address duplicative material).

The order granting summary judgment and judgment are reversed. The ruling sustaining the demurrer to the breach of governing documents cause of \*291 action without leave to amend is affirmed. The parties shall bear their own costs on appeal.

[24] Second, the burden is on the Association to articulate how it could amend its pleading to render it sufficient. (*Blank, supra*, 39 Cal.3d at p. 318, 216 Cal.Rptr. 718, 703 P.2d 58; *Goodman v. Kennedy* (1976) 18 Cal.3d 335, 349, 134 Cal.Rptr. 375, 556 P.2d 737 [“Plaintiff must show in what manner he can amend his complaint and how that amendment will change the legal effect of his pleading.”].) The Association offers no argument on this point and we therefore conclude that it has forfeited the issue. (*Stanley, supra*, 10 Cal.4th at p. 793, 42 Cal.Rptr.2d 543, 897 P.2d 481.)

Huffman, Acting P.J., and Prager, J. \*, concurred.

\* Judge of the San Diego Superior Court, assigned by the Chief Justice pursuant to [article VI, section 6 of the California Constitution](#).

All Citations

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## **LEGAL AUTHORITY CA-107**



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168 Cal.App.4th 1111

Court of Appeal, Fourth District, Division 3, California.

[Robert EKSTROM](#) et al., Plaintiffs and Respondents,

v.

MARQUESA AT MONARCH BEACH  
HOMEOWNERS ASSOCIATION,  
Defendant and Appellant.

No. G038537.

|

Nov. 3, 2008.

**Synopsis**

**Background:** Condominium homeowners brought action against homeowners association for declaratory and injunctive relief to compel association to comply with declaration of covenants, conditions, and restrictions (CC&Rs) by enforcing trimming of palm trees. The Superior Court, Orange County, No. 04CC12264, [Charles Margines, J.](#), granted declaratory and injunctive relief. Association appealed.

**Holdings:** The Court of Appeal, [O'Leary, J.](#), held that:

[1] association waived argument that judicial deference applied to its refusal to require trimming of palm trees;

[2] judicial deference did not apply to association's refusal to require trimming of palm trees;

[3] judicial deference did not apply to association's rules for determining what palm trees had to be trimmed;

[4] injunction requiring association to enforce CC&Rs provision requiring trees to be trimmed did not interfere impermissibly with association's discretion;

[5] injunction requiring association to enforce CC&Rs provision was not impermissibly vague; and

[6] association waived argument that individual homeowners whose palm trees obstructed plaintiffs' views were indispensable parties.

Affirmed.

West Headnotes (15)

[1] **Appeal and Error** Motions, hearings, and orders in general

**Appeal and Error** Judgment in General

An appealed judgment or order is presumed to be correct, and the appellant bears the burden of overcoming that presumption.

[3 Cases that cite this headnote](#)

[2] **Declaratory Judgment** Discretion of lower court

Generally, the trial court's decision to grant or deny declaratory and injunctive relief will not be disturbed on appeal unless it is clearly shown its discretion was abused.

[3 Cases that cite this headnote](#)

[3] **Declaratory Judgment** Scope and extent of review in general

Interpretation of provisions of a declaration of covenants, conditions, and restrictions (CC&Rs) is a question of law reviewed de novo, in reviewing a trial court's declaratory judgment.

[6 Cases that cite this headnote](#)

[4] **Corporations and Business Organizations** Business judgment rule in general

The common law business judgment rule has two components, one which immunizes corporate directors from personal liability if they act in accordance with its requirements, and another which insulates from court intervention those management decisions which are made by directors in good faith in what the directors believe is the organization's best interest.

[1 Cases that cite this headnote](#)



- [5] **Corporations and Business Organizations**  [Business judgment rule in general](#)

A hallmark of the business judgment rule is that, when the rule's requirements are met, a court will not substitute its judgment for that of the corporation's board of directors.

- [6] **Corporations and Business Organizations**  [Business judgment rule in general](#)

The corporate business judgment rule, as a rule of judicial deference to good faith management decisions of corporate boards, is a defense.

[2 Cases that cite this headnote](#)

- [7] **Common Interest Communities**  [Governing board; members, directors, and officers; committees](#)  
**Pleading**  [Necessity for defense](#)

The rule of judicial deference to good faith decisions of homeowner association boards is a defense, and thus may be waived if not raised in the trial court.

[2 Cases that cite this headnote](#)

- [8] **Appeal and Error**  [In general; asserting new defense or grounds of opposition](#)

An affirmative defense may be waived on appeal if it is not raised below.

[1 Cases that cite this headnote](#)

- [9] **Declaratory Judgment**  [Scope and extent of review in general](#)

By failing to raise the issue earlier than in its request for a statement of decision in the trial court, condominium homeowners association was precluded from asserting on appeal that its alleged violation of declaration of covenants, conditions, and restrictions (CC&Rs) in not

requiring trimming or removal of palm trees was supported by the *Lamden* rule of judicial deference to decisions of homeowner association boards, since that rule was a defense of good faith that was necessarily factual in nature.

[6 Cases that cite this headnote](#)

- [10] **Common Interest Communities**  [Other particular powers, duties, and functions](#)

Condominium homeowners association was not entitled to judicial deference in its position that it could exempt all palm trees from provision in declaration of covenants, conditions, and restrictions (CC&Rs) that "all trees, hedges and other plant materials shall be trimmed by the Owner of the Lot upon which they are located so that they shall not exceed the height of the house on the Lot," even if trimming the tops off of palm trees would require their removal, since the association's interpretation of the CC&Rs was inconsistent with the plain meaning of the document.

*See 12 Witkin, Summary of Cal. Law (10th ed. 2005) Real Property; § 104; Cal. Jur. 3d, Real Estate, § 1270; 9 Miller & Starr, Cal. Real Estate (3d ed. 2001) §§ 25B:70, 25B:101; Friedman et al., Cal. Practice Guide: Landlord-Tenant (The Rutter Group 2008) ¶ 3:4.3 (CALANDTEN Ch. 3-A).*

[10 Cases that cite this headnote](#)

- [11] **Common Interest Communities**  [Other particular powers, duties, and functions](#)

Condominium homeowners association's rules for determining what palm trees had to be trimmed to the height of their owners' residences were not entitled to judicial deference, since they were in direct conflict with provision in declaration of covenants, conditions, and restrictions (CC&Rs) requiring that all trees and plants be trimmed so that they do not exceed the height of the house on the lot, except those determined by the condominium Architectural Review Committee not to block a view; association's rules excluded all palm trees not within narrow corridors defined by the

homeowners' lot line, and excluded all palm trees planted before the year the rules were enacted, thus excluding the tallest palm trees.

[2 Cases that cite this headnote](#)

**[12] Injunction**  [Covenants as to Use of Property](#)

When a condominium homeowners association refuses to enforce its declaration of covenants, conditions, and restrictions (CC&Rs), a homeowner may seek an injunction compelling it to do so.

[1 Cases that cite this headnote](#)

**[13] Injunction**  [Other particular uses and restrictions](#)

Trial court's injunction ordering condominium homeowners association to utilize every enforcement mechanism available to it under the declaration of covenants, conditions, and restrictions (CC&Rs) and the law in order to enforce CC&Rs provision requiring trees to be trimmed to the height of their owners' residences was not so broad as to interfere impermissibly with association's discretion to determine how to enforce CC&Rs; in view of association's historical position that it need not and would not enforce the provision as to palm trees, a directive that it utilize all enforcement mechanisms available was necessary to ensure it did not simply make a token effort.

[7 Cases that cite this headnote](#)

**[14] Injunction**  [Fences and hedges](#)

Trial court's injunction ordering condominium homeowners association to utilize every enforcement mechanism available to it under the declaration of covenants, conditions, and restrictions (CC&Rs) and the law in order to enforce CC&Rs provision requiring trees to be trimmed to the height of their owners' residences was not impermissibly vague, even though it did not specify whether association was required to commence legal action, and if so against which homeowners and with respect to what trees;

the judgment was clear that association must exercise its discretion in good faith to determine which trees obstructed the plaintiff homeowners' views, and then undertake procedures outlined in CC&Rs to enforce CC&Rs as to those trees.

[9 Cases that cite this headnote](#)

**[15] Declaratory Judgment**  [Scope and extent of review in general](#)

By failing to raise the issue earlier than in its request for a statement of decision in the trial court, condominium homeowners association was precluded from asserting on appeal that judgment requiring association to enforce declaration of covenants, conditions, and restrictions (CC&Rs) provision requiring trees to be trimmed to the height of their owners' residences was void because the plaintiff homeowners failed to join as defendants the individual homeowners whose palm trees obstructed the plaintiffs' views, as indispensable parties. [West's Ann.Cal.C.C.P. § 389](#).

[3 Cases that cite this headnote](#)

### Attorneys and Law Firms

**\*\*147** Kulik, Gottesman, Mouton & Siegel, LLP, [Thomas M. Ware II](#), Sherman Oaks, Sharon Barber; Borton, Petrini & Conron, LLP, [Matthew J. Trostler](#), Los Angeles, for Defendant and Appellant.

Enterprise Counsel Group, [David A. Robinson](#), [Benjamin P. Pugh](#), Irvine; Jeffrey Lewis, for Plaintiffs and Respondents.

### \*1113 OPINION

[O'LEARY, J.](#)

Marquesa at Monarch Beach (Marquesa) is a common interest development governed by the Davis–Stirling Common Interest Development Act ([Civ.Code, § 1350, et seq.](#)). It is comprised of single family homes in the Monarch Beach development of Dana Point, many of which have ocean and golf course views. The community is managed by the Marquesa at Monarch Beach Homeowners Association (the



Association), which is governed by a board of directors (the Board), and is subject to a recorded declaration of conditions, covenants, and restrictions (CC & Rs).

The Plaintiffs are individual homeowners within Marquesa whose views have been blocked by many palm trees in the development (some planted by the original developer, and some planted by homeowners), which have grown to heights exceeding the height of rooftops.<sup>1</sup> Because **\*\*148** trimming a palm tree would effectively require its removal, the Association has taken the position over the **\*1114** years that the CC & Rs' express requirement "[a]ll trees" on a lot be trimmed so as to not exceed the roof of the house on the lot, unless the tree does not obstruct views from other lots, does not apply to palm trees. Accordingly, it denied the Plaintiffs' demands that it enforce the CC & Rs and require offending palm trees be trimmed, topped, or removed.

<sup>1</sup> The plaintiffs and respondents are Robert and Margaret Ekstrom, James and Shendel Haines, Michael and Betty Sue Hopkins, Robert and Leona Kampling, Stephen and Cheryl Kron, Jim O'Neil, G. John and Joanne Scheffel, and Nicholas Shubin. For convenience, they will hereafter be referred to collectively as the Plaintiffs, unless the context indicates otherwise. In their respondents' brief, the Plaintiffs inform us that while this appeal was pending, Robert Kempling passed away. His estate was not substituted in. Additionally, Jim O'Neil and Michael and Betty Sue Hopkins no longer reside in Marquesa, although they have not been dismissed from this action.

The trial court granted the Plaintiffs' request for declaratory relief and mandamus to compel the Association to enforce its CC & Rs. The Association appeals contending: (1) the business judgment rule precludes judicial intervention in this matter; (2) the judgment is overbroad and void for vagueness; and (3) the judgment is void because the Plaintiffs did not join as defendants the individual homeowners whose trees might be affected by the judgment. We reject the contentions and affirm the judgment.

## FACTS & PROCEDURE

### CC & Rs

The Marquesa CC & Rs, recorded in 1989, provide for approval of all exterior improvements by the Association's

Architectural Review Committee (ARC). Section 7.13 of the CC & Rs requires the owner of each lot to submit an exterior landscaping plan to the ARC for approval and "[e]ach Owner shall properly maintain and periodically replace when necessary all trees, plants, grass, vegetation and other landscaping improvements located on the Owner's lot... If any Owner fails to install or maintain landscaping in conformance with architectural rules ... the [ARC] ... shall have the right either to seek any remedies at law or in equity which it may have or to correct such condition and to enter upon such Owner's property for the purpose of doing so, and such Owner shall promptly reimburse the [ARC] for the cost thereof ...."

Section 7.10 of the CC & Rs provides: "*View Impairment.* Each Owner, by accepting a deed to a Lot, acknowledges that grading of, construction on or installation of improvements on other property within [the development] and surrounding real property may impair the view of such Owner, and consents to such impairment."

Section 7.18 of the CC & Rs, pertaining to plantings, provides: "*Trees.* All trees, hedges and other plant materials shall be trimmed by the Owner of the Lot upon which they are located so that they shall not exceed the height of the house on the Lot; provided, however, that where trees do not obstruct the view from any of the other Lots in the Properties, which determination shall be within the sole judgment of the [ARC], they shall not be required to be so **\*1115** trimmed. Before planting any trees, the proposed location of such trees shall be approved in writing by the [ARC] which approval shall consider the effect on views from other lots."

Section 13.1 of the CC & Rs, regarding their enforcement, provides: "The Association, Declarant and any Owner shall have the right to enforce, by any proceedings at law or in equity, all restrictions, conditions, covenants and reservations now or hereafter imposed by the [CC & Rs]. Failure by the Association, Declarant or any Owner to enforce any covenants or restrictions contained in the [CC & Rs] shall [not ] be **\*\*149** deemed a waiver of the right to do so thereafter."<sup>2</sup>

<sup>2</sup> As written, section 13.1 omitted the word "not," which we have italicized above, reading, "Failure ... to enforce any of the [CC & Rs] shall be deemed a waiver of the right to do so thereafter." The Plaintiffs introduced deposition testimony of the original drafter of the CC & Rs (now Justice

Alex McDonald), that this was a typographical error, and the sentence should read “shall *not* be deemed a waiver” as was his practice in all CC & Rs he drafted [and the norm for CC & Rs]. In its statement of decision, the trial court found the section contained a typographical error and was intended to read as we have recited. The Association does not challenge the court's conclusion, but does assert the Board in good faith believed that by not enforcing the CC & Rs as to palm trees, it had waived the right to do so.

#### *The Plaintiffs Buy View Homes*

When each of the Plaintiffs purchased their homes in Marquesa, their homes had ocean and/or golf course views for which they paid a premium. Many of those views are now blocked by palm trees, which have been allowed to grow far above the height of the houses on the lots on which they are situated.

Plaintiff John Schoffel testified that when he moved into his house in 1997, he had a full ocean view that was not blocked by any trees. By 2002, he noticed palm trees growing into his view and by the time of trial, his home's view was about 40 percent blocked by 15 to 20 palm trees.

When Plaintiff Robert Ekstrom bought his home in 1999, it had a full ocean view. At that time, no palm trees in the community exceeded the height of the rooftops. Ekstrom's downhill neighbor, Davis Christakes—a member of the Association's Board of Directors—had about 20 palm trees growing on his property. Ekstrom reviewed the CC & Rs before his purchase and was satisfied section 7.18 would require Christakes' trees be trimmed or removed if they grew above the roofline and blocked Ekstrom's view.

Plaintiff Steve Kron bought his house with a full ocean view in 2001. Concerned that palm trees might grow to interfere with that view, Kron \*1116 reviewed the CC & Rs prior to closing escrow and understood that section 7.18 would protect his view from the trees.

There was evidence the Association routinely enforced section 7.18 of the CC & Rs as to other tree species, ordering homeowners to trim their trees when they exceeded the height of the house. There was also evidence that when approving an individual homeowners landscape plans in 1991, the ARC specifically did so on the condition that if any approved tree grew to a height where it became a view obstruction, the

owner would be required to have the tree topped, trimmed, or removed. And on at least one occasion in 1992, the ARC advised a homeowner that palm trees (apparently planted without ARC approval), had become a view obstruction from adjoining lots and must be removed or relocated to an area where they would not interfere with neighbors' views.

Christakes, who served on the Association Board for many years, owned a property on which over 20 palm trees are planted, several of which are among those now blocking the Plaintiffs' views. He participated over the years in Board actions concerning the enforcement of section 7.18 of the CC & Rs, consistently taking the position that section 7.18 could not be enforced as to palm trees. When a resident suggested Christakes had a conflict of interest as to the applicability of section 7.18 to palm trees, Christakes told her that since he had lost his own ocean view due to construction outside the development, he did not care if she lost hers as \*\*150 well, and if she did not like the Board's decision to exclude palm trees completely from enforcement under section 7.18, she could file a legal action.

#### *View HomeOwners Start to Complain*

Sometime in 2002, various homeowners, including some of the Plaintiffs, saw their views being slowly eroded by growing palm trees. They demanded the Association enforce section 7.18 of the CC & Rs and require the offending trees be trimmed (or removed). The majority of the Board was of the opinion the aesthetic benefit to the entire community from the maturing and now very lush looking palm trees outweighed the value of preserving views of just a few homeowners. Since then, the community has been divided into two contentious factions: those opposing any effort to top or remove any existing palm tree and those wanting palm trees that obstruct individual homeowners' views topped or removed.

In May 2002, the Board asked its then attorney, Gary Dapelo, for a legal opinion as to the interpretation of the CC & R's and the Board's responsibilities regarding enforcement of the CC & Rs as to palm trees. Dapelo opined the CC & Rs did not give any homeowner a right to maintain an existing view \*1117 because section 7.10 acknowledged grading and construction of improvements could impair an existing view. Section 7.18 gave the ARC (which in this case was the Board) sole discretion to decide that a tree did not obstruct a view and thus trimming or removal of the tree was not required. Dapelo opined that consistent with that discretion, the Board could exempt all palm trees entirely from enforcement. Dapelo also concluded homeowners with palms trees had defenses they



could assert to any attempt to enforce section 7.18 of the CC & Rs making it unlikely the Association would prevail in any attempt to require any palm tree be trimmed or removed.

In June 2002, the Board sent a memorandum to all homeowners advising them it had decided it would be unreasonable to require any homeowner to top or remove any palm tree in the community. It referred homeowners to a set of Board Rules and Regulations adopted in 1996, in which palm trees were specifically excluded from section 7.18 of the CC & Rs, and which stated palm trees need only be trimmed to remove dead fronds.

In 2003, a newly elected board member, who sympathized with the home owners wanting to preserve their views, prevailed upon the Board to obtain a second legal opinion. It had been discovered that Christakes had a close personal relationship with Dapelo, who was inexperienced in representing homeowner's associations. In 2004, the Association retained attorney Richard Tinnelly to review the matter.

In May 2004, Tinnelly advised the Board that section 7.18 of the CC & Rs protected views from being obscured by trees growing above roof height on the lot where the tree was located, and the Board had no authority to exclude palm trees from application of the CC & Rs. Tinnelly advised the Board that CC & Rs section 7.10, concerning view impairment, applied to construction of physical improvements on properties, such as houses, fences, decks, but did not apply to view obstruction by trees, because that was specifically covered by section 7.18. He advised the Board it had no authority to promulgate rules and regulations that directly contradicted the express protection provided in the CC & Rs. Tinnelly advised the Board that if it wanted to continue with its policy of the wholesale exclusion of palm trees from the ambit of section 7.18, it would have to amend the CC & Rs, a prospect Tinnelly believed had little chance of success.

**\*\*151** Tinnelly recommended to the Board that as to existing palm trees, it should ascertain which specific palm trees interfered with views and as to those trees, the Board should determine which were planted with ARC approval (as part of a homeowner's approved landscaping plan), and which were planted without approval. As to palm trees planted with ARC approval, Tinnelly believed the homeowner might have a detrimental reliance defense to forced **\*1118** removal of the tree and the Board would need to look at each case

individually to determine the possibility of success in any attempt to have the trees removed. Tinnelly advised the Board to require trimming or removal of unapproved palm trees growing above roof lines if it determined the tree blocked a view. He believed the Board did have discretion to formulate a definition of view.

The Board then attempted to amend the CC & Rs to exempt palms trees entirely from section 7.18, but could not garner sufficient homeowner votes. After the amendment attempt failed, one Board member commented within hearing of a homeowner that the Board could adopt regulations defining what constituted a "view" so narrowly that no palm tress would have to be removed.

#### *Litigation Begins*

In September 2004, Ekstrom wrote to the Board again about the palm trees obstructing his view. The Board did not respond. In November, the Plaintiffs' attorney wrote to the Board demanding it begin enforcing section 7.18 as to palm trees that were obstructing the Plaintiffs' views, and requesting mediation of the dispute.

At a board meeting on December 9, 2004, Tinnelly again urged the Board to start enforcing section 7.18 as to palm trees. He also urged the Board to engage in mediation with the Plaintiffs. Chrisakes commented that 75 percent of the homeowners did not want any palms trees removed and the Plaintiffs should be forced to "spend their own money if they want to sue to have trees removed." The Association refused to participate in mediation, and the Plaintiffs filed this action on December 17, 2004, seeking enforcement of the CC & Rs. The Plaintiffs' declaratory relief cause of action sought a declaration the Association had a duty to enforce section 7.18 as to growing palm trees, and sought an injunction directing the Board to appoint a committee to make a determination as to which palm trees obstructed the Plaintiffs' views and to direct that those trees be trimmed or removed as necessary.<sup>3</sup>

<sup>3</sup> The complaint also contained causes of action against individual Board members and the Association's property management company. The individual Board members were dismissed after a successful summary judgment motion, and the management association settled.

#### *The Board Adopts New Rules Concerning Palm Trees*

While this lawsuit was pending, the Board adopted new rules and regulations concerning the enforcement of section 7.18 of the CC & Rs as to palm trees. The 2006 rules defined “view” as used in section 7.18 as being only that which is visible from the back of the view house, six feet above ground level, standing in the middle of the outside of the house looking straight ahead to infinity, with nothing to the left or right of the lot lines being considered part of the home's view. This definition of “view” precluded most of the Plaintiffs from claiming any view obstruction from palm trees either because of the shape of the lot (for example the Ekstroms' lot was pie shaped with the narrow point being at the back of the lot), or because the Plaintiffs' primary view was from the second floor of the house, not the first.

The 2006 rules provided no palm tree planted before adoption of the rules would be removed without the tree owners' approval. If the owner of the palm tree agreed to permit a palm tree be removed, the owner of the view lot would have to pay the cost of removal. The rules set out requirements for trimming and maintenance of each palm tree species (e.g., how many fronds the palm tree could have, which direction the fronds could be pointing, how often a palm tree owner could be required to trim the tree).

#### *Statement of Decision*

In its statement of decision, the trial court concluded section 7.18 was included in the CC & Rs to preserve ocean and golf course views. There was nothing unclear or ambiguous in the terms used. The provision required *all* trees be trimmed down to the height of the roof of the house on the lot where it sits if the tree obstructs the view from another lot. In the context of the CC & Rs, the plain meaning of the term “‘trimmed’ means removed, as by cutting, or cut down to a required size.” The word “[obstruct] means to block from sight or be in the way of (and thus even one palm frond would block some portion of a view)” and the term “[view] means that which is visible to the naked eye while standing, sitting or lying down anywhere in one's home, or anywhere on one's Lot, looking in any direction one wishes.” The court rejected the restrictive definition of view as used in the 2006 rules as being in conflict with the CC & R's.

The trial court concluded section 7.18 (trees must be trimmed) did not conflict with section 7.10 (view impairment from improvements), because the latter provision did not apply to trees or vegetation. It found requiring palms trees be trimmed or topped (even assuming trimming would result in death of the tree) was not unfair to the tree owners as

they acquired their properties with knowledge of section 7.18 and its requirement their trees could not be permitted to grow to block views from other lots. The court rejected the Association's argument section 7.18 gave the ARC discretion to allow all palm trees that exceeded the roof height of the house. That sentence gave the ARC discretion to decide whether a particular palm tree obstructed a neighbor's view, but not to allow a palm tree that did in fact block a view to remain untrimmed.

In its statement of decision, the court rejected the Association's various defenses. The hardship on view lot owners if views (for which they paid a premium price) were destroyed outweighed the hardship on the owner of a palm tree if required to trim or remove the trees. There was no hardship to the Association because the CC & Rs require the owners of trees bear the expense of trimming, and the possibility of lawsuits against the Association by tree owners was speculative.

The four-year statute of limitations applicable to actions to enforce CC & Rs ([Code Civ. Proc., § 337](#)) did not commence until homeowners demanded enforcement of the CC & Rs in 2002, which was when their views started becoming obscured. The court concluded there was no basis for concluding the Association was estopped to enforce the CC & Rs (by having approved landscaping plans), and there was no evidence to support a waiver (by failing to enforce the CC & Rs) defense.

The court rejected several additional affirmative defenses because they had not been pled by the Association in its answer, or raised by it during trial, but were referenced for the first time in the Association's request for a statement of decision. They included the business judgment-judicial deference rule, the litigation committee defense, and failure to join indispensable parties. The court also rejected those defenses on the merits as well. The business judgment-judicial deference rule did not apply to acts beyond the authority of the Board. The adoption of the 2006 rules did not resolve the matter because the rules conflicted with the CC & Rs. The “litigation committee” defense was applicable only in the context of shareholder derivative suits. And owners of lots with palm trees that might eventually need to be removed were not indispensable parties to this action.

#### *The Judgment*

In its judgment, the court ordered the Association to enforce section 7.18 as to palm trees. It ruled that consistent with the

CC & Rs, the ARC had discretion, to be exercised in good faith, to determine whether any particular palm tree exceeding roof height in fact blocked a view, but the Association did not have discretion to exempt from enforcement palm trees that were found to block views. The ARC's approval of a landscaping plan that included palm trees did not exempt the palm tree from the requirements of section 7.18. The judgment defined “ ‘view’ ” as “a view of the ocean or neighboring golf course visible in any direction from anywhere on a homeowner's lot, inside or outside one's house.” It defined “ ‘obstruct’ ” as “to block from sight or be in the way even partially, and thus even one palm frond could block some portion of a view.” Neither the Plaintiffs nor the Association had waived their rights to enforce the CC & Rs. The individual \*1121 homeowners with trees violating section 7.18 were not indispensable parties, and principles of res judicata would operate to bind all homeowners to the judgment. The judgment ordered the Association “to enforce [s]ection 7.18 and to utilize every enforcement mechanism available to it under the CC & Rs and the law in order to do so.” The court retained jurisdiction to enforce the judgment including jurisdiction to appoint a special master to ensure the Association's compliance with the judgment. The Plaintiffs were declared the prevailing parties and awarded their costs and attorney fees.

## DISCUSSION

### 1. Standard of Review

[1] [2] [3] An appealed judgment or order is presumed to be correct, and the appellant bears the burden of overcoming that presumption. (*Stevens v. Owens–Corning Fiberglas Corp.* (1996) 49 Cal.App.4th 1645, 1657, 57 Cal.Rptr.2d 525.) The Plaintiffs sought and obtained declaratory relief and injunctive relief. Generally, the trial court's decision to grant or deny such relief will not be disturbed on appeal unless it is clearly shown its discretion was abused. (*Salazar v. Eastin* (1995) 9 Cal.4th 836, 849–850, 39 Cal.Rptr.2d 21, 890 P.2d 43 [injunctive relief]; *Dolan–King v. Rancho Santa Fe Assn.* (2000) 81 Cal.App.4th 965, 974, 97 Cal.Rptr.2d 280 (*Dolan–King*) [declaratory relief].) Where, however, the essential facts are undisputed, “in reviewing the propriety of the trial court's decision, we are confronted with questions of law. [Citations.] Moreover, to the extent our review of the court's declaratory judgment involves an interpretation of the [CC & Rs] provisions, that too is a question of law we address de novo. [Citations.]” (*Ibid.*)

### 2. Lamden Judicial Deference Rule

The Association contends the “judicial deference rule” adopted by the California Supreme Court in *Lamden v. La Jolla Shores Clubdominium Homeowners* \*\*154 Assn. (1999) 21 Cal.4th 249, 87 Cal.Rptr.2d 237, 980 P.2d 940 (*Lamden*), which is an adaptation of the business judgment rule applicable to directors of corporations, precludes judicial review of any of its decisions concerning the enforcement or nonenforcement of section 7.18 of the CC & Rs as to palm trees. We disagree.

[4] [5] “ ‘The common law business judgment rule has two components—one which immunizes [corporate] directors from personal liability if they act in accordance with its requirements, and another which insulates from court intervention those management decisions which are made by directors in good faith in what the directors believe is the organization's best interest.’ [Citations.] A hallmark of the business judgment rule is that, when the rule's \*1122 requirements are met, a court will not substitute its judgment for that of the corporation's board of directors. [Citation.]” (*Lamden, supra*, 21 Cal.4th at p. 257, 87 Cal.Rptr.2d 237, 980 P.2d 940.)

In *Lamden*, the owner of a condominium unit objected to the association's board of directors' decision to spot treat for termites rather tenting and fumigating the entire building. The Supreme Court adopted a rule it termed as analogous to the business judgment rule, holding, “Where a duly constituted community association board, upon reasonable investigation, in good faith and with regard for the best interests of the community association and its members, exercises discretion within the scope of its authority under relevant statutes, covenants and restrictions to select among means for discharging an obligation to maintain and repair a development's common areas, courts should defer to the board's authority and presumed expertise.” (*Lamden, supra*, 21 Cal.4th at pp. 253, 265, 87 Cal.Rptr.2d 237, 980 P.2d 940.) The Supreme Court adopted the association's position, at least as far as ordinary managerial decisions are concerned: “Common sense suggests that judicial deference in such cases as this is appropriate, in view of the relative competence, over that of courts, possessed by owners and directors of common interest developments to make the detailed and peculiar economic decisions necessary in the maintenance of those developments.” (*Id.* at pp. 270–271, 87 Cal.Rptr.2d 237, 980 P.2d 940.)

*Lamden's* holding, however, is not so broad as the Association asserts. It applied the “rule of judicial deference to community association board decisionmaking” where owners “seek to litigate ordinary maintenance decisions entrusted to the discretion of their associations' boards of directors. [Citation.]” (*Lamden, supra*, 21 Cal.4th at pp. 253, 260, 87 Cal.Rptr.2d 237, 980 P.2d 940.) And *Lamden* did not purport to extend judicial deference to board decisions that are outside the scope of its authority under its governing documents. *Lamden* specifically reaffirmed the principle that, “ ‘Under well-accepted principles of condominium law, a homeowner can sue the association for damages and an injunction to compel the association to enforce the provisions of the declaration. [Citations.]’ ” (*Id.* at pp. 268–269, 87 Cal.Rptr.2d 237, 980 P.2d 940, citing *Posey v. Leavitt* (1991) 229 Cal.App.3d 1236, 1246–1247, 280 Cal.Rptr. 568, *Cohen v. Kite Hill Community Assn.* (1983) 142 Cal.App.3d 642, 191 Cal.Rptr. 209.)

[6] [7] [8] [9] The Plaintiffs contend the Association has waived the application of the *Lamden* rule of judicial deference because it is in the nature of an affirmative defense that was not pled in the Association's answer or litigated at trial. The Association responds it was not required to raise the *Lamden* rule below because the rule merely \*155 embodies the proper standard of judicial review—it is not a defense at all. But the very language used in *Lamden*, indicates judicial deference is owed only when its has been shown the Association acted after “reasonable investigation, in good faith and with regard for the best \*1123 interests of the community association and its members....” (*Lamden, supra*, 21 Cal.4th at pp. 253, 265, 87 Cal.Rptr.2d 237, 980 P.2d 940.) A defense of good faith is necessarily factual in nature. (*Everest Investors 8 v. McNeil Partners* (2003) 114 Cal.App.4th 411, 432, 8 Cal.Rptr.3d 31.) Just as the corporate business judgment rule, which is a rule of judicial deference to good faith management decisions of corporate boards, is a defense (see *Finley v. Superior Court* (2000) 80 Cal.App.4th 1152, 1157, 96 Cal.Rptr.2d 128), so to is the rule of judicial deference to decisions of homeowner association boards articulated in *Lamden*. An affirmative defense may be waived if it is not raised below. (*California Academy of Sciences v. County of Fresno* (1987) 192 Cal.App.3d 1436, 1442, 238 Cal.Rptr. 154.) The defense was raised for the first time after trial in the Association's request for a statement of decision. The trial court correctly ruled the Association waived application of the *Lamden* rule of judicial deference by not raising it earlier.

Even if the judicial deference rule was not waived, we conclude the trial court correctly found it inapplicable in this instance. We consider the rule in two contexts. First, we consider whether the Association's position prior to the institution of this litigation that it could simply exempt all palm trees from the purview of section 7.18 of the CC & Rs is entitled to judicial deference. Second, we consider whether the Board's adoption of the 2006 rules concerning the enforcement of section 7.18 as to palm trees is entitled to judicial deference.

[10] The former issue is not so hard. We review the interpretation of the CC & Rs de novo. (*Dolan–King, supra*, 81 Cal.App.4th at p. 974, 97 Cal.Rptr.2d 280.) Section 7.18 is not at all ambiguous. It provides that “[a]ll trees, hedges and other plant materials shall be trimmed by the Owner of the Lot upon which they are located so that they shall not exceed the height of the house on the Lot....” (Italics added.) If, however, the ARC determines the trees “do not obstruct the view from any of the other Lots” then the trees do not need to be so trimmed (i.e., they may exceed the height of the house). The only reasonable construction to be given to the provision is that homeowners are afforded protection from having their views obstructed by vegetation, including trees. Nothing in the CC & Rs permits the Association to exclude an entire species of trees from section 7.18's application simply because it prefers the aesthetic benefit of those trees to the community. Even if the Board was acting in good faith and in the best interests of the community as a whole, its policy of exempting all palm trees from the application of section 7.18 was not in accord with the CC & Rs, which require *all* trees be trimmed so as to not obscure views. The Board's interpretation of the CC & Rs was inconsistent with the plain meaning of the document and thus not entitled to judicial deference. (*Lamden, supra*, 21 Cal.4th at pp. 253, 265, 87 Cal.Rptr.2d 237, 980 P.2d 940.)

\*1124 The Association also argues the trial court was required to defer to the Association's decision in 2006 to adopt rules to enforce section 7.18 as to palm trees. It urges the new rules represent an appropriate balance between the communities' interest in maintaining the palm trees and the individual homeowner's interests in preserving their existing views. Accordingly, \*156 the Association argues the 2006 rules render moot the entire dispute.

[11] We disagree the new rules are entitled to judicial deference under *Lamden*. As with the Board's prior policy that palm trees are exempt from the CC & Rs, the new



rules are in direct conflict with the CC & Rs. The rules specifically exclude *all* palm trees planted before 2006—which basically means all trees that might currently obscure the Plaintiffs' views. But section 7.18 does not grant the Association discretion to exclude view-blocking trees, it only gives the ARC discretion to determine whether or not a particular tree blocks a view. Furthermore, the new rules established what might best be called a “bowling alley” definition of what constituted view. Even if the Board had some discretionary authority to define what was meant by “view”, it was not free to fashion a definition that rendered section 7.18 meaningless. (See *Nahrstedt v. Lakeside Village Condominium Assn.* (1994) 8 Cal.4th 361, 380–381, 33 Cal.Rptr.2d 63, 878 P.2d 1275 [CC & Rs to be interpreted according to rules of contracts with view toward enforcing reasonable intent of parties].)

The Association cites *Harvey v. Landing Homeowners Assn.* (2008) 162 Cal.App.4th 809, 76 Cal.Rptr.3d 41, for the proposition the trial court was required to defer to the Association's chosen method for enforcing the CC & Rs, i.e., the 2006 rules. In *Harvey*, the association board permitted owners of units adjacent to common area attic space to utilize portions of the common area for exclusive storage. (*Id.* at p. 813, 76 Cal.Rptr.3d 41.) The appellate court concluded the association board acted according to the authority granted to it in the CC & Rs. “ ‘The CC & R's make clear the Board has the ‘sole and exclusive’ right to ‘manage’ the common area ...; to ‘adopt reasonable rules and regulations not inconsistent with the provisions contained in [the CC & R's]’ relating to that use ...; to designate portions of the common area as ‘storage areas’ ...; and to authorize it to allow an owner to use exclusively portions of the common area ‘nominal in area’ adjacent to the owner's unit, provided such use ‘does not unreasonably interfere with any other owner's use or enjoyment of the project.’ ” (*Id.* at pp. 818–819, 76 Cal.Rptr.3d 41, fn. omitted.) *Harvey* went on to conclude the *Lamden* rule of judicial deference applied to more than just ordinary discretionary maintenance decisions. “Under the ‘rule of judicial deference’ adopted by the court in *Lamden*, we defer to the [b]oard's authority and presumed expertise regarding its sole and exclusive right to maintain, control and manage the common areas when it granted the fourth floor homeowners the right, under certain conditions, to use up to 120 square feet of inaccessible attic space common \*1125 area for rough storage.” (*Harvey, supra*, 162 Cal.App.4th at p. 821, 76 Cal.Rptr.3d 41.) *Harvey* is inapposite. In *Harvey*, the board was acting consistently within the authority granted

it in the CC & Rs. Here, the CC & Rs do not give the Board discretion to act as it did.

### 3. *Vagueness and Overbreadth*

The Association contends the judgment is void because it is too broad and too vague. Specifically, the Association attacks the language in the judgment ordering it not just to begin enforcing section 7.18, but “to utilize every enforcement mechanism available to it under the CC & Rs and the law in order to do so.”

[12] [13] The Association first contends this language is too broad and impermissibly interferes with its discretion to determine how (and whether and when) to enforce the CC & Rs. It cites us to *Lamden, supra*, 21 Cal.4th 249, 87 Cal.Rptr.2d 237, 980 P.2d 940, *Haley v. Casa Del Rey \*\*157 Homeowners Assn.* (2007) 153 Cal.App.4th 863, 63 Cal.Rptr.3d 514, and *Beehan v. Lido Isle Community Assn.* (1977) 70 Cal.App.3d 858, 137 Cal.Rptr. 528, for the proposition the Association alone has discretion to determine how to enforce its CC & Rs. But as noted in *Lamden*, when an association refuses to enforce its CC & Rs, a homeowner may seek an injunction compelling it to do so. (*Lamden, supra*, 21 Cal.4th at p. 268, 87 Cal.Rptr.2d 237, 980 P.2d 940 [“ ‘[u]nder well-accepted principles of condominium law, a homeowner can sue the association for damages and an injunction to compel the association to enforce the provisions of the declaration’ ”].) In view of the Association's historical position that it need not and would not enforce section 7.18 as to palm trees, a directive that it utilize all enforcement mechanisms available is necessary to ensure the Association does not simply now make a token effort.

[14] The Association also complains the directive that it “utilize every enforcement mechanism available to it under the CC & Rs and the law” is vague because it is could be construed as a directive that it commence legal action against specific homeowners who have not been identified. To satisfy the requirement that injunctions concerning real property be specific, the Association argues the judgment must specify “against which homeowners, what properties, and with respect to what trees” it must act. It complains the lack of such direction in the judgment “severely impairs” its ability to comply with the judgment. We disagree.

Under section 7.18, it is the Association, through its ARC, that has the sole discretion under the CC & Rs to determine whether a specific palm tree that has grown beyond roof-top height “obstruct[s] the view from any of the other Lots....”

Until now, the Association has simply avoided any exercise of this \*1126 discretion by taking the position *all* palm trees are excluded from the directive. Until the Association begins to do its job, the specific trees that must be trimmed will not be identified. The judgment is sufficiently clear as to what the Association must do. It must comply with its obligations by exercising its discretion “in good faith” to determine which trees obstruct the Plaintiffs’ views and it must then undertake the procedures outlined in the CC & Rs to enforce the CC & Rs as to those trees. The Association cannot feign ignorance of what it should do—it has apparently had no difficulty figuring out how to carry out its responsibilities as to other trees species and has in the past required homeowners to trim or remove such trees.

We are equally unimpressed by the Association’s assertion it should not be required to act at all to enforce section 7.18 as to palm trees because it has not been told how far it must go—specifically, whether it must go so far as to commence legal action. The trial court specifically retained jurisdiction to oversee enforcement. (See *Molar v. Gates* (1979) 98 Cal.App.3d 1, 25, 159 Cal.Rptr. 239.) It is pure speculation as to whether legal action against any homeowner will be necessary. And whether the Association should ultimately seek injunctive relief against any tree owner will have to be judged by the facts in existence at that time. (See *Beehan, supra*, 70 Cal.App.3d at p. 866, 137 Cal.Rptr. 528 [refusal of association to seek injunctive relief against homeowner in violation of CC & Rs “must be judged in light of the facts at the time the board consider[s] the matter”].) In current economic times, it might make little economic sense for the Association to pursue costly litigation against individual homeowners who refuse to comply with the CC & Rs, particularly since it is all the homeowners, \*\*158 including Plaintiffs, who will ultimately bear the cost of such litigation. And in such case, the Plaintiffs are certainly free to pursue

their own litigation against individual homeowners to compel removal of any specific offending palm trees. (See *Lamden, supra*, 21 Cal.4th at p. 268, 87 Cal.Rptr.2d 237, 980 P.2d 940 [homeowner can sue directly to enforce CC & Rs].)

#### 4. Failure to Join Indispensable Parties

[15] The Association contends the judgment is void because the Plaintiffs failed to join as defendants the individual homeowners whose palm trees are obstructing their views as required by [Code of Civil Procedure section 389](#). Accordingly, it argues the court in essence permitted an involuntary defense class action in which the rights of the individual tree owners have been adjudicated without their participation in this lawsuit. Because the Association did not raise this issue until after trial, in its request for a statement of decision, it has waived the argument on appeal. (*McKeon v. Hastings College* (1986) 185 Cal.App.3d 877, 889, 230 Cal.Rptr. 176.) Furthermore, [Civil Code section 1368.3](#) provides an association may defend litigation concerning enforcement of CC & Rs without joining the individual homeowners in the association.

#### \*1127 DISPOSITION

The judgment is affirmed. The Respondents are awarded their costs on appeal.

WE CONCUR: [RYLAARSDAM](#), Acting P.J., and [ARONSON](#), J.

#### All Citations

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**The Role Of Competition Agencies In Regulated Sectors**

~ Friday, May 11, 2007

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**THE ROLE OF COMPETITION AGENCIES IN REGULATED SECTORS**

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5<sup>th</sup> International Symposium on Competition Policy and Law  
Institute of Law  
Chinese Academy of Social Sciences  
Beijing, China

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**THE ROLE OF COMPETITION AGENCIES IN REGULATED SECTORS**

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Market economies operate from the general principle that the invisible hand of the market results in a more optimal distribution of resources and a higher level of economic welfare than does regulation of economic activity by the



heavy, visible hand of the government. The role of antitrust laws should be to ensure that the invisible hand is allowed to do its work efficiently and effectively.

That does not mean, however, that economic regulation has no place in market economies. Indeed, economists agree that in at least some industries—for example, industries characterized by constantly declining supply curves (often called "natural monopolies")—economic regulation by the government will provide more consumer welfare benefits than would a *laissez-faire* approach. Regulation has also been justified as a means of accomplishing objectives that go beyond pure competition goals—for example, to implement a policy of universal access to basic services, or to ensure that the economy can reap the benefits of network economies that might not otherwise be achieved. There may also be structural impediments or other market failures that counsel against deregulation at a given time. As a consequence, every country, including the United States, currently regulates some sectors of its economy.

Over the past 120 years and concurrent with the adoption and refinement of an economy-wide antitrust law, the United States has implemented a variety of federal regulatory schemes in particular sectors. After long experience with these regulatory approaches, however, we learned that over-regulation imposes substantial costs and inefficiencies on the economy. We also discovered that some sectors that we had considered to be natural monopolies and therefore appropriate subjects for regulation rather than competition have turned out, either because of better economic understanding or technological changes, not to be natural monopolies. These sectors are now understood to be suitable for market-based competition.

As a consequence, over the past 25 years the United States has pursued a policy of deregulation, during which we have eliminated or rolled-back regulation in most of the previously-regulated sectors, seeking instead to introduce competition and its market disciplines to the greatest extent possible. These deregulatory efforts have provided huge benefits to consumers and to the economy. One study estimated that deregulation in just three industries in the United States—airlines, motor carriers, and railroads—has increased U.S. GDP by about ½ percent *each year*.<sup>(2)</sup>

Where sectors have been fully deregulated, it is clear that the antitrust laws should fully apply. However, where there has been only partial deregulation, so that some competition has been introduced in a sector, but some regulation continues, the interplay between competition law and sectoral regulation becomes very important. Today I will discuss how the United States has approached this problem. I will then discuss the lessons that China may wish to take from the U.S. experience. Finally, I will make a few comments on the approach taken in the latest public version of China's draft Antimonopoly Law.

### U.S. Approaches to the Interface of Competition Law and Sectoral Regulation

In the United States, our courts have recognized the important role that our antitrust laws play in our economy and in our society as a whole. In fact, the U.S. Supreme Court has described the antitrust laws as a "comprehensive charter of economic liberty."<sup>(3)</sup> In light of this high status accorded the antitrust laws, it is not surprising that our courts have been reluctant to conclude that the antitrust laws have been superseded by other regulatory systems. On the contrary, our courts have held that unless our Congress has expressed a clear intention to displace competition in a particular sector, the courts should interpret the regulatory regime and the antitrust laws in a way that tries to give effect to both.<sup>(4)</sup>

In actual practice, the United States has adopted several different models to define the relationship between sectoral regulators and antitrust enforcement agencies.

In a very few instances, our Congress has explicitly decided that some or all of the activities of enterprises in a particular regulated industry should be completely exempt from the antitrust laws, and subject only to the supervision of the regulatory authority. The Interstate Commerce Act, for example, exempted from antitrust scrutiny any rail carrier merger that was approved or exempted from approval by the regulatory agency. Instead, the Surface Transportation Board ("Board"), which currently oversees the rail sector, must approve rail carrier mergers. The Board is required to approve mergers that are "consistent with the public interest," based on consideration of a variety of factors, including whether the proposed transaction would have an adverse effect on competition among rail carriers in the affected region.<sup>(5)</sup> However, the Department of Justice must be notified of proposed mergers between major (class 1) rail carriers, and may choose to participate as a party in the proceedings before the Board.<sup>(6)</sup>

In the vast majority of regulated sectors in the United States, by contrast, the antitrust enforcement agencies are empowered to investigate and take enforcement action against any anticompetitive conduct in that sector. This statement is subject to one important caveat, however. The courts have developed the concept of "implied immunity" to protect from antitrust attack conduct that is necessary to implement the regulatory scheme intended by Congress. However, implied antitrust immunity is not found frequently, and is reserved for situations where there is a "clear repugnancy between the antitrust laws and the regulatory system."<sup>(7)</sup>

In some regulated sectors, our Congress has made it clear that the antitrust laws should fully apply to the conduct of regulated enterprises and that the courts should not find any implied antitrust immunity for such conduct. For example, the Telecommunications Act of 1996 makes clear that telecommunications carriers must conform their conduct to the requirements of both the Sherman Act as well as to the Telecommunications Act. The Congress included a specific provision in the Telecommunications Act to make clear its intention that that Act not be construed "to modify, impair, or supersede the applicability of any of the antitrust laws."<sup>(8)</sup> So, for example, if long-distance telephone companies were to enter into a price-fixing agreement to set the rates for long-distance calls, the companies would be subject to criminal antitrust prosecution, just as would companies in any other sector.<sup>(9)</sup>

In most regulated sectors in the United States, however, both the antitrust authorities and the regulatory authorities have concurrent jurisdiction over anticompetitive conduct. Both authorities may independently block or challenge anticompetitive conduct, with the regulatory agency's operative review standard typically including both competition and non-competition factors. The approval of one agency does not necessarily mean that the other agency will refrain from challenging or blocking the same conduct. As is readily apparent, having two agencies investigating and addressing the competitive effects of the same conduct -- such as is frequently the case for mergers in regulated sectors -- can lead to conflicting decisions, particularly in the absence of close cooperation and coordination between the antitrust authorities and the regulator. Let me provide a few examples of the operation of concurrent jurisdiction in the review of competitive effects of business conduct in regulated sectors in the United States.

### *Telecommunications*

The telecommunications sector is one of the areas where concurrent jurisdiction over mergers works reasonably well. The Federal Communications Commission ("FCC") is required to review the transfer of telecommunications licenses and authorizations, such as will occur in the merger of two telecommunications companies. The FCC review is based on whether the transaction will serve "the public interest, convenience and necessity."<sup>(10)</sup> The FCC's public interest analysis is broader than the antitrust analysis conducted by the Department of Justice<sup>(11)</sup> under Section 7 of the Clayton Act,<sup>(12)</sup> since the FCC must consider not only whether the transaction preserves and enhances competition in relevant markets, but also whether the merger ensures that a diversity of voices is made available to the public and whether it will help accelerate the private sector deployment of advanced services.<sup>(13)</sup>

In its evaluation of the competitive effects of a merger, the FCC seeks to apply the same standards and criteria used by the Department of Justice.<sup>(14)</sup> To minimize the possibility that their respective analyses of the competitive effects of the transaction will lead to inconsistent results, our two agencies cooperate extensively on an informal basis. Although FCC rules generally require it to disclose any meetings with outside persons, the rules contain an exception for meetings with the antitrust authorities.<sup>(15)</sup> Consequently, we are able to share non-confidential industry information and discuss the appropriate relevant market parameters, theories of competitive harm, and proposed remedies. Cooperation is further enhanced when our agencies are able to share confidential information pursuant to a limited waiver of confidentiality by the parties to the transaction.

### *Electricity*

In the energy sector, the interstate transmission of electricity is regulated by the Federal Energy Regulatory Commission (FERC), and both FERC and the Department of Justice review mergers in the electricity sector. FERC reviews mergers pursuant to section 203 of the Federal Power Act,<sup>(16)</sup> which requires FERC to approve a merger if it will be "consistent with the public interest." Under this "public interest" test, FERC considers the effects of the merger in three areas: competition, rates, and regulation. In 1996, FERC issued a Merger Policy Statement, in which it adopted the antitrust agencies' Horizontal Merger Guidelines as the analytical framework under which it would analyze the competitive effects of a merger.<sup>(17)</sup> The adoption of the Merger Policy Statement by FERC means that it will analyze the competitive effects of mergers in the electricity sector with reference to the same merger guidelines

as used by the antitrust agencies, which one would expect would lead both agencies to come to the same conclusion regarding the likely competitive effects of a transaction. However, FERC rules concerning disclosure of any discussions about a pending matter with outside parties (including with the Department of Justice) preclude the same informal, cooperative exchanges of information and discussion between staffs as occurs with the FCC with regard to mergers in the telecommunications area. Therefore, competitive effects analyses by FERC have not always matched the conclusions reached by the Department of Justice. I will briefly discuss one example.

In December 2004 Exelon Corporation proposed to merge with Public Service Enterprise Group, Inc., a transaction that would have created the largest electric and gas utility in the United States with assets of nearly \$80 billion and annual revenues of \$27 billion. The merging parties competed for electricity customers in the mid-Atlantic region of the United States as well as in four other states.

Both the Department of Justice and FERC separately reviewed the transaction to determine its likely competitive effects. Both agencies concluded that the proposed transaction, as originally structured, would likely substantially reduce competition in wholesale electricity rates in the mid-Atlantic region of the United States (albeit using slightly different geographic market definitions.) In June 2005 FERC announced that it would approve the transaction if the companies divested 4,000 megawatts of unspecified generation facilities in that region, and additionally agreed to sell 2,600 megawatts of energy from their nuclear plants.<sup>(18)</sup> One year later, the Department of Justice determined that the merger was anticompetitive, but also concluded that the competitive effects could be resolved and the transaction allowed to proceed if the parties divested six specific electricity generation plants in Pennsylvania and New Jersey, the area in which the merging companies had the greatest concentration of assets. The companies agreed to divest those plants, and the Department of Justice announced that, subject to court approval of the proposed Consent Decree, it would agree to allow the transaction to proceed under those conditions.<sup>(19)</sup>

The most significant difference between the FERC and Justice Department approaches in that case was in the construction of the remedy. The FERC remedy was focused primarily on lowering the concentration of ownership of generating facilities. The Justice Department approach was different. Although the Justice Department's divestiture plan would have substantially reduced market shares and concentration levels compared to the levels that would have existed had the merger gone through as originally proposed, the purpose of the DOJ-approved divestitures was to preserve competition, not to maintain market shares or concentration levels at their pre-merger levels.<sup>(20)</sup> Instead, the DOJ remedy sought divestiture by Exelon of specific key assets that would have made it profitable for Exelon to withhold output and raise prices in the relevant market. By contrast, FERC's unspecified divestiture did not guarantee that the merged firm would give up the critical assets needed to ensure that the merged firm could not withhold output and raise price profitably.<sup>(21)</sup>

## Banking

The jurisdiction of the Department of Justice to review bank mergers was confirmed by the U.S. Supreme Court in its 1963 decision in the Philadelphia National Bank case.<sup>(22)</sup> Three years later, the Bank Merger Act and the Bank Holding Company Act were amended to provide for concurrent independent reviews of bank mergers by the Department of Justice and the relevant bank regulatory agency.<sup>(23)</sup> Under the Bank Merger Act of 1966, the bank regulator is required to seek a report on competitive factors involved in the merger from the Department of Justice. The bank regulator must take this report into consideration in its decision-making on the competitive effects of the transaction, but may not be required to follow the Justice Department's advice, depending on other factors. In 1995 the Department of Justice, Federal Reserve Board and Office of the Comptroller of the Currency jointly published bank merger screening guidelines<sup>(24)</sup> to help ensure that the bank regulators and the Department of Justice apply similar standards in evaluating the competitive effects of a merger, although the screening guidelines make clear that the regulatory agencies and the Department of Justice, in practice, do not necessarily use the same product market or geographic market definitions. For example, the Department of Justice examines the competitive effects of the transaction in disaggregated product markets (including retail, small business and middle-market lending) while the banking agencies look at the cluster of banking services. Remedies recommended by the Justice Department and the bank regulators may also differ, with Justice Department remedies more likely to be focused on ensuring that market competition is protected, rather than simply on restoring the pre-merger structural characteristics of the market (as was also the case in the Exelon electricity merger discussed earlier.) Unlike the laws applicable to mergers in the telecommunications or energy areas, however, the bank regulators are authorized to approve an

anticompetitive merger if they find that the anticompetitive effects are "clearly outweighed in the public interest by the probable effects of the transaction in meeting the convenience and needs of the community to be served."<sup>(25)</sup>

### Implications for China

With that background on U.S. practice, let me now turn to the question of whether China should adopt the same concurrent jurisdiction approach to review of the competitive effects of conduct in regulated sectors as is common in the United States. China should consider carefully whether it is appropriate to follow the practice of the United States in this area. It may make more sense to have one agency responsible for conducting competitive effects analyses of both mergers and other business conduct in regulated sectors. A concurrent jurisdiction approach may result in a wasteful duplication of efforts, as both the antitrust agency and the sectoral regulator each evaluate the particular conduct involved and its likely effects on competition in the industry. Although some of this duplication can be avoided through coordination between the agencies, the need for separate decisions will inevitably mean that both agencies will be required to expend significant resources investigating and evaluating the competitive effects of the same conduct.

Of even greater concern is the potential additional burden and uncertainty imposed on the business community by parallel reviews. First, both agencies will need to collect information necessary to conduct their respective competitive effects analyses from the enterprises engaged in the suspected anticompetitive conduct, as well as from other market participants. Since the competition agency and the sectoral regulator will typically not take identical approaches to the investigation, recipients of investigatory inquiries may have to incur significant costs responding separately to each agency's request. Second, separate competition reviews may lead to different and in some cases inconsistent determinations as to whether conduct is anticompetitive, which may make it more difficult for enterprises to determine in advance whether proposed conduct will be found to create competitive problems so that they can avoid costly mistakes. Finally, dual competition reviews may lead to inconsistent remedy orders, as happened in the Exelon case that I described earlier, or to over-intervention, since the more aggressive, interventionist decision will be the one that has the most binding effect.

Therefore China may want to avoid adopting a concurrent competition review approach and instead make just one agency responsible for reviewing the competitive effects of activities in regulated sectors. Generally, competition agencies will be in a better position than sectoral regulators to engage in that analysis for several reasons. First, the competition agency will have broad experience across many sectors in determining relevant product and geographic markets and in analyzing the competitive effects of business conduct. The competition agency will be able to apply a consistent and independent eye to the competitive consequences of particular activities, and will have developed good instincts, based on sound economic analysis and extensive experience, as to what types of conduct are more likely to present competitive problems and what questions to ask in evaluating that conduct. The Antimonopoly Authority is also likely to have better investigative tools for collecting the necessary information to make those determinations, since it will have been set up and organized with precisely those functions in mind.

The sectoral regulators, by contrast, will not be as experienced in conducting competition analyses as the antimonopoly enforcement agency. Moreover, sectoral regulators are susceptible to what is known as "regulatory capture" by the industry that they regulate. The day-to-day interactions between industry officials and regulatory agency bureaucrats may lead to a commonality of interests that can interfere with the arm's-length perspective necessary to evaluate competitive harms and to construct remedies that will protect competition for the benefit of the economy as a whole. This commonality of interests can be further strengthened if the regulatory agencies seek to hire people with expertise obtained by working in the industry. Moreover, it is possible that regulatory agency staff may develop an interest in promoting the status quo in the industry, in part because of a desire to ensure that their own jobs will remain relevant or that there is a demand for their bureaucratic expertise when they are ready to leave government service.

Another factor weighing against putting regulatory agencies in charge of protecting competition is that regulators will typically have a pro-regulatory bias to addressing behavioral problems in the industry, both for the reasons I just discussed and because their world view is naturally influenced by the scope of their work experience which is to rely on regulation rather than market forces. This means that in looking for remedies to address competition problems, regulators may be more comfortable approving proposed transactions that increase market power and then attempting to limit the consequences of their decisions by imposing behavioral remedies, implemented through day-



to-day price or other regulation, rather than preventing the increase in market power through efficient and effective structural remedies. As a consequence, the structure of the industry may never evolve to the point where sufficient new entry is induced to permit further deregulation.<sup>(26)</sup>

For all of these reasons, China may want to consider giving the Antimonopoly Authority sole jurisdiction to evaluate and take enforcement action against anticompetitive conduct in regulated sectors. This does not mean, however, that the sectoral regulator should have no role to play in evaluating mergers and other conduct, and in promoting and protecting competition in their industries. First, the regulatory agency should cooperate with the Antimonopoly Authority wherever possible. The sectoral regulator will have a great deal of knowledge about the structure and day-to-day behavior of the markets within its purview. To the extent that the regulatory agency can share that information and cooperate in the antimonopoly investigation, the quality and efficiency of the Antimonopoly Authority's investigation and competitive effects determination will be significantly improved. For that reason, China should ensure that there are no unnecessary barriers to cooperation between the relevant agencies in the competition area, consistent with confidentiality requirements. Second, it may be appropriate for the regulatory agency to review mergers and other conduct for consistency with the agency's regulatory objectives. For example, as I mentioned earlier, the FCC examines mergers not only for their impact on competition, but also to ensure that there are a diversity of voices made available to the public and that the transaction will promote the dissemination of advanced telecommunications services.

I would like to add one caveat to the view that the competition enforcement agency be solely responsible for analyzing the competitive effects of business activities in regulated sectors. If it is determined that competition is best preserved through day-to-day regulation such as is typically the case in enforcing mandatory access to natural monopoly transmission networks then this is the type of competition-protecting activity that is better suited for regulatory agencies rather than competition enforcers.

This last point raises an additional role for competition agencies in regulated sectors engaging in competition advocacy. Where regulatory agencies are given a lead or concurrent role in promoting or preserving competition in a sector, or in balancing competition and non-competition objectives, competition agencies will often be able to use their expertise to provide useful advice on how to accomplish those objectives through the implementation of market-based solutions. For example, in 2005 the Department of Justice engaged in competition advocacy by submitting comments to the Federal Aviation Administration on how best to allocate take-off and landing slots at congested airports in that case Chicago's O'Hare International Airport in a manner that both addresses the problem of airport congestion and encourages competition.<sup>(27)</sup> The Justice Department recommended that the FAA conduct periodic anonymous take-off and landing slot auctions, which would thereby enable all carriers, both incumbents and entrants, to compete for access based on how efficiently they can use that scarce resource.

The competition advocacy function of antitrust agencies is a very useful and important one, particularly in regulated sectors, and I would encourage China to make clear in the Antimonopoly Law that the Antimonopoly Authority will have the authority to engage in competition advocacy activities.

#### Comments on Draft Antimonopoly Law Approach

Before closing today, I would like to take a few minutes to comment on the Antimonopoly Authority's role in regulated sectors as envisioned by the draft Antimonopoly Law currently being considered by the National People's Congress.<sup>(28)</sup> There are two primary provisions that appear to relate to the role of the Antimonopoly Authority in regulated sectors. First, Article 2 provides that the Antimonopoly Law does not apply "where other laws or administrative regulations provide provisions." Second, Article 44 states that where other laws or regulations stipulate that a particular department or organ shall investigate and handle conduct that would be prohibited by the Antimonopoly Law, that administrative agency shall have primary jurisdiction to investigate and handle the conduct. However, if the agency fails to investigate and handle the matter, then the Antimonopoly Authority may investigate and take appropriate action after seeking the opinion of the relevant agency.

My first comment is that these two provisions do not appear to be completely consistent. If Article 2 is read literally, once another law or regulation gives authority to an agency to investigate anticompetitive behavior, the Antimonopoly Law should not apply, and hence there would be no scope for the Antimonopoly Authority to take action even if the regulatory authority failed to act. Putting that problem aside, the approach taken in Article 44 to vest in the sectoral

regulator or other supervisory agency primary jurisdiction to investigate and address potentially anticompetitive conduct appears to avoid the problems of duplicative competitive effects investigations that I discussed earlier. However, for the reasons I stated, China may want to consider whether it would be better to give that authority to the Antimonopoly Authority rather than to the sectoral regulator.

Finally, I would like to comment on the approach taken in Article 2 to declare the Antimonopoly Law invalid against conduct with respect to which other laws or regulations "provide provisions." As I discussed at the beginning of my talk, it is sensible to give priority to specific laws or regulations authorizing conduct that would otherwise be unlawful under the competition laws. In the United States, this conduct may be protected by an implied immunity, even where no statute explicitly immunizes the conduct, as Article 2 appears to do. However, not all conduct in sectors covered by regulatory systems needs to be immunized from the antitrust laws. On the contrary, only conduct that is necessary to give effect to the regulatory system should be immunized. The language of Article 2 is not very clear on this point, and could be interpreted to immunize a broader range of conduct than would be necessary or appropriate. Therefore, it might be useful to re-examine the language of Article 2 with a view to clarifying that the exemption only applies to the extent of the inconsistency between the regulatory scheme and the Antimonopoly Law.

### Conclusion

In conclusion, determining the proper relationship between competition enforcement authorities and sectoral regulators is a complex issue that depends very much on the legal and regulatory systems of a country, the appropriate balance between sometimes conflicting regulatory and market-oriented objectives and the confidence that the government has in the effectiveness of the market in determining outcomes that are best for its citizens and its economy as a whole. I have provided my views on how best to address this problem, but there are many possible solutions, as is apparent just by looking at the multiple approaches taken in the United States. I wish the Chinese Government success in determining which approach is best for China.

Thank you.

### FOOTNOTES

1. The views expressed are those of the author, and do not necessarily reflect the views of the Department of Justice.
2. Economic Report of the President (Feb. 2002) at p.63, available at [http://www.gpoaccess.gov/usbudget/fy03/pdf/2002\\_erp.pdf](http://www.gpoaccess.gov/usbudget/fy03/pdf/2002_erp.pdf).
3. "The Sherman Act was designed to be a comprehensive charter of economic liberty aimed at preserving free and unfettered competition as the rule of trade. It rests on the premise that the unrestrained interaction of competitive forces will yield the best allocation of our economic resources, the lowest prices, the highest quality and the greatest material progress, while at the same time providing an environment conducive to the preservation of our democratic political and social institutions." *Northern Pacific Railway Co. v. United States*, 356 U.S. 1, 4-5 (1958).
4. See *National Gerimedical Hospital & Gerontology Center v. Blue Cross*, 452 U.S. 378, 392 (1981).
5. See 49 U.S.C.A. §§ 11324(c) and 11324(b)(5).
6. 49 U.S.C.A. §11325(b)(1).
7. See *United States v. National Ass'n of Securities Dealers, Inc.* 422 U.S. 694, 719-20 (1975).
8. 47 U.S.C. §152 note.
9. On the other hand, a violation of the rules or duties imposed on telecommunications carriers by the Federal Communications Commission the federal telecommunications regulator is not necessarily sufficient to constitute a violation of the antitrust laws. See the Supreme Court decision in *Verizon Communications Inc. v. Law Offices of Curtis V. Trinko*, 540 U.S. 398 (2004). See also, *Goldwasser v. Ameritech Corp.*, 222 F.3d 390 (7<sup>th</sup> Cir. 2000).

10. Sections 214(a) and 310(d) of the Communications Act of 1934, 47 U.S.C. §214(a), §310(d). The FCC is also authorized to analyze telecommunications mergers under Section 7 of the Clayton Act. 15 U.S.C. §21.
11. The Federal Trade Commission does not have jurisdiction over telecommunications common carriers. See 15 U.S.C. §§21(a) and 45(a)(2).
12. 15 U.S.C. §18.
13. See *In re Applications for Consent to the Transfer of Control of Licenses from Comcast Corp. and AT&T Corp. to AT&T Comcast*, 17 F.C.C.R. 23246, at 23255.
14. See Department of Justice and Federal Trade Commission 1992 Horizontal Merger Guidelines, as revised in 1997, available at <http://www.usdoj.gov/atr/public/guidelines/hmg.htm>.
15. 47 C.F.R. §1.1204(a)(6).
16. 16 U.S.C.A. §824(b).
17. See Merger Policy Statement, FERC Order No. 592 (December 18, 1996), available at <http://www.ferc.gov/industries/electric/gen-info/mergers/rm96-6.pdf>.
18. See FERC order authorizing merger under section 203 of the Federal Power Act (Docket No. EC05-43-000, July 1, 2005), available at <http://www.ferc.gov/whats-new/comm-meet/063005/E-4.pdf>.
19. See Proposed Final Judgment in *U.S. v. Exelon Corp. and Public Service Enterprise Group, Inc.*, available at <http://www.usdoj.gov/atr/cases/f216700/216784.htm>.
20. See, U.S. Department of Justice, Antitrust Division Policy Guide to Merger Remedies, §II (October 2004), available at <http://www.usdoj.gov/atr/public/guidelines/205108.htm> ("Restoring competition requires replacing the competitive intensity lost as a result of the merger rather than focusing narrowly on returning to premerger HHI levels.")
21. See Competitive Impact Statement in *U.S. v. Exelon Corp. and Public Service Enterprise Group, Inc.*, available at <http://www.usdoj.gov/atr/cases/f217700/217717.htm>.
22. See *United States v. Philadelphia National Bank*, 374 U.S. 321 (1963).
23. There are four different industry-specific regulators that have authority to approve or deny bank mergers, depending on the type of bank involved in the transaction: the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision. Of those four regulators, only the Federal Reserve Board has the authority to approve or deny bank holding company mergers. See 12 U.S.C. §1828(c) and §1842.
24. Bank Merger Competitive Review Introduction and Overview (1995), available at <http://www.usdoj.gov/atr/public/guidelines/6472.htm>. The Office of the Comptroller of the Currency version, dated July 18, 1995, is OCC Advisory Letter 95-4.
25. 12 U.S.C. §1828(c)(5).
26. I am indebted to my colleague, Jade Eaton, for this point.
27. See Comments of the Department of Justice on Congestion and Delay Reduction at Chicago O'Hare International Airport (May 24, 2005), available at <http://www.usdoj.gov/atr/public/comments/209455.htm>.
28. My comments are based on the June 22, 2006 draft Antimonopoly Law that was the subject of the first reading by the Standing Committee of the National People's Congress.

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**Speaker:**

Stuart M. Chemtob, Special Counsel for International Trade

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**Component(s):**

[Antitrust Division](#)

*Updated June 25, 2015*



## **LEGAL AUTHORITY CA-109**

**Before the  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, D.C. 20554**

In the Matter of

Policies Regarding Mobile Spectrum Holdings

WT Docket No. 12-269

***Ex Parte* Submission of the United States Department of Justice**

**Executive Summary**

In this filing, the Department of Justice's Antitrust Division reviews the importance of spectrum to competition and innovation in the wireless industry. The Department believes that a set of well-defined, competition-focused rules for spectrum acquisitions, particularly in auctions, would best serve the dual goals of putting spectrum to use quickly and promoting consumer welfare in wireless markets. The Department notes that bands of spectrum have different characteristics that may affect the competitive landscape. In particular, for instance, the propagation characteristics of lower frequency spectrum permit better coverage in both rural areas and building interiors. A carrier's position in low-frequency spectrum may determine its ability to compete in offering a broad service area, including its ability to provide coverage efficiently in rural areas. Therefore, the Department concludes that rules that ensure the smaller nationwide networks, which currently lack substantial low-frequency spectrum, have an opportunity to acquire such spectrum could improve the competitive dynamic among nationwide carriers and benefit consumers.

## I. Introduction

The United States Department of Justice (“Department”) provides this filing in response to a Federal Communications Commission (“FCC” or “Commission”) Notice of Proposed Rulemaking (“Notice”), published in the *Federal Register* on October 9, 2012.<sup>1</sup> The Notice requests comments to assist the FCC in a comprehensive review of its policies governing mobile spectrum holdings. The last comprehensive review was in 2003. The FCC seeks to ensure that its rules provide “greater certainty, transparency and predictability to make investment and transactional decisions, while also promoting the competition needed” for continued innovation.<sup>2</sup>

The Department of Justice’s Antitrust Division, as a federal agency responsible for enforcing the antitrust laws and promoting competition, has significant expertise in telecommunications issues and has participated in prior Commission proceedings that addressed the role of competition in telecommunications.

Over the last thirty years, the Department has helped to facilitate the transformation of the telecommunications industry, either directly in its role as an agency that enforces the antitrust laws or indirectly in its role as competition policy advocate and statutory respondent in cases involving appeals of Commission orders under the Hobbs Act.<sup>3</sup> Thus, from the critical decisions involved in resolution of the AT&T antitrust litigation and the implementation of that consent decree, to the decisions related to the design of the wireless telecommunications marketplace and the implementation of the Telecommunications Act of 1996, the Department has ensured that the preservation of competition in the

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<sup>1</sup> Policies Regarding Mobile Spectrum Holdings, 77 Fed. Reg. 61,330 (proposed Oct. 9, 2012) (to be codified at 47 C.F.R. pt. 20), available at [www.gpo.gov/fdsys/pkg/FR-2012-10-09/pdf/2012-24790.pdf](http://www.gpo.gov/fdsys/pkg/FR-2012-10-09/pdf/2012-24790.pdf) (“Notice”).

<sup>2</sup> *Id.* at 61,334.

<sup>3</sup> Hobbs Anti-Racketeering Act, 18 U.S.C. § 1951.

telecommunications industry has been a key priority.<sup>4</sup> Similarly, with respect to its merger review authority, the Department has evaluated a series of transactions that have reshaped the telecommunications marketplace, including investigations of the evolving roles of broadband Internet access and wireless services.<sup>5</sup>

Most recently, in 2011, after close coordination with the FCC, the Department filed a lawsuit to block a transaction that would have combined two of the only four wireless carriers with nationwide networks, AT&T Inc. and T-Mobile USA, Inc., ultimately leading the parties to abandon the merger.<sup>6</sup>

In 2012, the Department and the Commission reviewed a transaction in which Verizon, the largest wireless carrier in the nation, entered marketing agreements with and acquired spectrum from four of the nation's largest cable companies. The Department obtained limitations on the scope and duration of Verizon's agreements with the cable companies to prevent competitive harm and approved the acquisition of spectrum after

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<sup>4</sup> See, e.g., *United States v. American Telephone & Telegraph Co.*, 552 F. Supp. 131 (D.D.C. 1982), *aff'd sub nom. Maryland v. United States*, 460 U.S. 1001 (1983) (Modification of Final Judgment requiring Bell System break-up); Reply Comments of the United States Department of Justice, *In re Amendment of the Commission's Rules To Establish New Personal Communications Services*, FCC Gen. Docket No. 90-314, E.T. Docket No. 92-100 (Jan. 19, 1993) (addressing competition between cellular and PCS providers and allocation of PCS spectrum to promote competition); Evaluation of the U.S. Department of Justice, *In re Application by SBC Communications Inc., Southwestern Bell Telephone Company, and Southwestern Bell Communications Services, Inc., d/b/a Southwestern Bell Long Distance for Provision of In-Region, InterLATA Services in Texas*, FCC CC Docket No. 00-4 (Feb. 14, 2000) (regarding Regional Bell Operating Company entry into long distance services under Section 271 of the Telecommunications Act). More recently, the Department participated in the Commission's initial "net neutrality" proceeding. *Ex Parte* Filing of the United States Department of Justice, *In re Broadband Industry Practices*, FCC WC Docket 07-52 (Sept. 6, 2007).

<sup>5</sup> See case filings involving *United States, et al. v. Cingular Wireless Corp., SBC Commc'n Inc., BellSouth Corp., and AT&T Wireless Serv's, Inc.*, available at [www.justice.gov/atr/cases/cingular.htm](http://www.justice.gov/atr/cases/cingular.htm); *United States, et al. v. Verizon Commc'n Inc. and Alltel Corp.*, available at [www.justice.gov/atr/cases/verizon3.htm](http://www.justice.gov/atr/cases/verizon3.htm); *United States v. AT&T Inc. and Dobson Commc'n Corp.*, available at [www.justice.gov/atr/cases/dobson.htm](http://www.justice.gov/atr/cases/dobson.htm); *United States et al. v. AT&T Inc. and Centennial Commc'n Corp.*, available at [www.justice.gov/atr/cases/attcentennial.htm](http://www.justice.gov/atr/cases/attcentennial.htm).

<sup>6</sup> See Press Release, U.S. Dep't of Justice, Justice Department Issues Statements Regarding AT&T Inc.'s Abandonment of Its Proposed Acquisition of T-Mobile USA Inc. (Dec. 19, 2011), available at [www.justice.gov/atr/public/press\\_releases/2011/278406.pdf](http://www.justice.gov/atr/public/press_releases/2011/278406.pdf).

Verizon agreed to sell a significant portion of that spectrum to T-Mobile.<sup>7</sup> In these cases and numerous other matters, the Department coordinated closely with the FCC.

In its Notice, the Commission sets forth a series of important questions. The Notice seeks comments on the Commission's current approach to product market definition in light of changes to technology and consumer demand, its approach to geographic market definition, and the most appropriate means for considering both local and national competitive effects. In addition, the Notice requests comments on how the Commission should approach differing characteristics of spectrum bands and how best to evaluate the spectrum holdings of each licensee.

The Commission also seeks comments on the costs and benefits of a case-by-case analysis of mobile spectrum aggregation to consumers and competition, and it requests comments on how those costs and benefits might differ when applying case-by-case analysis specifically to spectrum auctions. Furthermore, the Commission asks for comments on the application of bright-line limits to initial licenses acquired through competitive bidding.

The Department and the FCC, utilizing their respective expertise and statutory authority, work in complement to foster innovation and efficiency in our nation's telecommunications industry, to the benefit of consumers. For instance, the Commission possesses technical expertise in technology and spectrum, and the Department has broad expertise in analyzing how markets are structured and the dynamics of how they function. Under the federal antitrust laws, the Department's responsibilities include enforcing laws that prohibit transactions or conduct that substantially lessen competition or tend to create

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<sup>7</sup> See Press Release, U.S. Dep't of Justice, Justice Department Requires Changes to Verizon-Cable Company Transactions to Protect Consumers, Allows Procompetitive Spectrum Acquisitions to Go Forward (Aug. 16, 2012), available at [www.justice.gov/atr/public/press\\_releases/2012/286098.pdf](http://www.justice.gov/atr/public/press_releases/2012/286098.pdf).

a monopoly.<sup>8</sup> At the same time, the Commission has a statutory framework vital for managing the Nation’s scarce spectrum resources across a variety of essential public and private uses, making it possible for the Commission to more broadly serve the “public interest, convenience, and necessity” in promoting a better competitive environment in wireless markets.<sup>9</sup> As a result, the Department’s ability to benefit from the Commission’s expertise greatly enhances its review of transactions and conduct in the telecommunications industry, while the Department provides market analysis that assists the Commission in crafting policies that promote competition under its statutory framework.

The Department, the Commission, or both can further the goals of competition in a variety of ways, including: (a) merger enforcement; (b) prohibitions or prosecutions of business practices that thwart innovation; (c) distribution or allocation of public assets (such as spectrum); and (d) other public policies that affirmatively lower entry barriers facing new entrants and new technologies. In this filing, the Department discusses the importance of spectrum to competition and innovation in the wireless industry and the factors the Department considers to be important in assessing the competitive effects of transactions in wireless markets.

## **II. The Importance of Competition in Wireless Markets**

Competition has been a major force in driving innovation in telecommunications, bringing consumers a wider range of choices of products and services and better prices.

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<sup>8</sup> 15 U.S.C. § 1 *et seq.*

<sup>9</sup> 47 U.S.C. § 310(d).

Since the breakup of the Bell System in 1984<sup>10</sup> and passage of the Telecommunications Act of 1996,<sup>11</sup> the telecommunications industry has experienced significant technological, economic, and regulatory changes. Technological development has made it possible for providers of traditional telephone and video services to enter each others' markets while also bringing widespread access to mobile wireless data and broadband Internet services. At the same time, since the passage of the 1996 Act, federal laws and government policy increasingly have favored the provision of telecommunications services on a competitive basis. The Department's work with the Commission in support of this development is founded on the belief that competition generally represents the best method of ensuring that consumers receive low-priced, high-quality products and services, greater choice among providers, and important innovation.

Rivalry among competitors provides strong pressures to maintain existing demand and to win over new customers in a number of ways, such as seeking out means for lowering costs or for developing new or better products and services, through new technology, new business methods, or other sources of efficiency. Indeed, competitive forces have been a central driver of innovations that have enabled carriers to expand capacity and improve service quality. For instance, when challenging the proposed merger of AT&T and T-Mobile, the Department noted that AT&T felt competitive pressure from T-Mobile's network improvements, and that AT&T upgraded its own services in response.<sup>12</sup> In the year since the proposed AT&T and T-Mobile transaction was

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<sup>10</sup> *United States v. American Telephone & Telegraph Co.*, 552 F. Supp. 131 (D.D.C. 1982), *aff'd sub nom. Maryland v. United States*, 460 U.S. 1001 (1983).

<sup>11</sup> Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (1996), *codified at* 47 U.S.C. § 151 *et seq.*

<sup>12</sup> Complaint at 13-14, *United States et al. v. AT&T Inc., T-Mobile USA, Inc. and Deutsche Telekom AG* (D.D.C. filed Sep. 30, 2011) (No. 11-1560).

abandoned, T-Mobile has continued to develop new plan structures designed to win customers from AT&T, including by offering customers the choice of service plans that do not build in the cost of expensive handset subsidies.<sup>13</sup> In addition, T-Mobile and other carriers have aggressively pursued strategies for addressing their network constraints, such as reclaiming spectrum currently being used for older technologies, utilizing new “small cell” technology, or creating business models for commercializing new spectrum.<sup>14</sup>

Preserving rivalry and limiting or eliminating market power enables competitive forces to work to benefit consumers. The ability to exercise market power can take various forms and harm competition in multiple ways. Market power can lead directly to consumers paying higher prices, can insulate a carrier from the competitive pressures to expand service or improve quality, and can diminish innovation. Moreover, the fewer competitors in a market, the higher the risk that competitors can coordinate or act in concert to the detriment of consumers and innovation.

In its recent merger reviews the Department has found that the four largest wireless carriers (AT&T, Verizon, Sprint, and T-Mobile) compete across many dimensions,

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<sup>13</sup> See, e.g., Salvador Rodriguez, *T-Mobile to ditch phone subsidies, go after AT&T in 2013*, LOS ANGELES TIMES (Dec. 7, 2012), available at [www.latimes.com/business/technology/la-fi-tn-t-mobile-iphone-subsidize-att-20121206,0,2610892.story](http://www.latimes.com/business/technology/la-fi-tn-t-mobile-iphone-subsidize-att-20121206,0,2610892.story) (describing T-Mobile’s strategy to “aggressively target AT&T” with plans that “offer customers lower rates for their cellular services by disassociating it with the price of a subsidized phone”).

<sup>14</sup> See, e.g., Greg Bensinger, *T-Mobile to Pump \$4 Billion Into Network, 4G LTE Buildout*, WALL ST. J. (Feb. 24, 2012) (describing T-Mobile’s plans to re-deploy some of its spectrum currently dedicated to 2G services in order to launch LTE); Marguerite Reardon, *AT&T execs are confident about spectrum position*, CNET (Nov. 7, 2012), [news.cnet.com/8301-1035\\_3-57546288-94/at-t-execs-are-confident-about-spectrum-position](http://news.cnet.com/8301-1035_3-57546288-94/at-t-execs-are-confident-about-spectrum-position) (describing AT&T’s efforts to “chart a new path,” including AT&T’s plan to deploy LTE to cover 300 million Americans, and quoting an AT&T executive saying “AT&T is well-positioned now”); Marguerite Reardon, *4G spectrum spat settled: Sirius and AT&T can coexist after all*, CNET (Oct. 17, 2012), [news.cnet.com/8301-13578\\_3-57534378-38/4g-spectrum-spat-settled-sirius-and-at-t-can-coexist-after-all](http://news.cnet.com/8301-13578_3-57534378-38/4g-spectrum-spat-settled-sirius-and-at-t-can-coexist-after-all) (describing an agreement between AT&T and Sirius paving the way for WCS spectrum to be used for wireless services); David Goldman, *AT&T’s about-face on 4G*, CNN MONEY (Nov. 7, 2012), [money.cnn.com/2012/11/07/technology/mobile/att-4g/index.html](http://money.cnn.com/2012/11/07/technology/mobile/att-4g/index.html) (noting that AT&T was able to “charter[] a new path” after the merger in part using the WCS spectrum).



including coverage, network speed, network technologies, and price.<sup>15</sup> Moreover, the different arrays of choices offered by each of these carriers are important to consumers, creating an environment in which carriers are forced to compete and reposition themselves to improve and differentiate their offerings. Even though the carriers engage in this competition, the marketplace is not uniformly competitive. Carriers do have the ability and, in some cases, the incentive to exercise at least some degree of market power, particularly given that there is already significant nationwide concentration in the wireless industry. Therefore, the Department believes it is essential to maintain vigilance against any lessening of the intensity of competitive forces.

The Department also believes that spectrum policies that promote competition and enhance the potential for entry and expansion in the wireless market play a vital role in protecting, and indeed enhancing, the competitive dynamic to the benefit of American consumers. We therefore welcome the opportunity to provide our views on the relationship between the work of the Commission as it designs its auction and other spectrum-related rules and the preservation of the competitive forces that are a critical engine for innovation in the wireless market.

### **III. The Importance of Spectrum to Competition and Innovation**

The Department of Justice's principal concern is that acquisitions of spectrum, whether at auction or through subsequent transactions, should not be used to create or enhance market power. For its part, the Department is charged with preventing transactions that are harmful to consumers and competition, including transactions

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<sup>15</sup> In some local areas, smaller carriers may also offer alternatives that consumers value; for instance, in some rural areas, a local carrier operating with low-frequency spectrum may offer particularly strong coverage.

involving the acquisition of spectrum. It is equally important, however, that spectrum auctions set the stage for the wireless industry to innovate and for consumers to fully realize the benefits of competition.

#### **A. Spectrum Is a Key Input for Mobile Wireless Services**

Our nation's ability to improve the competitive environment in wireless markets hinges on the availability of spectrum. In recent years, mobile wireless markets have undergone tremendous change. Mobile wireless telecommunications devices have evolved into a profusion of smartphones, feature phones, tablets, data cards, e-readers, and other devices, feeding into consumer demand for faster, more reliable mobile broadband connections that drive further innovation. These changes in technology and demand have made spectrum a critically scarce resource. Consequently, the Department strongly supports the Commission in taking on this comprehensive review of its mobile spectrum holdings policies as it also moves to reallocate a considerable array of spectrum and make it available for mobile wireless services.

For each wireless carrier—whether an incumbent national provider, a small carrier looking to expand into new markets or services, or a new entrant—spectrum in part determines the carrier's capacity. Therefore, carriers will need to acquire additional spectrum and make more efficient use of spectrum if they are to respond to growing consumer demand for a wide array of wireless services and devices.<sup>16</sup>

#### **B. Spectrum Acquisitions Should Lead to Efficient Use of Spectrum**

The goal in assigning licenses to spectrum reallocated for commercial services

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<sup>16</sup> See Notice at 8 (citing the Council of Economic Advisers' finding that "the spectrum currently allocated to wireless is not sufficient to handle the projected growth in demand, even with technological improvements allowing for more efficient use of existing spectrum and significant investment in new facilities." Council of Economic Advisers, *The Economic Benefits of New Spectrum for Wireless Broadband*, at 5 (Feb. 2012)).

should be to ensure that it generates the greatest ultimate benefit to the consumers of those services. However, due to the scarcity of spectrum, the Department is concerned that carriers may have incentives to acquire spectrum for purposes other than efficiently expanding their own capacity or services.<sup>17</sup> Namely, the more concentrated a wireless market is, the more likely a carrier will find it profitable to acquire spectrum with the aim of raising competitors' costs. This could take the shape, for example, of pursuing spectrum in order to prevent its use by a competitor, independent of how efficiently the carrier uses the spectrum. Indeed, a carrier may even have incentives to acquire spectrum and not use it at all. The result is that spectrum may not be put to its most efficient use, which harms all consumers of wireless services and can have an exclusionary effect on the carrier's competitors.

Put another way, as the Department has explained previously,<sup>18</sup> once new spectrum is identified and freed up for broadband, there remains the issue of how to assign it to individual providers. When market power is not an issue, the best way to pursue this goal in allocating new resources is typically to auction them off, on the theory that the highest bidder, i.e., the one with the highest private value, will also generate the greatest benefits to consumers. But that approach may not lead to market outcomes that would ordinarily maximize consumer welfare due to the presence of strong wireline or wireless incumbents, since the private value for incumbents in a given locale includes not only the revenue from use of the spectrum but also any benefits gained by preventing rivals from improving their services and thereby eroding the incumbents' existing businesses. The latter might be

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<sup>17</sup> See *Ex Parte* Submission of the United States Department of Justice, *In the Matter of Economic Issues in Broadband Competition: A National Broadband Plan for Our Future*, FCC GN Docket No. 09-51 (January 4, 2010) (hereinafter "U.S. Dep't of Justice Broadband Comments"), at 23-24.

<sup>18</sup> *Id.*

called “foreclosure value” as distinct from “use value.” The total private value of spectrum to any given provider is the sum of these two types of value. However, the “foreclosure value” does not reflect consumer value; to the contrary, it represents the private value of foreclosing competition by, for instance, forestalling entry or expansion that threatens to inject additional competition into the market.

The Department believes that consideration of the role that “foreclosure value” might play in how spectrum is used is crucial because local mobile wireless markets across the nation are relatively concentrated. In a highly concentrated industry with large margins between the price and incremental cost of existing wireless broadband services, the value of keeping spectrum out of competitors’ hands could be very high. For example, if competitors acquire spectrum to provide broader service offerings, expand coverage, or increase capacity, prices for existing customers would fall, threatening the margins being earned. Also, a competitor’s lack of spectrum may require higher capital expenditures, such as having to build more cell towers, in order to provide competitive service. Thus, a large incumbent may benefit from acquiring spectrum even if its uses of the spectrum are not the most efficient if that acquisition helps preserve high prices. Accordingly, the Commission should consider the potential that the acquisition of specific blocks of spectrum may have to foreclose or raise the costs of competitors in its policies on spectrum acquisition.

This potential risk, in turn, underscores the need for additional spectrum. Based on the Department’s experience with highly concentrated telecommunications markets, and more generally, there are substantial advantages to making available new spectrum in order to enable smaller or additional providers to mount stronger challenges to large wireless

incumbents.<sup>19</sup> Absent compelling evidence that the largest incumbent carriers are already using their existing spectrum licenses efficiently and their networks are still capacity-constrained, the Department would normally expect the highest use value for new spectrum that is in the public interest to come from rivals to the leading firms that could effectively make use of additional spectrum to expand capacity, improve coverage, or introduce new services in an effort to challenge the dominant firms.

### **C. The Competitive Significance of Different Spectrum**

To determine whether a transaction will result in competitive harm in any relevant markets, the Department assesses each carrier's ability to compete, including its capacity to meet consumer demand. Since each carrier's portfolio of spectrum holdings in part determines its capacity, the differing characteristics of bands of spectrum are important. In its review of mergers involving spectrum transfers, the Department considers the characteristics of the spectrum being acquired and the capacity needs of the acquirer. For example, low-frequency spectrum (usually referring to frequencies below 1 GHz) has superior propagation characteristics, permitting better coverage in both rural areas and buildings. To the extent carriers have low-frequency spectrum available, often they seek to allocate at least some of that spectrum to each of their deployed technologies (as has been the case with 2G, 3G, and 4G) to ensure that customers with handsets utilizing each technology can maintain excellent coverage throughout the network. On the other hand, when a carrier is attempting to augment the capacity of its network in dense urban areas,

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<sup>19</sup> In the AT&T-Cingular merger, the Department required divestitures of bare spectrum in several markets. The Department was particularly concerned that, without the divestitures, the merged entity would control too much spectrum in those areas and therefore there would not be sufficient competition for new third generation high-speed data services. Competitive Impact Statement at 14-15, *United States et al. v. Cingular et al.* (D.D.C. filed Oct. 29, 2004) (No. 04-1850).

for example, higher-frequency spectrum may be just as effective as low-frequency spectrum. Therefore, the Department believes it is important to consider the differing characteristics of spectrum in determining its contribution to a carrier's competitive position.

The value of any particular block of spectrum also depends on the availability of networking equipment and consumer devices that support the use of that spectrum. When new spectrum first becomes available, it may be years before original equipment manufacturers can accommodate the spectrum in handsets. Because supporting each additional spectrum band class adds weight and cost to consumer devices, carriers usually seek to meet their capacity needs using as few different types of spectrum as possible. For the same reason, carriers may favor spectrum that is harmonized with the frequencies used by carriers in other countries, so that customers may continue to use their devices when travelling internationally. In addition to differences in propagation and device availability, spectrum can have a number of other characteristics that affect its value to a carrier, such as differing interference problems or regulatory obligations.

#### **IV. Technical Considerations for Competitive Analysis of Wireless Markets**

##### **A. Considerations for Analyzing the Competitive Significance of Spectrum**

###### **1. Carriers will be most competitive with at least some low-frequency spectrum to provide a good coverage layer**

As noted above, different bands of spectrum have characteristics that may have a crucial bearing on how the allocation of spectrum affects the competitive landscape. In particular, the propagation characteristics of low-frequency spectrum permit better coverage in both rural areas and building interiors. In previous wireless investigations, the

Department has paid careful attention to whether merging wireless carriers had a particularly strong position in low-frequency spectrum.<sup>20</sup> This factor is particularly important for determining a carrier's ability to compete in offering coverage across a broad service area, including its ability to provide coverage efficiently in rural areas. As such, the Department believes it is important that the Commission devise policies that address the allocation of low-frequency spectrum in particular so that acquisitions of such spectrum do not hamper the ability of carriers to compete in markets where that spectrum is important. Particularly if low-frequency spectrum remains scarce, the Commission must ensure that the allocation of spectrum at auction does not enable carriers with high market shares to foreclose smaller carriers from improving their customers' coverage. Today, the two leading carriers have the vast majority of low-frequency spectrum,<sup>21</sup> whereas the two other nationwide carriers have virtually none. This results in the two smaller nationwide carriers having a somewhat diminished ability to compete, particularly in rural areas where the cost to build out coverage is higher with high-frequency spectrum.<sup>22</sup> The Commission's policies, particularly regarding auction of new low-frequency spectrum, can potentially improve the competitive landscape by preventing the leading carriers from foreclosing their rivals from access to low-frequency spectrum.

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<sup>20</sup> See, e.g., Competitive Impact Statement at 10, *United States, et al. v. Verizon Commc'n Inc. and Alltel Corp.* (D.D.C. filed Oct. 30, 2008) (No. 08-1878) (noting that the merging parties owned the only two 850 MHz cellular licenses—the only low-frequency spectrum in use at the time—in a number of areas, and thus were one another's closest competitors for a significant number of customers in those markets).

<sup>21</sup> According to the most recent Commission report, the two leading carriers have 78% of low-frequency (cellular and 700 MHz) spectrum. See *Implementation of Section 6002(b) of the Omnibus Budget Reconciliation Act of 1993, Annual Report and Analysis of Competitive Market Conditions with Respect to Commercial Mobile Services*, WT Docket No. 10-133, Fifteenth Report, 26 FCC Rcd 9664, ¶ 298 (2011). Even this may understate the dominant position the two leading carriers hold in low-frequency spectrum given that the figure does not account for more recent transactions, and that there are interference and other concerns with a significant portion of the 700 MHz spectrum held by other carriers.

<sup>22</sup> A lack of low-frequency spectrum may also impair the ability of a local or regional carrier to provide an additional, significant, competitive option in particular local areas.

## **2. There are cost efficiencies associated with owning larger blocks of spectrum**

Although a wireless carrier with a large market share may have the ability and incentive to harm competition by buying up significant quantities of spectrum independent of its need for that spectrum or its intention to use it in a timely manner, as described above, the Department also recognizes that there may be substantial efficiencies associated with ownership of relatively large blocks of spectrum. Specifically, due to the nature of wireless technology, for example, twice the spectrum may under certain conditions provide over twice the amount of capacity.

Similarly, there may be capital cost efficiencies associated with deploying larger blocks of spectrum. Running a wireless network typically involves high fixed capital investments in towers and radio equipment and comparatively lower costs on the ongoing maintenance and operation of the network.<sup>23</sup> Even if a carrier has not yet identified a use for specific spectrum to accommodate its customers' data consumption, deploying the spectrum can provide a significant increase in user throughput at relatively low cost.

Thus, the Commission should develop policies on spectrum holdings with the above considerations in mind, but should not needlessly prevent carriers from assembling spectrum portfolios that can take advantage of these efficiencies.

## **3. The efficiencies associated with owning larger blocks of spectrum taper off**

However, the benefits of large blocks of spectrum may become more limited for larger and larger blocks of spectrum. For instance, although in some circumstances a carrier may be able to add incremental spectrum to existing cell sites to provide a

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<sup>23</sup> Some capital equipment, for example, base station controllers, can accommodate significant spectrum bandwidth at little or no incremental cost.



significant increase in capacity and peak user throughput at very low cost, beyond a certain point, deploying more spectrum may require sizeable investments in equipment at each site. Without a pressing capacity need, carriers may have limited incentive to incur the incremental costs of fully deploying such great quantities of spectrum and may instead leave some of it unused solely to keep it from rivals.<sup>24</sup>

Over time, the Department expects that carrier aggregation technology currently under development will permit wireless carriers to realize some of the efficiencies described above even with small, non-contiguous blocks of spectrum in different bands. This technology will enable carriers to achieve many of the capacity and peak throughput advantages previously attainable only with large blocks of contiguous spectrum by instead pairing small blocks of spectrum currently being used for older technologies with relatively small blocks of newly-allocated spectrum. Accordingly, larger incumbent carriers may be able to take significant advantage of economies of scale by acquiring relatively small blocks to pair with their existing holdings rather than acquiring large contiguous blocks. The Commission, therefore, may want to enable the acquisition of such smaller blocks even if it seeks to restrict the acquisition of larger blocks.

### **B. Measuring and Balancing Efficiencies**

In addition, the Commission should consider the serious potential, described above, that carriers with large market shares could pursue an input foreclosure strategy at auction. We urge the Commission to weigh the risk of consumer harm from an input foreclosure strategy. Economies of scale should be balanced against those risks.

In numerous wireless transactions, including most recently in the proposed

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<sup>24</sup> Cf. *In re Applications of Cellco Partnership d/b/a Verizon Wireless and SpectrumCo LLC and Cox TMI, LLC*, FCC Docket No. 12-175, ¶¶ 108-109 (released Aug. 23, 2012) (questioning whether Verizon Wireless would use more than 40 MHz of AWS spectrum in any market in the near term).

AT&T/T-Mobile merger and Verizon Wireless's acquisition of spectrum from a consortium of cable companies, the Department carefully considered assertions that the economies of scale arising from greater spectrum concentration will ultimately yield substantial benefits for consumers. As in any transaction, the key to this analysis is whether the efficiencies that could be realized as a result of the acquisition would reduce the marginal cost of service sufficiently to outweigh the often substantial benefits of additional competition.<sup>25</sup> Notably, the economies of scale often present in wireless networks are significantly tempered compared to those the Department has encountered when analyzing competition among wireline networks, since it is easier and less costly to expand capacity over a fixed amount of spectrum than it is, for example, to reduce the cost of constructing the physical "last-mile" link to each premises.<sup>26</sup>

Therefore, in the Department's experience in these and other matters, it is important that the efficiencies described above are assessed accurately, including accounting for all alternative means for carriers to use their existing spectrum resources to expand capacity or launch new services. For example, in the course of investigating the proposed transaction between AT&T and T-Mobile, the Department cast doubt on the parties' claims that there were few alternatives to deal with spectrum shortages. Since abandoning the transaction, both companies have announced plans to deploy LTE more extensively than they had earlier suggested would be possible by, for instance, deploying spectrum previously dedicated to older technologies.

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<sup>25</sup> See U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, HORIZONTAL MERGER GUIDELINES § 10 (2010), available at [www.usdoj.gov/atr/public/guidelines/hmg-2010.pdf](http://www.usdoj.gov/atr/public/guidelines/hmg-2010.pdf) (hereinafter Merger Guidelines).

<sup>26</sup> See U.S. Dep't of Justice Broadband Comments, at 13-14 (noting that "[t]he enormous sunk cost of wireline broadband networks makes it unlikely that additional wired broadband competitors will enter many geographic areas" but that "the sunk costs associated with deploying [wireless] networks are far less than those for wireline facilities").

As stated above, spectrum is a scarce resource and a key input for mobile wireless services. The Commission has an opportunity through its policies on spectrum holdings to preserve and promote competition and to ensure that the largest firms do not foreclose other rivals from access to low-frequency spectrum that would allow them to improve their coverage and make them stronger, more aggressive competitors.

### **C. The Appropriate Market Analysis for Promoting Competition**

The Commission is seeking comment on the appropriate product and geographic markets for evaluating wireless spectrum holdings, and specifically whether it should modify the relevant market definition to reflect differentiated service offerings, devices, and contract features.

The Department evaluates mergers under Section 7 of the Clayton Act, which prohibits acquisitions the effect of which “may be substantially to lessen competition, or to tend to create a monopoly.” The Department analyzes wireless mergers essentially the same way it does transactions in other industries, as explained in the *Horizontal Merger Guidelines* jointly issued by the Department of Justice and Federal Trade Commission. The Department’s legal role is fundamentally one of enforcement, on a case-by-case basis, rather than an exercise in prospective rule-making, and it investigates mergers when they are proposed and examines the specific circumstances surrounding each transaction.

The Department believes that competition typically is best served by a thorough, case-by-case analysis of the competitive effects of each transaction. In past proceedings, the Department has recommended that the Commission develop a classification for evaluating the degree of competition in different markets using a method of analysis

similar to that set forth in the *Horizontal Merger Guidelines*.<sup>27</sup> Over time, the Commission and the Department have aligned more closely their respective processes for analyzing transactions.

As part of its review of each transaction, the Department considers any and all factors relevant to the question of whether a transaction may give the parties the ability to exercise market power in any relevant antitrust market. Under the *Horizontal Merger Guidelines*, the touchstone for this inquiry should be the functional experience from the perspective of the customer, not the particular technologies used by the provider. Thus, when the Department evaluates a “market” for antitrust purposes, it assesses the extent to which consumers view various services as substitutes.<sup>28</sup> As the Department explains in the *Guidelines*, this involves defining the relevant geographic and product markets for the transaction.

For many wireless transactions, the Department has identified geographic areas of concern for mobile wireless telecommunications services via a fact-specific, market-by-market analysis. This analysis has included consideration of a number of factors, including, but not limited to, the number of mobile wireless service providers and their competitive strengths, weaknesses, and market shares; whether additional spectrum is likely to be currently or imminently available; whether any providers are limited by insufficient spectrum or other factors in their abilities to add new customers; the breadth and depth of coverage by different providers in each area and in surrounding areas; each carrier’s network coverage in relation to the population density of the license area; each provider’s retail presence; local wireless number portability data; the likelihood that any

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<sup>27</sup> U.S. Dep’t of Justice Broadband Comments, at 13. A screen on spectrum consolidation in conjunction with a case-by-case analysis can also be effective.

<sup>28</sup> Merger Guidelines § 4.

provider would expand its existing coverage or that new providers would enter; and other market characteristics.<sup>29</sup>

Generally, mobile wireless telecommunications services are sold to consumers in local markets, though these markets are affected by nationwide competition among the larger service providers. It is therefore appropriate both to identify local markets and to identify the nature of nationwide competitive effects affecting local markets. In its wireless investigations, the Department has typically considered the Cellular Market Areas (CMAs) that the Commission has identified and used to license mobile wireless services for certain spectrum bands as approximations of the local areas within which customers have the same competitive choices.<sup>30</sup>

In recent investigations of transactions involving mobile wireless carriers, the Department has defined mobile wireless telecommunications services as a relevant product market. For example, in its lawsuit challenging AT&T Inc.'s proposed acquisition of T-Mobile USA, Inc., the Department found that there are no cost-effective alternatives to mobile wireless telecommunications services: because neither fixed wireless services nor wireline services are mobile, they are not regarded by consumers of mobile wireless telecommunications services as reasonable substitutes.<sup>31</sup> However, because markets are dynamic, so are definitions of antitrust product markets: as wireless services have expanded to include offerings such as broadband access, consumer demand for new services can dictate different relevant product markets. This is one way the Department's

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<sup>29</sup> See, e.g., Competitive Impact Statement at 10, *United States, et al. v. Verizon Commc'n Inc. and Alltel Corp.* (D.D.C. filed Oct. 30, 2008) (No. 08-1878).

<sup>30</sup> See, e.g., Complaint at 9-10, *United States et al. v. AT&T Inc., T-Mobile USA, Inc. and Deutsche Telekom AG* (D.D.C. filed Sep. 30, 2011) (No. 11-1560); Complaint at 7, *United States v. Verizon and Alltel* (D.D.C. filed Oct. 30, 2008) (No. 08-1878).

<sup>31</sup> Complaint at 7, *United States v. AT&T and T-Mobile*.

competitive analysis accounts for changes in technology and consumer demand.

In addition, for some matters the Department also has considered whether business or government customers constitute a distinct set of customers. (In various industries, the Department has denoted such customers as “enterprise customers.”) For these customers, in addition to effects in local markets, the Department also analyzes the extent to which such customers value a carrier that can provide services to employees, facilities, and devices that are geographically dispersed, including whether these customers require services that are national in scope. As such, the Department considers the potential for transactions to have broader geographical competitive effects, including at a national level. Consequently, the same transaction can require competitive analysis in both local markets and regional or national markets to ensure competition is fully protected.<sup>32</sup>

#### **D. Spectrum Allocation Should Provide Certainty and Predictability**

The Commission is seeking comment on whether a case-by-case analysis affords auction participants sufficient certainty to determine whether they would be allowed to hold a given license post-auction. In considering the appropriate policy for evaluating purchases at auction, the Commission should weigh the time and resources involved in conducting a thorough case-by-case review against the advantages to competition of a quick allocation of spectrum pursuant to an easily administered rule. Secondary market transactions typically come before the Commission and the Department one at a time, permitting staff to carefully evaluate the likely competitive consequences of the transaction. However, a case-by-case review of every acquisition by a winning bidder in a

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<sup>32</sup> Complaint at 8, *United States v. AT&T and T-Mobile*; see also Competitive Impact Statement at 10, *United States v. Verizon and Alltel*; Competitive Impact Statement at 11, *United States, et al. v. Verizon Commc'n Inc., CellCo P'ship d/b/a Verizon Wireless, Comcast Corp., Time Warner Cable Inc., Cox Commc'n, Inc., and Bright House Networks, LLC* (D.D.C. filed Aug. 16, 2012) (No. 12-1354).

large auction could strain the agencies' resources and delay the quick allocation of spectrum critical for innovation and increased competition. As the Commission has found, the exploding demand for wireless broadband use and the time and resources historically involved in allocating spectrum to new use urge a more expedient process that increases clarity and predictability.<sup>33</sup> Therefore, in allocating spectrum at auction, the Commission's approach should reduce the time to make available scarce, much-needed spectrum while also preventing the transfers most likely to harm competition and minimizing the potential risk that procompetitive acquisitions would be erroneously prevented.

Moreover, for spectrum auctions the Department believes that predictability is especially important. On the occasions that the Commission auctions off significant quantities of spectrum—with different frequency bands auctioned by different geographic boundaries—the Commission may put specific regulatory restrictions on the use of some bands of spectrum being auctioned, but not on others. In addition, the value to any wireless carrier of any particular spectrum license depends in part on how complementary that license is to the carrier's other wireless holdings. For example, operating a network using too many different spectrum band classes increases the cost of handsets and radio network equipment, since the devices require hardware to support all of the band classes. Carriers also seek enough spectrum to meet their needs in all of the geographic areas within their networks.

For these reasons, before crafting a bid on one license in an auction, a wireless carrier considers all alternative licenses available and the likelihood that the carrier may be able to purchase any of those licenses. A carrier might, for example, be willing to bid

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<sup>33</sup> FED. COMM'NS COMM'N, CONNECTING AMERICA: THE NATIONAL BROADBAND PLAN 79 (2010) (highlighting that reallocations of spectrum historically have taken 6-13 years); *see also* FCC National Broadband Plan, September Commission Meeting, at 63, 66, 71, 73-74 (Sept. 29, 2009).

more on a particular block of spectrum if it knows it will also be permitted to acquire an adjacent block. Alternatively, if a carrier knows in advance it will only be permitted to purchase one of the available blocks of spectrum, it may be willing to bid higher to ensure that it is able to secure the block most complementary to its existing holdings. These complex interdependencies demonstrate that carriers' certainty of what spectrum they will be permitted to acquire can have a significant effect about whether the spectrum auction can achieve allocations that best serve the public interest.

Therefore, the Department believes that a set of well-defined rules for spectrum acquisitions in auctions would best serve the dual goals of putting spectrum to use quickly and promoting competition in wireless markets.<sup>34</sup> Such rules could both provide predictability and prevent foreclosure of entry or expansion. Given the characteristics of different spectrum bands, as discussed above, different rules, weights, or caps could, for example, apply based on the kinds of spectrum frequency put up for auction. For instance, rules that ensure that the two smaller nationwide carriers are not foreclosed from access to more spectrum, and particularly low-frequency spectrum, could benefit consumers. Auction rules of this nature would ensure the smaller nationwide networks, which currently lack substantial low-frequency spectrum, would have an opportunity to acquire it. Such an outcome could improve the competitive dynamic among nationwide carriers. As such, using a pre-announced set of rules would allow the Commission to realize substantial benefits to competition from quick allocation of new spectrum while minimizing the potential risk that procompetitive acquisitions would be prevented.

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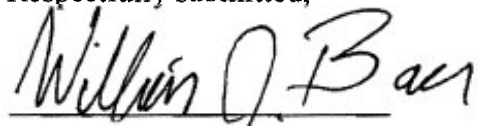
<sup>34</sup> In the context of mergers and other secondary market transactions, spectrum guidelines or screens can provide useful guidance while maintaining the flexibility inherent in a case-by-case analysis. *See supra* Part IV.C.



## V. Conclusion

In this proceeding, the Commission reaffirms its interest in crafting rules that address spectrum aggregation in a manner that promotes competition and innovation in telecommunications markets. The Department strongly supports this effort, and commends the FCC in taking on this comprehensive review of its mobile spectrum holdings policies as it also moves to reallocate a considerable array of spectrum to make it available for mobile wireless services. The Department looks forward to working with the Commission in this and other proceedings as the Commission develops policies that ensure that the allocation of spectrum continues to support growth and innovation in the nation's economy.

Respectfully submitted,



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## **LEGAL AUTHORITY CA-110**

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# Horizontal Merger Guidelines



U.S. Department of Justice  
and the  
Federal Trade Commission

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# 1. Overview

These Guidelines outline the principal analytical techniques, practices, and the enforcement policy of the Department of Justice and the Federal Trade Commission (the “Agencies”) with respect to mergers and acquisitions involving actual or potential competitors (“horizontal mergers”) under the federal antitrust laws.<sup>1</sup> The relevant statutory provisions include Section 7 of the Clayton Act, 15 U.S.C. § 18, Sections 1 and 2 of the Sherman Act, 15 U.S.C. §§ 1, 2, and Section 5 of the Federal Trade Commission Act, 15 U.S.C. § 45. Most particularly, Section 7 of the Clayton Act prohibits mergers if “in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly.”

The Agencies seek to identify and challenge competitively harmful mergers while avoiding unnecessary interference with mergers that are either competitively beneficial or neutral. Most merger analysis is necessarily predictive, requiring an assessment of what will likely happen if a merger proceeds as compared to what will likely happen if it does not. Given this inherent need for prediction, these Guidelines reflect the congressional intent that merger enforcement should interdict competitive problems in their incipiency and that certainty about anticompetitive effect is seldom possible and not required for a merger to be illegal.

These Guidelines describe the principal analytical techniques and the main types of evidence on which the Agencies usually rely to predict whether a horizontal merger may substantially lessen competition. They are not intended to describe how the Agencies analyze cases other than horizontal mergers. These Guidelines are intended to assist the business community and antitrust practitioners by increasing the transparency of the analytical process underlying the Agencies’ enforcement decisions. They may also assist the courts in developing an appropriate framework for interpreting and applying the antitrust laws in the horizontal merger context.

These Guidelines should be read with the awareness that merger analysis does not consist of uniform application of a single methodology. Rather, it is a fact-specific process through which the Agencies, guided by their extensive experience, apply a range of analytical tools to the reasonably available and reliable evidence to evaluate competitive concerns in a limited period of time. Where these Guidelines provide examples, they are illustrative and do not exhaust the applications of the relevant principle.<sup>2</sup>

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<sup>1</sup> These Guidelines replace the Horizontal Merger Guidelines issued in 1992, revised in 1997. They reflect the ongoing accumulation of experience at the Agencies. The Commentary on the Horizontal Merger Guidelines issued by the Agencies in 2006 remains a valuable supplement to these Guidelines. These Guidelines may be revised from time to time as necessary to reflect significant changes in enforcement policy, to clarify existing policy, or to reflect new learning. These Guidelines do not cover vertical or other types of non-horizontal acquisitions.

<sup>2</sup> These Guidelines are not intended to describe how the Agencies will conduct the litigation of cases they decide to bring. Although relevant in that context, these Guidelines neither dictate nor exhaust the range of evidence the Agencies may introduce in litigation.

The unifying theme of these Guidelines is that mergers should not be permitted to create, enhance, or entrench market power or to facilitate its exercise. For simplicity of exposition, these Guidelines generally refer to all of these effects as enhancing market power. A merger enhances market power if it is likely to encourage one or more firms to raise price, reduce output, diminish innovation, or otherwise harm customers as a result of diminished competitive constraints or incentives. In evaluating how a merger will likely change a firm's behavior, the Agencies focus primarily on how the merger affects conduct that would be most profitable for the firm.

A merger can enhance market power simply by eliminating competition between the merging parties. This effect can arise even if the merger causes no changes in the way other firms behave. Adverse competitive effects arising in this manner are referred to as "unilateral effects." A merger also can enhance market power by increasing the risk of coordinated, accommodating, or interdependent behavior among rivals. Adverse competitive effects arising in this manner are referred to as "coordinated effects." In any given case, either or both types of effects may be present, and the distinction between them may be blurred.

These Guidelines principally describe how the Agencies analyze mergers between rival suppliers that may enhance their market power as sellers. Enhancement of market power by sellers often elevates the prices charged to customers. For simplicity of exposition, these Guidelines generally discuss the analysis in terms of such price effects. Enhanced market power can also be manifested in non-price terms and conditions that adversely affect customers, including reduced product quality, reduced product variety, reduced service, or diminished innovation. Such non-price effects may coexist with price effects, or can arise in their absence. When the Agencies investigate whether a merger may lead to a substantial lessening of non-price competition, they employ an approach analogous to that used to evaluate price competition. Enhanced market power may also make it more likely that the merged entity can profitably and effectively engage in exclusionary conduct. Regardless of how enhanced market power likely would be manifested, the Agencies normally evaluate mergers based on their impact on customers. The Agencies examine effects on either or both of the direct customers and the final consumers. The Agencies presume, absent convincing evidence to the contrary, that adverse effects on direct customers also cause adverse effects on final consumers.

Enhancement of market power by buyers, sometimes called "monopsony power," has adverse effects comparable to enhancement of market power by sellers. The Agencies employ an analogous framework to analyze mergers between rival purchasers that may enhance their market power as buyers. See Section 12.

## **2. Evidence of Adverse Competitive Effects**

The Agencies consider any reasonably available and reliable evidence to address the central question of whether a merger may substantially lessen competition. This section discusses several categories and sources of evidence that the Agencies, in their experience, have found most informative in predicting the likely competitive effects of mergers. The list provided here is not exhaustive. In any given case, reliable evidence may be available in only some categories or from some sources. For each category of evidence, the Agencies consider evidence indicating that the merger may enhance competition as well as evidence indicating that it may lessen competition.

## **2.1 Types of Evidence**

### *2.1.1 Actual Effects Observed in Consummated Mergers*

When evaluating a consummated merger, the ultimate issue is not only whether adverse competitive effects have already resulted from the merger, but also whether such effects are likely to arise in the future. Evidence of observed post-merger price increases or other changes adverse to customers is given substantial weight. The Agencies evaluate whether such changes are anticompetitive effects resulting from the merger, in which case they can be dispositive. However, a consummated merger may be anticompetitive even if such effects have not yet been observed, perhaps because the merged firm may be aware of the possibility of post-merger antitrust review and moderating its conduct. Consequently, the Agencies also consider the same types of evidence they consider when evaluating unconsummated mergers.

### *2.1.2 Direct Comparisons Based on Experience*

The Agencies look for historical events, or “natural experiments,” that are informative regarding the competitive effects of the merger. For example, the Agencies may examine the impact of recent mergers, entry, expansion, or exit in the relevant market. Effects of analogous events in similar markets may also be informative.

The Agencies also look for reliable evidence based on variations among similar markets. For example, if the merging firms compete in some locales but not others, comparisons of prices charged in regions where they do and do not compete may be informative regarding post-merger prices. In some cases, however, prices are set on such a broad geographic basis that such comparisons are not informative. The Agencies also may examine how prices in similar markets vary with the number of significant competitors in those markets.

### *2.1.3 Market Shares and Concentration in a Relevant Market*

The Agencies give weight to the merging parties’ market shares in a relevant market, the level of concentration, and the change in concentration caused by the merger. See Sections 4 and 5. Mergers that cause a significant increase in concentration and result in highly concentrated markets are presumed to be likely to enhance market power, but this presumption can be rebutted by persuasive evidence showing that the merger is unlikely to enhance market power.

### *2.1.4 Substantial Head-to-Head Competition*

The Agencies consider whether the merging firms have been, or likely will become absent the merger, substantial head-to-head competitors. Such evidence can be especially relevant for evaluating adverse unilateral effects, which result directly from the loss of that competition. See Section 6. This evidence can also inform market definition. See Section 4.

### *2.1.5 Disruptive Role of a Merging Party*

The Agencies consider whether a merger may lessen competition by eliminating a “maverick” firm, i.e., a firm that plays a disruptive role in the market to the benefit of customers. For example, if one of the merging firms has a strong incumbency position and the other merging firm threatens to



disrupt market conditions with a new technology or business model, their merger can involve the loss of actual or potential competition. Likewise, one of the merging firms may have the incentive to take the lead in price cutting or other competitive conduct or to resist increases in industry prices. A firm that may discipline prices based on its ability and incentive to expand production rapidly using available capacity also can be a maverick, as can a firm that has often resisted otherwise prevailing industry norms to cooperate on price setting or other terms of competition.

## 2.2 Sources of Evidence

The Agencies consider many sources of evidence in their merger analysis. The most common sources of reasonably available and reliable evidence are the merging parties, customers, other industry participants, and industry observers.

### 2.2.1 *Merging Parties*

The Agencies typically obtain substantial information from the merging parties. This information can take the form of documents, testimony, or data, and can consist of descriptions of competitively relevant conditions or reflect actual business conduct and decisions. Documents created in the normal course are more probative than documents created as advocacy materials in merger review.

Documents describing industry conditions can be informative regarding the operation of the market and how a firm identifies and assesses its rivals, particularly when business decisions are made in reliance on the accuracy of those descriptions. The business decisions taken by the merging firms also can be informative about industry conditions. For example, if a firm sets price well above incremental cost, that normally indicates either that the firm believes its customers are not highly sensitive to price (not in itself of antitrust concern, see Section 4.1.3<sup>3</sup>) or that the firm and its rivals are engaged in coordinated interaction (see Section 7). Incremental cost depends on the relevant increment in output as well as on the time period involved, and in the case of large increments and sustained changes in output it may include some costs that would be fixed for smaller increments of output or shorter time periods.

Explicit or implicit evidence that the merging parties intend to raise prices, reduce output or capacity, reduce product quality or variety, withdraw products or delay their introduction, or curtail research and development efforts after the merger, or explicit or implicit evidence that the ability to engage in such conduct motivated the merger, can be highly informative in evaluating the likely effects of a merger. Likewise, the Agencies look for reliable evidence that the merger is likely to result in efficiencies. The Agencies give careful consideration to the views of individuals whose responsibilities, expertise, and experience relating to the issues in question provide particular indicia of reliability. The financial terms of the transaction may also be informative regarding competitive effects. For example, a purchase price in excess of the acquired firm's stand-alone market value may indicate that the acquiring firm is paying a premium because it expects to be able to reduce competition or to achieve efficiencies.

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<sup>3</sup> High margins commonly arise for products that are significantly differentiated. Products involving substantial fixed costs typically will be developed only if suppliers expect there to be enough differentiation to support margins sufficient to cover those fixed costs. High margins can be consistent with incumbent firms earning competitive returns.

### 2.2.2 *Customers*

Customers can provide a variety of information to the Agencies, ranging from information about their own purchasing behavior and choices to their views about the effects of the merger itself.

Information from customers about how they would likely respond to a price increase, and the relative attractiveness of different products or suppliers, may be highly relevant, especially when corroborated by other evidence such as historical purchasing patterns and practices. Customers also can provide valuable information about the impact of historical events such as entry by a new supplier.

The conclusions of well-informed and sophisticated customers on the likely impact of the merger itself can also help the Agencies investigate competitive effects, because customers typically feel the consequences of both competitively beneficial and competitively harmful mergers. In evaluating such evidence, the Agencies are mindful that customers may oppose, or favor, a merger for reasons unrelated to the antitrust issues raised by that merger.

When some customers express concerns about the competitive effects of a merger while others view the merger as beneficial or neutral, the Agencies take account of this divergence in using the information provided by customers and consider the likely reasons for such divergence of views. For example, if for regulatory reasons some customers cannot buy imported products, while others can, a merger between domestic suppliers may harm the former customers even if it leaves the more flexible customers unharmed. See Section 3.

When direct customers of the merging firms compete against one another in a downstream market, their interests may not be aligned with the interests of final consumers, especially if the direct customers expect to pass on any anticompetitive price increase. A customer that is protected from adverse competitive effects by a long-term contract, or otherwise relatively immune from the merger's harmful effects, may even welcome an anticompetitive merger that provides that customer with a competitive advantage over its downstream rivals.

*Example 1:* As a result of the merger, Customer C will experience a price increase for an input used in producing its final product, raising its costs. Customer C's rivals use this input more intensively than Customer C, and the same price increase applied to them will raise their costs more than it raises Customer C's costs. On balance, Customer C may benefit from the merger even though the merger involves a substantial lessening of competition.

### 2.2.3 *Other Industry Participants and Observers*

Suppliers, indirect customers, distributors, other industry participants, and industry analysts can also provide information helpful to a merger inquiry. The interests of firms selling products complementary to those offered by the merging firms often are well aligned with those of customers, making their informed views valuable.

Information from firms that are rivals to the merging parties can help illuminate how the market operates. The interests of rival firms often diverge from the interests of customers, since customers normally lose, but rival firms gain, if the merged entity raises its prices. For that reason, the Agencies do not routinely rely on the overall views of rival firms regarding the competitive effects of the

merger. However, rival firms may provide relevant facts, and even their overall views may be instructive, especially in cases where the Agencies are concerned that the merged entity may engage in exclusionary conduct.

*Example 2:* Merging Firms A and B operate in a market in which network effects are significant, implying that any firm's product is significantly more valuable if it commands a large market share or if it is interconnected with others that in aggregate command such a share. Prior to the merger, they and their rivals voluntarily interconnect with one another. The merger would create an entity with a large enough share that a strategy of ending voluntary interconnection would have a dangerous probability of creating monopoly power in this market. The interests of rivals and of consumers would be broadly aligned in preventing such a merger.

### **3. Targeted Customers and Price Discrimination**

When examining possible adverse competitive effects from a merger, the Agencies consider whether those effects vary significantly for different customers purchasing the same or similar products. Such differential impacts are possible when sellers can discriminate, e.g., by profitably raising price to certain targeted customers but not to others. The possibility of price discrimination influences market definition (see Section 4), the measurement of market shares (see Section 5), and the evaluation of competitive effects (see Sections 6 and 7).

When price discrimination is feasible, adverse competitive effects on targeted customers can arise, even if such effects will not arise for other customers. A price increase for targeted customers may be profitable even if a price increase for all customers would not be profitable because too many other customers would substitute away. When discrimination is reasonably likely, the Agencies may evaluate competitive effects separately by type of customer. The Agencies may have access to information unavailable to customers that is relevant to evaluating whether discrimination is reasonably likely.

For price discrimination to be feasible, two conditions typically must be met: differential pricing and limited arbitrage.

First, the suppliers engaging in price discrimination must be able to price differently to targeted customers than to other customers. This may involve identification of individual customers to which different prices are offered or offering different prices to different types of customers based on observable characteristics.

*Example 3:* Suppliers can distinguish large buyers from small buyers. Large buyers are more likely than small buyers to self-supply in response to a significant price increase. The merger may lead to price discrimination against small buyers, harming them, even if large buyers are not harmed. Such discrimination can occur even if there is no discrete gap in size between the classes of large and small buyers.

In other cases, suppliers may be unable to distinguish among different types of customers but can offer multiple products that sort customers based on their purchase decisions.

Second, the targeted customers must not be able to defeat the price increase of concern by arbitrage, e.g., by purchasing indirectly from or through other customers. Arbitrage may be difficult if it would void warranties or make service more difficult or costly for customers. Arbitrage is inherently impossible for many services. Arbitrage between customers at different geographic locations may be

impractical due to transportation costs. Arbitrage on a modest scale may be possible but sufficiently costly or limited that it would not deter or defeat a discriminatory pricing strategy.

## **4. Market Definition**

When the Agencies identify a potential competitive concern with a horizontal merger, market definition plays two roles. First, market definition helps specify the line of commerce and section of the country in which the competitive concern arises. In any merger enforcement action, the Agencies will normally identify one or more relevant markets in which the merger may substantially lessen competition. Second, market definition allows the Agencies to identify market participants and measure market shares and market concentration. See Section 5. The measurement of market shares and market concentration is not an end in itself, but is useful to the extent it illuminates the merger's likely competitive effects.

The Agencies' analysis need not start with market definition. Some of the analytical tools used by the Agencies to assess competitive effects do not rely on market definition, although evaluation of competitive alternatives available to customers is always necessary at some point in the analysis.

Evidence of competitive effects can inform market definition, just as market definition can be informative regarding competitive effects. For example, evidence that a reduction in the number of significant rivals offering a group of products causes prices for those products to rise significantly can itself establish that those products form a relevant market. Such evidence also may more directly predict the competitive effects of a merger, reducing the role of inferences from market definition and market shares.

Where analysis suggests alternative and reasonably plausible candidate markets, and where the resulting market shares lead to very different inferences regarding competitive effects, it is particularly valuable to examine more direct forms of evidence concerning those effects.

Market definition focuses solely on demand substitution factors, i.e., on customers' ability and willingness to substitute away from one product to another in response to a price increase or a corresponding non-price change such as a reduction in product quality or service. The responsive actions of suppliers are also important in competitive analysis. They are considered in these Guidelines in the sections addressing the identification of market participants, the measurement of market shares, the analysis of competitive effects, and entry.

Customers often confront a range of possible substitutes for the products of the merging firms. Some substitutes may be closer, and others more distant, either geographically or in terms of product attributes and perceptions. Additionally, customers may assess the proximity of different products differently. When products or suppliers in different geographic areas are substitutes for one another to varying degrees, defining a market to include some substitutes and exclude others is inevitably a simplification that cannot capture the full variation in the extent to which different products compete against each other. The principles of market definition outlined below seek to make this inevitable simplification as useful and informative as is practically possible. Relevant markets need not have precise metes and bounds.

Defining a market broadly to include relatively distant product or geographic substitutes can lead to misleading market shares. This is because the competitive significance of distant substitutes is unlikely to be commensurate with their shares in a broad market. Although excluding more distant substitutes from the market inevitably understates their competitive significance to some degree, doing so often provides a more accurate indicator of the competitive effects of the merger than would the alternative of including them and overstating their competitive significance as proportional to their shares in an expanded market.

*Example 4:* Firms A and B, sellers of two leading brands of motorcycles, propose to merge. If Brand A motorcycle prices were to rise, some buyers would substitute to Brand B, and some others would substitute to cars. However, motorcycle buyers see Brand B motorcycles as much more similar to Brand A motorcycles than are cars. Far more cars are sold than motorcycles. Evaluating shares in a market that includes cars would greatly underestimate the competitive significance of Brand B motorcycles in constraining Brand A's prices and greatly overestimate the significance of cars.

Market shares of different products in narrowly defined markets are more likely to capture the relative competitive significance of these products, and often more accurately reflect competition between close substitutes. As a result, properly defined antitrust markets often exclude some substitutes to which some customers might turn in the face of a price increase even if such substitutes provide alternatives for those customers. However, a group of products is too narrow to constitute a relevant market if competition from products outside that group is so ample that even the complete elimination of competition within the group would not significantly harm either direct customers or downstream consumers. The hypothetical monopolist test (see Section 4.1.1) is designed to ensure that candidate markets are not overly narrow in this respect.

The Agencies implement these principles of market definition flexibly when evaluating different possible candidate markets. Relevant antitrust markets defined according to the hypothetical monopolist test are not always intuitive and may not align with how industry members use the term "market."

Section 4.1 describes the principles that apply to product market definition, and gives guidance on how the Agencies most often apply those principles. Section 4.2 describes how the same principles apply to geographic market definition. Although discussed separately for simplicity of exposition, the principles described in Sections 4.1 and 4.2 are combined to define a relevant market, which has both a product and a geographic dimension. In particular, the hypothetical monopolist test is applied to a group of products together with a geographic region to determine a relevant market.

## **4.1 Product Market Definition**

When a product sold by one merging firm (Product A) competes against one or more products sold by the other merging firm, the Agencies define a relevant product market around Product A to evaluate the importance of that competition. Such a relevant product market consists of a group of substitute products including Product A. Multiple relevant product markets may thus be identified.

### *4.1.1 The Hypothetical Monopolist Test*

The Agencies employ the hypothetical monopolist test to evaluate whether groups of products in candidate markets are sufficiently broad to constitute relevant antitrust markets. The Agencies use the

hypothetical monopolist test to identify a set of products that are reasonably interchangeable with a product sold by one of the merging firms.

The hypothetical monopolist test requires that a product market contain enough substitute products so that it could be subject to post-merger exercise of market power significantly exceeding that existing absent the merger. Specifically, the test requires that a hypothetical profit-maximizing firm, not subject to price regulation, that was the only present and future seller of those products (“hypothetical monopolist”) likely would impose at least a small but significant and non-transitory increase in price (“SSNIP”) on at least one product in the market, including at least one product sold by one of the merging firms.<sup>4</sup> For the purpose of analyzing this issue, the terms of sale of products outside the candidate market are held constant. The SSNIP is employed solely as a methodological tool for performing the hypothetical monopolist test; it is not a tolerance level for price increases resulting from a merger.

Groups of products may satisfy the hypothetical monopolist test without including the full range of substitutes from which customers choose. The hypothetical monopolist test may identify a group of products as a relevant market even if customers would substitute significantly to products outside that group in response to a price increase.

*Example 5:* Products A and B are being tested as a candidate market. Each sells for \$100, has an incremental cost of \$60, and sells 1200 units. For every dollar increase in the price of Product A, for any given price of Product B, Product A loses twenty units of sales to products outside the candidate market and ten units of sales to Product B, and likewise for Product B. Under these conditions, economic analysis shows that a hypothetical profit-maximizing monopolist controlling Products A and B would raise both of their prices by ten percent, to \$110. Therefore, Products A and B satisfy the hypothetical monopolist test using a five percent SSNIP, and indeed for any SSNIP size up to ten percent. This is true even though two-thirds of the sales lost by one product when it raises its price are diverted to products outside the relevant market.

When applying the hypothetical monopolist test to define a market around a product offered by one of the merging firms, if the market includes a second product, the Agencies will normally also include a third product if that third product is a closer substitute for the first product than is the second product. The third product is a closer substitute if, in response to a SSNIP on the first product, greater revenues are diverted to the third product than to the second product.

*Example 6:* In Example 5, suppose that half of the unit sales lost by Product A when it raises its price are diverted to Product C, which also has a price of \$100, while one-third are diverted to Product B. Product C is a closer substitute for Product A than is Product B. Thus Product C will normally be included in the relevant market, even though Products A and B together satisfy the hypothetical monopolist test.

The hypothetical monopolist test ensures that markets are not defined too narrowly, but it does not lead to a single relevant market. The Agencies may evaluate a merger in any relevant market

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<sup>4</sup> If the pricing incentives of the firms supplying the products in the candidate market differ substantially from those of the hypothetical monopolist, for reasons other than the latter’s control over a larger group of substitutes, the Agencies may instead employ the concept of a hypothetical profit-maximizing cartel comprised of the firms (with all their products) that sell the products in the candidate market. This approach is most likely to be appropriate if the merging firms sell products outside the candidate market that significantly affect their pricing incentives for products in the candidate market. This could occur, for example, if the candidate market is one for durable equipment and the firms selling that equipment derive substantial net revenues from selling spare parts and service for that equipment.

satisfying the test, guided by the overarching principle that the purpose of defining the market and measuring market shares is to illuminate the evaluation of competitive effects. Because the relative competitive significance of more distant substitutes is apt to be overstated by their share of sales, when the Agencies rely on market shares and concentration, they usually do so in the smallest relevant market satisfying the hypothetical monopolist test.

*Example 7:* In Example 4, including cars in the market will lead to misleadingly small market shares for motorcycle producers. Unless motorcycles fail the hypothetical monopolist test, the Agencies would not include cars in the market in analyzing this motorcycle merger.

#### 4.1.2 *Benchmark Prices and SSNIP Size*

The Agencies apply the SSNIP starting from prices that would likely prevail absent the merger. If prices are not likely to change absent the merger, these benchmark prices can reasonably be taken to be the prices prevailing prior to the merger.<sup>5</sup> If prices are likely to change absent the merger, e.g., because of innovation or entry, the Agencies may use anticipated future prices as the benchmark for the test. If prices might fall absent the merger due to the breakdown of pre-merger coordination, the Agencies may use those lower prices as the benchmark for the test. In some cases, the techniques employed by the Agencies to implement the hypothetical monopolist test focus on the difference in incentives between pre-merger firms and the hypothetical monopolist and do not require specifying the benchmark prices.

The SSNIP is intended to represent a “small but significant” increase in the prices charged by firms in the candidate market for the value they contribute to the products or services used by customers. This properly directs attention to the effects of price changes commensurate with those that might result from a significant lessening of competition caused by the merger. This methodology is used because normally it is possible to quantify “small but significant” adverse price effects on customers and analyze their likely reactions, not because price effects are more important than non-price effects.

The Agencies most often use a SSNIP of five percent of the price paid by customers for the products or services to which the merging firms contribute value. However, what constitutes a “small but significant” increase in price, commensurate with a significant loss of competition caused by the merger, depends upon the nature of the industry and the merging firms’ positions in it, and the Agencies may accordingly use a price increase that is larger or smaller than five percent. Where explicit or implicit prices for the firms’ specific contribution to value can be identified with reasonable clarity, the Agencies may base the SSNIP on those prices.

*Example 8:* In a merger between two oil pipelines, the SSNIP would be based on the price charged for transporting the oil, not on the price of the oil itself. If pipelines buy the oil at one end and sell it at the other, the price charged for transporting the oil is implicit, equal to the difference between the price paid for oil at the input end and the price charged for oil at the output end. The relevant product sold by the pipelines is better described as “pipeline transportation of oil from point A to point B” than as “oil at point B.”

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<sup>5</sup> Market definition for the evaluation of non-merger antitrust concerns such as monopolization or facilitating practices will differ in this respect if the effects resulting from the conduct of concern are already occurring at the time of evaluation.

*Example 9:* In a merger between two firms that install computers purchased from third parties, the SSNIP would be based on their fees, not on the price of installed computers. If these firms purchase the computers and charge their customers one package price, the implicit installation fee is equal to the package charge to customers less the price of the computers.

*Example 10:* In Example 9, suppose that the prices paid by the merging firms to purchase computers are opaque, but account for at least ninety-five percent of the prices they charge for installed computers, with profits or implicit fees making up five percent of those prices at most. A five percent SSNIP on the total price paid by customers would at least double those fees or profits. Even if that would be unprofitable for a hypothetical monopolist, a significant increase in fees might well be profitable. If the SSNIP is based on the total price paid by customers, a lower percentage will be used.

#### 4.1.3 *Implementing the Hypothetical Monopolist Test*

The hypothetical monopolist's incentive to raise prices depends both on the extent to which customers would likely substitute away from the products in the candidate market in response to such a price increase and on the profit margins earned on those products. The profit margin on incremental units is the difference between price and incremental cost on those units. The Agencies often estimate incremental costs, for example using merging parties' documents or data the merging parties use to make business decisions. Incremental cost is measured over the change in output that would be caused by the price increase under consideration.

In considering customers' likely responses to higher prices, the Agencies take into account any reasonably available and reliable evidence, including, but not limited to:

- how customers have shifted purchases in the past in response to relative changes in price or other terms and conditions;
- information from buyers, including surveys, concerning how they would respond to price changes;
- the conduct of industry participants, notably:
  - sellers' business decisions or business documents indicating sellers' informed beliefs concerning how customers would substitute among products in response to relative changes in price;
  - industry participants' behavior in tracking and responding to price changes by some or all rivals;
- objective information about product characteristics and the costs and delays of switching products, especially switching from products in the candidate market to products outside the candidate market;
- the percentage of sales lost by one product in the candidate market, when its price alone rises, that is recaptured by other products in the candidate market, with a higher recapture percentage making a price increase more profitable for the hypothetical monopolist;
- evidence from other industry participants, such as sellers of complementary products;



- legal or regulatory requirements; and
- the influence of downstream competition faced by customers in their output markets.

When the necessary data are available, the Agencies also may consider a “critical loss analysis” to assess the extent to which it corroborates inferences drawn from the evidence noted above. Critical loss analysis asks whether imposing at least a SSNIP on one or more products in a candidate market would raise or lower the hypothetical monopolist’s profits. While this “breakeven” analysis differs from the profit-maximizing analysis called for by the hypothetical monopolist test in Section 4.1.1, merging parties sometimes present this type of analysis to the Agencies. A price increase raises profits on sales made at the higher price, but this will be offset to the extent customers substitute away from products in the candidate market. Critical loss analysis compares the magnitude of these two offsetting effects resulting from the price increase. The “critical loss” is defined as the number of lost unit sales that would leave profits unchanged. The “predicted loss” is defined as the number of unit sales that the hypothetical monopolist is predicted to lose due to the price increase. The price increase raises the hypothetical monopolist’s profits if the predicted loss is less than the critical loss.

The Agencies consider all of the evidence of customer substitution noted above in assessing the predicted loss. The Agencies require that estimates of the predicted loss be consistent with that evidence, including the pre-merger margins of products in the candidate market used to calculate the critical loss. Unless the firms are engaging in coordinated interaction (see Section 7), high pre-merger margins normally indicate that each firm’s product individually faces demand that is not highly sensitive to price.<sup>6</sup> Higher pre-merger margins thus indicate a smaller predicted loss as well as a smaller critical loss. The higher the pre-merger margin, the smaller the recapture percentage necessary for the candidate market to satisfy the hypothetical monopolist test.

Even when the evidence necessary to perform the hypothetical monopolist test quantitatively is not available, the conceptual framework of the test provides a useful methodological tool for gathering and analyzing evidence pertinent to customer substitution and to market definition. The Agencies follow the hypothetical monopolist test to the extent possible given the available evidence, bearing in mind that the ultimate goal of market definition is to help determine whether the merger may substantially lessen competition.

#### 4.1.4 *Product Market Definition with Targeted Customers*

If a hypothetical monopolist could profitably target a subset of customers for price increases, the Agencies may identify relevant markets defined around those targeted customers, to whom a hypothetical monopolist would profitably and separately impose at least a SSNIP. Markets to serve targeted customers are also known as price discrimination markets. In practice, the Agencies identify price discrimination markets only where they believe there is a realistic prospect of an adverse competitive effect on a group of targeted customers.

*Example 11:* Glass containers have many uses. In response to a price increase for glass containers, some users would substitute substantially to plastic or metal containers, but baby food manufacturers would not. If a

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<sup>6</sup> While margins are important for implementing the hypothetical monopolist test, high margins are not in themselves of antitrust concern.

hypothetical monopolist could price separately and limit arbitrage, baby food manufacturers would be vulnerable to a targeted increase in the price of glass containers. The Agencies could define a distinct market for glass containers used to package baby food.

The Agencies also often consider markets for targeted customers when prices are individually negotiated and suppliers have information about customers that would allow a hypothetical monopolist to identify customers that are likely to pay a higher price for the relevant product. If prices are negotiated individually with customers, the hypothetical monopolist test may suggest relevant markets that are as narrow as individual customers (see also Section 6.2 on bargaining and auctions). Nonetheless, the Agencies often define markets for groups of targeted customers, i.e., by type of customer, rather than by individual customer. By so doing, the Agencies are able to rely on aggregated market shares that can be more helpful in predicting the competitive effects of the merger.

## **4.2 Geographic Market Definition**

The arena of competition affected by the merger may be geographically bounded if geography limits some customers' willingness or ability to substitute to some products, or some suppliers' willingness or ability to serve some customers. Both supplier and customer locations can affect this. The Agencies apply the principles of market definition described here and in Section 4.1 to define a relevant market with a geographic dimension as well as a product dimension.

The scope of geographic markets often depends on transportation costs. Other factors such as language, regulation, tariff and non-tariff trade barriers, custom and familiarity, reputation, and service availability may impede long-distance or international transactions. The competitive significance of foreign firms may be assessed at various exchange rates, especially if exchange rates have fluctuated in the recent past.

In the absence of price discrimination based on customer location, the Agencies normally define geographic markets based on the locations of suppliers, as explained in subsection 4.2.1. In other cases, notably if price discrimination based on customer location is feasible as is often the case when delivered pricing is commonly used in the industry, the Agencies may define geographic markets based on the locations of customers, as explained in subsection 4.2.2.

### *4.2.1 Geographic Markets Based on the Locations of Suppliers*

Geographic markets based on the locations of suppliers encompass the region from which sales are made. Geographic markets of this type often apply when customers receive goods or services at suppliers' locations. Competitors in the market are firms with relevant production, sales, or service facilities in that region. Some customers who buy from these firms may be located outside the boundaries of the geographic market.

The hypothetical monopolist test requires that a hypothetical profit-maximizing firm that was the only present or future producer of the relevant product(s) located in the region would impose at least a SSNIP from at least one location, including at least one location of one of the merging firms. In this exercise the terms of sale for all products produced elsewhere are held constant. A single firm may operate in a number of different geographic markets, even for a single product.

*Example 12:* The merging parties both have manufacturing plants in City X. The relevant product is expensive to transport and suppliers price their products for pickup at their locations. Rival plants are some distance away in City Y. A hypothetical monopolist controlling all plants in City X could profitably impose a SSNIP at these plants. Competition from more distant plants would not defeat the price increase because supplies coming from more distant plants require expensive transportation. The relevant geographic market is defined around the plants in City X.

When the geographic market is defined based on supplier locations, sales made by suppliers located in the geographic market are counted, regardless of the location of the customer making the purchase.

In considering likely reactions of customers to price increases for the relevant product(s) imposed in a candidate geographic market, the Agencies consider any reasonably available and reliable evidence, including:

- how customers have shifted purchases in the past between different geographic locations in response to relative changes in price or other terms and conditions;
- the cost and difficulty of transporting the product (or the cost and difficulty of a customer traveling to a seller's location), in relation to its price;
- whether suppliers need a presence near customers to provide service or support;
- evidence on whether sellers base business decisions on the prospect of customers switching between geographic locations in response to relative changes in price or other competitive variables;
- the costs and delays of switching from suppliers in the candidate geographic market to suppliers outside the candidate geographic market; and
- the influence of downstream competition faced by customers in their output markets.

#### 4.2.2 *Geographic Markets Based on the Locations of Customers*

When the hypothetical monopolist could discriminate based on customer location, the Agencies may define geographic markets based on the locations of targeted customers.<sup>7</sup> Geographic markets of this type often apply when suppliers deliver their products or services to customers' locations. Geographic markets of this type encompass the region into which sales are made. Competitors in the market are firms that sell to customers in the specified region. Some suppliers that sell into the relevant market may be located outside the boundaries of the geographic market.

The hypothetical monopolist test requires that a hypothetical profit-maximizing firm that was the only present or future seller of the relevant product(s) to customers in the region would impose at least a SSNIP on some customers in that region. A region forms a relevant geographic market if this price increase would not be defeated by substitution away from the relevant product or by arbitrage,

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<sup>7</sup> For customers operating in multiple locations, only those customer locations within the targeted zone are included in the market.

e.g., customers in the region travelling outside it to purchase the relevant product. In this exercise, the terms of sale for products sold to all customers outside the region are held constant.

*Example 13:* Customers require local sales and support. Suppliers have sales and service operations in many geographic areas and can discriminate based on customer location. The geographic market can be defined around the locations of customers.

*Example 14:* Each merging firm has a single manufacturing plant and delivers the relevant product to customers in City X and in City Y. The relevant product is expensive to transport. The merging firms' plants are by far the closest to City X, but no closer to City Y than are numerous rival plants. This fact pattern suggests that customers in City X may be harmed by the merger even if customers in City Y are not. For that reason, the Agencies consider a relevant geographic market defined around customers in City X. Such a market could be defined even if the region around the merging firms' plants would not be a relevant geographic market defined based on the location of sellers because a hypothetical monopolist controlling all plants in that region would find a SSNIP imposed on all of its customers unprofitable due to the loss of sales to customers in City Y.

When the geographic market is defined based on customer locations, sales made to those customers are counted, regardless of the location of the supplier making those sales.

*Example 15:* Customers in the United States must use products approved by U.S. regulators. Foreign customers use products not approved by U.S. regulators. The relevant product market consists of products approved by U.S. regulators. The geographic market is defined around U.S. customers. Any sales made to U.S. customers by foreign suppliers are included in the market, and those foreign suppliers are participants in the U.S. market even though located outside it.

## **5. Market Participants, Market Shares, and Market Concentration**

The Agencies normally consider measures of market shares and market concentration as part of their evaluation of competitive effects. The Agencies evaluate market shares and concentration in conjunction with other reasonably available and reliable evidence for the ultimate purpose of determining whether a merger may substantially lessen competition.

Market shares can directly influence firms' competitive incentives. For example, if a price reduction to gain new customers would also apply to a firm's existing customers, a firm with a large market share may be more reluctant to implement a price reduction than one with a small share. Likewise, a firm with a large market share may not feel pressure to reduce price even if a smaller rival does. Market shares also can reflect firms' capabilities. For example, a firm with a large market share may be able to expand output rapidly by a larger absolute amount than can a small firm. Similarly, a large market share tends to indicate low costs, an attractive product, or both.

### **5.1 Market Participants**

All firms that currently earn revenues in the relevant market are considered market participants. Vertically integrated firms are also included to the extent that their inclusion accurately reflects their competitive significance. Firms not currently earning revenues in the relevant market, but that have committed to entering the market in the near future, are also considered market participants.

Firms that are not current producers in a relevant market, but that would very likely provide rapid supply responses with direct competitive impact in the event of a SSNIP, without incurring

significant sunk costs, are also considered market participants. These firms are termed “rapid entrants.” Sunk costs are entry or exit costs that cannot be recovered outside the relevant market. Entry that would take place more slowly in response to adverse competitive effects, or that requires firms to incur significant sunk costs, is considered in Section 9.

Firms that produce the relevant product but do not sell it in the relevant geographic market may be rapid entrants. Other things equal, such firms are most likely to be rapid entrants if they are close to the geographic market.

*Example 16:* Farm A grows tomatoes halfway between Cities X and Y. Currently, it ships its tomatoes to City X because prices there are two percent higher. Previously it has varied the destination of its shipments in response to small price variations. Farm A would likely be a rapid entrant participant in a market for tomatoes in City Y.

*Example 17:* Firm B has bid multiple times to supply milk to School District S, and actually supplies milk to schools in some adjacent areas. It has never won a bid in School District S, but is well qualified to serve that district and has often nearly won. Firm B would be counted as a rapid entrant in a market for school milk in School District S.

More generally, if the relevant market is defined around targeted customers, firms that produce relevant products but do not sell them to those customers may be rapid entrants if they can easily and rapidly begin selling to the targeted customers.

Firms that clearly possess the necessary assets to supply into the relevant market rapidly may also be rapid entrants. In markets for relatively homogeneous goods where a supplier’s ability to compete depends predominantly on its costs and its capacity, and not on other factors such as experience or reputation in the relevant market, a supplier with efficient idle capacity, or readily available “swing” capacity currently used in adjacent markets that can easily and profitably be shifted to serve the relevant market, may be a rapid entrant.<sup>8</sup> However, idle capacity may be inefficient, and capacity used in adjacent markets may not be available, so a firm’s possession of idle or swing capacity alone does not make that firm a rapid entrant.

## **5.2 Market Shares**

The Agencies normally calculate market shares for all firms that currently produce products in the relevant market, subject to the availability of data. The Agencies also calculate market shares for other market participants if this can be done to reliably reflect their competitive significance.

Market concentration and market share data are normally based on historical evidence. However, recent or ongoing changes in market conditions may indicate that the current market share of a particular firm either understates or overstates the firm’s future competitive significance. The Agencies consider reasonably predictable effects of recent or ongoing changes in market conditions when calculating and interpreting market share data. For example, if a new technology that is important to long-term competitive viability is available to other firms in the market, but is not available to a particular firm, the Agencies may conclude that that firm’s historical market share

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<sup>8</sup> If this type of supply side substitution is nearly universal among the firms selling one or more of a group of products, the Agencies may use an aggregate description of markets for those products as a matter of convenience.

overstates its future competitive significance. The Agencies may project historical market shares into the foreseeable future when this can be done reliably.

The Agencies measure market shares based on the best available indicator of firms' future competitive significance in the relevant market. This may depend upon the type of competitive effect being considered, and on the availability of data. Typically, annual data are used, but where individual transactions are large and infrequent so annual data may be unrepresentative, the Agencies may measure market shares over a longer period of time.

In most contexts, the Agencies measure each firm's market share based on its actual or projected revenues in the relevant market. Revenues in the relevant market tend to be the best measure of attractiveness to customers, since they reflect the real-world ability of firms to surmount all of the obstacles necessary to offer products on terms and conditions that are attractive to customers. In cases where one unit of a low-priced product can substitute for one unit of a higher-priced product, unit sales may measure competitive significance better than revenues. For example, a new, much less expensive product may have great competitive significance if it substantially erodes the revenues earned by older, higher-priced products, even if it earns relatively few revenues. In cases where customers sign long-term contracts, face switching costs, or tend to re-evaluate their suppliers only occasionally, revenues earned from recently acquired customers may better reflect the competitive significance of suppliers than do total revenues.

In markets for homogeneous products, a firm's competitive significance may derive principally from its ability and incentive to rapidly expand production in the relevant market in response to a price increase or output reduction by others in that market. As a result, a firm's competitive significance may depend upon its level of readily available capacity to serve the relevant market if that capacity is efficient enough to make such expansion profitable. In such markets, capacities or reserves may better reflect the future competitive significance of suppliers than revenues, and the Agencies may calculate market shares using those measures. Market participants that are not current producers may then be assigned positive market shares, but only if a measure of their competitive significance properly comparable to that of current producers is available. When market shares are measured based on firms' readily available capacities, the Agencies do not include capacity that is committed or so profitably employed outside the relevant market, or so high-cost, that it would not likely be used to respond to a SSNIP in the relevant market.

*Example 18:* The geographic market is defined around customers in the United States. Firm X produces the relevant product outside the United States, and most of its sales are made to customers outside the United States. In most contexts, Firm X's market share will be based on its sales to U.S. customers, not its total sales or total capacity. However, if the relevant product is homogeneous, and if Firm X would significantly expand sales to U.S. customers rapidly and without incurring significant sunk costs in response to a SSNIP, the Agencies may base Firm X's market share on its readily available capacity to serve U.S. customers.

When the Agencies define markets serving targeted customers, these same principles are used to measure market shares, as they apply to those customers. In most contexts, each firm's market share is based on its actual or projected revenues from the targeted customers. However, the Agencies may instead measure market shares based on revenues from a broader group of customers if doing so would more accurately reflect the competitive significance of different suppliers in the relevant market. Revenues earned from a broader group of customers may also be used when better data are thereby available.

### 5.3 Market Concentration

Market concentration is often one useful indicator of likely competitive effects of a merger. In evaluating market concentration, the Agencies consider both the post-merger level of market concentration and the change in concentration resulting from a merger. Market shares may not fully reflect the competitive significance of firms in the market or the impact of a merger. They are used in conjunction with other evidence of competitive effects. See Sections 6 and 7.

In analyzing mergers between an incumbent and a recent or potential entrant, to the extent the Agencies use the change in concentration to evaluate competitive effects, they will do so using projected market shares. A merger between an incumbent and a potential entrant can raise significant competitive concerns. The lessening of competition resulting from such a merger is more likely to be substantial, the larger is the market share of the incumbent, the greater is the competitive significance of the potential entrant, and the greater is the competitive threat posed by this potential entrant relative to others.

The Agencies give more weight to market concentration when market shares have been stable over time, especially in the face of historical changes in relative prices or costs. If a firm has retained its market share even after its price has increased relative to those of its rivals, that firm already faces limited competitive constraints, making it less likely that its remaining rivals will replace the competition lost if one of that firm's important rivals is eliminated due to a merger. By contrast, even a highly concentrated market can be very competitive if market shares fluctuate substantially over short periods of time in response to changes in competitive offerings. However, if competition by one of the merging firms has significantly contributed to these fluctuations, perhaps because it has acted as a maverick, the Agencies will consider whether the merger will enhance market power by combining that firm with one of its significant rivals.

The Agencies may measure market concentration using the number of significant competitors in the market. This measure is most useful when there is a gap in market share between significant competitors and smaller rivals or when it is difficult to measure revenues in the relevant market. The Agencies also may consider the combined market share of the merging firms as an indicator of the extent to which others in the market may not be able readily to replace competition between the merging firms that is lost through the merger.

The Agencies often calculate the Herfindahl-Hirschman Index ("HHI") of market concentration. The HHI is calculated by summing the squares of the individual firms' market shares,<sup>9</sup> and thus gives proportionately greater weight to the larger market shares. When using the HHI, the Agencies

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<sup>9</sup> For example, a market consisting of four firms with market shares of thirty percent, thirty percent, twenty percent, and twenty percent has an HHI of 2600 ( $30^2 + 30^2 + 20^2 + 20^2 = 2600$ ). The HHI ranges from 10,000 (in the case of a pure monopoly) to a number approaching zero (in the case of an atomistic market). Although it is desirable to include all firms in the calculation, lack of information about firms with small shares is not critical because such firms do not affect the HHI significantly.

consider both the post-merger level of the HHI and the increase in the HHI resulting from the merger. The increase in the HHI is equal to twice the product of the market shares of the merging firms.<sup>10</sup>

Based on their experience, the Agencies generally classify markets into three types:

- Unconcentrated Markets: HHI below 1500
- Moderately Concentrated Markets: HHI between 1500 and 2500
- Highly Concentrated Markets: HHI above 2500

The Agencies employ the following general standards for the relevant markets they have defined:

- *Small Change in Concentration:* Mergers involving an increase in the HHI of less than 100 points are unlikely to have adverse competitive effects and ordinarily require no further analysis.
- *Unconcentrated Markets:* Mergers resulting in unconcentrated markets are unlikely to have adverse competitive effects and ordinarily require no further analysis.
- *Moderately Concentrated Markets:* Mergers resulting in moderately concentrated markets that involve an increase in the HHI of more than 100 points potentially raise significant competitive concerns and often warrant scrutiny.
- *Highly Concentrated Markets:* Mergers resulting in highly concentrated markets that involve an increase in the HHI of between 100 points and 200 points potentially raise significant competitive concerns and often warrant scrutiny. Mergers resulting in highly concentrated markets that involve an increase in the HHI of more than 200 points will be presumed to be likely to enhance market power. The presumption may be rebutted by persuasive evidence showing that the merger is unlikely to enhance market power.

The purpose of these thresholds is not to provide a rigid screen to separate competitively benign mergers from anticompetitive ones, although high levels of concentration do raise concerns. Rather, they provide one way to identify some mergers unlikely to raise competitive concerns and some others for which it is particularly important to examine whether other competitive factors confirm, reinforce, or counteract the potentially harmful effects of increased concentration. The higher the post-merger HHI and the increase in the HHI, the greater are the Agencies' potential competitive concerns and the greater is the likelihood that the Agencies will request additional information to conduct their analysis.

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<sup>10</sup> For example, the merger of firms with shares of five percent and ten percent of the market would increase the HHI by 100 ( $5 \times 10 \times 2 = 100$ ).



## **6. Unilateral Effects**

The elimination of competition between two firms that results from their merger may alone constitute a substantial lessening of competition. Such unilateral effects are most apparent in a merger to monopoly in a relevant market, but are by no means limited to that case. Whether cognizable efficiencies resulting from the merger are likely to reduce or reverse adverse unilateral effects is addressed in Section 10.

Several common types of unilateral effects are discussed in this section. Section 6.1 discusses unilateral price effects in markets with differentiated products. Section 6.2 discusses unilateral effects in markets where sellers negotiate with buyers or prices are determined through auctions. Section 6.3 discusses unilateral effects relating to reductions in output or capacity in markets for relatively homogeneous products. Section 6.4 discusses unilateral effects arising from diminished innovation or reduced product variety. These effects do not exhaust the types of possible unilateral effects; for example, exclusionary unilateral effects also can arise.

A merger may result in different unilateral effects along different dimensions of competition. For example, a merger may increase prices in the short term but not raise longer-term concerns about innovation, either because rivals will provide sufficient innovation competition or because the merger will generate cognizable research and development efficiencies. See Section 10.

### **6.1 Pricing of Differentiated Products**

In differentiated product industries, some products can be very close substitutes and compete strongly with each other, while other products are more distant substitutes and compete less strongly. For example, one high-end product may compete much more directly with another high-end product than with any low-end product.

A merger between firms selling differentiated products may diminish competition by enabling the merged firm to profit by unilaterally raising the price of one or both products above the pre-merger level. Some of the sales lost due to the price rise will merely be diverted to the product of the merger partner and, depending on relative margins, capturing such sales loss through merger may make the price increase profitable even though it would not have been profitable prior to the merger.

The extent of direct competition between the products sold by the merging parties is central to the evaluation of unilateral price effects. Unilateral price effects are greater, the more the buyers of products sold by one merging firm consider products sold by the other merging firm to be their next choice. The Agencies consider any reasonably available and reliable information to evaluate the extent of direct competition between the products sold by the merging firms. This includes documentary and testimonial evidence, win/loss reports and evidence from discount approval processes, customer switching patterns, and customer surveys. The types of evidence relied on often overlap substantially with the types of evidence of customer substitution relevant to the hypothetical monopolist test. See Section 4.1.1.

Substantial unilateral price elevation post-merger for a product formerly sold by one of the merging firms normally requires that a significant fraction of the customers purchasing that product view

products formerly sold by the other merging firm as their next-best choice. However, unless pre-merger margins between price and incremental cost are low, that significant fraction need not approach a majority. For this purpose, incremental cost is measured over the change in output that would be caused by the price change considered. A merger may produce significant unilateral effects for a given product even though many more sales are diverted to products sold by non-merging firms than to products previously sold by the merger partner.

*Example 19:* In Example 5, the merged entity controlling Products A and B would raise prices ten percent, given the product offerings and prices of other firms. In that example, one-third of the sales lost by Product A when its price alone is raised are diverted to Product B. Further analysis is required to account for repositioning, entry, and efficiencies.

In some cases, the Agencies may seek to quantify the extent of direct competition between a product sold by one merging firm and a second product sold by the other merging firm by estimating the diversion ratio from the first product to the second product. The diversion ratio is the fraction of unit sales lost by the first product due to an increase in its price that would be diverted to the second product. Diversion ratios between products sold by one merging firm and products sold by the other merging firm can be very informative for assessing unilateral price effects, with higher diversion ratios indicating a greater likelihood of such effects. Diversion ratios between products sold by merging firms and those sold by non-merging firms have at most secondary predictive value.

Adverse unilateral price effects can arise when the merger gives the merged entity an incentive to raise the price of a product previously sold by one merging firm and thereby divert sales to products previously sold by the other merging firm, boosting the profits on the latter products. Taking as given other prices and product offerings, that boost to profits is equal to the value to the merged firm of the sales diverted to those products. The value of sales diverted to a product is equal to the number of units diverted to that product multiplied by the margin between price and incremental cost on that product. In some cases, where sufficient information is available, the Agencies assess the value of diverted sales, which can serve as an indicator of the upward pricing pressure on the first product resulting from the merger. Diagnosing unilateral price effects based on the value of diverted sales need not rely on market definition or the calculation of market shares and concentration. The Agencies rely much more on the value of diverted sales than on the level of the HHI for diagnosing unilateral price effects in markets with differentiated products. If the value of diverted sales is proportionately small, significant unilateral price effects are unlikely.<sup>11</sup>

Where sufficient data are available, the Agencies may construct economic models designed to quantify the unilateral price effects resulting from the merger. These models often include independent price responses by non-merging firms. They also can incorporate merger-specific efficiencies. These merger simulation methods need not rely on market definition. The Agencies do not treat merger simulation evidence as conclusive in itself, and they place more weight on whether their merger simulations consistently predict substantial price increases than on the precise prediction of any single simulation.

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<sup>11</sup> For this purpose, the value of diverted sales is measured in proportion to the lost revenues attributable to the reduction in unit sales resulting from the price increase. Those lost revenues equal the reduction in the number of units sold of that product multiplied by that product's price.

A merger is unlikely to generate substantial unilateral price increases if non-merging parties offer very close substitutes for the products offered by the merging firms. In some cases, non-merging firms may be able to reposition their products to offer close substitutes for the products offered by the merging firms. Repositioning is a supply-side response that is evaluated much like entry, with consideration given to timeliness, likelihood, and sufficiency. See Section 9. The Agencies consider whether repositioning would be sufficient to deter or counteract what otherwise would be significant anticompetitive unilateral effects from a differentiated products merger.

## **6.2 Bargaining and Auctions**

In many industries, especially those involving intermediate goods and services, buyers and sellers negotiate to determine prices and other terms of trade. In that process, buyers commonly negotiate with more than one seller, and may play sellers off against one another. Some highly structured forms of such competition are known as auctions. Negotiations often combine aspects of an auction with aspects of one-on-one negotiation, although pure auctions are sometimes used in government procurement and elsewhere.

A merger between two competing sellers prevents buyers from playing those sellers off against each other in negotiations. This alone can significantly enhance the ability and incentive of the merged entity to obtain a result more favorable to it, and less favorable to the buyer, than the merging firms would have offered separately absent the merger. The Agencies analyze unilateral effects of this type using similar approaches to those described in Section 6.1.

Anticompetitive unilateral effects in these settings are likely in proportion to the frequency or probability with which, prior to the merger, one of the merging sellers had been the runner-up when the other won the business. These effects also are likely to be greater, the greater advantage the runner-up merging firm has over other suppliers in meeting customers' needs. These effects also tend to be greater, the more profitable were the pre-merger winning bids. All of these factors are likely to be small if there are many equally placed bidders.

The mechanisms of these anticompetitive unilateral effects, and the indicia of their likelihood, differ somewhat according to the bargaining practices used, the auction format, and the sellers' information about one another's costs and about buyers' preferences. For example, when the merging sellers are likely to know which buyers they are best and second best placed to serve, any anticompetitive unilateral effects are apt to be targeted at those buyers; when sellers are less well informed, such effects are more apt to be spread over a broader class of buyers.

## **6.3 Capacity and Output for Homogeneous Products**

In markets involving relatively undifferentiated products, the Agencies may evaluate whether the merged firm will find it profitable unilaterally to suppress output and elevate the market price. A firm may leave capacity idle, refrain from building or obtaining capacity that would have been obtained absent the merger, or eliminate pre-existing production capabilities. A firm may also divert the use of capacity away from one relevant market and into another so as to raise the price in the former market. The competitive analyses of these alternative modes of output suppression may differ.

A unilateral output suppression strategy is more likely to be profitable when (1) the merged firm's market share is relatively high; (2) the share of the merged firm's output already committed for sale at prices unaffected by the output suppression is relatively low; (3) the margin on the suppressed output is relatively low; (4) the supply responses of rivals are relatively small; and (5) the market elasticity of demand is relatively low.

A merger may provide the merged firm a larger base of sales on which to benefit from the resulting price rise, or it may eliminate a competitor that otherwise could have expanded its output in response to the price rise.

*Example 20:* Firms A and B both produce an industrial commodity and propose to merge. The demand for this commodity is insensitive to price. Firm A is the market leader. Firm B produces substantial output, but its operating margins are low because it operates high-cost plants. The other suppliers are operating very near capacity. The merged firm has an incentive to reduce output at the high-cost plants, perhaps shutting down some of that capacity, thus driving up the price it receives on the remainder of its output. The merger harms customers, notwithstanding that the merged firm shifts some output from high-cost plants to low-cost plants.

In some cases, a merger between a firm with a substantial share of the sales in the market and a firm with significant excess capacity to serve that market can make an output suppression strategy profitable.<sup>12</sup> This can occur even if the firm with the excess capacity has a relatively small share of sales, if that firm's ability to expand, and thus keep price from rising, has been making an output suppression strategy unprofitable for the firm with the larger market share.

## **6.4 Innovation and Product Variety**

Competition often spurs firms to innovate. The Agencies may consider whether a merger is likely to diminish innovation competition by encouraging the merged firm to curtail its innovative efforts below the level that would prevail in the absence of the merger. That curtailment of innovation could take the form of reduced incentive to continue with an existing product-development effort or reduced incentive to initiate development of new products.

The first of these effects is most likely to occur if at least one of the merging firms is engaging in efforts to introduce new products that would capture substantial revenues from the other merging firm. The second, longer-run effect is most likely to occur if at least one of the merging firms has capabilities that are likely to lead it to develop new products in the future that would capture substantial revenues from the other merging firm. The Agencies therefore also consider whether a merger will diminish innovation competition by combining two of a very small number of firms with the strongest capabilities to successfully innovate in a specific direction.

The Agencies evaluate the extent to which successful innovation by one merging firm is likely to take sales from the other, and the extent to which post-merger incentives for future innovation will be lower than those that would prevail in the absence of the merger. The Agencies also consider whether the merger is likely to enable innovation that would not otherwise take place, by bringing together

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<sup>12</sup> Such a merger also can cause adverse coordinated effects, especially if the acquired firm with excess capacity was disrupting effective coordination.

complementary capabilities that cannot be otherwise combined or for some other merger-specific reason. See Section 10.

The Agencies also consider whether a merger is likely to give the merged firm an incentive to cease offering one of the relevant products sold by the merging parties. Reductions in variety following a merger may or may not be anticompetitive. Mergers can lead to the efficient consolidation of products when variety offers little in value to customers. In other cases, a merger may increase variety by encouraging the merged firm to reposition its products to be more differentiated from one another.

If the merged firm would withdraw a product that a significant number of customers strongly prefer to those products that would remain available, this can constitute a harm to customers over and above any effects on the price or quality of any given product. If there is evidence of such an effect, the Agencies may inquire whether the reduction in variety is largely due to a loss of competitive incentives attributable to the merger. An anticompetitive incentive to eliminate a product as a result of the merger is greater and more likely, the larger is the share of profits from that product coming at the expense of profits from products sold by the merger partner. Where a merger substantially reduces competition by bringing two close substitute products under common ownership, and one of those products is eliminated, the merger will often also lead to a price increase on the remaining product, but that is not a necessary condition for anticompetitive effect.

*Example 21:* Firm A sells a high-end product at a premium price. Firm B sells a mid-range product at a lower price, serving customers who are more price sensitive. Several other firms have low-end products. Firms A and B together have a large share of the relevant market. Firm A proposes to acquire Firm B and discontinue Firm B's product. Firm A expects to retain most of Firm B's customers. Firm A may not find it profitable to raise the price of its high-end product after the merger, because doing so would reduce its ability to retain Firm B's more price-sensitive customers. The Agencies may conclude that the withdrawal of Firm B's product results from a loss of competition and materially harms customers.

## **7. Coordinated Effects**

A merger may diminish competition by enabling or encouraging post-merger coordinated interaction among firms in the relevant market that harms customers. Coordinated interaction involves conduct by multiple firms that is profitable for each of them only as a result of the accommodating reactions of the others. These reactions can blunt a firm's incentive to offer customers better deals by undercutting the extent to which such a move would win business away from rivals. They also can enhance a firm's incentive to raise prices, by assuaging the fear that such a move would lose customers to rivals.

Coordinated interaction includes a range of conduct. Coordinated interaction can involve the explicit negotiation of a common understanding of how firms will compete or refrain from competing. Such conduct typically would itself violate the antitrust laws. Coordinated interaction also can involve a similar common understanding that is not explicitly negotiated but would be enforced by the detection and punishment of deviations that would undermine the coordinated interaction.

Coordinated interaction alternatively can involve parallel accommodating conduct not pursuant to a prior understanding. Parallel accommodating conduct includes situations in which each rival's response to competitive moves made by others is individually rational, and not motivated by

retaliation or deterrence nor intended to sustain an agreed-upon market outcome, but nevertheless emboldens price increases and weakens competitive incentives to reduce prices or offer customers better terms. Coordinated interaction includes conduct not otherwise condemned by the antitrust laws.

The ability of rival firms to engage in coordinated conduct depends on the strength and predictability of rivals' responses to a price change or other competitive initiative. Under some circumstances, a merger can result in market concentration sufficient to strengthen such responses or enable multiple firms in the market to predict them more confidently, thereby affecting the competitive incentives of multiple firms in the market, not just the merged firm.

## **7.1 Impact of Merger on Coordinated Interaction**

The Agencies examine whether a merger is likely to change the manner in which market participants interact, inducing substantially more coordinated interaction. The Agencies seek to identify how a merger might significantly weaken competitive incentives through an increase in the strength, extent, or likelihood of coordinated conduct. There are, however, numerous forms of coordination, and the risk that a merger will induce adverse coordinated effects may not be susceptible to quantification or detailed proof. Therefore, the Agencies evaluate the risk of coordinated effects using measures of market concentration (see Section 5) in conjunction with an assessment of whether a market is vulnerable to coordinated conduct. See Section 7.2. The analysis in Section 7.2 applies to moderately and highly concentrated markets, as unconcentrated markets are unlikely to be vulnerable to coordinated conduct.

Pursuant to the Clayton Act's incipiency standard, the Agencies may challenge mergers that in their judgment pose a real danger of harm through coordinated effects, even without specific evidence showing precisely how the coordination likely would take place. The Agencies are likely to challenge a merger if the following three conditions are all met: (1) the merger would significantly increase concentration and lead to a moderately or highly concentrated market; (2) that market shows signs of vulnerability to coordinated conduct (see Section 7.2); and (3) the Agencies have a credible basis on which to conclude that the merger may enhance that vulnerability. An acquisition eliminating a maverick firm (see Section 2.1.5) in a market vulnerable to coordinated conduct is likely to cause adverse coordinated effects.

## **7.2 Evidence a Market is Vulnerable to Coordinated Conduct**

The Agencies presume that market conditions are conducive to coordinated interaction if firms representing a substantial share in the relevant market appear to have previously engaged in express collusion affecting the relevant market, unless competitive conditions in the market have since changed significantly. Previous express collusion in another geographic market will have the same weight if the salient characteristics of that other market at the time of the collusion are comparable to those in the relevant market. Failed previous attempts at collusion in the relevant market suggest that successful collusion was difficult pre-merger but not so difficult as to deter attempts, and a merger may tend to make success more likely. Previous collusion or attempted collusion in another product market may also be given substantial weight if the salient characteristics of that other market at the time of the collusion are closely comparable to those in the relevant market.

A market typically is more vulnerable to coordinated conduct if each competitively important firm's significant competitive initiatives can be promptly and confidently observed by that firm's rivals. This is more likely to be the case if the terms offered to customers are relatively transparent. Price transparency can be greater for relatively homogeneous products. Even if terms of dealing are not transparent, transparency regarding the identities of the firms serving particular customers can give rise to coordination, e.g., through customer or territorial allocation. Regular monitoring by suppliers of one another's prices or customers can indicate that the terms offered to customers are relatively transparent.

A market typically is more vulnerable to coordinated conduct if a firm's prospective competitive reward from attracting customers away from its rivals will be significantly diminished by likely responses of those rivals. This is more likely to be the case, the stronger and faster are the responses the firm anticipates from its rivals. The firm is more likely to anticipate strong responses if there are few significant competitors, if products in the relevant market are relatively homogeneous, if customers find it relatively easy to switch between suppliers, or if suppliers use meeting-competition clauses.

A firm is more likely to be deterred from making competitive initiatives by whatever responses occur if sales are small and frequent rather than via occasional large and long-term contracts or if relatively few customers will switch to it before rivals are able to respond. A firm is less likely to be deterred by whatever responses occur if the firm has little stake in the status quo. For example, a firm with a small market share that can quickly and dramatically expand, constrained neither by limits on production nor by customer reluctance to switch providers or to entrust business to a historically small provider, is unlikely to be deterred. Firms are also less likely to be deterred by whatever responses occur if competition in the relevant market is marked by leapfrogging technological innovation, so that responses by competitors leave the gains from successful innovation largely intact.

A market is more apt to be vulnerable to coordinated conduct if the firm initiating a price increase will lose relatively few customers after rivals respond to the increase. Similarly, a market is more apt to be vulnerable to coordinated conduct if a firm that first offers a lower price or improved product to customers will retain relatively few customers thus attracted away from its rivals after those rivals respond.

The Agencies regard coordinated interaction as more likely, the more the participants stand to gain from successful coordination. Coordination generally is more profitable, the lower is the market elasticity of demand.

Coordinated conduct can harm customers even if not all firms in the relevant market engage in the coordination, but significant harm normally is likely only if a substantial part of the market is subject to such conduct. The prospect of harm depends on the collective market power, in the relevant market, of firms whose incentives to compete are substantially weakened by coordinated conduct. This collective market power is greater, the lower is the market elasticity of demand. This collective market power is diminished by the presence of other market participants with small market shares and little stake in the outcome resulting from the coordinated conduct, if these firms can rapidly expand their sales in the relevant market.

Buyer characteristics and the nature of the procurement process can affect coordination. For example, sellers may have the incentive to bid aggressively for a large contract even if they expect strong responses by rivals. This is especially the case for sellers with small market shares, if they can realistically win such large contracts. In some cases, a large buyer may be able to strategically undermine coordinated conduct, at least as it pertains to that buyer's needs, by choosing to put up for bid a few large contracts rather than many smaller ones, and by making its procurement decisions opaque to suppliers.

## **8. Powerful Buyers**

Powerful buyers are often able to negotiate favorable terms with their suppliers. Such terms may reflect the lower costs of serving these buyers, but they also can reflect price discrimination in their favor.

The Agencies consider the possibility that powerful buyers may constrain the ability of the merging parties to raise prices. This can occur, for example, if powerful buyers have the ability and incentive to vertically integrate upstream or sponsor entry, or if the conduct or presence of large buyers undermines coordinated effects. However, the Agencies do not presume that the presence of powerful buyers alone forestalls adverse competitive effects flowing from the merger. Even buyers that can negotiate favorable terms may be harmed by an increase in market power. The Agencies examine the choices available to powerful buyers and how those choices likely would change due to the merger. Normally, a merger that eliminates a supplier whose presence contributed significantly to a buyer's negotiating leverage will harm that buyer.

*Example 22:* Customer C has been able to negotiate lower pre-merger prices than other customers by threatening to shift its large volume of purchases from one merging firm to the other. No other suppliers are as well placed to meet Customer C's needs for volume and reliability. The merger is likely to harm Customer C. In this situation, the Agencies could identify a price discrimination market consisting of Customer C and similarly placed customers. The merger threatens to end previous price discrimination in their favor.

Furthermore, even if some powerful buyers could protect themselves, the Agencies also consider whether market power can be exercised against other buyers.

*Example 23:* In Example 22, if Customer C instead obtained the lower pre-merger prices based on a credible threat to supply its own needs, or to sponsor new entry, Customer C might not be harmed. However, even in this case, other customers may still be harmed.

## **9. Entry**

The analysis of competitive effects in Sections 6 and 7 focuses on current participants in the relevant market. That analysis may also include some forms of entry. Firms that would rapidly and easily enter the market in response to a SSNIP are market participants and may be assigned market shares. See Sections 5.1 and 5.2. Firms that have, prior to the merger, committed to entering the market also will normally be treated as market participants. See Section 5.1. This section concerns entry or adjustments to pre-existing entry plans that are induced by the merger.



As part of their full assessment of competitive effects, the Agencies consider entry into the relevant market. The prospect of entry into the relevant market will alleviate concerns about adverse competitive effects only if such entry will deter or counteract any competitive effects of concern so the merger will not substantially harm customers.

The Agencies consider the actual history of entry into the relevant market and give substantial weight to this evidence. Lack of successful and effective entry in the face of non-transitory increases in the margins earned on products in the relevant market tends to suggest that successful entry is slow or difficult. Market values of incumbent firms greatly exceeding the replacement costs of their tangible assets may indicate that these firms have valuable intangible assets, which may be difficult or time consuming for an entrant to replicate.

A merger is not likely to enhance market power if entry into the market is so easy that the merged firm and its remaining rivals in the market, either unilaterally or collectively, could not profitably raise price or otherwise reduce competition compared to the level that would prevail in the absence of the merger. Entry is that easy if entry would be timely, likely, and sufficient in its magnitude, character, and scope to deter or counteract the competitive effects of concern.

The Agencies examine the timeliness, likelihood, and sufficiency of the entry efforts an entrant might practically employ. An entry effort is defined by the actions the firm must undertake to produce and sell in the market. Various elements of the entry effort will be considered. These elements can include: planning, design, and management; permitting, licensing, or other approvals; construction, debugging, and operation of production facilities; and promotion (including necessary introductory discounts), marketing, distribution, and satisfaction of customer testing and qualification requirements. Recent examples of entry, whether successful or unsuccessful, generally provide the starting point for identifying the elements of practical entry efforts. They also can be informative regarding the scale necessary for an entrant to be successful, the presence or absence of entry barriers, the factors that influence the timing of entry, the costs and risk associated with entry, and the sales opportunities realistically available to entrants.

If the assets necessary for an effective and profitable entry effort are widely available, the Agencies will not necessarily attempt to identify which firms might enter. Where an identifiable set of firms appears to have necessary assets that others lack, or to have particularly strong incentives to enter, the Agencies focus their entry analysis on those firms. Firms operating in adjacent or complementary markets, or large customers themselves, may be best placed to enter. However, the Agencies will not presume that a powerful firm in an adjacent market or a large customer will enter the relevant market unless there is reliable evidence supporting that conclusion.

In assessing whether entry will be timely, likely, and sufficient, the Agencies recognize that precise and detailed information may be difficult or impossible to obtain. The Agencies consider reasonably available and reliable evidence bearing on whether entry will satisfy the conditions of timeliness, likelihood, and sufficiency.

## **9.1 Timeliness**

In order to deter the competitive effects of concern, entry must be rapid enough to make unprofitable overall the actions causing those effects and thus leading to entry, even though those actions would be profitable until entry takes effect.

Even if the prospect of entry does not deter the competitive effects of concern, post-merger entry may counteract them. This requires that the impact of entrants in the relevant market be rapid enough that customers are not significantly harmed by the merger, despite any anticompetitive harm that occurs prior to the entry.

The Agencies will not presume that an entrant can have a significant impact on prices before that entrant is ready to provide the relevant product to customers unless there is reliable evidence that anticipated future entry would have such an effect on prices.

## **9.2 Likelihood**

Entry is likely if it would be profitable, accounting for the assets, capabilities, and capital needed and the risks involved, including the need for the entrant to incur costs that would not be recovered if the entrant later exits. Profitability depends upon (a) the output level the entrant is likely to obtain, accounting for the obstacles facing new entrants; (b) the price the entrant would likely obtain in the post-merger market, accounting for the impact of that entry itself on prices; and (c) the cost per unit the entrant would likely incur, which may depend upon the scale at which the entrant would operate.

## **9.3 Sufficiency**

Even where timely and likely, entry may not be sufficient to deter or counteract the competitive effects of concern. For example, in a differentiated product industry, entry may be insufficient because the products offered by entrants are not close enough substitutes to the products offered by the merged firm to render a price increase by the merged firm unprofitable. Entry may also be insufficient due to constraints that limit entrants' competitive effectiveness, such as limitations on the capabilities of the firms best placed to enter or reputational barriers to rapid expansion by new entrants. Entry by a single firm that will replicate at least the scale and strength of one of the merging firms is sufficient. Entry by one or more firms operating at a smaller scale may be sufficient if such firms are not at a significant competitive disadvantage.

## **10. Efficiencies**

Competition usually spurs firms to achieve efficiencies internally. Nevertheless, a primary benefit of mergers to the economy is their potential to generate significant efficiencies and thus enhance the merged firm's ability and incentive to compete, which may result in lower prices, improved quality, enhanced service, or new products. For example, merger-generated efficiencies may enhance competition by permitting two ineffective competitors to form a more effective competitor, e.g., by combining complementary assets. In a unilateral effects context, incremental cost reductions may reduce or reverse any increases in the merged firm's incentive to elevate price. Efficiencies also may lead to new or improved products, even if they do not immediately and directly affect price. In a

coordinated effects context, incremental cost reductions may make coordination less likely or effective by enhancing the incentive of a maverick to lower price or by creating a new maverick firm. Even when efficiencies generated through a merger enhance a firm's ability to compete, however, a merger may have other effects that may lessen competition and make the merger anticompetitive.

The Agencies credit only those efficiencies likely to be accomplished with the proposed merger and unlikely to be accomplished in the absence of either the proposed merger or another means having comparable anticompetitive effects. These are termed merger-specific efficiencies.<sup>13</sup> Only alternatives that are practical in the business situation faced by the merging firms are considered in making this determination. The Agencies do not insist upon a less restrictive alternative that is merely theoretical.

Efficiencies are difficult to verify and quantify, in part because much of the information relating to efficiencies is uniquely in the possession of the merging firms. Moreover, efficiencies projected reasonably and in good faith by the merging firms may not be realized. Therefore, it is incumbent upon the merging firms to substantiate efficiency claims so that the Agencies can verify by reasonable means the likelihood and magnitude of each asserted efficiency, how and when each would be achieved (and any costs of doing so), how each would enhance the merged firm's ability and incentive to compete, and why each would be merger-specific.

Efficiency claims will not be considered if they are vague, speculative, or otherwise cannot be verified by reasonable means. Projections of efficiencies may be viewed with skepticism, particularly when generated outside of the usual business planning process. By contrast, efficiency claims substantiated by analogous past experience are those most likely to be credited.

Cognizable efficiencies are merger-specific efficiencies that have been verified and do not arise from anticompetitive reductions in output or service. Cognizable efficiencies are assessed net of costs produced by the merger or incurred in achieving those efficiencies.

The Agencies will not challenge a merger if cognizable efficiencies are of a character and magnitude such that the merger is not likely to be anticompetitive in any relevant market.<sup>14</sup> To make the requisite determination, the Agencies consider whether cognizable efficiencies likely would be sufficient to reverse the merger's potential to harm customers in the relevant market, e.g., by preventing price

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<sup>13</sup> The Agencies will not deem efficiencies to be merger-specific if they could be attained by practical alternatives that mitigate competitive concerns, such as divestiture or licensing. If a merger affects not whether but only when an efficiency would be achieved, only the timing advantage is a merger-specific efficiency.

<sup>14</sup> The Agencies normally assess competition in each relevant market affected by a merger independently and normally will challenge the merger if it is likely to be anticompetitive in any relevant market. In some cases, however, the Agencies in their prosecutorial discretion will consider efficiencies not strictly in the relevant market, but so inextricably linked with it that a partial divestiture or other remedy could not feasibly eliminate the anticompetitive effect in the relevant market without sacrificing the efficiencies in the other market(s). Inextricably linked efficiencies are most likely to make a difference when they are great and the likely anticompetitive effect in the relevant market(s) is small so the merger is likely to benefit customers overall.

increases in that market.<sup>15</sup> In conducting this analysis, the Agencies will not simply compare the magnitude of the cognizable efficiencies with the magnitude of the likely harm to competition absent the efficiencies. The greater the potential adverse competitive effect of a merger, the greater must be the cognizable efficiencies, and the more they must be passed through to customers, for the Agencies to conclude that the merger will not have an anticompetitive effect in the relevant market. When the potential adverse competitive effect of a merger is likely to be particularly substantial, extraordinarily great cognizable efficiencies would be necessary to prevent the merger from being anticompetitive. In adhering to this approach, the Agencies are mindful that the antitrust laws give competition, not internal operational efficiency, primacy in protecting customers.

In the Agencies' experience, efficiencies are most likely to make a difference in merger analysis when the likely adverse competitive effects, absent the efficiencies, are not great. Efficiencies almost never justify a merger to monopoly or near-monopoly. Just as adverse competitive effects can arise along multiple dimensions of conduct, such as pricing and new product development, so too can efficiencies operate along multiple dimensions. Similarly, purported efficiency claims based on lower prices can be undermined if they rest on reductions in product quality or variety that customers value.

The Agencies have found that certain types of efficiencies are more likely to be cognizable and substantial than others. For example, efficiencies resulting from shifting production among facilities formerly owned separately, which enable the merging firms to reduce the incremental cost of production, are more likely to be susceptible to verification and are less likely to result from anticompetitive reductions in output. Other efficiencies, such as those relating to research and development, are potentially substantial but are generally less susceptible to verification and may be the result of anticompetitive output reductions. Yet others, such as those relating to procurement, management, or capital cost, are less likely to be merger-specific or substantial, or may not be cognizable for other reasons.

When evaluating the effects of a merger on innovation, the Agencies consider the ability of the merged firm to conduct research or development more effectively. Such efficiencies may spur innovation but not affect short-term pricing. The Agencies also consider the ability of the merged firm to appropriate a greater fraction of the benefits resulting from its innovations. Licensing and intellectual property conditions may be important to this enquiry, as they affect the ability of a firm to appropriate the benefits of its innovation. Research and development cost savings may be substantial and yet not be cognizable efficiencies because they are difficult to verify or result from anticompetitive reductions in innovative activities.

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<sup>15</sup> The Agencies normally give the most weight to the results of this analysis over the short term. The Agencies also may consider the effects of cognizable efficiencies with no short-term, direct effect on prices in the relevant market. Delayed benefits from efficiencies (due to delay in the achievement of, or the realization of customer benefits from, the efficiencies) will be given less weight because they are less proximate and more difficult to predict. Efficiencies relating to costs that are fixed in the short term are unlikely to benefit customers in the short term, but can benefit customers in the longer run, e.g., if they make new product introduction less expensive.

## 11. Failure and Exiting Assets

Notwithstanding the analysis above, a merger is not likely to enhance market power if imminent failure, as defined below, of one of the merging firms would cause the assets of that firm to exit the relevant market. This is an extreme instance of the more general circumstance in which the competitive significance of one of the merging firms is declining: the projected market share and significance of the exiting firm is zero. If the relevant assets would otherwise exit the market, customers are not worse off after the merger than they would have been had the merger been enjoined.

The Agencies do not normally credit claims that the assets of the failing firm would exit the relevant market unless all of the following circumstances are met: (1) the allegedly failing firm would be unable to meet its financial obligations in the near future; (2) it would not be able to reorganize successfully under Chapter 11 of the Bankruptcy Act; and (3) it has made unsuccessful good-faith efforts to elicit reasonable alternative offers that would keep its tangible and intangible assets in the relevant market and pose a less severe danger to competition than does the proposed merger.<sup>16</sup>

Similarly, a merger is unlikely to cause competitive harm if the risks to competition arise from the acquisition of a failing division. The Agencies do not normally credit claims that the assets of a division would exit the relevant market in the near future unless both of the following conditions are met: (1) applying cost allocation rules that reflect true economic costs, the division has a persistently negative cash flow on an operating basis, and such negative cash flow is not economically justified for the firm by benefits such as added sales in complementary markets or enhanced customer goodwill;<sup>17</sup> and (2) the owner of the failing division has made unsuccessful good-faith efforts to elicit reasonable alternative offers that would keep its tangible and intangible assets in the relevant market and pose a less severe danger to competition than does the proposed acquisition.

## 12. Mergers of Competing Buyers

Mergers of competing buyers can enhance market power on the buying side of the market, just as mergers of competing sellers can enhance market power on the selling side of the market. Buyer market power is sometimes called “monopsony power.”

To evaluate whether a merger is likely to enhance market power on the buying side of the market, the Agencies employ essentially the framework described above for evaluating whether a merger is likely to enhance market power on the selling side of the market. In defining relevant markets, the Agencies

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<sup>16</sup> Any offer to purchase the assets of the failing firm for a price above the liquidation value of those assets will be regarded as a reasonable alternative offer. Liquidation value is the highest value the assets could command for use outside the relevant market.

<sup>17</sup> Because the parent firm can allocate costs, revenues, and intra-company transactions among itself and its subsidiaries and divisions, the Agencies require evidence on these two points that is not solely based on management plans that could have been prepared for the purpose of demonstrating negative cash flow or the prospect of exit from the relevant market.

focus on the alternatives available to sellers in the face of a decrease in the price paid by a hypothetical monopsonist.

Market power on the buying side of the market is not a significant concern if suppliers have numerous attractive outlets for their goods or services. However, when that is not the case, the Agencies may conclude that the merger of competing buyers is likely to lessen competition in a manner harmful to sellers.

The Agencies distinguish between effects on sellers arising from a lessening of competition and effects arising in other ways. A merger that does not enhance market power on the buying side of the market can nevertheless lead to a reduction in prices paid by the merged firm, for example, by reducing transactions costs or allowing the merged firm to take advantage of volume-based discounts. Reduction in prices paid by the merging firms not arising from the enhancement of market power can be significant in the evaluation of efficiencies from a merger, as discussed in Section 10.

The Agencies do not view a short-run reduction in the quantity purchased as the only, or best, indicator of whether a merger enhances buyer market power. Nor do the Agencies evaluate the competitive effects of mergers between competing buyers strictly, or even primarily, on the basis of effects in the downstream markets in which the merging firms sell.

*Example 24:* Merging Firms A and B are the only two buyers in the relevant geographic market for an agricultural product. Their merger will enhance buyer power and depress the price paid to farmers for this product, causing a transfer of wealth from farmers to the merged firm and inefficiently reducing supply. These effects can arise even if the merger will not lead to any increase in the price charged by the merged firm for its output.

### **13. Partial Acquisitions**

In most horizontal mergers, two competitors come under common ownership and control, completely and permanently eliminating competition between them. This elimination of competition is a basic element of merger analysis. However, the statutory provisions referenced in Section 1 also apply to one firm's partial acquisition of a competitor. The Agencies therefore also review acquisitions of minority positions involving competing firms, even if such minority positions do not necessarily or completely eliminate competition between the parties to the transaction.

When the Agencies determine that a partial acquisition results in effective control of the target firm, or involves substantially all of the relevant assets of the target firm, they analyze the transaction much as they do a merger. Partial acquisitions that do not result in effective control may nevertheless present significant competitive concerns and may require a somewhat distinct analysis from that applied to full mergers or to acquisitions involving effective control. The details of the post-acquisition relationship between the parties, and how those details are likely to affect competition, can be important. While the Agencies will consider any way in which a partial acquisition may affect competition, they generally focus on three principal effects.

First, a partial acquisition can lessen competition by giving the acquiring firm the ability to influence the competitive conduct of the target firm. A voting interest in the target firm or specific governance rights, such as the right to appoint members to the board of directors, can permit such influence. Such

influence can lessen competition because the acquiring firm can use its influence to induce the target firm to compete less aggressively or to coordinate its conduct with that of the acquiring firm.


Second, a partial acquisition can lessen competition by reducing the incentive of the acquiring firm to compete. Acquiring a minority position in a rival might significantly blunt the incentive of the acquiring firm to compete aggressively because it shares in the losses thereby inflicted on that rival. This reduction in the incentive of the acquiring firm to compete arises even if cannot influence the conduct of the target firm. As compared with the unilateral competitive effect of a full merger, this effect is likely attenuated by the fact that the ownership is only partial.

Third, a partial acquisition can lessen competition by giving the acquiring firm access to non-public, competitively sensitive information from the target firm. Even absent any ability to influence the conduct of the target firm, access to competitively sensitive information can lead to adverse unilateral or coordinated effects. For example, it can enhance the ability of the two firms to coordinate their behavior, and make other accommodating responses faster and more targeted. The risk of coordinated effects is greater if the transaction also facilitates the flow of competitively sensitive information from the acquiring firm to the target firm.

Partial acquisitions, like mergers, vary greatly in their potential for anticompetitive effects. Accordingly, the specific facts of each case must be examined to assess the likelihood of harm to competition. While partial acquisitions usually do not enable many of the types of efficiencies associated with mergers, the Agencies consider whether a partial acquisition is likely to create cognizable efficiencies.

## **LEGAL AUTHORITY CA-111**



 KeyCite Yellow Flag - Negative Treatment  
Proposed Legislation

United States Code Annotated  
Title 15. Commerce and Trade  
Chapter 1. Monopolies and Combinations in Restraint of Trade (Refs & Annos)

15 U.S.C.A. § 18

§ 18. Acquisition by one corporation of stock of another

Effective: February 8, 1996

[Currentness](#)

No person engaged in commerce or in any activity affecting commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital and no person subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the assets of another person engaged also in commerce or in any activity affecting commerce, where in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly.

No person shall acquire, directly or indirectly, the whole or any part of the stock or other share capital and no person subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the assets of one or more persons engaged in commerce or in any activity affecting commerce, where in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition, of such stocks or assets, or of the use of such stock by the voting or granting of proxies or otherwise, may be substantially to lessen competition, or to tend to create a monopoly.

This section shall not apply to persons purchasing such stock solely for investment and not using the same by voting or otherwise to bring about, or in attempting to bring about, the substantial lessening of competition. Nor shall anything contained in this section prevent a corporation engaged in commerce or in any activity affecting commerce from causing the formation of subsidiary corporations for the actual carrying on of their immediate lawful business, or the natural and legitimate branches or extensions thereof, or from owning and holding all or a part of the stock of such subsidiary corporations, when the effect of such formation is not to substantially lessen competition.

Nor shall anything herein contained be construed to prohibit any common carrier subject to the laws to regulate commerce from aiding in the construction of branches or short lines so located as to become feeders to the main line of the company so aiding in such construction or from acquiring or owning all or any part of the stock of such branch lines, nor to prevent any such common carrier from acquiring and owning all or any part of the stock of a branch or short line constructed by an independent company where there is no substantial competition between the company owning the branch line so constructed and the company owning the main line acquiring the property or an interest therein, nor to prevent such common carrier from extending any of its lines through the medium of the acquisition of stock or otherwise of any other common carrier where there is no substantial competition between the company extending its lines and the company whose stock, property, or an interest therein is so acquired.

Nothing contained in this section shall be held to affect or impair any right heretofore legally acquired: *Provided*, That nothing in this section shall be held or construed to authorize or make lawful anything heretofore prohibited or made illegal by the antitrust laws, nor to exempt any person from the penal provisions thereof or the civil remedies therein provided.

Nothing contained in this section shall apply to transactions duly consummated pursuant to authority given by the Secretary of Transportation, Federal Power Commission, Surface Transportation Board, the Securities and Exchange Commission in the exercise of its jurisdiction under [section 79j](#) of this title, the United States Maritime Commission, or the Secretary of Agriculture under any statutory provision vesting such power in such Commission, Board, or Secretary.

**CREDIT(S)**

(Oct. 15, 1914, c. 323, § 7, 38 Stat. 731; Dec. 29, 1950, c. 1184, 64 Stat. 1125; [Pub.L. 96-349](#), § 6(a), Sept. 12, 1980, 94 Stat. 1157; [Pub.L. 98-443](#), § 9(l), Oct. 4, 1984, 98 Stat. 1708; [Pub.L. 104-88, Title III, § 318\(1\)](#), Dec. 29, 1995, 109 Stat. 949; [Pub.L. 104-104, Title VI, § 601\(b\)\(3\)](#), Feb. 8, 1996, 110 Stat. 143.)

15 U.S.C.A. § 18, 15 USCA § 18  
Current through P.L. 116-149.

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## **LEGAL AUTHORITY CA-112**



KeyCite Blue Flag – Appeal Notification

Appeal Filed by [STEVES AND SONS, INC. v. JELD-WEN, INC.](#), 4th Cir., April 16, 2019

345 F.Supp.3d 614

United States District Court, E.D. Virginia.

STEVES AND SONS, INC., Plaintiff,

v.

JELD-WEN, INC., Defendants.

Civil Action No. 3:16cv545

Signed 10/05/2018

**Synopsis**

**Background:** Door manufacturer filed suit against supplier of interior molded doorskins, claiming that allegedly illegal merger between supplier and competitor substantially lessened competition in doorskin market in violation of Clayton Act and that supplier breached parties' supply agreement. After jury returned verdict in favor of manufacturer, awarding treble antitrust damages in amount of \$175,897,362 and breach of contract damages in amount of \$12,151,873, reduced by \$2,188,271 upon granting supplier judgment as matter of law, manufacturer moved for equitable relief, under Clayton Act, seeking order requiring supplier to divest acquired entity in order to restore competition in doorskin market and seeking behavioral or conduct remedies, including restrictions and obligations on supplier such that divested entity could successfully operate as viable stand-alone independent business or be successfully combined with assets of acquiring party so as to become effective competitor.

**Holdings:** The District Court, [Robert E. Payne](#), Senior District Judge, held that:

[1] manufacturer had standing to seek divestiture as equitable remedy;

[2] in matter of first impression, divestiture was appropriate remedy for private antitrust litigant;

[3] special master would be appointed to assure successful divestiture process;

[4] ancillary conduct remedies were partially appropriate; and

[5] manufacturer's antitrust action was not barred by laches.

Motion granted in part and denied in part.

**Procedural Posture(s):** Other; Motion for Judgment as a Matter of Law (JMOL)/Directed Verdict.

West Headnotes (66)

[1] **Antitrust and Trade Regulation** 🔑 Forfeiture and seizure of property; divestiture

Under the Clayton Act, the injunctive relief private parties are allowed to obtain against threatened loss or damage by violation of the antitrust laws may include an order requiring the acquiring company to divest the assets of the acquired firm. Clayton Act § 16, [15 U.S.C.A. § 26](#).

[2] **Antitrust and Trade Regulation** 🔑 Damages and Other Relief

Under the Clayton Act, whoever brings suit, the federal government or private party, the relief in an antitrust case must be effective to redress the violations and to restore competition. Clayton Act §§ 15, 16, [15 U.S.C.A. §§ 25, 26](#).

[3] **Antitrust and Trade Regulation** 🔑 Types and Forms

**Antitrust and Trade Regulation** 🔑 Damages and Other Relief

Mergers come in a wide variety of shapes and sizes, so the antitrust remedy awarded for violation of the Clayton Act should be carefully tailored to the competitive harm in the case; thus, district courts are clothed with large discretion to fit the decree to the special needs of the individual case. Clayton Act §§ 15, 16, [15 U.S.C.A. §§ 25, 26](#).

[4] **Antitrust and Trade**

**Regulation** 🔑 Forfeiture and seizure of property; divestiture

The most drastic, but most effective, of antitrust remedies, under the Clayton Act, is divestiture, but complete divestiture is the remedy best suited to redress the ills of a competitive merger. Clayton Act §§ 15, 16, 15 U.S.C.A. §§ 25, 26.

[5] **Antitrust and Trade**

**Regulation** 🔑 Forfeiture and seizure of property; divestiture

The relief which can be afforded for an antitrust violation, under the Clayton Act provision allowing the federal government to institute proceedings to prevent and restrain such violations, is not limited to the restoration of the status quo ante in the pre-acquisition market; consequently, divestiture may extend to assets that were unrelated to the antitrust violation if the divested entity would need those assets to become competitive, or if the integration of legally- and illegally-acquired assets makes their separation impossible. Clayton Act § 15, 15 U.S.C.A. § 25.

[6] **Antitrust and Trade**

**Regulation** 🔑 Forfeiture and seizure of property; divestiture

Structural remedies like divestiture ordered as an equitable remedy for an antitrust violation, under the Clayton Act provision allowing the federal government to institute proceedings to prevent and restrain such violations, can be coupled with, or replaced entirely by, conduct remedies that can preserve a merger's efficiencies and limit anticompetitive conduct at the same time. Clayton Act § 15, 15 U.S.C.A. § 25.

[7] **Antitrust and Trade Regulation** 🔑 Damages and Other Relief

Conduct relief can be a particularly effective option, under the Clayton Act provision allowing the federal government to institute proceedings

to prevent and restrain antitrust violations, when a structural remedy would eliminate the merger's potential efficiencies, but, absent a remedy, the merger would harm competition; however, conduct remedies risk excessive government entanglement in the market, so they should be tailored as precisely as possible to the competitive harms associated with the merger. Clayton Act § 15, 15 U.S.C.A. § 25.

[8] **Antitrust and Trade**

**Regulation** 🔑 Forfeiture and seizure of property; divestiture

Under the Clayton Act provision allowing private parties to obtain injunctive relief against threatened loss or damage by antitrust violations, a district court's ability to order divestiture does not mean that such power should be exercised in every situation in which the federal government would be entitled to such relief under the Clayton Act's provision allowing the government to institute proceedings to prevent and restrain antitrust violations. Clayton Act §§ 15, 16, 15 U.S.C.A. §§ 25, 26.

[9] **Antitrust and Trade Regulation** 🔑 Right of Action; Persons Entitled to Sue; Standing; Parties

**Antitrust and Trade**

**Regulation** 🔑 Forfeiture and seizure of property; divestiture

The Clayton Act provision, allowing private parties to obtain injunctive relief against threatened loss or damage by antitrust violations, requires a plaintiff to establish standing to seek injunctive relief, and a defendant can rely on equitable defenses and other equitable considerations to avoid divestiture. Clayton Act § 16, 15 U.S.C.A. § 26.

[10] **Antitrust and Trade**

**Regulation** 🔑 Restraints and misconduct in general

In actions by the federal government, under the Clayton Act, the proof of the antitrust violation

may itself establish sufficient public injury to warrant equitable relief of divestiture. Clayton Act § 15, 15 U.S.C.A. § 25.

merger at issue and where its collateral consequences can be mitigated. Clayton Act § 16, 15 U.S.C.A. § 26.

**[11] Antitrust and Trade**

**Regulation** 🔑 Forfeiture and seizure of property; divestiture

Under the Clayton Act provision allowing the government to institute proceedings to prevent and restrain antitrust violations, hardships of imposing divestiture as an equitable remedy do not need to be balanced nor the public interest assessed in the same way as in private cases. Clayton Act §§ 15, 16, 15 U.S.C.A. §§ 25, 26.

**[15] Antitrust and Trade**

**Regulation** 🔑 Injunction

Under the Clayton Act provision, allowing private parties to obtain injunctive relief against threatened loss or damage by antitrust violations, the appropriate remedy should be selected upon determining (1) what competitive harm the violation has caused or likely will cause and (2) how the proposed relief will remedy that particular competitive harm. Clayton Act § 16, 15 U.S.C.A. § 26.

**[12] Antitrust and Trade**

**Regulation** 🔑 Forfeiture and seizure of property; divestiture

Under the Clayton Act, in a private action, divestiture is not as easy a remedy for an antitrust violation as it is in a government action. Clayton Act §§ 15, 16, 15 U.S.C.A. §§ 25, 26.

**[16] Antitrust and Trade**

**Regulation** 🔑 Injunction

Under the Clayton Act provision, allowing private parties to obtain injunctive relief against threatened loss or damage by antitrust violations, the remedy should be calculated to minimize adverse economic effects upon the industry, the public, and the stockholders affected by the unlawful merger. Clayton Act § 16, 15 U.S.C.A. § 26.

**[13] Antitrust and Trade**

**Regulation** 🔑 Forfeiture and seizure of property; divestiture

Under the Clayton Act provision, allowing private parties to obtain injunctive relief against threatened loss or damage by antitrust violations, district courts must rely on the facts of each case to decide whether divestiture is an appropriate remedy, and courts should resort to divestiture in limited circumstances. Clayton Act § 16, 15 U.S.C.A. § 26.

**[17] Antitrust and Trade**

**Regulation** 🔑 Injunction

Under the Clayton Act provision, allowing private parties to obtain injunctive relief against threatened loss or damage by antitrust violations, caution, progressive enforcement, and remedy formulation on a case-by-case basis are essential ingredients to effectively combat the effects of an antitrust violation and to minimize the risk of economic dislocation. Clayton Act § 16, 15 U.S.C.A. § 26.

**[14] Antitrust and Trade**

**Regulation** 🔑 Forfeiture and seizure of property; divestiture

Under the Clayton Act provision, allowing private parties to obtain injunctive relief against threatened loss or damage by antitrust violations, divestiture should be ordered when it is the most effective way of restoring the substantially lessened competition brought about by the

**[18] Antitrust and Trade**

**Regulation** 🔑 Injunction

Under the Clayton Act provision, allowing private parties to obtain injunctive relief against threatened loss or damage by antitrust violations,

well-established principles of equity establish the framework governing requests for injunctive relief, including divestiture. Clayton Act § 16, 15 U.S.C.A. § 26.

**[19] Antitrust and Trade**

**Regulation** 🔑 Injunction

Under the Clayton Act provision, allowing private parties to obtain injunctive relief against threatened loss or damage by antitrust violations, plaintiff must satisfy a four-factor test before a district court may grant such relief by demonstrating: (1) that it has suffered an irreparable injury, (2) that remedies available at law, such as monetary damages, are inadequate to compensate for that injury, (3) that, considering the balance of hardships between the plaintiff and defendant, a remedy in equity is warranted, and (4) that the public interest would not be disserved by a permanent injunction. Clayton Act § 16, 15 U.S.C.A. § 26.

**[20] Antitrust and Trade**

**Regulation** 🔑 Injunction

Under the Clayton Act provision, allowing private parties to obtain injunctive relief against threatened loss or damage by antitrust violations, even where the factors governing requests for injunctive relief are met, district courts still retain equitable discretion to grant or deny permanent injunctive relief. Clayton Act § 16, 15 U.S.C.A. § 26.

**[21] Antitrust and Trade Regulation** 🔑 Injury to Business or Property

**Antitrust and Trade**

**Regulation** 🔑 Injunction

In order to seek injunctive relief under the Clayton Act, a private plaintiff must allege threatened loss or damage of the type the antitrust laws were designed to prevent and that flows from that which makes defendants' acts unlawful; in other words, the plaintiff must be able to demonstrate a significant threat of injury from an impending violation of the antitrust

laws or from a contemporary violation likely to continue or recur. Clayton Act § 16, 15 U.S.C.A. § 26.

**[22] Antitrust and Trade**

**Regulation** 🔑 Particular cases

**Antitrust and Trade**

**Regulation** 🔑 Forfeiture and seizure of property; divestiture

Door manufacturer suffered significant threat of injury from impending antitrust violation by supplier of interior molded doorskins and from supplier's contemporary violation that was likely to continue or recur, and thus, manufacturer had standing to seek divestiture as equitable remedy in private lawsuit, under Clayton Act, in order to remedy threatened loss and continuing damages from supplier's merger with competitor that substantially lessened competition in doorskin market, where manufacturer would be forced out of business upon impending termination of parties' supply agreement, which was enabled by supplier's increased market power after merger, and supplier continued to engage in anticompetitive conduct following merger. Clayton Act §§ 7, 16, 15 U.S.C.A. §§ 18, 26.

**[23] Jury** 🔑 Re-examination or other review of questions of fact tried by jury

A jury verdict in mixed law-equity cases is binding on the district court as to all matters in law and as to all matters in equity where the facts found are common to the law and equity issues.

**[24] Antitrust and Trade**

**Regulation** 🔑 Injunction

Generally, irreparable injury required for a private plaintiff to obtain equitable relief, under the Clayton Act, in the form of an injunction mandating divestiture and conduct remedies for antitrust violations, is suffered when monetary damages are difficult to ascertain or are inadequate. Clayton Act § 16, 15 U.S.C.A. § 26.



[25] **Antitrust and Trade Regulation** 🔑 Injunction

On a motion for equitable relief, under the Clayton Act, seeking an injunction mandating divestiture and conduct remedies for antitrust violations, whether a private plaintiff has an adequate remedy at law inevitably overlaps with whether it has suffered irreparable harm. Clayton Act § 16, 15 U.S.C.A. § 26.

[26] **Antitrust and Trade Regulation** 🔑 Injunction

On a motion for equitable relief, under the Clayton Act, seeking an injunction mandating divestiture and conduct remedies for antitrust violations, intentionally engaging in conduct that contributes to an irreparable injury may undermine a private plaintiff's irreparable harm showing. Clayton Act § 16, 15 U.S.C.A. § 26.

[27] **Antitrust and Trade Regulation** 🔑 Injunction

To obtain equitable relief for antitrust violations, under the Clayton Act, a private plaintiff must show that its harm cannot be compensated by money damages. Clayton Act § 16, 15 U.S.C.A. § 26.

[28] **Antitrust and Trade Regulation** 🔑 Injunction

On a motion for equitable relief, under the Clayton Act, seeking an injunction mandating divestiture and conduct remedies for antitrust violations, a private plaintiff's presentation of a future damages number may influence the irreparable injury and legal remedy inadequacy analysis. Clayton Act § 16, 15 U.S.C.A. § 26.

[29] **Antitrust and Trade Regulation** 🔑 Injunction

On a motion for equitable relief, under the Clayton Act, seeking an injunction mandating divestiture and conduct remedies for antitrust violations, a private plaintiff is not prohibited from seeking alternate injunctive relief merely because it tries to quantify its future harm in front of the jury. Clayton Act § 16, 15 U.S.C.A. § 26.

[30] **Election of Remedies** 🔑 Necessity and time for election

Generally, a party is not required to elect between inconsistent remedies or rights or theories of recovery during the trial or at the pleading stage or prior to the jury's verdict; election is generally made after the verdict is entered prior to the entry of judgment, and in any event, a decision as to the time of election rests within the sound discretion of the trial court.

[31] **Antitrust and Trade Regulation** 🔑 Forfeiture and seizure of property; divestiture


Door manufacturer would suffer irreparable injury from antitrust violation by supplier of interior molded doorskins for which adequate remedy at law was lacking, in absence of permanent injunctive relief mandating divestiture of competitor by supplier after their illegal merger substantially lessened competition in doorskin market in violation of Clayton Act; without injunctive relief restoring competition, manufacturer would likely, if not certainly, be forced out its family-owned business that had been operating for over 150 years, which could not be adequately remedied by award of future lost profits damages. Clayton Act §§ 7, 16, 15 U.S.C.A. §§ 18, 26.

[32] **Antitrust and Trade Regulation** 🔑 Injunction


Under the Clayton Act provision, allowing private parties to obtain injunctive relief against threatened loss or damage by antitrust violations, in balancing hardships district courts must balance the competing claims of injury and must



consider the effect on each party of the granting or withholding of the requested relief. Clayton Act § 16, 15 U.S.C.A. § 26.

**[33] Antitrust and Trade Regulation**  **Injunction**

Under the Clayton Act provision allowing the federal government to institute proceedings to prevent and restrain antitrust violations, there is no balance of hardships. Clayton Act § 15, 15 U.S.C.A. § 25.

**[34] Antitrust and Trade Regulation**  **Injunction**

Under the Clayton Act provision, allowing private parties to obtain injunctive relief against threatened loss or damage by antitrust violations, district courts may not conclude that any harm that would be suffered by a defendant was self-inflicted and thus entitled to lesser weight in the balancing-of-the-harms portion of the injunction calculus. Clayton Act § 16, 15 U.S.C.A. § 26.

**[35] Antitrust and Trade Regulation**  **Injunction**

Under the Clayton Act provision, allowing private parties to obtain injunctive relief against threatened loss or damage by antitrust violations, in balancing hardships of the parties loss of profits obtained through anticompetitive conduct is not a valid hardship because it is a product of doing what the antitrust laws require, that is, competing with other firms. Clayton Act § 16, 15 U.S.C.A. § 26.


**[36] Antitrust and Trade Regulation**  **Forfeiture and seizure of property; divestiture**

Balance of hardships tipped decidedly in favor of permanent injunctive relief mandating divestiture by supplier of interior molded doorskins after its illegal merger with competitor substantially lessened competition in doorskin market in violation of Clayton


Act antitrust provisions; without injunctive relief restoring competition, manufacturer would suffer irreparable harm of being forced out its family-owned business that was in operation for over 150 years, but all of supplier's alleged hardships could be ameliorated by allowing time for orderly divestiture so that supplier could be assured of reliable source of doorskin to satisfy external and internal requirements for at least two years, by assuring that divestiture occurred under circumstances producing reasonable purchase price. Clayton Act §§ 7, 16, 15 U.S.C.A. §§ 18, 26.

**[37] Antitrust and Trade Regulation**  **Injunction**

Under the Clayton Act provision, allowing private parties to obtain injunctive relief, including divestiture, against threatened loss or damage by antitrust violations, the obvious hardship of splitting up entities that have combined assets and operations after a merger weighs heavily in the equitable analysis when balancing the hardships of the parties. Clayton Act § 16, 15 U.S.C.A. § 26.

**[38] Antitrust and Trade Regulation**  **Injunction**

Under the Clayton Act provision, allowing private parties to obtain injunctive relief against threatened loss or damage by antitrust violations, the public interest inquiry primarily addresses impact on non-parties rather than parties. Clayton Act § 16, 15 U.S.C.A. § 26.

**[39] Antitrust and Trade Regulation**  **Injunction**

Under the Clayton Act provision, allowing private parties to obtain injunctive relief against threatened loss or damage by antitrust violations, district courts are reluctant to cause any concrete harms to innocent third parties; thus, if those potential effects exist, the public interest asserted in support of injunctive relief must rely on

more than broad, abstract rule of law concerns. Clayton Act § 16, 15 U.S.C.A. § 26.

[40] **Antitrust and Trade Regulation** 🔑 Injunction

Under the Clayton Act provision, allowing private parties to obtain injunctive relief against threatened loss or damage by antitrust violations, where a valid law speaks to the proper level of deference to a particular public interest, it controls in analyzing proposed injunctive relief. Clayton Act § 16, 15 U.S.C.A. § 26.

[41] **Antitrust and Trade Regulation** 🔑 Forfeiture and seizure of property; divestiture

Under the Clayton Act provision, allowing private parties to obtain injunctive relief against threatened loss or damage by antitrust violations, divestiture is not always the ideal equitable relief for the public interest; in some cases, the divested entity might not actually restore competition, depending on the circumstances in which the entity would operate, and in other cases, divestiture might restore competition, but other injunctive relief might also do so with fewer impacts on the public interest. Clayton Act § 16, 15 U.S.C.A. § 26.

[42] **Antitrust and Trade Regulation** 🔑 Injunction

Under the Clayton Act provision, allowing private parties to obtain injunctive relief against threatened loss or damage by antitrust violations, district court may and should assess the propriety of equitable relief in each particular case, and the court may decline to restructure a firm where there are serious doubts as to feasibility or a likelihood that other remedies are likely to be sufficient to restore effective competition. Clayton Act § 16, 15 U.S.C.A. § 26.

[43] **Antitrust and Trade Regulation** 🔑 Forfeiture and seizure of property; divestiture

Public interest in restoring competition supported grant of permanent injunctive relief mandating divestiture by supplier of interior molded doorskins after its illegal merger with competitor substantially lessened competition in doorskin market in violation of Clayton Act antitrust provisions, since divested competitor would be viable standalone entity capable of providing significant competition in doorskin market, earning substantial profits, and restoring competition that merger lessened, and no alternative to divestiture would restore competition that merger substantially lessened. Clayton Act §§ 7, 16, 15 U.S.C.A. §§ 18, 26.

[44] **Federal Civil Procedure** 🔑 Damages and relief obtainable

Special master would be appointed to assure that supplier of interior molded doorskins would receive fair price for divested entity after its illegal merger with competitor substantially lessened competition in doorskin market in violation of Clayton Act antitrust provisions and to assure that divestiture produced competitive entity that was likely to restore competition, where divestiture compliance involved extraordinarily complex issues that could not be effectively and timely addressed by district court or any judge in district, given state of court's docket and limited knowledge about asset sales in building products industry. Clayton Act §§ 7, 16, 15 U.S.C.A. §§ 18, 26; Fed. R. Civ. P. 53(a)(1)(C).

[45] **Antitrust and Trade Regulation** 🔑 Forfeiture and seizure of property; divestiture

Conduct remedies requested by door manufacturer would be partially granted, as equitable relief ancillary to divestiture for antitrust violations by interior molded doorskins supplier, whose illegal merger with competitor violated Clayton Act, including

divestment not only of facility but also its equipment, transfer or licensing of all intangible assets at facility, affording new owner of facility reasonable opportunity to retain current employees, prohibiting supplier from rehiring those employees for two years, requiring facility to offer manufacturer supply contract but without fixed duration or specified prices, allowing supplier's customers to terminate their supply agreements with supplier without penalty, and allowing supplier to buy from facility's new owner with limitations. Clayton Act §§ 7, 16, 15 U.S.C.A. §§ 18, 26.

**[46] Antitrust and Trade Regulation** — Forfeiture and seizure of property; divestiture

Laches is an available equitable defense to divestiture requested by a private litigant for antitrust violations, under the Clayton Act; the defense also can bar proposed ancillary remedies. Clayton Act § 16, 15 U.S.C.A. § 26.

**[47] Equity** — Grounds and Essentials of Bar  
**Equity** — Lapse of Time

Under the doctrine of laches, a court of equity, which is never active in relief against conscience or public convenience, has always refused its aid to stale demands, where the party has “slept” upon his rights and acquiesced for a great length of time; nothing can call forth the court into activity but conscience, good faith, and reasonable diligence.

**[48] Equity** — Nature and elements in general

“Laches” is defined as such neglect or omission to assert a right as, taken in conjunction with lapse of time, more or less great, and other circumstances causes prejudice to an adverse party.

**[49] Equity** — Grounds and Essentials of Bar  
**Equity** — Prejudice from Delay in General

Under the doctrine of laches, what might be inexcusable delay in one case would not be inconsistent with diligence in another, and unless the nonaction of the complainant operated to damage the defendant, or to induce it to change its position, there is no necessary estoppel arising from the mere lapse of time.

**[50] Equity** — Grounds and Essentials of Bar

Under the doctrine of laches, what constitutes reasonable diligence depends upon the particular facts of the case, including the relationship between the parties.

**[51] Equity** — Application of doctrine in general

Laches imposes on the defendant the ultimate burden of proving (1) lack of diligence by the party against whom the defense is asserted and (2) prejudice to the party asserting the defense.

**[52] Equity** — Prejudice from Delay in General

The laches defense applies to preclude relief for a plaintiff who has unreasonably “slept” on his rights, barring claims where a defendant is prejudiced by a plaintiff's unreasonable delay in bringing suit after the plaintiff knew of the defendant's violation.

**[53] Equity** — Nature and elements in general

The laches analysis is highly fact-dependent.

**[54] Equity** — Following Statute of Limitations

In the application of the doctrine of laches, courts of equity are not bound by, but they usually act or refuse to act in analogy to, the statute of limitations relating to actions at law of like character.

**[55] Equity** — Following Statute of Limitations  
**Equity** — Delay short of statutory period

Under ordinary circumstances, a suit in equity will not be stayed for laches, before, and will be stayed after the time fixed by the analogous statute of limitations at law; but if unusual conditions or extraordinary circumstances make it inequitable to allow the prosecution of a suit after a briefer period than that fixed by the statute, the court will not be bound by the statute, but will determine the extraordinary case in accordance with the equities which condition it.

[1 Cases that cite this headnote](#)

**[56] Equity** 🔑 [What constitutes unreasonable delay in general](#)

Under the doctrine of laches, an inexcusable or unreasonable delay may occur only after the plaintiff discovers or with reasonable diligence could have discovered the facts giving rise to his cause of action.

**[57] Antitrust and Trade Regulation** 🔑 [Mergers and Acquisitions](#)

In analyzing a laches defense, a Clayton Act antitrust violation from an illegal merger that restrains commerce or creates a monopoly may occur at or any time after the acquisition, depending upon the circumstances of the particular case. Clayton Act § 7, 15 U.S.C.A. § 18.

**[58] Antitrust and Trade Regulation** 🔑 [Forfeiture and seizure of property; divestiture](#)

Door manufacturer did not unreasonably delay in bringing antitrust action against interior molded doorskins supplier, claiming that supplier's illegal merger substantially lessened competition in violation of Clayton Act, and thus, laches did not bar equitable relief of divestment; although action was filed slightly over four years after merger was announced, manufacturer did not know and could not reasonably have known of anticompetitive effects from merger until two years later when supplier exercised market power by threatened price increases and contract

termination, after which manufacturer took all reasonable steps to try secure supply essential for survival including alternative dispute resolution process before filing novel suit against vastly better-financed opponent supplier. Clayton Act § 7, 15 U.S.C.A. § 18.

**[59] Federal Civil Procedure** 🔑 [Sufficiency](#)

Ordinarily, it is preferable for a court to articulate a single basis for decision, and thereby refrain from making alternative holdings.

**[60] Equity** 🔑 [Prejudice from Delay in General](#)

Even unreasonable delay does not animate the bar of laches if that delay does not cause harm to the defendant.

**[61] Equity** 🔑 [Prejudice from Delay in General](#)

Under the doctrine of laches, prejudice is shown by a disadvantage on the part of the defendant in asserting or establishing a claimed right or some other harm caused by detrimental reliance on the plaintiff's conduct, including economic prejudice.

**[62] Equity** 🔑 [Prejudice from Delay in General](#)

A defendant is always aided by the inference of prejudice warranted by the plaintiff's delay; the greater the delay, the less the prejudice required to show laches, and vice versa.

**[63] Equity** 🔑 [Application of doctrine in general](#)

In every case, the defendant is ultimately required to prove prejudice required for a laches defense, given the defendant's burden to plead and prove laches under the notice pleading rule. Fed. R. Civ. P. 8(c).

**[64] Antitrust and Trade Regulation** 🔑 [Forfeiture and seizure of property; divestiture](#)

Supplier of interior molded doorskins was not prejudiced by door manufacturer's delay in bringing antitrust action, claiming that supplier's illegal merger with competitor substantially lessened competition in violation of Clayton Act, and thus, equitable relief of divestment was not barred by laches, even though supplier made significant capital investments in acquired facility, since supplier did not rely on absence of asserted antitrust claim by manufacturer in making capital investments after merger, and instead made substantial investments even after being told that manufacturer had antitrust concerns and after manufacturer presented copy of antitrust complaint, and supplier had more than recovered capital investments made from any detrimental reliance on delay in filing suit. Clayton Act § 7, 15 U.S.C.A. § 18.

[65] [Trademarks](#) 🔑 [Alphabetical listing](#)  
MiraTEC

[66] [Trademarks](#) 🔑 [Alphabetical listing](#)  
Extira

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#### PUBLIC SEAL

#### MEMORANDUM OPINION

[Robert E. Payne](#), Senior United States District Judge

\*624 This matter is before the Court on PLAINTIFF STEVES AND SONS, INC.'S MOTION FOR EQUITABLE RELIEF (ECF No. 1191), which the parties addressed through briefs before and after the evidentiary hearing on equitable remedies (“the Remedies Hearing”). For the reasons set forth below, PLAINTIFF STEVES AND SONS, INC.'S MOTION FOR EQUITABLE RELIEF (ECF No. 1191) will be granted in part and denied in part.

#### GENERAL BACKGROUND

On June 29, 2016, Steves and Sons, Inc. (“Steves”) filed this action against JELD-WEN, Inc. (“JELD-WEN”) by filing a COMPLAINT FOR INJUNCTIVE AND DECLARATORY RELIEF, DAMAGES AND SPECIFIC PERFORMANCE (ECF No. 1). The Complaint contained six counts, including COUNT ONE which alleged a violation of Section 7 of the Clayton Act, § 15 U.S.C. § 18, and sought damages under Section 4 of the Clayton Act, and injunctive relief under Section 16 of the Clayton Act, all by virtue of an allegedly illegal merger that occurred in 2012 but that subsequently substantially lessened competition in the so-called molded interior doorskin market. COUNT TWO alleged various breaches of contract. Steves voluntarily dismissed COUNT THREE (Breach of Warranty), COUNT FIVE (Specific Performance), and COUNT SIX (Trespass to Chattels). In COUNT FOUR, Steves sought declaratory relief and that claim remains for decision by the Court.

COUNTS ONE and TWO were tried to a jury and the jury returned a verdict in favor of Steves on both the antitrust claim



and the breach of contract claims. Steves' claim for equitable relief is based on the jury's finding of liability on the antitrust violations in COUNT ONE and arises by virtue of Section 16 of the Clayton Act.

By agreement of the parties, the record in the antitrust and breach of contract trial is part of the record upon which the decision respecting Steves' motion for equitable remedies will be decided. In addition, the Court conducted a three day evidentiary hearing during which the parties presented additional evidence on the issues of equitable relief.

Equitable relief under Section 16 of the Clayton Act must be tethered to the alleged violation of Section 7 of the Clayton Act found by the jury. It is therefore appropriate briefly to summarize the evidence upon which the jury found that JELD-WEN had violated Section 7 of the Clayton Act.

The product at issue in this litigation is called an interior molded doorskin. It is created by pouring a moist, softened fibrous material (treated with resin and wax) into a mold and then subjecting it to heat and pressure. The doorskin is a component part of an interior molded door which is made with a four-sided wooden frame and certain filling material to which the molded doorskin is glued. The doorskin provides the decorative covering for the front and the back of the door. The end product resembles a solid wood door but is much lighter and can be made and shipped at a considerably lower cost than a solid wooden door.

Steves and JELD-WEN both sell interior molded doors. JELD-WEN also makes \*625 doorskins, some of which it uses to make its own doors, and some of which it sells to independent door manufacturers (the "Independents") of which Steves is one. Steves has never made its own doorskins and has to purchase doorskins from doorskins manufacturers.

From 2001 to 2012, there were three manufacturers from which the Independents, including Steves, could purchase doorskins: Masonite Corporation, JELD-WEN, and Craftmaster International ("CMI"). All three were vertically integrated manufacturers of doorskins and interior molded doors. In 2011, Steves was negotiating for possible long-term supply contracts with all three manufacturers. In May 2012, JELD-WEN and Steves entered into a long-term supply agreement (the "Supply Agreement") that was to last for seven years and that contained an evergreen provision by which the contract was automatically renewed annually if notice of termination was not given in accord with the

provisions of the Supply Agreement. In June 2012, JELD-WEN announced that it intended to acquire CMI and the acquisition was completed in October 2012.

The jury found that, as a consequence of the merger and JELD-WEN's conduct in 2014 and thereafter, competition was substantially lessened in the doorskin market and that, as a result, Steves sustained injuries of the type that the antitrust laws were designed to prevent. Thereupon, the jury awarded Steves \$58,632,454.00 in antitrust damages which, when trebled as required by statute, amounts to antitrust damages in the amount of \$175,897,362.00. The jury also found that JELD-WEN had breached Sections 1, 6, and 8 of the Long Term Supply agreement and awarded damages in the amount of \$12,151,873.00 on account of those breaches. That award will be reduced by \$2,188,271.00 because the Court granted JELD-WEN, INC'S MOTION FOR JUDGMENT AS A MATTER OF LAW AGAINST STEVES & SONS, INC. (ECF No. 1773).

As a primary equitable remedy, Steves asks the Court to order JELD-WEN to divest Towanda (formerly part of CMI) to restore competition in the doorskin market. Steves also asks the Court to impose certain so-called "behavioral" or "conduct" remedies, including restrictions and obligations on JELD-WEN, to the end that the divested entity will be able to successfully operate as a stand-alone independent business or to be successfully combined with the assets of the acquiring party so as to become an effective competitor. To those ends, Steves contends that the equitable remedy of divestiture must be accompanied by the following conduct remedies:

- (1) transfer of all tangible assets and likes necessary to develop, manufacture, and sell doorskins at Towanda;
- (2) a transfer of licensing of all intangible assets used in the development, manufacturing, and sale of molded doorskins at the Towanda facility to include:
  - Transfers or licenses to the purchasing entity of patents used to make doorskins, schematics or designs used to manufacture doorsins, customer lists, vendor lists, and know-how in trade secrets to operate the facility
- (3) an Order assuring that the acquiring entity can retain the services of the employees currently operating the Towanda facility;
- (4) an Order prohibiting JELD-WEN from hiring their employees for at least two-year transitional period;

\*626 (5) a provision requiring the divested entity to offer an eight-year long-term supply agreement to Steves at reasonable prices and terms (based on the LTSA);

\$8,630,567

(6) a provision allowing independent door manufacturers like Lynden, Haley, and Excel to terminate their supply agreements with JELD-WEN without penalty; and

(2) JELD-WEN's overcharging Steves for Madison and Monroe doorskins

\$1,303,035

(7) a provision allowing JELD-WEN to be allowed to buy doorskins from the divested entity for a period of two years, the so-called transition period.

(3) JELD-WEN's shipping defective doorskins to Steves and failing to reimburse Steves for those doorskins

\$441,458

At the trial on the merits, Steves proved, by a preponderance of the evidence that, before JELD-WEN acquired CMI in 2012, there was a competitive doorskin market with three vertically integrated suppliers. Indeed, the evidence showed, and the Court finds, that the competition among those three suppliers was vigorous and quite effective. The merger reduced the number of suppliers to two. Steves also proved that the merger substantially lessened competition in the doorskin market. The issue now to be decided is how competition can be restored, and whether divestiture of Towanda (without or along with the requested conduct remedies) is the correct, and, as Steves urges, indeed the only way to do that.

(4) JELD-WEN's refusing to reimburse Steves for the cost of doors that incorporated defective doorskins

\$1,776,813

(b) As to COUNT ONE, we, the jury, find by a preponderance of the evidence, that the plaintiff is entitled to damages in the amount of \$46,480,581 for *future lost profits*. If none, write "0."

Those findings are binding on the Court.

**I. FINDINGS OF FACT**

In making the decision about equitable relief, it is necessary to respect and apply the jury's findings which are binding factual findings and then for the Court to make factual findings based on the trial record and the record at the Remedies Hearing.

**B. Factual Findings by the Court**

The Court finds the following facts that pertain to the issues of equitable remedies as the parties have emphasized them in the briefing. Additional fact findings are set out along with topics to which they \*627 relate in the Conclusions of Law. All findings of fact are proved by a preponderance of the evidence.

**A. Jury Findings**

The jury found that "JELD-WEN's acquisition of CMI violated Section 7 of the Clayton Act." (ECF No. 1022, ¶ 1). The jury also found that "JELD-WEN's violation of the Clayton Act caused an injury to Steves that was of the type that the antitrust laws were intended to prevent." (ECF No. 1022, ¶ 2). As to antitrust damages, the jury found:

**1. Interior Molded Doorskin Market in 2001**

As explained above, Steves and JELD-WEN were in 2012, and are now, participants in the interior molded doorskin market in the United States. Steves is an independent door manufacturer that has never produced its own doorskins. As a result, it must purchase doorskins from doorskin manufacturers. JELD-WEN, however, is a vertically integrated door manufacturer, meaning that it both produces doorskins and uses them internally to manufacture and sell finished doors.

3. (a) As to COUNT ONE, we, the jury, find by a preponderance of the evidence, that the plaintiff is entitled to damages for antitrust injuries *already sustained* as a result of the following conduct (if none, write "0"):

Before 2001, JELD-WEN and Masonite were the only doorskin manufacturers in the United States. In the 1970s, Masonite had built a manufacturing facility in Towanda,

(1) JELD-WEN's overcharging Steves for doorskins (other than Madison or Monroe)

Pennsylvania (“Towanda”), the facility that is at the center of Steves' request for equitable relief.

In 2000, Masonite was owned by a parent company, International Paper Company. Masonite primarily sold doorskins made at Towanda to Premdor, Inc., but it also sold to eleven other independent door manufacturers. Towanda, as a part of Masonite, did not have “standalone administrative departments” with research and development, accounting, or sales and marketing capabilities; those services were instead provided from separate locations by either Masonite or International Paper.

In 2000, Premdor agreed to buy all of Masonite, including Towanda, from International Paper. However, after Premdor's competitors expressed concerns to the Department of Justice (“DOJ”) about the effect of the acquisition on the supply of doorskins, International Paper and Premdor reached a settlement with the DOJ. Pursuant to that settlement agreement, Towanda would be divested and set up as a separate entity to be known as Craftmaster International, Inc. (“CMI”).

CMI was to serve as a doorskin supplier to Masonite and JELD-WEN and other customers among the Independents. CMI was then incorporated on September 1, 2001, after Premdor's purchase closed. In March 2002, following an auction sale, CMI was purchased by its new owners, who also owned two of the Independents, Haley and Woodgrain.

When CMI was incorporated, International Paper and Masonite also entered into certain agreements with CMI to enable it to function as an independent entity. First, International Paper and Masonite would provide administrative and technical support services to CMI until it could set up its own services—a process that eventually took longer than a year. Second, CMI and Masonite would be given three years to manufacture the dies needed to produce certain types of doorskins, so that both entities could offer the same complement of doorskins to their customers. Even though Towanda and Masonite's doorskin manufacturing plant in Laurel, Mississippi (“Laurel”) were “very similar,” certain products were made only at Towanda, and some were made only at Laurel. Similarly, CMI would sell doorskins to Masonite, and vice versa under set terms for three years to help assure that CMI would prosper going forwards. Finally, CMI received a royalty-free license to use such of Masonite's intellectual property as was necessary to manufacture doorskins at Towanda.

## 2. CMI's Performance as Independent Doorskin Supplier Before the Merger: 2002-2012

According to Bob Merrill (“Merrill”), the former CEO of CMI, and a current JELD-WEN executive, CMI did not become a \*628 “completely standalone entity” until a little more than two and a half years after it was divested from Masonite. CMI's initial financial performance was strong because it could control costs and reduce overhead through the separation agreements, and the housing bubble increased demand for new homes and for doors, and in turn, component supplies like doorskins. For instance, in 2006—a year after the peak of the housing bubble—CMI's net sales were [ ], and its profitability was [ ], calculated as earnings before interest, taxes, depreciation, and allocations (“EBITDA”).<sup>1</sup> The Independents, including Steves, also benefitted from increased competition between CMI, Masonite, and JELD-WEN, each of which tried to create and sell new styles of doorskins as part of their efforts to win customers.

<sup>1</sup> EBITDA is a “surrogate ... for cash flow” that investors use as an approximate measure of an entity's profitability.

CMI also used Towanda to manufacture two so-called “trim board” products, MiraTEC and Extira. Masonite had started the MiraTEC business in 1998, but it had yielded only about [ ] in revenue (and negative EBITDA) by the time Towanda was divested in 2001. However, CMI viewed both MiraTEC and Extira as undeveloped products that held considerable promise and “worked to grow [them] aggressively.” As a result, those products' financial performance “grew rapidly,” and they were responsible for over [ ] in revenue and more than [ ] of EBITDA at CMI's peak in 2006. Moreover, they were important contributors to CMI's overall business after the housing bubble burst; indeed, Merrill testified that they were “the only thing that really kept [CMI] afloat.”

Like Masonite, CMI initially sold doorskins to eleven Independents in the United States and Canada. But beginning in 2003, CMI's customer base contracted significantly because eight of those eleven customers were acquired by companies to which CMI did not sell doorskins. In addition, CMI had only one long-term doorskin supply agreement, which ended when that customer was acquired by Masonite. This customer consolidation significantly reduced the volume of doorskins that CMI could sell. Consequently,



the company took a cue from JELD-WEN and Masonite and “forward integrat[ed]” from 2005 to 2010, buying two door manufacturers and building two door manufacturing plants to allow the company to more efficiently use the doorskin volume produced by Towanda—that is, by selling doorskins internally as well as externally. By 2011, CMI's internal doorskin sales constituted nearly 40% of its total doorskin sales.

There is a dispute respecting the performance of Towanda's doorskin business from 2009 to 2014. Steves relies on PTX 341 and PTX 342 to show that, looking only at the doorskin business, Towanda posted positive EBITDA annually from 2009 through 2013 and that there was positive, albeit not sizeable, EBITDA projected for 2014. And, that is what those documents show.

The record is not entirely clear as to the provenance of PTX 341 and 342, but the record does prove that JELD-WEN prepared these figures based both on historical CMI records (for 2009 through 2012) that were acquired in the merger and on JELD-WEN's own records thereafter. And, JELD-WEN used these documents to make business and strategy decisions. Thus, even though their provenance is not entirely clear, the record shows that they are reliable and probative of the state of \*629 the doorskin business at Towanda for the period involved.

JELD-WEN takes the view that the profitability of Towanda in 2011 and 2012 should be determined by CMI's audited financial statements, DTX 191, and by the information that JELD-WEN gave to the DOJ in August 2012, DTX 60. And, JELD-WEN says that the most important evidence on that point came from the testimony of Bob Merrill at the Remedies Hearing where Merrill testified that the figures in PTX 341 and 342 were not consistent with documents that he had seen.

The Court does not credit DTX 191 or DTX 60 on the issue of the profitability of the doorskin business at Towanda because those documents reflect information about CMI as a whole, not just Towanda's doorskin business. And, CMI had other businesses such as the door business and the trim business (MiraTEC and Extira) and locations other than Towanda.

Nor can the Court credit Merrill's testimony. If, as he said was the case, Merrill had documentary evidence to refute the proofs that appeared in PTX 341 and 342, those refuting documents would have, indeed should have, been produced. They were not. As a result, Merrill's testimony on the

profitability of the doorskin business at Towanda for the time period involved is rejected as not reliable.

The evidence on this issue is probative in the remedial phase of these proceedings because, to find that divestiture is an appropriate remedy, the Court must be satisfied that a divested Towanda can operate competitively and profitably in the doorskin market. And, the fact that Towanda did that in the past, even in the face of adverse market conditions, is evidence that supports a finding that a divested Towanda could do so now.

In any event, it is not disputed that CMI, as an entity, was in difficult financial straits in 2011 and 2012 before the merger. CMI certainly was not profitable then, even with a slightly positive EDITDA from the doorskin business and a positive contribution from the Miratec and Exitera lines.

Indeed, by 2011, CMI's owners had been forced to invest their own funds into CMI to support its cash flow. Thus, after exploring several options, they decided to sell the company by putting it up for auction. As part of that process, they engaged an investment firm that worked with CMI's management to prepare offering documents, send out teaser memos to prospective buyers, and solicit bids from interested entities. One such entity was Steves, which, in October 2011, offered to invest [ ] in CMI in exchange for a minority ownership stake in the company. See DX-462 at 6. CMI's owners rejected the offer, and Steves did not pursue that possibility any further. CMI then identified what management considered to be the “serious prospective buyers” (either four or five) that had submitted purchase bids, and selected JELD-WEN and Masonite as the finalists. JELD-WEN was ultimately chosen as the buyer because of concerns about Masonite's intentions for CMI's door manufacturing plants.

In sum, CMI's doorskin business was quite profitable, and CMI was a competitive factor in the doorskin market from the time of its creation until the housing crisis. Even during the housing crisis, the doorskin component of CMI's business (i.e., Towanda) fared adequately (with slightly positive EBITDA). But, by 2011, it was necessary to put the entirety of CMI up for sale. And, even under those conditions, there were several serious buyers.

**\*630 3. JELD-WEN's Acquisition of CMI and Execution of the Supply Agreement with Steves**

JELD-WEN was interested in acquiring CMI for three main reasons: (1) the availability of doorskins of a certain height that were made at Towanda; (2) the lower costs and higher efficiency of Towanda; and (3) the possibility of manufacturing MiraTEC and Extira (so-called “trim” products) at Towanda in addition to doorskins. JELD-WEN wanted to maintain CMI's doorskin volume, so it entered into long-term supply agreements with three of CMI's existing customers: Haley, Woodgrain, and Lynden Door (“Lynden”). The first two contracts were agreed to as part of JELD-WEN's acquisition of CMI (“the CMI Acquisition”) because Haley and Woodgrain were also owned by CMI's owners. See PTX-115 ¶ 1.

In 2011, JELD-WEN and Steves were parties to a long-term doorskin supply agreement that they had executed in 2003. But, in 2011, JELD-WEN terminated that agreement. Later in 2011, Steves initiated discussions with JELD-WEN about another long-term supply agreement. And, as part of its plan to secure merger approval, JELD-WEN entered into the current Supply Agreement.

Thus, it was that, on May 1, 2012, Steves and JELD-WEN entered into the Supply Agreement, pursuant to which Steves would purchase doorskins from JELD-WEN on defined terms. Stipulation of Undisputed Facts (ECF No. 1003-1) (“Stip.”) ¶ 10; see also Supply Agreement (PTX-149) at 1. Those terms applied to “the full range of JELD-WEN molded doorskin products.” Supply Agreement § 1. The Supply Agreement would be in effect through December 31, 2019, but would automatically renew for a successive seven-year term unless either party terminated the contract. Id. § 2. Steves could terminate the Supply Agreement for any reason upon two-year written notice to JELD-WEN, and JELD-WEN could likewise terminate it without cause upon seven-year written notice to Steves. Id. § 3(a)(2)(b).

The doorskin prices that JELD-WEN could charge Steves varied according to a contractually defined formula based on JELD-WEN's key input costs. The Supply Agreement, in fact, obligated JELD-WEN to give Steves annual notice of the prices and input costs for the coming year by November 30, and JELD-WEN could not impose any price increases if it failed to do so. Id. § 6(c). Although Steves had to purchase at least 80% of its interior molded doorskin requirements from JELD-WEN, Steves could purchase any quantity of doorskins from another supplier that offered a price at least 3% lower than JELD-WEN's purchase price, after JELD-WEN had the chance to match that lower price. Id. § 4.

Beyond those pricing provisions, the contract required JELD-WEN to provide Steves with doorskin products of satisfactory quality. If any doorskins were defective, JELD-WEN would have to reimburse Steves for the cost of those doorskins, but only after JELD-WEN's inspection and verification of the defect. Id. § 8. Reimbursements for any other costs beyond the price of the doorskins were to be negotiated on a case-by-case basis, Supply Agreement § 8, such that they were never mandatory.

Finally, any disputes under the Supply Agreement were to be resolved under a rather protracted alternative dispute resolution process. Only when that process was exhausted could a party begin litigation. That process would begin with an internal conference between the parties' senior executives. If they could not reach a resolution within thirty days of the dispute being submitted, the parties would have to proceed to mediation. A lawsuit could then be filed only where mediation had failed to \*631 yield a solution to the parties' disagreement. Id. § 10.

On July 18, 2012, soon after executing the Supply Agreement, JELD-WEN publicly announced the CMI Acquisition, Stip. ¶ 9, the completion of which was contingent on regulatory approval by government agencies, see PTX-115 ¶ 5; DX-50 § 6.1. Early in 2012, JELD-WEN and CMI had decided to preemptively request approval of the transaction from the DOJ because executives from both companies had been involved in Premdor's acquisition of Masonite, and were therefore aware of the problems that DOJ review could pose. The record is clear that JELD-WEN decided to approach the DOJ only after it had entered into long-term supply contracts with the Independents, knowing that this oft-used tactic would assuage the concerns of the DOJ and the Independents about anticompetitive effects of the proposed merger.

After JELD-WEN approached the DOJ, the agency's Antitrust Division notified JELD-WEN that it had opened a preliminary investigation into the proposed CMI Acquisition. Representatives of CMI and JELD-WEN—Merrill and James Morrison (“Morrison”), respectively—then gave presentations to the DOJ about the Acquisition. See DX-60; DX-54. That presentation emphasized that JELD-WEN had entered into long-term supply contracts with the Independents. Thereafter, the DOJ also contacted Steves, which told the DOJ that it did not oppose the merger because it believed that the Supply Agreement would prevent JELD-WEN from taking any anticompetitive actions. The Antitrust Division subsequently closed its investigation on September

28, 2012, *see* DX-48, and the Acquisition was completed on October 24, 2012. Stip. ¶ 8. The final purchase price paid by JELD-WEN was [ ].

#### 4. JELD-WEN's Integration of CMI's Operations

Following the merger, JELD-WEN made some general administrative changes. For instance, it closed CMI's head office in Chicago and two of CMI's four door manufacturing plants, and transitioned CMI's human resources, payroll, insurance, safety, environmental, and health and benefits functions into JELD-WEN's organizational structure. DX-933 at 2. Although JELD-WEN and CMI accounting managers were supposed to develop an integration plan, *see* DX-933 at 2, the accounting systems for Towanda and for JELD-WEN's "legacy plants" (the doorskin plants that it originally owned and developed) remain separate, with Towanda using different accounting software. Similarly, the consolidation of JELD-WEN's and CMI's operations has apparently not affected certain interactions with customers, at least from Steves' perspective. Steves still orders and pays for doorskins from Towanda in the same way it did before the CMI Acquisition; the same is true for Steves' orders of, and payments for, doorskins from JELD-WEN's legacy plants.

At the time of the merger, JELD-WEN operated a doorskin plant in Marion, North Carolina ("Marion" or "the Marion plant"). However, Marion's design prevented it from meeting environmental regulations, and bringing the plant up to standard was projected to be costly and time-consuming. In addition, Marion was both inefficient and unprofitable, with old equipment in poor condition. On the record as a whole, the Court finds that the Marion plant was closed because of the projected cost to bring it into compliance with environmental regulations, and the projected cost to improve its old and ill-maintained operational equipment, not because of the acquisition of CMI.

\*632 Nevertheless, the acquisition of CMI allowed JELD-WEN to move Marion's doorskin production to Towanda. Moving Marion's doorskin production to Towanda—a very efficient and less cost-intensive plant—would therefore enable JELD-WEN to save around [ ] in manufacturing costs, and would eliminate [ ] in fixed costs associated with maintaining Marion as an operational plant. JELD-WEN mothballed Marion in June or July 2013.

In 2011, JELD-WEN had determined that its Dubuque plant was "[i]mpaired," PTX-668 at JW-CIV-00369666, which is analogous to a decision to close the plant. Because Dubuque was situated in an urban environment that was not conducive to doorskin manufacturing, it was JELD-WEN's second-most expensive fiber facility. The location of the Dubuque plant restricted JELD-WEN's ability to perform necessary environmental control tasks. DX-935 at 2. Dubuque would have been closed in 2011, but closure in 2011 was not practical because of startup problems and doorskin quality issues that were occurring at JELD-WEN's newly-opened plant in Dodson, Louisiana ("Dodson"). PTX-668. Once JELD-WEN acquired CMI, it closed the Dubuque plant because the capacities of Dodson and Towanda together rendered Dubuque's doorskin production unnecessary to overcome the problems at the Dodson plant. *See* DX-935 at 2, 5. JELD-WEN sold Dubuque in or around August 2016. Morrison, who recommended that Dubuque be closed and sold, testified that he would not have made that recommendation if the CMI acquisition had not occurred or if there was a reasonable chance that JELD-WEN would have to divest Towanda. For reasons set forth later, the Court declines to credit Morrison's testimony, finding him to be an untruthful witness. But, apart from that, the record shows that JELD-WEN had determined to close Dubuque before the merger.

JELD-WEN also made certain process changes at the Towanda facility after the CMI Acquisition. It spent around [ ] to install its own manufacturing processes at Towanda by the end of 2013. Among other changes, JELD-WEN: switched the primer used to JELD-WEN primer instead of more expensive third-party primer; reduced the amount of petroleum wax and resin used to make doorskins; enabled Towanda to make lower density doorskins and thereby save on specific component costs; improved the humidization process; and reduced the thickness of doorskins. DX-933 at 3. The changes made by JELD-WEN to the manufacturing process also have resulted in annual savings on doorskin manufacturing costs. The record is that the [ ] expense yielded annual savings of approximately [ ]. *See* DX-190 at 2. On this record as a whole, the Court finds that, because all of these processes were useful, and used, in other facilities, they would have been implemented in any event and are not attributable to the merger.

After the merger and over time, JELD-WEN made capital improvements to Towanda in order to improve the state of the facility and to decrease the doorskin defect rate. These investments included: (1) adding new doorskin dies,

coating equipment, refiners, steam injection valves, a coating manufacturing plant to produce primer at Towanda, and a hydraulic commander to enhance doorskin fiber quality; DX-909 at 13; (2) replacing a line stacker that suffered from quality issues, the sprinkler system, malfunctioning mat separation conveyors, a fiber bin with water infiltration problems, and pressure pumps; DX-909 at 13-14; (3) repairing roofs to prevent water infiltration; DX-909 at 13; and (4) upgrading the doorskin coating process and boiler operating system. DX-909 at 14; DX-917.

\*633 These steps cost JELD-WEN around [ ] in 2015 and [ ] in 2016. DX-909 at 13-14. All told, JELD-WEN estimates that it spent approximately [ ] in capital improvements from July 2014 to July 2017). The investments have generated benefits for JELD-WEN. Many of the improvements noted above were deemed “high return on investment projects,” meaning that their projected annual savings were only slightly less than their initial costs. DX-909 at 13-14. And, the record shows that the total returns from those projects to date exceed their total expense.

Through Morrison, JELD-WEN offered evidence that it would not have pursued them if there was a possibility that the CMI Acquisition would not be consummated or that divestiture would be required. As explained, the Court simply does not find Morrison to be a credible witness.

However, it is, of course, self-evident that JELD-WEN would not have made changes to Towanda if the CMI acquisition had not been consummated, because JELD-WEN simply could not have done that. So that aspect of Morrison's testimony is disingenuous. And, the record is that JELD-WEN has known of the risk of divestiture since mid-2015 and still has made many changes to, and investment in, Towanda. So the record disproves that aspect of Morrison's testimony.

JELD-WEN also asserts that, because it acquired CMI, it was able to modify the doorskin designs (“SKUs”) manufactured at each of its doorskin plants. After acquiring Towanda, JELD-WEN had four operational plants, but each one does not produce all the different SKUs offered to customers—both because of increased demand for certain SKUs in different parts of the United States, and because of some plants' inability to make certain SKUs given their actual production capacity (which accounts for the die changes necessary to produce a specific quantity of doorskins in a given amount of time).<sup>2</sup> Instead, in 2013, the company began using a statistical tool called a mix model to examine,

every quarter, which particular SKUs should be produced at specific doorskin plants—in other words, how the total “mix” of SKUs should be allocated so that each plant's capacity is utilized most efficiently. The mix model accounts for a number of variables, including the overall sales of specific SKUs externally, to independent door manufacturers, and internally, to JELD-WEN's door manufacturing plants; the current and required location of different doorskin dies; and a freight analysis, which measures the freight costs associated with shipping doorskins from the four plants to the buyers' locations.

2 A die is a tool used to create a specific doorskin design. Because a plant cannot run all its dies simultaneously, the dies in service are rotated as needed to meet JELD-WEN's doorskin design needs. However, die changes increase downtime, reducing production efficiency and, in turn, production capacity.

The record shows that JELD-WEN would have developed the mix model whether or not it had acquired CMI. However, the record shows that having product from Towanda to use in the mix model provides some unquantified measure of savings to both JELD-WEN's internal customers and its external customers. That is because the model helps to balance doorskin production across four plants in different regions of the United States, thereby reducing transit times and freight costs. If one plant, such as Towanda, is closed or divested, then JELD-WEN's internal and JELD-WEN's freight-paying customers that received doorskins from that plant might pay higher freight costs because the doorskins would need to be shipped from another plant, from potentially \*634 much farther away.<sup>3</sup> Similarly, a customer who received its doorskins primarily from Towanda would not be able to receive every SKU from other plants without substantial changes to JELD-WEN's mix allocation. JELD-WEN says that would cause production inefficiencies and reduced capacity that would inflate JELD-WEN's doorskin prices. All of these apprehended consequences of divestiture were posited in general terms, but JELD-WEN offered no quantification of the apprehended cost increase.

3 JELD-WEN decides which plants will supply particular doorskins to customers. Accordingly, even if Steves orders doorskins from Towanda, JELD-WEN may supply those doorskins from Dodson or one of its West Virginia plants. Because the mix model “balance[s] the mix across the



group,” the plant identified by the customer might not make the requested SKU, or might not have sufficient volume for supply from that location to be most efficient for all customers.

The mix model also led to related changes in JELD-WEN's operations, such as a doorskin consolidation process that eliminated trade matches and redundant SKUs between JELD-WEN and CMI. That process cost around [ ] and took a year to complete. DX-917. This modification affected SKU availability at both Towanda and JELD-WEN's legacy plants. However, much like JELD-WEN's manufacturing process changes and capital improvements at Towanda, that project “paid for itself” within a relatively short period after it was finished. And, the record is that the mix model would still be used and useful in the event of divestiture. It would just operate differently.

Finally, JELD-WEN improved the MiraTEC and Extira business, which is independent of JELD-WEN's doorskin manufacturing business at Towanda. According to Merrill, JELD-WEN is the only company that currently makes both trim and doorskin products.

JELD-WEN has devoted significant resources to growing the MiraTEC and Extira business, which was responsible for around [ ] of Towanda's [ ] EBITDA in 2017. Moreover, exterior trim and panel products like MiraTEC and Extira are “key anchor products” that have allowed JELD-WEN to pursue expansion into the general building products industry, which involves other exterior components that JELD-WEN does not yet make, like siding and fencing. Based on this planned development, JELD-WEN's current CFO, L. Brooks Mallard (“Mallard”), has projected 2018 revenues and EBITDA for JELD-WEN of [ ] and [ ], respectively. See Apr. 12 Remedies Tr. at 710:19-711:21; DX-928 at 2-4.

Nothing in the record suggests that, in the event of divestiture, MiraTEC and Extira products made by an entity other than JELD-WEN could not be sold to JELD-WEN's existing customers for those products. But, if that is the case, the new owner of Towanda, not JELD-WEN, would be receiving the net revenues and the EBITDA generated by those sales.

### **5. Post-Merger Interactions Between Steves and JELD-WEN**

Pursuant to the Supply Agreement, JELD-WEN supplied doorskins to Steves in 2012 and 2013. It is helpful to

understand certain provisions of the Supply Agreement that were central to the antitrust violations found by the jury and that are important to the conduct of the parties.

Section 6a of the Supply Agreement sets forth the Initial Price of the doorskins to be supplied to Steves by reference to Schedule 1. Section 6b of the Supply Agreement provides that the “Initial Price shall remain in effect for the duration of this Agreement unless a price increase or \*635 decrease takes place in accordance with the terms hereof.” Compl. Ex. A. Section 6c sets out the adjustment mechanism for the price increases or decreases that are referred to in Section 6b.<sup>4</sup> Section 6c provides that price adjustments are to be made with references to what are called “key input costs” for Raw Material (wood; resin, wax, oil, and sealer; paint; and packaging) and for Energy (electric power prices, natural gas prices, boiler fuel. (Compl. Ex. A, § 6(c), Sch. 2.)

<sup>4</sup> By making the damage award in paragraph 3(a)(1) of the Verdict Form, the jury had to conclude, based on the evidence, that Section 6c operated to measure both price increases and price decreases. That is proved by the testimony of the negotiators and the evidence about how the parties administered the contract.

The record shows that, after the merger, JELD-WEN's key input costs declined every year. Steves' damages expert, Avram Tucker (“Tucker”), testified that, based on his assessment and calculations, JELD-WEN had not disclosed to Steves the full extent of the cost decreases.

And, notwithstanding these declining costs, JELD-WEN, in 2013, 2014 and 2015, increased the prices that it charged Steves to purchase doorskins under the Supply Agreement.<sup>5</sup> Tucker determined that JELD-WEN had overcharged Steves a cumulative amount of 7.87% in the years following the CMI Acquisition. Steves' antitrust expert, Carl Shapiro (“Shapiro”), testified that other JELD-WEN customers without a supply agreement, such as Excel, Unidoor, and ABS, experienced even greater price increases. Documentary evidence from JELD-WEN's files confirms that testimony. In addition, JELD-WEN charged Steves markedly higher prices for the Madison and Monroe styles of doorskins because JELD-WEN took the view that they were outside the scope of the Supply Agreement, a view that the jury rejected.

<sup>5</sup> JELD-WEN did not communicate with Steves about key input costs or price changes in 2016

or 2017, so the doorskin prices imposed in 2015 remained the same for those years.

As Shapiro explained, JELD-WEN's pricing decisions were a consequence of JELD-WEN's enhanced market power after the CMI Acquisition. Following the merger, JELD-WEN and Masonite were the only two doorskin suppliers in the United States. Steves believed, as found above, that the Supply Agreement would protect it from any anticompetitive activity. Then, in July 2014, Orsino's replacement as JELD-WEN's CEO, Kirk Hachigian ("Hachigian"), sent Steves a presentation made by Masonite on a publically available telephone call for its investors in which Masonite's CEO made clear that Masonite would not sell doorskins to companies that competed with it in the North American door market, as Steves did. Shortly thereafter, in September 2014, Hachigian sent Steves a notice of termination of the Supply Agreement, effective September 10, 2021.<sup>6</sup> That letter followed Steves' rejection of Hachigian's demand to add to the normal doorskin prices permitted under Section 6b of the Supply Agreement a so-called "capital charge," which (according to Hachigian) was to help offset the cost of making capital improvements to JELD-WEN's facilities that made the doorskins sold to Steves. Nothing in the contractual pricing provisions of the Supply Agreement allowed a capital charge.<sup>7</sup> Although these events made Steves concerned about its ability to obtain an adequate doorskin supply, Steves did not terminate the Supply Agreement (as it could have done) to seek a supply elsewhere because Steves believed that there was no viable supply alternative.

<sup>6</sup> Hachigian subsequently sent Steves a letter, in March 2015, stating that JELD-WEN reserved the right to assert that the Supply Agreement terminated on December 31, 2019 (at the end of its normal seven-year term) instead of in September 2021. PTX-521. JELD-WEN (through Hachigian) abandoned that position at trial. However, proposed acceleration of the termination date is further evidence that JELD-WEN was emboldened by the knowledge that, in 2014, the substantial lessening of competition caused by the merger allowed JELD-WEN to pressure Steves to accept JELD-WEN's new pricing demands.

<sup>7</sup> The record shows that JELD-WEN extracted new contracts from other independent manufacturers requiring them to pay the capital charge. That was

the result of lessened competition. It was either pay or face termination and the loss of doorskin supply.

In 2014, Steves also experienced a change in the way that JELD-WEN dealt with doorskin defects under the Supply Agreement. Before late 2014, the procedure followed between Steves and JELD-WEN was as follows:

If Steves discovers defects in JELD-WEN's doorskins after receiving them, it completes and submits a vendor debit memo ("VDM") to JELD-WEN to initiate the reimbursement process. From 2010 to 2011, JELD-WEN responded promptly after receiving VDMs, sometimes inspecting the defective doorskin at Steves' plant and sometimes extending Steves a credit based on a picture of the defect.

In mid-2014, JELD-WEN changed its approach and significantly limited reimbursements for those defects.

Likewise, in 2014-15, JELD-WEN changed the way that it compensated for defective doorskins that had been incorporated in the finished doors that Steves sold to its customers, for which Steves could negotiate for reimbursement under the Supply Agreement. Beginning in 2012, if a Steves' customer rejected a door as defective because of a defective doorskin, Steves would give its customer credits for the purchase price of the doors (assuming that Steves agreed with the defect assessments). Steves would then seek reimbursement from JELD-WEN for the full cost of the doors which had defective doorskin (*i.e.*, the sale price that Steves refunded to the customers) and JELD-WEN would typically pay that entire amount. In those situations, Steves would submit a VDM for the defective door to JELD-WEN, just as it did with the defective doorskins.

However, the record shows that JELD-WEN adopted a policy in late 2014 or early 2015, to reimburse Steves only for the defective doorskins, rather than for the full cost of the doors. In explanation, JELD-WEN told Steves that "[t]here was a specific change in their [door reimbursement] policy," which applied whether the doors with defective doorskins were sold to customers or remained in Steves' manufacturing plant. This shift followed what Fancher characterized as a "general

direction” from JELD-WEN's management to “tighten” its door reimbursement process.

At trial, JELD-WEN took the view that, although it was never contractually required to reimburse Steves for the cost of the doors, JELD-WEN did so as a matter of customer relations. However, it is clear that, because of the substantially lessened competition caused by the merger, JELD-WEN no longer felt that it was competitively necessary to extend this benefit to Steves in 2015 and thereafter.

The record establishes that JELD-WEN will continue to engage in this same sort of conduct respecting pricing and contract administration in the future. That is because, as Shapiro testified, the entry of another doorskin supplier besides JELD-WEN \*637 and Masonite into the U.S. market is unlikely. In addition, JELD-WEN is still charging Steves inflated prices for doorskins under the Supply Agreement, including Madison and Monroe doorskins. Likewise, JELD-WEN continues to disregard the price adjustment provisions of § 6c. Moreover, JELD-WEN has tried unilaterally to add labor costs as a key input cost under Schedule 2 and has refused to supply the backup information for the key input costs. The jury found that Steves sustained damages because JELD-WEN had violated Section 6c and other pricing provisions of the contract, including those for the pricing of Madison and Monroe doorskins. And, the jury rightly found that those damages were the consequence of the antitrust violation, *i.e.*, the substantial lessening of competition caused by the merger.

### **6. Steves' Efforts to Obtain Alternative Doorskin Supply and the Consequences of Not Doing So**

After receiving the original and the accelerated notices of termination from JELD-WEN, Steves, with knowledge that a reliable supply of doorskins was essential to its survival, began to explore ways to obtain doorskins without relying on JELD-WEN. Of course, between now and September 2021, Steves can purchase as many doorskins as it needs from JELD-WEN under the Supply Agreement. However, the record proves that JELD-WEN cannot be relied upon to supply Steves with doorskins after that point. Indeed, JELD-WEN has expressed the view that it might be necessary to “kill off” a few of the Independents. That, for Steves, is the predictable result of terminating the Supply Agreement.

Faced with loss of doorskin supply from JELD-WEN, Steves tried to arrange a supply contract with Masonite, even after Masonite's July 2014 announcement that it would no longer sell doorskins to independent door manufacturers such as Steves. Masonite's CEO, Fred Lynch, told Steves that Masonite will not enter into any long-term supply agreement with Steves. Lynch did advise that Masonite remains generally willing to sell doorskins to Steves on a spot sale basis, depending on availability and without a supply agreement. Nonetheless, the prices that Masonite has offered Steves are around 37% higher than the prices it pays under the Supply Agreement.

Unable to secure a reliable, competitively priced source of supply from either domestic supplier, Steves approached foreign doorskin suppliers like Teverpan, Kastamonu, and Yildiz to explore alternate sources of supply. And, those discussions continue today. But, the record shows that Steves could fill only a small part of its doorskin requirements from foreign supply sources. And, the record shows that foreign suppliers can supply only a limited number of the doorskin designs and sizes that Steves uses to manufacture its doors. Further, Steves has experienced serious quality deficiencies with doorskin samples that it has received from foreign suppliers.<sup>8</sup>

<sup>8</sup> In opposing divestiture, JELD-WEN has asserted that it too has experienced quality problems with the products made by these foreign manufacturers. Indeed, JELD-WEN argues that product from foreign suppliers cannot help fill the short-fall in supply that would ensue a divestiture of Towanda.

Finally, Steves has investigated the possibility of building its own doorskin manufacturing plant (“the MDS Project”) so as to have a reliable source of supply after the Supply Agreement ends in September 2021. To that end, Steves hired former JELD-WEN employee John Pierce (“Pierce”) in March 2015 to, among other \*638 things, provide information that Steves could use in furtherance of its MDS Project. Then, in July 2015, Steves engaged another former JELD-WEN employee, John Ambruz (“Ambruz”), for the primary purpose of completing a study about the feasibility of Steves building a doorskin manufacturing plant (“the Feasibility Study”). On March 30, 2016, Ambruz e-mailed Sam and Edward Steves the completed Feasibility Study, which discussed the challenges associated with building a doorskin manufacturing plant—particularly the cost, time, and need for a manufacturing partner.

In early 2017, Steves reached an interim conclusion that it could not feasibly build its own doorskin plant. The record establishes that Steves has made no concrete progress toward building a doorskin manufacturing plant. However, Ambruz and Gregory Wysock—a former Masonite employee hired to work on the MDS Project in July 2016—are still employed by Steves. Moreover, Steves has not completely abandoned its plans to build a plant. Thus, Steves continues to look for a manufacturing partner that could help construct a plant, and it was in contact with several potential partners before trial. However, Steves has had no further communication with those entities since before the trial began. Considered as a whole, the record establishes conclusively that Steves cannot fulfill its doorskin requirements from foreign manufacturers or by building its own doorskin plant.

If Steves cannot repair its relationship with JELD-WEN (which, on this record, will not happen) or acquire doorskins another way (which, as of now, is not possible), it will go out of business after the Supply Agreement expires in 2021. Steves' success rises and falls with its door manufacturing business; in 2017 alone, its interior molded doors sales constituted around 70% of its total revenue. And Steves cannot make those doors without interior molded doorskins. Consequently, if Steves cannot obtain a reliable doorskin supply, its business will soon fail.

That event would affect the 1,100 employees that currently work for Steves, and the members of the Steves family, which has run the company since it was founded in 1866. Steves' principal officers, Edward and Sam Steves, are the fifth generation of the Steves family to manage Steves. Moreover, Sam Steves' son and Edward Steves' daughter are current employees of Steves, and Sam Steves hopes to “pass[ ] on the reins” to them in the future. Maintaining Steves as a family business is an important goal of the entire Steves family.

#### **7. The Discussions Between JELD-WEN and Steves; The Initiation of Alternative Dispute Resolution Process; The Filing of This Action: 2012-2016**

JELD-WEN has presented the affirmative defense of laches, a topic that is separately considered in Section II.C, *infra*. The record contains considerable evidence about what Steves knew when, and what Steves did (in addition to attempting to secure an alternative source of supply as outlined in Section I.B.6). Additional facts on those topics are set out below

as well as in Section II.C below that addressed the laches defense.

Steves began noticing doorskin quality issues after the merger as soon as November 2012. However, at that time, it did not view those defects as a result of the merger. It is difficult to pinpoint the exact period when Steves connected the dots between the CMI Acquisition and the decrease \*639 in doorskin quality.<sup>9</sup> Similarly, Steves had concerns about JELD-WEN's doorskin prices when it received the first notification required by the Supply Agreement in late 2012, and had discussions with Orsino about accurate pricing throughout 2013. However, that initial disagreement concerned whether JELD-WEN's reduction of doorskin thickness should be reflected in doorskin pricing under the Supply Agreement, and it was not thought by Steves to be related to the CMI Acquisition. In fact, the problems with the key input costs provision that underlie Steves' pricing claims in this litigation did not arise until after Hachigian replaced Orsino as JELD-WEN's CEO in early 2014.

<sup>9</sup> Edward Steves stated during his deposition that he realized in early 2013 that the CMI Acquisition had caused the “degradation” of doorskin quality. Apr. 12 Remedies Tr. at 637:19-638:8. However, he later testified that he did not view the quality issues as related to the Acquisition. *Id.* at 685:6-17. Having heard the testimony and reviewed the deposition, the Court concludes that Edward Steves was speaking temporally, not causally.

The record shows that, as of August 2014, Sam and Edward Steves exchanged email messages that used the term “antitrust.” For example, on August 12, 2014, Sam Steves e-mailed Edward Steves to ask whether Steves was “finished with exploring anti trust issues if J[ELD-WEN] terms [terminated] the supply agreement.” DX-291. Then, on August 26, Sam Steves made reference to Steves' “claim on the overcharge” when considering how to respond to a Hachigian e-mail that discussed, in part, doorskin pricing under the Supply Agreement. Sam Steves noted that “the antitrust” was “perhaps the most important” issue at that point. DX-466.

Although the emails were offered in evidence, their meaning and context was not developed at trial. As explained more fully in Section II.C below, even though Steves was aware of potential antitrust ramifications of JELD-WEN's pricing pressure, changes in the treatment of defects, and arbitrary



treatment respecting the key input costs, Steves reasonably focused its attention on finding alternative sources of doorskin supply in an effort to survive JELD-WEN's conduct, rather than place its hope for survival on pursuing a first of its kind antitrust action.<sup>10</sup> Many of those efforts took place in the fall of 2014 and early 2015. In addition, Steves, quite reasonably, continued to meet with JELD-WEN in an effort to find some reasonable commercial solution. Indeed, JELD-WEN, largely through Hachigian, repeatedly told Steves that JELD-WEN wanted some commercial solution. Faced, as it was with losing the supply of a key component of its most important product, Steves was reasonable in continuing to try to work on a commercial solution with JELD-WEN.

<sup>10</sup> As the parties so often observe, no previous case brought by a private party seeking divestiture under the Clayton Act had gone to verdict at the time so Steves had no precedents to inform whether to pursue such a course or, if pursued, what the likelihood of success might be.

In early 2015, it became obvious that negotiations with JELD-WEN would not work. Therefore, Steves formally initiated dispute resolution procedures under the Supply Agreement in March 11, 2015. See DX-243 at 1; see also PTX-149 § 10(a)-(b). The formal invocation of Section 10 did not, however, provide JELD-WEN with notice of Steves' possible antitrust claim. However, the dispute process was addressed to contractual matters that lay at the heart of Steves' antitrust concerns so resolution of those issues in the contractually required dispute process likely would \*640 mean that Steves would have no antitrust injury.

Steves asked JELD-WEN to meet for the initial dispute resolution conference called for by the Supply Agreement on March 23, DX-243 at 2, but JELD-WEN deferred the internal conferences required by Section 10 until May 2015. Although the focus of those conferences was JELD-WEN's compliance with the key input costs and doorskin quality provisions of the Supply Agreement, Steves' attorney, Marvin Pipkin, also raised Steves' antitrust concerns at the second conference, and Bruce Taten responded on JELD-WEN's behalf. But, the record does not disclose the substance of the discussion about those antitrust concerns. After those conferences failed to yield a resolution to either the contract or antitrust issues, Steves requested, in July 2015, mediation, as is specified to be the next step under the Supply Agreement, see PTX-574 at 1. That occurred on September 4, 2015.

The mediation was also unsuccessful. At the end of it, Steves presented JELD-WEN with a draft complaint that raised both the contract and antitrust issues. The parties then chose to enter into a standstill agreement, which provided that Steves would not sue JELD-WEN on the date of the agreement, and that JELD-WEN would give Steves two days' notice before suing Steves, effective for thirty days. See PTX-591. The standstill agreement recited the mutual desire of Steves and JELD-WEN to continue efforts to work out a solution to their disputes, which then included both the contractual issues and the antitrust ramifications of JELD-WEN's conduct. Subsequently, Steves and JELD-WEN entered into standstill agreements with similar provisions on September 29, 2015; October 13, 2015; January 7, 2016; and April 25, 2016. See PTX-593; PTX-606; PTX-641; PTX-682. Sam Steves acknowledged that these agreements permitted Steves to file suit on any date other than the dates of the agreements themselves, but he said that Steves did not do so because it believed that the parties could resolve their dispute without litigation, as expressed in the standstill agreements.

As it was involved in this back-and-forth process with JELD-WEN, Steves, in December 2015, asked the DOJ to examine JELD-WEN's potentially anticompetitive conduct. Steves gave a presentation to the DOJ later that month, and then produced documents to the DOJ in January 2016, in response to a civil investigative demand. On April 7, 2016, JELD-WEN also made a presentation to the DOJ. See DX-45. On May 18, 2016, the DOJ closed its investigation without taking any action. See DX-182. Steves then asked JELD-WEN to execute another standstill agreement, and when JELD-WEN refused, Steves filed this action on June 29, 2016.

## 8. Current Status and Standalone Viability of Towanda

Whether divestiture is a viable remedy in this case depends, in part, on whether, if divested, Towanda would be able to operate as an effective competitor in the doorskin market and thereby restore the competition that the merger substantially lessened. The parties have quite different views on the subject.

Towanda occupies 19 of the 275 total acres of land on which the property sits. The plant consists of several different areas: the main plant, which contains the main production lines; the smaller "die form" plant, where Masonite originally manufactured doorskins and which still houses a production line today; the wood yard, which receives doorskin inputs like logs or chips; and the water treatment plant, which removes

chemicals from water used in the manufacturing process before that water is redistributed to the environment \*641 through the nearby spray fields. All these areas existed when JELD-WEN acquired Towanda, and JELD-WEN purchased the entire property. Towanda's operations require more than 400 total employees, and around 300 in the main plant alone.

Towanda has a design capacity of [ ] doorskins per year. That figure reflects Towanda's maximum production capacity based on its design, which accounts for the number of openings in a press, the number of dies that can be produced within that opening, the number of times the press can go up and down in a specific period of time, and some scheduled maintenance downtime.

However, design capacity is not the same as actual production capacity. The latter is more realistic for production calculations because it also incorporates the downtime that is required to change dies in the press so that different styles (SKUs) can be manufactured. A die change requires waiting for the press to cool down, replacing the die (using a crane), and then reheating the press.

Towanda's two doorskin manufacturing lines are Line 1 (in the main plant) and Dieform (in the die form plant). Line 1 is a high-volume/low-mix press, meaning that it produces a large quantity of a lower variety of SKUs. It currently produces only 6'8" doorskins—the most common size for residential construction—and can only produce between 50-60 different SKUs at one time. Line 1 is intended to be the “main production line” at Towanda. Thus, Line 1 has fewer die changes and far less downtime.

Dieform, in contrast, is a high-mix/low-volume press, sacrificing doorskin quantity for SKU variety. It uses smaller dies that can be changed without causing as much downtime as die changes for Line 1. Consequently, Dieform can produce over 250 different SKUs, and it accommodates all of JELD-WEN's 7' and 8' doorskins, as well as its smaller orders for more niche doorskin designs. That line's production capacity is therefore lower.

Even with Line 1 and Dieform being designed to maximize efficiency, some unaccounted-for downtime is still needed to produce the many SKUs sold. This downtime reduces Towanda's current actual production capacity to [ ] doorskins per year. In 2017, and for reasons not explained in the record, Towanda's actual production was [ ] doorskins. Towanda's

current doorskin business is strong, generating EBITDA of [ ] in 2017.

These earnings are attributable to several factors. First, doorskin volume has increased because the housing market is performing well. There is evidence that the number of domestic “housing starts”—new homes for which construction is started—was approximately [ ] in 2001, and around [ ] in 2017. Thus, the current demand for doorskins is roughly similar to the demand in the early 2000s, when CMI achieved positive EBITDA (albeit not as high as 2006, when the number of housing starts was approximately [ ]). The market has also improved considerably since 2011, as reflected in the significantly higher volume of doorskins sold to JELD-WEN's external customers in 2016 ( [ ]) compared to 2011 ( [ ]). Towanda's volume is also used to supply JELD-WEN's door manufacturing plants, which in 2017 purchased about [ ] of Towanda's [ ] doorskins.

Second, the increased demand has helped spread out Towanda's high fixed costs, reducing Towanda's cost per doorskin in 2017 to approximately [ ]. This expense is even lower than the [ ] that each doorskin cost CMI at its peak in 2006 (and substantially lower than the [ ] per-doorskin cost at CMI's nadir in 2011). That \*642 reduction is, in part, attributable to JELD-WEN's changes to Towanda, which have lowered both variable and fixed production costs.

Third, doorskin prices have rebounded since 2011, so that JELD-WEN can now charge an average of [ ] per doorskin—only slightly lower than the peak average price of [ ] in 2006.

Finally, JELD-WEN's mix model allows it to allocate SKU demand across its four doorskin plants, increasing Towanda's production efficiency and helping it operate at the level needed to achieve a profit. As Towanda's design capacity is [ ] doorskins, Towanda therefore must sell around [ ] doorskins each year at prices ranging from [ ] doorskin to be profitable. Given the current state of the market, Towanda's actual capacity of [ ] doorskins in 2017 easily surpassed that threshold.<sup>11</sup>

<sup>11</sup> Towanda's overall profitability is aided by its MiraTEC and Extira production. Towanda is the only facility in the world that makes those products. They are produced on Line 2, a sealed press that sits across from Line 1. However, the manufacturing process for doorskins and MiraTEC and Extira is intertwined in many respects, so those products

share many of the same manufacturing facilities in the main plant. As a result, Line 2 and the production equipment needed for MiraTEC and Extira cannot be removed as part of divestiture, because doing so would make doorskin production impossible. Any acquisition of Towanda's doorskin business, then, must include the acquisition of its MiraTEC and Extira business.

The record proves, without dispute, that today Towanda is a profitable competitor in the doorskin market. And, the Court so finds. Also, the record shows, also beyond dispute, that Towanda was profitable from the formation of CMI in 2001 until the down turn in the housing market in 2006 and it was a competitor in the supply of doorskins to independent door manufacturers then as well. And, the Court so finds.

JELD-WEN argues that, if divested from JELD-WEN, Towanda cannot operate profitably or be a competitor in the doorskin industry. In support of that view, JELD-WEN makes several arguments.

First, JELD-WEN argues that divesting Towanda in its current state would be more complex than the successful divestiture from Masonite in 2001. That earlier process benefited from the relatively amicable relationship between Masonite and SMI and the existence of fewer doorskin designs. Towanda and Masonite's Laurel plant were also similar and the designs offered by each were "exact trade matches," so the companies simply needed time to duplicate dies at each plant. Here, however, says JELD-WEN, CMI and JELD-WEN had "completely different designs" when they merged, and that distinction has largely persisted. That, however, is really just an argument that JELD-WEN would need at least two years to replicate Towanda's design offerings at its legacy plants. And, thus, it relates not to Towanda's future as a competitive entity, but to JELD-WEN's.

Second, JELD-WEN says that Towanda's fixed costs would increase because it would have to set up its own departments to provide administrative and technology services. Those expenses are currently absorbed by JELD-WEN and thus not factored into Towanda's per-doorskin costs. That may well be true, but it hardly shows that a divested Towanda would not be profitable or competitive.

Third, says JELD-WEN, Towanda cannot adequately utilize its capacity without benefitting from JELD-WEN's other doorskin plants or internal door customers. It is true that JELD-WEN uses a good deal of Towanda's output. But, it is

virtually \*643 certain that Steves alone would purchase [ ] doorskins from a divested Towanda. And, JELD-WEN would buy some of its requirements from the new owner of Towanda (at least [ ] doorskins) at least for two years while it seeks other sources of supply. And, JELD-WEN might well choose to continue buying from Towanda thereafter if, as JELD-WEN has argued, it will not likely make up any shortfall by buying from foreign suppliers or building another plant. Further, the Independents reasonably can be considered as other potential customers of a new owner of Towanda, especially considering (1) the higher prices recently extracted by JELD-WEN in requiring those companies to re-negotiate their contracts and (2) the higher prices sought by Masonite. Combined, (all three) the sales would exceed the 17-18 million needed for profitable operation.<sup>12</sup> Thus, the record establishes that a divested Towanda likely would be able to sell at least as much doorskin product as it did in 2017.

<sup>12</sup> The record shows that, in the event of divestiture, JELD-WEN would continue to buy from Towanda at least until it could build a new plant which would take several years or until JELD-WEN could find a reliable source of foreign supply (which, like Steves, JELD-WEN has not deemed to be a viable solution). JELD-WEN's counsel have argued that JELD-WEN would not buy from divested Towanda. Because JELD-WEN's witnesses said otherwise and counsel's argument makes no sense if JELD-WEN is to meet its needs, the argument is rejected.

Of course, the owner of a divested Towanda would find it necessary to supply a more diverse range of SKUs than CMI supplied in 2005 or 2006 because fewer SKUs existed at that time. Fancher opined that Towanda could not, as a standalone entity, supply all the SKUs needed to meet its external customers' needs—both because "the design mix that would run through [Towanda] couldn't support it," and because Towanda and JELD-WEN's legacy plants both make designs that the other does not.

However, the record contains no particularized evidence from JELD-WEN about which specific SKUs purchased by JELD-WEN's external customers would be implicated by divestiture, or about the effect on Towanda's production capacity and profitability of devoting its resources to meeting the SKU needs of its customers. The consequence of that evidentiary void is that no specific finding can be made.

Nonetheless, the record does permit the general conclusion that divestiture would restrict to some extent Towanda's ability to meet the needs of JELD-WEN's Independent customers because the die changes required to produce the requisite SKU variety would lead to increased downtime and reduced production capacity. This reduced capacity could also result in higher costs for Towanda, which could reduce profitability. There is no evidence that permits the Court to find whether those costs would increase or by how much.

From this record, the Court finds that a divested Towanda would be required to adjust product mix in a not insignificant way, but that the facility is capable of being operated to produce a mix of products that will allow Towanda to be profitable and competitive even if it must make substantial adjustments to do so.

Finally, JELD-WEN argues that it is not possible to conclude that a divested Towanda would be competitive because the existence of a potential buyer who could profitably sell doorskins from Towanda is unknown at this time. It is correct that the record does not identify entities, other than Steves, that are currently interested in buying Towanda and are capable of \*644 operating the plant within the scope of their corporate structure or separately.

Steves is the only entity that has expressed interest in acquiring Towanda. However, Steves' executives admittedly lack knowledge about operating a doorskin plant. Of course, in the event of divestiture, Towanda's management and line employees would be retained, or at least given the opportunity to remain. That would be so for a new owner because the retention of its operating personnel would afford the greatest likelihood for success in restoring competition that was substantially lessened by the merger. And, that approach succeeded when CMI was created and divested in 2002 and when CMI was acquired by JELD-WEN in 2012. The record discloses no reason why that approach would not be successful again.

It is not surprising that, at this juncture in the case, potential buyers have not emerged. This is, after all, the first privately brought action under Section 16 of the Clayton Act to have gone to verdict and, in which, a private party has sought divestiture. And, as the Supreme Court of the United States explained in [Brown Shoe Co. v. United States](#), 370 U.S. 294, 82 S.Ct. 1502, 8 L.Ed.2d 510 (1962), there are not likely to be firm expressions of interest until after the issue of whether divestiture is an appropriate remedy is settled on appeal and

the landscape is clear. But, the record shows that Towanda was a profitable operation before the housing crisis and is once again and that its doorskin business produced small, but positive, EBITDA even during the housing crisis. And, even when CMI was up for sale in 2011, at a time when it was not profitable, there were several interested buyers. On this record, the Court concludes that buyers for this profitable operation can be expected to emerge again when the legal battles are ended.

### 9. Impact of Divestiture on JELD-WEN and Other Entities

Divestiture has been on the table in this action since it was filed in June 2016. Nonetheless, the record is that JELD-WEN has not examined how it would operate in the event that JELD-WEN is ordered to divest Towanda. Nor has JELD-WEN developed a plan for that eventuality. Thus, there is no well thought-out or documented support for how JELD-WEN would be affected by divestiture.

Of course, the absence of such a plan does not foreclose testimony from JELD-WEN's officers and employees giving their opinions about how divestiture might affect JELD-WEN's overall operations in a general way and how a divestiture might affect JELD-WEN's customers. And that is how JELD-WEN has chosen to present evidence on those topics: by offering opinions of its executives. Those opinions may properly be considered even though they come from witnesses who admittedly have not studied the subject and who are biased to present the worst case scenario.

The lack of concrete analysis and the inherent bias make the opinions of JELD-WEN employees about future events (such as the restructuring of JELD-WEN's company-wide manufacturing operations, potential layoffs, and ripple effects on customers) quite speculative and rather unreliable. Nevertheless, it is possible to conclude that, if Towanda's capacity is removed from JELD-WEN's orbit, JELD-WEN will encounter, in the short run, difficulty manufacturing in its other facilities the number of doorskins that it needs to supply its own needs for making JELD-WEN doors and the needs of its independent doorskin customers.

It is helpful to review JELD-WEN's most recent production figures as a benchmark. In 2017, JELD-WEN, company-wide, \*645 including Towanda, made approximately [ ] doorskins, consuming 30 million internally and selling [ ] to



the Independents who are its customers, with [ ] of those going to Steves. If, after divestiture, Steves secured its requirements ( [ ] doorskins) from the new owner of Towanda, JELD-WEN would need to produce [ ] doorskins to meet its needs and those of its external customers.

The record is not precise on the point, but it appears that divestiture would result in a short-fall of approximately [ ] doorskins in JELD-WEN's internal and external needs (excluding Steves). However, that does not take into account that any divestiture order necessarily would make provision for JELD-WEN to purchase its short-fall from the new owner of Towanda for at least two years. That would be important to JELD-WEN, to its customers, and to the new owner of Towanda.

JELD-WEN also offered evidence that the “full production based on [m]ix” figures in [the record at PTX-1045] do not accurately reflect the effect of losing Towanda on JELD-WEN's doorskin capacity and production volume. That is because divestiture would make it necessary for JELD-WEN to redistribute to its legacy plants the SKUs that are currently manufactured at Towanda in order to provide the quantity and variety of doorskins that its customers desire. This change would cause two problems according to JELD-WEN. First, if those plants tried to accommodate those SKUs, their actual capacity would suffer, to some undefined extent, because the additional die changes needed would increase downtime, thereby reducing efficiency and lowering volume. Second, economics aside, producing the necessary quantity of the Towanda SKUs at the other plants is not possible without using the dies that are used at Towanda to produce those SKUs or making new dies of the same kind. Thus, those dies would have to be made for the legacy plants to use and that would require time.

The record does not show how much time or how much money that would require because JELD-WEN has not put “pen to paper” on that topic or any other relating to how to operate in the event of divestiture. That void notwithstanding, JELD-WEN has shown that divestiture would likely cause operational dislocations that would affect, to an undefined extent, its requirements for doorskins in the number of SKUs in its current line. However, because JELD-WEN has not analyzed how it would reallocate Towanda's SKUs, the degree of the resulting total capacity decrease at its legacy plants, like the degree of impact, is unclear.

It does appear from the record that it would be difficult to replace Towanda's production immediately. JELD-WEN's doorskin plant in Latvia currently has some excess capacity. However, that “excess” does not account for the reality that Latvia has never achieved close to its design capacity of [ ] doorskins per year. Furthermore, the Latvia plant is tailored to the European doorskin market and only produces a few doorskin designs that are usable in the U.S. market. Producing some of Towanda's SKUs in Latvia would also require the use of different dies than those used now in Latvia, and Latvia is currently running close to its total capacity, so that its production process could not be altered without consequences. The record does not show what those consequences are or what their economic impact would be.

Notwithstanding those difficulties, JELD-WEN's contingency business plans outlining options in the event that a natural disaster shuttered one or more of its plants shows that JELD-WEN considers that its Latvian plant, or other domestic plants (including a restarted Marion plant), \*646 could be used to augment doorskin supplies until the shuttered plant was back on line. Thus, contrary to JELD-WEN's urgings, it is not possible to conclude that divesting Towanda would leave JELD-WEN without options, even in the short term. JELD-WEN's own business records show otherwise.

The record also leads to the conclusion that obtaining doorskins from alternate suppliers or building a replacement plant is not any more promising for JELD-WEN than it is for Steves. Because of the merger, the only other domestic supplier of doorskins is Masonite, purchase from which is conceptually possible but not considered viable by JELD-WEN. And, given Masonite's position on sales to the Independents, JELD-WEN is likely correct. JELD-WEN conceptually could also purchase doorskins from foreign suppliers, such as Teverpan. But JELD-WEN, like Steves, has concerns about the quality of doorskins made by foreign suppliers, and those suppliers offer fewer SKUs than Towanda. Considering the record as a whole, the Court concludes that foreign suppliers cannot meet a significant part of JELD-WEN's requirements any more than they can meet a significant part of Steves' requirements.

Finally, the record is clear JELD-WEN could build its own doorskin manufacturing plant to replace Towanda's production. And, JELD-WEN is equipped to do that because it has extensive experience building such plants. However, that option would require considerable time and resources. The record shows that JELD-WEN would need at least two

to two and a half years, more likely longer, to complete the project. The cost to JELD-WEN has been estimated to be between [ ] to set up a facility with production lines similar to Towanda's. That is a very wide range and thus is quite imprecise.

In sum, the Court finds that divestiture of Towanda would have significant, but not well-documented, consequences for JELD-WEN. However, nothing in the record permits the Court to conclude that divestiture would create the “disaster” that JELD-WEN's counsel urge the Court to find.

The record shows that limitations on JELD-WEN's total production capacity could have several collateral consequences. For instance, JELD-WEN has long-term doorskin supply agreements with several door customers. One of those contracts, with a U.K.-based company called Howdens, provides for certain penalties if JELD-WEN cannot meet Howden's supply needs, with the precise consequences dependent on the size and frequency of the failure. See DX-943 §§ 3.3, 5.13. However, JELD-WEN's obligations with respect to those penalties are subject to a force majeure clause,<sup>13</sup> see id. § 22, which might apply to capacity reductions because of a divestiture order. See id. § 1.1, at 7. Although Howdens is a foreign customer that is supplied primarily by JELD-WEN U.K. and JELD-WEN Europe, see DX-943 § 3.3, JELD-WEN's contracts with domestic customers like The Home Depot and Lowe's contain similar provisions.

<sup>13</sup> JELD-WEN's assertion to the contrary is mistaken. See Def. FOF ¶ 190. The contract states that the force majeure provision applies “[w]ithout prejudice to clauses 5.10 to 5.16”—that is, including the cited penalty provision for delivery failures. DX-943 § 22; see also id. § 5.13.

In addition, JELD-WEN argues that both its internal and external customers would have to deal with higher doorskin prices and a less streamlined purchasing process. Reduced doorskin capacity, says JELD-WEN, would force JELD-WEN to raise its prices where permitted. Whether that would, or could, be done with a competitive \*647 Towanda as a supplier was not addressed by JELD-WEN's witness.

Furthermore, if JELD-WEN's legacy plants cannot produce all of Towanda's SKUs, customers who previously received doorskins made only at Towanda would need to purchase from both Towanda and JELD-WEN (or another supplier).

And, JELD-WEN projects that losing its external volume altogether would cause it to lose almost [ ] of revenue and [ ] in EBITDA. Finally, says JELD-WEN, its internal customers—its own door plants—would lose earnings without Towanda because they would lack the doorskins needed to make the current volume of doors. That loss is projected to be roughly [ ] decrease in JELD-WEN's EBITDA.

The Court is concerned that the foregoing figures were belatedly cobbled together for the Remedies Hearing and were not produced during discovery so that they could be tested. And, although the Court rejected Steves' motion to exclude this evidence from consideration in the remedies phase of the case, it is not the sort of evidence in which the Court can place much confidence. That said, the record shows that divestiture, if ordered, would result in some not insignificant collateral consequences.

Finally, says JELD-WEN, Towanda's purchase price in a divestiture auction sale would likely not capture Towanda's full value to JELD-WEN. JELD-WEN offered the opinion of its CFO that Towanda's current enterprise value<sup>14</sup> is approximately nine times its EBITDA. By applying that multiplier to Towanda's 2017 EBITDA of [ ], JELD-WEN contends that the plant's enterprise value is around [ ]. That number, says JELD-WEN, is the minimum a purchaser would have to pay JELD-WEN in recognition of Towanda's worth. According to JELD-WEN, a divestiture sale is unlikely to yield this price.

<sup>14</sup> Enterprise value assesses how the stock market values an entity, taking into account the entity's market capitalization and its net debt.

Whether that multiplier (and hence the asserted enterprise value) is appropriate here is not a matter that has been supported by economic evidence. It is, at best, an unresearched, undocumented ball park figure. Nonetheless, as Shapiro testified, a forced sale always contains some “presumed detriments” for the seller. Id. at 808:16-21. There is nothing in the record to suggest otherwise here. However, it is both premature and improvident to conclude that a post-appeals bidding process would not yield a fair price for Towanda as it exists today. That assessment cannot, and should not, be made until there are bids made after the appellate process is ended and future buyers have a clear picture that they will not be engaged in a futile activity. But, the record is sufficient to find that Towanda, including its doorskin business, as well as the MiraTEC and Extira

businesses, have value which potential buyers will recognize when it is clear whether divestiture is an appropriate legal remedy.

The jury findings and the foregoing factual findings made by the Court provide the framework for the legal analysis of Steves' request for equitable remedies. The legal analysis reflects additional factual findings that are most appropriately made in context of the specific legal issues to which those additional findings relate.

## II. LEGAL ANALYSIS AND CONCLUSIONS

The most significant form of requested relief is divestiture. It will be assessed first. Then, the opinion will consider the so-called “conduct” remedies sought by Steves.

### \*648 A. Steves' Request for Divestiture

#### 1. Legal Standard

[1] Section 16 of the Clayton Act allows private parties to obtain injunctive relief “against threatened loss or damage by a violation of the antitrust laws.” 15 U.S.C. § 26. This injunctive relief may include an order requiring the acquiring company to divest the assets of the acquired firm. [California v. Am. Stores](#), 495 U.S. 271, 295, 110 S.Ct. 1853, 109 L.Ed.2d 240 (1990).

Given the lack of authority from private suits based on Section 7 of the Clayton Act that have reached the divestiture issue, the decisional law respecting the standard for injunctive relief must come mostly from decisions in cases brought by the Government under Section 15. That provision allows the Government to institute proceedings “to prevent and restrain violations of [the Clayton] Act.” 15 U.S.C. § 25. Notwithstanding the semantic difference between Sections 15 and 16, those provisions offer largely the same (and possibly identical) remedies. See [Am. Stores](#), 495 U.S. at 281-82, 110 S.Ct. 1853.

[2] [3] Whoever brings suit, the Government or private party, “[t]he relief in an antitrust case must be ‘effective to redress the violations’ and ‘to restore competition.’” [Ford Motor Co. v. United States](#), 405 U.S. 562, 573, 92 S.Ct. 1142, 31 L.Ed.2d 492 (1972) (quoting [United States v. E. I. du Pont de Nemours & Co.](#), 366 U.S. 316, 326, 81 S.Ct. 1243, 6 L.Ed.2d 318 (1961)); see also [United States v. U.S. Gypsum Co.](#), 340 U.S. 76, 88, 71 S.Ct. 160, 95 L.Ed. 89

(1950) (an antitrust remedy must, “so far as practicable, cure the ill effects of the illegal conduct, and assure the public freedom from its continuance”). “Mergers come in a wide variety of shapes and sizes,” so the remedy awarded should be “carefully tailored to the competitive harm” in the case. U.S. Dep't of Justice, [Antitrust Division Policy Guide to Merger Remedies](#) § I(A) (2011) (“[Merger Remedies Guide](#)”). District courts are thus “clothed with large discretion to fit the decree to the special needs of the individual case.” [Ford](#), 405 U.S. at 573, 92 S.Ct. 1142 (internal quotations omitted); see also [Zenith Radio Corp. v. Hazeltine Research, Inc.](#), 395 U.S. 100, 131, 89 S.Ct. 1562, 23 L.Ed.2d 129 (1969) (“Section 16 should be construed and applied ... with the knowledge that the remedy it affords, like other equitable remedies, is flexible and capable of nice ‘adjustment and reconciliation between the public interest and private needs as well as between competing private claims.’ ” (quoting [Hecht Co. v. Bowles](#), 321 U.S. 321, 329–330, 64 S.Ct. 587, 88 L.Ed. 754 (1944))).

[4] [5] The “most drastic, but most effective, of antitrust remedies” is divestiture. [E.I. du Pont](#), 366 U.S. at 326, 81 S.Ct. 1243, but complete divestiture is “the remedy best suited to redress the ills of a competitive merger.” [Am. Stores](#), 495 U.S. at 285, 110 S.Ct. 1853; see also [Ford](#), 405 U.S. at 573, 92 S.Ct. 1142. For this reason, the DOJ seeks divestiture in “the vast majority of cases” like this one. [Merger Remedies Guide](#) § I(B)(1). Moreover, “[t]he relief which can be afforded [under Section 15] ... is not limited to the restoration of the status quo ante” in the pre-acquisition market. [Ford](#), 405 U.S. at 573 n.8, 92 S.Ct. 1142; cf. [U.S. Gypsum](#), 340 U.S. at 89, 71 S.Ct. 160 (equitable remedy for Sherman Act violation can affect “[legal] practices connected with acts actually found to be illegal,” so that defendants are “denied future benefits from their forbidden conduct”). Consequently, divestiture may extend to assets that were unrelated to the antitrust violation if the divested entity would need those assets to become competitive, or if the integration of legally- and illegally-acquired assets makes their \*649 separation impossible. See [Utah Pub. Serv. Comm'n v. El Paso Nat. Gas Co.](#), 395 U.S. 464, 469, 89 S.Ct. 1860, 23 L.Ed.2d 474 (1969) (approving equal division between defendant and divested entity of gas reserves developed post-merger); [Polypore Int'l, Inc. v. FTC](#), 686 F.3d 1208, 1218-19 (11th Cir. 2012) (affirming FTC's inclusion of a foreign plant in divestiture order because it “needed to be divested to restore the competition eliminated by the acquisition and provide the acquirer with the ability to compete”); see also Malcolm R. Pfunder et al., [Compliance with Divestiture Orders under Section 7 of the Clayton Act: An Analysis of the Relief Obtained](#), 17 [Antitrust Bull.](#) 19,

56-67 (1972) (detailing approaches to identifying divestiture assets).

[6] [7] Structural remedies like divestiture also can be coupled with—or replaced entirely by—conduct remedies that can “preserve a merger’s ... efficiencies” and limit anticompetitive conduct at the same time. Merger Remedies Guide § II. “Conduct relief can be a particularly effective option when a structural remedy would eliminate the merger’s potential efficiencies, but, absent a remedy, the merger would harm competition.” *Id.*; see also In re Evanston Nw. Healthcare Corp., 144 F.T.C. 1, 520 (2007). However, “conduct remedies risk excessive government entanglement in the market,” Saint Alphonsus Med. Ctr.-Nampa Inc. v. St. Luke’s Health Sys., Ltd., 778 F.3d 775, 793 (9th Cir. 2015), so they should be “tailored as precisely as possible to the competitive harms associated with the merger.” Merger Remedies Guide § II n.12. This approach is consistent with the general need for courts considering divestiture to avoid “impos[ing] sanctions ... which ultimately create economic havoc” in industries in which courts are not “well-versed.” 5 Earl W. Kintner et al., Federal Antitrust Law § 40.9 (2017).

At the same time, courts have observed that divestiture is an “‘extreme remedy.’” Taleff v. Sw. Airlines Co., 828 F.Supp.2d 1118, 1122 (N.D. Cal. 2011), *aff’d*, 554 F. App’x 598 (9th Cir. 2014) (quoting Broadcom Corp. v. Qualcomm Inc., 501 F.3d 297, 322 (3d Cir. 2007) ). It also has some drawbacks. One antitrust treatise highlights three particular problems:

By and large, spinoffs of established businesses or subsidiaries are far more successful than the creation of new ones. Second, the merging firms have every incentive to make the divestiture work poorly, particularly if it calls for the creation of a competitive firm. Third, buyers who are not competitors or are not established in the business may start out at a very considerable disadvantage, which sometimes later proves fatal.

9G Phillip E. Areeda & Herbert Hovenkamp, Antitrust Law ¶ 990c2 (4th ed. 2016) (footnotes omitted); see also 5 Kintner et al., supra, § 40.12 (listing “potential hazards of divestiture”).

[8] [9] [10] [11] [12] Divestiture also operates somewhat differently in private suits. The Supreme Court has explicitly noted that a district court’s ability to order divestiture does not “mean that such power should be exercised in every situation in which the Government would be entitled to such relief under [Section] 15.” Am. Stores, 495 U.S. at 295, 110 S.Ct. 1853. Also, Section 16 requires a plaintiff to establish standing to seek injunctive relief, and a defendant can rely on equitable defenses and other equitable considerations to avoid divestiture. *Id.* at 295-96, 110 S.Ct. 1853. And, in government actions, “the proof of the violation of law may itself establish sufficient public injury to warrant relief.” *Id.* at 295, 110 S.Ct. 1853. Thus, it is no surprise that, in cases brought by the government, \*650 Courts have viewed divestiture as “simple, relatively easy to administer, and sure,” E.I. du Pont, 366 U.S. at 331, 81 S.Ct. 1243, because hardships do not need to be balanced nor the public interest assessed in the same way as in Section 16 cases. See Ford, 405 U.S. at 575, 92 S.Ct. 1142 (“[O]nce the Government has successfully borne the considerable burden of establishing a violation of law, all doubts as to the remedy are to be resolved in its favor.” (quoting E.I. du Pont, 366 U.S. at 334, 81 S.Ct. 1243) ); El Paso Nat. Gas, 395 U.S. at 472, 89 S.Ct. 1860 (“[T]he pinch on private interests is not relevant to fashioning an antitrust decree, as the public interest is our sole concern.”); E.I. du Pont, 366 U.S. at 326, 81 S.Ct. 1243 (“[C]ourts are authorized, indeed required, to decree relief effective to redress the violations, whatever the adverse effect of such a decree on private interests.”). These differences do not make those precedents inapposite, but they do caution that, in a private action, divestiture is not as easy a remedy as it is in a government action.

It is also true that scholars have expressed doubt about the wisdom of divestiture under Section 16. Indeed, according to one treatise, “private divestiture is to be avoided when other injunctive relief is effective” because “courts are in agreement that divestiture should be applied in a relatively limited number of private suits due to the wide-ranging repercussions of such action, and the possible adverse effect on interests of those who are not parties to the antitrust violation.” 5 Kintner et al., supra, § 40.32 (citing, *inter alia*, Burkhead v. Phillips Petroleum Co., 308 F.Supp. 120, 127 (N.D. Cal. 1970) (“[D]ivestiture would appear to be appropriate only in a limited number of cases where no other form of preventative relief would suffice ....”); Schrader v. Nat’l Screen Serv. Corp., 1955 Trade Cas. ¶ 68,217, at 71,009 (E.D. Pa. 1955) (“[C]onsiderations of policy are against decreeing divestiture or the complete destruction of a



nationwide business at the suit of an individual in a private action under the antitrust laws ....”); cf. [Blue Cross & Blue Shield United of Wis. v. Marshfield Clinic](#), 883 F.Supp. 1247, 1264 (W.D. Wis. 1995), *aff'd in part, rev'd in part on other grounds*, 65 F.3d 1406 (7th Cir. 1995) (“It is questionable whether divestiture of a long completed transaction is an appropriate remedy in a private action under the Sherman Act.”). Similarly, Areeda and Hovenkamp take the view that “the Government’s recommendation of divestiture deserves far more weight than a similar request from other litigants.” 3D Areeda & Hovenkamp, *supra*, ¶ 326b. Because divestiture can have “far-reaching effects on persons who are not parties to the litigation” and “can affect the viability of otherwise profitable companies, the status of preexisting contracts, and the fortunes of rivals,” they recommend taking “great care” before ordering divestiture in private actions. *Id.*

[13] [American Stores](#), to some extent, has changed the Clayton Act landscape because most of the foregoing cases were decided and since the foregoing views were expressed by commentators. Nonetheless, the concerns expressed in the pre-[American Store](#) cases and comments teach that courts must rely on the facts of each case to decide whether divestiture is an appropriate remedy and that courts should resort to it in limited circumstances.

[14] [15] [16] [17] That said, it is still true that divestiture should be ordered when it is the most effective way of restoring the substantially lessened competition brought about by the merger at issue and where its collateral consequences can be mitigated. And, the appropriate remedy should be selected upon “determining (a) what competitive harm the violation has caused or likely will cause and (b) how the proposed relief will remedy that particular competitive harm.” [Merger Remedies Guide](#) § I(A). Moreover, that remedy should be “calculated to minimize adverse economic effects upon the industry, the public, and the stockholders affected by the unlawful merger.... [C]aution, progressive enforcement, and remedy formulation on a case-by-case basis are essential ingredients to effectively combat the effects of an antitrust violation, and to minimize the risk of economic dislocation.” 5 Kintner et al., *supra*, § 40.9 (footnote omitted).

[18] [19] [20] These general considerations should be kept in mind when assessing whether to award divestiture or alternate injunctive relief. However, the parties agree that “well-established principles of equity” establish the framework governing requests for injunctive relief,

including divestiture, under the Clayton Act. [eBay Inc. v. MercExchange, L.L.C.](#), 547 U.S. 388, 391, 126 S.Ct. 1837, 164 L.Ed.2d 641 (2006); see also [Am. Stores](#), 495 U.S. at 285, 110 S.Ct. 1853 (Section 16 permits divestiture only “when appropriate in light of equitable principles”). Under that approach,

a plaintiff ... must satisfy a four-factor test before a court may grant such relief. A plaintiff must demonstrate: (1) that it has suffered an irreparable injury; (2) that remedies available at law, such as monetary damages, are inadequate to compensate for that injury; (3) that, considering the balance of hardships between the plaintiff and defendant, a remedy in equity is warranted; and (4) that the public interest would not be disserved by a permanent injunction.

[eBay](#), 547 U.S. at 391, 126 S.Ct. 1837 (emphasis added).<sup>15</sup>

Even where those factors are met, district courts still retain “equitable discretion” to grant or deny permanent injunctive relief. *Id.*

<sup>15</sup> Although [eBay](#) applied that test to the Patent Act, the Supreme Court’s concluding statement that such discretion also extends to “other cases governed by such standards” makes clear that the test applies in other cases arising under federal statutes. [E.I. DuPont de Nemours & Co. v. Kolon Indus., Inc.](#), 894 F.Supp.2d 691, 697 (E.D. Va. 2012) (citing [eBay](#), 547 U.S. at 394, 126 S.Ct. 1837).

## 2. Section 16 Standing

[21] Before considering the [eBay](#) factors, the Court must assess whether Steves has standing to seek divestiture. “[I]n order to seek injunctive relief under [Section] 16, a private plaintiff must allege threatened loss or damage ‘of the type the antitrust laws were designed to prevent and that flows from that which makes defendants’ acts unlawful.’ ” [Cargill, Inc. v. Monfort of Colo., Inc.](#), 479 U.S. 104, 113, 107 S.Ct. 484, 93 L.Ed.2d 427 (1986) (quoting [Brunswick](#)

[Corp. v. Pueblo Bowl-O-Mat, Inc.](#), 429 U.S. 477, 489, 97 S.Ct. 690, 50 L.Ed.2d 701 (1977) ). In other words, Steves must be able to demonstrate “a significant threat of injury from an impending violation of the antitrust laws or from a contemporary violation likely to continue or recur.” [Zenith Radio](#), 395 U.S. at 130, 89 S.Ct. 1562.

[22] Steves contends that the likely loss of its business when the Supply Agreement expires in September 2021 gives it standing here. This “threatened loss” is linked to an antitrust injury that has already occurred: JELD-WEN’s termination of the Supply Agreement in September 2014, which was enabled by its increased market power after the CMI Acquisition. See Summary Judgment Op. at 30-31. JELD-WEN disagrees that Steves will go out of business when the \*652 Supply Agreement ends. See Def. Post-Remedies Equitable Br. (ECF No. 1652) (Under Seal) at 25-27 (discussing issue in context of irreparable harm). If JELD-WEN is correct, then Steves would need to identify other threatened antitrust loss or damage to support its request for divestiture.

[23] If JELD-WEN is asserting that Steves lacks standing because it will not go out of business in September 2021, that argument is unpersuasive. Steves’ Section 7 claim sought both legal and equitable relief, and the Seventh Amendment entitled Steves to a jury trial on “all issues common to both claims.” [Davis v. Amphill Rayon Workers, Inc.](#), 446 F.Supp. 681, 683 (E.D. Va. 1978), *aff’d*, 594 F.2d 856 (4th Cir. 1979) (citing [Beacon Theatres, Inc. v. Westover](#), 359 U.S. 500, 510-11, 79 S.Ct. 948, 3 L.Ed.2d 988 (1959) ). “[A] jury verdict in such mixed law-equity cases is binding on the court as to all matters in law and as to all matters in equity where the facts found are common to the law and equity issues.” *Id.* (citing [Dairy Queen v. Wood](#), 369 U.S. 469, 479, 82 S.Ct. 894, 8 L.Ed.2d 44 (1962) ); see also [Bresler v. Wilmington Tr. Co.](#), No. CIV. PJM 09-2957, 2015 WL 1402377, at \*22 (D. Md. Mar. 25, 2015), *amended in part*, 2015 WL 4385994 (D. Md. July 10, 2015) (“ [W]here claims at law and in equity are joined and the legal claims are tried separately by a jury, the jury’s verdict operates as a finding of fact binding on the trial court in its determination of the equitable claims.” (quoting [Dybczak v. Tuskegee Inst.](#), 737 F.2d 1524, 1526-27 (11th Cir. 1984) ) ); [Int’l Wood Processors v. Power Dry, Inc.](#), 593 F.Supp. 710, 737 (D.S.C. 1984), *aff’d*, 792 F.2d 416 (4th Cir. 1986) (“The court is ... bound by the jury verdict on its subsequent ruling on the equitable claims under the doctrine of collateral estoppel.”).

Here, the Court instructed the jury that Steves’ request for future lost profits was based on the claim that Steves “was harmed because, as a result of JELD-WEN’s alleged antitrust violation, Steves will be unable to maintain a viable interior molded door manufacturing business when the contract between Steves and JELD-WEN terminates on September 10, 2021, and will therefore be unable to exist as a company.” The Court further instructed the jury that it “must consider any factors that could affect the future success of Steves’ business and any other factors affecting Steves’ future performance.” Jury Instructions (ECF No. 1025), Instruction No. 35. After receiving these instructions, the jury awarded Steves damages for future lost profits. Verdict Form ¶ 3(b). Any factual determinations that were necessary to award these damages are binding on the Court.

To show that Steves will not go out of business, JELD-WEN relies on evidence suggesting that it might continue to sell doorskins to Steves after the Supply Agreement expires; that, without JELD-WEN, Steves can satisfy its doorskin needs through domestic or foreign suppliers like Masonite, Kastamonu, or Teverpan; and that Steves could build its own doorskin manufacturing plant to replace the lost volume from JELD-WEN. But JELD-WEN presented virtually the same evidence to the jury at trial. The jury could not have awarded future lost profits without considering and rejecting that evidence, which is essential to an issue the jury was required to consider—“the future success of Steves’ business and any other factors affecting Steves’ future performance.” Instead, the jury must have decided that Steves will go out of business because Steves cannot find any viable alternative means of doorskin supply. Furthermore, nothing from the Remedies Hearing or the trade secrets trial renders this jury’s conclusions \*653 improper or unreliable.<sup>16</sup> Consequently, JELD-WEN’s position about the likelihood of Steves going out of business is foreclosed by the verdict.

<sup>16</sup> The parties dispute whether the Court may rely on the record in the trade secrets trial to help resolve the divestiture issue. See Aug. 2 Tr. (ECF No. 1751) at 90:15-91:20, 203:18-206:10. Assuming, without deciding, that the Court can, that record does not establish that Steves can prevent going out of business by building a doorskin plant by September 2021. At best, the evidence at the trade secrets trial indicates that Steves has preliminarily concluded that building a doorskin plant is not feasible, but is continuing to investigate the possibility of doing

so. That is no different than what the evidence at the antitrust trial showed. See Def. FOF ¶¶ 265-78.

Moreover, given the factual overlay between the legal and equitable relief, the Court finds, by a preponderance of the evidence, that it is not likely that JELD-WEN will continue to supply Steves with doorskins after the Supply Agreement terminates. Indeed, part of JELD-WEN's pricing plan was to kill off some of the independent door makers that were its doorskin customers. And, the Court finds that JELD-WEN's conduct toward Steves (demanding price increases two years after the Supply Agreement was executed even though costs had decreased, engaging in evasive, sharp, and deceptive conduct over the calculation of input costs under Section 6 of the Supply Agreement, and in its general bullying conduct toward Steves) shows that JELD-WEN regarded Steves, a significant player in the interior door market, to be an independent to be killed off.

Further, the Court, as finder of the fact in the remedies phase of the case, finds that Steves has proved that, absent equitable relief, it will be forced out of business when the Supply Agreement terminates in 2021 (See Section II.A.3.(a), *infra*). And, as found above, JELD-WEN is still engaging in the conduct that led the jury to conclude that the merger had substantially lessened competition and that had caused Steves antitrust injury.

In sum, for the foregoing reasons, Steves has standing to seek injunctive relief under Section 16 that would remedy the threatened loss, and damage presented by the merger.

### 3. Equitable Factors Analysis

#### (a) Irreparable Injury & Absence of Adequate Remedy at Law

[24] [25] To obtain equitable relief in the form of an injunction here, and an order mandating divestiture and conduct remedies, Steves must prove that, absent such relief, it will suffer irreparable injury. Generally, “ ‘[i]rreparable injury is suffered when monetary damages are difficult to ascertain or are inadequate.’ ” [Handsome Brook Farm, LLC v. Humane Farm Animal Care, Inc.](#), 193 F.Supp.3d 556, 574 (E.D. Va. 2016) (quoting [Multi-Channel TV Cable Co. v. Charlottesville Quality Cable Operating Co.](#), 22 F.3d 546, 551 (4th Cir. 1994) ). Whether a plaintiff has an adequate remedy at law “inevitably overlaps” with whether it has suffered

irreparable harm. [MercExchange L.L.C. v. eBay, Inc.](#), 500 F.Supp.2d 556, 582 (E.D. Va. 2007).

Most courts to have confronted the question have found that the permanent loss of a business constitutes irreparable injury. See, e.g., [Warren v. City of Athens](#), 411 F.3d 697, 711 (6th Cir. 2005) (“financial ruin” that would happen without injunction is irreparable injury); [Am. Passage Media Corp. v. Cass Commc'ns, Inc.](#), 750 F.2d 1470, 1474 (9th Cir. 1985) (“The threat of being driven out of business is sufficient to establish irreparable harm.”). This is particularly true where a company has operated \*654 as a family business for a substantial period of time. Judge Friendly recognized long ago that “the right to continue a business in which [a father] had engaged for twenty years and into which his son had recently entered is not measurable entirely in monetary terms” because “the [family] want[s] to sell automobiles, not to live on the income from a damages award.” [Semmes Motors, Inc. v. Ford Motor Co.](#), 429 F.2d 1197, 1205 (2d Cir. 1970). This “seminal decision” has been cited often, including by the Fourth Circuit. [Auto. Elec. Serv. Corp. v. Ass'n of Auto. Aftermarket Distribs.](#), 747 F.Supp. 1483, 1514 (E.D.N.Y. 1990) (“This is not a case of mere lost profits, but rather the basic existence of a seventy year old business may be threatened.”); see also [Tom Doherty Assocs., Inc. v. Saban Entm't, Inc.](#), 60 F.3d 27, 38 (2d Cir. 1995) (threat to “the very viability of the plaintiff's business” is irreparable injury); [Wells Am. Corp. v. Ziff-Davis Pub. Co.](#), 900 F.2d 258, 1990 WL 33532, at \*2 (4th Cir. 1990) (“harm to plaintiffs' [sic] goodwill, its business reputation, business opportunities, or its continued existence” may be irreparable); [Roso-Lino Beverage Distribs., Inc. v. Coca-Cola Bottling Co. of N.Y.](#), 749 F.2d 124, 125–26 (2d Cir. 1984) (“The loss of [plaintiff]'s distributorship, an ongoing business representing many years of effort and the livelihood of its husband and wife owners, constitutes irreparable harm.”); [Fed. Leasing, Inc. v. Underwriters at Lloyd's](#), 650 F.2d 495, 500 (4th Cir. 1981) (plaintiff showed irreparable harm where it “s[ought] to preserve its existence and its business”).

There is no reason for the Court to deviate from that majority approach here. The termination of a plaintiff's business might not constitute irreparable harm if the entity has only been in business for a “short period of time,” [DFW Metro Line Servs. v. Sw. Bell Tel. Co.](#), 901 F.2d 1267, 1269 (5th Cir. 1990) (per curiam); see also [HCI Techs., Inc. v. Avaya, Inc.](#), 446 F.Supp.2d 518, 521 (E.D. Va. 2006) (citing [DFW Metro](#) in dicta), or if that injury could be fully remedied by money damages, see [Hardin v. Houston Chronicle Pub. Co.](#), 426 F.Supp. 1114, 1117-18 (S.D. Tex. 1977), *aff'd*, 572 F.2d 1106

(5th Cir. 1978); [Lamarca v. Miami Herald Publ'g Co.](#), 395 F.Supp. 324, 328 (S.D. Fla. 1975), [aff'd](#), 524 F.2d 1230 (5th Cir. 1975). But, Steves has been in business for more than 150 years, making the 1.5-year existence of the plaintiff in [DFW Metro](#) seem fleeting in comparison. 901 F.2d at 1269 n.7. In addition, as in several of the cases described above, there is independent value to continuing Steves as a family operation: Edward and Sam Steves described at the Remedies Hearing their family's deep connection with Steves' business, in which their children have begun to continue and, neither [Hardin](#) or [Lamarca](#) involved the facts that Steves has proved in this case.

[26] JELD-WEN tries to distinguish [Semmes Motors](#) and subsequent cases in three ways. First, it argues that Steves' business is not at risk because it has several viable doorskin supply alternatives when the Supply Agreement terminates. This line of reasoning has been addressed in connection with Steves' Section 16 standing. [See supra](#) Section I.A.2. In sum, the Court finds, as did the jury, that, after 2021, purchases from JELD-WEN, Masonite, or foreign suppliers do not provide viable alternative supplies of doorskins in the quantity and quality required by Steves. Indeed, it is disingenuous of JELD-WEN to suggest that Steves can turn to foreign suppliers when JELD-WEN itself will not do so. Further, as set out in Section II.B.6 above, the Court finds that building a doorskin plant of its own is \*655 not a viable alternative way to supply Steves' doorskin needs after 2021.<sup>17</sup>

<sup>17</sup> JELD-WEN's claim that Steves should be held accountable here for delaying its efforts to build a doorskin plant is unpersuasive, especially where that factor did not affect the jury's future lost profits award. Intentionally engaging in conduct that contributes to an irreparable injury may undermine a plaintiff's irreparable harm showing. [See Cone v. Randolph Cty. Schs. Bd. of Educ.](#), No. 1:06CV00579, 2006 WL 3000445, at \*5, \*7 (M.D.N.C. Oct. 20, 2006) (child's loss of educational services was not irreparable injury, in part because it was caused by parents' intentional obstruction of school placement plan). However, the minimal, and unpersuasive, evidence cited by JELD-WEN does not establish that Steves ceased efforts to build a doorskin plant in order to improve its position in this litigation. Moreover, the record shows that Steves would not have made any notable progress towards building a plant had it devoted its full attention during these proceedings to finding

a manufacturing partner. Steves' irreparable injury thus cannot be traced back to its decision to stop negotiations with manufacturing partners. In any event, the record shows that Steves simply cannot afford to build its own doorskin plant so JELD-WEN's position is academic at best.

Second, JELD-WEN argues that Steves' claimed injury is merely harm to members of the Steves family, which does not justify permanent injunctive relief for Steves. But the only two cases that JELD-WEN cites in support, [Moody v. Michigan Gaming Control Board](#), No. 12-CV-13593, 2013 WL 1664380 (E.D. Mich. Apr. 17, 2013) and [Law v. National Collegiate Athletic Association](#), No. 94-2053-KHV, 1996 WL 104328 (D. Kan. Jan. 5, 1996), are distinguishable. In [Moody](#), the only harm underlying the plaintiff's emergency preliminary injunction motion was his nephew's and son's inability to obtain their harness racing training licenses—an injury not suffered by the plaintiff, whose occupational license had been suspended. 2013 WL 1664380, at \*1-2. Similarly, in [Law](#), the plaintiff coaches sought a classwide injunction under the Clayton Act to prevent the NCAA from enforcing a restricted earnings rule against any coach. However, each named plaintiff had to demonstrate a threat of antitrust injury because the class had not been certified, and just two were employed under the rule in question. As a result, those two coaches could seek injunctive relief only for themselves, not for the whole class. [See Law](#), 1996 WL 104328, at \*3-4.

Steves, on the other hand, is not seeking divestiture to remedy some harm suffered by individuals in the Steves family rather than Steves itself. Instead, Steves' irreparable injury is the loss of its business. That the business also has a family character is relevant to the irreparable injury analysis. [See Semmes Motors](#), 429 F.2d at 1205; [Auto. Elec. Serv.](#), 747 F.Supp. at 1514. [Moody](#) and [Law](#) might be applicable if Steves had only identified as an irreparable injury the effect of the loss of Steves' business on, for instance, Edward and Sam Steves, but Steves has not made that claim here. Accordingly, the references to the Steves family in Steves' papers do not lessen the irreparable nature of the company's antitrust injury.

[27] Finally, JELD-WEN insists that [Semmes Motors](#) and its progeny, most of which deal with preliminary injunctions, are meaningless where, as here, a plaintiff has obtained future lost profits damages. To obtain equitable relief, a plaintiff must show that its harm cannot be compensated by money damages. [Dairy Queen](#), 369 U.S. at 478, 82 S.Ct. 894; [Hughes Network Sys., Inc. v. InterDigital Commc'ns Corp.](#),



17 F.3d 691, 694 (4th Cir. 1994). Tucker, however, told the jury that his lost profits calculation was a “reasonable,” “conservative,” and non-speculative estimate of Steves' future harm. As Tucker proposed, \*656 the jury awarded damages of \$46,480,581 in loss profits. Trebling that part of the award under the Clayton Act yields total future lost profit damages of around \$139 million. See 15 U.S.C. § 15(a).<sup>18</sup> In JELD-WEN's view, Steves' “strategic decision to calculate its future harm in money damages” at trial precludes it from now claiming that those damages are inadequate. Def. Post-Remedies Equitable Br. at 24.

18 There were other antitrust damages that also were trebled. Those that survived judgment as a matter of law also will be trebled.

[28] A plaintiff's presentation of a future damages number may influence the irreparable injury and legal remedy inadequacy analysis. In SAS Institute, Inc. v. World Programming Ltd., 874 F.3d 370 (4th Cir. 2017), the plaintiff sought and received damages for lost profits, almost half of which was based on expected future losses. The court rejected the plaintiff's request for permanent injunctive relief because it found that the “fact that [the plaintiff] already asked for and received these future damages undermines its claim of irreparable injury moving forward.” Id. at 386. Likewise, in International Wood Processors, the court determined that the plaintiff had an adequate remedy at law because it “requested and received prospective damages” at trial, and under its own damages theory, could “suffer no further future harm” after receiving future lost profits damages. 593 F.Supp. at 737. And, in Taleff, the court denied plaintiff's request for a post-merger divestiture order under Section 16 because the only alleged harm was “expressed in terms of monetary damages.” 828 F.Supp.2d at 1123. Thus, the plaintiff had not shown that legal remedies would be inadequate.

[29] [30] Nonetheless, a plaintiff is not prohibited from seeking alternate injunctive relief merely because it tries to quantify its future harm in front of the jury. The purpose of the Remedies Hearing was, in part, to allow Steves to present further evidence about the inadequacy of its future lost profits award. See Order (ECF No. 1127) at 2.<sup>19</sup> Steves then put on compelling evidence of the incalculable value of its business, which the Court (like the jury) finds would not survive without injunctive relief restoring competition. None of the cases cited by JELD-WEN involved this same sort of loss. See SAS Inst., 874 F.3d at 386 (“[Plaintiff]'s claims of difficult-to-calculate damages in the form of lost business relationships,

market share, and goodwill were largely unsupported by evidence.”); Taleff, 828 F.Supp.2d at 1123 n.7 (plaintiff alleged harm in terms of higher ticket prices and less cost-effective service); Int'l Wood Processors, 593 F.Supp. at 737 (plaintiff would “suffer no further future harm” after receiving future lost profits). And, Steves has consistently asserted that JELD-WEN's Section 7 violation threatens the very existence of its business, so its current position \*657 cannot be characterized as some sort of opportunistic about-face. Consequently, Steves' representations to the jury do not prevent it from arguing here that future lost profits damages are inadequate.

19 JELD-WEN continues to assert that Steves' quantification of damages must have been an election of legal over equitable remedies. But this wrongly assumes that Steves was required to make an election at some point before now. “Generally, a party is not required to elect between inconsistent remedies or rights or theories of recovery during the trial or at the pleading stage or prior to the jury's verdict; election is generally made after the verdict is entered prior to the entry of judgment.” 28A C.J.S. Election of Remedies § 6 (2018). In any event, “a decision as to the time of election rests within the sound discretion of the trial court.” Id.; see also Rahemtulla v. Hassam, No. CIV.A.3:05-0198, 2008 WL 2247195, at \*1 (M.D. Pa. May 30, 2008) (collecting cases). Further, the cases present the so-called “election of remedies” issue as a question of how to preclude double recovery and how to proceed with entry of judgment where the principles of Brown Shoe Co. operate as they do under the facts of this case.

[31] The Court finds that, with an adequate supply of doorskins, Steves would, as it has for 150 years, continue in business and prosper. There is nothing in the record to suggest otherwise. The lost profits award would not provide a supply of doorskins. Rather, the Steves shareholders would, like the Semmes family, just live off of the damages award, a choice which, as explained in Semmes, it does not have to make. Were it otherwise, well-heeled companies, like JELD-WEN, would never have to face the undoing of an illegal merger but, instead, could simply pay the damages and finance their way out of the violation of the Clayton Act, leaving in place a merger that has been proved to have substantially lessened competition.

For these reasons, JELD-WEN's arguments fall short, and Steves has shown that the likely, if not certain, loss of its business is an irreparable injury that cannot be adequately remedied by the future lost profits damages it has been awarded.<sup>20</sup>

<sup>20</sup> Steves has agreed that it is not entitled to both remedies.

### (b) Balance of Hardships

[32] Under the third [eBay](#) factor, “courts ‘must balance the competing claims of injury and must consider the effect on each party of the granting or withholding of the requested relief.’ ” [Winter v. Nat. Res. Def. Council, Inc.](#), 555 U.S. 7, 24, 129 S.Ct. 365, 172 L.Ed.2d 249 (2008) (quoting [Amoco Prod. Co. v. Gambell](#), 480 U.S. 531, 542, 107 S.Ct. 1396, 94 L.Ed.2d 542 (1987) ). Before undertaking that assessment, the Court must address Steves' assertion that the hardships claimed by JELD-WEN should be disregarded because the jury has already found that JELD-WEN violated the Clayton Act. [See](#) Pl. Post-Remedies Equitable Br. (ECF No. 1606) (Under Seal) at 20 (divestiture is appropriate even if it entails “harsh consequences” for JELD-WEN). That argument necessarily affects the weight given to JELD-WEN's harms.

[33] Steves cites three cases in support of its position, including [E.I. du Pont](#) and [El Paso Natural Gas](#). [See El Paso Nat. Gas](#), 395 U.S. at 472, 89 S.Ct. 1860 (“[T]he pinch on private interests is not relevant to fashioning an antitrust decree, as the public interest is our sole concern.”); [E.I. du Pont](#), 366 U.S. at 326, 81 S.Ct. 1243 (“[C]ourts are authorized, indeed required, to decree relief effective to redress the violations, whatever the adverse effect of such a decree on private interests.”). But Steves' reliance on those cases is misplaced. As noted above, in those cases, the Supreme Court was discussing divestiture in the context of Government actions, which, unlike Section 16 suits, do not implicate private hardships. The third case cited similarly involves an FTC enforcement action and, more importantly, relies on [E.I. du Pont](#). [See FTC v. Whole Foods Mkt., Inc.](#), 548 F.3d 1028, 1033 (D.C. Cir. 2008) (“Even remedies which ‘entail harsh consequences’ would be appropriate to ameliorate the harm to competition from an antitrust violation.” (quoting [E.I. du Pont](#), 366 U.S. at 327, 81 S.Ct. 1243) ). Notwithstanding what Steves believes about the perfect applicability of Government cases in the Section 16 setting, the differences between

Government and private cases limit the relevance of the Government case principles on the balance of hardship factor because, in Government cases, there is no balance of hardships. [See Am. Stores](#), 495 U.S. at 295-96, 110 S.Ct. 1853; [supra](#) Section II.A.1.

\*658 [34] [35] Moreover, assigning less, or no, weight to JELD-WEN's hardships would contradict Supreme Court and Fourth Circuit precedent. Steves' argument essentially reduces a court's role to rubber-stamping divestiture based on a jury verdict finding a Section 7 violation. The Supreme Court, however, “has consistently rejected invitations to replace traditional equitable considerations with a rule that an injunction automatically follows a determination that a copyright has been infringed,” instead requiring the hardships to be balanced in every case. [eBay](#), 547 U.S. at 392-93, 126 S.Ct. 1837. The Fourth Circuit found it “impossible to square this directive with the idea that hardship to the losing party should simply be ignored,” “even in cases involving clear wrongdoing.” [SAS Inst.](#), 874 F.3d at 388. This statement echoes its earlier determination that courts may not “conclude that any harm that would be suffered by a defendant was self-inflicted and thus entitled to lesser weight in the balancing-of-the-harms portion of the preliminary injunction calculus.” [Scotts Co. v. United Indus. Corp.](#), 315 F.3d 264, 285 (4th Cir. 2002). Thus, the Court must consider JELD-WEN's hardships in assessing the balance of hardships.<sup>21</sup>

<sup>21</sup> That is not to say that [all](#) harms that JELD-WEN might allege are cognizable here. For example, loss of profits obtained through anticompetitive conduct is not a valid hardship because it is a product of doing what the antitrust laws require—that is, competing with other firms. [See New York v. Actavis, PLC](#), No. 14 CIV. 7473, 2014 WL 7015198, at \*45 (S.D.N.Y. Dec. 11, 2014), [aff'd sub nom. New York ex rel. Schneiderman v. Actavis PLC](#), 787 F.3d 638 (2d Cir. 2015); [see also Cadence Design Sys., Inc. v. Avant! Corp.](#), 125 F.3d 824, 830 (9th Cir. 1997). Yet JELD-WEN does not rely much on any such harm, and the instances where it does will be appropriately disregarded without affecting the hardship balancing.

[36] Turning then to the balancing of hardships, the Court finds that Steves will suffer irreparable injury without permanent injunctive relief. If the Court does not order an equitable remedy to restore competition, Steves will likely lose its entire business when the Supply Agreement expires.

This effect looms large in the balance of hardships. See [Buffalo Courier-Express, Inc. v. Buffalo Evening News, Inc.](#), 601 F.2d 48, 58 (2d Cir. 1979) (balance would have been “amply passed” if plaintiff had “shown a significant possibility that it would be driven out of business” by defendant’s anticompetitive actions); [Auto. Elec. Serv.](#), 747 F.Supp. at 1514 (highlighting “ruinous financial hardship” that would result if no equitable relief imposed); cf. [SAS Inst.](#), 874 F.3d at 387-88 (noting that permanent injunction “would likely be ruinous” for defendant (internal quotation marks omitted) ). Furthermore, as Steves argues, the relative impact of all the hardships cited by JELD-WEN would be less severe on JELD-WEN than the hardship that will befall Steves. JELD-WEN is a much larger business than Steves, and it is a very diversified company. And, as Steves argues, the record shows that the impact of divestiture on JELD-WEN would not be as a serious a hardship on JELD-WEN as would the loss of doorskin supply. Nevertheless, it is necessary to assess the hardship that likely will befall JELD-WEN in the event of divestiture. Of course, it is JELD-WEN’s burden to prove the hardships that it will face.

[37] JELD-WEN’s chief witness on this topic was its CFO, Brooks Mallard, who testified to numerous speculative consequences of divestiture which the Court will not consider because of their speculative nature. Nonetheless, other witnesses have testified, at least generally, about the hardship that divestiture would visit upon \*659 JELD-WEN. Chief among those are the costs associated with separating Towanda as an independent entity. JELD-WEN and CMI integrated numerous functions when they merged in 2012, and it takes time and resources to “unscramble all those eggs” now. Suppl. Interrogatory Responses at 4. Courts have found that the “obvious hardship” of splitting up entities that have “combined ... assets and operations” after a merger weighs heavily in the equitable analysis. [Ginsburg v. InBev NV/SA](#), 623 F.3d 1229, 1235-36 (8th Cir. 2010); see also [Taleff](#), 828 F.Supp.2d at 1123 & n.8. That hardship is real, but it can be reduced by divestiture conditions that, for instance, allow current Towanda employees to remain at the plant and require the new owner and JELD-WEN to work together to effectuate an orderly transition of administrative support services. But JELD-WEN would still need to spend money to effect that transition, and there is no obvious way to eliminate that expense. And, of course, “[a] long time has elapsed between the closing of the merger and the conclusion of the litigation,” and that presents “greater risks of unforeseen costs and failure.” [In re Evanston Nw. Healthcare](#), 144 F.T.C. at 521. The record does not permit quantification of those costs,

but they are present in some measure, and must be considered in the balance of hardships.

As discussed in Section I.A.9, divestiture would also affect JELD-WEN’s ability to meet its customers’ doorskin demands. As explained previously, the mix model allocates SKU production across all four of JELD-WEN’s plants, and Towanda’s Dieform line permits the manufacture of many SKUs that JELD-WEN’s legacy plants do not currently produce. Even if Steves shifts its entire doorskin volume to the divested Towanda entity (thereby freeing capacity in JELD-WEN’s plants that supply much of Steves requirements), JELD-WEN would still need to satisfy its other customers’ demands for different doorskin varieties. JELD-WEN says that it could not fully accomplish this goal by simply increasing the number of SKUs produced by its legacy plants because those plants are already running close to full production capacity. But, there is present some unquantified additional capacity. Also, JELD-WEN says that attempting to produce more SKUs would add downtime because of die changes, thereby decreasing total production capacity.

The extent of this capacity decrease is not shown by the record because JELD-WEN has not studied how it would reallocate SKUs among its legacy plants if Towanda was divested, and thus the extent of the decrease must be considered as speculative and unproven. However, the Court can still consider that there will be some shortfall and that can be considered as a hardship. See [SAS Inst.](#), 874 F.3d at 387-88 (examining hardships in general manner); [Ginsburg](#), 623 F.3d at 1235-36 (same).

JELD-WEN’s alternatives for obtaining doorskins present their own hardships. JELD-WEN’s Latvia facility only produces a few doorskin designs that are usable in the U.S. doorskin market. Other foreign suppliers do not offer as many SKUs as Towanda and, as Steves knows from experience, the quality is not consistent. But, JELD-WEN’s “disaster plan” includes supply from Latvia and foreign suppliers as short-term options. However, based on the record, the Court cannot conclude that all SKUs lost to JELD-WEN by virtue of the divestiture of Towanda could be replaced by Latvia and foreign suppliers. In contrast, also as considered on JELD-WEN’s disaster plan, restarting operation of the Marion plant would go much further in remedying JELD-WEN’s doorskin deficit. Marion has a low-volume/high-mix line that could serve a similar function to Towanda’s Dieform \*660 line, even if the total production capacity is lower. It is estimated that to restart the Marion plant would cost [ ]

because of the need to replace old equipment and comply with environmental relations. And it would take about two years to activate Marion.<sup>22</sup>

<sup>22</sup> The record teaches that building a new doorskin plant is not realistic in the short run, even with JELD-WEN's experience.

Of course, Steves' current divestiture proposal would prevent JELD-WEN from incurring any immediate deficit in doorskin supply. That proposal includes a condition by which JELD-WEN can purchase from the divested entity, for a period of two years, enough doorskins "to ensure that JELD-WEN will be able to fulfill orders of its door and doorskin customers" that exist at the time any divestiture order is entered, as long as those doorskins "cannot reasonably be manufactured as one of its remaining doorskin manufacturing facilities." Proposed Divestiture Order § VI(J). This provision would, in theory, permit JELD-WEN to meet its customers' doorskin needs through Towanda while setting up another long-term solution during that proposed two-year transition period. That approach would ameliorate the doorskins shortfall hardship identified by JELD-WEN and could even eliminate it, particularly if some of JELD-WEN's other independent customers choose to exit their contracts and buy from the new owner of Towanda. Of course, in that event, JELD-WEN would lose the profits from those sales.

The new owner of a divested Towanda might choose to supply JELD-WEN for longer than the two-year period proposed by Steves. Based on JELD-WEN's claim of hardship, that would seem to be an attractive proposition to JELD-WEN. And, a new owner likely would prefer the stability that would ensure a longer term supply contract with JELD-WEN. Thus, there are ameliorating measures for an even longer term hardship (beyond the first two years after divestiture).

The collateral effects of any sustained drop in doorskin volume are hard to predict on this record. JELD-WEN emphasizes the penalties that might be imposed under certain long-term supply agreements if those customers' needs cannot be met, but the language of the force majeure clauses in those contracts suggests that supply failures because of a divestiture order would not give rise to any fines. At the same time, JELD-WEN says that its door manufacturing plants would produce fewer doors based on the doorskins available, thereby reducing the company's EBITDA.

It is also reasonably inferable that JELD-WEN would lose some external customers, both because of the limited doorskin quantities and if JELD-WEN increases prices to cope with lower production capacity. Counting this loss as a hardship is questionable because, in most cases, it would be impossible to tell whether customers left because of the fallout from JELD-WEN's doorskin deficit or because of increased competition, which is an appropriate result of injunctive relief. See [Actavis, 2014 WL 7015198, at \\*45](#). That issue aside, loss of any customers would lower JELD-WEN's total revenue and EBITDA to some extent. But, if customers shift because of increased competition, that is a hardship that is expected to accompany divestiture and it does not weigh heavy in the balance of hardships.

JELD-WEN also claims hardship because the reallocation of production could cause loss of employment in its legacy \*661 plants. That assertion is pure speculation. And, it is contrary to the assertion made by JELD-WEN that, after divestiture, its legacy plants would be operating at near capacity.

JELD-WEN also contends that divestiture would cause loss of employment at Towanda. That contention is illogical because a new owner would need the experience offered by Towanda's current management and employees. And, the contention is at odds with history because when JELD-WEN bought CMI, the Towanda management and employees came along with the facility. And, in any event, that apprehended harm will be lessened, or eliminated, by requiring the acquiring entity to allow Towanda's management and employees to remain. And, it is logical that those people would benefit from such a requirement.

Finally, JELD-WEN would lose the value of the improvements it has made at Towanda, as well as the MiraTEC and Extira business that it has developed there. JELD-WEN made total investments of around [ ] in manufacturing installations and capital improvements at the plant between 2014 and 2017, which it expected would pay dividends in the form of company-wide savings well into the future. Even if the loss of those investments can be discounted somewhat because they would not have been possible without the anticompetitive merger, they may still be considered as a hardship. See [Smith & Nephew, 955 F.Supp.2d at 79](#); [W. Watersheds Project v. Salazar, No. CV 11-00492, 2011 WL 13124018, at \\*20 \(C.D. Cal. Aug. 10, 2011\)](#). But, the record also shows that JELD-WEN has recouped (and then some) its investments in Towanda so they will not be lost.



JELD-WEN's acquisition of CMI's MiraTEC and Extira business, on the other hand, has never posed any antitrust concerns, so the loss of that business weighs more heavily in the hardship analysis. As detailed above, JELD-WEN has structured its business so that MiraTEC and Extira are important parts of its future trajectory, and divestiture would force the company to change course. The record establishes that the manufacturing of these lines could not be removed from Towanda.

Whether the new owner would be willing to pay an appropriate value for the MiraTEC and Extira lines is unknown. And, any sale of those lines would involve licensing of intellectual property necessary to make those products. But, here too, the existing management and employees know how to operate the lines and make the product, and there is no reason on the record to believe that the end products would not be bought by those who are buying them now. Certainly, JELD-WEN offered no evidence to that effect. And, if, as JELD-WEN says, the lines are good products, then a buyer of Towanda could be expected to place value on them.

As the foregoing discussion reflects, the consequences of divestiture on JELD-WEN cannot be discerned with certainty in large measure because JELD-WEN has chosen not to internally assess those effects, except in broad and somewhat speculative terms. Nonetheless, from the showing that JELD-WEN has made, the record proves that all of its claimed hardships can be ameliorated by allowing time for an orderly divestiture, by imposing terms to assure JELD-WEN a reliable source of doorskin supply to satisfy its external and internal requirements for at least two years, by assuring that divestiture occurs in an environment and under circumstances that will produce a reasonable purchase price. Steves, on the other hand, has presented forceful evidence to show a more certain and far more serious harm: permanently going out of business. Therefore, \*662 even though the scales are not so one-sided as Steves contends, the balance of hardships tips decidedly in Steves' favor.

### (c) Public Interest

#### (1) Legal Standard

[38] [39] The final [eBay](#) factor requires the Court to find “that the public interest would not be disserved by a

permanent injunction.” [eBay](#), 547 U.S. at 391, 126 S.Ct. 1837. “ ‘The public interest inquiry primarily addresses impact on non-parties rather than parties.’ ” [Inst. of Cetacean Research v. Sea Shepherd Conservation Soc.](#), 725 F.3d 940, 946 (9th Cir. 2013) (quoting [Bernhardt v. L.A. Cnty.](#), 339 F.3d 920, 931 (9th Cir. 2003) ). Courts are reluctant to cause any “concrete harms to innocent third parties.” If those potential effects exist, the public interest asserted must rely on more than “broad, abstract rule of law concerns.” [SAS Inst.](#), 874 F.3d at 388.

[40] That is not an issue here because the public interest in this case has been firmly established by Congress which is responsible not only for passing laws, but also “establish[ing] their relative priority for the Nation,” priorities which courts must respect. [Tenn. Valley Auth. v. Hill](#), 437 U.S. 153, 194, 98 S.Ct. 2279, 57 L.Ed.2d 117 (1978). Accordingly, “[w]here a valid law speaks to the proper level of deference to a particular public interest, it controls.” [Inst. of Cetacean Research](#), 725 F.3d at 946; see also 11A Charles Alan Wright & Arthur R. Miller, [Federal Practice and Procedure](#) § 2948.4 (3d ed. 1998) (“The public interest ... may be declared in the form of a statute.”). Here, by enacting Section 7 of the Clayton Act, Congress has explicitly indicated that preserving competition is in the public interest. [United States v. Ivaco, Inc.](#), 704 F.Supp. 1409, 1430 (W.D. Mich. 1989). Consequently, divestiture would serve the public interest here, assuming that such relief would “ ‘restore competition’ ”—the central aim of any injunctive relief under the Clayton Act. [Ford](#), 405 U.S. at 573, 92 S.Ct. 1142 (quoting [E.I. du Pont](#), 366 U.S. at 326, 81 S.Ct. 1243).

[41] [42] Nonetheless, divestiture is not always the ideal equitable relief for the public interest. In some cases, the divested entity might not actually restore competition, depending on the circumstances in which the entity would operate. In others, divestiture might restore competition, but other injunctive relief might also do so with fewer impacts on the public interest. Before ordering divestiture, then, the Court must consider two questions: (1) whether Towanda would be “a willing, independent competitor capable of effective production” in the doorskin market, [White Consol. Indus., Inc. v. Whirlpool Corp.](#), 781 F.2d 1224, 1228 (6th Cir. 1986); and (2) even if Towanda would be a viable entity, whether less intrusive injunctive relief can restore competition just as well as divestiture, see [E.I. du Pont](#), 366 U.S. at 327-28, 81 S.Ct. 1243 (equitable relief should cause “as little injury as possible to the interest of the general public” (internal

quotations omitted) ). Courts have not clearly addressed these issues before ordering divestiture. However,

[t]here is ... no doubt that the antitrust court may and should assess the propriety of equitable relief in each particular case ... and that the judge may decline to restructure a firm where there are serious doubts as to feasibility or a likelihood that other remedies are likely to be sufficient to restore effective competition.

3A Areeda & Hovenkamp, *supra*, ¶ 303e3 (emphasis added). See also Pfunder et al., *supra*, at 54 (“In order to achieve the goal of restoring or restructuring competition, a \*663 careful economic analysis must be undertaken of the particular assets or entity to be divested. In order for divestiture to achieve procompetitive structural relief, the assets to be divested must comprise an economically viable going concern—that is, the entity must have the economic capability of surviving and competing effectively in the market.” (emphasis added) ).

The parties vigorously dispute what showing Steves must make to enable the Court to answer these questions. JELD-WEN says that before deciding Steves' request for divestiture, Steves must prevail on five factors:

- (1) whether the divestiture assets are sufficient to create a business that will replace lost competition;
- (2) whether the divestiture buyer has the incentive to compete in the relevant market;
- (3) whether the divestiture buyer has the business acumen, experience, and financial ability to compete in the relevant market in the future;
- (4) whether the divestiture itself is likely to cause competitive harm; and
- (5) whether the asset sale is structured to enable the buyer to emerge as a viable competitor.

These factors are used by the DOJ in assessing the remedy of divestiture. Gov't Equitable Relief Statement (ECF No. 1640) at 1-2, 7; see also 5 Kintner et al., *supra*, § 40.12 (identifying similar “crucial factors considered when framing

divestiture order or decree”). This approach, says JELD-WEN, is necessary because it is the approach that the DOJ takes before ordering divestiture. Treating this analysis as a threshold requirement would be dispositive. Although the first and fourth DOJ factors are included in the public interest framework set out above, and will be addressed here, Steves has provided practically no information that would inform the other three factors.

Steves, on the other hand, argues that Towanda's viability as a successful competitor be assessed quite differently. This type of assessment, Steves says, would be more in line with the public interest because the results of the analysis urged by JELD-WEN could be made worthless by changed market conditions and the outcome of future appeals. Moreover, as Steves asserts, the Supreme Court has approved of the method that it urges in [Brown Shoe Co. v. United States](#), 370 U.S. 294, 82 S.Ct. 1502, 8 L.Ed.2d 510 (1962), another Section 7 case. There, the Supreme Court found that the trial court's divestiture order was sufficiently final to enable appellate review even though the order only commanded divestiture without specifying the details of the divestiture sale or separation process, which would be the subject of a proposed divestiture plan to be filed by the defendant. See [id.](#) at 304, 308-10, 82 S.Ct. 1502. According to Steves, the Court can conclude now that divestiture is appropriate, and then work out the particulars by appointing a special master to supervise divestiture after JELD-WEN appeals the order and if the remedy of divestiture is affirmed. The Fourth Circuit (and perhaps the Supreme Court) would then be able to affirm the liability and remedy decisions before the divestiture process moves to fruition. Only then, says Steves, would capable and serious buyers be willing to offer realistic prices for Towanda.

Steves is correct on this point. Neither JELD-WEN nor the DOJ cites any cases in which courts declined to order divestiture because the party seeking divestiture failed to provide the details that the DOJ uses in making its decisions. In fact, the general resources that address the issue teach that divestiture specifics are typically \*664 worked out in the compliance process by the court, the parties, or some other monitor. One treatise explains:

Divestiture decrees rarely contain provisions specifying the details of satisfactory compliance with the order to divest; however, usually courts include continuing supervision provisions to ensure that the acquiring company divests itself of the offending assets and that they are divested in such a manner as to assure restoration of the competitive

balance. Tribunals also retain jurisdiction to approve or reject the method of compliance, and to modify its decree or order if the prescribed remedy proves incapable of being carried out according to its terms....

Once the order to divest is entered, the defendant is required to propose within a specified time a plan of compliance indicating the method by which it proposes to locate a purchaser acceptable to the court. These plans are subject to the government's approval, and in instances where disagreements cannot be resolved at this late stage, the government must challenge the plan before the court. Some orders leave the defendant considerable discretion to choose the assets to be divested. Even broader is the defendant's discretion to negotiate with parties interested in purchasing the assets to be divested, and to accept the most lucrative offer that will not be attended by anticompetitive consequences.

5 Kintner et al., supra, § 40.12 (footnotes omitted); see also Pfunder et al., supra, at 95-111. The administrative law judge in one recent FTC case cited by JELD-WEN took this exact approach. See In re Evanston Nw. Healthcare, 144 F.T.C. at 335-45, 356-73. Although the FTC reversed that initial decision on substantive grounds, nothing in its opinion suggests that the ALJ's procedural methods were improper. See id. at 519-23.

Brown Shoe does not make it a hard and fast rule that courts must approach divestiture in this way. That case addressed the finality of a particular divestiture order under the Expediting Act, which would not provide the basis for any appeal here. See Brown Shoe, 370 U.S. at 306-08, 82 S.Ct. 1502. Nonetheless, the Supreme Court's guidance about the substance of general divestiture orders is both helpful and persuasive. In Brown Shoe, the district court's divestiture order only required the defendant to “divest itself completely of all stock, share capital, assets or other interests it held in [the divested entity], so that the “remaining task for the District Court [after appeal] w[ould] be its acceptance of a plan for full divestiture, and the supervision of the plan so accepted.” Id. at 304, 308, 82 S.Ct. 1502. The Supreme Court found the broader divestiture order ripe for review because it had “consistently reviewed antitrust decrees contemplating either future divestiture or other comparable remedial action prior to the formulation and entry of the precise details of the relief ordered.” Id. at 309-10, 82 S.Ct. 1502. The Supreme Court also instructed that policy interests supported that approach:

[A full divestiture] order requires careful, and often extended, negotiation and formulation. This process does not take place in a vacuum, but, rather, in a changing market place, in which buyers and bankers must be found to accomplish the order of forced sale. The unsettling influence of uncertainty as to the affirmance of the initial, underlying decision compelling divestiture would only make still more difficult the task of assuring expeditious enforcement of the antitrust laws. The delay in withholding review of any of the issues in the case until the details of a divestiture had \*665 been approved by the District Court and reviewed here could well mean a change in market conditions sufficiently pronounced to render impractical or otherwise unenforceable the very plan of asset disposition for which the litigation was held. The public interest, as well as that of the parties, would lose by such procedure.

Id. at 309 (emphasis added).

JELD-WEN's sole response to the compelling logic set out by the Supreme Court is to argue that Brown Shoe is inapposite because it was a Government case, and the Government was presumed to be acting in the public interest. Following that logic, there was no need for that district court to have considered the identity and intention of the buyer of the divested assets. There are undoubtedly distinctions between Government actions and private suits for injunctive relief under the Clayton Act. However, those differences do not compel the Court to decide the propriety of divestiture in a manner that is directly contrary to the forceful logic of the Supreme Court.

JELD-WEN's “fear of piecemeal appeals” may be real, id. at 310, 82 S.Ct. 1502, but that alone cannot dictate a result that Brown Shoe observed makes no sense. Those practical concerns apply equally here. Moreover, the Court can decide

whether divestiture is in the public interest without knowing the identity of the buyer. And, if divestiture is ordered and affirmed, and no buyer expresses interest in Towanda, then divestiture will simply not occur. If it turns out that the divestiture process yields a buyer that lacks the incentive or the means to operate Towanda competitively, the Court can decline to divest the plant to that buyer. Finally, if the Court orders a divestiture plan that directs the sale of Towanda to an unsatisfactory buyer, JELD-WEN could presumably appeal that order. That last issue remains unresolved. See *id.* (“No instance has been found in which the Court has reviewed a case following a divestiture decree such as the one we are asked to consider here, in which the party subject to that decree has later brought the case back to this Court with claims of error in the details of the divestiture finally approved.”). But, as this case has repeatedly shown, there is a first time for everything.

### (2) The DOJ's Statement of Interest

Pursuant to 28 U.S.C. § 517, the DOJ submitted a Statement of Interest (ECF No. 1640) after the jury returned its verdict that the merger had substantially lessened competition and that Steves had sustained antitrust injury as a consequence. To begin, the DOJ expressed, in general, a strong preference for the structural relief of divestiture to restore competition. The DOJ then suggested that the Court should use the same analytical framework that the DOJ employs. That framework will be quite useful later.

The DOJ also expressed reservation about ordering divestiture, noting that a potential buyer (other than Steves) had not been identified. And, as to Steves, the DOJ expressed concern that, if Steves were to acquire Towanda, there would be three vertically integrated doorskin suppliers whereas before the JELD-WEN/CMI merger there had been two vertically integrated suppliers and one (CMI) that was not. On that point, the DOJ was in error because CMI was vertically integrated well before the merger.

The DOJ's other concern—the absence of an identified buyer at this state—is, as explained earlier, premature for the reasons set out by the Supreme Court in *Brown Shoe*. Moreover, it is unrealistic to think that the divestiture process in a private party case could proceed in the same way as the Government would proceed until the validity of the divestiture remedy has been **\*666** affirmed on appeal. Certainly that is so here because appeal has been promised, and it is unrealistic to

expect that potential buyers will come forth and be vetted while an appeal looms. However, once the legal battles have ended, the Court fully expects that the Special Master will be able to proceed within much the same framework as used by the DOJ.

### (3) Standalone Viability of Towanda

[43] The record here shows that a divested Towanda would provide significant competition in the doorskin market and restore competition that the merger lessened. The analysis begins with the undisputed evidence that, from its formation in 2002 until the housing crisis started in 2007, CMI, including Towanda's doorskins, was profitable. In this case, both parties agree that EBITDA is an appropriate measure of profitability. And the Court finds from PTX 341 and PTX 342 that, looking only at Towanda's doorskin business, the EBITDA was positive in every year from 2009 to 2013 and that it was projected to be profitable on that basis in 2014. That is to say, in the doorskin aspect of its business, Towanda's EBITDA in 2009, 2010, 2011 and 2012 was positive even though overall finances for that same period showed a loss. <sup>23</sup>

<sup>23</sup> The record is not entirely clear why that is so but it appears to be that the losses largely occurred in the door manufacturing businesses of CMI at the time because the EBITDA for the doorskin business was positive and, according to JELD-WEN and the record, the MiraTec and Extira business was also profitable during that period of time.

It is also clear from the record that CMI was losing money in 2011 and that made it necessary for the owners of the company to put it on the market. But, the record also shows that the situation has changed. In particular, the record establishes that:

- since the merger in 2012, demand for doorskins has increased substantially so that Towanda's most recent annual output was [ ] doorskins;
- from the time it was created CMI (through Towanda) was an important supplier of doorskins to all the Independents. Towanda is a low cost plant;
- Towanda has been significantly improved;
- the new owner could expect Steves to order [ ] doorskins per year under a long term supply contract.



Likewise the new owner would be able to count on contracts to supply JELD-WEN with [ ] doorskins per year. Given the high prices that JELD-WEN charges the other independent doormakers, it is likely that a new competitor would be able to attract business from JELD-WEN's Independent doorknife manufacturer customers other than Steves. And, the new owner of Towanda would have every incentive to try to attract business from the Independents, who are now customers of JELD-WEN's by offering lower prices than the high prices they are now paying to JELD-WEN.<sup>24</sup>

<sup>24</sup> Further, as did JELD-WEN in 2012 when it acquired CMI, the new owner will also have the MiraTec and Extira lines and will make those products available to the customers who now buy them from JELD-WEN.

The events of 2011 and 2012 also provide some evidence probative of whether Towanda could be a viable competitor in the doorskin market after divestiture. In particular, when the company was last on the market in 2011, there were approximately five serious buyers for the company. It is fundamentally correct that companies are not prepared to invest in other companies unless they believe they can make a profit \*667 in so doing. And, the new buyer will be bidding on a far more successful entity than were the five serious buyers in 2011.

Further, the record shows that the margins at Towanda, which is a way of measuring profitability, were strong. The margin is the difference between the cost of manufacturing the doorskin against the selling price of the doorskin. Professor Shapiro testified that, as far back as 2012, the margin for doorskins made at Towanda was approximately 35%. Since then, JELD-WEN's costs have gone down because improvements have been made at Towanda, thereby lowering the cost of manufacturing the doorskins. Further, the evidence establishes that the key input costs at Towanda have declined. The ultimate conclusion from this information is that the margin has gone up.

Accordingly, there are three substantial reasons for concluding that a divestiture of Towanda is likely to be competitive and profitable. First, there is the fact that Towanda was profitable before the significant housing downturn and that it has returned significantly to profitability. Second, the EBITDA numbers show that, even during the rough periods during the housing crisis, Towanda's EBITDA

for doorskins was positive, albeit not large. Third, the margin figures indicate that a substantial profit can be made.

#### (4) Divestiture Will Remedy the Lessened Competition Found by the Jury

Here, as the jury found, and the record shows, the merger substantially reduced competition in the doorskin industry. Less than two years after the merger reduced the number of suppliers from three to two, one of those suppliers essentially withdrew from the market, thereby depriving the Independents of that key component of a reliable supply source. Masonite made that decision known to its investors and to JELD-WEN in a public telephone conference. Not long thereafter, the other supplier, JELD-WEN, embarked upon a plan to raise doorskin prices, and, in so doing, emphasized that it was then the only game in town. At the same time, JELD-WEN felt free to disregard existing contract obligations respecting pricing and to engage in bullying tactics to get increased prices even if that would kill off some of the Independents who were its customers.

Also, the quality of JELD-WEN's doorskins declined as the lessened competition took hold. And, by the beginning of 2015, the manner in which JELD-WEN dealt with defective products changed because competition had lessened.

None of that was possible when, in 2011 and 2012, CMI had been a competitor. Divestiture will once again restore three competitors who make and sell doorskins. The record does not show whether Masonite can be expected to increase its participation in selling to the Independents. But, it does permit the finding that JELD-WEN and divested Towanda can be expected to compete in selling doorskins.

Divestiture is stiff medicine. Therefore, it is important to assess whether an alternative equitable remedy, or a combination thereof, can effectively restore the competition that was substantially lessened by the merger. This assessment starts by remembering that, in the spring of 2012, there were three vertically integrated doorskin suppliers: Masonite; JELD-WEN; and CMI. The record shows that these three companies competed vigorously in selling doorskins to Steves and the other independent (non-integrated) door manufacturers. That is pointedly illustrated by the fact that, in 2011 and 2012, Steves was in negotiations for a new long-term supply contract, and there was significant price competition for Steves' business. \*668 The favorable terms

were reflected in the Supply Agreement that JELD-WEN and Steves executed in May 2012, a few months before the merger closed.

Divestiture would once again place three domestic doorskin suppliers in the doorskin market. Nothing in the record points to how that could be accomplished short of divestiture. Neither party has posited an alternative.

Although the Court could solve Steves' supply problem by ordering JELD-WEN to supply Steves' requirements for a long term, that alternate remedy would not restore competition in the industry as a whole. And, the record proves that the lessened competition has adversely affected the Independents other than Steves. So simply securing a long-term supply for Steves would not aid those manufacturers.

Even if the Court could order JELD-WEN to sell, for a period of time, to Steves and the other Independents at the prices that prevailed before JELD-WEN secured new prices in 2014 and 2015, there still would be only one domestic supplier willing to sell to the Independents other than on a spot basis. And, there would be no structure in place to foster competition after the Court-ordered prices expired.

Based on this record, the Court can discern no alternative to divestiture that would restore competition that the merger substantially lessened.

### (5) Use of Special Master

JELD-WEN also contests the potential appointment of a special master to assist with divestiture. JELD-WEN claims that using a special master exceeds the boundary defined in La Buy v. Howes Leather Co. See 352 U.S. 249, 256, 77 S.Ct. 309, 1 L.Ed.2d 290 (1957) (“The use of masters is to aid judges in the performance of specific judicial duties, as they may arise in the progress of a cause, and not to displace the court.” (internal citation and quotation marks omitted) ).

JELD-WEN is mistaken. Fed. R. Civ. P. 53 governs when a special master may be appointed. The cases cited by JELD-WEN discussed a version of Rule 53 that required an “exceptional condition” to justify special master referrals. See id. at 250, 256, 77 S.Ct. 309; Beazer E., Inc. v. Mead Corp., 412 F.3d 429, 440 (3d Cir. 2005); United States v. Microsoft Corp., 147 F.3d 935, 954 (D.C. Cir. 1998); Burlington N. R. Co. v. Dep't of Revenue of State of Wash., 934 F.2d 1064,

1071 (9th Cir. 1991). The current Rule 53 is very different, allowing special masters to, as relevant here, “address pretrial and posttrial matters that cannot be effectively and timely addressed by an available district judge or magistrate judge of the district.” Fed. R. Civ. P. 53(a)(1)(C). This provision accounts for courts' increased reliance on masters “to assist in framing and enforcing complex decrees.” In particular, it permits appointment of a special master “when a complex decree requires complex policing, particularly when a party has proved resistant or intransigent .... The master's role in enforcement may extend to investigation in ways that are quite unlike the traditional role of judicial officers in an adversary system.” Fed. R. Civ. P. 53(a)(1) advisory committee's note to 2003 amendment.

[44] Courts have frequently used Rule 53(a)(1)(C) to appoint special masters to oversee compliance with complex injunctive relief and make appropriate recommendations to those courts, see, e.g., RLI Ins. Co. v. Nexus Servs., Inc., No. 5:18-CV-00066, 2018 WL 3244413, at \*13-14 (W.D. Va. July 2, 2018); Ohio Valley Envtl. Coal. v. Fola Coal Co., LLC, No. CV 2:13-16044, 2016 WL 3190255, at \*14 (S.D.W. Va. June 7, 2016), or to conduct sales of disputed assets in foreclosure cases. See, e.g., \*669 Stearns Bank Nat'l Ass'n v. Come Again, Inc., No. 8:15-CV-322-T-30JSS, 2016 WL 695990, at \*2 (M.D. Fla. Feb. 22, 2016). Here, divestiture compliance involves extraordinarily complex issues that, given the state of the Court's docket and its limited knowledge about asset sales in the building products industry, “cannot be effectively and timely addressed by” the Court or any judge in this district. Fed. R. Civ. P. 53(a)(1)(C). And, even if Rule 53(a)(1)(C) did not confer appointment authority here, the Fourth Circuit has approved of special master appointments “based on [a court's] inherent authority to fashion appropriate post-verdict relief.” Trull v. Dayco Prods., LLC, 178 F. App'x 247, 251 (4th Cir. 2006). As a result, the Court has ample grounds for appointing a special master if it determines that divestiture is appropriate.

Finally, the parties will be afforded an opportunity to comment on and object to the order appointing the Special Master because the Court does not contemplate adopting the order proposed by Steves, and the Special Master would not be allowed to take significant action without the approval of the Court.

### B. The Requested Ancillary Conduct Remedies

[45] To assure that the requested divestiture is effective in restoring competition, Steves proposes several forms of so-

called “conduct remedies.” Some are appropriate. Others are not.

First, Steves says that JELD-WEN should divest to a new owner not only the Towanda facility, but also the equipment used to develop, manufacture, and sell doorskins there. That is a rather obvious requirement. Section II.A.1, supra.

Second, Steves would require transfer or licensing of all intangible assets used in the development, manufacturing, and sale of doorskins at Towanda (to include patents, schematics, designs, customer lists, vendor lists, trade secrets, and the know-how necessary to operate the facility).<sup>25</sup> A requirement of that sort is also permissible and appropriate. Section II.A.1, supra.

<sup>25</sup> If the buyer should be Steves, it will be necessary to make provisions that secure to JELD-WEN the benefits of the jury verdict and any relief granted in the trade secrets trial.

Third, Steves asks for an order affording the new owner a reasonable opportunity to retain the services of current Towanda employees. That too is permissible and appropriate so as to afford the divested entity an opportunity to succeed. Section II.A.1, supra.

Fourth, Steves asks that JELD-WEN be prohibited from rehiring those employees for two years. That is permissible and appropriate to afford the divested entity an opportunity to succeed. Section II.A.1, supra.

Fifth, to help assure the divested firm's success, Steves seeks an order requiring the divested entity to offer Steves an eight-year doorskin supply contract at prices based on the current Supply Agreement. Certainly, a provision requiring the new owner to agree to supply Steves beyond 2021 is a permissible, and necessary, step to remedy the irreparable remedy proved by Steves. And, the divested entity would benefit from a long-term supply agreement with Steves. However, fixing the duration of that agreement and specifying the prices to be based on the current supply agreement would be too great a restriction on the new owner which must be allowed to negotiate its own contract terms if it is to succeed. Section II.A.1, supra.

\*670 Sixth, Steves seeks a provision that would allow JELD-WEN's independent customers-such as Lynden, Haley, and Excel-to terminate, without penalty, their supply

agreement with JELD-WEN to help alleviate the effect of the lessened competition on them (the high prices recently extracted by JELD-WEN). Considering that the lessened competition from the merger allowed JELD-WEN to extract high prices from its independent customers, a provision of this sort would help restore competition. Section II.A.1, supra

Lastly, Steves asks that the Court limit JELD-WEN's ability to buy doorskins from the new owner of Towanda to a period of two years. A provision of that sort would not help the new owner to succeed. And, JELD-WEN, like Steves, would be a natural customer for the new owner because JELD-WEN already uses some of Towanda's output. On the other hand, JELD-WEN cannot be allowed to limit the quantity of doorskins that are available to the Independents by buying up all of the output of Towanda. Therefore, it would be appropriate to allow JELD-WEN to buy from the new owner of Towanda, but to require that, after the first two years following divestiture, the new owner satisfy the requirements of the Independents before supplying more than [ ] doorskins to JELD-WEN. Section II.A.1, supra.

For the foregoing reasons, and to the extent recited above, the ancillary provisions and conduct relief will be granted and denied.

### C. JELD-WEN's Equitable Defenses

[46] As noted in a separate opinion, unclean hands is not a valid defense to a Section 16 request for injunctive relief on the facts of this case. See Divestiture Evidentiary Issues Op. (ECF No. 1759) at 14. Accordingly, laches is the only pleaded equitable defense remaining to JELD-WEN here. Laches is an available equitable defense to divestiture. See Am. Stores, 495 U.S. at 296, 110 S.Ct. 1853. The defense also can bar the proposed ancillary remedies.

[47] [48] [49] Laches “operates throughout the entire remedial portion of equity jurisprudence.” 2 John Norton Pomeroy, A Treatise on Equity Jurisprudence § 418, at 169 (5th ed. 1941). According to the eminent English chancellor, Lord Camden:

A court of equity, which is never active in relief against conscience or public convenience, has always refused its aid to stale demands, where the party has slept upon his rights, and acquiesced

for a great length of time. Nothing can call forth this court into activity but conscience, good faith, and reasonable diligence.

Id. § 419, at 171 (emphasis added) (internal quotation marks omitted). Laches is thus defined as “such neglect or omission to assert a right as, taken in conjunction with lapse of time, more or less great, and other circumstances caus[es] prejudice to an adverse party.” Id. at 171-72 (internal quotation marks omitted). Each case turns on its own facts because, as explained by the Supreme Court,

what might be inexcusable delay in one case would not be inconsistent with diligence in another, and unless the nonaction of the complainant operated to damage the defendant, or to induce it to change its position, there is no necessary estoppel arising from the mere lapse of time.

N. Pac. R. Co. v. Boyd, 228 U.S. 482, 509, 33 S.Ct. 554, 57 L.Ed. 931 (1913) (citing Townsend v. Vanderwerker, 160 U.S. 171, 186, 16 S.Ct. 258, 40 L.Ed. 383 (1895)).

In Townsend, the Supreme Court considered the assertion of laches where the defendant's dead and intestate relative \*671 (“Marvin”) had agreed to convey to the plaintiff a one-half interest in a house on a lot owned by Marvin in exchange for the plaintiff contributing funds to build the house and supervising the construction. The plaintiff superintended the job from 1879 to 1880, and made the required payments from 1879 to 1884. But, he did not file a bill in equity until 1889, after Marvin had died. See Townsend, 160 U.S. at 172-73, 16 S.Ct. 258. The Supreme Court held that, this delay notwithstanding, the defense of laches was not available, and thus that plaintiff could treat the property as subject to a lien in his favor and could have it sold to satisfy his claim for half of its original value. Id. at 182-83, 16 S.Ct. 258.

[50] In making its decision, the Supreme Court examined the circumstances of the house payments and the relationship between Marvin and the plaintiff. As the Supreme Court explained, those individuals had lived together in the house after it was built. Moreover, Marvin regarded the plaintiff as

a foster child, and had stated that she would include him in her will and intended the house to be his when she was done with it. Mindful of these circumstances, the Supreme Court held that laches did not preclude the equitable relief sought because,

[d]ealing with the person who stood in this relationship with him and whom he had always been upon friendly, and even intimate, terms, the same diligence could not be expected of [the plaintiff] as would have been if he had been treating with a stranger.

Id. at 185-86. In other words, what constitutes reasonable diligence depends upon the particular facts of the case, including the relationship between the parties.

The Supreme Court was confronted with another ten-year delay in Northern Pacific Railway Company. In that case, a railroad reorganization pursuant to bankruptcy proceedings had been completed in 1896, and the plaintiff attacked that reorganization by filing a bill in equity in 1906. Noting that background, the Supreme Court held that:

[t]he fact that improvements are put upon the property—that the stocks and bonds of the new company almost immediately became the subject of transactions with third persons—calls for the special application of the rule of diligence. But the doctrine of estoppel by laches is not one which can be measured out in days and months, as though it were a statute of limitation. For what might be inexcusable delay in one case would not be inconsistent with diligence in another, and unless the nonaction of the complainant operated to damage the defendant, or to induce it to change its position, there is no necessary estoppel of laches arising from the mere lapse of time.



N. Pac. R., 228 U.S. at 508-09, 33 S.Ct. 554 (emphasis added). The Court went on to assess the plaintiff's diligence and concluded that he had made reasonable, albeit time-consuming, efforts to put himself in the position of a judgment creditor of the railroad so that he could proceed in equity to collect his debt. See id. at 509, 33 S.Ct. 554. As does Townsend, this decision teaches that the determination of laches must be made in perspective of the facts of each case respecting the circumstances of the delay and the effects thereof.

[51] [52] [53] The Fourth Circuit's approach to the doctrine of laches is consistent with that foundation. "Laches imposes on the defendant the ultimate burden of proving '(1) lack of diligence by the party against whom the defense is asserted, and (2) prejudice to the party asserting the defense.'" White v. Daniel, 909 F.2d 99, 102 (4th Cir. 1990) (quoting \*672 Costello v. United States, 365 U.S. 265, 282, 81 S.Ct. 534, 5 L.Ed.2d 551 (1961)). The defense "applies to preclude relief for a plaintiff who has unreasonably 'slept' on his rights," barring "claims where a defendant is prejudiced by a plaintiff's unreasonable delay in bringing suit after the plaintiff knew of the defendant's violation." PBM Prods., LLC v. Mead Johnson & Co., 639 F.3d 111, 121 (4th Cir. 2011); see also Kloth v. Microsoft Corp., 444 F.3d 312, 325 (4th Cir. 2006) (laches involves an "equitable balancing of a plaintiff's delay with prejudice to a defendant" (internal quotation marks omitted)). The laches analysis is highly fact-dependent. See White, 909 F.2d at 102.

Before addressing the elements of the laches framework, it is necessary to address Steves' contention that JELD-WEN must overcome the "strong presumption" that laches does not apply because Steves initiated this litigation within the Clayton Act's statute of limitations for damages claims. Synergistic Int'l, L.L.C. v. Korman, No. CIV. 2:05CV49, 2007 WL 517677, at \*8 (E.D. Va. Feb. 8, 2007). Both cases that Steves cites as establishing this "presumption" are trademark infringement suits, so their principles do not necessarily control in an antitrust case. See Elvis Presley Enters., Inc. v. Elvisly Yours, Inc., 936 F.2d 889, 894 (6th Cir. 1991) (citing Tandy Corp. v. Malone & Hyde, Inc., 769 F.2d 362, 365 (6th Cir. 1985)); Synergistic Int'l, 2007 WL 517677, at \*8 (citing Reno Air Racing Ass'n, Inc. v. McCord, 452 F.3d 1126, 1138-38 (9th Cir. 2006)).

Section 4B of the Clayton Act imposes a four-year statute of limitations for damages claims by any private plaintiff or by a government entity. See 15 U.S.C. § 15b. Section 16, on the

other hand, contains no statute of limitations. See id. § 26; New York ex rel. Spitzer v. Saint Francis Hosp., 94 F.Supp.2d 399, 421-22 (S.D.N.Y. 2000). Nonetheless, because Section 4 and Section 16 provide different remedies for the same antitrust violations, Cargill, 479 U.S. at 113, 107 S.Ct. 484, several courts have used Section 4B's limitations period as a guideline for analyzing laches defenses to Section 16 claims. See Oliver v. SD-3C LLC, 751 F.3d 1081, 1086 (9th Cir. 2014); Midwestern Mach. Co. v. Nw. Airlines, Inc., 392 F.3d 265, 277 (8th Cir. 2004); Duty Free Ams., Inc. v. Estee Lauder Cos., Inc., No. 12-60741-CIV, 2014 WL 1329359, at \*14 (S.D. Fla. Mar. 31, 2014), aff'd, 797 F.3d 1248 (11th Cir. 2015); KFC Corp. v. Marion-Kay Co., 620 F.Supp. 1160, 1168 (S.D. Ind. 1985); Argus Inc. v. Eastman Kodak Co., 552 F.Supp. 589, 600 (S.D.N.Y. 1982); Farbenfabriken Bayer, A. G. v. Sterling Drug, Inc., 197 F.Supp. 627, 629 (D.N.J. 1961), aff'd, 307 F.2d 210 (3d Cir. 1962).<sup>26</sup> Moreover, one of the first cases to adopt that approach was International Telephone & Telegraph Corp. v. General Telephone & Electronics Corp., 518 F.2d 913 (9th Cir. 1976). IT & T's conclusion was supported in part by the existence of what the court referred to as a "double standard" for calculating the laches period:

If relief is sought, not on the theory that past or present actions or behavior constitute actual violations of the substantive antitrust law, but because the plaintiff is threatened with an impending violation, then laches should normally run from the time when the plaintiff was first confronted with an enjoined threat and thus could have obtained injunctive relief. If the threat later matures into an actual violation and the plaintiff sues to prevent recurrence or \*673 continuation of the violation, then laches should be recomputed from the time of the subsequent actual violation.

This 'double standard' for laches reflects the fact that there are two basic theories of relief for actions under [Section] 16. Injunctions may be obtained against (1) impending violations of the substantive law, and (2) past or present violations likely to continue or recur.

Id. at 928-29 (emphasis added) (citing Zenith Radio, 395 U.S. at 130, 89 S.Ct. 1562). In IT & T, the plaintiff sought to restrain certain actual violations of the Sherman and Clayton Acts, and the court held that "the proper starting point for computation of the laches period is the time when the alleged violations occurred." Id. at 929 (emphasis added). In doing so, it noted that "[t]he four-year limitation of ... Section 4B for private antitrust actions for damages is long enough to enable potential plaintiffs to observe the actual effects and

the possible antitrust violation and to calculate its potential defects.” *Id.* That approach comports with the common sense understanding that the actual competitive effects of a merger may be delayed as they were in this case.

26 Although the Fourth Circuit implicitly approved of that approach, it has not directly addressed the question. See [Weinberger v. Retail Credit Co.](#), 498 F.2d 552, 556 (4th Cir. 1974).

[54] [55] Examining the laches period in this flexible manner is consistent with how laches operates in copyright infringement suits. See [Petrella v. Metro-Goldwyn-Mayer, Inc.](#), 572 U.S. 663, 134 S.Ct. 1962, 1977-78, 188 L.Ed.2d 979 (2014). More importantly, it comports with longstanding Fourth Circuit law:

In the application of the doctrine of laches, the settled rule is that courts of equity are not bound by, but that they usually act or refuse to act in analogy to, the statute of limitations relating to actions at law of like character. The meaning of this rule is that, under ordinary circumstances, a suit in equity will not be stayed for laches, before, and will be stayed after the time fixed by the analogous statute of limitations at law; but if unusual conditions or extraordinary circumstances make it inequitable to allow the prosecution of a suit after a briefer ... period than that fixed by the statute, the [court] will not be bound by the statute, but will determine the extraordinary case in accordance with the equities which condition it.

[King v. Richardson](#), 136 F.2d 849, 862 (4th Cir. 1943) (emphasis added) (internal quotation marks omitted). Using Section 4B's limitations period as a guideline (as posited by ITT) and not a firm rule better serves the purposes of the Fourth Circuit's settled laches approach because it accounts for the alternate ways in which the laches period may start running under Section 16.

As a result, although Steves' initiating this action within Section 4B's limitations period does not necessarily lead to a strong presumption against laches (as it would in trademark infringement suits), it is appropriate to rely on that four-year period as a guideline to determine whether Steves unreasonably delayed here.

### 1. Reasonableness of Steves' Delay

[56] “An inexcusable or unreasonable delay may occur only after the plaintiff discovers or with reasonable diligence could have discovered the facts giving rise to his cause of action.” [White](#), 909 F.2d at 102. This factor thus requires the Court to decide when Steves knew or should have known that it was facing “threatened loss or damage” from a Section 7 violation, as needed to establish Section 16 standing. 15 U.S.C. § 26. The laches period would have started running only at that time. See [Ray Commc'ns, Inc. v. Clear Channel Commc'ns, Inc.](#), 673 F.3d 294, 301 (4th Cir. 2012) (“Logic dictates that ‘unreasonable delay’ does not include any period of time before the [plaintiff] is able to pursue a claim ....” (internal quotation marks \*674 omitted) ). And, of course, Steves could not have been aware of any Section 7 violation until it was reasonably knowable that “the effect of [the CMI] [A]cquisition may be substantially to lessen competition.” 15 U.S.C. § 18.

[57] JELD-WEN argues that Steves should have known of a threatened Section 7 violation as early as April 2012, when Steves became aware of the planned CMI Acquisition, and at the latest on October 24, 2012, when the merger was consummated. But accrual principles for Section 4 damages claims help show why that is not correct. Section 4B's limitations period “starts to run at ‘the point the act first causes injury.’ ” <sup>27</sup> [Concord Boat Corp. v. Brunswick Corp.](#), 207 F.3d 1039, 1051 (8th Cir. 2000) (quoting [Klehr v. A.O. Smith Corp.](#), 521 U.S. 179, 190–91, 117 S.Ct. 1984, 138 L.Ed.2d 373 (1997) ). Because Section 7 makes the acquisition itself illegal, and the antitrust harm from the acquisition is usually known when the merger is consummated, Section 4 claims often begin accruing on that date. See *id.* at 1050. But a Section 7 violation “may occur ‘at or any time after the acquisition, depending upon the circumstances of the particular case.’ ” [Midwestern Mach., Inc. v. Nw. Airlines, Inc.](#), 167 F.3d 439, 443 (8th Cir. 1999) (quoting [United States v. E.I. du Pont de Nemours & Co.](#), 353 U.S. 586, 597, 77 S.Ct. 872, 1 L.Ed.2d 1057 (1957) ); see also [United States v. ITT Cont'l Baking Co.](#), 420 U.S. 223, 242, 95 S.Ct. 926, 43

[L.Ed.2d 148 \(1975\)](#) (violation may occur post-consummation if there was “no realistic threat of restraint of commerce or creation of a monopoly” when acquisition completed).

27 Steves did not need to suffer actual antitrust injury to bring a Section 16 claim, which requires only “threatened” injury. However, based on the facts in the record, it is not clear that this distinction is relevant to the outcome here.

Areeda and Hovenkamp's example of this sort of situation is particularly apt here:

One might imagine a merger that occurred in 1980 but with no immediate price increase, perhaps because the firm at that point lacked the power. But suppose the firm thereafter augmented its power and finally exacted a monopoly price increase in 1990 ... and the plaintiff brings its action in 1993. In such a case the statute of limitation would not begin to run until the post-merger price increase occurred.

12 Areeda & Hovenkamp, *supra*, ¶ 1205b.

[58] With these principles in mind, the first task is to ascertain the period of delay that is involved here. This action was filed on June 29, 2016, slightly more than four years after JELD-WEN announced that it was going to acquire CMI and a few months before the fourth anniversary of the consummation of the merger. Therefore, at its maximum reach, the period of delay was equivalent to the four-year statute of limitations set by Section 4B for damages claims. Thus, the filing of the antitrust action was within the guideline period as outlined in [ITT](#) and [King v. Richardson](#). That does not, however, resolve the reasonable delay analysis.

To begin, as explained below, the period from April 2012 to August 2014 cannot be included in the period of delay in the laches calculus. Thus, it is necessary to remember that JELD-WEN was aware at the time of the merger that the antitrust issues associated with the CMI Acquisition were significant. PTX-90. Indeed, having calculated market concentration as a consequence of the forthcoming acquisition and the

Herfindahl-Hirschman indices for markets impacted by the merger, JELD-WEN retained highly-qualified antitrust counsel from one of the nation's largest \*675 law firms, O'Melveny & Myers. In sum, and as the record shows, JELD-WEN knew full well of the merger's antitrust implications.

Mindful of those implications, JELD-WEN pursued an established merger strategy to assuage any possible concerns from the DOJ, from CMI's customers, and from JELD-WEN's own customers (including Steves). Specifically, JELD-WEN developed a plan to enter into long-term supply agreements with independent door manufacturers in the United States (notably Steves, Lynden, and Haley), *see* PTX-93; PTX-139. As part of its strategy, JELD-WEN deliberately decided not to approach the DOJ about the proposed CMI Acquisition until those long-term agreements had been entered. In fact, JELD-WEN's internal documents show that the company considered it a “tactical error to even call [the DOJ]” before entering into those supply agreements, and that JELD-WEN was fully aware that having those contracts in place would “be very positive for us [at the DOJ] if we ever go.” PTX-160. As Shapiro explained at trial, acquiring firms often enter into long-term contracts with customers in order to prevent a challenge to the merger. That tactic limits the DOJ's ability to secure evidence necessary to block a merger because customers with supply agreements are less willing to oppose a merger proposed by their supplier and because customers do not have reason to be threatened.

And, when JELD-WEN did approach the DOJ about the CMI Acquisition, it emphasized its long-term supply agreements with Steves, Lynden, and others. And Morrison, who led the company's presentation to the DOJ, admitted that the purpose of entering into such contracts was “to alleviate” customer concerns about not having a supply and “to assure the customers of CMI, who might eventually become customers of JELD-WEN, that JELD-WEN was committed to their continued supply.” *See* PTX-139.

Based on these facts, the Court finds that before, and at the time of, the merger in 2012, Steves had no reason to believe that there would be anticompetitive effects from the merger because JELD-WEN designed its pre-merger strategy to create that state of mind. To the contrary, Steves had a positive relationship with JELD-WEN through its CEO, Phillip Orsino, and had a recently signed long-term contract with JELD-WEN which Orsino described as a lifetime arrangement. And, although Steves did not take that assurance literally, under all the known circumstances, it was reasonable

for Steves to believe that the merger would not produce a substantial lessening of the competition that had produced the favorable terms in the Supply Agreement.

The record here establishes, and the Court finds, that Steves did not know, and could not reasonably have known, that JELD-WEN's conduct violated Section 7 until August 2014 at the earliest. JELD-WEN is right that Steves learned of the CMI Acquisition in April 2012, and it knew that the merger would reduce the number of doorskin suppliers from three to two. But that did not mean much to Steves because it reasonably believed that the prices that JELD-WEN could charge were constrained by the Supply Agreement. Applying Section 4 accrual rules here, any claim would have been dead in the water in April or October 2012 because there was no existing or threatened antitrust injury, and antitrust damages would have required speculation about JELD-WEN's future acts.

Although, in November 2012, Steves subsequently noticed some decline in doorskin quality, it did not associate those problems with the CMI Acquisition then. \*676 The same is true of the doorskin pricing issues arising in late 2012 through 2013, which Steves perceived as a purely contractual issue that could be, and eventually was, worked out through communications with Orsino. There was no reason for Steves to believe that these issues were anticompetitive effects from the merger; both sides treated Steves' concerns as essentially contract disputes. In any event, Steves could have tried to shift its doorskin purchases to Masonite if it was dissatisfied with JELD-WEN. In other words, even though JELD-WEN had acquired excess market power through the CMI Acquisition, it did not use that power before 2014.

However, the record establishes that, in May 2014, Hachigian, who had taken over from Orsino as JELD-WEN's new CEO, informed Steves that it would be necessary to renegotiate the Supply Agreement to secure higher prices, including a so-called "capital charge" (to help defray JELD-WEN's cost of capital invested in the business) because Hachigian thought that the Supply Agreement was mispriced and unfair to JELD-WEN. At that time, Hachigian also told Steves that he intended to invoke the termination provisions of the Supply Agreement to bring the parties to the bargaining table.

In retrospect, that conduct represented the first of a series of events wherein JELD-WEN exercised the market power brought about by the substantial lessening of competition effected by the merger (as found by the jury). However, Steves

was reasonable in believing that the purpose of the threatened termination was, as Hachigian had represented, to bring the parties to the negotiating table to try to get a more favorable agreement for JELD-WEN. Then, in July 2014, Hachigian sent Sam Steves a Masonite presentation stating that Masonite would not sell doorskins to competing door manufacturers like Steves. Hachigian sent that presentation to Steves, not for mere informational purposes, but as a message from JELD-WEN that Steves had to deal with JELD-WEN because the only other supplier (Masonite) was not to be a future source of supply. That conduct, combined with the termination notice and Hachigian's actions in May 2014, portended that the JELD-WEN might now be using the increased market power that it had gained as a result of the merger.

Sam and Edward Steves appear to have recognized that possibility in mid-August 2014. Thus, on August 12, 2014, Sam Steves e-mailed Edward Steves to express his concerns about Masonite's statements that it and JELD-WEN were the only vertically integrated doorskin manufacturers and that the barrier to entry in the doorskin market was "prohibitive." Sam Steves then asked whether Steves was "finished with exploring anti trust issues if J[ELD-WEN] term[inate]s the [S]upply [A]greement." DX-291. Then, on August 26, Sam Steves sent Edward Steves another e-mail that proposed a response to an e-mail from Hachigian about various issues under the Supply Agreement, including the proposed capital charge. In that e-mail to his brother, Sam Steves suggested that Steves send a "VERY strong response" and "tee up [its] claim on the overcharge." His proposed response also included this suggested language: "We remain troubled that you continue to threaten termination of the agreement if we don't consent to ... a price increase! Finally, and perhaps most important—the antitrust." DX-466.

Neither Sam nor Edward Steves were called upon to explain the comments made in those emails. So, it is difficult to discern their meaning. Nonetheless, those e-mails show that Steves should have been alerted to the possibility that the threatened price \*677 increases and the contract termination were effects of the merger. That possibility would have become more concrete when Hachigian sent the Supply Agreement termination letter on September 10, 2014. Accordingly, the record permits the conclusion that Steves should have known that it faced threatened or actual antitrust injury by August 12, 2014,<sup>28</sup> and that Steves did know by September 10, 2014.



28 At least one case has suggested that the continuing violations doctrine might apply to extend the laches period each time a new anticompetitive act occurs. See IT & T, 518 F.2d at 929. However, the Court already noted that this doctrine usually does not apply in Clayton Act cases, and held that the anticompetitive effects here were “unabated inertial consequences” of the CMI Acquisition, not independent Section 7 violations. See Summary Judgment Op. at 30-31 (internal quotations omitted). Therefore, any doorskin price increases or quality reductions after August 2014 did not change the beginning date of the laches period.

Therefore, the question becomes whether JELD-WEN has proven that the time between August 12, 2014 and June 29, 2016 (when this action was filed) constitutes unreasonable delay for purposes of laches. As previously explained, that is a case-specific inquiry that depends on the particular facts at hand.

In this case, the inquiry begins with the understanding that Steves needs a reliable supply of doorskins to survive, a fact known by both Steves and JELD-WEN. The inquiry also must take into account that, in August 2014, there were only two domestic doorskin manufacturers, and that one, Masonite, recently had announced that it would not sell doorskins to independent door manufacturers like Steves. The reasonableness assessment must also consider that the other supplier, JELD-WEN, had just given notice to Steves that the Supply Agreement would end in 2021 unless Steves agreed to JELD-WEN's demands for a substantial price increase. Also, in August 2014, there was virtually no decisional law around which to measure the viability of a private party antitrust lawsuit, much less one in which the substantial lessening of competition had been brought about under the circumstances presented by this record. Finally, the assessment must keep in mind that JELD-WEN was a far bigger and far better-heeled company than Steves. The question then becomes whether it was reasonable for Steves, confronted with these realities in August 2014, to have instituted a costly, protracted, and novel antitrust litigation to attempt to solve a supply dilemma that was then seven years in the future. The record teaches that such a course was not reasonable.

Instead, as the record here shows, when confronted with contract termination, Steves reasonably elected to try to find another reliable source of supply. To that end, in October 2014, the Steves Brothers met with Masonite's CEO, Fred

Lynch who informed them that Masonite would not sell doorskins to Steves except on a spot basis, and at prices that were so high that Steves could not make a profit. Faced with that position by Masonite, it became both necessary and reasonable for Steves to treat further with JELD-WEN. So, in January 2015, Sam and Edward Steves met with Hachigian, Merrill, and other JELD-WEN representatives in an effort to resolve the differences between the two companies, and thereby to secure the reliable source of supply on which Steves' survival depended.

However, in that meeting, Hachigian threatened that JELD-WEN would be “total pricks” over the remaining term of the Supply Agreement if Steves did not agree to renegotiate the contract to pay higher \*678 doorskin prices. See PTX-514. And, from January 2015 to the middle of that year, JELD-WEN informed Steves about a series of greater price increases, which JELD-WEN conceded at trial were actually prohibited by the Supply Agreement. During that same period, JELD-WEN refused to provide Steves with the contractually required information that would allow Steves to determine whether the proposed price increases were legitimate under the controlling provisions of the Supply Agreement.

With those developments, Steves again approached Masonite, the only other domestic supplier, about a supply of doorskins. It was reasonable to make the last ditch effort with Masonite. Lynch again informed Edward Steves that Masonite would not supply Steves with doorskins on a long-term basis, offering to sell Steves' doorskins only on a spot basis at prices that would be unprofitable for Steves.

Therefore, at about the same time, Steves found it necessary to explore the possibility of buying doorskins from foreign manufacturers or building its own doorskin plant. Steves ultimately determined that neither option was likely to provide an adequate source of supply by the time that the Supply Agreement would expire. Nonetheless, it was reasonable for a small company like Steves to explore securing a doorskin supply by purchasing from foreign suppliers or building its own plant rather than instituting a novel antitrust lawsuit against its much larger and more powerful supplier. The record shows that the process of assessing the viability of foreign manufacturers as a source of supply, like the process of evaluating whether it was possible or sensible to build a plant as the source of supply was complicated and time-consuming. Here, the record shows that, once Steves had determined that it could rely on

neither of the two domestic doorskin suppliers (Masonite or JELD-WEN), it timely and diligently pursued the only other conceivable alternatives to filing an antitrust suit. Accordingly, the record here shows, and the Court finds, that Steves proceeded with reasonable diligence to consider the viability of these alternate sources of supply rather than starting a lengthy, costly, and novel antitrust lawsuit against its vastly better-financed supplier.

By early 2015, Steves had concluded that its future was at serious risk because the Supply Agreement with JELD-WEN would expire in 2021, and neither Masonite nor foreign suppliers offered a reasonable alternative mean of supply. Moreover, it was entirely uncertain whether Steves could afford to build a doorskin plant, either on its own or with a partner.

However, there was available to Steves another means to try to resolve the problems that both threatened Steves' existence and that, if not solved, would present antitrust injury: the alternative dispute resolution provision ("ADR") in the Supply Agreement. That process required Steves and JELD-WEN, as a first step, to hold an internal conference among senior executives. PTX-149 § 10(a). If that step was unsuccessful, the contract required the parties to engage in mediation as a second step. *Id.* § 10(b).

On March 11, 2015, Steves invoked the ADR provisions of the Supply Agreement, and it requested an internal conference among senior executives to occur on March 23. DX-243 at 2. However, the two internal conferences did not take place until May 2015. At one of those meetings, Steves' attorney, Marvin Pipkin, expressed Steves' concern about antitrust issues arising out of JELD-WEN's conduct. The record does not reflect the exact details of Pipkin's statements or JELD-WEN's response. But it is clear that, by May 2015, JELD-WEN \*679 was aware of the risk of an antitrust claim if it persisted to exploit, in its dealings with Steves, the substantially lessened competition that the merger had produced. Of course, Steves too was aware of that potential antitrust claim.

After the internal conferences were unsuccessful, on July 2, 2015, Steves requested the mediation required by the Supply Agreement. That mediation took place in September 2015. The parties' disputes were not resolved then, but Steves presented JELD-WEN with a draft Complaint that raised both contract and antitrust claims.

Thereafter, on September 4, 2015, the parties entered into the first of several standstill agreements, which were extended on September 29, 2015; October 13, 2015; January 27, 2016; and April 25, 2016. Those agreements contained provisions reciting the parties' "desire to continue to discuss their differences in an effort to resolve these differences without litigation." See PTX-591; PTX-593; PTX-606; PTX-641; PTX-682.

While the standstill agreements were in effect, Steves, in December 2015, gave a presentation to the DOJ complaining of antitrust violations, after which the DOJ initiated a civil investigative demand. JELD-WEN subsequently gave a presentation to the DOJ on April 7, 2016. The investigation was closed by the DOJ on May 18, 2016. In June 2016, Steves requested JELD-WEN to agree to another extension of the standstill agreements, which JELD-WEN rejected. Immediately thereafter, on June 29, 2016, Steves filed this action.

On this record, the Court holds that JELD-WEN has not met its burden to prove that the delay between September 10, 2014 and June 29, 2016 was unreasonable. To the contrary, the record shows that, during that period, Steves took every reasonable step to try to secure a reliable supply of doorskins that was essential for its survival. It was reasonable for a small purchaser, like Steves, to try all reasonable measures to avoid litigation with the supplier of an ingredient essential to its core product line. That is especially so where, as here, the supplier is a vastly larger company that can afford costly litigation and where, as here, that supplier indicates a continued desire to attempt to work things out short of litigation. Public policy supports efforts by parties to work out difficult issues respecting their business relationships without resorting to litigation. See *Essilor Int'l v. Nidek Co.*, 217 F.3d 857, 1999 WL 989071, at \*5 (Fed. Cir. 1999); *NAACP v. NAACP Legal Def. & Educ. Fund, Inc.*, 753 F.2d 131, 137 (D.C. Cir. 1985); *Piper Aircraft Corp. v. Wag-Aero, Inc.*, 741 F.2d 925, 932 (7th Cir. 1984); cf. *Petrella*, 134 S.Ct. at 1976. Furthermore, common sense teaches that antitrust litigation would be lengthy and exceedingly expensive. And, in this case, the kind of antitrust case that Steves would have to bring would be the first of its kind. So there was no reliable way to predict what such litigation might cost or whether it would even be concluded before Steves would lose its source of supply in 2021.

Nor was it unreasonable for Steves to use the contractually-required ADR process to try to work out a business

compromise to the contract-related problems that actually produced its antitrust injury, instead of immediately commencing antitrust litigation. Even after those procedures failed, the parties, both mindful of the potential for antitrust litigation, agreed to standstill agreements with a view to solving their differences. Considering the representations in those agreements that both parties wanted to resolve their differences without litigation, Steves reasonably avoided \*680 filing an antitrust suit until JELD-WEN refused to continue the process.

Considering the record as a whole, JELD-WEN has not proven that the delay from August 2014 to June 2016 was unreasonable. That, of course, defeats JELD-WEN's laches defense, because it has failed to prove the first element of that defense. Thus, the inquiry respecting the application of laches to the equitable remedies is at an end.

## 2. Prejudice to JELD-WEN

[59] Ordinarily, it is preferable to articulate a single basis for decision, and thereby refrain from making alternative holdings. See [Karsten v. Kaiser Found. Health Plan of Mid-Atl. States, Inc.](#), 36 F.3d 8, 11 (4th Cir. 1994). However, this case presents an exception to that rule, given that it presents issues of first impression on which appeal is virtually certain, and considering the nature of the relief sought. Therefore, in the interest of judicial economy, it is appropriate to consider the prejudice element of JELD-WEN's laches defense so that the entire picture will be available for consideration in the likely event of appeal.

[60] [61] [62] [63] Even unreasonable delay does not animate the bar of laches if that delay does not cause harm to the defendant. [Ray Commc'ns](#), 673 F.3d at 305. Prejudice is shown by “a disadvantage on the part of the defendant in asserting or establishing a claimed right or some other harm caused by detrimental reliance on the plaintiff's conduct,” [White](#), 909 F.2d at 102, including economic prejudice. [Ray Commc'ns](#), 673 F.3d at 305. In addition, a defendant is always “aided by the inference of prejudice warranted by the plaintiff's delay.” ... [T]he greater the delay, the less the prejudice required to show laches, and vice versa.” [White](#), 909 F.2d at 102 (quoting [Giddens v. Isbrandtsen Co.](#), 355 F.2d 125, 128 (4th Cir. 1966)). But, in every case, “the defendant is ultimately required to prove prejudice (given the defendant's burden to plead and prove laches under [Fed. R. Civ. P. 8\(c\)](#) ).” [Id.](#)

[64] Here, there is no contention that JELD-WEN suffered any disadvantage in asserting or establishing a claimed right. Instead, JELD-WEN relies on the presence of “some other harm caused by detrimental reliance on [Steves'] conduct.” In particular, JELD-WEN asserts various economic disadvantages that it says constitute prejudice.

JELD-WEN contends that, beginning immediately after the merger and continuing through 2016, it took numerous steps to integrate Towanda into its overall manufacturing operation. It claims that it closed CMI's Chicago headquarters, consolidated administrative functions, mothballed the Marion plant in 2013, sold Dubuque in 2016, and otherwise integrated Towanda into its general manufacturing plans but for Steves' delay in initiating suit. Those positions are based almost exclusively on the testimony of Morrison, and the Court declines to accept his testimony.

Morrison, who also served as JELD-WEN's trade secrets expert in the liability phase of the trade secrets case, was shown at the trade secrets trial to be a witness who could not be believed. He lied on his resume, which was offered into evidence, stating that he had graduated from Louisiana State University when in fact he had attended but one semester. He lied again, at his deposition and trial, when asked about his resume and his education, and he allowed JELD-WEN to publicly tout him as a graduate of Louisiana State University for years. A person who will lie about something of that nature is not to be believed. Moreover, having observed Morrison's conduct when testifying in the Remedies Hearing, the Court notes that he was \*681 more advocate than witness, and regrettably concludes that he would say anything to support JELD-WEN's cause whether it was supported by facts or not.

Accordingly, the Court does not believe his testimony that, in reliance on the absence of an antitrust suit, JELD-WEN would not have mothballed the Marion plant, closed the Dubuque plant, made the modifications in its system, and effectuated the integration of the Towanda plant into JELD-WEN's operations. Wholly apart from Morrison's lack of credibility, the record shows that the Marion plant was mothballed because of the expense of meeting environmental regulations and updating antiquated equipment. And, the record also shows that the decision to close the Dubuque plant was made in 2011, before the merger. Thus, the record also shows that Morrison's testimony is not credible.

Putting aside Morrison's testimony, the evidence is generally undisputed that JELD-WEN expended significant funds installing capital improvements and manufacturing processes in Towanda and integrating Towanda into its operation. But, the preponderance of the evidence does not establish that JELD-WEN relied on the absence of an asserted antitrust claim by Steves, in taking those steps. To the contrary, JELD-WEN made substantial investment in Towanda even after it was told by Pipkin in May 2015 that Steves had antitrust concerns and after Steves presented a copy of an anti complaint in September 2015. That JELD-WEN continued to invest in Towanda with that knowledge materially undercuts JELD-WEN's contention that it would not have made investments in Towanda had it been aware of a possible antitrust claim.

Further, the Court finds that JELD-WEN was fully aware that an antitrust action could be filed at any time within four years after the merger and, in any event, it is charged with that knowledge. And, mindful of that possibility, JELD-WEN made its investments in Towanda, integrated Towanda into its operational system, and took all the actions it now uses to prove the prejudice component of its laches defense.

The record shows that JELD-WEN relied not on Steves' inaction but on having successfully lulled Steves and the DOJ into action by entering into long-term contracts with the independent doorskin customers, including Steves. JELD-WEN thus relied on that tactic to insulate it going forward after the merger, not on Steves' inaction. Accordingly, JELD-WEN has not met its burden of proof on the component of detrimental reliance.

But, even if JELD-WEN can be said to have made the requisite showing of detrimental reliance, it has nonetheless failed to show prejudice that would suffice to establish laches. For example, the record is clear that JELD-WEN has more than recovered the capital investments (plant modifications and new equipment) that it made in Towanda after the merger, the making of which JELD-WEN asserts as prejudice. And, its operation of Towanda has yielded considerable profit. JELD-WEN, of course, will not have to disgorge that profit.

As discussed fully in Section II.A.3.(b) (Balance of Hardships), the operational changes that, of necessity, will be made in the event of divestiture will no doubt be troublesome to achieve, will entail significant expense, and will have some detrimental collateral consequences. However, the making of the changes necessary to restore competition is not such

prejudice as will call into operation the equitable defense of laches into play.

JELD-WEN's position on laches is founded principally on the decisions in \*682 [Antoine L. Garabet M.D., LLC v. Antomonus Techy. Corp.](#), 116 F.Supp.2d 1159 (C.D. Ca. 2000) and [Taleff v. Southwest Airlines Co.](#), 828 F.Supp.2d 1118 (N.D. Ca. 2011). In both cases, the plaintiffs sued under Section 7 of the Clayton Act, alleging that the merger itself would substantially lessen competition. In both cases, the plaintiffs were aware of the proposed merger and the threat to competition for several months before the merger. In [Garabet](#), the plaintiffs filed suit after the merger (one day in [Taleff](#), the same day in [Garabet](#)). In [Garabet](#), the court held that the plaintiffs lacked antitrust standing for each antitrust injury and the court sustained a defense of laches. [Garabet](#), 116 F.Supp.2d at 1165-71. In [Taleff](#), the court did not actually decide the applicability of laches, but it held that the delay in filing suit until after the merger tipped the balance of hardship against the plaintiffs. 828 F.Supp.2d at 1123-24.

Neither [Garabet](#) nor [Taleff](#) apply here because the facts of this case are different. Here, unlike [Garabet](#) and [Taleff](#), there was no reason for the plaintiff to apprehend a lessening of competition before or at the time of the merger. To the contrary, JELD-WEN's strategy was intended to give Steves comfort. And, as explained above, the conduct causing antitrust injury occurred well after the merger.

Accepting JELD-WEN's theory would mean that where, as here, the lessening of competition occurs after the merger, a party thereby injured simply could never seek equitable redress to restore competition. For the reasons previously explained, the rules of antitrust injury and antitrust standing as well as the fundamental principles of equity foreclose such a result.

## CONCLUSION

For the reasons, and to the extent, set forth above, PLAINTIFF STEVES AND SONS, INC.'S MOTION FOR EQUITABLE RELIEF (ECF No. 1191) will be granted in part and denied in part. The motion will be granted to require that JELD-WEN divest itself of the Towanda facility and, to the extent set out in Section II.B, to grant the conduct remedies necessary to the success of the divested entity as a manufacturer of interior molded doorskins. The motion will



be denied as to the requested conduct remedies not necessary to that purpose.

To assure, to the extent reasonably possible, that JELD-WEN receives a fair price for Towanda, and to assure that divestiture produces a competitive entity that is likely to restore competition, the process specified by the Supreme Court in [Brown Shoe](#), will be followed so as to assure that the divestiture is conducted in a realistic setting that is conducive

to attracting qualified buyers who will pay a fair **price for Towanda. To assure the success of that process, a Special Master will be appointed.**

**It is so ORDERED.**

**All Citations**

345 F.Supp.3d 614, 2018-2 Trade Cases P 80,553

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## **LEGAL AUTHORITY CA-113**

Affirmed.



KeyCite Yellow Flag - Negative Treatment

Distinguished by [Poole v. Carter](#), Cal.App. 4 Dist., April 8, 2008

114 Cal.App.4th 1264

Court of Appeal, First District, Division 2, California.

Ala SINGH et al., Plaintiffs and Respondents,

v.

Gurdial SINGH et al., Defendants and Appellants.

No. A100705.

|

Jan. 20, 2004.

|

Certified For Partial Publication. \*

\* Pursuant to [California Rules of Court, rules 976\(b\)](#) and [976.1](#), this opinion is certified for publication with the exception of part I.

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Review Denied April 14, 2004. \*\*

\*\* [Kennard](#), [Chin](#) and [Brown, JJ.](#), dissented.

**Synopsis**

**Background:** Members of a religious society sued its board of directors alleging that they remained in office in violation of the Corporations Code. The Superior Court of Alameda County, No. 02-046093, [Julia Spain, J.](#), after a bench trial, entered judgment that election for board of directors be held. Board of directors appealed.

**Holdings:** The Court of Appeal, [Lambden, J.](#), held that:

[1] courts may adjudicate religious disputes concerning property;

[2] order for conducting election of board of directors was not unconstitutional;

[3] order outlining procedure for conducting election was constitutional; and

[4] order that members have equal time to address congregation concerning election was valid.

West Headnotes (16)

[1] **Religious Societies** [Judicial supervision in general](#)

Courts cannot intrude into a religious organization's determination of religious or ecclesiastical matters such as theological doctrine, church discipline, or the conformity of members to standards of faith and morality.

[6 Cases that cite this headnote](#)

[2] **Courts** [Construction of federal Constitution, statutes, and treaties](#)

California courts concerned with restraints under the First Amendment applicable to the states through the Fourteenth are bound by the authoritative interpretations of the First Amendment enunciated by the United States Supreme Court. [U.S.C.A. Const.Amends. 1, 14.](#)

[2 Cases that cite this headnote](#)

[3] **Religious Societies** [Judicial supervision in general](#)

No matter whether the religious organization is hierarchical or congregational, the decisions of the highest religious tribunal on questions of discipline, faith, or ecclesiastical rule, custom, or law must be accepted by the courts.

[7 Cases that cite this headnote](#)

[4] **Religious Societies** [Jurisdiction of courts to determine rights of property](#)

When a religious dispute to be resolved is essentially ownership or right to possession of property, the courts appropriately adjudicate the controversy even though it may arise out of a dispute over doctrine or other ecclesiastical question, provided the court can resolve the property dispute without attempting to resolve the underlying ecclesiastical controversy, and can use neutral principles of law.

8 Cases that cite this headnote

- [5] **Constitutional Law** 🔑 Internal affairs, governance, or administration; autonomy or polity

**Religious Societies** 🔑 Judicial supervision in general

In action by members of religious society to require board of directors, who had remained in office in violation of Corporations Code, to hold election for directors, court avoided impermissibly intruding into ecclesiastical matters by hearing evidence to determine whether any authority had determined whether reference in bylaws to certain religious traditions signified a life term for directors, and, upon determining that no ecclesiastical authority had decided issue, resolving dispute based on contract law and Corporations Code. *U.S.C.A. Const.Amend. 1; West's Ann.Cal. Const. Art. 1, § 4; West's Ann.Cal.Corp.Code § 9220.*

*See 7 Witkin, Summary of Cal. Law (9th ed. 1988) Constitutional Law, § § 373, 374.*

8 Cases that cite this headnote

- [6] **Constitutional Law** 🔑 Establishment of Religion

To avoid conflict with establishment clause: (1) challenged government activity must have secular legislative purpose; (2) principal or primary effect of the activity must be one that neither advances nor inhibits religion; and (3) activity must not foster excessive government entanglement with religion. *U.S.C.A. Const.Amend. 1; West's Ann.Cal. Const. Art. 1, § 4.*

- [7] **Constitutional Law** 🔑 Secular purpose

Under criterion of *Lemon* test inquiring whether government activity challenged under establishment clause has secular purpose, inquiry should be deferential and limited, and if government articulates plausible secular purpose, this should be accepted absent contrary

showing by challenger. *U.S.C.A. Const.Amend. 1; West's Ann.Cal. Const. Art. 1, § 4.*

- [8] **Constitutional Law** 🔑 Advancement, endorsement, or sponsorship of religion; favoring or preferring religion

**Constitutional Law** 🔑 Inhibiting, interfering with, or coercing religion

Under criterion of *Lemon* test inquiring whether principal or primary effect of government activity challenged under establishment clause is one that neither advances nor inhibits religion, question is whether, irrespective of government's actual purpose, practice under review in fact conveys message of endorsement or disapproval to interested parties under objective standard. *U.S.C.A. Const.Amend. 1; West's Ann.Cal. Const. Art. 1, § 4.*

- [9] **Constitutional Law** 🔑 Entanglement

Under criterion of *Lemon* test inquiring whether government activity challenged under establishment clause fosters excessive government entanglement with religion, court determines whether state will be required to monitor challenged government activity for its religious content in order to assure that it does not have unintended effect of encouraging or discouraging religion. *U.S.C.A. Const.Amend. 1; West's Ann.Cal. Const. Art. 1, § 4.*

- [10] **Constitutional Law** 🔑 Internal affairs, governance, or administration; autonomy or polity

**Constitutional Law** 🔑 Membership

**Religious Societies** 🔑 Judicial supervision in general

In action by members of religious society to require board of directors, who had remained in office in violation of Corporations Code, to hold election by members for directors, trial court's order outlining procedure for determining membership did not violate establishment clause; order had clear secular purpose to

comply with Corporations Code under which organization operated, order neither advanced nor inhibited religion, and appointment of special master to monitor procedure did not affect religious content or purport to set qualifications for members, but to settle disputes under organization's own bylaws. U.S.C.A. Const.Amend. 1; West's Ann.Cal. Const. Art. 1, § 4; West's Ann.Cal.Corp.Code § 9220(b).

5 Cases that cite this headnote

**[11] Constitutional Law** 🔑 Entanglement

It is not the mere fact that government may have to continue to monitor activity of religious society that constitutes entanglement with religion in violation of establishment clause, but whether court will be required to monitor the activity for its religious content. U.S.C.A. Const.Amend. 1; West's Ann.Cal. Const. Art. 1, § 4.

**[12] Constitutional Law** 🔑 Entanglement

**Religious Societies** 🔑 Judicial supervision in general

In action by members of religious society against board members, who had remained in office in violation of Corporations Code, order requiring that when directors used Sunday services as a platform to lobby for their retention or re-election, that members be afforded equal time, including the opportunity to speak to the congregation, was not entanglement with religion, in violation of establishment clause; court was not interpreting or applying any religious doctrine, but was simply ensuring that the election process was fair. U.S.C.A. Const.Amend. 1; West's Ann.Cal. Const. Art. 1, § 4.

See 55 Cal.Jur.3d, *Religious Organizations*, § 30.

2 Cases that cite this headnote

**[13] Appeal and Error** 🔑 Written documents or instruments in general

When the trial court's interpretation is based solely upon the terms of the written instrument, and there is no conflict in the evidence, appellate court reviews the ruling de novo.

3 Cases that cite this headnote

**[14] Appeal and Error** 🔑 Written documents or instruments in general

Although court reviews the construction of the express terms of an instrument de novo, it reviews the evidence regarding the interpretation of the words under the substantial evidence test.

4 Cases that cite this headnote

**[15] Appeal and Error** 🔑 Verdict, Findings, and Sufficiency of Evidence

**Appeal and Error** 🔑 Substantial evidence

Appellate court must uphold any factual determination of the trial court, express or implied, so long as there is substantial evidence in the record to support it; if the evidence is conflicting, court must accept that which supports the trial court's decision and make all reasonable inferences in support of the judgment.

3 Cases that cite this headnote

**[16] Corporations and Business Organizations** 🔑 Construction, operation, and effect

Corporate bylaws are to be construed according to the general rules governing the construction of statutes and contracts, and must be given a reasonable construction and, when reasonably susceptible thereof, they should be given a construction that will sustain their validity.

10 Cases that cite this headnote

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## Opinion

LAMBDEN, J.

The Sikh Temple–San Francisco Bay Area, Inc. (the Sikh Temple)<sup>1</sup> and its current board of directors (also referred to as the Supreme \*1269 Council or Panj Pyaras),<sup>2</sup> Gurdial Singh, Harjot Singh, Amarjit Singh, Gurdev Singh, and Mota Singh, challenge a judgment following a bench trial. The Sikh Temple members Ala Singh, Karnail Singh, Ram Singh, Sukhdev Singh, Harjinder Singh, Joginder Singh, and Gurmeet Singh (collectively respondents or plaintiffs) sued the Sikh Temple and its current board of directors (collectively appellants or defendants) because they alleged that the board of directors or Supreme Council remained in office in violation of Corporations Code section 9220, subdivision (b).<sup>3</sup> The trial court found, among other things, that the Temple's bylaws do not specify a life term for the Supreme Council and section 9220 therefore applies, creating a term of one year. Appellants challenge this ruling, contending that a prior judgment involving them as the defendants should have been given collateral estoppel effect; the ruling violates their First Amendment rights; the ruling represents an unconstitutional entanglement with religion; and the bylaws were not silent regarding the term of office for the Supreme Council. We are unpersuaded by their arguments and uphold the lower court.

<sup>1</sup> The Sikh Temple is a nonprofit corporation that is also known as Gurdwara Sahib–San Francisco Bay Area, Fremont, California.

<sup>2</sup> The parties stipulated that the members of the Supreme Council or Panj Pyaras were the board of

directors for the purposes of this lawsuit and the Corporations Code.

<sup>3</sup> All further unspecified code sections refer to the Corporations Code.

## BACKGROUND

The Sikh Temple was incorporated as a nonprofit religious corporation in 1977. Its articles of incorporation provide that the bylaws shall specify the qualifications for members, voting rights, and other privileges of membership. The current bylaws were adopted in 1987.

Article II of the bylaws provides that the general membership shall select and appoint the Supreme Council, or Panj Pyaras. Article II reads: “The principles and practices of the Gurdwara Management will be those espoused by Sikh faith and Gurmat tradition. The institution of Panj Pyaras (five beloved ones) will be revived in order to provide the guidelines \*\*8 for day-to-day functions of the Gurdwara. The Panj Pyaras (five beloved ones) will be selected and appointed by Sadh Sangat or membership of the Gurdwara Sahib [Sikh Temple]. If any of the Panj Pyaras is found unfit for his position, another Panj Pyara shall be selected by the General Body to fill up the vacancy. In the meantime, the Head Priest of the Gurdawara [*sic*] Sahib shall perform the duties of a Panj Pyara.”

Article IV concerns the dismissal of a member of the Supreme Council. It specifies that a member of the Supreme Council can be dismissed for breaking the Sikh code of conduct, as prescribed in Rehatnamas; for breaking the Sikh rule of objectivity by indulging in petty politics of factionalism and \*1270 name calling; and for being unable to get along with the Supreme Council. Article V sets forth the procedures for selecting the Executive Committee or Parbandhak Committee, which oversees daily management of the Sikh Temple. It provides in relevant part: “The Parbandhak Committee shall consist of eleven members. The Supreme Council will ask for the names of Sewadars from the Sadh Sangat [general membership] every now and then depending upon the availability of vacancy on the Parbandhak Committee. The Supreme Council will ask the Sadh Sangat for nominations. The term of the Parbandhak Committee shall be for a period of two years. A Parbandhak can stay on the Executive Committee for a maximum period of four years....”

Article XVI provides in relevant part that any amendment to the bylaws must “be first presented to the Supreme

Council of Panj Pyaras in the form of a petition, identifying major gaps or shortcomings according to Sikh tradition (Rahatmaryada). The Panj Pyaras should examine the petition carefully and submit their recommendations to the General Body of Gurdwara membership. The 3/4 majority of the Sikh membership in General Body can endorse the amendment and the Constitution can be changed accordingly.”

In 1988, pursuant to the newly adopted bylaws, the congregation nominated and elected five individuals to serve on the Supreme Council.<sup>4</sup> In 1991, four of the five members of the Supreme Council resigned. The congregation nominated and elected four new individuals. In 1993, all five members of the Supreme Council resigned and, subsequently, the congregation nominated and elected five new members.

<sup>4</sup> These undisputed facts regarding the history of the Supreme Council come from the statement of decision and/or the judgment.

In August 1996, a lawsuit was filed, *Dhami v. Tut* (Alameda County Superior Court, 1996, No. H–1921025). The plaintiffs sought, among other things, to remove three members of the Supreme Council, declare an earlier election valid or in the alternative order a new election, appoint a receiver, and determine the rights of the parties pursuant to [section 9220](#). This case settled when the parties agreed to a court-supervised election of the Supreme Council. That election occurred on December 22, 1996, and resulted in the election of five Supreme Council members, including Gurdial Singh, Jarjot Singh, Amarjit Singh, and Gurdev Singh, who are appellants in the action before us.

In 1999, one member of the Supreme Council was involuntarily removed pursuant to Article IV of the bylaws. Mota Singh, an appellant in this action, was nominated and selected as a replacement by the congregation. Other than \*1271 the filling of this vacancy, no elections for Supreme \*\*9 Council were held between December 22, 1996 and March 31, 2002.

In December 1998, a second lawsuit, *Dhami v. Singh* (Alameda County Superior Court, 1998, No. H–204698–5), was filed.<sup>5</sup> The complaint was for declaratory relief, injunctive relief, and a receivership. The plaintiffs alleged that pursuant to section 7710 their action was derivative. They complained that there was an unlawful cancellation of a general election scheduled for December 20, 1998, by the defendants named in that case and the assumption of

office by a new board of directors on December 6, 1998, without the benefit of an election. In their first cause of action for declaratory relief, they asserted that the defendants had violated the bylaws by refusing to permit the calling of the congregation to elect members of the Supreme Council and members of the Executive Committee or Management Committee. In the second cause of action, they requested the removal of these directors and officers. In their third cause of action, they alleged that the defendants had been in office for more than 12 consecutive months in violation of [section 9220](#). They also alleged intentional infliction of emotional distress and requested injunctive relief and a receivership.

<sup>5</sup> The plaintiffs in this action were Avtar Singh Dhami, Avtar Singh Chahal, Kulwant Singh Mehrok, Amarjit Singh Sidhu, Jagmail Singh Saran, and Devinder Singh Channa.

*Dhami v. Singh* proceeded to a court trial in February 1999, the Honorable John Burke, presiding. The court ruled in favor of the defendants on the first cause of action. Defendants' counsel requested an order reflecting that the first cause of action had been bifurcated for final adjudication “without dealing with the other issues.” The court responded that it had ruled for the defense on the first cause of action. As to the second, the removal of directors and officer for breach of the bylaws, the court stated that it was also ruling for the defense on that action. The court continued: “The third cause of action was declaratory relief and injunctive relief in violation of [Corporations Code \[section\] 9220](#), and I rule for the defense in that. [¶] The fourth cause of action is for intentional infliction of emotional distress. The Court makes no ruling and took no evidence on [this]. [¶] The fifth cause of action is for the injunctive relief for harassing and annoying and threatening, and the Court rules for the defense in that.” The court also ruled for the defense on the sixth cause of action. The fourth cause of action was bifurcated for trial and eventually dismissed.

Following this trial, a general body meeting for March 31, 2002, was called by appellants upon verbal notice given to those in attendance at the Sikh Temple meetings on the two Sundays prior to March 31.<sup>6</sup> The verbal notice of the general body meeting did not state an election would be held or that removal of the Supreme Council would be sought.

<sup>6</sup> For the last several years, the annual general body meeting had been held in March.



\*1272 Respondents submitted a written request to address the congregation at the March 31 meeting. Appellants wrote a letter back to them explaining that they deemed the request to address the congregation as a request to advocate for bylaw amendments and that no vote would take place because they had not followed the procedure set forth in Article XVI.

At the meeting of March 31, 2002, respondent Ram Singh addressed the congregation with the concern that the Supreme Council had been in office since 1996 and no elections had been held. He \*\*10 stated that an election should take place. Respondent Gurmeet Singh also addressed the congregation and he told the congregation that it had complete authority to form or to dissolve the Supreme Council. He then proceeded with the following three proclamations: The congregation has decided that every four years there should be elections for the Supreme Council; the present Supreme Council and Executive Committee are dissolved; and respondents Sukdev Singh, Karnail Singh, Ram Singh, Harjinger Singh, Bhal Ala Singh, and Joginder Singh are the new Supreme Council and they will hold new elections in six months. Following each proclamation, the people attending the meeting orally, and simultaneously, voiced their approval or disapproval.

Following this March meeting, appellants remained as the Supreme Council and refused to vacate. Consequently, on April 3, 2002, respondents filed this action. On April 22, they filed their first amended complaint for judicial determination of the validity of the March 2002 election and for declaratory relief. Respondents asserted that appellants remained in office in violation of [section 9220, subdivision \(b\)](#), which requires annual elections of the board of directors unless the bylaws or articles of incorporation specify otherwise. They requested the court to determine the validity of the election of the Supreme Council on March 31, 2002, or to order a new election and determine the right of the Sikh Temple members to vote pursuant to section 9418, subdivision (c).

The Honorable Julia A. Spain presided over a court trial on this action in June 2002. The parties stipulated that the Supreme Council is the board of directors for purposes of a Corporations Code analysis. The court heard evidence regarding the term of office for the Supreme Council. Respondents argued that members of the Supreme Council were not elected for life and appellants argued that the institution of Panj Pyaras is permanent without any term limit for the Supreme Council. During the trial, the court advised the parties, on its own motion, of its intent to take judicial notice of the court files in the two earlier cases, *Dhami v.*

*Tut and Dhami v. Singh*. Appellants objected to the court's taking judicial notice of the entire court files in those \*1273 actions, but later both parties stipulated that the court could take judicial notice of selected documents.<sup>7</sup>

<sup>7</sup> We have received several requests for judicial notice of court documents, which have been granted.

On July 23, 2002, the court issued its tentative statement of decision that the Supreme Council's term had expired and it ordered a new election. Appellants filed written objections asserting, for the first time, that the court was bound by *Dhami v. Singh* on the issue of the Supreme Council's term.

The court's judgment was filed September 4, 2002. The court concluded that *Dhami v. Singh* did not have any res judicata or collateral estoppel effect on the case before it. It found that no final judgment had been entered in *Dhami* and appellants had waived the argument because, despite the court's invitation, they failed to plead, prove, or argue collateral estoppel as an affirmative defense. In addition, the court found the issues litigated in the two actions were not identical. The court explained: "According to the First Amended Complaint in *Dhami v. Singh*, each and every cause of action arose to some degree from the alleged unlawful cancellation of a general election scheduled for December 20, 1998, by the defendants named in that \*\*11 case and the assumption of office by a new Board of Directors on December 6, 1998, without the benefit of an election. The First Amended Complaint in *Dhami v. Singh* refers to the members of the Supreme Council *and the members of the Executive Committee* (or Management Committee) as the 'Board of Directors,' and in the third cause of action seeks to limit the term of office for this collective group to one year and to compel a new election for this *combined 'Board of Directors.'* In the present case, the plaintiffs request judicial determination of the validity of an election held on March 31, 2002. For purposes of this litigation, the parties stipulated that only the Supreme Council is the corporate board of directors. The First Amended Complaint in this case seeks to compel a new election of the Supreme Council, *exclusive of the Executive Committee*. Thus, the Court finds the issues which were presented for judicial determination in *Dhami v. Singh* are not identical to those presented in the instant action. Defendants failed to carry their burden of proof on this requirement."



The court also found that appellants failed to establish that the Supreme Council's term had been actually litigated or necessarily decided in *Dhami v. Singh*. In addition, the court found there was no privity. None of the plaintiffs in the case before it was a party to the *Dhami v. Singh* action. In a footnote, the court explained that four of the named individual defendants in the action before it were also named defendants in *Dhami v. Singh*, as was the Sikh Temple. The court explained: “[T]hey are the parties ‘asserting’ collateral estoppel, not the parties against whom preclusion is sought. Therefore, that these four defendants are ‘identical’ is not determinative.”

\*1274 As to the validity and outcome of the election on March 31, 2002, the trial court ruled that it had jurisdiction to decide which persons were entitled to manage the Sikh Temple, including control of significant corporate assets, by applying neutral principles of law, focusing on the bylaws themselves. The court found that the bylaws do not specify the term of office for the Supreme Council and therefore pursuant to [section 9220, subdivision \(b\)](#), the terms of office shall be one year. The court stated that it could not determine the outcome of the March 31, 2002 election from the evidence presented at trial and, since the term of office for each of the current Supreme Council members had expired, it was ordering new elections. The court ordered a new election by written ballot to occur on January 12, 2003.

Since the Sikh Temple had failed to maintain membership records in violation of [section 9510, subdivision \(a\)](#), the court ordered that the Temple undertake to admit members upon application and consent as specified in [section 9350, subdivision \(b\)](#), by applying the standards in Article X and the first sentence of Article XI of the bylaws. For this purpose, it ordered the creation of a membership committee consisting of four representatives appointed by plaintiffs and four representatives appointed by defendants. Any membership disputes that the membership committee was unable to resolve by majority vote were to be submitted to a special master for decision.

On September 10, 2002, judgment in *Dhami v. Singh* was entered.

Appellants filed a timely notice of appeal from the judgment order in this case.

## \*\*12 DISCUSSION

### I. Collateral Estoppel\*\*

\*\* See footnote \*, *ante*.

### II. Jurisdiction

Appellants contend that the trial court did not have jurisdiction to consider respondents' request for declaratory relief in which they sought a determination of the validity and outcome of the election of March 31, 2002, or their request for a court-ordered election for the Supreme Council. They maintain that the court's decision violated the establishment clause of the First Amendment to the United States Constitution<sup>13</sup> and that the trial court was \*1275 “simply not correct to say that the doctrinal issues raised by the references to the Gurmat tradition and the Panj Pyaras were merely incidental to the resolution of this dispute.” Respondents counter that the Supreme Council, as the board of directors, maintains control of the property and assets of the Sikh Temple and the court has jurisdiction to resolve disputes concerning the control of property of a religious organization.

<sup>13</sup> The establishment clause of the First Amendment to the United States Constitution states: “Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof....”

[1] The question presented is whether the restraints of the First Amendment to the United States Constitution, as applied to the states through the Fourteenth Amendment, as well as the restraints imposed by our state Constitution ([Cal. Const., art. I, § 4](#)),<sup>14</sup> permitted the trial court to order an election for the members of the Supreme Council. Clearly, courts cannot intrude into a religious organization's determination of religious or ecclesiastical matters such as theological doctrine, church discipline, or the conformity of members to standards of faith and morality. (*Metropolitan Philip v. Steiger* (2000) 82 Cal.App.4th 923, 98 Cal.Rptr.2d 605; *Korean Philadelphia Presbyterian Church v. California Presbytery* (2000) 77 Cal.App.4th 1069, 92 Cal.Rptr.2d 275 [competing factions within congregation claimed to be “true” church and any judicial determination would have required courts to interpret and apply religious doctrine].) “Ecclesiastical matters include in the main, creeds and proper modes of

exercising one's belief.” (*Rosicrucian Fellow v. Rosicrucian etc. Ch.* (1952) 39 Cal.2d 121, 131, 245 P.2d 481 (*Rosicrucian* ).) Thus, we must determine whether the court in the case before us impermissibly intruded into the Sikh's Temple's ecclesiastical matters.

14 Section 4 of article I of the California Constitution provides: “Free exercise and enjoyment of religion without discrimination or preference are guaranteed. This liberty of conscience does not excuse acts that are licentious or inconsistent with the peace or safety of the State. The Legislature shall make no law respecting an establishment of religion.”

The United States Supreme Court and our state courts have grappled with the question of resolving disputes within religious organizations and excessive entanglement. Accordingly, prior to considering the facts of the case before us, we briefly review the extensive case law in this area.

#### **A. The United States Supreme Court and State Case Law on the Establishment Clause and Adjudicating Disputes Among Religious Organizations**

The approach of the United States Supreme Court to resolving property disputes involving religious organizations originally developed in *Watson v. Jones* (1871) 80 U.S. (13 Wall.) 679, 20 L.Ed. 666 \*\*13 (*Watson* ), which was decided prior to the application of the First Amendment to the States. In \*1276 resolving intra-church schisms or property disputes, the court identified two categories of church polities: congregational and hierarchical. (*Id.* at p. 722.) Although it was concerned with a hierarchical organization, the *Watson* court discussed the court's role in resolving property disputes in congregational organizations: “In such cases where there is a schism which leads to a separation into distinct and conflicting bodies, the rights of such bodies to the use of the property must be determined by the ordinary principles which govern voluntary associations. If the principle of government in such cases is that the majority rules, then the numerical majority of members must control the right to the use of the property. If there be within the congregation officers in whom are vested the powers of such control, then those who adhere to the acknowledged organism by which the body is governed are entitled to the use of the property. The minority in choosing to separate themselves into a distinct body, and refusing to recognize the authority of the governing body, can claim no rights in the property from the fact that they had once been members of the church or congregation. This

ruling admits of no inquiry into the existing religious opinions of those who comprise the legal or regular organization; for, if such was permitted, a very small minority, without any officers of the church among them, might be found to be the only faithful supporters of the religious dogmas of the founders of the church. There being no such trust imposed upon the property when purchased or given, the court will not imply one for the purpose of expelling from its use those who by regular succession and order constitute the church, because they may have changed in some respect their views of religious truth.” (*Id.* at p. 725.)

As already mentioned, *Watson* did not involve a congregational church, but a hierarchical organization. In a hierarchical organization, “the local congregation is itself but a member of a much larger and more important religious organization, and is under its government and control, and is bound by its orders and judgments.” (*Watson, supra*, 80 U.S. at pp. 726–727.) “In this class of cases we think the rule of action which should govern the civil courts, founded in a broad and sound view of the relations of church and state under our system of laws, and supported by a preponderating weight of judicial authority is, that, whenever the questions of discipline, or of faith, or ecclesiastical rule, custom, or law have been decided by the highest of these church judicatories to which the matter has been carried, the legal tribunals must accept such decisions as final, and as binding on them, in their application to the case before them.” (*Id.* at p. 727.) Accordingly, the Supreme Court in *Watson* refused to resolve a property dispute between a national Presbyterian organization and local churches of that organization, because such a determination would have required the court to determine whether there had been departures from doctrine by the general church. (*Id.* at pp. 733–735.)

\*1277 California courts interpreted *Watson* as supporting “the rule that civil and property rights [can] be adjudicated.” (*Rosicrucian, supra*, 39 Cal.2d at p. 131, 245 P.2d 481, citing *Watson, supra*, 80 U.S. 679, 20 L.Ed. 666 and other California cases.)<sup>15</sup> Shortly after issuing its opinion \*\*14 in *Rosicrucian*, our Supreme Court reiterated in *Providence Baptist Church v. Superior Ct.* that courts “will entertain jurisdiction of controversies in religious bodies although some ecclesiastical matters are incidentally involved” as long as civil or property rights are involved. (*Providence Baptist Church v. Superior Ct.* (1952) 40 Cal.2d 55, 60–61, 251 P.2d 10 (*Providence Baptist Church* ).) Our Supreme Court in *Providence Baptist Church* focused on the fact that the dispute involved a congregational type of church where its

affairs were controlled by the members. “That type exists ‘where each local group is in charge of all its affairs through majority vote of its members and there is no control from above.’ [Citation.]” (*Providence Baptist Church, supra*, at p. 61, 251 P.2d 10.) While acknowledging that there was some authority to the contrary of its holding, our Supreme Court stated: “[I]t has been held that where a religious society has no tribunal but the congregation, a court may determine whether the meeting at which a pastor was removed was properly conducted according to the usage, contracts and rules of the society, or according to pertinent principles of law where civil and property rights, such as the emoluments of the property rights, are involved, and that in so doing the court is not interfering with any ecclesiastical function.” (*Id.* at pp. 61–62, 251 P.2d 10.)

15 We note that this interpretation of *Watson* differs from the United States Supreme Court's conclusions in *Presbyterian Church v. Hull Church* (1969) 393 U.S. 440, 89 S.Ct. 601, 21 L.Ed.2d 658. The *Hull* court quoted *Watson* and then explained: “The logic of this language leaves the civil courts no role in determining ecclesiastical questions in the process of resolving property disputes.” (*Hull, supra*, at p. 447, 89 S.Ct. 601, citing *Watson, supra*, 80 U.S. at pp. 728–729.) The *Hull* court noted that later Supreme Court cases, such as *Gonzalez v. Archbishop* (1929) 280 U.S. 1, 16, 50 S.Ct. 5, 74 L.Ed. 131, recognized that marginal civil court review of ecclesiastical determinations is sometimes appropriate. (*Hull, supra*, at pp. 447–448 & fn. 6, 89 S.Ct. 601.)

In *Providence Baptist Church*, our Supreme Court held that it had jurisdiction to consider whether a congregational church had followed its own bylaws and internal procedures in discharging a pastor: “While we may not be dealing with the officer of a corporation in the strict sense (the pastor of a church is involved) the situation is similar and we see no reason why an election cannot be conducted where, as appears, a fair and proper election cannot be conducted by the church and the election previously held was irregular and of no effect. In other words the appropriate body of the church is assisted in acting within its proper sphere, according to its rules and regulations, to protect civil and property rights. If the problem was whether the pastor was preaching a theology contrary to the denominational doctrine or conducting religious services in a manner out of harmony with the ritual of the church, it would clearly not be within the province of a court to interfere, \*1278 and the controversy

would have to be settled by the church tribunals. But where, as here, the question presented is whether the property and funds of the church are being handled in accordance with the by-laws and rules of the church corporation or such by-laws and rules are being properly observed by the governing body of the church, those aggrieved may seek redress through court action.” (*Providence Baptist Church, supra*, 40 Cal.2d at pp. 63–64, 251 P.2d 10.)

The same year our Supreme Court decided *Providence Baptist Church*, a Court of Appeal addressed the issue, which is almost identical to the one raised in the case before us, whether the court could order and monitor an election of the directors of a religious corporation. (*Burnett v. Banks* (1955) 130 Cal.App.2d 631, 279 P.2d 579 (*Burnett* ).) In *Burnett*, the court adjudicated a dispute between rival \*\*15 church factions regarding a pastor's right to appoint the directors rather than to hold elections by the congregation. (*Id.* at p. 635, 279 P.2d 579.) The court explained: “Certainly no directors of a corporation, whatever their number, may perpetuate themselves in office by refusing to call an election.” (*Id.* at p. 634, 279 P.2d 579.) “It is clear that the court has the right when it appears that a corporation election will not be held because of the failure of its directors to call it, or that such directors will not conduct a free, fair and full election to order one held under court auspices. This is not an ecclesiastical matter but a corporation one. But even if it were ecclesiastical, as the corporation owns real and personal property, the matter would come within the qualified rule set forth in *Rosicrucian ....*” (*Id.* at p. 635, 279 P.2d 579.)

These California cases specifically concerned congregational organizations, while subsequent cases in front of the United States Supreme Court, such as *Presbyterian Church v. Hull Church, supra*, 393 U.S. 440, 89 S.Ct. 601, 21 L.Ed.2d 658 (*Hull* ), involved hierarchical religious organizations. In *Hull*, the disputes involved a decision by an association of local Presbyterian churches (general church) to take over the property of two local churches that had withdrawn from the association. (*Id.* at pp. 441–443, 89 S.Ct. 601.) In holding that the First Amendment barred courts from adjudicating this property dispute because it would require the court to interpret church doctrine, the *Hull* court set forth the doctrine of “neutral principles” for resolving property disputes: “[T]he First Amendment severely circumscribes the role that civil courts may play in resolving church property disputes. It is obvious, however, that not every civil court decision as to property claimed by a religious organization jeopardizes values protected by the First Amendment. Civil courts do not

inhibit free exercise of religion merely by opening their doors to disputes involving church property. And there are neutral principles of law, developed for use in all property disputes, which can be applied without ‘establishing’ churches to which property is awarded. But First Amendment values are plainly jeopardized when church property litigation is made to turn on the resolution by civil courts of controversies over religious doctrine and practice. If civil courts undertake to resolve such controversies in order to adjudicate the property dispute, the **\*1279** hazards are ever present of inhibiting the free development of religious doctrine and of implicating secular interests in matters of purely ecclesiastical concern. Because of these hazards, the First Amendment enjoins the employment of organs of government for essentially religious purposes, [citation]; the Amendment therefore commands civil courts to decide church property disputes without resolving underlying controversies over religious doctrine. Hence, states, religious organizations, and individuals must structure relationships involving church property so as not to require the civil courts to resolve ecclesiastical questions.’” (*Id.* at p. 449, 89 S.Ct. 601.)

About seven years later, the United States Supreme Court again addressed the question of adjudicating property rights within hierarchical religious organizations in *Serbian Orthodox Diocese v. Milivojevic* (1976) 426 U.S. 696, 708–720, 96 S.Ct. 2372, 49 L.Ed.2d 151 (*Serbian*). The Supreme Court held that civil courts could not properly countermand the decision by the highest authority of the Serbian Orthodox Church to defrock the bishop who presided over its American diocese, notwithstanding that this decision incidentally affected the control of diocesan property. (*Id.* at pp. 708–709, 96 S.Ct. 2372.) The **\*\*16** court stated that “this case essentially involves not a church property dispute, but a religious dispute the resolution of which under our cases is for ecclesiastical and not civil tribunals.” (*Id.* at p. 709, 96 S.Ct. 2372.) The court concluded: “In short, the First and Fourteenth Amendments permit hierarchical religious organizations to establish their own rules and regulations for internal discipline and government, and to create tribunals for adjudicating disputes over these matters. When this choice is exercised and ecclesiastical tribunals are created to decide disputes over the government and direction of subordinate bodies, the Constitution requires that civil courts accept their decisions as binding upon them.” (*Id.* at pp. 724–725, 96 S.Ct. 2372.)

The United States Supreme Court further explained and applied the neutral principles of law doctrine in *Jones v.*

*Wolf* (1979) 443 U.S. 595, 99 S.Ct. 3020, 61 L.Ed.2d 775 (*Wolf*). *Wolf* involved a dispute over ownership of church property following a schism in a local church affiliated with a hierarchical church organization. The court stated: “The State has an obvious and legitimate interest in the peaceful resolution of property disputes, and in providing a civil forum where the ownership of church property can be determined conclusively.” (*Id.* at p. 602, 99 S.Ct. 3020.) The court explained: “Most importantly, the First Amendment prohibits civil courts from resolving church property disputes on the basis of religious doctrine and practice. [Citations.] As a corollary to this commandment, the Amendment requires that civil courts defer to the resolution of issues of religious doctrine or polity by the highest court of a hierarchical church organization. [Citations.] Subject to these limitations, however, the First Amendment does not dictate that a State must follow a particular method of resolving church property disputes. Indeed, ‘a State may adopt *any* one of various approaches for settling church **\*1280** property disputes so long as it involves no consideration of doctrinal matters, whether the ritual and liturgy of worship or the tenets of faith.’” (*Ibid.*) In holding that there was no impermissible entanglement with religion in the case before it, the *Wolf* court set forth the “neutral principles of law” approach as requiring a civil court to examine in purely secular terms certain religious documents, such as a church constitution. (*Id.* at p. 604, 99 S.Ct. 3020.)

[2] [3] [4] Following these later Supreme Court case holdings, particularly that of *Hull* and *Serbian*, some California Courts of Appeal have asserted that the language, if not the holdings, in the earlier California cases of *Rosicrucian, supra*, 39 Cal.2d 121, 245 P.2d 481, *Providence Baptist Church, supra*, 40 Cal.2d 55, 251 P.2d 10, and *Burnett, supra*, 130 Cal.App.2d 631, 279 P.2d 579, is questionable. (See, e.g., *Wilson v. Hinkle* (1977) 67 Cal.App.3d 506, 512, 136 Cal.Rptr. 731; *Vukovich v. Radulovich* (1991) 235 Cal.App.3d 281, 293, 286 Cal.Rptr. 547.) Of course, California courts concerned with restraints under the First Amendment applicable to the states through the Fourteenth Amendment are bound by the authoritative interpretations of the First Amendment enunciated by the United States Supreme Court. We note that all of the United States Supreme Court cases, unlike the California cases, concerned hierarchical religious organizations; it remains unclear whether the constitutional analysis for congregational and hierarchical religious institutions is identical.<sup>16</sup> However, no matter whether the **\*\*17** religious organization is hierarchical or congregational, it is clear that the decisions



of the highest religious tribunal on questions of discipline, faith, or ecclesiastical rule, custom, or law must be accepted. (See, e.g., *Presbytery of Riverside v. Community Church of Palm Springs* (1979) 89 Cal.App.3d 910, 919, 152 Cal.Rptr. 854.) “However, when the dispute to be resolved is essentially ownership or right to possession of property, the civil courts appropriately adjudicate the controversy even though it may arise out of a dispute over doctrine or other ecclesiastical question, provided the court can resolve the property dispute without attempting to resolve the underlying ecclesiastical controversy.” (*Id.* at p. 920, 152 Cal.Rptr. 854.)

16

Other jurisdictions have held that the constitutional analysis applied to hierarchical organizations is the same as that applied to congregational organizations. (See, e.g., *Nunn v. Black* (W.D.Va.1981) 506 F.Supp. 444, 448 [applied *Serbian* and refused to decide internal church dispute despite church's having “no structured decision-making process”], affirmed, *Nunn v. Black* (4th Cir.1981) 661 F.2d 925; *Burgess v. Rock Creek Baptist Church* (D.D.C.1990) 734 F.Supp. 30 [should apply analysis of *Serbian* to congregational church]; *First Baptist Church of Glen Este v. State of Ohio* (S.D. Ohio 1983) 591 F.Supp. 676, 682 [“because the ‘hands off’ policy espoused by the *Serbian* Court is of constitutional dimension, we find it difficult to justify the application of a different standard where a congregational church is involved”].) However, none of these cases addresses the issue of adjudicating a property dispute in a congregational organization when no authority in the organization nor the congregation has spoken and the organization has no peaceful procedure in place for deciding the issue.

**\*1281** We do not necessarily agree that these California cases decided in the 1950's cannot be reconciled with the United States Supreme Court holdings. None of the California cases stated that courts could adjudicate matters that were predominantly ecclesiastical. To the extent that these cases held that *all* property disputes could be resolved by civil courts, their holdings should be refined to restrict review to the application of neutral principles of law taking care “to decide church property disputes without resolving underlying controversies over religious doctrine.” (*In re Metropolitan Baptist Church of Richmond, Inc.* (1975) 48 Cal.App.3d 850, 858–859, 121 Cal.Rptr. 899 (*Metropolitan Baptist Church*) [jurisdiction to adjudicate distribution of dissolving church's assets and any ecclesiastical concern was incidental and

remote]; see also *Wolf, supra*, 443 U.S. at p. 597, 99 S.Ct. 3020; *Presbytery of Riverside v. Community Church of Palm Springs, supra*, 89 Cal.App.3d at pp. 925–929, 152 Cal.Rptr. 854 [property dispute can be resolved without attempting to resolve underlying ecclesiastical controversy]; *Protestant Episcopal Church v. Barker* (1981) 115 Cal.App.3d 599, 615, 171 Cal.Rptr. 541.) “ [A]s long as the court does not have to resolve the doctrinal propriety [of a church's action] in order to determine who has legal control of the property, there is no unconstitutional intervention by the state in church affairs.” (*Metropolitan Baptist Church, supra*, at p. 859, 121 Cal.Rptr. 899.)

### **B. Applying Federal and State Precedent to Determine the Constitutionality of Ordering an Election for the Supreme Council**

Respondents requested the trial court to determine that the election in March 2002 was valid or, alternatively, to order a new election because the current Supreme Council's term had expired and the current Supreme Council refused to order an election. Respondents argued that the express terms of the Sikh Temple's bylaws do not specify a term of office for the Supreme Council and therefore the law of the Corporations Code should be applied, which imposes a one-year term limit when **\*\*18** the bylaws are silent. (§ 9220, subd. (b).) Appellants responded that their term on the Supreme Council was for life<sup>17</sup> in accordance to the doctrine of the Gurmat tradition and the institution of Panj Pyaras. Any determination of their term of office, appellants asserted, requires the court to violate the establishment clause of the First Amendment because the court would be resolving a dispute regarding religious doctrine.

17

The bylaws in Article II provide that members of the Supreme Council can be dismissed and replaced by the general membership if found unfit.

Before trial, the parties stipulated to the fact that the Supreme Council, also known as the Panj Pyaras, is the corporate board of directors for the Sikh Temple. The board of directors is entitled to manage the affairs of the Sikh **\*1282** Temple, and therefore controls significant corporate assets.<sup>18</sup> Article XII of the bylaws specifies that the Executive Committee “shall consult the Supreme Council in all important financial and policy matters.” Since the Supreme Council is involved with the control of the financial assets of the Temple, the term of office for the Supreme Council involves control of the Temple's property. As discussed *ante*, under both federal

and state law, courts have jurisdiction over disputes involving the control of property, even if they touch upon ecclesiastical concepts, as long as the court does not have to settle religious schisms and it can use neutral principles of law to settle the dispute. (See, e.g., *Wolf*, *supra*, 443 U.S. at pp. 602–604, 99 S.Ct. 3020; *Metropolitan Baptist Church*, *supra*, 48 Cal.App.3d at p. 858, 121 Cal.Rptr. 899.)

18 The record on appeal does not detail these assets, but neither party argued that property interests were not involved. Rather, appellants argued that the adjudication of property interests involved the determination of religious doctrine, which was unconstitutional.

The Sikh Temple has organized itself as a nonprofit religious corporation and is subject to the rules set forth in section 9110 et seq. Section 9210, subdivision (a) provides that each corporation shall have a board of directors and that the “activities and affairs of a corporation shall be conducted and all corporate powers shall be exercised by or under the direction of the board.” Section 9150, subdivision (a) provides: “ ‘Bylaws,’ as used in this part means the code or codes of rules used, adopted, or recognized for the regulation or management of the affairs of the corporation irrespective of the name or names by which such rules are designated.”

Of particular interest is section 9220, which provides in relevant part: “(a) The articles or bylaws may provide for the tenure, election, selection, designation, removal, and resignation of directors. [¶] (b) In the absence of any provision in the articles or bylaws, the term of directors shall be one year. [¶] (c) Unless the articles or bylaws otherwise provide, each director, including a director elected to fill a vacancy, shall hold office until the expiration of the term for which elected and until a successor has been elected and qualified.”

The bylaws of the Sikh Temple, as set forth in Article II, provide that the membership will select the Supreme Council or the board of directors. The bylaws do not specify the term of office. Appellants argue that the references to the Sikh faith, Gurmat tradition, and institution of Panj Pyaras in Article II require the court to interpret their religious doctrine.<sup>19</sup> Appellants **\*\*19** therefore **\*1283** seek to foreclose any court review based on the mention of the Gurmat tradition and Panj Pyaras in Article II. However, “ [t]here are occasions when civil courts must draw lines between the responsibilities of church and state for the disposition or use of property.” [Citation.] And the belief ‘that

any conduct can be made a religious rite and by the zeal of the practitioners swept into the First Amendment’ has been consistently repudiated. [Citations.]” (*Metropolitan Baptist Church*, *supra*, 48 Cal.App.3d at p. 858, 121 Cal.Rptr. 899.)

19 Article II reads: “The principles and practices of the Gurdwara Management will be those espoused by Sikh faith and Gurmat tradition. The institution of Panj Pyaras (five beloved ones) will be revived in order to provide the guidelines for day-to-day functions of the Gurdwara. The Panj Pyaras (five beloved ones) will be selected and appointed by Sadh Sangat or membership of the Gurdwara Sahib. If any of the Panj Pyaras is found unfit for his position, another Panj Pyara shall be selected by the General Body to fill up the vacancy. In the meantime, the Head Priest of the Gurdawara Sahib shall perform the duties of a Panj Pyara.”

In support of their position, appellants cite the following language in *Wolf*, *supra*, 443 U.S. at page 604, 99 S.Ct. 3020: “[T]here may be cases where the deed, the corporate charter, or the constitution of the general church incorporates religious concepts in the provisions relating to the ownership of property. If in such a case the interpretation of the instruments of ownership would require the civil court to resolve a religious controversy, then the court must defer to the resolution of the doctrinal issue by the authoritative ecclesiastical body.” Here, as appellants concede, there is no authoritative ecclesiastical body,<sup>20</sup> but they argue that the court improperly interpreted the Gurmat tradition and the institution of Panj Pyaras. Appellants, however, ignore the sentence shortly following the quoted passage from *Wolf* that states: “We therefore hold that a State is constitutionally entitled to adopt neutral principles of law as a means of adjudicating a church property dispute.” (*Ibid.*) In addition, the *Wolf* court declared: “The State has an obvious and legitimate interest in the peaceful resolution of property disputes, and in providing a civil forum” to settle such disputes. (*Id.* at p. 602, 99 S.Ct. 3020.)

20 Although they acknowledge there has been no decision by any ecclesiastical tribunal and that the Sikh Temple is congregational in type rather than hierarchical, they point out that Article XII, which sets forth the powers of the Executive Committee, does declare a hierarchy regarding doctrinal issues. Paragraph five reads: “In matters related to the Gurmat and Sikh Rehatmaryada, [t]he

Granthi/Priest of the Gurdwara Sahib should be the chief consultant. In matter of doubt, the opinion can be solicited from other Gursikhs, Gyanis and Saints. Sri Akal Takhat is the final authority on all religious matters.” The record does not indicate that the Granthi/Priest of the Sikh Temple has spoken regarding the term of office for the Supreme Council.

Integral to appellants' argument is that the court heard evidence on the meaning of Panj Pyaras and the Gurmat tradition and therefore it unconstitutionally decided the meaning of these terms. Appellants' witnesses testified that the institution of Panj Pyaras is permanent, and therefore no term limit for the Supreme Council exists. They relied upon the fact that the bylaws expressly provide a two-year term limit for the Executive Committee and provide for dismissal of Supreme Council members based on misconduct. Respondents' witnesses, including their expert, Dr. Tarlochan Singh Nahal, \*1284 opined that nothing in the wording of Article II dictated the term of office for the Supreme Council. Witnesses for respondents testified that, although the concept of the Panj Pyaras is eternal, the Sikh tradition is for members to serve as Panj Pyaras for a limited time and purpose before returning to the general congregation or Sadh Sangat.

**\*\*20** [5] Appellants contend that the mere fact that the court considered evidence on this issue means that it had to resolve an argument over what Panj Pyaras means. As discussed *ante*, if the court must resolve an incidental issue that is religious in nature, it must first defer to the decision by any ecclesiastical tribunal in the hierarchy of the religious society. (*Korean United Presbyterian Church v. Presbytery of the Pacific* (1991) 230 Cal.App.3d 480, 498, 281 Cal.Rptr. 396.) The record does not establish that any ecclesiastical tribunal, the Granthi/Priest of the Sikh Temple, the congregation, or any other authority in the Sikh Temple has determined the term of office for the Supreme Council. “Where a schism has developed within a church, resulting in dispute as to who holds ultimate authority for congregational or corporate decisions, civil courts are unavoidably put to the task of identifying the true or legitimate authority. [Citation.] To do otherwise would be to deny ‘all legal protection to churches and [allow] church disputes to be settled by physical force.’ [Citation.]” (*Higgins v. Maher* (1989) 210 Cal.App.3d 1168, 1173, 258 Cal.Rptr. 757.) Accordingly, the court properly heard evidence to determine whether any authority had determined that the reference to Panj Pyaras or the Gurmat tradition in Article II signified a life term. The fact that experts provided differing opinions and no witness

pointed to an authoritative decision on this issue within the Sikh Temple, amply established that there was neither a decision nor consensus on this matter.<sup>21</sup>

**21** It is true that in its statement of decision the court concluded that the “legal significance of designating the Supreme Council as Panj Pyaras in Article II of the bylaws is to require that decisions be unanimous to be binding on the Temple corporation.” The court also stated: “Ultimately, the testimony of plaintiffs and their expert, Dr. Tarlochan Singh Nahal, proved by a preponderance of the evidence that there is nothing in the wording of Article II which dictates the term of office for the Supreme Council.” The court further explained that it was not determining the meaning of these terms but simply that there was no consensus that they meant a life term. Even if some of these statements indicate an improper consideration of the meaning of these religious terms, such statements do not constitute reversible error because the court's ruling did not rely on defining or settling the meaning of Panj Pyaras or the Gurmat tradition.

In this case, the court did not have to determine the meaning of Panj Pyaras, only that no authority in the Sikh Temple had adjudicated this issue. A civil court retains jurisdiction to determine purely secular issues. Here, the court determined that religious doctrine was not relevant to the interpretation of the bylaws and resolved the dispute based on contract law and provisions in the Corporations Code. (See \*1285 *Berry v. Society of Saint Pius X* (1999) 69 Cal.App.4th 354, 365, 81 Cal.Rptr.2d 574 [civil court adjudications require analysis of language of instruments such as deeds, church charters, state statutes governing the holding of church property, and provisions in church constitutions pertaining to ownership and control of church property, taking special care to scrutinize documents in purely secular terms and not to rely on religious precepts].)

The court's application of contract law and provisions from the Corporations Code is a neutral-principles approach, which “cannot be said to ‘inhibit’ the free exercise of religion, any more than do other neutral provisions of state law governing the manner in which churches own property, hire employees, or purchase goods. Under the neutral-principles approach, the outcome of a church property dispute is not foreordained. At any time before the dispute erupts, the parties ... can modify the deeds or the corporate **\*\*21** charter.... The

burden involved in taking such steps will be minimal. And the civil courts will be bound to give effect to the result indicated by the parties, provided it is embodied in some legally cognizable form.” (*Wolf, supra*, 443 U.S. at p. 606, 99 S.Ct. 3020, fn. omitted.) Similarly, here, under Article XVI,<sup>22</sup> the Supreme Council is not without recourse. The Supreme Council can recommend an amendment of the bylaws that the term of office for the Supreme Council is life and put the recommendation to the membership for approval.

<sup>22</sup>

Article XVI provides in relevant part: “The amendments to the constitution must be first presented to the Supreme Council of Panj Pyaras in the form of a petition, identifying major gaps or shortcomings according to Sikh tradition (Rahatmaryada). The Panj Pyaras should examine the petition carefully and submit their recommendations to the General Body of Gurdwara membership. The 3/4 majority of the Sikh membership in General Body can endorse the amendment and the Constitution can be changed accordingly.”

We therefore conclude that the trial court did not need to determine the meaning of the Panj Pyaras or the Gurmat tradition to interpret the bylaws regarding the term of office for the Supreme Council. Further, the trial court did not determine who was qualified to be a member or who should be a member of the Supreme Council. Rather, the court's ruling that an election should occur resulted from the application of neutral principles of law and the Corporations Code when interpreting the bylaws. We stress that this case is significantly different from those situations where a religious authority has spoken on the issue. Not only has no religious authority spoken, but the Sikh Temple has no viable means of resolving this issue. The bylaws are silent regarding any method of resolving any schism involving the interpretation of the bylaws. We therefore cannot say that the trial court \*1286 overstepped its bounds of jurisdiction in ordering an election when doing so was secular in purpose.<sup>23</sup>

<sup>23</sup>

Although clearly not binding on us, we note that other jurisdictions have concluded that the First Amendment does not bar courts from ordering elections or developing procedures to ensure a fair election in religious institutions. (See, e.g., *McKinney v. Twenty-Fifth Ave. Baptist Ch., Inc.* (Ala.1987) 514 So.2d 837, 838–839 [ordered members of competing church factions to compile

a list of church members eligible to vote in an election]; *Wilkerson v. Battiste* (La.App.1980) 393 So.2d 195, 196–197 [court had jurisdiction over claim that board of directors were not elected according to procedures of charter because this is procedural issue and not related to religious law, custom, or policy]; *Pilgrim Rest Missionary Baptist Church v. Wallace* (Miss.2003) 835 So.2d 67, 72–74 [court had authority to order election regarding pastor's employment].)

### III. The Trial Court's Remedies and the Establishment Clause

Appellants contend that the trial court's remedies for resolving the disputes at the Sikh Temple represent an unconstitutional and excessive government entanglement with religion. Specifically, they complain that the court's interference into their method for accepting and denying membership, the ordering of an election, and the requirement that individuals have equal time to advocate for the election, violated the establishment clause of the First Amendment applied to the states through the Fourteenth Amendment of the United States Constitution.

#### A. The Three-Part Test

[6] Appellants complain that the remedies imposed by the trial court violate the three-part test regarding government action and the establishment clause set forth in \*\*22 *Lemon v. Kurtzman* (1971) 403 U.S. 602, 91 S.Ct. 2105, 29 L.Ed.2d 745 (*Lemon*). The United States Supreme Court established three criteria, which must be satisfied to avoid conflict with the establishment clause: First, the challenged government activity must have a secular legislative purpose; second, the principal or primary effect of the activity must be one that neither advances nor inhibits religion; and third, the activity must not foster an excessive government entanglement with religion. (*Id.* at pp. 612–613, 91 S.Ct. 2105.)

[7] [8] [9] Under the first criterion, inquiry into the purpose of the challenged government action should be deferential and limited. If the government articulates a plausible secular purpose, this should be accepted absent a contrary showing by the challenger. (*Wallace v. Jaffree* (1985) 472 U.S. 38, 74–75, 105 S.Ct. 2479, 86 L.Ed.2d 29 (conc. opn. of O'Connor, J.)) \*1287 Whereas the first criterion of the *Lemon* test involves a determination whether the purpose behind the challenged action is to endorse or disapprove religion, the second or effect criterion



“asks whether, irrespective of government's actual purpose, the practice under review in fact conveys a message of endorsement or disapproval.” (*Lynch v. Donnelly* (1984) 465 U.S. 668, 690, 104 S.Ct. 1355, 79 L.Ed.2d 604 (conc. opn. of O'Connor, J.)) Applying an objective standard, the question becomes whether the challenged action is sufficiently likely to be perceived by reasonable adherents of the controlling religion as an endorsement, or by reasonable nonadherents as a disapproval, of their individual religious choices. (*Grand Rapids School District v. Ball* (1985) 473 U.S. 373, 390, 105 S.Ct. 3216, 87 L.Ed.2d 267.) The third criterion of the *Lemon* test concerns entanglement with religion and contemplates a determination whether the state will be required to monitor the challenged government activity for its religious content in order to assure that it does not have the unintended effect of encouraging or discouraging religion. (*Lemon, supra*, 403 U.S. at p. 619, 91 S.Ct. 2105.)

### B. Membership Application

The trial court ruled that, pursuant to section 9350, subdivision (b)<sup>24</sup> and section 9510, subdivision (a),<sup>25</sup> appellants and respondents “shall meet and confer to draft a mutually acceptable membership application, which shall include a reasonable standard for ‘regular’ attendance, to be presented to the Court for approval as hereinafter provided.” The court further explained that membership applications were to be solicited at five consecutive Sunday congregational meetings on dates to be specified. It ruled that a membership committee shall be formed consisting of four representatives appointed by respondents and four representatives appointed by appellants who shall be charged with the duty of admitting or denying membership, advising applicants of their decision with the grounds for any denial, and the preparation and maintenance of a membership list. The court specified that no named party in this action or any of the prior actions involving the Sikh Temple elections could serve on **\*\*23** the membership committee. Any disputes over admission to membership, which the membership committee could not resolve by a five-person majority vote, would be submitted to a special master.

<sup>24</sup> Section 9350, subdivision (b) provides: “No person is liable for any obligation arising from membership unless the person was admitted to membership upon the person's application or with the person's consent.”

<sup>25</sup> Section 9510, subdivision (a) reads: “(a) Each corporation shall keep: [¶] (1) Adequate and correct books and records of account. [¶] (2) Minutes of the proceedings of its members, board and committees of the board. [¶] (3) A record of its members giving their names and addresses and the class of membership held by each....”

**\*1288** Appellants assert that the trial court's decision “has empowered Plaintiffs with authority equal to that of the same Supreme Council....” Appellants argue that no one requested the court to make any decision regarding membership and this decision violates the establishment clause of the First Amendment. Further, they complain that it requires the court to be entangled in the Sikh Temple's religious affairs in violation of the First Amendment.

Appellants' argument that no one requested the court to make any decision regarding membership is without merit. Respondents requested in their first amended complaint that the court “determine the validity of memberships in defendant Gurdwara Sahib to assure a valid election under the by-laws of defendant Gurdwara Sahib, and direct such other and further relief as may be just and proper to assure a valid and peaceful election.”

[10] As to their argument that the ruling violates the establishment clause, we apply the *Lemon* test. The first criterion is whether the court has a clear secular purpose. (*Lemon, supra*, 403 U.S. at p. 612, 91 S.Ct. 2105; *Wallace v. Jaffree, supra*, 472 U.S. at pp. 74–75, 105 S.Ct. 2479.) Under California Corporations law, every religious corporation is mandated to keep “[a] record of its members with their names and addresses and the class of membership held by each.” (§ 9510, subd. (a)(3).) The membership records must be kept in writing or in a form capable of being converted into writing. (§ 9510, subd. (b).) The compelling state interest in requiring religious or nonprofit corporations to maintain such a list has been upheld. (See, e.g., *Pacific–Union Club v. Superior Court* (1991) 232 Cal.App.3d 60, 71–81, 283 Cal.Rptr. 287.) It was undisputed at trial that appellants never made or maintained a membership list or roster. Since the membership votes for the offices on the Supreme Council, a fair election can only be held if a list of members can be ascertained. Accordingly, the court's clear purpose was to ensure that the Sikh Temple complied with the law by maintaining a record of membership, and therefore the court's ruling had a secular purpose.

The ruling also satisfies the second criterion in the *Lemon* test in that the ruling neither advances nor inhibits religion. Requiring the Sikh Temple to comply with the statutes governing nonprofit corporations does not convey any message of endorsement or disapproval of the religious practices of the Temple.

[11] Appellants never address the first two criteria of the *Lemon* test, but they do argue, in a conclusory fashion, that the court's action fosters excessive government entanglement with the Sikh Temple, especially since any remaining disputes regarding membership are to be addressed by a special master. Thus, they appear to be arguing the ruling violates the third prong of the \*1289 *Lemon* test. Appellants, however, misconstrue this final criterion. It is not the mere fact that the government may have to continue to monitor an activity that constitutes unconstitutional entanglement with religion. Rather, it is whether the court will be required to monitor the activity *for its religious content*. (*Lemon, supra*, 403 U.S. at p. 619, 91 S.Ct. 2105.)

In their reply brief, appellants assert that it is well settled that a church has the right to determine its own membership and that courts should not resolve disputes over who is or can be a member. (See, \*\*24 e.g., *Bouldin v. Alexander* (1872) 82 U.S. (15 Wall.) 131, 139–140, 21 L.Ed. 69.) We agree. However, the court did not rule that it has the discretion to determine who qualifies as a member. Rather, the court is to resolve any disputes regarding the application of the criteria for membership as set forth in the Sikh Temple's own bylaws.

Appellants contend that they should retain the discretion to admit or not admit members even if applicants meet the requirements set forth in Article X of the bylaws. They complain that nothing in the bylaws mandates that they must accept members who meet these threshold requirements. Further, they claim that respondents should not be part of this decision making process since they were never elected to the Supreme Council.

The requirements for admission to membership are specified in the articles of incorporation and bylaws, as required by section 9310, subdivision (a).<sup>26</sup> Article X of the bylaws provides the following regarding membership: “There will be only one class of membership. There is no membership fee. [¶] Definition of a Sadh Sangat member: [¶] 1. Membership of the Gurdwara Sahib is open to a person who is resident of these counties: Santa Clara, Santa Cruz, San Mateo, Alamada [*sic* ], Contra Costa, San Francisco, Solano. [¶] 2. Is 18

years of age or over. [¶] 3. Believes in Sikhism, teachings of ten Gurus, Rehatnamas, accepts Guru Granth Sahib as a living Guru. [¶] 4. Pledges to abide by the constitution of the Gurdwara Sahib.” Article XI provides, in pertinent part: “The General Body/Sadh Sangat should consist of all those persons who attend the Gurdwara Sahib regularly.” The court interpreted this sentence in Article XI as providing grounds for denying or suspending membership due to lack of regular attendance. Nothing in the bylaws indicates that the Supreme Council has the sole authority to determine membership.<sup>27</sup>

26 Section 9310, subdivision (a) declares: “A corporation may admit persons to membership, as provided in its articles or bylaws, or may provide in its articles or bylaws that it shall have no members. In the absence of any provision in its articles or bylaws providing for members, a corporation shall have no members.”

27 Article XIII sets forth the duties and responsibilities of the Supreme Council or Panj Pyaras: “1. The Supreme Council should meet at least once a month. Quorum of the meeting consists of five members. 2. The Supreme Council should select a coordinator among themselves, who could call meetings, record the minutes of these meetings and act as a liason [*sic* ] with Executive Committee. [¶] 3. The Supreme Council meetings should be presided by Panj Pyaras on rotation basis. The subject of the meetings should be circulated among the members of the council before the scheduled date of the meeting.”

\*1290 In the court's order, it made it clear that it recognized that the board of directors could augment the bylaws or develop written operating rules to further refine the process for accepting or denying membership. Thus, the court did not strip the board of directors from exercising their discretion. Rather, the court stated that the board of directors must comply with the law in setting forth the operating rules for accepting members. As the court noted, the bylaws and any operating rules must be applied “ ‘reasonably and equally ’ ” to all applicants and members. (See, e.g., *Braude v. Automobile Club of Southern Cal.* (1978) 78 Cal.App.3d 178, 182–185, 144 Cal.Rptr. 169.) If appellants desire to have the Supreme Council retain the ultimate right to accept or deny membership, they must propose such an amendment to the congregation for its approval.

The evidence indicates that, currently, appellants maintain an ad hoc method for **\*\*25** determining whether to accept or deny applications for membership. Thus, a full and fair election by the members cannot be conducted until criteria for membership are clearly set forth and fairly applied. The trial court established a procedure whereby the membership of the Sikh Temple could be ascertained to ensure a fair election and compliance with the Corporations Code. The court did so in the absence of clear bylaws and a higher religious authority. The order ensures that reasonable notice of the application procedure will be provided and that the application process will be conducted in an orderly manner. The court's order does not create the criteria for membership, nor does it inquire as to the reasons why certain criteria are or are not being used. Rather, the court specified that the membership committee must admit or deny membership based on the criteria set forth in the bylaws.

As already noted, the bylaws do not specify that only the Supreme Council retains the right to decide who can be a member. If a dispute regarding the membership occurs, the special master will hear evidence whether the applicant meets the criteria set forth in the bylaws. The special master will settle disputes if necessary, but the special master must limit any determination to the fairness of the procedure. The special master will not be determining the criteria for membership or whether the applicant, does in fact, believe in Sikhism, the teachings of ten Gurus, Rehatnamas, or accepts Guru Granth Sahib as a living Guru.<sup>28</sup> In settling any dispute regarding **\*1291** membership, the special master cannot make any determinations regarding the qualifications of that person, but only as to whether the criteria or qualifications have been applied fairly to that person.<sup>29</sup>

<sup>28</sup> Appellants further complain that a dispute could emerge about what “regularly” attending a meeting means, which is a threshold requirement for membership. Appellants and respondents are to determine what “regularly” means and then apply it uniformly. If the parties cannot agree on a definition of “regularly,” according to the court's order, the special master will hear evidence. As already stressed, the special master can ensure that procedures are being applied fairly and not arbitrarily, but the special master cannot adjudicate the meaning of any religious term. We need not decide at this point whether the court would have jurisdiction to resolve the question of “regularly”

attending if a dispute arises between appellants and respondents and the term remains undefined by the congregation, bylaws, or other authority in the Sikh Temple.

<sup>29</sup> To the extent that the court's statement of decision suggests that the special master can make such a determination, it is unconstitutional. At this point, no challenge has been made to the acceptance or rejection of an application for membership, and no adjudication has been made regarding a member's qualifications. Thus, at this time, the trial court has not exceeded its authority.

### C. Elections

The trial court found that the term of office for each of the current Supreme Council members had expired and it ordered a new election by written ballot on January 12, 2003, pursuant to section 9418 (see footnote 12, *ante*). The court reserved jurisdiction over this matter.

Appellants declare that requiring or overseeing an election involves excessive entanglement. They claim that their expert testified that “[t]he Panj Pyaras are usually selected from the Sangat [congregation].” Since 1988, the Sikh Temple has used a nomination and affirmation process. A contested election, according to appellants, is antithetical to this process of achieving unanimity in decisions made by the congregation.

To the contrary of appellants' argument, the record establishes that elections have **\*\*26** occurred at the Sikh Temple. More significantly, the bylaws require a vote of two-thirds of the Executive Committee to dismiss one of its members; they provide that “the majority vote will prevail” whenever the Executive Committee cannot reach a unanimous decision; they require a petition by at least one-fifth of the congregation to convene a special meeting of the general body; and they require a vote of three-fourths of the membership to amend the bylaws. Finally, appellants became members of the Supreme Council as a result of a court-supervised election after they had agreed that an election was the best way to resolve the leadership dispute.

Other than to state in a conclusory fashion that this ruling is an impermissible entanglement with religion, appellants fail to provide any analysis and avoid applying the *Lemon* test. (*Lemon, supra*, 403 U.S. at pp. 612–613, 91 S.Ct. 2105.) The **\*1292** court's ruling—to impose a fair election that complies with the law—satisfies the first prong of

the test in that the ruling has a secular purpose. The court clearly explained the need for a new election, as the court was unable to review the results of the election on March 31, 2002. The court could not discern the majority vote because, following each proclamation, “a cacophony of sound ensued with congregants voicing approval or disapproval simultaneously. [¶] Each party urges the court to weigh the decibel level of any distinguishable responses as recorded in videotapes of the meeting and make a ruling on the basis. **The court cannot determine a majority vote of either approval or disapproval from the evidence submitted.**” (Bold in original.) Moreover, the court noted that it was unclear whether the votes or verbal responses were limited to Sikh Temple members. The court explained: “The election procedure used on March 31, permitting approval and disapproval to be voiced simultaneously, is suspect because it is vulnerable to giving great weight to the loud or demonstrative voice of one person who may be a non-member and little weight to the soft or restrained voice of another who may be a member. All members have the same right to one, equally weighted vote. (Article X; Corp.Code 9310(a); 9331). Non-members have no right to participate in Temple elections.”

With regard to the second prong, the court's order regarding an election does not advance or inhibit religion. Requiring an election does not convey a message of endorsement or disapproval of Sikh traditions. Rather, the evidence clearly supports the finding that a full, fair, and free election cannot be held unless it is completed by written ballot.

Appellants appear to be arguing that this ruling violates the third prong of the *Lemon* test in that it fosters an excessive government entanglement with religion. (*Lemon, supra*, 403 U.S. at pp. 612–613, 91 S.Ct. 2105.) However, as stressed ante, it is not the monitoring of a religious corporation that is prohibited, but the monitoring of the activity for its religious content, which may have the unintended effect of encouraging or discouraging religion. (*Id.* at p. 619, 91 S.Ct. 2105.) “Certainly no directors of a corporation, whatever their number, may perpetuate themselves in office by refusing to call an election.” (*Burnett, supra*, 130 Cal.App.2d at p. 634, 279 P.2d 579.) “It is clear that the court has the right when it appears that a corporation election will not be held because of the failure of its directors to call it, or that such directors will not conduct a free, fair and full election to order one held under court auspices. This is not an ecclesiastical matter but a corporation one.” (*Id.* at p. 635, 279 P.2d 579.)

\*\*27 As discussed *ante*, the court had authority to order an election for the board of directors under the Corporations Code. The court merely sought to establish a procedure in which the majority of the congregation could be heard regarding their preference for who should be a member of the Supreme \*1293 Council. Section 9418, subdivision (c) provides: “The court, consistent with the provisions of this part and in conformity with the articles and bylaws to the extent feasible, may determine the person entitled to the office of director or may order a new election to be held or appointment to be made, may determine the validity of the issuance of memberships and the right of persons to vote and may direct such other relief as may be just and proper.”

Accordingly, we conclude that the order to hold an election by written ballot did not violate the establishment clause of the First Amendment.

#### D. Equal Time Requirement

[12] In its statement of decision, the trial court stated that appellants “shall preserve the religious purpose of Sunday Temple services. To the extent that defendants use Sunday Temple services as a platform to lobby for their retention or re-election, plaintiffs shall be afforded equal time, including the opportunity to address the congregation from the stage or platform.” Appellants argue that enforcement of this order would impermissibly require the court to determine whether the services did or did not “preserve the religious purpose” of the services.

We disagree. The court would not have to interpret any religious doctrine. Rather, the court would simply determine whether appellants advocated or discussed their retention or reelection. The court would not be interpreting or applying any religious doctrine, but would simply be ensuring that the election process was fair.

#### IV. Interpretation of the Bylaws

[13] [14] [15] Appellants argue that, even if the court had jurisdiction to interpret the bylaws and the relief it ordered did not violate the establishment clause of the First Amendment, the court erred when it interpreted the bylaws as failing to provide for a term of office for the Supreme Council. They assert that we must apply *de novo* review. When the trial court's interpretation is based solely upon the terms of the written instrument, and there is no conflict in the evidence, we review the ruling *de novo*. (E.g., *Peerless Lighting Corp. v. American Motorists Ins. Co.* (2000) 82 Cal.App.4th



995, 1005, 98 Cal.Rptr.2d 753.) Although we review the construction of the express terms of the instrument de novo, we review the evidence regarding the interpretation of the words under the substantial evidence test. (E.g., *Parsons v. Bristol Development Co.* (1965) 62 Cal.2d 861, 865, 44 Cal.Rptr. 767, 402 P.2d 839.) We must uphold any factual determination of the trial court, express or implied, so long as there is substantial evidence in the record to support it. \*1294 (*Williams v. City of Belvedere* (1999) 72 Cal.App.4th 84, 89, 84 Cal.Rptr.2d 658.) If the evidence is conflicting, we must accept that which supports the trial court's decision and make all reasonable inferences in support of the judgment. (*Lake v. Reed* (1997) 16 Cal.4th 448, 457, 65 Cal.Rptr.2d 860, 940 P.2d 311.)

[16] When interpreting the bylaws, the court properly used contract law and employed the applicable provisions of the Corporations Code. “ ‘It is generally accepted that corporate bylaws are to be construed according to the general rules governing the construction of statutes and contracts.’ [Citation.] Bylaws must ‘ ‘be \*\*28 given a reasonable construction and, when reasonably susceptible thereof, they should be given a construction which will sustain their validity....’ ’ [Citation.]” (*Sanchez v. Grain Growers Assn.* (1981) 126 Cal.App.3d 665, 672, 179 Cal.Rptr. 459.)

Appellants argue that Article IV, which concerns the dismissal of a Supreme Council member, specifies when a Supreme Council member may be removed. Article IV dictates that a member of the Supreme Council “can be dismissed” for breaking the Sikh code of conduct, as prescribed in Rehatnamas; for breaking the Sikh rule of objectivity by indulging in petty politics of factionalism and name calling; and for being unable to get along with the Supreme Council. They contend that the situations set forth in Article IV are the only grounds for removing a member of the Supreme Council and this bylaw does not provide for elections. In addition, they assert that Article V mandates a two-year term of service for members of the Executive Committee and therefore the bylaws would have spelled out the length of the term of office for the members of the Supreme Council if there had been an intent to limit it. Although they insist that we should review their challenge de novo because no factual issues are in dispute or are necessary to interpret the bylaws, they proceed to cite testimony of their witnesses and the paucity of any elections as support for the argument that the intent was for the Supreme Council members was to have life terms.

The evidence amply supported a finding that there was no consensus regarding the meaning of Panj Pyaras and the Gurmat tradition and that no religious authority had spoken on the subject. Appellants' argument regarding the dearth of elections is similarly unavailing. It is undisputed that elections were held for members of the Supreme Council by a majority voice vote of the congregation in 1988, which was pursuant to the newly adopted bylaws; by a majority vote in 1991 and 1993;<sup>30</sup> and by a court-supervised election in 1996. Thus, even if we agreed that evidence of no elections supported \*1295 appellants' interpretation that the Supreme Council serves a life term, the evidence in the record establishes that elections have occurred.

30 These votes following the resignation of four of the members of the Supreme Council in 1991 and all five members of the Supreme Council in 1993.

We also reject appellants' argument that Articles IV and V support the conclusion that the Supreme Council has a life term. Article II concerns the selection procedure for members of the Supreme Council. It also specifies that another person will be selected if a member is “found unfit.” Article IV concerns the situation when a member of the Supreme Council “can be dismissed” or be found unfit prior to the completion of the person's term of office. The fact that members can be dismissed does not mean that they otherwise serve indefinitely. Finally, Article V concerns the selection procedure for the Executive Committee. It is true that this Article limits the term for the Executive Committee member to two years, but this does not necessarily mean that the failure to specify a term for the Supreme Council indicates the intent to have the Supreme Council serve for life. Rather, it could also be argued that, if the intent was to have members of the Supreme Council appointed for life terms, Article II would have expressly provided for that.

The express terms of the bylaws provide for the selection of members of the Supreme Council, dismissal of members of the Supreme Council, and selection of and the terms of office for members of the Executive Committee. The bylaws are silent \*\*29 regarding the term of office for members of the Supreme Council.

Section 9210<sup>31</sup> requires that the activities and affairs of a nonprofit religious corporation, like the Sikh Temple, be conducted and its corporate powers be exercised under the direction of a board of directors, subject to the provisions of the Corporations Code and to “any provisions in the articles or

bylaws.” The bylaws of a religious corporation “may provide for the tenure, election, selection, designation, removal, and resignation of directors.” (§ 9220, subd. (a).) Subdivision (b) of section 9220 provides: “In the absence of any provision in the articles or bylaws, the term of directors shall be one year.” Since the bylaws were silent regarding the term of office for members of the Supreme Council, the trial court properly ruled that the members of the Supreme Council had a one-year term pursuant to section 9220, subdivision (b).

31 Section 9210 reads: “Subject to the provisions of this part and any provision in the articles or bylaws: [¶] (a) Each corporation shall have a board of directors. The activities and affairs of a corporation shall be conducted and all corporate powers shall be exercised by or under the direction of the board. [¶] (b) The board may delegate the

management of the activities of the corporation to any person or persons provided that the activities and affairs of the corporation shall be managed and all corporate powers shall be exercised under the ultimate direction of the board.”

**\*1296 DISPOSITION**

The judgment is affirmed. Respondents are awarded costs.

We concur: [KLINE](#), P.J., and [HAERLE](#), J.

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## **LEGAL AUTHORITY CA-114**

**18A Am. Jur. 2d Corporations § 262**

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**Corporations**

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**VII. Bylaws**

## § 262. Construction or interpretation

[Topic Summary](#) | [Correlation Table](#) | [References](#)**West's Key Number Digest**

- West's Key Number Digest, [Corporations and Business Organizations](#) 🔑 1259 to 1263, 3384

Corporate bylaws are construed according to the general rules governing the construction of contracts,<sup>1</sup> statutes,<sup>2</sup> and other written instruments.<sup>3</sup> The bylaws are presumed to be valid, and the courts will construe the bylaws in a manner consistent with the law rather than strike them down.<sup>4</sup> They are to be construed reasonably,<sup>5</sup> and if they are susceptible of two reasonable constructions, one of which would make them invalid, in accordance with the view sustaining their validity.<sup>6</sup> In construing corporate bylaws, courts attempt to harmonize and give effect to every provision and presume that the parties intended to impose reasonable terms.<sup>7</sup> For purposes of construing bylaws, courts presume that every word has a meaning and should avoid any construction that would render any part of a bylaw nugatory.<sup>8</sup> Furthermore, ambiguous or obscure provisions of bylaws will be construed in harmony with the intent of the governing regulations taken as a whole<sup>9</sup> and that construction will be adopted which is best calculated to promote the business or essential welfare of the corporation.<sup>10</sup>

A corporation's bylaws establish rules of internal governance, which, like contracts and statutes, are construed according to their plain meaning within the context of the document as a whole.<sup>11</sup> Language is to be construed according to its usual, ordinary, and commonly accepted meaning<sup>12</sup> unless the context clearly requires a different one or unless legal phrases having a special meaning are used.<sup>13</sup> Where a bylaw uses a term which as a matter of law has no fixed meaning, the intent and understanding of the parties must control.<sup>14</sup> Any ambiguity in the bylaws will be construed against the corporation and its officers.<sup>15</sup>

The construction of an ambiguous bylaw by a corporation will be recognized and adopted by the courts.<sup>16</sup>

Articles of incorporation, by-laws, and covenants are correlated documents that are construed together when interpreting the governing documents of a corporation.<sup>17</sup> The interpretation of the language of a bylaw, when called into question in a judicial



proceeding, has been deemed to present a question of law so that in cases tried before a jury, it must be determined by the court rather than the jury<sup>18</sup> although there is authority to the contrary.<sup>19</sup>

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### Footnotes

- 1 Scheenstra v. California Dairies, Inc., 213 Cal. App. 4th 370, 153 Cal. Rptr. 3d 21 (5th Dist. 2013), review denied, (Apr. 17, 2013); Gentile v. SinglePoint Financial, Inc., 788 A.2d 111 (Del. 2001); Berkowitz v. Delaire Country Club, Inc., 126 So. 3d 1215 (Fla. 4th DCA 2012); Oberbillig v. West Grand Towers Condominium Ass'n, 807 N.W.2d 143 (Iowa 2011); Robinson v. Lagenbach, 439 S.W.3d 853 (Mo. Ct. App. E.D. 2014).
- 2 As to the construction of contracts, generally, see Am. Jur. 2d, Contracts §§ 328 to 404.
- 3 Singh v. Singh, 114 Cal. App. 4th 1264, 9 Cal. Rptr. 3d 4 (1st Dist. 2004); P.F.P. Family Holdings, L.P. v. Stan Lee Media, Inc., 252 P.3d 1 (Colo. App. 2010); Gentile v. SinglePoint Financial, Inc., 788 A.2d 111 (Del. 2001); Slatterly v. Madiol, 257 Mich. App. 242, 668 N.W.2d 154 (2003); Purcell v. Milton Hershey School Alumni Ass'n, 884 A.2d 372, 202 Ed. Law Rep. 702 (Pa. Commw. Ct. 2005).
- 4 P.F.P. Family Holdings, L.P. v. Stan Lee Media, Inc., 252 P.3d 1 (Colo. App. 2010); Gentile v. SinglePoint Financial, Inc., 788 A.2d 111 (Del. 2001); Purcell v. Milton Hershey School Alumni Ass'n, 884 A.2d 372, 202 Ed. Law Rep. 702 (Pa. Commw. Ct. 2005); Virginia High School League, Inc. v. J.J. Kelly High School, 254 Va. 528, 493 S.E.2d 362, 122 Ed. Law Rep. 536 (1997).
- 5 Boilermakers Local 154 Retirement Fund v. Chevron Corp., 73 A.3d 934 (Del. Ch. 2013), judgment entered, 2013 WL 3810127 (Del. Ch. 2013); Kansas Heart Hospital, L.L.C. v. Idbeis, 286 Kan. 183, 184 P.3d 866 (2008); Adams v. Christie's Inc., 880 A.2d 774 (R.I. 2005).
- 6 Phillips v. National Trappers Ass'n, 407 N.W.2d 609 (Iowa Ct. App. 1987).
- 7 Sanchez v. Grain Growers Ass'n of California, 123 Cal. App. 3d 444, 176 Cal. Rptr. 655 (3d Dist. 1981); Dugan v. Firemen's Pension Fund of Philadelphia, 372 Pa. 429, 94 A.2d 353 (1953).
- 8 In re Aguilar, 344 S.W.3d 41 (Tex. App. El Paso 2011).
- 9 Slatterly v. Madiol, 257 Mich. App. 242, 668 N.W.2d 154 (2003).
- 10 Storrs v. Lutheran Hospitals and Homes Soc. of America, Inc., 609 P.2d 24 (Alaska 1980) (repugnant provisions must be harmonized); Phillips v. National Trappers Ass'n, 407 N.W.2d 609 (Iowa Ct. App. 1987).
- 11 Denton Milling Co. v. Blewett, 254 S.W. 236 (Tex. Civ. App. Texarkana 1923), writ denied, 114 Tex. 582, 278 S.W. 1114 (1923).
- 12 Isaacs v. American Iron & Steel Co., 690 N.W.2d 373 (Minn. Ct. App. 2004).
- 13 Hibbert v. Hollywood Park, Inc., 457 A.2d 339 (Del. 1983); Wigod v. Chicago Mercantile Exchange, 141 Ill. App. 3d 129, 95 Ill. Dec. 566, 490 N.E.2d 39 (1st Dist. 1986).
- 14 A corporate bylaw is construed as it is written, and the language, if simple and unambiguous, is given the force and effect required. Kansas Heart Hospital, L.L.C. v. Idbeis, 286 Kan. 183, 184 P.3d 866 (2008).
- 15 Hibbert v. Hollywood Park, Inc., 457 A.2d 339 (Del. 1983).
- 16 Area, Inc. v. Stetenfeld, 541 P.2d 755 (Alaska 1975) (construction of term "book value").
- 17 Palermo v. Old Tram Hunting Club, 227 So. 2d 644 (La. Ct. App. 3d Cir. 1969).
- 18 Voss v. Lakefront Realty Corp., 48 Ill. App. 3d 56, 8 Ill. Dec. 109, 365 N.E.2d 347 (1st Dist. 1977).
- 19 Oberbillig v. West Grand Towers Condominium Ass'n, 807 N.W.2d 143 (Iowa 2011); Kansas City University of Medicine and Biosciences v. Pletz, 351 S.W.3d 254, 273 Ed. Law Rep. 891 (Mo. Ct. App. W.D. 2011); Roats v. Blakely Island Maintenance Com'n, Inc., 169 Wash. App. 263, 279 P.3d 943 (Div. 1 2012).
- 20 Carney v. New York Life Ins. Co., 162 N.Y. 453, 57 N.E. 78 (1900); Middle Tenn. Elec. Membership Corp. v. State ex rel. Adams, 193 Tenn. 513, 246 S.W.2d 958 (1952).

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## **LEGAL AUTHORITY CA-115**




SINCE 1828

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**accountability**

noun

ac·count·abil·i·ty | \ ə-,kaʊn-tə-'bi-lə-tē  \

## Definition of *accountability*

: the quality or state of being [accountable](#) especially : an obligation or willingness to accept responsibility or to account for one's actions public officials lacking accountability

## Examples of *accountability* in a Sentence

Recent Examples on the Web The damage goes beyond the lack of *accountability*, argues Sullivan, a media columnist for The Washington Post. — [Susan Benkelman](#), *Washington Post*, "[Local journalism has collapsed. Can anything save it?](#)," [10 July 2020](#) As opposed to punitive justice, which excises people from their communities, the principles of transformative justice are rooted in a practice of community *accountability*. — [Isabel Cristo](#), *The New Republic*, "[Policing Doesn't Protect Women](#)," [6 July 2020](#)

These example sentences are selected automatically from various online news sources to reflect current usage of the word 'accountability.' Views expressed in the examples do not represent the opinion of Merriam-Webster or its editors. [Send us feedback](#).

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## **LEGAL AUTHORITY CA-116**

# Oxford English Dictionary | The definitive record of the English language

## accountability, *n.*

**Pronunciation:** Brit. /əˌkaʊntəˈbɪlɪti/, U.S. /əˌkaʊn(t)əˈbɪlədi/

**Frequency (in current use):**

**Origin:** Formed within English, by derivation. **Etymon:** ACCOUNTABLE *adj.*

**Etymology:** < ACCOUNTABLE *adj.*: see -BILITY *suffix*. Compare earlier ACCOUNTABLENESS *n.*

**1.** The quality of being accountable; liability to account for and answer for one's conduct, performance of duties, etc. (in modern use often with regard to parliamentary, corporate, or financial liability to the public, shareholders, etc.); responsibility. Frequently with modifying word. Cf. ACCOUNTABLENESS *n.*, ANSWERABILITY *n.*, *public accountability n.* at PUBLIC *adj.* and *n.*

Compounds 1b.

- 1750 *Censor censured: Answer to Mr. Droz's Remarks* 10 It will still lie on you to prove..that the aforementioned moral Sensations, are, in any Propriety, Laws, when abstracted from all Idea of Accountability, and of Rewards and Punishments.
- 1808 *Mem. Dr. J. Cadman* (1853) 75 To affect the accountability of man.
- 1816 R. S. COXE *Rep. Supreme Court New-Jersey* 1 155 The orphan's court is..instituted by law to remedy and supply the defects in the powers of the perogative court, with regard to the accountability of executors, administrators and guardians.
- 1859 J. S. MILL *Diss. & Disc.* I. 467 Pushing to its utmost extent the accountability of governments to the people.
- 1935 *Harvard Law Rev.* 48 788 The reason why this distinction becomes crucial is..that financial accountability in the government means conformity with the legal requirements governing spending.
- 1986 G. KEILLOR *Lake Wobegon Days* 127 I had reached the age of accountability.
- 2007 R. LOVEGROVE *Silent Fields* iv. 87 They assumed accountability for..the supporting of maimed seamen and soldiers, highway maintenance, disbursing the poor rates, [etc..].

**2.** As a count noun: an instance of being accountable; a task, function, etc., for which one is accountable or responsible; a responsibility. Usually in *plural*.

- 1801 T. JEFFERSON *Let. in Jrnl. Senate U.S.* 16 Bringing back to a single department all accountabilities for money, where the examinations may be prompt, efficacious and uniform.
- 1880 *Friends' Intelligencer* 26 June 297/2 His energies are quickened, and, if he be a true man, he awakens to all the accountabilities of his new position.
- 1964 L. L. FULLER *Morality of Law* ii. 75 Blasting operations may be attended by an accountability for all harm that may result to others even though no intent to harm..can be demonstrated.
- 1996 *Financial Times* 11 Jan. 8/1 (*advt.*) Specific accountabilities include all aspects of Treasury management information, analysing product and market developments, communicating treasury policies, acting as senior dealer for forex, money markets and derivatives.



2004 *N.Y. Times Mag.* 19 Sept. 105 (*adv.*) In addition to investigating violations of federal criminal law, we are taking on new accountabilities as we work in conjunction with the Department of Homeland Security and other Federal agencies.

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This entry has been updated (OED Third Edition, December 2011).

**Oxford University Press**

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## **LEGAL AUTHORITY CA-117**

DEFINITIONS ▾ | redress

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# redress

 [ *noun* ree-dres, ri-dres; *verb* ri-dres ] [SHOW IPA](#) [SEE SYNONYMS FOR redress ON THESAURUS.COM](#)

## *noun*

- 1 the setting right of what is wrong:  
*redress of abuses.*
- 2 relief from wrong or injury.
- 3 compensation or satisfaction for a wrong or injury.

## *verb (used with object)*

- 4 to set right; remedy or repair (wrongs, injuries, etc.).
- 5 to correct or reform (abuses, evils, etc.).
- 6 to remedy or relieve (suffering, want, etc.).

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## **LEGAL AUTHORITY CA-118**

## Black's Law Dictionary (11th ed. 2019), redress

## REDRESS

Bryan A. Garner, Editor in Chief

[Preface](#) | [Guide](#) | [Legal Maxims](#) | [Bibliography](#)

**redress** (ri-**dres** or ree-dres) *n.* (14c) **1.** Relief; remedy <money damages, as opposed to equitable relief, is the only redress available>. **2.** A means of seeking relief or remedy <if the statute of limitations has run, the plaintiff is without redress>. —

**redressable**, *adj.* — **redress** (ri-**dres**), *vb.* — **redresser**, *n.*

- **penal redress.** (1874) A form of penal liability requiring full compensation of the injured person as an instrument for punishing the offender; compensation paid to the injured person for the full value of the loss (an amount that may far exceed the wrongdoer's benefit). See [RESTITUTION](#).

- **restitutionary redress.** (1970) Money paid to one who has been injured, the amount being the pecuniary value of the benefit to the wrongdoer. See [RESTITUTION](#).

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## **LEGAL AUTHORITY CA-119**

PUBLICATIONS DE LA COUR PERMANENTE DE JUSTICE  
INTERNATIONALE

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*SÉRIE A — N° 17*

Le 13 septembre 1928

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RECUEIL DES ARRÊTS

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N° 13

AFFAIRE RELATIVE A  
L'USINE DE CHORZÓW  
(DEMANDE EN INDEMNITÉ)  
(FOND)

---

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PUBLICATIONS OF THE PERMANENT COURT  
OF INTERNATIONAL JUSTICE

---

*SERIES A.—No. 17*

September 13th, 1928

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COLLECTION OF JUDGMENTS

---

No. 13

CASE CONCERNING  
THE FACTORY AT CHORZÓW  
(CLAIM FOR INDEMNITY)  
(MERITS)

LEYDE  
SOCIÉTÉ D'ÉDITIONS  
A. W. SIJTHOFF  
1928



LEYDEN  
A. W. SIJTHOFF'S  
PUBLISHING COMPANY  
1928



COUR PERMANENTE DE JUSTICE INTERNATIONALE

---

1928.  
Le 13 septembre.  
Dossier E. c. XIII.  
Rôle XIV: 1.

QUATORZIÈME SESSION (ORDINAIRE)

---

*Présents :*

MM. ANZILOTTI,	<i>Président,</i>	
HUBER,	<i>ancien Président,</i>	
Lord FINLAY,		} <i>Juges,</i>
MM. LODER,		
NYHOLM,		
DE BUSTAMANTE,		
ALTAMIRA,		
ODA,		
PESSÔA,		
M. BEICHMANN,	<i>Juge suppléant,</i>	
MM. RABEL,		} <i>Juges nationaux.</i>
EHRlich,		

---

ARRÊT N° 13

---

AFFAIRE RELATIVE A L'USINE  
DE CHORZÓW  
(DEMANDE EN INDEMNITÉ)  
(FOND)

Entre le Gouvernement d'Allemagne, représenté par M. le  
D<sup>r</sup> Erich Kaufmann, professeur à Berlin,

*Demandeur,*

et le Gouvernement de Pologne, représenté par M. le D<sup>r</sup> Thadée  
Sobolewski, agent du Gouvernement polonais auprès du Tribunal  
arbitral mixte polono-allemand,

*Défendeur.*

PERMANENT COURT OF INTERNATIONAL JUSTICE.

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FOURTEENTH (ORDINARY) SESSION.

---

1928.  
September 13th.  
File E. c. XIII.  
Docket XIV: 1.

*Before :*

MM. ANZILOTTI,	<i>President,</i>	
HUBER,	<i>Former President,</i>	
Lord FINLAY,		} <i>Judges,</i>
MM. LODER,		
NYHOLM,		
DE BUSTAMANTE,		
ALTAMIRA,		
ODA,		
PESSÔA,		
M. BEICHMANN,	<i>Deputy-Judge,</i>	
MM. RABEL,		} <i>National Judges.</i>
EHRlich,		

---

JUDGMENT No. 13.

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CASE CONCERNING THE FACTORY  
AT CHORZÓW  
(CLAIM FOR INDEMNITY)  
(THE MERITS).

The Government of Germany, represented by Dr. Erich Kaufmann, Professor at Berlin,

*Applicant,*

*versus*

The Government of the Polish Republic, represented by Dr. Thadeus Sobolewski, Agent for the Polish Government before the Polish-German Mixed Arbitral Tribunal,

*Respondent.*

LA COUR,

composée ainsi qu'il est dit ci-dessus,  
après avoir entendu les Parties en leurs observations et conclusions,  
a rendu l'arrêt suivant :

Par Requête introductive d'instance, déposée au Greffe de la Cour le 8 février 1927, en conformité de l'article 40 du Statut et de l'article 35 du Règlement, le Gouvernement du Reich a introduit devant la Cour permanente de Justice internationale une instance relative à la réparation qui serait due par le Gouvernement polonais du chef du préjudice souffert par les Sociétés anonymes Oberschlesische Stickstoffwerke A.-G. (ci-après dénommée l'Oberschlesische) et Bayerische Stickstoffwerke A.-G. (ci-après dénommée la Bayerische) à la suite de l'attitude adoptée par ce Gouvernement, lors de la prise de possession par lui de l'usine d'azote sise à Chorzów, vis-à-vis de ces Sociétés, attitude que la Cour avait déclarée, dans son Arrêt n° 7 du 25 mai 1926, comme n'étant pas conforme aux dispositions des articles 6 et suivants de la Convention relative à la Haute-Silésie, conclue à Genève, le 15 mai 1922, entre l'Allemagne et la Pologne (et désignée ci-après sous le nom de Convention de Genève).

Au reçu, le 3 mars 1927, du Mémoire du Gouvernement allemand en l'affaire, le Gouvernement polonais souleva, le 14 avril 1927, une exception préliminaire qui, contestant la compétence de la Cour pour connaître de l'instance introduite devant elle, concluait à ce qu'il plaise à la Cour, « sans entrer dans le fond, se déclarer incompétente ».

Sur ce moyen, la Cour se prononça par son Arrêt n° 8 du 26 juillet 1927, par lequel elle décida de rejeter l'exception préliminaire soulevée par le Gouvernement de Pologne et de retenir, pour statuer au fond, l'instance introduite le 8 février 1927 par le Gouvernement d'Allemagne.

Cet arrêt chargeait, en outre, le Président de fixer les délais pour le dépôt des Contre-Mémoire, Réplique et Duplique sur le fond. Ces délais, fixés d'abord aux 30 septembre, 15 novembre et 30 décembre 1927, furent par la suite étendus, en vertu

THE COURT,

composed as above,

having heard the observations and conclusions of the Parties,  
delivers the following judgment :

The Government of the German Reich, by an Application instituting proceedings filed with the Registry of the Court on February 8th, 1927, in conformity with Article 40 of the Statute and Article 35 of the Rules of Court, has submitted to the Permanent Court of International Justice a suit concerning the reparation which, in the contention of the Government of the Reich, is due by the Polish Government for the damage suffered by the Oberschlesische Stickstoffwerke A.-G. (hereinafter designated as the Oberschlesische) and the Bayerische Stickstoffwerke A.-G. (hereinafter designated as the Bayerische) in consequence of the attitude adopted by that Government towards those Companies in taking possession of the nitrate factory situated at Chorzów, which attitude has been declared by the Court in Judgment No. 7 (May 25th, 1926) not to have been in conformity with the provisions of Article 6 and the following articles of the Convention concerning Upper Silesia concluded at Geneva on May 15th, 1922, between Germany and Poland (hereinafter described as the Geneva Convention).

On receipt of the German Government's Case in the suit, on March 3rd, 1927, the Polish Government, on April 14th, 1927, raised a preliminary objection denying the Court's jurisdiction to hear the suit brought before it and submitting that the Court should, "without entering into the merits, declare that it had no jurisdiction".

The Court dealt with this plea in its Judgment No. 8 given on July 26th, 1927, by which it overruled the preliminary objection raised by the Polish Government and reserved for judgment on the merits the suit brought on February 8th, 1927, by the German Government.

Furthermore, under the terms of this judgment, the President was instructed to fix the times for the filing of the Counter-Case, Reply and Rejoinder on the merits. These times, which were in the first place fixed to expire on

de décisions successives, aux 30 novembre 1927, 20 février et 7 mai 1928 respectivement.

Les pièces de la procédure écrite furent dûment déposées au Greffe dans les délais définitivement fixés, et firent l'objet des communications prévues à l'article 43 du Statut.

Au cours des audiences tenues les 21, 22, 25, 27 et 29 juin 1928, la Cour a entendu, en leurs plaidoiries, réplique et duplique, les agents des Parties, indiqués ci-dessus.

\* \* \*

Les conclusions formulées dans la Requête du 8 février 1927 du Gouvernement allemand étaient ainsi conçues :

« Plaise à la Cour,

Dire et juger,

- 1° que, en raison de son attitude vis-à-vis des Sociétés anonymes Oberschlesische Stickstoffwerke et Bayerische Stickstoffwerke, constatée par la Cour comme n'étant pas conforme aux dispositions des articles 6 et suivants de la Convention de Genève, le Gouvernement polonais est tenu à la réparation du préjudice subi de ce chef par lesdites Sociétés à partir du 3 juillet 1922 jusqu'à la date de l'arrêt demandé ;
- 2° que le montant des indemnités à payer par le Gouvernement polonais est de 59.400.000 Reichsmarks pour le dommage causé à l'Oberschlesische Stickstoffwerke A.-G. et de 16.775.200 Reichsmarks pour le dommage causé à la Bayerische Stickstoffwerke A.-G. ;
- 3° en ce qui concerne le mode de paiement :
  - a) que le Gouvernement polonais devra payer, pendant le délai d'un mois à dater de l'arrêt, les indemnités dues à l'Oberschlesische Stickstoffwerke A.-G. pour la reprise de son capital d'exploitation (matières premières, produits finis et demi-finis, matériel emmagasiné, etc.) et les indemnités dues à la Bayerische Stickstoffwerke A.-G. pour la période d'exploitation du 3 juillet 1922 jusqu'à l'arrêt ;
  - b) que le Gouvernement polonais devra payer les sommes restantes, au plus tard, le 15 avril 1928 ;

September 30th, November 15th and December 30th, 1927, were subsequently extended by successive decisions until November 30th, 1927, February 20th and May 7th, 1928, respectively.

The documents of the written proceedings were duly filed with the Registrar of the Court within the times finally fixed and were communicated to those concerned as provided in Article 43 of the Statute.

In the course of hearings held on June 21st, 22nd, 25th, 27th and 29th, 1928, the Court has heard the oral statements, reply and rejoinder submitted by the above-mentioned Agents for the Parties.

\* \* \*

The submissions made in the German Government's Application of February 8th, 1927, were as follows:

It is submitted:

[*Translation.*]

- (1) that by reason of its attitude in respect of the Oberschlesische Stickstoffwerke and Bayerische Stickstoffwerke Companies, which attitude has been declared by the Court not to have been in conformity with the provisions of Article 6 and the following articles of the Geneva Convention, the Polish Government is under an obligation to make good the consequent damage sustained by the aforesaid Companies from July 3rd, 1922, until the date of the judgment sought;
- (2) that the amount of the compensation to be paid by the Polish Government is 59,400,000 Reichsmarks for the damage caused to the Oberschlesische Stickstoffwerke Company and 16,775,200 Reichsmarks for the damage caused to the Bayerische Stickstoffwerke Company;
- (3) in regard to the method of payment:
  - (a) that the Polish Government should pay within one month from the date of judgment, the compensation due to the Oberschlesische Stickstoffwerke Company for the taking possession of the working capital (raw material, finished and half-manufactured products, stores, etc.) and the compensation due to the Bayerische Stickstoffwerke Company for the period of exploitation from July 3rd, 1922, to the date of judgment;
  - (b) that the Polish Government should pay the sums remaining unpaid by April 15th, 1928, at latest;

- c) que, à partir de l'arrêt, des intérêts à raison de 6 % l'an seront payés par le Gouvernement polonais ;
- d) que les paiements visés sous a) — c) seront effectués sans aucune déduction au compte des deux Sociétés près la Deutsche Bank à Berlin ;
- e) que, jusqu'au 30 juin 1931, aucune exportation de chaux azotée et de nitrate d'ammoniaque n'aura lieu en Allemagne, dans les États-Unis d'Amérique, en France et en Italie.»

Ces conclusions ont, au cours de la procédure soit écrite, soit orale, subi des modifications dont il sera rendu compte ci-après. La Cour ne s'étant pas prévalué, dans la présente espèce, du droit à elle conféré par l'article 48 du Statut, de déterminer par voie d'ordonnance les « formes et délais dans lesquels chaque Partie doit finalement conclure », elle admet, aux fins de cette instance, la faculté pour les Parties de modifier, conformément aux précédents établis, leurs conclusions primitives, non seulement dans les mémoire et contre-mémoire (article 40 du Règlement), mais aussi tant dans les pièces ultérieures de la procédure écrite que dans les déclarations qu'elles peuvent faire au cours des débats oraux (article 55 du Règlement), sous réserve, seulement, que l'autre Partie soit toujours en mesure de se prononcer sur les conclusions amendées.

La conclusion n° 1 de la Requête n'a pas été modifiée par la suite.

En ce qui concerne, par contre, la conclusion n° 2, des modifications importantes sont intervenues. Dans le Mémoire, cette conclusion se trouve libellée de la manière suivante :

« Dire et juger. . . .

- 2) que le montant des indemnités à payer par le Gouvernement polonais est de 75.920.000 Reichsmarks, plus la valeur actuelle du capital d'exploitation (matières premières, produits finis et demi-finis, matières emmagasinées, etc.), saisi le 3 juillet 1922, pour le dommage causé à l'Oberschlesische Stickstoffwerke A.-G., et de 20.179.000 Reichsmarks pour le dommage causé à la Bayerische Stickstoffwerke A.-G.»

En comparant la conclusion 2) du Mémoire avec la conclusion 2) de la Requête, il convient de tenir compte des faits suivants résultant du Mémoire, savoir :

- (c) that, from the date of judgment, interest at 6% per annum should be paid by the Polish Government;
- (d) that the payments mentioned under (a)—(c) should be made without deduction to the account of the two Companies with the Deutsche Bank at Berlin;
- (e) that, until June 30th, 1931, no nitrated lime and no nitrate of ammonia should be exported to Germany, to the United States of America, to France or to Italy.

These submissions have, in the course of the written or oral proceedings, undergone modifications which will be indicated below. As the Court has not in the present suit availed itself of the right conferred upon it under Article 48 of the Statute to make orders as to "the form and time in which each Party must conclude its arguments", it, in this case, allows the Parties, in accordance with established precedent, to amend their original submissions, not only in the Case and Counter-Case (Article 40 of the Rules), but also both in the subsequent documents of the written proceedings and in declarations made by them in the course of the hearings (Article 55 of the Rules), subject only to the condition that the other Party must always have an opportunity of commenting on the amended submissions.

Submission No. 1 of the Application has not been subsequently amended.

On the other hand, with regard to submission No. 2, important amendments have been made. In the Case this submission is worded as follows:

It is submitted: . . . .

[*Translation.*]

- (2) that the amount of the compensation to be paid by the Polish Government is 75,920,000 Reichsmarks, plus the present value of the working capital (raw materials, finished and half-manufactured products, stores, etc.) taken over on July 3rd, 1922, for the damage caused to the Oberschlesische Stickstoffwerke Company, and 20,179,000 Reichsmarks for the damage caused to the Bayerische Stickstoffwerke Company.

In comparing submission (2) of the Case with submission (2) of the Application, regard must be had to the following facts resulting from the Case:



- a) que le montant de 59.400.000 indiqué dans la Requête comme le dommage de l'Oberschlesische est calculé au 3 juillet 1922 ;
- b) que ce montant comprend la somme d'un million pour matières premières, produits finis et demi-finis, matières emmagasinées, etc. ;
- c) que la somme de 75.920.000 indiquée dans le Mémoire à titre de dommage pour l'Oberschlesische se décompose en 58.400.000 de dommages au 3 juillet 1922, et 17.520.000 d'intérêts à 6 % sur 58.400.000 pour la période 3 juillet 1922 — 2 juillet 1927 ;
- d) que cette somme ne comprend pas de montant pour le « capital d'exploitation », une indemnité pour ce capital « valeur actuelle » étant dans le Mémoire demandée en termes généraux ;
- e) que la somme de 16.775.200 indiquée dans la Requête comme montant du dommage de la Bayerische est calculée au 3 juillet 1922 ; et
- f) que la somme de 20.179.000 indiquée dans le Mémoire pour le dommage de la Bayerische est calculée au 2 (ou 3) juillet 1927 à un taux d'intérêt de 6 % ; le montant pour la Bayerische fourni dans la Requête serait entaché d'une erreur de calcul.

En dernier lieu, la conclusion 2) de la Requête a été modifiée dans la réplique orale de l'agent du Gouvernement allemand, savoir, en ce qui concerne l'indemnité réclamée pour le dommage causé à l'Oberschlesische. Ladite conclusion se trouve, en effet, dans les conclusions lues par l'agent à l'issue de sa réplique orale, libellée comme suit :

« Dire et juger que le montant des indemnités à payer au Gouvernement allemand est de 58.400.000 Reichsmarks, plus 1.656.000 Reichsmarks, plus les intérêts à 6 % de cette somme à partir du 3 juillet 1922 jusqu'à la date de l'arrêt (pour le dommage causé à l'Oberschlesische Stickstoffwerke A.-G.) ;

que le montant des indemnités à payer au Gouvernement allemand est de 20.179.000 Reichsmarks pour le dommage causé à la Bayerische Stickstoffwerke A.-G. »

Il s'ensuit que, pour l'Oberschlesische, le Gouvernement allemand a) revient à la somme de 58.400.000 au 3 juillet 1922 ;

- (a) that the total of 59,400,000 mentioned in the Application as the figure representing the damage suffered by the Oberschlesische is calculated as on July 3rd, 1922 ;
- (b) that this sum includes the sum of 1 million for raw materials, finished and half-manufactured products, stores, etc. ;
- (c) that the sum of 75,920,000 mentioned in the Case as the figure representing the damage suffered by the Oberschlesische is made up of 58,400,000 for damages as on July 3rd, 1922, and 17,520,000 for interest at 6 % on 58,400,000 for the period July 3rd, 1922, to July 2nd, 1927 ;
- (d) that this sum does not include an amount for "working capital", compensation for the "present value" of this capital being in the Case sought in general terms ;
- (e) that the sum of 16,775,200 mentioned in the Application as the figure representing the damage suffered by the Bayerische is calculated as on July 3rd, 1922 ;
- (f) that the sum of 20,179,000 mentioned in the Case as representing the damage suffered by the Bayerische is calculated as on July 2nd (or 3rd), 1927, at a rate of interest of 6 % ; the amount for the Bayerische indicated in the Application is said to contain an error of calculation.

Lastly, submission (2) of the Application has been amended in the German Agent's oral reply as concerns the compensation claimed for the damage suffered by the Oberschlesische. This submission runs as follows in the submissions read by the Agent at the conclusion of his oral Reply :

It is submitted :

[*Translation.*]

that the total of the compensation to be paid to the German Government is 58,400,000 Reichsmarks, plus 1,656,000 Reichsmarks, plus interest at 6 % on this sum as from July 3rd, 1922, until the date of judgment (for the damage done to the Oberschlesische Stickstoffwerke A.-G.) ;

that the total of the compensation to be paid to the German Government is 20,179,000 Reichsmarks for the damage done to the Bayerische Stickstoffwerke A.-G.

It follows that, as regards the Oberschlesische, the German Government (a) reverts to the sum of 58,400,000 as on

b) fixe à 1.656.000 la valeur du capital d'exploitation à cette date ; c) demande sur ces deux sommes les intérêts à 6 % jusqu'à la date de l'arrêt, en renonçant au calcul forfaitaire avancé dans le Mémoire.

En ce qui concerne la conclusion 3) de la Requête du Gouvernement allemand, il y a à noter, dans la suite de la procédure, des modifications tant de forme que de fond.

Pour ce qui est de la forme, l'alinéa e) de la conclusion 3 de la Requête constitue, dans le Mémoire, à elle seule une nouvelle conclusion 3, tandis que la substance des alinéas a) — d) de la conclusion 3 de la Requête a été versée dans une nouvelle conclusion 4 a) — d) du Mémoire. Dans ces conditions, il est préférable de retracer les modifications survenues à chacun des alinéas de la conclusion 3 primitive.

L'alinéa 3 a) est ainsi libellé dans le Mémoire (où il porte le n° 4 a) :

« Dire et juger, en ce qui concerne le mode de paiement, que le Gouvernement polonais devra payer, pendant le délai d'un mois à dater de l'arrêt, les indemnités dues à l'Oberschlesische Stickstoffwerke A.-G., pour la reprise de son capital d'exploitation et les indemnités dues à la Bayerische Stickstoffwerke A.-G., pour la période d'exploitation du 3 juillet 1922 jusqu'à l'arrêt. »

Par rapport à la Requête, cet alinéa n'a, par conséquent, subi qu'une modification de pure forme (suppression d'une parenthèse explicative) ; elle n'a plus été amendée par la suite.

L'alinéa 3 b) est libellé de la manière suivante dans le Mémoire (où il porte le n° 4 b) :

« Dire et juger que le Gouvernement polonais devra payer les sommes restantes, au plus tard le 15 avril 1928 ; subsidiairement que, pour autant que le paiement serait effectué par tranches, le Gouvernement polonais délivre, pendant le délai d'un mois à dater de l'arrêt, des lettres de change aux montants des tranches, y compris les intérêts, à payer aux dates d'échéance respectives à l'Oberschlesische Stickstoffwerke A.-G. et à la Bayerische Stickstoffwerke A.-G. »

July 3rd, 1922; (b) fixes as 1,656,000 the value of the working capital on that date; (c) claims on these two sums interest at 6% until the date of judgment, thus abandoning the claim for a lump sum made in the Case.

As regards submission (3) of the German Government's Application, amendments both of form and of substance are to be noted in the course of the subsequent procedure.

As regards form, paragraph (e) of submission (3) of the Application constitutes by itself a new third submission in the Case, whilst the substance of paragraphs (a)—(d) of submission No. 3 of the Application has been embodied in a new submission No. 4 (a)—(d) in the Case. In these circumstances, it is preferable to trace back the modifications made to each of the paragraphs of the original third submission.

Paragraph 3 (a) is worded as follows in the Case (where it is numbered 4 (a)):

[*Translation.*]

that the Polish Government should pay, within one month from the date of judgment, the compensation due to the Oberschlesische Stickstoffwerke Company for the taking possession of the working capital and the compensation due to the Bayerische Stickstoffwerke Company for the period of exploitation from July 3rd, 1922, to the date of judgment.

As compared with the Application, therefore, this paragraph has undergone a purely superficial modification (deletion of an explanatory remark in parenthesis), and it has not subsequently been amended.

Paragraph 3 (b) is worded as follows in the Case (where it is numbered 4 (b)):

[*Translation.*]

that the Polish Government should pay the remaining sums by April 15th, 1928, at latest;

in the alternative, that, in so far as payment may be effected in instalments, the Polish Government shall deliver, within one month from the date of judgment, bills of exchange for the amounts of the instalments, including interest, payable on the respective dates on which they fall due to the Oberschlesische Stickstoffwerke Company and to the Bayerische Stickstoffwerke Company.

Ainsi, à la conclusion principale primitive a été ajoutée une conclusion subsidiaire visant l'éventualité d'un paiement par tranches.

Le même alinéa est formulé comme suit dans la Réplique orale :

« Dire et juger que le Gouvernement polonais doit payer les sommes restantes au plus tard dans un délai de quinze jours à dater du commencement de l'année budgétaire qui suit l'arrêt ; subsidiairement, que, pour autant que le paiement serait effectué par tranches, le Gouvernement polonais délivre, pendant le délai d'un mois à dater de l'arrêt, des lettres de change aux montants des tranches, y compris les intérêts à payer aux dates d'échéance respectives à l'Oberschlesische Stickstoffwerke A.-G. et à la Bayerische Stickstoffwerke A.-G. »

La modification par rapport à la version précédente consiste en la substitution à la date du 15 avril 1928, déjà écoulée, d'un délai calculé en rapport avec l'ouverture de l'année budgétaire polonaise.

L'alinéa 3 c) des conclusions de la Requête (4 c) du Mémoire) n'a pas subi de changements par la suite.

Par contre, l'alinéa 3 d) de la Requête figure dans le Mémoire sous la forme suivante (n° 4 d) du Mémoire) :

« Dire et juger que le Gouvernement polonais n'est pas autorisé à compenser contre la créance susdite du Gouvernement allemand d'être indemnisé sa créance résultant des assurances sociales en Haute-Silésie ; qu'il ne peut se prévaloir d'aucune autre compensation contre ladite créance d'indemnité ; et que les paiements visés sous a) — c) seront effectués sans aucune déduction au compte des deux Sociétés près la Deutsche Bank à Berlin. »

La conclusion primitive se trouve dans le dernier membre de phrase de cette formule, dont la partie principale demande maintenant une déclaration excluant toute possibilité de compensation extra-judiciaire.

La formule du Mémoire a été maintenue tant dans la Réplique écrite que dans la réplique orale, sauf addition d'une nouvelle conclusion subsidiaire, relative à la question de l'interdiction d'une compensation extra-judiciaire, et ainsi conçue :

Thus to the main original submission has been added an alternative contemplating the possibility of payment by instalments.

The same paragraph is couched in the following terms in the oral reply :

[*Translation.*]

It is submitted that the Polish Government should pay the remaining sums at latest within fifteen days after the beginning of the financial year following the judgment; in the alternative that, in so far as payment may be effected by instalments, the Polish Government should, within one month from the date of judgment, give bills of exchange for the amounts of the instalments, including interest, payable on maturity to the Oberschlesische Stickstoffwerke A.-G. and to the Bayerische Stickstoffwerke A.-G.

The modification as compared with the previous version consists in the substitution for the date April 15th, 1928, which had already passed, a time-limit fixed in relation to the beginning of the Polish financial year.

Paragraph 3 (c) of the submissions of the Application (4 (c) of the Case) has undergone no subsequent modification.

On the other hand, paragraph 3 (d) of the Application appears in the Case in the following form (No. 4 (d) of the Case) :

[*Translation.*]

that the Polish Government is not entitled to set off, against the above-mentioned claim for indemnity of the German Government, its claim in respect of social insurances in Upper Silesia; that it may not make use of any other set-off against the above-mentioned claim for indemnity; and that the payments mentioned under (a)—(c) should be made without any deduction to the account of the two Companies with the Deutsche Bank at Berlin.

The original submission is contained in the last part of this paragraph, the principal clause of which now seeks a declaration excluding any possibility of extra-judicial set-off.

The wording of the Case is retained both in the written and in the oral reply, except that a new alternative submission is added in regard to the question of the prohibition of extra-judicial set-off. This addition runs as follows :

« Dire et juger, subsidiairement, qu'une compensation n'est autorisée que lorsque le Gouvernement polonais invoque à cette fin une créance reconnue par le Gouvernement allemand ou constatée par un arrêt rendu entre les deux Gouvernements. »

Venant, enfin, à l'alinéa 3 e) des conclusions de la Requête, il y a lieu de constater que ce dernier se retrouve sans aucun changement dans la conclusion 3 du Mémoire. Par contre, la Réplique écrite, tout en reproduisant également la formule de la Requête, y ajoute la conclusion subsidiaire suivante :

« Juger et décider que le Gouvernement polonais est obligé de cesser l'exploitation de l'usine, respectivement des installations chimiques pour transformer l'azote de chaux en nitrate d'ammoniaque, etc. »

Ainsi complétée, la conclusion dont il s'agit figure également dans la réplique orale, savoir dans la forme suivante :

« subsidiairement, pour le cas où la Cour n'adopterait pas les points de vue développés aux paragraphes 55 et 57 de la Réplique, dire et juger que le Gouvernement polonais est obligé de cesser l'exploitation de l'usine, respectivement des installations chimiques pour produire le nitrate d'ammoniaque, etc. »

\* \* \*

À l'occasion de certaines conclusions présentées par le Gouvernement polonais et relatives à l'indemnisation de l'Oberschlesische, le Gouvernement allemand a non seulement demandé à la Cour de les rejeter, mais a encore formulé deux autres conclusions, savoir :

« Dire et juger

1° que le Gouvernement polonais n'est pas autorisé à refuser le paiement au Gouvernement allemand des indemnités en raison d'arguments tirés de l'article 256 et en raison d'égards vis-à-vis de la Commission des Réparations et d'autres tierces personnes ;

2° que l'obligation du Gouvernement polonais de payer l'indemnité allouée par la Cour n'est nullement écartée par un jugement rendu ou à rendre par un tribunal interne polonais dans un procès ayant pour objet la question de la propriété de l'usine sise à Chorzów. »

[*Translation.*]

In the alternative it is submitted that set-off is only permissible if the Polish Government puts forward for this purpose a claim in respect of a debt recognized by the German Government or established by a judgment given between the two Governments.

Turning lastly to paragraph 3 (*e*) of the submissions in the Application, it is to be observed that this reappears unchanged in submission 3 of the Case. On the other hand, in the written Reply, whilst the submission of the Application is repeated, the following alternative is added :

[*Translation.*]

It is submitted that the Polish Government should be obliged to cease the exploitation of the factory and of the chemical equipment for the transformation of nitrate of lime into ammonium nitrate, etc.

With this addition, this submission also appears in the oral reply in the following form :

[*Translation.*]

in the alternative, should the Court not adopt the points of view set out in paragraphs 55 and 57 of the Reply, it is submitted that the Polish Government should be obliged to cease the exploitation of the factory or of the chemical equipment for the production of ammonium nitrate, etc.

\* \* \*

In connection with certain submissions made by the Polish Government in regard to the compensation of the Oberschlesische, the German Government has not merely asked the Court to reject these submissions but has also formulated two other submissions, namely :

[*Translation.*]

(1) that the Polish Government is not entitled to refuse to pay compensation to the German Government on the basis of arguments drawn from Article 256 and for motives of respect for the rights of the Reparation Commission and other third parties ;

(2) that the Polish Government's obligation to pay the indemnity awarded by the Court is in no way set aside by a judgment given or to be given by a Polish municipal court in a suit concerning the question of the ownership of the factory at Chorzów.



Ces conclusions, formulées soit dans la Réplique écrite soit dans la première plaidoirie de l'agent allemand, ont été maintenues sans changement dans la réplique orale.

Abstraction faite de ces deux demandes complémentaires, les conclusions finales du Gouvernement allemand sont donc les suivantes :

« 1) que, en raison de son attitude vis-à-vis des Sociétés anonymes Oberschlesische Stickstoffwerke et Bayerische Stickstoffwerke constatée par la Cour comme n'étant pas conforme aux dispositions des articles 6 et suivants de la Convention de Genève, le Gouvernement polonais est tenu à la réparation du préjudice subi de ce chef par lesdites Sociétés à partir du 3 juillet 1922 jusqu'à la date de l'arrêt demandé ;

2) a) que le montant des indemnités à payer au Gouvernement allemand est de 58.400.000 Reichsmarks, plus 1.656.000 Reichsmarks, plus les intérêts à 6 % de cette somme à partir du 3 juillet 1922 jusqu'à la date de l'arrêt (pour le dommage causé à l'Oberschlesische Stickstoffwerke A.-G.) ;

b) que le montant des indemnités à payer au Gouvernement allemand est de 20.179.000 Reichsmarks pour le dommage causé à la Bayerische Stickstoffwerke A.-G. ;

3) que, jusqu'au 30 juin 1931, aucune exportation de chaux azotée et de nitrate d'ammoniaque n'aura lieu en Allemagne, dans les États-Unis d'Amérique, en France et en Italie ;

subsidiatement, que le Gouvernement polonais est obligé de cesser l'exploitation de l'usine, respectivement des installations chimiques pour produire le nitrate d'ammoniaque, etc. ;

4) a) que le Gouvernement polonais devra payer, pendant le délai d'un mois à dater de l'arrêt, les indemnités dues à l'Oberschlesische Stickstoffwerke A.-G. pour la reprise de son capital d'exploitation, et les indemnités dues à la Bayerische Stickstoffwerke A.-G. pour la période d'exploitation du 3 juillet 1922 jusqu'à l'arrêt ;

b) que le Gouvernement polonais doit payer les sommes restantes au plus tard pendant un délai de quinze jours à dater du commencement de l'année budgétaire qui suit l'arrêt ; subsidiatement, que, pour autant que le paiement serait effectué par tranches, le Gouvernement polonais délivre, pendant le délai d'un mois à dater de l'arrêt, des lettres de change aux montants des tranches, y compris les intérêts à payer aux dates d'échéance respectives à l'Oberschlesische Stickstoffwerke A.-G. et à la Bayerische Stickstoffwerke A.-G. ;

c) que, à partir de l'arrêt, des intérêts à raison de 6 % l'an seront payés par le Gouvernement polonais ;

These submissions, which were made in the written Reply and in the first oral statement of the German Agent respectively, have been maintained unaltered in the oral reply.

Apart from the two additional claims just referred to, the final submissions of the German Government are therefore as follows :

[*Translation.*]

(1) that by reason of its attitude in respect of the Oberschlesische Stickstoffwerke and Bayerische Stickstoffwerke Companies, which attitude has been declared by the Court not to have been in conformity with the provisions of Article 6 and the following articles of the Geneva Convention, the Polish Government is under an obligation to make good the consequent injury sustained by the aforesaid Companies from July 3rd, 1922, until the date of the judgment sought ;

(2) (a) that the amount of the compensation to be paid to the German Government is 58,400,000 Reichsmarks, plus 1,656,000 Reichsmarks, plus interest at 6 % on this sum as from July 3rd, 1922, until the date of judgment (for the damage caused to the Oberschlesische Stickstoffwerke A.-G.) ;

(b) that the amount of the compensation to be paid to the German Government is 20,179,000 Reichsmarks for the damage caused to the Bayerische Stickstoffwerke A.-G. ;

(3) that until June 30th, 1931, no nitrated lime and no nitrate of ammonia should be exported to Germany, to the United States of America, to France or to Italy ;

in the alternative, that the Polish Government should be obliged to cease from exploiting the factory or the chemical equipment for the production of nitrate of ammonia, etc. ;

(4) (a) that the Polish Government should pay, within one month from the date of judgment, the compensation due to the Oberschlesische Stickstoffwerke A.-G. for the taking possession of the working capital and the compensation due to the Bayerische Stickstoffwerke A.-G. for the period of exploitation from July 3rd, 1922, to the date of judgment ;

(b) that the Polish Government should pay the remaining sums at latest within fifteen days after the beginning of the financial year following the judgment ; in the alternative, that, in so far as payment may be effected by instalments, the Polish Government should within one month from the date of judgment, give bills of exchange for the amounts of the instalments, including interest, payable on maturity to the Oberschlesische Stickstoffwerke A.-G. and to the Bayerische Stickstoffwerke A.-G. ;

(c) that from the date of judgment, interest at 6 % per annum should be paid by the Polish Government ;

d) que le Gouvernement polonais n'est pas autorisé à compenser contre la créance susdite du Gouvernement allemand d'être indemnisé sa créance résultant des assurances sociales en Haute-Silésie; qu'il ne peut se prévaloir d'aucune autre compensation contre ladite créance d'indemnité; et que les paiements visés sous a) à c) seront effectués sans aucune déduction au compte des deux Sociétés près la Deutsche Bank à Berlin;

subsidiatement, qu'une compensation n'est autorisée que lorsque le Gouvernement polonais invoque à cette fin une créance reconnue par le Gouvernement allemand ou constatée par un arrêt rendu entre les deux Gouvernements.»

Le Gouvernement polonais n'a pas soulevé d'objection en la forme contre les modifications apportées successivement aux conclusions primitives du Gouvernement allemand.

\* \* \*

Les conclusions que le Gouvernement polonais a formulées en réponse à celles qui se trouvent exprimées dans la Requête et dans le Mémoire allemand sont libellées de la manière suivante dans le Contre-Mémoire :

«Plaise à la Cour :

A. Pour ce qui concerne l'Oberschlesische :

- 1) débouter le Gouvernement requérant de sa demande;
- 2) subsidiatement, surseoir provisoirement sur la demande en indemnité;
- 3) très subsidiatement, pour le cas où la Cour serait amenée à allouer une indemnité quelconque, dire et juger que celle-ci ne sera payable que: a) après le retrait préalable par ladite Société de sa requête pendante au Tribunal arbitral mixte germano-polonais relative à l'usine de Chorzów et après sa renonciation en bonne et due forme à toute prétention contre le Gouvernement polonais, du chef de la prise en possession et de l'exploitation de l'usine de Chorzów; b) lorsque le procès civil intenté contre ladite Société par le Gouvernement polonais et ayant pour objet la validité de l'inscription de son titre de propriété au registre foncier sera définitivement jugé en faveur de la Société Oberschlesische.
- 4) En tout cas, dire et juger que le Gouvernement allemand doit, en premier lieu, livrer au Gouvernement polonais la totalité des actions de la Société anonyme Oberschlesische

(d) that the Polish Government is not entitled to set off against the above-mentioned claim for indemnity of the German Government, its claim in respect of social insurances in Upper Silesia; that it may not make use of any other set-off against the said claim for indemnity; and that the payments mentioned under (a) to (c) should be made without any deduction to the account of the two Companies with the Deutsche Bank at Berlin;

in the alternative, that set-off is only permissible if the Polish Government puts forward for this purpose a claim in respect of a debt recognized by the German Government or established by a judgment given between the two Governments.

The Polish Government has made no formal objection to the amendments successively made in the original submissions of the German Government.

\* \* \*

The submissions formulated by the Polish Government in reply to those set out in the Application and Case of the German Government are worded as follows in the Counter-Case:

It is submitted:

[*Translation.*]

A. In regard to the Oberschlesische:

- (1) that the applicant Government's claim should be dismissed;
- (2) in the alternative, that the claim for indemnity should be provisionally suspended;
- (3) as a further alternative, in the event of the Court awarding some compensation, that such compensation should only be payable: (a) after the previous withdrawal by the said Company of the action brought by it and pending before the German-Polish Mixed Arbitral Tribunal in regard to the Chorzów factory and after the formal abandonment by it of any claim against the Polish Government in respect of the latter's taking possession and exploitation of the Chorzów factory; (b) when the civil action brought against the said Company by the Polish Government in respect of the validity of the entry of its title to ownership in the land register has been finally decided in favour of the Oberschlesische.
- (4) In any case, it is submitted that the German Government should, in the first place, hand over to the Polish Government the whole of the shares of the Oberschlesische

Stickstoffwerke, de la valeur nominale de 110.000.000 de marks dont il dispose en vertu du contrat du 24 décembre 1919.

B. Pour ce qui concerne la Bayerische :

- 1) a) débouter le Gouvernement requérant de sa demande en indemnité pour le passé, pour autant qu'elle dépasse la somme de 1.000.000 de Reichsmarks ;
  - b) allouer *pro futuro* une rente annuelle de 250.000 Reichsmarks payable à partir du 1<sup>er</sup> janvier 1928 jusqu'au 31 mars 1941 ;
  - c) dire et juger que ces indemnités ne seront payables qu'après le retrait préalable par ladite Société de sa requête pendante au Tribunal arbitral mixte germano-polonais relative à l'usine de Chorzów, et après sa renonciation, en bonne et due forme, à toute prétention contre le Gouvernement polonais du chef de la prise en possession et de l'exploitation de l'usine de Chorzów ;
- 2) débouter le Gouvernement requérant de sa conclusion n° 3, tendant à ce qu'il soit dit et jugé que, jusqu'au 30 juin 1931, aucune exportation de chaux azotée et de nitrate d'ammoniaque n'aura lieu en Allemagne, dans les États-Unis d'Amérique, en France et en Italie.

C. Pour ce qui concerne l'Oberschlesische et la Bayerische en commun :

rejeter la conclusion n° 4 tendant à ce qu'il soit dit et jugé que le Gouvernement polonais n'est pas autorisé à compenser, contre la créance susdite du Gouvernement allemand d'être indemnisé, sa créance résultant des assurances sociales en Haute-Silésie ; qu'il ne peut se prévaloir d'aucune autre compensation contre ladite créance d'indemnité, et que les paiements visés sous 4 a) — c) seront effectués sans aucune déduction au compte des deux Sociétés près la Deutsche Bank à Berlin. »

Ces conclusions n'ont, par la suite, subi d'autres modifications que le retrait, opéré au moyen d'une déclaration insérée dans la Duplique écrite, de la conclusion A, 3 b).

Le Gouvernement allemand ayant contesté le droit pour le Gouvernement polonais de retirer cette conclusion, à laquelle le Gouvernement allemand avait opposé une demande de débouté, dans le stade de la procédure où ce retrait avait eu lieu, le Gouvernement polonais a déclaré maintenir le retrait.

Pour les motifs développés ci-dessus, la Cour estime qu'il n'y a rien qui puisse empêcher le Gouvernement polonais de

Stickstoffwerke Company, of the nominal value of 110,000,000 Marks, which are in its hands under the contract of December 24th, 1919.

B. In regard to the Bayerische :

- (1) (a) that the applicant Government's claim for compensation in respect of the past, in excess of 1,000,000 Reichsmarks, should be dismissed ;
  - (b) that, *pro futuro*, an annual rent of 250,000 Reichsmarks, payable as from January 1st, 1928, until March 31st, 1941, should be awarded ;
  - (c) that these indemnities should only be payable after previous withdrawal by the said Company of the claim pending before the German-Polish Mixed Arbitral Tribunal in respect of the Chorzów factory and after the formal abandonment by it of any claim against the Polish Government in respect of the latter's taking possession and exploitation of the Chorzów factory ;
- (2) that the applicant Government's third submission to the effect that until June 30th, 1931, no exportation of nitrated lime or nitrate of ammonia should take place to Germany, the United States of America, France or Italy, should be dismissed.

C. In regard to the Oberschlesische and Bayerische jointly :

that submission No. 4—to the effect that it is not permissible for the Polish Government to set off, against the above-mentioned claim for indemnity of the German Government, its claim in respect of social insurances in Upper Silesia, that it may not make use of any other set-off against the above-mentioned claim for indemnity, and that the payments mentioned under 4 (a)—(c) should be made without any deduction to the account of the two Companies with the Deutsche Bank at Berlin—should be rejected.

These submissions have not subsequently been amended except that submission A, 3 (b), was withdrawn by means of a declaration contained in the written Rejoinder.

The German Government having disputed the right of the Polish Government to withdraw this submission (the rejection of which had been demanded by the former) at the stage of the proceedings reached when the withdrawal took place, the latter Government maintained its withdrawal.

For the reasons given above, the Court holds that there is nothing to prevent the Polish Government for its part from

modifier, quant à lui, ses conclusions primitives, d'autant moins que cette modification s'est produite encore au cours de la phase écrite de la procédure et a pris la forme d'un abandon d'une partie des conclusions. De l'avis de la Cour, la seconde des « demandes complémentaires » du Gouvernement allemand, mentionnée ci-dessus, se dirigeait sans doute contre la conclusion polonaise qui a été abandonnée.

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La Cour considère, par conséquent, qu'elle se trouve en présence de conclusions finales polonaises ainsi libellées :

« Plaise à la Cour :

A. pour ce qui concerne l'Oberschlesische :

- 1) débouter le Gouvernement requérant de sa demande ;
- 2) subsidiairement, surseoir provisoirement sur la demande en indemnité ;
- 3) très subsidiairement, pour le cas où la Cour serait amenée à allouer une indemnité quelconque, dire et juger que celle-ci ne sera payable qu'après le retrait préalable par ladite Société de sa requête pendante au Tribunal arbitral mixte germano-polonais relative à l'usine de Chorzów et après sa renonciation en bonne et due forme à toute prétention contre le Gouvernement polonais, du chef de la prise en possession et de l'exploitation de l'usine de Chorzów.
- 4) En tout cas, dire et juger que le Gouvernement allemand doit, en premier lieu, livrer au Gouvernement polonais la totalité des actions de la Société anonyme Oberschlesische Stickstoffwerke, de la valeur nominale de 110.000.000 de marks, dont il dispose en vertu du contrat du 24 décembre 1919.

B. Pour ce qui concerne la Bayerische :

- 1) a) débouter le Gouvernement requérant de sa demande en indemnité pour le passé, pour autant qu'elle dépasse la somme de 1.000.000 de Reichsmarks ;
- b) allouer *pro futuro* une rente annuelle de 250.000 Reichsmarks payable à partir du 1<sup>er</sup> janvier 1928 jusqu'au 31 mars 1941 ;
- c) dire et juger que ces indemnités ne seront payables qu'après le retrait préalable par ladite Société de sa requête pendante au Tribunal arbitral mixte germano-

amending its original submissions, especially seeing that this amendment occurred while the written proceedings were still in progress and took the form of the abandonment of a part of its submissions. In the Court's opinion, the second of the "additional claims" of the German Government mentioned above, was doubtless designed to meet the Polish submission which has been thus abandoned.

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The Court therefore considers that the final submissions of the Polish Government may be set down as under :

"It is submitted :

A. As regards the Oberschlesische :

- (1) that the claim of the applicant Government should be dismissed ;
- (2) in the alternative, that the claim for indemnity should be provisionally suspended ;
- (3) as a further alternative, in the event of the Court awarding some compensation, that such compensation should only be payable after the previous withdrawal by the said Company of the action brought by it and pending before the German-Polish Mixed Arbitral Tribunal in regard to the Chorzów factory, and after the formal abandonment by it of any claim against the Polish Government in respect of the latter's taking possession and exploitation of the Chorzów factory.
- (4) In any case, it is submitted that the German Government should, in the first place, hand over to the Polish Government the whole of the shares of the Oberschlesische Stickstoffwerke Company, of the nominal value of 110,000,000 Marks, which are in its hands under the contract of December 24th, 1919.

B. As regards the Bayerische :

- (1) (a) that the applicant Government's claim for compensation in respect of the past, in excess of 1,000,000 Reichsmarks, should be dismissed ;
- (b) that, *pro futuro*, an annual rent of 250,000 Reichsmarks, payable as from January 1st, 1928, until March 31st, 1941, should be awarded ;
- (c) that these indemnities should only be payable after previous withdrawal by the said Company of the claim pending before the German-Polish Mixed Arbitral



polonais relative à l'usine de Chorzów, et après sa renonciation, en bonne et due forme, à toute prétention contre le Gouvernement polonais du chef de la prise en possession et de l'exploitation de l'usine de Chorzów ;

- 2) débouter le Gouvernement requérant de sa conclusion n° 3 tendant à ce qu'il soit dit et jugé que, jusqu'au 30 juin 1931, aucune exportation de chaux azotée et de nitrate d'ammoniaque n'aura lieu en Allemagne, dans les États-Unis d'Amérique, en France et en Italie.

C. Pour ce qui concerne l'Oberschlesische et la Bayerische en commun :

rejeter la conclusion n° 4 tendant à ce qu'il soit dit et jugé que le Gouvernement polonais n'est pas autorisé à compenser contre la créance susdite du Gouvernement allemand d'être indemnisé, sa créance résultant des assurances sociales en Haute-Silésie ; qu'il ne peut se prévaloir d'aucune autre compensation contre ladite créance d'indemnité, et que les paiements visés sous 4 a) — c) seront effectués sans aucune déduction au compte des deux Sociétés près la Deutsche Bank à Berlin.»

\* \* \*

D'une comparaison entre les conclusions finales allemandes et polonaises qui ont été ainsi établies, il ressort :

- I. — A) en ce qui concerne la conclusion allemande n° 1 : qu'il y a désaccord entre les Parties, sauf pour ce qui est de la réparation du dommage subi par la Bayerische ;
- B) en ce qui concerne la conclusion allemande n° 2 a : que le Gouvernement polonais demande que le Gouvernement allemand soit débouté ; et, subsidiairement, qu'il soit sursis provisoirement à la demande en indemnité ; c'est sans doute contre la demande subsidiaire opposée ainsi par le Gouvernement polonais à la conclusion n° 2 a du Gouvernement allemand que se dirige la première des « demandes complémentaires » de ce Gouvernement, mentionnées plus haut ;
- C) en ce qui concerne la conclusion allemande n° 2 b : que le Gouvernement polonais demande que le Gouvernement allemand en soit débouté, sauf pour ce

Tribunal in respect of the Chorzów factory and after the formal abandonment by it of any claim against the Polish Government in respect of the latter's taking possession and exploitation of the Chorzów factory;

- (2) that the applicant Government's third submission to the effect that until June 30th, 1931, no exportation of nitrate of lime or nitrate of ammonia should take place to Germany, the United States of America, France or Italy.

C. As regards the Oberschlesische and Bayerische jointly:

that submission No. 4—to the effect that it is not permissible for the Polish Government to set off against the above-mentioned claim for indemnity of the German Government its claim in respect of social insurances in Upper Silesia, that it may not make use of any other set-off against the above-mentioned claim for indemnity, and that the payments mentioned under 4 (a)—(c) should be made without any deduction to the account of the two Companies with the Deutsche Bank at Berlin—should be rejected.

\* \* \*

A comparison between the German and Polish final submissions as thus set out leads to the following results:

- I.—(A) as regards the first German submission: that the Parties are at variance except in regard to the reparation of the damage sustained by the Bayerische;
- (B) as regards submission No. 2 *a* of the German Government: that the Polish Government asks that it should be dismissed; and, in the alternative, that the claim for indemnity should be provisionally suspended; it is doubtless the alternative claim thus put forward by Poland in reply to submission No. 2 *a* of the German Government that the first of the "additional claims" of the latter Government mentioned above is intended to meet;
- (C) as regards submission No. 2 *b* of the German Government: that the Polish Government asks that it should be dismissed except as regards the award, in respect of

qui est de l'allocation, pour le passé, d'une somme ne dépassant pas 1.000.000 de Reichsmarks et, pour l'avenir, d'une rente annuelle de 250.000 Reichsmarks payable du 1<sup>er</sup> janvier 1928 au 31 mars 1941 ;

- D) en ce qui concerne la conclusion allemande n° 3 : que le Gouvernement polonais demande que le Gouvernement allemand soit débouté de la conclusion *principale*, mais ne se prononce pas en forme de conclusion sur la conclusion *subsidaire* inscrite sous ce numéro ;
- E) en ce qui concerne les conclusions allemandes n° 4 a) — c) : que le Gouvernement polonais ne se prononce pas spécifiquement sur ces conclusions, sauf en formulant sa conclusion A 3, relative au sursis de paiement ;
- F) en ce qui concerne la conclusion allemande n° 4 d) : que le Gouvernement polonais conclut au rejet de la conclusion *principale* portant ce numéro, mais ne se prononce pas en forme de conclusion sur la conclusion *subsidaire* allemande.

II. — En ce qui concerne les conclusions polonaises : que la conclusion A 4, dépassant le cadre des conclusions allemandes, a provoqué de la part du Gouvernement allemand une demande en rejet, formulée au cours de la phase orale de la procédure.

\* \* \*

C'est donc exclusivement sur les points de divergence ainsi constatés qu'il appartient à la Cour de statuer dans l'arrêt qu'elle va rendre. Il est vrai que les Parties ont formulé, au cours de la procédure tant écrite qu'orale, encore d'autres demandes. Pour autant, cependant, que ces demandes ne constituent pas des développements des conclusions primitives, ou des demandes subsidiaires à ces conclusions, la Cour ne saurait les regarder autrement que, suivant l'expression de l'agent du Gouvernement allemand, comme des « motivations à titre subsidiaire », ou bien comme de simples suggestions quant à la procédure à suivre ; cela est certainement le cas en ce qui concerne les nombreuses demandes tendant à obtenir la consul-

the past, of a sum not exceeding 1,000,000 Reichsmarks for the future, of an annual rent of 250,000 Reichsmarks payable as from January 1st, 1928, until March 31st, 1941;

- (D) as regards the German submission No. 3: that the Polish Government asks that the German Government's *principal* submission should be dismissed but does not formulate a definite submission with regard to the *alternative* submission under this number;
- (E) as regards the German submissions Nos. 4 (a)—(c): that the Polish Government does not say anything specific concerning these submissions except in so far as it formulates its submission A 3, regarding the suspension of payment;
- (F) as regards the German Government's submission No. 4 (d): that the Polish Government submits that the *principal* submission under this number should be rejected, but does not formulate any definite submission regarding the *alternative* German submission.

II.— As regards the Polish submissions: that submission A 4, which goes beyond the scope of the German submissions, has given rise to a claim for its rejection on the part of the German Government, formulated during the oral proceedings.

\* \* \*

It is therefore solely with the points of divergence as set out above that the Court has to deal in the judgment which it is about to deliver. It is true that the Parties have, both in the written and oral proceedings, formulated yet other claims. In so far, however, as these claims do not constitute developments of the original submissions, or alternatives to them, the Court cannot regard them otherwise than—to use the expression of the Agent of the German Government—as “subsidiary arguments” or as mere suggestions as to the procedure to be adopted; this is certainly the case as regards the numerous requests with a view to the consultation of experts or the hearing of witnesses. There is no occasion for the Court

tation d'experts ou l'audition de témoins. Sur toutes ces demandes, la Cour n'a pas besoin de statuer ; elle peut donc se borner à en tenir compte, dans la mesure où cela convient, au cours de la discussion, aux fins de l'exposé des motifs de l'arrêt des arguments avancés par les Parties à l'appui de leurs conclusions.

\* \* \*

Les Parties ont soumis à la Cour de nombreux documents, soit comme annexes aux pièces de la procédure écrite, soit au cours des débats oraux, soit, enfin, à la suite de demandes formulées ou de questions posées par la Cour. (Annexe.)

#### POINT DE FAIT.

Les faits qui se trouvent à la base de la présente affaire ont déjà été succinctement exposés ou rappelés dans les Arrêts n<sup>os</sup> 6, 7, 8 et 11 rendus par la Cour les 25 août 1925, 25 mai 1926, 26 juillet 1927, et 16 décembre 1927.

Le présent arrêt, cependant, doit s'occuper de l'affaire dite de l'usine de Chorzów à un point de vue où la Cour n'a pas eu à se placer antérieurement, savoir, à celui de la nature — et, le cas échéant, du montant ainsi que des modalités de paiement — de la réparation due éventuellement par la Pologne pour avoir, ainsi que l'a constaté la Cour par son Arrêt n° 7, adopté une attitude qui n'était pas conforme à la Convention de Genève du 15 mai 1922. Il y a donc lieu, avant d'aborder le point de droit soulevé par la Requête allemande du 8 février 1927, de retracer brièvement les faits pertinents à ce point de vue particulier.

Le 5 mars 1915 avait été conclu entre le chancelier de l'Empire allemand, pour le Reich et la Bayerische, un contrat aux termes duquel la Société s'engageait à « installer pour le Reich et à commencer immédiatement à construire », entre autres, une usine d'azote de chaux à Chorzów en Haute-Silésie. Les terrains nécessaires seraient acquis pour le compte du Reich

to pass upon all these requests; it may therefore confine itself to taking them into account, in so far as may be necessary during the discussion of the arguments advanced by the Parties in support of their submissions, for the purposes of stating the reasons of the judgment.

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The Parties have presented to the Court numerous documents either as annexes to the documents of the written proceedings or in the course of the hearings, or, lastly, in response to requests made or questions put by the Court. (Annex.)

#### THE FACTS.

The facts underlying the present suit have already been succinctly stated or referred to in Judgments Nos. 6, 7, 8 and 11, given by the Court on August 25th, 1925, May 25th, 1926, July 26th, 1927, and December 16th, 1927.

The present judgment, however, must deal with the so-called case of the factory at Chorzów from a point of view with which the Court has not hitherto had to concern itself, namely, that of the nature—and, if necessary, the amount and method of payment—of the reparation which may be due by Poland in consequence of her having, as established by the Court in Judgment No. 7, adopted an attitude not in conformity with the Geneva Convention of May 15th, 1922. Accordingly, it is necessary, before approaching the point of law raised by the German Application of February 8th, 1927, briefly to trace out the relevant facts from this particular standpoint.

On March 5th, 1915, a contract was concluded between the Chancellor of the German Empire, on behalf of the Reich, and the Bayerische, according to which that Company undertook "to establish for the Reich and forthwith to begin the construction of", amongst other things, a nitrate factory at Chorzów in Upper Silesia. The necessary lands were to be acquired on

et inscrits à son nom dans le livre foncier. Les installations mécaniques devaient être établies conformément aux brevets et licences ainsi qu'aux expériences de la Société, qui s'engageait à diriger, jusqu'au 31 mars 1941, l'exploitation de l'usine, en utilisant l'ensemble des brevets, licences, expériences et innovations, améliorations et perfectionnements, ainsi que tous contrats de fournitures et de livraisons qui lui revenaient. Dans ce but, une section spéciale de la Société devait être établie ; elle serait soumise, dans une certaine mesure, au contrôle du Reich, qui avait le droit de participer, pour chaque année financière, à l'excédent résultant de l'exploitation. Le Reich avait le droit de résilier au 31 mars de chaque année à partir du 31 mars 1926, après préavis de quinze mois, la direction de l'usine par la Société. Cette résiliation pouvait avoir lieu déjà à partir du 31 mars 1921, toujours après préavis de quinze mois, si la participation du Reich à l'excédent n'atteignait pas un niveau déterminé.

Ce contrat fut plus tard complété par une série de sept contrats additionnels, dont, cependant, seuls les deuxième et septième, conclus les 16 novembre 1916 et 22 novembre 1918 respectivement, ont trait à l'usine de Chorzów. Le 14 mai 1919, la Bayerische intenta un procès contre le Reich, demandant que celui-ci fût tenu à dédommager la Société pour le préjudice qu'elle aurait souffert à la suite de certains manquements allégués à l'exécution du contrat du 5 mars 1915 et des contrats additionnels. Cette affaire, toutefois, fut liquidée à l'amiable par une transaction conclue le 24 octobre 1919 entre le Reich et la Bayerische, transaction qui, remplaçant le cinquième contrat additionnel, n'avait pas trait à l'usine de Chorzów.

Le 24 décembre 1919 furent passés à Berlin divers actes juridiques notariés ayant pour but la création d'une nouvelle Société, l'Oberschlesische, au capital social de 250.000 marks, augmenté plus tard à 110.000.000 de marks, et la vente par le Reich à cette Société de l'usine de Chorzów, c'est-à-dire de l'ensemble des terrains, bâtiments et installations y appartenant, avec tous accessoires, réserves, matières premières et matériaux d'exploitation, ainsi que les stocks. La direction et l'exploita-

behalf of the Reich and entered in its name in the land register. The machinery and equipment were to be in accordance with the patents and licences of the Company and the experience gained by it, and the Company undertook to manage the factory until March 31st, 1941, making use of all patents, licences, experience gained, innovations and improvements, as also of all supply and delivery contracts of which it had the benefit. For this purpose, a special section of the Company was to be formed which was, to a certain extent, to be subject to the supervision of the Reich, which had the right to a share of the profits resulting from the working of the factory during each financial year. The Reich had the right, commencing on March 31st, 1926, to terminate the contract for the management of the factory by the Company on March 31st of any year upon giving fifteen months' notice. The contract could be determined as early as March 31st, 1921, always on condition of fifteen months' notice being given, if the Reich's share of the surplus did not reach a fixed level.

This contract was subsequently supplemented by a series of seven additional contracts, of which, however, only the second and seventh, concluded on November 16th, 1916, and November 22nd, 1918, respectively, relate to the Chorzów factory. On May 14th, 1919, the Bayerische brought an action against the Reich, claiming that the latter was bound to compensate the Company for the damage said to have been suffered by it, owing to certain alleged shortcomings with respect to the fulfilment of the contract of March 5th, 1915, and the additional contracts. This matter was, however, settled out of court by an arrangement concluded on October 24th, 1919, between the Reich and the Bayerische, an arrangement which replaced the fifth additional contract and did not relate to the Chorzów factory.

On December 24th, 1919, a series of legal instruments were signed and legalized at Berlin with a view to the formation of a new Company, the Oberschlesische Stickstoffwerke A.-G., with a share capital of 250,000 marks, increased subsequently to 110 millions of marks, and the sale by the Reich to this Company of the factory at Chorzów, that is to say, the whole of the land, buildings and installations belonging thereto, with all accessories, reserves, raw material, equipment and stocks. The



tion de l'usine devaient rester entre les mains de la Bayerische, qui utiliserait dans ce but ses brevets, licences, expériences et contrats. Ces rapports entre les deux Sociétés furent confirmés au moyen de lettres échangées entre elles, datées des 24 et 28 décembre 1919. L'Oberschlesische fut dûment inscrite, le 29 janvier 1920, à l'*Amtsgericht* de Königshütte, dans le livre foncier de Chorzów, comme propriétaire des biens-fonds qui constituaient l'usine d'azote de Chorzów. Le siège social de l'Oberschlesische qui, aux termes de l'acte de fondation, était établi à Chorzów, fut, dans la suite, par acte du 14 janvier 1920, transféré à Berlin.

Dans le contrat du 24 décembre 1919 entre le Reich et l'Oberschlesische nouvellement créée, intervint également une deuxième Société, à responsabilité limitée, créée le même jour, et appelée *Stickstoff Treuhand Gesellschaft m. b. H.* (ci-après dénommée la « Treuhand »), Société dont le capital social était de 300.000 marks, augmenté plus tard à 1.000.000 de marks. Aux termes du contrat, l'ensemble de l'usine pour la production de l'azote à chaux avec installations accessoires, sise à Chorzów, fut cédé par le Reich à l'Oberschlesische au prix de 110.000.000 de marks environ, prix calculé sur certaines données indiquées dans le contrat même, — la Treuhand reprenant aux lieu et place de l'Oberschlesische, comme débiteur unique et indépendant, toutes les obligations que le contrat imposait à cette Société à l'égard du Reich et obtenant, comme contre-prestation sans paiement, des actions de l'Oberschlesische de la valeur nominale de 109.750.000 marks. Plus tard, la Treuhand a acquis également les actions restantes de l'Oberschlesische et est ainsi devenue l'actionnaire unique de cette Société. En garantie des créances appartenant au Reich en vertu du contrat, la Treuhand s'engageait à procurer au Reich le droit de gage sur toutes les actions de l'Oberschlesische. La Treuhand amortirait le prix d'achat exclusivement en versant au Reich des dividendes sur les actions de l'Oberschlesische. Néanmoins, la Treuhand était autorisée à payer, à tout moment, en tout ou en partie, le prix d'achat, ce qui aurait pour effet de libérer du gage les actions dont le capital nominal correspondrait au versement ainsi effectué. Le Reich était auto-

management and working of the factory were to remain in the hands of the Bayerische, which, for this purpose, was to utilize its patents, licences, experience gained and contracts. These relations between the two Companies were confirmed by means of letters dated December 24th and 28th, 1919, exchanged between them. The Oberschlesische was duly entered, on January 29th, 1920, at the *Amtsgericht* of Königs-hütte, in the Chorzów land register, as owner of the landed property constituting the nitrate factory at Chorzów. The registered office of the Oberschlesische which, under the memorandum of association, was established at Chorzów, was subsequently, by an amendment executed on January 14th, 1920, transferred to Berlin.

In the contract of December 24th, 1919, between the Reich and the newly created Oberschlesische, a second limited liability company, founded the same day and known as the *Stickstoff Treuhand Gesellschaft m. b. H.* (hereinafter called the "Treuhand") was also concerned. This Company had a share capital of 300,000 marks, subsequently increased to 1,000,000 marks. Under the contract, the whole of the factory for the production of nitrated lime, with the accessory installations, situated at Chorzów, was ceded by the Reich to the Oberschlesische at the price of approximately 110 million marks,—which price was calculated according to certain data indicated in the contract itself,—the Treuhand taking over, in the place of the Oberschlesische, as sole and independent debtor, all the obligations imposed by the contract upon the latter in regard to the Reich, and obtaining in consideration thereof, without payment, shares of the Oberschlesische—to the nominal value of 109,750,000 marks. Later, the Treuhand also acquired the rest of the shares of the Oberschlesische, thus becoming the sole shareholder of that Company. As guarantee for the sums due to the Reich under the contract, the Treuhand undertook to obtain for the Reich a lien on all the shares of the Oberschlesische. The Treuhand was to liquidate the purchase price exclusively by paying to the Reich the dividends on the shares of the Oberschlesische. Nevertheless, the Treuhand was authorized to pay at any time the whole or a part of the purchase price; this would have the effect of removing the lien on shares of a nominal value corresponding to the payment

risé à exercer lui-même tous les droits découlant de la possession des actions et en particulier le droit de vote à l'assemblée générale, mais se déclarait d'accord pour maintenir la direction de l'exploitation de l'Oberschlesische entre les mains de la Bayerische. Une aliénation des actions engagées ne serait autorisée, même après l'expiration du droit de gage, qu'avec l'assentiment du Reich. En garantie de l'exécution de cette obligation, le Reich conserverait, même après cette expiration, la possession des actions et l'exercice de tous les droits découlant de cette possession. Le prix réalisé lors d'une vente éventuelle des actions servirait en premier lieu à amortir le solde de la créance du Reich. De tout excédent, le Reich toucherait, le cas échéant, soit les 85 % — si la vente était faite par la Treuhand —, soit les 90 % — si elle était faite par le Reich ; dans les deux cas, le solde seulement reviendrait à la Treuhand, qui, cependant, dans la seconde éventualité, obtenait le droit d'acquérir les actions au prix auquel le Reich désirait les réaliser.

Le 15 mai 1922 fut signée à Genève entre l'Allemagne et la Pologne la Convention relative à la Haute-Silésie.

Après la signature de cette Convention, mais avant la cession effective de la Haute-Silésie polonaise à la Pologne, la Treuhand offrit, par lettre du 26 mai 1922, à une société suisse, la Compagnie d'azote et de fertilisants S. A. à Genève, une option jusqu'à la fin de l'année pour l'achat, au prix de cinq millions de francs suisses à verser au plus tard le 2 janvier 1923, de la moitié (55 millions de marks) des actions de l'Oberschlesische, moyennant quoi la société genevoise obtiendrait, entre autres, le droit de participer aux négociations avec le Gouvernement polonais. Cette offre n'aboutit pas.

Le 1<sup>er</sup> juillet 1922, le Tribunal polonais de Huta Krolewska, qui avait succédé à l'*Amtsgericht* de Königshütte, rendit une décision suivant laquelle l'enregistrement près ce Tribunal de l'Oberschlesische comme propriétaire de l'usine en question, déclaré nul, devait être rayé, la situation antérieure rétablie, et le droit de propriété sur les biens-fonds dont il s'agit enregistré au profit du Fisc de l'État polonais. Cette décision, qui

made. The Reich was authorized itself to exercise all the rights resulting from the possession of the shares, and in particular the right to vote at the general meeting of shareholders, but agreed that the management of the exploitation of the Oberschlesische should be left in the hands of the Bayerische. An alienation of the shares so pledged would be authorized only with the approval of the Reich, even after the lien had expired. As a guarantee for the fulfilment of this obligation, the Reich would, even after expiration of the lien, retain possession of the shares and the exercise of all rights resulting from such possession. The price realized in the event of a sale of the shares was in the first place to be devoted to the liquidation of the balance of the Reich's claim. Of any surplus, the Reich was to receive either 85%—if the sale were effected by the Treuhand—or 90 %—if it were effected by the Reich; in both cases, the balance only would fall to the Treuhand which, however, in the second case, would obtain a right to acquire the shares at the price at which the Reich wished that they should be disposed of.

On May 15th, 1922, was signed at Geneva between Germany and Poland the Convention concerning Upper Silesia.

After the signature of this Convention, but before the actual cession of Polish Upper Silesia to Poland, the Treuhand, by a letter dated May 26th, 1922, offered to a Swiss company, the *Compagnie d'azote et de fertilisants S. A.* at Geneva, an option until the end of the year for the purchase, at a price of five million Swiss francs, to be paid by January 2nd, 1923, at latest, of one half (55 million marks) of the shares of the Oberschlesische, in consideration of which the Genevese Company would, amongst other things, acquire the right to take part in the negotiations with the Polish Government. This offer came to nothing.

On July 1st, 1922, the Polish Court of Huta Krolewska, which had replaced the *Amtsgericht* of Königshütte, gave a decision to the effect that the registration with this Court of the Oberschlesische as owner of the factory, which was declared null and void, was to be cancelled and the previously existing situation restored and that the right of ownership in the landed property in question was to be registered in the name of the

invoquait l'article 256 du Traité de Versailles, ainsi que les lois polonaises des 14 juillet 1920 et 16 juin 1922, fut mise à exécution le même jour.

Le 3 juillet suivant, M. Ignacy Moscicki, nommé fondé de pouvoirs général de l'usine de Chorzów, par un décret ministériel polonais du 24 juin 1922, prit possession de l'usine et en assumait l'administration, conformément aux termes du décret ; le Gouvernement allemand a allégué, et le Gouvernement polonais n'a pas contesté, que ledit fondé de pouvoirs, en entreprenant la gestion de l'exploitation de l'usine, se mit en même temps en possession des biens meubles et des brevets, licences, etc.

Après avoir saisi l'usine, le Gouvernement polonais l'inscrivit sur la liste des biens à lui transférés en vertu de l'article 256 du Traité de Versailles, liste qu'il a dûment notifiée à la Commission des Réparations. Le Gouvernement polonais allègue qu'à la suite de l'Arrêt n° 7 de la Cour, le Gouvernement allemand a demandé la radiation de l'usine de la liste en question ; il n'a cependant pas été informé que cette radiation ait été effectuée.

Entre temps, l'Oberschlesische avait introduit, le 15 novembre 1922, devant le Tribunal arbitral mixte germano-polonais à Paris, une requête concluant à faire condamner le Gouvernement polonais notamment à la restitution de l'usine. Cette requête, signifiée au Gouvernement défendeur le 17 janvier 1923, fut retirée par l'Oberschlesische en juin 1928, avant que le Tribunal eût eu l'occasion de statuer.

L'Oberschlesische intenta une action parallèle concernant les biens meubles qui se trouvaient à Chorzów lors de la prise de l'usine, en ouvrant, le 24 novembre 1922, une procédure contre le Fisc polonais devant le Tribunal civil de Katowice, procédure dont le but était d'obtenir soit la restitution à l'Oberschlesische ou à la Bayerische de ces biens, soit le remboursement de leur valeur ; ce procès n'aboutit cependant à aucune décision quant au fond.

En ce qui la concerne, la Bayerische a, elle aussi, intenté, le 25 mars 1925, devant le Tribunal arbitral mixte germano-polo-

Polish Treasury. This decision, which cited Article 256 of the Treaty of Versailles and the Polish laws of July 14th, 1920, and June 16th, 1922, was carried into effect on the same day.

On July 3rd, 1922, M. Ignacy Moscicki, who was delegated with full powers to take charge of the factory at Chorzów by a Polish ministerial decree of June 24th, 1922, took possession of the factory and took over the management in accordance with the terms of the decree. The German Government contended, and the Polish Government did not deny, that the said delegate, in undertaking the control of the working of the factory, at the same time took possession of the movable property, patents, licences, etc.

After having taken over the factory, the Polish Government entered it in the list of property transferred to it under Article 256 of the Treaty of Versailles, which list was duly communicated to the Reparation Commission. The Polish Government alleges that after the pronouncement of Judgment No. 7 by the Court, the German Government asked that the factory should be struck out of the list in question; the former Government has not, however, been informed whether this has been done.

In the meantime, the Oberschlesische, on November 15th, 1922, had brought an action before the German-Polish Mixed Arbitral Tribunal at Paris, claiming, amongst other things, that the Polish Government should be ordered to restore the factory. This action, notice of which was served upon the respondent Government on January 17th, 1923, was withdrawn by the Oberschlesische in June 1928, before the Tribunal had been able to give a decision.

The Oberschlesische, on November 24th, 1922, instituted a parallel action in regard to the movable property existing at Chorzów at the time of the taking over of the factory, against the Polish Treasury before the Civil Court of Katowice, with a view to obtaining either the restitution to the Oberschlesische or the Bayerische of such property, or the payment of the equivalent value. This action however led to no decision on the merits.

As regards the Bayerische, that Company also, on March 25th, 1925, brought an action before the German-Polish Mixed

nais, une action contre le Fisc polonais, en vue d'obtenir une indemnité annuelle jusqu'à la restitution de l'usine à l'Oberschlesische et de se faire restituer la possession et la direction de l'usine. La requête introduisant cette instance fut signifiée au Gouvernement défendeur le 16 décembre 1925; mais l'affaire fut retirée en juin 1928, en même temps que l'instance introduite par l'Oberschlesische, et dans les mêmes conditions.

L'Arrêt n° 7 de la Cour fut rendu le 25 mai 1926. Cet arrêt fut la source d'événements qui se développèrent dans deux directions différentes.

D'une part, en effet, sur l'initiative du Gouvernement allemand, il vint à former le point de départ pour des négociations directes entre les deux Gouvernements intéressés. De ces négociations il y a lieu de retenir ici uniquement que, le 14 janvier 1927, le Gouvernement allemand avait reconnu que l'usine ne pouvait plus être restituée en nature, et que, par conséquent, la réparation due devait en principe prendre la forme du versement d'une indemnité, déclaration d'ailleurs formellement répétée dans le Mémoire. Les négociations, par ailleurs, n'aboutirent pas, à cause notamment du fait que, de l'avis du Gouvernement polonais, la nécessité d'une compensation entre l'indemnité à allouer à l'Allemagne et différents montants dont la Pologne serait créancière de l'Allemagne, s'imposerait. Leur insuccès eut pour résultat la présente instance.

D'autre part, l'Arrêt n° 7 de la Cour provoqua de la part du Gouvernement polonais une requête adressée au Tribunal polonais de Katowice contre l'Oberschlesische et demandant qu'il fût déclaré que celle-ci n'était pas devenue propriétaire des biens-fonds de Chorzów; que l'inscription au registre foncier opérée en sa faveur le 29 janvier 1922 était dépourvue de validité; et que — indépendamment des lois du 14 juillet 1920 et 16 juin 1922 — la propriété des biens-fonds en question revenait au Fisc de l'État polonais. L'arrêt du Tribunal sur cette requête — arrêt qui, rendu par contumace, fut publié le 12 novembre 1927 et entra en force de chose jugée le 2 janvier 1928. — fit droit à toutes les conclusions du demandeur.

Arbitral Tribunal against the Polish Treasury with a view to obtaining an annual indemnity until the restitution of the factory to the Oberschlesische, and to causing the possession and management of the factory to be restored to it. Notice of this action was served on the respondent Government on December 16th, 1925; but the case was withdrawn in June 1928, at the same time as the action brought by the Oberschlesische and in the same circumstances.

The Court's Judgment No. 7 was given on May 25th, 1926. This judgment was the source of developments tending in two different directions.

On the one hand, at the initiative of the German Government, it formed the starting point for direct negotiations between the two Governments concerned. In regard to these negotiations, it is only necessary here to note that, on January 14th, 1927, the German Government had recognized that the factory could no longer be restored in kind and that consequently the reparation due must, in principle, take the form of the payment of compensation, a statement which is moreover formally repeated in the Case. The negotiations were unsuccessful owing, amongst other things, to the fact that, in the opinion of the Polish Government, certain claims which Poland was said to have against Germany, must be set off against the indemnity to be awarded to Germany. The failure of the negotiations resulted in the institution of the present proceedings.

On the other hand, the Court's Judgment No. 7 gave rise on the part of the Polish Government to the bringing of an action before the Polish Court of Katowice against the Oberschlesische in order to obtain a declaration that that Company had not become owner of the landed property at Chorzów; that the entry in the land register made in its favour on January 29th, 1922, was not valid, and that—independently of the laws of July 14th, 1920, and June 16th, 1922,—the ownership of the landed property in question fell to the Polish Treasury. The judgment of the Court in this action—which was given by default—was published on November 12th, 1927, and took effect on January 2nd, 1928; it admitted all the submissions of the claimant.



Entre temps, la Cour avait été saisie, le 18 octobre 1927, d'une nouvelle requête, émanant du Gouvernement allemand qui, se fondant sur les dispositions de l'article 60 du Statut et l'article 66 du Règlement de la Cour, demanda à celle-ci de donner une interprétation de ses Arrêts n° 7, du 25 mai 1926, et n° 8, du 26 juillet 1927, dont le sens et la portée seraient devenus litigieux entre les deux Gouvernements, à savoir, sur le point qui avait servi d'origine à la procédure devant le Tribunal de Katowice.

La Cour rendit, le 16 décembre 1927, son arrêt, qui porte le n° 11, sur ladite requête. A teneur de cet arrêt, la Cour avait entendu reconnaître, par son Arrêt n° 7, avec force obligatoire pour les Parties au litige et dans le cas décidé, entre autres choses, le droit de propriété de l'Oberschlesische sur l'usine de Chorzów au point de vue du droit civil.

Tandis que la procédure relative à la demande en interprétation se poursuivait, le Gouvernement allemand, par Requête datée du 14 octobre 1927 et déposée au Greffe le 15 novembre suivant, demanda à la Cour d'indiquer au Gouvernement polonais qu'il devait payer au Gouvernement allemand, à titre provisoire, la somme de trente millions de Reichsmarks.

La Cour, statuant sur cette demande, qui était présentée sur la base de l'article 41 du Statut, décida par une Ordonnance, rendue le 21 novembre 1927, qu'il n'y avait pas lieu d'y donner suite, la demande du Gouvernement allemand devant être considérée comme visant non l'indication de mesures conservatoires, mais bien l'adjudication d'une partie des conclusions de la Requête du 8 février 1927.

Meanwhile, on October 18th, 1927, the Court had received a fresh application from the German Government which, relying on the terms of Article 60 of the Statute and Article 66 of the Rules of Court, prayed the Court to give an interpretation of its Judgments Nos. 7, of May 25th, 1926, and 8, of July 26th, 1927, alleging that a divergence of opinion had arisen between the two Governments in regard to the meaning and scope of these two judgments in connection with the point which had given rise to the proceedings before the Court of Katowice.

The Court, on December 16th, 1927, delivered its judgment in this suit (No. 11). According to this judgment the Court's intention in Judgment No. 7 had been to recognize, with binding effect between the Parties concerned and in respect of that particular case, amongst other things, the right of ownership of the Oberschlesische in the Chorzów factory under municipal law.

Whilst the proceedings in connection with the request for an interpretation were in progress, the German Government, by means of a Request dated October 14th, 1927, and filed with the Registry on November 15th, besought the Court to indicate to the Polish Government that it should pay to the German Government, as a provisional measure, the sum of 30 million Reichsmarks.

The Court gave its decision upon this request, which was submitted under the terms of Article 41 of the Statute, in the form of an Order made on November 21st, 1927. It held that effect could not be given to the request of the German Government, since it was to be regarded as designed to obtain not the indication of measures of protection, but judgment in favour of a part of the claim formulated in the Application of February 8th, 1927.

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POINT DE DROIT.

I.

La Cour, avant d'aborder l'examen des conclusions des Parties, doit fixer le sens de la requête qui est à la base de la procédure actuelle, afin d'en établir la nature et la portée. C'est à la lumière de ces constatations qu'elle devra apprécier ensuite les conclusions qui lui ont été soumises au cours de la procédure tant écrite qu'orale.

La requête demande à la Cour :

1° de constater l'obligation du Gouvernement polonais, en raison de son attitude à l'égard des Sociétés Oberschlesische et Bayerische, attitude que la Cour a déclarée non conforme à la Convention de Genève, de réparer le préjudice subi de ce chef par lesdites Sociétés ;

2° d'allouer des indemnités, dont le montant est indiqué dans la requête, pour le dommage causé respectivement à l'une et à l'autre desdites Sociétés ;

3° de fixer le mode de paiement, entre autres de dire que les paiements à faire par le Gouvernement polonais devraient être effectués au compte des deux Sociétés près la Deutsche Bank à Berlin.

Au cours de la procédure orale, une divergence de vues s'est fait jour entre les Parties quant à la nature et à la portée de la requête. L'agent du Gouvernement allemand avait émis dans sa plaidoirie la thèse selon laquelle un gouvernement peut accepter une réparation dans toute forme qu'il jugera convenable, et que la réparation ne doit pas nécessairement consister en un dédommagement des personnes lésées. Il convient de retenir notamment le passage suivant :

« C'est, en effet, de son propre droit, du droit du Gouvernement allemand, qu'il s'agit. Le Gouvernement allemand n'intervient pas en qualité de représentant des individus qui ont souffert le dommage, mais il peut mesurer le dommage dont il réclame la réparation en son propre nom, d'après l'échelle des pertes subies par les sociétés pour lesquelles il a pris fait et

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THE LAW.

I.

The Court, before proceeding to consider the Parties' submissions, must determine the import of the application which has given rise to the present proceedings, in order to ascertain its nature and scope. In the light of the results of this investigation, it will then proceed to consider the submissions made in the course of the written and oral proceedings.

In the application the Court is asked :

(1) to declare that the Polish Government, by reason of its attitude in respect of the Oberschlesische and Bayerische Companies, which attitude the Court had declared not to be in conformity with the Geneva Convention, is under an obligation to make good the consequent damage sustained by those Companies ;

(2) to award compensation, the amount of which is indicated in the application, for the damage caused to each of the respective Companies ;

(3) to fix the method of payment, and amongst other things to order the payments to be made by the Polish Government to be effected to the account of the two Companies with the Deutsche Bank at Berlin.

In the course of the oral proceedings, a difference of opinion between the two Parties became apparent as to the nature and scope of the application. The Agent for the German Government argued in his address to the Court that a government may content itself with reparation in any form which it may consider proper, and that reparation need not necessarily consist in the compensation of the individuals concerned. The following passage should especially be noted :

[*Translation.*]

"It is in fact a question of the German Government's own rights. The German Government has not brought this suit as representative of the individuals who have suffered injury, but it may estimate the damage for which it claims reparation on its own behalf, according to the measure provided by the losses suffered by the companies whose case it has

cause. Le Gouvernement allemand peut demander le paiement de cette indemnité à tout *locus solutionis* qui lui semble utile en l'espèce, que ce soit une caisse publique ou une caisse privée.

Le litige actuel est donc un litige entre gouvernements, et rien qu'un litige entre gouvernements; il se distingue très nettement d'un procès ordinaire en dommages-intérêts, intenté par des particuliers par-devant un tribunal civil, comme le dit le Gouvernement polonais dans sa Duplique.»

L'agent du Gouvernement polonais, dans sa duplique, a dit estimer que cette manière de voir comportait une modification de l'objet du litige et, d'une certaine manière, aussi de la nature de la requête, car, selon la thèse polonaise, le demandeur aurait défini l'objet du litige comme étant l'obligation d'indemniser les deux Sociétés. Or, le dommage étant en corrélation avec l'indemnisation, la demande allemande se trouverait placée sur un autre terrain, dès qu'il s'agirait de l'indemnisation non plus des Sociétés, mais de l'État pour les torts par lui subis. L'agent du Gouvernement polonais a contesté au Gouvernement allemand le droit de faire ce changement dans l'état où se trouvait la procédure, et a refusé d'y consentir.

Même si les termes de la requête, ainsi que des conclusions ultérieures de la Partie demanderesse, permettaient de les interpréter comme visant une indemnisation due directement aux deux Sociétés pour les dommages subis par elles, et non une réparation due à l'Allemagne pour une violation de la Convention de Genève, il résulte toutefois des conditions dans lesquelles la Cour a été saisie de la présente affaire, ainsi que des considérations pour lesquelles elle l'a retenue, par son Arrêt n° 8, pour statuer quant au fond, que l'objet de la requête allemande ne peut viser que la réparation due pour un tort subi par l'Allemagne en sa qualité de Partie contractante de la Convention de Genève.

La présente requête se base explicitement et exclusivement sur l'Arrêt n° 7 qui a constaté que l'attitude du Gouvernement polonais à l'égard des deux Sociétés Oberschlesische et Baye-rische n'était pas conforme aux dispositions des articles 6 et suivants de ladite Convention. Déjà dans l'Arrêt n° 6, qui a établi la compétence de la Cour pour statuer sur la violation alléguée de la Convention de Genève, il a été reconnu par la

taken up. The German Government may claim the payment of this compensation at any *locus solutionis* which it may think fit in this case, whether it be a public or a private office.

The present dispute is therefore a dispute between governments and nothing but a dispute between governments. It is very clearly differentiated from an ordinary action for damages, brought by private persons before a civil court, as the Polish Government has said in its Rejoinder."

The Agent for the Polish Government in his Rejoinder submitted that this method of regarding the question involved a modification of the subject of the dispute and, in some sort also, of the nature of the application, for, according to Poland's view, the subject of the dispute had been defined by Germany as the obligation to compensate the two Companies. But damage and compensation being interdependent conceptions, the German claim assumed another aspect if it was no longer a question of compensating the Companies, but of compensating the State for the injury suffered by it. The Agent for the Polish Government disputed the German Government's right to make this change at that stage of the proceedings and refused to accept it.

Even should it be possible to construe the terms of the application and of the subsequent submissions of the Applicant as contemplating compensation due directly to the two Companies for damages suffered by them and not reparation due to Germany for a breach of the Geneva Convention, it follows from the conditions in which the Court has been seized of the present suit, and from the considerations which led the Court to reserve it by Judgment No. 8 for decision on the merits, that the object of the German application can only be to obtain reparation due for a wrong suffered by Germany in her capacity as a contracting Party to the Geneva Convention.

The present application is explicitly and exclusively based on Judgment No. 7 which declared that the attitude of the Polish Government in respect of the two Companies, the Oberschlesische and Bayerische, was not in conformity with Article 6 and the following articles of the said Convention. Already in Judgment No. 6, establishing the Court's jurisdiction to deal with the alleged violation of the Geneva Convention, the

Cour, conformément à une thèse de la Partie demanderesse, qu'il s'agissait exclusivement d'une contestation entre États au sujet de l'interprétation et application d'une convention en vigueur entre eux. L'article 23 de la Convention de Genève ne vise que les divergences d'opinions résultant de l'interprétation et application des articles 6 à 22 de la Convention de Genève, qui s'élèveraient entre les deux Gouvernements signataires. En effet, la Cour a affirmé sa compétence pour statuer sur la réparation demandée parce qu'elle considérait la réparation comme le corollaire de la violation des obligations résultant d'un engagement entre États. Cette manière de voir, conforme au caractère général d'une juridiction internationale qui, en principe, ne connaît que des rapports d'État à État, s'impose avec une force particulière en l'espèce parce que la Convention de Genève, dans son système très développé d'instances de recours, a précisément créé ou maintenu pour certaines catégories de réclamations de particuliers des instances arbitrales d'un caractère international spécial, telles que le Tribunal arbitral haut-silézien et le Tribunal arbitral mixte germano-polonais. C'est en se basant, entre autres, sur le caractère purement interétatique de la contestation tranchée par l'Arrêt n° 7 que la Cour avait retenu l'affaire, nonobstant le fait que des réclamations introduites par les deux Sociétés étaient pendantes devant l'une des instances arbitrales mentionnées ci-dessus, réclamations relatives à la même dépossession qui a donné lieu à la requête actuellement soumise à la Cour par le Gouvernement allemand.

La Cour ayant, par son Arrêt n° 8, retenu cette requête pour statuer au fond, n'a pu le faire que sur les mêmes bases qu'elle a admises pour son Arrêt n° 7, arrêt qui est le point de départ pour la demande en réparation avancée actuellement par l'Allemagne. C'est donc à la lumière de cette conception qu'il convient d'interpréter les déclarations de la Partie demanderesse dans la présente procédure ; il y aurait également lieu de suivre cette méthode même si ladite Partie n'avait pas formulé aussi explicitement sa thèse dans sa plaidoirie.

Il est un principe de droit international que la réparation d'un tort peut consister en une indemnité correspondant au dommage que les ressortissants de l'État lésé ont subi par

Court recognized that—as had been maintained by the Applicant—the matter was exclusively a dispute between States as to the interpretation and application of a convention in force between them. Article 23 of the Geneva Convention only contemplates differences of opinion respecting the interpretation and application of Articles 6 to 22 of the Geneva Convention arising between the two Governments. The Court in fact declared itself competent to pass upon the claim for reparation because it regarded reparation as the corollary of the violation of the obligations resulting from an engagement between States. This view of the matter, which is in conformity with the general character of an international tribunal which, in principle, has cognizance only of interstate relations, is indicated with peculiar force in this case for the specific reason that the Geneva Convention, with its very elaborate system of legal remedies, has created or maintained for certain categories of private claims arbitral tribunals of a special international character, such as the Upper Silesian Arbitral Tribunal and the German-Polish Mixed Arbitral Tribunal. It was on the basis, amongst other things, of the purely interstate character of the dispute decided by Judgment No. 7 that the Court reserved the case for judgment, notwithstanding the fact that actions brought by the two Companies were pending before one of the arbitral tribunals above mentioned, actions which related to the same act of dispossession which led to the filing with the Court of the German Government's Application now before it.

The Court, which by Judgment No. 8 reserved the present application for judgment on the merits, could only do so on the grounds on which it had already based its Judgment No. 7 which constitutes the starting point for the claim for compensation now put forward by Germany. Accordingly the declarations of the Applicant in the present proceedings must be construed in the light of this conception and this method must also have been followed even if that Party had not stated its contention as explicitly as it has done in the German Agent's address to the Court.

It is a principle of international law that the reparation of a wrong may consist in an indemnity corresponding to the damage which the nationals of the injured State have suffered



suite de l'acte contraire au droit international. C'est même la forme de réparation la plus usitée ; l'Allemagne l'a choisie en l'espèce, et son admissibilité n'est pas contestée. Mais la réparation due à un État par un autre État ne change pas de nature par le fait qu'elle prend la forme d'une indemnité pour le montant de laquelle le dommage subi par un particulier fournira la mesure. Les règles de droit qui déterminent la réparation sont les règles de droit international en vigueur entre les deux États en question, et non pas le droit qui régit les rapports entre l'État qui aurait commis un tort et le particulier qui aurait subi le dommage. Les droits ou intérêts dont la violation cause un dommage à un particulier se trouvent toujours sur un autre plan que les droits de l'État auxquels le même acte peut également porter atteinte. Le dommage subi par le particulier n'est donc jamais identique en substance avec celui que l'État subira ; il ne peut que fournir une mesure convenable de la réparation due à l'État.

Le droit international n'exclut pas qu'un État accorde à un autre le droit de demander à des instances arbitrales internationales d'allouer directement aux ressortissants de ce dernier des indemnités pour des dommages qu'ils ont subis à la suite d'une violation du droit international par le premier État. Mais rien — ni dans les termes de l'article 23, ni dans les rapports entre cette clause et certaines autres dispositions d'ordre juridictionnel insérées dans la Convention de Genève — ne porte à croire que la juridiction établie par l'article 23 s'étende à des réparations autres que celles dues par une des Parties contractantes à l'autre comme conséquence d'une violation des articles 6 à 22 dûment constatée par la Cour.

Cette manière de voir peut, d'ailleurs, très bien se concilier avec les conclusions présentées par la Partie demanderesse. La première de ses conclusions vise, dans toutes les phases de la procédure, la constatation de l'obligation de réparer. Les indemnités à payer au Gouvernement allemand, selon la conclusion finale n° 2, constituent, aux termes de la conclusion 4 *d*, aussi bien du Mémoire que de la réplique orale, une créance de ce Gouvernement. La demande formulée dans la même conclusion et tendant à faire effectuer le paiement aux comptes des deux

as a result of the act which is contrary to international law. This is even the most usual form of reparation; it is the form selected by Germany in this case and the admissibility of it has not been disputed. The reparation due by one State to another does not however change its character by reason of the fact that it takes the form of an indemnity for the calculation of which the damage suffered by a private person is taken as the measure. The rules of law governing the reparation are the rules of international law in force between the two States concerned, and not the law governing relations between the State which has committed a wrongful act and the individual who has suffered damage. Rights or interests of an individual the violation of which rights causes damage are always in a different plane to rights belonging to a State, which rights may also be infringed by the same act. The damage suffered by an individual is never therefore identical in kind with that which will be suffered by a State; it can only afford a convenient scale for the calculation of the reparation due to the State.

International law does not prevent one State from granting to another the right to have recourse to international arbitral tribunals in order to obtain the direct award to nationals of the latter State of compensation for damage suffered by them as a result of infractions of international law by the first State. But there is nothing—either in the terms of Article 23 or in the relation between this provision and certain others of a jurisdictional character included in the Geneva Convention—which tends to show that the jurisdiction established by Article 23 extends to reparation other than that due by one of the contracting Parties to the other in consequence of an infraction of Articles 6 to 22, duly recognized as such by the Court.

This view is moreover readily reconcilable with the submissions of the Applicant. The first of its submissions, throughout all stages of the proceedings, aims at the establishment of an obligation to make reparation. The indemnities to be paid to the German Government, according to No. 2 of the final submissions, constitute, in the terms of submission 4*d*, as set out in both the Case and the oral reply, a debt due to that Government. The claim formulated in the same submission, to the effect that payment should be made to the account of the

Sociétés près la Deutsche Bank à Berlin est interprétée par l'agent du Gouvernement allemand comme visant seulement un *locus solutionis*.

La Cour est donc d'avis que la Partie demanderesse n'a pas changé l'objet du litige au cours de la procédure.

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Il résulte de ce qui vient d'être exposé que la requête tend à obtenir, en faveur de l'Allemagne, une réparation dont le montant est déterminé par le dommage subi par les Sociétés Oberschlesische et Bayerische. Trois questions essentielles se posent :

1° L'existence de l'obligation de réparer.

2° L'existence des dommages qui doivent servir de base pour l'évaluation du montant de l'indemnité.

3° L'étendue de ces dommages.

Quant au premier point, la Cour constate que c'est un principe du droit international, voire une conception générale du droit, que toute violation d'un engagement comporte l'obligation de réparer. Déjà dans son Arrêt n° 8, la Cour, statuant sur la compétence qu'elle dérivait de l'article 23 de la Convention de Genève, a dit : la réparation est le complément indispensable d'un manquement à l'application sans qu'il soit nécessaire que cela soit inscrit dans la convention même. L'existence du principe établissant l'obligation de réparer comme un élément du droit international positif n'a du reste jamais été contestée au cours des procédures relatives aux affaires de Chorzów.

L'obligation de réparer étant reconnue en principe, il s'agit de savoir si une violation d'un engagement international a en effet eu lieu dans le cas d'espèce. Or, à cet égard, la Cour se trouve en présence d'une chose jugée. La non-conformité de l'attitude de la Pologne envers les deux Sociétés avec les articles 6 et suivants de la Convention de Genève est établie par le point n° 2 du dispositif de l'Arrêt n° 7. L'application du principe à la présente espèce s'impose donc.

two Companies with the Deutsche Bank at Berlin, is interpreted by the Agent for the German Government as solely relating to the *locus solutionis*.

The Court therefore is of opinion that the Applicant has not altered the subject of the dispute in the course of the proceedings.

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It follows from the foregoing that the application is designed to obtain, in favour of Germany, reparation the amount of which is determined by the damage suffered by the Oberschlesische and Bayerische. Three fundamental questions arise:

- (1) The existence of the obligation to make reparation.
- (2) The existence of the damage which must serve as a basis for the calculation of the amount of the indemnity.
- (3) The extent of this damage.

As regards the first point, the Court observes that it is a principle of international law, and even a general conception of law, that any breach of an engagement involves an obligation to make reparation. In Judgment No. 8, when deciding on the jurisdiction derived by it from Article 23 of the Geneva Convention, the Court has already said that reparation is the indispensable complement of a failure to apply a convention, and there is no necessity for this to be stated in the convention itself. The existence of the principle establishing the obligation to make reparation, as an element of positive international law, has moreover never been disputed in the course of the proceedings in the various cases concerning the Chorzów factory.

The obligation to make reparation being in principle recognized, it remains to be ascertained whether a breach of an international engagement has in fact taken place in the case under consideration. Now this point is *res judicata*. The non-conformity of Poland's attitude in respect of the two Companies with Article 6 and the following articles of the Geneva Convention is established by No. 2 of the operative provisions of Judgment No. 7. The application of the principle to the present case is therefore evident.

Pour ce qui est du deuxième point, la question de savoir si un dommage a résulté du tort qui est constant, n'est aucunement résolue par les arrêts antérieurs de la Cour relatifs à l'affaire de Chorzów. La Partie demanderesse ayant calculé le montant de la réparation qu'elle réclame sur la base du dommage subi par les deux Sociétés par suite de l'attitude du Gouvernement polonais, il est nécessaire, pour la Cour, de vérifier si ces Sociétés ont effectivement subi un dommage de ce chef.

En ce qui concerne la Bayerische, la Pologne reconnaît l'existence d'un dommage qui donne lieu à réparation ; la divergence entre les Parties n'a trait qu'à l'étendue de ce dommage et aux modalités de la réparation ; par contre, la Pologne conteste pour l'Oberschlesische l'existence d'un dommage donnant lieu à réparation et conclut, par conséquent, à débouter l'Allemagne de sa demande. Le fait de la dépossession de l'Oberschlesische n'est aucunement contesté. Mais, selon le Gouvernement polonais, cette Société n'aurait nonobstant pas subi de dommage ; il allègue, en effet, d'une part, que le droit de propriété revendiqué par l'Oberschlesische aurait été entaché de nullité ou d'annulabilité ; et, d'autre part, que le contrat du 24 décembre 1919 attribuait au Reich des droits et avantages si considérables qu'en substance un dommage éventuel ne frapperait pas la Société. Subsidiairement, le Gouvernement polonais fait valoir que ces mêmes circonstances ont pour conséquence au moins de réduire essentiellement le dommage pouvant entrer en ligne de compte en ce qui concerne ladite Société.

Abstraction faite de ces objections de nature préalable, il y a désaccord entre les Parties sur le montant et les modalités de paiement d'une réparation éventuelle.

Dans ces conditions, il incombe à la Cour d'examiner tout d'abord s'il y a eu, non seulement pour la Bayerische, mais aussi pour l'Oberschlesische, un dommage susceptible de donner lieu à réparation.

As regards the second point, the question whether damage has resulted from the wrongful act which is common ground, is in no wise settled by the Court's previous decisions relating to the Chorzów case. The Applicant having calculated the amount of the reparation claimed on the basis of the damage suffered by the two Companies as a result of the Polish Government's attitude, it is necessary for the Court to ascertain whether these Companies have in fact suffered damage as a consequence of that attitude.

As regards the Bayerische, Poland admits the existence of a damage affording ground for reparation; the Parties only differ as to the extent of this damage and the mode of reparation; on the other hand, Poland denies the existence of any damage calling for reparation in the case of the Oberschlesische and consequently submits that Germany's claim should be dismissed. The fact of the dispossession of the Oberschlesische is in no way disputed. But notwithstanding this, in the contention of the Polish Government, that Company has suffered no damage: it argues, first, that the right of ownership claimed by the Oberschlesische was null and void or subject to annulment, and, secondly, that the contract of December 24th, 1919, attributed to the Reich rights and benefits so considerable that any possible damage would not materially affect the Company. In the alternative, the Polish Government contends that these same circumstances at all events have the effect of essentially diminishing the extent of the damage to be taken into account in so far as the said Company is concerned.

Apart from these preliminary objections, the Parties are at issue as to the amount and method of payment of any compensation which may be awarded.

In these circumstances, the Court must first of all consider whether damage affording ground for reparation has ensued as regards not only the Bayerische but also the Oberschlesische.

## II.

Abordant cet examen, il convient de constater avant tout que, pour évaluer le dommage causé par un acte illicite, il faut tenir compte exclusivement de la valeur des biens, droits et intérêts qui ont été atteints et dont le titulaire est la personne au profit de laquelle l'indemnité est réclamée ou le dommage de qui doit servir de mesure pour l'évaluation de la réparation réclamée. Ce principe, admis dans la jurisprudence arbitrale, a pour conséquence, d'une part, d'exclure du préjudice à évaluer, les dommages causés aux tiers par l'acte illicite, et d'autre part de n'en pas exclure le montant des dettes et autres obligations à la charge du lésé. Le montant du préjudice causé à l'Oberschlesische du fait de la dépossession de l'entreprise de Chorzów est donc égal à la valeur totale — mais exclusivement à la valeur totale — des biens, droits et intérêts de cette Société dans ladite entreprise, sans déduction de passifs.

Le Gouvernement polonais soutient en premier lieu que l'Oberschlesische n'a pas subi de dommage à la suite de la dépossession, parce qu'elle n'était pas la propriétaire légitime, son droit de propriété n'ayant jamais été valable et, en tout cas, ayant cessé de l'être en vertu de l'arrêt rendu le 12 novembre 1927 par le Tribunal de Katowice ; de sorte qu'à partir de cette date tout au moins aucun dommage subi par ladite Société ne pourrait donner lieu pour elle à réparation.

A cet égard, la Cour constate ce qui suit : la Cour a été déjà appelée, lors de la procédure terminée par l'Arrêt n° 7, à s'occuper, comme d'un point incident et préalable, de la question de la validité des transactions en vertu desquelles la propriété de l'usine de Chorzów est passée du Reich à l'Oberschlesische. Elle est arrivée à la conclusion que les diverses transactions dont il s'agit étaient des actes réels et de bonne foi ; et c'est pourquoi elle a pu considérer l'usine de Chorzów comme appartenant à une société contrôlée par des ressortissants allemands, savoir, l'Oberschlesische. Quel que soit l'effet de cette décision incidente sur le droit de propriété du point de vue du droit civil, il est évident que le fait que l'usine

## II.

On approaching this question, it should first be observed that, in estimating the damage caused by an unlawful act, only the value of property, rights and interests which have been affected and the owner of which is the person on whose behalf compensation is claimed, or the damage done to whom is to serve as a means of gauging the reparation claimed, must be taken into account. This principle, which is accepted in the jurisprudence of arbitral tribunals, has the effect, on the one hand, of excluding from the damage to be estimated, injury resulting for third parties from the unlawful act and, on the other hand, of not excluding from the damage the amount of debts and other obligations for which the injured party is responsible. The damage suffered by the Oberschlesische in respect of the Chorzów undertaking is therefore equivalent to the total value—but to that total only—of the property, rights and interests of this Company in that undertaking, without deducting liabilities.

The Polish Government argues in the first place that the Oberschlesische has suffered no loss as a result of its dispossession, because it was not the lawful owner, its right of ownership having never been valid and having in any case ceased to be so in virtue of the judgment given on November 12th, 1927, by the Court of Katowice; so that from that date at all events no damage for which reparation should be made could ensue as regards that Company.

In regard to this the Court observes as follows: the Court has already, in connection with Judgment No. 7, had to consider as an incidental and preliminary point, the question of the validity of the transactions in virtue of which the ownership of the Chorzów factory passed from the Reich to the Oberschlesische. It then arrived at the conclusion that the various transactions in question were genuine and bona fide; that is why it was able to regard the Chorzów factory as belonging to a company controlled by German nationals, namely, the Oberschlesische. Whatever the effect of this incidental decision may be as regards the right of ownership under municipal law, it is evident that the fact that the



de Chorzów appartenait à l'Oberschlesische était la condition logique de la décision de la Cour d'après laquelle l'attitude du Gouvernement polonais à l'égard de l'Oberschlesische n'était pas conforme aux articles 6 et suivants de la Convention de Genève. Car, si l'usine n'appartenait pas à l'Oberschlesische, cette Société non seulement n'aurait pu subir aucun dommage du fait de la dépossession, mais elle n'aurait pas même pu être l'objet d'une dépossession contraire à la Convention de Genève ; or, par son Arrêt n° 7, la Cour a constaté que tel était le cas. Il y a lieu de faire observer que dans son Arrêt n° 7 la Cour ne s'est pas bornée à constater l'incompatibilité, avec ladite Convention, de l'application de la loi du 14 juillet 1920 aux propriétés inscrites au registre foncier au nom de sociétés contrôlées par des ressortissants allemands ; mais, en répondant aux objections soulevées par la Partie défenderesse, a dû s'occuper aussi de la question de savoir si cette inscription était le résultat de transactions fictives et frauduleuses ou bien réelles et de bonne foi. C'est la Pologne elle-même qui a allégué contre la deuxième conclusion de la Requête allemande du 15 mai 1925 que l'inscription de l'Oberschlesische au registre foncier, étant basée sur une transaction fictive et frauduleuse, n'était en tout cas pas valable, et qui a ainsi amené la Cour à se prononcer sur ce point.

Or, la requête qui donne lieu au présent arrêt étant basée sur le tort constaté par l'Arrêt n° 7, il n'est pas possible que le droit de l'Oberschlesische à l'usine de Chorzów soit apprécié d'une manière différente pour les besoins dudit Arrêt n° 7 et par rapport à la demande en réparation basée sur cet arrêt. La Cour ayant été d'avis que le droit de l'Oberschlesische sur l'usine de Chorzów justifiait la conclusion que l'attitude du Gouvernement polonais à l'égard de ladite Société n'était pas conforme aux articles 6 et suivants de la Convention de Genève, elle ne saurait se départir de cet avis alors qu'il s'agit actuellement d'apprécier la même situation juridique aux fins de statuer sur la demande en réparation fondée sur l'acte dont la non-conformité à la Convention a été constatée par la Cour.

Le Gouvernement polonais fait maintenant observer qu'après le prononcé de l'Arrêt n° 7, le Tribunal civil de Katowice, qui,

Chorzów factory belonged to the Oberschlesische was the necessary condition precedent to the Court's decision that the attitude of the Polish Government in respect of the Oberschlesische was not in conformity with Article 6 and the following articles of the Geneva Convention. For if the factory did not belong to the Oberschlesische Stickstoffwerke, not only would that Company not have suffered damage as a result of dispossession, but furthermore it could not have been subjected to a dispossession contrary to the Geneva Convention, but the Court established by Judgment No. 7 that such was the case. It should be noted that the Court in Judgment No. 7 has not confined itself to recording the incompatibility with the Geneva Convention of the application of the law of July 14th, 1920, to properties entered in the land register in the name of companies controlled by German nationals, but has, in replying to the objections put forward by the Respondent, also had to deal with the question whether such entry was the outcome of fictitious and fraudulent transactions or of genuine and bona-fide transactions. Poland herself objected in connection with the second submission of the German Application of May 15th, 1925, that the entry of the Oberschlesische in the land register was in any case not valid as it was based on a fictitious and fraudulent transaction and thus caused the Court to deal with this point.

As the application now under consideration is based on the damage established by Judgment No. 7, it is impossible that the Oberschlesische's right to the Chorzów factory should be looked upon differently for the purposes of that judgment and in relation to the claim for reparation based on the same judgment. The Court, having been of opinion that the Oberschlesische's right to the Chorzów factory justified the conclusion that the Polish Government's attitude in respect of that Company was not in conformity with Article 6 and the following articles of the Geneva Convention, must necessarily maintain that opinion when the same situation at law has to be considered for the purpose of giving judgment in regard to the reparation claimed as a result of the act which has been declared by the Court not to be in conformity with the Convention.

The Polish Government now points out that, after Judgment No. 7 had been rendered, the Civil Court of Katowice

selon les règles du droit international, est sans doute compétent pour connaître des contestations civiles touchant les immeubles situés dans sa circonscription, a déclaré non valable du point de vue du droit civil, et cela indépendamment des lois polonaises des 14 juillet 1920 et 16 juin 1922, l'inscription de l'Oberschlesische au registre foncier comme propriétaire ; il allègue également que la Cour, en statuant maintenant sur la question de la réparation, devrait tenir compte de ce fait nouveau.

La Cour n'a pas besoin de se prononcer sur la question de savoir quelle aurait été la situation juridique par rapport à la Convention de Genève, si la dépossession avait été précédée d'un jugement régulièrement rendu par une instance compétente. Il suffit de rappeler que la Cour, dans son Arrêt n° 8, a dit que la violation de la Convention de Genève qui consistait dans la dépossession d'un propriétaire protégé par les articles 6 et suivants de la Convention de Genève ne pouvait être effacée par un jugement national qui, après coup, enlèverait la base à l'applicabilité de la Convention, base que la Cour avait admise dans son Arrêt n° 7. Le jugement du Tribunal de Katowice du 12 novembre 1927 — jugement rendu par défaut vis-à-vis de l'Oberschlesische, et le Reich n'ayant pas été partie au procès — ne contient pas, dans le texte qui est connu de la Cour, les motifs pour lesquels l'inscription de la propriété en faveur de l'Oberschlesische est déclarée nulle ; mais il résulte de la requête qui a donné lieu à ce jugement que les motifs invoqués par le Fisc polonais sont essentiellement les mêmes que ceux qui ont été déjà débattus sur la base des conclusions du Gouvernement polonais devant la Cour dans la procédure qui a abouti à l'Arrêt n° 7, et qui, de l'avis de la Cour, n'ont pas suffi pour considérer l'Oberschlesische comme ne tombant pas sous le coup des articles 6 et suivants de la Convention de Genève. Si, considérant que l'usine n'appartenait pas à l'Oberschlesische, la Cour niait l'existence d'un dommage au détriment de cette Société, elle se mettrait en contradiction avec un des motifs sur lesquels elle a fondé son Arrêt n° 7 et elle admettrait qu'un jugement national pût infirmer indirectement un arrêt rendu par une instance internationale, ce qui est impossible. Quel que soit l'effet du jugement du Tribunal de Katowice, du 12 novembre 1927, du point de vue du

which, under International Law, doubtless has jurisdiction in disputes at civil law concerning immovable property situated within its district, has declared the entry of the Oberschlesische in the land register as owner not to be valid under the municipal law applicable to the case, and this apart from the Polish laws of July 14th, 1920, and June 16th, 1922; it further contends that the Court, in now giving judgment on the question of damages, should bear in mind this new fact.

There is no need for the Court to consider what would have been the situation at law as regards the Geneva Convention, if dispossession had been preceded by a judgment given by a competent tribunal. It will suffice to recall that the Court in Judgment No. 8 has said that the violation of the Geneva Convention consisting in the dispossession of an owner protected by Article 6 and following of the Geneva Convention could not be rendered non-existent by the judgment of a municipal court which, after dispossession had taken place, nullified the grounds rendering the Convention applicable, which grounds were relied upon by the Court in Judgment No. 7. The judgment of the Tribunal of Katowice given on November 12th, 1927,—which judgment was given by default as regards the Oberschlesische, the Reich not being a Party to the proceedings,—does not contain in the text known to the Court the reasons for which the entry of the property in the name of the Oberschlesische was declared null and void; but it appears from the application upon which this judgment was given that the reasons advanced by the Polish Treasury are essentially the same as those already discussed before the Court on the basis of the Polish Government's submissions in the proceedings leading up to Judgment No. 7, which reasons, in the opinion of the Court, did not suffice to show that the Oberschlesische did not fall within the scope of Article 6 and the following articles of the Geneva Convention. If the Court were to deny the existence of a damage on the ground that the factory did not belong to the Oberschlesische, it would be contradicting one of the reasons on which it based its Judgment No. 7 and it would be attributing to a judgment of a municipal court power indirectly to invalidate a judgment of an international court, which is impossible. Whatever the

droit interne; ce jugement ne saurait ni effacer la violation de la Convention de Genève constatée par la Cour dans son Arrêt n° 7, ni soustraire à cet arrêt une des bases sur lesquelles il est fondé.

C'est à l'objection dont la Cour vient de s'occuper, ainsi qu'à la conclusion y relative, formulée par le Gouvernement polonais dans son Contre-Mémoire mais retirée par lui plus tard, que se réfère la conclusion du Gouvernement allemand à l'effet

que l'obligation du Gouvernement polonais de payer l'indemnité allouée par la Cour n'est nullement écartée par un jugement rendu ou à rendre par un tribunal interne polonais dans un procès ayant pour objet la question de la propriété de l'usine sise à Chorzów.

Cette conclusion a été maintenue malgré le retrait de ladite conclusion polonaise.

La Cour, étant d'avis que cette dernière conclusion doit être considérée comme valablement retirée, mais que, nonobstant, l'objection à laquelle elle se référerait subsiste, estime qu'il n'y a pas lieu de statuer en termes exprès sur la conclusion y relative formulée par le Gouvernement allemand, autrement qu'en rejetant la thèse du Gouvernement polonais fondée sur le jugement du Tribunal de Katowice.

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Le Gouvernement polonais ne s'est pas borné à contester l'existence d'un dommage en alléguant que l'Oberschlesische ne serait pas ou aurait cessé d'être propriétaire de l'usine de Chorzów; il soutient en outre, à différents points de vue, que les droits que le Reich possède dans l'entreprise, étant passés à la Pologne, ne pourraient entrer en ligne de compte pour l'évaluation du dommage dont dépendra le montant de la réparation due par la Pologne à l'Allemagne.

Admettant, par hypothèse, que le contrat du 24 décembre 1919 ne soit pas nul, mais doive être traité comme un acte juridique réel et valable, le Gouvernement polonais considère que, d'après ledit contrat, c'est le Gouvernement allemand qui

effect of the judgment of the Tribunal of Katowice of November 12th, 1927, may be at municipal law, this judgment can neither render in-existent the violation of the Geneva Convention recognized by the Court in Judgment No. 7 to have taken place, nor destroy one of the grounds on which that judgment is based.

It is to the objection dealt with above and to a submission connected therewith which the Polish Government made in its Counter-Case but subsequently withdrew, that the following submission of the German Government relates:

[*Translation.*]

that the obligation of the Polish Government to pay the indemnity awarded by the Court is in no way set aside by a judgment given or to be given by a Polish municipal court in a suit concerning the question of the ownership of the factory situated at Chorzów.

This submission has been maintained notwithstanding the withdrawal of the Polish submission referred to.

The Court, being of opinion that this latter submission is to be regarded as having been validly withdrawn, but that, nevertheless, the objection to which it referred still subsists, considers that there is no need expressly to deal with the submission in regard thereto made by the German Government, save in order to dismiss the submission of the Polish Government based on the judgment of the Tribunal of Katowice.

\* \* \*

The Polish Government not only disputes the existence of a damage for the reason that the Oberschlesische is not or is no longer owner of the factory at Chorzów, but also contends from various points of view that the rights possessed by the Reich in the undertaking, having passed into the hands of Poland, cannot be included amongst the assets to be taken into account in the calculation of the damage sustained on which calculation will depend the amount of the reparation due by Poland to Germany.

The Polish Government, admitting, for the sake of argument, that the contract of December 24th, 1919, was not null and void, but must be regarded as a genuine and valid legal instrument, holds that, according to that contract, the Ger-

est le propriétaire de la totalité des actions de l'Oberschlesische lesquelles représentent l'unique bien de celle-ci, à savoir l'usine. Il en tire la conclusion qu'il s'agit de la transformation d'une entreprise fiscale en une entreprise d'État par actions, et comme il est d'avis que les biens d'une société allemande, dont la totalité des actions appartient au Reich, rentrent dans la catégorie des « biens et propriétés appartenant à l'Empire » qui seraient dévolus à la Pologne en vertu de l'article 256 du Traité de Versailles, il estime qu'il est « difficile de se rendre compte quels furent les droits de l'Oberschlesische auxquels il a été porté atteinte par le Gouvernement polonais ».

Il a développé cette argumentation en insistant notamment sur ce que l'Oberschlesische serait en réalité une société contrôlée par le Gouvernement allemand et non une société contrôlée par des ressortissants allemands, non plus qu'une entreprise privée dans laquelle le Reich posséderait seulement des intérêts prépondérants.

Même s'il n'en était pas ainsi et qu'on voulût, par hypothèse, traiter l'acte du 24 décembre 1919 comme un contrat effectif et réel de vente de l'usine par le Reich à l'Oberschlesische, on ne saurait, selon le Gouvernement polonais, omettre de tenir compte de la circonstance que l'État allemand a conservé toute une série d'intérêts et droits dans l'entreprise. Comme l'indemnité demandée par le Gouvernement allemand est calculée, entre autres, sur la mesure du dommage présumé de l'Oberschlesische, il ne serait pas « fondé logiquement de reconnaître à cette Société des indemnités pour les droits et intérêts qui, dans l'entreprise de Chorzów, appartenaient au Reich ». Il faudrait donc éliminer ces droits des droits de l'Oberschlesische, lesquels, cette élimination effectuée, se réduiraient au seul *nudum jus domini*.

Le Gouvernement polonais invoque, en outre, qu'en vertu de l'article 256 du Traité de Versailles, les droits et intérêts du Gouvernement allemand dans l'entreprise de Chorzów sont transférés à l'État polonais, au plus tard à partir du moment du transfert à la Pologne de la souveraineté sur la partie de la Haute-Silésie à elle attribuée, et que, à supposer que le contrat du 24 décembre 1919 ait donné à l'État allemand la

man Government is the owner of the whole of the shares of the Oberschlesische representing the sole property of that Company, namely the factory. It deduces from this that the transaction consists in the transformation of an ordinary State enterprise into a State enterprise with a share capital, and as it holds that the property of a German company, the whole of the shares of which belong to the Reich, falls within the category of "property and possessions belonging to the Empire" acquired by Poland under Article 256 of the Treaty of Versailles, it considers that it is "difficult to see what the rights of the Oberschlesische were which had been infringed by the Polish Government".

In developing this argument, it has laid special stress on the allegation that the Oberschlesische is in reality a company controlled by the German Government and not a company controlled by German nationals, or even a private enterprise in which the Reich merely possesses preponderating interests.

Even if this should not be the case and if the instrument of December 24th, 1919, were, for argument's sake, to be regarded as an effective and genuine contract for the sale of the factory by the Reich to the Oberschlesische, the Polish Government contends that it is impossible not to take into account the circumstance that the German State retained a whole complex of rights and interests in the undertaking. As the indemnity claimed by the German Government is calculated, amongst other things, on the extent of the damage presumed to have been sustained by the Oberschlesische, it would not be "logically correct to award to that Company compensation for rights and interests in the Chorzów undertaking which belonged to the Reich". These rights should therefore be eliminated from the rights of the Oberschlesische, which, if this were done, would amount simply to a *nudum jus domini*.

The Polish Government also alleges that, under Article 256 of the Treaty of Versailles, the rights and interests of the German Government in the Chorzów undertaking are transferred to the Polish State, at latest as from the date of the transfer to Poland of sovereignty over the part of Upper Silesia allotted to her, and that, on the supposition that the contract of December 24th, 1919, gave the German State



totalité des actions de l'Oberschlesische afin de garantir au Reich ses droits et de lui permettre d'en faire usage, ces actions, à la possession desquelles sont attachés les droits du Reich, doivent être livrées à la Pologne. Si l'acte du 24 décembre 1919 doit être traité comme réel et effectif, le Gouvernement polonais estime que pour déterminer l'indemnité éventuellement due à l'Oberschlesische, il faudrait d'abord éliminer les droits du Reich ; et comme il est d'avis que cette élimination ne peut être réalisée que sous une seule forme, savoir la livraison par l'État allemand à la Pologne des actions de l'Oberschlesische d'une valeur nominale de 110 millions de marks, le Gouvernement polonais, à ce sujet, a formulé, dans son Contre-Mémoire, sous le n° A 4, une conclusion ainsi conçue :

« En tout cas, dire et juger que le Gouvernement allemand doit, en premier lieu, livrer au Gouvernement polonais la totalité des actions de la Société anonyme Oberschlesische Stickstoffwerke de la valeur nominale de 110.000.000 de marks dont il dispose en vertu du contrat du 24 décembre 1919. »

A l'égard de cette conclusion, le Gouvernement allemand a, dans sa Réplique, fait les observations suivantes :

« D'abord, le Gouvernement polonais n'invoque aucune disposition sur laquelle peut être basée la compétence de la Cour pour connaître de cette question, qui résulte de l'interprétation de l'article 256. Dans les procédures antérieures, le Gouvernement polonais avait fortement souligné que l'interprétation de cet article ne serait pas même admissible en tant que question incidente et préalable pour l'interprétation des articles 6 à 22 de la Convention de Genève.

Le Gouvernement allemand ignore si le Gouvernement polonais pense au traité général d'arbitrage signé à Locarno et d'après lequel toute contestation d'ordre juridique doit être soumise à l'arbitrage, et, faute d'entente sur un tribunal arbitral spécial, à la Cour permanente de Justice internationale. Mais quoi qu'il en soit, le Gouvernement allemand, animé du désir d'assurer au Traité de Locarno toute l'étendue qu'il comporte sans s'arrêter aux questions des formes y prévues, et de voir vidée définitivement l'affaire de Chorzów, s'abstient d'entreprendre un examen détaillé sur les questions d'incompétence ou de prématurité même si ces questions entraînent en considération pour la demande reconventionnelle que le Gouvernement allemand veut voir dans la conclusion A 4 du Contre-Mémoire. Il se borne à rappeler l'article 40, alinéa 2, chiffre 4, du

the whole of the shares of the Oberschlesische, as guarantee for its rights, and to enable it to exercise those rights, these shares, on the possession of which depend the rights of the Reich, should be transferred to Poland. If the contract of December 24th, 1919, is to be regarded as genuine and effective, the Polish Government holds that, in order to determine the indemnity which may be due to the Oberschlesische, the rights of the Reich must first be eliminated; and as it is of opinion that this can only be done in one way, namely, by the handing over by Germany to Poland of the shares of the Oberschlesische to the nominal value of 110 million marks, the Polish Government has in regard to this point made the following submission (No. A 4) in its Counter-Case:

[*Translation.*]

"In any case, it is submitted that the German Government should, in the first place, hand over to the Polish Government the whole of the shares of the Oberschlesische Company of the nominal value of 110,000,000 marks, which are in its hands under the contract of December 24th, 1919."

The German Government in its Reply made the following observations in regard to this submission:

[*Translation.*]

"In the first place, the Polish Government cites no provision on which it is possible to base the Court's jurisdiction to take cognizance of this question, which arises from the interpretation of Article 256. In the previous proceedings, the Polish Government strongly maintained that the interpretation of this article would not be admissible even as a question incidental and preliminary to the interpretation of Articles 6 to 22 of the Geneva Convention.

The German Government does not know whether the Polish Government has in mind the general treaty of arbitration signed at Locarno, according to which any dispute of a legal nature must be submitted to arbitration, and, unless some special arbitral tribunal is agreed upon, to the Permanent Court of International Justice. But, however that may be, the German Government, being animated by a wish to ensure that full scope shall be given to the Treaty of Locarno, without pausing to debate questions as to the procedure therein provided for, and also to see the Chorzów case settled once and for all, abstains from undertaking a detailed examination of the questions of lack of jurisdiction or prematurity, even though these questions might enter into account in connection with the counter-claim which, in the German Government's

Règlement de la Cour, en vertu duquel la Cour peut statuer sur des demandes reconventionnelles pour autant que ces dernières rentrent dans la compétence de la Cour. Entre l'Allemagne et la Pologne, ce cas est réalisé pour toute question de droit litigieuse entre elles. On pourrait uniquement discuter le point de savoir si, pour le jeu dudit article du Règlement, aussi les conditions de forme et de délais doivent être remplies, ou s'il suffit que les conditions matérielles soient remplies. Mais ce point peut rester indécié puisque le Gouvernement allemand accepte la juridiction de la Cour pour la question soulevée par le Contre-Mémoire. Lors des négociations relatives à l'affaire de Chorzów, le plénipotentiaire allemand avait déjà proposé au plénipotentiaire polonais de soumettre cette question à la Cour.»

Dans les débats ultérieurs, le Gouvernement polonais ne s'est pas prononcé sur la question de la compétence de la Cour. On ne saurait donc dire s'il accepte la manière de voir du Gouvernement allemand selon laquelle cette compétence pourrait être déduite de la Convention entre l'Allemagne et la Pologne, paraphée à Locarno le 16 octobre 1925, ou s'il revendique la compétence en vertu d'un autre titre. En tout cas, il est constant qu'il n'a pas retiré sa demande et que, partant, il désire que la Cour statue sur la conclusion en question. D'autre part, le Gouvernement allemand, tout en fondant la compétence sur la Convention de Locarno, paraît avant tout désireux que la Cour statue sur cette conclusion au cours de la présente procédure.

Il y a donc accord entre les Parties pour soumettre à la décision de la Cour la question soulevée par ladite conclusion. Comme la Cour l'a dit dans son Arrêt n° 12, relatif à certains droits de minorités en Haute-Silésie, l'article 36 du Statut consacre le principe suivant lequel la juridiction de la Cour dépend de la volonté des Parties; la Cour est donc toujours compétente du moment où celles-ci acceptent sa juridiction, car il n'y a aucun différend que les États admis à ester devant la Cour ne puissent lui soumettre, sauf dans les cas exceptionnels où le différend serait de la compétence exclusive

contention, is formulated in submission A 4 of the Counter-Case. It will simply refer to Article 40, paragraph 2, No. 4, of the Rules of Court, according to which the Court may give judgment on counter-claims in so far as the latter come within its jurisdiction. As between Germany and Poland this applies in respect of any question of law in dispute between them. The only point which might be disputed is the question whether, for the application of this article of the Rules, the conditions respecting forms and times must also be fulfilled, or whether it is enough that the material conditions should be fulfilled. This point, however, may be left open, since the German Government accepts the jurisdiction of the Court in regard to the question raised in the Counter-Case. In the course of the negotiations in regard to the Chorzów case, the German plenipotentiary had already proposed to the Polish plenipotentiary that this question should be referred to the Court."

In the subsequent proceedings, the Polish Government has not made any statement in regard to the question of the Court's jurisdiction. It is impossible, therefore, to say whether it accepts the view of the German Government according to which it may be inferred that such jurisdiction exists under the Convention between Germany and Poland initialled at Locarno on October 16th, 1925, or whether it contends that the Court has jurisdiction on some other basis. In any case, it is certain that it has not withdrawn its claim and that, consequently, it wishes the Court to give judgment on the submission in question. For its part the German Government, though basing the Court's jurisdiction on the Locarno Convention, seems above all anxious that the Court should give judgment on this submission in the course of the present proceedings.

The Parties therefore are agreed in submitting to the Court for decision the question raised by this submission. As the Court has said in Judgment No. 12, concerning certain rights of minorities in Upper Silesia, Article 36 of the Statute establishes the principle that the Court's jurisdiction depends on the will of the Parties; the Court therefore is always competent once the latter have accepted its jurisdiction, since there is no dispute which States entitled to appear before the Court cannot refer to it, save in exceptional cases where a dispute may be within the exclusive jurisdiction of some other body.

d'un autre organe. Or, tel n'est pas le cas en ce qui concerne la conclusion en question.

La Cour constate, en outre, que la demande reconventionnelle est basée sur l'article 256 du Traité de Versailles, qui constitue le fondement de l'exception soulevée par la Partie défenderesse, et que, partant, elle se trouve en rapport de connexité juridique avec la demande principale.

D'autre part, l'article 40 du Règlement de la Cour que le Gouvernement allemand a invoqué, stipule, entre autres, que les contre-mémoires comprennent :

« 4° des conclusions fondées sur les faits énoncés. Ces conclusions peuvent comprendre des demandes reconventionnelles, pour autant que ces dernières rentrent dans la compétence de la Cour. »

La demande ayant été formulée dans le Contre-Mémoire, les conditions de forme exigées par le Règlement pour des demandes reconventionnelles se trouvent donc réalisées en l'espèce aussi bien que les conditions de fond.

En ce qui concerne les rapports qui existent entre les demandes allemandes et la conclusion polonaise dont il s'agit, la Cour croit utile d'ajouter ce qui suit : Bien qu'étant formellement une demande reconventionnelle, car elle tend à condamner la Partie demanderesse à une prestation envers la défenderesse — en réalité, si l'on tient compte des motifs sur lesquels elle se fonde, la conclusion contient un moyen opposé à la demande de l'Allemagne tendant à obtenir de la Pologne une indemnité dont le montant serait calculé, entre autres, sur la base du dommage subi par l'Oberschlesische. Il s'agit, en effet, d'éliminer du montant de cette indemnité ce qui correspondrait à la valeur des droits et intérêts que le Reich possédait dans l'entreprise en vertu du contrat du 24 décembre 1919, valeur qui, selon le Gouvernement polonais, ne constitue pas une perte pour l'Oberschlesische, parce que ces droits et intérêts appartiendraient au Gouvernement polonais lui-même en vertu de l'article 256 du Traité de Versailles. La Cour ayant, par son Arrêt n° 8, admis sa compétence en vertu de l'article 23 de la Convention de Genève pour connaître de la réparation due du chef du dommage causé aux deux Sociétés par l'attitude du Gouvernement polonais envers elles, elle ne saurait se soustraire à l'examen des objections qui ont pour

But this is not the case as regards the submission in question.

The Court also observes that the counter-claim is based on Article 256 of the Versailles Treaty, which article is the basis of the objection raised by the Respondent, and that, consequently, it is juridically connected with the principal claim.

Again, Article 40 of the Rules of Court, which has been cited by the German Government, lays down amongst other things that counter-cases shall contain:

“4° conclusions based on the facts stated; these conclusions may include counter-claims, in so far as the latter come within the jurisdiction of the Court.”

The claim having been formulated in the Counter-Case, the formal conditions required by the Rules as regards counter-claims are fulfilled in this case, as well as the material conditions.

As regards the relationship existing between the German claims and the Polish submission in question, the Court thinks it well to add the following: Although in form a counter-claim, since its object is to obtain judgment against the Applicant for the delivery of certain things to the Respondent—in reality, having regard to the arguments on which it is based, the submission constitutes an objection to the German claim designed to obtain from Poland an indemnity the amount of which is to be calculated, amongst other things, on the basis of the damage suffered by the Oberschlesische. It is in fact a question of eliminating from the amount of this indemnity a sum corresponding to the value of the rights and interests which the Reich possessed in the enterprise under the contract of December 24th, 1919, which value, according to the Polish Government, does not constitute a loss to the Oberschlesische because these rights and interests are said to belong to the Polish Government itself under Article 256 of the Treaty of Versailles. The Court, having by Judgment No. 8 accepted jurisdiction, under Article 23 of the Geneva Convention, to decide as to the reparation due for the damage caused to the two Companies by the attitude of the Polish Government towards them, cannot dispense with an examination of the objections the

but de démontrer soit qu'un tel dommage n'existe pas, soit qu'il n'a pas l'étendue que prétend la Partie demanderesse. Cela étant, il semble naturel de reconnaître aussi, en vertu du même titre, la compétence pour statuer sur les moyens allégués par le Gouvernement polonais afin d'obtenir que l'indemnité soit limitée au montant correspondant au dommage effectivement subi.

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Passant maintenant à l'examen des objections susdites du Gouvernement polonais, la Cour estime utile, tout d'abord, de préciser quelle est, selon son avis, la nature des droits que le Gouvernement allemand possède à l'égard de l'entreprise de Chorzów en vertu du contrat du 24 décembre 1919, dont le contenu essentiel se trouve exposé plus haut. Renvoyant à cet exposé, la Cour constate que c'est la Treuhand et non le Reich allemand qui, en droit, est propriétaire des actions de l'Oberschlesische. Le Reich est créancier de la Treuhand et a, en cette qualité, un droit de gage sur les actions. Il a aussi, à côté de ce droit de gage, tous les droits découlant de la possession des actions, y compris le droit à la plus grande partie du prix en cas de vente de celles-ci. Ce droit, qui peut être considéré comme prépondérant, est, au point de vue économique, très proche de la propriété, mais il n'est pas la propriété; et on ne peut, même en se plaçant au point de vue économique, faire abstraction des droits de la Treuhand.

Telle étant la situation en droit, vouloir maintenant identifier l'Oberschlesische avec le Reich, ce qui aurait pour conséquence que la propriété de l'usine serait dévolue à la Pologne en vertu de l'article 256 du Traité de Versailles, serait se mettre en opposition avec la manière de voir adoptée par la Cour dans son Arrêt n° 7 et maintenue ci-dessus, manière de voir qui est le fondement de la décision selon laquelle l'attitude de la Pologne, aussi bien vis-à-vis de l'Oberschlesische que vis-à-vis de la Bayerische, n'était pas conforme aux dispositions de la Convention de Genève.

Il en est de même en ce qui concerne la thèse suivant laquelle l'Oberschlesische serait une société contrôlée non par des ressortissants allemands, mais par le Reich. Il est vrai, comme l'a rappelé le Gouvernement polonais, que la Cour, dans

aim of which is to show either that no such damage exists or that it is not so great as it is alleged to be by the Applicant. This being so, it seems natural on the same grounds also to accept jurisdiction to pass judgment on the submissions which Poland has made with a view to obtaining the reduction of the indemnity to an amount corresponding to the damage actually sustained.

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Proceeding now to consider the above-mentioned objections of the Polish Government, the Court thinks it well first of all to define what is, in its opinion, the nature of the rights which the German Government possesses in respect of the Chorzów undertaking under the contract of December 24th, 1919, the main features of which have been described above. Referring to this description, the Court points out that the Treuhand, and not the Reich, is legally the owner of the shares of the Oberschlesische. The Reich is the creditor of the Treuhand and in this capacity has a lien on the shares. It also has, besides this lien, all rights resulting from possession of the shares, including the right to the greater portion of the price in the event of the sale of these shares. This right, which may be regarded as preponderating, is, from an economic standpoint, very closely akin to ownership, but it is not ownership; and even from an economic point of view it is impossible to disregard the rights of the Treuhand.

Such being the situation at law, to endeavour now to identify the Oberschlesische with the Reich—the effect of which would be that the ownership of the factory would have passed to Poland under Article 256 of the Treaty of Versailles—would be in conflict with the view taken by the Court in Judgment No. 7 and reaffirmed above, on which view is based the decision to the effect that Poland's attitude as regards both the Oberschlesische and Bayerische was not in conformity with the provisions of the Geneva Convention.

The same applies in regard to the contention that the Oberschlesische is a company controlled not by German nationals but by the Reich. It is true, as the Polish Government has recalled, that the Court in Judgment No. 7 has declared



son Arrêt n° 7, a déclaré ne pas avoir besoin d'examiner la question de savoir si l'Oberschlesische, vu les droits que le contrat du 24 décembre 1919 confère au Reich, doit être considérée comme contrôlée par ce dernier et, au cas où cette hypothèse se trouverait réalisée, quelles conséquences pourraient en découler pour l'application de la Convention de Genève. Mais la raison en était que la Cour était d'avis que le Gouvernement polonais n'avait pas soulevé cette question et que, abstraction faite de sa thèse relative à la fictivité des actes du 24 décembre 1919, il ne paraissait pas avoir contesté que ladite Société fût contrôlée par des ressortissants allemands.

En tout cas, il est clair que c'est seulement en estimant que ladite Société est, au point de vue de l'article 6 de la Convention de Genève, à considérer comme une société contrôlée par des ressortissants allemands, que la Cour a pu constater que l'attitude du Gouvernement polonais vis-à-vis de cette Société n'était pas conforme aux dispositions des articles 6 et suivants de ladite Convention.

Même si la question n'était pas préjugée et si la Cour était libre de l'examiner à nouveau maintenant, elle devrait arriver à la conclusion que l'Oberschlesische était contrôlée par la Bayerische. Car, vu que, d'après le contrat du 24 décembre 1919, le Reich s'était déclaré d'accord pour maintenir la direction de l'entreprise de Chorzów entre les mains de la Bayerische aux conditions antérieurement convenues avec le Reich, et que, par le contrat ultérieur, conclu entre la Bayerische et la Treuhand à la date du 25 novembre 1920, il avait été stipulé qu'à cette fin la Bayerische désignerait au moins deux membres de sa propre direction comme membres de la direction de l'Oberschlesische, c'est, de l'avis de la Cour, la Bayerische plutôt que le Reich qui a le contrôle sur l'Oberschlesische.

La Cour conclut donc que n'est pas fondée la thèse polonaise suivant laquelle l'Oberschlesische n'a pas subi de dommage parce que cette Société doit être considérée comme s'identifiant avec le Reich, et suivant laquelle les biens dont ladite Société a été privée par l'acte du Gouvernement polonais sont acquis à la Pologne en vertu de l'article 256 du Traité de Versailles.

that there was no need for it to consider the question whether the Oberschlesische, having regard to the rights conferred by the contract of December 24th, 1919, on the Reich, should be considered as controlled by the Reich, and, should this be the case, what consequences would ensue as regards the application of the Geneva Convention. But the reason for this was that the Court held that the Polish Government had not raised this question, and that, apart from its contention as to the fictitious character of the instruments of December 24th, 1919, that Government did not seem to have disputed that the Company was controlled by German nationals.

At all events, it is clear that only by regarding the said Company as a company controlled by German nationals within the meaning of Article 6 of the Geneva Convention, was the Court able to declare that the attitude of the Polish Government towards that Company was not in conformity with the terms of Article 6 and the following articles of the said Convention.

Even if the question were still open and the Court were now free once more to consider it, it would be bound to conclude that the Oberschlesische was controlled by the Bayerische. For seeing that, under the contract of December 24th, 1919, the Reich had declared that it agreed to leave the management of the Chorzów undertaking in the hands of the Bayerische, under the conditions previously settled with the Reich, and that, under the subsequent contract concluded on November 25th, 1920, between the Bayerische and the Treuhänder, it had been stipulated that for this purpose the Bayerische was to appoint at least two members of its own board as members of the board of the Oberschlesische, the Court considers that the Bayerische, rather than the Reich, controls the Oberschlesische.

The Court, therefore, arrives at the conclusion that the Polish contention to the effect that the Oberschlesische has not suffered damage, because that Company is to be regarded as identifiable with the Reich, and that the property of which the said Company was deprived by the action of the Polish Government has passed to Poland under Article 256 of the Treaty of Versailles, is not well founded.

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A titre subsidiaire, le Gouvernement polonais a allégué que, même si les droits que le Reich possède d'après le contrat du 24 décembre 1919 dans l'entreprise de Chorzów ne devaient pas être considérés comme comportant la propriété des actions de l'Oberschlesische, la valeur de ces droits, qui tomberaient sous le coup de l'article 256 du Traité de Versailles, devrait néanmoins être déduite de l'indemnité réclamée du chef de l'Oberschlesische. La Cour ne saurait davantage accepter cette thèse.

A ce sujet, il y a lieu de remarquer que l'article 256 pose deux conditions, savoir qu'il s'agisse de « biens et propriétés » appartenant à l'Empire ou aux États allemands, et que ces « biens et propriétés » soient « situés » dans un territoire allemand cédé en vertu du Traité.

Il s'agit donc de savoir, entre autres, si les droits du Reich selon le contrat du 24 décembre 1919 sont « situés » dans la partie de la Haute-Silésie cédée à la Pologne. En tant que créance contre la Treuhand, il est clair que cette créance ne peut être considérée comme située dans la Haute-Silésie polonaise, la Treuhand étant une société dont le siège social est en Allemagne et dont les parts appartiennent à des sociétés qui ont également leur siège en Allemagne, et sur lesquelles le contrôle appartient sans conteste à des ressortissants allemands. Le fait que cette créance est garantie par un droit de gage sur les actions, dont les bénéfices, de même que le prix obtenu en cas de vente, serviront à amortir la créance, ne peut, de l'avis de la Cour, justifier l'opinion suivant laquelle les droits du Reich seraient situés en Haute-Silésie polonaise où se trouve l'usine. Ce ne sont que des droits sur les actions, lesquels, si on ne veut pas les considérer comme situés là où se trouvent les actions, doivent être regardés comme étant localisés au siège de la société, siège qui, en l'espèce, est à Berlin et non en Haute-Silésie polonaise. Le transfert du siège de l'Oberschlesische de Chorzów à Berlin après l'entrée en vigueur du Traité de Versailles ne peut être considéré comme illégal et nul ; les motifs pour lesquels la Cour, dans son Arrêt n° 7,

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Alternatively, the Polish Government has contended that, even if the rights possessed by the Reich under the contract of December 24th, 1919, in the Chorzów undertaking are not to be considered as involving ownership of the shares of the Oberschlesische, the value of these rights, which fall within the scope of Article 256 of the Treaty of Versailles, should nevertheless be deducted from the indemnity claimed as regards the Oberschlesische. The Court is likewise unable to admit this contention.

In this respect, it should be noted that Article 256 contains two conditions, namely, that the "property and possessions" with which it deals must belong to the Empire or to the German States, and that such "property and possessions" must be "situated" in German territory ceded under the Treaty.

It must therefore be ascertained, amongst other things, whether the rights of the Reich under the contract of December 24th, 1919, are "situated" in the part of Upper Silesia ceded to Poland. In so far as these rights consist in a claim against the Treuhand, it is clear that this claim cannot be regarded as situated in Polish Upper Silesia, since the Treuhand is a company whose registered office is in Germany and whose shares belong to companies which also have their registered office in Germany and which are undeniably controlled by German nationals. The fact that this claim is guaranteed by a lien on the shares on which the profit, as well as the price obtained in the event of sale, is to be devoted to the payment of this claim, does not, in the Court's opinion, justify the view that the rights of the Reich are situated in Polish Upper Silesia where the factory is. These are only rights in respect of the shares; and these rights, if not regarded as situated where the shares are, must be considered as localized at the registered office of the Company which in this case is at Berlin and not in Polish Upper Silesia. The transfer of the registered office of the Oberschlesische from Chorzów to Berlin after the coming into force of the Treaty of Versailles cannot be regarded as illegal and null:

a considéré que des aliénations de biens publics sis dans la zone soumise au plébiscite n'étaient pas interdites par ledit Traité, s'appliquent à plus forte raison à l'acte par lequel une société anonyme a transféré son siège de cette zone en Allemagne.

C'est encore en vain que le Gouvernement polonais invoque le paragraphe 10 de l'annexe aux articles 297 et 298 du Traité de Versailles, paragraphe qui établit le devoir pour l'Allemagne de remettre « à chaque Puissance alliée ou associée tous les contrats, certificats, actes et autres titres de propriété se trouvant entre les mains de ses ressortissants et se rapportant à des biens, droits et intérêts situés sur le territoire de ladite Puissance alliée ou associée, y compris les actions, obligations ou autres valeurs mobilières de toutes sociétés autorisées par la législation de cette Puissance ». Même abstraction faite de la circonstance que l'Oberschlesische a été constituée sous le régime des lois allemandes et n'a pas été « autorisée » par la législation polonaise, ladite disposition est étrangère à l'article 256 et se réfère seulement aux articles en annexe auxquels elle se trouve.

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L'exposé qui précède ayant établi que, selon l'opinion de la Cour, l'article 256 du Traité de Versailles n'est pas applicable aux droits que le Reich possède en vertu du contrat du 24 décembre 1919, il s'ensuit qu'il faut rejeter la thèse polonaise basée sur l'applicabilité dudit article, et selon laquelle il est nécessaire d'éliminer du montant de l'indemnité à allouer la valeur de ces droits. Il en est de même en ce qui concerne la conclusion du Gouvernement polonais demandant la remise à la Pologne de la totalité des actions de l'Oberschlesische, conclusion dont le but exprès est d'aboutir à une telle élimination. Car cette conclusion, elle aussi, a pour seul fondement la prétendue applicabilité dudit article du Traité de Versailles.

the reasons for which the Court, in Judgment No. 7, held that alienations of public property situated in the plebiscite zone were not prohibited by that Treaty, apply *a fortiori* in respect of the transfer by a company of its registered office from this zone to Germany.

It is also in vain that the Polish Government cites paragraph 10 of the Annex to Articles 297 and 298 of the Treaty of Versailles, which paragraph lays down that Germany shall deliver "to each Allied or Associated Power all securities, certificates, deeds, or other documents of title held by its nationals and relating to property, rights or interests situated in the territory of that Allied or Associated Power, including any shares, stock, debentures, debenture stock, or other obligations of any company incorporated in accordance with the laws of that Power". Even disregarding the circumstances that the Oberschlesische was constituted under German law and has not been "incorporated" in accordance with the laws of Poland, the clause quoted has nothing to do with Article 256 and relates only to the articles to which it is annexed.

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Since, as has been shown above, Article 256 of the Treaty of Versailles is not, in the Court's opinion, applicable to the rights possessed by the Reich under the contract of December 24th, 1919, it follows that the Polish Government's contention—based on the applicability of that article—to the effect that the value of these rights should be eliminated from the amount of the indemnity to be awarded, must be rejected. The same is true as regards the Polish Government's submission that the whole of the shares of the Oberschlesische should be handed over to Poland, a submission the aim of which is precisely to bring about the elimination referred to. For this submission is likewise based solely on the alleged applicability of the same article of the Treaty of Versailles.

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A titre subsidiaire, également au sujet de la demande d'une indemnité fondée sur le préjudice subi par l'Oberschlesische, le Gouvernement polonais a prié la Cour de « surseoir provisoirement » sur ladite demande en indemnité.

Les raisons pour lesquelles il demande ce sursis paraissent être les suivantes :

Le Gouvernement polonais a notifié à la Commission des Réparations la prise de possession, en vertu de l'article 256 du Traité de Versailles, de l'usine de Chorzów, en la portant sur la liste des biens d'État allemands acquis conformément audit article. Il appartient à la Commission des Réparations de fixer la valeur de ces biens, valeur qui doit être payée à la Commission par l'État cessionnaire pour être portée au crédit de l'Allemagne à valoir sur les sommes dues au titre des réparations. Or, après que la Cour eut rendu son Arrêt n° 7, le Gouvernement allemand avait demandé à la Commission des Réparations de radier l'usine de Chorzów de la liste des biens transférés à la Pologne, sans que, cependant, la Commission eût encore pris de décision à cet égard. La question de savoir si la Pologne doit être débitée de la valeur de l'usine reste donc en suspens, et le Gouvernement polonais est d'avis que, tant que cette question n'est pas tranchée et que la Commission des Réparations n'a pas radié l'usine de Chorzów de la liste, le Gouvernement polonais ne peut être contraint à un paiement en faveur de l'Oberschlesische.

A côté de ces considérations, le Gouvernement polonais invoque encore la Convention d'armistice et l'article 248 du Traité de Versailles. Ce dernier établit que, « sous réserve des dérogations qui pourraient être accordées par la Commission des Réparations, un privilège de premier rang est établi sur tous les biens et ressources de l'Empire et des États allemands, pour le règlement des réparations et autres charges résultant du présent Traité, ou de tous autres traités et conventions complémentaires, ou des arrangements conclus entre l'Allemagne et les Puissances alliées ou associées pendant l'armistice et ses prorogations ». Le Gouvernement polonais constate que, dans son Arrêt n° 7, la Cour a jugé que la Pologne, n'ayant pas

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Alternatively, and also in regard to the claim for an indemnity based on the damage sustained by the Oberschlesische, the Polish Government has asked the Court "provisionally to suspend" its decision on the claim for indemnity.

The reasons for which it seeks this suspension appear to be as follows:

The Polish Government has notified the Reparation Commission of the taking over of the Chorzów factory, under Article 256 of the Treaty of Versailles, by entering it on the list of German State property acquired under that article. It is for the Reparation Commission to fix the value of such property, which value is to be paid to the Commission by the succession State and credited to Germany on account of the sums due for reparations. Now after the Court had delivered Judgment No. 7, the German Government asked the Reparation Commission to strike out the Chorzów factory from the list of property transferred to Poland, but the Commission has not yet taken any decision in regard to this. The question whether Poland is to be debited with the value of the factory therefore remains undecided, and the Polish Government considers that, until this question has been decided and the Reparation Commission has struck the Chorzów factory off the list, it—the Polish Government—cannot be compelled to make a payment in favour of the Oberschlesische.

In addition to these considerations, the Polish Government also cites the Armistice Convention and Article 248 of the Treaty of Versailles. The latter lays down that, "subject to such exceptions as the Reparation Commission may approve, a first charge upon all the assets and revenues of the German Empire and its constituent States shall be the cost of reparation and all other costs arising under the present Treaty or any treaties or agreements supplementary thereto or under arrangements concluded between Germany and the Allied and Associated Powers during the armistice or its extensions". The Polish Government says that in Judgment No. 7 the Court has decided first that Poland, not having been a party



pris part à la Convention d'armistice, n'a pas le droit de se prévaloir des stipulations de celle-ci pour considérer nulle et non avenue l'aliénation de l'usine, et qu'elle ne peut se réclamer individuellement, dans le même but, de l'article 248 du Traité de Versailles. Mais il semble soutenir que, vu le droit que les États signataires de la Convention d'armistice peuvent avoir à s'opposer à la vente de l'usine, et vu le droit de la Commission des Réparations à veiller sur l'acquittement de la dette de réparation en général, et vu spécialement le droit qui lui est réservé par l'article 248, l'obligation de la Pologne de payer à l'Allemagne une indemnité en faveur de l'Oberschlesische dépend d'une approbation préalable desdits États ainsi que de la Commission des Réparations.

De son côté, le Gouvernement allemand, tout en contestant le bien-fondé desdites objections du Gouvernement polonais, a déclaré admettre la compétence de la Cour pour statuer sur celles-ci « en tant que questions préalables, pour les questions de la forme, du montant et des modes du paiement des indemnités qu'il réclame, questions pour lesquelles la Cour a déjà affirmé sa compétence ». Il a prié la Cour de rejeter la conclusion subsidiaire polonaise et de dire et juger :

« que le Gouvernement polonais n'est pas autorisé à refuser le paiement au Gouvernement allemand des indemnités en raison d'arguments tirés de l'article 256 ou en raison d'égards vis-à-vis de la Commission des Réparations ou d'autres tierces personnes ».

La Cour est d'avis que sa compétence pour statuer sur la conclusion polonaise en question n'est pas douteuse, mais que cette conclusion doit être rejetée comme non fondée.

A ce sujet, il y a lieu de remarquer, tout d'abord, que les faits allégués par la Pologne ne peuvent empêcher la Cour, saisie maintenant d'une demande en indemnité sur la base de son Arrêt n° 7, de statuer sur cette demande en ce qui concerne la fixation d'une indemnité correspondant, entre autres, au montant du dommage subi par l'Oberschlesische, dommage dont l'élément le plus important est représenté par la perte de l'usine. Car, en constatant par son Arrêt n° 7 que l'attitude du Gouvernement polonais vis-à-vis de l'Oberschle-

to the Armistice Convention, is not entitled to avail itself of the terms of that instrument in order to establish that the alienation of the factory is null and void, and secondly, that that country cannot, on her own account, cite Article 248 of the Treaty of Versailles for the same purpose. It would seem, however, that the said Government contends that, in view of the right which the States signatory to the Armistice Convention may have to oppose the sale of the factory and in view of the right of the Reparation Commission to ensure the discharge of reparation debts in general and especially in view of the right reserved to it under Article 248, Poland's obligation to pay to Germany an indemnity in favour of the Oberschlesische is dependent on the previous approval of the said States and of the Reparation Commission.

The German Government, for its part, whilst disputing the justice of these objections of the Polish Government, has accepted the jurisdiction of the Court to decide upon them "as preliminary points in regard to the questions of form, amount and methods of payment of the indemnities claimed by it, questions with which the Court has already declared itself competent to deal". It has asked the Court to dismiss the Polish alternative submission and to decide:

"that the Polish Government is not justified in refusing to pay compensation to the German Government on the basis of arguments drawn from Article 256 or for motives of respect for the rights of the Reparation Commission or other third parties".

The Court considers that there is no doubt as to its jurisdiction to pass judgment upon the Polish submission in question, but that this submission must be rejected as not well-founded.

In this respect, it should be observed in the first place that the facts cited by Poland cannot prevent the Court, which now has before it a claim for indemnity based on its Judgment No. 7, from passing judgment upon this claim in so far as concerns the fixing of an indemnity corresponding, amongst other things, to the amount of the damage sustained by the Oberschlesische, of which damage the most important element is represented by the loss of the factory. For the Court, when it declared in Judgment No. 7 that the attitude

sische n'était pas conforme aux dispositions des articles 6 et suivants de la Convention de Genève, — attitude qui consistait à considérer et à traiter ladite usine comme acquise par la Pologne en vertu de l'article 256 du Traité de Versailles, — la Cour a écarté, avec effet entre les Parties, l'applicabilité dudit article à l'usine de Chorzów. D'autre part, il ressort des documents soumis à la Cour par les Parties que la Commission des Réparations ne revendique pas la compétence pour statuer sur la question de savoir si tel ou tel bien est, oui ou non, acquis par un État cessionnaire en vertu dudit article. Elle accepte à ce sujet la solution que la question a pu recevoir, soit par les moyens dont disposent les intéressés — négociations diplomatiques, arbitrages, etc. — soit par un acte unilatéral de l'État cessionnaire lui-même. Et si maintenant les Parties sont d'accord sur ce que la Pologne doit conserver l'usine, cela n'est pas à cause de l'article 256 du Traité de Versailles, mais en raison de l'impossibilité pratique de restituer l'usine. Il ne semble pas douteux, dans ces circonstances, que la Pologne ne court aucun risque de devoir payer à nouveau la valeur de l'usine à la Commission des Réparations, si, conformément à la demande de l'Allemagne, elle paie à cet État la valeur de l'usine.

En ce qui concerne la Convention d'armistice et l'article 248 du Traité de Versailles, la question se pose autrement. La Convention d'armistice semble avoir été invoquée dans le but de réserver la possibilité de faire invalider la vente de l'usine à l'Oberschlesische par une action que les États signataires de ladite Convention intenteraient à cet effet. Comme, cependant, la Cour, dans son Arrêt n° 7, a estimé que la Pologne ne peut pas se prévaloir des dispositions de cette Convention, à laquelle elle n'est pas partie, la Cour ne saurait, sans inconséquence, lui reconnaître le droit d'invoquer la Convention aux fins d'obtenir un sursis à la réparation du dommage qu'elle avait causé par une attitude non conforme aux obligations résultant pour elle de la Convention de Genève.

Comme il a déjà été dit, la Cour, dans son Arrêt n° 7, a déclaré que la Pologne ne peut pas se réclamer individuellement de l'article 248 du Traité de Versailles aux fins d'annuler

of the Polish Government in regard to the Oberschlesische was not in conformity with the provisions of Article 6 and the following articles of the Geneva Convention—which attitude consisted in considering and treating the Chorzów factory as acquired by Poland under Article 256 of the Treaty of Versailles—established that, as between the Parties, that article was not applicable to the Chorzów factory. Again it appears from the documents submitted to the Court by the Parties that the Reparation Commission does not claim to be competent to decide whether any particular property is or is not acquired by a succession State under the said article. The Commission accepts in this respect the solution arrived at in regard to this question either by the means at the disposal of those concerned—diplomatic negotiations, arbitration, etc.—or as the result of a unilateral act on the part of the succession State itself. The fact that the Parties are now agreed that Poland must retain the factory has nothing to do with Article 256 of the Treaty of Versailles, but is owing to the impracticability of returning it. In these circumstances there seems to be no doubt that Poland incurs no risk of having again to pay the value of the factory to the Reparation Commission, if, in accordance with Germany's claim, she pays this value to that State.

With regard to the Armistice Convention and Article 248 of the Treaty of Versailles, the question assumes a different aspect. The Armistice Convention appears to have been cited in order to reserve the possibility of getting the sale of the factory to the Oberschlesische declared invalid by means of an action to be brought to that end by the States signatory to that Convention. As, however, the Court, in Judgment No. 7, has held that Poland cannot avail itself of the provisions of the said Convention to which she is not a party, the Court cannot without inconsistency admit that country's right to invoke the Convention in order to delay making reparation for the damage resulting from her adoption of an attitude not in conformity with her obligations under the Geneva Convention.

As has already been said, the Court in Judgment No. 7 has declared that Poland cannot on her own account rely on Article 248 of the Treaty of Versailles in order to obtain the

la vente de l'usine ; en outre, la Cour a constaté que cet article ne comporte pas de défense d'aliénation et que les droits réservés aux Puissances alliées et associées dans ledit article sont exercés par l'intermédiaire de la Commission des Réparations. Mais il serait difficile de comprendre comment lesdits droits pourraient être lésés du fait du versement au Reich, à titre d'indemnité, de la valeur de l'usine, vu que, sans un tel versement, les droits du Reich dans l'entreprise perdraient probablement toute valeur. L'objection basée sur cet article doit donc, elle aussi, être écartée.

La Cour estime devoir se borner à rejeter la conclusion par laquelle le Gouvernement polonais demande un sursis, considérant que, par ce rejet, ainsi que par le rejet des exceptions présentées par le Gouvernement polonais sur la base de l'article 256 du Traité de Versailles, elle fait droit à la conclusion allemande, dans toute la mesure où cette conclusion est justifiée ; en effet, la Cour ne saurait examiner la conclusion dont il s'agit pour autant qu'elle se réfère à des tierces personnes qui ne sont pas spécifiées.

### III.

L'existence d'un dommage à indemniser étant reconnue par la Partie défenderesse en ce qui concerne la Bayerische, et les objections soulevées par cette Partie contre l'existence d'un dommage justifiant une indemnisation de l'Oberschlesische étant écartées, la Cour doit maintenant fixer les critères d'après lesquels il y a lieu de procéder à la détermination du montant de l'indemnité due.

L'acte de la Pologne que la Cour a jugé être contraire à la Convention de Genève, n'est pas une expropriation à laquelle n'aurait manqué, pour être légitime, que le paiement d'une indemnité équitable ; c'est une mainmise sur des biens, droits et intérêts qui ne pouvaient être expropriés même contre indemnité, sauf dans les conditions exceptionnelles déterminées par l'article 7 de ladite Convention. Comme la Cour l'a expressément constaté dans son Arrêt n° 8, la réparation est, en l'espèce, la conséquence non pas de l'application des articles 6 à 22 de la Convention de Genève, mais d'actes qui sont contraires aux dispositions de ces articles.

annulment of the sale of the factory. Furthermore, the Court has stated that this article does not involve a prohibition of alienation, and that the rights reserved to the Allied and Associated Powers in the article are exercised through the Reparation Commission. But it would be difficult to understand how these rights could be affected by the payment to the Reich, as an indemnity, of the value of the factory, seeing that, without such a payment, the rights of the Reich in the enterprise would probably lose all value. The objection based on this article must therefore also be overruled.

The Court considers that it should confine itself to rejecting the submission whereby the Polish Government asks for a suspension, since by so doing and by overruling the objections raised by the Polish Government on the basis of Article 256 of the Treaty of Versailles, it is deciding in conformity with the German submission to the extent that that submission is well-founded; the Court cannot, in fact, consider the submission in question in so far as it relates to third parties who are not specified.

### III.

The existence of a damage to be made good being recognized by the respondent Party as regards the Bayerische, and the objections raised by the same Party against the existence of any damage that would justify compensation to the Oberschlesische being set aside, the Court must now lay down the guiding principles according to which the amount of compensation due may be determined.

The action of Poland which the Court has judged to be contrary to the Geneva Convention is not an expropriation—to render which lawful only the payment of fair compensation would have been wanting; it is a seizure of property, rights and interests which could not be expropriated even against compensation, save under the exceptional conditions fixed by Article 7 of the said Convention. As the Court has expressly declared in Judgment No. 8, reparation is in this case the consequence not of the application of Articles 6 to 22 of the Geneva Convention, but of acts contrary to those articles.

Il s'ensuit que l'indemnité due au Gouvernement allemand n'est pas nécessairement limitée à la valeur qu'avait l'entreprise au moment de la dépossession, plus les intérêts jusqu'au jour du paiement. Cette limitation ne serait admissible que si le Gouvernement polonais avait eu le droit d'exproprier et que si son tort se réduisait à n'avoir pas payé aux deux Sociétés le juste prix des choses expropriées ; dans le cas actuel, elle pourrait aboutir à placer l'Allemagne et les intérêts protégés par la Convention de Genève, et pour lesquels le Gouvernement allemand a pris fait et cause, dans une situation plus défavorable que celle dans laquelle l'Allemagne et ces intérêts se trouveraient si la Pologne avait respecté ladite Convention. Une pareille conséquence serait non seulement inique, mais aussi et avant tout incompatible avec le but visé par les articles 6 et suivants de la Convention, voire la défense, en principe, de liquider des biens, droits et intérêts des ressortissants allemands et des sociétés contrôlées par des ressortissants allemands en Haute-Silésie, car elle équivaldrait à identifier la liquidation licite et la dépossession illicite en ce qui concerne leurs effets financiers.

Le principe essentiel, qui découle de la notion même d'acte illicite et qui semble se dégager de la pratique internationale, notamment de la jurisprudence des tribunaux arbitraux, est que la réparation doit, autant que possible, effacer toutes les conséquences de l'acte illicite et rétablir l'état qui aurait vraisemblablement existé si ledit acte n'avait pas été commis. Restitution en nature, ou, si elle n'est pas possible, paiement d'une somme correspondant à la valeur qu'aurait la restitution en nature ; allocation, s'il y a lieu, de dommages-intérêts pour les pertes subies et qui ne seraient pas couvertes par la restitution en nature ou le paiement qui en prend la place ; tels sont les principes desquels doit s'inspirer la détermination du montant de l'indemnité due à cause d'un fait contraire au droit international.

Cette conclusion s'impose avec une force toute particulière à l'égard de la Convention de Genève, qui a pour but d'assurer le maintien de la vie économique en Haute-Silésie sur la base du respect du *statu quo*. La dépossession d'une entreprise industrielle, que la Convention défendait d'exproprier, a donc

It follows that the compensation due to the German Government is not necessarily limited to the value of the undertaking at the moment of dispossession, plus interest to the day of payment. This limitation would only be admissible if the Polish Government had had the right to expropriate, and if its wrongful act consisted merely in not having paid to the two Companies the just price of what was expropriated; in the present case, such a limitation might result in placing Germany and the interests protected by the Geneva Convention, on behalf of which interests the German Government is acting, in a situation more unfavourable than that in which Germany and these interests would have been if Poland had respected the said Convention. Such a consequence would not only be unjust, but also and above all incompatible with the aim of Article 6 and following articles of the Convention—that is to say, the prohibition, in principle, of the liquidation of the property, rights and interests of German nationals and of companies controlled by German nationals in Upper Silesia—since it would be tantamount to rendering lawful liquidation and unlawful dispossession indistinguishable in so far as their financial results are concerned.

The essential principle contained in the actual notion of an illegal act—a principle which seems to be established by international practice and in particular by the decisions of arbitral tribunals—is that reparation must, as far as possible, wipe out all the consequences of the illegal act and reestablish the situation which would, in all probability, have existed if that act had not been committed. Restitution in kind, or, if this is not possible, payment of a sum corresponding to the value which a restitution in kind would bear; the award, if need be, of damages for loss sustained which would not be covered by restitution in kind or payment in place of it—such are the principles which should serve to determine the amount of compensation due for an act contrary to international law.

This conclusion particularly applies as regards the Geneva Convention, the object of which is to provide for the maintenance of economic life in Upper Silesia on the basis of respect for the *status quo*. The dispossession of an industrial undertaking—the expropriation of which is prohibited by the



pour conséquence l'obligation de la restituer, et, si cela n'est pas possible, d'en payer la valeur à l'époque de l'indemnisation destinée à remplacer la restitution devenue impossible. A cette obligation s'ajoute, en vertu des principes généraux du droit international, celle d'indemniser les pertes éprouvées à la suite de la mainmise. L'impossibilité, constatée par un accord des Parties, de restituer l'usine de Chorzów ne saurait donc avoir d'autre effet que celui de remplacer la restitution par le paiement de la valeur de l'entreprise ; il ne serait conforme ni aux principes juridiques, ni à la volonté des Parties, d'en déduire que la question de l'indemnité doit désormais être traitée comme si l'on était sur le terrain d'une véritable expropriation.

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Tels étant les principes d'après lesquels il y a lieu de procéder à la détermination de l'indemnité due, il convient maintenant de rechercher si les dommages à indemniser doivent être évalués distinctement pour chacune des deux Sociétés, comme l'a fait la Partie demanderesse, ou s'il est préférable d'en déterminer la valeur globale.

Si la Cour était en présence de dommages qui, tout en étant causés par un même acte, auraient frappé des personnes indépendantes les unes des autres, la méthode qui s'imposerait naturellement serait l'évaluation séparée du dommage éprouvé par chacune d'elles ; la somme des indemnités ainsi évaluées constituerait alors le montant de la réparation due à l'État.

En l'espèce, la situation est différente. L'unité économique de l'entreprise de Chorzów, que la Cour a déjà fait remarquer dans son Arrêt n° 6, se manifeste surtout par le fait que les intérêts possédés par les deux Sociétés dans ladite entreprise sont interdépendants et complémentaires ; il s'ensuit qu'on ne saurait les additionner purement et simplement, sous peine d'indemniser deux fois le même dommage ; car tout ce que la Bayerische aurait retiré de sa participation à l'entreprise (redevances et parts des bénéfiques) aurait été à la charge de l'Oberschlesische. La valeur du droit d'option de la Bayerische à

Geneva Convention—then involves the obligation to restore the undertaking and, if this be not possible, to pay its value at the time of the indemnification, which value is designed to take the place of restitution which has become impossible. To this obligation, in virtue of the general principles of international law, must be added that of compensating loss sustained as the result of the seizure. The impossibility, on which the Parties are agreed, of restoring the Chorzów factory could therefore have no other effect but that of substituting payment of the value of the undertaking for restitution; it would not be in conformity either with the principles of law or with the wish of the Parties to infer from that agreement that the question of compensation must henceforth be dealt with as though an expropriation properly so called was involved.

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Such being the principles to be followed in fixing the compensation due, the Court may now consider whether the damage to be made good is to be estimated separately for each of the two Companies, as the Applicant has claimed, or whether it is preferable to fix a lump sum.

If the Court were dealing with damage which, though caused by a single act, had affected persons independent the one of the other, the natural method to be applied would be a separate assessment of the damage sustained by each of them; the total amount of compensation thus assessed would then constitute the amount of reparation due to the State.

In the present case, the situation is different. The economic unity of the Chorzów undertaking, pointed out by the Court in its Judgment No. 6, is shown above all in the fact that the interests possessed by the two Companies in the said undertaking are interdependent and complementary; it follows that they cannot simply be added together without running the risk of the same damage being compensated twice over; for all that the Bayerische would have obtained from its participation in the undertaking (sums due and shares in the profits) would have been payable by the Oberschlesische. The value

l'achat de l'usine dépendait également de la valeur de l'entreprise. Tous les dommages que l'une ou l'autre des Sociétés ont subis à la suite de la dépossession, pour autant qu'ils ont trait à la suppression de l'exploitation et à la perte des bénéfices qu'elle aurait rapportés, sont déterminés par la valeur de l'entreprise comme telle ; partant, les indemnités à fixer de ce chef doivent se tenir dans ce cadre.

D'autre part, il est clair que les rapports juridiques entre les deux Sociétés sont tout à fait étrangers à la procédure internationale et ne sauraient constituer un obstacle à ce que la Cour se place sur le terrain d'une évaluation globale, correspondant à la valeur de l'entreprise, si, comme elle l'estime, cette évaluation est plus simple et donne plus de garanties d'arriver à une juste appréciation du montant du dommage et d'éviter des doubles emplois.

Une réserve cependant s'impose. L'évaluation globale, ci-dessus visée, ne concerne que l'entreprise de Chorzów et n'exclut pas la possibilité de tenir compte d'autres dommages que les Sociétés auraient subis du fait de la dépossession, mais en dehors de l'entreprise elle-même. Aucun dommage de cette nature n'a été allégué en ce qui concerne l'Oberschlesische, et il ne semble guère concevable qu'il en existe, car toute l'activité de l'Oberschlesische était concentrée dans l'entreprise. Par contre, il est possible que des dommages de cet ordre se soient vérifiés pour ce qui est de la Bayerische, laquelle possède ou exploite d'autres usines du même genre que celle de Chorzów ; la Cour examinera plus tard si de tels dommages entrent en ligne de compte pour la fixation du montant de l'indemnité.

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Placée devant la nécessité de déterminer quelle est la somme qu'il convient d'allouer au Gouvernement allemand afin de lui permettre de remettre, autant que possible, les Sociétés dépossédées dans la situation économique dans laquelle elles se trouveraient vraisemblablement si la mainmise n'avait pas eu lieu, la Cour ne croit pas pouvoir se contenter des éléments d'évaluation qui lui ont été fournis par les Parties.

of the Bayerische's option on the factory depended also on the value of the undertaking. The whole damage suffered by the one or the other Company as the result of dispossession, in so far as concerns the cessation of the working and the loss of profit which would have accrued, is determined by the value of the undertaking as such; and, therefore, compensation under this head must remain within these limits.

On the other hand, it is clear that the legal relationship between the two Companies in no way concerns the international proceedings and cannot hinder the Court from adopting the system of a lump sum corresponding to the value of the undertaking, if, as is the Court's opinion, such a calculation is simpler and gives greater guarantees that it will arrive at a just appreciation of the amount, and avoid awarding double damages.

One reservation must, however, be made. The calculation of a lump sum referred to above concerns only the Chorzów undertaking, and does not exclude the possibility of taking into account other damage which the Companies may have sustained owing to dispossession, but which is outside the undertaking itself. No damage of such a nature has been alleged as regards the Oberschlesische, and it seems hardly conceivable that such damage should exist, for the whole activity of the Oberschlesische was concentrated in the undertaking. On the other hand, it is possible that damage of such a nature may be shown to exist as regards the Bayerische, which possesses or works other factories of the same nature as Chorzów; the Court will consider later whether such damage must be taken into account in fixing the amount of compensation.

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Faced with the task of determining what sum must be awarded to the German Government in order to enable it to place the dispossessed Companies as far as possible in the economic situation in which they would probably have been if the seizure had not taken place, the Court considers that it cannot be satisfied with the data for assessment supplied by the Parties.

Les frais de construction de l'usine de Chorzów, que le demandeur a pris pour base de son calcul en ce qui concerne l'indemnité de l'Oberschlesische, ont soulevé de la part du défendeur des objections et des critiques, qui ne sont peut-être pas dénuées de tout fondement. Sans entrer dans cette discussion et sans nier l'importance que les frais de construction pourront avoir dans la détermination de la valeur de l'entreprise, la Cour se borne à observer qu'il n'est certainement pas exclu que les frais encourus pour la construction d'une usine ne soient pas en rapport avec la valeur qu'aura l'usine une fois bâtie. Cette possibilité doit entrer particulièrement en ligne de compte lorsque, comme dans le cas présent, l'usine a été bâtie par l'État en vue de faire face à des exigences impérieuses d'intérêt public et au milieu de circonstances exceptionnelles comme celles créées par la guerre.

D'autre part, la Cour ne saurait pas non plus s'arrêter au prix stipulé dans le contrat du 24 décembre 1919 entre le Reich, l'Oberschlesische et la Treuhand, ou à l'offre de vente d'actions de l'Oberschlesische à la Compagnie de l'azote et des fertilisants de Genève faite le 26 mai 1922. Il a déjà été observé ci-dessus que la valeur de l'entreprise au moment de la dépossession ne constitue pas nécessairement la mesure pour la fixation de l'indemnité. Or, il est constant que le moment auquel remontent le contrat de vente et les négociations avec la Société genevoise appartient à une période de crise économique et monétaire profonde ; l'écart entre la valeur qu'avait alors l'entreprise et la valeur qu'elle aurait eu actuellement peut donc être fort considérable. Tout cela sans compter que le prix stipulé dans le contrat de 1919 était déterminé par des circonstances et accompagné de clauses qui, en réalité, ne permettent guère de le regarder comme la véritable expression de la valeur que les Parties attribuaient à l'usine ; et que l'offre à la Société genevoise s'explique probablement par la crainte de mesures du genre de celles que le Gouvernement polonais a effectivement prises peu après contre l'entreprise de Chorzów et que la Cour a jugé n'avoir pas été conformes à la Convention de Genève.

The cost of construction of the Chorzów factory, which the Applicant has taken as a basis for his calculation as regards compensation to the Oberschlesische, gave rise to objections and criticisms by the Respondent which are perhaps not without some foundation. Without entering into this discussion and without denying the importance which the question of cost of construction may have in determining the value of the undertaking, the Court merely observes that it is by no means impossible that the cost of construction of a factory may not correspond to the value which that factory will have when built. This possibility must more particularly be considered when, as in the present case, the factory was built by the State in order to meet the imperious demands of public necessity and under exceptional circumstances such as those created by the war.

Nor yet can the Court, on the other hand, be satisfied with the price stipulated in the contract of December 24th, 1919, between the Reich, the Oberschlesische and the Treuhand, or with the offer of sale of the shares of the Oberschlesische to the Geneva *Compagnie d'azote et de fertilisants* made on May 26th, 1922. It has already been pointed out above that the value of the undertaking at the moment of dispossession does not necessarily indicate the criterion for the fixing of compensation. Now it is certain that the moment of the contract of sale and that of the negotiations with the Genevese Company belong to a period of serious economic and monetary crisis; the difference between the value which the undertaking then had and that which it would have had at present may therefore be very considerable. And further, it must be considered that the price stipulated in the contract of 1919 was determined by circumstances and accompanied by clauses which in reality seem hardly to admit of its being considered as a true indication of the value which the Parties placed on the factory; and that the offer to the Genevese Company is probably to be explained by the fear of measures such as those which the Polish Government in fact adopted afterwards against the Chorzów undertaking, and which the Court has judged not to be in conformity with the Geneva Convention.

Pour ce qui est enfin de la somme sur laquelle les deux Gouvernements, à un moment donné, étaient tombés d'accord au cours des négociations qui suivirent l'Arrêt n° 7 — somme, d'ailleurs, à laquelle ni l'une ni l'autre Partie n'a cru devoir se référer au cours de la présente procédure —, il suffit de rappeler que la Cour ne saurait faire état des déclarations, admissions ou propositions qu'ont pu faire les Parties au cours des négociations directes qui ont eu lieu entre elles, lorsque ces négociations n'ont pas abouti à un accord complet.

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Dans ces circonstances, la Cour, afin d'éclairer sa religion, ayant toute détermination de l'indemnité que le Gouvernement polonais doit payer au Gouvernement allemand, fera procéder, conformément à l'article 50 de son Statut et aux suggestions mêmes de la Partie demanderesse, à une expertise. Cette expertise, dont les modalités sont déterminées par une Ordonnance en date de ce jour d'hui, portera sur les questions suivantes :

I. — A. Quelle était la valeur, exprimée en Reichsmarks actuels, au 3 juillet 1922, de l'entreprise pour la fabrication de produits azotés dont l'usine était sise à Chorzów, en Haute-Silésie polonaise, telle que cette entreprise (y compris les terrains, bâtiments, outillage, stocks, procédés dont elle disposait, contrats de fourniture et de livraison, clientèle et chances d'avenir) se trouvait à la date indiquée entre les mains des Bayerische et Oberschlesische Stickstoffwerke ?

B. Quels auraient été les résultats financiers, exprimés en Reichsmarks actuels (profits ou pertes), que l'entreprise ainsi constituée aurait vraisemblablement donnés depuis le 3 juillet 1922 jusqu'à la date du présent arrêt, entre les mains desdites Sociétés ?

II. — Quelle serait la valeur, exprimée en Reichsmarks actuels, à la date du présent arrêt, de ladite entreprise de Chorzów, si cette entreprise (y compris les terrains, bâtiments, outillage, stocks, procédés disponibles, contrats de fourniture et de livraison, clientèle et chances d'avenir), étant restée entre les mains des Bayerische et Oberschlesische Stickstoffwerke, soit était demeurée essentiellement en l'état de 1922, soit avait reçu, toutes proportions gardées, un développement analogue à

And finally as regards the sum agreed on at one moment by the two Governments during the negotiations which followed Judgment No. 7—which sum, moreover, neither Party thought fit to rely on during the present proceedings—it may again be pointed out that the Court cannot take into account declarations, admissions or proposals which the Parties may have made during direct negotiations between themselves, when such negotiations have not led to a complete agreement.

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This being the case, and in order to obtain further enlightenment in the matter, the Court, before giving any decision as to the compensation to be paid by the Polish Government to the German Government, will arrange for the holding of an expert enquiry, in conformity with Article 50 of its Statute and actually with the suggestions of the Applicant. This expert enquiry, directions for which are given in an Order of Court of to-day's date, will refer to the following questions:

I.—A. What was the value, on July 3rd, 1922, expressed in Reichsmarks current at the present time, of the undertaking for the manufacture of nitrate products of which the factory was situated at Chorzów in Polish Upper Silesia, in the state in which that undertaking (including the lands, buildings, equipment, stocks and processes at its disposal, supply and delivery contracts, goodwill and future prospects) was, on the date indicated, in the hands of the Bayerische and Oberschlesische Stickstoffwerke?

B. What would have been the financial results, expressed in Reichsmarks current at the present time (profits or losses), which would probably have been given by the undertaking thus constituted from July 3rd, 1922, to the date of the present judgment, if it had been in the hands of the said Companies?

II.—What would be the value at the date of the present judgment, expressed in Reichsmarks current at the present time, of the same undertaking (Chorzów) if that undertaking (including lands, buildings, equipment, stocks, available processes, supply and delivery contracts, goodwill and future prospects) had remained in the hands of the Bayerische and Oberschlesische Stickstoffwerke, and had either remained substantially as it was in 1922 or had been developed proportionately on



celui d'autres entreprises du même genre, dirigées par la Bayerische, par exemple l'entreprise dont l'usine est sise à Piesteritz ?

La question I a pour but d'établir la valeur en argent, tant de l'objet qui aurait dû être restitué en nature que du dommage supplémentaire, sur la base de la valeur estimée de l'entreprise, y compris les stocks, au moment de la prise de possession par le Gouvernement polonais, augmentée du profit éventuel présumable de cette entreprise entre la date de la prise de possession et celle de l'expertise.

D'autre part, la question II vise à arriver à la valeur actuelle en se fondant sur la situation au moment de l'expertise et en laissant de côté la situation présumée en 1922.

Cette question envisage la valeur actuelle de l'entreprise à deux points de vue : en premier lieu, on suppose que l'usine serait restée essentiellement dans l'état où elle se trouvait à la date du 3 juillet 1922, et en second lieu on envisage l'usine telle que celle-ci aurait hypothétiquement, mais raisonnablement, dû être entre les mains de l'Oberschlesische et de la Bayerische, si, au lieu d'être prise en 1922 par la Pologne, l'entreprise avait pu poursuivre son développement présumé normal à partir de cette époque. Le caractère hypothétique de cette question est atténué considérablement par la possibilité de la comparaison avec d'autres entreprises du même genre, dirigées par la Bayerische, et surtout avec l'usine de Piesteritz, dont l'analogie avec l'usine de Chorzów, de même d'ailleurs que certaines différences entre les deux, ont été signalées à maintes reprises au cours de la présente procédure.

A cet égard, il y a lieu d'observer que l'agent du Gouvernement allemand a déposé, au cours de la séance publique du 21 juin 1928, deux certificats notariés contenant un résumé des contrats passés le 16 avril 1925 et le 27 août 1927 entre la *Mitteldeutsche Stickstoffwerke A.-G.* et la Bayerische avec adhésion des *Vereinigte Industrie-Unternehmungen A.-G.*, contrats moyennant lesquels les Mitteldeutsche donnent en bail à la Bayerische les biens-fonds à Piesteritz leur appartenant avec toutes les installations et pertinences y afférentes. L'agent du Gouvernement polonais cependant, dans sa plaidoirie du 25 juin,

lines similar to those applied in the case of other undertakings of the same kind, controlled by the Bayerische, for instance, the undertaking of which the factory is situated at Piesteritz?

The purpose of question I is to determine the monetary value, both of the object which should have been restored in kind and of the additional damage, on the basis of the estimated value of the undertaking including stocks at the moment of taking possession by the Polish Government, together with any probable profit that would have accrued to the undertaking between the date of taking possession and that of the expert opinion.

On the other hand, question II is directed to the ascertainment of the present value on the basis of the situation at the moment of the expert enquiry and leaving aside the situation presumed to exist in 1922.

This question contemplates the present value of the undertaking from two points of view: firstly, it is supposed that the factory had remained essentially in the state in which it was on July 3rd, 1922, and secondly, the factory is to be considered in the state in which it would (hypothetically but probably) have been in the hands of the Oberschlesische and Bayerische, if, instead of being taken in 1922 by Poland, it had been able to continue its supposedly normal development from that time onwards. The hypothetical nature of this question is considerably diminished by the possibility of comparison with other undertakings of the same nature directed by the Bayerische, and, in particular, with the Piesteritz factory, the analogy of which with Chorzów, as well as certain differences between the two, have been many times pointed out during the present proceedings.

In regard to this, it should be observed that the Agent for the German Government, at the public sitting of June 21st, 1928, handed in two certificates by notaries containing a summary of contracts concluded on April 16th, 1925, and August 27th, 1927, between the *Mitteldeutsche Stickstoffwerke A.-G.* and the Bayerische, and adhered to by the *Vereinigte Industrie-Unternehmungen A.-G.*, under which contracts the Mitteldeutsche leased to the Bayerische the landed properties at Piesteritz belonging to it, together with all installations, etc., connected therewith. The Agent for the Polish Govern-

a déclaré que, ne connaissant pas les contrats, et ne pouvant nullement apprécier si les résumés en question contiennent tous les éléments nécessaires pour faire des calculs exacts, il s'opposait formellement à ce que lesdits résumés fussent pris pour base des présents débats.

En ce qui concerne le *lucrum cessans*, par rapport à la question II, il convient d'observer que les dépenses d'entretien des choses corporelles faisant partie de l'entreprise et même les dépenses d'amélioration et de développement normal des installations et de la propriété industrielle y incorporée, doivent absorber en première ligne les profits, présumables ou réels, de l'entreprise. Il y a donc lieu de faire abstraction, jusqu'à un certain point, des profits éventuels, car ils se trouveront être compris dans la valeur hypothétique ou réelle de l'entreprise au moment actuel. Si, cependant, de la réponse que les experts donneront à la question I B, il devait résulter qu'après compensation des déficits des années pendant lesquelles l'usine a fonctionné à perte et après application aux dépenses d'entretien et d'amélioration normale pendant les années suivantes, il reste une marge de profits, le montant de cette marge devrait être additionné à l'indemnité à allouer.

D'autre part, si le développement normal présupposé par la question II représentait un élargissement de l'entreprise et un investissement de capitaux nouveaux, leur montant devrait être déduit de la valeur recherchée.

La Cour ne manque pas de se rendre compte des difficultés que présentent ces deux questions : difficultés d'ailleurs inhérentes au cas spécial dont il s'agit et liées avec le temps qui s'est écoulé entre la dépossession et la demande en indemnité et avec les transformations de l'usine et les progrès de l'industrie qui en forme l'objet. C'est en vue de ces difficultés qu'elle estime préférable de chercher à arriver par des méthodes différentes à la valeur recherchée, afin de permettre une comparaison et de pouvoir éventuellement compléter les résultats de l'une par ceux des autres. Partant, la Cour se réserve toute liberté d'apprécier les évaluations visées par les diverses formules ; c'est sur la base des résultats desdites évaluations, ainsi que des faits et documents qui lui ont été soumis, qu'elle procédera à la fixation de la somme qu'il convient d'allouer

ment, however, in his speech on June 25th, said that, not being acquainted with the contracts and being entirely unable to form an opinion as to whether the summaries in question contained all the data necessary for accurate calculations, he formally objected to the said summaries being taken as a basis in the present proceedings.

As regards the *lucrum cessans*, in relation to question II, it may be remarked that the cost of upkeep of the corporeal objects forming part of the undertaking and even the cost of improvement and normal development of the installation and of the industrial property incorporated therein, are bound to absorb in a large measure the profits, real or supposed, of the undertaking. Up to a certain point, therefore, any profit may be left out of account, for it will be included in the real or supposed value of the undertaking at the present moment. If, however, the reply given by the experts to question I B should show that after making good the deficits for the years during which the factory was working at a loss, and after due provision for the cost of upkeep and normal improvement during the following years, there remains a margin of profit, the amount of such profit should be added to the compensation to be awarded.

On the other hand, if the normal development presupposed by question II represented an enlargement of the undertaking and an investment of fresh capital, the amount of such sums must be deducted from the value sought for.

The Court does not fail to appreciate the difficulties presented by these two questions, difficulties which are however inherent in the special case under consideration, and closely connected with the time that elapsed between the dispossession and the demand for compensation, and with the transformations of the factory and the progress made in the industry with which the factory is concerned. In view of these difficulties, the Court considers it preferable to endeavour to ascertain the value to be estimated by several methods, in order to permit of a comparison and if necessary of completing the results of the one by those of the others. The Court, therefore, reserves every right to review the valuations referred to in the different formulæ; basing itself on the results of the said valuations and of facts and documents submitted to it, it will then

au Gouvernement allemand, conformément aux principes de droit qui ont été résumés ci-dessus.

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Il convient de constater que l'usine de Chorzów, à évaluer par les experts, comprend aussi l'usine chimique.

Le Gouvernement polonais, à côté des arguments qui, dans son opinion, auraient pour effet de démontrer que l'exploitation de ladite usine n'aurait pu être profitable — arguments qu'il appartiendra aux experts d'apprécier —, a fait valoir que l'exploitation dépendait d'une autorisation spéciale, et que les autorités polonaises étaient en droit de la refuser. Mais la Cour est d'avis que cette thèse n'est pas fondée.

L'autorisation visée semble être celle dont il est question dans le paragraphe 18 de la loi prussienne de 1861, aux termes duquel, sauf dispositions contraires d'un traité international, les personnes morales étrangères ne peuvent exercer une industrie sans l'autorisation du Gouvernement. Or, dans le cas dont il s'agit, il est certain que la Convention de Genève constitue bien le traité international qui, garantissant aux entreprises industrielles la continuation de leur activité, exclut toute nécessité de l'autorisation spéciale requise par la loi de 1861.

Le fait que l'usine chimique non seulement ne fonctionnait pas, mais encore n'était pas même achevée lors du transfert du territoire à la Pologne, ne saurait entrer en ligne de compte ; en effet, l'industrie chimique de toute espèce était expressément mentionnée dans les statuts de l'Oberschlesische comme un des buts de l'activité de cette Société, et les sections et installations de l'usine chimique, d'ailleurs étroitement liées aux sections et installations où était produite la chaux azotée, avaient été déjà prévues et mentionnées dans le contrat de construction et d'exploitation du 5 mars 1915 ; de la sorte, l'entrée en fonctionnement de l'usine n'était que le développement normal et prévu de l'activité industrielle que l'Oberschlesische avait le droit d'exercer en Haute-Silésie polonaise.

proceed to determine the sum to be awarded to the German Government, in conformity with the legal principles set out above.

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It must be stated that the Chorzów factory to be valued by the experts includes also the chemical factory.

Besides the arguments which, in the Polish Government's opinion, tend to show that the working of the said factory was not established on a profitable basis—arguments which it will be for the experts to consider—that Government has claimed that the working depended on a special authorization, which the Polish authorities were entitled to refuse. But the Court is of opinion that this argument is not well-founded.

The authorization referred to seems to be that envisaged by paragraph 18 of the Prussian law of 1861, under which, failing international treaty provisions to the contrary, moral persons of foreign nationality cannot engage in industry without the authorization of the Government. In the present case, it is certain that the Geneva Convention does actually constitute the international treaty which, guaranteeing to industrial undertakings the continuation of their activities, does away with any necessity for the special authorization required by the law of 1861.

The fact that the chemical factory was not only not working, but not even completed, at the time of transfer of the territory to Poland, can be of no importance; for chemical industry of all kinds was expressly mentioned in the articles of the Oberschlesische Company as one of the objects of that Company's activities, and the sections and plant of the chemical factory, which were, moreover, closely connected with the sections and plant producing nitrate of lime, had already been provided for and mentioned in the contract for construction and exploitation of March 5th, 1915; thus, the entry into working of the factory was only the normal and duly foreseen development of the industrial activity which the Oberschlesische had the right to exercise in Polish Upper Silesia.

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De l'avis de la Cour, la valeur envisagée par les questions formulées ci-dessus suffira pour lui permettre de fixer, en connaissance de cause, le montant de l'indemnité à laquelle a droit le Gouvernement allemand, en prenant comme mesure les dommages subis par les deux Sociétés dans l'entreprise de Chorzów.

Il est vrai que le Gouvernement allemand a fait valoir à plusieurs reprises, au cours de la procédure écrite et orale, qu'une indemnisation équitable du dommage éprouvé par la Bayerische ne saurait se borner au montant de la valeur de ce qu'on a appelé les « droits contractuels », savoir, la rémunération stipulée dans les contrats entre le Reich ou l'Oberschlesische et ladite Société, pour la mise à disposition de ses brevets, licences, expériences, etc., ainsi que pour la direction et l'organisation de la vente des produits finis. La raison en serait que cette rémunération, acceptée en vue des rapports particuliers qui liaient les Parties, ne correspondrait guère à la rémunération équitable à laquelle la Bayerische aurait pu, pour les mêmes prestations, prétendre d'un tiers quelconque, comme le Gouvernement polonais. C'est en partant de ce point de vue que le Gouvernement allemand a proposé de prendre pour base de l'évaluation du dommage souffert par la Bayerische, un contrat de licence, qui serait supposé conclu entre un tiers et ladite Société, dans des conditions normales et équitables.

Le point de vue auquel s'est placée la Cour en posant aux experts les questions indiquées ci-dessus, donne cependant satisfaction à la thèse du Gouvernement allemand pour autant qu'elle est justifiée. Car, si la Bayerische avait demandé une redevance plus élevée ou des paiements supplémentaires en sa faveur, ou bien si elle avait stipulé d'autres conditions à son profit, la valeur de son apport pour l'Oberschlesische en serait diminuée dans la même mesure, ce qui prouve que la relation entre prestation et contre-prestation n'entre pas en ligne de compte pour la valeur de l'entreprise dans son ensemble. Si la Bayerische avait eu, non seulement la direction, mais aussi la propriété de l'entreprise, cette valeur serait encore la même ;

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In the Court's opinion, the value to which the above questions relate will be sufficient to permit it with a full knowledge of the facts to fix the amount of compensation to which the German Government is entitled, on the basis of the damage suffered by the two Companies in connection with the Chorzów undertaking.

It is true that the German Government has pointed out several times during the written and oral proceedings that fair compensation for damage suffered by the Bayerische could not be limited to the value of what has been called the "contractual rights", namely, the remuneration provided for in the contracts between the Reich or the Oberschlesische and the said Company for having made available its patents, licences and experience gained, for the management and for the organization of the sale of the finished products. The reason given is that this remuneration, which was accepted in view of the special relationship between the Parties, would hardly correspond to the fair remuneration which the Bayerische might have claimed from any third party, like the Polish Government, for the same consideration. It was on these grounds that the German Government proposed to take as a basis for the calculation of damage suffered by the Bayerische a licence supposed to be granted by the said Company to a third party under fair and normal conditions.

The method adopted by the Court in putting the questions set out above to the experts meets the German Government's contention, in so far as that contention is justified. For if the Bayerische had demanded a larger sum or additional payments in its favour, or if it had stipulated for other conditions to its advantage, the value to the Oberschlesische of its participation would to the same extent be diminished; this shows that the relation between value given and value received does not enter into consideration in calculating the worth of the enterprise as a whole. If the Bayerische had not merely managed but also owned the undertaking, this amount would still be the same; in fact, all the elements constituting the



en effet, tous les éléments qui constituent l'entreprise — l'usine avec ses accessoires, d'une part, l'apport incorporel et autre de la Bayerische, d'autre part — sont indépendants des avantages qu'aux termes de ses contrats chacune des deux Sociétés peut retirer de l'entreprise.

Pour cette raison, la différence qui pourrait exister entre les conditions stipulées dans les contrats de 1915, 1919 et 1920 et celles d'un supposé contrat de licence avec un tiers, est sans importance pour l'évaluation du dommage.

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Il ne reste alors qu'à examiner si, conformément à la réserve faite ci-dessus, la Bayerische a subi, par suite de la dépossession, des dommages autres que ceux qu'a subis l'entreprise et qui pourraient entrer en ligne de compte aux fins de l'indemnisation demandée par le Gouvernement allemand.

Bien que la position prise à cet égard par ledit Gouvernement ne lui semble pas claire, la Cour peut constater qu'il n'a pas manqué d'appeler l'attention sur certaines circonstances qui seraient de nature à démontrer l'existence de dommages de cet ordre. La possibilité d'une concurrence nuisible aux usines de la Bayerische par une tierce personne qui, moyennant un fait illicite, se serait procurée la connaissance et l'utilisation des procédés de fabrication de cette Société, est certainement la circonstance la plus importante et la plus facile à saisir dans cet ordre d'idées.

La Cour doit cependant observer qu'elle ne se trouve pas en possession d'éléments permettant de déterminer l'existence et l'étendue du dommage qui résulterait de la concurrence que l'usine de Chorzów aurait faite aux usines de la Bayerische; la Cour ne saurait pas même dire, en connaissance de cause, si l'on a employé et si l'on emploie encore à Chorzów les méthodes de la Bayerische, ni si les produits de cette usine se trouvent sur les marchés où la Bayerische vend ou pourrait vendre les produits de ses usines. Dans ces conditions, la Cour ne peut que constater le fait que le dommage qui aurait résulté de la concurrence est insuffisamment établi.

undertaking—the factory and its accessories on the one hand, the non-corporeal and other values supplied by the Bayerische on the other—are independent of the advantages which, under its contracts, each of the two Companies may derive from the undertaking.

For this reason, any difference which might exist between the conditions fixed in the contracts of 1915, 1919 and 1920 and those laid down in a contract supposed to be concluded with a third party, is of no importance in estimating the damage.

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It therefore only remains to be considered whether, in conformity with the reservation made above, the Bayerische has, owing to the dispossession, suffered damage, other than that sustained by the undertaking, such as might be considered in calculating the compensation demanded by the German Government.

Although the position taken up on this subject by the German Government does not seem clear to it, the Court is in a position to state that this Government has not failed to draw attention to certain circumstances which are said to prove the existence of damage of such a nature. The possibility of competition injurious to the Bayerische's factories by a third party, alleged to have unlawfully become acquainted with and have obtained means of making use of that Company's processes, is certainly the circumstance which is most important and easiest to appreciate in this connection.

The Court must however observe that it has not before it the data necessary to enable it to decide as to the existence and extent of damage resulting from alleged competition of the Chorzów factory with the Bayerische factories; the Court is not even in a position to say for certain whether the methods of the Bayerische have been or are still being employed at Chorzów, nor whether the products of that factory are to be found in the markets in which the Bayerische sells or might sell products from its own factories. In these circumstances, the Court can only observe that the damage alleged to have resulted from competition is insufficiently proved.

Il rentrerait en outre dans la catégorie des dommages possibles mais éventuels et indéfinis dont, conformément à la jurisprudence arbitrale, il n'y a pas lieu de tenir compte.

Il en est de même, à plus forte raison, du dommage qui pourrait résulter du fait que la Bayerische a vu restreindre le champ où elle peut faire des expériences, perfectionner ses procédés et en trouver des nouveaux, ainsi que du dommage qui pourrait résulter du fait qu'elle n'est plus à même de faire sentir son influence sur le marché dans la mesure où elle aurait pu le faire si elle était restée à la direction de l'usine de Chorzów.

La Cour ayant écarté, faute de preuves suffisantes, les dommages que la Bayerische aurait subis hors de l'entreprise, il n'est pas nécessaire d'examiner si les intérêts dont il s'agit seraient protégés par les articles 6 à 22 de la Convention de Genève.

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En plus de l'indemnité en argent au bénéfice de la Bayerische, le Gouvernement allemand demande à la Cour de dire et juger :

« que, jusqu'au 30 juin 1931, aucune exportation de chaux azotée et de nitrate d'ammoniaque n'aura lieu en Allemagne, dans les États-Unis d'Amérique, en France et en Italie ;

subsidièrement, que le Gouvernement polonais est obligé de cesser l'exploitation de l'usine, respectivement des installations chimiques pour produire le nitrate d'ammoniaque, etc. »

Au sujet de ces conclusions, il convient de constater, tout d'abord, qu'elles ne sauraient viser le dommage qui s'est déjà produit, mais uniquement celui que pourrait souffrir la Bayerische à l'avenir.

Si la défense d'exportation a pour objet le dommage résultant de la concurrence que l'usine de Chorzów serait à même de faire aux usines de la Bayerische, elle doit être écartée sans autre, en vertu du résultat auquel la Cour est arrivée ci-dessus. Aux raisons sur lesquelles se fondait ce résultat s'ajoute, en ce qui concerne la défense d'exportation, que la Partie demanderesse n'a fourni aucun renseignement qui permette à

Moreover, it would come under the heading of possible but contingent and indeterminate damage which, in accordance with the jurisprudence of arbitral tribunals, cannot be taken into account.

This is more especially the case as regards damage which might arise from the fact that the field in which the Bayerische can carry out its experiments, perfect its processes and make fresh discoveries has been limited, and from the fact that the Company can no longer influence the market in the manner that it could have done if it had continued to work the Chorzów factory.

As the Court has discarded for want of evidence, indemnity for damage alleged to have been sustained by the Bayerische outside the undertaking, it is not necessary to consider whether the interests in question would be protected by Articles 6 to 22 of the Geneva Convention.

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In addition to pecuniary damages for the benefit of the Bayerische, the German Government asks the Court to give judgment:

“that, until June 30th, 1931, no nitrated lime and no nitrate of ammonia should be exported to Germany, to the United States of America, to France or to Italy;

in the alternative, that the Polish Government should be obliged to cease working the factory or the chemical equipment for the production of nitrate of ammonia, etc.”

In regard to these submissions, it should be observed in the first place that they cannot contemplate damage already sustained, but solely damage which the Bayerische might suffer in the future.

If the prohibition of export is designed to prevent damage arising from the competition which the Chorzów factory might offer to the Bayerische factories, this claim must be at once dismissed, in view of the result arrived at above by the Court. To the reasons on which this result was based, it is to be added, in so far as the prohibition of export is concerned, that the Applicant has furnished no information

la Cour d'admettre le bien-fondé de la conclusion allemande relativement à la désignation de certains pays dans lesquels aucune exportation ne devrait avoir lieu, et à une durée déterminée de cette défense.

Il convient encore d'observer que si la défense avait pour but de protéger les droits de propriété industrielle de la Bayerische et d'exclure le dommage que celle-ci pourrait éprouver par l'usage de ces droits par la Pologne en contradiction avec des licences accordées par la Bayerische à d'autres personnes ou sociétés, le Gouvernement allemand aurait dû fournir des renseignements précis en ce qui concerne l'existence et la durée des brevets et licences en question. Mais, malgré les demandes expresses formulées à ce sujet par le Gouvernement polonais, le Gouvernement allemand n'en a pas présenté. Cela s'explique, d'ailleurs, par le fait que le Gouvernement allemand ne paraît pas vouloir fonder sur l'existence de ces brevets et licences sa demande visant une défense d'exportation.

Par contre, la demande du Gouvernement allemand semble envisager la défense d'exportation sous la forme d'une clause qui aurait dû se trouver dans un contrat de licence juste et équitable, conclu entre la Bayerische et une tierce personne quelconque ; à ce sujet, il y a lieu de faire les observations suivantes :

Le simple fait d'exclure de tel ou tel marché les produits d'une entreprise déterminée ne saurait évidemment en lui-même être dans l'intérêt ni de cette entreprise, ni, en tant que telles, des personnes qui y sont intéressées. Si la Bayerische — qui, tout en participant avec l'Oberschlesische dans l'entreprise de Chorzów, constitue une entreprise absolument distincte de celle de Chorzów et pouvant même avoir des intérêts contraires, dans une certaine mesure, à ceux de Chorzów — limitait par une clause contractuelle les débouchés de l'usine en sa faveur, il s'ensuivrait que les bénéfices qu'elle retirerait de sa participation à l'entreprise de Chorzów se trouveraient éventuellement diminués dans une mesure correspondante. La Cour ayant, comme il est dit plus haut, adopté pour le calcul de l'indemnité à allouer au Gouvernement allemand une méthode suivant laquelle cette indemnité comprendra la valeur globale de l'entreprise, il s'ensuit que les bénéfices de la Bayerische seront évalués sans déduction des avantages qui pourraient résulter pour elle d'une clause limitant la faculté d'ex-

enabling the Court to satisfy itself as to the justification for the German submission naming certain countries to which export should not be allowed and stating a definite period for which this prohibition should be in force.

It must further be observed that if the object of the prohibition were to protect the industrial property rights of the Bayerische and to prevent damage which the latter might suffer as a result of the use of these rights by Poland, in conflict with licences granted by the Bayerische to other persons or companies, the German Government should have furnished definite data as regards the existence and duration of the patents or licences in question. But notwithstanding the express requests made in this respect by the Polish Government, the German Government has produced no such data. The explanation no doubt is that the German Government does not appear to wish to base its claim respecting a prohibition of export upon the existence of these patents and licences.

On the contrary, the German Government's claim seems to present the prohibition of export as a clause which should have been included in a fair and equitable licensing contract concluded between the Bayerische and any third party; in this connection the following remarks should be made:

The mere fact that the produce of any particular undertaking is excluded from any particular market cannot evidently in itself be in the interests of such undertaking, nor of the persons who, as such, are interested therein. If the Bayerische—which, whilst participating with the Oberschlesische in the Chorzów undertaking, constitutes an entirely separate undertaking from that of Chorzów and one that may even to a certain extent have interests conflicting with those of Chorzów—were to limit in its own favour, by contract, the number of the markets of that factory, it would follow that the profit which it would draw from its share in the Chorzów undertaking might be correspondingly diminished. The Court having, as is said above, adopted, in calculating the compensation to be awarded to the German Government, a method by which such compensation shall include the total value of the undertaking, it follows that the profits of the Bayerische will be estimated without deducting the advantages which that Company might draw from a clause limiting export. The

portation. La défense d'exportation demandée par le Gouvernement allemand ne saurait donc être accordée sous peine de donner deux fois la même indemnité.

Dès lors, la Cour n'a pas besoin de s'occuper de la question de savoir si une telle défense, tout en étant usitée dans les contrats entre particuliers, pourrait faire l'objet d'une injonction adressée par la Cour à un gouvernement, même si ce gouvernement, en tant que fisc, exploitait l'usine dont les exportations devraient être limitées, ni si la défense demandée serait équitable et appropriée dans les circonstances.

Pour ce qui est de la défense d'exploitation, subsidiairement demandée par le Gouvernement allemand, il y a lieu d'ajouter qu'elle ne semble guère compatible avec l'allocation d'une indemnité représentant la valeur actuelle de l'entreprise, car, lorsqu'aura été versée cette indemnité qui comprendra les chances d'avenir et sera constituée par une somme d'argent portant intérêts, le Gouvernement polonais aura acquis le droit de continuer l'exploitation de l'entreprise telle qu'elle aura été évaluée, d'autant plus qu'il y a accord entre les Parties pour reconnaître que l'usine doit rester entre les mains du Gouvernement polonais. Cet accord ne saurait être interprété dans ce sens que l'usine devrait rester une usine morte ou être adaptée à une destination différente, si la réparation envisagée ne comprenait pas, en dehors d'une indemnité pécuniaire, la défense d'exportation demandée. Il est d'ailleurs fort douteux que, abstraction faite de toute autre considération, une défense d'exploitation soit admissible sous l'empire de la Convention de Genève, laquelle a pour but d'assurer le maintien des entreprises industrielles, et qui, à cet effet, en permet même exceptionnellement l'expropriation (article 7).

#### IV.

La Cour estime préférable de ne pas examiner dès maintenant les conclusions des Parties concernant certaines conditions et modalités du paiement de l'indemnité à allouer, qui sont étroitement liées, soit au montant de la somme à payer, soit aux circonstances qui pourront exister au moment où le paiement devra être fait. Il en est ainsi notamment de la conclusion allemande n° 4 a) — b) — c) et des conclusions

prohibition of export asked for by the German Government cannot therefore be granted, or the same compensation would be awarded twice over.

This being so, the Court need not deal with the question whether such a prohibition, although customary in contracts between individuals, might form the subject of an injunction issued by the Court to a government, even if that government were working, as a State enterprise, the factory of which export was to be limited, nor if the prohibition asked for would be fair and appropriate in the circumstances.

As regards the German Government's alternative claim for a prohibition of exploitation, it may be added that this seems hardly compatible with the award of compensation representing the present value of the undertaking; for when that compensation, which is to cover future prospects and will consist in a sum of money bearing interest, has been paid, the Polish Government will have acquired the right to continue working the undertaking as valued, more especially as the Parties agree that the factory shall remain in the hands of the Polish Government. This agreement cannot, in fact, be construed as meaning that the factory should remain inoperative or be adapted to some other purpose, if the reparation contemplated did not include, in addition to a pecuniary indemnity, the prohibition of export sought for. It is moreover very doubtful whether, apart from any other consideration, prohibition of exploitation is admissible under the Geneva Convention, the object of which is to provide for the maintenance of industrial undertakings, and which, for this purpose, even permits them, in exceptional cases, to be expropriated (Article 7).

#### IV.

The Court thinks it preferable not to proceed at this stage to consider the Parties' submissions concerning certain conditions and methods in regard to the payment of the indemnity to be awarded, which conditions and methods are closely connected either with the amount of the sum to be paid or with circumstances which may exist when the time comes for payment. This applies more especially as regards the



polonaises A 3 et B I c), sur lesquelles, partant, la Cour se réserve de statuer dans l'arrêt qui fixera l'indemnité.

Il est, par contre, possible et convenable de trancher dès à présent la question dite de la compensation, à laquelle ont traité respectivement la conclusion n° 4 d) de la Partie demanderesse et la conclusion C de la Partie défenderesse.

La demande du Gouvernement allemand à cet égard a pris finalement la forme suivante :

« Dire et juger, que le Gouvernement polonais n'est pas autorisé à compenser contre la créance susdite du Gouvernement allemand d'être indemnisé, sa créance résultant des assurances sociales en Haute-Silésie ; qu'il ne peut se prévaloir d'aucune autre compensation contre ladite créance d'indemnité ; subsidiairement, qu'une compensation n'est autorisée que lorsque le Gouvernement polonais invoque à cette fin une créance reconnue par le Gouvernement allemand ou constatée par un arrêt rendu entre les deux Gouvernements. »

Quant au Gouvernement polonais, il s'est borné à demander le rejet de la susdite conclusion.

Si l'on prend la conclusion allemande au pied de la lettre, on peut croire qu'elle vise en premier lieu à exclure un cas de compensation concret, savoir la compensation qui résulterait de la créance que le Gouvernement polonais prétend avoir en vertu des assurances sociales en Haute-Silésie, et qui fut cause de l'échec des négociations entre les deux Gouvernements à la suite de l'Arrêt n° 7. Mais, si l'on examine la conclusion à la lumière des observations contenues dans le Mémoire et surtout dans la Réplique, il est facile de constater que la créance résultant des assurances sociales en Haute-Silésie n'est visée qu'à titre d'exemple. En réalité, le Gouvernement allemand demande à la Cour une décision de principe, dont l'effet serait, soit d'exclure toute compensation de la créance résultant du futur arrêt de la Cour, soit, subsidiairement, de n'admettre pareille compensation que dans des circonstances déterminées.

Quant au Gouvernement polonais, s'il se borne, comme on l'a vu plus haut, à demander dans sa conclusion le rejet de la conclusion allemande, il résulte avec certitude des motifs à

German submission No. 4 (a)—(b)—(c), and the Polish submissions A 3 and B I (c), which the Court therefore reserves for the judgment fixing the indemnity.

On the other hand, it is possible and convenient at once to decide the so-called question of set-off to which submission No. 4 (d) of the Applicant and submission C of the Respondent respectively relate.

The claim of the German Government in regard to this matter has, in the last instance, been couched in the following terms:

[*Translation.*]

“It is submitted that the Polish Government is not entitled to set off, against the above-mentioned claim for indemnity of the German Government, its claim in respect of social insurances in Upper Silesia; that it may not make use of any other set-off against the above-mentioned claim for indemnity; in the alternative, that set-off is only permissible if the Polish Government puts forward for this purpose a claim in respect of a debt recognized by the German Government or established by a judgment given between the two Governments.”

The Polish Government, for its part, has simply asked for the rejection of this submission.

If the German submission is read literally, it is possible to regard it as mainly designed to prevent a specific case of set-off, that is to say, the setting-off in this case of the claim which the Polish Government contends that it possesses in respect of social insurances in Upper Silesia, and which was the cause of the failure of the negotiations between the two Governments following Judgment No. 7. But, if we consider the submission in the light of the observations contained in the Case and more especially in the Reply, it is easy to see that the claim in respect of social insurances in Upper Silesia is only taken as an example. In reality, the German Government asks the Court for a decision of principle the effect of which would be either to prevent the set-off of any counter-claim against the indemnity fixed in the judgment to be given by the Court, or, alternatively, only to allow such set-off in certain defined circumstances.

Though, as has been seen, the Polish Government for its part confines itself in its submission to asking the Court to reject the German submission, the arguments advanced in

l'appui de sa demande qu'à son avis, ladite conclusion allemande est à la fois prématurée et inadmissible et que, par conséquent, la Cour n'a pas le pouvoir de s'en occuper.

Dès lors, la question de la compétence de la Cour se trouve posée. Un accord des Parties pour soumettre à la Cour la question dite de la compensation étant exclu, il convient d'examiner avant tout si la Cour est compétente pour statuer sur la conclusion allemande n° 4 *d*) en vertu d'un autre titre qui, en l'espèce, ne saurait être que l'article 23 de la Convention de Genève.

Il est évident que la question de savoir si le droit international admet la compensation des créances, et, dans l'affirmative, quelles sont les conditions dans lesquelles la compensation est admise, est, comme telle, en dehors de la compétence que la Cour puise dans ledit article. Mais le Gouvernement allemand prétend que la question posée par lui ne concerne qu'une modalité du paiement que le Gouvernement polonais devra faire, et que, de ce chef, elle constitue une divergence d'opinions comprise dans la clause compromissoire de l'article.

La Cour croit devoir interpréter cette thèse dans le sens que l'exclusion de la compensation est demandée dans le but d'assurer, en l'espèce, l'effectivité et l'efficacité de la réparation.

On peut admettre, comme la Cour l'a dit dans son Arrêt n° 8, que la compétence pour statuer sur la réparation, due à raison de la violation d'une convention internationale, implique la compétence pour statuer sur les formes et modalités de la réparation. Si la réparation consiste dans le paiement d'une somme d'argent, la Cour peut donc fixer les modalités de ce paiement. C'est pourquoi elle peut bien déterminer à qui le paiement doit être fait, dans quel endroit, et à quel moment ; si le paiement doit être intégral ou peut avoir lieu par tranches ; qui doit en supporter les frais, etc. Il s'agit alors de l'application au cas d'espèce des règles générales relatives aux paiements, et la compétence de la Cour découle tout naturellement de sa compétence pour allouer une indemnité en argent.

Mais on étendrait d'une manière injustifiée la portée de ce principe si on l'entendait dans le sens que la Cour pourrait connaître de n'importe quelle question de droit international,

support of its claim clearly show that it considers the said German submission to be both premature and inadmissible, and that the Court has therefore no power to deal with it.

The question of the Court's jurisdiction is thus clearly raised. Since there is no agreement between the Parties to submit to the Court the so-called question of set-off, it remains first of all to be considered whether the Court has jurisdiction to pass judgment on the German submission No. 4 (*d*) in virtue of any other provision, which, in the present case, could only be Article 23 of the Geneva Convention.

It is clear that the question whether international law allows claims to be set-off against each other, and if so, under what conditions such set-off is permitted, is, in itself, outside the jurisdiction derived by the Court from the said article. But the German Government contends that the question raised by it only relates to one aspect of the payment which the Polish Government must make and that, this being so, it constitutes a difference of opinion covered by the arbitration clause contained in the article.

The Court considers that this argument must be interpreted in the sense that the prohibition of set-off is asked for in order to ensure that in the present case reparation shall be really effective.

It may be admitted, as the Court has said in Judgment No. 8, that jurisdiction as to the reparation due for the violation of an international convention involves jurisdiction as to the forms and methods of reparation. If the reparation consists in the payment of a sum of money, the Court may therefore determine the method of such payment. For this reason it may well determine to whom the payment shall be made, in what place and at what moment; in a lump sum or maybe by instalments; where payment shall be made; who shall bear the costs, etc. It is then a question of applying to a particular case the general rules regarding payment, and the Court's jurisdiction arises quite naturally out of its jurisdiction to award monetary compensation.

But this principle would be quite unjustifiably extended if it were taken as meaning that the Court might have cognizance of any question whatever of international law.

même tout à fait étrangère à la convention dont il s'agit, pour le seul motif que la manière dont cette question est résolue peut avoir une influence sur l'efficacité de la réparation demandée. Pareille thèse ne semble guère conciliable avec les principes qui sont à la base de la compétence de la Cour, compétence limitée aux cas spécialement prévus dans les traités et conventions en vigueur.

Le point de vue du Gouvernement allemand est cependant que le pouvoir pour la Cour de statuer sur l'exclusion de la compensation découlerait du pouvoir qu'elle a d'assurer l'efficacité de la réparation. Or, il semble clair que cette thèse ne peut se référer qu'à une exception de compensation opposée au bénéficiaire par le débiteur, et qui serait de nature à dénuer la réparation de son efficacité. Tel serait notamment le cas si la créance opposée à la créance de réparation était contestée et devait donner lieu à un procès qui aurait en tout cas pour effet de retarder l'entrée en possession par l'intéressé de l'indemnité qui lui a été reconnue. Au contraire, si à la créance de réparation était opposée une créance liquide et non contestée, on ne voit pas pourquoi une exception de compensation fondée sur cette demande affecterait nécessairement l'efficacité de la réparation. Il s'ensuit que la compétence de la Cour, fondée sur l'article 23 de la Convention de Genève, ne pourrait en tout cas être invoquée qu'à l'égard d'une exception soulevée par la Partie défenderesse.

Or, il est constant que la Pologne n'a soulevé aucune exception de compensation ayant trait à telle ou telle créance déterminée qu'elle prétendrait avoir envers le Gouvernement allemand.

Il est vrai que, dans les négociations qui suivirent l'Arrêt n° 7, la Pologne avait avancé la prétention de compenser une partie de l'indemnité qu'elle se serait obligée de verser au Gouvernement allemand contre sa prétendue créance résultant des assurances sociales en Haute-Silésie. Mais la Cour a déjà eu l'occasion de constater qu'elle ne saurait faire état des déclarations, admissions ou propositions qu'ont pu faire les Parties au cours de négociations directes qui ont eu lieu entre elles. Rien, d'ailleurs, n'autorise la Cour à penser que le Gouvernement polonais voudrait faire valoir, à l'encontre d'un arrêt de la Cour, des prétentions qu'il a cru pouvoir avancer,

even quite foreign to the convention under consideration, for the sole reason that the manner in which such question is decided may have an influence on the effectiveness of the reparation asked for. Such an argument seems hardly reconcilable with the fundamental principles of the Court's jurisdiction, which is limited to cases specially provided for in treaties and conventions in force.

The German Government's standpoint however is that the power of the Court to decide on the exclusion of set-off is derived from the power which it has to provide that reparation shall be effective. Now, it seems clear that this argument can only refer to a plea of set-off raised against the beneficiary by the debtor, of such a nature as to deprive reparation of its effectiveness. Such for instance would be the case if the claim put forward against the claim on the score of reparation was in dispute and was to lead to proceedings which would in any case have resulted in delaying the entry into possession by the person concerned of the compensation awarded to him. On the contrary, if a liquid and undisputed claim is put forward against the reparation claim, it is not easy to see why a plea of set-off based on this demand should necessarily prejudice the effectiveness of the reparation. It follows that the Court's jurisdiction under Article 23 of the Geneva Convention could in any case only be relied on in regard to a plea raised by the respondent Party.

Now it is admitted that Poland has raised no plea of set-off in regard to any particular claim asserted by her against the German Government.

It is true that in the negotiations which followed Judgment No. 7 Poland had put forward a claim to set off a part of the indemnity which she would have undertaken to pay the German Government, against the claim which she put forward in regard to social insurances in Upper Silesia. But the Court has already had occasion to state that it can take no account of declarations, admissions or proposals which the Parties may have made during direct negotiations between them. Moreover, there is nothing to justify the Court in thinking that the Polish Government would wish to put forward, against a judgment of the Court, claims which it may have thought

au cours d'une négociation amiable destinée, dans l'intention des Parties, à aboutir à une transaction. La Cour doit aussi rappeler à ce propos ce qu'elle a déjà dit dans son Arrêt n° 1, savoir qu'elle ne peut ni ne doit envisager l'éventualité que l'arrêt resterait inexécuté après l'expiration du délai fixé pour son exécution.

Dans ces conditions, la Cour doit s'abstenir de statuer sur les conclusions dont il s'agit.

\* \* \*

PAR CES MOTIFS,

La Cour,

statuant contradictoirement,

par neuf voix contre trois,

1) décide et juge que, en raison de l'attitude prise par le Gouvernement polonais vis-à-vis des Sociétés anonymes Oberschlesische Stickstoffwerke et Bayerische Stickstoffwerke et constatée par la Cour comme n'étant pas conforme aux dispositions des articles 6 et suivants de la Convention de Genève, le Gouvernement polonais est tenu de payer, à titre de réparation, au Gouvernement allemand une indemnité correspondant au préjudice subi par lesdites Sociétés du chef de ladite attitude ;

2) rejette les exceptions du Gouvernement polonais, tendant à exclure de l'indemnité à payer tout montant correspondant à tout ou partie du dommage subi par les Oberschlesische Stickstoffwerke, et fondées soit sur le jugement rendu par le Tribunal de Katowice, le 12 novembre 1927, soit sur l'article 256 du Traité de Versailles ;

3) rejette la conclusion formulée par le Gouvernement polonais tendant à ce que le Gouvernement allemand, en premier lieu, livre au Gouvernement polonais la totalité des actions de la Société anonyme Oberschlesische Stickstoffwerke, de la valeur nominale de 110.000.000 de marks, dont le Gouverne-

fit to raise during friendly negotiations which the Parties intended should lead to a compromise. The Court must also draw attention in this connection to what it has already said in Judgment No. 1 to the effect that it neither can nor should contemplate the contingency of the judgment not being complied with at the expiration of the time fixed for compliance.

In these circumstances the Court must abstain from passing upon the submissions in question.

\* \* \*

FOR THESE REASONS,

The Court,

having heard both Parties,

by nine votes to three,

(1) gives judgment to the effect that, by reason of the attitude adopted by the Polish Government in respect of the Oberschlesische Stickstoffwerke and Bayerische Stickstoffwerke Companies, which attitude has been declared by the Court not to have been in conformity with the provisions of Article 6 and the following articles of the Geneva Convention, the Polish Government is under an obligation to pay, as reparation to the German Government, a compensation corresponding to the damage sustained by the said Companies as a result of the aforesaid attitude ;

(2) dismisses the pleas of the Polish Government with a view to the exclusion from the compensation to be paid of an amount corresponding to all or a part of the damage sustained by the Oberschlesische Stickstoffwerke, which pleas are based either on the judgment given by the Tribunal of Katowice on November 12th, 1927, or on Article 256 of the Treaty of Versailles ;

(3) dismisses the submission formulated by the Polish Government to the effect that the German Government should in the first place hand over to the Polish Government the whole of the shares of the Oberschlesische Stickstoffwerke Company, of the nominal value of 110,000,000



ment allemand dispose en vertu du contrat en date du 24 décembre 1919 ;

4) rejette la conclusion formulée subsidiairement par le Gouvernement polonais tendant à faire surseoir provisoirement sur la demande en indemnité pour ce qui concerne la Société Oberschlesische Stickstoffwerke ;

5) rejette les conclusions du Gouvernement allemand tendant à ce qu'il soit dit et jugé que, jusqu'au 30 juin 1931, aucune exportation de chaux azotée et de nitrate d'ammoniaque n'aura lieu en Allemagne, dans les États-Unis d'Amérique, en France et en Italie ; et, subsidiairement, que le Gouvernement polonais est obligé de cesser l'exploitation de l'usine de Chorzów, respectivement, des installations chimiques pour produire le nitrate d'ammoniaque, etc. ;

6) décide et juge qu'il n'y a pas lieu de statuer sur les conclusions formulées par le Gouvernement allemand et tendant à ce qu'il soit dit et jugé que le Gouvernement polonais n'est pas autorisé à compenser contre la créance susdite du Gouvernement allemand d'être indemnisé sa créance résultant des assurances sociales en Haute-Silésie ; qu'il ne peut se prévaloir d'aucune autre compensation contre ladite créance d'indemnité, et, subsidiairement, qu'une compensation n'est autorisée que lorsque le Gouvernement polonais invoque à cette fin une créance reconnue par le Gouvernement allemand ou constatée par un arrêt rendu entre les deux Gouvernements ;

7) décide et juge que l'indemnité à payer par le Gouvernement polonais au Gouvernement allemand sera fixée à une somme globale ;

8) se réserve de déterminer, dans un futur arrêt, le montant de ladite indemnité, après avoir reçu le rapport des experts qu'elle nommera pour éclairer sa religion sur les questions formulées dans le présent arrêt et après avoir entendu les Parties au sujet de ce rapport ;

9) réserve également, pour ce futur arrêt, les conditions et modalités du paiement de l'indemnité en ce qui concerne les points qui ne sont pas tranchés par le présent arrêt.

marks, which are in the hands of the German Government under the contract of December 24th, 1919 ;

(4) dismisses the alternative submission formulated by the Polish Government to the effect that the claim for indemnity, in so far as the Oberschlesische Stickstoffwerke Company is concerned, should be provisionally suspended ;

(5) dismisses the submission of the German Government asking for judgment to the effect that, until June 30th, 1931, no nitrated lime and no nitrate of ammonia should be exported to Germany, to the United States of America, to France or to Italy, or, in the alternative, that the Polish Government should be obliged to cease working the factory or the chemical equipment for the production of nitrate of ammonia, etc. ;

(6) gives judgment to the effect that no decision is called for on the submissions of the German Government asking for judgment to the effect that the Polish Government is not entitled to set off, against the above-mentioned claim for indemnity of the German Government, its claim in respect of social insurances in Upper Silesia ; that it may not make use of any other set-off against the said claim for indemnity, and, in the alternative, that set-off is only permissible if the Polish Government puts forward for this purpose a claim in respect of a debt recognized by the German Government or established by a judgment given between the two Governments ;

(7) gives judgment to the effect that the compensation to be paid by the Polish Government to the German Government shall be fixed as a lump sum ;

(8) reserves the fixing of the amount of this compensation for a future judgment, to be given after receiving the report of experts to be appointed by the Court for the purpose of enlightening it on the questions set out in the present judgment and after hearing the Parties on the subject of this report ;

(9) also reserves for this future judgment the conditions and methods for the payment of the compensation in so far as concerns points not decided by the present judgment.

Le présent arrêt ayant été rédigé en français et en anglais, c'est le texte français qui fait foi.

Fait au Palais de la Paix, à La Haye, le treize septembre mil neuf cent vingt-huit, en trois exemplaires, dont l'un restera déposé aux archives de la Cour et dont les autres seront transmis aux agents des Gouvernements des Puissances requérante et défenderesse respectivement.

Le Président :

(Signé) D. ANZILOTTI.

Le Greffier-adjoint :

(Signé) PAUL RUEGGER.

M. de Bustamante, juge, déclare ne pouvoir se rallier à l'arrêt rendu par la Cour, en ce qui concerne le n° 8 du dispositif, en ce sens qu'il est d'avis que les questions indiquées sous les numéros I B et II dans l'arrêt ne devraient pas être posées aux experts.

M. Altamira, juge, déclare ne pouvoir se rallier à l'arrêt rendu par la Cour en ce qui concerne le n° 6 du dispositif.

M. Rabel, juge national, désire ajouter à l'arrêt les observations qui suivent.

Lord Finlay, juge, et M. Ehrlich, juge national, déclarant ne pouvoir se rallier à l'arrêt rendu par la Cour et se prévalant du droit que leur confère l'article 57 du Statut, ont joint audit arrêt les exposés suivants de leur opinion individuelle.

M. Nyholm, juge, ne pouvant se rallier au résultat de l'arrêt, désire y ajouter les observations suivantes.

(Paraphé) D. A.

(Paraphé) P. R.

Done in French and English, the French text being authoritative, at the Peace Palace, The Hague, this thirteenth day of September nineteen hundred and twenty-eight, in three copies, one of which is to be placed in the archives of the Court, and the others to be forwarded to the Agents of the applicant and respondent Parties respectively.

(Signed) D. ANZILOTTI,  
President.

(Signed) PAUL RUEGGER,  
Deputy-Registrar.

M. de Bustamante, Judge, declares that he is unable to concur in the judgment of the Court as regards No. 8 of the operative portion; he considers that the questions numbered I B and II in the judgment should not be put to the experts.

M. Altamira, Judge, declares that he is unable to concur in the judgment of the Court as regards No. 6 of the operative portion.

M. Rabel, National Judge, desires to add to the judgment the remarks which follow hereafter.

Lord Finlay, Judge, and M. Ehrlich, National Judge, declaring that they cannot concur in the judgment of the Court and availing themselves of the right conferred on them by Article 57 of the Statute, have delivered the separate opinions which follow hereafter.

M. Nyholm, Judge, being unable to concur in the result arrived at by the judgment, desires to add the remarks which follow hereafter.

(Initialled) D. A.

(Initialled) P. R.

## **LEGAL AUTHORITY CA-120**



[Home](#)   [US English](#)   [resolve](#)

Definition of resolve in English:

# resolve



Pronunciation    /rəˈzɒlv/   /rəˈzɔlv/

Translate [resolve](#) into Spanish

## VERB

**1** [*with object*] Settle or find a solution to (a problem, dispute, or contentious matter)  
*'the firm aims to resolve problems within 30 days'*

[More example sentences](#)

[Synonyms](#)

**1.1** *Medicine* [*with object*] Cause (a symptom or condition) to disperse, subside, or heal.  
*'endoscopic biliary drainage can rapidly resolve jaundice'*

[More example sentences](#)

**1.2** [*no object*] (of a symptom or condition) disperse, subside, or heal.  
*'symptoms resolved after a median of four weeks'*

[More example sentences](#)

**1.3** *Music* [*no object*] (of a discord) lead into a concord during the course of harmonic change.

*[no object] 'dissonant notes resolve conventionally by rising or falling to form part of a new chord'*

More example sentences

1.4 **Music** *[with object]* Cause (a discord) to pass into a concord.

2 *[no object]* Decide firmly on a course of action.  
*[with infinitive] 'she resolved to call Dana as soon as she got home'*

More example sentences

Synonyms

2.1 *[with clause]* (of a legislative body, committee, or other formal meeting) make a decision by a formal vote.

*[with infinitive] 'the conference resolved to support an alliance'*

More example sentences

Synonyms

### 3 **Chemistry**

Separate or cause to be separated into components.

*[with object] 'alpha-zein is often resolved into two major size components'*

More example sentences

Synonyms

3.1 **(resolve something into)** *[with object]*

Reduce a subject, statement, etc. by mental analysis into (separate elements or a more elementary form)

*'the ability to resolve facts into their legal categories'*

More example sentences

Synonyms

3.2 **Physics** *[with object]* Analyze (a force or velocity) into components acting in particular directions.

*'Harriot resolved the forces acting on the projectile into horizontal and vertical components.'*

More example sentences

4 *[no object]* (of something seen at a distance) turn into a different form when seen more clearly.

*'the orange glow resolved itself into four lanterns'*

More example sentences

Synonyms

- 4.1 [*with object*] (of optical or photographic equipment) separate or distinguish between (closely adjacent objects)  
*'Hubble was able to resolve six variable stars in M31'*

More example sentences

- 4.2 [*with object*] Separately distinguish (peaks in a graph or spectrum).  
*'For the detector to resolve two peaks, one pixel between the two peaks must receive a lower signal than its neighbors.'*

More example sentences

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## NOUN

- 1 Firm determination to do something.

*'she received information that strengthened her resolve'*

More example sentences

Synonyms

- 1.1 *US* A formal resolution by a legislative body or public meeting.  
*'A resolution does not carry any force of law; it expresses the resolve of a legislative body by drawing attention and awareness to an important subject.'*

More example sentences

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## Origin

Late Middle English (in the senses 'dissolve, disintegrate' and 'solve (a problem)'): from Latin *resolvere*, from *re-* (expressing intensive force) + *solvere* 'loosen'.



## **LEGAL AUTHORITY CA-121**

# Oxford English Dictionary | The definitive record of the English language

## resolve, *v.*

**Pronunciation:** Brit. /rɪ'zɒlv/, U.S. /rə'zɒlv/, /ri'zɒlv/,

/rə'zɑlv/, /ri'zɑlv/

**Forms:** ME **resolu**, ME–16 **resolue**, ME– **resolve**, 15 **resoulve**, 16 **resollve**, 16 **resolv**; *Scottish* pre-17 **resol**, pre-17 **resolf**, pre-17 **resoll**, pre-17 **resollve**, pre-17 **resolue**, pre-17 **resolwe**, pre-17 **resoul**, pre-17 **risolv**, pre-17 17– **resolve**, 18 **resoal** (*Shetland*), 19– **rezol** (*Shetland*).

**Frequency (in current use):**

**Origin:** A borrowing from Latin. **Etymons:** Latin *resolvere*, French *resolver*.

**Etymology:** < classical Latin *resolvere* to loosen, undo, unfasten, to unravel, solve, to unbind, to release, to separate into components, break up, to reduce to liquid, melt, dissolve, to soften, reduce to pulp, to make less tense, relax, to weaken the nerves of, paralyse, to make less strict or disciplined, to pay back (money owed), to discharge (a promise or vow), to put an end to, finish, settle, to cancel, nullify, to refute, rebut, in post-classical Latin also to flow out, emerge (6th cent.; < *re-* RE- *prefix* + *solvere* SOLVE *v.*), perhaps partly via Middle French (rare) *resolver* to solve (a problem), to make a decision (both c1370), to cause (a substance) to melt or dissolve (c1380); compare (with change of conjugation) Middle French *resolvir* to dissolve, melt (1528). The usual French verb expressing the senses of the English verb is Middle French *resoudre*, *resouldre*, *ressoudre* (French *résoudre*) (first quarter of the 13th cent. in Old French in past participle *resous*, originally in sense '(of a sum of money or damages) paid'; see below for a summary of its senses), a borrowing of classical Latin *resolvere* with alteration after Old French *soldre*, *soudre* SOIL *v.*<sup>2</sup> Compare Catalan *resoldre* (1438), Spanish *resolver* (first half of the 14th cent.), Portuguese *resolver* (14th cent.), Italian *risolvere* (c1340; also †*resolvere*). Compare SOLVE *v.* and earlier DISSOLVE *v.*, which show partial semantic overlap with this word.

Senses of French *résoudre* which have a parallel in English include the following: to cause to melt or dissolve (beginning of the 14th cent., originally in passive construction *etre resoult*), to decide to follow a course of action (1356 in *resoldre de*; also used reflexively (c1500)), to break up or separate (a material thing) into constituent parts or elements, to reduce (a subject, statement, phenomenon, etc.) by analysis into more elementary forms, principles, etc. (both c1377), to release (something) from its bonds (second half of the 15th cent.), to cause to disappear (1525), to come to a conclusion about, to make a decision concerning (an issue) (1535), to disperse or dissolve (humours, morbid material, etc.) (1549), to change or transform (a material or immaterial thing) into some other state or form (1559), to cause (a thing, especially a part of the body) to become slack or limp (second half of the 16th cent.), to solve (a problem) (1564; 1690 with specific reference to a mathematical problem, 1765 with specific reference to an equation), to be satisfied or convinced (1568 in the passage translated in quot. 1585 at sense 22c), to inform (a person) about (something) (1609), to annul (a law, contract, etc.) (1668), (in music) to alter or transform (a discord) into a concord (1753).

### I. Senses relating to liquefaction, dissolution, or softening.

#### 1. In later use only with *into* (cf. sense 8).

**a. transitive.** To cause to melt or dissolve; to reduce from a solid to a liquid or fluid state. Now *rare*.

In quot. a1398: to soften by the application of heat.

- ▶ a1398 J. TREVISA tr. Bartholomaeus Anglicus *De Proprietatibus Rerum* (BL Add.) f. 199 A stoon resolueþ [read resolved; L. *resolutus*] wiþ hete torneþ in to bras.
- ?c1400 (▶ c1380) G. CHAUCER tr. Boethius *De Consol. Philos.* (BL Add. 10340) (1868) iv. met. v. l. 3814 Þe wey3te of þe snowe yhardid by þe colde is resolued [L. *solvier*] by þe brennyngte hete of phebus þe sonne.
- ▶ ?1440 tr. Palladius *De re Rustica* (Duke Humfrey) (1896) xii. 526 (*MED*) For brousty oil, whit wex is to resolue In fynest oil, and theryn throwe hit so.

- 1530 J. PALSGRAVE *Lesclarcissement* 688/1 This metall can nat be resolved without a marvayllous sharpe fyre.
- 1555 R. EDEN tr. Peter Martyr of Angleria *Decades of Newe Worlde* III. i. f. 93<sup>v</sup> Cleopatra..resolved a pearle in vineger and drunke it.
- 1609 P. HOLLAND tr. Ammianus Marcellinus *Rom. Hist.* 117 Euphrates was risen by reason of snow newly thawed and resolved.
- 1678 J. DRYDEN *All for Love* III. 32 He could resolve his mind, as Fire does Wax, From that hard rugged Image, melt him down [etc.].
- 1732 J. ARBUTHNOT *Pract. Rules of Diet* i. 270 Soaps which resolve solid Substances.
- 1735 T. DALLOWE tr. H. Boerhaave *Elements Chem.* I. II. 240 Let it [sc. the white of an egg] be exposed to 92 degrees of Heat..and it will in a little time be resolved into a Liquid, that grows continually thinner and thinner.
- 1834 P. M. ROGET *Animal & Veg. Physiol.* I. 97 A soft and transparent jelly, which by spontaneous decomposition after death..is resolved almost wholly into a limpid watery fluid.
- 1905 *Atlantic Monthly* Nov. 656/2 There it [sc. ice] will remain..until the warm sun of spring shall resolve it into water again.
- 1998 D. GARBER et al. in D. Garber & M. Ayers *Camb. Hist. 17th-Cent. Philos.* (2003) I. xviii. 560 Solid combustibles..., like resins and waxes, must first be resolved into liquid.

†**b. transitive.** To condense (a vapour or mist) to a liquid. Also *figurative*.  
*Obsolete.*

- ▶ a1398 J. TREVISA tr. Bartholomaeus Anglicus *De Proprietatibus Rerum* (BL Add.) f. 199<sup>v</sup> Myst..soone þer after..is resolued in to reyn dropes.
- c1450 (▶ c1415) in W. O. Ross *Middle Eng. Serm.* (1940) 247 (*MED*) Som tyme he resolueþ by very contricion þe thike cloudes of synne in-to swete dewy teres.
- 1635 J. SWAN *Speculum Mundi* v. §2. 144 Green clouds..are altogether watery, and as it were already resolved into water.
- 1668 N. CULPEPER & A. COLE tr. T. Bartholin *Anat.* (new ed.) I. xxvii. 65 The sooty Vapors are condensed, and being resolved into water, are [etc.].
- 1878 *Sanitary Rec.* 4 Jan. 9/1 Another physicist..has attacked oxygen, and, with the aid of great pressure and cold, has resolved it into a liquid.
- 1892 T. S. HUNT *Systematic Mineral.* (ed. 2) iii. 18 The vapor of water above 100°..behaves like a true gas, but below that point is resolved into a liquid.

**c. intransitive.** To melt; to dissolve; to become liquid. Also *figurative*. Now *rare*.

- c1450 *Alphabet of Tales* (1905) II. 443 Þis yse resoluyd into watir.
- a1500 (▶ ?a1425) tr. *Secreta Secret.* (Lamb.) 72 In þis tyme..þe wyndes blowyn, þe snow resoluys.
- c1540 J. BELLENDEN tr. H. Boece *Cosmog. viii*, in tr. H. Boece *Hyst. & Cron. Scotl.* sig. Bv<sup>v</sup> Ony frosyn thyng (that is cassyn in it) meltis and resoluys hastelie.
- 1611 B. JONSON *Catiline* III. sig. H2 May my braine Resolue to water, and my bloud turne phlegme.
- a1616 W. SHAKESPEARE *King John* (1623) v. iv. 25 Euen as a forme of waxe Resolueth from his figure 'gainst the fire.
- 1665 *Philos. Trans.* (Royal Soc.) 1 106 After a while it resolves again, and grows dilute.

- 1696 T. SOUTHERNE *Oroonoko* v. v Our honours, interests resolving down, Run in the gentle current of our joys.
- 1731 J. ARBUTHNOT *Ess. Nature Aliments* iv. 46 When the Blood stagnates in any part of the Body, it first coagulates, then resolves, turns Alkaline.
- 1759 B. MARTIN *Nat. Hist. Eng.* I. 19 Congealed (as it were) in Clusters, which resolve, and the frozen Swallows revive by the Warmth.
- 1791 W. NICHOLSON tr. J. A. C. Chaptal *Elements Chem.* III. vi. ix. 365 White flocks are deposited on the sides of the glass, which resolve into a liquor by the contact of moist air.
- 1848 A. NORMANDY tr. H. Rose *Pract. Treat. Chem. Anal.* I. II. ii. 450 The compounds..all absorb moisture from the air, and resolve into a yellow liquid.
- 1912 A. TEIXEIRA DE MATTOS tr. J. H. Fabre *Life of Spider* vii. 187 When ripe, the fleshy core resolves into a liquid in which float the seeds.

**d.** *transitive (reflexive)*. = sense 1c. Now rare.

- 1604 W. SHAKESPEARE *Hamlet* I. ii. 130 O that this too too sallid flesh would melt, Thaw and resolve it selfe into a dewe.
- 1800 R. SOUTHEY *Cool Reflections* in *Ann. Anthol.* II. 31 For the flesh upon them That hath resolved itself into a dew.
- 1808 *Jrnl. Nat. Philos.* Dec. 267 A white salt, which on exposure to the air speedily resolved itself into a fluid.
- 1868 SIR J. HERSCHEL in *People's Mag.* Jan. 63 Its pileus..has the singular property of resolving itself..into a black liquid.
- 1954 A. MOOREHEAD *Summer Night* iii. 61 Inside the press the grapes were bursting under their own weight, resolving themselves into a dark liquid pulp.

†**2.** *transitive*. To soften (*literal* and *figurative*); to cause to become slack or limp; to weaken. Also (occasionally) *intransitive* with object implied.

*Obsolete.*

- a1398 J. TREVISA tr. Bartholomaeus Anglicus *De Proprietatibus Rerum* (BL Add. 27944) (1975) I. x. vii. 563 By his scharpnesse cool sowdiþ iren and resolyth and slakeþ þe parties þerof and makeþ it neissche.
- ?a1425 tr. Guy de Chauliac *Grande Chirurgie* (N.Y. Acad. Med.) f. 24 (*MED*) When..þe ende is of þe state, be þer noȝt but þat resoluēþ & makeþ laxē.
- c1451 J. CAPGRAVE *Life St. Gilbert* (1910) 100 (*MED*) Þe grete constrictiō of hir wombe was resolved meruelously.
- 1484 W. CAXTON tr. *Subtyl Historyes & Fables Esope* f. iij By cause the water was hote and their stomake [was] resolved by the water.
- 1541 T. ELYOT *Image of Gouvernance* x. f. 18<sup>v</sup> Like as by the other the strength of body is resolved.
- 1577 H. RHODES *Bk. Nurture* (new ed.) sig. Eiii It is a very hard work of continence, to repell the paynting glose of flatterings whose words resolve the hart with plesure.
- 1588 T. KYD tr. T. Tasso *Housholders Philos.* f. 6<sup>v</sup> The night..[in which] we may sufficiently restore our bodies resolved with exceeding heate and contagions of the day.
- 1644 J. BULWER *Chirologia* 35 The Hand collected, the Fingers looking downwards, then turned and resolved.

1715 N. ROWE *Lady Jane Gray* II Every moving accent that she breathes Resolves my courage, slackens my tough nerves.

### 3. *Medicine.*

†**a.** *transitive.* To disperse or dissolve (humours, morbid material, etc.); to soften (an accumulation of hardened material). Also *intransitive:* to perform or undergo such a process. *Obsolete.*

In later use there is some overlap with sense 3c.

- ▶ a1398 J. TREVISA tr. Bartholomaeus Anglicus *De Proprietatibus Rerum* (BL Add. 27944) (1975) II. XVIII. lxxxvii. 1238 In wynter humours ben sadde yfastned togidres by colde... And þefore fewe fumositees ben resolved in þat tyme for passyng colde þat fastneþ þe humours in þe body.
- a1400 tr. Lanfranc *Sci. Chirurgie* (Ashm.) (1894) 210 (MED) If þou miȝt not..do awei þe enpostym ne resolve him..þan þou schalt do þerto medicyns maturatiuis.
- a1400 tr. Lanfranc *Sci. Chirurgie* (Ashm.) (1894) 353 (MED) þan oonli wiþ resolutiuis..þe sotil mater wole resolve, & þat oþir part wole bicombe hard.
- ?a1425 *MS Hunterian 95* f. 105<sup>v</sup> (MED) Ane harde enpostume is cured wiþ resolutiues & mollificatiues, so þat o tyme þu schalt resolve & anoþer tyme mollifie.
- a1500 tr. Lanfranc *Sci. Chirurgie* (Wellcome) f. 23 (MED) If þe mater..is gret..resolu it with a light resolutiue.
- ?1541 R. COPLAND *Galen's Fourth Bk. Terapeutyke* sig. Hiv, in *Guy de Chauliac's Questyonyary Cyrurgyens* When ecchymosis is all dygested & resolved, than it is parmytted to drye the broken flesshe.
- 1562 W. TURNER *Herball* (1568) II. 117 Oyl that is made of vnrype oliues..doth myghtely resolve.
- 1585 J. BANISTER *Wecker's Compend. Chyrurg.* I. 242 If the tumor doe by these meanes resolve and vanish, pursue it with a cataplasme.
- 1601 P. HOLLAND tr. Pliny *Hist. World* II. 274 Those plasters which resolve or maturat any impostumed place.
- 1610 G. MARKHAM *Maister-peece* II. clxxiii. 483 It burneth, draweth, and resolueth, and is goode for scurfe.
- 1683 W. SALMON *Doron Medicum* II. 427 For it resolves all hard humors.
- 1708 *Brit. Apollo* 29–31 Dec. Green Tea..Resolves, and Attenuates.
- 1717 D. TURNER *Syphilis* II. 208 The inguinal Tumour entirely resolving, and the Pustules every where dying away and falling off.
- 1749 D. HARTLEY *Observ. Man* I. ii. §i. 127 Embrocations are of Use in resolving Obstructions.
- 1800 W. C. BROWN tr. G. Borsieri de Kanifeld *Inst. Pract. Med.* I. 296 Friction during the paroxysm..contributed much to resolve the remains of the swelling.

†**b.** *transitive.* To relieve or reduce (a condition, esp. pain or numbness). *Obsolete. rare.*

- 1573 *Treas. Hid. Secrets* xix Oyle of Rue is hot, resolving pain.
- a1617 P. BAYNES *Comm. Ephes.* (1658) 130 Fire..hath not onely heat resolving numbnesse,..but it hath light.
- 1638 W. RAWLEY tr. F. Bacon *Hist. Nat. & Exper. Life & Death* 29 The Drying caused by Cold, is but weak, and easily resolved.
- 1651 D. BORDER *Πολυφαρμακος και Χυμωστης* 135 It helpeth digestion and resolveth pain throughout the body, in what part soever they shall come, especially, when they have their beginning of cold.

**c. transitive.** To bring (a disease, pathological process, etc.) to resolution (RESOLUTION *n.*<sup>1</sup> 2c).

- 1730 *Dr. Allen's Synopsis Medicinæ* II. xii. 88 *Aq. calcis vivæ*, if anything else, always takes away the Inflammation, resolves and discusses it.
- 1732 J. ARBUTHNOT *Pract. Rules of Diet* iii. 321 Such a Fever is often resolv'd by a bleeding at the Nose.
- 1811 E. G. CLARKE *New London Pract. Physic* (ed. 7) 158 Emetics should be given with caution, if at all; and the clyster thrown up, which often resolves the inflammation.
- 1861 *Chicago Med. Examiner* 2 493 In relapsing fever, the powerful diaphoresis which so frequently at once resolves the fever, inculcates the same doctrine.
- 1898 T. C. ALLBUTT et al. *Syst. Med.* V. 361 When empyema follows upon pneumonia, the pulmonary inflammation sometimes is never resolved.
- 2002 *Daily Tel.* 3 May 24/8 This [sc. aloe vera gel] may resolve nasal polyps within eight weeks.

**d. intransitive.** Of a disease, pathological process, etc.: to undergo resolution (RESOLUTION *n.*<sup>1</sup> 2c).

- 1793 W. ROWLEY *Rational Pract. Physic* III. 13 Its cure should be attempted by a mode similar to the foregoing, by which the tumor often resolves.
- 1822 J. M. GOOD *Study Med.* II. 505 Regular fit of gout..gradually resolving, and leaving the constitution in its usual or improved health.
- 1898 P. MANSON *Trop. Dis.* xxvii. 434 These drugs have undoubtedly the power of causing the eruption in yaws to resolve.
- 1933 *Jrnl. Hygiene* 33 283/1 Eustachian drainage is quickly re-established, allowing middle ear inflammation to resolve.
- 2001 *Cats* Aug. 9/1 Another possibility is cholangiohepatitis... It often never completely resolves, and tends to flare up from time to time.

†4. *intransitive.* With *of, from*. To flow out, issue. *Obsolete. rare.*

- ?c1400 (► c1380) G. CHAUCER tr. Boethius *De Consol. Philos.* (BL Add. 10340) (1868) v. met. i. l. 4369 Tigris [and] eufrates resoluen [L. *resolvunt*] and spryngen of a welle in þe kragges of þe roche of þe contre of achemenye.
- 1601 P. HOLLAND tr. Pliny *Hist. World* I. XII. xvi. 369 Little peeces..yeeld a certaine whitish liquor which issueth and resolveth from them.

†5. *transitive.* With *in, into, to*. To cause to lapse into or be given over to a particular emotional state or mode of behaviour. Usually in *passive*. *Obsolete.*

When used in relation to tears (of grief, etc.) often as part of an extended metaphor, and as such closer in meaning to sense 1; cf. DISSOLVE *v.* 3.

- a1438 *Bk. Margery Kempe* (1940) I. 153 (MED) Sche was resoluyd in-to terys of pyte & compassyon.
- c1460 *Tree & 12 Frutes* (McClean) (1960) 15 (MED) Ofte tymes after mete many ben resoluid to lightnes and in to vnreligious myrthes.

- 1533 T. ELYOT *Pasquil the Playne* f. 7 Where thou seest thy lorde or mayster in the presence of many, resolved in to fury or wantonnesse.
- 1611 B. JONSON *Catiline* III. sig. G4 Each house [being] Resolu'd in freedome.
- 1631 R. BOLTON *Instr. Right Comf. Affl. Consciences* 260 The Alien..is by the heate of his slavish horrour, rather enraged with malice, then resolved into mercy.
- 1679 J. GOODMAN *Penitent Pardoned* II. i. 157 Such reflections and considerations as these break the very heart of a sinner, and resolve him into sighs and tears.

†6. *transitive*. To cause (conflict) to cease. *Obsolete*.

- a1530 W. BONDE *Pylgrimage of Perfeccyon* (1531) III. f. CCLxxxii<sup>v</sup> It resolueth discorde, reconsyleth ennemyes, & maketh them frendes.

7. *transitive*. Chiefly *Scots Law*. To annul (a law, contract, etc.). Also *intransitive*: (of a contract of sale) to become void. Now *rare*.

- 1537 in *State Papers Henry VIII* (1849) VII. 706 The act made for money by exchange, the wiche,..onles it be resolvid, wilbe a great ocacion..to cawse a stey for salis of wolen clothis.
- a1768 J. ERSKINE *Inst. Law Scotl.* (1773) II. III. iii. 449 If he fail to pay the price within the time limited, the sale resolves, and the property returns from him to the seller.
- 1771 in M. P. BROWN *Decisions Lords of Council & Session 1766–91* (1826) I. 435 I do not see a substantial difference between the contract before and after the tailie: all the parties concerned may still agree to resolve the contract and tailie.
- 1838 W. BELL *Dict. Law Scotl.* 859 *Resolutive Condition*, a condition in a sale, which does not suspend the completion of the contract; but which resolves the sale, if the condition be purified at the time specified.
- 1978 *Internat. & Compar. Law Q.* 27 277 The far more usual practice [in Roman law] was for the contract of sale to fix the latest date by which the price should be paid and empower the seller to resolve the contract if it was not paid by then.

II. Senses relating to splitting, breaking up, or transformation.

8.

a.

(a) *transitive*. To break up or separate (a material thing) into constituent parts or elements; to disintegrate (something); (also) to cause (a body, earth, etc.) to decompose. Frequently (now usually) with *into* (formerly also †*to*).

- ▶ a1398 J. TREVISA tr. Bartholomaeus Anglicus *De Proprietatibus Rerum* (BL Add. 27944) (1975) I. VII. xxxvi. 384 Whanne picke mater and gret and glemy so ioyned in þe body meoviþ by hete, hit nediþ þat it be resolved..into vapour.
- ?c1400 (▶ c1380) G. CHAUCER tr. Boethius *De Consol. Philos.* (BL Add. 10340) (1868) II. pr. vii. l. 1600 What atteineiþ fame to swiche folk whan þe body is resolved by þe deēþ atte þe last[e].
- a1450 *St. Katherine* (Richardson 44) (1884) 52 (MED) Þou haue power for a tyme to vse þy cruelte vpon my body, whyche..abydeth to be resolved in to deþ.
- a1500 (▶ c1477) T. NORTON *Ordinal of Alchemy* (BL Add.) (1975) 2296 (MED) Liqueours departith qualitees a-sondyre, Substance resoluynge in attoms with wondire.



- 1533 J. BELLENDEN tr. Livy *Hist. Rome* (1901) I. i. xv. 85 Because þe stoupis and pillaris þareof war all of tre, they war haistelie brynt and resolut in powder.
- 1577 B. GOUGE tr. C. Heresbach *Fourre Bks. Husbandry* I. f. 17<sup>v</sup> A mellowe ground that is fatte, and wyll soone be resolved.
- 1579 T. LUPTON *Thousand Notable Things* II. 27 A flynt stone lying in Vineger the space of seuen dayes: maye be resolved into powder by rubbing betweene the fyngers.
- 1620 T. VENNER *Via Recta* iii. 52 They will too soon resolve the iuyce of lighter meats.
- 1633 BP. J. HALL *Plaine Explic. Hard Texts* I. 321 O ye my faithfull ones, who are now resolved to the very dust of the earth.
- 1667 T. VINCENT *Christ's Appearance to Judgment* iv. 17 The flesh is consumed, and resolved into its first elements.
- 1727 P. SHAW & E. CHAMBERS tr. H. Boerhaave *New Method Chem.* 177/1 The common doctrine., that the different substances into which mix'd bodies are commonly resolved by fire, are not of pure and elementary nature.
- 1776 T. BOWDEN *Farmer's Director* 18 By the assistance of alternate rain and drought, to resolve and break the hard clods.
- 1838 T. THOMSON *Chem. Org. Bodies* 54 When malic acid is distilled at the temperature of 349°, it is resolved into water, and two pyro-acids, which are isomeric.
- 1891 *Spectator* 4 July 5/2 A..campaign intended to break up Italy, or to resolve the German Empire back again into its elements.
- 1931 A. D. HALL *Soil* (ed. 4) ii. 48 Repeatedly kneading and working it [sc. clay], by which process the naturally formed aggregates are resolved into their ultimate particles.
- 1945 R. A. KNOX *God & Atom* i. 13 It might be possible..to resolve the molecule into its component parts, but beyond that lay something smaller yet, completely indivisible.
- 1989 *Hobart Mercury* (Nexis) 10 Jan. The polysaccharide plastic can be resolved into soil in one to 12 months, depending on its ingredients.
- 2005 D. J. DAVIES & L. H. MATES *Encycl. Cremation* 327/2 The cremationists..argued..that cremation merely resolved the body into its constituent elements.

(b) *intransitive*. Usually with *into* (formerly also *+to*). Of a material thing: to undergo dissolution or separation into constituent parts or elements, or into a more basic or fundamental state; to decompose; to disintegrate. Also *figurative*.

- a1500 ( ▶ ?a1425) tr. *Secreta Secret.* (Lamb.) 68 (MED) Mannys body, þat ys takynge mete and drynke, continuely er dimunished and resoluyn aʒeyn, als wel þe bodyes þat ressayuen als þe mete and þe drynke ressayued.
- 1509 J. FISHER *Mornyngge Remembraunce Countesse of Rychemonde* (de Worde) sig. Biii<sup>v</sup> Fyrst it [sc. the body] anone begynneth to putrefye & resolute in to foule corrupcyon.
- 1589 R. GREENE *Menaphon* sig. F4<sup>v</sup> Pleusidippus eyes at this speach resolved into fire.
- 1648 R. SANDERSON *Serm.* II. 245 As soon as touched..[they] resolve all into dust and smoak.
- a1657 G. DANIEL *Trinarchodia: Henry IV* lxxvii, in *Poems* (1878) IV. 20 This Insect..Resolves to dirt againe in the next Storme.
- 1674 *Philos. Trans.* (Royal Soc.) 9 4 They [sc. leaves] will soon become very hot..and after a few days resolve into a pappy substance.
- 1716 A. POPE tr. Homer *Iliad* II. VII. 113 Go then! resolve to Earth from whence ye grew.



- 1787 G. ADAMS *Ess. Microscope* 462 The several species of microscopic animals may subside, resolve again into gelatinous filaments, and again give lesser animals.
- 1820 *Edinb. Encycl.* (1830) XIV. 138/1 The iron..becomes dry and brittle, resolves into grains, and refuses to cohere or extend under the hammer.
- 1878 M. A. BROWN tr. J. L. Runeberg *Nadeschda* 66 The marble then In transformation dire into speech resolved.
- 1916 *Lancet* 8 July 67/1 The proteins do not all alike resolve into the same amino-acids.
- 1976 *Compar. Biochem. & Physiol. B.* 54 434/2 The haemolysates of both plaice and flounder resolve into several components during isoelectric focusing.
- 2004 G. J. H. GRUBBEN & O. A. DENTON *Plant Resources Trop. Afr.* II. 273/2 When cooked the flesh of mature fruits resolves into thin strands which look like spaghetti.

(c) *transitive (reflexive)* in same sense. Now *rare*.

- 1812 *Q. Rev.* Sept. 30 The whole fabric [of the ship] resolves itself into its constituent parts, scarcely any two of them remaining in adhesion.
- 1851 W. B. CARPENTER *Man. Physiol.* (ed. 2) 487 The first change..in the Mammalian ovum, is the 'segmentation' of the yolk; the entire mass of which..resolves itself..into..segments.
- 1905 *Bot. Gaz.* 40 88 This vesicle..resolves itself into fibers.
- 1937 C. D. DARLINGTON *Rec. Adv. in Cytol.* (ed. 2) i. 22 The characteristic process of mitosis in the course of which the whole nucleus, apart from the nucleoli, resolves itself into longitudinally split threads, the chromosomes.

†**b.** *transitive*. To produce (a substance) by disintegration or decomposition;  
*esp.* to cause (smoke or vapour) to be given off from something. *Obsolete*.

- ▶ a1398 J. TREVISA tr. Bartholomaeus Anglicus *De Proprietatibus Rerum* (BL Add. 27944) (1975) I. x. x. 565 Asken..is gendrid and resolued [L. *resolutus*] of substaunce of erþy matiere by strengþe of hete.
  - ▶ a1398 J. TREVISA tr. Bartholomaeus Anglicus *De Proprietatibus Rerum* (BL Add. 27944) (1975) II. xvii. ii. 892 More smal and sotil smoke is resolued of þe male [tree] þan of þe femel.
- c1425 tr. J. Arderne *Treat. Fistula* (Sloane 6) (1910) 59 (*MED*) Of rawnes of digestion is þe vryne discolored, And it appereþ with poudry resolucions which bene resolued of malencolious blode.
- a1475 in *Neuphilol. Mitteilungen* (1957) 58 61 (*MED*) The son and other sterrys, sendyng ther beemys unto the erthe and water, resolveth of and pulleþe fro the erthe diverse vapores.
- a1500 ( ▶ c1477) T. NORTON *Ordinal of Alchemy* (BL Add.) (1975) l. 1973 (*MED*) Odour is a smokish vapour resoluyd with hete Owte of a substance bi a Invisible swete.

## 9.

### a.

(a) *transitive*. To reduce (a subject, statement, phenomenon, etc.) by analysis *into* more elementary forms, principles, etc.; to consider or demonstrate (something) to be divisible or analysable *into*. Formerly also with †*in*.

- ▶ a1398 J. TREVISA tr. Bartholomaeus Anglicus *De Proprietatibus Rerum* (BL Add.) f. 329v Þe triangle may nouȝt be so y-deled in oþre figures than triangles in þis wise..þat oþere figures beþ resolued and deled in

triangles.

- a1450 ( ▶ a1397) *Prol. Old Test.* in *Bible (Wycliffite, L.V.)* (Cambr. Mm.2.15) (1850) xv. 57 An ablatif case absolute may be resoluid into these thre wordis.
- 1570 H. BILLINGSLEY tr. Euclid *Elements Geom.* i. f. 41<sup>v</sup> Euery right lined figure is resolued in two triangles.
- 1628 T. SPENCER *Art of Logick* 284 When the causes doe argue the effect, the effect is resolued into the causes.
- a1674 EARL OF CLARENDON *Brief View Leviathan* (1676) 8 He resolv'd all Wisdom and Religion itself into a simple obedience and submission to it.
- 1719 D. DEFOE *Life Robinson Crusoe* 237 After I had entertain'd these Notions, and by long musing, had as it were resolved them all into nothing.
- 1774 T. PENNANT *Tour Scotl.* 1772 233 I was for resolving this phænomenon into Ship-wrecks.
- 1841–8 F. MYERS *Catholic Thoughts* II. iv. §2. 184 Why may we not..resolve Christianity into a system of practical Morality?
- 1871 B. JOWETT in tr. Plato *Dialogues* III. 335 All sensation is to be resolved into a similar combination of an agent and patient.
- 1916 J. E. BOODIN *Realistic Universe* ii. 20 We cannot resolve reality, whether conscious or unconscious, into bundles of perception, or into experience of any form, altogether.
- 1958 J. S. HINES tr. A. Mathiot *Brit. Polit. Syst.* i. ii. 88 Such an issue can be resolved into a simple choice between two parties.
- 2003 *Jrnl. Paleontol.* 77 1088/1 The distribution of living corbulid genera can be resolved into three broad biogeographic regions.

(b) *transitive (reflexive)*. Of a subject, statement, etc.: to be susceptible of such reduction or analysis.

- 1739 D. HUME *Treat. Human Nature* I. i. 11 All the perceptions of the human mind resolve themselves into two distinct kinds, which I shall call Impressions and Ideas.
- 1814 T. CHALMERS *Evid. Christian Revel.* ii. 46 The argument..resolves itself into four parts.
- 1879 J. LUBBOCK *Addresses, Polit. & Educ.* iii. 44 His complaint resolves itself into two parts.
- 1904 *Athenæum* 9 Apr. 464/3 I find..upon making a careful stichometrical analysis of the Libellus, that it resolves itself into thirty-eight sections.
- 1956 *Shakespeare Q.* 7 387 It will be seen from the above printing that the song resolves itself into five sections.
- 2001 D. KEPPEL-JONES *Strict Metrical Trad.* 26 Rhythm tends to resolve itself into three aspects.

**b. transitive.** To reduce or convert (a quantity) *into* specified units. Now *rare*.

- ?a1560 L. DIGGES *Geom. Pract.: Pantometria* (1571) i. xxi. sig. G j<sup>v</sup> Then resolue 20 foote into inches.
- 1669 S. STURMY *Mariners Mag.* II. vi. 66 The Degrees resolved into Hours and Minutes, is 1 Hour 49 Min.
- a1687 W. PETTY *Polit. Anat. Ireland* (1691) 352 The victuals.., resolved into money, may be estimated 3s. 6d. per week.
- a1803 R. CHAMBERS *Treat. Estates & Tenures* (1824) vi. 189 The reliefs in earlier times..were paid in horses, and arms, and habiliments of war: but these, like other things, were in time resolved into money.
- 1873 *Amer. Educ. Monthly* May 193 This day.., if resolved into minutes, and divided by 365, will give the four minutes difference between solar and sidereal time.

- 1908 *Strand Mag.* Oct. 440/1 Eighteen thousand francs is not a large sum when resolved into pounds, shillings, and pence.
- 1938 *Navy Dept. Appropriation Bill: Hearings before House Appropriations Comm.* (75th U.S. Congr., 3rd Sess.) 207 I should like to have that resolved into dollars and cents... The cost..is \$1,713.88.

†**c.** *transitive.* To analyse, examine (a statement). *Obsolete. rare.*

- 1593 R. HOOKER *Of Lawes Eccl. Politie* II. vii. 120 Examine, sift, and resolute their alleaged proofes, till you come to the very roote..whence they springe.
- 1599 tr. A. Munday *Treat. Vertue of Crosse* sig. C4<sup>v</sup> These matters first heere noted, haue vrged vs to resolute such allegations, as are containyd in the first placard.

## 10.

### a.

(a) *transitive.* To convert, transform, alter, render (a material or immaterial thing) *into* some other thing or form. Formerly also with †*to*. Also *figurative*.

- a1450 ( ▶ a1397) *Prol. Old Test.* in *Bible (Wycliffite, L.V.)* (Cambr. Mm.2.15) (1850) xv. 57 A participle of a present tens..mai be resoluid into a verbe of the same tens, and a coniunccion copulatif, as thus..seinyge, mai be resoluid thus, *and seith*, eithir *that seith*.
- a1538 T. STARKEY *Dial. Pole & Lupset* (1989) 11 Yf ther be any cyvyll law ordeynyd wych can not be resolvyd therto, hyt ys of no value.
- 1565 N. SANDERS *Supper of Our Lord* IV. f. 196 The cause why the verb *est* should be resolved into the verb *significat*, must nedes come from the word *corpus* body.
- 1591 R. WILMOT *Tancred & Gismund* II. iii. sig. C2<sup>v</sup> A resolution that resolves my bloud Into the Ice-sie drops of Lethes flood.
- a1616 W. SHAKESPEARE *Timon of Athens* (1623) IV. iii. 441 The Seas a Theefe, whose liquid Surge, resolves The Moone into Salt teares.
- a1623 H. SWINBURNE *Treat. Spousals* (1686) 27 By the same means..are those Spousals by them contracted in their Minority..resolved or turned into Matrimony.
- 1674 R. BAXTER *Full & Easie Satisfaction* IV. vii. 127 All their faith of this [sc. the doctrine of transubstantiation] is by them resolved into a phanattick pretence of Inspiration.
- 1743 M. TOMLINSON *Protest. Birthright* 13 Into whose Authority all Christians have resolved their Faith and Obedience.
- 1750 J. CAMPBELL *Present State Europe* x. 281 A very large Proportion of the Debt was, if not paid, at least resolved into Waste Paper.
- 1861 C. DICKENS *Great Expectations* III. v. 84 The spectral figure..seemed all resolved into a ghastly stare.
- 1875 E. C. STEDMAN *Victorian Poets* (ed. 13) 387 The succeeding chorus..resolves attention to enchantment.
- 1889 *Standard* 9 Apr. Emin..has seen islands resolved into headlands.
- 1933 *Mod. Psychologist* Nov. 247 Old mind-sets have to be resolved into a hospitable flexibility in order that new attitudes and expectancies may be formed.
- 1951 A. SCHWARZSCHILD tr. R. Luxemburg *Accumulation of Capital* II. 55 Referring each private capital unit to its place of production in order to resolve it into a mere product of labour.
- 2007 D. CLARKE in P. Cheney *Cambr. Compan. Shakespeare's Poetry* x. 193 Her suffering has been resolved into narrative, as she retells her rape.

(b) *intransitive*. With *into* or (now less commonly) *to*. Of an immaterial thing: to change or be transformed into some other form or state; *esp.* to be susceptible of being interpreted as some other thing. Formerly also with †*in*.

- 1598 R. BARCKLEY *Disc. Felicitie of Man* v. 393 It resolveth into this inconvenience, that the covetousnes of one wicked man is satisfied by the prejudice of a whole nation.
- 1647 BP. J. TAYLOR *Θεολογία Ἐκλεκτικῆ* II. 30 The whole businesse of submitting our understanding to humane authority, comes to nothing; for either it resolves into the direct duty of submitting to God, or if it be spoken of abstractedly, it is no duty at all.
- 1679 J. DRYDEN *Troilus & Cressida* I. i. 2 Then every thing resolves to brutal force And headlong force is led by hoodwink'd will.
- 1709 LD. SHAFTESBURY *Moralists* III. i. 158 I..celebrate the Beautys which resolve in Thee, the Source..of all..Perfection.
- 1752 D. HUME *Balance of Trade* in *Ess.* (1817) I. 315 These cases, when examined, will be found to resolve into our general theory.
- 1819 W. SCOTT *Bride of Lammermoor* ii, in *Tales of my Landlord* 3rd Ser. II. 32 It would resolve into an equitable claim.
- 1877 G. MEREDITH in *New Q. Mag.* Apr. 20 The Comedy might be performed by a troop of the corps de ballet; and in the recollection of the reading it resolves to an animated shuffle of feet.
- 1955 R. GRAVES *Crowning Privilege* 227 Each scowl resolves into a leer.
- 1995 I. DUNCAN in A. Conan Doyle *Lost World* (1998) p. xix It is at that moment..that Malone resolves into a murderous, alien, yet organic and original self.

(c) *transitive (reflexive)* in same sense.

- 1652 H. L'ESTRANGE *Americans No Iewes* 73 At last the ridiculous excesse thereof was restrained, and soon after the folly of the devise resolved it self into its dissolution.
- 1840 *U.S. Mag. & Democratic Rev.* Jan. 24 The *quasi* discords of Sappho's melodized passion—still recurring, and still resolving themselves into music.
- 1856 C. J. LEVER *Martins of Cro' Martin* xxiii. 245 All resolves itself to some question of a harm to one side.
- 1920 W. T. TILDEN *Art of Lawn Tennis* 67 Match play..resolves itself into a battle of wits and nerve.
- 1928 *Amer. Mercury* Oct. 180/1 Consequently, between the violent outrushing of the Holy Spirit and the bad acoustics, the service is apt to resolve itself into one vast gr-r-r-r-r.
- 1976 *Times* 26 Jan. 6/7 It was a pity that a match which reached such a high pitch of excitement should have resolved itself into a trial by ordeal.
- 2000 M. RICKARDS *Encycl. Ephemera* (2001) 244/1 In many cases the matter resolved itself into a dispute between one parish and another.

**b.** *transitive (reflexive)*. Of a deliberative body, meeting, etc.: to convert itself *into* a committee for some particular purpose. Also in *passive* and *intransitive* in same sense.

- 1641 S. D'EWES *Speech Commons, July 7th* (title page) Being resolved into a committee, (so neer as it could be collected together) in the Palatine cause.

- 1654 T. FULLER *Ephemeris Parliamentaria* 240 Let us be resolved into a Committee, and presently fall to debate thereof.
- 1659 S. BUTLER *Acts & Monuments Late Parl.* 5 Thereupon the house resolved into a grand Committee to debate the proportioning of the said lands to the particular members.
- 1710 *London Gaz.* No. 4699/3 The House resolved it self into a Committee of the whole House.
- 1753 *Scots Mag.* Aug. 388/2 The house having resolved itself into a committee of the whole house upon the..bill.
- 1828 tr. A.-J.-M.-R. Savary *Mem.* I. II. v. 43 The commission resolved itself into a council to deliberate.
- 1885 *Manch. Examiner* 7 Oct. 5/3 The meeting unanimously resolved itself into a committee.
- 1902 *Jrnl. Polit. Econ.* 10 414 A formal motion to the effect that on a certain day the house will resolve itself into a committee to consider the supply to be granted to His Majesty.
- 1977 *S. Central Bull.* 37 12/1 Professor Werbow moved that the executive committee resolve into a committee of the whole to discuss a matter of general welfare.
- 1995 *Sunday Mail (Queensland)* (Nexis) 24 Sept. The use of a council local law on meeting procedure might allow it to resolve itself into a committee to allow the consideration of a secret ballot.

## 11.

**a. transitive and intransitive. Mathematics.** To analyse (a force or other vector quantity) into two or more components acting in different directions but collectively having the same effect as the original vector. Cf. RESOLUTION *n.*<sup>1</sup> 10.

- 1719 G. GORDON *Remarks Newtonian Philos.* 13 All that can here be inferred is, that the actual Motion of the Body in the Line *bc*, may be resolved into the Forces *bf* and *bg*; but then it may as well be resolved into *bf*, *bo* and *br*.
- 1781 *Philos. Trans.* 1780 (Royal Soc.) 70 559 Let FD..represent the force communicating the motion at the point D, which resolve into two others.
- 1806 O. G. GREGORY *Treat. Mech.* I. I. ii. 24 Resolve each of the forces into components respectively parallel to these co-ordinates.
- 1852 J. B. PHEAR *Elem. Hydrostatics* v. 89 Hence, resolving along *cO* and in a plane perpendicular to it, we have [etc.].
- 1909 W. H. P. CREIGHTON *Steam-engine & Other Heat-motors* (ed. 2) xv. 452 Resolve these velocities along the line of motion of the bucket.
- 1948 *Sci. News* 7 23 In aerodynamics it is customary to resolve the reaction of the air on a surface into two components, namely lift..and drag.
- 1956 W. MERCHANT & A. BOLTON *Introd. Theory Structures* i. 11 Find the size and position of the resultant force *R* acting on the lamina. Resolving vertically,  $V = 4 - 2 = 2$  lb.
- 2005 B. J. NELSON et al. in P. Dario & R. Chatila *Robotics Res.* III. 120 Capacitors are orthogonally configured to make the force sensor capable of resolving forces in both the *x* and *y* directions.

**b. transitive. Science.** To analyse (a phenomenon, esp. a wave motion) into components which when added together give that phenomenon. Cf. *Fourier analysis* at FOURIER *n.*

- 1873 *Med. Times & Gaz.* 4 Oct. 396/1 This wave the ear can resolve into its component parts.

- 1894 *Proc. Physical Soc.* **13** 94 It was most useful to resolve the motion into its fundamental harmonic motions and its overtones.
- 1936 R. S. GLASGOW *Princ. Radio Engin.* i. 22 The flat-topped wave of Fig. 16a and the peaked wave of Fig. 16b may be resolved into a fundamental and third harmonic.
- 1965 *Math. in Biol. & Med.* (Med. Res. Council) i. 38 Figure 3 shows how an analogue computer is used to resolve such a curve into its components.
- 2005 *Proc. National Acad. Sci. U.S.A* **102** 13928/1 To resolve the early phases of the isotonic velocity transient, the acquisition rate was 200 kHz.

## 12. Music.

**a. transitive.** To alter or transform (a discord, or relatively dissonant harmony) so as to form a concord, or relatively more consonant harmony.

Cf. RESOLUTION *n.*<sup>1</sup> 9b.

- 1728 E. CHAMBERS *Cycl.* at *Discord* The Discord is resolved by being immediately succeeded by a Concord.
- 1797 *Encycl. Brit.* XVI. 125/1 There is no possible manner of resolving a dissonance which is not derived from an operation of cadence.
- 1838 *Penny Cycl.* XII. 50/1 Most discords require to be prepared, and all must be resolved.
- 1868 F. A. G. OUSELEY *Harmony* (1875) ii. 20 When the discords have thus been rendered agreeable to the ear, they are said to be resolved.
- 1924 *Musical Times* Feb. 132/2 If we resolve the dominant chord at the double-bar on page 5, it makes a complete movement in itself.
- 2003 L. BLACK *Franz Schubert* 31 The root of the dominant-seventh chord..is not actually heard in the crucial chord..., though it is there again in the upper part immediately the dissonance is resolved.

**b. intransitive.** Of a discord or relatively dissonant harmony: to undergo such a transformation. Of a note: to effect such a transformation by passing to another note. Frequently with *on to* or *upon*.

- 1825 J. F. DANNELEY *Encycl. Music* The seventh and ninth are dissonant, and therefore resolve or descend one degree.
- 1878 *Johnson's New Universal Cycl.* (new ed.) III. 683/1 A seventh, instead of resolving into the perfect triad, may be succeeded by another seventh.
- 1889 E. PROUT *Harmony* xiv. §332 All chords of the ninth can resolve upon their own generator.
- 1942 *Music & Lett.* **23** 20 In the middle parts there is an F persisting which only resolves on to Eb on the final two notes.
- 1989 P. VAN DER MERWE *Origins Pop. Style* (1992) xx. 173 Typically these blue sevenths..fall to the dominant, resolving onto the dominant in much the same way as the blue third resolves onto the tonic.
- 2006 *Daily Tel.* (Nexis) 17 June 4 Basically, Wagner sounds a chord at the beginning and it never resolves until the very end.

## 13.

**a. transitive. Science.** Originally: (of optical instruments or persons using them) to reveal or perceive (a nebula) as a cluster of distinct stars. Later more widely: to distinguish parts or components of (something) that are



close together in space or time; to identify or distinguish individually (peaks in a graph, lines in a spectrum, etc.). Cf. RESOLUTION *n.*<sup>1</sup> 6.

- 1785 *Philos. Trans.* (Royal Soc.) 75 219 When he resolves one nebula into stars, he discovers ten new ones which he cannot resolve.
- 1833 *London & Edinb. Philos. Mag.* 2 338 These small brown moths possess very delicate and unique scales, requiring some tact in the management of the illumination, to resolve their lines distinctly.
- 1868 J. N. LOCKYER *Elem. Lessons Astron.* §77 Star-clusters..so distant that even in telescopes of great power they could not be resolved.
- 1932 *Proc. Royal Soc. A.* 136 313 Two particles separated by as little as 1/500th second could be 'resolved' and correctly recorded.
- 1962 H. D. BUSH *Atomic & Nucl. Physics* iii. 58 If the fine structure is examined with the aid of very high resolution instruments, each component of the fine structure is resolved into further components.
- 2001 N. J. LANE in R. Catlow & S. Greenfield *Cosmic Rays* 73 The light microscope was unable to resolve detail much below 0.2µm.

**b.** *intransitive* and *transitive (reflexive)*. With *into*. Of an object initially perceived indistinctly: to become identifiable, esp. as a number of discrete objects, when seen more clearly. Also in extended use.

- 1825 R. TAYLOR *Key to Knowl. Nature* iv. 78 Many of the stars which appear single to the naked eye, on the application of the telescope, resolve themselves into two or more.
- 1853 L. SUNDERLAND *Bk. Human Nature* 42 Were we to look at our solar system from myriad millions of miles, it would appear to us a conglobated or solid mass... But when we near it, it resolves into planets and satellites.
- 1890 K. MUNROE *Under Orders* v. 67 As he rounded a corner this noise resolved itself into the shouts, cheers, and yells of an angry mob.
- 1897 *Yale Literary Mag.* Oct. 35 It resolved into a black speck and a white one.
- 1921 *National Geographic Mag.* Mar. 269/1 A minute object that separated into two as we drew nearer, and finally resolved itself into a pair of vessels linked together with a tow-line.
- 1985 *Pop. Sci.* Feb. 70/1 As the distance closes, the pod resolves into a trio of connected cylinders, each larger than a tour bus.
- 1992 F. KEMSKE *Lifetime Employ.* xii. 161 The faint cracking sound resolved itself into the din of a half dozen different kinds of firearm being discharged repeatedly.
- 2002 A. PROULX *That Old Ace in Hole* (2003) i. 3 There appeared, far ahead..a wambling black dot that resolved into a bicyclist.

**14.** *transitive. Chemistry.* To separate (a racemic compound or mixture) into optical isomers.

- 1899 J. MCCRAE tr. H. Landolt *Optical Activity & Chem. Composition* 90 Fermentation lactic acid in the form of its zinc ammonium salt..has been resolved [Ger. *zerfällt*] by crystallisation into the *d*- and *l*-lactates.
- 1919 S. W. COLE *Pract. Physiol. Chem.* (ed. 5) v. 151 Equal parts of the *d*- and *l*- varieties are formed. These can often be resolved into their active constituents.

- 1983 R. O. C. NORMAN & D. J. WADDINGTON *Mod. Org. Chem.* (ed. 4) xv. 245 Racemic mixtures which are not acids or bases can often be resolved by first making them into derivatives with acid groups.
- 2001 J. S. VARCOE *Clin. Biochem.* xi. 16 Chiral additives can be included in the buffer to resolve stereo isomers.

**15. transitive. Computing.** To translate (a readable, alphanumeric domain name) into a numerical IP address, typically by means of the domain name system. Also: to identify (the IP address) of a particular domain name. Cf. RESOLVER *n.* 5.

- 1983 P. MOCKAPETRIS *Request for Comments* (Network Working Group) (Electronic text) No. 882. 15 These name servers..must resolve names for at least all the hosts in the domain.
- 1993 *InfoWorld* (Nexis) 25 Oct. 65 We noticed we were unable to use our host's file to resolve IP addresses. Another call to technical support.
- 2003 B. KOMAR et al. *Firewalls for Dummies* (ed. 2) x. 175 Type the Web site name in the address bar of the Web browser. This name is resolved to the IP address of the Web site with the help of DNS servers.

**III.** To untie; to answer, solve; to decide, determine.

**16. transitive.** To untie, unbind, loosen; to release (something) from its bonds (*literal and figurative*); (perhaps) to disentangle.

In later use only in figurative contexts with reference to knots.

- ▶ a1398 J. TREVISA tr. Bartholomaeus Anglicus *De Proprietatibus Rerum* (BL Add. 27944) (1975) I. III. xxii. 123 ȝif þis spirit ben apeired and ihurt and ilette of here worchinge..þe acord of þe body and soule is resolued.
- ▶ a1398 J. TREVISA tr. Bartholomaeus Anglicus *De Proprietatibus Rerum* (BL Add. 27944) (1975) I. XI. iii. 574 Þe west wynd..resolueþ and vnbindiþ wyntir and bringiþ for[þ] gras, herbis, and floures.
- c1450 (▶ 1410) J. WALTON tr. Boethius *De Consol. Philos.* (Linc. Cathedral 103) 204 (*MED*) Youre resouns weyuen [y]e so wondirly In maner like þe hous of Dydalus Full hard for to resoluen and vnplye [L. *inextricabilem labyrinthum rationibus texens*].
- ?1518 A. BARCLAY tr. D. Mancinus *Myrroure Good Maners* sig. B.iv<sup>v</sup> Thy wyttes to apply To resolue or argue: with wordes superflue The knottes intrycate, of bablynge sophystry.
- 1558 T. PHAER tr. Virgil *Seuen First Bks. Eneidos* VII. 155 Resolue [L. *solvite*] your heades attyre, & celebrate this daunce with me.
- 1591 H. SMITH *Treat. Lords Supper* I. 26 Resolue this knot & al is cleere.
- 1610 *Bible* (Douay) II. Dan. v. 16 Thou canst interpret obscure thinges, and resolue [L. *dissolvere*] thinges bound.
- a1637 B. JONSON *Magnetick Lady* IV. viii. 51 in *Wks.* (1640) III What deserves he In your opinion, Madam..can resolve the knot?
- 1776 J. BERINGTON *Lett. Materialism* II. 30 He..resolves the knot, by asking another question.
- 1844 *N. Brit. Rev.* May 132 A true philosophy..resolves the knot when it is most perplexed.
- 1881 T. WOOLNER *Pygmalion* VI. 89 You..Tend to resolve all tangles by the stroke Of steel.
- 1936 E. FITZGERALD tr. F. Mehring *Karl Marx* III. 65 In the one case it is a question of resolving the knot, and in the other one of first tying it.
- 2005 *Windsor (Ont.) Star* (Nexis) 29 Dec. B4 Perhaps he can unravel and resolve some of the emotional knots that leave him so tied up that he cannot be successful.



## 17.

## a.

(a) *transitive*. To answer (a question); to solve (a problem of any kind); to determine, settle, or decide upon (a point or matter regarding which there is doubt or dispute). Formerly also: †to make an effective response to (a proposition, argument, etc.) (*obsolete*). Also *reflexive*.

Sometimes with indirect question as object.

- ▶ a1438 *Bk. Margery Kempe* (1940) I. 35 (*MED*) Þe clerkys askyd þis creatur many hard qwestyons, þe wych sche be þe grace of Ihesu resoluyd, so þat hir answerys lykyd þe Bysshop rygth wel.
- ▶ c1454 R. PECOCK *Folewer to Donet* 34 Þilke persoones whiche ben so lowȝe and symple in witt, leernyng, and kunnyng þat þei not sufficen to resolue and bryngte maters of philosophie in to her groundis of resoun.
- 1550 T. CRANMER *Def. Sacrament* IV. f. 94 S. Augustine, most plainly resolueth this matter in his booke., disputing against two kinds of heretiques.
- 1577 tr. St. Augustine in H. I. tr. H. Bullinger *50 Godlie Serm.* II. III. ix. sig. Oo.j<sup>v</sup>/1 Mee thinketh therefore that this question can bee none otherwise resolved.
- 1581 J. BELL tr. W. Haddon & J. Foxe *Against Jerome Osorius* 212 Least he exclayme agayne that his argumentes are not throughly resolved, I will answer in few wordes.
- 1612 T. TAYLOR *Αρχη ἂν Ἀπάντων: Comm. Epist. Paul to Titus* (i. 9) 29 Resolving all doubtful cases.
- 1647 J. SPRIGGE *Anglia Rediviva* (1854) II. i. 72 This resolved the question at the council of war without putting it.
- 1661 J. DAVIES tr. D. Blondel *Treat. Sibyls* II. xi. 110 Does the Flaming Sword keep the entrance of Paradise against the Saints? But the Question resolves it self.
- 1704 J. SWIFT *Disc. Mech. Operat. Spirit* i, in *Tale of Tub* 284 I have been perplexed for some time, to resolve what would be the most proper Form to send it abroad in.
- 1749 H. FIELDING *Tom Jones* II. IV. xii. 87 Whether Mrs. Honour really deserved that Suspicion..is a Matter which we cannot indulge the Reader's Curiosity by resolving .
- 1750 S. JOHNSON *Rambler* No. 19. ¶15 After a great part of life spent in enquiries which can never be resolved.
- 1830 J. F. W. HERSCHEL *Prelim. Disc. Study Nat. Philos.* III. i. 221 We are called upon to resolve the important but complicated problem.
- 1858 D. BOUCICAULT *Pope of Rome* I. ii. 9 The business our friends are summoned hither to determine will resolve the matter.
- 1941 *Astounding Sci.-Fiction* Feb. 115/2 Don't drive yourself crazy trying to resolve the paradoxes of time-travel.
- 1969 *Times* 15 Aug. 4/5 New studies designed to resolve how insulin works.
- 1980 J. CALDER *RLS* iii. 56 He reflected on the tricky problem of chastity, but could not resolve it.
- 2002 *New Yorker* 11 Nov. 78/3 Comedy theorists..have yet to resolve even such simple questions as where knock-knock jokes come from.

(b) *transitive*. With double object. Now *rare*.

- 1577 M. HANMER tr. Socrates Scholasticus IV. xviii, in *Aunc. Eccl. Hist.* 331 I mused what to answer, and requested him to resolue me the doubt.
- 1594 W. SHAKESPEARE *Titus Andronicus* v. iii. 35 Resolue me this, Was it well done..To slay his daughter.

- 1706 R. ESTCOURT *Fair Example* I. i Pray will you resolve me one Question?
- a1707 T. BROWN *Saints in Uproar* in *Wks.* (1707) I. 109 Resolve me a Question or two.
- 1786 E. INCHBALD *I'll tell you What* IV. i. 65 If you can resolve me that..I have no censure for you.
- 1819 W. SCOTT *Ivanhoe* III. x. 233 And how should my poor valour succeed, Sir Jester, when thy light wit halts?—resolve me that.
- 1862 *Church of People* Jan. 10 Perhaps so,—but first resolve me the question *in what does brutishness consist?*
- 1905 H. C. BEECHING *Let.* 30 Sept. in E. V. Lucas *Post-bag Diversions* (1934) 13 Now resolve me a question.
- 1946 L. DE LA TORRE *Dr. Sam: Johnson, Detector* 190 'Pray, Dr. Johnson,' said I, 'resolve me one thing. If the strange message was not Ogam, what was it?'

†**b. transitive.** To explain; to make clear. *Obsolete.*

- c1592 *Faire Em* sig. B2<sup>v</sup> In frendship then resolue What is the cause of your vnlookt for stay?
- 1633 J. FORD *'Tis Pitty shee's Whore* I. sig. B2<sup>v</sup> *Flo.* What's the ground? *Sor.* That with your patience Signiors, I'll resolue.
- a1661 T. FULLER *Worthies* (1662) Yorks. 206 Some resolve all his passion on a point of meer revenge.
- 1718 M. PRIOR *Solomon on Vanity* III, in *Poems Several Occasions* (new ed.) 504 The Man who would resolve the Work of Fate, May limit Number, and make Crooked Strait.
- 1821 W. WORDSWORTH *Eccl. Sonn.* I. xxix The full-orbed Moon..doth appear Silently to consume the heavy clouds; *How* no one can resolve.
- 1866 H. BUSHNELL *Vicarious Sacrifice* Introd. 14 Attempts have been made, in all ages,..to assert..what is called 'the moral view' of the atonement, and resolve it by the power it wields in human character.
- 1877 E. LEIGH *Gloss. Words Dial. Cheshire* 168 Au canna mak it out, yoe mun resolve it.

**c. transitive. Mathematics.** To solve (a mathematical problem, esp. an equation); to find a simpler form of (an equation) from which a solution can be readily inferred. Cf. RESOLUTION *n.*<sup>1</sup> 14a(b).

- 1613 R. WITT (*title*) Arithmetical questions..briefly resolved.
- 1669 *Philos. Trans.* (Royal Soc.) 4 934 Dr Wallis, who hath so excellently resolved..Cubick Æquations.
- 1685 J. WALLIS *Let.* 25 Apr. in R. Boyle *Corr.* (2001) VI. 115 A Question of Compound Interest, Resolved by Logarithms, at One Operation.
- 1737 tr. I. Newton *Treat. Method of Fluxions* 21 I then assume some Number for *a* and resolve this Equation.
- 1798 C. HUTTON *Course Math.* I. 240 All equations, in which there are two terms involving the unknown quantity..are resolved like quadratics, by completing the square.
- 1850 C. DAVIES *Logic & Utility Math.* 266 Every geometrical question can be solved, if we can resolve the corresponding algebraic equation.
- 1874 J. FICKLIN *Compl. Algebra* xiii. 240 Resolve the first member of the equation  $x^2 + 73x + 780 = 0$  into two binomial factors. *Ans.*  $(x + 60)(x + 13) = 0$ .
- 1905 F. M. SAXELBY *Course Pract. Math.* vi. 68 No general rule can be given for resolving an expression into factors.
- 1970 *Times* 16 June p. vii/2 The optimum development of so many schemes depends upon resolving a simultaneous equation where the unknowns are design, cost and return.
- 2007 *Desalination* 209 302/1 We resolve the equation system by fixing parameters.

**d. transitive.** To settle (a dispute or argument); to reconcile opposing elements or tendencies within (a conflict, contradiction, etc.).

- 1875 *Pall Mall Gaz.* 7 Jan. 7/1 If, to resolve those conflicts, you should think it desirable..to arm the Executive Power with the right of appealing to the judgment of the country.
- 1901 *Times* 1 Feb. 3/6 He suggested that it be given to a tribunal to resolve the dispute which existed between Protestants and Roman Catholics.
- 1914 *Philos. Rev.* 23 353 Plotinus's effort..to resolve the conflict between these two elements in his view, Dr. Fuller finds to be wholly futile.
- 1972 M. HALPERIN *Rise & Decline Fidel Castro* xxv. 280 A special mode of communication that permitted the two parties to conduct and resolve the quarrel in public without acknowledging the existence of the quarrel.
- 1988 *Engineer* 17 Mar. 7/1 British Coal is expected to meet the South of Scotland Electricity Board to try to resolve the stand-off over cheap coal imports.
- 2005 *Campaign* 22 July 21/4 Since this spat is more damaging to you than to him, he may not be all that keen to resolve it.

## 18.

**a. transitive.** To remove, clear away, dispel (a doubt, uncertainty, or obscurity).

- 1548 *Hall's Vnion: Edward IV* f. cxci<sup>v</sup> All suche doubttes, were now shortly resolued and determind, and all feare of his doynge, wer clerely put vnder and extinct.
- ?a1560 L. DIGGES *Geom. Pract.: Pantometria* (1571) I. xix. sig. F ij Small practize will resolue all doubttes.
- a1616 W. SHAKESPEARE *Henry VI, Pt. 3* (1623) IV. i. 132 But ere I goe, Hastings and Mountague Resolue my doubt.
- 1643 SIR T. BROWNE *Religio Medici* (authorized ed.) 48 Myself can shew a catalogue of Doubts which are not resolved at the first hearing.
- 1667 A. MARVELL *Let.* 2 Feb. in *Poems & Lett.* (1971) II. 54 If you find any thing perplex in it I shall..resolue any scruple that you may haue of its exposition.
- 1706 J. VANBRUGH *Mistake* II. i. 10 You must resolve one Doubt which often gives me great Disturbance.
- 1776 E. GIBBON *Decline & Fall* I. xvii. 464 He was frequently requested to resolve the doubts of inferior judges.
- 1817 J. MILL *Hist. Brit. India* II. IV. v. 165 All doubts might be resolved by the interrogation..of the commander.
- 1873 W. BLACK *Princess of Thule* xiii. 198 She had bravely resolved her doubts and made up her mind.
- 1939 *Chester (Pa.) Times* 22 Mar. 3/4 Such grim statistics resolve any lingering doubt as to the effectiveness of Russia's military power.
- 1991 *Times Educ. Suppl.* 22 Feb. 38/3 The encyclopaedist aims to resolve uncertainty, not to enjoy its multiple creative possibilities.
- 2008 P. MASTERSON *Sense of Creation* 110 Such observations..cannot be presumed to resolve the profoundly held misgivings of atheists about the existence..of God.

**b. transitive.** To dispel, allay, assuage (an emotion or feeling, as fear, curiosity, etc.).

- 1580 J. LYLY *Euphues & his Eng.* in *Euphues* (new ed.) f. 18<sup>v</sup> Your reply hath fully resolved that feare.
- a1626 W. ROWLEY *Birth of Merlin* (1662) sig. G4 Speak learned Merlin, and resolve my fears.
- 1635 J. REYNOLDS *Triumphs Gods Revenge* (new ed.) iv. xvii. 341 The patience of a little time, will shortly resolve our curiositie, whereunto these different affections will tend.
- 1723 J. ROBE *Fatal Legacy* v. 67 While yet I have remaining Life to hear thee, Resolve the Fears thy Words have rais'd within me.
- 1749 H. FIELDING *Tom Jones* III. vii. iii. 15 Indeed we cannot resolve his Curiosity as to this Point.
- 1833 W. J. NEALE *Port Admiral* III. xii. 243 She..ascended to the top of Maker Tower, anxious yet dreading to descry the approach of some vessel, which would resolve her fears.
- 1958 J. BETJEMAN *Coll. Poems* 278 The waltz was played, the songs were sung, The night resolved our fears.

†**19.** *transitive (reflexive).* To join oneself to a person's opinion. *Obsolete.*  
*rare*<sup>-1</sup>.

- 1548 *Hall's Vnion: Henry VI* f. clxxxij Therle of Salisbury and other his frendes, seing his corage, resolved themselves to his opinion.

†**20.**

**a.** *transitive.* To free (a person) from doubt or perplexity; to bring to a clear understanding; to provide with definite information. *Obsolete.*

In quot. 1548 with the senses as object.

- 1548 E. GEST *Treat. againste Masse* sig. Biv<sup>v</sup> The broken bread and blessed wyne be institute purposely to resolve and ascertayn our senses.
- 1549 J. PONET *Def. Mariage Priestes* sig. Dviii<sup>v</sup> I haue wysshed that som learned man wold take the paynes to resolve the vnlearned sorte touchyng that poynt.
- 1596 W. LAMBARDE *Perambulation of Kent* (rev. ed.) 399 If you yet doubt, conferre (I pray you) his report with theirs, and it shall resolve you.
- a1616 W. SHAKESPEARE *Measure for Measure* (1623) iv. ii. 208 Yet you are amaz'd, but this shall absolutely resolve you.
- 1649 Bp. J. TAYLOR *Great Exemplar* II. 98 To strengthen the weake, to resolve the scrupulous, to teach the ignorant.
- 1719 D. DEFOE *Life Robinson Crusoe* 356 We knew not what Course to take, but the Creatures resolv'd us soon.
- 1766 A. WILLIAMS tr. P. Metastasio *Uninhabited Island* vi, in *Misc.* 161 Whate'er it be, it has a pleasing form: My Sister shall resolve me.
- 1772 J. WESLEY *Jrnl.* 31 Oct. They asked me, 'whether they were good or bad spirits?' But I could not resolve them.

**b.** *transitive.* With *of* or *in* and complement expressing the matter of doubt. *Obsolete.*

- 1549 J. PONET tr. B. Ochino *Tragoedie Unjuste Usurped Primacie* sig. f.iii<sup>v</sup> I am also resolved nowe in another doubt, whereof I shoulde neuer haue ben answered yf ye had not made me perceyue it.

- 1549 J. PONENT tr. B. Ochino *Tragoedie Unjuste Usurped Primacie* sig. y.ii We haue sent for you..to resolue vs of a dout, that is come to our minde.
- 1567 in J. H. Burton *Reg. Privy Council Scotl.* (1877) 1st Ser. I. 515 That thai being certifiit of the veritie may be resolvit of all doubt.
- ?1573 H. CHEKE tr. F. Negri *Freewyl* II. ii. 75 I haue ben desirous of long tyme to know it, and I could neuer meete with any whiche was able to resolue me in this poynt.
- 1597 T. MORLEY *Plaine & Easie Introd. Musicke* 4 If you remember that which before you tolde mee you vnderstood: you would resolue your selfe of that doubt.
- 1648 T. GAGE *Eng.-Amer.* 6 To resolve the Pope himself of whatsoever difficult points in Divinity may be questioned.
- 1651 N. CULPEPER *Semeiotica Uranica* sig. B3<sup>v</sup> I know you would be resolved in one particular.
- a1742 T. STORY *Jrnl. of Life* (1747) 212 Not knowing how we might afterwards be engaged, we did not resolve him in that Point.
- 1767 'CORIAT JUNIOR' *Another Traveller!* II. 23 You may ask whatever questions you please, and you shall be resolved of everything within my power.

**c. transitive.** With indirect question as complement. *Obsolete* (in later use passing into sense 23b).

- 1565 J. JEWEL *Replie Hardinges Answere* i. 18 Concerning Consecration, he doth greate wronge to charge vs with y<sup>e</sup> breache thereof, before he him selfe and others of his side be better resolved wherein standeth Consecration.
- 1595 W. SHAKESPEARE *Henry VI, Pt. 3* II. i. 9 I cannot ioy vntil I be resolu'de, Where our right valiant father is become.
- a1648 LD. HERBERT *Life Henry VIII* (1649) 520 He sent to Spain to be resolved..which of the two Marriages were most convenient.
- 1690 J. LOCKE *Two Treat. Govt.* I. xi. §147 It will always remain a Doubt..till our A. resolves us, whether Shem..had right to Govern.
- 1720 D. DEFOE *Life Capt. Singleton* 273 Whether we..may come off any better..I cannot resolve thee.
- 1756 G. WASHINGTON *Let. in Writings* (1889) I. 253 I wish your Honor would resolve me, whether the militia..must be supplied out of the public stocks of provisions.

## †21.

**a. transitive.** To come to a conclusion about, settle in one's mind, be sure of. Also with clause or infinitive as object. *Obsolete*.

- c1565 'T. C.' tr. G. Boccaccio *Galesus Cymon & Iphigenia* sig. A.vi<sup>v</sup> Her Heere, like goulden wyre, he painted foorth with praise, And fully was resolved in minde, they shonne as Phebvs rayes.
- a1618 W. RALEIGH *Remains* (1644) 237 He left me so weak that he resolved not to find me alive.
- 1659 T. BURTON *Diary* (1828) IV. 55 I was some days since to seek what to resolve in this great debate.
- 1702 J. LOGAN in *Mem. Hist. Soc. Pennsylvania* (1870) IX. 122 Having solicitously resolved several things in my thoughts relating to it, I endeavoured to stave them off.

**b. transitive.** With object complement: to be certain that (a person or thing) is what is specified; (also) to show conclusively to be of a certain

character. *Obsolete. rare.*

- 1613 J. STEPHENS *Cinthias Reuenge* v. vi. sig. R<sup>v</sup> I (Madam) will remoue the deere suspence Of question..And so resolue you a whore absolute.
- 1616 B. JONSON *Epicœne* IV. v, in *Wks.* I. 579 But he looses no reputation with vs, for we all resolu'd him an asse before.
- 1625 R. MONTAGU *Appello Cæsarem* 2 All things..so Delivered..are Errors actuall in themselves; and so stand resolved and accounted of in the Doctrine of the Church.

**c. transitive.** To fix upon (a person) *for* a particular purpose. *Obsolete. rare*

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- 1710 D. MANLEY *Mem. Europe* I. III. 358 She had..resolved him for her peculiar Pleasures, tho' she knew not what way to compass what she had resolved.

†22.

**a. transitive.** Chiefly with *of* or *that*. To convince or assure (a person) that something is the case. *Obsolete.*

- 1567 G. FENTON tr. M. Bandello *Certaine Tragical Disc.* i. f. 13 Being at larg resolved of that which you haue hard by speciall reporte [he] went imediatlye to his chamber [Fr. *Ayant ouy ceste histoire*; It. *Anselmo hebbe inteso il periglio oue Carlo si trouaua*].
- 1567 T. STAPLETON *Counterblast* IV. ix. f. 473 M. Horn..goeth roundlye to the matter, and resolueth vs, that this Decree was made not by the Apostles only.
- 1590 E. WEBBE *Rare & Wonderful Things* (new ed.) To Rdr. They doubtles will resolue them that it is true which is here expressed.
- a1604 M. HANMER *Chron. Ireland* 159 in J. Ware *Two Hist. Ireland* (1633) This Lacy behaved himselfe so discreetly..that the King was resolved of his truth and fidelity.
- a1616 W. SHAKESPEARE *Henry VI, Pt. 1* (1623) III. viii. 20 Long since we were resolved of your truth.
- 1642 D. ROGERS *Naaman* 830 It is said of Hanna, that ere Eli had resolved her from God of a sonne, shee was full of trouble.
- 1650 R. STAPLETON tr. F. Strada *De Bello Belgico* VIII. 30 And, when they resolved him no danger should accrue to either [etc.].
- 1726 W. R. CHETWOOD *Voy. & Adventures Capt. R. Boyle* 258 The Colonel resolv'd me that he had the Means in his own Hands to pacify him.
- 1736 H. FIELDING *Tumble-down Dick* Argt. sig. Aiv She advises him to go to the Round-House,..and there be resolved from his own Mouth of the Truth of his Sire.

**b. transitive (reflexive).** To assure, satisfy, or convince oneself in regard to something. Also: to be assured, know with certainty (frequently in *imperative*). *Obsolete.*

- 1567 W. PAINTER *Palace of Pleasure* II. xxv. f. 223<sup>v</sup> Rhomeo, thou must fully resolue thy selfe vpon one of these .ij. points.



- 1585 T. BILSON *True Difference Christian Subiection* I. 139 You shall thereby resolve your selfe howe farre Princes then lawfully might, and carefully did medle with guiding and ruling the Church of God.
- 1587 A. FLEMING et al. *Holinshed's Chron.* (new ed.) III. Contin. 1351/1 Resolve your selfe my lord, you haue a goodlie soule.
- 1593 T. LODGE *Life & Death William Long Beard* C 3 In youth be true, and then in age resolve thee, Friends will be friends.
- a1618 W. RALEIGH *Remains* (1644) 237 If I live to return, resolve your self that it is the care for you that hath strengthened my heart.
- 1657 S. PURCHAS *Theatre Flying-insects* 74 If you taste it, you will easily resolve your self.
- 1692 T. TAYLOR tr. G. Daniel *Voy. World Cartesius* I. 39 Settle and compose your self, for you seem a little disturb'd: And resolve your self you need not fear, and that you shall receive no harm.
- 1707 D. MANLEY *Almyna* I. i. 9 Soon resolve your self, he is a Lover, But with that Duty, to his Royal Brother, As without his permission, not to hope.
- 1709 LD. SHAFTESBURY *Moralists* II. iii. 92 We apprehend a larger Scheme, and easily resolve our selves why Things were not compleated in this State.
- 1814 H. F. CARY tr. Dante *Vision* III. xxviii. 7 [As one who] turneth to resolve him, if the glass Have told him true.
- 1830 E. BULWER-LYTTON *Paul Clifford* II. i. 32 Could he do so? Umph! No, I have resolved myself, that is impossible.
- 1869 E. M. GOULBURN *Pursuit of Holiness* vi. 48 He must resolve himself on the question.

**c. intransitive.** To be satisfied, certain, or convinced. *Obsolete.*

- 1585 T. WASHINGTON tr. N. de Nicolay *Nauigations Turkie* I. xx. 24 The Gouvernor by the counsell of those that had perswaded him too surrender,..resolved vppon so smal an assurance of the Bascha [Fr. *resolut soubz tant peu assurée parole du Bascha*].
- 1601 B. JONSON *Every Man in his Humor* I. iii. sig. C3 *Bob.* For do you see sir,..I would not extend thus farre. *Mat.* O Lord sir I resolve so.
- a1616 W. SHAKESPEARE *Henry VI, Pt. 1* (1623) I. iii. 70 Resolve on this, thou shalt be fortunate, If thou receiue me for thy Warlike Mate.
- 1659 H. HAMMOND *Paraphr. & Annot. Psalms* (cxix. 151–152 Paraphr.) 610 I have allwayes, since I knew any thing of thee, resolved of the truth of it.

†23.

**a. transitive.** To inform or tell (a person) of something. *Obsolete.*

- 1568 *Reg. Privy Council Scotl.* I. 629 It is thocht convenient to resolve all personis of the same, that nane heireftir sall pretend occasioun of ignorance.
- 1597 W. SHAKESPEARE *Richard III* IV. v. 19 These letters will resolve him of my minde.
- 1632 W. LITHGOW *Total Disc. Trav.* x. 451 He went back, resolving them of my stiffe denyall.
- 1645 J. CORBET *Hist. Relation Mil. Govt. Gloucester* 124 Colonell Massie tooke courage to resolve them of the incapacitie of that service for the present.

**b. transitive.** With clause as complement, esp. expressing an indirect question. Also in *imperative* with a direct question to which the speaker seeks an answer. *Obsolete* (archaic in later use).

- 1568 in J. Anderson *Coll. Mary Queen of Scotl.* (1728) IV. II. 56 We desir to be resolvit quhether ye haife..sufficient autoritie..to pronounce..giltie or not giltie.
- 1588 A. MUNDAY tr. *Palmerin D'Oliua* xxx. f. 93 Are ye (my Lord) the king of Thessalie, for whom my hart hath suffered exceeding greefe? I praie ye resolute me presentlie.
- a1593 C. MARLOWE *Massacre at Paris* (c1600) sig. D5 The wound I warrant ye is deepe my Lord, Search Surgeon and resolute me what thou seest.
- 1602 B. JONSON *Poetaster* IV. ii. sig. G<sup>v</sup> Pray you, resolute me, why you giue that heauenly praise, to this earthly Banquet?
- 1607 J. NORDEN *Surueyours Dialogue* II. 56 I pray thee, if thou canst, resolute me. Whether is the heriot payd [etc.]?
- 1697 J. DRYDEN tr. Virgil *Aeneis* VIII, in tr. Virgil *Wks.* 438 Resolve me, Strangers, whence, and what you are.
- a1704 T. BROWN *Saints in Uproar* in *Wks.* (1707) I. 111 Who was your Father? Come, resolve me immediately.
- 1709 M. PRIOR *Poems Several Occasions* 137 Can Sense this Paradox endure? Resolve me, Cambray, or Fontaine.
- 1778 R. CUMBERLAND *Battle of Hastings* III. 46 Go! Yet stay—resolve me, hast thou weigh'd the danger?
- 1840 E. S. WORTLEY *Jairah* I. ii. 36 But first—resolve me!—saidst thou thou hadst prayed, And *vainly* to thy Zöphiel's silent shade?
- 1860 A. C. SWINBURNE *Queen-mother* III. iii. 91 *Cino*. Are you yet satisfied? *Ca*. This is dead ware... *Cino*. But are you not? resolve me; are not you?

**c. transitive.** To answer (a person); to reply to. *Obsolete.*

- 1586 G. PETTIE & B. YONG tr. S. Guazzo *Ciuile Conuersat.* (rev. ed.) IV. f. 219 I resolute thee (faire Ladie) thus [Fr. *Vous devez sçavoir que*; It. *Io ui faccio sapere, che*], that many times I tried [etc.].
- 1632 J. VICARS tr. Virgil *XII Aeneids* v. 144 Then aged Nautes..Resolves him thus; [etc.].

†24.

**a. transitive.** To advise (a person) to do something. Also with subordinate clause: to give advice to (a person) regarding something. *Obsolete.*

- 1579 G. FENTON tr. F. Guicciardini *Hist. Guicciardin* x. 577 He..was nowe resolved [Fr. *resolu*] by discreete councill..to spare no liberalities nor offers of money to reduce them to his amitie.
- a1648 LD. HERBERT *Life Henry VIII* (1649) 395\* He was resolv'd by his Counsel rather to weary and famish the Emperors Army.
- 1656 T. BURTON *Diary* (1828) I. 32 I would have the Committee to resolve you how you will proceed.

**b. intransitive.** To consult, take counsel. *Obsolete.*

- 1591 E. SPENSER *Prosopopoeia* in *Complaints* 123 It behoves, ere that into the race We enter, to resolve first hereupon.
- a1629 W. HINDE *Faithfull Remonstr.* (1641) xviii. 56 He made them sometimes as his counsellours, to advise, conferre, consult, and resolve with them, in matters of conscience.



1719 D. DEFOE *Life Robinson Crusoe* 303 Let us retreat out of their View or Hearing, least they awake, and we will resolve further.

**25. transitive.** With clause as object: to decide or establish conclusively; to conclude. Also in *passive* with *it* as subject.

- 1586 EARL OF LEICESTER *Corr.* (1844) 401 The surgion doth fully resolue..he is without danger for this blowe.
- 1621 M. WROTH *Countesse of Mountgomeries Urania* 40 They all beheld this place with great wonder, Parselius resolving it was some Enchantment.
- 1642 J. MARCH *Argument Militia* 18 It is resolved by the Judges..that the King may well hold his Parliament..without the Spirituall Lords.
- a1729 J. ROGERS *19 Serm.* (1735) iii. 49 This Happiness, it was presently resolved by all.., must be some one uniform End,..attainable by every Man.
- 1735 *Lives Most Remarkable Criminals* I. 354 I..could not resolve..whether these humorous gentlemen..were to be ranked under the Denomination of Knights Errants, or plain robbery.
- 1818 W. CRUISE *Digest Laws Eng. Real Prop.* (ed. 2) II. 309 It was resolved, that the remainder limited to B. was good.
- 1842 COLE *Westm. Abbey* 107 Whether or not they [sc. mandates] were executed, our antiquaries have not yet resolved.
- 1883 W. BLACK *Shandon Bells* I. iii. 76 He resolved that it was now too late for doubt.
- 1916 *Outlook* (N.Y.) 5 July 552/1 The plain people of Mexico resolved that there was nothing divine about the order which fattened the few at the cost of the many.
- 1969 *Eng. Hist. Rev.* **84** 504 They [sc. the House of Lords] resolved that there had been a plot.
- 2003 R. A. GABRIEL *Mil. Hist. Anc. Israel* iii. 63 Although the *habiru* were..an important factor in Egyptian and Israelite history, further research has not completely resolved that they were not the Hebrews.

**IV.** To determine or fix upon a course of action.

**26.**

**a.** To determine or decide upon (a course of action, something to be achieved or brought about, etc.); to make (something) one's firm intention.

(a) *transitive.* With simple object, or (more commonly) with clause as object (usually preceded by *that*).

- 1523 KING HENRY VIII in J. O. Halliwell *Lett. Kings Eng.* (1846) I. 284 We..have resolved and determined that..ye shall then have our letters of discharge.
- 1594 W. SHAKESPEARE *Titus Andronicus* II. i. 106 So must you resolue, That..You must perforce accomplish as you may.
- 1616 B. JONSON *Epicæne* III. iii, in *Wks.* I. 557 It shall be done, that's resolu'd .
- 1632 J. HAYWARD tr. G. F. Biondi *Eromena* 21 They resolved that the Admirall should goe disguised..to assure himselfe of the fact.
- 1667 J. MILTON *Paradise Lost* IX. 830 Confirm'd then I resolve, Adam shall share with me in bliss or woe.
- 1759 W. ROBERTSON *Hist. Scotl.* (1761) (ed. 4) II. VII. 151 Elizabeth resolved that no circumstance of pomp or solemnity should be wanting.
- 1781 E. GIBBON *Decline & Fall* III. xxix. 125 As soon as they had resolved his death, they condescended to flatter his pride.

- 1819 P. B. SHELLEY *Cenci* III. i. 42 All must be suddenly resolved and done.
- 1842 R. I. WILBERFORCE *Rutilius & Lucius* 265 He had seen enough of the Christians to resolve that nothing should induce him to stain his hands with their blood.
- 1870 J. J. McCLOSKEY & O. D. BYRON *Across Continent* in L. Grover et al. *Davy Crockett & Other Plays* (1940) 105 I resolved I would lead such a life no longer, and I became a gambler.
- 1952 T. ARMSTRONG *Adam Brunskill* ix. 305 She sternly resolved that, if she really were to be a support to her uncle, she must take herself in hand.
- 1996 J. LANCHESTER *Debt to Pleasure* (1997) 4 I resolved that I would jot down my thoughts on the subject of food as I went.

(b) *transitive*. With infinitive as object. Also *reflexive*, with infinitive complement, in same sense.

- 1542 N. UDALL tr. Erasmus *Apophtegmes* II. f. 238 Thei had purposed and fully resolved to murdre hym, when he should nexte bee in dooyng sacrifice.
- 1596 W. LAMBARDE *Perambulation of Kent* (rev. ed.) sig. A2<sup>v</sup> I resolved (for sundrie iust respectes) to begin first with that Shire.
- 1598 W. SHAKESPEARE *Love's Labour's Lost* IV. iii. 347 Shall we resolve to woe these gyrls of Fraunce?
- 1600 E. BLOUNT tr. G. F. di Conestaggio *Hist. Uniting Portugall to Castill* 25 Solliciting Sebastian to resolve himselfe either to enter or be excluded.
- 1613 S. PURCHAS *Pilgrimage* VIII. iii. 744 He..committed many errorrs, especially in resolving to winter in that desolate place.
- 1653 W. RAMESEY *Astrologia Restaurata* To Rdr. 10 So they fell to words and at last..they resolved to kill one another.
- 1707 J. MORTIMER *Whole Art Husbandry* 427 I resolved to cut a Cart-way..to carry off both my Wood and Timber.
- 1761 F. SHERIDAN *Mem. Miss Sidney Bidulph* III. 312 Having resolved himself to attend him as far as Harwich, he would, at the hour appointed, call on him in a coach.
- 1791 A. RADCLIFFE *Romance of Forest* II. viii. 32 She resolved to acquaint Madame La Motte with the purport of the late conversation.
- 1856 J. A. FROUDE *Hist. Eng.* (1858) I. iii. 252 At one time he had resolved..to give way.
- 1879 W. H. DIXON *Royal Windsor* I. ii. 15 He resolved to take the Scottish invader in a trap.
- 1920 A. CARNEGIE *Autobiogr.* x. 140 I resolved to leave the service of the railway company and devote myself exclusively to my own affairs.
- 1966 M. PEI *How to learn Langs.* 92 If you resolve to learn a language, you must grit your teeth and stick at it.
- 1988 *Amer. Art Jrnl.* 20 75/1 He finally resolved himself to remain while La Farge painted.
- 2005 T. UMRIGAR *Space between Us* (2007) xii. 132 Bhima resolves to ask Serabai for the name of some strength tonic for the girl.

**b.** *intransitive*, and *transitive (reflexive)*. To come to a firm decision in regard to future action or intention; to determine to do something.

(a) With *on* or *upon*; formerly also †*of*, †*in*.

- a1528 in J. Strype *Eccl. Memorials* (1721) I. App. 57 We desired his Ho[liness] that it wold please hym schortely to resolve hymself therin.
- 1548 *Hall's Vnion: Henry VI* f. clxxxv These two great lordes, resoluinge them selfs vpon this purpose,..entered the cite of London.
- 1586 C. MARLOWE *Tamburlaine: 1st Pt.* II. vi Since..He dares so doubtlessly resolve of rule.
- a1616 W. SHAKESPEARE *Antony & Cleopatra* (1623) III. xi. 9 I haue my selfe resolu'd vpon a course, Which has no neede of you.
- 1649 BP. J. TAYLOR *Great Exemplar* I. v. iii. 90 After..the punitive part of repentance is resolved on, and begun, and put forward..we then enter into the illuminative way of religion.
- 1660 S. PEPYS *Diary* 23 Jan. (1970) I. 26 This day the Parliament..resolved of the declaration to be printed for the people's satisfaction.
- 1706 W. NICOLSON *London Diaries* 30 Jan. (1985) 367 He..was there informed (and convinced) that the Conclave had resolved on his Death.
- 1782 F. BURNEY *Cecilia* IV. VIII. vii. 294 Cecilia..had still the..good sense..to resolve upon making the best use [etc.].
- 1809 *Susan* II. 103 Mrs. Howard..immediately resolved in going with him.
- 1837 T. HOOK *Jack Brag* III. v. 180 He resolved upon having a strong reinforcement of *comestibles*.
- 1872 *1st Rep. Vermont State Board Agric. 1871–2* 289 He who sets out to subdue a piece of quack must resolve on no half-way measures.
- 1934 'J. FIELD' *Life of One's Own* vi. 96 When what I had resolved upon did not happen I thought it must be due to some inherent weakness.
- 1951 *Times* 3 Aug. 7/1 Anderson..resolved himself upon a gallant attack, and, with Stedman..keeping his end up, they achieved the task.
- 1975 N. LUCAS *Mod. Hist. Israel* xv. 380 Ben-Gurion had resolved on pre-emptive military action in the autumn of 1955.
- 1992 E. PEARCE *Election Rides* iii. 29 We resolve upon lunch at the Cutty Sark pub.

†(b) Without construction. *Obsolete.*

- a1528 in J. Strype *Eccl. Memorials* (1721) I. App. 62 I desired his Ho[liness] to resolve hymself without delay or difficultie.
- 1581 P. WIBURN *Checke or Reproofe M. Howlets Shreeching* f. 59<sup>v</sup> Hee resolueth generally euen like hymselfe,..and for fornication particularly.
- 1590 J. SMYTHE *Certain Disc. Weapons* Ded. 8 To know, how of hymselfe..with valour to resolute and performe.
- 1597 F. BACON *Of Coulers Good & Euill* f. 20<sup>v</sup>, in *Ess.* As he sayth well, Not to resolute, is to resolute, and many times it..ingageth as farre in some other sort as to resolute.
- 1667 J. MILTON *Paradise Lost* IX. 97 Thus he resolv'd, but first..His bursting passion into plaints thus pour'd.
- 1748 J. THOMSON *Castle of Indolence* II. lxii Resolve! resolve! and to be men aspire!
- 1762 O. GOLDSMITH *Citizen of World* I. 107 So after resolving, and re-resolving, I had courage enough to tell her my mind.
- a1859 J. AUSTIN *Lect. Jurispr.* (1879) I. xxi. 452 When such expressions as 'resolving' and 'determining' are applied to a present intention to do a future act.

**c. transitive. to resolve with oneself:** = sense 26a. Now rare.

- 1578 G. BEST *True Disc. Passage to Cathaya* I. 45 He determined and resolved wyth himselfe, to go make full prooffe thereof.
- 1588 J. UDALL *True Remedie* v. 86<sup>v</sup> The prophet..resolueth with himselfe, that though they regard not their owne good, yet will hee continue his care ouer them.
- 1624 E. BOLTON *Nero Caesar* 140 It must necessarily precede, that he resolved with himselfe, not to issue out to fight with Boadicia.
- 1710 LD. SHAFTESBURY *Soliloquy* 1 I have resolv'd with my self, that the Maxim might be admitted.
- 1743 H. FIELDING *Jonathan Wild* III. ii, in *Misc.* III. 196 Am I so absolutely their Master, that I can resolve with myself, *so far only will I grieve?*
- 1823 J. GALT *Ringan Gilhaize* I. 122 My grandfather resolved with himself to depart betimes for Kilmarnock, in case of any change in his temper.
- 1859 H. B. STOWE *Minister's Wooing* xvii. 277 He had inly resolved with himself that he would give Candace his opinion.
- 1908 E. PHILLPOTTS *Mother* 396 Seriously he resolved with himself to destroy Northmore.

†**d.** *intransitive*. To decide to set one's course *for* a place, destination, etc.

Also (occasionally) *transitive (reflexive)* in same sense. *Obsolete*.

- a1592 R. GREENE *Frier Bacon* (1594) sig. D3 [They] Haue in their iests resolved for Oxford towne.
- 1600 W. SHAKESPEARE *Henry IV, Pt. 2* II. iii. 67 I will resolute for Scotland.
- a1625 J. FLETCHER *Noble Gentleman* IV. iv, in F. Beaumont & J. Fletcher *Comedies & Trag.* (1647) sig. Ff/1 Tell me, have you resolv'd your selfe for Court?
- a1643 W. CARTWRIGHT *Ordinary* (1651) v. v. 88 Let's swear Fidelity to one another, and So resolve for New England.
- 1700 'AN APOTHECARY' *Devil's Journey to London* 9 This mighty Prince..Resolves for London now what ere betide.
- 1740 tr. C. Rollin *Anc. Hist.* (ed. 2) VII. 261 He resolved for Sicily, which would open him a passage into Africa.
- 1760 *Impostors Detected* II. iv. iii. 189 We were obliged to separate, and every one take his chance... As for me I resolved for Lisbon.

**e.** *transitive*. Of an event or circumstance: to make (a person) resolved or determined *to* do something. Also with *on*.

- 1814 J. H. MERIVALE *Orlando in Roncesvalles* III. 66 Smarting Pride contended with his fear, And half resolved him to abide the tempest hurrying near.
- 1836 R. BROWNING & J. FORSTER *Life Strafford* (1892) 15 The events of the interim had resolved the leaders of the house on abandoning the terms proposed.
- 1890 SIR C. RUSSELL in *Daily News* 24 July 2/7 The knowledge of this marriage resolved Lord and Lady C...to send their son abroad.
- a1902 S. BUTLER *Way of All Flesh* (1903) lxvii. 300 It was this that resolved him to part once and for all with his parents.
- 1933 A. BRYANT *S. Pepys* (1934) iv. 80 He received such unmistakable signs of the spirit of the people as resolved him to wait no longer.
- 2005 A. J. HACIKYAN et al. *Heritage Armenian Lit.* 875 This episode resolved him to learn his native tongue.

**27.**

**a. transitive.** Esp. of a deliberative body or meeting: to determine formally as a resolution (**RESOLUTION** *n.*<sup>1</sup> 15a); to adopt or pass as a resolution.

Usually with *that*-clause as object; frequently in *passive* with *it* as subject (also with ellipsis of *it* and the auxiliary verb *to be*).

- 1563 *Orig. Jrnls. House of Commons* 21 Jan. 1 f. 219 Yt is resolved that M<sup>r</sup> Speaker shall direct hys letter in the name of the house to come and [etc.].
- 1590 *Articles against Cartwright* in T. Fuller *Church-hist. Brit.* (1655) ix. 201 At some of such meetings..it was resolved..that such..conferences in severall Shires should be erected.
- 1604 *Orig. Jrnls. House of Commons* 26 June 3 f. 325<sup>v</sup> Resolved vpon further mocion, that Mr. Speaker..should present thanks to his ma<sup>tie</sup>.
- 1641 in E. Nicholas *Papers* (1886) I. 10 It was resolved that there shalbe on ye 7<sup>th</sup> of September next a publique thanksgiving for this good accord betweene ye 2 nacions.
- 1706 in *Acts & Resolves Mass. Bay* (1895) VIII. 721 Resolved That the sum of three hundred & fifty Pounds, be allowed..to Mr Thomas Oakes the memorialist.
- 1781 G. COCKINGS *Amer. War* v. 124 They [sc. Congress] resolved, 'That the embarkation of Lieutenant-general Burgoyne, and the army under his command, be suspended till [etc.]'.
- 1806 *Med. & Physical Jrnl.* 15 253 Resolved unanimously, that this meeting..entertains the most firm conviction that [etc.].
- 1835 *Baptist Mag.* July 282/1 The following Resolutions were resolved unanimously.
- 1849 T. B. MACAULAY *Hist. Eng.* I. ii. 175 The Commons began by resolving that every member should, on pain of expulsion, take the sacrament [etc.].
- 1905 S. DILL *Roman Society* (ed. 2) II. iii. 275 The meeting..formally resolved that the honourable Julianus should be requested to accept the distinction.
- 1970 *Music Educators Jrnl.* 56 85/2 Therefore, be it resolved that we..do nominate John Philip Sousa to the Hall of Fame for Great Americans.
- 1995 *Methodist Recorder* 3 Aug. 3/3 A special meeting..resolved that one of its five ministerial appointments..be devoted exclusively to outreach among young people in the circuit.

**†b. transitive.** To put (a person) *out of* a condition by passing a resolution.  
*Obsolete. rare.*

- 1798 I. ALLEN *Nat. & Polit. Hist. Vermont* 237 The inhabitants of Vermont had lived in a state of independence.., and could not now submit to be resolved out of it.

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## **LEGAL AUTHORITY CA-122**

PUBLICATIONS DE LA COUR PERMANENTE DE JUSTICE  
INTERNATIONALE

*SÉRIE A — N° 13*

Le 16 décembre 1927

RECUEIL DES ARRÊTS

N° 11

INTERPRÉTATION  
DES ARRÊTS N<sup>OS</sup> 7 ET 8  
(USINE DE CHORZÓW)

PUBLICATIONS OF THE PERMANENT COURT  
OF INTERNATIONAL JUSTICE.

*SERIES A.—No. 13*

December 16th, 1927

COLLECTION OF JUDGMENTS

No. 11

INTERPRETATION  
OF JUDGMENTS Nos. 7 AND 8  
(THE CHORZÓW FACTORY)

LEYDE  
SOCIÉTÉ D'ÉDITIONS  
A. W. SIJTHOFF  
1927



LEYDEN  
A. W. SIJTHOFF'S  
PUBLISHING COMPANY  
1927

COUR PERMANENTE DE JUSTICE INTERNATIONALE

1927.  
Le 16 décembre.  
Dossier E. c. XIV.  
Rôle XII. 5.

DOUZIÈME SESSION (ORDINAIRE)

*Présents :*

MM. HUBER, *Président*,  
LODER, *ancien Président*,  
Lord FINLAY,  
MM. NYHOLM,  
ALTAMIRA, } *Juges*,  
ODA,  
ANZILOTTI, }  
BEICHMANN, } *Juges suppléants*,  
NEGULESCO, }  
MM. RABEL, } *Juges nationaux*.  
EHRlich, }

ARRÊT N° II

INTERPRÉTATION  
DES ARRÊTS N<sup>OS</sup> 7 ET 8  
RELATIFS A L'AFFAIRE DITE  
DE L'USINE DE CHORZÓW

entre le Gouvernement allemand, représenté par M. le D<sup>r</sup> Erich Kaufmann, professeur à Bonn,

*Demandeur,*

et le Gouvernement de Pologne, représenté par M. le D<sup>r</sup> Thadée Sobolewski, agent du Gouvernement polonais auprès du Tribunal arbitral mixte polono-allemand,

*Défendeur.*



PERMANENT COURT OF INTERNATIONAL JUSTICE.

1927.  
December 16th.  
File E. c. XIV.  
Docket XII. 5.

TWELFTH (ORDINARY) SESSION.

*Before :*

MM. HUBER, *President*,  
LODER, *Former President*,  
Lord FINLAY,  
MM. NYHOLM,  
ALTAMIRA, } *Judges*,  
ODA, }  
ANZILOTTI, }  
BEICHMANN, } *Deputy-Judges*,  
NEGULESCO, }  
MM. RABEL, } *National Judges*.  
EHRlich, }

JUDGMENT No. II.

INTERPRETATION  
OF JUDGMENTS Nos. 7 AND 8  
CONCERNING THE CASE  
OF THE FACTORY AT CHORZÓW.

The Government of Germany, represented by Dr. Erich Kaufmann, Professor at Bonn,

*Applicant,*

*versus*

The Government of Poland, represented by Dr. Thadeus Sobolewski, Agent of the Polish Government before the Polish-German Mixed Arbitral Tribunal,

*Respondent.*

LA COUR,  
composée ainsi qu'il est dit ci-dessus,  
après avoir entendu les Parties en leurs observations et  
conclusions,  
a rendu l'arrêt suivant :

Par une Requête déposée au Greffe de la Cour le 18 octobre 1927, en conformité de l'article 60 du Statut et de l'article 66 du Règlement de la Cour, le Gouvernement allemand a introduit devant la Cour permanente de Justice internationale, une demande en interprétation des Arrêts n°s 7 et 8 rendus respectivement par la Cour les 25 mai 1926 et 26 juillet 1927, entre les Gouvernements allemand et polonais, et dont, aux termes de la Requête, le sens et la portée seraient devenus litigieux entre ces deux Gouvernements.

La Requête conclut à ce qu'il plaise à la Cour dire et juger :

« que la thèse que

1° dans son Arrêt n° 7, la Cour aurait réservé au Gouvernement polonais le droit d'annuler par la voie judiciaire, encore après l'arrêt susdit, l'acte du 24 décembre 1919 et l'inscription, basée sur cet acte, de l'Oberschlesische comme propriétaire aux registres fonciers ;

2° la requête introduite par le Gouvernement polonais contre l'Oberschlesische Stickstoffwerke A.-G. auprès du Tribunal civil de Kattowitz, tendant à effectuer cette annulation, serait d'une importance internationale pour l'affaire relative à l'usine de Chorzów (demande en indemnité) et pendante auprès de la Cour,

ne correspond pas à une bonne interprétation des Arrêts n°s 7 et 8. »

La Requête du Gouvernement allemand fut notifiée, le jour même de son dépôt, conformément aux dispositions de l'article 66, alinéa 2, du Règlement, au Gouvernement polonais, qui fut en même temps informé qu'il lui appartenait, s'il le désirait, de présenter ses observations sur la demande en interprétation dans un délai que la Cour fixa ultérieurement au 7 novembre 1927. En communiquant aux Parties en cause

THE COURT,  
 composed as above,  
 having heard the observations and conclusions of the Parties,  
 delivers the following judgment :

The German Government, by an Application filed with the Registry of the Court on October 18th, 1927, in conformity with Article 60 of the Statute and Article 66 of the Rules of Court, has submitted to the Permanent Court of International Justice a request for an interpretation of Judgments Nos. 7 and 8 given by the Court on May 25th, 1926, and July 26th, 1927, respectively, in suits between the German and Polish Governments, a divergence of opinion having, according to the Application, arisen between the two Governments in regard to the meaning and scope of these two judgments.

It is submitted in the Application :

“that the contention

- (1) that in Judgment No. 7 the Court reserved to the Polish Government the right to annul by process of law, even after the rendering of that judgment, the Agreement of December 24th, 1919, and the entry, based on that agreement, of the name of the Oberschlesische as owner in the land registers ;
- (2) that the action brought by the Polish Government against the Oberschlesische Stickstoffwerke A.-G. before the Civil Tribunal of Kattowitz, with a view to effecting this annulment, is of international importance in connection with the suit concerning the Chorzów factory (claim for indemnity) now pending before the Court,

is not in accordance with the true construction of Judgments Nos. 7 and 8.”

Notice of the German Government's Application was given, on the date of filing, in conformity with the terms of Article 66, paragraph 2, of the Rules, to the Polish Government, which was at the same time informed that it might, if it desired to do so, submit its observations upon the request for an interpretation within a time-limit subsequently fixed by the Court to expire on November 7th, 1927. When notifying

la décision relative à ce délai, la Cour ne manqua pas d'attirer leur attention sur le fait qu'il correspondait, pour la procédure en interprétation, au délai de présentation du Contre-Mémoire visé, en ce qui concerne la procédure ordinaire, par l'article 38, alinéa premier, du Règlement.

Le 7 novembre 1927, le Gouvernement polonais déposa au Greffe de la Cour des « Observations » sur la demande en interprétation des Arrêts n°s 7 et 8 formulée par le Gouvernement allemand. Ces observations conclurent à ce qu'il plaise à la Cour :

« Déclarer qu'il n'y a pas lieu de donner suite à la demande du Gouvernement allemand en date du 17 octobre 1927. »

Saisie de cette conclusion ainsi que des observations qui la précédaient, la Cour adopta, le 9 novembre, la Résolution suivante, laquelle fut dûment communiquée aux Parties en cause :

« La Cour, vu l'article 60 de son Statut et les articles 38 et 66 de son Règlement, décide :

1° d'inviter le Gouvernement allemand à présenter, s'il le désire, dans un délai expirant le 21 novembre, un exposé écrit contenant, avec un supplément d'information sur les conclusions de sa Requête du 17 octobre 1927, ses observations et conclusions au sujet des observations soumises par le Gouvernement polonais ;

2° d'inviter le Gouvernement polonais à présenter, s'il le désire, dans le même délai, un supplément d'information sur les conclusions de la requête allemande du 17 octobre 1927. »

Dans le délai fixé, le Gouvernement allemand déposa, conformément à la décision de la Cour, un « Exposé » en conclusion duquel il pria la Cour de

« 1° Prononcer la jonction des procédures relatives aux exceptions préliminaires soulevées par le Gouvernement polonais et relatives au fond.

2° Déclarer qu'il y a lieu de donner suite à la demande du Gouvernement allemand tendant à obtenir, conformément à l'article 60 du Statut, une interprétation des Arrêts n°s 7 et 8.

3° Dire et juger conformément aux conclusions de la Requête allemande. »

the Parties of the decision in regard to this time-limit, the Court duly drew their attention to the fact that it corresponded, as regards the proceedings for an interpretation, to the time-limit for the submission of the Counter-Case provided for, in the case of ordinary proceedings, by Article 38, paragraph 1, of the Rules of Court.

On November 7th, 1927, the Polish Government filed with the Registry "Observations" upon the request for an interpretation of Judgments Nos. 7 and 8 made by the German Government. In these observations it was submitted

"that effect should not be given to the Request of the German Government dated October 17th, 1927".

On receipt of this submission and of the observations leading up to it, the Court, on November 9th, adopted the following Resolution which was in due course communicated to the Parties in the case:

"The Court, having regard to Article 60 of the Statute and Articles 38 and 66 of the Rules of Court, decides:

(1) to invite the German Government to submit, should it so desire, on or before November 21st, a written statement containing, together with further explanations regarding the submissions of its Application of October 17th, 1927, its observations and conclusions in regard to the observations filed by the Polish Government;

(2) to invite the Polish Government to submit, should it so desire, within the same limit of time, further explanations regarding the submissions of the German Application of October 17th, 1927."

Within the time laid down, the German Government, in accordance with the Court's decision, filed a "Statement" in which it was submitted

"(1) that the proceedings in regard to the preliminary objections raised by the Polish Government should be joined to the proceedings on the merits;

(2) that effect should be given to the request made by the German Government with a view to obtaining an interpretation of Judgments Nos. 7 and 8 in conformity with Article 60 of the Statute;

(3) that judgment should be given in accordance with the submissions of the German Application."

De son côté, le Gouvernement polonais déclara « renoncer à la déposition d'informations supplémentaires concernant la demande en interprétation des Arrêts nos 7 et 8 ».

Dans ces conditions, la Cour, conformément à sa Résolution du 9 novembre 1927, tint, le 28 novembre, une audience au cours de laquelle elle entendit les exposés oraux de MM. Kaufmann et Sobolewski, agents des Gouvernements en cause. La Cour ayant, à la suite de ces exposés, décidé de clore les débats, après avoir fourni auxdits agents l'occasion de répliquer, M. Kaufmann prononça une brève réplique, tandis que M. Sobolewski, déclarant qu'à son avis les discussions antérieures avaient complètement épuisé la matière, renonça à la parole.

\* \* \*

#### POINT DE FAIT.

L'Arrêt n° 7 de la Cour, rendu le 25 mai 1926 dans le procès entre les Gouvernements allemand et polonais au sujet de « certains intérêts allemands en Haute-Silésie polonaise » — intérêts qui, aux termes de l'arrêt, avaient trait, entre autres, « à la radiation aux registres fonciers, comme propriétaire de certains biens-fonds à Chorzów, de la Société Oberschlesische Stickstoffwerke A.-G., et à l'inscription à sa place du Trésor polonais » —, déclara, dans son dispositif, « que l'attitude du Gouvernement polonais vis-à-vis des Sociétés anonymes Oberschlesische Stickstoffwerke . . . n'était pas conforme aux dispositions . . . de la Convention de Genève », conclue le 15 mai 1922 entre l'Allemagne et la Pologne.

Partant de cette décision de la Cour, les deux Gouvernements entrèrent en négociations en vue de régler à l'amiable les demandes de ladite Société, entre autres, par le paiement d'une indemnité en argent.

Ces négociations n'aboutirent pas, et le Gouvernement allemand, ayant informé le Gouvernement polonais que les points de vue des deux Gouvernements lui semblaient si différents qu'il paraissait impossible d'éviter un appel à une

The Polish Government, for its part, announced that it "did not intend to file further explanations in regard to the request for an interpretation of Judgments Nos. 7 and 8".

In these circumstances, the Court, in accordance with its Resolution of November 9th, 1927, held a public sitting on November 28th, 1927, at which it heard the oral statements of MM. Kaufmann and Sobolewski, the Agents of the Governments concerned in the case. At the conclusion of these statements, the Court decided to close the hearing, after having given the Agents an opportunity of replying; whereupon M. Kaufmann replied briefly, and M. Sobolewski, stating that in his opinion the previous discussions had completely exhausted the question, waived his right to reply.

\* \* \*

#### THE FACTS.

In the terms of Judgment No. 7 given by the Court on May 25th, 1926, in the case between the German and Polish Governments, in regard to "certain German interests in Polish Upper Silesia"—which interests, according to the Judgment, related, amongst other things, to the "deletion from the land registers of the name of the Oberschlesische Stickstoffwerke A.-G. as owner of certain landed property at Chorzów, and the entry, in its place, of the Polish Treasury"—it was declared "that the attitude of the Polish Government in regard to the Oberschlesische Stickstoffwerke . . . was not in conformity with . . . the Geneva Convention" concluded on May 15th, 1922, between Germany and Poland.

On the basis of this decision of the Court, the two Governments entered upon negotiations with a view to a settlement by friendly arrangement in regard to the claims of the above-mentioned Company amongst others, by means of the payment of pecuniary compensation.

These negotiations failed, and the German Government, having informed the Polish Government that the points of view of the two Governments seemed so different that it appeared impossible to avoid recourse to an international

instance internationale, saisit la Cour, le 8 février 1927, d'une Requête tendant à ce que la Cour dise et juge, entre autres, « que le Gouvernement polonais est tenu à la réparation du préjudice subi » par l'Oberschlesische, à raison de l'attitude dudit Gouvernement vis-à-vis d'elle. Le Gouvernement polonais ayant excipé de l'incompétence de la Cour de connaître de l'instance ainsi introduite, la Cour rendit, sur cette exception, le 26 juillet 1927, son Arrêt n° 8, par lequel elle décida de retenir l'instance en question pour statuer au fond, et de charger le Président de fixer les délais pour le dépôt des pièces de la procédure écrite ; ces délais furent ultérieurement arrêtés de manière à permettre à l'affaire au fond d'être en état le 1<sup>er</sup> mars 1928.

Or, d'après la Requête déposée par le Gouvernement allemand au Greffe de la Cour le 18 octobre 1927, le Gouvernement polonais avait introduit auprès du Tribunal régional de Katowice, dans le ressort duquel sont sis les immeubles dont il s'agit et qui sont connus sous la dénomination d'« usine de Chorzów », une requête contre l'Oberschlesische, signifiée à cette dernière le 16 septembre 1927. Cette requête aurait conclu à ce que :

- « 1° il soit déclaré que la société défenderesse n'est pas devenue propriétaire des biens-fonds Chorzów (vol. XXIII, fol. 725, etc.) ;
- 2° il soit déclaré que l'inscription en faveur de la société défenderesse du changement de la propriété, effectué le 29 janvier 1920, était invalide, et que les fonds mentionnés au chiffre 1° des présentes conclusions sont restés la propriété du Reich allemand en dépit de l'*Auflassung* et de l'inscription, en date du 29 janvier 1920, de la société défenderesse comme propriétaire ;
- 3° il soit déclaré que, indépendamment des lois du 14 juillet 1920 (*Bulletin des Lois de la République polonaise* — pos. 400) et du 16 juin 1922 (*Bulletin* — pos. 388), la propriété des biens-fonds mentionnés sous chiffre 1° revient au Fisc de l'État polonais. »

L'exposé des motifs sur lesquels la requête fondait ses conclusions aurait contenu, entre autres, le passage suivant :



tribunal, filed with the Court on February 8th, 1927, an Application submitting, amongst other things, "that the Polish Government is under an obligation to make good the injury sustained" by the Oberschlesische in consequence of the attitude of that Government in respect of the Company mentioned. The Polish Government having disputed the jurisdiction of the Court to entertain the suit thus brought, the Court, on July 26th, 1927, delivered judgment (No. 8) upon this objection, deciding to reserve the suit for judgment on the merits, and to instruct the President to fix the times for the deposit of the documents of the written proceedings; these times were subsequently fixed in such a way as to enable the suit on the merits to be ready for hearing on March 1st, 1928.

According to the Application deposited by the German Government with the Registry on October 18th, 1927, the Polish Government had filed with the District Court of Katowice, within the jurisdiction of which are situated the landed properties in question, known as "the factory of Chorzów", a claim against the Oberschlesische, which claim was served upon that Company on September 16th, 1927. In this claim it is—according to the German Government's Application—submitted:

- "(1) that it should be declared that the defendant Company has not become the owner of the landed property at Chorzów (vol. XXIII, fol. 725, etc.);
- (2) that it should be declared that the entry of the change of ownership in favour of the defendant Company, made on January 29th, 1920, was null and void, and that the landed properties mentioned under No. (1) of these submissions remained the property of the German Reich, notwithstanding the *Auflassung* and entry in the register on January 29th, 1920, of the defendant Company as owner;
- (3) that it should be declared that, independently of the laws of July 14th, 1920 (*Legal Gazette of the Polish Republic*—pos. 400), and of June 16th, 1922 (*Gazette*—pos. 388), the ownership of the landed properties mentioned under No. (1) falls to the Polish Treasury."

The statement of the grounds on which these submissions are based is said to contain the following passage amongst others:

« L'arrêt [*scil.* n° 7 de la Cour] a décidé le différend sous l'angle de vue des dispositions du droit international; et la Cour a observé dans les considérants qu'elle ne préjugait pas à la question de savoir si le transfert de la propriété et l'inscription aux registres fonciers étaient valides sous l'angle de vue du droit civil. L'argumentation polonaise basée sur l'exception de l'invalidité civile de la transaction du 24 décembre 1919, et, partant, de l'inscription du 29 janvier 1920, n'a pas été discutée par la Cour, qui se retrancha derrière l'existence formelle de l'inscription. Mais, en même temps, la Cour a dit que, si la Pologne veut contester la validité de cette inscription, son annulation ne saurait, en tout cas, résulter que d'une décision rendue par la juridiction compétente.

Se basant sur l'arrêt susdit, le Reich allemand a introduit, le 8 février 1927, auprès de la Cour permanente de Justice internationale à La Haye, une nouvelle requête relative à l'indemnité due en raison de la violation des droits de la société défenderesse ainsi que de ceux des Bayerische Stickstoffwerke, violation effectuée par la reprise de l'usine par l'État polonais.

Dans ces conditions, le Fisc utilise la possibilité, lui réservée par l'arrêt de la Cour à La Haye, de contester devant le tribunal compétent la validité tant du changement de la propriété que de l'inscription.»

L'exactitude de ces citations n'a pas été contestée par le Gouvernement polonais.

D'un autre côté, le texte complet de la requête signifiée, le 16 septembre 1927, à l'Oberschlesische, n'a pas été soumis à la Cour dans la présente procédure. De même, le texte de la décision que, selon les informations données au cours de la procédure orale, le Tribunal régional de Katowice aurait rendue par défaut sur cette requête et qui aurait adjugé au Gouvernement polonais ses conclusions, n'a pas été porté à la connaissance de la Cour.

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#### POINT DE DROIT.

La demande en interprétation émanant du Gouvernement allemand, et dont les conclusions sont reproduites ci-dessus,

“The Judgment [i.e. No. 7 of the Court] has decided the dispute from the standpoint of the rules of international law; and the Court observes in its reasoning that it does not pass any opinion on the question whether the transfer of ownership and entry in the land registers were valid at municipal law. The Polish argument based on the objection that the transaction of December 24th, 1919, was not valid at municipal law and that consequently the entry of January 29th, 1920, was also invalid, is not discussed by the Court, which simply relies on the mere fact of the existence of the entry. At the same time, however, the Court says that if Poland wishes to dispute the validity of this entry, it can, in any case, only be annulled in pursuance of a decision given by the competent tribunal.

Relying on this judgment, the German Reich, on February 8th, 1927, filed with the Permanent Court of International Justice at The Hague a new application respecting the indemnity due in consequence of the violation of the rights of the defendant Company and of those of the Bayerische Stickstoffwerke, which violation consisted in the taking over of the factory by the Polish State.

In these circumstances, the Treasury avails itself of the possibility, reserved to it by the judgment of the Hague Court, of disputing before the competent tribunal both the validity of the change of ownership and the entry in the land register.”

The correctness of these quotations has not been disputed by the Polish Government.

On the other hand, the complete text of the claim served upon the Oberschlesische on September 16th, 1927, has not been laid before the Court in the present proceedings. Similarly, the text of the decision which, according to information given during the oral proceedings, has been rendered by default by the District Court of Katowice upon this claim, and which is said to have granted to the Polish Government the relief sought, has not been placed before the Court.

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#### THE LAW.

The request for an interpretation submitted by the German Government, the conclusions of which are reproduced above,

a été introduite en vertu de l'article 60 du Statut de la Cour, lequel est ainsi conçu :

« L'arrêt est définitif et sans recours. En cas de contestation sur le sens et la portée de l'arrêt, il appartient à la Cour de l'interpréter, à la demande de toute Partie. »

Le Gouvernement polonais ayant contesté que, dans le cas présent, les conditions requises par ledit article pour qu'il puisse être donné suite à une demande en interprétation se trouvent réalisées, il faut d'abord examiner si tel est bien le cas.

Il ressort de l'article que ces conditions sont les suivantes :

1° il faut qu'il y ait contestation sur le sens et la portée d'un arrêt de la Cour ;

2° il faut que la demande vise une interprétation de l'arrêt.

En ce qui concerne la dernière condition, la Cour est d'avis que, par l'expression « interprétation », il faut entendre l'indication précise du « sens » et de la « portée » que la Cour a entendu attribuer à l'arrêt en question, et le Gouvernement polonais ne paraît pas prétendre que tel ne soit pas le sens. En revanche, il nie l'existence d'une contestation, entre les deux Gouvernements, sur le sens et la portée des arrêts cités dans la demande allemande, et sa conclusion est qu'il n'y a pas lieu de donner suite à la demande.

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Avant d'aborder la question ainsi posée, la Cour croit utile de préciser le sens à donner aux termes « contestation » et « sens et portée de l'arrêt », tels qu'ils ont été employés dans l'article 60 du Statut.

Pour ce qui est du terme « contestation », la Cour constate que l'article 60 du Statut, d'après sa teneur, n'exige pas que l'existence de la contestation se soit manifestée d'une certaine manière, par exemple par des négociations diplomatiques. Il paraît bien désirable qu'un État ne procède pas à une démarche aussi sérieuse que l'assignation d'un autre État devant la

was made under Article 60 of the Statute of the Court, which runs as follows :

“The judgment is final and without appeal. In the event of dispute as to the meaning or scope of the judgment, the Court shall construe it upon the request of any Party.”

The Polish Government having refused to admit the existence in this case of the conditions required by the article in question in order that a request for interpretation may be proceeded with, it is necessary in the first place to consider whether this contention is well-founded.

From the article it appears that these conditions are the following :

(1) there must be a dispute as to the meaning and scope of a judgment of the Court ;

(2) the request should have for its object an interpretation of the judgment.

As regards the latter condition, the Court is of the opinion that the expression “to construe” must be understood as meaning to give a precise definition of the meaning and scope which the Court intended to give to the judgment in question, and the Polish Government does not appear to claim that this is not its meaning. But it denies the existence of a dispute between the two Governments as to the meaning and scope of the judgments referred to in the German Request, and its submission is that there is no ground for proceeding with the Request.

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Before examining the question which has thus been raised, the Court thinks it advisable to define the meaning which should be given to the terms “dispute” and “meaning or scope of the judgment”, as employed in Article 60 of the Statute.

In so far as concerns the word “dispute”, the Court observes that, according to the tenor of Article 60 of the Statute, the manifestation of the existence of the dispute in a specific manner, as for instance by diplomatic negotiations, is not required. It would no doubt be desirable that a State should not proceed to take as serious a step as summoning

## II ARRÊT N° II. — ARRÊTS N°S 7 ET 8 (INTERPRÉTATION)

Cour, sans avoir auparavant, dans une mesure raisonnable, tâché d'établir clairement qu'il s'agit d'une différence de vues qui ne peut être dissipée autrement. Mais, vu la teneur du texte, la Cour estime ne pas pouvoir exiger que la contestation se soit formellement manifestée ; à son avis, il doit suffire que les deux Gouvernements aient en fait manifesté des opinions opposées quant au sens et à la portée d'un arrêt de la Cour. Celle-ci croit, à ce sujet, devoir rappeler que, dans son Arrêt n° 6 (relatif à l'exception d'incompétence soulevée par la Pologne au sujet de la requête qu'avait introduite le Gouvernement allemand en vertu de l'article 23 de la Convention de Genève concernant la Haute-Silésie), elle a estimé que, ledit article ne posant pas la condition de négociations diplomatiques préalables, la Cour pouvait être saisie aussitôt que l'une des Parties estimait qu'il y avait divergence d'opinions résultant de l'interprétation et de l'application des articles 6 à 22 de la Convention.

Pour apprécier le sens que revêt, dans l'article 60 du Statut, l'expression « sens et portée de l'arrêt », il y a lieu de rapprocher cette expression de l'article précédent du Statut, qui déclare qu'une décision de la Cour n'est obligatoire que pour les Parties en litige et dans le cas qui a été tranché.

Il semble tout naturel de penser que c'est afin de permettre à la Cour de préciser au besoin ce qui a été décidé avec force obligatoire dans un arrêt, que la deuxième phrase de l'article 60 a été introduite, et qu'en revanche, une demande qui n'a pas ce but ne rentre pas dans le cadre de cette disposition. Pour qu'une divergence de vues puisse faire l'objet d'une demande en interprétation en vertu de l'article 60 du Statut, il faut donc qu'il y ait divergence entre les Parties sur ce qui, dans l'arrêt en question, a été tranché avec force obligatoire. Cela ne veut pas dire qu'il doive être incontesté que le point dont le sens prête à discussion regarde une partie de l'arrêt ayant force obligatoire. Une divergence de vues, si tel ou tel point a été décidé avec force obligatoire, constitue, elle aussi, un cas qui rentre dans le cadre de la disposition

another State to appear before the Court without having previously, within reasonable limits, endeavoured to make it quite clear that a difference of views is in question which has not been capable of being otherwise overcome. But in view of the wording of the article, the Court considers that it cannot require that the dispute should have manifested itself in a formal way; according to the Court's view, it should be sufficient if the two Governments have in fact shown themselves as holding opposite views in regard to the meaning or scope of a judgment of the Court. The Court in this respect recalls the fact that in its Judgment No. 6 (relating to the objection to the jurisdiction raised by Poland in regard to the application made by the German Government under Article 23 of the Geneva Convention concerning Upper Silesia), it expressed the opinion that, the article in question not requiring preliminary diplomatic negotiations as a condition precedent, recourse could be had to the Court as soon as one of the Parties considered that there was a difference of opinion arising out of the interpretation and application of Articles 6 to 22 of the Convention.

In order to realize the meaning of the expression "meaning or scope of the judgment" in Article 60 of the Statute, this expression should be compared with the terms of the preceding article of the Statute, which states that a decision of the Court has no binding force except between the Parties and in respect of the particular case decided.

The natural inference to be drawn is that the second sentence of Article 60 was inserted in order, if necessary, to enable the Court to make quite clear the points which had been settled with binding force in a judgment, and, on the other hand, that a request which has not that object does not come within the terms of this provision. In order that a difference of opinion should become the subject of a request for an interpretation under Article 60 of the Statute, there must therefore exist a difference of opinion between the Parties as to those points in the judgment in question which have been decided with binding force. That does not imply that it must be beyond dispute that the point the meaning of which is questioned is related to a part of the judgment having binding force. A difference of opinion as to whether

en question, et la Cour ne pourrait se soustraire à l'obligation d'interpréter l'arrêt dans la mesure nécessaire pour pouvoir se prononcer sur pareille divergence.

Il s'agit donc de savoir si une telle divergence de vues s'est, en fait, manifestée entre les deux Gouvernements dans le cas présent, quant au sens et à la portée des Arrêts n°s 7 et 8. La Cour traitera cette question séparément par rapport à chacun des arrêts dont il s'agit et à chacune des deux thèses qu'attribuent au Gouvernement polonais les conclusions de la Requête allemande.

Il y a lieu, à ce sujet, de rappeler les faits qui ont précédé l'introduction de la Requête en interprétation par le Gouvernement allemand.

Déjà au cours des négociations entamées sur la base de l'Arrêt n° 7, dans une lettre du 9 septembre 1926 adressée au Gouvernement allemand, le Gouvernement polonais avait exprimé l'opinion que — dans la mesure où il s'agissait de l'indemnisation de l'Oberschlesische pour ses dommages prétendus —, restait encore ouverte, indépendamment de l'arrêt de la Cour, la question de savoir si, au point de vue du droit civil, l'inscription aux registres fonciers de ladite société comme propriétaire de l'usine de Chorzów était valide. Le Gouvernement allemand répondit le 2 octobre, en faisant valoir que la Cour avait, en termes exprès, décidé qu'il n'y avait aucun motif justifiant le point de vue selon lequel le transfert de l'usine de Chorzów à l'Oberschlesische ne constituerait pas une aliénation ayant pleine validité juridique, et que, par conséquent, à la date où le transfert de la souveraineté à la Pologne s'était produit, la propriété de l'usine revenait indubitablement à cette société et non au Reich allemand. « Toute l'affaire », disait le Gouvernement allemand, « a été définitivement réglée et décidée par l'arrêt de la Cour permanente de La Haye. » Les négociations ayant échoué et la question de l'indemnité ayant été portée devant la Cour par le Gouvernement allemand, l'avocat du Gouvernement polonais, dans sa plaidoirie du 22 juin 1927 relative à la



a particular point has or has not been decided with binding force also constitutes a case which comes within the terms of the provision in question, and the Court cannot avoid the duty incumbent upon it of interpreting the judgment in so far as necessary, in order to adjudicate upon such a difference of opinion.

It thus becomes necessary to ascertain whether such a difference of opinion has in fact become manifest in the present case between the two Governments, as regards the meaning or scope of Judgments Nos. 7 and 8. The Court will deal with this question separately in relation to each of the judgments in question and each of the two contentions which the conclusions of the German Government impute to the Polish Government.

In this respect, the facts which preceded the submission of the Application for an interpretation by the German Government should be recalled.

In the course of the negotiations entered upon on the basis of Judgment No. 7, the Polish Government, by a letter of September 9th, 1926, addressed to the German Government, had already expressed the opinion that—in so far as the compensation of the Oberschlesische for the damages which they claimed to have sustained was concerned—the question whether, at municipal law, the entry in the land register of the Company in question as owners of the factory of Chorzów was valid, remained open, independently of the judgment of the Court. The German Government replied, on October 2nd, pointing out that the Court had expressly decided that there was no ground justifying the contention that the transfer of the factory of Chorzów to the Oberschlesische did not constitute an alienation valid at law, and that, consequently, at the time when the transfer of sovereignty to Poland took place, the ownership of the factory unquestionably belonged to that Company and not to the German Reich. "The whole matter", the German Government stated, "has been finally settled and decided by the judgment of the Permanent Court at The Hague." The negotiations having failed, and the question of indemnities having been brought before the Court by the German Government, Counsel for the Polish Government, in the course of his pleadings on June 22nd, 1927, in relation

compétence de la Cour pour juger de cette question, a repris le point de vue exprimé par le Gouvernement polonais dans la lettre du 9 septembre 1926, et y a expressément déclaré que le principe de l'indemnité de l'Oberschlesische continue à être contesté sur la base même dudit arrêt (l'Arrêt n° 7), qui avait reconnu à la Pologne « la faculté de contester la validité de cette inscription ». Il en tirait la conclusion que la question relative à la reconnaissance du principe des réparations réclamées n'était pas encore « litigieuse » en ce qui concerne l'Oberschlesische, « tant que la question de la validité de l'inscription de son titre de propriété, réservé par la Cour », n'aurait « pas été réglée par les tribunaux compétents, c'est-à-dire par les tribunaux polonais, que le Gouvernement polonais » était « sur le point de saisir ».

L'agent allemand y répondit dans sa plaidoirie du 24 juin : il contestait que la Cour ne se fût pas encore définitivement prononcée et qu'elle eût fait une réserve quant à la validité des transactions de 1919 au point de vue du droit civil ; il soutenait que, à son avis, vu les considérants et le dispositif de l'arrêt, il n'était guère douteux que la phrase invoquée par l'avocat du Gouvernement polonais ne peut avoir le sens qui lui avait été attribué par ce Gouvernement et, par conséquent, que cette phrase ne pouvait être opposée aux réclamations du Gouvernement allemand. Il faut noter que l'agent du Gouvernement polonais, qui assistait à ces plaidoiries, n'a rien dit pour démentir ou modifier lesdites observations de l'avocat de son Gouvernement. Au contraire, il y a fait allusion dans son propre plaidoyer devant la Cour. Il n'y a donc pas lieu de douter que telles aient bien été alors les vues du Gouvernement polonais.

Peu après que la question de compétence eut été tranchée par la Cour (Arrêt n° 8), le Gouvernement polonais introduisit, contre l'Oberschlesische, la requête annoncée par son représentant lors des débats de juin, et dont les motifs allégués et cités ci-dessus paraissent confirmer l'opinion que la requête a bien été introduite dans le dessein annoncé lors desdits débats.

to the jurisdiction of the Court to adjudicate upon this question, again took up the point of view put forward by the Polish Government in its letter of September 9th, 1926; and he then expressly stated that the principle of the right of the Oberschlesische to compensation was still in dispute, on the very basis of the said Judgment (Judgment No. 7), which was said to have reserved to Poland "the right to dispute the validity of this entry". From that he inferred that the question relating to the recognition of the principle of the compensation claimed did not as yet constitute an issue as far as concerned the Oberschlesische, pending the decision by the competent tribunals, that is to say by the Polish tribunals—before which the Polish Government was on the point of bringing the matter—, of the question of the validity of the registration of its title as owner, a question said to have been reserved by the Court.

The German Agent replied in his pleadings on June 24th: he disputed the contention that the Court had not so far given a definite ruling and that it had made a reservation as to the lawful character under municipal law of the transactions which took place in 1919; he maintained that, in his opinion, having regard to the grounds and the operative part of the Judgment, there could be no doubt that the phrase invoked by Counsel for the Polish Government could not have the meaning which it was given by that Government, and that consequently that phrase could not be quoted in argument against the claims of the German Government. It should be observed that the Agent for the Polish Government, who was present at these pleadings before the Court, said nothing calculated to impugn or modify the said remarks of Counsel for that Government. On the contrary, he alluded to them in his own statement before the Court. There is thus no room for doubt that at the time those were the views of the Polish Government.

Shortly after the question of jurisdiction had been decided by the Court (Judgment No. 8), the Polish Government brought against the Oberschlesische the application announced by its representative during the hearings in June; and the grounds upon which this application is based, which are given above, appear to confirm the view that it was indeed brought

De ces faits il résulte que, tandis que le Gouvernement allemand soutient que l'Arrêt n° 7 de la Cour a définitivement tranché, avec effet obligatoire pour la demande en indemnisation présentée en faveur de l'Oberschlesische, la question relative à la propriété de cette société sur l'usine de Chorzów, voire du point de vue du droit civil, le Gouvernement polonais a soutenu une opinion contraire et s'est appuyé sur un certain passage dudit arrêt (p. 42) qui, selon lui, démontrait le bien-fondé de son opinion et qui, dans un certain sens, pourrait être caractérisé comme une réserve. Il y a donc vraiment une contestation sur un point qui, selon les explications apportées ci-dessus, concerne le sens et la portée dudit Arrêt n° 7, pour autant qu'il s'agit de la première conclusion du Gouvernement allemand.

Le Gouvernement polonais objecte que ledit passage n'a pas été invoqué par lui comme conférant un titre au droit de saisir le Tribunal de Katowice de la Requête qui y a été introduite, mais seulement comme étant la constatation par la Cour d'un droit qui lui appartenait déjà, abstraction faite de toute réserve. Le Gouvernement polonais objecte également que la demande allemande d'interprétation ne porte pas sur le dispositif de l'arrêt, qui, selon le Gouvernement polonais, peut seul faire l'objet d'une demande en interprétation, et qu'il ne prétend pas que le dispositif contienne une réserve telle qu'elle est visée dans la conclusion n° 1 du Gouvernement allemand. La Cour, cependant, ne peut se rallier à cette manière de voir. Car il est clair en tout cas que, s'il n'y a pas divergence sur le fait que le texte du dispositif de l'arrêt ne contient pas la réserve en question, l'existence, dans les motifs de l'arrêt, d'un passage que l'une des Parties interprète comme exprimant une réserve — réserve qui aurait pour effet de limiter la force obligatoire de l'Arrêt n° 7 — ou comme la constatation d'un droit qui serait incompatible avec la situation juridique que l'autre Partie considère comme établie avec force obligatoire, permet de saisir valablement la Cour du point relatif à l'interprétation des vrais sens et portée dudit arrêt.

for the purpose indicated at the time of the hearing in question.

From a consideration of these facts, it follows that—whereas the German Government contends that Judgment No. 7 of the Court finally decided, with binding effect as concerns the claim for compensation put forward on behalf of the Oberschlesische, the question relating to the right of ownership possessed by that Company over the factory at Chorzów, also under municipal law—the Polish Government supported the opposite view and, at the same time, relied on a certain passage in the judgment in question (p. 42) which, according to its opinion, showed the soundness of this view, and which might in one sense be described as a reservation. There is therefore, in so far as the first of the submissions of the German Government is concerned, a true dispute over a point which, in accordance with the explanations set out above, relates to the meaning and scope of Judgment No. 7.

The Polish Government contends that the passage in question was not invoked by it as conferring a right of bringing before the Tribunal of Katowice the Application actually submitted to that Tribunal, but only as an affirmation by the Court of a right which that Government already possessed, apart from any reservation. The Polish Government also contends that the German request for an interpretation does not relate to the operative part of the judgment (which, according to the former Government, can alone be the subject of a request for interpretation), and asserts that it does not claim that the operative part contains a reservation of the kind referred to in submission No. 1 of the German Government. The Court, however, is unable to take this view. For it is clear in any case that, although it is not contested that the terms of the operative part of the judgment do not contain the reservation in question, the fact that the grounds for the judgment contain a passage which one of the Parties construes as a reservation (the effect of which would be to restrict the binding force of Judgment No. 7) or as affirming a right inconsistent with the situation at law which the other Party considers as established with binding force, allows of the Court's being validly requested to give an interpretation fixing the true meaning and scope of the judgment in question.

D'autre part, en ce qui concerne l'Arrêt n° 8, la Cour estime que le sens et la portée de cet arrêt ne sont pas directement touchés par la première conclusion allemande. En effet, ledit arrêt ne statue que sur la compétence de la Cour pour juger l'affaire introduite par la Requête allemande du 8 février 1927. Toutefois, il y a lieu de mentionner que certains passages de cet arrêt peuvent entrer ici en ligne de compte comme exprimant le sens et la portée que la Cour attribuait à l'Arrêt n° 7 en prononçant son Arrêt n° 8.

La deuxième conclusion allemande semble poser la question des effets que la requête introduite auprès du Tribunal de Katowice pourrait avoir sur l'affaire pendante devant la Cour et relative à l'indemnité réclamée par l'Allemagne sur la base de l'Arrêt n° 7. D'après l'argumentation donnée, il est cependant clair que cette conclusion vise une application à un cas spécial d'un point que le Gouvernement allemand considère comme réglé avec force obligatoire par les arrêts déjà rendus, mais qui, selon le Gouvernement polonais, laisse encore ouverte la question relative à la validité, au point de vue du droit civil, du transfert de la propriété à l'Oberschlesische et de son inscription aux registres fonciers. Cette deuxième conclusion a donc, elle aussi, implicitement pour objet une question contestée visant le sens et la portée de l'Arrêt n° 7. En revanche, pour ce qui est de l'Arrêt n° 8, la Cour se borne à renvoyer à ce qu'elle a dit à ce sujet par rapport à la première conclusion allemande.

\* \* \*

Ayant ainsi constaté que les conclusions allemandes contiennent toutes les deux des demandes en interprétation de l'Arrêt n° 7 de la Cour, la Cour doit passer à l'examen de ce qu'on peut considérer comme le fond de l'affaire.

En procédant à cet examen, la Cour ne se considère pas comme tenue de répondre simplement par oui ou non aux propositions formulées dans les conclusions de la Requête allemande. Elle se place à ce point de vue parce que, pour interpréter un arrêt, elle ne saurait être liée par des formules

On the other hand, as regards Judgment No. 8, the Court considers that the meaning and scope of that Judgment are not directly affected by the first of the German submissions. For that Judgment only decides as to the jurisdiction of the Court to entertain the case submitted by the German Application of February 8th, 1927. It may, however, be stated that certain passages of that Judgment may in this connection be taken into account as showing the meaning and scope which the Court, when it pronounced Judgment No. 8, attributed to Judgment No. 7.

The second of the submissions of the German Government appears to raise the question of the effect which the application made to the Katowice Tribunal might have on the case pending before the Court with regard to the indemnity claimed by Germany on the basis of Judgment No. 7. According to the reasoning put forward, it is nevertheless clear that this submission relates to the application to a particular case of a point which the German Government considers as having been settled with binding effect by the judgments already rendered, but which, according to the Polish Government, leaves open the question as to the validity under municipal law of the transfer of the ownership to the Oberschlesische and of its entry in the land register. This second submission thus also refers, implicitly, to a disputed question relating to the meaning and scope of Judgment No. 7. On the other hand, as regards Judgment No. 8, the Court confines itself to a reference to what it has stated on this subject in relation to the first of the German submissions.

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Having thus shown that the submissions of the German Government both comprise requests for the interpretation of the Court's Judgment No. 7, the Court must now proceed to consider what may be regarded as the merits of the suit.

In so doing, the Court does not consider itself as bound simply to reply "yes" or "no" to the propositions formulated in the submissions of the German Application. It adopts this attitude because, for the purpose of the interpretation of a judgment, it cannot be bound by formulæ chosen by the

choisies par les Parties en cause, mais doit pouvoir se prononcer librement. Cette manière de voir se trouve en harmonie avec le texte actuel de l'article 66 du Règlement. En effet, aux termes de cet article — par lequel la Cour a entendu donner les indications indispensables relatives à la procédure en interprétation —, la requête introduisant la demande en interprétation doit comprendre :

« a) la mention de l'arrêt dont l'interprétation est demandée ;

« b) l'indication précise du ou des points litigieux. »

Tandis que l'article 35 du Règlement, qui a trait à la requête introduisant une affaire ordinaire, exige « la désignation de la chose demandée », l'article 66 parle de « l'indication . . . des points litigieux ». Et tandis que, pour la procédure ordinaire, l'article 40 du Règlement prévoit la présentation obligatoire de mémoires contenant, comme un élément essentiel, « les conclusions », l'article 66 ne mentionne que des « observations » facultatives et « un supplément d'information » à fournir sur invitation de la Cour.

La Cour estime donc devoir interpréter les conclusions de la Requête allemande du 18 octobre 1927 comme constituant simplement l'indication, au sens de l'article 66 du Règlement, des points dont le sens et la portée sont contestés entre les Parties. Selon toute autre interprétation, en effet, la Requête en question ne satisferait pas aux conditions formelles posées par ledit article ; et, comme elle a déjà eu l'occasion de le dire dans des arrêts antérieurs, la Cour peut, dans des limites raisonnables, faire abstraction des imperfections de forme des pièces qui lui sont soumises.

Au point de vue qui vient d'être invoqué, il y a lieu de retenir que les deux conclusions formulées dans la Requête allemande se révèlent, à l'analyse, comme ayant trait au même point litigieux, envisagé sous un double aspect. Ce point, qui a été suffisamment défini ci-dessus, se rattache au passage, figurant à la page 42 de l'Arrêt n° 7, que le Gouvernement polonais a invoqué dans la requête adressée par lui au Tribunal de Katowice ; ce passage est ainsi conçu :



Parties concerned, but must be able to take an unhampered decision. This view is consistent with the present terms of Article 66 of the Rules of Court. In fact, according to this article—which was intended by the Court to furnish information indispensable in regard to proceedings for interpretation—, the application submitting the request for an interpretation shall contain :

“(a) a specification of the judgment the interpretation of which is requested ;

“(b) an indication of the precise point or points in dispute.”

Whereas Article 35 of the Rules, which deals with an application instituting ordinary proceedings, requires “an indication of the claim”, Article 66 provides for “an indication of the . . . points in dispute”. And whereas, in the case of ordinary procedure, Article 40 of the Rules provides for the compulsory submission of Cases containing, as an essential part, “a statement of conclusions”, Article 66 only mentions optional “observations” and “further explanations” to be furnished upon the invitation of the Court.

The Court therefore considers that it should interpret the “submissions” of the German Application of October 18th, 1927, as simply constituting an indication, within the meaning of Article 66 of the Rules, of the points the meaning and scope of which are in dispute between the Parties. Construed in any other way, the Application in question would not satisfy the express conditions laid down by the above-mentioned article ; and the Court, as it has already had occasion to observe in previous judgments, may within reasonable limits disregard the defects of form of documents placed before it.

Adopting the standpoint indicated above, it is to be observed that, on analysis, the two submissions formulated in the German Application are seen to refer to the same disputed point regarded from two different aspects. This point, which has been sufficiently defined above, relates to the passage appearing on page 42 of Judgment No. 7, which passage the Polish Government has cited in the claim brought by it before the Tribunal of Katowice ; this passage is as follows :

« Si la Pologne veut contester la validité de cette inscription, son annulation ne saurait, en tout cas, résulter que d'une décision rendue par la juridiction compétente. »

C'est donc, en réalité, de ce passage de l'Arrêt n° 7, considéré par rapport à l'ensemble de l'arrêt, que le Gouvernement allemand demande l'interprétation au double point de vue du sens et de la portée.

S'occupant d'abord du premier de ces points de vue, la Cour observe que, pris isolément, les termes du passage qui vient d'être cité peuvent donner l'impression que la Cour a entendu réserver à la Pologne la faculté de faire établir, par un recours aux tribunaux polonais, et avec effet pour l'affaire alors tranchée, que l'Oberschlesische n'était pas, du point de vue du droit civil, valablement inscrite comme propriétaire de l'usine de Chorzów.

Le raisonnement, dans lequel se trouvent les lignes citées, a la teneur suivante (p. 42) :

« En ce qui concerne la thèse du défendeur, selon laquelle le contrat du 24 décembre 1919 et le transfert de la propriété, les 28-29 janvier suivants, par l'*Auflassung* et l'inscription au registre foncier, seraient entachés de fictivité ou de fraude, il y a lieu de constater d'abord que la Cour ne saurait attribuer à cette thèse, pour autant que l'on peut considérer que la Partie défenderesse a voulu l'appuyer sur des considérations tirées du droit civil allemand, une valeur indépendante ; en effet, la loi polonaise, dont l'application à l'usine de Chorzów a provoqué le présent différend entre les deux Puissances, ne se fonde ni principalement ni à titre subsidiaire sur la validité ou l'invalidité, au point de vue du droit civil allemand, du transfert des propriétés qu'elle vise, mais exclusivement sur la date du transfert par rapport au 11 novembre 1918. Il faut constater ensuite que la Cour, en exercice de la juridiction visée par l'article 23 de la Convention de Genève, n'examinera qu'en tant qu'un point incident ou préliminaire la question de l'existence éventuelle de droits au regard de la législation allemande.

La Cour a déjà constaté qu'au point de vue du droit international la transaction dont il s'agit doit, à son avis, être considérée comme effective et de bonne foi. Elle n'a trouvé dans les arguments portés à sa connaissance par la Pologne, à l'appui de sa thèse susmentionnée aucune raison propre à modifier, au point de vue du droit civil, le résultat auquel

“If Poland wishes to dispute the validity of this entry, it can, in any case, only be annulled in pursuance of a decision given by the competent tribunal.”

In reality, therefore, what the German Government seeks is an interpretation of this passage—considered in relation to the Judgment as a whole—from two aspects, namely that of its meaning and that of its scope.

Proceeding first of all to consider the first of these aspects, the Court observes that, considered by themselves, the terms of the passage above quoted may give the impression that the Court meant to reserve to Poland the right to obtain from the Polish Courts a decision which would apply to the case settled by Judgment No. 7, to the effect that the Oberschlesische was not, from the point of view of municipal law, validly entered as owner of the Chorzów factory.

The argument, in the course of which the lines quoted above occur, is as follows (p. 42):

“With regard to the argument of the Respondent to the effect that the contract of December 24th, 1919, and the transfer of ownership on the following January 28th-29th, by means of *Auflassung* and entry in the land register, are fictitious or fraudulent, it should in the first place be observed that the Court cannot consider this argument, in so far as it may be assumed that the intention of the Respondent is to support it, by considerations of German municipal law, as an independent one; for the Polish law, the application of which in regard to the Chorzów factory has led to the present dispute between the two Powers, is based neither directly nor indirectly on the validity or invalidity, from the standpoint of German municipal law, of the transfer of the properties covered by it; it is based exclusively on the date of the transfer in relation to November 11th, 1918. In the next place, it must be observed that the Court, in the exercise of the jurisdiction granted by Article 23 of the Geneva Convention, will not examine, save as an incidental or preliminary point, the possible existence of rights under German municipal law.

The Court has already observed that from the point of view of international law, the transaction under consideration must, in its opinion, be regarded as effective and as entered into in good faith. The Court has found in the arguments advanced by Poland in support of the above-mentioned contention no reasoning calculated to

elle est ainsi arrivée sur la base du droit international. Dans le cas actuel, la Cour est, en effet, d'avis que le droit de propriété de l'Oberschlesische sur l'usine de Chorzów doit être considéré comme établi, son inscription dans cette capacité au registre foncier ayant été dûment effectuée. Si la Pologne veut contester la validité de cette inscription, son annulation ne saurait, en tout cas, résulter que d'une décision rendue par la juridiction compétente ; c'est ce qui ressort du principe du respect des droits acquis, principe qui, ainsi que la Cour a eu l'occasion de le constater à maintes reprises, fait partie du droit international commun qui, sur ce point, entre autres, est à la base de la Convention de Genève.

Ceci est exact bien que, ainsi que le fait observer la Pologne, les contrats du 24 décembre 1919 aient été conclus à un moment où, faute d'inscription au registre du commerce, l'Oberschlesische manquait encore de personnalité juridique. La Cour constate, en effet, que ces contrats ont été conclus après la fondation de l'Oberschlesische et par ses directeurs régulièrement constitués ; elle constate, en outre, que l'aliénation de l'usine de Chorzów fut effectuée par l'*Auflassung*, acte de caractère contractuel, et par l'inscription au livre foncier, ce qui eut lieu seulement après l'inscription de l'Oberschlesische au registre du commerce. D'ailleurs, par des actes concluants, s'étendant sur une période de plus de deux ans, tous les intéressés ont continué de reconnaître la validité des contrats dont il s'agit. »

Il ressort tout d'abord de ce raisonnement — ceci avait d'ailleurs été expressément dit plus haut dans l'arrêt (p. 35) — que, pour répondre à la conclusion n° 2 *a* de la demande du Gouvernement allemand en l'affaire qui lui était alors soumise, la Cour a constaté la nécessité de trancher, bien que comme un point incident et préliminaire, la question relative à la thèse de la Pologne, selon laquelle le contrat du 24 décembre 1919 et le transfert de la propriété (savoir de l'usine de Chorzów à l'Oberschlesische), effectué les 28-29 janvier suivants, l'*Auflassung* et l'inscription au registre foncier, seraient entachés de fictivité et de fraude.

Il s'ensuit encore, entre autres, que la Cour n'a trouvé dans les arguments de la Pologne aucun motif propre à modifier, au point de vue du droit civil, le résultat auquel elle

modify, from the standpoint of municipal law, the conclusion at which it has thus arrived on the basis of international law. In the present case, in fact, the Court holds that the Oberschlesische's right of ownership of the Chorzów factory must be regarded as established, its name having been duly entered as owner in the land register. If Poland wishes to dispute the validity of this entry, it can, in any case, only be annulled in pursuance of a decision given by the competent tribunal; this follows from the principle of respect for vested rights, a principle which, as the Court has already had occasion to observe, forms part of generally accepted international law, which, as regards this point, amongst others, constitutes the basis of the Geneva Convention.

This is true, though, as is pointed out by Poland, the contracts of December 24th, 1919, had been concluded at a time when, not having been entered in the commercial register, the Oberschlesische possessed as yet no legal personality. The Court, in fact, notes that the contracts in question were concluded after the creation of the Oberschlesische and by its regularly appointed Directors; it further notes that the transfer of the Chorzów factory was effected by means of the *Auflassung*, a transaction of the nature of a contract, and of the entry in the land register, which formality took place only after the entry of the Oberschlesische in the commercial register. Moreover, by acts extending over a period of more than two years, all the Parties concerned have clearly shown that they still recognized the validity of the contracts in question."

In the first place—and this is expressly stated earlier in the Judgment (p. 35)—it follows from this reasoning that the Court found it necessary, in order to reply to submission 2a of the German Government's Application in the suit then under consideration, to decide, though as an incidental and preliminary point, the question raised by Poland's contention that the contract of December 24th, 1919, the transfer of ownership (i.e. of the Chorzów factory to the Oberschlesische) effected on January 28th-29th following, the *Auflassung* and the entry in the land register, were fictitious and fraudulent.

Again it follows, amongst other things, that the Court found in the arguments of Poland nothing calculated to modify, from the standpoint of municipal law, the conclusion at

était arrivée sur la base du droit international, mais qu'en revanche, de l'avis de la Cour, le droit de propriété de l'Oberschlesische sur l'usine de Chorzów était établi, « son inscription dans cette capacité au registre foncier ayant été dûment effectuée ». Cette dernière partie de la phrase ne peut être considérée ni comme constituant la seule raison qui ait motivé pour la Cour le résultat auquel elle arrivait, ni comme conditionnée par la non-observation de la manière de procéder indiquée dans les lignes précitées qui lui font suite. Ce qu'on peut trouver exprimé dans ces lignes est plutôt un argument additionnel, tiré du droit international commun. Si de l'emploi du verbe au temps présent on peut conclure que la Cour a envisagé la possibilité, pour la Pologne, d'instituer, même après l'arrêt, une procédure en vue d'obtenir l'annulation de l'inscription par une décision des tribunaux nationaux compétents, il serait contraire à tout le raisonnement d'y voir une réserve dans ce sens que les effets obligatoires de l'arrêt rendu et spécialement du paragraphe n° 2 a du dispositif (« que l'attitude du Gouvernement polonais vis-à-vis des Sociétés anonymes Oberschlesische Stickstoffwerke et Bayerische Stickstoffwerke n'était pas conforme aux dispositions des articles 6 et suivants de la Convention de Genève »), doivent dépendre du résultat d'une telle procédure instituée ultérieurement. En effet, une réserve dans ce sens aurait pour résultat de priver ladite conclusion 2 a de sa base logique et nécessaire, et ainsi de ne donner à ladite conclusion 2 a que le caractère d'une décision provisoire.

C'est aussi en ce sens que la Cour s'est exprimée dans son Arrêt n° 8 (p. 15). Elle y a dit, en ce qui concerne le transfert de l'usine à l'Oberschlesische, qu'elle a estimé, entre autres, « que le droit de propriété de l'Oberschlesische devait être considéré comme établi et *n'aurait pu* être contesté que devant un tribunal compétent ». Quant au passage qui figure à la page 31 de l'Arrêt n° 8 et qui est ainsi libellé :

« . . . il s'ensuit qu'une fois la dépossession accomplie sans examen préalable du droit de propriété, la possibilité d'entreprendre pareil examen afin de justifier, après coup, cette dépossession, ne saurait effacer une violation qui a

which it arrived on the basis of international law; but that, on the contrary, the Oberschlesische's right of ownership of the Chorzów factory was established, "its name having been duly entered as owner in the land register". This latter part of the sentence cannot be regarded either as constituting the only reason upon which the Court based the result at which it arrived, nor as dependent upon failure to act in the manner indicated in the lines which follow it in the above quotation. These lines are rather to be regarded as containing an additional argument, drawn from generally accepted international law. Though from the use of the present tense it may be concluded that the Court had in view the possibility of the institution by Poland, even after the judgment, of proceedings with a view to obtaining the annulment of the entry by means of a decision of the competent municipal tribunals, it would be contrary to the whole of the reasoning to construe it as a reservation implying that the binding effect of the Judgment given—and more especially of paragraph 2*a* of the operative part thereof ("that the attitude of the Polish Government in regard to the Oberschlesische Stickstoffwerke and Bayerische Stickstoffwerke Companies was not in conformity with Article 6 and the following articles of the Geneva Convention")—were to depend on the result of such proceedings instituted subsequently. Such a reservation would in fact have the result of depriving conclusion 2*a* of the Judgment of its logical and necessary foundation, and would thus give that conclusion merely the character of a provisional decision.

And the Court has also expressed itself to this effect in Judgment No. 8 (p. 15). It there stated, in regard to the transfer of the factory to the Oberschlesische, that it held—amongst other things—"that the Oberschlesische's right of ownership must be regarded as established, and *could have been* disputed only before a competent tribunal". As regards the passage appearing on page 31 of Judgment No. 8, which runs as follows:

"... it follows that once dispossession has taken place without previous investigation of the right of ownership, the possible undertaking of this investigation in order to justify such dispossession after it has taken

déjà eu lieu de la Convention de Genève, ni affecter la compétence de la Cour »,

il semble également démontrer que, dans la pensée de la Cour, une démarche ultérieure du Gouvernement polonais pour justifier, après coup, son attitude à l'égard de l'Oberschlesische ne pourrait pas entrer en ligne de compte.

Ayant ainsi établi le sens qu'il convient d'attribuer au passage par rapport auquel elle a été priée d'interpréter son Arrêt n° 7, la Cour procède maintenant à l'examen de la portée de l'arrêt, visée par la conclusion n° 2 de la Requête allemande.

Ainsi qu'il a été rappelé ci-dessus, la Cour a, par ledit arrêt, dit et jugé que l'attitude du Gouvernement polonais vis-à-vis de l'Oberschlesische n'était pas conforme aux dispositions de la Convention de Genève. Cette conclusion, qui est maintenant, sans conteste, passée en force de chose jugée, reposait, entre autres, d'une part, sur la constatation qu'au point de vue du droit international, le Gouvernement allemand avait bien le droit d'aliéner l'usine de Chorzów, et, d'autre part, sur la constatation qu'au point de vue du droit civil, l'Oberschlesische avait valablement acquis le droit de propriété sur l'usine — constatations qui constituent une condition absolue de la décision de la Cour. La constatation suivant laquelle, au point de vue du droit civil, l'usine appartenait à l'Oberschlesische fait, par conséquent, partie des points que l'Arrêt n° 7 a tranchés avec force obligatoire aux termes de l'article 59 du Statut. Le contexte dans lequel se trouve le passage dont il s'agit sert précisément à établir le droit de propriété de l'Oberschlesische au point de vue du droit civil.

L'Arrêt n° 7 de la Cour est de la nature d'un jugement déclaratoire qui, selon son idée, est destiné à faire reconnaître une situation de droit une fois pour toutes et avec effet obligatoire entre les Parties, en sorte que la situation juridique ainsi fixée ne puisse plus être mise en discussion, pour ce qui est des conséquences juridiques qui en découlent.

La Cour a eu l'occasion, dans son Arrêt n° 7 (p. 19), de se prononcer sur le point de savoir si l'article 59 du Statut de la Cour lui interdit de rendre des jugements purement décla-



place, cannot undo the fact that a breach of the Geneva Convention has already taken place, or affect the Court's jurisdiction",

this also seems to show that, in the intention of the Court, subsequent action on the part of the Polish Government to justify, after the event, its attitude in respect of the Oberschlesische, could not enter into account.

Having thus established the meaning to be attributed to the passage in regard to which it has been requested to construe Judgment No. 7, the Court will now proceed to consider the scope of the Judgment, which scope forms the subject of submission No. 2 of the German Application.

As has been recalled above, the Court, by that Judgment, decided that the attitude of the Polish Government in regard to the Oberschlesische was not in conformity with the provisions of the Geneva Convention. This conclusion, which has now indisputably acquired the force of *res judicata*, was based, amongst other things, firstly, on the finding by the Court that, from the standpoint of international law, the German Government was perfectly entitled to alienate the Chorzów factory, and, secondly, on the finding that, from the standpoint of municipal law, the Oberschlesische had validly acquired the right of ownership to the factory—and these findings constitute a condition essential to the Court's decision. The finding that, in municipal law, the factory did belong to the Oberschlesische is consequently included amongst the points decided by the Court in Judgment No. 7, and possessing binding force in accordance with the terms of Article 59 of the Statute. The very context in which the passage in question occurs is calculated to establish the right of ownership of the Oberschlesische from the standpoint of municipal law.

The Court's Judgment No. 7 is in the nature of a declaratory judgment, the intention of which is to ensure recognition of a situation at law, once and for all and with binding force as between the Parties; so that the legal position thus established cannot again be called in question in so far as the legal effects ensuing therefrom are concerned.

The Court has had occasion in Judgment No. 7 (p. 19) to state its opinion upon the question whether Article 59 of the Court's Statute prevents it from rendering purely

ratoires ; elle y a répondu négativement en déclarant que le but de l'article 59 est seulement d'éviter que des principes juridiques admis par la Cour dans une affaire déterminée, soient obligatoires pour d'autres États ou d'autres litiges.

Dans cet ordre d'idées, il y a lieu de constater ce qui suit : L'affaire concernant l'indemnisation demandée par le Gouvernement allemand sur la base de l'Arrêt n° 7 de la Cour est encore pendante quant au fond, et la procédure écrite ne sera terminée que le 1<sup>er</sup> mars 1928. Selon les observations de l'agent du Gouvernement polonais, il est possible que ce Gouvernement veuille se prévaloir dans ce procès de l'issue de l'action intentée devant le Tribunal de Katowice contre l'Oberschlesische. Une exception de litispendance à ce sujet n'a pas été formulée. En tout cas, l'obligation, imposée à la Cour par l'article 60 du Statut, d'interpréter ses arrêts à la demande de toute Partie, ne saurait fléchir pour la seule raison que l'interprétation que la Cour doit donner pourrait avoir éventuellement de l'importance pour un autre procès en cours. L'interprétation n'ajoute rien à la chose jugée et ne peut avoir effet obligatoire que dans les limites de la décision de l'arrêt interprété.

D'autre part, la Cour écarte dans ses interprétations toute appréciation de faits autres que ceux qu'elle a examinés dans l'arrêt qu'elle interprète, et, en conséquence, tous faits postérieurs à cet arrêt. De même, la Cour s'abstient de toute appréciation au sujet de la portée qu'aurait l'arrêt à interpréter sur les conclusions énoncées par les Parties dans une autre procédure ou autrement à elle signalées. Elle se borne à expliquer par l'interprétation ce qu'elle a déjà dit et jugé.

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PAR CES MOTIFS,

La Cour, jugeant contradictoirement,

décide et juge, par huit voix contre trois :

declaratory judgments; it answered this question in the negative, stating that the object of Article 59 is simply to prevent legal principles accepted by the Court in a particular case from being binding also upon other States or in other disputes.

In this connection, the Court thinks it right to make the following statement: The proceedings on the merits in the case concerning the compensation claimed by the German Government on the basis of Judgment No. 7 are still pending, and the written procedure will not be terminated until March 1st, 1928. Judging from the observations of the Agent for the Polish Government, it is possible that that Government may wish in this suit to rely on the result of the action brought by it before the Tribunal of Katowice against the Oberschlesische. No plea of litispendency has been formulated in this connection. At all events, the obligation incumbent upon the Court under Article 60 of the Statute to construe its judgments at the request of any Party, cannot be set aside merely because the interpretation to be given by the Court might possibly be of importance in another case which is pending. The interpretation adds nothing to the decision, which has acquired the force of *res judicata*, and can only have binding force within the limits of what was decided in the judgment construed.

Moreover, the Court, when giving an interpretation, refrains from any examination of facts other than those which it has considered in the judgment under interpretation, and consequently all facts subsequent to that judgment. Similarly, the Court abstains from any consideration of the effect which the judgment to be construed might exercise upon submissions made by the Parties in another case or otherwise brought to its knowledge. It confines itself to explaining, by an interpretation, that upon which it has already passed judgment.

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FOR THESE REASONS,

The Court, having heard both Parties,  
gives judgment as follows, by eight votes to three:

Que, dans son Arrêt n° 7, la Cour n'a pas réservé au Gouvernement polonais le droit de demander par la voie judiciaire, même après l'arrêt susdit et avec effet sur le cas décidé, la constatation de la nullité de l'inscription, basée sur l'acte du 24 décembre 1919, de la Société Oberschlesische Stickstoffwerke A.-G. comme propriétaire de l'usine de Chorzów aux registres fonciers ; mais que, par ledit arrêt, la Cour a entendu reconnaître, avec force obligatoire pour les Parties au litige et dans le cas décidé, entre autres choses, le droit de propriété de la Société Oberschlesische Stickstoffwerke A.-G. sur l'usine de Chorzów au point de vue du droit civil.

Le présent arrêt ayant été rédigé en français et en anglais, c'est le texte français qui fait foi.

Fait au Palais de la Paix, à La Haye, le seize décembre mil neuf cent vingt-sept, en trois exemplaires, dont l'un restera déposé aux archives de la Cour, et dont les autres seront transmis aux agents des Gouvernements des Puissances requérante et défenderesse respectivement.

Le Président :

(Signé) MAX HUBER.

Le Greffier :

(Signé) Å. HAMMARSKJÖLD.

M. Moore, juge, a pris part aux débats en l'affaire et voté en faveur de l'arrêt rendu par la Cour, mais a dû quitter La Haye avant le prononcé de cet arrêt.

M. Anzilotti, juge, déclarant ne pouvoir se rallier à l'arrêt et se prévalant du droit que lui confère l'article 57 du Statut, a joint audit arrêt l'exposé suivant de son opinion individuelle.

(Paraphé) M. H.

(Paraphé) Å. H.

That, in Judgment No. 7, the Court did not reserve to the Polish Government the right of asking by process of law, even after the rendering of that Judgment and with application to that particular case, for a declaration that the entry, in pursuance of the Agreement of December 24th, 1919, of the name of the Oberschlesische Stickstoffwerke A.-G. in the land registers as owners of the Chorzów factory is null and void; but that, by the aforesaid Judgment, the Court meant to recognize, with binding effect between the Parties concerned and in respect of that particular case, amongst other things, the right of ownership of the Oberschlesische Stickstoffwerke A.-G. in the Chorzów factory under municipal law.

Done in English and French, the French text being authoritative, at the Peace Palace, The Hague, this sixteenth day of December 1927, in three copies, one of which is to be placed in the archives of the Court and the others to be forwarded to the Agents of the applicant and respondent Parties respectively.

*(Signed)* MAX HUBER,  
President.

*(Signed)* Å. HAMMARSKJÖLD,  
Registrar.

Mr. Moore, Judge, took part in the discussion and voted for the adoption of the present Judgment, but had to leave The Hague before judgment was delivered.

M. Anzilotti, Judge, declaring that he is unable to concur in the Judgment delivered by the Court, and availing himself of the right conferred on him by Article 57 of the Statute, has delivered the separate opinion which follows hereafter.

*(Initialed)* M. H.

*(Initialed)* Å. H.

## **LEGAL AUTHORITY CA-123**

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## Chapter 23: Form and Contents of International Arbitral Awards

[Chapter 23] (1)

P 3013 An arbitral award possesses particular legal significance, conferred by both international arbitration conventions and national law. Concurrent with producing ● these legal effects, most national laws require that arbitral awards satisfy a number of important legal requirements, as to form, content and other matters. This Chapter addresses the categories of international arbitral awards, the form requirements applicable to arbitral awards, the requirement for a “reasoned” arbitral award, the possibility of majority and other non-unanimous awards, dissenting, concurring and other separate opinions, and the types of relief typically granted in arbitral awards. The subjects of annulment and recognition of international arbitral awards, as well as the *res judicata* effects of awards, are discussed in separate Chapters below. (2)

### § 23.01 CATEGORIES OF INTERNATIONAL ARBITRAL AWARDS (3)

Most national laws and institutional arbitration rules provide for a variety of different types of arbitral “awards,” (4) including final awards, partial awards, interim awards, consent awards and default awards. Each of these categories of arbitral award is discussed below. Unfortunately, there is some inconsistency in the usage of these various terms; as discussed below, different authorities, and different legal systems, sometimes adopt different meanings for the same term, or the same meaning for different terms, requiring that these labels be used with care. (5)

#### [A] Final Awards

The term “final award” is used in a number of different senses, and has often led to confusion. It is important to avoid such confusion by being clear about those different meanings.

First, as discussed above, all arbitral awards can be regarded as “final,” in the sense that they finally resolve a particular claim or matter with preclusive effect. (6) Even awards granting provisional relief can be considered to be “final,” notwithstanding the fact that they will be superseded by subsequent relief, because they finally dispose of a particular request for relief. (7) Much the same is true with regard to interim awards that decide a particular issue (e.g., choice of applicable law) without granting or denying a party’s underlying claim. (8) In this sense, every award rendered during the course of an ● arbitration, before its final conclusion, is “final” because of the preclusive effect that it enjoys. (9)

Second, as also discussed below, some international arbitration conventions and national arbitration statutes provide for the recognition of only “final” awards, and not of other, “non-final” awards. (10) Used in this sense, a “final” award refers only to those awards that have achieved a sufficient degree of finality in the arbitral seat (most obviously, by being granted confirmation or *exequatur*) or that are no longer subject to appeal or annulment in the arbitral seat. (11) Typically, only after an award has been granted *exequatur*, or after appeals from the award have been rejected (or become untimely), is it categorized as “final.” (12) (The categorization of an award as “final,” in this sense, should not be confused with the categorization of an award as “binding,” as generally required for recognition of awards under the New York Convention. (13) )

Third, and also confusingly, there is a further usage of the term “final” in connection with arbitral awards. The concept of a “final award” must be distinguished from an “award” that is “final,” with the latter two terms being used together in the sense of an award no longer being subject to judicial review. As its name suggests, the term “final award” refers to the last award in an arbitration, which disposes of all (or all remaining) claims and terminates the tribunal’s mandate. (14) This is a “final” award in the sense used by Article 32(1) of the UNCITRAL Model Law. (15) A “final” award in this sense is also to be distinguished from “partial awards,” which “finally” resolve part (but not all) of the parties’ claims, and which may become sufficiently “final” for recognition, in each case without terminating the arbitration. (16)

Most national legislation is consistent with this terminology; (17) these are also the formulae used in most institutional rules. (18) Under this approach, a “final award” is the ● award that disposes of either all the parties’ claims or all the parties’ remaining claims in the arbitration. Both such a “final award” and earlier “partial awards” are “final,” and may be capable of recognition and enforcement, but only a “final award” concludes the arbitration and renders the tribunal *functus officio*. (19)

It follows from the above that an arbitral tribunal should not purport to make a “final

award” unless it has considered and disposed of all the parties’ claims in the arbitration (including claims for costs and interest). If a tribunal fails to resolve all the parties’ claims, then its final award will be subject to annulment or non-recognition on grounds of *infra petita* or otherwise. (20) Alternatively, under some national laws, the award may be subject to an application for remission to the tribunal for disposition of the remaining claims or the tribunal may be authorized to issue an “additional award.” (21)

## [B] Partial Awards

A “partial award” is an arbitral decision that finally disposes of part, but not all, of the parties’ claims in an arbitration, leaving some claims for further consideration and resolution in future proceedings in the arbitration. (22) As to the claims that it disposes of, a partial award may become final and binding on the parties and may be recognized and enforced (or annulled). (23) Under many national laws, a “partial” award differs from an “interim” award in that it finally decides and disposes of a particular claim (e.g., awards damages for a particular breach of contract), while an interim award decides an issue (e.g., choice of law, liability) relevant to disposing of a claim, but does not finally dispose of the claim. (24)

- P 3016 ● Many national laws provide expressly that an arbitral tribunal has the power to make partial awards (absent contrary agreement). (25) For example, the Swiss Law on Private International Law provides that “unless the parties have agreed otherwise, the arbitral tribunal may make partial awards.” (26) Other arbitration statutes are similar. (27)

Institutional rules also generally provide for the possibility of partial awards. Article 34(1) of the 2010 UNCITRAL Rules provides that, “[t]he arbitral tribunal may make separate awards on different issues at different times.” (28) Other institutional rules are similar. (29) There is no question but that such provisions validly grant the arbitrators authority to make partial awards, even in the absence of statutory authorization; this is merely an application of the parties’ more general procedural autonomy. (30)

Moreover, even in the absence of statutory authorization or institutional rules permitting partial awards, a tribunal has the power to take such an approach (except in the case of contrary agreement by the parties). (31) This authority is inherent in the arbitrators’ mandate to resolve the parties’ dispute in an efficient manner. (32) Only clear and unambiguous language should be permitted to produce the unusual and inefficient result of denying arbitrators the authority to make partial awards.

- P 3017 ● Partial awards are typically used for separate determinations of specified claims, with other claims reserved for further proceedings. (33) For example, a tribunal might render an award rejecting the claimant’s contractual claims or upholding such claims and awarding damages, while leaving for subsequent proceedings the parties’ noncontractual claims. Alternatively, a tribunal might deal with some of the parties’ contractual claims, while leaving other contractual claims for later proceedings.

There are many circumstances where partial (or interim) awards are important to a constructive and efficient arbitral procedure. As with partial or interlocutory decisions in judicial proceedings, such awards allow a tribunal to decide a complex case in steps, enabling it and the parties to focus on and resolve issues sequentially, rather than in a single decision. (34) This sometimes has very significant advantages in terms of efficiency and speed.

On the other hand, if the parties’ arbitration agreement excludes partial awards, and requires a single award disposing of the entire dispute, that agreement must be given effect. (35) In practice, parties generally do not exclude the possibility of partial awards in their arbitration agreements (and, on the contrary, do the opposite, by incorporating institutional rules that provide for partial awards). (36) In the rare cases that this approach is considered, it is usually in an effort to ensure a “fast-track” process that resolves all disputes in a single, concentrated proceeding.

It is also conceivable that a tribunal would abuse its authority to make a partial award (or refuse to make a partial award). (37) In general, a challenge on this basis would be exceedingly difficult to sustain.

- P 3018 ● A tribunal’s decision whether or not to bifurcate proceedings, and to resolve certain issues before others, usually turns on minute assessments of efficiency that are the domain of the arbitral tribunal, where national courts should virtually never interfere. Some institutional rules encourage the use of partial awards in certain instances (particularly jurisdictional issues). (38) Even in these cases, however, it is highly unlikely (and undesirable) that a tribunal’s exercise of its procedural discretion would be second-guessed by a national court.

The overwhelming trend of modern arbitration legislation, and national court decisions, has been to permit the recognition and enforcement of partial awards that finally dispose of a particular, discrete aspect of a dispute (e.g., a particular set of claims), even if other aspects of the dispute remain to be decided in further arbitral proceedings. (39) The decisive issue is whether the parties’ arbitration agreement permits bifurcation and partial awards (which, as discussed above, is the case absent express contrary agreement). (40)



The same analysis applies to annulment proceedings under most national laws, including the UNCITRAL Model Law: a partial award, like other forms of awards, is subject to annulment under Article 34 of the Model Law. In one commentary's words, "[s]etting aside proceedings under Article 34 are admissible against all types of arbitral awards, irrespective of whether they completely terminate the proceedings or are ● awards finally determining certain claims only." (41) Among other things, separate awards on costs may be the subject of annulment proceedings. (42)

### [C] Jurisdictional Awards

As discussed above, national arbitration legislation, institutional rules and customary practice recognize the arbitrators' authority to consider and decide jurisdictional disputes involving challenges to the existence, validity and scope of a putative agreement to arbitrate. (43) There is uncertainty regarding the characterization of the arbitrators' jurisdictional rulings and, in particular, whether or not the tribunal's decision is characterized as an "award," rather than an "order" or "direction." (44)

Positive jurisdictional decisions (upholding an arbitral tribunal's jurisdiction) are generally subject to interlocutory judicial review. (45) Nonetheless, it is unclear whether those decisions are "awards," subject to annulment and recognition, or interim rulings that are either not subject to immediate judicial review or subject only to specialized judicial review (for example, under Article 16(3) of the UNCITRAL Model Law). (46) As discussed above, the better view is that positive jurisdictional rulings are properly characterized as awards, generally subject to annulment, recognition and enforcement like other awards, but national court authority on the subject remains divided. (47)

Similarly, courts in a few jurisdictions have held that negative jurisdictional rulings are "non-awards," (48) while other courts have held that, although constituting an "award," a negative jurisdictional decision cannot be the subject of judicial review in an annulment proceeding. (49) As discussed above, these decisions are unpersuasive; the better view is that negative jurisdictional decisions should be categorized in the same manner as positive jurisdictional rulings, namely, as awards.

### [D] Interim Awards

As noted above, national law, institutional rules and arbitral practice also provide for "interim awards," also sometimes referred to as "interlocutory" awards. (50) As with other ● terminology in this field, there is sometimes unfortunate confusion about the meaning of this phrase. (51)

As a practical matter, the term "interim award" is often used synonymously with "partial award," in the sense that an award is made, disposing of certain claims for relief, prior to disposition of all the issues (*i.e.*, the award is made at an interim stage in the arbitration). In this usage, an interim award is no different than a partial award. (52)

The term "interim award" is sometimes used more narrowly to refer to an award that does not dispose finally of a particular claim (*e.g.*, one of several claims for damages arising from several alleged breaches of contract), but instead decides a preliminary issue relevant to disposing of such claims (*e.g.*, choice of law, liability, construction of a particular contractual provision). In this sense, an award is "interim" because it is a step towards disposing of a portion of the parties' claims (like a partial award), but does not purport to make a final decision either granting or rejecting those claims.

The phrase "interim award" is also used with respect to decisions granting provisional relief. (53) In this sense, an award is "interim" because it is subject to subsequent revision ● by the arbitral tribunal, either in the final award or in a revised decision on provisional measures. (54) In this usage, an "interim award" is distinguishable from a "partial award" in that the former does not provide final resolution of part of the dispute, but resolution of all of a claim for provisional relief, subject to later revision.

There is little point to debating this terminology at length. The better practice is to explain with precision what is meant by a reference to an "interim award," and in particular whether the award grants provisional relief, finally decides a particular issue, or does something else. Confusion could be reduced by use of a reference such as "interim award of provisional relief," which specified clearly what the tribunal's decision entailed.

Some legal systems do not permit applications to annul (or recognize) interim awards, although they do permit applications to annul (and recognize) partial awards. That is true of Austria, where judicial decisions have consistently held that interim awards of provisional relief are not subject to annulment or recognition; (55) Germany, where similar results have been reached; (56) and Australia, where the Queensland Supreme Court held that an interim award of provisional relief "is not an 'arbitral award' within the meaning of the Convention nor a 'foreign award.'" (57)

As discussed above, however, the better view of the New York Convention, as well as national arbitration legislation, is that interim awards of provisional relief "finally" dispose of requests for such relief and should be capable of recognition and enforcement in national courts, like other awards granting relief. (58) The same conclusion applies to a tribunal's reasoned decision regarding a significant legal and factual issue (*e.g.*, liability,

choice of law). (59)

## [E] Consent Awards

P 3022 Parties not infrequently arrive at agreements to settle ongoing arbitrations. Indeed, one of the perceived benefits of the arbitral process is that the arbitration can be structured so as to encourage settlement and that the confidentiality and (sometimes) collegiality of the arbitral process can facilitate settlement efforts. (60)

### [1] Reasons for Consent Awards

If parties succeed in reaching a negotiated resolution of their dispute(s), one option is to simply dismiss the arbitration, recording the terms of the settlement in an agreement to this effect. Alternatively, however, parties may wish to obtain a “consent award” (or “award on agreed terms”), which records some or all of the terms of their settlement. (61)

A consent award is often perceived as providing a greater degree of certainty and enforceability than a simple settlement agreement: in particular, a consent award may be capable of being enforced as an award (e.g., if it contains a payment obligation), (62) rather than requiring suit for breach of contract. (63) A consent award may also have practical benefits, such as conferring a degree of formality on the parties’ settlement agreement. (64)

P 3023 Many arbitration statutes expressly allow for the possibility of consent awards. (65) Article 30(1) of the UNCITRAL Model Law provides that, if the parties reach a settlement during the arbitration, the tribunal “shall ... if requested by the parties and not objected to by the arbitral tribunal, record the settlement in the form of an arbitral award on agreed terms.” (66) Similar provisions exist in other arbitration legislation, (67) or are accepted by national court decisions. (68) Most institutional rules also provide that arbitral tribunals may make consent awards if requested to do so by the parties. (69) Both national laws (70) and institutional rules (71) provide that any general requirement that arbitral awards be “reasoned” does not apply to consent awards.

### [2] Arbitral Tribunal’s Power to Make Consent Award

The prevailing approach of both institutional rules (72) and national law (73) is to permit an arbitral tribunal to make a consent award if requested to do so by the parties, but not to expressly require the arbitrators to do so. On the contrary, most national statutes and institutional rules leave the arbitrators with the choice of whether or not to make a consent award when requested by the parties to do so. The UNCITRAL Model Law is representative, with Article 30(1) granting the arbitrators discretion to make (or not to make) a consent award if requested by the parties during the course of an arbitration. (74)

P 3024 An arbitral tribunal has the authority to make a consent award only if the parties commenced an arbitration regarding an actual dispute. The authority to make a consent award does not extend to cases where the parties settle a dispute and then subsequently commence an arbitration solely for the purpose of recording the settlement as a consent award. (75) Some courts have explained this result on the basis that no “dispute” exists to be referred to arbitration where a claim is settled before arbitral proceedings are initiated. (76) In Model Law jurisdictions, a few states have amended Article 30 to permit the making of consent awards where a settlement agreement is reached in the course of conciliation or mediation proceedings. (77)

Article 30(1) of the Model Law does not impose formalistic restrictions on the arbitrators’ consideration of requests to make consent awards. One arbitral tribunal granted the parties’ request to reopen proceedings for the purpose of recording a settlement agreement and make it in the form of a consent award. (78) That is an appropriate exercise of the arbitrators’ procedural discretion and is fully consistent with Article 30(1).

On the other hand, Article 30(1) imposes minimal formal requirements for a consent award: in order for Article 30(1) to apply, a tribunal must “record” the parties’ settlement “in the form of an arbitral award on agreed terms”; in turn, Article 30(2) incorporates the generally-applicable formal requirements of Article 31. (79) It is not sufficient that parties merely conclude a settlement agreement; rather, the tribunal must take the further, affirmative action of recording that settlement in an instrument satisfying the formal requirements of an award. Consistent with the language of Article 30(1), some Model Law courts have held that only a settlement agreement, which has been recorded in the form of an award on agreed terms pursuant to the formal requirements of Article 30(2) and that stated it was an award on its face, could be recognized under Article 36; a mere record of the settlement is insufficient. (80)

### [3] Arbitral Tribunal’s Power to Refuse to Make Consent Award

It is sometimes suggested that the tribunal is subject to the parties’ agreement and should therefore be obliged, absent illegality, to make a consent award if so requested by the parties. That misconceives an arbitral tribunal’s adjudicatory role: the parties are free to settle their claims as they wish, but they are not free to require that the tribunal exercise its own authority to approve that settlement.

A tribunal may consider that a consent award would improperly affect the rights of third parties, or public interests, which had not been (and could not be) spoken for in the arbitration. In these circumstances, the issuance of a consent award might be considered as giving effect to a private settlement to the detriment of either other parties or the law. The drafting history of the Model Law suggests that an arbitral tribunal could refuse to make a consent award in cases of fraud, illegality, or gross unfairness. (81) Judicial authority in Model Law jurisdictions is similar. (82)

P 3025 ● It is unclear whether these concerns warrant refusing to make a consent award. In principle, the arbitral tribunal's mandate extends to the issuance of a consent award, resolving the parties' dispute (which is the fundamental objective of the arbitral process). Only where there is a compelling reason for declining to make an award, including a consent award, may a tribunal properly do so: the objective of international arbitrations is to resolve disputes, which is what consent awards accomplish, and tribunals should in principle endeavor to advance this objective by making such awards. (83)

In practice, tribunals rarely decline to make consent awards. The fundamental purpose of arbitration is to provide a means for resolving disputes and tribunals are not only obliged, but almost always willing, to contribute to this objective insofar as possible, including by making a consent award. Only if there are well-founded bases for refusing to approve a settlement – such as indications of fraud, corruption, or violation of applicable mandatory law (e.g., exchange controls, money-laundering regulations, competition laws) should a tribunal refuse a request for a consent award. (84)

#### [4] Legal Status of Consent Awards

If a consent award is made, questions may arise as to whether it is to be treated as an arbitral award for purposes of the New York Convention (or other international treaties) and national arbitration legislation. There is little authority on the topic.

The New York Convention does not address the question of whether a consent award qualifies as an “arbitral award” for purposes of Article V. (85) Although a consent award is intended as an award (in that it is a formal written instrument made and signed by the arbitrators that finally disposes of the parties' claims and terminates the arbitration), (86) it arguably lacks the adjudicative character required of an “award” (in that it is not the product of adversarial proceedings and is not “reasoned” (87)).

The better view is that a consent award should be regarded as an award, within the meaning of the Convention and national arbitration legislation (including the UNCITRAL Model Law), insofar as the rights of the parties to the arbitration are concerned. (88) Parties are fully entitled to settle their claims, including in arbitration, (89) and if they do so in the form of a consent award, after having previously presented their respective positions in an adversarial process, that award should be fully binding and enforceable on the parties to the arbitration.

This is confirmed by the text of most national arbitration statutes. Article 30(2) of the Model Law is representative, providing that a consent award “has the same status and effect as any other award on the merits of the case.” (90) This text leaves no doubt but that consent awards are subject to recognition, confirmation and enforcement in the same manner as other arbitral awards. (91) Conversely, a consent award should also in principle be subject to annulment, again like other awards. (92)

Nevertheless, great care should be taken in recognition and enforcement of consent awards insofar as third party rights are arguably affected. In general, an award will only have preclusive effects on the parties to the arbitration. (93) There may be unusual circumstances, however, where a consent award is alleged to affect third parties; in these circumstances, recognition of the award under international arbitration conventions and/or arbitration statutes should be subject to particular scrutiny.

#### [F] Default Awards

As discussed above, arbitral proceedings sometimes involve one party's failure or refusal to appear and present its case in the arbitration. (94) A party's default does not prevent the arbitral tribunal from considering the parties' claims and resolving their dispute. On the contrary, most national arbitration legislation (95) and judicial authority (96) provides that arbitral tribunals may make default awards and that such awards are subject to recognition (and annulment), just as contested awards are. The fact that a party refuses to participate in arbitral proceedings, and an award is rendered against it in its absence, has also repeatedly been held not to constitute a denial of procedural rights under either Article V(1)(b) of the New York Convention or developed arbitration statutes. (97)

As discussed above, most institutional rules provide for default proceedings and awards if one party refuses to participate in the arbitration. (98) Even without express authorization from national law or institutional rules, a tribunal has the inherent authority to conduct proceedings in the absence of one party and to make a default award. (99) Doing so is an essential element of adjudicatory power and is necessary in order to ensure an effective arbitral process which one party cannot frustrate or obstruct through a refusal to participate.

As also discussed above, an arbitral tribunal may not simply accept the non-defaulting

P 3028 party's claims, without independently reviewing them and an evidentiary record. (100) In ● this regard, a default proceeding in an arbitration is in concept no different from a proceeding in which both parties participate: the tribunal must afford both parties the opportunity to present their cases and then make an award based upon the evidence that has been submitted and the law. (101) That award then has precisely the same status and effects as an award made after proceedings in which both parties participated. (102)

### [G] Additional Award

As discussed below, many arbitration statutes and institutional rules provide for the making of "additional awards" (sometimes also referred to as "complementary" or "supplemental" awards), after what was intended as the final award is made. (103) These additional awards are made, at the request of a party, when a tribunal's final award mistakenly fails to dispose of a claim that had been asserted in the arbitration. An additional award is treated no differently from other "awards," (104) and is subject to applications for annulment and to recognition and enforcement. (105)

### [H] Corrections and Interpretations

As also discussed below, many arbitration statutes and institutional rules provide for the possibility of corrections or interpretations by an arbitral tribunal of its award(s). (106) These corrections and interpretations should themselves have the same status as an award (107) and should be capable of annulment, recognition and enforcement under both international arbitration conventions and national law. (108)

### P 3029 ● [I] Termination of Arbitral Proceedings Without Award

Arbitrations are occasionally concluded without an arbitral award. This is typically because the parties agree to settle their dispute (but without a consent award) or because the claimant abandons its claims.

#### [1] National Arbitration Legislation

Most national arbitration regimes permit the arbitral tribunal to terminate the arbitration without an award in limited circumstances. Article 32(2) of the Model Law provides for the termination of arbitral proceedings by "order" if: (a) the claimant withdraws its claims, "unless the respondent objects thereto and the arbitral tribunal recognized a legitimate interest on his part in obtaining a final settlement of the dispute"; (b) the parties agree to terminate the proceedings; or (c) the continuation of the arbitration has "become unnecessary or impossible." (109) This provision is more detailed than the broadly similar UNCITRAL Rules (discussed below). (110)

Other arbitration legislation is usually silent concerning the termination of arbitral proceedings without an award. (111) For the most part, however, national law provides results comparable to those under the Model Law. That is, the arbitrators may – in limited cases of settlement, impossibility and claimant's withdrawal of its claims – terminate the arbitral proceedings without an award. (112)

The consequences of termination of the arbitration for the parties' claims are generally governed by national law. In principle, there is nothing that should prevent either party from reasserting its claims or counterclaims in a new arbitration; the parties' arbitration agreement remains in effect, notwithstanding termination of the arbitration, (113) and applies to any further claims by either party.

Ordinarily, national law would not prevent either party from reasserting previously-asserted claims or counterclaims. The arbitration (which had been terminated) would not produce an award, capable of being recognized or having preclusive effects; at the same time, termination of the arbitration does not itself ordinarily produce preclusive ● effects. (114) Rather, termination of the arbitration would merely be a withdrawal of both parties' claims and defenses without prejudice to their being reasserted in subsequent proceedings.

P 3030

#### [2] Institutional Arbitration Rules

Most institutional rules make express provision for the termination of arbitral proceedings without an award. The 2010 UNCITRAL Rules provide for the arbitral tribunal to "issue an order for the termination of the arbitral proceedings" if the parties agree upon a settlement (115) or if "the continuation of the arbitral proceedings becomes unnecessary or impossible." (116) These provisions allow the tribunal, in appropriate cases, to terminate the arbitration and the arbitrators' mandate without making an award.

Similarly, the LCIA Rules provide for the arbitral tribunal to be "discharged" and "the arbitration proceedings concluded" in the event of a settlement between the parties. (117) The ICC Rules also (impliedly) contemplate termination of arbitral proceedings in the case of a settlement that is not recorded in a consent award. (118) Neither the LCIA Rules nor the ICC Rules provide expressly for the termination of arbitral proceedings, without an award, in other circumstances.

Even absent express authorization in institutional rules for termination of an arbitration,

however, such a power is implicit in the tribunal's procedural authority. (119) The tribunal has the authority, if the parties do not pursue their claims or agree to settle their dispute, to terminate the arbitration.

## § 23.02 FORMAL REQUIREMENTS FOR INTERNATIONAL ARBITRAL AWARDS

Like an arbitration agreement, (120) an international arbitral award must satisfy specialized form requirements. Unless these requirements are complied with, the award is potentially subject to annulment, in the place of arbitration, or, less clearly, non-recognition, in other jurisdictions. As discussed below, the form requirements applicable to international arbitral awards are generally set forth in the arbitration ● legislation of the arbitral seat, (121) and the parties' arbitration agreement, including any applicable institutional rules.

### [A] No Form Requirements in International Arbitration Conventions

In contrast to their treatment of arbitration agreements, (122) international arbitration conventions do not generally impose form requirements with respect to arbitral awards. (123) As discussed above, it is implicit in most arbitration conventions that an award will be a written instrument made by the arbitrators: (124) in particular, Article IV(1)(a) of the New York Convention requires presentation of a "duly authenticated original award or a duly certificated copy thereof" as a condition of recognition, presupposing the existence of a written instrument. (125) This provision would presumably allow a Contracting State to deny recognition to a foreign "award" that was not in writing, although oral awards are virtually never made in international arbitration practice. (126)

Although international arbitration conventions do not prescribe form requirements for arbitral awards, they also do not expressly forbid Contracting States from doing so. As discussed below, national arbitration legislation routinely imposes formal requirements on locally-seated arbitrations, (127) and there is no suggestion that the New York Convention (or other international arbitration conventions) were intended to forbid this. (128)

P 3032 ● The New York Convention arguably does not permit Contracting States to impose form requirements on foreign awards as a requirement for recognition (as distinguished from a basis for annulment). That conclusion would rest on the fact that Article V includes no exception based on a failure to satisfy formal requirements of the recognition state (or otherwise). (129)

Consistent with this conclusion, states have in practice virtually never invoked the form requirements of the arbitral seat (or of the judicial enforcement forum) as grounds for denying recognition to foreign arbitral awards. (130) A potential exception involves the requirement that awards be reasoned, (131) although most courts have been prepared to recognize unreasoned awards if this was permitted in the arbitral seat. (132)

### [B] Form Requirements in National Arbitration Legislation

Many national laws prescribe mandatory form requirements for international arbitral awards. In general, these provisions require a written and (almost always) reasoned instrument, signed by some or all of the arbitrators, which is dated. In some cases, these requirements are mandatory and parties are not capable of altering them by agreement. In general, these requirements are non-controversial and readily complied with, thus giving rise to few issues of interpretation.

#### [1] Parties' Autonomy to Alter Form Requirements

The UNCITRAL Model Law is representative of most national arbitration statutes' treatment of form requirements. It provides that an award (a) "shall be made in writing," (133) (b) "shall be signed by the arbitrator or arbitrators," (134) (c) "shall state its date and the place of arbitration," (135) and (d) "shall state the reasons upon which it is based, unless the parties have agreed that no reasons are to be given or the award is an award on agreed terms." (136) With the exception of the requirement for a reasoned award, these form requirements are mandatory under the Model Law. (137) Although every jurisdiction imposes its own particular form requirements for awards made locally, most other arbitration legislation is broadly similar. (138)

P 3033 ● In the United States, the FAA does not impose any express form requirement(s), although it presumes that awards will be written. (139) This is in contrast to certain U.S. state law requirements (likely preempted by the FAA) that contain form requirements. (140)

In some jurisdictions, the parties' autonomy to agree upon the form requirements applicable to the award is expressly recognized. In contrast to the generally mandatory provisions of the UNCITRAL Model Law, §52(1) of the English Arbitration Act, 1996, provides that "the parties are free to agree on the form of the award." (141) Absent agreement, the English Arbitration Act provides (like the Model Law) that the award shall be in writing, signed and reasoned, and shall provide the date of the award and seat of the arbitration. (142) This approach, giving effect to the parties' agreement, is to be preferred and, where statutory language will permit, other national arbitration statutes should be interpreted



to produce the same result.

## [2] Writing and Signature, Place and Date Requirements

For the most part, the form requirements for arbitral awards under national law are readily satisfied and non-controversial. As noted above, most national laws simply require a writing, signature, date and place. Not surprisingly, little debate has arisen concerning these requirements, which are almost always satisfied.

### P 3034 ● [a] Writing and Signature

It is not unusual or controversial that awards must generally be in writing. (143) This is essential both to ensure due reflection by the arbitral tribunal and to record with (hopeful) clarity precisely what the tribunal has decided, both for the parties and for any subsequent judicial enforcement or annulment proceedings. (144)

In some national legal systems, all of the arbitrators are required to sign the award. (145) Where such a requirement exists, it is ordinarily a matter of mandatory law, which prevails over inconsistent institutional rules. (146) Although early authority was sometimes to the contrary, (147) there is no requirement that the arbitrators all sign the award at the same time or when they are physically located in the same place. (148) There is also no requirement that all of the pages of the award be signed and, instead, only a requirement that the final page of the award be signed. (149)

### P 3035 ● Interpreted literally, and without exceptions, the requirement for a signed award by all the members of a multi-person tribunal would give a dissenting arbitrator the wholly-inappropriate power to block the making of an award, by refusing to sign the award. This is not the intention or the effect of such statutory requirements. The real purpose of the signature requirement is to ensure personal attention and responsibility (150) and to provide an evidentiary record.

As discussed below, in most jurisdictions, the award may, if necessary, be signed by either a majority of the arbitrators (151) or by the chairman alone. (152) Where one arbitrator refuses to sign the award, an explanation of the refusal is generally required (from the majority or chairman of the tribunal). (153) National courts have adopted relatively lenient approaches to the requirements for an explanation for the lack of a signature, (154) although there are occasional exceptions (particularly when the arbitrator whose signature is missing did not participate in the tribunal's deliberations). (155)

### P 3036 The requirement that the absence of a signature be explained (contained in Article 32(3) of the 1976 UNCITRAL Rules, as well as a number of national arbitration ● statutes) was misused in the Iran-U.S. Claims Tribunal, which saw "numerous attempts by Iranian judges to turn this rule on its head. In many cases, the Iranian judges insisted on supplying their own statement of reasons for why they refused to sign an award, with the apparent aim of invalidating the award and undermining the Tribunal's legitimacy." (156)

#### [b] Place

As discussed elsewhere, the place where the award is made can have significant legal consequences, including in determining the forum for an annulment action. (157) To minimize uncertainties, most arbitration legislation requires arbitrators to confirm the place of the arbitration by specifying it in the award; (158) similarly, many arbitration statutes also provide that the award will be deemed to have been made at the place of the arbitration. (159) Consistent with this, it is common practice for arbitrators to specify the location of the arbitral seat on the face of the award, regardless where they sign the award.

As discussed elsewhere, the place where an award is physically signed has been held, in a few older decisions, as affecting the place where the award is "made" for purposes of the New York Convention and some national arbitration statutes. (160) More recent authority almost universally deems that the award is made in the arbitral seat, as selected by the parties' agreement, regardless where it is physically signed by each of the arbitrators. (161)

#### [c] Date

### P 3037 As noted above, most arbitration legislation requires that awards be dated. The date on which the award is made may have consequences for the commencement of the ● time period for seeking to correct, annul, or confirm the award under applicable national law. (162)

## [3] Reasons for Award

The requirement that arbitral awards state their reasons, which is imposed by most developed arbitration statutes, has provoked more discussion than other formal requirements. This requirement typically involves questions more readily considered to be matters of substance, and not form, and is addressed separately below. (163)

## [4] Consequences of Noncompliance With Statutory Form Requirements

As noted above, statutory form requirements for arbitral awards are often mandatory. In many instances, failure to satisfy a formal requirement (e.g., to sign or date the award or indicate the place of arbitration) will be capable of invalidating the award in a subsequent annulment proceeding. (164) Such errors are readily capable of correction, where applicable arbitration legislation or institutional rules permit, and this is obviously the preferable course to annulling an otherwise valid award. (165) In many other jurisdictions, arbitration legislation does not provide for annulment based on technical formal defects in the award. (166)

As noted above, states have virtually never relied upon noncompliance with form requirements for arbitral awards as grounds for denying recognition to foreign awards. (167) The only arguable exception is the requirement that for reasoned awards, (168) and, even here, most courts have recognized unreasoned awards if the law of the arbitral seat permitted such awards. (169)

#### P 3038 ● [C] Form Requirements Under Arbitration Agreement and Institutional Rules

Arbitral awards must also comply with any form requirements set forth in the parties' arbitration agreement. In general, arbitration clauses themselves do not expressly impose specific or additional form requirements. (170) Nevertheless, institutional rules typically do prescribe form requirements for arbitral awards, although these usually do not differ materially from those set forth in the Model Law.

The UNCITRAL Rules track precisely the form requirements of the Model Law, (171) as do most other modern institutional rules. (172) In contrast, some institutional rules impose more detailed form requirements (which are not generally difficult to satisfy). (173) Noncompliance with these requirements may expose the award to annulment or non-recognition on the grounds that the parties' agreed arbitral procedures were not complied with. (174)

#### [D] Language of Award

Typically, parties will specify (through their arbitration agreement) the language of the arbitration, which will impliedly extend to the award. (175) Where the parties have not selected the language of the arbitration, the tribunal will do so, again generally impliedly encompassing the language of the award. (176) In both instances, failure to make the award in the requisite language may constitute a defect of form and provide a basis for annulment or non-recognition of the award. (177)

It is possible that national law in the arbitral seat would impose language requirements on the award. (178) If this were the case, the award would be exposed to annulment or non-recognition if it were not in the required language (subject to arguments that, where the parties had otherwise agreed, national law was contrary to Articles II and V(1)(d) of the New York Convention). (179)

#### P 3039 ● § 23.03 REQUIREMENT THAT INTERNATIONAL ARBITRAL AWARDS BE REASONED (180)

It is now a nearly universal principle that, unless otherwise agreed, international arbitral awards must set forth the reasons for the tribunal's decision, as well as containing a dispositive section specifying the relief ordered by the tribunal. This requirement for a reasoned award is reflected in international arbitration conventions, national law and institutional rules, and plays a central role in the international arbitral process.

#### [A] Requirements for Reasoned Award in International Arbitration Conventions

The New York Convention (like the Inter-American Convention) does not expressly address the subject of reasoned awards. In contrast, Article VIII of the European Convention provides that the parties "shall be presumed to have agreed that reasons shall be given for the award," except where: (a) the parties "expressly declare" to the contrary, or (b) the parties "have assented to an arbitration procedure under which it is not customary to give reasons for awards" and neither party requests reasons. (181) This provision is expressive of the expectations of parties in most contemporary international contexts, and (absent contrary agreement) can be regarded as a general principle of law in the context of international commercial arbitration. (182)

#### P 3040 ● [B] Requirement for Reasoned Award in National Arbitration Legislation

Historically, there was no universal rule under many national laws that arbitral awards be reasoned. (183) The traditional rule under English common law was that unreasoned awards were enforceable and the practice of making unreasoned awards was common. (184) Consistent with this, English, U.S., Indian and Hong Kong courts historically did not require that arbitral awards state the arbitrators' reasons for their award. (185) Nonetheless, modern arbitration legislation in most developed jurisdictions – save the United States – has superseded the common law rule and expressly requires that arbitrators give reasons for awards made within national territory, unless otherwise agreed by the parties. (186)

Article 31(2) of the UNCITRAL Model Law is representative of contemporary arbitration legislation, providing that “the award shall state the reasons upon which it is based, unless the parties have agreed that no reasons are to be given.” (187) Under the Model Law, reasoned awards are the default rule, unless the parties affirmatively agree to the contrary. (188) Other arbitration legislation is similar, (189) while some statutes go further, mandatorily requiring reasons to be given in all cases (regardless of the parties’ agreement). (190) Similarly, leading institutional rules almost uniformly require reasoned awards, either on a mandatory basis (191) or absent contrary agreement. (192)

P 3041

The requirement for reasoned awards rests on contemporary assessments of the demands of the adjudicative process. A leading English authority expressed the rationale as follows:

“By the end of the judgment the whole of the judge’s thinking on the facts and the law should have been laid bare, that all who run may read. It should be fair to assume that he has not been led to his decision by matters he has not mentioned. No cards regarded by him as significant should remain face downwards or in the pack. His decision may later be held to have been right or wrong, but at least there should be no real doubt what he decided or why.” (193)

Simply put, it is regarded as an essential aspect of the judicial process – and the related adjudicative process of arbitration (194) – that the decision-maker be required to explain his or her reasons. This is necessary in order to constrain the power of the decision-maker (reducing the risk of arbitrary, whimsical, or lazy decisions), to enhance the quality of the decision-making process (by requiring thoughtful, diligent analysis) and to provide the parties with the opportunity not only to be heard, but to hear that their submissions have been considered and how they have been disposed of. (195)

P 3042

Indeed, a reasoned decision, explaining how legal rules apply to factual determinations, is the essence of adjudication, distinguishing it from legislative, executive and other forms of decision-making. (196) These considerations are more, not less, important in the context of arbitral decisions, as compared to judicial decisions, because arbitrators do not have the training, institutional responsibilities and discipline, or appellate oversight, of national court judges. (197)

It has been suggested that the requirement for reasoned awards conflicts with the arbitrator’s independence and ability creatively and flexibly to resolve commercial disputes:

“When we talk about the arbitrator’s freedom from reasoned awards, it will frequently be the case that we are really talking about his freedom from over-broad rules or time-honoured categories that might otherwise appear to dictate a result he would prefer to avoid. This is, then, a freedom that makes possible an arbitrator’s flexibility in decision-making and a maximum attention to context.” (198)

Although there is practical force to this observation, it mischaracterizes the essential character of international commercial arbitration, which is an adjudicative process in which arbitrators apply the law. If parties wish to give an arbitrator “freedom from over-broad rules or time-honoured categories,” they agree to arbitration *ex aequo et bono*, which grants arbitrators that freedom from legal rules. If parties do not do so, however, then the arbitrators’ mandate is to apply the law – hopefully with a strong sense of the parties’ commercial setting and objectives – with the requirement for reasons serving to guarantee the diligence and quality of that adjudicatory process.

### [C] Content of Requirement for Reasoned Award Under National Arbitration Legislation

The requirement for reasons under most national arbitration legislation does not demand that the arbitrators write a learned article on the issues in dispute, nor deliver an award of any particular length. Indeed, in some instances, longer is not better, but worse, by tending to obscure the real issues and bases for decision. (199) The essential requirement is that the tribunal identify the issues that were dispositive in the dispute and explain, concisely, the thought-process underlying its decision.

P 3043

There are various formulations for what constitutes a reasoned award. (200) One of the most satisfactory is:

“All that is necessary is that the arbitrators should set out what, on their view of the evidence, did or did not happen and should explain succinctly why, in the light of what happened, they have reached their decision and what that decision is. This is all that is meant by a ‘reasoned award.’” (201)

This requirement for a concisely-reasoned award can be regarded as expressing the parties’ presumptive expectations in any contemporary international commercial arbitration. Indeed, a well-reasoned Australian decision adopts precisely this view under the UNCITRAL Model Law:



“The Model Law, Art. 31(2) ... [does] not say that the arbitrator must deal with every substantial argument put forward by the contending parties. Nor [does it] state that the arbitrator should state the evidence from which he or she draws his or her findings of fact and give reasons for preferring some evidence over other evidence. The reasons required are those for making the award. To the extent that a crisp summary of that is required, I would adopt the statement of principle of Donaldson LJ in *Bremer v Westzucker* [quoted above].” (202)

P 3044 ● Among other things, there is no requirement that a “reasoned” award list the evidence that the parties submit or discuss how the tribunal evaluates each item of evidence. (203) Some courts have also held that an arbitral award need not satisfy the same standard of reasoning as a national court judgment, on the basis that arbitration is designed to settle disputes expeditiously. (204)

The requirement for a reasoned award is also not a requirement for a well-reasoned award: bad or unpersuasive reasons are still reasons, and satisfy statutory requirements for reasoned awards. (205) As discussed below, in a limited number of jurisdictions, awards made in locally-seated arbitrations may be annulled if they are internally-contradictory. (206) This requirement focuses on the dispositive portions, rather than the reasoning, of the award and should not be seen as a form of requirement for clear or consistent reasoning.

It is essential that the requirement for reasons not be turned into a vehicle for substantive review of the arbitral award. Reasons can be short and concise or they can be ill-phrased, unpersuasive and unreflective; but they are still reasons. As long as the award demonstrates that the arbitrators have applied their understanding of the law to their understanding of the facts, the requirement for reasons is satisfied. (207)

It is important to note that, in most developed jurisdictions, the requirement for a reasoned award is not mandatory: parties are free to contract out of this requirement and to agree to the arbitrators’ provision of an unreasoned award. (208) This reflects the parties’ general autonomy with regard to the arbitral procedure, (209) including with regard to fundamental procedural safeguards of the adjudicative process.

There is no reason to criticize this recognition of the parties’ procedural autonomy: where commercial parties choose to dispense with the costs, delays and formalities of reasoned awards, and to encourage the informality and compromise that may sometimes accompany unreasoned awards, it is virtually always appropriate to permit ● this. (210) Thus, where statutory language will allow, arbitration legislation should be interpreted to permit parties to agree to unreasoned arbitral awards. Based on similar analysis, where parties have so agreed, an unreasoned foreign award should be recognized; that is true even if local law in the judicial enforcement forum ordinarily requires reasoned arbitral awards in locally-seated arbitrations. (211)

There are a limited number of industries and/or institutional settings where reasoned arbitral awards are not the rule. So-called “quality” arbitrations, where the quality of commodities are assessed, traditionally do not involve reasoned awards; this is understandable because of the nature of the decision, the need for expedition and the ongoing relations among the parties concerned. In these circumstances, unreasoned awards should be permitted even absent express agreement permitting an unreasoned award (on the basis of clear evidence demonstrating the parties’ implied expectations). (212)

Some national legal systems provide for the annulment of awards that violate statutory requirements that awards be reasoned. (213) Courts in other states, including some states that require reasoned awards, have held that an award’s lack of reasons is not grounds for annulment. (214) The rationale for these decisions is that the lack of reasoning, although a violation of statutory requirements for arbitral awards, is not sufficiently fundamental to warrant annulling an award.

#### **[D] No General Requirement for Reasoned Award Under U.S. Domestic Federal Arbitration Act**

A significant exception to the general international consensus presumptively requiring reasoned awards is the United States, where older authority has preserved the historic common law rule permitting unreasoned awards. (215) A 1960 opinion of the U.S. Supreme Court is representative, remarking in dicta that “[a]rbitrators have no obligation to the court to give their reasons for an award.” (216) Similarly, U.S. courts have generally held that unreasoned awards are valid and enforceable (provided that applicable institutional rules or the parties’ agreement do not require a reasoned award). (217)

P 3046 Where the parties’ agreement or applicable institutional rules provide for a ● reasoned award, as is generally the case, (218) U.S. courts will demand compliance with this requirement. (219)

In many respects, the domestic U.S. approach to reasoned awards is the mirror-image of the UNCITRAL Model Law and most other contemporary arbitration legislation. Under both approaches, the parties are free to agree to either reasoned or unreasoned awards; the difference between the two approaches is that the domestic U.S. default rule is to

permit unreasoned awards, while the UNCITRAL Model Law's default rule is to require reasoned awards.

The U.S. domestic approach is out of line with contemporary international views and should not be applied in international arbitrations (including international arbitrations seated in the United States). In international arbitrations, reasoned awards are customary and represent the implied expectations of the parties: that is reflected in the essentially unanimous approach of institutional rules (220) and national arbitration legislation, (221) presumptively requiring reasoned awards. This is supported by the parties' presumptive desire to avoid potential uncertainties with regard to the enforcement of unreasoned awards outside the United States. Given these considerations, the presumptive default rule in international arbitrations seated in the United States and elsewhere should be that reasoned awards are required, absent contrary agreement.

### [E] Recognition of Unreasoned Arbitral Awards

P 3047 Significant questions arise concerning the recognition and enforcement of an unreasoned foreign award that is made in a place where local law permits unreasoned ● awards (e.g., the United States). There is substantial authority for the proposition that unreasoned awards will be recognized and enforced in foreign courts, even in states that require reasoned awards in arbitrations seated on their territory, provided that unreasoned awards were permitted in the arbitral seat. (222) Where the parties to a foreign arbitration have agreed, expressly or impliedly, that awards may be unreasoned, it is particularly difficult to see what grounds would exist for denying recognition of an unreasoned foreign award. (223)

Even where a recognition court requires that foreign awards be reasoned, courts proceed from the premise that different legal systems adopt different approaches to the arbitral process, (224) including with regard to the methods of drafting awards. (225) In one court's words, "[i]n the case of foreign arbitral awards, it must be borne in mind that the deciding arbitrators come from different legal cultures and follow the customs of their procedural systems when writing reasons." (226)

P 3048 ● Although there is force to these conclusions, unreasoned awards sometimes attract objections under Article V(2)(b)'s public policy exception where the parties have not affirmatively agreed to waive a statement of reasons by the arbitrators (as can occur under the FAA): in these instances, an unreasoned award arguably deprives the parties, without their agreement, of a fundamental procedural protection. A few national courts have denied recognition of unreasoned awards in these circumstances. (227) Other courts are also likely to be attracted by the notion, underlying these decisions, that a statement of reasons is an expected, vitally-important aspect of the adjudicative process, upon which parties should be permitted to insist, absent express contrary agreement. (228)

The better view is that unreasoned awards should not be subject to non-recognition where the parties have expressly or impliedly agreed that no reasons are required or where unreasoned awards are permitted under the law of the arbitral seat. The requirement for reasons does not rise to the level of a mandatory international requirement; where parties have accepted unreasoned awards, either directly or by choice of an arbitral seat that does not require reasoned awards, there is no justification for imposing a different result. Similarly, there is generally no basis for concluding that national public policy permits non-recognition of an award under Article V(2)(b) of the New York Convention; if the parties have agreed, in a foreign-seated arbitration where such agreements are permitted, to forego reasons, that agreement should not ordinarily violate another state's public policies.

Conversely, where the parties have agreed upon a reasoned award, either directly or by choice of the arbitral seat, the failure to provide one will ordinarily be grounds for non-recognition. That will generally be true under Article V(1)(d) of the Convention, providing for non-recognition of awards where the arbitrators did not apply the parties' agreed arbitral procedures. (229)

### § 23.04 MAJORITY AWARDS AND AWARDS BY PRESIDING ARBITRATOR

Virtually all arbitration legislation and institutional rules provide, in cases of multi-person tribunals, for non-unanimous decisions by the arbitrators. This typically permits majority awards, but can also include awards by the presiding arbitrator acting alone. P 3049 Although possible, both of these avenues are exceptions, with the vast majority ● of all international arbitral awards being unanimous awards, signed by all members of the tribunal. (230)

### [A] Majority Awards

Almost all modern arbitration legislation permits awards to be made by a majority of the arbitrators (i.e., non-unanimous or majority awards). (231) Article 29 of the UNCITRAL Model Law is representative: "In arbitral proceedings with more than one arbitrator, any decision of the arbitral tribunal shall be made, unless otherwise agreed by the parties, by a majority of all of its members." (232) Arbitration legislation in other jurisdictions also

provides that an award may be made by less than all the members of the arbitral tribunal. (233) If not all the arbitrators sign an award, national law generally requires that a statement of the reasons for the omitted signatures be included in or appended to the award. (234)

In most arbitration statutes, the principle permitting majority awards is subject to contrary agreement, although in practice this seldom occurs. (235) Similar provisions for P 3050 ● majority awards exist in many institutional rules. (236) As discussed above, the dynamics of an arbitral tribunal's decision-making are affected significantly by provisions granting the majority of the arbitrators (or, as discussed below, the chairman alone) the right to make an award, without the concurrence of a co-arbitrator (or both co-arbitrators). (237)

Institutional rules sometimes require that all members of the arbitral tribunal sign the award. (238) Where such a rule exists, an arbitrator is contractually required to sign the award even if he or she dissents from its conclusions. (239) A refusal to fulfill this obligation would subject the arbitrator to challenge and removal. (240)

### **[B] Awards by Presiding Arbitrator**

There are instances in which all three arbitrators may have different views about the appropriate resolution of a dispute (for example, regarding quantum of monetary relief or where more than two claims or types of relief are sought). Where this occurs, there may be no majority at all, and instead only three different views. In this event, and as discussed above, some arbitration statutes (241) and institutional rules (242) provide for the decisive position to be that of the presiding arbitrator, with the presiding arbitrator being authorized to make an award alone. In contrast, other arbitration statutes (243) and institutional rules (244) do not provide for awards by the presiding arbitrator alone (instead either expressly or impliedly requiring a majority award).

P 3051 ● As discussed above, the existence of such a provision obviously also further affects the dynamics of the tribunal's decision-making and deliberations, by vesting the chairman with power to proceed alone, notwithstanding the disagreement of both co-arbitrators. (245) If no such provision exists, then deliberations must continue until a majority can be formed; until a majority exists for a particular position, there can be no award, which increases the co-arbitrators' influence materially vis-à-vis the presiding arbitrator. (246)

### **[C] Alleged Nonexistence of Majority Award**

In legal regimes requiring a majority award, there have been instances in which awards have been challenged on the grounds that there was supposedly no "majority" award – even though two arbitrators signed a final award. This has occurred, for example, when one arbitrator in the "majority" has appended a separate or concurring opinion to the award, stating that he or she believed that the correct result should have been different from that of the final award (e.g., that more or different relief should have been granted or that an alternative ground should have been relied upon). (247) In one case, for example, a co-arbitrator joined the presiding arbitrator in making a majority award, while stating in a concurrence that he had agreed because deliberations were required P 3052 to continue "until a majority, and probably a compromise ● solution has been reached. ... I concur ... in order to form a majority so that an award can be rendered." (248)

A distinguished commentator commented on this practice, with grudging acceptance, as follows:

"so much of the judicial and arbitral process is characterized by judges and arbitrators voting to form a majority rather than voting to express what each of them may see as the optimum judgment. In a collective body, there is very frequently a process of accommodation of differing views, sometimes sharply differing views. The result may be consecration of the least common denominator. That may not be a noble result, but it is a practical result. It is better than no result." (249)

This conclusion is clearly correct. There is no requirement that an arbitrator agree with all, or even any, of the reasoning in an award; nor is there any requirement that the arbitrator be happy with the result he or she accepts, nor believe that it is the best or fairest outcome. All that is important, for these purposes, is that the arbitrator voluntarily sign the award. That is confirmed, in very clear terms by the possibility of arbitrators signing an award while appending a dissenting or concurring opinion or statement. (250)

Some arbitration legislation also deals expressly with circumstances where an arbitrator refuses to take part in a vote on a decision by the members of the tribunal (which is different from taking part in a vote, but then dissenting from the tribunal's decision). The German version of the Model Law provides that, in such instances, and with advance notice to the parties, the majority of the tribunal can make an award without the third arbitrator's participation. (251)

Even absent such express statutory authorization, a majority of a tribunal would generally be held to have the authority to make an award without the participation of the third arbitrator, provided that he or she had been given sufficient opportunities to deliberate

and participate in a vote. (252) (The related subject of a “truncated tribunal,” where an arbitrator resigns, is discussed above. (253) )

P 3053 ● **§ 23.05 SEPARATE, CONCURRING AND DISSENTING OPINIONS** (254)

An almost inevitable consequence of the possibility of majority awards is the possibility of “separate” or “dissenting” views by individual members of the arbitral tribunal. One mechanism for indicating disagreement or dissent is for the arbitrator simply to decline to sign the award in question. (255) Under most modern arbitration legislation, this will not prevent the award from being final, or from being an “award,” but will signify the arbitrator’s personal disagreement with his colleagues’ conclusions. (256)

Nevertheless, consistent with the tradition of requiring reasoned awards, and often for reasons of professional pride, some arbitrators wish to go further and explain the reasons for their dissent. This is sometimes expressed in the form of a separate or dissenting statement or opinion, which is often annexed to the tribunal’s award. (257)

Notably, a dissenting or concurring opinion is not part of the award, nor is it another or independent award; rather, it is merely a separate statement by the dissenting arbitrator, without any of the legal consequences of an award. (258) Separate, dissenting ● and concurring opinions are common in both litigation and arbitration in some legal systems; (259) they are somewhat less common in international commercial arbitration, particularly in civil law regimes.

Dissenting or separate opinions were historically customary in state-to-state practice. The 1899 Hague Convention for the Pacific Settlement of International Disputes provided expressly for dissenting opinions, allowing “[t]hose members who are in the minority [to] record their dissent when signing” the award. (260) Nonetheless, dissenting opinions are unusual or forbidden in many domestic legal systems and, more recently, there have been reservations about such opinions in international arbitration. (261)

**[A] Treatment of Separate, Concurring, or Dissenting Opinions Under National Law and Institutional Rules**

Most arbitration legislation is silent on the subject of separate or dissenting opinions, although a few such statutes expressly permit dissenting opinions. (262) That is true of the UNCITRAL Model Law, whose provisions make no mention of dissenting, concurring, or other separate opinions. (263)

During the drafting of the UNCITRAL Model Law, proposals were made to specifically permit dissenting opinions, but insufficient need was seen to do so. (264) That is apparently because it was clear that dissenting opinions were permissible (absent contrary agreement), even without express statutory authorization, but not to be ● encouraged. In jurisdictions where local arbitration legislation does not expressly permit separate or dissenting opinions, judicial or academic authority often approves the practice. (265)

A number of institutional arbitration rules provide for dissenting or separate opinions, (266) although there are some notable exceptions, including the UNCITRAL Rules (267) and ICC Rules. (268) Even where institutional rules provide for the possibility of a dissenting or separate opinion, it is sometimes suggested, usually by civil law practitioners, that such an opinion may only be attached to an award or issued separately if the majority of the tribunal permits it. (269) In some instances, tribunals have refused to release a dissenting opinion, notwithstanding the dissenting arbitrator’s request that they do so. (270)

Even absent express authorization in national law or applicable institutional rules (or otherwise), the right to provide a dissenting or separate opinion is an appropriate concomitant of the arbitrator’s adjudicative function and the tribunal’s related obligation to make a reasoned award. (271) Although there are legal systems where dissenting or separate opinions are either not permitted or not customary, these domestic rules have little application in the context of party-nominated co-arbitrators and diverse tribunals. (272)

P 3056 ● Indeed, the right of an arbitrator to deliver a dissenting opinion is properly considered as an element of his or her adjudicative mandate, particularly in circumstances where a reasoned award is required. (273) Only clear and explicit prohibitions should preclude the making and publication to the parties of a dissenting opinion, which serves an important role in the deliberative process and can provide a valuable check on arbitrary or indefensible decision-making.

**[B] Criticisms of Separate, Concurring and Dissenting Opinions**

It has been suggested by some authors that the confidentiality of the arbitral tribunal’s deliberations (274) forbids any separate or dissenting opinion, because this would reveal that the tribunal was non-unanimous. (275) This view is generally rejected in more recent authority (276) and, in any event, is misconceived.

The confidentiality of the arbitral deliberations does not extend to a formal statement of an arbitrator’s views concerning the claims submitted to the tribunal; indeed, the same

P 3057 argument would prevent an arbitrator from refusing to do anything other than sign an award with which he or she disagrees, which is both unacceptable and not the law. (277) It would also be contrary to both historic practice (278) and the tradition of reasoned awards (279) for an arbitrator to be forbidden to express his or her views on the matters he or she has been mandated to consider and make a reasoned decision on.

The fact that arbitrators are permitted to issue dissenting or separate opinions does not mean that they should – or even are entitled to – issue *any* dissenting or separate opinion that they choose. In a substantial number of cases, an arbitrator will eventually “go along” with his or her colleagues on a tribunal, where on reflection his or her disagreements are equivocal, caveated, or not strongly-held. Doing so is not an abdication of the arbitrator’s responsibilities or independence, but an application of his or her obligations of collegiality and open-mindedness. (280)

Moreover, not unlike the making of arbitral awards, the making of a dissenting opinion is a serious act, that implicates the arbitrator’s personal duties of impartiality, confidentiality, collegiality and diligence. (281) These duties require that any separate or dissenting opinion respect the secrecy of the arbitral deliberations (*i.e.*, not disclose or comment upon statements allegedly made during deliberations or prior drafts of awards), respect the collegiality of the arbitral tribunal (*i.e.*, not make offensive or personal comments or accusations) and respect the arbitrator’s duties of impartiality (*i.e.*, not adopt a partisan approach merely advocating one party’s position). (282) A failure to respect these obligations is a breach of the arbitrator’s obligations to the parties and his or her fellow arbitrators. (283)

P 3058 ● There have inevitably been instances where the foregoing principles were not observed (albeit often in politically-charged circumstances). Classic examples include various of the separate and/or dissenting opinions issued by members of the Iran-United States Claims Tribunal, (284) by members of bilateral investment treaty tribunals (285) and by members of state-to-state arbitral tribunals. (286) These opinions have sometimes included harsh personal accusations and overt efforts to undermine the validity and enforceability of the award. (287)

It has been correctly observed that it is very often party-nominated arbitrators who issue dissenting opinions of this nature. In the words of one practitioner:

“Certain arbitrators, so as not to lose the confidence of the company or the state which appointed them, will be tempted, if they have not put their point of view successfully in the course of the tribunal’s deliberations, systematically to draw up a dissenting opinion and to insist that it be communicated to the parties.” (288)

P 3059 ● Although there are exceptions to this general rule, in which a presiding arbitrator dissents from an award made by the two party-nominated co-arbitrators, (289) they are unusual. The substantial majority of all dissenting opinions are issued by party-nominated co-arbitrators, in favor of the position of the party that nominated them.

It is important to be clear about what is proper, and what is improper, for a separate or dissenting opinion to do. There should be nothing objectionable at all about an arbitrator “systematically drawing up a dissenting opinion and insisting that it be communicated to the parties.”

If an arbitrator believes that the tribunal is making a seriously wrong decision, which cannot fairly be reconciled with the law and the evidentiary record, then he or she may express that view. There is nothing wrong – and on the contrary, much that is right – with such a course as part of the adjudicatory process in which the tribunal’s conclusion is explained in a reasoned manner. And, if the arbitrator considers that the award’s conclusions require a “systematic” discussion, that is also entirely appropriate; indeed, it is implied in the adjudicative process and the requirement for a reasoned award.

Any experienced practitioner will also have seen cases where a decision-maker’s views changed – sometimes radically – in the course of deliberations, including after receiving a draft dissent. One of the reasons for requiring a written, reasoned award is precisely to force the tribunal to articulate its conclusions and reasoning in black-and-white.

In a surprising number of cases, views that were expressed confidently in oral discussions “just won’t write”: equally, views that are expressed in a draft award will, in some instances, not withstand the force of a careful dissenting opinion. For these reasons, a diligent co-arbitrator will not merely voice – but also write – his objections, in a respectful effort to persuade. Doing so is in no way inappropriate, but is a fundamental element of arriving at a reasoned – and correctly-reasoned – award.

It is sometimes said that, having expressed his or her views in writing, but failed to persuade his or her colleagues, an arbitrator should withdraw and not issue a dissenting opinion. That ignores the fact that the possible eventual publication of a dissenting opinion is one of the reasons that an arbitrator’s views are considered carefully and given respect by the other members of the tribunal.

At least as important, this view also ignores the fact that the very concept of a reasoned award by a multi-member tribunal permits a statement of different reasons – if different



members of the tribunal in fact hold different views. This is an essential aspect of the process by which the parties have an opportunity to both present their case and hear the reasons for the tribunal's decision; not hearing the dissent deprives the parties of an important aspect of this process.

P 3060 At the same time, a process that includes dissenting views also enhances the quality of the tribunal's deliberations and ultimate award, resulting in more diligent and ● focused attention to difficult issues. In some cases, dissents or disagreements coupled with the possibility of a dissenting opinion result in more nuanced or qualified majority (or unanimous) awards that deal with the parties' dispute in a more careful or balanced manner. All of this materially enhances, rather than detracts from, the international arbitral process. (290)

Finally, dissenting and separate opinions must be directed only towards explaining the reasons for the arbitrator's conclusions, and not towards obstructing recognition and enforcement of the award. An arbitrator's duties of collegiality require that he or she accept the tribunal's award as such – even where he or she issues a dissenting opinion – and not seek to overturn or undermine it. (291) Accordingly, save in the most exceptional cases, a separate or dissenting opinion may not identify or comment on alleged biases of the tribunal, or purported procedural errors or similar matters. These are matters that a party seeking to annul an award may raise, but they should not be advocated by an arbitrator. (292)

Equally, an arbitrator who intends to issue a dissent has no right to delay notification of the tribunal's award to the parties. Instances sometimes arise in practice where an arbitrator (often the co-arbitrator appointed by the party whose claims or defenses are about to be rejected by the majority) seeks to delay the process of finalizing the award. This tactic was firmly rejected by a Swedish Court of Appeal decision:

“when two arbitrators are agreed upon the outcome of the dispute, the third arbitrator cannot prolong the deliberations by demanding continued discussions in an attempt to persuade the others as to the correctness of his opinion. The dissenting arbitrator is thus not afforded any opportunity to delay the writing of the award.” (293)

This language can be read as going too far, at least as literally formulated, by suggesting that there is little, if any, scope for an arbitrator ever objecting to inadequate deliberations. If two members of an arbitral tribunal prevented the third member from any meaningful opportunity to present his or her objections to their joint view, serious P 3061 questions would be raised about the regularity and fairness of the ● arbitral process and resulting award. (294) An arbitrator has no right unreasonably to delay the issuance of the award, and would breach his or her duties by attempting to do so, (295) but he or she does have the right to a meaningful opportunity to meet with, and attempt to persuade, the other members of the tribunal. (296)

Some commentators have suggested that the prevalence of dissenting opinions by party-nominated co-arbitrators, typically supporting the position of the party that nominated them, suggests bias and, more broadly, defects in the system of party-appointed arbitrators. (297) In fact, the vast majority of all international arbitrations do not involve dissenting (or separate) opinions, (298) and there are not insignificant numbers of cases where a presiding arbitrator dissents from an award by the two co-arbitrators. (299)

More fundamentally, it is in no way surprising that co-arbitrators, selected by each party independently, would have views about legal, commercial and cultural issues that made the co-arbitrators more likely to be responsive to his or her nominating party; that is one of the main objectives of parties in selecting co-arbitrators. (300) As discussed in greater detail elsewhere, there is nothing at all that is surprising or objectionable about this result. (301)

## § 23.06 TIME LIMITS, SERVICE AND PUBLICATION OF INTERNATIONAL ARBITRAL AWARDS

National law, institutional rules and/or arbitration agreements often prescribe requirements with regard to time limits for making an award, service and notification of an award and related matters. (302) Like formal requirements, these requirements are generally non-controversial and capable of being readily satisfied, but require attention and diligence by the tribunal.

### P 3062 ● [A] Time Limits for Making Awards

As discussed above, most national arbitration statutes contains no provision regarding the time limits for making an award. (303) This leaves the timing of an award within the parties' procedural autonomy or, absent agreement, the arbitrators' general procedural discretion. (304)

In contrast, a few (usually older) arbitration statutes prescribe time limits within which an arbitral tribunal, seated within national territory, must make its final award. (305) For example, the French Code of Civil Procedure provides that a final award in a domestic

arbitration must be made within six months of the constitution of the tribunal. (306) A limited number of other arbitration statutes are similar. (307) These legislative time limits are typically vestiges of historic statutory codes mandating the arbitral procedures.

Statutory time limits apply only to arbitrations seated within national territory, not to arbitrations seated abroad; that is virtually always true as a matter of straightforward statutory construction and, in any event, follows from the territorial limitations of national arbitration legislation. (308) A statutory time limit might also, exceptionally, apply to an arbitration seated abroad, if the parties had chosen the relevant jurisdiction's law as the procedural law of the arbitration. (309) In many instances, statutory time limits will apply, or be interpreted to apply, only to domestic, and not to international, arbitrations, even if they are locally-seated. (310)

Some institutional rules prescribe deadlines for the making of an award. (311) Less frequently, the parties' arbitration agreement may prescribe a time limit for making an award. (312)

P 3063 ● Most national arbitration legislation gives effect to such agreements, (313) as an element of the parties' more general procedural autonomy. (314) As one French decision explains:

“the principle that the time-limit fixed by the parties, either directly or by reference to arbitration rules, cannot be extended by the arbitrators themselves is a requirement of both domestic and international public policy, in that it is inherent in the contractual nature of arbitration.” (315)

Further, some jurisdictions also adopt statutory mechanisms for either the tribunal or local courts to extend a contractual time limit. That is the case in France, (316) England, (317) Belgium (318) and elsewhere. (319)

The consequences of violation of the parties' agreed time limit vary. In some jurisdictions, such violations may be excused (for example, on the theory that “time was not of the essence” (320) ), while in other jurisdictions the violation of a time limit will result in the invalidity and potential annulment of the award. (321)

P 3064 ● **[B] Delivery, Service and Notification of Awards**

Once an arbitral award has been made, it must be provided to the parties in some fashion: if this does not occur, it is impossible to see how the parties could be bound by or able to challenge the award's (unknown) terms.

Despite the practical importance of publication of an award, there are generally no provisions in international arbitration conventions regarding the delivery, service, or notification of awards to the parties. That is true for the New York Convention, (322) as well as the European and Inter-American Conventions.

In contrast, most national arbitration legislation prescribes some sort of requirement for delivery, notification and/or service of arbitral awards on the parties. In virtually all developed legal systems, the arbitrators are statutorily required to communicate the award to the parties.

Thus, the UNCITRAL Model Law provides “after the award is made, a copy signed by the arbitrators ... shall be delivered to each party.” (323) Many other arbitration statutes make similar provision, for awards to be “delivered,” (324) “transmitted,” (325) “communicated,” (326) or “notified” (327) to the parties.

Under the English Arbitration Act, 1996, the parties are “free to agree on the requirements as to notification of the award,” (328) failing which “the award shall be notified to the parties by service on them of copies of the award, which shall be done without delay after the award is made.” (329) Characteristically, the FAA is silent on the topic, although U.S. courts have generally held that in the absence of agreement by the parties, awards should be served on parties according to the applicable arbitration rules or other methods permitted by law. (330)

P 3065 ● It appears clear in most developed legal systems that a signed and dated award, complying with all relevant formalities, is still an “award” even if not yet communicated to the parties: most national arbitration statutes provide that the “award” shall be communicated or delivered, not that delivery is one of the formal requirements for an “award.” (331) (An arguable exception is Switzerland, where an award only becomes “final” upon communication to the parties. (332) ) As discussed below, however, it appears that an award may be altered by a tribunal up until the moment that it is communicated to the parties. (333)

The delivery or communication of an award to the parties often has significant procedural consequences under national arbitration legislation: in particular, it frequently triggers the time period for applying to correct or modify the award (334) and for filing an application to annul the award. (335) In the case of final awards, the delivery

P 3066 ● or communication of the award also defines when a tribunal becomes *functus officio*. (336)

Most arbitration legislation either requires or assumes that the arbitrators themselves will arrange for delivery or notification of the award to the parties. In practice, however, this duty is often delegated (without controversy) to either an arbitral institution in accordance with its institutional rules (337) or to another third party (e.g., a secretary, barrister's clerk, or delivery firm).

National arbitration statutes almost uniformly require that the award be delivered to both (or all) of the parties, and not to only one of them. (338) Even where not expressly provided by statute, this is an implied, but mandatory, requirement. It reflects the general equality of the parties, as well as specific concerns that the parties have equal opportunities to challenge or seek correction or modification of awards. (339) Arbitration legislation also generally provides that awards will be delivered only to the parties, and not to others, consistent with general expectations regarding the confidentiality of the arbitral process. (340)

National arbitration statutes sometimes also contain provisions regarding the mode of delivery of an award to the parties, including delivery by hand, mail, courier, or otherwise. (341) It is this type of delivery, however defined, that provides the starting point for calculating time periods (for applications to correct, modify, or annul an award).

Arbitral institutions or arbitral tribunals sometimes informally provide the parties with copies of the award (whether denominated as advance copies, courtesy copies, or otherwise) in a means other than the statutorily-defined manner. (342) Informal provision of awards to both parties in this manner is entirely proper, but generally does not suffice to trigger applicable statutory time periods for applications to annul or correct the award. (343)

P 3067 It is very common in international arbitration (indeed, almost the rule) that the award will need to be delivered to persons residing outside the country where the arbitral seat is located. That raises the question whether there is any requirement for "service abroad" of an award in accordance with national (344) or international (345) requirements for serving documents in national court litigation abroad. ●

Although there is surprisingly little authority on the issue, the correct view is clearly that there is no requirement that an award be served abroad pursuant to either national or international requirements of this nature. That is not because awards are not "extrajudicial" documents, to which instruments such as the Hague Service Convention apply, but instead because national arbitration legislation uniformly provides only that awards must be "delivered" or "communicated," and not "served," which are the topics regulated by such instruments. This is in keeping with the practical, commercially-oriented objectives of the arbitral process and should preclude arguments based upon alleged noncompliance with national or international service requirements. (346)

Institutional arbitration rules almost invariably address the question of delivery or notification of an award. Such rules typically provide that the arbitral institution itself, rather than the arbitrators, will notify the award to the parties. (347)

Most national laws do not expressly provide for the validity of these forms of notification, (348) although in practice they have not raised any questions. Given the central role of party autonomy in defining arbitral procedures, (349) there should be no question regarding the validity of delivery provisions established by institutional rules.

#### P 3068 ● [C] Registration of Awards

Some legal systems continue to require that an award made in a locally-seated arbitration be "registered" or "deposited" with a local court or notary. (350) This provision was more frequent under older arbitration legislation, and was related to the requirement for confirmation or *exequatur* of the award. (351) The decisive trend over the past half-century has been away from such requirements and instead towards simply notifying the parties of the making of the award. (352)

### § 23.07 RELIEF GRANTED IN ARBITRAL AWARDS (353)

The most critical aspect of any arbitral award is the relief that it grants. In many cases, this is a straightforward matter, which gives rise to few difficulties. If one party seeks amounts due in payment for goods or services, or satisfaction of a debt or guarantee, then there will typically be little basis for disagreement over the nature of the relief or the tribunal's power to grant it. In other cases, involving requests for injunctive or declaratory orders, some forms of monetary damages (e.g., punitive or double/treble damages), or interim measures, disputes can arise regarding the tribunal's power to award such relief and the appropriate standards for doing so.

#### [A] Arbitrators' Powers With Regard to Relief

The remedial powers of an international arbitral tribunal are defined in the first instance by the parties' arbitration agreement. This is an element of the parties' general autonomy, with respect to both the arbitrators' jurisdiction (354) and the arbitral procedures, (355) given effect by both the New York Convention and virtually all national arbitration legislation. (356)



P 3069 In principle, the parties should be free to confer authority on the arbitrators to grant any form of civil remedy calculated to resolve the parties' dispute. (357) It is of course, elementary that a tribunal may only order relief against the parties to the arbitration, ● consistent with the consensual status of the arbitral process. (358) There may also be exceptional limits on the arbitrators' remedial authority, arising from the nonarbitrability and public policy doctrines (discussed elsewhere), (359) but the general rule is that the arbitral tribunal's remedial powers are defined by the parties' arbitration agreement, given effect by the Convention and national law.

In a few jurisdictions, arbitration legislation affirmatively provides arbitral tribunals the same remedial authority as local courts, expressly incorporating the powers of national courts. (360) In principle, these statutory provisions should be regarded as non-mandatory (e.g., subject to limitations or extensions by the parties). Other legislation expressly permits parties to agree upon the arbitral tribunal's remedial authority, while providing default rules regarding remedial authority; the default provisions of these statutes again generally provide arbitral tribunals with the same authority with regard to monetary payments, declaratory relief, injunctive relief, specific performance and rectification as local courts. (361)

In contrast, most arbitration legislation is silent with regard to the arbitrators' remedial powers, generally treating this as a matter for the parties' agreement, which is held presumptively to grant the arbitrators very broad remedial authority. Moreover, in many jurisdictions, the arbitrators' remedial powers are treated as an aspect of the substantive dispute between the parties. As a consequence, there will generally be no proper basis for judicial review of an arbitral tribunal's exercise of its remedial authority, beyond the review applicable generally to the arbitrator's substantive decisions. (362)

P 3070 Thus, under most national arbitration regimes, it is well-settled that arbitrators have broad discretion in fashioning relief. Indeed, it is frequently said that "arbitrators have broad powers to grant relief that a court could not," (363) that "arbitrators have broad ● discretion in fashioning remedies and 'may grant equitable relief that a Court could not'" (364) and that "[i]n selecting appropriate measures, the arbitrators are not limited to the remedies known in the procedural law of the country of the seat." (365) Some authorities suggest that arbitral tribunals have broader authority with regard to remedies than with regard to resolution of the parties' substantive dispute regarding liability. (366)

Most authorities also hold that arbitrators possess broad inherent remedial authority. (367) In the words of one Canadian decision:

"the analysis of the powers granted to an arbitrator under an arbitration agreement should also be made through a generous and liberal vision which is more in line with the modern interpretation of conventional arbitration." (368)

P 3071 These views reflect in part judicial deference to the arbitrators' commercial expertise, which is considered peculiarly well-suited to fashioning workable and practical remedies, as well as the discretion accorded to first instance courts in remedial matters in many legal systems. These views also accord with commercial parties' presumptive intentions, being to grant the arbitrators broad powers to fully and ● satisfactorily resolve their dispute in a practical manner. There are occasional anomalous decisions to the contrary, suggesting that arbitrators' remedial authority is inherently narrow and limited, but these are aberrations. (369)

Some authorities recognize the arbitrators' authority to grant remedies not requested expressly by either party (subject to procedural protections against "surprise decisions"). In one court's words:

"judges are not limited to resolving disputes by simply choosing between two options presented by the parties. Rather, we are often required to use our judgment and to craft a different remedy. For example, a party might seek an injunction and provide specific terms to the court. The court, however, may decide to delete, amend, or add terms before issuing an order. Arbitrators generally have broader discretion in ruling on an issue submitted to them, since they are usually relieved of the procedural and substantive strictures placed upon courts by legislative enactments and binding precedent." (370)

Despite this, relief ordered by an arbitrator can potentially be challenged in either annulment or recognition proceedings on the grounds that it exceeds the arbitrator's authority (an "excess of authority"), particularly where a tribunal grants relief fundamentally different from that sought by either party (371) or where a tribunal exercises an authority that the parties' arbitration agreement clearly denies it. (372) Given the presumptive breadth of the arbitrator's remedial powers, such challenges are difficult to sustain: as discussed below, national courts have concluded that most purported "excess of authority" challenges to an arbitrator's remedial orders are nothing more than (groundless) substantive objections to the tribunal's decision on the merits. (373)

As discussed elsewhere, there are limited categories of relief that arbitral tribunals may not be permitted to award, on the grounds that it involves nonarbitrable matters. (374) These categories are, under most national laws and the New York Convention, very

limited and exceptional, encompassing only matters such as criminal penalties (e.g., fines, imprisonment), regulatory approvals (e.g., merger approval, securities offerings), declarations of bankruptcy, grants of intellectual property rights and the like. (375)

#### P 3072 ● [B] Awards of Monetary Damages

Most arbitral awards involve determinations that a specified monetary sum is payable by one party to another. There is no question but that, unless agreed otherwise, arbitrators have the power to make an award of monetary damages. (376) That authority extends to practical aspects and logistics of payment (e.g., timing, means). (377)

Most national laws grant arbitral tribunals the power to denominate an award in any currency for which the parties' contract and/or the governing law provides. (378) Section 48 of the English Arbitration Act, 1996, is specific in this regard, providing that the arbitrators may "order the payment of a sum of money in any currency." (379) Other legal systems can be expected to adopt similar approaches, either by legislative or judicial solutions.

In general, the question of the currency of an award is a question of substantive law, governed by the terms of the parties' contract and the applicable law. (380) A tribunal's application of these authorities should be subject to the same deference in annulment and recognition actions as its other substantive decisions. (381)

#### [C] Awards of Injunctive and Declaratory Relief

International arbitration conventions and national arbitration statutes are generally silent on the arbitral tribunal's authority to order injunctive or declaratory relief; there are a few exceptions, but these are unusual. (382) Nonetheless, national courts have repeatedly upheld international arbitral awards that order injunctive or declaratory relief if the parties' agreement, or the institutional rules that it incorporates, supply a basis for such authority. (383) Indeed, arbitral institutions report that a substantial percentage of all disputes involve requests for specific performance or declaratory relief. (384)

Even absent an express agreement conferring such powers, courts have routinely upheld grants of injunctive relief, including specific performance of contractual obligations. (385) This conclusion has been reached under the UNCITRAL Model Law, (386) as well as by common law courts (where specific performance is an exception) (387) and civil law courts. (388) International arbitral awards affirm the same remedial power on the part of the arbitrators, both in the commercial (389) and investor-state (390) contexts.

Among other things, national courts have upheld awards that required: (i) a company to stop using its name and to transfer certain patents and other intellectual property rights; (391) (ii) specific performance of a contract to take delivery of coal; (392) (iii) specific performance of a contract to deliver cotton; (393) (iv) drawing on proceeds of a letter of credit; (394) (v) making staged payments of a damages award; (395) (vi) making an interim payment into an escrow account as security for a final award; (396) (vii) fixing prices for disputed products for one year and obtaining the tribunal's approval for future prices; (397) (viii) specific performance to complete a construction project; (398) (ix) ordering the transfer of property (including a business); (399) (x) ordering the reinstatement of corporate officers or other "formative" legal acts; (400) (xi) ordering the grant of a royalty-free license to intellectual property; (401) (xii) ordering an accounting; (402) and (xiii) ordering the extension of contractual time periods. (403) Similarly, awards frequently – even routinely – grant declaratory or injunctive relief. (404)

P 3076 ● It has been suggested that arbitrators should not be permitted to exercise the power to order specific performance, or other forms of injunctive relief, because they lack the authority to supervise compliance with their award. (405) This view has attracted no discernible judicial (or arbitral) support, although there is force to concerns about adequate oversight of long-term remedies.

Rather, the correct analysis is that, absent express language to the contrary, the parties' agreement to arbitrate contemplates that the arbitrators will have the authority to award injunctive and declaratory relief, including orders of specific performance. That authority is recognized as an essential and inherent (406) element of remedial authority in virtually all developed legal systems and materially enhances the efficacy of the arbitral process; absent clear agreement to the contrary, this remedial authority is an element of the parties' agreement to arbitrate and the tribunal's powers. (407) For the same reasons, arbitration agreements are interpreted broadly with respect to the arbitrators' authority to grant injunctive and declaratory relief. (408) (As discussed in detail elsewhere, both the New York Convention and national arbitration legislation require giving effect to the parties' agreements to arbitrate, which extends to agreements concerning the arbitrators' remedial powers. (409))

In some cases, it may be appropriate for an arbitral tribunal that orders some form of continuing injunctive relief to retain jurisdiction over the parties' dispute. Some national courts have held that there is in principle no obstacle to this and that the retention of jurisdiction is not contrary to the *functus officio* doctrine. (410) In other cases, disputes over compliance with declarative or injunctive relief granted in an award can be resolved

in a new arbitration or in judicial enforcement proceedings. In virtually no case, however, is it appropriate for the possibility of difficulties in enforcement, against a party that might refuse to comply with its obligations under the award, to justify withholding otherwise appropriate relief.

P 3077 ● **[D] Awards of Punitive, Exemplary, or Statutory Damages (411)**

In some legal systems (generally in the common law world), punitive or exemplary damages have long been among the remedies available to a claimant in a civil litigation. In principle, punitive and exemplary damages are also available in international arbitral proceedings, although in practice awards of punitive damages are unusual. (412) Despite the infrequency with which they are awarded, punitive damages claims in international arbitration raise a number of difficult issues.

A leading U.S. authority describes punitive damages as “sums awarded, apart from any compensatory or nominal damages, usually ... because of particularly aggravated misconduct on the part of the defendant.” (413) The availability of punitive or exemplary damages has been well-settled at common law for centuries, (414) and remains a significant feature of tort remedies in many common law systems. (415) Punitive damages

P 3078 are most widely available in the United States, where such relief is awarded in ● commercial and contract cases, (416) as well as in defamation, assault and similar cases of aggravated torts.

Some legal systems have also enacted legislation providing for multiple or statutory damages in particular categories of cases, generally calculated as a multiple of the claimant’s actual damages. Such legislation is, again, most common in the United States, where double or treble damages are available for either violations of statutory protections or deliberate, willful misconduct. (417) Multiple damages are typically provided for by legislation regarding competition, fair trade and similar types of market conduct.

Punitive or exemplary damages have historically been much less common in civil law jurisdictions. The basic principle of civil relief in most such jurisdictions is to compensate the injured party for damage suffered, which is generally held to either implicitly or explicitly preclude punitive or exemplary damages. (418) In some civil law jurisdictions, the unavailability of punitive damages is said to rise to the level of public policy, and courts have refused to recognize and enforce foreign judgments granting punitive damages. (419)

On the other hand, some civil law regimes recognize the concept of “moral damages” which are available, among other things, to victims of personal injury, sexual harassment and violations of civil rights. (420) Moral damages are occasionally sought, particularly in cases involving state or state-related parties. (421) At the same time, there ● are recent indications that some civil law jurisdictions may be revising historic prohibitions and making provision for awards of punitive damages in at least some circumstances. (422)

P 3079

Even in jurisdictions where national courts may award punitive damages, there have been substantial doubts concerning the power of arbitrators to award such relief. In the United States, New York courts historically held, as a matter of New York state law, that arbitrators were precluded by considerations of public policy from awarding punitive damages, which were regarded as exclusively the province of state courts. (423) This rule was reflected, among other things, in a leading New York decision titled *Garrity v. Lyle Stuart, Inc.* (424)

The *Garrity v. Lyle Stuart* theory was a variation of the nonarbitrability doctrine, (425) which emphasized that punitive damages were intended to serve principally public, not private, interests:

“An arbitrator has no power to award punitive damages, even if agreed upon by the parties,” because the “freedom of contract does not embrace the freedom to punish, even by contract.” (426)

Other authorities relied on the confidentiality or privacy of most arbitral awards (reducing the deterrent effect of punitive damage awards), the asserted lack of judicial safeguards that would accompany arbitral consideration of punitive damages and the perceived anomaly of “private” arbitrators awarding “public” penalties. (427)

P 3080

These doubts as to the authority of arbitrators to award punitive damages, as a matter of U.S. law, were resolved decisively in favor of the arbitrability of punitive damage claims by the U.S. Supreme Court in *Mastrobuono v. Shearson Lehman Hutton, Inc.* (428) There, the Court held that the domestic FAA preempted New York’s state law public policy forbidding the arbitrability of punitive damages claims. (429)

The Supreme Court treated New York’s rule that arbitrators could not award punitive damages as an instance of a state law refusal to give effect to an agreement to arbitrate (specifically, an agreement to arbitrate punitive damage claims); according to the Supreme Court, that state law rule was preempted by the FAA’s requirement that arbitration agreements be recognized and enforced in accordance with their terms. (430) The Court also held that the general New York choice-of-law agreement in the parties’ contract did not have the effect of incorporating New York’s public policy against the

arbitrability of punitive damage claims into the parties' arbitration agreement, relying on the "federal policy favoring arbitration [and requiring that] ambiguities as to the scope of the arbitration clause itself [must be] resolved in favor of arbitration." (431)

P 3081 Applying *Mastrobuono*, U.S. lower courts have repeatedly held that particular arbitration agreements (and institutional rules (432)) provide for the arbitration of punitive damages claims. (433) These decisions have not generally addressed the ● treatment of arbitration agreements incorporating institutional rules commonly used in the international commercial context, but the same results should apply. (434) For example, in *Fahnestock & Co. v. Waltman*, the appellate court held that the general language of the AAA Commercial Rules, which provided that arbitrators may award "any remedy which [is] just and equitable and within the scope of the agreement," evidenced an intention that punitive damages claims would be pursued in the arbitration. (435)

As noted above, punitive damages are arguably contrary to public policy in some civil law jurisdictions, (436) with the possible result that arbitral tribunals seated in those jurisdictions may not validly make awards of punitive damages (including when putatively authorized to do so by applicable substantive law and the arbitration agreement). This was the conclusion of an arbitral tribunal seated in Switzerland, applying New York law pursuant to a New York choice-of-law clause:

"Damages that go beyond compensatory damages to constitute a punishment of the wrongdoer (punitive or exemplary damages) are considered contrary to Swiss public policy, which must be respected by an arbitral tribunal sitting in Switzerland even if the arbitral tribunal must decide a dispute according to a law that may allow punitive or exemplary damages as such." (437)

P 3082 ● Similarly, a number of commentators have suggested that at least some civil law jurisdictions would not recognize arbitral awards of punitive damages, again on public policy grounds. (438)

The better view is that an arbitral tribunal may (and must) give effect to mandatory laws and public policies: (439) that extends to public policies forbidding punitive damages. As discussed above, however, the application of mandatory laws and public policies requires a conflict-of-laws analysis, (440) and not merely automatic application of the public policies of the arbitral seat.

In principle, it is difficult to see why the public policy of the arbitral seat should apply to a transaction having no connection to the place of arbitration: more appropriate is application of the public policy of the jurisdiction most closely connected to the parties' dispute. Where applicable conflicts rules provide for application of a public policy forbidding punitive damages, then an arbitral tribunal should refuse to award such damages. (441)

Similar analysis applies to the recognition of awards of punitive damages. As discussed below, applying Article V(2)(b) of the New York Convention, the courts of a Contracting State may exceptionally deny recognition to an award of punitive damages based on a local public policy; again, however, it is difficult to see why a recognition forum's public policy would by its own terms apply to a transaction having no material connection to the forum. Of course, non-recognition of an award of punitive damages in one state does not imply non-recognition in other states. (442)

### [E] Awards Imposing Penalties or Sanctions

Arbitral tribunals sometimes attempt to impose "penalties" on parties to the arbitration, typically as sanctions for noncompliance with interim measures or procedural rulings of the tribunal. For example, if a party is ordered provisionally to provide security, for its counter-party's claims or costs, but refuses to do so, the tribunal may impose monetary sanctions (for example, daily or weekly fines, payable until security is posted). (443)

P 3083 ● As with punitive damages, there is controversy regarding arbitrators' authority to impose penalties. It is sometimes suggested that "private" arbitrators lack the power to impose "public" sanctions, which must be reserved to national courts. (444)

The better view is that this distinction misunderstands the arbitral function – which entails the arbitrators' authority to apply mandatory laws and public policies and to impose "public" sanctions. Provided that the parties' arbitration agreement grants the arbitral tribunal authority to impose penalties, there should be no mandatory prohibition against such authority. That is particularly true with regard to sanctions for noncompliance with a tribunal's procedural rulings or interim measures: there is no reason that arbitrators should not have the authority to ensure compliance with their rulings and the absence of such power would materially detract from the efficacy of the arbitral process.

Consistent with this view, most recent national court authority affirms the general authority of arbitral tribunals to impose penalties on parties to an arbitration. (445) In one U.S. court's words, "the authority to sanction inheres in the comprehensive arbitral authority": "the underlying purposes of arbitration, i.e., efficient and swift resolution of disputes without protracted litigation, could not be achieved but for good faith arbitration by the parties. Consequently, sanctions, including attorney's fees, are

appropriately viewed as a remedy within an arbitrator's authority to effect the goals of arbitration." (446) Authorities from civil law jurisdictions also generally uphold arbitrators' authority to impose penalties. (447)

P 3084 Disputes sometimes arise as to whether, assuming that arbitrators may in principle impose penalties, a particular arbitration agreement grants the arbitrators the power to impose penalties or sanctions (or, alternatively, particular types of penalties or ● sanctions). Some courts have required that agreements granting arbitrators authority to impose sanctions must be express or particularly clear. (448) Even where a tribunal may be empowered to order sanctions in principle, it may not be permitted to order particular types or categories of sanctions or penalties. (449)

The better view is that, although it is essential that the parties' arbitration agreement authorize the imposition of penalties, that authority may be, and generally should be, implied. (450) The authority to impose penalties or sanctions contributes materially to an efficient and effective arbitral process and, absent contrary indications, reasonable commercial parties should be assumed to have intended that such authority be available.

### [F] Choice of Law Governing Relief

As discussed above, the choice of law governing issues of relief and remedial authority has produced divergent approaches. In many civil law jurisdictions, the law governing issues of remedies and relief is the substantive law governing the parties' dispute. (451) In contrast, in some common law jurisdictions, remedies were historically governed by the law of the forum. (452) Arbitral awards take differing approaches to the subject of the law governing issues of remedies and relief, with the weight of authority applying the law governing the parties' substantive claims. (453)

P 3085 The better view is that issues concerning the arbitral tribunal's authority and jurisdiction are governed by the law of the arbitral seat (or, in the rare cases where a foreign procedural law is chosen, the procedural law of the arbitration (454)), while issues concerning the substantive standards for granting relief and the quantum and character of relief are governed by the substantive law applicable to the parties' underlying claims. This treatment of the law governing the arbitrators' remedial powers is consistent with the treatment of other issues concerning the arbitrators' ● authority (e.g., interim relief (455) and competence-competence (456)). It is also consistent with the treatment of choice-of-law analysis concerning awards of legal costs and interest. (457)

In all of these settings, the tribunal's authority is best regarded as governed by the law of the arbitral seat, because it is that law that has the closest connection to the arbitral process and questions concerning the arbitrators' powers. At the same time, the substantive standards governing relief are most appropriately governed by the law of the underlying dispute, because that law has the closest relationship to the parties' commercial relationship, the liability determination and the remedies for that determination.

In almost all cases, the law of the arbitral seat will generally give effect to the parties' agreement to arbitrate, providing the arbitral tribunal with the authority conferred upon them by the parties. If the law of the arbitral seat contained mandatory limitations on the arbitrators' authority, those restrictions would need to be considered in light of the New York Convention's requirement that Contracting States recognize and enforce all the material terms of the parties' arbitration agreement, including provisions regarding the arbitrators' authority. (458) In the absence of any express or implied agreement by the parties regarding the arbitrators' remedial authority, the law of the arbitral seat is the source of default rules which define the tribunal's powers. (459)

In contrast, the law governing the standards for granting relief and the quantum and character of relief are closely related to the substantive law governing the parties' underlying claims. That is consistent with contemporary choice-of-law rules in most developed jurisdictions (460) and with the weight of arbitral authority. (461) This analysis also ensures that issues of relief are governed by the same law as issues of liability, which are often related.

### P 3086 ● § 23.08 AWARDS OF COSTS OF ARBITRATION AND LEGAL REPRESENTATION (462)

International arbitration can be expensive, in large part because of the fees of the parties' legal representatives. (463) As discussed below, international arbitral tribunals generally possess, and exercise, the authority to award the prevailing party in an arbitration the costs of the arbitration, including its legal costs. The standards for making awards of costs of legal representation and related expenses are of corresponding importance.

### [A] Awards of Costs of Arbitration Under National Arbitration Legislation

P 3087 National arbitration legislation frequently contains provisions addressing the allocation of costs in the arbitral proceedings. These provisions generally grant the ● arbitrators authority to make an award of the costs of the arbitration, including legal costs, usually



without specifying standards governing the exercise of such authority. (464)

As discussed below, virtually all developed legal regimes will give effect to the parties' agreement with regard to awards of legal costs in international arbitration. (465) That is true where the parties agree that the arbitrators shall have the power to make such awards, as well as where they agree to exclude the possibility of such awards. (466) This is simply an application of the broader principle of party autonomy in the context of international arbitration (467) and should raise no questions of enforceability. (One limited exception is England, where parties are precluded from agreeing, prior to the dispute arising, that one party pay "the whole or part of the costs of the arbitration in any event," regardless of the outcome. (468) )

In general, a decision by the arbitral tribunal ordering one party to pay the arbitration costs, including the costs of legal representation, is an "award" within the meaning of the New York Convention and national arbitration legislation, including the UNCITRAL Model Law. That is because the arbitrators' decision finally resolves a claim by one party against the other (specifically, that one party is entitled to repayment by the other party of amounts spent during the arbitration). This decision falls squarely within the definition of an "award," and "Awards on Costs" are routinely and properly treated as "awards" for purposes of annulment, recognition and enforcement. (469)

- P 3088 ● In contrast, a decision by an arbitral tribunal that the parties are jointly liable to the members of the tribunal for payment of its fees and expenses has been held not to constitute an "award," on the theory that it does not resolve claims between the parties and instead resolves a claim by the arbitrator(s) against the parties. (470) The same result has been reached with regard to an arbitral tribunal's decision regarding the amount of its own fees. (471)

### [1] Costs of Legal Representation Under UNCITRAL Model Law

The UNCITRAL Model Law does not expressly address the question of the costs of legal representation. There were proposals during the drafting of the Model Law for a provision that would have authorized the arbitrators to request a deposit from the parties for the tribunal's fees and expenses, and to fix the amount of such fees and expenses. (472) Even these relatively limited proposals were not pursued, and the Model Law's final text, and the 2006 Revisions, are silent on the entire subject of the allocation of the costs of the arbitration.

Nonetheless, there is no question but that, absent contrary agreement, the Model Law permits arbitrators to make awards of the costs of the arbitration and legal costs. (473) A number of states that have adopted the Model Law have added provisions regarding awards of the costs of arbitration. (474)

- P 3089 ● [2] Costs of Arbitration Under English Arbitration Act

In England, the Arbitration Act, 1996, provides the tribunal with authority to award legal costs, (475) as well as (relatively unusual) standards for exercising such authority. (476) Specifically, §61(2) of the Act provides that, absent contrary agreement, "the tribunal shall award costs on the general principle that costs should follow the event except where it appears to the tribunal that in the circumstances this is not appropriate in relation to the whole or part of the costs." (477)

Unusually for national law on the subject, this provision is binding on arbitral tribunals seated in England (absent contrary agreement). (478) Arbitral tribunals are nonetheless able to vary the general principle that costs follow the event dependent on the facts of each arbitration and the conduct of the parties. (479)

### [3] Costs of Arbitration Under Other National Arbitration Legislation

- Many arbitration statutes, including those in the United States, France and Switzerland, are silent on the topic of awards of legal costs in international arbitration. It is clear, however, that arbitral tribunals seated in most such jurisdictions – for example, France (480) and Switzerland (481) – are fully authorized to make awards of legal costs. (482) This ● reflects a general principle that, absent contrary indication in the parties' agreement, international arbitrators should be presumed to have the authority to make an award of the costs of legal representation as part of their overall remedial powers. It is also clear that the tribunal in an international arbitration need not apply local rules regarding awards of legal costs in domestic litigation. (483)

### [4] Costs of Arbitration Under U.S. Federal Arbitration Act

Like the Model Law, the FAA is silent regarding the costs of the arbitration and the parties' legal representation. In contrast to most other jurisdictions, a number of U.S. courts have held that arbitrators lack the power in an arbitration seated in the United States under the FAA to award legal fees incurred in the arbitration unless the parties have expressly conferred this authority on the tribunal. (484) These decisions, rendered principally in domestic U.S. arbitrations, reflect the "American Rule" against fee-shifting in U.S. civil litigations. (485)

In contrast, and more recently, a number of U.S. courts have taken a broader view and

P 3091 concluded that arbitrators have implied authority to award attorneys' fees. (486) U.S. courts have reached this result even in states where local law provides that arbitrators ● have the authority to allocate responsibility for the arbitrators' fees, but not to award attorneys' fees. (487)

In international arbitrations seated in the United States, any relevant provisions of institutional arbitration rules or the parties' arbitration agreement should, and will, be given full effect. The "American rule" regarding costs of legal representation clearly does not rise to the level of U.S. public policy, so as to forbid a tribunal's exercise of its authority under the parties' arbitration agreement or applicable institutional rules to award legal costs. (488) Rather, the presumptive rule in international arbitrations seated in the United States should be that, absent contrary agreement, the tribunal will have the authority to award the costs of legal representation.

Moreover, the "American Rule" should generally have little influence on the standards adopted by international arbitral tribunals seated in the United States for awarding legal costs. That is particularly true under the UNCITRAL Rules and LCIA Rules, which provide generally for awards of at least some legal costs to the prevailing party. (489)

Even where institutional rules provide no express standards for awarding legal costs (as under the ICC Rules), the "American Rule" should have little effect on the relevant standards for awarding costs in an international arbitration. That is because the rule is designed specifically for domestic U.S. litigation, not international arbitration between commercial parties, where different expectations and considerations apply.

Even where the parties have agreed that their underlying contract or other commercial relations are governed by the substantive law of a U.S. state, whose domestic law includes the "American rule," an arbitral tribunal seated in the United States (or elsewhere) should not be bound by the American rule, and particularly not as a matter of jurisdiction or authority. Again, the American rule is meant specifically for domestic litigation and is not encompassed in general choice-of-law clauses, which should be interpreted to address the parties' underlying contract and commercial dealings. Nonetheless, although this is the better view, there is some contrary U.S. lower court authority. (490)

There is recent U.S. judicial authority holding that, notwithstanding provisions in an arbitration agreement generally excluding awards of costs for legal representation, ● P 3092 arbitrators have inherent authority to make such awards in cases of bad faith during the arbitral proceedings. (491) This analysis is well-reasoned: absent clear language to the contrary, arbitrators should be presumed to have been granted the authority to award costs and other appropriate sanctions for bad faith conduct during or associated with the arbitral process. However, where the parties have clearly and unequivocally excluded such authority, it is difficult under either the New York Convention or national arbitration legislation to justify overriding their agreement to authorize costs awards.

A U.S. court should also recognize and enforce foreign arbitral awards of legal costs, notwithstanding the "American rule." (492) As already noted, the "American rule" is not a principle of public policy, and therefore does not require or permit a U.S. court to deny recognition to a foreign costs award. If the arbitration agreement and the law applicable in the arbitration permit an award of the costs of legal representation, no excess of authority argument can be sustained; even if applicable law does not provide for costs to be awarded, a tribunal's award of costs should generally be considered a substantive error, not an excess of authority or jurisdiction. (493)

The costs of legal representation can also be awarded by U.S. courts with respect to costs incurred in actions to vacate or enforce arbitral awards. The general rule under the FAA appears to be that refusals to pay an award must be in bad faith before attorneys' fees ● P 3093 for confirmation or vacatur proceedings are awardable. (494) Provisions in an arbitration agreement regarding the costs of legal representation are generally not applicable to fees incurred in subsequent enforcement litigation, although this is an issue of interpretation. (495)

### **[B] Awards of Costs of Arbitration Under Institutional Rules**

Most institutional rules expressly grant arbitral tribunals the power to award the costs of legal representation. (496) In addition, arbitration agreements sometimes specifically address the issue of the costs of legal representation. (497) Virtually all modern arbitration legislation gives effect to the provisions of institutional rules and the parties' arbitration agreement concerning the tribunal's power to make an award of legal costs and the amount of such award. (498)

The 2010 UNCITRAL Rules provide the arbitral tribunal with the authority, and duty, to "fix the costs of arbitration" in its award. (499) The costs of arbitration are defined to include the "legal and other costs incurred by the parties in relation to the arbitration," but only "to the extent that the tribunal determines that the amount of such costs is reasonable." (500) The UNCITRAL Rules also provide that "the costs of the arbitration shall in principle be borne by the unsuccessful party or parties," (501) except that, in fixing the costs of legal representation, "the arbitral tribunal may apportion each of such costs between the parties if it determines that apportionment is reasonable, taking into account the

circumstances of the case.” (502) These provisions grant arbitrators broad discretion with regard to awards of legal costs, starting from the principle that the prevailing party will be entitled to its costs. (503)

P 3094 ● The 2012 ICC Rules provide that the final award “shall fix the costs of the arbitration and decide which of the parties shall bear them or in what proportion they shall be borne by the parties.” (504) The “costs of the arbitration” are defined to include the “reasonable legal and other costs incurred by the parties for the arbitration.” (505)

Unlike the UNCITRAL Rules, the 1998 ICC Rules did not further prescribe standards for awarding legal costs, (506) leaving this to the tribunal’s discretion and any relevant rules of national (or other) law. The 2012 ICC Rules provide somewhat more guidance, providing that, “[i]n making decisions as to costs, the arbitral tribunal may take into account such circumstances as it considers relevant, including the extent to which each party has conducted the arbitration in an expeditious and cost-effective manner.” (507) Under the ICC Rules, the arbitrators’ fees and expenses are fixed by the ICC Court (rather than the arbitrators), while the allocation of such fees and expenses between the parties is made by the arbitrators. (508)

The LCIA Rules provide for the arbitral tribunal to “determine the proportions in which the parties shall bear all or part of the arbitration costs” (509) (as fixed by the LCIA Court), as well as to “order in its award that all or part of the legal or other costs incurred by a party be paid by another party.” (510) The LCIA Rules prescribe a general standard that, absent contrary agreement, the tribunal shall “make its orders on both arbitration and legal costs on the general principle that costs should reflect the parties’ relative success and failure in the award or arbitration, except where it appears to [the tribunal] that in the particular circumstances this general approach is inappropriate.” (511) The LCIA Rules reflect the general English approach towards legal costs (e.g., the prevailing party is presumptively entitled to its costs (512)), while authorizing the tribunal to adopt a different standard if appropriate in particular circumstances.

The overriding theme of these, and other, (513) institutional rules is to grant the arbitral tribunal broad powers to award legal costs, according to standards established by the arbitrators; the exercise of these powers is left largely to the arbitrators, with general references to the degree of a party’s success on its claims and the ● reasonableness of a party’s legal expenses. (514) All leading institutional rules also expressly confirm the arbitrators’ authority to “apportion” legal costs, allowing awards of less than 100% of a party’s reasonable costs. (515)

Even where applicable institutional rules do not expressly grant the arbitral tribunal power to award legal costs, the parties’ arbitration agreement should be interpreted to impliedly grant such authority. (516) That follows from the overwhelming weight of authority in developed jurisdictions, (517) and from the basic principle that a commercial party’s right to compensation for wrongful damage in a business dispute must include the costs of righting that damage. (518) An implied agreement granting the arbitrators power to award the costs of the arbitration, including legal costs, is a natural and inherent aspect of the tribunal’s authority (absent contrary agreement).

### [C] Awards of Costs of Arbitration in International Arbitral Practice

As a practical matter, arbitrators in international cases routinely award the costs of legal representation, usually without discussing questions of applicable law or detailed substantive analysis. Most arbitral awards either rely exclusively on grants of discretion (or other standards) pursuant to applicable institutional rules, (519) or simply award a ● “reasonable” or “appropriate” amount. (520) Given this general lack of analysis, some ● commentators have concluded that “[t]he awarding of arbitration costs and attorney’s fees in international arbitrations is often arbitrary and unpredictable.” (521)

Where the parties’ agreement addresses the subject of legal costs, tribunals will virtually always purport to give effect to its terms. (522) More frequently, however, the parties will not have addressed the subject of legal costs, or will have simply granted the tribunal discretion to make an award of legal costs.

In exercising their discretion, international arbitral tribunals have often made some award of the costs of legal representation to the “prevailing party.” (523) In doing so, arbitrators generally take into account the extent to which that party recovered what it initially claimed, the extent to which each party’s position was substantively reasonable, the extent to which a party’s conduct needlessly complicated the proceedings, and similar factors. (524) In the words of one award:

P 3097 ● “The [1998 ICC] Rules do not contain any rules or criteria for the decision that the Tribunal must take [regarding costs]. The decision is left to the discretion of the arbitrator. Nevertheless, the results of the arbitration play a predominant role in the exercise of this discretion by the arbitrator. A party who loses his case is, in principle, ordered to pay the costs of the arbitration. However, other criteria can be taken into account, and notably the manner in which the case was conducted and the costs caused by reckless or abusive requests or delaying tactics.” (525)



In general, arbitral tribunals do not require, and prefer for the parties not to present, detailed documentary or other evidence about their respective costs. Although tribunals may demand more extensive evidence, summary statements of the costs billed by and paid to legal representatives are ordinarily sufficient. (526)

Despite the tendency of tribunals to award at least a measure of legal costs to the prevailing party, some authorities question the existence of any “costs follow the event” or “loser pays” rule. (527) As one very experienced practitioner explains:

- P 3098 ● “Arbitrators may consider it too draconian to impose the burden of an opponent’s attorney fees on a losing party, and thereby create a system that could chill the assertion of claims unreasonably, without evidence of additional culpability in a particular case. Some claims are deservedly brought, even if they are largely unsuccessful for sound factual or legal reasons that emerge after an airing by adversarial process.” (528)

Despite these views, a study of ICC awards made between 1989 and 1991 reports that where claimants were largely successful, they were awarded a substantial portion of the arbitration costs in most cases (*i.e.*, in 39 of 48 cases) and a substantial portion of their legal costs in about half of all cases (*i.e.*, in 24 of 38 cases). (529) Where claimants were partially successful, or where both parties obtained relief, the arbitrators typically ordered the parties to bear their own legal costs and shares of the arbitration costs; (530) in some cases, however, claimants were awarded a proportion of their legal costs relative to the extent of their success *vis-à-vis* their claims. (531) Finally, in ICC cases where claimants obtained substantially less than half of the amounts claimed, or where the respondent recovered larger amounts than the claimant, tribunals generally have either left the arbitration and legal costs with the party that incurred them or ordered the unsuccessful claimant to pay some or all of the respondents’ costs. (532)

- P 3099 Where one of the parties was uncooperative or inefficient, it was less likely to recover its costs (or its full costs); (533) in some cases, a party that has adopted unnecessary ● litigation tactics has been held liable for costs. (534) On the other hand, where there was a good faith basis for the parties’ differing positions, ICC tribunals were more likely to leave the parties to bear their own costs. (535)

Awards of legal fees and costs may be different in specialized settings where particular expectations or considerations exist. For example, a study of investment arbitrations between 1990 and 2006 concluded that only 13 of 54 final awards required one party to contribute to a counter-party’s legal fees and costs. (536) It is unclear what justifies this approach, although it appears to be reflected in the weight of investment arbitration authority to date.

Some practitioners have proposed more principled and systematic approaches to the award of legal costs in international arbitration. One approach proposes a “loser pays” principle, adjusted to take account of numerous considerations, including efficiency of proceedings, difficulty of issues and the like. (537) Other approaches have suggested focusing only on degree of success and efficiency of proceedings, with the motto, “keep it simple.” (538) These proposals have substantial merit; it is unsatisfactory that awards of legal costs, which can entail millions or tens of millions of dollars or Euro in some cases, be unpredictable and based purely on discretion. (539) Even if the precise terms of these proposals are not adopted, the underlying concept of a more reasoned, principled approach to costs decisions is clearly to be favored.

### [D] Choice of Law Governing Costs of Legal Representation

- P 3100 A potentially significant issue relating to awards of legal costs in international arbitration is the choice of the law governing the tribunal’s power to make a costs award and the standards governing the award of costs. There is little question that the arbitrators’ power ● to make a costs award is governed by the procedural law of the arbitration (typically, that of the seat of the arbitration). That is consistent with the treatment of the arbitrators’ power to order provisional measures, (540) disclosure (541) and other forms of relief, (542) and no other national legal system is a plausible candidate to govern this issue. (If a national law refused to give effect to the parties’ agreement granting the arbitrators power to award the costs of the arbitration, this would, for reasons discussed elsewhere, likely be inconsistent with Articles II and V(1)(d) of the New York Convention. (543) )

The law governing the substantive standards for awards of legal costs is not necessarily the same as that governing the tribunal’s authority to make a costs award. (544) In particular, a serious argument can be made that the substantive law governing the parties’ underlying contract (or dispute) should provide the standard for awards of legal costs. (545) This body of law arguably has the closest connection to the parties’ presentation of their respective claims, and could therefore appropriately be applied to determine their rights to reimbursement of the costs of such presentation; that would be particularly true where the parties had contractually selected the law governing their agreement. (546)

- P 3101 Despite this, the better view is that the standards governing awards of legal costs should be international standards, developed in light of the particular nature and ● needs of

international arbitration. (547) That is because domestic rules regarding legal costs are designed with domestic litigation systems and legal professions in mind; these rules have little direct relevance to the international arbitral process, involving *sui generis* procedures, specialized objectives and lawyers from different jurisdictions. Rather, arbitral tribunals should develop international standards, appropriate to the commercial arbitration context, to ensure that parties are fully compensated for all reasonable costs of successfully vindicating their rights and that efficient, cooperative conduct in the dispute resolution process is rewarded.

These objectives are largely reflected in leading institutional rules and arbitral authority applying these rules. In particular, as discussed below, these rules generally specify *sui generis* standards, without reference to national law. (548) These standards typically provide that (a) the prevailing party is presumptively entitled to a costs award; (b) only reasonable costs will be reimbursed; and (c) expenses that were inefficient or unnecessary will not be reimbursed, while costs resulting from the need to respond to unreasonable or uncooperative actions will be recoverable. (549) The application of these standards is discussed below.

### **[E] Costs of Legal Representation in Proceedings Resulting in Negative Jurisdictional Awards**

The award of costs by an arbitral tribunal in or following an award denying jurisdiction over the claimant's claims presents conceptual challenges. (550) In such cases, the tribunal has determined that it lacks jurisdiction, thereby ruling for the respondent and rejecting the claimant's claims. (551) Ordinarily, under the general rule that the prevailing party is entitled to its legal costs, (552) the respondent would have the right to obtain an award of the reasonable expenses it incurred in procuring the negative jurisdictional award.

Nonetheless, it is sometimes argued that the tribunal's determination that it lacked jurisdiction disables it from making an award of costs in favor of either party. If the tribunal holds that there was no valid arbitration agreement between the parties, (553) P 3102 ● then there is uncertainty as to what empowers the tribunal to make an award that one party pay the other party's legal costs.

In some instances, the parties may have expressly accepted the tribunal's authority to make a jurisdictional determination (for example, by signing ICC Terms of Reference without reservation); in these cases, there should be no dispute regarding the arbitral tribunal's power to make an award of costs. (554) Even in other instances, however, there should be no true difficulty in ordering costs against an unsuccessful claimant. The claimant's submission of the parties' jurisdictional dispute to the arbitral tribunal constitutes a submission by the claimant to the tribunal's competence-competence to rule on its own jurisdiction and an incident of this competence-competence is the power to make a costs award in favor of the prevailing party. That makes both analytical and practical sense, and is the approach generally adopted in international arbitration practice. (555)

### **§ 23.09 AWARDS OF INTEREST (556)**

Under most national laws, interest on sums awarded as damages may be recovered in civil actions. (557) The same is generally true in international arbitration, where interest is routinely requested and recovered.

P 3103 ● The availability and rate of interest in an international arbitration can have substantial practical importance. Major arbitrations can take a number of years to resolve, involving disputes arising some years earlier. With market rates of interest accruing, the ultimate interest award can exceed the principal amount in dispute. In one celebrated arbitration during the 1980s, the principal award was \$83 million, to which \$96 million in interest (in 1980s dollars) was added. (558)

### **[A] Awards of Interest Under National Arbitration Legislation**

Many arbitration statutes are silent on the subject of awards of interest by arbitral tribunals. The UNCITRAL Model Law contains no provisions regarding interest, nor do the FAA, Swiss Law on Private International Law, or French Code of Civil Procedure.

A number of states that have adopted the Model Law have modified the statute, to include an express authorization for the arbitrators to award interest, but typically without specifying any standards governing such awards. The typical formulation in such legislation is "[u]nless otherwise agreed by the parties, the arbitral tribunal may award interest." (559) Some statutes address pre-award interest and post-award interest separately. (560)

Even in the absence of express statutory authority, there should be no doubt concerning the authority of an arbitral tribunal to award interest. (561) The authority to award interest is an inherent element of a tribunal's adjudicatory authority and is implicitly contained within the terms of agreements to arbitrate, at least absent contrary indication by the parties.

P 3104 Institutional rules do not ordinarily address the subject of interest, including the UNCITRAL and ICC Rules. One exception involves the LCIA Rules which provide ● that the tribunal may award compound interest. (562) Again, even absent express authorization in institutional rules, the parties' implied agreement ordinarily includes the power to award interest.

Interest is potentially awardable by an international arbitral tribunal on a variety of legal grounds. Applicable substantive law may permit the award of interest as an element of compensatory damages. (563) Alternatively, statutory provisions of national law concerning pre-judgment or post-judgment interest, typically designed for application in litigations in the arbitral seat, may be deemed applicable by an arbitral tribunal.

Most national legal systems have enacted statutory provisions regulating awards of interest in domestic litigations. These provisions typically establish statutory interest rates that are payable, either on "pre-judgment" liabilities or "post-judgment" awards of monetary damages. (564) These provisions are generally not, by their terms, applicable in international arbitral awards, although tribunals sometimes either apply them or look to them by analogy. (565) (As discussed below, statutory interest provisions may be applicable to judgments confirming arbitral awards, in which case they may have direct application to interest in connection with international arbitral awards. (566) )

The parties' arbitration agreement must, of course, encompass interest claims in order for the arbitrators to be able to make a valid award of interest. In virtually all cases, an arbitration agreement applicable to an underlying claim will be interpreted to encompass claims for interest in connection with that claim. The conclusion is almost always (correctly) assumed without discussion.

### **[B] Choice of Law Governing Awards of Interest**

Requests for an award of interest raise choice-of-law issues. (567) In particular, as in other contexts, questions arise as to the tribunal's authority to award interest and the standards governing the exercise of such authority.

P 3105 As to the tribunal's authority or power to award interest, there is a substantial argument for applying the law governing the arbitration agreement, on the rationale ● that the arbitrators' authority derives from the agreement to arbitrate. (568) An alternative approach would be to apply the law of the arbitral seat – on the theory that most questions regarding the arbitrators' authority are governed by the law of the seat, including competence-competence, authority to grant provisional measures and authority to order disclosure. (569)

Although there is room for debate, the better view appears to be that, absent contrary agreement, questions concerning the arbitrators' authority to award interest are better regarded as subject to the law of the arbitral seat. It is that law which is generally regarded as having the closest connection to questions of the tribunal's powers and which should ordinarily be applicable to questions regarding the arbitrators' authority. (570)

It is correct that most questions regarding the arbitrators' authority to award interest will be resolved by reference to the parties' arbitration agreement, and the authority granted by that agreement to the tribunal. Nonetheless, given the general role of the arbitral seat in defining the tribunal's authority, the provisions of the parties' arbitration agreement dealing with the authority to award interest should be interpreted under the law of the arbitral seat. (571)

In almost all cases, the law of the arbitral seat will give full effect to the parties' agreement regarding the arbitrators' authority, including to award interest. Despite this, some national laws may contain mandatory prohibitions against interest awards (by either courts or arbitrators), (572) or mandatory rules concerning the availability or rate of any interest awards. (573) These sorts of prohibitions are arguably inconsistent with the New York Convention's requirement that Contracting States recognize and enforce the material provisions of agreements to arbitrate, including provisions concerning the arbitral tribunal's authority. (574)

P 3106 As to the standards governing awards of interest, several possibilities exist for the law governing a party's right to interest: (a) the substantive law governing the parties' ● underlying dispute; (b) the law of the arbitral seat (or, if different, the procedural law of the arbitration); (c) the law of the currency in which an award is sought; or (d) an "international" standard. (575) There is no consensus as to which of these options is preferred: "international tribunals ... furnish precedents for almost any decision one might wish to make in regard to interest." (576)

In many civil law jurisdictions, rules concerning interest are regarded as "substantive" for conflict-of-law purposes. (577) In other jurisdictions, including the United States, (578) rules governing interest may be deemed "procedural" or are governed by the law of the arbitral seat. The interplay between differing national laws dealing with interest, as well as national characterizations of interest rules and national choice-of-law rules, can be metaphysical in their theoretical complexity.

Notwithstanding these potential by-ways, arbitrators have in practice generally looked to the substantive law governing the parties' underlying claims for standards regarding interest. (579) At the same time, other approaches also exist, including application of a "reasonable" rate based on international practice, (580) the law of the arbitral seat (581) and the law of the jurisdiction in whose currency payment is due (*i.e.*, if the payment obligation is in U.S. dollars, U.S. law should apply). (582)

Application of the arbitral seat's law is especially likely where that law contains mandatory prohibitions or requirements concerning interest. (583) Conversely, if the applicable substantive law governing the parties' contract forbids awards of interest, arbitrators also have often not awarded it. (584)

The better view is to apply, as discussed above, the law of the arbitral seat to the question of the arbitrators' authority to award interest, and not the law of the contract. (585) The better view is also, absent contrary agreement, to apply the law of the currency in which any award is made to determine the substantive standards, including the applicable interest rates, for any award of interest; this approach is particularly true where a tribunal applies a statutory interest rate (which is often fixed by reference to the currency in question (and the rate of inflation of that currency)). Whatever law is applied, however, it is essential to take into account the fact that statutory interest rates are almost always linked to a particular currency (that of the state whose law specifies the interest rate), and that it generally makes no sense to apply that interest rate to other currencies.

P 3108 ● In some jurisdictions, the confirmation of an award has the effect of merging the award into the local court judgment, with the consequence that local statutory interest rates applicable to local judgments may become applicable. (586) In these jurisdictions, "the law governing interest for the post-judgment period will most likely be the law of the enforcement jurisdiction." (587)

In the United States, for example, the confirmation of an award (foreign or domestic) will merge the award into the U.S. judgment, making the applicable U.S. statutory rate for judgments applicable. (588) Parties are able, by express agreement, to provide for alternative interest rates, but U.S. courts have been demanding in requiring clear agreement upon a different rate than the statutory rate generally-applicable to judgments. (589)

### [C] Awards of Interest by International Arbitral Tribunals

In practice, international arbitral tribunals are generally inclined to grant interest and, less clearly, to do so at a rate approximating market rates of interest during the period in question for the relevant currency. (590) They do so, at the end of the day, because interest often represents an essential element of the damage suffered by the aggrieved party. As an early judicial decision held:

P 3109 "It is a dictate of natural justice, and the law of every civilized country, that a man is bound in equity, not only to perform his engagements, but also to repair all the damages that accrue naturally from their breach. ... Every one who contracts to pay money on a certain day knows that, if he fails to fulfill his contract, he must pay the established rate of interest as damages for his non-performance. Hence it may correctly be said that such is the implied contract of the parties." (591)

There is controversy whether simple interest or compound interest should be awarded by arbitral tribunals. Some national arbitration legislation specifically authorizes awards of compound interest. (592) Nonetheless, there is authority for the proposition that only simple interest should ordinarily be available. (593) The better view is that, in order to fully compensate a successful party for its loss, compound interest should ordinarily be permitted. Typically, the commercial loss suffered by a business will be compound interest, reflecting the fact that most businesses would be in a position to earn compound interest or to otherwise realize compound return on their investments.

International arbitral tribunals often award interest for both the period prior to their award and for periods after the award but prior to payment. A few older awards concluded that the tribunal lacked the power to grant post-award interest, on the theory that it was then *functus officio*. (594) The more general practice, however, is to award interest until the date of payment of the award or, less commonly, the date of a judgment confirming the award. (595) As noted above, in some jurisdictions, national law may prescribe a different (statutory) rate of interest for post-judgment interest than for pre-award or pre-judgment interest. (596)

### [D] Enforcement of Awards of Interest in National Courts

P 3110 In general, national courts will enforce arbitrators' interest awards, even where the award is made under foreign law, and regardless whether the applicable rates exceed those under national law. (597) Awards of interest are subject to public policy prohibitions against "penal" or "usurious" interest, as well as to other generally-applicable grounds for challenging arbitral awards, but these ordinarily do not result in non-enforcement of

awards of interest. (598) Arbitral decisions refusing to award interest will also generally be upheld, as with the arbitrators' general authority to resolve the parties' substantive dispute, even if applicable law generally requires awards of interest by local courts. (599) National courts have also upheld awards of interest even where the parties' contract and submissions did not specifically request it. (600)

### **[E] Awards of Interest in Connection With International Arbitrations by National Courts**

National courts may themselves sometimes award additional interest, both for the post-award/pre-judgment period, the post-judgment period, and (less clearly) the pre-award period. In general, national courts have applied their own law, rather than the law of the seat of the arbitration or another national law, to determine the entitlement to interest on a foreign award. (601)

P 3111 ● Most national courts have rejected requests that they grant pre-award interest that the arbitrators have refused to award. (602) These decisions correctly conclude that a request for an award of interest generally falls within the scope of the parties' arbitration agreement and therefore may not be pursued in a national court. In contrast, one U.S. decision has granted pre-award interest, albeit in unusual circumstances where the tribunal arguably invited a judicial interest award. (603)

As described above, arbitrators sometimes render awards that establish an interest rate that applies until payment of the award, which can include post-judgment, as well as post-award/pre-judgment, interest. National courts have generally enforced such awards as to the post-award/pre-judgment interest provisions. (604)

As to post-judgment interest, some courts have refused to enforce awards of post-judgment interest by arbitrators, holding instead that post-judgment interest is provided for by statutory provisions in the enforcement forum; these decisions have sometimes ordered payment of interest for the post-judgment period at the statutory interest rate. P 3112 (605) Some authorities have declared broadly that, "under US law an ● arbitrator will not be recognised as having authority to award interest for the post-judgment period." (606) Where the parties' contract provides for a post-judgment interest rate, however, it is doubtful that this generalization should be accepted; in that case, the arbitrators' jurisdiction should ordinarily extend to interpretation and application of the parties' agreement, including for post-judgment periods. (607)

Post-award/pre-judgment interest has been awarded by some national courts when tribunals have not addressed the issue. (608) Similarly, some courts have ordered post-judgment interest when the arbitral tribunal has not done so. (609) ●

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### **References**



- 1) For commentary, see [Arroyo, \*Dealing With Dissenting Opinions in the Award: Some Options for the Tribunal\*, 26 ASA Bull. 437 \(2008\)](#); [Bingham, \*Reasons and Reasons for Reasons\*](#), 4 Arb. Int'l 141 (1988); [Brower & Rosenberg, \*The Death of the Two-Headed Nightingale: Why the Paulsson-van den Berg Presumption That Party-Appointed Arbitrators Are Untrustworthy Is Wrongheaded\*](#), 29 Arb. Int'l 7 (2013); [Carbonneau, \*Rendering Arbitral Awards With Reasons: The Elaboration of A Common Law of International Transactions\*](#), 23 Colum. J. Transnat'l L. 579 (1984-1985); [Chiu, \*Final, Interim, Interlocutory or Partial Award: Misnomers Apt to Mislead\*](#), 13 Sing. Acad. L.J. 461 (2001); [Cole, \*Authority and International Arbitration\*](#), 70 La. L. Rev. 801 (2010); [Cuniberti, \*The Law Governing the Modality of Arbitral Awards\*](#), 25 Arb. Int'l 347 (2009); [Delvolvé, \*Essai sur la Motivation des Sentences Arbitrales\*](#), 1989 Rev. arb. 149; [Dunaud & Kostytska, \*Declaratory Relief in International Arbitration\*](#), 29 J. Int'l Arb. 1 (2012); [E. Gaillard & J. Savage \(eds.\), \*Fouchard Gaillard Goldman on International Commercial Arbitration\*](#) ¶¶1389-1412 (1999); [Gaitis, \*International and Domestic Arbitration Procedure: The Need for A Rule Providing A Limited Opportunity for Arbitral Reconsideration of Reasoned Awards\*](#), 15 Am. Rev. Int'l Arb. 1 (2004); [Grabundzija, \*Partial Arbitral Awards in International Commercial Arbitration\*](#), 8(2) Transnat'l Disp. Mgt (2011); [Hunter, \*Final Report on Interim and Partial Awards\*](#), 1(2) ICC Ct. Bull. 26 (1990); [ICC, \*Final Report on Dissenting and Separate Opinion of the ICC Commission on International Arbitration\*](#), 2(1) ICC Ct. Bull. 32 (1991); [Jarvin, \*Non-Pecuniary Remedies: The Practices of Declaratory Relief and Specific Performance in International Commercial Arbitration\*](#), in A. Rovine (ed.), *Contemporary Issues in International Arbitration and Mediation: The Fordham Papers 2006* 167 (2007); [Knoepfler & Schweizer, \*Making of Awards and Termination of Proceedings\*](#), in P. Sarcevic (ed.), *Essays on International Commercial Arbitration* 160 (1989); [Lévy, \*Dissenting Opinions in International Arbitration in Switzerland\*](#), 5 Arb. Int'l 35 (1989); [L. Lévy & F. De Ly \(eds.\), \*Interest, Auxiliary and Alternative Remedies in International Arbitration\*](#) (2008); [Malinvaud, \*Non-Pecuniary Remedies in Investment Treaty and Commercial Arbitration\*](#), in A. van den Berg (ed.), *50 Years of the New York Convention 209 (ICCA Congress Series No. 14 2009)*; [Mosk & Ginsburg, \*Dissenting Opinions in International Arbitration\*](#), 15(4) Mealey's Int'l Arb. Rep. 26 (2000); [Mourre, \*Judicial Penalties and Specific Performance in International Arbitration\*](#), in L. Lévy & F. De Ly (eds.), *Interest, Auxiliary and Alternative Remedies in International Arbitration* 53-73 (2008); [Petsche, \*Punitive Damages in International Commercial Arbitration: Much Ado About Nothing?\*](#), 29 Arb. Int'l 89 (2013); [Redfern, \*Dissenting Opinions in International Commercial Arbitration: The Good, the Bad and the Ugly\*](#), 20 Arb. Int'l 223 (2004); [Rees & Rohn, \*Dissenting Opinions: Can They Fulfil A Beneficial Role?\*](#), 25 Arb. Int'l 329 (2009); [Reichert & Murphy, \*Enforceability of Foreign Arbitral Decisions\*](#), 67 Arb. 369 (2001); [M. Schneider & J. Knoll \(eds.\), \*Performance as A Remedy: Non-Monetary Relief in International Arbitration\*](#) (ASA Spec. Series No. 30 2011); [Schreuer, \*Non-Pecuniary Remedies in ICSID Arbitration\*](#), 20 Arb. Int'l 325 (2004); [Schwebel, \*May the Majority Vote of An International Arbitral Tribunal Be Impeached?\*](#), 13 Arb. Int'l 145 (1997); [Shore & Figueroa, \*Dissents, Concurrences and A Necessary Divide Between Investment and Commercial Arbitration\*](#), *Global Arbitration Review* (1 December 2008); [Smit, \*Judgments and Arbitral Awards in A Foreign Currency: A Means of Dealing With Currency Fluctuations in International Adjudication\*](#), 7 Am. Rev. Int'l Arb. 21 (1996); [Trittman, \*When Should Arbitrators Issue Interim or Partial Awards and/or Procedural Orders?\*](#), 20 J. Int'l Arb. 225 (2003); [van den Berg, \*Dissenting Opinions by Party-Appointed Arbitrators in Investment Arbitration\*](#), in M. Arsanjani et al. (eds.), *Looking to the Future: Essays on International Law in Honor of W. Michael Reisman* 821 (2010); [van Houtte, \*The Delivery of Awards to the Parties\*](#), 21 Arb. Int'l 177 (2005); [Werner, \*Dissenting Opinions – Beyond Fears\*](#), 9(4) J. Int'l Arb. 23 (1992); [Wong, \*The Misapprehension of Moral Damages in Investor-State Arbitration\*](#), in A. Rovine (ed.), *Contemporary Issues in International Arbitration and Mediation: The Fordham Papers 2012* (2013).
- 2) See [Chapters 25-27](#).
- 3) For commentary, see [Hunter, \*Final Report on Interim and Partial Awards\*](#), 1(2) ICC Ct. Bull. 26 (1990); [Knoepfler & Schweizer, \*Making of Awards and Termination of Proceedings\*](#), in P. Sarcevic (ed.), *Essays on International Commercial Arbitration* 160 (1989); [Trittman, \*When Should Arbitrators Issue Interim or Partial Awards and/or Procedural Orders?\*](#), 20 J. Int'l Arb. 225 (2003).
- 4) As discussed above, arbitral “awards” must be distinguished from other categories of arbitral decisions, including “orders” or “directions.” See [§22.02\[B\]\[3\]\[d\]](#). Similarly, as also discussed above, “arbitral” awards must be distinguished from the results of other dispute resolution processes, including mediation, expert determination and conciliation. See [§22.02\[B\]](#).
- 5) See D. Caron & L. Caplan, *The UNCITRAL Arbitration Rules: A Commentary* 734 (2d ed. 2013) (“as the *travaux préparatoires* indicate, the terms ‘interim award,’ ‘interlocutory award,’ and ‘partial award,’ were meant to be used broadly and even interchangeably”); [Gaitis, \*International and Domestic Arbitration Procedure: The Need for A Rule Providing A Limited Opportunity for Arbitral Reconsideration of Reasoned Awards\*](#), 15 Am. Rev. Int'l Arb. 1, 65-66 (2004).
- 6) See [§§22.02\[B\]\[3\]\[c\]-\[d\]](#).
- 7) See [§17.03\[A\]](#); [§22.02\[B\]\[3\]\[e\]](#).

- 8) See §22.02[B][3][c] & [e].
- 9) Some instruments that are denominated “awards,” but which only tentatively address particular issues without resolving the parties’ claims, are not properly regarded as arbitral awards. See §22.02[B][3][d].
- 10) See §26.05[C][7]. This is true with regard to the Geneva Convention and a number of bilateral arbitration treaties. See §1.01[C][2]; §26.03[A]; §26.05[C][7].
- 11) See §26.05[C][7].
- 12) See §26.03[B][4]; §26.05[C][7].
- 13) See §1.02[B][5]; §22.02[B][3][c]; §26.05[C][7].
- 14) *Restatement (Third) U.S. Law of International Commercial Arbitration* §1-1, comment n (Tentative Draft No. 2 2012) (“All awards by definition set forth a ‘final and binding’ determination on the merits of a claim, defense, or issue. There is, however, only one final award.”).
- 15) See *UNCITRAL Model Law, Art. 32(1)* (“The arbitral proceedings are terminated by the final award or by an order of the arbitral tribunal in accordance with paragraph (2) of this article.”); §23.01[A]; §26.05[B].
- 16) See §23.01[B].
- 17) See, e.g., *UNCITRAL Model Law, Arts. 32(1), 33-35*; *English Arbitration Act, 1996, §58(1)*; *Belgian Judicial Code, Art. 1713*; *Japanese Arbitration Law, Arts. 39, 43, 45*.
- 18) See, e.g., 2010 *UNCITRAL Rules, Art. 34(1)* (“The arbitral tribunal may make separate awards on different issues at different times.”), *Art. 34(2)* (“All awards ... shall be final and binding on the parties.”); 1976 *UNCITRAL Rules, Art. 32(1)* (“In addition to making a final award, the arbitral tribunal shall be entitled to make interim, interlocutory or partial awards.”); 2012 *ICC Rules, Art. 2(v)* (defining award to include “an interim, partial or final Award”), *Art. 34(6)* (“Every Award shall be binding on the parties” and “the parties undertake to carry out any Award without delay”); *LCIA Rules, Art. 26(7)* (“The Arbitral Tribunal may make separate awards at different times. Such awards shall have the same status and effect as any other award made by the Arbitral Tribunal.”); 2013 *HKIAC Rules, Arts. 34(1)-(3)*. See also §23.01[B].
- 19) See §24.02.
- 20) See §25.04[F][3][b]; §26.05[C][4][h].
- 21) See §24.05[A].
- 22) *Restatement (Third) U.S. Law of International Commercial Arbitration* §1-1(w) (Tentative Draft No. 2 2012) (“A ‘partial award’ is an arbitral award that disposes of some, but not all, of the claims, defenses, or issues before the arbitral tribunal. A partial award does not include an order addressing scheduling, procedural, or evidentiary matters.”).
- 23) See E. Gaillard & J. Savage (eds.), *Fouchard Gaillard Goldman on International Commercial Arbitration* ¶1357 (1999); Grabundzija, *Partial Arbitral Awards in International Commercial Arbitration*, 8(2) *Transnat’l Disp. Mgt* (2011); Kurkela, *Partial “Milestone” Awards and Lost Future Profits: Would It Take Part of the Challenge Away?*, 30 *ASA Bull.* 51 (2012); Pinna, *L’annulation d’une sentence arbitrale partielle*, 2008 *Rev. arb.* 615; Riegler, in S. Riegler et al. (eds.), *Arbitration Law of Austria: Practice and Procedure* §607, ¶5 (2007); Sanders, *Commentary on the UNCITRAL Arbitration Rules*, II *Y.B. Comm. Arb.* 172, 210 (1977) (“partial” award “related to part of a case which could be settled immediately”); Schlosser, in F. Stein & M. Jonas (eds.), *Kommentar zur Zivilprozessordnung* §1061, ¶12 (22d ed. 2002). Compare *Judgment of 23 February 1999, Econerg Ltd v. Nat’l Elec. Co.*, XXV *Y.B. Comm. Arb.* 678 (Bulgarian S.Ct. App.) (2000) (apparently not regarding partial award as final).
- 24) See §23.01[B] & [D]; Sanders, *Commentary on the UNCITRAL Arbitration Rules*, II *Y.B. Comm. Arb.* 172, 210 (1977) (“interim” award is “to bring the case closer to a solution”; “partial” award “related to part of a case which could be settled immediately”; distinction is unimportant, because arbitrators are entitled to make “any kind of award they deem appropriate for the conduct of the arbitration”).
- 25) The *UNCITRAL Model Law* does not expressly provide for partial awards. It does, however, recognize that multiple awards are possible. See *UNCITRAL Model Law, Arts. 33(3), (5)*. As discussed below, because the arbitral tribunal’s authority to make partial or interim awards is inherent, they may do so even without express authorization.
- 26) *Swiss Law on Private International Law, Art. 188*. See Wirth, in S. Berti et al. (eds.), *International Arbitration in Switzerland* Art. 188, ¶¶11 et seq. (2000).
- 27) See, e.g., *English Arbitration Act, 1996, §47*; German ZPO, §§301, 1042; *Belgian Judicial Code, Art. 1713*; *Netherlands Code of Civil Procedure, Art. 1049*; *Swedish Arbitration Act, §29*; *Chinese Arbitration Law, Art. 55*; *Indian Arbitration and Conciliation Act, Art. 31(6)*; *Dominican Republic Arbitration Law, Art. 36(1)*; *Peruvian Arbitration Law, Art. 54*.

- 28) 2010 UNCITRAL Rules, Art. 34(1). The 1976 UNCITRAL Rules provided that, “in addition to making a final award, the arbitral tribunal shall be entitled to make interim, interlocutory or partial awards.” 1976 UNCITRAL Rules, Art. 32(1).

The 2010 UNCITRAL Rules were drafted to avoid “qualifications regarding the nature of the award such as ‘final’, ‘interim’, or ‘interlocutory’”: Article 34(1) “clarifies that the arbitral tribunal may render awards on different issues during the course of the proceedings. It is based on Article 26.7 of the Rules of the London Court of International Arbitration.” *Settlement of Commercial Disputes: Revision of the UNCITRAL Arbitration Rules, UNCITRAL Working Group II, Forty-Ninth Session, U.N. Doc. A/CN. 9/WG.II/WP.151/Add.1, 13, ¶23* (2008).

- 29) See, e.g., 2012 ICC Rules, Art. 2(v) (defining “award” as including “an interim, partial or final award”); LCIA Rules, Art. 26(7) (“The Arbitral Tribunal may make separate awards on different issues at different times.”); 2012 CIETAC Rules, Art. 48; 2010 NAI Rules, Art. 44; 2010 SCC Rules, Art. 38; WIPO Rules, Art. 62(a).
- 30) See §15.02[C].
- 31) See, e.g., *Photopaint v. Smartlens*, 335 F.3d 152 (2d Cir. 2003); *Hart Surgical, Inc. v. UltraCision*, 244 F.3d 231 (2d Cir. 2001); *Halliburton Energy Servs., Inc. v. NL Indus.*, 553 F.Supp.2d 733, 775 (S.D. Tex. 2008); *Gulf Petrol Trading Co. v. Nigerian Nat’l Petroleum Corp.*, 288 F.Supp.2d 783, 794 (N.D. Tex. 2003); *Judgment of 8 March 1988, Sociétés Sofidif v. OIAETI*, 1989 Rev. arb. 481 (French Cour de cassation civ. 1e); *Judgment of 25 June 1992, XXII Y.B. Comm. Arb.* 619 (Austrian Oberster Gerichtshof) (1997). Compare N. Blackaby et al. (eds.), *Redfern and Hunter on International Arbitration* ¶9.23 (5th ed. 2009).
- 32) See §15.02; §15.03.
- 33) See D. Caron & L. Caplan, *The UNCITRAL Arbitration Rules: A Commentary* 736 (2d ed. 2013) (Iran-US Claims Tribunal used partial awards on jurisdiction, liability, damages and costs); Y. Derains & E. Schwartz, *A Guide to the ICC Rules of Arbitration* 37 (2d ed. 2005).
- 34) See §15.07[D][1]; §15.08[N]; Brower, *What I Tell You Three Times Is True: U.S. Courts and Pre-Award Interim Measures Under the New York Convention*, 35 Va. J. Int’l L. 971 (1994-1995); I. Dore, *The UNCITRAL Framework for Arbitration in Contemporary Perspective* 36 (1993) (“The authorization for ‘partial’ awards suggests a lower degree of finality than separate final awards on different issues.”); Reichert, *Provisional Remedies in the Context of International Commercial Arbitration*, 3 Int’l Tax & Bus. L. 368, 369 (1986).
- 35) If the tribunal disregards that agreement, its award(s) will be subject to annulment and non-recognition (under Article V(1)(d) of the New York Convention). See §25.02[C][3][a]; §26.05[C][5][b]; *Assoc’d Corset & Brassiere Mfrs v. Corset & Brassiere Workers*, 16 N.Y.S.2d 736, 736 (N.Y. Sup. Ct. 1939) (“The award of the arbitrator was void in that he failed to pass on all the matters submitted to him for determination and there was no consent to a partial award.”); *Judgment of 8 March 1988, Sociétés Sofidif v. OIAETI*, 1989 Rev. arb. 481 (French Cour de cassation civ. 1e).
- 36) Only an express agreement excluding partial awards should suffice to produce this result. The almost universal approach of national arbitration legislation and institutional rules, permitting partial awards, reflects both the parties’ expectations and efficiency considerations. Only where an agreement explicitly requires a different result should this approach be abandoned. See *Hart Surgical, Inc. v. UltraCision, Inc.*, 244 F.3d 231, 234 (2d Cir. 2001); *Providence Journal Co. v. Providence Newspaper Guild*, 271 F.3d 16 (1st Cir. 2001); *Hyosung (Am.) Inc. v. Tranax Techs. Inc.*, 2010 WL 1853764, at \*5 (N.D. Cal.); *Mitsubishi Heavy Indus., Ltd v. Stone & Webster, Inc.*, 2009 WL 3169973, at \*5 (S.D.N.Y.); *Halliburton Energy Servs., Inc. v. NL Indus.*, 553 F.Supp.2d 733, 741 (S.D. Tex. 2008); *Andrea Doreen, Ltd v. Bldg Material Local Union* 282, 250 F.Supp.2d 107 (E.D.N.Y. 2003); K. Lionnet & A. Lionnet, *Handbuch der internationalen und nationalen Schiedsgerichtsbarkeit* ¶16 II 3(a)(2) (3d ed. 2005); Wirth, in S. Berti et al. (eds.), *International Arbitration in Switzerland* Art. 188, ¶13 (2000).
- 37) For example, a party might argue that its rights were prejudiced by being prevented from submitting certain evidence or seeking certain discovery at early stages of a proceeding, because of the tribunal’s decision to bifurcate; alternatively, a party might claim that a refusal to bifurcate proceedings imposed unnecessary expense on it. See W. Craig, W. Park & J. Paulsson, *International Chamber of Commerce Arbitration* ¶19.03 (3d ed. 2000) (“For the most part ... the arbitrator has discretion whether to make an intermediate decision by way of procedural decision, with the result to be incorporated in the final award as part of the tribunal’s ratio descendi, or to make an interim award which creates a definitive title.”).
- 38) See, e.g., 1976 UNCITRAL Rules, Art. 21(4) (“In general, the arbitral tribunal should rule on a plea concerning its jurisdiction as a preliminary question ...”). The 2010 UNCITRAL Rules amended this article to provide that, “the arbitral tribunal may rule on a plea referred to in paragraph 2 either as a preliminary question or in an award on the merits. The arbitral tribunal may continue the arbitral proceedings and make an award, notwithstanding any pending challenge to its jurisdiction before a court.” 2010 UNCITRAL Rules, Art. 23(3). See also §§7.05[C] & [E].



- 39) See, e.g., U.S. FAA, 9 U.S.C. §16(a)(D) (referring to confirmation of “award or partial award”); [English Arbitration Act, 1996](#), §§47, 66; [Swiss Law on Private International Law, Arts. 188, 190](#); *Trade & Transp., Inc. v. Natural Petroleum Charterers, Inc.*, 931 F.2d 191 (2d Cir. 1991) (partial award enforced); *Metallgesellschaft AG v. M/V Capitan Constante*, 790 F.2d 280 (2d Cir. 1986) (same); *The Home Ins. Co. v. RHA/Pa. Nursing Homes*, 127 F.Supp.2d 482 (S.D.N.Y. 2001) (same); *Corporate Printing Co. v. N.Y. Typographical Union No. 6*, 1994 WL 376093 (S.D.N.Y.) (same). Compare *Kerr-McGee Refining Corp. v. M/T Triumph*, 924 F.2d 467, 471 (2d Cir. 1991) (award determining some, but not all, damages claims not “final”). See J.-L. Delvolvé, J. Rouche & G. Pointon, *French Arbitration Law and Practice* ¶¶303, 558 (2003); Gaitis, *The Federal Arbitration Act: Risks and Incongruities Relating to the Issuance of Interim and Partial Awards in Domestic and International Arbitrations*, 16 Am. Rev. Int’l Arb. 1 (2005); Patocchi & Jermini, in S. Berti et al. (eds.), *International Arbitration in Switzerland* Art. 194, ¶8 (2000); Voit, in H.-J. Musielak (ed.), *Kommentar zur Zivilprozessordnung* §1061, ¶3 (5th ed. 2007).
- 40) See§23.01[B].
- 41) [UNCITRAL, 2012 Digest of Case Law on the Model Law on International Commercial Arbitration 137 \(2012\)](#).
- 42) *VV v. VW*, [2008] SLR 929 (Singapore High Ct.). See also *Tang Boon Jek Jeffrey v. Tan Poh Leng Stanley*, [2001] 3 SLR 237 (Singapore Ct. App.); *Maruna v. Lopatka*, [2002] BCSC 1084 (B.C. S.Ct.).
- 43) See§7.02; §7.03.
- 44) See§7.03[A][4]; §22.02[B][3][f].
- 45) See§7.03[A][4].
- 46) See§7.03[A][4]. See also *Judgment of 12 November 2010, Case No. Ö 2301-09, ¶13 (Swedish S.Ct.)* (“In the current case the arbitrators ruled on their jurisdiction in an ‘Award on Jurisdiction.’ This is not an arbitral award which can be challenged under Section 34 of the Arbitration Act. In the Swedish terminology it is a decision on jurisdiction during an ongoing arbitration (cf. Section 27(3) of the Act).”).
- 47) See§7.03[A][4]; §22.02[B][3][f].
- 48) See§22.02[B][3][f].
- 49) See§7.03[A][4][c].
- 50) See§23.01[D]; [Netherlands Code of Civil Procedure, Art. 1049](#) (“arbitral tribunal may render a final award, a partial final award, or an interim award”).
- 51) See *Judgment of 25 June 1992, XXII Y.B. Comm. Arb. 619, 621 (Austrian Oberster Gerichtshof) (1997)* (“Interim awards (*Zwischenschiedssprüche*) on the merits concerning partial requests for determination differ from such formal decisions, because they involve a settlement of the merits. ... It is irrelevant that it does not settle [Claimant’s] request for performance in a final manner. Further, the fact that no party requested this decision does not affect the decision’s nature as a decision on the merits.”); Peters & Koller, *The Award and the Courts – The Nature of Arbitral Award: An Attempt to Overcome A Babylonian Confusion*, 2010 Austrian Y.B. Int’l Arb. 161 (“In practice, two different applications of the terms ‘interim’ or ‘interlocutory’ awards can be distinguished: while the first one refers to the issue resolved by the decision, the second describes the nature of the decision itself.”). See also *Tang Boon Jek Jeffrey v. Tan Poh Leng Stanley*, [2001] 3 SLR 237 (Singapore Ct. App.); *MCIS Ins. Bhd v. Assoc’d Cover Sdn Bhd*, [2001] 2 MLJ 561 (Kuala Lumpur High Ct.); Chiu, *Final, Interim, Interlocutory or Partial Award: Misnomers Apt to Mislead*, 13 Sing. Acad. L.J. 461 (2001); Trittmann, *When Should Arbitrators Issue Interim or Partial Awards and/or Procedural Orders?*, 20 J. Int’l Arb. 225, 258-60 (2003).
- 52) N. Blackaby et al. (eds.), *Redfern and Hunter on International Arbitration* ¶9.19 (5th ed. 2009); Chiu, *Final, Interim, Interlocutory or Partial Award: Misnomers Apt to Mislead*, 13 Sing. Acad. L.J. 461 (2001); J. Lew, L. Mistelis & S. Kröll, *Comparative International Commercial Arbitration* ¶24-24 (2003); [UNCITRAL, 2012 Digest of Case Law on the Model Law on International Commercial Arbitration 137 \(2012\)](#) (“A controversial issue is whether setting aside proceedings are admissible against an award that merely determines preliminary questions of the claim. There is no uniform terminology for such awards. They are in practice often referred to as ‘interim awards’ or sometimes as ‘partial awards.’”).
- Arbitral tribunals and national courts are often inconsistent in their terminology, referring to arbitral decisions that decide some of the issues relevant to a claim (e.g., liability, choice of law) as “partial” awards, rather than “interim” awards. See, e.g., *Mitsubishi Heavy Indus., Ltd v. Stone & Webster, Inc.*, 2009 U.S. Dist. LEXIS 91199, at \*13-20 (S.D.N.Y.) (“partial” award on liability issues not “final”).
- 53) See§17.02[A]; §22.02[B][3][e]; *Publicis Commc’n v. True N. Commc’ns, Inc.*, 206 F.3d 725, 729 (7th Cir. 2000); *Yasuda Fire & Marine Ins. Co. of Europe v. Cont’l Cas. Co.*, 37 F.3d 345, 348 (7th Cir. 1994); *Pac. Reins. v. Ohio Reins.*, 935 F.2d 1019, 1022-23 (9th Cir. 1991); *Hyosung (Am.) Inc. v. Tranax Techs. Inc.*, 2010 WL 1853764, at \*1 (N.D. Cal.); *Wellpoint Health Networks, Inc. v. John Hancock Life Ins. Co.*, 547 F.Supp.2d 899, 908 (N.D. Ill. 2008); *S. Seas Navigation Ltd v. Petroleos Mexicanos*, 606 F.Supp. 692, 694 (S.D.N.Y. 1985); H. Holtzmann & J. Neuhaus, *A Guide to the UNCITRAL Model Law on International Commercial Arbitration: Legislative History and Commentary* 867 (1989).
- 54) See§17.02[G][4]; §17.03[A].

- 55) See *Judgment of 14 June 2005*, 2 Ob 136/05x (Austrian Oberster Gerichtshof) (due to its non-final character, interim award may not be challenged in absence of agreement to that effect); *Judgment of 25 June 1992*, XXII Y.B. Comm. Arb. 619, 627 (Austrian Oberster Gerichtshof) (1997) (“The first court correctly denied that this interim decision (Zwischenentscheid) could be challenged separately.”). *Contra* A. Reiner, *Das neue Österreichische Schiedsrecht – SchiedsRÄG 2006* §611, ¶¶190-91 (2006); Riegler, in S. Riegler et al. (eds.), *Arbitration Law of Austria: Practice and Procedure* §611, ¶10 (2007).
- 56) *Judgment of 10 May 2007*, 2007 SchiedsVZ 278, 278 (Oberlandesgericht Frankfurt) (rejecting application to annul award finding liability but leaving issue of damages open: “An arbitral award for the purpose of this section [German ZPO, §1059] is a decision of the arbitral tribunal which disposes comprehensively and finally of a dispute or a separable portion of a dispute. So-called interim awards, which only deal with individual issues such as admissibility of the claim, preliminary substantive issues or the basis of a claim, at least in those cases where an arbitral tribunal still has to decide on the amount due, do not fall within this category.”).
- 57) *Resort Condominiums Int’l Inc. v. Bolwell*, XX Y.B. Comm. Arb. 628, 642 (Queensland S.Ct. 1993) (1995).
- 58) See §17.03[A].
- 59) See §22.02[B][3][e] & [g].
- 60) See §1.02[B][9].
- 61) Kreindler, *Settlement Agreements and Arbitration in the Context of the ICC Rules*, 9(2) ICC Ct. Bull. 22 (1998); Tchakoua, *The Status of the Arbitral Award by Consent: The Limits of the Useful*, 2002 RDAI/IBLJ 775.
- 62) See §23.07[B].
- 63) In some jurisdictions, settlement agreements enjoy special legal status and can be enforced reasonably expeditiously. See, e.g., *French Civil Code, Art. 2052(1)*; German ZPO, §§796a, 1053; *Costa Rican Arbitration Law, 2011, Art. 30(2)*; Dominican Arbitration Law, Art. 35(2); Peruvian Arbitration Law, Art. 50(1). Nevertheless, recording a settlement as an award grants it the protections of the New York Convention (and national arbitration legislation).
- 64) See N. Blackaby et al. (eds.), *Redfern and Hunter on International Arbitration* ¶9.34 (5th ed. 2009) (suggesting that consent award may be easier for state entity to pay than settlement agreement).
- 65) The New York Convention and other leading arbitration conventions are silent on the question of consent awards.
- 66) *UNCITRAL Model Law, Art. 30(1)*. See H. Holtzmann & J. Neuhaus, *A Guide to the UNCITRAL Model Law on International Commercial Arbitration: Legislative History and Commentary* 822-25 (1989).
- 67) See, e.g., *English Arbitration Act, 1996, §51*; German ZPO, §1053; *Belgian Judicial Code, Art. 1712(1)*; Austrian ZPO, §605; *Singapore International Arbitration Act, 2012, §18*; *Hong Kong Arbitration Ordinance, 2013, Art. 66*; *Chinese Arbitration Law, Art. 49*; *Japanese Arbitration Law, Art. 38(1)*; *Korean Arbitration Act, Art. 31*; *Australian International Arbitration Act, 2011, Schedule 2, Art. 30*; *Indian Arbitration and Conciliation Act, Art. 30(2)*; *Malaysian Arbitration Act, §32*; *Costa Rican Arbitration Law, 2011, Art. 30(1)*; Peruvian Arbitration Law, Art. 50(1).
- 68) See *Mazza v. Dist. Council of N.Y.*, 2007 WL 2668116, at \*1, 10 (E.D.N.Y.) (consent award by arbitral tribunal given same preclusive effect as consent judgment issued by court); *Dawes v. Treasure & Son Ltd* [2010] EWHC 3218 (TCC) (English High Ct.); *Halifax Life Ltd v. Equitable Life Assur. Soc’y* [2007] EWHC 503 (Comm) (English High Ct.); *Benaim (U.K.) Ltd v. Davies Middleton & Davies Ltd* [2004] EWHC 737 (TCC) (English High Ct.).
- 69) See, e.g., *2010 UNCITRAL Rules, Art. 36(1)*; *2012 ICC Rules, Art. 32*; *LCIA Rules, Art. 26(8)*; *ICSID Rules, Rule 43(2)*; *2013 HKIAC Rules, Art. 36(1)*; *2010 SCC Rules, Art. 39(1)*; *2013 SIAC Rules, Art. 28(8)*; *2013 VIAC Rules, Art. 38*.
- 70) *UNCITRAL Model Law, Art. 30(1)*; *English Arbitration Act, 1996, §52(4)*.
- 71) *2010 UNCITRAL Rules, Art. 36(1)* (“The arbitral tribunal is not obliged to give reasons for such an award.”); *1976 UNCITRAL Rules, Art. 34(1)*; *LCIA Rules, Art. 26(8)*; *2013 HKIAC Rules, Art. 36(1)*.
- 72) See, e.g., *2010 UNCITRAL Rules, Art. 36(1)*; *1976 UNCITRAL Rules, Art. 34(1)*; *2012 ICC Rules, Art. 32*; *ICDR Rules, Art. 29(1)*; *LCIA Rules, Art. 26(8)*.
- 73) See, e.g., *English Arbitration Act, 1996, §51(2)*; *Belgian Judicial Code, Art. 1712(1)*; *Chinese Arbitration Law, Art. 49*; *Japanese Arbitration Law, Art. 38(1)*; *Costa Rican Arbitration Law, 2011, Art. 30*; Peruvian Arbitration Law, Art. 50(1).

- 74) UNCITRAL Model Law, Art. 30(1) (“If, during arbitral proceedings, the parties settle the dispute, the arbitral tribunal shall terminate the proceedings and, if requested by the parties and not objected to by the arbitral tribunal, record the settlement in the form of an arbitral award on agreed terms.”). See also *Summary Record of the 151st Meeting of the UNCITRAL, Eighth Session*, U.N. Doc. A/CN.9/SR.167, 203 (1975) (“arbitrators should be left free to decide whether they agreed or refused to record a settlement in the form of an arbitral award [because otherwise] arbitrators [would be] at the mercy of possible abuses by the parties”). See also *Draft on Arbitral Procedure Prepared by the International Law Commission at Its Fourth Session*, U.N. Doc. A/CN.4/59, Art. 22, II Y.B. I.L.C. 60, 65, (1952) (“The tribunal may take note of the conclusion of a settlement reached by the parties. At the request of the parties, it may embody the settlement in an award.”).
- 75) That is clear under Article 30 of the Model Law, whose text addresses cases where “during arbitral proceedings, the parties settle the dispute.” See *UNCITRAL, 2012 Digest of Case Law on the Model Law on International Commercial Arbitration* 124 (2012) (“Article 30 only applies if arbitral proceedings have commenced and the final award has yet to be made. Where a full and final settlement of any claim has been reached before arbitral proceedings have commenced, a dispute no longer subsists to be referred to arbitration. It follows that such an agreed settlement may not be made in the form of an award under Article 30. ... In contrast, where the parties have commenced the arbitral proceedings and subsequently enter into a settlement agreement (prior to oral hearing), the dispute over the existence of a settlement agreement still falls under the jurisdiction of the arbitral tribunal.”)
- 76) *Nathani Steels Ltd v. Assoc’d Constr.*, (1995) Supp 3 SCC 324 (Indian S.Ct.).
- 77) See, e.g., *Indian Arbitration and Conciliation Act, Arts. 73, 74.*
- 78) *Ad Hoc Award in CRCICA Case No. 497/2006 of 17 February 2006*, CLOUT Case 779, U.N. Doc. A/CN.9/SER.C/ABSTRACTS/75.
- 79) UNCITRAL Model Law, Art. 30(2) (“An award on agreed terms shall be made in accordance with the provisions of Article 31 and shall state that it is an award.”).
- 80) *Judgment of 14 March 2003*, 20 Sch 01/02 (Oberlandesgericht Frankfurt) (formal requirements applicable to consent award not satisfied by settlement agreement); *Judgment of 28 June 1999*, 3 Sch 01/99 (Oberlandesgericht Frankfurt).
- 81) *Report of the Secretary-General on the Analytical Commentary on Draft Text of A Model Law on International Commercial Arbitration*, U.N. Doc. A/CN.9/264, Art. 30, ¶2 (1985) (consent award may be refused “in case of suspected fraud, illicit or utterly unfair terms”). See also *Draft on Arbitral Procedure Prepared by the International Law Commission at Its Fourth Session*, U.N. Doc. A/CN.4/59, Art. 22, comment (2), II Y.B. I.L.C. 60, 65 (1952) (“The use of the word ‘may’ in article 22 is important, as it leaves the tribunal free to embody the settlement reached in an award or not. It is, in fact, necessary that the tribunal should be able to verify the legality and effective scope of the agreement. It cannot be compelled, even by an agreement between the parties to give binding force to an illegal or a purely fictitious settlement.”).
- 82) See, e.g., *Kiyue Co. v. Aquagen Int’l Pte Ltd*, [2003] 3 SLR 130 (Singapore High Ct.) (controlling shareholder commenced arbitration against subsidiary and then influenced subsidiary to agree not to contest merits of claim: “It is manifestly wrong for a controlling shareholder to sue its subsidiary and then order it not to defend. On this fact alone, equity is against it. And that is not all. It appears that the company had received legal advice to the effect that the claim ought to be resisted.”).
- 83) If third parties are allegedly adversely affected by a consent award they will generally be free to challenge its effects, on the grounds that the award does not bind nonparties. Equally, awards that are contrary to public policy would be subject to non-recognition in subsequent national court proceedings. See §26.05[C][9]. Nonetheless, there can be cases of fraud or illegality where the existence of other potential remedies does not alter the desirability of refraining from making a consent award that involves or facilitates illegal or wrongful conduct. Tribunals should properly refuse to make a consent award only where there are serious and credible grounds for doing so.
- 84) See, e.g., *Iran v. U.S.A., Decision No. DEC 8-A1-FT of 17 May 1982*, 1 Iran-US C.T.R. 144, 152-53 (1981) (arbitrators “should not attempt to review the reasonableness of the settlement in the place of the arbitrating parties”); D. Caron & L. Caplan, *The UNCITRAL Arbitration Rules: A Commentary* 785 (2d ed. 2013) (“It is not the task of the arbitrators to investigate the parties’ reasons for settlement.”).
- 85) Other arbitration conventions are also silent on the subject.
- 86) See §22.02[B][3][c]; §23.01[E].
- 87) See §1.05[A]; §2.02[C][4]; §23.02[B]; §23.03[E].
- 88) See, e.g., *Judgment of 2 November 2000*, 2001 WM 104 (German Bundesgerichtshof). See also E. Gaillard & J. Savage (eds.), *Fouchard Gaillard Goldman on International Commercial Arbitration* ¶1366 (1999); Newmark & Hill, *Can A Mediated Settlement Become An Enforceable Arbitration Award?*, 16 Arb. Int’l 84 (2000).
- 89) This is confirmed by the terms of the UNCITRAL Model Law and other national arbitration legislation, as discussed above. See §23.01[E][1]. Indeed, the arbitrators’ duties arguably include the duty to propose settlement to the parties. See §13.04[D].
- 90) UNCITRAL Model Law, Art. 30(2).

- 91) As a practical matter, there will ordinarily be no need for recognition and enforcement of consent awards (because the parties will have just concluded a settlement agreement, with which they are presumptively content).
- 92) See, e.g., *Judgment of 2 November 2000*, 2001 WM 104 (German Bundesgerichtshof) (applicant alleged that forged annual reports had been submitted to induce party to agree to settlement which formed basis of consent award). See also UNCITRAL, *2012 Digest of Case Law on the Model Law on International Commercial Arbitration 137 (2012)* (“The mere fact that a party consented to an award on agreed terms pursuant to Article 30 does not prohibit it from applying for the setting aside of the award under Article 34.”).

Again, it is unlikely as a practical matter that parties will seek to annul a consent award, that they have just concluded. Moreover, given that the consent award is based on the parties’ agreement, it is unlikely that there will be substantive grounds for annulling the award. Challenge on grounds of fraud, public policy, or nonarbitrability would seem more plausible than other potential grounds for challenge. See Brekoulakis & Shore, *UNCITRAL Model Law, Chapter VI, Article 30*, in L. Mistelis (ed.), *Concise International Arbitration* 639 (2010) (“award on agreed terms should be open to challenge by either party on grounds that pertain to public policy, which parties cannot waive”). One court has held that the invalidity of the settlement agreement, on which a consent award is based, does not necessarily invalidate the award itself, which is subject only to annulment and non-recognition under Articles 34, 35 and 36 of the Model Law. See *Judgment of 2 November 2000*, 2001 WM 104 (German Bundesgerichtshof).

- 93) See §27.01[A].
- 94) See §15.08[HH].
- 95) See §15.08[HH]; UNCITRAL Model Law, Art. 25; English Arbitration Act, 1996, §41. See also §25.04[B][4]; §26.05[C][4].
- 96) See, e.g., *Comprehensive Accounting Corp. v. Rudell*, 760 F.2d 138, 140-41 (7th Cir. 1985); *Kentucky River Mills v. Jackson*, 206 F.2d 111, 118 (6th Cir. 1953); *Real Color Displays, Inc. v. Universal Applied Tech. Corp.*, 950 F.Supp. 714, 716-17 (E.D.N.C. 1997); *Oh Young Indus. Co. v. E & J Textile Group, Inc.*, 2005 WL 2470824, at \*3 (Cal. Ct. App.) (“if parties agree to arbitration before an entity whose rules permit proceedings in the absence of one of the parties ... arbitration may proceed at a party’s request without recourse to the courts for an order to compel arbitration, provided that the other party has adequate notice and an opportunity to participate”); *Judgment of 13 September 2007*, 2008 Rev. arb. 313 (Paris Cour d’appel); *Judgment of 14 February 1985*, 1987 Rev. arb. 325 (Paris Cour d’appel); *Judgment of 8 June 1967*, II Y.B. Comm. Arb. 234 (Landgericht Bremen) (1977); *Judgment of 8 August 1990*, XVII Y.B. Comm. Arb. 545 (Italian Corte di Cassazione) (1992) (enforcing default award and rejecting argument that domestic provisions regarding recognition of default judgments apply to arbitral awards); *Hainan Mach. Imp. & Exp. Corp. v. Donald & McArthy Pte Ltd*, XXII Y.B. Comm. Arb. 771 (Singapore High Ct. 1995) (1997).
- 97) See §25.04[B]; §26.05[C][3]. See also N. Blackaby et al. (eds.), *Redfern and Hunter on International Arbitration* ¶9.31 (5th ed. 2009) (“The importance of ensuring that the defaulting party is given, and is seen to have been given, a full and proper opportunity of presenting its case to the arbitral tribunal is clear.”).
- 98) See §15.08[HH]; 2010 UNCITRAL Rules, Art. 30; 2012 ICC Rules, Arts. 23(3), 26(2); 2013 AAA Rules, Rule 31; LCIA Rules, Art. 15(8); ICSID Rules, Rule 45.
- 99) See §15.08[HH].
- 100) See §15.08[HH]. See also N. Blackaby et al. (eds.), *Redfern and Hunter on International Arbitration* ¶9.30 (5th ed. 2009) (“In effect, the tribunal takes on itself the burden of testing the assertions made by the active party; and it must call for such evidence and legal argument as it may require to this end. The task of an arbitral tribunal is not to ‘rubber stamp’ claims that are presented to it. It must make a *determination* of these claims. If one of the parties is not there to help, the arbitral tribunal must make this determination on its own.”) (emphasis in original).
- 101) See §15.08[HH].
- 102) For a rare decision refusing to recognize a default award, see *Victrix SS Co. v. Salen Dry Cargo AB*, 825 F.2d 709, 713-14 (2d Cir. 1987) (refusing to enforce default award against bankrupt company, on grounds that payment of award would undermine foreign policy of equal distribution of assets from bankrupt estate); Style & Reid, *The Challenge of Unopposed Arbitrations*, 16 Arb. Int’l 219 (2000).
- 103) See §24.05.



- 104)** UNCITRAL Model Law, Art. 33(5) (“The provisions of Article 31 [concerning the form and contents of an award] shall apply to a correction or interpretation of the award or to an additional award.”); English Arbitration Act, 1996, §57(6) (“Any additional award shall be made within 56 days of the date of the original award or such longer period as the parties may agree.”); German ZPO, §1058(1) (“Any party may request the arbitral tribunal to make an additional award as to claims presented in the arbitral proceedings but omitted from the arbitral award. §1054 shall apply to a correction or interpretation of the award or to an additional award.”); Netherlands Code of Civil Procedure, Art. 1061(4) (“An additional award shall be regarded as an arbitral award ...”); Austrian ZPO, §610; Singapore International Arbitration Act, 2012, §43; Costa Rican Arbitration Law, 2011, Art. 33(3); Ugandan Arbitration and Conciliation Act, §34 (“A party may, within thirty days after receipt of the arbitral award, request the arbitral tribunal to make an additional arbitral award as to claims presented in the arbitral proceedings but omitted from the arbitral award.”).
- 105)** See§24.05[B]. See also Brekoulakis & Shore, UNCITRAL Model Law, Chapter VI, Article 33, in L. Mistelis (ed.), *Concise International Arbitration* 643, 643 (2010) (“additional awards are autonomous and therefore they can be challenged or enforced independently from the main award”).
- 106)** See§24.03[B]-[C].
- 107)** See, e.g., UNCITRAL Model Law, Art. 33(5); English Arbitration Act, 1996, §57(7); German ZPO, §1058; Netherlands Code of Civil Procedure, Art. 1060(5); Austrian ZPO, §610; Swedish Arbitration Act, §32; Costa Rican Arbitration Law, 2011, Art. 33(1), (2); Peruvian Arbitration Law, Art. 60(2).
- 108)** See§24.03; §24.04.
- 109)** UNCITRAL Model Law, Art. 32(2). See also German ZPO, §1056(2); Austrian ZPO, §608(2); Danish Arbitration Act, §32(2); Japanese Arbitration Law, Art. 40; Costa Rican Arbitration Law, 2011, Art. 32(2); Peruvian Arbitration Law, Art. 60(2).
- 110)** See§23.01[i][2].
- 111)** That is true of the U.S. FAA and French Code of Civil Procedure.
- 112)** German ZPO, §1056; Münch, in G. Lüke & P. Wax (eds.), *Münchener Kommentar zur Zivilprozessordnung* §1056, ¶9 (2d ed. 2001); J.-F. Poudret & S. Besson, *Comparative Law of International Arbitration* ¶455 (2d ed. 2007). See also§13.04[E].
- 113)** SeeF. Schwarz & C. Konrad, *The Vienna Rules: A Commentary on International Arbitration in Austria* ¶25-009 (2009) (“order as such does not prevent the parties from reasserting their claim”); von Schlabrendorff & Sessler, *Making of the Award and Termination of the Proceedings*, in K. Böckstiegel et al. (eds.), *Arbitration in Germany: The Model Law in Practice* 412 (2007) (“parties are free to agree on the commencement of new arbitral proceedings”).
- 114)** B. Berger & F. Kellerhals, *International and Domestic Arbitration in Switzerland* ¶1431 (2d ed. 2010) (“an order for the termination of the proceedings does not constitute a decision on the merits of dispute and is, thus, not final and binding on the parties”); Söderlund, *A Comparative Overview of Arbitration Laws*, 20 *Arb. Int’l* 73, 81 (2010) (“The English and the Russian Acts (in conformity with the general approach) reserve the award for any decision on a substantive issue, while any termination of the proceedings without any review of the merits will be described as a ‘termination order’ or the like.”).
- 115)** 2010 UNCITRAL Rules, Art. 36(1); 1976 UNCITRAL Rules, Art. 34(1).
- 116)** 2010 UNCITRAL Rules, Art. 36(2); 1976 UNCITRAL Rules, Art. 34(2).
- 117)** LCIA Rules, Art. 26(8).
- 118)** 2012 ICC Rules, Art. 32. SeeY. Derains & E. Schwartz, *A Guide to the ICC Rules of Arbitration* 311 (2d ed. 2005).
- 119)** SeeN. Blackaby et al. (eds.), *Redfern and Hunter on International Arbitration* ¶9.01 (5th ed. 2009); W. Craig, W. Park & J. Paulsson, *International Chamber of Commerce Arbitration* ¶¶19.02, 25.06 (3d ed. 2000).
- 120)** See§5.02.
- 121)** See, e.g., UNCITRAL Model Law, Arts. 1(2), 31; English Arbitration Act, 1996, §§2, 3, 52; Netherlands Code of Civil Procedure, Art. 1058; Hong Kong Arbitration Ordinance, 2013, Art. 67(1); Chinese Arbitration Law, Art. 54; Japanese Arbitration Law, Arts. 1, 3(1), 39; Korean Arbitration Act, Art. 32; Australian International Arbitration Act, 2011, Schedule 2, Art. 31; Malaysian Arbitration Act, §33; Costa Rican Arbitration Law, 2011, Arts. 1(2), 31; Peruvian Arbitration Law, Art. 55.
- 122)** See§2.03[H]; §5.02[A][2].
- 123)** See§22.02[B][3][b]. Article IV of the New York Convention also provides that a party seeking to enforce an award shall provide “the original agreement referred to in Article II or a duly certified copy thereof.” New York Convention, Art. IV. See§22.02[B][3][b]; §26.01[A][1].
- 124)** See§22.02[B][3][b]; New York Convention, Art. IV(1)(a).

- 125)** See Otto, in H. Kronke *et al.* (eds.), *Recognition and Enforcement of Foreign Arbitral Awards: A Global Commentary on the New York Convention Art. IV*, 152 (2010) (“An arbitration award not in written format would not be enforceable under the New York Convention, even if permitted under the applicable *lex arbitri*.”).
- Nonetheless, oral arbitral awards were historically valid at common law in England. R. Merkin, *Arbitration Law* ¶¶18.19 (1991 & Update August 2013) (citing *Oates v. Bromhill* [1794] 87 Eng. Rep. 931 (English K.B.); *Cocks v. Macclesfield* [1562] 2 Dyer 218 (English K.B.)).
- 126)** For example, an oral (or, less clearly, unsigned) award would encounter objections in recognition proceedings in most jurisdictions.
- 127)** See§23.02[B][1].
- 128)** Nonetheless, if a Contracting State imposed discriminatory or idiosyncratic form requirements as a condition of confirmation or non-annulment of international arbitral awards made locally, the Convention should be interpreted as forbidding such a practice. This would parallel similar obligations of neutrality and non-discrimination under the Convention regarding arbitration agreements and arbitral procedures. See§4.04[A][1][b][v]; §4.04[A][2][j][v]; §4.05[A][2]; §4.07[B][3]; §4.08; §11.03[C][1][c][vi]; §12.01[B]; §12.01[B][2][a]; §12.04[B][7]; §12.04[E]; §15.04[A][1][a]. Moreover, if a Contracting State refused to give effect to the parties’ agreement with regard to the formal requirements for an award, this would likely be contrary to Articles II and V(1)(d) of the Convention. These provisions require giving effect to the material terms of the parties’ arbitration agreement. See§2.01[A][1][a]; §5.01[B][2]; §5.04[D][1][a]; §11.03[B]; §12.02[B] (especially §12.01[B][2][b]; §14.03[A]; §15.02[A]; §15.04[A][1][a]; §17.02[A][2]; §17.04[B][3]; §18.02[A]; §23.02[A]; §23.07[F]; §25.02[B]; §26.04[A].
- 129)** See§26.03[B][5]; §26.05[A].
- 130)** Formal requirements in national arbitration legislation have been applied in annulment actions to awards made locally, but not as grounds for non-recognition of awards made abroad. See§25.02[C]; §26.05[C][13].
- 131)** See§23.03.
- 132)** See§23.03[E].
- 133)** UNCITRAL Model Law, Art. 31(1).
- 134)** UNCITRAL Model Law, Art. 31(1).
- 135)** UNCITRAL Model Law, Art. 31(3).
- 136)** UNCITRAL Model Law, Art. 31(2).
- 137)** H. Holtzmann & J. Neuhaus, *A Guide to the UNCITRAL Model Law on International Commercial Arbitration: Legislative History and Commentary* 837 *et seq.* (1989).
- 138)** See, e.g., *French Code of Civil Procedure*, Art. 1481 (“The arbitral award shall state: the full names of the parties, as well as their domicile or corporate headquarters; if applicable, the names of the counsel or other persons who represented or assisted the parties; the names of the arbitrators who made it; the date on which it was made; the place where the sentence was made.”), Art. 1482(2) (“The award shall state the reasons upon which it is based.”); *Swiss Law on Private International Law*, Art. 189 (award must be in writing, reasoned, signed and dated); German ZPO, §1054; *Belgian Judicial Code*, Art. 1713; *Netherlands Code of Civil Procedure*, Art. 1057(4) (“In addition to the decision, the award shall contain in any case: (a) the names and addresses of the arbitrator or arbitrators; (b) the names and addresses of the parties; (c) the date on which the award is made; (d) the place where the award is made; (e) the reasons for the award, unless the award concerns merely the determination only of the quality or condition of goods ... or the recording of a settlement ...”); Austrian ZPO, §606; *Hong Kong Arbitration Ordinance, 2013*, Art. 67(1); *Australian International Arbitration Act, 2011*, Schedule 2, Art. 31; *Chinese Arbitration Law*, Art. 54; *Japanese Arbitration Law*, Art. 39; *Korean Arbitration Act*, Art. 32; *Malaysian Arbitration Act*, §33; *Venezuelan Commercial Arbitration Law*, Arts. 29, 30.
- 139)** U.S. FAA, 9 U.S.C. §§9, 13(b) (requiring submission of copy of award). See also U.S. FAA, 9 U.S.C. §§10, 207 (not prescribing rules regarding form of award).
- As discussed elsewhere, a few U.S. courts have (relying on archaic language in §9) held that an award is not subject to confirmation unless the parties’ agreement to arbitrate provides that a judgment may be entered upon the arbitrators’ award (a so-called “entry-of-judgment” provision). See§25.10.
- 140)** See, e.g., *New Jersey Statutes Annotated* 2A:24-7 (to obtain court confirmation, arbitral award must be in writing and verified).
- 141)** *English Arbitration Act, 1996*, §52(1). See R. Merkin, *Arbitration Law* ¶¶18.21 (signature), ¶¶18.22 to 18.23 (date), ¶¶18.30 to 18.31 (seat) (1991 & Update August 2013).
- 142)** *English Arbitration Act, 1996*, §52. See R. Merkin, *Arbitration Law* ¶¶18.17 to 18.32 (1991 & Update August 2013).
- 143)** Nonetheless, as noted above, oral awards were historically valid and capable of enforcement in some jurisdictions (notably, England). See§23.02[B][2]. There was also no historical requirement in some jurisdictions (again, England) that arbitral awards be signed, although parties were entitled to demand that a signature be provided. R. Merkin, *Arbitration Law* ¶¶18.21 (1991 & Update August 2013) (citing *Everard v. Paterson* [1816] 6 Taunt. 625 (English Ct. Common Pleas); *Columbel v. Columbel* [1676] 2 Mod. Rep. 77 (English K.B.)).

**144)** D. Caron & L. Caplan, *The UNCITRAL Arbitration Rules: A Commentary* 745 (2d ed. 2013) (“The requirement of a written award contained in Article 34(2) is an obvious necessity. No doubt the arbitrators will express the terms of the award and their underlying reasoning more clearly and precisely in written form, especially where the dispute involves complex issues. Likewise, the parties will better understand their rights and obligations under the award when they are memorialized in a written product. Moreover, a written award is a common prerequisite for enforcement of the award in court proceedings, where it can serve as the primary record of the arbitral proceedings.”).

**145)** *Report of the UNCITRAL on the Work of Its Ninth Session*, U.N. Doc. A/31/17, Annex II, ¶163, VII Y.B. UNCITRAL 66, 78 (1976) (“all the arbitrators, including an arbitrator who dissented from the award should be required to sign the award”); *Report of the Secretary-General on the Revised Draft Set of Arbitration Rules, UNCITRAL, Ninth Session*, U.N. Doc. A/CN.9/112/Add.1, VII Y.B. UNCITRAL 166, 178 (1976) (arbitrators must sign award “in order to make clear that all the arbitrators participated in the arbitral proceedings and in the making of the award”).

**146)** *Report of the Secretary-General on the Revised Draft Set of Arbitration Rules, UNCITRAL, Ninth Session*, U.N. Doc. A/CN.9/112/Add.1, VII Y.B. UNCITRAL 166, 178 (1976) (“In some jurisdictions the applicable arbitration law may require that an arbitral award be signed by all the arbitrators before it becomes valid and enforceable; in such a case the applicable national law would prevail over the provision” of the UNCITRAL Rules.).

National law that overrode the parties’ agreement would in turn be subject to the provisions of Articles II(3) and V(1)(d) of the New York Convention. See §11.03[C][1][c][ii]; §26.05[C][5][b][viii].

**147)** R. Merkin, *Arbitration Law* ¶18.21 (1991 & Update August 2013) (citing *Little v. Newton* [1841] 2 Man. & G. 351 (English Ct. Common Pleas); *Thomas v. Harrop* [1823] 1 Sim. & St. 524 (English Vice-Ch. Ct.)).

**148)** *Euro’n Grain & Shipping Ltd v. Johnston* [1982] 3 All ER 989 (English Ct. App.) (historic rule “unnecessary and undesirable”); *Bank Mellat v. GAA Dev. Constr. Co.* [1988] 2 Lloyd’s Rep. 44 (QB) (English High Ct.).

**149)** *Judgment of 30 March 2010, P & T Architects & Eng’rs Ltd v. Nakheel PJSC*, DWT/0022/2010 (Dubai World Special Tribunal) (rejecting argument that, under Dubai law, every page of award must be individually signed by arbitrators; holding that pages of award were numbered sufficiently to satisfy signature requirement). Cf. *Judgment of 8 May 2011, Case No. 2009/310, Cassation No. 156/2009* (Dubai Ct. Cassation) (“[I]f grounds are contained in papers separate from the paper in which the order is written, all of those papers must be signed by all of the arbitrators who issue the award, in addition to the final paper containing the order, otherwise the award will be void. Such voidness is a matter of public order.”).

**150)** As discussed above, an arbitrator may not delegate his adjudicative responsibilities. See §13.04[A][6].

**151)** See, e.g., *UNCITRAL Model Law, Art. 31(1)*; *English Arbitration Act, 1996, §52(3)*; *French Code of Civil Procedure, Arts. 1513(1)-(2)* (“Unless the arbitration agreement provides otherwise the award shall be made by majority decision. It shall be signed by all the arbitrators.”; “However, if a minority among them refuses to sign, the others shall so state in the award.”); *German ZPO, §1054(1)*; *Netherlands Code of Civil Procedure, Art. 1057(3)*; *Austrian ZPO, §606*; *Hong Kong Arbitration Ordinance, 2013, Art. 67(1)*; *Chinese Arbitration Law, Art. 54*; *Japanese Arbitration Law, Art. 39(1)*; *Korean Arbitration Act, Art. 32(1)*; *Australian International Arbitration Act, 2011, Schedule 2, Art. 31(1)*; *Malaysian Arbitration Act, §33(2)*; *Costa Rican Arbitration Law, 2011, Art. 31(1)*; *Peruvian Arbitration Law, Art. 55(1)*; *Venezuelan Commercial Arbitration Law, Art. 29*.

As discussed below, the Model Law and other arbitration statutes make provision for the refusal of an arbitrator (in the case of tribunals with multiple members) to sign the award. In general, this refusal will not affect the award’s validity, although it must be noted and explained. See §23.05. Leading institutional rules are similar. See §23.05.

**152)** See, e.g., *French Code of Civil Procedure, Art. 1513(3)*; *Swiss Law on Private International Law, Art. 189* (requiring only signature of chairman); *ICDR Rules, Art. 27*.

For an example of an award made following such a procedure, see *Award in ICC Case No. 3881, 113 J.D.I. (Clunet) 1096* (1986); *Award in ICC Case No. 1703, “RAKTA” v. Parsons & Whittemore Overseas Co.*, reprinted in J. Wetter (ed.), *The International Arbitral Process: Public and Private* Vol. V, 361 (1979). See also §23.04[B].

**153)** *UNCITRAL Model Law, Art. 32(4)*; *D. Frampton & Co. v. Thibeault*, [1988] F.C.J. No. 305 (Canadian Fed. Ct.).

**154)** See, e.g., *D. Frampton & Co. v. Thibeault*, [1988] F.C.J. No. 305 (Canadian Fed. Ct.).

- 155)** See *Judgment of 5 December 2008, Bursa Büyükşehir Belediyesi v. Güris Insaat VE Mühendislik AS, Case No. C07/166HR* (Dutch Hoge Raad) (annulling award where one of three arbitrators did not participate in deliberations or drafting award, for medical reasons, but drafted dissent that was attached to award signed by other two arbitrators because signature of all three arbitrators was mandatory requirement and dissenting opinion did not form part of award). The decision is very likely wrong. The dissenting arbitrator's failure to attend the deliberations, putatively for medical reasons, but be able to review the award and prepare a dissent, strongly suggest that he had a full opportunity to take part in the tribunal's deliberations, but chose to express his views as a dissent; in these circumstances, the absence of the dissenting arbitrator's signature should not provide grounds for annulment or non-recognition.
- 156)** D. Caron & L. Caplan, *The UNCITRAL Arbitration Rules: A Commentary* 749-50 (2d ed. 2013). See also *id.* at 826-34 (examples of statements of reasons for refusing to sign award).
- 157)** See §11.01 (especially §11.01[B][2]); §11.03[D][1]; §22.04.
- 158)** See §23.02[B][1].
- 159)** See, e.g., UNCITRAL Model Law, Art. 31(3); English Arbitration Act, 1996, §53; German ZPO, §1054(3); Hong Kong Arbitration Ordinance, 2013, Art. 67(1); Japanese Arbitration Law, Art. 39(4); Korean Arbitration Act, Art. 32(3); Australian International Arbitration Act, 2011, Schedule 2, Art. 31(3); Malaysian Arbitration Act, §33(2); Costa Rican Arbitration Law, 2011, Art. 31(3); Venezuelan Commercial Arbitration Law, Art. 30.
- Institutional rules are generally similar. See, e.g., 2010 UNCITRAL Rules, Art.18(2); 2012 ICC Rules, Art. 31(3); ICDR Rules, Art. 27(3); LCIA Rules, Art. 26(1); 2013 HKIAC Rules, Art. 14(2), 34(5); 2010 SCC Rules, Art. 20(3); 2013 VIAC Rules, Art. 36(2). See also §11.03[B]; §11.03[D][2][j]; §22.02[E][1].
- 160)** See §22.02[E][1][a][i](3), p. 2949.
- 161)** *Judgment of 30 March 2010, P & T Architects & Eng'rs Ltd v. Nakheel PJSC*, DWT/0022/2010 (Dubai World Special Tribunal) (Article 212(5) of Dubai Law of Civil Procedure, requiring that award state "the place at which it was issued," refers to place where award was made available to parties, not place where award was made; Article 212(5) satisfied because arbitral institution was based in Dubai and institution's rules and correspondence made clear that award was issued in Dubai).
- 162)** See §25.08; UNCITRAL Model Law, Art. 34(3); U.S. FAA, 9 U.S.C. §§9, 10; English Arbitration Act, 1996, §70(3); French Code of Civil Procedure, Art. 1519(2); Chinese Arbitration Law, Art. 59; Japanese Arbitration Law, Art. 44(2).
- Institutional rules are to the same effect. See, e.g., 2010 UNCITRAL Rules, Art. 34(4); ICDR Rules, Art. 27(3); LCIA Rules, Art. 26(1). See also 2012 ICC Rules, Art. 31(3) ("The Award shall be deemed to be made at the place of the arbitration and on the date stated therein.").
- 163)** See §23.03.
- 164)** See, e.g., English Arbitration Act, 1996, §68(2)(h); Belgian Judicial Code, Arts. 1713(5) (formal requirements), 1717 (annulment); Netherlands Code of Civil Procedure, Art. 1065(1)(d); Brazilian Arbitration Law, Art. 32. *Contra Judgment of 10 November 2005*, 4P.154/2005, ¶3.1 (Swiss Federal Tribunal) (lack of signature of one arbitrator not *per se* ground for annulment but just indication that arbitrator has not participated in deliberations); §25.02[C]. Compare §26.05[C][13], pp. 3712-13.
- 165)** See §23.01[H]; §24.03[B]-[C].
- 166)** See, e.g., UNCITRAL Model Law, Art. 34(2); U.S. FAA, 9 U.S.C. §10; French Code of Civil Procedure, Art. 1483 (domestic arbitration), Art. 1520; Hong Kong Arbitration Ordinance, 2013, Art. 81(1); Chinese Arbitration Law, Art. 70; Japanese Arbitration Law, Art. 44; Korean Arbitration Act, Art. 36(3); Australian International Arbitration Act, 2011, Schedule 2, Art. 34(2); Malaysian Arbitration Act, §7(4).
- 167)** Formal requirements in national arbitration legislation have been applied in annulment actions to awards made locally, but not as grounds for non-recognition of awards made abroad. See §25.05[C]; §26.05[C][13].
- 168)** See §23.03.
- 169)** See §23.03[E].
- 170)** One exception concerns language, where the arbitration clause may provide the language of the arbitration and the award. See §1.04[E][6]; §12.04[D][3]. Arbitration agreements may also address the question of who must sign the award, whether a majority vote is acceptable, and how the award must be delivered to the parties.
- 171)** 2010 UNCITRAL Rules, Art. 34; 1976 UNCITRAL Rules, Art. 32(4). The Rules provide that if the award is not signed by all arbitrators then the award must state why any arbitrator has refused to sign it. They also permit the presiding arbitrator alone to sign the award where there is no majority.
- 172)** See, e.g., ICDR Rules, Art. 27; LCIA Rules, Art. 26(1); 2013 AAA Rules, Rule 46; 2012 Swiss Rules, Art. 32; 2012 CIETAC Rules, Art. 47; DIS Rules, §34; 2013 HKIAC Rules, Art. 34; ICAC Rules, Art. 37; 2013 VIAC Rules, Art. 36; WIPO Rules, Art. 62.
- 173)** ICSID Rules, Rule 47; 2012 CIETAC Rules, Art. 47(4).
- 174)** See §25.04[C] (especially §25.04[C][4]); §26.05[C][5] (especially §26.05[C][5][b]).
- 175)** See §1.04[E][6]; §12.04[D][3].
- 176)** See §1.04[E][6]; §12.04[D][3].



- 177) See §25.05[C]; §26.05[C][13].
- 178) Van Houtte, *Conduct of Arbitral Proceedings*, in P. Sarcevic (ed.), *Essays on International Commercial Arbitration* 113, 117 (1989) (arbitral awards in various Middle Eastern jurisdictions must be rendered in official language of arbitral seat).
- 179) See §11.05[B][3]; §23.02[B][4].
- 180) For commentary, see Bingham, *Reasons and Reasons for Reasons*, 4 *Arb. Int'l* 141 (1988); Carbonneau, *Rendering Arbitral Awards With Reasons: The Elaboration of A Common Law of International Transactions*, 23 *Colum. J. Transnat'l L.* 579 (1984-1985); Delvolvé, *Essai sur la Motivation des Sentences Arbitrales*, 1989 *Rev. arb.* 149; Lalive, *On the Reasoning of International Arbitral Awards*, 1 *J. Int'l Disp. Sett.* 55 (2010); Schauer, *Giving Reasons*, 47 *Stan. L. Rev.* 633 (1995); Schlosser, *Right and Remedy in Common Law Arbitration and in German Arbitration Law*, 4(1) *J. Int'l Arb.* 27 (1987).
- 181) European Convention, Art. VIII. The ICSID Convention is to the same effect. ICSID Convention, Art. 48(3). In neither instance is the requirement for reasoned awards mandatory: parties are free to agree to an arbitral process culminating in an unreasoned award, but are presumed to have intended the contrary. Human rights conventions also arguably require that arbitrators state the reasons for their awards. See European Convention on Human Rights, Art. 6; *Hiro Balani v. Spain*, [1994] No. 18064/91 (E.C.H.R.); *Van de Hurk v. Netherlands*, [1994] No. 16034/90 (E.C.H.R.).
- 182) The requirement for reasoned awards is also common in state-to-state settings. See Statute of the International Court of Justice, Art. 56 (“The judgment shall state the reasons on which it is based.”); 1907 Convention for the Pacific Settlement of International Disputes (“1907 Hague Convention”), Art. 79 (“The Award must give the reasons on which it is based.”). See also *Gov't of Sudan v. Sudan People's Liberation Movement/Army, Final Award in PCA Case of 22 July 2009*, ¶531 (“To meet the minimum requirement, an award should contain sufficient ratiocination to allow the reader to understand how the tribunal reached its binding conclusions (regardless of whether the ratiocination might persuade a disengaged third party that the award is substantively correct). As to the substantive issue, awards may be set aside for failure to state reasons where conclusions are not supported by any reasons at all, where the reasoning is incoherent or where the reasons provided are obviously contradictory or frivolous.”).
- 183) The requirement for reasoned awards appears to have had its principal origins in civil law systems. UNCITRAL, *Report of the Secretary-General on the Revised Draft Set of Arbitration Rules, Ninth Session*, U.N. Doc. A/CN.9/112/Add.1, VII Y.B. UNCITRAL 166, 178 (1976) (requirement for reasoned award “reflect[s] the law in many jurisdictions, particularly countries with a civil law system, to require that arbitral awards incorporate the reasons for the decision reached by the arbitrators”). Compare *Draft on Arbitral Procedure Prepared by the International Law Commission at Its Fourth Session*, U.N. Doc. A/CN.4/60, Art. 24(2), II Y.B. I.L.C. 60, 65 (1952) (“The award shall include a full statement of reasons.”).
- 184) See Bingham, *Reasons and Reasons for Reasons*, 4 *Arb. Int'l* 141, 145 (1988); R. Merkin, *Arbitration Law* ¶18.45 (1991 & Update August 2013). See also Carbonneau, *Rendering Arbitral Awards With Reasons: The Elaboration of A Common Law of International Transactions*, 23 *Colum. J. Transnat'l L.* 579 (1984-1985).
- 185) See, e.g., *United Steelworkers of Am. v. Enter. Wheel Car Corp.*, 363 U.S. 593, 598 (U.S. S.Ct. 1960) (“Arbitrators have no obligation to the court to give their reasons for an award.”); *Tame Shipping Ltd v. Easy Navigation Ltd, The “Easy Rider”* [2004] EWHC 1862 (Comm) (English High Ct.) (“It is undoubtedly the case that by the time of the passing of the Arbitration Act, 1979 there was a well-established practice among arbitrators of publishing their reasons in ‘confidential’ form in those cases where the parties had not asked for the award to be stated in the form of a special case.”); Bingham, *Reasons and Reasons for Reasons*, 4 *Arb. Int'l* 141, 145 (1988); R. Morgan, *The Arbitration Ordinance of Hong Kong: A Commentary* 232 (1997).
- 186) See, e.g., UNCITRAL Model Law, Art. 31(2); English Arbitration Act, 1979, §1(6); English Arbitration Act, 1996, §52(4); Québec Code of Civil Procedure, Art. 945(2); British Columbia International Commercial Arbitration Act, §31(3); Indian Arbitration and Conciliation Act, Art. 31(3); New Zealand Arbitration Act, Schedule 1, Art. 31(2). See generally Carbonneau, *Rendering Arbitral Awards With Reasons: The Elaboration of A Common Law of International Transactions*, 23 *Colum. J. Transnat'l L.* 579 (1984-1985); A. van den Berg, *The New York Arbitration Convention of 1958* 380-81 (1981).
- 187) UNCITRAL Model Law, Art. 31(2). The provision excludes consent awards from the requirement that reasons be given for the award. *Ibid.* See §23.01[E][1].
- 188) See *Report of the Secretary-General on the Analytical Commentary on Draft Text of A Model Law on International Commercial Arbitration*, U.N. Doc. A/CN.9/264, Art. 31, ¶13 (1985); H. Holtzmann & J. Neuhaus, *A Guide to the UNCITRAL Model Law on International Commercial Arbitration: Legislative History and Commentary* 838 (1989).

- 189)** See, e.g., [English Arbitration Act, 1996, §52\(4\)](#); [Swiss Law on Private International Law, Art. 189\(2\)](#); [German ZPO, §1054](#); [Netherlands Code of Civil Procedure, Arts. 1057\(e\), 1065\(1\)\(d\)](#) (annulment of award if “award is not signed or does not contain reasons in accordance with the provision of Article 1057”); [Austrian ZPO, §606\(2\)](#); [Norwegian Arbitration Act, §36](#); [Hong Kong Arbitration Ordinance, 2013, Art. 67\(1\)](#); [Chinese Arbitration Law, Art. 54](#); [Japanese Arbitration Law, Art. 39\(2\)](#); [Korean Arbitration Act, Art. 32\(2\)](#); [Australian International Arbitration Act, 2011, Schedule 2, Art. 31](#); [Malaysian Arbitration Act, §33\(3\)](#); [Costa Rican Arbitration Law, 2011, Art. 31\(2\)](#); [Peruvian Arbitration Law, 2008, Art. 56\(1\)](#); [Venezuelan Commercial Arbitration Law, Art. 30](#); [Egyptian Arbitration Law, Art. 43\(2\)](#) (“The arbitral award shall state the reasons upon which it is based unless the parties to arbitration have agreed otherwise or the law applicable to the arbitral proceeding does not require the award to be supported by reasons ...”). See also [French Code of Civil Procedure, Art. 1506](#) (duty to give reasons in domestic awards (Art. 1482(2)) applies to international arbitration, “unless the parties have agreed otherwise”).
- 190)** See, e.g., [French Code of Civil Procedure, Art. 1482](#); [Belgian Judicial Code, Art. 1713\(4\)](#); [Russian Arbitration Law, Art. 31\(2\)](#) (omitting Model Law phrase “unless otherwise agreed by the parties”); [Ukrainian Arbitration Law, Art. 31\(2\)](#); [Brazilian Arbitration Law, Art. 26](#). See [Delvolvé, \*Essai sur la Motivation des Sentences Arbitrales\*, 1989 Rev. arb. 149](#); [M.-C. Rondeau-Rivier, \*JurisClasseur Procédure Civile\*, Fasc. 1042, ¶¶47-50 \(1996\)](#).
- 191)** See, e.g., [2012 ICC Rules, Art. 31\(2\)](#); [ICSID Rules, Rule 47\(1\)\(i\)](#); [2012 CIETAC Rules, Art. 47\(3\)](#); [2013 HKIAC, Art. 34\(4\)](#); [ICAC Rules, Art. 41\(1\)](#); [2010 NAI Rules, Art. 49\(2\)\(e\)](#).
- 192)** See, e.g., [2010 UNCITRAL Rules, Art. 34\(3\)](#); [1976 UNCITRAL Rules, Art. 32\(3\)](#); [ICDR Rules, Art. 27\(2\)](#); [LCIA Rules, Art. 26\(1\)](#); [2013 HKIAC Rules, Art. 34\(4\)](#); [2013 VIAC Rules, Art. 36\(1\)](#); [WIPO Rules, Art. 62\(c\)](#).

The United States and United Kingdom initially opposed the 1976 UNCITRAL Rules’ proposed requirement for reasoned awards. After debate, the Rules were drafted to require reasons, except where the parties agreed otherwise (either expressly or by implication). [UNCITRAL, \*Summary Record of the Tenth Meeting of the Committee of the Whole \(II\), Ninth Session\*, U.N. Doc. A/CN.9/9/C.2/SR.10, 8, ¶¶62, 64, 65, 73-75 \(1976\)](#).

- 193)** [Bingham, \*Reasons and Reasons for Reasons\*, 4 Arb. Int’l 141, 145 \(1988\)](#). See also [Fuller, \*The Forms and Limits of Adjudication\*, 92 Harv. L. Rev. 353, 366 \(1978\)](#) (“Adjudication is ... a device which gives formal and institutional expression to the influence of reasoned argument in human affairs.”); [Helfer & Slaughter, \*Toward A Theory of Effective Supranational Adjudication\*, 107 Yale L.J. 273, 320 \(1997\)](#) (“Reasons should explain why and how a particular conclusion was reached. To reason in this context, means to give reasons for a particular result, regardless of the logic or mode of reasoning underlying those reasons.”); [Shapiro, \*The Giving Reasons Requirement\*, 1992 U. Chi. Legal F. 179, 181](#) (“in the Western tradition, the very concept of political authority ... implies the capacity to give reasons”).
- 194)** See [§1.05\[A\]](#); [§2.02\[C\]\[4\]](#); [§13.04](#); [§23.03\[E\]](#).
- 195)** [D. Caron & L. Caplan, \*The UNCITRAL Arbitration Rules: A Commentary\* 801 \(2d ed. 2013\)](#) (“Among the most important obligations that the arbitral tribunal owes the parties is the rendering of a coherent, accurate and complete award.”).
- 196)** The requirement for a reasoned award arguably encourages principled decision-making, by making it more difficult to adopt unprincipled compromise decisions.
- 197)** Compare [M. Bühler & T. Webster, \*Handbook of ICC Arbitration: Commentary, Precedents, Materials\* 313 \(2d ed. 2008\)](#) (“Providing legal reasons is often the most difficult part of drafting the Award, which often turns out to be the weakest part of the Award. ... Some view the weaknesses in legal reasoning as in part a result of the fact that most ICC Awards are not published and when they are published it is often without the names of the arbitrators who participated in drafting them.”).
- 198)** [Rau, \*On Integrity in Private Judging\*, 14 Arb. Int’l 115, 148 \(1998\)](#).
- 199)** For a sharply-critical view of lengthy awards, see [Mohsen Asgari Nazari v. Islamic Repub. of Iran, \*Dissenting and Concurring Opinion of Howard Holtzmann in Award in IUSCT Case No. 559-221-1 of 24 August 1994\*, 30 Iran-US C.T.R. 163, 168-69 \(1994\)](#) (“I also write separately to call attention to the Tribunal’s growing tendency to write Awards that are overly long and excessively detailed – a tendency that, regrettably, this Award exemplifies. ... A plea for brevity must, in principle, be brief. ... The issue is not a choice of literary style. At stake is the efficient use of the Tribunal’s limited time, funds and facilities – resources which are, in my view, endangered by the present practice in drafting awards.”).

- 200)** See, e.g., *Starrett Housing Corp. v. Islamic Repub. of Iran*, Concurring Opinion of Howard H. Holtzmann in *Interlocutory Award in IUSCT Case No. ITL 32-24-1 of 20 December 1983*, 4 Iran-US C.T.R. 159, 179-80 (1983) (“That calls for an explanation of the Tribunal’s views, but it is not a requirement that an award regurgitate every unsupported allegation in every pleading and argument. The purpose of an award is to express and explain the decision of the Tribunal, not to serve as vehicle for polemics of any party.”); *Bay Hotel & Resort Ltd v. Cavalier Constr. Co.*, [2001] UKPC 34 (Turks & Caicos Islands Privy Council) (rejecting claim that skeletal award was unreasoned); *Navigation Sonamar Inc. v. Algoma Steamships Ltd*, [1987] R.J.Q. 1346 (Québec S.Ct.); *Trave Schiffahrtsgesellschaft mbH & Co. KG v. Ninemia Maritime Corp.* [1986] QB 802, 807 (QB) (English High Ct.) (reasoned award is “one which states the reasons for the award in sufficient detail for the court to consider any question of law arising therefrom”); Knoepfler & Schweizer, *Making of Awards and Termination of Proceedings*, in P. Sarcevic (ed.), *Essays on International Commercial Arbitration* 160 (1989) (“Reasons should be comprehensible to the parties.”).
- 201)** *Bremer Handelsgesellschaft v. Westzucker* [1981] 2 Lloyd’s Rep. 130, 132-33 (English Ct. App.).
- 202)** *Gordian Runoff Ltd v. Westport Ins. Corp.*, [2010] NSWCA 57 (NSW Ct. App.) (rejecting requirement for reasons imposed in prior Australian authority (*Oil Basins*) and holding that arbitrators were not required to provide reasons equivalent to those of a court). Compare *Oil Basins Ltd v. BHP Billiton Ltd*, [2007] VSCA 255 (Vict. Ct. App.) (in domestic arbitration, arbitral tribunal was required to provide reasons equivalent to those of a domestic court).
- 203)** See, e.g., *Judgment of 16 December 2004*, 2005 Rev. arb. 217 (Paris Cour d’appel) (tribunal has no obligation to list all evidence it considers).
- 204)** *Judgment of 3 April 2007*, Case No. 123/119 (Cairo Ct. App.).
- 205)** If an award reaches a badly wrong result, it may be exposed to annulment in states where judicial review of the substance of arbitrators’ decisions is available. See §§25.02[D][1]-[2]. In these instances, annulment results from the arbitral tribunal’s erroneous conclusions, rather than an absence of reasons in the award.
- 206)** See §§25.05[B], pp. 3358-60.
- 207)** This requirement is discussed in greater detail below. See §§25.04[D][5].
- 208)** See §§23.03[B]; UNCITRAL Model Law, Art. 31(2); English Arbitration Act, 1996, §52(4); Swiss Law on Private International Law, Art. 189(2); Netherlands Code of Civil Procedure, Art. 1057(e); Norwegian Arbitration Act, §36; Hong Kong Arbitration Ordinance, 2013, Art. 67(1); Chinese Arbitration Law, Art. 54; Japanese Arbitration Law, Art. 39(2); Korean Arbitration Act, Art. 32(2); Australian International Arbitration Act, 2011, Schedule 2, Art. 31; Malaysian Arbitration Act, §33(3)(a).

In contrast, a few states impose a mandatory requirement for a reasoned award. See §§23.03[B]. Legislation in the arbitral seat overriding the parties’ agreement for an unreasoned award is likely not inconsistent with the New York Convention, but an unreasoned award would generally be recognized notwithstanding such mandatory requirements. See §12.02[B]; §14.03; §15.02[A]; §15.04[A][1][a]; §23.02[A]; New York Convention, Art. V(1)(d).

- 209)** See §§11.03[B]; §15.02.
- 210)** That is particularly true given the parties’ freedom to agree to *amiable compositeur* and arbitration *ex aequo et bono*. See §19.07. If parties are free to agree to resolution of their dispute without reference to strict legal principles, it is very difficult to see why they cannot waive a statement of the legal reasoning justifying the award.
- 211)** See §§23.03[E], pp. 3046-48.
- 212)** This is consistent with the approach of the European Convention. See §§23.02[B][2][c]; European Convention, Art. VIII.
- 213)** See §§25.04[D][5].
- 214)** See §§25.04[D][5], pp. 3046-48. Compare §§23.03[E]; French Code of Civil Procedure, Art. 1520; *Judgment of 22 November 1966, Gerstlé v. Merry Hull*, 94 J.D.I. (Clunet) 631 (French Cour de cassation civ. 1e) (1967); *Judgment of 21 August 1990*, DFT 116 II 373, 375 (Swiss Federal Tribunal); Berti & Schnyder, in S. Berti et al. (eds.), *International Arbitration in Switzerland* Art. 190, ¶77 (2000).
- 215)** See §§23.03[B].
- 216)** *United Steelworkers of Am. v. Enter. Wheel & Car Corp.*, 363 U.S. 593, 597 (U.S. S.Ct. 1960).

- 217)** See, e.g., *Bernhardt v. Polygraphic Co. of Am.*, 350 U.S. 198, 204 n.4 (U.S. S.Ct. 1956); *Bosack v. Soward*, 586 F.3d 1096, 1104 (9th Cir. 2009); *D.H. Blair & Co. v. Gottdiener*, 462 F.3d 95, 110 (2d Cir. 2006); *Stark v. Sandberg, Phoenix & von Gontard, PC*, 381 F.3d 793, 802 (8th Cir. 2004); *Wallace v. Buttar*, 378 F.3d 182, 190 (2d Cir. 2004); *El Dorado Sch. Dist. v. Cont'l Cas. Co.*, 247 F.3d 843, 847 (8th Cir. 2001); *Eljer Mfg Inc. v. Kowin Dev. Corp.*, 14 F.3d 1250, 1254 (7th Cir. 1994) (“an arbitrator is simply not required to state the reasons for his decision”); *A.G. Edwards & Sons, Inc. v. McCullough*, 967 F.2d 1401, 1403 (9th Cir. 1992); *Antwine v. Prudential Bache Sec., Inc.*, 899 F.2d 410, 412 (5th Cir. 1990); *Virgin Islands Nursing Ass’n’s Bargaining Unit v. Schneider*, 668 F.2d 221, 223 (3d Cir. 1981) (rejecting argument that court should “exercise [its] supervisory power to enunciate a new requirement that arbitrators file written opinions, or, at least, findings of fact”); *Repub. of Argentina v. BG Group plc*, 715 F.Supp.2d 108, 124 (D.D.C. 2010) (“[The arbitrator’s] failure to provide an explanation for his decision is hardly evidence of nefarious intent on his part, especially given the well-settled principle that arbitrators have no obligation to disclose the basis upon which their awards are made.”), *rev’d on other grounds*, 665 F.3d 1363 (D.C. Cir. 2012); *Vitarroz Corp. v. G. Willi Food Int’l Ltd*, 637 F.Supp.2d 238, 247 (D.N.J. 2009); *Dunhill Franchisees Trust v. Dunhill Staffing Sys., Inc.*, 513 F.Supp.2d 23, 32 (S.D.N.Y. 2007) (“Arbitrators are not required to give reasoned analysis for their decisions, or any particular aspect of them.”). See also Rau, *On Integrity in Private Judging*, 14 Arb. Int’l 115, 149 (1998) (“It is striking that by contrast to the judicial forum, arbitration shares with other processes of private settlement two major characteristics: both a tendency to look for intermediate solutions – responsive to the uniqueness of each dispute – and the absence of any need to justify the outcome.”).
- 218)** See §23.03[B].
- 219)** See *Long John Silver’s Rests., Inc. v. Cole*, 514 F.3d 345, 349 (4th Cir. 2008) (arbitrator had “satisfied his obligation to render a reasoned award”); *Choice Hotels Int’l, Inc. v. Patel*, 2004 WL 57658, at \*6 (D. Md.) (AAA Rules, which governed arbitration, provided that “the arbitrator need not render a reasoned award unless the parties request such an award in writing prior to the appointment of the arbitrator or unless the arbitrator determines that a reasoned award is appropriate”).
- 220)** See §23.03[B].
- 221)** See §23.03[B].
- 222)** See §26.05[C][3][d]; *Judgment of 29 January 1958*, 1958 Rev. arb. 123, 125 (Nancy Cour d’appel) (1958) (“failure to give reasons, although contrary in principle to French procedure is not contrary to French international public policy, if it is permitted by the foreign law”); *Judgment of 15 December 2009*, I-4 Sch 10/09 (Oberlandesgericht Düsseldorf) (refusing to deny recognition of unreasoned award; institutional rules agreed by parties did not require reasoned award); *Inter-Arab Inv. Guar. Corp. v. Banque Arabe et Int’l d’Investissements*, XXII Y.B. Comm. Arb. 643, 651-52 (Brussels Tribunal de Première Instance) (1997) (rejecting objections to recognition of allegedly unreasoned foreign award, on grounds that law of judicial enforcement forum (requiring reasoned awards) was not applicable to foreign awards and that requirement for reasoned award was not a principle of public policy), *aff’d*, *Judgment of 24 January 1997*, XXII Y.B. Comm. Arb. 643, 655 (Brussels Cour d’appel) (1997); *Judgment of 24 November 1994*, XXI Y.B. Comm. Arb. 635 (Rotterdam Rechtbank) (1996) (unreasoned award recognized where parties did not request reasons); *Judgment of 2 May 1980*, *Efxinos Shipping Co. v. Rawi Shipping Lines Ltd*, VIII Y.B. Comm. Arb. 381 (Genoa Corte d’Appello) (1983); *Judgment of 8 October 1977*, *Bobbie Brooks, Inc. v. Lanificio Walter Banci*, IV Y.B. Comm. Arb. 289, 292 (Florence Corte d’Appello) (1979) (“fact that the reasoning constitutes a principle of the Italian Constitution is not important because what is fundamental in Italian law of procedure may not be considered as such by foreign legislative and judicial authorities”).
- 223)** If the parties have expressly agreed upon an unreasoned award, there is no basis for denying recognition of an award under Article V(1)(d) of the New York Convention. See §11.03[B]; §11.05[B][3]; §26.05[C][3][d]. Nor is there a basis for denying recognition of an unreasoned foreign award under Article V(2)(b), particularly in states where parties are free to agree upon an unreasoned award in locally-seated arbitrations. See §23.03[B]. Put simply, if parties are free to agree to unreasoned awards in a local arbitration, it is impossible to see why local public policy would forbid them from doing so in a foreign arbitration.
- 224)** See §15.02[B]; §§15.06[A]-[B]; §26.03[B]; §26.05[C][3][d].



- 225)** See, e.g., *Judgment of 30 September 1999*, XXXI Y.B. Comm. Arb. 640, 648 (Hanseatisches Oberlandesgericht Bremen) (2006) (foreign arbitral award was scantily-reasoned (“would hardly meet the requirements of German domestic procedural public policy”), but not grounds for non-recognition under Article V(2) (b)); *Judgment of 10 July 2002*, XXVIII Y.B. Comm. Arb. 821, 825 (Vardo Enforcement Ct.) (2003) (“arbitral tribunals in some countries have different traditions for wording awards than Norwegian arbitral tribunals ... an award lacking a clear dispositive part, which is a characteristic of Norwegian awards, should be enforced in Norway if its conclusions are evident”); *The Bay Hotel & Resort Ltd v. Cavalier Constr. Co.*, [2001] UKPC 34 (Turks & Caicos Islands Privy Council). See also Wells, *French and American Judicial Opinions*, 19 Yale J. Int’l L. 81, 92 (1994) (“Rather than a reasoned and candid essay, an opinion in the highest courts [in France] is a terse and opaque summary of the outcome and the reasons for it.”).
- 226)** *Judgment of 30 September 1999*, XXXI Y.B. Comm. Arb. 640, 648 (Hanseatisches Oberlandesgericht Bremen) (2006).
- 227)** See, e.g., *Mut. Shipping Corp. v. Bayshore Shipping Co.*, *The Montan* [1985] 1 Lloyd’s Rep. 189 (English Ct. App.) (unreasoned award contrary to English public policy); *Domotique Secant Inc. v. Smart Sys. Tech. Inc.*, [2005] Can. LII 36874 (Québec S.Ct.) (refusing to recognize unreasoned U.S. award); *Judgment of 3 April 1987*, XVII Y.B. Comm. Arb. 529 (Italian Corte di Cassazione) (1992) (public policy requires non-recognition of award with insufficient and illogical reasons). See Schlosser, *Right and Remedy in Common Law Arbitration and in German Arbitration Law*, 4(1) J. Int’l Arb. 27 (1987). But see Brekoulakis & Shore, *UNCITRAL Model Law, Chapter VI, Article 31*, in L. Mistelis (ed.), *Concise International Arbitration* 640, 640-41 (2010) (“Reasoning is part of the required form of an award. However, the reasoning of an award should not be considered a public policy requirement.”).
- 228)** See §23.03[B].
- 229)** See §25.04[C][1].
- 230)** M. Bühler & T. Webster, *Handbook of ICC Arbitration: Commentary, Precedents, Materials* 308 (2d ed. 2008) (“Many, if not most Awards rendered in ICC arbitrations are rendered by unanimity.”). See also Brower & Rosenberg, *The Death of the Two-Headed Nightingale: Why the Paulsson-van den Berg Presumption That Party-Appointed Arbitrators Are Untrustworthy Is Wrongheaded*, 29 Arb. Int’l 7 (2013).
- 231)** French Code of Civil Procedure, Arts. 1480, 1513; German ZPO, §1052(1); Chinese Arbitration Law, Arts. 53, 54; Indian Arbitration and Conciliation Act, Arts. 29(1), 31(2); New Zealand Arbitration Act, Schedule 1, Arts. 29, 31(1); Iranian International Commercial Arbitration Law, Arts. 29, 30(1). See also 2010 UNCITRAL Rules, Arts. 33(1), 34(4); LCIA Rules, Arts. 26(3), (4).
- 232)** UNCITRAL Model Law, Art. 29. Article 31(2) provides that the award may be signed by only a majority of the arbitrators, provided that the reason for the omitted signature(s) is stated. UNCITRAL Model Law, Art. 31(2). See §23.02[B][2][a].
- 233)** Some arbitration legislation provides for majority decisions unless otherwise agreed by the parties. See French Code of Civil Procedure, Art. 1513; Swiss Law on Private International Law, Art. 189(2); German ZPO, §1052(1); Belgian Judicial Code, Art. 1713(3); Netherlands Code of Civil Procedure, Art. 1057(1); Austrian ZPO, §604; Italian Code of Civil Procedure, Art. 823; New Zealand Arbitration Act, Schedule 1, Art. 29.
- Other legislation simply provides for majority decisions, without reference to the parties’ agreement. See English Arbitration Act, 1996, §52(3); Chinese Arbitration Law, Art. 53; Japanese Arbitration Law, Art. 37(2). See also Hong Kong Arbitration Ordinance, 2013, Art. 65; Korean Arbitration Act, Art. 30; Australian International Arbitration Act, 2011, Schedule 2, Art. 29; Malaysian Arbitration Act, §31(1); Costa Rican Arbitration Law, 2011, Art. 29; Peruvian Arbitration Law, Art. 52(1); Iranian International Commercial Arbitration Law, Art. 29.
- 234)** See, e.g., UNCITRAL Model Law, Art. 31(2); German ZPO, §1054(1); Austrian ZPO, §606; Hong Kong Arbitration Ordinance, 2013, Art. 67(1); Chinese Arbitration Law, Art. 53; Japanese Arbitration Law, Art. 39(1); Korean Arbitration Act, Art. 32(1); Indian Arbitration and Conciliation Act, Art. 31(2); Australian International Arbitration Act, 2011, Schedule 2, Art. 31(1); New Zealand Arbitration Act, Schedule 1, Art. 31(1); Malaysian Arbitration Act, §33(2); Iranian International Commercial Arbitration Law, Art. 30(1); Costa Rican Arbitration Law, 2011, Art. 31(1); Venezuelan Commercial Arbitration Law, Art. 29. See also the institutional rules cited in §23.04[A].
- 235)** See statutes cited in §23.04[A]. Agreements requiring unanimity among the arbitrators would obviously alter significantly the dynamics of decision-making by the tribunal. Such provisions are virtually never encountered.
- 236)** See, e.g., 2010 UNCITRAL Rules, Art. 33(1); 2012 ICC Rules, Art. 31(1); ICDR Rules, Art. 26(1); LCIA Rules, Art. 26(3); 2012 CIETAC Rules, Arts. 47(5), (6); 2013 HKIAC Rules, Art. 32(1); 2010 SCC Rules, Art. 35(1); 2013 SIAC Rules, Art. 28(5); 2013 VIAC Rules, Art. 35(1).
- 237)** See §13.07.
- 238)** See, e.g., 2012 GAFTA Rules, Art. 9:1.
- 239)** See, e.g., *Cargill Int’l SA v. Sociedad Iberica de Molturacion SA* [1998] 1 Lloyd’s Rep. 489 (English Ct. App.).
- 240)** See §12.06[C]; §12.07[B]; §13.04[E]; §13.05[D].

- 241)** See §13.07[A][3]; English Arbitration Act, 1996, §20(4); French Code of Civil Procedure, Art. 1513(3); Swiss Law on Private International Law, Art. 189(2); Belgian Judicial Code, Art. 1711(3); Chinese Arbitration Law, Art. 53.
- 242)** See, e.g., 2012 ICC Rules, Art. 31(1); LCIA Rules, Art. 26(3); Euro-Arab Chambers of Commerce Rules of Conciliation, Arbitration and Expertise, Art. 24(2); 2013 HKIAC Rules, Art. 32(1); 2013 SIAC Rules, Art. 28(5).

Article 46 of the former International Arbitration Rules of the Zurich Chamber of Commerce adopts a similar approach, but restricted the chairman's discretion by providing that an award in favor of the prevailing party can be neither less than the lowest proposal made by the co-arbitrators, nor greater than the highest proposal.

- 243)** See, e.g., German ZPO, §1052(1) ("In arbitral proceedings with more than one arbitrator, any decision of the arbitral tribunal shall be made, unless otherwise agreed by the parties, by a majority of all its members."); Japanese Arbitration Law, Art. 39(1).
- 244)** See, e.g., 2010 UNCITRAL Rules, Art. 33(1); ICDR Rules, Art. 26(1). See also UNCITRAL, *Report of the Secretary-General on the Revised Draft Set of Arbitration Rules, Ninth Session*, U.N. Doc. A/CN.9/112/Add.1, VII Y.B. UNCITRAL 166, 178 (1976) ("If a majority of the arbitrators fail to agree on an award, the arbitral tribunal must resolve the deadlock in accordance with the relevant law and practice at the place of arbitration.").

While the UNCITRAL Working Group considered amending Article 31(1), as it appeared in the 1976 version of the UNCITRAL Rules, it ultimately retained paragraph (1) with the replacement of the word "three" by the words "more than one." *Report of Working Group II (Arbitration and Conciliation), Fifty-First Session*, U.N. Doc. A/CN.9/684, ¶¶52-62 (2009).

- 245)** See §13.07[A][3]. See also §23.04[B]-[C].
- 246)** See Schwebel, *May the Majority Vote of An International Arbitral Tribunal Be Impeached?*, 13 Arb. Int'l 145, 152-53 (1997).
- 247)** For examples of cases where an arbitrator went along with the presiding arbitrator's views, in order to form a majority, see *Starrett Housing Corp. v. Islamic Repub. of Iran, Concurring Opinion of Howard H. Holtzmann in Interlocutory Award in IUSCT Case No. ITL 32-24-1 of 19 December 1983*, 4 Iran-US C.T.R. 159 (1983) ("I concur with reluctance in the Interlocutory Award in this case. I do so in order to form a majority for the key finding that the Government of the Islamic Republic of Iran has expropriated property of the Claimants in Iran. ... In view of the many errors in the Interlocutory Award, it would be easier to dissent from it than to concur in it. ... My colleague, Judge Kashani having dissented, I am faced with the choice of joining the President in the present Interlocutory Award despite its faults, or accepting the prospect of an indefinite delay in progress towards a final decision of this case."); *Am. Int'l Group, Inc. v. Islamic Repub. of Iran, Concurring Opinion of Richard M. Mosk in Award in IUSCT Case No. 93-2-3 of 19 December 1983*, 4 Iran-US C.T.R. 111, 111-12 (1983) ("I concur in the Tribunal's Award in order that a majority can be formed. ... This Award represents a 'compromise solution' in which I have joined so that some award could be issued. Otherwise, this case heard almost a year ago, would remain undecided."); *Economy Forms Corp. v. Islamic Repub. of Iran, Concurring Opinion of Howard H. Holtzmann in Award in IUSCT Case No. 55-165-1 of 14 June 1983*, 3 Iran-US C.T.R. 42, 55 (1983) ("Why then do I concur in this inadequate Award, rather than dissenting from it? The answer is based on the realistic old saying that there are circumstances in which 'something is better than nothing.'"); *RayGo Wagner Equip. Co. v. Iran Express Terminal Corp., Concurring and Dissenting Opinion of Richard M. Mosk in Award in IUSCT Case No. 30-16-3 of 18 March 1983*, 2 Iran-US C.T.R. 141 (1983) (co-arbitrator attached concurring opinion indicating his personal views differed from majority); *Granite State Mach. Co. v. Islamic Repub. of Iran, Award in IUSCT Case No. 18-30-3 of 15 December 1982*, 1 Iran-US C.T.R. 442, 450-51 (1982). See also *Ad Hoc Award of 31 July 1989* (I.C.J.), reprinted in *Case Concerning the Arbitral Award of 31 July 1989*, [1991] I.C.J. Rep. 53, 59-61 (chairman appended declaration stating his separate opinion, while also signing majority award).
- 248)** *Granite State Mach. Co. v. Islamic Repub. of Iran, Concurring Opinion of Richard M. Mosk in Award No. 18-30-3 of 15 December 1982*, 1 Iran-US C.T.R. 442, 450-51 (1982).
- 249)** Schwebel, *May the Majority Vote of An International Arbitral Tribunal Be Impeached?*, 13 Arb. Int'l 145, 153 (1997).
- 250)** See §23.05. In some cases, an arbitrator will sign an award, notwithstanding also appending an opinion that dissents or concurs, in whole or in part; in other cases, an arbitrator may refuse entirely to sign the award.
- 251)** German ZPO, §1052(2); Austrian ZPO, §604. The requirement for advance notice applies only to awards, not procedural orders.
- 252)** See §13.04[B]; §15.03; §15.08[KK].
- 253)** See §12.07.

- 254)** For commentary, see [Arroyo, \*Dealing With Dissenting Opinions in the Award: Some Options for the Tribunal\*](#), 26 *ASA Bull.* 437 (2008); ICC, *Final Report on Dissenting and Separate Opinion of the ICC Commission on International Arbitration*, 2(1) *ICC Ct. Bull.* 32 (1991); Lévy, *Dissenting Opinions in International Arbitration in Switzerland*, 5 *Arb. Int'l* 35 (1989); Luiso, *In tema di ricasazione degli arbitri e di dissenting opinion*, 2 *Rivista dell' Arbitrato* 496 (1992); Mosk & Ginsburg, *Dissenting Opinions in International Arbitration*, 15(4) *Mealey's Int'l Arb. Rep.* 26 (2000); Redfern, *Dangerous Dissents*, 71 *Arb.* 200 (2005); Redfern, *Dissenting Opinions in International Commercial Arbitration: The Good, the Bad and the Ugly*, 20 *Arb. Int'l* 223 (2004); Rees & Rohn, *Dissenting Opinions: Can They Fulfil A Beneficial Role?*, 25 *Arb. Int'l* 329 (2009); Smit, *Dissenting Opinions in Arbitration*, 15(1) *ICC Ct. Bull.* 37 (2004); Werner, *Dissenting Opinions – Beyond Fears*, 9(4) *J. Int'l Arb.* 23 (1992).
- 255)** Compare [UNCITRAL, \*Summary Record of the Eleventh Meeting of the Committee of the Whole \(II\), Ninth Session\*](#), U.N. Doc. A/CN.9/9/C.2/SR.11, ¶40 (1976) (“There was no reason for an arbitrator who disagreed with the majority decision not to sign the award; his signature would not signify his agreement with the majority decision, but would simply render the award valid. If, however, the arbitrator was physically unable to sign the award, his failure to sign should not invalidate the award.”).
- 256)** See, e.g., [UNCITRAL Model Law, Art. 31\(1\)](#) (“In arbitral proceedings with more than one arbitrator, the signatures of the majority of all the members of the tribunal shall suffice, provided that the reason for any omitted signature is stated.”); [French Code of Civil Procedure, Arts. 1480\(3\), 1513\(2\)](#); [German ZPO, §1054\(1\)](#); [Netherlands Code of Civil Procedure, Art. 1057\(3\)](#); [Austrian ZPO, §606\(1\)](#); [Hong Kong Arbitration Ordinance, 2013, Art. 67\(1\)](#); [Chinese Arbitration Law, Art. 54](#); [Japanese Arbitration Law, Art. 39\(1\)](#); [Korean Arbitration Act, Art. 32\(1\)](#); [Indian Arbitration and Conciliation Act, Art. 31\(2\)](#); [Malaysian Arbitration Act, §33\(2\)](#); [Costa Rican Arbitration Law, 2011, Art. 31\(1\)](#); [Peruvian Arbitration Law, Art. 55\(1\)](#); [Iranian International Commercial Arbitration Law, Art. 30\(1\)](#).
- 257)** For examples of dissenting or separate opinions, see [TME Int'l, Inc. v. Islamic Repub. of Iran, Award in IUSCT Case No. 473-357-1 of 12 March 1990](#), XVI *Y.B. Comm. Arb.* 349 (1991); [Société d'Economie Mixte Guineo v. Martin Marietta Aluminium, Inc., Partial Ad Hoc Award of 12 September 1986 & Final Ad Hoc Award of 21 December 1988](#), XV *Y.B. Comm. Arb.* 11, 21, 29 (1990). See also [Arroyo, \*Dealing With Dissenting Opinions in the Award: Some Options for the Tribunal\*](#), 26 *ASA Bull.* 437 (2008) (discussing possibilities as to how tribunal may proceed if arbitrator submits dissenting opinion).
- 258)** See [B v. A \[2010\] 2 CLC 1, 11 \(QB\)](#) (English High Ct.) (“[the Dissenting Opinion] is not in my view formally part of the Award of the Tribunal”) (citing [Final Report on Dissenting and Separate Opinions Prepared by A Working Party of the ICC Commission on International Arbitration](#)); [W. Craig, W. Park & J. Paulsson, \*International Chamber of Commerce Arbitration\* ¶19.06](#) (3d ed. 2000) (“A dissenting opinion is thus extraneous to the award.”) (emphasis in original); [Rees & Rohn, \*Dissenting Opinions: Can They Fulfil A Beneficial Role?\*](#), 25 *Arb. Int'l* 329, [339 \(2009\)](#) (“A dissenting opinion does not form part of the award itself; it is merely an independent opinion which remains foreign to the award and which neither affects the ruling nor the reasons.”).
- 259)** See [§23.05\[A\]](#).
- 260)** See 1899 Convention for the Pacific Settlement of International Disputes (First Hague Conference), Art. 52(2); Statute of the International Court of Justice, Art. 57; ILC Model Rules on Arbitral Procedure, 1958, Art. 28(2) (“Unless otherwise provided in the compromis, any member of the tribunal may attach his separate or dissenting opinion to the award.”). See also ICSID Rules, Rule 47(3) (any member of tribunal “may attach his individual opinion to the award, whether he dissents from the majority or not, or a statement of his dissent”). Compare 1907 Hague Convention, Art. 79 (no reference to dissent); [Appellate Body Report: United States-Subsidies on Upland Cotton](#), WTO Doc. WT/DS267/AB/R, ¶631 (2005) (first dissenting opinion in WTO proceedings).
- 261)** See, e.g., [Holtzmann & Donovan, \*National Report for USA \(2005\)\*](#), in [J. Paulsson \(ed.\), \*International Handbook on Commercial Arbitration\* 1, 50](#) (1984 & Update 2005) (“In practice, arbitrators in US domestic arbitrations do not write opinions stating the reasons for their dissents, just as they do not write opinions stating the reasons for their awards.”); Lévy, *Dissenting Opinions in International Arbitration in Switzerland*, 5 *Arb. Int'l* 35 (1989); Redfern, *Dissenting Opinions in International Commercial Arbitration: The Good, the Bad and the Ugly*, 20 *Arb. Int'l* 223, 224 (2004) (“In Continental Europe, dissenting opinions were traditionally unknown.”). See also [van den Berg, \*Dissenting Opinions by Party-Appointed Arbitrators in Investment Arbitration\*](#), in [M. Arsanjani et al. \(eds.\), \*Looking to the Future: Essays on International Law in Honor of W. Michael Reisman\* 821, 824](#) (2010).
- 262)** See, e.g., [Québec Code of Civil Procedure, Art. 945](#); [Spanish Arbitration Act, 2011, Art. 37\(3\)](#); [Chinese Arbitration Law, Art. 53](#); [Bulgarian Law on International Commercial Arbitration, Art. 39\(1\)](#); [Brazilian Arbitration Law, Art. 24\(2\)](#).
- 263)** [UNCITRAL, 2012 Digest of Case Law on the Model Law on International Commercial Arbitration 126](#) (2012) (“Model Law neither requires nor prohibits ‘dissenting opinions’”).
- 264)** [H. Holtzmann & J. Neuhaus, \*A Guide to the UNCITRAL Model Law on International Commercial Arbitration: Legislative History and Commentary\* 837, 856](#) (1989).

- 265)** See, e.g., Blessing, *The New International Arbitration Law in Switzerland: A Significant Step Towards Liberalism*, 5(2) J. Int'l Arb. 9, 67 (1988); P. Sanders & A. van den Berg, *The Netherlands Arbitration Act 1986* Art. 33 (1987).
- 266)** See, e.g., ICSID Rules, Rule 47(3); 2012 CIETAC Rules, Art. 47(5).
- 267)** 2010 UNCITRAL Rules, Arts. 34(3), (4).

The drafters of the 1976 UNCITRAL Rules rejected a proposal to prohibit dissenting opinions. UNCITRAL, *Report of the Secretary-General on the Revised Draft Set of Arbitration Rules, Ninth Session*, U.N. Doc. A/CN.9/112/Add.1, VII Y.B. UNCITRAL 166, 178 (1976) (original draft of UNCITRAL Rules contained prohibition on dissenting opinions, which was deleted during drafting).

The Iran-United States Claims Tribunal adopted the UNCITRAL Rules with an amendment to expressly permit dissenting and separate opinions. Iran-US Claims Tribunal Rules of Procedure, Art. 32 ("any arbitrator may request that his dissenting vote and the reasons therefore be recorded").

- 268)** The 2012 ICC Rules do not expressly address the question of dissenting opinions. A working group considered the subject, issuing a final report in 1988 that recognized the possibility (and practice) of dissenting opinions in ICC arbitrations. ICC, *Final Report on Dissenting and Separate Opinion of the ICC Commission on International Arbitration*, 2(1) ICC Ct. Bull. 32 (1991).
- 269)** See, e.g., Hausmaninger, *Rights and Obligations of the Arbitrator With Regard to the Parties and the Arbitral Institution – A Civil Law Viewpoint*, in ICC, *The Status of the Arbitrator* 47 (ICC Ct. Bull. Spec. Supp. 1995); ICC, *Final Report on Dissenting and Separate Opinion of the ICC Commission on International Arbitration*, 2(1) ICC Ct. Bull. 32 (1991).
- 270)** *Noble China Inc. v. Lei*, (1998) 42 O.R.3d 69 (Ontario Super. Ct.) (rejecting application to annul award, but ordering release of dissenting opinion; also refusing to admit into evidence in annulment proceeding dissenting arbitrator's affidavit regarding tribunal's deliberations and refusal to release dissenting opinion).
- 271)** See §23.03; *Interim Award in ICC Case No. 3879*, XI Y.B. Comm. Arb. 127 (1986); *Ad Hoc Award of 29 December 1993*, 9(12) Mealey's Int'l Arb. Rep. A-1 (1994). The obligation of the arbitrators to provide a reasoned explanation for an adjudicative decision almost inevitably implies that members of the tribunal who are unable to agree with all or important parts of the decision have to state this in the award, together with their reasons for dissenting.
- 272)** The process of constituting an international arbitral tribunal is discussed above. See §12.03[A]. One may also fairly question whether prohibitions on dissenting opinions are fully consistent with the model of an adjudicative process.
- 273)** E. Gaillard & J. Savage (eds.), *Fouchard Gaillard Goldman on International Commercial Arbitration* ¶¶1399-1402 (1999); La Spada, in T. Zuberbühler, C. Müller & P. Habegger (eds.), *Swiss Rules of International Arbitration: Commentary* Art. 43, ¶18 (2005).

Some authorities have suggested that a dissenting opinion is permitted only where the parties have expressly authorized it. See Geimer, in R. Zöller (ed.), *Zivilprozessordnung* §1052, ¶5 (26th ed. 2007) ("A dissenting opinion is only admitted given express permission in the parties' arbitration agreement."); J.-P. Lachmann, *Handbuch für die Schiedsgerichtspraxis* ¶1018 (2d ed. 2002) ("It is necessary to require a corresponding agreement of the parties for a dissenting opinion to be admissible."). The correct approach is the converse, treating dissenting opinions as an inherent aspect of the adjudicative process unless affirmatively excluded.

- 274)** Some French judicial decisions held that dissenting opinions were inconsistent with the confidentiality of the arbitrators' deliberations. *Judgment of 15 October 1991, Affichage Giraudy v. Consorts Judlin*, 1991 Rev. arb. 643, 647 (Paris Cour d'appel), Note, Jarrosson ("The secrecy of deliberation is not just a traditional legal rule."); *Judgment of 9 November 1945*, 1946:1 Gaz. Pal. 22 (French Cour de cassation civ. Soc.) (arbitrators required to maintain secrecy of deliberations and therefore are not allowed to reveal arbitrators' votes). See §13.04[C]; §15.08[J]; §20.06 for a discussion of the secrecy of the arbitrators' deliberations.
- 275)** See Geimer, in R. Zöller (ed.), *Zivilprozessordnung* §1052, ¶5 (26th ed. 2007) ("Absent different agreement by the parties, the arbitrators have to keep the secrecy of deliberations (including the voting result). ... A dissenting opinion is only admitted given express permission in the parties' arbitration agreement."); J. Robert, *L'arbitrage: Droit interne, Droit international privé* ¶360 (5th ed. 1983) ("Although it is customary under a certain number of foreign laws, notably Anglo-Saxon, the dissenting opinion is prohibited in French domestic law since it violates the secrecy of the tribunal's deliberations."). For a comprehensive discussion, see Arroyo, *Dealing With Dissenting Opinions in the Award: Some Options for the Tribunal*, 26 ASA Bull. 437, 457-58 (2008).



- 276)** Despite earlier French judicial authority questioning dissenting opinions, more recent French authority rejects this view. *Judgment of 9 October 2008*, 2009 Rev. arb. 352, Note, *Betto & Canivet (Paris Cour d'appel)* ("secrecy of the arbitrators' deliberations, which is not a cause of annulment of the award neither under international nor under domestic law, does not prevent the expression of dissenting or separate opinions"). See also *Arroyo, Dealing With Dissenting Opinions in the Award: Some Options for the Tribunal*, 26 ASA Bull. 437, 459 (2008) ("scientific debate [about dissenting opinions in international arbitration] has become stale and redundant").
- 277)** See §23.04[A]. See also *Rees & Rohn, Dissenting Opinions: Can They Fulfil A Beneficial Role?*, 25 Arb. Int'l 329, 337-38 (2009) ("As long as the dissenting opinion is restricted to issues of evaluation of facts and /or interpretation of the applicable law, and as long as it does not reveal who said what and when and for what reason, there is no violation of confidentiality. Only when the real substance of the tribunal's deliberations is revealed, i.e., the views expressed individually by the arbitrators, their thought processes and the remarks made in the bargaining process through which they tried to reach unanimity or finally formed a majority, would it constitute a violation of the rule of secrecy.").
- 278)** See §23.05[A].
- 279)** See §23.03.
- 280)** *Kirby, With Arbitrators, Less Can Be More: Why the Conventional Wisdom on the Benefits of Having Three Arbitrators May Be Overrated*, 26 J. Int'l Arb. 337, 346, n.37 (2009) ("Most unanimous decisions are unanimous because the arbitrators actually agree on the material points. However, a decision may be unanimous even though material differences of opinion exist within the tribunal. This is because some arbitrators are reluctant (usually for reasons of professional courtesy and a desire to protect the secrecy of deliberations) to issue dissenting opinions, or even highlight points of disagreement in the text of a decision. As a result, an arbitrator who disagrees with the majority will sometimes nevertheless agree to sign on to a decision once the issues are discussed and it becomes clear that his view will not carry the day.").
- 281)** See §13.04; *W. Craig, W. Park & J. Paulsson, International Chamber of Commerce Arbitration* ¶19.06 (3d ed. 2000) ("The view of the present authors is that while dissenting opinion may exceptionally be justified, they are generally to be discouraged."). As discussed below, these duties are particularly weighty with respect to co-arbitrators, nominated by one of the parties. See §23.05[B], p. 3058 n. 288.
- 282)** See §12.05[B]; §13.04[A][1].
- 283)** See *Redfern, Dangerous Dissents*, 70 Arb. 200, 204 (2005) ("reprehensible" dissent "does not merely disagree with his or her colleagues on issues of fact or law, or on their reasoning, but instead takes the opportunity of issuing a dissenting opinion to attack the way in which the arbitration itself was conducted"); *Schwartz, The Rights and Duties of ICC Arbitrators*, in *ICC, The Status of the Arbitrator* 67, 84 (ICC Ct. Bull. Spec. Supp. 1995) ("Even if an arbitrator disagrees with the decisions of his or her co-arbitrators and ultimately with the award rendered, it is therefore not proper for the arbitrator to attempt to sabotage the decisions of the majority.").
- 284)** For examples of dissenting opinions that have revealed the confidential aspects of the tribunal's deliberations, see *Unidyne Corp. v. Islamic Repub. of Iran, Award in IUSCT Case No. 551-368-3 of 10 November 1993*, 29 Iran-US C.T.R. 349, 355-56 (1993); *Phillips Petroleum Co. v. Islamic Repub. of Iran, Award in IUSCT Case No. 425-39-2 of 29 June 1989*, 21 Iran-US C.T.R. 256 (1989); *Granger Assocs. v. Islamic Repub. of Iran, Award in IUSCT Case No. 320-184-1 of 20 October 1987*, 16 Iran-US C.T.R. 317, 332 (1988) ("It is also wrong for my colleagues to confirm the improper actions of the Claimant in pestering the Chamber Clerk ..."; "It is completely unjustifiable to contend, as my colleagues do ..."; "My colleagues have gone a long way in their speculation ..."); *RayGo Wagner Equip. Co. v. Star Line Iran Co., Award No. 20-17-3 of 15 December 1982*, 1 Iran-US C.T.R. 424 (1981).
- 285)** See, e.g., *Eureko BV v. Repub. of Poland, Partial Ad Hoc Award of 19 August 2005, Dissenting Opinion* ¶6, available at ita.law.uvic.ca ("This confusion is still visible throughout the Tribunal's reasons and probably contributed to a certain extent to its decision."; "both inaccurate and groundless"); *CME Czech Repub. BV v. Czech Repub., Partial Ad Hoc Award of 13 September 2001, Dissenting Opinion* ¶4 ("The mistakes and errors in the legal conclusions have been basically [produced] by the fact that the two arbitrators seem to have firstly agreed upon the final decision as it is expressed in the Award and only thereafter they looked for the arguments to the favor of the Claimant.").
- 286)** See, e.g., *Abyei Arbitration, Dissenting Opinion of Judge Al-Khasawneh in PCA Case No. GOS-SPLM 53,391 of 22 July 2009* ("The question therefore, and it is a disquieting one, is why does a Tribunal, provided with all the available evidence and guided through it by learned counsel on both sides, and moreover provided with the benefit of hindsight that all reviewing bodies have, and in a position to assess the evidence before it comprehensively, elect, instead, to look at reality not in a holistic manner but in a disconnected way, making wild flights of fancy on the basis of misinterpreted sentences taken out of context so as to make dead men say what they never said or intended?").

- 287)** See, e.g., *A v. B* [2010] EWHC 1626, ¶13 (Comm) (English High Ct.) (“The dissenting arbitrator issued a Dissenting Opinion of some 19 pages. It is expressed in unusually trenchant terms. ... The dissenting arbitrator was highly critical of her colleagues. They had, she said, decided to ignore the parties’ agreement to submit the SPA to Spanish law and had in an arbitrary fashion proceeded to decide the dispute “*ex aequo et bono*.”).
- 288)** M. de Boissésou, *Le droit français de l’arbitrage interne et international* ¶781 (2d ed. 1990). See also Rees & Rohn, *Dissenting Opinions: Can They Fulfil A Beneficial Role?*, 25 *Arb. Int’l* 329, 336 (2009) (“possibility of issuing a dissenting opinion provides the minority arbitrator with an easy way out of the deliberations as soon as he suspects that he cannot prevail with his opinion, and some arbitrators might even feel pressure to please and support the party that appointed them and to disclose that support”); van den Berg, *Dissenting Opinions by Party-Appointed Arbitrators in Investment Arbitration*, in M. Arsanjani et al. (eds.), *Looking to the Future: Essays on International Law in Honor of W. Michael Reisman* 821, 825 (2010).
- 289)** *Tokios Tokelés v. Ukraine*, *Dissenting Opinion by Chairman Prosper Weil in Decision on Jurisdiction in ICSID Case No. ARB/02/18 of 29 April 2004*, 20 *ICSID Rev. Foreign Inv. L.J.* 205, 245 (2005) (“The chairman of an arbitral tribunal dissenting from a decision drafted by his two colleagues: this is not a frequent occurrence.”).
- 290)** Brower & Rosenberg, *The Death of the Two-Headed Nightingale: Why the Paulsson-van den Berg Presumption That Party-Appointed Arbitrators Are Untrustworthy Is Wrongheaded*, 29 *Arb. Int’l* 7, 27 (2013) (“dissenting opinions play a critical role in fostering the legitimacy of international arbitration”).
- 291)** See also van den Berg, *Dissenting Opinions by Party-Appointed Arbitrators in Investment Arbitration*, in M. Arsanjani et al. (eds.), *Looking to the Future: Essays on International Law in Honor of W. Michael Reisman* 821, 828 (2010) (“a dissent should not be a platform for preparing for annulment”).
- 292)** It is theoretically possible that an arbitrator will witness improprieties in the course of the arbitral proceedings, which go to the integrity of the proceeding. In that event, the arbitrator might properly raise these matters in a dissenting or separate opinion. Doing so would be an exceptional action, restricted to extraordinary circumstances with any such comments being accordingly limited.
- 293)** *Judgment of 15 May 2003, Czech Repub. v. CME Czech Repub. BV*, Case No. T 8735-01 (Svea Ct. App.), reprinted in S. Jarvin & A. Magnusson (eds.), *International Arbitration Court Decisions* 663, 678-79 (2006). The court also discussed the process of deliberations, emphasizing the need for flexibility, cost-effectiveness and freedom to fix deadlines for presenting views. See also §15.08[J]; §25.04[B][4]; §26.05[C][3][d].
- 294)** See, e.g., *Bank Mellat v. GAA Dev. & Constr. Co.* [1988] 2 *Lloyd’s Rep.* 44 (QB) (English High Ct.) (obligation to deliberate with dissenting arbitrator is dispensed with only where it would be futile); *Re Pering & Keymer* [1835] 3 *Ad. & El.* 245 (English K.B.) (annulling award because dissenting arbitrator was not given opportunity to present views to other arbitrators).
- 295)** See §25.04[B][4]; §26.05[C][3][d].
- 296)** See §13.07[A][2] and §15.08[J] for a discussion of the arbitrators’ rights and duties during deliberations and the role of the presiding arbitrator in deliberations.
- 297)** Paulsson, *Moral Hazard in International Dispute Resolution*, 8(2) *Transnat’l Disp. Mgt* 12 (2011); van den Berg, *Dissenting Opinions by Party-Appointed Arbitrators in Investment Arbitration*, in M. Arsanjani et al. (eds.), *Looking to the Future: Essays on International Law in Honor of W. Michael Reisman* 821, 825 (2010) (“That nearly 100 percent of the dissents [in investment arbitration] favour the party that appointed the dissenter raises concerns about neutrality.”).
- 298)** See Brower & Rosenberg, *The Death of the Two-Headed Nightingale: Why the Paulsson-van den Berg Presumption That Party-Appointed Arbitrators Are Untrustworthy Is Wrongheaded*, 29 *Arb. Int’l* 7 (2013); C. Rogers, *Ethics in International Arbitration* (2014).
- 299)** See Brower & Rosenberg, *The Death of the Two-Headed Nightingale: Why the Paulsson-van den Berg Presumption That Party-Appointed Arbitrators Are Untrustworthy Is Wrongheaded*, 29 *Arb. Int’l* 7 (2013).
- 300)** See §12.03[A][2].
- 301)** See §12.03[A][2].
- 302)** International arbitration conventions do not address the issue of time limits for awards.
- 303)** See, e.g., UNCITRAL Model Law; U.S. FAA; English Arbitration Act, 1996; Swiss Law on Private International Law.
- 304)** See §15.02[B]. Some legislation expressly confirms this discretion. See, e.g., *Netherlands Code of Civil Procedure, Art. 1048* (“The arbitral tribunal is free to determine the time when the award shall be made.”); *Peruvian Arbitration Law, Art. 53* (“The controversy must be notified and decided according to the time established by the parties, by the arbitral rules, or in default, by the arbitral tribunal.”).
- 305)** See §15.08[O]; §25.04[D][3]; §26.05[C][5][c].

**306)** [French Code of Civil Procedure, Art. 1463\(1\)](#). This time limit may be extended by agreement or by a French court. [French Code of Civil Procedure, Art. 1463\(2\)](#). The limit does not apply in international arbitration. [French Code of Civil Procedure, Art. 1506](#).

Historically, English arbitration legislation imposed a three-month limit for the making of an award. [English Arbitration Act, 1950, §13](#). The English Arbitration Act, 1996, abrogated this limitation.

**307)** See, e.g., [Belgian Judicial Code, Art. 1713\(2\)](#) (six months); [Italian Code of Civil Procedure, Art. 820](#) (domestic arbitration) (time limit of 240 days unless otherwise agreed); [Brazilian Arbitration Law, Art. 23](#) (time limit of six months unless otherwise agreed).

**308)** See [§11.03\[C\]\[2\]](#); [§11.03\[D\]\[2\]\[b\]](#).

**309)** See [§11.05\[B\]\[2\]](#); E. Gaillard & J. Savage (eds.), *Fouchard Gaillard Goldman on International Commercial Arbitration* ¶1382 (1999).

**310)** That is the case in France. Article 1463 of the French Code of Civil Procedure only applies to domestic arbitrations and not to international arbitration (see Art. 1506). See also *Judgment of 15 June 1994, Sonidep v. Sigmoil*, 1995 Rev. arb. 88 (French Cour de cassation civ. 1e) (under earlier French legislation); E. Gaillard & J. Savage (eds.), *Fouchard Gaillard Goldman on International Commercial Arbitration* ¶1384 (1999) (same). Compare [Belgian Judicial Code, Art. 1680\(3\)](#).

**311)** See, e.g., 2012 ICC Rules, Art. 30(1) (six months, subject to extensions); 2012 LMAA Terms, Art. 20 (six weeks); 2010 SCC Rules, Art. 37; 2013 SIAC Rules, Art. 5(2)(d) (expedited procedure).

Most institutional rules are to the contrary, containing no time limits (including the UNCITRAL, ICDR and LCIA Rules). See also [§15.08\[O\]](#); [§25.04\[C\]\[5\]](#); [§26.05\[C\]\[5\]](#).

**312)** See [§15.08\[O\]](#); G. Born, *International Arbitration and Forum Selection Agreements: Drafting and Enforcing 104-05* (4th ed. 2013).

**313)** See, e.g., *Art & Sound Ltd v. W. End Litho Ltd* [1992] 1 EG 110 (Ch) (English High Ct.); *Bradley & Sons v. Telefusion Ltd* [1981] 259 EG 337 (Ch) (English High Ct.); *Judgment of 16 June 1976, Dame Krebs v. Milton Stern*, 1977 Rev. arb. 269 (French Cour de cassation civ. 1e); *Judgment of 22 January 1982, Appareils Dragon v. Construiport*, 1982 Rev. arb. 91 (Paris Cour d'appel).

**314)** See [§15.02\[B\]](#).

**315)** *Judgment of 15 June 1994, Communauté urbaine de Casablanca v. Degrémont*, 1995 Rev. arb. 88, 88 (French Cour de cassation civ. 1e).

**316)** [French Code of Civil Procedure, Art. 1463\(2\)](#) (applicable in both domestic and international arbitration); E. Gaillard & J. Savage (eds.), *Fouchard Gaillard Goldman on International Commercial Arbitration* ¶1387 (1999).

As discussed above, under French law, the extension of time limits must result from judicial action or the parties' agreement. See, e.g., *Judgment of 18 October 2001*, 2002 Rev. arb. 899 (French Cour de cassation civ. 2e), Note, Betto (allowing a tacit extension).

**317)** [English Arbitration Act, 1996, §50](#). The possibility of judicial extension can be excluded by agreement.

**318)** [Belgian Judicial Code, Art. 1680\(3\)](#).

**319)** See, e.g., [Italian Code of Civil Procedure, Art. 820](#) (arbitral tribunal may extend deadline once).

**320)** *Art & Sound Ltd v. W. End Litho Ltd* [1992] 1 EG 110 (Ch) (English High Ct.); *Bradley & Sons v. Telefusion Ltd* [1981] 259 EG 337 (Ch) (English High Ct.).

**321)** For decisions under Article 1484 (domestic arbitration) and Article 1502 (international arbitration) of the former French New Code of Civil Procedure, see *Judgment of 19 November 2009*, 2011 Rev. arb. 152 (Paris Cour d'appel); *Judgment of 22 September 1995, Dubois et Vanderwalle v. Boots Frites BV*, 1996 Rev. arb. 101 (Paris Cour d'appel); *Judgment of 17 January 1984, Bloch et Fils v. Delatrae Mockfjaerd*, 1984 Rev. arb. 498 (Paris Cour d'appel); E. Gaillard & J. Savage (eds.), *Fouchard Gaillard Goldman on International Commercial Arbitration* ¶1388 (1999).

The revised French arbitration statute does not explicitly provide that an award shall be set aside if it was rendered outside the statutory time limit. Instead, the new provisions state that "an award may ... be set aside where: (1) the arbitral tribunal wrongly upheld or declined jurisdiction" or where "(3) the arbitral tribunal ruled without complying with the mandate conferred upon it." [French Code of Civil Procedure, Art. 1492](#) (domestic), [Art. 1520](#) (international). See Derains & Kiffer, *National Report for France (2013)*, in J. Paulsson (ed.), *International Handbook on Commercial Arbitration 1* (1984 & Update 2013). See also [§25.04\[C\]\[5\]](#), pp. 3267-68.

**322)** *Judgment of 21 February 1978, X Y.B. Comm. Arb. 418* (Austrian Oberster Gerichtshof) (1985) ("Proof of notification of the claim and of the arbitral award to the respondent is, according to Art. IV of the Convention, not a requirement for an application for enforcement."). See van Houtte, *The Delivery of Awards to the Parties*, 21 Arb. Int'l 177 (2005).

- 323)** [UNCITRAL Model Law, Art. 31\(4\)](#). See H. Holtzmann & J. Neuhaus, *A Guide to the UNCITRAL Model Law on International Commercial Arbitration: Legislative History and Commentary* 856 (1989); P. Sanders, *The Work of UNCITRAL on Arbitration and Conciliation* 123 (2d ed. 2004).
- 324)** See, e.g., [Finnish Arbitration Act, §37](#); [Italian Code of Civil Procedure, Art. 825](#); [Indian Arbitration and Conciliation Act, Art. 31\(5\)](#); [New Zealand Arbitration Act, Schedule 1, Art. 31\(4\)](#); [Brazilian Arbitration Law, Art. 29](#); [Iranian International Commercial Arbitration Law, Art. 30\(4\)](#).
- 325)** See, e.g., [German ZPO, §1054\(4\)](#); [Netherlands Code of Civil Procedure, Art. 1058\(1\)\(a\)](#); [Austrian ZPO, §606\(4\)](#).
- 326)** [Swiss Law on Private International Law, Art. 190](#) (“The award is final from the time when it is communicated.”).
- 327)** [Belgian Judicial Code, Art. 1713\(8\)](#); [Costa Rican Arbitration Law, 2011, Art. 31\(4\)](#); [Venezuelan Commercial Arbitration Law, Art. 31](#).
- 328)** [English Arbitration Act, 1996, §55\(1\)](#). In practice, this permits the parties to agree that an arbitrator may inform the parties that the award is available to be collected or that such a procedure can be impliedly agreed from common practice.
- 329)** [English Arbitration Act, 1996, §55\(2\)](#); R. Merkin, *Arbitration Law* ¶18.32 (1991 & Update August 2013).
- 330)** See *Dist. Council 1707 v. Hope Day Nursery, Inc.*, 2006 WL 17791, at \*3 (S.D.N.Y.) (applying AAA Labor Arbitration Rule 40 that “[p]arties shall accept as legal delivery of the award the placing of the award or a true copy thereof in the mail by the AAA, addressed to the party at its last known address or to its representative; personal service of the award; or the filing of the award in any other manner that is permitted by law”); *Skaarup Shipping Corp. v. Sea Marshall Navigation, Ltd.*, 1995 WL 110371, at \*1-2 (S.D.N.Y.) (applying service of award provision in Society of Maritime Arbitrators arbitration rules as agreed by parties, such that “[p]arties shall accept as legal delivery of the award (a) the placing of the award or a true copy thereof in the mail by the arbitrator(s), addressed to such party at his last known address or to his attorney, or (b) personal service of the award”).

U.S. courts generally construe “notice” in contracts according to its ordinary meaning. *Detroit Coil Co. v. Int’l Ass’n of Machinists & Aerospace Workers*, 594 F.2d 575, 580 (6th Cir. 1979) (“The term ‘notified,’ as used in the Agreement, must be given its ordinary meaning in the absence of evidence indicating that the parties to this contract intended to expand or otherwise deviate from that meaning. The word ‘notified,’ in its ordinary usage, means the completed act of bringing information to the attention of another.”). Where issues of service or notification raise due process concerns, courts apply “the forum state’s standards of due process,” which requires notice “reasonably calculated, under all the circumstances, to apprise interested persons of the pendency of the action and afford them an opportunity to present their objections.” *Compagnie des Bauxites de Guinee v. Hammermills, Inc.*, 1992 WL 122712, at \*4 (D.D.C.) (quoting *Mullane v. Cent. Hanover Bank & Trust Co.*, 339 U.S. 306, 314 (U.S. S.Ct. 1950)). See also *Geotech Lizenz AG v. Evergreen Sys., Inc.*, 697 F.Supp. 1248, 1263 (E.D.N.Y. 1988).

- 331)** Indeed, as noted above, the Model Law provides “[a]fter an award is made,” it shall be delivered to the parties. [UNCITRAL Model Law, Art. 31\(4\)](#).

Different national arbitration statutes deal differently with the question whether an “original” or a signed “copy” of the award is to be delivered to the parties. Compare [German ZPO, §1054\(4\)](#) (originals of award delivered to parties) and [Belgian Judicial Code, Art. 1713\(8\)](#) (same) and [Austrian ZPO, §606\(4\)](#) (same) and [Italian Code of Civil Procedure, Art. 825](#) (same) with [English Arbitration Act, 1996, §55](#) (one original with signed copies) and [Netherlands Code of Civil Procedure, Art. 1058\(1\)](#) (same) and [Swedish Arbitration Act, §31\(3\)](#) (same). There is no apparent substantive difference between these approaches, save arguably in the extremely unlikely case of differences in different versions of signed originals.

- 332)** [Swiss Law on Private International Law, Art. 190](#). See Berti & Schnyder, in S. Berti et al. (eds.), *International Arbitration in Switzerland* Art. 190, ¶¶6 et seq. (2000).
- 333)** See §24.02.
- 334)** See, e.g., [UNCITRAL Model Law, Art. 33\(1\)](#) (“Within thirty days of receipt of the award ...”); [French Code of Civil Procedure, Art. 1486\(1\)](#); [Netherlands Code of Civil Procedure, Art. 1060\(1\)](#); [Japanese Arbitration Law, Art. 41\(2\)](#); §§24.03[A]-[B].



- 335)** See, e.g., [UNCITRAL Model Law, Art. 34\(3\)](#) (“three months from the date on which the party making that application had received the award”); [French Code of Civil Procedure, Art. 1494\(2\)](#), 1519; [Swiss Law on Private International Law, Art. 190\(3\)](#) (“time-limit runs from the communication of the decision”); [Hong Kong Arbitration Ordinance, 2013, Art. 81\(1\)](#); [Chinese Arbitration Law, Art. 59](#); [Japanese Arbitration Law, Art. 44\(2\)](#) (“from the date on which the party making the application had received the notice by the sending of a copy of the arbitral award”); [Korean Arbitration Act, Art. 36\(3\)](#); [Australian International Arbitration Act, 2011, Schedule 2, Art. 34\(3\)](#); [Malaysian Arbitration Act, §7\(4\)](#); [Peruvian Arbitration Law, Art. 64](#) (“twenty days from the notification of the award”); [Venezuelan Commercial Arbitration Law, Art. 43](#) (“five working days following the notification of the award or of the decision that corrects, clarifies or completes it”). See also [§24.02\[B\]](#). Compare [English Arbitration Act, 1996, §70\(3\)](#) (date award was rendered).
- 336)** [UNCITRAL Model Law, Art. 32\(1\)](#); [French Code of Civil Procedure, Art. 1485](#); [Hong Kong Arbitration Ordinance, 2013, Art. 68](#); [Japanese Arbitration Law, Art. 40\(1\)](#); [Korean Arbitration Act, Art. 33\(1\)](#); [Australian International Arbitration Act, 2011, Schedule 2, Art. 32\(1\)](#); [Malaysian Arbitration Act, §34\(1\)](#).
- 337)** See, e.g., 2012 ICC Rules, Art. 34; ICDR Rules, Art. 27; LCIA Rules, Art. 26; DIS Rules, §36; 2013 VIAC Rules, Art. 36(5). Compare 2012 Swiss Rules, Art. 32(6).
- 338)** See, e.g., [UNCITRAL Model Law, Art. 31\(4\)](#); [English Arbitration Act, 1996, §55\(2\)](#); [German ZPO, §1054\(4\)](#); [Netherlands Code of Civil Procedure, Art. 1058\(1\)\(a\)](#); [Austrian ZPO, §606\(4\)](#); [Hong Kong Arbitration Ordinance, 2013, Art. 67\(1\)](#); [Japanese Arbitration Law, Art. 39\(5\)](#); [Korean Arbitration Act, Art. 32\(4\)](#); [Australian International Arbitration Act, 2011, Schedule 2, Art. 31\(4\)](#); [Malaysian Arbitration Act, §33\(5\)](#); [Venezuelan Commercial Arbitration Law, Art. 31](#).
- 339)** See [§15.04\[B\]\[2\]](#); [§25.04\[B\]\[1\]](#); [§26.05\[C\]\[3\]\[a\]](#).
- 340)** See [Chapter 20](#) (especially [§20.03\[D\]](#)).
- 341)** [French Code of Civil Procedure, Art. 1484\(3\)](#) (domestic arbitration), [Art. 1519\(3\)](#) (international arbitration); [Finnish Arbitration Act, §37](#).
- 342)** This is increasingly common with the widespread usage of emails and fax transmissions.
- 343)** See, e.g., [Belgian Judicial Code, Arts. 1678\(1\), 1716](#). See also van Houtte, *The Delivery of Awards to the Parties*, 21 Arb. Int’l 177, 180-81 (2005).
- 344)** These requirements can be complex and highly-formalistic. For the U.S. position, see G. Born & P. Rutledge, *International Civil Litigation in United States Courts* 871-81 (5th ed. 2011).
- Equally complex and formalistic are European requirements. EC Regulation 1348/2000. As discussed above, similar issues are sometimes raised in connection with other formal written instruments in the arbitral process (e.g., service of the Request for Arbitration). See [§15.08\[KK\]](#).
- 345)** The Hague Convention on the Service Abroad of Judicial and Extrajudicial Documents is the principal example of an international treaty regulating cross-border service of process in national court proceedings. See G. Born & P. Rutledge, *International Civil Litigation in United States Courts* 875-77 (5th ed. 2011). The Convention provides for service via a Central Authority mechanism, with alternative means where Member States have not objected. *Id.* at 876-77. In general, the formalities and delays that attend service under the Hague Service Convention make it unsuitable for international arbitration. See also [§15.08\[B\]](#).
- 346)** Compare van Houtte, *The Delivery of Awards to the Parties*, 21 Arb. Int’l 177, 184-85 (2005).
- 347)** See, e.g., 2012 ICC Rules, Art. 34(1) (“The Secretariat shall notify to the parties the text signed by the Arbitral Tribunal.”); ICDR Rules, Art. 27(5) (“Copies of the award shall be communicated to the parties by the administrator.”); LCIA Rules, Art. 26(5) (“The sole arbitrator or chairman shall be responsible for delivering the award to the LCIA Court, which shall transmit certified copies to the parties.”); 2013 VIAC Rules, Art. 36(5) (“The award shall be served on the parties by the Secretary General.”).
- 348)** One exception is the [English Arbitration Act, 1996, §55\(1\)](#), which recognizes the parties’ autonomy to agree upon modes of notification of the award. This express recognition reflects the implied understanding that exists under other national legal systems.
- 349)** See [§15.02](#).
- 350)** [Belgian Judicial Code, Art. 1713\(8\)](#); [Netherlands Code of Civil Procedure, Art. 1060](#); [Korean Arbitration Act, Art 32\(4\)](#).
- 351)** See [§1.01\[C\]\[2\]](#); [§1.04\[A\]\[1\]](#).
- 352)** For example, the revised Spanish Arbitration Act abandoned the historic requirement that the award be deposited with a notary, which had resulted in awards being set aside when not complied with. See Mullerat, *Spain Joins the Model Law*, 20 Arb. Int’l 139, 146 (2004).

- 353)** For commentary, see Y. Derains & R. Kreindler, in ICC Dossiers, *Evaluation of Damages in International Arbitration* (2006); Jarvin, *Non-Pecuniary Remedies: The Practices of Declaratory Relief and Specific Performance in International Commercial Arbitration*, in A. Rovine (ed.), *Contemporary Issues in International Arbitration and Mediation: The Fordham Papers 2006* 167 (2007); L. Lévy & F. De Ly (eds.), *Interest, Auxiliary and Alternative Remedies in International Arbitration* (2008); M. Schneider & J. Knoll (eds.), *Performance as A Remedy: Non-Monetary Relief in International Arbitration* (ASA Spec. Series No. 30 2011); Schreuer, *Non-Pecuniary Remedies in ICSID Arbitration*, 20 *Arb. Int'l* 325 (2004).
- 354)** See §1.02[B][6].
- 355)** See §15.02.
- 356)** See §11.03[B]; §12.01; §12.02[A]; §12.04[D]; §12.05[C]; §15.02; §17.02[C]; §17.04[D]; §18.02[B][2]. A Contracting State's refusal to give effect to the parties' agreement regarding an arbitral tribunal's remedial authority would potentially be contrary to Articles II and V(1)(d) of the New York Convention.
- 357)** Requests for certain forms of relief (e.g., criminal sanctions, purported declarations of bankruptcy) would be considered nonarbitrable in most jurisdictions. See §6.01.
- 358)** See Part I; §2.02; §10.01[A]; §16.02[D]; §17.02[A][5][a].
- 359)** See §6.04; §23.07[D]; §25.04[G]; §26.05[C][10].
- 360)** See, e.g., *Singapore International Arbitration Act, 2012, §12(5)* (providing arbitrators power to award any remedy or relief that could be ordered by Singapore court if dispute had been subject of civil proceedings in such court and power to award interest).
- 361)** See, e.g., *English Arbitration Act, 1996, §48* (permitting parties to agree upon tribunal's remedial authority, but prescribing default powers). Section 48 provides that an arbitral tribunal may, absent contrary agreement: (a) order payment of money; (b) grant declaratory relief; (c) grant the same relief as an English court with regard to injunctive relief and rectification; and (d) grant specific performance (except for contracts relating to land). See R. Merkin, *Arbitration Law* ¶18.55 (1991 & Update August 2013). See also *Hong Kong Arbitration Ordinance, 2013, Art. 70* (similar to England but denying arbitrators power to order specific performance of contracts relating to land or any interest in land).
- 362)** See §19.03; §26.05[C][12].
- 363)** *Avraham v. Shigur Express, Ltd*, 1991 WL 177633, at \*4 (S.D.N.Y.). See also *United Steelworkers of Am. v. Enter. Wheel & Car Corp.*, 363 U.S. 593, 597 (U.S. S.Ct. 1960); *Reliastar Life Ins. Co. of N.Y. v. EMC Nat'l Life Co.*, 564 F.3d 81, 86 (2d Cir. 2009) ("Where an arbitration clause is broad, arbitrators have the discretion to order such remedies as they deem appropriate."); *Todd Shipyards Corp. v. Cunard Line Ltd*, 943 F.2d 1056, 1064 (9th Cir. 1991) ("Federal law takes an expansive view of arbitrator authority to decide disputes and fashion remedies."); *Chameleon Dental Prods., Inc. v. Jackson*, 925 F.2d 223, 226 (7th Cir. 1991); *Anderman/Smith Operating Co. v. Tenn. Gas Pipeline Co.*, 918 F.2d 1215, 1219 (5th Cir. 1990); *Resilient Floor v. Welco Mfg Co.*, 542 F.2d 1029, 1032 (8th Cir. 1976); *David Co. v. Jim Miller Constr., Inc.*, 444 N.W.2d 836, 842 (Minn. 1989) (broad remedial authority).
- 364)** *Konkar Maritime Enters., SA v. Compagnie Belge d'Affretement*, 668 F.Supp. 267, 271 (S.D.N.Y. 1987). See also *Advanced Micro Devices, Inc. v. Intel Corp.*, 885 P.2d 994, 1002 (Cal. 1994) ("The principle of arbitral finality [and] the practical demands of deciding on an appropriate remedy for breach ... dictate that arbitrators, unless expressly restricted by the agreement or the submission to arbitration, have substantial discretion to determine the scope of their contractual authority to fashion remedies, and that judicial review of their awards must be correspondingly narrow and deferential."); Revised Uniform Arbitration Act, §21, comment 3 (2000) ("traditional, broad right of arbitrators to fashion remedies ... generally, their authority to structure relief is defined and circumscribed not by legal principle or precedent but by broad concepts of equity and justice").
- 365)** K. Berger, *International Economic Arbitration* 339 (1993). See also Munoz, *The Power of Arbitrators to Make Pro Futuro Orders*, in M. Schneider & J. Knoll (eds.), *Performance as A Remedy: Non-Monetary Relief in International Arbitration* 118 (ASA Spec. Series No. 30 2011) ("arbitrators have the broadest autonomy to frame non-pecuniary orders, the criteria of substantive law notwithstanding"); Nossia, *Punitive Damages in Arbitration: Panacea or Curse?*, in M. Moser & D. Hascher (eds.), 27 *J. Int'l Arb.* 277, 283 (2010) ("arbitral tribunal may in certain respects have wider powers than those of a judge, because the tribunal's powers flow from, inter alia, the arbitration agreement"); Platte, in S. Riegler et al. (eds.), *Arbitration Law of Austria: Practice and Procedure* §593, ¶11 (2007) ("An arbitral tribunal with its seat within Austria may issue those types of interim measures known to Austrian law. The arbitral tribunal is not however limited to these types of measures. It may also grant interim measures of a type unknown to Austrian law.").

- 366)** See, e.g., *Harper Ins. Ltd v. Century Indem. Co.*, 819 F.Supp.2d 270, 277 (S.D.N.Y. 2011) (“Petitioners conflate the question of whether an *issue* was presented to the arbitrators with the question of whether a *potential remedy* was presented to the arbitrators. It is indisputable that arbitrators have no authority to rule on an issue not submitted to them. However, there is no parallel per se rule that it is beyond the authority of the arbitrators to issue a remedy directed to an issue squarely before them unless it was requested by one of the parties. The case law presented by petitioners only supports the former, uncontested, rule of law.”) (emphasis in original).
- 367)** See, e.g., *Reliastar Life Ins. Co. v. EMC Nat’l Life Co.*, 564 F.3d 81, 86 (2d Cir. 2009) (“Where an arbitration clause is broad, arbitrators have the discretion to order such remedies as they deem appropriate.”); *Banco de Seguros del Estado v. Mut. Marine Office, Inc.*, 344 F.3d 255 (2d Cir. 2003); *Serv. Employees Int’l Union v. Local 1199 N.E.*, 70 F.3d 647 (1st Cir. 1995) (arbitral tribunal has inherent remedial authority); *United Elec. Radio & Mach. Workers of Am. v. Honeywell, Inc.*, 522 F.2d 1221 (7th Cir. 1975) (arbitral tribunal has inherent remedial authority); *Vogel v. Simon*, 201 N.Y.S.2d 877 (N.Y. Sup. Ct. 1960) (arbitral tribunal has inherent remedial authority).
- 368)** *Nearctic Nickel Mines Inc. v. Canadian Royalties Inc.*, [2012] QCCA 385 (Québec Ct. App.).
- 369)** See, e.g., *Shoprite Checkers (Pty) Ltd v. Comm’n for Conciliation Mediation & Arbitration*, [2006] ZALC 56, ¶8 (South African Labour Ct.) (“The commissioner is required to ‘establish picketing rules’ and not issue an award with brief reasons. Arbitration lacks the flexibility that is required for determining picketing rules.”).
- 370)** *Harper Ins. Ltd v. Century Indem. Co.*, 819 F.Supp.2d 270, 277 (S.D.N.Y. 2011) (“LMCs’ position essentially asks us to ... find that the arbitrators necessarily exceeded the scope of their authority by fashioning relief not specifically requested, even though the relief was ordered to remedy an issue they concede was submitted to the Panel. Such a holding is fundamentally at odds with the role of the courts in reviewing arbitration awards. ... [A] reviewing court simply asks whether the award ‘draws its essence from the agreement to arbitrate’ or has a ‘barely colorable justification.’”) (quoting *Banco de Seguros*, 344 F.3d at 260).
- 371)** See §25.04[F][3][a]; §26.05[C][4][c][i].
- 372)** See §25.04[F][3][c]; §26.05[C][4][c][ii].
- 373)** See §25.04[F][3][h]; §26.05[C][12].
- 374)** See §6.02; §23.07[A].
- 375)** See §6.02; §§23.07[D]-[E].
- 376)** See, e.g., [English Arbitration Act, 1996, §48](#); [Singapore International Arbitration Act, 2012, §12\(5\)](#); [Hong Kong Arbitration Ordinance, 2013, Art. 70](#).
- 377)** R. Merkin, *Arbitration Law* ¶¶18.57 to 18.60 (1991 & Update August 2013).
- 378)** Smit, *Judgments and Arbitral Awards in A Foreign Currency: A Means of Dealing With Currency Fluctuations in International Adjudication*, 7 Am. Rev. Int’l Arb. 21 (1996).
- 379)** [English Arbitration Act, 1996, §48\(4\)](#); *Kinetics Tech. Int’l v. Cross Seas Shipping Corp.* [2001] 2 Lloyd’s Rep. 313, 313 (Comm) (English High Ct.) (award is to be made in “currency which most justly expressed the loss which has been sustained by the claimants”); R. Merkin, *Arbitration Law* ¶18.60 (1991 & Update August 2013).
- At common law, English courts held that arbitral awards made in London (or abroad) could be expressed in currencies other than pounds sterling and that such awards could be enforced in England; this was true even at a time when English courts were only able to issue judgments in pounds sterling. *Jugoslavenska Oceanska Plovidba v. Castle Inv. Co.* [1974] QB 292 (English Ct. App.) (award made in USD in London enforced; USD amount converted to sterling as of date of award).
- 380)** See, e.g., *Lesotho Highlands Dev. Auth. v. Impregilo SpA* [2006] 1 AC 221 (House of Lords).
- In some legal systems, an award may in some circumstances be required to be converted into local currency for enforcement purposes. See [Judgment of 30 May 2006, 3 Ob 98/06t \(Austrian Oberster Gerichtshof\) \(forced sale of real property\)](#).
- 381)** *Lesotho Highlands Dev. Auth. v. Impregilo SpA* [2006] 1 AC 221 (House of Lords); *Miliangos v. George Frank (Textiles) Ltd* [1976] AC 443 (House of Lords); *Jugoslavenska Oceanska Plovidba v. Castle Inv. Co.* [1974] QB 292 (English Ct. App.).
- 382)** The English Arbitration Act, 1996, provides that an arbitral tribunal has the power to grant declaratory and injunctive relief (in the latter case, generally to the same extent as an English court). [English Arbitration Act, 1996, §48\(5\)](#) (relief arbitral tribunal may order is generally identical to remedies available in English courts (with exception of contracts concerning land)); [Irish Arbitration Act, §26](#) (“Unless a contrary intention is expressed therein, every arbitration agreement shall, where such a provision is applicable to the reference, be deemed to contain a provision that the arbitrator or umpire shall have the same power as the Court to order specific performance of any contract other than a contract relating to land or any interest in land.”); [Singapore International Arbitration Act, 2012, §12\(1\)](#); [Hong Kong Arbitration Ordinance, 2013, Art. 70](#). See R. Merkin, *Arbitration Law* ¶¶18.55, 18.71 to 18.72 (1991 & Update August 2013).

- 383)** See [§25.04\[F\]\[3\]\[h\]](#); [§26.05\[C\]\[4\]](#); *Bowen v. Amoco Pipeline Co.*, 254 F.3d 925, 937 (10th Cir. 2001) (“The arbitrators’ power to award equitable relief is also well established.”); *Brown v. Coleman Co.*, 220 F.3d 1180, 1183–84 (10th Cir. 2000) (same); *Island Creek Coal Sales Co. v. City of Gainesville*, 729 F.2d 1046, 1049 (6th Cir. 1984) (“The Agreement here does not provide any specific limitations on the power of arbitrators under Rule 43 [of the AAA Rules, granting that power to award ‘any remedy or relief which the arbitrator deems just and equitable’], and we are required to give deference to the arbitrators’ interpretation of the Rule and Agreement unless they have clearly exceeded their authority.”); *Sperry Int’l Trade, Inc. v. Gov’t of Israel*, 689 F.2d 301, 306 (2d Cir. 1982); *Eyewonder, Inc. v. Abraham*, 2010 WL 3528882 (S.D.N.Y.) (arbitrator’s award of injunctive relief was not excess of authority; parties’ agreement authorized such relief); *Staklinski v. Pyramid Elec. Co.*, 160 N.E.2d 78, 79 (N.Y. 1959) (“The power of an arbitrator to order specific performance in an appropriate case has been recognized from early times.”); *Nearctic Nickel Mines Inc. v. Canadian Royalties Inc.*, [2012] QCCA 385 (Québec Ct. App.) (“an order of specific performance within a commercial dispute can legally be issued by an arbitrator”). See also [Dunaud & Kostytska, Declaratory Relief in International Arbitration](#), 29 J. Int’l Arb. 1 (2012); [E. Gaillard & J. Savage \(eds.\), Fouchard Gaillard Goldman on International Commercial Arbitration ¶¶1305 et seq.](#) (1999); Geimer, in R. Zöller (ed.), *Zivilprozessordnung* §1041, ¶16 (26th ed. 2007); K.-H. Schwab & G. Walter, *Schiedsgerichtsbarkeit* 312 (6th ed. 2000).
- 384)** LCIA, *Registrar’s Report* (2012) (29% of LCIA arbitrations in 2012 and 31% in 2011 sought declaratory relief or specific performance).
- 385)** A number of courts have held that the New York Convention applies to awards granting declaratory or injunctive relief (as well as to monetary awards). See [Adamas Mgt & Servs. Inc. v. Aurado Energy Inc.](#), XXX Y.B. Comm. Arb. 479 (New Brunswick Q.B. 2004) (2005); *IPOC Int’l Growth Fund Ltd v. LV Fin. Group Ltd*, XXXIII Y.B. Comm. Arb. 408, ¶150 (B.V.I. Ct. App. 2008) (2008) (nothing in Convention or implementing legislation “that indicates that purely declaratory Convention awards are excluded” from Convention’s recognition provisions); *LV Fin. Group Ltd v. IPOC Int’l Growth Fund Ltd*, [2006] Bda LR 69 (Bermuda Comm. Ct.). See also [§25.04\[F\]\[3\]\[h\]](#).
- 386)** See, e.g., *Judgment of 28 September 2004*, 4 Ob 142/04t (Austrian Oberster Gerichtshof); *NSW Racing v. TAB*, [2002] NSWSC 742, ¶126 (N.S.W. S.Ct.) (“The words used to confer power to resolve the dispute confer almost unlimited flexibility in the method of its resolution. For this reason, I think that the arbitrator has been given power to grant an injunction.”); *AED Oil Ltd v. Puffin Fpso Ltd*, [2010] VSCA 37, ¶120 (Victoria Ct. App.) (“We think the Model Law gives an arbitrator appointed under that law power to make an order in the nature of an injunction and if necessary, a declaration.”) (quoting *Electra Air Conditioning BV v Seeley Int’l Pty Ltd*, [2008] FCAFC 169, ¶144 (Australian Fed. Ct.)).
- 387)** See, e.g., *Restatement (Second) Contracts* §366, comment a (1981); *McNeil v. Magee*, 16 F.Cas. 326, 330 (D. Mass. 1829); *Grossman v. Ilowitz*, 898 N.Y.S.2d 621, 623 (N.Y. App. Div. 2010); *Greenspan v. Ladit, LLC*, 111 Cal.Rptr.3d 468, 496 (Cal. Ct. App. 2010); *950 Corbindale, LP v. Kotts Capital Holdings Ltd P’ship*, 316 S.W.3d 191, 196 (Tex. Ct. App. 2010) (“provision giving the arbitrator authority to ‘award compensatory damages only’ does not foreclose an arbitrator’s ability to grant declaratory relief”); *McFin. Ltd v. City Fed. Sav. & Loan Ass’n*, 279 N.W.2d 507 (Wis. Ct. App. 1979); *In re Staklinski/Pyramid Elec. Co.*, 180 N.Y.S.2d 20, 26 (N.Y. App. Div. 1958), *aff’d*, 160 N.E.2d 78 (N.Y. 1959); *Freydberg Bros. Inc. v. Corey*, 31 N.Y.S.2d 10, 11 (N.Y. Sup. Ct. 1941), *aff’d mem.*, 32 N.Y.S.2d 129 (N.Y. App. Div. 1941); *Ethiopian Oilseeds & Pulses Exp. Corp. v. Rio del Mar Foods Inc.* [1990] 1 Lloyd’s Rep. 86 (QB) (English High Ct.).
- 388)** *Judgment of 7 April 1994, Lechevalier v. Société Croisière Loisir et Commc’ns Internationale*, 1996 Rev. arb. 61 (Paris Cour d’appel) (ordering rescission of yacht sale contract against partial refund of purchase price); K.-H. Schwab & G. Walter, *Schiedsgerichtsbarkeit* 209 (6th ed. 2000).

In the words of one commentator, “specific performance is so widely available in legal systems that it can be considered a general principle of law.” *Schneider, Non-Monetary Relief in International Arbitration: Principles and Practice*, in M. Schneider & J. Knoll (eds.), *Performance as A Remedy: Non-Monetary Relief in International Arbitration* 6 (ASA Spec. Series No. 30 2011). See also [Dunaud & Kostytska, Declaratory Relief in International Arbitration](#), 29 J. Int’l Arb. 1 (2012); [Malinvaud, Non-Pecuniary Remedies in Investment Treaty and Commercial Arbitration](#), in [A. van den Berg \(ed.\), 50 Years of the New York Convention 210](#) (ICCA Congress Series No. 14 2009) (discussing non-pecuniary remedies available in commercial arbitration, including judicial penalties and specific performance); [Schreuer, Non-Pecuniary Remedies in ICSID Arbitration](#), 20 Arb. Int’l 325 (2004).



- 389)** See, e.g., *Texaco Overseas Petroleum Co. v. Libyan Arab Repub.*, *Ad Hoc Award of 19 January 1977*, IV Y.B. Comm. Arb. 177, 184-86 (1979) (“*restitutio in integrum* is ... the normal sanction for non-performance of contractual obligations and ... is inapplicable only to the extent that restoration of the status quo ante is impossible”); *Libyan Am. Oil Co. (LIAMCO) v. Gov’t of the Libyan Arab Repub.*, *Ad Hoc Award of 12 April 1977*, VI Y.B. Comm. Arb. 89, 105 (1981) (recognizing power to order specific performance, but declining to do so); *BP Exploration Co. v. Gov’t of the Libyan Arab Repub.*, *Ad Hoc Award on Merits of 10 October 1973*, V Y.B. Comm. Arb. 143, 150 *et seq.* (1980) (same). See also Malinvaud, *Non-Pecuniary Remedies in Investment Treaty and Commercial Arbitration*, in A. van den Berg (ed.), *50 Years of the New York Convention 210-16* (ICCA Congress Series No. 14 2009) (discussing non-pecuniary remedies available in commercial arbitration, including judicial specific performance); Schneider, *Non-Monetary Relief in International Arbitration: Principles and Practice*, in M. Schneider & J. Knoll (eds.), *Performance as A Remedy: Non-Monetary Relief in International Arbitration 16* (ASA Spec. Series No. 30 2011) (concluding, based on review of reports from leading arbitral institutions, that “international arbitral tribunals first of all accept that, as a matter of principle, they have the power to grant [non-monetary relief] and that, in the right circumstances, they are prepared to exercise these powers”), 127-207 (summaries of awards of non-monetary relief by Chamber of Arbitration of Milan, Geneva Chamber of Commerce, German Institution of Arbitration, VIAC, ICC, ICDR/AAA, Kuala Lumpur Regional Centre for Arbitration and LCIA).
- 390)** See, e.g., *Case Concerning the Factory at Chorzów*, PCIJ Series A, No. 13, 20 (P.C.I.J. 1928) (“The Court’s Judgment No. 7 is in the nature of a declaratory judgment, the intention of which is to ensure recognition of a situation of law, once and for all and with binding force as between the parties; so that the legal position thus established cannot again be called in question in so far as the legal effects ensuing therefrom are concerned.”; “The essential principle contained in the actual notion of an illegal act ... is that reparation must, as far as possible, wipe out all the consequences of the illegal act and re-establish the situation which would, in all probability, have existed if that act had not been committed.”); ILC, *Memorandum on Arbitral Procedure, Prepared by the Secretariat*, U.N. Doc. A/CN.4/35, II Y.B. I.L.C. 157, 167 (1950); Malinvaud, *Non-Pecuniary Remedies in Investment Treaty and Commercial Arbitration*, in A. van den Berg (ed.), *50 Years of the New York Convention 217-28* (ICCA Congress Series No. 14 2009) (restitution and satisfaction in investment arbitration).
- 391)** *Engis Corp. v. Engis Ltd*, 800 F.Supp. 627, 631 (N.D. Ill. 1992); *Young v. Deschler*, 110 N.Y.S.2d 220 (N.Y. Sup. Ct. 1952) (order of specific performance of non-competition clause). See also Chappuis, *A Comparative Overview on Performance as A Remedy: A Key to Divergent Approaches*, in M. Schneider & J. Knoll (eds.), *Performance as A Remedy: Non-Monetary Relief in International Arbitration 51* (ASA Spec. Series No. 30 2011) (collecting awards granting injunctions prohibiting certain conduct).
- 392)** *Island Creek Coal Sales Co. v. City of Gainesville*, 729 F.2d 1046, 1049 (6th Cir. 1984) (relying on Rule 43 of AAA Rules).
- 393)** *Marion Mfg Co. v. Long*, 588 F.2d 538, 541 (6th Cir. 1978).
- 394)** *Sperry Int’l Trade, Inc. v. Gov’t of Israel*, 689 F.2d 301, 306 (2d Cir. 1982).
- 395)** *Carte Blanche (Singapore) Pte Ltd v. Carte Blanche Int’l, Ltd*, 888 F.2d 260, 266 (2d Cir. 1989).
- 396)** See, e.g., *Pac. Reins. Mgt Corp. v. Ohio Reins. Corp.*, 935 F.2d 1019, 1023-24 (9th Cir. 1991); *Blue Sympathy Shipping Co. v. Serviocean Int’l SA*, 1994 WL 597144, at \*1 (S.D.N.Y.). *Contra Swift Indus., Inc. v. Botany Indus., Inc.*, 466 F.2d 1125, 1134 (3d Cir. 1972).
- 397)** *Anderman/Smith Operating Co. v. Tenn. Gas Pipeline Co.*, 918 F.2d 1215, 1219-20 (5th Cir. 1990).
- 398)** *Grayson-Robinson Stores, Inc. v. Iris Constr. Co.*, 168 N.E.2d 377 (N.Y. 1960) (order of specific performance to finish construction of mall).
- 399)** *Gen. Fuse Co. v. Sightmaster Corp.*, 162 N.Y.S.2d 630 (N.Y. Sup. Ct. 1957) (order of specific performance to transfer business). See also Schneider, *Non-Monetary Relief in International Arbitration: Principles and Practice*, in M. Schneider & J. Knoll (eds.), *Performance as A Remedy: Non-Monetary Relief in International Arbitration 18-19* (ASA Spec. Series No. 30 2011) (collecting awards ordering transfers of property and other affirmative conduct).
- 400)** *Staklinski v. Pyramid Elec. Co.*, 6 N.Y.2d 159 (N.Y. 1959) (order of specific performance to reinstate managing director of company). See also Schneider, *Non-Monetary Relief in International Arbitration: Principles and Practice*, in M. Schneider & J. Knoll (eds.), *Performance as A Remedy: Non-Monetary Relief in International Arbitration 25* (ASA Spec. Series No. 30 2011) (collecting awards granting “formative actions,” such as creation, transformation, or termination of legal relationship).
- 401)** *Advanced Micro Devices v. Intel Corp.*, 885 P.2d 994 (Cal. 1994) (upholding award ordering granting free license to use product (despite absence of such license in parties’ contract)).
- 402)** *Puerto Rico Maritime Shipping Auth. v. Star Lines Ltd*, 454 F.Supp. 368, 375 (S.D.N.Y. 1978) (confirming award requiring an accounting).

- 403)** *Brown v. Coleman Co.*, 220 F.3d 1180, 1182 (10th Cir. 2000) (tribunal did not exceed power by granting equitable relief of extending time in which wrongfully terminated employee's stock options could be exercised).
- 404)** *Watkins-Johnson v. Bank Saderat Iran*, Award in IUSCT Case No. 429-370-1 of 28 July 1989, 22 Iran-US C.T.R. 218 (1989). For ICSID arbitrations, see *Enron Corp. & Ponderosa Assets, LP v. Argentine Repub.*, Decision on Jurisdiction in ICSID Case No. ARB/01/3 of 14 January 2004, ¶81 ("in addition to declaratory powers, [the Tribunal] has the power to order measures involving performance or injunction of certain acts"); *Saudi Arabia v. Arabian Am. Oil Co. (Aramco)*, Ad Hoc Award of 23 August 1958, 27 I.L.R. 117, 145 (1963). See also Mourre, *Judicial Penalties and Specific Performance in International Arbitration*, in L. Lévy & F. De Ly (eds.), *Interest, Auxiliary and Alternative Remedies in International Arbitration* 53-73 (2008); Schneider, *Non-Monetary Relief in International Arbitration: Principles and Practice*, in M. Schneider & J. Knoll (eds.), *Performance as A Remedy: Non-Monetary Relief in International Arbitration* 24 (ASA Spec. Series No. 30 2011) (collecting awards granting declaratory relief).
- 405)** Elder, *The Case Against Arbitral Awards of Specific Performance in Transnational Commercial Disputes*, 13 Arb. Int'l 1 (1997). Contra Munoz, *The Power of Arbitrators to Make Pro Futuro Orders*, in M. Schneider & J. Knoll (eds.), *Performance as A Remedy: Non-Monetary Relief in International Arbitration* 91 (ASA Spec. Series No. 30 2011).
- 406)** See §9.02[1]; §15.02.
- 407)** See Schneider, *Non-Monetary Relief in International Arbitration: Principles and Practice*, in M. Schneider & J. Knoll (eds.), *Performance as A Remedy: Non-Monetary Relief in International Arbitration* 4 (ASA Spec. Series No. 30 2011) ("Why specific performance as a remedy in arbitration? The answer is simple: this is what the parties have agreed.").
- 408)** See, e.g., *Freydberg Bros., Inc. v. Lewis Corey*, 31 N.Y.S.2d 10, 11 (N.Y. Sup. Ct. 1941) (relying on broad arbitration clause to hold arbitrators had authority to grant specific performance); *Telia Sonera AB v. Hilcourt Docklands Ltd* [2003] EWHC 3353 (English High Ct.) (limitations on remedial authority of arbitrators interpreted narrowly). See also Munoz, *The Power of Arbitrators to Make Pro Futuro Orders*, in M. Schneider & J. Knoll (eds.), *Performance as A Remedy: Non-Monetary Relief in International Arbitration* 118 (ASA Spec. Series No. 30 2011) ("arbitrators enjoy a wide power to make non-pecuniary orders, committing the parties' future activities").
- 409)** See §2.01[A]; §5.01[D]; §9.02[1]; §23.07[A].
- 410)** See, e.g., *Dreis & Krump Mfg Co. v. Int'l Ass'n of Machinists & Aerospace Workers*, 802 F.2d 247, 250 (7th Cir. 1986); *Engis Corp. v. Engis Ltd*, 800 F.Supp. 627, 632 (N.D. Ill. 1992).
- 411)** For commentary, see Davis, *A Proposed Framework for Reviewing Punitive Damage Awards of Commercial Arbitrators*, 58 Alb. L. Rev. 55 (1994); Derains, *Intérêts moratoires, dommages-intérêts compensatoires et dommages punitifs devant l'arbitre international*, in *Etudes offertes à Pierre Bellet* 100 (1991); Donahy, *Punitive Damages in International Commercial Arbitration*, 10(3) J. Int'l Arb. 67 (1995); Farnsworth, *Punitive Damages in Arbitration*, 7 Arb. Int'l 3 (1991); Gotanda, *The Unpredictability Paradox: Punitive Damages and Interest in International Arbitration*, 7(1) Transnat'l Disp. Mgt 3 (2010); Gotanda, *Awarding Punitive Damages in International Commercial Arbitrations in the Wake of Mastrobucchi v. Shearson Lehman Hutton, Inc.*, 38 Harv. Int'l L.J. 59 (1997); Gotanda, *Charting Developments Concerning Punitive Damages: Is the Tide Changing?*, 45 Colum. J. Transnat'l L. 508 (2007); Jones, *Punitive Damages as An Arbitration Remedy*, 4(2) J. Int'l Arb. 35 (1987); Larsen, *Punitive Damages in International Commercial Arbitration: Adapting U.S. Policy to International Norms*, in R. Lillich & C. Brower (eds.), *International Arbitration in the 21st Century: Towards "Judicialization" and Uniformity?* 245 (1994); Mourre, *Arbitration and Criminal Law: Reflections on the Duties of the Arbitrator*, 22 Arb. Int'l 95, 105-09 (2006); Noussia, *Punitive Damages in Arbitration: Panacea or Curse?*, 27 J. Int'l Arb. 277 (2010); Petsche, *Punitive Damages in International Commercial Arbitration: Much Ado About Nothing?*, 29 Arb. Int'l 89 (2013); Stipanowich, *Punitive Damages in Arbitration: Garrity v. Lyle Stuart, Inc. Reconsidered*, 66 B.U. L. Rev. 953 (1986); Ware, *Punitive Damages in Arbitration: Contracting Out of Government's Role in Punishment and Federal Preemption of State Law*, 63 Ford. L. Rev. 529 (1994).
- 412)** Petsche, *Punitive Damages in International Commercial Arbitration: Much Ado About Nothing?*, 29 Arb. Int'l 89, 103 (2013) ("punitive arbitral awards are either inexistent or extremely rare").
- 413)** D. Dobbs, *Handbook on the Law of Remedies* 204 (1973). See Noussia, *Punitive Damages in Arbitration: Panacea or Curse?*, 27 J. Int'l Arb. 277 (2010) ("Punitive damages are awarded in addition to compensatory damages. Because of their role to punish and deter a tortfeasor whose conduct is grossly negligent, willfully malicious, criminally indifferent or in reckless disregard for the rights of others from similar actions, they are action-oriented, tortfeasor-oriented and mostly prospective"); L. Schlueter & K. Redden, *Punitive Damages* §2.2(A)(1) (1995).
- 414)** H. McGregor, *McGregor on Damages* §§309-11 (1980); L. Schlueter & K. Redden, *Punitive Damages* §22.1 (1995).

- 415)** Gotanda, *Awarding Punitive Damages in International Commercial Arbitrations in the Wake of Mastrobuono v. Shearson Lehman Hutton, Inc.*, 38 Harv. Int'l L.J. 59, Appendix III (1997) (punitive damages available in Australia, Canada, England, New Zealand, Northern Ireland, Ireland and United States).
- 416)** J. Ghiardi et al., *Punitive Damages Law and Practice* §4.01 (1996); Noussia, *Punitive Damages in Arbitration: Panacea or Curse?*, 27 J. Int'l Arb. 277 (2010); L. Schlueter & K. Redden, *Punitive Damages* 369 et seq. (1995).
- 417)** See, e.g., 15 U.S.C. §15(a) (treble damages for antitrust violations); 18 U.S.C. §1964(c) (treble damages for RICO violations).
- 418)** See generally Gotanda, *Awarding Punitive Damages in International Commercial Arbitrations in the Wake of Mastrobuono v. Shearson Lehman Hutton, Inc.*, 38 Harv. Int'l L.J. 59, Appendix II (1997) (in most civil law jurisdictions, no punitive damages except only for limited, aggravated torts); Noussia, *Punitive Damages in Arbitration: Panacea or Curse?*, 27 J. Int'l Arb. 277, 282-83 (2010) ("In civil law countries, the concept of punitive damages is scarcely known.").
- 419)** *Judgment of 4 June 1992*, 1992 WM 1451 (German Bundesgerichtshof); *Judgment of 19 January 2007, P.J. v. Fimez*, Case No. 1183 (Italian Corte di Cassazione); *Judgment of 15 October 2001*, 37 Riv. Dir. Int'l Priv. Proc. 1021 (Venice Corte d'Appello) (2002). Compare *Judgment of 1 February 1989*, 1991 BJM 31 (Basel-Stadt Zivilgericht) (recognizing judgment for punitive damages), *appeal dismissed*, *Judgment of 12 July 1990*, DFT 116 II 376 (Swiss Federal Tribunal); Mourre, *Arbitration and Criminal Law: Reflections on the Duties of the Arbitrator*, 22 Arb. Int'l 95, 108 (2006). See also *Final Award in ICC Case No. 5946*, XVI Y.B. Comm. Arb. 97 (1991).
- 420)** See, e.g., *French Civil Code*, Art. 1382; German BGB, §253; *Austrian Civil Code*, §§1325 et seq.
- 421)** See, e.g., *Tadonki v. Secretary Gen. of the United Nations*, Award in UNDT Case No. UNDT/NBI/2009/36 of 26 February 2013 (awarding \$50,000 in moral damages); *Joseph Charles Lemire v. Ukraine*, Award in ICSID Case No. ARB/06/18 of 28 March 2011 ("as a general rule, moral damages are not available to a party injured by the wrongful acts of a State, but ... moral damages can be awarded in exceptional cases, provided that [1] the State's actions imply physical threat, illegal detention or other analogous situations in which the ill-treatment contravenes the norms according to which civilized nations are expected to act; [2] the State's actions cause a deterioration of health, stress, anxiety, other mental suffering such as humiliation, shame and degradation, or loss of reputation, credit and social position; and [3] both cause and effect are grave or substantial."); *Award in ICSID Case No. ARB/05/17 of 6 February 2008, Desert Line Projects LLC v. Repub. of Yemen*, 1(2) Int'l J. Arab Arb. 350 (2009) (tribunal awarded \$1,000,000 for moral damages: "It is generally accepted in most legal systems that moral damages may also be recovered besides pure economic damages. There are indeed no reasons to exclude them."); *Award in ICSID Case No. ARB/77/2 of 8 August 1980, Benvenuti & Bonfant v. People's Repub. of the Congo*, VIII Y.B. Comm. Arb. 144, 151 (1983) ("the measures to which Claimant has been subject and the suit that was the consequence thereof [made it] equitable to award it the amount of CFA 5,000,000 for moral damages"). See also Wong, *The Misapprehension of Moral Damages in Investor-State Arbitration*, in A. Rovine (ed.), *Contemporary Issues in International Arbitration and Mediation: The Fordham Papers 2012* (2013).
- 422)** A preliminary draft law revising the French law on civil liability, the so-called "Catala Project," was submitted to the French Minister of Justice on 22 September 2005. The revised Article 1371 intends to introduce the concept of punitive damages into French law: "One whose fault is manifestly premeditated, particularly when aiming for monetary gain, may be ordered to pay punitive damages besides compensatory damages." See Gotanda, *The Unpredictability Paradox: Punitive Damages and Interest in International Arbitration*, 7(1) Transnat'l Disp. Mgt 3 (2010). See also *Judgment of 13 November 2001, Miller Imp. Corp. v. Alabastres Alfredo, SL*, in Jablonski, *Translation and Comment: Enforcing U.S. Punitive Damages Awards in Foreign Courts – A Recent Case in the Supreme Court of Spain*, 24 J. L. & Comm. 225, 231-43 (2005) (enforcing U.S. punitive damages judgment); Gotanda, *Charting Developments Concerning Punitive Damages: Is the Tide Changing?*, 45 Colum. J. Transnat'l L. 508 (2007).
- 423)** *Garrity v. Lyle Stuart, Inc.*, 353 N.E.2d 793, 794 (N.Y. 1976). See Stipanowich, *Punitive Damages in Arbitration: Garrity v. Lyle Stuart, Inc. Reconsidered*, 66 B.U. L. Rev. 953 (1986); Ware, *Punitive Damages in Arbitration: Contracting Out of Government's Role in Punishment and Federal Preemption of State Law*, 63 Ford. L. Rev. 529 (1994).
- 424)** *Garrity*, 353 N.E.2d at 797.
- 425)** See Chapter 6 (especially §6.02.).
- 426)** *Garrity*, 353 N.E.2d at 797 ("The law does not and should not permit private persons to submit themselves to punitive sanction of the order reserved to the State.").
- 427)** Davis, *A Proposed Framework for Reviewing Punitive Damage Awards of Commercial Arbitrators*, 58 Alb. L. Rev. 55 (1994).
- 428)** *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52, 59 (U.S. S.Ct. 1995).
- 429)** *Mastrobuono*, 514 U.S. at 52.

- 430)** *Mastrobuono*, 514 U.S. at 58. The Court reasoned: “we think our decisions in *Allied-Bruce, Southland* and *Perry* make clear that if contracting parties agree to include claims for punitive damages within the issue to be arbitrated, the FAA ensures that their agreement will be enforced according to its terms even if a rule of state law would otherwise exclude such claims from arbitration.” *Id.* at 58. See also §6.03[C][4].
- 431)** *Mastrobuono*, 514 U.S. at 61, 68-69. The Court also relied on the parties’ agreement upon the NASD Code, which provided generally that the arbitrators could include damages and other relief, without qualifications.
- 432)** Some institutional rules exclude awards of punitive or exemplary damages. See, e.g., ICDR Rules, Art. 28(5); ARIAS-UK Rules, Art. 14(2)(2).
- 433)** See *Lagstein v. Certain Underwriters at Lloyd’s London*, 607 F.3d 634 (9th Cir. 2010) (district court erred in concluding that amount of punitive damages awarded demonstrated manifest disregard of law); *OurLink, LLC v. Goldberg*, 2011 WL 9076, at \*3 (N.D. Tex.) (“arbitrators presumptively enjoy the power to award [punitive damages] unless the arbitration contract unequivocally excludes punitive damage claims”); *Sanders v. Gardner*, 7 F.Supp.2d 151, 170-79 (E.D.N.Y. 1998) (analyzing and applying *Mastrobuono* in confirming \$10,000,000 punitive damages award); *Tucker v. Scott*, 1997 WL 151509, at \*4 (S.D.N.Y.) (allowing punitive damages claims to go forward); *Prudential Sec. Inc. v. Laurita*, 1997 WL 109438, at \*5 (S.D.N.Y.) (denying petition for stay to prevent arbitrator from awarding punitive damages in light of *Mastrobuono*); *Kidder, Peabody & Co. v. Marriner*, 961 F.Supp. 50, 54 (S.D.N.Y. 1997) (finding *Mastrobuono* does not bar arbitrators from awarding punitive damages and denying stay of arbitration); *Cowen & Co. v. Tecnoconsult Holdings Ltd*, 1996 WL 391884, at \*5 (S.D.N.Y.) (denying application to prevent arbitrators from awarding punitive damages in light of *Mastrobuono*); *A.S. Goldmen & Co. v. Bochner, M.D.*, 1996 WL 413676, at \*1 (S.D.N.Y.) (denying petition to stay arbitration pending claims for punitive damages, based on *Mastrobuono*); *PaineWebber, Inc. v. Richardson*, 1995 WL 236722, at \*2-3 (S.D.N.Y.) (denying stay of arbitration as it relates to punitive damages in light of *Mastrobuono*); *Americorp Sec., Inc. v. Sager*, 656 N.Y.S.2d 762, 764 (N.Y. App. Div. 1997) (reversing stay of arbitration because arbitration clause did not unequivocally exclude punitive damages claim); *Mulder v. Donaldson, Lufkin & Jenrette*, 648 N.Y.S.2d 535, 538 (N.Y. App. Div. 1996) (“In sum, the decision of the Supreme Court in *Mastrobuono* makes it unmistakably clear that, with respect to arbitration proceeding governed by the FAA which preempts the *Garrity* rule, the arbitration of punitive damage claims is required except where the parties have unequivocally agreed otherwise.”); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Adler*, 651 N.Y.S.2d 38, 39 (N.Y. App. Div. 1996) (reversing lower court stay of arbitration of punitive damages claim because choice-of-law provision was ambiguous, as in *Mastrobuono*, and therefore strong federal policy favoring arbitration included deciding punitive damages award); *Prudential Sec. Inc. v. Pesce*, 642 N.Y.S.2d 466, 468 (N.Y. Sup. 1996) (leaving punitive damages issue to arbitrators because *Mastrobuono* preempts *Garrity* rule). See also *Lee v. Chica*, 983 F.2d 883, 887 (8th Cir. 1993) (“when the choice of law provision in an arbitral clause incorporates the rules of the AAA, some circuits have held, and we agree, that AAA arbitrators may grant any remedy or relief including punitive damages”); *Raytheon Co. v. Automated Bus. Sys., Inc.*, 882 F.2d 6, 10 (1st Cir. 1989) (“it would seem sensible to interpret the ‘all disputes’ and ‘any remedy or relief’ phrases to indicate, at a minimum, an intention to resolve through arbitration any dispute that would otherwise be settled in a court, and to allow the chosen dispute resolvers to award the same varieties and forms of damages or relief as a court would be empowered to award”).
- 434)** See, e.g., 2010 UNCITRAL Rules, Art. 34(1); 2012 ICC Rules, Arts. 21(1), 23(c); LCIA Rules, Art. 16.

For an argument that these rules should not be interpreted as authorizing consideration of punitive damage claims (because of the atypical character of punitive damages internationally), even under *Mastrobuono*’s rule that arbitration agreements should be construed in favor of extending to claims of punitive damages, see Gotanda, *Awarding Punitive Damages in International Commercial Arbitrations in the Wake of Mastrobuono v. Shearson Lehman Hutton, Inc.*, 38 Harv. Int’l L.J. 59, 78-81 (1997).

- 435)** *Fahnestock & Co. v. Waltman*, 935 F.2d 512, 519 (2d Cir. 1991).
- 436)** See §23.07[D], pp. 3078-79.



- 437)** *Final Award in ICC Case No. 5946, XVI Y.B. Comm. Arb. 97, 113 (1991)*. This award has been criticized on the grounds that, while punitive damages are against Swiss (national) public policy, the grounds for setting aside under [Article 190\(2\)\(c\) of the Swiss Law on Private International Law](#) relate only to transnational public policy. If the parties chose a law which provides for punitive damages, an arbitral tribunal sitting in Switzerland should be entitled to award such damages. See B. Berger & F. Kellerhals, *Internationale und interne Schiedsgerichtsbarkeit in der Schweiz* ¶1604 (2006); Schlosser, *Right and Remedy in Common Law Arbitration and in German Arbitration Law*, 4(1) J. Int'l Arb. 27, 32-33 (1987). Compare Donahay, *Punitive Damages in International Commercial Arbitration*, 10(3) J. Int'l Arb. 67 (1995) ("Generally, the principle of party autonomy would be thought to apply where the parties have, by their agreement, expressly empowered the arbitral tribunal to award punitive damages."); Larsen, *Punitive Damages in International Commercial Arbitration: Adapting U.S. Policy to International Norms*, in R. Lillich & C. Brower (eds.), *International Arbitration in the 21st Century: Towards "Judicialization" and Uniformity?* 245, 274 (1994).
- 438)** See Rostock-Jensen & Mikkelsen, *Denmark*, in L. Garb & J. Lew (eds.), *Enforcement of Foreign Judgments* 1, 6-7 (2013); Yamauchi & Kobayashi, *Japan*, in L. Garb & J. Lew (eds.), *Enforcement of Foreign Judgments* 1, 4 (2013). See also [§26.05\[C\]\[9\]\[h\]\[viii\]](#).
- 439)** See [§19.03\[B\]\[1\]](#).
- 440)** See [§19.03\[D\]\[3\]\[e\]](#); [§19.04\[B\]\[5\]\[b\]](#).
- 441)** Ordinarily, the tribunal's decision will be a substantive one, not a jurisdictional determination. For reasons analogous to those identified by the U.S. Supreme Court in *Mastrobuono*, claims for punitive damages falling within the scope of the parties' arbitration agreement should be subject to arbitration. See [§9.02\[I\]](#); [§23.07\[D\]](#).
- 442)** See [§25.11](#), p. 3390.
- 443)** See, e.g., *Certain Underwriters at Lloyd's v. Argonaut*, 264 F.Supp.2d 926, 943 (C.D. Cal. 2003) (tribunal order: "Petitioners, jointly and severally, are ordered to pay Respondent, in addition to the amount set forth in Interim Order No. 2, the additional sum of \$10,000.00 for every day that they [Certain Underwriters] are not in compliance with that Order, commencing on January 17, 2003, the first day following the date on which payment was to have been made or letter or credit established."). See also *Superadio LP v. Winstar Radio Prods. LLC*, 844 N.E.2d 246, 254 (Mass. 2006) (party sanctioned for failing to comply with discovery orders).
- 444)** *Pac. Reins. Mgt Corp. v. Ohio Reins. Corp.*, 935 F.2d 1019, 1023 (9th Cir. 1991) ("Arbitrators have no power to enforce their decisions. Only courts have that power.").
- 445)** See, e.g., *Reliastar Life Ins. Co. v. EMC Nat'l Life Co.*, 564 F.3d 81, 86 (2d Cir. 2009); *Synergy Gas Co. v. Sasso*, 853 F.2d 59 (2d Cir. 1988); *Certain Underwriters at Lloyd's v. Argonaut*, 264 F.Supp.2d 926, 943 (C.D. Cal. 2003) ("there is no categorical ban to an arbitrator's imposition of sanctions for non-compliance with his or her orders"; "in light of the strong public policy favoring expeditious arbitration the parties should not be barred from consensually conferring such power on the arbitrator; enforcement via sanctions by the arbitrator is likely to be more efficient than mandating judicial review and enforcement in every instance"); *Polin v. Kellwood Co.*, 103 F.Supp.2d 238 (S.D.N.Y. 2000) (upholding award of legal costs as sanction for outrageous conduct and refusal to respond to panel's questions by claimant's counsel); *Konkar Maritime Enters., SA v. Compagnie Belge D'Affretement*, 668 F.Supp. 267, 274 (S.D.N.Y. 1987) ("it was not improper for the Panel to consider respondent's failure to comply with its interim order" in assessing 85% of costs against party that ignored tribunal's order to provide security). Compare *Grynberg v. BP Exploration Operating Ltd*, 92 A.D.3d 547, 548 (N.Y. App. Div. 2012) (affirming lower court's ruling vacating award of \$3 million in sanctions because it was punitive in nature and thus violation of New York public policy).
- 446)** *Reliastar Life Ins. Co. v. EMC Nat'l Life Co.*, 564 F.3d 81, 86 n.2 (2d Cir. 2009).
- 447)** See, e.g., Malinvaud, *Non-Pecuniary Remedies in Investment Treaty and Commercial Arbitration*, in A. van den Berg (ed.), *50 Years of the New York Convention 210 (ICCA Congress Series No. 14 2009)* (judicial penalties available in commercial arbitration); Mourre, *Judicial Penalties and Specific Performance in International Arbitration*, in L. Lévy & F. De Ly (eds.), *Interest, Auxiliary and Alternative Remedies in International Arbitration* 60 (2008) ("[T]here is no reason to consider that an arbitral tribunal should be deprived of jurisdiction to liquidate the penalty it has ordered. As a matter of fact ... this is not a matter that relates to the enforcement of the penalty but rather to the determination of the final amount in respect to which the creditor will be entitled to seek enforcement.").
- 448)** *Inter-Chem Asia 2000 Pte Ltd v. Oceana Petrochem.*, 373 F.Supp.2d 340, 356-58 (S.D.N.Y. 2005) ("[T]he parties' agreement did not explicitly grant the Arbitrator power to afford any remedy available in courts. ... [I]f the Arbitrator had inherent authority to sanction DiDonna [it] would directly contradict the principle that an arbitrator's authority is circumscribed by the agreement of the parties."); *Certain Underwriters at Lloyd's v. Argonaut*, 264 F.Supp.2d 926, 944 (C.D. Cal. 2003) ("potential for conflict with FAA policy counsels in favor of requiring that any intent of the parties to afford contempt-like power on the arbitrator must be clearly evident").

- 449) *Inter-Chem Asia 2000 Pte Ltd v. Oceana Petrochem.*, 373 F.Supp.2d 340, 356-58 (S.D.N.Y. 2005).
- 450) *Reliastar Life Ins. Co. v. EMC Nat'l Life Co.*, 564 F.3d 81, 86 (2d Cir. 2009) (“broad arbitration clause ... confers inherent authority on arbitrators to sanction a party that participates in the arbitration in bad faith and ... such a sanction may include an award of attorney’s fees or arbitrator’s fees”).
- 451) Schneider, *Non-Monetary Relief in International Arbitration: Principles and Practice*, in M. Schneider & J. Knoll (eds.), *Performance as A Remedy: Non-Monetary Relief in International Arbitration* 43 (ASA Spec. Series No. 30 2011) (“In civil law countries, the rights and the remedies that flow from them, as a matter of principle, are regulated in the substantive law.”).
- 452) L. Collins (ed.), *Dicey, Morris and Collins on The Conflict of Laws* ¶7-011 (15th ed. 2012); D. Dobbs, *Law of Remedies* §§1.1, 1.6 (2d ed. 1993).
- 453) Y. Derains & R. Kreindler, in ICC Dossiers, *Evaluation of Damages in International Arbitration* 87 (2006).
- 454) N. Blackaby et al. (eds.), *Redfern and Hunter on International Arbitration* ¶9.100 (5th ed. 2009).
- 455) See §17.02[F].
- 456) See §7.04.
- 457) See §23.08[D]; §23.09[B].
- 458) See §5.01[B]; §15.02[A]; §15.04[B].
- 459) See, e.g., *Irish Arbitration Act*, §26 (“Unless a contrary intention is expressed therein, every arbitration agreement shall, where such a provision is applicable to the reference, be deemed to contain a provision that the arbitrator or umpire shall have the same power as the Court to order specific performance of any contract other than a contract relating to land or any interest in land.”).
- 460) See §17.02[F]; §19.03[H][3], p. 2670 n. 297; *Restatement (Second) Conflict of Laws* §207 (1971) (“measure of recovery for a breach of contract is determined by the local law of the state selected [by the parties to govern the contract]”).
- 461) See §19.03[H][3].
- 462) For commentary, see Carter, *A Kiss For Arbitration Costs Allocation*, 23 Am. Rev. Int’l Arb. 475 (2013); Chartered Institute of Arbitrators, *Costs of International Arbitration Survey* (2011); Frank, *Rationalizing Cost Awards in Investment Treaty Arbitration*, 88 Wash. U. L. Rev. 769 (2011); Goldstein, *Some Thoughts About Costs in International Arbitration*, 3 Int’l Arb. News 16 (2003); Gotanda, *Attorneys’ Fees Agonistes: The Implications of Inconsistency in the Awarding of Fees and Costs in International Arbitrations*, in M. Fernández-Ballesteros & D. Arias (eds.), *Liber Amicorum Bernardo Cremades* 539-55 (2010); Gotanda, *Awarding Costs and Attorney’s Fees in International Commercial Arbitration*, 21 Mich. J. Int’l L. 1 (1999); Gurry, *Fees & Costs*, 6 World Arb. & Med. Rep. 227 (1995); Hanotiau, *The Parties’ Costs of Arbitration*, in ICC Dossiers, *Evaluation of Damages in International Arbitration* 213 (2006); Hanotiau, *The Parties’ Costs of Arbitration*, 7(1) Transnat’l Disp. Mgt (2010); Kreindler, *Final Rulings on Costs: Loser Pays All?*, 7(1) Transnat’l Disp. Mgt 1 (2010); Kreindler, *Die Kostenentscheidung im Schiedsgerichtsverfahren aus US-amerikanischer Sicht*, 7(1) Transnat’l Disp. Mgt (2010); O’Reilly, *Rethinking Costs in Commercial Arbitration*, 69(2) Arb. 122 (2003); Power & Konrad, *Costs in International Commercial Arbitration – A Comparative Overview of Civil and Common Law Doctrines*, 2007 Austrian Arb. Y.B. 261; Rosell, *Arbitration Costs as Relief and/or Damages*, 28 J. Int’l Arb. 115 (2011); Rubino Sammartano, *Costs Awards in Arbitration*, 28 J. Int’l Arb. 113 (2011); Schwartz, *The Costs of ICC Arbitration*, 4(1) ICC Ct. Bull. 8 (1993); Smit & Robinson, *Cost Awards in International Arbitration: Proposed Guidelines for Promoting Time and Cost Efficiency*, 20 Am. Rev. Int’l Arb. 267 (2009); Smith, *Shifting Sands: Cost-and-Fee Allocation in International Investment Arbitration*, 51 Va. J. Int’l L. 749 (2011); Wetter & Priem, *Costs and Their Allocation*, 2 Am. Rev. Int’l Arb. 249 (1991).
- 463) See Carter, *A Kiss For Arbitration Costs Allocation*, 23 Am. Rev. Int’l Arb. 475 (2013) (“Attorney fees in significant commercial arbitrations, on the other hand, regularly run into the millions of dollars on each side.”); Gotanda, *Attorneys’ Fees Agonistes: The Implications of Inconsistency in the Awarding of Fees and Costs in International Arbitrations*, in M. Fernández-Ballesteros & D. Arias (eds.), *Liber Amicorum Bernardo Cremades* 541 (2010) (“The costs of international arbitration are two-fold and consist of the costs of the proceeding and the costs of the parties. The proceeding’s costs generally include administrative fees, tribunal fees, and costs associated with the tribunal. The parties’ costs are principally comprised of legal costs: attorneys’ fees, expert fees and related expenses.”); Gotanda, *Awarding Costs and Attorney’s Fees in International Commercial Arbitration*, 21 Mich. J. Int’l L. 1, 3 (1999); Rosell, *Arbitration Costs as Relief and/or Damages*, 28 J. Int’l Arb. 115, 115 (2011) (“costs of proceeding in the dispute resolution process ... include not only the amount that a party will have to pay at the end of the arbitration but also, for example, the litigation costs which would be generated if procedural issues had to be resolved prior to the arbitration or if parallel arbitration and/or litigation were engaged during the arbitration proceedings”).

- 464) Some national courts have held that arbitral tribunals have an obligation to consider costs claims before terminating their mandate and the arbitration. See, e.g., *Casata Ltd v. Gen. Distributions Ltd*, [2006] NZSC 8, ¶110 (N.Z. S.Ct.) (“[O]n the true meaning of cl 6(1)(a) of the Second Schedule an arbitral tribunal which is bound by that provision may not end its jurisdiction until after it has addressed the parties’ costs in the arbitration. ... [T]he tribunal in general should first determine those issues in an interim award, reserving the final determination on costs until it has given the parties an opportunity to be heard. If a party seeks costs, the tribunal must determine that question, either making an award of costs or deciding not to do so. In the latter case, or if no party seeks costs, the statutory default provision in cl 6(1)(b) will apply.”).
- 465) See E. Gaillard & J. Savage (eds.), *Fouchard Gaillard Goldman on International Commercial Arbitration* ¶¶1162, 1255 (1999); J. Lew, L. Mistelis & S. Kröll, *Comparative International Commercial Arbitration* ¶¶24-78 (2003); R. Merkin, *Arbitration Law* ¶18.77 (1991 & Update August 2013).
- 466) See, e.g., *Severtson v. Williams Constr. Co.*, 220 Cal.Rptr. 400, 406 (Cal. Ct. App. 1985); *Judgment of 19 December 1996, Société Qualiconsult v. Groupe Lincoln*, 1998 Rev. arb. 121, 124 (Paris Cour d’appel) (“arbitrators have ... the power to decide on the costs except where otherwise stipulated in the arbitration agreement”); *Judgment of 16 February 1993, Brega Oil Mktg Co. v. Techint Compagnie et Tecnica Internazionale SpA*, 13 ASA Bull. 57, 61-62 (Vaud Ct. App.) (1995) (ICC tribunal seated in Switzerland not required to apply Swiss law to issue of costs of arbitration); G. Keutgen & G. Dal, *L’arbitrage en droit belge et international Tome I: Le droit belge* ¶¶510 et seq. (2d ed. 2006); Voit, in H.-J. Musielak (ed.), *Kommentar zur Zivilprozessordnung* §1057, ¶¶1, 2, 4, 6 (5th ed. 2007); Wirth, in S. Berti et al. (eds.), *International Arbitration in Switzerland* Art. 189, ¶¶53-55, 60 (2001).
- 467) See §15.02.
- 468) *English Arbitration Act, 1996, §60*; R. Merkin, *Arbitration Law* ¶18.77 (1991 & Update August 2013). See also *Virdee v. Viridi* [2003] EWCA Civ 41 (English Ct. App.) (agreement excluded costs of legal representation); *Shashoua v. Sharma* [2009] EWHC 957 (Comm) (English High Ct.) (§60 is mandatory); *Mansfield v. Robinson* [1928] All ER 69, 71-73 (QB) (English High Ct.).
- 469) See, e.g., *Judgment of 16 October 2012, DFT 4A\_314/2012 (Swiss Federal Tribunal)*; B. Berger & F. Kellerhals, *International and Domestic Arbitration in Switzerland* ¶1492 (2d ed. 2010).
- 470) *Judgment of 10 November 2010, DFT 136 III 597, 603 (Swiss Federal Tribunal)* (rejecting argument that arbitral tribunal’s “Interim Award,” holding parties jointly liable for tribunal’s fees, was not an award: “[A]ccording to the majority of legal writing the arbitral tribunal has no authority to issue an enforceable decision as to the fees it may derive from the arbitration agreement (*receptum arbitri*). This is because claims resulting from the relationship between the arbitral tribunal and the parties do not fall within the arbitration clause; also because this would be an unacceptable decision in one’s own case. The decision on costs in an arbitral award is therefore nothing else as a rendering of account which does not bind the parties or a circumscription of the arbitrators’ private law claim based on the arbitration agreement on which in case of dispute the State Court will have to decide.”).
- 471) *Judgment of 24 October 2008, XXXIV Y.B. Comm. Arb. 533 (Oberlandesgericht Frankfurt) (2009)* (denying recognition of portion of award regarding costs of arbitration, as arbitrators are prohibited from determining their own costs and fees, except when agreed between parties and arbitrators).
- 472) H. Holtzmann & J. Neuhaus, *A Guide to the UNCITRAL Model Law on International Commercial Arbitration: Legislative History and Commentary* 1118-19 (1989) (“Commentary on Matters Not Addressed in the Final Text”).
- 473) Böhler, *Awarding Costs in International Commercial Arbitration: An Overview*, 22 ASA Bull. 249, 252-53 (2004); H. Holtzmann & J. Neuhaus, *A Guide to the UNCITRAL Model Law on International Commercial Arbitration: Legislative History and Commentary* 1119 (1989).

- 474)** See, e.g., [English Arbitration Act, 1996, §61\(1\)](#); German ZPO, §1057(1) (unless agreed otherwise, tribunal shall allocate costs, including those incurred by parties necessary for pursuit of claims); Austrian ZPO, §§609(1), (4) (unless agreed otherwise, tribunal shall decide on allocation of costs, taking into account circumstances of case, including particularly outcome of proceedings); [British Columbia International Commercial Arbitration Act, §31](#) (same); [Singapore International Arbitration Act, 2012, §12](#) (unless award otherwise directs, costs directed by award to be paid shall be taxable by Registrar); [Hong Kong Arbitration Ordinance, 2013, Art. 57](#) (“Unless otherwise agreed to by the parties, an arbitral tribunal may direct that the recoverable costs ... are limited to a specific amount”), Art. 74 (tribunal may award costs that are “reasonable,” including costs incurred in preparation prior to the commencement of the proceeding, unless otherwise agreed to by the parties); [Australian International Arbitration Act, 2011, §27](#) (parties authorized to agree that tribunal may make award of legal costs, including fixing its own fees and expenses); Russian Arbitration Law, Art. 31(2) (award shall contain amount of arbitrators’ fee and its apportionment); [Bermuda International Conciliation and Arbitration Act, §32](#) (tribunal may make award of legal costs, including fixing its own fees and expenses); [Mexican Commercial Code, Arts. 1454-1456](#); [Nigerian Arbitration and Conciliation Decree, §§49, 50](#).
- 475)** [English Arbitration Act, 1996, §61\(1\)](#) (“The tribunal may make an award allocating the costs of the arbitration as between the parties, subject to any agreement of the parties.”); R. Merkin, *Arbitration Law* ¶18.75 (1991 & Update August 2013).
- 476)** [English Arbitration Act, 1996, §61\(2\)](#); R. Merkin, *Arbitration Law* ¶18.75 (1991 & Update August 2013).
- 477)** [English Arbitration Act, 1996, §61\(2\)](#). See *Newfield Constr. Ltd v. John Lawton Tomlinson* [2004] EWHC 3051 (TCC) (English High Ct.) (annulling costs award because it ignored which party genuinely prevailed); Chartered Institute of Arbitrators, *Guidelines for Arbitrators on Making Orders Relating to the Costs of Arbitration*, 69 Arb. 130, 132 (2003) (“If a Claimant recovers a monetary award, he is normally regarded as successful since he had to bring the arbitration in order to recover the sum in question. The ‘event’ is the recovery of money. It is normally no ground for depriving the Claimant of his costs that the amount recovered is less than that claimed unless the recovery is so small that it can be regarded as nominal or derisory.”).
- 478)** See, e.g., *Newfield Constr. Ltd v. John Lawton Tomlinson* [2004] EWHC 3051, ¶¶28, 34, 36 (TCC) (English High Ct.); *Fence Gate Ltd v. NEL Constr. Ltd* [2001] 82 ConLR 41(TCC) (English High Ct.); R. Merkin, *Arbitration Law* ¶¶18.80 to 18.82 (1991 & Update August 2013).
- 479)** *Fence Gate Ltd v. NEL Constr. Ltd* [2001] 82 ConLR 41(TCC) (English High Ct.); N. Blackaby et al., *Redfern and Hunter on International Arbitration* ¶9.99 (5th ed. 2009); R. Merkin, *Arbitration Law* ¶¶18.80 to 18.82 (1991 & Update August 2013).
- 480)** Y. Derains & L. Kiffer, *National Report for France* (2013), in J. Paulsson (ed.), *International Handbook on Commercial Arbitration* 1, 64 (1984 & Update 2013); E. Gaillard & J. Savage (eds.), *Fouchard Gaillard Goldman on International Commercial Arbitration* ¶1255 (1999).
- 481)** B. Berger & F. Kellerhals, *Internationale und interne Schiedsgerichtsbarkeit in der Schweiz* ¶1477 (2006); Wirth, in S. Berti et al. (eds.), *International Arbitration in Switzerland* Art. 189, ¶¶51-61 (2001).
- 482)** Austrian ZPO, §609 (arbitral tribunals authorized to make awards of legal costs); [Swedish Arbitration Act, §37\(2\)](#); [Finnish Arbitration Act, §49](#); [Singapore International Arbitration Act, 2012, §21](#); [Hong Kong Arbitration Ordinance, 2013, Art. 74](#).
- 483)** *Judgment of 16 February 1993, Brega Oil Mktg Co. v. Techint Compagnie et Tecnica Internazionale SpA*, 13 ASA Bull. 57, 61-62 (Vaud Ct. App.) (1995).
- 484)** See, e.g., *McNabb v. Riley*, 29 F.3d 1303, 1306-07 (8th Cir. 1994); *Bacardi Corp. v. Congreso de Uniones Industriales de Puerto Rico*, 692 F.2d 210, 214 (1st Cir. 1982) (vacating award of attorneys’ fees); *Irving v. Ebix, Inc.*, 2010 WL 3168429, at \*4 (S.D. Cal.); *Prudential-Bache Sec., Inc. v. Depew*, 814 F.Supp. 1081, 1082-84 (M.D. Fla. 1993); *C.T. Shipping, Ltd v. DMI (U.S.A.) Ltd*, 774 F.Supp. 146, 152-53 (S.D.N.Y. 1991); *Sammi Line Co. v. Altamar Navigation SA*, 605 F.Supp. 72, 73-74 (S.D.N.Y. 1985) (relying on “traditional American rule” to conclude that agreement not addressing power to award attorneys’ fees did not permit such award); *Transvenezuelan Shipping Co. v. Czarnikow-Rionda Co.*, 1981 U.S. Dist. LEXIS 10059, at \*2 (S.D.N.Y.) (vacating award of attorneys’ fees as exceeding arbitrators’ authority where parties’ agreement provided for discretion to apportion “expenses and costs of the arbitration,” but was silent as to attorneys’ fees); *Koenigsberg v. Zinn*, 381 N.Y.S.2d 248 (N.Y. App. Div. 1976). See also Revised Uniform Arbitration Act, §21(b) (2000) (“An arbitrator may award reasonable attorney’s fees and other reasonable expenses of arbitration if such an award is authorized by law in a civil action involving the same claim or by the agreement of the parties to the arbitration proceeding.”).



- 485)** See *Alyeska Pipeline Serv. Co. v. Wilderness Soc’y*, 421 U.S. 240, 247 (U.S. S.Ct. 1975); *Prudential-Bache Sec, Inc. v. Tanner*, 72 F.3d 234, 242-43 (1st Cir. 1995); *Prudential-Bache Sec., Inc. v. Depew*, 814 F.Supp. 1081, 1082 (M.D. Fla. 1993) (in context of arbitration, observing that “[l]itigants in the United States must follow the so-called ‘American rule’ for attorneys’ fees,” and that “[a] litigant cannot collect attorneys’ fees from the losing party unless a statute or contract provides for the award, or the losing party willfully disobeyed a court order or brought suit in bad faith”).
- 486)** See, e.g., *Wells Fargo Bank v. WMR e-Pin LLC*, 653 F.3d 702, 713-14 (8th Cir. 2011); *Gen. Sec. Nat’l. Ins. Co. v. Aequicap Program Administrators*, 785 F.Supp.2d 411, 418 (S.D.N.Y. 2011) (broad scope of arbitration agreement provided tribunal “inherent authority” to award attorney’s fees); *Zimmer v. Scott*, 771 F.Supp.2d 905, 908 (N.D. Ill. 2011); *Eyewonder, Inc. v. Abraham*, 2010 WL 3528882 (S.D.N.Y.) (arbitrator’s award of attorneys’ fees was not excess of authority; parties’ agreement authorized such award); *MCT Shipping Corp. v. Sabet*, 497 F.Supp. 1078, 1083 (S.D.N.Y. 1980) (confirming award of attorneys’ fees); *Commercial Metals Co. v. Int’l Union Marine Corp.*, 1973 A.M.C. 515 (S.D.N.Y. 1972); *J.R. Snyder Co. v. Soble*, 226 N.W.2d 276, 278 (Mich. App. 1975).
- 487)** See New York Civil Practice Law and Rules, §7513 (arbitrator fees, but not attorneys’ fees, may be allocated in the final award); *Gen. Sec. Nat’l Ins. Co. v. Aequicap Program Admin.*, 785 F.Supp.2d 411, 423 (S.D.N.Y. 2011) (despite New York C.P.L.R. §7513, permitting only awards of arbitrators’ fees, arbitral tribunal had authority to award attorneys’ fees incurred by prevailing party in arbitration; award of fees not vacated).
- 488)** *Contra* authorities cited [§23.08\[A\]\[4\]](#), p. 3091 n. 490.
- 489)** See [§23.08\[B\]](#).
- 490)** See, e.g., *Asturiana de Zinc Mktg Inc. v. LaSalle Rolling Mills, Inc.*, 20 F.Supp. 670, 674-75 (S.D.N.Y. 1998) (arbitrator is not authorized to award costs of legal representation in AAA arbitration seated in New York, under contract governed by New York law); *CIT Project Fin., LLC v. Credit Suisse First Boston, LLC*, 2004 WL 2941331, at \*4 (N.Y. Sup. Ct.) (arbitrators lack authority to award attorneys’ fees notwithstanding incorporation of AAA International Rules).
- 491)** *Reliastar Life Ins. Co. of N.Y. v. EMC Nat’l Life Co.*, 564 F.3d 81, 87 (2d Cir. 2009) (“recognizing a bad faith exception to the general ‘American Rule’ that each party bears its own attorney’s fees”; interpreting clause providing that each party will bear own attorney’s fees as not precluding arbitrators’ award of attorney’s fees as sanction for bad faith conduct); *Chase Bank USA, NA v. Hale*, 859 N.Y.S.2d 342, 346 (2008) (“where arbitrators find a claim to have been brought in bad faith, they may, in the exercise of their broad powers to fashion remedies, award attorneys’ fees”).
- 492)** *Aasma v. Am. SS Owners Mut. Protection & Indem.*, 238 F.Supp.2d 918, 921-22 (N.D. Ohio 2003) (rejecting argument that foreign award should not be recognized because it awarded legal costs: “[T]he parties’ agreement established that the arbitration was to be conducted in accordance with the [English] Arbitration Act 1996. Sections 59-64 of the Act specifically provide for the awarding of costs and set forth default provisions in the absence of an agreement between the parties as to costs.”); *Employers Ins. Warsaw v. Banco Seguros del Estado*, 34 F.Supp.2d 1115, 1122 (E.D. Wis. 1999); *Compagnie des Bauxites de Guinee v. Hammermills Inc.*, 1992 WL 122712, at \*7 (D.D.C.).
- 493)** If the substantive and procedural law differ, difficulties may arise. Suppose the arbitration is conducted in England, with English law as the procedural law, but the parties’ underlying dispute is governed by New York law. English law permits (arguably requires) awards of legal costs; New York law arguably does not. If the tribunal awards the costs of legal representation, would a U.S. court enforce the award? As a matter of principle, the arbitrators’ award rests on a choice-of-law decision concerning the respective scope and priority of the curial and substantive laws, and that conflicts decision should not be reviewable in a recognition action in U.S. courts. See [§19.03\[H\]\[3\]](#).
- 494)** See, e.g., *Sun Ship, Inc. v. Matson Navigation Co.*, 785 F.2d 59, 64 (3d Cir. 1986); *Gelco Corp. v. Baker Indus., Inc.*, 779 F.2d 26, 28 (8th Cir. 1985); *Rhonda Enters. SA v. Projector SA*, 2009 WL 290537 (S.D.N.Y.) (awarding sanctions for fees and costs for non-meritorious attempts to vacate arbitral award); *Nitron Int’l Corp. v. Golden Panagia Maritime, Inc.*, 1999 WL 223155, at \*3 (S.D.N.Y.) (awarding attorney’s fees for cost of recognition proceedings; fees available, despite American rule, where award debtor “refused to abide by the arbitrator’s decision without justification”); *C.T. Shipping, Ltd v. DMI (U.S.A.) Ltd*, 774 F.Supp. 146, 155 (S.D.N.Y. 1991); *Hunt v. Commodity Haulage Corp.*, 647 F.Supp. 797, 799 (E.D.N.Y. 1986) (awarding attorney’s fees because party refused to comply with award without justification); *Supermkts Gen. Corp. v. Local 919*, 645 F.Supp. 831, 836 (D. Conn. 1986) (refusing to award attorneys’ fees for party’s action to vacate award because challenge was not in bad faith); *Jarrell v. Wilson Warehouse Co.*, 490 F.Supp. 412, 417 (M.D. La. 1980) (same); *Shearson Hayden Stone, Inc. v. Liang*, 493 F.Supp. 104, 110 (N.D. Ill. 1980) (refusing to award fees because defendant’s opposition was not “without justification”).
- 495)** *Sun Ship, Inc. v. Matson Navigation Co.*, 785 F.2d 59, 64 (3d Cir. 1986).

- 496)** See§23.08[B]. Some institutional rules contain limits on the amount of costs for legal representation that may be awarded. The Rules of the Court of Arbitration of the Polish Chamber of Commerce limit recovery of legal costs (to the costs of the arbitration proceedings and fees for one legal representative) to 100,000 Polish zloty [approximately USD 30,000]. Polish Chamber of Commerce Court of Arbitration Rules, Art. 43(4). These sorts of provisions are unusual and most institutional rules contain no such limits.
- 497)** See*Final Award in ICC Cases Nos. 7385 and 7402*, XVIII Y.B. Comm. Arb. 68, 78 (1993); *Koch Shipping, Inc. v. Antco Shipping Ltd, Award in SMA Case No. 2219 of 4 March 1986*, XII Y.B. Comm. Arb. 169, 172 (1987); *Ad Hoc Award of 27 May 1991*, XVII Y.B. Comm. Arb. 11, 26-27 (1992); G. Born, *International Arbitration and Forum Selection Agreements: Drafting and Enforcing* 91-93 (4th ed. 2013).
- 498)** See§23.08[A].
- 499)** 2010 UNCITRAL Rules, Art. 40(1); 1976 UNCITRAL Rules, Art. 38.
- 500)** 2010 UNCITRAL Rules, Art. 40(2)(e). See also 1976 UNCITRAL Rules, Art. 38(2)(e).
- 501)** 2010 UNCITRAL Rules, Art. 42(1). See also 1976 UNCITRAL Rules, Art. 40(1).
- 502)** 2010 UNCITRAL Rules, Art. 42(1). See 1976 UNCITRAL Rules, Art. 40(2). See also D. Caron & L. Caplan, *The UNCITRAL Arbitration Rules: A Commentary* 870 (2d ed. 2013) (“neither the [UNCITRAL] Rules nor the *travaux préparatoires* provide any guidance on the meaning of [Article 42(1)]”); UNCITRAL, *Summary Record of the Thirteenth Meeting of the Committee of the Whole (II), Ninth Session, U.N. Doc. A/CN.9/9/C.2/SR.13, ¶20* (1976) (for legal costs, “no principle of compensation would be laid down”).
- 503)** The tribunal’s discretion with regard to other costs of arbitration (e.g., the arbitrators’ expenses and fees) is more limited, with Article 42(1) providing only that these costs “shall in principle be borne by the unsuccessful party.” See also D. Caron & L. Caplan, *The UNCITRAL Arbitration Rules: A Commentary* 846 (2d ed. 2013) (“Legal and other costs are considered under Article 40 only if the arbitral tribunal determines that the amount of such costs is ‘reasonable.’”); UNCITRAL, *Report of the Secretary-General on the Preliminary Draft Set of Arbitration Rules for Optional Use in Ad Hoc Arbitration Relating to International Trade, Eighth Session, U.N. Doc. A/CN.9/97, VI UNCITRAL Y.B. 163, 180* (1975) (initial proposal allowing legal costs only where “arbitrators deem that legal assistance was necessary under the circumstances of the case” was deleted as unnecessarily restrictive).
- 504)** 2012 ICC Rules, Art. 37(4). See also 1998 ICC Rules, Art. 31(3).
- 505)** 2012 ICC Rules, Art. 37(4). See also 1998 ICC Rules, Art. 31(3).
- 506)** W. Craig, W. Park & J. Paulsson, *International Chamber of Commerce Arbitration* ¶21.04 (3d ed. 2000); Y. Derains & E. Schwartz, *A Guide to the ICC Rules of Arbitration* 366 (2d ed. 2005) (“This wording is intended to permit the arbitrators the greatest possible discretion.”).
- 507)** 2012 ICC Rules, Art. 31(5).
- 508)** 2012 ICC Rules, Art. 37(1); Y. Derains & E. Schwartz, *A Guide to the ICC Rules of Arbitration* 357-58 (2d ed. 2005). See also 1998 ICC Rules, Art. 31(1).
- 509)** LCIA Rules, Art. 28(2).
- 510)** LCIA Rules, Art. 28(3).
- 511)** LCIA Rules, Art. 28(4).
- 512)** See§23.08[A][2]; R. Merkin, *Arbitration Law* ¶18.79 (1991 & Update August 2013).
- 513)** See, e.g., ICDR Rules, Art. 31; 2013 HKIAC Rules, Art. 33; 2013 VIAC Rules, Art. 37; WIPO Rules, Art. 72.
- 514)** See, e.g., 2010 UNCITRAL Rules, Art. 40(2)(e); 1976 UNCITRAL Rules, Art. 38(1)(e); 2012 ICC Rules, Art. 37(1); LCIA Rules, Art. 28(3); DIS Rules, §35(1) (“costs incurred by the parties and which were necessary for the proper pursuit of their claim or defence”); 2013 VIAC Rules, Art. 7 (“determine the amount of the appropriate costs of the parties”). SeeRosell, *Arbitration Costs as Relief and/or Damages*, 28 J. Int’l Arb. 115, 116 (2011) (“[T]he arbitrators must determine the items that form part of the recoverable party costs and fix the resulting amounts on the basis of their discretion. The costs must have been incurred by a party for the purpose of the arbitration, and they must be ‘reasonable’ or ‘necessary.’ The test of reasonableness requires the arbitrators to determine whether the activities for which the costs were incurred were necessary in light of the complexity of the case, and, in the case of an affirmative answer, if the amounts claimed were reasonable.”).
- 515)** See, e.g., 2010 UNCITRAL Rules, Arts. 40(1), 42(1); 2012 ICC Rules, Art. 37(3); LCIA Rules, Art. 28(2).
- 516)** M. Bühler & T. Webster, *Handbook of ICC Arbitration: Commentary, Precedents, Materials* 361 (2d ed. 2008) (“In opting out of national courts with international arbitration, the parties are agreeing to pay the costs associated with international arbitration.”).
- 517)** See§23.08[A].
- 518)** See§23.08[C].

- 519)** See, e.g., *Final Award in ICC Case No. 7006*, XVIII Y.B. Comm. Arb. 58 (1993); *Beckman Instruments, Inc. v. Overseas Private Inv. Corp., Award in AAA Case No. 16 199 00209 87G of 20 February 1988*, XIV Y.B. Comm. Arb. 73, 81 (1989); *Final Award in NAI Case No. 1930 of 12 October 1999*, XXVI Y.B. Comm. Arb. 181, 196-97 (2001); *Econet Wireless Ltd v. First Bank of Nigeria, Ad Hoc Award of 2 June 2005*, XXXI Y.B. Comm. Arb. 49, 64-65 (2006); *Himpurna Cal. Energy Ltd v. PT (Persero) Perusahaan Listrik Negara, Final Ad Hoc Award of 4 May 1999*, XXV Y.B. Comm. Arb. 13, 106-07 (2000). See also Rosell, *Arbitration Costs as Relief and/or Damages*, 28 J. Int'l Arb. 115, 115 (2011) ("While the institutional rules can provide general directions on the apportionment of costs, they usually do not provide much guidance as to how costs should be assessed or allocated.").
- 520)** See, e.g., *Final Award in ICC Case No. 11670*, 22 ASA Bull. 333, 341-42 (2004); *Final Award in ICC Case No. 6752*, XVIII Y.B. Comm. Arb. 54, 57 (1993); *Final Award in ICC Case No. 6527*, XVIII Y.B. Comm. Arb. 44, 53 (1993); *Final Award in ICC Case No. 5460*, XIII Y.B. Comm. Arb. 104 (1988); *Award in CRCICA Case No. 20/1990 of 22 April 1992*, in M. Alam Eldin (ed.), *Arbitral Awards of the Cairo Regional Centre for International Commercial Arbitration* 29, 38, 41 (2000); *William J. Levitt v. Islamic Repub. of Iran, Award in IUSCT Case No. 520-210-3 of 29 August 1991*, 28 Iran-US C.T.R. 145, ¶¶ 125-27 (1991); *Himpurna Cal. Energy Ltd v. PT (Persero) Perusahaan Listrik Negara, Final Ad Hoc Award of 4 May 1999*, XXV Y.B. Comm. Arb. 13, 106-07 (2000).
- 521)** Gotanda, *Attorneys' Fees Agonistes: The Implications of Inconsistency in the Awarding of Fees and Costs in International Arbitrations*, in M. Fernández-Ballesteros & D. Arias (eds.), *Liber Amicorum for Bernado Cremades* 539 (2010); Gotanda, *Awarding Costs and Attorney's Fees in International Commercial Arbitrations*, 21 Mich. J. Int'l L. 1, 2 (1999). See also Carter, *A Kiss For Arbitration Costs Allocation*, 23 Am. Rev. Int'l Arb. 475 (2013) ("Arbitrators may and regularly do either (1) apportion costs, including attorney fees, based on some version of their perception of the extent of success on the merits ... ; (2) determine which is the 'prevailing' party, without much regard for the degree of its success, and award that party all or substantially all of the costs; or (3) leave each party to bear its own attorney fees and split the other costs of arbitration (sometimes called the purely 'procedural' costs) more or less evenly between the parties. But there are no rules or general principles by which to determine when a tribunal should or will apply one or another of these approaches."); Smith, *Shifting Sands: Cost-and-Fee Allocation in International Investment Arbitration*, 51 Va. J. Int'l L. 749, 750 (2011) ("[I]n recent years, ICSID and UNCITRAL tribunals have reached widely divergent results that are inconsistent with the application of a steady costs-application regime. Rather, these outcomes result from the variable application of multiple factors. The result is a regime in which victorious claimants are substantially more likely to recover some measure of legal fees or arbitral costs than victorious respondents. However, this outcome is nothing more than a tendency. Depending on the other circumstances of the case – particularly excessive filings, wholly unmeritorious claims, or fraud – respondents can and do recover large amounts of expenses from losing claimants.").
- 522)** *Final Award in ICC Case No. 6320*, XX Y.B. Comm. Arb. 62, 108-09 (1995); *Banque Arabe et Int'l d'Inv. v. Inter-Arab Inv. Guarantee Corp., Ad Hoc Award of 17 November 1994*, XXI Y.B. Comm. Arb. 13, 38 (1996).
- 523)** See §23.08[C]; *S.D. Myers, Inc. v. Gov't of Canada, Final Award on Costs in NAFTA Case of 30 December 2002*, available at [www.naftaclaims.com](http://www.naftaclaims.com) (successful claimant, who has been "forced to go through the process in order to achieve success, ... should not be penalised by having to pay for the process itself"); Smit & Robinson, *Cost Awards in International Arbitration: Proposed Guidelines for Promoting Time and Cost Efficiency*, 20 Am. Rev. Int'l Arb. 267 (2009) ("loser pays [principle]" is "well suited to international commercial arbitration"). Compare UNCITRAL, *Summary Record of the Thirteenth Meeting of the Committee of the Whole (II), Ninth Session*, U.N. Doc. A/CN.9/9/C.2/SR.13, 2-4 (1976) (noting opposition to rule that legal costs can be recovered by prevailing party, as contrary to state practice and disfavoring less affluent).
- 524)** See, e.g., *Award in ICC Case No. 8486*, XXIVa Y.B. Comm. Arb. 162, 172 (1999) ("According to general principles, the costs of the arbitration must be borne by the party which loses the arbitration"; "the arbitral tribunal must take into account for its decision on costs not only the result of the proceedings but also the behaviour of the parties during the proceedings"); *Final Award in ICC Case No. 7006*, XVIII Y.B. Comm. Arb. 58, 67 (1993) (listing factors; awarding all fees because of respondent's procedural misconduct); *Final Award in ICC Case No. 6527*, XVIII Y.B. Comm. Arb. 44, 53 (1993) (no award of fees, because prevailing party claimed "excessive" damages); *Final Award in ICC Case No. 6363*, XVII Y.B. Comm. Arb. 186, 211 (1992) (awarding all fees because claimant prevailed "in substance"); *Final Award in ICC Case No. 5759*, XVIII Y.B. Comm. Arb. 34, 43 (1993) (percentage corresponding to success); *Final Award in ICC Case No. 4629*, XVIII Y.B. Comm. Arb. 11 (1993) (awarding 90% of all fees because of respondent's delaying tactics); Rosell, *Arbitration Costs as Relief and/or Damages*, 28 J. Int'l Arb. 115, 117-18 (2011).

- 525) *Final Award in ICC Case No. 11670*, 22 ASA Bull. 333 (2004). See also M. Bühler & T. Webster, *Handbook of ICC Arbitration: Commentary, Precedents, Materials* 373-81 (2d ed. 2008) (relevant considerations in awarding legal costs); D. Caron & L. Caplan, *The UNCITRAL Arbitration Rules: A Commentary* 870-75 (2d ed. 2013) (factors relevant to costs awards).

As discussed above, the 2012 ICC Rules identify the same criteria in Article 31(5): “In making decisions as to costs, the arbitral tribunal may take into account such circumstances as it considers relevant, including the extent to which each party has conducted the arbitration in an expeditious and cost-effective manner.”

- 526) M. Bühler & T. Webster, *Handbook of ICC Arbitration: Commentary, Precedents, Materials* 377 (2d ed. 2008) (“Tribunals are reluctant to review in detail the time spent by lawyers in preparing the case.”); J. Waincymer, *Procedure and Evidence in International Arbitration* 1294 (2012) (“Many arbitrators would appear to simply accept a general fee note from counsel.”); Wehrli, *Contingency Fees/Pactum de Talnario “Civil Law Approach”*, 26 ASA Bull. 241, 254 (2008) (“[P]arties do not have to give full evidence on the parties’ costs and therefore have only a limited duty to substantiate. In practice, the proceedings relating to the parties’ costs are a kind of ‘summary proceeding’ and the decision is based on prima facie evidence.”) (emphasis in original). Summaries detailing monthly charges, broken down by individual lawyers’ rates and time spent, plus expenses, is ordinarily sufficiently detailed.
- 527) Carter, *A Kiss For Arbitration Costs Allocation*, 23 Am. Rev. Int’l Arb. 475, 479 (2013) (“in practice, many American arbitrators tend to apply ‘loser pays’ only to the procedural costs and not to attorney fees”); Frank, *Rationalizing Cost Awards in Investment Treaty Arbitration*, 88 Wash. U. L. Rev. 769, 777-78 (2011) (“When tribunals did make decisions, they did not regularly cite to any legal authority (i.e., citing less than one authority on average) to justify the result. Where tribunals offered reasons, justifications diverged across categories. Although the literature suggests cost decisions are often based on a pure ‘loser-pays’ approach or a desire to punish inappropriate behavior, these were not the most frequent rationales. ... Tribunals were most likely to rationalize their decisions using the parties’ relative success and equitable considerations. They were unlikely to base their decisions expressly on concerns related to the public interest, party equality, stare decisis, or settlement efforts.”).
- 528) Carter, *A Kiss For Arbitration Costs Allocation*, 23 Am. Rev. Int’l Arb. 475, 479 (2013).
- 529) See, e.g., *Final Award in ICC Case No. 10188*, XXVIII Y.B. Comm. Arb. 68 (2003) (75/25% allocation of arbitration costs and legal costs, based upon relative success); *Final Award in ICC Case No. 8528*, XXV Y.B. Comm. Arb. 341, 348 (2000) (claimant prevailed, holding that respondent bears 80% of arbitration costs and 60% of claimant’s legal costs); *Final Award in ICC Case No. 8445*, XXVI Y.B. Comm. Arb. 153 (2001) (awarding 75% of arbitration costs and legal costs, based on substantial success on merits of claimant’s claims); *Interim Award in ICC Case No. 7645*, XXVI Y.B. Comm. Arb. 130 (2001) (awarding costs of arbitration in proportion to percentage of success on amounts claimed (96/4%); reducing costs of legal representation “if only a modest proportion” because prevailing party was represented by two firms); ICC, *Statistics Concerning Awards of Legal Costs*, 4 ICC Ct. Bull. 43 (1993). See also Y. Derains & E. Schwartz, *A Guide to the ICC Rules of Arbitration* 371-73 (2d ed. 2005).
- 530) Y. Derains & E. Schwartz, *A Guide to the ICC Rules of Arbitration* 371-73 (2d ed. 2005); J. Fry, S. Greenberg & F. Mazza, *Secretariat’s Guide to ICC Arbitration* 407 (2012).
- 531) Y. Derains & E. Schwartz, *A Guide to the ICC Rules of Arbitration* 371-73 (2d ed. 2005); J. Fry, S. Greenberg & F. Mazza, *Secretariat’s Guide to ICC Arbitration* 407 (2012).
- 532) See, e.g., *Final Award in ICC Case No. 9466*, XXVII Y.B. Comm. Arb. 170, 180 (2002) (given relative success of each party, “costs of the arbitration [shall] be borne by the parties in equal proportions (50/50) and ... each party shall bear its own legal costs”); *Final Award in NAI Case No. 1930 of 12 October 1999*, XXVI Y.B. Comm. Arb. 181, 196 (2001) (“The practice of international arbitral tribunals vary widely. ... [T]here are no rigid rules. ... [C]laimant succeeded only in relation to a small proportion of its total claims. ... [T]he Tribunal awards that each party shall bear its own costs of legal assistance.”). See also Y. Derains & E. Schwartz, *A Guide to the ICC Rules of Arbitration* 371-73 (2d ed. 2005); J. Fry, S. Greenberg & F. Mazza, *Secretariat’s Guide to ICC Arbitration* 407 (2012).
- 533) See, e.g., *Final Award in ICC Case Nos. 6515 and 6516*, XXIV Y.B. Comm. Arb. 80, 139 (1999) (“The tribunal is reluctant to award costs in favor of either party. Not only has the claimant ... not fully succeeded, but the dispute in this instance is one that could have been handled in a more commercially effective manner. ... Neither party has contributed in any way to lessening the number or complexity of the issues to be resolved by the tribunal[;] on the contrary, each has contributed to inflate this arbitration in particular by raising numerous procedural issues. Therefore, the tribunal has no difficulty in deciding that each party shall bear an equal share of the costs of the arbitration ... and bear the legal costs ... that it has incurred.”); UNCITRAL, *Summary Record of the Thirteenth Meeting of the Committee of the Whole (II)*, Ninth Session, U.N. Doc. A/CN.9/9/C.2/SR.13, ¶4 (1976) (delaying tactics would justify award of legal costs).



- 534) D. Caron & L. Caplan, *The UNCITRAL Arbitration Rules: A Commentary* 871-72 (2d ed. 2013).
- 535) Y. Derains & E. Schwartz, *A Guide to the ICC Rules of Arbitration* 371-73 (2d ed. 2005).
- 536) Franck, *Empirically Evaluating Claims About Investment Treaty Arbitration*, 86 N.C.L. Rev. 1, 69 (2007). See also C. Schreuer et al., *The ICSID Convention: A Commentary* 1229 (2d ed. 2009) (“practice of ICSID tribunals in apportioning costs is neither clear nor uniform”); Smith, *Shifting Sands: Cost-and-Fee Allocation in International Investment Arbitration*, 51 Va. J. Int’l L. 749, 779 (2011) (“When respondents recovered costs, it was frequently in cases of abuse of process, fraud, or other such misconduct by claimants.”).
- 537) Smit & Robinson, *Cost Awards in International Arbitration: Proposed Guidelines for Promoting Time and Cost Efficiency*, 20 Am. Rev. Int’l Arb. 267 (2009).
- 538) Carter, *A Kiss For Arbitration Costs Allocation*, 23 Am. Rev. Int’l Arb. 475 (2013) (“One could call what now tends to be the norm the ‘Keep It Simple Solution’ (hereinafter, ‘KISS’) for cost allocation problems, and I see no convincing reason to change it. ... There are no multi-factor analyses to be conducted, just a pair of questions to be answered: does degree of success or inefficiencies merit shifting procedural costs, and does party/attorney conduct call for a shifting of attorney fees?”).
- 539) Some practitioners have also usefully suggested that arbitral tribunals discuss allocation of costs at the outset of arbitral proceedings. Smit & Robinson, *Cost Awards in International Arbitration: Proposed Guidelines for Promoting Time and Cost Efficiency*, 20 Am. Rev. Int’l Arb. 267 (2009) (recommending that arbitrators discuss cost allocation with counsel at beginning of arbitration).
- 540) See §11.03[D][2][i]; §17.02[A].
- 541) See §11.03[D][2][c]; §16.02[A].
- 542) See §11.03[D][2][h]; §23.07[F].
- 543) See §11.03[C][1][c][v]; §16.02[A]; §17.02[A][5]. Thus, annulment of an award of legal costs in the arbitral seat should not, where the parties’ agreement provided for such awards, prevent recognition of the award elsewhere. See §11.03[C][1][c]; §25.04[D][6].
- 544) The same distinction is drawn with regard to a tribunal’s power to order disclosure and provisional measures, on the one hand, and the standards governing such relief, on the other hand. See §16.02[A]; §17.02[A][5]; §17.02[G][2].
- 545) *Nucor Corp. v. Gen. Bearing Corp.*, 423 S.E.2d 747, 748-49 (N.C. 1992) (where agreement included North Carolina choice-of-law clause, court applied North Carolina statute that “specifically prohibits arbitrators from awarding attorneys’ fees unless ‘the agreement to arbitrate’ which compelled the parties to arbitration says otherwise”); *Grynberg v. BP Exploration Operating Ltd*, 2010 WL 5137912 (N.Y. Sup.) (substantive law governing contract also governed whether to award attorney’s fees: “[w]here an arbitration agreement expressly invokes state rules, those rules govern the arbitration”), *rev’d on other grounds*, 938 N.Y.S.2d 439 (N.Y. App. Div. 2012); P. Schlosser, *Das Recht der internationalen privaten Schiedsgerichtsbarkeit* ¶1701 (2d ed. 1989) (law applicable to arbitration agreement determines allocation of costs). *But cf. PaineWebber, Inc. v. Bybyk*, 81 F.3d 1193, 1202 (2d Cir. 1996) (“[A] choice of law provision will not be construed to impose substantive restrictions on the parties’ rights under the Federal Arbitration Act, including the right to arbitrate claims for attorneys’ fees. Therefore, [the appellant] cannot rely on the New York choice-of-law provision to prevent [the appellee] from seeking in arbitration a remedy that is not foreclosed by the Agreement.”); *Nat’l Union Fire Ins. Co. of Pittsburgh, PA v. Odyssey Am. Reins. Corp.*, 2009 WL 4059183, at \*1, 8 (S.D.N.Y.) (agreement for New York-seated arbitration provided: “The arbitrators and umpire are relieved from all judicial formality and may abstain from the strict rules of the law; however, punitive damages shall not be awarded. They shall settle any dispute under the Contract according to an equitable rather than a strict legal interpretation of its terms”; court held that “New York law prohibiting an arbitral award of attorneys’ fees is not applicable in the instant case”).
- 546) See §19.04[A][6].
- 547) Relatively few awards appear to have adopted this analysis. For one example, see *Award in Paris Chamber of Arbitration of 8 March 1996*, XXII Y.B. Comm. Arb. 28 (1997) (applying “lex mercatoria”).
- 548) See §23.08[B].
- 549) For example, if a party rejects a settlement offer of X and goes on to obtain an award of X (or less than X), it generally should not be entitled to amounts expended after rejecting the settlement offer, and should instead be liable for the other party’s costs for that period.
- 550) Aeberli, *Jurisdictional Disputes Under the Arbitration Act 1996: A Procedural Route Map*, 21 Arb. Int’l 253, 271-72 (2005); Kröll, *Recourse Against Negative Decisions on Jurisdiction*, 20 Arb. Int’l 55, 69-70 (2004).
- 551) See §7.03[A][5][b]; §7.03[F]. By definition, the respondent will have contested the tribunal’s jurisdiction. If not, then there will have been a waiver of jurisdictional objections. See §7.05[A][5].
- 552) See §23.08[C].

- 553)** Where the tribunal decides that there was a valid arbitration agreement (or this is not contested), but that the dispute is outside the scope of that agreement, then the difficulties concerning the tribunal's power to make a costs award should not exist. In these cases, generally-applicable standards regarding the tribunal's power to award costs apply without controversy.
- 554)** See, e.g., *Final Award in ICC Case No. 9302*, XXVIII Y.B. Comm. Arb. 54, 67 (2003) (dismissing arbitration on jurisdictional grounds, but ordering costs split: "The issue of jurisdiction was a complex one, the outcome of which was difficult to predict. ... [B]oth parties operated in good faith in the genuine belief that different rules governed their relationship. ... [B]oth parties have fully cooperated in the arbitration, and acted, through their counsel, in a highly professional manner, which the tribunal appreciated."); *Montague v. Commonwealth Dev. Corp.*, XXVI Y.B. Comm. Arb. 744, 749 (Queensland S.Ct. 1999) (2001) (rejecting argument that tribunal lacked power, after concluding that there was no valid arbitration agreement, to award costs against unsuccessful claimant: "there was clearly an agreement ... that the preliminary jurisdictional point ... should be determined in the arbitration and ... that the arbitrator should make a decision with respect to the cost of the arbitration on this issue").
- 555)** Bühler, *Awarding Costs in International Commercial Arbitration: An Overview*, 22 ASA Bull. 249, 258-59 (2004); Y. Derains & E. Schwartz, *A Guide to the ICC Rules of Arbitration* 108-09 (2d ed. 2005). See also Austrian ZPO, §609(2) ("Upon application of respondent, the arbitral tribunal may also decide upon the obligation of the claimant to reimburse the costs of the proceedings, if it has declared itself as not competent on the grounds that there is no arbitration agreement.").
- 556)** For commentary, see Branson & Wallace, *Awarding Interest in International Commercial Arbitration: Establishing A Uniform Approach*, 28 Va. J. Int'l L. 919 (1988); Gotanda, *Awarding Interest in International Arbitration*, 90 Am. J. Int'l L. 40 (1996); Gotanda, *A Study of Interest*, in L. Lévy & F. De Ly (eds.), *Interest, Auxiliary and Alternative Remedies in International Arbitration* 170 (2008); Gotanda, *Compound Interest in International Disputes*, 2004 Oxford U. Comp. L. Forum; Gotanda, *The Unpredictability Paradox: Punitive Damages and Interest in International Arbitration*, 7(1) Transnat'l Disp. Mgt 1 (2010); Gotanda, *When Recessions Create Windfalls: The Problems of Using Domestic Law to Fix Interest Rates Under Article 78 CISG*, 13 Vindobona J. Int'l Comm. Law & Arb. 229 (2009); Hammoud & Secomb, *Interest in ICC Arbitral Awards*, 15(1) ICC Ct. Bull. 53 (2004); Hunter & Triebel, *Awarding Interest in International Arbitration: Some Observations Based on A Comparative Study of the Laws of England and Germany*, 6(1) J. Int'l Arb. 7 (1989); Note, *The Provision of Compound Interest Under International Law*, 95 Am. J. Int'l L. 633 (2001); Reisberg & Pauley, *An Arbitrator's Authority to Award Interest on An Award Until "Date of Payment": Problems and Limitations*, 2013 Int'l Arb. L. Rev. 25; Wetter, *Interest as An Element of Damages in the Arbitral Process*, 5 Int'l Fin. L. Rev. 20 (1986).
- 557)** F. Mann, *The Legal Aspect of Money* 70-71 (5th ed. 1992).
- 558)** *Kuwait v. Am. Independent Oil Co., Ad Hoc Award of 24 March 1982*, 21 Int'l Legal Mat. 976, 1042 (1982).
- 559)** *British Columbia International Commercial Arbitration Act, §31(7)*. See also *English Arbitration Act, 1996, §§49(3), (4)* (authority to award simple or compound interest (i) "in respect of any period up to the date of the award" and (ii) "from the date of the award (or any later date) until payment"); *Singapore International Arbitration Act, 2012, §12(4)* ("may award interest (including interest on a compound basis)"); *Hong Kong Arbitration Ordinance, 2013, Arts. 79, 80* ("Unless otherwise agreed by the parties, an arbitral tribunal may, in the arbitral proceedings before it, award simple or compound interest from the dates, at the rates, and with the rests that the tribunal considers appropriate. ... Interest is payable on the judgment rate, except when the award otherwise provides."); *Australian International Arbitration Act, 2011, §§25, 26* (tribunal may award simple interest until date of award and interest at reasonable rate from date of award until specified later date); *Malaysian Arbitration Act, §33(6)* ("Unless otherwise provided in the arbitration agreement, the arbitral tribunal may award interest on any sum of money ordered to be paid by the award from the date of the award to the date of realization; and determine the rate of interest."); *Bermuda International Conciliation and Arbitration Act, §31* (same).
- 560)** See §23.09[A].
- 561)** Berger, *General Principles of Law in International Commercial Arbitration: How to Find Them – How to Apply Them*, 5 World Arb. & Med. Rev. 97, 130-36 (2011) (practice of international tribunals "to award interest goes back to the famous 'Alabama' Award of 1872").
- 562)** LCIA Rules Art. 26(6). See also *Westminster Constr. Corp. v. PPG Indus., Inc.*, 376 A.2d 708, 711 (R.I. 1977); *Matter of Burke*, 191 N.Y. 437, 440 (N.Y. 1908); Gotanda, *Compound Interest in International Disputes*, 2004 Oxford U. Comp. L. Forum; Note, *The Provision of Compound Interest Under International Law*, 95 Am. J. Int'l L. 633 (2001).
- 563)** See, e.g., Branson & Wallace, *Awarding Interest in International Commercial Arbitration: Establishing A Uniform Approach*, 28 Va. J. Int'l L. 919 (1988); D. Dobbs, *Remedies* 164-81 (1973).

- 564)** Statutory rates of interest vary, of course, from nation to nation. In the United States, 28 U.S.C. §1961 provides for a market rate of interest. In other jurisdictions, a fixed rate is established, which may bear little relation to market rates. See, e.g., New York Civil Practice Law and Rules §§5001, 5004 (6%). In other nations, a rate calculated by reference to some specified premium above market rates is established to deter delays in payment. See Wetter, *Interest as An Element of Damages in the Arbitral Process*, 5 Int'l Fin. L. Rev. 20, 22 (1986).
- 565)** See§23.09[C].
- 566)** See§23.09[E].
- 567)** See Giardina, *Issues of Applicable Law and Uniform Law on Interest: Basic Distinctions in National and International Practice*, in L. Lévy & F. De Ly (eds.), *Interest, Auxiliary and Alternative Remedies in International Arbitration* 131 (2008).
- 568)** SeeN. Blackaby et al. (eds.), *Redfern and Hunter on International Arbitration* ¶9.75 (5th ed. 2009) (referring to German conflict of law rules as an example).
- 569)** See§16.02[A]; §17.02[E]; §23.07[F]; §23.08[D]; *Judgment of 30 June 2004*, 2004 Rev. arb. 738 (French Cour de cassation civ. 1e) (law governing default interest was procedural law of arbitration); Chabot, *Intérêts moratoires dus sur la condamnation prononcée par une sentence arbitrale*, 2004 JCP E 1860. CompareDr. Horst Reiniccus v. Bank for Int'l Settlements, *Final Award in PCA Case of 19 September 2003*, XXVIII Y.B. Comm. Arb. 100, 151-52 (2003) (law governing rates of interest was law of state with closest contacts to case); *Guinea v. Maritime Int'l Nominees Establishment – MINE (Liechtenstein)*, *Decision on Application for Annulment in ICSID Case No. ARB/84/4 of 14 December 1989*, XVI Y.B. Comm. Arb. 40, 45, 51 (1991) (law governing rates of interest was law designated in contractual choice-of-law provision).
- 570)** See§11.03[D].
- 571)** This is a specialized application of the principle of *depeçage*, discussed above. See§11.05[A][2].
- 572)** That is the case in some Middle Eastern states, where neither local courts nor arbitrators may award interest. See Saleh, *Interest and Public Policy From Recognition and Enforcement of Foreign Arbitral Awards in the Arab Middle East*, in J. Lew (ed.), *Contemporary Problems in International Arbitration* 348, 349 (1986). The consistency of such provisions with Articles II and V(1)(d) of the New York Convention is open to debate.
- 573)** French Civil Code, Art. 1153(1) (interest at statutory rate).
- 574)** See§15.02[A].
- 575)** As discussed above, differing laws potentially apply to the tribunal's power to order disclosure, provisional measures and costs, on the one hand, and the standards for granting such relief, on the other. See§16.02[A]; §17.02[E]; §23.07[F]; §23.08[D]; §23.09[B], p. 3107 n. 580.
- 576)** *McCullough & Co. v. Ministry of Post, Tel. & Tel., Award in IUSCT Case No. 225-89-3 of 22 April 1986*, XII Y.B. Comm. Arb. 316, 328 (1987) (Brower, J., dissenting).
- 577)** See Hunter & Triebel, *Awarding Interest in International Arbitration: Some Observations Based on A Comparative Study of the Laws of England and Germany*, 6(1) J. Int'l Arb. 7 (1989); Wetter, *Interest as An Element of Damages in the Arbitral Process*, 5 Int'l Fin. L. Rev. 20, 22 (1986).
- 578)** Compare *Restatement (Second) Conflict of Laws* §207, comment e (1971) with *Klaxon Co. v. Stentor Elec. Mfg Co.*, 313 U.S. 487 (U.S. S.Ct. 1941). See also J. Story, *Commentaries on the Conflict of Laws* 395, 405-06 (8th ed. 1883) ("as a general rule ... the *lex loci contractus* will, in all cases, govern as to the rule of interest").

- 579)** See, e.g., *Final Award in ICC Case No. 6531*, XVII Y.B. Comm. Arb. 221, 223-34 (1992) (applying French statutory rates of interest because French law governed agreement; French arbitral seat); *Award in ICC Case No. 6281*, XV Y.B. Comm. Arb. 96 (1990) (applying Yugoslav statutory interest rules where Yugoslav law governed contract; rates apparently based on historical market rates, with 7.25% to accrue from date of award until payment); *Final Award in ICC Case No. 6230*, XVII Y.B. Comm. Arb. 164, 175-76 (1992) (applying Swiss statutory interest rules, which looked to official discount rates at place of payment, because Swiss law governed contract; Swiss arbitral seat); *Final Award in ICC Case No. 6162*, XVII Y.B. Comm. Arb. 153, 162 (1992) (applying 5% statutory Egyptian rate of interest because contract was governed by Egyptian law, notwithstanding higher market rates; Swiss arbitral seat); *Final Award in ICC Case No. 5485*, XIV Y.B. Comm. Arb. 156, 173 (1989) (applying Spanish statutory rates of interest because Spanish law governed agreement; French arbitral seat); *Award in ICC Case No. 4237*, X Y.B. Comm. Arb. 52, 59-60 (1985) (applying English law, granting arbitrator discretion regarding interest, because English law governed contract; French arbitral seat); *Award in ICC Case No. 2637*, II Y.B. Comm. Arb. 153 (1977) (applying statutory French interest rate where French law governed contract; Swiss arbitral seat); *AGIP SpA v. People's Repub. of the Congo*, Award in ICSID Case No. ARB/77/1 of 30 November 1979, 21 Int'l Legal Mat. 726, 731, 739 (1982); *RJ Reynolds Tobacco Co. v. Islamic Repub. of Iran*, Award in IUSCT Case No. 145-35-3 of 6 August 1984, 7 Iran-US C.T.R. 181, 191-92 (1984) (applying law governing contract to availability of interest); *Rexnord Inc. v. Islamic Repub. of Iran*, Award in IUSCT Case No. 21-132-3 of 10 January 1983, 2 Iran-US C.T.R. 6, 12 (1983) (applying substantive law of contract to interest rate); *Ad Hoc Award of 27 May 1991*, XVII Y.B. Comm. Arb. 11, 26-27 (1992) (applying 5% statutory Swiss rate of interest because contract was governed by Swiss law; New York arbitral seat); *Libyan Am. Oil Co. (LIAMCO) v. Gov't of the Libyan Arab Repub.*, *Ad Hoc Award of 12 April 1977*, VI Y.B. Comm. Arb. 89, 115-16 (1981) (applying Libyan interest rates). See also Reisberg & Pauley, *An Arbitrator's Authority to Award Interest on An Award Until "Date of Payment": Problems and Limitations*, 2013 Int'l Arb. L. Rev. 25, 25 ("As to the pre-award time period, it is now generally accepted that arbitrators usually apply the substantive law of the contract.").
- 580)** *Asian Agric. Prods. Ltd v. Democratic Socialist Repub. of Sri Lanka*, Award in ICSID Case No. ARB/87/3 of 27 June 1990, 30 Int'l Legal Mat. 577, 625 (1991) (applying "long established rule of international law" that "it is just and reasonable to allow interest at a reasonable rate"); *McCullough & Co. v. Ministry of Post, Tel. & Tel.*, Award in IUSCT Case No. 225-89-3 of 22 April 1986, XII Y.B. Comm. Arb. 316, 321-22 (1987).
- 581)** Hunter & Triebel, *Awarding Interest in International Arbitration: Some Observations Based on A Comparative Study of the Laws of England and Germany*, 6(1) J. Int'l Arb. 7 (1989).
- 582)** See, e.g., *Final Award in ICC Case No. 5460*, XIII Y.B. Comm. Arb. 104, 109 (1988) (applying statutory rate of interest prescribed by Austrian law to debt in Austrian currency, notwithstanding applicability of English law to contract and English arbitral seat); *Award in ICC Case No. 2930*, IX Y.B. Comm. Arb. 105, 107-08 (1984) (awarding interest at Swiss statutory rate because payment was due in Swiss currency, notwithstanding fact that law governing contract was Yugoslav); Giardina, *Issues of Applicable Law and Uniform Law on Interest: Basic Distinctions in National and International Practice*, in L. Lévy & F. De Ly (eds.), *Interest, Auxiliary and Alternative Remedies in International Arbitration* 131, 141 (2008); Kleiner, *Money in Private International Law: What Are the Problems? What Are the Solutions?*, 2009 Y.B. Private Int'l L. 595, 595-96 (2009) ("[A]pplication of the law applicable to the obligation for the determination of the rate of interest is a blind solution and disregards the connection that should be respected between interest and the currency in which the interest must be paid. Accordingly, the application of the *lex monetæ* should be applied in order to assess the rate of interest.").
- 583)** See §23.09[A].
- 584)** See, e.g., *Second Interim Award in ICC Case No. 5277*, XIII Y.B. Comm. Arb. 80, 89-90 (1988) (refusing to award interest, notwithstanding contractual provision for such, because parties' chosen law had been Islamized and forbids interest awards); *Award in ICC Case No. 4606*, *Parker Drilling Co. v. Sonatrach*, described in Branson & Wallace, *Awarding Interest in International Commercial Arbitration: Establishing A Uniform Approach*, 28 Va. J. Int'l L. 919, 937 *et seq.* (1988) (denying interest because applicable (Algerian) substantive law contained no provision for interest); *Final Ad Hoc Award of 20 November 1987*, XIV Y.B. Comm. Arb. 47, 51, 68 (1989) (refusing to award interest under contract governed by Saudi law).
- 585)** See §23.09[B], p. 3105.
- 586)** Reisberg & Pauley, *An Arbitrator's Authority to Award Interest on An Award Until "Date of Payment": Problems and Limitations*, 2013 Int'l Arb. L. Rev. 25, 25 ("[A]n arbitration award upon court confirmation is considered to be 'merged' into and superseded by the judgment. As a result, the post-judgment interest rate will be the same as that applicable to court judgments.").
- 587)** Reisberg & Pauley, *An Arbitrator's Authority to Award Interest on An Award Until "Date of Payment": Problems and Limitations*, 2013 Int'l Arb. L. Rev. 25, 25.



- 588)** *Parsons & Whittemore Alabama Mach. & Servs. Corp. v. Yeargin Constr. Co.*, 744 F.2d 1482, 1484 (11th Cir. 1984); *Banque Nat'l De Paris v. 1567 Broadway Ownership Assocs.*, 248 A.D.2d 154 (N.Y. App. Div. 1998); *Marine Mgt, Inc. v. Seco Mgt, Inc.*, 176 A.D.2d 252, 253 (N.Y. App. Div. 1991), *aff'd*, 600 N.E.2d 627 (1992). See J. Gotanda, *Supplemental Damages in Private International Law* §3.4 (1988) (“an arbitral award is enforced in a country as a court judgment, interest then accrues at the domestic rate applicable to civil judgments in that country, instead of at the rate set forth in the original award”); Reisberg & Pauley, *An Arbitrator’s Authority to Award Interest on An Award Until “Date of Payment”: Problems and Limitations*, 2013 Int’l Arb. L. Rev. 25, 25 (“law governing interest for the post-judgment period will most likely be the law of the enforcement jurisdiction”).
- 589)** *Retirement Accounts, Inc. v. Pacst Realty LLC*, 49 A.D.3d 846, 847 (N.Y. App. Div. 2008) (“Where there is a clear, unambiguous, and unequivocal expression to pay an interest rate higher than the statutory interest rate until the judgment is satisfied, the contractual interest rate is the proper rate to be applied.”); T. Oehmke, *Commercial Arbitration* §124:2 (2003 & Update 2013) (“Parties may ‘contract out’ of statutory interest rates if their agreement expresses the parties’ intent to deviate from a post-judgment interest rate set by statute.”).
- 590)** See generally the awards cited in §23.09[C]. See also N. Blackaby et al. (eds.), *Redfern and Hunter on International Arbitration* ¶9.81 (5th ed. 2009); Branson & Wallace, *Awarding Interest in International Commercial Arbitration: Establishing A Uniform Approach*, 28 Va. J. Int’l L. 919, 920, 924 (1988); J. Ralston, *International Arbitral Law and Procedure* 82-83 (1910); Senechal & Gotanda, *Interest as Damages*, 47 Colum. J. Transnat’l L. 491 (2009) (arguing that tribunals fail to adequately compensate for loss because risk-free U.S. Treasury bills and LIBOR rates fail to account for greater risk and return that investors would usually seek in their investments).
- 591)** *Spalding v. Mason*, 161 U.S. 375, 396 (U.S. S.Ct. 1896) (quoting *Curtis v. Innerarity*, 47 U.S. 146, 154 (U.S. S.Ct. 1848)). See also Senechal, *Present-Day Valuation in International Arbitration: A Conceptual Framework for Awarding Interest*, in L. Lévy & F. De Ly (eds.), *Interest, Auxiliary and Alternative Remedies in International Arbitration* 219 et seq. (2008) (“award of interest should be a significant element in full compensation to reflect the lapse of time between the original injury and the decision of the arbitral tribunal”).
- 592)** *English Arbitration Act, 1996*, §§49(3), (4) (“The Tribunal may award simple or compound interest.”); *Singapore International Arbitration Act, 2012*, §12(4) (“may award interest (including interest on a compound basis)”; *Hong Kong Arbitration Ordinance, 2013*, Arts. 79, 80 (“Unless otherwise agreed by the parties, an arbitral tribunal may, in the arbitral proceedings before it, award simple or compound interest from the dates, at the rates, and with the rests that the tribunal considers appropriate. ... Interest is payable on the judgment rate, except when the award otherwise provides.”). Compare *Australian International Arbitration Act, 2011*, §§25, 26 (tribunal may award simple interest until date of award and interest at reasonable rate from date of award until specified later date).
- 593)** *RJ Reynolds Tobacco Co. v. Islamic Repub. of Iran, Award in IUSCT Case No. 145-35-3 of 6 August 1984*, 7 Iran-US C.T.R. 181, 191-92 (1984) (“The Tribunal ... does not find that there are any special reasons for departing from international precedents which normally do not allow the awarding of compound interest.”). See also Gotanda, *Compound Interest in International Disputes*, 2004 Oxford U. Comp. L. Forum; Note, *The Provision of Compound Interest Under International Law*, 95 Am. J. Int’l L. 633 (2001). But see LCIA Rules, Art. 26(6).
- 594)** Lillich, *Interest in the Law of International Claims in Essays in Honor of Voitto Saario and Toivo Sainio* 51, 57 (1983).
- 595)** See §23.09[C], p.3109 n. 592.
- 596)** See §23.09[A].
- 597)** See *Waterside Ocean Navigation Co. v. Int’l Navigation Ltd*, 737 F.2d 150, 153-54 (2d Cir. 1984) (“we do not see why pre-judgment interest should not be available in actions brought under the Convention”); *Int’l Standard Elec. Corp. v. Bidas Sociedad Anonima Petrolera*, 745 F.Supp. 172, 182 (S.D.N.Y. 1990); *Am. Constr. Mach. & Equip. Corp. v. Mechanised Constr. of Pakistan Ltd*, 659 F.Supp. 426, 429 (S.D.N.Y. 1987) (confirming award made in Geneva under Swiss procedural law), *aff’d*, 828 F.2d 117 (2d Cir. 1987); *Brandeis Intsel, Ltd v. Calabrian Chem. Corp.*, 656 F.Supp. 160, 170 (S.D.N.Y. 1987); *Al-Haddad Bros. Enter., Inc. v. M/S Agapi*, 635 F.Supp. 205, 210 (D. Del. 1986) (enforcing foreign award, which included 15% pre-award interest *per annum*); *Judgment of 9 January 1995, Inter Maritime Mgt SA v. Russian & Vecchi*, XXII Y.B. Comm. Arb. 789, 797-98 (Swiss Federal Tribunal) (1997) (compound interest not violation of public policy).

- 598)** For rare exceptions, see *Laminoirs-Trefileries-Cableries de Lens, SA v. Southwire Co.*, 484 F.Supp. 1063, 1069 (N.D. Ga. 1980) (vacating award of “penal” interest); *Judgment of 26 January 2005*, XXX Y.B. Comm. Arb. 421 (Austrian Oberster Gerichtshof) (2005) (denying recognition to portion of award granting interest, on grounds that annual interest rate of 73% violates Austrian public policy). See §26.05[C][9][h][vii]. Compare *Int’l Standard Elec. Corp. v. Bidas Sociedad Anonima Petrolera Indus. y Comercial*, 745 F.Supp. 172, 182 (S.D.N.Y. 1990) (“We find no merits in ISEC’s claim that the interest component of the Award is penal in nature.”); *Brandeis Intsel Ltd v. Calabrian Chem. Corp.*, 656 F.Supp. 160, 170 (S.D.N.Y. 1987) (absent showing that interest award was, under English law, “penal only and relate[d] to the punishing of public wrongs as contradistinguished from the redressing of private injuries,” award was not contrary to U.S. public policy); *Am. Constr. Mach. & Equip. Corp., Ltd v. Mech. Constr. of Pakistan Ltd*, 659 F.Supp. 426, 428 (S.D.N.Y. 1987) (giving effect to interest rate of 17%).
- 599)** See, e.g., *Millmaker v. Bruso*, 2008 WL 4560624 (S.D. Tex.) (although pre-judgment interest is mandatory in breach of contract cases under New York law, arbitrators had discretion to award or not award interest); *Coastal Caisson Corp. v. E.E. Cruz/NAB/Frontier-Kemper*, 2007 WL 2285936 (S.D.N.Y.) (same).
- 600)** *Gordon Sel-Way, Inc. v. Spence Bros., Inc.*, 475 N.W.2d 704, 711 (Mich. 1991) (arbitrators committed no substantial or material error in including pre-award interest in their award, even though parties’ contract was silent concerning right to interest); *Westminster Constr. Corp. v. PPG Indus., Inc.*, 376 A.2d 708, 711 (R.I. 1977) (“arbitrators may award interest, even if not claimed, unless otherwise specifically provided by the parties’ in the agreement”).
- 601)** See, e.g., *Sarhank Group v. Oracle Corp.*, 2004 U.S. Dist. LEXIS 2493 (S.D.N.Y.) (U.S. law governs availability of post-award, pre-judgment interest on foreign award; law of arbitral seat irrelevant); *Suraleb, Inc. v. Prod. Ass’n Minsk Tractor Works*, 1996 WL 3523747 (N.D. Ill.) (U.S. federal common law governs availability of post-award, pre-judgment interest on foreign award); *Judgment of 30 June 2004, Inter-Arab Inv. Guarantee Corp. v. Bail Recouvrement*, 2005 Rev. arb. 645, 646 (French Cour de cassation civ. 1e) (French law governs right to interest on awards made in Jordan when enforcement is sought in France: “when the dispute has arisen out of the enforcement in France of an arbitral award declared enforceable, when the arbitral tribunal did not rule on the issue and can no longer be petitioned, the law governing post-award interest, which flows automatically from the order to pay, is the law of enforcement, here French law”).
- 602)** See, e.g., *Schlobohm v. Pepperidge Farm, Inc.*, 806 F.2d 578, 581 (5th Cir. 1986) (“where the parties made an agreement intended to avoid court litigation by resolving the entire dispute through arbitration, intervention by the court to award additional relief would be inconsistent with the language and policy of the [FAA]”); *Dealer Computer Servs., Inc. v. Johnson Ford Lincoln Mercury Nissan, Inc.*, 2010 WL 2991064, at \*4 (S.D. Tex.); *Millmaker v. Bruso*, 2008 WL 4560624 (S.D. Tex.); *Diaz v. Cruz*, 926 N.E.2d 1182, 1184 (Mass. App. Ct. 2010); *Levin & Glasser, PC v. Kenmore Prop., LLC*, 896 N.Y.S.2d 311, 313 (N.Y. App. Div. 2010); *Levin & Glasser, PC v. Kenmore Prop., LLC*, 70 A.D.3d 443, 445-46 (N.Y. App. Div. 2010) (court lacked authority to add pre-award interest in connection with confirming award “[g]iven that arbitrators had authority to award pre-award interest and made no such award”); *Sansone v. Metro. Prop. & Liability Ins. Co.*, 572 N.E.2d 588, 589-90 (Mass. App. Ct. 1991); *Creative Builders, Inc. v. Avenue Dev. Inc.*, 715 P.2d 308, 312 (Ariz. App. 1986) (“trial judge may not modify an award so as to grant pre-award interest”); *Kermacy v. First Unitarian Church*, 361 S.W.2d 734, 735 (Tex. Civ. App. 1962) (“appellant’s claim for interest prior to the date of the award of the arbitrators was merged in the award”); *Penco Fabrics Inc. v. Louis Bogopulsky, Inc.*, 146 N.Y.S.2d 514 (N.Y. App. Div. 1955). Compare *Finger Lakes Bottling Co. v. Coors Brewing Co.*, 2010 WL 4104690, at \*4 (S.D.N.Y.) (granting pre-award interest because arbitrator concluded that issue was “beyond the scope of the arbitration”).
- 603)** *Schlobohm v. Pepperidge Farm, Inc.*, 806 F.2d 578, 581 (5th Cir. 1986).
- 604)** See, e.g., *Newmont USA Ltd v. Ins. Co. of N. Am.*, 615 F.3d 1268, 1277 (10th Cir. 2010); *IHX (U.K.) Ltd v. Ashapura Minechem Ltd*, 2009 WL 3169541, at \*3 (S.D.N.Y.); *Int’l Standard Elec. Corp. v. Bidas Sociedad Anonima Petrolera*, 745 F.Supp. 172, 181 (S.D.N.Y. 1990); *Am. Constr. Mach. & Equip. Corp. v. Mech. Constr. of Pakistan Ltd*, 659 F.Supp. 426 (S.D.N.Y. 1987), *aff’d*, 828 F.2d 117 (2d Cir. 1987). See also *Foley Co. v. Grindsted Prods., Inc.*, 662 P.2d 1254, 1263 (Kan. 1983).
- One court has said, however, that an arbitral tribunal would have “lacked authority to decide the ... question of prejudgment interest on the amount confirmed by the district court judgment,” by which the court meant post-award/pre-judgment interest. *Sun Ship, Inc. v. Matson Navigation Co.*, 785 F.2d 59, 63 (3d Cir. 1986).
- 605)** See, e.g., *Carte Blanche (Singapore) Pte Ltd v. Carte Blanche Int’l, Ltd*, 888 F.2d 260, 268 *et seq.* (2d Cir. 1989). *Contra French v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 784 F.2d 902, 907 (9th Cir. 1986).
- 606)** Reisberg & Pauley, *An Arbitrator’s Authority to Award Interest on An Award Until “Date of Payment”*: *Problems and Limitations*, 2013 Int’l Arb. L. Rev. 25, 25.

- 607)** *Newmont USA Ltd v. Ins. Co. of N. Am.*, 615 F.3d 1268, 1274 (10th Cir. 2010) (“no reason why an arbitration panel with authority to decide a contractual dispute cannot also determine whether the contract in question includes language stating the parties’ intent to bypass §1961”).
- 608)** See *Bhd of Locomotive Eng’rs & Trainmen v. Long Island R.R. Co.*, 340 F.Appx 727, 730 (2d Cir. 2009) (“it was within the District Court’s authority in enforcing the action to require the payment of postaward prejudgment interest”); *Waterside Ocean Navigation Co. v. Int’l Navigation Ltd*, 737 F.2d 150, 153-54 (2d Cir. 1984); *Parsons & Whittemore Alabama Mach. & Serv. Corp. v. Yeargin Constr. Co.*, 744 F.2d 1482, 1485 (11th Cir. 1984); *Abondolo v. H. & M.S. Meat Corp.*, 2008 WL 2047612, at \*3 (S.D.N.Y.); *P.M.I. Trading v. Farstad Oil*, 2001 WL 38282, at \*3 (S.D.N.Y.) (“Absent persuasive argument to the contrary, post-award, prejudgment interest is available for judgments rendered under the Convention and is presumed to be appropriate.”); *Creative Builders, Inc. v. Ave. Dev., Inc.*, 715 P.2d 308, 313-14 (Ariz. App. 1986). See also *McCabe Hamilton & Renny Co., Ltd v. Int’l Longshore & Warehouse Union, Local 142, AFL-CIO*, 557 F.Supp.2d 1171, 1178 (D. Haw. 2008) (“This court concludes that the circumstances of this case do not warrant an award of prejudgment interest.”); *Trustees of Lawrence Academy v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 821 F.Supp. 59, 63 (D.N.H. 1993) (court has power to award post-award interest); *Bergesen v. Joseph Muller Corp.*, 548 F.Supp. 650, 651 (S.D.N.Y. 1982), *aff’d*, 710 F.2d 928 (2d Cir. 1983); *Laminoirs-Trefileries-Cableries de Lens, SA v. Southwire Co.*, 484 F.Supp. 1063, 1069 (N.D. Ga. 1980).
- 609)** See, e.g., *Indus. Risk Insurers v. M.A.N. Gutehoffnungshütte GmbH*, 141 F.3d 1434, 1447 (11th Cir. 1998) (post-award interest “should normally be awarded when damages have been liquidated by an international arbitration award”); *Waterside Ocean Navigation Co. v. Int’l Navigation Ltd*, 737 F.2d 150, 155-55 (2d Cir. 1984) (confirming English award and granting post-award, pre-judgment interest); *P.M.I. Trading Ltd v. Farstad Oil, Inc.*, 2001 WL 38382, at \*3 (S.D.N.Y.) (“post-award, prejudgment interest is available for judgments rendered under the Convention and is presumed to be appropriate”); *Al-Haddad Bros. Enter., Inc. v. M/S Agapi*, 635 F.Supp. 205, 210 (D. Del. 1986) (“Federal courts have the power to grant such post-award, pre-judgment interest when enforcement of foreign arbitral awards is sought.”). See also Reisberg & Pauley, *An Arbitrator’s Authority to Award Interest on An Award Until “Date of Payment”: Problems and Limitations*, 2013 Int’l Arb. L. Rev. 25, 28 (“United States courts have long held that the courts in confirming international arbitration awards may add an award of interest for the post-award, pre-judgment time period under federal law at rates set by the court as a matter within its discretion.”).

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## **LEGAL AUTHORITY CA-124**

*Status: This version of this Act contains provisions that are prospective.*

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# Arbitration Act 1996

## 1996 CHAPTER 23

An Act to restate and improve the law relating to arbitration pursuant to an arbitration agreement; to make other provision relating to arbitration and arbitration awards; and for connected purposes. [17th June 1996]

Be it enacted by the Queen's most Excellent Majesty, by and with the advice and consent of the Lords Spiritual and Temporal, and Commons, in this present Parliament assembled, and by the authority of the same, as follows:—

### Annotations:

#### Extent Information

**E1** This Act extends to England, Wales and Northern Ireland; for exceptions see s.108

#### Modifications etc. (not altering text)

- C1** Act modified (11.11.1999) by 1999 c. 31, s. 8(1)(2) (with application as mentioned in s. 10(2)(3))
- C2** Act excluded (31.1.1997) by 1966 c. 41, s. 3 (as substituted by 1996 c. 23, s. 107(1), **Sch. 3 para. 24** (with s. 81(2)); S.I. 1996/3146, art. 3 (with transitional provisions in art. 4, **Sch. 2**)  
Act excluded (1.8.1998) by 1992 c. 52, s. 212A(6) (as inserted (1.8.1998) by 1998 c. 8, s. 7; S.I. 1998/1658, art. 2(1), **Sch. 1**)  
Act excluded (N.I.) (1.3.1999) by S.I. 1998/3162 (N.I. 21), art. 89(6); S.R. 1999/81, art. 3  
Act excluded (31.3.2002) by The Dairy Produce Quotas Regulations 2002 (S.I. 2002/457), regs. 2, 9(b), 10(1)(b)(4)(b), 11(2), 33(5)(b)(iii), **Sch. 1 para. 34**  
Act excluded (31.3.2002) by The Dairy Produce Quotas (Wales) Regulations 2002 (S.I. 2002/897), regs. 2, 9(b), 10(1)(b)(4)(b), 11(2), 33(5)(b)(iii), **Sch. 1 para. 34**
- C3** Power to apply conferred (11.9.1996 for certain purposes and otherwise 1.5.1998) by 1996 c. 53, s. 108(6); S.I. 1996/2352, art. 2(2); S. I. 1998/650, art. 2
- C4** Act applied (E.) (4.7.2002) by Vehicular Access Across Common and Other Land (England) Regulations 2002 (S.I. 2002/1711), regs. 1, 12(3)(b)
- C5** Act applied (W.) (9.2.2004) by The Vehicular Access Across Common and Other Land (Wales) Regulations 2004 (S.I. 2004/248), regs. 1, 12(3)(b)
- C6** Act excluded (31.3.2005) by The Dairy Produce Quotas Regulations 2005 (S.I. 2005/465), regs. 10(2), 11, 12(3), 39(4), **Sch. 1 para. 34**

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- C7 Act excluded (W.) (31.3.2005) by The Dairy Produce Quotas (Wales) Regulations 2005 (S.I. 2005/537), regs. 10(2), 11, 12(3), 39(4), **Sch. 1 para. 34**
- C8 Act applied (W.) (13.1.2006) by The Tir Cynnal (Wales) Regulations 2006 (S.I. 2006/41), **reg. 13(3)**
- C9 Act applied (E.W.) (10.11.2008) by The Land Registration Rules 2003 (S.I. 2003/1417), rule 194A(4) (b) (as inserted by The Land Registration (Amendment) Rules 2008 (S.I. 2008/1919), rule 4(1), **Sch. 1 para. 61**)
- C10 Act applied (E.W.) (10.11.2008) by The Land Registration Rules 2003 (S.I. 2003/1417), rule 194C(3) (b) (as inserted by The Land Registration (Amendment) Rules 2008 (S.I. 2008/1919), rule 4(1), **Sch. 1 para. 61**)
- C11 Act: functions transferred (N.I.) (12.4.2010) by virtue of The Northern Ireland Act 1998 (Devolution of Policing and Justice Functions) Order 2010 (S.I. 2010/976), art. 15(1), **Sch. 17 para. 13** (with arts. 28-31)
- C12 Act applied (N.I.) (14.2.2016) by The Animal Feed (Hygiene, Sampling etc. and Enforcement) Regulations (Northern Ireland) 2016 (S.R. 2016/5), **reg. 28(7)**
- C13 Act applied (E.W.) (10.8.2016) by The York Potash Harbour Facilities Order 2016 (S.I. 2016/772), **Sch. 10 para. 21(7)** (with arts. 35, 36)
- C14 Act applied (20.5.2018) by The Motorcycles (Type-Approval) Regulations 2018 (S.I. 2018/235), **Sch. 1 para. 13(2)(a)** (with reg. 1(c), Sch. 1 paras. 16, 17)
- C15 Act applied (20.5.2018) by The Agricultural and Forestry Vehicles (Type-Approval) Regulations 2018 (S.I. 2018/236), **Sch. 1 para. 13(2)(a)** (with reg. 1(c), Sch. 1 paras. 16, 17)
- C16 Act applied (21.9.2018) by The Non-Road Mobile Machinery (Type-Approval and Emission of Gaseous and Particulate Pollutants) Regulations 2018 (S.I. 2018/764), **Sch. 1 para. 13(2)(a)** (with reg. 1(c))

## PART I

### ARBITRATION PURSUANT TO AN ARBITRATION AGREEMENT

#### Annotations:

#### Modifications etc. (not altering text)

- C17 Pt. I excluded (E.W.) (1.11.1996) by 1996 c. 56, s. 336(4), 476(4), 582(4), **Sch. 40, para. 4** (with s. 1(4))  
 Pt. I excluded (31.1.1997) by 1988 c. 8, s. 6 (as substituted (31.1.1997) by 1996 c. 23, s. 107(1), **Sch. 3 para. 49**; S.I. 1996/3146, art. 3 (with art. 4, **Sch. 2**))  
 Pt. I excluded (N.I.) (1.3.1999) by S.I. 1998/3162 (N.I. 21), **art. 89(6)**; S.R. 1999/81, **art. 3**
- C18 Pt. I (ss. 1-84) excluded (E.W.) by 1998 c. 14, s. 16(9) (which is in force: at 4.3.1999 for specified purposes by S.I. 1999/528, art. 2(a), **Sch.**; at 5.7.1999 for specified purposes by S.I. 1999/1958, art. 2(1)(b), **Sch. 1** (with transitional provisions in **Sch. 12**, and as amended by S.I. 1999/3178, art. 3(20), **Sch. 20**); at 6.9.1999 for specified purposes by S.I. 1999/2422, art. 2(c), **Sch. 1** (subject to transitional provisions in **Sch. 14**, and as amended by S.I. 1999/3178, art. 3(20), **Sch. 20**); at 5.10.1999 for specified purposes by S.I. 1999/2739, art. 2, **Sch. 1** (subject to transitional provisions in **Sch. 2**); at 18.10.1999 for specified purposes by S.I. 1999/2860, art. 2(c), **Sch. 1** (subject to transitional provisions in **Schs. 16-18**, and as amended by S.I. 1999/3178, art. 3(20), **Sch. 20**); 29.11.1999 for specified purposes by S.I. 1999/3178, art. 2(1), **Sch. 1** (subject to transitional provisions in s. 5 and **Schs. 21-23**)
- C19 Pt. I (ss. 1-84) excluded by S.I. 1998/1506 (N.I. 10), **art. 16(9)** (which is in force: at 10.3.1999 for specified purposes by S.R. 1999/102, art. 2(a), **Sch. Pt. I**; at 5.7.1999 for specified purposes by S.R. 1999/310, art. 2(1)(b), **Sch. 1**; at 6.9.1999 for specified purposes by S.R. 1999/371, art. 2(b), **Sch. 1**; at 5.10.1999 for specified purposes by S.R. 1999/407, art. 2(b), **Sch.**; at 18.10.1999 for specified purposes by S.R. 1999/428, art. 2(b), **Sch. 1**; at 29.11.1999 for specified purposes by S.R. 1999/472, art. 2(1), **Sch. 1**)



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- C20** Pt. I excluded (E.W.) (1.9.2000) by 1999 c. 14, s. **9(4)**; S.I. 2000/2337, **art. 2(1)(e)**  
Pt. I excluded (prosp.) by 1999 c. 14, **ss. 9(4)**, 14(2)  
Pt. I excluded (N.I.) (22.11.2000 for specified purposes and otherwise 2.7.2001) by 2000 c. 4, ss. 59, 68, **Sch. 7 para. 10** (with s. 66(6)); S.R. 2000/358, art. 2, **Sch. Pt. II**; S.R. 2001/141, art 2(1)(c), **Sch.**  
Pt. I excluded (E.W.) (2.7.2001) by 2000 c. 19, s. 68, **Sch. 7 para. 10(8)** (with s. 83(6)); S.I. 2001/1252, **art. 2(2)(a)(i)**
- C21** Pt. I: specified provisions applied (with modifications) (N.I.) (28.4.2002) by Labour Relations Agency Arbitration Scheme Order (Northern Ireland) 2002 (S.R. 2002/120), **art. 3**, Sch.
- C22** Pt. I excluded (22.2.2005 for specified purposes and otherwise 6.4.2005) by Pensions Appeal Tribunals Act 1943 (c. 39), s. **6D(8)** (as inserted by Armed Forces (Pensions and Compensation) Act 2004 (c. 32), ss. 5, 8, **Sch. 1 para. 4**); S.I. 2005/356, art. 2, {Sch. 1, 2}
- C23** Pt. I excluded (N.I.) (1.3.2005 for specified purposes and otherwise 1.4.2005) by Health and Personal Social Services (Quality, Improvement and Regulation) (Northern Ireland) Order 2003 (S.I. 2003/431 (N.I. 9)), **art. 44(4)**; S.R. 2005/44, **arts. 2, 3**, Schs. 1, 2 (subject to arts. 4-13)
- C24** Pt. I excluded (N.I.) (1.9.2005) by The Special Educational Needs and Disability (Northern Ireland) Order 2005 (S.I. 2005/1117 (N.I. 6)), **art. 23(5)** (with arts. 46, 47); S.R. 2005/336, **art. 2**, Sch.
- C25** Pt. I excluded (N.I.) (1.9.2005) by The Education (Northern Ireland) Order 1996 (S.I. 1996/274 (N.I. 1)), art. 23(4) (as substituted by The Special Educational Needs and Disability (Northern Ireland) Order 2005 (S.I. 2005/1117 (N.I. 6)), **Sch. 5 para. 7(4)**; S.R. 2005/336, **art. 2**, Sch.)
- C26** Pt. I: power to exclude or restrict conferred (19.9.2007) by virtue of Tribunals, Courts and Enforcement Act 2007 (c. 15), ss. 22, 148, **Sch. 5 para. 14**; S.I. 2007/2709, **art. 2(i)**
- C27** Pt. I excluded (3.11.2008) by The Tribunal Procedure (First-tier Tribunal) (Social Entitlement Chamber) Rules 2008 (S.I. 2008/2685), **rule 3(2)**
- C28** Pt. I excluded (3.11.2008) by The Tribunal Procedure (First-tier Tribunal) (War Pensions and Armed Forces Compensation Chamber) Rules 2008 (S.I. 2008/2686), **rule 3(2)**
- C29** Pt. I excluded (3.11.2008) by The Tribunal Procedure (Upper Tribunal) Rules 2008 (S.I. 2008/2698), **rule 3(2)**
- C30** Pt. I excluded (3.11.2008) by The Tribunal Procedure (First-tier Tribunal) (Health, Education and Social Care Chamber) Rules 2008 (S.I. 2008/2699), **rule 3(2)**
- C31** Pt. I excluded (1.4.2009) by The Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009 (S.I. 2009/273), **rule 3(2)**
- C32** Pt. I excluded (1.9.2009) by The Tribunal Procedure (First-tier Tribunal) (General Regulatory Chamber) Rules 2009 (S.I. 2009/1976), **rule 3(2)**
- C33** Pt. I excluded (4.8.2010 for specified purposes and otherwise 1.10.2010) by Equality Act 2010 (c. 15), ss. 116(3), 216(3), **Sch. 17 para. 6(6)**; S.I. 2010/1736, art. 2, **Sch.**; S.I. 2010/1966, **art. 2**; S.I. 2010/2317, **art. 2(9)(k)(i)** (with art. 15)
- C34** Pt. I excluded (1.7.2013) by The Tribunal Procedure (First-tier Tribunal) (Property Chamber) Rules 2013 (S.I. 2013/1169), art. 1(1) **rule 4(2)** (with art. 2)

## Introductory

### 1 General principles.

The provisions of this Part are founded on the following principles, and shall be construed accordingly—

- (a) the object of arbitration is to obtain the fair resolution of disputes by an impartial tribunal without unnecessary delay or expense;
- (b) the parties should be free to agree how their disputes are resolved, subject only to such safeguards as are necessary in the public interest;
- (c) in matters governed by this Part the court should not intervene except as provided by this Part.

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## **2 Scope of application of provisions.**

- (1) The provisions of this Part apply where the seat of the arbitration is in England and Wales or Northern Ireland.
- (2) The following sections apply even if the seat of the arbitration is outside England and Wales or Northern Ireland or no seat has been designated or determined—
  - (a) sections 9 to 11 (stay of legal proceedings, &c.), and
  - (b) section 66 (enforcement of arbitral awards).
- (3) The powers conferred by the following sections apply even if the seat of the arbitration is outside England and Wales or Northern Ireland or no seat has been designated or determined—
  - (a) section 43 (securing the attendance of witnesses), and
  - (b) section 44 (court powers exercisable in support of arbitral proceedings);
 but the court may refuse to exercise any such power if, in the opinion of the court, the fact that the seat of the arbitration is outside England and Wales or Northern Ireland, or that when designated or determined the seat is likely to be outside England and Wales or Northern Ireland, makes it inappropriate to do so.
- (4) The court may exercise a power conferred by any provision of this Part not mentioned in subsection (2) or (3) for the purpose of supporting the arbitral process where—
  - (a) no seat of the arbitration has been designated or determined, and
  - (b) by reason of a connection with England and Wales or Northern Ireland the court is satisfied that it is appropriate to do so.
- (5) Section 7 (separability of arbitration agreement) and section 8 (death of a party) apply where the law applicable to the arbitration agreement is the law of England and Wales or Northern Ireland even if the seat of the arbitration is outside England and Wales or Northern Ireland or has not been designated or determined.

## **3 The seat of the arbitration.**

In this Part “the seat of the arbitration” means the juridical seat of the arbitration designated—

- (a) by the parties to the arbitration agreement, or
  - (b) by any arbitral or other institution or person vested by the parties with powers in that regard, or
  - (c) by the arbitral tribunal if so authorised by the parties,
- or determined, in the absence of any such designation, having regard to the parties’ agreement and all the relevant circumstances.

## **4 Mandatory and non-mandatory provisions.**

- (1) The mandatory provisions of this Part are listed in Schedule 1 and have effect notwithstanding any agreement to the contrary.
- (2) The other provisions of this Part (the “non-mandatory provisions”) allow the parties to make their own arrangements by agreement but provide rules which apply in the absence of such agreement.
- (3) The parties may make such arrangements by agreeing to the application of institutional rules or providing any other means by which a matter may be decided.



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- (4) It is immaterial whether or not the law applicable to the parties' agreement is the law of England and Wales or, as the case may be, Northern Ireland.
- (5) The choice of a law other than the law of England and Wales or Northern Ireland as the applicable law in respect of a matter provided for by a non-mandatory provision of this Part is equivalent to an agreement making provision about that matter.

For this purpose an applicable law determined in accordance with the parties' agreement, or which is objectively determined in the absence of any express or implied choice, shall be treated as chosen by the parties.

## **5 Agreements to be in writing.**

- (1) The provisions of this Part apply only where the arbitration agreement is in writing, and any other agreement between the parties as to any matter is effective for the purposes of this Part only if in writing.

The expressions "agreement", "agree" and "agreed" shall be construed accordingly.

- (2) There is an agreement in writing—
  - (a) if the agreement is made in writing (whether or not it is signed by the parties),
  - (b) if the agreement is made by exchange of communications in writing, or
  - (c) if the agreement is evidenced in writing.
- (3) Where parties agree otherwise than in writing by reference to terms which are in writing, they make an agreement in writing.
- (4) An agreement is evidenced in writing if an agreement made otherwise than in writing is recorded by one of the parties, or by a third party, with the authority of the parties to the agreement.
- (5) An exchange of written submissions in arbitral or legal proceedings in which the existence of an agreement otherwise than in writing is alleged by one party against another party and not denied by the other party in his response constitutes as between those parties an agreement in writing to the effect alleged.
- (6) References in this Part to anything being written or in writing include its being recorded by any means.

### *The arbitration agreement*

## **6 Definition of arbitration agreement.**

- (1) In this Part an "arbitration agreement" means an agreement to submit to arbitration present or future disputes (whether they are contractual or not).
- (2) The reference in an agreement to a written form of arbitration clause or to a document containing an arbitration clause constitutes an arbitration agreement if the reference is such as to make that clause part of the agreement.

## **7 Separability of arbitration agreement.**

Unless otherwise agreed by the parties, an arbitration agreement which forms or was intended to form part of another agreement (whether or not in writing) shall not be

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regarded as invalid, non-existent or ineffective because that other agreement is invalid, or did not come into existence or has become ineffective, and it shall for that purpose be treated as a distinct agreement.

## **8 Whether agreement discharged by death of a party.**

- (1) Unless otherwise agreed by the parties, an arbitration agreement is not discharged by the death of a party and may be enforced by or against the personal representatives of that party.
- (2) Subsection (1) does not affect the operation of any enactment or rule of law by virtue of which a substantive right or obligation is extinguished by death.

### *Stay of legal proceedings*

## **9 Stay of legal proceedings.**

- (1) A party to an arbitration agreement against whom legal proceedings are brought (whether by way of claim or counterclaim) in respect of a matter which under the agreement is to be referred to arbitration may (upon notice to the other parties to the proceedings) apply to the court in which the proceedings have been brought to stay the proceedings so far as they concern that matter.
- (2) An application may be made notwithstanding that the matter is to be referred to arbitration only after the exhaustion of other dispute resolution procedures.
- (3) An application may not be made by a person before taking the appropriate procedural step (if any) to acknowledge the legal proceedings against him or after he has taken any step in those proceedings to answer the substantive claim.
- (4) On an application under this section the court shall grant a stay unless satisfied that the arbitration agreement is null and void, inoperative, or incapable of being performed.
- (5) If the court refuses to stay the legal proceedings, any provision that an award is a condition precedent to the bringing of legal proceedings in respect of any matter is of no effect in relation to those proceedings.

## **10 Reference of interpleader issue to arbitration.**

- (1) Where in legal proceedings relief by way of interpleader is granted and any issue between the claimants is one in respect of which there is an arbitration agreement between them, the court granting the relief shall direct that the issue be determined in accordance with the agreement unless the circumstances are such that proceedings brought by a claimant in respect of the matter would not be stayed.
- (2) Where subsection (1) applies but the court does not direct that the issue be determined in accordance with the arbitration agreement, any provision that an award is a condition precedent to the bringing of legal proceedings in respect of any matter shall not affect the determination of that issue by the court.

## **11 Retention of security where Admiralty proceedings stayed.**

- (1) Where Admiralty proceedings are stayed on the ground that the dispute in question should be submitted to arbitration, the court granting the stay may, if in those

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proceedings property has been arrested or bail or other security has been given to prevent or obtain release from arrest—

- (a) order that the property arrested be retained as security for the satisfaction of any award given in the arbitration in respect of that dispute, or
  - (b) order that the stay of those proceedings be conditional on the provision of equivalent security for the satisfaction of any such award.
- (2) Subject to any provision made by rules of court and to any necessary modifications, the same law and practice shall apply in relation to property retained in pursuance of an order as would apply if it were held for the purposes of proceedings in the court making the order.

### *Commencement of arbitral proceedings*

## **12 Power of court to extend time for beginning arbitral proceedings, &c.**

- (1) Where an arbitration agreement to refer future disputes to arbitration provides that a claim shall be barred, or the claimant's right extinguished, unless the claimant takes within a time fixed by the agreement some step—
  - (a) to begin arbitral proceedings, or
  - (b) to begin other dispute resolution procedures which must be exhausted before arbitral proceedings can be begun,the court may by order extend the time for taking that step.
- (2) Any party to the arbitration agreement may apply for such an order (upon notice to the other parties), but only after a claim has arisen and after exhausting any available arbitral process for obtaining an extension of time.
- (3) The court shall make an order only if satisfied—
  - (a) that the circumstances are such as were outside the reasonable contemplation of the parties when they agreed the provision in question, and that it would be just to extend the time, or
  - (b) that the conduct of one party makes it unjust to hold the other party to the strict terms of the provision in question.
- (4) The court may extend the time for such period and on such terms as it thinks fit, and may do so whether or not the time previously fixed (by agreement or by a previous order) has expired.
- (5) An order under this section does not affect the operation of the Limitation Acts (see section 13).
- (6) The leave of the court is required for any appeal from a decision of the court under this section.

## **13 Application of Limitation Acts.**

- (1) The Limitation Acts apply to arbitral proceedings as they apply to legal proceedings.
- (2) The court may order that in computing the time prescribed by the Limitation Acts for the commencement of proceedings (including arbitral proceedings) in respect of a dispute which was the subject matter—

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- (a) of an award which the court orders to be set aside or declares to be of no effect, or
  - (b) of the affected part of an award which the court orders to be set aside in part, or declares to be in part of no effect,
- the period between the commencement of the arbitration and the date of the order referred to in paragraph (a) or (b) shall be excluded.
- (3) In determining for the purposes of the Limitation Acts when a cause of action accrued, any provision that an award is a condition precedent to the bringing of legal proceedings in respect of a matter to which an arbitration agreement applies shall be disregarded.
- (4) In this Part “the Limitation Acts” means—
- (a) in England and Wales, the <sup>M1</sup>Limitation Act 1980, the <sup>M2</sup>Foreign Limitation Periods Act 1984 and any other enactment (whenever passed) relating to the limitation of actions;
  - (b) in Northern Ireland, the <sup>M3</sup>Limitation (Northern Ireland) Order 1989, the <sup>M4</sup>Foreign Limitation Periods (Northern Ireland) Order 1985 and any other enactment (whenever passed) relating to the limitation of actions.

**Annotations:**

**Marginal Citations**

- M1** 1980 c. 58.
- M2** 1984 c. 16.
- M3** S.I. 1989/1339 (N.I. 11).
- M4** S.I. 1985/754 (N.I. 5).

**14 Commencement of arbitral proceedings.**

- (1) The parties are free to agree when arbitral proceedings are to be regarded as commenced for the purposes of this Part and for the purposes of the Limitation Acts.
- (2) If there is no such agreement the following provisions apply.
- (3) Where the arbitrator is named or designated in the arbitration agreement, arbitral proceedings are commenced in respect of a matter when one party serves on the other party or parties a notice in writing requiring him or them to submit that matter to the person so named or designated.
- (4) Where the arbitrator or arbitrators are to be appointed by the parties, arbitral proceedings are commenced in respect of a matter when one party serves on the other party or parties notice in writing requiring him or them to appoint an arbitrator or to agree to the appointment of an arbitrator in respect of that matter.
- (5) Where the arbitrator or arbitrators are to be appointed by a person other than a party to the proceedings, arbitral proceedings are commenced in respect of a matter when one party gives notice in writing to that person requesting him to make the appointment in respect of that matter.

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**Annotations:**

**Modifications etc. (not altering text)**

**C35** S. 14 applied (31.1.1997) by 1894 c. 60, s. 496(5) (as inserted by 1996 c. 23, s. 107(1), Sch. 3 para. 1) (with s. 81(2)); S.I. 1996/3146, art. 3 (with art. 4, Sch. 2)

*The arbitral tribunal*

**15 The arbitral tribunal.**

- (1) The parties are free to agree on the number of arbitrators to form the tribunal and whether there is to be a chairman or umpire.
- (2) Unless otherwise agreed by the parties, an agreement that the number of arbitrators shall be two or any other even number shall be understood as requiring the appointment of an additional arbitrator as chairman of the tribunal.
- (3) If there is no agreement as to the number of arbitrators, the tribunal shall consist of a sole arbitrator.

**16 Procedure for appointment of arbitrators.**

- (1) The parties are free to agree on the procedure for appointing the arbitrator or arbitrators, including the procedure for appointing any chairman or umpire.
- (2) If or to the extent that there is no such agreement, the following provisions apply.
- (3) If the tribunal is to consist of a sole arbitrator, the parties shall jointly appoint the arbitrator not later than 28 days after service of a request in writing by either party to do so.
- (4) If the tribunal is to consist of two arbitrators, each party shall appoint one arbitrator not later than 14 days after service of a request in writing by either party to do so.
- (5) If the tribunal is to consist of three arbitrators—
  - (a) each party shall appoint one arbitrator not later than 14 days after service of a request in writing by either party to do so, and
  - (b) the two so appointed shall forthwith appoint a third arbitrator as the chairman of the tribunal.
- (6) If the tribunal is to consist of two arbitrators and an umpire—
  - (a) each party shall appoint one arbitrator not later than 14 days after service of a request in writing by either party to do so, and
  - (b) the two so appointed may appoint an umpire at any time after they themselves are appointed and shall do so before any substantive hearing or forthwith if they cannot agree on a matter relating to the arbitration.
- (7) In any other case (in particular, if there are more than two parties) section 18 applies as in the case of a failure of the agreed appointment procedure.

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## **17 Power in case of default to appoint sole arbitrator.**

- (1) Unless the parties otherwise agree, where each of two parties to an arbitration agreement is to appoint an arbitrator and one party (“the party in default”) refuses to do so, or fails to do so within the time specified, the other party, having duly appointed his arbitrator, may give notice in writing to the party in default that he proposes to appoint his arbitrator to act as sole arbitrator.
- (2) If the party in default does not within 7 clear days of that notice being given—
  - (a) make the required appointment, and
  - (b) notify the other party that he has done so,
 the other party may appoint his arbitrator as sole arbitrator whose award shall be binding on both parties as if he had been so appointed by agreement.
- (3) Where a sole arbitrator has been appointed under subsection (2), the party in default may (upon notice to the appointing party) apply to the court which may set aside the appointment.
- (4) The leave of the court is required for any appeal from a decision of the court under this section.

## **18 Failure of appointment procedure.**

- (1) The parties are free to agree what is to happen in the event of a failure of the procedure for the appointment of the arbitral tribunal.  
  
 There is no failure if an appointment is duly made under section 17 (power in case of default to appoint sole arbitrator), unless that appointment is set aside.
- (2) If or to the extent that there is no such agreement any party to the arbitration agreement may (upon notice to the other parties) apply to the court to exercise its powers under this section.
- (3) Those powers are—
  - (a) to give directions as to the making of any necessary appointments;
  - (b) to direct that the tribunal shall be constituted by such appointments (or any one or more of them) as have been made;
  - (c) to revoke any appointments already made;
  - (d) to make any necessary appointments itself.
- (4) An appointment made by the court under this section has effect as if made with the agreement of the parties.
- (5) The leave of the court is required for any appeal from a decision of the court under this section.

## **19 Court to have regard to agreed qualifications.**

In deciding whether to exercise, and in considering how to exercise, any of its powers under section 16 (procedure for appointment of arbitrators) or section 18 (failure of appointment procedure), the court shall have due regard to any agreement of the parties as to the qualifications required of the arbitrators.

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## **20 Chairman.**

- (1) Where the parties have agreed that there is to be a chairman, they are free to agree what the functions of the chairman are to be in relation to the making of decisions, orders and awards.
- (2) If or to the extent that there is no such agreement, the following provisions apply.
- (3) Decisions, orders and awards shall be made by all or a majority of the arbitrators (including the chairman).
- (4) The view of the chairman shall prevail in relation to a decision, order or award in respect of which there is neither unanimity nor a majority under subsection (3).

## **21 Umpire.**

- (1) Where the parties have agreed that there is to be an umpire, they are free to agree what the functions of the umpire are to be, and in particular—
  - (a) whether he is to attend the proceedings, and
  - (b) when he is to replace the other arbitrators as the tribunal with power to make decisions, orders and awards.

- (2) If or to the extent that there is no such agreement, the following provisions apply.
- (3) The umpire shall attend the proceedings and be supplied with the same documents and other materials as are supplied to the other arbitrators.
- (4) Decisions, orders and awards shall be made by the other arbitrators unless and until they cannot agree on a matter relating to the arbitration.

In that event they shall forthwith give notice in writing to the parties and the umpire, whereupon the umpire shall replace them as the tribunal with power to make decisions, orders and awards as if he were sole arbitrator.

- (5) If the arbitrators cannot agree but fail to give notice of that fact, or if any of them fails to join in the giving of notice, any party to the arbitral proceedings may (upon notice to the other parties and to the tribunal) apply to the court which may order that the umpire shall replace the other arbitrators as the tribunal with power to make decisions, orders and awards as if he were sole arbitrator.
- (6) The leave of the court is required for any appeal from a decision of the court under this section.

## **22 Decision-making where no chairman or umpire.**

- (1) Where the parties agree that there shall be two or more arbitrators with no chairman or umpire, the parties are free to agree how the tribunal is to make decisions, orders and awards.
- (2) If there is no such agreement, decisions, orders and awards shall be made by all or a majority of the arbitrators.

## **23 Revocation of arbitrator's authority.**

- (1) The parties are free to agree in what circumstances the authority of an arbitrator may be revoked.

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- (2) If or to the extent that there is no such agreement the following provisions apply.
- (3) The authority of an arbitrator may not be revoked except—
  - (a) by the parties acting jointly, or
  - (b) by an arbitral or other institution or person vested by the parties with powers in that regard.
- (4) Revocation of the authority of an arbitrator by the parties acting jointly must be agreed in writing unless the parties also agree (whether or not in writing) to terminate the arbitration agreement.
- (5) Nothing in this section affects the power of the court—
  - (a) to revoke an appointment under section 18 (powers exercisable in case of failure of appointment procedure), or
  - (b) to remove an arbitrator on the grounds specified in section 24.

#### **24 Power of court to remove arbitrator.**

- (1) A party to arbitral proceedings may (upon notice to the other parties, to the arbitrator concerned and to any other arbitrator) apply to the court to remove an arbitrator on any of the following grounds—
  - (a) that circumstances exist that give rise to justifiable doubts as to his impartiality;
  - (b) that he does not possess the qualifications required by the arbitration agreement;
  - (c) that he is physically or mentally incapable of conducting the proceedings or there are justifiable doubts as to his capacity to do so;
  - (d) that he has refused or failed—
    - (i) properly to conduct the proceedings, or
    - (ii) to use all reasonable despatch in conducting the proceedings or making an award,
 and that substantial injustice has been or will be caused to the applicant.
- (2) If there is an arbitral or other institution or person vested by the parties with power to remove an arbitrator, the court shall not exercise its power of removal unless satisfied that the applicant has first exhausted any available recourse to that institution or person.
- (3) The arbitral tribunal may continue the arbitral proceedings and make an award while an application to the court under this section is pending.
- (4) Where the court removes an arbitrator, it may make such order as it thinks fit with respect to his entitlement (if any) to fees or expenses, or the repayment of any fees or expenses already paid.
- (5) The arbitrator concerned is entitled to appear and be heard by the court before it makes any order under this section.
- (6) The leave of the court is required for any appeal from a decision of the court under this section.



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#### Annotations:

##### Modifications etc. (not altering text)

- C36** S. 24(1)(a)(c)(2)(3)(5)(6) applied (with modifications) (E.W.) (21.5.2001) by S.I. 2001/1185, arts. 2, 3, **Sch. para. 43(1)** (which amending S.I. was revoked (6.4.2004) by S.I. 2004/753, art. 3 (subject to art. 8))
- C37** S. 24(1)(a)(c)(2)(3)(5)(6) applied (with modifications) (E.W.) (6.4.2003) by The ACAS (Flexible Working) Arbitration Scheme (England and Wales) Order 2003 (S.I. 2003/694), art. 2, **Sch. para. 43** (which amending S.I. was revoked (1.10.2004) by S.I. 2004/2333, art. 3 (subject to art. 6))
- C38** S. 24(1)(a)(c)(2)(3)(5)(6) applied (with modifications) (E.W.) (6.4.2004) by The ACAS Arbitration Scheme (Great Britain) Order 2004 (S.I. 2004/753), art. 1, **Sch. para. 52EW**
- C39** S. 24(1)(a)(c)(2)(3)(5)(6) applied (with modifications) (E.W.) (1.10.2004) by The ACAS (Flexible Working) Arbitration Scheme (Great Britain) Order 2004 (S.I. 2004/2333), art. 4, **Sch. para. 52EW** (with art. 6)
- C40** S. 24(1)(a)(c)(2)(3)(5)(6) applied (with modifications) (N.I.) (21.5.2006) by The Labour Relations Agency (Flexible Working) Arbitration Scheme Order (Northern Ireland) 2006 (S.R. 2006/206), arts. 2, 3, **Sch. para. 43**
- C41** S. 24(1)(a) applied (with modifications) (N.I.) (27.9.2012) by The Labour Relations Agency Arbitration Scheme Order (Northern Ireland) 2012 (S.R. 2012/301), art. 1, **Sch. para. 40**
- C42** S. 24(1)(c) applied (with modifications) (N.I.) (27.9.2012) by The Labour Relations Agency Arbitration Scheme Order (Northern Ireland) 2012 (S.R. 2012/301), art. 1, **Sch. para. 40**
- C43** S. 24(2) applied (with modifications) (N.I.) (27.9.2012) by The Labour Relations Agency Arbitration Scheme Order (Northern Ireland) 2012 (S.R. 2012/301), art. 1, **Sch. para. 40**
- C44** S. 24(3) applied (with modifications) (N.I.) (27.9.2012) by The Labour Relations Agency Arbitration Scheme Order (Northern Ireland) 2012 (S.R. 2012/301), art. 1, **Sch. para. 40**
- C45** S. 24(5) applied (with modifications) (N.I.) (27.9.2012) by The Labour Relations Agency Arbitration Scheme Order (Northern Ireland) 2012 (S.R. 2012/301), art. 1, **Sch. para. 40**
- C46** S. 24(6) applied (with modifications) (N.I.) (27.9.2012) by The Labour Relations Agency Arbitration Scheme Order (Northern Ireland) 2012 (S.R. 2012/301), art. 1, **Sch. para. 40**

## 25 Resignation of arbitrator.

- (1) The parties are free to agree with an arbitrator as to the consequences of his resignation as regards—
  - (a) his entitlement (if any) to fees or expenses, and
  - (b) any liability thereby incurred by him.
- (2) If or to the extent that there is no such agreement the following provisions apply.
- (3) An arbitrator who resigns his appointment may (upon notice to the parties) apply to the court—
  - (a) to grant him relief from any liability thereby incurred by him, and
  - (b) to make such order as it thinks fit with respect to his entitlement (if any) to fees or expenses or the repayment of any fees or expenses already paid.
- (4) If the court is satisfied that in all the circumstances it was reasonable for the arbitrator to resign, it may grant such relief as is mentioned in subsection (3)(a) on such terms as it thinks fit.
- (5) The leave of the court is required for any appeal from a decision of the court under this section.

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## **26 Death of arbitrator or person appointing him.**

- (1) The authority of an arbitrator is personal and ceases on his death.
- (2) Unless otherwise agreed by the parties, the death of the person by whom an arbitrator was appointed does not revoke the arbitrator's authority.

## **27 Filling of vacancy, &c.**

- (1) Where an arbitrator ceases to hold office, the parties are free to agree—
  - (a) whether and if so how the vacancy is to be filled,
  - (b) whether and if so to what extent the previous proceedings should stand, and
  - (c) what effect (if any) his ceasing to hold office has on any appointment made by him (alone or jointly).
- (2) If or to the extent that there is no such agreement, the following provisions apply.
- (3) The provisions of sections 16 (procedure for appointment of arbitrators) and 18 (failure of appointment procedure) apply in relation to the filling of the vacancy as in relation to an original appointment.
- (4) The tribunal (when reconstituted) shall determine whether and if so to what extent the previous proceedings should stand.

This does not affect any right of a party to challenge those proceedings on any ground which had arisen before the arbitrator ceased to hold office.
- (5) His ceasing to hold office does not affect any appointment by him (alone or jointly) of another arbitrator, in particular any appointment of a chairman or umpire.

## **28 Joint and several liability of parties to arbitrators for fees and expenses.**

- (1) The parties are jointly and severally liable to pay to the arbitrators such reasonable fees and expenses (if any) as are appropriate in the circumstances.
- (2) Any party may apply to the court (upon notice to the other parties and to the arbitrators) which may order that the amount of the arbitrators' fees and expenses shall be considered and adjusted by such means and upon such terms as it may direct.
- (3) If the application is made after any amount has been paid to the arbitrators by way of fees or expenses, the court may order the repayment of such amount (if any) as is shown to be excessive, but shall not do so unless it is shown that it is reasonable in the circumstances to order repayment.
- (4) The above provisions have effect subject to any order of the court under section 24(4) or 25(3)(b) (order as to entitlement to fees or expenses in case of removal or resignation of arbitrator).
- (5) Nothing in this section affects any liability of a party to any other party to pay all or any of the costs of the arbitration (see sections 59 to 65) or any contractual right of an arbitrator to payment of his fees and expenses.
- (6) In this section references to arbitrators include an arbitrator who has ceased to act and an umpire who has not replaced the other arbitrators.

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## **29 Immunity of arbitrator.**

- (1) An arbitrator is not liable for anything done or omitted in the discharge or purported discharge of his functions as arbitrator unless the act or omission is shown to have been in bad faith.
- (2) Subsection (1) applies to an employee or agent of an arbitrator as it applies to the arbitrator himself.
- (3) This section does not affect any liability incurred by an arbitrator by reason of his resigning (but see section 25).

### *Jurisdiction of the arbitral tribunal*

## **30 Competence of tribunal to rule on its own jurisdiction.**

- (1) Unless otherwise agreed by the parties, the arbitral tribunal may rule on its own substantive jurisdiction, that is, as to—
  - (a) whether there is a valid arbitration agreement,
  - (b) whether the tribunal is properly constituted, and
  - (c) what matters have been submitted to arbitration in accordance with the arbitration agreement.
- (2) Any such ruling may be challenged by any available arbitral process of appeal or review or in accordance with the provisions of this Part.

## **31 Objection to substantive jurisdiction of tribunal.**

- (1) An objection that the arbitral tribunal lacks substantive jurisdiction at the outset of the proceedings must be raised by a party not later than the time he takes the first step in the proceedings to contest the merits of any matter in relation to which he challenges the tribunal's jurisdiction.

A party is not precluded from raising such an objection by the fact that he has appointed or participated in the appointment of an arbitrator.

- (2) Any objection during the course of the arbitral proceedings that the arbitral tribunal is exceeding its substantive jurisdiction must be made as soon as possible after the matter alleged to be beyond its jurisdiction is raised.
- (3) The arbitral tribunal may admit an objection later than the time specified in subsection (1) or (2) if it considers the delay justified.
- (4) Where an objection is duly taken to the tribunal's substantive jurisdiction and the tribunal has power to rule on its own jurisdiction, it may—
  - (a) rule on the matter in an award as to jurisdiction, or
  - (b) deal with the objection in its award on the merits.

If the parties agree which of these courses the tribunal should take, the tribunal shall proceed accordingly.

- (5) The tribunal may in any case, and shall if the parties so agree, stay proceedings whilst an application is made to the court under section 32 (determination of preliminary point of jurisdiction).

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### **32 Determination of preliminary point of jurisdiction.**

- (1) The court may, on the application of a party to arbitral proceedings (upon notice to the other parties), determine any question as to the substantive jurisdiction of the tribunal.

A party may lose the right to object (see section 73).

- (2) An application under this section shall not be considered unless—
- (a) it is made with the agreement in writing of all the other parties to the proceedings, or
  - (b) it is made with the permission of the tribunal and the court is satisfied—
    - (i) that the determination of the question is likely to produce substantial savings in costs,
    - (ii) that the application was made without delay, and
    - (iii) that there is good reason why the matter should be decided by the court.
- (3) An application under this section, unless made with the agreement of all the other parties to the proceedings, shall state the grounds on which it is said that the matter should be decided by the court.
- (4) Unless otherwise agreed by the parties, the arbitral tribunal may continue the arbitral proceedings and make an award while an application to the court under this section is pending.
- (5) Unless the court gives leave, no appeal lies from a decision of the court whether the conditions specified in subsection (2) are met.
- (6) The decision of the court on the question of jurisdiction shall be treated as a judgment of the court for the purposes of an appeal.

But no appeal lies without the leave of the court which shall not be given unless the court considers that the question involves a point of law which is one of general importance or is one which for some other special reason should be considered by the Court of Appeal.

#### *The arbitral proceedings*

### **33 General duty of the tribunal.**

- (1) The tribunal shall—
- (a) act fairly and impartially as between the parties, giving each party a reasonable opportunity of putting his case and dealing with that of his opponent, and
  - (b) adopt procedures suitable to the circumstances of the particular case, avoiding unnecessary delay or expense, so as to provide a fair means for the resolution of the matters falling to be determined.
- (2) The tribunal shall comply with that general duty in conducting the arbitral proceedings, in its decisions on matters of procedure and evidence and in the exercise of all other powers conferred on it.

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### **34 Procedural and evidential matters.**

- (1) It shall be for the tribunal to decide all procedural and evidential matters, subject to the right of the parties to agree any matter.
- (2) Procedural and evidential matters include—
  - (a) when and where any part of the proceedings is to be held;
  - (b) the language or languages to be used in the proceedings and whether translations of any relevant documents are to be supplied;
  - (c) whether any and if so what form of written statements of claim and defence are to be used, when these should be supplied and the extent to which such statements can be later amended;
  - (d) whether any and if so which documents or classes of documents should be disclosed between and produced by the parties and at what stage;
  - (e) whether any and if so what questions should be put to and answered by the respective parties and when and in what form this should be done;
  - (f) whether to apply strict rules of evidence (or any other rules) as to the admissibility, relevance or weight of any material (oral, written or other) sought to be tendered on any matters of fact or opinion, and the time, manner and form in which such material should be exchanged and presented;
  - (g) whether and to what extent the tribunal should itself take the initiative in ascertaining the facts and the law;
  - (h) whether and to what extent there should be oral or written evidence or submissions.
- (3) The tribunal may fix the time within which any directions given by it are to be complied with, and may if it thinks fit extend the time so fixed (whether or not it has expired).

### **35 Consolidation of proceedings and concurrent hearings.**

- (1) The parties are free to agree—
  - (a) that the arbitral proceedings shall be consolidated with other arbitral proceedings, or
  - (b) that concurrent hearings shall be held,on such terms as may be agreed.
- (2) Unless the parties agree to confer such power on the tribunal, the tribunal has no power to order consolidation of proceedings or concurrent hearings.

### **36 Legal or other representation.**

Unless otherwise agreed by the parties, a party to arbitral proceedings may be represented in the proceedings by a lawyer or other person chosen by him.

#### **Annotations:**

#### **Modifications etc. (not altering text)**

C47 Power to apply conferred (31.1.1997) by 1966 c. 41, s. 3 (as substituted by 1996 c. 23, s. 107(1), Sch. 3 para. 24) (with s. 81(2)); S.I. 1996/3146, art. 3

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**C48** Power to apply conferred (31.1.1997) by 1988 c. 8, s. 6(1)(as substituted by 1996 c. 23, s. 107(1), Sch. 3 para. 49) (with s. 81(2)); S.I. 1996/3146, art. 3 (with art. 4, Sch. 2)

### **37 Power to appoint experts, legal advisers or assessors.**

- (1) Unless otherwise agreed by the parties—
  - (a) the tribunal may—
    - (i) appoint experts or legal advisers to report to it and the parties, or
    - (ii) appoint assessors to assist it on technical matters,
 and may allow any such expert, legal adviser or assessor to attend the proceedings; and
  - (b) the parties shall be given a reasonable opportunity to comment on any information, opinion or advice offered by any such person.
- (2) The fees and expenses of an expert, legal adviser or assessor appointed by the tribunal for which the arbitrators are liable are expenses of the arbitrators for the purposes of this Part.

### **38 General powers exercisable by the tribunal.**

- (1) The parties are free to agree on the powers exercisable by the arbitral tribunal for the purposes of and in relation to the proceedings.
- (2) Unless otherwise agreed by the parties the tribunal has the following powers.
- (3) The tribunal may order a claimant to provide security for the costs of the arbitration.  
 This power shall not be exercised on the ground that the claimant is—
  - (a) an individual ordinarily resident outside the United Kingdom, or
  - (b) a corporation or association incorporated or formed under the law of a country outside the United Kingdom, or whose central management and control is exercised outside the United Kingdom.
- (4) The tribunal may give directions in relation to any property which is the subject of the proceedings or as to which any question arises in the proceedings, and which is owned by or is in the possession of a party to the proceedings—
  - (a) for the inspection, photographing, preservation, custody or detention of the property by the tribunal, an expert or a party, or
  - (b) ordering that samples be taken from, or any observation be made of or experiment conducted upon, the property.
- (5) The tribunal may direct that a party or witness shall be examined on oath or affirmation, and may for that purpose administer any necessary oath or take any necessary affirmation.
- (6) The tribunal may give directions to a party for the preservation for the purposes of the proceedings of any evidence in his custody or control.

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*Status:* This version of this Act contains provisions that are prospective.  
*Changes to legislation:* Arbitration Act 1996 is up to date with all changes known to be in force on or before 15 April 2019. There are changes that may be brought into force at a future date. Changes that have been made appear in the content and are referenced with annotations. (See end of Document for details)

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**Annotations:**

**Modifications etc. (not altering text)**

- C49** Power to apply conferred (31.1.1997) by 1966 c. 41, s. 3 (as substituted by 1996 c. 23, s. 107(1), **Sch. 3 para. 24**) (with s. 81(2)); S.I. 1996/3146, art. 3 (with art. 4, Sch. 2)
- C50** Power to apply conferred (31.1.1997) by 1988 c. 8, s. 6(1) (as substituted by 1996 c. 23, s. 107(1), **Sch. 3 para. 49**) (with S. 81(2)); S.I. 1996/3146, art. 3 (with art. 4, **Sch. 2**)

**39 Power to make provisional awards.**

- (1) The parties are free to agree that the tribunal shall have power to order on a provisional basis any relief which it would have power to grant in a final award.
- (2) This includes, for instance, making—
  - (a) a provisional order for the payment of money or the disposition of property as between the parties, or
  - (b) an order to make an interim payment on account of the costs of the arbitration.
- (3) Any such order shall be subject to the tribunal's final adjudication; and the tribunal's final award, on the merits or as to costs, shall take account of any such order.
- (4) Unless the parties agree to confer such power on the tribunal, the tribunal has no such power.

This does not affect its powers under section 47 (awards on different issues, &c.).

**Annotations:**

**Modifications etc. (not altering text)**

- C51** Power to apply conferred (31.1.1997) by 1966 c. 41, s. 3 (as substituted by 1996 c. 23, s. 107(1), **Sch. 3 para. 24**) (with s. 81(2)); S.I. 1996/3146, art. 3 (with art. 4, Sch. 2)
- C52** Power to apply conferred (31.1.1997) by 1988 c. 8, s. 6(1) (as substituted by 1996 c. 23, s. 107(1), **Sch. 3 para. 49**) (with s. 81(2)); S.I. 1996/3146, art. 3 (with art. 4, **Sch. 2**)

**40 General duty of parties.**

- (1) The parties shall do all things necessary for the proper and expeditious conduct of the arbitral proceedings.
- (2) This includes—
  - (a) complying without delay with any determination of the tribunal as to procedural or evidential matters, or with any order or directions of the tribunal, and
  - (b) where appropriate, taking without delay any necessary steps to obtain a decision of the court on a preliminary question of jurisdiction or law (see sections 32 and 45).

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#### Annotations:

#### Modifications etc. (not altering text)

- C53** Power to apply conferred (31.1.1997) by 1966 c. 41, s. 3 (as substituted by 1996 c. 23, s. 107(1), **Sch. 3, para. 24**) (with s. 81(2)); S. I. 1996/3146, **art. 3** (with **art. 4, Sch. 2**)
- C54** Power to apply conferred (31.1.1997) by 1988 c. 8, s. 6(1) (as substituted by 1996 c. 23, s. 107(1), **Sch. 3 para. 49**) (with s. 81(2)); S.I. 1996/3146, **art. 3** (with **art. 4, Sch. 2**)

## 41 Powers of tribunal in case of party's default.

- (1) The parties are free to agree on the powers of the tribunal in case of a party's failure to do something necessary for the proper and expeditious conduct of the arbitration.
- (2) Unless otherwise agreed by the parties, the following provisions apply.
- (3) If the tribunal is satisfied that there has been inordinate and inexcusable delay on the part of the claimant in pursuing his claim and that the delay—
  - (a) gives rise, or is likely to give rise, to a substantial risk that it is not possible to have a fair resolution of the issues in that claim, or
  - (b) has caused, or is likely to cause, serious prejudice to the respondent,
 the tribunal may make an award dismissing the claim.
- (4) If without showing sufficient cause a party—
  - (a) fails to attend or be represented at an oral hearing of which due notice was given, or
  - (b) where matters are to be dealt with in writing, fails after due notice to submit written evidence or make written submissions,
 the tribunal may continue the proceedings in the absence of that party or, as the case may be, without any written evidence or submissions on his behalf, and may make an award on the basis of the evidence before it.
- (5) If without showing sufficient cause a party fails to comply with any order or directions of the tribunal, the tribunal may make a peremptory order to the same effect, prescribing such time for compliance with it as the tribunal considers appropriate.
- (6) If a claimant fails to comply with a peremptory order of the tribunal to provide security for costs, the tribunal may make an award dismissing his claim.
- (7) If a party fails to comply with any other kind of peremptory order, then, without prejudice to section 42 (enforcement by court of tribunal's peremptory orders), the tribunal may do any of the following—
  - (a) direct that the party in default shall not be entitled to rely upon any allegation or material which was the subject matter of the order;
  - (b) draw such adverse inferences from the act of non-compliance as the circumstances justify;
  - (c) proceed to an award on the basis of such materials as have been properly provided to it;
  - (d) make such order as it thinks fit as to the payment of costs of the arbitration incurred in consequence of the non-compliance.



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**Annotations:**

**Modifications etc. (not altering text)**

- C55** Power to apply conferred (31.1.1997) by 1966 c. 41, s. 3 (as substituted by 1996 c. 23, s. 107(1), Sch. 3, para. 24) (with s. 81(2)); S. I. 1996/3146, art. 3 (with art. 4, Sch. 2)
- C56** Power to apply conferred (31.1.1997) by 1988 c. 8, s. 6(1) (as substituted by 1996 c. 23, s. 107(1), Sch. 3 para. 49) (with s. 81(2)); S.I. 1996/3146, art. 3 (with art. 4, Sch. 2)

*Powers of court in relation to arbitral proceedings*

**42 Enforcement of peremptory orders of tribunal.**

- (1) Unless otherwise agreed by the parties, the court may make an order requiring a party to comply with a peremptory order made by the tribunal.
- (2) An application for an order under this section may be made—
  - (a) by the tribunal (upon notice to the parties),
  - (b) by a party to the arbitral proceedings with the permission of the tribunal (and upon notice to the other parties), or
  - (c) where the parties have agreed that the powers of the court under this section shall be available.
- (3) The court shall not act unless it is satisfied that the applicant has exhausted any available arbitral process in respect of failure to comply with the tribunal's order.
- (4) No order shall be made under this section unless the court is satisfied that the person to whom the tribunal's order was directed has failed to comply with it within the time prescribed in the order or, if no time was prescribed, within a reasonable time.
- (5) The leave of the court is required for any appeal from a decision of the court under this section.

**Annotations:**

**Modifications etc. (not altering text)**

- C57** Power to apply conferred (31.1.1997) by 1966 c. 41, s. 3 (as substituted by 1996 c. 23, s. 107(1), Sch. 3 para. 24) (with s. 81(2)); S.I. 1996/3146, art. 3 (with art. 4, Sch. 2)
- C58** S. 42 applied (with modifications)(E.W.)(1.5.1998) by S.I. 1998/649, art. 2, Sch. Pt. I para.24
- C59** Power to apply conferred (31.1.1997) by 1988 c. 8, s. 6(1)(as substituted by 1996 c. 23, s. 107(1), Sch. 3 para. 49) (with s. 81(2)); S.I. 1996/3146, art. 3 (with art. 4, Sch. 2)

**43 Securing the attendance of witnesses.**

- (1) A party to arbitral proceedings may use the same court procedures as are available in relation to legal proceedings to secure the attendance before the tribunal of a witness in order to give oral testimony or to produce documents or other material evidence.
- (2) This may only be done with the permission of the tribunal or the agreement of the other parties.
- (3) The court procedures may only be used if—

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- (a) the witness is in the United Kingdom, and
  - (b) the arbitral proceedings are being conducted in England and Wales or, as the case may be, Northern Ireland.
- (4) A person shall not be compelled by virtue of this section to produce any document or other material evidence which he could not be compelled to produce in legal proceedings.

**Annotations:**

**Modifications etc. (not altering text)**

- C60** Power to apply conferred (31.1.1997) by 1966 c. 41, s. 3 (as substituted by 1996 c. 23, s. 107(1), **Sch. 3, para. 24**) (with s. 81(2)); S.I. 1996/3146 art. 3 (with art. 4, Sch. 2)
- C61** Power to apply conferred (31.1.1997) by 1988 c. 8, s. 6(1) (as substituted by 1996 c. 23, s. 107(1), **Sch. 3 para. 49**) (with s. 81(2)); S.I. 1996/3146, **art. 3** (with art. 4, Sch. 2)

**44 Court powers exercisable in support of arbitral proceedings.**

- (1) Unless otherwise agreed by the parties, the court has for the purposes of and in relation to arbitral proceedings the same power of making orders about the matters listed below as it has for the purposes of and in relation to legal proceedings.
- (2) Those matters are—
- (a) the taking of the evidence of witnesses;
  - (b) the preservation of evidence;
  - (c) making orders relating to property which is the subject of the proceedings or as to which any question arises in the proceedings—
    - (i) for the inspection, photographing, preservation, custody or detention of the property, or
    - (ii) ordering that samples be taken from, or any observation be made of or experiment conducted upon, the property;
 and for that purpose authorising any person to enter any premises in the possession or control of a party to the arbitration;
  - (d) the sale of any goods the subject of the proceedings;
  - (e) the granting of an interim injunction or the appointment of a receiver.
- (3) If the case is one of urgency, the court may, on the application of a party or proposed party to the arbitral proceedings, make such orders as it thinks necessary for the purpose of preserving evidence or assets.
- (4) If the case is not one of urgency, the court shall act only on the application of a party to the arbitral proceedings (upon notice to the other parties and to the tribunal) made with the permission of the tribunal or the agreement in writing of the other parties.
- (5) In any case the court shall act only if or to the extent that the arbitral tribunal, and any arbitral or other institution or person vested by the parties with power in that regard, has no power or is unable for the time being to act effectively.
- (6) If the court so orders, an order made by it under this section shall cease to have effect in whole or in part on the order of the tribunal or of any such arbitral or other institution or person having power to act in relation to the subject-matter of the order.

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- (7) The leave of the court is required for any appeal from a decision of the court under this section.

**Annotations:**

**Modifications etc. (not altering text)**

- C62** Power to apply conferred (31.1.1997) by 1966 c. 41, s. 3 (as substituted by 1996 c. 23, s. 107(1), Sch. 3 para. 24) (with s. 81(2)); S.I. 1996/3146, art. 3 (with art. 4, Sch. 2)
- C63** Power to apply conferred (31.1.1997) by 1988 c. 8, s. 6(1) (as substituted by 1996 c. 23, Sch. 3 para. 49) (with s. 81(2)); S.I. 1996/3146, art. 3

**45 Determination of preliminary point of law.**

- (1) Unless otherwise agreed by the parties, the court may on the application of a party to arbitral proceedings (upon notice to the other parties) determine any question of law arising in the course of the proceedings which the court is satisfied substantially affects the rights of one or more of the parties.

An agreement to dispense with reasons for the tribunal's award shall be considered an agreement to exclude the court's jurisdiction under this section.

- (2) An application under this section shall not be considered unless—
- it is made with the agreement of all the other parties to the proceedings, or
  - it is made with the permission of the tribunal and the court is satisfied—
    - that the determination of the question is likely to produce substantial savings in costs, and
    - that the application was made without delay.
- (3) The application shall identify the question of law to be determined and, unless made with the agreement of all the other parties to the proceedings, shall state the grounds on which it is said that the question should be decided by the court.
- (4) Unless otherwise agreed by the parties, the arbitral tribunal may continue the arbitral proceedings and make an award while an application to the court under this section is pending.
- (5) Unless the court gives leave, no appeal lies from a decision of the court whether the conditions specified in subsection (2) are met.
- (6) The decision of the court on the question of law shall be treated as a judgment of the court for the purposes of an appeal.

But no appeal lies without the leave of the court which shall not be given unless the court considers that the question is one of general importance, or is one which for some other special reason should be considered by the Court of Appeal.

**Annotations:**

**Modifications etc. (not altering text)**

- C64** S. 45 applied (with modifications) (E.W.) (21.5.2001) by S.I. 2001/1185, arts. 2, 3, Sch. para. 94(1) (which amending S.I. was revoked (6.4.2004) by S.I. 2004/753, art. 3 (subject to art. 8))

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- C65** S. 45 applied (with modifications) (E.W.) (6.4.2003) by [The ACAS \(Flexible Working\) Arbitration Scheme \(England and Wales\) Order 2003 \(S.I. 2003/694\)](#), [art. 2](#), [Sch. para. 93](#) (which amending S.I. was revoked (1.10.2004) by [S.I. 2004/2333](#), [art. 3](#) (subject to [art. 6](#)))
- C66** S. 45 applied (with modifications) (E.W.) (6.4.2004) by [The ACAS Arbitration Scheme \(Great Britain\) Order 2004 \(S.I. 2004/753\)](#), [art. 1](#), [Sch. para. 110EW](#)
- C67** S. 45 applied (with modifications) (E.W.) (1.10.2004) by [The ACAS \(Flexible Working\) Arbitration Scheme \(Great Britain\) Order 2004 \(S.I. 2004/2333\)](#), [art. 4](#), [Sch. para. 108EW](#) (with [art. 6](#))
- C68** S. 45 applied (with modifications) (N.I.) (21.5.2006) by [The Labour Relations Agency \(Flexible Working\) Arbitration Scheme Order \(Northern Ireland\) 2006 \(S.R. 2006/206\)](#), [arts. 2, 3](#), [Sch. para. 93](#)
- C69** S. 45 applied (with modifications) (N.I.) (27.9.2012) by [The Labour Relations Agency Arbitration Scheme Order \(Northern Ireland\) 2012 \(S.R. 2012/301\)](#), [art. 1](#), [Sch. para. 89](#)

### *The award*

#### **46 Rules applicable to substance of dispute.**

- (1) The arbitral tribunal shall decide the dispute—
- (a) in accordance with the law chosen by the parties as applicable to the substance of the dispute, or
  - (b) if the parties so agree, in accordance with such other considerations as are agreed by them or determined by the tribunal.
- (2) For this purpose the choice of the laws of a country shall be understood to refer to the substantive laws of that country and not its conflict of laws rules.
- (3) If or to the extent that there is no such choice or agreement, the tribunal shall apply the law determined by the conflict of laws rules which it considers applicable.

#### **Annotations:**

##### **Modifications etc. (not altering text)**

- C70** S. 46(1)(b) applied (with modifications) (E.W.) (21.5.2001) by [S.I. 2001/1185](#), [art. 4\(1\)](#) (which amending S.I. was revoked (6.4.2004) by [S.I. 2004/753](#), [art. 3](#) (subject to [art. 8](#)))  
 S. 46(1)(b) applied (with modifications) (N.I.) (28.4.2002) by [Labour Relations Agency Arbitration Scheme Order \(Northern Ireland\) 2002 \(S.R. 2002/120\)](#), [art. 4](#)
- C71** S. 46(1)(b) applied (with modifications) (E.W.) (6.4.2003) by [The ACAS \(Flexible Working\) Arbitration Scheme \(England and Wales\) Order 2003 \(S.I. 2003/694\)](#), [art. 4](#) (which amending S.I. was revoked (1.10.2004) by [S.I. 2004/2333](#), [art. 3](#) (subject to [art. 6](#)))
- C72** S. 46(1)(b) applied (with modifications) (E.W.) (6.4.2004) by [The ACAS Arbitration Scheme \(Great Britain\) Order 2004 \(S.I. 2004/753\)](#), [art. 5\(1\)](#)
- C73** S. 46(1)(b) applied (with modifications) (E.W.) (1.10.2004) by [The ACAS \(Flexible Working\) Arbitration Scheme \(Great Britain\) Order 2004 \(S.I. 2004/2333\)](#), [art. 5](#) (with [art. 6](#))
- C74** S. 46(1)(b) applied (with modifications) (N.I.) (21.5.2006) by [The Labour Relations Agency \(Flexible Working\) Arbitration Scheme Order \(Northern Ireland\) 2006 \(S.R. 2006/206\)](#), [art. 4](#)
- C75** S. 46(1)(b) applied (with modifications) (N.I.) (27.9.2012) by [The Labour Relations Agency Arbitration Scheme Order \(Northern Ireland\) 2012 \(S.R. 2012/301\)](#), [arts. 1, 6](#)

#### **47 Awards on different issues, &c.**

- (1) Unless otherwise agreed by the parties, the tribunal may make more than one award at different times on different aspects of the matters to be determined.

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- (2) The tribunal may, in particular, make an award relating—
  - (a) to an issue affecting the whole claim, or
  - (b) to a part only of the claims or cross-claims submitted to it for decision.
- (3) If the tribunal does so, it shall specify in its award the issue, or the claim or part of a claim, which is the subject matter of the award.

#### **48 Remedies.**

- (1) The parties are free to agree on the powers exercisable by the arbitral tribunal as regards remedies.
- (2) Unless otherwise agreed by the parties, the tribunal has the following powers.
- (3) The tribunal may make a declaration as to any matter to be determined in the proceedings.
- (4) The tribunal may order the payment of a sum of money, in any currency.
- (5) The tribunal has the same powers as the court—
  - (a) to order a party to do or refrain from doing anything;
  - (b) to order specific performance of a contract (other than a contract relating to land);
  - (c) to order the rectification, setting aside or cancellation of a deed or other document.

#### **49 Interest.**

- (1) The parties are free to agree on the powers of the tribunal as regards the award of interest.
- (2) Unless otherwise agreed by the parties the following provisions apply.
- (3) The tribunal may award simple or compound interest from such dates, at such rates and with such rests as it considers meets the justice of the case—
  - (a) on the whole or part of any amount awarded by the tribunal, in respect of any period up to the date of the award;
  - (b) on the whole or part of any amount claimed in the arbitration and outstanding at the commencement of the arbitral proceedings but paid before the award was made, in respect of any period up to the date of payment.
- (4) The tribunal may award simple or compound interest from the date of the award (or any later date) until payment, at such rates and with such rests as it considers meets the justice of the case, on the outstanding amount of any award (including any award of interest under subsection (3) and any award as to costs).
- (5) References in this section to an amount awarded by the tribunal include an amount payable in consequence of a declaratory award by the tribunal.
- (6) The above provisions do not affect any other power of the tribunal to award interest.

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## **50 Extension of time for making award.**

- (1) Where the time for making an award is limited by or in pursuance of the arbitration agreement, then, unless otherwise agreed by the parties, the court may in accordance with the following provisions by order extend that time.
- (2) An application for an order under this section may be made—
  - (a) by the tribunal (upon notice to the parties), or
  - (b) by any party to the proceedings (upon notice to the tribunal and the other parties),but only after exhausting any available arbitral process for obtaining an extension of time.
- (3) The court shall only make an order if satisfied that a substantial injustice would otherwise be done.
- (4) The court may extend the time for such period and on such terms as it thinks fit, and may do so whether or not the time previously fixed (by or under the agreement or by a previous order) has expired.
- (5) The leave of the court is required for any appeal from a decision of the court under this section.

## **51 Settlement.**

- (1) If during arbitral proceedings the parties settle the dispute, the following provisions apply unless otherwise agreed by the parties.
- (2) The tribunal shall terminate the substantive proceedings and, if so requested by the parties and not objected to by the tribunal, shall record the settlement in the form of an agreed award.
- (3) An agreed award shall state that it is an award of the tribunal and shall have the same status and effect as any other award on the merits of the case.
- (4) The following provisions of this Part relating to awards (sections 52 to 58) apply to an agreed award.
- (5) Unless the parties have also settled the matter of the payment of the costs of the arbitration, the provisions of this Part relating to costs (sections 59 to 65) continue to apply.

## **52 Form of award.**

- (1) The parties are free to agree on the form of an award.
- (2) If or to the extent that there is no such agreement, the following provisions apply.
- (3) The award shall be in writing signed by all the arbitrators or all those assenting to the award.
- (4) The award shall contain the reasons for the award unless it is an agreed award or the parties have agreed to dispense with reasons.
- (5) The award shall state the seat of the arbitration and the date when the award is made.

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**53 Place where award treated as made.**

Unless otherwise agreed by the parties, where the seat of the arbitration is in England and Wales or Northern Ireland, any award in the proceedings shall be treated as made there, regardless of where it was signed, despatched or delivered to any of the parties.

**54 Date of award.**

- (1) Unless otherwise agreed by the parties, the tribunal may decide what is to be taken to be the date on which the award was made.
- (2) In the absence of any such decision, the date of the award shall be taken to be the date on which it is signed by the arbitrator or, where more than one arbitrator signs the award, by the last of them.

**55 Notification of award.**

- (1) The parties are free to agree on the requirements as to notification of the award to the parties.
- (2) If there is no such agreement, the award shall be notified to the parties by service on them of copies of the award, which shall be done without delay after the award is made.
- (3) Nothing in this section affects section 56 (power to withhold award in case of non-payment).

**56 Power to withhold award in case of non-payment.**

- (1) The tribunal may refuse to deliver an award to the parties except upon full payment of the fees and expenses of the arbitrators.
- (2) If the tribunal refuses on that ground to deliver an award, a party to the arbitral proceedings may (upon notice to the other parties and the tribunal) apply to the court, which may order that—
  - (a) the tribunal shall deliver the award on the payment into court by the applicant of the fees and expenses demanded, or such lesser amount as the court may specify,
  - (b) the amount of the fees and expenses properly payable shall be determined by such means and upon such terms as the court may direct, and
  - (c) out of the money paid into court there shall be paid out such fees and expenses as may be found to be properly payable and the balance of the money (if any) shall be paid out to the applicant.
- (3) For this purpose the amount of fees and expenses properly payable is the amount the applicant is liable to pay under section 28 or any agreement relating to the payment of the arbitrators.
- (4) No application to the court may be made where there is any available arbitral process for appeal or review of the amount of the fees or expenses demanded.
- (5) References in this section to arbitrators include an arbitrator who has ceased to act and an umpire who has not replaced the other arbitrators.

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- (6) The above provisions of this section also apply in relation to any arbitral or other institution or person vested by the parties with powers in relation to the delivery of the tribunal's award.

As they so apply, the references to the fees and expenses of the arbitrators shall be construed as including the fees and expenses of that institution or person.

- (7) The leave of the court is required for any appeal from a decision of the court under this section.
- (8) Nothing in this section shall be construed as excluding an application under section 28 where payment has been made to the arbitrators in order to obtain the award.

## **57 Correction of award or additional award.**

- (1) The parties are free to agree on the powers of the tribunal to correct an award or make an additional award.
- (2) If or to the extent there is no such agreement, the following provisions apply.
- (3) The tribunal may on its own initiative or on the application of a party—
- (a) correct an award so as to remove any clerical mistake or error arising from an accidental slip or omission or clarify or remove any ambiguity in the award, or
  - (b) make an additional award in respect of any claim (including a claim for interest or costs) which was presented to the tribunal but was not dealt with in the award.

These powers shall not be exercised without first affording the other parties a reasonable opportunity to make representations to the tribunal.

- (4) Any application for the exercise of those powers must be made within 28 days of the date of the award or such longer period as the parties may agree.
- (5) Any correction of an award shall be made within 28 days of the date the application was received by the tribunal or, where the correction is made by the tribunal on its own initiative, within 28 days of the date of the award or, in either case, such longer period as the parties may agree.
- (6) Any additional award shall be made within 56 days of the date of the original award or such longer period as the parties may agree.
- (7) Any correction of an award shall form part of the award.

## **58 Effect of award.**

- (1) Unless otherwise agreed by the parties, an award made by the tribunal pursuant to an arbitration agreement is final and binding both on the parties and on any persons claiming through or under them.
- (2) This does not affect the right of a person to challenge the award by any available arbitral process of appeal or review or in accordance with the provisions of this Part.



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*Changes to legislation:* Arbitration Act 1996 is up to date with all changes known to be in force on or before 15 April 2019. There are changes that may be brought into force at a future date. Changes that have been made appear in the content and are referenced with annotations. (See end of Document for details)

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### *Costs of the arbitration*

#### **59 Costs of the arbitration.**

- (1) References in this Part to the costs of the arbitration are to—
  - (a) the arbitrators' fees and expenses,
  - (b) the fees and expenses of any arbitral institution concerned, and
  - (c) the legal or other costs of the parties.
- (2) Any such reference includes the costs of or incidental to any proceedings to determine the amount of the recoverable costs of the arbitration (see section 63).

#### **60 Agreement to pay costs in any event.**

An agreement which has the effect that a party is to pay the whole or part of the costs of the arbitration in any event is only valid if made after the dispute in question has arisen.

#### **61 Award of costs.**

- (1) The tribunal may make an award allocating the costs of the arbitration as between the parties, subject to any agreement of the parties.
- (2) Unless the parties otherwise agree, the tribunal shall award costs on the general principle that costs should follow the event except where it appears to the tribunal that in the circumstances this is not appropriate in relation to the whole or part of the costs.

#### **62 Effect of agreement or award about costs.**

Unless the parties otherwise agree, any obligation under an agreement between them as to how the costs of the arbitration are to be borne, or under an award allocating the costs of the arbitration, extends only to such costs as are recoverable.

#### **63 The recoverable costs of the arbitration.**

- (1) The parties are free to agree what costs of the arbitration are recoverable.
- (2) If or to the extent there is no such agreement, the following provisions apply.
- (3) The tribunal may determine by award the recoverable costs of the arbitration on such basis as it thinks fit.

If it does so, it shall specify—

- (a) the basis on which it has acted, and
  - (b) the items of recoverable costs and the amount referable to each.
- (4) If the tribunal does not determine the recoverable costs of the arbitration, any party to the arbitral proceedings may apply to the court (upon notice to the other parties) which may—
    - (a) determine the recoverable costs of the arbitration on such basis as it thinks fit, or
    - (b) order that they shall be determined by such means and upon such terms as it may specify.

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- (5) Unless the tribunal or the court determines otherwise—
  - (a) the recoverable costs of the arbitration shall be determined on the basis that there shall be allowed a reasonable amount in respect of all costs reasonably incurred, and
  - (b) any doubt as to whether costs were reasonably incurred or were reasonable in amount shall be resolved in favour of the paying party.
- (6) The above provisions have effect subject to section 64 (recoverable fees and expenses of arbitrators).
- (7) Nothing in this section affects any right of the arbitrators, any expert, legal adviser or assessor appointed by the tribunal, or any arbitral institution, to payment of their fees and expenses.

#### **64 Recoverable fees and expenses of arbitrators.**

- (1) Unless otherwise agreed by the parties, the recoverable costs of the arbitration shall include in respect of the fees and expenses of the arbitrators only such reasonable fees and expenses as are appropriate in the circumstances.
- (2) If there is any question as to what reasonable fees and expenses are appropriate in the circumstances, and the matter is not already before the court on an application under section 63(4), the court may on the application of any party (upon notice to the other parties)—
  - (a) determine the matter, or
  - (b) order that it be determined by such means and upon such terms as the court may specify.
- (3) Subsection (1) has effect subject to any order of the court under section 24(4) or 25(3)
  - (b) (order as to entitlement to fees or expenses in case of removal or resignation of arbitrator).
- (4) Nothing in this section affects any right of the arbitrator to payment of his fees and expenses.

#### **65 Power to limit recoverable costs.**

- (1) Unless otherwise agreed by the parties, the tribunal may direct that the recoverable costs of the arbitration, or of any part of the arbitral proceedings, shall be limited to a specified amount.
- (2) Any direction may be made or varied at any stage, but this must be done sufficiently in advance of the incurring of costs to which it relates, or the taking of any steps in the proceedings which may be affected by it, for the limit to be taken into account.

#### *Powers of the court in relation to award*

#### **66 Enforcement of the award.**

- (1) An award made by the tribunal pursuant to an arbitration agreement may, by leave of the court, be enforced in the same manner as a judgment or order of the court to the same effect.

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- (2) Where leave is so given, judgment may be entered in terms of the award.
- (3) Leave to enforce an award shall not be given where, or to the extent that, the person against whom it is sought to be enforced shows that the tribunal lacked substantive jurisdiction to make the award.

The right to raise such an objection may have been lost (see section 73).

- (4) Nothing in this section affects the recognition or enforcement of an award under any other enactment or rule of law, in particular under Part II of the<sup>M5</sup> Arbitration Act 1950 (enforcement of awards under Geneva Convention) or the provisions of Part III of this Act relating to the recognition and enforcement of awards under the New York Convention or by an action on the award.

#### Annotations:

##### Modifications etc. (not altering text)

- C76** S. 66 applied (with modifications) (E.W.) (21.5.2001) by [S.I. 2001/1185](#), [arts. 2, 3](#) Sch. para. 159(1) (which amending S.I. was revoked (6.4.2004) by [S.I. 2004/753](#), [art. 3](#) (subject to [art. 8](#)))
- C77** S. 66 applied (with modifications) (E.W.) (6.4.2003) by [The ACAS \(Flexible Working\) Arbitration Scheme \(England and Wales\) Order 2003 \(S.I. 2003/694\)](#), [art. 2](#), [Sch. para. 111](#) (which amending S.I. was revoked (1.10.2004) by [S.I. 2004/2333](#), [art. 3](#) (subject to [art. 6](#)))
- C78** S. 66 applied (with modifications) (E.W.) (6.4.2004) by [The ACAS Arbitration Scheme \(Great Britain\) Order 2004 \(S.I. 2004/753\)](#), [art. 1](#), [Sch. para. 183EW](#)
- C79** S. 66 applied (with modifications) (E.W.) (1.10.2004) by [The ACAS \(Flexible Working\) Arbitration Scheme \(Great Britain\) Order 2004 \(S.I. 2004/2333\)](#), [art. 4](#), [Sch. para. 135EW](#) (with [art. 6](#))
- C80** S. 66 applied (with modifications) (N.I.) (21.5.2006) by [The Labour Relations Agency \(Flexible Working\) Arbitration Scheme Order \(Northern Ireland\) 2006 \(S.R. 2006/206\)](#), [arts. 2, 3](#), [Sch. para. 111](#)
- C81** S. 66 applied (with modifications) (N.I.) (27.9.2012) by [The Labour Relations Agency Arbitration Scheme Order \(Northern Ireland\) 2012 \(S.R. 2012/301\)](#), [art. 1](#), [Sch. para. 108](#)

##### Marginal Citations

- M5** 1950 c. 27.

## 67 Challenging the award: substantive jurisdiction.

- (1) A party to arbitral proceedings may (upon notice to the other parties and to the tribunal) apply to the court—
  - (a) challenging any award of the arbitral tribunal as to its substantive jurisdiction; or
  - (b) for an order declaring an award made by the tribunal on the merits to be of no effect, in whole or in part, because the tribunal did not have substantive jurisdiction.

A party may lose the right to object (see section 73) and the right to apply is subject to the restrictions in section 70(2) and (3).

- (2) The arbitral tribunal may continue the arbitral proceedings and make a further award while an application to the court under this section is pending in relation to an award as to jurisdiction.

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- (3) On an application under this section challenging an award of the arbitral tribunal as to its substantive jurisdiction, the court may by order—
- (a) confirm the award,
  - (b) vary the award, or
  - (c) set aside the award in whole or in part.
- (4) The leave of the court is required for any appeal from a decision of the court under this section.

**Annotations:**

**Modifications etc. (not altering text)**

- C82** S. 67 applied (with modifications) (E.W.) (21.5.2001) by [S.I. 2001/1185](#), arts. 2, 3, **Sch. para. 162(1)** (which amending S.I. was revoked (6.4.2004) by [S.I. 2004/753](#), **art. 3** (subject to art. 8))
- C83** S. 67 applied (with modifications) (E.W.) (6.4.2003) by [The ACAS \(Flexible Working\) Arbitration Scheme \(England and Wales\) Order 2003 \(S.I. 2003/694\)](#), art. 2, **Sch. para. 113** (which amending S.I. was revoked (1.10.2004) by [S.I. 2004/2333](#), art. 3 (subject to art. 6))
- C84** S. 67 applied (with modifications) (E.W.) (6.4.2004) by [The ACAS Arbitration Scheme \(Great Britain\) Order 2004 \(S.I. 2004/753\)](#), art. 1, **Sch. para. 187EW**
- C85** S. 67 applied (with modifications) (E.W.) (1.10.2004) by [The ACAS \(Flexible Working\) Arbitration Scheme \(Great Britain\) Order 2004 \(S.I. 2004/2333\)](#), art. 4, **Sch. para. 138EW** (with art. 6)
- C86** S. 67 applied (with modifications) (N.I.) (21.5.2006) by [The Labour Relations Agency \(Flexible Working\) Arbitration Scheme Order \(Northern Ireland\) 2006 \(S.R. 2006/206\)](#), arts. 2, 3, **Sch. para. 113**
- C87** S. 67 applied (with modifications) (N.I.) (27.9.2012) by [The Labour Relations Agency Arbitration Scheme Order \(Northern Ireland\) 2012 \(S.R. 2012/301\)](#), art. 1, **Sch. para. 110**

**68 Challenging the award: serious irregularity.**

- (1) A party to arbitral proceedings may (upon notice to the other parties and to the tribunal) apply to the court challenging an award in the proceedings on the ground of serious irregularity affecting the tribunal, the proceedings or the award.

A party may lose the right to object (see section 73) and the right to apply is subject to the restrictions in section 70(2) and (3).

- (2) Serious irregularity means an irregularity of one or more of the following kinds which the court considers has caused or will cause substantial injustice to the applicant—
- (a) failure by the tribunal to comply with section 33 (general duty of tribunal);
  - (b) the tribunal exceeding its powers (otherwise than by exceeding its substantive jurisdiction: see section 67);
  - (c) failure by the tribunal to conduct the proceedings in accordance with the procedure agreed by the parties;
  - (d) failure by the tribunal to deal with all the issues that were put to it;
  - (e) any arbitral or other institution or person vested by the parties with powers in relation to the proceedings or the award exceeding its powers;
  - (f) uncertainty or ambiguity as to the effect of the award;
  - (g) the award being obtained by fraud or the award or the way in which it was procured being contrary to public policy;
  - (h) failure to comply with the requirements as to the form of the award; or

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- (i) any irregularity in the conduct of the proceedings or in the award which is admitted by the tribunal or by any arbitral or other institution or person vested by the parties with powers in relation to the proceedings or the award.
- (3) If there is shown to be serious irregularity affecting the tribunal, the proceedings or the award, the court may—
- (a) remit the award to the tribunal, in whole or in part, for reconsideration,
  - (b) set the award aside in whole or in part, or
  - (c) declare the award to be of no effect, in whole or in part.
- The court shall not exercise its power to set aside or to declare an award to be of no effect, in whole or in part, unless it is satisfied that it would be inappropriate to remit the matters in question to the tribunal for reconsideration.
- (4) The leave of the court is required for any appeal from a decision of the court under this section.

#### Annotations:

##### Modifications etc. (not altering text)

- C88** S. 68 applied (with modifications) (E.W.) (21.5.2001) by [S.I. 2001/1185](#), arts. 2, 3, **Sch. para. 163(1)** (which amending S.I. was revoked (6.4.2004) by [S.I. 2004/753](#), **art. 3** (subject to **art. 8**))
- C89** S. 68 applied (with modifications) (E.W.) (6.4.2003) by [The ACAS \(Flexible Working\) Arbitration Scheme \(England and Wales\) Order 2003 \(S.I. 2003/694\)](#), art. 2, **Sch. para. 114** (which amending S.I. was revoked (1.10.2004) by [S.I. 2004/2333](#), **art. 3** (subject to **art. 6**))
- C90** S. 68 applied (with modifications) (E.W.) (6.4.2004) by [The ACAS Arbitration Scheme \(Great Britain\) Order 2004 \(S.I. 2004/753\)](#), art. 1, **Sch. para. 194EW**
- C91** S. 68 applied (with modifications) (E.W.) (1.10.2004) by [The ACAS \(Flexible Working\) Arbitration Scheme \(Great Britain\) Order 2004 \(S.I. 2004/2333\)](#), art. 4, **Sch. para. 145EW** (with **art. 6**)
- C92** S. 68 applied (with modifications) (N.I.) (21.5.2006) by [The Labour Relations Agency \(Flexible Working\) Arbitration Scheme Order \(Northern Ireland\) 2006 \(S.R. 2006/206\)](#), arts. 2, 3, **Sch. para. 114**
- C93** S. 68 applied (with modifications) (N.I.) (27.9.2012) by [The Labour Relations Agency Arbitration Scheme Order \(Northern Ireland\) 2012 \(S.R. 2012/301\)](#), art. 1, **Sch. para. 111**

## 69 Appeal on point of law.

- (1) Unless otherwise agreed by the parties, a party to arbitral proceedings may (upon notice to the other parties and to the tribunal) appeal to the court on a question of law arising out of an award made in the proceedings.

An agreement to dispense with reasons for the tribunal's award shall be considered an agreement to exclude the court's jurisdiction under this section.

- (2) An appeal shall not be brought under this section except—
- (a) with the agreement of all the other parties to the proceedings, or
  - (b) with the leave of the court.

The right to appeal is also subject to the restrictions in section 70(2) and (3).

- (3) Leave to appeal shall be given only if the court is satisfied—
- (a) that the determination of the question will substantially affect the rights of one or more of the parties,

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- (b) that the question is one which the tribunal was asked to determine,
  - (c) that, on the basis of the findings of fact in the award—
    - (i) the decision of the tribunal on the question is obviously wrong, or
    - (ii) the question is one of general public importance and the decision of the tribunal is at least open to serious doubt, and
  - (d) that, despite the agreement of the parties to resolve the matter by arbitration, it is just and proper in all the circumstances for the court to determine the question.
- (4) An application for leave to appeal under this section shall identify the question of law to be determined and state the grounds on which it is alleged that leave to appeal should be granted.
- (5) The court shall determine an application for leave to appeal under this section without a hearing unless it appears to the court that a hearing is required.
- (6) The leave of the court is required for any appeal from a decision of the court under this section to grant or refuse leave to appeal.
- (7) On an appeal under this section the court may by order—
- (a) confirm the award,
  - (b) vary the award,
  - (c) remit the award to the tribunal, in whole or in part, for reconsideration in the light of the court's determination, or
  - (d) set aside the award in whole or in part.

The court shall not exercise its power to set aside an award, in whole or in part, unless it is satisfied that it would be inappropriate to remit the matters in question to the tribunal for reconsideration.

- (8) The decision of the court on an appeal under this section shall be treated as a judgment of the court for the purposes of a further appeal.

But no such appeal lies without the leave of the court which shall not be given unless the court considers that the question is one of general importance or is one which for some other special reason should be considered by the Court of Appeal.

#### **Annotations:**

##### **Modifications etc. (not altering text)**

- C94** S. 69 applied (with modifications) (E.W.) (21.5.2001) by [S.I. 2001/1185](#), arts. 2, 3, **Sch. para. 164(1)** (which amending S.I. was revoked (6.4.2004) by [S.I. 2004/753](#), **art. 3** (subject to **art. 8**))
- C95** S. 69 applied (with modifications) (E.W.) (6.4.2003) by [The ACAS \(Flexible Working\) Arbitration Scheme \(England and Wales\) Order 2003 \(S.I. 2003/694\)](#), art. 2, **Sch. para. 115** (which amending S.I. was revoked (1.10.2004) by [S.I. 2004/2333](#), **art. 3** (subject to **art. 6**))
- C96** S. 69 applied (with modifications) (E.W.) (6.4.2004) by [The ACAS Arbitration Scheme \(Great Britain\) Order 2004 \(S.I. 2004/753\)](#), art. 1, **Sch. para. 200EW**
- C97** S. 69 applied (with modifications) (E.W.) (1.10.2004) by [The ACAS \(Flexible Working\) Arbitration Scheme \(Great Britain\) Order 2004 \(S.I. 2004/2333\)](#), art. 4, **Sch. para. 151EW** (with **art. 6**)
- C98** S. 69 applied (with modifications) (N.I.) (21.5.2006) by [The Labour Relations Agency \(Flexible Working\) Arbitration Scheme Order \(Northern Ireland\) 2006 \(S.R. 2006/206\)](#), arts. 2, 3, **Sch. para. 115**

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**C99** S. 69 applied (with modifications) (N.I.) (27.9.2012) by [The Labour Relations Agency Arbitration Scheme Order \(Northern Ireland\) 2012 \(S.R. 2012/301\)](#), art. 1, [Sch. para. 112](#)

## 70 Challenge or appeal: supplementary provisions.

- (1) The following provisions apply to an application or appeal under section 67, 68 or 69.
- (2) An application or appeal may not be brought if the applicant or appellant has not first exhausted—
  - (a) any available arbitral process of appeal or review, and
  - (b) any available recourse under section 57 (correction of award or additional award).
- (3) Any application or appeal must be brought within 28 days of the date of the award or, if there has been any arbitral process of appeal or review, of the date when the applicant or appellant was notified of the result of that process.
- (4) If on an application or appeal it appears to the court that the award—
  - (a) does not contain the tribunal’s reasons, or
  - (b) does not set out the tribunal’s reasons in sufficient detail to enable the court properly to consider the application or appeal,the court may order the tribunal to state the reasons for its award in sufficient detail for that purpose.
- (5) Where the court makes an order under subsection (4), it may make such further order as it thinks fit with respect to any additional costs of the arbitration resulting from its order.
- (6) The court may order the applicant or appellant to provide security for the costs of the application or appeal, and may direct that the application or appeal be dismissed if the order is not complied with.

The power to order security for costs shall not be exercised on the ground that the applicant or appellant is—

- (a) an individual ordinarily resident outside the United Kingdom, or
  - (b) a corporation or association incorporated or formed under the law of a country outside the United Kingdom, or whose central management and control is exercised outside the United Kingdom.
- (7) The court may order that any money payable under the award shall be brought into court or otherwise secured pending the determination of the application or appeal, and may direct that the application or appeal be dismissed if the order is not complied with.
  - (8) The court may grant leave to appeal subject to conditions to the same or similar effect as an order under subsection (6) or (7).

This does not affect the general discretion of the court to grant leave subject to conditions.

### Annotations:

#### Modifications etc. (not altering text)

**C100** S. 70 applied (with modifications) (E.W.) (21.5.2001) by [S.I. 2001/1185](#), arts. 2, 3, [Sch. para. 165\(1\)](#) (which amending S.I. was revoked (6.4.2004) by [S.I. 2004/753](#), [art. 3](#) (subject to [art. 8](#)))



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- C101** S. 70 applied (with modifications) (E.W.) (6.4.2003) by [The ACAS \(Flexible Working\) Arbitration Scheme \(England and Wales\) Order 2003 \(S.I. 2003/694\)](#), art. 2, **Sch. para. 116** (which amending S.I. was revoked (1.10.2004) by [S.I. 2004/2333](#), art. 3 (subject to art. 6))
- C102** S. 70 applied (with modifications) (E.W.) (6.4.2004) by [The ACAS Arbitration Scheme \(Great Britain\) Order 2004 \(S.I. 2004/753\)](#), art. 1, **Sch. para. 205EW**
- C103** S. 70 applied (with modifications) (E.W.) (1.10.2004) by [The ACAS \(Flexible Working\) Arbitration Scheme \(Great Britain\) Order 2004 \(S.I. 2004/2333\)](#), art. 4, **Sch. para. 156EW** (with art. 6)
- C104** S. 70 applied (with modifications) (N.I.) (27.9.2012) by [The Labour Relations Agency Arbitration Scheme Order \(Northern Ireland\) 2012 \(S.R. 2012/301\)](#), art. 1, **Sch. para. 113**
- C105** s. 70(3) modified (E.W.) (25.3.2002) by [S.I. 2001/4015](#), Rule 29, **Sch. Rule 62.9**

## 71 Challenge or appeal: effect of order of court.

- (1) The following provisions have effect where the court makes an order under section 67, 68 or 69 with respect to an award.
- (2) Where the award is varied, the variation has effect as part of the tribunal's award.
- (3) Where the award is remitted to the tribunal, in whole or in part, for reconsideration, the tribunal shall make a fresh award in respect of the matters remitted within three months of the date of the order for remission or such longer or shorter period as the court may direct.
- (4) Where the award is set aside or declared to be of no effect, in whole or in part, the court may also order that any provision that an award is a condition precedent to the bringing of legal proceedings in respect of a matter to which the arbitration agreement applies, is of no effect as regards the subject matter of the award or, as the case may be, the relevant part of the award.

### Annotations:

#### Modifications etc. (not altering text)

- C106** S. 71 applied (with modifications) (E.W.) (21.5.2001) by [S.I. 2001/1185](#), arts. 2, 3, **Sch. para. 167(1)** (which amending S.I. was revoked (6.4.2004) by [S.I. 2004/753](#), art. 3 (subject to art. 8))
- C107** S. 71 applied (with modifications) (E.W.) (6.4.2003) by [The ACAS \(Flexible Working\) Arbitration Scheme \(England and Wales\) Order 2003 \(S.I. 2003/694\)](#), art. 2, **Sch. para. 118** (which amending S.I. was revoked (1.10.2004) by [S.I. 2004/2333](#), art. 3 (subject to art. 6))
- C108** S. 71 applied (with modifications) (E.W.) (6.4.2004) by [The ACAS Arbitration Scheme \(Great Britain\) Order 2004 \(S.I. 2004/753\)](#), art. 1, **Sch. para. 212EW**
- C109** S. 71 applied (with modifications) (E.W.) (1.10.2004) by [The ACAS \(Flexible Working\) Arbitration Scheme \(Great Britain\) Order 2004 \(S.I. 2004/2333\)](#), art. 4, **Sch. para. 163EW** (with art. 6)
- C110** S. 71 applied (with modifications) (N.I.) (21.5.2006) by [The Labour Relations Agency \(Flexible Working\) Arbitration Scheme Order \(Northern Ireland\) 2006 \(S.R. 2006/206\)](#), arts. 2, 3, **Sch. para. 118**
- C111** S. 71 applied (with modifications) (N.I.) (27.9.2012) by [The Labour Relations Agency Arbitration Scheme Order \(Northern Ireland\) 2012 \(S.R. 2012/301\)](#), art. 1, **Sch. para. 115**



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### Miscellaneous

#### **72 Saving for rights of person who takes no part in proceedings.**

- (1) A person alleged to be a party to arbitral proceedings but who takes no part in the proceedings may question—
- (a) whether there is a valid arbitration agreement,
  - (b) whether the tribunal is properly constituted, or
  - (c) what matters have been submitted to arbitration in accordance with the arbitration agreement,
- by proceedings in the court for a declaration or injunction or other appropriate relief.
- (2) He also has the same right as a party to the arbitral proceedings to challenge an award—
- (a) by an application under section 67 on the ground of lack of substantive jurisdiction in relation to him, or
  - (b) by an application under section 68 on the ground of serious irregularity (within the meaning of that section) affecting him;
- and section 70(2) (duty to exhaust arbitral procedures) does not apply in his case.

#### **73 Loss of right to object.**

- (1) If a party to arbitral proceedings takes part, or continues to take part, in the proceedings without making, either forthwith or within such time as is allowed by the arbitration agreement or the tribunal or by any provision of this Part, any objection—
- (a) that the tribunal lacks substantive jurisdiction,
  - (b) that the proceedings have been improperly conducted,
  - (c) that there has been a failure to comply with the arbitration agreement or with any provision of this Part, or
  - (d) that there has been any other irregularity affecting the tribunal or the proceedings,
- he may not raise that objection later, before the tribunal or the court, unless he shows that, at the time he took part or continued to take part in the proceedings, he did not know and could not with reasonable diligence have discovered the grounds for the objection.
- (2) Where the arbitral tribunal rules that it has substantive jurisdiction and a party to arbitral proceedings who could have questioned that ruling—
- (a) by any available arbitral process of appeal or review, or
  - (b) by challenging the award,
- does not do so, or does not do so within the time allowed by the arbitration agreement or any provision of this Part, he may not object later to the tribunal's substantive jurisdiction on any ground which was the subject of that ruling.

#### **74 Immunity of arbitral institutions, &c.**

- (1) An arbitral or other institution or person designated or requested by the parties to appoint or nominate an arbitrator is not liable for anything done or omitted in the discharge or purported discharge of that function unless the act or omission is shown to have been in bad faith.

*Status: This version of this Act contains provisions that are prospective.*

*Changes to legislation: Arbitration Act 1996 is up to date with all changes known to be in force on or before 15 April 2019. There are changes that may be brought into force at a future date. Changes that have been made appear in the content and are referenced with annotations. (See end of Document for details)*

- (2) An arbitral or other institution or person by whom an arbitrator is appointed or nominated is not liable, by reason of having appointed or nominated him, for anything done or omitted by the arbitrator (or his employees or agents) in the discharge or purported discharge of his functions as arbitrator.
- (3) The above provisions apply to an employee or agent of an arbitral or other institution or person as they apply to the institution or person himself.

## 75 Charge to secure payment of solicitors' costs.

The powers of the court to make declarations and orders under section 73 of the <sup>M6</sup>Solicitors Act 1974 or Article 71H of the <sup>M7</sup>Solicitors (Northern Ireland) Order 1976 (power to charge property recovered in the proceedings with the payment of solicitors' costs) may be exercised in relation to arbitral proceedings as if those proceedings were proceedings in the court.

### Annotations:

#### Marginal Citations

- M6** 1974 c. 47.  
**M7** S.I. 1976/582 (N.I. 12).

### *Supplementary*

## 76 Service of notices, &c.

- (1) The parties are free to agree on the manner of service of any notice or other document required or authorised to be given or served in pursuance of the arbitration agreement or for the purposes of the arbitral proceedings.
- (2) If or to the extent that there is no such agreement the following provisions apply.
- (3) A notice or other document may be served on a person by any effective means.
- (4) If a notice or other document is addressed, pre-paid and delivered by post—
  - (a) to the addressee's last known principal residence or, if he is or has been carrying on a trade, profession or business, his last known principal business address, or
  - (b) where the addressee is a body corporate, to the body's registered or principal office,
 it shall be treated as effectively served.
- (5) This section does not apply to the service of documents for the purposes of legal proceedings, for which provision is made by rules of court.
- (6) References in this Part to a notice or other document include any form of communication in writing and references to giving or serving a notice or other document shall be construed accordingly.

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## 77 Powers of court in relation to service of documents.

- (1) This section applies where service of a document on a person in the manner agreed by the parties, or in accordance with provisions of section 76 having effect in default of agreement, is not reasonably practicable.
- (2) Unless otherwise agreed by the parties, the court may make such order as it thinks fit—
  - (a) for service in such manner as the court may direct, or
  - (b) dispensing with service of the document.
- (3) Any party to the arbitration agreement may apply for an order, but only after exhausting any available arbitral process for resolving the matter.
- (4) The leave of the court is required for any appeal from a decision of the court under this section.

### Annotations:

#### Modifications etc. (not altering text)

- C112** s. 77 applied (with modifications) (E.W.) (21.5.2001) by [S.I. 2001/1185](#), arts. 2, 3, **Sch. para. 177(1)**
- C113** S. 77 applied (with modifications) (E.W.) (6.4.2003) by [The ACAS \(Flexible Working\) Arbitration Scheme \(England and Wales\) Order 2003 \(S.I. 2003/694\)](#), art. 2, **Sch. para. 128** (which amending S.I. was revoked (1.10.2004) by [S.I. 2004/2333](#), art. 3 (subject to art. 8))
- C114** S. 77 applied (with modifications) (E.W.) (6.4.2004) by [The ACAS Arbitration Scheme \(Great Britain\) Order 2004 \(S.I. 2004/753\)](#), art. 1, **Sch. para. 223EW**
- C115** S. 77 applied (with modifications) (E.W.) (1.10.2004) by [The ACAS \(Flexible Working\) Arbitration Scheme \(Great Britain\) Order 2004 \(S.I. 2004/2333\)](#), art. 4, **Sch. para. 174EW** (with art. 6)
- C116** S. 77 applied (with modifications) (N.I.) (21.5.2006) by [The Labour Relations Agency \(Flexible Working\) Arbitration Scheme Order \(Northern Ireland\) 2006 \(S.R. 2006/206\)](#), arts. 2, 3, **Sch. Para. 128**
- C117** S. 77 applied (with modifications) (N.I.) (27.9.2012) by [The Labour Relations Agency Arbitration Scheme Order \(Northern Ireland\) 2012 \(S.R. 2012/301\)](#), art. 1, **Sch. para. 123**

## 78 Reckoning periods of time.

- (1) The parties are free to agree on the method of reckoning periods of time for the purposes of any provision agreed by them or any provision of this Part having effect in default of such agreement.
- (2) If or to the extent there is no such agreement, periods of time shall be reckoned in accordance with the following provisions.
- (3) Where the act is required to be done within a specified period after or from a specified date, the period begins immediately after that date.
- (4) Where the act is required to be done a specified number of clear days after a specified date, at least that number of days must intervene between the day on which the act is done and that date.
- (5) Where the period is a period of seven days or less which would include a Saturday, Sunday or a public holiday in the place where anything which has to be done within the period falls to be done, that day shall be excluded.

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In relation to England and Wales or Northern Ireland, a “public holiday” means Christmas Day, Good Friday or a day which under the <sup>M8</sup>Banking and Financial Dealings Act 1971 is a bank holiday.

**Annotations:**

**Modifications etc. (not altering text)**

- C118** S. 78(2)(3)(4)(5) applied (with modifications) (E.W.) (21.5.2001) by S.I. 2001/1185, arts. 2, 3, **Sch. para. 178(1)** (which amending S.I. was revoked (6.4.2004) by S.I. 2004/753, **art. 3** (subject to **art. 8**))
- C119** S. 78(2)(3)(4)(5) applied (with modifications) (E.W.) (6.4.2003) by **The ACAS (Flexible Working) Arbitration Scheme (England and Wales) Order 2003** (S.I. 2003/694), **art. 2**, **Sch. para. 129** (which amending S.I. was revoked (1.10.2004) by S.I. 2004/2333, **art. 3** (subject to **art. 6**))
- C120** S. 78(2)(3)(4)(5) applied (with modifications) (E.W.) (6.4.2004) by **The ACAS Arbitration Scheme (Great Britain) Order 2004** (S.I. 2004/753), **art. 1**, **Sch. para. 224EW**
- C121** S. 78(2)(3)(4)(5) applied (with modifications) (E.W.) (1.10.2004) by **The ACAS (Flexible Working) Arbitration Scheme (Great Britain) Order 2004** (S.I. 2004/2333), **art. 4**, **Sch. para. 175EW** (with **art. 6**)
- C122** S. 78(2)(3)(4)(5) applied (with modifications) (N.I.) (21.5.2006) by **The Labour Relations Agency (Flexible Working) Arbitration Scheme Order (Northern Ireland) 2006** (S.R. 2006/206), arts. 2, 3, **Sch. Para. 129**
- C123** S. 78(2)-(5) applied (with modifications) (N.I.) (27.9.2012) by **The Labour Relations Agency Arbitration Scheme Order (Northern Ireland) 2012** (S.R. 2012/301), **art. 1**, **Sch. para. 124**

**Marginal Citations**

**M8** 1971 c. 80.

**79 Power of court to extend time limits relating to arbitral proceedings.**

- (1) Unless the parties otherwise agree, the court may by order extend any time limit agreed by them in relation to any matter relating to the arbitral proceedings or specified in any provision of this Part having effect in default of such agreement.

This section does not apply to a time limit to which section 12 applies (power of court to extend time for beginning arbitral proceedings, &c.).

- (2) An application for an order may be made—
- (a) by any party to the arbitral proceedings (upon notice to the other parties and to the tribunal), or
  - (b) by the arbitral tribunal (upon notice to the parties).
- (3) The court shall not exercise its power to extend a time limit unless it is satisfied—
- (a) that any available recourse to the tribunal, or to any arbitral or other institution or person vested by the parties with power in that regard, has first been exhausted, and
  - (b) that a substantial injustice would otherwise be done.
- (4) The court’s power under this section may be exercised whether or not the time has already expired.
- (5) An order under this section may be made on such terms as the court thinks fit.

*Status: This version of this Act contains provisions that are prospective.*

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- (6) The leave of the court is required for any appeal from a decision of the court under this section.

## 80 Notice and other requirements in connection with legal proceedings.

- (1) References in this Part to an application, appeal or other step in relation to legal proceedings being taken “upon notice” to the other parties to the arbitral proceedings, or to the tribunal, are to such notice of the originating process as is required by rules of court and do not impose any separate requirement.
- (2) Rules of court shall be made—
- requiring such notice to be given as indicated by any provision of this Part, and
  - as to the manner, form and content of any such notice.
- (3) Subject to any provision made by rules of court, a requirement to give notice to the tribunal of legal proceedings shall be construed—
- if there is more than one arbitrator, as a requirement to give notice to each of them; and
  - if the tribunal is not fully constituted, as a requirement to give notice to any arbitrator who has been appointed.
- (4) References in this Part to making an application or appeal to the court within a specified period are to the issue within that period of the appropriate originating process in accordance with rules of court.
- (5) Where any provision of this Part requires an application or appeal to be made to the court within a specified time, the rules of court relating to the reckoning of periods, the extending or abridging of periods, and the consequences of not taking a step within the period prescribed by the rules, apply in relation to that requirement.
- (6) Provision may be made by rules of court amending the provisions of this Part—
- with respect to the time within which any application or appeal to the court must be made,
  - so as to keep any provision made by this Part in relation to arbitral proceedings in step with the corresponding provision of rules of court applying in relation to proceedings in the court, or
  - so as to keep any provision made by this Part in relation to legal proceedings in step with the corresponding provision of rules of court applying generally in relation to proceedings in the court.
- (7) Nothing in this section affects the generality of the power to make rules of court.

### Annotations:

#### Modifications etc. (not altering text)

**C124** S. 80(1)(2)(4)(5)(6)(7) applied (with modifications) (E.W.) (21.5.2001) by [S.I. 2001/1185](#), arts. 2, 3, [Sch. para. 171\(1\)](#) (which amending S.I. was revoked (6.4.2004) by [S.I. 2004/753](#), [art. 3](#) (subject to [art. 8](#)))

**C125** S. 80(1)(2)(4)(5)(6)(7) applied (with modifications) (E.W.) (6.4.2003) by [The ACAS \(Flexible Working\) Arbitration Scheme \(England and Wales\) Order 2003](#) (S.I. 2003/694), [art. 2](#), [Sch. para. 122](#) (which amending S.I. was revoked (1.10.2004) by [S.I. 2004/2333](#), [art. 3](#) (subject to [art. 6](#)))

**C126** S. 80(1)(2)(4)(5)(6)(7) applied (with modifications) (E.W.) (6.4.2004) by [The ACAS Arbitration Scheme \(Great Britain\) Order 2004](#) (S.I. 2004/753), [art. 1](#), [Sch. para. 217EW](#)

*Status: This version of this Act contains provisions that are prospective.*  
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- C127** S. 80(1)(2)(4)(5)(6)(7) applied (with modifications) (N.I.) (21.5.2006) by [The Labour Relations Agency \(Flexible Working\) Arbitration Scheme Order \(Northern Ireland\) 2006 \(S.R. 2006/206\)](#), arts. 2, 3, **Sch. para. 122**
- C128** S. 80(1)(2) applied (with modifications) (N.I.) (27.9.2012) by [The Labour Relations Agency Arbitration Scheme Order \(Northern Ireland\) 2012 \(S.R. 2012/301\)](#), art. 1, **Sch. para. 119**
- C129** S. 80(4)-(7) applied (with modifications) (N.I.) (27.9.2012) by [The Labour Relations Agency Arbitration Scheme Order \(Northern Ireland\) 2012 \(S.R. 2012/301\)](#), art. 1, **Sch. para. 119**

## 81 Saving for certain matters governed by common law.

- (1) Nothing in this Part shall be construed as excluding the operation of any rule of law consistent with the provisions of this Part, in particular, any rule of law as to—
- (a) matters which are not capable of settlement by arbitration;
  - (b) the effect of an oral arbitration agreement; or
  - (c) the refusal of recognition or enforcement of an arbitral award on grounds of public policy.
- (2) Nothing in this Act shall be construed as reviving any jurisdiction of the court to set aside or remit an award on the ground of errors of fact or law on the face of the award.

### Annotations:

#### Modifications etc. (not altering text)

- C130** S. 81(1)(c)(2) applied (E.W.) (21.5.2001) by [S.I. 2001/1185](#), arts. 2, 3, **Sch. para. 166** (which amending S.I. was revoked (6.4.2004) by [S.I. 2004/753](#), art. 3 (subject to art. 8))
- C131** S. 81(1)(c)(2) applied (E.W.) (6.4.2003) by [The ACAS \(Flexible Working\) Arbitration Scheme \(England and Wales\) Order 2003 \(S.I. 2003/694\)](#), art. 2, **Sch. para. 117** (which amending S.I. was revoked (1.10.2004) by [S.I. 2004/2333](#), art. 3 (subject to art. 6))
- C132** S. 81(1)(c)(2) applied (E.W.) (6.4.2004) by [The ACAS Arbitration Scheme \(Great Britain\) Order 2004 \(S.I. 2004/753\)](#), art. 1, **Sch. para. 209EW**
- C133** S. 81(1)(c)(2) applied (E.W.) (1.10.2004) by [The ACAS \(Flexible Working\) Arbitration Scheme \(Great Britain\) Order 2004 \(S.I. 2004/2333\)](#), art. 4, **Sch. para. 160EW** (with art. 6)
- C134** S. 81(1)(c)(2) applied (N.I.) (21.5.2006) by [The Labour Relations Agency \(Flexible Working\) Arbitration Scheme Order \(Northern Ireland\) 2006 \(S.R. 2006/206\)](#), arts. 2, 3, **Sch. para. 117**
- C135** S. 81(1)(c) applied (with modifications) (N.I.) (27.9.2012) by [The Labour Relations Agency Arbitration Scheme Order \(Northern Ireland\) 2012 \(S.R. 2012/301\)](#), art. 1, **Sch. para. 114**
- C136** S. 81(2) applied (with modifications) (N.I.) (27.9.2012) by [The Labour Relations Agency Arbitration Scheme Order \(Northern Ireland\) 2012 \(S.R. 2012/301\)](#), art. 1, **Sch. para. 114**

## 82 Minor definitions.

- (1) In this Part—
- “arbitrator”, unless the context otherwise requires, includes an umpire;
- “available arbitral process”, in relation to any matter, includes any process of appeal to or review by an arbitral or other institution or person vested by the parties with powers in relation to that matter;
- “claimant”, unless the context otherwise requires, includes a counterclaimant, and related expressions shall be construed accordingly;
- “dispute” includes any difference;

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“enactment” includes an enactment contained in Northern Ireland legislation;

“legal proceedings” means civil proceedings [<sup>F1</sup> in England and Wales in the High Court or the county court or in Northern Ireland ] in the High Court or a county court;

“peremptory order” means an order made under section 41(5) or made in exercise of any corresponding power conferred by the parties;

“premises” includes land, buildings, moveable structures, vehicles, vessels, aircraft and hovercraft;

“question of law” means—

(a) for a court in England and Wales, a question of the law of England and Wales, and

(b) for a court in Northern Ireland, a question of the law of Northern Ireland;

“substantive jurisdiction”, in relation to an arbitral tribunal, refers to the matters specified in section 30(1)(a) to (c), and references to the tribunal exceeding its substantive jurisdiction shall be construed accordingly.

(2) References in this Part to a party to an arbitration agreement include any person claiming under or through a party to the agreement.

**Annotations:**

**Amendments (Textual)**

**F1** Words in s. 82(1) inserted (22.4.2014) by [Crime and Courts Act 2013 \(c. 22\), s. 61\(3\), Sch. 9 para. 60\(1\)](#); [S.I. 2014/954, art. 2\(c\)](#) (with [art. 3](#)) (with transitional provisions and savings in [S.I. 2014/956](#), arts. 3-11)

**83 Index of defined expressions: Part I.**

In this Part the expressions listed below are defined or otherwise explained by the provisions indicated—

agreement, agree and agreed	section 5(1)
agreement in writing	section 5(2) to (5)
arbitration agreement	sections 6 and 5(1)
arbitrator	section 82(1)
available arbitral process	section 82(1)
claimant	section 82(1)
commencement (in relation to arbitral proceedings)	section 14
costs of the arbitration	section 59
the court	section 105
dispute	section 82(1)
enactment	section 82(1)
legal proceedings	section 82(1)



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Limitation Acts	section 13(4)
notice (or other document)	section 76(6)
party—	
—in relation to an arbitration agreement	section 82(2)
—where section 106(2) or (3) applies	section 106(4)
peremptory order	section 82(1) (and see section 41(5))
premises	section 82(1)
question of law	section 82(1)
recoverable costs	sections 63 and 64
seat of the arbitration	section 3
serve and service (of notice or other document)	section 76(6)
substantive jurisdiction (in relation to an arbitral tribunal)	section 82(1) (and see section 30(1)(a) to (c))
upon notice (to the parties or the tribunal)	section 80
written and in writing	section 5(6)

#### **84 Transitional provisions.**

- (1) The provisions of this Part do not apply to arbitral proceedings commenced before the date on which this Part comes into force.
- (2) They apply to arbitral proceedings commenced on or after that date under an arbitration agreement whenever made.
- (3) The above provisions have effect subject to any transitional provision made by an order under section 109(2) (power to include transitional provisions in commencement order).

## **PART II**

### OTHER PROVISIONS RELATING TO ARBITRATION

#### *Domestic arbitration agreements*

PROSPECTIVE

#### **85 Modification of Part I in relation to domestic arbitration agreement.**

- (1) In the case of a domestic arbitration agreement the provisions of Part I are modified in accordance with the following sections.
- (2) For this purpose a “domestic arbitration agreement” means an arbitration agreement to which none of the parties is—



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- (a) an individual who is a national of, or habitually resident in, a state other than the United Kingdom, or
  - (b) a body corporate which is incorporated in, or whose central control and management is exercised in, a state other than the United Kingdom, and under which the seat of the arbitration (if the seat has been designated or determined) is in the United Kingdom.
- (3) In subsection (2) “arbitration agreement” and “seat of the arbitration” have the same meaning as in Part I (see sections 3, 5(1) and 6).

PROSPECTIVE

### **86 Staying of legal proceedings.**

- (1) In section 9 (stay of legal proceedings), subsection (4) (stay unless the arbitration agreement is null and void, inoperative, or incapable of being performed) does not apply to a domestic arbitration agreement.
- (2) On an application under that section in relation to a domestic arbitration agreement the court shall grant a stay unless satisfied—
  - (a) that the arbitration agreement is null and void, inoperative, or incapable of being performed, or
  - (b) that there are other sufficient grounds for not requiring the parties to abide by the arbitration agreement.
- (3) The court may treat as a sufficient ground under subsection (2)(b) the fact that the applicant is or was at any material time not ready and willing to do all things necessary for the proper conduct of the arbitration or of any other dispute resolution procedures required to be exhausted before resorting to arbitration.
- (4) For the purposes of this section the question whether an arbitration agreement is a domestic arbitration agreement shall be determined by reference to the facts at the time the legal proceedings are commenced.

PROSPECTIVE

### **87 Effectiveness of agreement to exclude court’s jurisdiction.**

- (1) In the case of a domestic arbitration agreement any agreement to exclude the jurisdiction of the court under—
  - (a) section 45 (determination of preliminary point of law), or
  - (b) section 69 (challenging the award: appeal on point of law),is not effective unless entered into after the commencement of the arbitral proceedings in which the question arises or the award is made.
- (2) For this purpose the commencement of the arbitral proceedings has the same meaning as in Part I (see section 14).

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- (3) For the purposes of this section the question whether an arbitration agreement is a domestic arbitration agreement shall be determined by reference to the facts at the time the agreement is entered into.

## **88 Power to repeal or amend sections 85 to 87.**

- (1) The Secretary of State may by order repeal or amend the provisions of sections 85 to 87.
- (2) An order under this section may contain such supplementary, incidental and transitional provisions as appear to the Secretary of State to be appropriate.
- (3) An order under this section shall be made by statutory instrument and no such order shall be made unless a draft of it has been laid before and approved by a resolution of each House of Parliament.

### *Consumer arbitration agreements*

## **89 Application of unfair terms regulations to consumer arbitration agreements.**

- (1) The following sections extend the application of [F<sup>2</sup>Part 2 (unfair terms) of the Consumer Rights Act 2015] in relation to a term which constitutes an arbitration agreement.

For this purpose “arbitration agreement” means an agreement to submit to arbitration present or future disputes or differences (whether or not contractual).

- [F<sup>3</sup>(2) In those sections “the Part” means Part 2 (unfair terms) of the Consumer Rights Act 2015.]

- (3) Those sections apply whatever the law applicable to the arbitration agreement.

#### **Annotations:**

##### **Amendments (Textual)**

- F2** Words in s. 89(1) substituted (1.10.2015) by [Consumer Rights Act 2015 \(c. 15\)](#), s. 100(5), [Sch. 4 para. 31\(2\)](#); S.I. 2015/1630, art. 3(g) (with art. 6(1))
- F3** S. 89(2) substituted (1.10.2015) by [Consumer Rights Act 2015 \(c. 15\)](#), s. 100(5), [Sch. 4 para. 31\(3\)](#); S.I. 2015/1630, art. 3(g) (with art. 6(1))

## **[F<sup>4</sup>90 Part applies where consumer is a legal person**

The Part applies where the consumer is a legal person as it applies where the consumer is an individual.]

#### **Annotations:**

##### **Amendments (Textual)**

- F4** S. 90 substituted (1.10.2015) by [Consumer Rights Act 2015 \(c. 15\)](#), s. 100(5), [Sch. 4 para. 32](#); S.I. 2015/1630, art. 3(g) (with art. 6(1))

*Status: This version of this Act contains provisions that are prospective.*

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## 91 Arbitration agreement unfair where modest amount sought.

- (1) A term which constitutes an arbitration agreement is unfair for the purposes of the <sup>F5</sup>Part] so far as it relates to a claim for a pecuniary remedy which does not exceed the amount specified by order for the purposes of this section.
- (2) Orders under this section may make different provision for different cases and for different purposes.
- (3) The power to make orders under this section is exercisable—
  - (a) for England and Wales, by the Secretary of State with the concurrence of the Lord Chancellor,
  - (b) for Scotland, by the Secretary of State <sup>F6</sup> . . . , and
  - (c) for Northern Ireland, by the Department of Economic Development for Northern Ireland with the concurrence of the Lord Chancellor.
- (4) Any such order for England and Wales or Scotland shall be made by statutory instrument which shall be subject to annulment in pursuance of a resolution of either House of Parliament.
- (5) Any such order for Northern Ireland shall be a statutory rule for the purposes of the <sup>M9</sup>Statutory Rules (Northern Ireland) Order 1979 and shall be subject to negative resolution, within the meaning of section 41(6) of the <sup>M10</sup>Interpretation Act (Northern Ireland) 1954.

### Annotations:

#### Amendments (Textual)

**F5** Word in s. 91(1) substituted (1.10.2015) by [Consumer Rights Act 2015 \(c. 15\)](#), s. 100(5), [Sch. 4 para. 33](#); [S.I. 2015/1630](#), art. 3(g) (with art. 6(1))

**F6** Words in s. 91(3)(b) repealed (19.5.1999) by [S.I. 1999/678](#), [art. 6](#)

#### Modifications etc. (not altering text)

**C137** S. 91(3): functions of the Lord Advocate transferred (19.5.1999) to the Secretary of State by virtue of [S.I. 1999/678](#), arts. 2(1), [Sch.](#) (with art. 7)

#### Commencement Information

**II** S. 91 wholly in force 31.1.1997: S. 91 not in force at Royal Assent see s. 109(1); S. 91 in force for certain purposes only at 17.12.1996 otherwise in force at 31.1.1997 by [S.I.1996/3146](#), arts. 2, 3, [Sch. 1](#);

#### Marginal Citations

**M9** [S.I. 1979/1573 \(N.I. 12\)](#).

**M10** [1954 c. 33 \(N.I.\)](#).

### *Small claims arbitration in the county court*

## 92 Exclusion of Part I in relation to small claims arbitration in the county court.

Nothing in Part I of this Act applies to arbitration under section 64 of the <sup>M11</sup>County Courts Act 1984.

*Status: This version of this Act contains provisions that are prospective.*

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**Annotations:**

**Marginal Citations**

**M11** 1984 c. 28.

*Appointment of judges as arbitrators*

**93 Appointment of judges as arbitrators.**

- (1) [<sup>F7</sup>An eligible High Court judge] or an official referee may, if in all the circumstances he thinks fit, accept appointment as a sole arbitrator or as umpire by or by virtue of an arbitration agreement.
  - (2) [<sup>F8</sup>An eligible High Court judge] shall not do so unless the Lord Chief Justice has informed him that, having regard to the state of business in the High Court and the Crown Court, he can be made available.
  - (3) An official referee shall not do so unless the Lord Chief Justice has informed him that, having regard to the state of official referees' business, he can be made available.
  - (4) The fees payable for the services of [<sup>F9</sup>an eligible High Court judge] or official referee as arbitrator or umpire shall be taken in the High Court.
- [<sup>F10</sup>(4A) The Lord Chief Justice may nominate a senior judge (as defined in section 109(5) of the Constitutional Reform Act 2005) to exercise functions of the Lord Chief Justice under this section.]
- (5) In this section—
    - “arbitration agreement” has the same meaning as in Part I; <sup>F11</sup> ...
    - [<sup>F12</sup>“eligible High Court judge” means—
    - (a) a puisne judge of the High Court, or
    - (b) a person acting as a judge of the High Court under or by virtue of section 9(1) of the Senior Courts Act 1981;]
    - “official referee” means a person nominated under section 68(1)(a) of the <sup>M12</sup>[<sup>F13</sup>Senior Courts Act 1981]<sup>F13</sup> to deal with official referees' business.
  - (6) The provisions of Part I of this Act apply to arbitration before a person appointed under this section with the modifications specified in Schedule 2.

**Annotations:**

**Amendments (Textual)**

- F7** Words in s. 93(1) substituted (20.2.2019) by [Courts and Tribunals \(Judiciary and Functions of Staff\) Act 2018 \(c. 33\)](#), [ss. 1\(6\)\(a\)](#), 4(2)
- F8** Words in s. 93(2) substituted (20.2.2019) by [Courts and Tribunals \(Judiciary and Functions of Staff\) Act 2018 \(c. 33\)](#), [ss. 1\(6\)\(a\)](#), 4(2)
- F9** Words in s. 93(4) substituted (20.2.2019) by [Courts and Tribunals \(Judiciary and Functions of Staff\) Act 2018 \(c. 33\)](#), [ss. 1\(6\)\(b\)](#), 4(2)
- F10** S. 93(4A) inserted (20.2.2019) by [Courts and Tribunals \(Judiciary and Functions of Staff\) Act 2018 \(c. 33\)](#), [ss. 1\(6\)\(c\)](#), 4(2)
- F11** Word in s. 93(5) omitted (20.2.2019) by virtue of [Courts and Tribunals \(Judiciary and Functions of Staff\) Act 2018 \(c. 33\)](#), [ss. 1\(6\)\(d\)\(i\)](#), 4(2)

*Status: This version of this Act contains provisions that are prospective.*

*Changes to legislation: Arbitration Act 1996 is up to date with all changes known to be in force on or before 15 April 2019. There are changes that may be brought into force at a future date. Changes that have been made appear in the content and are referenced with annotations. (See end of Document for details)*

**F12** Words in s. 93(5) inserted (20.2.2019) by [Courts and Tribunals \(Judiciary and Functions of Staff\) Act 2018 \(c. 33\)](#), **ss. 1(6)(d)(ii), 4(2)**

**F13** Words in s. 93(5) substituted (1.10.2009) by [Constitutional Reform Act 2005 \(c. 4\)](#), **ss. 59(5), 148(1), Sch. 11 para. 1(2)**; [S.I. 2009/1604](#), **art. 2(d)**

#### Marginal Citations

**M12** 1981 c. 54.

### *Statutory arbitrations*

#### **94 Application of Part I to statutory arbitrations.**

- (1) The provisions of Part I apply to every arbitration under an enactment (a “statutory arbitration”), whether the enactment was passed or made before or after the commencement of this Act, subject to the adaptations and exclusions specified in sections 95 to 98.
- (2) The provisions of Part I do not apply to a statutory arbitration if or to the extent that their application—
  - (a) is inconsistent with the provisions of the enactment concerned, with any rules or procedure authorised or recognised by it, or
  - (b) is excluded by any other enactment.
- (3) In this section and the following provisions of this Part “enactment”—
  - (a) in England and Wales, includes an enactment contained in subordinate legislation within the meaning of the <sup>M13</sup>Interpretation Act 1978;
  - (b) in Northern Ireland, means a statutory provision within the meaning of section 1(f) of the <sup>M14</sup>Interpretation Act (Northern Ireland) 1954.

#### Annotations:

#### Modifications etc. (not altering text)

**C138** S. 94 modified (W.) (15.2.2006) by [The Valuation Tribunals \(Wales\) Regulations 2005 \(S.I. 2005/3364\)](#), **regs. 1(4), 42(2)**

#### Marginal Citations

**M13** 1978 c. 30.

**M14** 1954 c. 33 (N.I.).

#### **95 General adaptation of provisions in relation to statutory arbitrations.**

- (1) The provisions of Part I apply to a statutory arbitration—
  - (a) as if the arbitration were pursuant to an arbitration agreement and as if the enactment were that agreement, and
  - (b) as if the persons by and against whom a claim subject to arbitration in pursuance of the enactment may be or has been made were parties to that agreement.
- (2) Every statutory arbitration shall be taken to have its seat in England and Wales or, as the case may be, in Northern Ireland.

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**96 Specific adaptations of provisions in relation to statutory arbitrations.**

- (1) The following provisions of Part I apply to a statutory arbitration with the following adaptations.
- (2) In section 30(1) (competence of tribunal to rule on its own jurisdiction), the reference in paragraph (a) to whether there is a valid arbitration agreement shall be construed as a reference to whether the enactment applies to the dispute or difference in question.
- (3) Section 35 (consolidation of proceedings and concurrent hearings) applies only so as to authorise the consolidation of proceedings, or concurrent hearings in proceedings, under the same enactment.
- (4) Section 46 (rules applicable to substance of dispute) applies with the omission of subsection (1)(b) (determination in accordance with considerations agreed by parties).

**97 Provisions excluded from applying to statutory arbitrations.**

The following provisions of Part I do not apply in relation to a statutory arbitration—

- (a) section 8 (whether agreement discharged by death of a party);
- (b) section 12 (power of court to extend agreed time limits);
- (c) sections 9(5), 10(2) and 71(4) (restrictions on effect of provision that award condition precedent to right to bring legal proceedings).

**98 Power to make further provision by regulations.**

- (1) The Secretary of State may make provision by regulations for adapting or excluding any provision of Part I in relation to statutory arbitrations in general or statutory arbitrations of any particular description.
- (2) The power is exercisable whether the enactment concerned is passed or made before or after the commencement of this Act.
- (3) Regulations under this section shall be made by statutory instrument which shall be subject to annulment in pursuance of a resolution of either House of Parliament.

**PART III**

RECOGNITION AND ENFORCEMENT OF CERTAIN FOREIGN AWARDS

*Enforcement of Geneva Convention awards*

**99 Continuation of Part II of the Arbitration Act 1950.**

Part II of the <sup>M15</sup>Arbitration Act 1950 (enforcement of certain foreign awards) continues to apply in relation to foreign awards within the meaning of that Part which are not also New York Convention awards.

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**Annotations:**

**Marginal Citations**

**M15** 1950 c. 27.

*Recognition and enforcement of New York Convention awards*

**100 New York Convention awards.**

- (1) In this Part a “New York Convention award” means an award made, in pursuance of an arbitration agreement, in the territory of a state (other than the United Kingdom) which is a party to the New York Convention.
- (2) For the purposes of subsection (1) and of the provisions of this Part relating to such awards—
  - (a) “arbitration agreement” means an arbitration agreement in writing, and
  - (b) an award shall be treated as made at the seat of the arbitration, regardless of where it was signed, despatched or delivered to any of the parties.

In this subsection “agreement in writing” and “seat of the arbitration” have the same meaning as in Part I.

- (3) If Her Majesty by Order in Council declares that a state specified in the Order is a party to the New York Convention, or is a party in respect of any territory so specified, the Order shall, while in force, be conclusive evidence of that fact.
- (4) In this section “the New York Convention” means the Convention on the Recognition and Enforcement of Foreign Arbitral Awards adopted by the United Nations Conference on International Commercial Arbitration on 10th June 1958.

**101 Recognition and enforcement of awards.**

- (1) A New York Convention award shall be recognised as binding on the persons as between whom it was made, and may accordingly be relied on by those persons by way of defence, set-off or otherwise in any legal proceedings in England and Wales or Northern Ireland.
- (2) A New York Convention award may, by leave of the court, be enforced in the same manner as a judgment or order of the court to the same effect.

As to the meaning of “the court” see section 105.

- (3) Where leave is so given, judgment may be entered in terms of the award.

**102 Evidence to be produced by party seeking recognition or enforcement.**

- (1) A party seeking the recognition or enforcement of a New York Convention award must produce—
  - (a) the duly authenticated original award or a duly certified copy of it, and
  - (b) the original arbitration agreement or a duly certified copy of it.

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- (2) If the award or agreement is in a foreign language, the party must also produce a translation of it certified by an official or sworn translator or by a diplomatic or consular agent.

### **103 Refusal of recognition or enforcement.**

- (1) Recognition or enforcement of a New York Convention award shall not be refused except in the following cases.
- (2) Recognition or enforcement of the award may be refused if the person against whom it is invoked proves—
- (a) that a party to the arbitration agreement was (under the law applicable to him) under some incapacity;
  - (b) that the arbitration agreement was not valid under the law to which the parties subjected it or, failing any indication thereon, under the law of the country where the award was made;
  - (c) that he was not given proper notice of the appointment of the arbitrator or of the arbitration proceedings or was otherwise unable to present his case;
  - (d) that the award deals with a difference not contemplated by or not falling within the terms of the submission to arbitration or contains decisions on matters beyond the scope of the submission to arbitration (but see subsection (4));
  - (e) that the composition of the arbitral tribunal or the arbitral procedure was not in accordance with the agreement of the parties or, failing such agreement, with the law of the country in which the arbitration took place;
  - (f) that the award has not yet become binding on the parties, or has been set aside or suspended by a competent authority of the country in which, or under the law of which, it was made.
- (3) Recognition or enforcement of the award may also be refused if the award is in respect of a matter which is not capable of settlement by arbitration, or if it would be contrary to public policy to recognise or enforce the award.
- (4) An award which contains decisions on matters not submitted to arbitration may be recognised or enforced to the extent that it contains decisions on matters submitted to arbitration which can be separated from those on matters not so submitted.
- (5) Where an application for the setting aside or suspension of the award has been made to such a competent authority as is mentioned in subsection (2)(f), the court before which the award is sought to be relied upon may, if it considers it proper, adjourn the decision on the recognition or enforcement of the award.

It may also on the application of the party claiming recognition or enforcement of the award order the other party to give suitable security.

### **104 Saving for other bases of recognition or enforcement.**

Nothing in the preceding provisions of this Part affects any right to rely upon or enforce a New York Convention award at common law or under section 66.



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## PART IV

### GENERAL PROVISIONS

#### 105 Meaning of “the court”: jurisdiction of High Court and county court.

- (1) In this Act “the court” [<sup>F14</sup> in relation to England and Wales means the High Court or the county court and in relation to Northern Ireland ] means the High Court or a county court, subject to the following provisions.
- (2) The Lord Chancellor may by order make provision—
  - [<sup>F15</sup>(za) allocating proceedings under this Act in England and Wales to the High Court or the county court;]
  - (a) allocating proceedings under this Act [<sup>F16</sup> in Northern Ireland ] to the High Court or to county courts; or
  - (b) specifying proceedings under this Act which may be commenced or taken only in the High Court or in [<sup>F17</sup> the county court or (as the case may be) ] a county court.
- (3) The Lord Chancellor may by order make provision requiring proceedings of any specified description under this Act in relation to which a county court [<sup>F18</sup> in Northern Ireland ] has jurisdiction to be commenced or taken in one or more specified county courts.

Any jurisdiction so exercisable by a specified county court is exercisable throughout [<sup>F19</sup> ... Northern Ireland.

- [<sup>F20</sup>(3A) The Lord Chancellor must consult the Lord Chief Justice of England and Wales or the Lord Chief Justice of Northern Ireland (as the case may be) before making an order under this section.
- (3B) The Lord Chief Justice of England and Wales may nominate a judicial office holder (as defined in section 109(4) of the Constitutional Reform Act 2005) to exercise his functions under this section.
- (3C) The Lord Chief Justice of Northern Ireland may nominate any of the following to exercise his functions under this section—
  - (a) the holder of one of the offices listed in Schedule 1 to the Justice (Northern Ireland) Act 2002;
  - (b) a Lord Justice of Appeal (as defined in section 88 of that Act).]
- [<sup>F20</sup>(4) An order under this section—
  - (a) may differentiate between categories of proceedings by reference to such criteria as the Lord Chancellor sees fit to specify, and
  - (b) may make such incidental or transitional provision as the Lord Chancellor considers necessary or expedient.
- (5) An order under this section for England and Wales shall be made by statutory instrument which shall be subject to annulment in pursuance of a resolution of either House of Parliament.
- (6) An order under this section for Northern Ireland shall be a statutory rule for the purposes of the [<sup>M16</sup>Statutory Rules (Northern Ireland) Order 1979 which shall

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be subject to <sup>F21</sup>negative resolution (within the meaning of section 41(6) of the Interpretation Act (Northern Ireland) 1954)].

**Annotations:**

**Amendments (Textual)**

- F14** Words in s. 105(1) inserted (22.4.2014) by [Crime and Courts Act 2013 \(c. 22\)](#), s. 61(3), [Sch. 9 para. 60\(2\)\(a\)](#); S.I. 2014/954, art. 2(c) (with art. 3) (with transitional provisions and savings in S.I. 2014/956, arts. 3-11)
- F15** S. 105(2)(za) inserted (22.4.2014) by [Crime and Courts Act 2013 \(c. 22\)](#), s. 61(3), [Sch. 9 para. 60\(2\)\(b\)](#); S.I. 2014/954, art. 2(c) (with art. 3) (with transitional provisions and savings in S.I. 2014/956, arts. 3-11)
- F16** Words in s. 105(2)(a) inserted (22.4.2014) by [Crime and Courts Act 2013 \(c. 22\)](#), s. 61(3), [Sch. 9 para. 60\(2\)\(c\)](#); S.I. 2014/954, art. 2(c) (with art. 3) (with transitional provisions and savings in S.I. 2014/956, arts. 3-11)
- F17** Words in s. 105(2)(b) inserted (22.4.2014) by [Crime and Courts Act 2013 \(c. 22\)](#), s. 61(3), [Sch. 9 para. 60\(2\)\(d\)](#); S.I. 2014/954, art. 2(c) (with art. 3) (with transitional provisions and savings in S.I. 2014/956, arts. 3-11)
- F18** Words in s. 105(3) inserted (22.4.2014) by [Crime and Courts Act 2013 \(c. 22\)](#), s. 61(3), [Sch. 9 para. 60\(2\)\(e\)](#); S.I. 2014/954, art. 2(c) (with art. 3) (with transitional provisions and savings in S.I. 2014/956, arts. 3-11)
- F19** Words in s. 105(3) omitted (22.4.2014) by virtue of [Crime and Courts Act 2013 \(c. 22\)](#), s. 61(3), [Sch. 9 para. 60\(2\)\(f\)](#); S.I. 2014/954, art. 2(c) (with art. 3) (with transitional provisions and savings in S.I. 2014/956, arts. 3-11)
- F20** S. 105(3A)-(3C) inserted (3.4.2006) by [Constitutional Reform Act 2005 \(c. 4\)](#), ss. 15(1), 148, [Sch. 4 para. 250](#); S.I. 2006/1014, art. 2(a), Sch. 1 para. 11(v)
- F21** Words in s. 105(6) substituted (12.4.2010) by [The Northern Ireland Act 1998 \(Devolution of Policing and Justice Functions\) Order 2010 \(S.I. 2010/976\)](#), art. 15(5), [Sch. 18 para. 50\(2\)](#) (with arts. 28-31)

**Marginal Citations**

- M16** [S.I. 1979/1573 \(N.I. 12\)](#).

**106 Crown application.**

- (1) Part I of this Act applies to any arbitration agreement to which Her Majesty, either in right of the Crown or of the Duchy of Lancaster or otherwise, or the Duke of Cornwall, is a party.
- (2) Where Her Majesty is party to an arbitration agreement otherwise than in right of the Crown, Her Majesty shall be represented for the purposes of any arbitral proceedings
  - (a) where the agreement was entered into by Her Majesty in right of the Duchy of Lancaster, by the Chancellor of the Duchy or such person as he may appoint, and
  - (b) in any other case, by such person as Her Majesty may appoint in writing under the Royal Sign Manual.
- (3) Where the Duke of Cornwall is party to an arbitration agreement, he shall be represented for the purposes of any arbitral proceedings by such person as he may appoint.

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- (4) References in Part I to a party or the parties to the arbitration agreement or to arbitral proceedings shall be construed, where subsection (2) or (3) applies, as references to the person representing Her Majesty or the Duke of Cornwall.

## 107 Consequential amendments and repeals.

- (1) The enactments specified in Schedule 3 are amended in accordance with that Schedule, the amendments being consequential on the provisions of this Act.
- (2) The enactments specified in Schedule 4 are repealed to the extent specified.

### Annotations:

#### Commencement Information

- I2** S. 107 wholly in force 31.1.1997; S. 107 not in force at Royal Assent see s. 109(1); S. 107 in force for certain purposes at 17.12.1996 and otherwise in force at 31.1.1997 by [S.I. 1996/3146](#), [arts. 2, 3](#), [Sch. 1](#)

## 108 Extent.

- (1) The provisions of this Act extend to England and Wales and, except as mentioned below, to Northern Ireland.
- (2) The following provisions of Part II do not extend to Northern Ireland—  
section 92 (exclusion of Part I in relation to small claims arbitration in the county court), and  
section 93 and Schedule 2 (appointment of judges as arbitrators).
- (3) Sections 89, 90 and 91 (consumer arbitration agreements) extend to Scotland and the provisions of Schedules 3 and 4 (consequential amendments and repeals) extend to Scotland so far as they relate to enactments which so extend, subject as follows.
- (4) The repeal of the <sup>M17</sup>Arbitration Act 1975 extends only to England and Wales and Northern Ireland.

### Annotations:

#### Marginal Citations

- M17** 1975 c. 3.

## 109 Commencement.

- (1) The provisions of this Act come into force on such day as the Secretary of State may appoint by order made by statutory instrument, and different days may be appointed for different purposes.
- (2) An order under subsection (1) may contain such transitional provisions as appear to the Secretary of State to be appropriate.

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**Annotations:**

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**Subordinate Legislation Made**

- P1** S. 109 power partly exercised (16.12.1996): 17.12.1996 and 31.1.1997 appointed for specified provisions by [S.I. 1996/3146](#), [arts. 2, 3](#) (with transitional provisions in [art. 4](#), [Sch. 2](#))

**110 Short title.**

This Act may be cited as the Arbitration Act 1996.

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## SCHEDULES

### SCHEDULE 1

Section 4(1).

#### MANDATORY PROVISIONS OF PART I

sections 9 to 11 (stay of legal proceedings);  
section 12 (power of court to extend agreed time limits);  
section 13 (application of Limitation Acts);  
section 24 (power of court to remove arbitrator);  
section 26(1) (effect of death of arbitrator);  
section 28 (liability of parties for fees and expenses of arbitrators);  
section 29 (immunity of arbitrator);  
section 31 (objection to substantive jurisdiction of tribunal);  
section 32 (determination of preliminary point of jurisdiction);  
section 33 (general duty of tribunal);  
section 37(2) (items to be treated as expenses of arbitrators);  
section 40 (general duty of parties);  
section 43 (securing the attendance of witnesses);  
section 56 (power to withhold award in case of non-payment);  
section 60 (effectiveness of agreement for payment of costs in any event);  
section 66 (enforcement of award);  
sections 67 and 68 (challenging the award: substantive jurisdiction and serious irregularity), and sections 70 and 71 (supplementary provisions; effect of order of court) so far as relating to those sections;  
section 72 (saving for rights of person who takes no part in proceedings);  
section 73 (loss of right to object);  
section 74 (immunity of arbitral institutions, &c.);  
section 75 (charge to secure payment of solicitors' costs).

### SCHEDULE 2

Section 93(6).

#### MODIFICATIONS OF PART I IN RELATION TO JUDGE-ARBITRATORS

##### *Introductory*

- 1 In this Schedule “judge-arbitrator” means [<sup>F22</sup>an eligible High Court judge] or official referee appointed as arbitrator or umpire under section 93.

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**Annotations:**

**Amendments (Textual)**

- F22** Words in [Sch. 2 para. 1](#) substituted (20.2.2019) by [Courts and Tribunals \(Judiciary and Functions of Staff\) Act 2018 \(c. 33\), ss. 1\(7\), 4\(2\)](#)

*General*

- 2 (1) Subject to the following provisions of this Schedule, references in Part I to the court shall be construed in relation to a judge-arbitrator, or in relation to the appointment of a judge-arbitrator, as references to the Court of Appeal.
- (2) The references in sections 32(6), 45(6) and 69(8) to the Court of Appeal shall in such a case be construed as references to the [<sup>F23</sup>Supreme Court]<sup>F23</sup>.

**Annotations:**

**Amendments (Textual)**

- F23** Words in [Sch. 2 para. 2\(2\)](#) substituted (1.10.2009) by [Constitutional Reform Act 2005 \(c. 4\), ss. 40\(4\), 148, Sch. 9 para. 60; S.I. 2009/1604, art. 2\(d\)](#)

*Arbitrator's fees*

- 3 (1) The power of the court in section 28(2) to order consideration and adjustment of the liability of a party for the fees of an arbitrator may be exercised by a judge-arbitrator.
- (2) Any such exercise of the power is subject to the powers of the Court of Appeal under sections 24(4) and 25(3)(b) (directions as to entitlement to fees or expenses in case of removal or resignation).

*Exercise of court powers in support of arbitration*

- 4 (1) Where the arbitral tribunal consists of or includes a judge-arbitrator the powers of the court under sections 42 to 44 (enforcement of peremptory orders, summoning witnesses, and other court powers) are exercisable by the High Court and also by the judge-arbitrator himself.
- (2) Anything done by a judge-arbitrator in the exercise of those powers shall be regarded as done by him in his capacity as judge of the High Court and have effect as if done by that court.

Nothing in this sub-paragraph prejudices any power vested in him as arbitrator or umpire.

*Extension of time for making award*

- 5 (1) The power conferred by section 50 (extension of time for making award) is exercisable by the judge-arbitrator himself.
- (2) Any appeal from a decision of a judge-arbitrator under that section lies to the Court of Appeal with the leave of that court.

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#### *Withholding award in case of non-payment*

- 6 (1) The provisions of paragraph 7 apply in place of the provisions of section 56 (power to withhold award in the case of non-payment) in relation to the withholding of an award for non-payment of the fees and expenses of a judge-arbitrator.
- (2) This does not affect the application of section 56 in relation to the delivery of such an award by an arbitral or other institution or person vested by the parties with powers in relation to the delivery of the award.
- 7 (1) A judge-arbitrator may refuse to deliver an award except upon payment of the fees and expenses mentioned in section 56(1).
- (2) The judge-arbitrator may, on an application by a party to the arbitral proceedings, order that if he pays into the High Court the fees and expenses demanded, or such lesser amount as the judge-arbitrator may specify—
- (a) the award shall be delivered,
  - (b) the amount of the fees and expenses properly payable shall be determined by such means and upon such terms as he may direct, and
  - (c) out of the money paid into court there shall be paid out such fees and expenses as may be found to be properly payable and the balance of the money (if any) shall be paid out to the applicant.
- (3) For this purpose the amount of fees and expenses properly payable is the amount the applicant is liable to pay under section 28 or any agreement relating to the payment of the arbitrator.
- (4) No application to the judge-arbitrator under this paragraph may be made where there is any available arbitral process for appeal or review of the amount of the fees or expenses demanded.
- (5) Any appeal from a decision of a judge-arbitrator under this paragraph lies to the Court of Appeal with the leave of that court.
- (6) Where a party to arbitral proceedings appeals under sub-paragraph (5), an arbitrator is entitled to appear and be heard.

#### *Correction of award or additional award*

- 8 Subsections (4) to (6) of section 57 (correction of award or additional award: time limit for application or exercise of power) do not apply to a judge-arbitrator.

#### *Costs*

- 9 Where the arbitral tribunal consists of or includes a judge-arbitrator the powers of the court under section 63(4) (determination of recoverable costs) shall be exercised by the High Court.
- 10 (1) The power of the court under section 64 to determine an arbitrator's reasonable fees and expenses may be exercised by a judge-arbitrator.
- (2) Any such exercise of the power is subject to the powers of the Court of Appeal under sections 24(4) and 25(3)(b) (directions as to entitlement to fees or expenses in case of removal or resignation).

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*Enforcement of award*

- 11 The leave of the court required by section 66 (enforcement of award) may in the case of an award of a judge-arbitrator be given by the judge-arbitrator himself.

*Solicitors' costs*

- 12 The powers of the court to make declarations and orders under the provisions applied by section 75 (power to charge property recovered in arbitral proceedings with the payment of solicitors' costs) may be exercised by the judge-arbitrator.

*Powers of court in relation to service of documents*

- 13 (1) The power of the court under section 77(2) (powers of court in relation to service of documents) is exercisable by the judge-arbitrator.
- (2) Any appeal from a decision of a judge-arbitrator under that section lies to the Court of Appeal with the leave of that court.

*Powers of court to extend time limits relating to arbitral proceedings*

- 14 (1) The power conferred by section 79 (power of court to extend time limits relating to arbitral proceedings) is exercisable by the judge-arbitrator himself.
- (2) Any appeal from a decision of a judge-arbitrator under that section lies to the Court of Appeal with the leave of that court.

SCHEDULE 3

Section 107(1).

CONSEQUENTIAL AMENDMENTS

*Merchant Shipping Act 1894 (c. 60)*

- 1 In section 496 of the Merchant Shipping Act 1894 (provisions as to deposits by owners of goods), after subsection (4) insert—

“(5) In subsection (3) the expression “legal proceedings” includes arbitral proceedings and as respects England and Wales and Northern Ireland the provisions of section 14 of the Arbitration Act 1996 apply to determine when such proceedings are commenced.”.

*Stannaries Court (Abolition) Act 1896 (c. 45)*

- 2 In section 4(1) of the Stannaries Court (Abolition) Act 1896 (references of certain disputes to arbitration), for the words from “tried before” to “any such reference” substitute “referred to arbitration before himself or before an arbitrator agreed on by the parties or an officer of the court”.

*Tithe Act 1936 (c. 43)*

- 3 F24 .....



*Status:* This version of this Act contains provisions that are prospective.

*Changes to legislation:* Arbitration Act 1996 is up to date with all changes known to be in force on or before 15 April 2019. There are changes that may be brought into force at a future date. Changes that have been made appear in the content and are referenced with annotations. (See end of Document for details)

**Annotations:**

**Amendments (Textual)**

**F24** Sch. 3 para. 3 repealed (22.7.2004) by Statute Law (Repeals) Act 2004 (c. 14), s. 1(1), {Sch. 1 Pt. 6 Group 3}

*Education Act 1944 (c.31)*

F25 4 .....

**Annotations:**

**Amendments (Textual)**

**F25** Sch. 3 para. 4 repealed (1.11.1996) by 1996 c. 56, ss. 582(2)(3), 583(2), Sch. 38 Pt. I, Sch. 39 (with s. 1(4))

*Commonwealth Telegraphs Act 1949 (c.39)*

5 In section 8(2) of the Commonwealth Telegraphs Act 1949 (proceedings of referees under the Act) for “the Arbitration Acts 1889 to 1934, or the Arbitration Act (Northern Ireland) 1937,” substitute “ Part I of the Arbitration Act 1996 ”.

*Lands Tribunal Act 1949 (c.42)*

6 F26 .....

**Annotations:**

**Amendments (Textual)**

**F26** Sch. 3 para. 6 repealed (1.6.2009) by The Transfer of Tribunal Functions (Lands Tribunal and Miscellaneous Amendments) Order 2009 (S.I. 2009/1307), art. 5(5), Sch. 4 (with Sch. 5)

*Wireless Telegraphy Act 1949 (c.54)*

7 F27 .....

**Annotations:**

**Amendments (Textual)**

**F27** Sch. 3 para. 7 repealed (25.7.2003) by Communications Act 2003 (c. 21), ss. 406, 411(2)(3), Sch. 19(1) (with Schs. 18, 19(1) Note 1); S.I. 2003/1900, art. 2(1), Sch. 1 (with arts. 3-6)

*Patents Act 1949 (c.87)*

8 In section 67 of the Patents Act 1949 (proceedings as to infringement of pre-1978 patents referred to comptroller), for “The Arbitration Acts 1889 to 1934” substitute “ Part I of the Arbitration Act 1996 ”.

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*National Health Service (Amendment) Act 1949 (c.93)*

- 9 In section 7(8) of the <sup>M18</sup>National Health Service (Amendment) Act 1949 (arbitration in relation to hardship arising from the National Health Service Act 1946 or the Act), for “the Arbitration Acts 1889 to 1934” substitute “ Part I of the Arbitration Act 1996 ” and for “the said Acts” substitute “ Part I of that Act ”.

**Annotations:**

**Marginal Citations**

**M18** 1946 c. 81.

*Arbitration Act 1950 (c.27)*

- 10 In section 36(1) of the Arbitration Act 1950 (effect of foreign awards enforceable under Part II of that Act) for “section 26 of this Act” substitute “ section 66 of the Arbitration Act 1996 ”.

*Interpretation Act (Northern Ireland) 1954 (c.33 (N.I.))*

- 11 In section 46(2) of the Interpretation Act (Northern Ireland) 1954 (miscellaneous definitions), for the definition of “arbitrator” substitute—  
 ““arbitrator” has the same meaning as in Part I of the Arbitration Act 1996;”.

*Agricultural Marketing Act 1958 (c.47)*

- 12 In section 12(1) of the Agricultural Marketing Act 1958 (application of provisions of Arbitration Act 1950)—
- (a) for the words from the beginning to “shall apply” substitute “ Sections 45 and 69 of the Arbitration Act 1996 (which relate to the determination by the court of questions of law) and section 66 of that Act (enforcement of awards) apply ”; and
  - (b) for “an arbitration” substitute “ arbitral proceedings ”.

*Carriage by Air Act 1961 (c.27)*

- 13 (1) The Carriage by Air Act 1961 is amended as follows.
- (2) In section 5(3) (time for bringing proceedings)—
- (a) for “an arbitration” in the first place where it occurs substitute “ arbitral proceedings ”; and
  - (b) for the words from “and subsections (3) and (4)” to the end substitute “ and the provisions of section 14 of the Arbitration Act 1996 apply to determine when such proceedings are commenced. ”.
- (3) In section 11(c) (application of section 5 to Scotland)—
- (a) for “subsections (3) and (4)” substitute “ the provisions of section 14 of the Arbitration Act 1996 ”; and
  - (b) for “an arbitration” substitute “ arbitral proceedings ”.

*Status:* This version of this Act contains provisions that are prospective.

*Changes to legislation:* Arbitration Act 1996 is up to date with all changes known to be in force on or before 15 April 2019. There are changes that may be brought into force at a future date. Changes that have been made appear in the content and are referenced with annotations. (See end of Document for details)

*Factories Act 1961 (c.34)*

- 14 In the Factories Act 1961, for section 171 (application of Arbitration Act 1950), substitute—

**“171 Application of the Arbitration Act 1996.**

Part I of the Arbitration Act 1996 does not apply to proceedings under this Act except in so far as it may be applied by regulations made under this Act.”.

*Clergy Pensions Measure 1961 (No. 3)*

- 15 In the Clergy Pensions Measure 1961, section 38(4) (determination of questions), for the words “The Arbitration Act 1950” substitute “ Part I of the Arbitration Act 1996 ”.

*Transport Act 1962 (c.46)*

- 16 (1) The Transport Act 1962 is amended as follows.
- (2) In section 74(6)(f) (proceedings before referees in pension disputes), for the words “the Arbitration Act 1950” substitute “ Part I of the Arbitration Act 1996 ”.
- (3) In section 81(7) (proceedings before referees in compensation disputes), for the words “the Arbitration Act 1950” substitute “ Part I of the Arbitration Act 1996 ”.
- (4) In Schedule 7, Part IV (pensions), in paragraph 17(5) for the words “the Arbitration Act 1950” substitute “ Part I of the Arbitration Act 1996 ”.

*Corn Rents Act 1963 (c.14)*

- 17 In the Corn Rents Act 1963, section 1(5) (schemes for apportioning corn rents, &c.), for the words “the Arbitration Act 1950” substitute “ Part I of the Arbitration Act 1996 ”.

*Plant Varieties and Seeds Act 1964 (c.14)*

- F28 18 .....

**Annotations:**

**Amendments (Textual)**

F28 Sch. 3 para. 18 repealed (8.5.1998) by 1997 c. 66, s. 52, Sch. 4; S.I. 1998/1028, art. 2

*Lands Tribunal and Compensation Act (Northern Ireland) 1964 (c.29 (N.I.))*

- 19 In section 9 of the Lands Tribunal and Compensation Act (Northern Ireland) 1964 (proceedings of Lands Tribunal), in subsection (3) (where Tribunal acts as arbitrator) for “the Arbitration Act (Northern Ireland) 1937” substitute “ Part I of the Arbitration Act 1996 ”.

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*Industrial and Provident Societies Act 1965 (c.12)*

F29 20 .....

**Annotations:**

**Amendments (Textual)**

**F29** Sch. 3 para. 20 repealed (1.8.2014) by [Co-operative and Community Benefit Societies Act 2014 \(c. 14\)](#), s. 154, [Sch. 7](#) (with [Sch. 5](#))

*Carriage of Goods by Road Act 1965 (c.37)*

- 21 In section 7(2) of the Carriage of Goods by Road Act 1965 (arbitrations: time at which deemed to commence), for paragraphs (a) and (b) substitute—
- “(a) as respects England and Wales and Northern Ireland, the provisions of section 14(3) to (5) of the Arbitration Act 1996 (which determine the time at which an arbitration is commenced) apply;”.

*Factories Act (Northern Ireland) 1965 (c.20 (N.I.))*

- 22 In section 171 of the Factories Act (Northern Ireland) 1965 (application of Arbitration Act), for “The Arbitration Act (Northern Ireland) 1937” substitute “Part I of the Arbitration Act 1996”.

*Commonwealth Secretariat Act 1966 (c.10)*

23 F30 .....

**Annotations:**

**Amendments (Textual)**

**F30** Sch. 3 para. 23 omitted (7.6.2005) by virtue of [International Organisations Act 2005 \(c. 20\)](#), [ss. 1\(2\), 11](#)(with s. 1(3)); [S.I. 2005/1870](#), [art. 2](#) and said provision repealed (prosp.) by [International Organisations Act 2005 \(c. 20\)](#), s. 9, [Sch.](#)

*Arbitration (International Investment Disputes) Act 1966 (c.41)*

- 24 In the Arbitration (International Investment Disputes) Act 1966, for section 3 (application of Arbitration Act 1950 and other enactments) substitute—

**“3 Application of provisions of Arbitration Act 1996.**

- (1) The Lord Chancellor may by order direct that any of the provisions contained in sections 36 and 38 to 44 of the Arbitration Act 1996 (provisions concerning the conduct of arbitral proceedings, &c.) shall apply to such proceedings pursuant to the Convention as are specified in the order with or without any modifications or exceptions specified in the order.
- (2) Subject to subsection (1), the Arbitration Act 1996 shall not apply to proceedings pursuant to the Convention, but this subsection shall not be

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taken as affecting section 9 of that Act (stay of legal proceedings in respect of matter subject to arbitration).

- (3) An order made under this section—
- (a) may be varied or revoked by a subsequent order so made, and
  - (b) shall be contained in a statutory instrument.”.

*Poultry Improvement Act (Northern Ireland) 1968 (c.12 (N.I.))*

- 25 In paragraph 10(4) of the Schedule to the Poultry Improvement Act (Northern Ireland) 1968 (reference of disputes), for “The Arbitration Act (Northern Ireland) 1937” substitute “ Part I of the Arbitration Act 1996 ”.

*Industrial and Provident Societies Act (Northern Ireland) 1969 (c.24 (N.I.))*

- 26 (1) Section 69 of the Industrial and Provident Societies Act (Northern Ireland) 1969 (decision of disputes) is amended as follows.

- (2) In subsection (7) (decision of disputes)—
- (a) in the opening words, omit the words from “and without prejudice” to “1937”;
  - (b) at the beginning of paragraph (a) insert “ without prejudice to any powers exercisable by virtue of Part I of the Arbitration Act 1996, ”; and
  - (c) in paragraph (b) omit “the registrar or” and “registrar or” and for the words from “as might have been granted by the High Court” to the end substitute “ as might be granted by the registrar ”.

- (3) For subsection (8) substitute—

“(8) The court or registrar to whom any dispute is referred under subsections (2) to (6) may at the request of either party state a case on any question of law arising in the dispute for the opinion of the High Court.”.

*Health and Personal Social Services (Northern Ireland) Order 1972 (N.I.14)*

- 27 In Article 105(6) of the Health and Personal Social Services (Northern Ireland) Order 1972 (arbitrations under the Order), for “the Arbitration Act (Northern Ireland) 1937” substitute “ Part I of the Arbitration Act 1996 ”.

*Consumer Credit Act 1974 (c.39)*

- 28 (1) Section 146 of the Consumer Credit Act 1974 is amended as follows.
- (2) In subsection (2) (solicitor engaged in contentious business), for “section 86(1) of the Solicitors Act 1957” substitute “ section 87(1) of the Solicitors Act 1974 ”.
- (3) In subsection (4) (solicitor in Northern Ireland engaged in contentious business), for the words from “business done” to “Administration of Estates (Northern Ireland) Order 1979” substitute “ contentious business (as defined in Article 3(2) of the Solicitors (Northern Ireland) Order 1976. ”.

*Friendly Societies Act 1974 (c.46)*

- 29 (1) The Friendly Societies Act 1974 is amended as follows.

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(2) For section 78(1) (statement of case) substitute—

“(1) Any arbitrator, arbiter or umpire to whom a dispute falling within section 76 above is referred under the rules of a registered society or branch may at the request of either party state a case on any question of law arising in the dispute for the opinion of the High Court or, as the case may be, the Court of Session.”.

(3) In section 83(3) (procedure on objections to amalgamations &c. of friendly societies), for “the Arbitration Act 1950 or, in Northern Ireland, the Arbitration Act (Northern Ireland) 1937” substitute “ Part I of the Arbitration Act 1996 ”.

*Industry Act 1975 (c.68)*

30 In Schedule 3 to the Industry Act (arbitration of disputes relating to vesting and compensation orders), in paragraph 14 (application of certain provisions of Arbitration Acts)—

- (a) for “the Arbitration Act 1950 or, in Northern Ireland, the Arbitration Act (Northern Ireland) 1937” substitute “ Part I of the Arbitration Act 1996 ”, and  
 (b) for “that Act” substitute “ that Part ”.

*Industrial Relations (Northern Ireland) Order 1976 (N.I.16)*

<sup>F31</sup>31 .....

**Annotations:**

**Amendments (Textual)**

**F31** Sch. 3 para. 31 repealed (24.9.1996) by S.I. 1996/1921 (N.I. 18), art. 28, Sch. 3

*Aircraft and Shipbuilding Industries Act 1977 (c.3)*

<sup>F32</sup>32 .....

**Annotations:**

**Amendments (Textual)**

**F32** Sch. 3 para. 32 repealed (22.3.2013) by The Public Bodies (Abolition of the Aircraft and Shipbuilding Industries Arbitration Tribunal) Order 2013 (S.I. 2013/686), art. 1(2), Sch. 1 para. 7

*Patents Act 1977 (c.37)*

33 In section 130 of the Patents Act 1977 (interpretation), in subsection (8) (exclusion of Arbitration Act) for “The Arbitration Act 1950” substitute “ Part I of the Arbitration Act 1996 ”.

*Judicature (Northern Ireland) Act 1978 (c.23)*

34 (1) The Judicature (Northern Ireland) Act 1978 is amended as follows.

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(2) In section 35(2) (restrictions on appeals to the Court of Appeal), after paragraph (f) insert—

“(fa) except as provided by Part I of the Arbitration Act 1996, from any decision of the High Court under that Part;”.

(3) In section 55(2) (rules of court) after paragraph (c) insert—

“(cc) providing for any prescribed part of the jurisdiction of the High Court in relation to the trial of any action involving matters of account to be exercised in the prescribed manner by a person agreed by the parties and for the remuneration of any such person;”.

*Health and Safety at Work (Northern Ireland) Order 1978 (N.I.9)*

35 In Schedule 4 to the Health and Safety at Work (Northern Ireland) Order 1978 (licensing provisions), in paragraph 3, for “The Arbitration Act (Northern Ireland) 1937” substitute “ Part I of the Arbitration Act 1996 ”.

*County Courts (Northern Ireland) Order 1980 (N.I.3)*

36 (1) The County Courts (Northern Ireland) Order 1980 is amended as follows.

(2) In Article 30 (civil jurisdiction exercisable by district judge)—

(a) for paragraph (2) substitute—

“(2) Any order, decision or determination made by a district judge under this Article (other than one made in dealing with a claim by way of arbitration under paragraph (3)) shall be embodied in a decree which for all purposes (including the right of appeal under Part VI) shall have the like effect as a decree pronounced by a county court judge.”;

(b) for paragraphs (4) and (5) substitute—

“(4) Where in any action to which paragraph (1) applies the claim is dealt with by way of arbitration under paragraph (3)—

- (a) any award made by the district judge in dealing with the claim shall be embodied in a decree which for all purposes (except the right of appeal under Part VI) shall have the like effect as a decree pronounced by a county court judge;
- (b) the district judge may, and shall if so required by the High Court, state for the determination of the High Court any question of law arising out of an award so made;
- (c) except as provided by sub-paragraph (b), any award so made shall be final; and
- (d) except as otherwise provided by county court rules, no costs shall be awarded in connection with the action.

(5) Subject to paragraph (4), county court rules may—

- (a) apply any of the provisions of Part I of the Arbitration Act 1996 to arbitrations under paragraph (3) with such modifications as may be prescribed;
- (b) prescribe the rules of evidence to be followed on any arbitration under paragraph (3) and, in particular, make

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provision with respect to the manner of taking and questioning evidence.

(5A) Except as provided by virtue of paragraph (5)(a), Part I of the Arbitration Act 1996 shall not apply to an arbitration under paragraph (3).”.

(3) After Article 61 insert—

*“ Appeals from decisions under Part I of Arbitration Act 1996*

61A(1) Article 61 does not apply to a decision of a county court judge made in the exercise of the jurisdiction conferred by Part I of the Arbitration Act 1996.

(2) Any party dissatisfied with a decision of the county court made in the exercise of the jurisdiction conferred by any of the following provisions of Part I of the Arbitration Act 1996, namely—

- (a) section 32 (question as to substantive jurisdiction of arbitral tribunal);
- (b) section 45 (question of law arising in course of arbitral proceedings);
- (c) section 67 (challenging award of arbitral tribunal: substantive jurisdiction);
- (d) section 68 (challenging award of arbitral tribunal: serious irregularity);
- (e) section 69 (appeal on point of law),

may, subject to the provisions of that Part, appeal from that decision to the Court of Appeal.

(3) Any party dissatisfied with any decision of a county court made in the exercise of the jurisdiction conferred by any other provision of Part I of the Arbitration Act 1996 may, subject to the provisions of that Part, appeal from that decision to the High Court.

(4) The decision of the Court of Appeal on an appeal under paragraph (2) shall be final.”.

**Annotations:**

**Commencement Information**

**I3** [Sch. 3 para. 36](#) wholly in force 31.1.1997: [Sch. 3 para. 36](#) not in force at Royal Assent see [s. 109\(1\)](#); [Sch. 3 para. 36](#) in force for certain purposes only at 17.12.1996 otherwise in force at 31.1.1997 by [S.I. 1996/3146](#), [arts. 2, 3](#), [Sch. 1](#)

*Supreme Court Act 1981 (c.54)*

37 (1) The Supreme Court Act 1981 is amended as follows.

(2) In section 18(1) (restrictions on appeals to the Court of Appeal), for paragraph (g) substitute—

“(g) except as provided by Part I of the Arbitration Act 1996, from any decision of the High Court under that Part;”.



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- (3) In section 151 (interpretation, &c.), in the definition of “arbitration agreement”, for “the Arbitration Act 1950 by virtue of section 32 of that Act;” substitute “ Part I of the Arbitration Act 1996; ”.

*Merchant Shipping (Liner Conferences) Act 1982 (c.37)*

- 38 In section 7(5) of the Merchant Shipping (Liner Conferences) Act 1982 (stay of legal proceedings), for the words from “section 4(1)” to the end substitute “ section 9 of the Arbitration Act 1996 (which also provides for the staying of legal proceedings). ”.

*Agricultural Marketing (Northern Ireland) Order 1982 (N.I.12)*

- 39 In Article 14 of the Agricultural Marketing (Northern Ireland) Order 1982 (application of provisions of Arbitration Act (Northern Ireland) 1937)—
- (a) for the words from the beginning to “shall apply” substitute “ Section 45 and 69 of the Arbitration Act 1996 (which relate to the determination by the court of questions of law) and section 66 of that Act (enforcement of awards) ” apply; and
  - (b) for “an arbitration” substitute “ arbitral proceedings ”.

*Mental Health Act 1983 (c.20)*

- 40 In section 78 of the Mental Health Act 1983 (procedure of Mental Health Review Tribunals), in subsection (9) for “The Arbitration Act 1950” substitute “ Part I of the Arbitration Act 1996 ”.

*Registered Homes Act 1984 (c.23)*

- [<sup>F33</sup>41 In section 43 of the Registered Homes Act 1984 (procedure of Registered Homes Tribunals), in subsection (3) for “The Arbitration Act 1950” substitute “ Part I of the Arbitration Act 1996 ”.]

**Annotations:**

**Amendments (Textual)**

**F33** Sch. 3 para. 41 repealed (1.4.2002 for E.W.) by 2000 c. 14, ss. 117(2), 122, Sch. 6; S.I. 2001/4150, art. 3(3)(c)(xi) (subject to art. 4 and to S.I. 2002/1493, art. 4) (as amended by S.I. 2002/1493, art. 6); S.I. 2002/920, art. 3(3)(g)(ix) (subject to art. 3(4)(5), Schs. 1-3 and with art. 3(6)-(10))

*Housing Act 1985 (c.68)*

- 42 In section 47(3) of the Housing Act 1985 (agreement as to determination of matters relating to service charges) for “section 32 of the Arbitration Act 1950” substitute “ Part I of the Arbitration Act 1996 ”.

*Landlord and Tenant Act 1985 (c.70)*

- <sup>F34</sup>43 .....

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**Annotations:**

**Amendments (Textual)**

**F34** Sch. 3 para. 43 repealed (1.9.1997) by 1996 c. 52, s. 227, Sch. 19, Pt. III; S.I. 1997/1851, art. 1, 2

*Credit Unions (Northern Ireland) Order 1985 (N.I.12)*

- 44 (1) Article 72 of the Credit Unions (Northern Ireland) Order 1985 (decision of disputes) is amended as follows.
- (2) In paragraph (7)—
- (a) in the opening words, omit the words from “and without prejudice” to “1937”;
  - (b) at the beginning of sub-paragraph (a) insert “ without prejudice to any powers exercisable by virtue of Part I of the Arbitration Act 1996, ”; and
  - (c) in sub-paragraph (b) omit “the registrar or” and “registrar or” and for the words from “as might have been granted by the High Court” to the end substitute “ as might be granted by the registrar ”.
- (3) For paragraph (8) substitute—
- “(8) The court or registrar to whom any dispute is referred under paragraphs (2) to (6) may at the request of either party state a case on any question of law arising in the dispute for the opinion of the High Court.”.

*Agricultural Holdings Act 1986 (c.5)*

45 <sup>F35</sup> .....

**Annotations:**

**Amendments (Textual)**

**F35** Sch. 3 para. 45 repealed (19.10.2006) by The Regulatory Reform (Agricultural Tenancies) (England and Wales) Order 2006 (S.I. 2006/2805), arts. 1(1), 18, Sch. 2 (with art. 10)

*Insolvency Act 1986 (c.45)*

46 In the Insolvency Act 1986, after section 349 insert—

**“349A Arbitration agreements to which bankrupt is party.**

- (1) This section applies where a bankrupt had become party to a contract containing an arbitration agreement before the commencement of his bankruptcy.
- (2) If the trustee in bankruptcy adopts the contract, the arbitration agreement is enforceable by or against the trustee in relation to matters arising from or connected with the contract.
- (3) If the trustee in bankruptcy does not adopt the contract and a matter to which the arbitration agreement applies requires to be determined in connection with or for the purposes of the bankruptcy proceedings—

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- (a) the trustee with the consent of the creditors' committee, or
- (b) any other party to the agreement,

may apply to the court which may, if it thinks fit in all the circumstances of the case, order that the matter be referred to arbitration in accordance with the arbitration agreement.

(4) In this section—

“arbitration agreement” has the same meaning as in Part I of the Arbitration Act 1996; and

“the court” means the court which has jurisdiction in the bankruptcy proceedings.”.

*Building Societies Act 1986 (c.53)*

- 47 In Part II of Schedule 14 to the Building Societies Act 1986 (settlement of disputes: arbitration), in paragraph 5(6) for “the Arbitration Act 1950 and the Arbitration Act 1979 or, in Northern Ireland, the Arbitration Act (Northern Ireland) 1937” substitute “ Part I of the Arbitration Act 1996 ”.

*Mental Health (Northern Ireland) Order 1986 (N.I.4)*

- 48 In Article 83 of the Mental Health (Northern Ireland) Order 1986 (procedure of Mental Health Review Tribunal), in paragraph (8) for “The Arbitration Act (Northern Ireland) 1937” substitute “ Part I of the Arbitration Act 1996 ”.

*Multilateral Investment Guarantee Agency Act 1988 (c.8)*

- 49 For section 6 of the Multilateral Investment Guarantee Agency Act 1988 (application of Arbitration Act) substitute—

**“6 Application of Arbitration Act.**

(1) The Lord Chancellor may by order made by statutory instrument direct that any of the provisions of sections 36 and 38 to 44 of the Arbitration Act 1996 (provisions in relation to the conduct of the arbitral proceedings, &c.) apply, with such modifications or exceptions as are specified in the order, to such arbitration proceedings pursuant to Annex II to the Convention as are specified in the order.

(2) Except as provided by an order under subsection (1) above, no provision of Part I of the Arbitration Act 1996 other than section 9 (stay of legal proceedings) applies to any such proceedings.”.

*Copyright, Designs and Patents Act 1988 (c.48)*

- 50 In section 150 of the Copyright, Designs and Patents Act 1988 (Lord Chancellor's power to make rules for Copyright Tribunal), for subsection (2) substitute—

“(2) The rules may apply in relation to the Tribunal, as respects proceedings in England and Wales or Northern Ireland, any of the provisions of Part I of the Arbitration Act 1996.”.

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*Fair Employment (Northern Ireland) Act 1989 (c.32)*

F36 51 .....

**Annotations:**

**Amendments (Textual)**

**F36** Sch. 3 para. 51 repealed (1.3.1999) by S.I. 1998/3162, art. 105(4), Sch. 5; S.R. 1999/81, art. 3

*Limitation (Northern Ireland) Order 1989 (N.I.11)*

52 In Article 2(2) of the Limitation (Northern Ireland) Order 1989 (interpretation), in the definition of “arbitration agreement”, for “the Arbitration Act (Northern Ireland) 1937” substitute “ Part I of the Arbitration Act 1996 ”.

*Insolvency (Northern Ireland) Order 1989 (N.I.19)*

53 In the Insolvency (Northern Ireland) Order 1989, after Article 320 insert—

*“ Arbitration agreements to which bankrupt is party.*

320A(1) This Article applies where a bankrupt had become party to a contract containing an arbitration agreement before the commencement of his bankruptcy.

(2) If the trustee in bankruptcy adopts the contract, the arbitration agreement is enforceable by or against the trustee in relation to matters arising from or connected with the contract.

(3) If the trustee in bankruptcy does not adopt the contract and a matter to which the arbitration agreement applies requires to be determined in connection with or for the purposes of the bankruptcy proceedings—

(a) the trustee with the consent of the creditors’ committee, or

(b) any other party to the agreement,

may apply to the court which may, if it thinks fit in all the circumstances of the case, order that the matter be referred to arbitration in accordance with the arbitration agreement.

(4) In this Article—

“arbitration agreement” has the same meaning as in Part I of the Arbitration Act 1996; and

“the court” means the court which has jurisdiction in the bankruptcy proceedings.”.

*Social Security Administration Act 1992 (c.5)*

54 In section 59 of the Social Security Administration Act 1992 (procedure for inquiries, &c.), in subsection (7), for “The Arbitration Act 1950” substitute “ Part I of the Arbitration Act 1996 ”.

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*Social Security Administration (Northern Ireland) Act 1992 (c.8)*

<sup>F37</sup>55 .....

**Annotations:**

**Amendments (Textual)**

**F37** Sch. 3 para. 55 repealed (29.11.1999) by S.I. 1998/1506, art. 78(2), Sch. 7; S.R. 1999/472, art. 2(2)(1) (a), Sch. I

*Trade Union and Labour Relations (Consolidation) Act 1992 (c.52)*

56 In sections 212(5) and 263(6) of the Trade Union and Labour Relations (Consolidation) Act 1992 (application of Arbitration Act) for “the Arbitration Act 1950” substitute “ Part I of the Arbitration Act 1996 ”.

*Industrial Relations (Northern Ireland) Order 1992 (N.I.5)*

57 In Articles 84(9) and 92(5) of the Industrial Relations (Northern Ireland) Order 1992 (application of Arbitration Act) for “The Arbitration Act (Northern Ireland) 1937” substitute “ Part I of the Arbitration Act 1996 ”.

*Registered Homes (Northern Ireland) Order 1992 (N.I.20)*

58 [<sup>F38</sup>In Article 33(3) of the Registered Homes (Northern Ireland) Order 1992 (procedure of Registered Homes Tribunal) for “The Arbitration Act (Northern Ireland) 1937” substitute “ Part I of the Arbitration Act 1996 ”.<sup>F38</sup>]

**Annotations:**

**Amendments (Textual)**

**F38** Sch. 3 para. 58 repealed (N.I.) (1.4.2005) by The Health and Personal Social Services (Quality, Improvement and Regulation) (Northern Ireland) Order 2003 (S.I. 2003/431 (N.I. 9)), arts. 1, 50(2), Sch. 5; S.R. 2005/44, art. 3, Sch. 1 (with arts. 4-13)

*Education Act 1993 (c.35)*

<sup>F39</sup>59 .....

**Annotations:**

**Amendments (Textual)**

**F39** Sch. 3 para. 59 repealed (1.11.1996) by 1996 c. 56, ss. 582(2)(3), 583(2), Sch. 38 Pt. I, Sch. 39 (with s. 1(4))

*Roads (Northern Ireland) Order 1993 (N.I.15)*

60 (1) The Roads (Northern Ireland) Order 1993 is amended as follows.

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- (2) In Article 131 (application of Arbitration Act) for “the Arbitration Act (Northern Ireland) 1937” substitute “ Part I of the Arbitration Act 1996 ”.
- (3) In Schedule 4 (disputes), in paragraph 3(2) for “the Arbitration Act (Northern Ireland) 1937” substitute “ Part I of the Arbitration Act 1996 ”.

*Merchant Shipping Act 1995 (c.21)*

- 61 In Part II of Schedule 6 to the Merchant Shipping Act 1995 (provisions having effect in connection with Convention Relating to the Carriage of Passengers and Their Luggage by Sea), for paragraph 7 substitute—

“7 Article 16 shall apply to arbitral proceedings as it applies to an action; and, as respects England and Wales and Northern Ireland, the provisions of section 14 of the Arbitration Act 1996 apply to determine for the purposes of that Article when an arbitration is commenced.”.

*[<sup>F40</sup>Employment Tribunals Act 1996] (c.17)*

**Annotations:**

**Amendments (Textual)**

**F40** Words in crossheading to Sch. 3 para. 62 substituted (E.W.S.) (1.8.1998) by virtue of 1998 c. 8, s. 1(2)(c) (with s. 16(2)); S.I. 1998/1658, art. 2(1), Sch. 1

- 62 In section 6(2) of [<sup>F41</sup>the Employment Tribunals Act 1996] (procedure of [<sup>F41</sup>employment tribunals]), for “The Arbitration Act 1950” substitute “ Part I of the Arbitration Act 1996 ”.

**Annotations:**

**Amendments (Textual)**

**F41** Words in Sch. 3 para. 62 substituted (E.W.S.) (1.8.1998) by 1998 c. 8, s. 1(2)(b)(c) (with s. 16(2)); S.I. 1998/1658, art. 2(1), Sch. 1

SCHEDULE 4

Section 107(2).

REPEALS

**Annotations:**

**Commencement Information**

**I4** Sch. 4 wholly in force 31.1.1997: Sch. 4 not in force at Royal Assent see s. 109(1); Sch. 4 in force for certain purposes only at 17.12.1996 otherwise in force at 31.1.1997 by S.I. 1996/3146, arts. 2, 3, Sch. 1

Chapter	Short title	Extent of repeal
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1892 c. 43.	Military Lands Act 1892.	In section 21(b), the words “under the Arbitration Act 1889”.
1922 c. 51.	Allotments Act 1922.	In section 21(3), the words “under the Arbitration Act 1889”.
1937 c. 8 (N.I.).	Arbitration Act (Northern Ireland) 1937.	The whole Act.
1949 c. 54.	Wireless Telegraphy Act 1949.	In Schedule 2, paragraph 3(3).
1949 c. 97.	National Parks and Access to the Countryside Act 1949.	In section 18(4), the words from “Without prejudice” to “England or Wales”.
1950 c. 27.	Arbitration Act 1950.	Part I. Section 42(3).
1958 c. 47.	Agricultural Marketing Act 1958.	Section 53(8).
1962 c. 46.	Transport Act 1962.	In Schedule 11, Part II, paragraph 7.
1964 c. 14.	Plant Varieties and Seeds Act 1964.	In section 10(4) the words from “or in section 9” to “three arbitrators”. Section 39(3)(b)(i).
1964 c. 29 (N.I.).	Lands Tribunal and Compensation Act (Northern Ireland) 1964.	In section 9(3) the words from “so, however, that” to the end.
1965 c. 12.	Industrial and Provident Societies Act 1965.	In section 60(8)(b), the words “by virtue of section 12 of the said Act of 1950”.
1965 c. 37.	Carriage of Goods by Road Act 1965.	Section 7(2)(b).
1965 c. 13 (N.I.).	New Towns Act (Northern Ireland) 1965.	In section 27(2), the words from “under and in accordance with” to the end.
1969 c. 24 (N.I.).	Industrial and Provident Societies Act (Northern Ireland) 1969.	In section 69(7)— (a) in the opening words, the words from “and without prejudice” to “1937”; (b) in paragraph (b), the words “the registrar or” and “registrar or”.
1970 c. 31.	Administration of Justice Act 1970.	Section 4. Schedule 3.
1973 c. 41.	Fair Trading Act 1973.	Section 33(2)(d).

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1973 N.I. 1.	Drainage (Northern Ireland) Order 1973.	<p>In Article 15(4), the words from “under and in accordance” to the end. Article 40(4).</p> <p>In Schedule 7, in paragraph 9(2), the words from “under and in accordance” to the end.</p>
1974 c. 47.	Solicitors Act 1974.	In section 87(1), in the definition of “contentious business”, the words “appointed under the Arbitration Act 1950”.
1975 c. 3.	Arbitration Act 1975.	The whole Act.
1975 c. 74.	Petroleum and Submarine Pipe-Lines Act 1975.	<p>In Part II of Schedule 2—</p> <p>(a) in model clause 40(2), the words “in accordance with the Arbitration Act 1950”;</p> <p>(b) in model clause 40(2B), the words “in accordance with the Arbitration Act (Northern Ireland) 1937”.</p> <p>In Part II of Schedule 3, in model clause 38(2), the words “in accordance with the Arbitration Act 1950”.</p>
1976 N.I. 12.	Solicitors (Northern Ireland) Order 1976.	<p>In Article 3(2), in the entry “contentious business”, the words “appointed under the Arbitration Act (Northern Ireland) 1937”.</p> <p>Article 71H(3).</p>
1977 c. 37.	Patents Act 1977.	<p>In section 52(4) the words “section 21 of the Arbitration Act 1950 or, as the case may be, section 22 of the Arbitration Act (Northern Ireland) 1937 (statement of cases by arbitrators); but”.</p> <p>Section 131(e).</p>
1977 c. 38.	Administration of Justice Act 1977.	Section 17(2).
1978 c. 23.	Judicature (Northern Ireland) Act 1978.	<p>In section 35(2), paragraph (g)(v).</p> <p>In Schedule 5, the amendment to the Arbitration Act 1950.</p>
1979 c. 42.	Arbitration Act 1979.	The whole Act.



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1980 c. 58.	Limitation Act 1980.	Section 34.
1980 N.I. 3.	County Courts (Northern Ireland) Order 1980.	Article 31(3).
1981 c. 54.	Supreme Court Act 1981.	Section 148.
1982 c. 27.	Civil Jurisdiction and Judgments Act 1982.	Section 25(3)(c) and (5).  In section 26— (a) in subsection (1), the words “to arbitration or”; (b) in subsection (1)(a)(i), the words “arbitration or”; (c) in subsection (2), the words “arbitration or”.
1982 c. 53.	Administration of Justice Act 1982.	Section 15(6). In Schedule 1, Part IV.
1984 c. 5.	Merchant Shipping Act 1984.	Section 4(8).
1984 c. 12.	Telecommunications Act 1984.	Schedule 2, paragraph 13(8).
1984 c. 16.	Foreign Limitation Periods Act 1984.	Section 5.
1984 c. 28.	County Courts Act 1984.	In Schedule 2, paragraph 70.
1985 c. 61.	Administration of Justice Act 1985.	Section 58. In Schedule 9, paragraph 15.
1985 c. 68.	Housing Act 1985.	In Schedule 18, in paragraph 6(2) the words from “and the Arbitration Act 1950” to the end.
1985 N.I. 12.	Credit Unions (Northern Ireland) Order 1985.	In Article 72(7)— (a) in the opening words, the words from “and without prejudice” to “1937”; (b) in sub-paragraph (b), the words “the registrar or” and “registrar or”.
1986 c. 45.	Insolvency Act 1986.	In Schedule 14, the entry relating to the Arbitration Act 1950.
1988 c. 8.	Multilateral Investment Guarantee Agency Act 1988.	Section 8(3).
1988 c. 21.	Consumer Arbitration Agreements Act 1988.	The whole Act.
1989 N.I. 11.	Limitation (Northern Ireland) Order 1989.	Article 72. In Schedule 3, paragraph 1.

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1989 N.I. 19.	Insolvency (Northern Ireland) Order 1989.	In Part II of Schedule 9, paragraph 66.
1990 c. 41.	Courts and Legal Services Act 1990.	Sections 99 and 101 to 103.
1991 N.I. 7.	Food Safety (Northern Ireland) Order 1991.	In Articles 8(8) and 11(10), the words from “and the provisions” to the end.
1992 c. 40.	Friendly Societies Act 1992.	In Schedule 16, paragraph 30(1).
1995 c. 8.	Agricultural Tenancies Act 1995.	Section 28(4).
1995 c. 21.	Merchant Shipping Act 1995.	Section 96(10). Section 264(9).
1995 c. 42.	Private International Law (Miscellaneous Provisions) Act 1995.	Section 3.

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**Changes and effects yet to be applied to :**

- Pt. 1 excluded by [2018 anaw 2 s. 75\(4\)](#)